REPORT BY THE HUNGARIAN AUTHORITIES TO THE CMIT COMMITTEE ON PROGRESS TOWARDS FULL LIBERALISATION

(Note by the Hungarian Authorities)

This note has been submitted by the Hungarian authorities and is circulated for discussion at the CMIT meeting on 12 October 2000.
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1. The post-accession review of Hungary’s position under the Codes of Liberalisation took place in June 1998. In their conclusions, "the Committees commended Hungary’s compliance with its accession legal commitments and political undertakings” [Report by the Committees to Council in C(99)21\textsuperscript{1} and Background Report in DAFFE/INV/IME(98)3/REV2]. Further, the Hungarian authorities proposed to submit a report to the Committees in mid-2000 on progress made in moving towards the goal of full liberalisation.

2. Accordingly, the present progress report, prepared by the Hungarian authorities, informs the Committees on liberalisation measures implemented since the post-accession review, addresses the specific recommendations and comments made by the Committees in their conclusions of the post-accession review and presents the authorities’ plans with respect to phasing-out the remaining restrictions on capital movements. This report follows the structure of the Conclusions of the 1998 post-accession review.

I. The abolition of remaining capital controls

In their conclusions of the post-accession review of June 1998, "the Committees welcomed Hungary’s determination to complete the abolition of remaining capital controls by the end of 2000" [C(99)21].\textsuperscript{2}

3. Since the conclusion of the post-accession review, the Hungarian authorities have continued the implementation of their strategy of gradual liberalisation. In line with this strategy, as well as with one of the specific recommendations of the Committees, outward financial credits and residents’ investments into units of non-resident collective investment funds were liberalised (for details see the section on ‘capital controls’ in Part II – dealing with the specific issues – of this report).

4. With respect to the envisaged date of 2000 for the completion of the liberalisation process, it needs to be recalled that the – legally non-binding – commitment to that specific date on the part of the Hungarian authorities was formulated at the time of accession, i.e. well before the emergence of a series of international financial crises (Southeast Asia, Russia and Brazil). According to the assessment of these events by the international financial community including the international organisations (e.g. IMF, OECD), though capital controls can not substitute for sound macro-economic policies, the removal of existing restrictions should be pursued in an orderly manner.

5. Hungary weathered the episodes of financial turmoil – of which the Russian crisis in the second half of 1998 affected Hungary the most – with relative ease.\textsuperscript{3} Nevertheless, the lessons learnt from these events prompted the Hungarian authorities to revise their plans concerning the early removal of all the

\textsuperscript{1} Paragraph 22.
\textsuperscript{2} Paragraph 22.
existing capital controls. Indeed, the existence of specific restrictions on capital inflows certainly contributed to the fact that no massive speculative pressure was built up against the Hungarian currency in the wake of the Russian financial turmoil in the autumn of 1998. The positive role played by these specific restrictions in withstanding the contagion effects of the Russian crisis was recognised by international financial institutions, particularly by the IMF. Concluding the 1999 Article IV consultation, “Directors considered the authorities’ recourse to controls on short-term capital inflows to reduce speculative pressures as prudent. They endorsed the authorities’ intention to maintain these controls until Hungary moved closer to EU membership”.\(^4\)

6. Taking into account the experience of recent financial crises and the broad consensus concerning the positive contribution of some of the existing restrictions to coping with the repercussions (contagion effects) of the turmoil, the Hungarian authorities carefully evaluated the currently existing restrictions. In their assessment, the sequencing of the removal of currently existing restrictions should be determined by their impact on the conduct of monetary and exchange rate policies. The liberalisation of transactions not involving perceptible monetary policy risk is scheduled for the year 2001, while a limited number of restrictions involving substantial risk for the conduct of monetary and exchange rate policies is envisaged for a later stage. The phasing-out of this group of restrictions is conditional upon further improvement in international investors’ assessment of Hungary’s economic situation – when the prospects of EU membership and the sustainable convergence toward monetary union are clearly recognised by the financial market agents – and this is reflected in lower risk premium on assets denominated in domestic currency.

7. It needs to be emphasised that the decision to maintain a limited number of restrictions for a longer period than originally intended is not a recourse to controls in order to stall off unsustainable domestic economic policies from the discipline of international markets, but to partially shield Hungary from potentially contagious financial market crises.

8. Restrictions on capital outflows belong to those transactions that can be liberalised in the first stage, while restrictions on inflows (particularly on investments into short-term, domestic currency denominated assets) can only be lifted at the later stage. In the course of the completion of the liberalisation process, the Hungarian authorities wish to rely on the recommendations and proposals recently developed by a number of international organisations and fora (e.g. IMF, OECD and the Financial Stability Forum).

9. The Hungarian authorities are currently drafting the amendment of the Foreign Exchange Act with a view to implement the liberalisation measures of the first stage in the course of 2001. The envisaged liberalisation measures would eliminate most of the currently existing restrictions regarding the foreign exchange denominated transactions of residents and would affect a large number of items under the Code of Capital Movements, such as

- the purchase and sale of currently restricted money market securities by residents (V/D1 and 2);
- the admission of these securities to domestic markets (V/B1 and 2);
- liberalisation of investments by residents into units of non-resident collective investment funds (VII/B1 and 2, and D1);

\(^4\) Public Information Notice (PIN) No. 00/23, IMF Concludes Article IV Consultation with Hungary, 17 March, 2000.
granting commercial credits by residents to non-residents in cases where no resident participates in the underlying transaction (VIII(ii)B);

- granting financial credits by residents to non-residents (IX/B);

- granting sureties, guarantees and financial back-up facilities by residents to non-residents (X/i/A2 and B2; X/ii/A2 and B2);

- operation by residents of deposit accounts with non-resident institutions (XI/B2).5

10. In addition to the liberalisation measures of direct relevance for Hungary’s position under the Codes, some other liberalisation steps are also envisaged, including changes in the payment regulations (an extended domestic use of payments in foreign exchange/currency between residents and non-residents) and changes in the regulations governing the operation of foreign exchange accounts of residents with resident credit institutions (there will be no restrictions on placing foreign currency receipts on these accounts).

11. With respect to the restrictions still remaining in place after the implementation of the planned liberalisation measures in 2001, the Hungarian authorities are committed to remove them as soon as possible.

II. Specific issues in the Committees’ conclusions on the post-accession review

I. Foreign direct investment

(a) Branching in mortgage banking and asset management services to voluntary private pension funds

In their conclusions of the post-accession review of June 1998, the Committees “while noting the Hungarian authorities’ readiness to reconsider remaining exceptions to this principle [of national treatment] concerning branching in mortgage banking and asset management services to voluntary private pension funds, urged them to take early corrective action so as to achieve Hungary’s full compliance with its obligations under the Code as soon as possible” [C(99)21].6

(i) Branching in mortgage banking

12. As noted in the Background Report to the 1998 post-accession review [DAFFE/INV/IME(98)3/REV2], non-resident investors can establish mortgage banks in the form of both subsidiaries and branches. Further, branches, similarly to subsidiaries, can lend against arable land as collateral. However, branches of non-resident mortgage banks can not, unlike subsidiaries, acquire the property of arable land in case the collateral needs to be validated.

5. In conjunction with this measure, the obligation to repatriate foreign currency acquired abroad by residents will also cease to exist. Nevertheless, it is not planned to eliminate the reservation concerning the sale of foreign currency for domestic currency abroad by residents (XII/B2), but the reference to the repatriation in the text of the remark to the reservation will be changed.

6. Paragraph 23, point b.
13. The Hungarian authorities indicated in the Report by the Committees [C(99)21] that they were ready to propose appropriate legislative action to correct the situation. Having considered the possibilities of such a corrective action, however, it turned out – and reported in the Background Report [DAFFE/INV/IME(98)3/REV2] – that appropriate changes in the domestic regulation in this area can only be implemented in the context of an overall review of the Hungarian legislation concerning the ownership of arable land.

14. Since the conclusion of the post-accession review, it became clear that due to the politically sensitive nature of the ownership of arable land – similarly to a number of member states of the OECD – the overall review of the legislation requires not only a very thorough and careful preparation, but also appropriate political, economic and social climate. Consequently, Hungary is not in the position to change the domestic legislation for the time being. Therefore, the Hungarian authorities would now like to propose to the Committees an approach that reconciles the current domestic legal framework with Hungary’s position under the Codes. This interpretation is as follows:

- Hungary has a reservation concerning the acquisition of real estate by non-residents. The Hungarian authorities are of the view that Hungary’s general reservation under III/A of the Code of Capital Movements sufficiently covers the acquisition of arable land in case the collateral has to be validated, since, in the end, the property rights of the arable land would fall on the non-resident mortgage institution.

- However, for the sake of transparency, the Hungarian authorities would accept, if a new, limited reservation were lodged to items I/A and E/7 of the Codes. In this context it is worth recalling the conclusions of the post-accession examination of the Czech Republic where the establishment of foreign branches as mortgage banks was also an issue under discussion. In this case the Committees came to the conclusion that, indeed, the general reservation under III/A of the Capital Movements Code covers the restriction concerning the acquisition of real estate by branches of non-resident companies. At the same time, the Committees considered it appropriate that the Czech authorities introduced a new, specific reservation with respect to mortgage banking branches concerning items I/A and E/7 of the Codes for the sake of greater transparency [C(98)7]. Notwithstanding the differences in the details of the regulation of mortgage banking in the Czech Republic and in Hungary, in view of the Hungarian authorities the approach adopted by the Committees in the case of the Czech Republic could also be applied with respect to Hungary.

(ii) The provision of asset management services to voluntary private pension funds by branches of non-resident financial institutions

15. The piece of legislation pertaining to this issue (Act CXII of 1996 on Credit Institutions) is currently under review in order to implement the necessary corrective action. The Government has already adopted the draft bill and submitted it to Parliament. The bill is expected to be passed in the Autumn legislative session.

16. Para. (9) of Art. 5 of the amended Act will stipulate that branches of non-resident financial institutions may provide asset management services to voluntary private pension funds if the non-resident financial institution has the licence from its home supervisory authority for the conduct of this activity. This provision will take effect form 1 January, 2001, thus full compliance with Hungary’s obligation under the Code will be ensured.
(iii) Remaining restrictions on custodial and asset management services by branches of non-resident financial institutions to Hungarian investment funds

In their conclusions of the post-accession review of June 1998, the Committees “agreed to return to the issue arising from remaining restrictions on custodial and asset management services by foreign branches to Hungarian investment funds in due course, after a closer investigation of the regulatory regimes applicable in other OECD countries and their treatment under the Codes has been made” [C(99)21].

17. As noted in the Background Report to the 1998 post-accession review [DAFFE/INV/IME(98)3/REV2], the Hungarian authorities considered the restrictions on the provision of custodial and asset management services by branches of non-resident financial institutions to domestic investment funds as a prudential measure. It was also indicated that this was a common practice in a number of OECD Member countries, notably in Europe. Based on the conclusions of the Committees, the Secretariat launched a horizontal project to explore the practices among member countries [DAFFE/INV/(99)15]. In light of the comments by member countries, the Secretariat prepared a revised document [DAFFE/INV/(99)15/REV1] which indicates that, indeed, (a) there are restrictions similar to those applied by Hungary in several member countries; and (b) these restrictions are not reflected in an identical manner in the reservations of member countries under the Codes. According to the latest information available to the Hungarian authorities, the Secretariat is currently revising the document which is likely to be discussed in one of the forthcoming CMIT meetings.

(iv) Reservation on the provision of asset management services to compulsory private pension funds by branches of non-resident financial institutions

In their conclusions of the post-accession review of June 1998, the Committees "agreed that a restriction on asset management services by foreign branches to the newly-created compulsory private pension funds did not constitute a breach of the standstill obligation of the Codes, and that a new reservation to the Codes could therefore be introduced to reflect this restriction. At the same time, the Committees encouraged Hungary to consider early removal of this restriction" [C(99)21].

18. As noted in the Background Report to the 1998 post-accession review [DAFFE/INV/IME(98)3/REV2], the operation of compulsory pension funds was a completely new field of activity; the mandatory private pension system became effective from September 1, 1997. The compulsory private pension funds are expected to play an increasingly important role in supplementing the general PAYG pension system and promoting and channelling domestic savings. The experience with the functioning of the new system has so far been favourable. Nevertheless, the operation of the newly established private pension funds needs to be closely monitored and evaluated by the financial supervisory authority. The extension of the number of possible asset managers through opening this segment also for branches of non-resident financial institutions needs therefore careful preparations. In light of these considerations, the Hungarian authorities are of the view that it is appropriate to maintain this restriction for the time being.

7. Paragraph 23, point c.
8. Paragraph 23, point d.
(b) Privatisation and companies in permanent public ownership

In their conclusions of the post-accession review of June 1998, the Committees "[w]elcomed the successful achievement of Hungary’s privatisation programmes envisaged by the time of accession and the large foreign participation in the sectors concerned, including the financial sector; and encouraged the Hungarian authorities to keep as limited as possible the list of those enterprises which might remain under state control pursuant to the Privatisation Act" [C(99)21].

19. As noted in the Background Report to the 1998 post-accession review [DAFFE/INV/IME(98)3/REV2], the sale of publicly-owned assets in the context of the transition to a full market economy was completed. The share of the private sector in GDP (as measured by its contribution to the gross value added of the economy) exceeded 80 per cent at the end of 1997.

20. The companies in public ownership consist of enterprises (or stakes in enterprises) yet for sale and companies which will be – totally or partially – publicly owned in the longer term. The Annex of Act XXXIX of 1995 on the Privatisation of publicly-owned entrepreneurial assets and its subsequent amendments contain the lists of enterprises remaining in public ownership in the longer term.

21. The bulk of entrepreneurial assets belonging to the public sector, both those in permanent public ownership and those designed for privatisation are handled and/or being privatised by ÁPV Rt (Hungarian Privatisation State Holding Company).

22. Since the conclusion of the post-accession review, the privatisation process continued with the sale of both companies in full public ownership and (minority) stakes in companies that were already controlled partially by private investors. Between the end of 1997 and April 2000, the number of companies in which ÁPV Rt. had a stake dropped from 286 to 192.10

23. The ongoing privatisation of companies and stakes in public ownership resulted in revenues of HUF 255 billion (ca. USD 1 billion) realised by ÁPV Rt. in 1998 and 1999. Most of the revenues were generated through international public offerings of equity stakes. The most significant privatisation transactions completed in the past two years included the sale of stakes in MATÁV (Hungarian Telecommunications Co.), a number of regional electricity companies and Borsodchem (a chemical company).11

24. Similarly to the privatisation transactions prior to the conclusion of the post-accession review, the Hungarian authorities continued to pursue the privatisation process on a non-discriminatory basis in the past two years, and they are committed to do so in the future.

2. Capital controls

In their conclusions of the post-accession review of June 1998, the Committees "[e]ncouraged the Hungarian authorities to proceed by no later than 1999 with the planned liberalisation of remaining restrictions on capital flows (operations in collective investment securities, outward

9. Paragraph 23, point e.
10. Excluding companies under liquidation.
11. For a detailed account of the privatisation process (including recent developments) see FDI Review of Hungary, OECD, Paris (September) 2000.
financial credits, and non-prudential ceiling on lending abroad by domestic banks) which no longer appear justified by the Hungarian government's current policy priorities" [C(99)21].

25. As noted in the Background Report to the 1998 post-accession review [DAFFE/INV/IME(98)3/REV2], the Hungarian authorities envisaged the liberalisation of outward financial credits and investment by residents into foreign collective investment securities which are based on underlying foreign assets otherwise available for resident investors, provided that international and domestic financial market conditions would remain appropriate.

26. Based on this tentative schedule, the Hungarian government considered the developments in late 1999, and adopted a decree (Government Decree 220 of 1999) which implemented the following liberalisation measures:

a) As of 1 January, 2000 foreign currency denominated credits and loans – with a maturity of more than one year – granted by residents to non-residents located in OECD member states (items VIII(ii)/B and IX/B) were liberalised. This measure is based on Art. 5 paragraph 3 of Government Decree 220/1999.

b) As of 1 July, 2000 further liberalisation measures were taken in the field of operations in collective investment securities. Pursuant to Art. 1 of Government Decree 220/1999, the admission of foreign collective investment securities on the domestic securities market (item VII/B) was liberalised on the following conditions:

i) The fund manager of the non-resident investment fund is registered in a member state of the OECD;

ii) Under the investment policy of the fund, at least 50 per cent of its assets are kept in instruments that are already liberalised and freely available for residents in Hungary;

iii) The initial offering of the collective investment securities has taken place in a member state of the OECD.

c) Residents may also freely purchase abroad the above-mentioned collective investment securities (item VII/D) through resident investment companies (Art. 1 of Government Decree 220/1999).

d) As of 1 July, 2000 resident fund managers may keep the securities and the earnings abroad (item XI/B2) in order to facilitate technical arrangement of the investment operations (Arts. 2 and 3 of Government Decree 220/1999).

27. The Hungarian authorities would like to point out that the liberalisation concerning investment by residents into foreign collective investment securities goes beyond the measure discussed in the course of the post-accession review. The original objective was to liberalise investment into the units of those foreign collective investment funds whose portfolio contains already liberalised foreign assets only. The regulation that entered into force on 1 July, 2000, however, stipulates that investment is also possible into units of those foreign collective investment funds where – under the investment policy of the fund – the share of liberalised assets is (at least) 50 per cent. As noted in the first part – dealing with the abolition of

12. Paragraph 23, point g.

remaining capital controls – of this report, the envisaged amendment of the Foreign Exchange Act will further liberalise residents’ foreign exchange denominated investments into collective investment securities in 2001.

28. With respect to the quantitative limit on lending abroad by resident commercial banks (50 per cent of their liabilities denominated in foreign currency),\textsuperscript{14} it was indicated in the Background Report to the 1998 post-accession review [DAFFE/INV/IME(98)3/REV2] that the elimination of this restriction is envisaged in the context of the overall revision of the foreign exchange regulation pertaining to commercial banks. In view of the Hungarian authorities, this overall revision should be implemented in the final phase of foreign exchange liberalisation.

3. **Cross-border financial services**

(a) **Cross-border insurance services**

In their conclusions of the post-accession review of June 1998, the Committees "[e]ncouraged Hungary to amend as a matter of priority its Insurance Law so as to liberalise, as envisaged by the Hungarian authorities, insurance with non-resident insurers for risks not covered by domestic insurers and to relax other remaining restrictions when the initiative to purchase insurance services is taken by the consumer without solicitation on the part of the non-resident insurer." [C(99)21]\textsuperscript{15}

29. As noted in the Background Report to the 1998 post-accession review [DAFFE/INV/IME(98)3/REV2], Act XCVI of 1995 on Insurance provided for the possibility for residents to conclude insurance contracts with non-resident insurance companies in the case of compulsory third party insurance, if it was not possible to cover the risk concerned with a resident insurer. However, as compulsory insurance is excluded from the scope of the provisions of the Code concerning cross-border insurance services, there was no basis to reflect this measure in Hungary’s reservations. It should also be noted that the Background Report explicitly calls for liberalisation with respect to non-life insurance services which is not reflected in the conclusions of the Report by the Committees to the Council.

30. A recently adopted amendment to the Insurance Act implements further liberalisation in this field, in line with the above recommendation, as it extends the possibility to cover the risk with a non-resident insurance company to the whole segment of non-life insurance if it is not possible to cover the risk concerned with a resident insurer. The modified Art. 5, paragraph 6, point g of the Act stipulates that residents may conclude insurance contracts with non-resident insurance companies for non-life risks not covered by domestic insurers. This provision will enter into force on 1 January, 2001. The implementation of this measure will make it possible to narrow the scope of reservation lodged by Hungary to item D/4 of the Code of Liberalisation of Current Invisible Operations.

\textsuperscript{14} Decree 15 of 1995 by the President of the National Bank.

\textsuperscript{15} Paragraph 23, point h.
(b) Other cross-border financial services

In their conclusions of the post-accession review of June 1998, the Committees "[e]ncouraged the Hungarian authorities to consider liberalising other cross-border financial services as early as possible." [C(99)21]16

31. As noted in the Background Report to the 1998 post-accession review [DAFFE/INV/IME(98)3/REV2], the Hungarian authorities were of the view that further liberalisation of cross-border banking and financial services would require in practice the liberalisation of many of the underlying capital transactions which were still subject to restriction. Further, it was also indicated that the Hungarian authorities would examine the possibility to make a distinction between the cross-border supply of services by non-residents "in Hungary" and services purchased “abroad” by residents – a distinction which is commonly made in reservations by other member countries.

32. As presented in the first part – dealing with the abolition of remaining capital controls – of this report, the envisaged amendment of the Foreign Exchange Act will liberalise a large number of capital transactions, denominated in foreign exchange, of residents. According to the proposal to be approved by the Government, the operation of foreign exchange deposit accounts with non-resident financial institutions by residents will also be liberalised. In this context, the Hungarian authorities also intend to examine the possibility to liberalise banking and investment services purchased abroad by residents. If this approach is adopted, remaining restrictions on the cross-border provision of these services by non-residents in Hungary will be contained in financial laws other than the Foreign Exchange Act (e.g. banking law and securities law).

16. Paragraph 23, point i.