INTERNATIONAL MONETARY FUND

IMF Country Report No. 19/357

HUNGARY

December 2019

2019 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 2019 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 November 27, 2019 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 November 27, 2019, following discussions that ended on October 3, 2019, 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 November 12, 2019.
- An **Informational Annex** prepared by the IMF staff.
- A **Statement by the Executive Director** for Hungary.

The documents listed below have been or will be separately released.

Selected Issues

The IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

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December 5, 2019

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IMF Executive Board Concludes 2019 Article IV Consultation with Hungary

On November 27, 2019, the Executive Board of the International Monetary Fund (IMF) concluded the 2019 Article IV consultation[1] with Hungary.

Over the last decade, Hungary achieved further income convergence at an impressive speed and has become less vulnerable to shocks. In 2018, Hungary was one of the fastest growing economies in Europe. It was largely driven by domestic demand, including record-high EU funds-related investment. The current account surplus has disappeared reflecting the high level of investment-related imports and buoyant consumption. Both headline and core inflation remained within the tolerance band. Public debt continued to declined, and external deleveraging has been even more sizable. Unemployment fell threefold to new historical lows amid a tight labor markets, intensifying wage pressures.

The budget deficit target was met in 2018 due to higher-than-expected VAT collection and lower spending on goods and services. However, fiscal policy appears to have stayed procyclical and the primary structural balance worsened further. The 2019 budget deficit target will likely be met, driven by strong revenue due to the rapid growth in private consumption and gains in tax collection efficiency, but with output growth above potential, the structural primary balance would continue to deteriorate.

Monetary policy remained accommodating, notwithstanding a modest tightening in the spring of 2019. As inflation approached the upper half of the tolerance band in March 2019, the MNB increased the overnight deposit rate from -15 to -5 bp and modestly reduced excess liquidity by limiting the rollover of its FX liquidity swaps, resulting in a slight increase in short-term money market rates.

Growth is projected to register 4.9 percent in 2019, and to gradually decelerate from its highs starting in amid relatively sluggish global activity and declining EU funds-related

[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.

investment, but to remain above 2 percent over the medium term despite the negative demographics. Average inflation should stay around 3.4 percent in 2019 and move back towards the midpoint of the tolerance band over the medium term.

Executive Board Assessment[2]

Executive Directors agreed with the thrust of the staff appraisal. They commended Hungary's continued strong economic performance, which has led to faster income convergence towards the European Union average and reduction of vulnerabilities. Directors noted that growth has been underpinned by strong domestic consumption and investment. However, given the increased external uncertainty and Hungary's still high public debt and gross financing needs, Directors encouraged continued fiscal consolidation and supply-side reforms, to further build resilience and sustain the growth momentum.

Directors were reassured by the government's medium-term fiscal targets, which will help reverse the procyclical fiscal stance, alleviate demand pressures, and increase the available fiscal space that can be used in future downturns. In this context, Directors encouraged specific growth-friendly revenue and expenditure measures, including reducing exemptions, broadening the tax base, phasing out sectoral taxes, moderately reducing spending on goods and services, containing the public wage bill and rationalizing generalized subsidies. Directors saw merit in a public debt management strategy that reduces rollover and foreign exchange rate risks, while avoiding large increases in domestic interest costs. It will also be important to implement the government's plan to enhance the monitoring of state-owned enterprises to improve efficiency and reduce the risk of contingent liabilities.

Directors supported the current monetary policy stance and acknowledged the challenges posed by divergent domestic and external conditions. Since risks to inflation from domestic conditions appear to be on the upside, they encouraged the Central Bank of Hungary (MNB) to be attentive to demand pressures. In this respect, Directors noted that close monitoring of the housing market is warranted, and consideration should be given to reducing housing bottlenecks and scaling down existing incentives that stimulate demand. Directors also recommended continued assessment of new and existing unconventional arrangements to reduce the risk of market distortions. Clear and timely communication will remain essential for effective forward guidance.

Directors emphasized that rapidly rising wages relative to productivity, decelerated export growth, and remaining shortcomings in the business environment underline the need to invigorate supply-side reforms. Accordingly, they welcomed the authorities' extensive

[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.

agenda to improve competitiveness and to help address demographic challenges. Directors called for timely implementation of prioritized reform measures that focus on reducing impediments to doing business. Such prioritization should focus on leveling the playing field for small and medium-sized enterprises, improving governance and transparency, increasing labor force participation, particularly of women, and enhancing education and vocational training.

Hungary: Selected Economic Indicators, 2014–20

	2014	2015	2016	2017	2018	2019	2020
						Proj.	
	Percentage change, unless otherwise indicated						
Real economy							
Real GDP (percentage change)	4.2	3.8	2.2	4.3	5.1	4.9	3.5
Total domestic demand (contribution to growth)	4.9	2.3	1.6	4.8	6.7	7.0	5.2
Private consumption	1.3	2.2	2.5	2.5	2.4	2.0	2.1
Government consumption	1.0	0.1	0.0	0.3	0.2	0.3	0.3
Gross fixed investment	2.6	1.1	-2.4	3.7	3.8	3.0	1.1
Foreign balance (contribution to growth)	-0.7	1.6	0.6	-0.5	-1.7	-2.1	-1.7
CPI inflation (average)	-0.2	-0.1	0.4	2.4	2.8	3.4	3.4
CPI inflation (end year)	-0.9	0.9	1.8	2.1	2.7	3.4	3.2
Unemployment rate (average, ages 15-64)	7.7	6.8	5.1	4.2	3.7	...	...
Gross fixed capital formation (percent of GDP)	22.1	22.3	19.7	22.2	25.2	26.6	26.7
Gross national saving (percent of GDP, from BOP)	23.4	24.6	24.2	24.5	24.6	25.7	26.0
General government							
Overall balance	-2.8	-2.0	-1.8	-2.4	-2.3	-1.8	-1.6
Primary balance	1.0	1.4	1.3	0.2	0.0	0.1	0.4
Primary structural balance (percent of potential GDP)	2.0	2.2	1.6	0.0	-0.5	-0.8	-0.5
Public debt	76.8	76.1	75.5	72.9	70.2	66.5	64.0
Money and credit (end-of-period)							
Broad money	5.1	6.3	7.1	7.8	11.8	9.1	7.3
Lending to the private sector, flow-based 1/	-0.9	-10.9	2.0	6.5	10.7	12.0	10.0
Interest rates							
T-bill (90-day, average) 1/	2.1	1.1	0.7	0.0	0.1	0.0	...
Government bond yield (5-year, average) 1/	3.9	2.7	2.1	1.7	2.2	1.0	...
Balance of payments							
Current account	1.3	2.4	4.5	2.3	-0.5	-0.9	-0.7
Reserves (billions of Euros)	34.6	30.3	24.4	23.4	27.4	29.2	28.5
Gross external debt	118.4	107.0	95.7	83.3	79.6	69.5	63.0
Gross official reserves (percent of short-term debt at remaining maturity)	161.8	139.5	129.7	136.4	156.7	168.6	178.5
Exchange rate							
Exchange regime							
Exchange rate, HUF per euro, period average 1/	309	310	311	309	319	332	...
Nominal effective rate (2000=100, average) 2/	114.2	116.5	116.7	115.5	118.6	120.5	...
Real effective rate, CPI basis (2000=100, average) 2/	77.7	79.6	79.7	78.4	79.8	79.5	...
Memorandum Items:							
Nominal GDP (billions of Forints)	32,694	34,785	35,896	38,835	42,662	46,095	49,139
Per capita GDP (EUR)	10,723	11,389	11,725	12,816	13,685	14,743	15,670
Output gap (percent of potential GDP)	-2.7	-1.6	-1.7	-0.2	1.2	2.2	2.0
Potential GDP growth	1.8	2.7	2.3	2.8	3.6	3.9	3.7

Sources: Hungarian authorities; IMF, International Financial Statistics; Bloomberg; and Fund staff estimates and projections.

1/ Data as of August and September 30, 2019.

2/ Q2 data for 2019.

INTERNATIONAL MONETARY FUND

HUNGARY

STAFF REPORT FOR THE 2019 ARTICLE IV CONSULTATION

November 12, 2019

KEY ISSUES

Context: In an increasingly uncertain global economic environment, Hungary's growth registered one of the highest rates in Europe in 2018. The economy now appears to be running above capacity and wages are growing rapidly amid historically low unemployment. It is thus likely that growth will slow down over the medium-term. Supply-side reforms can help sustain the momentum.

Policy recommendations. Policies have reduced vulnerabilities substantially, however, measures to support the targeted fiscal consolidation could be more ambitious to ensure that room for fiscal policy maneuver is rebuilt. Wages outstripping labor productivity growth, slower export growth, and shortcomings in the business environment for SMEs call for invigorating structural reform efforts.

- **Fiscal policy**: It will be important to achieve the government's medium-term fiscal targets to help alleviate demand pressures and increase the available fiscal space that can be used in future downturns. Specific growth-friendly measures are needed to meet the authorities' consolidation plans. Emphasis should be on improving the structure of revenue and expenditure.

- **Monetary policy and the financial sector**: Monetary policy can afford to stay on hold in the near term given the ongoing easing by major central banks, and the still weak external outlook and downside risks but should continue to be attentive to domestic demand pressures. Close monitoring of the housing market is warranted, and consideration should be given to scaling down existing incentives that stimulate demand.

- **Structural agenda:** Improvements in competitiveness are needed to sustain rapid income convergence and address demographic challenges. The government's competitiveness program contains important elements. Focus should be on improving the business environment (especially for SMEs), enhancing the legal and regulatory framework, and increasing labor force participation.

Approved By
Jorg Decressin (EUR) and Martin Sommer (SPR)

Discussions took place in Budapest during September 24–October 3, 2019. Staff team comprised Messrs. Sakr (head), Lybek, and Dybczak, and Ms. Vtyurina (all EUR). Mr. Benk attended most of the meetings and Mr. Kaya joined the concluding meetings (all OED). Mses. Batog, Samuel and Mr. Park (all EUR) assisted in the preparations of the staff report. The staff met with the State Secretaries of the Ministry of Finance Messrs. Banai, Gion, and Rákossy, Central Bank Deputy Governors Messrs. Nagy, Kandrács, and Patai, other senior officials, and representatives from the private sector, employers' associations, and think tanks.

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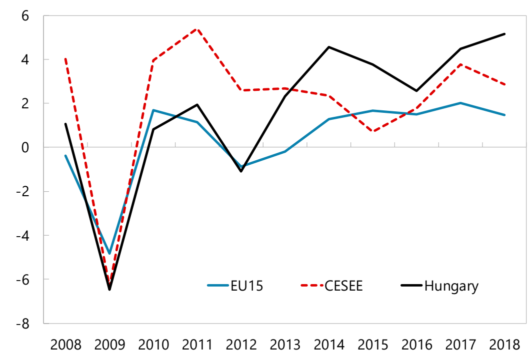
CONTEXT

1. **Building on its impressive recovery from the global financial crisis, Hungary could utilize more the current upswing to further strengthen its resilience and potential growth.** In 2018, Hungary was one of the fastest growing economies in Europe (Figure 1). Public debt declined 10 percentage points to 70.2 percent of GDP over 2011–18, and external deleveraging has been even more sizable (Annex I). Unemployment fell threefold to 3.7 percent. However, notwithstanding the ongoing fiscal consolidation, the structural fiscal position still appears procyclical. Wages have been rising rapidly against labor shortages, and key structural reforms that would help increase labor participation, apart from fiscal measures, have been lagging.

Figure 1. Real PPP GDP per Capita Growth

(In percent)



Sources: IMF; World Economic Outlook (WEO); and IMF staff calculations.

BACKGROUND AND RECENT DEVELOPMENTS: GOING STRONG

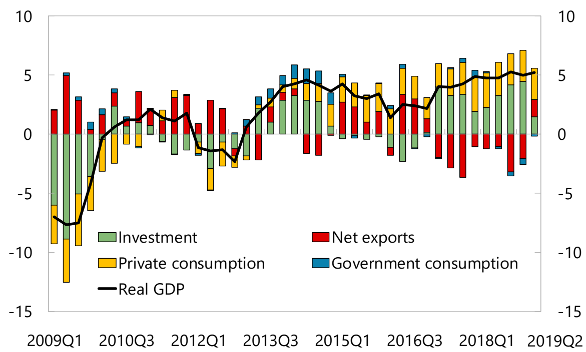
2. **Booming domestic activity mitigated the effect of the external slowdown, while inflation hovered close to the upper end of the tolerance band.** Growth in 2018 was considerably higher than projected, at 5.1 percent. It was largely driven by domestic demand, including record-high EU funds-related investment (Figure 2). Growth remained high in 2019, averaging 5.1 percent in the first two quarters. Both headline and core inflation, increased in 2018-H1 2019 but remained within the tolerance band (3±1 percent) (Figure 2). Headline inflation has been driven by food and energy prices, as well as increases in excises on alcohol and tobacco.

3. **Unemployment reached historic lows and wage pressures persist.** Unemployment has been below 4 percent since late-2017. Wage growth was 10.6 percent in 2018 and remained strong in 2019 (Figure 2). The spillover from wages into inflation has been contained in part due to a relatively low wage share in production costs, high profitability, well-anchored inflation expectations, reduced social security contributions, and low imported inflation.

4. **While the budget targets have been met, fiscal policy appears to have stayed procyclical.** The overall deficit deteriorated somewhat in 2017 and improved only slightly in 2018 – during two years with appreciably above-potential growth. This was mainly due to the reduction in corporate income tax rates, social contributions, and increased capital spending. Thus, the primary structural (PS) balance worsened further by about two percentage points over 2017–18 (Figure 2). Nonetheless, the 2018 deficit slightly outperformed the budget target of 2.4 percent of GDP due to higher-than-expected VAT collection and lower spending on goods and services.

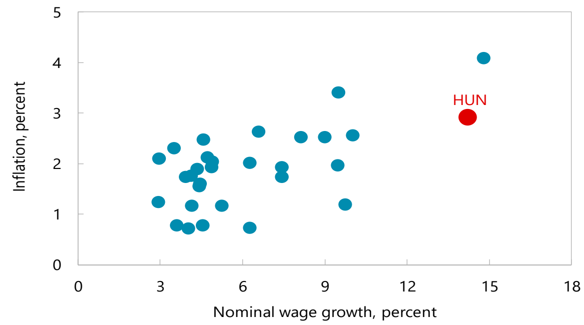
Figure 2. Real and Fiscal Sector Developments

Contributions to Growth
(Percent)



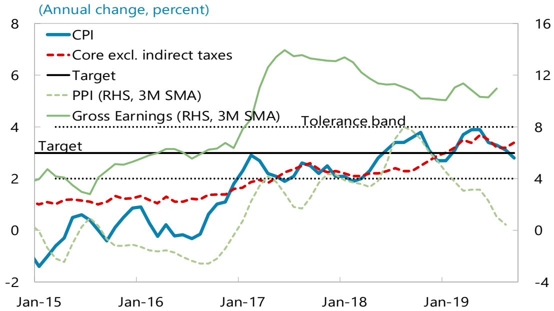
Source: Haver.

Nominal Wage Growth and Inflation in EU Countries
(Year-on-year percentage change, 2018)



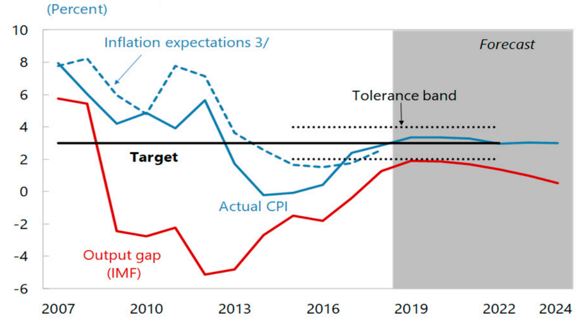
Sources: Haver Analytics; and IMF staff calculations.

Selected Inflation Indicators
(Annual change, percent)



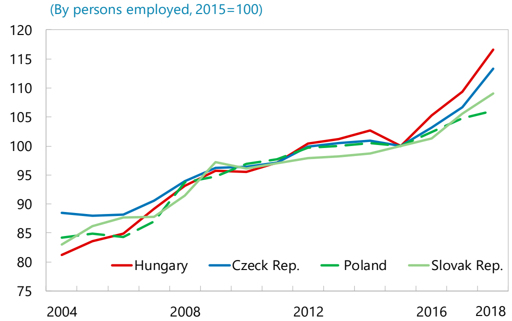
Source: Hungarian Central Statistical Office and Magyar Nemzeti Bank .

Inflation Expectations
(Percent)



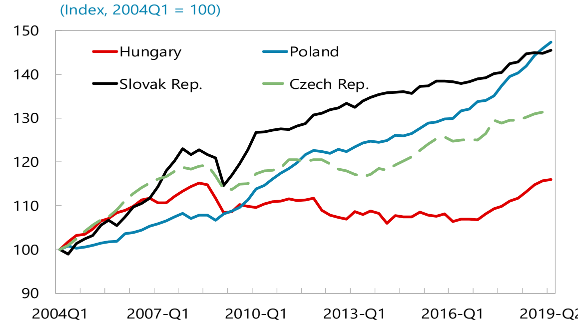
Sources: Magyar Nemzeti Bank; and IMF staff calculations.

Unit Labor Cost
(By persons employed, 2015=100)



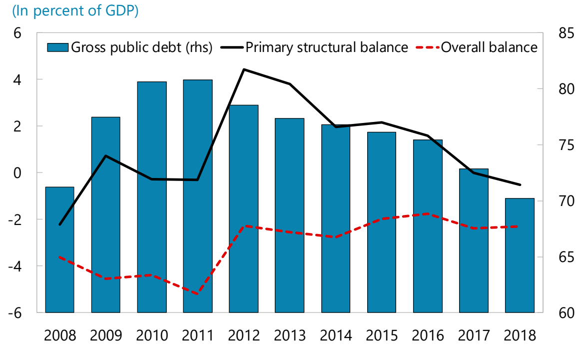
Source: Haver.

Labor Productivity
(Index, 2004Q1 = 100)



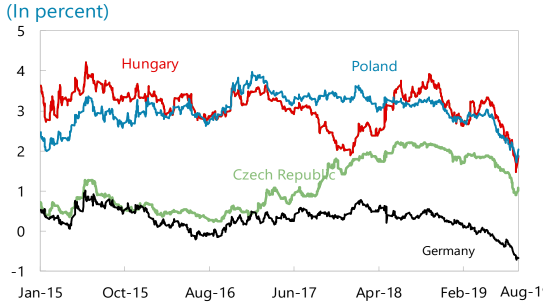
Source: Haver.

Fiscal Stance of the General Government
(In percent of GDP)



Sources: Hungarian authorities; and IMF staff estimates.

10-Year Government Bond Yields
(In percent)

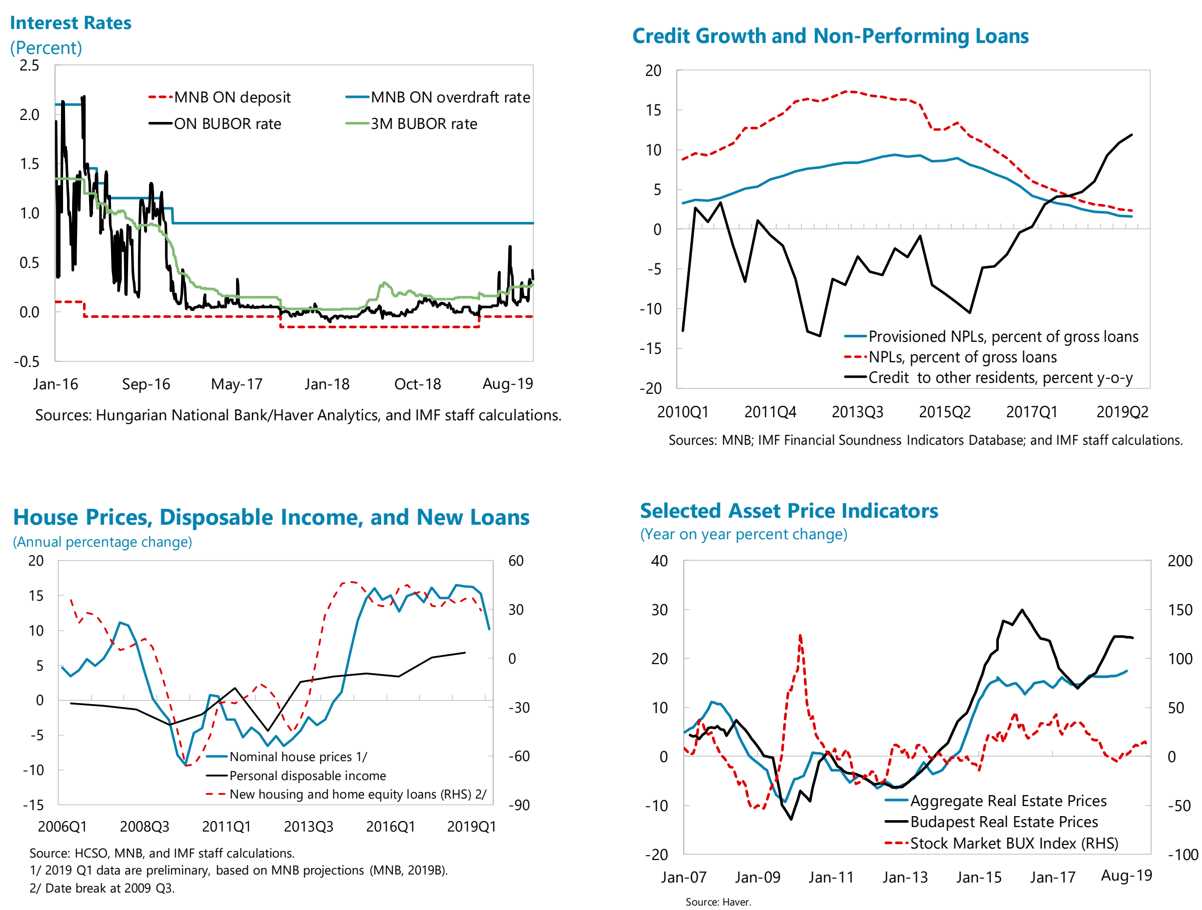


Sources: Hungarian National Bank (MNB); Haver.
Note: The MNB's unconditional interest rate swaps were announced in H2 2017 and ended in 2018.

5. Monetary policy remained accommodating, notwithstanding a modest tightening in Spring 2019. As inflation approached the upper half of the tolerance band in March 2019, the MNB increased the overnight deposit rate from -15 to -5 bp and modestly reduced excess liquidity by limiting the rollover of its FX liquidity swaps, resulting in a slight increase in short-term money market rates (Figure 3).

6. Credit continued to grow and NPLs reached new lows. Bank lending to non-financial companies and households increased by 10.6 percent, y-o-y, during 2018 and remained buoyant in 2019 (Figure 3). The NPL ratio declined to 2.5 percent at end-2018. System-wide liquidity is above prudential requirements, and profits are solid.

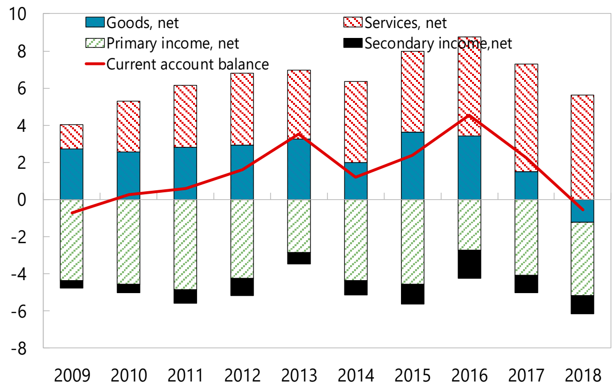
Figure 3. Financial Sector and Housing Indicators



7. Hungary's external position in 2018 is estimated to be moderately stronger than the medium-term fundamentals and desirable policy settings (Annex II). Although the current account receded towards a deficit, it is still somewhat stronger than the estimated current account norm. The current account gap mostly reflects the stock of the private sector credit being low. Reserves increased significantly, resulting in an improvement in adequacy indicators. HUF has been depreciating against the euro throughout 2019 but remained stable in real effective terms. Hungary's deleveraging process has contributed to a reduction in portfolio flows and, combined with policies to reduce external vulnerabilities, led to an upgrade by rating agencies (Figure 4).

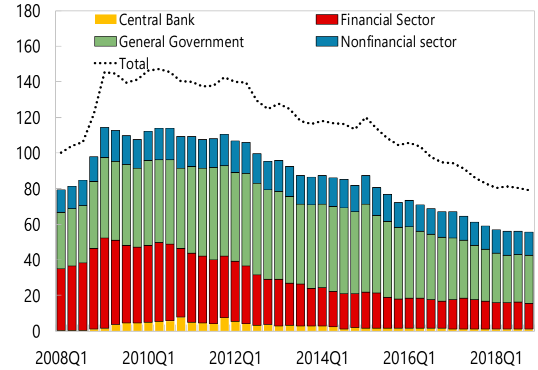
Figure 4. External Sector Developments

Current Account Balance
(Percent of GDP)



Sources: Haver Analytics and IMF staff calculations.

External Debt by Sector /1
(Percent of GDP)



1/ Sectoral debt excludes intercompany/direct investment instruments.
Sources: Hungarian National Bank/Haver Analytics; and IMF staff calculations.

OUTLOOK AND RISKS: A BALANCING ACT

8. **The outlook remains broadly favorable.** Growth is projected to decelerate from its highs starting in 2019 amid relatively sluggish global activity and declining EU funds-related investment, but to remain in the 3.5-2.0 percent range in the medium term despite the negative demographics. Capacity has been constrained by labor shortages, but the pressures are somewhat less now, as businesses are preparing for a gradual deceleration in growth. Wage pressures also seem to be moderating after the recent hikes and more leveled workers' expectations given the global developments. The substantial increase in household savings over the past years and the completion of the deleveraging process will help keep up consumer spending. On the external front, despite the coming on line of exports from recent FDI investments, the still buoyant imports and slowing growth in the EU will keep the current account in a slight deficit. Inflation is expected to hover around 3 percent, with some downside risks given the cooling off in the labor market and low imported prices, reflecting the developments in the main EU trading partners.

9. **Risks to the baseline scenario for real GDP growth are somewhat to the downside owing to deteriorating global growth prospects and trade tensions** (Annex III). Exports may come under pressure due to the slowdown in Germany, lower foreign demand and possible increase in trade barriers. This said, Hungary's specialization in high-end vehicles and the recently announced high-tech investments in the car and electric batteries industry may protect its production and exports compared to neighboring automotive producers. Nonetheless, some delays in execution or

scaling down cannot be ruled out (Box 1). A worsening in global macro conditions could also hamper growth more broadly but the substantial deleveraging and the authorities' strategy of reducing external financial exposure would limit possible spillovers. Domestically, risks appear to the upside. The aforementioned demand boom could go on to generate more growth than projected, and there could be more capacity in the economy than estimated, as may be indicated by the repeated under-estimation of projected growth and potential output. There could also be an important contribution from a further increase in labor participation or inward migration by ethnic Hungarians. The authorities have implemented past staff advice to a certain degree, in particular with steady fiscal deficit reduction (albeit not in structural terms) and substantial progress in scaling back the public works scheme (PWS) (Box 2). Some of the impediments to doing business were also addressed (Annex IV).

Authorities' Views:

10. The authorities agreed with the balance of risks. They see the slowdown in global (especially eurozone and major emerging economies) activity, Brexit, and increased trade protectionism as key downside risks, although they noted that spillovers from Germany's manufacturing cycle have recently moderated. In their view, upside risks include stronger labor supply and household consumption. They also believed that additional impetus could come from the implementation of competitiveness reforms.

POLICY AGENDA

11. Strong growth should be used as a springboard for building fiscal space, while improving expenditure quality, and addressing long-standing structural challenges. The favorable position in the cycle supports further fiscal consolidation to increase buffers and improve the structure and efficiency of spending. Less procyclical fiscal policy would also facilitate a more gradual normalization of monetary policy and help ease demand pressures, including in the housing market. Any short-term reform costs can be absorbed more easily during the current favorable cyclical position. Staff stressed that this was also an opportune time to pursue reforms targeted at improving potential growth and thus welcomed the roll-out of the government's "Program for a More Competitive Hungary."

A. Fiscal Policy: Creating Space While Enhancing Quality

12. Although the overall fiscal deficit targets a decline to 1.8 percent of GDP in 2019, it would still constitute a procyclical impulse. Data thus far indicate that the budget deficit will likely be met. Revenue losses from the 2018–19 reduction in tax rates are being offset by higher receipts due to positive developments in the labor

Selected Stimulus Measures

Reduction of the VAT on accommodation from 18 to 5 percent
Increase in R&D spending
Subsidized loan for young married couples
Granted debt relief for mortgage loans after the birth of up to three children
Car sales subsidy for families with at least three children
Support for language studies by secondary-school students

Source: Hungarian Authorities.

market, a rapid growth in private consumption, and gains in tax collection efficiency. Efforts have been made to reduce the share of gray economy which is evident from buoyant gains in VAT collection. On the expenditure side, the ongoing small cuts in public employment, mostly through attrition and a marked reduction in central government administrative staff, are not expected to produce budgetary savings as wages continue to increase. EU funds-related expenditure will peak over 2019–20. Several fiscal stimulus measures, mostly aimed at improving demographics, were introduced with the 2019 budget. The cost of the stimulus measures is expected to be fully covered by a general budgetary reserve of about 0.6–1.0 percent of GDP over 2019–21. With output growth above potential, the structural primary balance would deteriorate by about 0.3 percentage points, to reach around -0.8 percent in 2019.

13. Hungary's public debt and financing needs (GFN) remained high as of end-2018. Despite being on a downward trend, public debt was slightly above 70 percent of GDP, GFN increased in recent years and were among the highest in the EU in 2018, at around 20 percent of GDP. In view of this situation, staff assess Hungary's fiscal space to be at risk. However, GFN are projected to decline over the short and medium terms, including under the standard stress tests. Other baseline projections are favorable for the overall balance and debt-to-GDP ratio (Annex I). This positive outlook would help create some fiscal space, which can be used in future downturn and to address the demographic pressures.

14. The public debt strategy should therefore continue to focus on lengthening maturities, while striking a balance between further reducing foreign exposure and containing the interest expenditure. The recently introduced new retail bond (MÁP+) is helping to reduce rollover and FX risks and to attract greater household savings. However, its much higher yield than other government bonds has led to subscriptions so far surpassing expectations.[1] Staff highlighted the opportunity cost of such an expensive funding and its potential crowding-out effects. In addition, this funding program does not impose an upper subscription limit for an individual or a household, which makes it potentially regressive and increases the risk of arbitrage. Staff therefore suggested to cap the size of the total current offering and to anchor the interest rate of future offerings closer to the government bond market yield curve.

15. The 2020 budget foresees a further reduction in the overall deficit to 1 percent of GDP. While staff welcomes the planned fiscal consolidation, this would imply only a modest fiscal withdrawal. The ambitious 2020 budget target is planned to be achieved through further improvements in tax collection and lower public investment. Staff projects a somewhat higher deficit (1.5 percent of GDP) due to a lower GDP growth assumption and a somewhat smaller decline in expenditure.

16. The authorities' medium-term targets reflect steady consolidation, although the underlying measures have not been specified. Staff considers the authorities' consolidation plan

[1] In June 2019, the government launched a new 5-year retail bond that has an initial interest rate of 3.5 percent the first half year, 4 percent the second half year, and then increases by 50-basis point each year leading to an interest rate of 6 percent by the end of its maturity.

presented in the 2019 *"Convergence Programme"* appropriate. According to this plan, both the overall and cyclically-adjusted balances would move close to zero by 2023, thus providing room for fiscal policy maneuver, especially with the resulting downward debt path. Similar to its 2020 projection, staff's medium-term baseline scenario implies somewhat higher deficits than the authorities' plan due to lower growth projections and the absence of explicit consolidation measures, other than a possible reduction in public investment.

Figure 5. Adjustment Scenario and Measures

Cummulative Fiscal Impact of Staff-Recommended Measures

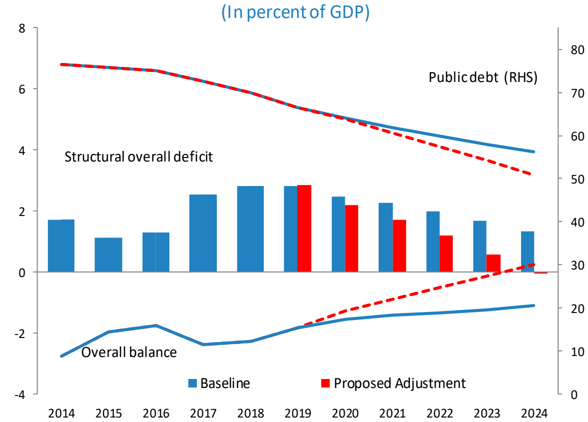
(In percent of GDP, 2020-24)

Total	1.4
Revenue	-0.4
Phasing out of sector-specific taxes	-1.0
Streamlining VAT rates	0.4
Elimination of excise exemptions for fuel	0.2
Expenditure	1.8
Reduction in the wage bill 1/	0.8
Rationalization of spending on goods and services 2/	0.6
Rationalization of generalized subsidies	0.4

Sources: Hungarian authorities; and IMF staff estimates.
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.

Baseline and Adjustment Scenarios

(In percent of GDP)



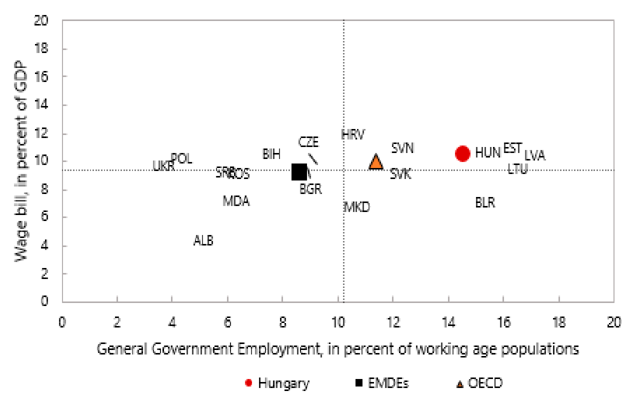
17. To achieve the authorities' targets, staff recommended a mix of growth-friendly revenue and expenditure measures (Figure 5).

- Revenue: (i) reduce exemptions and preferential regimes; (ii) further phase out sectoral taxes; and (iii) offset any further tax rate cuts with other revenue through broadening the tax base.

- Expenditure: (i) reduce spending on goods and services, which is above the peers' average; (ii) continue to reduce the public wage bill, focusing on rationalizing employment in the public sector (which is substantially higher than in peers), while ensuring adequate provision of quality public services (Figure 6); and (iii) rationalize generalized subsidies, including on energy and transport, while adequately protecting the poor through better targeting .

Figure 6. General Government Wage Bill and Employment

(Latest available data)



Source: IMF FAD Government Wage Bill and Employment Dataset.

18. The above measures are largely similar to those recommended in recent years but lower in magnitude given the more favorable outlook for the deficit and public debt. The proposed average annual adjustment of around 0.3 percentage points over the next five years would lead to public debt falling to 50 percent of GDP (which is lower than under last year's adjustment scenario) and a structural primary surplus of about 2 percent of GDP by 2024 (Figure 5). Any additional savings beyond the recommended amount can be used to boost infrastructure investment in the outer years of the medium term to compensate for the projected decline in EU funds. In general, to support growth, particular emphasis needs to be placed on the quality of public spending. Rationalizing public sector employment would also release labor force to the private sector, thus helping to ease the severe shortages.

Authorities' Views:

19. To achieve the planned fiscal consolidation, the authorities intend to continue to increase the efficiency of tax collection and reduce public investment as needed. They pointed out that substantial reserves programmed on the expenditure side provide buffers for achieving the targets. The authorities highlighted their success in cutting more than 20 percent of staff positions across the central government administrative level in 2018–19. They indicated that they would further consider possible rationalization of public employment based on identification of inefficiencies and progress in digitalization and improvements in processes. The authorities view most of the remaining sectoral taxes as turnover taxes with less distortive impact on the economy. They could be reduced in the future if efficiency gains lead to lower profits and price reductions for consumers. The authorities plan to further reduce the tax burden on labor whenever the economic situation allows. They believed that the retail bond MÁP+ is contributing to lengthening maturities, reducing external vulnerabilities, and containing consumption and imports as well as the pressure in the real estate market.

B. Monetary Policy: Staying Tuned to the Challenges

20. Over the near term, monetary policy can afford to be somewhat more patient with removing accommodation, especially in view of the weaker global outlook and downside risks. While domestic demand has surprised on the upside, prospects for global demand have worsened. Also, inflationary pressures have abated since May 2019. Strong wage growth has been mitigated by reduced social security contributions and profit margins. Despite a positive output gap, inflation is being contained by cheaper imports given the price dynamics in European trading partners. Staff projects average inflation to stay around 3.4 percent in 2019 and move back towards the midpoint of the tolerance band over the medium term. This is premised on current staff projection for growth and imported inflation, as well as the MNB maintaining the money market rates at current levels in the near term. Should data point to upward inflationary pressure building up, the MNB will need to take prompt action in view of the usual monetary policy transmission lags. Clear and timely communication would also be key under these circumstances.

21. Close monitoring of the implications of the existing and new unconventional arrangements is warranted. Two measures—the MNB's mortgage bond purchase scheme and its sales of unconditional interest rate swaps—were phased out by end-2018, as planned. With respect to the FX liquidity swaps, the MNB has been calibrating them to achieve the intended money market rates within its interest rate corridor, becoming a net provider of liquidity to banks. In January 2019, a "*Funding for Growth Scheme Fix"* was introduced to encourage long-term fixed-rate lending to SMEs. In July 2019, a "*Bond Funding for Growth"* scheme was rolled out to develop the corporate bond market. Staff advised that their effectiveness in achieving their other objectives be continuously assessed to minimize market distortions.

Authorities Views:

22. The MBN considers that downside risks to inflation have recently increased due to the disinflationary impact from the slowdown in Europe. The MNB will continue to assess the effects on inflation from the pass-through effects from the eurozone, the monetary policy stance of major central banks, the effect of the new retail government security on savings, the impact of the counter-cyclical fiscal policy, and other domestic factors on the economy. The authorities stressed that the new unconventional tools are not intended to achieve immediate monetary policy objectives as their liquidity impact is being sterilized. The objectives are to further enhance financial stability (by reducing interest rate risk for SMEs) and develop the corporate bond market.

C. Financial Sector: Harnessing Stability

23. The banking system is overall healthy, and its resilience should continue to be buttressed. The system remains, on average, well capitalized, profitable, and liquid. The NPL ratio continues to decline due to improved repayment capacity, NPL sales, and credit growth. The MNB's stress tests show that all banks observe the solvency test and that most banks can meet the regulatory liquidity requirement without adjustments. The MNB's recommendations to use independent evaluators for collateral appraisals appear to have harmonized evaluation practices. The integration of the many credit cooperatives into one banking group is continuing. A final decision on the privatization of Budapest Bank is currently being worked out. It would be important that consolidation of the banking system continued to be market-based. Some amendments have been made to the insolvency legislation to increase the ability of creditors to enforce their interests and improve the rate of recovery of claims, but further improvements are needed. Staff thus welcomed the intention to review the legislative and institutional framework for bankruptcy and liquidation proceedings in 2020.

24. Efforts to scale back house purchase incentives and to address supply constraints are needed to mitigate market pressures. In 2018, housing price growth was in double digits, especially in Budapest, partly supported by high wage growth, fiscal incentives, and labor scarcity in the construction sector (Figure 3). Budapest house prices appear high compared to fundamentals. Given that a large part of purchases is paid for with private savings, including by foreign citizens, and is done for investment purposes, tightening of macroprudential measures (loan-to-value and debt service-to-income (DSTI) may not be sufficient to contain house price inflation, but can reduce the likelihood of risky mortgages. Moderating price increases would therefore be helped by reviewing the various fiscal incentives for house purchases, basing them on means-testing and targeting, reducing impediments to doing business to spur construction, improving transportation network and commuting options, and improving urban planning to increase housing supply over time. In the context of money laundering risks in the sector, staff also encouraged the authorities to continue their AML/CFT efforts, as Hungary remains on enhanced follow-up based on Moneyval's 2016 assessment, including by continuing to monitor large purchases of luxury real estate.

25. The authorities launched several initiatives to reduce the mortgage interest rate risk.[2] While most *new* housing loans now have longer interest fixation periods—likely facilitated by the *MNB Certified Consumer-Friendly Housing Loans* and the DSTI requirements—there is still a high portion of existing housing loans with variable rates. The MNB thus agreed with banks that they inform their clients about the interest rate risk and offer to convert to fixed-rates.[3] Thus far, the impact of this measure has been limited. To contain potential risks from FX exposure of some of the commercial real estate companies, the MNB has announced that beginning in 2020 a small risk-weight would be also assigned to FX *performing* project loans when calculating the systemic risk buffer.

Authorities' Views:

26. The authorities are monitoring housing prices, especially in Budapest, even though they are still much lower than in comparable cities in Western Europe. They also noted that assessment models do not capture the fact that many of these purchases are for investment and generate rental income. They agree that additional tightening of macro prudential measures is unlikely to have a significant impact. There is preliminary evidence that the introduction of the retail bond MÁP+ coincided with a decline in apartment sales transactions in Budapest. Some of the MNB's proposals—included in the MNB's *Competitiveness Program,* like tightening the rules for purchases of residences for investment purposes and expanding construction capacity, could help moderate the market.

D. Structural Reforms: It's Go Time

27. Improvements in competitiveness are needed to sustain high income convergence and address demographic challenges. Rising wages against low labor productivity, decelerated export growth, and shortcomings in the business environment underline the need to invigorate the reform efforts. The government's *Program for a More Competitive Hungary* and the Central Bank's extensive agenda to improve competitiveness rightly seek to boost potential output. What is needed now is timely implementation of prioritized reform measures that focus on reducing the identified impediments to doing business. Such prioritization should focus on leveling the playing field for

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[2] Hungary's experience will be featured as a case study in the forthcoming EUR WP "Macroprudential Policies and House Prices in Europe".

[3] Total households' financial debt is about 21½ percent of GDP, with housing credit at 8 percent of GDP, which is low compared to other EU countries.

SMEs, improving governance and transparency, increasing labor participation, and enhancing education and vocational training.

28. Staff lauded the increased focus on enhancing productivity of SMEs. Ongoing efforts to simplify the tax system for the SMEs will be helpful. Staff, in particular, supported the authorities' intention to reduce the large number of taxes and advised to phase out the sector-specific taxes. There is also merit in removing sectoral exemptions and applying a modern competition policy framework as widely as possible. Further, it would be important to closely monitor the implementation of R&D investments supported by grants to safeguard transparency and to maximize value and efficiency.

Main Parameters of the Authorities Growth Strategy:

The government is determined to keep GDP growth 2 percentage points above the average of advanced EU countries by:

- Gradually reducing the tax burden as fiscal space allows (reduction of the number of various taxes and fees to below 40),
- Improving education and vocational training to address skills mismatches,
- Increasing employment by attracting ethnic Hungarians from neighboring countries and enhancing incentives to work for women and pensioners, and
- Supporting SMEs and increasing their export orientation by implementing structural reforms.

29. Over the past few years, the authorities have been taking steps to improve the business environment, but important challenges persist. High frequency of issuing regulations, protecting minority investors, getting electricity, among others, are the areas that still need improvement (Figure 7). Perceived corruption and public procurement practices have also been reported as impediments to doing business. A digital land registry map and data service were introduced to improve construction permit procedures, and connection to utilities should now take less time. Registration for most common types of companies has become free of charge, and companies no longer need to register at a local level as tax payer data is now synchronized. These improvements should help enhance competitiveness indicators (Figure 7). The introduction of the central electronic public procurement system, in line with the EU Public Procurement Directive, is a step in the right direction. However, it would be important to address any remaining concerns, including by ensuring transparent and competitive procurement processes, in line with EC recommendations.

30. SOEs' productivity lagged behind since 2012.[4] The authorities intend to monitor better their efficiency and, more generally, the services provided by state agencies. Staff also advocated to improve the oversight of risks emanating from the SOEs and introduce clear rules for fiscal support to maintain competitive neutrality, good governance, and budgetary transparency (Figure 7).

31. Labor market shortages should be addressed through further increasing participation rates and scaling down the PWS. Participation rates have registered one of the fastest rises among

[4] Muraközy et al. 2017, "Productivity differences in Hungary and Mechanisms of TFP-growth Slowdown". SOEs constitute about 7 percent of value added.

the EU members, especially in the older age groups, and now stand slightly below the EU average of 74 percent. Further progress in offering adult education and vocational training opportunities as well as increasing the number of daycare centers will help raise the active labor force, especially among the female population. Releasing labor from PWS already decreased the number of participants from the peak of 202,000 to around 100,000 in 2019 (Box 2). Going forwards, the authorities intend to further reduce this number but keep the scheme operational, mostly giving an opportunity to those who have most difficulties in entering the primary market.

Authorities' Views:

32. The authorities broadly concurred with staff's recommendations and highlighted that their competitiveness agenda is comprehensive and broad-based. In order to ensure timely progress, actions have been taken to strengthen the monitoring of implementation. The identification of tasks and deadlines for all the line ministries have been established together with a set-up of a monitoring system. The first report will be published soon. The MNB will monitor progress through the "Competitiveness Mirror" (released in the fall) which will assess to what extent the 330 competitiveness recommendations have been implemented. The authorities recently introduced a new procurement system with simplified procedures and lower administrative burdens expect this to help improve doing business indicators and perceived governance rankings. With regards to simplifying the tax system, the advertising tax is suspended till 2022. The authorities are determined to support innovation, especially by SMEs, including through the recently introduced cash incentive scheme to encourage technology-oriented investments and R&D spending.

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33. Over the last decade, Hungary achieved further income convergence at an impressive speed and has become less vulnerable to shocks. Over the medium-term, the fiscal balance is expected to further improve. Public and external debts would continue to decline, and domestic credit growth is envisaged to remain buoyant. However, short-term prospects are clouded by wavering global growth, trade tensions, and Brexit. Furthermore, Hungary's growth is likely to decelerate unless structural reform efforts are redoubled to improve productivity and boost the economy's potential.

34. The government's medium-term fiscal policy targets are appropriate but specific measures are needed to secure them. The government's envisaged consolidation would gradually reverse the procyclical fiscal stance of the past few years and allow monetary policy to remain accommodative for a longer period. Introducing a mix of growth-friendly revenue and expenditure measures will help achieve the authorities' fiscal targets. Revenue can be enhanced through reducing exemptions and preferential regimes, as well as broadening the tax base while continuing to phase out sectoral taxes. Streamlining expenditure can be achieved through moderately reducing spending on goods and service and the public wage bill, building on the progress made at the central government administrative level. Generalized transport and energy subsidies could also be rationalized and targeting improved to protect the poorer households. Any additional savings can be used to finance infrastructural investment in the medium term to compensate for the eventual decline in EU funds. It is also important to implement the government's plan to enhance the monitoring of SOEs to improve efficiency and reduce the risk of contingent liabilities. While reducing currency risks is a prudent objective of the public debt management strategy, there is also merit in avoiding a large increase in interest costs and in achieving a further lengthening of maturities.

35. Given the recent moderation of inflation and weaker external environment, it is appropriate for the monetary stance to remain accommodative. However, attention should be given to any emerging price pressures. In addition, clear and timely communication will remain essential for effective forward guidance. Close monitoring of the unconventional arrangements is warranted to continually assess their success in achieving their objectives while reducing the risk of market distortions. To help contain real estate price pressures, there is merit in reviewing the various fiscal incentives for house purchases, basing them on means-testing targeting, and reducing impediments to doing business in the construction sector.

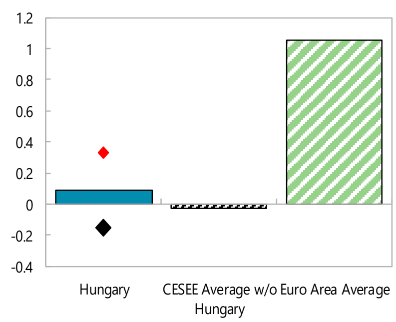
36. Improvements in competitiveness are needed to boost potential output. It is important to further simplify and shorten the processes required to obtain building permits and business licenses and to continue to speed up connection to utilities. Additional efforts to enhance governance, including in public procurement practices, would also be helpful. Supporting the growth and development of SMEs will also require simplifying regulations as well as changing them less frequently. The commendable effort to increase participation in the labor market, especially for women, should be complemented with the above reforms, and with improving the quality of education, vocational training, and public services. The timely downsizing of the PWS, with a view of releasing workers to the very tight primary labor market, is also encouraging and should continue.

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

Figure 7. Competitiveness, Doing Business and Governance Indicators

Governance
(low scores indicates weaker governance)

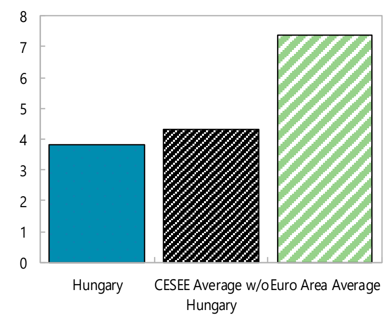
Control of Corruption, 2017 1/



1/ Confidence intervals are estimated with 2 standard deviations of the starndard error.

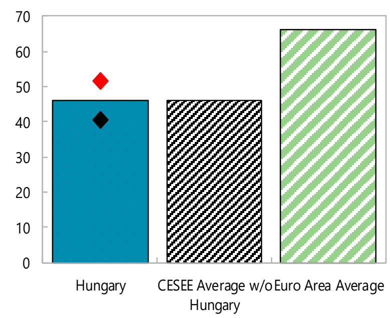
Sources: Worldwide Governance Indicator; IMF Staff Calculations.

Corruption Index, 2018



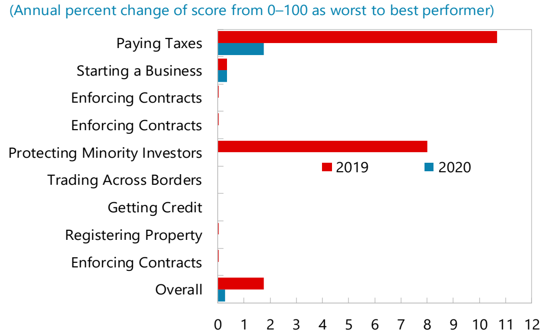
Sources: Verisk Maplecroft; IMF Staff Calculations.

Corruption Perception Index, 2018 1/



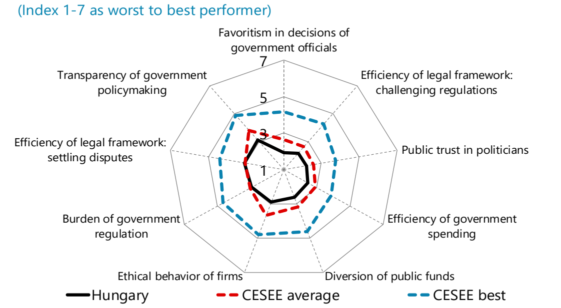
Sources: Transparency International; IMF Staff Calculations

Hungary: Improvements in Doing Business
(Annual percent change of score from 0–100 as worst to best performer)



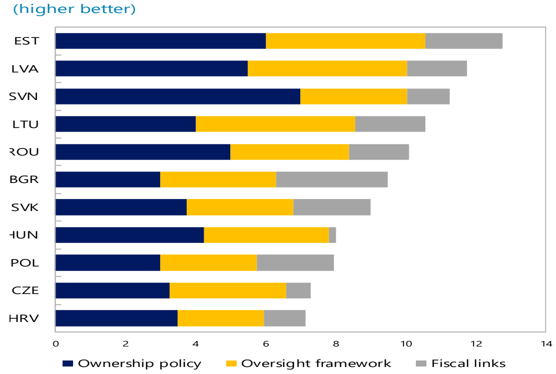
Sources: World Bank, *Doing Business* (2019), and IMF staff calculations.

Selected Sub-Components of Pillar 1. Institutions 1/, 2018
(Index 1-7 as worst to best performer)

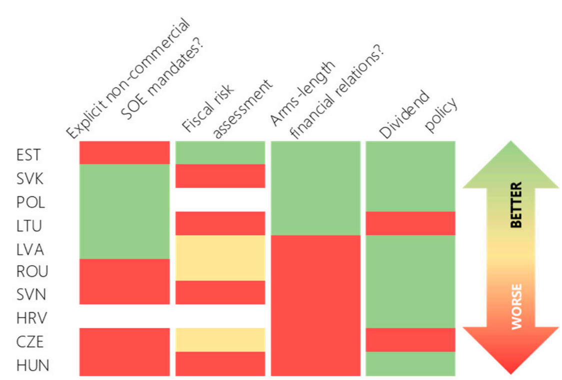


Sources: World Economic Forum, *Global Competitiveness Index*; and IMF staff calculations.
1/ Selection displays Hungary's 9 lowest-performance indicators out of the total 12.

Composite of SOE Governance Index
(higher better)



SOE and Fiscal Policy Interactions



Sources: National authorities; IMF staff calculations from "Reassessing the Role of State-Owned Enterprises in Central, Eastern, and South Eastern Europe: European Department, June 18, 2019.

Table 1. Hungary: Selected Economic Indicators, 2014–20

	2014	2015	2016	2017	2018	2019	2020
						Proj.	
	Percentage change, unless otherwise indicated						
Real economy							
Real GDP (percentage change)	4.2	3.8	2.2	4.3	5.1	4.9	3.5
Total domestic demand (contribution to growth)	4.9	2.3	1.6	4.8	6.7	7.0	5.2
Private consumption	1.3	2.2	2.5	2.5	2.4	2.0	2.1
Government consumption	1.0	0.1	0.0	0.3	0.2	0.3	0.3
Gross fixed investment	2.6	1.1	-2.4	3.7	3.8	3.0	1.1
Foreign balance (contribution to growth)	-0.7	1.6	0.6	-0.5	-1.7	-2.1	-1.7
CPI inflation (average)	-0.2	-0.1	0.4	2.4	2.8	3.4	3.4
CPI inflation (end year)	-0.9	0.9	1.8	2.1	2.7	3.4	3.2
Unemployment rate (average, ages 15-64)	7.7	6.8	5.1	4.2	3.7	...	...
Gross fixed capital formation (percent of GDP)	22.1	22.3	19.7	22.2	25.2	26.6	26.7
Gross national saving (percent of GDP, from BOP)	23.4	24.6	24.2	24.5	24.6	25.7	26.0
General government							
Overall balance	-2.8	-2.0	-1.8	-2.4	-2.3	-1.8	-1.6
Primary balance	1.0	1.4	1.3	0.2	0.0	0.1	0.4
Primary structural balance (percent of potential GDP)	2.0	2.2	1.6	0.0	-0.5	-0.8	-0.5
Public debt	76.8	76.1	75.5	72.9	70.2	66.5	64.0
Money and credit (end-of-period)							
Broad money	5.1	6.3	7.1	7.8	11.8	9.1	7.3
Lending to the private sector, flow-based 1/	-0.9	-10.9	2.0	6.5	10.7	12.0	10.0
Interest rates							
T-bill (90-day, average) 1/	2.1	1.1	0.7	0.0	0.1	0.0	...
Government bond yield (5-year, average) 1/	3.9	2.7	2.1	1.7	2.2	1.0	...
Balance of payments							
Current account	1.3	2.4	4.5	2.3	-0.5	-0.9	-0.7
Reserves (billions of Euros)	34.6	30.3	24.4	23.4	27.4	29.2	28.5
Gross external debt	118.4	107.0	95.7	83.3	79.6	69.5	63.0
Gross official reserves (percent of short-term debt at remaining maturity)	161.8	139.5	129.7	136.4	156.7	168.6	178.5
Exchange rate							
Exchange regime							
Exchange rate, HUF per euro, period average 1/	309	310	311	309	319	332	...
Nominal effective rate (2000=100, average) 2/	114.2	116.5	116.7	115.5	118.6	120.5	...
Real effective rate, CPI basis (2000=100, average) 2/	77.7	79.6	79.7	78.4	79.8	79.5	...
Memorandum Items:							
Nominal GDP (billions of Forints)	32,694	34,785	35,896	38,835	42,662	46,095	49,139
Per capita GDP (EUR)	10,723	11,389	11,725	12,816	13,685	14,743	15,670
Output gap (percent of potential GDP)	-2.7	-1.6	-1.7	-0.2	1.2	2.2	2.0
Potential GDP growth	1.8	2.7	2.3	2.8	3.6	3.9	3.7

Sources: Hungarian authorities; IMF, International Financial Statistics; Bloomberg; and Fund staff estimates and projections.

1/ Data as of October 1, 2019.

2/ Q2 data for 2019.

Table 2. Hungary: Medium-Term Scenario, 2014–24

	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
								Proj.			
	Percentage change, unless otherwise indicated										
Real GDP growth	4.2	3.8	2.2	4.3	5.1	4.9	3.5	3.0	2.6	2.4	2.2
Inflation (CPI; year average basis)	-0.2	-0.1	0.4	2.4	2.8	3.4	3.4	3.3	3.0	3.0	3.0
Inflation (CPI; end-year basis)	-0.9	0.9	1.8	2.1	2.7	3.4	3.2	3.1	3.0	3.0	3.0
	Percentage Change										
Domestic demand	5.3	2.4	1.7	5.2	7.3	7.0	5.8	4.5	3.9	2.9	2.9
Consumption	3.1	3.3	3.7	4.1	3.7	3.4	3.5	2.8	2.3	2.2	2.2
Gross fixed capital formation	12.3	4.8	-10.6	18.7	17.1	12.0	4.0	2.0	1.9	1.8	1.5
Exports of GNFS	9.2	7.4	3.8	6.9	4.3	4.6	5.1	5.5	5.6	5.6	5.5
Imports of GNFS	11.0	6.0	3.4	8.2	6.8	7.4	7.3	6.9	6.8	6.1	6.0
Lending to the private sector, flow-based (current prices, eop) 1/	-0.9	-10.9	2.0	6.5	10.7	12.0	10.0	8.0	6.7	6.3	6.0
	In percent of GDP										
External current account balance	1.3	2.4	4.5	2.3	-0.5	-0.9	-0.7	-0.4	-0.2	0.1	-0.1
Gross national saving	23.4	24.6	24.2	24.5	24.6	25.7	26.0	26.1	26.1	26.1	25.6
Gross domestic investment	22.1	22.3	19.7	22.2	25.2	26.6	26.7	26.5	26.3	26.0	25.7
Gross external debt 1/	118.4	107.0	95.7	83.3	79.6	69.5	63.0	58.5	54.7	51.8	49.1
Gross official reserves (percent of short-term debt at remaining maturity)	162	140	130	136	157	169	179	177	219	234	242
General government	In percent of GDP										
Revenue, total	47.5	48.7	45.4	44.6	44.4	44.5	44.0	43.1	42.7	42.4	42.4
Expenditure, total	50.3	50.6	47.2	47.0	46.7	46.3	45.5	44.5	44.0	43.7	43.5
General government overall balance	-2.8	-2.0	-1.8	-2.4	-2.3	-1.8	-1.6	-1.4	-1.3	-1.2	-1.1
Structural general government balance (percent of potential GDP)	-1.7	-1.1	-1.3	-2.5	-2.8	-2.8	-2.5	-2.3	-2.0	-1.7	-1.3
Structural primary balance (percent of potential GDP)	2.0	2.2	1.6	0.0	-0.5	-0.8	-0.5	-0.5	-0.2	0.2	0.6
General government debt	76.8	76.1	75.5	72.9	70.2	66.5	64.0	61.7	59.8	58.0	56.2
Memorandum items:	Percentage change, unless otherwise indicated										
Output gap (percent of potential GDP)	-2.7	-1.6	-1.7	-0.2	1.2	2.2	2.0	1.9	1.5	1.0	0.5
Potential GDP growth	1.8	2.7	2.3	2.8	3.6	3.9	3.7	3.1	3.0	2.9	2.7

Sources: Hungarian authorities; and Fund staff estimates and projections.

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

Table 3. Hungary: Consolidated General Government, 2014–24

(In percent of GDP, unless otherwise indicated)

	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
								Proj.			
Revenue	47.5	48.7	45.4	44.6	44.4	44.5	44.0	43.1	42.7	42.4	42.4
Tax revenue	25.3	25.6	25.5	25.4	25.1	25.6	25.5	25.5	25.5	25.5	25.5
Taxes on goods and services	18.6	18.7	18.2	18.1	18.4	18.4	18.4	18.4	18.4	18.4	18.4
VAT	9.2	9.5	9.2	9.3	9.7	9.8	9.8	9.8	9.8	9.8	9.8
Excises and other 1/ 2/	9.3	9.2	9.0	8.7	8.7	8.6	8.6	8.6	8.6	8.6	8.6
Taxes on income, profits and capital gains	6.7	6.8	7.3	7.2	6.7	7.1	7.0	7.0	7.0	7.0	7.0
Personal income tax	4.9	4.9	4.8	5.0	5.2	5.3	5.3	5.3	5.3	5.3	5.3
Corporate taxes	1.5	1.6	2.1	1.9	1.2	1.4	1.4	1.4	1.4	1.4	1.4
Other	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Social contributions	13.3	13.3	13.9	12.9	12.3	11.7	11.7	11.7	11.7	11.7	11.7
Current non-tax revenue	4.2	4.3	4.2	4.2	4.0	3.9	3.9	3.9	3.9	3.9	3.9
Current grants	1.9	1.6	1.3	1.2	1.6	1.1	0.9	0.8	0.8	0.8	0.7
Capital revenues and grants	2.9	3.9	0.6	1.0	1.3	2.3	2.0	1.2	0.8	0.6	0.6
Expenditure	50.3	50.6	47.2	47.0	46.7	46.3	45.5	44.5	44.0	43.7	43.5
Compensation of employees 3/	10.3	10.4	10.8	10.9	10.5	10.7	10.7	10.6	10.6	10.6	10.6
Goods and services	7.7	7.9	7.5	8.0	7.5	7.1	7.1	7.1	7.0	7.0	7.0
Interest	4.0	3.5	3.1	2.7	2.4	2.0	2.0	1.8	1.9	1.9	2.0
Subsidies	2.0	1.9	2.0	1.9	1.7	1.3	1.3	1.3	1.3	1.3	1.3
Current transfers to households	15.7	14.7	14.5	13.7	13.1	13.4	13.4	13.4	13.4	13.4	13.4
Social security	12.3	11.7	11.7	11.2	10.7	9.3	9.3	9.3	9.3	9.3	9.3
Other	3.5	3.0	2.8	2.6	2.3	4.1	4.1	4.1	4.1	4.1	4.1
Other current transfers	3.1	2.8	3.5	3.0	3.4	3.5	3.5	3.5	3.5	3.5	3.5
Capital expenditures	5.5	6.6	2.9	4.3	5.9	5.9	5.1	4.4	4.0	3.6	3.3
Capital transfers	1.8	2.8	2.7	2.4	1.9	2.4	2.4	2.4	2.4	2.4	2.4
General government balance	-2.8	-2.0	-1.8	-2.4	-2.3	-1.8	-1.6	-1.4	-1.3	-1.2	-1.1
Primary balance	1.0	1.4	1.3	0.2	0.0	0.1	0.4	0.3	0.5	0.6	0.8
Memorandum items:											
Structural balance (% of potential GDP)	-1.7	-1.1	-1.3	-2.5	-2.8	-2.8	-2.5	-2.3	-2.0	-1.7	-1.3
Structural primary balance (% of potential GDP)	2.0	2.2	1.6	0.0	-0.5	-0.8	-0.5	-0.5	-0.2	0.2	0.6
Gross public debt (Maastricht definition)	76.8	76.1	75.5	72.9	70.2	66.5	64.0	61.7	59.8	58.0	56.2
GDP (billions of Forints)	32,694	34,785	35,896	38,835	42,662	46,095	49,139	52,132	55,092	58,107	61,167

Sources: Hungarian authorities and Fund staff estimates.

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

2/ Includes the levy on financial institutions.

3/ Includes social security contributions.

Table 4. Hungary: Central Bank Survey, 2014–20

(In Billions of Forints, unless otherwise indicated)

	2014	2015	2016	2017	2018	2019	2020
						Proj.	
Net foreign assets	10,501	9,294	7,376	7,112	8,690	8,582	8,388
Foreign Assets	11,186	9,846	8,213	7,841	9,442	9,334	9,141
Foreign Liabilities	685	552	837	730	752	752	752
Net domestic assets	-5,984	-4,512	-1,943	-812	-1,434	-666	14
Net claims on government	-849	-620	-1,101	-655	-1,357	-1,073	-1,099
Assets	139	39	39	39	39	39	39
Liabilities (Govt Deposits at MNB)	988	660	1,140	694	1,397	1,112	1,138
HUF	525	404	786	385	1,164	…	…
FX	463	256	354	309	233	…	…
Net claims on banks	-4,247	-2,982	-156	384	1,038	1,189	1,748
Assets	1,037	1,401	1,546	1,240	1,383	1,551	2,018
Liabilities	5,284	4,383	1,702	856	345	362	271
Deposits & CDs excl. current & overnight deposits	5,281	4,383	1,702	856	345	362	271
Securities Issued by MNB 1/	3	0	0	0	0	0	0
Net claims on the economy 2/	6	13	11	11	13	10	7
Other items, net	-894	-923	-696	-552	-1,128	-792	-642
Base money (M0)	4,517	4,781	5,433	6,300	7,256	7,916	8,402
Currency in Circulation	3,785	4,357	4,655	5,177	6,078	6,631	7,038
Banks' Reserves	732	424	778	1,123	1,178	1,285	1,364
Current Account Balances	499	363	180	212	259	282	300
Overnight Deposits	233	61	598	912	919	1,003	1,065
Memorandum items:							
International Reserves (billions of Euros)	34.6	30.3	24.4	23.4	27.4	29.1	28.4
Base Money (yoy percent change)	19.0	5.9	13.6	16.0	15.2	9.1	6.1
NFA (contribution to change)	30.1	-26.7	-40.1	-4.9	25.1	-1.5	-2.4
NDA (contribution to change)	-11.1	32.6	53.7	20.8	-9.9	10.6	8.6
Government Deposits at Central Bank (percent of GDP)	3.0	1.9	3.2	1.8	3.3	2.4	2.3
HUF	1.6	1.2	2.2	1.0	2.7	…	…
FX	1.4	0.7	1.0	0.8	0.5	…	…
Reserve Requirement Ratio (percent of select liabilities)	2-5	2.0	1.0	1.0	1.0	1.0	1.0

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

1/ Data are from MNB's monetary statistics Table 2.a.1 on bank assets.

2/ Does not include holdings of shares and equity stakes issued by other residents, which are captured in other items net. The Pallas Athene Foundations are not part of the MNB's balance sheet.

Table 5. Hungary: Monetary Survey, 2014–20

(In Billions of Forints, unless otherwise indicated)

	2014	2015	2016	2017	2018	2019	2020
						Proj.	
Net foreign assets	7,505	7,762	8,443	8,051	10,381	10,130	9,695
Central Bank	10,501	9,294	7,376	7,112	8,690	8,582	8,388
Commercial Banks	-2,996	-1,531	1,067	940	1,692	1,547	1,306
Net domestic assets	11,181	12,100	12,821	14,876	15,255	17,849	20,326
Domestic credit	18,821	19,166	19,469	21,376	22,252	24,747	26,658
Net claims on government	4,284	6,006	6,334	7,895	7,308	8,013	8,255
From Central Bank	-849	-620	-1,101	-655	-1,357	-1,073	-1,099
From Commercial Banks	5,132	6,626	7,435	8,549	8,665	9,086	9,354
Gross Credit to the economy	14,537	13,160	13,134	13,482	14,945	16,734	18,403
From Commercial Banks	14,531	13,147	13,124	13,471	14,931	16,723	18,396
Other items, net	-7,640	-7,066	-6,648	-6,500	-6,997	-6,897	-6,331
Broad money (M3)	18,686	19,862	21,264	22,928	25,637	27,979	30,021
M2	17,264	18,557	20,389	22,405	25,212	27,516	29,524
M1	10,738	13,226	16,306	19,360	21,971	23,979	25,729
Currency in circulation	3,548	4,109	4,368	4,878	5,708	6,230	6,685
Overnight Deposits	7,190	9,117	11,939	14,482	16,263	17,749	19,044
Deposits with Maturities up to 2 years	6,526	5,331	4,083	3,045	3,241	3,537	3,795
Repos	53	43	31	0	9	9	9
Money Market Fund Shares/Units	1,228	1,151	781	488	371	405	435
Debt Securities	140	111	63	35	44	48	51
Memorandum items:							
	(Percentage change by contribution, y-o-y)						
Broad Money	5.1	6.3	7.1	7.8	11.8	9.1	7.3
NFA	7.5	1.4	3.4	-1.8	10.2	-1.0	-1.6
NDA	-2.3	4.9	3.6	9.7	1.7	10.1	8.9
	(Percentage change, y-o-y)						
Credit to Private Sector 1/ 2/	-0.9	-10.9	2.0	6.5	10.7	12.0	10.0
HUF	6.0	41.1	3.4	4.4	11.7	…	…
FX	-7.4	-61.3	-2.3	14.1	7.6	…	…
Bank Deposits	6.3	5.2	9.9	8.4	11.2	11.1	9.3
Bank Holdings of Government Paper (percent of GDP)	14.8	18.7	21.0	21.8	19.7	19.2	18.5

Sources: Hungarian National Bank (MNB) and Fund staff estimates and projections.
1/ Only credit to households and firms.
2/ Based on transaction data, i.e., adjusted for exchange rate changes.

Table 6. Hungary: Balance of Payments, 2014–24

(In Millions of Euros, unless otherwise indicated)

	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
						Proj.					
Current Account	**1,342**	**2,648**	**5,210**	**2,830**	**-717**	**-1,320**	**-1,063**	**-634**	**-315**	**157**	**-208**
Goods and service (GS), net	6,713	8,959	10,084	9,153	5,871	5,816	6,410	6,514	6,783	7,065	7,510
Exports	92,595	98,762	100,466	109,417	113,617	120,021	126,726	134,811	143,105	152,108	162,758
Imports	-85,882	-89,803	-90,382	-100,264	-107,746	-114,205	-120,315	-128,297	-136,322	-145,044	-155,248
Primary Income, net	-4,543	-5,131	-3,131	-5,131	-5,293	-5,912	-6,184	-5,926	-5,953	-5,841	-6,548
Secondary Income/Current transfers, net	-827	-1,180	-1,744	-1,192	-1,295	-1,224	-1,289	-1,222	-1,145	-1,067	-1,170
Capital Account	**3,908**	**5,160**	**-21**	**1,076**	**3,459**	**2,300**	**1,660**	**1,501**	**1,387**	**1,001**	**1,026**
Financial Account 1/	**1,757**	**11,571**	**8,148**	**1,726**	**-2,444**	**-786**	**1,270**	**1,365**	**618**	**-943**	**705**
Direct investment, net	-3,079	-1,438	-2,563	-2,164	-2,812	-3,884	-2,523	-2,690	-3,365	-3,777	-3,504
Net acquisition of assets	4,186	5,753	-8,414	5,044	5,657	5,039	4,578	4,532	4,233	4,083	3,816
Net incurrence of liabilities	7,264	7,192	-5,851	7,208	8,469	8,923	7,101	7,223	7,598	7,860	7,320
Portfolio investment, net 2/	3,577	4,971	4,876	2,724	-1,159	1,276	2,128	2,634	2,658	1,514	3,005
Other investment	1,258	8,039	5,835	1,166	1,527	1,823	1,664	1,421	1,325	1,320	1,204
Net errors and omissions	**-671**	**-1,150**	**-1,640**	**-2,152**	**-1,589**	**0**	**0**	**0**	**0**	**0**	**0**
Overall Balance	**2,822**	**-4,914**	**-4,599**	**28**	**3,598**	**1,766**	**-673**	**-498**	**454**	**2,101**	**113**
Financing	**-2,740**	**4,913**	**4,600**	**-28**	**-3,598**	**-1,766**	**673**	**498**	**-454**	**-2,101**	**-113**
Gross Reserves ("-": increase)	-740	4,913	6,100	-28	-3,598	-1,766	673	498	-454	-2,101	-113
Other Official Financing (EU) (net)	-2,000	0	-1,500	0	0	0	0	0	0	0	0
Memorandum Items:											
Current account (percent of GDP)	1.3	2.4	4.5	2.3	-0.5	-0.9	-0.7	-0.4	-0.2	0.1	-0.1
Exports volume (percentage change)	9.2	7.4	3.8	6.9	4.3	4.6	5.1	5.5	5.6	5.6	5.5
Imports volume (percentage change)	11.0	6.0	3.4	8.2	6.8	5.4	5.1	5.0	5.1	5.2	5.3
Gross external debt (percent of GDP) 3/	114.4	106.3	96.2	84.1	79.6	69.5	63.0	58.5	54.7	51.8	49.1
Gross official reserves	34,578	30,322	24,384	23,368	27,403	29,169	28,496	27,998	28,452	30,553	30,666
In percent of s-t debt at remaining maturity 4/	162	140	129.7	136.4	156.7	168.6	178.5	176.7	219.4	233.7	242.1
In months of next year's imports of G&S	4.6	4.0	2.9	2.6	2.9	2.9	2.7	2.5	2.4	2.4	2.4

Sources: Hungarian authorities and Fund staff estimates.
1/ A negative sign for financial accounts items indicates a net inflow per BPM6.
2/ Includes financial derivatives.
3/ Excludes Special Purpose Entities.
4/ Excludes Special Purpose Entities and direct investment (inter-company) debt liabilities.

Table 7. Hungary: Financial Soundness Indicators for the Banking Sector, 2014–19

(In percent, unless otherwise indicated, end of period)

	2014	2015	2016	2017	2018	2019 Q1	2019 Q2
Capital							
Regulatory capital to risk-weighted assets	16.9	16.9	18.0	18.1	18.5	17.5	17.9
Regulatory Tier 1 capital to risk-weighted assets	13.7	13.9	15.9	16.2	16.7	15.8	16.3
Asset Quality 1/							
NPLs (90 days overdue) net of provisions to capital	33.8	17.4	9.4	5.0	3.2	3.3	3.1
NPLs (90 days overdue) to gross loans	15.6	11.7	7.4	4.2	2.5	2.4	2.0
Distribution of Loans (Percent of Total)							
Firms	38.4	38.0	35.9	37.9	39.3	38.3	38.7
Households and Non-Profits	40.5	40.3	37.9	37.0	35.2	34.3	33.7
Non-Residents	6.7	6.9	9.7	7.7	8.2	9.4	9.4
Other	14.4	14.8	16.5	17.4	17.3	18.0	18.2
FX loans	50.7	23.5	22.0	23.4	23.5	23.9	23.8
Profitability							
ROA	-2.2	0.2	1.6	1.9	1.9	1.4	1.8
ROE	-20.6	1.9	16.7	19.7	19.4	13.6	17.6
Net interest income to gross income	53.6	49.5	46.9	46.0	47.7	50.3	49.4
Noninterest expenses to gross income	73.7	88.1	71.9	72.8	70.1	77.4	71.8
Liquidity							
Liquid assets to total assets	38.0	41.9	36.0	30.5	27.0	26.9	24.1
Liquid assets to short term liabilities	63.6	68.8	59.7	46.9	41.6	42.2	37.9
Sensitivity to Market risk							
Net open FX position to Regulatory capital	21.9	17.1	16.4	-1.3	-1.0	-0.2	1.0

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

1/ The decline in NPLs in 2015 was partially 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.

Box 1. Global Automotive Industry: Hungary's Participation and Prospects[1]

Recent developments: The global car industry witnessed important changes in 2018. Vehicle production in 2018 fell (by 6 percent) for the first time since the Global Financial Crisis, and sales (and exports) were also weak. The downturn was synchronized across markets. There were several factors behind the downturn: China phased-out tax credits on car purchases and tighter lending conditions for auto loans were observed in large car buyers (US, UK, China). Structural changes also contributed to the developments through technological changes (demand for electric cars, car sharing) and higher environmental standards. Finally, increased tariffs on steel and aluminum, issues with emissions compliance in Germany, and expectations of the rise in car tariffs, have added to the fallout.

Hungary's exposure. The motor vehicle industry in Hungary accounted for 4.9 percent of gross value added in 2017, and over 7 percent considering input linkages. Cars are Hungary's top exports, followed by vehicle parts, and spark-ignition engines, all accounting for 16 percent of total exports. Germany is Hungary's most important trading partner (27 percent share), not least due to the linkages with the German Value Chain (Figure 8). Hungary is also a net exporter of car components, and the ratio of export to import of car parts remained unchanged between 2007–17 comparing to a decline in some of its competitors (Figure 8).

Risks to output. Hungary is predisposed to various of the aforementioned car industry shocks. While it is difficult to gauge, some estimates suggest that a demand shock of a 10 percent decline in the demand for (and subsequently production of) German finished vehicles would lead to the reduction in gross output and value added in Hungary at -0.25 and -0.15 percentage points, respectively (Bank of Spain, 2019; Figure 8).[2] A supply shock of a 22.5 pps car tariff increase by the US on Hungarian car exports could shave off around 0.25 pps from Hungary's growth (Morgan Stanley Research (2019) based on latest available data as of 2014). The economies that would be directly exposed experience somewhat smaller declines as part of the shock is 'exported' to their main trading partners through reduced demand for intermediate goods imports. Also, Hungary's direct car exposure to the US has declined in recent years.

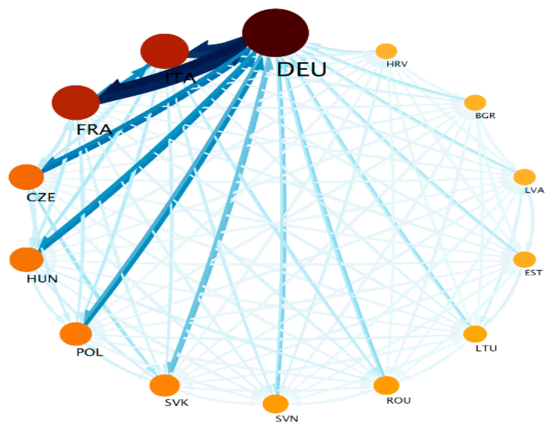
Mitigating factors and opportunities. Assuming lower demand elasticities for more expensive goods, demand shocks are somewhat cushioned for Hungary given that the production is concentrated on high-end (German brand) vehicles unlike in Slovakia and to some extent in Czech Republic (Figure 8). Several manufactures are also opening electric car production lines in their plants following the current demand trends. Battery production (by Samsung, GS Yuasa, SK Innovations) and exports (including for electric cars) are gaining speed due to FDI in the sector (Convergence Program, 2019; Figure 8). To further mitigate its exposure to various shocks, together with adapting to new trends in the industry, Hungary should make efforts to expand the potential of the external sector by increasing productivity, including through targeted skills training and automation, upgrading transport and digital infrastructure, and reducing impediments to doing business for domestic companies to become GVC suppliers and exporters, in general.

1/ Prepared by S. Vtyurina.

2/ Given the integration of the car industry value chain, a decline in car production in each of the economies will have a knock-on effect on the industry itself (direct effect) and on other sectors and countries that provide the inputs needed for car manufacturing (indirect effect). Germany would suffer the greatest impact on their own gross output and value added and would have the biggest knock-on effects on other economies, in particular in eastern Europe.

Figure 8. Automotive Sector Statistics

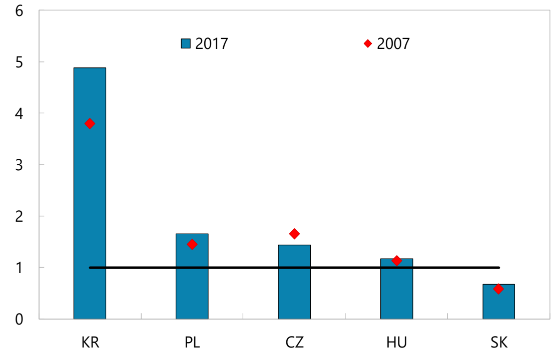
German Supply Chains 1/



1/ Arrows are proportional to nominal GVC trade flows between countries
Source: EORA Database; and IMF staff calculations.

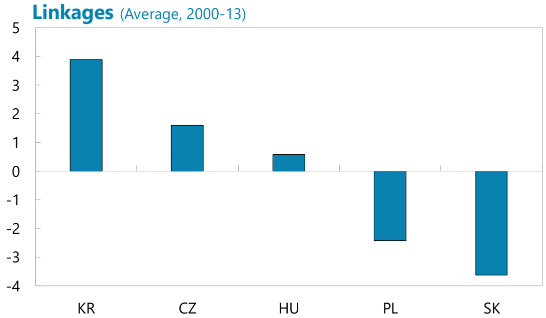
Car Parts: Export to Import Ratio, 2017

(1 means trade Saldo is in balance)



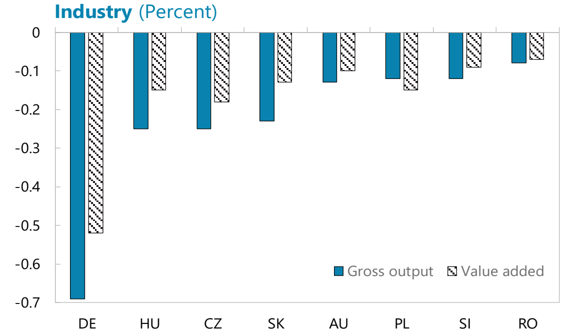
Sources: Comtrade; and IMF staff calculations.

Transport Equipment Exports: Change in Forward Linkages (Average, 2000-13)



Sources: EORA database; and IMF staff calculations.
Note: Forward linkage is the share of Slovak's exports that subseuently get re-exported by other countries.

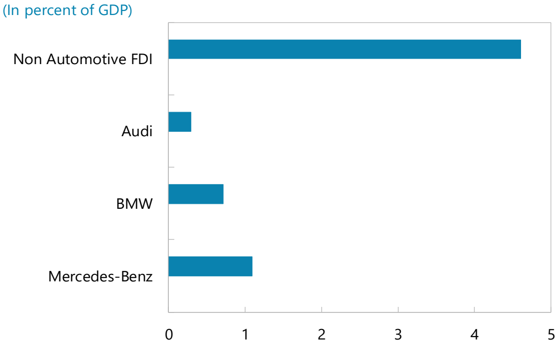
Impact on Activity from a Decline in the German Car Industry (Percent)



Source: Bank of Spain (Quarterly Report 2019).

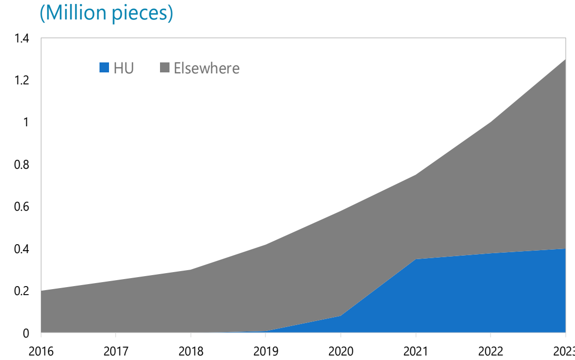
Recently Announced Large Investment Projects

(In percent of GDP)



Source: Hungarian Investment Promotion Agency.

Projected Electric Car Batteries Sales in Europe (Million pieces)



Sources: *Citi GPS*; Hungarian Ministry of Finance

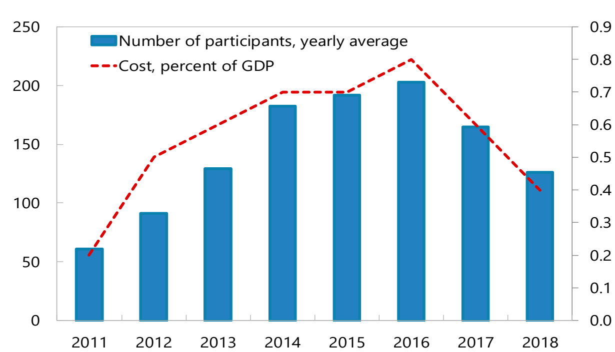
Box 2. Public Works Scheme[1]

The public works program is the single largest government intervention in the Hungarian labor market. It involves three subprograms: national public works, longer-term public works, and "start-work" pilots. Most of the programs' clients are jobseekers with past work experience but no recent employment history. Additionally, many public works clients who have been inactive earlier and lost their income as a result of the unemployment benefit scheme transformation are coming from poor and vulnerable households (World Bank, 2017).

Given the booming labor market, the initial objectives of providing employment opportunities and social support have been reached and the program is being scaled down. Participation decreased from the high of 202 thousand in 2016 to 101 thousand in Q2 2019, or about 2.6 percent of the total workforce, well ahead of the government's 2020 target. Several changes to the scheme took place after 2013 with the program's objective shifting from reaching out to and mobilizing inactive individuals towards facilitating participants' successful exit to the primary labor market. The replacement allowance was in place till end-2018, which allowed public employees to be employed in a private sector before exiting the PWS while compensating for any wage difference. The wages of public workers will not be raised for the third year in a row in 2019 as the government encourages people to seek opportunities elsewhere, while also limiting the fiscal costs.

The program structure and incentives could be improved. Efforts should be made to limit the time of participation in the program as an inverse relationship has been observed between the duration of participation and the likelihood of employment outside the program, except for some groups (partially disabled, very low skilled) (European Commission, 2017). Perhaps an overview of the universal unemployment benefit (UB)duration is warranted as participation in the PWS has been incentivized by the UB's very short duration, which at 3 months is the lowest in the EU. One of the most prominent shortcomings is that the program absorbed funds from other more efficient labor market tools (as active labor market policies (ALMPs)) and provided a lower income than the minimum wage. The per capita cost of the scheme is higher, and its efficiency is lower than that of ALMPs (Fertig and Csillag, 2015). While the reemployment rate is gender-balanced, there is a higher reemployment rate for younger age cohorts (younger than 25 years), perhaps, suggesting that increasing the availability of child-care facilities would improve participation among an oder cohort of women (25–39 age group) coming out of this program, and women, in general.

Public Works Scheme



Source: Hungarian Authorities.

1/Prepared by S. Vtyurina.

Annex I. Public and External Debt Sustainability Analysis

Public Debt Sustainability Analysis

1. The baseline scenario assumes no material fiscal adjustment over the projection horizon, except for the small intended reduction in public investment. It is underpinned by the following assumptions:

- *Real GDP growth* is projected to moderate from 4.9 percent in 2019 to 3.5 and 3.0 percent in 2020 and 2021, respectively. The projected slowdown in growth reflects the expected slowdown in the EU funds absorption and lower growth in major trade partners. Over the medium term, growth is projected to decline close to 2 percent, which is broadly consistent with the medium-term growth potential.

- *GDP deflator* is projected to grow by 3 percent over the medium term in line with the central bank's inflation target.

- *The primary fiscal position* is projected to remain broadly unchanged averaging about 0.5 percent of GDP over the projection period. The projections incorporate the already announced reductions in the social security rate for employers and tax rates, lower EU funds (starting in 2020), higher compensations of public employees, declining public investment and still favorable financing conditions.

2. The baseline projections are underpinned by realistic assumptions but risks to growth are on the upside. Previous forecasts of growth, primary balance and inflation tended to be conservative. Comparing to other countries, projection errors seem reasonable, as reflected in the interquartile range.

3. The projected decline in public debt reflects only small fiscal adjustment. The public debt-to-GDP ratio is forecast to decline from 70.2 percent in 2018 to about 56 percent by 2024. Under the baseline scenario, in cumulative terms, the primary balance will contribute only by 2.7 percentage points to the declining debt path. In contrast, the cumulative contribution of the interest rate-growth differential is projected to be about 10 percentage points, reflecting growth being above the effective interest rate on public debt. Gross financing needs are forecast to drop between 10 to 12 percent of GDP over the projection horizon on account of recently extended maturities of sovereign bonds.[1]

4. The projections of public debt and gross financing needs are particularly sensitive to growth, combined macro-fiscal, and contingent liabilities shocks:

[1] Gross financing needs are estimated at about 21.6 percent of GDP at the end of 2018. Excluding the value of buybacks and switches by the AKK, the gross financing needs have been quantified at 18.9 percent of GDP in 2018.

- *Growth shock.* Slower growth remains the principal risk to debt sustainability. Assuming a decline in growth by one standard deviation for 2019 and 2020, the debt-to-GDP ratio is forecast to reach 70 percent, i.e., 10 percentage points above the baseline in 2024. Under the same assumptions, gross financing needs would reach 16 percent of GDP, i.e., about 3 percentage points above the baseline level by the end of the projection period.

- *Macro-fiscal shock.* If shocks to growth, interest rate, and primary balance occur simultaneously, the debt-to-GDP ratio would reach at 74 percent at the end of the projection horizon. In this case, financing needs would reach at 17 percent of GDP.

- *Contingent liabilities shock.* A standardized shock of 10 percent of financial sector assets is used to represent a hypothetical realization of contingent liabilities. In such a scenario, the debt-to-GDP ratio would reach 74 percent at the end of the projection horizon and financing needs would reach 19.5 percent of GDP.

5. The fan charts show moderate uncertainty around the baseline. The width of the symmetric fan chart, estimated at almost 20 percent of GDP, illustrates the degree of uncertainty for equal-probability upside and downside shocks. Assuming less favorable economic conditions than under the baseline scenario—upside shocks to growth and primary balance are constrained to zero—public debt dynamics would remain broadly stable at about 70 percent of GDP.

6. Hungary's debt profile has improved but still indicate some risks. The external financing needs are above the upper risk-assessment benchmark, but the risk is to a certain extent mitigated by the fact that a sizeable share of foreign liabilities accounts for intra-company loans. Public debt in foreign currency and public debt held by non-residents have declined considerably in recent years. To further reduce external financing requirements and the share of public debt held by non-residents, a new five-year retail bond denominated in domestic currency with gradually increasing interest rates over time was launched in mid-2019. In line with current favorable financing conditions and large investor base, spreads are below the lower-risk assessment benchmarks. The share of short-term debt has decline recently, although from relatively high levels.

7. Risks to debt sustainability, however, can be weighed against a number of mitigating factors.

- *Investor base.* Debt is now held predominantly by domestic financial institutions and households, with the non-resident component decreasing and estimated below 40 percent of total debt. This factor—coupled with ample liquidity in the system and still relatively low demand for private sector credit—has incentivized banks to purchase sovereign debt.

- *Buffers.* There is a cash cushion in the form of deposits accumulated by the public sector, which is around 5 percent of GDP. This implies a lower public debt-to-GDP ratio on a net basis and some liquidity cushion that could help cover financing needs for a few months.

Figure 1. Hungary Public Sector Debt Sustainability Analysis (DSA) - Baseline Scenario

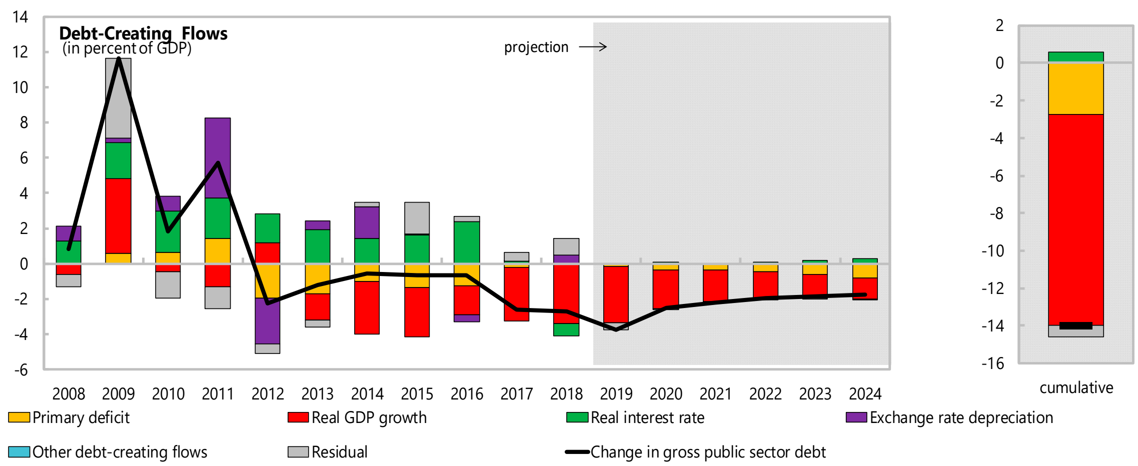
Debt, Economic and Market Indicators [1/]

	Actual			Projections					
	2008-2016 [2/]	2017	2018	2019	2020	2021	2022	2023	2024
Nominal gross public debt	75.0	72.9	70.2	66.5	64.0	61.7	59.8	58.0	56.2
Public gross financing needs	14.7	22.8	21.6	18.3	15.5	11.4	10.8	11.5	12.4
Real GDP growth (in percent)	0.8	4.3	5.1	4.9	3.5	3.0	2.6	2.4	2.2
Inflation (GDP deflator, in percent)	3.0	3.7	4.5	3.0	3.0	3.0	3.0	3.0	3.0
Nominal GDP growth (in percent)	3.8	8.2	9.9	8.0	6.6	6.1	5.7	5.5	5.3
Effective interest rate (in percent) [4/]	5.8	3.8	3.6	3.1	3.2	3.1	3.2	3.4	3.6

As of September 30, 2019		
Sovereign Spreads		
EMBIG (bp) 3/		100
5Y CDS (bp)		79.8
Ratings	Foreign	Local
Moody's	Baa3	Baa3
S&Ps	BBB	BBB
Fitch	BBB	BBB

Contribution to Changes in Public Debt

	Actual			Projections							
	2008-2016	2017	2018	2019	2020	2021	2022	2023	2024	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	1.6	-2.6	-2.7	-3.7	-2.5	-2.2	-1.9	-1.8	-1.8	-14.0	
Identified debt-creating flows	1.4	-3.1	-3.6	-3.3	-2.5	-2.2	-1.9	-1.8	-1.7	-13.4	
Primary deficit	-0.5	-0.2	0.0	-0.1	-0.4	-0.3	-0.5	-0.6	-0.8	-2.7	-0.9
Primary (noninterest) revenue and grants	45.9	44.5	44.3	44.4	43.9	43.0	42.6	42.3	42.3	258.6	
Primary (noninterest) expenditure	45.4	44.3	44.3	44.3	43.5	42.7	42.2	41.7	41.5	255.9	
Automatic debt dynamics [5/]	1.9	-2.9	-3.6	-3.2	-2.1	-1.8	-1.4	-1.2	-0.9	-10.7	
Interest rate/growth differential [6/]	1.2	-2.9	-4.1	-3.2	-2.1	-1.8	-1.4	-1.2	-0.9	-10.7	
Of which: real interest rate	1.9	0.1	-0.7	0.0	0.1	0.0	0.1	0.2	0.3	0.6	
Of which: real GDP growth	-0.7	-3.0	-3.4	-3.2	-2.2	-1.8	-1.5	-1.4	-1.2	-11.3	
Exchange rate depreciation [7/]	0.6	0.0	0.5	…	…	…	…	…	…	…	
Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Please specify (1) (e.g., drawdown of deposits) (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Please specify (2) (e.g., ESM and Euroarea loans)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes [8/]	0.3	0.5	0.9	-0.4	0.0	0.0	0.0	0.0	0.0	-0.6	



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).

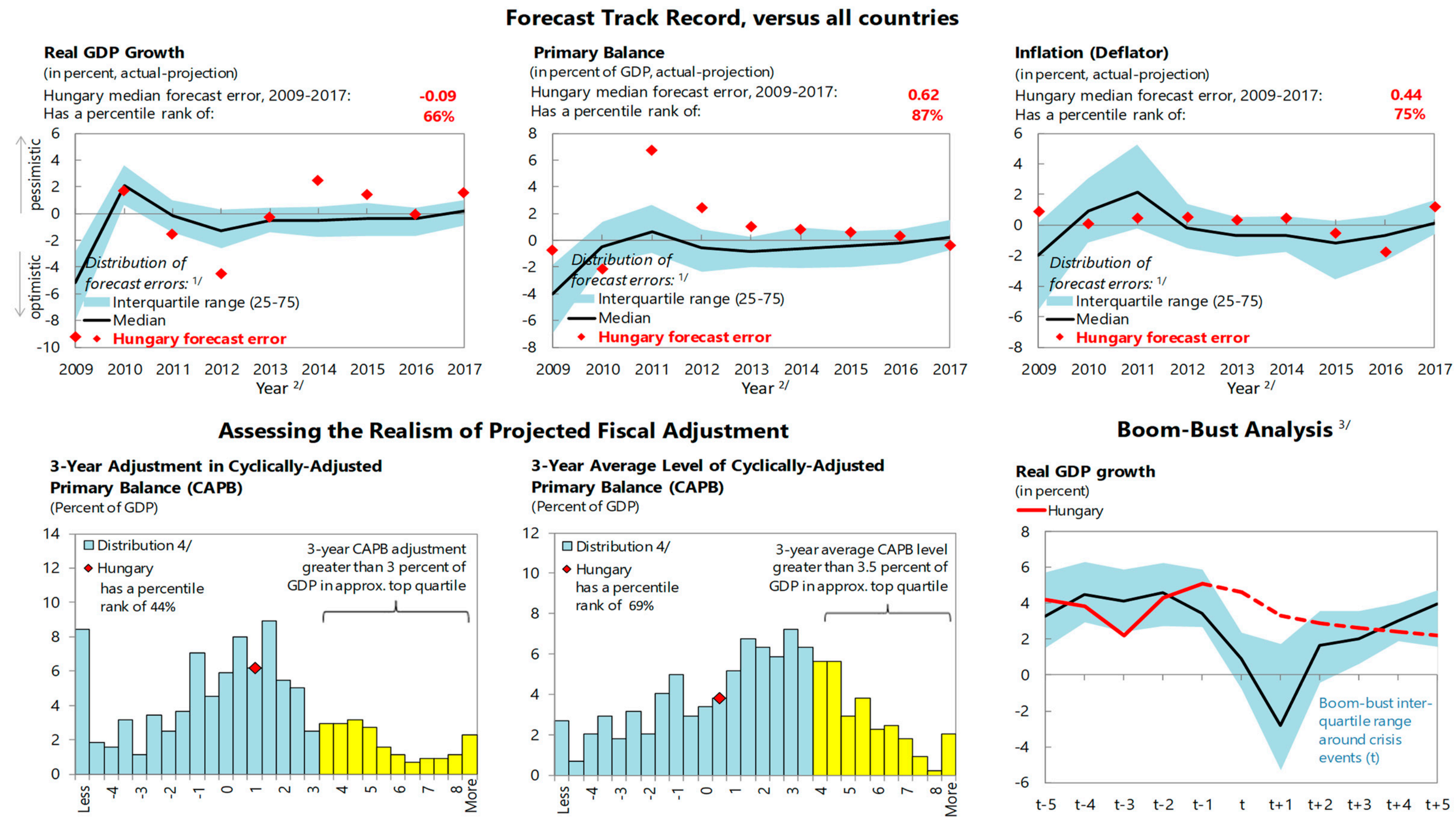
6/ The real interest rate contribution is derived from the numerator in footnote 5 as r - π (1+g) and the real growth contribution as -g.

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.

Figure 2. Hungary Public DSA - Realism of Baseline Assumptions



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/ Hungary has had a cumulative increase in private sector credit of 80 percent of GDP, 2015-2018. For Hungary, t corresponds to 2019; for the distribution, t corresponds to the first year of the crisis.

4/ Data cover annual obervations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

Figure 3. Hungary Public DSA Risk Assessment

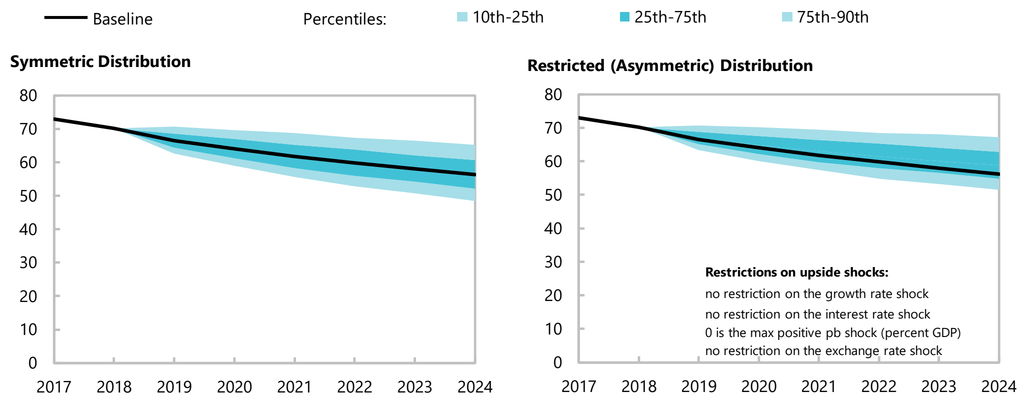
(In percent of GDP, unless otherwise indicated)

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

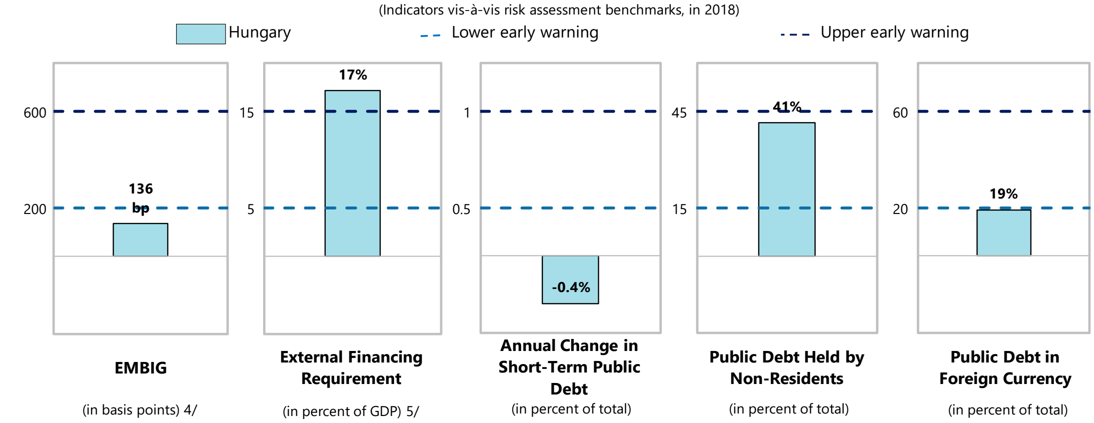
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2018)



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, 11/1/2018-1/30/2019.

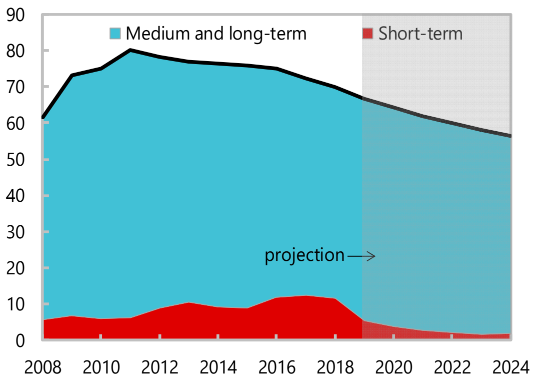
5/ External financing requirement is defined as the sum of current account deficit, amortization of medium and long-term total external debt, and short-term total external debt at the end of previous period.

Figure 4. Hungary Public DSA – Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

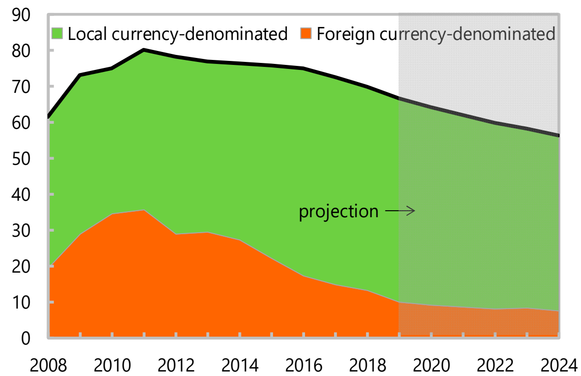
By Maturity

(in percent of GDP)



By Currency

(in percent of GDP)

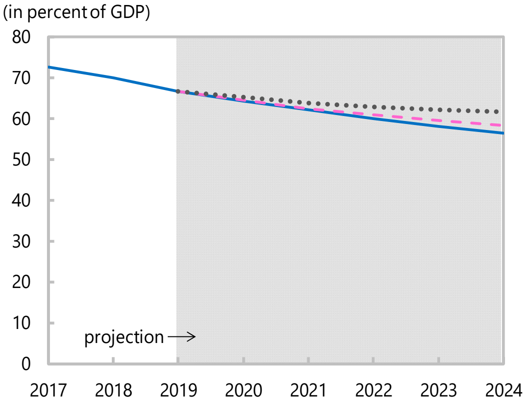


Alternative Scenarios

Baseline   Historical   Constant Primary Balance

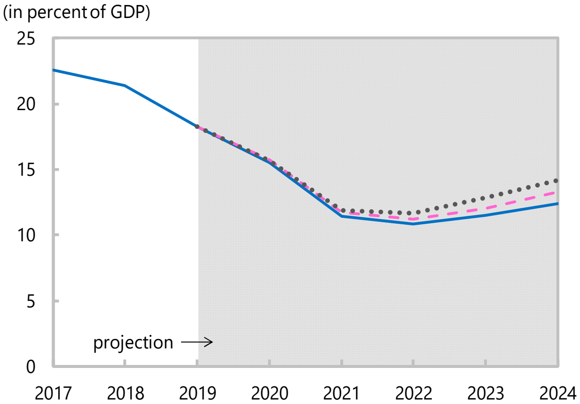
Gross Nominal Public Debt

(in percent of GDP)



Public Gross Financing Needs

(in percent of GDP)



Underlying Assumptions

(in percent)

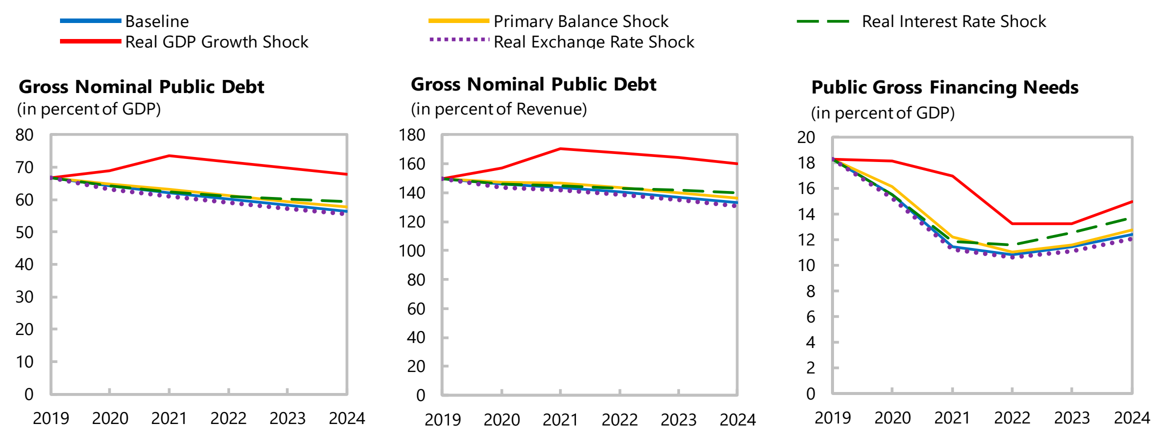
Baseline Scenario	2019	2020	2021	2022	2023	2024
Real GDP growth	4.6	3.3	2.9	2.6	2.4	2.2
Inflation	3.0	3.0	3.0	3.0	3.0	3.0
Primary Balance	0.2	0.4	0.4	0.5	0.6	0.8
Effective interest rate	3.2	3.2	3.1	3.2	3.4	3.6
Constant Primary Balance Scenario						
Real GDP growth	4.6	3.3	2.9	2.6	2.4	2.2
Inflation	3.0	3.0	3.0	3.0	3.0	3.0
Primary Balance	0.2	0.2	0.2	0.2	0.2	0.2
Effective interest rate	3.2	3.2	3.1	3.2	3.4	3.6

Historical Scenario	2019	2020	2021	2022	2023	2024
Real GDP growth	4.6	1.6	1.6	1.6	1.6	1.6
Inflation	3.0	3.0	3.0	3.0	3.0	3.0
Primary Balance	0.2	0.5	0.5	0.5	0.5	0.5
Effective interest rate	3.2	3.2	3.5	3.9	4.3	4.7

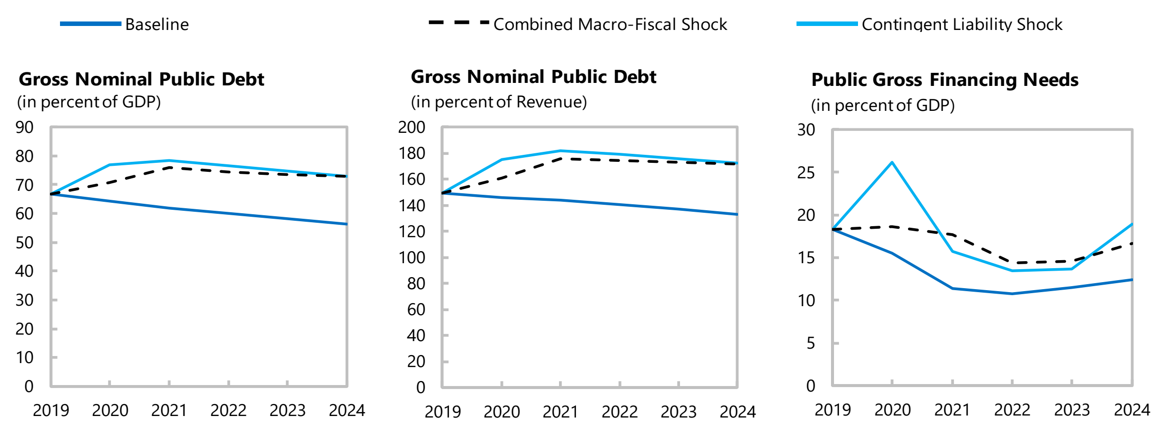
Source: IMF staff.

Figure 5. Hungary Public DSA – Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions
(in percent)

Primary Balance Shock	2019	2020	2021	2022	2023	2024
Real GDP growth	4.6	3.3	2.9	2.6	2.4	2.2
Inflation	3.0	3.0	3.0	3.0	3.0	3.0
Primary balance	0.2	-0.2	-0.2	0.5	0.6	0.8
Effective interest rate	3.2	3.2	3.1	3.3	3.4	3.6
Real Interest Rate Shock						
Real GDP growth	4.6	3.3	2.9	2.6	2.4	2.2
Inflation	3.0	3.0	3.0	3.0	3.0	3.0
Primary balance	0.2	0.4	0.4	0.5	0.6	0.8
Effective interest rate	3.2	3.2	3.7	4.3	4.9	5.5
Combined Shock						
Real GDP growth	4.6	-0.2	-0.6	2.6	2.4	2.2
Inflation	3.0	2.1	2.1	3.0	3.0	3.0
Primary balance	0.2	-1.5	-3.5	0.5	0.6	0.8
Effective interest rate	3.2	3.4	3.8	4.5	5.1	5.6

Real GDP Growth Shock	2019	2020	2021	2022	2023	2024
Real GDP growth	4.6	-0.2	-0.6	2.6	2.4	2.2
Inflation	3.0	2.1	2.1	3.0	3.0	3.0
Primary balance	0.2	-1.5	-3.5	0.5	0.6	0.8
Effective interest rate	3.2	3.2	3.2	3.5	3.7	3.8
Real Exchange Rate Shock						
Real GDP growth	4.6	3.3	2.9	2.6	2.4	2.2
Inflation	3.0	7.4	3.0	3.0	3.0	3.0
Primary balance	0.2	0.4	0.4	0.5	0.6	0.8
Effective interest rate	3.2	3.4	3.1	3.2	3.4	3.5
Contingent Liability Shock						
Real GDP growth	4.6	-0.2	-0.6	2.6	2.4	2.2
Inflation	3.0	2.1	2.1	3.0	3.0	3.0
Primary balance	0.2	-9.4	0.4	0.5	0.6	0.8
Effective interest rate	3.2	3.5	3.7	3.9	4.0	3.9

Source: IMF staff.

Table 1. Hungary: External Debt Sustainability Framework, 2014–2024

(In percent of GDP, unless otherwise indicated)

	Actual							Projections						
	2014	2015	2016	2017	2018			2019	2020	2021	2022	2023	2024	**Debt-stabilizing non-interest current account 6/**
Baseline: External debt	118.4	107.0	95.7	83.3	79.6			**69.5**	**63.0**	**58.5**	**54.7**	**51.8**	**49.1**	**-3.4**
Change in external debt	1.3	-11.4	-11.3	-12.3	-3.7			-10.1	-6.5	-4.5	-3.8	-2.9	-2.8	
Identified external debt-creating flows (4+8+9)	-9.2	11.1	-9.5	-12.9	-5.6			-5.5	-3.3	-3.1	-3.3	-3.5	-3.1	
Current account deficit, excluding interest payments	-5.5	-5.6	-7.3	-4.0	-1.3			-0.8	-0.9	-1.1	-1.3	-1.4	-1.2	
Deficit in balance of goods and services	-7.1	-8.2	-9.1	-6.9	-4.6			-4.0	-4.2	-4.0	-4.0	-4.0	-4.0	
Exports	97.5	90.3	91.0	82.3	88.4			83.4	82.7	83.4	84.3	85.3	87.1	
Imports	90.4	82.1	81.8	75.5	83.8			79.4	78.6	79.4	80.3	81.3	83.1	
Net non-debt creating capital inflows (negative)	-2.9	-2.0	-2.2	-1.5	-2.2			-2.7	-1.7	-1.7	-2.0	-2.2	-2.2	
Automatic debt dynamics 1/	-0.8	18.6	0.0	-7.4	-2.1			-2.0	-0.7	-0.3	0.0	0.1	0.2	
Contribution from nominal interest rate	3.5	3.4	2.5	2.1	1.6			1.7	1.6	1.5	1.5	1.3	1.3	
Contribution from real GDP growth	-4.7	-5.1	-2.3	-3.7	-3.7			-3.7	-2.3	-1.8	-1.5	-1.3	-1.1	
Contribution from price and exchange rate changes 2/	0.4	20.4	-0.2	-5.8	-4.7			...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	10.5	-22.5	-1.8	0.6	1.9			-4.6	-3.2	-1.4	-0.6	0.6	0.3	
External debt-to-exports ratio (in percent)	121.4	118.4	105.2	101.2	90.1			83.4	76.2	70.2	64.9	60.8	56.3	
Gross external financing need (in billions of US dollars) 4/	44.4	33.7	11.5	17.5	21.7			20.7	18.5	14.6	12.5	10.1	13.1	
in percent of GDP	35.2	27.8	9.4	11.6	14.3	10-Year	10-Year	12.7	10.7	7.9	6.4	4.9	6.0	
Scenario with key variables at their historical averages 5/					79.6			**71.0**	**64.1**	**59.3**	**54.3**	**50.8**	**47.0**	**-0.6**
Key Macroeconomic Assumptions Underlying Baseline						Historical Average	Standard Deviation							
Real GDP growth (in percent)	4.2	3.8	2.2	4.3	5.1	1.6	3.5	4.9	3.5	3.0	2.6	2.4	2.2	
GDP deflator in US dollars (change in percent)	-0.4	-14.7	0.2	6.4	14.8	-0.9	8.0	1.1	2.5	3.5	2.2	2.5	2.7	
Nominal external interest rate (in percent)	3.1	2.5	2.4	2.5	2.2	3.1	0.7	2.3	2.4	2.6	2.6	2.6	2.6	
Growth of exports (US dollar terms, in percent)	6.2	-10.9	1.4	11.1	8.6	1.3	11.8	0.9	6.1	7.2	6.9	7.0	7.8	
Growth of imports (US dollar terms, in percent)	7.1	-12.6	0.4	13.2	12.4	1.0	13.3	1.2	5.8	7.4	7.0	7.1	7.8	
Current account balance, excluding interest payments	5.5	5.6	7.3	4.0	1.3	5.3	1.9	0.8	0.9	1.1	1.3	1.4	1.2	
Net non-debt creating capital inflows	2.9	2.0	2.2	1.5	2.2	1.8	0.8	2.7	1.7	1.7	2.0	2.2	2.2	

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.

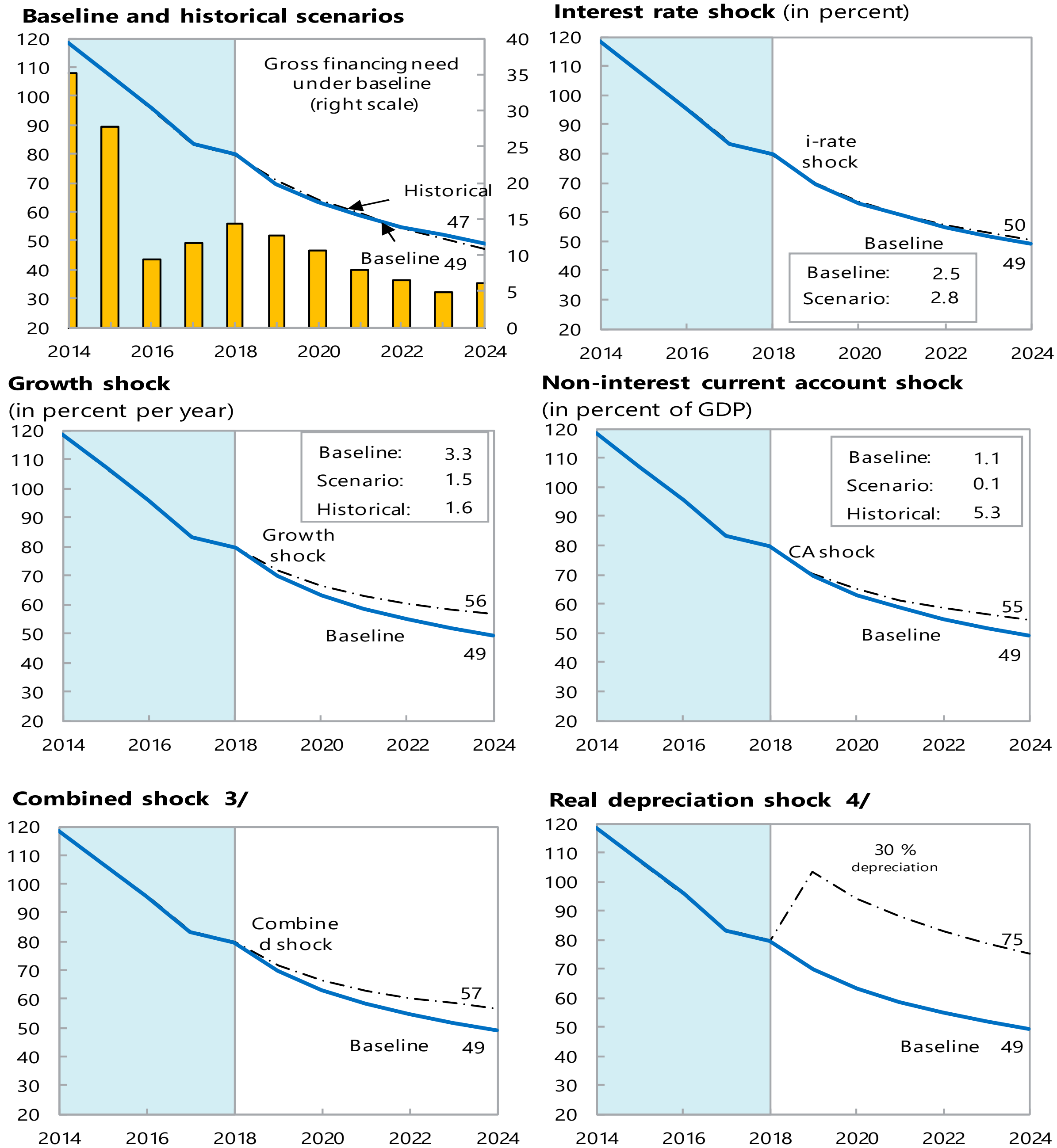
4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

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 6. Country: 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 2019.

Annex II. External Sector Assessment

1. Hungary's current account switched into deficit in 2018. This was attributed to continuing strong domestic consumption on the back of growing disposable income, and import-intensive investment, resulting in higher growth rate of imports than that of exports for the second year in a row. The current account surplus declined from 2.3 percent of GDP in 2017 to a deficit of 0.5 percent in 2018. The deficit on the primary income increased, mainly due to higher profit earned by foreign investors. Over the medium term, the current account is projected to improve somewhat as new capacities generated by recent large FDI will start generating exports, and investment related imports wind down.

2. Hungary's international investment position (IIP) continued to improve and external debt edged further down. The net IIP improved to about -54.2 percent of GDP in 2018, compared to about -59.6 in 2017 (Figure 1). It is expected to further improve over the medium term. This is largely driven by a continued reduction in external debt and increase in Hungarian companies' assets abroad. Gross external debt declined from 83.3 percent of GDP in 2017 to 79.6 percent in 2018. It is expected to continue to decline over the medium term under the baseline scenario, towards 50 percent of GDP by 2024.

3. International reserves remain adequate according to the Fund's metric. They increased by €4 billion in 2018 mainly due to the EU transfers (Figure 1). Due to this increase and short-term external debt falling to a historic low, reserve coverage of s-t debt increased substantially and continued to provide a comfortable cushion of 155 percent, relative to the benchmark of 100 percent. Reserves are expected to increase moderately over the medium term and remain in the recommended ranges (Figure 1).

4. Hungary's external position is assessed to be moderately stronger than the medium-term fundamentals and desirable policies. As in previous years, the EBA models yield mixed results for Hungary:

External Balance Assessment Results

	CA	REER-level	REER-index	ES
CA Norm (percent of GDP)	-3			
CA-stabilizing NFA at 2017 level				-2.5
CA gap (percent of GDP)	2.4			4.2
Exchange-rate gap (percent)	-9	19.6	10.2	-10.6

Source: 2018 External Balance Assessment (June).

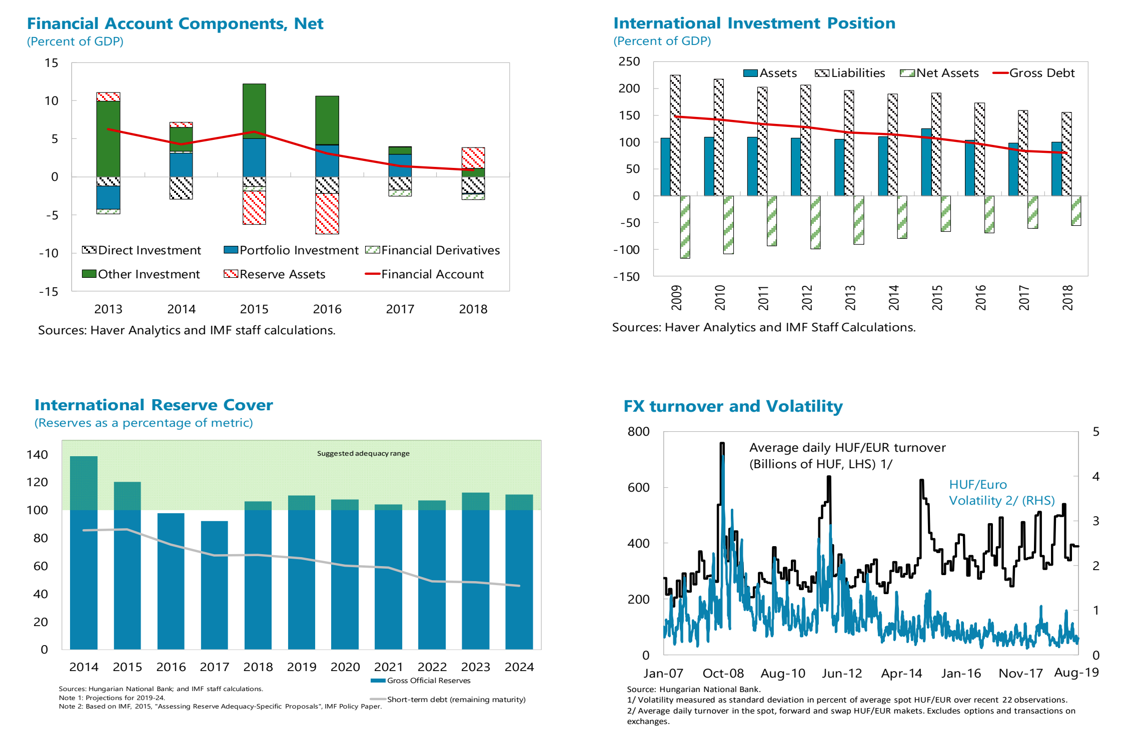
- The two *Real Effective Exchange Rate (REER) approaches* suggest an overvaluation of the exchange rate between 10 and 20 percent. However, they produce a large residual (up to about 24 percent) that is not explained by the policy variables. Furthermore, these results appear inconsistent with Hungary's previously buoyant albeit declining current account surpluses.

- The *External Sustainability (ES)* approach suggests that the exchange rate may be undervalued by close to 11 percent. However, this is based on stabilizing Hungary's net borrower position (NFA/GDP) at its recent level, which would be consistent with a medium-term current account deficit of 2.5 percent of GDP.

- The *CA approach* estimates Hungary's current account norm at -2.5 percent of GDP, which implies an exchange rate undervaluation of about 6 percent. The current account gap estimated by the model is therefore 2.4 percent of GDP 2017, out of which 2 percentage points are attributed to identified policies, while the residual accounts for 0.4 percentage points. A large part of the explained current account gap is attributed by the model to weak private sector credit[1].

5. On balance, staff judges the external *position in 2018* was *moderately stronger* than medium-term fundamentals and desired policy settings. The estimates of CA gaps from CA and ES method point to a stronger position, although the REER model provides some offsetting evidence. At the same time, the exchange rate gaps from CA and ES models are around 10 percent, consistent with moderately stronger external position. Furthermore, despite sizable deleveraging in recent years, the external debt ratio should be reduced further, implying a higher CA norm than in the baseline model (Table). Looking forward, implementation of structural reforms would encourage more private investment (with attendant imports of investment goods), which would help move the external position closer towards the medium-term fundamentals and desired policy settings. The preliminary 2019 estimates suggest that the CA gap further narrowed towards 2 percent.

Figure 1. External Indicators



[1] This implies the presence of the credit policy gap (in the case of Hungary this could be explained that after a credit bust the credit to GDP ratio is not expected to return to its pre-crisis level over a protracted period

Annex III. Hungary: Risk Assessment Matrix (RAM)[1]

	Source of Risks	Relative Likelihood	Impact if Realized	Policy Response
Global	*Sharp tightening of global financial conditions (short - term).*	**High** An abrupt change in global risk appetite (e.g., due to higher-than-expected inflation in the U.S.) could lead to sudden, sharp increases in interest rates and associated tightening of financial conditions. Higher debt service and refinancing risks could stress leveraged firms, households, and vulnerable sovereigns, including through capital account pressures in some cases.	**Medium** A significant increase in interest rates or in capital outflows would raise borrowing costs and put pressure on reserves. Financing availability would decline and its cost rise.	Monetary policy may have to be tightened, if capital outflows trigger exchange rate developments that put the achievement of the inflation target at risk. Fiscal policy will have to be attuned to evolving growth and financing conditions, which may push policy in opposite directions. Public debt strategy might have to be revisited if stresses surface in the bond market.
	Rising protectionism and retreat from multilateralism (short to medium-term).	**High** Fraying consensus about the benefits of globalization leads to protectionism and economic isolationism, resulting in reduced global and regional policy and regulatory collaboration with negative consequences for trade, capital and labor flows, sentiment, and growth.	**High** This could slow down, or even reverse, policy coordination and collaboration, and weigh on economic activity through trade and confidence channels.	If near-term growth slows sharply, automatic stabilizers should be allowed to operate, and monetary policy should remain accommodative.
	Weaker-than-expected global growth (short to medium-term).	**High/Medium** Low productivity growth (U.S., euro area and Japan), high debt, and failure to fully address crisis legacies by undertaking structural reforms amidst persistently low inflation undermine medium-term growth.	**Medium** Weaker external demand would hurt exports and tourism and would weigh on economic growth.	Allow automatic stabilizers to operate if financing conditions allow. Advance structural reforms to accelerate the transition towards a higher, sustainable growth path.

[1] The Risk Assessment Matrix (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 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 between 30 and 50 percent). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly. "Short term (ST)" and "medium term (MT)" are meant to indicate that the risk could materialize within 1 year and 3 years, respectively.

Source of Risks		Relative Likelihood	Impact if Realized	Policy Response
Domestic	*A faster than expected wage growth or weaker investment activity (short/medium term).*	**Medium** A faster wage growth would trigger a stronger domestic demand, leading to inflationary pressures. Weaker investment activity would have a negative impact on growth.	**Medium** A faster wage growth could accelerate inflation above the forecast in the baseline scenario. Weaker-than-expected investment activity, due to smaller-then-expected disbursement of EU finds, would dampen growth prospects.	Trigger the need for monetary tightening sooner than anticipated. Accelerate the implementation of structural reforms to raise productivity and to encourage investment.
	Continued pro-cyclical policy mix (short/medium-term).	**Medium** The expansionary fiscal policy and accommodative monetary policy environment would overheat the economy and worsen debt sustainability.	**Medium** Worsening debt sustainability would increase financing costs and raise vulnerabilities. The overheating could fuel an asset price bubble. House prices and the indebtedness of households would rise.	As a first step, adopt a growth-friendly fiscal adjustment strategy. As a second step, start unwinding the unconventional monetary tools and tighten macroprudential ratios. Thirdly, rise the policy interest rate.

Annex IV. 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
Take advantage of the strong economic conditions and implement a growth-friendly fiscal consolidation to achieve a faster decline in public debt and deficit.	As expected, in 2018 the general government balance slightly overperformed the budget target and the public debt ratio declined moderately. However, GDP growth and lower interest payments have contributed substantially to this outcome, and the underlying structural balance deteriorated further contrary to staff recommendation.
Keep the monetary policy stance under review, in light of inflationary pressures and pro-cyclicality of fiscal policy.	As inflation remained below expectations in 2018, the MNB continued with the accommodating monetary policy. It tightened the policy in 2019 and unwound some of the unconventional measures but introduced new ones.
Remain prudent and guard from financial sector risks, including those that can raise from the real estate market.	The MNB has pre-emptively tightened its macroprudential tools and is monitoring the real estate market. On the other hand, fiscal incentives continue to stimulate demand.
Improve labor market policies.	The number of participants in the PWS has been reduced and the number of child-care facilities is being increased.
Improve competitiveness indicators and remove impediments to doing business, especially for the SMEs sector.	Some measures have been taken to ease regulation, improve access to utility services, and reduce tax burden and para-fiscal costs on SMEs. Competitiveness Agenda has been rolled out. While it is comprehensive, it falls short of addressing some weakness recommended by staff and other observers.

INTERNATIONAL MONETARY FUND

HUNGARY

November 12, 2019

STAFF REPORT FOR THE 2019 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Prepared By

European Department
In Consultation with Other Departments

CONTENTS

FUND RELATIONS

(As of September 30, 2019)

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	2.67	0.27

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			
	2019	2020	2021	2022	2023
Principal					
Charges/Interest	2.25	8.42	8.41	8.42	8.42
Total	2.25	8.42	8.41	8.42	8.42

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:

Hungary's de jure exchange rate arrangement is free floating, and the de facto exchange rate arrangement 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).

Article IV Consultation:

Hungary is on a 12-month consultation cycle. The last Article IV Board discussion took place on June 26, 2018 (LOT). The associated the staff report at https://www.imf.org/en/Publications/CR/Issues/2018/08/03/Hungary-2018-Article-IV-Consultation-Press-Release-and-Staff-Report-46151

Technical Assistance:

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

Hungary: Technical Assistance from the Fund, FY2010–2016

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
FAD	PIT and CIT Micro-Simulation	January 2018
FAD	VAT Gap Analysis	February 2018

STATISTICAL ISSUES

Assessment of Data Adequacy for Surveillance

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

- **Government Finance Statistics**: The statistical authorities compile and disseminate comprehensive general government annual and quarterly accrual based data according to the ESA 2010 methodology. The data include non-financial accounts, financial accounts, and financial balance sheet. These data are bridged into the GFSM 2014 framework and provided to the Fund through Eurostat for the IFS and GFS yearbooks. However, data provided to the Fund for surveillance needs to be improved further. The monthly cash-basis accounts of the central government prepared by the Ministry of Finance reflect the GFS presentation and provide information on financing. 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 September 30, 2019

	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]	Memo Items: Data Quality Accuracy and reliability[9]
Exchange Rates	10/30/2019	11/2/2019	D and M	D and M	D and M		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	August 2019	09/30/2019 (Preliminary)	M	M	M		
Reserve/Base Money	September 2019	10/30/2019	M	M	M	O,O,LO,LO	O,O,O,O,LO
Broad Money	September 2019	10/30/2019	M	M	M		
Central Bank Balance Sheet	September 2019	10/30/2019	M	M	M		
Consolidated Balance Sheet of the Banking System	September 2019	10/30/2019	M	M	M		
Interest Rates[2]	September 2019	10/30/2019	M	M	M		
Consumer Price Index	September 2019	10/30/2019	M	M	M	O,O,O,O	O,O,O,O,NO
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	September 2019	10/30/2019	M	M	M	O,LNO,LO,O	LO,O,O,O,NO
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	September 2019	10/30/2019	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	December 2018	10/30/2019	Q	Q	Q		
External Current Account Balance	Q2 2019	10/30/2019	Q	Q	Q	O,LO,LO,LO	O,O,O,O,NO
Exports and Imports of Goods and Services	Q2 2019	10/30/2019	Q	Q	Q		
GDP/GNP	Q2 2019	10/30/2019	Q	Q	Q	O,O,O,LO	O,LO,O,O,NO
Gross External Debt	Q2 2019	10/30/2019	Q	Q	Q		
International investment Position [6]	Q2 2019	10/30/2019	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. Daily data are readily available.
[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
November 27, 2019

My Hungarian authorities thank staff for the candid discussion and their report, which presents the economic developments and policy challenges in a very balanced way. The authorities broadly agree with staff's assessment of Hungary's economic and financial position and appreciate the thorough and constructive policy dialogue and policy recommendations.

Economic growth remains strong, supporting economic convergence and building resilience amid a gloomy global outlook. Hungary has been one of the fastest growing economies in Europe, registering 5.1 percent growth in 2018, and similar performance is expected to be achieved in 2019. Unemployment is at historic low levels at close to 3 percent and the employment rate exceeds EU average. The growth momentum has been preserved despite the significant deterioration of the global economic outlook and the slowdown in Hungary's main trading partners, with strong signs of a decoupling from the German business cycle. Growth has primarily been driven by strong domestic demand, while the external balance has been maintained. Investment has been buoyant in recent years, with a steadily rising investment rate exceeding 26 percent by 2019.

Although growth is expected to decelerate in the medium term, the authorities intend to maintain a 2-percentage point growth surplus over the euro area which would continue to support convergence. The authorities broadly share staff's assessment on the sources of global risks and plan to preemptively implement a series of measures to preserve Hungary's economic results and further build resilience. Hence, the government decided in May on the Economy Protection Action Plan, which is now in the course of legislation, and includes several tax cuts, simplification of tax administration, various supportive measures for SMEs, and increased spending on R&D. Additional impetus would also come from the implementation of the competitiveness reform, outlined in this Buff statement.

Fiscal performance remains strong with prudent fiscal planning and execution, and a steadily declining debt trajectory. The public debt-to-GDP ratio has decreased from above 80 percent in 2011, to around 68 percent by the end of 2019, and is expected to decline further in the coming years. External debt has declined significantly too. The composition of the debt has shifted to a healthier and less vulnerable structure as a result of the debt management strategy to reduce the share of foreign debt and replace it by domestic debt on one hand, and refinance maturing FX debt with domestic currency-denominated debt on the other hand. The central bank's self-financing program, and the domestic wholesale bond and retail bond issuances were helpful in this respect. In addition, the new domestic retail bond (MAP+) is instrumental in lengthening maturities, reducing external vulnerabilities, building a stable domestic investor base, and not least in alleviating pressure in the real estate market.

The budgetary balance is expected to decrease to historically low levels in 2020 and 2021. After a 1.8 percent deficit in 2019, the 2020 budget foresees a further reduction in the overall deficit to 1 percent. In addition, exceptionally high contingency reserves of about 1 percent of GDP are budgeted, as a buffer that would allow for the operation of the automatic stabilizers, should the downside risks to the economy materialize. The budget is built on a rigorous expenditure control resulting in a countercyclic fiscal stance, in line with the IMF staff's previous recommendations. In the medium term, the authorities aim for a zero overall deficit, which is in line with staff's proposed medium-term target, and attainable under realistic macro assumptions.

On the revenue side, the continuously improving efficiency in tax collection and the whitening of the economy has been crucial for the fiscal performance in recent years. Owing to the installation of the on-line cash registers and the electronic billing system, the VAT-gap has decreased significantly in recent years, and is now well below the EU average. The previously imposed taxes to mitigate the impact of the global financial crisis, directly affecting certain sectors, have been mostly phased out. Some of them were replaced with consumption-turnover type taxes having a less distortive effect on investment and growth. The bank levy has been significantly reduced.

Having said this, and given staff's overall positive assessment of the fiscal developments, we are puzzled by staff's categorization in the context of the pilot Fiscal Space Assessment Framework, that fiscal space is "at risk". Within this framework we would deem more appropriate the usage of the term "some fiscal space".

Monetary policy has been accommodative and continues to be data driven. The central bank of Hungary (MNB) has kept the policy rate unchanged at 0.9 percent since 2016, with some minor tightening of the interest rate corridor in March. Monetary conditions have been further fine-tuned by using the crowded-out liquidity target and FX-swaps. The MNB cautiously monitors international monetary policy developments as well as domestic inflation developments and stands ready to fine-tune monetary conditions as deemed necessary. Domestic inflation has been fluctuating within the MNB's tolerance band, at levels somewhat lower than the earlier forecasts. A dichotomy remains between the factors determining domestic inflation, as domestic demand remained buoyant, while external activity is restraining inflation, along with global monetary policy turning dovish. Nonetheless, the MNB assesses that the previously symmetric risks to inflation became asymmetric in the second half of the year, with downside risks having strengthened further reflecting the economic slowdown in Europe.

The MNB has launched two new instruments recently: The Funding for Growth Scheme Fix (FGSfix) was launched at the beginning of 2019, targeting SMEs, in order to increase the share of predictable, fixed rate loan products within the financing of investments of SMEs. The Bond Funding for Growth Scheme (BGS) was launched in July, targeting larger enterprises, with the aim to purchase bonds issued by domestic non-financial corporations with an at least B+ rating, to promote the diversification of funding to the domestic corporate sector and develop the corporate bond market.

The financial sector is overall healthy and resilient. The shock-absorbing capacity of the Hungarian banking system continues to be robust. Banks' capital adequacy ratios indicate strong solvency, while the liquidity coverage ratio is also well above the regulatory requirements. Banks continued to expand their balance sheet, especially their outstanding loans vis-à-vis the private sector.

In order to foster the mitigation of households' interest rate risk, the MNB issued a recommendation to financial institutions, advising banks to offer customers with variable-rate mortgage loans the option of transition to a fixed-rate scheme. In the corporate loan segment, the share of fixed-rate loans increased for longer maturities, thanks to the FGSfix. Further improvement in the corporate sector's resilience to crises as well as opportunities for diversifying funding may be fostered by the BGS.

Beside its regulatory mandate, the MNB is committed to tackle the existing inefficiencies in the banking and the broader financial sector, enhance competition and support the consolidation of the sector, while paying attention also to consumer protection. The launch of the frameworks for "Certified Consumer Friendly Housing Loans" and "Certified Consumer Friendly House Insurance" point into this direction.

The MNB has just published in October its FinTech strategy, which provides a comprehensive framework for the MNB's digitalization efforts in the financial system and sets out 24 specific initiatives and proposals.

Further structural reforms aimed at enhancing competitiveness and potential growth are high on the authorities' agenda. The government's Program for a More Competitive Hungary, prepared under the guidance of the National Competitiveness Board, and relying on proposals from the MNB, the Hungarian Chamber of Commerce and other independent bodies, sets out the structural reform agenda in six areas: employment, business environment, taxation, public sector, education and healthcare. With its main objective to improve medium- and long-term growth prospects and competitiveness of the economy, the program targets key areas and bottlenecks where reforms can lead to substantial productivity gains. Measures include facilitating widespread access to quality health care and education, decreasing administrative burdens, improving the competitiveness of the tax system and promoting digitalization. Special attention is given to labor market reforms, facilitation of mobility, the employment of mothers with small children and retired persons. The government just published its new SME strategy with the aim to improve access to finance, reduce administrative burdens and provide targeted support in various fields including innovation, management practices, business transfers and access to export markets and to global value chains. The support of SMEs is a priority of the authorities, as SMEs employ the largest share of the work force, while their productivity and competitiveness lag behind the bigger enterprises.

The MNB has also published a 330-point proposal with measures intended to unlock the growth potential and secure convergence to the most developed economies. These were also taken into account during the formulation of the government's Program for a More Competitive Hungary. The Competitiveness Mirror launched recently assesses the extent of the implementation of this agenda. Since the publication of the 330-points agenda in February, there has been progress in 165 points, out of which 33 have been partially or fully completed.

Final remarks

The Hungarian authorities are grateful for the meaningful and constructive discussions. They appreciate the staff's recommendations which they are planning to accommodate to the extent possible. They remain committed to prudent policies, focusing their strategy on promoting growth, sustainable debt reduction, improving competitiveness, and reducing financial vulnerabilities.