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Hungary: 2004 Article IV Consultation—Staff Report; Staff Supplement; and Public Information Notice on the Executive Board Discussion

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 2004 Article IV consultation with Hungary, the following documents have been released and are included in this package:

- the staff report for the 2004 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **January 30, 2004,** with the officials of Hungary on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on April 2, 2004.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a staff supplement of **May 7, 2004,** updating information on recent economic developments.

- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its May 10, 2004 discussion** of the staff report that concluded the Article IV consultation.

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

Report on the Observance of Standards and Codes—Data Module—Update
Report on the Observance of Standards and Codes—Fiscal Transparency Module—Update
Selected Issues Paper

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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HUNGARY

Staff Report for the 2004 Article IV Consultation

Prepared by the Staff Representatives for
the 2004 Consultation with Hungary

Approved by Carlo Cottarelli and Liam P. Ebrill

April 2, 2004

The 2004 Article IV consultation discussions were held in Budapest during January 19–30, 2004. The mission met with: President Járai of the Magyar Nemzeti Bank (MNB or the National Bank); Finance Minister Lászlo; then Finance Minister designate Draskovics; senior officials in the MNB, government ministries, Hungarian Financial Supervisory Authority, and parliament; trade unions; and representative of financial and research institutions. The staff team was headed by Mr. Feldman, included Messrs. Drummond and Kuijs and Ms. Fabrizio (all EUR), and was assisted by Mr. Sassanpour (resident representative in Poland) and Mr. Jiménez (STA) in the preparation of updates of the Report on Standards and Codes (ROSC) modules on the fiscal sector and data dissemination. Mr. Abel, of the office of the Executive Director for Hungary, participated in the discussions. The concluding statement was published.

Hungary has accepted the obligations of Article VIII and meets the Special Data Dissemination Standard (SDDS) specifications. The economic and financial statistics provided to the Fund are adequate for conducting effective surveillance.

In concluding the last consultation on May 9, 2003, Directors noted that Hungary's high level of integration with the EU provided a good basis for progress towards adoption of the euro—as long as vigorous fiscal adjustment, wage restraint, and continued structural reforms were pursued. While Hungary has responded to many of the policy challenges identified in past Article IV consultations (e.g., enhancing exchange rate flexibility and strengthening fiscal transparency), large public sector wage increases, an expansionary fiscal policy, and limited progress on structural fiscal reforms ran counter to Fund advice.

The center-left coalition is led by the socialist party; the next parliamentary elections are scheduled for 2006; Hungary is joining the EU in May 2004; and European Parliamentary elections are scheduled for mid-June 2004.

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I. BACKGROUND

1. **Hungary's entry into the EU comes on the heels of impressive accomplishments** (Figure 1). Its successes were based on the long-lasting effects of significant structural reforms and privatization during the 1990s, which also facilitated Hungary's outward orientation, FDI inflows, strong export performance, flexible labor and product markets, and sound banking system. This success was also rooted in undertaking macroeconomic adjustment measures when needed, and in maintaining an adequate level of international competitiveness.

2. **More recently, while growth held up well despite the global slowdown, developments point to the emergence of significant macroeconomic imbalances.**

- As a result of election promises, most public sector employees received a 50 percent increase in ***wages*** in the fall of 2002. Together with increases in the minimum wage of over 90 percent during 2001–02, these increases spilled over into the private sector. This resulted in year-average real wages on an economy-wide basis surging by some 13 percent in 2002. Real wage growth slowed in 2003, but remained high at about 7½ percent. Such rapid wage growth had adverse consequences for fiscal policy, inflation, and the current account. (Table 1 and Figure 2, panel C).

- The jump in government wages and its impact on pensions made it difficult to contain the ***deficit of the general government*** (Figure 2, panel D). Combined with spending overruns in health, housing subsidies (see Appendix IV on these subsidies), and interest expenditures (described below), the deficit in 2003, according to preliminary data, was 6 percent of GDP (ESA-95 basis), compared with an original target of 4½ percent (Table 2).

- ***Real GDP*** growth stayed significantly positive in 2003 (at 2.9 percent). However, consumption—fueled by wage increases, and a sharp drop in household savings and rapid credit growth, both partly stemming from an expanded housing subsidy scheme—was a leading factor (Figure 2, panels A and B).

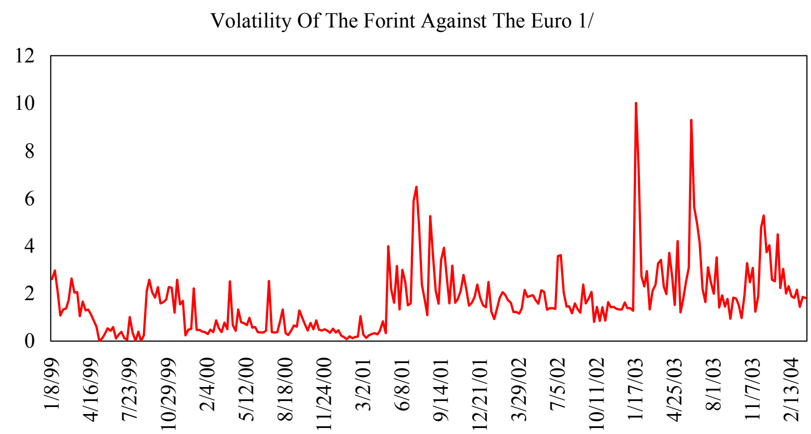
- Core ***inflation*** has recently picked up, and, in the face of rapid consumption demand, wage and price growth in the services sector has been stubbornly high, (Figure 2, panel E). Year-on-year headline inflation reached 5.7 percent in December 2003, compared with the MNB target of 3½ ± 1 percent.

- Rapid consumption growth spilled over into imports (limiting the external sector's contribution to growth) and the ***external current account deficit*** widened to 5.5 percent of GDP in 2003 (Table 3a and Figure 2, panels F and G).[1] This widening also reflected the lagged effects

[1] Official BOP statistics now use a new methodology for calculating FDI-related income, mainly by including reinvested earnings. However, these new statistics, which only became available at end-March 2004, were unavailable at the time of the Article IV discussions, and are therefore not incorporated in the BOP for this report. Including reinvested earnings (as in Table 3b) raises both the current account deficit and FDI, with no impact on the overall BOP.

of the decline in competitiveness in 2001–02 (Figure 2, panel J) and sluggish exports in the first half of the year, also because of weak external demand. At the same time, net FDI turned negative. The large current account deficit was therefore financed mainly by debt-creating inflows that can be especially volatile in the face of lost policy credibility (Figure 2, panel I).

3. **Over the course of the past year or so, the imbalances together with policy inconsistencies have weakened policy credibility contributing to volatility in financial markets.** Several factors were at play: in the second half of 2003, the pursuit and announcement of a Ft 250–260 per euro target (within Hungary's ERM2-like exchange rate regime) when policies were inconsistent; conflicting statements by policymakers about the appropriate exchange rate level; and targets and estimates that went unfulfilled (including revisions to the 2003 fiscal deficit target and the mid-December estimate of the 2003 fiscal outcome). As markets became increasingly concerned about external and fiscal developments (and policy credibility generally), Hungary experienced significant bouts of volatility, with the forint weakening to almost Ft 275 per euro in early December (Text Figure and Figure 3). Interest rates were increased to support the currency. The main short-term policy interest rate was increased by 300 basis points in November 2003 to 12½ percent, bringing the total increase to 600 basis points since June.



Sources: Bloomberg; and IMF staff calculations.
1/ The ratio of the difference between the weekly high and low over the weekly average (expressed in percent).

4. **Recent data have, however, included some bright spots that give rise to optimism on the prospects for economic growth** (Figure 2, panels F and J–L). The significant deterioration in external competitiveness in 2001–02 was reversed during 2003. This reflected the forint depreciating by about 11 percent against the euro, and wage moderation, alongside steady improvements in productivity, in manufacturing. Industrial production and export growth began accelerating in the second half of 2003. Meanwhile, investment growth was also rising; and although imports were booming, the share of investment goods also increased. In all, the fourth quarter saw year-on-year real GDP growth continuing to gather pace, reaching 3.6 percent.

5. **The authorities announced a revised target for the general government deficit in 2004 of 4.6 percent of GDP, compared with an outturn of 6 percent in 2003.** While the new target is larger than the original proposal of 3.8 percent, it reflected the slippages in 2003. With a view to enhancing transparency and credibility, the government decided on a more realistic target, rather than risking another miss by a wide margin. Consistent with this revision, expenditures are slated to drop by 1.2 percentage point of GDP compared with 2003; revenues are expected to rise by 0.1 percentage point of GDP, with increases in VAT and social security taxes (of 1 percentage point of GDP) almost offset by declines in other revenues (mostly non-tax receipts).

II. Report on the Discussions

6. **Dealing with macroeconomic imbalances and re-establishing policy credibility were the most pressing issues, along with minimizing vulnerabilities on the road to euro adoption.** There was general agreement that large fiscal and current account deficits, if left unattended, would impair economic prospects. Moreover, the loss of policy credibility, if not reversed, would make the financing of these twin deficits all the more precarious. Thus, without action, Hungary would be vulnerable to significant exchange rate and interest rate risks in the period immediately ahead. Over the medium term, with the market focused on the timing of euro adoption, shifts in market expectations about progress with nominal convergence will be an ever-present potential source of financial market pressure. Nevertheless, in part because Hungary stacks up well on optimal currency area criteria, the advantages of euro adoption are clear, and a credible target date would surely help to anchor expectations and minimize the output costs of bringing inflation down.[2] Thus, developing and expounding a consistent policy strategy with euro adoption in mind and communicating it effectively were key aspects of the discussion.

A. Economic Outlook and Objectives

7. **There was broad agreement that the outlook for this year is characterized by a pick up in growth, a temporary acceleration of inflation, and a narrowing of the current account deficit.**

- With the envisaged strengthening of foreign demand and the depreciation of the forint in 2003, the external sector and business investment can be expected to make increasing contributions to ***real GDP*** growth. Meanwhile, private consumption seems set to slow in response to a slower pace of real wage gain and higher taxes. The National Interest Reconciliation Council (NIRC)—representing government, employers, and employees—recommended an increase in gross nominal wages for the private sector of 7–8 percent; after the mission, the government in late-February agreed with trade unions on an average nominal increase in the wage rate for the public sector of 6 percent. These broad considerations underlie most forecasts, with staff and official GDP growth projections ranging from 3.1 to 3.5 percent (the finance ministry based the budget on 3.5 percent growth).

- The main one-off effects on ***inflation*** are adjustments to VAT rates and excise tax hikes. According to MNB estimates, which seem reasonable to staff, the direct effect of these factors will boost the price level by 1.9 percent; the lagged effects of the recent depreciation also raise prices. Assuming no indirect effects and private sector wage growth somewhat above the NIRC recommendation (wage increases have tended to be higher), the MNB projects headline inflation of 6.9 percent at end-2004, compared with its target of 3½ ±1 percent. Largely because of lower assumptions on fuel prices, staff's projection is 6½ percent. The finance ministry's projection relies on lower pass-through of VAT and excise adjustments to consumer prices, with recent statements by ministry representatives suggesting inflation might be below 6½ percent.

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[2] These issues are discussed in *Adopting the Euro in Central Europe—Challenges of the Next Step in European Integration* (forthcoming IMF Occasional paper).

- A projected narrowing of the ***current account deficit*** reflects a slowdown in domestic demand (with slower consumption growth). The narrowing also stems from robust export growth on the back of recovery abroad and the gains in external competitiveness in 2003. Staff projects a deficit of 5¼ percent of GDP, compared with 5.5 percent in 2003 and a sustainable level of roughly 4 percent.[3] The MNB projects a deficit of 5.2 percent.

- Various ***risks*** were apparent to both the authorities and staff. Among them, a weaker-than-expected recovery abroad would lower growth and widen the current account deficit. It was generally acknowledged that the current account deficit would be larger if consumption growth did not moderate as anticipated. However, staff projections assumed conservative increases in export market share so higher exports and a smaller current account deficit are also possible. The importance of communication was also stressed: avoiding inconsistent policy statements would help to minimize the risks that could arise to investment and growth if policy uncertainty were heightened. Finally, on inflation, the up-tick in 2004 could adversely affect expectations and make it more difficult to keep inflationary pressures at bay; exchange rate weakening is another risk. On the other hand, the pass-through from VAT and excise adjustments could be lower than expected.

8. **With respect to the medium term, the authorities were in the process of revising their macroeconomic framework.** They noted the difficulties in keeping to the original 2005–06 fiscal targets envisaged in their last Pre-Accession Economic Program (PEP) (2.8 and 2.5 percent of GDP, respectively) in light of the fiscal slippages in 2003. They were also concerned about announcing targets that would be difficult to stick to, in circumstances in which further slippages could hurt credibility. But irrespective of any possible delay in the target date for adopting the euro,[4] the authorities saw the importance of fiscal consolidation and containing the current account deficit in its own right, and the need to adjust policy further if the current account deficit did not continue to narrow. The authorities stressed, additionally, their goal of seeing investment once again grow more rapidly than consumption, noting that this, and disinflation over the medium term, would require wage moderation.

9. **The authorities were considering various factors related to the timing of ERM2 entry.** The government saw advantages to entry soon after joining the EU, as ERM2 could act as a disciplining factor and reinforce credibility. At the same time, the authorities saw the advantages of waiting until both the details of their macroeconomic framework were fleshed out and a narrowing of the twin deficits was more firmly in train. They also recognized the complications in determining the "right" central parity given the fragility of the current conjuncture. Thus, timing was under active review, with a sense that sooner would be better than later. For its part, staff stressed that re-establishing policy credibility and having in place policies

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[3] Drawing on *External Sector Issues in Hungary*, *IMF Country Report No. 03/125*, with lower FDI.

[4] The goal is to announce a target date in the spring.

that provide greater assurances that the necessary fiscal adjustment and disinflation would materialize were essential for establishing a timeframe for entering ERM2 and euro adoption.

10. **Staff's medium-term scenario, based on continued fiscal consolidation, shows Hungary's current account moving to a sustainable path.** The baseline (Table 4) assumes the authorities meet their target for the general government deficit in 2004 and adjustment in later years is in line with the last PEP (though the level of the deficits would be larger). Thus, the (3 percent of GDP) Maastricht fiscal deficit criterion is met in 2007. With the increase in private saving expected to be insufficient to finance rising investment (also assuming household saving rises only moderately), the current account deficit contracts to about 3.5 percent of GDP by 2007; government and external debt also decline in relation to GDP. Interest rates gradually fall from their currently high levels. The alternative scenario—which assumes fiscal slippage in 2004[5] and less adjustment than the baseline in later years—illustrates the risks in terms of a higher current account deficit and debt, higher interest rates and interest payments, and, over the medium term, lower growth. More generally, if various downside risks or other shocks were to materialize in line with the stress tests shown in Tables 5 and 6, external and public debt dynamics could become problematic in the absence of a policy response. All this strengthens the case for fiscal adjustment against the background of a large current account deficit.

11. **An important aspect of the discussions, for both the short and medium term, was external competitiveness—which was judged to be broadly adequate.** A key question was whether the exchange rate level was appropriate. Both the authorities and private sector representatives saw competitiveness as comfortably adequate. Among the considerations noted were that: (i) while competitiveness had deteriorated earlier, it improved during 2003 (Figure 4); (ii) Hungary continued to gain market share, and export growth has been accelerating; and (iii) while anecdotal, exporters were not complaining recently. Staff broadly shared the general conclusion, noting that with wage moderation and declining inflation, external competitiveness would continue to improve. An accompanying selected issues paper analyzes competitiveness.

B. Fiscal Policy

12. **At this critical juncture, there was consensus that taking decisive actions in support of fiscal adjustment was the only way to restore policy credibility and improve the monetary-fiscal policy mix.** Taking into account the slippages in 2003, staff concurred that the original fiscal deficit target for 2004 had become unrealistic, and that the new deficit target of 4.6 percent of GDP (a reduction of almost 1½ percentage points with respect to 2003) was sufficiently ambitious. Moreover, both the authorities and staff felt that significant fiscal tightening would allow risk premia and interest rates to come down and limit vulnerability to shifts in market sentiment. Thus, with questions hanging over the market on the government's

[5] The slippage is ¾ percent of GDP, consistent with the additional measures that the Article IV mission estimated would be needed to hit the government's target.

ability to secure its 2004 fiscal deficit target, the benefits of the early implementation of credible fiscal measures toward this end were apparent.

13. **Important measures—announced in general terms just before and during the mission—were firmed up by the cabinet in late February.** These measures, equivalent to about 1 percent of GDP, come from reducing ministries' operational spending (including the suspension of certain expenditures announced in December by the previous finance minister, and cutting back on maintenance, renovation, IT, and vehicles); from restraining transfers from the ministries to institutions under their purview; and from scaling back project and investment spending (excluding EU-related spending on highways and other items). Also important were changes in the housing subsidy scheme, which imply relatively smallg budgetary savings in 2004, but will contribute to substantial saving in the coming years.

14. **Notwithstanding these actions, achieving the 2004 deficit target will likely pose serious challenges.** Largely due to lower projected tax revenue, staff estimated that the deficit would exceed the target by about ¾ percent of GDP. Staff thought that the finance ministry's reliance on efficiency gains in tax collection of VAT and social security contributions, and their projection of the tax base for the personal income and profit taxes, were too optimistic.[6]

15. **The authorities indicated their readiness to make timely corrections to achieve the deficit target if needed.** As a measure of last resort, they saw room to further delay nonpriority investment spending (unrelated to EU funding). Taking into account the risks posed by the current account deficit and the election cycle, staff urged the authorities to quickly identify specific contingency measures to facilitate a timely response.

16. **Staff regretted that the progress so far with structural fiscal reforms recommended in recent years has been limited overall.** The discussions revealed the difficulties that have arisen because of a heavily polarized political climate. This was evident in wage policy: the authorities reached an agreement on an increase in most public sector wages of 6 percent; staff had recommended a nominal wage freeze in the general government (worth up to 0.5 percent of GDP in saving). Staff recognized that formulating and implementing fundamental structural reforms in the short time available in 2004 would border on the implausible. However, given the lead time necessary for structural reforms, staff stressed the importance of beginning the preparation early of structural spending measures that would support durable fiscal adjustment over the medium term and improve the quality of public services. In this connection, steps in starting health care reform in 2005 are encouraging, but implementation is key. Wage moderation in the public sector—possibly a nominal wage freeze in 2005—is also needed.

[6] For example, in the case of personal income taxes, the finance ministry uses a rise in the tax base of over 13 percent, which appears to be inconsistent with the projections of wages and employment. In the case of the VAT, a Ft 40 billion efficiency gain (about 0.2 percent of GDP) was assumed, which seemed unlikely in light of the experience of the recent past and absent concrete measures.

17. **All agreed that, while perhaps difficult politically, further fiscal consolidation is required in the medium term and would be especially beneficial if centered on expenditure restraint.** This reflects the already high tax incidence, particularly on labor (indeed there is talk in government circles of trying to lower taxes). At the same time, to leave room for spending pressures arising from public investment needs and EU accession, careful expenditure prioritization will be needed while focusing on consolidating current expenditure. And, as analyzed in a selected issues paper from last year's Article IV consultation, the experience in other countries suggests that expenditure-based adjustment tends to be more durable, friendly to growth, and credible.[7] Earlier technical assistance from the Fund had provided a menu of options to achieve saving in the areas of government employment, pensions, social benefits, subsidies, education, and health care (see text table). Staff welcomed the authorities' plans to reduce public employment in 2003–04 (by 10 percent in ministries and 6 percent in public administration) but felt further civil service reform is needed, given the large size of the public sector. In the discussions, staff also emphasized that delaying the timetable for euro adoption should not be seen as a reason for delaying fiscal adjustment, in light of macroeconomic requirements. In addition, the potential benefits were noted of increasing the labor force participation rate—including by leaving room for labor tax cuts (and phasing out the lump-sum health care contribution from employers as planned) and reducing disincentives to work stemming from the structure of benefits—which could be expected to raise potential output and help mitigate pressures on public finances over the medium term.

Menu of Expenditure Reform Options and Estimates of their Potential Budgetary Savings (In Percent of GDP)

Reform Options	**Savings**
Government employment and wages (hiring freeze and abolition of unusual benefits)	0.30
Health care (mainly introduction of co-payments)	0.5
Education (notably to obtain economies of scale)	>0.7
Pension reform (including revisions to formulas and eligibility)	0.8-1.1
Social benefits (reduction and better targeting of benefits)	0.50
Reform of government subsidies (housing, transport, and pharmaceuticals)	0.8-1.0
Total	**>3.6-4.1**

18. **Fiscal performance and credibility would be enhanced by developing a well-defined medium-term fiscal strategy, backed by expenditure ceilings.** Thus, staff urged the authorities to adopt the three-year rolling framework under consideration last year, which included a ceiling on overall expenditure and sub-ceilings on key components. In the staff's view, in an effort to garner broad political support, such a framework should be submitted to parliament with a clear statement of policy as part of the budgetary process. Moreover, in circumstances in which fiscal adjustment is crucial, staff encouraged the authorities to use realistic but conservative assumptions, with a view to erring on the side of fiscal over performance. Casting changes in the tax system within a coherent medium-term strategy, rather than undertaking them from time to time in an uncoordinated way, would enhance the predictability and quality of fiscal policy, and the business climate.

[7] *Fiscal Adjustment Strategy in Hungary*, *IMF Country Report No. 03/125*.

B. Monetary and Exchange Rate Policy

19. **After the significant interest rate hikes in 2003, monetary policy was appropriately on hold at the time of the discussions.** While all agreed that inflation would be outside the target range this year, this largely reflected transitory factors. The MNB has noted that decelerating unit labor costs would set the stage for a resumption of disinflation in 2005 (forecasting 4.3 percent at end-2005, assuming that economic agents see the spike in inflation in 2004 as temporary). Staff agreed that the inflation target for end-2005 (4.0 ± 1 percent) was in reach, noting, in line with WEO inputs, that support would also come from subdued oil and other import prices. Thus, taking into account that the lagged effects of the sizable interest rate hikes since mid-2003 are still in the pipeline, staff did not see a compelling reason to raise interest rates further. However, while the level of interest rates seemed broadly appropriate, staff felt that re-establishing confidence, including through convincing fiscal adjustment, and limited second-round effects from the transitory inflation factors were conditions that would permit interest rates to be lowered. The finance ministry expressed confidence in meeting its fiscal deficit target and therefore felt there would be room to lower interest rates reasonably soon. The MNB acknowledged the various considerations above, but stressed the difficulties for monetary policy without fiscal consolidation. On March 22, the MNB reduced its key policy rate by 25 basis points to 12¼ percent, against the background of the cabinet's approval of spending measures, an appreciating exchange rate during March (to Ft 250–255 per euro), and favorable economic data (including smaller-than-expected general government and trade deficits for February).

20. **The advantages of the MNB's move to greater exchange rate flexibility within the existing regime was recognized.** While the authorities had been targeting publicly an exchange rate of Ft 250–260 per euro, this became increasingly untenable in the face of inconsistent policies and the widening current account deficit, and the target was abandoned around the start of the 2004. This was welcomed by staff, which emphasized that greater exchange rate flexibility made good sense because, in circumstances in which the current account deficit was large, it provided some room to absorb unanticipated shocks (including fiscal slippages)—albeit probably at some cost to inflation.

21. **In the years ahead, monetary policy will need to grapple with a couple of key questions.**

- *How to adapt to ERM2?* Once in ERM2, disinflation over the medium term will increasingly need to take place in circumstances in which exchange rate variability against the euro will be limited, consistent with the interpretation of the exchange rate stability criterion within ERM2. Thus, inflation targeting will be operated in a qualified way with limited monetary policy flexibility.[8] Balassa-Samuelson effects are not expected to be particularly problematic,

[8] Letting the exchange rate appreciate would enhance flexibility (and central parity revaluations are allowed on the strong side without stopping the clock on the two-year requirement within ERM2). However, with a large current account deficit, this would carry risks. For a discussion of the country experience with targeting inflation in the face of the limited monetary policy

(continued…)

with economists at the MNB estimating the effects to now be small at about 1 percent or less. However, inflationary pressures could arise from domestic sources or from capital inflows and credit growth.

- *What are the key supporting policies?* The authorities and staff agreed that monetary policy would therefore need to be supported by the full use of policy tools required to achieve disinflation. To this end, fiscal consolidation would be essential, for market confidence, to contain demand pressures, and to avoid unwanted upward pressure on the currency. Wage discipline needs to be backed by actions of the government: as the latter is a sizable employer, it can play a lead role by signaling the importance it attaches to wage moderation through its public sector wage policy. Moreover, drawing on the experience of current members of the euro area in bringing inflation down to the Maastricht criterion, closer cooperation between the social partners to achieve private sector wage agreement would also seem necessary.[9] The goal of euro adoption could help provide the necessary policy momentum on this score. To further minimize vulnerabilities, there was agreement that it would be essential to get the central parity right and develop and expound a consistent policy strategy.

C. The Financial Sector

22. **The supervisory authorities felt that the Hungarian financial system is basically sound.** Banks have remained adequately capitalized and liquid; profitability has been solid; and the quality of banks' loan portfolios has remained broadly stable (Table 7).

23. **The authorities nevertheless recognized potential vulnerabilities on various fronts.** While they considered the associated risks to be manageable for now, they agreed that careful monitoring is warranted.

- Vulnerabilities arose, first, from rapidly growing consumer lending. Consumer loans increased by some 4 percentage points of GDP (to about 12½ percent) in 2003, with housing loans accounting for more than 40 percent of this increase. On the one hand, the increase in housing loans is expected to subside after the revisions to the housing subsidy scheme in December 2003. The authorities also noted that rapid credit growth started from a low base so growing credit could be seen as a positive structural development toward long-run equilibrium. On the other hand, in circumstances in which the housing subsidy scheme is being scaled back

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flexibility within ERM (see *Adopting the Euro in Central Europe—Challenges of the Next Step in European Integration (forthcoming IMF Occassional Paper).*

[9] At the risk of oversimplification, econometric estimation of a simple inflation determination equation demonstrates the extent to which wage growth affects inflation (Appendix V).

and the banking market is highly competitive, the potential for financial intermediaries to take on more risk to boost profitability was recognized.[10]

- Second, potential vulnerabilities arose from credit risk as a result of exchange rate volatility. The authorities noted that many companies have natural hedges and that the share of households' foreign currency borrowing from banks is small (3 percent of total bank lending to households). However, they also indicated that such lending is highly concentrated within a few banks and that lending to households by bank-owned financial enterprises (amounting to roughly 10 percent of households' total liabilities) is mainly denominated in foreign currency. Staff has encouraged the authorities to strengthen monitoring of the financial sector's indirect exposure to exchange rate movements (including through surveys of borrowers' exposure).

- A third vulnerability was the growing share of commercial property loans in overall corporate lending, its high concentration within a few banks, and, in less developed parts of the country, risks from less liquid collateral. In addition, commercial property lending is mainly denominated in foreign currency, adding another element of risk.

- Looking further ahead to the period close to euro adoption and afterward, interest rate convergence can be expected to contribute to credit expansion. The Hungarian Financial Supervisory Authority (HFSA) and the MNB agreed this should be closely watched for a credit boom and shared the view that a strong fiscal policy and supervision of banks' internal risk management systems would be the main lines of defense.

24. **Important issues have arisen with respect to the HFSA.** With the authorities having requested technical assistance to ensure that legal changes governing the HFSA and its institutional setup would be in line with best practices, an accompanying selected issues paper summarizes practices in other countries. During the discussions, staff stressed that it is important to maintain the independence of the supervisory authority, while ensuring its accountability.

D. Structural Reforms, Transparency, and International Standards

25. **Privatization is in its final stage, and structural reforms continue with the liberalization of the energy sector and adjustment of electricity and natural gas prices to cost recovery levels.** Further privatization would help to increase FDI. In addition, the liberalization of the electricity market is progressing and subsidies were eliminated as a result of raising regulated prices by over 18 percent in 2003. This rise, according to Energy Office estimates, closed the gap between costs and revenues at the state-owned grid-operator and public wholesaler. Natural gas prices moved close to world market levels. Meanwhile, Hungary's

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[10] Empirical work by Fund staff indicates that the ratio of bank credit to the private sector to GDP in Hungary is well below long-run equilibrium, but that the pace of the expansion of this credit in recent years has been sufficiently fast to at least raise a warning flag. See *Early Birds, Late Risers, and Sleeping Beauties: Bank Credit Growth to the Private Sector in Central and Eastern Europe and the Balkans* (WP/03/213).

competition legislation and enforcement, and market regulation, compare favorably with advanced countries. However, with only modest progress in reforming the rail transport and postal services sectors, there remains scope to increase efficiency. In addition, while the labor market is generally quite flexible, the authorities could explore the possibility of differentiating minimum wages and social benefits across regions with a view to alleviating regional imbalances.

26. **Hungary's trade policy will soon be guided by the common EU policy**. The authorities did not envisage any significant negative impact from adopting the EU import duty structure. The negative effects of the required elimination of some existing free-trade agreements (e.g., with Serbia and Montenegro) were expected to be offset by the current EU trade agreements with other third countries.

27. **Hungary made further progress in observing standards and codes in the fiscal and data dissemination areas.**[11] BOP statistics are being moved to a full accrual basis. In this connection, reinvested earnings have been incorporated at end-March 2004. Recent initiatives have also been taken to increase transparency in the spending of public funds by strengthening interim audits, financial control and management, and information dissemination. However, the 2002 amendment to the organic budget law allowed considerable leeway in undertaking additional spending without supplementary appropriations and parliamentary approval as this can be done as long as the deficit does not exceed what is budgeted by more than 5 percent of total expenditure.

III. Staff Appraisal

28. **Hungary's entry into the EU is a tribute to more than a decade of far-reaching institutional and structural reforms although, more recently, large macroeconomic imbalances have re-emerged.** The country's willingness and ability to undertake macroeconomic adjustment measures in the middle of the 1990s laid the groundwork for the subsequent macroeconomic successes that were achieved. However, in recent years, inappropriate macroeconomic policies have led to large fiscal and current account deficits. If these are not reined in, economic prospects would be seriously impaired, and Hungary would continue to be vulnerable to significant exchange rate and interest rate volatility.

29. **The concerns raised by large twin deficits have only been exacerbated by the loss of policy credibility.** Such a loss increases the risks to the financing of the deficits. This is not only because markets become less inclined to give Hungary the benefit of the doubt, but also the risk of contagion from unexpected shocks outside of Hungary becomes greater.

30. **Looking ahead, there is reason for optimism concerning the short-term outlook.** The momentum of recovery has been evident in recent data on GDP, industrial production, exports, and investment. Moreover, the deterioration in competitiveness in 2001–02 has been reversed and can be expected to improve further with continued productivity growth and wage moderation.

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[11] See the accompanying data and fiscal ROSCs for more details.

Thus, with the right policies and an appropriate exchange rate level, Hungary would be well poised to take advantage of a strengthening external environment and set the stage for a period of more balanced economic growth—with exports and investment again taking the lead. The current upswing forms a favorable backdrop for the challenges ahead.

31. **At this fragile juncture, decisive and concrete actions in support of fiscal adjustment are the only way to restore policy credibility and improve the monetary-fiscal policy mix.** Such actions would help to lower risk premia, facilitate a reduction in interest rates, and limit vulnerability to shift in market sentiment—all of which would strengthen prospects for sustainable economic growth.

32. **Fiscal policy is embarking on an appropriately ambitious course, with the authorities targeting a general government deficit of 4.6 percent of GDP in 2004** This implies a narrowing of the deficit by almost 1½ percentage points of GDP from the previous year and would facilitate a return of the current account toward a sustainable path. Moreover, a more ambitious target would not have been realistic in light of the slippages in 2003.

33. **But the fiscal deficit target is again at risk.** Based on announced policies, the risks of falling short of the target, potentially by some ¾ percent of GDP, are significant. In view of the importance of re-establishing policy credibility and taking into account the risk posed by the current account deficit and the election cycle with parliamentary elections in 2006, timely corrections are likely to be needed soon. Against this background, the authorities' announced intention to make such corrections is well placed and they are urged to quickly identify contingent spending measures.

34. **At the same time, more fundamental expenditure reforms are needed to ensure durable fiscal adjustment over the medium term.** While the composition of fiscal adjustment in 2004 could have been better geared to sustainable expenditure consolidation, fundamental expenditure reforms would be difficult in the short time frame of one year, so the authorities must prepare early for permanent structural spending measures if they are to begin to implement them in 2005. Given the high tax incidence, particularly on labor, and the need to leave room for spending pressures arising from public investment needs and EU accession, consolidating current expenditure is particularly key. Moreover, consolidation focused on spending, when the latter is high, tends to be more durable, friendly to growth, and credible. With reforms, savings could be achieved in the areas of government employment, pensions, social benefits, subsidies, education, and health care (where recently developed plans are encouraging). Related to this, a further scaling back, if not elimination, of the housing subsidy scheme is warranted. Greater public sector wage restraint is also warranted in the period ahead, after the lamentable lack of a freeze in 2004.

35. **Mechanisms to enhance fiscal discipline and bring forward policy credibility are also needed.** In this connection, the authorities had been considering a three-year rolling framework, which included a ceiling on overall spending and sub-ceilings on key components. Introducing such a framework would be beneficial and, in an effort to garner broad political support, should be submitted to parliament along with a clear policy statement.

36. **The level of official interest rates is broadly appropriate, but there could be room to reduce them as confidence is re-established.** In light of the one-off factors affecting inflation in 2004, and the lagged effects of the sizable interest rate hikes of last year, it would be a mistake for the authorities to try to bring inflation within the target range in the immediate future by raising interest rates. Moreover, the authorities are rightly focusing their public pronouncements on their medium-term inflation objectives, and the supporting policies to achieve them, communicating clearly that the impact of one-off factors are not expected to be repeated. However, room would be created for interest rate reductions, following the recent small cut, by re-establishing policy credibility, including through convincing fiscal adjustment, and to the extent that the temporary hike in inflation is not igniting second-round effects that would threaten the 2005 inflation target.

37. **The recent practice of allowing greater exchange rate flexibility is welcome.** Focusing on keeping the exchange rate within a particular narrow range and announcing this publicly was problematic in light of the futility of defending particular rates when policies were inconsistent. Faced with a large current account deficit, the greater flexibility provides a degree of insurance—albeit at some cost to inflation—against unanticipated shocks, including fiscal slippage.

38. **The overarching challenge in the medium term will be to adapt the policy framework to the goal of and requirements for adopting the euro.** While Hungary stacks up well on optimal currency area criteria and the advantages of adopting the euro are clear, putting in place policies that provide greater assurances that the necessary fiscal adjustment and disinflation will materialize are essential for establishing a time frame for ERM2 entry and euro adoption. As ERM2 approaches, it will be important to avoid public communication that implies a hard and fast commitment to a particular exchange rate level or range that could prompt another speculative attack. Once in ERM2, monetary independence will be significantly lower, which will make it more important to make full use of all policy tools for sustainable disinflation, including fiscal consolidation and wage moderation. To minimize exchange rate vulnerabilities, it will also be important to get the central parity right. A strong incomes policy is particularly needed for alleviating tensions between inflation and current account objectives. In this area, the government should take the lead with its public sector wage policies, including in state-owned enterprises.

39. **Available information indicates a healthy financial system, but it will be important to keep an eye on the vulnerabilities that have arisen.** These mostly reflect strong credit growth and increasing credit risk and, while manageable now, warrant careful monitoring with a view to taking timely corrective action if needed. Moreover, any legal changes to the supervisory framework must preserve the independence of the HFSA while ensuring its accountability.

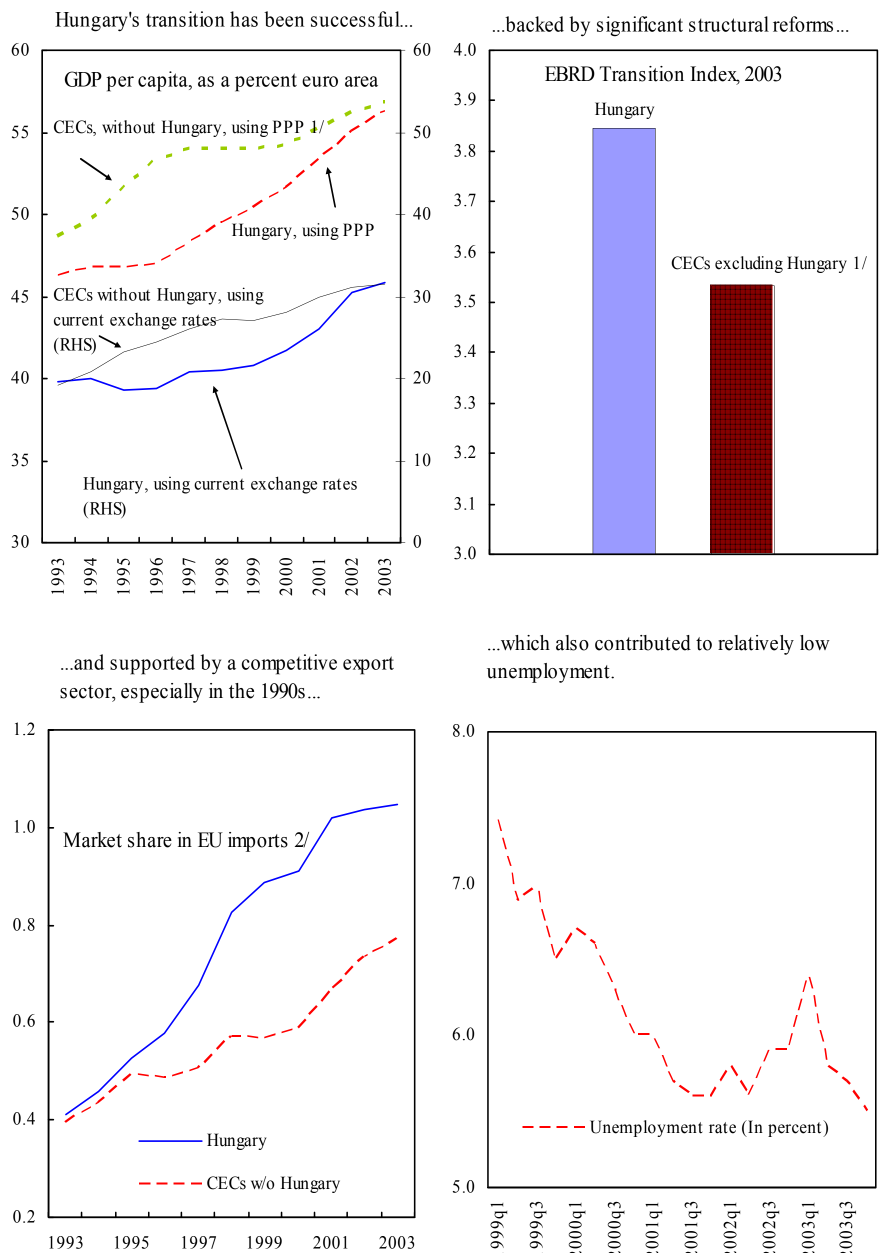
40. **Recent product market reforms are encouraging.** Plans to complete the final stage of privatization are welcome, as are the increases in gas and electricity prices, which take them to cost recovery levels and eliminate implicit subsidies.

41. **Hungary's commitment to transparency and standards, through its continued participation in ROSC updates, is to be commended.** Recent further improvements are welcome, but the amendment to the organic budget law that allowed considerable leeway in

undertaking additional spending without supplementary appropriations and parliamentary approval should be discontinued.

42. The next Article IV consultation with Hungary is expected to be conducted under the standard 12-month cycle.

Figure 1. Hungary: Transition and Export Performance, 1993-2003

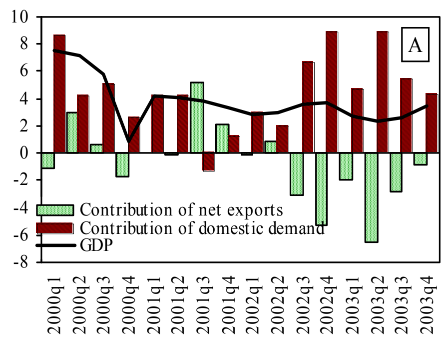


Sources: IMF, *World Economic Outlook* ; Direction of Trade Statistics; EBRD Transition Report, 2003; and IMF staff calculations.

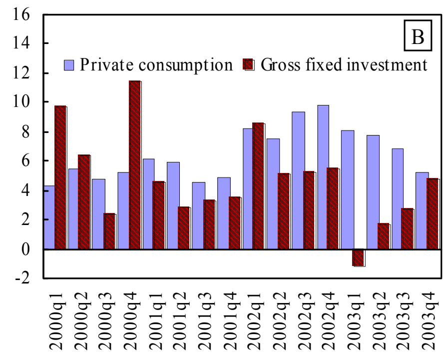
1/ The CECs include the Czech Republic, Hungary, Poland, the Slovak Republic, and Slovenia.
2/ Data for 2003 are based on the first three quarters of the year.

Figure 2. Hungary: Recent Economic Indicators, 2000–04
(Year-on-year, in percent, unless otherwise indicated)

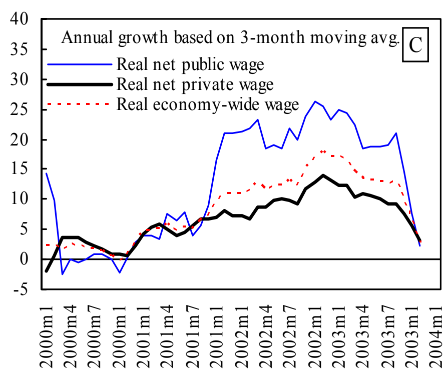
Growth stayed significantly positive but unbalanced in 2003, with the contribution of net exports negative.



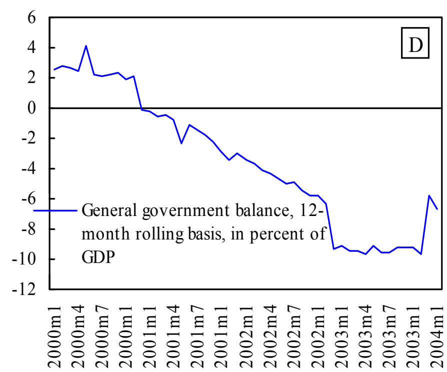
Consumption boomed...



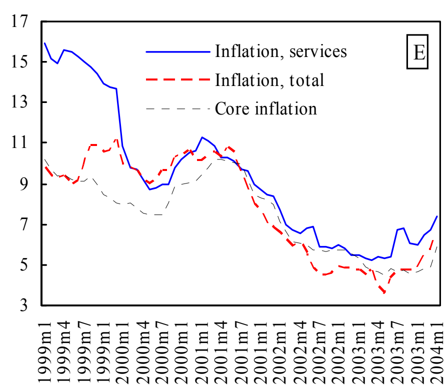
...reflecting large wage increases, led by huge upward wage adjustments in the public sector...



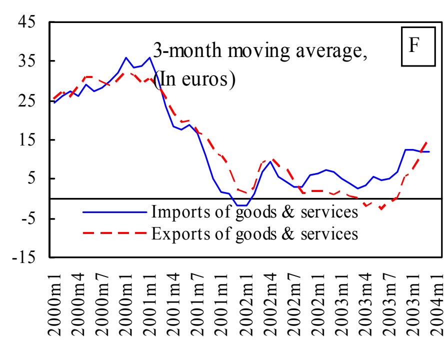
...that went along with large fiscal deficits.



The downward trend in inflation reversed.



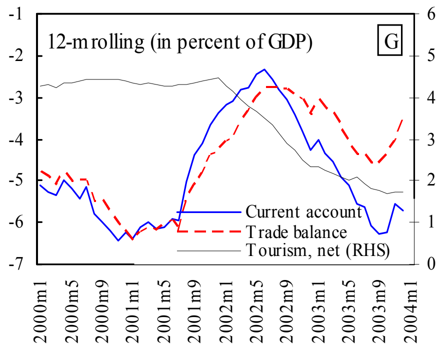
Import growth boomed, while export growth only started accelerating in the second half of 2003, but now exceeds the growth rate of imports.



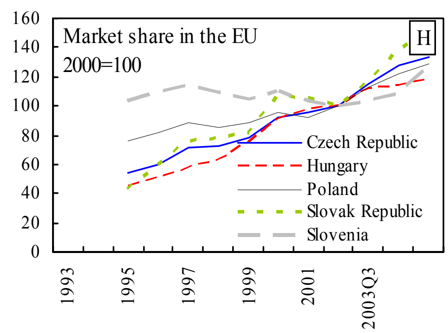
Sources: Hungarian authorities; and IMF staff calculations.

Figure 2. Hungary: Recent Economic Indicators (Concluded), 2000–04

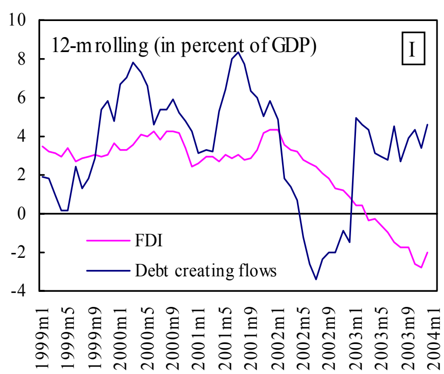
Thus, the current account deficit widened sharply and has only recently started to narrow.



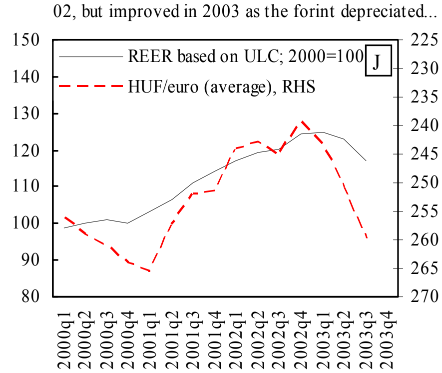
While Hungary continued increasing its market share, the rise has recently been less than for its peers.



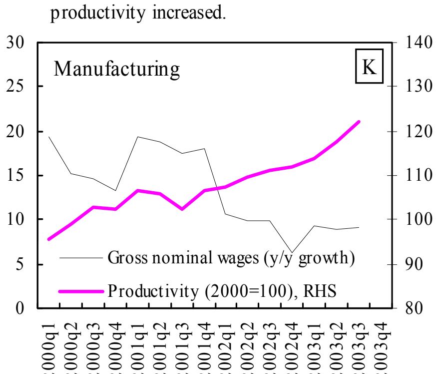
Meanwhile, the current account deficit has been increasingly financed by debt creating flows.



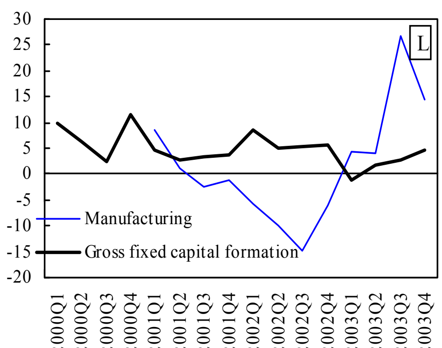
Reflecting large wage increases and nominal appreciation, competitiveness deteriorated in 2001-02, but improved in 2003 as the forint depreciated...



...while manufacturing wage growth was flat and productivity increased.



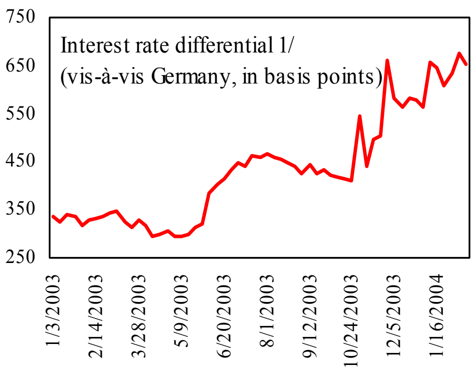
Investment growth began to rise recently, especially manufacturing investment.



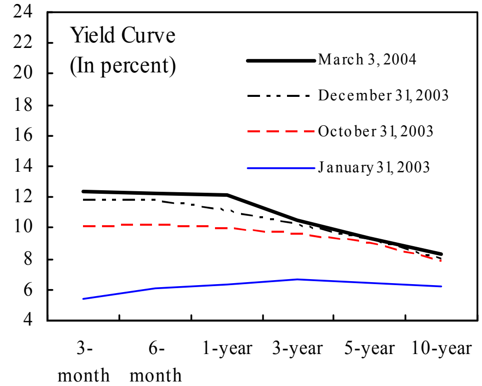
Sources: Direction of Trade Statistics; Hungarian authorities; and IMF staff calculations.

Figure 3. Hungary: Financial Indicators, 2003-04

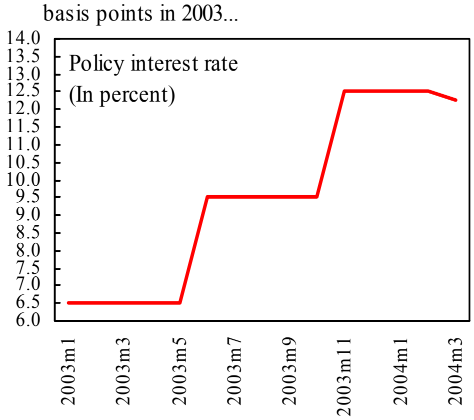
Risk premia increased significantly during 2003...



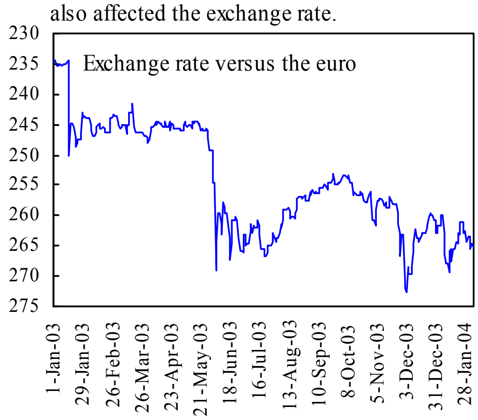
...and the yield curve moved up across all maturities.



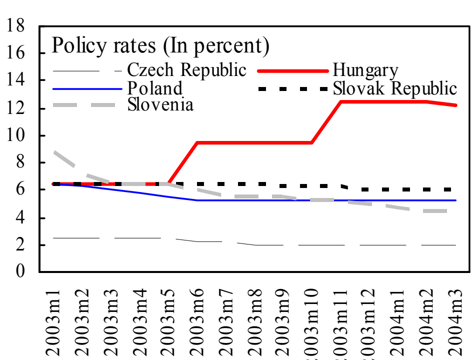
The main policy interest rate was hiked by 600 basis points in 2003...



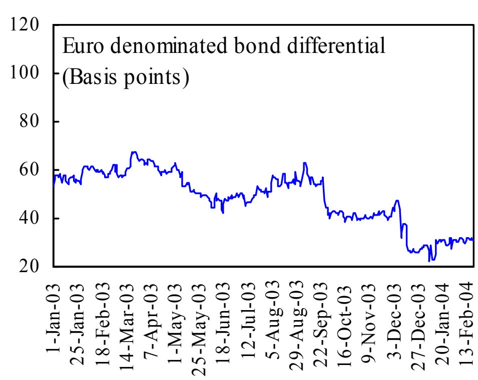
...in the face of lost policy credibility that also affected the exchange rate.



Official interest rates are now much higher than in other countries in the region.

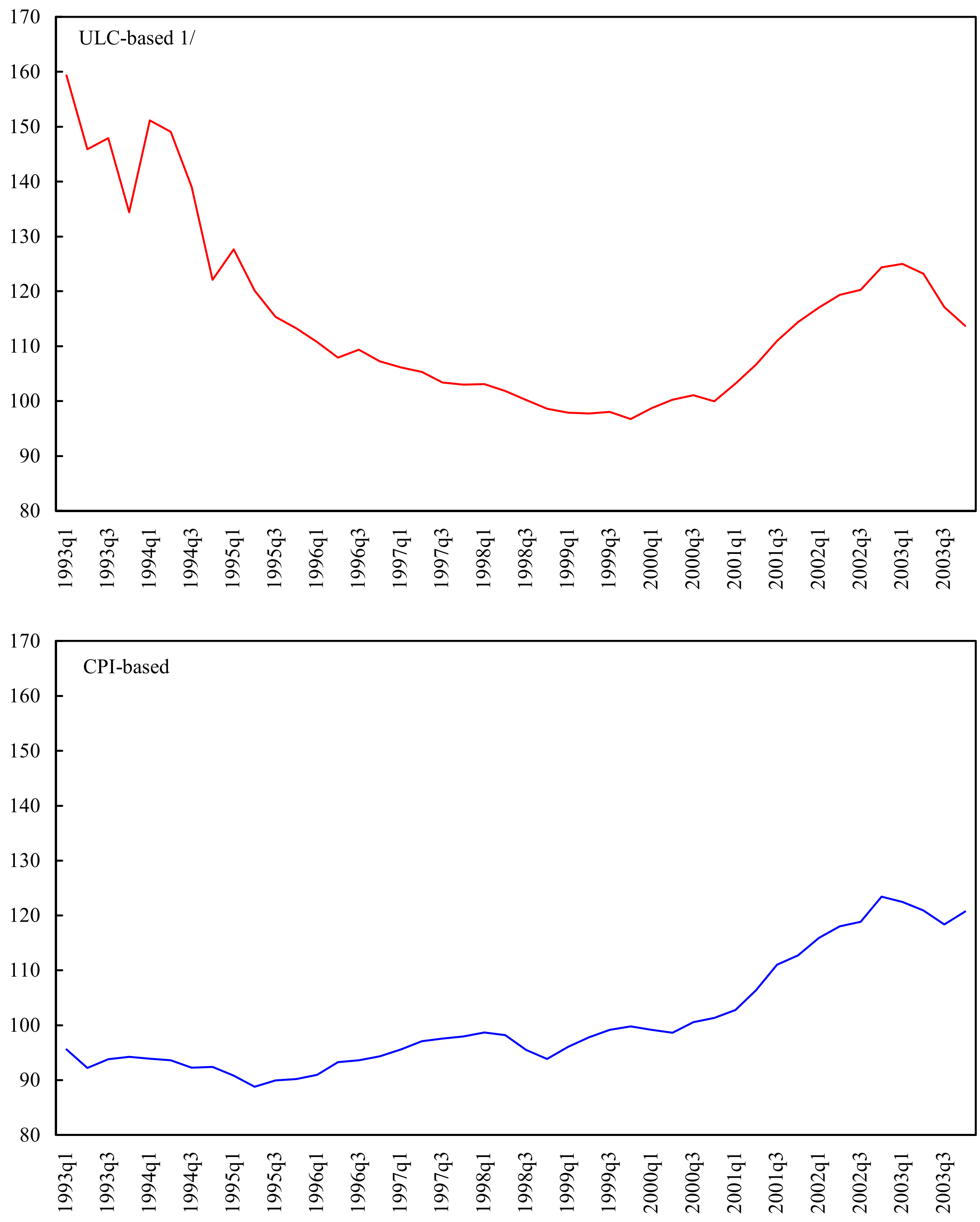


Nevertheless, default risk appears to remain low.



Sources: Bloomberg; Hungarian authorities; and IMF staff calculations.
1/ On the basis of a domestic currency denominated five-year bond. While difficult to disentangle, this differential reflects exchange rate, liquidity, and default risk.

Figure 4. Hungary: Real Effective Exchange Rates, 1993–2003
(2000=100)



Sources: Country authorities; and IMF staff calculations.
1/ Staff estimates in Q4 2003 based on partial data.

Table 1. Hungary: Main Economic Indicators, 1999–2004

	1999	2000	2001	2002	2003 Prel.	2004 Proj. 1/
Real economy (change in percent)						
Real GDP	4.2	5.2	3.8	3.5	2.9	3.2
CPI (average)	10.0	9.8	9.2	5.3	4.7	7.1
Unemployment rate (in percent)	7.0	6.4	5.7	5.8	5.9	6.2
Wage Growth (gross wages)						
Economy wide	16.1	13.5	18.0	18.3	12.0	...
Private	14.8	14.2	16.3	13.3	8.9	...
Public	19.2	12.3	22.4	29.2	17.5	...
Gross national saving (percent of GDP) 2/	23.5	24.3	23.5	21.2	19.5	20.1
Gross domestic investment (percent of GDP)	28.6	30.5	26.8	25.2	25.0	25.4
General government (percent of GDP), ESA-95 basis 3/						
Balance	...	-3.0	-4.7	-9.4	-6.0	-4.6
Debt	61.0	55.4	53.5	57.1	59.1	59.5
Money and credit (end-of-period, percent change) 4/						
M3	13.1	18.1	17.1	9.5	11.9	...
Credit to non government	21.5	34.8	18.2	22.2	35.2	...
Interest rates (percent)						
T-bill (90-day, average) 5/	14.5	10.9	10.6	8.9	8.8	12.5
Government bond yield (5-year, average) 5/	11.8	9.1	8.5	7.8	7.4	9.6
Balance of payments						
Trade balance (percent of GDP)	-4.5	-6.3	-4.3	-3.3	-4.1	-4.0
Current account (percent of GDP)	-5.0	-6.2	-3.3	-4.1	-5.5	-5.3
Reserves (months of imports of goods and services)	4.1	3.7	3.4	2.9	2.8	2.7
Net external debt (percent of GDP) 6/	22.5	25.4	23.4	22.5	24.0	...
Fund relations (February 29, 2004)						
Fund holding of currency (in percent of quota)					58.8	
Holdings of SDRs (in percent of allocation)					...	
Quota (SDR million)					1,038.4	
Exchange rate						
Exchange regime			Peg against euro, with band +/-15 percent			
Present rate (March 30, 2004)			Ft 204.83 = US$1			
Nominal effective rate (1990=100)	37.6	35.5	36.2	38.9	38.8	...
Real effective rate, CPI basis (1990=100)	135.0	135.8	146.5	162.9	166.4	...

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

1/ These projections assume the government achieves its fiscal deficit target for 2004.
2/ Consistent with the balance of payment data (not necessarily with the national accounts data).
3/ Consists of the central budget, social security funds, extrabudgetary funds, and local governments.
4/ For more on monetary developments see Table 8.
5/ Average of January-February for 2004.
6/ Including inter-company loans, and nonresident holdings of forint-denominated assets; figure for 2003 refers to the third quarter.

Table 2. Hungary: Consolidated General Government, 2000-04
(ESA-95 Basis)

	2000	2001	2002	2003 Est.	2004 revised budget 1/	2004 alternative scenario 2/
	(In percent of GDP)					
Total revenues	46.4	45.4	44.7	43.7	43.8	43.2
Current revenues and current grants	45.6	44.5	43.7	42.8	42.8	42.3
Tax revenues total	39.7	38.7	38.6	38.2	38.8	38.3
Taxes on income	9.6	9.9	9.9	9.3	9.2	9.0
Personal income tax	7.4	7.6	7.6	7.0	7.1	7.0
Corporate income tax	2.3	2.3	2.1	2.2	2.1	2.0
Social security contributions	12.9	12.5	12.9	12.1	12.6	12.5
Taxes on goods and services	14.8	14.0	13.6	14.6	15.0	14.8
of which : VAT	8.9	8.4	8.2	9.1	9.6	9.4
Other taxes	2.3	2.2	2.2	2.3	2.0	2.0
Current non tax revenues total	5.5	4.3	4.5	4.2	3.6	3.6
Of which : interest	0.8	0.4	0.3	0.3	0.2	0.2
Current grants	0.4	1.5	0.6	0.3	0.4	0.4
Capital revenues and capital grants	1.0	1.0	0.9	0.8	0.9	0.9
Capital revenues	0.6	0.6	0.6	0.4	0.3	0.3
Capital grants	0.4	0.3	0.4	0.4	0.6	0.6
Non-allocable revenues	-0.2	0.0	0.0	0.0	0.0	0.0
Total expenditures	49.4	50.1	54.0	49.6	48.4	48.6
Current expenditures and current transfers	41.3	42.3	44.5	43.9	41.9	42.1
Goods and services	17.7	18.0	18.8	19.4	17.8	18.0
Of which : wages and salaries 3/	10.5	10.4	12.0	12.5	12.3	12.3
Transfers	18.0	19.7	21.7	20.2	19.8	19.8
Of which : to households	14.6	15.0	15.5	16.3	15.7	15.7
Interest payments	5.7	4.7	4.1	4.4	4.3	4.3
Capital expenditures and capital transfers	8.0	7.7	9.5	5.5	6.3	6.3
Capital expenditures	4.3	4.5	6.1	2.9	4.3	4.3
Capital transfers	3.7	3.3	3.4	2.6	1.9	1.9
Unallocable expenditures	0.1	0.1	0.0	0.3	0.2	0.2
Of which : General government reserves	0.0	0.0	0.0	0.2	0.2	0.2
General government balance	-3.0	-4.7	-9.4	-6.0	-4.6	-5.3
Net interest	-4.9	-4.2	-3.8	-4.1	-4.1	-4.1
Primary balance	1.8	-0.5	-5.6	-1.9	-0.5	-1.2
Memorandum items:						
GDP, in current prices (forint billions)	13,092	14,850	16,740	18,574	20,380	...
Gross debt (in percent of GDP)	55.8	53.5	57.1	59.1	59.5	60.0

Sources: Hungarian authorities.

1/ Staff estimates.
2/ Based on staff estimates assuming no additional measures are taken other than those discussed in paragraph 13.

Table 3a. Hungary: Balance of Payments, 1999-2007 1/

	1999	2000	2001	2002	2003	2004	2005	2006	2007
							Proj.		
				(In billions of U.S. dollars)					
Current account balance	-2.4	-2.9	-1.7	-2.6	-4.6	-4.8	-4.3	-4.1	-4.1
In percent of GDP	*-5.0*	*-6.2*	*-3.3*	*-4.1*	*-5.5*	*-5.3*	*-4.3*	*-3.9*	*-3.6*
Merchandise trade balance	-2.2	-2.9	-2.2	-2.1	-3.4	-3.6	-3.1	-2.9	-2.9
In percent of GDP	*-4.5*	*-6.3*	*-4.3*	*-3.3*	*-4.1*	*-4.0*	*-3.2*	*-2.7*	*-2.6*
Exports goods	25.6	28.7	31.1	34.8	43.2	49.1	53.3	57.7	62.1
Percentage change in volume	15.9	21.7	7.7	5.9	11.0	7.0	7.5	7.5	6.7
Imports goods	27.7	31.6	33.3	36.9	46.6	52.7	56.4	60.6	65.0
Percentage change in volume	14.3	20.8	4.0	5.1	12.4	6.6	6.4	6.9	6.6
Services balance	0.9	1.1	1.4	0.6	-0.2	0.4	0.6	0.7	0.6
Of which: net travel	2.0	2.1	2.3	1.6	1.4	1.8	1.9	2.0	1.9
Net income	-1.5	-1.4	-1.3	-1.6	-1.7	-1.9	-2.0	-2.2	-2.2
Net transfers	0.4	0.4	0.4	0.5	0.7	0.3	0.2	0.4	0.4
Capital account, net	0.0	0.3	0.3	0.2	-0.1	0.7	1.8	2.2	2.2
Financial account, net	5.3	4.0	1.4	0.5	5.1	5.6	4.3	4.2	3.7
In percent of GDP	*11.1*	*8.6*	*2.7*	*0.8*	*6.2*	*6.1*	*4.4*	*3.9*	*3.3*
Net direct investment	1.9	1.2	2.2	0.7	-1.3	0.7	-0.1	0.8	1.8
Net portfolio investments	2.0	-0.4	1.5	1.6	3.0	3.7	3.3	3.0	1.5
Net other investments	1.4	3.2	-2.3	-1.8	3.4	1.1	1.1	0.3	0.4
Errors and omissions	-0.4	-0.2	0.1	0.3	0.5	0.0	0.0	0.0	0.0
Overall balance	2.3	1.1	-0.1	-1.8	0.4	1.5	1.9	2.3	1.9
Net reserves (change)	-2.3	-1.1	0.1	1.8	-0.4	-1.5	-1.9	-2.3	-1.9
Memorandum of items (end of period):									
Gross reserves	11.0	11.2	10.8	10.4	12.8	13.6	14.7	16.1	16.9
In months of goods and services imports	*4.1*	*3.7*	*3.4*	*2.9*	*2.8*	*2.7*	*2.7*	*2.7*	*2.7*
Gross foreign debt, in percent of GDP 2/	*64.3*	*64.7*	*64.9*	*62.4*	*69.5*	*66.8*	*66.1*	*64.2*	*61.5*
Net foreign debt, in percent of GDP 3/	*22.5*	*25.4*	*23.4*	*26.4*	*29.4*	*30.6*	*32.2*	*32.2*	*31.5*

Sources: Magyar Nemzeti Bank; and IMF staff estimates.

1/ These data reflect the methodological changes to the BOP statistics (described in the statistical issues appendix and the data ROSC update) that were introduced in late February 2003.
2/ Including intercompany loans.
3/ Foreign liabilities net of foreign assets, excluding equity but including intercompany loans.

Table 3b. Hungary: Balance of Payments, 1999-2007 1/

	1999	2000	2001	2002	2003	2004	2005	2006	2007
							Proj.		
				(In billions of U.S. dollars)					
Current account balance	-3.8	-4.0	-3.2	-4.7	-7.4	-7.8	-7.5	-7.4	-7.6
In percent of GDP	*-7.9*	*-8.7*	*-6.2*	*-7.2*	*-8.9*	*-8.6*	*-7.6*	*-7.0*	*-6.7*
Merchandise trade balance	-2.2	-2.9	-2.2	-2.1	-3.4	-3.6	-3.1	-2.9	-2.9
In percent of GDP	-4.5	-6.3	-4.3	-3.3	-4.1	-4.0	-3.2	-2.7	-2.6
Exports goods	25.6	28.7	31.1	34.8	43.2	49.1	53.3	57.7	62.1
Percentage change in volume	15.9	21.7	7.7	5.9	11.0	7.0	7.5	7.5	6.7
Imports goods	27.7	31.6	33.3	36.9	46.6	52.7	56.4	60.6	65.0
Percentage change in volume	14.3	20.8	4.0	5.1	12.4	6.6	6.4	6.9	6.6
Services balance	0.9	1.1	1.4	0.6	-0.2	0.4	0.6	0.7	0.6
Of which: net travel	2.0	2.1	2.3	1.6	1.4	1.8	1.9	2.0	1.9
Net income	-2.9	-2.6	-2.9	-3.6	-4.5	-4.8	-5.2	-5.5	-5.7
Net transfers	0.4	0.4	0.4	0.5	0.7	0.3	0.2	0.4	0.4
Capital account, net	0.0	0.3	0.3	0.2	-0.1	0.7	1.8	2.2	2.2
Financial account, net	6.5	5.0	2.8	2.4	7.3	7.9	6.7	6.6	6.2
In percent of GDP	*13.5*	*10.7*	*5.3*	*3.7*	*8.8*	*8.7*	*6.8*	*6.3*	*5.5*
Net direct investment	3.1	2.2	3.6	2.6	0.9	3.0	2.2	3.3	4.3
Net portfolio investments	2.0	-0.4	1.5	1.6	3.0	3.7	3.3	3.0	1.5
Net other investments	1.4	3.2	-2.3	-1.8	3.4	1.1	1.1	0.3	0.4
Errors and omissions	-0.4	-0.2	0.1	0.3	0.5	0.0	0.0	0.0	0.0
Overall balance	2.3	1.1	-0.1	-1.8	0.4	1.5	1.9	2.3	1.9
Net reserves (change)	-2.3	-1.1	0.1	1.8	-0.4	-1.5	-1.9	-2.3	-1.9

Sources: Magyar Nemzeti Bank; and IMF staff estimates.

1/ Incorporates the new methodology, introduced at end-March 2004, for calculating FDI-related income – mainly by including reinvested earnings but also revising estimates of repatriated earnings.

2/ These data reflect the methodological changes to the BOP statistics (described in the statistical issues appendix and the data ROSC update) that were introduced in late February 2003.

Table 4. Hungary: Staff's Illustrative Medium-Term Scenario

	2000	2001	2002	2003	2004	2005	2006	2007
				Est.	Staff projections 1/			
	(In percent, unless otherwise indicated)							
Real GDP growth	5.2	3.8	3.5	2.9	3.2	3.4	4.0	4.0
Nominal GDP, forint billions	13,092	14,850	16,740	18,574	20,380	22,000	23,704	25,305
Inflation (CPI; end-year basis)	10.1	6.8	4.8	5.7	6.5	4.2	3.0	2.3
	(Annual percentage change, constant prices)							
Domestic demand	4.8	1.9	5.4	5.5	2.7	3.4	4.0	4.0
Consumption	4.4	5.8	8.7	5.9	2.1	2.6	3.5	4.0
Gross fixed capital formation	7.7	5.0	8.0	3.0	4.4	6.2	5.4	4.0
Exports of GNFS	21.0	7.8	3.7	7.2	7.8	6.3	6.1	5.4
Imports of GNFS	19.4	5.1	6.2	10.3	6.8	6.1	5.9	5.4
	(In percent of GDP)							
External current account balance 2/	-6.2	-3.3	-4.1	-5.5	-5.3	-4.3	-3.9	-3.6
Private sector savings-investment balance 2/	-3.2	1.4	1.6	-0.1	-0.7	-0.7	-0.6	-0.6
Gross private savings	23.0	23.7	22.2	20.5	20.4	20.8	21.1	21.1
Gross private investment	26.2	22.4	20.6	20.6	21.0	21.5	21.7	21.7
General government (ESA-95)								
Revenue, primary	45.6	45.0	44.4	43.3	43.6	43.3	42.9	42.6
Expenditure, primary	43.8	45.5	49.9	45.2	44.1	43.0	42.5	42.1
Primary balance	1.8	-0.5	-5.6	-1.9	-0.5	0.3	0.4	0.5
General government balance 2/	-3.0	-4.7	-9.4 3/	-6.0	-4.6	-3.6	-3.3	-3.0
Net interest	4.9	4.2	3.8	4.1	4.1	3.9	3.7	3.5
General government debt	55.8	53.5	57.1	59.1	59.5	58.8	57.8	57.1
Memorandum items								
Output gap 4/	0.7	0.4	-0.4	-1.3	-1.9	-2.3	-2.1	-1.9
Structural general government balance	-3.2	-4.8	-9.2	-5.6	-4.1	-2.9	-2.6	-2.4
Structural primary balance	1.6	-0.6	-5.5	-1.5	0.0	1.0	1.0	1.0

Source: IMF staff estimates.

1/ These projections assume the government achieves its fiscal deficit target for 2004 and the pace of fiscal adjustment in 2005-06 is the same as in the 2003 Pre-Accession Economic Program (PEP).

2/ Pending further data revision and reconciliation, there is a statistical discrepancy between the private sector savings-investment balance, the general government balance, and the external current account balance of about one-half percent of GDP in 2002 and 2003.

3/ The 2002 general government balance includes various one-off financial operations (amounting to 3.1 percent of GDP) that are not part of the saving-investment balance on a national accounts basis.

4/ Measuring the output gap is epecially difficult for a transition economy. For 2000 through 2003, the estimates are from the 2003 PEP (except that an adjustment is made for 2003 for the difference between the estimated outcome for actual GDP and the projection contained in the PEP). For 2004-07, potential GDP is assumed to grow by 4 percent.

Table 4 (Continued). Hungary: Staff's Alternative Scenario, 2003–07

	2003	2004	2005	2006	2007
	(In percent of GDP, unless otherwise specified)				
General government balance 1/	-6.0	-5.3	-4.6	-4.4	-4.4
Primary	-1.9	-1.2	-0.5	-0.5	-0.5
Net interest	-4.1	-4.1	-4.1	-4.0	-3.9
General government debt 1/	59.1	60.2	60.0	59.8	60.1
Real GDP growth (percentage points) 2/	2.9	3.4	3.3	3.8	3.6
External current account balance	-5.5	-5.6	-4.8	-4.4	-4.3
Memorandum items:					
Deviations from baseline (in percentage points)					
General government balance 1/	0.0	-0.7	-1.0	-1.2	-1.4
Primary	0.0	-0.7	-0.8	-0.9	-1.0
Net interest	0.0	0.0	-0.2	-0.3	-0.4
General government debt 1/	0.0	0.7	1.3	2.0	3.0
Real GDP growth	0.0	0.2	-0.1	-0.2	-0.4
External current account balance	0.0	-0.3	-0.5	-0.6	-0.7
Nominal GDP, forint billions (alternative scenario)		20,412	22,022	23,678	25,175

1/ ESA-95.

2/ Growth is assumed to differ from the baseline as a result of (i) a different fiscal impulse (measured by the change in the primary fiscal balance, with a multiplier of one-third); and (ii) different government debt (with a 1 percentage

Table 5. Hungary: Public Sector Debt Sustainability Framework, 1998-2008
(In percent of GDP, unless otherwise indicated)

	Actual							Projections					
	1998	1999	2000	2001	2002			2003	2004	2005	2006	2007	2008
								I. Baseline Projections					
1 **Public sector debt 1/**	61.1	61.2	55.8	53.5	57.1			**59.1**	**59.5**	**58.8**	**57.8**	**57.1**	**56.6**
O/w foreign-currency denominated	24.1	22.7	19.6	16.3	13.5			13.9	15.4	13.7	13.5	13.3	13.2
2 Change in public sector debt	-1.8	0.2	-5.5	-2.2	3.6			1.9	0.5	-0.8	-1.0	-0.7	-0.5
3 Identified debt-creating flows (4+7+12)	-2.2	0.4	-1.4	-1.8	0.7			-0.6	-1.1	-0.6	-0.8	-0.5	-0.4
4 Primary deficit	-3.1	-2.7	-1.8	0.5	5.6			1.9	0.5	-0.3	-0.4	-0.5	-0.4
5 Revenue and grants	43.5	42.1	45.6	45.0	44.4			43.3	43.6	43.3	42.9	42.6	42.4
6 Primary (noninterest) expenditure	40.4	39.4	43.8	45.5	49.9			45.2	44.1	43.0	42.5	42.1	42.0
7 Automatic debt dynamics 2/	0.1	4.1	0.4	-2.3	-4.9			-2.2	-1.0	-0.3	-0.4	0.0	0.0
8 Contribution from interest rate/growth differential 3/	-1.7	0.5	-2.3	-1.9	-1.9			-1.3	-1.0	-0.3	-0.4	0.0	0.0
9 Of which contribution from real interest rate	0.8	2.8	0.5	-0.1	-0.3			0.3	0.8	1.6	1.8	2.1	2.2
10 Of which contribution from real GDP growth	-2.6	-2.2	-2.8	-1.9	-1.7			-1.5	-1.7	-1.9	-2.2	-2.2	-2.1
11 Contribution from exchange rate depreciation 4/	1.8	3.6	2.7	-0.4	-2.9			-1.0	0.0	0.0	0.0	0.0	0.0
12 Other identified debt-creating flows	0.9	-1.0	0.0	0.0	0.0			-0.3	-0.7	0.0	0.0	0.0	0.0
13 Privatization receipts (negative)	-0.9	-1.0	0.0	0.0	0.0			-0.3	-0.7	0.0	0.0	0.0	0.0
14 Recognition of implicit or contingent liabilities	1.8	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0
15 Other (specify, e.g., bank recapitalization)	0.0	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0
16 Residual, including asset changes (2-3)	0.3	-0.2	-4.1	-0.4	2.9			2.5	1.6	-0.2	-0.2	-0.2	-0.1
Public sector debt-to-revenue ratio 1/	140.5	145.4	122.2	119.0	128.8			136.3	136.6	135.7	134.7	134.1	133.4
Gross financing need 5/	17.8	16.8	16.7	16.0	27.0			17.8	21.4	20.4	20.0	19.8	19.7
In billions of U.S. dollars	8.4	8.1	7.8	8.3	17.5			14.7	19.4	20.0	21.1	22.3	23.6
Key macroeconomic and fiscal assumptions						10-Year Historical Average	10-Year Standard Deviation						
Real GDP growth (in percent)	4.9	4.2	5.2	3.8	3.5	3.1	1.8	2.9	3.2	3.4	4.0	4.0	4.0
Average nominal interest rate on public debt (in percent) 6/	14.8	13.9	10.6	9.5	8.6	11.8	3.3	8.5	7.9	7.4	7.0	6.7	6.5
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	2.2	5.5	1.4	0.2	-0.3	-3.6	6.9	0.7	1.6	3.0	3.4	4.0	4.2
Nominal appreciation (increase in U.S. dollar value of local currency, in percent)	-7.1	-13.3	-11.3	2.0	23.9	-8.6	13.2	8.3	0.0	0.0	0.0	0.0	0.0
Inflation rate (GDP deflator, in percent)	12.6	8.4	9.2	9.2	8.9	15.4	6.4	7.8	6.3	4.4	3.6	2.7	2.3
Growth of real primary spending (deflated by GDP deflator, in percent)	7.0	1.7	16.8	7.9	13.6	3.8	8.7	-6.7	0.6	0.7	2.9	3.2	3.6
Primary deficit	-3.1	-2.7	-1.8	0.5	5.6	-0.9	4.0	1.9	0.5	-0.3	-0.4	-0.5	-0.4
								II. Stress Tests for Public Debt Ratio					
A. Alternative scenarios													
A1. Key variables are at their historical averages in 2004-08 7/								**59.1**	**55.3**	**50.6**	**46.3**	**42.2**	**38.4**
A2. Primary balance under no policy change in 2004-08								**59.1**	**58.9**	**58.1**	**57.2**	**56.6**	**56.1**
A3. Country-specific shock with less fiscal adjustment in 2004-08 8/								**59.1**	**60.1**	**60.0**	**59.9**	**60.4**	**61.3**
A4. Selected variables are consistent with market forecast in 2004-08 9/								**59.1**	**59.5**	**58.8**	**57.8**	**57.1**	**56.6**
B. Bound tests													
B1. Real interest rate is at historical average plus two standard deviations in 2004 and 2005								**59.1**	**64.1**	**67.5**	**66.4**	**65.8**	**65.3**
B2. Real GDP growth is at historical average minus two standard deviations in 2004 and 2005								**59.1**	**63.4**	**68.5**	**70.8**	**73.4**	**76.2**
B3. Primary balance is at historical average minus two standard deviations in 2004 and 2005								**59.1**	**66.0**	**72.5**	**71.4**	**70.8**	**70.3**
B4. Combination of 2-4 using one standard deviation shocks								**59.1**	**64.0**	**68.0**	**67.0**	**66.3**	**65.8**
B5. One time 30 percent real depreciation in 2004 10/								**59.1**	**67.1**	**66.3**	**65.2**	**64.6**	**64.1**
B6. 10 percent of GDP increase in other debt-creating flows in 2004								**59.1**	**69.5**	**68.7**	**67.7**	**67.0**	**66.5**

Sources: Hungarian authorities; and IMF staff estimates.
1/ Consolidated general government debt, gross debt, ESA-95 basis.
2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and ε = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).
3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi(1+g)$ and the real growth contribution as -g.
4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.
5/ Defined as public sector deficit, plus amortization of medium- and long-term public sector debt, plus short-term debt at end of previous period.
6/ Derived as nominal interest expenditure divided by previous period debt stock.
7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.
8/ This scenario is discussed in the text.
9/ The macroeconomic variables in the baseline scenario are broadly in line with market consensus. Thus, this scenario is similar to the baseline.
10/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).
11/ Assumes that key variables (real GDP growth, real interest rate, and primary balance) remain at the level in percent of GDP/growth rate of the last projection year.

Table 6. Hungary: External Sustainability Framework, 1996-2008
(In percent of GDP, unless otherwise indicated)

	Actual								Projections				
	1996	1997	1998	1999	2000	2001	2002	2003 4/	2004	2005	2006	2007	2008
I. Baseline Medium-Term Projections													
1 **External debt**	62.2	54.2	55.2	64.3	64.7	64.9	62.4	**69.5**	**66.8**	**66.1**	**64.2**	**61.5**	**58.8**
2 Change in external debt	-10.1	-8.0	1.0	9.1	0.4	0.2	-2.5	7.1	-2.8	-0.7	-1.9	-2.7	-2.8
3 Identified external debt-creating flows (4+8+11)	-2.6	0.5	3.4	3.9	8.0	-1.9	-5.8	-4.7	0.3	0.6	0.2	0.6	0.7
4 Current account deficit, excluding interest payments	-1.4	-0.4	3.0	4.8	5.2	2.9	4.6	6.7	5.7	4.9	4.4	4.2	4.1
5 Deficit in balance of goods and services	4.3	-0.9	1.4	2.7	3.9	1.5	2.4	4.3	3.6	2.6	2.1	2.0	2.0
6 Exports	41.8	54.2	61.3	64.2	74.0	72.8	64.2	61.9	64.1	64.5	64.8	65.3	66.1
7 Imports	46.0	53.3	62.8	67.0	77.9	74.3	66.6	66.2	67.7	67.1	66.9	67.3	68.0
8 Net non debt creating capital inflows (negative)	-4.1	-3.4	-2.1	-3.0	-1.8	-1.2	-1.4	-1.9	-2.1	-2.1	-2.1	-2.1	-2.1
9 Net foreign direct investment, equity	4.1	3.4	2.1	3.0	1.8	1.2	1.4	1.9	2.1	2.1	2.1	2.1	2.1
10 Net portfolio investment,equity	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
11 Automatic debt dynamics 1/	3.0	4.3	2.4	2.1	4.6	-3.6	-9.1	-9.5	-3.3	-2.2	-2.1	-1.6	-1.4
12 Contribution from nominal interest rate	5.1	4.9	4.2	3.1	3.5	3.3	2.6	2.2	2.8	2.7	2.6	2.5	2.3
13 Contribution from real GDP growth	-0.9	-2.8	-2.6	-2.3	-3.5	-2.2	-1.8	-1.4	-2.0	-2.1	-2.5	-2.4	-2.3
14 Contribution from price and exchange rate changes 2/	-1.2	2.2	0.8	1.3	4.5	-4.7	-9.8	-10.2	-4.1	-2.8	-2.3	-1.7	-1.4
14 Residual, incl. change in gross foreign assets (2-3)	-7.5	-8.4	-2.4	5.2	-7.6	2.1	3.3	11.9	-3.1	-1.3	-2.1	-3.2	-3.5
External debt-to-exports ratio (in percent)	148.9	100.0	90.0	100.2	87.4	89.2	97.2	112.4	104.2	102.5	99.1	94.2	88.9
Gross external financing need (in billions of US dollars) 3/	12.3	13.0	12.6	11.4	12.3	12.5	14.9	14.7	20.4	22.1	21.7	21.3	20.6
In percent of GDP	26.7	28.2	26.5	23.9	26.5	24.0	22.9	17.8	22.4	22.5	20.5	18.9	17.2
Key macroeconomic and external assumptions													
hide Nominal GDP (U.S. dollars)	45.9	46.2	47.4	47.9	46.4	51.8	64.9	82.8	90.9	98.1	105.7	112.8	120.0
Real GDP growth (in percent)	1.3	4.6	4.9	4.2	5.2	3.8	3.5	2.9	3.2	3.4	4.0	4.0	4.0
Exchange rate appreciation (U.S. dollar value of local currency, change in percent)	-17.7	-18.3	-12.9	-9.6	-16.0	-1.5	11.1	15.0	0.0	0.0	0.0	0.0	0.0
GDP deflator in U.S. dollars (change in percent)	1.5	-3.7	-2.2	-3.0	-8.0	7.6	21.0	23.9	6.3	4.4	3.6	2.7	2.3
Nominal external interest rate (in percent)	7.3	7.9	7.9	5.6	5.3	5.8	5.0	4.6	4.5	4.4	4.3	4.2	4.1
Growth of exports (U.S. dollar terms, in percent)	12.0	30.7	16.0	5.8	11.6	9.8	10.5	22.9	13.7	8.6	8.2	7.6	7.7
Growth of imports (U.S. dollar terms, in percent)	11.7	16.6	20.8	7.8	12.6	6.5	12.3	26.7	12.2	7.0	7.5	7.5	7.5
II. Stress Tests for External Debt Ratio													
1. Real GDP growth, nominal interest rate, dollar deflator, non interest current account, and non debt inflows at historical avg. 2004-08								**69.5**	**67.0**	**66.3**	**64.7**	**62.0**	**59.1**
2. Nominal interest rate is at historical average plus two standard deviations in 2004 and 2005								**69.5**	**69.6**	**71.7**	**69.7**	**66.9**	**64.0**
3. Real GDP growth is at historical average minus two standard deviations in 2004 and 2005								**69.5**	**68.0**	**68.6**	**66.6**	**63.9**	**61.1**
4. Change in U.S. dollar GDP deflator is at historical average minus two standard deviations in 2004 and 2005								**69.5**	**86.0**	**106.8**	**103.6**	**99.9**	**96.3**
5. Non interest current account is at historical average minus two standard deviations in 2004 and 2005								**69.5**	**68.9**	**71.1**	**69.1**	**66.3**	**63.4**
6. Combination of 2-5 using one standard deviation shocks								**69.5**	**79.2**	**92.1**	**89.3**	**86.1**	**82.8**
7. One time 30 percent nominal depreciation in 2004								**69.5**	**72.4**	**71.5**	**69.5**	**66.7**	**63.8**

Historical statistics for key variables (past 7 years)	Historical Average	Standard Deviation
Current account deficit, excluding interest payments	2.7	2.6
Net non debt creating capital inflows	2.4	1.1
Nominal interest rate (in percent)	6.4	1.3
Real GDP growth (in percent)	3.9	1.3
GDP deflator in U.S. dollars (change in percent)	1.9	9.7

Sources: Magyar Nemzeti Bank; *International Financial Statistics, IMF*; and IMF staff estimates.

1/ Derived as $[r - g - \rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in U.S. 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 $[-\rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock. ρ increases with an appreciating domestic currency ($\varepsilon > 0$) and rising inflation (based on GDP deflator).
3/ Defined as non interest current account deficit, plus interest and amortization on medium- and long-term debt, plus short-term debt at end of previous period.
4/ Includes preliminary data as well as projections.

Table 7. Hungary: Frequently Used Indicators of Stability and Vulnerability in the Financial and External Sectors

(Year end, in percent of GDP, unless otherwise indicated)

	1999	2000	2001	2002	2003	2004	Date of latest Observation
Financial indicators							
Public sector debt	61.0	55.4	53.4	57.1	59.1	59.5	Dec '03
Broad money (M3, percent change, 12-month basis)	13.1	18.1	17.1	9.5	12.0	12.0	Jan '04
Private sector credit (percent change, 12-month basis)	21.5	34.8	18.2	22.2	35.2	38.4	Jan '04
Credit to non financial corporations	17.7	30.5	9.5	6.1	14.3	17.4	Jan '04
Credit to households	36.2	47.4	46.4	68.4	60.4	63.3	Jan '04
Total domestic credit (percent change, 12-month basis)	-5.1	16.1	3.1	23.7	22.9	19.5	Jan '04
3-month T-bill yield	12.4	11.6	9.7	7.9	11.8	12.4	Feb '04
3-month T-bill yield (real) 1/	1.1	1.3	2.7	3.0	5.8	5.3	Jan '04
Non performing loans as a percent of total loans 2/	4.2	3.0	2.2	2.0	1.7		Sep '03
Capital adequacy ratio (in percent)	14.2	13.7	13.9	13.0	11.6		Jun '03
Foreign exchange loans as a percent of total loans	...	41.6	37.4	36.5	39.9		Jun '03
External indicators							
Exports of goods & services (percent change, 12-month basis in U.S. dollars) 3	5.8	11.6	9.8	10.5	22.9	23.0	Jan '04
Imports of goods & services (percent change, 12-month basis in U.S. dollars) 3	7.8	12.6	6.5	12.3	26.7	27.1	Jan '04
Terms of trade (percent change, 12-month basis)	0.6	-2.7	-0.3	0.4	...		
Current account balance 3/	-5.7	-6.2	-3.4	-4.1	-5.7	-5.6	Jan '04
Capital and financial account balance 3/	13.5	11.2	5.9	3.9	8.8		Dec '03
Of which: Inward portfolio investment (debt securities etc.)	2.5	-1.8	2.1	-0.4	0.1		Dec '03
Other investment (loans, trade credits etc.)	3.0	6.8	-4.5	-2.7	4.1		Dec '03
Inward foreign direct investment (other than equity)	1.4	0.7	3.1	-0.1	-1.7		Dec '03
Net foreign assets (NFA) of commercial banks (in billions of U.S. dollars)	0.6	0.2	2.3	1.8	2.1	3.3	Jan '04
Gross official reserves (in billions of US dollars)	11.0	11.2	10.8	10.4	12.8	13.1	Feb '04
Central bank foreign currency exposure (in billions of U.S. dollars) 4/	8.2	8.2	8.9	8.9	11.7		Dec '03
Official reserves in months of imports of goods and services 5/	4.1	3.7	3.4	2.9	2.8	2.8	Jan '04
Ratio of reserve money to official reserves	0.9	0.7	0.7	1.0	0.7	0.7	Jan '04
Ratio of broad money to official reserves	1.9	1.8	2.4	3.3	3.2	3.2	Jan '04
Ratio of total short-term external debt to net official reserves 6/	1.1	1.1	0.0	0.0	0.4		Dec '03
Total external debt 7/	64.2	64.3	64.3	55.3	47.0		2003 Q2
Of which: Public sector debt	38.1	31.9	28.9	25.5	28.1		2003 Q3
Total external debt 8/	58.0	59.9	55.5	46.4	51.7		2003 Q3
Total external debt as a percent of exports of goods & services 8/	85.8	80.5	76.3	81.5	89.2		2003 Q3
Total external debt service as a percent of exports of goods & services 9/	16.6	14.3	13.0	12.6	...		
Exchange rate (per US$, period average)	237.1	282.2	286.5	257.9	224.3	209.8	Jan '04
REER depreciation (-) (12 month basis; CPI-based)	1.6	0.6	7.9	11.2	3.5		Nov '03
Financial market indicators							
Stock market index (end of period)	10,101	7,850	7,131	7798	9,380	10,644	23-Mar-04
Foreign currency debt rating (Moody's)	Baa1	A3	A3	A1	A1	A1	23-Mar-04
Spread of dollar-denominated benchmark bond (basis points, end of period)	107.0	116.0	78.0	59.5	...		
Spread of DM-denominated benchmark bond (basis points, end of period) 10/	...	91.4	110.7	53.3	32.5	28.5	23-Mar-04

Sources: Magyar Nemzeti Bank; Ministry of Finance; Bloomberg; and IMF staff estimates.

1/ Backward-looking using actual CPI.
2/ Comprised of loans classified as substandard, doubtful, and bad.
3/ These data reflect the methodological changes to the BOP statistics (described in the statistical issues appendix and the data ROSC update) that were introduced in late February 2003.
4/ Net foreign assets plus foreign exchange credit to the government and banks less foreign exchange deposits of banks.
5/ Data for 2004 are expressed in terms of imports in 2003.
6/ Includes short-term loans (by remaining maturity), and nonresident holdings of domestic bonds. Official reserves are net of resident foreign exchange deposits with the National Bank.
7/ Including intercompany loans.
8/ Excluding intercompany loans.
9/ Medium-term credit amortization and gross interest expenditures, denominated in foreign currencies, excluding intercompany loans.
10/ NBH bond maturing December 2005 (DM-denominated) and a German government bond with similar maturity.

Table 8. Hungary: Monetary Survey, 2002-2003
(In Billions of Forint, at Current Exchange Rates, End-of-Period)

	2002				2003			
	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec
Domestic claims 1/	8,302	8,585	8,995	9,284	9,862	10,511	10,648	11,085
Claims on non-financial corporations	3,850	3,961	4,142	3,880	4,011	4,272	4,425	4,615
Of which:								
Securities	293	285	306	187	188	182	190	197
Credits	3,557	3,676	3,835	3,693	3,823	4,091	4,235	4,418
Forint	2,361	2,454	2,547	2,482	2,469	2,539	2,671	2,690
Foreign currency	1,196	1,220	1,289	1,211	1,354	1,552	1,565	1,728
Claims on other financial corporations	441	520	579	652	722	862	912	1,020
Of which:								
Securities	41	41	38	50	47	44	56	59
Credits	400	479	540	602	675	818	857	961
Forint	154	163	175	175	180	214	203	197
Foreign currency	246	316	365	427	495	603	653	765
Claims on the Consolidated Central Government	2,995	2,921	2,875	3,162	3,401	3,386	3,047	2,935
Of which:								
Securities	1,704	1,717	1,700	1,818	2,123	2,153	2,061	2,086
Credits	1,290	1,204	1,175	1,344	1,279	1,233	987	849
Local governments	74	85	88	118	112	123	128	148
Households	932	1,086	1,298	1,459	1,605	1,855	2,121	2,349
Forint	906	1,055	1,263	1,424	1,563	1,800	2,059	2,269
Foreign currency	26	30	34	36	42	55	62	80
Non-profit institutions	11	12	13	13	12	13	14	19
Net foreign assets	653	438	420	516	539	406	539	445
Broad money (M3)	6,818	6,945	7,145	7,859	7,785	8,114	8,287	8,792
M2	6,468	6,704	6,870	7,547	7,450	7,775	7,996	8,576
Currency outside monetary institutions	1,005	1,101	1,149	1,182	1,198	1,287	1,306	1,346
Deposits	5,762	5,886	5,994	6,652	6,554	6,791	6,994	7,538
Of which:								
Non-financial corporations	1,651	1,839	1,827	2,109	1,818	2,098	2,129	2,353
Forint	1,318	1,452	1,453	1,714	1,474	1,714	1,735	1,915
Foreign currency	333	388	375	396	345	384	394	437
Households	3,397	3,407	3,477	3,729	3,757	3,840	3,935	4,324
Forint	2,672	2,729	2,813	3,102	3,137	3,202	3,332	3,737
Foreign currency	725	678	665	627	620	638	603	587
Sale and repurchase agreements	39	27	97	109	90	122	90	34
Securities issues by monetary financial institutions with maturity up to 2 years	161	58	28	19	7	5	13	9
Money market funds shares/units	150	155	150	183	237	212	187	173
Other claims, net	-2,137	-2,077	-2,270	-1,941	-2,616	-2,804	-2,900	-2,738
Memorandum Item:								
Domestic Credit	6,264	6,542	6,950	7,229	7,505	8,133	8,342	8,743

Sources: Magyar Nemzeti Bank; International Financial Statistics; and staff calculations.

1/ Claims consist of credit (loans) and securities (securities other than shares and shares and other equities).

In this table Domestic credit consists of only credit (loans) granted by MFIs to residents other than MFIs which is differ from domestic credit earlier published in the monetary survey which consisted credit (loans) granted by MFIs to central government net of its deposits and securities issued by central government (state bonds, treasury bills) and credit to other residents (other than MFIs and central government).

Table 9. Hungary: Millennium Development Goals, 1990-2015

	1990	1995	2001	2002	2015 Target
Goal 1: Eradicate extreme poverty and hunger					
Target 1: Halve, between 1990 and 2015, the proportion of people whose income is less than one dollar a day.					
Population below $1 a day (%)	...	...	...	...	0.0
Poverty gap at $1 a day (%)	...	...	...	...	...
Target 2: Halve, between 1990 and 2015, the proportion of people who suffer from hunger.					
Percentage share of income or consumption held by poorest 20%	...	...	...	...	...
Prevalence of child malnutrition (% of children under 5)	2.2	...	...	...	...
Population below minimum level of dietary energy consumption (%)	...	...	...	...	...
Goal 2: Achieve universal primary education					
Target 3: Ensure that, by 2015, children everywhere, boys and girls alike, will be able to complete a full course of primary schooling.					
Net primary enrollment ratio (% of relevant age group)	91.3	96.6	90.2	...	[100]
Percentage of cohort reaching grade 5 (%)	97.6	...	...	...	...
Youth literacy rate (% ages 15-24)	99.7	99.8	99.8	99.8	...
Goal 3: Promote gender equality					
Target 4: Eliminate gender disparity in primary and secondary education preferably by 2005 and to all levels of education no later than 2015.					
Ratio of girls to boys in primary and secondary education (%)	95.5	97.9	100.0	...	100.0
Ratio of young literate females to males (% ages 15-24)	99.9	100.0	100.0	100.0	...
Share of women employed in the nonagricultural sector (%)	...	...	...	...	...
Proportion of seats held by women in national parliament (%)	21.0	11.0	8.0	8.0	...
Goal 4: Reduce child mortality					
Target 5: Reduce by two-thirds, between 1990 and 2015, the under-five mortality rate.					
Under 5 mortality rate (per 1,000)	16.8	12.5	9.0	9.6	[5.5]
Infant mortality rate (per 1,000 live births)	14.8	10.7	8.0	7.5	...
Immunization, measles (% of children under 12 months)	99.0	99.0	99.0	...	...
Goal 5: Improve maternal health					
Target 6: Reduce by three-quarters, between 1990 and 2015, the maternal mortality ratio.					
Maternal mortality ratio (modeled estimate, per 100,000 live births)	...	23.0	...	...	...
Births attended by skilled health staff (% of total)	...	...	...	...	...
Goal 6: Combat HIV/AIDS, malaria and other diseases					
Target 7: Have halted by 2015, and begun to reverse, the spread of HIV/AIDS. Have halted by 2015, and begun to reverse, the incidence of malaria and other major diseases.					
Prevalence of HIV, female (% ages 15-24)	...	...	0.0	...	...
Contraceptive prevalence rate (% of women ages 15-49)	...	72.5	...	...	...
Number of children orphaned by HIV/AIDS	...	...	...	...	...
Incidence of tuberculosis (per 100,000 people)	...	...	41.5	...	...
Tuberculosis cases detected under DOTS (%)	...	...	22.0	...	...

Table 9. Hungary: Millennium Development Goals (Concluded), 1990-2015

	1990	1995	2001	2002	2015 Target
Goal 7: Ensure environmental sustainability					
Target 8: Integrate the principles of sustainable development into country policies and programs and reverse the loss of environmental resources. Halve, by 2015, the proportion of people without sustainable access to safe drinking water. By 2020, to have achieved a significant improvement in the lives of at least 100 million slum dwellers.					
Forest area (% of total land area)	19.1	...	19.9	...	...
Nationally protected areas (% of total land area)	...	6.8	7.0	7.0	...
GDP per unit of energy use (PPP $ per kg oil equivalent)	3.4	3.8	5.0	...	...
CO2 emissions (metric tons per capita)	5.6	5.6	5.6	...	...
Access to an improved water source (% of population)	99.0	...	99.0	...	...
Access to improved sanitation (% of population)	99.0	...	99.0	...	...
Access to secure tenure (% of population)	...	...	...	...	...
Goal 8: Develop a Global Partnership for Development					
Target 9: Develop further an open, rule-based, predictable, non-discriminatory trading and financial system. Address the Special Needs of the Least Developed Countries. Address the Special Needs of landlocked countries and small island developing states. Deal comprehensively with the debt problems of developing countries through national and international measures in order to make debt sustainable in the long term. In cooperation with developing countries, develop and implement strategies for decent and productive work for youth. In cooperation with pharmaceutical companies, provide access to affordable, essential drugs in developing countries. In cooperation with the private sector, make available the benefits of new technologies, especially information and communications.					
Youth unemployment rate (% of total labor force ages 15-24)	17.5	18.6	12.4	...	...
Fixed line and mobile telephone numbers (per 1,000 people)	96.2	236.4	872.2	...	...
Personal computers (per 1,000 people)	9.6	39.0	100.3	...	...
General indicators					
Population (millions of persons)	10.4	10.2	10.2	10.2	...
Gross national income (billions of USD)	29.8	42.4	49.2	53.7	...
GNI per capita ($)	2,880	4,140	4,830	5,280	...
Adult literacy rate (% of people ages 15 and over)	99.1	99.2	99.3	99.4	...
Total fertility rate (births per woman)	1.8	1.6	1.3	1.3	...
Life expectancy at birth (years)	69.3	69.8	71.5	71.8	...
Aid (% of GNI)	0.2	-0.6	0.8	...	...
External debt (%GNI)	67.1	73.8	60.2	...	...
Investment (% of GDP) 1/	25.4	23.9	27.1	...	...
Trade (% GDP)	59.7	75.8	123.3	...	...

Source: World Development Indicators Database.

1/ Different concept than IMF staff calculations.
Note: The data shown are for the closest available year.

HUNGARY: FUND RELATIONS
(As of February 29, 2004)

I. **Membership Status**: Hungary became a member of the Fund on May 6, 1982; Article VIII.

II. **General Resources Account**:

	SDR Million	Percent of Quota
Quota	1,038.40	100.00
Fund holdings of currency	610.89	58.83
Reserve position in Fund	427.51	41.17

III. **SDR Department**:

	SDR Million	Allocation
Holdings	32.95	N/A

IV. **Outstanding Purchases and Loans**: None

V. **Financial Arrangements**:

Type	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
Stand-by	3/15/96	2/14/98	264.18	0.00
Stand-by	9/15/93	12/14/94	340.00	56.70
EFF	2/20/91	9/15/93	1,114.00	557.24

VI. **Projected Obligations to Fund**: None

VII. **Exchange Rate Arrangement**:

Between May 16, 1994 and January 1, 1997, the exchange rate of the forint was linked to a basket of the European Currency Unit (with a weight of 70 percent) and the U.S. dollar (with a weight of 30 percent). On January 1, 1997, the NBH changed the composition of its fixing basket to a combination of deutsche mark (with a weight of 70 percent) and the U.S. dollar (with a weight of 30 percent). Since January 1, 1997, the NBH has based its official rate on the interbank spot rates. As of January 1, 2000, the central parity of the intervention band has been defined solely in terms of the euro. Margins for the NBH's intervention band were widened to ±2.25 percent on December 23, 1994; and ±15 percent on May 4, 2001. Until March 13, 1995, the value of the peg to the basket was adjusted periodically, mainly on the basis of the difference between domestic and foreign inflation rates; from then until October 1, 2001, the value of the peg was adjusted in accordance with a preannounced rate of crawl. Since October 1, 2001, the central parity has been set at 276.1 forint per euro. Between March 13 and June 30, 1995, the rate of devaluation against the basket was 1.9 percent per month; it was reduced to 1.3 percent per month as of July 1, 1995; to 1.2 percent per month as of January 1, 1996; to 1.1 percent per month from April 1, 1997; to 1.0 percent per month as of August 15, 1997; to 0.9 percent per month from January 1, 1998; to 0.8 percent per month from June 15, 1998; to 0.7 percent per month from October 1, 1998; to 0.6 percent per month from January 1, 1999; to 0.5 percent per month from July 1, 1999; to 0.4 percent per month from October 1, 1999; to 0.3 percent as of April 1, 2000; to 0.2 percent as of April 1, 2001; and eliminated effective October 1, 2001.

Hungary accepted the obligations of Article VIII as of January 1, 1996, and its exchange system is free of restrictions on payments and transfers of current international transactions. In accordance with UN Resolution 661 and Executive Board decision No.144–(52/51), Hungary continues to maintain exchange restrictions against Iraq. The UN Security Council Resolution on food for oil was implemented in December 1996. As confirmed by the authorities on March 23, 2004, Hungary continues to maintain exchange restrictions against Iraq, in accordance with the UN Resolution 661, and financial restrictions against organizations and individuals suspected of terrorism listed in the relevant UN Security Council Resolutions. Hungary has notified these measures to the Fund consistently with the Articles of Agreement.

VIII. **Article IV Consultations**:

Hungary is on a 12-month consultation cycle. The 2003 Article IV staff report was issued on April 2, 2003 (IMF Country Report No. 03/24). The last Article IV Board discussion took place on May 2, 2003. The Public Information Notice No. 03/58 was released on May 9, 2003.

IX. **Technical Assistance:**

Year	**Dept**.	**Purpose**	**Date**
1991	FAD	Tax reform	April
1991	EU1/IMF Institute	Seminar on financial programming	May
1991	FAD	Budget reform	May
1991	FAD	Tax administration reform	June
1991	MAE/PDR	Development of a foreign exchange interbank market	September
1991	MAE/PDR	Development of a foreign exchange interbank market	October

1991	FAD	Budget reform	November
1991	FAD	Tax administration reform	November
1992	STA	Money and banking statistics seminar	March
1992	FAD	Design and implementation of a "flash" fiscal reporting system	May
1992	FAD	Revenue forecasting	June
1993	MAE/EU1/IBRD	Financial and enterprise restructuring	March
1993	MAE	Central bank reorganization	May
1994	FAD/EU1	Treasury/debt management	February
1994	FAD	Tax administration	March
1994	STA/PDR	International trade and balance of payments statistics	April
1994	FAD	Tax administration follow-up	May
1994	FAD	Expenditure management	June
1994	FAD	Tax administration long-term expert assignment (on-going)	July
1994	FAD	Local government	August
1994	FAD	Tax administration	November
1995	FAD	Tax administration	February
1995	FAD	Treasury	February
1995	FAD	Treasury	May
1995	FAD	Treasury	November
1995	FAD	Debt management	November
1995	MAE	Central bank internal auditing	November
1995	MAE	Monetary analysis and research	December
1996	FAD	Tax policy	May
1996	MAE	Central bank accounts	September
1996	FAD	Subsidies	November
1997	FAD	Subsidies follow-up	May
2000	FAD	Tax legislation	June
2000	STA	Money and banking statistics	October
2000	FAD	Tax legislation follow-up	November
2002	FAD	Expenditure rationalization	November

X. **Regional Resident Representative:**

The regional office was closed in July 2002.

HUNGARY—STATISTICAL ISSUES

1. Significant progress has been made in improving the coverage, periodicity, and quality of Hungarian economic and financial statistics. Most data quality issues noted in the data dissemination module of the 2001 Report on the Observance of Standards and Codes (ROSC) have been satisfactorily addressed, but some still remain.[12]

2. Hungary subscribes to the Special Data Dissemination Standard (SDDS), and its metadata are posted on the Fund's Dissemination Standards Bulletin Board (http://dsbb.imf.org). Hungary meets the SDDS specifications for the coverage, periodicity, and timeliness of the data, and for the dissemination of advance release calendars.

A. Real Sector Issues

National accounts

3. A statistical discrepancy between the final version of GDP by production activities and GDP by expenditure components appeared in 1997, and has persisted. From 2000, the Hungarian Central Statistical Office (HCSO) has been regularly publishing an estimate of this discrepancy for final annual data. Subsequent methodological refinements and a change in the base year have trimmed the magnitude of the discrepancy to about 1¼ percent of GDP, based on 2001 current price data. From June 2002, the HCSO began publishing seasonally adjusted estimates of quarterly GDP by type of economic activity and by expenditure components beginning with the first quarter of 2002, with retrospective coverage from 1995. The benchmarking of the quarterly estimates to the annual estimates has been applied from 2000. Beginning with the annual data for 2000, the methodology for estimation of imputed owner-occupied rent, which had been based on 1993 benchmarks, was changed in line with recommendations of Eurostat.

B. Balance of Payments

4. A work plan, with clear time tables, is being implemented to replace the current cash-based balance of payments statistics, compiled by the Magyar Nemzeti Bank (MNB), with the accrual-based accounting principles of the fifth edition of IMF's *Balance of Payments Manual* (BPM5). A number of improvements has already been implemented: customs data are used to derive trade in goods; balance of payments statistics record goods under processing and repair as goods and financial lease arrangements according to the *BPM5* methodology; and estimates of reinvested earnings have been included in the balance of payments statistics, raising the current account deficit with an offsetting impact on the financial accounts. Further improvement is expected in 2004, when investment income will be recorded on an accrual basis. These modifications will complete the process

[12] The original 2001 ROSC Data Module and its annual 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* (forthcoming).

of shifting Hungary's balance of payments statistics to accrual accounting consistent with the BPM5. The release of revised quarterly series is scheduled by the MNB for end-March 2004 and will cover the period 1995–2003.

5. The MNB and the HCSO have reconciled their data sources and methodologies with regard to travel receipts and payments, eliminating a discrepancy which had existed in this area between the balance of payments statistics and the national accounts.

6. Since 2002, the cooperation between the HCSO and the MNB has been formalized through memoranda of understanding signed each year between the two institutions, identifying areas to improve statistics and harmonize data sources and methodologies.

C. Monetary Sector

7. The *International Financial Statistics* (*IFS)* country page for Hungary provides timely data for the monetary authorities, banking institutions, and the banking survey. The coverage of the MNB's analytical accounts has been extended, and Hungary complies with the strengthened reserves standard. The framework for the compilation of monetary statistics in Hungary basically conforms to the Fund's current methodology.

8. The Statistics Department (STA) had suggested excluding deposit liabilities of credit institutions under liquidation from the monetary aggregates by reclassifying them as "restricted deposits." The MNB has decided, as from beginning 2003, that these credit institutions are no longer classified as Monetary Financial Institutions (depository corporations) and hence deposits held with them are excluded from the monetary aggregates. Moreover, the deposits of these credit institutions held with the MNB and with other credit institutions have been reclassified as deposits of "nonfinancial enterprises," thus excluding them from base money. However, it should be noted that in line with the IMF's *Monetary and Financial Statistics Manual* and consistent with the advice of the European Central Bank (ECB), such institutions should be reclassified as other financial intermediaries.

9. STA had also recommended that securities on the balance sheets of depository corporations be valued at market prices; these securities are currently based on partial market valuation. Work is in progress in this area. From 2004, depository corporations are encouraged to use market valuation for securities in their trading portfolio. From 2005, this requirement is compulsory for those depository corporations that are listed on the stock exchange. Also, securities of all companies that are listed on the stock exchange and are held by depository corporations in their trading portfolio should be based on market valuation.[13]

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[13] The securities of those companies not listed on the stock exchange will be priced on the basis of secondary market values. In the absence of a secondary market, the valuation will be: (i) on the basis of company profitability using the last two annual company reports, or (ii) by calculating the present value of securities using acquisition prices. If no other information is available, acquisition prices could be used for the valuation.

Depository corporations are required to revalue their securities at least quarterly, and more frequently if possible.

10. Starting with the release of data for January 2003, the MNB has been compiling and publishing the monetary aggregates by adopting a new methodology consistent with that used by the ECB. In addition to the central bank and credit institutions, monetary financial institutions now also comprise money market funds (MMFs), as the investment units issued by MMFs show characteristics similar to those of bank deposits. Accordingly, the MMFs' balance sheet data are included in the consolidated balance sheet of the banking system (depository corporations survey). Other classifications that are already in conformity with ECB guidelines include: classification of credit extended on a gross basis (excluding interest accrued); fixed assets at acquisition cost; deposits at face value (without interest accrued); and debt securities not reported at market value are recorded at face value and zero coupon bonds at discounted value.

D. Government Finance Statistics (GFS)

11. In January 2004, STA conducted a substantive update of the GFS dataset using the July 2003 Data Quality Assessment Framework that it had developed for assessing the quality of five macroeconomic datasets. The mission reported that, overall, significant progress has been made in addressing the shortcomings of budget execution data and GFS identified in the original ROSC Data Module. These improvements relate mainly to institutional coverage of general government, consolidation of data and reconciliation of deficit and financing. However, plans to report monthly expenditures classified on an economic basis have yet to come to fruition.

12. Following a GFS mission in 1998, the authorities provided annual data for publication in the *GFS Yearbook* starting from 1991. The latest data reported for publication in the 2003 *GFS Yearbook* are for 2002. These data now cover the operations of the State Property Management and Privatization Company, since its inception in 1995, National Road Construction Company, State Debt Management Co., CASA Co., and the Participation Management Co. Data for 2000 through 2002 were compiled on an accrual basis, in accordance with the methodology of the 2001 *Government Finance Statistics Manual.* The *GFS Yearbook* data, and the monthly data reported for *IFS,* still contain inconsistencies between the measures of the deficit and financing.

Hungary: Core Statistical Indicators

(As of March 3, 2004)

	Exchange Rates	International Reserves	Central Bank Balance Sheet	Reserve/ Base Money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	External Debt/ Debt Service	Consolidated Government Balance	GDP
Date of Latest Observation	Feb. 2004	Jan. 2004	Nov. 2003	Nov. 2003	Nov. 2003	Dec. 2003	31-Jan	31-Dec	31-Dec	31-Dec	31-Jan	2003 Q4
Date Received	5-Mar	5-Mar	Jan. 7, 2004	Jan. 7, 2004	Jan. 7, 2004	Jan. 5, 2004	17-Feb	25-Jan	25-Jan	25-Jan	15-Feb	15-Feb
Frequency of Data	Daily	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Quarterly
Frequency of Reporting	Daily	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Quarterly
Source of Update	National Bank of Hungary	National Bank of Hungary	National Bank of Hungary	National Bank of Hungary	National Bank of Hungary	National Bank of Hungary	Central Statistical Office of Hungary	National Bank of Hungary	National Bank of Hungary	National Bank of Hungary	Ministry of Finance	Central Statistical Office of Hungary
Mode of Reporting	Internet	Internet	Internet	Internet	Internet	Internet	Internet	Internet	Internet	Internet	Internet	Email
Confidentiality	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public
Frequency of Publication	Daily	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Quarterly

HUNGARY— RELATIONS WITH THE WORLD BANK GROUP

Hungary joined the World Bank in 1982. Since then the Bank has committed some US$4.3 billion for 40 projects and programs. During the 1980s, Bank assistance focused on liberalizing the economy and modernizing and expanding its productive capacity, and infrastructure. During the 1990s, support for macroeconomic and structural adjustment was a key element of the Bank's assistance program. Bank assistance included structural adjustment loans in the early 1990s, accompanied by Japan Exim co-financing and an IMF EFF Program, and sector adjustment loans in the mid-1990s supporting financial sector and pension reform. The Bank also provided support to help strengthen public institutions (e.g., in tax administration and public finance, health and social assistance).

Hungary continues to enjoy access to private capital at terms that are extremely competitive for sovereign borrowings, and to significant financing from European institutions. Consequently, Hungary has ceased to borrow from the World Bank and does not envisage any further borrowing. In accordance with the last CAS Progress Report, discussed by the Bank's Board in April 2002, which envisaged a pre-graduation assistance program, the Bank has been providing analytical and advisory services, to complement support from the EU and other sources, and taking into account the Bank's comparative advantage.

There is only one ongoing Bank-financed project, the Municipal Wastewater Management with an undisbursed balance of about US$12 million as of mid-November 2003. In addition to the Wastewater Project, ongoing activities include a GEF Project Development Facility grant to prepare a Nutrient Reduction Project, an IDF grant for a Center of Excellence in Hungary for Property Rights and Land Market Development in EU Candidate and Balkan countries, an IDF grant for the new Office of Roma Affairs in Hungary, and advisory work on health, pensions, and energy reform options to help meet EU requirements, increase effectiveness and ensure financial viability. The Bank is also providing policy and institutional advice on sub-national development issues. In addition, Hungary is participating in the "Cities of Change" initiative established jointly by the Bank and the Bertelsmann Foundation to support policy and administration reform at the municipal level in medium-sized cities in Hungary, Poland, Latvia, Slovakia, and Bulgaria.

Hungary has started to pre-pay some loans and its outstanding obligations to the Bank amount to about US$253 million as of the end of October 2003. IFC has not undertaken new investments and guarantees in Hungary in recent years.

HUNGARY—THE HOUSING SUBSIDY SCHEME

The housing subsidy scheme introduced in 2001 has had a significant impact on the general government deficit and the external current account. Under the scheme, households can obtain mortgage loans from commercial banks at below-market rates, while the banks are compensated with a subsidy from the government. With subsidies initially available only towards the purchase of new houses, the use of the scheme increased significantly when in March 2002 subsidies under the scheme also became available towards the purchase or reconstruction of used houses. Increases in market interest rates in 2003 further boosted subsidy spending to 0.7 percent of GDP in 2003. The impact of the scheme on domestic demand and external balances is difficult to quantify. Nevertheless, because of fungability, the usage of subsidized loans—particularly those for used houses—partly for consumption purposes is considered to have boosted domestic demand significantly. The MNB estimates that 15–30 percent of the loans granted towards used houses are used for consumption.[14]

Recent amendments—reducing the credit limit and the size of the interest subsidy and tightening the eligibility criteria—are expected to reduce the fiscal costs and the impact on private consumption over the medium term. In June 2003, the maximum credit limit was reduced from Ft 30 million to Ft 15 million (still almost 10 times the average annual wage), while the number of subsidized mortgage loans per households was restricted to one. In December 2003, the maximum credit limit for the purchase or reconstruction of used homes was further decreased to F5 5 million. In addition, the interest subsidy element was reduced by making the interest rate for customers partly dependent on market interest rates. These changes are expected to rein in the fiscal expenditures and domestic demand pressures stemming from the scheme. The MNB estimates the fiscal savings to increase to 0.3–0.4 percent of GDP in 2006/7, and the impact on the current account deficit to rise from 0.1–0.3 percent of GDP in 2005 to 0.45–0.75 percent of GDP in 2006/7.[1] Nevertheless, with the changes applying only to new contracts, the immediate impact is expected to be modest, while high market interest rates and a spurt of new contracts arranged during the grace period in December 2003 are expected to boost expenditures in 2004 to 0.9 percent of GDP in 2004.

[14] See the MNB's February 2004 Inflation Report.

HUNGARY—ESTIMATION ERROR CORRECTION MODEL FOR CPI INFLATION

This appendix uses a simple econometric estimation method (the Engle-Granger two step error correction method) to assess the relative importance of wage costs and import prices in the determination of inflation. In a first step, a long-term relationship was estimated for the CPI index (excluding regulated prices), using wages and productivity in the enterprise sector (or unit labor costs, so that the coefficients on these variables are constrained to be equal in size) and import prices. This estimation suggested weights for wages and productivity of around 0.7 and somewhat over 0.4 for import prices (see equation 1). That the sum of these weights is close to 1 is encouraging.

$$\underset{}{LCPIXR} = \underset{(0.022)}{0.69} * LULCEP + \underset{(0.025)}{0.43} * LCPIGF - \underset{(0.142)}{2.86} + \text{seasonality}, \tag{1}$$

where CPIXR is the CPI index excluding regulated prices, ULCEP is unit labor costs in the enterprise sector, CPIGF is the German consumer price index denominated in forint, and L is the log operator.

Inclusion of this long-term relationship as an error correction term in a dynamic equation for the CPI index confirms that inflation responds to disequilibria with respect to the long-term relationship (see equation 2).

$$DLCPIXR = \underset{(0.089)}{0.374} * DLCPIXR\_1 + \underset{(0.093)}{0.236} * DLCPIXR\_3 + \underset{(0.095)}{0.231} * DLCPIXR\_4$$

$$- \underset{(0.021)}{0.069} * ECM\_1 + \underset{(0.0298)}{0.0597} * OPG + \underset{(0.002)}{0.002} + \text{seasonality}, \tag{2}$$

where ECM is the long run relationship from equation 1, and OPG is the output gap estimated using GDP data.[15]

The coefficient of the ECM suggests that 60 percent of a disequilibrium would be closed in one year. The output gap appears with a significant coefficient in the dynamic equation, suggesting that price pressures increase when activity becomes more buoyant.

[15] Key test results include: a standard error of 0.0039, and a Durban-Watson statistic of 2.11. The equation passed a number of specification tests.

INTERNATIONAL MONETARY FUND

HUNGARY

Staff Report for the 2004 Article IV Consultation
Supplementary Information

Prepared by the European Department

Approved by Carlo Cottarelli and Liam P. Ebrill

May 7, 2004

1. This supplement reviews developments in Hungary since the preparation of the staff report for the 2004 Article IV consultation. The additional information does not change the thrust of the staff appraisal.

RECENT ECONOMIC DEVELOPMENTS AND DATA REVISIONS

2. Recent economic developments include:

- Merchandise exports in euro terms were 13.1 higher in January-February 2004 than a year earlier (about 20 percent in volume terms). With imports in euros higher by 8.4 percent during that period (about 15 percent in volume terms), the trade deficit was substantially lower (totaling € 270 million in January-February of this year, compared with € 467 million in January-February 2003). However, the overall external current account did not improve much: the 12-month rolling current account deficit (including reinvested earnings) was 9 percent of GDP in February, down from its peak of 9.2 percent in August-October 2003. Industrial output benefited from the strength of exports: it was up 10.8 percent in the first quarter of 2004 from a year earlier.

- Year-on-year headline CPI inflation was lower than expected in March, declining to 6.7 percent from 7.1 percent in February, as food prices developed favorably. Core inflation (which excludes food and fuel) remained constant at 6.1 percent.

- Gross monthly wage growth in the private sector was 10.1 percent, year-on-year, in January-February 2004 (3.3 percent in real—CPI deflated—terms), compared with year-average growth of 9.0 percent in 2003 (4.3 percent in real terms). In the public sector, wage growth fell to 5.5 percent in January-February 2004 (-1.4 percent in real terms), compared with 17.8 percent in 2003 (13.2 percent in real terms).

- Since the preparation of the staff report, the forint has continued to stabilize in the Ft 250-255 per euro range. The Magyar Nemzeti Bank (MNB) reduced its key policy rate by 25 basis points on April 5, and on May 3 by another 50 basis points (to 11½ percent), citing with the latest cut improvements in foreign investors' assessment of the risks facing the Hungarian economy.

- Based on preliminary data, the general government deficit was about 2.1 percent of estimated annual GDP in the first quarter of 2004, compared with 1.6 percent in the first quarter of 2003 (excluding local governments, who typically run a small deficit). Tax revenues increased by 8.3 percent in the year to the first quarter of 2004; total expenditures increased by 17.3 percent, though the increase was 7.8 percent excluding "chapter administered professional appropriations." The latter is a bulky item which includes transfers to central budgetary institutions, a large share of which occurred earlier than usual this year. The Ministry of Finance expects that the general government deficit will continue to increase through the second quarter, but will then be very low in the second half of 2004.

3. Fiscal data have been revised:

- On April 5, after the staff report was prepared, the Ministry of Finance provided staff with revised estimates of the allocation within the 2004 budget, partly reflecting revised estimates of the 2003 fiscal outcome (see attached table). The latter revision incorporated information on local governments and the consolidation among different parts of the general government, which had previously been unavailable. While some numbers and ratios used in the tables and text of the staff report would be modified (see below), the analysis and conclusions of the staff report would not change in a substantive way. The revisions largely reflect adjustments to the consolidation of the fiscal data for 2003 across different parts of the general government, increasing both consolidated revenues and expenditures by about 1.2 percent of GDP, while changing the balance by only a very small amount (to 5.9 percent of GDP from the preliminary estimate of 6.0 percent mentioned in the staff report). The revised projections for 2004 show roughly unchanged total revenues and expenditures—and therefore an unchanged deficit—although the composition of these components differs from the budget projections in the staff report.

- Nevertheless, staff still sees risks to achieving the 2004 fiscal deficit target, consistent with those elaborated in the staff report.

Anti Money Laundering and Combating the Financing of Terrorism (AML/CFT)

4. The authorities updated staff on the status of AML/CFT legislation and its enforcement. In June 2003, the new AML Act came into force. Its key features include: (i) bringing rules for lawyers and public notaries fully in line with the second AML Directive of the European Union; and (ii) introducing re-identification and verification of identification

documents of existing customers of financial sector institutions. Other developments include an increase in the number of suspicion reports, and an increase in the number of staff of the Financial Intelligence Unit. Hungary was removed from the FATF monitoring list in June 2003.

Table. Hungary: Consolidated General Government, 2003-04
(ESA-95 Basis)

	2003 Revised	2004 Revised budget
(In percent of GDP)		
Total revenues	44.9	43.7
Current revenues and current grants	43.2	42.3
Tax revenues total	39.3	39.0
Taxes on income	9.3	9.0
Personal income tax	7.1	6.9
Corporate income tax	2.2	2.1
Social security contributions	12.6	12.4
Taxes on goods and services	15.9	15.6
of which : VAT	9.2	9.7
Other taxes	1.5	2.0
Current non tax revenues total	3.7	2.8
Of which : interest	0.2	0.3
Current grants	0.2	0.5
Capital revenues and capital grants	1.1	1.4
Capital revenues	0.9	0.8
Capital grants	0.2	0.5
Non-allocable revenues	0.6	0.0
Total expenditures	50.8	48.3
Current expenditures and current transfers	44.9	42.2
Goods and services	19.6	17.3
Of which : wages and salaries 1/	12.4	11.9
Transfers	21.2	20.5
Of which : to households	16.5	15.9
Interest payments	4.1	4.4
Capital expenditures and capital transfers	5.6	6.0
Capital expenditures	3.8	3.7
Capital transfers	1.8	2.3
Unallocable expenditures	0.3	0.2
Of which : General government reserves	0.0	0.2
General government balance	-5.9	-4.6
Net interest	-3.9	-4.1
Primary balance	-2.1	-0.5
Memorandum items:		
GDP, in current prices (forint billions)	18,574	20,380
Gross debt (in percent of GDP)	59.0	59.5

Source: Hungarian authorites.

1/ Including social security contributions.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

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International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Concludes 2004 Article IV Consultation with Hungary

On May 10, 2004, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Hungary.[1]

Background

Hungary's entry into the EU comes on the heels of impressive accomplishments. Its successes were based on the long-lasting effects of significant structural reforms and privatization during the 1990s, which also facilitated Hungary's outward orientation, foreign direct investment (FDI) inflows, strong export performance, flexible labor and product markets, and sound banking system. The success was also rooted in undertaking macroeconomic adjustment measures when needed, and in maintaining an adequate level of international competitiveness.

However, while growth held up well in recent years despite the global slowdown, significant macroeconomic imbalances have emerged. Reflecting huge increases in public sector and minimum wages, economy-wide real wages surged by some 14 percent in 2002 and grew by another 10 percent in 2003. Such rapid wage growth had adverse consequences for fiscal policy, inflation, and the current account. And, while real GDP growth stayed significantly positive (at 2.9 percent) in 2003, consumption was a leading factor—fueled by the large wage increases, and a sharp drop in household savings and rapid credit growth (partly reflecting an expanded housing subsidy scheme). The general government deficit in 2003, according to preliminary data, was 5.9 percent of GDP (ESA-95 basis), compared with an original target of 4.5 percent. In addition to the carryover effect of large public sector wage increases and its impact on pensions, the deficit outturn resulted from overruns in spending on health, housing

[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. 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.

subsidies, and interest payments. Core inflation has recently picked up and, in the face of rapid consumption demand, price growth in the services sector has been stubbornly high. Meanwhile, year-on-year headline inflation was above target at 5.7 percent in December 2003. Rapid consumption growth also spilled over into imports and the current account deficit, influenced additionally by the lagged effects of declining competitiveness in 2001-02, widened to 5.5 percent of GDP in 2003 (excluding reinvested earnings). This deficit was financed mainly by debt-creating inflows.

Over the course of the past year or so, the imbalances together with policy inconsistencies weakened policy credibility—contributing to volatility in financial markets. Several factors were at play: in the second half of 2003, the pursuit and announcement of a Ft 250–260 per euro target (within Hungary's ERM2-like exchange rate regime) when policies were inconsistent; conflicting statements by policymakers about the appropriate exchange rate level; and targets and estimates that went unfulfilled (including revisions to the 2003 fiscal deficit target and the mid-December estimate of the 2003 fiscal outcome). As markets became increasingly concerned about external and fiscal developments (and policy credibility generally), Hungary experienced significant bouts of volatility. Interest rates were increased to support the currency. The main short-term policy interest rate was increased by 300 basis points in November 2003 to 12.5 percent, bringing the total increase to 600 basis points since June.

Recent data have, however, included some bright spots that give rise to optimism on the prospects for economic growth. The significant deterioration in external competitiveness in 2001-02 was reversed in 2003. This reflected forint depreciation against the euro, and wage moderation, alongside steady improvements in productivity, in manufacturing. Industrial production and export growth began accelerating in the second half of 2003, while investment growth was also rising. In all, the fourth quarter saw year-on-year real GDP growth continuing to gather pace, reaching 3.5 percent.

The authorities announced a revised target for the general government deficit in 2004 of 4.6 percent of GDP, compared with an outturn of 5.9 percent in 2003. While the new target is larger than the original one of 3.8 percent, it reflected the slippages in 2003. With a view to enhancing transparency and credibility, the government decided on a revised but more realistic target, rather than risking another miss by a wide margin.

Executive Board Assessment

Executive Directors saw Hungary's entry into the EU as a fitting tribute to a successful transition to a market economy, based on more than a decade of far-reaching institutional and structural reforms. However, Directors were concerned about the emergence of large fiscal and current account deficits, as well as continued inflationary pressures, and saw important benefits to strengthening policy credibility.

Looking to the period immediately ahead, most Directors welcomed recent indications that growth prospects have improved. They observed that continued productivity growth and wage moderation would support further competitiveness gains. Overall, Directors felt that, with the right policies, Hungary is well poised to take advantage of a strengthening external environment to achieve more balanced economic growth. However, they stressed that a lasting improvement in economic prospects and a reduction in Hungary's vulnerability to exchange rate and interest rate volatility will require reining in the macroeconomic imbalances.

Directors called upon the authorities to move ahead forcefully in taking decisive and concrete actions in support of fiscal adjustment to improve the monetary-fiscal policy mix. Credible fiscal policy measures will help strengthen the external current account, lower risk premia, facilitate a reduction in interest rates, and limit vulnerability to shifts in market sentiment.

Directors generally considered that the fiscal adjustment envisaged by the authorities in 2004 is appropriately ambitious. However, Directors noted the risks of falling short of the 2004 deficit target, and cautioned that further fiscal corrections could be needed soon. They were encouraged by the authorities' intention to stand ready to introduce such corrections, and urged them to quickly identify specific contingent spending cutbacks.

Directors considered that more fundamental expenditure reforms are needed to ensure durable fiscal adjustment over the medium term. They noted that, given the high tax incidence, particularly on labor, and the need to leave room for spending pressures arising from public investment needs and EU accession, priority should be given to consolidating current expenditure. In this connection, Directors identified a number of areas in which reforms can achieve significant savings, also with a view to improving the efficiency and delivery of public services. These include rationalizing government employment, continuing pension reform, improving the targeting and structure of social benefits and subsidies, and reforms in education and health care. In a related vein, Directors recommended a further scaling back of the housing subsidy scheme and called for greater public sector wage restraint in the period ahead. In addition, as a way to enhance fiscal discipline, Directors encouraged the authorities to follow through on plans to introduce a rolling medium-term fiscal framework with expenditure ceilings, and to integrate it in the annual budget process.

Directors welcomed the authorities' focus on medium-term inflation objectives.
Several Directors noted that official interest rates remain high, and some saw room, after the cuts in official rates of the last few months, to reduce them somewhat further in light of the recent strength of the currency. Several other Directors, however, considered that the stance of monetary policy remains appropriate for the time being. Directors agreed that room for more significant cuts would be created once demonstrated fiscal adjustment is undertaken to firmly re-establish policy credibility.

Directors noted that in the face of inconsistent policies, the authorities' focus on keeping the exchange rate within a narrow range in 2003 had become problematic. In light of the large current account deficit, they welcomed the recent shift to greater exchange rate flexibility, which, they felt, will provide a welcome cushion against unanticipated shocks.

Directors noted that the overarching challenge in the medium term will be to adapt the policy framework to the requirements for adopting the euro. In this context, they underlined that there will need to be greater assurance that the necessary fiscal adjustment and disinflation will materialize before the authorities proceed to establish a definitive time frame for ERM2 entry and euro adoption. Directors added that, as ERM2 approaches, it will be important to avoid public communication that implies a rigid commitment to a particular exchange rate level or range, which could prompt another speculative attack.

Recalling that ERM2 will reduce monetary flexibility, Directors stressed that the authorities should ensure that they make full use of all policy tools for sustainable disinflation, including fiscal consolidation and wage moderation. To minimize exchange rate vulnerabilities, they also emphasized the importance of getting the central parity right. Several Directors also underscored the benefits that could derive from an incomes policy aimed at alleviating tensions between the inflation and current account objectives, adding that the government should take the lead on restraining wages.

Available information indicates that the Hungarian financial system is healthy and that the vulnerabilities that have arisen appear manageable. Directors noted that some of these reflect strong credit growth and increasing credit risk. Directors recommended that the authorities carefully monitor these vulnerabilities, with a view to taking timely corrective action if needed. Moreover, they emphasized the importance of ensuring an independent and accountable financial supervisory authority. Directors commended the authorities' effort to comply with international standards on Anti-Money Laundering/Combating The Financing of Terrorism, and encouraged the implementation of the new AML law.

Directors were encouraged by recent product market reforms. They welcomed plans to complete the final stage of privatization, as well as the increases in gas and electricity prices to cost recovery levels, which will eliminate implicit subsidies. As regards the labor market, Directors encouraged actions to help raise the current low labor participation rate.

Directors commended Hungary's commitment to transparency and standards, through its continued participation in Report on the Observance of Standards and Codes updates. While welcoming the further improvements made recently, Directors suggested that the authorities' considerable leeway to undertake government spending above budgeted levels without supplementary appropriations and parliamentary approval threatens fiscal discipline and needs to be rectified.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board. The Staff Report for the 2004 Article IV Consultation with Hungary is also available.

Hungary: Main Economic Indicators

	1999	2000	2001	2002	2003	2004 1/
Real economy (change in percent)						
Real GDP	4.2	5.2	3.8	3.3	2.9	3.2
CPI (average)	10.0	9.8	9.2	5.3	4.7	7.1
CPI (end-year)	11.2	10.1	6.8	4.8	5.7	6.5
Unemployment rate (percent)	7.0	6.4	5.7	5.8	5.9	6.2
Gross national saving (percent of GDP)	23.4	24.6	23.8	20.0	18.2	19.0
Gross domestic investment (percent of GDP)	28.5	30.9	27.1	24.0	23.9	24.2
General government (percent of GDP, ESA-95) 2/						
Balance	...	-3.0	-4.7	-9.4	-5.9	-4.6
Debt	61.0	55.4	53.4	57.1	59.1	59.5
Money and credit (end-year, percent change)						
M3	13.1	18.1	17.1	9.5	11.9	...
Credit to nongovernment	21.5	34.8	18.2	22.2	35.2	...
Interest rates (percent)						
T-bill (90-day, average) 3/	14.5	10.9	10.6	8.8	8.5	12.5
Government bond yield (five-year, average) 3/	11.8	9.1	8.5	7.7	6.5	9.6
Balance of payments						
Trade balance (percent of GDP)	-5.1	-6.3	-4.3	-3.3	-4.1	-4.0
Current account (percent of GDP)	-5.0	-6.2	-3.3	-4.1	-5.5	-5.3
Current account (percent of GDP), new methodology including reinvested earnings	-7.9	-8.7	-6.2	-7.2	-8.9	-8.6
Gross international reserves						
Billions of U.S. dollars	11.0	11.2	10.8	10.4	12.8	14.2
In months of imports of goods and services 4/	4.1	3.7	3.4	2.9	2.8	2.7
Net external debt (percent of GDP) 5/	22.5	25.4	23.4	26.4	29.4	...
Fund position (February 29, 2004)						
Quota (SDR millions)					1038.4	
Holdings of currency (in percent of quota)					58.8	
Holdings of SDRs (SDR millions)					...	
Exchange rate						
Exchange regime		Peg against euro with band +/- 15 percent				
Present exchange rate (March 23, 2004)			forint 204.48 = US$1			
Real effective rate, CPI basis (1990=100)	135.0	135.8	146.5	162.9	166.4	...

Sources: Data provided by authorities; *IFS*; and IMF Staff estimates.

1/ Projections, assuming the government achieves its fiscal deficit target for 2004.
2/ Consists of the central budget, social security funds, extra-budgetary funds, and local governments.
3/ Data for 2004 are the average of January–February.
4/ Data for 2004 are expressed in terms of imports in 2003.
5/ Including inter-company loans, and nonresident holdings of forint denominated assets.