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April 2016

2016 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR HUNGARY

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2016 Article IV consultation with Hungary, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its April 22, 2016 consideration of the staff report that concluded the Article IV consultation with Hungary.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on April 22, 2016, following discussions that ended on February 15, 2016, with the officials of Hungary on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on April 6, 2016.
- An **Informational Annex** prepared by the IMF staff.
- A **Statement by the Executive Director** for Hungary.

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IMF Executive Board Concludes Article IV Consultation with Hungary

On April 22, 2016 the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Hungary.

The Hungarian economy has been growing at a robust pace over the past few years helped by supportive macroeconomic policies, a favorable external environment, and high utilization of EU funds. Driven by strong domestic demand, output expanded by 2.9 percent in 2015. External demand was also robust thus helping maintain a sizable current account surplus. Unemployment declined sharply, despite a rise in participation rate, reflecting solid employment growth in the private sector, but also continued expansion of the public works programs. Inflationary pressures have been subdued and inflation expectations appear anchored around the lower end of the National Bank of Hungary's (MNB) inflation target (2 percent).

Private sector credit continued to contract, non-performing loans, while declining, remain high, and bank profitability has been recovering. Steps were taken to resolve legacy NPLs, including the establishment of an asset management company and the enactment of the Personal Insolvency Law.

Vulnerabilities continued to decline thanks to large and persistent current account surpluses, and the FX-loan conversion along with MNB's self-financing program. While many of the recent measures have reduced vulnerabilities, they have also shifted risks to the public sector and to the MNB. Moreover, debt levels remain high and the associated large financing needs together with still sizable reliance on nonresident financing, and a highly negative IIP continue to pose risks. At the same time, the role of the state in the economy has been increasing including through acquisition of stakes in the banking and energy sectors.

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

The 2015 fiscal deficit came in below target, as revenues were propelled by accelerating economic activity, tax administration improvements, and one-off revenues, and were only partially offset by higher expenditures. Public debt declined to 75.3 percent of GDP from 76.2 percent in 2014. For 2016, the deficit is projected to meet the 2 percent of GDP target, implying a structural fiscal relaxation of about 1 percentage point of GDP and the debt ratio is expected to decline to 74.25 percent of GDP.

Comforted by subdued inflationary pressures, low risk premia, and a negative output gap, the MNB resumed its easing cycle in March 2015, and cut the policy rate by 75 basis points in five equal steps to 1.35 percent in July 2015. With inflation projected to remain very low in the monetary policy horizon, the MNB cut the policy rate further to 1.20 percent in March 2016. Moreover, several refinements of the traditional and unconventional monetary instruments have been introduced to strengthen the transmission channel, reduce vulnerabilities, and promote lending to small- and medium-sized enterprises, while ensuring cheap government financing.

Going forward, output growth is projected to decelerate to 2.3 percent this year. Private consumption will remain robust reflecting higher disposable income and employment, while favorable terms-of-trade will underpin a further increase in the current account surplus. Headline inflation is expected to remain low on account of low import prices and a still negative—albeit closing—output gap. Over the medium-term, growth prospects remain subdued reflecting an adverse business climate, which continues to weigh on private investment, including from abroad; and weaknesses in the labor market as reflected in still low labor participation, particularly among women and low-skilled workers.

Executive Board Assessment[2]

Executive Directors welcomed Hungary's favorable economic performance, including strong economic growth, a decline in unemployment and continued reduction in external vulnerabilities. They noted, however, that still elevated debt levels and financing needs leave the economy prone to shocks and medium-term growth prospects appear subdued. Moreover, the overall strategy has expanded the role of the state in the economy and shifted risks to the public sector. Against this background, Directors underscored the need for policy actions to further reduce vulnerabilities and boost medium-term, private sector-led growth.

Directors welcomed the authorities' continued commitment to fiscal discipline and advocated growth-friendly fiscal consolidation to help build policy space, reduce fiscal risks, and firmly place public debt on a declining path. They noted that priority should be given to improving the composition and efficiency of public spending, broadening the tax base and rationalizing

[2] At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

the tax system. These reforms would allow a further reduction in sectoral taxes and higher infrastructure spending.

Directors noted that monetary policy has been appropriately accommodative. They agreed that monetary easing may be required if downside risks to inflation and growth materialize, unless external financing conditions worsen unexpectedly. Directors underscored the need to maintain adequate foreign exchange reserves to support financial stability.

Directors welcomed steps to improve financial intermediation, including by reducing the tax burden on banks. They noted that efforts to clean up banks' balance sheets should be complemented with increased focus on addressing impediments to credit demand. Directors encouraged the authorities to follow through with their commitment to reduce state presence in the banking sector. They also noted that additional measures to promote lending should consider risks and be time-bound. Directors welcomed the start of operations of the asset management company for commercial real estate, but underscored the need to ensure that the transfer of assets is done on a voluntary basis and at market-related prices. They also emphasized the need to further strengthen the company's governance structure and keep its operations fully transparent.

Directors stressed the importance of structural reforms to improve the business climate and increase potential growth. They called for efforts to reduce the regulatory burden, enhance policy predictability, and limit state involvement in the economy. Directors underscored the importance of upgrading labor skills, promoting innovation and entrepreneurship, and increasing the efficiency of EU funds utilization to boost competiveness. Directors welcomed progress on improving the labor market, but saw scope for additional reforms to increase labor force participation and address skill mismatches.

Hungary: Selected Economic Indicators, 2011-18

	2011	2012	2013	2014	2015	2016	2017	2018
					Prel.		Proj.	
Real economy								
Real GDP (percentage change)	1.8	-1.7	1.9	3.7	2.9	2.3	2.5	2.4
Total domestic demand (contribution to growth) 1/	-0.2	-2.9	1.4	3.9	1.8	1.8	2.2	2.3
Private consumption 2/	0.5	-1.4	0.4	1.0	1.6	1.6	1.3	1.3
Government consumption	0.0	0.0	0.3	0.6	0.1	0.1	0.2	0.2
Gross fixed investment	-0.3	-0.9	1.4	2.3	0.4	0.0	0.7	0.9
Foreign balance (contribution to growth)	2.0	1.3	0.5	-0.2	1.2	0.5	0.3	0.1
Exports	5.4	-1.6	5.5	6.7	7.5	6.0	6.0	6.4
Imports	3.4	-2.8	5.1	6.9	6.4	5.5	5.8	6.2
CPI inflation (average)	3.9	5.7	1.7	-0.2	-0.1	0.5	2.4	2.5
CPI inflation (end year)	4.1	5.0	0.4	-0.9	0.9	1.2	2.6	3.0
Unemployment rate (average, ages 15-64)	11.1	11.1	10.2	7.8	6.8	6.6	6.4	6.2
Gross domestic investment (percent of GDP) 3/	19.8	19.4	20.5	21.7	21.3	20.8	21.2	21.5
Gross national saving (percent of GDP, from BOP)	20.5	21.1	24.5	23.7	25.7	25.7	25.8	25.4
General government 4/								
Overall balance	-5.5	-2.3	-2.5	-2.5	-1.9	-2.0	-2.1	-2.1
Primary balance	-1.7	1.9	1.8	1.3	1.6	1.2	0.9	0.8
Primary structural balance (percent of potential GDP)	-0.6	4.4	3.6	2.1	2.3	1.1	1.1	0.8
Gross debt	80.8	78.3	76.8	76.2	75.3	74.2	73.7	72.6
Money and credit (end-of-period)								
Broad money	5.9	-3.3	5.5	5.6	6.2	5.1	5.9	5.5
Lending to the private sector, flow-based 5/	-6.8	-7.4	-3.3	-0.9	-10.9	-2.0	1.5	2.5
Interest rates								
T-bill (90-day, average)	6.0	6.8	4.1	2.1	1.1	...	...	...
Government bond yield (5-year, average)	7.4	7.7	5.2	3.9	2.7	...	...	...
5-year sovereign CDS (annual average)	384	465	297	197	152	...	...	...
Balance of payments								
Goods and services trade balance	6.2	6.8	7.3	7.1	8.6	9.5	8.9	8.0
Current account	0.7	1.8	4.0	2.0	4.4	4.9	4.6	4.0
Reserves (billions of Euros)	37.8	33.9	33.8	34.6	30.3	25.4	24.0	27.4
Gross external debt 6/	134.4	129.0	118.4	114.8	108.8	103.4	96.3	86.4
Gross official reserves (percent of short-term debt at remaining maturity)	65.3	67.4	97.4	102.4	105.8	102.6	103.5	111.4
Exchange rate								
Exchange regime	Floating							
Present rate (March 2016, eop)	Ft. 314.16 = €1; Ft. 287.25 = CHF1							
Nominal effective rate (2000=100, average)	104.2	109.0	110.3	114.2	116.5	...	...	...
Real effective rate, CPI basis (2000=100, average)	72.6	73.6	74.3	77.7	79.4	...	...	...
Quota at the Fund	SDR 1,940 million							
Memorandum Items:								
Nominal GDP (billions of Forints)	28,134	28,628	30,065	32,180	33,712	35,211	36,976	38,886

Sources: Hungarian authorities; IMF, International Financial Statistics; Bloomberg; and Fund staff estimates.
1/ Includes change in inventories.
2/ Actual final consumption of households.
3/ Excludes change in inventories.
4/ Consists of the central government budget, social security funds, extrabudgetary funds, and local governments.
5/ 2015 reflects the effects of the Settlement Act on credit stock.
6/ Excluding Special Purpose Entities. Including inter-company loans, and nonresident holdings of forint-denominated assets.

INTERNATIONAL MONETARY FUND

HUNGARY

STAFF REPORT FOR THE 2016 ARTICLE IV CONSULTATION

April 6, 2016

KEY ISSUES

Context. Supportive macroeconomic policies over the past few years, a favorable external environment, and high utilization of EU funds have contributed to a strong growth rebound and a welcome drop in unemployment. There has also been a continuous decline in vulnerabilities, which has underpinned Hungary's financial stability during bouts of global market volatility. Still, debt levels and associated financing needs remain elevated, thus leaving the economy prone to shocks. At the same time, a weak business environment, low productivity, and labor market problems weigh on Hungary's medium-term growth prospects. While the overall strategy has been successful in maintaining strong growth in the near term, it has also expanded the role of the state in the economy and shifted risks to the public sector.

Policy recommendations. Policies should aim at supporting strong, sustained, private sector-led growth while further reducing vulnerabilities.

- **Fiscal policy.** Growth-friendly fiscal consolidation would help build policy space, reduce fiscal risks, and firmly put public debt on a downward path. The consolidation strategy should rely on durable expenditure retrenchment and a rationalization of the tax system.

- **Monetary policy.** Monetary policy may have to ease further if downside risks to activity and inflation materialize. Adequate reserves are necessary to support financial stability.

- **Financial sector.** Reviving private credit requires increased focus on addressing impediments to credit demand. Additional measures to promote lending should properly consider the risks and be time-bound. The operations of the asset management company should be kept fully transparent and its governance structure be strengthened. The role of the state in the banking sector should be limited.

- **Structural reforms.** Adopt policies to improve the business environment, enhance competitiveness, and address challenges in the labor market. Enhance policy predictability and limit the state's involvement in the economy to help strengthen confidence and support private investment.

Approved By
Jörg Decressin (EUR) and Masato Miyazaki (SPR)

Discussions took place in Budapest during February 3–15, 2016. The staff team comprised Messrs. Christou (Head), and Lybek, Mses. ElGanainy and Shabunina (all EUR), and Sanya (SPR). Mr. Benk (OED) attended most meetings. Ms. Samuel and Ms. Borisova (both EUR) assisted in the preparation of the staff report. The staff team met with State Secretaries of the Ministry for National Economy Ms. Hornung and Mr. Banai, Central Bank of Hungary (MNB) Deputy Governor Mr. Nagy, other senior officials, including from the Prime Minister's Office and from the Ministry for National Development, academics, and representatives from the private sector and think tanks. A workshop was held in Budapest during the mission jointly with the MNB and the Ministry for National Economy on analytical topics that informed the consultation discussions. Hungary is an Article VIII country (Informational Annex: Fund Relations). Data provision is adequate for surveillance (Informational Annex: Statistical Issues).

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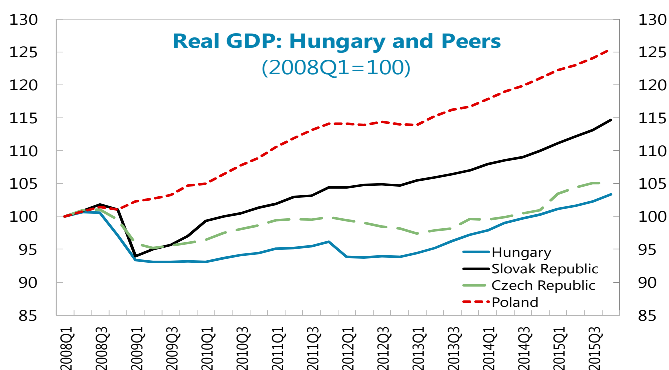
CONTEXT

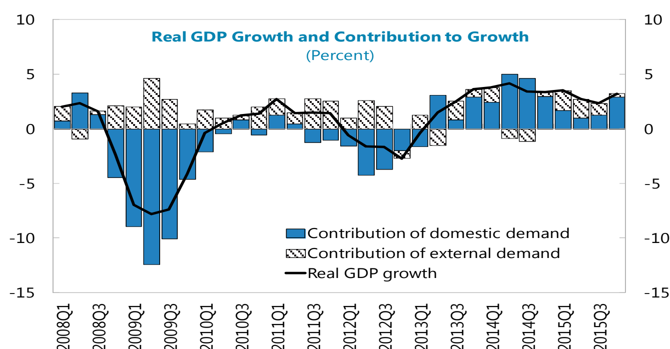
1. Robust growth has been accompanied by a sharp reduction in vulnerabilities, but challenges remain. Hungary endured a prolonged period of stagnation in the aftermath of the global crisis, largely attributed to significant deleveraging, fiscal consolidation, and weak external demand. Over the past three years, supportive macroeconomic policies, along with a favorable external environment—low global interest rates and low commodity prices—and high utilization of EU funds, contributed to a strong growth rebound and a welcome drop in unemployment. At the same time, the economy's vulnerability to shocks declined substantially. The current account has been in record surplus, and external debt, especially FX-denominated, dropped sharply. Still, debt levels and financing needs remain high. While government policies have supported the economy and boosted household income, they have kept public spending elevated and the tax burden above the EU average. These policies also expanded the state's role in the economy and shifted risks to the public sector. Also, many initiatives in the financial sector have reduced vulnerabilities, but have shifted risk to the central bank. Moreover, frequent and unpredictable policy changes and a still-high level of sectoral taxes weaken the business climate, and along with low productivity and labor market problems weigh on prospects for private investment. This clouds Hungary's medium-term prospects and call for a strategy to comprehensively address obstacles to stronger growth.



Sources: Haver Analytics; and IMF staff calculations.

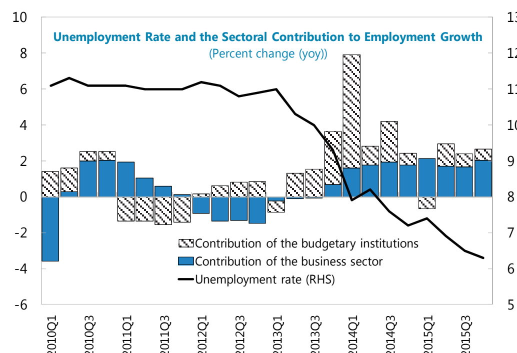
BACKGROUND AND RECENT DEVELOPMENTS

2. The economy has been growing at a robust pace. Driven by strong domestic demand, output expanded by just below 3 percent in 2015. Export growth was robust on the back of an improved external environment and new automobile production lines, while import growth slowed down due to lower commodity prices. As a result, the current account surplus continued to widen. Private consumption expanded significantly, benefitting from a boost to disposable income from higher employment and wages, lower energy prices, and lower household indebtedness. Investment decelerated as the previous EU funds programming period (2007–13) reached an end and manufacturing capacity upgrades in the automotive industry have been largely completed.



Sources: Haver Analytics and Fund staff calculations.

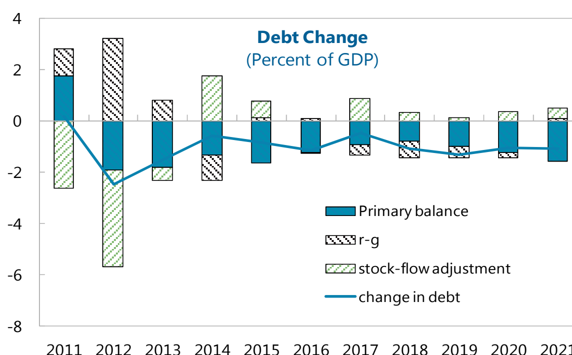
3. Unemployment declined sharply, amid a continuous rise in labor participation. Solid employment growth—led by the private sector, but also continued expansion of public works—helped reduce the unemployment rate to 6.2 percent in 2015:Q4, below pre-crisis levels. The labor participation rate reached an average of 68½ percent in 2015 (up from 67 percent in 2014), but remains well-below the EU average.



Sources: Haver Analytics and Fund staff calculations.

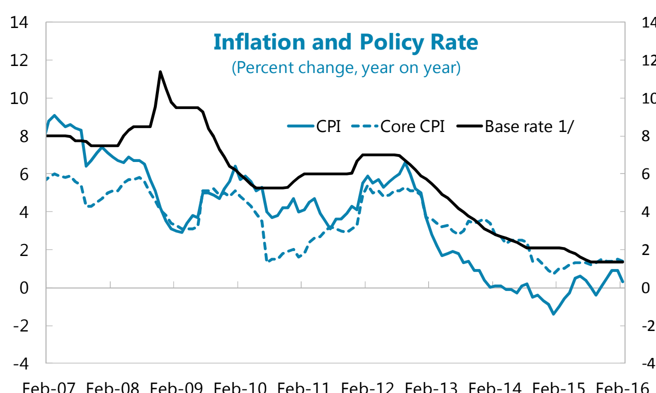
4. Inflationary pressures have remained subdued. Headline inflation has hovered at zero due to declining oil and initially also low food prices. Core inflation has been increasing steadily reaching 1.4 percent y-o-y in February 2016. Average monthly gross earnings grew by 5¼ percent y-o-y in 2015:Q4, while asset (stock market and real estate) prices also picked up. Inflation expectations appear anchored around the lower end of the Central Bank's (MNB) inflation band (2 percent).

5. Better-than-budgeted fiscal performance last year helped reduce the public debt ratio. The overall deficit is estimated at 1.9 percent of GDP against the 2.4 percent target. Revenues over-performed helped by the strong economy, improvements in tax administration, and sizable one-off corporate income tax and excise revenues. The effect on the deficit was partially offset by higher expenditures on wages, co-financing of EU projects, and refugee-related outlays (Box 1). Gross public debt declined to 75.3 percent of GDP from 76.2 percent in 2014. The total positive impact from a primary surplus was mitigated by government asset purchases and delayed EU funds transfers. Meanwhile, the MNB's self-financing program helped reduce the shares of FX-denominated public debt and of non-resident holdings. Nevertheless, net public debt has plateaued since 2013.



Sources: Hungarian authorities and Fund staff estimates

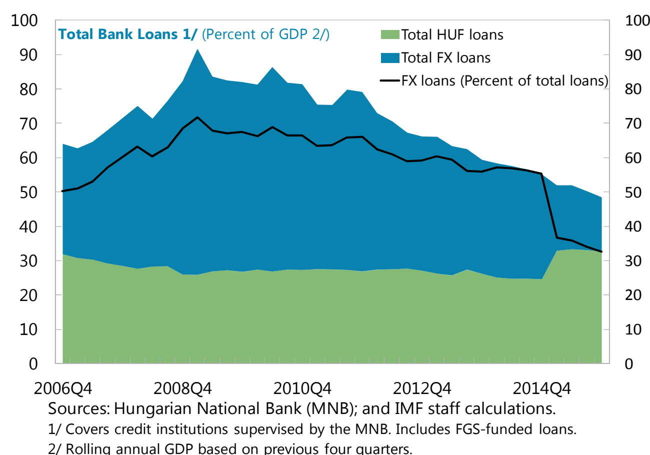
6. The monetary stance has remained accommodative. Comforted by subdued inflationary pressures, and in line with staff advice (Annex I), the MNB resumed its easing cycle in March 2015, and cut the policy rate by 75 basis points in five equal steps to 1.35 percent in July. Moreover, several refinements of the traditional and unconventional monetary instruments have



Sources: Hungarian National Bank (MNB); Hungarian Central Statistical Office (HCSO); and IMF staff calculations.
1/ Base rate of the MNB.

aimed at strengthening the interest rate, credit, and expectations channels; reducing vulnerabilities; promoting lending to small-and medium-sized enterprises (SMEs); and ensuring cheap government financing.[1]

7. The recovery has so far been "credit less." Bank lending to the private sector has continued to contract. Compensation paid by banks and the conversion of FX-denominated loans contributed, respectively, to a sharp decline in household indebtedness and their FX risk. Bank lending to non-financial companies continued to decline, although this decline is masked by: (i) a few large companies having switched financing to foreign sources; and (ii) the Funding for Growth Scheme (FGS), which was successful in increasing lending to SMEs. While many of these operations have reduced vulnerabilities, they have also shifted risks, including to the MNB.



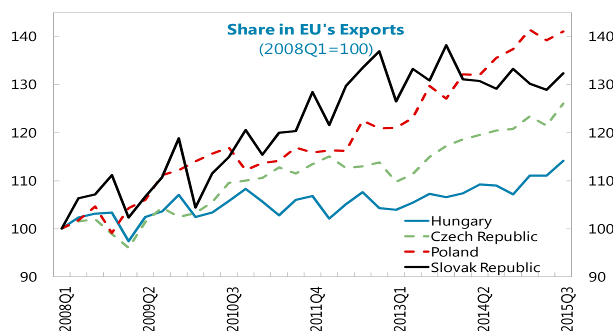
Sources: Hungarian National Bank (MNB); and IMF staff calculations.
1/ Covers credit institutions supervised by the MNB. Includes FGS-funded loans.
2/ Rolling annual GDP based on previous four quarters.

8. Banking sector soundness indicators have been improving, although lending remains subdued. The loan-to-deposit ratio has declined sharply and permitted a further reduction of foreign funding. On average, liquidity is ample and the capital adequacy ratio is comfortable. After large losses in 2014, profitability is recovering. The NPL ratios have declined, although some of the improvement for household loans is temporary. Loans issued after the crisis typically have lower NPL ratios but initiatives to reduce the legacy NPL stock are also helping, including the new Personal Bankruptcy Law and the asset management company for commercial real estate (MARK) (Annex II). Macro-prudential measures for new loans were tightened effective January 2015, but have not yet been binding. Finally, state ownership in the banking system has increased with the acquisition of Budapest Bank, but the purchase of a stake in Erste's Hungarian subsidiary has been delayed.

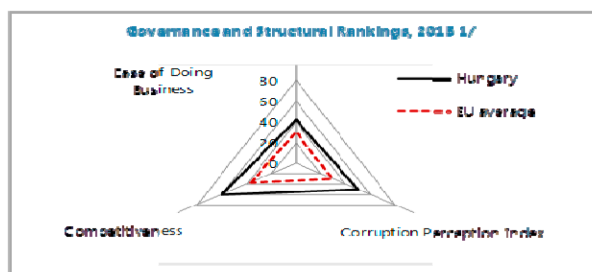
9. External vulnerabilities have declined substantially, but external stability concerns remain. Large and persistent current account surpluses, and cross-border deleveraging have contributed to a substantial decline in gross external debt and an improvement in the international investment position (IIP). The FX-loan conversion along with MNB's self-financing program have further reduced external vulnerabilities: e.g., the share of FX-denominated public debt dropped from 52 percent in 2011 to 35 percent in 2015. Markets responded by pushing five-year credit default swap (CDS) rates and bond yields lower. However, gross external financing needs of 20 percent of GDP, a still-sizable reliance on non-resident funding of domestic public debt (26 percent), and a highly negative IIP (-79 percent) continue to raise concerns, especially at the current juncture of elevated levels of risk aversion.

[1] See http://www.mnb.hu/en/monetary-policy/monetary-policy-instruments.

10. The real exchange rate is broadly in line with fundamentals, but non-price indicators suggest that Hungary faces competitiveness challenges. The EBA methodology yields mixed results with a negative current account norm (Box 2). However, to further improve Hungary's external position and its IIP, there is a need to maintain current account surpluses over the medium term. While price indicators do not point to competitiveness problems, Hungary's export market share had stagnated until recently compared to its peers; and low FDI weighs on future export performance. Finally, Hungary's ranking in the global competitiveness index has slipped, with the business and regulatory environment providing a drag.



Sources: IMF, Direction of Trade Statistics and Fund staff calculation.



Sources: Transparency International, World Bank, and World Economic Forum.
1/ Out of 189 countries for Ease of Doing Business, 168 countries for Corruption Perception, and 144 countries for Competitiveness.

OUTLOOK AND RISKS

11. Economic activity is expected to decelerate in 2016. Private consumption will remain robust on the heels of higher disposable income and employment, but the projected slowdown in EU fund absorption will weigh on growth. Over the medium term, output growth is set to stabilize at around 2 percent. Favorable terms-of-trade will underpin a further improvement in the current account, which will remain in surplus over the medium term, albeit declining due to a slowdown in deleveraging and an aging population, thus contributing to a sharp IIP decline. Headline inflation will remain low in 2016 on account of low import prices and a still negative—albeit closing—output gap, and reach the 3 percent target in late-2018 as the output gap closes and energy prices recover (Box 3).

Hungary: Key Macroeconomic Indicators, 2013-21 (Percent of GDP, unless otherwise indicated)

	2013	2014	2015	2016	2017	2018	2019	2020	2021
			Est.			Proj.			
Real GDP Growth (percent)	1.9	3.7	2.9	2.3	2.5	2.4	2.2	2.1	2.1
Inflation (period average, percent)	1.7	-0.2	-0.1	0.5	2.4	2.5	2.9	3.0	3.0
General government overall balance	-2.5	-2.5	-1.9	-2.0	-2.1	-2.1	-1.9	-1.8	-1.7
General government gross debt	76.8	76.2	75.3	74.2	73.7	72.6	71.3	70.2	69.1
Current account	4.0	2.0	4.4	4.9	4.6	4.0	3.1	2.2	1.4
Reserves (billions of Euros)	33.8	34.6	30.3	25.4	24.0	27.4	32.1	35.6	38.0
Gross external debt 1/	118.4	114.8	108.8	103.4	96.3	86.4	79.4	72.2	68.1

Sources: Hungarian authorities, and Fund staff projections.
1/ Excluding special purpose entities. Including inter-company loans, and nonresident holdings of forint-denominated assets.

12. The balance of risks—highlighted in the Risk Assessment Matrix—is tilted to the downside. A sharp deterioration in global or emerging market risk perceptions could lead to capital outflows with adverse effects on government financing and private balance sheets. Further, weak external demand, notably from the euro area but also indirectly from China and other emerging markets, would weigh on exports. An escalation of the refugee crisis in Europe could impact trade and economic activity. On the domestic front, policy uncertainty and continued expansion of the state's role in the economy could adversely affect confidence and investment prospects. Upside risks are associated with persistently lower energy prices, which would reduce production costs and boost purchasing power, while initiatives to boost housing construction and stimulate credit could increase near-term growth.

13. While broadly agreeing on the near-term outlook, the authorities were more optimistic about Hungary's medium-term growth prospects and the balance of risks. They shared staff's assessment that GDP growth would decelerate this year but were more sanguine about growth prospects over the medium-term citing the continued improvement in fundamentals, which helped Hungary regain market trust, as evidenced by the historically low sovereign CDS spreads. Nevertheless, they concurred that despite recent improvement, vulnerabilities—particularly ones stemming from the elevated public debt level and associated large financing needs—remain high. The authorities viewed the risks to the outlook broadly balanced arguing that the sharp reduction in external vulnerabilities had reduced the likelihood of capital outflows as evidenced by the very limited impact of the recent bouts of global market volatility on Hungarian assets. Finally, they agreed that lower import prices could boost consumption and investment more than expected, and that deterioration in the external environment represented a downside risk to exports.

POLICY AGENDA

Discussions focused on the need to further reduce vulnerabilities and to transition to growth driven by a vibrant private sector. On the policy mix, staff advocated for a growth-friendly fiscal consolidation to help build buffers and provide space for greater private-sector activity, and accommodative monetary policy to support growth and external adjustment. Staff called for structural policies to improve the investment climate, enhance competitiveness, and address weaknesses in the labor market.

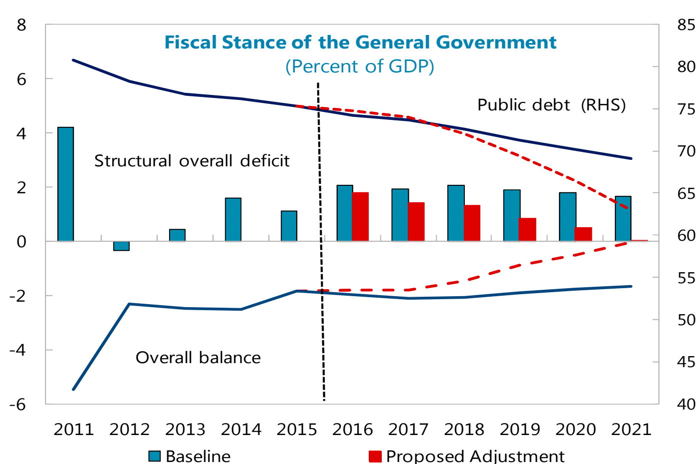
Such a policy mix would increase Hungary's medium-term growth potential, as structural reforms advance and the budget quality improves. Increased market confidence and enhanced competitiveness would lift private investment, including from abroad. Labor market reforms would increase participation, particularly that of women and the low-skilled, also supporting higher growth. Under this strategy, growth could accelerate to more than 3 percent over the medium term, the investment ratio could reach pre-crisis levels, and the public debt ratio could fall gradually to around 60 percent.

A. Fiscal Policy

14. Fiscal policy is turning expansionary. Staff projects the 2016 headline deficit to meet the government's target of 2 percent. The budget relies on sizeable one-off revenues from land sales

and also includes various tax reduction measures: a 1 percentage point reduction in the personal income tax (PIT) rate, a cut in the VAT rate on pork products and on new housing construction, higher tax allowances for families with two children, and a welcome reduction in the bank levy. Moreover, a new open-ended housing support scheme,[2] and public works and career model programs will increase expenditure. On the other hand, significant savings will materialize in the interest bill. All in all, the envisaged fiscal stance implies a structural relaxation of about 1 percentage point of GDP.

15. The authorities' medium-term fiscal plans face a number of risks and would leave public debt elevated. The government targets a reduction in the deficit to 1.5 percent of GDP by 2019, underpinned by savings from the social benefits reform, containment of health and education costs, and discretionary spending freezes. However, besides the intention to further reduce the bank levy and reform public administration, specific fiscal reforms are yet to be elaborated. Moreover, the fiscal cost of the housing support scheme is subject to large uncertainty and constitutes a significant risk for the budget; and health and education spending have a long history of under-budgeting. Additionally, the state's ambitious investment and asset acquisition plans would have to be balanced against rising pressures for further tax cuts. In staff's baseline scenario, the structural deficit would hover at around 2 percent of GDP over the medium term. The public debt ratio would decline to just below 70 percent and be exposed to considerable risks, particularly from lower GDP growth, higher interest rates, and growing contingent liabilities (Annex V).[3]



Sources: Hungarian authorities and Fund staff estimates

16. Decisive fiscal action—encompassing moderate expenditure-based adjustment and a rebalancing of the budget—is needed to put public debt on a firmly downward path, help reduce fiscal risks, and provide more space for increased private-sector activity. Staff recommended a moderate average annual structural fiscal tightening of about ⅓ percent of GDP during 2016–21 complemented with growth-enhancing reforms consistent with gradually reducing public debt to below 60 percent of GDP by 2022.[4] With the tax burden above the EU average and

[2] A grant of HUF10 million (about €32,000) is provided to families with (or committing to have) 3 or more children towards a new house purchase. An interest rate subsidy is also provided for a HUF10 million mortgage.

[3] In 2015, the stock of public guarantees increased by 1.7 percentage points of GDP to 9.5 percent of GDP. The stock could increase further, if additional state acquisitions materialize.

[4] The magnitude of the proposed adjustment is below the median sustained fiscal effort of historical fiscal consolidations; see: http://www.imf.org/external/pubs/ft/fm/2013/01/fmindex.htm.

public spending of 50 percent of GDP, consolidation efforts should be focused on streamlining public expenditure while rationalizing the tax system in a growth-friendly manner. Specifically:

- Staff welcomed the reduction in the bank levy, along with the commitment for further reductions, and ongoing efforts to improve tax administration. However, the continued shifting of items to the lower VAT rate complicates administration and introduces new distortions in a system that remains burdened by sectoral taxes. Staff thus recommended broadening the tax base by reducing exemptions and preferential regimes; and further cutting remaining sectoral taxes.

- There is a need for lowering the tax wedge, which is among the highest in the region particularly for low-income earners. While the PIT rate cut this year aims at addressing this issue, more targeted instruments, such as progressive in-work tax credits could be more cost effective with a potentially higher impact on employment.

- Staff reiterated its long-standing recommendations to eliminate generalized subsidies, improve the efficiency of SOEs, increase the efficiency of public spending in health and education, and rationalize the relatively-high and increasing wage bill. The authorities' intention to downsize public administration is welcome but needs to be complemented by a public expenditure review clearly identifying government priorities regarding the provision of public services.

Fiscal impact of potential measures, 2016-2021 average per year
(in percent of GDP)

Total	0.38
Revenue	-0.12
Phasing out of sectoral taxes	-0.30
Streamlining VAT rates	0.08
Elimination of excise duty refunds for fuel	0.10
Expenditure	0.50
Reduction in wage bill 1/	0.30
Rationalization of spending on non-EU-related goods and services 2/	0.10
Rationalisation of transport and fuel subcidies	0.10

Sources: IMF staff estimates, based on data provided by the authorities.

1/ Reduce employment (rather than wages) through consolidation of institutions and responsibilities, attrition; and rationalization of local government employment.

2/ Savings largely associated with the proposed public sector consolidation and limiting discretionary spending of the central government.

- Finally, staff recommended close monitoring of the housing support program to ensure it is appropriately targeted, time-bound, and eliminates loopholes for abuse. The authorities should stand ready to modify the eligibility criteria and the program's parameters, if necessary.

17. The authorities emphasized their strong commitment to reduce public debt and adhere to the national and European fiscal rules. They highlighted Hungary's significant progress, compared with other EU countries, in reducing debt. While agreeing that the current high debt level

remains a source of vulnerability, they underscored the need for fiscal policy to strike the right balance between debt reduction and supporting growth. They reiterated their commitment to a gradual reduction in debt, in line with European fiscal rules, and added that remaining fiscal space should be mainly devoted to addressing infrastructure needs.

18. There was agreement on the need for a growth-friendly rebalancing of the budget but differences in views arose on the most appropriate policy instruments. The authorities reiterated their preference to further reduce the PIT, if fiscal space allows. They highlighted the positive outcomes of the social security cuts on employment of vulnerable groups. Given limited fiscal space, they did not plan to reduce sectoral taxes (other than the bank levy) or streamline the multiple VAT rates in the near-term. They noted that the lower VAT rates for some items are considered a policy tool to support vulnerable groups who disproportionately consume such products, and could significantly improve tax compliance.

B. Monetary Policy

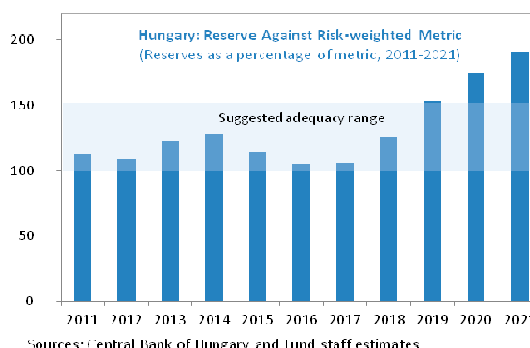
19. Monetary policy has been appropriately accommodative, but may have to ease further if downside risks to activity and inflation materialize. An uncertain external environment, oil price dynamics, highly-accommodative monetary conditions in the euro area, and the negative, albeit closing, output gap call for continued accommodation, as long as inflationary pressures remain subdued. Should inflation fail to pick up as projected and/or downside risks to activity threaten to materialize, monetary easing should be the primary line of defense, especially if fiscal policy is tightened as recommended by staff. On the other hand, should wage increases continue to outpace productivity gains, the output gap closes faster than expected in light of the ongoing fiscal easing, further monetary easing should be put on hold. Finally, if the downside risks materialize with large capital outflows, monetary tightening may be needed if the exchange rate overshoots and inflation threatens to durably rise above target.

20. The use of unconventional monetary policy instruments has eased the monetary stance more than indicated by the base rate cuts. The MNB is of the view that the reduction of vulnerabilities has effectively eased the monetary policy stance. Staff noted that although many of these measures have indeed reduced risks, part of the risks have been shifted between balance sheets. For instance, while the FX risk of households has largely been eliminated, most of the refinancing is now at variable interest rates, making households sensitive to domestic interest rate hikes. Official reserves are now lower, even if still broadly adequate, while the self-financing program has increased bank-sovereign links. Moreover, part of the self-financing program for the government as well as part of the new initiative to promote bank lending mean that the MNB accepts interest rate risk by issuing interest rate swaps. While this may be sensible in circumstances where the private sector is very risk averse, it becomes less appropriate as activity and inflation begin to normalize.

21. MNB officials hinted that, subject to inflation developments, it is more likely to ease using unconventional instruments than lowering of the base rate. They noted that the pausing

in the easing cycle in July 2015 was warranted on the basis of already accommodative monetary conditions, the absence of underlying deflationary pressures, and substantial uncertainty about the impact of the many recent unconventional measures. In their view, further easing could include additional unconventional measures, while keeping the policy rate at the current rate, given that the base rate deflated with inflation expectations is already negative. Subsequent to the mission, and in the backdrop of a downward revision in inflation projections and further easing by the ECB, MNB cut the policy rate by 15 basis points to 1.20 percent.

22. Staff welcomed MNB's commitment to maintain adequate reserves thus helping safeguard financial stability. Reserves are broadly adequate at 114 percent of the IMF's reserve adequacy metric and above the standard rules-of-thumb. Although reserves would fall in 2016–17, as MNB would provide FX liquidity to help banks close their open FX position that emerged from the loan conversion, they would remain within the Fund's adequacy range, albeit close to the lower bound. The authorities noted that the envisaged decline will be accompanied by a reduction in short-term external debt, keeping reserves above the adequacy range in the medium term. There was agreement on the importance of maintaining adequate reserve coverage because of still elevated risks and volatile global conditions.



Sources: Central Bank of Hungary and Fund staff estimates.

C. Financial Sector

23. Although banks are on average very liquid and well-capitalized, bank lending to the private sector remains subdued. Indeed, the willingness of banks to lend has tightened since the crisis. MNB officials noted that relatively high costs and legacy NPLs also impede banks' willingness to lend. While these factors play a role, market observers and staff see the lack of new bank lending primarily driven by still insufficient demand from borrowers with credible projects. This could be a reflection of volatile external demand, relatively-low potential growth, a weak business climate, sudden regulatory changes, and uncertainty regarding the future landscape of the banking sector.

24. Additional measures to promote lending should properly consider the risks and be time bound. Staff argued that the MNB should not share credit risk from banks' lending and thus welcomed the expiration of FGS+, while recommending not to lower risk-weights for certain more risky lending. Instead, consideration should be given to further reduce the perils and costs of debt recovery by refining the insolvency legislation and its implementation.

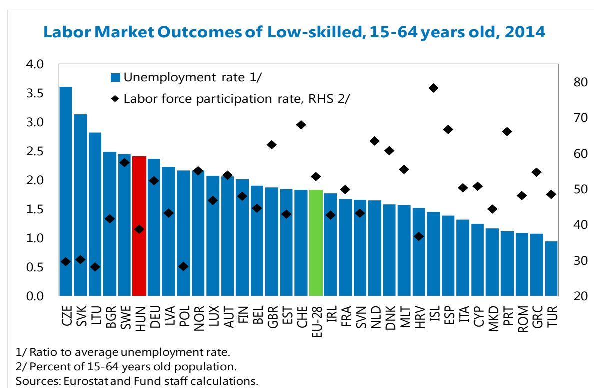
25. Staff supported efforts to resolve legacy NPLs, but emphasized the importance of keeping the operations of MARK fully transparent. The recently enacted Personal Insolvency Law is a good step toward resolving household NPLs, and it is encouraging that improvements to make the procedures less cumbersome are already under way. While welcoming the beginning of

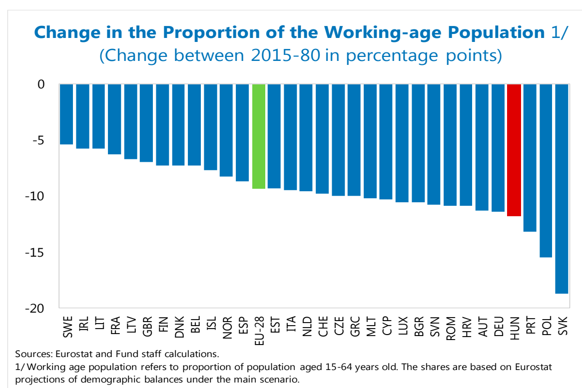
operations of MARK, which would entail the transfer of assets on a voluntary basis and at market-related prices, staff urged the authorities to further strengthen MARK's governance structure in line with IMF technical assistance recommendations. To this end, staff welcomed considerations to transition to private sector funding and also, when a track record has been established, to revisit the ownership structure.

26. Improving financial intermediation should also entail lower state presence in the banking sector. The authorities noted that the recent expansion in state ownership of banks was necessitated by market failure as some foreign parent banks had decided to exit Hungary. They reiterated their commitment though to improve banks' operating environment and to privatize the restructured MKB Bank and later Budapest Bank. Staff welcomed this commitment and stressed the importance of lifting uncertainty regarding the banking sector landscape, including by letting the number of credit institutions be market determined.

D. Structural Policies

27. There was agreement on the need to raise potential growth. Potential growth is currently estimated at 1½ percent and, as investment increases, is projected to reach 2 percent over the medium term—still below that of regional peers. In staff's view, this reflects an adverse business climate—on account of, among other, frequent and unpredictable policy changes and a still-high level of sectoral taxes; low productivity; and continued weaknesses in the labor market. Specifically,





labor participation and employment rates are still low, particularly among the low-skilled, a group that faces substantially higher unemployment. Further, while the increase in the female labor participation to 62¼ percent (2015) is welcome, it still remains well-below the EU-average of 66½ percent (2014). Hungary also faces demographic headwinds, with the proportion of the working age population projected to fall substantially. Finally, the expanding role of the state in the economy could adversely affect investment prospects. In fact, the sizeable gap between Hungary's post-crisis and "optimal" investment rates suggests scope for boosting investment (Box 4).

28. Staff noted that priority should be given to reforms, with an increased role for the private sector, as unconventional policy measures are phased out.

- *Business environment:* Staff called for steps to increase investment and promote private-sector activity, including by improving transparency and predictability of policymaking, strengthening anti-corruption efforts, easing the regulatory burden, and limiting the state's role in the economy. Enhancing the ease of paying taxes; streamlining the tax system; further improving tax compliance; and perseverance on tackling VAT fraud would all go a long way to support directly or indirectly investment and growth. The framework for anti-money laundering and combating the financing of terrorism could complement efforts to detect instances of corruption and VAT fraud.

- *Competitiveness:* Given the importance of non-price factors in boosting Hungary's competitiveness, staff called for measures to move up the value chain, increase export diversification, and improve productivity in the labor and services markets, including by upgrading labor skills and improving the efficiency of SOEs. Focus should be on boosting innovation and R&D, further enhancing vocational training, and promoting entrepreneurship. Efficient EU fund utilization would also be important to maximize their growth impact (Annex III).

- *Labor market:* Renewed efforts will be needed to further increase labor force participation, particularly for the young, old, and the low-skilled. Staff also reiterated its previous recommendations (e.g., reshuffling spending on family benefits to provide affordable child care, and reducing the gender wage gap) to further boost female labor participation. In addition, there is a need to upgrade labor force skills, address skill mismatches, and increase employment of low-skilled. To this end, staff argued that active labor market policies should entail strengthened training components and enhanced job-matching services, while tax-benefit systems should be reformed (Annex IV).

29. The authorities were confident that recent policy measures boded well for higher potential growth over the medium-term. They agreed on the need to increase competitiveness, enhance productivity, improve the quality of education, and foster innovation and R&D—as elaborated in the most recent MNB Growth Report. As for the state's increasing role in the economy, they considered that temporary and necessary to address various market failures. They further argued that in the energy sector, the overall strategy aims at securing and diversifying energy supply with a view to enhance competitiveness. The authorities saw scope for improving the efficiency of EU funds utilization and underscored that the next programming period would entail greater private-sector participation. They felt confident that ongoing labor market reforms aimed at addressing both supply and demand side barriers would continue to yield results. They stressed that the public works scheme has been instrumental in activating and providing temporary jobs for the low-skilled, and highlighted on-going efforts to promote the transition of those workers to the primary labor market.

STAFF APPRAISAL

30. The Hungarian economy is performing very well and its vulnerability to shocks has continued to decline substantially. Supportive macroeconomic policies over the past three years,

along with a favorable external environment and high utilization of EU funds have contributed to a strong growth rebound and a welcome drop in unemployment. The economy's vulnerability to shocks has declined substantially thanks to persistent current account surpluses, a sharp reduction in external debt, especially FX-denominated, and improved market sentiment.

31. While these developments are welcome, more needs to be done to further reduce vulnerabilities and to transition to private sector-led growth. Still-elevated debt levels, high financing needs, and subdued medium-term growth prospects make the economy prone to shocks. Moreover, although the overall strategy has been successful in maintaining strong growth in the near term, it has also expanded the role of the state in the economy and shifted risks to the public sector. The improved economic conditions provide an opportune time to further reduce vulnerabilities and unlock Hungary's untapped growth potential. To this end, priority should be given to: gradual, growth-friendly fiscal consolidation, revival of private credit by addressing impediments to credit demand, and structural reforms to improve the business environment, enhance competitiveness, and address labor market challenges.

32. Growth-friendly fiscal consolidation would help build policy space, reduce fiscal risks, and firmly place public debt on a downward path. The recent reduction in the public debt ratio is welcome, but, going forward, stronger fiscal consolidation efforts along with ambitious growth-friendly fiscal reforms would be needed. Those could include the rationalization of the wage bill as part of a well-articulated public administration reform, an increase in the efficiency of public spending on health and education, and the elimination of generalized subsidies. These reforms, along with measures to broaden the tax base, would free up fiscal space for further reduction in sectoral taxes and for higher infrastructure spending.

33. Monetary policy has been appropriately accommodative, but may have to ease further if downside risks to growth and/or inflation materialize. Easy monetary conditions have supported domestic demand in the context of subdued inflationary pressures. Going forward, stable inflation expectations, the dynamics of oil prices, and the negative, albeit closing, output gap call for continued accommodation as long as inflationary pressures remain subdued. If inflation fails to pick up as projected or downside risks to activity threaten to materialize, monetary easing should be the primary line of defense. On the other hand, should a sharp deterioration in risk perception result in large capital outflows, some intervention in exchange markets to smooth excess volatility along with monetary tightening could be needed. Adequate international reserves are necessary to support financial stability.

34. Efforts to clean up balance sheets should be complemented by increased focus on addressing impediments to credit demand. Despite on average strong bank capital positions, recovering profitability, and ample liquidity positions, and an increase in lending to SMEs through the FGS, bank lending to the private sector has continued to contract. Additional measures to promote lending should properly consider the risks and be time-bound. While the beginning of operations of MARK is welcome, it is important to ensure that the transfer of assets is done on a voluntary basis and market-related prices, and that MARK's governance structure is further strengthened. Last but not least, improving financial intermediation will necessitate addressing

impediments to credit demand, including enhancing the business climate, other measures to increase potential growth, and removing uncertainty regarding the landscape of the banking sector. To this end, the authorities should stick to their commitment to reduce the state's presence in this sector over time.

35. Sustained progress on wide-ranging structural reforms would be key to unleashing Hungary's full growth potential. Medium-term growth is constrained by low productivity, a challenging business environment, and weaknesses in the labor market. Easing the regulatory burden, enhancing policy predictability, improving the ease of paying taxes, and limiting state involvement in the economy would help improve the environment for private-sector led growth. The economy's competitiveness could be enhanced by moving up the value chain, upgrading skills, boosting innovation and R&D, promoting entrepreneurship, and improving the efficiency of EU funds usage. Finally, the labor market could be further improved by addressing skills mismatches, strengthening training and enhancing job-matching services, and taking further steps to increase female labor participation.

36. It is recommended to hold the next Article IV consultation on the standard 12-month cycle.

Hungary: Risk Assessment Matrix (RAM)[1/]

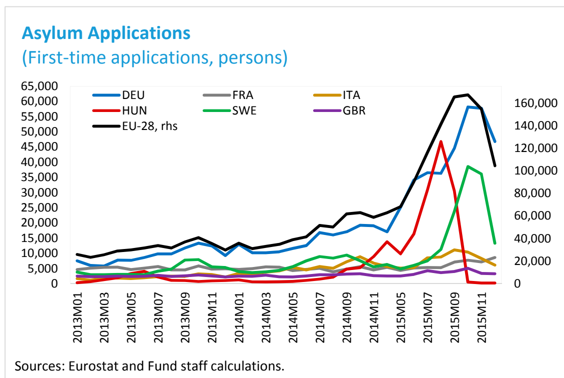
	Source of Risks	Relative Likelihood	Impact if Realized	Policy response
Global	*Tighter or more volatile global financial conditions (short-term)*	**High** A possible change in risk perception may lead to non-residents sell off of HUF securities.	**High** A reversal of capital flows would raise borrowing costs, and put pressure on reserves. Financing pressures could arise.	Use FX intervention to smooth excessive exchange rate volatility. Fiscal stabilizers should be allowed to operate. Monetary policy may have to be tightened depending on market conditions. Public debt strategy might have to be revisited if stresses surface in the bond market.
	Heightened risk of fragmentation/security dislocation in part of Europe (short-term)	**High** A non-cooperative outcome of the refugee crisis could weigh on economic activity through trade and confidence channels.	**Medium** Border closures and restrictions on the free movement of goods, services, and labor could weigh on trade. Failure to reach an agreement at the EU-level to address the refugee crisis could weigh on confidence and economic activity.	If near-term growth were to slow too sharply, automatic stabilizers should be allowed to operate, and monetary policy should remain accommodative or ease further.
	Structurally weak growth in key advanced and emerging economies (medium-term)	**High/Medium** External demand would wane, weighing on Hungary's exports and growth.	**Medium** Weaker export growth would weigh on growth and perpetuate macroeconomic vulnerabilities.	Advance structural reforms to accelerate the transition towards a higher, sustainable growth path. Adopt a growth-friendly fiscal consolidation plan.
	Persistently low energy prices (medium-term)	**High** Domestic demand would accelerate supporting Hungary's growth, while inflation would decline, potentially complicating the conduct of monetary policy. The current account surplus would further widen.	**Medium** Household incomes would be boosted and lower production costs would support growth. Lower inflation would pose challenges to anchoring inflation expectations.	If inflation expectations get un-anchored and there are signs of second round effects, ease monetary policy, and use forward guidance to anchor expectations. If inflation expectations remain well-anchored, enhance communication.
Domestic	*Increased state role in the economy (short/medium term)*	**Medium** Increased policy uncertainty and a weakening of institutions would undermine policy credibility and erode confidence.	**Medium** Continued resource misallocation, leading to significant TFP slowdown and lower potential growth could limit availability of financing, foster sharper cross-border deleveraging, and lower FDI flows. Credit and investment growth would slow.	Accelerate the implementation of structural reforms and limit the state's involvement in the economy.
	Continued fiscal relaxation, and slippages in structural reforms (short/medium term)	**Medium** Fiscal and structural reforms needed to boost potential growth could be delayed due to lack of political appetite, expenditure overruns, delays in the public administration reform, or a contingent liabilities shock.	**Medium** Borrowing costs would rise, market confidence would wane, and debt sustainability would worsen. Reserves would come under pressure. Competitiveness would be eroded and economic prospects would worsen.	Adopt a growth-friendly fiscal adjustment strategy, and accelerate the implementation of structural reforms to boost Hungary's potential growth.

[1/]The RAM shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability of 30 percent or more). The RAM reflects staff views on the source of risks at the time of discussions with the authorities.

Box 1. The Recent Refugee Crisis

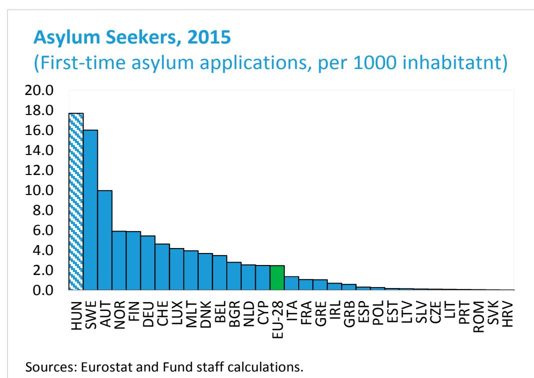
The number of asylum seekers arriving in Hungary in 2015 was unprecedented. It reached almost 174,400—representing close to 14 percent of all first-time asylum seeker applications in the EU—the largest share following that of Germany. Relative to its population, in 2015, Hungary received the largest number of asylum applications in the EU. Syrians accounted for close to 37 percent of all first-time asylum applications, followed by applicants from Afghanistan at 26 percent.

Asylum Applications
(First-time applications, persons)



Sources: Eurostat and Fund staff calculations.

Asylum Seekers, 2015
(First-time asylum applications, per 1000 inhabitatnt)



Sources: Eurostat and Fund staff calculations.

Hungary is a transit point to other European countries, particularly Germany, Austria, and Sweden. Refugees typically make their way to other destinations quickly and before completion of the asylum application process. The rising numbers of arrivals required an expansion of capacities in reception facilities. Due to their transit nature, migrant inflows are not expected to have an impact on labor market conditions.

The fiscal cost of the refugee crisis has increased substantially. In 2015, the government allocated HUF 83.9 billion (about ¼ percent of GDP) to cover security and humanitarian expenses. Of this, about HUF 45.7 billion was spent in 2015, with the majority of spending directed to strengthening border control and security. Future fiscal costs will critically depend on the number of new arrivals, which is highly uncertain—but the remaining amount of the initial allocation would be expected to be spent in 2016.

Box 2. External Sustainability and Competitiveness

Current account: Hungary's current account surplus increased to 4.4 percent of GDP in 2015 from 2percent in 2014, reflecting a moderate improvement in the terms-of-trade, and is expected to remain in surplus over the medium-term.

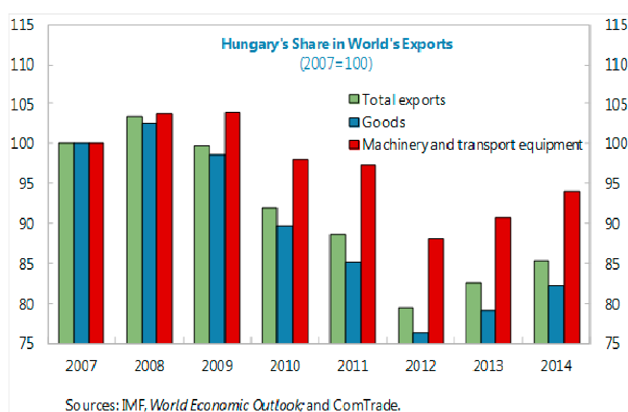
Foreign assets and liabilities: Several measures have helped reduce external vulnerabilities significantly. The IIP stood at -79 percent of GDP in 2015 and is projected to decline to -38 percent in 2021. However, external debt and gross financing needs are still high—109 and 20 percent of GDP, respectively.

Reserve adequacy: Reserves were broadly adequate at 114 percent of the IMF's reserve adequacy metric at end-2015 and above the standard rules of-thumb of three months coverage of prospective imports, as well as 100 percent of short-term debt.

Staff's assessment is that Hungary's real exchange rate is broadly in line with medium-term fundamentals. EBA estimates have low explanatory power and yield mixed results. Specifically, the Real Effective Exchange Rate (REER) approach reveals an overvaluation of the exchange rate by 30.7 percent. In contrast, the External Sustainability approach finds the REER undervalued by 10 percent and the Current Account Balance approach suggests that Hungary's REER also appears to be undervalued. However, in staff's view, although the latter approach is based on various fundamentals, it does not adequately capture the need for savings to remain elevated to help reduce Hungary's still-large external liabilities. Thus, the current-account norm would need to be adjusted upward consistent with the need to strengthen Hungary's balance sheet. Unit labor costs and a positive trade balance do not point to pressures on the exchange rate.

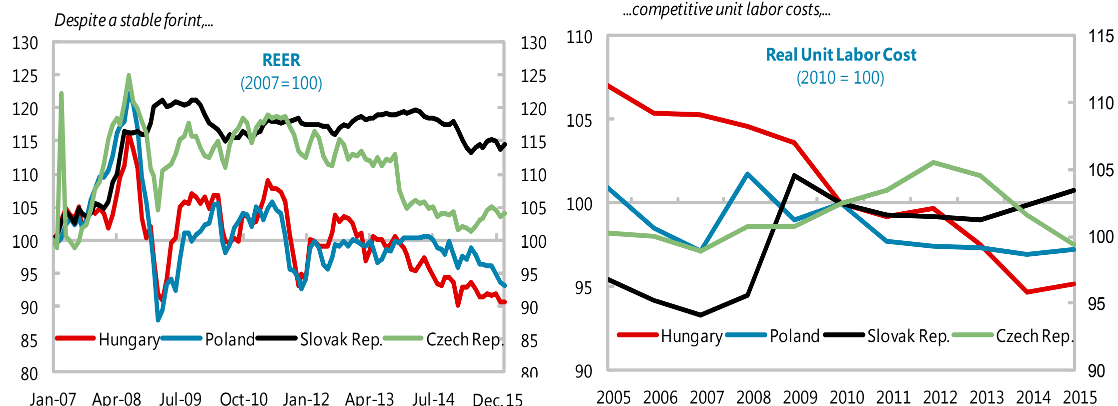
However, non-price indicators suggest that Hungary faces competitiveness challenges. Since 2011/12, Hungary's ranking in the Global Competitiveness Report slipped by 15 places with the institutional framework and labor market efficiency providing a drag on competitiveness. On the domestic front, continued government interference in the economy could have adverse confidence effects, undermine competitiveness, and hurt investment.

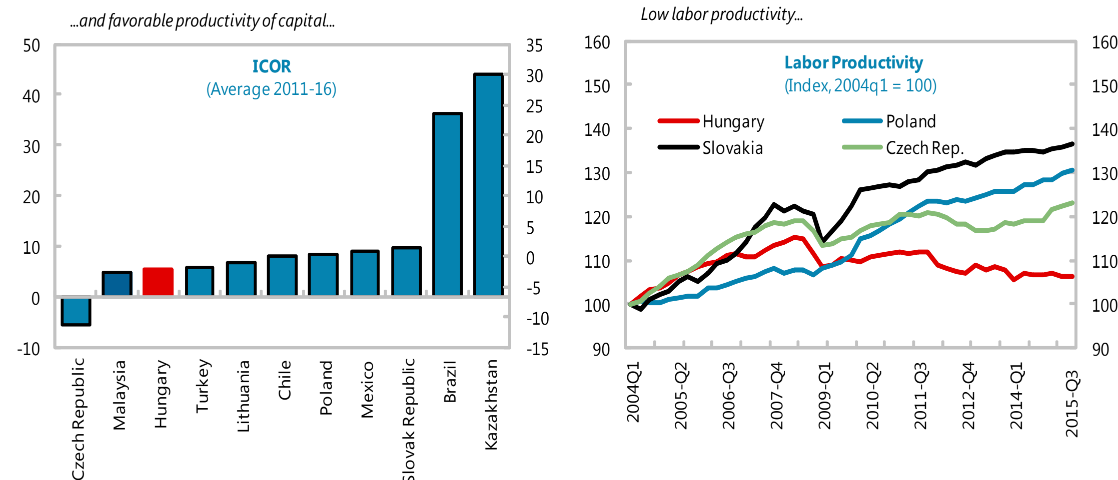
Export performance has been strong recently, but more efforts are needed to diversify exports and boost foreign direct investment. The foreign investment environment played an important role in promoting exports during 2003–06, but its contribution has gradually declined. Medium-term FDI inflows are projected to remain significantly below their historical average at the same time when Hungary's incremental capital-output ratio is relatively high. A broader look at export performance shows that Hungary's export market share had stagnated compared to peers during 2008–14. Shift-share analysis shows that the drop in trading partners' demand for machinery and transport equipment emerges as a key factor behind that stagnation in exports. However, with the coming on line of new automobile capacity, pertinent exports have exhibited robust growth. Nevertheless, the trade dependency on Germany, together with concentration of exports in the knowledge-intensive industries such as machinery and transport equipment, suggests the need for diversification of markets and products.

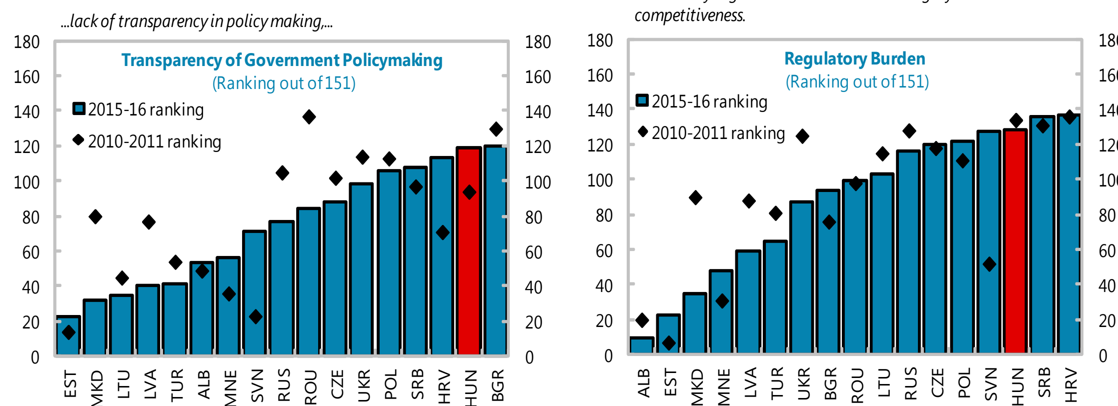


Sources: IMF, *World Economic Outlook* and ComTrade.

Box 2. External Sustainability and Competitiveness (concluded)



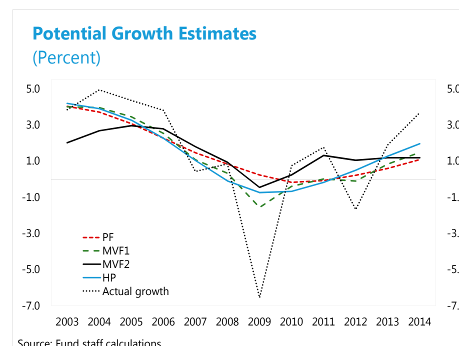




Sources: Eurostat; European Commission; Direction of Trade; World Economic Outlook; Hungarian Statistical Office; MNB; WEF Global Competitiveness Report; World Bank; and IMF staff calculations.

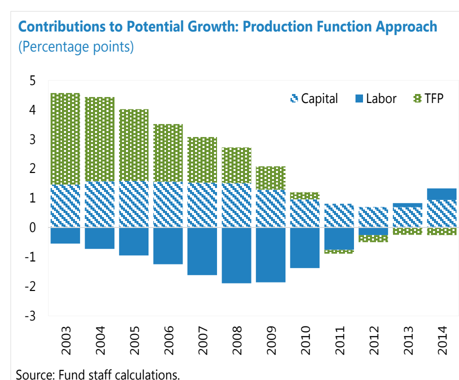
Box 3. Potential Growth

Potential output is estimated using four methods: the Hodrick-Prescott (HP) filter, the multivariate filter (MVF1), the multivariate filter with financial frictions (MVF2), and the production function approach (PF).[1] The MVF1 approach models potential output in relation to actual GDP, unemployment and inflation. The MVF2 approach takes into account financial cycles and capacity utilization. The PF approach employs a Cobb-Douglas production function and removes cyclical factors pertaining to capital and labor—using capacity utilization, the NAIRU, and average hours worked—and thus, the remaining residual captures the 'structural' component of total factor productivity (TFP).



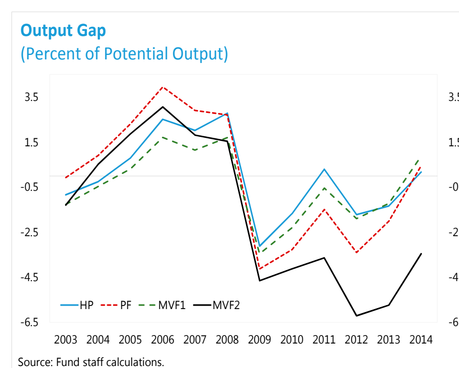
Source: Fund staff calculations.

Hungary's potential growth decelerated sharply during the global financial crisis but has accelerated subsequently. It accelerated from an average of–½ percent during 2009–10 to an average of 1½ percent in 2014. Moreover, since the crisis, estimates based on the MVF2 have been higher than those by other methods, suggesting that house prices and credit have been particularly low relative to potential levels.



Source: Fund staff calculations.

Different underlying factors have been contributing to the evolution of potential growth. The deceleration during the crisis was largely due to decreased contributions of labor and TFP, while the acceleration since 2012 was driven by an increased contribution of labor and capital. TFP remains a drag on potential growth, possibly suggesting that factors, such as the weak business climate and high regulatory burden weigh on growth. That said, TFP estimates are obtained as a "residual" and thus are, by definition, difficult to explain.



Source: Fund staff calculations.

These estimates suggest that although the output gap has been closing rapidly, it is on average still negative. The divergence of results between the MVF2 approach and the rest could be explained by Hungary's post-crisis credit-less recovery—with the labor market showing signs of tightness and capacity utilization being high, but credit still contracting. These findings suggest that the financial cycle is still lagging behind the business cycle, in part reflecting still-impaired private sector balance sheets and financial intermediation. Lastly, it is important to bear in mind that significant uncertainty surrounds these estimates.

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[1] See J. Podpiera *et al.*, "A Fresh Look at Potential Output in Central, Eastern, and Southeastern European Countries," IMF Working Paper, *forthcoming*.

Box 4. Is the Post-Crisis Decline in Investment Permanent?[1]

In the aftermath of the crisis, investment rates fell in most EU countries, with steeper declines in new member states. Despite the subsequent recovery and easing of financial conditions, private investment rates remain below pre-crisis levels.

To examine whether investment rates have undershot their equilibrium levels, the neo-classical (Ramsey-Cass-Koopmans) growth model is calibrated for EU countries, using national accounts data and European Commission's estimates of capital stocks and TFP.[2] In this model, an economy converges to its steady-state equilibrium, in which consumption is maximized, the saving/investment rate is constant at its "golden-rule" value, and income, consumption, and capital all grow at a fixed rate equal to the sum of the exogenous growth rates of the labor force and labor-augmenting productivity. The model implies that the investment rate would fall monotonically toward the "golden-rule", as the economy converges to its steady state. As such, the closed-economy, "golden-rule" saving/investment can be interpreted as a lower bound for the investment rate in Hungary along its path of convergence to euro area income levels.

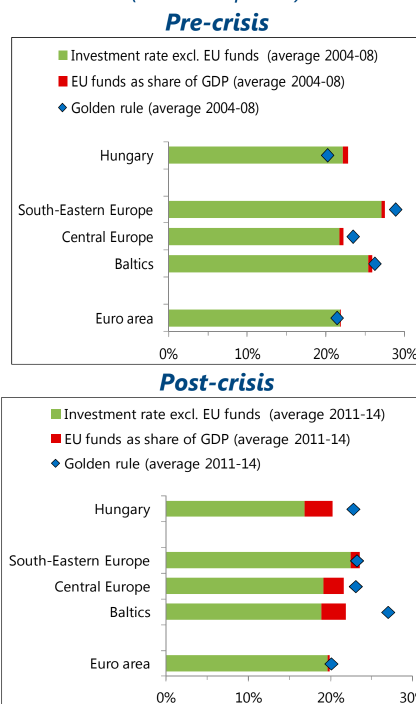
Estimation results suggest that Hungary's average investment rate had been higher than its closed-economy steady-state value before the crisis. This could be a sign that the economy was converging from above to the "golden rule", but could also be an artifact of over-investment in specific sectors. The latter interpretation finds support in the fact that the decline in investment was to a large degree concentrated in construction.

In the post-crisis period, Hungary's investment rate appears to have undershot the "golden rule", thus suggesting scope for boosting investment. EU funds have contributed toward this goal, but the weak business climate seems to have limited the private-sector contribution.

EU: Actual vs "Golden-rule" Investment Rates

(Percent of GDP)

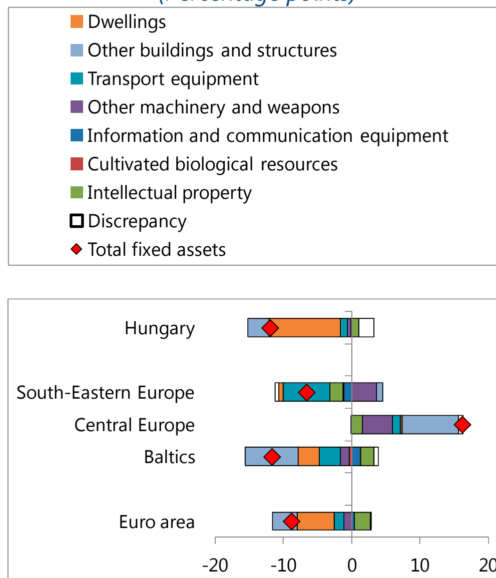
Pre-crisis



Source: AMECO, Eurostat, and Fund staff estimates.
Note: Aggregates are constructed using GDP PPP weights

Contributions to Decline in Real Investment between 2004-08 and 2011-14

(Percentage points)



Source: Eurostat and Fund staff calculations

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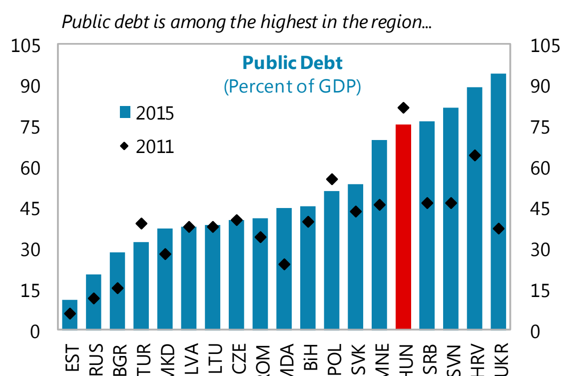
[1] Prepared by P. Iossifov.

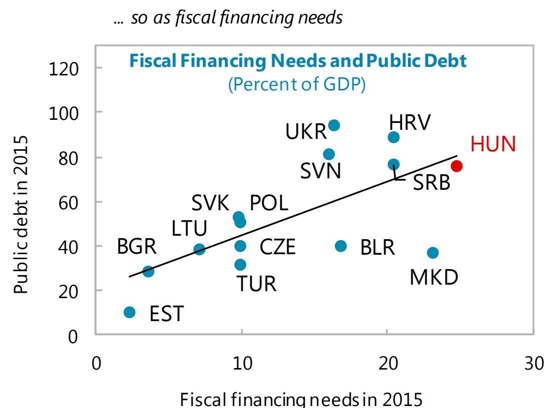
[2] See: Iossifov, P. and D. Milkov, "Investment in Central and Eastern European EU Member States: Too Much, Too Little or Just Right?" IMF Working Paper, *forthcoming*.

Figure 1. Hungary and Peers

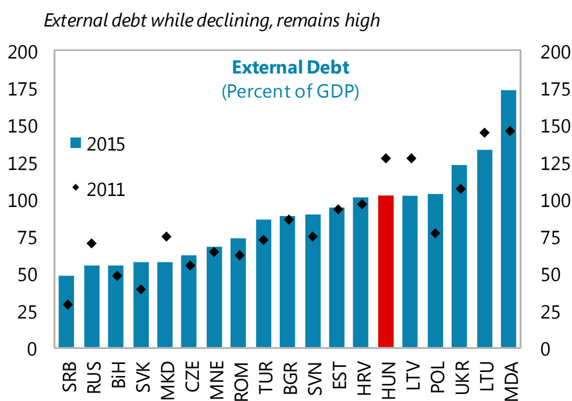
Public debt is among the highest in the region...



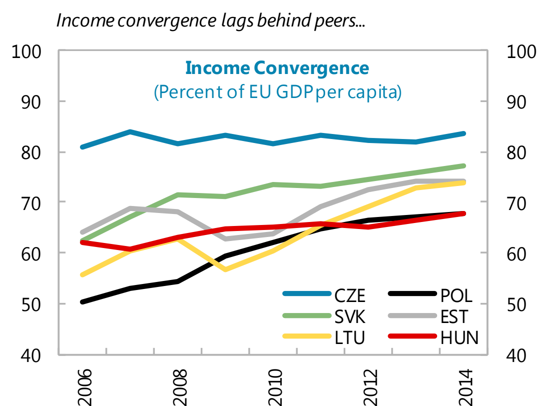
... so as fiscal financing needs



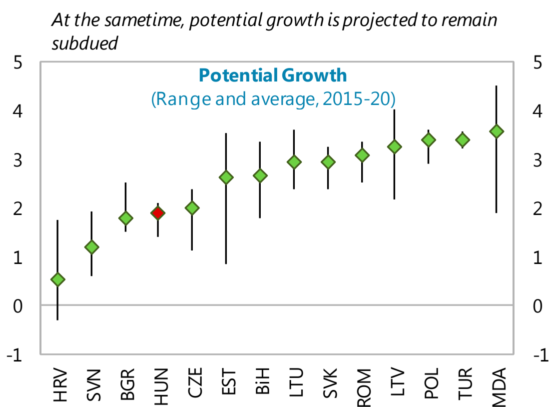
External debt while declining, remains high



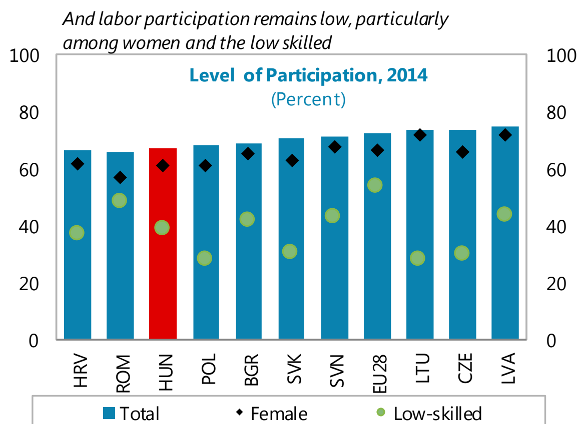
Income convergence lags behind peers...



At the sametime, potential growth is projected to remain subdued

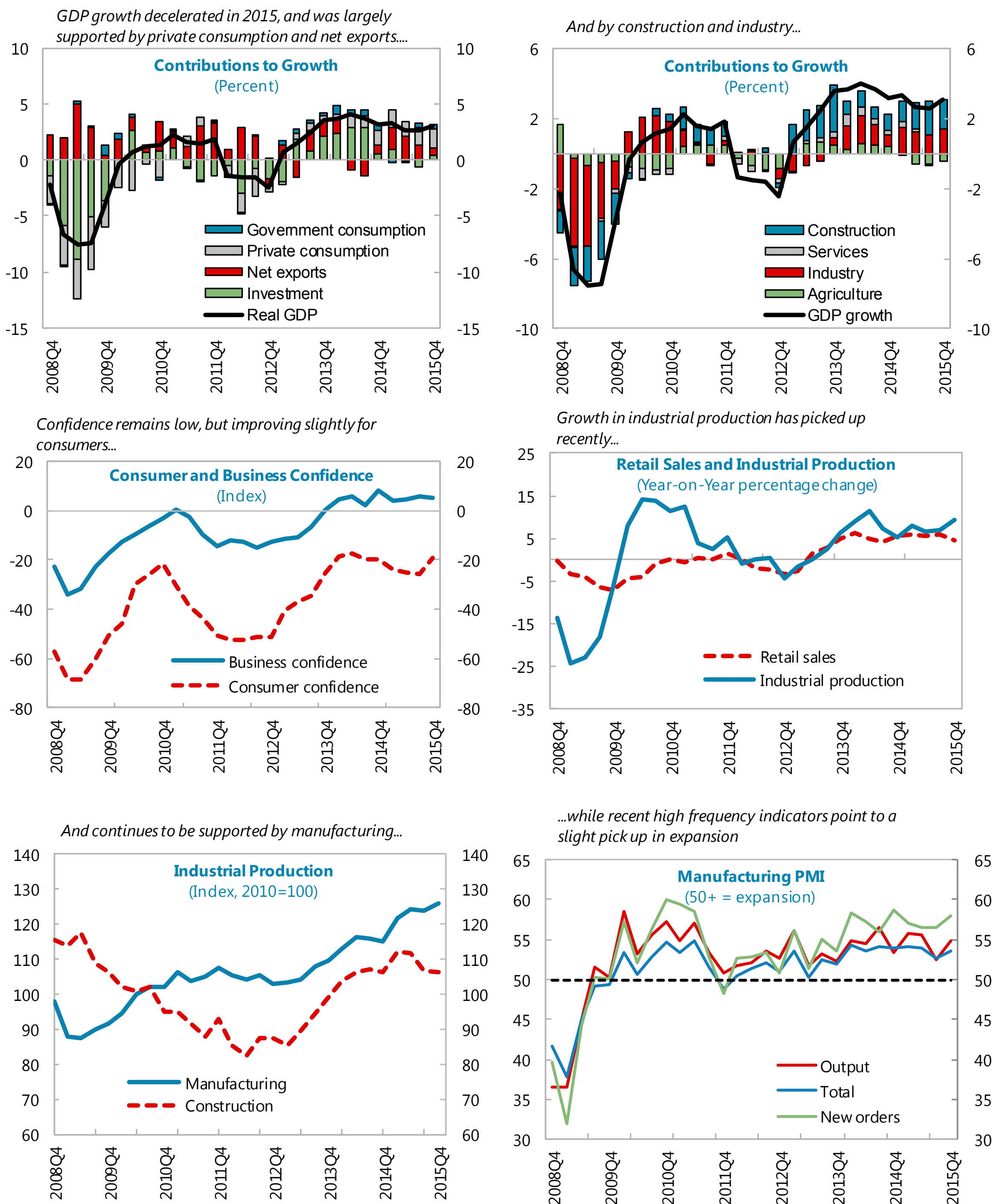


And labor participation remains low, particularly among women and the low skilled



Source: Eurostat, Hungarian Statistical Office, IMF World Economic Outlook database, Haver Analytics; and Fund staff calculations.

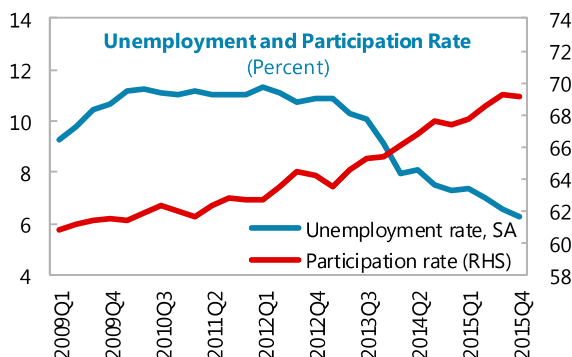
Figure 2. Hungary: Real Sector



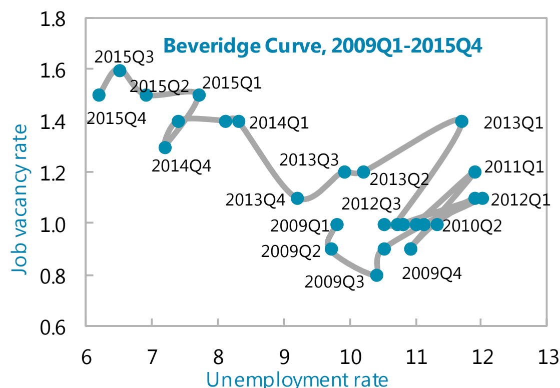
Sources: Eurostat, Haver Analytics, Hungarian Statistical Office, and Fund staff calculations.

Figure 3. Hungary: Labor Market

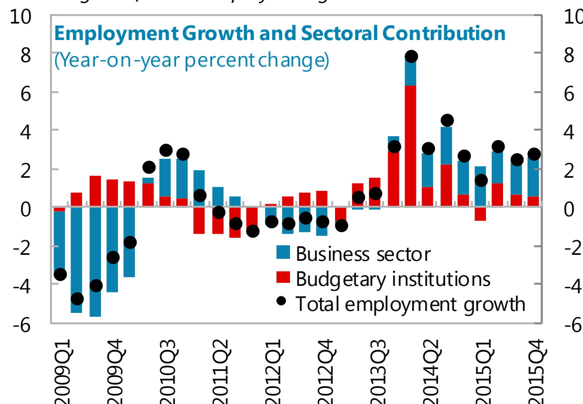
Unemployment rate continued to decline despite the continued rise in participation rate



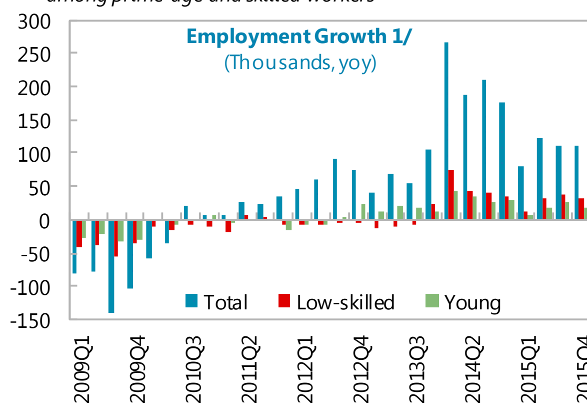
And vacancy rate has risen...



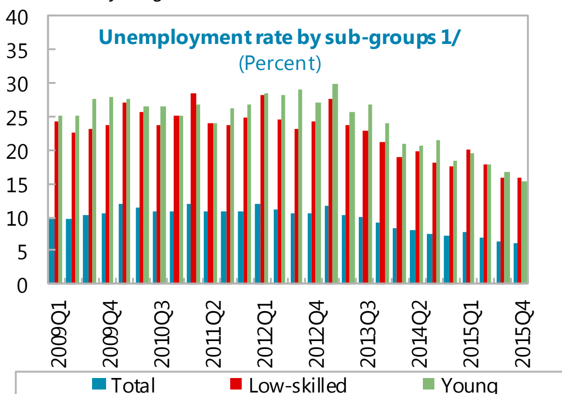
Private sector employment was the main engine of recent employment gains



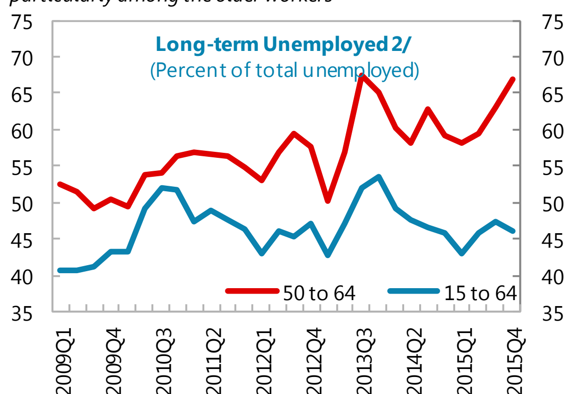
But employment gains have been largely concentrated among prime-age and skilled workers



Leaving high unemployment among the low-skilled and the young...



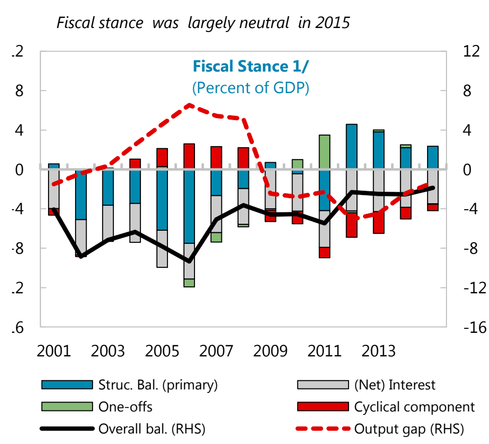
At the same time, long-term unemployment remains high, particularly among the older workers



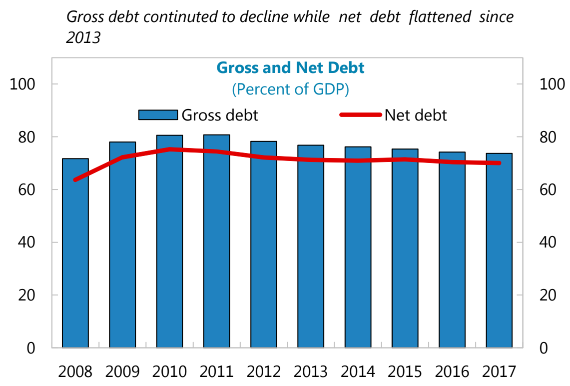
Sources: Eurostat, Hungary Statistical Office, and Fund staff calculations.
1/ Low-skilled refers to those with less than primary, primary, and lower secondary education (levels 0-2) according to the ISCED classification.
2/ Long-term unemployed refers to unemployment of 12 months or more.

Figure 4. Hungary: Fiscal Sector

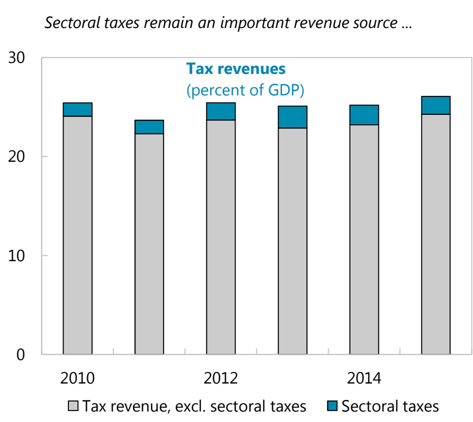
Fiscal stance was largely neutral in 2015



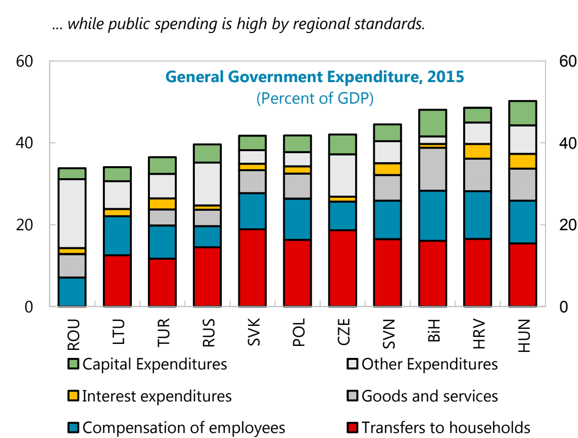
Gross debt continuted to decline while net debt flattened since 2013



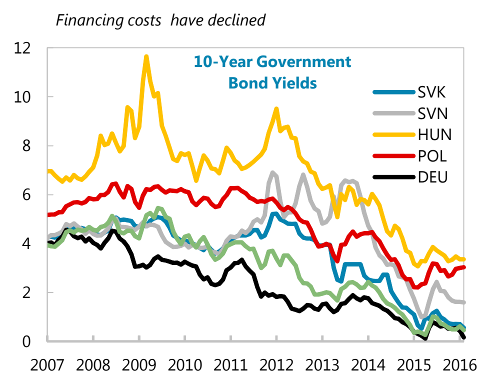
Sectoral taxes remain an important revenue source ...



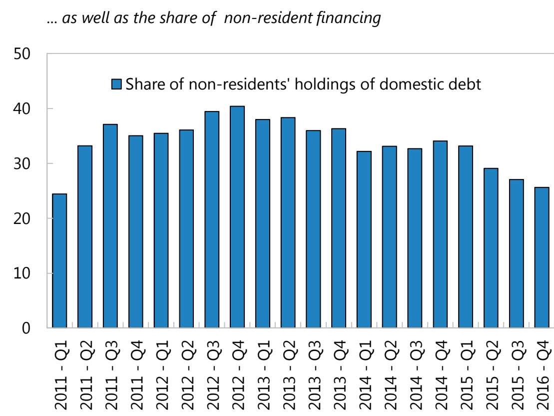
... while public spending is high by regional standards.



Financing costs have declined

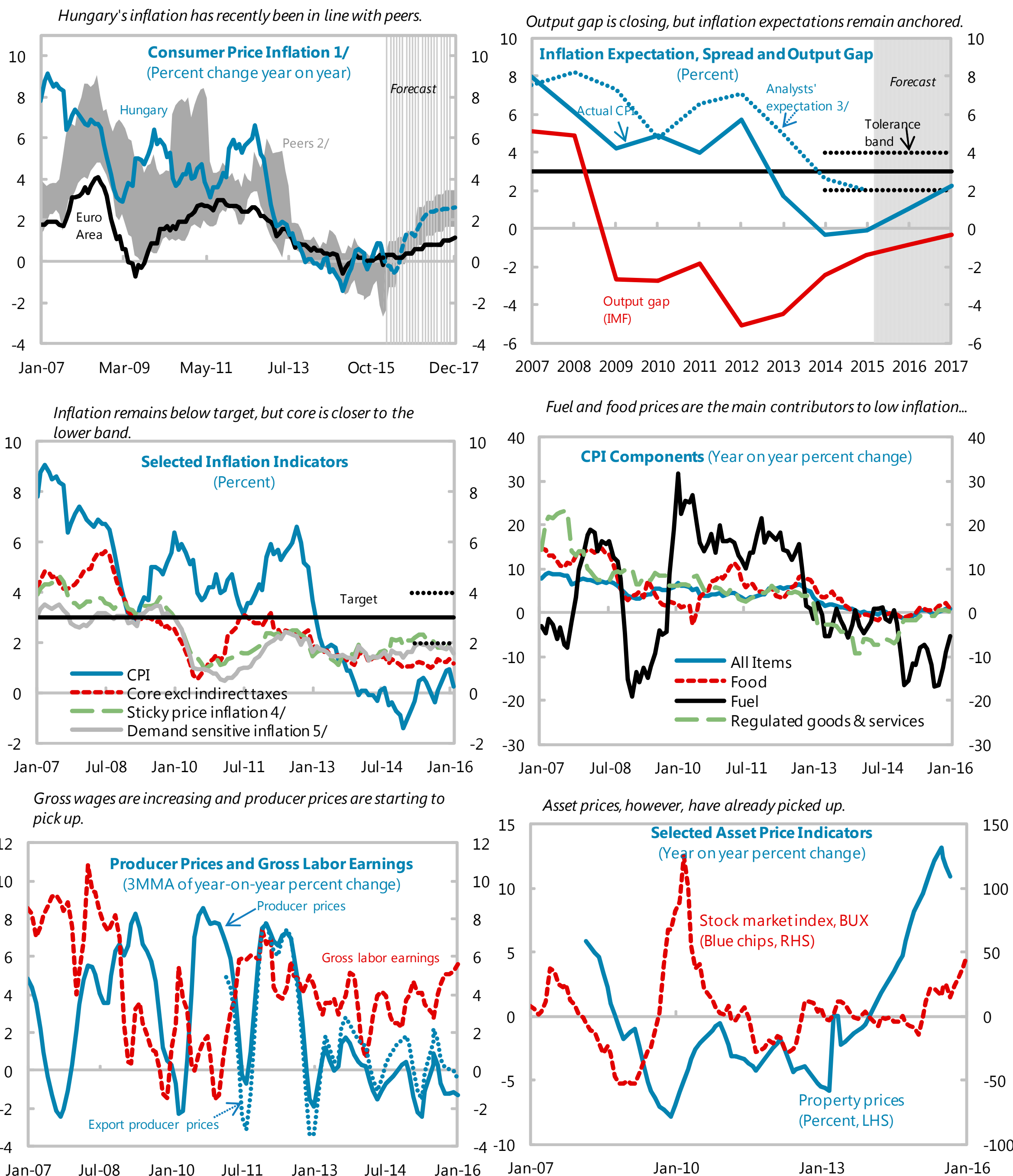


... as well as the share of non-resident financing



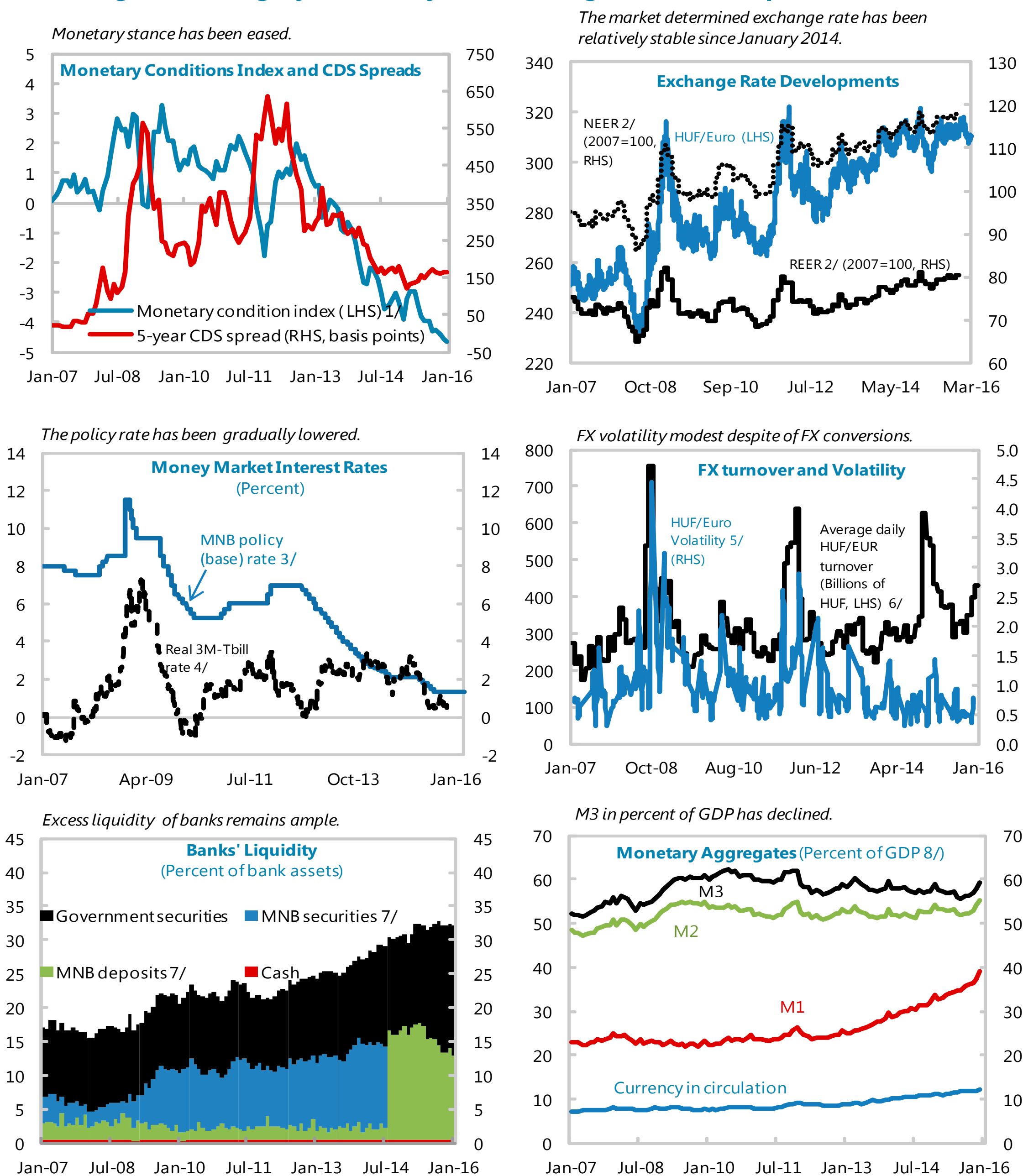
Sources: Hungarian Authorities, IMF World Economic Outlook, Bloomberg and IMF staff estimates and projections.

Figure 5. Hungary: Inflation Developments and Projections, 2007–17



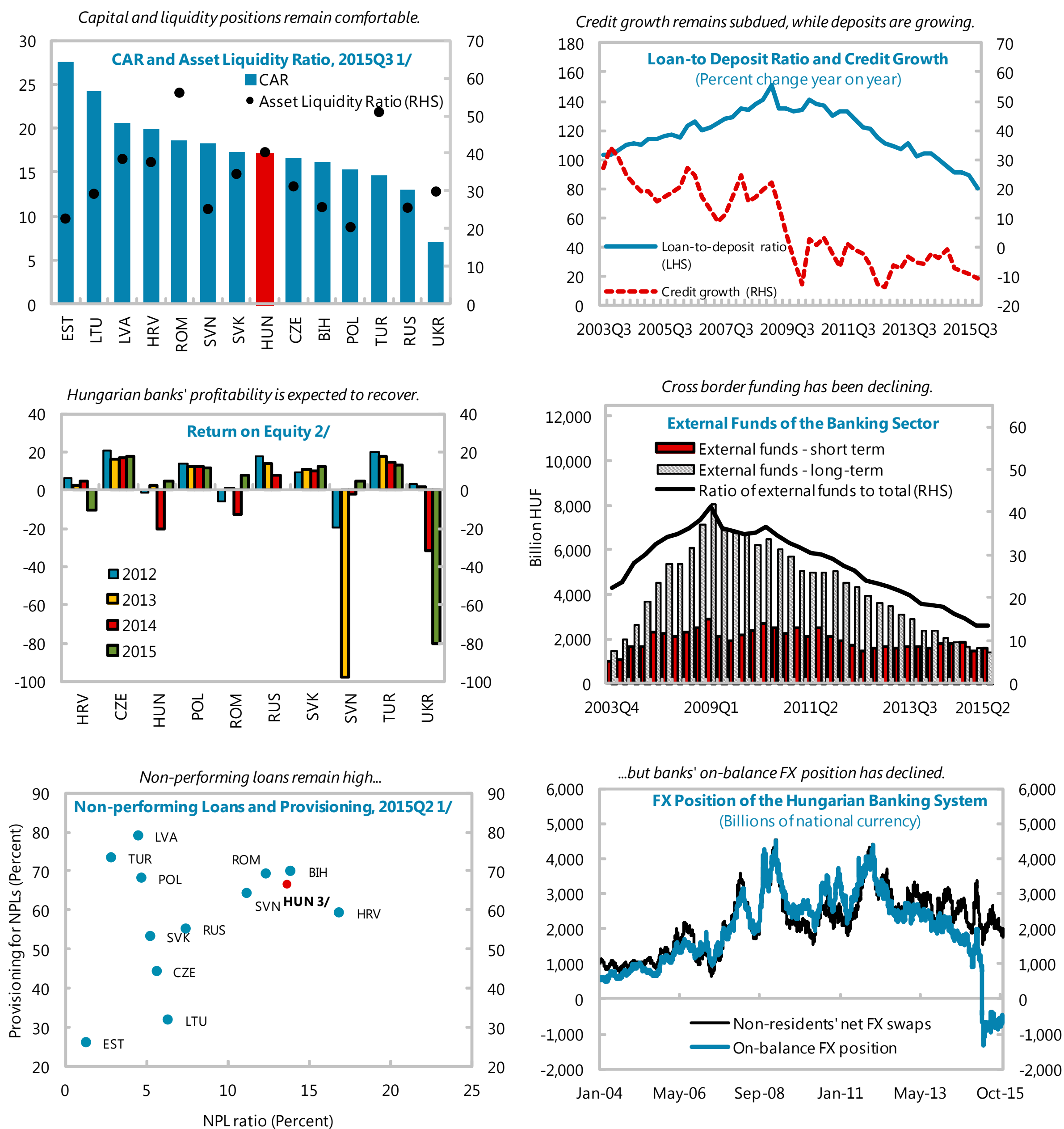
Sources: Magyar Nemzeti Bank (MNB); Hungarian Central Statistical Office (HCSO;) Consensus forecast; Haver; IS; and IMF staff calculations.
1/ Dotted lines reflect WEO forecasts, and full line MNB's most recent forecast.
2/ Peers include Czech Republic, Slovakia, Poland and Romania. Shaded area represents area between max and min of peers.
3/ Analysts' expectations according to MNB calculations based on information compiled by the EC.
4/ Prices that are slow to change.
5/ Excludes processed food prices.

Figure 6. Hungary: Monetary and Exchange Rate Developments, 2007–16



Sources: Magyar Nemzeti Bank (MNB); Hungarian Central Statistical Office (HCSO); Bloomberg; and IMF staff calculations.
1/ Monetary stance compared to the period average. Weight on real interest rate is 0.75.
2/ As reported by the MNB. An increase means a depreciation.
3/ In August 2014, the base rate was changed from 2-week MNB bills to 2-week MNB deposits (non-tradable). Since September 23, 2015, the base rate refers to the 3-month MNB deposit rate.
4/ Real-interest rate refers to the 3-month T-bill rate deflated by the previous 12-month change in the CPI.
5/ Volatility measured as standard deviation in percent of average spot HUF/EUR over recent 22 observations.
6/ Average daily turnover in the spot, forward and swap HUF/EUR markets. Excludes options and transactions on exchanges.
7/ Since September 23, 2015, the amount of 2-week MNB deposits have been gradually reduced. Instead, 3-month MNB deposits were introduced and used to set the policy rate.
8/ Nominal GDP is the cumulative GDP over recent four quarters.

Figure 7. Hungary: Banking Sector Indicators



Sources: Magyar Nemzeti Bank (MNB), IMF *Financial Soundness Indicators Database*, IMF, *World Economic Outlook;* and IMF staff calculations.

1/ Latest available data used for countries where 2015Q3 is not yet available.

2/ Used latest quarter available for each year. No 2015 data available for Russia.

3/ Hungarian NPLs of households declined temporarily related to compensations due to the Settlement Act and Fair Banking Act of 2014.

Table 1. Hungary: Selected Economic Indicators, 2011–18

	2011	2012	2013	2014	2015	2016	2017	2018
					Prel.		Proj.	
Real economy								
Real GDP (percentage change)	1.8	-1.7	1.9	3.7	2.9	2.3	2.5	2.4
Total domestic demand (contribution to growth) 1/	-0.2	-2.9	1.4	3.9	1.8	1.8	2.2	2.3
Private consumption 2/	0.5	-1.4	0.4	1.0	1.6	1.6	1.3	1.3
Government consumption	0.0	0.0	0.3	0.6	0.1	0.1	0.2	0.2
Gross fixed investment	-0.3	-0.9	1.4	2.3	0.4	0.0	0.7	0.9
Foreign balance (contribution to growth)	2.0	1.3	0.5	-0.2	1.2	0.5	0.3	0.1
Exports	5.4	-1.6	5.5	6.7	7.5	6.0	6.0	6.4
Imports	3.4	-2.8	5.1	6.9	6.4	5.5	5.8	6.2
CPI inflation (average)	3.9	5.7	1.7	-0.2	-0.1	0.5	2.4	2.5
CPI inflation (end year)	4.1	5.0	0.4	-0.9	0.9	1.2	2.6	3.0
Unemployment rate (average, ages 15-64)	11.1	11.1	10.2	7.8	6.8	6.6	6.4	6.2
Gross domestic investment (percent of GDP) 3/	19.8	19.4	20.5	21.7	21.3	20.8	21.2	21.5
Gross national saving (percent of GDP, from BOP)	20.5	21.1	24.5	23.7	25.7	25.7	25.8	25.4
General government 4/								
Overall balance	-5.5	-2.3	-2.5	-2.5	-1.9	-2.0	-2.1	-2.1
Primary balance	-1.7	1.9	1.8	1.3	1.6	1.2	0.9	0.8
Primary structural balance (percent of potential GDP)	-0.6	4.4	3.6	2.1	2.3	1.1	1.1	0.8
Gross debt	80.8	78.3	76.8	76.2	75.3	74.2	73.7	72.6
Money and credit (end-of-period)								
Broad money	5.9	-3.3	5.5	5.6	6.2	5.1	5.9	5.5
Lending to the private sector, flow-based 5/	-6.8	-7.4	-3.3	-0.9	-10.9	-2.0	1.5	2.5
Interest rates								
T-bill (90-day, average)	6.0	6.8	4.1	2.1	1.1	...	...	...
Government bond yield (5-year, average)	7.4	7.7	5.2	3.9	2.7	...	...	...
5-year sovereign CDS (annual average)	384	465	297	197	152	...	...	...
Balance of payments								
Goods and services trade balance	6.2	6.8	7.3	7.1	8.6	9.5	8.9	8.0
Current account	0.7	1.8	4.0	2.0	4.4	4.9	4.6	4.0
Reserves (billions of Euros)	37.8	33.9	33.8	34.6	30.3	25.4	24.0	27.4
Gross external debt 6/	134.4	129.0	118.4	114.8	108.8	103.4	96.3	86.4
Gross official reserves (percent of short-term debt at remaining maturity)	65.3	67.4	97.4	102.4	105.8	102.6	103.5	111.4
Exchange rate								
Exchange regime	Floating							
Present rate (March 2016, eop)	Ft. 314.16 = €1; Ft. 287.25 = CHF1							
Nominal effective rate (2000=100, average)	104.2	109.0	110.3	114.2	116.5	...	...	...
Real effective rate, CPI basis (2000=100, average)	72.6	73.6	74.3	77.7	79.4	...	...	...
Quota at the Fund	SDR 1,940 million							
Memorandum Items:								
Nominal GDP (billions of Forints)	28,134	28,628	30,065	32,180	33,712	35,211	36,976	38,886

Sources: Hungarian authorities; IMF, International Financial Statistics; Bloomberg; and Fund staff estimates.
1/ Includes change in inventories.
2/ Actual final consumption of households.
3/ Excludes change in inventories.
4/ Consists of the central government budget, social security funds, extrabudgetary funds, and local governments.
5/ 2015 reflects the effects of the Settlement Act on credit stock.
6/ Excluding Special Purpose Entities. Including inter-company loans, and nonresident holdings of forint-denominated assets.

Table 2. Hungary: Medium-Term Scenario, 2011–21

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
					Prel.			Proj.			
	Percentage change, unless otherwise indicated										
Real GDP growth	1.8	-1.7	1.9	3.7	2.9	2.3	2.5	2.4	2.2	2.1	2.1
Nominal GDP (billions of Forints)	28,134	28,628	30,065	32,180	33,712	35,211	36,976	38,886	40,814	42,796	44,875
Inflation (CPI; year average basis)	3.9	5.7	1.7	-0.2	-0.1	0.5	2.4	2.5	2.9	3.0	3.0
Inflation (CPI; end-year basis)	4.1	5.0	0.4	-0.9	0.9	1.2	2.6	3.0	3.0	3.0	3.0
	Percentage Change										
Total consumption	0.6	-2.0	0.9	2.1	2.3	2.3	2.2	2.2	2.2	2.2	2.2
Gross fixed capital formation	-1.3	-4.4	7.3	11.2	1.9	-0.2	3.5	4.3	4.5	4.8	5.0
Exports of GNFS	6.6	-1.8	6.4	7.6	8.4	6.5	6.3	6.2	6.0	5.5	5.1
Imports of GNFS	4.5	-3.5	6.3	8.5	7.8	6.6	6.6	6.7	6.5	5.9	5.6
Lending to the private sector, flow-based (current prices, eop) 1/	-6.8	-7.4	-3.3	-0.9	-10.9	-2.0	1.5	2.5	3.0	3.5	4.0
Unemployment rate (average, ages 15-64)	11.1	11.1	10.2	7.8	6.8	6.6	6.4	6.2	6.0	5.8	5.6
	In percent of GDP										
External current account balance	0.7	1.8	4.0	2.0	4.4	4.9	4.6	4.0	3.1	2.2	1.4
Gross national saving	20.5	21.1	24.5	23.7	25.7	25.7	25.8	25.4	24.9	24.2	23.8
Gross domestic investment 2/	19.8	19.4	20.5	21.7	21.3	20.8	21.2	21.5	21.8	22.1	22.3
Gross external debt 3/	134.4	129.0	118.4	114.8	108.8	103.4	96.3	86.4	79.4	72.2	68.1
General government	In percent of GDP										
Revenue, total	44.3	46.3	47.0	47.4	48.9	44.7	44.9	44.7	44.6	44.6	44.2
Expenditure, total	49.7	48.6	49.5	49.9	50.7	46.6	47.0	46.8	46.5	46.3	45.8
Primary balance	-1.7	1.9	1.8	1.3	1.6	1.2	0.9	0.8	1.0	1.2	1.6
General government overall balance	-5.5	-2.3	-2.5	-2.5	-1.9	-2.0	-2.1	-2.1	-1.9	-1.8	-1.7
General government debt	80.8	78.3	76.8	76.2	75.3	74.2	73.7	72.6	71.3	70.2	69.1
Memorandum items:	Percentage change, unless otherwise indicated										
Output gap (percent of potential GDP)	-2.3	-5.1	-4.5	-2.4	-1.3	-0.9	-0.3	0.0	0.0	0.0	0.0
Potential GDP growth	1.2	1.2	1.3	1.5	1.8	1.8	1.9	2.1	2.1	2.1	2.1
Structural general government balance (percent of potential GDP)	-4.2	0.3	-0.5	-1.6	-1.1	-2.1	-2.0	-2.1	-1.9	-1.8	-1.7
Structural primary balance (percent of potential GDP)	-0.6	4.4	3.6	2.1	2.3	1.1	1.1	0.8	1.0	1.2	1.6
Gross official reserves (percent of short-term debt at remaining maturity)	65.3	67.4	97.4	102.4	105.8	102.6	103.5	111.4	136.8	149.9	170.6

Sources: Hungarian authorities; and Fund staff estimates.

1/ 2015 reflects the effects of the Settlement Act on credit stock.

2/ Excludes change in inventories.

3/ Excluding Special Purpose Entities. Including inter-company loans, and nonresident holdings of forint-denominated assets.

Table 3a. Hungary: Consolidated General Government, 2011–18 1/

(In Billions of Forints)

	2011	2012	2013	2014	2015	2016	2017	2018
					Prel.		Proj.	
Revenue	12,458	13,254	14,143	15,243	16,472	15,728	16,613	17,398
Tax revenue	6,657	7,278	7,546	8,108	8,790	8,601	8,982	9,376
Taxes on goods and services	4,881	5,324	5,548	5,957	6,394	6,368	6,655	6,949
VAT	2,379	2,628	2,694	3,011	3,307	3,281	3,443	3,606
Excises and other 2/ 3/	2,501	2,696	2,854	2,946	3,086	3,086	3,213	3,343
Taxes on income, profits and capital gains	1,769	1,947	1,991	2,141	2,387	2,223	2,316	2,415
Personal income tax	1,368	1,513	1,501	1,598	1,685	1,644	1,708	1,775
Corporate taxes	338	368	416	472	631	506	532	559
Other	63	66	73	71	70	73	77	81
Capital taxes	7	8	7	10	10	10	11	11
Social contributions	3,686	3,734	3,907	4,204	4,459	4,698	4,957	5,231
Current non-tax revenue	1,149	1,196	1,322	1,379	1,421	1,437	1,451	1,465
o/w interest revenue	123	105	74	64	35	36	36	37
Current grants	353	460	589	601	660	536	582	601
Capital revenues and grants	612	586	779	951	1,142	457	641	725
Expenditure	13,996	13,916	14,891	16,055	17,097	16,421	17,390	18,210
Compensation of employees 4/	2,867	2,850	3,028	3,339	3,595	3,928	4,029	4,240
Goods and services	2,044	2,080	2,246	2,537	2,410	2,348	2,453	2,532
Interest	1,172	1,314	1,363	1,301	1,209	1,161	1,159	1,162
Subsidies	348	397	398	438	455	475	499	525
Current transfers to households	5,039	4,995	5,126	5,156	5,196	5,242	5,351	5,466
Social security	3,835	3,722	3,936	4,021	4,043	4,063	4,131	4,204
Other	1,204	1,273	1,190	1,135	1,153	1,179	1,220	1,263
Other current transfers 5/	743	750	977	1,016	1,130	1,110	1,166	1,226
Capital expenditures	941	1,043	1,265	1,665	2,245	1,429	1,903	2,146
Capital transfers 6/	821	467	468	584	857	726	829	913
Other	20	20	20	20	0	0	0	0
General government balance	-1,538	-662	-748	-812	-625	-693	-777	-813
Primary balance	-488	547	542	425	549	433	345	312
Memorandum items:								
Public gross debt (Maastricht definition)	22,721	22,414	23,076	24,514	25,394	26,117	27,246	28,227
GDP	28,134	28,628	30,065	32,180	33,712	35,211	36,976	38,886

Sources: Hungarian authorities and Fund staff estimates.

1/ Based on the ESA 2010 methodology.

2/ Includes sectoral levies. Also, starting 2013 includes revenues from the financial transaction levy.

3/ Includes the levy on financial institutions.

4/ Includes social security contributions.

5/ Assumes that the extraordinary reserves, included under this spending category, will not be spent in order to reach the deficit targets.

6/ In 2011 includes debt takeover of the transport sector company MAV (0.2 percent of GDP)and the capitalization of the National Development Bank (0.1 percent of GDP).

Table 3b. Hungary: Consolidated General Government, 2011–18 1/

(In percent of GDP, unless otherwise indicated)

	2011	2012	2013	2014	2015	2016	2017	2018
					Prel.		Proj.	
Revenue	44.3	46.3	47.0	47.4	48.9	44.7	44.9	44.7
Tax revenue	23.7	25.4	25.1	25.2	26.1	24.4	24.3	24.1
Taxes on goods and services	17.3	18.6	18.5	18.5	19.0	18.1	18.0	17.9
VAT	8.5	9.2	9.0	9.4	9.8	9.3	9.3	9.3
Excises and other 2/ 3/	8.9	9.4	9.5	9.2	9.2	8.8	8.7	8.6
Taxes on income, profits and capital gains	6.3	6.8	6.6	6.7	7.1	6.3	6.3	6.2
Personal income tax	4.9	5.3	5.0	5.0	5.0	4.7	4.6	4.6
Corporate taxes	1.2	1.3	1.4	1.5	1.9	1.4	1.4	1.4
Other	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Capital taxes	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Social contributions	13.1	13.0	13.0	13.1	13.2	13.3	13.4	13.5
Current non-tax revenue	4.1	4.2	4.4	4.3	4.2	4.1	3.9	3.8
o/w interest revenue	0.4	0.4	0.2	0.2	0.1	0.1	0.1	0.1
Current grants	1.3	1.6	2.0	1.9	2.0	1.5	1.6	1.5
Capital revenues and grants	2.2	2.0	2.6	3.0	3.4	1.3	1.7	1.9
Expenditure	49.7	48.6	49.5	49.9	50.7	46.6	47.0	46.8
Compensation of employees 4/	10.2	10.0	10.1	10.4	10.7	11.2	10.9	10.9
Goods and services	7.3	7.3	7.5	7.9	7.1	6.7	6.6	6.5
Interest	4.2	4.6	4.5	4.0	3.6	3.3	3.1	3.0
Subsidies	1.2	1.4	1.3	1.4	1.3	1.3	1.3	1.3
Current transfers to households	17.9	17.4	17.0	16.0	15.4	14.9	14.5	14.1
Social security	13.6	13.0	13.1	12.5	12.0	11.5	11.2	10.8
Other	4.3	4.4	4.0	3.5	3.4	3.3	3.3	3.2
Other current transfers 5/	2.6	2.6	3.2	3.2	3.4	3.2	3.2	3.2
Capital expenditures	3.3	3.6	4.2	5.2	6.7	4.1	5.1	5.5
Capital transfers 6/	2.9	1.6	1.6	1.8	2.5	2.1	2.2	2.3
Other	0.1	0.1	0.1	0.1	0.0	0.0	0.0	0.0
General government balance	-5.5	-2.3	-2.5	-2.5	-1.9	-2.0	-2.1	-2.1
Primary balance	-1.7	1.9	1.8	1.3	1.6	1.2	0.9	0.8
Memorandum items:								
Structural balance (percent of potential GDP)	-4.2	0.3	-0.5	-1.6	-1.1	-2.1	-2.0	-2.1
Change in structural balance (percentage points of potential GDP)	-4.2	4.6	-0.8	-1.2	0.5	-0.9	0.1	-0.1
Public gross debt (Maastricht definition)	80.8	78.3	76.8	76.2	75.3	74.2	73.7	72.6
GDP (billions of Forints)	28,134	28,628	30,065	32,180	33,712	35,211	36,976	38,886

Sources: Hungarian authorities and Fund staff estimates.

1/ Based on the ESA 2010 methodology.

2/ Includes sectoral levies. Also, starting 2013 includes revenues from the financial transaction levy.

3/ Includes the levy on financial institutions.

4/ Includes social security contributions.

5/ Assumes that the extraordinary reserves, included under this spending category, will not be spent in order to reach the deficit targets.

6/ In 2011 includes debt takeover of the transport sector company MAV (0.2 percent of GDP)and the capitalization of the National Development Bank (0.1 percent of GDP).

Table 4. Hungary: Central Government Financing, 2011–18

(In percent of GDP, unless otherwise indicated)

	2011	2012	2013	2014	2015	2016	2017	2018
					Prel.		Proj.	
Gross financing needs	**19.3**	**16.2**	**20.5**	**23.1**	**24.8**	**16.4**	**15.5**	**18.9**
Central government cash deficit	1.7	2.2	2.8	2.9	3.6	0.3	2.1	2.1
Repayments	15.4	14.0	17.7	20.0	20.3	16.1	13.2	16.6
Domestic	10.9	8.8	12.4	13.7	16.2	11.8	11.2	14.6
Loans	0.2	0.1	0.0	0.3	0.8	0.0	0.2	0.2
LT bonds	5.3	3.3	6.0	7.4	10.6	9.2	8.4	11.9
T bills	5.4	5.4	6.3	5.9	4.7	2.6	2.6	2.6
External	4.4	5.1	5.3	4.9	3.6	4.3	2.0	2.0
Bonds	2.0	1.5	1.4	2.5	2.8	2.9	1.5	1.7
Loans	2.4	3.7	3.9	2.4	0.8	1.4	0.5	0.3
Other debt	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other debt-creating measures	2.2	0.0	0.0	0.2	0.9	0.0	0.1	0.2
Gross financing sources	**19.3**	**16.2**	**20.5**	**23.1**	**24.8**	**16.4**	**15.5**	**18.9**
Domestic	13.3	15.2	14.4	18.5	20.9	15.5	14.1	17.6
Loans	0.0	0.0	0.0	0.0	1.0	0.4	0.0	0.0
LT bonds	7.4	8.6	8.0	13.6	17.2	12.4	11.4	14.9
T bills	5.9	6.6	6.4	4.9	2.7	2.7	2.7	2.7
External	4.5	1.0	5.0	4.1	0.6	1.4	1.4	1.3
Bonds	3.8	0.3	5.0	4.1	0.6	1.4	1.4	1.3
Loans	0.8	0.7	0.0	0.0	0.0	0.0	0.0	0.0
Drawdown of deposits and liquidation of financial assets	1.4	0.0	1.1	0.4	1.9	-0.6	0.0	0.0
Memorandum items:								
Central Government deposits	6.0	5.4	3.0	4.0	2.8	…	…	…
Gross financing needs excl. short term debt	13.9	10.8	14.2	17.1	20.1	13.8	12.9	16.4
Gross financing requirements (billions of Euros)	19	16	21	24	27	17	17	21
o/w short term amortization	5.4	5.3	6.4	6.2	5.1	2.7	2.7	2.9
GDP (billions of Forints)	28,134	28,628	30,065	32,180	33,712	35,211	36,976	38,886

Sources: Hungarian authorities, and Fund staff estimates.

Table 5. Hungary: General Government Stock Positions, 2011–15

(In percent of GDP, unless otherwise indicated)

	2011	2012	2013	2014	2015 Prel.
Net Financial Worth	-62.6	-69.8	-70.4	-71.4	-69.3
Financial Assets	33.8	29.4	26.9	28.8	29.7
Currency and deposits	7.0	7.0	5.2	5.8	4.6
Debt securitites	0.4	0.5	0.8	0.4	0.6
Loans	1.6	1.2	0.8	0.7	0.7
Equity and inv. fund shares	17.6	14.4	13.5	14.3	13.6
Other financial assets	7.3	6.4	6.5	7.6	10.1
Liabilities	96.4	99.2	97.3	100.1	99.0
Currency and deposits	0.2	0.2	0.2	0.2	0.2
Securities other than shares	55.2	63.6	66.6	73.6	73.5
Loans	23.7	18.7	14.1	11.2	11.3
Other liabilities	17.3	16.7	16.5	15.1	13.9
Memorandum Items:					
Public gross debt (Maastricht definition)	80.8	78.3	76.8	76.2	75.3
Foreign currency debt	41.8	34.0	32.3	30.3	26.6
GDP (billions of Forints)	28,134	28,628	30,065	32,180	33,712

Sources: Hungarian authorities and Fund staff estimates.

Table 6. Hungary: Balance Sheet of the Central Bank, 2011–2017
(In billions of Forints, unless otherwise indicated)

	2011	2012	2013	2014	2015	2016	2017
						Proj.	
Net foreign assets	9,709	9,025	9,360	10,501	9,294	7,925	7,770
Foreign Assets	11,969	10,092	10,262	11,186	9,846	8,476	8,319
Foreign Liabilities	2,260	1,068	902	685	552	551	549
Net domestic assets	-5,836	-5,613	-5,564	-5,984	-4,512	-2,934	-2,740
Net claims on government	-1,215	-1,236	-614	-849	-620	-639	-672
Assets	169	142	138	139	39	39	39
Liabilities (Govt Deposits at MNB)	1,383	1,378	752	988	660	678	711
HUF	597	443	242	525	404	...	...
FX	786	935	510	463	256	...	...
Net claims on banks	-2,923	-3,402	-3,779	-4,247	-2,982	-1,755	-1,765
Assets	119	184	821	1,037	1,401	1,751	1,581
Liabilities	3,041	3,586	4,600	5,284	4,383	3,506	3,346
Two week & Three month deposit facilities	211	337	319	5,281	4,383	3,506	3,346
Securities Issued by MNB	2,830	3,249	4,281	3	0	0	0
Net claims on the economy	-163	-274	-598	6	13	10	7
Other items, net	-1,536	-701	-574	-894	-923	-550	-310
Base money (M0)	3,873	3,412	3,796	4,517	4,781	4,991	5,030
Currency in Circulation	2,766	2,740	3,251	3,785	4,357	4,548	4,584
Banks' Reserves	1,106	673	545	732	424	443	447
Current Account Balances	471	477	435	499	363	379	382
Overnight Deposits	635	195	110	233	61	64	65
Memorandum items:							
International Reserves (billions of Euros)	37.8	33.9	33.8	34.6	30.3	25.4	24.0
Base Money (yoy percent change)	20.8	-11.9	11.2	19.0	5.9	4.4	0.8
NFA (contribution to change)	70.5	-17.7	9.8	30.1	-26.7	-28.6	-3.1
NDA (contribution to change)	-49.7	5.8	1.4	-11.1	32.6	33.0	3.9
Government Deposits at Central Bank (percent of GDP)	4.9	4.8	2.5	3.1	2.0	1.9	1.9
HUF	2.1	1.5	0.8	1.6	1.2	...	...
FX	2.8	3.3	1.7	1.4	0.8	...	...
Reserve Requirement Ratio (percent of select liabilities)		2% to 5%			2.0	2.0	2.0

Sources: Hungarian National Bank (MNB) and Fund staff estimates.

Table 7. Hungary: Monetary Survey, 2011–17
(In billions of Forints, unless otherwise indicated)

	2011	2012	2013	2014	2015	2016	2017
						Proj.	
Net foreign assets	4,141	5,064	6,175	7,505	7,782	7,196	8,730
Central Bank	9,709	9,025	9,360	10,501	9,294	7,925	8,116
Commercial Banks	-5,568	-3,961	-3,185	-2,996	-1,512	-729	613
Net domestic assets	13,277	11,774	11,597	11,256	12,148	13,746	13,450
Domestic credit	20,806	18,611	18,257	18,821	19,164	18,971	19,750
Net claims on government	3,041	3,356	4,163	4,284	6,006	6,078	6,667
From Central Bank	-1,215	-1,236	-614	-849	-620	-639	-672
From Commercial Banks	4,256	4,592	4,777	5,132	6,626	6,717	7,339
Gross Credit to the economy	17,765	15,255	14,094	14,537	13,158	12,892	13,083
From Comercial Banks	17,927	15,528	14,692	14,531	13,145	12,882	13,076
Other items, net	-7,529	-6,837	-6,659	-7,565	-7,016	-5,225	-6,300
Broad money (M3)	17,418	16,838	17,772	18,761	19,929	20,942	22,179
M2	15,369	15,179	15,845	17,340	18,624	19,570	20,726
M1	7,343	7,297	8,896	10,738	13,220	13,891	14,712
Currency in circulation	2,551	2,554	3,001	3,548	4,109	4,318	4,573
Overnight Deposits	4,791	4,743	5,895	7,190	9,111	9,574	10,139
Deposits with Maturities up to 2 years	8,026	7,882	6,949	6,601	5,404	5,679	6,014
Repos	23	22	30	53	43	45	48
Money Market Fund Shares/Units	1,320	1,179	1,399	1,228	1,151	1,210	1,281
Debt Securities	706	458	499	140	111	116	123
Memorandum items:							
	(Percentage change by contribution, y-o-y)						
Broad Money	5.9	-3.3	5.5	5.6	6.2	5.1	5.9
NFA	17.6	5.3	6.6	7.5	1.5	-2.9	7.3
NDA	-11.7	-8.6	-1.0	-1.9	4.8	8.0	-1.4
	(Percentage change, y-o-y)						
Credit to Private Sector 1/ 2/	-6.8	-7.4	-3.3	-0.9	-10.9	-2.0	1.5
HUF	3.5	5.7	5.6	6.0	41.0	…	…
FX	-13.0	-15.3	-10.4	-7.4	-61.3	…	…
Bank Deposits	6.2	0.1	2.5	6.6	5.3	2.7	4.3
Bank Holdings of Government Paper (percent of GDP)	13.8	14.3	13.8	15.1	19.3	18.7	19.5

Sources: Hungarian National Bank (MNB) and Fund staff estimates.
1/ Adjusted for changes in exchange rate.
2/ Only credit to households and firms.

Table 8. Hungary: Financial Soundness Indicators for the Banking Sector, 2011–15
(In percent, unless otherwise indicated, end of period)

	2011	2012	2013	2014	Mar-15	Jun-15	Sep-15
Capital							
Regulatory capital to risk-weighted assets	13.8	16.3	17.4	16.9	17.0	17.2	17.2
Regulatory Tier 1 capital to risk-weighted assets	11.3	13.3	14.6	13.7	13.8	14.1	14.1
Asset Quality 1/							
NPLs net of provisions to capital	60.0	53.9	46.7	39.1	22.1	21.0	23.4
NPLs to gross loans	13.7	16.0	16.8	15.6	12.6	12.6	13.6
Distribution of Loans (Percent of Total)							
Firms	34.6	37.1	37.7	38.4	38.6	38.1	39.2
Households and Non-Profits	39.8	39.7	39.7	40.5	39.8	39.6	40.2
Non-Residents	9.8	8.4	7.2	6.7	7.5	7.3	7.4
Other	15.8	14.8	15.4	14.4	14.1	15.0	13.2
FX loans	62.2	55.6	51.9	50.7	26.1	26.6	25.4
Profitability							
ROA	-0.7	-0.1	0.2	-2.2	-0.3	0.5	0.5
ROE	-8.5	-1.4	2.3	-20.6	-2.4	4.5	4.9
Net interest income to gross income	51.6	54.0	46.6	53.6	44.6	49.3	48.3
Noninterest expenses to gross income	75.7	86.9	80.6	73.7	117.9	100.6	91.8
Liquidity							
Liquid assets to total assets	24.7	30.8	32.8	38.0	38.4	38.7	40.3
Liquid assets to short term liabilities	45.6	55.2	57.5	63.5	64.6	64.3	66.8
Sensitivity to Market risk							
Net open FX position to Regulatory capital	23.9	20.5	15.5	21.9	14.6	17.8	16.5

Sources: Magyar Nemzeti Bank (MNB) and IMF's Financial Soundness Indicators Database.

1/ The decline in NPLs in 2015 is due to the settlement of unilateral interest hikes and exchange rate margins deemed unfair by the Supreme Court. The oldest unpaid interest, fees and penalties were paid first. NPLs can thus temporarily become performing without any actual debt servicing.

Table 9. Hungary: Balance of Payments, 2011–21

(In millions of Euros, unless otherwise indicated)

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
					Prel.			Proj.			
Current Account	**754**	**1,752**	**4,027**	**2,125**	**4,768**	**5,136**	**4,955**	**4,401**	**3,591**	**2,633**	**1,797**
Goods and service, net	6,213	6,730	7,384	7,449	9,348	10,096	9,547	8,951	8,127	7,227	6,299
Exports	87,833	86,021	89,039	93,267	100,198	101,814	109,165	116,689	124,084	131,757	138,761
Imports	-81,620	-79,291	-81,655	-85,818	-90,849	-91,718	-99,618	-107,738	-115,958	-124,531	-132,462
Primary Income, net	-4,892	-4,226	-2,905	-4,667	-4,000	-4,007	-3,616	-3,584	-3,553	-3,581	-3,410
Secondary Income/Current transfers, net	-567	-752	-453	-657	-580	-953	-976	-966	-982	-1,012	-1,092
Capital Account	**2,353**	**2,523**	**3,613**	**3,877**	**4,765**	**2,006**	**2,448**	**2,780**	**2,779**	**2,362**	**2,265**
Net capital transfers	2,383	2,496	3,594	3,900	4,891	1,987	2,435	2,764	2,767	2,349	2,249
Financial Account	**-3,149**	**4,180**	**116**	**4,193**	**13,213**	**10,543**	**8,785**	**3,815**	**1,638**	**1,559**	**1,612**
Direct investment, net	-972	-2,095	-1,152	-2,969	218	-294	-400	-447	-497	-524	-549
Portfolio investment, net 1/	-5,629	-1,813	-3,692	3,447	4,986	2,667	-113	-1,701	-2,213	-2,243	-2,234
Other investment	3,451	8,088	4,960	3,715	8,009	8,170	9,298	5,963	4,349	4,326	4,396
Net errors and omissions	**-2,383**	**391**	**-1,261**	**-1,067**	**-1,223**	**0**	**0**	**0**	**0**	**0**	**0**
Overall Balance	**3,874**	**486**	**6,263**	**742**	**-4,904**	**-3,402**	**-1,383**	**3,367**	**4,732**	**3,436**	**2,449**
Official Financing (European Union)	**-2,000**	**0**	**0**	**-2,000**	**0**	**-1,500**	**0**	**0**	**0**	**0**	**0**
Net International Reserves (increase -)	**-1,874**	**-486**	**-6,263**	**1,258**	**4,904**	**4,902**	**1,383**	**-3,367**	**-4,732**	**-3,436**	**-2,449**
Gross Reserves	-3,874	3,351	-1,210	-742	4,904	4,902	1,383	-3,367	-4,732	-3,436	-2,449
Reserve Liabilities	0	-3,837	-5,053	0	0	0	0	0	0	0	0
IMF	0	-3,837	-5,053	0	0	0	0	0	0	0	0
Memorandum Items:											
Current account (percent of GDP)	0.7	1.8	4.0	2.0	4.4	4.9	4.6	4.0	3.1	2.2	1.4
Exports, g&s (percent of GDP)	87.2	86.9	88.0	89.5	92.1	96.1	101.7	104.0	105.8	108.8	111.0
Volume (percentage change)	6.6	-1.8	6.4	7.6	8.4	6.5	6.3	6.2	6.0	5.5	5.1
Imports, g&s (percent of GDP)	81.0	80.1	80.7	82.3	83.5	86.5	92.8	96.1	98.9	102.8	106.0
Volume (percentage change)	4.5	-3.5	6.3	8.5	7.8	6.6	6.6	6.7	6.5	5.9	5.6
Gross external debt (percent of GDP) 2/	134.4	129.0	118.4	114.8	108.8	103.4	96.3	86.4	79.4	72.2	68.1
Gross official reserves	37,774	33,881	33,782	34,578	30,322	25,420	24,037	27,404	32,137	35,573	38,022
In percent of short-term debt at remaining maturity 3/	65.3	67.4	97.4	102.4	105.8	102.6	103.5	111.4	136.8	149.9	170.6
In months of next year's imports of good and services	5.7	5.0	4.7	4.6	4.0	3.1	2.7	2.8	3.1	3.2	3.2

Sources: Hungarian authorities and Fund staff estimates.
1/ Includes financial derivatives. In 2011 includes liquidation of foreign assets in 2nd pillar pension funds projected at euro 2.5 bn.
2/ Includes intercompany debt liabilities and excludes Special Purpose Entities
3/ Short term debt at remaining maturity includes 20 percent of inter-company debt liabilities

Table 10. Hungary: External Financing Needs, 2011–2021
(In millions of Euros, unless otherwise indicated)

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
					Prel.	Proj.					
Total financing requirements	**44,432**	**37,721**	**29,749**	**29,446**	**21,602**	**17,644**	**12,183**	**10,812**	**9,352**	**13,473**	**11,576**
Current account - Capital account	-3,107	-4,275	-7,640	-6,002	-9,533	-7,141	-7,403	-7,181	-6,371	-4,995	-4,062
Current account	-754	-1,752	-4,027	-2,125	-4,768	-5,136	-4,955	-4,401	-3,591	-2,633	-1,797
Capital account	2,353	2,523	3,613	3,877	4,765	2,006	2,448	2,780	2,779	2,362	2,265
Amortizations	45,156	42,387	36,128	34,382	29,911	24,785	19,585	17,993	15,723	18,468	15,638
FDI (incl. intra-company)	6,228	6,069	5,998	6,089	6,515	7,406	7,376	7,317	7,244	7,099	6,886
General government	7,681	10,417	12,341	9,079	6,551	6,239	4,706	5,786	4,480	6,811	3,395
Eurobonds	1,989	1,436	1,419	2,597	2,997	3,057	1,632	1,907	1,746	2,397	1,847
Loans and others	2,548	3,837	5,053	2,573	1,498	1,521	577	337	130	112	314
o/w: to IMF and EU	2,000	3,837	5,053	2,000	0	1,500	0	0	0	0	0
Non-resident holding of government securities	3,144	5,145	7,086	3,909	3,056	1,660	2,496	3,541	2,604	4,301	1,235
Central bank	5,035	4,877	1,934	1,921	987	544	545	547	550	545	545
Banks	18,465	14,431	10,012	9,824	9,041	2,390	4,792	3,201	1,489	1,810	1,507
Subsidiaries	15,806	12,353	8,570	8,409	7,739	2,045	4,102	2,740	1,275	1,549	1,290
Domestic banks without parents (OTP, FHB+FKB, ...) 1/	2,659	2,078	1,442	1,415	1,302	344	690	461	214	261	217
Other investment (mainly corporate)	7,747	6,593	5,844	7,469	6,818	8,207	2,166	1,142	1,959	2,203	3,304
Net errors and omissions	2,383	-391	1,261	1,067	1,223	0	0	0	0	0	0
Total financing sources	**44,432**	**37,721**	**29,749**	**29,446**	**21,602**	**17,644**	**12,183**	**10,812**	**9,352**	**13,473**	**11,576**
FDI net inflows (incl. intra-company)	7,200	8,164	7,150	9,058	6,296	7,700	7,776	7,764	7,741	7,623	7,435
Disbursements (debt)	29,730	23,599	23,909	23,316	16,149	8,585	4,209	4,030	4,889	6,230	6,912
General government 2/	10,423	9,645	12,305	7,225	3,195	2,541	1,547	2,719	3,348	2,799	2,733
Eurobonds	4,696	309	5,060	4,284	581	1,324	1,209	692	744	-1,533	1,484
Loans and others	1,096	700	0	0	4	0	0	0	0	0	0
Non-resident holding of government securities	4,631	8,636	7,245	2,941	2,611	1,217	338	2,027	2,604	4,332	1,248
Central bank	4,583	1,280	1,934	1,921	1,029	541	539	539	544	542	542
Banks	12,612	8,111	6,235	9,680	7,789	1,319	1,920	994	473	1,448	1,205
Other investment (mainly corporate)	6,695	5,843	5,369	6,411	5,166	4,725	741	317	1,069	1,983	2,974
Other portfolio flows net	11,377	2,609	-99	-2,186	-5,748	-3,542	-1,185	2,384	1,453	3,056	-321
Drawdown in gross reserves	-3,874	3,351	-1,210	-742	4,904	4,902	1,383	-3,367	-4,732	-3,436	-2,449
Memorandum items:											
Gross international reserves (millions of Euros)	37,774	33,881	33,782	34,578	30,322	25,420	24,037	27,404	32,137	35,573	38,022
In percent of short-term debt at remaining maturity	65.3	67.4	97.4	102.4	105.8	102.6	103.5	111.4	136.8	149.9	170.6
Government rollover rates (percent)	135.7	92.6	99.7	79.6	48.8	40.7	32.9	47.0	74.7	41.1	80.5
Banks' rollover rates (percent)	68.3	56.2	62.3	98.5	86.2	55.2	40.1	31.0	31.7	80.0	80.0
Corporate rollover rates (percent)	86.4	88.6	91.9	85.8	75.8	57.6	34.2	27.8	54.5	90.0	90.0

Sources: Hungarian authorities and Fund staff estimates.

1/ In 2012 excludes external debt amortization of the Hungarian Development Bank MFB

2/ Excludes EU and IMF loans

Annex I. Response to Past Fund Policy Advice

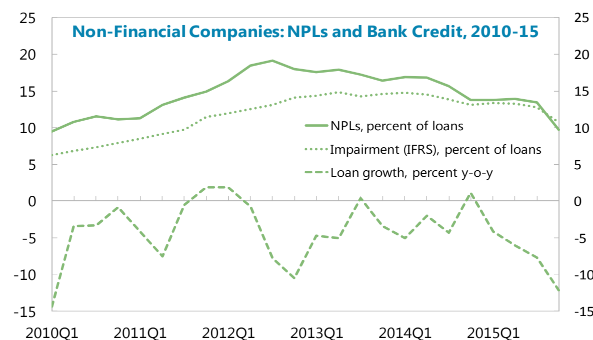
The authorities have actively engaged in a policy dialogue with the Fund and implemented a number of its recommendations, but some policies deviated from previous IMF advice.

Key recommendations	**Implemented policies**
Implement a growth-friendly fiscal adjustment to sustainably reduce the public debt-to-GDP ratio.	The 2015 fiscal deficit came in below target and the public debt ratio declined moderately. However, the budget composition remains a concern, as sectoral taxes and the public wage bill are still high, while allocations to health and education are inadequate.
Adopt a cautious monetary easing if disinflationary pressures persist.	The MNB resumed the easing cycle in March 2015 and cut the policy rate by 75 basis points in five equal steps to 1.35 percent in July 2015. In March 2016, the MNB cut the policy rate further to 1.20 percent. Refinements to the monetary policy instruments were implemented to strengthen the transmission mechanism, provide cheap funding for SMEs, ensure cheap financing for the government, and reduce vulnerabilities.
Reduce external vulnerabilities.	The FX mortgage conversion has significantly reduced households' exposure to exchange rate risk. The MNB's self-financing program has helped reduce reliance on non-residents funding and on FX-denominated public debt.
Restore financial intermediation—including by reducing the tax burden and facilitating a faster balance sheet cleanup. Limit the role of the state in the banking system.	Initiatives to reduce NPLs are proceeding, including the setup of an asset management company and the new Personal Bankruptcy Law. The bank levy was reduced in 2016 and further reductions are expected. However, state ownership of banks has increased.
Address weaknesses in the labor market, enhance competitiveness, and improve the business climate, including by limiting the state's role in the economy.	Affordable child-care facilities, flexible child-care services, and flexible employment opportunities are gradually expanding to help increase female labor participation. The public works scheme continued to expand to support the activation and employment of disadvantaged groups, particularly the low-skilled and long-term unemployed. The role of the state in the economy remained high.

Annex II. Debt and Non-Performing Loans

A. Non-Financial Corporations

1. The share of loans overdue more than 90 days as percent of gross loans (NPL ratio) granted by banks to non-financial companies (NFCs) has declined, but a substantial overhang of NPLs remains a challenge.[1] Most of the non-performing project loans have already been restructured and many relate to commercial real estate in the Budapest area. The average loan-loss coverage ratio of these loans is reportedly around 71 percent. Since 2012, the NPL ratio has slowly declined, which is remarkable given the subdued credit growth, but may have been facilitated by previous initiatives,[2] real GDP growth, and more recently a recovery of commercial real estate.



Sources: Hungarian National Bank (MNB); and IMF staff calculations.
Note 1: Covers credit institutions supervised by the MNB.
Note 2: Lending includes FGS-funded loans.

2. NFCs have continued to repair their balance sheets. Construction and market services were the worst sectors affected by the global recession.[3] While NFCs on average have been reducing their debt (unconsolidated loans and issued securities), it is still high compared to peers. However, they have also managed to build up deposits with the domestic banks (17.8 percent of GDP at end-2015 compared to 14.5 percent at end-2009).

3. Domestic bank lending to NFCs has remained subdued (-12.2 percent y-o-y, end-2015), but this is masked by two distinct factors as well as some one-off factors. First, large reputable companies have substituted domestic bank lending with less expensive foreign funding.[4] The MNB estimates that loans from abroad account for almost 59 percent of their total debt (end-June 2015), compared to around 43½ percent at end-2009. Secondly, bank lending to the more risky SMEs has increased—3.6 percent (y-o-y, end-2015)—mainly due to the Funding for Growth Scheme. One-off factors include write-offs by MKB Bank, which is under resolution.

[1] This refers to the old definition of NPLs (90 days overdue). Since end-2014, the MNB has also reported the new and broader EU definition, which includes loans where the debtor will not be able to repay all his debt without realizing the collateral. At end-June 2015, the old NPL ratio for NFC loans was 14 percent, but the new stood at 24 percent. The new definition mainly affects project loans.

[2] In 2010, out-of-court guidelines for distressed companies were adopted, but have reportedly rarely been used. In 2012, the bankruptcy legislation was amended with a view to facilitate mutual agreements. In 2014, some one-off effects helped, including MKB bank moved under resolution.

[3] See Box 5 in *Regional Economic Issues, May 2015*, European Department, International Monetary Fund.

[4] NFC bank loans are highly concentrated. According to the MNB (*Financial Stability Report, November 2015*, page 23): "… over half of the [corporate] loan stock belongs to less than 1 per cent of the loan contracts."

4. In November 2014, an asset management company (MARK) was established as a fully-owned subsidiary of the MNB and funded by almost €1 billion to purchase non-performing commercial real estate loans from banks. Operations began on March 21, 2016, after DGCOMP (February 10, 2016) felt assured that any transaction would be (i) voluntary and (ii) based on market prices, using a rule-based approach, hence avoiding state-aid issues. During its 10 year time horizon, MARK will sell these assets for profit. MARK is not envisaged to become a developer, but will improve assets based on a case-by-case cost-benefit analysis. The MNB has taken measures to encourage banks to use MARK.[5] The MNB has hinted that it is open to seek external funding on market terms and to pursue a broader ownership structure at a later stage.[6] Fund staff has encouraged the authorities to be transparent and strengthen the governance structure in line with IMF technical assistance recommendations.[7]

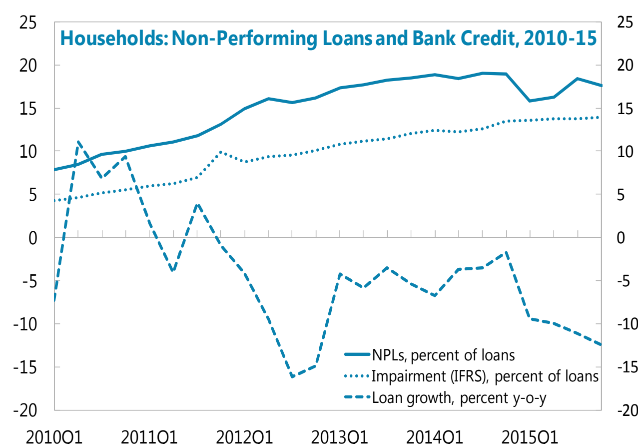
[5] In October 2015, the MNB decided to introduce a systemic risk buffer, effective January 2017, with a view to encourage banks to eliminate their large non-performing project loans. The buffer will depend on the share of problematic project exposures relatively to the domestic pillar I capital requirement of a bank. The additional capital buffer will range from 0 to 2 percentage points.

[6] According to Ingves et al. ("Issues in the Establishment of Asset Management Companies," *IMF PDP/04/3*), it is preferable that an asset management company not be set-up as a unit within a central bank or a subsidiary thereof.

[7] MCM has provided technical assistance (http://www.imf.org/external/pubs/cat/longres.aspx?sk=42858.0 and http://www.imf.org/external/pubs/cat/longres.aspx?sk=43212.0).

B. Households

5. In 2015, following 2014 legislation on unfair banking practices,[8] significant compensations were paid to indebted natural persons (households), which lowered their outstanding debt as well as temporarily reduced their non-performing loans (NPLs).[9] Since compensations were used to first pay overdue payments, the NPLs initially declined in 2015. When compensations no longer were adequate to cover overdue payments, the NPL ratio increased again. Banks have reportedly strengthened their loan-loss coverage (from almost 59 percent at end-2014 to around 64 percent by mid-2015). Better employment opportunities and wages, lower energy prices and taxes, improved real estate prices in selected areas, and the conversion of foreign currency denominated loans have all contributed to lower risks. Nevertheless, households are still repaying more than they borrow from banks. Effective January 1, 2015, a payment-to-income ratio was introduced and the loan-to-value ratio strengthened with a view to prevent future excesses. These ratios have not yet been binding.



Sources: Hungarian National Bank (MNB); and IMF staff calculations.
Note: Covers credit institutions supervised by the MNB.

6. The conversion of foreign-currency denominated mortgages in Q1:2015, and car and personal loans in Q4:2015, has significantly reduced the exchange rate risk of households. The share of foreign currency denominated lending to households has declined from 52.8 percent at end-2014 to below 1 percent at end-2015. Since the MNB largely provided the banks with the FX at market prices, when the decision on mortgage conversion was taken, it did, in principle, not affect banks' profitability. The bank losses of the much smaller conversion of FX denominated car and personal loans (about 242,000 contracts) at a preferential exchange rate is estimated to have cost HUF 31 billion. It will be shared between banks and the government, since banks can deduct these losses from their future profits.

[8] Several measures have previously been introduced to alleviate indebted households, as discussed in past Staff Reports. In 2011, early repayment of foreign currency denominated mortgages was facilitated. In 2012, 5-year exchange rate caps were made available, and conversion of non-performing mortgages was encouraged. The 2014 Settlement Act required compensation for past unilateral contract modifications and use of bid-ask spreads by banks when calculating the disbursement and repayments for loans disbursed after May 1, 2004 and not terminated before July 26, 2009. The Fair Banking Act restricts unilateral interest rate and cost hikes, regulates information to be provided to borrowers, and permits borrowers to terminate contracts under certain conditions. These losses were assumed by banks and adversely affected their 2014 profits.

[9] The old definition of NPLs (90 days overdue) is used. Since end-2014, the MNB has also reported the new and broader EU definition. It includes loans where the debtor will not be able to repay the debt without realizing the collateral. At end-June 2015, the old NPL ratio for household loans was 16 percent, but the new was 22 percent.

7. In 2015, the budget allocation to the asset management agency for non-performing residential loans of vulnerable households (NAFA) was increased. NAFA was established in 2011, and began operations in mid-2012. It purchases residences of vulnerable and delinquent households, while taking into account social aspects. For instance, initially debtors had to have at least one child and receive certain social benefits. The debtor can remain in the residence provided the agreed rent is paid. Initially, resources were granted to cover 5,000 households, which later have been increased to 25,000, and 35,000 in 2015.

8. The new Personal Insolvency Law is a step in the right direction to reduce the uncertainty and costs of resolving debt of natural persons as well as to offer them a second chance, but its effectiveness is yet to be tested. The first phase became effective September 2, 2015, and applies to households whose dwelling would be subject to enforcement and sale,[10] while other over-indebted persons will be covered effective October 1, 2016. This phasing is intended to give priority to those in most need and to reduce the administrative challenges. The procedures are complex and consideration is being given to streamline them and later, as experience is gained, to review the law.

9. Natural persons with debt between HUF 2 and 60 million (about €6,500 to almost €200,000) can under certain circumstances apply.[11] They can initiate out-of-court debt settlement, under the coordination of the main creditor. In this case, the "Family Bankruptcy Services" check the legal conditions, and register the initiation and the settlement agreement in the official register. In the out-of-court procedure, the parties are free to reach any agreement, including in terms of repayment period. Debtors will usually be allowed to keep the ownership of their primary residence, provided it does not exceed a reasonable size and value. If an agreement cannot be reached within 120 days (90 days if there is only one creditor), the court decides whether to pursue the first phase of the "in-court" procedure, which is a kind of mediation at the court; or the second phase of the "in-court" procedure, where the court decides. In case of the latter, a minimum recovery is guaranteed by the law for all creditors. The repayment plan then covers five years, whereupon the remaining debt is discharged, but the period can be extended by up to two years in exceptional cases. If the repayment plan is not observed, creditors may ask the court to terminate the debt resolution procedure and such termination will annul the agreement on the repayment plan. A debtor cannot file again before 10 years after the termination of the procedure.

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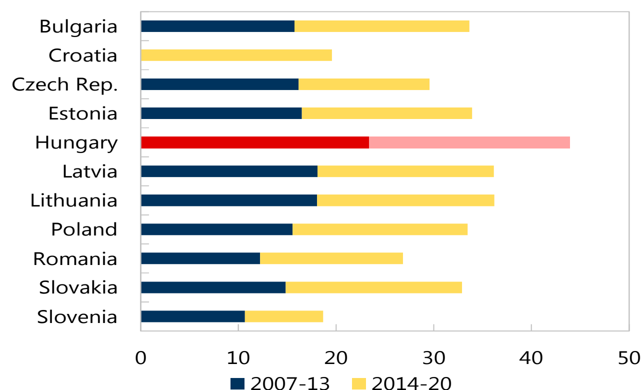
[10] Although the inability of households to service their debt is a major social problem, it seems that frequent moratoriums on evictions may also have contributed to moral hazard problems. See "Comprehensive Analysis of the Non-Performing Household Mortgage Portfolio Using Micro-Level Data, *MNB Occasional Papers Special Issue, 2015*, by Bálint Dancsik et al.

[11] Such settlement may not be initiated if the debtor has significant public debt, properties are locked due to criminal proceedings, the debtor is assessed to have unlimited responsibility due to unlawful treatment of joint stock, and there is a legal dispute among debtors. Other requirements include: overdue debt must exceed HUF 0.5 million (approximately €1,600); be over 90 days overdue; total debt must exceed the combined value of assets and income for the next five years, but debt may not exceed twice the value of assets and projected income during the settlement period; at least 80 percent of the debt is not disputed by the debtor; and there are no more than five creditors. Socially disadvantaged debtors whose insolvency may not be restored may sell their property to NAFA, while other more complicated cases go directly to court.

Annex III. EU Structural and Investment Funds

1. EU's Structural and Investment Funds (ESIF) allocation for Hungary—the highest in the region—over two program periods amounts to 45 percent of 2015 GDP.[1] Hungary has the third largest allocation in absolute terms (€47 billion) after Poland and the Czech Republic; and second after Estonia in per capita terms (€4,700). The main objectives of these funds are to promote convergence, regional competitiveness and employment. The allocations come from three funds with specific objectives that are administered by national authorities under close monitoring by the European Commission (EC). National authorities choose the individual projects in line with the more detailed "operational programs" and "priority axes" agreed with the EC. Besides some advance payments, reimbursements are made upon the presentation of invoices that are vetted and certified initially by the national certifying authority and then ultimately by the EC.[2]

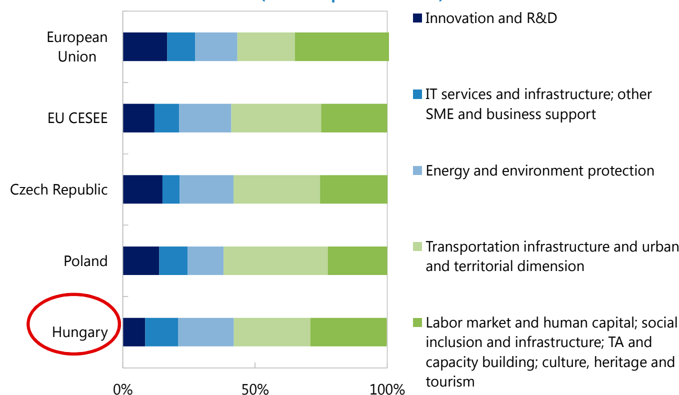
Figure 1. EU Structural and Cohesion Funds Allocations under 2007–13 and 2014-20 Programs *(Percent of recipient country's 2015 GDP)*



Sources: European Commission and IMF staff estimates.

2. ESIFs grants are not "free" money.[3] To ensure ownership, national authorities provide co-financing—typically, around 15 percent. Certain costs, e.g., most land purchases and value-added taxes on certain inputs, have to be fully covered by national authorities hence raising the effective co-financing some times to 30–50 percent. In Hungary, the effective co-financing in 2015 constituted around 32 percent, or equivalent to about 2¾ percent of

Figure 2. Breakdown of 2007-13 Structural and Cohesion Funds by Types of Projects (Shares in percent of total)



Sources: European Commission and IMF staff estimates.

[1] Excluding agricultural subsidies and the Rural Development Fund.

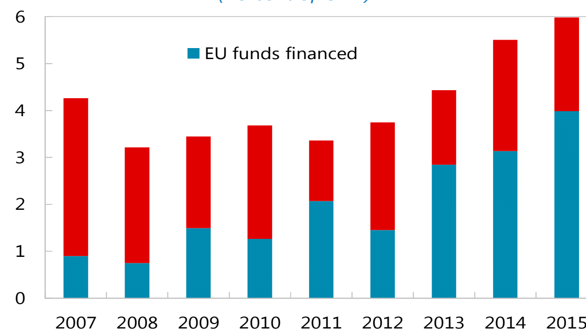
[2] See Box 1 in *Central Eastern and South Eastern Regional Economic Issues, November 2015*, International Monetary Fund, Washington, D.C.

[3] Note that the *European Fund for Regional Development* and *European Social Fund* are subject to the "additionality principle", under which EU funds should not replace, but be an addition to national regional resources.

GDP. Additionally, most projects require maintenance translating into permanent increases in budget spending.

3. Three quarters of EU transfers received by Hungary were spent on investment, with significant focus on infrastructure. For the 2007–13 program period, Hungary used a bigger share of the funds, relative to the average for the EU, on infrastructure and environmental projects (Figure 2), but was lagging behind most of its peers in R&D investment. The share of investment projects financed by the ESIF has increased from 20 percent in 2007 to around 70 percent in 2015 of the total public investment (Figure 3), which together with the private investment projects amounted to about a third of the total investments in 2015.

Figure 3 Public Investment in Hungary.
(Percent of GDP)



Sources: European Commission and IMF staff estimates.

4. The rate of absorption is uneven with a significant acceleration toward the end of the program period. Grants that are not drawn within the pertinent deadlines (i.e., 2015 for the 2007–13 program period) are lost for the recipients. In 2015, Hungary is estimated to have absorbed almost 20 percent of all ESIF funds available for the past program period, resulting in the expected inflow of about 5¾ percent of GDP, of which 3½ percent of GDP were received in 2015. Many countries in the region followed similar patterns: Czech Republic and Slovakia have even more back-loaded absorption with preliminary figures suggesting an increase of 21 and 25 percent of available funds, respectively, in 2015 (Figure 4), while Poland has had a smoother absorption during the program period.[4]

5. The rushed spending of EU funds may compromise their efficacy and could adversely affect the fiscal position.[5] Latest payment data indicate that Hungary is likely to reach almost a 100 percent absorption rate for the 2007–13 program period. This is ensured by an "oversubscription" practice.[6] At the same time, while EU funds supported growth in the short

[4] The Hungarian State Audit Office speculates that the smoother and higher Polish absorption ratio at end-2014 can be due to: (i) larger share of funds being used for, typically bigger and well-prepared, transport projects (40.6 percent of total funds in Poland compared to 25.6 percent in Hungary); and (ii) integrated centralized management, monitoring and implementation of the use of EU funds. See *Report on Hungary's Absorption of EU Funds during the 2007-2013 Program Period*, August 2015, Hungarian State Audit Office, Budapest (Only available in Hungarian)

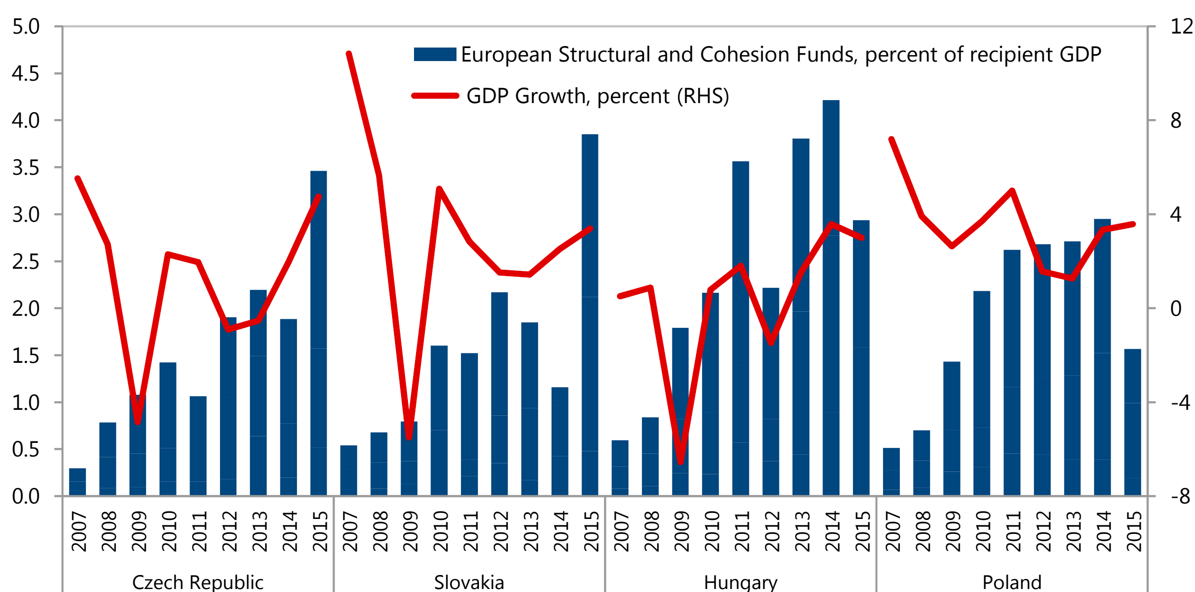
[5] Efficient use of EU structural and cohesion funds has for long remained a challenge for EU member states. See, for instance, *Fiscal Transfers and Economic Convergence in the EU: An Analysis of Absorption Problems and an Evaluation of the Literature* by Yves Hervé and Robert Holzmann, 1998, Nomos Verlagsgesellschaft, Baden-Baden.

[6] In order to ensure full utilization of EU grants, Hungary "oversubscribes" the amount available. Based on past experience, about 5–6 percent of the submitted invoices will typically be rejected in subsequent checks. If the grants are "oversubscribed," they can in some cases be rolled over into the next program period (2014–20).

term, by focusing on "shovel-ready" projects, market observers have noted that their impact on potential output could likely have been higher, if the projects were better prioritized. Hastened absorption could have also caused more irregularities in project certification by the EC, resulting in potential additional fiscal costs, since the EC will not reimburse these costs.[7] The Hungarian government has been in talks with the EC regarding the reimbursement of around HUF 500 billion (approximately 1½ percent of GDP) of EU funding.

6. The disbursements for the 2014–20 program period are proceeding. The Partnership Agreement and all the operational programs have been approved and disbursements have

Figure 4. Payouts from EU Structural and Cohesion Funds under 2007–13 Program.



Sources: European Commission and IMF staff estimates.

started. The final decisions on competing projects are made, after careful consideration, by the Office of the Prime Minister. In contrast to the previous program period, where roughly 70/30 percent was allocated to the public/private sector, it will be 60/40 in the current program period. Furthermore, slightly more will be allocated to research and development.

7. The projected slowdown in absorption in 2016 is subject to downside risks. The government has taken measures to boost absorption in the first years of the 2014–20 program period by announcing that all tenders of this period should be finalized by mid-2017. But, the shift in administrative focus, absorption fatigue, as well as the limited pool of potential projects pose risks to these plans. The Hungarian National Bank projects that EU grants (without agricultural subsidies) could decline by over HUF 1000 billion (about 3 percent of GDP) from

[7] In some cases, however, these grants could be re-directed to other projects. Irregularities of absorption of EU funds are in many EU countries related to poor procurement practices. In November 2015, a new Hungarian procurement law became effective.

2015 to 2016.[8] The Ministry for National Economy, however, hopes that some of the "absorption energy" from 2015 will be carried over to 2016.

8. A number of additional measures could improve the efficiency of investment spending. The utilization of EU funds could be enhanced through better planning of public investment, costing and prioritization of public investment plans,[9] employing a standard methodology for cost-benefit analysis and project appraisal, taking account of potential risks to the project, and having a central review process of major projects, and more efficient and open procurement process.[10]

[8] See Box 5.1 (pages 70-71) in the *Inflation Report, December 2015*, Hungarian National Bank: https://www.mnb.hu/en/publications/reports/inflation-report/17-12-2015-inflation-report-december-2015.

[9] A study analyzing EU Structural and Cohesion Funds during 2004–12, found that municipalities with a mayor endorsed by the governing parties, typically received 10 percent higher grants per capita. See *Political Incentives and State Subsidy Allocation: Evidence from Hungarian Municipalities* by Balázs Muraközy and Álmos Telegdy, Discussion Paper 2015/31, Centre for Economic and Regional Studies, Hungarian Academy of Sciences.

[10] For details, see *Making Public Investment More Efficient*, 2015, International Monetary Fund, Washington, D.C.

Annex IV. The Impact of Labor Cost Reduction on Employment of Vulnerable Groups

A. Introduction

1. **The literature provides ample evidence that a reduction in the tax wedge has a positive effect on employment and recommends targeted social security contribution (SSC) cuts as a cost efficient solution**. The precise employment effects differ across countries, depending on the degree of competition in labor and product markets and on the elasticities of demand and supply in these markets, as well as on labor market institutions. Although across-the-board tax cuts can be very costly for the budget,[1] tax cuts targeted to the groups with higher elasticity of labor supply could help boost employment while containing fiscal costs. Since the crisis, a number of EU countries have introduced cuts in employer SSC targeted to elderly, young, low-paid and female workers with a varying degree of effectiveness.

2. **A number of lessons can be learned from the experience of countries that have cut SSC rates**. The success of these measures crucially depends on minimizing new distortions and scope for employment substitution. Therefore, targeting the low-skilled and youth groups regardless of employment status, employee size or contract type, has proven to be more effective than targeting narrowly-defined groups, such as long-term unemployed, disadvantaged groups from specific regions, or "new hires" that are particularly difficult to monitor and lead to large substitution effects (problems of definition, manipulation stemming from re-characterizing existing workers as new workers, and enforcement). Also a phased reduction of employer SSC according to wage level has been shown to be effective when targeting the low–paid as it prevents the creation of a "low-pay" trap. Good communication and limited paperwork are other key components of the successful implementation.[2]

3. **Hungary implemented targeted reductions in the social security contributions three years ago.** Under the Job Protection Action Plan (JPAP), effective January 2013, employer's SSC were permanently cut in half for employees under 25 and over 55 years old, as well as employees working in elementary occupations. Additionally, a 100 percent cut was introduced for the long-term unemployed re-entering the labor market, those returning to work after child-care leave, and career starters for the first two years of employment, followed by a 50 percent cut in the third year.[3] This annex discusses the comparative developments in labor market conditions for the targeted groups.

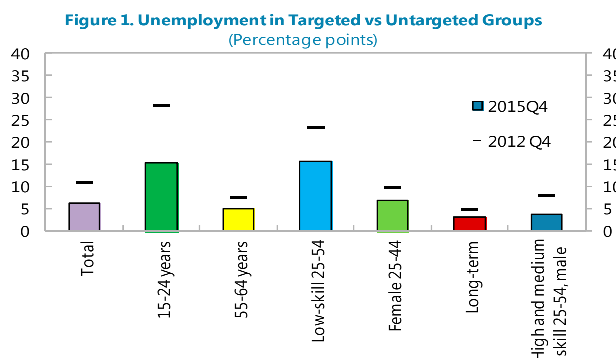
[1] Estimates show that a 1 percentage point cut is, on average, associated with a revenue loss of 0.3-0.5 percent of GDP (Fiscal Monitor, April 2014).

[2] See April 2014 Fiscal Monitor for more recommendations on the design of targeted SSC cuts.

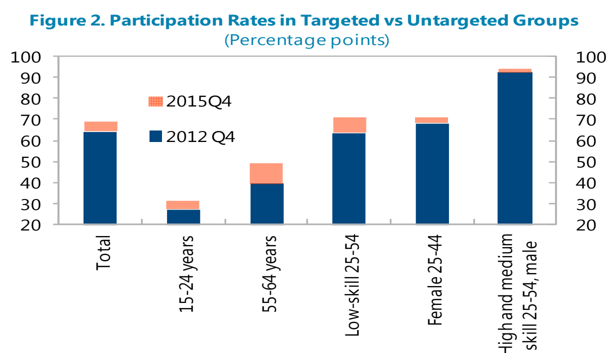
[3] Since July 2015, the government extended the eligibility to agricultural workers between the ages of 25 and 55, which may affect a further 30,000-35,000 employees.

B. Stylized Facts

4. Labor market performance in Hungary has been strong. Over the last three years, overall labor market conditions have improved significantly on the back of robust domestic and external demand and supportive economic policies, including the expansion of the public works program. The overall unemployment rate dropped from 11 percent at end-2012 to 6.2 percent in 2015:Q4, below pre-crisis levels; and labor force participation increased by 4.9 percentage points to 69.1 percent. Thus, to assess the impact of targeted tax cuts on employment and separate it from the general improvement in labor market conditions one needs to compare employment and participation performance of targeted groups with those in a non-targeted "control" group, i.e., high and medium skill male employees of 25–54 years old. Figures 1 and 2 show that improvement in employment and participation rates since 2013 for some targeted groups has outperformed those of the comparator group.



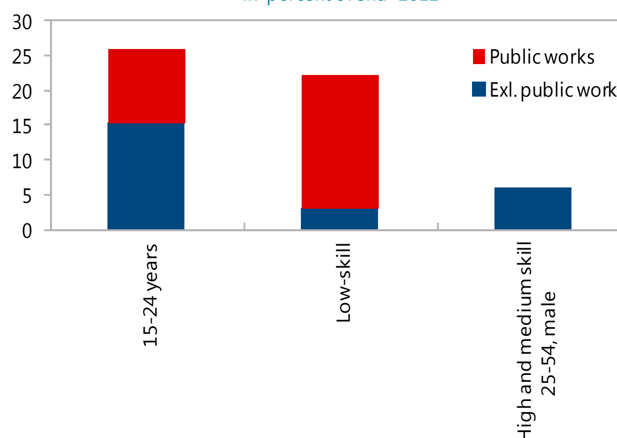
5. Employment growth for the young and elderly has benefitted from the tax rate cuts and was stronger than the average in the economy. Youth unemployment declined from 28 percent at end-2012 to 16.7 percent in 2015:Q4 (below the EU average), while at the same time participation rates went up by 4.2 percentage points (Figures 1 and 2). Moreover, cumulative growth in youth employment amounted to 26 percent since end-2012, overtaking growth of employment in a non-targeted group after the introduction of the SSC cut by a large margin (Figure 3, and Figure 4 panel 1). While it's true that the public works program was responsible for about 40 percent of the growth, youth employment outside of public works was still two times higher than that of a non-targeted group (Figure 3). In absolute terms, unemployment has declined the most for low-skilled young workers, shrinking from 52 percent to 26 percent; while for high-skilled young employees it was reduced in half to 10 percent. Older workers have also benefitted from the tax cuts: employment of those above 55 years old was growing significantly faster than that of a non-targeted group (Figure 4 panel 2). The unemployment rate of older workers has declined but to a lesser degree compared with the young and low skilled due to a sharp rise in participation rate of this group (9.5 percentage points since end-2012).



6. The improvement in labor market conditions for low-skilled middle-age workers was driven by the expansion of public works program.[4] Unemployment for the low-skilled 25–54 years old has declined from 23 percent at end-2012 to 16 percent in 2015:Q4, while the participation rate of this group increased by 8 percentage points to 71 percent during the same period. Cumulative employment growth since end-2012 was 19.2 percent; however, most of it was due to the expansion of public works from 92,000 to 230,000 employees, adding 78,600 new low-skill jobs. Outside the public works program, cumulative employment growth was significantly lower than the comparators group, at 3.1 percent.

7. The impact of the tax cuts on the employment of long-term unemployed and women coming back to work from maternity has been limited. While the unemployment of women in the age group of 25–45 years declined since the introduction of tax cuts and labor force participation increased, these improvements were subpar or similar to those of the untargeted group. As for the long-term unemployment, there was no visible change in the declining trend vis-à-vis short-term unemployed after the introduction of tax cuts.

Figure 3. Employment growth, 2013- 2015
in percent of end -2012



Sources: Hungarian authorities, Eurostat and IMF staff calculations.

C. Policy Considerations

8. Preliminary findings from labor market developments in targeted groups in Hungary are in line with previous findings for other countries. *Ex-post* evaluations found that targeting based on broad characteristics (the low-paid, the young) rather than on specific employment status (long-term unemployed, new hires, employer size) is more effective as it avoids stigmatizing certain job seekers and minimizes the scope for substitution effects[5] . Also, women's participation in the labor force is influenced by a number of additional factors, including the availability of affordable childcare, use of flexible work arrangements, and cultural preferences. In line with these findings, targeted tax cuts introduced in Hungary seem to have been more effective in generating employment for the young and the elderly, while the impact on female and long-term unemployed has been less pronounced. Moreover, the employment impact on the low-skilled is biased by the influence of public works program.

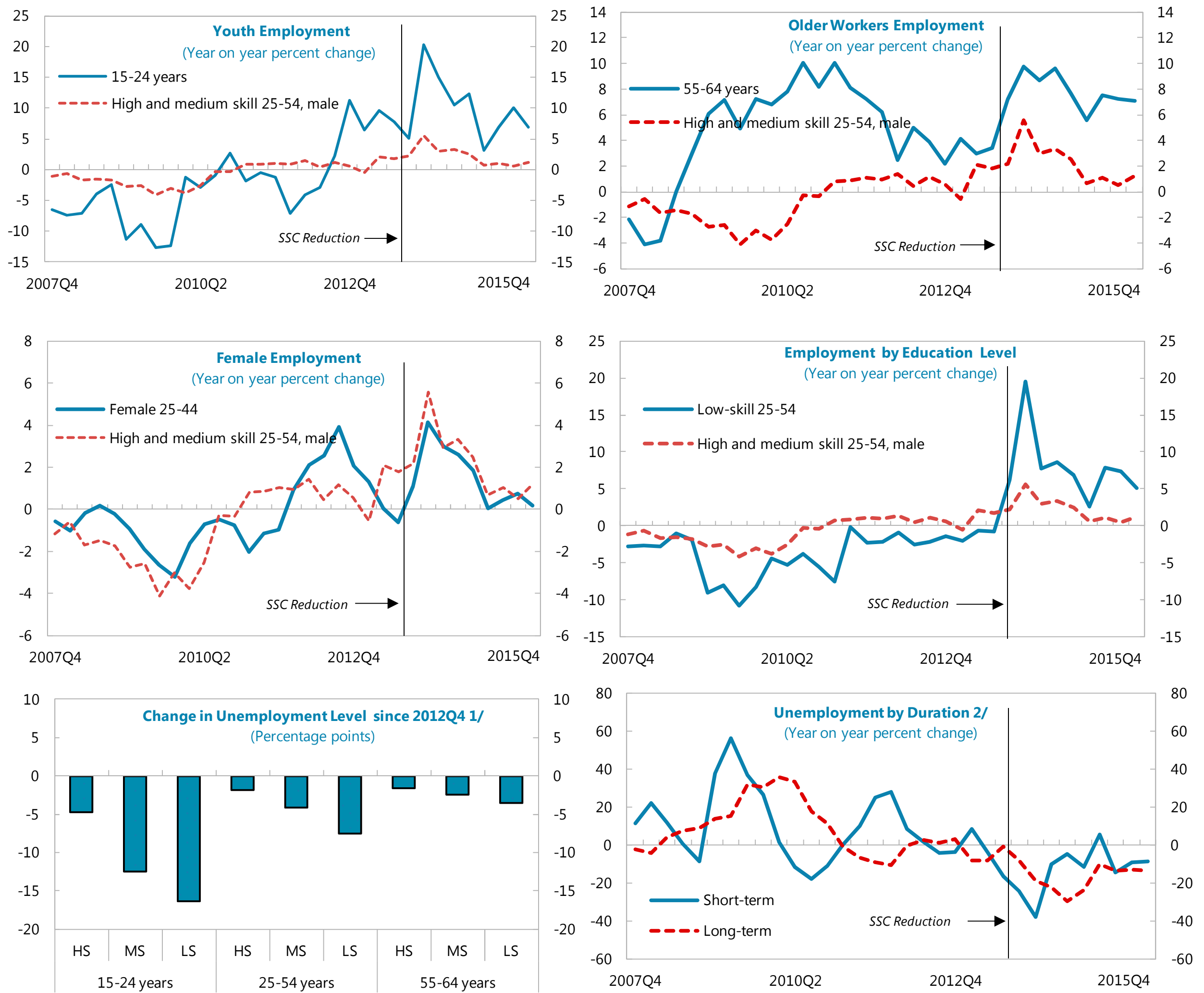
[4] Those with less than primary, primary and lower secondary education (ISCED 11 levels 0-2).
[5] See Crepon and Desplatz (2001) and Kramarz and Philippon (2001).

9. Current policies could be refined to improve their cost efficiency. The implemented measures target a very wide range of employees by international comparison: around 25 percent of the work force is eligible for a SSC cut under the JPAP. The authorities estimate the short-term fiscal costs (i.e., the reduction in the wage costs in the private sector) at 0.4 percent of GDP annually.[6] The net costs could be lower due to the increase in employment but the medium-term fiscal cost could be higher depending on the balances of the social security funds. In order to increase cost effectiveness, eligibility could be narrowed to the groups for which tax cuts had a high impact on employment, while the saved resources could be redirected towards additional labor market measures, such as higher spending on active labor market policies.

10. A set of complementary measures could be considered to address the remaining weaknesses in the labor market. The tax wage for low-income earners remains high even after the SSC cuts, and unemployment levels for the young and low-skilled are almost three times higher than the average unemployment rate. A number of measures could be considered to further promote employment in vulnerable groups, including introducing differentiated minimum wages, broadening the definition of eligible skilled workers from the currently narrowly defined group. This should be accompanied by additional supply-side measures, such as better monitoring of the disability system and the eligibility criteria for unemployment and social benefits. Moreover, demand-pull measures, including apprenticeship programs and vocational education, and strengthened training components could help boost employment. For the long-term unemployed, labor market policies providing training and placement services to these groups have shown to be a more effective instrument than the tax cuts. For the young, better skills matching through improved cooperation between the universities and employers could also have high payoffs.

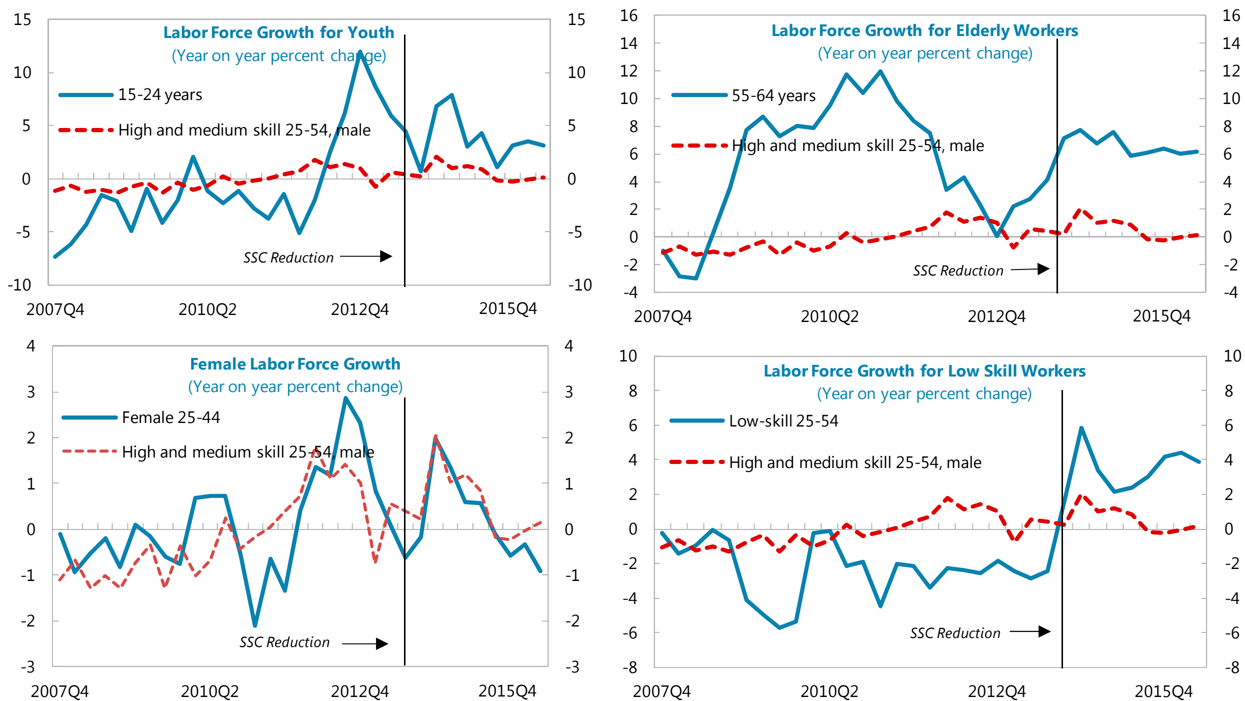
[6] Convergence Programs of Hungary 2014-2017 and 2015-2018.

Figure 4. Employment in Groups with Reduced SSC Rate



Sources: Eurostat and IMF staff calculations.
1/ HS refers to tertiary education and LS to less than primary education.
2/ Short-term is less than 6 months; Long-term is 6 months and over.

Figure 5. Labor Force Participation in Groups with Reduced SSC Rate



Sources: Eurostat and IMF staff calculations.

Annex V. Hungary: Debt Sustainability Analysis

Hungary's high public and external debt and financing needs, together with still heavy, though declining, reliance on nonresident funding, remain important sources of vulnerability. Under the baseline scenario, public debt is projected to decline but will remain around 70 percent of GDP while gross financing needs are forecast to decline to around 11 percent of GDP. Public debt sustainability is subject to considerable risks, particularly from lower GDP growth. External debt is expected to continue to decline, with all sectors except for the government continuing to make net repayments. The projected downward path is sensitive mainly to current account shocks.

In the absence of credible fiscal reforms, the public debt-to-GDP ratio would decline modestly to just below 70 percent of GDP over the medium-term. The baseline scenario comprises a primary surplus of around 1 percent of GDP; the effective interest rate declining in 2016 and 2017 and gradually rising afterwards in line with global WEO assumptions, a decline in the share of short-term debt in line with the authorities' debt strategy; and medium-term output growth at 2 percent. The scenario also assumes that financial markets remain accessible and there are no significant interest rate spikes.

Risks from the public debt profile are declining; however, the debt level and financing needs remain elevated. The share of public debt held by non-residents and that denominated in foreign currency declined last year due to the "self-financing" program and are expected to decline further in the medium-term.[1] Notwithstanding these welcome developments, with the public debt stock at 75.3 percent of GDP and gross financing needs at around 20 percent of GDP, Hungary remains vulnerable to negative shocks. Possible shocks include an increase in sovereign spreads through contagion effects from other emerging economies, exchange rate depreciation, reduced appetite by international investors, and an increase in global interest rates in line with U.S. monetary policy normalization. On the domestic front, risks include possible shocks to the debt trajectory from growing contingent liabilities of the state, as well as deterioration in the primary fiscal balance from expenditure overruns, inefficient SOEs, and delays in the public administration reform. Based on historical volatility, probabilistic analysis of debt dynamics indicates that public debt could enter an increasing trajectory with a probability of 20 percent.

Hungary's external debt has declined in recent years but remains high. Gross external debt has declined from its peak of 149 percent of GDP in 2009 to about 109 percent by end-2015. The improvement reflects heavy bank deleveraging that began during the global financial crisis and continued till recently, and the FX household loan conversion. Intra-company loans related to FDI remain broadly stable, amounting to about 24 percent of gross debt throughout this period, although they have been trending upward in recent years from 25 percent of gross debt in 2013

[1] The self-financing program so far did not have any adverse impact on the average debt maturity or effective interest rates. Debt maturity increased slightly in 2015 due to the smaller share of T-bill issuance, while domestic interest rates remain at historical lows at levels close to yields on Hungarian Eurobonds.

to 31 percent in 2015. Going forward, external debt is expected to continue to decline, with all sectors except for the government continuing to make net repayments. The FX conversion and MNB's self-financing program (to reduce the stock of HUF-denominated securities held by nonresidents) are expected to keep external debt on a declining path over the medium term.

External debt remains sustainable under a range of shocks. Staff analysis shows that external debt is particularly vulnerable to current account shocks, and to a lesser extent, to a growth shock. An adverse permanent current account (growth) shock of ½ standard deviation of their historical variation would add about 14 (7) percentage points of GDP to external debt; while a one-time real depreciation of 30 percent would add 7 percentage points of GDP to external debt.

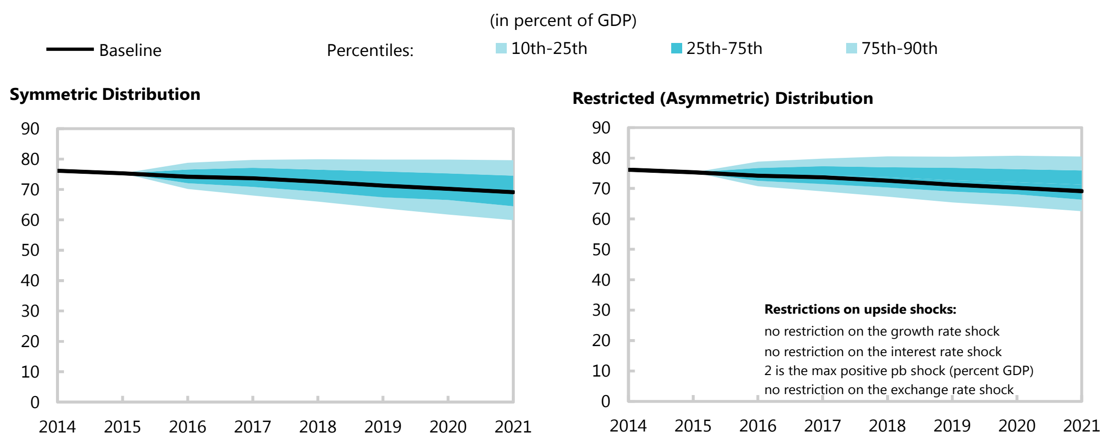
Hungary Public DSA Risk Assessment

Heat Map

Debt level [1/]	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability shock
Gross financing needs [2/]	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability Shock
Debt profile [3/]	Market Perception	External Financing Requirements	Change in the Share of Short-Term Debt	Public Debt Held by Non-Residents	Foreign Currency Debt

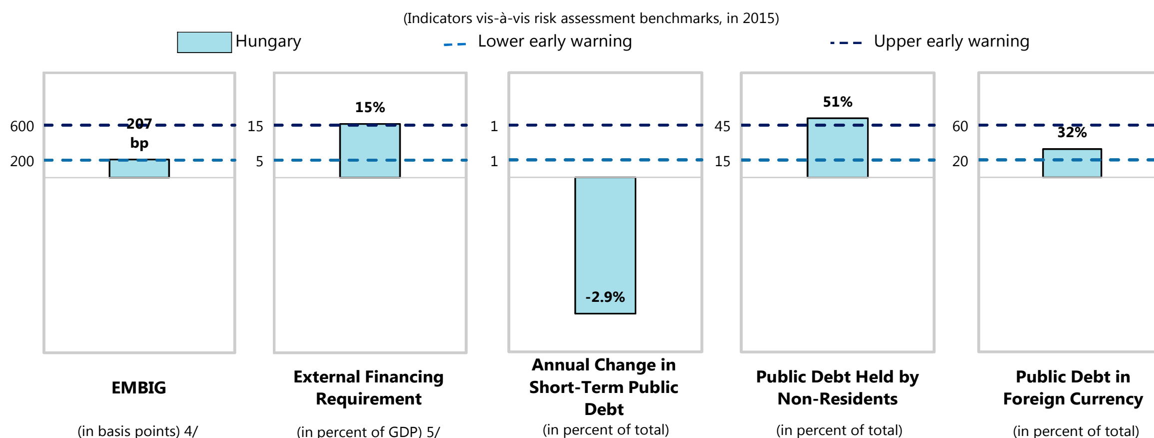
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2015)



Source: IMF staff.

1/ The cell is highlighted in green if debt burden benchmark of 70% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

2/ The cell is highlighted in green if gross financing needs benchmark of 15% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

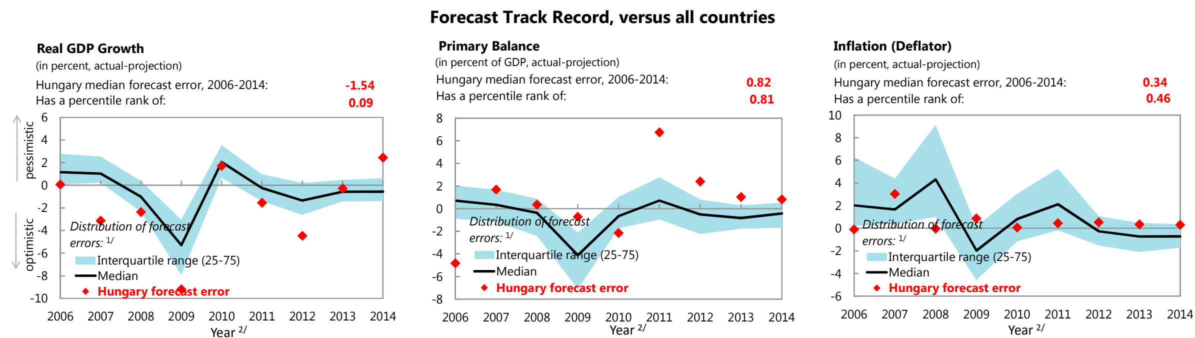
3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, cell is white.
Lower and upper risk-assessment benchmarks are:

200 and 600 basis points for bond spreads; 5 and 15 percent of GDP for external financing requirement; 0.5 and 1 percent for change in the share of short-term debt; 15 and 45 percent for the public debt held by non-residents; and 20 and 60 percent for the share of foreign-currency denominated debt.

4/ EMBIG, an average over the last 3 months, 4-Dec-15 through 7-Mar-16.

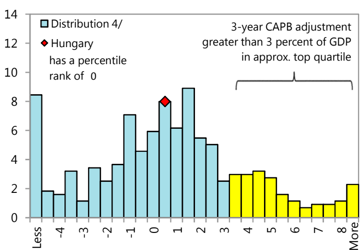
5/ External financing requirement is defined as the sum of current account deficit, amortization of medium and long-term total external debt, and short-term total external debt at the end of previous period.

Hungary Public DSA – Realism of Baseline Assumptions

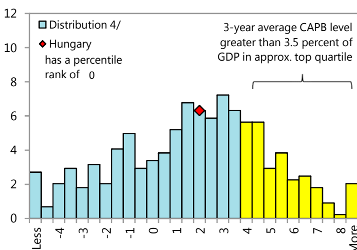


Assessing the Realism of Projected Fiscal Adjustment

3-Year Adjustment in Cyclically-Adjusted Primary Balance (CAPB)
(Percent of GDP)

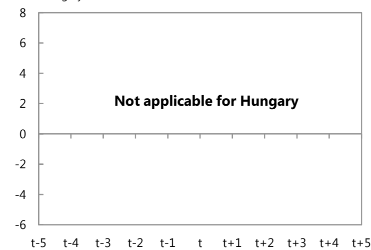


3-Year Average Level of Cyclically-Adjusted Primary Balance (CAPB)
(Percent of GDP)



Boom-Bust Analysis 3/

Real GDP growth
(in percent)
Hungary



Source : IMF Staff.
1/ Plotted distribution includes all countries, percentile rank refers to all countries.
2/ Projections made in the spring WEO vintage of the preceding year.
3/ Not applicable for Hungary, as it meets neither the positive output gap criterion nor the private credit growth criterion.
4/ Data cover annual observations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

Hungary Public Sector Debt Sustainability Analysis (DSA) – Baseline Scenario

(in percent of GDP unless otherwise indicated)

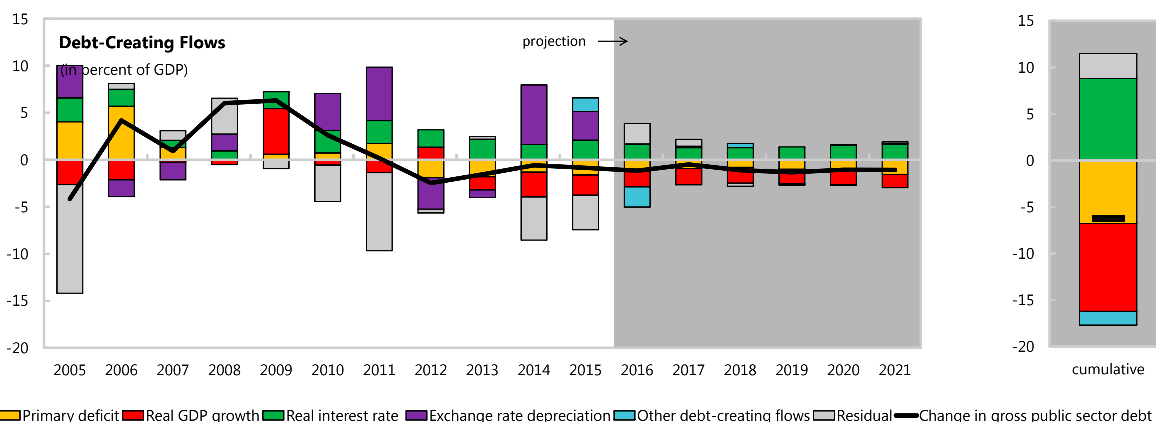
Debt, Economic and Market Indicators [1/]

	Actual			Projections					
	2005-2013 [2/]	2014	2015	2016	2017	2018	2019	2020	2021
Nominal gross public debt	73.0	76.2	75.3	74.2	73.7	72.6	71.3	70.2	69.1
Public gross financing needs	22.7	21.9	21.4	17.8	14.3	18.1	17.9	21.5	17.2
Real GDP growth (in percent)	0.6	3.7	2.9	2.3	2.5	2.4	2.2	2.1	2.1
Inflation (GDP deflator, in percent)	3.5	3.2	2.0	2.3	2.7	2.7	2.7	2.7	2.7
Nominal GDP growth (in percent)	4.1	7.0	4.8	4.4	5.0	5.2	5.0	4.9	4.9
Effective interest rate (in percent) [4/]	6.2	5.6	4.9	4.7	4.6	4.6	4.7	5.0	5.2

As of March 07, 2016		
Sovereign Spreads		
EMBIG (bp) 3/		209
5Y CDS (bp)		164
Ratings	Foreign	Local
Moody's	Ba1	Ba1
S&Ps	BB+	BB+
Fitch	BB+	BBB-

Contribution to Changes in Public Debt

	Actual			Projections							
	2005-2013	2014	2015	2016	2017	2018	2019	2020	2021	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	1.3	-0.6	-0.9	-1.2	-0.5	-1.1	-1.3	-1.1	-1.1	-6.2	
Identified debt-creating flows	3.5	4.0	2.8	-3.3	-1.2	-0.8	-1.2	-1.2	-1.2	-8.9	
Primary deficit	1.2	-1.3	-1.6	-1.2	-0.9	-0.8	-1.0	-1.2	-1.6	-6.8	0.3
Primary (noninterest) revenue and grants	44.4	47.2	48.8	44.6	44.8	44.6	44.5	44.5	44.1	267.1	
Primary (noninterest) expenditure	45.6	45.8	47.1	43.3	43.9	43.8	43.5	43.2	42.5	260.4	
Automatic debt dynamics [5/]	2.3	5.3	3.0	0.0	-0.4	-0.4	-0.2	0.1	0.3	-0.6	
Interest rate/growth differential [6/]	1.6	-1.0	0.0	0.0	-0.4	-0.4	-0.2	0.1	0.3	-0.6	
Of which: real interest rate	1.9	1.6	2.1	1.7	1.3	1.3	1.4	1.5	1.7	8.8	
Of which: real GDP growth	-0.3	-2.6	-2.1	-1.7	-1.7	-1.7	-1.5	-1.4	-1.4	-9.4	
Exchange rate depreciation [7/]	0.8	6.3	3.1	…	…	…	…	…	…	…	
Other identified debt-creating flows	0.0	0.0	1.5	-2.1	0.2	0.4	0.0	0.0	0.1	-1.5	
Privatization/Drawdown of deposits (negative)	0.0	0.0	1.5	-1.4	0.0	0.0	0.0	0.0	0.0	-1.4	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other debt-creating flows and adjustments	0.0	0.0	0.0	-0.7	0.2	0.4	0.0	0.0	0.1	-0.1	
Residual, including asset changes [8/]	-2.2	-4.6	-3.7	2.2	0.7	-0.3	-0.1	0.1	0.2	2.7	



Source: IMF staff.

1/ Public sector is defined as general government.

2/ Based on available data.

3/ EMBIG.

4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.

5/ Derived as [(r - π(1+g) - g + ae(1+r)]/(1+g+π+gπ)) times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

6/ The real interest rate contribution is derived from the numerator in footnote 5 as r - π (1+g) and the real growth contribution as -g.

7/ The exchange rate contribution is derived from the numerator in footnote 5 as ae(1+r).

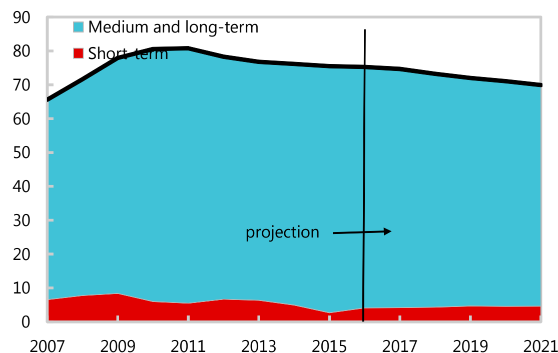
8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

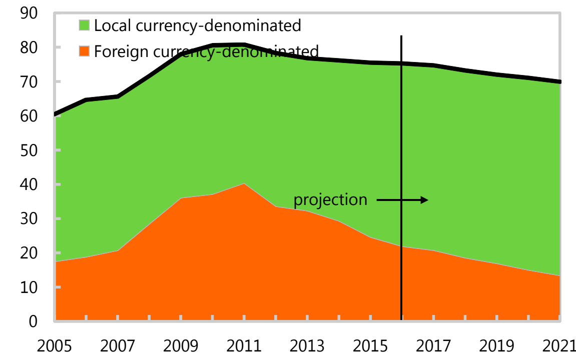
Hungary Public DSA – Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

By Maturity
(in percent of GDP)



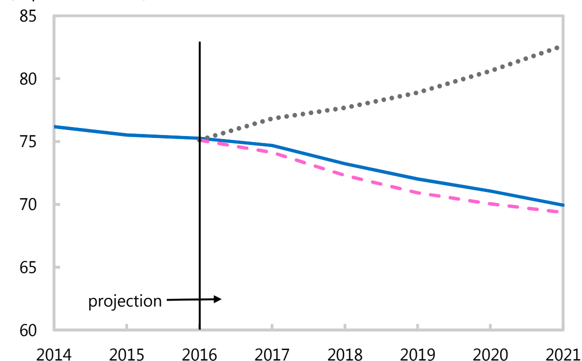
By Currency
(in percent of GDP)



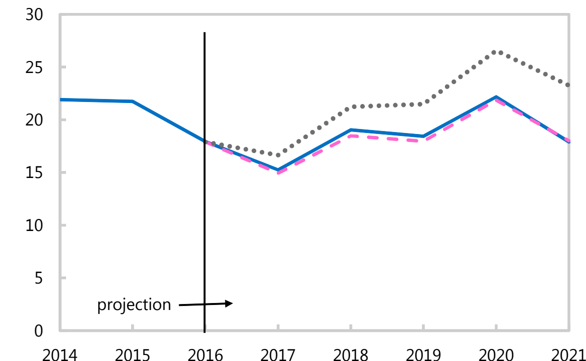
Alternative Scenarios

Baseline — Historical — Constant Primary Balance

Gross Nominal Public Debt
(in percent of GDP)



Public Gross Financing Needs
(in percent of GDP)



Underlying Assumptions
(in percent)

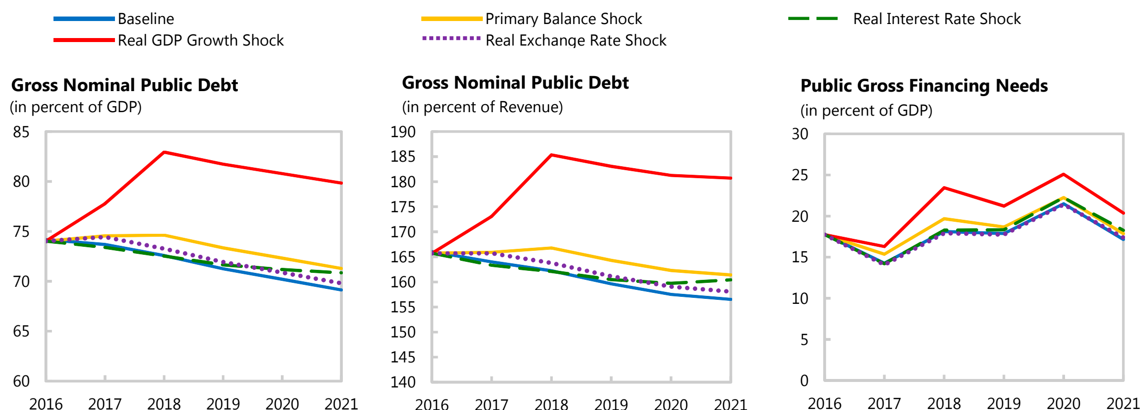
Baseline Scenario	2016	2017	2018	2019	2020	2021
Real GDP growth	2.3	2.5	2.4	2.2	2.1	2.1
Inflation	2.3	2.7	2.7	2.7	2.7	2.7
Primary Balance	1.1	0.8	0.7	0.9	1.2	1.5
Effective interest rate	4.7	4.5	4.6	4.7	5.0	5.2
Constant Primary Balance Scenario						
Real GDP growth	2.3	2.5	2.4	2.2	2.1	2.1
Inflation	2.3	2.7	2.7	2.7	2.7	2.7
Primary Balance	1.1	1.1	1.1	1.1	1.1	1.1
Effective interest rate	4.7	4.5	4.6	4.7	5.0	5.2

Historical Scenario	2016	2017	2018	2019	2020	2021
Real GDP growth	2.3	0.8	0.8	0.8	0.8	0.8
Inflation	2.3	2.7	2.7	2.7	2.7	2.7
Primary Balance	1.1	-0.4	-0.4	-0.4	-0.4	-0.4
Effective interest rate	4.7	4.5	4.6	4.8	5.1	5.4

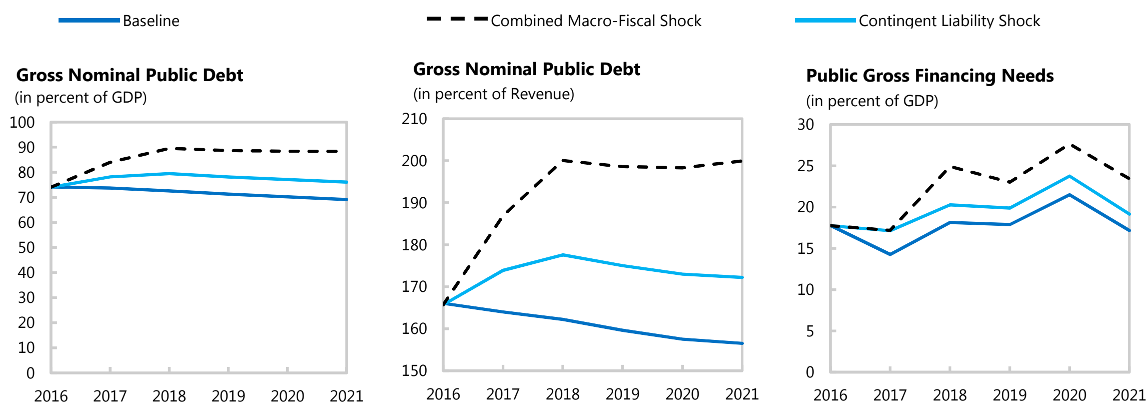
Source: IMF staff.

Hungary Public DSA – Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions
(in percent)

Primary Balance Shock	2016	2017	2018	2019	2020	2021
Real GDP growth	2.3	2.5	2.4	2.2	2.1	2.1
Inflation	2.3	2.7	2.7	2.7	2.7	2.7
Primary balance	1.2	-0.2	-0.4	1.0	1.2	1.6
Effective interest rate	4.7	4.6	4.6	4.8	5.0	5.3
Real Interest Rate Shock						
Real GDP growth	2.3	2.5	2.4	2.2	2.1	2.1
Inflation	2.3	2.7	2.7	2.7	2.7	2.7
Primary balance	1.2	0.9	0.8	1.0	1.2	1.6
Effective interest rate	4.7	4.6	4.9	5.4	5.9	6.3
Combined Shock						
Real GDP growth	2.3	-0.6	-0.7	2.2	2.1	2.1
Inflation	2.3	1.9	1.9	2.7	2.7	2.7
Primary balance	1.2	-0.6	-2.5	1.0	1.2	1.6
Effective interest rate	4.7	5.0	4.9	5.4	5.8	6.3

Real GDP Growth Shock	2016	2017	2018	2019	2020	2021
Real GDP growth	2.3	-0.6	-0.7	2.2	2.1	2.1
Inflation	2.3	1.9	1.9	2.7	2.7	2.7
Primary balance	1.2	-0.6	-2.5	1.0	1.2	1.6
Effective interest rate	4.7	4.6	4.6	4.9	5.1	5.3
Real Exchange Rate Shock						
Real GDP growth	2.3	2.5	2.4	2.2	2.1	2.1
Inflation	2.3	9.4	2.7	2.7	2.7	2.7
Primary balance	1.2	0.9	0.8	1.0	1.2	1.6
Effective interest rate	4.7	5.0	4.6	4.7	5.0	5.2
Contingent Liability Shock						
Real GDP growth	2.3	-0.6	-0.7	2.2	2.1	2.1
Inflation	2.3	2.7	2.7	2.7	2.7	2.7
Primary balance	1.2	-1.1	0.8	1.0	1.2	1.6
Effective interest rate	4.7	5.2	4.7	4.8	5.0	5.2

Source: IMF staff.

Hungary: External Debt Sustainability Framework, 2010–2021
(In percent of GDP, unless otherwise indicated)

		Actual														
		2010	2011	2012	2013	2014	2015			2016	2017	2018	2019	2020	2021	Debt-stabilizing non-interest current account 6/
1	**Baseline: External debt**	143.1	134.4	129.0	118.4	114.8	**108.8**			**103.4**	**96.3**	**86.4**	**79.4**	**72.2**	**68.1**	**2.7**
2	Change in external debt	-5.6	-8.7	-5.3	-10.6	-3.6	-5.9			-5.4	-7.1	-9.9	-7.0	-7.2	-4.1	
3	Identified external debt-creating flows (4+8+9)	-1.7	-11.1	5.6	-12.0	-9.3	-8.1			-8.0	-8.5	-7.2	-5.6	-5.0	-3.9	
4	Current account deficit, excluding interest payments	-5.3	-6.1	-7.3	-8.4	-5.8	-7.6			-6.2	-6.4	-5.5	-4.5	-3.5	-2.7	
5	Deficit in balance of goods and services	-5.4	-6.2	-6.8	-7.3	-7.1	-8.6			-9.5	-8.9	-8.0	-6.9	-6.0	-5.0	
6	Exports	82.2	87.2	86.9	88.0	89.5	92.1			96.1	101.7	104.0	105.8	108.8	111.0	
7	Imports	76.9	81.0	80.1	80.7	82.3	83.5			86.5	92.8	96.1	98.9	102.8	106.0	
8	Net non-debt creating capital inflows (negative)	-0.5	-1.1	-2.7	-1.2	-2.6	-0.5			-0.6	-1.4	-1.1	-0.7	-1.2	-1.0	
9	Automatic debt dynamics 1/	4.0	-3.9	15.5	-2.5	-1.0	0.0			-1.3	-0.7	-0.6	-0.3	-0.3	-0.2	
10	Contribution from nominal interest rate	5.2	5.1	6.0	4.3	3.8	3.8			1.3	1.8	1.6	1.5	1.3	1.2	
11	Contribution from real GDP growth	-1.1	-2.3	2.5	-2.3	-4.2	-3.9			-2.6	-2.5	-2.2	-1.8	-1.6	-1.5	
12	Contribution from price and exchange rate changes 2/	-0.1	-6.7	7.1	-4.4	-0.5	...			...	...	...	...	...	...	
13	Residual, incl. change in gross foreign assets (2-3) 3/	-3.8	2.5	-10.9	1.4	5.7	2.1			2.6	1.4	-2.7	-1.4	-2.2	-0.2	
	External debt-to-exports ratio (in percent)	174.0	154.1	148.4	134.6	128.3	118.2			107.7	94.7	83.0	75.0	66.4	61.4	
	Gross external financing need (in billions of Euros) 4/	39.3	44.2	40.6	33.3	32.3	26.2			19.6	14.6	13.6	12.1	15.8	13.8	
	in percent of GDP	40.0	43.9	41.1	32.9	30.9	24.1	10-Year	10-Year	18.5	13.6	12.1	10.3	13.1	11.1	
	Scenario with key variables at their historical averages 5/						**108.8**			**104.3**	**103.6**	**100.9**	**100.1**	**97.1**	**95.6**	**1.0**
								Historical	Standard							
	Key Macroeconomic Assumptions Underlying Baseline							Average	Deviation							
	Real GDP growth (in percent)	0.7	1.8	-1.7	1.9	3.7	2.9	0.8	3.1	2.3	2.5	2.4	2.2	2.1	2.1	
	GDP deflator in Euros (change in percent)	-0.5	5.7	-7.6	3.7	-0.7	-15.3	0.5	10.8	-4.6	-0.4	2.2	2.7	1.8	0.9	
	Nominal external interest rate (in percent)	3.5	3.9	4.0	3.5	3.3	2.9	3.9	0.7	1.2	1.8	1.7	1.8	1.7	1.8	
	Growth of exports (Euro terms, in percent)	15.2	8.7	-2.1	3.5	4.7	7.4	6.2	10.5	1.6	7.2	6.9	6.3	6.2	5.3	
	Growth of imports (Euro terms, in percent)	13.8	8.1	-2.9	3.0	5.1	5.9	5.1	11.2	1.0	8.6	8.2	7.6	7.4	6.4	
	Current account balance, excluding interest payments	5.3	6.1	7.3	8.4	5.8	7.6	3.6	4.7	6.2	6.4	5.5	4.5	3.5	2.7	
	Net non-debt creating capital inflows	0.5	1.1	2.7	1.2	2.6	0.5	1.0	1.9	0.6	1.4	1.1	0.7	1.2	1.0	

1/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as [-r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock. r increases with an appreciating domestic currency (e > 0) and rising inflation (based on GDP deflator).

3/ For projection, line includes the impact of price and exchange rate changes.

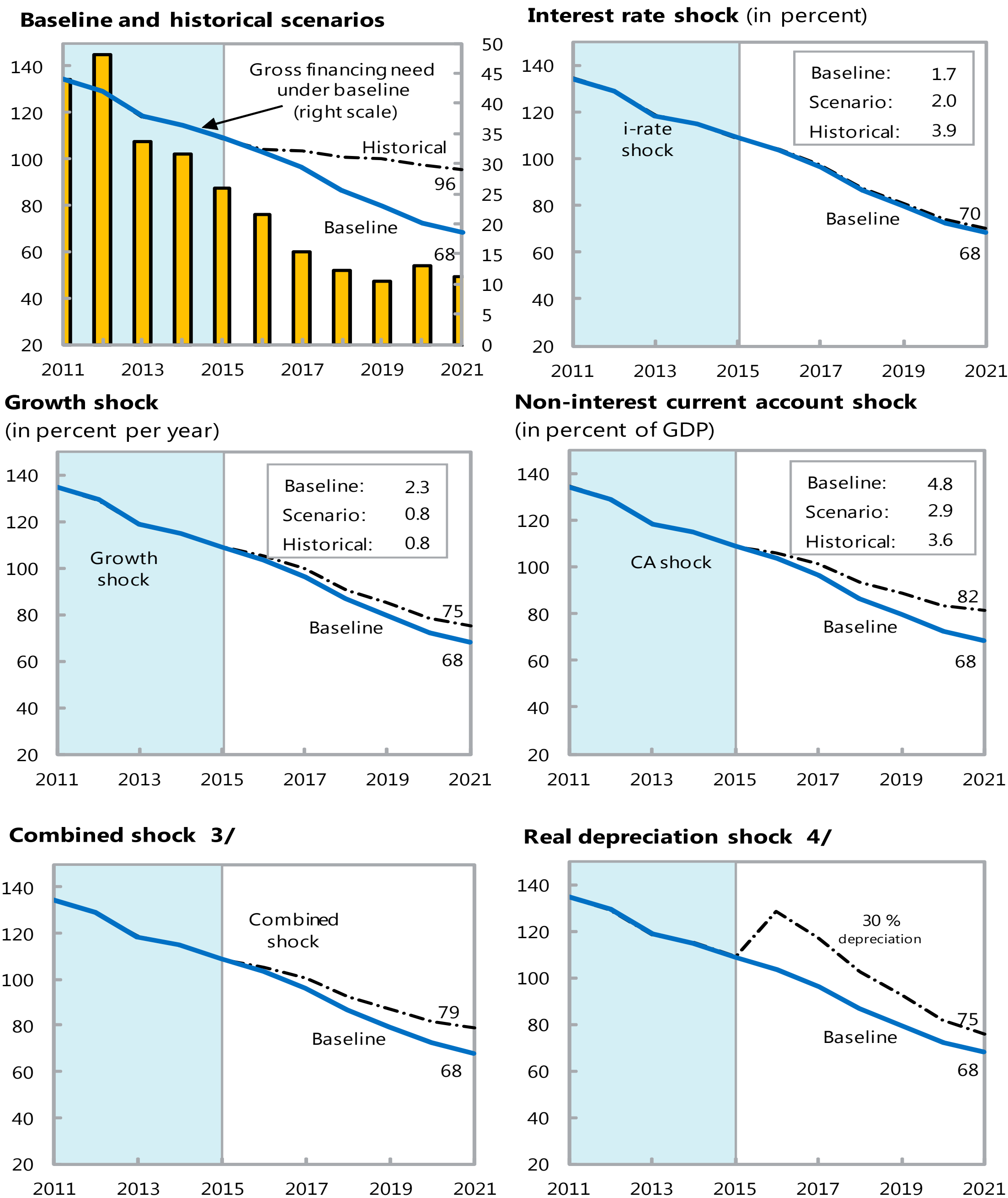
4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Figure 1. Hungary: External Debt Sustainability: Bound Tests 1/ 2/

(External debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.
3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
4/ One-time real depreciation of 30 percent occurs in 2016.

INTERNATIONAL MONETARY FUND

HUNGARY

April 6, 2016

STAFF REPORT FOR THE 2016 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Prepared By

European Department
(In Consultation with Other Departments)

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FUND RELATIONS

(As of February 29, 2016)

Membership Status: Joined on May 6, 1982; Article VIII.

General Resources Account:

	SDR Million	Percent Quota
Quota	1940.00	100.00
Fund holdings of currency (Holdings Rate)	1640.76	84.58
Reserve tranche position	299.24	15.42

SDR Department:

	SDR Million	Percent Allocation
Net cumulative allocation	991.05	100.00
Holdings	12.24	1.24

Outstanding Purchases and Loans: None

Latest Financial Arrangements:

Type	Date of Arrangement	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
Stand-By	Nov 6, 2008	Oct 5, 2010	10,537.50	7,637.00
Stand-By	Mar 15, 1996	Feb 14, 1998	264.18	0.00
Stand-By	Sep 15, 1993	Dec 14, 1994	340.00	56.70

Projected Payments to Fund:

(SDR million; based on existing use of resources and present holdings of SDRs)

	Forthcoming				
	2016	2017	2018	2019	2020
Principal					
Charges/Interest	0.45	0.60	0.60	0.60	0.60
Total	0.45	0.60	0.60	0.60	0.60

Current Status of Safeguards Assessment:

The safeguards assessment of the Magyar Nemzeti Bank (MNB) was finalized on January 28, 2009. The assessment found that the central bank had a relatively strong safeguards framework in place. The MNB's control environment was well established, and the audit and financial reporting practices adhered to international standards. The assessment recommended measures to improve the process of program data reporting to the Fund and to strengthen audit oversight, especially over the central bank's basic tasks. In recent years the central bank law was subject to numerous changes. Going

forward, it is critical to avoid undue changes to the MNB's legal framework and to ensure that the law continues to support MNB's operational and legal independence.

Exchange Rate Arrangements:

The Hungarian forint is classified as floating, effective November 1, 2008. Hungary has accepted the obligations of Article VIII and maintains an exchange rate system free of restrictions on the making of payments and transfers on current international transactions except for those maintained solely for the preservation of national or international security and that have been notified to the Fund pursuant to Executive Board Decision No. 144-(52/51). Effective February 27, 2012, the MNB discontinued the program of foreign exchange sale tenders, which involved multiple exchange rates for spot transactions.

Article IV Consultation:

Hungary is on a 12-month consultation cycle. The last Article IV Board discussion took place on March 27, 2015. The associated Executive Board assessment is available at http://www.imf.org/external/np/sec/pr/2015/pr15156.htm and the staff report at http://www.imf.org/external/pubs/cat/longres.aspx?sk=42828.0

Technical Assistance:

The table below summarizes the technical assistance missions provided by the Fund to Hungary.

HUNGARY: TECHNICAL ASSISTANCE FROM THE FUND, FY2010–2015

Department	Purpose	Date
MCM	Banking Supervision	June 2009
LEG	Bank Resolution Framework	September 2009
FAD	Expenditure policy	October 2009
MCM	Monetary Policy	February 2010
FAD	Expenditure Policy	June 2010
MCM	Financial Stability	July 2010
FAD	Tax Policy	September 2010
MCM	Financial Stability	November 2010
MCM	Monetary and Foreign Exchange Policy	June 2011
FAD	Fiscal Federalism	October 2011
MCM	Monetary and Foreign Exchange Policy	November 2011
LEG	VAT Fraud and Anti-Money Laundering Activities	January 2013
LEG	Bank Resolution and Crisis Management	November 2013
MCM	Operational Aspects of Establishing an Asset Management Company	January 2015 and June 2015
FAD	Workshop on Revenue Forecasting and Micro-simulation Analysis	January 2016

Resident Representative:
The resident representative office closed on December 31, 2013.

STATISTICAL ISSUES

Assessment of Data Adequacy for Surveillance

- **General**: Data provision is adequate for surveillance.

- **Government Finance Statistics**: Data reporting on fiscal accounting needs to be improved further. The monthly cash-basis accounts of the central government prepared by the Ministry of National Economy do not reflect the GFS presentation and provide no information on financing. This complicates staff's ability to analyze trends and to appropriately anticipate the impact on general government accounts. Data on revenue and expenditure arrears as well as that on local government revenues and expenditures, and financial statements of state-owned enterprises has been readily provided by the authorities upon request, but provision of this data on an automatic basis would facilitate the monitoring of obligations on an accrual basis and allow for closer regular monitoring of the general government.

Data Standards and Quality

- Subscriber to the Fund's Special Data Dissemination Standard (SDDS) since May, 1996.

- Hungary published its original ROSC Data Module in 2001 and updates are available on the IMF internet web site. The latest update is Hungary: Report on the Observance of Standards and Codes—Data Module, 2004 Update (July 2004).

Hungary: Table of Common Indicators Required for Surveillance as of March 11, 2016

	Date of latest observation	Date received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of publication[7]	Memo Items:	
						Data Quality – Methodological soundness[8]	Data Quality Accuracy and reliability[9]
Exchange Rates	2/29/2016	3/2/2016	D and M	D and M	D and M		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	January 2016	2/29/2016	M	M	M		
Reserve/Base Money	January 2016	2/29/2016	M	M	M	O,O,LO,LO	O,O,O,O,LO
Broad Money	January 2016	2/29/2016	M	M	M		
Central Bank Balance Sheet	January 2016	2/12/2016	M	M	M		
Consolidated Balance Sheet of the Banking System	January 2016	2/29/2016	M	M	M		
Interest Rates[2]	January 2016	2/29/2016	M	M	M		
Consumer Price Index	February2016	3/11/2016	M	M	M	O,O,O,O	O,O,O,O,NA
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Q3 2015	1/6/2016	Q	Q	Q	O,LNO,LO,O	LO,O,O,O,NA
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	February 2016	3/7/2016	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	January 2016	2/19/2016	M	M	M		
External Current Account Balance	Q3 2015	12/31/2015	Q	Q	Q	O,LO,LO,LO	O,O,O,O,NA
Exports and Imports of Goods and Services	Q3 2015	12/31/2015	Q	Q	Q		
GDP/GNP	Q4 2015	3/8/2016	Q	Q	Q	O,O,O,LO	O,LO,O,O,NA
Gross External Debt	Q3 2015	12/31/2015	Q	Q	Q		
International investment Position [6]	Q3 2015	12/31/2015	Q	Q	Q		

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Includes external gross financial asset and liability positions vis-à-vis nonresidents.
[7] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A); Irregular (I); Not Available (NA).
[8] Reflects the assessment provided in the data ROSC and Substantive Update published in May 2001 and July 2004, respectively, and based on the findings of the respective missions that took place during January 2001 and January 2004 for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning (respectively) concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O), largely observed (LO), largely not observed (LNO), or not observed (NO).
[9] Same as footnote 8, except referring to international standards concerning (respectively) source data, statistical techniques, assessment and validation of source data, assessment and validation of intermediate data and statistical outputs, and revision studies.

Statement by Szilard Benk, Alternate Executive Director for Hungary
April 22, 2016

Since the last Article IV consultation, the Hungarian economy has continued to grow on a balanced path. The economic rebalancing has been backed by prudent and supportive policies that have led to a strengthening external balance, stable fiscal balance, and gradually declining public debt, and consequently, to substantially declining vulnerabilities.

Economic developments and outlook

The economy has been growing at a robust pace, at a rate close to 3 percent in 2015. Growth has been driven both by domestic demand and net exports. The current account has continued to widen as exports accelerated further, partly on the back of the favorable external environment and new production lines, while the terms of trade also improved, mainly due to lower commodity prices. Unemployment continued to decline below pre-crisis levels on the account of the accelerating private sector job creation and continuing public works, and despite the increasing labor force participation. Headline inflation remained suppressed by the falling oil prices and the still-negative output gap.

Going forward, the growth momentum is expected to continue, temporarily restrained somewhat by the weaker inflow of EU funds. Household consumption and domestic demand will continue to accelerate on the back of favorable income developments, repaired household balance sheets, and increased consumer confidence, as well as the pickup in housing investment and lending. On the corporate side, the Growth-Supporting Program will stimulate lending and investment. Nevertheless, despite the solid employment growth, nominal wages are expected to increase only gradually as inflation expectations remain contained.

A number of government measures are further supporting growth from 2016 onward. The extended Family Housing Support Program (CSOK) and the VAT reduction on dwellings will add to the investment activity of the private sector. The Irinyi Plan, the new industrial strategy in line with the reindustrialization policy of the European Union, focuses on promoting innovation and key enabling technologies, also supporting more productive sectors with higher value added. The tax reductions and allowances generate additional income for households and corporations. The substantial cut in the banking tax also promotes the pick-up of credit supply and supports financial stability.

The authorities assess the risks around the outlook as more balanced than in staff's view. External vulnerabilities are considerably lessening as the share of FX-denominated bonds have significantly dropped and the nonresident holdings of public debt has been on a firmly declining trend, also aided by the self-financing program; the composition of the foreign investor base shifted towards more stable, real money players; and the foreign liabilities of the banks have

been reduced substantially by the large scale and timely conversion of the Swiss franc-dominated household FX loans.

Fiscal Policy and Debt

The public debt-to-GDP ratio has been on a declining trend since 2011, moderating to 75.3 percent by the end of 2015, notwithstanding the one-off items related to asset purchases and the need to pre-finance some EU-related projects. The composition of the debt has been shifting to a more healthy structure, with a firmly declining share of FX-denominated securities, owing to the debt financing strategy to refinance maturing FX debt with domestic currency-denominated debt (except a small issuance in renminbi in April 2016). In addition, the central bank's self-financing program shifted the incentive of holding government securities from non-resident investors to the domestic banks, thus aiding the decline of non-resident holdings of public debt. Domestic households increased further their bond holdings as well.

The authorities are committed to conducting prudent fiscal policies compatible with sustainable debt reduction, and to adhering to national and European fiscal rules. Fiscal discipline and rigorous budget execution, coupled with revenue over-performance, ensured that the 2012, 2013, 2014, and also the 2015 deficits over-performed relative to the initial targets. The 2015 deficit stood at 1.9 percent on the background of the good macro performance, and improvements in tax administration and tax compliance. The installation of online cash registers and the electronic trade and transport control system proved to be especially helpful in increasing VAT collection, fostering the whitening of the economy and tackling fraud.

The 2016 budget targets a 2.0 percent deficit. It incorporates a series of measures that strike the right balance between the efforts to reduce debt further and support growth: a 1-percentage point reduction in the personal income tax rate, higher tax allowance for families with two children, halving the bank levy, and a support scheme for new housing investments. The budget plans for 2017 will continue to follow a strategy with adhering to a declining public debt, while rationalizing and prioritizing public expenditure to leave space for high-return spending on investment in infrastructure and in human capital.

Monetary Policy

Monetary policy has been accommodative. After pausing the easing cycle in July 2015, the central bank (MNB) again cut the policy rate by 15 basis points to 1.20 percent in its March meeting, and narrowed the interest rate corridor in an asymmetric way, and unprecedentedly reduced the overnight deposit rate into negative territories. Amid the historically low level of inflation expectations, the MNB stands ready to use every instrument at its disposal to contain second-round inflationary effects, and to continue with interest rate cuts if necessary.

After announcing the Self-Financing Program in 2014, the MNB gradually transformed its monetary policy framework over the course of the past two years, with a view to channeling the liquidity of domestic banks to the sovereign bond and private sector securities markets. This included introducing the three-month deposit rate as the new monetary policy tool, phasing out the two-week central bank bill and converting it into two-week deposit, an asymmetric interest rate corridor, changing the system of reserve requirements, and the offering of 3-, 5-, and 10-year interest rate swaps.

The Self-Financing Program has been successful in contributing to the reduction of the external vulnerabilities of the economy. The FX-denominated share of government debt declined from its peak of about 50 percent, to around 30 percent. The share of domestic banks holding government securities now outweighs the share of non-resident holdings. The sovereign yields at the longer end of the yield curve declined to levels identical to those of peer countries with substantially higher sovereign ratings. The program has been unique in its achievement of reducing external vulnerabilities, while at the same time easing the monetary conditions.

The current level of international reserves is adequate by a variety of metrics, and is staying within a comfortable range even after gradually supplying the banking sector with the necessary foreign exchange for the conversion of FX-based mortgage loans. There is no compelling evidence showing that the exchange rate is misaligned.

Financial Sector

The capital positions of the banks are strong and liquidity is ample in the system. The profitability of banks has returned to normal levels. Last year, the government signed a memorandum of understanding with the EBRD, committing to a set of measures intended to increase the profitability and lending capacity of the banking sector. These steps are already tangible or evolving: the levy on credit institution was significantly reduced and is envisaged to be reduced further next year, the contract regarding the sale of the MKB Bank has been signed, and there is intention to privatize the majority equity stakes of Budapest Bank.

A series of measures are further enhancing the resolution framework of non-performing loans. In the household segment, the new Personal Insolvency Law is expected to bear fruit in the coming period. Further allocations to the asset management agency for impaired mortgages, and the recent lifting of the moratorium on foreclosures and evictions are currently strengthening the resolution framework of housing loans. Concerning the corporate segment, the MNB, also building on the Fund’s technical assistance recommendations, established an asset management company (MARK) with the aim of serving as a voluntary and market-based option for the banks for removing distressed commercial real estate assets from their balance sheets. MARK has just started the voluntary registration period after concluding the negotiations with the European Commission on the implementation of the asset acquisition methodology, ensuring that any

transaction would be voluntary and based on market prices without any state aid. The MNB's objective is that in the medium-term MARK would operate entirely by market sources.

To enable the banking system to be more supportive of economic growth, in 2013, the MNB launched the Funding for Growth Scheme, aiming to provide liquidity to credit institutions at a preferential rate to alleviate disruptions in lending and to reverse the vicious credit squeeze/low growth cycle. Limited in size and time, the program is being phased out this year. It has been substituted by the Growth-Supporting Program launched in 2015, which intends to facilitate banks' return to market-based lending and assists bank lending to the small- and medium-sized enterprises (SMEs) with a series of tools.

Structural Reforms

The authorities are continuing with the structural transformations and supply-side measures, intended to address structural bottlenecks and raise Hungary's potential growth. Focusing on promoting private sector activity and improving the business environment, a series of regulatory and administrative changes have been implemented, as follows.

The reorganization of the tax authority towards a more customer-friendly system is under way. The act on the rules of taxation will be recodified in order to make the operations of the tax authority more transparent and decrease the administrative burden of taxpayers, on overall fundamentally changing the relationship between the taxpayers and the tax authority.

Building on the success of previous measures to whiten the economy and promote VAT tax compliance (e.g. online cash registers, Electronic Public Road Trade Control System), additional measures will follow. The mandatory system of online cash registers will be extended to some segments of the service sector. In 2017, an online electronic invoicing system will be introduced to provide real-time data on the invoicing. The government will encourage the use of debit cards by supporting the extension of the number of POS terminals installed with retailers.

More investment funding will be directed for the development of the local economy, especially industrial parks for SMEs, within the framework of the Modern Cities Program.

The public administration reform is under way. It seeks to streamline the government administration agencies and create more efficient structures. The forthcoming review of the civil servants' compensation system will enhance the merit-based nature of the system while containing the wage bill.

The labor market policies are focused on boosting both labor supply and labor demand. The Job Protection Act reduced the tax wedge in a targeted manner for disadvantaged groups with the lowest productivity but with the highest responsiveness to incentives to join the labor market, such as the low-skilled, young, old, long-term unemployed, returning mothers, and career

starters. Its results are already reflected in the continuously rising labor force participation alongside the declining unemployment. The increasing labor force also reflects the transition towards a work-based social security system in which the long-term unemployed have access to public works, facilitating their return to the primary labor market.

Final Remarks

The authorities thank staff for the thorough and constructive discussions during the Article IV mission, and for their valuable advice on macroeconomic policies. They remain committed to prudent policies, focusing their strategy on promoting growth, sustainable debt reduction, increasing labor participation, improving competitiveness, and reducing financial vulnerabilities.