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Hungary: 2005 Article IV Consultation—Staff Report; Staff Statement; and Public Information Notice on the Executive Board Discussion

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2005 Article IV consultation with Hungary, the following documents have been released and are included in this package:

- the staff report for the 2005 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on March 11, 2005, 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 May 20, 2005. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a staff statement of June 15, 2005 updating information on recent developments.

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its June 15, 2005 discussion of the staff report that concluded the Article IV consultation.

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

Financial System Stability Assessment—Update
Selected Issues Paper

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

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

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HUNGARY

Staff Report for the 2005 Article IV Consultation

Prepared by the Staff Representatives for
the 2005 Consultation with Hungary

Approved by Susan Schadler and Liam P. Ebrill

May 20, 2005

Discussions for the 2005 Article IV consultation concluded in Budapest on March 11, 2005. The staff team comprised Mr. Mody (Head), Ms. Fabrizio, and Messrs. Abiad and Leigh (all EUR). Mr. Abel (Advisor to the Executive Director) joined the discussions. The mission met with the then Finance Minister Draskovics, President Járai of the Magyar Nemzeti Bank (MNB), other senior officials, and representatives of the private sector and the academic community.

The staff report for the 2004 Article IV consultation was discussed by the Board on May 10, 2004 and was subsequently published as IMF Country Report No. 04/145. Executive Directors viewed Hungary's entry into the European Union (EU) as a fitting culmination of its successful transition to a market economy. Directors were concerned about the emergence of large fiscal and current account deficits and also about continued inflationary pressures. They saw important benefits to strengthening policy credibility.

Hungary has accepted the obligations of Article VIII and maintains an exchange rate system free of restrictions. In accordance with UN Security Council resolutions, Hungary maintains restrictions on and imposes sanctions against individuals, groups, and organizations associated with terrorism.

Hungary subscribes to the Fund's Special Data Dissemination Standard. Data provision is timely and facilitates effective surveillance.

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EXECUTIVE SUMMARY

Background: GDP growth was 4 percent in 2004, and was especially brisk in the first half, helped by a bounce in the euro area economy. Inflation fell through much of the year. Some fiscal consolidation was achieved. The current account deficit stabilized, albeit at about 9 percent of GDP. Financial markets maintained a generally optimistic view of Hungary.

Outlook: The economic slowdown in the second half of 2004 appears to have persisted in early 2005. Real GDP growth is expected to slow to 3.4 percent in 2005. Disinflation is expected to continue. The current account deficit is projected to decline in 2004 and in the medium term, but the trajectory of the external deficit and debt remain crucially linked to the extent of fiscal consolidation. In the medium term, growth is expected to be in range of 3½ to 4 percent a year, with movements reflecting euro area growth.

Policy Discussions

Euro adoption: The authorities' goal of adopting the euro by 2010 has so far not been supported by an active structural reform agenda. Meeting the fiscal Maastricht limits for euro adoption will require substantial effort. Staff emphasized that sustainable structural reforms, particularly fiscal reforms, would not only ensure successful adoption of the euro, but also vibrant economic performance thereafter.

Public finances: Meeting the 2005 fiscal deficit target will require strong discipline, exercised through the use of reserves and expenditure controls. In the medium term, adhering to the fiscal consolidation path in the Convergence Program is critical, and needs to be supported by structural expenditure measures. The authorities recognized the durable benefits of structural measures, including raising households' incentive to save and modernization of public services. They also agreed that increased checks and balances in the budget process would increase accountability and discipline.

Monetary policy: Following the rapid decline in the policy interest rate, further reductions must be cautiously undertaken, based on the market's inflation expectations. Staff also suggested, and the authorities agreed, that markets must learn to interpret changes in the policy interest rate as being motivated primarily by inflation-targeting considerations. This implies a move to a constant inflation goal, targeted over a moving horizon and a smaller role for exchange rate considerations in setting interest rates.

Financial sector: The financial system is generally sound and well supervised. The growing share of foreign currency debt held especially by households and SMEs, which likely are not hedged, could become a source of vulnerability and should be monitored closely.

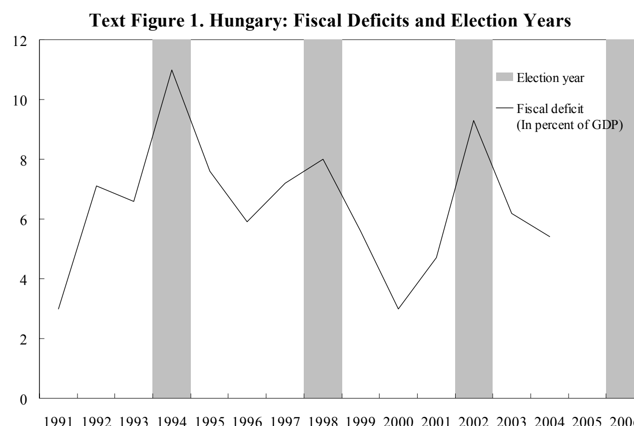
Structural reforms: Raising the country's low labor force participation rate and increasing labor market flexibility are priorities. The authorities also recognized that further efforts were needed to raise productivity. The appropriate use of EU funds will be crucial for fostering the knowledge economy, promoting small business, and improving infrastructure.

I. INTRODUCTION

1. **Against the background of weakening growth and declining policy credibility in previous years, Hungary made valuable gains in 2004.** A star performer in the late 1990s, Hungary lost ground starting in mid-2001: growth slowed and large budget and current account deficits emerged. Between January 2001 and September 2003, minimum and public sector wages were raised. In combination with housing subsidies and higher pensions, the larger wage bill put upward pressure on the budget deficit. Public sector wages pulled up private wages, which, together with rapid credit growth, induced a surge in consumption. An appreciating real exchange rate and the spillover of consumption into import growth contributed to worsening trade and current account balances. In 2004, real wages stayed relatively flat, growth recovered, its composition improved, inflation was lower, and the current account balance stabilized. Efforts to contain the fiscal deficit and procedures to control government expenditures were steps in the right direction. Although burdened by the memories of large policy swings, monetary policy achieved greater predictability.

2. **Regaining sustainable control over fiscal policy remains the key challenge.** The legacy of repeatedly missed budget deficit targets and the decline in fiscal transparency—including in 2004—continue to generate policy uncertainty, presenting a serious risk to further structural transformation and growth. Sustainable fiscal reforms are needed to achieve euro adoption by the authorities' targeted date of 2010, and also to crowd in private investment and reduce the current account deficit (Box 1). The government has committed to further fiscal consolidation before the April 2006 elections. However, election years have not been propitious for fiscal reform and consolidation (Text Figure 1). The relatively benign current international environment and Hungary's catch-up potential argue for taking decisive steps—delays will only make the task harder.

Text Figure 1. Hungary: Fiscal Deficits and Election Years

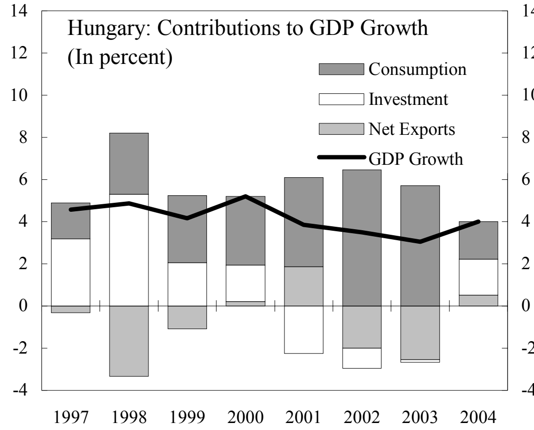


II. RECENT ECONOMIC DEVELOPMENTS

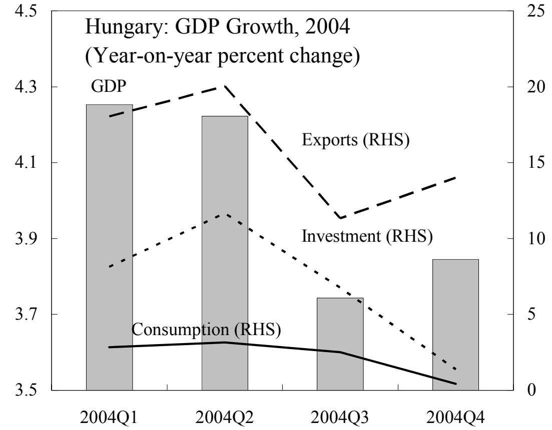
3. **Brisk growth in the first half of 2004 was helped by a bounce in the euro area economy.** Following growth of 3–3.5 percent in 2002–03, GDP rose in 2004 by 4 percent (Figure 1 and Table 1). Growth was especially buoyant in the first half of the year, based on strong export and investment performance, but slowed in the second half. These developments were influenced by Hungary's close ties to the euro area. A weaker labor market moderated consumption growth. The unemployment rate increased from 5.5 percent in the last quarter of 2003 to 6.3 percent in October-December 2004; labor force participation remained low, at 60.5 percent in 2004, compared with 68 percent in the euro area. A slowing of public sector wage growth dampened private wages.

Figure 1. Selected Economic Indicators

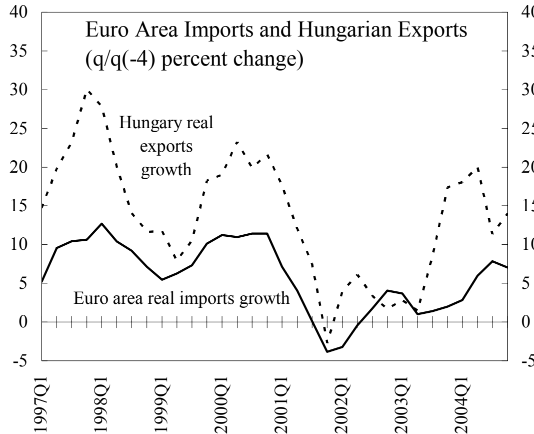
Growth recovered and was well-balanced in 2004...



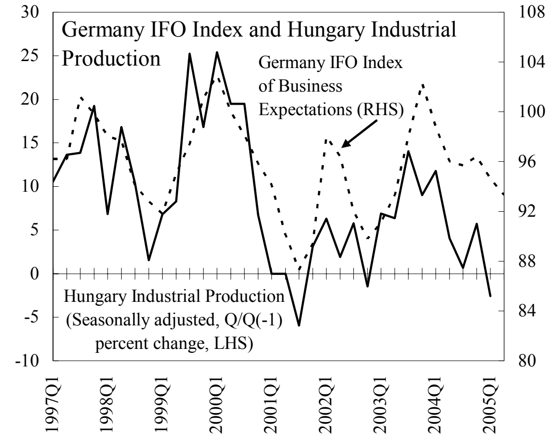
...but weak investment led to a slowdown in the second half.



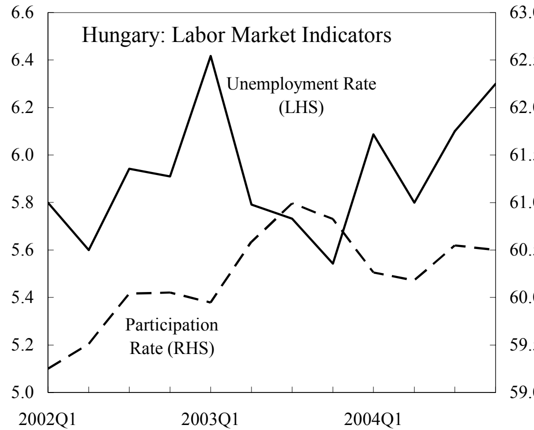
This was in response to signs of weakening demand prospects in the euro area...



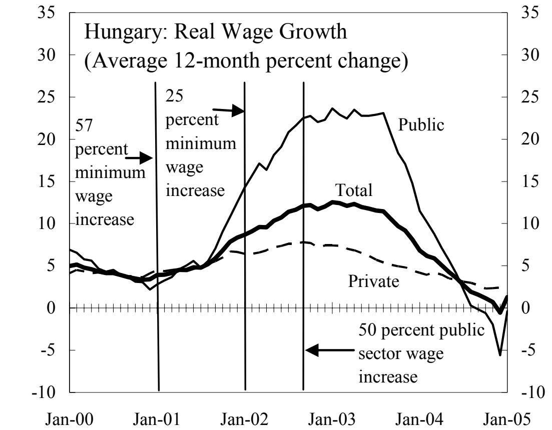
...to which the Hungarian economy is closely linked.



Moderating consumption growth was a response to a weaker labor market...



...and restrained real wage growth.



Sources: Hungarian authorities, Eurostat, IFO.

Box 1. Response to Fund Advice

The authorities have generally concurred with the thrust of Fund advice, including the need for fiscal consolidation and structural reforms. However, domestic political considerations have limited the implementation of the Fund's recommendations.

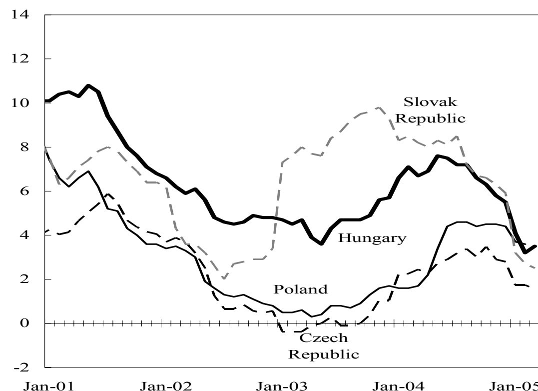
Fiscal policy. Public wages were restrained in 2004. But only modest steps were taken to implement measures on government employment, pensions, social benefits, subsidies, education, and health care, as recommended by the Fund's previous technical assistance. Staff's suggestion to establish a three-year rolling fiscal framework has also not been adopted.

Interest rate policy. After the sizable interest rate hikes in 2003 to defend a depreciating forint, the policy rate was gradually lowered in 2004 following the faster-than-expected decline in inflation, broadly in line with the Fund's recommendations. The authorities continue, however, to indicate to markets the appropriate range of the exchange rate, despite being in an inflation-targeting framework.

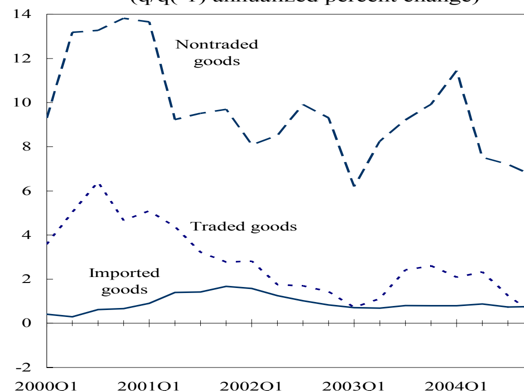
Financial sector. The recent Financial Sector Assessment Program (FSAP) update concluded that the regulatory and supervisory framework had significantly improved over the last four years, as recommended in the 2000 FSAP.

4. **An encouraging fall in the rate of inflation started in June 2004 (Text Figure 2).** The 2004 average inflation rate—just under 7 percent—reflected one-off effects of value-added tax (VAT) and excise tax rate hikes in early 2004 and higher oil prices; excluding the direct effect of the tax rate increase, average inflation was 4.8 percent. Inflation fell through much of the year—indicating that the tax adjustments did not have persistent effects—and on a month-on-month basis was down to an annualized rate of 3.5 percent by year's end. The prices of traded goods are now rising at about the same rate as those of imported goods (Text Figure 3). From a regional perspective, Hungary's inflation remains relatively high, reflecting the slower decline in the inflation of nontraded goods and services prices.

Text Figure 2. Regional CPI Inflation
(Year-on-year percent change)



Text Figure 3. Hungary: Prices of Traded, Nontraded, and Imported Goods
(q/q(-1) annualized percent change)



5. **Still preliminary data suggest that the general government deficit fell in accrual (European System of Accounts (ESA) 1995) terms in 2004.** When the contributions to the second pillar of the pension scheme are added to government revenues, the general government deficit fell from 6.2 percent in 2003 to 4.4 percent of GDP in 2004 (Table 2). Excluding these notional revenues, the budget deficit declined from 7.2 percent to 5.4 percent of GDP. The deficit targets were revised upward twice during the year, in large part due to overspending and lower-than-projected VAT revenues. Moreover, the trends in VAT refunds remain unclear, and their accounting conventions have not been finalized; the deficits for 2003 and 2004 may, therefore, be revised further.

6. **The extent of the underlying fiscal consolidation, however, was less than suggested by the decline in the fiscal deficit.** As one indication of this, the cash deficit (*Government Finance Statistics* (*GFS*) 1986 definition) actually rose (Text Table 1). Consolidation was helped by restraint in the wage bill and capital expenditures. The wage bill was reduced by 1 percent of GDP. But half of that reduction resulted from a change in the convention to account for bonus (or "thirteenth-month" salary) payments to public employees. Under the new convention, payments made in January 2005 were shifted to the 2005 budget rather than accruing to 2004; the January 2004 payments were treated as 2003 expenditures on an accrual basis. Also contributing to the larger cash deficit was another one-off effect: about one month of VAT receipts due in 2004 but delayed following procedural changes related to EU accession will be recorded in 2004 on an accrual basis.

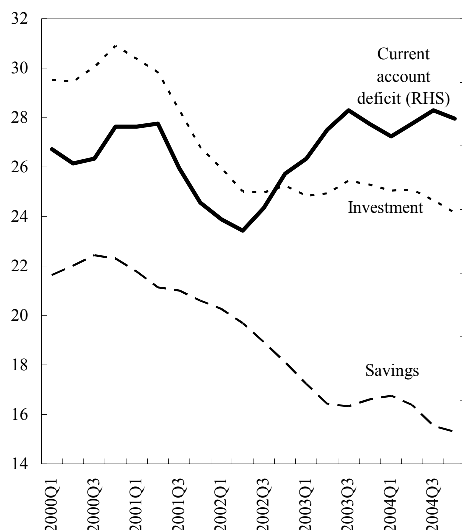
Text Table 1. Hungary: Cash-Based and Accrual Fiscal Deficit
(In percent of GDP)

	2003	2004 Est.
ESA '95 definition 1/ 2/	7.2	5.4
GFS '86 definition 1/	5.9	6.3

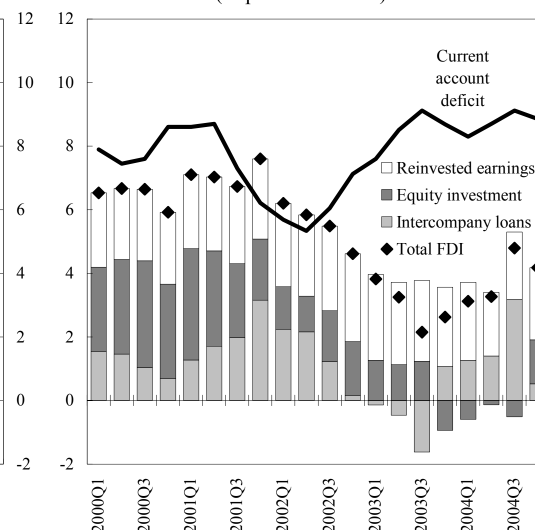
Sources: Hungarian authorities and staff estimates.
1/ The figure for 2004 includes top-up payments to farmers.
2/ The figures for 2003 and 2004 have been adjusted following the new methodology for recording VAT refunds.

7. **The current account deficit stabilized at about 9 percent of GDP in 2004.** The size of the deficit reflects the relatively low savings rate (15 percent of GDP)—the result of the public deficit and declining private savings rates—and a stable investment rate (24 percent of GDP) (Text Figure 4). Foreign direct investment (FDI), which averaged 8 percent of GDP in the late 1990s (more than 100 percent of the current account deficit), fell in 2003 to 2.6 percent of GDP before recovering to 4.2 percent in 2004 (Text Figure 5 and Table 3). Despite higher FDI in 2004, the large current account deficit required significant debt-creating financing.

Text Figure 4. Hungary: Savings and Investment
(Four-quarter rolling basis, in percent of GDP)

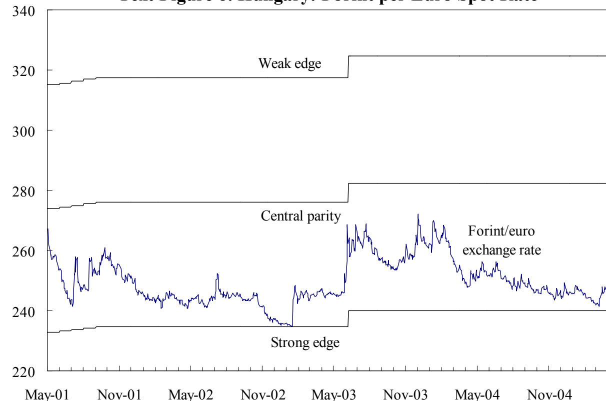


Text Figure 5. Hungary: Current Account Deficit and Foreign Direct Investment
(In percent of GDP)



8. **Financial markets remain generally optimistic about Hungarian prospects.** In 2004, the forint strengthened by 7 percent against the euro (Figure 2) despite a sharp decline in policy interest rates. Even following the currency's recent weakening, the exchange rate has been close to the strong edge of its band (a 15 percent range around a central parity of 282.36 forint per euro) (Text Figure 6). Risk premiums on both domestic and foreign currency bonds have fallen with improved sentiment toward the region. Financial markets may, however, be differentiating Hungary from its neighbors. Fitch downgraded Hungary's local currency rating in January 2005 in response to concerns about the twin deficits. The magnitudes of exchange rate appreciation and spread compression have been smaller than those of other countries in the region, and forward spreads on local currency bonds have not narrowed, reflecting greater uncertainty regarding the timing of euro adoption (Figure 2).

Text Figure 6. Hungary: Forint per Euro Spot Rate

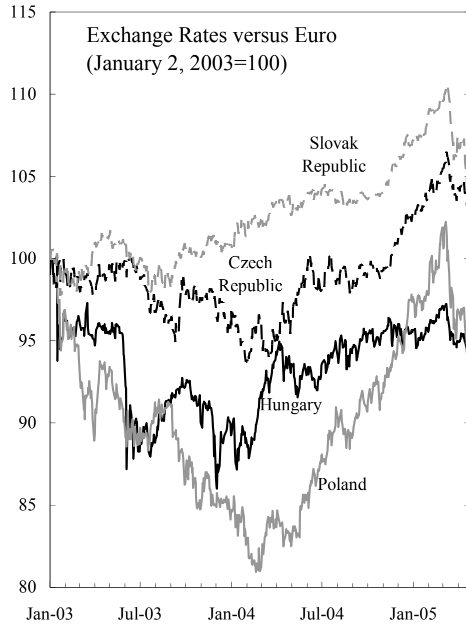


III. Report on the Policy Discussions

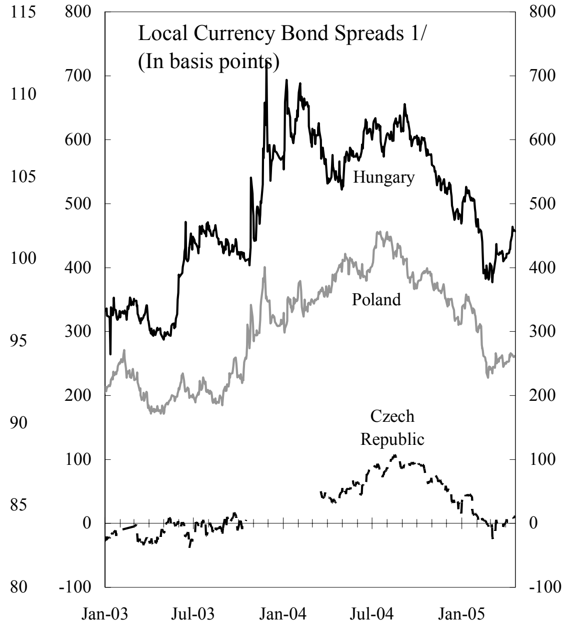
9. **The authorities have anchored their policy program to the goal of adopting the euro by 2010, but this goal has not yet been supported by an active agenda of broad structural reforms.** Meeting the fiscal deficit and public debt Maastricht targets will require substantial effort, despite the revisions to the Stability and Growth Pact (Box 2). Staff urged that the Maastricht criteria be achieved with a more forceful agenda of sustainable reforms. This would not only ensure successful euro adoption but also vibrant economic performance

Figure 2. Selected Financial Indicators, 2003-05

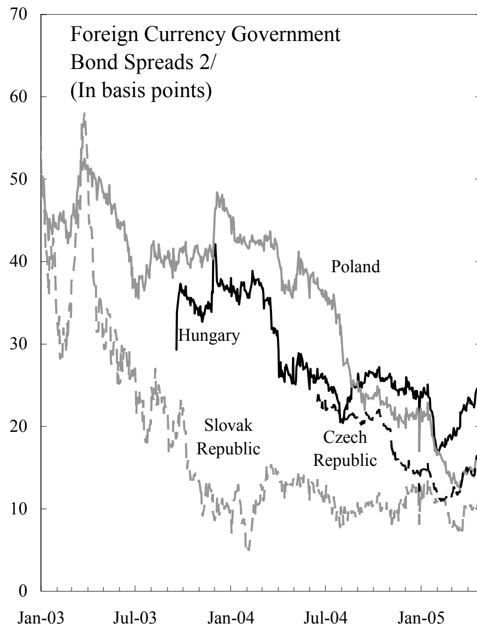
The forint appreciated throughout 2004...



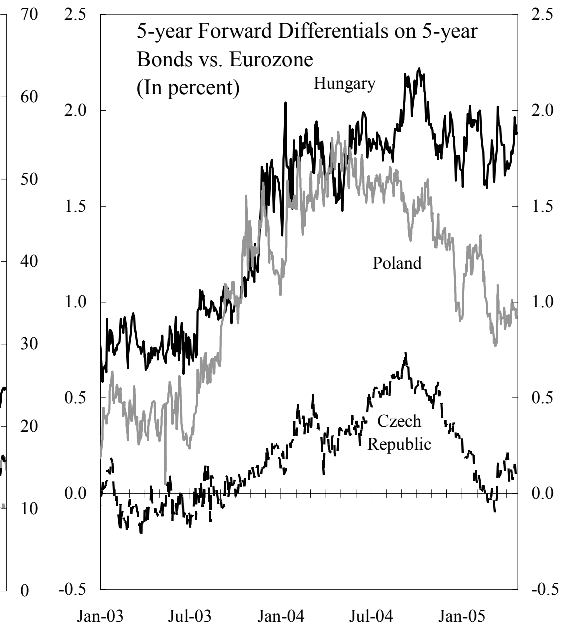
...and spreads have narrowed, both on local currency bonds...



...and foreign currency bonds.



Expectations of timely interest rate convergence with the Eurozone have stagnated since 2003.



Sources: Bloomberg, Deutsche Bank.

1/ Maturing in five years, compared to bunds.
2/ Foreign currency bond spreads to Germany maturing in 2010, Czech Republic matures in 2014.

thereafter. If euro adoption is achieved largely by ad hoc measures, the scope for future policy maneuver will be reduced, and long-term growth will likely be anemic. In this context, the discussions centered on the economic outlook, the state of public finances, the strengthening of monetary policy, financial sector stability, and structural policies for increasing employment and productivity.

Box 2. Revisions to the Stability and Growth Pact: Implications for Hungary

In its report of March 21, 2005, the ECOFIN Council presented proposals for "strengthening and clarifying the implementation of the Stability and Growth Pact (SGP)." When assessing whether the excessive deficit procedure (EDP) applies and whether a country complies with the Maastricht criteria, "other relevant factors" (e.g., the adjustment costs of mandatory, fully funded pension pillars) will be taken into account on a case-by-case basis. However, the overarching principles will remain: compliance with the deficit criterion requires that the deficit be close to the reference value (3 percent of GDP) and that the excess be temporary. In practice, the allowance seems unlikely to be greater than 0.5 percent of GDP. Against this background, the table below reports Hungary's current position relative to the pre-revision Maastricht ceilings.

Table 1. Hungary: The Maastricht Criteria

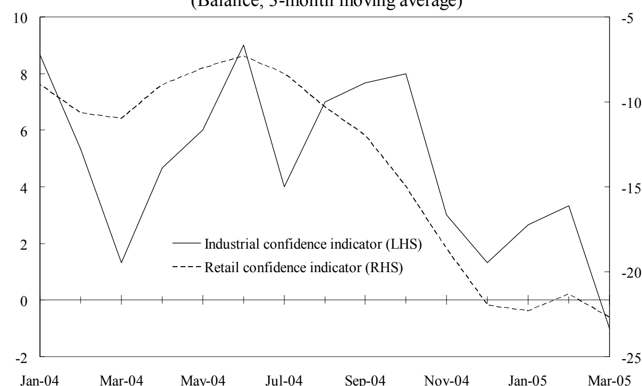
	2004		2005	
	Criterion	Estimate	Criterion	Forecast
Inflation 1/	2.4	6.8	2.9	4.0
Budget deficit (in percent of GDP, including the cost of pension reform)	3.0	5.4	3.0	4.7
Budget deficit (in percent of GDP, excluding the cost of pension reform)		4.4		3.6
Long-term interest rates 2/	5.7	7.2	...	...
Debt (in percent of GDP, including the cost of pension reform)	60.0	60.7	60.0	59.9
Debt (in percent of GDP, excluding the cost of pension reform)		57.6		56.7

Sources: IMF, *World Economic Outlook;* Hungarian authorities; and European Commission.
1/ Criterion is 1.5 percentage points above three best performers. The figures for 2004 are actual.
2/ Criterion is 200 basis points above the three best performers in terms of inflation. The figures for 2004 are actual.

A. Short-Term Outlook

10. **The slowdown of the economy in the second half of 2004 appears to have persisted in early 2005.** Industrial production (Figure 1) and indices of business sentiment are down (Text Figure 7), mirroring the weakening euro area economy. The unemployment rate has continued to rise, reaching 7.1 percent in the first quarter of 2005. Staff expects real GDP to grow at 3.4 percent in 2005 (Table 4), somewhat lower than the authorities' projection of 3.5–3.8 percent and the consensus forecast of 3.6 percent. Staff projects that the current account deficit will decline to 8.6 percent of GDP,

Text Figure 7. Hungary: Industrial and Retail Business Confidence
(Balance, 3-month moving average)



as the trade balance stabilizes in GDP terms and net current transfers through EU funds increase.

11. **The decline in inflation can be expected to continue.** Average inflation in 2005 is projected at 4 percent. The authorities assessed that the recent disinflation had been helped by intensified import competition following EU accession and by an appreciating exchange rate. They noted that the indirect tax hikes in early 2004 had not produced second-round effects on inflation. This observation is consistent with staff findings of low inflation persistence associated with forward-looking behavior of price setters and consumers (documented in an accompanying selected issues paper). Upside risks to inflation arise from movements in oil, other commodity, and unprocessed food prices; a reacceleration of wage growth; and a hike in the tobacco excise duty in 2006 (which is expected to affect the core consumer price index (CPI)).

12. **The authorities acknowledged significant risks exist to meeting the 2005 budget deficit target of 3.6 percent of GDP (or 4.7 percent of GDP excluding the second-pillar pension contributions).** The 2005 budget assumed GDP growth and inflation at 4 and 4½ percent, respectively, higher than the currently projected outcomes. Staff estimates that the slower growth and lower inflation could cause a revenue shortfall of about 0.6 percent of GDP. While recognizing this possibility, the authorities remain more concerned that shortfalls in projected VAT revenues could continue on account of administrative problems. In addition, the risks of overspending are serious. The traditional risk of municipal overspending is aggravated by the political cycle. Of concern also are possible overruns in open-ended spending obligations (including transfers to institutions under ministries' purview) and pharmaceutical and housing subsidies. Past commitments (such as the thirteenth-month pension) have added to budgetary pressures and rigidities, further reducing budgetary flexibility and the ability to deal with unexpected revenue shortfalls or urgent expenditure requirements.

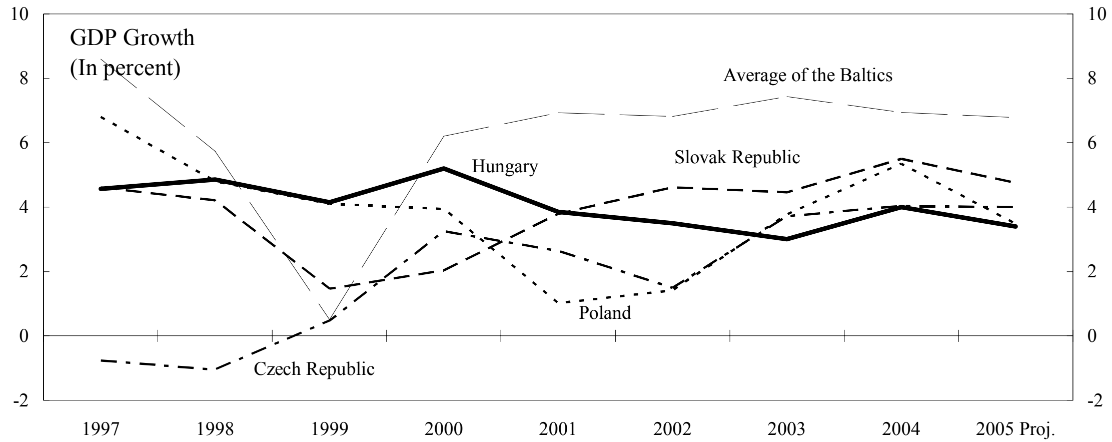
13. **The evident risks to the deficit target will require careful use of budgeted reserves and expenditure controls.** Between January and April, the cash deficit reached about 70 percent of the annual target. While some part of this deficit (that relating to delayed VAT refunds) would be recorded in 2004 on an accrual basis and the early part of the year is usually associated with large expenditures, the task for the rest of the year is a difficult one. Thus, staff emphasized that meeting the budget deficit target would require the careful release of reserves (overall 1.3 percent of GDP), based on timely identification of priority spending. There is also a need to strictly enforce the measures to limit overspending and the carryover of unused funds introduced in the 2005 budget law. If these restraints prove infeasible, staff project a deficit overshoot of 0.6 percent of GDP, which will raise the risks of a larger current account deficit, increased debt and slower growth in the medium-term.

B. Medium-Term Trends

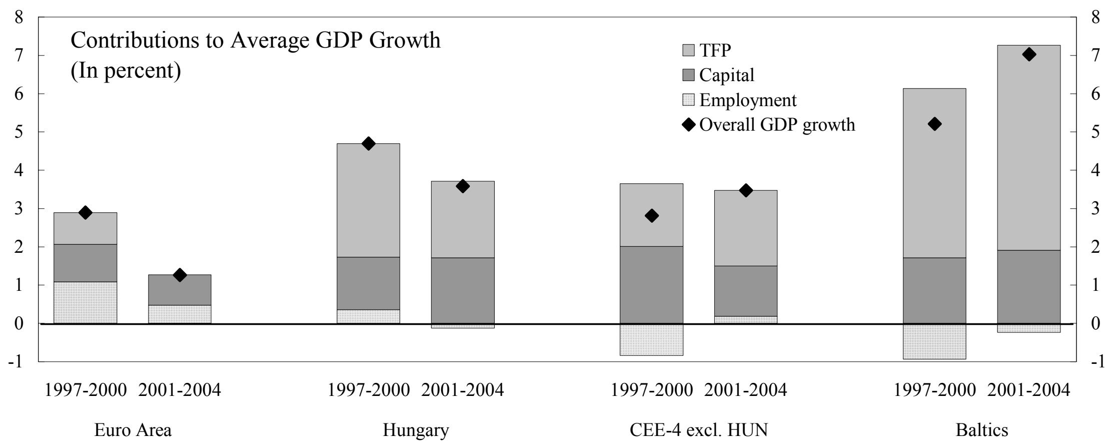
14. **Seen from a regional perspective, Hungary's growth advantage has faded.** In the late 1990s, Hungary's reputation as a star performer was based on its rapid and consistent growth record (Figure 3). As its growth rate slowed (from an average of 4.7 percent between

Figure 3. Growth Trends, 1997-2004

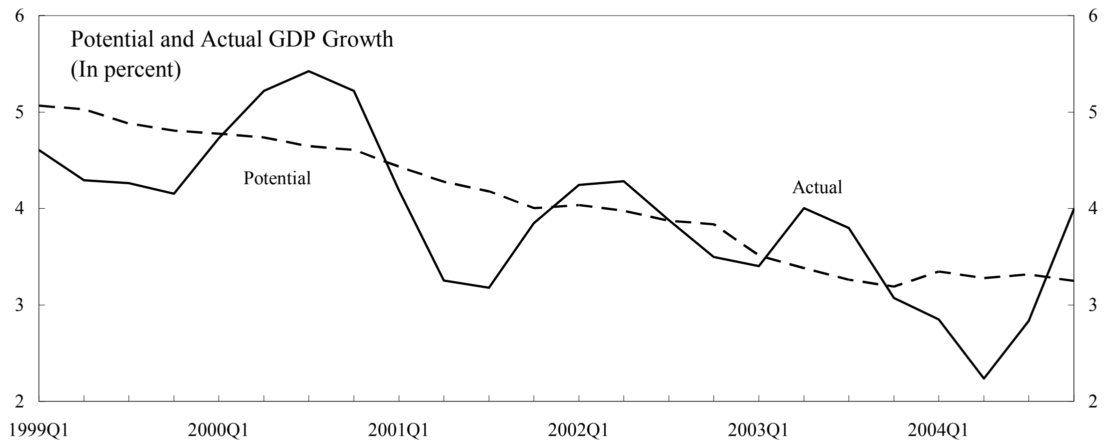
Though respectable in absolute terms, Hungary's relative growth has declined recently...



...reflecting a slowdown in TFP growth and a contraction in employment.



Growth in 2004 was above potential, which has been trending down.



Sources: IMF staff estimates, country authorities.

1997 and 2000 to 3.6 percent a year between 2001 and 2004), so did its position relative to the other new EU member states. The short elapsed period precludes a firm assessment, but moderation in total factor productivity (TFP) growth (Figure 3) appears to have accounted for Hungary's slower recent growth.

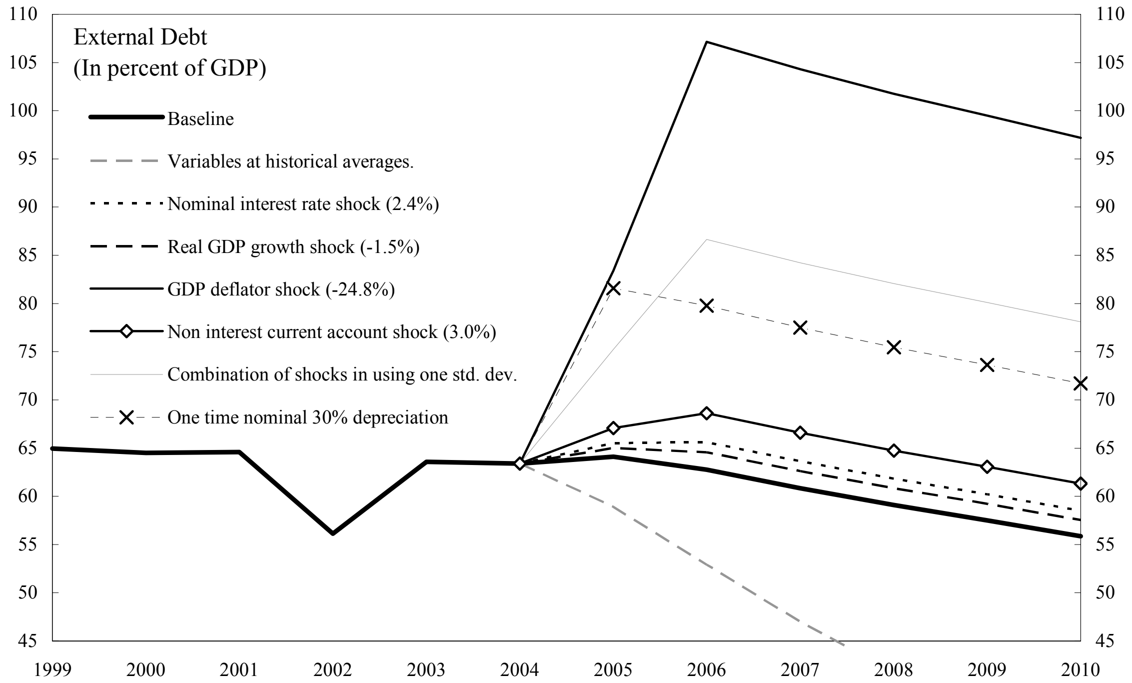
15. **The authorities were concerned that medium-term growth may be constrained by the apparent trend decline in potential growth.** In line with the authorities' view, staff estimates show that potential growth (based on a production function approach) declined from just under 5 percent a year in the late 1990s to about 3½ percent in 2004 (Figure 3), possibly reflecting the winding down of the privatization process. Cross-country benchmarks suggest that Hungary's potential growth rate could be considerably higher than the current 3½ percent. A staff analysis of the European growth experience—taking into account the catch-up potential due to lower initial per capita income and access to foreign capital—shows Hungary's long-run growth potential to be in the 3.8–5.8 percent range (Box 3). If potential growth remains unchanged at the lower end of this range, growth beyond 2005 will stay in the range of 3½ to 4 percent a year, with movements reflecting euro area growth. As the authorities recognized, raising potential growth will require structural reforms to achieve higher productivity growth and greater labor force participation.

16. **In the medium-term, the projected decline in the current account is crucially dependent on fiscal consolidation.** With the effective real interest rate on external debt expected to be lower than the growth rate, at the current exchange rate the external debt-to-GDP ratio is projected to decline from 63 percent in 2004 to 56 percent in 2010. Increased EU resources will also reduce reliance on external borrowing. A setback to fiscal tightening and a variety of shocks, including to growth and FDI, could reverse the projected decline in the external debt ratio (Figure 4 and Table 5).

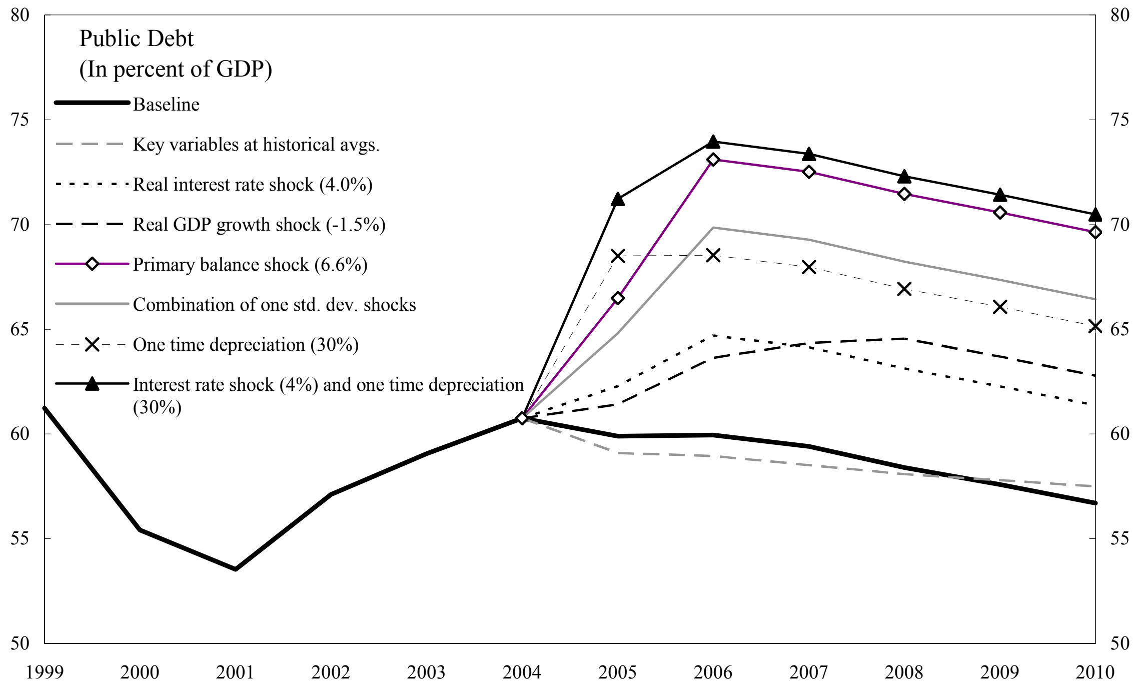
17. **The authorities do not regard the exchange rate as the main mechanism for maintaining competitive exports and reducing the current account deficit.** CPI- and unit labor cost (ULC)-based real exchange rates have appreciated in recent years (Figure 5). Since significant uncertainties surround the estimates of the equilibrium exchange rate, several considerations were discussed. The authorities judged that Hungary's high-tech export structure had, in part, insulated its exports from the real wage increases. However, staff cautioned that the technological upgrading of the economy may have slowed and Hungary faced increasing competition from other industrializing countries (Figure 5). Moreover, at least in the short run, an appreciation of the real exchange rate appears weakly associated with slower domestic production of traded goods (Figure 6). While the relative productivity of Hungary's tradable and nontradable sectors has recently moved in line with that of its trading partners, the accumulation of net external liabilities raises questions about real exchange rate misalignments. Given the uncertainties, however, staff agreed with the authorities that the focus should be on measures to raise productivity growth and the savings rate, which are crucial for long-term external sustainability.

Figure 4. Hungary: Debt Dynamics, 1999-2010

External debt is expected to decline modestly over 2005-10, but remains susceptible to shocks, in particular, to the exchange rate and current account.



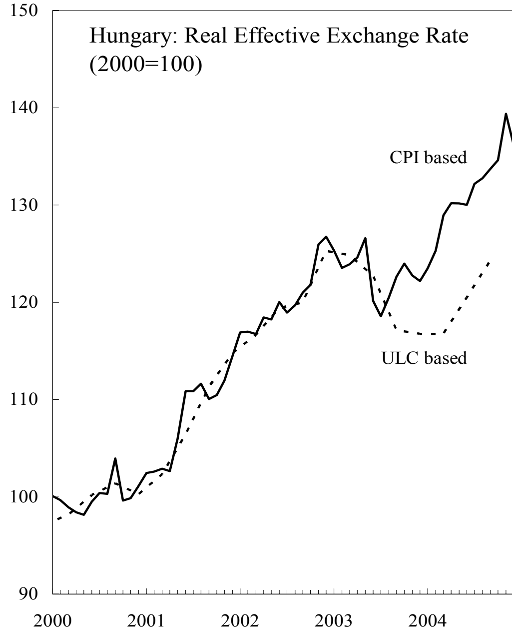
Public debt is projected to decline modestly, but is vulnerable to shocks, in particular, to primary balance shocks.



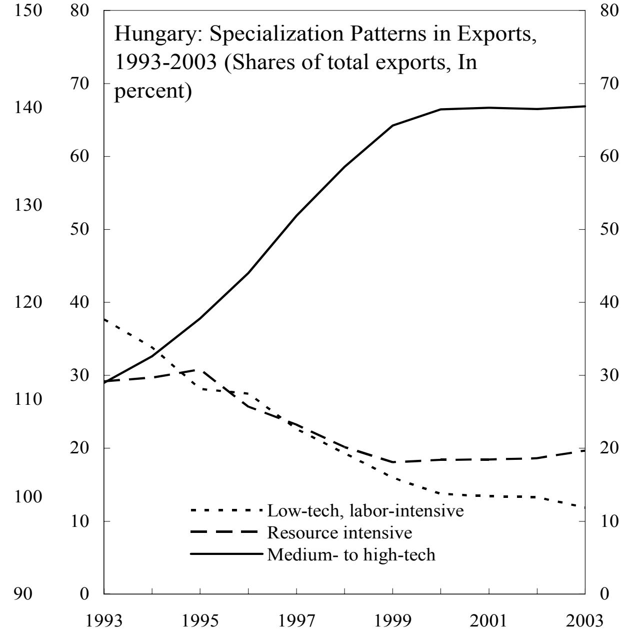
Sources: Hungarian authorities, IMF staff estimates.

Figure 5. Selected Competitiveness Indicators

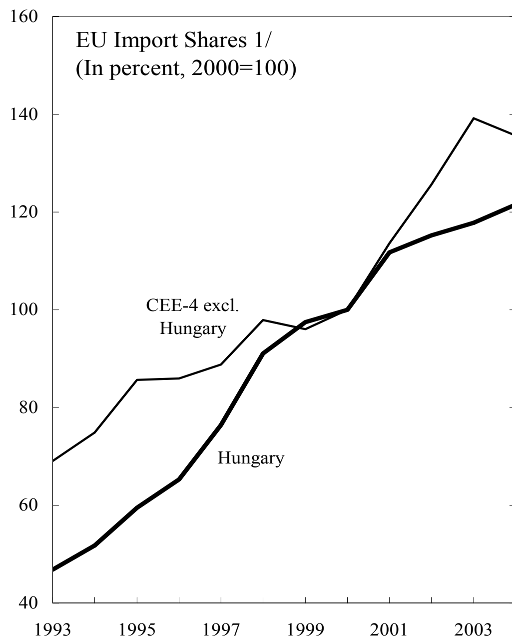
CPI- and ULC-based real exchange rates have appreciated...



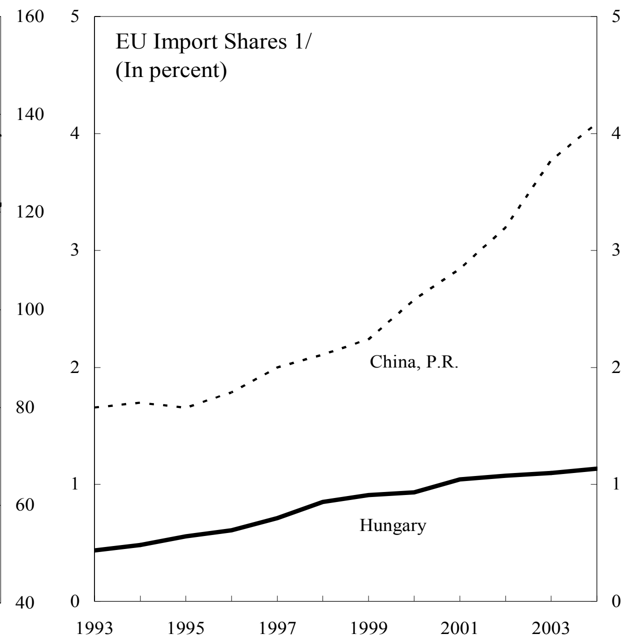
...and the process of technological upgrading in exports seems to have plateaued.



Hungary has seen slower market share gains in the EU since 2001...



...and it is facing greater competition from countries such as China.

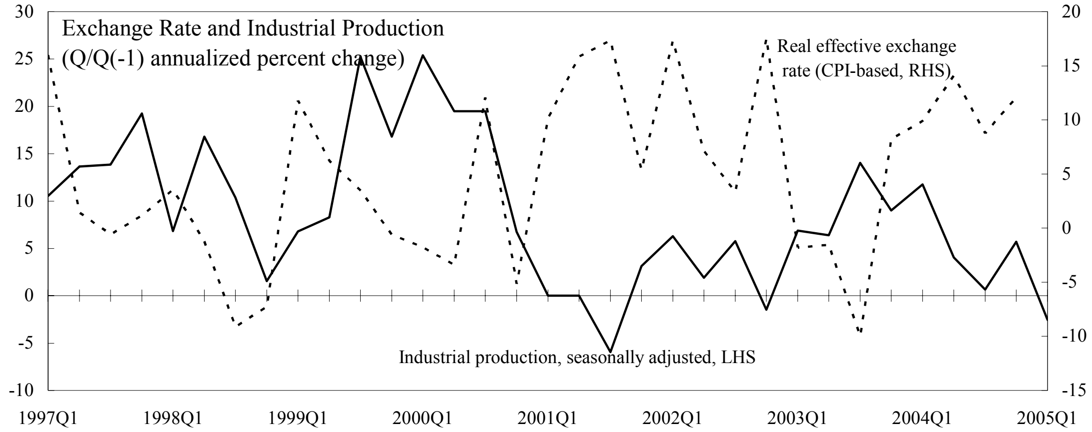


Sources: UN Comtrade database; Taxonomy of export categories is based on Landesmann and Stehrer (2003).

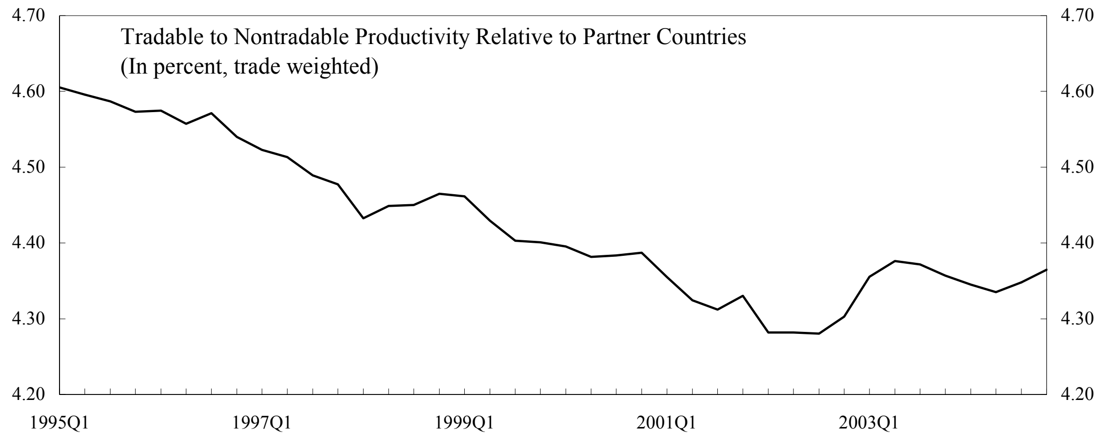
1/ Figures for 2004 are through November.

Figure 6. Hungary: Selected External Indicators

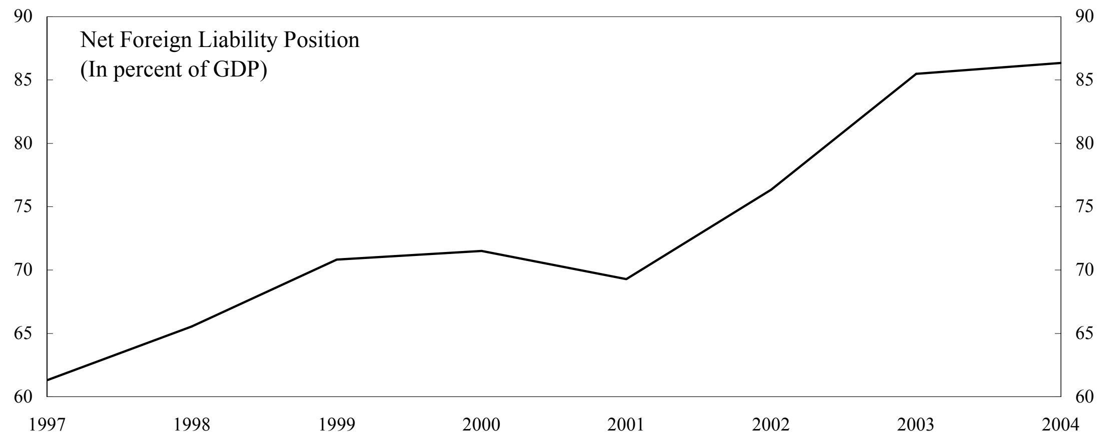
Real appreciation is weakly associated with lower domestic production.



The relative decline in the productivity of tradables has stabilized...



...however, the net liability position continues to worsen.



Sources: Hungarian authorities, IMF staff estimates.

Box 3. Growth and the Current Account

Hungary's GDP growth rate averaged about 3½ percent a year between 2002 and 2004, while its current account deficit was around 9 percent of GDP. A country with the potential to catch up to the technology and income levels of advanced economies can be expected to grow relatively rapidly, while also spending more than its current income—that is, borrowing capital from the rest of the world and, hence, running current account deficits. How much of Hungary's growth and current account deficit can be explained by this catch-up—or income convergence—process?

A cross-country analysis of European economies suggests that, in general, larger current account deficits (capital inflows) are associated with faster income convergence. However, the model's benchmark for Hungary suggests that its current account deficit has been larger than would be expected based on the income convergence process. Hungary's current account deficit of 9 percent of GDP was about 2½ percent of GDP larger than the central prediction of the model, though just within the statistical confidence band (Figure 1). Growth of 4 percent in 2004 was about 1 percentage point less than the central prediction (Figure 2).

Figure 1. Hungary: Current Account Predicted by Model
(In percent of GDP)

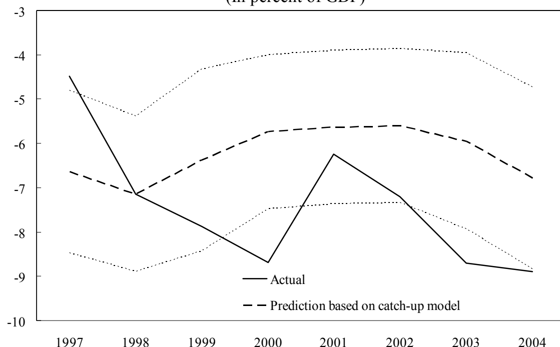
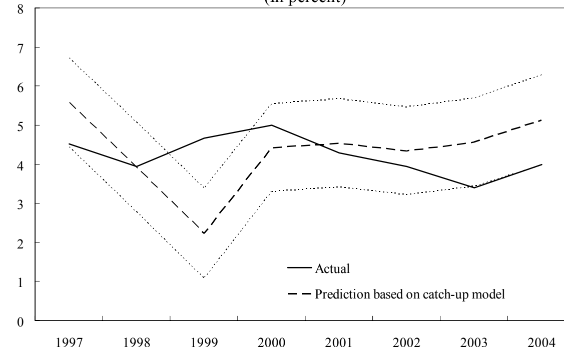


Figure 2. Hungary: Growth Predicted by Model
(In percent)



C. Public Finances

18. **The authorities reiterated their commitment to the targets set out in the government's Convergence Program (CP).** A fiscal consolidation relative to GDP of 0.6 percentage point per year is targeted over the next three years. In achieving consolidation, the authorities recognized that the recent divergence in accrual and cash deficit trends cannot be allowed to persist, and staff urged that changes in accounting conventions be minimized. Staff emphasized that lowering the deficit below the Maastricht limit was important, not only for euro adoption, but also because fiscal tightening, if achieved with high-quality sustainable measures, would improve macroeconomic stability, address debt sustainability issues, and contribute to higher growth. The public debt-to-GDP ratio is at 60 percent, and stress tests show that a slowdown in real growth could raise the debt ratio well above the Maastricht ceiling by 2010 (Figure 4 and Table 6). Staff, therefore, pointed out that as long as debt

remained at this level the authorities would need to be prepared to respond quickly with more ambitious fiscal consolidation should debt dynamics turn adverse. Further consolidation was also desirable to make room for automatic stabilizers.

Box 4. Fiscal Stimulus in 2005

PPP-based investment spending for highways is to be stepped up. Though possibly based on funding from private sources, much of the new investment will be under the operational supervision of a public company (the motorway operator AAK). The expenditures for these projects, which are estimated at 1.2 percent of GDP in 2005, contribute to a fiscal stimulus. Also, as the 2001 IMF Report of the Observance of Standard and Codes notes, discretionary spending of privatization receipts should form part of the government's consolidated budget. Spending based on these receipts is expected to reach 0.5 percent of GDP in 2005, as estimated by the MNB in the underlying calculations of its February 2005 *Quarterly Report on Inflation*, adding to the stimulus.

Table 1. Fiscal Operations, 2004-05

	2004	2005
	(In percent of GDP)	
Fiscal deficit	5.4	4.7
Pimary fiscal deficit	1.2	0.9
Capital expenditures under PPPs 1/	0.0	1.2
Privatization receipts spending 2/	0.4	0.5
Adjusted fiscal deficit	5.8	6.4
Adjusted primary fiscal deficit	1.6	2.6
Fiscal stimulus	...	1.0

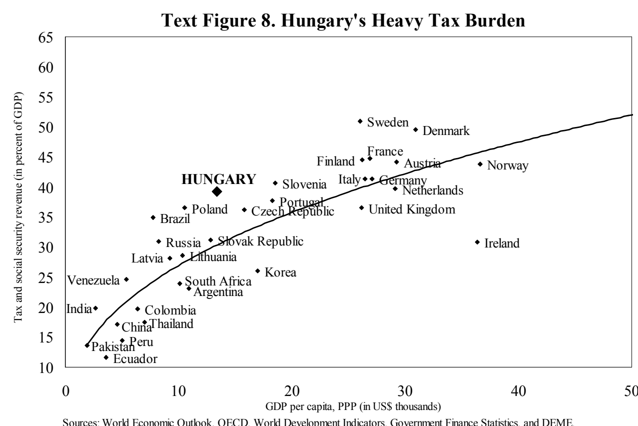
Sources: IMF staff estimates, Hungarian authorities.
1/ Amount of capital expenditure moved off budget in 2005 that will be carried out by the Motorway Operator Company (AAK).
2/ Figures represent activities of the privatization company not included in the general government budget (as estimated by the MNB, *Quarterly Report on Inflation* of February 2005).

19. **Staff cautioned against the use of extrabudgetary mechanisms primarily to achieve consolidation of the on-budget balance.** The authorities noted that off-budget financing through public-private partnerships (PPPs) can accelerate needed infrastructure development. But staff cautioned that the Hungarian experience and that of other countries suggested that PPPs did not have a good track record of producing value for money. Moreover, they provide a fiscal stimulus (Box 4) and represent a burden for future fiscal budgets, reducing fiscal flexibility. Absent careful disclosure and accounting, PPPs also render difficult the interpretation of public debt, as well as of budget trends and their macroeconomic impact.

20. **The authorities acknowledged that specific structural measures to limit and rationalize public expenditures had yet to be formulated.** In line with previous Fund advice, staff urged bolder steps, which, while politically difficult, were crucial to achieve durable and credible consolidation. The authorities recognized that structural measures would also increase household incentives to save and modernize the delivery of public services. They acknowledged that recent modest reforms in the health and education sectors needed to proceed further, with reduced direct government involvement in the provision of these services. Costs of the first-pillar pension and social support systems should be contained. Further reductions in, or, preferably, removal of, the current housing subsidy scheme could,

the authorities agreed, help raise household savings. Phasing out subsidies to state-owned enterprises and completing the privatization process would enhance economic efficiency.

21. **Expenditure-based consolidation was critical to create space for the needed tax reform, the authorities agreed**. Hungary's heavy tax burden creates disincentives for employment and investment (Text Figure 8). The tax wedge on labor is particularly onerous (Text Table 2). Options for a comprehensive tax reform, based on lower rates, a broader base, and greater ease of administration, are under consideration. The authorities agreed that tax reductions, while ultimately stimulative, could temporarily reduce revenues and must, therefore, be linked to expenditure reforms that ensure fiscal consolidation. The envisaged early elimination of the local business tax, which the EU is likely to require, could be achieved on a revenue-neutral basis through a surcharge on the corporate tax or a real estate tax.



Text Figure 8. Hungary's Heavy Tax Burden

Sources: World Economic Outlook, OECD, World Development Indicators, Government Finance Statistics, and DEME.

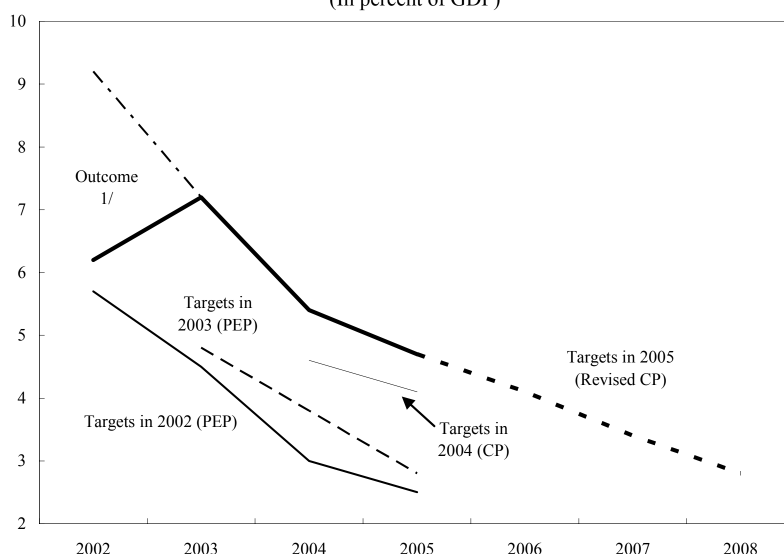
Text Table 2. Tax Wedge, 2003 1/

	Income Tax (In percent of gross wage)	Income Tax plus Employee Contributions less Cash Benefits (in percent of gross wage)	Income Tax plus Employee and Employer Contributions less Cash Benefits (in percent of labor costs)
Hungary	13.0	25.5	45.7
Czech Republic	11.6	24.1	43.8
Poland	6.2	31.2	42.9
Slovak Republic	6.3	19.1	41.4
Ireland	11.4	16.4	24.5
Korea	2.3	6.8	14.1
Mexico	2.9	4.4	17.3
Euro-area	13.4	26.7	41.1

Source: OECD.
1 / Single person without children at 100 percent of average earnings.

22. **The authorities also recognized that sustainable consolidation would require strengthening the rules and procedures for budget formulation and implementation.** Though some fiscal consolidation has been achieved in accrual terms in recent years, there has been a persistent overshooting of the deficit targets, which have been gradually revised upward (Text Figure 9). In international comparisons, Hungary ranks low in the quality of its rules and budgetary procedures (see the accompanying selected issues paper). This is particularly so for containing overruns of expenditures that are not nominally anchored. To restore credibility to policy targets, staff emphasized the strengthening of fiscal institutions in providing the necessary checks and balances.

Text Figure 9. Hungary: Fiscal Deficit Performance and Targets, 2002-08
(In percent of GDP)



Sources: IMF staff estimates, Hungarian authorities.

1/ The 2002 fiscal deficit outcome figure was adjusted downward from 9.2 percent of GDP to 6.2 percent of GDP to take into account statistical operations which implied a one-off increase in the deficit. IMF staff projection for 2005.

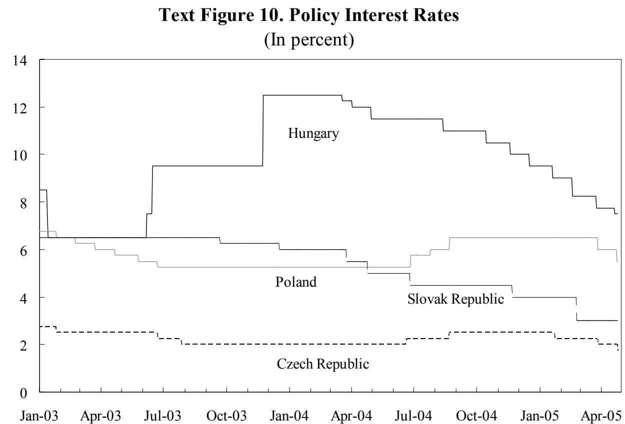
23. **In this context, staff welcomed the measures in the recently approved Public Finances Law but cautioned that much remained to be done.** Stricter rules for the carryover of unused funds from the previous fiscal year will help in 2005. Limiting additional budgetary spending without supplementary appropriations and parliamentary approval was also a step in the right direction; however, staff suggested that the practice be discontinued altogether. The authorities recognized the importance of creating a medium-term fiscal budget framework to impose fiscal discipline while also achieving greater budgetary transparency and predictability. In this context, staff urged the authorities to adopt the three-year rolling framework under consideration in 2003 (which included ceilings on overall expenditure and subceilings on key components), further checks and balances in the expenditure management system, and more extensive oversight by the State Audit Office to enhance transparency and credibility.

D. Monetary Policy

24. **The authorities acknowledged that inflation was still relatively high and the recent gains could be reversed.** At 3.9 percent year on year as of April 2005, inflation is high relative to a number of benchmarks: (i) the Maastricht limits, (ii) inflation rates in most new member states, and (iii) the MNB's own estimated optimal inflation rate of 3 percent. Risks to inflation arise from possible supply shocks and a reversal of recent wage trends.

25. **Any further lowering of rates should be guided by the market's inflation expectations.** The policy interest rate has been rapidly reduced in the past year to 7.5 percent (Text Figure 10). Current market expectations of further interest rate reductions are consistent with achievement of the 2005 and 2006 inflation targets of 4 and 3.5 percent (±1 percent), respectively. A gradual easing of rates in line with these expectations is therefore likely to be appropriate. Staff suggested, and the authorities agreed, that markets must learn to interpret changes in the policy interest rate as being motivated primarily by inflation-targeting considerations. A cautious reduction in rates, communicated appropriately, will facilitate the necessary learning.

Text Figure 10. Policy Interest Rates
(In percent)



26. **To further anchor inflation expectations, the authorities plan to strengthen the inflation-targeting framework.** The authorities estimate a 3 percent inflation rate as optimal for Hungary, though they recognized that a lower rate may be necessary to meet the Maastricht inflation criterion. The significant forward-looking component in Hungary's inflation dynamics should facilitate moving toward a lower target rate if necessary (Box 5). In line with international best practice, the authorities expect to replace the current system of setting targets for December inflation with a constant inflation objective, targeted over a rolling horizon.

27. **The importance of exchange rates for forecasting inflation has declined with time.** Staff suggested, and the authorities agreed, that, with short-term movements in exchange rates mainly reflecting market sentiments and volatile capital movements, and with evidence of reduced pass-through from exchange rates to domestic prices, exchange rate considerations should play a smaller role in setting interest rates. The authorities noted that, in setting policy interest rates, the Monetary Council had appropriately considered the implications of exchange rate movements for inflation. However, in 2002 and 2003, the commitment to the exchange rate band had guided interest rate policy decisions beyond inflation-targeting considerations (Box 5). While acknowledging that policy interest rates had recently moved more consistently with inflation-targeting objectives, staff reiterated recommendations from previous consultations that greater flexibility within the exchange rate band was desirable, emphasizing the dangers of pursuing exchange rate targets in an inflation-targeting framework, including the confusion that this could create in the markets about the central bank's objectives.

Box 5. Inflation Persistence and Inflation Targeting

Since year-end inflation targets have not been consistently met, the credibility of inflation targeting has yet to be strongly established. Yet, the basis for achieving credibility exists in Hungary's low inflation persistence. Analysis in an accompanying selected issues paper reveals a substantial forward-looking component in Hungarian inflation, a finding that explains why the recent inflation shocks did not have second-round effects.

Figure 1. Hungary: Realized Versus Target Inflation
(12-month percent change)

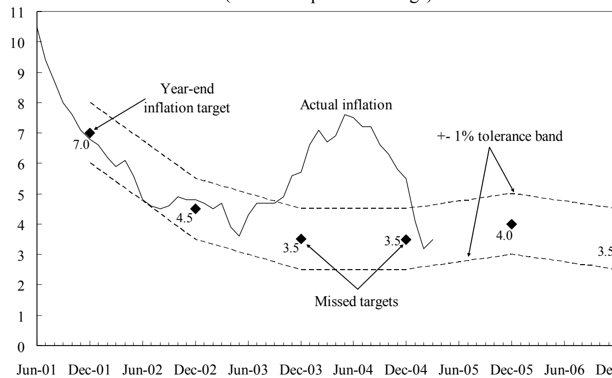
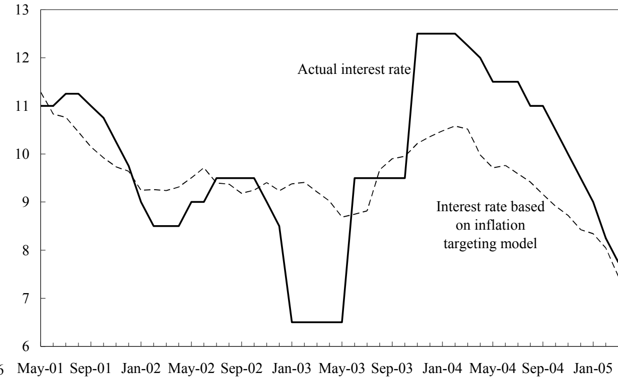


Figure 2. Hungary: Interest Rate Based on Inflation Targeting Model
(In percent)



Achieving credibility will require a more consistent focus on inflation targeting. On occasion, changes in policy interest rates have been greater than can be rationalized based on inflation-targeting considerations alone. The selected issues paper decomposes the MNB's policy rate changes into inflation-targeting and exchange rate-targeting responses. In late 2002 and early 2003, inflation had been expected to meet or slightly overshoot its target, but the exchange rate approached the strong edge of the band. As Figure 2 suggests, the MNB responded by cutting rates below the level that could be rationalized based on inflation targeting. In late 2003 and early 2004, the interest rate was raised partly in response to rising inflation expectations but also because of exchange rate and inflation uncertainties.

28. **Following changes to the Central Bank Act, vigilance is required to ensure effective functioning of the Monetary Council, necessary for central bank independence.** In February 2004, the Central Bank Act was amended to allow nominations to the Monetary Council by the Prime Minister. With the appointment of four new members, the Council was temporarily expanded to thirteen members, making it one of the largest in the world. Even with its scaling back to eleven members in September 2006, the Council will remain large.

E. Financial Sector

29. **Financial sector performance, as well as regulation and supervision, has continued to improve**. An FSAP update confirmed that the well-capitalized financial system had recently also been exceptionally profitable (Text Table 3). The authorities observed that profitability had been boosted by temporary factors and may moderate somewhat. The update recommended that the authorities further clarify the Finance Minister's role in overseeing the Hungarian Financial Supervisory Authority (HFSA). In accordance with the authorities' request, the update focused on critical developmental issues in the areas of pension funds, insurance, and capital markets. As described in the accompanying Financial Sector Stability Assessment (FSSA), the update cautioned that the regulatory framework for the pension payout phase was deficient and could lead to future vulnerabilities. The authorities welcomed the suggestions for improvements in these and other areas.

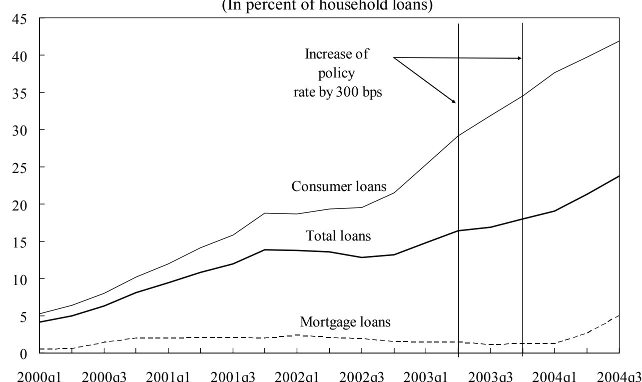
Text Table 3. Hungary: Financial Soundness Indicators for Commercial Banks

	2000	2001	2002	2003	2004
Regulatory capital-to-risk-weighted assets	13.7	13.9	13.0	11.8	11.2
Nonperforming loans (in percent of total loans)	3.0	2.7	2.9	2.6	2.7
Loan-loss provisions (in percent of NPLs)	57.0	42.6	50.8	47.3	51.1
Return on equity (after tax)	13.5	17.7	16.2	19.5	25.2
Liquid assets (in percent of total assets)	31.3	29.9	24.3	19.5	21.1

Source: National Bank of Hungary.

30. **A source of concern is the increase in foreign currency borrowing that appears not to be hedged**. Reflecting low international interest rates and a relatively stable exchange rate, household borrowing in foreign currencies (mainly in the euro and the Swiss franc) increased from about 10 percent of total household loans at end-2002 to 25 percent in September 2004 (Text Figure 11). In 2005, almost all new lending of the banking system has been foreign currency denominated. Since households and small businesses are unlikely to be "naturally hedged," this is generating credit risks for banks. Borrowers are also more vulnerable because foreign currency loans typically carry a shorter fixed-rate period than domestic currency loans. To stem potential vulnerabilities, staff reiterated the recommendation of the FSAP update to better inform borrowers of their foreign exchange risk. The authorities agreed that lenders should be required to provide detailed information to customers regarding the effect of exchange and interest rate movements on their debt-servicing expenses. Regarding the possibility of additional provisioning for foreign currency borrowing, the MNB cautioned that any such measures should not distort competition and must be in line with EU prudential directives.

Text Figure 11. Hungary: Share of Foreign Currency Loans in Household Loans
(In percent of household loans)



F. Structural Issues

31. **Raising Hungary's low labor participation rate and increasing labor market flexibility are priorities.** The recently published National Action Plan for Employment identified reforms needed to improve labor market participation and flexibility. The retirement age is gradually being increased to 62 years, and income replacement benefits are being better targeted (currently, almost 60 percent of the inactive population not in school receive some form of pension). Vocational training is being overhauled with the greater involvement of employers. Geographic mobility is to be improved by addressing deficiencies in transport infrastructure (the upgrading of bypass roads, and development of suburban community transportation and intermodal transport connection centers) and rigidities in the housing market. Also, the authorities intend to phase out by 2006 the fixed component of employers' contributions to health care, which creates a disincentive to hiring part-time workers (only 5 percent of total employment, compared with almost 20 percent in the euro area). Finally, the authorities acknowledged that the large minimum wage hikes of 2001–02 had hurt employment, with small and medium-sized enterprises and low-skilled workers especially affected, and that future wage developments should be well balanced, predictable, and in line with productivity growth.

32. **Hungary has made considerable progress in improving its business climate, but further efforts are needed to reach the higher standards of more advanced economies.** In international competitiveness rankings, Hungary ranks about in the middle of the new EU members (Text Table 4). The World Bank's *Doing Business* survey points to specific strengths (e.g., efficient contract enforcement, as measured by the low cost of recovering debt through the legal system) and weaknesses (e.g., more days to register a new business; high registration and legal costs; underdeveloped credit information systems; and a weak insolvency regime characterized by low recovery rates). The authorities' strategy for raising productivity is tied to the National Development Plan. In the context of this plan, EU funds are to be used for development in three interlinked areas: fostering the knowledge economy, promoting small businesses, and developing infrastructure. Accession to the EU has resulted in a reduction of the average tariff level (from 3.5 percent to 8.9 percent); however, since changes in the trade regime have occurred gradually, accession is not expected to have a major impact on trade.

Text Table 4. Global Competitiveness Indicators, 2004 1/

	Rank	
	WEF	IMD
Finland	1	8
USA	2	1
Estonia	20	28
Germany	13	21
Korea	29	35
Ireland	30	10
Slovenia	33	45
Lithuania	36	...
Hungary	39	42
Czech Republic	40	43
Slovak Republic	43	40
Latvia	44	...
Poland	60	57

Sources: World Economic Forum and Institute for Management Development.
1/ These survey-based indicators take into account a broad range of factors thought to be related to national economic performance, including value added, the cost of living, the degree of economic openness, the cost of capital, intellectual property, labor costs, labor force characteristics, and human capital measures.

IV. Staff Appraisal

33. **Hungary's economy has shown resilience in its first year as an EU member.** Accession to the EU created administrative challenges in tax collection, and tax rate increases generated temporary inflationary pressures. These challenges were successfully navigated. Hungarian exporters largely held their own against increased competition. Macroeconomic imbalances were contained. Foreign investors—both direct investors and creditors—remained confident about Hungarian prospects.

34. **A commitment is needed to raising potential growth, not least to dampen vulnerabilities and retain the confidence of financial markets.** The slowdown in 2005 is a reminder that Hungary's short-term economic developments remain tied to the fortunes of its main European trading partners. Productivity enhancements remain crucial to achieve higher growth and to compete in international markets. Policies designed to raise employment are needed to ensure that the benefits of growth are widespread. Under current baseline projections of interest and growth rates, public and external debt as a proportion of GDP will decline modestly, but remain susceptible to shocks. To guard against these shocks—and in light of the large appreciation of the real exchange rate in recent years—growth-enhancing policies are necessary, as are policies to increase the savings rate.

35. **To raise growth in the short term—and, more seriously, to prevent its erosion in the medium term—the authorities now need to reestablish a track record of consistent and predictable policies.** Policy efforts are needed in four broad areas:

- achieving fiscal consolidation, at least as ambitious as that spelled out in the authorities' Convergence Program;
- strengthening the inflation-targeting framework;
- reducing financial sector vulnerabilities; and
- undertaking a more ambitious agenda of structural reforms.

36. **Fiscal consolidation is central.** The risks to achieving the government's 2005 fiscal deficit target are evident, as the early trends highlight. To meet the target, it will be necessary to enforce the system of reserves and expenditure controls, which, in turn, will require timely identification of spending priorities. Another missed target would set back debt reduction and further damage policy credibility. Beyond 2005, adherence to at least the fiscal targets in the Convergence Program is essential not only for euro adoption by 2010 but also because slippages will undermine macroeconomic stability and debt sustainability. A more ambitious consolidation trajectory would reduce the risk from shocks to public debt and create space for automatic stabilizers.

37. **Ad hoc fiscal measures obscure budgetary trends and will likely damage long-term growth.** Recent differences in accrual and cash deficits not only reflect one-off VAT effects due to EU accession but also changes in accounting practices, which have

increased the difficulty of interpreting budgetary trends. In 2005, off-budget PPPs will finance needed infrastructure expenditures. International experience cautions that PPPs do not always produce value for money and further obscure budgetary trends. Ad hoc accounting and expenditure reduction measures may help meet the Maastricht criteria, but with reduced economic flexibility and structural distortions, long-term growth prospects will likely suffer.

38. **A focus on structural improvements in expenditures—and in the budget process—will bring durable fiscal consolidation.** Fundamental expenditure reforms—in the pension, health, and education sectors—and the phasing out of interest rate subsidies would not only reduce the budget deficit but also improve the delivery of public services and help raise private savings. A wide-ranging tax reform—based on lower rates and a broader base—is necessary, along with improvements in tax administration. However, tax reform without structural measures to reduce spending would endanger fiscal consolidation plans. To restrain the various claims on fiscal resources—and, hence, to overcome the tendency to miss targets—stronger checks and balances are needed in budgetary processes.

39. **The inflation outlook improved in late 2004 and early 2005, and monetary policy responded appropriately by reducing interest rates.** Current market expectations suggest that inflation will meet the 2005 and 2006 targets of 4 and 3.5 percent (±1 percent), respectively. However, given the risks of a reversal of the recent disinflation, a cautious approach to future interest rate changes is warranted.

40. **A stronger inflation-targeting framework will help further lower and stabilize inflation expectations.** The authorities' intention of lowering the inflation target to 3 percent a year in the medium term is welcome, though meeting the Maastricht inflation criterion may require an even lower target. The introduction of a constant target, to be achieved over a rolling targeting horizon, would make monetary policy more predictable, help to anchor inflation expectations, and bring policies closer in line with international best practice. Also, within the scope provided by the authorities' desire to maintain the exchange rate band, the focus of monetary policy on containing domestic inflationary pressures—rather than on stabilizing the exchange rate—should be reemphasized.

41. **Although the financial sector remains sound, the growing share of foreign currency debt held by the private sector could become a source of vulnerability.** The expansion of foreign currency-denominated borrowing—especially by households and small and medium-sized firms that likely are not naturally hedged—should be closely monitored to prevent it from becoming a source of macroeconomic vulnerability. Stronger disclosure requirements and appropriately formulated additional provisioning for foreign currency loans could help. Adoption of regulatory initiatives in the pension and insurance sectors, as recommended by the recent FSAP update, should also be pursued.

42. **Further structural reforms are needed to promote employment and productivity growth.** Labor market flexibility can be increased by facilitating geographic and occupational mobility, reducing the impediments to part-time employment, and implementing vocational educational reforms that decrease the extent of skills mismatches.

Since the sizable increases in the minimum wage in 2001–02 ill served the goal of employment generation, further increases should be contained. The authorities' strategy for using EU funds to build a knowledge economy, raise the productivity of small and medium-sized firms, and develop infrastructure is welcome. However, fiscal structural reforms are necessary to ensure that EU funds are used to achieve long-lasting gains.

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

Table 1. Hungary: Main Economic Indicators, 2000–06

	2000	2001	2002	2003	2004	2005	2006
						Proj.	
Real economy (change in percent)							
Real GDP	5.2	3.8	3.5	3.0	4.0	3.4	3.6
CPI (average)	9.8	9.2	5.3	4.7	6.8	4.0	3.6
Unemployment rate (in percent)	6.4	5.7	5.8	5.9	6.1	6.4	6.2
Wage Growth (gross wages)							
Economy wide	13.6	18.0	18.3	12.0	6.1	...	...
Private	14.3	16.3	13.4	8.9	9.3	...	...
Public 1/	12.3	22.4	29.2	17.5	0.7	...	...
Gross national saving (percent of GDP) 2/	22.3	20.6	18.1	16.6	15.3	15.9	16.3
Gross domestic investment (percent of GDP) 3/	30.9	26.8	25.2	25.3	24.1	24.5	24.4
General government (percent of GDP), ESA-95 basis 4/							
Balance	-3.0	-4.7	-9.4	-7.2	-5.4	-4.7	-4.1
Debt	55.4	53.5	57.1	59.1	60.7	59.9	59.9
Money and credit (end-of-period, percent change)							
M3	18.2	17.1	9.3	12.0	11.6	...	...
Credit to nongovernment	33.7	17.3	22.3	34.4	19.2	...	...
Interest rates (percent)							
T-bill (90-day, average)	10.9	10.7	8.9	8.2	11.1	...	...
Government bond yield (5-year, average)	9.1	8.6	7.8	7.3	9.2	...	...
Balance of payments							
Trade balance (percent of GDP)	-6.2	-4.3	-3.3	-4.0	-3.0	-3.0	-2.7
Current account (percent of GDP)	-8.6	-6.2	-7.2	-8.7	-8.9	-8.6	-8.1
Reserves (months of imports of goods and services)	3.7	3.3	2.9	2.8	2.6	2.4	2.3
Net external debt (percent of GDP) 5/	26.0	23.9	23.5	29.1	31.7	32.1	31.0
Exchange rate							
Exchange regime	Peg against euro, with band +/-15 percent						
Present rate (May 12, 2005)	Ft 196.0 = US$1						
Nominal effective rate (1990=100)	35.5	36.2	38.9	38.8	39.6	...	...
Real effective rate, CPI basis (1990=100)	138.4	149.6	166.2	170.1	181.3	...	...

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

1/ In 2004, adjusting for the 13th-month bonus paid out in January 2005 results in public sector wage growth of 5.7 percent.
2/ Consistent with the balance of payments data (not necessarily with the national accounts data).
3/ Includes change in inventories.
4/ Consists of the central budget, social security funds, extrabudgetary funds, and local governments. Includes the costs of pension reform
5/ Including inter-company loans, and nonresident holdings of forint-denominated assets.

Table 2. Hungary: Consolidated General Government, 2000-05
(ESA-95 Basis)

	2000	2001	2002	2003	2004	2005	
					Est.	Budget	Proj. 1/
			(In percent of GDP)				
Total revenues	46.0	45.2	44.6	43.7	45.1	43.6	44.0
Current revenues and current grants	44.8	43.7	42.7	41.7	43.3	41.6	42.0
Tax revenues total	39.6	39.3	38.8	38.2	38.7	38.2	38.5
Taxes on income	9.5	10.1	10.1	9.3	9.0	8.8	9.0
Personal income tax	7.3	7.7	7.7	7.1	6.9	6.7	6.9
Corporate income tax	2.2	2.4	2.4	2.2	2.2	2.1	2.1
Social security contributions	12.9	13.0	12.9	12.4	12.4	12.3	12.6
Taxes on goods and services	14.9	14.1	13.8	14.0	15.0	14.7	14.7
of which : VAT	9.0	8.3	8.0	8.3	9.4	9.3	9.1
Other taxes	2.3	2.1	2.1	2.5	2.3	2.3	2.3
Current non tax revenues total	4.9	4.0	3.6	3.4	4.3	3.2	3.3
Of which : interest	0.8	0.7	0.3	0.2	0.3	0.2	0.2
Current grants	0.4	0.3	0.2	0.0	0.3	0.3	0.3
Capital revenues and capital grants	1.0	1.5	1.7	2.0	1.8	1.9	2.0
Non-allocable revenues	0.2	0.1	0.2	0.0	0.0	0.0	0.0
Total expenditures	48.8	49.7	54.0	50.9	50.4	48.3	48.8
Current expenditures and current transfers	42.0	42.1	43.8	44.3	44.5	43.3	44.1
Goods and services	17.6	18.0	18.9	20.0	18.9	18.6	18.8
Of which : wages and salaries 2/	10.4	11.1	12.0	12.8	11.7	11.9	12.1
Transfers	18.8	19.2	20.8	20.2	21.1	20.8	21.2
Of which : to households	14.8	15.2	16.0	15.7	16.5	16.4	16.7
Interest payments	5.6	4.9	4.1	4.0	4.5	4.0	4.1
Capital expenditures and capital transfers	6.8	7.6	10.3	6.5	5.9	4.6	4.7
Capital expenditures	4.3	5.1	6.3	4.3	4.1	2.8	2.9
Capital transfers	2.5	2.5	4.0	2.3	1.8	1.8	1.8
Unallocable expenditures	0.0	0.0	0.0	0.0	0.0	0.4	0.0
Of which : General government reserves	0.0	0.0	0.0	0.0	0.0	0.4	0.0
General government balance	-2.8	-4.5	-9.4	-7.2	-5.4	-4.7	-4.7
Net interest	-4.8	-4.2	-3.8	-3.8	-4.2	-3.8	-3.9
Primary balance	2.1	-0.3	-5.6	-3.4	-1.2	-0.9	-0.9
General government balance (excluding the costs of pension reform)	...	...	...	-6.2	-4.4	-3.6	-3.6
Memorandum items:							
GDP, in current prices (forint billions)	13,172	14,850	16,740	18,568	20,216	22,180	21,740
Gross debt (in percent of GDP; including the costs of pension reforr	55.4	53.5	57.1	59.1	60.7	58.7	59.9
Gross debt in percent of GDP; (excluding the costs of pension refori	...	...	...	56.9	57.6	55.5	56.7

Sources: Hungarian authorities, and staff estimates.

1/ Staff estimates, assuming that part of the reserves (0.6 percent of GDP) will not be spent.
2/ Including social security contributions.

Table 3. Hungary: Balance of Payments, 2000-2008

	2000	2001	2002	2003	2004	2005	2006	2007	2008
						Proj.			
				(In billions of U.S. dollars)					
Current account balance	-4.0	-3.2	-4.6	-7.2	-8.8	-9.2	-9.3	-9.3	-9.4
In percent of GDP	*-8.6*	*-6.2*	*-7.2*	*-8.7*	*-8.9*	*-8.6*	*-8.1*	*-7.6*	*-7.1*
Merchandise trade balance	-2.9	-2.2	-2.1	-3.3	-3.0	-3.3	-3.1	-2.7	-2.6
In percent of GDP	*-6.2*	*-4.3*	*-3.3*	*-4.0*	*-3.0*	*-3.0*	*-2.7*	*-2.2*	*-1.9*
Exports goods	28.8	31.1	34.7	43.3	55.3	65.5	72.4	80.0	87.9
Percentage change in volume	21.7	7.7	5.9	9.1	17.0	12.0	10.1	10.1	8.9
Imports goods	31.7	33.3	36.7	46.6	58.3	68.7	75.4	82.7	90.5
Percentage change in volume	20.8	4.0	5.1	10.1	13.4	10.7	9.6	8.6	8.6
Services balance	1.1	1.5	0.6	-0.4	0.0	0.0	0.3	0.4	0.5
Of which: net travel	2.1	2.4	1.6	1.5	1.2	1.1	1.1	1.3	1.4
Net income	-2.6	-2.9	-3.6	-4.2	-6.1	-6.9	-7.5	-8.1	-8.4
In percent of GDP	*-5.5*	*-5.5*	*-5.6*	*-5.0*	*-6.1*	*-6.4*	*-6.5*	*-6.5*	*-6.4*
Net transfers	0.4	0.4	0.5	0.7	0.3	0.9	0.9	1.0	1.1
In percent of GDP	*0.8*	*0.8*	*0.8*	*0.8*	*0.3*	*0.8*	*0.8*	*0.8*	*0.8*
Capital account, net	0.3	0.3	0.2	0.0	0.4	1.8	2.2	2.2	2.2
Financial account, net	5.0	2.8	2.5	7.6	10.4	9.1	7.7	7.3	7.4
Net direct investment	2.2	3.6	2.7	0.5	3.7	2.8	3.0	3.2	3.4
Net portfolio investments	-0.3	1.5	1.9	3.3	7.4	4.9	4.4	3.7	3.2
Net other investments	3.2	-2.3	-2.1	3.8	-0.6	1.3	0.4	0.4	0.7
Errors and omissions	-0.2	0.0	0.1	0.2	-0.1	0.0	0.0	0.0	0.0
Overall balance	1.1	-0.1	-1.8	0.4	1.9	1.7	0.6	0.2	0.3
Net reserves (change)	-1.1	0.1	1.8	-0.4	-1.9	-1.7	-0.6	-0.2	-0.3
Memorandum of items (end of period):									
Gross reserves	11.2	10.8	10.4	12.8	14.7	16.4	16.9	17.2	17.4
In months of goods and services imports	*3.7*	*3.3*	*2.9*	*2.8*	*2.6*	*2.4*	*2.3*	*2.1*	*2.0*
Gross foreign debt, in percent of GDP 1/	*64.5*	*64.6*	*56.1*	*63.6*	*63.4*	*64.1*	*62.8*	*60.9*	*59.1*
Net foreign debt, in percent of GDP 2/	*26.0*	*23.9*	*23.5*	*29.1*	*31.7*	*32.1*	*31.0*	*29.6*	*28.4*

Sources: Magyar Nemzeti Bank; and IMF staff estimates.
1/ Including intercompany loans.
2/ Foreign liabilities net of foreign assets, excluding equity but including intercompany loans.

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

	2000	2001	2002	2003	2004	2005	2006	2007	2008
						Staff projections			
	(In percent, unless otherwise indicated)								
Real GDP growth	5.2	3.8	3.5	3.0	4.0	3.4	3.6	3.9	4.0
Nominal GDP, forint billions	13,172	14,850	16,740	18,568	20,216	21,740	23,333	24,995	26,722
Inflation (CPI; end-year basis)	10.1	6.8	4.8	5.7	5.5	4.0	3.2	3.0	2.6
	(Annual percentage change, constant prices)								
Domestic demand	4.8	1.9	5.4	5.4	3.3	2.7	3.2	2.6	3.8
Consumption	4.4	5.8	8.7	7.3	2.2	3.1	3.1	3.4	3.6
Gross fixed capital formation	7.7	5.0	8.0	3.4	8.3	4.3	4.9	5.7	5.4
Exports of GNFS	21.0	7.8	3.7	7.6	15.7	11.3	10.3	10.1	8.8
Imports of GNFS	19.4	5.1	6.2	10.4	14.0	10.0	9.6	8.5	8.5
	(In percent of GDP)								
External current account balance	-8.6	-6.2	-7.2	-8.7	-8.9	-8.6	-8.1	-7.6	-7.1
Gross national saving	22.3	20.6	18.1	16.6	15.3	15.9	16.3	16.6	17.1
Gross national investment 1/	30.9	26.8	25.2	25.3	24.1	24.5	24.4	24.2	24.2
Private sector savings-investment balance 2/	-5.8	-1.7	-1.4	-2.0	-3.5	-3.9	-4.0	-4.0	-4.1
Gross private savings	20.8	20.0	19.0	17.5	16.5	17.8	17.5	17.3	17.2
Gross private investment	26.6	21.7	20.5	19.5	20.0	21.6	21.5	21.3	21.4
General government (ESA-95)									
Revenue, primary	45.2	44.6	44.3	43.4	44.8	43.8	43.4	43.0	42.6
Expenditure, primary	43.2	44.8	49.9	46.8	45.9	44.7	43.8	43.0	42.2
Primary balance	2.1	-0.3	-5.6	-3.4	-1.2	-0.9	-0.5	0.0	0.4
General government balance (including the costs of pension reform) 3/	-2.8	-4.5	-9.4	-7.2	-5.4	-4.7	-4.1	-3.5	-2.9
General government balance (excluding the costs of pension reform) 3/ 4/	...	...	...	-6.2	-4.4	-3.6	-3.2	-2.8	-2.5
Net interest	4.8	4.2	3.8	3.7	4.2	3.8	3.7	3.5	3.4
General government debt	55.4	53.5	57.1	59.1	60.7	59.9	59.9	59.4	58.4
General government debt (excluding the costs of pension reform) 4/				56.9	57.6	56.7	...	...	...
Memorandum items									
Output gap	0.6	0.0	-0.4	-0.9	-0.3	-0.3	-0.1	0.4	1.0
Structural general government balance	-2.9	-4.5	-9.3	-6.9	-5.3	-4.6	-4.1	-3.7	-3.2
Structural primary balance	1.9	-0.3	-5.5	-3.2	-1.1	-0.8	-0.4	-0.1	0.1

Sources: IMF staff estimates, Hungarian authorities.

1/ Includes change in inventories.
2/ Consistent with the balance of payments data (not necessarily with the national accounts data).
3/ The 2002 general government balance includes various one-off financial operations (amounting to 3.1 percent of GDP) that are not part of the saving-investment balance on a national accounts basis.
4/ The exclusion of the costs of the pension reform is as indicated under the revised Growth and Stability Pact.

Table 5. Hungary: External Sustainability Framework, 1999-2010
(In percent of GDP, unless otherwise indicated)

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
							Projections					
							I. Baseline Medium-Term Projections					
1 **External debt**	65.0	64.5	64.6	56.1	63.6	63.4	**64.1**	**62.8**	**60.9**	**59.1**	**57.5**	**55.9**
2 Change in external debt	8.6	-0.5	0.1	-8.5	7.4	-0.2	0.7	-1.4	-1.9	-1.8	-1.6	-1.7
3 Identified external debt-creating flows (4+8+11)	-1.3	6.2	-4.4	-8.1	-1.3	-4.6	0.7	-1.4	-1.9	-1.8	-1.6	-1.7
4 Current account deficit, excluding interest payments	4.8	5.1	2.9	4.8	6.5	6.6	6.0	5.3	4.7	4.2	3.7	3.1
5 Deficit in balance of goods and services	2.7	3.8	1.4	2.3	4.5	3.0	3.0	2.4	1.8	1.5	1.3	0.8
6 Exports	64.3	74.4	73.6	64.8	62.9	65.5	72.2	74.4	76.8	79.0	81.3	83.5
7 Imports	67.0	78.3	75.0	67.1	67.3	68.5	75.2	76.9	78.7	80.5	82.6	84.3
8 Net non debt creating capital inflows (negative)	-7.5	-3.0	-4.1	-4.0	0.0	-4.6	-2.3	-2.3	-2.2	-2.2	-2.1	-2.0
9 Net foreign direct investment, equity	5.0	3.8	3.8	4.1	-0.3	3.2	1.9	1.8	1.8	1.8	1.7	1.6
10 Net portfolio investment,equity	2.5	-0.8	0.3	-0.2	0.4	1.5	0.5	0.5	0.4	0.4	0.4	0.4
11 Automatic debt dynamics 1/	1.4	4.0	-3.3	-8.9	-7.8	-6.6	-2.9	-4.4	-4.4	-3.8	-3.2	-2.7
12 Contribution from nominal interest rate	3.1	3.5	3.3	2.4	2.2	2.2	2.6	2.8	2.8	2.8	2.8	2.7
13 Contribution from real GDP growth	-2.3	-3.5	-2.2	-1.8	-1.3	-2.1	-2.0	-2.2	-2.3	-2.3	-2.2	-2.2
14 Contribution from price and exchange rate changes 2/	0.7	4.0	-4.3	-9.4	-8.7	-6.7	-3.6	-5.0	-4.9	-4.4	-3.8	-3.3
15 Residual, incl. change in gross foreign assets (2-3)	9.9	-6.6	4.5	-0.4	8.8	4.5	0.0	0.0	0.0	0.0	0.0	0.0
External debt-to-exports ratio (in percent)	101.1	86.6	87.8	86.6	101.1	96.7	88.8	84.3	79.2	74.8	70.8	66.9
Gross external financing need (in billions of US dollars) 3/	11.4	12.3	12.4	14.0	17.0	19.7	23.5	23.4	24.4	23.5	23.0	23.0
In percent of GDP	23.8	26.3	24.0	21.5	20.5	19.7	21.9	20.3	19.8	17.8	16.4	15.3
Key macroeconomic and external assumptions												
Real GDP growth (in percent)	4.2	5.2	3.8	3.5	3.0	4.0	3.4	3.6	3.9	4.0	4.0	4.0
Exchange rate appreciation (U.S. dollar value of local currency, change in percent)	-9.6	-15.9	-1.5	11.1	15.0	10.8	0.0	0.0	0.0	0.0	0.0	0.0
GDP deflator in U.S. dollars (change in percent)	-2.0	-7.6	6.9	21.0	23.7	15.9	4.0	3.6	3.1	2.8	2.6	2.6
Nominal external interest rate (in percent)	5.6	5.2	5.7	4.6	4.9	4.2	4.5	4.7	4.8	5.0	5.0	5.0
Growth of exports (U.S. dollar terms, in percent)	6.2	12.6	9.8	10.3	23.7	25.7	18.4	10.7	10.6	9.9	9.8	9.6
Growth of imports (U.S. dollar terms, in percent)	8.1	13.6	6.4	12.1	27.9	22.7	18.0	9.7	9.6	9.4	9.4	9.0
							II. Stress Tests for External Debt Ratio					
Alternative Scenarios												
1. Real GDP growth, nominal interest rate, dollar deflator, non interest current account, and non debt inflows at historical avg. 2005-10.							**59.0**	**53.1**	**47.4**	**42.3**	**38.0**	**34.5**
2. Nominal interest rate is at baseline level plus a two standard deviation shock in 2005 and 2006.							**65.5**	**65.6**	**63.6**	**61.8**	**60.2**	**58.5**
3. Real GDP growth is at baseline level minus a two standard deviation shock in 2005 and 2006.							**65.0**	**64.6**	**62.6**	**60.8**	**59.2**	**57.5**
4. Change in U.S. dollar GDP deflator is at baseline level minus a two standard deviation shock in 2005 and 2006.							**83.4**	**107.1**	**104.3**	**101.8**	**99.5**	**97.2**
5. Non interest current account is at baseline level minus a two standard deviation shock in 2005 and 2006.							**67.1**	**68.6**	**66.6**	**64.7**	**63.1**	**61.3**
6. Combination of 2-5 using one standard deviation shocks							**75.3**	**86.6**	**84.2**	**82.1**	**80.1**	**78.1**
7. One time 30 percent nominal depreciation in 2005.							**81.6**	**79.8**	**77.5**	**75.5**	**73.6**	**71.7**

Historical statistics for key variables	7-Year Historical Average	7-Year Standard Deviation
Current account deficit, excluding interest payments	4.8	1.5
Net non debt creating capital inflows	4.2	2.4
Nominal interest rate (in percent)	5.5	1.2
Real GDP growth (in percent)	4.1	0.7
GDP deflator in U.S. dollars (change in percent)	8.0	12.4

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

1/ Derived as [r - g - ρ(1+g) + εα(1+r)]/(1+g+ρ+gρ) times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in U.S. dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.
2/ The contribution from price and exchange rate changes is defined as [-ρ(1+g) + εα(1+r)]/(1+g+ρ+gρ) times previous period debt stock. ρ increases with an appreciating domestic currency (ε > 0) and rising inflation (based on GDP deflator).
3/ Defined as non interest current account deficit, plus interest and amortization on medium- and long-term debt, plus short-term debt at end of previous period.

Table 6. Hungary: Public Sector Debt Sustainability Framework, 1999-2010
(In percent of GDP, unless otherwise indicated)

	Actual								Projections					
	1999	2000	2001	2002	2003	2004			2005	2006	2007	2008	2009	2010
									I. Baseline Projections					
1 **Public sector debt 1/**	61.2	55.4	53.5	57.1	59.1	60.7			**59.9**	**59.9**	**59.4**	**58.4**	**57.6**	**56.7**
O/w foreign-currency denominated	22.7	19.5	16.3	13.5	13.9	15.5			13.9	13.9	13.8	13.5	13.3	13.1
2 Change in public sector debt	0.2	-5.8	-1.9	3.6	2.0	1.7			-0.9	0.1	-0.5	-1.0	-0.8	-0.9
3 Identified debt-creating flows (4+7+12)	0.4	-2.0	-1.5	0.7	0.5	-1.9			2.1	0.3	-0.3	-0.8	-0.6	-0.7
4 Primary deficit	-2.7	-2.1	0.3	5.6	3.4	1.2			1.0	0.5	0.0	-0.4	-0.4	-0.4
5 Revenue and grants	42.1	45.2	44.6	44.3	43.4	44.8			43.8	43.4	43.0	42.6	42.6	42.6
6 Primary (noninterest) expenditure	39.4	43.2	44.8	49.9	46.8	45.9			44.7	43.8	43.0	42.2	42.2	42.2
7 Automatic debt dynamics 2/	4.1	0.0	-1.7	-4.9	-2.6	-2.1			1.7	-0.2	-0.2	-0.3	-0.2	-0.3
8 Contribution from interest rate/growth differential 3/	0.5	-2.6	-1.4	-1.9	-1.6	-0.3			-0.2	-0.2	-0.2	-0.3	-0.2	-0.3
9 Of which contribution from real interest rate	2.8	0.1	0.5	-0.3	0.0	1.8			1.7	1.9	1.9	2.0	1.9	1.9
10 Of which contribution from real GDP growth	-2.2	-2.8	-1.9	-1.7	-1.6	-2.2			-1.9	-2.0	-2.2	-2.2	-2.2	-2.2
11 Contribution from exchange rate depreciation 4/	3.6	2.7	-0.4	-2.9	-1.0	-1.8			1.9	0.0	0.0	0.0	0.0	0.0
12 Other identified debt-creating flows	-1.0	0.0	0.0	0.0	-0.3	-0.9			-0.5	0.0	-0.1	-0.1	0.0	0.0
13 Privatization receipts (negative)	-1.0	0.0	0.0	0.0	-0.3	-0.9			-0.5	0.0	-0.1	-0.1	0.0	0.0
14 Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0
15 Other (specify, e.g., bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0
16 Residual, including asset changes (2-3)	-0.2	-3.8	-0.4	2.8	1.4	3.5			-3.0	-0.2	-0.2	-0.2	-0.2	-0.2
Public sector debt-to-revenue ratio 1/	145.4	122.5	120.1	129.0	136.1	135.7			136.9	138.2	138.2	137.1	135.1	133.1
Gross financing need 5/	16.8	16.7	16.0	27.1	18.9	22.2			21.6	21.0	20.4	19.8	22.4	22.2
In billions of U.S. dollars	8.1	7.8	8.3	17.6	15.7	22.2			23.2	24.2	25.2	26.2	31.6	33.3
Key macroeconomic and fiscal assumptions							7-Year Historical Average	7-Year Standard Deviation						
Real GDP growth (in percent)	4.2	5.2	3.8	3.5	3.0	4.0	4.1	0.7	3.4	3.6	3.9	4.0	4.0	4.0
Average nominal interest rate on public debt (in percent) 6/	13.9	10.6	10.0	8.7	7.8	8.3	10.6	2.8	7.2	7.1	6.7	6.5	6.3	6.2
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	5.5	0.7	1.4	-0.3	0.2	3.6	1.9	2.0	3.2	3.5	3.6	3.7	3.7	3.6
Nominal appreciation (increase in U.S. dollar value of local currency, in percent)	-13.3	-11.3	2.0	23.9	8.3	15.3	2.6	14.1	-11.0	0.0	0.0	0.0	0.0	0.0
Inflation rate (GDP deflator, in percent)	8.4	9.9	8.6	8.9	7.6	4.7	8.7	2.4	4.0	3.6	3.1	2.8	2.6	2.6
Growth of real primary spending (deflated by GDP deflator, in percent)	1.7	15.2	7.9	15.1	-3.3	2.0	6.5	7.0	0.7	1.6	2.0	2.0	4.2	4.0
Primary deficit	-2.7	-2.1	0.3	5.6	3.4	1.2	0.4	3.3	1.0	0.5	0.0	-0.4	-0.4	-0.4
									II. Stress Tests for Public Debt Ratio					
Alternative scenarios														
1. Key variables are at their historical averages in 2005-10 7/									**59.1**	**58.9**	**58.5**	**58.1**	**57.8**	**57.5**
2. Real interest rate is at baseline level plus a two standard deviation shock in 2005 and 2006.									**62.3**	**64.7**	**64.1**	**63.1**	**62.3**	**61.4**
3. Real GDP growth is at baseline level minus a two standard deviation shock in 2005 and 2006.									**61.4**	**63.6**	**64.3**	**64.6**	**63.7**	**62.8**
4. Primary balance is at baseline level plus a two standard deviation shock in 2005 and 2006.									**66.5**	**73.1**	**72.5**	**71.5**	**70.6**	**69.6**
5. Combination of 2-3 using one standard deviation shocks.									**64.8**	**69.9**	**69.3**	**68.2**	**67.4**	**66.4**
6. One time 30 percent real depreciation in 2005. 10/									**68.5**	**68.5**	**68.0**	**66.9**	**66.1**	**65.1**
7. Combination of 2 and 6: a two standard deviation interest rate shock and a one time 30 percent depreciation.									**71.2**	**74.0**	**73.4**	**72.3**	**71.4**	**70.5**

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

Table 7. Hungary: Monetary Survey, 2002-04
(In billions of forint, at current exchange rates, end-of-period)

	2002				2003				2004			
	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec
Domestic claims 1/	7,708	8,134	8,465	9,093	9,318	10,178	10,174	10,815	10,717	11,535	11,759	12,053
Claims on non financial corporations	3,840	3,949	4,131	3,864	4,001	4,262	4,415	4,604	4,721	4,855	4,987	5,194
Of which:												
Securities	283	274	296	176	178	172	180	187	182	186	166	187
Credits	3,557	3,675	3,835	3,688	3,823	4,090	4,235	4,417	4,539	4,670	4,820	5,007
Forint	2,358	2,450	2,542	2,472	2,463	2,532	2,664	2,684	2,781	2,723	2,772	2,835
Foreign currency	1,199	1,225	1,293	1,216	1,360	1,558	1,571	1,734	1,757	1,947	2,048	2,172
Claims on other financial corporations	441	521	579	652	721	861	912	1,018	1,022	1,162	1,183	1,279
Of which:												
Securities	41	41	38	49	46	43	55	56	63	65	66	66
Credits	400	480	540	603	675	818	857	961	959	1,097	1,116	1,213
Forint	154	164	176	175	180	214	203	197	192	190	174	172
Foreign currency	246	316	365	427	495	603	653	765	767	907	942	1,041
Claims on the consolidated central governmen	2,410	2,481	2,355	2,987	2,868	3,063	2,584	2,678	2,319	2,676	2,568	2,383
Of which:												
Securities	1,703	1,715	1,699	1,815	2,126	2,154	2,109	2,080	2,099	2,290	2,262	2,141
Credits	1,290	1,204	1,175	1,344	1,279	1,233	987	846	752	790	728	559
Local governments	74	85	88	116	112	123	128	148	148	164	173	185
Households	932	1,086	1,299	1,461	1,605	1,855	2,121	2,347	2,487	2,658	2,831	2,997
Forint	898	1,046	1,253	1,411	1,547	1,782	2,039	2,246	2,375	2,487	2,569	2,619
Foreign currency	34	40	46	50	57	73	82	101	112	171	261	378
Non profit institutions	11	12	13	13	12	13	14	20	20	20	18	15
Net foreign assets	856	567	541	575	558	353	497	313	477	105	141	240
Broad money (M3)	7,103	7,336	7,614	8,523	8,622	9,148	9,436	10,073	10,086	10,359	10,620	11,159
M2	6,767	6,987	7,143	7,830	7,751	8,078	8,300	8,885	8,782	8,998	9,208	9,696
Currency outside monetary institutions	1,005	1,101	1,149	1,182	1,198	1,287	1,306	1,347	1,256	1,329	1,329	1,342
Deposits	5,762	5,886	5,994	6,648	6,554	6,791	6,994	7,538	7,526	7,669	7,880	8,355
Of which:												
Non financial corporations	1,662	1,849	1,836	2,116	1,832	2,112	2,145	2,370	2,242	2,392	2,416	2,493
Forint	1,329	1,461	1,461	1,720	1,486	1,727	1,749	1,931	1,761	1,887	1,821	1,908
Foreign currency	333	388	375	397	345	385	396	439	481	505	595	585
Households	3,698	3,693	3,751	4,012	4,027	4,112	4,205	4,598	4,682	4,783	4,878	5,127
Forint	2,971	3,014	3,086	3,384	3,407	3,473	3,601	4,009	4,116	4,217	4,309	4,563
Foreign currency	727	679	665	628	621	639	605	588	566	566	569	564
Money market funds shares/units	153	157	153	186	246	221	195	174	191	219	246	299
Other claims, net	1,461	1,365	1,392	1,145	1,253	1,382	1,235	1,055	1,108	1,282	1,280	1,135
Memorandum Item:												
Domestic Credit	7,382	7,816	8,130	8,866	9,091	9,961	9,938	10,572	10,472	11,285	11,526	11,800

Sources: Magyar Nemzeti Bank; *International Financial Statistics,* IMF; and IMF staff calculations.
1/ Claims consist of credit (loans) and securities (securities other than shares and shares and other equities).
In this table domestic credit consists only of credit (loans) granted by MFIs to residents other than MFIs.

Table 8. Hungary: Frequently Used Indicators of Stability and Vulnerability in the Financial and External Sectors
(Year end, in percent of GDP, unless otherwise indicated)

	2000	2001	2002	2003	2004
Financial indicators					
Public sector debt	55.4	53.4	57.1	59.1	60.8
Broad money (M3, percent change, 12-month basis)	18.2	17.1	9.3	12.0	11.6
Private sector credit (percent change, 12-month basis)	41.3	15.9	15.9	30.5	17.8
Credit to non financial corporations	37.8	10.9	3.5	19.2	12.8
Credit to households	64.3	44.5	69.7	60.7	27.7
Total domestic credit (percent change, 12-month basis)	15.2	2.8	23.5	19.2	11.6
3-month T-bill yield	11.6	9.7	7.9	11.8	9.3
3-month T-bill yield (real) 1/	1.3	2.7	3.0	5.8	3.1
Non performing loans as a percent of total loans 2/	3.0	2.7	2.9	2.6	2.7
Capital adequacy ratio (in percent)	13.7	13.9	13.0	11.8	11.2
Foreign exchange loans as a percent of total loans	42.0	36.3	30.3	30.8	34.1
External indicators					
Exports of goods & services (percent change, 12-month basis in U.S. dollars) 3/	11.6	9.8	10.7	23.4	29.2
Imports of goods & services (percent change, 12-month basis in U.S. dollars) 3/	12.6	6.5	12.6	27.8	26.0
Terms of trade (percent change, 12-month basis)	-2.7	-0.3	0.4	-0.4	...
Current account balance 3/	-8.6	-6.2	-7.2	-8.7	-8.9
Capital and financial account balance 3/	11.2	6.0	4.3	9.1	8.4
Net foreign assets (NFA) of commercial banks (in billions of U.S. dollars)	0.2	2.3	1.8	2.1	3.3
Gross official reserves (in billions of US dollars)	11.2	10.8	10.4	12.8	16.0
Official reserves in months of imports of goods and services 4/	3.7	3.4	2.9	2.8	2.9
Ratio of reserve money to official reserves	0.7	0.7	1.0	0.7	0.7
Ratio of broad money to official reserves	1.8	2.4	3.3	3.2	3.2
Total external debt 5/	64.5	64.6	56.1	63.6	63.4
Of which: Public sector debt	31.9	28.9	25.5	26.9	29.0
Total external debt 6/	57.6	55.5	46.9	52.9	58.8
Total external debt as a percent of exports of goods & services 6/	77.4	75.4	72.4	84.2	89.6
Exchange rate (per US$, period average)	282.2	286.5	257.9	224.3	202.6
REER depreciation (-) (12 month basis; CPI-based)	0.7	8.1	11.2	-3.6	11.5
Financial market indicators					
Stock market index (end of period)	7,850	7,131	7798	9,380	14,743
Foreign currency debt rating (Moody's)	A3	A3	A1	A1	A1
Spread of DM-denominated benchmark bond (basis points, end of period) 7/	91.4	110.7	53.3	32.5	24.2

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

1/ Backward-looking using actual CPI.
2/ Comprised of loans classified as substandard, doubtful, and bad.
3/ These data reflect the methodological changes to the BOP statistics (described in the statistical issues appendix and the data ROSC update) that were introduced in late February 2003.
4/ Data for 2004 are expressed in terms of the 4-quarter moving average of imports.
5/ Including intercompany loans.
6/ Excluding intercompany loans.
7/ NBH bond maturing December 2005 (DM-denominated) and a German government bond with similar maturity.

Table 9. Selected Vulnerability Indicators, 2000-04

	2000	2001	2002	2003	2004
	(In perent of GDP, unless otherwise indicated)				
Current Account Balance					
Hungary	-8.6	-6.2	-7.2	-8.7	-8.9
Argentina	-3.2	-1.4	9.0	6.2	1.4
Brazil	-4.0	-4.5	-1.6	0.8	2.0
Latvia	-6.4	-8.9	-6.5	-8.6	-13.6
Poland	-6.0	-2.9	-2.6	-1.9	-1.6
Slovak Republic	-3.5	-8.4	-8.0	-0.9	-3.0
Turkey	-4.9	2.4	-0.8	-3.3	-4.9
GIR to Short Term Debt					
Hungary	118	101	118	95	96
Argentina	62	40	37	43	74
Brazil	49	50	55	74	81
Latvia	93	113	108	123	104
Poland	289	264	232	176	170
Slovak Republic	102	95	132	86	123
Turkey	53	61	87	84	73
External Debt					
Hungary	65	65	56	64	63
Argentina	52	52	132	115	100
Brazil	39	41	45	43	38
Latvia	61	68	76	82	85
Poland	42	39	44	50	48
Slovak Republic	53	53	54	56	48
Turkey	59	78	71	61	54
REER (2000=100)					
Hungary	100	113	125	121	135
Argentina	100	106	47	53	50
Brazil	100	85	77	71	73
Latvia	100	98	93	88	91
Poland	100	111	102	92	98
Slovak Republic	100	100	100	112	122
Turkey	100	82	92	100	101
Fiscal Balance					
Hungary	-2.8	-4.5	-9.4	-7.2	-5.4
Argentina	3.6	-5.9	-1.5	1.3	3.7
Brazil	-3.6	-3.6	-4.6	-5.2	-2.8
Latvia	-3.0	-2.0	-2.4	-1.6	0.2
Poland	-3.0	-5.3	-6.3	-5.8	-7.0
Slovak Republic	-12.3	-6.0	-5.7	-3.4	-3.6
Turkey	-11.2	-20.0	-15.1	-11.1	-7.5
NPL as Share of Total Loans					
Hungary	3.0	2.7	2.9	2.6	2.7
Argentina	16.0	19.1	38.6	33.5	20.8
Brazil	8.4	5.7	5.3	4.4	3.8
Latvia	4.6	2.8	2.0	1.4	1.4
Poland	15.0	17.9	21.1	20.9	...
Slovak Republic	20.1	20.5	9.2	6.4	5.4
Turkey	11.1	25.2	17.6	11.5	6.1

Source: PDR Quarterly Assessment of Vulnerabilities in Emerging Countries, December 2004.

HUNGARY: FUND RELATIONS
(As of February 28, 2005)

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

II. **General Resources Account**:

	SDR Million	Percent of Quota
Quota	1,038.40	100.00
Fund holdings of currency	705.84	67.97
Reserve position in Fund	332.56	32.03

III. **SDR Department**:

	SDR Million	
Allocation		
Holdings	39.35	N/A

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

V. **Financial Arrangements**:

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

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

VII. **Exchange Rate Arrangement**:

The Hungarian forint trades against the euro within a band of +/- 15 percent around a central parity, which is fixed to the euro at Ft. 282.36 per euro, effective June 4, 2003.

Hungary maintains an exchange system free of restrictions on the making of payments and transfers for current international transactions, except for the exchange restrictions

imposed by Hungary solely for the preservation of national or international security that have been notified to the Fund pursuant to Executive Board Decision No. 144-(52/51). Those exchange restrictions are contained in the following legal instruments:

- Council Regulation (EC) No. 2488/2000 of November 14, 2000, as amended (freezing of funds and economic resources of former Yugoslav President Slobodan Milosevic and certain other natural persons).

- Council Regulation (EC) No. 2580/2001 of December 28, 2001, as amended (freezing of funds and economic resources of certain persons, groups and entities with a view to combating terrorism).

- Council Regulation (EC) No. 881/2002 of May 29, 2002, as amended (freezing of funds and economic resources of persons and entities associated with Osama bin Laden, the Taliban and Al-Qaida).

- Council Regulation (EC) No. 1210/2003 of July 8, 2003, as amended (freezing of funds and economic resources of certain persons and entities in respect of Iraq).

- Council Regulation (EC) No. 314/2004 of February 24, 2004, as amended (freezing of funds and economic resources in respect of Zimbabwe.

- Council Regulation (EC) No. 798/2004 of April 28, 2004, as amended (freezing of funds and economic resources in respect of Burma/Myanmar.

- Council Regulation (EC) No. 872/2004 of April 30, 2004, as amended (freezing of funds and economic resources of persons and entities associated with Liberia's former President Taylor).

- Council Regulation (EC) No. 1763/2004 of October 14, 2004, as amended (freezing of funds and economic resources of certain persons indicted by the International Criminal Tribunal for the former Yugoslavia).

- Council Regulation (EC) No. 560/2005 of April 14, 2005 (freezing of funds and economic resources of certain persons who constitute a threat to the peace and national reconciliation process in Côte d'Ivoire).

VIII. **Article IV Consultations**:

Hungary is on a 12-month consultation cycle. The 2004 Article IV staff report was issued on April 6, 2004 (IMF Country Report No. 04/145). The last Article IV Board discussion took place on May 10, 2004. The Public Information Notice No. 04/59 was released on May 24, 2004.

IX. **Technical Assistance:**

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

2000	FAD	Tax legislation	June
2000	STA	Money and banking statistics	October
2000	FAD	Tax legislation follow-up	November
2002	FAD	Expenditure rationalization	November

X. **Regional Resident Representative:**

The regional office was closed in July 2002.

HUNGARY—STATISTICAL ISSUES

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

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

A. Real Sector Issues

National accounts

3. A statistical discrepancy between the final version of GDP by production activities and GDP by expenditure components emerged in 1997, and has persisted. From 2000, the Hungarian Central Statistical Office (HCSO) has been regularly publishing an estimate of this discrepancy for final annual data. Subsequent methodological refinements and a change in the base year have trimmed the magnitude of the discrepancy to about 1 percent of GDP, based on 2001 current price data, and ½ percent in 2002. From June 2002, the HCSO began publishing seasonally adjusted estimates of quarterly GDP by type of economic activity and by expenditure components beginning with the first quarter of 2002, with retrospective coverage from 1995. The benchmarking of the quarterly estimates to the annual estimates has been applied from 2000. Beginning with the annual data for 2000, the methodology for estimation of imputed owner-occupied rent, which had been based on 1993 benchmarks, was changed in line with recommendations of Eurostat.

4. There were some methodological changes in the 2001–2002 annual national accounts calculations and all of these were also calculated going back some years. There was a change in the accounting method of re-export and the net base accounting was calculated for 1998 going backwards. The full set of non-financial accounts of the general government sector was compiled for the period of 2001–02. There was a leap forward in the transition to calculating the data on accrual basis. Revision of the Gross Fixed Capital Formation (GFCF) data mainly related to the improvement of the data quality, based on the development of the data collection system, to the estimation of the previously missing items of GFCF, and the application of the methodology of ESA95. All the important GFCF items were estimated by applying the same methodology for the breakdown of sectors, industries, and regions for 2000–02.

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

B. Balance of Payments

5. A work plan, with clear time tables, has been implemented to replace the cash-based balance of payments statistics, compiled by the Magyar Nemzeti Bank (MNB), with the accrual-based accounting principles of the fifth edition of IMF's Balance of Payments *Manual* (BPM5). The following improvements have been implemented: customs data are used to derive trade in goods; and balance of payments statistics record goods under processing and repair on goods, and financial lease arrangements according to the BPM5 methodology. Moreover, in 2004, estimates of reinvested earnings were included in the balance of payments statistics, raising the current account deficit with an offsetting impact on the financial accounts. Further improvements were implemented in 2004, with the recording of investment income on an accrual basis. These modifications completed the process of shifting Hungary's balance of payments statistics to accrual-based accounting consistent with the BPM5. The release of revised quarterly series by the MNB in 2004 covered the period 1995–2003.

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

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

C. Monetary Sector

8. The International Financial Statistics (IFS) country page for Hungary now provides timely data for the monetary authorities, banking institutions, and the banking survey. The coverage of the MNB's analytical accounts has been extended, and Hungary now complies with the strengthened reserves standard. The framework for the compilation of monetary statistics in Hungary conforms, with three exceptions, to international standards for monetary statistics. Moreover, progress made recently in one of the areas in which national practice differs from international standards (i.e., valuation of instruments), is described in paragraph 9.

9. In the course of two missions,[2] the Statistics Department (STA) suggested excluding deposit liabilities of credit institutions under liquidation from the monetary aggregates by reclassifying them as "restricted deposits." Instead of reclassifying these deposit liabilities as "restricted deposits" until such time as the nonoperating units continue to exist as legal entities, the MNB undertook to reclassify these credit institutions from Monetary Financial

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[2] STA staff visit on monetary and financial statistics (October 2000) and the ROSC data module (May 2001). The ROSC updates of 2002–04 do not indicate any further developments on the restricted deposits issue.

Institutions (depository corporations) to "nonfinancial enterprises." Hence, deposits of these credit institutions held with the MNB and with other credit institutions are excluded from the monetary aggregates, as of January 2003. However, it should be noted that, in line with the IMF's Monetary and Financial Statistics Manual and consistent with the advice of the European Central Bank (ECB), such institutions should be reclassified as other financial intermediaries.

10. STA had also recommended that securities on the balance sheets of depository corporations be valued at market prices; these securities are currently based on partial market valuation. Work is in progress in this area. From 2004, depository corporations are encouraged to use market valuation for securities in their trading portfolio. From 2005, this requirement is compulsory for those depository corporations that are listed on the stock exchange. Also, securities of all companies that are listed on the stock exchange and are held by depository corporations in their trading portfolio should be based on market valuation.[3] Depository corporations are required to revalue their securities at least quarterly, and more frequently if possible.

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

12. The ROSC mission of 2001 also noted that the MNB's statistical practices are not guided by revisions studies.

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

D. Government Finance Statistics (GFS)

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

14. The latest data reported for publication in the 2004 GFS Yearbook are for 2003. These data now cover the operations of the consolidated central government and consolidated general government sectors, as well as their corresponding subsectors. The data for 2000 onwards have been compiled on an accrual basis and reported in the Government Finance Statistics Manual 2001 format.

HUNGARY: TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE
AS OF MAY 5, 2005

	Date of latest observation	Date received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of publication[6]	Memo Items:	
						Data Quality – Methodological soundness[7]	Data Quality Accuracy and reliability[8]
Exchange Rates	4/29/05	4/29/05	D and M	D and M	D and M		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Mar 2005	4/26/05	M	M	M		
Reserve/Base Money	Mar 2005	4/8/05	M	M	M	O,O,LO,LO	O,O,O,O,LO
Broad Money	Mar 2005	4/26/05	M	M	M		
Central Bank Balance Sheet	Mar 2005	4/08/05	M	M	M		
Consolidated Balance Sheet of the Banking System	Mar 2005	4/26/05	M	M	M		
Interest Rates[2]	Mar 2005	4/27/05	M	M	M		
Consumer Price Index	Mar 2005	4/12/05	M	M	M	O,O,O,O	O,O,O,O,NA
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	2003	7/13/04	A	A	A	O,LNO,LO,O	LO,O,O,O,NA
Revenue, Expenditure, Balance and Composition of Financing[3] – Central Government	Mar 2005	4/29/05	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Q1 2005	4/29/05	Q	Q	Q		
External Current Account Balance	Q4 2004	3/31/05	Q	Q	Q	O,LO,LO,LO	O,O,O,O,NA
Exports and Imports of Goods and Services	Q4 2004	3/31/05	Q	Q	Q		
GDP/GNP	Q4 2004	3/10/05	Q	Q	Q	O,O,O,LO	O,LO,O,O,NA
Gross External Debt	Q4 2004	3/31/05	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] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A); Irregular (I); Not Available (NA).
[7] 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).
[8] Same as footnote 7, 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 IMF Staff Representative
June 15, 2005

This staff statement presents recent developments that have occurred after the issuance of the Staff Report. The overall thrust of the staff appraisal has not changed, but the case for fiscal restraint has been strengthened by recent information suggesting that the risks of revenue shortfalls and expenditure overruns, anticipated by the staff, are now more imminent. In order to achieve the authorities' fiscal target for 2005, staff considers that it is important to freeze all remaining reserves and take additional measures consistent with durable fiscal consolidation.

1. **The authorities are revising their 2005 GDP growth forecasts downwards, close to the staff's projection of 3.4 percent.** After increasing at a revised 4.2 percent in 2004, GDP growth was 2.9 percent in the first quarter of 2005, while unemployment rose to 7.2 percent. As a result, in its latest *Inflation Report*, issued on May 23, the Central Bank lowered its 2005 forecast to 3.3 percent, from 3.8 percent. The Finance Ministry maintains a projection band between 3.5 and 4.0 percent, but recent announcements suggest that they expect growth to be closer to the lower end of this band. Staff projections had already incorporated these developments, as well as an anticipated pick up in the second half of the year, paralleling an expected recovery in euro area growth. Downward risks to the 2005 projections can arise should the recovery in euro area growth fail to materialize.

2. **Standard and Poor's (S&P) has followed Fitch in downgrading Hungary's long-term local currency debt from A to A- and the short-term debt from A1 to A2.** This action reflects continuing concerns about the ability of the government to meet its fiscal targets. S&P emphasizes the lack of flexibility in Hungary's fiscal accounts, as highlighted in the staff report. S&P also notes risks to debt dynamics arising from sharply higher interest rates and a significant depreciation of the forint.

3. **The authorities have now recognized fiscal slippages, but maintain that the deficit target for this year will be achieved, if necessary, with additional measures.** On this basis, staff's projection of a revenue shortfall (amounting to about 0.6 percent of GDP) looks increasingly likely. Expenditure overshooting, by about half a percent of GDP, is also likely. In staff's view, the authorities' commitment to maintaining the fiscal target now requires freezing all remaining reserves (estimated by the authorities at around 0.6–0.7 percent of GDP out of the original 1.3 percent of GDP). Additional measures will also be necessary to meet the target. In line with the staff appraisal, the authorities should seek durable consolidation through expenditure reduction, eschewing one-off measures that lower the reported deficit but do not reduce the fiscal stimulus (such as sales of assets to public sector companies).

4. **In May the government began rolling out its "100 Steps" program.** Consisting of various measures to reform the labor market, healthcare, pensions, education and the tax system, the measures are being announced incrementally. The revenue and cost implications of these measures are not known, but the bulk of the changes will enter into force only in 2006, with little impact on the 2005 fiscal outcome.

INTERNATIONAL MONETARY FUND

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June 29, 2005

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

IMF Executive Board Concludes 2005 Article IV Consultation with Hungary

On June 15, 2005, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Hungary.[1]

Background

Hungary's entry into the European Union on May 1, 2004 was a tribute to its successful transition to a market economy. The country's willingness and ability to undertake structural reforms in the middle of the 1990s laid the groundwork for the subsequent macroeconomic successes. However, Hungary lost ground starting in mid-2001: growth slowed and large budget and current account deficits emerged.

In 2004, valuable gains were achieved. Real GDP growth recovered to 4 percent, supported by strong investment and robust export growth, in turn, helped by a bounce in the euro area economy in the first half of the year. Consumption slowed in response to rising unemployment, a moderation in wage growth and a tightening of the housing subsidy scheme.
Wage deceleration also helped support disinflation, with inflation declining to an annualized 3.5 percent by year-end. The current account deficit stabilized, albeit at a still high level of 9 percent of GDP. Financial markets retained an optimistic view of Hungary. Despite a sharp

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

decline in policy interest rates, the forint appreciated modestly against the euro and risk premiums fell.

Despite these favorable developments, risks associated with the twin deficits remained. Although some fiscal consolidation has taken place (in European Standards of Accounts' 95 terms), the twice upward-revised fiscal deficit target was not met. While Foreign Direct Investment recovered in 2004 to 4.2 percent of GDP from its 2003 trough, more than half of the current account deficit still had to be financed by debt-creating flows. A new vulnerability is emerging, as households and small businesses are borrowing in foreign currencies, likely without adequate hedging. Forward spreads on local currency bonds have not narrowed, reflecting uncertainty regarding the timing of euro adoption.

Moreover, growth slowed in the second half of 2004 and in the first months of 2005, with a slowdown in industrial production and a continued increase in unemployment. Business and consumer confidence indices have also deteriorated.

Executive Board Assessment

Executive Directors commended the authorities on Hungary's robust performance in its first year as an European Union (EU) member. Administrative challenges generated by EU accession were overcome successfully, the export sector responded positively to increased competition, and macroeconomic imbalances were contained.

At the same time, Directors noted that vulnerabilities exist, including the high current account and fiscal deficits, and that Hungary's growth potential and performance have declined. They urged the authorities to maintain a track record of consistent and predictable policies in order to raise productivity and growth in the short run and prevent their erosion in the medium term. This will be necessary to secure a satisfactory rate of income convergence with other EU members. Growth- and savings-enhancing policies will also help reduce domestic and external vulnerabilities and retain the confidence of financial markets, especially in the context of the large appreciation of the real exchange rate in recent years. Directors also stressed that policies for raising employment will be vital to ensuring that the benefits of growth are widely spread.

Directors considered regaining control over fiscal policy to be the key challenge facing Hungary. They emphasized that fiscal consolidation is crucial, noting that missing the 2005 fiscal deficit target would set back debt reduction and further damage policy credibility. Beyond 2005, Directors felt that adherence to at least the fiscal targets in the Convergence Program is essential not only for euro adoption by 2010, but also because slippages would undermine macroeconomic stability, debt sustainability, and medium-term growth prospects.

For 2005, Directors noted that the anticipated risks of overspending and revenue shortfalls are now materializing. At the same time, available budgetary reserves are substantially lower than originally budgeted. Directors therefore welcomed the authorities' commitment not to use the remaining budgetary reserves, and urged the authorities to take prompt additional deficit-reducing measures. They cautioned against actions that lower the reported deficit while

maintaining fiscal stimulus. They felt, instead, that expenditure-reducing reforms—particularly in the health and education sectors—and the phasing out of interest rate subsidies would not only reduce the budget deficit, but also improve the delivery of public services and help raise private savings. They underscored also the need for a wide-ranging tax reform, with a focus on lower rates and a broader base. Such a reform needs to be taken alongside structural measures to reduce spending, so as not to endanger fiscal consolidation. Directors welcomed the authorities' intention to request a fiscal Report on the Observance of Standards and Codes (ROSC) in 2006.

In order to improve fiscal performance and restore credibility to policy targets, Directors recommended the strengthening of fiscal institutions and the budgetary process. They welcomed the recently approved Public Finances Law, while cautioning that much remains to be done. In particular, they stressed the importance of creating a medium-term fiscal framework to improve fiscal discipline, while also achieving greater budgetary transparency and predictability. In this context, they urged the adoption of a three-year rolling framework, further checks and balances in the expenditure management system, and more extensive budgetary oversight by the State Audit Office.

Directors advised against frequent changes in fiscal accounting practices, and urged caution and transparent reporting on the use of private-public partnerships. They warned that if ad hoc accounting and expenditure reduction measures are relied upon to meet the Maastricht criteria, Hungary would risk entering the euro area with a large underlying deficit, which would undermine long-term growth prospects.

Directors welcomed the disinflation in late 2004 and early 2005, and viewed the reduction in interest rates as an appropriate response. With the 2005 and 2006 inflation targets projected to be on track, Directors recommended that future interest rate policy be cautious and guided by the market's inflation expectations. In this regard, most Directors also emphasized the importance of focusing monetary policy on containing domestic inflationary pressures, rather than on stabilizing the exchange rate, and of communicating this clearly to markets.

Most Directors commended the authorities' intention to strengthen the inflation-targeting framework. They supported the planned reduction in the inflation target to 3 percent a year in the medium term, to be achieved over a rolling horizon, noting that this would bring policies closer in line with international best practice.

Directors commended the continuing soundness and increased profitability of the financial sector, but were concerned that the growing share of foreign currency debt held by the private sector could become a source of vulnerability. In this context, they urged authorities to closely monitor the expansion of foreign currency-denominated borrowing—especially by households and small- and medium-sized firms that likely are not naturally hedged. In this regard, they encouraged stronger disclosure requirements, appropriately formulated additional provisioning for foreign currency loans, and the development of market-oriented risk-hedging instruments. They also urged adoption of regulatory initiatives in the pension funds and insurance sectors,

and changes to safeguard the independence of the Hungarian Financial Supervisory Authority, as recommended by the recent Financial Sector Assessment Program (FSAP) update.

Regarding structural measures, Directors considered that raising Hungary's low labor participation rate, enhancing labor market flexibility, and increasing productivity are priorities. They therefore welcomed the recently-published National Action Plan for Employment, which aims at facilitating geographic and occupational mobility, reducing the impediments to part-time employment, and implementing vocational educational reforms. Moreover, they recommended that further increases in the minimum wage be limited to productivity growth. They welcomed the authorities' strategy for using EU funds to raise the productivity of small- and medium-sized firms and improve the business environment, but stressed the importance of fiscal structural reforms to ensure that EU funds are used to achieve long-lasting gains.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

Hungary: Main Economic Indicators, 2000–05

	2000	2001	2002	2003	2004	2005 Proj.
Real economy (change in percent)						
Real GDP	5.2	3.8	3.5	3.0	4.0	3.4
CPI (average)	9.8	9.2	5.3	4.7	6.8	4.0
Unemployment rate (in percent)	6.4	5.7	5.8	5.9	6.1	6.4
Wage Growth (gross wages) 1/	13.6	18.2	18.2	12.1	8.0	...
Gross national saving (percent of GDP) 2/	22.3	20.6	18.1	16.6	15.3	15.9
Gross domestic investment (percent of GDP)	30.9	26.8	25.2	25.3	24.1	24.5
General government (percent of GDP), ESA-95 basis 3/						
Balance	-3.0	-4.7	-9.4	-7.2	-5.4	-4.7
Debt	55.4	53.5	57.1	59.1	60.8	60.2
Money and credit (end-of-period, percent change)						
M3	18.1	17.1	9.5	11.9	11.1	...
Credit to nongovernment	34.8	18.2	22.2	35.2	18.5	...
Interest rates (percent)						
T-bill (90-day, average)	10.9	10.6	8.9	8.8	11.0	...
Government bond yield (5-year, average)	9.1	8.5	7.8	7.4	9.1	...
Balance of payments						
Trade balance (percent of GDP)	-6.2	-4.3	-3.3	-4.0	-3.0	-3.0
Current account (percent of GDP)	-8.6	-6.2	-7.2	-8.7	-8.9	-8.6
Reserves (months of imports of goods and services)	3.7	3.3	2.9	2.8	2.6	2.4
Net external debt (percent of GDP) 4/	26.0	23.9	23.5	29.1	31.7	32.1
Exchange rate						
Exchange regime	Peg against euro, with band +/-15 percent					
Present rate (May 2, 2005)	Ft 196.1 = US$1					
Nominal effective rate (1990=100)	35.5	36.2	38.9	38.8	39.6	...
Real effective rate, CPI basis (1990=100)	138.4	149.6	166.2	170.1	181.3	...

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

1/ Adjusted to include public sector 13th-month bonus paid in January 2005.

2/ Consistent with the balance of payments data (not necessarily with the national accounts data).

3/ Consists of the central budget, social security funds, extrabudgetary funds, and local governments. Includes the costs of pension reform

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