IMF Country Report No. 23/70

HUNGARY

February 2023

2022 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR HUNGARY

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2022 Article IV consultation with Hungary, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its February 1, 2023 consideration of the staff report that concluded the Article IV consultation with Hungary.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on February 1, 2023, following discussions that ended on November 18, 2022, with the officials of Hungary on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on January 17, 2023.
- An **Informational Annex** prepared by the IMF staff.
- A **Statement by the Executive Director** for Hungary.

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

Selected Issues

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

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Washington, D.C.

PR23/30

IMF Executive Board Concludes 2022 Article IV Consultation with Hungary

FOR IMMEDIATE RELEASE

Washington, DC – **February 3, 2023:** On February 1, 2023, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Hungary. A succession of shocks, including Russia's war in Ukraine, widened economic imbalances which, together with loose fiscal policy in late 2021-early 2022, intensified inflation, now among the highest in Europe at 24.5 percent y/y, and widened the current account deficit. Appropriately, monetary policy significantly tightened, and the government plans a large fiscal adjustment in 2023. Strong growth in 2022 led by buoyant domestic demand and a tight labor market is expected to slow considerably in 2023 as domestic and external demand wane. Inflation is expected to remain elevated but decelerating, as global energy and commodity price pressures ease. Uncertainty remains high, and sizeable risks could significantly worsen the outlook.

Executive Board Assessment[2]

Executive Directors noted that, following a robust recovery from the COVID-19 crisis, Hungary is now facing high inflation, slowing growth, and large economic imbalances. Against this backdrop and given elevated downside risks to the outlook, Directors stressed that a tight and consistent policy mix is needed to reduce economic imbalances and vulnerabilities. They also recommended structural reforms to sustain medium-term growth, strengthen energy security, and unlock EU funds to support the country's digital and green transitions.

Directors supported the government's planned front-loaded fiscal tightening, which will complement monetary policy in fighting inflation, help rebuild buffers, and safeguard fiscal sustainability. They emphasized the importance of growth-friendly fiscal adjustments by prioritizing productivity-enhancing expenditures and avoiding revenue measures that may discourage investment. Directors recommended relying more on direct support to vulnerable households rather than on costly and ineffective price caps. In that context, they considered that direct support to vulnerable groups and further refinement of regulated household energy tariffs would improve price signals, be fairer, and be more cost-effective. Directors considered that contingency measures would also be important given the significant uncertainty.

Directors welcomed the significant monetary tightening and emphasized the need to maintain a well-communicated, tight policy stance until inflationary pressures clearly and sustainably ease. They noted that interest rate caps hamper monetary policy transmission and called for their abolishment. Directors agreed that maintaining exchange rate flexibility remains

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

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

important as a shock absorber. While noting the soundness of overall banking sector buffers, Directors agreed that continued financial supervisory vigilance is needed, as credit risk may rise due to slower growth and higher interest rates.

Directors emphasized the importance of pressing ahead with structural reforms and of meeting the requirements needed for the full and timely receipt of EU funds that will help finance reforms in critical areas such as energy transition, digitalization, and governance. They generally agreed on the importance of enhancing energy security given near-term risks to energy supply. Directors also stressed that strengthening governance and transparency, the rule of law, judicial independence, and the anti-corruption and AML/CFT frameworks will help improve the business environment, the efficiency of public spending, and medium-term growth.

Hungary: Selected Economic Indicators, 2018–2022

	2018	2019	2020	2021	2022
					Proj.
Output					
Real GDP growth (%)	5.4	4.9	-4.5	7.1	4.9
Employment					
Unemployment rate (average %)	3.7	3.5	4.1	4.1	3.6
Prices					
Inflation	2.8	3.4	3.3	5.1	14.5
General government finances (% of GDP)					
Revenue	44.0	44.0	43.5	41.3	43.9
Expenditure	46.2	46.1	51.1	48.4	50.0
Fiscal balance	-2.1	-2.0	-7.5	-7.1	-6.1
Primary structural balance (percent of potential GDP)	-0.7	-1.1	-4.7	-4.0	-2.1
Public debt	69.1	65.3	79.3	76.8	76.4
Gross financing need	21.1	23.4	24.6	21.4	17.5
Money and credit					
Broad money (% change)	11.8	8.1	21.1	16.3	11.5
Credit to the private sector (flow based, % change)	10.6	15.3	11.8	12.8	10.9
Government bond yield (5-year, average, %)	2.2	1.6	1.5	2.4	9.5
5-year sovereign CDS (average in bps)	86.6	80.4	67.2	68.2	69.2
External sector					
Current account (% of GDP)	0.2	-0.8	-1.1	-4.2	-8.1
Reserves (percent of short-term debt at remaining maturity)	162.1	160.8	150.8	139.4	98.1
External debt (% of GDP)	79.2	73.1	81.0	84.7	85.4
Exchange rate					
Exchange rate, HUF per euro, period average	319.3	325.2	351.2	358.5	391.1
REER (% change, "-" = appreciation)	1.8	0.7	4.8	-0.2	…

Sources: Hungarian authorities, OECD, and staff projections.

INTERNATIONAL MONETARY FUND

HUNGARY

STAFF REPORT FOR THE 2022 ARTICLE IV CONSULTATION

January 17, 2023

KEY ISSUES

Context and outlook: While the economy was recovering from the COVID-crisis, a succession of shocks and loose fiscal policy intensified inflation and fueled a large external deficit. Appropriately, the central bank significantly tightened monetary policy and the government plans a large fiscal adjustment. However, regulatory measures undermine the tighter fiscal and monetary policy mix. Growth is expected to slow sharply with still-elevated inflation and sizable risks can worsen the outlook.

Policy recommendations: Consistent overall policy tightening is needed to address imbalances amid large uncertainty. Shocks that significantly weaken growth and inflation may prompt a more gradual tightening, while shocks that intensify inflation would require a faster tightening.

- **Fiscal policy.** The government's front-loaded adjustment is broadly appropriate and needed to complement monetary policy in dampening demand and inflation and to rebuild fiscal buffers considering significant risks, although keeping the original 2023 deficit target of 3.5 percent of GDP would have been preferable to the revised target of 3.9 percent of GDP. The composition of the adjustment can be improved to minimize its impact on growth while providing well-targeted support to mitigate the impact of rising costs of living on the vulnerable.
- **Monetary and financial policies.** Significant monetary policy tightening to date has been appropriate considering rapid increases in core inflation. Though inflation is expected to recede, it may not return to target before 2025 and uncertainty is high. Tight monetary policy remains needed until inflationary pressures clearly and sustainably ease. Overall banking sector buffers appear adequate, but supervisory vigilance and timely provisioning remain warranted in a deteriorating environment.
- **Regulatory policies.** Caps on energy and food prices and on interest rates are costly, ineffective in fighting inflation, and undermine monetary policy transmission. Direct support to the vulnerable would be more effective in mitigating the impact of high inflation while maintaining price signals and allowing demand to adjust.
- **Structural policies.** Strengthening energy security will help meet climate objectives and reduce vulnerabilities to supply shocks. Strengthening governance is needed to improve the business environment and the efficiency of spending.

Approved By
Laura Papi (EUR) and Eugenio Cerutti (SPR)

The meetings took place in Budapest from November 8-18, 2022. The staff team comprised Messrs. Jean-François Dauphin (head), Karim Foda, Tonny Lybek, Agustin Roitman and Ms. Xuege Zhang (all EUR). Mr. Dániel Palotai and Mr. Gábor Meizer (both OED) also attended meetings. Mses. Estefania Cohn Bech and Ninfa Gonzales (both EUR) assisted in the preparation of the report. Staff met with State Secretaries Banai and Tóth (Ministry of Finance), Máté Lóga and Anikó Túri (Ministry of Economic Development), János Bóka (Ministry of Justice), Szabolcs Ágostházy (Ministry of Regional Development), Attila Steiner (Ministry of Technology and Industry), Deputy Central Bank Governors Patai and Virág, Deputy State Secretary Adorján, and other officials, representatives from banks, companies in energy, pharmaceutical and agricultural sectors, trade chambers, employer and employee associations and research institutions.

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RECENT DEVELOPMENTS: GROWING IMBALANCES

1. A succession of shocks has widened economic imbalances. In 2021:H2, as the economy was recovering from the COVID-crisis, rising commodity prices and supply-chain disruptions began increasing inflation and the current account deficit. Russia's war in Ukraine exacerbated those pressures as energy and commodity prices surged, external demand slowed, and uncertainty skyrocketed. Hungary implements the sanctions imposed at the European Union (EU) level on Russia in response to its invasion of Ukraine. Other spillover channels, including financial sector exposures and refugees, have been less important.

2. Large pre-election stimulus compounded imbalances, before the government reversed course. Early in 2022, the government provided large income-tax refunds, six-month bonuses to armed forces, an additional month of pension benefits, and a 20 percent minimum-wage increase. It also capped the price of motor fuels, some food products, and mortgage rates for some borrowers (Table 1). Corrective measures were subsequently introduced to help meet the (then) deficits targets of 4.9 percent of GDP in 2022 (from 7.1 percent of GDP in 2021) and 3.5 percent of GDP in 2023. They include temporary profit taxes on the financial and energy sectors, sectoral levies and indirect taxes, untargeted operational spending cuts, and the postponement of investment projects. A one-off purchase of natural gas reserves subsequently raised the 2022 deficit target to 6.1 percent of GDP, while in early January 2023, the government decided to relax its 2023 target to 3.9 percent of GDP, primarily on account of higher energy subsidy costs.

3. Wide imbalances and increased risk perceptions, including related to EU funds, added to market pressure on borrowing costs and the exchange rate. Amidst tightening global financial conditions and increased market risk aversion, Hungary's large current account deficit driven by energy imports and investors' skepticism about the government's ability to meet its fiscal targets contributed to pressure on the exchange rate and government bond yields. Contentions with the EU, which centered around the rule of law, human rights, sanctions against Russia, and minimum corporate taxation, delayed conditional agreements on EU funds until December 2022 and worsened risk perceptions. Borrowing costs rose and the exchange rated depreciated more than peers' in 2022 (Figures 1 and 5).

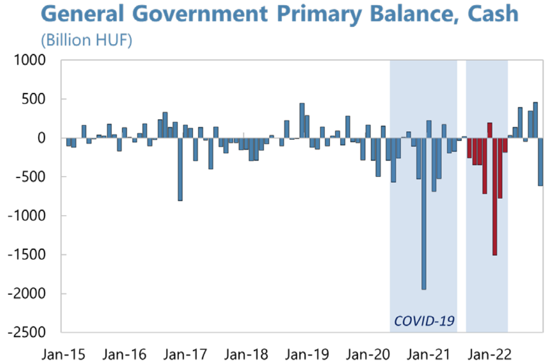
4. After accelerating early in the year, economic growth began to slow. GDP growth decelerated from nearly 8 percent y/y in 2022:Q1 to about 4 percent in 2022:Q3 as strong domestic demand began to lose momentum. A tight labor market, pre-election stimulus, and drawdown of high household savings boosted real private consumption to nearly 13 percent y/y in Q1 before it slowed to 5.4 percent in Q3. Similarly, investment decelerated from a strong 10.6 percent to 4.2 percent. On the other hand, auto production started recovering, exports rebounded, and external demand turned positive by Q3. After an exceptional build-up in inventories in 2021 and 2022:Q1, their contribution to GDP growth turned negative in the second and third quarters y/y. On a quarterly basis, GDP contracted in the third quarter primarily due to the impact of a severe drought leading to a nearly 40 percent decline in agriculture production, though the manufacturing and service sectors kept growing.

5. The labor market has become very tight. The unemployment and labor force participation rates are near their historical low and high, respectively. The working-age population is declining due to aging and emigration, adding structural pressures to the labor market. Reflecting low slack and the minimum-wage increase, private- and public-sector wages each grew by around 16 percent y/y in 2022:Q3.

Figure 1. Hungary: Fiscal Indicators

Large fiscal stimulus in late 2021 and early 2022 increased the deficit and further fueled domestic demand.

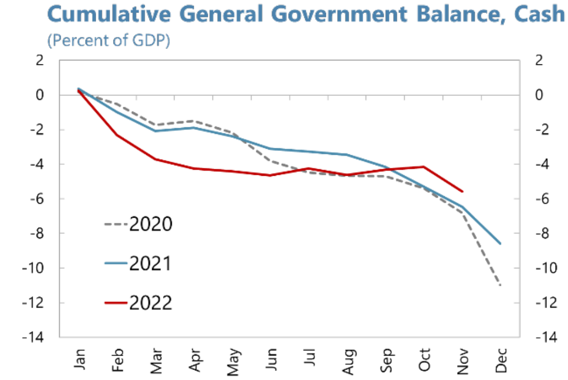
General Government Primary Balance, Cash



Sources: Ministry for National Economy, Haver Analytics, and IMF staff calculations. Data through November 2022.

Inflation windfall and tighter policy then started supporting cash balances.

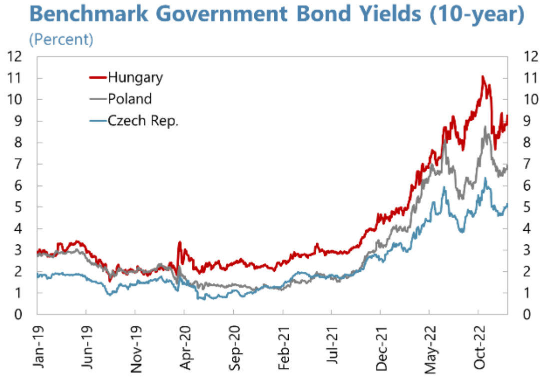
Cumulative General Government Balance, Cash



Sources: Ministry for National Economy, Haver Analytics, and IMF staff calculations

Yields diverged from peers in the second half of 2022 and remain higher.

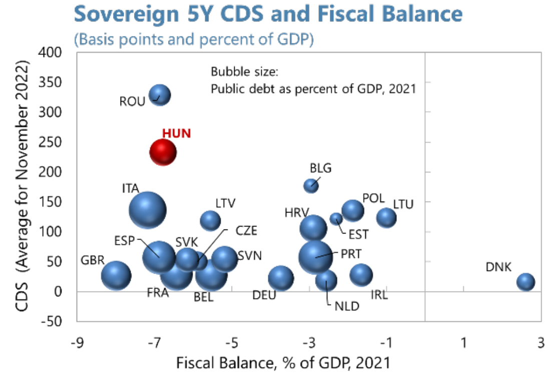
Benchmark Government Bond Yields (10-year)



Sources: Refinitiv and Haver Analytics. Data through December 30, 2022.

Credit default swaps are higher than in other EU countries with similar fiscal deficits and public debt levels.

Sovereign 5Y CDS and Fiscal Balance



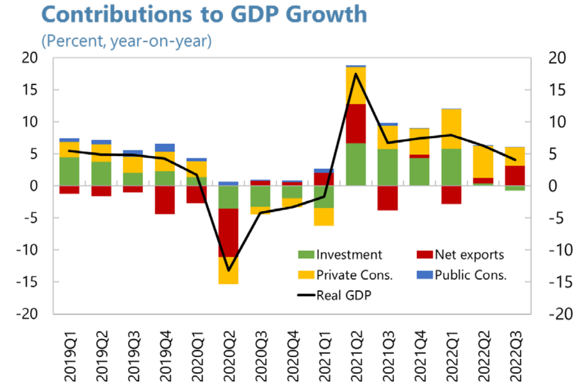
Sources: IMF *World Economic Outlook*; Bloomberg Finance L.P.; and IMF staff calculations

Table 1. Hungary: Price and Interest Rate Caps

		Coverage	Description	Cost borne by
Household utility price	2014-	All households	Prices of household gas and electricity fixed at around 24 and 75 euros per MWh, respectively, for all levels of consumption. In August 2022, the cap was increased for consumption above the national average to price levels closer to market rates, which are to be adjusted quarterly.	Utility companies and government
Motor fuels price	Nov. 15, 2021 to Dec. 6, 2022	Resident privately-owned vehicles, taxis and agricultural machinery	Price of petrol and diesel capped at HUF 480 per liter (EUR 1.3 euros at 11/15/21 exchange rate). Coverage was initially universal, then narrowed to residents only in July 2022. The cap had been extended twice to end-2022, but eventually ended earlier than planned as it led to supply pressure and closures of petrol stations.	Wholesalers
Food price cap	Feb. 2022 to Apr. 30, 2023	Universal	Prices of granulated sugar, wheat flour, sunflower oil, pork leg, chicken breast, and 2.8% cow milk capped at their 10/15/21 levels. The cap has been extended several times, and the list was expanded in November 2022 to include potatoes and eggs capped at end-September retail price.	Retailers
Mortgage interest	Jan. 2022 to mid-2023	Variable rate mortgages, and those with fixation dates through June 2023	Mortgage rates capped until June 30, 2023 at October 27, 2021 levels for mortgages with short- to medium-term interest fixation periods. Analysts estimate that capped mortgages amount to about 2.3 percent of GDP or 22.7 percent of own funds (total bank lending for housing purchases was 8.1 percent of GDP at end-August 2022).	Banks
SME interest	Nov. 15, 2022 to Jun. 30, 2023	All SMEs with variable interest-rate loans	Interest rates on HUF-denomitated business loans to SMEs capped at the reference rate as of June 28, 2022. The MNB estimates the cost to banks at about 0.1 percent of GDP.	Banks
Large deposits interest	Nov. 21, 2022 to Mar. 31, 2023	Large depositors with at least HUF 20mn in deposits	Interest rates on some large deposits capped at the average 3-month T-bill yield. The government's objective is to divert those funds toward government securities.	Large depositors (foregone interest)
Student loan interest	Jan. 2023-	Student loans	The interest rate on student loans that are subject to interest will stay at 4.99 percent as of January 2023, when it would otherwise have increased to 10 percent for 100,000 borrowers. Other student loans are interest free.	State-owned student loan provider

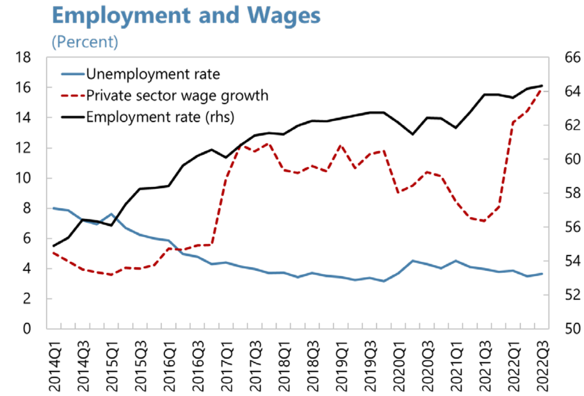
Figure 2. Hungary: Real Activity Indicators

Domestic demand has driven growth in 2022 …



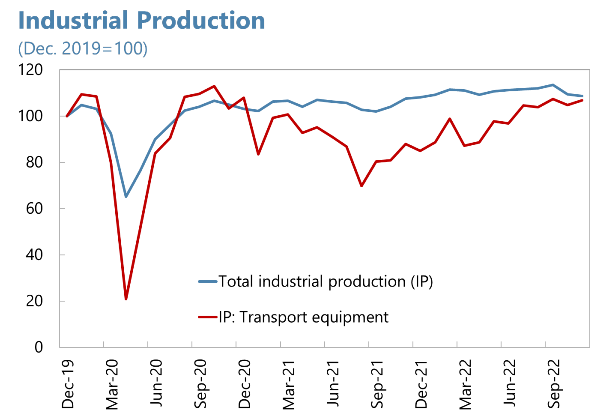
Sources: Hungarian Central Statistical Office (CSO), Haver Analytics, and IMF staff calculations

…as the labor market tightened to near historic levels.



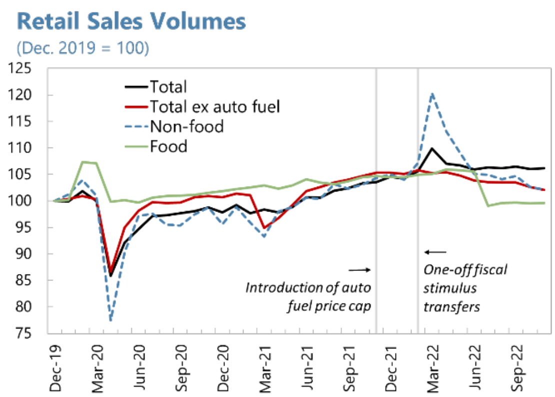
Sources: CSO, Haver Analytics, and IMF staff calculations

Industrial production continues to grow and auto production is recovering….



Sources: CSO, Haver Analytics, and IMF staff calculations. Data through November 2022.

… but retail sales are losing momentum as impact of fiscal stimulus fades and inflation bites.



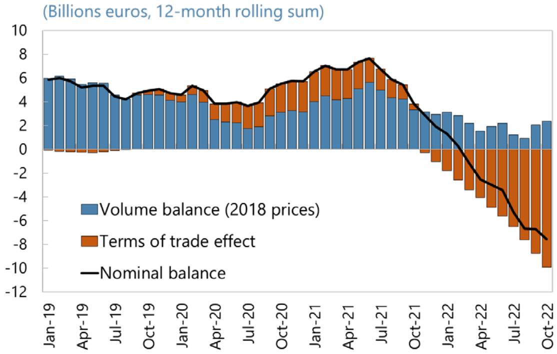
Sources: CSO and IMF staff calculations. Data through November 2022.

6. **The external balance has deteriorated significantly.** Hungary's external position in 2022 is assessed as substantially weaker than implied by fundamentals and desirable policies (Annex II). Strong domestic demand and rising commodity prices drove import values, while exports mostly lagged. Led by the declining trade balance, the current account deficit began to rapidly deteriorate in mid-2021, reaching -7.3 percent of rolling GDP by 2022:Q3. Continued strong FDI net inflows, EU funds, and FX bond issuances financed most of the current account deficit and supported reserves, which remain above the Fund's metric adequacy threshold. Gross external debt-to-GDP was broadly stable at around 85 percent of rolling GDP through the third quarter of 2022, with an increase in debt issuance broadly offset by revaluation effects of outstanding debt as yields rose and by the rapidly growing nominal GDP. Reflecting the deteriorating external balance and markets' wariness, the exchange rate adjusted and depreciated in 2022 by as much as 17 percent through October, and around 9 percent by year-end following actions by the MNB in mid-October and conditional agreements with the EU in mid-December.

Figure 3. Hungary: Trade Balance and Terms of Trade

The trade balance swung to deficit with a declining volume balance and deteriorating terms of trade (ToT).

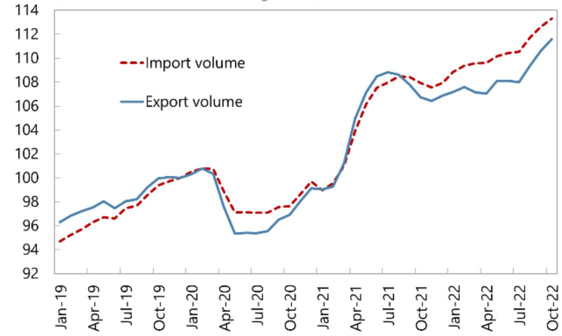
Goods Trade Balance
(Billions euros, 12-month rolling sum)



Sources: CSO and IMF staff calculations

Imports grew strongly while exports mostly lagged.

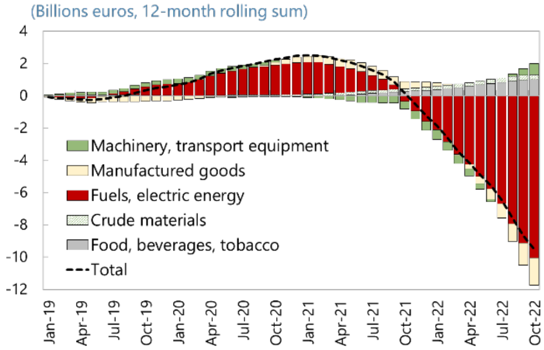
Import and Export Volumes
(2019=100, 12-month rolling sums)



Sources: CSO and IMF staff calculations

The ToT deterioration was almost entirely led by energy prices.

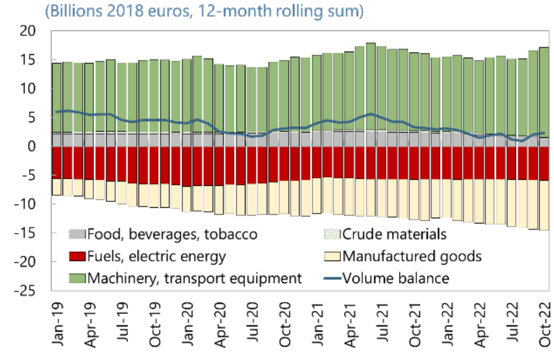
Terms of Trade Effects on Trade Balance
(Billions euros, 12-month rolling sum)



Sources: CSO and IMF staff calculations

Energy and food volume balances held steady, while other balances deteriorated.

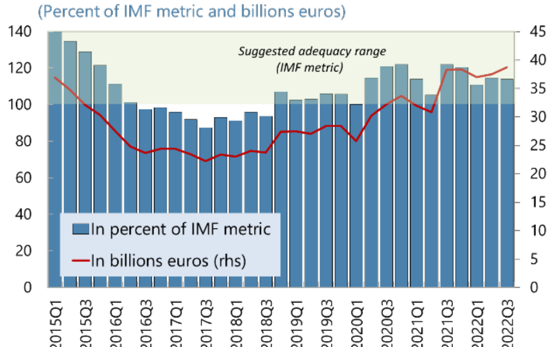
Goods Trade Balance, Volumes
(Billions 2018 euros, 12-month rolling sum)



Sources: CSO and IMF staff calculations

Reserves remain adequate.

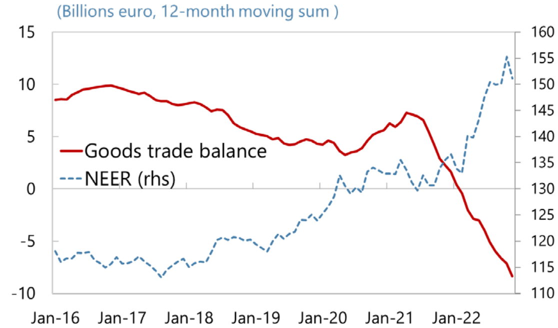
International Reserves
(Percent of IMF metric and billions euros)



Sources: Magyar Nemzeti Bank (MNB) and IMF staff calculations

The exchange rate depreciated as the trade balance swung to deficit and Hungary's risk perception worsened.

Trade Balance and Exchange Rate
(Billions euro, 12-month moving sum)



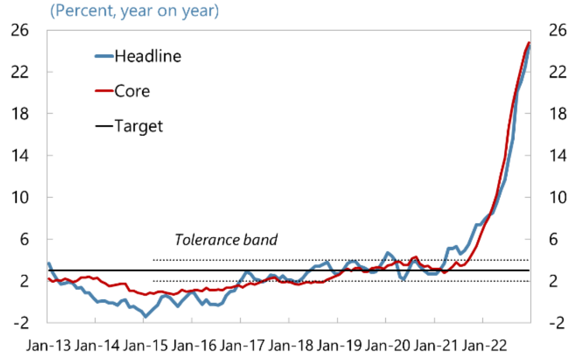
Sources: CSO, MNB, and IMF staff calculations. Data through November 2022.
Note: Increase in nominal effective exchange rate index denotes depreciation

Figure 4. Hungary: Inflation

Inflation has rapidly increased since early 2021…

Headline and Core CPI Inflation

(Percent, year on year)

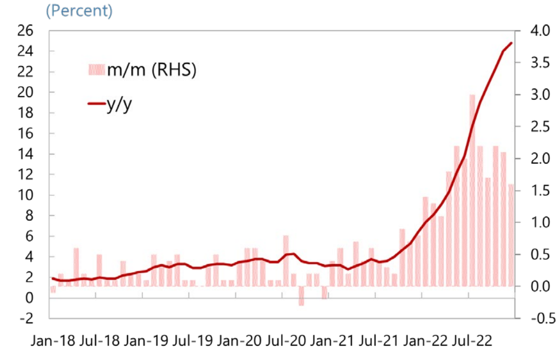


Sources: CSO and MNB. Data through December 2022.

…and m/m core inflation remains strong, but may have reached a peak.

Core CPI Inflation

(Percent)

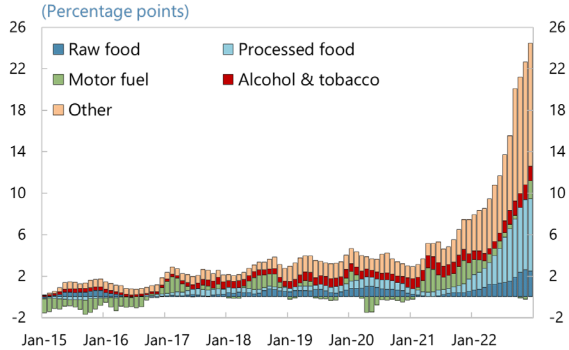


Sources: MNB and IMF staff calculations. Data through December 2022.

Though led by food, inflation is broad based.

Contributions to CPI Inflation

(Percentage points)

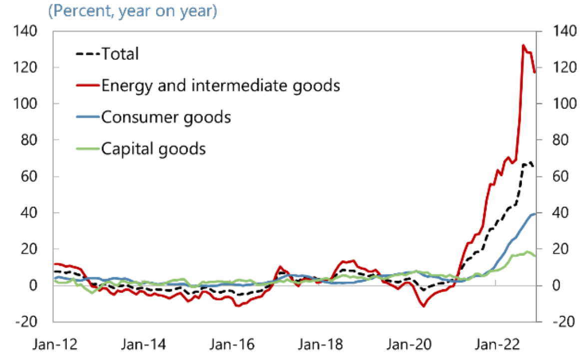


Sources: CSO, Haver Analytics, and IMF staff calculations. Data through December 2022.

Goods industries face record-high producer price inflation, led by energy and intermediate goods…

Domestic Producer Price Inflation

(Percent, year on year)



Sources: CSO and Haver Analytics. Data through November 2022.

…leading to a surge in goods consumer prices. Second-round effects and demand drove services inflation as well.

Market Goods and Services CPI Inflation

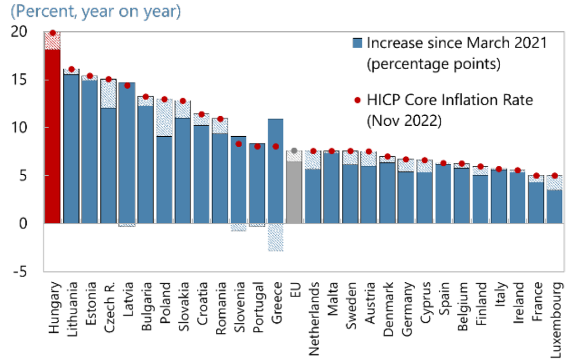
(Percent, year on year)

Sources: MNB, Haver Analytics, and IMF staff calculations. Data through Dec. 2022.
Notes: Based on MNB classification, non-food market goods include industrial products, market energy, alcohol and tobacco, and fuel.

Hungary's HICP core inflation is the highest in the EU.

HICP Core Inflation (excl. energy and uncprocessed food)

(Percent, year on year)



Sources: Eurostat, Haver Analytics, and IMF staff calculations

7. Inflation accelerated to its highest level in decades. Headline CPI inflation surged from 2.7 percent in early 2021 to 24.5 percent in December 2022 (y/y), led by food and energy prices, notably following the relaxation of the utility price cap in August and, more recently, the lifting of the motor fuels price cap in December. Second-round effects of energy prices on domestic producer-price inflation (63.7 percent in November), wage pressures, exchange rate depreciation, and pre-election fiscal stimulus intensified a broad-based rise in core inflation, which reached 24.8 percent (accompanying Selected Issues Paper).

8. In response, the central bank (MNB) significantly tightened monetary policy. The MNB started raising rates mid-2021. With inflation intensifying, expectations well-above target and exchange rate pressures, it gradually phased-out its unconventional measures and increased the one-week deposit rate—then, the main liquidity absorbing instrument—cumulatively by 12.4 percentage points to 13.0 percent. In September 2022, the MNB announced that it would stop increasing rates, but that tightening policy would continue by draining liquidity through an increase in the minimum reserve requirement from 1 to 5 percent, central bank bills, and a new long-term deposit instrument.

9. Following a rapid depreciation of the exchange rate, the MNB accelerated its tightening in mid-October. Notwithstanding the liquidity measures, pressures on the exchange rate accelerated in the early Fall as global market nervousness and concerns about EU funds increased. To increase the cost of speculating against the currency, on October 14 the MNB raised the upper limit of its interest rate corridor from 15.5 percent to 25 percent, introduced daily overnight deposit tenders at 18 percent, and accelerated the mopping up of liquidity. It also committed to directly meeting major foreign currency liquidity needs arising from covering energy imports through end-2022 (a measure subsequently extended in early 2023). The forint appreciated by over 4 percent during the following week.

Figure 5. Hungary: Inflation Expectations, Exchange Rate, and Monetary Policy

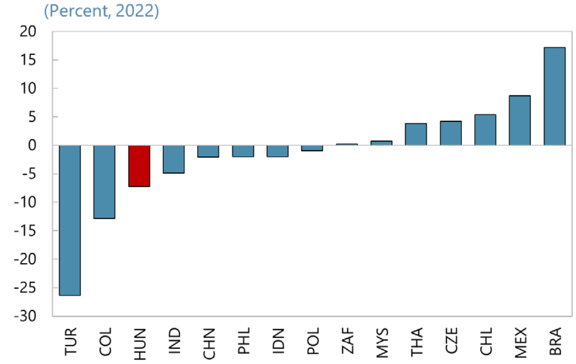
Inflation expectations have been rising.

CPI Inflation and Inflation Expectations
(Percent, year on year)

Sources: CSO, MNB, European Commission (EC), Consensus Forecast, and IMF staff calculations. Data through December 2022.

The exchange rate depreciated in 2022 by more than most emerging markets globally.

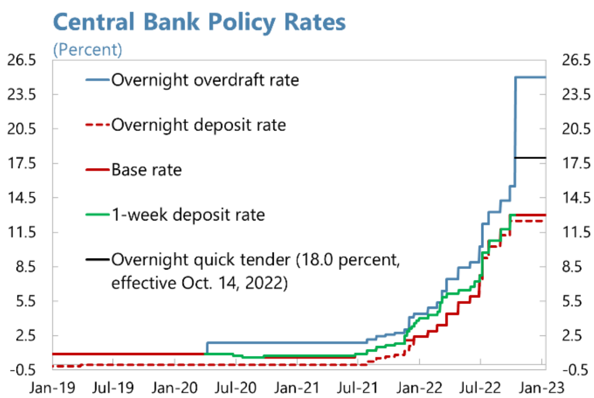
NEER Exchange Rate Movements
(Percent, 2022)



Sources: Bank for International Settlements, Haver Analytics, and IMF staff calculations

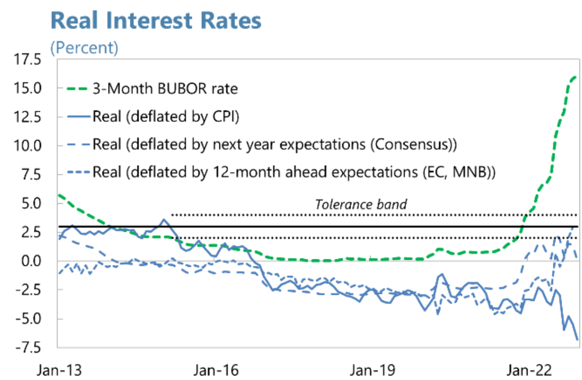
Figure 5. Hungary: Inflation Expectations, Exchange Rate, and Monetary Policy (concluded)

Key policy rates have risen since 2021, with more decisive hikes in 2022.



Sources: MNB, Haver Analytics, and IMF staff calculations. As of Jan. 12, 2023.

Real short-term rates recently reached positive territory when deflated by 1 year-ahead inflation expectations.

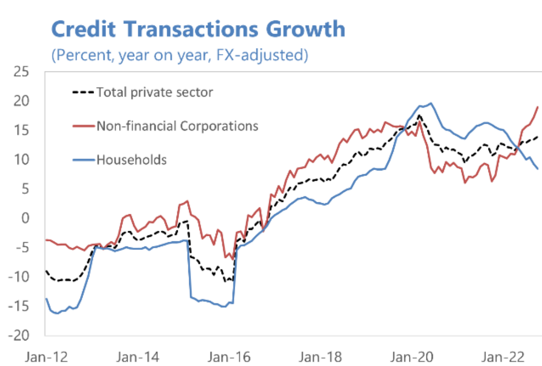


Sources: CSO, MNB, EC, Consensus Forecasts, and IMF staff calculations. Data through December 2022.

10. The banking system remains on average well-capitalized, profitable, and liquid. Despite the pandemic and debt-servicing moratorium, banks recorded an average return on assets of 1.2 in 2021, although five small banks made losses, and an average capital-adequacy ratio of 17.6 percent in 2022:Q3. The moratorium was extended to end-2022 (changed to opt in) but covered only about 1 percent of corporate loans and 3 percent of households' as of August 2022. A moratorium of agricultural loans introduced in September 2022, effective till end-2023, currently covers about 25 percent of eligible loans, amounting to about 1.3 percent of bank loans to the private sector. Credit growth to corporates increased in 2022, reflecting working capital needs and demand for investment, which was partly front-loaded ahead of expiring subsidized lending programs. Meanwhile, lending to households decelerated as mortgage demand cooled. Net interest margins grew, as deposit rates have stayed low while lending rates rose until the introduction of interest rate caps on selected lending. Sberbank-Hungary was promptly closed early in the war, and insured deposits paid out.

Figure 6. Hungary: Financial Sector and Housing Market Indicators

Credit transactions growth has begun to moderate led by cooling household demand, including mortgages.



Source: MNB and IMF staff calculations. Data through October 2022.
Note: The drop in household transactions in 2015 is related to the FX conversion

Nominal house price inflation remains rapid, but less so when deflating by construction prices.

Sources: MNB, CSO and IMF staff calculations. Data through 2022:Q2.

CHALLENGING OUTLOOK, SIGNIFICANT RISKS

11. Growth is expected to decelerate sharply in 2023 while inflation remains elevated. Under the baseline scenario, growth slows from close to 5 percent in 2022 to about ½ percent in 2023 as the policy mix tightens under the authorities' current policy plans discussed below, external demand weakens, and uncertainty weighs on investment. Despite labor-market tightness and strong wage growth, high inflation erodes household real incomes and weighs on consumption. Headline and core inflation are expected to peak in early 2023, after a pick-up in inflation from expiring price caps (Table 1), before slowing as commodity prices retreat, demand cools, and the output gap turns negative. The current account deficit is expected to decrease to about 5 percent of GDP in 2023 with improving terms of trade and contracting import demand, financed through FDI, EU funds, and portfolio investment.

12. A gradual recovery is expected over the medium-term. As demand recovers and policy tightening lessens, growth is expected to pick up and the output gap to gradually close from below. Inflation may only return within the tolerance band by end-2025. EU funds under the RRF and MFF 2021-27 are expected to start flowing in 2023:Q2 assuming related conditions are met in Q1 (Text Table 1), supporting a recovery in potential output over the medium-term. Over the medium-term, continued FDI inflows, including in battery production and auto sector, and EU funds are expected to remain the main sources of external financing.

13. Uncertainty around the baseline is high, and risks could significantly worsen the outlook (Annex III). Untimely or incomplete delivery of expected EU funds would increase risk premia, intensify exchange rate pressures, increase inflation, and lower output as investment drops. A full shut-off of Russian gas to Europe would further increase energy prices and likely result in physical gas shortages for the 2023-24 winter season, driving higher inflation and output losses (Box 2). Developments in Russia's war in Ukraine, other supply disruptions or a cold winter could lead to further or more persistent commodity price shocks. This would drive inflation higher, weigh on firm profits and investment, reduce output and intensify balance of payments pressures. Widespread firm closures from high energy costs would magnify those impacts. Faster-than-expected tightening in global financial conditions could adversely affect capital flows. Global demand could disappoint. Inflation could become entrenched. Any combination of these risks could occur, with the direction and magnitude of the net impact on the external balance, output and inflation depending on their interaction. In a worse-case scenario, market conditions could become disorderly and drive capital outflows. On the positive side, a faster-than-expected drop in commodity prices could reduce inflation and the external deficit faster.

Authorities' Views

14. The authorities broadly shared staff's views on the outlook and risks. They agree that 2023 will be a challenging year but believe that a recession can be avoided. After a strong recovery in the first half of 2022, they expect that the slowdown in 2022:H2 will continue into 2023 as external and domestic demand weaken, notwithstanding a tight labor market. The MNB expects inflation to moderate in 2023 and reach its target tolerance band by 2024, as demand cools and food and energy prices retreat, in turn supporting an improvement in the current account deficit. The authorities recognized the high level of uncertainty and broadly agreed with staff on the key downside risks to the outlook. However, they emphasized their confidence in the expected delivery in 2023 of EU funds from the Recovery and Resilience Facility (RRF) and the 2021-27 Multiannual Financial Framework (MFF). They noted that risks are rapidly evolving and warrant careful and persistent monitoring.

POLICY DISCUSSION: CONSISTENTLY ADDRESSING IMBALANCES

15. Heightened imbalances, significant risks, and major uncertainty require a tighter and consistent policy mix. Within a tighter stance, policies need to carefully balance restoring fiscal and external buffers in an orderly fashion, providing relief from the cost-of-living crisis, and flexibly responding to changing circumstances. Under the baseline, the planned fiscal adjustment will complement tight monetary policy to fight inflation, but administrative price and interest rates regulations work at cross-purposes of fiscal and monetary policies and need to be lifted. Under a scenario in which further supply-side shocks significantly weakens growth and increases inflation, monetary policy should tighten faster to contain second-round effects and fiscal policy would need to remain tight while making room for additional support the vulnerable. Disorderly market conditions would require an even tighter policy mix. A demand shock that lowers both growth and inflation would call for somewhat looser policies, including a slower pace of fiscal adjustment, provided market confidence is maintained. Longer-term structural issues were discussed in the context of their impact on short-term pressures, including on energy security and governance.

A. Fiscal Policy: Consolidating While Protecting the Vulnerable

16. A tight fiscal policy stance is critical to contain economic imbalances and rebuild fiscal buffers. The government plans a large fiscal adjustment for 2023, aiming to reduce the deficit from a targeted 6.1 percent of GDP in 2022 to 3.9 percent of GDP in 2023 and 2.5 percent in 2024. Under the baseline, staff expects an improvement in the primary cyclically-adjusted and structural balances of 3.3 and 2.3 percentage points in 2023, respectively, with smaller improvements thereafter. Such front-loaded fiscal adjustment will complement monetary policy in dampening demand and inflation. However, keeping the original deficit target at 3.5 percent of GDP would have been preferable considering the continued increase in inflation to date. Considering significant risks, an ambitious adjustment is also important to firmly place debt on a downward path amidst sizeable financing needs and rising financing costs, and to restore market confidence. Under the baseline, public debt (76 percent of GDP in 2022:Q3) remains elevated but is sustainable under the most plausible shock scenarios (see Annex I for medium-term debt sustainability considerations).

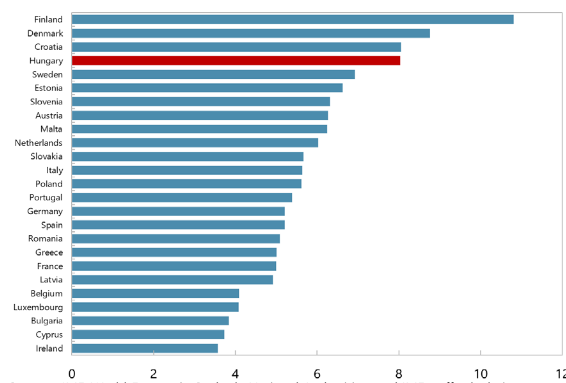
17. The composition of the fiscal adjustment could be improved. The planned adjustment appears achievable owing to higher revenues boosted by inflation in 2022-23 and new tax measures, the unwinding of one-off bonuses and other expenses carried out in 2022, discretionary cuts in goods and services spending, and the postponement of investment projects. In addition, the government has the discretion to re-allocate and cap spending if additional measures are needed to meet the 2023 deficit target. Improvements in current adjustment measures could minimize their impact on growth:

- *Revenue*. Discretionary windfall taxes are easy to implement but can impede a growth-friendly allocation of resources. Though Hungary's exemption from the EU's oil embargo has provided a windfall for state-owned energy company MOL, staff cautioned that the ex-post nature of the windfall tax (recently raised to 95 percent) risks discouraging investment, an argument that also holds for the ex-post tax on banking sector profits. Furthermore, for the banking sector, it is unclear that profits are due to an exogenous windfall. In addition, the newly extended financial transaction tax is distortive and may incentivize informality.

- *Expenditure*. Staff cautioned against reducing productivity-enhancing capital spending and advised a careful prioritization of projects to delay. With one of the highest goods and services expenditure shares in the EU, staff agrees that there is likely scope to reduce operational spending. This should first be achieved through efficiency gains where feasible and should preserve basic public services and spending on human capital (e.g., health, education).

Figure 7. Hungary: Government Expenditure on Goods and Services

(Percent of GDP, average 2015–2019)



Sources: IMF, World Economic Outlook; National Authorities; and IMF staff calculations

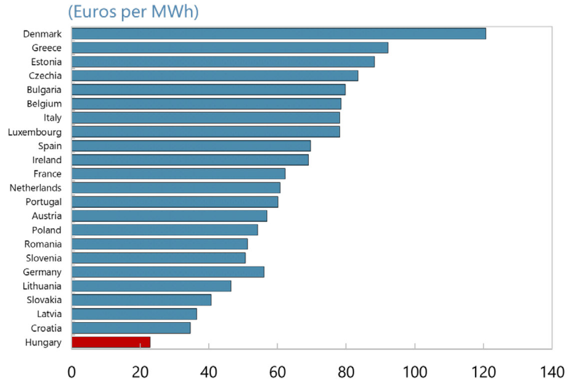
18. The household energy utility price cap should be further relaxed to encourage energy saving and reduce fiscal costs. The long-standing cap has shielded households from surges in energy costs but is regressive, prevents demand adjustment, and undermines climate objectives. The subsidies to state-owned utility companies as compensation for the cap amounted to 0.7 percent of GDP in 2022. The cost is likely to be higher in 2023, as long-term contracts between the state-owned utility company and wholesale energy providers, last made in 2020, are renewed at prevailing market prices. The recent reform of this utility price cap through the introduction of a market-based, quarterly-adjusted rate for consumption above average was welcome, but more is needed to compress energy demand considering the risk of persistent energy-supply shocks. Targeted transfers through existing social safety nets or household lump-sum payments would protect the vulnerable, maintain price signals, and be less costly. As a second best, if existing mechanisms to provide targeted transfers prove inadequate, the new block utility tariffs could be refined by lowering the threshold for the subsidized rate to a basic consumption amount per household with the rest charged at market prices and by increasing the frequency of tariff-setting from quarterly to monthly. This would improve targeting of the existing system and price signals.

19. The motor-fuel price cap ended slightly earlier than planned after it triggered supply shortage. The cap increased demand and led to disruptive closures of petrol stations. The state-owned energy company MOL had been the only wholesale supplier of fuel domestically, and its challenges worsened during the maintenance of the domestic oil refinery. This is a welcome step as this regressive price caps had contributed to increasing demand and worsening the current account, while weighing on the budget through reduced profits taxes and dividends from the oil state-owned enterprises.

Figure 8. Hungary: Household Gas Prices and Demand

Household gas prices in Hungary were the lowest in the EU as of the first half of 2022

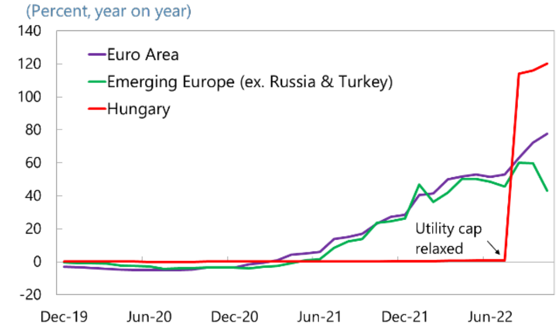
Household Gas Prices, 2022:H1
(Euros per MWh)



Source: Eurostat (excludes taxes and levies).

...and remain among the lowest even after the utility cap relaxation in August more than doubled gas prices.

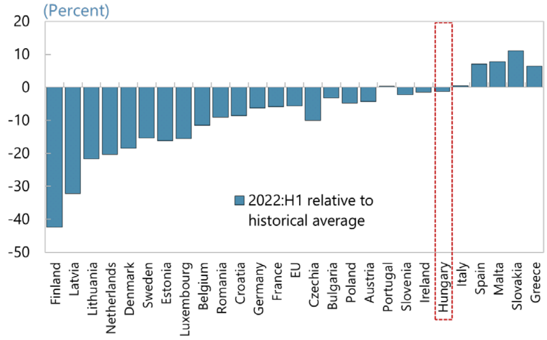
HICP Gas Inflation
(Percent, year on year)



Sources: Eurostat, Haver Analytics, and IMF staff calculations. Data through October 2022.
Note: Emerging Europe includes Bulgaria, Croatia, Hungary, North Macedonia, Poland, Romania and Serbia. HICP indicators for Belarus, Moldova and Montenegro are not available.

In the months prior to relaxing the cap, demand remained flat while most EU countries scaled back.

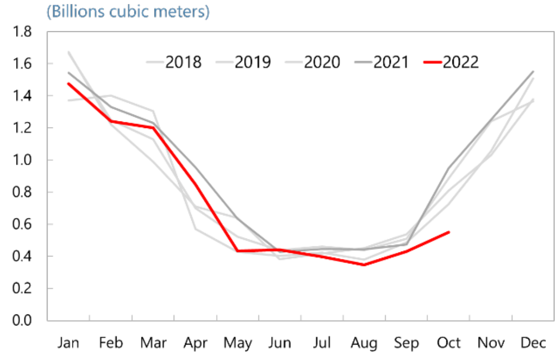
Change in Gas Consumption
(Percent)



Sources: Eurostat and IMF staff calculations
Note: Historical average refers to H1 averages over prior five years (2017-2021)

Mild weather and some scaling back by firms, who face market prices, delayed the start of peak winter season.

Gas Consumption
(Billions cubic meters)



Source: Eurostat

20. Timely and complete delivery of expected EU funds will help foster much-needed investment and avoid added pressure on risk premia and financing costs. EU funds have played an essential role in boosting Hungary's growth over many years and should be instrumental in supporting medium-term convergence through investments in physical and human capital. Therefore, steady progress in the reforms and investments agreed with the EU in the context of the rule-of-law procedure, the partnership agreement covering financing under the EU's multiannual financial framework (MFF), and the financing under the resilience and recovery fund (RFF) is critical so expected funds can be timely disbursed (Text Table 1). Under a downside scenario of persistent delays and heightened uncertainty in receiving fresh disbursements, pressure on the exchange rate and financing costs could intensify. Should the funds not be delivered in full or in a timely manner, the budget may need to adjust as fiscal policy cannot afford to be relaxed considering the need to reduce inflationary pressures and lower the current account and the fiscal deficits.

Text Table 1. Status of Planned EU Transfers

	MFF 2021-27		RRF		MFF 2014-20	
	EUR bn	% 2021GDP	EUR bn	% 2021GDP	EUR bn	% 2021GDP
Total planned allocation as of 2022	35.0	22.7	5.8	3.8	5.4	3.5
o/w cohesion funds	22.0	14.3	-	-	-	-
Subject to conditions	21.7	14.1	5.8	3.8	-	-
o/w Suspended	6.3	4.1	-	-	-	-
Status	▪ Partnership agreement adopted on 12/22/22. ▪ Initial RRP super-milestones on judicial independence must be met for any disbursement under cohesion funds. ▪ Disbursements under 3 operational programs subject to enabling conditions. ▪ Full rule-of-law conditionality must be satisfied within two years to unlock suspended portion of cohesion funds.		▪ Resilience and Recovery Plan (RRP) approved on 12/15/22. ▪ Initial super-milestones must be met before receiving funds, with ongoing milestones thereafter.		▪ Available through 2023	

Source: European Commission

Note: RRF funds shown refer to grants. Relevant enabling conditions relate to fulfilment of the EU Charter of Fundamental Rights.

Authorities' Views

21. **The authorities agreed on the need for a tight fiscal stance consistent with monetary policy.** The government did not consider that fiscal policy early in the year was inflationary. It noted that the 2022 fiscal stance is overall tighter than in 2021 and stressed the one-off nature of some fiscal measures to increase household incomes. Looking ahead, the authorities shared staff's view that fiscal and monetary policies should be consistent and tight and highlighted the strong coordination between the MNB and Ministry of Finance. The Ministry of Finance took steps to meet the 2022 target and stressed its determination to achieve its 2023 and 2024 fiscal targets, noting its track record in this regard. It is closely monitoring risks and stands ready to introduce corrective measures if needed. The authorities consider that prudent fiscal policy will be key to sustaining medium-term growth. Regarding EU funds related to the RRP and 2021-27 MFF, they stressed their determination to reach an agreement with EU partners, which was subsequently achieved in December. They were confident that funds will eventually be delivered in a timely manner, despite what they saw as higher demands from the European Commission than in the past and for other countries. In the short-term, EU funds from the previous MFF continue to flow, and the government does not anticipate any liquidity issue in meeting its financing needs.

B. Monetary and Financial Policies: Reducing Inflation and Preserving Financial Stability

22. **Monetary policy has significantly tightened since mid-2021.** The MNB was one of the first European central banks to start raising interest rates in June 2021 from a low base of 0.6 percent, although until end-2021, liquidity was still added through the MNB's asset purchase program. At this stage, the overnight one-day deposit tender has become the de facto policy rate. At 18 percent, it amounted to a significant tightening in monetary policy, particularly in 2022. In that context, recent liquidity-absorbing measures were welcome. Considering the rapid acceleration in core inflation, which is now among the highest in Europe, such large overall tightening was appropriate.

23. **Maintaining a tight monetary policy stance is critical to drive inflation towards its target.** Notwithstanding the impact of expiring price caps, under the baseline, inflation is expected to decrease to about 7 percent y/y by the end of 2023, as policy tightening cools demand and commodity prices decline. However, it will remain above the MNB's target until end-2025. Structural tightness in the labor market, and de-anchored, backward-looking expectations add persistence to core inflation and risk feeding a wage-price spiral. While core inflation is also expected to decrease as domestic demand decelerates, it will likely remain somewhat higher than headline inflation until 2024:H2. Furthermore, food price caps, which were recently extended, have added to food price inflation by diverting price increases to uncapped foods. In this context, in weighing policy trade-offs under high uncertainty, the potential costs of under-tightening (including entrenched high inflation and a higher eventual cost of controlling it) outweigh the risks of excessively lowering output through over-tightening. As the recent rate hikes transmit to the economy with a lag,

monetary policy should remain data dependent, including on monthly core inflation dynamics, changes in expectations, and the evolution of credit.

24. Interest rate caps undermine monetary policy transmission and work at cross-purposes with policy tightening. The MNB's shift toward more conventional tools is welcome. The MNB has used many unconventional tools and changed them frequently, aiming to mitigate temporary market dysfunction. Historically, it adjusted or revoked tools when they met their objectives or proved ineffective. However, the multiplicity of tools risks blurring the MNB guidance and, ultimately, affecting MNB's credibility (Selected Issues Paper). The recent shift toward more standard liquidity-absorbing tools should help strengthen monetary policy transmission.[1] However, the government's caps on mortgage, SMEs, and student loans interest rates and on large deposits are disconnecting key transmission channels of monetary policy. By hampering the effectiveness of monetary tightening, they will result in pressure to raise rates further than otherwise warranted. Furthermore, they are untargeted, are likely regressive (especially caps on mortgage interest rates) and discourage prudent credit demand. They should be abolished.

25. In a period of high uncertainty, continued exchange rate flexibility is needed to serve as a shock absorber in the face of numerous external risks. Foreign exchange intervention should be limited to containing excess volatility and should not prevent the exchange rate from adjusting as needed. In this regard, the MNB's temporary measure to provide foreign exchange directly to energy importers should not be extended further.

26. Banking sector buffers can absorb the most plausible shocks but continued supervisory vigilance is warranted in a challenging environment. Although aggregate buffers are comfortable, they are somewhat unevenly distributed. Furthermore, credit risks are expected to rise even under the baseline, as growth slows, energy intensive industries face exceptionally high costs, and rising construction costs and interest rates test imbalances in the real estate market. Mortgage demand has recently slowed, though nominal house price growth remains elevated (Figure 6) and may take time to stabilize. Bank profitability may come under pressure, if higher net-interest margins do not fully offset the costs of additional windfall and indirect taxes, and caps on selected interest rates. Moreover, bank holdings of tradeable fixed-income securities are subject to valuation losses from rising interest rates. Currently, bank exposures to Ukraine and Russia appear manageable, including for OTP, the largest Hungarian bank, which has subsidiaries in both Russia and Ukraine. The MNB should continue to closely monitor these risks and encourage timely provisioning. Within its comprehensive set of macroprudential rules, including borrower-based limits, its decision to increase the countercyclical capital buffer by 0.5 percentage points effective July 2023 for resident exposures was appropriate. Among non-bank financial institutions, insurance companies (assets of which amounted to about 6 percent of GDP at end-2021, compared to 113 percent of GDP for the banking system) appear to be also affected by higher interest rates and should continue to be closely monitored.

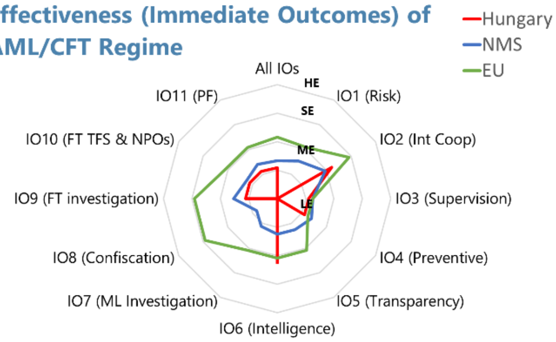
[1] The sterilization costs are expected to result in MNB losses. The authorities, in consultation with the ECB, are amending the MNB Act to smooth the expected recapitalization transfers over a longer period.

27. Continued progress in strengthening the AML/CFT framework in line with the international FATF standard is important to improve its effectiveness. Per the May 2022 MONEYVAL report, Hungary made progress in improving the legal framework in the areas of correspondent banking relationships, internal controls in financial institutions, and transparency and beneficial ownership of legal persons.[2] The authorities should continue to address the remaining technical deficiencies relating to non-profit organizations, revised requirements for virtual asset providers, and cash couriers, and to strengthen the effective implementation of all requirements.

Figure 9. Hungary: AML/CFT Indicators

While below the EU level, Hungary's AML/CFT technical compliance is largely in line with the FATF standard…

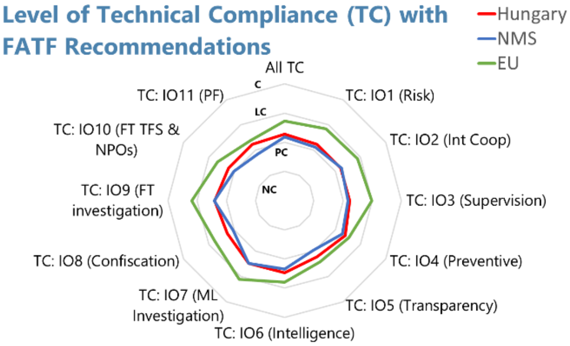
Effectiveness (Immediate Outcomes) of AML/CFT Regime



Source: MONEYVAL 5th Round Mutual Evaluation of HUN Sep. 2016 and MONEYVAL Follow-Up Report of HUN May 2022 issued by the Financial Action Task Force (FATF).
Note: NMS=New Member States: BGR, HRV, CZE, EST, HUN, LVA, LTU, POL, ROU, SVK and SVN. FATF's four effectiveness ratings: HE=High, SE=Substantial, ME=Moderate, and LE=Low.

…but significant shortcomings remain in the effectiveness of its AML/CFT regime, performing well below peers

Level of Technical Compliance (TC) with FATF Recommendations



Source: MONEYVAL 5th Round Mutual Evaluation of HUN Sep. 2016 and MONEYVAL Follow-Up HUN May 2022 issued by the Financial Action Task Force (FATF).
Note: NMS = New Member States: BGR, HRV, CZE, EST, HUN, LVA, LTU, POL, ROU, SVK and SVN. FATF's compliance ratings: C=Compliant, LC=Largely, PC=Partially, and NC=Non-Compliant.

Authorities' Views

28. The MNB underscored its commitment to maintaining a tight monetary policy stance to achieve price stability. It considers that high inflation and the large current account deficit are the main, inter-related, challenges facing the economy. With hindsight, continuing the asset purchase program through the end of 2021, albeit at a slowing pace, made the efforts of the MNB to tighten monetary policy through rate increases that began mid-2021 more difficult but the high degree of uncertainty around the post-covid recovery justified cautious tapering. Looking ahead, as staff, the MNB expects overall inflation to peak in early 2023. It will then recede as food and energy prices, which the MNB considers were the primary drivers of inflation, begin to retreat and domestic demand cools. Both factors will also help improve the current account. The MNB sees inflation reaching the tolerance band earlier than staff, in 2024. It agrees that monetary policy should remain data dependent and tight until inflationary pressures consistently ease and the current account deficit retreats. However, it considers that the base rate is high enough for driving inflation toward its target, while the overnight deposit tender rate is geared toward ensuring market stability. On monetary operations, the MNB suggested that its use of a wide variety of instruments has resulted in a successful track record in achieving its objectives. It sees financial stability risks as low given adequate overall buffers and an expected soft landing in the real estate market.

[2] MONEYVAL is the Council of Europe's AML/CFT body.

C. Structural Reforms: Achieving Energy Security, Driving Convergence

29. Discussions on longer-term structural challenges centered around energy security, governance, and the importance of EU funds in financing related investments. Hungary's recently approved RRP provides financing for key and appropriate structural priorities of the government in line with Next Generation EU objectives (Box 1), including energy transition, digitalization, and governance. Meeting in 2023:Q1 the initial super-milestones, which are related to governance issues, will be required to allow for disbursements to begin.

30. Hungary is working to improve its energy security. The authorities have taken emergency measures to avoid winter shortages, including filling gas storages to a high level, expanding domestic production, and contracting additional imports from Gazprom. Hungary was also granted an exception from the EU's embargo on Russian oil. However, an extended interruption in Russian gas supply would likely result in shortages for the 2023-24 winter as Hungary, a landlock country, is the most dependent EU country on Russian gas and has limited alternative supply options. This puts a premium on fostering demand adjustment and accelerating improvements in energy efficiency. Under its long-term energy transition strategy, the government aims to invest in expanding nuclear power generation, enhance the electricity grid, further develop storage capacities and, ultimately, reduce the gas share of overall energy consumption. Meanwhile, demand for electricity will rise as households shift from gas to electricity-powered heating and the energy-intensive battery industry grows. Overall, total capital expenditures on such investments could exceed EUR 20 billion (13 percent of 2021 GDP). Securing the financing for these plans, which exceed amounts available through EU funds, is critical.

Box 1. Hungary's Recovery and Resilience Plan

Hungary's RRP was approved by the European Council in December 2022. The RRF provides for EUR 5.8bn in grants (3.8 percent of 2021 GDP) through 2026 and access to EUR 9.6bn (6.2 percent of 2021 GDP) in loans to support reforms and investments to facilitate economic recovery from the COVID-19 crisis and promote the green and digital transition. Hungary can begin to request disbursements after 27 super-milestones on the rule of law, judicial independence, and anti-corruption are met. The government is considering tapping into the RRF loans, particularly for energy investments. In Hungary's plan, grants aim to:

- **Support the green transition (48 percent of grant financing),** through reforms and investments in sustainable transport (EUR 1.4bn), renewable energy sources (EUR 825mn), and energy efficiency of buildings (EUR 386mn).
- **Foster the digital transition (30 percent)**, via reforms and investments in digital skills and digital equipment in education (EUR 570mn), digitalization of the healthcare sector (EUR 488mn), and safer and digital public transport (EUR 212mn).
- **Reinforce economic and social resilience**, including investments in modern healthcare (EUR 1.3bn), quality education and social inclusion (EUR 266mn), and reforms in anti-corruption, strengthening of judicial independence, and quality of public finances such as in the sustainability of the pension system and efficiency of the tax system.

Box 2. Energy Security

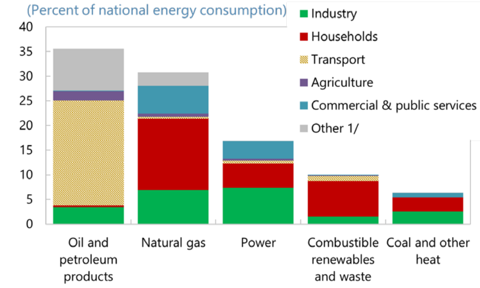
Hungary depends on Russian gas and oil for around 40 percent of its energy needs, with limited alternative in the short-term. In turn, Russian gas and oil imports account for nearly 70 percent of Hungary's gas and oil consumption, respectively. Landlocked, Hungary is reliant on pipeline flows for gas and oil. Turkstream (via Serbia) is now the primary channel of Russian gas imports. Potential non-Russian sources of gas, including LNG, are limited by transmission capacity constraints (Croatia, Romania) and production constraints (Central Asia suppliers). Furthermore, repurposing refineries, currently equipped for Russian-grade oil, for alternatives takes time. In addition, nearly all nuclear fuel is sourced from Russia, though Hungary maintains a two-year reserve of nuclear fuel supply.

Hungary's ability to rapidly reduce gas demand is limited. Households are the largest consumers of natural gas, primarily for heating. Higher price-passthrough can help reduce demand but substituting away from gas-powered heating would require major investment. Electricity generation primarily relies on nuclear, but the use of gas has grown to power energy-intensive industry to about 30 percent, including chemicals and battery. Investments in the electricity grid are also needed to reliably absorb increasing energy from renewable sources, in particular solar. The lifespan of existing coal- and nuclear-powered plants have been extended by 4 and 20 years, respectively.

If Russian gas flows to Europe were fully shut off, Hungary would likely face significant shortfalls. Under the baseline, Hungary is expected to avoid shortages this winter owing to recent measures and high storage. If Russian gas were shut-off for twelve months, however, Hungary could face shortages equivalent to 25 percent of its annual consumption. This assumes that Hungary's only gas supply would be current gas storage, some shared gas through EU solidarity, LNG and other pipeline imports via Southeast Europe, and the unlocking of emergency strategic oil reserves to temporarily substitute gas-led power generation. Previous IMF staff estimates suggest that the impact on output from such shortages could range from -1 percent of GDP to -4 percent of GDP. However, the impact through the 2023-24 winter could be worse as storages would be depleted and new supply sources could only increase modestly. Separately, the EU's price cap on seaborne oil imports from Russia, announced in December, may potentially trigger some diesel fuel shortages in Hungary and slow industrial production.

Energy Mix

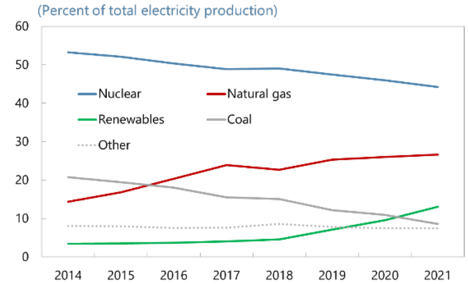
(Percent of national energy consumption)



Sources: Hungarian Energy and Public Utility Regulatory Authority and IMF staff calculations
Notes: Average over 2016-2020. 1/ Includes non-energy uses

Power Generation

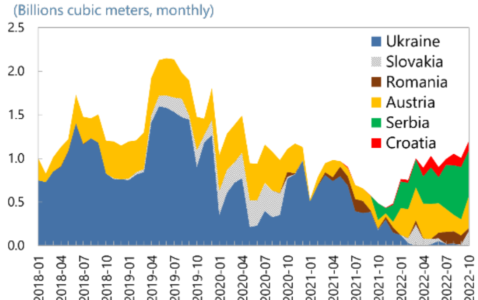
(Percent of total electricity production)



Sources: Hungarian Energy and Public Utility Regulatory Authority and IMF staff calculations
Note: Renewables consist of solar, wind and water

Natural Gas Imports by Import Point

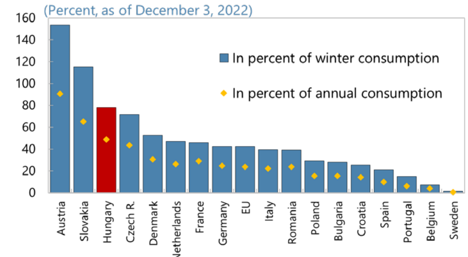
(Billions cubic meters, monthly)



Source: Eurostat

Total Gas Storage

(Percent, as of December 3, 2022)



Sources: Gas Infrastructure Europe (AGSI+), Eurostat and IMF staff calculations
Note: Some countries may earmark gas for other purposes. Consumption data is average over past 5 years (Eurostat). Winter includes Nov-Mar.

31. Timely and effectively-implemented measures to strengthen governance and anti-corruption frameworks are critical. On some dimensions, including regarding the speed of judiciary processed and AML CFT international cooperation, governance perception indicators are better for Hungary than non-EU and EU peers (Figure 10). However, in several key areas, such as the rule of law, judicial independence, and corruption, perception indicators are below EU peers and have deteriorated significantly in recent years. Governance issues—in particular related to weakened rule-of-law, procurement fraud and corruption involving EU funds—have concerned the EC, jeopardizing EU funding. Measures to address those issues are key conditions for timely and complete disbursement of RRF and cohesion funds (Text Table 1 and Box 1). In that context, the authorities established an independent integrity authority for public procurements and an anti-corruption task force and committed to amending their public procurement and criminal legal frameworks, including adopting a national anti-corruption strategy and extending the scope of the asset declaration system. Timely and effective implementation of these remedial measures is not only important to unlock EU funds but because strengthening transparency, the anticorruption framework, and governance is crucial to improve the business environment and the efficiency of public spending.

Figure 10. Hungary: Governance Indicators

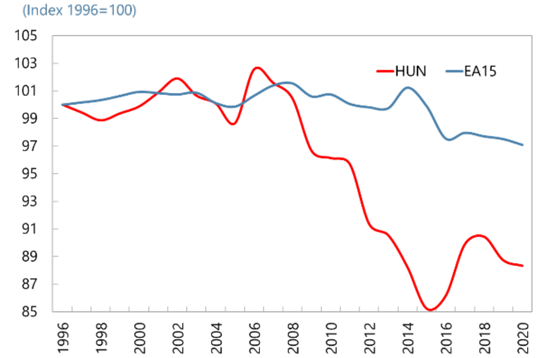
Corruption perception and AML/CFT indicators lag peers.

Governance Indicators in Hungary, the NMS, and the EU
(Index, normalized between 0 and 1)

Sources: Economic Freedom of the World; EU Justice Scoreboard; Financial Action Task Force; IMF staff calculations; Maplecroft; Open Budget Survey; OECD; Transparency International; World Justice Project; World Bank; World Economic Forum; and World Governance Indicator.
Note: Data as of 2021.

Rule-of-law perception indicator has deteriorated in recent years...

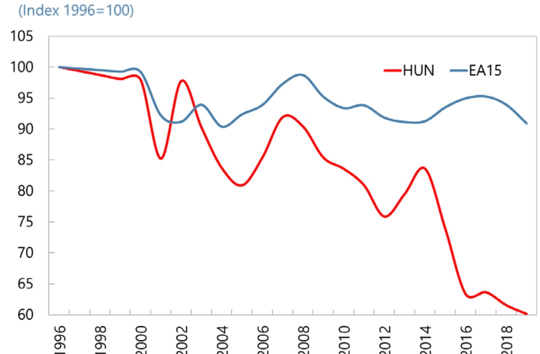
Rule of Law
(Index 1996=100)



Sources: Worldwide Governance Indicators; and IMF staff calculations.

...and so did the judicial independence indicator.

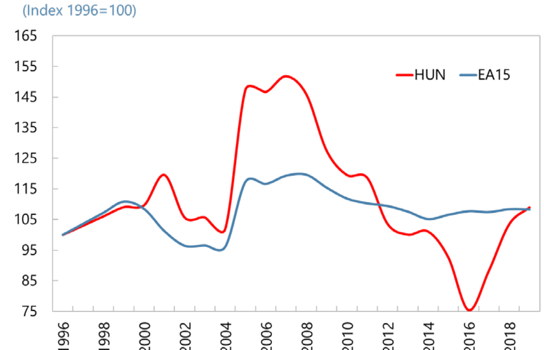
Judicial Independence
(Index 1996=100)



Sources: World Economic Forum; and IMF staff calculations

Protection of property rights indicator has recently improved after years of decline.

Protection of Property Rights
(Index 1996=100)



Sources: World Economic Forum; and IMF staff calculations

Authorities' Views

32. Diversification in energy supply will take time and governance is largely a perception issue. The authorities agree that, given dependency on Russian oil and gas and limited alternative supply, measures are needed to foster demand adjustment. They noted that although energy supply is secured for the 2022-23 winter, any major and sustained interruptions in Russian gas imports could lead to shortages in the 2023-24 winter. They consider that energy sanctions against Russia cause significant harm also to the European economy. They agreed that it is critical to secure the financing for large-scale energy investments to strengthen energy security in the medium-term. The authorities consider that governance in Hungary is much better than reflected in perception indicators. They stressed that they nonetheless have made significant efforts to address the EU's concerns in this area notwithstanding what they see as moving goalposts from the EC.

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33. Economic imbalances have widened, growth momentum is slowing, and sizable risks can significantly worsen the outlook. Together with loose fiscal policy in late 2021-early 2022 that boosted domestic demand, a series of shocks, including Russia's war in Ukraine, intensified inflation and turned the current account into a large deficit. International reserves remain adequate, but the external balance in 2022 was substantially weaker than warranted by medium-term fundamentals and desirable policies. In 2023, growth is expected to slow sharply with inflation remaining elevated while the current account deficit is expected to notably shrink as terms of trade improve and domestic demand weakens. Significant risks cloud the outlook, including untimely or incomplete delivery of expected EU funds, lower external demand, higher-than-expected commodity prices, higher-than-expected global funding costs, more entrenched inflation, and natural gas shortages.

34. Consistent overall policy tightening is needed to reduce vulnerabilities amid large uncertainty. Maintaining a tight and consistent policy mix is important to drive inflation towards the central bank's target, reduce the fiscal and current account deficits, and lower public debt. At the same time, well-targeted support is needed to alleviate the impact of rising cost of living on vulnerable households. In a volatile global environment in which financing conditions are tightening, prudent policies are also needed to avoid the risk of disorderly market conditions.

35. The planned fiscal tightening in 2023 is broadly appropriate. The government's large, front-loaded adjustment is needed to complement monetary policy in dampening demand and inflation and rebuild fiscal buffers considering significant risks. In this context, retaining the original 3.5 percent of GDP deficit target would have been preferable to the revised target of 3.9 percent of GDP. In a worse scenario of weaker growth and higher inflation, fiscal policy would need to remain tight while making room for additional support to vulnerable. A demand shock that lowers both growth and inflation would call for slower pace of fiscal adjustment, provided market confidence is maintained.

36. Fiscal adjustment measures should minimize their impact on growth. Temporary windfall taxes on the energy and banking sectors should end upon expiration, as ex-post taxes risk discouraging investment and their extensions could erode the credibility of tax policy. The recently-increased financial transaction tax is distortive and may incentivize informality. Careful prioritization of delayed projects is important to preserve the most productivity-enhancing investment. Reductions in operational spending should be achieved through efficiency gains to the extent feasible and preserve basic public services.

37. Direct support to vulnerable households is a better way to support them than costly and ineffective price caps. The removal of the motor fuels price cap in December was welcome. The price cap on selected food products has been ineffective in controlling food inflation and should be left to expire. While the longstanding household utility price cap has shielded households from surges in energy costs, it also benefits the richer more, disincentivizes energy savings, and contributes to deteriorating the trade and fiscal balances. In turn, this puts pressure on the exchange rate and domestic inflation. Introducing new block utility tariffs was one step in the right direction, but further refinements are needed to foster energy saving as pressures on energy supply may last long. A more effective approach to mitigating the impact of high inflation while maintaining price signals is through direct targeted support to the vulnerable.

38. Tight monetary policy is needed until inflationary pressures clearly and sustainably ease. The overnight one-day deposit tender, initially introduced to counter rapid exchange rate depreciation and defend market stability, has become the de-facto policy rate to fight inflation, appropriately further tightening monetary policy. Monetary policy ahead should remain data dependent and focused on driving inflation towards its target. While the recent tightening will transmit to the economy with a lag, more may still be needed as costs of under-tightening are likely to exceed costs of over-tightening. In a period of high uncertainty, continued exchange rate flexibility serves as a shock absorber in the face of numerous external risks.

39. Interest rates caps run counter to monetary policy efforts and should be abolished. The MNB's shift toward more conventional liquidity-absorbing tools is welcome, as it should help strengthen monetary policy transmission. However, the caps on mortgage, SMEs, and student loan interest rates and on commercial bank deposit rates of large deposits by institutional investors and retail customers hamper the transmission of monetary tightening, ultimately requiring stronger rate increases than would otherwise be needed.

40. Banking sector buffers appear adequate but continued supervisory vigilance remains important in the challenging macroeconomic environment. An expected rise in credit risks from slow growth, high inflation, and high interest rates warrant timely provisioning. Bank profitability may come under pressure if higher net-interest margins do not fully offset costs of additional windfall and indirect taxes, and caps on variable interest rates. Furthermore, the impact of rising interest rates on the insurance sector also requires close monitoring.

41. Strengthening energy-supply security is critical but will take time. A high level of gas storage and additional imports from Gazprom makes shortages unlikely for the 2022-23 winter, though an interruption in Russian energy supply would possibly lead to shortages in the 2023-24 winter. Limited short-term supply alternatives to Russian gas and oil puts a premium on measures to foster demand adjustment. Diversification away from gas will require significant investment over several years. Securing its financing is critical.

42. Strengthening transparency and the anticorruption framework will improve the business environment and the efficiency of public spending. Continued progress in regulatory and institutional reforms aiming to strengthen the rule of law, judicial independence, and the anti-corruption framework will help strengthen the business environment, long-term growth prospects, and efficiency in public spending. Continued strengthening of the AML/CFT framework in line with the international FATF standard is also important to address remaining shortcomings and improve effectiveness.

43. It is recommended that the next Article IV consultation be held on the standard 12-month cycle.

Table 2. Hungary: Selected Economic Indicators, 2018–24

	2018	2019	2020	2021	2022	2023	2024
						Proj.	
	(Percentage change, unless otherwise indicated)						
Real economy							
Real GDP (percentage change)	5.4	4.9	-4.5	7.1	4.9	0.5	3.2
Total domestic demand (contribution to growth)	6.6	6.8	-2.4	6.0	4.5	-0.1	3.3
Private consumption	2.5	2.6	-1.0	2.5	3.7	0.2	1.9
Government consumption	0.5	1.0	0.4	0.4	0.1	-1.6	0.5
Gross fixed investment	3.6	3.2	-1.9	1.4	1.5	0.0	0.7
Foreign balance (contribution to growth)	-1.2	-2.0	-2.1	1.1	0.4	0.7	-0.1
CPI inflation (average)	2.8	3.4	3.3	5.1	14.5	17.7	5.4
CPI inflation (end year)	2.7	4.0	2.7	7.4	24.5	6.8	5.2
Core CPI inflation (average)	2.5	3.7	3.8	3.9	15.7	16.6	5.6
Core CPI inflation (end year)	2.8	3.8	3.1	6.4	24.8	7.0	4.5
Unemployment rate (average, ages 15-64)	3.6	3.3	4.1	4.1	3.6	4.1	3.8
Gross fixed capital formation (percent of GDP)	24.7	27.0	26.5	27.2	31.0	30.7	29.7
Gross national saving (percent of GDP, from BOP)	24.9	26.2	25.4	23.0	22.8	26.0	27.8
General government 1/							
Overall balance (percent of GDP)	-2.1	-2.0	-7.5	-7.1	-6.1	-3.9	-2.5
Primary balance (percent of GDP)	0.2	0.1	-5.3	-5.0	-3.7	-0.8	0.6
Primary structural balance (percent of potential GDP)	-0.7	-1.1	-4.7	-4.0	-2.1	0.2	0.8
Public debt (percent of GDP)	69.1	65.3	79.3	76.8	76.4	73.2	70.0
Money and credit (end-of-period)							
Broad money	11.8	8.1	21.1	16.3	11.5	9.6	8.7
Lending to the private sector, flow-based	10.6	15.3	11.8	12.8	10.9	8.8	8.6
Interest rates							
T-bill (90-day, average)	0.0	0.0	0.4	0.9	10.0	...	...
Government bond yield (5-year, average)	2.2	1.6	1.5	2.4	9.5	...	...
Balance of payments							
Current account (percent of GDP)	0.2	-0.8	-1.1	-4.2	-8.1	-4.6	-1.9
Reserves (billions of Euros)	27.4	28.4	33.7	38.4	38.7	42.0	44.3
Gross external debt (percent of GDP) 2/	79.3	73.0	80.9	84.6	85.4	77.2	69.8
Gross official reserves in percent of the IMF ARA metric	106.4	104.9	120.7	119.2	106.4	115.4	119.8
Exchange rate							
Exchange regime							
Exchange rate, HUF per euro, period average	319.3	325.2	351.2	358.5	391.1	...	...
Nominal effective rate (2000=100, average)	118.6	121.5	130.5	133.0	...	...	...
Real effective rate, CPI basis (2000=100, average)	79.8	80.4	84.2	84.1	...	...	...
Memorandum Items:							
Nominal GDP (billions of Forints)	43,386	47,665	48,412	55,126	62,279	67,882	73,697
Per capita GDP (EUR)	13,898	14,996	14,110	15,804	16,417	18,081	19,637

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

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

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

Table 3. Hungary: Medium-Term Scenario, 2018–28

	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028
								Proj.			
	Percentage change, unless otherwise indicated										
Real GDP growth	5.4	4.9	-4.5	7.1	4.9	0.5	3.2	3.3	3.4	3.5	3.5
Inflation (CPI; year average basis)	2.8	3.4	3.3	5.1	14.5	17.7	5.4	4.2	3.6	3.2	3.1
Inflation (CPI; end-year basis)	2.7	4.0	2.7	7.4	24.5	6.8	5.2	3.9	3.2	3.1	3.1
Domestic demand	7.1	7.1	-2.6	6.2	4.9	-0.2	3.3	2.8	3.1	3.1	3.4
Consumption	4.2	5.2	-1.0	4.0	5.9	-1.8	3.1	3.0	3.1	3.1	3.2
Gross fixed capital formation	16.3	12.8	-7.1	5.2	5.4	0.0	2.4	3.4	4.0	4.2	4.3
Exports of GNFS	5.0	5.4	-6.1	10.3	7.0	3.4	4.4	4.9	4.6	4.7	4.6
Imports of GNFS	7.0	8.2	-3.9	9.1	6.6	2.6	4.5	4.4	4.4	4.4	4.5
	In percent of GDP										
External current account balance	0.2	-0.8	-1.1	-4.2	-8.1	-4.6	-1.9	-0.4	-0.2	0.1	0.1
Gross national saving	24.9	26.2	25.4	23.0	22.8	26.0	27.8	29.1	29.3	29.6	29.6
Gross domestic investment	24.7	27.0	26.5	27.2	31.0	30.7	29.7	29.5	29.5	29.5	29.6
Gross external debt 1/	79.3	73.0	80.9	84.6	85.4	77.2	69.8	65.0	59.7	55.6	51.7
Gross official reserves in percent of the IMF ARA metric	106.4	104.9	120.7	119.2	106.4	115.4	119.8	122.0	128.3	139.4	136.7
General government	In percent of GDP										
Revenue, total	44.0	44.0	43.5	41.3	43.9	43.6	44.4	43.5	43.5	43.0	42.6
Expenditure, total	46.2	46.1	51.1	48.4	50.0	47.5	46.9	46.4	45.7	45.1	43.7
General government overall balance	-2.1	-2.0	-7.5	-7.1	-6.1	-3.9	-2.5	-2.9	-2.2	-2.1	-1.1
Structural general government balance (percent of potential GDP)	-3.0	-3.4	-6.9	-6.0	-4.5	-2.9	-2.4	-2.8	-2.1	-2.1	-1.1
Structural primary balance (percent of potential GDP) 2/	-0.7	-1.1	-4.7	-4.0	-2.1	0.2	0.8	0.4	0.8	0.7	1.0
General government cyclically adjusted primary balance 2/	-0.7	-1.1	-4.7	-5.0	-3.8	-0.5	0.8	0.4	0.8	0.7	1.0
General government debt	69.1	65.3	79.3	76.8	76.4	73.2	70.0	68.2	66.1	64.1	61.3
Memorandum items:											
Output gap (percent of potential GDP)	1.9	2.9	-1.3	0.0	0.1	-0.7	-0.4	-0.3	-0.2	-0.1	0.0
Potential GDP growth (percentage change)	3.6	3.9	-0.6	5.8	4.8	1.3	2.9	3.2	3.3	3.3	3.4

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

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

2/ The difference between the cyclically-adjusted and structural balances in 2021 mostly reflect one-off health spending and time-bound tax holidays to address the covid crisis.

Table 4. Hungary: Consolidated General Government, 2018–28

(In percent of GDP, unless otherwise indicated)

	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028
								Proj.			
Revenue	44.0	44.0	43.5	41.3	43.9	43.6	44.4	43.5	43.5	43.0	42.6
Tax revenue	24.7	24.5	24.7	23.2	25.8	27.7	26.6	25.8	25.9	26.0	26.1
Taxes on goods and services	18.0	17.9	18.0	17.6	19.1	20.0	19.0	19.1	19.2	19.3	19.4
VAT	9.5	9.5	9.7	9.9	10.8	11.4	10.9	10.9	11.0	11.0	11.1
Excises and other	8.5	8.4	8.3	7.7	8.3	8.6	8.1	8.2	8.2	8.3	8.3
Taxes on income, profits and capital gains	6.6	6.5	6.7	5.6	6.7	7.6	7.6	6.7	6.7	6.7	6.7
Personal income tax	5.4	5.4	5.5	4.4	5.5	5.4	5.4	5.4	5.4	5.4	5.4
Corporate taxes	1.2	1.1	1.2	1.2	1.2	2.2	2.2	1.3	1.3	1.3	1.3
Other	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Social contributions	12.1	11.7	11.1	10.5	10.3	10.0	10.0	10.0	10.0	10.0	10.0
Current non-tax revenue	4.4	4.7	4.5	4.5	4.5	3.8	4.5	4.5	4.5	4.5	4.5
Current grants	1.5	1.4	1.6	1.1	1.0	0.7	1.1	1.1	1.0	1.0	0.8
Capital revenues and grants	1.3	1.8	1.5	2.0	2.2	1.5	2.2	2.1	2.0	1.4	1.1
Expenditure	46.2	46.1	51.1	48.4	50.0	47.5	46.9	46.4	45.7	45.1	43.7
Compensation of employees 1/	10.5	10.5	11.0	10.6	10.7	9.4	9.1	9.1	9.1	9.1	9.1
Goods and services	8.2	8.7	8.8	8.7	8.7	7.8	8.5	8.4	8.4	8.3	8.2
Interest	2.3	2.2	2.3	2.3	2.5	3.3	3.3	3.3	3.1	2.9	2.3
Subsidies	1.4	1.1	1.3	1.2	1.2	1.6	1.2	1.2	1.2	1.2	1.2
Current transfers to households	12.8	12.1	12.5	12.2	12.3	13.4	12.9	12.5	12.2	11.8	11.4
Social security	10.5	10.1	10.4	10.3	10.4	11.3	10.9	10.6	10.3	9.9	9.6
Other	2.3	2.0	2.1	1.9	1.9	2.1	2.0	2.0	1.9	1.8	1.8
Other current transfers	3.3	3.2	4.1	3.9	5.0	4.2	4.1	4.0	3.9	3.7	3.6
Capital expenditures	6.0	6.4	7.5	6.6	6.5	5.3	5.0	5.0	5.1	5.3	5.4
Capital transfers	3.3	1.8	3.6	3.0	2.9	2.4	2.7	2.7	2.7	2.7	2.6
General government balance	-2.1	-2.0	-7.5	-7.1	-6.1	-3.9	-2.5	-2.9	-2.2	-2.1	-1.1
Primary balance	0.2	0.1	-5.3	-5.0	-3.7	-0.8	0.6	0.3	0.7	0.6	1.0
Memorandum items:											
Structural balance (% of potential GDP) 2/	-3.0	-3.4	-6.9	-6.0	-4.5	-2.9	-2.4	-2.8	-2.1	-2.1	-1.1
Structural primary balance (% of potential GDP) 2/	-0.7	-1.1	-4.7	-4.0	-2.1	0.2	0.8	0.4	0.8	0.7	1.0
Cyclically-adjusted primary balance (% of potential GDP)	-0.7	-1.1	-4.7	-5.0	-3.8	-0.5	0.8	0.4	0.8	0.7	1.0
Gross public debt (Maastricht definition)	69.1	65.3	79.3	76.8	76.4	73.2	70.0	68.2	66.1	64.1	61.3
GDP (billions of Forints)	43,386	47,665	48,412	55,126	62,279	67,882	73,697	78,969	84,348	89,876	95,766

Sources: Hungarian authorities; and Fund staff estimates.

1/ Includes social security contributions.

2/ The structural fiscal balance excludes one-offs: a) personal income tax refund in 2021, and b) exceptional gas purchases to replenish reserves and bonuses for selected public employees in 2022.

Table 5. Hungary: Central Bank Survey, 2018–24

(In billions of Forints, unless otherwise indicated)

	2018	2019	2020	2021	2022	2023	2024
					Prel.	*Proj.*	
Net foreign assets	8,690	9,168	9,389	7,985	7,582	7,511	8,370
Foreign Assets	9,442	10,040	12,988	14,900	16,297	16,226	17,085
Foreign Liabilities	752	872	3,599	6,915	8,715	8,715	8,715
Net domestic assets	-1,434	-991	-109	2,305	8,301	9,868	10,453
Net claims on government	-1,357	-907	-1,631	1,596	1,711	2,336	2,369
Assets	39	39	1,114	3,303	3,312	3,297	3,280
Liabilities (Govt Deposits at MNB)	1,397	946	2,745	1,706	1,601	961	911
HUF	1,164	603	1,733	1,361	993	...	...
FX	233	343	1,012	346	608	...	...
Net claims on banks 1/	1,038	1,006	1,900	39	5,102	5,931	6,582
Assets	1,383	1,749	5,144	6,323	6,194	6,756	7,374
Liabilities	345	742	3,244	6,284	1,092	825	792
Deposits & CDs excl. current & overnight deposits	345	742	3,244	6,244	1,092	825	792
Securities Issued by MNB 2/	0	0	0	40	0	0	0
Net claims on the economy 3/	13	197	547	1,322	1,590	1,703	1,603
Other items, net	-1,128	-1,287	-925	-652	-101	-101	-101
Base money (M0)	7,256	8,177	9,280	10,290	15,882	17,379	18,822
Currency in Circulation	6,078	6,641	7,332	7,856	8,411	9,204	9,968
Banks' Reserves	1,178	1,536	1,948	2,434	7,471	8,175	8,854
Current Account Balances	259	258	339	371	2,807	3,072	3,327
Overnight Deposits	919	1,278	1,608	2,062	4,664	5,103	5,527
Memorandum items :							
International Reserves (billions of Euros)	27.4	28.4	33.7	38.4	38.7	42.0	44.3
Base Money (yoy percent change)	15.2	12.7	13.5	10.9	54.4	9.4	8.3
NFA (contribution to change)	25.1	6.6	2.7	-15.1	-3.9	-0.4	4.9
NDA (contribution to change)	-9.9	6.1	10.8	26.0	58.3	9.9	3.4
Government Deposits at Central Bank (percent of GDP)	3.2	2.0	5.7	3.1	2.6	1.4	1.2
HUF	2.7	1.3	3.6	2.5	1.6	...	...
FX	0.5	0.7	2.1	0.6	1.0	...	...
Reserve Requirement Ratio (percent of select liabilities) 4/	1.0	1.0	1.0	1.0	5.0-10.0	5.0-10.0	5.0-10.0

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

1/ Excluding swaps. Evaluation effects of swaps with other credit institutions are captured in other items net.

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

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

4/ The mandatory reserve requirement ratio was increased from 1 to 5 percent (without averaging) in October 2022. Banks have an option to maintain additionally 5 percent, which are averaged. Required reserves are remunerated with the base rate.

Table 6. Hungary: Monetary Survey, 2018–24

(In billions of Forints, unless otherwise indicated)

	2018	2019	2020	2021	2022	2023	2024
						Proj.	
Net foreign assets	10,381	10,646	11,916	10,765	10,397	10,382	11,315
Central Bank	8,690	9,168	9,389	7,985	7,582	7,511	8,370
Commercial Banks	1,692	1,478	2,527	2,780	2,815	2,871	2,946
Net domestic assets	15,255	17,078	21,647	28,252	33,103	37,294	40,516
Domestic credit	22,250	24,699	28,977	35,295	39,664	43,534	46,466
Net claims on government	7,308	7,525	8,894	11,392	13,033	14,586	15,275
From Central Bank	-1,357	-907	-1,631	1,596	1,711	2,336	2,369
From Commercial Banks	8,665	8,432	10,525	9,796	11,322	12,250	12,906
Gross Credit to the economy	14,942	17,174	20,083	23,902	26,631	28,948	31,191
From Commercial Banks	14,929	16,977	19,536	22,580	25,041	27,245	29,588
Other items, net	-6,995	-7,621	-7,330	-7,043	-6,562	-6,240	-5,951
Broad money (M3)	25,637	27,724	33,563	39,017	43,499	47,676	51,831
M2	25,212	27,610	33,496	38,870	43,335	47,496	51,635
M1	21,971	24,531	30,264	34,915	38,925	42,663	46,381
Currency in circulation	5,708	6,188	6,969	7,507	8,369	9,173	9,972
Overnight Deposits	16,263	18,343	23,295	27,408	30,556	33,490	36,409
Deposits with Maturities up to 2 years	3,241	3,079	3,232	3,955	4,409	4,833	5,254
Repos	9	9	0	35	35	35	35
Money Market Fund Shares/Units	371	68	42	22	24	27	29
Debt Securities	44	38	25	91	101	111	121
Memorandum items:							
	(Percentage change by contribution, y-o-y)						
Broad Money	11.8	8.1	21.1	16.3	11.5	9.6	8.7
NFA	10.2	1.0	4.6	-3.4	-0.9	0.0	2.0
NDA	1.7	7.1	16.5	19.7	12.4	9.6	6.8
	(Percentage change, y-o-y)						
Credit to Private Sector 1/ 2/	10.6	15.3	11.8	12.8	10.9	8.8	8.6
HUF	11.7	15.0	16.6	16.1	…	…	…
FX	7.2	16.3	-4.2	1.0	…	…	…
Bank Deposits	11.2	9.6	22.5	17.1	11.6	9.6	8.7
Bank Holdings of Government Paper (percent	19.4	17.0	21.0	18.5	18.5	18.3	17.8

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

Note: The dissolution of Sberbank in 2022, which accounted for about one percent of total bank assets, has affected the banking statistics. Its credit, securities, and deposits not taken over by other banks are shown under financial intermediaries beginning end-March 2022.

1/ Only credit to households and firms.

2/ Based on transaction data, i.e., adjusted for exchange rate changes.

Table 7. Hungary: Balance of Payments, 2018–28

(in billions of Euros, unless otherwise indicated)

	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028
							Proj.				
Current Account	0.2	-1.1	-1.6	-6.4	-13.0	-8.1	-3.6	-0.9	-0.4	0.2	0.2
Goods and service (GS), net	5.8	3.4	2.7	0.5	-7.0	-2.2	3.0	6.2	7.4	8.4	9.0
Exports	113.9	119.4	108.5	125.4	160.4	164.3	171.8	183.1	193.4	204.2	215.5
Imports	-108.1	-116.0	-105.9	-124.9	-167.5	-166.4	-168.8	-176.9	-186.0	-195.8	-206.5
Primary Income, net	-5.0	-3.7	-3.5	-5.2	-4.6	-4.7	-5.2	-5.6	-6.1	-6.5	-7.0
Secondary Income/Current transfers, net	-0.5	-0.8	-0.7	-1.7	-1.4	-1.3	-1.4	-1.5	-1.6	-1.7	-1.8
Capital Account	3.1	2.7	2.8	3.9	4.7	5.0	4.3	4.8	5.1	5.4	5.7
Financial Account 1/	-2.3	-0.4	-8.4	-10.7	-8.6	-6.5	-1.6	1.7	2.7	2.6	4.8
Direct investment, net	-2.6	-1.1	-2.4	-2.8	-2.2	-2.4	-2.8	-3.1	-3.2	-3.4	-3.6
Net acquisition of assets	4.1	1.9	0.8	4.2	4.4	4.8	5.1	5.6	5.8	6.1	6.5
Net incurrence of liabilities	6.7	3.1	3.2	7.1	6.6	7.2	7.9	8.7	9.0	9.6	10.1
Portfolio investment, net 2/	-1.1	1.6	-2.9	-2.3	-2.6	-2.3	2.1	2.8	3.4	3.2	4.3
Other investment	1.5	-0.8	-3.1	-5.5	-3.6	-1.6	-0.4	2.5	3.0	3.3	4.5
Net errors and omissions	-2.0	-1.6	-3.7	-3.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Overall Balance	3.6	0.3	5.9	4.9	0.3	3.3	2.2	2.2	2.0	2.9	1.1
Financing	-3.6	-0.3	-5.9	-4.9	-0.3	-3.3	-2.2	-2.2	-2.0	-2.9	-1.1
Gross Reserves ("-": increase)	-3.6	-0.3	-5.9	-4.9	-0.3	-3.3	-2.2	-2.2	-2.0	-2.9	-1.1
Other Official Financing (EU) (net)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum Items:											
Current account (percent of GDP)	0.2	-0.8	-1.1	-4.2	-8.1	-4.6	-1.9	-0.4	-0.2	0.1	0.1
Exports volume (percentage change)	5.0	5.4	-6.1	10.3	7.0	3.4	4.4	4.9	4.6	4.7	4.6
Imports volume (percentage change)	7.0	8.2	-3.9	9.1	6.6	2.6	4.5	4.4	4.4	4.4	4.5
Terms of trade (percentage change)	-1.0	0.6	2.1	-3.4	-5.0	2.3	3.2	1.2	0.2	0.1	0.0
Gross external debt (percent of GDP) 3/	79.3	73.0	80.9	84.6	85.4	77.2	69.8	65.0	59.7	55.6	51.7
Net International Investment Position	-51.0	-49.3	-45.8	-51.6	-61.6	-53.3	-46.3	-42.7	-39.6	-37.5	-36.1
Gross official reserves	27.4	28.4	33.7	38.4	38.7	42.0	44.3	46.4	48.4	51.4	52.4
In percent of s-t debt at remaining maturity 4/	162.1	160.8	150.8	139.4	99.8	115.1	123.6	127.9	149.9	195.6	185.9
In months of next year's imports of G&S	2.8	3.2	3.2	2.7	2.8	3.0	3.0	3.0	3.0	3.0	3.0
In percent of IMF metric	106.4	104.9	120.7	119.2	106.4	115.4	119.8	122.0	128.3	139.4	136.7

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

Table 8. Hungary: Financial Soundness Indicators for the Banking Sector, 2018–22
(In percent, unless otherwise indicated, end of period)

	2018	2019	2020	2021	2022		
					Q1	Q2	Q3
Capital							
Regulatory capital to risk-weighted assets	18.5	18.0	18.3	18.6	18.7	18.2	*17.6*
Regulatory Tier 1 capital to risk-weighted assets	16.7	15.9	16.2	17.1	17.2	16.7	*16.1*
Asset Quality							
NPLs (90 days overdue) net of provisions to capital	3.2	2.2	10.1	11.5	10.9	11.2	...
NPLs (90 days overdue) to gross loans	2.5	1.5	4.0	3.7	3.4	3.7	...
New NPL definition 1/	5.4	4.1	3.5	3.2	3.2	3.5	3.4
FX loans	23.4	23.4	21.7	19.6	20.4	21.5	...
Profitability							
ROA	1.9	2.0	0.9	*1.2*	*0.4*	*0.6*	*0.9*
ROE	19.4	19.5	9.7	12.7	4.6	6.5	*10.1*
Net interest income to gross income	47.7	46.8	52.1	53.4	54.7	57.4	...
Noninterest expenses to gross income	70.1	68.1	64.7	64.4	65.5	69.6	...
Liquidity							
Liquid assets to total assets	27.0	24.9	27.7	15.6	15.5	14.4	...
Liquid assets to short term liabilities	41.6	39.7	34.4	17.9	17.7	16.7	...
Sensitivity to Market risk							
Net open FX position to Regulatory capital	-1.0	-0.8	-1.4	...	...	...	...

Sources: IMF's *Financial Soundness Indicators Database*, while more current data from the Magyar Nemzeti Bank (MNB) are indicated in italics.

1/ New definition to better reflect the EBA methodology and the introduction of IFRS 9.

Annex I. Debt Sustainability Analysis

After the steep pandemic-driven increase in 2020, the public debt-to-GDP ratio declined by almost 3 percentage points in 2021. Despite a projected slowdown in growth and tighter financial conditions, the large fiscal consolidation plan under the baseline would help debt stay sustainable under most plausible scenarios. Considering the exceptional uncertainty and risks that may affect the debt trajectory, frontloading the adjustment is appropriate. A scenario featuring an unchanged primary deficit after 2022 would place the public debt-to-GDP ratio on an upward path. A strong fiscal framework anchored in the EU Stability and Growth pact, dampens but does not eliminate risks to debt sustainability. The track record of sustained deleveraging in the decade preceding the Covid crisis provides further reassurance.

1. A strong post pandemic recovery contributed to reducing public debt in 2021. Unprecedented policy stimulus in 2020 pushed the public debt-to-GDP ratio to almost 80 percent of GDP. In 2021, the recovery gathered strength, and both real GDP growth (7.1 percent) and negative real interest rates (around –3 percent) contributed to lower the debt-to-GDP ratio. Hungary took advantage of favorable financing conditions ahead of the expected global financial tightening in 2022, and the external financing share in total debt increased by about ½ percentage point in 2021. Short-term debt as a share of total debt remained materially unchanged between 2020 and 2021. As part of ongoing efforts to reduce vulnerabilities and refinancing risks, the average term to maturity of public debt was further increased in 2021.

2. Under the baseline, large and frontloaded fiscal consolidation is expected to rein in the primary deficit. Fiscal consolidation efforts are expected to be sustained in the medium term. The DSA is based on the following assumptions underpinning the baseline scenario:

- *Real GDP growth* slows to 4.9 and 0.5 percent in 2022 and 2023, respectively, rebounding to 3.2 percent in 2024. The growth path assumes the expected disbursement of grants from the 2021–27 EU structural funds, the RRF, and 2021-26 Next Generation EU funds.

- *GDP deflator* decelerates from 8.4 percent in 2023 to 3 percent in 2027.

- *The primary fiscal deficit* improves from 5.0 percent in 2021 to 3.7 percent in 2022, and 0.8 percent in 2023. Starting in 2024, a primary surplus of 0.6 percent of GDP, on average, is projected over the forecast horizon. Despite the deceleration in economic activity and tighter financing conditions, the improvement in the primary deficit is driven by inflation, which boosts revenues in 2022, and a package of discretionary measures underpinning the fiscal adjustment plans.

3. Exceptionally large uncertainty surrounds baseline assumptions and projections. In the past, growth forecasts' errors for Hungary have been larger (outside the interquartile range) than in other countries but less so for the primary balance and inflation. The projected fiscal adjustment appears ambitious, as it lies in the top quartile of a distribution of relevant comparators, but the authorities have a track record of commitment to restoring fiscal balances, as evidenced by the sustained deleveraging during 2011-20, following the GFC and euro area crisis. Still, global risks loom large (Annex III), posing large risks for the macroeconomic, fiscal and debt outlook.

4. The authorities' debt management strategy aims to continue reducing vulnerabilities. To reduce refinancing risk, the authorities have continued to increase the average term maturity of domestic debt. They recently reached 5.1 years average maturity from 4.1 year in 2019. They have recently accepted a slightly higher than 20 percent share in foreign currency denominated debt. They remain committed to keeping it below 25 percent, while maintaining the share of fixed-rate financing instruments—both domestic and foreign-currency denominated—between 70 and 90 percent. To mitigate risks from cross-currency exchange rate movements, foreign currency obligations—after swaps—are aimed to be 100 percent in euros.

5. Public debt is projected to decline under the baseline, amid sizeable financing needs. The public debt-to-GDP ratio is forecast to decline from 76.8 percent in 2021 to about 64 percent by 2027. Under the baseline, the primary balance will cumulatively contribute to increasing the debt to GDP ratio by 2.3 percentage points between 2022 and 2027. The interest rate-growth differential is projected to contribute to a reduction in debt by about 15.5 percentage points over the same period, as the real GDP growth rate is projected to be higher than the effective real interest rate on public debt. Gross financing needs are forecast to drop from 21.1 percent of GDP in 2021 to 11.7 percent of GDP in 2027. While the projected interest rate-growth differential and planned fiscal consolidation would place debt on a descending path, the maturity structure (about 5 years) and debt repayments' schedule on existing debt keep financing needs sizeable.

6. Growth and combined macro-fiscal shocks can have substantial impact on projected public debt and gross financing needs paths.

- *Growth shock.* A decline in growth by one standard deviation for 2 consecutive years would push the economy into a 2-year recession. Debt would reach 82.1 percent of GDP in 2024 and then decline to 76.4 percent of GDP in 2027, about 12 percentage points higher than under the baseline. Under this scenario, gross financing needs would peak at about 20 percent of GDP in 2024, then decline to 14 percent of GDP at the end of the forecast horizon.

- *Macro-fiscal shock.* Simultaneous shocks to growth, interest rate, and primary balance would increase the debt-to-GDP ratio to 85.0 percent by 2024, falling to 84.4 percent at the end of the forecast horizon. Financing needs would reach almost 17 percent in 2027.

- *Contingent liabilities shock.* Should the government have to absorb contingent liabilities equivalent to 10 percent of financial sector assets in 2023, the debt-to-GDP ratio would reach 81.9 percent in 2027 and financing needs would reach 17 percent of GDP.

- *No fiscal adjustment beyond 2022.* An unchanged primary deficit after 2022 would place the public debt-to-GDP ratio on an unsustainable path. Under such a scenario, in five years, public debt would reach 84 percent of GDP and gross financing needs about 18.5 percent of GDP.

Given authorities commitment to restoring fiscal prudence and track record of doing so, this scenario is unlikely. However, given exceptionally high uncertainty clouding the global outlook, headwinds from tighter financial conditions, and the war in Ukraine, a scenario in which authorities need to postpone or soften fiscal adjustment to dampen the impact of adverse shocks, if they materialize, cannot be ruled out.

7. Hungary's external debt vulnerabilities have increased. While the investor base remains large, Hungary, as other emerging markets, faces headwinds from tightening global financing conditions. Spreads are within the risk assessment benchmarks but have increased during 2022. Adverse terms-of-trade shocks have negatively affected the current account, and external financing needs are above the upper risk-assessment benchmark. Given Hungary's dependence on foreign energy, navigating terms-of-trade shocks remains a key policy challenge. Public debt in foreign currency and public debt held by non-residents are both within the risk-assessment benchmark range.

8. A strong fiscal framework dampens, but does not eliminate, risks to debt sustainability. Hungary's fiscal policy is bound by the European Stability and Growth Pact (SGP). In addition to commitments under the SGP, the authorities adopted strict fiscal and debt rules in 2008 and amended them in 2013. As a result, under the fiscal framework, the general government deficit must not exceed 3 percent of GDP (with SGP escape clauses), and parliament may only adopt budget laws that result in the reduction of the government debt-to-GDP ratio, until this ratio falls to below 50 percent of GDP. The rule on debt reduction can be suspended when real GDP contracts. Amid global and domestic headwinds, under the baseline, real GDP growth is projected to decelerate but remain positive next year and over the medium term. Consequently, the fiscal framework requires that, under the baseline, budgets would put debt on a downward trajectory.

Figure I.1. Hungary: Public Sector Debt Sustainability Analysis – Baseline Scenario

(In percent of GDP unless otherwise indicated)

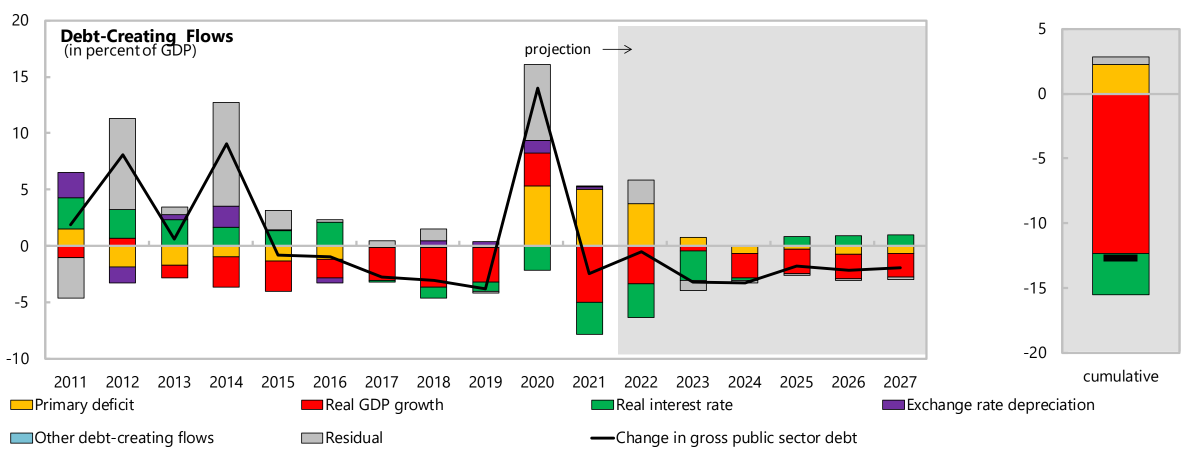
Debt, Economic and Market Indicators [1/]

	Actual			Projections					
	2011-2019 [2/]	2020	2021	2022	2023	2024	2025	2026	2027
Nominal gross public debt	69.6	79.3	76.8	76.4	73.2	70.0	68.2	66.1	64.1
Public gross financing needs	22.1	24.3	21.1	17.5	13.1	14.2	12.8	10.5	11.7
Real GDP growth (in percent)	3.0	-4.5	7.1	4.9	0.5	3.2	3.3	3.4	3.4
Inflation (GDP deflator, in percent)	3.2	6.4	6.3	7.7	8.4	5.2	3.7	3.3	3.0
Nominal GDP growth (in percent)	6.3	1.6	13.9	13.0	9.0	8.6	7.2	6.8	6.6
Effective interest rate (in percent) [4/]	5.4	3.6	3.2	3.7	4.7	4.9	5.1	4.9	4.7

As of January 05, 2023		
Sovereign Spreads		
EMBIG (bp) 3/		466
5Y CDS (bp)		212
Ratings	Foreign	Local
Moody's	Baa2	Baa2
S&Ps	BBB	BBB
Fitch	BBB	BBB

Contribution to Changes in Public Debt

	Actual			Projections							
	2011-2019	2020	2021	2022	2023	2024	2025	2026	2027	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	0.9	14.0	-2.5	-0.5	-3.2	-3.2	-1.8	-2.1	-2.0	-12.7	
Identified debt-creating flows	-1.0	7.3	-2.6	-2.6	-2.2	-3.1	-1.6	-2.0	-1.8	-13.2	
Primary deficit	-0.7	5.3	5.0	3.7	0.8	-0.6	-0.3	-0.7	-0.6	2.3	-1.2
Primary (noninterest) revenue and grants	45.5	43.4	41.1	43.7	43.5	44.2	43.4	43.3	42.8	260.9	
Primary (noninterest) expenditure	44.8	48.8	46.2	47.5	44.3	43.6	43.1	42.6	42.2	263.2	
Automatic debt dynamics [5/]	-0.4	1.9	-7.6	-6.3	-3.0	-2.5	-1.3	-1.2	-1.2	-15.5	
Interest rate/growth differential [6/]	-0.8	0.8	-7.8	-6.3	-3.0	-2.5	-1.3	-1.2	-1.2	-15.5	
Of which: real interest rate	1.2	-2.1	-2.8	-3.0	-2.6	-0.3	0.8	0.9	1.0	-3.2	
Of which: real GDP growth	-2.0	2.9	-5.0	-3.3	-0.4	-2.2	-2.2	-2.2	-2.1	-12.3	
Exchange rate depreciation [7/]	0.4	1.1	0.2	…	…	…	…	…	…	…	
Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Prefinancing (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes [8/]	2.0	6.7	0.1	2.1	-0.9	-0.2	-0.2	-0.2	-0.2	0.5	



Source: IMF staff.

1/ Public sector is defined as general government.

2/ Based on available data.

3/ EMBIG.

4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.

5/ Derived as [(r - π(1+g) - g + ae(1+r)]/(1+g+π+gπ)) times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

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

7/ The exchange rate contribution is derived from the numerator in footnote 5 as ae(1+r).

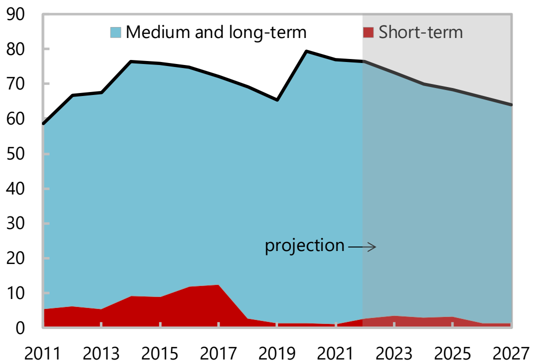
8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

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

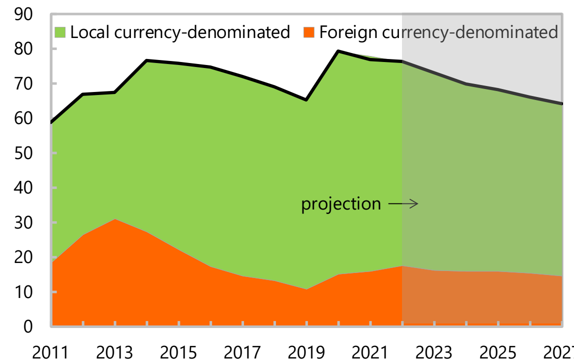
Figure I.2. Hungary: Public Debt Sustainability Analysis – Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

By Maturity
(in percent of GDP)



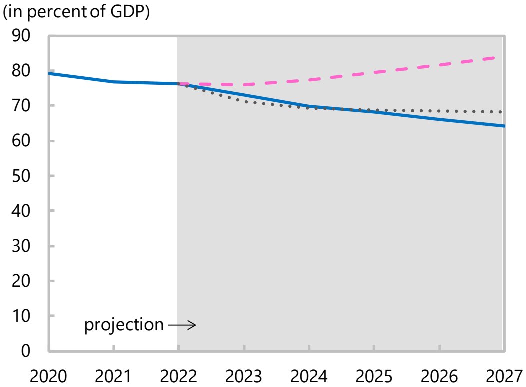
By Currency
(in percent of GDP)



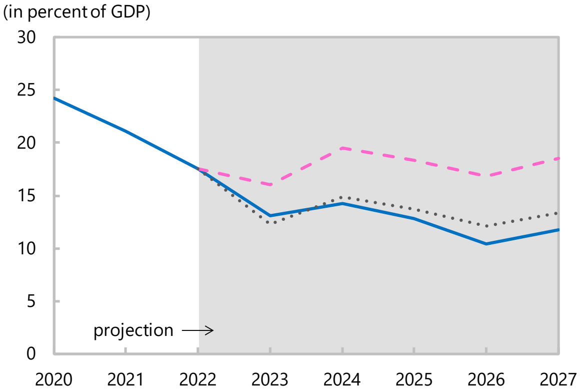
Alternative Scenarios

Baseline Historical Constant Primary Balance

Gross Nominal Public Debt
(in percent of GDP)



Public Gross Financing Needs
(in percent of GDP)



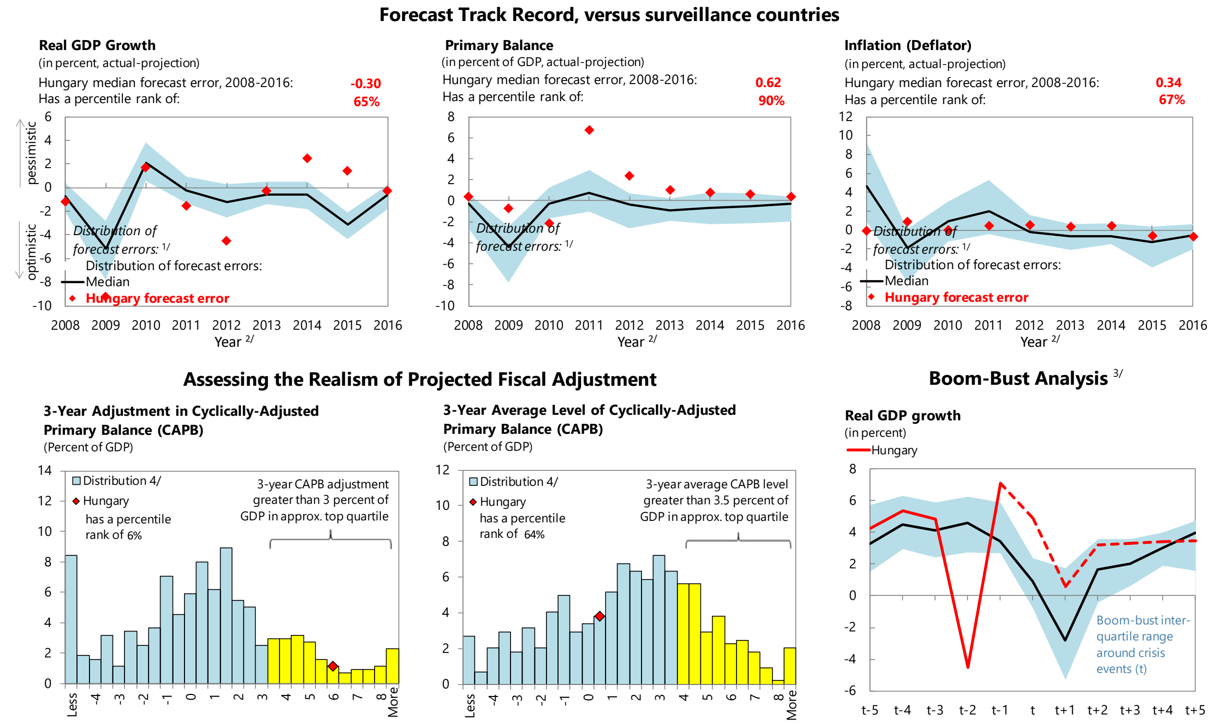
Underlying Assumptions
(in percent)

Baseline Scenario	2022	2023	2024	2025	2026	2027
Real GDP growth	4.9	0.5	3.2	3.3	3.4	3.4
Inflation	7.7	8.4	5.2	3.7	3.3	3.0
Primary Balance	-3.7	-0.8	0.6	0.3	0.7	0.6
Effective interest rate	3.7	4.7	4.9	5.1	4.9	4.7
Constant Primary Balance Scenario						
Real GDP growth	4.9	0.5	3.2	3.3	3.4	3.4
Inflation	7.7	8.4	5.2	3.7	3.3	3.0
Primary Balance	-3.7	-3.7	-3.7	-3.7	-3.7	-3.7
Effective interest rate	3.7	4.7	5.0	5.3	5.1	4.9

Historical Scenario	2022	2023	2024	2025	2026	2027
Real GDP growth	4.9	2.8	2.8	2.8	2.8	2.8
Inflation	7.7	8.4	5.2	3.7	3.3	3.0
Primary Balance	-3.7	-0.3	-0.3	-0.3	-0.3	-0.3
Effective interest rate	3.7	4.7	5.1	5.5	5.5	5.4

Source: IMF staff.

Figure I.3. Hungary: Public Debt Sustainability Analysis – Realism of Baseline Assumptions



Source : IMF Staff.

1/ Plotted distribution includes surveillance countries, percentile rank refers to all countries.

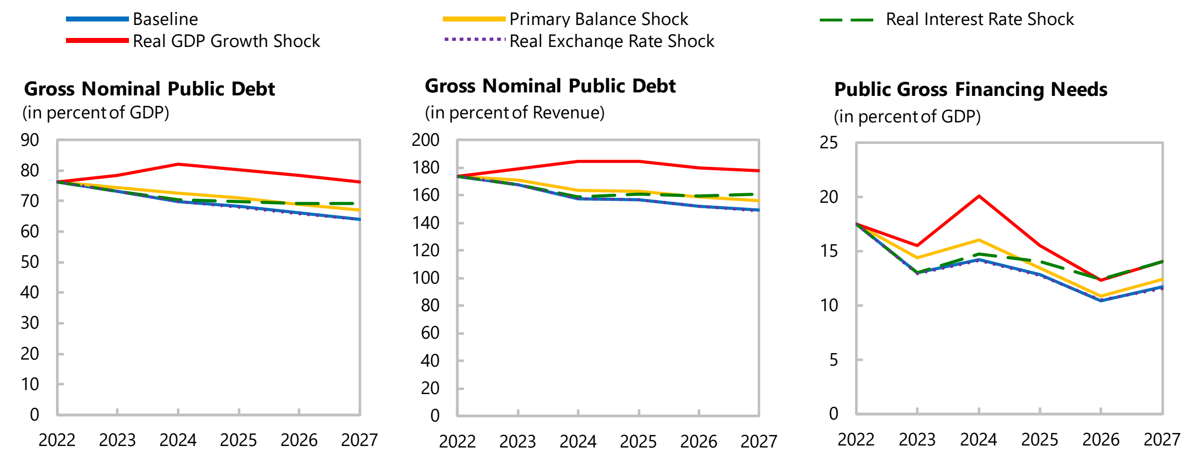
2/ Projections made in the spring WEO vintage of the preceding year.

3/ Hungary has had a cumulative increase in private sector credit of 80 percent of GDP, 2018-2021. For Hungary, t corresponds to 2022; for the distribution, t corresponds to the first year of the crisis.

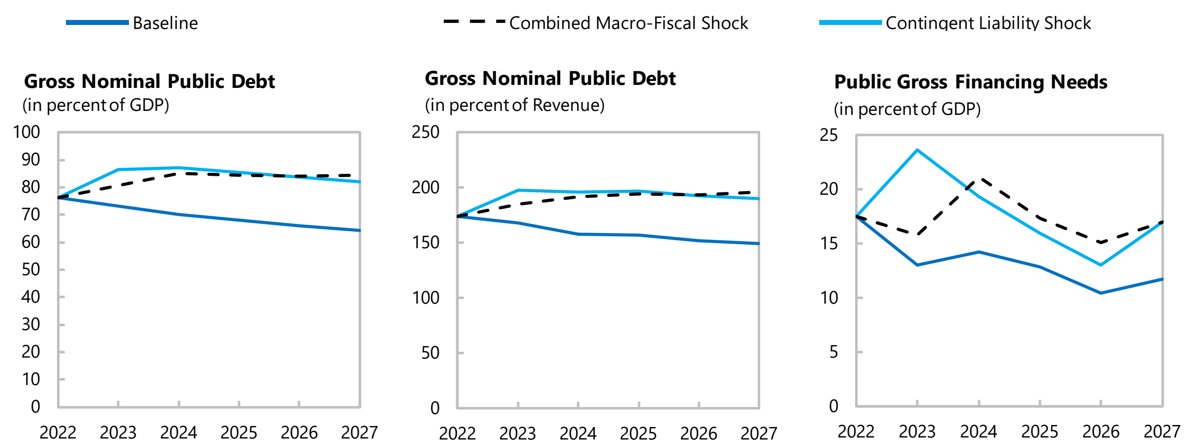
4/ Data cover annual obervations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

Figure I.4. Hungary: Public Debt Sustainability Analysis – Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions

(in percent)

Primary Balance Shock	2022	2023	2024	2025	2026	2027
Real GDP growth	4.9	0.5	3.2	3.3	3.4	3.4
Inflation	7.7	8.4	5.2	3.7	3.3	3.0
Primary balance	-3.7	-2.1	-0.7	0.3	0.7	0.6
Effective interest rate	3.7	4.7	5.0	5.3	5.0	4.8
Real Interest Rate Shock						
Real GDP growth	4.9	0.5	3.2	3.3	3.4	3.4
Inflation	7.7	8.4	5.2	3.7	3.3	3.0
Primary balance	-3.7	-0.8	0.6	0.3	0.7	0.6
Effective interest rate	3.7	4.7	5.7	6.8	7.3	7.6
Combined Shock						
Real GDP growth	4.9	-2.9	-0.2	3.3	3.4	3.4
Inflation	7.7	7.5	4.3	3.7	3.3	3.0
Primary balance	-3.7	-2.7	-3.2	0.3	0.7	0.6
Effective interest rate	3.7	4.8	5.9	7.1	7.5	7.9

Real GDP Growth Shock	2022	2023	2024	2025	2026	2027
Real GDP growth	4.9	-2.9	-0.2	3.3	3.4	3.4
Inflation	7.7	7.5	4.3	3.7	3.3	3.0
Primary balance	-3.7	-2.7	-3.2	0.3	0.7	0.6
Effective interest rate	3.7	4.7	5.1	5.5	5.2	5.0
Real Exchange Rate Shock						
Real GDP growth	4.9	0.5	3.2	3.3	3.4	3.4
Inflation	7.7	11.8	5.2	3.7	3.3	3.0
Primary balance	-3.7	-0.8	0.6	0.3	0.7	0.6
Effective interest rate	3.7	4.8	4.9	5.1	4.8	4.6
Contingent Liability Shock						
Real GDP growth	4.9	-2.9	-0.2	3.3	3.4	3.4
Inflation	7.7	7.5	4.3	3.7	3.3	3.0
Primary balance	-3.7	-10.6	0.6	0.3	0.7	0.6
Effective interest rate	3.7	5.0	5.8	5.9	5.6	5.2

Source: IMF staff.

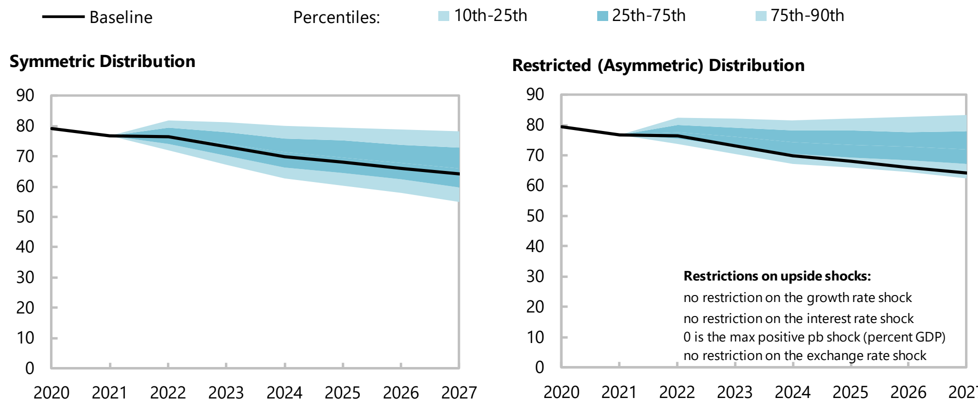
Figure I.5. Hungary: Public Debt Sustainability Analysis – Risk Assessment

Heat Map

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

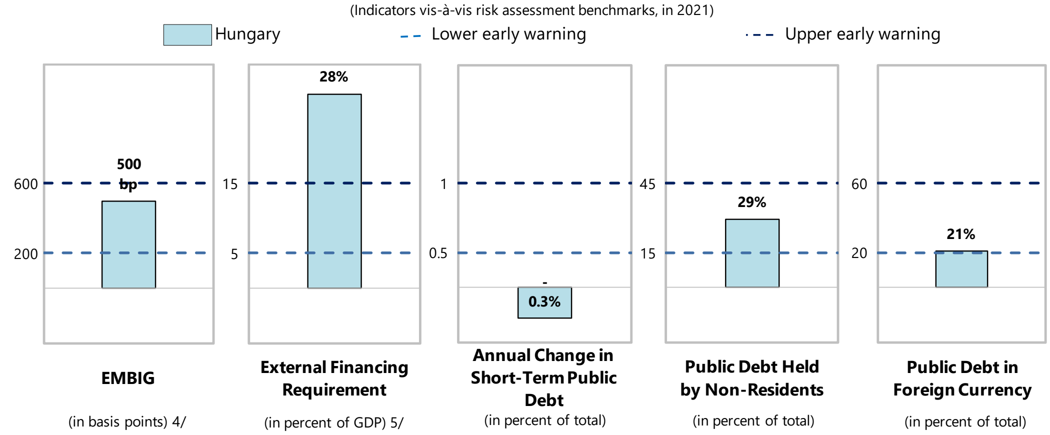
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2021)



Source: IMF staff.

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

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

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

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

4/ EMBIG, an average over the last 3 months, 10/5/2022-1/5/2023.

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

Annex II. External Sector Assessment

Impaired by major terms-of-trade shocks, supply-chain disruption, slowing external demand, and pumped-up domestic demand, Hungary's current account deficit widened significantly in 2021 and 2022. Hungary's external position in 2022 is assessed as substantially weaker than warranted by medium-term fundamentals and desirable policies.

1. **Surging global energy prices and strong import demand put significant pressure on the current account.** Energy imports led the rise in the trade deficit as prices surged while the volume balance—partly supported by domestic price caps—remained in surplus but declined. Meanwhile, exports mostly lagged behind until the third quarter when auto sector production picked up. A recovery in tourism provided some support to the services balance but was dwarfed by the surging goods deficit. Reduced incomes from temporary workers abroad lowered the income balance but an increase in EU funds absorption from the 2014-2020 MFF provided some offset. Under the baseline, declining energy prices and compressed demand would notably reduce the current account deficit in 2023 and further improvement is expected over the medium term as FDI expands export capacity and external demand gradually recovers.

2. **Significant downside risks could further deteriorate the current account and heighten balance of payments pressures.** Gross FDI inflows have been a crucial source of external financing and has been stable in Hungary, followed by government borrowing, EU funds inflows, and other capital flows as sources of external financing. Larger external financing needs in a downside scenario that widen the current account deficit would require greater government and private external borrowing amidst increased risk premia and tighter global conditions (Annex III). In a worse-case scenario, faster drawdown in liquid external assets may trigger rapid valuation losses and larger capital outflows as confidence collapses, while rapid inflation and a plummeting exchange rate could push households and firms to euroize, increasing the risk of disorderly adjustment. Considering a possible increase in market risk aversion and the deteriorated risk perception of the region and Hungary, restoring macro-balances and unlocking conditional EU funds would buttress market confidence and help advert such scenario.

3. **International reserves have remained adequate but are vulnerable to risks.** After rising to 38.4 billion euros in 2021, international reserves held broadly steady in 2022 at 38.7 billion euros. EU funds inflows and FX bonds issuances have remained sources of foreign exchange while the deteriorating current account has been a drag on reserves in 2022. High uncertainty around the baseline and significant downside risks could lower reserves below the adequacy range. So far, however, reserves have remained adequate and are expected to improve along with the current account under the baseline.

4. **Hungary's net international investment position (NIIP) improved in 2021 and by 2022:Q3.** The NIIP improved from -49 percent of GDP in 2020 to -46 percent of GDP in 2021 and -37 percent of GDP by the third quarter of 2022. The improvement stems from rising holdings of financial assets abroad and lower external liabilities mainly reflecting a reduction in equity holdings

by foreign investors. External debt liabilities through 2022:Q3 held broadly steady as a modest decline in long-term external public debt-to-GDP (following an increase during the pandemic in 2020) partially offset a rise in private debt-to-GDP. While transactions increased the stock of external debt, revaluation effects of outstanding debt from rising yields broadly offset it. An increase in external short-term debt at remaining maturity in 2022 is also due to maturing medium- and long-term debt of the general government and banking sectors in 2023. The NIIP is expected to remain broadly steady under the baseline.

5. Hungary's 2022 external position is preliminary assessed to be substantially weaker than warranted by medium-term fundamentals and desirable policies. The EBA models yield mixed preliminary results with exceptionally high residuals, pointing to a range of estimates for the valuation of the real effective exchange rate (REER) of about -32 percent to +6 percent.

- The *Current Account (CA) approach* estimates a current account gap of -5.1 percent of GDP, which implies an exchange rate *overvaluation* of 8.0 percent. The policy gap contributed -0.3 percent of GDP, with the contribution of the fiscal gap (-1.2 percent of GDP overall and -4.0 percent domestically) offset by higher contributions of credit and health expenditures. The cyclical-adjustment contributed -1.2 percent of GDP. In part, the large residual may reflect the impact of regulatory policies not captured by the model's policy gap variable. Regulated retail energy price caps have led to stable retail demand for gas and electricity and an increased demand for motor fuels, inhibiting demand adjustment to prices and contributing to a larger current account deficit.
- The *External Sustainability* (ES) approach suggests that the exchange rate is *overvalued* by 6.7 percent. However, this is based on stabilizing Hungary's net foreign asset position (in percent of GDP) at the 2022 level, which is an outlier year in the baseline given high energy import prices and a large deterioration in the current account. This approach is inconsistent with the current account balance returning to positive territory over the medium-term.
- The two *REER* approaches suggest that the real exchange rate is *undervalued* in the range of 5 (Index model) to 32 percent (level model). However, they produce especially large residuals (29 percent in the level model) that are not explained by the policy variables.
- Staff assesses the external position as substantially weaker than warranted by fundamentals and desirable policies. Looking ahead, an easing of commodity prices, tighter macroeconomic policies, and a relaxation of price caps would help move the external position closer to levels consistent with medium-term fundamentals and desired policy settings.

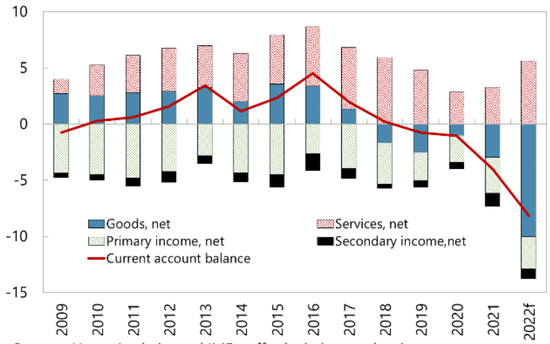
Table II.1. Hungary: 2022 External Balance Assessment Results

	CA	REER-level	REER-index	ES
		(percent of GDP)		
CA balance	-8.1	…	…	…
Cyclically-adjusted CA	-6.9	…	…	…
Model CA norm (percent of GDP)	-1.8	…	…	…
CA-stabilizing NFA at 2022 level	…	…	…	-2.6
Model residual	-4.8	-29.0	-3.4	…
Model CA gap	**-5.1**	**…**	**…**	**-4.3**
Semi-elasticity of CA/GDP to REER	0.64	…	…	0.64
Exchange-rate gap (percent)	**8.0**	**-32.3**	**-5.6**	**6.7**

Source: October 2022 External Balance Assessment.

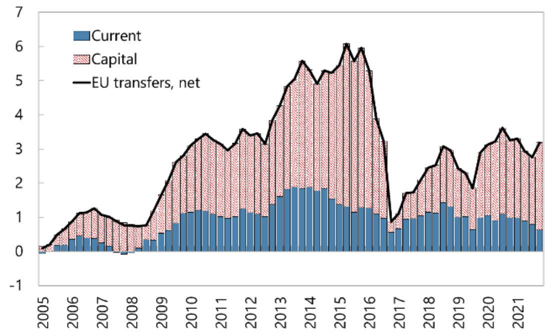
Figure II.1. Hungary: External Indicators

Current Account Balance
(Percent of GDP)



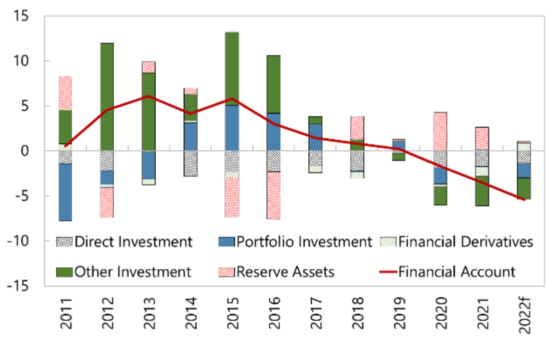
Sources: Haver Analytics and IMF staff calculations and estimates

EU Funds Transfers
(Percent of GDP, 4-quarter moving sum)



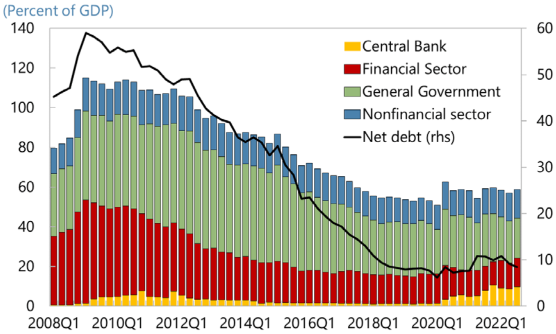
Sources: MNB and IMF staff calculations

Financial Account Components, Net
(Percent of GDP)



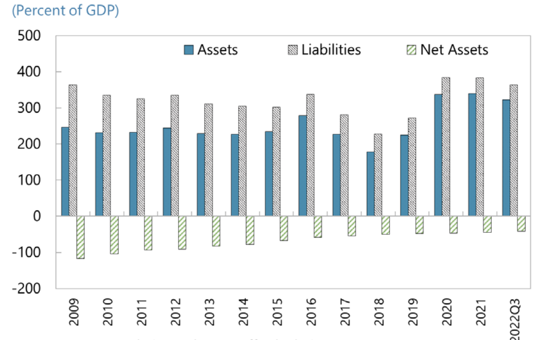
Sources: Haver Analytics and IMF staff calculations and estimates

External Debt by Sector /1
(Percent of GDP)



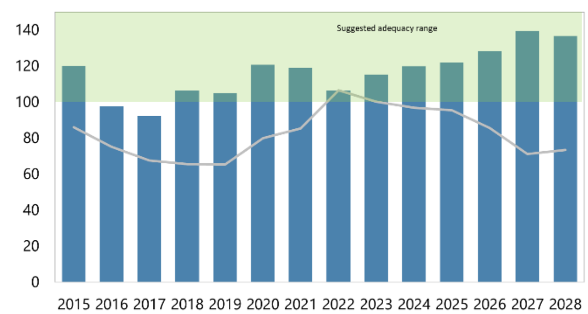
Sources: MNB, Haver Anayltics, and IMF staff calculations. Data through 2022:Q3.
1/ Sectoral debt excludes intercompany/direct investment instruments

International Investment Position
(Percent of GDP)



Sources: Haver Analytics and IMF staff calculations
Note: 2022Q3 expressed as a percent of four quarter rolling GDP

International Reserve Cover
(Reserves as a percentage of metric)



Sources: Hungarian National Bank; and IMF staff calculations.
Note 1: Projections for 2022-27.
Note 2: Based on IMF, 2015, "Assessing Reserve Adequacy-Specific Proposals", IMF Policy Paper.

Annex III. Risk Assessment Matrix[1]

Risks	Likelihood	Impact of Risk	Policy Response
Global risks			
Intensifying spillovers from Russia's war in Ukraine. Further sanctions resulting from the war and related uncertainties exacerbate trade and financial disruptions and commodity price volatility.	H	**High:** Commodity price volatility would likely intensify terms of trade deterioration, external imbalances, and inflationary pressures.	Fiscal policy should remain tight while making room for additional support the vulnerable Central bank should stand ready to smooth excess exchange rate volatility and tighten further to reduce second-round effects on inflation.
Commodity price shocks. A combination of continuing supply disruptions (e.g., due to conflicts and export restrictions) and negative demand shocks causes recurrent commodity price volatility and social and economic instability	H	**High** (same as above)	Same as above.
Abrupt global slowdown or recession. • The fallout from the war in Ukraine is exacerbated by a gas shutoff by Russia, resulting in acute gas shortages and further supply disruptions, which triggers an EU recession.	H	**High:** Gas and power shortages in industry will lead to output and job losses. Increased credit losses effects banks. Fiscal borrowing costs soar. Financial markets reprice risk assets.	Pace of fiscal tightening could afford to slow if inflationary pressures do not increase. Encourage greater price-induced demand reduction by further relaxing utility price caps, implement national emergency contingency plans, and extend targeted support to industry to avoid widespread closures and spillovers to financial sector.
• Sharp tightening of global financial conditions combined with volatile commodity prices leads to spiking risk premia, widening of external imbalances and fiscal pressures, capital outflows, and sudden stops	H	**Medium:** Despite relatively low reliance on external financing, market pressures on yields and currency will raise fiscal and external imbalances.	Tighten monetary policy further and intervene in the FX market if necessary to prevent market disfunction. Allow demand to adjust and reduce the current account deficit. Tighten fiscal policy.

[1] The risk assessment matrix (RAM) shows events that could materially alter the baseline path. The relative likelihood is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability between 30 and 50 percent).

Risks	Likelihood	Impact of Risk	Policy Response
De-anchoring of inflation expectations and stagflation. Central banks tighten monetary policy more than envisaged leading to weaker global demand, currency depreciations in EMDEs, and sovereign defaults. Together, this could lead to the onset of stagflation.	M	**Medium:** Higher rates for longer will prolong the recovery and make fiscal adjustment costlier.	Tighten monetary policy further and intervene in the FX market if necessary to prevent market disfunction. Ensure fiscal policy supports monetary policy, which may require further adjustment.
Deepening geo-economic fragmentation. Broadening of conflicts and reduced international cooperation accelerate deglobalization, resulting in a reconfiguration of trade, supply disruptions, and lower potential growth.	H	**High:** Reduced FDI and contribution of auto industry value chains lowers actual and potential output employment. Energy supply security weakens.	Prioritize structural reforms and investments that support potential output and productivity.
Domestic risks			
Incomplete or untimely delivery of Next Generation EU funds and cohesion funds. Unmet conditions to unlock funds lead to delays or incomplete disbursements of EU funds. Confidence effects raise financial market pressures via lower asset prices, higher risk premia and greater exchange rate depreciation.	M	**Medium:** Reduced or delayed investment, delayed FX inflows, increased external borrowing needs and costs.	Accelerate pace of investments and reforms to unlock EU funds and reassure markets through demonstrated commitment to strong economic relations with EU. The central bank should stand ready to tighten or intervene in FX markets if conditions become disorderly.
More entrenched inflation. Core inflation is more persistent, remaining elevated for longer.	M	**High:** Wage pressures intensify and feed into a wage-price spiral. Real household incomes erode. Credit risk and non-performing loans rise, deteriorating bank balance sheets.	Further tighten monetary policy to slow demand and anchor expectations. Fiscal policy should also further tighten to complement monetary policy in dampening demand and slowing inflation.
Widespread firm closures due to high energy prices. Persistence of high energy prices reduces firms' ability to meet operating costs.	M	**Medium:** Firm closures result in lower output, higher unemployment, and lower wage growth amidst persistent high inflation.	Extend targeted and temporary support to firms while encouraging energy savings.

Annex IV. Authorities' Response to Past IMF Policy Recommendations

IMF 2021 Article IV Recommendations	Authorities' Response
Fiscal Policy	
1. Scale back accommodative stance if recovery is faster than expected. 2. Create fiscal space by implementing a mix of growth-friendly revenue and expenditure measures and by rationalizing public sector employment. 3. Make publicly available all COVID-related procurement contracts in support of fiscal transparency.	1. Fiscal policy loosened late 2021/early 2022. The fiscal stance subsequently tightened. 2. No progress. Fiscal space was reduced by stimulus and energy prices. The government is tightening but the composition of the adjustment could be improved. 3. As part of reforms to address rule of law concerns by the EU, the government is preparing a publicly-available online data registry on public procurement bidders, including information on beneficial ownership. Timeline is under discussion with the EC.
Monetary and Financial Policies	
1. Review effectiveness of unconventional tools and only conduct asset purchases in corporate securities secondary market. 2. Address Moneyval recommendations in strengthening AML framework.	1. Asset purchase program was discontinued end-2021, and authorities now relying on more conventional policy tools. 2. Ongoing.
Structural Reforms	
1. Review unemployment benefits structure. 2. Enhance training and life-long learning programs. 3. Increase carbon pricing. 4. Incentivize green investment through fiscal policy, including transparent fiscal subsidies, rather than the macroprudential framework.	1. No progress. 2. No progress. 3. Energy price shocks have driven focus on mitigating impact and securing short-term gas supplies. 4. Part of energy strategies.

INTERNATIONAL MONETARY FUND

HUNGARY

January 17, 2023

STAFF REPORT FOR THE 2022 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Prepared By

European Department
In Consultation with Other Departments

CONTENTS

FUND RELATIONS

(As of December 31, 2022)

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

General Resources Account:

	SDR Million	Percent Quota
Quota	1,940.00	100.00
Fund holdings of currency (Holdings Rate)	1,640.76	84.58
Reserve tranche position	301.18	15.52

SDR Department:

	SDR Million	Percent Allocation
Net cumulative allocation	2,850.45	100.00
Holdings	1,855.92	65.11

Outstanding Purchases and Loans: None

Latest Financial Arrangements:

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

Projected Payments to Fund:

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

		Forthcoming			
	2023	**2024**	**2025**	**2026**	**2027**
Principal					
Charges/Interest	28.76	29.05	29.02	29.04	29.04
Total	28.76	29.05	29.02	29.04	29.04

Current Status of Safeguards Assessment:

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

Exchange Rate Arrangements:

Hungary's de jure exchange rate arrangement is free floating, and the de facto exchange rate arrangement is classified as floating. Hungary has accepted the obligations of Article VIII and maintains an exchange rate system free of multiple currency practices and restrictions on the making of payments and transfers on current international transactions except for those maintained solely for the preservation of national or international security and that have been notified to the Fund pursuant to Executive Board Decision No. 144-(52/51).

Article IV Consultation:

Hungary is on a 12-month consultation cycle. The last Article IV Board discussion took place on June 18, 2021, on a lapse of time basis. The associated the staff report is available at https://www.imf.org/en/Publications/CR/Issues/2021/06/22/Hungary-2021-Article-IV-Consultation-Press-Release-and-Staff-Report-461121

Technical Assistance: See the table below.

Hungary: Technical Assistance from the Fund, FY2010–2022

Department	Purpose	Date
MCM	Banking Supervision	June 2009
LEG	Bank Resolution Framework	September 2009
FAD	Expenditure Policy	October 2009
MCM	Monetary Policy	February 2010
FAD	Expenditure Policy	June 2010
MCM	Financial Stability	July 2010
FAD	Tax Policy	September 2010
MCM	Financial Stability	November 2010
MCM	Monetary and Foreign Exchange Policy	June 2011
FAD	Fiscal Federalism	October 2011
MCM	Monetary and Foreign Exchange Policy	November 2011
LEG	VAT Fraud and Anti-Money Laundering Activities	January 2013
LEG	Bank Resolution and Crisis Management	November 2013
MCM	Operational Aspects of Establishing an Asset Management Company	January 2015 and June 2015
FAD	Workshop on Revenue Forecasting and Micro-simulation Analysis	January 2016
FAD	PIT and CIT Micro-Simulation	January 2018
FAD	VAT Gap Analysis	February 2018
FAD	Revenue Administration	January 2020 and February 2020

STATISTICAL ISSUES

Assessment of Data Adequacy for Surveillance

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

- **Government Finance Statistics**: The statistical authorities compile and disseminate comprehensive general government annual and quarterly accrual-based data according to the ESA 2010 methodology. The data include non-financial accounts, financial accounts, and financial balance sheet. These data are bridged into the GFSM 2014 framework and provided to the Fund through Eurostat for dissemination in the International Financial Statistics and the GFS yearbooks. However, there is some room to further improve how data is provided to the Fund to facilitate surveillance. Data on central government revenue and expenditure arrears as well as that on local government revenues and expenditures, and financial statements of state-owned enterprises have been readily provided to the mission team by the authorities upon request, but provision of this data on an automatic basis would facilitate the monitoring of obligations on an accrual basis and allow for closer regular monitoring of the general government.

- **Monetary and Financial Statistics**: Monthly monetary data consisting of the central bank and other depository corporations which accords to the IMF's Monetary and Financial Statistics Manual are reported by the authorities to STA databases. The source data are obtained through a gateway arrangement with the European Central Bank and are based on the ECB framework for collecting, compiling, and reporting monetary data. Hungary also reports several data and indicators of the Financial Access Survey (FAS), including mobile and internet banking, mobile money, and the two indicators (commercial bank branches per 100,000 adults and ATMs per 100,000 adults) adopted by the UN to monitor Target 8.10 of the Sustainable Development Goals (SDGs). Hungary doesn't report gender-disaggregated FAS data.

- **Financial Sector Surveillance:** Hungary reports 16 core and 5 additional Financial Soundness Indicators (FSIs) for DTs and two additional FSIs on real estate markets on a quarterly basis. The latest FSIs and metadata are available on the IMF's FSI webpage.

- **External sector statistics:** Hungary reports quarterly BOP and IIP statistics to the IMF's STA on a timely basis and in line with the sixth edition of the Balance of Payments and International Investment Position Manual (BPM6). Hungary also participates in the semi-annual Coordinated Portfolio Investment Survey and the annual Coordinated Investment Survey, and disseminates monthly reserves data using the International Reserves and Foreign Currency Liquidity Template.

Data Standards and Quality

- Adherer to the Fund's Special Data Dissemination Standard (SDDS) Plus since July 2022.

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

Hungary: Table of Common Indicators Required for Surveillance

(as of January 13, 2023)

	Date of latest observation	Date received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of publication[7]	Memo Items:	
						Data Quality – Methodological soundness[8]	Data Quality Accuracy and reliability[9]
Exchange Rates	01/12/2023	01/12/2023	D and M	D and M	D and M		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	December 2022	01/13/2023	M	M	M		
Reserve/Base Money	December 2022	01/04/2023	M	M	M	O,O,LO,LO	O,O,O,O,LO
Broad Money	December 2022	01/13/2023	M	M	M		
Central Bank Balance Sheet	December 2022	01/13/2023	M	M	M		
Consolidated Balance Sheet of the Banking System	November 2022	01/04/2023	M	M	M		
Interest Rates[2]	November 2022	01/04/2023	M	M	M		
Consumer Price Index	December 2022	01/13/2023	M	M	M	O,O,O,O	O,O,O,O,NO
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	2021	09/21/2022	A	A	A	O,LNO,LO,O	LO,O,O,O,NO
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	November 2022	12/08/2022	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Q3 2022	01/03/2023	Q	Q	Q		
External Current Account Balance	Q3 2022	12/22/2022	Q	Q	Q	O,LO,LO,LO	O,O,O,O,NO
Exports and Imports of Goods and Services	Q3 2022	12/22/2022	Q	Q	Q		
GDP/GNP	Q3 2022	12/03/2022	Q	Q	Q	O,O,O,LO	O,LO,O,O,NO
Gross External Debt	Q3 2022	12/22/2022	Q	Q	Q		
International investment Position [6]	Q3 2022	12/22/2022	Q	Q	Q		

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds. Daily data are readily available.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Includes external gross financial asset and liability positions vis-à-vis nonresidents.
[7] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A); Irregular (I); Not Available (NA).
[8] Reflects the assessment provided in the data ROSC and Substantive Update published in May 2001 and July 2004, respectively, and based on the findings of the respective missions that took place during January 2001 and January 2004 for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning (respectively) concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O), largely observed (LO), largely not observed (LNO), or not observed (NO).
[9] Same as footnote 8, except referring to international standards concerning (respectively) source data, statistical techniques, assessment and validation of source data, assessment and validation of intermediate data and statistical outputs, and revision studies.

Statement by Mr. Palotai and Mr. Meizer on Hungary - 2022 Article IV Consultation
Executive Board Meeting
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On behalf of the Hungarian authorities, we would like to thank Mr. Jean-François Dauphin and his team for the constructive and insightful discussions during the Article IV mission as well as their continued engagement. The authorities greatly value the time and effort staff spent on better understanding the current context of the Hungarian economy and policy priorities, especially at a time when the repercussions of geo-economic fragmentation pose severe challenges to the whole region. Despite a confluence of external shocks, the Hungarian economy has proven to be resilient in recent years. To keep the economy on a sustainable development path, protecting macroeconomic stability through a consistent and sufficiently targeted policy mix remains a high priority of the Hungarian authorities, while advancing the structural reform agenda is also in the focus. Candid and constructive exchanges of views on policy choices continue to provide valuable inputs for the authorities. They broadly agree with the thrust of staff's appraisal and the findings of the Selected Issues Papers.

Macroeconomic developments and outlook

Hungary's robust economic recovery from the COVID-19 pandemic has been adversely impacted by Russia's war against Ukraine and the escalation of sanctions, but has nevertheless remained on a solid footing. The Hungarian economy had returned to its pre-pandemic level by mid-2021, and registered a remarkable annual GDP growth of 7.1 percent in 2021. Spillovers from geopolitical tensions have subsequently been weighing on the performance of the Hungarian economy through multiple channels, including through surging energy prices, disrupted trade relations and heightened external uncertainties, but the growth momentum was nevertheless maintained in the first half of 2022 and the Hungarian economy is estimated to have grown by at least 4.5 percent in 2022. Market services and industry, even though with decreasing contributions, remained the main drivers of economic growth, while agriculture hampered growth due to an extraordinary drought in the country. Looking ahead, in parallel with weakening domestic demand and rising corporate costs, economic activity is also showing signs of moderation, but the Hungarian economy can still avoid recession and the overall growth performance will likely be above regional peers in 2023. The investment rate is projected to stabilize around 29 percent. Meanwhile, employment is still at historically high levels, and the unemployment rate is projected to stay below 4 percent.

Due to a worsening energy balance, the current account deficit has temporarily but significantly increased in 2022, before starting to shrink in 2023. Like in the whole region, the terms-of-trade deteriorated significantly due to surging mineral fuel prices. The costs of imported energy more than doubled, causing the imported energy bill to reach around 10 percent of GDP in 2022. The strong fundamentals of the Hungarian economy are well reflected in the fact that the current account balance excluding the energy account remained in surplus. Meanwhile, net foreign direct investment has continued to rise, largely related to new investments by manufacturing companies. With the normalizing global economic environment and the utilization of new export capacities, the external position is expected to improve significantly from 2024 onwards.

After steady price increases which were mostly driven by supply side shocks, inflation is projected to peak in the coming months, and then to decline in a progressive manner. Average annual inflation reached 14.5 percent in 2022, which largely corresponds to the data in several EU countries in the CEE region. The high price increases were mainly attributable to the soaring global energy and food prices, but the unusual severe drought in Hungary also added to the inflationary pressures. Accordingly, processed food prices contributed the most to the rise in core inflation. Although the annual headline inflation remained above 20 percent in December 2022, falling commodity prices and other global factors as well as a cooling of the domestic economy will have an increasingly strong disinflationary effect going forward. From the middle of the year, base effects will also contribute to a faster decline in the consumer price index, which may subsequently moderate to single-digits by end-2023. Looking further ahead, inflation is expected to return to the central bank's tolerance band in 2024. In that regard, it is important that longer-term inflation expectations of analysts are still anchored and remained around the upper side of the tolerance band of 4 percent. However, with due attention to the persistent nature of inflationary pressures, including changes in companies' repricing practices, close monitoring of second-round effects as well as guarding against the risk of high inflation becoming more entrenched, remain essential.

While risks to the outlook have recently become more balanced, vigilance against still elevated downside risks is warranted. Adverse risk scenarios are largely linked to the uncertain course of the war in Ukraine, the energy crisis in Europe as well as structural changes in inflation developments. As one of the most open economies in the world, Hungary is exposed to deteriorating external conditions; the policy measures, however, remain strongly focused on strengthening economic resilience. Equally, the authorities remain vigilant against the build-up of macroeconomic vulnerabilities and stand ready to address risks.

Fiscal policies

Facing a series of external shocks, fiscal policy has been proactively calibrated with the explicit aim of protecting the fundamentals of economic activity and limiting the socio-economic scars, while also safeguarding debt sustainability. Consequently, the government continued to put a high premium on preserving achievements in the labor market as well as on policies supporting families. With a view to support stability and security goals, it also set up a special utility protection and a defense fund within the budget. In the course of 2022, a broad set of measures was implemented to keep the fiscal target within reach, even in spite of the sharply deteriorating external environment. These adjustments were mostly driven by streamlining expenditures but were also underpinned by revenue mobilization measures. The government postponed a large proportion of public investments, while current expenditures in ministry budgets were also cut. Cognizant of the persistent energy crisis, the government decided to narrow the access to the long-standing system of subsidized utility prices available to households, maintaining this system up to the average consumption only. On the revenue side, in the spirit of social responsibility, the government – like a range of countries at a later stage – introduced windfall taxes on energy, banking and a few other sectors. These taxes have been typically imposed on a temporary basis and affected only a part of extra profits. Furthermore, the authorities have continuously been providing targeted assistance to refugees fleeing from the war in Ukraine. The government sector's accrual-based deficit as a percentage of GDP may amount to 6.1 percent in

2022 in relation to the special natural gas reserve accumulation accounting for about 1.2 percent of GDP.

Supporting households and SMEs in coping with high energy and food prices has become a key priority for the government, with an ever-increasing emphasis on the appropriate targeting of these measures. In the government's view, a set of price caps have allowed more space for domestic actors to adjust to the new economic environment and thus played an important role in the transition period. There is broad agreement on the need to phase out these regulatory measures, but the government is in favor of a gradual approach. Some important steps, however, have already been taken. The above-mentioned overhaul of the utility price caps deserves particular attention in that regard. With the introduction of a so-called 'block pricing' system, in which higher-usage households pay more for natural gas and electricity, there are clear incentives to lower consumption. As a result, also considering other measures in public institutions, the natural gas consumption significantly declined from the beginning of the heating season – even if controlled for the effects of milder weather. After gradually narrowing the access to price-capped motor fuels, this scheme has been completely phased out at the end of 2022. Interest rate caps, mainly aimed at outstanding loans, have been introduced by the government with the aim of temporarily alleviating burdens on the household and SME sectors. To cushion the impact of surging food prices, the government also fixed the price of certain staple food products. These latter administrative measures are still in place but have been introduced in a time-limited manner.

Fiscal prudence remains a key priority for 2023. Since the external environment has fundamentally changed following the first adoption of the 2023 budget, the government submitted a revised version of the annual budget to Parliament in January 2023. Although the maintenance of the block pricing energy system necessitated a slight increase in the initial deficit target from 3.5 to 3.9 percent, this still envisages a decisive fiscal consolidation for the year. In addition to Hungary's proven track record in meeting deficit targets, it is also important to note that the government, in line with the recommendations of the Fiscal Council, is also determined to use any revenues stemming from higher-than-expected economic growth to reduce the fiscal deficit.

The government, in conformity with their constitutional obligation, is firmly resolved to keep public debt on a declining path. To anchor the sustainability of debt dynamics and keep fiscal risks stemming from adverse scenarios in check, the government has been embarking on a growth-friendly multi-year fiscal consolidation. With this aim, the government envisages continuously decreasing deficit targets, dipping below 3 percent of GDP in 2024. Together with a dynamic expansion in nominal GDP and a more subdued debt issuance, the authorities expect a steady decline in the debt ratio over the forecast horizon. The gross government debt-to-GDP ratio is projected to fall to around 70 percent by end-2023. Taking advantage of proactive debt management operations, the authorities attach high importance to lengthening average debt maturity, while also keeping the share of FX dominated debt below 30 percent.

Monetary and financial policies

The primary objective of the MNB is to achieve and maintain price stability. In full compliance with its mandate, the central bank of Hungary (Magyar Nemzeti Bank, MNB) has played a prominent role in buttressing macrofinancial stability and resilience over the

past decade. Without prejudice to its primary objective, the MNB preserves financial stability and supports the government's economic policy, as well as its policy on environmental sustainability. The MNB appreciates that staff took a closer look at its operations over a decade's horizon, with special attention to the links between its objectives and instruments. Relatedly, the MNB also welcomes staff's general conclusion that changes of monetary operations have fallen within its statutory mandate, while being clearly communicated and generally smoothly implemented. The MNB firmly believes in taking a proactive approach to monetary policy formulation and implementation, which evidently generated outstanding improvements in a number of areas during the examined period.

As for recent developments, the MNB has acted resolutely to rein in inflationary pressures and anchor inflation expectations. The MNB also welcome staff's assessment that monetary tightening to date has been appropriate. Recognizing the early signs of changing patterns of global inflation developments during the recovery from the COVID-19 pandemic and associated domestic developments, the MNB launched an interest rate hiking cycle already in June 2021, as the first central bank in the EU. The MNB subsequently raised the central bank base rate in a data-dependent manner, with a total of 17 steps, by more than 12 percentage points, to 13 percent. After the forward-looking real interest rates have entered into positive territory and risks around inflation became symmetric by September 2022, the Monetary Council decided to stop the base rate hike cycle and continued the tightening of monetary conditions in a more targeted way with the tightening of liquidity.

While keeping its focus on ensuring price stability, the MNB's recent policy measures have also been centered on maintaining market stability and strengthening monetary policy transmission along with mopping out excess liquidity. While the Monetary Council has maintained its assessment that the current level of the base rate is adequate to manage fundamental inflation risks, in a more turbulent period for financial markets in the middle of autumn, the Council, *inter alia*, also introduced new o/n deposit quick tenders with higher interest rate conditions than the base rate and significantly raised the upper bound of the interest rate corridor altogether with the explicit aim of warding off financial stability risks and thus, a potential new round of inflationary pressures. In parallel, a broad set of instruments has been introduced to absorb interbank HUF liquidity on a longer term as well; i.e., the one-week discount bill, the long-term deposit tender and the revised reserve requirement system. To this end, the MNB has recently also announced to increase the minimum reserve requirements to 10 percent from April 2023.

The MNB remains firmly committed to bringing back inflation to the target, and consequently, also agrees with the need to maintain tight monetary conditions for a prolonged period of time. The Monetary Council continues to thoroughly assess economic and financial market developments and stands ready to take appropriate actions – using every instrument in its monetary policy toolkit – should risks increase.

In the same breath, the MNB places high value on keeping financial risks under close monitoring and facilitating futureproofing of the financial sector. As a result, the financial sector also remains resilient. The Hungarian banking sector is stable, and entered the current complex, challenging period with significant capital position and liquidity reserves as well as adequate shock resiliency. Following the phasing out of the general loan repayment moratorium, the NPL ratios remained relatively low, at around 4 percent. Although the portfolio quality is still largely favorable historically, duly considering complex effects stemming from the changing interest rate and economic environment, the MNB keeps a close eye on associated portfolio risks. Housing market developments, where early signs of a slowdown can already be seen after a multi-year upcycle, are assessed in detail. A broad set of macroprudential policy tools is in place in Hungary which greatly reduces vulnerabilities to several systemic shocks. Furthermore, with the aim of bolstering sustainable development, the MNB takes concerted efforts to promote green and digital transformations in the financial sector.

Structural policies

Ensuring energy security on a sustainable basis is a cornerstone of the authorities' structural agenda. Being a landlocked country, Hungary's heating systems are heavily dependent on natural gas and most natural gas has been imported through pipelines from Russia. Similarly, also in the case of crude oil, it necessarily takes time for Hungary to adjust to the rapidly evolving energy landscape and current policy choices have to be made accepting existing physical realities. Albeit the government has made important strides in upgrading the transmission system and building new interconnectors with the neighboring countries over the last decade, the integration of the European natural gas and oil markets is still not developed enough to ensure efficient and affordable access for Hungary to fully replace its energy imports from Russia. Along with that, the key to maintaining energy security continues to lie in greater diversification, both in terms of the energy sources and energy mix, and the authorities remain steadfast towards meeting this objective.

In parallel with diversification efforts, laying the foundations of a more sustainable and efficient energy system is equally important. Despite the ongoing energy crisis, the authorities remain committed to achieve their ambitious emission reduction targets by 2030 and climate neutrality by 2050. The carbon neutrality goal is also set by law in Hungary. Duly considering the appreciation of the energy and climate policies, a systemic overhaul of the Hungarian energy system is already underway, and to support these objectives, a new, separate Ministry of Energy has recently been set up. After Hungary has achieved one of the most dynamic growth rates in Europe in the field of installing new solar capacities in recent years, creating the appropriate environment for further expansion of renewables remains a high priority. In parallel, with curbing gas consumption, nuclear power generation remains a major pillar of the energy mix and a carbon-free future. Similarly, the authorities attach high importance to fostering energy efficiency through a broad set of policies. Among other things, a special energy-efficiency scheme has already been launched to support energy-intensive factories.

Governance frameworks broadly correspond to the EU average according to a wide range of objective indicators. However, to improve perceptions, the government, in close dialogue with EU institutions, decided to undertake targeted reform measures on this front. Although the government has reservations about the application of the EU's conditionality mechanism to Hungary, taking a constructive approach, they have made significant efforts to resolve the points of disputes and elaborated a set of mutually reinforcing measures to strengthen respective governance frameworks. A new and independent Integrity Authority, tasked with investigating fraud, conflicts of interest and other violations related to the use of EU funds, has been set up. The government is also undertaking comprehensive judicial reforms, *inter alia,* to further underpin judiciary independence. Concurrently, promoting a more competitive public procurement system is also high on the government's agenda. Following a substantial progress in the agreed upon commitments, the government came to agreements with the respective EU institutions at the end of 2022 on both the Partnership Agreement for 2021-27 and the Recovery and Resilience Facility, paving the way for disbursements in the course of 2023. Some remedial measures are still underway, but the government remains committed to their full implementation and intends to maintain the reform momentum demonstrated over the last few months. Consequently, the government expects that Hungary can eventually fully absorb all eligible EU funds.

Boosting competitiveness remains a key policy priority to buttress the long-term real convergence. As a result of robust economic growth, Hungary has achieved an outstanding catching-up process over the last decade. The Hungarian economy has every opportunity to stay on this track, but also considering tectonic shifts in the global economy, the importance of rejuvenating the structural reform agenda, including sectoral policies and accelerating the implementation of reform measures is also growing, in addition to the need for addressing near-term challenges. To advance digital and green transitions, the government devotes more funds to these objectives under its Recovery and Resilience Plan than the EU average and intends to mobilize additional financing to these purposes. There are active discussions on the societal level about how to promote a more resilient and sustainable growth trajectory. Within its mandate, with various analyses and recommendations on competitiveness, the MNB also actively contributes to these reform efforts.