IMF Country Report No. 12/13

HUNGARY

January 2012

2011 ARTICLE IV CONSULTATION AND SECOND POST-PROGRAM MONITORING DISCUSSIONS

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 2011 Article IV consultation and Second Post-Program Monitoring with Hungary, the following documents have been released and are included in this package:

- **Staff Report** for the 2011 Article IV consultation and Second Post-Program Monitoring Discussions, prepared by a staff team of the IMF, following discussions that ended on December 14, 2011, 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 3, 2012. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- **Supplementary Information** on recent developments (January 13).
- **Informational Annex** prepared by the IMF.
- **Public Information Notice** (PIN) summarizing the views of the Executive Board as expressed during its January 18, 2012 discussion of the staff report that concluded the Article IV consultation and Second Post-Program Monitoring Discussions.
- **Statement by the Executive Director** for Hungary.

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

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INTERNATIONAL MONETARY FUND

HUNGARY

January 3, 2012

STAFF REPORT FOR THE 2011 ARTICLE IV CONSULTATION AND SECOND POST-PROGRAM MONITORING DISCUSSIONS

KEY ISSUES

Overview: External financing risks are rising in the wake of growth and financial spillovers from the Eurozone crisis. Stock vulnerabilities remain high while fiscal and external buffers are under pressure. Meanwhile, obstacles to higher medium-term potential growth–namely poor investment growth and low labor participation–persist. Unexpected and interventionist policy measures, many affecting the financial sector, have further increased policy uncertainty, contributing to elevated risk premia and a weakening of the exchange rate. Against this background, the authorities have requested precautionary financial assistance from the IMF and EU. With constrained room for policy accommodation, a policy mix that builds credibility, strengthens the policy framework, increases competitiveness and lays the groundwork for sustainable medium-term economic growth will be critical.

Fiscal policy: Ambitious deficit targets remain appropriate, although their attainment may be jeopardized by deteriorating macroeconomic conditions and policy slippages. The increasingly complex tax system should be revisited to take account of medium-term growth and distributional aspects, planned structural reforms should be implemented in full, and distortions in the labor market must be avoided.

Financial sector: Regulators should thoroughly examine banks' financial health and continue to proactively prepare them for a weakening in the economic outlook and possible funding pressures. The government's efforts to address the foreign currency mortgage burden have generally been ineffective; the most recent scheme is an improvement but still falls short of best practice.

Monetary policy: Under current circumstances, the MNB's tightening bias is justified. While the output gap remains relatively large, the scope for rate cuts is constrained by the worsened inflation outlook and the need to avoid a destabilizing weakening of the exchange rate and capital outflows. Official reserve levels are too modest to provide additional room for maneuver. Recent initiatives to change the governance structure of the Central Bank (MNB) raise serious concerns, both in terms of process and content.

Approved By
Anne-Marie Gulde and Lorenzo Giorgianni

Mr. Rosenberg (Head), Mr. Gottlieb, Mr. Stepanyan (all EUR), Ms. Seal (MCM), Mr. Guerson (FAD) and Mr. Noah (SPR) visited Budapest from November 9 to November 21, 2011 and met with Minister for National Economy Matolcsy, Central Bank Deputy Governors Karvalits and Király, Minister for National Development Fellegi, President of Financial Supervisory Authority Szász, other senior officials, members of Parliament, and representatives of the private sector and academia. Ms. Ivaschenko (Resident Representative) assisted the mission. Mr. Kiekens (OED) participated in some of the policy discussions. Hungary is an Article VIII country (Informational Annex: Fund Relations). Data provision is adequate for surveillance (Informational Annex: Statistical Issues).

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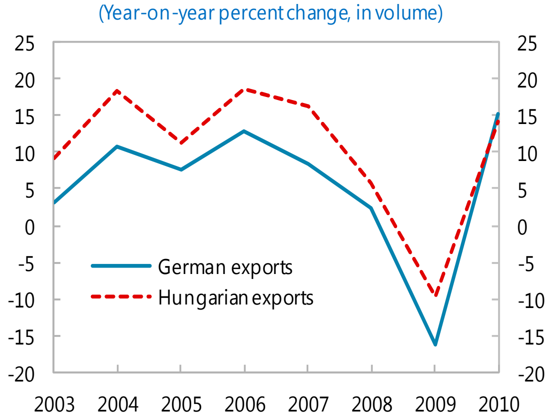
A. Recent Developments

1. **Hungary's rebound from the 2008–09 crisis has been modest.** After contracting nearly 7 percent, real output rose only 1.3 percent in 2010. Exports, helped by strong links with the resilient German export sector, were the sole engine of growth as domestic demand contracted for a second consecutive year (See text figure). Indeed, in Eastern Europe, only the Baltics, Croatia and Ukraine have weaker output relative to the pre-crisis peak.

Hungarian and German Exports of Goods
(Year-on-year percent change, in volume)



Source: IMF WEO Database.

2. **This already weak recovery is now faltering largely due to spillovers from the eurozone crisis.** Private consumption is constrained by tightening credit, rising foreign currency (FX) debt service, weak wage growth, high unemployment, and a sharp decline in consumer confidence. Meanwhile, fixed investment, which is particularly important for medium-term growth, is declining sharply with little sign of stabilizing amid a volatile policy environment and ample excess supply. Finally, the latest stage of the eurozone crisis is now weighing on Hungary's external demand, with exports to Europe decelerating since June. Growth in 2011 is now forecasted to be only 1-1½ percent.

3. **The slower growth and recent government actions are weighing on the financial sector.** Non-performing loans to firms and households have risen to 14 percent. The resulting need to increase provisioning—compounded by the large bank tax and the government's recent early repayment scheme for FX mortgages—has sharply reduced bank profits: four of the eight largest banks in Hungary are now making material losses. System-wide capital adequacy remains well above the regulatory minimum but the sharp losses have necessitated equity increases from select foreign banks. Meanwhile, liquidity appears adequate but funding is increasingly short term and expensive.

4. **Despite the slowing growth, the authorities have started to tighten fiscal and monetary policy.** In 2010–11, fiscal policy was expansionary, as significant tax cuts caused a widening in the structural deficit by around 3 percent of GDP. However, the recently adopted 2012 budget tightens fiscal policy substantially. In addition, despite a still large output gap, the Central Bank recently increased the policy rate to 6.5 percent given ongoing risks to both inflation and the financial sector from a rising risk premium and a weakening exchange rate.

5. **At the same time, the authorities have tried to support growth through a mix of well-received reforms and some more**

controversial policy steps. Some measures, largely in the context of the Szell Kalman plan announced in early 2011 (discussed in detail in IMF Country Report No. 11/137), are aimed at improving the medium term growth potential and are in line with recommendations at the last Article IV consultation. However, other efforts aimed at supporting output have been more controversial, such as schemes to aid FX mortgage holders, highly regressive and complex changes to the tax regime and intrusive labor market policies. Furthermore, the loosening of the fiscal stance in 2010–11 was—against Fund advice—financed with excessive special levies on largely foreign-owned sectors (retail, telecommunication, energy and banking) and the de facto nationalization of the second pillar of the pension system.

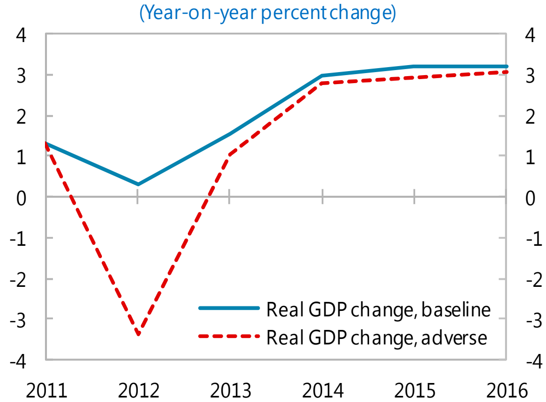
6. In this difficult environment, Hungary's financial market indicators are deteriorating. Between late-July and late-December, the forint lost almost 20 percent against the euro. During the same period, CDS spreads have widened 160 bps relative to peers and, at about 600 bps in absolute terms, are approaching the peak levels seen during the 2008–09 crisis. Meanwhile, yields on five-year government bonds (a proxy for the marginal cost of government financing) have risen to around 9 percent, well above the average nominal interest rate on public debt of 5 percent. Two rating agencies have in recent months downgraded Hungary to below investment grade. Nonetheless, based on available data through September, the share of domestic government debt held by non-residents remains high at 37 percent, suggesting both some resilience on the part of investors thus far and a significant risk to the balance of payments in the event risk sentiment continues to deteriorate.

B. Outlook and Risks

7. The outlook is unusually uncertain and risks are on the downside. While the domestic policy mix will be important in determining both Hungary's short- and medium-term prospects, the near term path for a small open economy like Hungary largely depends on the extent and duration of the ongoing Eurozone crisis. To illustrate these risks, staff discussed with the authorities both a baseline and an adverse "crisis" scenario.

8. In the baseline scenario, staff expects a further slowdown in Europe, which causes the Hungarian economy to stagnate in 2012 and recover only gradually thereafter. Domestic demand declines for a fourth consecutive year, as credit growth remains negative, rising inflation undermines real incomes, and unemployment is high. Even if the authorities credibly commit to less interventionist policies, residual uncertainty may continue to weigh on consumer and investor confidence. Exports are forecasted to decelerate in line with developments on Germany, which is expected to slightly outperform the eurozone; the current account will remain in surplus. In this environment, large external financing needs can still be met, but at a higher cost and shorter maturity as non-residents investors' risk aversion rises and parent banks continue to deleverage. Public debt remains broadly sustainable and begins to fall as growth normalizes and announced medium-term fiscal consolidation (see IMF Country Report No. 11/137) takes hold; it nonetheless remains sensitive to growth and exchange rate shocks (DSA—Appendix I).

Real GDP Under Baseline and Adverse Scenarios
(Year-on-year percent change)



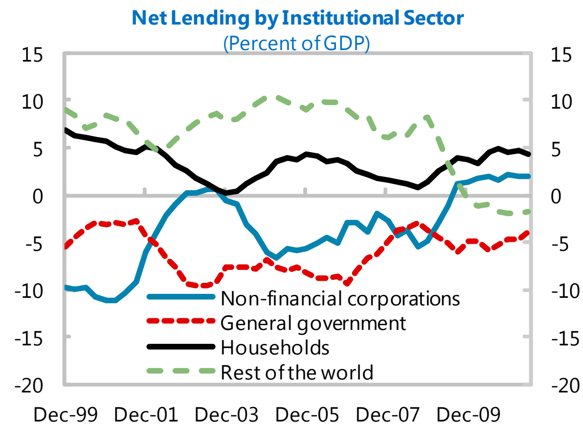
Source: IMF staff estimates.

9. By contrast, in the adverse scenario, a worsening of the Eurozone crisis triggers a recession and the emergence of an external financing gap. The contraction—which would primarily stem from a sharp fall in export growth—would likely be less severe than in 2009 given already weak domestic demand (See Text Figure and Table 2a). In this context, an external financing gap would emerge in 2012–13, largely because non-residents reduce funding of both sovereign debt and the banking sector (including off balance sheet pressures in the FX swap market as in the 2008–09 crisis). Unlike in the previous crisis, parent banks may be less likely to significantly increase their funding to subsidiaries given the policy environment in Hungary and pressures in the eurozone. Given low fiscal and external buffers, such a scenario could well weaken Hungary's capacity to meet its external obligations in 2012–13. Assuming automatic fiscal stabilizers are allowed to operate fully, a sharp surge in bond yields, and only a slow recovery in economic growth, public debt would continually rise over the forecast horizon.

10. The authorities broadly agreed with staff's assessment but saw a low likelihood of the adverse scenario materializing in its entirety. They concurred that growth faced downward risks in the event of a sustained eurozone crisis. Furthermore, amid rising global risk aversion, the authorities were particularly concerned about the spike in sovereign borrowing needs stemming largely from the pending repayments to the IMF. However, they were more upbeat about the economy's resilience. On growth, the government underlined increasing export capacity, rising trade with non-EU countries, improving absorption of EU funds, and recent reductions in impediments to labor participation as key sources of strength. On financing, the authorities highlighted the fact that reserves were twice the level seen before the last crisis and pointed to large non-resident holdings of domestic debt as a sign of confidence in current policies. Staff countered that reserves are not large compared to short-term liabilities (see section D below) and that and that non-resident investment could quickly reverse, as seen in 2008.

POLICY CHALLENGES

11. The core policy challenge for Hungary going forward is addressing large debt burdens without choking already weak growth. In the decade before the 2008–09 crisis, economic activity was supported by substantial foreign borrowing by both the public and private sectors. As a result, external and public debt (including inter-company loans) surged to 140 percent of GDP and 80 percent of GDP, respectively. However, the arrival of the crisis was a turning point for Hungary: as capital flows to Hungary dried up, the private sector was forced to reverse course, sharply increasing saving rates and driving a dramatic correction in the current account (See Text Figure). As a result, the economy contracted sharply in 2009, though the collapse was short-lived due to a fortunate recovery in external demand. In discussions with the authorities, staff pointed out that Hungary may now be at a second critical juncture. In addition to ongoing headwinds for private sector spending, external demand is set to slow sharply, the government is starting to tighten fiscal policy, and the MNB has increased policy rates. Thus, like much of Europe, Hungary now faces the difficult task of addressing large debt burdens in an increasingly difficult growth environment. In this context of constrained options, staff argued that a policy mix that maintains stability and builds credibility, strengthens economic institutions, increases competitiveness and provides growth support where possible will be critical. With such conditions in place, backup facilities from international financial institutions, as recently requested by the authorities, could support credibility, provide additional insurance against external liquidity shocks and help reduce funding costs.



Sources: MNB, IMF staff estimates

A. Fiscal Policy: Staying the Course

12. Staff supported the authorities plan to consolidate the fiscal stance. The 2012 budget targets a general government deficit of 2½ percent of GDP and implies around 3 percent of GDP in structural fiscal adjustment. The already announced tightening—which relies heavily on measures outlined earlier this year in the Szell-Kalman plan as well as the more recent sharp increase in VAT (to 27 percent) and excise tax rates—is adequate to generate small primary surpluses going forward. Staff agreed that, while ambitious and pro-cyclical, material adjustment was justified given that public debt (at close to 80 percent of GDP) remains high and policy credibility in the financial markets is low. Furthermore, there is a real risk that EU commitments concerning Cohesion Fund could be suspended from 2013 if Hungary remains in violation of the excessive deficit procedure which inter alia requires a deficit below 3 percent.

13. Achieving the authorities' fiscal target will in any event be difficult. In contrast to the authorities forecast, staff projects the 2012 budget deficit to reach a looser 3½ percent of GDP, primarily reflecting more conservative estimates of key macroeconomic parameters (e.g., growth, interest rates, and the exchange rate) and more cautious savings assumptions in regards to transport sector reforms. Admittedly, even with staff's more conservative deficit projection, fiscal policy is adequate to gradually reduce the debt burden. However, implementation risks loom large, particularly given the weak economic environment. Furthermore, even on a downward path, the debt would remain susceptible to shocks and take many years for the burden to reach moderate levels by emerging market standards.

14. Staff encouraged the authorities to upfront identify possible corrective measures in the event that downside risks materialize. Both the authorities' and staff's forecast include ¾ of percent of GDP in fiscal "reserves" which are unallocated expenditures: unless they receive special authorization in 3Q2012 the reserves cannot be spent and thus would reduce the deficit accordingly. This cushion may not be adequate, however, to avoid slippage in the event that the macroeconomic environment or budget execution deteriorate materially. In such a case, the implied outturn could jeopardize Hungary's medium term debt sustainability. Staff suggested that further contingency measures be identified upfront. In doing so, the authorities should aim at increasing the durability of adjustment by focusing on greater efficiencies in expenditures (e.g. restructuring state-owned transport companies, rationalizing public employment on the local level, and means testing social assistance) rather than increasing taxes further. Addressing these issues now could in any event be important from a medium term perspective: as special sector taxes on retail, telecommunications, and energy sectors are expected to be eliminated in 2013 (contributing to a permanent loss of revenue from that year), growth may not pick up sufficiently to provide the hoped-for support to further deficit reduction.

15. Staff expressed concerns about the underlying composition of fiscal policy. Staff pointed out that some recent changes make the tax and expenditure mix highly regressive, with negative implications for income distribution and possibly growth. In addition, efforts to limit the regressivity of the flat tax (expanded in 2012 with the elimination of the basic tax credit), have prompted a large (18 percent) hike in the minimum wage and the creation of complex compensation schemes that considerably increase the administrative burden of fiscal compliance. Eliminating special sector levies, revisiting elements of the flat tax, and rationalizing related wage and compensation reforms would minimize adverse effects on medium-term growth prospects (see section E) and the poor.

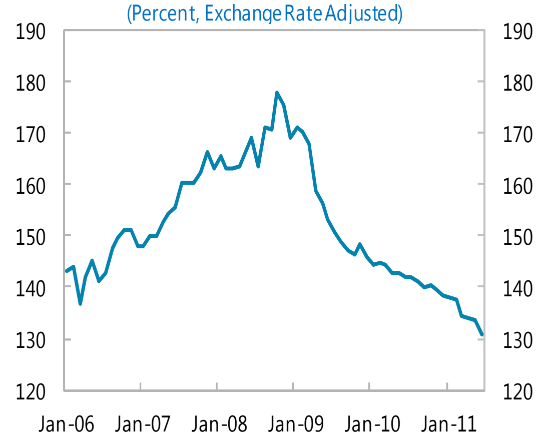
16. Staff called for improvements in fiscal governance as an added way of reducing the risk premium. Given already weak growth, seeking other methods of building policy credibility could usefully supplement the necessary fiscal tightening. In this context, staff suggested a strengthening in proposed fiscal rules. First, guidelines restricting the growth in general government debt should be related to the output gap in order to avoid excessive pro-cyclical tightening. And second, with respect to local governments, more explicit rules-based borrowing constraints that guide ex-ante budgeting for individual municipalities and include formal triggers for non-compliance would be more effective than current proposals (See Box 1). In addition, staff expressed continued concern about the effectiveness and independence of the reformed Fiscal Council. At a minimum, it should be tasked with independent impact analysis of all fiscal initiatives, including those with impact outside the current budget cycle.

17. The authorities pointed to the improvement in headline fiscal policy indicators. At a general level, they highlighted the fact that Hungary's debt and deficits compare favorably with the more troubled countries in the EU periphery. In particular, the 2011 budget would likely show a surplus. Furthermore, the recent structural loosening (i.e. correcting for large one-off revenues due to the transfer of private pension assets to the state) was a short-term cost worth paying to support medium term growth with broader labor market reform and the "whitening" of the economy. Looking forward, the authorities underscored their commitment to meeting the 2012 deficit target, including the stipulation in the budget law to not spend the budget reserves in the event of slippage. For 2013 and beyond, determination to fully implement the Szell Kalman plan and additional yet to be identified measures would ensure staying within deficit targets under their Convergence Program.

B. Financial Sector Policies: Increasing Resilience During the Downturn

18. Both cyclical and structural changes are weighing on the health of the Hungarian banking sector. On the one hand, staff and the authorities agreed that a series of temporary factors are affecting the banking sector. The deteriorating economy has reduced loan demand and undermined portfolio quality while stress in Europe has shortened the maturities and increased the costs of new funding. On the other hand, staff noted that the banking system may also be undergoing a more structural change in its business model, as a combination of the difficult policy climate in Hungary and increasing liquidity needs in parent banks' home countries have triggered a move toward more locally funded subsidiaries. The decline in the loan-to-deposit ratio, which fell from a peak of 170 to 130 percent in September, may constitute a more structural trend (See Text Figure). If so, the Hungarian banking sector faces a sustained and difficult period of adjustment to a new steady state: though potentially more stable in the long run, a financial sector that needs to rely predominantly on modest local savings for funding asset growth is likely one in which funding is more expensive, loan growth is slower, and profitability is more modest.

Loan to Deposit Ratio
(Percent, Exchange Rate Adjusted)



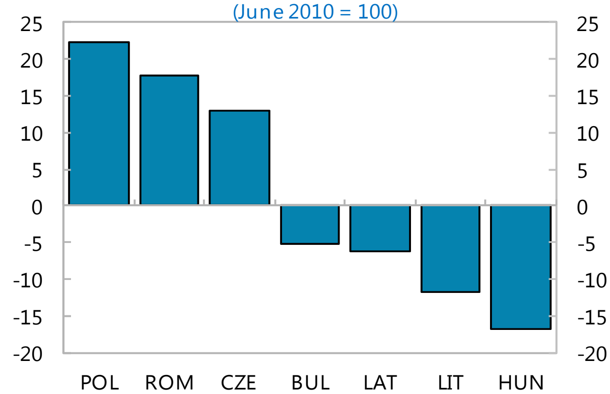
Sources: MNB, IMF staff estimates

19. In this difficult environment, staff stressed the importance of safeguarding near-term stability in the face of the ongoing crisis in the eurozone. Asset quality is a particular concern: non-performing loans to households and firms are high at 14 percent and are expected to continue to rise over the coming two years. Meanwhile, amid weak loan growth, persistent high bank taxes and the mortgage relief scheme, profitability is likely to remain low–and in fact negative for some banks–putting further pressure on capital. Staff underscored that such challenges call for a proactive approach by regulators and banks alike. In this regard, staff welcomed forthcoming regulations establishing minimum liquidity ratios and encouraged regulators to develop contingency plans for sudden increases in liquidity pressure. In terms of other buffers, system-wide capital adequacy continues to be above the regulatory minimum though there is significant variation among banks and staff argued that some foreign owned banks should increase equity expediently. To provide further safeguards, staff urged the finalization of a bank resolution framework as well as creation of a personal insolvency regime to aid in the process of addressing distressed debtors and troubled institutions. Continued and enhanced cooperation among the government, HFSA, and the MNB in the context of the Financial Stability Council would help coordinate the macro-prudential surveillance.

20. At the same time, staff argued that the broader policy framework for the financial sector needed to adjust to be more consistent with supporting growth. The antagonistic policy environment likely contributed to the far deeper fall in Hungary's external funding and credit growth than seen elsewhere in Eastern Europe (See Text Figure). While external funding of Hungarian credit growth may remain permanently lower than pre-crisis levels, staff called for a policy mix that provides banks with the incentive to avoid excessive deleveraging. In this regard, reducing the bank tax to an appropriate size and avoiding any household debt relief schemes that put undue burdens on banks were critical first steps to ensuring adequate economic growth.

21. The authorities argued that in many respects the banking sector was in a much stronger position than before the last crisis. Specifically, system-wide capital and liquidity ratios were considerably stronger and the main domestic bank without a parent had considerable buffers and a more benign near term FX amortization schedule than in 2007–08. The new liquidity ratios referenced above would help prevent a rapid deleveraging in the event of an external shock. And the MNB had improved its tool kit by creating a short term FX swap facility.

Percent Change in Bank External Liabilities
(June 2010 = 100)



Sources: MNB, IMF staff estimates

In terms of the more controversial banking measures, the authorities reiterated their commitment to cut the banking tax in half in 2013. However, the government also argued that banks played a key role in building vulnerabilities currently weighing on growth such as Swiss Franc debt and should thus play a large role in any solution to the problem.

C. Dealing with foreign exchange (FX) Mortgages: Less Government Intervention

22. The authorities are focused on reducing the burden of CHF debt on households. The government argues that with two-thirds of all housing-backed debt in Swiss Francs, the sharp appreciation relative to the Forint must be a key explanation for the persistently weak growth in private consumption. As a result, schemes to reduce the burden were necessary to resume economic growth. Staff countered that the impact of Swiss franc debt on growth was not clear: only roughly 15 percent of households have Swiss franc debt and only a subset are severely liquidity strained, leaving a majority of households with reasonably healthy balance sheets (See Box 2); furthermore, there are several other, possibly greater, headwinds to private consumption like unemployment, high interest rates, weak real wage growth, and falling consumer confidence amid policy uncertainty.

23. The authorities did not contest staff's assertion that the most recent measures to address the burden have been, on the whole, unproductive. There was agreement that measures taken earlier in the summer may eventually provide some relief, such as a National Asset Management Company to buy properties from insolvent debtors, an interest rate subsidy scheme, and the option to rephase mortgage payments by temporary fixing of the exchange rate used for debt service at preferred rates (discussed in IMF Country Report No. 11/137). However, staff expressed great concern about a far more interventionist law that was passed in September. The law allows participating debtors to pre-pay mortgages at preferred exchange rates, which implies roughly at 25 percent haircut. This scheme threatened the stability of the financial sector by reducing bank capital and triggering further exchange rate depreciation and FX reserve losses. At the same time, it provided little relief to the most distressed borrowers as predominantly well-off households have access to the forint liquidity to buy back FX mortgages. More broadly, the implicit retroactive revision of private contracts without consulting the banking sector may have inflicted large and lasting damage on Hungary's reputation among investors. In general, the policy was not consistent with best practice or recent international experience (See Box 3).

24. At the same time, staff conceded that a voluntary, limited and well designed restructuring of Swiss franc debt may help the recovery. The sharp appreciation in the CHF in the past two years has resulted in acute pressure on certain households and banks. Furthermore, despite net debt repayment, the outstanding liabilities of households have not fallen due to the valuation effects of FX depreciation on the debt stock. Staff agreed with the authorities that thus far, restructuring initiated by individual banks has not provided extensive relief. Looking forward, it argued that regulators should be vigilant and proactive, ensuring that banks deal with distressed assets in an expeditious manner. The government could play an additional role by facilitating broader and deeper restructuring of distressed loans throughout the banking sector before creditors proceed with foreclosure; such loan modifications could support the economic recovery and actually increase expected repayment rates. If the government chose to play this role, staff argued that three principles should be respected. First, any policy to coordinate such relief should be based on voluntary participation and designed in conjunction with the banking sector in a way that respects private contracts. Second, relief should be targeted at only distressed loans rather than all CHF debt in order to maximize support for financial stability and growth while avoiding the creation of moral hazard. And third, burden sharing, both across sectors and time, was appropriate give the severe stress already hitting bank balance sheets; however, any costs borne by the government should be limited and consistent with debt sustainability.

25. On December 15, the government reached agreement with the banking sector association on measures to reduce the burden of FX mortgages on households. The agreement includes a 25-percent write off and conversion into forint for some non-performing FX loans, flow relief for all debtors current on their loans, interest subsidies by the government, and some scope for banks to deduct losses incurred through the recent early repayment scheme from the special bank tax (See Box 4). The scheme's impact on the budget depends on participation and the path of the exchange rate, but appears contained. Staff pointed out that, as opposed to the early repayment scheme, the agreement contains welcome burden sharing and may provide some relief to distressed debtors, but also raises some concerns. For example, relief could be better targeted as all debtors will benefit. Furthermore, while the final details were devised in concert with banks, the process as a whole has not been entirely voluntary.

26. The repayment, write-off and conversion of FX loans, in addition to the halt on new such lending will reduce currency mismatches. Over time, this will mitigate an important policy constraint. On new FX lending, a de facto ban on CHF lending remains in place and strict prudential regulations apply to euro-denominated lending to households (see IMF Country Report No. 11/137). Recent recommendations by the ESRB reinforce the authorities' measures to curb FX lending.

D. Monetary and Exchange Rate Policy: Tightening Bias is Appropriate

27. Staff and the authorities agreed that the constraints facing monetary policy have increased. For a small open economy with weak aggregate demand, tightening fiscal policy, and high real lending rates, a looser monetary policy stance and a weaker exchange rate may appear appropriate. But for several years, underlying vulnerabilities have limited the MNB's ability to pursue such counter-cyclical policy: beyond the constraint provided by frequent above-target inflation results, Hungary's large net external debt implies that the expansionary impulse from lower lending rates and more competitive exports can be more than offset by the weaker exchange rate's effect on increasing debt service, reducing net worth, and raising the risk premium. The MNB noted that the scope for such easing had nonetheless increased during the summer as overall risk premia had fallen amid improved medium–term fiscal prospects in the context of the Szell Kalman plan. However, since late August, the situation has reversed course. External risks from the Eurozone crisis resumed their upward surge, the FX mortgage repayment scheme significantly increased pressure on the currency, and the planned sharp increase in indirect taxes pushed inflation forecasts upwards. In this context, the MNB argued that stabilizing investor expectations with tighter policy rates was the most effective route to attaining their inflation target, safeguarding financial sector stability and ultimately supporting the economy. Nonetheless, the only sustainable solution over time was one in which risk premia are reduced via a more consistent policy mix. Staff agreed with this view.

28. Foreign exchange reserves do not provide additional room for maneuver. The authorities pointed out that while more reserves would be helpful, the current level is nearly twice that seen before the last crisis. Staff noted, however, that short-term external debt of 45 percent of GDP (on a residual maturity basis) in a context of rising global risk aversion suggests a large potential demand on FX buffers. Furthermore, recent events—notably the government's purchase of EUR 2 billion of shares in the energy company MOL and the MNB's provision of FX liquidity after the recent early mortgage repayment scheme[1]—are proof of the unexpected need for reserves. With respect to the latter, staff supported the MNB's decision to provide such liquidity as it mitigates excessive pressure on the exchange rate and the particular agreement with banks included a requirement on their part to reduce short-term external liabilities.

29. Staff expressed serious concern about planned changes in the legal framework pertaining to the MNB. Without prior consultation with Fund and EC teams in Budapest at the time, the authorities on December 13–14 submitted under expedited emergency procedures to parliament both a new Central Bank law and an amendment to the Constitution which imply fundamental changes to the institutional structure of the MNB. Though some amendments were subsequently made, aspects of both legislations in staff's view point toward risks of a material erosion of Central Bank independence. More generally, staff warned that frequent changes to the MNB law—this is the third in 1½ years—create unnecessary uncertainties. The Governing Council of the ECB, in an opinion published on December 22, voiced similar concerns both on substance and the process of the proposed legislation. At a minimum, staff recommended that the proposals be delayed to allow adequate discussion both with the IMF and other partners, including the ECB. The legislation was nevertheless passed on December 30. Staff countered that Hungary's mixed record of meeting inflation targets (see IMF Country Report No. 11/35) and still not well anchored inflation expectations strongly argued against any steps that may be seen as undermining in the MNB's independence.

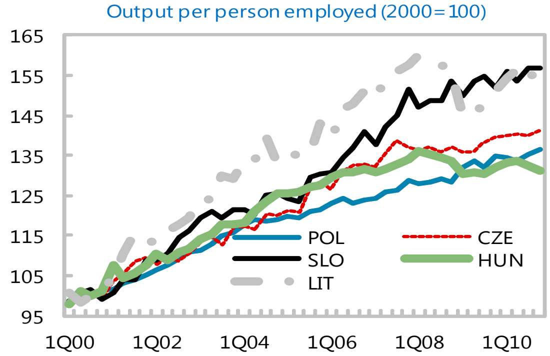
[1]Fund staff is currently assessing the jurisdictional implications of this voluntary scheme, which enables commercial banks to hedge against the exchange rate risk and the uncertainty in scale of early repayments in HUF at predetermined and more favorable exchange rates by FX-denominated mortgage debtors pursuant to a government-established mechanism. This scheme, which consists of various transactions, is structured in four interrelated steps, namely (i) a FX auction, (ii) possibly multiple daily overnight swaps, (iii) the receipt and use of the FX, and (iv) a re-exchange of any unused FX.

E. Structural Issues: Address Constraints to Potential Growth

30. Staff also raised broader concerns about long-term growth. The authorities shared staff's view that potential growth had declined in Hungary since the mid-2000s and, although expected to recover going forward, will stay relatively modest over the forecast horizon. The MNB in particular highlighted the ongoing weak corporate credit conditions as posing a risk to the growth outlook in the medium term. Staff emphasized obstacles regarding investment and labor participation as particularly worrisome.

31. While falling sharply since the crisis, investment has been in a sustained decline for roughly a decade. Relative to 2000, Hungary now has the lowest fixed investment in Eastern Europe; construction is at only 55 percent of its 2005 peak. Such low investment has in turn weighed on real labor productivity which has stagnated since 2006 and is now the lowest among regional competitors (See Text Figure). Staff is concerned both that cyclical factors may be longer lasting than originally expected and that the sustained weakness in investment points to underlying structural factors.

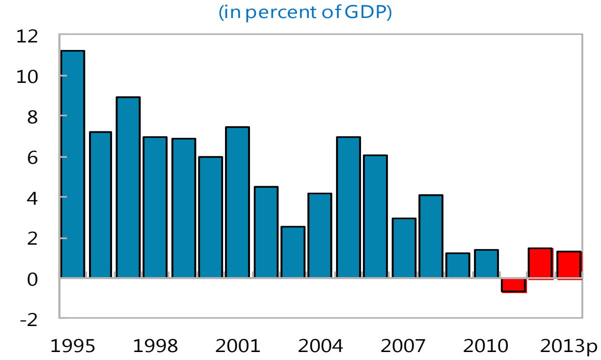
Real Labor Productivity
Output per person employed (2000=100)



Source: Eurostat

32. The authorities shared the concern about investment but argued that continued strong FDI and EU funds would support investment going forward. In particular, the authorities pointed to several high-profile foreign direct investment projects in automobile manufacturing—expected to total EUR2.3bn during 2010–13—which will increase export capacity going forward. Staff conceded this point but cautioned that total FDI flows remain a fraction of levels seen in the nineties and earlier parts of this decade (See Text Figure). Furthermore, these projects had been planned over many years and included material tax incentives suggesting that they may not be indicative of the broader and more recent constraints facing foreign direct investment. Staff did agree that increased absorption of EU funds would help increase public investment (forecasted to rise from 3 to 4 percent of GDP) and could support private sector productivity if well targeted.

FDI
(in percent of GDP)

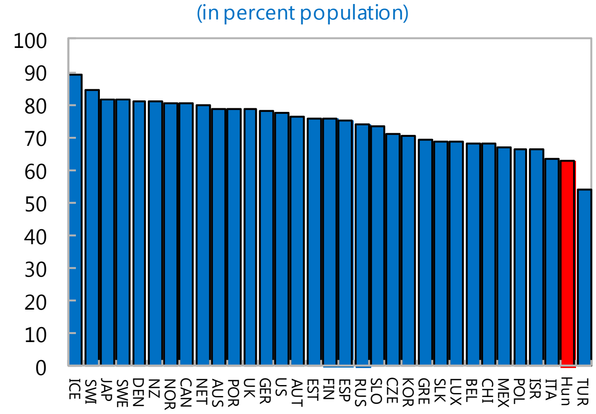


Sources: HAVER, IMF Staff Estimates

33. Staff argued that a series of policy changes could support investment and increase the competitiveness of the Hungarian economy, particularly over the medium term. As noted in Box 5, standard CGER methodologies find the exchange rate to be broadly in line with fundaments, although other indicators (e.g., the Global Competitiveness Report), suggest that Hungary's competitiveness relative to peers has deteriorated in the last five years. The two most problematic factors for doing business are tax rates and tax regulations. As highlighted in Section A above, a more systematic approach to tax and labor market policies would support growth. The introduction of crisis taxes and other discriminatory actions in foreign dominated sectors and regular interventions in the labor code have reduced both the receptiveness and the stability of the investment climate. The third most problematic factor for doing business relates to access to financing and is likely getting more difficult at the margin. The financial sector appears ill-positioned to support a recovery with affordable local currency lending given the steady decline in the loan to deposit ratio, lack of adequate domestic savings, and high risk premia which in part are policy induced. Amid such concerns, even a cyclical recovery in demand may not be adequate to raise fixed investment to needed levels. In this context, the reforms referenced in Section B above are particularly critical.

34. **On improving the labor supply, the authorities have demonstrated more progress.** For much of the last decade, Hungary has had one of the lowest labor participation rates in Europe (at 62 percent, only Turkey in the OECD is lower). The gap between male and female participation rates was around 13 percentage points during the period. Among other factors, generous benefits have played a major role in keeping labor participation at such low levels. However, with the Szell Kalman plan, the authorities have begun to address such barriers, namely with changes to the retirement age and early retirement schemes, disability pension and sick-pay systems, and social benefits. Nonetheless, staff argued that certain aspects of recent reforms–namely the elimination of the employment tax credit for minimum wage and increase in employees' social security contributions-undermine such progress (See Box 6).

Labor Force Participation
(in percent population)



Source: OECD

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35. **Hungary has yet to recover from the previous crisis but is now facing renewed pressure.** Falling external demand and tightening fiscal policy are occurring amid already weak private sector spending to create strong headwinds for growth. At the same time, domestic policy missteps and rising global risk aversion are weighing on financial market indicators. Meanwhile, stock vulnerabilities remain high. In this difficult environment, Hungary is entering a period of particularly large borrowing needs due in large part to pending repayments on the 2008–09 official sector assistance. While many of the external factors are beyond Hungary's control, a well-crafted policy mix that avoids the ad hoc interventionist measures of the past year and strengthens economic institutions can reduce the likelihood of an adverse scenario where Hungary loses market access. It may also lay the groundwork for a recovery in growth which has been hampered by deep-seated constraints to investment and labor supply.

36. Despite the weaker growth outlook, the planned fiscal tightening is necessary. Hungary is not in a position to pursue counter-cyclical fiscal policy due to high public debt, low policy credibility and rising financing constraints. An added constraint is that after eight years in violation of the EC's excessive deficit procedure, there is a real risk that cohesion funds may be suspended. In this context, the authorities' deficit target in 2012 of 2½ percent of GDP is appropriate, even if the somewhat larger deficit projected by staff is consistent with debt sustainability. To meet the government's targets, more measures should be identified upfront, despite the implied very ambitious structural tightening.

37. The underlying composition of fiscal policy needs to improve. The authorities' commendable efforts to pursue tighter fiscal policy and reduce bottlenecks to labor participation have had unintended adverse consequences. In particular, fiscal policy has become more regressive, administratively complex, and distortionary. This calls for a tax and expenditure mix that is consistent with debt sustainability but does not at the same time unnecessarily undermine growth or burden the most vulnerable. A more systematic approach could include revisiting elements of the flat tax, reducing the outsized crisis taxes, means-testing universal transfers, rationalizing public employment (especially at the local government level), and restructuring public transport companies.

38. Strengthening the fiscal framework would improve governance on budgetary matters and could reduce risk premia. The constitutional mandate to maintain public debt below 50 percent of GDP is commendable and recently proposed rules to achieve this goal over time are a good first step. These, however, need to be improved and put in place quickly to be meaningful and thus increase confidence. Despite some recent improvements, the reformed Fiscal Council remains significantly constrained in its ability to provide an independent and timely assessment of fiscal developments; it could be strengthened, inter alia by legally empowering it with appropriate resources for independent analysis on all fiscal matters, including those with impact outside the current budget cycle.

39. With respect to the weakening financial sector, regulators should continue to proactively address prudential concerns. In an environment of deteriorating portfolio quality, negative profits, and increasing pressure on funding, it is important to ensure that banks maintain adequate provisioning, capital, and liquidity. The authorities' forthcoming regulations on minimum liquidity ratios are welcome. Meanwhile, some foreign banks should move more quickly to address capital shortages. To provide further safeguards, finalizing a bank resolution framework and instituting a personal insolvency regime would help the authorities deal with distressed institutions and debtors in an efficient manner. Looking beyond the immediate stability issues, the legal framework for the banking sector needs to become more consistent with promoting growth by reducing the outsized bank tax and avoiding interventionist policies to reduce households' mortgage debt.

40. Limited restructuring of Swiss Franc debt may help the economic

recovery if designed appropriately. The impact of mortgage debt in foreign currency on economic growth may be overstated and initial efforts to remedy the problem notably the early repayment scheme, were detrimental to growth, financial stability and Hungary's reputation as a safe place to invest. There may nonetheless be case for the government to play a role in facilitating broader and deeper restructuring of distressed loans. In doing so, it should closely coordinate such relief—which should be voluntary—with all relevant stakeholders, target only distressed loans, and ensure adequate burden sharing—both across sectors and time. The recent agreement with the banking association is an improvement on earlier efforts but only partially meets these standards. In particular, it is not targeted solely at distressed loans and it is not voluntary in the strict sense.

41. The MNB's tightening bias is appropriate. Despite weakening output and high real lending rates, Hungary does not have the latitude to run counter-cyclical monetary policy. Though poorly anchored inflation expectations and above target inflation are factors, a key near term constraint are significant currency mismatches in the economy as reflected in net external debt of close to 60 percent of GDP. Furthermore, Hungary lacks the reserves to ease policy rates and lean against the pressure on exchange rate as witnessed in some emerging markets elsewhere. In this context, an increase in policy rates that helps stabilize investor sentiment and the balance of payments is likely to be the most expedient route to supporting growth in the near term. This constraint raises the importance of progress in reducing Hungary's currency mismatches and risk premia more broadly.

42. Changes in the governance structure of the Central Bank are worrisome. Though details of the legislation passed on December 30 still need to be examined, there are three particular concerns. First, the frequency with which changes to the Central Bank law have been made (nine rounds of amendments in the last three years) creates an unstable operating environment for monetary policy. Second, the rushed process in which the most recent changes have been submitted raises serious concerns: there is inadequate time for comment and consideration by relevant parties on an issue of considerable macroeconomic importance. And finally, the content of the recent proposals themselves raise questions about the authorities' commitment to Central Bank independence.

43. If underpinned by a strong policy framework, a precautionary Fund arrangement could relieve some of the constraints cited above. By increasing potentially available reserves and anchoring a stability-oriented policy mix, a Fund-supported program in concert with other international lenders, may help to relieve financing constraints and improve investor confidence. Such external support, which has been requested by the authorities, will only be available and effective to the degree it is based on a strong policy framework and a sound policy mix with strong ownership from the authorities.

44. Staff proposes to hold the next Article IV consultation on the regular 12-month cycle.

Box 1. Considerations Regarding Hungary's Recently Proposed Fiscal Rule

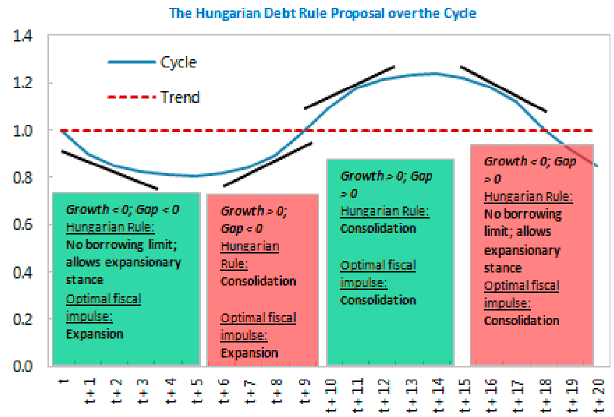
In the Constitution passed earlier this year, Hungary adopted two fiscal rules which effectively require each subsequent deficit to reduce the public debt to GDP ratio until it is below 50 percent and then keep it there. The authorities are now seeking to make this fiscal framework more operationally effective with two new proposals. While broadly consistent with the EU's debt reduction objectives, these transitional rules were developed independently of the December 9 "fiscal compact" which Hungary has yet to formally join.

1. **Public Debt Growth**—Percentage growth of the nominal debt stock for the next budget period (*d*) cannot exceed the difference between inflation (*p*) and half the real GDP growth rate (*g*): $d < (p - \frac{1}{2} g)$. The rule would apply to the general government as a whole but would include intermediate targets for each level of government. It will only come into effect in 2016 and the debt reduction is temporarily suspended if real GDP contracts.

2. **Local Government Finances**—There are three key restrictions: (I) no issuance of debt to finance current deficits; (ii) debt issuance can be for investment purposes only, and requires central government approval; (iii) debt service is to remain below 50 percent of a local government's own revenues.

Debt Growth

The key concern about this rule is that it does not relate the allowed growth in debt to the size of the output gap. For example, it allows unlimited borrowing when growth is contracting even if output is above potential. This latter element, which is aimed at providing space for a counter-cyclical fiscal reaction appears overly blunt. A superior fiscal rule would prevent excessive borrowing when growth is negative to anchor creditors' expectations even in bad times.



Local Government Finances

Certain aspects of the proposed restrictions on local governments are sensible, namely preventing current deficits, requiring central government approval for borrowing, and ensuring that debt incurred is used for investment. However, the design of the law has a number of shortcomings, including: (i) the debt service constraint on local governments may be ineffective given sensitivity to discount rates; (ii) it is administratively costly (over three thousand local entities); (iii) allows significant discretion by the approving administrators.

The application of the debt growth rule to the local governments may also prove difficult to implement. As it applies to the consolidated local government system rather than each local entity separately, it raises two key issues: First, it does not provide guidance for budgeting for any individual entity, and deviations for the aggregate local government system could only be discovered ex-post. And second, it allows a subset of administrative jurisdictions to remain unsustainable

Sources: MNB; Staff Estimates

Box 2. The Burden of Swiss Franc Lending for Households

Hungary's attraction to Swiss franc (CHF) debt started in 2004. The government had removed a fiscally unsustainable interest subsidy the previous year, rendering HUF credit considerably more expensive. Shortly thereafter, banks responded by offering CHF-linked products at rates up to 10 percentage points lower than comparable HUF rates. As a result, lending in CHF soared, mainly to households, reaching 21 percent of GDP, the largest such exposure in Eastern Europe **(Chart 1).**

However, with the crisis, banks' willingness (and legal ability) to lend in FX plummeted, triggering a sharp de facto tightening in lending conditions much like the subsidy removal in 2003 **(Chart 2 and 3)**. Without a new innovation to provide cheap credit, households have been repaying debt in net terms **(Chart 4).** The authorities argue that residents' persistent indebtedness in Swiss francs explains the sharp fall in consumption and thus the need for government intervention.

Debt service for holders of Swiss franc loans has indeed increased sharply. The Swiss National Bank's recently imposed ceiling on the CHF-EUR exchange rate limited one source of vulnerability but considerable depreciation has already occurred and the HUF remains exposed in movements against the euro. Seventy percent of CHF debt was incurred at HUF-CHF levels of 145–165 vs current levels of around 240, implying a 60 percent increase due to the weaker exchange rate alone. Furthermore, despite monetary easing in Switzerland, the CHF interest rate burden has not fallen as it has in Poland—the second largest holder of CHF loans—due to weaker consumer protection laws regarding interest rates and higher risk premia **(Chart 5).**

Changes in household balance sheets can also weigh on consumption. The move in the exchange rate has prevented net debt repayment from actually reducing the debt stock, meaning the standard channel for working through a debt burden is not yet effective **(Chart 6)**.

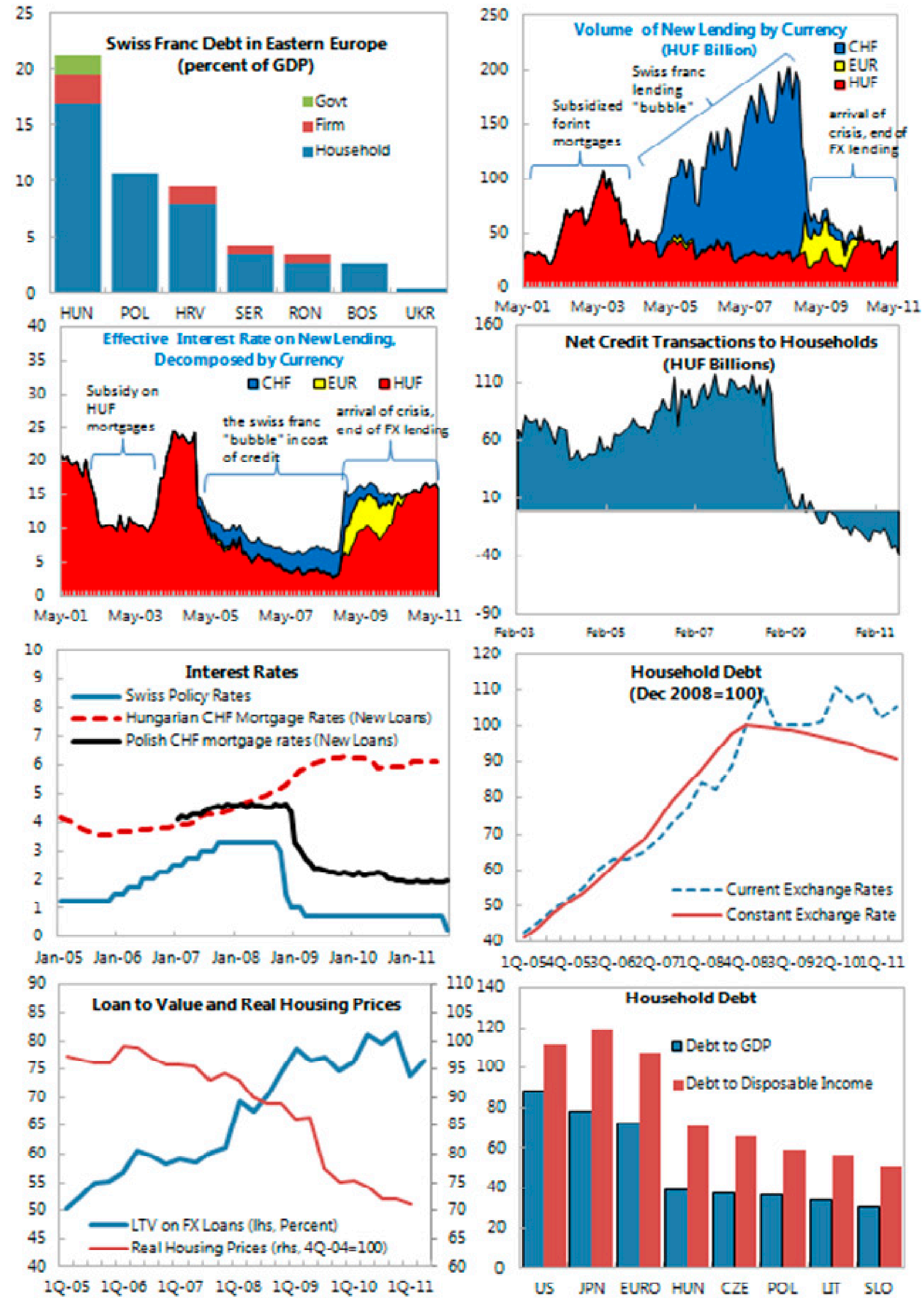
Meanwhile, though available information on loan to value ratios does not point to a major concern about households' net worth, there is some reason to believe that the data understates the full extent of the burden **(Chart 7)**.

However, the importance of the burden to the broader economy is not clear. First, aggregate household debt indicators such as debt service to income are in line with peers and not at stress levels **(Chart 8)**. Second, household mortgage and home equity loans, which account for 85 percent of total CHF debt, are held by only roughly 15 percent of households. And third, the majority of distressed FX loans are concentrated in those with lower incomes or those that received the loans just before the crisis when lending standards had deteriorated.

Swiss franc debt may therefore be a headwind for private consumption but is unlikely to be a key driver of the slowdown. High interest rates on new lending, still high unemployment, and falling consumer confidence are major drags for all households, including the majority that do not hold CHF debt.

Nonetheless, several principles could guide a way forward. For example, to the extent there are government efforts to reduce the burden, the most effective route would target only the most distressed households that are more likely to feel compelled to reduce consumption and/or default on loans. Over the longer term, what is needed is higher domestic savings and a lower risk premium in order to render local currency credit more affordable without subsidies.

Box 2. The Burden of Swiss Franc Lending for Households(continued)



Box 3. Considerations and Experience with "Government Coordinated" Household Debt Restructuring

Though usually not necessary, government intervention in household debt restructuring can be appropriate. Traditionally, banks deal with a non-performing asset by either modifying the terms of the loan or writing off the loan altogether and taking any residual loss after recovering collateral. However, particularly when the banking system faces a sudden, sharp, and widespread (systemic) deterioration in portfolio quality, this normal approach of dealing with NPLs can become suboptimal. As noted in Laeven and Laryea (2010), the quantity of needed restructurings can clog the courts, individual bank incentives may conflict with helping the economy recover, and the cost of restructuring can swamp bank buffers.

Partially to overcome such problems, several governments in the recent crisis have intervened in the banking system to coordinate restructurings. The global economic downturn of recent years was triggered in part by a bursting of bubbles in household credit. In the aftermath, fears that the impact on both the financial sector and the real economy pressured several governments to intervene in standard bank procedures and coordinate top down restructurings.

- *United States (2008)*—Refinancing at subsidized rates; write-offs to approved loan-to-value ratios.
- *United Kingdom* (2008)—Payment deferral; limited government guarantees of deferred interest payments.
- *Iceland (2010)*—Payment freeze on FX loans; fast track write off of most of negative equity.
- *Hungary (July 2011)*—Mortgage servicing at preferred FX rate, reschedule difference; quota on foreclosures; national asset management company buys some distressed properties.
- *Croatia (2011)*—Extension of repayment period and debt service at preferential FX rate.
- *Hungary (Sept 2011)*—Permitted full pre-payment of mortgages at preferred FX.

Hungary's recent proposal contrasts sharply with the government restructurings conducted elsewhere. Several key design principles have emerged that can help the benefits of such involvement outweigh the costs. Restructuring should occur when there is a systemic risk to the economy and provide targeted relief at the most distressed assets. If borrowers are insolvent, an NPV negative restructuring is usually needed and burden sharing with the government can be appropriate provided it is consistent with debt sustainability. Finally, the proposals should be designed in conjunction with the banks and participation should be voluntary. Measured against these principles, Hungary's recent scheme stands out:

- *Clear Systemic Risk*. In the US, nearly 30 percent of all mortgages are underwater and in Iceland, household debt is 130 percent of GDP.
- *Targeted Relief*. In Iceland, the focus is reducing loan to value ratios to sustainable levels. In the UK, eligibility required income and mortgages below certain thresholds and proof of payment difficulties.
- *Appropriate Burden Sharing*. In the UK, the government guaranteed the deferred interest payments for banks participating in the program.
- *Collaborative solution*. Participation in the US, UK, Croatia, and Iceland schemes was voluntary both for the banks and the debtors.

	US (2008)	UK (2008)	Hungary (July 2011)	Hungary (Sept 11)	Croatia (2011)	Iceland (2010)
Strong Case for intervention	✓	✓	×	×	×	✓
Collaborative solution	✓	✓	✓	×	✓	✓
Impact on NPV	✓	✓	×	✓	×	✓
Burden sharing	✓	✓	✓	×	✓	✓

Box 4. Agreement Between the Government and the Hungarian Banking Association

On December 15, 2011, the government reached agreement with the Banking Association on a set of proposals to guide regulation in the near term, both with respect to FX loans and the sector more broadly. Key details of the agreement follow below:

Relief for Banks Who Suffered Losses in Previous Scheme. In September, the government had announced a regulation to allow the early repayment of FX mortgage loans at a preferred exchange rate. To lessen the impact of this scheme on bank profits, the government has agreed to allow 30 percent of the losses to be deducted from the 2011 bank tax.

Relief for Holders of Non-Performing FX Mortgages. Loans that are more than 90 days delinquent as of September 30 of 2011 will be converted into HUF and 25 percent of the outstanding principle will be forgiven. As the new HUF loan on the remaining principle will carry a higher interest rate than the original CHF loans, the state will provide an interest rate subsidy equivalent to 50 percent of the benchmark government yield, declining by 5 percentage points each year for five years. In an effort to target the benefit to those more likely in need, eligibility is limited to loans whose collateral does not exceed a specific threshold. As with the first pillar described above, 30 percent of banks' losses related to this debt cancellation can be deducted from the 2012 bank tax. The agreement states that the MNB will provide FX liquidity at market exchange rates to help banks close the open currency position that results from the conversion of the loans (note that the MNB has not separately confirmed its willingness to do this. In turn, banks will use the FX liquidity to repay short term external liabilities. In the case of those debtors who re-default on this subsidized payment scheme, a National Asset Management Company will buy the property. The expectation is that the NAMC will purchase 25,000 properties by 2014, including 8000 by end of 2012.

Relief for Holders of Performing FX Mortgages. For debtors current on their loans, the scheme introduced this past summer that fixes monthly debt service on FX mortgage loans (CHF, EUR, and JPY) at preferred exchange rates will be extended from three to five years. However, if the forint depreciates beyond a certain level, the state will cover all debt service. For example, if the CHF/HUF rate is between 180 and 270, the debtor will pay 180 but if the exchange rate goes above 270, the state will pay the additional principle installments. Meanwhile, similar to the scheme over the summer, the difference between the market and preferred exchange rate will accumulate in the form of a separate loan denominated in HUF to be repaid by the debtor after the five years. A new development is that the interest on the HUF loan will be paid in equal parts by the bank and the government; the rescheduled portion is effectively a 5-year interest free loan for the debtor. To reduce the near-term burden on banks, the government will temporarily delay the implementation of a recently passed bill requiring transparent pricing of interest rates (fixed spreads over market rates).

Broader Policies for Growth. As previously expected, the government confirmed that the basis and rate of the bank tax will remain unchanged in 2012 but the rate will decrease by 50 percent in 2013. In 2014, the bank tax will not exceed the level set by the EU regulation or in the absence of that, the average of bank tax rates in the EU. Meanwhile, the government agrees to not submit or support any further regulation concerning FX lending unless it is supported by the Banking Association. With respect to credit growth, any net increase in the SME portfolio or gross increase in the retail mortgage portfolio can be deducted from the basis of the 2012 bank tax, provided the deductions do not exceed 30 percent of this tax. As of January 2012, the government and the banking association will meet quarterly to discuss the economy and the role of the financial sector in fostering economic growth. The government will inform the EC and IMF on the outcome of the consultations.

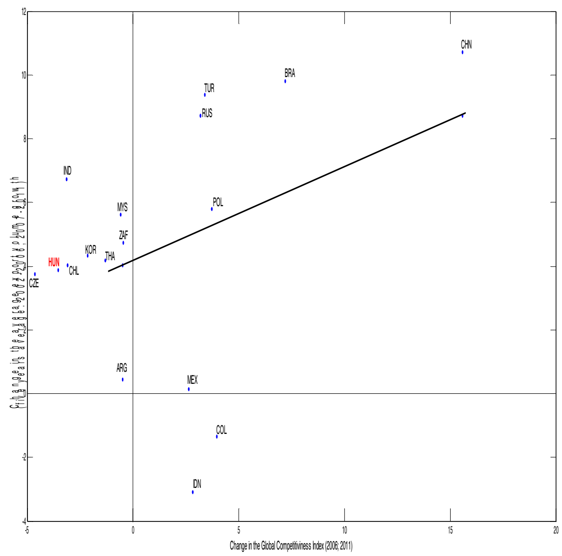
Box 5. Exchange Rate Assessment and Competitiveness of the Hungarian Economy

Standard CGER methodologies suggest that, over the course of 2011, the real effective exchange rate has been broadly in line with fundamentals. The ERER approach registered a material move relative to the fall CGER exercise, now suggesting no misalignment. This can largely be explained by the recent sharp depreciation of the nominal and real exchange rates. This change, however, appears to be in part driven by recent fluctuations in investor sentiment and may be temporary. The MB and ES approaches showed only marginal changes. Overall, none of the three approaches reveals a significant misalignment of the forint for the period.

	CGER Spring 2011	CGER Fall 2011	Staff Estimate 1/ Dec-2011
Macro balance (MB) approach	4	-4	-3
Equilibrium Exchange rate (ERER) approach	8	10	-1
External Stability (ES) approach	9	0	-1
Average	**7**	**2**	**-2**

1/ December estimates reflect annual assessment (January 1, 2011 to December 31, 2011)

A broader set of indicators suggests some loss of competitiveness, with implications for export performance relative to emerging market peers. The dynamic of competitiveness in a sample of emerging markets economies is evaluated by the change in the World Economic Forum's Global Competitiveness index (GCI) (see figure). Typically, an increase in the GCI reflects an improvement in competeveness. From 2006 to 2011, the competiveness of the Hungarian economy has fallen relative to many emerging market economies (specifically in East Asia and Central Europe).



Improvement of competitiveness would particularly benefit the manufacturing sector. Goods exports have been increasingly oriented to the eurozone, particularly Germany, which represents more than one third of Hungary's external trade. Much potential lies in Hungary's further integration in trans-European supply chains for machinery and transport equipment, provided weaknesses identified in the GCI can be addressed and the overall policy environment remains conducive to foreign investment.

This deterioration appears to have had an adverse effect on long-term export performance as measured by the change in average real export growth. The recent REER depreciation has induced temporary competitiveness gains, which are even stronger when using a PPI-based REER index. Nonetheless, addressing constraints to doing business, particularly regarding tax policy, access to capital, and labor productivity will boost long-term competitiveness.

Box 6. Measures Affecting the Labor Market

The authorities are taking a host of labor market measures (see table), with potentially profound effects. Several policies contradict each other, introduce long-lasting distortions, and/or not fully developed yet, making it difficult to assess the overall effect on the labor market. It is likely, however, that the measures taken together will increase unemployment in the short term, essentially making the government the "employer of last resort"; while improving labor supply conditions in the long term.

Measures	Impact on labor demand	Impact on labor supply
Elimination of job-seeking assistance, shortening the eligibility period for job-seeking benefits from 270 to 90 days		+
Capping total social benefits at below public work wage		+
Elimination of early retirement schemes		+
Review of eligibility for disability pensions		+
Extending public work programmes	+	+
Social security allowances for hiring former public sector workers and low-skilled out of welfare	+	
Revision to the labor code: more flexible hiring and firing conditions; possibility for differentiated minimum wage	+	
PIT reform		-
Elimination of employment tax credit		-
Partial elimination of super-grossing (for app. below-average wage)		+
Mandatory minimum wage hike of 18 percent	-	+
Recommended gross wage hike, to be determined later	-	+
Wage compensation scheme for wages just below average wage:	?	?
(i) employers complying with recommended gross wage hike are compensated for recommended wage increases above 5 percent; (ii) employees of non-complying emolyers will be compensated according to a scheme that is to be specified.		
Increase in employees' social security contribution by 1 percent		-

***Review of various social benefits will boost labor supply by reducing disincentives to work*.** Implemented measures include significant tightening of unemployment assistance and capping total social benefits at below public work wage. There are also plans, not yet final, to repeal early retirement benefit (possibly retroactively) and preferential pension schemes; and to review disability pensions. Partial-equilibrium simulations by Benczúr et al. (2011)[1] suggest that, if implemented with maximum rigor, these measures can increase employment by 1 percent in the long-term. Additional incentives to return to the labor market include: revoking the long-term unemployment support from those who refuse job offers under the public work programs (see below), and setting the public work wage well below the minimum wage (at 70 percent in 2011 and 60 percent in 2012).

Publicly-funded employment schemes could halt increases in recorded unemployment temporarily:

- *Extending public work programs:* the 2012 Budget envisages the doubling of appropriations (to ½ percent of GDP). The government plan is 200,000 new jobs, but it may not be enough if a large number of those pushed out of welfare are unable to find work (FRIB, June 2011).[2]
- *Fiscal incentives for employing persons made unemployed as a result of the government actions***:** a social security allowance will be made for employing former public sector workers and early retirees. If available only temporarily, this measure will not increase labor demand but shift demand towards preferred unemployed groups, creating a *de facto* two-tier job-seeking market.

The PIT reform and related ad hoc measures are likely to be negative for employment, on balance:

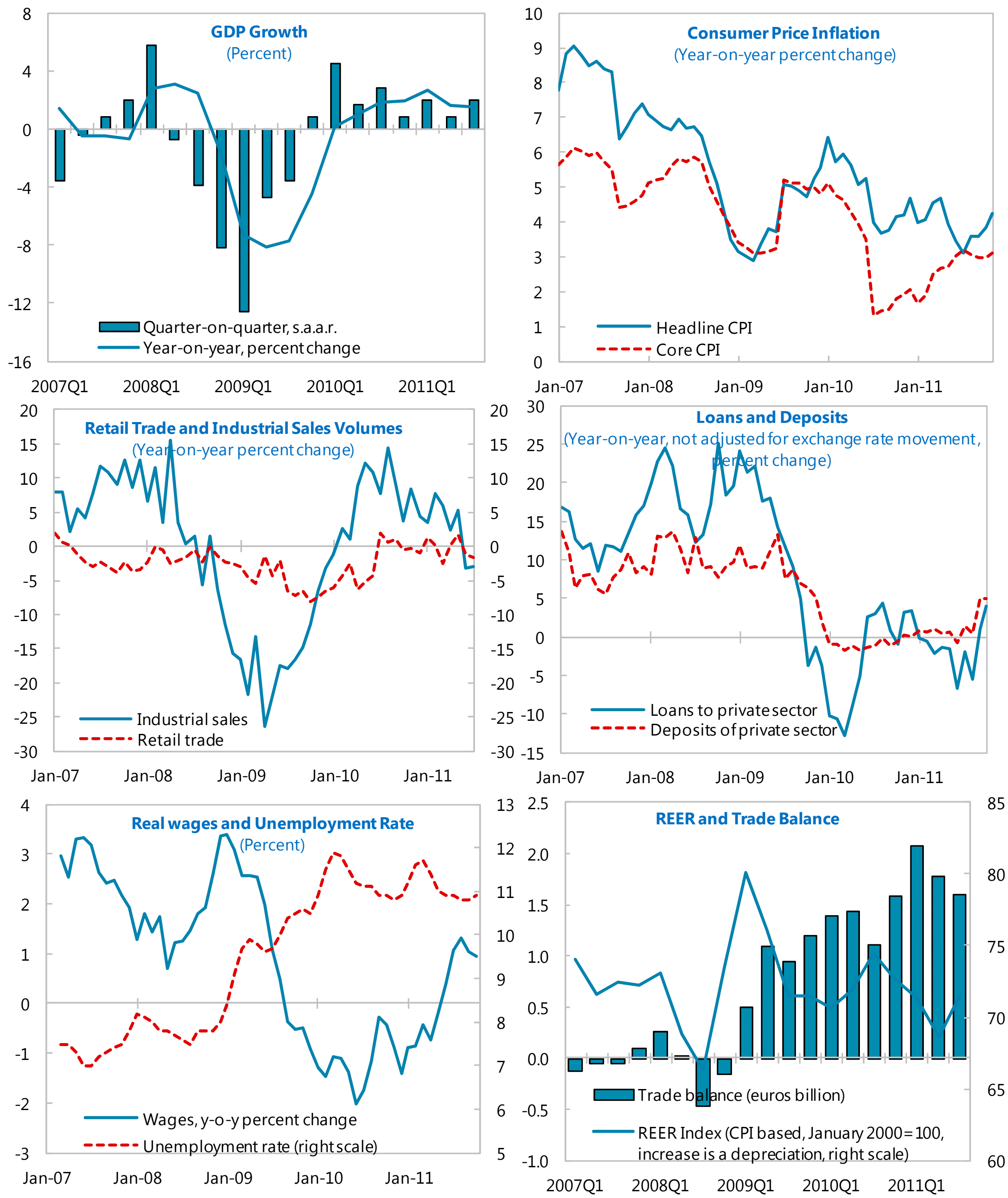
- *Resulting changes in tax rates seem unfavorable for employment.* An increase in labor supply from eliminating the super-gross tax base for low incomes is estimated to be much smaller than a decline in labor supply due to the repealing of the employment tax (Benczúr et al).[1] A hike in the worker's health care contributions will further depress employment.
- *Wage increases (including a minimum wage hike of 18 percent) are aimed at compensating workers negatively affected by PIT changes, but will depress labor demand*. The last minimum wage hike of similar magnitude, in 2001–02, caused well-documented employment losses, especially among low-income.[3]
- *The effects of PIT-related wage compensation scheme is difficult to assess.* The scheme to partially compensate employers for mandatory and recommended wage hikes, or employees for tax increases is likely to complicate the tax system and substantially increase the administrative burden.

[1] Benczúr, P., G. Kátay, Á. Kiss, B. Reizer and M. Szoboszlai, 2011, *The analysis of the changes in the tax and welfare system using a behavioral microsimulation model* (in Hungarian), MNB Bulletin, October 2011.

[2] Fiscal Responsibility Institute of Budapest (FRIB), June 2011, Fiscal Impact Assessment of Actual and Proposed Government Measures Relating to the Labor Market, Social Benefits, and The Pension System. Budapest, June 28 2011.

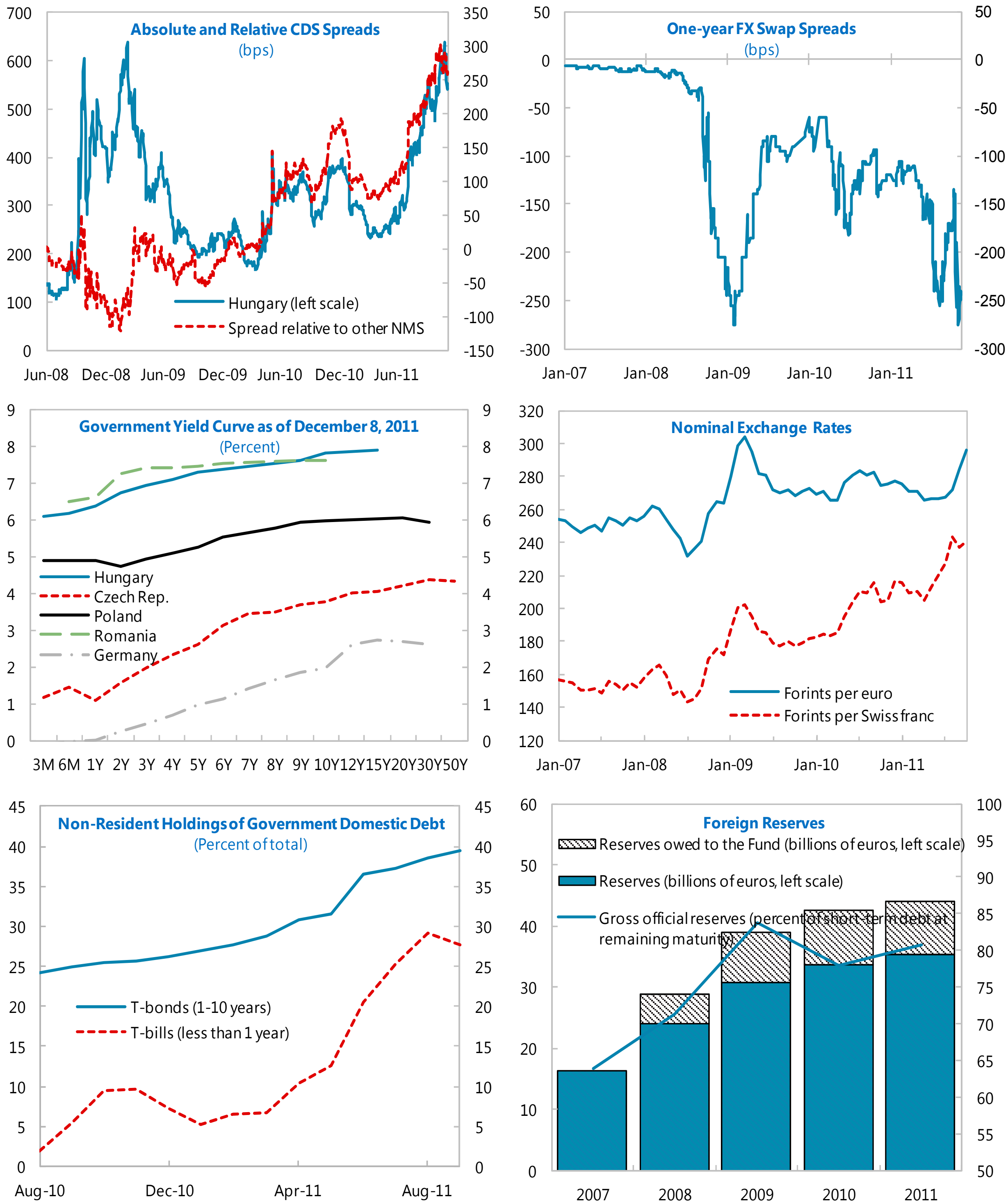
[3] Kertesi, G. and J. Köllő, 2004, *The effects of the 2001 minimum wage hike on employment* (in Hungarian), Közgazdasági Szemle LI./4. p. 293-324 and Halpern, L., G. Koren, G. Kőrösi, J. Vincze, 2004, *The budgetary impact of the minimum wage* (in Hungarian), Közgazdasági Szemle LI./4, p. 325-345.

Figure 1. Hungary: Recent Economic Developments, 2007-11



Sources: Hungarian Statistical Office; NBH and IMF staff estimates.

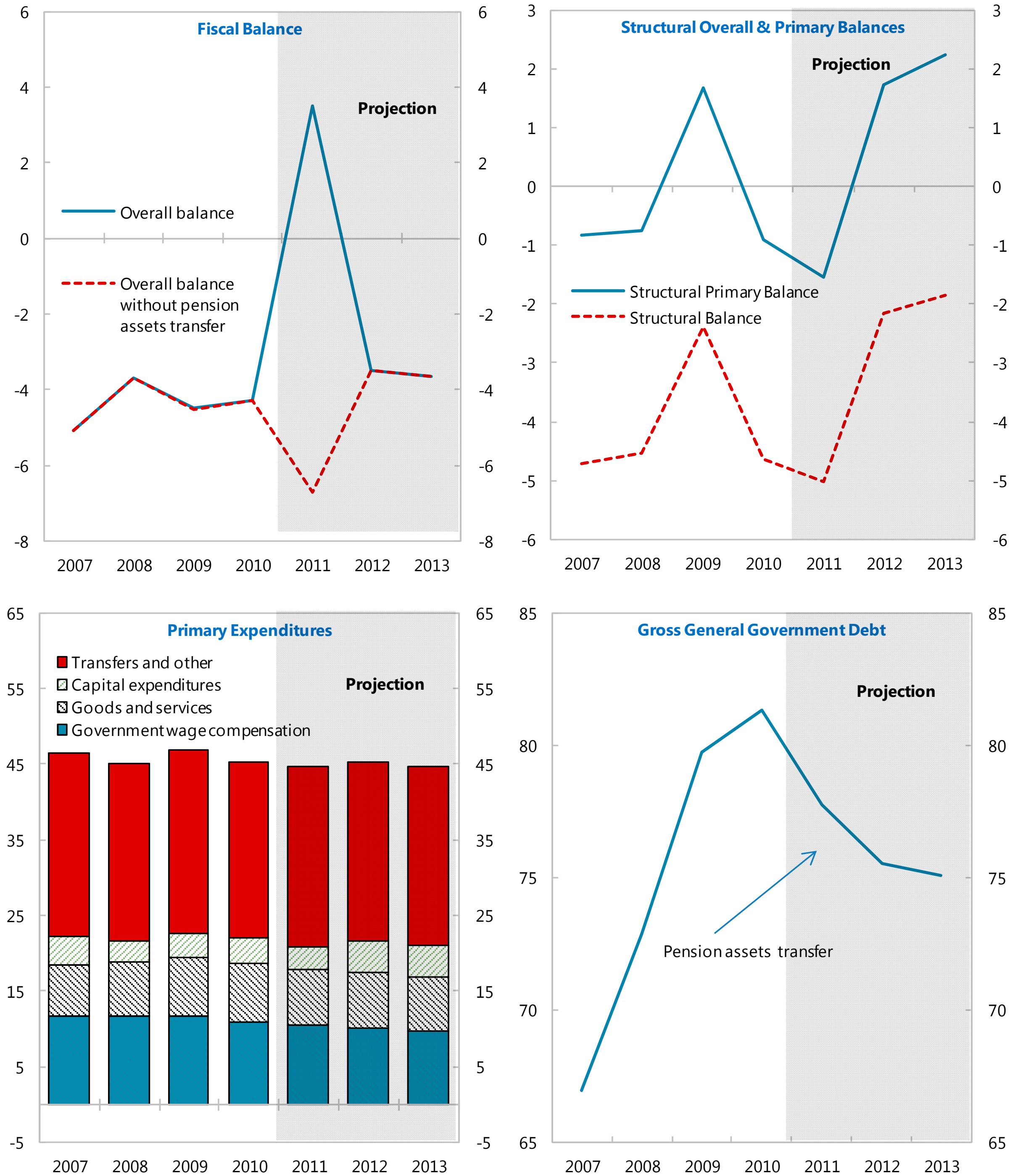
Figure 2. Hungary: Recent Financial Market Developments, 2007-11



Sources: Bloomberg; Haver; NBH and IMF staff estimates.

Figure 3. Hungary: Fiscal Developments, 2007-13

(Percent of GDP)



Source: Hungarian authorities; IMF staff estimates.

Table 1. Hungary: Selected Economic Indicators, 2007–13

	2007	2008	2009	2010	2011	2012	2013
					Projections		
Real economy (change in percent)							
Real GDP	0.1	0.9	-6.8	1.3	1.3	0.3	1.5
Total domestic demand 1/	-1.5	0.7	-10.5	-0.5	-0.3	-0.8	0.4
Private consumption 2/	-1.0	-0.2	-5.8	-2.7	0.1	-1.0	0.4
Public Consumption	-4.2	-0.2	2.6	1.1	-1.0	-0.8	-0.7
Gross fixed investment	3.8	2.9	-11.0	-9.7	-2.0	-0.5	1.5
Foreign balance 1/	1.6	0.2	3.7	1.8	1.6	1.1	1.1
Exports	15.0	5.7	-10.2	14.3	9.5	6.5	8.0
Imports	12.8	5.5	-14.8	12.8	8.2	5.7	7.6
CPI inflation (average)	8.0	6.1	4.2	4.9	4.0	5.0	3.7
CPI inflation (end year)	7.4	3.5	5.6	4.7	4.2	4.8	3.4
Unemployment rate (average, in percent)	7.4	7.8	10.0	11.2	11.1	11.5	11.0
Gross domestic investment (percent of GDP) 3/	21.8	21.7	20.7	18.0	17.2	16.9	16.9
Gross national saving (percent of GDP, from BOP)	14.5	14.4	20.5	19.1	19.1	19.1	18.0
General government (percent of GDP), ESA-95 basis 4/							
Overall balance	-5.1	-3.7	-4.5	-4.3	3.5	-3.5	-3.7
Primary balance	-1.2	0.0	-0.2	-0.5	7.0	0.5	0.5
Primary structural balance, in percent of potential GDP	-0.8	-0.7	1.7	-0.9	-1.5	1.9	2.3
Debt	67.0	72.9	79.7	81.3	77.7	75.7	75.3
Money and credit (end-of-period, percent change)							
Broad money	11.0	7.7	4.4	3.0	5.1	5.5	6.8
Lending to the private sector, flow-based	18.5	12.2	-2.3	-2.4	-4.0	-3.5	-1.0
Interest rates (percent)							
T-bill (90-day, average)	7.6	8.9	8.2	5.4	5.9	...	...
Government bond yield (5-year, average)	7.0	9.3	9.3	7.1	7.2	...	...
5-year sovereign CDS (average in bps; for 2011, as of December 20)	28	196	335	282	572	...	...
Balance of payments							
Goods and services trade balance (percent of GDP)	0.7	0.3	4.7	6.3	7.3	8.1	7.6
Current account (percent of GDP)	-7.3	-7.3	-0.2	1.1	1.9	2.2	1.1
Reserves (in billions of euros)	16.4	24.0	30.7	33.7	35.3	36.6	38.0
Gross external debt (percent of GDP) 5/	104.6	116.8	149.9	141.7	140.6	136.7	128.7
Gross official reserves (percent of short-term debt at remaining maturity) 6/	63.8	71.3	83.7	77.9	80.8	82.1	81.3
Exchange rate							
Exchange regime	Floating						
Present rate (December 21, 2011)	Ft. 301.2 = €1; Ft. 246.7 = CHF1						
Nominal effective rate (2000=100, average)	93.7	93.3	102.6	102.7	...	...	...
Real effective rate, CPI basis (2000=100, average)	72.6	70.4	74.8	72.4	...	...	...
Quota at the Fund	SDR 1038.4 million						
Memorandum Items							
Nominal GDP (billions of forints)	24,991	26,546	25,623	26,748	27,869	29,075	30,362

Sources: Hungarian authorities; IMF, International Financial Statistics; Bloomberg; and IMF staff estimates.
1/ Contribution to growth. Includes change in inventories.
2/ Actual final consumption of households.
3/ Excludes change in inventories.
4/ Consists of the central government budget, social security funds, extrabudgetary funds, and local governments.
5/ Excluding Special Purpose Entities. Including inter-company loans, and nonresident holdings of forint-denominated assets.
6/ Short-term debt at remaining maturity includes 20 percent of inter-company debt liabilities.

Table 2. Hungary: Staff's Illustrative Medium-Term Scenario, 2007–16

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	Average 2002-07	Average 2013-16
					Projections							
				(In percent, unless otherwise indicated)								
Real GDP growth	0.1	0.9	-6.8	1.3	1.3	0.3	1.5	3.0	3.2	3.2	3.5	2.7
Nominal GDP, forint billions	24,991	26,546	25,623	26,748	27,869	29,075	30,362	32,237	34,287	36,435	...	...
Inflation (CPI; year average basis)	8.0	6.1	4.2	4.9	4.0	5.0	3.7	3.0	3.0	3.0	5.4	3.2
Inflation (CPI; end-year basis)	7.4	3.5	5.6	4.7	4.2	4.8	3.4	3.0	3.0	3.0	...	...
				(Annual percentage change, constant prices)								
Domestic demand	-1.4	0.7	-10.6	-0.5	0.5	-0.9	0.5	4.0	4.1	3.9	3.1	3.1
Total consumption	-1.4	-0.2	-4.7	-2.2	0.0	-1.0	0.2	4.0	4.1	3.7	3.3	3.0
Gross fixed capital formation	3.8	2.9	-11.0	-9.7	-2.0	-0.5	1.5	4.0	4.0	4.5	3.6	3.5
Exports of GNFS	15.0	5.7	-10.2	14.3	9.5	6.5	8.0	8.0	8.0	7.8	11.7	8.0
Imports of GNFS	12.8	5.5	-14.8	12.8	8.2	5.7	7.6	9.5	9.2	8.8	10.9	8.8
Lending to the private sector, flow-based (current prices, e.o.p.)	18.5	12.2	-2.3	-2.4	-4.0	-3.5	-1.0	4.0	4.0	4.0	...	...
Unemployment rate (percent of labor force, year average basis)	7.4	7.8	10.0	11.2	11.1	11.5	11.0	10.0	9.5	9.0	6.6	9.9
				(In percent of GDP, unless otherwise indicated)								
External current account balance	-7.3	-7.3	-0.2	1.1	1.9	2.2	1.1	-1.4	-1.8	-2.5	-7.4	-1.2
Gross national saving	14.5	14.4	20.5	19.1	19.1	19.1	18.0	15.8	15.6	15.2	15.1	16.2
Gross domestic investment 1/	21.8	21.7	20.7	18.0	17.2	16.9	16.9	17.2	17.5	17.7	22.5	17.3
Capital account, net	0.7	1.0	1.2	1.8	2.8	3.5	1.3	0.9	0.8	0.8	...	...
Financial account, net	6.7	9.2	-4.0	1.3	0.7	0.8	3.8	3.8	2.0	3.8	...	...
Gross external debt 2/	104.6	116.8	149.9	141.7	140.6	136.7	128.7	122.9	117.4	112.6	...	...
General government (ESA-95)												
Revenue, total	45.6	45.5	46.9	45.2	52.0	45.6	45.0	45.2	45.4	45.4	43.5	45.3
Expenditure, primary	46.5	45.1	46.8	45.3	44.5	45.0	44.4	44.4	44.4	44.4	46.9	44.4
Primary balance 3/	-1.2	0.0	-0.2	-0.5	7.0	0.5	0.5	0.7	0.9	0.9	-3.6	0.8
General government overall balance	-5.1	-3.7	-4.5	-4.3	3.5	-3.5	-3.7	-3.6	-3.5	-3.5	-7.4	-3.6
Interest expenditure	4.1	4.1	4.6	4.2	4.0	4.2	4.4	4.5	4.5	4.5	4.1	4.5
General government debt	67.0	72.9	79.7	81.3	77.7	75.7	75.3	74.2	72.9	71.7	64.8	73.5
Memorandum items												
Output gap	1.3	2.3	-4.0	-2.5	-1.6	-2.5	-2.9	-2.4	-1.8	-1.2	...	...
Potential GDP growth	0.8	-0.1	-0.7	-0.3	0.4	1.2	1.9	2.4	2.6	2.6	3.2	2.4
Structural general government balance (in percent of potential GDP)	-4.7	-4.5	-2.4	-4.6	-5.0	-2.0	-1.8	-2.5	-2.6	-2.9	...	...
Structural primary balance (in percent of potential GDP)	-0.8	-0.7	1.7	-0.9	-1.5	1.9	2.3	1.8	1.7	1.4	...	...
Gross official reserves (in percent of short-term debt at remaining maturity) 4/	63.8	71.3	83.7	77.9	80.8	82.1	81.3	93.3	85.3	86.8	...	...

Sources: Hungarian authorities; and staff estimates.

1/ Excludes change in inventories.
2/ Excluding Special Purpose Entities. Including inter-company loans, and nonresident holdings of forint-denominated assets.
3/ Includes interest revenue.
4/ Short-term debt at remaining maturity includes 20 percent of inter-company debt liabilities.

Table 2a. Hungary: Staff's Illustrative Adverse Scenario, 2007–13

	2007	2008	2009	2010	2011	2012	2013
						Projections	
	(In percent, unless otherwise indicated)						
Real GDP growth	0.1	0.9	-6.8	1.3	1.3	-3.4	1.0
Nominal GDP, forint billions	24,991	26,546	25,623	26,748	27,845	28,108	29,312
Inflation (CPI; year average basis)	8.0	6.1	4.2	4.9	4.0	5.5	4.0
Inflation (CPI; end-year basis)	7.4	3.5	5.6	4.7	4.2	5.2	3.8
	(Annual percentage change, constant prices)						
Domestic demand	-1.4	0.7	-10.6	-0.5	0.5	-3.7	0.9
Total consumption	-1.4	-0.2	-4.7	-2.2	-0.1	-3.4	0.8
Gross fixed capital formation	3.8	2.9	-11.0	-9.7	-2.0	-5.0	1.0
Exports of GNFS	15.0	5.7	-10.2	14.3	9.5	0.0	3.0
Imports of GNFS	12.8	5.5	-14.8	12.8	8.2	0.0	3.0
Unemployment rate (percent of labor force, year average basis)	7.4	7.8	10.0	11.2	11.3	12.3	12.0
	(In percent of GDP, unless otherwise indicated)						
External current account balance	-7.3	-7.3	-0.2	1.1	1.9	1.6	1.7
Gross national saving	14.5	14.4	20.5	19.1	19.1	18.5	18.5
Gross domestic investment 1/	21.8	21.7	20.7	18.0	17.2	16.8	16.8
Capital account, net	0.7	1.0	1.2	1.8	2.8	4.1	1.6
Financial account, net	6.7	9.2	-4.0	1.3	0.7	-7.8	-3.8
Gross external debt 2/	104.6	116.8	149.9	141.7	140.6	155.5	138.9
General government (ESA-95)							
Revenue, total	45.6	45.5	46.9	45.2	52.2	46.5	45.4
Expenditure, primary	46.5	45.1	46.8	45.3	44.6	47.3	46.5
Primary balance 3/	-1.2	0.0	-0.2	-0.5	7.1	-1.0	-1.5
General government overall balance	-5.1	-3.7	-4.5	-4.3	3.5	-5.8	-7.1
Interest expenditure	4.1	4.1	4.6	4.2	3.9	4.9	6.0
General government debt	67.0	72.9	79.7	81.3	77.6	84.2	87.5
Memorandum items							
Output gap	1.3	2.3	-4.0	-2.5	-1.6	-5.4	-5.4
Potential GDP growth	0.8	-0.1	-0.7	-0.3	0.4	0.5	1.0
Structural general government balance	-4.7	-4.4	-2.5	-4.6	-4.5	-3.0	-3.3
Gross official reserves (percent of short-term debt at remaining maturity) 4/	63.8	71.3	83.7	77.9	78.1	85.3	87.1

Sources: Hungarian authorities; and staff estimates.

1/ Excludes change in inventories.
2/ Excluding Special Purpose Entities. Including inter-company loans, and nonresident holdings of forint-denominated assets.
3/ Includes interest revenue.
4/ Short-term debt at remaining maturity includes 20 percent of inter-company debt liabilities.

Table 3. Hungary: Consolidated General Government, 2007–16 1/

(In percent of GDP, unless otherwise indicated)

					Projections					
	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Revenue	45.6	45.5	46.9	45.2	52.0	45.6	45.0	45.2	45.4	45.4
Tax revenue	26.3	26.3	26.6	25.4	22.6	25.0	23.8	23.9	23.9	23.9
Taxes on goods and services	15.9	15.6	16.6	16.9	15.9	17.8	17.2	17.2	17.2	17.2
VAT	7.9	7.6	8.4	8.6	7.7	9.1	9.0	9.2	9.3	9.4
Excises and other 2/ 3/	8.0	8.0	8.2	8.3	8.2	8.8	8.1	8.0	7.9	7.8
Taxes on income, profits and capital gains	10.4	10.6	10.0	8.5	6.7	7.1	6.6	6.6	6.7	6.7
Personal income tax	7.3	7.7	7.4	6.5	4.9	5.2	5.0	5.0	5.0	5.0
Corporate taxes	2.8	2.6	2.3	1.2	1.1	1.1	1.1	1.1	1.1	1.1
Capital taxes 2/	0.1	0.1	0.1	0.5	0.5	0.5	0.3	0.2	0.2	0.2
Other 2/	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Social contributions	13.9	13.8	13.3	12.1	13.1	13.0	13.5	13.7	13.7	13.8
Current non-tax revenue	3.9	4.1	4.3	4.0	3.9	3.7	3.7	3.7	3.7	3.7
o.w. interest revenue	0.3	0.4	0.3	0.3	0.4	0.2	0.2	0.2	0.1	0.1
Current grants	0.7	0.8	1.3	1.5	1.0	1.4	1.4	1.4	1.4	1.4
Capital revenues and grants 4/	0.8	0.6	1.4	2.1	11.3	2.6	2.6	2.6	2.6	2.6
Expenditure 5/	50.6	49.2	51.4	49.5	48.5	49.2	48.7	48.9	48.9	48.9
Compensation of employees 6/	11.7	11.6	11.5	10.9	10.4	10.1	9.7	9.7	9.7	9.7
Goods and services	6.8	7.2	7.8	7.8	7.3	7.4	7.2	7.2	7.2	7.2
Interest	4.1	4.1	4.6	4.2	4.0	4.2	4.4	4.5	4.5	4.5
Subsidies	1.4	1.1	1.0	1.1	1.1	1.1	1.1	1.1	1.1	1.1
Current transfers to households	18.4	18.7	19.4	18.5	18.3	17.2	17.0	17.0	17.0	17.0
Social security	13.7	14.3	14.8	14.3	14.3	13.7	13.5	13.5	13.5	13.5
o.w. unemployment benefits	0.4	0.4	0.6	0.6	0.5	0.2	0.2	0.2	0.2	0.2
Other	4.7	4.4	4.6	4.2	4.0	3.5	3.5	3.5	3.5	3.5
Other current transfers	2.7	2.3	2.6	2.4	2.3	3.5	3.4	3.4	3.4	3.4
Capital expenditures	3.6	2.7	3.1	3.3	3.2	4.2	4.2	4.2	4.2	4.2
Capital transfers 7/	1.9	1.4	1.3	1.2	1.9	1.5	1.7	1.7	1.7	1.7
General government balance	-5.1	-3.7	-4.5	-4.3	3.5	-3.5	-3.7	-3.6	-3.5	-3.5
Primary balance	-1.2	0.0	-0.2	-0.5	7.0	0.5	0.5	0.7	0.9	0.9
Memorandum items:										
Convergence program overall balance	..	..	..	..	2.0	-2.5	-2.2	-1.9	-1.5	..
Gap to convergence program	..	..	..	..	-1.5	1.0	1.5	1.7	2.0	..
Transfer of pension assets to the state system	0.0	0.0	0.1	0.2	9.6	0.0	0.0	0.0	0.0	0.0
General government balance excl. pension assets	-5.1	-3.7	-4.6	-4.5	-6.1	-3.5	-3.7	-3.6	-3.5	-3.5
Cyclically-adj. balance	-5.6	-4.7	-2.5	-3.1	4.3	-2.4	-2.3	-2.5	-2.7	-2.9
Annual change	4.6	0.9	2.2	-0.6	7.5	-6.7	0.0	-0.2	-0.1	-0.2
One-off items (net)	-1.0	-0.3	0.0	1.6	9.4	0.2	-0.5	0.0	0.0	0.0
Structural balance (% of potential GDP)	-4.7	-4.5	-2.4	-4.6	-5.0	-2.4	-1.8	-2.5	-2.6	-2.9
Annual change	4.9	0.2	2.1	-2.2	-0.4	2.6	0.7	-0.7	-0.2	-0.2
Structural primary balance (% of potential GDP)	-0.8	-0.7	1.7	-0.9	-1.5	1.4	2.3	1.8	1.7	1.4
Annual change	5.0	0.1	2.4	-2.6	-0.6	3.0	0.9	-0.6	-0.1	-0.2
Output gap	1.3	2.3	-4.0	-2.5	-1.6	-2.5	-2.9	-2.4	-1.8	-1.2
Gross public debt	67.0	72.9	79.7	81.3	77.7	75.7	75.3	74.2	72.9	71.7
In nominal terms (HUF billions)										
Revenue	11,387	12,086	12,015	12,080	14,478	13,272	13,678	14,584	15,554	16,535
Of which tax revenues	6,577	6,972	6,821	6,804	6,307	7,255	7,233	7,693	8,193	8,698
Expenditure	12,656	13,062	13,165	13,228	13,504	14,294	14,797	15,757	16,760	17,805
Transfer of pension assets	0	0	26	65	2,688	0	0	0	0	0
Primary balance	-310	7	-56	-124	1,956	138	163	236	295	322
Overall balance	-1,269	-976	-1,150	-1,147	974	-1,021	-1,119	-1,173	-1,206	-1,269

Sources: Hungarian authorities; and staff estimates.

1/ Data are classified following the ESA'95 methodology.

2/ Includes the transitory sector levy on financial institutions. Starting 2013 it is assumed that the financial sector levy is replaced by a permanent financial sector tax targeting half of the revenues obtained from the current levy.

3/ Includes transitory sector levy on telecommunications, retail and energy sectors, which expire in 2012.

4/ In 2011 includes 9.6 percent of GDP from the transfer of pension assets to the state system, net of pension return payout to contributors remaining in the private pension system of 0.9 percent of GDP.

5/ For 2013-2016, all non-interest expenditure categories are projected according to the nominal GDP growth rate.

6/ Includes social security contributions.

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

Table 4. Hungary: Central Government Financing, 2011-16
(In percent of GDP)

	2011	2012	2013	2014	2015	2016
Gross financing needs	**19.1**	**18.5**	**18.7**	**16.2**	**12.4**	**13.8**
Central government cash deficit	2.2	3.3	3.2	2.9	3.0	2.9
Repayments	15.6	15.7	16.3	13.7	9.8	11.2
Domestic	10.6	11.1	11.6	8.7	8.6	8.0
Loans	0.0	0.0	0.0	0.2	0.1	0.1
LT bonds 1/ 2/	4.7	4.2	6.1	3.0	3.1	2.6
T bills 2/	5.8	6.9	5.5	5.4	5.4	5.4
External	4.2	4.6	4.7	4.9	1.2	3.2
Bonds	2.0	1.3	1.3	2.3	0.9	1.4
Loans	2.3	3.3	3.4	2.6	0.3	1.8
Other debt	0.8	0.0	0.0	0.0	0.0	0.0
Impact of bond cancellation 3/	-0.4	-0.5	-0.8	-0.4	-0.4	-0.3
Impact of debt assumption of transport companies	-0.2	0.0	0.0	0.0	0.0	0.0
Purchase of MOL shares	1.8	0.0	0.0	0.0	0.0	0.0
Recapitalization of MFB	0.1	0.0	0.0	0.0	0.0	0.0
Gross financing sources	**19.1**	**18.5**	**18.7**	**16.2**	**12.4**	**13.8**
Domestic	12.4	13.9	13.0	10.4	10.3	9.8
Loans	0.0	0.0	0.0	0.0	0.0	0.0
LT bonds 1/ 2/	5.2	8.1	7.3	4.7	4.6	4.1
T bills 2/	7.2	5.8	5.8	5.7	5.7	5.7
External	4.9	4.6	5.6	5.8	2.1	4.0
Bonds	4.3	4.0	4.7	4.9	1.2	3.2
Loans	0.6	0.6	0.9	0.9	0.8	0.8
Deposit drawdown	1.8	0.0	0.0	0.0	0.0	0.0
Memo items:						
Gross financing needs excl. short term debt	13.3	11.5	13.1	10.7	7.0	8.4
Gross financing requirements, in US$ bn.	18.7	18.5	20.1	18.5	15.1	17.8
o/w short term amortization	5.7	6.9	6.0	6.2	6.5	6.9
Rollover rate, in percent	111	117	115	118	126	123
Rollover rate of long-term bonds, in percent	141	220	162	178	146	183

Source: Hungarian authorities and staff calculations
1/ Net of bond buy-backs.
2/ Excludes flows related to non-residents' holdings of HUF bonds.
3/ Captures operations from the transfer of pension assets to the state system.

Table 5. Hungary: Central Bank Survey, 2007-2013

(Local Currency Billions)

	2007	2008	2009	2010	2011		2012	2013
					Sep	Dec	Dec	Dec
					Actual	*Projected*	*Projected*	*Projected*
Net foreign assets	3941	5988	7261	7449	10217	8671	9031	9405
Foreign Assets	4359	6584	8484	9598	11523	10809	11171	11566
Foreign Liabilities	418	596	1223	2149	1306	2138	2140	2161
Net domestic assets	-890	-2340	-4460	-4244	-7121	-5145	-5293	-5481
Net claims on government	-108	-1286	-709	-827	-2154	-1034	-995	-995
Assets	147	360	279	249	216	216	140	140
Liabilities (Govt Deposits at MNB)	255	1646	988	1077	2370	1250	1135	1135
HUF	197	128	248	273	935	...	...	...
FX	58	1518	741	804	1435	...	...	...
Net claims on banks	-706	-910	-3147	-2565	-3568	-2713	-2899	-3087
Assets	0	177	0	35	57	40	40	40
Liabilities	706	1087	3147	2600	3626	2752	2939	3126
Two Week Deposit Facility	270	-114	244	120	152	0	0	0
Securities Issued by MNB	436	1201	2903	2480	3474	2752	2939	3126
Net claims on the economy	-118	-50	-197	-355	-361	-361	-361	-361
Other items, net	42	-95	-406	-496	-1038	-1038	-1038	-1038
Base money (M0)	3051	3647	2801	3206	3096	3526	3737.7	3924.6
Currency in Circulation	2258	2404	2268	2464	2508	2748	2913.0	3058.7
Banks' Reserves	793	1243	533	741	588	778	824.7	865.9
Current Account Balances	683	328	339	448	465	518	549	576
Overnight Deposits	110	915	194	293	123	260	276	290
***Memorandum items*:**								
International Reserves (Euros)	16.4	24.0	30.7	33.7	...	35.3	36.6	38.0
Base Money (yoy percent change)	11.4	19.5	-23.2	14.4	8.6	10.0	6.0	5.0
NFA (by contribution)	3.8	67.1	34.9	6.7	77.3	38.1	10.2	10.0
NDA (by contribution)	7.7	-47.5	-58.1	7.7	-68.7	-28.1	-4.2	-5.0
Government Deposits at Central Bank (percent of GDP)	1.0	6.2	3.9	4.0	8.6	4.5	3.9	3.7
HUF	0.8	0.5	1.0	1.0	...	...	...	...
FX	0.2	5.7	2.9	3.0	...	...	...	...
Central Bank Bills Outstanding (percent of GDP)	1.7	4.5	11.3	9.3	13.0	9.9	10.1	10.7
Portion of CB Bills Owned by Non-Residents (percent)	15.2	7.2	4.0	9.3	...	...	...	...
Reserve Requirement Ratio (percent of select liabilities)	5.0	2.0	2.0		2% to 5%			

Sources: Magyar Nemzeti Bank and IMF staff calculation.

Table 6. Hungary: Monetary Survey, 2007-13
(Local Currency Billions)

	2007	2008	2009	2010	2011		2012	2013
					Sep	Dec		
					Actual	*Projected*	*Projected*	*Projected*
Net foreign assets	-947	-1486	568	1244	3921	3261	4400	5002
Central Bank	3941	5988	7261	7449	10217	8671	9031	9405
Commercial Banks	-4888	-7474	-6693	-6205	-6296	-5410	-4631	-4403
Foreign Assets	2942	3737	3767	3675	3612	3460	3745	3801
Foreign Liabilities	7829	11211	10460	9880	9908	8870	8376	8205
Net domestic assets	15143	16779	15397	15197	13149	14017	13836	14482
Domestic credit	18302	21002	20303	21135	19728	20596	20415	21060
Net claims on government	3270	2953	3037	3461	2050	3426	4047	4657
From Central Bank	-108	-1286	-709	-827	-2154	-1034	-995	-995
From Commercial Banks	3378	4239	3747	4288	4205	4460	5042	5652
Gross Credit to the economy	15032	18049	17266	17674	17677	17170	16368	16404
From Central Bank	-118	-50	-197	-355	-361	-361	-361	-361
From Comercial Banks	15150	18099	17462	18029	18038	17308	16702	16535
Other items, net	-3159	-4223	-4906	-5938	-6579	-6579	-6579	-6579
Broad money (M3)	14196	15292	15964	16441	17070	17279	18236	19483
M2	12937	14097	14354	14351	14803	15082	15918	17006
M1	6348	6162	6122	6635	6822	6973	7359	7863
Currency in circulation	2068	2137	2039	2218	2370	2331	2461	2629
Overnight Deposits	4280	4025	4082	4417	4453	4642	4899	5234
Deposits with Maturities up to 2 years	6589	7935	8233	7716	7981	8109	8558	9144
Repos	82	22	35	34	30	36	38	40
Money Market Fund Shares/Units	978	858	1115	1335	1340	1403	1481	1582
Debt Securities	200	316	460	721	897	758	800	854
Memorandum items :								
	(percentage change by contribution, y-o-y)							
Broad Money	11.0	7.7	4.4	3.0	5.3	5.1	5.5	6.8
NFA	-6.8	-3.8	13.4	4.2	16.7	12.3	6.6	3.3
NDA	17.8	11.5	-9.0	-1.3	-11.4	-7.2	-1.0	3.5
	(percentage change, y-o-y)							
Credit to Private Sector 1/ 2/	18.5	12.2	-2.3	-2.4	-3.0	-4.0	-3.5	-1.0
HUF	-0.4	-3.1	0.4	5.2	3.7	...	...	
FX	42.2	25.6	-4.0	-7.1	-7.6	...	...	
Bank Deposits (% yoy)	9.1	9.8	2.1	0.0	4.9	0.6	7.2	6.1
Bank Holdings of Government Paper	12.2	14.9	15.3	15.4	14.4	15.1	16.5	17.8

Sources: Magyar Nemzeti Bank and IMF staff calculation.
1/ Adjusted for changes in exchange rate
2/ Only credit to households and firms

Table 7. Hungary: Financial Soundness Indicators for the Banking Sector, 2008-11
(In percent unless otherwise indicated, end of period)

	2008	2009	2010	2011 1/
Capital				
Regulatory capital to risk-weighted assets	12.4	13.9	13.9	14.5
Regulatory Tier1 capital to risk-weighted assets	10.4	11.7	11.4	12.2
Asset Quality				
NPLs net of provisions to capital	15.6	33.0	49.3	51.2
NPLs to gross loans	3.0	6.7	9.8	12.4
Distribution of Loans (Percent of Total)				
Firms	36.0	35.9	34.6	34.8
Households and Non-Profits	36.7	37.7	40.4	41.6
Non-Residents	11.6	11.8	10.3	8.9
Other	15.7	14.7	14.8	14.7
Profitability				
ROA	1.2	0.6	0.0	0.7
ROE	16.6	8.3	0.4	8.1
Net interest income to gross income	65.4	66.8	71.6	73.1
Noninterest expenses to gross income	59.3	48.9	48.5	48.9
Liquidity				
Liquid assets to total assets	16.9	23.7	21.6	24.4
Liquid assets to short term liabilities	33.0	45.7	41.5	45.4
Sensitivity to Market risk				
Net open FX position to Regulatory capital	15.27	17.76	15.89	15.27

Source: MNB.
1/ As of June 2011.

Table 8. Hungary: Balance of Payments, 2005–16
(in millions of euros)

	2005	2006	2007	2008	2009	2010	2011 Proj.	2012 Proj.	2013 Proj.	2014 Proj.	2015 Proj.	2016 Proj.
Current Account	**-6,624**	**-6,636**	**-7,223**	**-7,752**	**-181**	**1,064**	**1,845**	**2,237**	**1,097**	**-1,698**	**-2,401**	**-3,447**
Goods and service, net	-1,322	-1,033	652	309	4,328	6,137	7,193	8,125	8,092	5,776	5,620	5,088
Exports	60,022	69,247	80,395	85,915	70,667	83,626	91,385	97,888	105,924	114,505	125,524	137,177
Imports	-61,345	-70,281	-79,743	-85,606	-66,340	-77,489	-84,193	-89,762	-97,832	-108,729	-119,903	-132,088
Income, net	-5,019	-5,298	-7,372	-7,481	-4,926	-5,468	-5,782	-6,307	-7,099	-7,609	-8,169	-8,681
Current transfers, net	-282	-305	-503	-579	417	395	435	418	104	135	147	145
Capital Account	**599**	**685**	**708**	**1,016**	**1,093**	**1,735**	**2,722**	**3,501**	**1,412**	**1,013**	**1,013**	**1,013**
Net capital transfers	586	670	789	919	1,691	2,017	2,722	3,501	1,412	1,013	1,013	1,013
Financial Account	**12,007**	**8,841**	**6,663**	**9,771**	**-3,612**	**1,391**	**666**	**763**	**4,127**	**4,408**	**2,417**	**4,909**
Direct investment, net	4,417	2,327	209	2,677	-162	429	-1,788	294	110	527	1,170	1,672
Direct Investment Abroad	-1,756	-3,127	-2,643	-1,514	-1,304	-949	-1,095	-1,183	-1,246	-1,116	-1,195	-1,203
In Hungary	6,172	5,454	2,852	4,191	1,143	1,378	-693	1,477	1,356	1,643	2,365	2,876
Portfolio investment, net 1/	3,388	5,222	-789	-3,202	-2,852	536	5,511	1,945	4,141	3,462	908	2,845
Other investment	4,203	1,292	7,242	10,297	-599	425	-3,057	-1,476	-124	419	339	392
Net errors and omissions	-2,075	-1,923	-13	-2,283	-298	-1,171	-1,600	-1,600	-1,000	-1,000	-1,000	-1,000
Overall Balance	3,908	968	134	753	-2,998	3,018	3,633	4,900	5,636	2,723	29	1,475
Official Financing				2,000	3,500	0	-2,000	0	0	-2,000	0	-1,500
European Union				2,000	3,500	0	-2,000	0	0	-2,000	0	-1,500
Net International Reserves (increase -)	-3,908	-968	-134	-2,753	-502	-3,018	-1,633	-4,900	-5,636	-723	-29	25
Gross Reserves	-3,908	-968	-134	-7,676	-5,486	-3,018	-1,633	-1,266	-1,304	-40	-29	24
Reserve Liabilities	0	0	0	4,923	4,984	0	0	-3,634	-4,332	-683	0	1
Bank Guarantee Fund	0	0	0	0	0	0	0	0	0	0	0	0
Prospective Fund credits	0	0	0	4,923	4,984	0	0	-3,634	-4,332	-683	0	1
Current account (in percent of GDP)	-7.5	-7.4	-7.3	-7.3	-0.2	1.1	1.9	2.2	1.0	-1.5	-2.0	-2.7
Gross external debt (in percent of GDP) 2/	80.9	96.8	104.6	116.8	149.9	141.7	140.6	136.7	128.7	122.9	117.4	112.6
Gross official reserves	15,721	16,397	16,385	24,040	30,676	33,675	35,308	36,574	37,878	37,919	37,947	37,923
In percent of short-term debt at remaining maturity 3/	99.9	95.9	63.8	71.3	83.7	77.9	80.8	82.1	81.2	92.7	84.4	85.5

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

Table 9. Hungary: Balance of Payments, 2005–16
(in percent of GDP)

	2005	2006	2007	2008	2009	2010	2011 Proj.	2012 Proj.	2013 Proj.	2014 Proj.	2015 Proj.	2016 Proj.
Current Account	**-7.5**	**-7.4**	**-7.3**	**-7.3**	**-0.2**	**1.1**	**1.9**	**2.2**	**1.0**	**-1.5**	**-2.0**	**-2.7**
Goods and service, net	-1.5	-1.2	0.7	0.3	4.7	6.3	7.4	8.1	7.5	5.0	4.6	3.9
Exports	67.6	77.3	80.8	81.3	77.4	86.1	93.5	97.5	98.2	100.0	103.0	106.0
Imports	-69.1	-78.4	-80.2	-81.0	-72.6	-79.8	-86.1	-89.4	-90.7	-94.9	-98.4	-102.0
Income, net	-5.7	-5.9	-7.4	-7.1	-5.4	-5.6	-5.9	-6.3	-6.6	-6.6	-6.7	-6.7
Current transfers, net	-0.3	-0.3	-0.5	-0.5	0.5	0.4	0.4	0.4	0.1	0.1	0.1	0.1
Capital Account	**0.7**	**0.8**	**0.7**	**1.0**	**1.2**	**1.8**	**2.8**	**3.5**	**1.3**	**0.9**	**0.8**	**0.8**
Net capital transfers from the EU	0.7	0.7	0.8	0.9	1.9	2.1	2.8	3.5	1.3	0.9	0.8	0.8
Financial Account	**13.5**	**9.9**	**6.7**	**9.2**	**-4.0**	**1.4**	**0.7**	**0.8**	**3.8**	**3.8**	**2.0**	**3.8**
Direct investment, net	5.0	2.6	0.2	2.5	-0.2	0.4	-1.8	0.3	0.1	0.5	1.0	1.3
Direct Investment Abroad	-2.0	-3.5	-2.7	-1.4	-1.4	-1.0	-1.1	-1.2	-1.2	-1.0	-1.0	-0.9
In Hungary	7.0	6.1	2.9	4.0	1.3	1.4	-0.7	1.5	1.3	1.4	1.9	2.2
Portfolio investment, net 1/	3.8	5.8	-0.8	-3.0	-3.1	0.6	5.6	1.9	3.8	3.0	0.7	2.2
Other investment	4.7	1.4	7.3	9.7	-0.7	0.4	-3.1	-1.5	-0.1	0.4	0.3	0.3
Net errors and omissions	-2.3	-2.1	0.0	-2.2	-0.3	-1.2	-1.6	-1.6	-0.9	-0.9	-0.8	-0.8
Overall Balance	4.4	1.1	0.1	0.7	-3.3	3.1	3.7	4.9	5.2	2.4	0.0	1.1
Official Financing	0.0	0.0	0.0	1.9	3.8	0.0	-2.0	0.0	0.0	-1.7	0.0	-1.2
European Union	0.0	0.0	0.0	1.9	3.8	0.0	-2.0	0.0	0.0	-1.7	0.0	-1.2
Net International Reserves (increase -)	-4.4	-1.1	-0.1	-2.6	-0.5	-3.1	-1.7	-4.9	-5.2	-0.6	0.0	0.0
Gross Reserves	-4.4	-1.1	-0.1	-7.3	-6.0	-3.1	-1.7	-1.3	-1.2	0.0	0.0	0.0
Reserve Liabilities	0.0	0.0	0.0	4.7	5.5	0.0	0.0	-3.6	-4.0	-0.6	0.0	0.0
Bank Guarantee Fund	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Prospective Fund credits	0.0	0.0	0.0	4.7	5.5	0.0	0.0	-3.6	-4.0	-0.6	0.0	0.0
Gross external debt (in percent of GDP) 2/	80.9	96.8	104.6	116.8	149.9	141.7	140.6	136.7	128.7	122.9	117.4	112.6
Gross official reserves	15,721	16,397	16,385	24,040	30,676	33,675	35,308	36,574	37,878	37,919	37,947	37,923
In percent of short-term debt at remaining maturity 3/	99.9	95.9	63.8	71.3	83.7	77.9	80.8	82.1	81.2	92.7	84.4	85.5

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

Table 10. Hungary: External Financing Needs, 2009 - 16

(in millions of euros)

	2009 Est.	2010 Est.	2011 Proj.	2012 Proj.	2013 Proj.	2014 Proj.	2015 Proj.	2016 Proj.
Total financing requirements	**31,426**	**35,665**	**35,470**	**33,539**	**36,545**	**41,056**	**36,208**	**41,302**
Current account deficit - EU capital transfers	-912	-2,799	-4,542	-5,751	-2,600	541	1,230	2,250
Amortizations	32,040	37,292	38,412	37,690	38,146	39,515	33,978	38,052
FDI (inter company)	4,394	6,388	6,057	5,974	6,151	6,314	6,511	6,795
General government	4,340	4,688	7,287	9,354	11,656	11,920	7,563	10,212
Eurobonds		1,155	1,946	1,307	1,398	2,684	1,124	1,809
Loans and others		441	2,197	3,634	4,332	2,955	387	2,307
o/w: to IMF and EU		0	2,000	3,634	4,332	2,683	0	1,500
Non-resident holding of government securities		3,004	3,144	3,408	4,847	6,280	6,052	6,097
HUF Tbills	2,433	2,548	2,624	2,624	3,628	4,707	4,707	4,707
HUF TBonds		456	520	784	1,219	1,574	1,346	1,390
Cash deficit financed by non-residents 1/				1,004	1,079			
Banks	17,696	20,057	18,458	15,460	13,516	13,670	11,686	12,672
Other investment (mainly corporate)	5,611	6,159	6,609	6,902	6,822	7,610	8,217	8,374
Net errors and omissions	298	1,171	1,600	1,600	1,000	1,000	1,000	1,000
Total financing sources	**22,942**	**35,665**	**35,470**	**33,539**	**36,545**	**41,056**	**36,208**	**41,302**
FDI net inflows (incl. inter-company)	4,232	6,817	4,269	6,268	6,262	6,841	7,681	8,467
Disbursements (debt)	25,192	31,383	29,439	29,670	31,706	34,084	28,390	32,163
General government 2/	4,661	5,293	7,910	9,012	11,973	12,920	8,563	11,214
Eurobonds		2,405	4,166	4,000	5,048	5,640	1,511	4,116
Loans and others		182	600	600	1,000	1,000	1,000	1,000
Non-resident holding of government securities		2,706	3,144	4,412	5,925	6,280	6,052	6,097
HUF Tbills		2,250	2,624	3,628	4,707	4,707	4,707	4,707
HUF TBonds		456	520	784	1,219	1,574	1,346	1,390
Banks	13,703	19,135	14,921	13,756	12,911	13,554	11,610	12,575
Other investment (mainly corporate)	6,828	6,954	6,609	6,902	6,822	7,610	8,217	8,374
Other portfolio flows net	-996	371	3,369	-1,120	-27	314	324	832
Drawdown in gross reserves	-5,486	-2,907	-1,608	-1,280	-1,395	-184	-187	-160
Financing gap (baseline)	**8,484**	**0**	**0**	**0**	**0**	**0**	**0**	**0**
EU loan	3,500	0	-2,000	0	0	-2,000	0	-1,500
Fund credits	3,811	0	0	-3,634	-4,332	-683	0	0
SDR allocation	1,173	0	0	0	0	0	0	1
Memo items								
Gross international reserves (level in Euro million)	30,676	33,675	35,283	36,563	37,958	38,142	38,328	38,489
Government rollover rates (in percent)	107	113	109	96	103	108	113	110
Eurobonds		178	214	306	361	210	134	228
Loans and others		41	27	17	23	34	259	43
Non-resident holding of government securities		90	100	129	122	100	100	100
HUF Tbills		88	100	138	130	100	100	100
HUF TBonds		100	100	100	100	100	100	100
Banks' rollover rates (in percent)	77	95	81	89	96	99	99	99
Corporate rollover rates (in percent)	122	113	100	100	100	100	100	100

Sources: Hungarian authorities and staff projections.

1/ The cash deficit is partially financed by an increase in non-residents holding of HUF Tbills

2/ Excludes EU and IMF loans

Table 11. Hungary: Indicators of External Vulnerability, 2006–11

	2006	2007	2008	2009	2010	2011 Est.
Financial Indicators						
M3, end-of-period, percent change	13.7	11.0	7.7	4.4	3.0	5.1
Lending to the private sector, flow based, end-of-period, percentage chan	20.6	18.5	12.2	-2.3	-2.4	-4.0
T-bill, 90-day, average, in percent	7.0	7.6	8.9	8.2	5.4	5.9
Government bond yield, 5-year, average, in percent	7.4	7.0	9.3	9.3	7.1	7.2
Share of foreign currency liabilities in total liabilities	37.5	38.7	43.4	43.8	42.2	41.7
Share of foreign currency loans by sector						
Households	42.6	55.0	66.7	66.2	67.2	66.5
Corporates	45.7	51.6	58.3	57.9	57.6	57.9
Non-performing loans to gross loans 2/	2.6	2.3	3.0	6.7	9.8	12.4
External Indicators						
Exports of goods and services, annual percentage change	15.4	16.1	6.9	-17.7	18.3	9.3
Imports of goods and services, annual percentage change	14.6	13.5	7.4	-22.5	16.8	8.7
Real effective exchange rate, percentage change, + = appreciation	-5.2	11.4	2.8	-8.3	3.3	-2.6
Current account balance, in percent of GDP	-7.4	-7.3	-7.3	-0.2	1.1	1.9
Capital account, in percent of GDP	0.8	0.7	1.0	1.2	1.8	2.8
Financial account, in percent of GDP	9.9	6.7	9.2	-4.0	1.3	0.7
Net foreign direct investment, in percent of GDP	2.6	0.2	2.5	-0.2	0.4	-1.8
Gross official reserves, in millions of euros	16,397	16,385	24,040	30,676	33,675	35,283
In months of imports of goods and services	2.5	2.3	4.3	4.8	4.8	4.7
In percent of short-term debt at remaining maturity	95.9	63.8	71.3	83.7	77.9	80.8
Total external debt, including SPEs, in percent of GDP 3/	112.1	121.3	149.8	180.3	…	…
Total external debt, excluding SPEs, in percent of GDP	96.8	104.6	116.8	149.9	141.7	140.6
Of which:						
Direct investment intercompany loans	14.7	16.6	23.0	35.9	31.2	31.0
General government	33.3	34.2	36.3	47.7	46.7	46.4
Of which: non-residents holdings of local currency government bon	13.0	13.0	8.1	7.6	8.3	8.2
Central bank	1.1	0.6	1.1	3.8	6.8	6.8
Banks	27.7	31.1	40.4	42.3	36.2	36.0
Non-financial institutions	20.0	22.0	16.0	20.3	20.7	20.6
Short-term debt at remaining maturity 4/	17,100	25,666	33,698	36,658	43,215	43,691
Financial Market Indicators						
Stock market index, local currency, end-of-period	24,844	26,236	12,242	21,227	21,327	17,148
EMBI Global bonds spread, end-of-period	58	84	504	186	411	570
CDS spread, 5-year, end-of-period	21	55	419	238	384	575

Source: Hungarian authorities; and IMF staff estimates.

1/ Loans to households and non-financial corporations adjusted for movements in the exchange rate.

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

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

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

Table 12. Hungary: Indicators of Fund Credit, 2008-16

(In millions of SDR)

	2008	2009	2010	2011	2012	2013	2014	2015
Existing and prospective Fund credit								
Disbursement	4,215	3,422	0	0	0	0	0	0
Stock 1/	4,215	7,637	7,637	7,637	4,417	598	0	0
Obligations	0	148	186	201	3,378	3,874	603	1
Repurchase	0	0	0	0	3,220	3,819	598	0
Charges	0	148	186	201	158	56	5	1
Stock of existing and prospective Fund credit								
In percent of quota	406	735	735	735	425	58	0	0
In percent of GDP	4	9	9	9	5	1	0	0
In percent of exports of goods and services	5	12	11	9	5	1	0	0
In percent of gross reserves	19	28	26	24	14	2	0	0
Obligations to the Fund from existing and prospective Fund arrangements								
In percent of quota	0	14	18	19	325	373	58	0
In percent of GDP	0	0	0	0	4	4	1	0
In percent of exports of goods and services	0	0	0	0	4	4	1	0
In percent of gross reserves	0	1	1	1	10	12	2	0

Source: IMF staff estimates.
1/ End of period. Calculated based on proposed extension and rephasing of purchases.

Appendix I. Hungary: Public Debt Sustainability

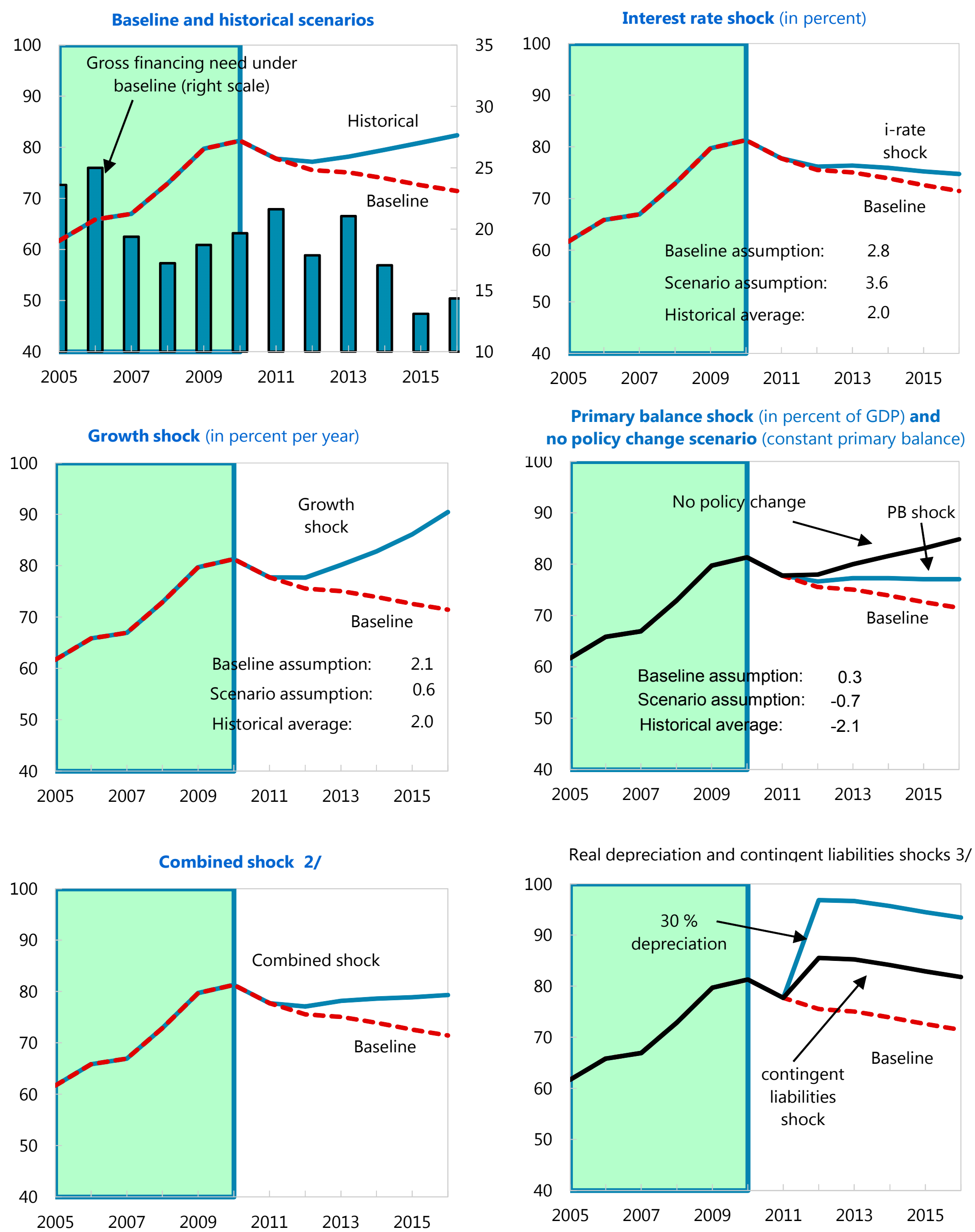
1. **Under the baseline, Hungary's public debt as a percent of GDP is expected to have peaked in 2010.** It is forecast to decline to around 72 percent of GDP by 2016 primarily as a result of an increase in primary surpluses and the continuation of a relatively small interest rate-growth differential going forward. To simply stabilize the debt, a primary surplus of 0.5 percent of GDP is needed, marginally above the result recorded in recent years. Nonetheless, given the high level of the debt, high surpluses are likely necessary in order to reduce Hungary's exposure to shocks. Thus, the authorities' commitment to meet the deficit targets spelled out in their March 2011 convergence report is the most important factor in ensuring debt sustainability in the medium term.

2. **The main risks to the baseline scenario stem from the impact of an escalation of the Eurozone crisis.** Under an adverse scenario, as discussed above, a recession in the Eurozone weighs heavily on demand for Hungarian exports while bottlenecks in the financial sector undermine a recovery in domestic demand. In particular, staff assumes that automatic fiscal stabilizers are allowed to operate fully. Furthermore, the assumptions include a sharp but temporary surge in bond yields of 400 basis points, continued exchange rate weakness and only a slow recovery in economic growth. In this context, public and external debt would continually rise over the medium term. In order to stabilize the debt under the adverse scenario, a primary surplus in the range of 1.5-2 percent of GDP is necessary.

3. **In the longer term, fiscal sustainability may require additional reforms to the pension system, but the need for these does not appear immediate.** The de-facto nationalization of second pillar private pension assets in 2011 provides relief to the pension cash balances in the near-term, given that new contributors to the state system will retire only gradually, as they reach retirement age. The recent increase in retirement age, the elimination of early retirement schemes and recent changes to the pension indexation formula also contribute to improving the sustainability of the pension system.

4. **Authorities' calculations nonetheless point to additional need for reform.** After these changes to the system are taken into consideration, the net present value of net pension expenditures to 2060 is about -30 percent of GDP (discounted at a differential of real interest rate and growth of 1 percent). Moreover, some key assumptions in the authorities' pension projections appear optimistic, implying that the need for reform may be even more significant. First, they assume an increase of 5 percentage points in labor participation through the next decade. Staff estimates indicate that, for example, if only half of this increase were to materialize, the authorities' pension balance would deteriorate about ½ percent of GDP per year. Second, the authorities' projections imply a sustained decline in the average pension relative to wages, which may prove unrealistic for social reasons. Third, the authorities assume a decline in the number of pensioners relative to the population at retirement age after 2040, which appears difficult to rationalize.

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



Sources: International Monetary Fund, country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown. 2011 data adjusted for one-off items.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.
3/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2009, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Appendix Table 1. Hungary: Public Sector Debt Sustainability Framework, 2006–16

(In percent of GDP, unless otherwise indicated)

	Actual											
	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	**Debt-stabilizing primary balance 9/**
Baseline: Public sector debt 1/	65.9	67.0	72.9	79.7	81.3	**77.7**	**75.5**	**75.1**	**73.9**	**72.6**	**71.5**	**0.5**
o/w foreign-currency denominated	16.2	17.6	27.8	35.5	36.0	37.8	34.4	34.1	33.5	32.6	31.8	
Change in public sector debt	4.2	1.1	5.9	6.8	1.6	-3.6	-2.2	-0.5	-1.1	-1.3	-1.1	
Identified debt-creating flows (4+7+12)	6.1	-0.9	-1.5	10.1	1.3	2.7	0.3	0.5	-0.6	-0.8	-0.7	
Primary deficit 10/	5.7	1.2	0.0	0.2	0.5	1.9	-0.5	-0.5	-0.7	-0.9	-0.9	
Revenue and grants 10/	42.5	45.3	45.1	46.5	44.8	40.2	45.4	44.8	45.0	45.1	45.2	
Primary (noninterest) expenditure 10/	48.2	46.5	45.1	46.8	45.3	42.1	44.9	44.3	44.3	44.3	44.3	
Automatic debt dynamics 2/	2.3	-1.0	-1.5	9.9	0.8	0.7	0.8	1.0	0.1	0.1	0.2	
Contribution from interest rate/growth differential 3/	-0.3	0.7	0.2	7.2	0.8	0.7	0.8	1.0	0.1	0.1	0.2	
Of which contribution from real interest rate	1.9	0.7	0.8	2.1	1.8	1.8	1.0	2.1	2.2	2.3	2.4	
Of which contribution from real GDP growth	-2.2	-0.1	-0.6	5.1	-1.0	-1.0	-0.2	-1.1	-2.1	-2.2	-2.2	
Contribution from exchange rate depreciation 4/	2.6	-1.7	-1.7	2.7	3.8	...	...	...	...	...	...	
Other identified debt-creating flows	-1.8	-1.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Privatization receipts (negative)	-1.8	-1.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes (2-3) 5/	-2.0	2.0	7.4	-3.3	0.3	-6.3	-2.5	-1.0	-0.5	-0.6	-0.5	
Public sector debt-to-revenue ratio 1/	154.9	147.9	161.6	171.2	181.4	193.5	166.3	167.5	164.2	160.8	158.2	
Gross financing need 6/	25.0	19.4	17.2	18.7	19.7	21.6	17.9	21.1	17.0	13.1	14.3	
in billions of U.S. dollars	28.1	26.4	26.5	23.7	25.3	29.8	25.3	31.8	27.1	22.0	25.4	
Scenario with key variables at their historical averages 7/						**77.7**	**77.2**	**78.1**	**79.5**	**80.9**	**82.3**	**0.2**
Scenario with no policy change (constant primary balance) in 2010-2016						**77.7**	**78.0**	**80.0**	**81.6**	**83.1**	**84.8**	**0.5**
Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
Real GDP growth (in percent)	3.9	0.1	0.9	-6.8	1.3	1.3	0.3	1.5	3.0	3.2	3.2	
Average nominal interest rate on public debt (in percent) 8/	6.9	6.6	6.6	6.1	5.4	5.1	5.6	6.0	6.4	6.5	6.6	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	3.4	1.2	1.3	2.5	2.4	2.3	1.3	3.0	3.3	3.4	3.6	
Nominal appreciation (increase in US dollar value of local currency, in percent)	-15.6	11.5	11.0	-8.2	-9.9	...	...	...	...	...	...	
Inflation rate (GDP deflator, in percent)	3.5	5.5	5.3	3.6	3.1	2.8	4.2	3.0	3.1	3.1	3.0	
Growth of real primary spending (deflated by GDP deflator, in percent)	9.1	-3.4	-2.2	-3.3	-1.9	-5.8	7.0	0.1	3.0	3.2	3.2	
Primary deficit	5.7	1.2	0.0	0.2	0.5	1.9	-0.5	-0.5	-0.7	-0.9	-0.9	
Memorandum item												
Growth of real public debt	7.8	-0.1	11.7	0.0	1.8	-4.4	-3.1	0.5	1.5	1.4	1.6	

1/ General government gross debt. Estimates based on AKK data.

2/ Derived as [(r - p(1+g) - g + ae(1+r)]/(1+g+p+gp)) times previous period debt ratio, with r = interest rate; p = 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).

3/ The real interest rate contribution is derived from the denominator in footnote 2/ as r - π (1+g) and the real growth contribution as -g.

4/ The exchange rate contribution is derived from the numerator in footnote 2/ as ae(1+r).

5/ For projections, this line includes exchange rate changes. The large residual in 2011 is explained by the transfer of private pension assets to the public sector.

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

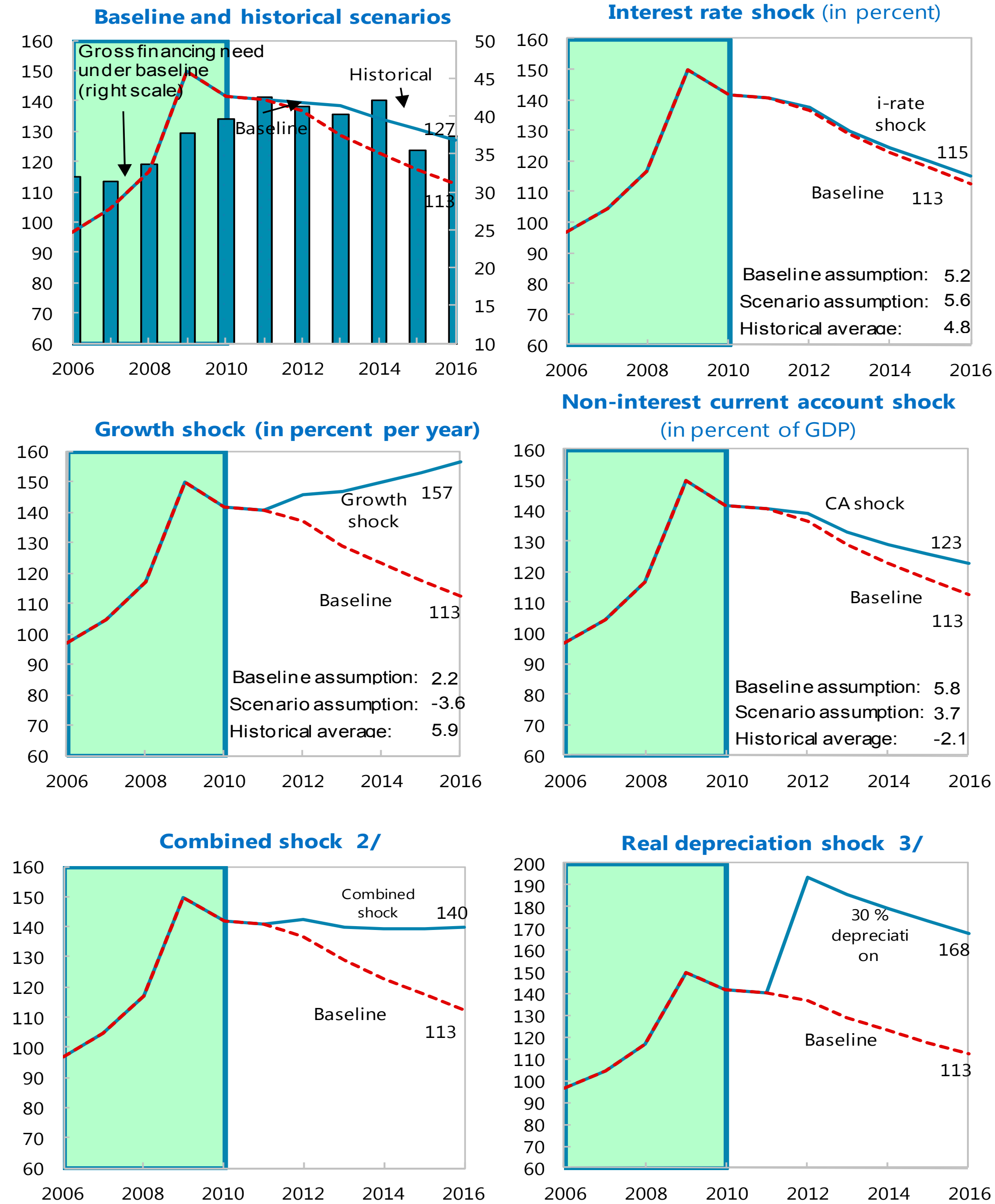
7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.

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

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

10/ For 2011 excludes one-off items.

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



Sources: International Monetary Fund, Country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
3/ One-time real depreciation of 30 percent occurs in 2011.

Appendix Table 2. Hungary: External Debt Sustainability Framework, 2006-16
(In percent of GDP, unless otherwise indicated) 1/

	Actual					Projections						
	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	**Debt-stabilizing non-interest current account 7/**
Baseline: External debt	96.8	104.6	116.8	149.9	141.7	**140.6**	**136.7**	**128.7**	**122.9**	**117.4**	**112.6**	**-3.5**
Change in external debt	8.8	7.8	12.3	33.0	-8.2	-1.1	-3.8	-8.0	-5.9	-5.4	-4.9	
Identified external debt-creating flows (4+8+9)	3.3	3.3	0.0	14.8	-11.1	-4.3	-5.8	-4.9	-4.0	-4.1	-3.5	
Current account deficit, excluding interest payments	4.2	3.5	1.9	-5.3	-6.1	-8.3	-8.8	-7.5	-5.0	-4.3	-3.4	
Deficit in balance of goods and services	1.2	-0.7	-0.3	-4.7	-6.3	-7.3	-8.1	-7.6	-5.2	-4.7	-4.1	
Exports	77.3	80.8	81.3	77.4	86.1	93.6	97.6	98.2	100.0	103.0	106.0	
Imports	78.4	80.2	81.0	72.6	79.8	86.3	89.5	90.6	94.8	98.3	101.9	
Net non-debt creating capital inflows (negative) 2/	-2.4	4.6	-1.2	-0.8	-1.6	-0.6	-3.1	-1.9	-1.8	-2.2	-2.5	
Automatic debt dynamics 3/	1.6	-4.8	-0.7	20.9	-3.4	4.6	6.1	4.5	2.7	2.5	2.4	
Contribution from nominal interest rate	3.5	3.8	5.4	5.5	5.0	6.4	6.6	6.4	6.3	6.2	5.9	
Contribution from real GDP growth	-3.4	-0.1	-0.9	9.2	-1.8	-1.8	-0.4	-2.0	-3.6	-3.7	-3.5	
Contribution from price and exchange rate changes 4/	1.5	-8.5	-5.3	6.3	-6.6	...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 5/	5.5	4.5	12.3	18.2	2.9	3.2	1.9	-3.1	-1.8	-1.4	-1.4	
External debt-to-exports ratio (in percent)	125.2	129.3	143.7	193.7	164.5	150.2	140.1	131.1	122.9	114.0	106.2	
Gross external financing need (in billions of euros) 6/	28.5	31.1	35.5	34.5	38.4	41.4	41.4	43.3	48.2	43.1	48.2	
in percent of GDP	31.9	31.3	33.6	37.8	39.5	42.4	41.3	40.2	42.1	35.4	37.2	
Scenario with key variables at their historical averages 7/						**140.6**	**139.6**	**138.1**	**134.2**	**130.6**	**126.8**	**-7.4**
Key Macroeconomic Assumptions Underlying Baseline 8/												
Real GDP growth (in percent)	3.9	0.1	0.9	-6.8	1.3	1.3	0.3	1.5	3.0	3.2	3.2	
GDP deflator in euros (change in percent)	-2.9	10.9	5.3	-7.3	5.0	-0.8	2.4	6.0	3.1	3.1	3.0	
Nominal external interest rate (in percent)	4.1	4.3	5.5	4.0	3.5	4.6	4.8	5.0	5.2	5.3	5.4	
Growth of exports (euro terms, in percent)	15.4	16.1	6.9	-17.7	18.3	9.3	7.1	8.2	8.1	9.6	9.3	
Growth of imports (euro terms, in percent)	14.6	13.5	7.4	-22.5	16.8	8.7	6.6	8.9	11.1	10.3	10.2	
Current account balance, excluding interest payments	-4.2	-3.5	-1.9	5.3	6.1	8.3	8.8	7.5	5.0	4.3	3.4	
Net non-debt creating capital inflows	2.4	-4.6	1.2	0.8	1.6	0.6	3.1	1.9	1.8	2.2	2.5	

1/ Excluding Special Purpose Entities. Including inter-company loans and nonresidents' holdings of forint-denominated assets.
2/ Includes EU capital transfers.
3/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in euro terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.
4/ The contribution from price and exchange rate changes is defined as [-r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock. r increases with an appreciating domestic currency (e > 0) and rising inflation (based on GDP deflator).
5/ For projection, line includes the impact of price and exchange rate changes.
6/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.
7/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.
8/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

INTERNATIONAL MONETARY FUND

HUNGARY

Staff Report for the Article IV Consultation and Second Post-Program Monitoring Discussions—Supplementary Information

Prepared by the European Department
(In Consultation with Other Departments)

Approved by Anne-Marie Gulde-Wolf and Martin Mühleisen

January 13, 2012

This statement provides information that has become available since the issuance of the staff report. *While the thrust of the staff appraisal remains broadly unchanged, several concerns raised in the Article IV report have become more pronounced in recent weeks. First, recent policy steps have added to the already high risks of missing fiscal targets going forward and reinforced concerns about the quality of fiscal adjustment. Second, the MNB legislation passed on December 30, 2011 raises serious questions about central bank independence. And third, new measures that could complete the nationalization of the second pillar pension system begun last year risk undermining consumer and investor confidence*.

On a separate matter, staff recommends that the Executive Board approve multiple currency practices maintained under the MNB's scheme of providing foreign exchange (FX) to banks. The MNB scheme was prompted by the early repayment mechanism for FX mortgages introduced by the government in September 2011.

Recent Economic Developments

1. **Incoming data point to a further weakening of output**. In December, consumer confidence fell to its lowest level since September 2009, having declined in 11 out of the last 14 months. The deceleration in export growth, which began in early 2011, continued in November and may moderate the annual current account surplus below forecast levels. Net FDI was negative for a third consecutive quarter, resulting in an outflow of €1.3bn in the year through September. Due in part to currency depreciation, end-September external debt and public debt rose in local currency terms to 146.3 percent and 82.6 percent of GDP, respectively.

2. **In December, the MNB raised the base rate by 50 basis points to 7 percent and maintained its tightening bias, citing elevated risk premia and inflation concerns**. Consumer price inflation accelerated in November to 4.1 percent year-on-year (versus a 3 percent target) despite a still large output gap. According to preliminary data, the Central Bank's FX reserves were higher than expected at end year (€37.8 bn compared to the staff

report estimate of €35.2 bn); slightly less than half of the higher result stems from EU funds while the rest appears to reflect temporary factors that will be reversed in coming months.

3. **Market indicators deteriorated sharply in recent weeks.** In the month through January 6, the forint depreciated by 11 percent to an all-time low against the Euro. During the same period, bond yields rose to above 10 percent. Meanwhile, five-year CDS spreads exceeded 700 basis points, an increase of more than 100 bps relative to regional peers in one month. Also in early January, Fitch became the third rating agency to downgrade Hungary's sovereign rating to below investment grade with a negative outlook, citing concerns over policy uncertainty, the medium-term outlook, the weakening of economic governance, and the overall decline in the investor climate. In recent days, market pressures have moderated amid comments by the authorities suggesting a greater willingness to reach agreement on a Fund program.

Fiscal Policy

4. **Prior to approving the 2012 budget, the government adopted several measures to respond to the increasingly difficult macroeconomic outlook**. The government revised down its official GDP growth forecast for 2012 from 1½ to ½ percent, closer to staff's view of 0.3 percent. To keep the deficit target unchanged at 2½ of GDP, the authorities increased their fiscal buffers, raising contingency reserves by HUF120bn (roughly 0.4 percent of GDP), to 1.1 percent of GDP. This increase in reserves is financed by (i) making permanent the redirection of the private pension pillar members' contributions to the state (HUF 48 bn), (ii) additional excise taxes on tobacco (HUF 20 bn) and (iii) reclassification of HUF 52 bn in existing expenditures into reserves. As reserves are considered an expenditure item, the headline revenue and expenditure numbers have each increased by HUF 68 bn, leaving the deficit unchanged.

5. **However, other steps taken will have a negative effect on the fiscal balance**. First, more details have emerged after the issuance of the Article IV report on the size of the costs associated with the agreement with the Banking Association (described in Box 4 of the report). Given the latest assumptions on participation in the mortgage relief scheme and the level of the exchange rate, staff estimates that the agreement will cost the government about 0.4 percent of GDP. This cost is not included in the authorities' 2012 budget. Second, a government decree provided more details on the wage compensation scheme which staff now estimates will increase budgetary costs by a further 0.2 percent of GDP. As noted in the Article IV report, the scheme provides partial compensation to employers who increase wages for workers hurt by the flat tax regime. However, to be eligible for such wage compensation, employers must not only comply with the already implemented mandatory minimum wage hike of 18 percent, but, as specified in December, also increase all lower end wages (up to just above the average wage) by an explicit schedule. In addition to the budgetary costs, there is the broader concern that such large wage increases—while indeed temporarily offsetting the decline in nominal wages due to tax changes—may have negative effects on employment, especially for new hires for whom no compensation is provided.

6. **At the end of December, Parliament passed the "Financial Stability Law" which significantly constrains future changes to the composition of fiscal policy.** The Financial Stability Law entrenches several controversial fiscal reforms by being passed as a 'cardinal' law, which requires a 2/3 parliamentary majority to change. There are three key components to this law:

- First, it fixes in place the flat average tax structure of the personal income tax (from 2013) and corporate income tax (from 2015) that was passed late last year.
- Second, it completes the *de facto* nationalization of the second pillar pension system by permanently diverting all individual contributions to the state and reopening the possibility of transferring the remaining second pillar pension assets to the state.
- Third, the law implements the fiscal responsibility framework described in Box 1 of the staff report, albeit with some modifications that weaken its effectiveness. For example, the final version of the fiscal responsibility framework relaxed rules requiring central government approval of local government borrowing and reduced the frequency at which the Fiscal Council is required to express its opinions on the budget.

7. **The newly available information worsens staff's projections of the fiscal outlook and the quality of fiscal adjustment.** Based on an unchanged macroeconomic framework, staff now forecasts that the deficit will be wider by 0.4 percent of GDP in net terms in both 2012 and 2013 (see table). As noted above, the revisions compared to the staff report primarily stem from the cost associated with the banking association agreement and the new estimate for the wage compensation scheme. Without further measures, staff now expects headline deficits between 3½ and 4 percent of GDP to persist in the medium term, which will cause the debt-to-GDP ratio to decline more gradually than in the baseline presented in the staff report. More broadly, the recent measures reinforce staff concerns about the quality of fiscal policy. For example, the pension reform further undermines the sanctity of contracts and may weigh on consumer confidence. In addition, an increasingly large portion of the adjustment relies on unspecified increases in 'contingency reserves' which are unallocated expenditures with high implementation risks as a budget-cutting measure.

8. **Meanwhile, downside risks to the budget outlook have become more substantive.** If recent pressure on the exchange rate is maintained or increased, the size of the interest rate subsidies (related to the banking association agreement) as well as budgetary interest expenditures and contributions to the EU would increase. In addition, there is now a statistical risk (in ESA95 terms) that at least part of the 2011 costs of the banking association agreement will be recognized in 2012. The European Commission's recent decision to step up Hungary's excessive deficit procedure may imply the loss of EU cohesion funds and negatively affect the budget outlook from 2013 onwards. On the other hand, if the authorities choose to transfer the remaining second pillar pension assets to the state, it would improve the measured fiscal balance. Furthermore, recent improvements in revenue collection, if they persist, would

help the fiscal outturn. Finally, second-round effects of the wage compensation scheme and the banking agreement on gross wages and credit may partially compensate their respective costs.

Table 1. Hungary - Changes in fiscal projections relative to Article IV

	2011	2012	2013	2014	2015	2016
Revenue, HUF bn.	**0**	**24**	**11**	**75**	**79**	**84**
Changes in 2012 budget document	*0*	*68*	*71*	*75*	*79*	*84*
Redirection of private pension fund members contribution to the state system (permanent)		48	51	54	57	61
Further increase in excise taxes (permanent)		20	20	21	22	22
New information	*0*	*-44*	*-60*	*0*	*0*	*0*
New estimate of the revenue loss due to the private wage compensation scheme (temporary)		-44	-60			
Expenditure, HUF bn.	**37**	**131**	**124**	**142**	**93**	**92**
Changes in 2012 budget document	*0*	*20*	*21*	*22*	*24*	*25*
Increase in the Country Protection Fund reserve (financed by further increase in excise taxes)		20	21	22	24	25
New information	*37*	*111*	*103*	*120*	*70*	*67*
Swiss Franc mortgage relief - agreement with banks (temporary)	50	104	88	98	45	41
Reduction in MAV debt takeover amount	-14					
Change in interest expenditure (as per change in deficits)	1	7	15	22	25	26
Net Impact, HUF bn.	**-37**	**-107**	**-113**	**-68**	**-15**	**-8**
Net impact, in percent of GDP	***-0.1***	***-0.4***	***-0.4***	***-0.2***	***0.0***	***0.0***
Overall balance based on budget proposal (Article IV table)	3.5	-3.5	-3.7	-3.6	-3.5	-3.5
Overall balance based on approved budget (Supplement, as shows in the new projections)	3.4	-3.9	-4.1	-3.8	-3.5	-3.5
Change in OB projection	***-0.1***	***-0.4***	***-0.4***	***-0.2***	***0.0***	***0.0***
Memo:						
Possible one-off revenue from pension system switch to pillar 2 (upside risk)		200				

New Central Bank Legislation

9. **On December 30, parliament adopted a set of amendments to the MNB Act, which provided the Central Bank with some macroprudential functions**. The MNB has become responsible for the analysis, prevention and mitigation of macro prudential risks inherent in the financial system. For this purpose, the Act also enables the Governor, in accordance with policy decisions of the Monetary Council, to issue binding decrees that aim to reduce systemic risk or prevent their build up in areas not regulated by law or government decrees, such as provisions preventing the excessive outflows of credit; liquidity criteria preventing the build-up of systemic liquidity risks; the conditions for the timing, structure and operation of the anti-cyclical capital buffer; and additional criteria which reduce the probability of bankruptcy for systemically important institutions.

10. **At the same time, the Act contains several material changes to the governance structure of the Central Bank**. There are at least three key changes:

- First, the new law reinstates an Executive Board comprising the Governor and an increased number of Deputy Governors. The Executive Board's quorum for making simple majority decisions only requires the presence of two members and not necessarily the Governor.
- Second, an enlarged MNB Monetary Council (which now is actually its governing board) has been granted executive powers in addition to its existing policy making powers: it is responsible for implementing its own policy decisions. In key areas, the

extent of the newly created Executive Board's executive powers depends on how much power the Monetary Council is willing to delegate—under the previous MNB Act, executive power was the Governor's exclusive prerogative.

- Third, the Governor's power to nominate Deputy Governors and to determine their portfolios has been transferred to, respectively, the Prime Minister and the Monetary Council.

11. **These changes weaken the autonomy of MNB executives in the current context**. The recent changes are the tenth set of amendments to the MNB act in less than three years; as a general matter, such a volatile legal environment is not conducive to central bank autonomy. But the content of the specific measures also raises concerns. For example, the increased executive powers of the Monetary Council clearly weaken the operational autonomy of the Executive Board. In addition, according to the MNB, there is no clear operational need for a third deputy governor right now so the increase in the current context raises concerns about government influence. And the Governor, not a Monetary Council with membership appointed by the government, is in the best position to determine the responsibilities of his staff, including the Deputy Governors. In combination with the government's recent and frequent criticisms of monetary policy (including calls for unorthodox uses for FX reserves), these measures raise a warning flag regarding the independence of the central bank.

12. **A recently passed constitutional amendment may further infringe upon the MNB's autonomy**. A new provision in the Constitution allows for the possibility of a merger between the MNB and the HFSA. Although such mergers are not uncommon, the envisaged institutional arrangement seems to suggest that the current MNB Governor would be demoted and become a Deputy-Governor in the new entity; accordingly a new Governor would be appointed to head the new entity. This would entail a removal from office of the current Governor on grounds other than those enshrined in the MNB Act. Furthermore, it is unclear how the autonomy of the new entity as a whole and the MNB portion within that entity would be safeguarded with respect to policy setting and implementation. In the context of the political climate described above, such a change to the MNB's governance structure would raise significant additional concerns.

Exchange System

The early FX mortgage repayment mechanism

13. **In September 2011, the authorities adopted a mechanism by law which enables debtors to repay early in full FX denominated mortgages at more favorable exchange rates than current market exchange rates.** It is understood that applications by mortgage debtors to use the mechanism had to be submitted by December 31, 2011. The repayment of the FX mortgage is made either (i) from the households' own HUF resources or (ii) through new loans lent to the mortgage debtors in HUF. The special (more favorable) exchange rate is a reference rate used only to calculate the amounts of HUF needed for the early and full

repayment of the FX denominated mortgage and is not available for the conduct of FX transactions, which continue to be conducted at market exchange rates. Commercial banks need to absorb the losses resulting from the use of the more favorable exchange rate in the repayment of the FX denominated mortgages.

14. **The transactions enabled under the government mechanism relate to a capital—rather than current—transactions**. This is because the government mechanism permits the mortgage debtor to make a single bullet-type full repayment of the FX denominated mortgage. To date, the Fund has not asserted jurisdiction over MCPs that relate solely to capital transactions.[1] Therefore, MCPs, if any, under the government mechanism would not give rise to MCPs subject to Fund approval. In any event, however, the government mechanism involves the use of a special FX rate solely for "reference" purposes and thus, there is no actual exchange of currencies at this special rate and accordingly does not result in a multiplicity of exchange rates.

MNB scheme to provide FX to banks

15. **The MNB in early October 2011 put in place a scheme to provide banks with foreign currency required in the context of the early FX mortgage repayment scheme.** The MNB anticipated that commercial banks would choose to purchase the necessary FX in the FX market to close their open positions arising from the early repayment of FX denominated mortgages early on to hedge against the anticipated HUF depreciation. Such action was perceived by the MNB as having the potential to put additional downward pressure on the HUF with an adverse macro-economic impact, including on financial stability. To prevent such downward pressure, the MNB established the FX scheme.

16. **The MNB scheme enables commercial banks—if they so elect—to hedge against (i) the exchange rate risk (further depreciation) and (ii) the uncertainty in volume of early repayments in HUF by mortgage debtors pursuant to the government mechanism.** Participation in the MNB's scheme is voluntary and it will be in place until March 2012. The MNB scheme consists of a series of interrelated exchange transactions, namely, commercial banks' acquisitions of euros at FX multi-price auctions, mandatory daily swaps of the acquired euros with the MNB using the official exchange rate, and the re-sale of any unused euros back to the MNB at the original auction rate.

17. **The MNB scheme gives rise to multiple currency practices subject to Fund approval under Article VIII, Section 3.**[2] The MNB scheme involves the use of multiple exchange rates for spot exchange transactions at the same time, such as among accepted auction bids, between accepted auction bids and the prevailing market rates, the official exchange rate

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[1] See: Decision No. 8648, July 17, 1987. http://www.imf.org/external/pubs/ft/sd/index.asp?decision=8648-(87/104)

[2] See: Decision No. 6790-(81/43) March 20, 1981, as amended. http://www.imf.org/external/pubs/ft/sd/index.asp?decision=6790-(81/43)

for daily swaps and the prevailing market rates, and the auction rate for the re-sale and the prevailing market rates. All elements for MCPs under IMF policy are met: (i) The MNB has established the MNB scheme by way of "terms and conditions." Thus, it constitutes official action. (ii) Under the MNB scheme, exchange transactions need to occur in accordance with the terms of the scheme. Accordingly, the official action is also directly related to FX transactions (namely, the commercial banks' acquisitions of euros from the MNB at the weekly multi-price auctions, the mandatory daily swaps of the acquired euros with the MNB, and the re-sale of any unused euros back to the MNB). (iii) The official action gives rise to a multiplicity of effective exchange rates, which can differ from each other by more than two percent at any given time.

18. **Staff recommends that the Executive Board approve the maintenance of these multiple currency practices.** They do not materially impede Hungary's balance of payments adjustment and do not harm the interest of other members. The MCPs are also maintained temporarily (the MNB scheme is scheduled to expire in March 2012) and are non-discriminatory.

INTERNATIONAL MONETARY FUND

HUNGARY

January 3, 2012

STAFF REPORT FOR THE 2011 ARTICLE IV CONSULTATION AND SECOND POST-PROGRAM MONITORING DISCUSSIONS—INFORMATIONAL ANNEX

Prepared By

European Department

CONTENTS

FUND RELATIONS

(As of December 15, 2011)

Membership Status

Joined on May 6, 1982; Article VIII.

General Resources Account

	SDR Million	Percent Quota
Quota	1,038.40	100.00
Fund holdings of currency	8,601.57	828.35
Reserve position in Fund	73.83	7.11

SDR Department

	SDR Million	Percent Allocation
Net cumulative allocation	991.05	100.00
Holdings	548.53	55.35

Outstanding Purchases and Loans

	SDR Million	Percent of Quota
Stand-By Arrangements	7,637.00	735.46

Financial Arrangements

In millions of SDR, (mm/dd/yyyy)

Type	Date of Arrangement	Expiration Date	Amount Approved (SDR Million)	Amount Drawn
Stand-by	11/6/2008	10/5/2010	10,537.50	7,637.00
Stand-By	03/15/1996	02/14/1998	264.18	0.00
Stand-By	09/15/1993	12/14/1994	340	56.70

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

	Forthcoming			
	2012	2013	2014	2015
Principal	3,220.19	3,818.50	598.31	
Charges/ Interest	160.20	57.33	5.16	0.81
Total	3,380.39	3,875.83	603.47	0.81

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.

Exchange Rate Arrangements:

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

Article IV Consultation:

Hungary is on a 12-month consultation cycle. The last Article IV Board discussion took place on January 31, 2011. The associated Executive Board assessment is available at http://www.imf.org/external/np/ms/2010/102510.htm and the staff report at http://www.imf.org/external/pubs/cat/longres.aspx?sk=24614.0 . Hungary has accepted the obligations of Article VIII and maintains an exchange rate system free of restrictions on the making of payments and transfers on current international transactions except for those maintained solely for the preservation of national or international security and that have been notified to the Fund pursuant to Executive Board Decision No. 144-(52/51).[1]

[1] Since the Informational Annex was issued, the Fund made jurisdictional findings that Hungary maintains multiple currency practices subject to the Fund's approval under Article VIII, Section 3 arising from the establishment by the MNB of a foreign exchange scheme that involves a multiplicity of effective exchange rates for spot transactions without a mechanism to ensure that such rates will not deviate among each other by more than two percent.

Technical Assistance:
The table on the following page summarizes the technical assistance missions provided by the Fund to Hungary.

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

HUNGARY: TECHNICAL ASSISTANCE FROM THE FUND, 1999–2011

Department	Purpose	Date
FAD	Tax policy	April 2007
FAD	Public financial management	June 2007
FAD	Tax administration	October 2007
FAD	Pension reform	May 2008
FAD	Tax administration	October 2008
FAD	Tax administration	March 2009
MCM	Banking Supervision	July 2009
FAD	Tax administration	August 2009
LEG	Bank resolution framework	September 2009
FAD	Tax administration	November2009
FAD	Expenditure Rationalization	June 2010
MCM	Macro Modeling	July 2010
FAD	Tax Revenue Forecasting	September 2010
MCM	Macro Modeling	November 2010
FAD	Expenditure Rationalization	October 2011
RES	Inflation Targeting	November 2011

STATISTICAL ISSUES

Assessment of Data Adequacy for Surveillance

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

- **Government Finance Statistics**: Data reporting on fiscal accounting needs to be improved further. The monthly cash-basis accounts of the Central Government prepared by the Ministry of Finance and National Economy do not reflect the GFS presentation. This complicates staff's ability to analyze trends and to appropriately anticipate the impact on general government accounts. Data on revenue and expenditure arrears has been readily provided by the authorities upon request, but provision of this data on an automatic basis would facilitate the monitoring of obligations on an accrual basis. Similarly, automatic provision of local government revenues and expenditures, as well as of financial statements of state-owned enterprises (an important source of contingent liabilities), would allow for closer regular monitoring of the general government.

Data Standards and Quality

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

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

HUNGARY: TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE

AS OF DECEMBER 21, 2011

	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	12/20/2011	12/20/2011	D and M	D and M	D and M		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Nov 2011	12/7/2011	M	M	M		
Reserve/Base Money	Oct 2011	11/30/2011	M	M	M	O,O,LO,LO	O,O,O,O,LO
Broad Money	Oct 2011	11/30/2011	M	M	M		
Central Bank Balance Sheet	Oct 2011	11/30/2011	M	M	M		
Consolidated Balance Sheet of the Banking System	Oct 2011	11/30/2011	M	M	M		
Interest Rates[2]	Nov 2011	12/5/2011	M	M	M		
Consumer Price Index	Nov 2011	12/13/2011	M	M	M	O,O,O,O	O,O,O,O,NA
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	2010	9/30/2011	A	A	A	O,LNO,LO,O	LO,O,O,O,NA
Revenue, Expenditure, Balance and Composition of Financing[3] – Central Government	Nov 2011	12/10/2011	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Q2 2011	10/3/2011	Q	Q	Q		
External Current Account Balance	Q2 2011	9/30/2011	Q	Q	Q	O,LO,LO,LO	O,O,O,O,NA
Exports and Imports of Goods and Services	Q2 2011	9/30/2011	Q	Q	Q		
GDP/GNP	Q3 2011	12/9/2011	Q	Q	Q	O,O,O,LO	O,LO,O,O,NA
Gross External Debt	Q2 2011	9/30/2011	Q	Q	Q		
International investment Position[6]	Q2 2010	9/30/2011	Q	Q	Q		

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

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL
RELATIONS
DEPARTMENT

Public Information Notice (PIN) No. 12/4
FOR IMMEDIATE RELEASE
January 25, 2012

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

IMF Executive Board Concludes Article IV Consultation and Second Post-Program Monitoring Discussions with Hungary

On January 18, 2012, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation and the Second Post-Program Monitoring discussions with Hungary.[1]

Background

Economic growth in Hungary is slowing and market perception of recent policy measures has been negative. After a modest rebound from the 2008–09 crisis, the economic growth is estimated at about 1¼ percent in 2011; exports, helped by strong links with the resilient German export sector, were the sole engine of growth as domestic demand contracted for a second consecutive year.

Growth prospects for the current year are negatively affected by spillovers from the eurozone crisis and domestic policy missteps. The eurozone crisis is weighing on Hungary's external demand, with exports to Europe decelerating since June. Domestically, private consumption is constrained by tightening credit, rising foreign currency debt service, weak wage growth, high unemployment, and a sharp decline in consumer confidence. Meanwhile, fixed investment, which is particularly important for medium-term growth, is declining sharply with little sign of stabilizing amid a volatile policy environment and ample excess supply.

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

Over the past year, the authorities have enacted a number of significant structural reforms and policy changes. The “Szell Kalman plan” announced in 2011 aimed at improving the medium term growth potential through structural reforms on the expenditure side. A range of other policy measures were more controversial, including with financial markets, in particular steps to support foreign currency mortgage holders, changes to the tax regime and labor market policies, special levies on largely foreign-owned sectors (retail, telecommunication, energy and banking) and the de facto nationalization of the second pillar of the pension system.

Fiscal and monetary policy are facing constraints, given financial market pressures and inflationary pressures. In 2010–11, fiscal policy was expansionary, as permanent tax cuts caused a widening in the structural deficit by around 3 percent of GDP. The recently adopted 2012 budget tightens fiscal policy substantially, primarily by incorporating elements of the Szell Kalman plan and raising VAT and excise taxes. In addition, despite a still large output gap, the Central Bank recently increased the policy rate to 7 percent given ongoing risks to both inflation and the financial sector from a rising risk premium and a weakening exchange rate.

The slower growth, Europe-wide deleveraging and recent government actions are weighing on the financial sector. Non-performing loans to firms and households have risen to 14 percent. The resulting need to increase provisioning–compounded by the large bank tax and the government’s recent early repayment scheme for foreign currency mortgages–has sharply reduced bank profits. System-wide capital adequacy remains well above the regulatory minimum but the sharp losses have necessitated equity increases among select foreign banks. Meanwhile, liquidity appears adequate but funding is increasingly short term and expensive.

Looking forward, growth is expected to resume gradually from 2013, largely dependent on euro area growth prospects, but remain below potential for some time. The outlook is subject to significant downside risks, including possibly the emergence of an external funding gap.

Executive Board Assessment

Executive Directors noted that the rebound from the crisis has been modest and vulnerabilities remain high. Furthermore, concerns about domestic policies and rising global risk aversion are weighing on sentiments in financial markets. Directors therefore underscored the need for a well-crafted policy mix that restores confidence in economic governance, anchors the ongoing adjustment, and strengthens economic institutions.

Directors concurred that, despite the weaker growth outlook, fiscal tightening is necessary given Hungary’s high public debt and uncertain financing prospects. The authorities’ 2012 deficit target of 2½ percent of GDP, while ambitious, is broadly appropriate. However, given downside risks, Directors suggested identifying contingency measures, focusing on durable and fiscally-sustainable measures that help lay the groundwork for a credible medium-term fiscal

stance. Directors also called for a coherent tax and expenditure policy mix that would limit the impact of fiscal consolidation on growth and protect the most vulnerable sections of the population.
Directors commended the authorities' commitment to fiscal sustainability in the recently-passed constitutional mandate, which requires reducing public debt to below 50 percent of GDP. They emphasized that lasting improvement in fiscal performance will require a strengthening of fiscal institutions and governance. In this connection, they underscored that the recently-reformed Fiscal Council should be significantly strengthened, so it can provide an independent and timely assessment of fiscal developments.

Regarding the financial sector, Directors noted that in an environment of deteriorating portfolio quality, negative profits, and increasing pressure on funding, it is important to ensure that banks maintain adequate buffers. Recent efforts by supervisors to proactively address potential pressures on banks' provisioning, capital, and liquidity were therefore appropriate. In particular, Directors welcomed the forthcoming regulations on minimum liquidity ratios and planned reduction in the bank tax, and encouraged the finalization of a bank resolution framework. Directors also noted that the limited restructuring of Swiss franc debt contained in the recent agreement with the banking sector could help the economic recovery, while suggesting that the scheme could be better targeted.

Directors agreed that the tightening bias of monetary policy is appropriate at this time to help contain inflation and better anchor inflation expectations. Monetary tightening, by limiting exchange rate depreciation, will also support financial sector stability given the large exposure of banks to foreign-currency household debt. Directors expressed concern that recent legislation, which changes the governance structure of the central bank, calls into question the authorities' commitment to central bank independence.

Directors stressed the importance of tackling the structural bottlenecks that impede investment. Particular attention must be paid to reforms that improve the business environment, competitiveness, and labor supply. Directors welcomed recent initiatives to increase labor force participation rates, while noting that some other labor market reforms need to be better aligned with this objective.

Directors agreed that a Fund-supported program in concert with other international lenders, which would require a strengthened policy framework and strong ownership by the authorities, could relieve some of the constraints facing the Hungarian economy.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The staff report (use the free Adobe Acrobat Reader to view this pdf file) for the 2011 Article IV Consultation with Hungary is also available.

Hungary: Selected Economic Indicators, 2007–13

	2007	2008	2009	2010	2011	2012	2013
					Projections		
Real economy (change in percent)							
Real GDP	0.1	0.9	-6.8	1.3	1.3	0.3	1.5
Total domestic demand 1/	-1.5	0.7	-10.5	-0.5	-0.3	-0.8	0.4
Private consumption 2/	-1.0	-0.2	-5.8	-2.7	0.1	-1.0	0.4
Public Consumption	-4.2	-0.2	2.6	1.1	-1.0	-0.8	-0.7
Gross fixed investment	3.8	2.9	-11.0	-9.7	-2.0	-0.5	1.5
Foreign balance 1/	1.6	0.2	3.7	1.8	1.6	1.1	1.1
Exports	15.0	5.7	-10.2	14.3	9.5	6.5	8.0
Imports	12.8	5.5	-14.8	12.8	8.2	5.7	7.6
CPI inflation (average)	8.0	6.1	4.2	4.9	4.0	5.0	3.7
CPI inflation (end year)	7.4	3.5	5.6	4.7	4.2	4.8	3.4
Unemployment rate (average, in percent)	7.4	7.8	10.0	11.2	11.1	11.5	11.0
Gross domestic investment (percent of GDP) 3/	21.8	21.7	20.7	18.0	17.2	16.9	16.9
Gross national saving (percent of GDP, from BOP)	14.5	14.4	20.5	19.1	19.1	19.1	18.0
General government (percent of GDP), ESA-95 basis 4/							
Overall balance	-5.1	-3.7	-4.5	-4.3	3.5	-3.5	-3.7
Primary balance	-1.2	0.0	-0.2	-0.5	7.0	0.5	0.5
Primary structural balance	-0.8	-0.7	1.7	-0.9	-1.6	1.9	2.3
Debt	67.0	72.9	79.7	81.3	77.7	75.5	75.1
Money and credit (end-of-period, percent change)							
Broad money	11.0	7.7	4.4	3.0	5.1	5.5	6.8
Lending to the private sector, flow-based	18.5	12.2	-2.3	-2.4	-4.0	-3.5	-1.0
Interest rates (percent)							
T-bill (90-day, average)	7.6	8.9	8.2	5.4	5.9	...	...
Government bond yield (5-year, average)	7.0	9.3	9.3	7.1	7.2	...	...
5-year sovereign CDS (average in bps, for 2012, as of January 12)	28	196	335	282	379	671	...
Balance of payments							
Goods and services trade balance (percent of GDP)	0.7	0.3	4.7	6.3	7.3	8.1	7.6
Current account (percent of GDP)	-7.3	-7.3	-0.2	1.1	1.9	2.2	1.1
Reserves (in billions of euros)	16.4	24.0	30.7	33.7	35.3	36.6	38.0
Gross external debt (percent of GDP) 5/	104.6	116.8	149.9	141.7	140.6	136.7	128.7
Gross official reserves (percent of short-term debt at remaining maturity)	63.8	71.3	83.7	77.9	80.8	82.1	81.3
Exchange rate							
Exchange regime			Floating				
Present rate (January 13, 2012)			Ft. 309.3 = €1; Ft. 255.5 = CHF1				
Nominal effective rate (2000=100, average)	93.7	93.3	102.6	102.7	...	...	...
Real effective rate, CPI basis (2000=100, average)	72.6	70.4	74.8	72.4	...	...	...
Quota at the Fund			SDR 1038.4 million				
Memorandum Items							
Nominal GDP (billions of forints)	24,991	26,546	25,623	26,748	27,869	29,075	30,362

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

1/ Contribution to growth. Includes change in inventories.

2/ 2/ Actual final consumption of households.

3/ Excludes change in inventories.

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

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

Statement by Willy Kiekens, Executive Director for Hungary and Szilard Benk, Senior Advisor to the Executive Director January 18, 2012

The authorities thank staff for the thorough discussions during the Article IV consultation and for their valuable advice. They agree with the general thrust of the report although differences of opinion remain on some of staff's findings. In spite of the challenging external environment, the authorities are committed to implement prudent macroeconomic policies and comprehensive structural reforms, including structural fiscal consolidation measures.

Economic Outlook

Economic growth has resumed after the 2008–09 crisis, although the recovery remains fragile with growth rates below the pre-crisis levels. The recovery was mainly driven by a rebound in external demand and exports. Internal demand (both consumption and investments) remains weak.

Renewed risks from the debt crisis in Europe have heightened financial uncertainties, affecting business and household confidence in major foreign trading partners. The slowdown in exports negatively affects the Hungarian manufacturing sector, the most buoyant sector during the recovery, in turn negatively impacting labor demand, households' disposable income and corporate profits.

Increasing risk premia and tighter credit conditions constrain investment and household consumption. Even though previously announced major manufacturing investments are carried out as planned, household investments fall short of previous projections. The appreciation of the Swiss Franc increased the debt service of households, which is a serious drag on their disposable income. Moreover, the increased and prolonged uncertainty and unfavorable unemployment developments structurally reduce households' propensity to consume, despite the additional overall net income gained with the introduction of the flat tax system.

Besides the weak external environment, constrained credit conditions, the weakening of the exchange rate, the protracted balance sheet adjustment of the private sector and the tightened fiscal policy, all suggest weaker than expected economic growth. Consequently, the government has revised its growth projection, and now projects a nearly stagnating economy for 2012 with a 0.5 percent growth which will only gradually recover in the next few years. For 2012, inflation is expected to remain above target due to the one-off effect of indirect tax increases. Inflation is expected to return to around 3 percent in the course of 2013.

Fiscal Policy and Structural Reforms

The government is fully committed to keep the budget deficit below the EU requirement of 3 percent in 2012 and beyond. For this year, the general government deficit target is 2.5 percent of GDP, one of the lowest in the EU. Reaching this target implies a major adjustment in the structural fiscal position of more than 3 percent of GDP. This fiscal adjustment is based on a broad set of measures, in particular: (i) the growth supporting measures of the structural reform program announced in March 2011 (Szell Kalman Plan); (ii) expenditure cuts, in particular cuts in public wage costs, a freeze of social transfers and other budgetary chapters) and (iii) hikes in VAT rate and excise taxes. The government has recently taken additional measures due to the weaker growth outlook.

While the authorities prepared the 2012 budget based on a conservative macroeconomic forecast, they are aware of the risks surrounding the macroeconomic outlook. To ensure that the 2.5 percent deficit target is achieved even under deteriorating macroeconomic conditions, high fiscal reserves, now amounting to more than 1 percent of GDP are included in the budget. Indeed, recent measures have further increased these reserves from the 0.75 percent of GDP level mentioned in the Staff Report. The government is committed to make every effort to save these reserves. The budget bill explicitly stipulates that reserves can only be used in the fourth quarter of 2012 and only to the extent this would not jeopardize reaching the 2.5 percent deficit target. Under these conditions staff's deficit projection of 3.5 percent seems exaggerated, since staff implicitly assumes unrealistically that the full amount of reserves will be spent.

Structural Reforms

The bulk of the fiscal consolidation in 2012 is based on expenditure measures in the Szell Kalman Plan. Besides yielding savings equivalent to 1.8 percent of GDP in 2012, and an additional 1 percent of GDP in 2013, the Szell Kalman Plan is expected to stimulate growth and employment by addressing the key bottlenecks in the Hungarian economy: the functioning of the labor market, the pension system, public transportation, higher education, pharmaceutical subsidies, and local government financing. Last December, Parliament has adopted legislation to implement all structural reforms planned for 2013, including legislation on local governments, public and higher education, public employment, old-age pensions, and health care, in particular pharmaceutical subsidies. The review of public administration institutions and their tasks is ongoing and should be accomplished by April 2012.

Taxation

The government has introduced a new flat tax rate system in 2011. It reduces the marginal tax rate in order to promote employment. To smooth the transition from the old to the new system, a set of measures alleviate the uneven impact of the new tax system on various income groups. The minimum wage has been increased on a one-off basis to compensate for the tax hike for low-income earners. At the same time, and to preserve employment, enterprises are compensated for the labor cost increase resulting from the increased minimum wage. The minimum wage hike, coupled with the compensatory scheme, should also reduce prevalent tax evasion consisting of only declaring the minimum wage income. Indeed, compared to the previous general tax credit scheme, the new system is seen as creating targeted and efficient incentives for unskilled low-income earners to better comply with tax obligations.

The so-called crisis taxes, introduced in 2010 on the telecommunication, energy, and retail sectors will be phased out as of 2013. The special taxes on the financial sector are reduced in 2012 as stipulated in the recent agreement with the Banking Association (see below). Their level will be halved in 2013 and should be in line with the average level in the EU countries from 2014 onwards.

Debt Sustainability and Fiscal Rules

The new constitution, effective January 1, 2012, requires a permanent reduction of the public debt which is currently close to 80 percent of GDP, to no more than 50 percent of GDP. Until this target is reached, budget bills must ensure a declining debt-to-GDP ratio, barring special circumstances such as a severe recession.

The pace of the debt reduction is determined by a countercyclical, simple fiscal rule included in the recently adopted Stability Act. Under this rule, the allowed debt growth rate is related to the expected inflation and output growth. Staff observes that the new rule may be suboptimal under some specific circumstances. However, there is a trade-off between a simple, easily understandable rule and a rule that fits every circumstance. The government believes that a parsimonious rule, coupled with the 50 percent debt ceiling serves as an effective communication tool with market participants, to demonstrate the commitment of the government to keep the public debt on a sustainably declining path. Experience shows that the previously more complicated fiscal rule was not well understood by the markets, and therefore less suitable to build confidence. The government is carefully considering the staff's suggestion to relate the allowed debt growth to the output gap instead of the output growth. This proposal may be justified from a theoretical perspective. However, its practical implementation faces well-known difficulties, in particular a credible estimation of the output gap that could lead to policy mistakes.

Monetary Policy and the Central Bank

The authorities concur with staff's assessment that the current tight monetary policy stance is appropriate. While the weak internal demand points to little inflationary pressures, the significant currency mismatch (large stock of FX denominated loans) and the increasing risk premia leave little room to run a countercyclical monetary policy.

As part of the new constitutional system, a new Central Bank Act has been passed on December 30, 2011. All comments by the European Central Bank on the draft law have been taken into serious consideration and most ECB recommendations have been accepted. The new constitution creates the possibility for merging the financial supervisor and the central bank. However, no such reorganization will be implemented during the tenure period of the current central bank governor. The government confirms that it has respected the central bank independence, and will continue to do so.

Under the new law, the central bank is responsible for the analysis, prevention and mitigation of macroprudential risks, in particular those stemming from the financial system. The Central Bank Act enables the central bank Governor, in accordance with the decision of the Monetary Council, to issue binding decrees to reduce systemic risk or prevent their build up in areas not regulated by law or Government Decrees. Such decrees may for instance aim at curbing excessive credit growth, and introduce liquidity requirements to avoid the build-up of systemic liquidity risks. Such measures may also regulate the timing, structure and operation of the anti-cyclical capital buffers and establish additional requirements to reduce the risk of failure of systemically important financial institutions.

Financial Sector and FX Mortgage Repayment

Since two-thirds of housing loans are denominated in foreign currency, especially Swiss Francs, the sharp appreciation of the CHF triggered the adoption of measures to support households indebted in foreign currency. The measures adopted last summer were generally well received. They consisted of granting additional credit to finance the increased debt service due to the appreciation of the foreign currency. However, the measures adopted in September, allowing full repayment of foreign currency mortgage loans at a preferential exchange rate, created controversy. They may result in a significant loss for the banking sector and create pressures in the exchange market. Moreover, the staff argues that the measures were not sufficiently targeted to borrowers for whom the appreciation of the Swiss Franc created the most serious difficulties. Therefore, last December, the government has reached agreement with the Banking Association on a scheme that ensures a more balanced burden sharing among households, the banking sector and the government, as detailed in Box 4 of the Staff Report. The government agreed to not submit or support any further regulation concerning FX lending unless it is supported by the Banking Association. Furthermore, this recent agreement should have a positive impact on growth as it also includes a lowering of the bank levies according to the amount of new loans that banks extend to small and medium size enterprises.

Final remarks

Hungary is in the process of implementing long-lasting structural reforms. The aim of the government is to enhance credibility in the financial markets, preserve macroeconomic stability and increase the economic growth potential. These ambitious objectives could be more successfully reached under a program supported by the European Union and the Fund. Therefore, the authorities have requested from the EU and the Fund a precautionary financial support arrangement. The authorities are committed to engage in these negotiations in a constructive manner, ensuring a successful outcome.