

## **Hungary: Staff Report for the 2010 Article IV Consultation and Proposal for Post-Program Monitor**

The following documents have been released and are included in this package:

- The staff report, prepared by a staff team of the IMF, following discussions that ended on December 9, 2010, 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 January 11, 2011. 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 statement.
- A Public Information Notice (PIN).

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HUNGARY

**Staff Report for the 2010 Article IV Consultation and Proposal for Post-Program Monitoring**

Prepared by the Staff Representatives for the 2010 Consultation with Hungary

Approved by Anne-Marie Gulde-Wolf and Lorenzo Giorgianni

January 11, 2011

**Context:** Hungary was hit hard by the global financial crisis of 2008–09, reflecting large underlying vulnerabilities and a high degree of integration into global financial markets. Following a severe recession, an export-driven recovery is now underway, while domestic demand continues to lag. A new government, which took office in June 2010, let the IMF/EU-supported program lapse and has begun a fundamental redirection of policies towards increasing the state's role in the economy, stimulating growth and reversing structural fiscal adjustment.

**Challenges:** Even though some short-term crisis risks seem less pressing than before the crisis, underlying stock vulnerabilities remain large, notably Hungary's high level of public debt, the dependence of the financial system on external funding, and large-scale currency mismatches. This places a premium on policies that foster confidence by anchoring expectations. Raising the low potential growth rate requires wide-ranging structural reforms.

**Authorities' strategy:** The government's focus is to quickly stimulate the economy through income tax relief for households and corporations, enhanced family benefits, and targeted support to Small and Medium Sized Enterprises (SMEs). To reconcile these policies with the limited fiscal space provided by the EU's Stability and Growth Pact, the government is primarily resorting to temporary revenues measures targeted at largely foreign-owned sectors and dissolving the funded second pension pillar. The role of independent institutions in economic policy making and assessment (such as constitutional court, central bank, and fiscal council) is being curtailed.

**Staff's views:** Staff pointed out that the government's strategy is risky as it needs the otherwise costly tax cuts to trigger a strong response in economic activity, which may not materialize. By contrast, a credible medium-term fiscal adjustment program to safeguard fiscal sustainability could set off a virtuous cycle of lower risk spreads, reduced public and private financing costs, and, ultimately, higher growth. Specifically, staff advocated to focus on expenditure rationalization and structural reforms. It also urged to maintain a strong institutional framework, including for economic governance and financial supervision.

**Mission team:** Messrs. Rosenberg (head), Gottlieb, Wiegand, Mdms. Carare (all EUR), Seal (MCM), Messrs. Martin (FAD) and Saenz (SPR) met with Deputy Prime Minister Navracsics, Minister of the National Economy Matolcsy, Central Bank Governor Simor, Chairman of the Financial Supervisory Agency Szasz, senior officials of Ministries, the Central Bank, and other government agencies, banks, and think tanks. Ms. Ivaschenko (Resident Representative) assisted the mission and maintains regular contact to parliament, the business and diplomatic community, and civil society. Messrs. Kiekens and Abel (OED) participated in some of the mission's policy discussions.

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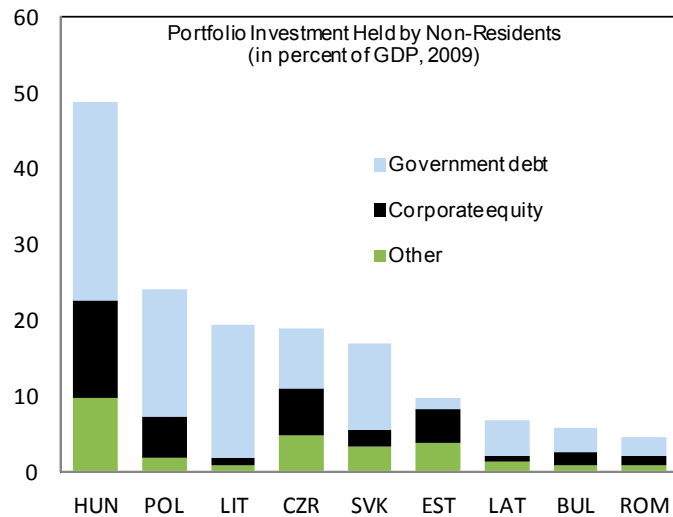
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## I. CONTEXT

1. **Hungary is emerging from a severe economic crisis.** The economy was immediately and profoundly affected by the global financial strains erupting in late 2008, reflecting high pre-crisis vulnerabilities<sup>1</sup> and close integration into global financial and goods markets.<sup>2</sup> Further, Hungary's growth performance was already sub-par before the crisis, given weak structural foundations. The combination of improved policies in the context of the IMF/EU-supported program (Box 1), availability of large and upfront official financing, and an easing of global financial conditions brought a stabilization from mid-2009. However, while Hungary escaped a financial meltdown, a sharp recession was not avoided: real GDP contracted by almost 7 percent in 2009 as exports fell sharply in the context of a global retrenchment in trade and domestic demand declined amid financial strains and limited policy space. Controlling for Hungary's trade openness and pre-existing vulnerabilities, however, the GDP decline was roughly in line with other countries in the region (Section II).



2. **The government formed in mid-2010 has taken a decidedly new direction in economic policies.** The elections in April 2010 saw the opposition party Fidesz win a two-thirds parliamentary majority, succeeding the technocratic government of Prime Minister Gordon Bajnai.<sup>3</sup> The new government led by Prime Minister Viktor Orbán let the IMF/EU-supported program lapse and has stated that it is not seeking a successor arrangement.

<sup>1</sup>These vulnerabilities were well-identified prior to the crisis, including in the 2008 Article IV Consultation (IMF Country Report No. 08/313). They included high public and external debt, a banking system dependent on external funding and with large on-balance sheet currency mismatches, and corporations and households indebted in foreign currencies that exposed the economy to swings in the exchange rate.

<sup>2</sup>For a detailed discussion of these transmission channels see Wiegand, 2011, "Hungary's Financial Crisis of 2008–09: Causes, Evolution, Lesson", International Monetary Fund Working Paper (IMF WP) forthcoming.

<sup>3</sup>This government took office in April 2009, following the resignation of Socialist (MSZP) Prime Minister Ferenc Gyurcsány. The Bajnai government relied on support of the MSZP and Free Democrat factions in parliament, but Bajnai and most ministers had no party affiliation.

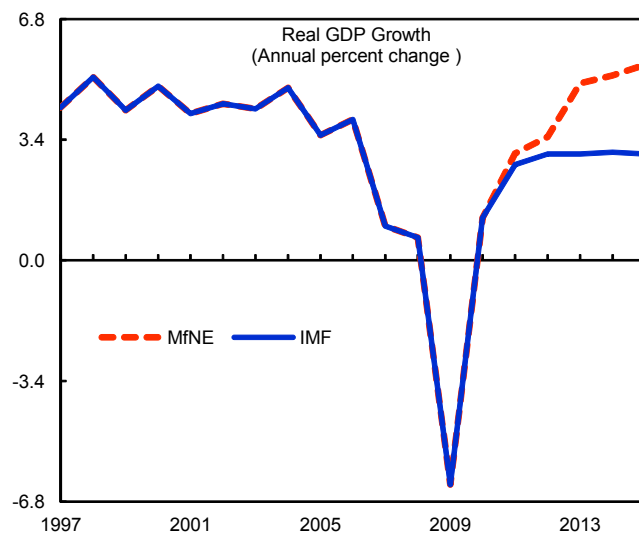
3. **The new government’s focus is to jump-start the economy.** With virtually all state institutions under its control and a sufficient parliamentary majority to change the constitution, the authorities see an historic opportunity for forceful policy actions, supported by an enhanced role of the state in the economy. Key pillars of this strategy are tax relief for households, enhanced family benefits (to increase low fertility rates), and targeted support to SMEs in sectors considered strategic (the so-called “New Széchenyi Plan”). In order to reconcile these policies with the limited fiscal space under the EU’s Stability and Growth Pact, the government is primarily resorting to temporary revenues measures targeted at sectors that had made large profits in recent years, as well as the de facto re-nationalization of the second pillar private pension system. Austerity measures that directly impact households’ disposable incomes are considered politically unacceptable. The efficiency of policy implementation is to be improved by reducing the role for institutions like the Constitutional Court or the Fiscal Council (Section III).

4. **Two years after the crisis outbreak, Hungary’s underlying stock vulnerabilities remain significant (Figure 1).** On the one hand, liquidity buffers in the financial sector and the external current account have improved, while the government’s cash position is strengthening, especially as it assumes a significant amount of private pension assets. On the other hand, high public and external debt (about 80 and 140 percent of GDP, respectively), low reserve coverage, large-scale currency mismatches, and the economy’s growing reliance on external funding (Section IV) have allowed vulnerabilities to persist, placing a premium on sustainable macroeconomic policies that anchor investor expectations.

## II. MACROECONOMIC OUTLOOK AND RISKS

5. **The recovery that began at end-2009 is expected to gain strength (Figure 2).** Exports have increased for six consecutive quarters and employment has been rising since February 2010. More recently, signs of a pick-up in private consumption have also emerged.

Going forward, tax cuts announced for 2011 are estimated to increase disposable income by about 5 percent, while solid demand in trading partner countries is projected to support export growth. As a result, staff expects real GDP growth to increase from around 1 percent in 2010 to about 2¾ percent in 2011. The current account, temporarily in surplus in 2010, will swing into deficit starting in 2012, as domestic demand and import growth strengthen. Average inflation is expected to be around 4 percent in 2011, reflecting higher commodity



Sources: IMF staff calculations; Ministry for National Economy; and Hungarian Statistical Office.

prices and a pass-through from tax increases.

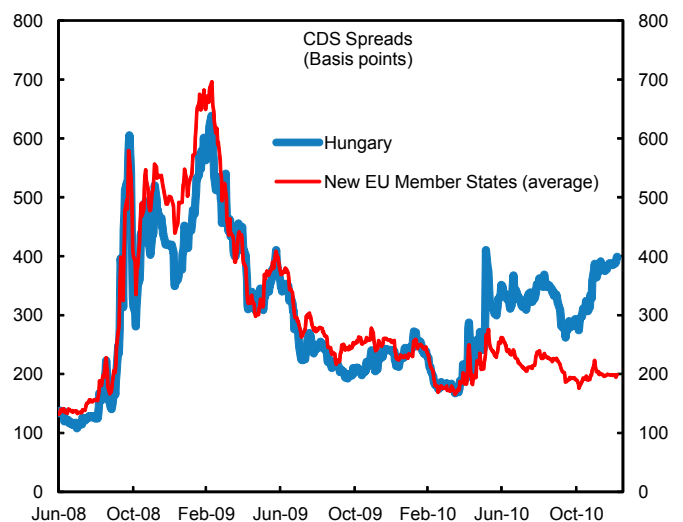
**6. Staff expects medium-term growth rates to remain below pre-crisis averages.**

Exports will continue to be an engine for growth, helped by some boost to export capacity from large FDI projects and the impact of the recent tax wedge reduction. More generally, competitiveness appears adequate, with CGER estimates suggesting the real exchange rate broadly in equilibrium—although qualitative indicators point to further scope for improvement through structural reforms (Box 2). The boost to disposable income from income tax cuts should persist through 2013, but the impact on consumption may be limited if the uncertain policy environment and high unemployment trigger further increases in precautionary savings. Overall, staff projects potential growth of 2–2½ percent over the medium term as recent policy initiatives may boost labor supply but discourage investment. Actual growth is projected to be roughly one percentage point higher than potential in 2012-15, gradually narrowing the large output gap. The authorities’ medium-term projections are considerably more optimistic, with actual output growth reaching 5½ percent in 2015, reflecting more favorable assumptions about labor participation (due to the income tax reform) and especially investment rates (Box 3).

**7. The uncertainty around staff’s central scenario is considerable.**

- **On the downside**, the global recovery may slow (thus affecting exports) and risk appetite may deteriorate. Given Hungary’s high external and public debt, a change in investor sentiment would compound financing risks. Domestic demand would suffer if the Swiss franc (CHF), whose value directly impacts households’ debt servicing costs, strengthens further. High policy uncertainty could lead to a more cautious behavior by households and investors than currently built into the baseline.
- **On the upside**, accommodative macro policies in advanced economies could spur global growth and induce stronger capital flows to emerging markets, which could compress Hungary’s borrowing spreads. In the long term, the effects of the recent policy package on employment and investment, if supplemented by structural reforms and improvements in the business climate, could turn out stronger than assumed in staff’s baseline. This, in addition to the expected short-term improvement in headline fiscal indicators, could reduce risk premia.

**8. A high degree of openness implies spillover risks both from and to Hungary.** Statements by Fidesz officials in June 2010, suggesting an imminent risk of government insolvency, upset regional markets and temporarily impacted the euro.



Sources: Bloomberg; and IMF staff estimates.

Negative outward spillovers may also occur, should markets become concerned that policies perceived as hostile to business (such as ad hoc taxes, reversals of pension reform) set precedents elsewhere. Meanwhile, clear evidence of contagion from market pressures in European peripherals is thus far limited. Hungary's risk premia have recently increased markedly, especially relative to regional peers (Figure 3), but this deterioration occurred amid sharp changes in the domestic policy environment. Over the last months, the three main rating agencies have downgraded Hungary to the lowest investment grade, with a negative outlook.

### III. POLICY DISCUSSIONS

9. **Discussions centered on the viability of the authorities' economic strategy, with staff advocating a more cautious approach that safeguards institutional integrity, fiscal sustainability, and financial stability.** While welcoming the focus on growth, staff pointed out that the government's strategy is risky as it relies on fiscally costly tax cuts triggering a strong response in economic activity which may not materialize. This risk is further compounded by recent steps undermining economic governance. Such an approach was particularly perilous given Hungary's significant vulnerabilities, which make anchoring long-term market expectations a key precondition for stability. Staff suggested phasing in economic stimulus measures gradually, in line with progress in fiscal consolidation. To the extent that such policies succeed in enhancing confidence in the sustainability of Hungary's policy framework, they would set in motion a virtuous cycle of lower risk spreads, reduced financing costs for the public and private sectors, and ultimately higher growth. Lower risks spreads would also reduce constraints on monetary policy.

#### A. Fiscal Policy

10. **Upon taking office, the government's first task was to contain slippages in the 2010 budget.** In mid-2010 it became clear that the budget's deficit target of 3.8 percent of GDP was unattainable due to spending overruns around the elections and revenue shortfalls. The authorities promptly adopted an emergency package that included a large special levy on financial institutions, as well as some spending cuts, but also reductions in the corporate income tax and the elimination of a number of small taxes. A second package, introduced in October to compensate for additional spending (mainly on state-owned enterprises and outlays related to floods), contained further levies on primarily foreign-owned retail chains, telecommunication and energy companies, as well as a 14-months diversion of second pillar private pension contributions to the budget. Taken together, the net deficit-reducing effect of these two rounds of measures amounted to 2 percent of GDP. Nevertheless, new revenue slippages emerged in December, putting into question the attainability of the deficit target (defined in ESA95 terms).

11. **The 2011 budget is centered on the introduction of a flat-rate personal income tax, reflecting the government's desire to quickly spur growth.** This reform, which will



be implemented over three years, envisages the unification and phased reduction of the marginal tax rate to 16 percent, as well as the introduction of more generous child allowances. The immediate revenue loss is estimated at 1¾ percent of GDP (and a further 1½ percent in 2012–13). The authorities explained that these tax cuts aim at improving competitiveness and spurring labor supply and investment, which—together with greater tax compliance—would eventually compensate for short-term revenue losses. Staff, while supportive of reducing the tax wedge, cautioned against overestimating Laffer-curve effects (Box 3) and argued for a more modest tax cut as envisaged in the 2009 tax reform.

**12. To compensate for these tax cuts, while still meeting the deficit target of 2.9 percent of GDP agreed with the EU, the budget relies primarily on temporary measures.** Key elements are a continuation of the temporary sectoral levies, the diversion of second pillar pension contributions (about 1.2 and 1.3 percent of GDP, respectively), and using assets transfers from the second pillar to fund spending (about 2 percent of GDP).<sup>4</sup> Incentives are such that virtually all contributors are expected return to the PAYG system in early 2011,<sup>5</sup> implying total one-off revenues of about 11 percent of GDP in 2011. The use of pension assets not needed to cover current expenditures will be ultimately determined by a new supervisory body, but at least half is expected to be used to reduce gross debt. Structural measures in the 2011 budget amount to about one percent of GDP, including some staff cuts (0.5 percent of total government employment), reduced bonuses and in-kind benefits, streamlined public works programs, and lower capital spending by local governments.

**13. While these measures are sufficient to meet the headline fiscal target, staff raised serious concerns about the structural fiscal position.** In staff's view, revenues in the 2011 budget are optimistic in light of the 2010 revenue performance (especially on VAT and CIT), which may signal a deterioration of the tax base. Excluding the pension asset transfer, the deficit would be close to 5 percent of GDP, i.e. higher than in 2010. The heavy reliance on temporary measures implies a substantial loosening of the underlying fiscal stance in 2010. In 2011, the further structural weakening due to tax cuts is only partly offset by the above-mentioned expenditure cuts and the now permanent redirection of pension contributions (text table). Staff also argued that the envisaged measures will partly be passed on to consumers, introduce distortions by discriminating between sectors, and—through higher risk premia—send negative signals about foreign investment, which is critical for Hungary.

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<sup>4</sup>Assets transfers are statistically treated as government revenue as long as second pillar contributors fully switch back to the government's pay-as-you-go (PAYG) system.

<sup>5</sup>Those who remain in the private pension system no longer accrue rights under the PAYG system while still subject to the employer social security contribution (24 percent of gross wage); those switching receive a tax holiday on gains from transferred assets; and returning to the PAYG system is the default option while remaining in the private system entails a cumbersome and time-bound application process.

Hungary: Main Fiscal Indicators  
(In percent of GDP, unless otherwise indicated)

	2008	2009	2010 Est.	2011 Proj.
General government balance	-3.7	-4.3	-4.0	5.7
General government balance (excl. transfer of pension assets)	-3.7	-4.4	-4.2	-5.1
Structural balance (in percent of potential GDP)	-4.0	-1.5	-3.0	-3.9
Primary structural balance (in percent of potential GDP)	0.2	2.8	0.8	-0.3
Change in the primary structural balance	1.1	2.6	-1.9	-1.1

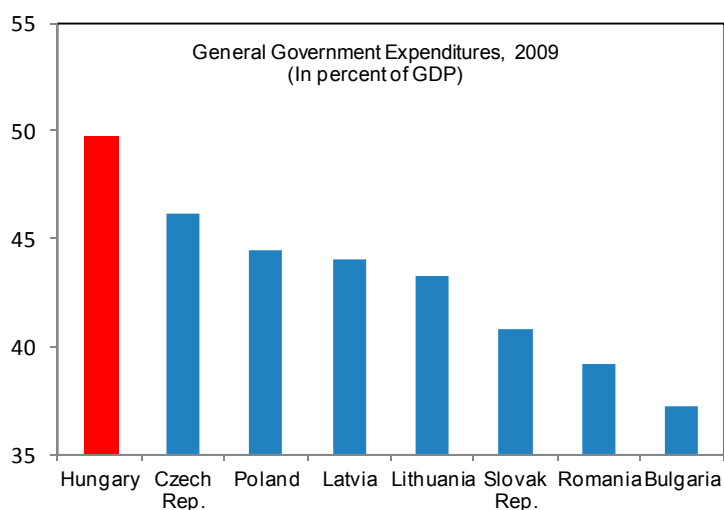
Sources: Hungarian authorities; and IMF staff estimates.

14. **To reverse the deterioration of the underlying fiscal stance, staff argued to focus on further rationalization of current primary spending and other structural reforms.** At about 50 percent of GDP, public expenditure is much larger than in comparable countries in the region. Staff, drawing on technical assistance advice, identified expenditure-reducing measures of about 4 percent of GDP, which would eliminate the 2011 structural deficit and set debt on a downward trajectory.

These include rationalizing the public wage bill and social benefits as well as restructuring public transportation companies.<sup>6</sup> A property tax could be an additional source of revenue.

Finally, staff urged progress in public finance management to avoid recurrence of spending slippages, as well as continued implementation of the tax administration's compliance strategy, and the merger of the customs and tax administrations.

Greater budget transparency could be



Sources: IMF Staff Calculations ; respective Finance Ministries

<sup>6</sup>State subsidies to the two main loss-makers, the railway group MAV and the Budapest public transport company BKV have fluctuated between  $\frac{3}{4}$  and 1 percent of GDP over the last 5 years. This reflects inefficient operation, steady losses, growing indebtedness, and government policy on ticket pricing. Transport State Owned Enterprises (SOEs) have frequently received additional state financial support through capital injections, asset sales, or debt assumptions. Malev airline is a recent addition to the state portfolio requiring financial support.

achieved by publishing contingent liabilities; the latter was particularly important in view of the greater prominence given to state guarantees in the New Széchenyi plan and the recently expanded role of the state development bank MFB.

Options for fiscal consolidation (Fiscal savings in percent of GDP)	
Total potential consolidation from proposed measures	4.0
Better targeting of social benefits 1/	1.8
Active labor market policies' rationalization 2/	0.3
Reduction of the public sector wage bill 3/	1.0
Rationalization of state-owned transport enterprises to eliminate losses 4/	1.0

Source: IMF staff estimates, based on Hungarian authorities data.

1/ Decreasing the generosity of benefits, introducing means-testing to universal transfers (such as child allowances), eliminating untargeted price subsidies, consolidating the design and administration of social benefits at the central and local levels.

2/ Reduce generosity and coverage of public works programs should. Narrow the scope of active labor market policies on groups most disadvantaged in the labor market.

3/ Reduce employment (rather than wages, which appear low relative to the private sector) through attrition; consolidate local governments to achieve better economies of scale.

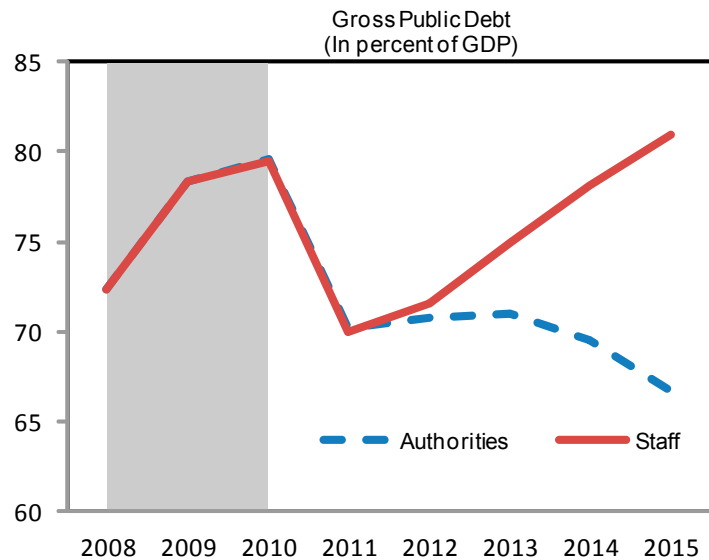
4/ Refers to the operational annual losses of MAV, BKV and MALEV.

15. **The authorities agreed with some measures proposed by staff, but were reluctant to commit to concrete steps at this stage.** They noted that a medium-term reform plan, to be announced in February, may yield up to 2½ percent of GDP in savings. In addition to administrative reforms (in local governments) and recent changes to public finance management (introduction of budget inspectors), the authorities envisage inter alia steps to restructure state-owned enterprises and a permanent (but smaller) bank levy. They agreed, however, that implementing structural reforms will take time and that budgetary implications are uncertain. In general, they expressed a preference for measures on the revenue side that spare households.

16. **Staff also raised a number of concerns about the envisaged pension reform.** First, despite the initial debt reduction, the reform puts into question fiscal sustainability, particularly if—as in the 2011 budget—assets moved to the PAYG system are used for current spending. Second, it reduces transparency and increases fiscal risks (Box 4). Third, by heavily biasing the terms in favor of switching to the PAYG system, it raises concerns about business environment and property rights. Fourth, the implied erosion of liquidity in domestic bond and equity markets could negatively impact the depth of the capital market, one of Hungary's strengths in the region. The authorities, while acknowledging some of these drawbacks, were optimistic regarding the viability of the now expanded PAYG system, pointing to measures such as the tax reforms aimed at increasing employment and fertility rates. Further, the authorities argued that pensions were in safer hands with the state than with private pension funds, which had performed poorly. Staff countered that low returns could be better addressed by improved regulation.

17. **Views on the medium-term fiscal outlook differed significantly.** The authorities said that they were aiming at the medium-term objectives spelled out in Hungary's last

Convergence Programme, which envisage a headline fiscal deficit of below 2 percent of GDP in 2014 and public debt rapidly declining towards 60 percent. Staff pointed out that with the phasing out of temporary measures coinciding with further tax cuts in 2012–13,<sup>7</sup> fiscal sustainability was not ensured under present policies, as deficit and debt levels will bounce back sharply after 2013, especially assuming staff’s more cautious macroeconomic framework. Staff’s public debt sustainability analysis shows that the debt level is particularly sensitive to growth and real exchange rate shocks (Appendix).



Sources: IMF staff calculations and Hungarian authorities

18. **Staff urged the authorities to frontload durable expenditure measures and to postpone personal and corporate tax cuts planned for 2012–13 until fiscal space emerges.** Such an approach was less risky than the authorities’ strategy, especially given the large required cumulative adjustment (5–5½ percent of GDP in 2013–14 to achieve the authorities own targets) and elections scheduled in 2014. In response, the authorities pointed to a relatively benign fiscal outlook under their more optimistic GDP growth assumptions and possible gains from the consolidation measures to be announced in February. If necessary, sectoral levies could be kept in place until the recovery fully took hold.

## B. Financial Sector Policies

19. **Hungary’s banking system has displayed resilience throughout the downturn.** The sector entered the financial crisis with a solid aggregate capital position (10.2 capital adequacy ratio in Q3 2008) but relatively thin liquidity buffers (Table 10), which left some banks exposed to funding pressures in late 2008. Subsequently, liquidity positions have improved significantly. Furthermore, retained profits and capital injections by some parent banks increased the aggregate capital cushion to more than 13 percent by end- September 2010. Nonetheless, lending to the private sector contracted by almost 5 percent in 2009 and continued to stagnate in the first nine months of 2010, with mortgage lending falling particularly sharply. Pre-tax profitability has recently dropped amid an increase in non-performing loans to 9.3 percent at end-September 2010, with problem loans

<sup>7</sup>Once fully phased in, the PIT reform will cost more than 3 percent of GDP a year from 2013 onward. In addition, a reduction of the standard CIT rate from 19 to 10 percent in 2013 has already been put into law, at an annual cost of 0.5 percent of GDP.

concentrated in unsecured consumer lending and commercial real estate. Moreover, capital and profitability are unevenly distributed across banks, with a particularly strong position at the main bank without a foreign parent.

Hungary: Key Financial Soundness Indicators  
(end of period)

	2007	2008	2009	End-Sept 2010
Regulatory Capital to Risk-Weighted Assets	10.4	11.2	13.1	13.2
Liquid Assets to Total Assets	16.4	15.6	22.7	22.1
Return on Equity (After-Tax)	18.4	11.6	9.4	4.4

Source: Central Bank of Hungary

20. **While it was agreed that banks appear well placed to withstand challenges going forward, staff noted that recent financial developments and policy initiatives increase risks and may constrain credit supply (Figure 4).**

- Under the baseline scenario, *non-performing loans* are expected to peak around 12 percent in 2011, with most banks able to finance additional provisions from income or capital cushions. A key risk is the recent weakness of the forint against the Swiss Franc (CHF), as about 60 percent of mortgages are denominated in CHF. Stress tests conducted by the Central Bank (MNB) suggest that the capital positions of most banks could absorb even a sharp additional forint depreciation. However, in such a scenario banks may restrain credit supply to preserve capital, and higher debt servicing costs could further dampen households' demand for credit. Moreover, with the supply of mortgage lending stagnating, a further drop in housing prices—which have already dropped by 10 percent—could reinforce pressure on household balance sheets (Figure 5).
- The *financial sector levy* introduced in July 2010 is large at 0.7 percent of GDP annually<sup>8</sup> (more than three times higher than the largest such tax elsewhere), disproportionately affects foreign-owned banks, and, for less profitable banks, amounts to a de-facto expropriation of capital. The size of the levy across institutions has been fixed for 2010–11, but remains undefined for 2012 and beyond. The risk is that uncertainty about the future design of the levy may lead banks to reduce their balance sheet over time. Staff urged the authorities to pre-commit to sharply reducing the levy after 2011 and aligning its design and size with emerging EU standards.

<sup>8</sup> Of the total annual revenue of HUF 186 billion, about 70 percent will come from banks and the remainder will be from insurance firms and other financial intermediaries. The CIT and a recently introduced special profit tax can be credited against the levy.

- *A moratorium on mortgage foreclosures* has been extended until end-April 2011. Staff suggested its elimination, as it prevents banks from managing their mortgage portfolios effectively and risks undermining credit discipline.
- Banks seem generally prepared to meet the forthcoming higher *Basel III capital and liquidity standards*, although detailed analyses have yet to be carried out.

21. **Staff generally welcomed the government’s plans—still in the concept phase—to help certain homeowners unable to pay their mortgages**, notably efforts to target support to the most vulnerable while limiting moral hazard and risks to the budget (Box 5). Other support measures for mortgage borrowers include provisions to prevent unilateral changes to contracts and arbitrary fees and penalties, as well as the imposition of the mid-exchange rate for the repayment of foreign exchange loans.

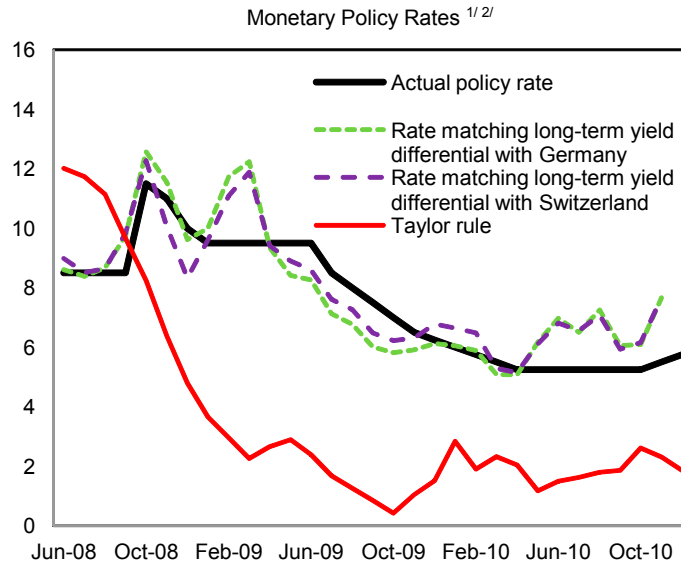
22. **The authorities and staff concurred that important yet still incomplete progress has been made in financial supervision, but disagreed on the need for a cooperative institutional framework.** Staff welcomed a recently proposed legislation to grant the Hungarian Supervisory Authority (HFSA) the authority to issue binding decrees on a range of topics, although this power should be widened further. Meanwhile, despite staff’s urging to the contrary, a new law removes the right of the Financial Stability Council (FSC) consisting of MNB, HFSA and government to propose regulation or legislation on a “comply or explain” basis, i.e., the government needs to indicate approval or explain its disagreement within 15 days. Further, the FSC will in future only meet quarterly and its minutes will no longer be published. Staff expressed concern that this change weakens an important element in the financial supervisory architecture and is part of a broader pattern of a lack of cooperation between the government and MNB that risks compromising the central bank’s ability to safeguard financial stability.

23. **Staff noted that progress on some outstanding financial sector reforms would be desirable.** A legislative proposal submitted to parliament earlier this year to strengthen the bank resolution regime has made little progress. Similarly, efforts to develop longer term funding instruments, notably by strengthening the mortgage bond market, had to be suspended.

### C. Monetary and Exchange Rate Policies

24. **Throughout the crisis, monetary policy has been constrained by the need to avoid a disorderly exchange rate depreciation.** Forint weakening feeds not only into inflation through import prices, but can also destabilize the financial sector given considerable household and corporate indebtedness in foreign exchange. In October 2008, the MNB hiked interest rates by 300 basis points to avoid excessive currency depreciation in the context of a sharp decrease in global risk appetite. Since then, the evolution of Hungary’s risk premium has been a key determinant of monetary policy, allowing the MNB to ease in a sustained way only from the second half of 2009, despite the emergence a large output gap

and generally contained inflationary pressures. The cutting cycle ended in May 2010 amid resurgence in financial strains and a more uncertain inflation outlook. These factors accelerated in the third quarter and in November and December, the MNB hiked policy rates from 5¼ to 5¾ percent (Figure 6).



Sources: MNB; and staff calculations.

1/ The matching rates are computed as: *Implied Hungarian policy rate = foreign policy rate + long-term spread* where the long-term spread is the difference in yield between Hungarian and German/Swiss 5-year government bonds (in domestic currency).  
 2/ The Taylor rate is computed with a weight of 1/2 on both the output gap and inflation, with inflation expectations proxied by actual inflation.

25. **Looking forward, the MNB argued that inflation concerns may require a proactive policy stance.** It noted that tax increases, an unfreezing of administered energy prices, and rising food prices would increase headline inflation above target in both 2010 and 2011, under unchanged policies. Moreover, inflation expectations may not be fully anchored, given Hungary's history of overshooting the central inflation target (Box 6). Thus, if domestic demand recovers as expected, Hungary may witness higher wage inflation and second-round effects from food price hikes. Staff acknowledged that inflation expectations may not be fully anchored but suggested caution when tightening on inflation grounds alone, in view of still low core inflation (1.9 percent in November) and the large output gap. However, staff also noted that Hungary's risk premium remains elevated and volatile, putting constraints on the monetary stance. More generally, staff and MNB agreed that a clear shift toward a sustainable medium term fiscal framework would help reduce risk premia and facilitate a more accommodative monetary stance in the context of Hungary's inflation targeting framework, which remains adequate.

#### D. Economic Governance

26. **The authorities have recently initiated important institutional changes that affect economic governance:**

- A constitutional change limits the powers of the *Constitutional Court* in assessing fiscal and pension matters.
- The *Fiscal Council* is being replaced by a consultative body consisting of the chairman of the State Audit Office, the MNB governor, and a presidential appointee, without support staff. Unlike the present Council, which immediately assessed the macroeconomic and fiscal impact of all government initiatives, the new body's role will be limited to commenting on the draft budget once a year.
- A draft change to the MNB law allows parliament to appoint all 4 external members of the 7-member *Monetary Policy Council*—instead of the current rule where the MNB governor and the Prime Minister nominate two members each. The government has publicly criticized the present Council's policy stance as too restrictive, raising expectations about a change in monetary policy once the new members are appointed in March 2011.

27. **Staff argued that such actions, besides removing important checks and balances, undermine policy credibility and could translate into yet higher borrowing spreads.** The authorities said that the recent changes were aimed at improving the efficiency of economic policy making. They also pointed out that the new institutional framework will not be weaker than in many other EU countries and the functions of the Fiscal Council's staff could be performed more efficiently by existing institutions like the MNB or the State Audit Office.

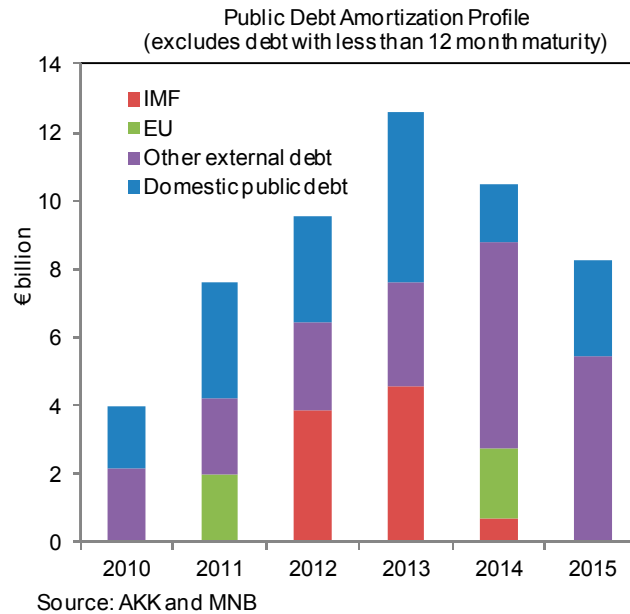
#### IV. CAPACITY TO REPAY THE FUND

28. **Hungary's capacity to repay the Fund remains adequate, although modest international reserves and a challenging sovereign amortization schedule pose risks.**

External debt is broadly sustainable, albeit particularly sensitive to real depreciation shocks (Appendix). Hungary's exposure to the IMF is currently €8.7 billion (9 percent of GDP and 26 percent of gross international reserves) (Table 11). The bulk of repayment is scheduled for 2012 and 2013. In addition, repayments to the EU in excess of 3.5 percent of GDP are falling due in 2011 and 2014. Further to the current modest reserve coverage, the baseline envisages slow deleveraging by foreign banks and moderate net corporate financing. As a result, repayments will need to be at least partly financed through the net issuance of long-term debt from 2013, just when staff sees a risk of public debt dynamics reversing. Thus investor demand cannot be taken for granted—especially since, in the wake of sovereign distress in peripheral Europe, attention will continue to be focused on highly indebted countries. A possible mitigating factor is the planned transfer of private pension assets to the



budget, the foreign portion of which (about €3 billion) could be used to increase reserves and repay the Fund.



29. **In accordance with Fund policy, the Managing Director recommends the initiation of Post-Program Monitoring (PPM).** Outstanding Fund credit to Hungary exceeds the 200 percent of quota threshold for PPM (it is expected to remain above this threshold until August 2013 under the repurchase schedule), and there are no exceptional circumstances that would indicate that PPM is not warranted. A Fund mission is expected to visit Hungary in the spring to hold PPM discussions with the authorities. The first PPM Board discussion is envisaged in mid-2011, concurrent with Board consideration of the Ex-post Program Evaluation.

## V. STAFF APPRAISAL

30. **Hungary was hit hard by the global crisis, given large underlying vulnerabilities and considerable integration in international markets.** A tightening of monetary and fiscal policies in the context of substantial IMF and EU assistance helped avoid a financial meltdown. A deep recession could not be avoided but the economy has now begun to rebound. The recovery is nonetheless fragile and vulnerabilities persist. In this environment, risk premia remain elevated and volatile.

31. **Going forward, the challenge is to reduce uncertainty and improve the quality of policies.** Given the public and private sectors' dependence on external financing, maintaining investor confidence is critical and requires sound policies in the context of a coherent medium-term macroeconomic framework. This could set off a virtuous cycle of lower risk spreads, reduced public and private financing costs, and, ultimately, higher growth.

32. **The government that took office in mid-2010 is using its considerable political mandate to fundamentally reorient fiscal and financial sector policies.** The new authorities have embarked on tax cuts and targeted support to small and medium-sized enterprises, aimed at jumpstarting growth. As a result, much of the structural fiscal adjustment achieved in the past two years is being unwound and replaced by temporary revenue measures. Institutional changes reduce the capacity of the Fiscal Council, Constitutional Court, and MNB to provide independent economic analysis and governance.

33. **The authorities' fiscal strategy has positive aspects but for the most part increases risks.** Steps towards reducing the tax wedge on labor are welcome, as is the focus on SMEs, and the desire to achieve these goals while meeting the headline fiscal deficit targets agreed with the EU. However, the strategy's success relies heavily on high GDP growth which may not materialize. Moreover, temporary revenue measures increase uncertainty and are distortive. Once they expire in 2013, debt ratios are likely to rise again and—under unchanged policies—threaten fiscal sustainability. The dissolution of the second pillar of the pension system allows the government to improve headline fiscal indicators without undertaking structural fiscal adjustment, and—by replacing current obligations with unrecorded future liabilities—reduces fiscal transparency. Overall, the deterioration in the quality, extent, and permanence of fiscal adjustment amid large vulnerabilities increases risks to the Hungarian economy.

34. **To achieve sustainable fiscal adjustment, a focus on durable expenditure rationalization is needed.** There is room to further rationalize current primary spending, including poorly targeted social benefits and price subsidies. Restructuring of public transportation companies and administrative reforms could also generate substantial savings and efficiency gains. Revenues could be enhanced by improved tax administration and a property tax. Such structural measures should be tackled quickly, thus freeing up fiscal space for growth-enhancing tax reforms.

35. **The financial sector has remained resilient, but important risks remain and require a strong supervisory framework.** Sector-wide liquidity and capitalization are adequate, but profitability has fallen amid rising non-performing loans. Looking forward, a strong Swiss Franc may further impair banks' mortgage portfolios while the outsized financial sector levy will likely erode capital cushions. Such risks threaten to stall the resumption of credit growth. Efforts to help distressed mortgage holders are welcome, as long as moral hazard and fiscal cost are contained. Regarding financial supervision, the government has appropriately given the HFSA the right to issue binding decrees. However, the weakening of the Financial Stability Council erodes its capacity to safeguard financial stability and contain systemic risks.

36. **The MNB's cautious monetary policy stance remains appropriate, balancing persistently high risk premia with ongoing slack in the economy.** The forint's vulnerability to changes in investor appetite will likely remain a constraint on monetary

policy, given significant economy-wide currency mismatches. Tax hikes and global supply shocks have renewed upward pressure on headline inflation, but the large output gap has helped to keep underlying price inertia in check thus far. A clear shift toward a sustainable fiscal framework would help reduce risk premia and facilitate a more accommodative monetary stance, provided underlying inflation remains muted.

37. **Steps that undermine economic governance add to policy uncertainty.** Besides removing important checks and balances, this may undermine Hungary's credibility with investors and contribute to a further widening of risk premia compared to regional peers.

38. **It is recommended that the next Article IV Consultation with Hungary will be held on the 12-month cycle.**

### Box 1. The IMF/EU Supported Program

The IMF's Executive Board approved a Stand-By Arrangement on November 6, 2008, with a total amount of SDR 10½ billion (about €12½ billion at the time). It was complemented by EU financial assistance of €6½ billion. Five program reviews were completed on schedule and SDR 7½ billion (€8.7 billion) was disbursed (plus €5½ billion from the EU), before the new government decided in mid-2010 not to seek completion of the remaining reviews before the program's expiration on October 5. Policies under the program were largely in line with the recommendations made at the time of the 2008 Article IV consultation—notably in the fiscal area—and included:

- **Structural fiscal adjustment:** the primary structural balance improved by about 4 percent of GDP over 2008–09, notwithstanding some loosening of the headline deficit target in 2009 to avoid exacerbating the economic contraction. Most adjustment reflected spending reforms. When added to the 5 percent of GDP adjustment in 2007, Hungary's structural fiscal improvement ranked among the largest in emerging Europe in recent decades.
- **Financial supervision:** on-site bank inspections were intensified. Moreover, in 2009 a tri-partite Financial Stability Council (FSC) was established with participation of the Hungarian Financial Supervisory Agency (HFSA), the Central Bank (MNB) and the Ministry of Finance, with a view to better integrate micro- and macro-prudential aspects of supervision. The FSC and separately the MNB were granted the right to initiate legislative and regulatory action.

Moreover, steps were taken in late 2008 and early 2009 to stabilize market conditions. Not all measures were covered by program conditionality, but they often implied the use of funds from the IMF/EU package.

- **Government bond market:** following a sharp sell-off by non-residents (€3.5 billion Q4 2008) and several failed auctions, the government debt management agency (AKK) suspended issuance in October 2008 for several months and re-purchased significant amounts of debt. While the AKK drew down IMF/EU funds deposited at the MNB to finance these operations, the MNB sterilized the impact on the money supply by issuing central bank bills. Thus, government bonds held by non-residents were largely replaced by MNB bills held by domestic banks to assure the continued financing of Hungary's public sector.
- **External funding of domestic banks:** in March 2009, the government extended foreign exchange (FX) loans of €2½ billion to three banks without a foreign parent to compensate for the loss in external wholesale funding. By contrast, foreign parent banks greatly stepped up funding of their Hungarian subsidiaries during the crisis, and confirmed their commitment to maintain exposure in the context of the European Bank Coordination Initiative.
- **Foreign exchange swap market:** following severe disruptions in the foreign exchange swap market that banks use to hedge their open foreign exchange positions, the central bank introduced an overnight FX swap facility in October 2008, and 3- and 6-month foreign exchange swap facilities in March 2009. Conditions normalized in the second quarter of 2009.
- **Foreign exchange spot market:** in early 2009, the MNB intervened to prevent a disorderly forint depreciation that would have harmed foreign exchange-indebted households and corporations. However, the MNB relied primarily on interest rate policy to maintain orderly financial conditions, including a hike by 300 bps at the crisis' onset.

## Box 2. External Competitiveness Indicators of the Hungarian Economy

### Based on CGER methodologies, Hungary's real exchange rate remains broadly in equilibrium

As growth collapsed during the global recession, so did Hungary's imports and payments for factor services, thereby allowing for an adjustment in the current account of 8.6 percentage points of GDP to a surplus of 1.2 percent of GDP in 2010. For 2015, after a projected 6.9 percent appreciation in REER, the current account balance is expected to decrease to -2.9 percent of GDP, still above the current account

norm of -3.3 percent of GDP. As a result, real exchange rate undervaluation is estimated at 2 percent, based on the macro-balance and external stability methodologies. The Equilibrium Exchange Rate methodology, on the other hand, points to a 6 percent overvaluation, as its equilibrium rate estimates are more in line with the much lower real exchange rate observed in earlier years. Hungary maintains a de facto 'floating' exchange rate regime which is free of exchange restrictions and multiple currency practices.

Estimates of Overvaluation	
Reference period	Oct-2010
<b>Methodology</b>	
Macrobalance	-2
External sustainability	-2
Equilibrium exchange rate	6
<b>Average</b>	<b>1</b>

**The authorities consider the current real exchange rate level appropriate.** They noted that Hungary's high technological content in exports should allow it to remain competitive and that the real exchange rate had evolved broadly in line with regional peers. Over the medium term, a gradual and modest real appreciation was expected, consistent with income convergence.

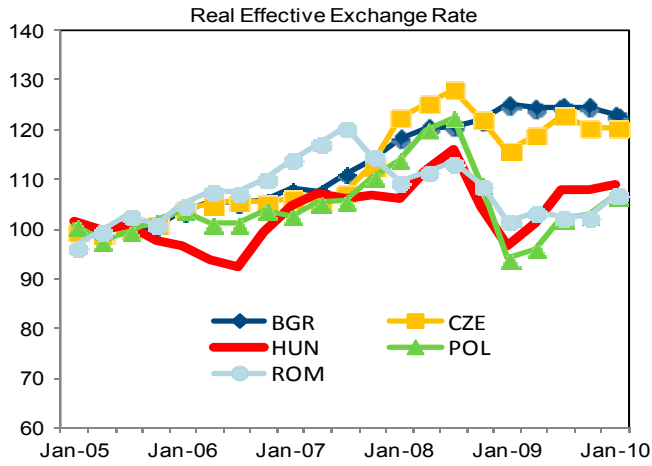
### Broader indicators suggest that structural reforms are key to maintaining competitiveness.

Hungary's export share in world exports is quickly recovering after feeling the impact from the global crisis.<sup>9</sup> The Doing Business 2011 Report notes that Hungary improved its business environment on the back of reforms implemented in 2008–09, including simplified taxes and tax bases, amendments to the bankruptcy law, and improving conditions for acquiring construction permits and registering property. Nevertheless, Hungary still lags behind its peers in terms of the quality of institutions, infrastructure and macro environment (Global Competitiveness Report 2010–11),<sup>10</sup> highlighting the importance of additional structural reforms.

<sup>9</sup>See World Bank (2010): "Doing Business 2011".

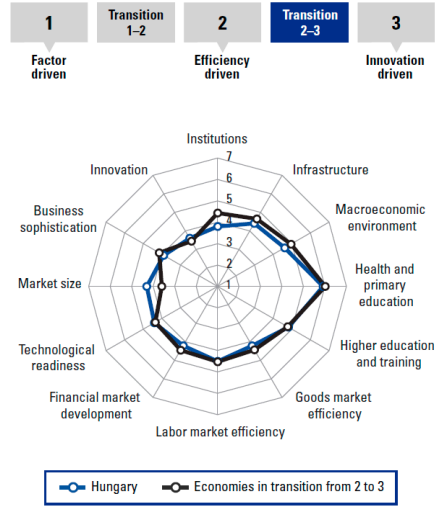
<sup>10</sup>See World Economic Forum (2010): "Global Competitiveness Report 2010–11".

### Box 2. External Competitiveness Indicators of the Hungarian Economy (continued)



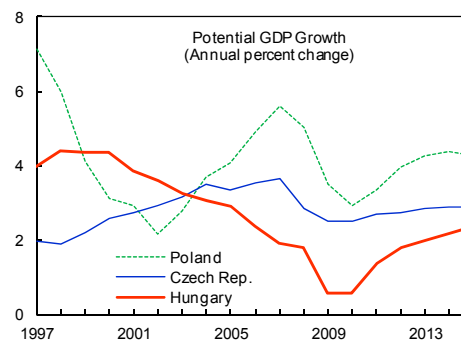
Source: IMF.

#### Stage of development



### Box 3. The Authorities' Policy Package and GDP Growth

**Potential growth declined in Hungary since mid-2000, while it accelerated in the other CE3 countries due to markedly different underlying trends in investment and employment growth.** As an early reformer, Hungary benefited from strong productivity and capital stock growth in the pre-2000 period. Then, despite a temporary uptick in FDI inflows around EU accession in 2004, investment growth declined. Moreover, social benefits and the labor tax wedge increased from the early 2000s, contributing to lackluster employment growth.<sup>11</sup> In contrast, regional peers attracted more FDI inflows, benefitted from lower funding spreads, and increased work incentives.



Sources: IMF staff calculations, based on data from National Statistical Offices; MNB; and OECD, etc.

**In the medium-term, potential growth is expected to recover ground lost in the crisis, but again remain below regional peers.**

- On *capital*, a modest increase in capital stock growth is expected post-crisis, with the recent FDI inflows projected to increase manufacturing capacity. However, markets are now differentiating against countries with high vulnerabilities and perceived weak policies more than pre-crisis. Policy uncertainty and growth reforms achieved at the cost of fiscal adjustment are already resulting in higher risk premia and an increased cost of capital. The investment climate will also be affected by the selective taxation of specific sectors.
- On *employment*, labor supply is expected to increase on the back of reforms implemented during the IMF/EU-supported program and the introduction of a reduced-rate flat PIT, albeit modestly. The latter is in line with empirical evidence from Russia and elsewhere (Ivannova and others, 2005,<sup>12</sup> and Keen and others, 2006).<sup>13</sup> The flat PIT reform mainly benefits high income earners who will also benefit from a generous increase in family allowances. Therefore, the substitution effect of lower marginal rates may be offset by the income effect of lower average taxes, leading to an ambiguous effect on labor supply for high income earners. Meanwhile, low income earners will see no change in their marginal tax rate and an increase in their average tax burden (mostly if they have no children).<sup>14</sup> Experience in Slovakia (Moore, 2005)<sup>15</sup> and Germany suggests that labor supply effects can be increased by simultaneously implementing well-designed benefit reform.

<sup>11</sup> See Carare, Alina (2011): "Estimating Potential Growth in Hungary", IMF WP (forthcoming).

<sup>12</sup> See IMF WP 05/16.

<sup>13</sup> See IMF WP 06/218.

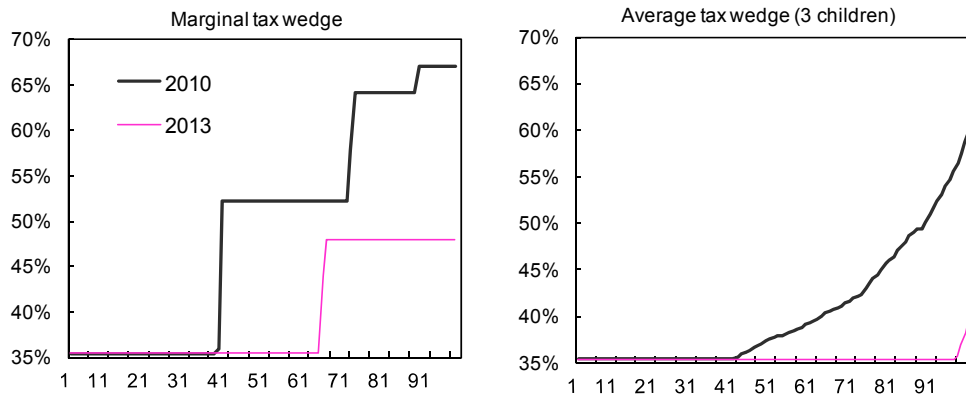
<sup>14</sup> Other announced measures, like restructuring the public works program, social security contribution reductions for part-time employment of women, or simplified employment rules for occasional employment may contribute to positive employment effects of the new flat tax system at the low end of income distribution (Norregaard and Khan, IMF WP 07/274).

<sup>15</sup> See IMF WP 05/133.

### Box 3. The Authorities' Policy Package and GDP Growth (continued)

**Staff forecast actual growth of 3–3½ in the medium term is markedly below the authorities' latest projections.** Actual GDP projections are above potential growth (2–2½ percent), allowing a large output gap (over 6 percent in 2010) to gradually close beyond 2015. By contrast, the authorities are now projecting considerably higher actual growth over the medium term (5½ percent). They assume actual employment growth of 3 percent versus staff's 1 percent per year from 2012, based on larger effects from the PIT reform. And they do not expect negative effects from their policy package on investment, with growth rates of up to 12 percent in the medium-term, versus staff's more moderate rates of 4 percent. The authorities view the effects of their package as mostly cyclical, however, as their estimates of medium-term potential growth (3–3½ percent) are only somewhat higher than their previous forecast. Staff's more cautious views on the potential and actual growth are broadly shared by the MNB, the European Commission and private analysts.

Hungary - The effect of the 2011 tax reform on tax wedges across gross wage percentiles 1/



Source: Ministry for National Economy

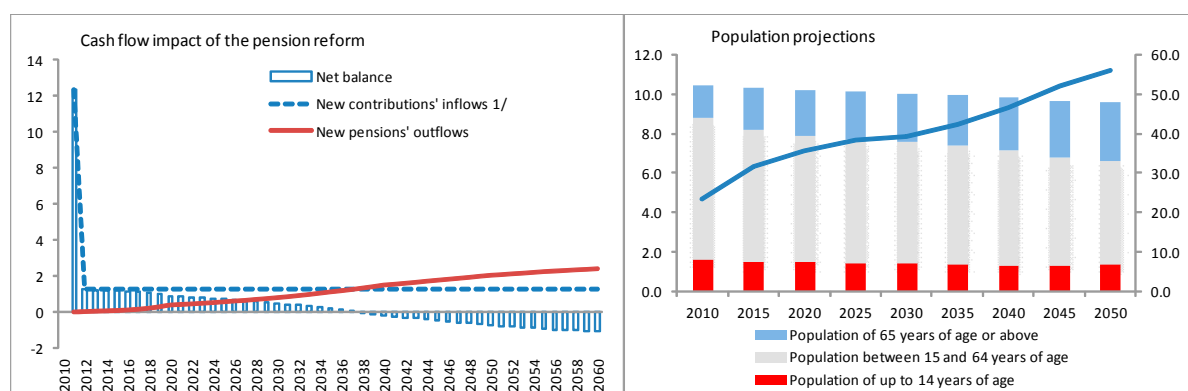
1/ Income tax on gross wages plus employee's and employer's social security contributions as a percentage of the total labor cost per employee.



### Box 4. Fiscal Implications of the Pension Reform

The changes in the pension system add to already existing uncertainties regarding the long-term strength of public finances:

- **Additional expenditure pressures**, given the transitory improvement in the fiscal balance and the apparent creation of fiscal space. First, workers shifting from the private defined-contribution (pillar 2) system to the government's defined-benefits system (pillar 1) provide immediately a stream of pension contributions, while corresponding pension benefit payments increase only as these workers retire (left chart). Second, the transfer of pension assets from 1<sup>st</sup> to 2<sup>nd</sup> pillar is recorded as revenue under ESA95 accounting rules, thus creating additional room for expenditures while still meeting headline fiscal targets. Finally, to the extent that the government's financial debt is reduced, the interest bill declines and provides further fiscal space.
- **Heightened need to introduce reforms to make pillar 1 sustainable**. Although Hungary's defined-benefit pension system compares favorably within Europe, the reform compounds on a preexisting pension sustainability problem. The government's own estimates of pillar 1 sustainability, including the impact of the reform and using optimistic assumptions about labor market participation, indicates a negative net present value of the discounted contributions and pension benefits to 2060 of about 10 percent of GDP. Sustainability could be further undermined if pension parameters (retirement age, promised pension payout, indexation formula) were made more generous.
- **Additional pension risk assumed by the government**. All risks related to ensuring a commensurate pension to retirees have now been shifted to the government, including from adverse trends in labor markets, economic growth, or population dynamics (right chart).
- **Reduced transparency**. The reform improves headline deficit and debt stock by exchanging an explicit liability in government bonds for an implicit pension liability of initially about 11 percent of GDP (the value of transferred assets, equivalent to pillar 2 pension claims).



Source: Hungarian authorities, United Nations and staff calculations.

1/ In 2011 and 2012 includes the transfer of assets in pillar 2. Assumes 100 percent switch from pillar 2 to pillar 1.

### **Box 5. The Support Scheme for Distressed Mortgage Borrowers**

**Structure.** The scheme is constructed around three “pillars”. Under pillar 1, banks are encouraged to offer a range of restructuring options. If the loan becomes non-performing again, the bank can seek a state guarantee under pillar 2 to cover the incremental costs of a further loan restructuring. Finally, under pillar 3, the local government can acquire the property at foreclosure and may rent it back to the distressed borrower. Pillars 2 and 3 will be overseen by a National Asset Management Agency (NAMA), whose governance structure is yet to be established.

**Targeting.** Only low-income households who have serviced their mortgage for at least 12 consecutive months will be eligible.

**Costs.** The government will collect a guarantee fee to fund pillar 2. There will still be upfront costs to the government as some households are likely to qualify immediately for support under pillar 3. Ultimately, up to one-third of currently distressed debtors may become eligible, although detailed estimates have yet to be finalized. The government envisages that the process of going through pillars 1 and 2 will delay pillar 3-related costs. Tentative estimates by the Ministry for National Economy suggest budget outlays of HUF 10–11 billion for 2011–12, increasing to HUF 120–130 billion for 2013–14 (about 0.45 percent of GDP).

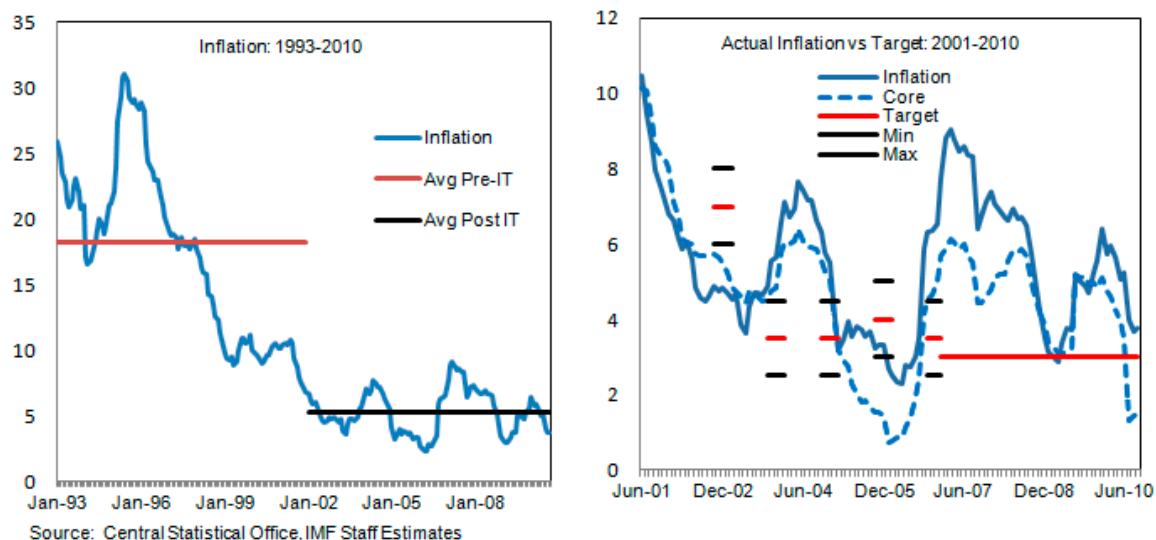
### Box 6. Hungary's Experience with Inflation Targeting

**Hungary initially adopted inflation targeting (IT) in mid-2001 to accelerate progress in meeting its primary objective of price stability.** At inception, the MNB had many of the elements needed for successful implementation of an IT framework (Heenan and others, 2006)<sup>16</sup>: statutory priority placed on price stability, instrument independence, reasonable control over short term rates, well developed financial markets, and a law prohibiting government financing.

**Despite these strengths, the regime has faced challenges.** First, until 2008, Hungary had a second nominal anchor in the form of an exchange rate band which often conflicted with the inflation target. Second, Hungary faced a series of fiscal shocks which frequently necessitated monetary tightening. And third, particularly in the late 2000s, monetary policy has been complicated by the increase in foreign exchange indebtedness of households and corporations, increasing the importance of the exchange rate as transmission channel at the expense of domestic currency lending conditions.

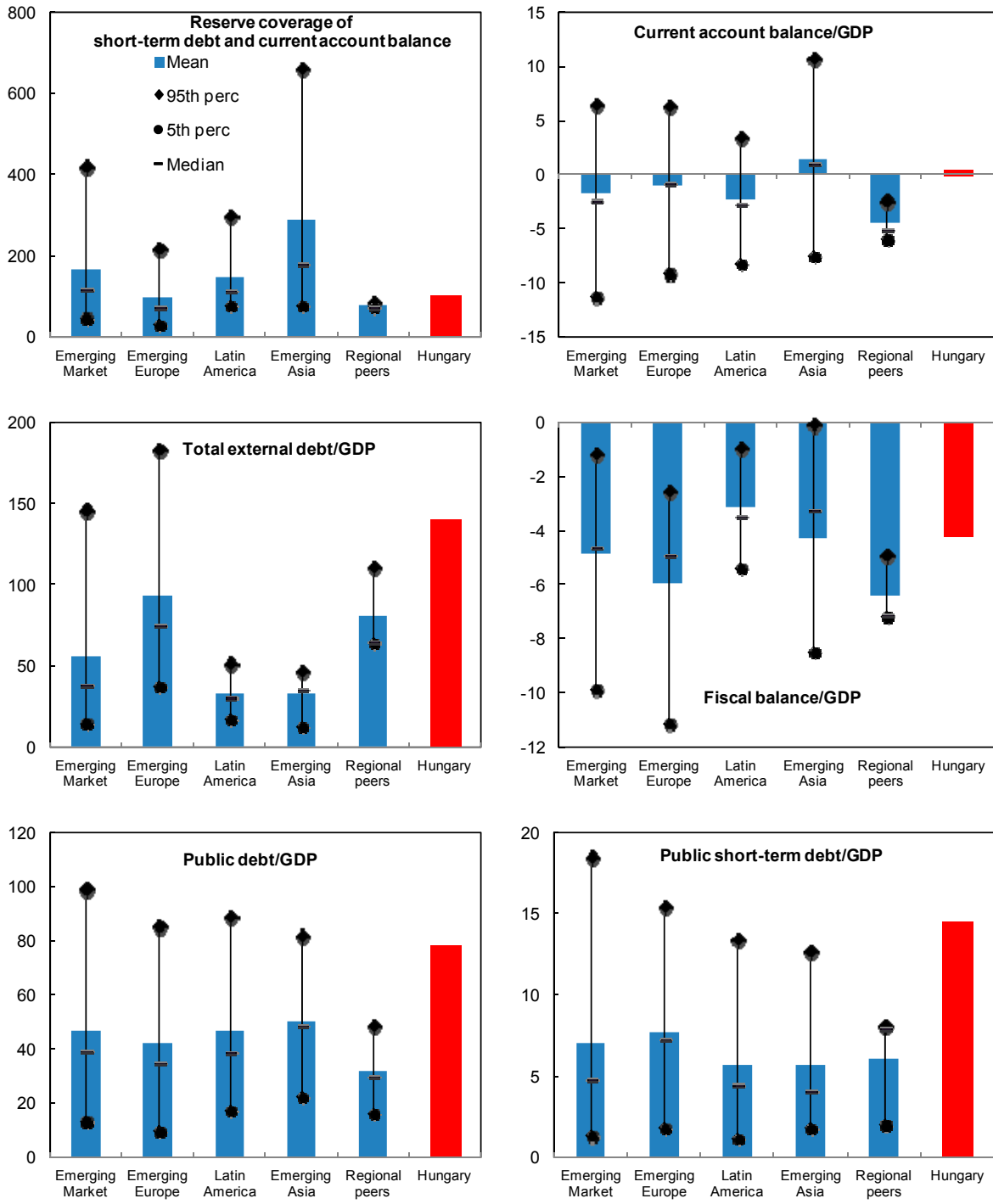
**Nonetheless, from the broad perspective of achieving lower average inflation, the IT regime has been a success.** Average inflation in the decade before adoption was 18 percent and 9.2 percent in 2001, the year of adoption. By contrast, during 2002–08, a period characterized by steady if moderate growth and large global shocks, headline inflation has averaged only 5.3 percent. Similar progress can be seen in core prices.

**The record is more mixed relative to the narrow parameters of meeting the announced inflation targets.** From 2001–06, the MNB met its annual end-year target only half the time. As of end-2007, the MNB started targeting a “continuous medium term target.” Since then, inflation was within ½ percentage point of its target during only one five-month period in early 2009. In recent years, the key drivers of these deviations from target have been exogenous supply shocks, currency sell-offs, and ad hoc tax increases.



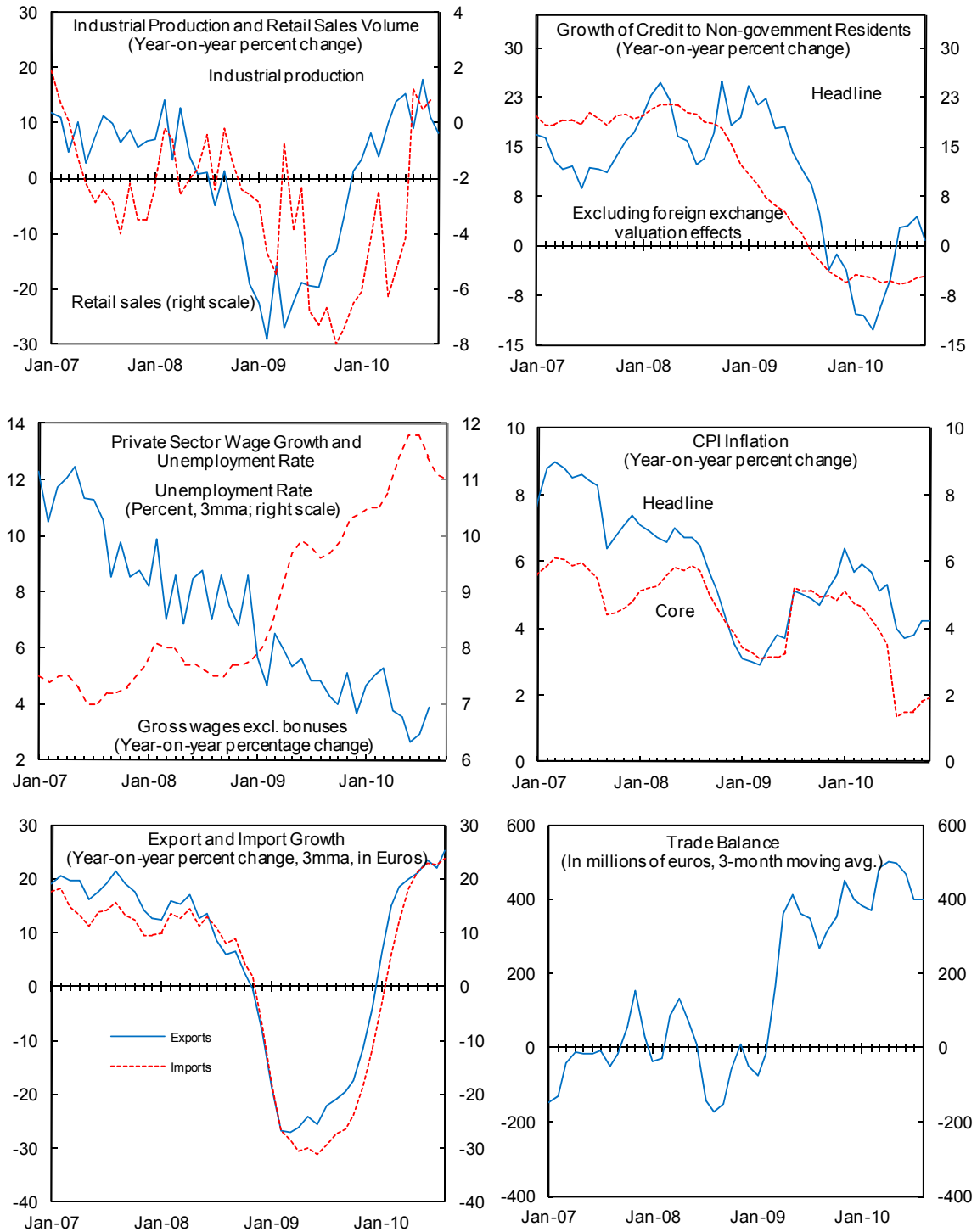
<sup>16</sup> See IMF WP 06/278.

Figure 1. Vulnerability Indicators in Hungary Compared to Other Emerging Markets, 2009



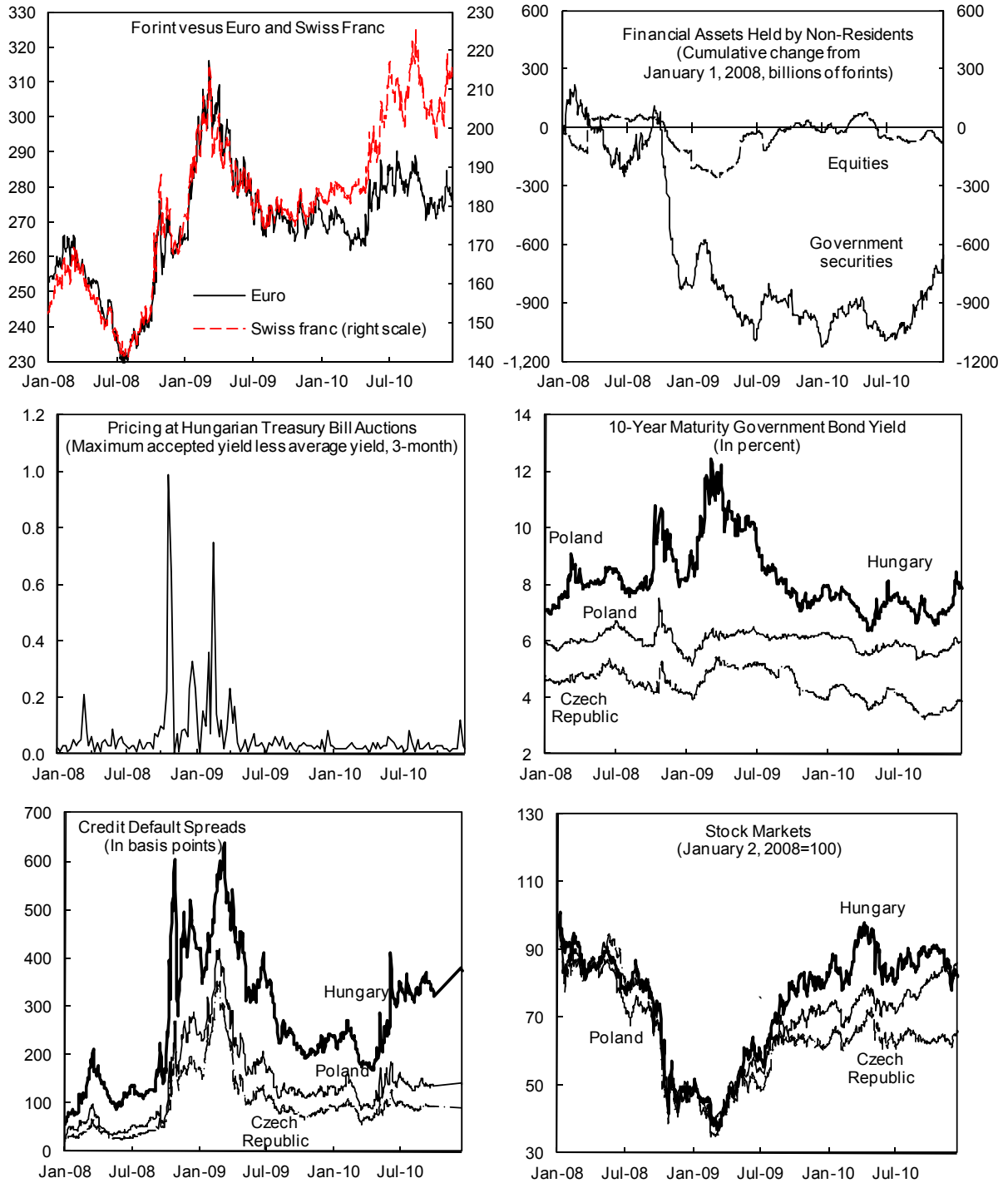
Source: IMF staff estimates.

Figure 2 Hungary: Recent Economic Developments, 2007-10



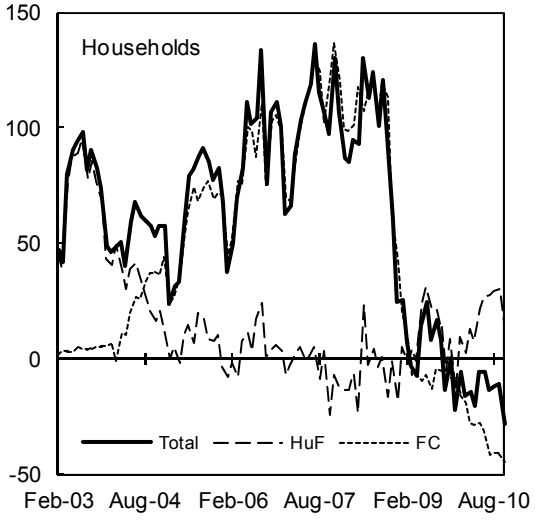
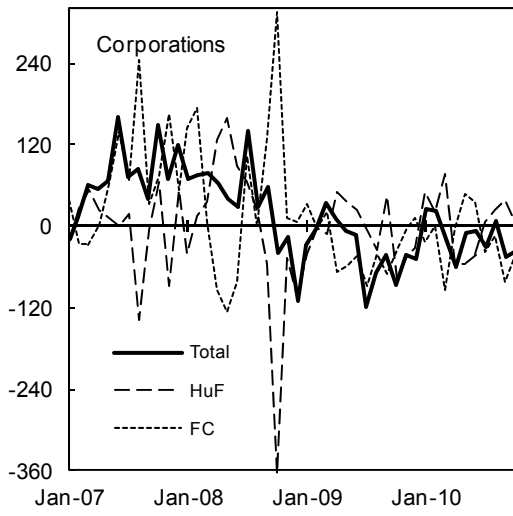
Sources: Hungarian Statistical Office; and IMF staff estimates.

Figure 3. Hungary: Financial Market Developments, 2008-10



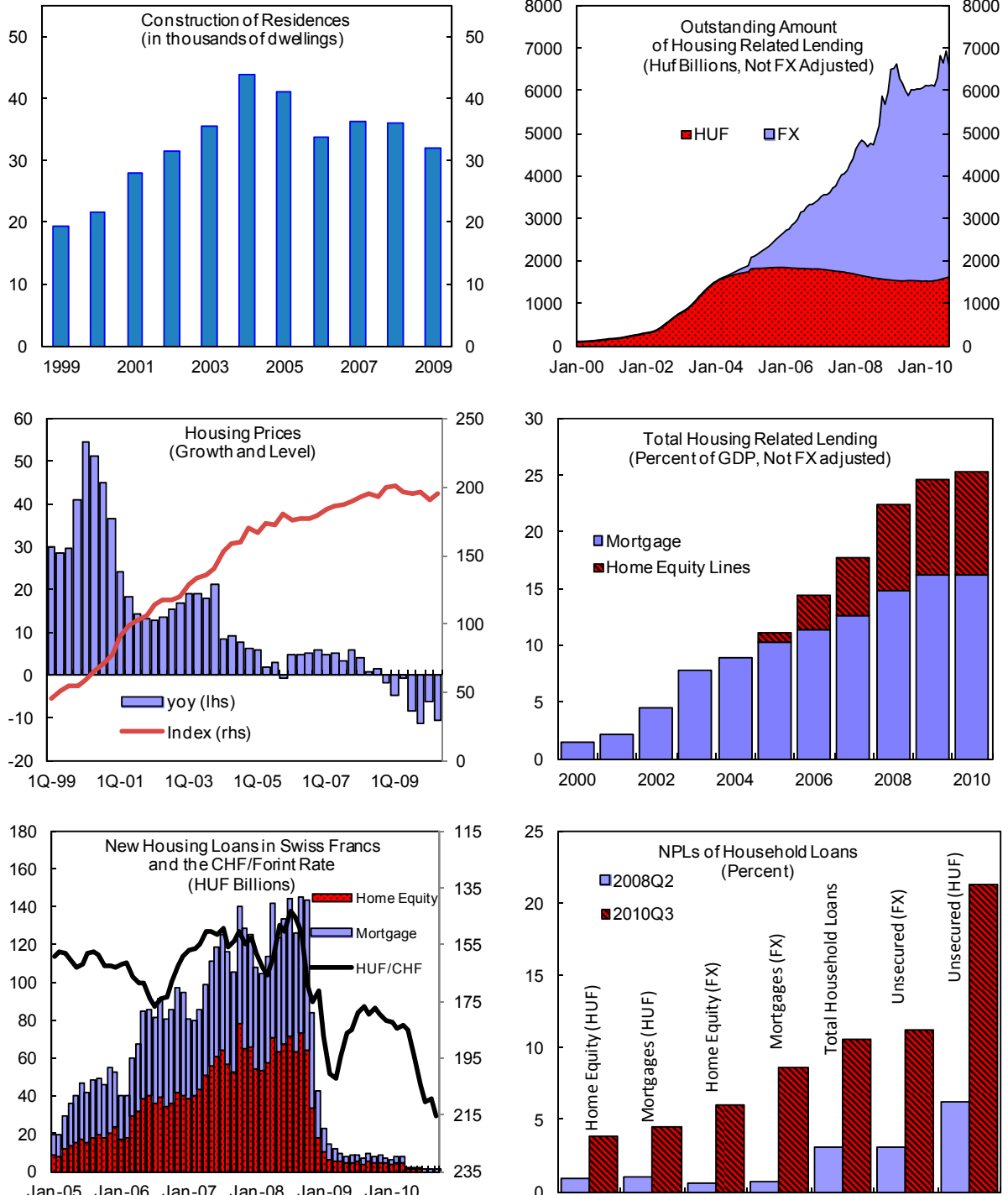
Sources: Hungarian national authorities; Bloomberg; and Hungarian Debt Management Agency.

Figure 4. Hungary: Bank Lending to Corporations and Households, 2007-10  
 (In billions of forints, flows, sa)



Source: Magyar Nemzeti Bank.

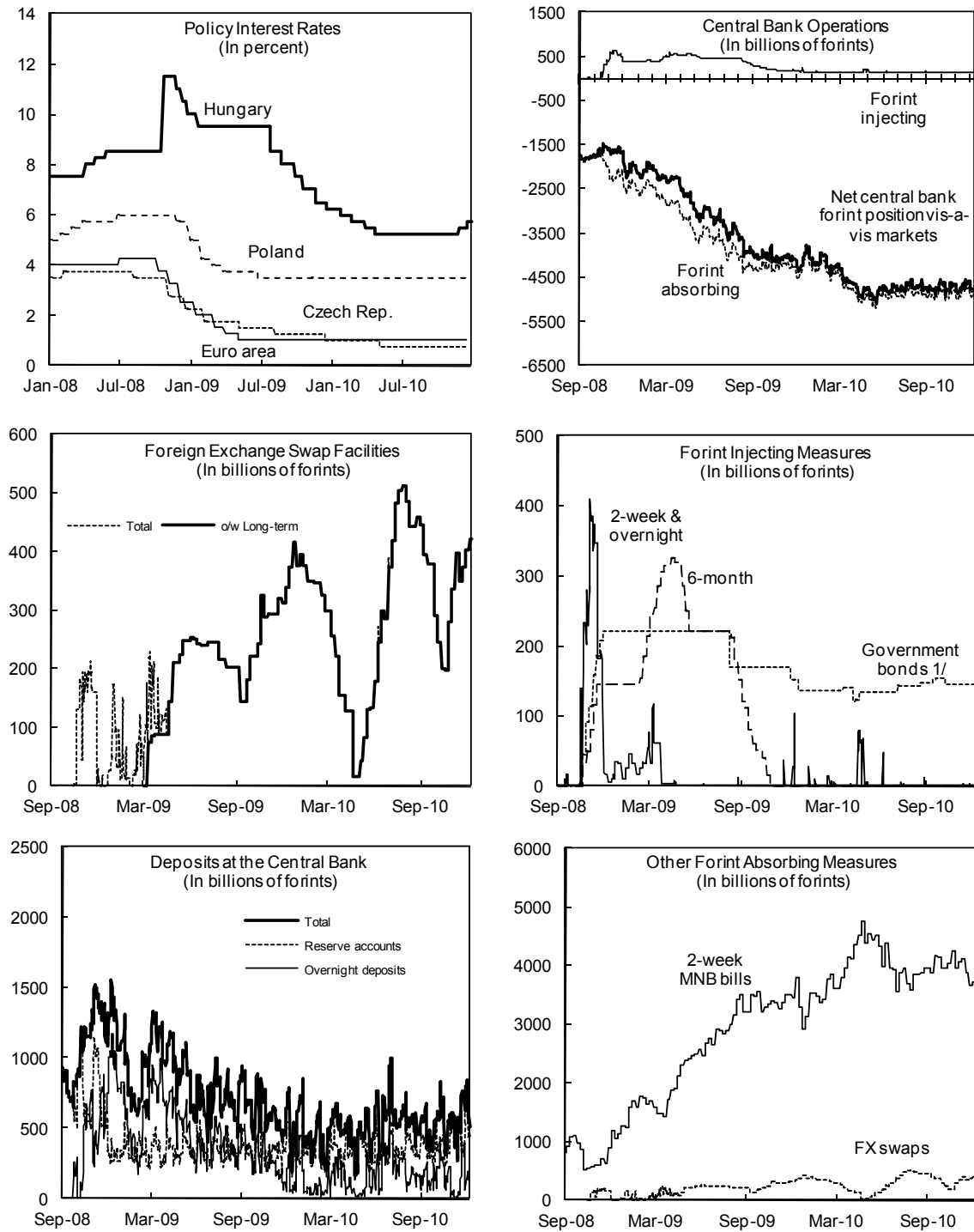
Figure 5. Hungary: Developments in Residential Real Estate, 1999-2010



Sources: Central Bank of Hungary; and IMF staff Calculations



Figure 6. Hungary: Monetary Policy Indicators, 2008-10



Sources: Hungarian national authorities; Bloomberg; and IMF staff estimates.  
 1/Facility to purchase government bonds from primary dealers.

Table 1. Hungary: Main Economic Indicators, 2006–11

	2006	2007	2008	2009	2010	2011
					Projections	
<b>Real economy</b> (change in percent)						
Real GDP	3.3	0.8	0.8	-6.7	1.1	2.8
Total domestic demand 1/	0.3	-2.3	0.7	-12.6	-2.4	2.3
Private consumption	2.1	-1.7	0.6	-6.8	-2.3	2.1
Gross fixed investment	-3.2	1.7	2.9	-8.0	-2.5	0.7
Foreign balance 1/	3.0	3.0	0.2	5.9	3.5	0.6
Exports	18.7	16.2	5.7	-9.6	13.8	8.9
Imports	14.9	13.3	5.8	-14.6	11.9	9.4
CPI (end year)	6.5	7.4	3.5	5.6	4.2	3.9
CPI (average)	3.9	7.9	6.1	4.2	4.9	4.1
Unemployment rate (average, in percent)	7.5	7.4	7.8	10.1	11.1	11.2
Gross domestic investment (percent of GDP) 2/	24.0	23.5	23.7	19.2	18.3	18.8
Gross national saving (percent of GDP, from BOP)	16.4	16.6	16.4	18.7	19.5	19.0
<b>General government</b> (percent of GDP), ESA-95 basis 3/						
Overall balance	-9.3	-5.0	-3.7	-4.3	-4.0	5.7
Primary balance	-5.4	-0.9	0.4	0.2	0.1	9.5
Primary structural balance	-6.1	-0.9	0.2	2.8	0.8	-0.3
Debt	65.7	66.1	72.3	78.4	79.5	69.8
<b>Money and credit</b> (end-of-period, percent change)						
Broad money	13.6	11.0	8.8	3.4	4.3	8.3
Lending to the private sector, flow-based	20.6	18.5	12.2	-2.3	1.0	5.0
<b>Interest rates</b> (percent)						
T-bill (90-day, average)	7.0	7.6	8.9	8.9	...	...
Government bond yield (5-year, average)	7.4	7.0	9.3	9.3	...	...
<b>Balance of payments</b>						
Goods and services trade balance (percent of GDP)	-1.4	0.9	0.4	5.1	6.5	5.7
Current account (percent of GDP)	-7.6	-6.9	-7.3	-0.5	1.2	0.1
Reserves (in billions of euros)	16.4	16.4	24.0	30.7	33.5	38.0
Gross external debt (percent of GDP) 4/	96.5	103.2	116.0	146.2	144.2	139.5
<b>Exchange rate</b>						
Exchange regime					Floating	
Present rate (December 15, 2010)					Ft 207.3 = US\$1; Ft. 274.4 = €1	
Nominal effective rate (2005=100)	93.9	99.6	100.9	91.8	...	...
Real effective rate, CPI basis (2005=100)	95.4	106.4	110.2	103.8	...	...
<b>Quota at the Fund</b>						
					SDR 1038.4 million	

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

1/ Contribution to growth. Calculated using 2000 prices. It includes change in inventories.

2/ Includes change in inventories.

3/ Consists of the central budget, social security funds, extrabudgetary funds, and local governments. It includes the IMF staff assessment of the impact of all government announced measures (October 2010), including the full amount of the bank levy in 2011.

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

Table 2. Hungary: Central Bank Survey 2006-11  
(Local Currency Billions)

	2006	2007	2008	2009	2010				2011
					Mar	June	Sep	Dec	
								<i>Proj.</i>	
Net foreign assets	3,838	3,941	5,988	7,261	7,891	8,764	8,014	8,209	9,506
Foreign Assets	4,362	4,359	6,584	8,484	9,191	10,290	9,542	9,738	11,035
Foreign Liabilities	524	418	596	1,223	1,300	1,526	1,528	1,528	1,528
Net domestic assets	-1,171	-1,150	-3,383	-4,786	-5,461	-6,136	-5,419	-5,539	-6,584
Net claims on government	-141	-108	-1,286	-709	-1,148	-1,200	-1,011	-642	-786
Assets	233	147	360	279	279	260	260	269	267
Liabilities (Govt Deposits at MNB)	373	255	1,646	988	1,427	1,460	1,271	911	1,053
HUF	280	197	128	248	413	419	524	214	216
FX	93	58	1,518	741	1,014	1,041	747	697	836
Net claims on banks	-998	-1,029	-1,907	-3,589	-3,971	-4,011	-3,755	-4,297	-5,199
Assets	0	0	177	0	4	16	36	19	23
Liabilities	998	1,029	2,084	3,589	3,975	4,027	3,791	4,315	5,222
Two Week Deposit Facility	991	474	834	489	213	671	215	215	215
Securities Issued by MNB	7	555	1,250	3,100	3,762	3,356	3,575	4,100	5,007
Net claims on the economy	-4	1	0	0	0	0	0	0	0
Other items, net	-29	-13	-190	-487	-342	-924	-652	-600	-600
Base money (M0)	2,434	2,791	2,605	2,475	2,430	2,628	2,595	2,671	2,922
Currency in Circulation	1,968	2,202	2,309	2,188	2,149	2,310	2,335	2,403	2,629
Banks' Reserves	466	589	296	287	281	318	260	267	292
Current Account Balances	618	683	328	339	342	356	358	368	403
Overnight Deposits	81	110	915	194	210	244	136	-101	-111
<b>Memorandum items :</b>									
Base Money (yoy percent change)	10.7	14.7	-6.7	-5.0	-7.2	5.0	4.5	7.9	9.4
Government Deposits at Central Bank (percent of GDP)	1.6	1.0	6.2	3.8	5.4	5.5	4.8	3.4	3.7
HUF	1.2	0.8	0.5	1.0	1.6	1.6	2.0	0.8	0.8
FX	0.4	0.2	5.7	2.8	3.9	3.9	2.8	2.6	2.9
Central Bank Bills Outstanding (percent of GDP)	0.0	2.2	4.7	11.9	13.9	12.4	13.2	15.2	17.5
Portion of CB Bills Owned by Non-Residents (percent)		15.2	7.2	4.0	11.2	8.8	12.2	...	...
Reserve Requirement Ratio (percent of select liabilities)	5.0	5.0	2.0	2.0	2.0	2.0	2.0	...	...

Sources: Magyar Nemzeti Bank and IMF staff calculations.

Table 3. Hungary: Monetary Survey 2006-11  
(Local Currency Billions)

	2006	2007	2008	2009	2010				2011
					Mar	June	Sep	Dec	
					<i>Proj.</i>				
Net foreign assets	-83	-952	-1,487	564	1,192	1,454	1,216	1,875	3,325
Central Bank	3,838	3,941	5,988	7,261	7,891	8,764	8,014	8,209	9,506
Commercial Banks	-3,920	-4,892	-7,475	-6,697	-6,699	-7,310	-6,798	-6,335	-6,182
Net domestic assets	12,868	15,148	16,934	15,410	14,790	14,985	15,016	14,792	14,724
Domestic credit	16,255	18,966	21,534	20,938	20,545	21,905	21,582	21,357	21,290
Net claims on government	3,026	3,270	2,952	3,035	2,785	3,037	3,323	3,758	2,816
Central Bank	-141	-108	-1,286	-709	-1,148	-1,200	-1,011	-642	-786
Commercial Banks	3,166	3,378	4,238	3,745	3,933	4,237	4,334	4,400	3,601
Credit to the economy	13,229	15,696	18,583	17,903	17,760	18,868	18,259	17,599	18,474
Central Bank	-4	1	0	0	0	0	0	0	0
Commercial Banks	13,233	15,694	18,583	17,903	17,760	18,868	18,259	17,599	18,474
o/w Loans	12,857	15,057	17,994	17,326	17,174	18,278	17,681	17,499	18,374
HUF	6,478	6,449	6,210	6,201	6,303	6,184	6,378	6,662	7,730
FX	6,379	8,608	11,784	11,125	10,872	12,094	11,304	10,837	10,644
o/w Securities	46	87	97	118	123	132	101	100	100
Other items, net	-3,387	-3,818	-4,600	-5,528	-5,755	-6,920	-6,566	-6,566	-6,566
Broad money (M3)	12,785	14,196	15,447	15,974	15,982	16,439	16,232	16,667	18,049
M2	11,913	12,937	14,252	14,364	14,063	14,371	14,211	14,592	15,802
M1	5,833	6,348	6,162	6,122	5,942	6,346	6,326	6,495	7,034
Currency in circulation	1,838	2,068	2,137	2,039	1,993	2,150	2,173	2,232	2,417
Overnight Deposits	3,995	4,280	4,025	4,082	3,949	4,196	4,152	4,263	4,617
HUF	3,225	3,498	3,277	3,205	3,021	3,266	3,168	3,253	3,523
FX	770	783	746	877	928	930	984	1,010	1,094
Deposits with Maturities up to 2 years	6,080	6,589	8,090	8,243	8,121	8,025	7,886	8,097	8,768
HUF	4,617	5,248	6,510	6,473	6,263	6,281	6,189	6,355	6,882
FX	1,462	1,341	1,580	1,769	1,858	1,744	1,697	1,742	1,887
Repos	73	82	22	35	29	33	33	34	37
Money Market Fund Shares/Units	764	978	858	1,115	1,247	1,345	1,372	1,409	1,525
Debt Securities	35	200	316	460	643	690	616	632	684
<b>Memorandum items :</b>									
					(percentage change by contribution, y-o-y)				
Broad Money	13.6	11.0	8.8	3.4	0.1	3.5	2.7	4.3	8.3
NFA	-4.1	-6.8	-3.8	13.3	11.4	12.3	3.6	8.2	8.7
NDA	17.7	17.8	12.6	-9.9	-11.3	-8.8	-0.9	-3.9	-0.4
					(percentage change, y-o-y)				
Credit to Private Sector 1/ 2/	20.6	18.5	12.2	-2.3	-2.4	-3.3	-2.8	1.0	5.0
HUF	9.7	-0.4	-3.1	0.4	4.3	-0.2	1.4	7.4	16.0
FX	37.1	42.2	25.6	-4.0	-5.7	-5.2	-5.4	-2.6	-1.8
					(percentage as share of total)				
Foreign Currency Loans to Total Loans 2/	49.6	57.2	65.5	64.2	63.3	66.2	63.9	61.9	57.9
Foreign Currency Deposits to Total Deposits 2/	22.2	19.5	19.2	21.5	23.1	21.9	22.3	22.3	22.3
					(percent of GDP)				
Total Bank Credit to the Private Sector	54.2	59.5	67.3	66.5	65.3	68.9	66.1	...	...
o/w Households	20.0	23.4	28.9	30.1	30.0	32.6	31.2	...	...
o/w Corporates	27.4	28.8	29.9	29.4	28.7	29.3	28.4	...	...

Sources: Magyar Nemzeti Bank and IMF staff calculation.

1/ Adjusted for changes in exchange rate

2/ Only credit to households and firms

Table 4. Hungary: Balance of Payments, 2005-15  
(in millions of euros)

	2005	2006	2007	2008	2009	2010 Proj.	2011 Proj.	2012 Proj.	2013 Proj.	2014 Proj.	2015 Proj.
<b>Current Account</b>	<b>-6,709</b>	<b>-6,831</b>	<b>-6,965</b>	<b>-7,772</b>	<b>-429</b>	<b>1,126</b>	<b>126</b>	<b>-658</b>	<b>-1,234</b>	<b>-2,274</b>	<b>-3,712</b>
Goods and service, net	-1,408	-1,228	910	395	4,718	6,376	5,799	5,459	5,300	4,702	3,734
Exports	60,022	69,247	80,946	86,558	71,663	83,811	91,877	101,088	111,184	120,035	129,417
Imports	-61,430	-70,476	-80,035	-86,163	-66,945	-77,435	-86,078	-95,629	-105,884	-115,332	-125,683
Income, net	-5,019	-5,298	-7,372	-7,571	-5,501	-5,226	-5,423	-5,855	-6,257	-6,682	-7,135
Current transfers, net	-282	-305	-503	-596	354	-23	-249	-263	-278	-294	-311
<b>Capital Account</b>	<b>599</b>	<b>685</b>	<b>708</b>	<b>1,016</b>	<b>1,182</b>	<b>2,086</b>	<b>2,370</b>	<b>2,097</b>	<b>2,230</b>	<b>2,359</b>	<b>2,495</b>
Net capital transfers	586	670	789	919	1,603	2,086	2,370	2,097	2,230	2,359	2,495
<b>Financial Account</b>	<b>12,007</b>	<b>8,841</b>	<b>6,663</b>	<b>10,031</b>	<b>-3,592</b>	<b>699</b>	<b>3,974</b>	<b>1,562</b>	<b>2,099</b>	<b>3,690</b>	<b>2,913</b>
Direct investment, net	4,417	2,327	209	2,802	-158	-2	428	553	731	409	324
Direct Investment Abroad	-1,756	-3,127	-2,643	-2,095	-1,709	-1,314	-1,324	-1,294	-1,671	-1,753	-1,838
In Hungary	6,172	5,454	2,852	4,897	1,550	1,312	1,752	1,846	2,403	2,162	2,162
Portfolio investment, net	3,388	5,222	-789	-3,153	-2,659	1,052	3,462	893	1,294	3,172	2,448
Other investment	4,203	1,292	7,242	10,383	-775	-351	84	116	74	108	141
Net errors and omissions	-1,989	-1,728	-272	-2,522	-159	-533	0	0	0	0	0
<b>Overall Balance</b>	<b>3,908</b>	<b>968</b>	<b>134</b>	<b>753</b>	<b>-2,998</b>	<b>3,378</b>	<b>6,471</b>	<b>3,001</b>	<b>3,094</b>	<b>3,775</b>	<b>1,697</b>
<b>Prospective Financing</b>				2,000	3,500	0	-2,000	0	0	-2,000	0
European Union				2,000	3,500	0	-2,000	0	0	-2,000	0
World Bank				0	0	0	0	0	0	0	0
<b>Net International Reserves (increase -)</b>	<b>-3,908</b>	<b>-968</b>	<b>-134</b>	<b>-2,753</b>	<b>-502</b>	<b>-3,378</b>	<b>-4,471</b>	<b>-3,001</b>	<b>-3,094</b>	<b>-1,775</b>	<b>-1,697</b>
Gross Reserves	-3,908	-968	-134	-7,676	-5,486	-3,378	-4,471	738	1,364	-1,072	-1,697
Reserve Liabilities	0	0	0	4,923	4,984	0	0	-3,739	-4,458	-702	0
Bank Guarantee Fund	0	0	0	0	0	0	0	0	0	0	0
Prospective Fund credits	0	0	0	4,923	4,984	0	0	-3,739	-4,458	-702	0
Current account (in percent of GDP)	-7.6	-7.6	-6.9	-7.3	-0.5	1.2	0.1	-0.6	-1.1	-1.9	-2.9
Gross external debt (in percent of GDP)	81.0	96.5	103.2	116.0	146.2	144.2	139.5	131.2	122.8	117.9	114.8
Gross official reserves	15,721	16,397	16,385	24,040	30,676	33,547	38,017	37,280	35,916	36,988	38,685
In percent of short-term debt at remaining maturity	112.2	123.6	88.9	71.1	83.2	81.3	84.1	80.1	74.6	81.2	84.3

Sources: Hungarian authorities and staff projections.

Table 5. Hungary: External Financing Needs 2009-15

(in millions of euros)

	2009 Est.	2010 Proj.	2011 Proj.	2012 Proj.	2013 Proj.	2014 Proj.	2015 Proj.
<b>Total financing requirements</b>	<b>31,279</b>	<b>34,527</b>	<b>39,937</b>	<b>41,889</b>	<b>43,240</b>	<b>46,182</b>	<b>45,173</b>
Current account deficit - EU capital transfers	-753	-3,829	-2,496	-1,439	-996	-85	1,217
Amortizations	31,874	37,727	42,433	43,328	44,236	46,267	43,956
FDI (inter company)	4,291	6,283	6,509	6,588	6,810	7,098	7,357
General government	4,340	4,571	7,034	8,610	9,641	10,784	7,649
o/w: to IMF and EU	0	0	2,000	3,739	4,458	2,702	0
Banks	17,632	20,027	20,921	20,097	19,952	19,809	19,670
Other investment (mainly corporate)	5,611	6,845	7,969	8,032	7,833	8,576	9,281
Net errors and omissions	159	628	0	0	0	0	0
<b>Total financing sources</b>	<b>22,795</b>	<b>34,527</b>	<b>39,937</b>	<b>41,889</b>	<b>43,240</b>	<b>46,182</b>	<b>45,173</b>
FDI net inflows (excl. inter-company)	4,133	6,087	6,936	7,141	7,541	7,507	7,681
Disbursements (debt)	25,192	31,685	34,541	34,361	34,686	40,109	39,488
General government 1/	4,661	5,289	6,076	5,975	6,653	11,435	10,210
Banks	13,703	19,004	20,097	19,952	19,809	19,670	19,533
Other investment (mainly corporate)	6,828	7,392	8,368	8,434	8,224	9,005	9,745
Other portfolio flows net	-1,044	430	2,930	-350	-351	-362	-299
Drawdown in gross reserves	-5,486	-3,676	-4,471	738	1,364	-1,072	-1,697
<b>Memo items</b>							
Gross international reserves (level in Euro million)	30,676	33,547	38,017	37,280	35,916	36,988	38,685
Government rollover rates	107	116	86	69	69	106	133
o/w: Percent rollover on long-term non-EU/IMF debt		123	138	143	151	158	148
Banks' rollover rates	78	95	96	99	99	99	99
Corporate rollover rates (in percent)	122	108	105	105	105	105	105
Total long-term roll-over rate on non-EU/IMF debt		118	108	109	112	122	118

Sources: Hungarian authorities and staff projections.

1/ Excludes EU and IMF loans

Table 6. Hungary: Indicators of External Vulnerability, 2005-10

	2005	2006	2007	2008	2009	2010 1/ Est.
<b>Financial Indicators</b>						
M3, end-of-period, percent change	14.7	13.7	11.0	8.7	3.5	4.3
Lending to the private sector, flow based, end-of-period, percentage change 2/	15.4	20.6	18.5	12.2	-2.3	1.0
T-bill, 90-day, average, in percent	6.7	7.0	7.6	8.8	8.4	5.4
Government bond yield, 5-year, average, in percent	6.8	7.4	7.0	9.2	9.3	7.0
Share of foreign currency liabilities in total liabilities	34.4	39.3	42.4	45.6	47.1	45.6
Share of foreign currency loans by sector						
Corporates	47.7	47.1	52.6	60.3	61.3	60.7
Households	32.6	46.8	59.0	70.7	70.2	70.6
Other loans	75.2	75.4	81.7	87.1	85.7	83.2
Non-performing loans to gross loans 3/	2.3	2.6	2.3	3.0	6.7	9.3
<b>External Indicators</b>						
Exports of goods and services, annual percentage change	12.9	15.4	16.9	6.9	-17.2	17.0
Imports of goods and services, annual percentage change	10.6	14.7	13.6	7.7	-22.3	15.7
Real effective exchange rate, percentage change, + = appreciation	2.0	-5.2	11.3	2.9	-8.4	2.7
Current account balance, in percent of GDP	-7.6	-7.6	-6.9	-7.3	-0.5	1.2
Capital account, in percent of GDP	0.7	0.8	0.7	1.0	1.3	2.1
Financial account, in percent of GDP	13.5	9.8	6.6	9.4	-3.9	0.7
Net foreign direct investment, in percent of GDP	5.0	2.6	0.2	2.6	-0.2	0.0
Gross official reserves, in millions of euros	15,721	16,397	16,385	24,040	30,676	33,547
In months of imports of goods and services	2.7	2.5	2.3	4.3	4.8	4.7
In percent of short-term debt at remaining maturity	112.2	123.6	88.9	71.1	83.2	81.3
Total external debt, including SPEs, in percent of GDP 4/	..	111.9	119.7	148.6	177.3	...
Total external debt, excluding SPEs, in percent of GDP	81.0	96.5	103.2	116.0	146.2	144.2
Of which:						
Direct investment intercompany loans	11.1	14.7	16.4	22.8	30.5	30.5
General government	29.2	33.2	33.7	36.0	42.4	42.4
Of which: non-residents holdings of local currency government bonds	11.6	13.0	12.8	8.0	8.7	8.7
Central bank	1.2	1.1	0.6	1.1	5.1	5.1
Banks	21.5	27.6	30.7	40.1	42.8	42.8
Non-financial institutions	18.1	19.9	21.8	16.1	20.2	20.2
Short-term debt at remaining maturity, in millions of euros 5/	14,012	13,270	18,428	33,816	36,871	41,269
<b>Financial Market Indicators</b>						
Stock market index, local currency, end-of-period	20,785	24,844	26,236	12,242	21,227	21,460
EMBI Global bonds spread, end-of-period	74.0	58.0	84.0	504.0	186.0	411.0
CDS spread, 5-year, end-of-period	26.2	20.8	54.8	419.1	237.9	383.9

Sources: Hungarian authorities; and staff estimates.

1/ Data for Financial Indicators are as of end-Sep. (M3, Lending), end-Nov. (yields), or end-Sep. (share of foreign currency loans and NPLs), and data for Financial Market Indicators are as of Dec. 28th 2010. Projections for External Indicators are for end-2010.

2/ Loans to households and non-financial corporations only, exchange rate adjusted

3/ Non-performing loans are defined as corporate, household, interbank, foreign and other loans that are past due for more than 90 days.

4/ Special Purpose Entities are defined as resident corporations of non-resident owners, which perform a passive, financial intermediary function between their non-resident partners. SPEs have a marginal impact on the domestic economy, and their transactions have negligible net impact on the balance of payments (an enterprise that has a non-negligible net impact on the balance of payments is removed from the list of SPEs). Foreign assets and liabilities of SPEs are largely matched, and loans are considered as FDI in accordance with international statistical standards. Data for SPEs are not available prior to 2006.

5/ Includes an estimate of intercompany loans falling due in the short-term.

Table 7. Hungary: Staff's Illustrative Medium-Term Scenario, 2007-15

	2007	2008	2009	2010	2011	2012	2013	2014	2015	Average 2012-15	Average 2002-07		
							Proj.						
				(In percent, unless otherwise indicated)									
Real GDP growth	0.8	0.8	-6.7	1.1	2.8	3.0	3.0	3.0	3.0	3.0	3.4		
Nominal GDP, forint billions	25,321	26,754	26,054	26,986	28,547	30,102	31,868	33,716	35,665				
Inflation (CPI; year average basis)	7.9	6.1	4.2	4.9	4.1	3.5	3.0	3.0	3.0				
Inflation (CPI; end-year basis)	7.4	3.5	5.6	4.2	3.9	3.2	3.0	3.0	3.0				
				(Annual percentage change, constant prices)									
Domestic demand	-2.3	0.7	-13.0	-2.7	2.6	4.4	2.9	3.2	3.3	3.4	2.6		
Total consumption	-2.0	0.5	-5.7	-1.7	2.0	3.2	2.3	2.5	2.5	2.6	3.8		
Gross fixed capital formation	1.7	2.9	-8.0	-2.5	0.7	2.7	3.3	3.7	3.7	3.3	7.5		
Exports of GNFS	16.2	5.7	-9.6	13.8	8.9	9.2	8.7	8.0	8.0	8.4	11.9		
Imports of GNFS	13.3	5.8	-14.6	11.9	9.4	9.2	9.1	8.5	8.5	8.8	10.9		
Lending to the private sector, flow-based (current prices, e.o.p.)	18.5	12.2	-2.3	1.0	5.0	...	...	...	...				
Unemployment rate (percent of labor force, year average basis)	7.4	7.8	10.1	11.1	11.2	10.6	10.0	9.4	8.8				
				(In percent of GDP, unless otherwise indicated)									
External current account balance	-6.9	-7.3	-0.5	1.2	0.1	-0.6	-1.1	-1.9	-2.9				
Gross national saving	16.6	16.4	18.7	19.5	19.0	18.4	19.2	19.9	20.2				
Gross national investment 1/	23.5	23.7	19.2	18.3	18.8	19.0	20.3	21.8	23.2				
Capital account, net	0.7	1.0	1.3	2.1	2.3	2.0	2.0	2.0	2.0				
Financial account, net	6.6	9.4	-3.9	0.7	3.9	1.5	1.9	3.1	2.3				
Net international investment position	-102.8	-98.8	-117.2	-120.1	-111.7	-102.4	-94.2	-91.5	-92.8				
Gross external debt 2/	103.2	116.0	146.2	144.2	139.5	131.2	122.8	117.9	114.8				
General government (ESA-95)													
Revenue, total	45.1	45.1	46.0	44.3	52.9	41.3	39.5	39.6	39.8				
Expenditure, primary	46.0	44.7	45.9	44.5	43.3	42.9	42.5	42.2	42.0				
Primary balance 3/	-0.9	0.4	0.2	0.1	9.5	-1.6	-3.0	-2.6	-2.3				
General government balance (including the costs of pension reform)	-5.0	-3.7	-4.3	-4.0	5.7	-5.2	-7.2	-7.1	-7.1				
Interest expenditure	4.1	4.1	4.5	4.0	3.8	3.7	4.2	4.5	4.8				
General government debt	66.1	72.3	78.4	79.5	69.8	71.5	74.7	77.8	80.6				
Memorandum items													
Output gap	2.1	1.2	-6.2	-5.7	-4.4	-3.4	-2.5	-1.9	-1.4				
Potential GDP growth	1.8	1.8	0.6	0.6	1.4	1.9	2.1	2.3	2.5	2.2	2.7		
Structural general government balance	-5.0	-4.0	-1.5	-3.0	-3.9	-4.5	-6.0	-6.3	-6.4				
Structural primary balance (in percent of potential GDP)	-0.9	0.2	2.8	0.8	-0.3	-0.9	-2.0	-1.8	-1.7				
Gross official reserves (percent of short-term debt at remaining maturity)	88.9	71.1	83.2	81.3	84.1	80.1	74.6	81.2	84.3				

Sources: Hungarian authorities; and staff estimates.

1/ Includes change in inventories.

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

3/ Includes interest revenue.



Table 8. Hungary. Consolidated General Government, 2008-15 1/  
(In percent of GDP, unless otherwise indicated)

	2007	2008	2009	2010	2011	2012	2013	2014	2015
						Staff Proj.			
Total revenues	45.1	45.1	46.0	44.3	42.0	41.3	39.5	39.6	39.8
Current revenues and current transfers (incl. grants)	44.1	44.5	44.6	42.7	40.2	39.5	37.7	37.8	38.0
Tax revenues	39.7	39.8	39.3	37.9	35.8	35.1	33.3	33.4	33.6
Taxes on income, profits and capital gains	10.3	10.5	9.8	9.3	7.3	6.3	4.4	4.4	4.4
Personal income tax	7.1	7.6	7.3	6.6	4.6	3.9	3.2	3.3	3.3
Corporate income tax	2.8	2.6	2.2	1.3	1.2	1.2	0.8	0.8	0.8
Levy on financial institutions	0.0	0.0	0.0	0.6	0.6	0.3	0.0	0.0	0.0
Levy on energy, telecommunication, and retail companies	0.0	0.0	0.0	0.4	0.6	0.6	0.0	0.0	0.0
Other (incl. wealth, capital, and property taxes)	0.4	0.3	0.3	0.4	0.4	0.4	0.4	0.4	0.4
Taxes on payroll and workforce and Social Security contributions	13.7	13.8	13.1	12.1	12.5	12.5	12.6	12.8	12.9
Taxes on goods and services	15.7	15.5	16.3	16.4	16.0	16.2	16.2	16.2	16.2
VAT	7.8	7.6	8.3	8.6	8.3	8.5	8.5	8.5	8.5
Other (incl. excises and duties)	7.9	7.9	8.1	7.9	7.7	7.7	7.7	7.7	7.7
Current non-tax revenues	3.8	4.0	4.3	4.2	3.6	3.6	3.6	3.6	3.6
Of which: interest	0.3	0.5	0.0	0.3	0.2	0.2	0.2	0.2	0.2
Current transfers (incl. grants)	0.6	0.7	1.1	0.6	0.8	0.8	0.8	0.8	0.8
Capital revenues and capital transfers (incl. grants)	0.9	0.6	1.4	1.6	1.8	1.8	1.8	1.8	1.8
Total expenditures 3/	50.0	48.8	50.4	48.5	47.2	46.5	46.7	46.8	46.8
Current expenditures and current transfers	44.5	44.7	46.2	43.7	42.5	41.9	42.1	42.2	42.3
Compensation of employees 2/	11.5	11.5	11.3	10.9	9.9	9.8	9.7	9.6	9.6
Goods and services	6.7	7.0	7.7	7.2	7.5	7.4	7.3	7.3	7.3
Interest payments	4.1	4.1	4.5	4.0	3.8	3.7	4.2	4.5	4.8
Subsidies	1.4	1.1	1.0	0.9	0.8	0.8	0.8	0.8	0.8
Current transfers to households	18.2	18.5	19.2	18.2	17.8	17.6	17.5	17.3	17.3
Social security	13.5	14.2	14.7	14.4	14.3	14.1	14.0	13.9	13.8
Of which: unemployment benefits	0.4	0.4	0.6	0.5	0.5	0.5	0.5	0.5	0.5
Other	4.6	4.3	4.5	3.8	3.5	3.5	3.5	3.4	3.4
Other current transfers	2.6	2.5	2.5	2.4	2.7	2.6	2.6	2.6	2.6
Capital expenditures	3.6	2.6	3.0	3.5	3.2	3.2	3.2	3.1	3.1
Capital transfers	1.9	1.5	1.2	1.3	1.5	1.4	1.4	1.4	1.4
Other net expenditure	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Unidentified measures	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
General government balance (excl. transfer of pension assets)	-7.5	-3.7	-4.4	-4.2	-5.1	-5.2	-7.2	-7.1	-7.1
Transfer of assets from the 2nd to the 1st pillar of the pension system)	0.0	0.0	0.1	0.2	10.8	0.0	0.0	0.0	0.0
General government balance	-5.0	-3.7	-4.3	-4.0	5.7	-5.2	-7.2	-7.1	-7.1
Primary balance	-0.9	0.4	0.2	0.1	9.5	-1.6	-3.0	-2.6	-2.3
Convergence program overall balance	..	-3.8	-3.9	-3.8	-2.8	-2.4	-2.3	-1.9	..
Gap to convergence program	..	-0.1	0.4	0.2	-8.5	2.8	4.9	5.2	..
Memorandum items:									
Primary expenditure 3/	46.0	44.7	45.9	44.5	43.3	42.9	42.5	42.2	42.0
Output gap (in percent of potential GDP)	2.1	1.2	-6.2	-5.7	-4.4	-3.4	-2.5	-1.9	-1.4
Cyclically-adjusted overall balance (CAB, in percent of potential GDP)	-6.0	-4.3	-1.3	-1.4	7.3	-3.6	-6.0	-6.3	-6.4
Change in CAB	5.0	1.7	3.0	-0.1	8.7	-10.9	-2.4	-0.2	-0.2
One-off items (net)	-1.0	-0.3	0.2	1.5	11.2	0.8	0.0	0.0	0.0
Structural balance (in percent of potential GDP)	-5.0	-4.0	-1.5	-3.0	-3.9	-4.5	-6.0	-6.3	-6.4
Change in the structural balance	5.1	1.1	2.5	-1.5	-1.0	-0.5	-1.6	-0.2	-0.2
Primary structural balance (in percent of potential GDP)	-0.9	0.2	2.8	0.8	-0.3	-0.9	-2.0	-1.8	-1.7
Change in the primary structural balance	5.2	1.1	2.6	-1.9	-1.1	-0.7	-1.0	0.1	0.2
Gross public debt	66.1	72.3	78.4	79.5	69.8	71.5	74.7	77.8	80.6
GDP, in current prices (forint billions, yearly)	25321.5	26,754	26,054	26,986	28,547	30,102	31,868	33,716	35,665
Real GDP growth (in percent)	0.8	0.8	-6.7	1.1	2.8	3.0	3.0	3.0	3.0
In nominal terms (HUF billions)									
Total revenue	11,411	12,077	11,986	11,968	12,000	12,440	12,579	13,352	14,187
Of which tax revenues	10,043	10,654	10,233	10,224	10,224	10,568	10,597	11,255	11,969
Total expenditure	12,666	13,069	13,141	13,101	13,468	14,013	14,872	15,762	16,709
Of which primary expenditure	11,638	11,970	11,959	12,008	12,375	12,912	13,545	14,243	14,990
Transfer of assets	0	0	26	64	3,088	0	0	0	0
Primary balance	-227	107	54	23	2,713	-472	-965	-891	-803
Overall balance	-1,256	-992	-1,128	-1,069	1,620	-1,572	-2,293	-2,410	-2,521

Sources: Hungarian authorities; and staff estimates.

1/ Data are classified following the ESA'95 methodology, as reported to the European Commission.

2/ Including social security contributions.

3/ For 2012-2014, all non-interest expenditure categories are projected using the potential GDP projected growth rate.

Table 9. Hungary: Central Government Financing Needs and Sources, 2009-11  
(in billion of forints)

	2009	2010	2011
Net financing requirement	1,597	504	-1,669
Overall deficit of the central government system (cash basis)	889	896	-1,688
Net EU transfers	-34	152	171
Other factors 1/	743	-545	-153
Net Financing	1,596	476	-1,669
Net debt issuance	916	463	1,257
Gross issuance (actual and planned)	7,672	6,446	6,210
In Hungarian forints 2/	5,675	5,995	5,059
In foreign currency 2/	1,997	451	1,151
Repayments	6,756	5,983	4,953
In Hungarian forints 2/	6,445	5,614	3,936
In foreign currency (euro) 2/	312	369	1,017
Change in government holdings of repos	-4	-6	0
Drawing on deposits with banking system	684	19	-1,382
Deposits in forints 3/	-120	29	-832
Deposits in foreign currencies 4/	804	-10	-550
Public debt redemption (private pension assets) 5/	0	0	-1,544
Residual/valuation	1	27	0

Source: AKK data and Fund staff estimates.

1/ Extension/reimbursement of loans by the government, and other operations affecting the central government deposits.

2/ In 2011 the decline in repayments from the redemption of pension assets is a staff estimate. It is computed as the outstanding repayment obligations prior to the pension reform minus the prorated share of holdings of government assets in the pension system.

3/ In 2011 includes accumulation of assets other than government bonds denominated in HUF from the redemption of assets under the pension reform.

4/ In 2011 includes accumulation of assets other than government bonds denominated in foreign currency from the redemption of assets under the pension reform.

5/ Refers to government bonds held by pension administrators redeemed under the pension reform.

Table 10. Financial Soundness Indicators for the Banking Sector, 2006-10  
(In percent unless otherwise indicated, end of period)

	2006	2007	2008	2009	End-Sep 2010
<b>Capital adequacy</b>					
Regulatory capital to risk-weighted assets 1/	11.0	10.4	11.2	13.1	13.2
Capital (net worth) to assets	8.3	8.2	8.0	8.3	8.7
<b>Asset composition and quality</b>					
Annual growth of bank loans 2/	18.4	22.1	20.9	-8.5	-1.8
Sectoral distribution of bank loans (in % of total)					
Corporates	43.2	39.8	35.3	34.8	33.7
o/w in foreign currency	20.3	20.9	21.3	21.3	20.5
Households	31.5	32.7	36.0	37.0	38.9
o/w in foreign currency	14.8	19.3	25.4	26.0	27.5
Other loans	25.3	27.5	28.7	28.2	27.3
o/w in foreign currency	19.1	22.5	25.0	24.1	22.7
Financial institutions	11.3	10.7	9.5	9.2	8.6
Central government	0.5	0.5	0.2	0.2	0.4
Nonresidents	6.2	9.1	12.2	12.5	11.6
Other	7.2	7.2	6.8	6.4	6.7
Denomination of FX loans to corporates					
EUR	70.8	67.6	66.9	75.2	75.8
USD	4.6	4.9	4.1	3.4	3.3
CHF	24.4	26.4	27.8	20.6	20.0
Other	0.2	1.0	1.1	0.9	0.9
NPLs to gross loans 3/	2.6	2.3	3.0	6.7	9.3
Provisions to NPLs 3/	57.1	64.8	58.9	53.7	53.3
NPLs net of provisions to capital 3/	8.9	6.8	11.3	23.8	33.2
<b>Earnings and profitability</b>					
ROA (after tax) 4/	1.5	1.2	0.8	0.7	0.4
ROE (after tax) 4/	23.8	18.4	11.6	9.4	4.4
Income Share (in % of Total)					
Net interest income to gross income			56.0	55.7	62.0
Trading and fee income to total income	64.7	61.3	30.7	38.9	31.5
Noninterest expenses to gross income	32.3	36.1	50.4	43.3	40.3
Personnel expenses to noninterest expenses	48.7	50.2	49.4	48.2	47.7
Spread between loan and deposit rates 4/	3.5	3.2	2.6	2.3	2.7
<b>Liquidity</b>					
Liquid assets to total assets	20.0	16.4	15.6	22.7	22.1
Liquid assets to short term liabilities	36.8	30.5	31.4	45.2	44.1
Loans to deposits	109.9	121.6	125.1	115.1	112.9
FX liabilities to total liabilities (own capital is excluded)	39.3	42.4	45.6	47.1	45.6
<b>Sensitivity to market risk</b>					
Net open position in FX to capital	7.2	6.0	13.7	16.4	14.6

Source: Magyar Nemzeti Bank.

1/ Capital Adequacy Ratio

2/ Method of calculation: annual growth 2007 = (2007-2006)/2006\*100.

3/ Definition 90 days + overdue, full portfolio

4/ Annualized

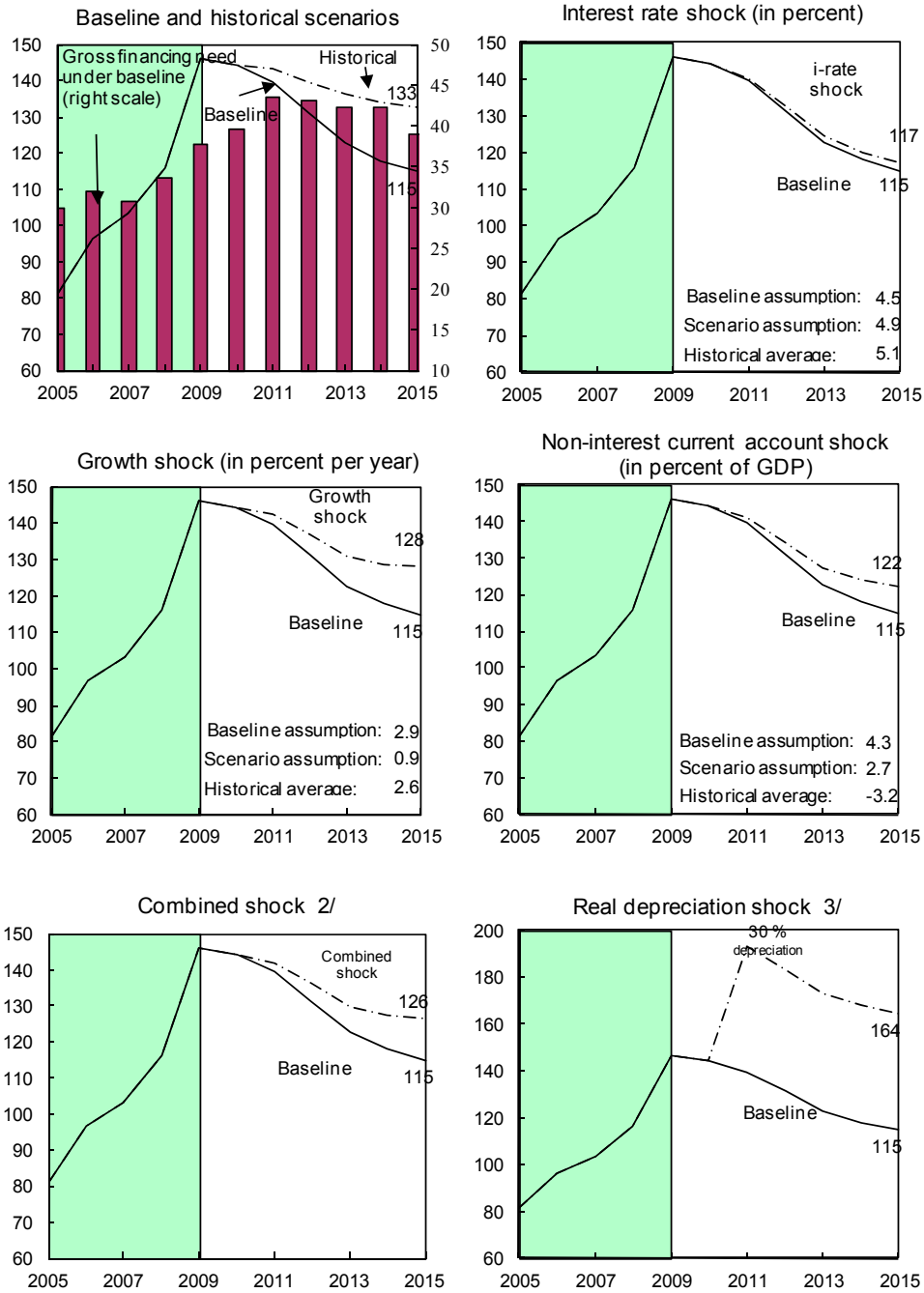
Table 11. Hungary: Indicators of Fund Credit, 2008-16  
(In millions of SDR)

	2008	2009	2010	2011	2012	2013	2014	2015	2016
<b>Existing and prospective Fund credit</b>									
Disbursement	4215	3422	0	0	0	0	0	0	0
Stock 1/	4215	7637	7637	7637	4417	598	0	0	0
Obligations	0	148	186	186	3384	3878	603	0	0
Repurchase	0	0	0	0	3220	3819	598	0	0
Charges	0	148	186	186	164	59	5	0	0
<b>Stock of existing and prospective Fund credit</b>									
In percent of quota	405.9	735.5	735.5	735.5	425.3	57.6	0.0	0.0	0.0
In percent of GDP	4.3	9.1	9.0	8.7	4.8	0.6	0.0	0.0	0.0
In percent of exports of goods and services	5.2	11.8	10.5	9.6	5.1	0.6	0.0	0.0	0.0
In percent of gross reserves	18.8	27.6	26.2	23.2	13.8	1.9	0.0	0.0	0.0
<b>Obligations to the Fund from existing and prospective Fund arrangements</b>									
In percent of quota	0.0	14.2	17.9	17.9	325.9	373.4	58.1	0.0	0.0
In percent of GDP	0.0	0.2	0.2	0.2	3.7	4.0	0.6	0.0	0.0
In percent of exports of goods and services	0.0	0.2	0.3	0.2	3.9	4.1	0.6	0.0	0.0
In percent of gross reserves	0.0	0.5	0.6	0.6	10.5	12.6	1.9	0.0	0.0

Source: IMF staff estimates.

1/ End of period. Calculated based on proposed extension and rephasing of purchases.

Appendix Figure 1. Hungary: External Debt Sustainability: Bound Tests 1/  
(External debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.

3/ One-time real depreciation of 30 percent occurs in 2011.

Appendix Table 1. Hungary: External Debt Sustainability Framework, 2005-15  
(In percent of GDP, unless otherwise indicated) 1/

	Actual					Projections						Debt-stabilizing non-interest current account 7/ -3.8
	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	
<b>1 Baseline: External debt</b>	81.0	96.5	103.2	116.0	146.2	<b>144.2</b>	<b>139.5</b>	<b>131.2</b>	<b>122.8</b>	<b>117.9</b>	<b>114.8</b>	
2 Change in external debt	8.8	15.5	6.7	12.8	30.2	-2.0	-4.7	-8.4	-8.4	-4.9	-3.1	
3 Identified external debt-creating flows (4+8+9)	-2.0	2.8	2.0	0.5	13.3	-4.1	-7.2	-6.2	-5.7	-4.3	-3.1	
4 Current account deficit, excluding interest payments	4.6	4.4	3.2	1.9	-4.9	-5.8	-5.8	-5.1	-4.5	-3.5	-2.4	
5 Deficit in balance of goods and services	1.6	1.4	-0.9	-0.4	-5.1	-6.5	-5.7	-5.1	-4.7	-3.9	-3.0	
6 Exports	67.7	77.1	80.3	81.3	77.2	86.0	90.9	94.8	98.5	100.6	102.5	
7 Imports	69.3	78.5	79.4	80.9	72.1	79.5	85.2	89.7	93.8	96.6	99.5	
8 Net non-debt creating capital inflows (negative) 2/	-5.0	-2.4	4.6	-1.3	-1.0	-1.3	-3.1	-2.9	-3.1	-2.8	-2.7	
9 Automatic debt dynamics 3/	-1.7	0.9	-5.8	-0.2	19.2	3.1	1.8	1.8	1.9	2.0	2.0	
10 Contribution from nominal interest rate	3.2	3.2	3.7	5.4	5.3	4.6	5.7	5.7	5.6	5.4	5.3	
11 Contribution from real GDP growth	-0.9	-2.6	-0.7	-0.8	8.9	-1.6	-3.9	-3.9	-3.7	-3.4	-3.3	
12 Contribution from price and exchange rate changes 4/	-4.0	0.3	-8.8	-4.7	5.0	...	...	...	...	...	...	
13 Residual, incl. change in gross foreign assets (2-3) 5/	10.8	12.7	4.7	12.3	16.9	2.1	2.5	-2.1	-2.7	-0.5	0.0	
External debt-to-exports ratio (in percent)	119.6	125.2	128.5	142.7	189.5	167.7	153.5	138.3	124.6	117.3	112.0	
<b>Gross external financing need (in billions of euros) 6/</b>	26.5	28.7	30.9	35.7	35.1	38.6	44.0	45.9	47.8	50.4	49.3	
in percent of GDP	30.0	32.0	30.6	33.5	37.8	39.7	43.6	43.0	42.3	42.2	39.0	
<b>Scenario with key variables at their historical averages 7/</b>						<b>144.2</b>	<b>143.2</b>	<b>139.7</b>	<b>136.1</b>	<b>134.2</b>	<b>132.6</b>	<b>-7.4</b>
<b>Key Macroeconomic Assumptions Underlying Baseline 8/</b>												
Real GDP growth (in percent)	1.3	3.3	0.8	0.8	-6.7	1.1	2.8	3.0	3.0	3.0	3.0	
GDP deflator in euros (change in percent)	6.3	-1.9	11.3	4.8	-6.5	3.7	0.9	2.4	2.8	2.8	2.7	
Nominal external interest rate (in percent)	4.7	4.1	4.3	5.5	4.0	3.3	4.1	4.3	4.5	4.7	4.8	
Growth of exports (euro terms, in percent)	12.2	15.4	16.9	6.9	-17.2	17.0	9.6	10.0	10.0	8.0	7.8	
Growth of imports (euro terms, in percent)	10.3	14.7	13.6	7.7	-22.3	15.7	11.2	11.1	10.7	8.9	9.0	
Current account balance, excluding interest payments	-4.6	-4.4	-3.2	-1.9	4.9	5.8	5.8	5.1	4.5	3.5	2.4	
Net non-debt creating capital inflows	5.0	2.4	-4.6	1.3	1.0	1.3	3.1	2.9	3.1	2.8	2.7	

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

2/ Includes EU capital transfers.

3/ 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;  $\rho$  = change in domestic GDP deflator in euro terms,  $g$  = real GDP growth rate,  $\varepsilon$  = nominal appreciation (increase in dollar value of domestic currency), and  $\alpha$  = share of domestic-currency denominated debt in total external debt.

4/ 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.  $\rho$  increases with an appreciating domestic currency ( $\varepsilon > 0$ ) and rising inflation (based on GDP deflator).

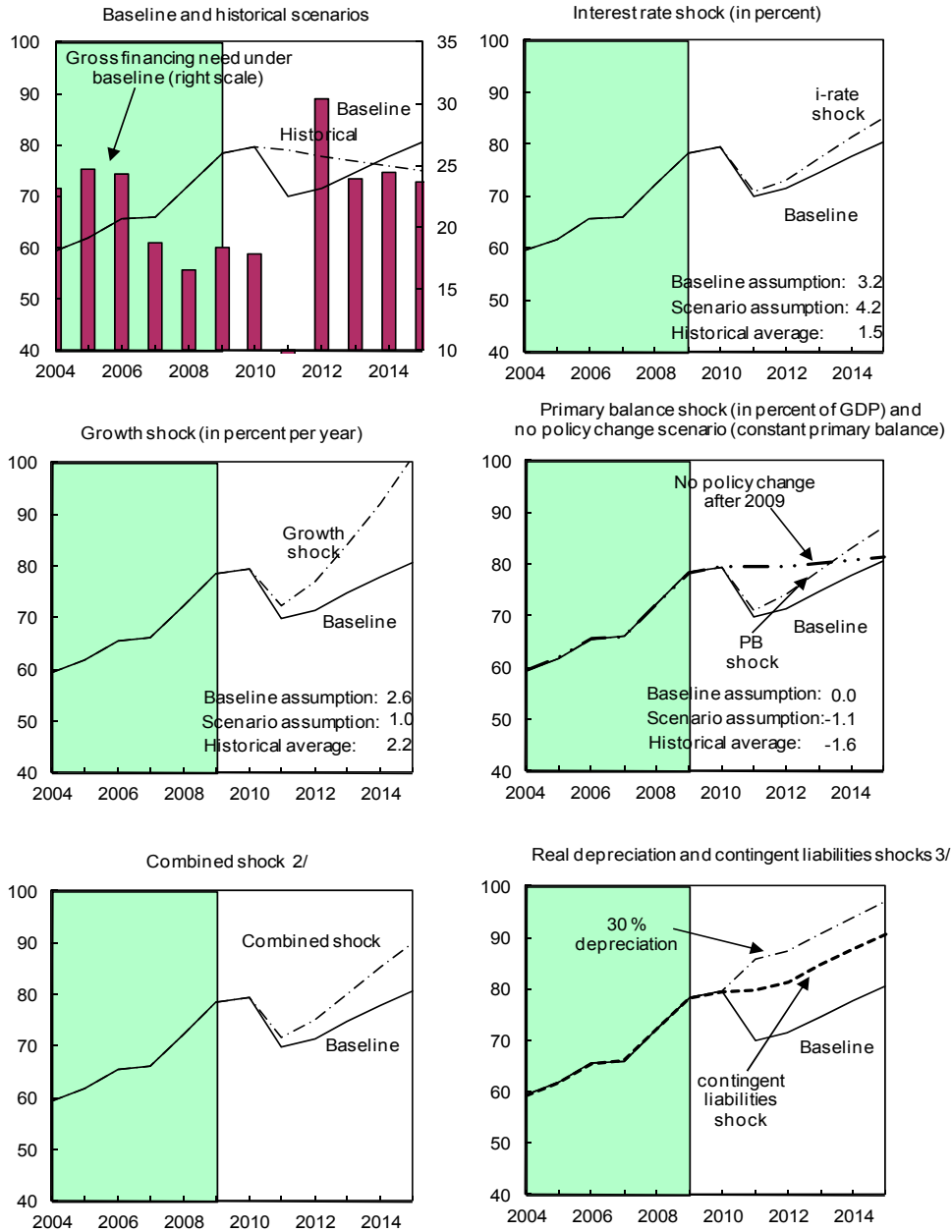
5/ For projection, line includes the impact of price and exchange rate changes.

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

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

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

Appendix Figure 2. Hungary: Public Debt Sustainability: Bound Tests 1/  
(Public debt in percent of GDP)



Sources: International Monetary Fund, country desk data, and staff estimates.  
 1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.  
 2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.  
 3/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2009, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Appendix Table 2. Hungary: Public Sector Debt Sustainability Framework, 2005-15  
(In percent of GDP, unless otherwise indicated)

	Actual											Debt-stabilizing primary balance 9/
	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	
<b>1 Baseline: Public sector debt 1/</b> o/w foreign-currency denominated	61.8	65.6	66.1	72.3	78.4	<b>79.5</b>	<b>69.8</b>	<b>71.5</b>	<b>74.7</b>	<b>77.8</b>	<b>80.6</b>	
	17.4	18.5	18.6	26.1	33.4	33.9	32.5	29.3	28.8	28.3	28.4	<b>0.7</b>
2 Change in public sector debt	2.4	3.8	0.4	6.2	6.1	1.1	-9.6	1.6	3.2	3.1	2.8	
3 Identified debt-creating flows (4+7+12)	5.2	1.7	-0.8	2.5	6.4	1.5	-10.0	1.6	3.2	3.1	2.8	
4 Primary deficit	3.7	5.4	0.9	-0.4	-0.1	0.2	-9.5	1.6	3.0	2.6	2.3	
5 Revenue and grants	42.3	42.6	45.1	45.1	46.0	44.3	52.9	41.3	39.5	39.6	39.8	
6 Primary (noninterest) expenditure	46.0	48.0	46.0	44.7	45.9	44.5	43.3	42.9	42.5	42.2	42.0	
7 Automatic debt dynamics 2/	3.4	-2.4	-1.7	2.9	6.5	1.3	-0.5	0.0	0.2	0.4	0.6	
8 Contribution from interest rate/growth differential 3/	0.6	-0.7	0.1	0.6	6.5	1.3	-0.5	0.0	0.2	0.4	0.6	
9 Of which contribution from real interest rate	2.9	1.6	-1.4	1.1	1.5	2.2	1.6	2.0	2.2	2.5	2.8	
10 Of which contribution from real GDP growth	-2.3	-2.3	1.5	-0.5	5.0	-0.9	-2.1	-2.0	-2.0	-2.1	-2.2	
11 Contribution from exchange rate depreciation 4/	2.8	-1.7	-1.8	2.3	-1.3	...	...	...	...	...	...	
12 Other identified debt-creating flows	-2.0	-1.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
13 Privatization receipts (negative)	-2.0	-1.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
14 Recognition of implicit or contingent liabilities	0.0	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) 5/	-2.8	2.1	1.3	3.8	-0.3	-0.4	0.4	0.0	0.0	0.0	0.0	
Public sector debt-to-revenue ratio 1/	146.3	154.1	146.6	160.2	170.4	179.2	132.2	172.9	189.2	196.3	202.5	
<b>Gross financing need 6/</b> in billions of U.S. dollars	24.6	24.3	18.7	16.6	18.3	17.8	7.9	30.4	23.9	24.4	23.7	
	27.2	27.5	25.9	26.0	23.7	23.1	10.7	43.2	35.9	38.5	39.3	
<b>Scenario with key variables at their historical averages 7/</b>						<b>79.5</b>	<b>78.9</b>	<b>77.9</b>	<b>76.9</b>	<b>76.0</b>	<b>75.0</b>	<b>-1.0</b>
<b>Scenario with no policy change (constant primary balance) in 2009-2015</b>						<b>79.5</b>	<b>79.5</b>	<b>79.7</b>	<b>80.1</b>	<b>80.7</b>	<b>81.5</b>	<b>0.7</b>
<b>Key Macroeconomic and Fiscal Assumptions Underlying Baseline</b>												
Real GDP growth (in percent)	4.0	4.0	-2.5	0.8	-6.7	1.1	2.8	3.0	3.0	3.0	3.0	
Average nominal interest rate on public debt (in percent) 8/	7.4	6.9	6.6	6.6	6.1	5.3	5.1	5.5	6.2	6.4	6.6	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	5.2	3.0	-2.6	1.8	1.7	2.9	2.2	3.1	3.4	3.6	3.9	
Nominal appreciation (increase in US dollar value of local currency, in percent)	-15.6	11.5	11.0	-11.2	4.8	...	...	...	...	...	...	
Inflation rate (GDP deflator, in percent)	2.2	3.9	9.2	4.8	4.4	2.4	2.9	2.4	2.8	2.8	2.7	
Growth of real primary spending (deflated by GDP deflator, in percent)	7.2	8.6	-6.6	-1.9	-4.3	-1.9	0.2	1.9	2.0	2.3	2.5	
Primary deficit	3.7	5.4	0.9	-0.4	-0.1	0.2	-9.5	1.6	3.0	2.6	2.3	
Memorandum item												
Growth of real public debt	7.0	7.8	-0.2	11.7	0.0	1.2	-10.3	4.3	7.4	6.9	6.4	

1/ General government gross debt.

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;  $\pi$  = growth rate of GDP deflator;  $g$  = real GDP growth rate;  $\alpha$  = share of foreign-currency denominated debt; and  $\varepsilon$  = 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/ For projections, this line includes exchange rate changes.

6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.

8/ Derived as nominal interest expenditure divided by previous period debt stock.

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



INTERNATIONAL MONETARY FUND

HUNGARY

**Staff Report for the 2010 Article IV Consultation and  
Proposal for Post-Program Monitoring—Informational Annex**

Prepared by the European Department

January 11, 2011

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II.	Statistical Issues.....	4

**APPENDIX I. HUNGARY: FUND RELATIONS**  
(As of January 10, 2011)

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

II. <b>General Resources Account:</b>		<b>SDR Million</b>	<b>Percent of Quota</b>
	Quota	1,038.40	100.00
	Fund holdings of currency	8,601.57	828.35
	Reserve position in Fund	73.83	7.11

III. <b>SDR Department</b>		<b>SDR Million</b>	<b>Percent of Allocation</b>
	Net cumulative allocation	991.05	100.00
	Holdings	749.64	75.64

IV. <b>Outstanding Purchases and Loans:</b>		<b>SDR Million</b>	<b>Percent of Quota</b>
	Stand-By Arrangements	7,637.00	735.46

V. <b>Financial Arrangements:</b>			<b>Amount Approved</b>	<b>Amount Drawn</b>	
	<b>Type</b>	<b>Date of Arrangement</b>	<b>Expiration Date</b>	<b>(SDR Million)</b>	<b>(SDR Million)</b>
	Stand-by	11/6/08	10/5/10	10,537.50	7,637.00
	Stand-by	3/15/96	2/14/98	264.18	0.00
	Stand-by	9/15/93	12/14/94	340.00	56.70

VI. **Projected Payments to Fund:** (SDR million; based on existing use of resources and present holdings of SDRs)

		<u>Forthcoming</u>			
		<u>2011</u>	<u>2012</u>	<u>2013</u>	<u>2014</u>
	Principal		3,220.19	3,818.50	598.31
	Charges/Interest	196.83	173.47	64.03	5.99
	Total	196.83	3,393.65	3,882.53	604.30

VII. **Exchange Rate Arrangement:**

The de facto exchange rate arrangement for the Hungarian forint is floating, effective November 1st, 2008.

VIII. **Article IV Consultations:**

Hungary is on a 12-month consultation cycle. The last Article IV Board discussion took place on September 17, 2008. The associated Executive Board assessment is available at <http://www.imf.org/external/np/sec/pn/2008/pn08124.htm> and the staff report and selected issues papers at <http://www.imf.org/external/pubs/cat/longres.cfm?sk=22374.0> and <http://www.imf.org/external/pubs/cat/longres.cfm?sk=22375.0>. Hungary has accepted the obligations of Article VIII and maintains an exchange rate system free of restrictions on the making of payments and transfers on current international transactions except for those maintained solely for the preservation of national or international security and that have been notified to the Fund pursuant to Executive Board Decision No. 144-(52/51).

IX. **Technical Assistance:**

<b>Year</b>	<b>Department.</b>	<b>Purpose</b>	<b>Date</b>
2007	FAD	Tax policy	April
2007	FAD	Public financial management	June
2007	FAD	Tax administration	October
2008	FAD	Pension reform	May
2008	FAD	Tax administration	October
2009	FAD	Tax administration	March
2009	MCM	Banking Supervision	July
2009	FAD	Tax administration	August
2009	LEG	Bank resolution framework	September
2009	FAD	Tax administration	November
2010	FAD	Expenditure Rationalization	June
2010	MCM	Macro Modeling	July
2010	FAD	Tax Revenue Forecasting	September
2010	MCM	Macro Modeling	November

X. **Resident Representative:** Ms. Iryna Ivaschenko assumed her duties on May 1, 2009.

**APPENDIX II. HUNGARY—STATISTICAL ISSUES**  
As of January 10, 2011

<b>I. ASSESSMENT OF DATA ADEQUACY FOR SURVEILLANCE</b>	
<b>General:</b> Data provision is adequate for surveillance	
<p><b>Government Finance Statistics:</b> Data reporting on fiscal accounting needs to be improved further. The monthly cash-basis accounts of the central government prepared by the Ministry of Finance and National Economy do not reflect the GFS presentation. This complicates staff's ability to analyze trends and to appropriately anticipate the impact on general government accounts. Data on revenue and expenditure arrears has been readily provided by the authorities upon request, but provision of this data on an automatic basis would facilitate the monitoring of obligations on an accrual basis. Similarly, automatic provision of local government revenues and expenditures, as well as of financial statements of state-owned enterprises (an important source of contingent liabilities), would allow for closer regular monitoring of the general government. Currently, in the absence of a specific request for this information, local government finances can only be monitored from the financing flows as compiled by the central bank.</p>	
<b>II. DATA STANDARDS AND QUALITY</b>	
Subscriber to the Fund's Special Data Dissemination Standard (SDDS) since May, 1996	Hungary published its original ROSC Data Module in 2001 and updates are available on the IMF internet web site. The latest update is <i>Hungary: Report on the Observance of Standards and Codes—Data Module, 2004 Update</i> (July 2004).

## Hungary: Table of Common Indicators Required for Surveillance

As January 10, 2011

	Date of latest observation	Date received	Frequency of Data <sup>7</sup>	Frequency of Reporting <sup>7</sup>	Frequency of publication	Memo Items:	
						Data Quality – Methodological soundness <sup>8</sup>	Data Quality Accuracy and reliability <sup>9</sup>
Exchange Rates	1/7/2011	1/7/2011	D and M	D and M	D and M		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities <sup>1</sup>	Dec 2010	1/7/2011	M	M	M		
Reserve/Base Money	Nov 2010	12/31/2010	M	M	M	O,O,LO,LO	O,O,O,O,LO
Broad Money	Nov 2010	12/31/2010	M	M	M		
Central Bank Balance Sheet	Nov 2010	12/31/2010	M	M	M		
Consolidated Balance Sheet of the Banking System	Nov 2010	12/31/2010	M	M	M		
Interest Rates <sup>2</sup>	Dec 2010	1/5/2011	M	M	M		
Consumer Price Index	Dec 2010	1/14/2011	M	M	M	O,O,O,O	O,O,O,O,NA
Revenue, Expenditure, Balance and Composition of Financing <sup>3</sup> – General Government <sup>4</sup>	2009	4/1/2010	A	A	A	O,LNO,LO,O	LO,O,O,O,NA
Revenue, Expenditure, Balance and Composition of Financing – Central Government	Dec 2010	1/10/11	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt <sup>5</sup>	Q3 2010	1/3/2011	Q	Q	Q		
External Current Account Balance	Q3 2010	12/30/2010	Q	Q	Q	O,LO,LO,LO	O,O,O,O,NA
Exports and Imports of Goods and Services	Q3 2010	12/30/2010	Q	Q	Q		
GDP/GNP	Q3 2010	12/9/2010	Q	Q	Q	O,O,O,LO	O,LO,O,O,NA
Gross External Debt	Q3 2010	12/30/2010	Q	Q	Q		
International investment Position <sup>6</sup>	Q3 2010	12/30/2010					

<sup>1</sup>Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.

<sup>2</sup>Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.

<sup>3</sup>Foreign, domestic bank, and domestic nonbank financing.

<sup>4</sup>The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.

<sup>5</sup>Including currency and maturity composition.

<sup>6</sup>Includes external gross financial asset and liability positions vis-à-vis nonresidents.

<sup>7</sup>Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A); Irregular (I); Not Available (NA).

<sup>8</sup>Reflects the assessment provided in the data ROSC and Substantive Update published in May 2001 and July 2004, respectively, and based on the findings of the respective missions that took place during January 2001 and January 2004 for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning (respectively) concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O), largely observed (LO), largely not observed (LNO), or not observed (NO).

<sup>9</sup>Same as footnote 8, except referring to international standards concerning (respectively) source data, statistical techniques, assessment and validation of source data, assessment and validation of intermediate data and statistical outputs, and revision studies

**Statement by the Staff Representative on the Hungary  
Executive Board Meeting  
January 31, 2011**

1. **This statement provides information that has become available since the issuance of the staff report (EBS/11/8).** The new information does not alter the thrust of the staff appraisal.
2. **Based on preliminary Central Government data, the authorities 2010 fiscal deficit target of 3.8 percent of GDP was just about met in cash terms.** The budget outcome in ESA95 terms is expected to be available only in mid-2011.
3. **The dismantling of the second pension pillar is proceeding as planned.** According to the law passed in December, all second pillar assets are automatically transferred to the first pillar unless the individual contributor actively opts out. Thus far, only some 40,000 out of a total of 3.1 million private pension fund members have done so, suggesting that virtually all second pillar pension assets will be transferred to the state.
4. **The authorities announced elements of the structural reform package to be formally discussed by the government in February.** According to initial statements, the reforms could include better targeted social benefits, a redesign of drug subsidies, and broadening of the tax base. Several of the proposals appear in line with guidance from past IMF technical assistance and recommendations under the 2008–10 Stand-By Arrangement. Depending on the size and nature of these measures, the package could help address debt sustainability concerns raised in the staff report. Staff's assessment will be provided as part of the first post-program monitoring report.
5. **On January 24, the Central Bank increased the policy rate by 25 basis points to 6 percent.** The press statement cited cost-push shocks amid unanchored inflation expectations as driving the decision. Inflation rose to 4.6 percent in December (above the 4.4 percent consensus and 3 percent center target), driven largely by food and energy prices but also an incipient upward trend in core inflation. Amid still high unemployment of 11 percent, real wage growth was roughly flat. However, the annual collective wage negotiation in December, which agreed to recommend a general wage increase of 4–6 percent for 2011, could provide upward pressure going forward.
6. **The latest balance of payments data suggest that Hungary, unlike regional peers, experienced net capital outflows in both Q2 and Q3, 2010.** This reflects, inter alia, a further decline of parent banks' funding of their Hungarian subsidiaries. According to preliminary data, at end-December 2010 aggregate funding of the six subsidiaries that had participated in European Bank Coordination Initiative (EBCI) stood at 120 percent of end-September 2008 level, compared to peak exposure of 140 percent at end-July 2010. The counterpart of the funding decline has been a reduction banks' liquid assets, especially central bank bills.
7. **Prime Minister Orban publicly stated that the government is considering to partially repay the IMF early.** While timing and amount are still unclear, technical staff have indicated that the government may tap foreign exchange deposits at the MNB earmarked for contingent bank funding (€3 billion or roughly one third of outstanding IMF debt) to finance the repayment. Such a move would reduce Hungary's fiscal and foreign exchange reserve buffers while paying down low cost debt. At present, Hungary's official reserves stand at €33 billion, equivalent to 81 percent of short term debt.



INTERNATIONAL MONETARY FUND

*Public Information Notice*

EXTERNAL  
RELATIONS  
DEPARTMENT

Public Information Notice (PIN) No. 11/15  
FOR IMMEDIATE RELEASE  
February 3, 2011

International Monetary Fund  
700 19<sup>th</sup> Street, NW  
Washington, D. C. 20431 USA

## **IMF Executive Board Concludes 2010 Article IV Consultation and Proposal for Post-Program Monitoring with Hungary**

On January 31, 2011, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation and Proposal for Post-Program Monitoring with Hungary.<sup>1</sup>

### **Background**

Hungary was hit hard by the global crisis, given large underlying vulnerabilities and considerable integration with international markets. The adoption of a sustainable fiscal stance and policies to safeguard financial stability in the context of substantial assistance from the IMF and European Union helped avoid a financial meltdown, but could not avert a deep recession. Economic output fell nearly 7 percent in 2009 because the global retrenchment in trade sharply reduced exports while financial strains and limited policy space weighed on domestic demand.

The economy has begun to rebound with exports increasing for six consecutive quarters and employment rising since February 2010. More recently, signs of a pick-up in private consumption have also emerged. As a result, GDP growth is expected to be around 1 percent in 2010 and the sharp correction in the current account, which reached a surplus early in the year, has begun to slow. The recovery is nonetheless fragile and large vulnerabilities persist. In this environment, risk premia remain elevated and volatile.

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<sup>1</sup> 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. An explanation of any qualifiers used in summings up can be found here: <http://www.imf.org/external/np/sec/misc/qualifiers.htm>.

The government that took office in mid-2010 has used its considerable political mandate to fundamentally reorient fiscal policies. Following the considerable structural fiscal adjustment by the previous government, the new authorities embarked on tax cuts and targeted support to small and medium-sized enterprises, aimed at jumpstarting growth. The government has sought to maintain its previously agreed deficit target of 3.8 percent in 2010 via temporary levies on primarily foreign-owned financial institutions, retail chains, telecommunication and energy companies, as well as the diversion of second pillar private pension contributions to the budget. The government is not seeking a renewal of the now expired IMF/EU-supported program.

The financial sector has remained resilient throughout the crisis. After initial strains in late 2008, banks substantially increased liquidity and capitalization to adequate levels. However, more recently, profitability has begun to fall sharply amid rising non-performing loans. As the financial sector began to stabilize in early 2009, the Central Bank (MNB) reduced the policy rate by over 600 basis points from a crisis high of 11.50 percent. The MNB paused in mid-2010 and has tightened interest rates by 50 basis points since November in response to a sharp rise in risk premia and higher headline inflation prints.

### **Executive Board Assessment**

Executive Directors commended the ongoing recovery of the Hungarian economy in the aftermath of a sharp fall in output in 2009 and welcomed the improvement in capital and liquidity financial indicators. Given the still fragile state of the economy and continued large vulnerabilities, notably the dependence on foreign funding, Directors underscored the importance of implementing a consistent medium-term macroeconomic framework that reduces uncertainty and lowers risk spreads.

Directors noted that the main challenge will be to establish a sustainable fiscal stance over the medium term. While the recent tax reduction could improve competitiveness, it also entails a substantial fiscal cost. Directors stressed that measures taken thus far to offset this revenue loss, including levies on select industries, are in large part temporary and distortionary. They noted that the unwinding of the defined-benefit private pension pillar, in particular, is a source of concern as it increases medium-term fiscal risks while reducing transparency.

Directors pointed toward a need for durable expenditure rationalization in the near term, notably better targeting of social benefits and restructuring of state-owned transportation companies. In this context, they welcomed the authorities' plan to detail a comprehensive set of structural fiscal reforms in February.

Directors underscored the importance of addressing financial sector vulnerabilities. The ongoing rise in credit losses, driven in part by the impact of the strong Swiss Franc on the balance sheets of households indebted in foreign currency, has placed new burdens on banks. In this context, Directors welcomed efforts to support distressed mortgage holders, as long as moral hazard and fiscal costs are contained. They noted that bank earnings are already under pressure due to the disproportionately large levy on assets that could also dampen credit growth and undermine the economic recovery.



Directors welcomed action to strengthen the legal authority of the Hungarian Financial Supervisory Agency. They noted, however, that the weakening of the Financial Stability Council reduces the capacity to monitor and control systemic risk.

Directors noted that the central bank's recent tightening amid elevated risk premia and incipient price pressures helped anchor inflation expectations and protect the financial sector. However, Directors underscored that there is still substantial slack in the economy, as evidenced in particular by high unemployment. They emphasized that a sound medium-term fiscal framework would create room for monetary easing.

Directors expressed concern over the weakening of economic governance, noting that steps to lessen the independence of both the Fiscal and the Monetary Policy Councils and the reduced role of the Constitutional Court in assessing budgetary matters undermine key checks and balances. Directors underscored that these steps run counter to the authorities' stated goal of restoring investor confidence and lowering borrowing costs.

Directors welcomed the use of post-program monitoring, which will maintain a close policy dialogue between the Hungarian authorities and the Fund.

**Public Information Notices (PINs)** form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The [staff report](#) (use the free [Adobe Acrobat Reader](#) to view this pdf file) for the 2010 Article IV Consultation with Hungary is also available.

## Hungary: Selected Economic Indicators, 2006–11

	2006	2007	2008	2009	2010	2011
					Projections	
<b>Real economy</b> (change in percent)						
Real GDP	3.3	0.8	0.8	-6.7	1.1	2.8
Total domestic demand 1/	0.3	-2.3	0.7	-12.6	-2.4	2.3
Private consumption	2.1	-1.7	0.6	-6.8	-2.3	2.1
Gross fixed investment	-3.2	1.7	2.9	-8.0	-2.5	0.7
Foreign balance 1/	3.0	3.0	0.2	5.9	3.5	0.6
Exports	18.7	16.2	5.7	-9.6	13.8	8.9
Imports	14.9	13.3	5.8	-14.6	11.9	9.4
CPI (end year)	6.5	7.4	3.5	5.6	4.2	3.9
CPI (average)	3.9	7.9	6.1	4.2	4.9	4.1
Unemployment rate (average, in percent)	7.5	7.4	7.8	10.1	11.1	11.2
Gross domestic investment (percent of GDP) 2/	24.0	23.5	23.7	19.2	18.3	18.8
Gross national saving (percent of GDP, from BOP)	16.4	16.6	16.4	18.7	19.5	19.0
<b>General government</b> (percent of GDP), ESA-95 basis 3/						
Overall balance	-9.3	-5.0	-3.7	-4.4	-4.0	5.6
Primary balance	-5.4	-0.9	0.4	0.3	0.1	9.5
Primary structural balance	-6.1	-0.9	0.2	2.8	0.8	-0.3
Debt	65.7	66.1	72.3	78.4	79.5	69.9
<b>Money and credit</b> (end-of-period, percent change)						
Broad money	13.6	11.0	8.8	3.4	4.1	8.3
Lending to the private sector, flow-based	20.6	18.5	12.2	-2.3	1.0	5.0
<b>Interest rates</b> (percent)						
T-bill (90-day, average)	7.0	7.6	8.9	8.9	...	...
Government bond yield (5-year, average)	7.4	7.0	9.3	9.3	...	...
<b>Balance of payments</b>						
Goods and services trade balance (percent of GDP)	-1.4	0.9	0.4	5.1	6.5	5.7
Current account (percent of GDP)	-7.6	-6.9	-7.3	-0.5	1.2	0.1
Reserves (in billions of euros)	16.4	16.4	24.0	30.7	33.5	38.0
Gross external debt (percent of GDP) 4/	96.5	103.2	116.0	146.2	144.2	139.5
<b>Exchange rate</b>						
Exchange regime					Floating	
Present rate (December 15, 2010)					Ft 207.3 = US\$1; Ft. 274.4 = €1	
Nominal effective rate (2005=100)	93.9	99.6	100.9	91.8	...	...
Real effective rate, CPI basis (2005=100)	95.4	106.4	110.2	103.8	...	...
<b>Quota at the Fund</b>						
					SDR 1038.4 million	

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

1/ Contribution to growth. Calculated using 2000 prices. It includes change in inventories.

2/ Includes change in inventories.

3/ Consists of the central budget, social security funds, extrabudgetary funds, and local governments. It includes the IMF staff assessment of the impact of all government announced measures (October 2010), including the full amount of the bank levy in 2011.

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