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**Report No. P-4906-HU**

**MEMORANDUM AND RECOMMENDATION**  
**OF THE**  
**PRESIDENT OF THE**  
**INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT**  
**TO THE**  
**EXECUTIVE DIRECTORS**  
**ON A**  
**PROPOSED LOAN**  
**IN AN AMOUNT EQUIVALENT TO US\$140 MILLION**  
**TO THE**  
**NATIONAL BANK OF HUNGARY**  
**WITH THE GUARANTEE OF THE**  
**HUNGARIAN PEOPLE'S REPUBLIC**  
**FOR A**  
**THIRD INDUSTRIAL RESTRUCTURING PROJECT**

**JANUARY 13, 1989**

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**CURRENCY EQUIVALENTS**

Currency Unit - Forint (Ft.)

**AVERAGE EXCHANGE RATES**  
(Forints per US\$)

	<u>1983</u>	<u>1984</u>	<u>1985</u>	<u>1986</u>	<u>1987</u>	<u>1988</u> (Oct.)
US\$1.00 = Ft.	42.7	48.0	50.1	45.8	47.0	52.0

**WEIGHTS AND MEASURES**

Metric System

**ABBREVIATIONS**

GDP	-	Gross Domestic Product
ISAL	-	Industrial Sector Adjustment Loan
NBH	-	National Bank of Hungary
RPO	-	Restructuring Program Office

**FISCAL YEAR**

January 1 - December 31

HUNGARYTHIRD INDUSTRIAL RESTRUCTURING PROJECTLoan and Project Summary

Borrower: National Bank of Hungary (NBH).

Guarantor: Hungarian People's Republic.

Beneficiaries: Direct and indirect industrial exporters; small business firms; firms in regions affected by emerging unemployment; commercial banks; Government agencies and county councils.

Amount: US\$140 million equivalent.

Terms: Fifteen years, including a five-year grace period, at the Bank's standard variable interest rate.

Onlending Terms: NBH will onlend US\$135.7 million equivalent in Forints to the participating banks (including the unallocated part of the Bank loan), and US\$4.15 million equivalent in Forints to the Government for technical assistance, at maturities not exceeding 15 years including five years of grace, at its prevailing refinancing rate or at the prevailing Bank rate plus a mark-up of 20 percent, whichever is higher. Participating banks will onlend to beneficiaries in Forints for periods not exceeding 12 years, including three years of grace, at rates determined pursuant to their lending policy statements agreed with the Bank, which would allow adequate spread, be positive in real terms, and not include a subsidy. The remaining US\$0.15 million will be used by NBH for technical assistance. NBH will bear the foreign exchange risk.

Financing Plan:

IBRD	US\$ 140.0 million
Domestic Loans	US\$ 87.5 million
Sub-borrowers' Contribution	US\$ 98.8 million
Government Contribution	<u>US\$ 16.5 million</u>
TOTAL	<u>US\$ 342.8 million</u>

Staff Appraisal Report: Report No. 7456-HU dated January 13, 1989.

Map: IBRD - 21148R

MEMORANDUM AND RECOMMENDATION OF THE PRESIDENT  
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TO THE EXECUTIVE DIRECTORS  
ON A PROPOSED LOAN  
TO THE NATIONAL BANK OF HUNGARY  
WITH THE GUARANTEE OF THE HUNGARIAN PEOPLE'S REPUBLIC  
FOR A THIRD INDUSTRIAL RESTRUCTURING PROJECT

1. The following memorandum and recommendation on a proposed loan to the National Bank of Hungary for US\$140 million equivalent is submitted for approval. The proposed loan would have 15 years maturity with five years grace and carry the Bank's standard variable interest rate, and help finance a third industrial restructuring project.

2. Background. Industry is the leading sector in the Hungarian economy, representing about one third of GDP, employment and investment, and 85% of exports. Sector growth, productivity and exports to convertible currency markets stagnated in the first half of the 1980s, while its structure, dominated by large vertically-integrated enterprises, did not sufficiently shift to activities with competitive advantage. Most dynamism has been demonstrated by the small business sector which grew rapidly from a small base in the early 1980s. Industry sector performance, including exports, improved during 1987 - 88. Constraints to better performance include: restricted domestic and international competition, limited resource mobility, and lack of financial discipline and autonomy of enterprises. To address the above issues the Government has engaged since 1985 in a medium-term program of industrial restructuring, developed jointly with the Bank, including comprehensive policy reforms and support for specific restructuring investments. To strengthen economic performance and accelerate the policy reforms, the Government adopted in 1987 a medium-term economic stabilization and structural reform program supported in 1988 by an IMF Standby Arrangement, and a Bank-financed Industrial Sector Adjustment Loan (ISAL). Small business development is being encouraged through broadening of the private sector, and rationalization of the tax and association framework. Parliament approved a law of economic associations and a unified company profit tax law which have become effective on January 1, 1989. The Government has initiated measures to address emerging unemployment due to restructuring, including support for productive new job creation activities, and development of employment and retraining services.

3. Rationale for Bank Involvement. The project contains two novel features in the Bank's assistance program for Hungary in line with the country's drive for reform. These are: (i) support for small business and entrepreneurial development, including the private sector, and (ii) development of measures for efficient employment creation and new employment services as a means of alleviating the social costs of restructuring. Support in these areas would help accelerate the restructuring program. The Bank has played an important role in the analysis of issues related to the small business sector and designed an appropriate small business credit component for the project. Further, the Bank's review of the Government sponsored schemes for addressing emerging unemployment problems has led to adjustments being made in the schemes. The project provides for further development of the policy and institutional framework in this area. Also, Bank involvement would help improve the institutional framework for industrial restructuring, particularly the banking system, and improve the

feedback from enterprises on the impact of the reforms which facilitates the formulation of necessary adjustments to the reform process.

4. Project Objectives. To support the restructuring of the industrial sector in order to enhance its international competitiveness, the project aims to help: (i) redirect the product/market mix of the sector to competitive areas suitable for convertible currency exports, (ii) improve enterprise management practices and capabilities, (iii) stimulate the establishment and growth of small business firms, including the private sector, (iv) alleviate the adverse employment impact of industrial restructuring, and (v) strengthen the institutional capabilities in support of industrial restructuring.

5. Project Description. The project includes three enterprise credit components, to be onlent through the participating banks, to support enterprise investments for: (a) increased direct and indirect exports to convertible currency markets (US\$110 million of the Bank loan); (b) growth of entrepreneurs and small businesses (US\$10 million); and (c) efficient employment creation in regions affected by emerging unemployment due to industrial restructuring (US\$15 million). An additional US\$0.7 million would be onlent to enterprises for preparation of business plans. Eligible manufacturing subprojects under the first credit component should export to convertible currency markets at least 60% of output directly or at least 70% directly and indirectly combined (of which at least 40% indirectly) and pay back foreign exchange investment costs within five years from direct or indirect foreign exchange revenues, or should be carried out by firms with convertible currency exports of at least 30% of total sales to help increase or maintain convertible currency exports of such enterprises. Subprojects should be viable from commercial (including export marketing plans), technical, financial and economic (including minimum rates of return of 18% in real terms) points of view. Implementing enterprises should prepare restructuring programs for their entire operations, and be financially healthy. Maximum subloans would be US\$10 million for direct exporters, and US\$4 million for indirect exporters.

6. The second credit component would support growth of proprietorships, partnerships, small cooperatives and limited liability companies engaged in manufacturing or related business services, with employment up to 60 persons prior to investment. A firm's eligibility will be evaluated based on its past performance, business plan, creditworthiness, and ability to service the proposed credit, while subproject viability would be assessed in simplified fashion, regarding commercial, technical and financial aspects, for which criteria will be developed by each participating bank in an operations manual for small business credit to be reviewed and agreed by the Bank. Subloan limits would be US\$150,000 (for a maturity up to three years). To stimulate the build up by the banks of small business portfolios and flexibility, they can borrow for such purpose for a maturity up to fifteen years, and maintain up to 30% of funds onlent to them in short term working capital financing of small firms.

7. Eligibility under the third credit component would be for employment creating investments in manufacturing, agro-processing and business services in regions suffering employment problems due to industrial restructuring. Project support initially would be for three counties in North Hungary affected by unemployment due to restructuring of the steel and coal mining industries.

Subprojects should be eligible under the Government supported investment promotion program for job creation which is being revised following a review by the Bank, including actions to stimulate the development of small firms in manufacturing, tourism, construction, trade and business services, while the commercial, technical and financial viability will be assessed along criteria similar to those for the other credit components. Minimum financial and economic rates of return would be 12% in real terms. The subloan limit would be US\$2 million. The subprojects supported by the project should be undertaken in accordance with the country's safety, health and environmental standards, which are considered satisfactory.

8. Onlending would be based on a refinancing facility in the National Bank of Hungary (NBH) to which fourteen participating banks have access on a first-come first-served basis. The participating banks would take the final credit decision on each subloan, based on appraisal carried out by the banks with assistance from consultants and/or the Restructuring Program Office (RPO) which has been established. The institutional, operational, and financial aspects of the participating banks have been assessed as satisfactory by the Bank, and will continue to be monitored.

9. The project also includes technical assistance: to strengthen the participating banks in the area of small business credit; to prepare subsector restructuring programs; to carry out a comprehensive study of the performance and constraints facing the small business sector; and to help improve the Government measures for addressing unemployment. The latter includes assistance for improving appraisal skills for productive employment projects and preparation of a strategic plan for an area facing unemployment, and assistance and investment support for development of new employment and retraining services. Procurement will be based on Bank guidelines. The establishment of a revolving fund of US\$6 million and retroactive financing of up to US\$7 million (5% of the Bank loan) are recommended. A breakdown of costs and the financing plan are shown in Schedule A. The disbursement schedule is shown in Schedule B. (Due to the nature of the project largely involving support to subprojects which have not been preappraised, no detailed breakdown of project expenditures by procurement method is available.) A timetable of key project processing events and the status of Bank Group operations in Hungary are given in Schedules C and D, respectively. The Staff Appraisal Report No. 7456-HU dated January 13, 1989, and a map are also attached.

10. Agreed Actions. Industry-wide policy issues regarding the incentive framework for industrial restructuring are addressed in the recent ISAL, including incentives for convertible currency exports, and for entry of new firms, including the private sector. Signing of a subsidiary loan agreement between NBH and the State, and of subsidiary financing agreements between NBH and at least three participating banks would be a condition of Bank loan effectiveness. For the small business credit component, completion of a satisfactory small business credit manual by each bank is a condition of disbursement to such bank. At negotiations, the following salient agreements were obtained from the Government, NBH and the participating banks: (i) implementation of agreed actions to improve the export credit and insurance system; (ii) implementation of agreed adjustments to the investment promotion program for regional employment creation; (iii) ensuring prompt availability of

funds to beneficiaries for project implementation including foreign exchange; (iv) monitoring compliance of participating banks with eligibility criteria for their continued participation in onlending, including satisfactory policies, procedures, staffing, and financial situation; (v) maintenance of interest rates which would allow adequate spread, be positive in real terms and not include a subsidy; (vi) lending in accordance with agreed eligibility criteria, and on agreed terms and conditions (paras 5-7); (vii) appraisal and supervision of subprojects in accordance with agreed policies and procedures; and (viii) procurement along Bank guidelines and following agreed reporting and auditing procedures.

11. Benefits. The project would help to strengthen the ongoing restructuring efforts in the industrial sector, and lead to increased exports to convertible currency markets in support of the country's trade balance. It would also help balance the structure of the sector by promoting the establishment and growth of small, including private, firms which would stimulate domestic competition, innovation and employment creation. The project would help accelerate enterprise restructuring and assistance to dislocated workers through its support for employment creation and development of suitable employment and retraining services in regions severely affected by restructuring.

12. Risks. The main risk is the uncertainty perceived by enterprise and small business managers about Hungary's future macro-economic situation and possible further changes in the industrial policy framework, which may affect the incentives for enterprise restructuring and small business development, and the level of credit demand under the project. This risk is reduced by the strong support that the new Government and political leadership give to the economic reform and by the policy actions agreed to by the Government with the IMF, and with the Bank under the recent ISAL, which are aimed at creating a stable business environment, conducive to restructuring and development of entrepreneurship. Another risk concerns the capacity of the participating banks to promote and appraise restructuring and small business investments. The project addresses this risk with technical assistance measures and project coordination and supervision arrangements.

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

Barber B. Conable  
President

Attachments

Washington, D.C.  
January 13, 1989

HUNGARY

THIRD INDUSTRIAL RESTRUCTURING PROJECT

ESTIMATED COSTS AND FINANCING PLAN

<u>Estimated Costs:</u>	<u>Local</u>	<u>Foreign</u>	<u>Total</u>
	-----	(US\$ million)	-----
<u>Enterprise Investment</u>			
Export-oriented	135.0	110.0	245.0
Small Business	15.0	10.0	25.0
Employment Creation	45.0	15.0	60.0
<u>Technical Assistance</u>			
Small Business Credit Training	0.1	0.2	0.3
<u>Restructuring Studies:</u>			
- Subsector	0.2	0.8	1.0
- Enterprise	0.2	0.7	0.9
Small Business Sector Study	0.1	0.1	0.2
<u>Employment:</u>			
- Regional Plan and Appraisal Skills	0.1	0.3	0.4
- Employment Services	0.1	0.5	0.6
- Retraining Center	<u>7.0</u>	<u>2.4</u>	<u>9.4</u>
Total	<u>202.8</u>	<u>140.0</u>	<u>342.8</u>
<u>Financing Plan:</u>			
	<u>Local</u>	<u>Foreign</u>	<u>Total</u>
	-----	(US\$ million)	-----
IBRD	-	140.0	140.0
Domestic loans	87.5	-	87.5
Sub-borrowers' Contribution	98.8	-	98.8
Government Contribution	<u>16.5</u>	<u>-</u>	<u>16.5</u>
Total	<u>202.8</u>	<u>140.0</u>	<u>342.8</u>



HUNGARY

THIRD INDUSTRIAL RESTRUCTURING PROJECT

DISBURSEMENTS

<u>Loan Category</u>	<u>Amount</u> (US\$ million)	<u>% Financing</u>
<u>Eligible Enterprises:</u>		
- Technical Assistance	0.70	100% of foreign expenditures.
- Export-oriented	104.00 <sub>a/</sub>	100% of foreign exp. & 100%
- Employment Creation	13.00 <sub>a/</sub>	of local exp. (ex-factory) for goods; and 100% of foreign exp. for consultants' services and training.
- Small Business	8.00 <sub>a/</sub>	For goods, 100% of foreign exp. & 100% of local exp. (ex-factory), or 75% of local expenditures for off-the-shelf purchases; and 100% of foreign exp. for consultants' services and training.
<u>NBH</u> (Small Business Credit Training)	0.15	100% of foreign expenditures.
<u>Government</u> (Small Business Study, Subsector Study, Employment Assistance)	4.15	100% of foreign exp. & 100% of local exp. (ex-factory) for goods; and 100% of foreign exp. for consultants' services and training.
<u>Unallocated</u>	<u>10.00</u>	
<u>Total</u>	<u>140.00</u>	

a/ For purpose of project financing, it has been assumed that the unallocated part of the Bank loan be distributed among enterprise components as follows: export-oriented (to increase to US\$110 million); employment creation (to increase to US\$15 million); and small business (to increase to US\$10 million).

Estimated IBRD Disbursements

	<u>IBRD Fiscal Year</u>						
	<u>1989</u>	<u>1990</u>	<u>1991</u>	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>
	----- (US\$ million) -----						
Annual	3.0	12.4	32.2	36.4	33.6	15.4	7.0
Cumulative	3.0	15.4	47.6	84.0	117.6	133.0	140.0

Schedule C

HUNGARY

THIRD INDUSTRIAL RESTRUCTURING PROJECT

Timetable of Key Project Processing Events

(a)	Time taken to prepare:	18 months
(b)	Prepared by:	Government with Bank Assistance
(c)	First Bank Mission:	June 1987
(d)	Appraisal Mission Departure:	May 1988
(e)	Negotiations:	December 12-16, 1988
(f)	Planned Date of Effectiveness:	April 1989
(g)	List of Relevant PCRs and PPARs:	None

THE STATUS OF BANK GROUP OPERATIONS IN HUNGARY

A. STATEMENT OF BANK LOANS <sup>a/</sup>  
(As of September 30, 1988)

Loan No.	Fiscal Year	Borrower	Purpose	US\$ Million	
				(Less Cancellations) Loan	Undisbursed
One loan and six B-Loans loans fully disbursed				266.5	-
2317	1983	HPR / <u>b</u>	Industrial Energy Conservation	109.0	11.6
2397	1984	NBH / <u>c</u>	Ind. Exports and Restructuring	110.0	6.5
2398	1984	OKGT/ <u>d</u>	Petroleum	90.0	4.9
2510	1985	NBH	Integrated Livestock	80.0	53.9
2511	1985	NBH	Fine Chemicals	73.0	13.0
2557	1985	HPR	Transport (Rail/Road)	75.0	21.0
2697	1986	NBH	Power	64.0	57.1
2700	1986	NBH	Industrial Restructuring	100.0	41.7
2709	1986	NBH	Industrial Energy Cons. II	25.0	16.8
2738	1987	NBH	Crop Production Improvement	100.0	42.0
2834	1987	NBH	Industrial Restructuring II	150.0	85.9
2847	1987	NBH	Telecommunications	70.0	57.5
2936	1988	NBH	Agroprocessing Modernization	70.0	65.0
2966	1988	NBH	Technology Development	50.0	50.0
2965	1988	NBH	Industrial Sector Adjustment	<u>200.0</u>	<u>124.0</u>
Total				1,632.5	
Of which repaid				<u>56.6</u>	
Total now held by Bank				1,575.9	
Total Undisbursed					<u>650.9</u>

a/ The status of these projects is described in a separate report on all Bank/IDA-financed projects in execution, which is updated twice yearly and circulated to the Executive Directors on April 30 and October 31.

b/ Hungarian People's Republic.

c/ National Bank of Hungary.

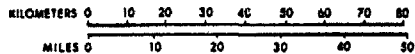
d/ National Oil and Gas Trust.

**B. STATEMENT OF IFC LOANS**  
(As of September 30, 1988)

Fiscal Year	Obligor	Type of Business	US\$ million		
			Loan	Equity	Total
1988	Dunament Polistirologyart	Chemical	29.78	4.13	33.91
1988	Salgotarjan Glass Wool	Glasswool	3.44	1.39	4.83
1987	UNIC Bank	Banking	-	3.21	3.21
1987	Huni Fermentation Limited	Lysine Manuf.	<u>8.55</u>	<u>2.70</u>	<u>11.25</u>
	Total Gross Commitments		41.77	11.43	53.20
	Less cancellations, terminations, repayments and sales		<u>-</u>	<u>-</u>	<u>-</u>
	Total Commitments now held by IFC		<u>41.77</u>	<u>11.43</u>	<u>53.20</u>
	Total undisbursed		<u>11.29</u>	<u>0.33</u>	<u>11.62</u>

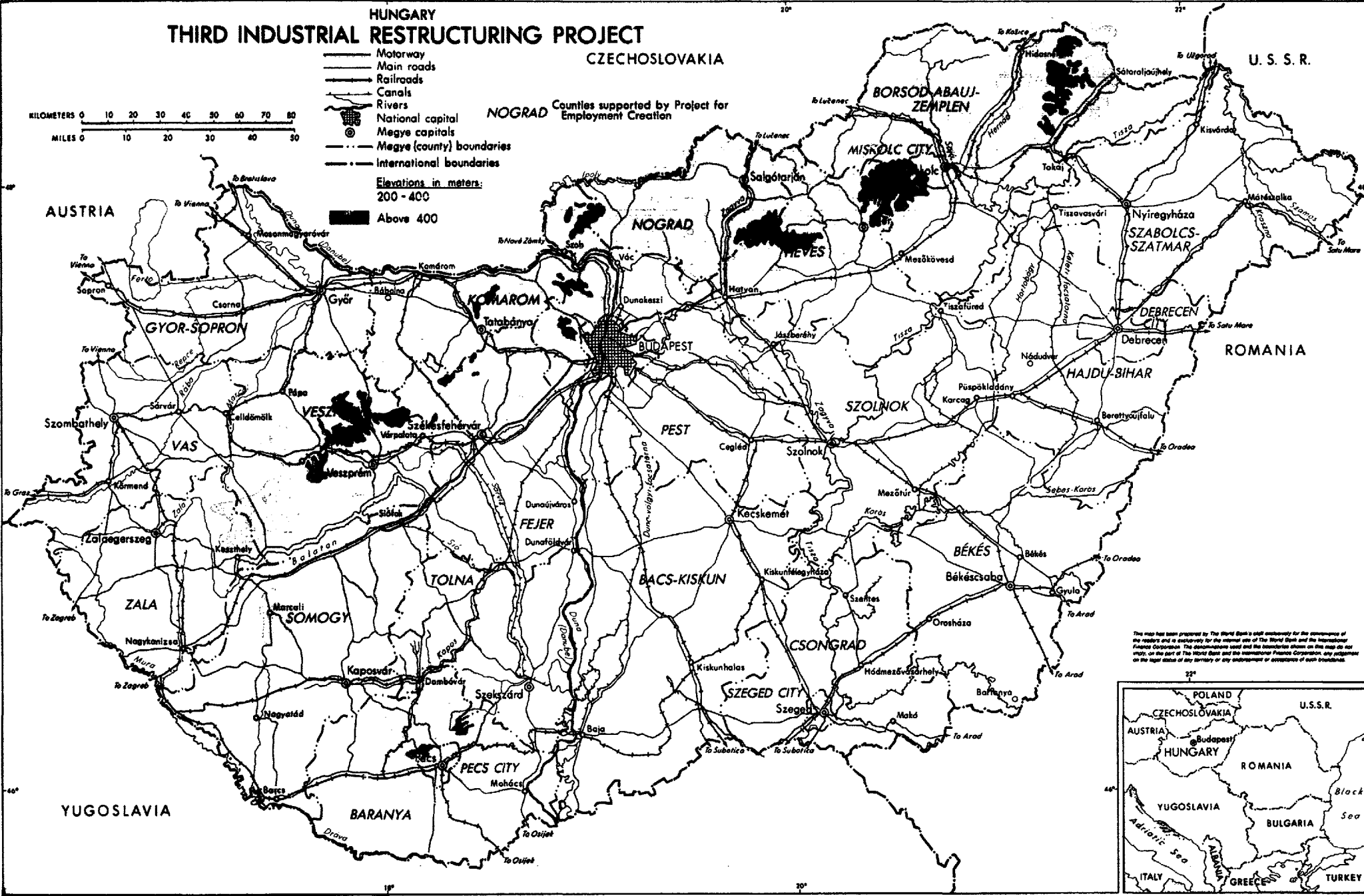
# HUNGARY THIRD INDUSTRIAL RESTRUCTURING PROJECT

- Motorway
- Main roads
- Railroads
- Canals
- Rivers
- National capital
- Megye capitals
- Megye (county) boundaries
- International boundaries



Elevations in meters:  
 200 - 400  
 Above 400

**NOGRAD** Counties supported by Project for Employment Creation



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