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HUNGARY

April 2015

2015 ARTICLE IV CONSULTATION—STAFF REPORT; PRESS RELEASE; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR HUNGARY

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2015 Article IV consultation with Hungary, the following documents have been released and are included in this package:

- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on March 27, 2015, following discussions that ended on January 30, 2015, 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 March 11, 2015.
- An **Informational Annex** prepared by the IMF.
- A **Staff Statement** of March 27, 2015 updating information on recent developments.
- A **Press Release** summarizing the views of the Executive Board as expressed during its March 27, 2015 consideration of the staff report that concluded the Article IV consultation with Hungary.
- A **Statement by the Executive Director** for Hungary.

The document listed below has been or will be separately released.

Selected Issues Paper

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

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INTERNATIONAL MONETARY FUND

HUNGARY

STAFF REPORT FOR THE 2015 ARTICLE IV CONSULTATION

March 11, 2015

KEY ISSUES

Context. The economy is recovering steadily helped by supportive macroeconomic policies and improved market sentiment. There has been a welcome decline in vulnerabilities but debt levels remain elevated, leaving the economy prone to shocks, and medium-term growth prospects appear subdued. The government took steps to address these challenges, but the overall strategy relies on measures that increase the role of the state in the economy and shift the burden of the adjustment to specific sectors. This may deter private domestic and foreign direct investment.

Policy recommendations. Policies should aim at further reducing vulnerabilities and comprehensively tackling impediments to strong, private sector-led growth.

- **Fiscal policy.** Adopt a growth-friendly fiscal consolidation strategy to rebuild room for policy maneuver and sustainably reduce the public debt ratio. The strategy should rely on durable expenditure retrenchment, improved efficiency of spending, and a simplification of the tax system, including a gradual elimination of distortionary sectoral taxes.

- **Monetary policy.** Monetary policy needs to guard against building disinflationary pressures. Adequate reserves are necessary to support financial stability.

- **Financial sector.** Strengthen efforts (and follow up on recently-announced commitments) to repair financial intermediation by improving the operating environment for banks. Steps should include facilitating faster cleanup of bank portfolios and reducing the tax burden on banks. The Funding for Growth Scheme should remain targeted and time bound; while the role of the state in the banking sector should be contained.

- **Structural reforms.** Increase policy predictability and reduce state interference in the economy to help strengthen confidence and support private investment. Adopt policies to enhance labor participation, particularly among women and older workers; improve the business environment; and enhance competitiveness.

Approved By
Jörg Decressin (EUR) and Mark Flanagan (SPR)

Discussions took place in Budapest during January 21–30, 2015. The staff team comprised Messrs. Christou (Head) and Klein, Mses. El-Ganainy (all EUR), Jenkner (FAD), and Sanya (SPR); and was joined by Mr. Roaf (senior regional resident representative, EUR) for a few days. Mr. Benk (OED) attended most meetings. Ms. Samuel and Mr. Scutaru (both EUR) assisted in the preparation of the staff report. The staff team met with State Secretaries of the Ministry for National Economy Orban and Banai, State Secretary for Energy Affairs of the Ministry for National Development Aradszki, Central Bank of Hungary (MNB) Deputy Governor Balog, other senior officials, and representatives from the private sector and think tanks. A workshop was held in Budapest during the mission jointly with the MNB and the Ministry for National Economy to discuss background papers prepared by staff (included in the Selected Issues Paper (SIP) accompanying this report) and the authorities. Hungary is an Article VIII country (Informational Annex: Fund Relations). Data provision is adequate for surveillance (Informational Annex: Statistical Issues).

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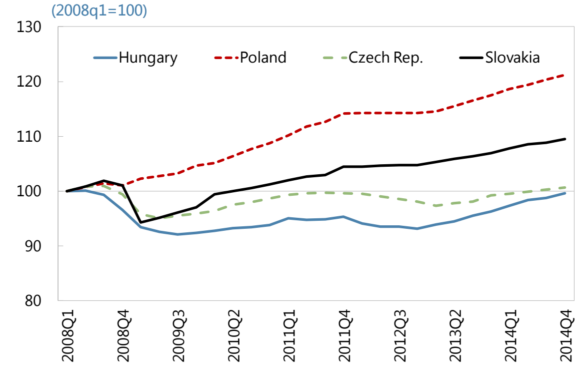
CONTEXT

1. **Economic recovery has gained momentum and vulnerabilities have declined, but underlying weaknesses continue to weigh on Hungary's growth potential.** Expansionary macroeconomic policies contributed to strong output growth in 2014 and real GDP is about to reach its pre-crisis level. Vulnerabilities have declined, but debt levels remain elevated and the associated high financing needs pose significant risks, particularly given the heavy reliance on non-resident funding, and the large concentration of the investor base. Thus, a shift in market sentiment could destabilize the economy, particularly in light of its exposure to exchange rate risk. Weak underlying fundamentals, along with policy unpredictability and a frail business environment cloud Hungary's medium-term growth prospects. A comprehensive strategy in needed to nurture a continued recovery and stronger medium-term growth prospects, while reducing vulnerabilities.

Real GDP: Hungary and Peers
(2008q1=100)



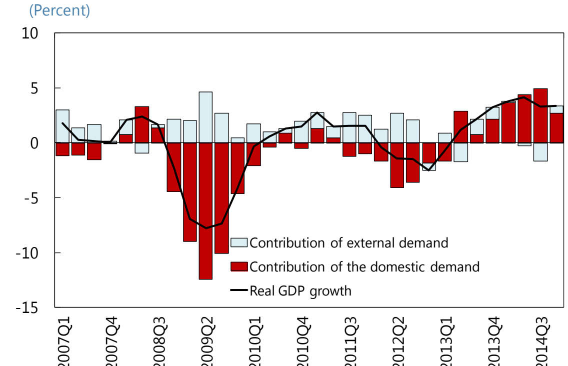
Sources: Haver and IMF staff calculations.

2. **The role of state in the economy has been increasing.** The government acquired energy companies and foreign bank subsidiaries, increased the scope of sectoral taxes, and boosted disposable incomes by expanding public works, cutting administered utility prices, and introducing the Settlement Act, which required banks to compensate borrowers for deemed unfair lending practices (Appendix I). In contrast, the government welcomes FDI in manufacturing, where it sees significant benefits to the Hungarian economy. Recently, it committed to improve the operating environment of banks.

BACKGROUND AND RECENT DEVELOPMENTS

3. **The economy is growing at a strong pace, helped by accommodative policies and improved market sentiment.** Driven by strong domestic demand, output expanded by 3½ percent in 2014. This reflects expansionary macroeconomic policies, higher investment on the back of increased utilization of EU funds, and a boost to consumption from utility price cuts. The contribution of net exports was largely driven by the rapid growth of imports. Nevertheless, improving terms of trade and strong export volume growth helped maintain a strong current account surplus.

Real GDP Growth and Contribution to Growth
(Percent)

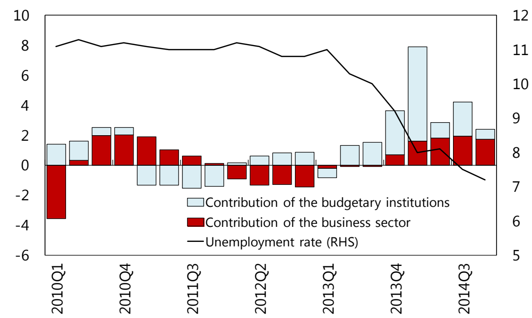


Sources: Haver and IMF staff's calculations.

4. Inflation continued its precipitous fall. In the face of a negative output gap, administered price cuts, and a drop in import prices, headline and core inflation decelerated sharply, to -1 and 1 percent, respectively, in February. Inflation expectations continued to drop to 2.2 percent, below the National Bank of Hungary's (MNB) 3 percent inflation target.

5. Unemployment declined sharply, but appreciable slack remains. The unemployment rate stood at 7.2 percent in 2014:Q4, reflecting the expansion of public works programs and job creation in the private sector. Nominal wage growth in the private sector moderated to about 3½ percent in 2014:Q4. Moreover, the labor participation rate increased by 2 percentage points, but, at 67 percent, it remains significantly below the EU average.

Unemployment Rate and the Sectoral Contribution to Employment Growth (y-o-y)



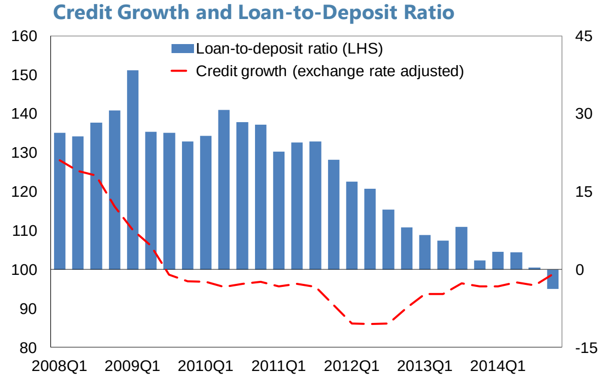
Sources: Haver Analytics and IMF staff's calculations.

6. The 2014 fiscal deficit came in below target and the public debt ratio is estimated to have declined moderately. Preliminary estimates suggest that the deficit reached 2.6 percent of GDP against the 2.9 percent target, as revenues were propelled by accelerating economic activity and tax administration improvements. However, this performance masks a strong pro-cyclical increase in spending, especially on wages, and goods and services, and the fiscal impulse is estimated at 1⅓ percent of GDP. The public debt-to-GDP ratio declined moderately to just below 77 percent.

7. Monetary conditions remain accommodative. In the absence of inflationary pressures, and in the face of a negative output gap and improved risk premia, MNB kept its policy rate at a record low 2.1 percent since July 2014 and signaled its intent to maintain an accommodative monetary stance for an extended period. Meanwhile, forward rate agreements are pricing a 30 bps policy rate cut in the next 12 months. In October 2014, MNB also decided to double the allocation for the second phase of the Funding for Growth Scheme (FGS) to the equivalent of 3¼ percent of GDP and extended the program to end-2015.

8. Pressure on banks continues and state intervention in the banking sector is increasing. Private sector credit keeps contracting and the loan-to-deposit ratio has dropped to 95 percent. A heavy tax burden, significant loan-loss provisioning, and the Settlement Act have kept the banking sector in the red. Moreover, the Fair Banking Act—although increasing the transparency of pricing—will weigh on future bank profitability. Against a non-performing loan (NPL) ratio of 16 percent and sluggish portfolio cleaning, MNB set up an Asset Management Company (MARK) that will buy up to the equivalent of 1.3 percent of GDP in distressed commercial real estate loans from banks. At the same time, the state is gradually increasing its role in the banking

Credit Growth and Loan-to-Deposit Ratio

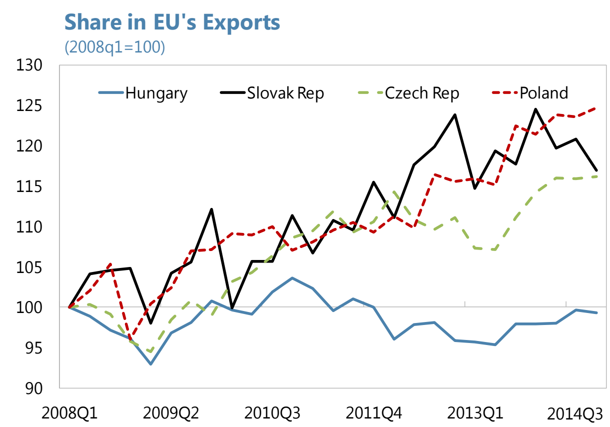


Sources: MNB.

system. Following the acquisition of MKB in 2014, it is about to finalize the purchase of Budapest Bank, and has announced the acquisition of a 15 percent stake in Erste's subsidiary.

9. Despite a reduction in vulnerabilities, external stability concerns remain. Large and persistent current account surpluses, reflecting in part elevated savings to accelerate deleveraging, together with sharp cross-border deleveraging have contributed to a significant decline in external debt to 116 percent of GDP in 2014. However, gross external financing needs of 21 percent of GDP in 2015, about 30 percent of GDP open FX position on private balance sheets, an international investment position of -76 percent of GDP, and heavy reliance on non-resident funding of public debt, raise external stability concerns. Going forward, the decision in November 2014 to convert the FX mortgage stock (25 percent of household loans, almost all denominated in Swiss francs) to local currency loans will result in a reduction in bank foreign liabilities and lower (but still adequate) official reserves (Appendix I).

10. The real exchange rate is broadly in line with fundamentals, but non-price indicators suggest that Hungary faces competitiveness challenges. While the EBA methodology yields mixed results with a negative current account norm, the need to improve Hungary's external balance sheet over time suggests the need for a stronger current account (Box 2). Other price indicators such as unit labor costs do not point to competitiveness problems. However, Hungary's export market share has stagnated compared to its peers; the share of products in the top-quality quartile is low; while skill mismatches and a deteriorating foreign investment environment also weigh on export performance. Finally, Hungary's ranking in the global competitiveness index has slipped, with the institutional framework, transparency of government policy making, and the business and regulatory environment reducing the country's attractiveness for FDI.



Source: IMF Direction of Trade Statistics.

OUTLOOK AND RISKS

11. Staff expects growth to decelerate to 2¾ percent in 2015, on account of a smaller domestic-demand impetus due to less supportive fiscal stance and lower investment growth—given the projected decline in EU funds. Private consumption is expected to continue to grow, reflecting lower household indebtedness, accommodative monetary conditions, and higher employment. Over the medium term, output growth is set to stabilize at around 2 percent. Domestic demand is expected to recover only modestly, due to the ongoing deleveraging and tight credit conditions as time will be necessary for banks to strengthen their balance sheets. Improved terms-of-trade, thanks notably to lower oil prices, are forecast to lead to a higher current account surplus in the short run—which, coupled with continued cross-border bank deleveraging would further improve the IIP. Over the medium term, the current account surplus is expected to gradually decline, owing to a slowdown in deleveraging and aging population dynamics. Headline inflation is projected to remain very low in the coming months on account of a still negative, albeit closing, output gap and lower import prices. Provided monetary policy anchors inflation expectations, inflation will gradually return to target.

12. While there are upside risks to the baseline, the balance of risks—highlighted in the Risk Assessment Matrix—is somewhat tilted to the downside. An abrupt change in risk perception, e.g., from re-emergence of sovereign stress in Europe, further escalation of geopolitical tensions in the region, or financial stress in emerging markets, could lead to capital outflows with adverse effects on government financing and private balance sheets. A protracted period of weak external demand, notably from the euro area, would also weigh on exports. On the domestic front, continued state interference in the economy could have adverse confidence effects, further eroding competitiveness, and foster sharper cross-border deleveraging. On the upside, the Settlement Act and sustained lower oil prices could provide a higher-than-expected boost to purchasing power and investment, while the government's commitment to improve the operating environment of banks could support a fast repair of financial intermediation and higher credit growth.

13. The authorities broadly agreed on the near-term outlook and the balance of risks, but were more optimistic about Hungary's medium-term growth prospects. They shared staff's view that GDP growth would decelerate somewhat this year but were more upbeat about Hungary's medium-term growth potential arguing that the economy's sustained improvement in fundamentals has contributed to increased confidence—as evidenced by the historically low sovereign CDS spreads. Regarding the balance of risks, they agreed that recent banking legislation and lower import prices could boost consumption and investment more than expected, but concurred that deterioration in the external environment represented a key downside risk. Nevertheless, they argued that the risk of capital outflows is low given the increased share of institutional investors and the continued shift to domestic financing of the government, while the vulnerability of balance sheets to exchange rate risk declined significantly following the conversion of FX mortgages.

POLICY DISCUSSIONS

Discussions focused on the need for a comprehensive strategy to support growth and a reduction in vulnerabilities. On the macroeconomic front, staff advocated growth-friendly fiscal consolidation with monetary policy continuing to support growth. Regarding structural policies, staff argued for measures to revive financial intermediation, improve the investment climate, and support greater labor force participation.

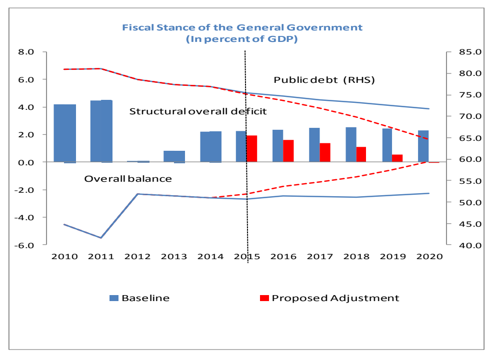
A. Fiscal Policy

14. While welcoming the authorities' commitment to fiscal consolidation, staff noted that their current strategy falls short of reducing public debt significantly over the medium term.

- **The 2015 budget implies a broadly neutral fiscal stance.** Staff projects the 2015 deficit at 2.7 percent of GDP—vis-à-vis a budget target of 2.4 percent—in light of sizeable unidentified revenue sources and less optimistic assumptions on expenditure restraint and gains from tax administration improvements. This would imply only a moderate decline in public debt. The expenditure-to-GDP ratio is expected to remain high, while large allocations to discretionary programs compromise the quality of spending and inefficiencies are significant, particularly in the health sector (Box 3). Moreover, the budget continues to rely on (and includes new) sectoral taxes.[1]

- **Staff projects the public debt ratio to come down only modestly over the medium term.** In staff's view, the authorities' medium-term fiscal target (1.7 percent of GDP structural deficit) is not ambitious and not backed by well-specified policies. For example, although the intention to downsize the public sector is welcome, more concrete steps are needed to rein in spending and add credence to such objectives. The authorities saw limited scope to reduce distortionary sectoral taxes beyond the announced reduction in the bank levy over 2016–19. Based on staff's baseline macro scenario and current policies, the deficit would hover at around 2½ percent of GDP and public debt, at around 72 percent, would remain a significant vulnerability (Appendix II).

15. Staff advocated a growth-friendly fiscal consolidation strategy aimed at reducing debt. To this end, staff recommended a moderate annual structural fiscal tightening by about ½ percent of potential GDP starting in 2015 consistent with a reduction in public debt to below 60 percent of GDP by 2022. The adjustment should be anchored in a medium-term budget framework that would incorporate reforms aimed at enhancing the economy's human and physical capital, while also providing necessary fiscal space and being mindful of equity considerations. With expenditure close to 50 percent of GDP, priority should be given to a sustainable expenditure retrenchment and enhanced composition of spending, which would also create room to gradually rationalize the tax system. Staff thus recommended a menu of options for measures that could be adopted over 2015–20 (text table), including:



- Steps to enhance the efficiency and progressivity of the tax system, including by reducing exemptions and gradually eliminating distortionary sectoral taxes that undermine the simplicity and predictability of tax policies, and reduce profitability with adverse consequences for private investment and growth. In particular, streamlining of financial taxation should contribute to the much-needed restoration of financial intermediation and a recovery in credit growth.

[1] Special taxes are imposed on financial institutions, energy service providers, telecommunications, and retail and advertizing companies; pertinent revenues are projected at 1.9 percent of GDP in 2015, with the majority (1.2 percent) accounted for by taxes on financial institutions.

- Tackling compliance issues, such as VAT fraud, through a comprehensive approach, that focuses on preventing fraud by identifying fraudulent companies at the registration stage and enhancing detection by further mobilizing the AML/CFT framework.

- A more efficient social welfare system based on targeted, conditional transfers linked to revamped active labor market policies that focus on individualized skills-training and job-search assistance.

- A scaling down of costly and inefficient programs, such as the public works program, along with the envisaged reduction in public sector employment to streamline responsibilities, and improved spending efficiency in education and health (see accompanying SIP).

Fiscal Impact of Potential Measure (2015–2020)
(in percent of GDP)

Total [1/]	4.2
Reduction in public sector employment [2/]	0.6
Rationalization of spending on non-EU-related goods and services [3/]	1.5
Scaled-down public works program and improved ALMPs and targeted transfers	0.3
Reduction of public transport tariff subsidies by 50 percent	0.2
Reduction of operational subsidies to transport enterprises by 50 percent	0.4
Streamlining of VAT rates from 3 to 2	0.2
Elimination of selected CIT exemptions (sports, entertainment)	0.3
Elimination of excise exemptions for diesel fuel and tobacco	0.4
Reduction of VAT fraud [4/]	0.9

Sources: IMF staff estimates, based on data provided by the authorities, and FAD and LEG TA reports.
[1/] Total adjustment exceeds recommended net adjustment due to the need to eliminate distortions in the tax system.
[2/] Reduce employment (rather than wages) through consolidation of institutions and responsibilities, attrition; and rationalization of local government employment.
[3/] Savings largely associated with the proposed public sector consolidation and limiting discretionary spending of the central government.
[4/] Assumes implementation of measures, which focus on preventing fraud by identifying fraudulent companies at the registration stage and enhancing detection by further mobilizing the AML/CFT framework.

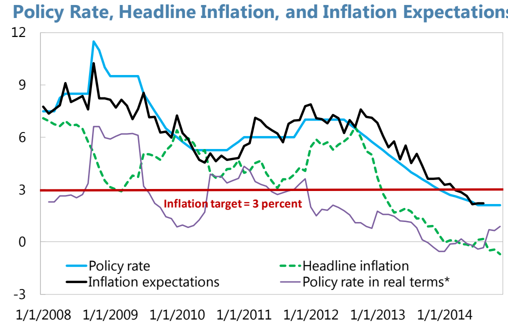
16. The authorities reaffirmed their commitment to fiscal consolidation. While they agreed in principle with some of the fundamental weaknesses of the 2015 budget—for example, the unidentified revenue sources—they underscored their strong commitment to adhering to their national and European fiscal targets. They also saw scope to improve the efficiency of public investment and spending on health and education, and argued that the impact of recent and on-going reforms is yet to yield results. Over the medium term, they project a substantial reduction in the fiscal deficit largely on the basis of past adjustments to the social transfer system and discretionary spending freezes, supported by a stronger macroeconomic outlook than staff's. Should fiscal space materialize, they would reduce the corporate income tax, and cut the flat income tax to lower the still-high tax wedge.

17. Differences in views centered on the efficiency and desirability of select fiscal policy instruments. The authorities strongly defended the public works program—which they plan to expand and include all able-bodied welfare recipients—notwithstanding the recovery of private employment and the scheme's uncertain benefits with regard to helping participants re-enter the primary job market. They also disagreed with the desirability to re-introduce some element of progressivity in the tax system (to counter rising inequality and create fiscal space), and the need to improve the targeting of the Job Protection Act.

B. Monetary Policy

18. Staff's projections suggest that headline inflation will likely remain below target for an extended period. Inflation is projected to moderately pick up later in the year as the effect of last year's administered price cuts wanes and the effect of oil price declines peters out. However, the still negative output gap would exert downward pressure on consumer prices, keeping inflation below target throughout 2016. Furthermore, the weakness in the external environment and the dynamics of oil prices pose downside risks to inflation, particularly if they continue to feed into inflation expectations.

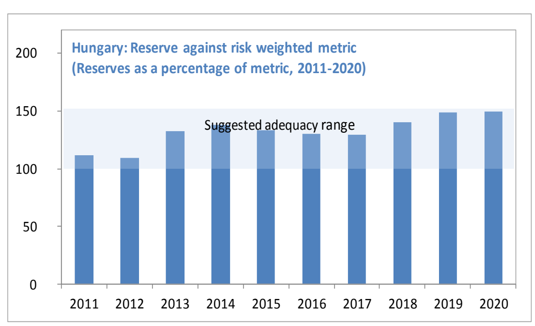
Policy Rate, Headline Inflation, and Inflation Expectations



*Policy rate deflated by core inflation.
Source: MNB , and IMF staff's calculations.

19. Further cautious monetary easing would help guard against persistent disinflationary pressures. Staff recognized that, with the policy rate at a record-low level and increased utilization of the FGS, monetary policy has been supportive, though, with inflation falling of late, the real policy rate has increased. In light of persistent disinflationary pressures, staff saw scope for further easing, particularly given the improved resilience of household balance sheets to exchange rate risk, and potential pressure for capital inflows from easing monetary conditions in the euro area. The recommended fiscal policy stance would provide further scope for monetary easing. Nevertheless, a sharp deterioration in risk perception and capital outflows (perhaps triggered by a sudden jump of the term premium on U.S. long-term interest rates) would require monetary tightening to preserve financial stability. Effective communication about the future trajectory of the policy rate would be critical to avoid adverse market reactions (see accompanying SIP).

20. Reserves are projected to decline but remain within the Fund's adequacy range. At about €34½ billion, Hungary's level of reserves is estimated at slightly below the upper limit of the Fund's adequacy range. Going forward, reserves are projected to fall gradually by 2017 as MNB would provide FX liquidity to help banks close the on-balance sheet open FX position that emerged from the conversion of FX mortgages and the Settlement Act. The envisaged decline in reserves will be accompanied with a reduction in short-term external debt, keeping reserves comfortably within the adequacy range. Nevertheless, on account of



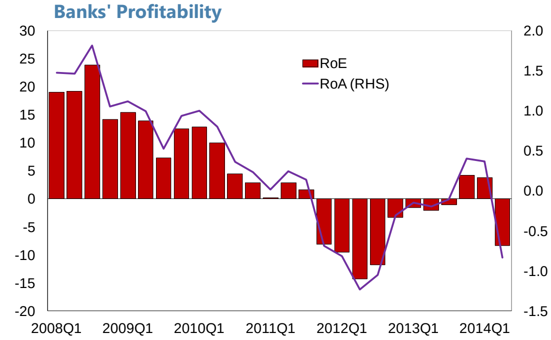
still elevated financial risks, staff underscored the importance of maintaining adequate reserves for safeguarding financial stability.

21. The authorities stressed their intent to maintain accommodative monetary conditions for an extended period. Central bank officials acknowledged that inflation dynamics in recent months were weaker-than-expected, reflecting low imported inflation. They observed that the recent steps by the ECB and the FX mortgage conversion provided greater room for maneuver, and noted that further monetary easing would be considered if disinflationary pressures persist. In this regard, they added that the recent changes in the modalities of the FGS, in which the MNB assumes part of the credit risk are likely to increase its utilization. Finally, the authorities reiterated their commitment to maintain sufficient reserves as a buffer against shocks.

C. Financial Sector

22. The banking sector remains under pressure, though its vulnerability to exchange rate risk has declined. Banks continue to face a contraction in their balance sheets and, while aggregate capital and liquidity positions are adequate, MNB's stress tests suggest that in an unfavorable macroeconomic scenario nearly one-fifth of the banking system could need substantial capital injections. On the other hand, the FX mortgage conversion has significantly reduced private sector's exposure to exchange rate risk, and—while resulting in a more rapid cross-border deleveraging—is likely to improve asset quality and reduce the banking sector's reliance on FX swaps.

Banks' Profitability

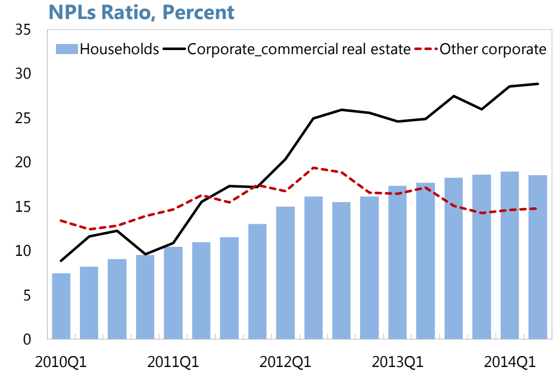


Source: MNB

23. Repairing financial intermediation is critical for sustained growth. With strained balance sheets, banks' willingness to lend is projected to remain limited. Staff, therefore, called for improving the operating environment for banks, including through removing impediments for portfolio cleanup and reducing the tax burden. In this regard, staff welcomes the government's recent commitment to gradually reduce the bank levy and to refrain from steps that could harm bank profitability. While the FGS has improved SME access to finance, there is still scope to modify the scheme to better support monetary transmission and enhance its impact on growth, possibly by linking the lending rate to the policy rate in a manner that adequately compensates banks for lending to riskier SMEs. Staff repeated its call to keep the FGS limited, targeted, and time bound.

24. Absent efforts to accelerate the cleanup of bank portfolios, NPLs are projected to remain elevated for a protracted period, undermining lending activity. Staff underscored the need for removing legal, tax, and regulatory impediments to help banks accelerate the cleanup of their portfolio and refocus on core business. In this regard, staff called for streamlining the liquidation process, including by increased out-of-court-framework use, provision of tax incentives for write offs, and introduction of a personal insolvency law. While the establishment of the MARK would help banks clean their portfolio in the absence of private sector demand for distressed commercial real estate loans, it is important to keep MARK's operations fully independent and transparent to avoid a potential conflict with MNB's price and stability objectives. In line with the recommendations of the recent MCM technical assistance mission, the MARK should be given an exclusive objective of maximizing the value of purchased assets while ensuring that the transfer of assets be done on a voluntary basis, based on a clear and consistent set of valuation criteria. This would help limit MNB's exposure and a potential build up of contingent liabilities.

NPLs Ratio, Percent



Source: MNB.

25. The authorities' recent measures are likely to improve private sector balance sheets and could help re-invigorate credit growth, but staff cautioned against an increasing role of the state in the banking system. The FX mortgage conversion and MARK initiative will reduce private sector vulnerabilities and help banks repair their balance sheets faster, thus supporting investment and growth. However, announcements in favor of banking system consolidation, together with state purchases of banks, have increased uncertainty regarding the future landscape of the banking system, notwithstanding the government's stated intention to divest bank stakes within three years. Staff stressed that lending activity should be based on adequate risk-management practices, and recommended to limit the state's role in the banking system, also arguing that, with limited fiscal space, there is no room to build up further contingent liabilities.

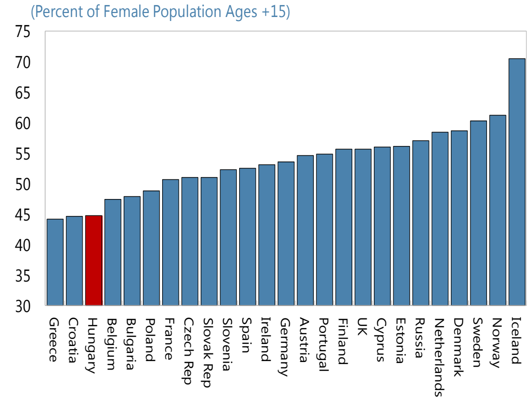
26. A strong regulatory and supervisory framework is essential for safeguarding financial stability. The integration of the Hungarian Financial Supervisory Authority into the MNB in 2013 equipped it with micro-prudential instruments and re-enforced its macro-prudential tool kit. Staff welcomed the authorities' commitment to strengthen the regulatory and supervisory framework, including through the recent adoption of a new macro-prudential regulation (that introduces more stringent LTV and PTI ratios, especially for FX loans) to prevent excessive household indebtedness.

27. The authorities were optimistic that recent policy measures will help stimulate credit. They argued that the Settlement and Fair Banking Acts will help boost households' demand for credit, while the extension of the FGS will continue to support lending to SMEs. They acknowledged that the high level of NPLs continues to weigh on banks' balance sheets and constrains new lending, but noted that they are working closely with the EBRD to identify ways to expedite NPL resolution. They also argued that the MARK is likely to induce more dynamic portfolio cleaning. The authorities stressed that the consolidation in the banking sector is warranted to foster competition and improve efficiency through economies of scale. They view the government's increased role in the banking system as a necessary, but transitory, vehicle, to facilitate the consolidation and restructuring of bank balance sheets.

D. Structural Policies

28. Raising Hungary's growth potential remains a key challenge. Potential growth is currently estimated at about 1 percent and, as investment increases, is projected to increase to around 2 percent over the medium term. These rates are below those of Hungary's regional peers, suggesting a slow convergence towards higher income levels. This reflects a difficult business climate, the state's increased role in the economy, demographic headwinds, low productivity, and weaknesses in the labor market, notably low labor participation among women and older workers (Box 4). Weak SME performance, partly reflecting low internationalization, weighs on growth (Box 5).

Female Labor Force Participation, 2013
(Percent of Female Population Ages +15)



Sources: WBWDI.

29. Staff called for an ambitious structural reform agenda to remove impediments to growth. Such an agenda should focus on:

- *Improving the business climate*. This would entail increasing policy predictability and transparency, strengthening anti-corruption efforts, reducing the regulatory burden, gradually eliminating distortionary sectoral taxes, and enhancing the ease of paying taxes. Staff cautioned against the government's interventionist strategy, arguing that it could weigh on private investment and growth.

- *Enhancing competitiveness*. Given the importance of non-price factors in addressing Hungary's competitiveness challenges, staff underscored the need to move-up the value chain, increase export diversification, and improve productivity in the labor and services markets. Focus should be on strengthening R&D, alleviating SME-internationalization impediments (see accompanying SIP), and restructuring loss-making transport SOEs.

- *Addressing structural weaknesses in the labor market*. Measures should aim at strengthening incentives for women to enter the labor market, including by reforming parental benefits, re-shuffling spending on family benefits to also provide affordable child care, phasing out the early retirement scheme for women, and reducing the gender wage gap (see accompanying SIP). Equally important would be to upgrade labor skills and reduce skill mismatches to enhance productivity, including by strengthening the training component of active labor market programs.

30. The authorities were optimistic that recent policy measures would help improve Hungary's growth prospects. They assessed medium-term potential growth at 2½ percent, owing to higher investment—due to increased EU fund utilization, and more favorable financing conditions for SMEs—and increased labor participation on the back of on-going labor market reforms. Moreover, they saw scope for moving up the value chain by focusing on innovation and for better integrating SMEs into the supply chain. On-going efforts to diversify export destinations and the increase in the production capacity in the automobile industry would help boost Hungary's export performance. Nevertheless, they agreed on the need to improve the level and predictability of taxation, insolvency procedures, and access to finance. Finally, they argued that their strategy in the energy sector, that includes the creation of a state-owned utility company and acquisition of energy companies, is aimed at securing and diversifying energy supply, which is critical for enhancing Hungary's competitiveness.

STAFF APPRAISAL

31. The Hungarian economy is growing at a strong pace and there has been a welcome reduction in vulnerabilities. The strong economic upturn is driven by a pickup in domestic demand on the back of expansionary macroeconomic policies. Meanwhile, vulnerabilities continued to decline thanks to large and persistent current account surpluses, recent policy measures, and improved market sentiment.

32. However, vulnerabilities are still elevated and medium-term growth prospects appear subdued. External and public debt levels remain high and the associated financing needs together with heavy reliance on nonresident financing, large concentration of the investor base, and the economy's large open FX position continue to pose risks. Hungary's subdued medium-term growth prospects further exacerbate these vulnerabilities. At the same time, the state's increased role in the economy along with sectoral taxes weaken the business environment, while state acquisitions in the banking and energy sectors contribute to the buildup of contingent liabilities.

33. A comprehensive strategy is needed to further reduce vulnerabilities and boost growth. Emphasis should be given to growth-friendly fiscal consolidation, revival of financial intermediation, and reforms aimed at addressing structural impediments to growth, strengthening institutions, and increasing policy predictability. Implementation of such a strategy, along with reduced state interference in the economy, would help support strong, private sector-led growth and foster a further reduction in risk premia.

34. A key priority is to put the public debt ratio firmly on a downward path while supporting growth. The authorities' commitment to fiscal discipline is welcome, but, going forward, more ambitious efforts are needed to make a significant dent in the high public debt ratio. Such efforts should be backed by a clear and credible strategy encompassing growth-friendly fiscal reforms, including enhancing the efficiency of the tax system and public spending, tackling VAT fraud, improving the targeting of social benefits, and scaling down inefficient programs. These reforms can help enhance the economy's human and physical capital.

35. Further cautious monetary policy easing would help guard against disinflationary pressures. Monetary conditions have appropriately supported the recovery of domestic demand. However, persistent disinflationary pressures and further moderation in inflation expectations call for a further cautious easing of monetary policy. The reduced exposure of household balance sheets to exchange rate risk and weak euro area conditions support a move in this direction. However, the central bank should stand ready to tighten if external conditions deteriorate sharply. Maintaining an adequate level of international reserves is necessary to mitigate excessive exchange rate volatility and support financial stability.

36. There is a need to repair financial intermediation. Improving the operating environment for banks, including through removing impediments for portfolio cleanup, reducing the tax burden, and enhancing policy predictability would support lending activity. Recent government pronouncements in this regard are welcome and need to be followed by concrete policy actions. Moreover, removing regulatory, legal, and tax impediments to NPL resolution, mitigating potential institutional and financial operational risks associated with the Asset Management Company, alongside a prompt introduction of a personal insolvency framework, are essential. At the same time, lending activity should be based on adequate risk-management practices, and the role of the state in the banking sector be contained. While lending under the FGS has helped improve credit conditions for SMEs, further refinement of the scheme's modalities would help enhance its impact on growth, while avoiding risk to the central bank. The scheme should remain targeted, time-bound and limited to SMEs.

37. An ambitious reform agenda is key to lifting Hungary's growth potential. Sustained progress on wide-ranging structural reforms aimed at improving the business climate, enhancing competitiveness, and reforming the labor market is essential for higher investment and strong, private sector-led growth. Priority should be given to promoting entrepreneurship and innovation, reducing the regulatory and tax burden, alleviating impediments to SME internationalization, and boosting productivity in the services sectors. Reforms of the labor market should aim at increasing labor participation, particularly among women and older workers, while greater emphasis should be placed on mitigating skill mismatches.

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

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

	Source of Risks	Relative Likelihood	Impact if Realized
Global	*An abrupt surge in global financial market volatility*	**High** A possible change in risk perception may lead to nonresident sell-off of HUF securities, and deposit withdrawals from banks.	**High** A reversal would sharply raise borrowing costs, and put pressure on reserves. Depreciation would impair banks' balance sheets given large foreign currency risk exposures.
	Geo-political fragmentation that erodes the globalization process and fosters inefficiency	**Medium** A sharp increase in the tensions surrounding Russia/Ukraine may lead to re-pricing of risks, and spillovers through trade, financial and confidence channels.	**Medium** A shift in risk perception would increase borrowing costs and, coupled with lower external demand, put pressure on reserves. Disruption of gas supply and increase in gas prices would adversely affect production.
	Protracted period of slower growth in advanced and emerging economies	**High** External demand would wane, weighing on Hungary's growth.	**Medium** Weaker export growth would weigh on the recovery and perpetuate macroeconomic vulnerabilities.
	Bond market stress from reassessment in sovereign risk	**Low** Sovereign stress re-emerges due to incomplete delivery of policy commitments at the national or euro area level.	**High** Through strong trade and financial ties with Europe, could lead to a sharp reversal of capital flows, credit crunch and economic slowdown. Financing pressures could arise.
Domestic	*Unconventional policies*	**Medium** Unconventional fiscal policies and a weakening of institutions would undermine policy credibility and erode confidence.	**High** Could limit availability of financing, foster sharper cross-border deleveraging, and lower FDI flows. Credit and investment would continue contracting, and put pressure on reserves.
	No fiscal consolidation, and slippages in structural reforms	**Medium** Fiscal and structural reforms needed to boost potential growth could be delayed due to lack of political appetite.	**Medium** Borrowing costs would rise, and debt dynamics would worsen. Reserves would come under pressure. Competitiveness would be eroded and Hungary's economic prospects would worsen.

Policy response

In episodes of a sharp deterioration in risk perception and large capital outflows, the immediate policy response would entail tightening the monetary stance and using FX intervention to smooth excessive exchange rate volatility. Adopting a growth-friendly fiscal adjustment, increasing policy predictability, and accelerating structural reforms in a manner that would also limit government interference in the economy, would help tackle domestic risks.

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

Box 1. Response to Past Fund Policy Advice

The authorities have actively engaged in a policy dialogue with the Fund, but some policies deviated from previous IMF advice.

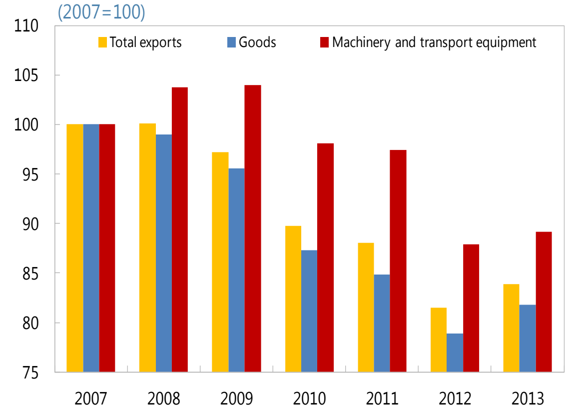
Key recommendations	Implemented policies
Implement a durable, growth-friendly fiscal adjustment to sustainably reduce the public debt-to-GDP ratio.	The 2014 fiscal deficit came in below target, but the budget composition remains a concern, as the scope of sectoral taxes and allocations to discretionary programs increased. The public debt ratio remained unchanged.
Reduce external vulnerabilities.	The FX mortgage conversion has significantly reduced household exposure to exchange rate risk. Steps have been taken to reduce reliance on FX-denominated public debt.
Improve the operating environment for banks—including by reducing the tax burden and facilitating a faster balance sheet cleanup—to help repair financial intermediation. Improve the effectiveness of the FGS.	Bank portfolio cleaning remains sluggish and the tax burden on banks is high. An asset management company was set up to facilitate cleanup of bank balance sheets and, government recently announced its commitment to gradually reduce bank taxes. The FGS was extended to end-2015, and was expanded to include riskier companies with the MNB assuming half of the credit risk.
Address weaknesses in the labor market, promote competition in product markets, restructure loss-making state-owned enterprises (SOEs), and improve the business climate, including by limiting the state's role in the economy.	Flexible child-care benefits and compulsory early childhood education were introduced to boost female labor participation. The role of the state in the economy increased, including through acquisitions of banks and energy companies, while reforms in other areas were largely stalled.

Box 2. External Sustainability and Competitiveness

Staff's assessment is that the real exchange rate is broadly in line with medium-term fundamentals. EBA estimates have low explanatory power and yield mixed results for Hungary. Specifically, the Real Effective Exchange Rate (REER) approach reveals an overvaluation of the exchange rate by 15 percent, and the External Sustainability approach finds the REER undervalued by 12 percent. Moreover, the Current Account Balance approach suggests that Hungary's REER appears to be undervalued. However, in staff's view, although this approach is based on various fundamentals, it does not adequately capture the need for savings to remain elevated to help reduce Hungary's still-large external liabilities. Thus, the current-account norm would need to be adjusted upward consistent with the need to strengthen Hungary's balance sheet. Other price indicators, such as unit labor costs, do not point to price pressure on exchange rates.

Non-price factors have undermined Hungary's competitiveness. Since 2008, Hungary's export market share has stagnated compared to peers, reflecting sharp moderation in export growth from the pre-crisis rates. Moreover, indicators of Hungary's attractiveness to investment suggest that competitiveness has recently eroded: its ranking in the Global Competitiveness Report slipped by 12 places in the past 3 years with the institutional framework providing a drag on overall competitiveness.

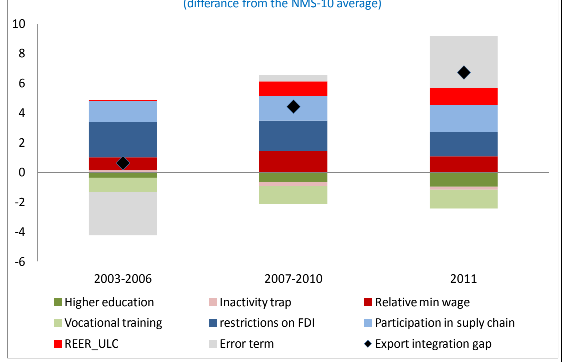
Hungary's share in world's exports
(2007=100)



Sources: WEO and ComTrade.

Low levels of foreign direct investment may detract from Hungary's medium-term growth prospects. The foreign investment environment played an important role in promoting exports to the EU single market especially during 2003–06, but its contribution has gradually declined. Medium-term FDI inflows are projected to remain significantly below their historical average at the same time when Hungary's incremental capital-output ratio is relatively favorable. This may partly reflect a leveling off of the substantial FDI Hungary received in the 1990's as it became integrated with the regional supply chain. However, staff analysis suggests that further gains from the EU single market would depend on the authorities' ability to reverse the deteriorating trend in the foreign investment environment and address structural bottlenecks.[1]

Figure 1. Hungary: Relative Contributions of Structural Factors for Exports to the EU Single Market
(differance from the NMS-10 average)



Going forward, improvement in export quality, and diversification in products and markets would boost exports. While integration into the supply chain has helped improve Hungary's export quality, the share of products in the top quartile of quality is relatively low. To strengthen its position as top quality product exporter, Hungary should focus on increasing innovation, enhancing vocational training and post-graduate education, scientific research, effective cooperation between science and industry and R&D. Some degree of diversification in products and markets would also help.

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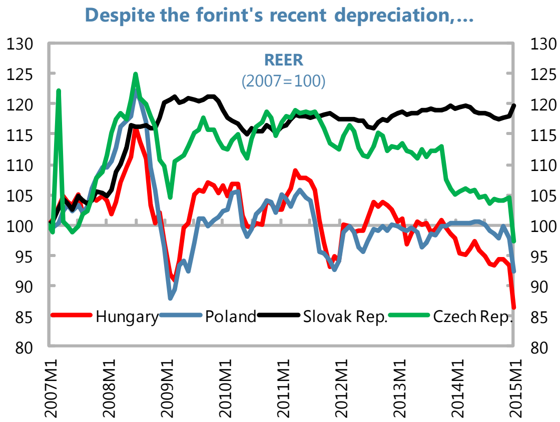
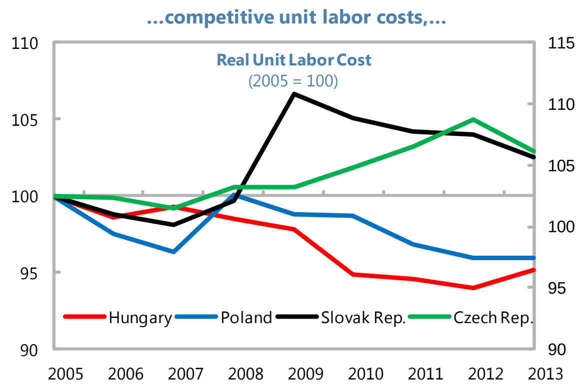
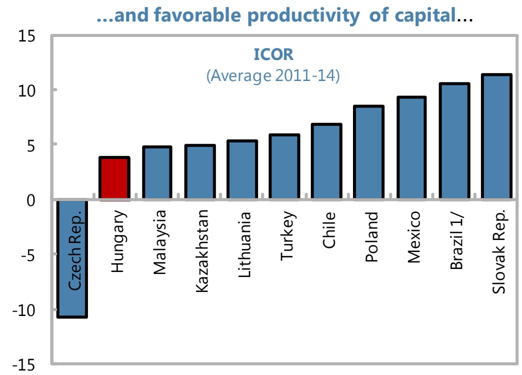
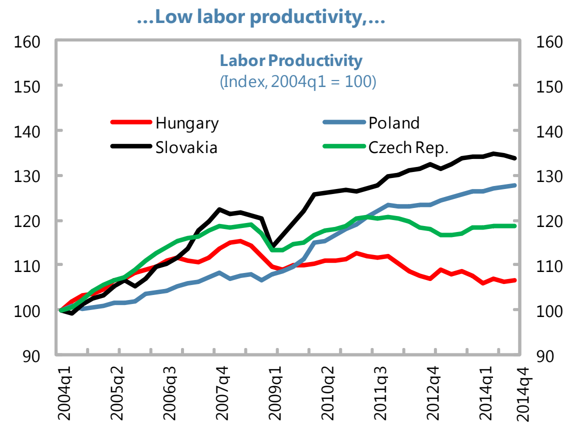
[1] See forthcoming paper for the NMS Policy Forum: "Making the Most of the EU Single Market."

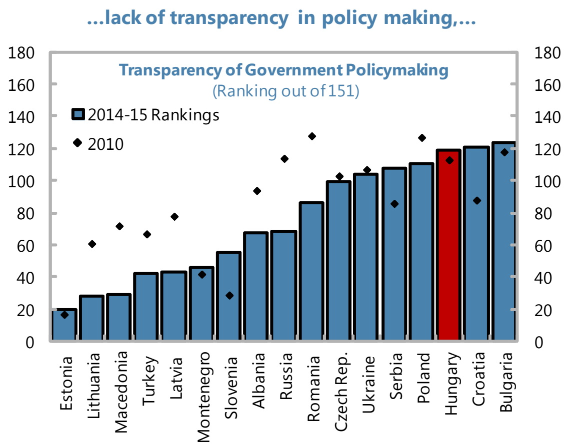
Box 2. External Sustainability and Competitiveness (concluded)

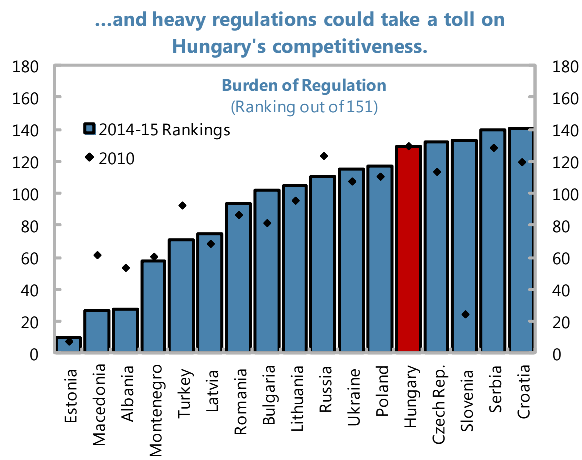












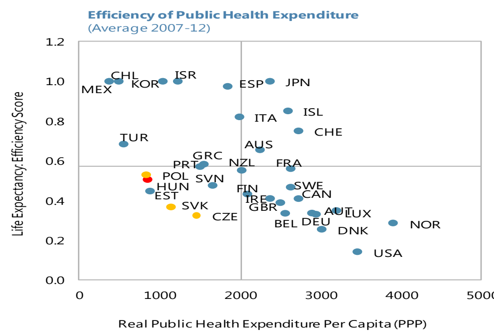
1/ 2011-13 average for Brazil.

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

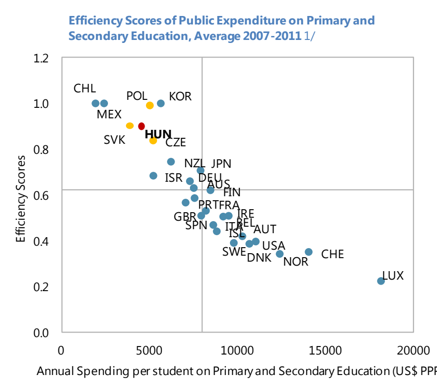
Box 3. Efficiency of Public Spending on Health and Education

Hungary's public spending on health and education is not high by international standards and related outcomes lag behind (Figure 1). Public spending on health and education amounted to 5 percent (2012) and 4½ percent of GDP (2011), respectively, below the OECD average. At the same time, Hungary underperforms in terms of outcomes: life expectancy and infant mortality, while showing significant improvement recently, remain below the OECD average, and educational outcomes—as measured by Program for International Student Assessment (PISA) performance—are low compared to the OECD average, and have deteriorated recently.[1]

In the health sector, there is scope for efficiency gains of up to 2¾ percentage points of GDP over the medium-term. Data envelopment analysis suggests that efficiency has improved over time, but, at 0.45 (compared to 1 for an 'efficient/frontier' country), it is below the average OECD efficiency score (of 0.57), including that of countries with similar level of per capita public spending on health (with scores estimated to average 0.68). This implies potential gains of up to 2¾ percentage points of GDP, if Hungary were operating with the efficiency of frontier OECD countries. If it was as efficient as the average OECD country or as the average OECD country with similar per capita public spending on health, potential gains would range between 2/3–1¼ percentage points of GDP, while still achieving the same health outcome. Potential savings from such efficiency gains could be channeled to improving outcomes.



In the education sector, there is scope for further efficiency gains, but focus should be on improving outcomes and access to education. Efficiency of public spending on education has improved over the past decade, and at 0.90, Hungary's efficiency score is above the OECD average of 0.61, and that of countries with similar level of per student spending on primary and secondary education (0.79). This implies that if Hungary was operating with the efficiency of frontier OECD countries, potential gains could amount up to ⅓ percentage point of GDP over the medium-term, while still achieving the same education outcomes. Once efficiency gaps are closed, consideration could be given to increasing spending with a view to further enhancing outcomes, while strengthening access to quality mainstream education, particularly for disadvantaged groups.

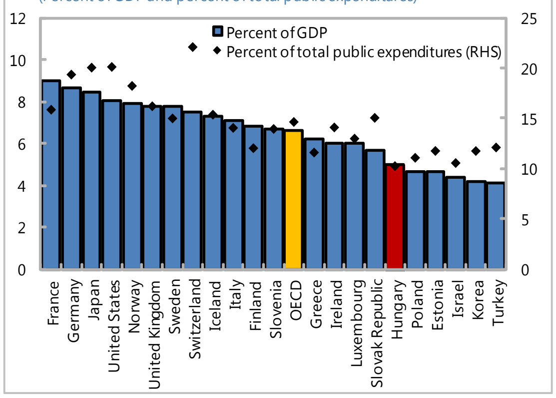


Source: IMF Staff Estimates
1/ Spending data is up to 2011, while the PISA scores refer to 2012.

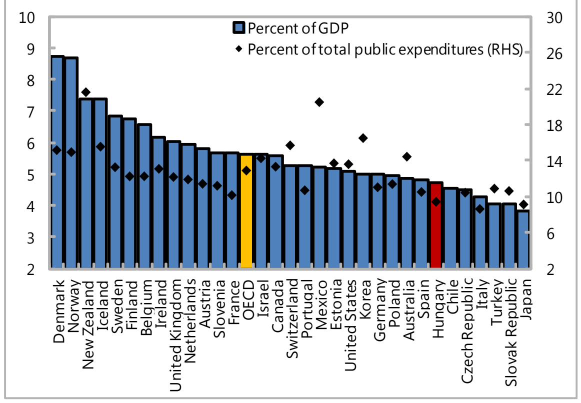
[1] Other educational outcomes, however, suggest strong performance: first-time graduation rate at upper secondary school was 94 percent in 2012, surpassing the OECD average of 84 percent.

Box 3. Hungary and Selected OECD Countries Spending and Outcomes in Health and Education (concluded)

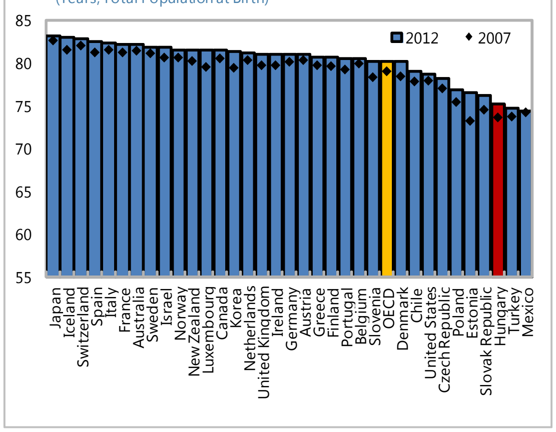
Public Spending on Health, 2012
(Percent of GDP and percent of total public expenditures)



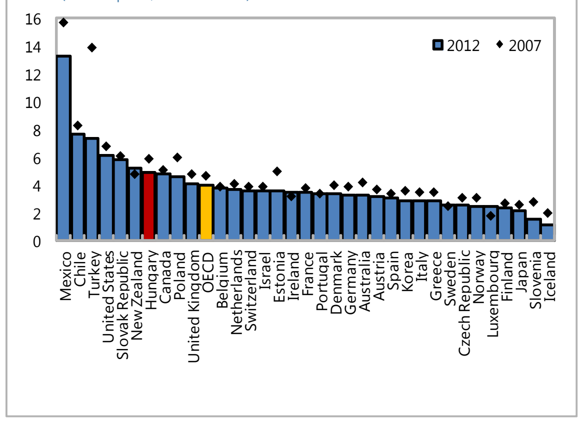
Public Spending on Education, All Levels, 2011 1/ 2/



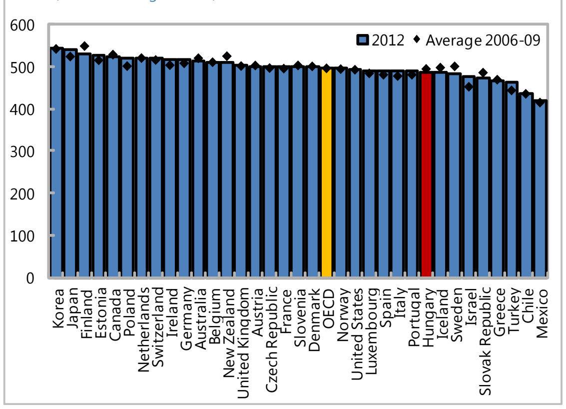
Life Expectancy
(Years, Total Population at Birth)



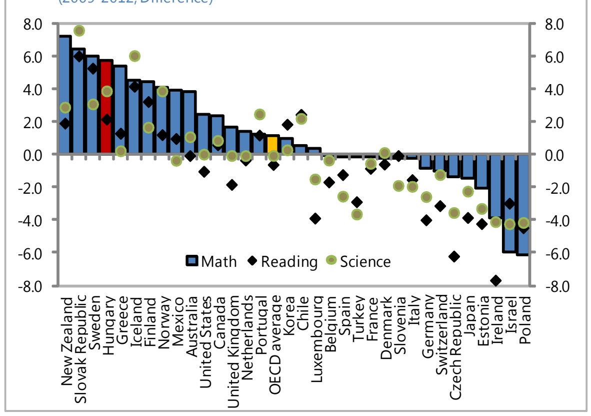
Infant Mortality Rate
(Deaths per 1,000 live births)



PISA Scores: Hungary and Selected OECD Countries
(Overall Average Scores)



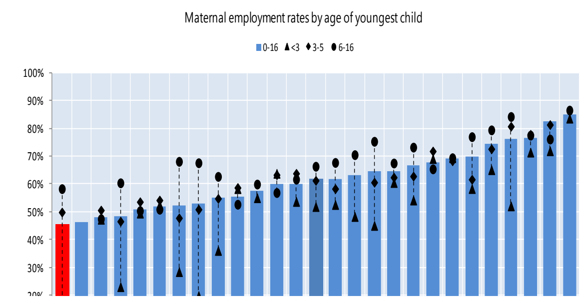
Change in the percentage of low achievers in PISA by subjects, 1/ 2/
(2009-2012, Difference)



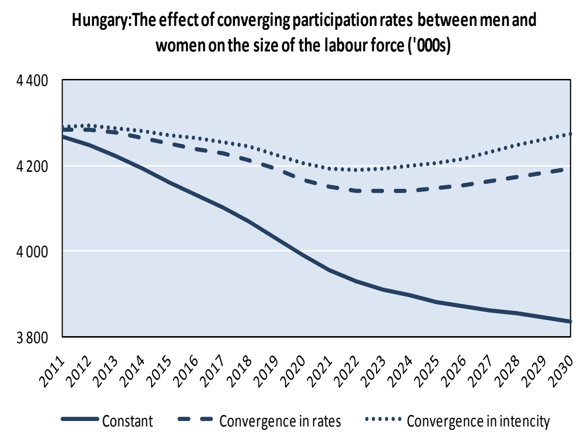
Sources: OECD Health and Education Database; PISA 2012.
1/ Public expenditure includes public subsidies to households for living costs (scholarships and grants to students/households and students loans), which are not spent on educational institutions.
2/ Or latest year available.

Box 4. Gender Gaps in the Labor Market

Female labor market participation (FLMP) in Hungary is very low. It is below EU and OECD averages, and also lags rates in peer countries in the region. In particular, employment of mothers with children under 2 (at 10 percent in 2008) is the lowest in the OECD.

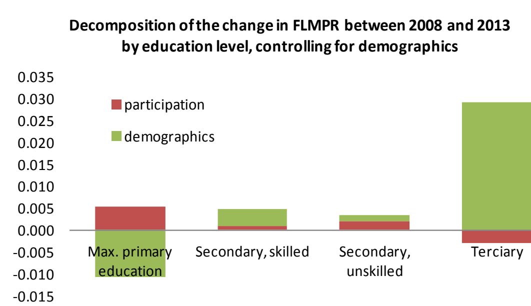


Increasing FLMP is an economic imperative for shoring up long-term growth. In many advanced and emerging economies, population ageing and low fertility rates are compressing the size of active labor forces. This issue is also acute in Hungary. Taking into account current trends, Hungary's labor force will shrink by around 10 percent by 2030. Increasing low FLMP will be necessary to help offset these adverse trends and boost long-term growth. The OECD estimates that full convergence in participation rates by 2030 can increase annual per capita growth rates in Hungary by 0.6 percent, on average.



A number of factors affect FLMP in Hungary. Parental leave policies and cultural pressures are tilted towards mothers of young children staying at home. This is reinforced by a shortage of affordable child care options. Older women are forced to care for elderly relatives in light of limited availability of long-term care; and—in contrast to efforts to roll back early retirement schemes and encourage participation—a new early retirement program for women was established in 2011. On the labor market, the wage gap between men and women has been growing; and tax policies result in higher marginal tax rates for second earners.

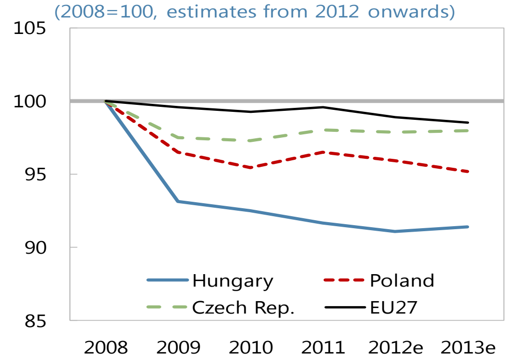
The impact of recent activation policies has been uneven. The overall female labor force participation rate (FLFPR) increased by 2.8 pp during 2008-13, to 50.6 percent in 2013. A decomposition of this increase by education groups and controlling for "passive" demographic effects (i.e., changes in the absolute size of these groups) reveals that activation policies primarily induced a significant increase in participation amongst women with primary education or less. In other words, while the share (and total number) of women with primary education in the female labor force decreased substantially, their participation rate also went up significantly. This was possibly induced by measures such as tightened access to benefits and participation requirements in public works programs. At the other end of the spectrum, a much larger share of working-age women now hold tertiary degrees. While this shift in itself is pushing up the aggregate FLFPR, controlling for its impact shows that women with tertiary education actually *decreased* their participation. This calls into question the efficacy of activation policies aimed at higher income groups, including tax incentives and attempts at making parental leave policies more flexible.



Box 5. Internationalization of Small and Medium Sized Enterprises (SMEs)

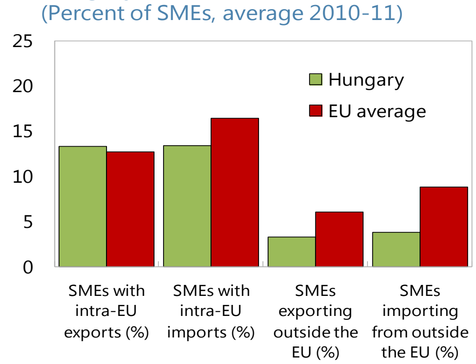
SMEs remain an important driver for Hungary's economic activity and employment creation. However, since the outset of the crisis, their performance has been particularly weak and below that of the EU average, reflecting a host of factors, including limited access to credit for riskier SMEs, sharp deleveraging, and a deteriorating business environment. The low level of Hungarian SME internationalization, which is below the EU average, together with the collapse of domestic demand in 2009 and the weak recovery thereafter also played an important role.

Employment of SMEs
(2008=100, estimates from 2012 onwards)



SME internationalization in Hungary is generally low. The EC's 2014 Small Business Factsheet, shows that apart from the cost required to export/import, Hungary scores well below the EU's average in all internationalization criteria. The share of SMEs exporting and importing outside the EU is significantly below the EU average, and the bureaucracy—the time and number of documents required to export/import—is poorer than the EU average.

Hungary and the EU: SMEs Trade
(Percent of SMEs, average 2010-11)



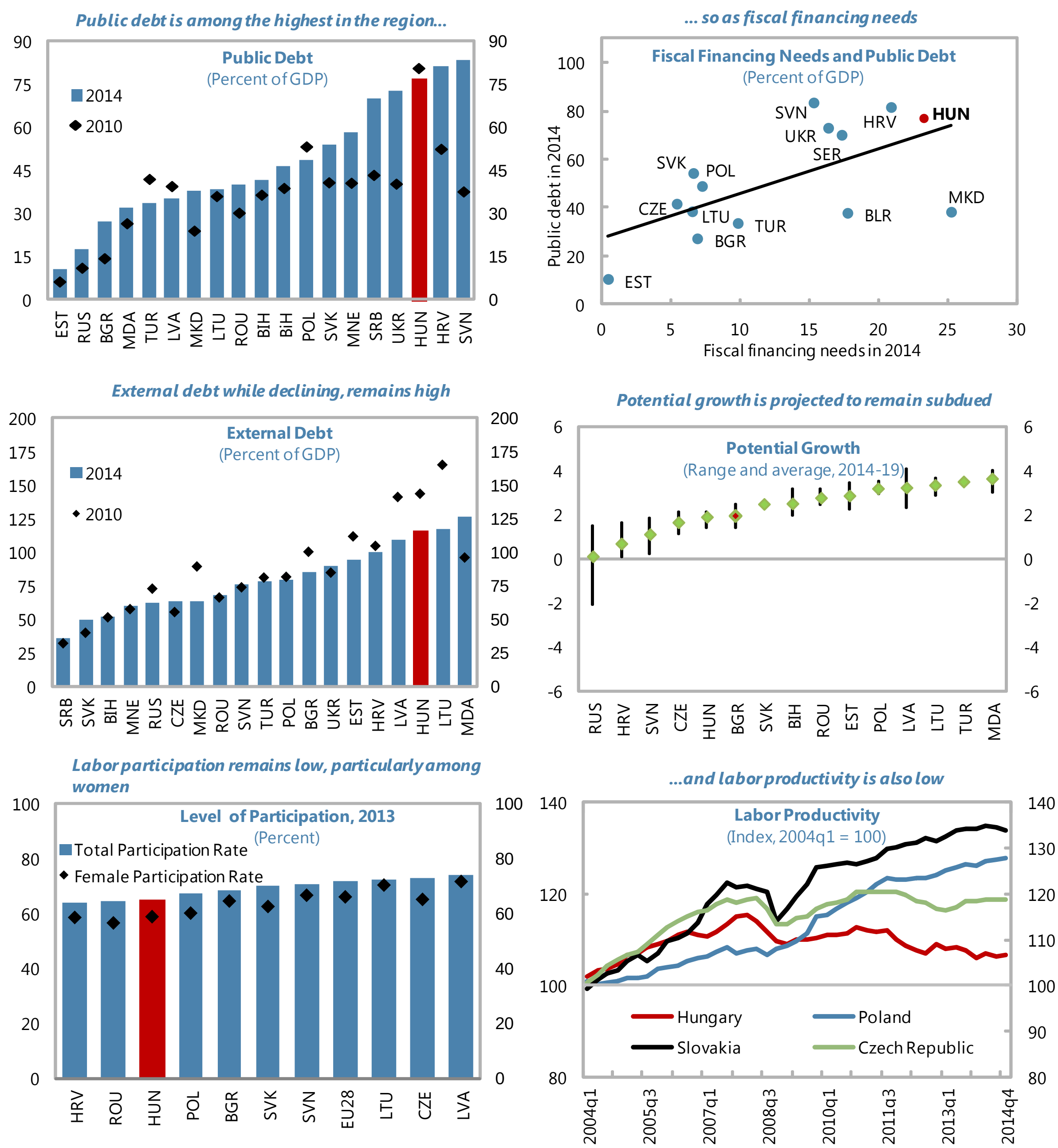
Source: EU's Small Business Act (SBA), 2013-14.

Staff analysis corroborates the benefits of internationalization. It finds positive correlation between an increase in SMEs' export-to-operating revenue ratio and growth of revenue and employment, suggesting that greater internationalization may generate positive spillovers through technology and knowledge transfer, and ultimately productivity and competitiveness gains. The analysis also suggests that larger firms with high share of fixed tangible assets are more likely to increase internationalization, and higher labor productivity, more favorable liquidity position, and higher leverage are associated with higher internationalization, though the positive effect of the leverage ratio disappears when its level is "excessive".

Policies could help alleviate barriers to internationalization. There is a need to develop stronger infrastructure to improve SMEs' exporting capacity, including by simplifying pertinent procedures, and help SMEs obtain greater information about foreign markets. Additionally, promoting innovation and reducing skill mismatches could enhance factor productivity, and facilitate faster penetration to foreign markets. Such policies can be complemented by efforts to foster higher degree of cooperation between SMEs and large multi-national companies so as to facilitate positive spillovers, through knowledge and technology transfer.

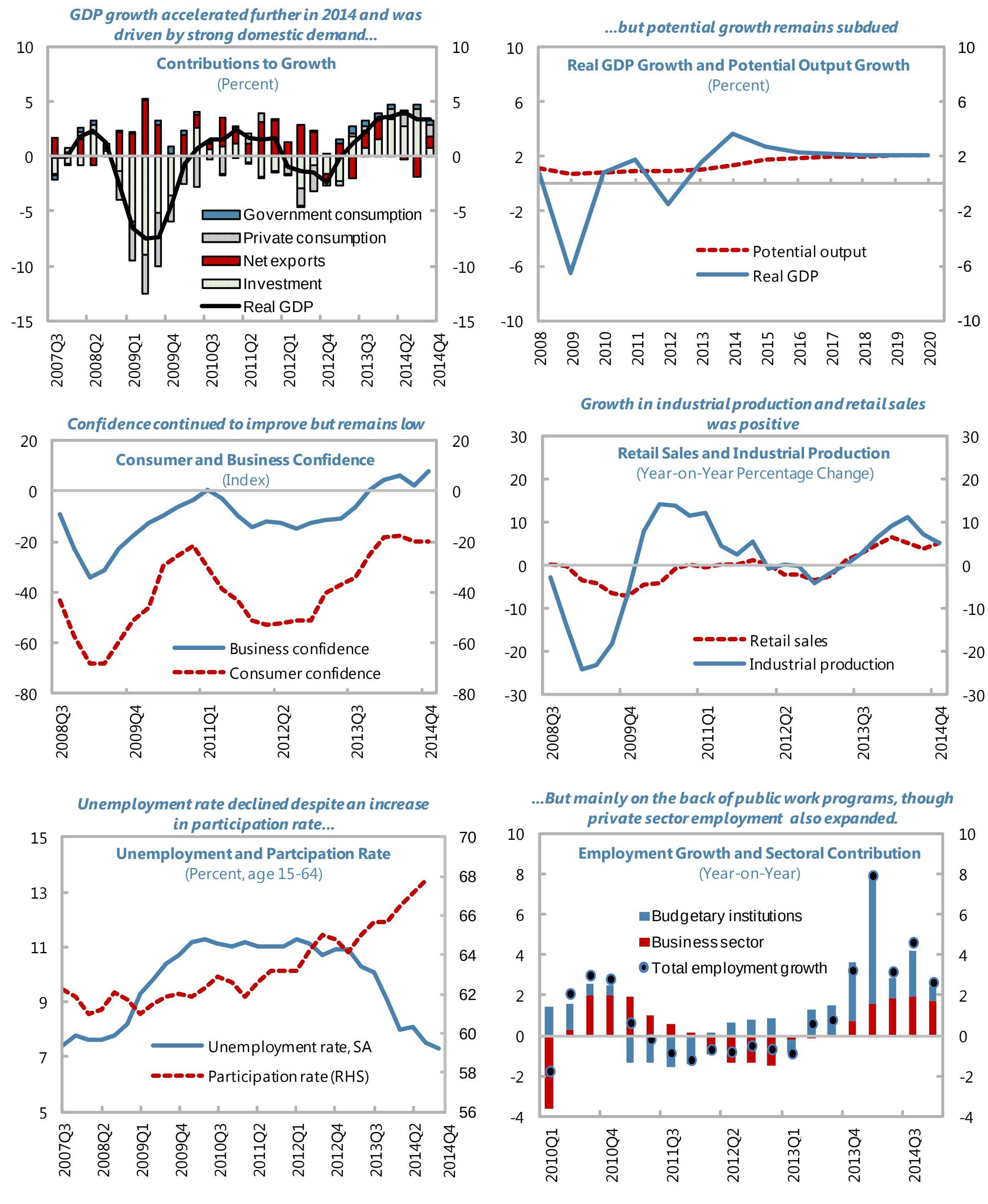
Greater SME access to finance is equally important. It is critical to repair financial intermediation by creating a better operating environment for banks through a reduction in their tax burden and accelerated portfolio cleanup. Finally, there is a need to develop an infrastructure for non-bank financing, including by increasing the availability of venture capital.

Figure 1. Hungary and Peers



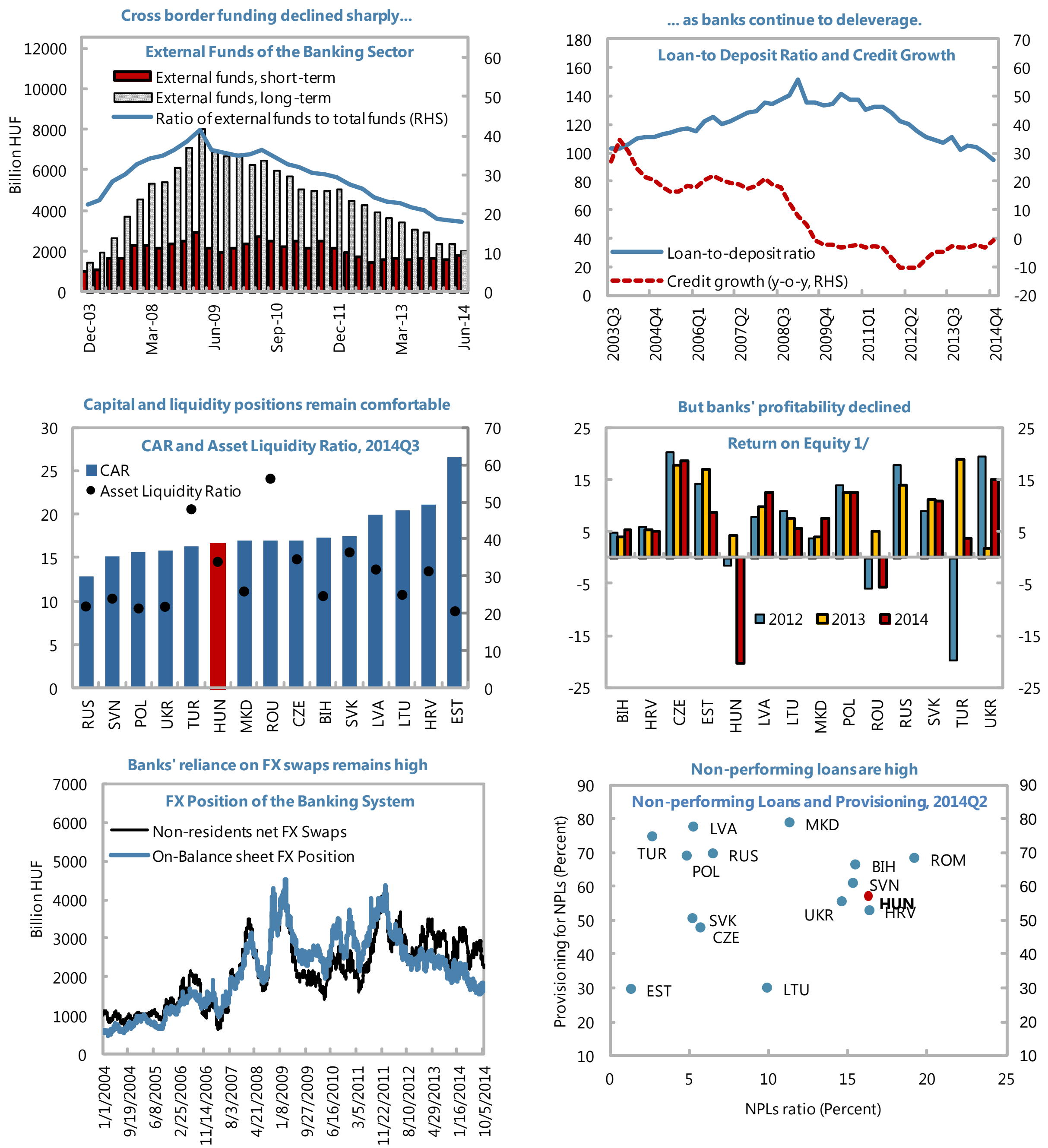
Source: Hungarian Statistical Office, MNB, EUROSTAT, IMF World Economic Outlook database, Haver Analytics; and IMF staff calculations and estimates.

Figure 2. Real Sector



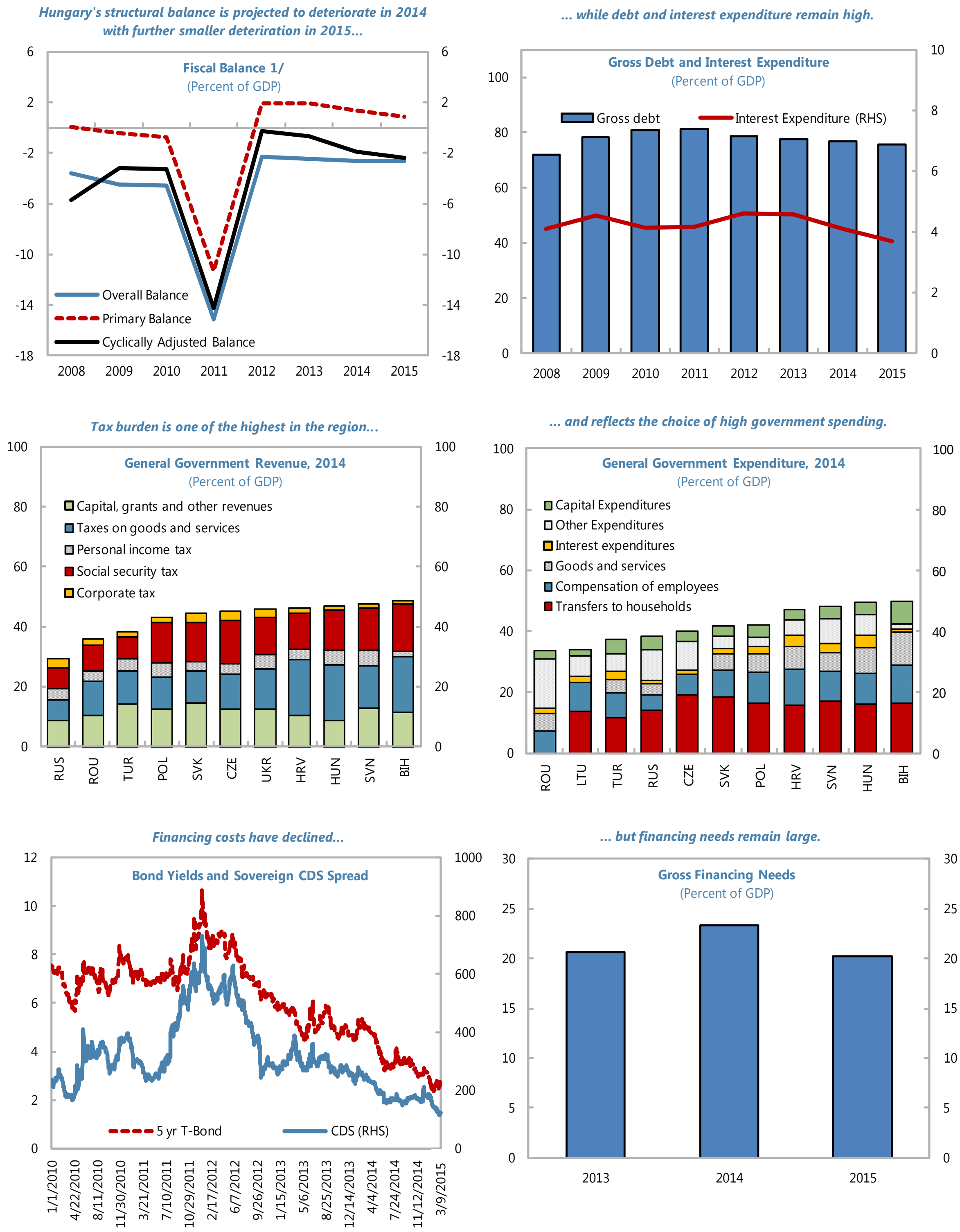
Source: Eurostat, Hungarian Statistical Office; NBH and IMF staff estimates.

Figure 3. Banking Sector



1/ 2014q3 data for all countries except Czech Republic and Lithuania - 2014q2. 2014 data for Russia is unavailable.
Sources: MNB, FSI, WEO and IMF staff estimates.

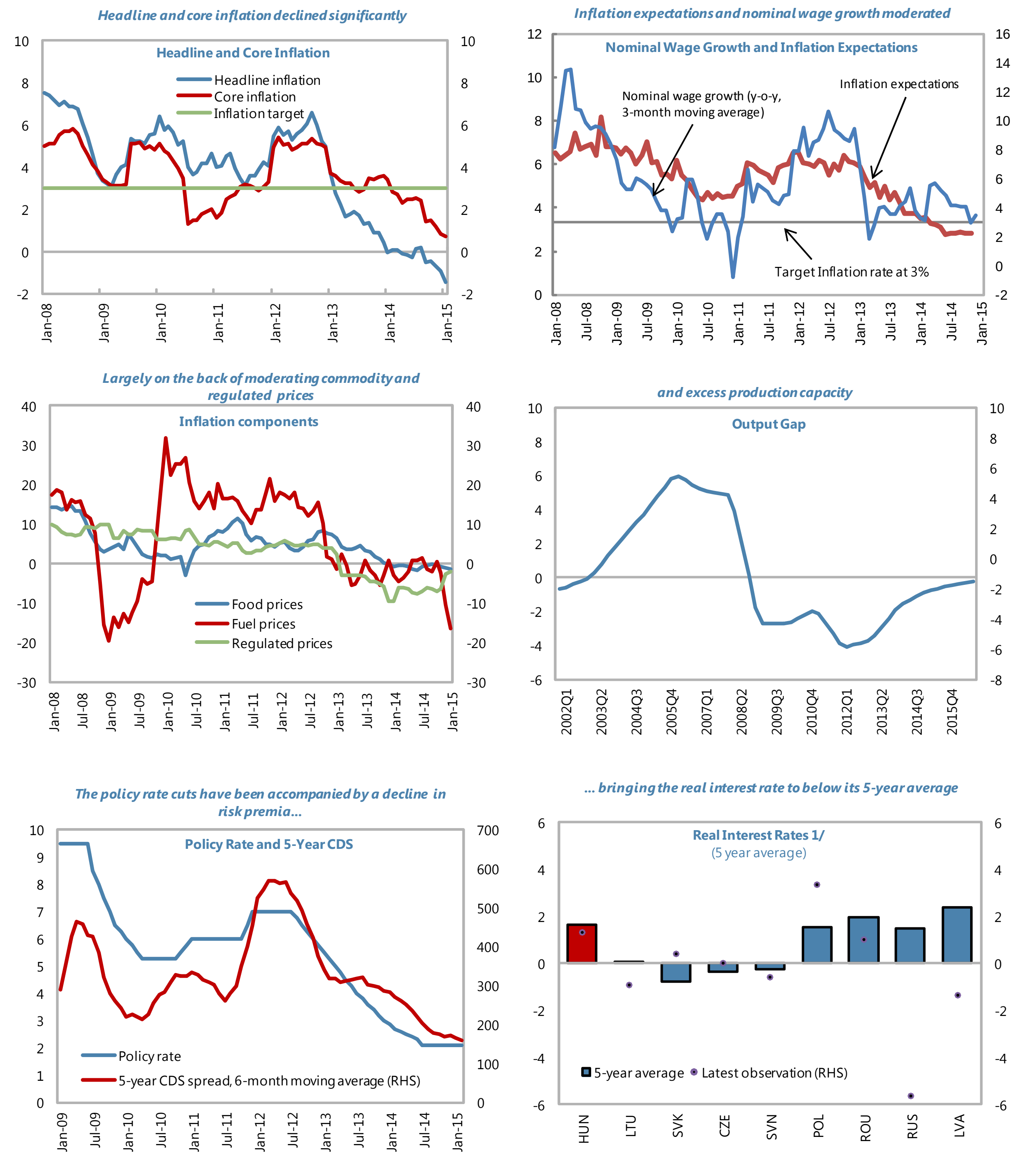
Figure 4. Fiscal Sector



1/ Excludes 9.6 percent of GDP in pension assets transfer to government in 2011.

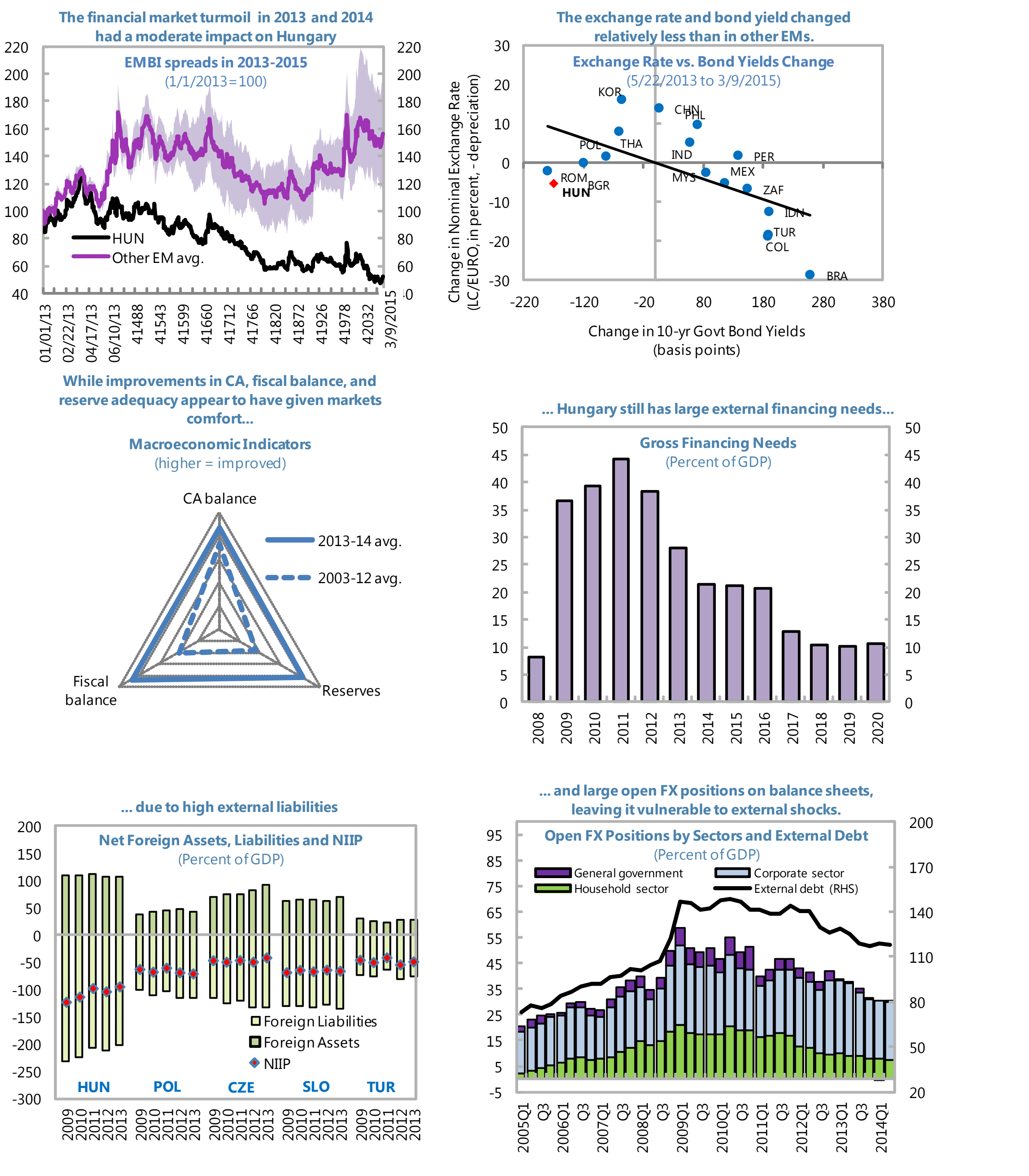
Sources: Hungarian Authorities, IMF World Economic Outlook, Bloomberg and IMF staff estimates and projections.

Figure 5. Inflation and Monetary Policy



1/ Policy rate deflated by core inflation. Latest observation is January 2015 for all except Poland and Romania where December 2014 is used. 5-year average is calculated in a similar way.
Sources: MNB, Bloomberg, WEO and IMF staff estimates.

Figure 6. External Vulnerabilities



Sources: MNB, Haver Analytics, and IMF staff estimates.

Table 1. Selected Economic Indicators, 2010–17

	2010	2011	2012	2013	2014 Prel.	2015 Proj.	2016 Proj.	2017 Proj.
Real economy								
Real GDP (percentage change)	0.8	1.8	-1.5	1.5	3.6	2.7	2.3	2.2
Total domestic demand (contribution to growth) 1/	-0.5	-0.2	-2.8	1.1	4.0	2.4	1.8	1.9
Private consumption 2/	-1.8	0.5	-1.3	0.1	1.0	1.6	1.5	1.5
Government consumption	0.2	0.0	0.0	0.5	0.3	0.3	-0.1	0.3
Gross fixed investment	-2.2	-0.4	-0.8	1.0	2.3	0.2	0.0	0.6
Foreign balance (contribution to growth)	1.3	2.0	1.4	0.4	-0.4	0.3	0.5	0.3
Exports	8.5	5.4	-1.3	5.1	7.8	5.6	5.1	4.9
Imports	7.2	3.4	-2.6	4.7	8.1	5.3	4.6	4.6
CPI inflation (average)	4.9	3.9	5.7	1.7	-0.3	0.0	2.3	2.9
CPI inflation (end year)	4.7	4.1	5.0	0.4	-0.9	1.7	2.4	3.0
Unemployment rate (average, ages 15-64)	11.3	11.1	11.1	10.2	7.8	7.6	7.4	7.2
Gross domestic investment (percent of GDP) 3/	20.4	19.8	19.1	19.9	21.3	20.4	19.9	19.9
Gross national saving (percent of GDP, from BOP)	20.7	20.6	21.0	24.1	25.6	25.2	24.0	23.2
General government (GFSM 2001 basis) 4/								
Overall balance	-4.5	-5.5	-2.3	-2.4	-2.6	-2.7	-2.5	-2.5
Primary balance	-0.7	-1.7	1.9	1.9	1.4	0.9	0.9	1.0
Primary structural balance, in percent of potential GDP	-0.5	-0.7	4.0	3.3	1.7	1.3	1.1	1.0
Gross debt	80.9	81.0	78.5	77.3	76.9	75.5	74.7	73.9
Money and credit (end-of-period)								
Broad money	3.0	5.9	-3.3	5.5	5.9	7.3	7.8	8.0
Lending to the private sector, flow-based 5/	-2.4	-6.9	-7.4	-3.3	-0.9	-5.0	3.0	4.0
Interest rates								
T-bill (90-day, End of Period)	5.7	7.2	5.6	2.9	1.4	...	...	...
Government bond yield (5-year, End of Period)	7.9	8.9	6.1	4.8	3.1	...	...	...
5-year sovereign CDS (December 31, 2014)	282	379	450	260	180	...	...	...
Balance of payments								
Goods and services trade balance	5.4	6.2	6.9	7.6	7.4	8.8	8.2	7.5
Current account	0.3	0.8	1.9	4.1	4.2	4.8	4.1	3.3
Reserves (in billions of euros)	33.7	37.8	33.9	33.8	34.6	33.8	28.5	26.5
Gross external debt 6/	143.6	134.8	128.9	118.6	115.8	106.5	89.8	80.2
Gross official reserves (percent of short-term debt at remaining maturity)	62.6	65.3	67.5	97.4	106.9	120.7	144.6	164.0
Exchange rate								
Exchange regime	Floating							
Present rate (January 31, 2015, eop)	Ft. 311 = €1; Ft. 296.7 = CHF1							
Nominal effective rate (2000=100, average)	102.7	104.2	109.0	110.3	...	...	...	...
Real effective rate, CPI basis (2000=100, average)	72.4	72.6	73.6	74.3	...	...	...	...
Quota at the Fund	SDR 1,038.4 million							
Memorandum Items								
Nominal GDP (billions of forints)	26,946	28,035	28,549	29,846	31,891	33,636	35,339	37,091

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

1/ Includes change in inventories.

2/ Actual final consumption of households.

3/ Excludes change in inventories.

4/ Consists of the central government budget, social security funds, extrabudgetary funds, and local governments.

5/ 2015 reflects the effects of the Settlement Act on credit stock.

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

Table 2. Medium-Term Scenario, 2010–20

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
					Prel.			Projection			
					Percentage change, unless otherwise indicated						
Real GDP growth	0.8	1.8	-1.5	1.5	3.6	2.7	2.3	2.2	2.1	2.1	2.1
Nominal GDP, forint billions	26,946	28,035	28,549	29,846	31,891	33,636	35,339	37,091	38,893	40,782	42,762
Inflation (CPI; year average basis)	4.9	3.9	5.7	1.7	-0.3	0.0	2.3	2.9	3.0	3.0	3.0
Inflation (CPI; end-year basis)	4.7	4.1	5.0	0.4	-0.9	1.7	2.4	3.0	3.0	3.0	3.0
					Percentage Change						
Domestic demand	-0.5	-0.2	-3.0	1.2	4.3	1.1	2.0	2.0	2.1	2.4	2.7
Total consumption	-2.1	0.6	-1.7	0.8	1.8	2.6	2.0	2.5	2.8	2.5	2.5
Gross fixed capital formation	-9.5	-2.2	-4.2	5.2	11.7	1.0	0.0	3.0	3.5	4.5	5.0
Exports of GNFS	11.3	6.6	-1.5	5.9	8.7	6.2	5.5	5.3	5.1	4.7	4.5
Imports of GNFS	10.1	4.5	-3.3	5.9	10.0	6.3	5.6	5.4	5.4	5.2	5.2
Lending to the private sector, flow-based (current prices, e.o.p.) 1/	-2.4	-6.9	-7.4	-3.3	-0.9	-5.0	3.0	4.0	5.0	5.0	5.0
Unemployment rate (percent of labor force, ages 15-64, average)	11.3	11.1	11.1	10.2	7.8	7.6	7.4	7.2	7.0	6.8	6.7
					In percent of GDP						
External current account balance	0.3	0.8	1.9	4.1	4.2	4.8	4.1	3.3	2.4	1.9	1.2
Gross national saving	20.7	20.6	21.0	24.1	25.6	25.2	24.0	23.2	22.5	22.6	22.4
Gross domestic investment 2/	20.4	19.8	19.1	19.9	21.3	20.4	19.9	19.9	20.2	20.6	21.2
Capital account, net	1.8	2.3	2.6	3.6	2.6	0.3	0.7	0.9	0.7	0.8	0.4
Financial account, net 3/	-2.0	-3.1	4.4	0.9	3.8	5.7	8.3	5.9	1.2	1.3	1.0
Gross external debt 4/	143.6	134.8	128.9	118.6	115.8	106.5	89.8	80.2	73.6	67.9	63.5
General government (GFSM 2001)					In percent of GDP						
Revenue, total	45.2	44.4	46.4	47.3	47.0	46.2	44.0	44.4	44.9	45.6	46.6
Expenditure, primary	45.6	45.7	44.1	45.1	45.5	45.2	42.9	43.3	44.0	44.6	45.3
Primary balance	-0.7	-1.7	1.9	1.9	1.4	0.9	0.9	1.0	0.8	0.9	1.1
General government overall balance	-4.5	-5.5	-2.3	-2.4	-2.6	-2.7	-2.5	-2.5	-2.5	-2.4	-2.3
Interest expenditure	4.1	4.2	4.6	4.6	4.1	3.7	3.5	3.6	3.5	3.5	3.5
General government debt	80.9	81.0	78.5	77.3	76.9	75.5	74.7	73.9	73.2	72.4	71.8
Memorandum items					Percentage change, unless otherwise indicated						
Output gap	-2.7	-1.8	-4.2	-3.7	-1.5	-0.7	-0.3	-0.1	0.0	0.0	0.0
Potential GDP growth	0.8	0.9	0.9	1.0	1.4	1.8	1.9	2.0	2.0	2.1	2.1
Structural general government balance (in percent of potential GDP)	-4.2	-4.5	-0.1	-0.8	-2.2	-2.3	-2.3	-2.5	-2.5	-2.4	-2.3
Structural primary balance (in percent of potential GDP)	-0.5	-0.7	4.0	3.3	1.7	1.3	1.1	1.0	0.8	0.9	1.1
Gross official reserves (in percent of short-term debt at remaining maturity)	62.6	65.3	67.5	97.4	106.9	120.7	144.6	164.0	177.4	192.1	192.3

Sources: Hungarian authorities; and staff estimates.
1/ 2015 reflects the effects of the Settlement Act on credit stock.
2/ Excludes change in inventories.
3/ Positive values indicate net incurrence of assets greater than net incurrence of liabilities.
4/ Excluding Special Purpose Entities. Including inter-company loans, and nonresident holdings of forint-denominated assets.

Table 3. Consolidated General Government, 2010–17 1/

(In percent of GDP, unless otherwise indicated)

	2010	2011	2012	2013	2014	2015	2016	2017
					Prel.		Proj.	
Revenue	45.2	44.4	46.4	47.3	47.0	46.2	44.0	44.4
Tax revenue	25.5	23.7	25.5	25.3	25.2	24.5	24.3	24.4
Taxes on goods and services	17.6	17.4	18.6	18.6	18.5	18.0	17.8	17.9
VAT	8.6	8.5	9.2	9.0	9.3	9.3	9.3	9.4
Excises and other 2/ 3/	9.0	8.9	9.4	9.5	9.2	8.7	8.5	8.5
Taxes on income, profits and capital gains	7.9	6.3	6.8	6.7	6.7	6.5	6.5	6.5
Personal income tax	6.4	4.9	5.3	5.0	5.0	4.9	4.9	4.9
Corporate taxes	1.2	1.2	1.3	1.4	1.5	1.4	1.4	1.4
Capital taxes 3/	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other 2/	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Social contributions	12.1	13.1	13.1	13.1	13.1	13.0	13.0	13.0
Current non-tax revenue	4.3	4.1	4.2	4.4	4.4	4.2	4.1	4.1
o.w. interest revenue	0.3	0.4	0.3	0.3	0.1	0.1	0.1	0.1
Current grants	1.5	1.3	1.6	2.0	1.9	2.0	1.3	1.4
Capital revenues and grants	1.9	2.2	2.1	2.6	2.3	2.5	1.3	1.5
Expenditure	49.7	49.9	48.7	49.7	49.6	48.9	46.4	46.9
Compensation of employees 4/	10.9	10.2	10.0	10.1	10.2	10.2	10.3	10.3
Goods and services	7.6	7.3	7.3	7.5	8.5	8.3	7.5	7.6
Interest	4.1	4.2	4.6	4.6	4.1	3.7	3.5	3.6
Subsidies	1.1	1.2	1.4	1.3	1.4	1.4	1.4	1.4
Current transfers to households	18.3	18.0	17.5	17.2	16.0	15.4	15.3	15.2
Social security	14.1	14.2	13.3	13.4	12.7	12.0	12.0	12.0
o.w. unemployment benefits	0.5	0.5	0.3	0.2	0.2	0.1	0.1	0.1
Other	4.2	3.8	4.2	3.7	3.3	3.4	3.3	3.2
Other current transfers 5/	2.5	2.6	2.6	3.2	3.4	3.6	3.7	3.7
Capital expenditures	3.7	3.4	3.6	4.2	4.1	4.5	2.9	3.3
Capital transfers 6/	1.4	2.9	1.6	1.5	1.8	1.8	1.8	1.8
Other	0.1	0.1	0.1	0.1	0.0	0.0	0.0	0.0
General government balance	-4.5	-5.5	-2.3	-2.4	-2.6	-2.7	-2.5	-2.5
Primary balance	-0.7	-1.7	1.9	1.9	1.4	0.9	0.9	1.0
Memorandum items:								
Convergence program overall balance	..	..	..	-2.2	-2.9	-2.4	-2.1	-1.8
Gap to convergence program	..	..	..	0.2	-0.3	0.3	0.4	0.7
Transfer of pension assets to the state system	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0
General government balance excl. pension assets	-4.5	-5.5	-2.3	-2.4	-2.6	-2.7	-2.5	-2.5
Cyclically-adj. balance (% of potential GDP)	-3.2	-4.6	-0.3	-0.6	-1.8	-2.3	-2.3	-2.5
Annual change	-0.1	-1.4	4.3	-0.3	-1.2	-0.5	0.0	-0.1
One-off items (net)	1.0	-0.1	-0.2	0.2	0.4	-0.1	0.0	0.0
Structural balance	-4.3	-4.6	-0.1	-0.9	-2.2	-2.3	-2.3	-2.5
Annual change	-1.3	-0.2	4.5	-0.7	-1.4	-0.1	0.0	-0.1
Structural balance (% of potential GDP)	-4.2	-4.5	-0.1	-0.8	-2.2	-2.3	-2.3	-2.5
Annual change	-1.2	-0.3	4.4	-0.7	-1.4	-0.1	-0.1	-0.1
Structural primary balance	-0.5	-0.8	4.2	3.5	1.7	1.3	1.1	1.0
Annual change	-1.5	-0.2	4.9	-0.7	-1.8	-0.4	-0.2	-0.1
Structural primary balance (% of potential GDP)	-0.5	-0.7	4.0	3.3	1.7	1.3	1.1	1.0
Annual change	-1.4	-0.2	4.7	-0.6	-1.7	-0.4	-0.2	-0.1
Cyclically-adj. balance	-3.3	-4.7	-0.3	-0.7	-1.9	-2.4	-2.3	-2.5
Annual change	-0.1	-1.4	4.4	-0.4	-1.2	-0.5	0.0	-0.1
Gross public debt	80.9	81.0	78.5	77.3	76.9	75.5	74.7	73.9
In billions of HUF								
Revenue	12,180	12,459	13,249	14,114	14,982	15,539	15,536	16,460
Of which tax revenues	6,875	6,657	7,278	7,539	8,044	8,234	8,594	9,058
Expenditure	13,406	13,997	13,911	14,838	15,808	16,434	16,404	17,389
Primary balance	-199	-471	555	569	433	302	331	354
Overall balance	-1,225	-1,538	-663	-724	-826	-896	-868	-929
GDP	26,946	28,035	28,549	29,846	31,891	33,636	35,339	37,091

Sources: Hungarian authorities; and staff estimates.

1/ Based on the ESA 2010 methodology.

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

3/ Includes the levy on financial institutions.

4/ Includes social security contributions.

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

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

Table 4. Central Government Financing, 2010–17

(In percent of GDP)

	2010	2011	2012	2013	2014	2015	2016	2017
					Prel.	Projections		
Gross financing needs	**16.5**	**19.3**	**16.2**	**20.6**	**23.3**	**20.2**	**20.0**	**22.8**
Central government cash deficit	3.2	1.7	2.2	2.8	3.0	2.6	2.5	2.5
Repayments	13.2	15.4	14.0	17.8	20.1	17.6	17.5	20.3
Domestic	11.8	11.0	8.9	12.5	15.2	15.4	12.6	18.1
Loans	0.0	0.2	0.1	0.1	0.4	0.6	0.3	0.3
LT bonds	5.7	5.3	3.4	6.0	8.8	10.1	8.0	13.9
T bills	6.1	5.4	5.4	6.4	6.0	4.7	4.3	4.0
External	1.3	4.4	5.2	5.3	4.9	2.2	4.9	2.1
Bonds	1.2	2.0	1.5	1.4	2.5	2.0	2.9	1.6
Loans	0.1	2.5	3.7	3.9	2.4	0.2	2.0	0.5
Of which : IMF	0.0	0.0	3.7	3.9	0.0	0.0	0.0	0.0
Other debt	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other debt-creating measures	0.0	2.2	0.0	0.0	0.2	0.0	0.0	0.0
Gross financing sources	**16.5**	**19.3**	**16.2**	**20.6**	**23.3**	**20.2**	**20.0**	**22.8**
Domestic	14.9	13.4	15.2	14.5	18.7	19.7	19.1	20.6
Loans	0.3	0.0	0.0	0.0	0.0	0.7	0.3	0.0
LT bonds	8.6	7.5	8.6	8.1	13.7	14.5	14.6	16.8
T bills	6.0	5.9	6.6	6.4	5.0	4.5	4.2	3.8
External	1.7	4.6	1.0	5.0	4.1	0.5	0.9	2.1
Bonds	1.5	3.8	0.3	5.0	4.1	0.5	0.9	2.1
Loans	0.2	0.8	0.7	0.0	0.0	0.0	0.0	0.0
Drawdown of deposits and liquidation of financial assets	-0.1	1.4	0.0	1.1	0.4	0.0	0.0	0.0
Memo items:								
Central Government deposits	4.0	4.9	4.8	4.3	...	...	...	...
Gross financing needs excl. short term debt	10.3	13.9	10.8	14.3	17.3	15.5	15.7	18.8
Gross financing requirements, in US$ bn.	16.1	19.4	16.0	20.7	24.1	21.3	22.0	26.2
o/w short term amortization	6.0	5.4	5.3	6.4	6.2	5.0	4.8	4.6

Sources: Hungarian authorities, and staff estimates and projections.

Table 5a. General Government Operations (GFSM presentation), 2010–17 1/

In percent of GDP

	2010	2011	2012	2013	Prel. 2014	Projections 2015	2016	2017
Revenue	45.2	44.4	46.4	47.3	47.0	46.2	44.0	44.4
Taxes	25.5	23.7	25.5	25.3	25.2	24.5	24.3	24.4
Taxes on goods and services	17.6	17.4	18.6	18.6	18.5	18.0	17.8	17.9
VAT	8.6	8.5	9.2	9.0	9.3	9.3	9.3	9.4
Excises and other	9.0	8.9	9.4	9.5	9.2	8.7	8.5	8.5
Taxes on income, profits and capital gains	7.9	6.3	6.8	6.7	6.7	6.5	6.5	6.5
Personal income tax	6.4	4.9	5.3	5.0	5.0	4.9	4.9	4.9
Corporate income tax	1.2	1.2	1.3	1.4	1.5	1.4	1.4	1.4
Other	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Capital taxes	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Social contributions	12.1	13.1	13.1	13.1	13.1	13.0	13.0	13.0
Grants and other revenues	7.6	7.5	7.8	8.9	8.6	8.7	6.7	7.0
Current non-tax revenue	4.3	4.1	4.2	4.4	4.4	4.2	4.1	4.1
o.w. interest revenue	0.3	0.4	0.3	0.3	0.1	0.1	0.1	0.1
o.w. dividends	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Current transfers 2/	1.5	1.3	1.6	2.0	1.9	2.0	1.3	1.4
Capital transfers 2/	1.9	2.2	2.1	2.6	2.3	2.5	1.3	1.5
o.w. transfer of pension assets	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Expenditure	49.7	49.9	48.8	49.7	49.6	48.9	46.4	46.9
Expense	49.1	49.6	48.4	48.9	48.8	47.6	46.7	46.8
Compensation of employees	10.8	10.1	9.8	10.1	10.2	10.2	10.3	10.3
Goods and services	7.7	7.4	7.5	7.5	8.5	8.3	7.5	7.6
Consumption of fixed capital	3.3	3.2	3.3	3.4	3.3	3.3	3.2	3.2
Interest	4.1	4.2	4.2	4.6	4.1	3.7	3.5	3.6
Subsidies	1.1	1.2	1.2	1.3	1.4	1.4	1.4	1.4
Social benefits	18.3	18.0	17.4	17.2	16.0	15.4	15.3	15.2
o.w. social security	14.1	14.2	13.3	13.4	12.7	12.0	12.0	12.0
Other expense	3.8	5.4	4.9	4.8	5.2	5.4	5.5	5.5
Net acquisition of nonfinancial assets	0.6	0.1	0.4	0.8	0.8	1.3	-0.3	0.0
Gross fixed capital formation 3/	3.7	3.4	3.6	4.2	4.1	4.5	2.9	3.3
Consumption of fixed capital	3.3	3.2	3.3	3.4	3.3	3.3	3.2	3.2
Gross operating balance 4/	-0.6	-1.9	1.3	1.7	1.5	1.9	0.5	0.8
Net operating balance	-3.9	-5.1	-2.0	-1.6	-1.8	-1.4	-2.8	-2.5
Net lending (+) / borrowing (-)	-4.5	-5.5	-2.4	-2.4	-2.6	-2.7	-2.5	-2.5
Net acquisition of financial assets	-1.6	4.1	-1.1	0.1	0.0	0.0	0.0	0.0
Currency and deposits	-0.8	0.5	0.3	-0.3	0.0	0.0	0.0	0.0
Securities other than shares	0.0	0.2	0.1	0.0	0.0	0.0	0.0	0.0
Loans	-0.7	-0.6	-0.4	0.5	-0.4	-0.4	-0.3	-0.3
Shares and other equity	0.0	4.3	-0.7	0.0	0.0	0.0	0.0	0.0
Insurance technical reserves	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financial derivatives	-0.3	-0.3	-0.5	0.0	0.0	0.0	0.0	0.0
Other accounts receivable	0.1	-0.1	0.0	0.0	0.4	0.4	0.3	0.3
Monetary gold and SDRs	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net incurrence of liabilities	2.9	-0.1	0.8	0.5	2.1	3.2	2.6	2.7
Currency and deposits	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Securities other than shares	1.7	-0.9	4.7	5.0	5.1	2.9	4.5	3.3
Loans	1.5	-0.7	-3.4	-5.3	-3.7	0.2	-2.0	-0.8
Shares and other equity	0.0	0.0	0.0	0.5	0.0	0.0	0.0	0.0
Insurance technical reserves	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financial derivatives	-0.1	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0
Other accounts payable	-0.3	1.6	-0.5	0.4	0.7	0.2	0.2	0.2
Statistical discrepancy	-0.1	-9.6	-0.4	-2.0	-0.5	0.6	0.2	0.2
Memo:								
Nominal GDP, HUF bn.	26,946	28,035	28,549	29,846	31,891	33,636	35,339	37,091

1/ Subcategories within tax revenues follow the ESA95 presentation.

2/ The distinction between grants and other transfers is not available in the ESA95 main tables which are the source of data for this table.

3/ Includes net acquisition of nonproduced nonfinancial assets.

4/ Excludes fixed capital consumption.

Table 5b. General Government Stock Positions, 2010–15 1/

In percent of GDP

	2010	2011	2012	2013	Prel. 2014	Proj. 2015
Net Financial Worth	-60.8	-52.5	-60.0	-57.0	-57.9	-57.7
Financial Assets	25.7	33.3	28.4	27.3	25.6	24.2
Currency and deposits	6.1	6.8	6.8	6.2	5.8	5.5
Securities other than shares	0.0	0.2	0.3	0.3	0.3	0.3
Loans	1.7	1.2	0.7	1.1	0.7	0.3
Shares and other equity	11.6	17.9	14.3	13.7	12.8	12.1
Insurance technical reserves	0.0	0.0	0.0	0.0	0.0	0.0
Financial derivatives	1.0	2.2	1.4	1.3	1.2	1.2
Other accounts receivable	5.3	5.0	4.9	4.7	4.8	4.9
Monetary gold and SDRs	0.0	0.0	0.0	0.0	0.0	0.0
Liabilities	86.5	85.8	88.4	84.3	83.5	81.9
Currency and deposits	0.1	0.1	0.1	0.1	0.1	0.1
Securities other than shares	58.1	55.2	63.6	62.6	65.2	63.8
Loans	22.3	23.2	18.1	14.4	10.7	10.8
Shares and other equity	0.0	0.0	0.0	0.5	0.4	0.4
Insurance technical reserves	0.0	0.0	0.0	0.0	0.0	0.0
Financial derivatives	0.6	0.5	0.4	0.4	0.4	0.4
Other accounts payable	5.4	6.8	6.2	6.4	6.7	6.5
Gross debt at face value	86.3	87.9	84.7	83.7	83.6	82.0
Maastricht Debt	80.9	81.0	78.5	77.3	76.9	75.5
Memo Items:						
Foreign currency debt	38.0	42.0	34.9	32.9	30.5	27.8
Other economic flows	0.5	1.8	-6.5	0.8	-2.5	0.5

1/ GFSM 2001 presentation.

Table 6. Balance Sheet of the Central Bank, 2010–2016

(In billions of forints)

	2010	2011	2012	2013	2014	2015 Proj.	2016 Proj.
Net foreign assets	7,449	9,709	9,025	9,360	10,501	10,094	8,479
Foreign Assets	9,598	11,969	10,092	10,262	11,186	10,765	9,150
Foreign Liabilities	2,149	2,260	1,068	902	685	672	672
Net domestic assets	-4,244	-5,836	-5,613	-5,564	-5,984	-5,306	-3,389
Net claims on government	-827	-1,215	-1,236	-614	-849	-792	-735
Assets	249	169	142	138	139	196	253
Liabilities (Govt Deposits at MNB)	1,077	1,383	1,378	752	988	988	988
HUF	273	597	443	242	525	...	...
FX	804	786	935	510	463	...	...
Net claims on banks	-2,565	-2,923	-3,404	-3,779	-4,243	-3,640	-2,069
Assets	35	119	184	821	1,042	842	1,042
Liabilities	2,600	3,041	3,588	4,600	5,284	4,482	3,111
Two Week Deposit Facility	120	211	337	319	5,281	4,482	3,111
Securities Issued by MNB	2,480	2,830	3,251	4,281	3	0	0
Net claims on the economy	-355	-163	-272	-598	2	-284	-164
Other items, net	-496	-1,536	-701	-574	-894	-590	-421
Base money (M0)	3,206	3,873	3,412	3,796	4,517	4,788	5,089
Currency in Circulation	2,464	2,766	2,740	3,251	3,785	4,011	4,264
Banks' Reserves	741	1,106	673	545	732	776	825
Current Account Balances	448	471	477	435	499	529	562
Overnight Deposits	293	635	195	110	233	247	263
***Memorandum items*:**							
International Reserves (billions of euros)	33.7	37.8	33.9	33.8	34.6	33.8	28.5
Base Money (yoy percent change)	14.4	20.8	-11.9	11.2	19.0	6.0	6.3
NFA (contribution to change)	6.7	70.5	-17.7	9.8	30.1	-9.0	-33.7
NDA (contribution to change)	7.7	-49.7	5.8	1.4	-11.1	15.0	40.0
Government Deposits at Central Bank (percent of GDP)	4.0	4.9	4.8	2.5	3.1	2.9	2.8
HUF	1.0	2.1	1.6	0.8	1.6	...	...
FX	3.0	2.8	3.3	1.7	1.5	...	...
Reserve Requirement Ratio (percent of select liabilities)		2% to 5%					

Sources: Magyar Nemzeti Bank and IMF staff projections.

Table 7. Monetary Survey, 2010–16

(In billions of forints, unless otherwise indicated)

	2010	2011	2012	2013	2014	2015 Proj.	2016 Proj.
Net foreign assets	1,242	4,167	5,062	6,175	7,522	7,782	7,994
Central Bank	7,449	9,709	9,025	9,360	10,501	10,094	8,479
Commercial Banks	-6,207	-5,541	-3,963	-3,185	-2,979	-2,312	-485
Net domestic assets	15,199	13,250	11,776	11,597	11,296	12,410	13,766
Domestic credit	21,135	20,806	18,611	18,257	18,824	18,244	18,986
Net claims on government	3,461	3,041	3,357	4,163	4,283	4,716	4,923
From Central Bank	-827	-1,215	-1,236	-614	-849	-792	-735
From Commercial Banks	4,288	4,256	4,593	4,777	5,132	5,508	5,658
Gross Credit to the economy	17,674	17,765	15,254	14,094	14,540	13,528	14,062
From Comercial Banks	18,029	17,927	15,525	14,692	14,539	13,812	14,226
Other items, net	-5,936	-7,556	-6,835	-6,659	-7,527	-5,834	-5,220
Broad money (M3)	16,441	17,418	16,838	17,772	18,818	20,192	21,760
M2	14,351	15,369	15,179	15,845	17,396	18,667	20,115
M1	6,635	7,343	7,297	8,896	10,746	11,530	12,425
Currency in circulation	2,218	2,551	2,554	3,001	3,548	3,807	4,103
Overnight Deposits	4,417	4,791	4,743	5,895	7,197	7,723	8,322
Deposits with Maturities up to 2 years	7,716	8,026	7,882	6,949	6,651	7,136	7,690
Repos	34	23	22	30	53	57	61
Money Market Fund Shares/Units	1,335	1,320	1,179	1,399	1,228	1,318	1,420
Debt Securities	721	706	458	499	141	151	163
***Memorandum items*:**							
	(percentage change by contribution, y-o-y)						
Broad Money	3.0	5.9	-3.3	5.5	5.9	7.3	7.8
NFA	4.2	17.8	5.1	6.6	7.6	1.4	1.0
NDA	-1.2	-11.9	-8.5	-1.1	-1.7	5.9	6.7
	(percentage change, y-o-y)						
Credit to Private Sector 1/ 2/	-2.4	-6.9	-7.4	-3.3	-0.9	-5.0	3.0
HUF	5.2	3.5	5.7	5.7	6.0	...	...
FX	-7.1	-13.0	-15.4	-10.4	-7.2	...	...
Bank Deposits (% yoy)	0.0	6.2	0.1	2.5	9.5	10.6	12.6
Bank Holdings of Government Paper (percent of GDP)	15.3	13.8	14.4	13.9	15.2	14.9	14.6

Sources: Magyar Nemzeti Bank and IMF staff projections.

1/ Adjusted for changes in exchange rate

2/ Only credit to households and firms

Table 8. Financial Soundness Indicators for the Banking Sector, 2010–14
(In percent, unless otherwise indicated, end of period)

	2010	2011	2012	2013	Sep-14
Capital					
Regulatory capital to risk-weighted assets	13.9	13.8	16.3	17.5	17.9
Regulatory Tier 1 capital to risk-weighted assets	11.3	11.3	13.3	14.7	14.8
Asset Quality					
NPLs net of provisions to capital	49.7	60.0	53.9	46.7	42.6
NPLs to gross loans	10.0	13.7	16.0	16.8	16.3
Distribution of Loans (Percent of Total)					
Firms	34.5	34.6	37.1	37.7	37.7
Households and Non-Profits	40.4	39.8	39.7	39.7	39.7
Non-Residents	10.3	9.8	8.4	7.2	7.1
Other	14.9	15.8	14.8	15.4	15.5
Profitability					
ROA	0.0	-0.7	-0.1	0.2	-2.2
ROE	0.4	-8.5	-1.4	2.4	-20.2
Net interest income to gross income	56.1	51.6	54.0	46.6	54.0
Noninterest expenses to gross income	73.3	75.7	86.9	80.6	76.0
Liquidity					
Liquid assets to total assets	22.3	24.7	30.8	32.8	35.4
Liquid assets to short term liabilities	42.8	45.6	55.2	57.5	60.3
Sensitivity to Market risk					
Net open FX position to Regulatory capital	15.9	23.9	20.5	15.5	18.2

Source: MNB.

Table 9. Balance of Payments, 2010–20

(in millions of euros, unless otherwise indicated)

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
					Est.			Proj.			
Current Account	**274**	**754**	**1,873**	**4,162**	**4,382**	**5,031**	**4,492**	**3,746**	**2,865**	**2,456**	**1,566**
Goods and service, net	5,260	6,213	6,836	7,623	7,670	9,292	9,019	8,622	8,250	7,869	6,995
Exports	80,780	87,833	86,424	89,197	95,896	98,375	104,223	108,002	112,630	117,589	123,679
Imports	-75,519	-81,620	-79,588	-81,573	-88,225	-89,083	-95,204	-99,381	-104,380	-109,720	-116,683
Primary Income, net	-4,623	-4,892	-4,160	-2,907	-2,818	-3,409	-3,660	-3,944	-4,444	-4,774	-4,827
Secondary Income/Current transfers, net	-364	-567	-802	-554	-470	-852	-867	-932	-941	-638	-603
Capital Account	**1,796**	**2,353**	**2,532**	**3,641**	**2,641**	**360**	**722**	**1,021**	**808**	**1,012**	**553**
Net capital transfers	2,008	2,383	2,496	3,592	2,641	360	722	1,021	808	1,012	553
Financial Account	**-1,912**	**-3,149**	**4,304**	**914**	**3,917**	**6,065**	**9,123**	**6,846**	**1,426**	**1,677**	**1,346**
Direct investment, net	-762	-972	-2,021	-373	-427	-463	-495	-509	-445	-460	-434
Portfolio investment, net 1/	-361	-5,629	-1,782	-3,652	1,885	812	-1,037	-3,387	-3,455	-2,995	-2,465
Other investment	-790	3,451	8,106	4,939	2,459	5,717	10,654	10,743	5,327	5,132	4,245
Net errors and omissions	**-965**	**-2,383**	**384**	**-625**	**-310**	**-106**	**110**	**115**	**-121**	**-126**	**-130**
Overall Balance	**3,018**	**3,874**	**486**	**6,264**	**2,796**	**-780**	**-3,799**	**-1,964**	**2,126**	**1,665**	**642**
Official Financing (European Union)	**0**	**-2,000**	**0**	**0**	**-2,000**	**0**	**-1,500**	**0**	**0**	**0**	**0**
Net International Reserves (increase -)	**-3,018**	**-1,874**	**-486**	**-6,264**	**-796**	**780**	**5,299**	**1,964**	**-2,126**	**-1,665**	**-642**
Gross Reserves	-3,018	-1,874	3,351	-1,210	-796	780	5,299	1,964	-2,126	-1,665	-642
Reserve Liabilities	0	0	-3,837	-5,054	0	0	0	0	0	0	0
IMF	0	0	-3,837	-5,054	0	0	0	0	0	0	0
Memorandum Items:											
Current account (in percent of GDP)	0.3	0.8	1.9	4.1	4.2	4.8	4.1	3.3	2.4	1.9	1.2
Exports, g&s (in percent of GDP)	82.5	87.5	87.6	88.8	92.8	93.2	94.7	93.8	93.5	93.3	94.8
Volume (percent change)	11.3	6.6	-1.5	5.9	8.7	6.2	5.5	5.3	5.1	4.7	4.5
Imports, g&s (in percent of GDP)	77.2	81.3	80.7	81.2	85.4	84.4	86.5	86.3	86.6	87.1	89.5
Volume (percent change)	10.1	4.5	-3.3	5.9	10.0	6.3	5.6	5.4	5.4	5.2	5.2
Gross external debt (in percent of GDP) 2/	143.6	134.8	128.9	118.6	115.8	106.5	89.8	80.2	73.6	67.9	63.5
Gross official reserves	33,675	37,774	33,881	33,782	34,578	33,798	28,499	26,535	28,661	30,326	30,968
In percent of short-term debt at remaining maturity 3/	62.6	65.3	67.5	97.4	106.9	120.7	144.6	164.0	177.4	192.1	192.3
In months of next year's imports of good and services	5.0	5.7	5.0	4.6	4.7	4.3	3.4	3.1	3.1	3.1	3.0

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

Table 10. External Financing Needs, 2011–2020

(in millions of euros, unless otherwise indicated)

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
				Est.	Projections					
Total financing requirements	**44,432**	**37,598**	**28,129**	**22,133**	**22,335**	**22,683**	**14,826**	**12,627**	**12,811**	**13,803**
Current account - Capital account	-3,107	-4,406	-7,803	-7,023	-5,391	-5,214	-4,767	-3,673	-3,468	-2,119
Current account	-754	-1,873	-4,162	-4,382	-5,031	-4,492	-3,746	-2,865	-2,456	-1,566
Capital account	2,353	2,532	3,641	2,641	360	722	1,021	808	1,012	553
Amortizations	45,156	42,387	35,306	28,846	27,621	28,007	19,708	16,179	16,153	15,792
FDI (incl. intra-company)	6,228	6,069	5,974	6,003	6,263	6,251	6,226	6,176	6,114	5,992
General government	7,681	10,417	11,584	7,572	5,715	6,943	3,128	2,788	3,243	4,293
Eurobonds	1,989	1,436	1,418	2,597	1,511	1,403	-872	534	843	2,555
Loans and others	2,548	3,837	5,054	2,573	248	2,261	665	407	183	164
o/w: to IMF and EU	2,000	3,837	5,054	2,000	0	1,500	0	0	0	0
Non-resident holding of government securities	3,144	5,145	5,112	2,402	3,956	3,278	3,335	1,847	2,216	1,573
Banks	18,465	14,431	10,012	8,327	9,747	8,634	5,044	3,431	2,759	2,852
Subsidiaries	15,806	12,353	8,570	7,128	8,344	7,390	4,318	2,937	2,362	2,442
Domestic banks without parents (OTP, FHB+FKB, ...) 1/	2,659	2,078	1,442	1,199	1,404	1,243	726	494	397	411
Other investment (mainly corporate)	7,747	6,593	5,803	5,024	5,627	5,953	5,083	3,580	3,832	2,449
Net errors and omissions	2,383	-384	625	310	106	-110	-115	121	126	130
Total financing sources	**44,432**	**37,598**	**28,129**	**22,133**	**22,335**	**22,683**	**14,826**	**12,627**	**12,811**	**13,803**
FDI net inflows (incl. intra-company)	7,200	8,090	6,347	6,431	6,726	6,745	6,735	6,621	6,574	6,426
Disbursements (debt)	29,730	23,282	21,814	20,629	13,955	8,060	7,109	6,359	7,340	7,672
General government 2/	10,423	9,645	10,243	6,622	1,993	1,000	2,493	2,705	3,179	4,248
Eurobonds	4,696	309	5,058	4,284	470	910	2,326	2,058	963	2,659
Loans and others	1,096	700	0	0	0	0	0	0	0	0
Non-resident holding of government securities	4,631	8,636	5,185	2,338	1,523	90	167	646	2,216	1,589
Central bank	4,583	1,280	1,934	1,921	227	227	205	205	205	206
Banks	12,612	8,111	6,235	8,848	6,335	3,731	1,857	1,914	1,862	1,881
Other investment (mainly corporate)	6,695	5,527	5,336	5,158	5,627	3,328	2,759	1,740	2,299	1,543
Other portfolio flows net	9,377	2,875	5,015	-4,130	875	2,580	-982	1,773	561	348
Drawdown in gross reserves	-1,874	3,351	-5,047	-796	780	5,299	1,964	-2,126	-1,665	-642
Memo items										
Gross international reserves (level in Euro million)	37,774	33,881	33,782	34,578	33,798	28,499	26,535	28,661	30,326	30,968
In percent of short-term debt at remaining maturity	65	67	97	107	121	145	164	177	192	192
Government rollover rates (in percent)	136	93	88	87	35	14	80	97	98	99
Banks' rollover rates (in percent)	68	56	62	106	65	43	37	56	67	66
Corporate rollover rates (in percent)	86	84	92	103	100	56	54	49	60	63

Sources: Hungarian authorities; IMF staff estimates and projections.

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

2/ Excludes EU and IMF loans

Appendix I. Recent Legislation Affecting Household Debt

Settlement Act. This Act (adopted in September 2014), stipulates that banks and leasing companies should compensate borrowers for past unilateral contract modification and for the use of bid-ask spreads in calculating FX loan disbursements and repayments. It applies to all loans disbursed after May 1, 2004 and not terminated before July 26, 2009. MNB estimates the impact of this Act at HUF900–1000 billion (3–3¼ percent of GDP), of which HUF800 billion will be incurred by banks and non-resident credit institutions. The net effect on banks, however, will be somewhat smaller because of previous loan-loss provisioning. The compensation will take the form of a principle reduction of ongoing contracts, and a cash transfer to borrowers with expired contracts.[1] The compensation deadline is end-March 2015.

Fair Banking Act. This Act (adopted in November 2014), restricts unilateral interest rate and cost hikes by banks, regulates the information provided to borrowers, and allows borrowers to terminate a loan contract under certain conditions. The interest rate could change only in line with the reference rate, without any change in the interest margin for loans based on a floating rate with less than three-year maturity. For loans with longer maturity, the Act allows hikes both in the reference rate and the interest rate margin. Banks will, however, need to fix the margin hike at least three years in advance.

FX mortgage conversion. In early November 2014, the MNB and the Bank Association agreed on a fast and orderly conversion of FX mortgage loans to local currency in order to reduce the exposure of household balance sheet to exchange rate risk. To avoid strong pressure on the exchange rate, the MNB used its reserves to allocate to the banks about € 9 billion to help them close their open FX position that emerged from the conversion through euro sale instruments at the spot exchange rate at day of the agreement (November 7). The scheme has been designed to ensure it does not jeopardize the MNB's reserve adequacy given that the amount of foreign currency made available will reduce short-term external debt and consequently the MNB's foreign exchange reserve needs. Furthermore, the amount will be provided gradually over 2015–17 according to maturity of banks' foreign liabilities. On conversion, households had the option to transfer their HUF mortgage to another bank. The new loans were pegged to the 3-month interbank rate, with interest rate margins not exceeding those in the original FX loans.

[1] The Settlement Act would result in a 16 percent decline, on average, in the indebtedness of FX mortgage borrowers. Together with the Fair Banking Act, monthly installments of FX mortgages would decline by 20–25 percent.

Appendix II. Hungary: Debt Sustainability Analysis

Hungary's high public and external debt and financing needs, together with heavy reliance on non-resident funding, remain important sources of vulnerability. Under the baseline scenario, public debt is projected to remain at around 72percent of GDP while gross financing needs are forecast to hover above 20 percent of GDP. This exposes Hungary's public debt to considerable risks, particularly from lower GDP growth. External debt is expected to continue to decline, with all sectors except for the government continuing to make net repayments. The projected downward path is sensitive mainly to exchange rate and current account shocks.

Under current policies, public debt is projected to diminish only marginally, to about 72 percent of GDP over the medium term. This scenario is underpinned by a net lending/borrowing balance around 2½percent of GDP; interest rates on sovereign bonds and loans gradually increasing in line with global WEO assumptions; and medium-term output growth of about 2 percent. The scenario assumes that financial markets remain accessible and there are no significant interest rate spikes, with sovereign and maturity spreads remaining at near 2014 levels.

The baseline scenario is subject to considerable risks which, if materialized, would likely set public debt on an increasing trajectory. With public debt well above 70 percent of GDP, negative shocks, even of a relatively small size, may trigger adverse reactions from financial markets, especially considering that annual gross financing needs are hovering above 20 percent of GDP with large reliance on non-resident financing (around 35 percent). Possible shocks include exchange rate depreciation pressure, an increase in sovereign spreads through contagion effects from other emerging economies, reduced appetite by international investors, and an increase in global interest rates in line with U.S. monetary policy normalization. On the domestic front, possible shocks to the primary fiscal balance include public wage pressures, large allocations to projects in the investment fund, and pressures in sectors with increased public sector ownership. On the revenue side, risks are driven by unidentified revenue sources and underlying vulnerabilities such as large-spread VAT fraud and evasion of social contribution payments. Debt and gross financing needs also remain vulnerable to a sudden realization of contingent liabilities. While contingent liabilities are not a principal vulnerability at this stage, fiscal risks have been rising along with the expansion of quasi-fiscal activities.

Based on historical volatility, probabilistic analysis of debt dynamics indicates that public debt could enter an increasing trajectory with a probability of 50 percent. Moreover, assuming that policy rigidities do not allow improving the primary balance by more than 2 percent of GDP in a single year, the probability that public debt enters an increasing trajectory increases to approximately 60 percent. This constraint is driven by the already high tax burden that leaves virtually no room for significant revenue-raising measures, and also by the fact that expenditure-based consolidations typically take more time to design and implement.

Hungary's external debt has declined in recent years but remains high. Gross external debt has declined from its peak of about 150 percent of GDP in 2009 to 116 percent by end-2014. The improvement mainly reflects heavy bank deleveraging that began during the global financial crisis, although this was partly offset by higher external government debt. Intra-company loans related to FDI remain broadly stable, amounting to about 15 percent of gross debt throughout this period. Going forward, external debt is expected to continue to decline, with all sectors except for the government continuing to make net repayments. The FX conversion and the government's self financing program (to reduce purchases of HUF-denominated securities by nonresidents) are expected to keep external debt on a declining path over the medium term.

External debt remains sustainable under a range of shocks. Staff analysis shows that external debt is particularly vulnerable to exchange rate and current account shocks, and to a lesser extent, to growth and interest rate shocks. A one-time real depreciation of 30 percent would add 15 percentage points of GDP to external debt. An adverse permanent growth or current account shock of ½ standard deviation of their historical variation would add about 8 to 15 percentage points of GDP to external debt, respectively.

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

(in percent of GDP unless otherwise indicated)

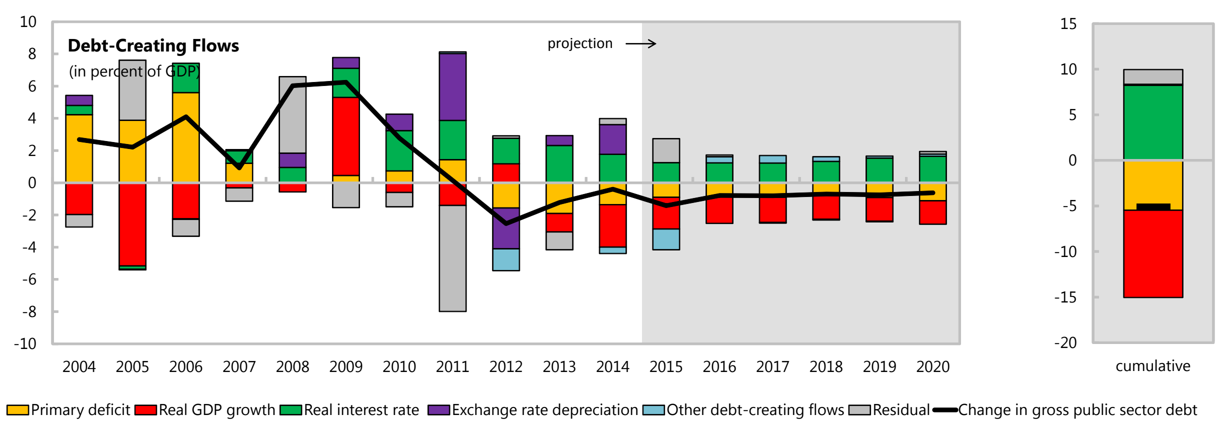
Debt, Economic and Market Indicators 1/

	Actual			Projections					
	2004-2012 2/	2013	2014	2015	2016	2017	2018	2019	2020
Nominal gross public debt	71.2	77.3	76.9	75.5	74.7	73.9	73.2	72.4	71.8
Public gross financing needs	18.4	19.4	22.1	21.4	16.2	21.1	22.4	22.7	23.3
Real GDP growth (in percent)	1.6	1.5	3.6	2.7	2.3	2.2	2.1	2.1	2.1
Inflation (GDP deflator, in percent)	4.3	3.0	3.1	2.7	2.7	2.7	2.7	2.7	2.7
Nominal GDP growth (in percent)	6.0	4.5	6.8	5.5	5.1	5.0	4.9	4.9	4.9
Effective interest rate (in percent) 4/	6.4	6.1	5.7	4.5	4.5	4.5	4.6	5.0	5.1

As of February 19, 2015		
Sovereign Spreads		
EMBIG (bp) 3/		180
5Y CDS (bp)		135
Ratings	Foreign	Local
Moody's	Ba1	Ba1
S&Ps	BB	BB
Fitch	BB+	BBB-

Contribution to Changes in Public Debt

	Actual			Projections							
	2004-2012	2013	2014	2015	2016	2017	2018	2019	2020	cumulative	debt-stabilizing primary balance 9/
Change in gross public sector debt	2.5	-1.2	-0.4	-1.4	-0.8	-0.8	-0.7	-0.8	-0.6	-5.1	
Identified debt-creating flows	2.8	-0.1	-0.8	-2.9	-0.9	-0.8	-0.6	-0.7	-0.8	-6.7	
Primary deficit	1.8	-1.9	-1.4	-0.9	-0.9	-0.9	-0.8	-0.9	-1.1	-5.5	0.3
Primary (noninterest) revenue and grants	43.8	47.0	46.8	46.1	44.0	44.4	44.9	45.6	46.6	271.6	
Primary (noninterest) expenditure	45.6	45.1	45.5	45.2	43.1	43.5	44.2	44.7	45.5	266.1	
Automatic debt dynamics 5/	1.2	1.8	1.0	-0.7	-0.4	-0.3	-0.2	0.1	0.2	-1.3	
Interest rate/growth differential 6/	0.7	1.2	-0.9	-0.7	-0.4	-0.3	-0.2	0.1	0.2	-1.3	
Of which: real interest rate	1.4	2.3	1.8	1.3	1.2	1.2	1.3	1.5	1.6	8.2	
Of which: real GDP growth	-0.7	-1.1	-2.6	-2.0	-1.7	-1.6	-1.5	-1.5	-1.5	-9.6	
Exchange rate depreciation 7/	0.5	0.6	1.8	…	…	…	…	…	…	…	
Other identified debt-creating flows	-0.1	0.0	-0.4	-1.3	0.4	0.5	0.3	0.1	0.1	0.1	
Privatization/Drawdown of deposits (negative)	-0.1	0.0	-1.1	-0.5	0.0	0.0	0.0	0.0	0.0	-0.5	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other debt-creating flows and adjustments	0.0	0.0	0.6	-0.8	0.4	0.5	0.3	0.1	0.1	0.6	
Residual, including asset changes 8/	-0.3	-1.1	0.4	1.5	0.1	0.0	-0.1	0.0	0.2	1.6	



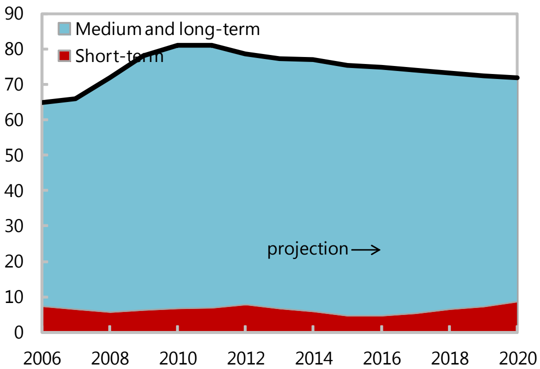
Source: IMF staff.
1/ Public sector is defined as general government.
2/ Based on available data.
3/ EMBIG.
4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.
5/ Derived as $[(r - \pi(1+g) - g + ae(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).
6/ The real interest rate contribution is derived from the numerator in footnote 5 as r - π (1+g) and the real growth contribution as -g.
7/ The exchange rate contribution is derived from the numerator in footnote 5 as ae(1+r).
8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Hungary Public DSA – Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

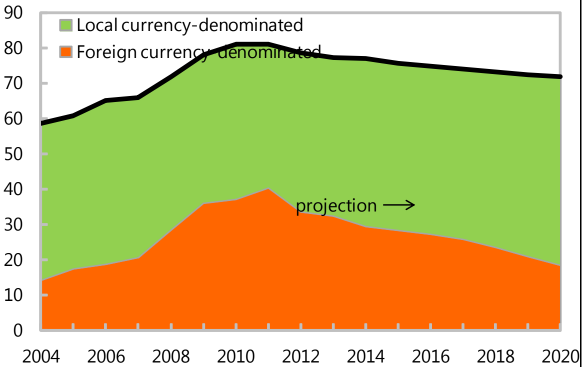
By Maturity

(in percent of GDP)



By Currency

(in percent of GDP)

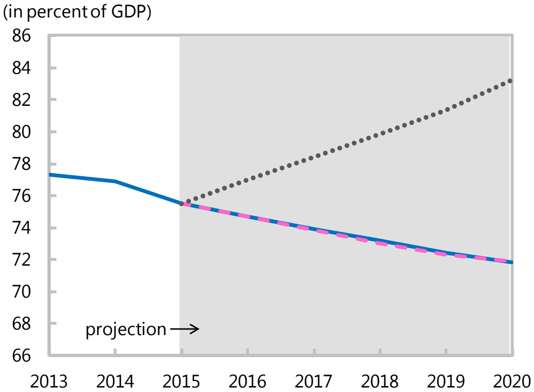


Alternative Scenarios

Baseline Historical Constant Primary Balance

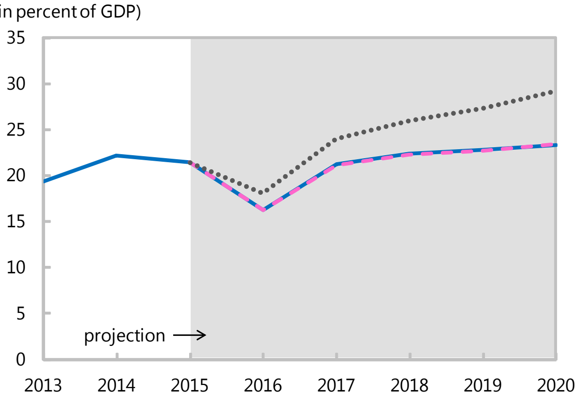
Gross Nominal Public Debt

(in percent of GDP)



Public Gross Financing Needs

(in percent of GDP)



Underlying Assumptions

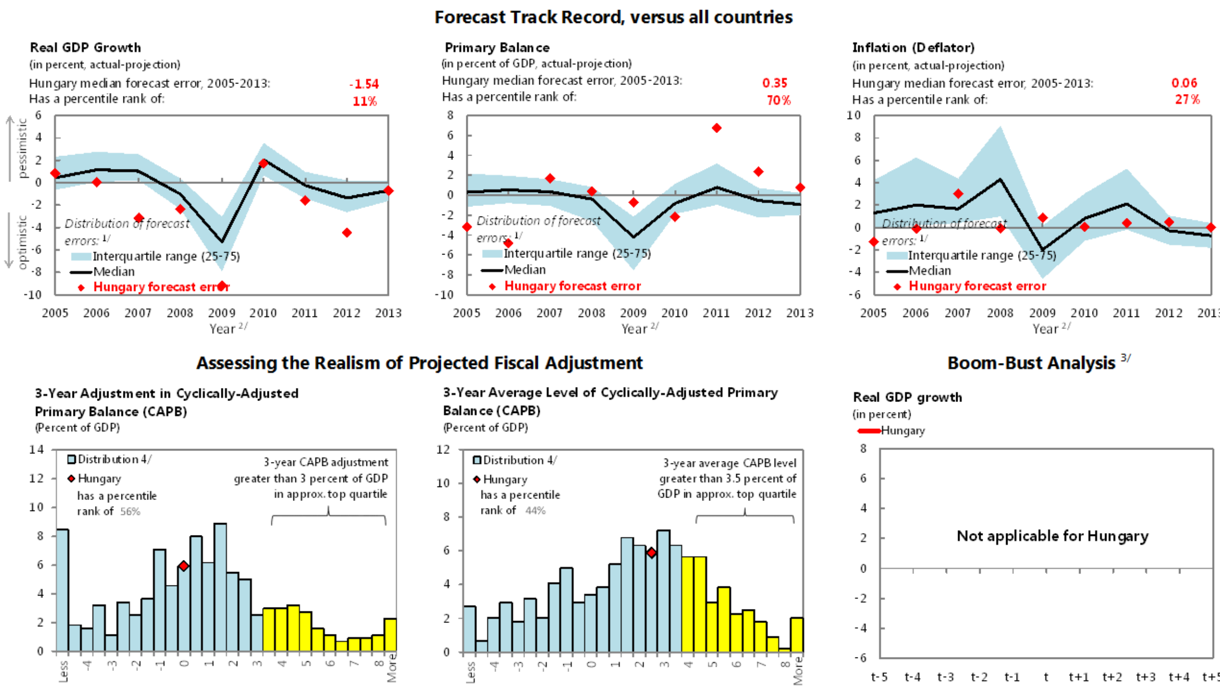
(in percent)

Baseline Scenario	2015	2016	2017	2018	2019	2020
Real GDP growth	2.7	2.3	2.2	2.1	2.1	2.1
Inflation	2.7	2.7	2.7	2.7	2.7	2.7
Primary Balance	0.9	0.9	0.9	0.8	0.9	1.1
Effective interest rate	4.5	4.5	4.5	4.6	5.0	5.1
Constant Primary Balance Scenario						
Real GDP growth	2.7	2.3	2.2	2.1	2.1	2.1
Inflation	2.7	2.7	2.7	2.7	2.7	2.7
Primary Balance	0.9	0.9	0.9	0.9	0.9	0.9
Effective interest rate	4.5	4.5	4.5	4.6	5.0	5.1

Historical Scenario	2015	2016	2017	2018	2019	2020
Real GDP growth	2.7	1.6	1.6	1.6	1.6	1.6
Inflation	2.7	2.7	2.7	2.7	2.7	2.7
Primary Balance	0.9	-0.8	-0.8	-0.8	-0.8	-0.8
Effective interest rate	4.5	4.5	4.5	4.7	5.1	5.3

Source: IMF staff.

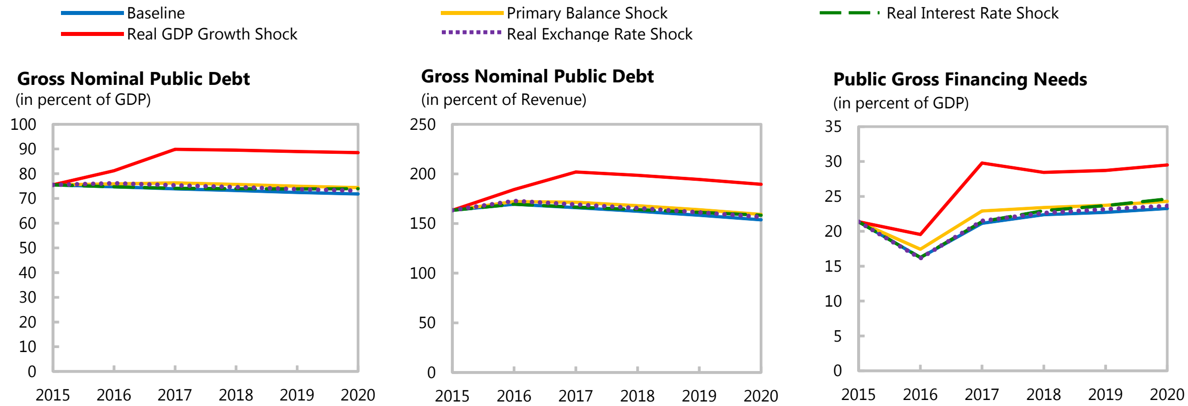
Hungary Public DSA – Realism of Baseline Assumptions



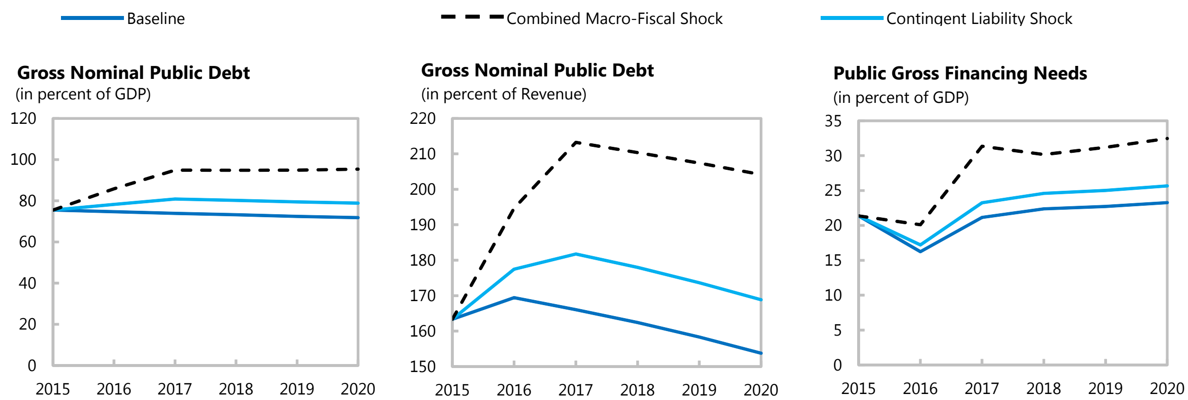
Source : IMF Staff.
1/ Plotted distribution includes all countries, percentile rank refers to all countries.
2/ Projections made in the spring WEO vintage of the preceding year.
3/ Not applicable for Hungary, as it meets neither the positive output gap criterion nor the private credit growth criterion.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

Hungary Public DSA – Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions
(in percent)

	2015	2016	2017	2018	2019	2020
Primary Balance Shock						
Real GDP growth	2.7	2.3	2.2	2.1	2.1	2.1
Inflation	2.7	2.7	2.7	2.7	2.7	2.7
Primary balance	0.9	-0.3	-0.3	0.8	0.9	1.1
Effective interest rate	4.5	4.5	4.5	4.7	5.0	5.2
Real Interest Rate Shock						
Real GDP growth	2.7	2.3	2.2	2.1	2.1	2.1
Inflation	2.7	2.7	2.7	2.7	2.7	2.7
Primary balance	0.9	0.9	0.9	0.8	0.9	1.1
Effective interest rate	4.5	4.5	4.8	5.3	5.9	6.2
Combined Shock						
Real GDP growth	2.7	-2.0	-2.1	2.1	2.1	2.1
Inflation	2.7	1.6	1.6	2.7	2.7	2.7
Primary balance	0.9	-1.5	-4.0	0.8	0.9	1.1
Effective interest rate	4.5	4.7	4.8	5.3	5.8	6.2

	2015	2016	2017	2018	2019	2020
Real GDP Growth Shock						
Real GDP growth	2.7	-2.0	-2.1	2.1	2.1	2.1
Inflation	2.7	1.6	1.6	2.7	2.7	2.7
Primary balance	0.9	-1.5	-4.0	0.8	0.9	1.1
Effective interest rate	4.5	4.5	4.6	5.0	5.2	5.3
Real Exchange Rate Shock						
Real GDP growth	2.7	2.3	2.2	2.1	2.1	2.1
Inflation	2.7	6.6	2.7	2.7	2.7	2.7
Primary balance	0.9	0.9	0.9	0.8	0.9	1.1
Effective interest rate	4.5	4.7	4.4	4.6	4.9	5.1
Contingent Liability Shock						
Real GDP growth	2.7	-2.0	-2.1	2.1	2.1	2.1
Inflation	2.7	2.7	2.7	2.7	2.7	2.7
Primary balance	0.9	0.9	0.9	0.8	0.9	1.1
Effective interest rate	4.5	4.8	4.5	4.6	5.0	5.1

Source: IMF staff.

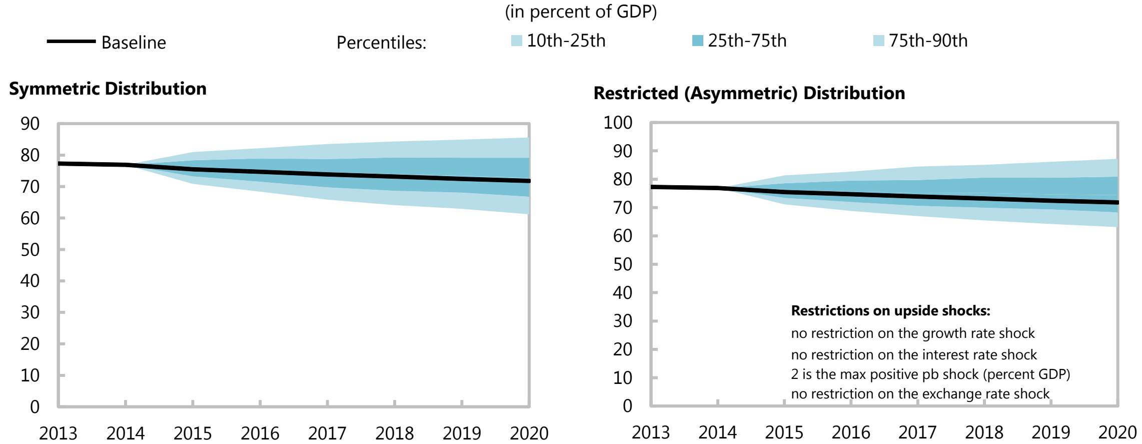
Hungary Public DSA Risk Assessment

Heat Map

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

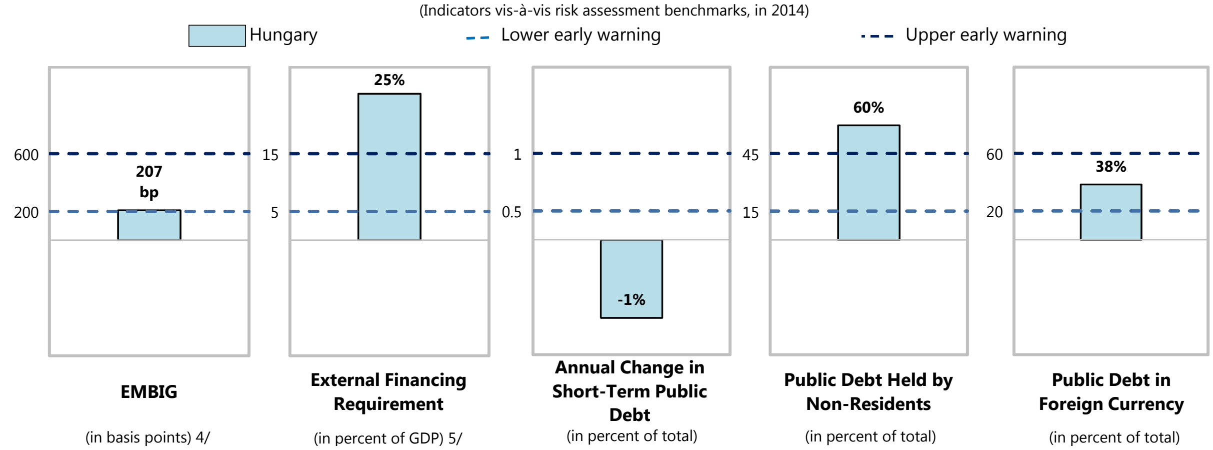
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2014)



Source: IMF staff.

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

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

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

Lower and upper risk-assessment benchmarks are:

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

4/ EMBIG, an average over the last 3 months, 19-Nov-14 through 19-Feb-15.

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

Hungary: External Debt Sustainability Framework, 2009–2020

(In percent of GDP, unless otherwise indicated)

	Actual					Projections							
	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	Debt-stabilizing non-interest current account 6/
1 **Baseline: External debt**	149.1	143.6	134.8	128.9	118.6	**115.8**	**106.5**	**89.8**	**80.2**	**73.6**	**67.9**	**63.5**	**2.5**
2 Change in external debt	33.4	-5.5	-8.8	-5.9	-10.4	-2.7	-9.4	-16.7	-9.6	-6.6	-5.7	-4.5	
3 Identified external debt-creating flows (4+8+9)	22.1	-7.8	-2.4	0.0	-6.4	-8.9	-6.1	-5.5	-4.7	-3.6	-2.1	-1.6	
4 Current account deficit, excluding interest payments	-4.6	-5.3	-6.2	-7.4	-8.5	-7.1	-6.4	-5.7	-4.9	-3.9	-3.3	-2.5	
5 Deficit in balance of goods and services	-4.1	-5.4	-6.2	-6.9	-7.6	-7.4	-8.8	-8.2	-7.5	-6.8	-6.2	-5.4	
6 Exports	75.2	82.5	87.5	87.6	88.8	92.8	93.2	94.7	93.8	93.5	93.3	94.8	
7 Imports	71.1	77.2	81.3	80.7	81.2	85.4	84.4	86.5	86.3	86.6	87.1	89.5	
8 Net non-debt creating capital inflows (negative)	7.0	-1.1	2.4	0.7	1.1	-0.5	1.7	1.0	0.4	0.4	1.3	1.0	
9 Automatic debt dynamics 1/	19.8	-1.4	1.4	6.7	1.0	-1.3	-1.4	-0.8	-0.3	-0.1	-0.1	-0.1	
10 Contribution from nominal interest rate	5.5	5.0	5.4	5.5	4.4	2.9	1.7	1.6	1.6	1.5	1.4	1.3	
11 Contribution from real GDP growth	8.7	-1.1	-2.5	2.0	-1.9	-4.2	-3.1	-2.3	-1.9	-1.6	-1.5	-1.4	
12 Contribution from price and exchange rate changes 2/	5.7	-5.3	-1.5	-0.9	-1.4	...	...	...	...	...	...	...	
13 Residual, incl. change in gross foreign assets (2-3) 3/	11.2	2.3	-6.4	-5.9	-4.0	6.6	-3.2	-11.2	-4.8	-3.1	-3.5	-2.8	
External debt-to-exports ratio (in percent)	198.3	174.0	154.1	147.2	133.6	124.8	114.3	94.8	85.6	78.7	72.8	66.9	
Gross external financing need (in billions of US dollars) 4/	54.7	58.9	68.8	65.0	48.5	41.2	37.4	35.1	22.8	17.5	17.1	17.0	
in percent of GDP	58.7	60.2	68.5	65.8	48.3	39.9	35.4	31.9	19.7	14.6	13.6	13.0	
Scenario with key variables at their historical averages 5/						**115.8**	**116.5**	**111.4**	**112.8**	**115.9**	**118.3**	**120.5**	**5.9**
Key Macroeconomic Assumptions Underlying Baseline													
Real GDP growth (in percent)	-6.6	0.8	1.8	-1.5	1.5	3.6	2.7	2.3	2.2	2.1	2.1	2.1	
GDP deflator in US dollars (change in percent)	-6.9	4.1	0.7	-0.2	0.3	-0.8	-0.5	1.9	2.4	2.5	2.4	1.4	
Nominal external interest rate (in percent)	4.1	3.5	3.9	4.0	3.5	2.5	1.5	1.6	1.9	1.9	1.9	2.0	
Growth of exports (US dollar terms, in percent)	-18.3	15.2	8.7	-1.6	3.2	7.5	2.6	5.9	3.6	4.3	4.4	5.2	
Growth of imports (US dollar terms, in percent)	-22.3	13.8	8.1	-2.5	2.5	8.2	1.0	6.9	4.4	5.0	5.1	6.3	
Current account balance, excluding interest payments	4.6	5.3	6.2	7.4	8.5	7.1	6.4	5.7	4.9	3.9	3.3	2.5	
Net non-debt creating capital inflows	-7.0	1.1	-2.4	-0.7	-1.1	0.5	-1.7	-1.0	-0.4	-0.4	-1.3	-1.0	

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

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

3/ For projection, line includes the impact of price and exchange rate changes. Large residuals in 2014 and 2016 are related to Eurobond payment (2014) and the Fx conversion scheme of banks over the period 2015-17 that would have the largest impact on reserves in 2016.

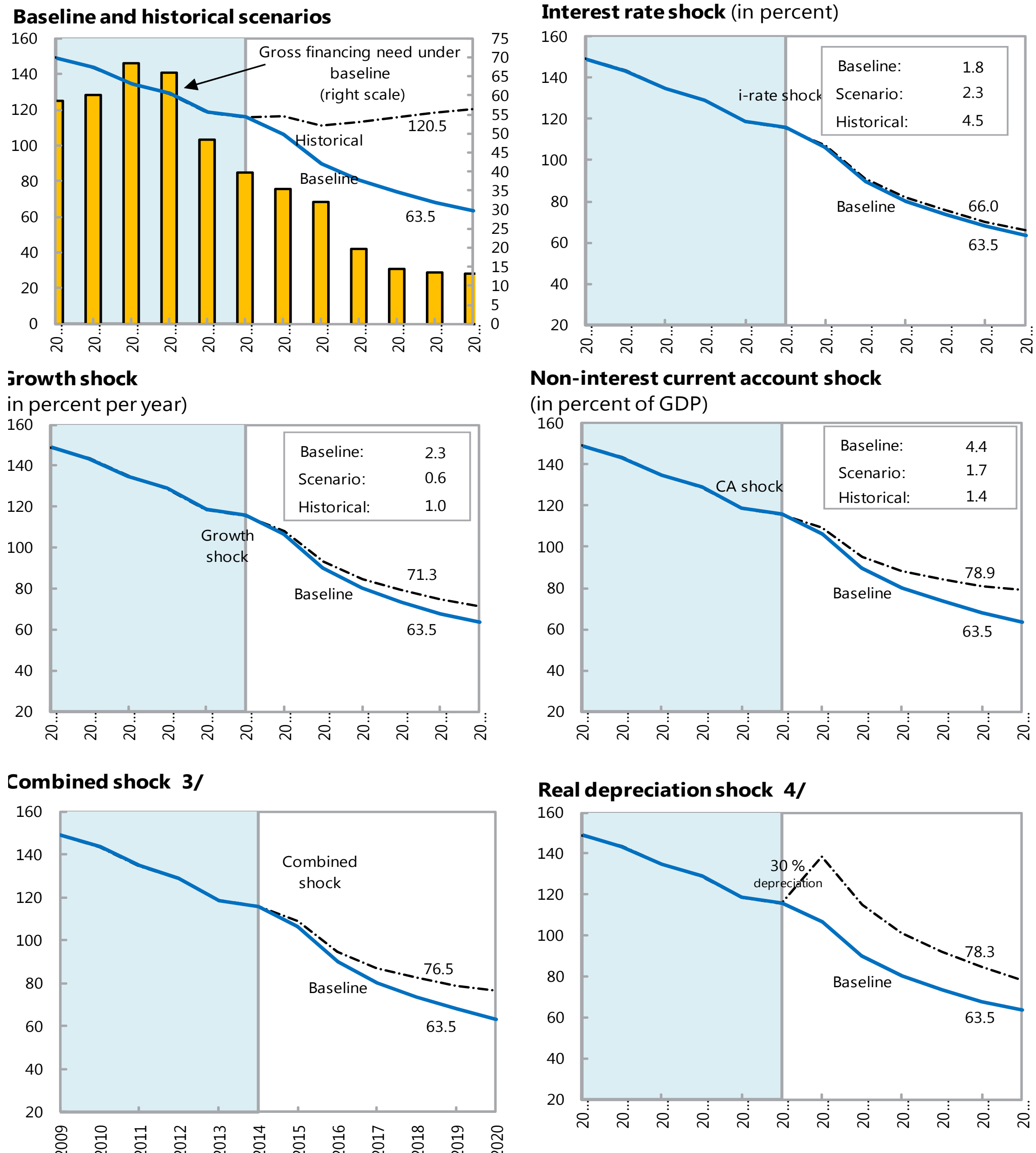
4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

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

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

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

(External debt in percent of GDP)



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

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

2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics six years ahead.

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

4/ One-time real depreciation of 30 percent occurs in 2015.

HUNGARY

March 11, 2015

STAFF REPORT FOR THE 2015 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Prepared By

European Department
(In Consultation with Other Departments)

CONTENTS

FUND RELATIONS

(As of February 28, 2015)

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

General Resources Account:

	SDR Million	Percent Quota
Quota	1,038.40	100.00
Fund holdings of currency	964.56	92.89
Reserve position in Fund	73.84	7.11

SDR Department:

	SDR Million	Percent Allocation
Net cumulative allocation	991.05	100.00
Holdings	12.74	1.29

Outstanding Purchases and Loans: None

Latest Financial Arrangements:

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

Projected Payments to Fund:

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

			Forthcoming		
	2015	**2016**	**2017**	**2018**	**2019**
Principal					
Charges/Interest	0.37	0.50	0.50	0.50	0.50
Total	0.37	0.50	0.50	0.50	0.50

Current Status of Safeguards Assessment:

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

Exchange Rate Arrangements:

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

Article IV Consultation:

Hungary is on a 12-month consultation cycle. The last Article IV Board discussion took place on May 23, 2014. The associated Executive Board assessment is available at http://www.imf.org/external/np/sec/pr/2014/pr14268.htm and the staff report at http://www.imf.org/external/pubs/cat/longres.aspx?sk=41618.0

Technical Assistance:

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

HUNGARY: TECHNICAL ASSISTANCE FROM THE FUND, FY2010–2015

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

Resident Representative:

The resident representative office closed on December 31, 2013.

STATISTICAL ISSUES

Assessment of Data Adequacy for Surveillance

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

- **Government Finance Statistics**: Data reporting on fiscal accounting needs to be improved further. The monthly cash-basis accounts of the central government prepared by the Ministry of National Economy do not reflect the GFS presentation and provide no information on financing. This complicates staff's ability to analyze trends and to appropriately anticipate the impact on general government accounts. Data on revenue and expenditure arrears 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.

Data Standards and Quality

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

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

HUNGARY: TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE
AS OF FEBRUARY 27, 2015

	Date of latest observation	Date received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of publication[7]	Memo Items: Data Quality – Methodological soundness[8]	Memo Items: Data Quality Accuracy and reliability[9]
Exchange Rates	1/31/2015	2/2/2015	D and M	D and M	D and M		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Dec 2014	1/31/2015	M	M	M		
Reserve/Base Money	January 2015	2/12/2015	M	M	M	O,O,LO,LO	O,O,O,O,LO
Broad Money	February 2015	2/27/2015	M	M	M		
Central Bank Balance Sheet	January 2015	2/12/2015	M	M	M		
Consolidated Balance Sheet of the Banking System	February 2015	2/27/2015	M	M	M		
Interest Rates[2]	February 2015	2/27/2015	M	M	M		
Consumer Price Index	January 2015	2/11/2015	M	M	M	O,O,O,O	O,O,O,O,NA
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Q3 2014	1/6/2015	Q	Q	Q	O,LNO,LO,O	LO,O,O,O,NA
Revenue, Expenditure, Balance and Composition of Financing[3] – Central Government	December 2014	1/7/2015	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	December 2014	2/19/2015	M	M	M		
External Current Account Balance	Q3 2014	12/31/2014	Q	Q	Q	O,LO,LO,LO	O,O,O,O,NA
Exports and Imports of Goods and Services	Q3 2014	12/31/2014	Q	Q	Q		
GDP/GNP	Q4 2014	3/6/2015	Q	Q	Q	O,O,O,LO	O,LO,O,O,NA
Gross External Debt	Q3 2014	12/31/2014	Q	Q	Q		
International investment Position[6]	Q3 2014	12/31/2014	Q	Q	Q		

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.

[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.

[3] Foreign, domestic bank, and domestic nonbank financing.

[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.

[5] Including currency and maturity composition.

[6] Includes external gross financial asset and liability positions vis-à-vis nonresidents.

[7] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A); Irregular (I); Not Available (NA).

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

[9] Same as footnote 8, except referring to international standards concerning (respectively) source data, statistical techniques, assessment and validation of source data, assessment and validation of intermediate data and statistical outputs, and revision studies.

Statement by the Staff Representative on Hungary
Executive Board Meeting
March 27, 2015

1. **This statement provides information that has become available since the issuance of the Staff Report on March 13, 2015.** This information does not alter the thrust of the staff appraisal.

2. **On March 24, the Monetary Council lowered the policy rate.** On the back of continued disinflationary pressures and as recommended by staff, the Council reduced its policy rate by 15 basis points from 2.10 percent to 1.95 percent. This cut was slightly smaller than market expectations for a 20 basis points cut. In its communication following the meeting, the Council noted that cautious easing of monetary conditions may continue as long as it supports the achievement of the medium-term inflation target.

3. **At the same time, the Monetary Council confirmed its 3 percent inflation target and introduced a ±1 percent ex-ante band around it.** The introduction of the band is a change from the previous framework whereby the central bank adhered to a continuous 3 percent point target with a tolerance band of ±1 percent which was used to evaluate ***ex post*** the attainment of price stability. Confirmation of the 3 percent inflation target helps reaffirm the central bank's (MNB) intentions at a point of deflationary risk, and the introduction of the ***ex-ante*** band is in line with practices of other inflation targeting central banks. It will be important for the MNB to continue anchoring inflation expectations around the mid-point of the band.

4. **Standard and Poor's (S&P) upgraded Hungary's rating, but it still remains non-investment grade.** On March 20, S&P raised its long-term foreign and local currency sovereign credit ratings to BB+ from BB and affirmed the short-term foreign and local currency sovereign credit ratings at B. S&P noted that the upgrade mainly reflects the improvement in Hungary's external vulnerability and growth outlook, as well as the positive impact of the FX mortgage conversion.

INTERNATIONAL MONETARY FUND
COMMUNICATIONS DEPARTMENT

Press Release No. 15/156
FOR IMMEDIATE RELEASE
April 3, 2015

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

IMF Executive Board Concludes Article IV Consultation with Hungary

On March 27, 2015 the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Hungary.

The Hungarian economy is growing at a strong pace helped by accommodative macroeconomic policies and improved market sentiment. Driven by strong domestic demand, output grew by 3.6 percent in 2014. Unemployment declined sharply reflecting the expansion of public works programs and job creation in the private sector. Headline and core inflation decelerated sharply, and inflation expectations fell below the National Bank of Hungary's (MNB) inflation target. Improving terms of trade and strong export volume growth helped maintain a sizeable current account surplus. Private sector credit continued to contract and the banking sector remains under pressure reflecting the heavy tax burden and high non-performing loans.

Vulnerabilities continued to decline thanks to large and persistent current account surpluses, and recent policy measures, including the conversion of foreign exchange mortgages into local currency loans. However, debt levels remain high and the associated financing needs together with heavy reliance on nonresident financing, large concentration of the investor base and the economy's large open FX position continue to pose risks. At the same time, the state has been increasing its role in the economy including through acquisition of stakes in the banking and energy sectors thereby contributing to a buildup of contingent liabilities.

The 2014 fiscal deficit came in below target, as revenues were propelled by accelerating economic activity and tax administration improvements, and were only partially offset by higher expenditures. However, the fiscal stance eased significantly and public debt declined only moderately to just below 77 percent of GDP. For 2015, the deficit is projected at 2.7 percent of GDP, implying a broadly neutral fiscal stance despite relatively favorable cyclical conditions, and the debt ratio is expected to decline only modestly.

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

Comforted by decelerating inflation, low risk premia, and a negative output gap, the MNB kept its policy rate at 2.10 percent since July 2014 and cut it to 1.95 percent on March 24. It also doubled the allocation for the second phase of the Funding for Growth Scheme (FGS) and extended the program to end-2015.

Going forward, output growth is projected to decelerate to 2.75 percent this year, on account of a smaller domestic-demand impetus due to less supportive fiscal stance and lower investment growth. Private consumption is expected to continue to grow, reflecting lower household indebtedness, accommodative monetary conditions, and higher employment. Headline inflation is projected to remain very low in the coming months on account of a still negative output gap and lower import prices. Over the medium-term, growth prospects remain subdued, as private consumption is still constrained by the ongoing deleveraging; while the difficult business environment continues to weigh on private investment. Labor participation, while somewhat increasing, remains low, particularly among women and older workers. These challenges are further compounded by competitiveness pressures and lack of attractiveness for foreign direct investment.

Executive Board Assessment[2]

Executive Directors welcomed Hungary's strong economic rebound, which has been underpinned by supportive policies and improved market sentiment. However, they noted that medium-term prospects appear subdued, and the economy continues to face risks arising from high debt levels and heavy reliance on non-resident funding. Against this background, Directors agreed that policies in the period ahead should focus on further reducing vulnerabilities and boosting medium-term growth, while enhancing policy predictability and limiting the role of the state in the economy.

Directors welcomed the authorities' continued commitment to fiscal discipline. Given the favorable near-term outlook, most Directors encouraged more ambitious efforts to curb the public debt ratio. They recommended pushing ahead with growth-friendly consolidation centered on improving the efficiency and composition of public spending, and rationalizing the tax system, including by gradually reducing sectoral taxes. Continued efforts are also needed to tackle VAT fraud and improve the targeting of social benefits.

Directors concurred that monetary conditions have supported the recovery. They agreed that persistent disinflation warrants further cautious easing of monetary policy, particularly in light of the improved resilience of households' balance sheets to exchange rate risk and the weak external demand. Directors noted, however, that the central bank should stand ready to tighten the policy stance if external financing conditions deteriorate sharply. They also

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

underscored the need to maintain adequate foreign exchange reserves to mitigate excessive exchange rate volatility and support financial stability.

Directors emphasized the importance of improving financial intermediation to sustain the recovery. In this regard, they welcomed the government's commitment to gradually reduce the tax burden on banks. Noting that the recent establishment of a national asset management company would help clean up bank balance sheets, Directors stressed the need for transparency and good governance and called on the authorities to mitigate financial and operational risks that might be associated with the new institution. More broadly, Directors cautioned against the increasing role of the state in the banking sector.

Directors stressed that sustained progress on wide-ranging structural reforms is essential to boost Hungary's growth potential. Noting progress in improving the labor market, Directors saw scope for additional reforms to increase labor participation, particularly among women and older workers, and address skill mismatches. Directors agreed that these steps, together with measures to enhance competitiveness and strengthen the business climate, would stimulate higher investment and strong private-sector-led growth.

Hungary: Selected Economic Indicators, 2010–17

	2010	2011	2012	2013	2014	2015	2016	2017
					Prel.	Proj.	Proj.	Proj.
Real economy								
Real GDP (percentage change)	0.8	1.8	-1.5	1.5	3.6	2.7	2.3	2.2
Total domestic demand (contribution to growth) 1/	-0.5	-0.2	-2.8	1.1	4.0	2.4	1.8	1.9
Private consumption 2/	-1.8	0.5	-1.3	0.1	1.0	1.6	1.5	1.5
Government consumption	0.2	0.0	0.0	0.5	0.3	0.3	-0.1	0.3
Gross fixed investment	-2.2	-0.4	-0.8	1.0	2.3	0.2	0.0	0.6
Foreign balance (contribution to growth)	1.3	2.0	1.4	0.4	-0.4	0.3	0.5	0.3
Exports	8.5	5.4	-1.3	5.1	7.8	5.6	5.1	4.9
Imports	7.2	3.4	-2.6	4.7	8.1	5.3	4.6	4.6
CPI inflation (average)	4.9	3.9	5.7	1.7	-0.3	0.0	2.3	2.9
CPI inflation (end year)	4.7	4.1	5.0	0.4	-0.9	1.7	2.4	3.0
Unemployment rate (average, ages 15-64)	11.3	11.1	11.1	10.2	7.8	7.6	7.4	7.2
Gross domestic investment (percent of GDP) 3/	20.4	19.8	19.1	19.9	21.3	20.4	19.9	19.9
Gross national saving (percent of GDP, from BOP)	20.7	20.6	21.0	24.1	25.6	25.2	24.0	23.2
General government (GFSM 2001 basis) 4/								
Overall balance	-4.5	-5.5	-2.3	-2.4	-2.6	-2.7	-2.5	-2.5
Primary balance	-0.7	-1.7	1.9	1.9	1.4	0.9	0.9	1.0
Primary structural balance, in percent of potential GDP	-0.5	-0.7	4.0	3.3	1.7	1.3	1.1	1.0
Gross debt	80.9	81.0	78.5	77.3	76.9	75.5	74.7	73.9
Money and credit (end-of-period)								
Broad money	3.0	5.9	-3.3	5.5	5.9	7.3	7.8	8.0
Lending to the private sector, flow-based 5/	-2.4	-6.9	-7.4	-3.3	-0.9	-5.0	3.0	4.0
Interest rates								
T-bill (90-day, End of Period)	5.7	7.2	5.6	2.9	1.4	...	...	...
Government bond yield (5-year, End of Period)	7.9	8.9	6.1	4.8	3.1	...	...	...
5-year sovereign CDS (December 31, 2014)	282	379	450	260	180	...	...	...
Balance of payments								
Goods and services trade balance	5.4	6.2	6.9	7.6	7.4	8.8	8.2	7.5
Current account	0.3	0.8	1.9	4.1	4.2	4.8	4.1	3.3
Reserves (in billions of euros)	33.7	37.8	33.9	33.8	34.6	33.8	28.5	26.5
Gross external debt 6/	143.6	134.8	128.9	118.6	115.8	106.5	89.8	80.2
	62.6	65.3	67.5	97.4	106.9	120.7	144.6	164.0
Exchange rate								
Exchange regime	Floating							
Present rate (January 31, 2015, eop)	Ft. 311 = €1; Ft. 296.7 = CHF1							
Nominal effective rate (2000=100, average)	102.7	104.2	109.0	110.3	...	...	...	...
Real effective rate, CPI basis (2000=100, average)	72.4	72.6	73.6	74.3	...	...	...	...
Quota at the Fund								
Memorandum Items								
Nominal GDP (billions of forints)	26,946	28,035	28,549	29,846	31,891	33,636	35,339	37,091

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

Statement by Szilard Benk, Alternate Executive Director for Hungary
March 27, 2015

Since the last Article IV consultation, Hungary has continued to improve its macroeconomic fundamentals. Economic activity remained strong while vulnerabilities declined, backed by prudent and supportive policies. The external balance continued to strengthen, while disciplined fiscal policy preserved a stable fiscal balance and a gradually declining public debt. On March 20, Standard & Poor's raised Hungary's credit rating by one notch, citing the reduced vulnerability to external shocks and a pickup in economic growth. The authorities expect a further upgrade in the near future on the basis of Hungary's strengthening macroeconomic fundamentals.

Economic developments and outlook

The economy has continued to grow at a strong pace, reaching an annual rate of 3.6 percent in 2014 on the back of improving domestic demand. Unemployment continued to decline, reaching its pre-crisis level, on the account of accelerating private sector job creation and persisting public work programs. Notwithstanding the accelerating growth, the current account has remained in a substantial surplus. Headline inflation decelerated sharply, reflecting the still negative output gap, the decline in import prices, and one-off effects from regulated utility price cuts.

The growth momentum is expected to persist over the forecast horizon. Against the background of the latest incoming data and supportive policies, the authorities are more optimistic than staff about the growth prospects, expecting GDP to grow at a rate close to 3 percent in 2015, while in the medium- and long-run, GDP is expected to remain dynamic, driven mainly by the underlying factors which also boost potential GDP growth. The extended and prolonged Funding for Growth Scheme (FGS) is likely to promote corporate, in particular SME, investment, while the cyclicality of the EU funding receipts is likely to work in the opposite manner in 2016, acting as a temporary drag on growth. Households' investment activity is expected to rise gradually as consumer confidence, labor conditions, and real income recover. The improving household balance sheets resulting from the settlement and conversion of FX mortgages, and the consequent removal of uncertainties, would further support the revival of private consumption.

The authorities assess the risks around the outlook as more balanced than in staff's view. External vulnerabilities, though still important, are gradually lessening as the share of the nonresident holdings of public debt turned to a firmly declining trend during the past years; the composition of the foreign investor base shifted towards more stable, real money players; and the foreign liabilities of the banks have been reduced substantially by the conversion of the Swiss franc-dominated FX loans.

Fiscal Policy and Debt

The public debt-to-GDP ratio has been on a declining path since 2011, moderating to 76.9 percent by the end of 2014, notwithstanding a weaker exchange rate. The financing strategy allowed for the composition of the debt to shift to a more healthy structure, with a firmly declining share of FX-denominated securities. In addition, the central bank's self-financing scheme shifted the incentive of holding government securities from the foreign banks to the domestic banks, thus aiding the decline of nonresident holdings of public debt. Domestic households continued to increase their bond holdings as well.

The authorities are fully committed to conducting prudent fiscal policies compatible with sustainable debt reduction, and building buffers which allow for countercyclical policies. Fiscal discipline and prudence helped the government to keep the deficit comfortably within EU limits, and rigorous budget execution and corrective actions, where needed, ensured that the 2012, 2013, and also the 2014 deficits over-performed relative to the initial target. The 2014 deficit is estimated at 2.6 percent on the background of an accelerating economy and significant improvements in tax administration, especially in increasing VAT collection and tackling fraud. The installation of online cash registers was especially helpful in this regard, and the recent implementation of the Electronic Trade and Transport Control System is expected to yield similar positive results.

The 2015 budget targets a 2.4 percent deficit, planning a broadly neutral fiscal stance for the current and the subsequent years. This would allow a convergence to the medium-term structural deficit target of 1.7 percent and a steadily declining public debt trajectory.

The government plans a number of changes to the fiscal framework. The intended early adoption of the 2016 budget would enhance predictability, while harmonizing the budgeting process with the European Semester. A new Tax Code is under preparation, with the intention to develop a more customer-friendly system and ease the taxpayers' administrative burden.

The authorities appreciate staff's constructive policy recommendations on the medium-term fiscal adjustment strategy. Some of them, where feasible, are already under implementation, or given due consideration for the fiscal plan of the coming years. For example, some measures to address VAT compliance and fraud are already yielding promising results (online cash registers) or are in the early implementation phase (road control system). Spending on non-EU related goods and services will remain under close monitoring. The government has committed to substantially lower the bank levy starting from 2016. Nevertheless, the authorities wish to keep the public work programs in operation as an important element for integrating inactive groups into the active labor force.

Monetary Policy

The central bank (MNB) cut the policy rate by 15 basis points to 1.95 percent in its March meeting, re-launching its easing cycle after an eight-month stall, and is committed to maintaining accommodative monetary conditions for an extended period. This reflects the authorities' assessment – in agreement with Fund staff – that inflationary pressures continue to stay moderate in the medium term, supported by both domestic and international factors. Headline inflation stayed in the negative territory in the past months, while households' inflation expectations adjusted and declined continuously during the last year. Going forward, this may help align the price- and wage-setting decisions of economic agents with the inflation target over the medium term, despite the pickup in domestic demand. The launch of the ECB's asset purchase program and the ongoing monetary easing in the region also point to easier monetary conditions.

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

Financial System

The aggregate capital and liquidity positions of the banking system are adequate, though most banks' balance sheets have continued to shrink and their profitability has remained curtailed. Nonperforming loans, although stabilized, remained high both in the corporate and in the household segments. To repair the financial intermediation and enable the banking system to be more supportive of economic growth, the authorities have taken a series of measures, as follows:

The MNB launched the Funding for Growth Scheme (FGS) in 2013, aiming at providing liquidity to credit institutions at a preferential rate to alleviate disruptions in lending to SMEs and to reverse the vicious credit squeeze/low growth cycle. The first and second phase of the program provided financing to more than twenty-thousand SMEs, amounting to about HUF 1325 billion (over 4 percent of GDP), predominantly new investment loans. Notwithstanding the FGS' beneficial effects, lending outside of the FGS has yet to recover, as excessive risk aversion by banks and tight credit conditions have remained present in the riskier but viable SME segment. As a response, the MNB just launched in March the FGS+ scheme, targeting SMEs with medium risk spreads that exceed the FGS' 2.5 percent cap. Under the FGS+, the MNB will assume 50 percent of the credit risk from credit institutions, but limited to only up to a five-year period, and capped at a maximum of 2.5 percent of the outstanding FGS+ loan stock of the individual credit institution.

To clean the nonperforming commercial real estate loan portfolio, the MNB established an asset management company (MARK) with the aim of serving as a voluntary option for the banks for removing distressed assets from their balance sheets, hence catalyzing the market. Following consultations with the European Commission and the ECB, and building on the Fund's TA recommendations, the MNB has improved the market-based characteristics of the vehicle and shifted to market pricing, and is examining the implementation of further safeguards to ensure the financial independence of the central bank. The MNB pursues its macroprudential mandate with MARK, namely, to achieve a well-functioning banking sector which sufficiently supports economic growth. MARK is expected to begin operations in the second half of 2015. The MNB highly appreciates the prompt technical assistance provided by the Fund in the set-up of the MARK.

A number of decisive steps have been taken to address the longstanding issue of foreign exchange- (mostly Swiss franc) denominated mortgages. First, the Settlement Act ensured the settlement of the non-justified interest rate, fee increases, and exchange rate spreads, setting the stage for the transition to a "fair banking system". The Conversion Act stipulated the conversion of the FX-denominated mortgage stock at the market exchange rate. Lastly, the Fair Banking Act will ensure the transparency in pricing going forward, fostering competition. The immediate effect of these measures will reduce the profitability of the banking sector for this year; however, in the longer term, the return to fair interest margins will increase households' repayment ability, ease their balance sheet pressures, and increase predictability. Not least, these measures will reduce banks' exposure to foreign funding. The MNB is playing an active role in this process, both in terms of macroprudential regulation and consumer protection, and in supplying the foreign exchange for the conversion.

In order to increase the profitability and lending capacity of the banking sector, the government signed a memorandum of understanding with the EBRD, opening a new chapter with the banking sector, committing to: (i) create a framework that ensures the long-term sustainability of a stable and predictable economic policy; (ii) decrease the bank tax to the EU standards by 2019, starting in 2016; (iii) refrain from any measure that may have a negative impact on the profitability of the banking sector; and (iv) transfer all direct and indirect majority equity stakes it currently holds in local banks to the private sector within the next three years.

Structural Reforms

The authorities are continuing with the structural transformations and supply-side measures, intended to address structural bottlenecks and raise Hungary's medium-term growth prospects. A series of regulatory and administrative changes have been implemented with an impact on the business environment, such as: a new Labor Code facilitating the shift towards more flexible employment types; a new Civil Code with reforms in the field of corporate law and contract law; the implementation of the Cutting Red Tape program, aiming to reduce entrepreneurial administrative burdens, reduce the timeframe for administrative procedures, and simplify the tax system by abolishing several minor taxes; and the one-stop-shop government windows for administrative matters. A new Tax Code is under preparation, intended to develop a more customer-friendly system with less administrative burden.

Labor market reforms are aimed at creating a workfare state, a work-based social security system where the long-term unemployed have access to public work, facilitating their return to the primary labor market. The Job Protection Act reduced the tax wedge for disadvantaged groups with the lowest productivity but with the highest responsiveness to incentives to join the workforce, such as the low-skilled, young, old, long-term unemployed, returning mothers, and career starters. Its results are already reflected in the continuously rising labor force participation alongside the declining unemployment. Several measures aimed to transform primary and higher education, as well as vocational training, serve the enhancement of human capital.

Efforts have been stepped up to diversify export destinations. The energy strategy is focused on developing a non-profit energy sector to reduce high energy costs for investors to international levels, which is key to enhancing the economy's competitiveness.

Final Remarks

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