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HUNGARY

June 2014

2014 ARTICLE IV CONSULTATION—STAFF REPORT; PRESS RELEASE; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR HUNGARY

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2014 Article IV consultation with Hungary, the following documents have been released and are included in this package:

- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on May 23, 2014, following discussions that ended on April 12, 2014, with the officials of Hungary on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on May 9, 2014.
- An **Informational Annex** prepared by the IMF.
- A **Press Release** summarizing the views of the Executive Board as expressed during its May 23, 2014 consideration of the staff report that concluded the Article IV consultation with Hungary.
- A **Statement by the Executive Director** for Hungary.

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

Selected Issues Paper

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

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INTERNATIONAL MONETARY FUND

HUNGARY

STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION

May 9, 2014

KEY ISSUES

Context. The economy is recovering gradually, helped by supportive macroeconomic policies, favorable external conditions, and improved market confidence. This, together with a welcome reduction in vulnerabilities, supported Hungary's financial stability during bouts of volatility in emerging markets over the past year. Nevertheless, external and public debts remain high, thus making the economy susceptible to shocks; and the country faces subdued growth prospects. The government's strategy to address these challenges included sizeable fiscal consolidation and unconventional measures that increased the state's role in the economy and shifted the burden of adjustment to specific sectors.

Policy recommendations. Policies should aim at building buffers and comprehensively addressing obstacles to strong, sustained growth.

- **Fiscal policy.** Adopt an ambitious and growth-friendly fiscal adjustment strategy to reduce the public debt ratio sustainably and build policy space. The strategy should rely on durable expenditure consolidation, enhanced composition of spending, and a gradual elimination of distortionary taxes.
- **Monetary policy.** Stop monetary policy easing and stand ready to raise the policy rate if market conditions warrant. A clear communication strategy will play a crucial role in guiding market expectations. Maintain adequate reserve coverage to support financial stability.
- **Financial sector.** Help restore financial intermediation by improving the banks' operating environment, including steps to facilitate faster resolution of non-performing loans and to reduce the tax burden on banks. The Funding for Growth Scheme should remain limited, targeted, and time-bound, with fiscal costs clearly recognized.
- **Structural reforms.** Advance structural reforms aimed at removing labor market bottlenecks, enhancing the business climate, and boosting productivity in the services sectors. Limited government interference in the economy and increased policy predictability could strengthen confidence, and foster private sector investment and employment creation.

Approved By
Jörg Decressin and Mark Flanagan

Discussions took place in Budapest during March 5–17, 2014, and were continued in Washington, D.C. on April 11–12, 2014. The staff team comprised Messrs. Christou (Head) and Klein, Ms. ElGanainy (all EUR), Ms. Jenkner (FAD), and Ms. Oner (SPR); and was joined by Mr. Roaf (senior regional resident representative, EUR) for a few days. Messrs. Prader and Benk (OED) attended some meetings. Mmes. Blasco and Nguyen (both EUR) assisted in the preparation of the staff report. The staff team met with Minister for National Economy Varga, Minister for National Development Németh, Central Bank of Hungary Deputy Governors Balog and Gerhardt, other senior officials, and representatives from the private sector and think tanks. A workshop was held in Budapest during the mission jointly with the Central Bank of Hungary and the Ministry for National Economy to discuss background papers prepared by staff (included in the Selected Issues Paper accompanying this report) and the authorities. Hungary is an Article VIII country (Informational Annex: Fund Relations). Data provision is adequate for surveillance (Informational Annex: Statistical Issues).

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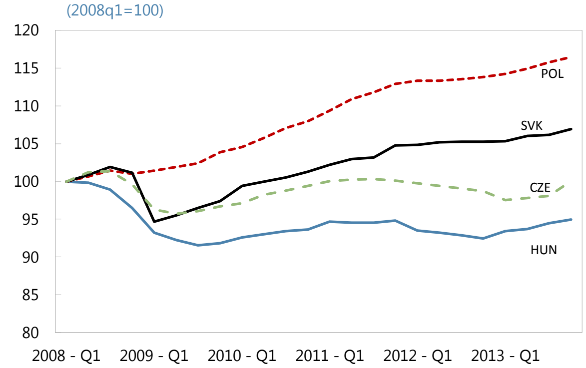
CONTEXT

1. **Hungary achieved a welcome reduction in vulnerabilities, but the economy remains susceptible to shocks.** Since the 2008 global financial crisis, the country underwent sizeable fiscal consolidation, the current account turned into surplus, external debt declined, and inflation decelerated sharply. These improvements in fundamentals helped Hungary weather recent financial market volatility well and maintain market access. However, external and public debt levels are still among the highest in the region resulting in large financing needs and heavy reliance on nonresident funding. A shift in market sentiment could thus destabilize the economy, particularly given the high balance sheet exposure of the private and public sectors to exchange rate risk. Therefore, reducing the still-high vulnerabilities should be the focus of policies going forward.

2. **Growth performance continues to lag behind that of some regional peers that are also participants in the German-Central European supply chain.** Hungary has endured a prolonged period of stagnation largely attributed to significant deleveraging, fiscal consolidation (to a lesser extent), and the government's interventionist policies (Box 1). These have included frequent and unpredictable policy changes and placing the brunt of the adjustment on particular sectors, e.g., banking, energy, retail, and telecom, all of which appear to have weakened market confidence and undermined the business climate and private investment. As a result, growth performance remains weak and real GDP now stands at about 5 percent below its pre-crisis level. Moreover, Hungary faces subdued growth prospects. This calls for a strategy to comprehensively address obstacles to stronger growth.

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



Sources: Haver and IMF staff calculations.

3. **The ruling party's convincing win in the April 2014 elections suggests no major change in the thrust of economic policies .** Fidesz retained its two-third majority in parliament and full control over the legislative process. The party's economic policy platform features a continuation of efforts to increase disposable income (including by adopting a debt relief scheme for FX mortgage holders), reducing utility prices, and maintaining the sizable public work programs. Fidesz has also vowed to ease the tax burden on labor, to boost the industrialization of the economy by signing strategic agreements with large multinational manufacturers, to increase domestic ownership in the banking sector, and to create a non-profit utility sector.

Box 1. Response to Past Fund Policy Advice

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

Key recommendations	Implemented policies
Implement a more balanced and growth-friendly fiscal adjustment to durably reduce the public debt-to-GDP ratio.	Fiscal restraint continued and the 2013 fiscal deficit over-performed the target, but the composition of the budget remained largely unchanged as additional ad-hoc revenue measures were taken. The public debt ratio declined only slightly.
Improve the operating environment for banks—including by reducing the tax burden and putting in place conditions to facilitate a cleanup of balance sheets—to help repair financial intermediation.	The Funding for Growth Scheme has improved credit conditions for small and medium enterprises (SMEs). However, the tax burden on banks has increased further following the hike of the bank transaction tax rate in June 2013.
Pursue a broader structural reform agenda, including by promoting competition in the product markets, and restructuring loss-making state-owned enterprises (SOEs).	Some tax incentives were introduced to boost labor demand and supply, including the Job Protection Plan and an extension of the family tax allowance. Implementation of structural reforms in other areas largely stalled.

BACKGROUND AND RECENT DEVELOPMENTS

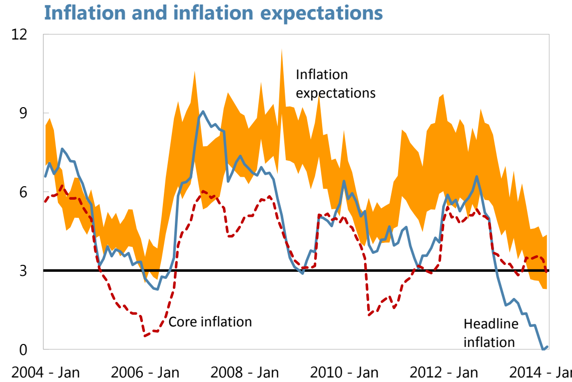
4. **The economy has started to turn around in recent months.** Following the 2012 recession, GDP posted 1.1 percent growth in 2013, with domestic demand as the main driver—for the first time since 2008. This largely reflected higher public spending, including on projects co-financed with the EU and—to a lesser extent—a recovery of private investment and consumption on the back of accommodative monetary conditions and improved market confidence. Better external conditions, alongside increased production capacity in the automotive industry, boosted exports and contributed to the widening in the current account surplus to 2.9 percent of GDP in 2013 from 1 percent in 2012. High frequency indicators suggest that growth remained strong in the first quarter of 2014.

Real GDP growth and Business confidence

Source: Haver.

5. **Inflation has fallen to a record-low level.** Against excess production capacity, utility price cuts, and a moderation of import prices, headline inflation decelerated sharply to 0.4 percent at end-2013. More recently, it has remained around zero reflecting in part another round of utility price cuts. Core inflation and inflation expectations have decelerated as well, albeit more gradually, and have remained around the National Bank of Hungary's (MNB) 3 percent inflation target.

Inflation and inflation expectations



Source: MNB

6. **Unemployment has declined sharply, but labor market conditions are still weak.** Labor market participation increased by about one percentage point to 65.1 percent at end-2013. At the same time, public works programs continued to expand (Box 2), with the number of registered individuals exceeding 400,000 (or about 10 percent of total employment) at end-2013. Largely as a result of this expansion, the unemployment rate declined to 9½ percent in 2013:Q4 from 11 percent (both seasonally-adjusted) in 2012:Q4. Meanwhile, job creation in the private sector has been weak and real wage growth in this sector moderated further to about 3 percent at end-2013.

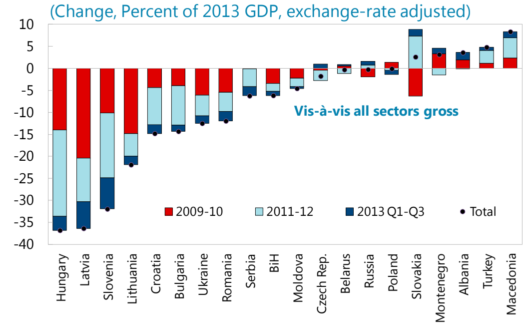
7. **The fiscal deficit remained well below the EU limit in 2013.** Following the substantial adjustment in 2012 (3½ percent of GDP) and additional measures in 2013 to ensure that the fiscal deficit remains below 3 percent of GDP, Hungary exited the EU's Excessive Deficit Procedure in June 2013. With lower-than-budgeted tax revenues more than offset by strict expenditure control, the 2013 fiscal deficit (2.2 percent of GDP) over-performed the 2.7 percent target, thus keeping the policy stance broadly neutral. Public debt declined only slightly to just above 79 percent of GDP.

8. **The central bank continued to ease monetary policy through both conventional and unconventional measures.** Against decelerating inflation, low risk premia, and a negative output gap, the Monetary Council reduced the policy rate—albeit at a slowing pace—to a record-low level of 2.5 percent. Furthermore, the central bank introduced the Funding for Growth Scheme (FGS) with the aim of easing access to finance for SMEs and improving their credit conditions, *inter alia*, through a subsidized lending interest rate (Box 3). After the implementation of the Scheme's first phase under which the equivalent of 2.4 percent of GDP was lent by commercial banks, the MNB extended the Scheme with a possible increase in the allocated amount to up to 6.6 percent of GDP.

9. **The banking sector is still under pressure and bank balance sheets continued to contract.** While aggregate capital and liquidity positions remained adequate, many banks posted losses for a third year in a row, due to high levels of NPLs (16.9 percent, 2013:Q4), weak economic activity, and a heavy tax burden. Portfolio cleaning remained sluggish, and speculation about future debt relief for FX mortgage holders has incentivized some borrowers to suspend their debt service payments, thereby adding further pressure on bank balance sheets. Despite the accommodative

monetary conditions and improving economic activity, credit to households and corporates continued to contract in 2013, albeit at a slowing pace (by 3 percent and 2 percent, respectively). The deleveraging process has brought the loan-to deposit ratio further down to 102 percent in 2013:Q4 from about 150 percent in early 2009, and contributed to a further decline in banks' foreign funding. In an effort to boost the lending capacity of cooperative credit institutions, the government integrated them into a single body under the ownership of the state-owned Development Bank. The integration process is expected to be completed by end-2014 and is likely to add a key market player to the banking system.[1]

External Positions of BIS-reporting banks, 2009Q1-2013Q3
(Change, Percent of 2013 GDP, exchange-rate adjusted)



Sources: BIS, Locational Banking Statistics; and IMF staff calculations.

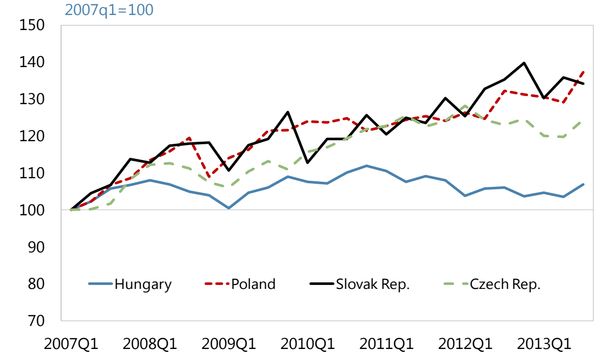
10. **External stability has improved, but still-high external debt and financing needs are a reason for concern.** The current account is in surplus, reflecting in part elevated savings in response to ongoing deleveraging, and external debt has fallen substantially. However, despite the decline, external debt is 119 percent of GDP, the net international position is at -93 percent of GDP, open FX positions on private sector balance sheets are about 21 percent of GDP; and gross external financing needs average 26 percent of GDP per year over the medium term. Moreover, reliance on nonresidents for local currency-denominated government securities continues, and such holdings stood at 32 percent of the end-March 2014 outstanding stock, with a high concentration in the investor base (see accompanying Selected Issues Paper).

11. **Staff's assessment is that the real exchange rate is broadly in line with medium-term fundamentals**. Econometric estimates based on the EBA methodology have low explanatory power and yield mixed results for Hungary. Specifically, the Current Account Balance approach suggests that the current account norm is a small deficit, about 5 percent of GDP below the cyclically-adjusted balance in 2013; thus, Hungary's real effective exchange rate (REER) appears to be undervalued. However, in staff's view, this approach does not adequately capture savings (and therefore the current account) remaining elevated due to Hungary's still-large external liabilities, and the need to substantially reduce them over the medium term. The Real Effective Exchange Rate approach reveals an overvaluation of the exchange rate by about 20 percent, and the External Sustainability approach finds the REER undervalued by just under 10 percent. Other price indicators, such as unit labor costs, do not point to competitiveness problems.

[1] The total assets of cooperative credit institutions amounted to €7.2 billion at end-2013, thus making the integrated body the fourth-largest in the banking system. The authorities' plans to increase their loan-to-deposit ratio (currently 60 percent) would increase their importance in the banking system further.

12. **However, non-price indicators point to an erosion in Hungary's market share and attractiveness for FDI.** After an impressive expansion in export markets starting in the mid-1990s, reflecting growing links with the German supply chain, Hungary's export market share has been recently underperforming its regional peers (Box 4).[2] At the same time, the FDI stock in manufacturing, which peaked at 23 percent of GDP in 2007, has declined sharply since then. Additionally, Hungary's ranking in the global competitiveness index has slipped 11 places since 2010/11 (63 out of 148 in 2013/14), with the institutional framework providing a drag on overall competitiveness—transparency of government policy making, property rights, and public trust in politicians received exceptionally low ranking.

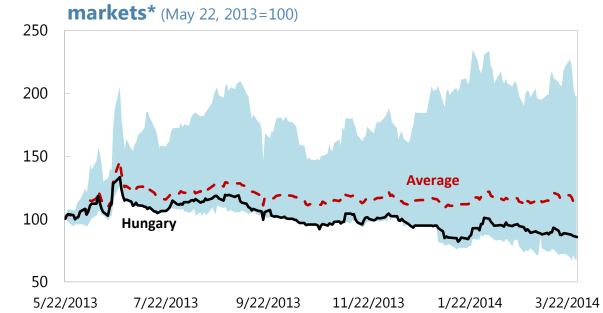
Share in the EU's Exports
2007q1=100



Sources: IMF Direction of Trade Statistics.

13. **Hungary withstood various bouts of emerging market turmoil over the past year relatively well.** Financial markets seem to have taken confidence in the recent economic recovery, current account surplus, sizeable fiscal consolidation, and low headline inflation. Domestic issuance of government bonds has continued smoothly and yields—although increasing by 50–60 basis points toward end-2013—have eased somewhat recently. The exchange rate depreciated by 3½ percent against the euro in the first quarter of 2014 and has since been broadly stable, while the equity market recorded moderate losses (6 percent in 2014:Q1). Sovereign CDS spreads have moderated recently to just above 200 basis points (end-April). Taking advantage of favorable external conditions, the government secured financing for most of its maturing external debt in 2014 (US$7¼ billion, 5½ percent of GDP) with the US$2 billion and US$3 billion Eurobond placements in November 2013 and March 2014, respectively.

5-year CDS spreads in selected European emerging markets* (May 22, 2013=100)



Sources: Bloomberg and IMF staff calculations.
* Countries included are Slovak Rep., Poland, Slovenia, Russia, Turkey, Bulgaria, Croatia, Romania, Estonia, Latvia, and Lithuania.

OUTLOOK AND RISKS

14. **Staff expects the economic recovery to gather further momentum, with excess productive capacity narrowing slowly.** Real GDP is projected to grow 2 percent in 2014 as investment and private consumption continue to improve on the back of more favorable financing conditions and a lower drag from deleveraging. Driven by a significant expansion in automobile production, exports are expected to expand further, but given their high import content and the expected surge in imported consumer and investment goods, the overall contribution to growth

[2] See: German-Central European Cluster Report, Country Report No. 13/263.

from net external demand would be limited. At the same time, the current account is projected to remain in surplus this year. Over the medium term, output growth is set to stabilize at around 1¾ percent. The impetus from domestic demand is expected to strengthen somewhat, and the contribution from net external demand is set to decline as import growth recovers. The latter together with slowing deleveraging and aging population dynamics would help normalize savings and turn the current account to a deficit, in line with its norm. Underlying inflationary pressures are expected to gradually build up, as spare capacity diminishes and the impact of one-off effects on prices wanes.

15. **Risks to the outlook—highlighted in the Risk Assessment Matrix—are tilted to the downside.** Staff noted that in an unchanged policy scenario, external vulnerabilities would pose risks to financial and economic stability in case of adverse external shocks. Uncertainty regarding advanced economies' monetary policies or a further re-pricing of emerging markets or other risks

Hungary: Key Macroeconomic Indicators, 2012-2019, (in percent of GDP, unless otherwise indicated)

	2012 Act.	2013 Est.	2014 Proj.	2015 Proj.	2016 Proj.	2017 Proj.	2018 Proj.	2019 Proj.
Real GDP Growth (percent)	-1.7	1.1	2.0	1.7	1.7	1.7	1.7	1.7
Inflation (period average, percent)	5.7	1.7	0.9	3.0	3.0	3.0	3.0	3.0
General government overall balance	-2.0	-2.2	-2.9	-2.9	-2.9	-2.8	-2.8	-2.7
General government gross debt	79.8	79.2	78.9	78.9	78.8	78.6	78.4	78.2
Current account	0.9	3.0	2.5	2.0	1.2	0.4	-0.6	-1.7
Reserves (in billions of Euros)	33.9	33.8	34.6	35.5	36.6	37.6	38.8	39.9
Gross external debt 1/	128.8	118.7	116.8	107.8	100.2	94.2	89.9	87.1

Sources: Hungarian authorities, and IMF staff projections.

1/ Excluding special purpose entities. Including inter-company loans, and nonresident holdings of forint-denominated assets.

could erode demand for Hungarian assets, spilling over through the banking (deleveraging) and balance sheet (exchange rate) channels. Moreover, escalation of geopolitical tensions in the region would exacerbate downside risks through trade and financial linkages, including through exposure to common nonresident financial institutions and investors (Box 5). A protracted slowdown in key trading partners could also hurt Hungary's recovery through its impact on exports. On the domestic front, continued government interference in the economy could exacerbate deleveraging with adverse confidence effects, undermine Hungary's international competitiveness further, and hurt investment and growth. On the upside, the expansion of the FGS may temporarily boost growth further and so could upside surprises to euro-area growth.

Authorities' views

16. **While broadly agreeing with the near-term outlook, the authorities were more upbeat about Hungary's medium-term prospects and the balance of risks.** They agreed that, despite the recent improvement, external vulnerabilities remain high, and concurred that deterioration in the external environment would adversely influence Hungary through trade, financial, and confidence channels. To this end, they agreed that developments in Russia and Ukraine could affect Hungary; but they had not observed any immediate impact. The authorities viewed the risks to the outlook as broadly balanced and argued that the likelihood of capital outflows is low, particularly given that Hungary's investor base has become more stable in recent years following the increase in the share

of real-money investors. They also argued that the economy's improved fundamentals have instilled confidence in foreign investors as evidenced by the recent decline in the sovereign CDS spreads and the heavily-oversubscribed auctions of government paper. Finally, they were more upbeat about Hungary's growth potential and also noted considerable upside risks to growth, including from a pickup in corporate lending and on the back of the stimulatory impact of the FGS; as well as from a stronger external environment.

POLICY DISCUSSIONS

Policies should be geared toward boosting potential growth, and reducing public and external debts. Discussions thus focused on the need to build policy buffers further and adopt a comprehensive growth strategy that would encompass a growth-friendly fiscal adjustment, revival of financial intermediation, and structural reforms. Such a strategy would contribute to a faster reduction in risk premia and a higher level of investment and growth.

A. Fiscal Policy—Finding the Right Balance

17. **Staff welcomed the authorities' commitment to fiscal consolidation, but noted that policies appeared insufficient to reduce the public debt ratio.**

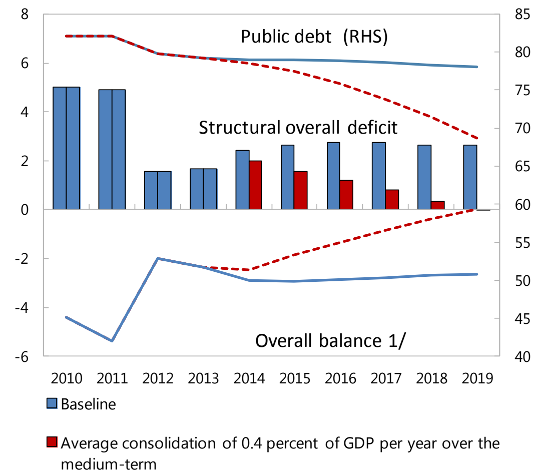
- **The fiscal stance is projected to relax in 2014.** With the deficit target increasing to 2.9 percent of GDP, mainly on the back of increases in expenditure on health, education and projects co-financed with the EU, the structural deficit is set to widen by about one percentage point of GDP, leaving public debt roughly unchanged at about 79 percent of GDP. Moreover, in staff's assessment, the budget over-estimates potential revenue collection, which implies that the deficit target is likely to be met only if all budget reserves (0.7 percent of GDP) are saved.

- **Over the medium term, staff projects the fiscal deficit to come down only modestly.** In the updated convergence program, the government targets a reduction in the deficit to 1.9 percent of GDP by 2017. However, based on staff's baseline macro scenario, current policies, and the authorities' ambitious investment agenda, partly funded by EU transfers, the fiscal deficit would decline only slightly to 2¾ percent of GDP. This would imply a further easing of the fiscal stance as the output gap closes and revenues recover back to their potential. Public debt, at around 78 percent of GDP, would remain a significant vulnerability (Appendix I).

18. **There is a need for a clear and credible strategy to gradually but steadily reduce public deficits and debt over the medium term.** Staff sees scope for a smooth fiscal consolidation path that would strike a balance between sustaining the economic recovery and putting the debt-to-GDP ratio decisively on a downward trajectory. To this end, staff recommended containing the fiscal impulse in 2014 to ½ percent of GDP, which would entail an adjustment of about ½ percent of GDP compared with the approved budget, followed up by a structural tightening of about ½ percent of GDP annually throughout 2015–19. Such a strategy—which would help build much-needed fiscal

buffers and strengthen confidence—would bring the structural deficit to about zero and reduce public debt to just below 70 percent of GDP by 2019.[3]

Fiscal Stance of the General Government
(In percent of GDP)



Sources: Hungarian authorities and IMF staff calculations.
1/ In 2011 excludes one-off revenues of 9.6 percent of GDP from the transfer of private pension assets to the government.

19. **The adjustment strategy should rely on durable expenditure consolidation, enhanced composition of expenditure, and gradual elimination of distortionary taxes.**[4] At over 50 percent of GDP, government spending is among the highest in the region, financed increasingly by distortionary sectoral taxes. A sustainable expenditure retrenchment would, therefore, create the needed fiscal space to rationalize the tax system.

- Staff sees room for: (i) better targeting of social benefits, employer tax breaks, and price subsidies; (ii) rationalizing remaining loss-making SOEs; (iii) containing discretionary spending on goods and services; and (iv) rationalizing the wage bill.[5] The growth impact of expenditure can be enhanced by re-directing spending on public works to individualized employment services and training, and re-directing savings in family benefits towards the provision of child-care.

- On the tax front, there is a need to: (i) streamline the tax regime through a reduction of exemptions, special regimes, and elimination of distortionary sectoral taxes; (ii) reduce the high tax wedge for low-income workers; and (iii) decisively tackle VAT fraud, particularly in the basic food sector (See: Box 7, Country Report No. 13/85).

[3] Under the current GDP growth path, if the structural deficit were maintained at this level beyond 2019, public debt would decline to below 60 percent of GDP by 2022.
[4] Revenues from sectoral taxes were about 2.3 percent of GDP in 2013, of which 1.2 percent of GDP was collected from the banking system (bank transaction taxes and the special bank levy).
[5] There is a need to streamline employment at the municipal level, particularly since lower-level government functions have been transferred to the central government in 2012.

Fiscal impact of potential measures
(in percent of GDP)

Total 1/	4.8
Nominal freeze of spending on non-EU-related goods and services	1.2
Reduction in public sector employment 2/	0.5
Reduction in public transport tariff subsidies	0.2
Elimination of operational subsidies to transport enterprises	0.9
Streamlining of VAT rates from 3 to 2	0.3
Elimination of selected CIT exemptions (e.g., sports and entertainment)	0.2
Elimination of excise exemptions for diesel fuel and tobacco	0.4
Reduction of VAT fraud 3/	1.3

Sources: IMF staff estimates, based on data provided by the authorities, and FAD and LEG TA reports.

1/ The total reflects the needed adjustment to compensate for the elimination of sectoral taxes and the staff's recommended structural consolidation. The individual impacts do not add to the total due to rounding.

2/ Reduce employment (rather than wages) through attrition; rationalize local government employment further.

3/ Assumes measures to eliminate 75 percent of the estimated total fraud.

20. **Strong fiscal institutions are critical to boost policy credibility and investor confidence.** Frequent changes in the fiscal targets and adoption of ad-hoc measures weaken policy predictability. The fiscal rules currently in place are broadly in line with the requirements of the Stability and Growth Pact, and are supplemented by a framework of domestic fiscal rules that exhibits a number of design flaws (see: Box 1, Country Report No. 12/13). Staff thus recommended simplifying the system and stressed the need to set the rules in structural terms to avoid pro-cyclicality. The authorities' intention to adopt a binding multi-year budget framework, which would help anchor market expectations and contain spending pressures are welcome. Finally, staff called for providing the Fiscal Council adequate resources and greater operational independence to assess the sustainability of the fiscal stance and risks ahead.

Authorities' views

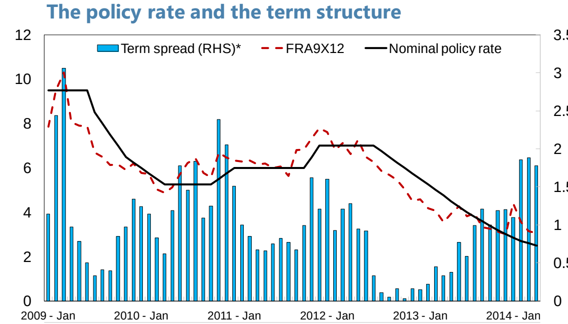
21. **The authorities reaffirmed their commitment to fiscal consolidation.** While they acknowledged some risks to the 2014 budget, including due to the inclusion of substantive gains in tax collection through administrative improvements, they believe that saving only part of the budget reserves will be more than sufficient to meet their deficit target. Over the medium term, they expect the deficit to come down mainly by continuing their policies of partial freezes in government wages and in spending on goods and services; but also benefitting from past reforms to restrict eligibility and reduce the generosity of social transfers.

22. **Regarding structural fiscal policies, differences in views centered on ways to boost demand and supply of labor and appropriate tax policies.** The authorities felt strongly about the merits of the public works program and targeted reductions in employer contributions under the Job Protection Act. They were hesitant about potential intervention based on reported income, such as lowering the substantial tax-wedge for low income workers which has increased in recent years. The authorities pointed to progress in rationalizing loss-making SOEs and putting the pension system on a firmer footing. Regarding sectoral taxes, they stressed that they do not intend to phase them out in the near future given the lack of fiscal space. Furthermore, they disagreed with the mission's characterization of the taxes as distortionary sectoral taxes arguing that taxes such as the financial transactions tax or the telecom levy are relatively broad-based consumption taxes.

B. Monetary and Exchange Rate Policies

23. **Under the baseline scenario, with the economic recovery gathering momentum, inflationary pressures are set to build up, but only gradually.** At the current level of the policy rate, staff projects headline inflation to revert towards the MNB's inflation target of 3 percent as the output gap narrows and one-off effects on prices wane. The pace of inflation acceleration, however, is likely to remain moderate because weak labor market conditions and the recent moderation of inflation expectations would help keep private sector wage growth contained, while the deceleration of import prices is projected to offset the impact of recent exchange rate depreciation.

The policy rate and the term structure

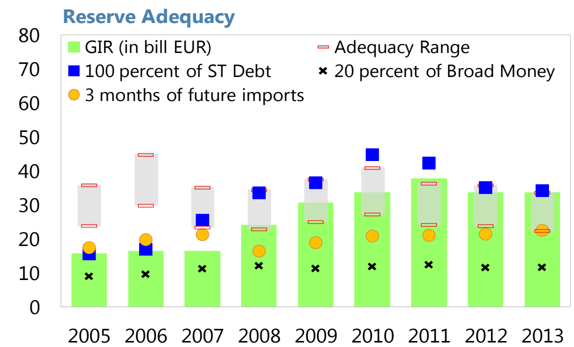


Sources: Haver and IMF staff calculations.
*The spread between the yields on 3-year and 3-month government bonds.

24. **At the same time, there is considerable uncertainty surrounding the external environment**. Hungary's interest rate differentials have reached a record low, and further compression—also due to normalization of monetary policies in advanced economies—may reduce the attractiveness of Hungarian securities. This, together with possible re-pricing of emerging market risk in the wake of a slowdown in some large emerging markets and geopolitical tensions in the region, could potentially lead to a disorderly movement of capital flows. The recent steepening of the yield curve may point to increased uncertainty regarding the inflation outlook, and forward rate agreements are pricing a policy rate hike of 40 basis points by end-2014.

25. **With these considerations in mind, staff recommended keeping the policy rate on hold and adopting a monetary policy tightening bias.** The proposed monetary policy stance strikes a balance between cyclical considerations and financial stability concerns. The former set of considerations would justify maintaining the current accommodative stance before commencing the tightening cycle later in the year. However, the economy is still susceptible to shocks and remains highly vulnerable to exchange rate risk given its large open FX position. Sharp and persistent

exchange rate depreciation could also endanger price stability.[6] Staff, therefore, urged the authorities to keep the policy rate on hold, maintaining the present accommodative policy stance until there are signs that inflationary pressures are building up. In the event that external conditions deteriorate sharply, the MNB should also stand ready to tighten. Staff emphasized the importance of maintaining the confidence of market participants in the central bank's inflation targeting framework and recommended a clear communication strategy to guide market expectations.



Source: IMF staff estimates.

26. **Maintaining sufficient reserves is imperative for supporting financial stability.** While Hungary's reserve position is projected to remain within the Fund's adequacy range over the medium term, large financial sector vulnerabilities, including from heavy reliance on FX swaps with nonresidents, and risk of market volatility are expected to remain elevated. Accordingly, staff underscored the need to maintain adequate reserve coverage to support financial stability and smooth exchange rate volatility if the FX market dries up.

Authorities' views

27. **The authorities broadly agreed that changes in market sentiment continue to pose risks, but didn't see a need for adopting a tightening bias.** With inflation expectations moderating to around the MNB's inflation target and the still-sizeable negative output gap, the authorities argued that inflationary pressures are likely to remain contained in the period ahead. In their projections, headline inflation is set to remain below 3 percent in 2014 and reach the inflation target in 2015. They concurred, however, that the increased volatility in the global financial markets requires enhanced vigilance, as risk perceptions can shift rapidly. In this connection, they reiterated the view of the Monetary Council to reassess the policy stance in light of market conditions. Finally, they considered the current level of reserves comfortable, and reaffirmed their commitment to maintain reserves within the adequacy range in the period ahead.

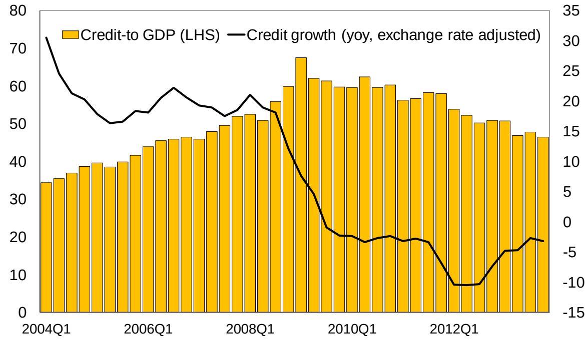
C. Financial Sector—Repairing Financial Intermediation

28. **There is an urgent need to restore financial intermediation.** Despite the recent improvement in economic activity, credit is projected to contract further in 2014. Staff argued that long-lasting restoration of financial intermediation should rely primarily on a sustainable improvement in banks' operating environment, including a reduction in the heavy tax burden on banks and higher policy predictability. Staff cautioned about the high level of restructured loans (about 18 percent of total loans) and argued that the high level of NPLs continues to hinder credit growth.

[6] The pass-through from exchange rate depreciation of 1 percent to prices is estimated at about 0.3 percent over a period of one year.

This underscores the need for a faster cleanup of banks' asset portfolios, including by removing legal, regulatory, and tax impediments.[7] To this end, staff welcomed MNB's efforts to address such impediments, and stressed that a swift adoption and implementation of a personal insolvency framework in line with best international practice would be important. Staff also stressed that a possible new FX mortgage debt relief scheme should envisage appropriate burden sharing among all stakeholders.

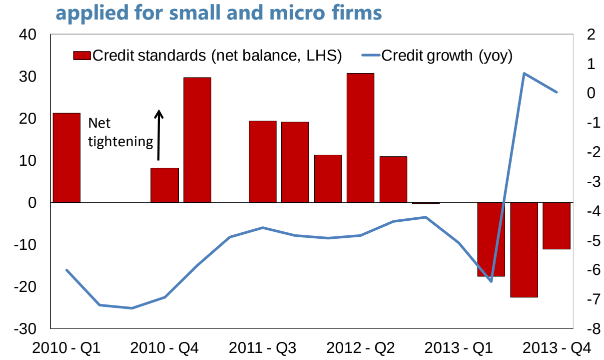
Bank Credit



Sources: MNB and IMF staff calculations.

29. **Lending under the FGS should be limited, targeted, and time-bound, with fiscal costs clearly recognized.** The first phase of the FGS helped extend SME loan maturity, and reduce borrowing costs and exposure to exchange rate risk. Weak demand for the second phase, along with the broad market expectation that the overall amount is unlikely to be utilized, suggest a limited impact on economic growth. While supporting the authorities' objective to reduce fragmentation and improve SME access to finance (Box 6), staff saw scope to alter some of the Scheme's modalities to increase its impact on growth and better support the effectiveness of monetary policy transmission. More specifically, there is a need to link the lending rate to the policy rate, so as to remove the monetary policy easing bias embedded in the scheme, in a manner that adequately compensates banks for lending to more risky SMEs. Moreover, this Scheme should remain time-bound and limited to SMEs, while fiscal costs should be transparently reported.

Credit growth of SMEs and credit standards applied for small and micro firms



Source: MNB.

30. **The ongoing integration of the co-operative credit institutions responds to the increasing need of improving their financial standing and operations.** The integration process should help ensure adequate risk management practices, enhance their lending capacity, and ultimately increase their market share. As their overall role in the banking system is expected to increase substantially over time, it is important to put in place appropriate safeguards to ensure no state interference in their lending activity and strategic decisions.

31. **Staff welcomed recent improvements in the financial stability framework, which would help safeguard the Hungarian financial system against a wider range of risks.** The adoption of the new MNB Act, which facilitated the integration of the Hungarian Financial Supervisory Authority

[7] Impediments to the banks' portfolio cleaning process include the lengthy and costly process of liquidation, and limited use of the out-of-court framework for debt resolution. Additionally, there are some tax disincentives given that debt cancelation is not recognized as expenditure for tax deductibility.

into the MNB and equipped it with micro-prudential instruments, also reinforced the MNB's macro-prudential tool kit, and thus allowed the MNB to address financial gaps in a more efficient and effective manner.[8] While noting that financial and price stability are interlinked, staff stressed the importance of establishing adequate checks and balances to ensure that financial stability concerns will not override the MNB's objective of price stability. In this regard, the establishment of the Financial Stability Council, which is responsible for financial sector stability, and decides about macro-and micro-prudential supervisory and regulatory instruments, is a step in the right direction. While the authorities have yet to decide whether to join the European Banking Union, staff stressed the importance of not falling "behind the curve" and encouraged the authorities to strengthen the supervisory framework further, including by adopting a bank resolution framework.

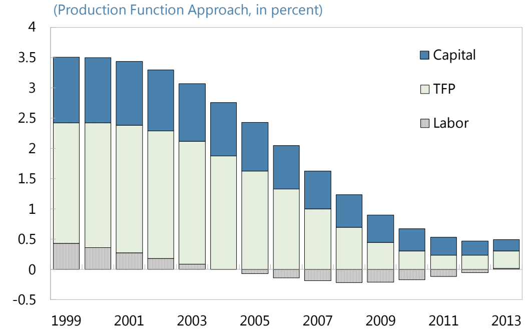
Authorities' views

32. **The authorities emphasized the role of the FGS in repairing financial intermediation and didn't share staff's concerns about its modalities.** They agreed that credit is likely to remain weak in the period ahead, reflecting both demand and supply-side factors. In this regard, they viewed the FGS as a useful monetary tool to boost bank lending to SMEs. The authorities considered the FGS's modalities appropriate and were confident that demand would pick up later in the year. They agreed that the FGS involves costs, but considered them as relating to the MNB's monetary operations that could be offset by balance sheet management. While agreeing that commercial bank profitability is likely to remain subdued in the period ahead, they considered the bank levy and the bank transaction tax necessary given the limited fiscal space. On NPLs, the authorities concurred that their high level impedes credit growth and expected the task force responsible for identifying measures to facilitate faster portfolio cleaning to submit its recommendations to the Financial Stability Council in the coming months. As for their efforts to strengthen the supervisory framework, the authorities are in the process of drafting a new law that will implement the Bank Recovery and Resolution Directive, with full implementation envisaged early next year.

D. Structural Policies—Engendering Higher Potential Growth

33. **Improving Hungary's growth prospects remains a key challenge.** Potential output growth is currently estimated at around 1 percent and is projected to increase modestly to around 1½– 1¾ percent over the medium term (see accompanying Selected Issues Paper). As such, it remains well below that of Hungary's regional peers—thus weighing on domestic and external vulnerabilities and impeding Hungary's convergence towards a higher income level. The subdued growth potential is driven by low investment and total factor productivity, which appear to be a reflection of the

Contributions to Potential Output Growth
(Production Function Approach, in percent)



Source: IMF staff calculations.

[8] Several instruments that were under the responsibility of government were transferred to the MNB. These include minimum liquidity levels, regulation of maturity and currency mismatches, LTV and limits on lending (DTI and PTI).

adverse business environment. Moreover, weaknesses in the labor market, including the low participation and employment rates, also weigh on long-term growth.

34. **The erosion in market share and the drop in FDI undermine Hungary's growth prospects.** In staff's assessment, this mainly reflects structural factors rather than exchange rate developments and it could undermine Hungary's current role in the German-Central European Supply Chain. Staff underscored the need to move up in the value chain. This should entail measures to upgrade labor force skills, promote entrepreneurship and innovation, reduce the tax burden, and improve the business climate to support investment and growth.

35. **Renewed structural reform momentum is needed to remove obstacles to growth.** Past reforms to boost labor demand and supply have borne fruit, but further steps are required. Consideration should be given to boosting labor demand by differentiating the minimum wage across different groups and linking future increases to productivity growth; and reducing labor market skills mismatches by strengthening the training component of active labor market policies (see accompanying Selected Issues Paper). Moreover, there is a need to increase policy predictability, and reduce the regulatory and tax compliance burden on businesses. Finally, staff called for the restructuring of the remaining loss-making transport SOEs, and cautioned against recent measures to reduce utility prices further as part of the government's strategy to make the energy sector non-profit, arguing that it may compromise the quality of services and undermine investment plans.

36. **Staff analysis suggests that a comprehensive and ambitious structural reform package could lift Hungary's potential growth substantially**. Such a policy package could entail measures to: (i) increase labor participation; (ii) improve the quality of fiscal policy, including by eliminating distortionary sectoral taxes; and (iii) enhance the business environment. While considerable uncertainty surrounds the quantification of reforms and their impact on potential growth, model simulations suggest that in such a reform scenario, potential growth could return to its pre-crisis rates over the medium term (see accompanying Selected Issues Paper).

Authorities' views

37. **The authorities were more optimistic about Hungary's medium-term growth prospects citing strong impetus from structural reforms and recent policy measures.** They viewed medium-term potential growth at about 2½ percent, largely on account of higher investment due to increased EU funds, more favorable financing conditions for SMEs, and labor market reforms. The authorities noted that the recent decline in Hungary's export market share is mainly linked to the changing structure in the manufacturing sector, particularly in the telecom sector, and argued that the increase in the peers' market shares mainly reflects a catching-up process. However, they indicated that the diversification of Hungary's export destinations, including through trade links with Asian countries, the expansion of Eximbank operations, and the planned increase in the production capacity in the automobile industry, would boost export performance. Finally, the authorities added that the utility price cuts were part of their strategy to develop a non-profit energy sector, which is critical to reduce high energy costs and enhance competitiveness.

STAFF APPRAISAL

38. **The Hungarian economy is strengthening but continues to face vulnerabilities.** The economy has emerged from the 2012 recession and growth is gaining momentum. External demand has been supportive, but the economic upturn is largely driven by a pickup in domestic demand, on the back of stimulative macroeconomic policies. Inflationary pressures have subsided, and external vulnerabilities have declined somewhat, thanks to persistent current account surpluses and improved market sentiment, which allowed the government to secure most of its external financing needs for this year. While these developments are welcome, still-high public debt and related financing needs, heavy reliance on nonresident financing, and a large open FX position continue to pose significant risks. Hungary's subdued medium-term growth prospects further exacerbate these vulnerabilities.

39. **A stronger policy framework would help tackle these challenges.** The improved economic conditions provide an opportune time to reduce vulnerabilities and unlock Hungary's untapped growth potential. To this end, a recalibration of macroeconomic policies to build the necessary policy buffers, alongside a renewed reform momentum aimed at addressing structural impediments, strengthening institutions, and increasing policy predictability would contribute to a faster reduction in risk premia, sustain market access, and boost investment and potential growth.

40. **Growth-friendly fiscal consolidation is necessary to put the public debt ratio firmly on a downward path**. To this end, the authorities' commitment to fiscal adjustment over the medium term is welcome, and it will need to be backed by a clear and credible strategy encompassing ambitious growth-friendly fiscal reforms. Those could include better targeting of social benefits, restructuring the remaining loss-making SOEs, and streamlining public sector employment. This, along with measures to reduce tax exemptions and address VAT fraud, would free up fiscal space for growth-enhancing tax and expenditure measures. The government's plan to introduce a binding multi-year budget framework with the 2015 budget would bolster fiscal policy predictability and help contain spending pressures. However, a more independent and adequately-resourced fiscal council is essential to monitor the risks ahead and ensure the sustainability of public finances.

41. **The monetary policy easing should end and a tightening bias should be adopted.** While underlying inflationary pressures have eased and inflation expectations have come down to around the MNB's inflation target, uncertainty about the external environment justifies a cautious monetary policy stance, particularly given Hungary's vulnerability to exchange rate risk. In this regard, the policy rate should be kept on hold and the current accommodative monetary stance can continue to support economic activity. The precise timing of commencing the tightening cycle should depend on signs that inflationary pressures are building up. However, the central bank should also stand ready to tighten if external conditions deteriorate sharply. Adequate international reserves need to be maintained to mitigate excessive exchange rate volatility and support financial stability.

42. **Well-functioning financial intermediation is essential for economic growth.** While demand factors contribute to weak credit market activity, banks' balance sheet constraints have also played a role. Removing regulatory, legal, and tax impediments, alongside a prompt introduction of

a personal insolvency framework, would help accelerate the cleanup of banks' asset portfolios and prevent repeated restructuring of non-performing loans. Reducing the tax burden on banks and improving policy predictability would also support lending activity. To this end, it is essential to ensure that future FX debt relief schemes would entail appropriate burden sharing among all stakeholders. Subsidized lending under the FGS has helped improve credit conditions for SMEs, but further refinement of the Scheme's modalities could ensure a more effective monetary policy transmission mechanism and a higher impact on economic activity. All in all, the scheme should remain time-bound and limited to SMEs, with fiscal costs clearly recognized.

43. **Sustained progress on wide-ranging structural reforms would help unleash Hungary's full growth potential.** Demand management policies cannot address the root causes of weak long-term growth. Instead, decisive implementation of structural reforms aimed at improving the business climate, promoting entrepreneurship and innovation, reducing the regulatory burden, rationalizing taxes, and boosting productivity in the services sectors, including by restructuring the remaining loss-making SOEs, is critical to boost potential growth and support Hungary's advancement in the regional supply chain. Increased policy predictability and limited government interference in the economy would enhance market confidence and support private investment. Efforts to increase labor supply and demand should continue, and greater emphasis should be placed on mitigating skill mismatches, investing in knowledge industries to move up in the value chain and compensate for the narrowing labor cost differentials, adjusting the tax wedge on low income earners, and ensuring that minimum wage increases are in line with productivity growth.

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

Hungary - Risk Assessment Matrix [1/]

Source of Risks		Relative Likelihood	Impact if Realized
Global	*Surges in global financial market volatility*	**High** Uncertainty regarding the pace of UMP exit and possible change in risk perception may lead to nonresident sell-off of HUF securities, and deposit withdrawals from banks.	**High** A reversal would sharply raise borrowing costs, and put pressure on reserves. Depreciation would impair banks' balance sheets given large foreign currency risk exposures.
	A sharp increase in geo- political tensions surrounding Russia/Ukraine	**Medium** Re-pricing of risks and heightened volatility in the financial markets. Regional spillovers through trade, financial and confidence channels.	**Medium** A shift in risk perception would increase borrowing costs and, coupled with lower external demand, put pressure on reserves. Disruption of gas supply and increase in gas prices would adversely affect production.
	Protracted period of slower growth in advanced and emerging economies	**High** External demand would wane, slowing Hungary's main engine of growth.	**Medium** Coupled with a fragile recovery in domestic demand, weaker export growth would delay the recovery from the crisis while perpetuating macroeconomic vulnerabilities.
	Bond market stress from reassessment in sovereign risk	**Low** Sovereign stress re-emerges due to incomplete reforms, unanticipated outcomes from the asset quality review and stress tests in the absence of fiscal backstop.	**High** Through strong trade and financial ties with Europe, could lead to a sharp reversal of capital flows, credit crunch and economic slowdown. Financing pressures could arise.
Domestic	*Unconventional policies*	**Medium** Unconventional fiscal policies and a weakening of institutions would undermine policy credibility and erode confidence.	**High** Could limit availability of financing, foster sharper cross-border deleveraging, and lower FDI flows. Credit and investment would continue contracting, and put pressure on reserves.
	Stalling of fiscal consolidation, and slippages in structural reforms	**Medium** Fiscal and structural reforms needed to boost potential growth could be delayed due to lack of political appetite.	**Medium** Borrowing costs would rise, market confidence would wane, and debt sustainability would worsen. Reserves would come under pressure. Competitiveness would be eroded and Hungary's economic prospects would worsen.

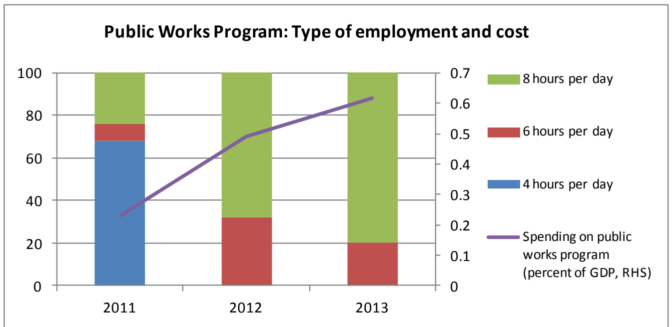
Policy response

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

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

Box 2. Public Works Program

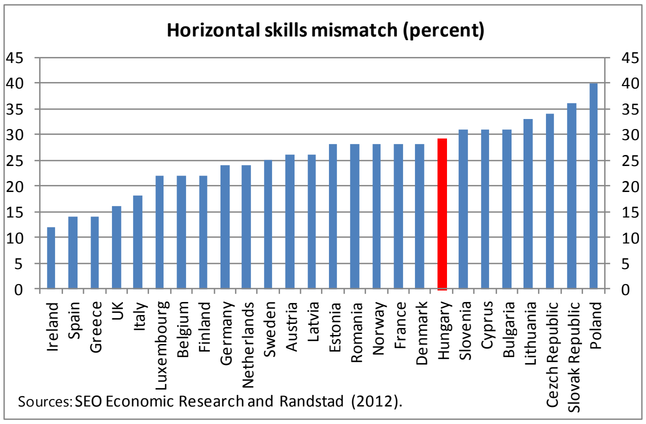
Hungary's public works program played a key role in the recent employment creation. Its aim is to facilitate the return of discouraged workers (many of whom were unemployed for extended periods) to the labor market by providing temporary employment opportunities with public agencies, mainly in the agricultural and construction sectors. The program was recently expanded and became a major contributor to public sector employment and to the decline in unemployment. The number of registered individuals grew from 271,600 in 2011–12 to 402,700 in 2013. As such, the size of the program reached 10 percent of total employment at end-2013.



Sources: Hungarian Ministry of Interior, and IMF staff estimates.

However, the program has been increasing the burden on public finances. Its focus has shifted over time, from mostly part-time employment to largely full-time employment and the cost to the budget almost tripled (to about 0.6 percent of GDP in 2013). The bulk of the funds under the program have been spent on wages, while spending on training has constituted 0.1 percent of GDP.

The expansion of the program raises questions about its long-term effectiveness. Although it directly contributes to domestic demand and employment, it resembles a social assistance scheme with questionable impact on long-term employment and growth. The 2013 data suggests that the program's effectiveness has been limited as the share of participants finding jobs on the primary labor market within 180 days of leaving the program was 13.3 percent.[1/] However, the authorities consider this a significant result as many participants found jobs in relatively underdeveloped regions.



Sources: SEO Economic Research and Randstad (2012).

Raising Hungary's growth potential should entail a more effective use of funds spent on the public works program. This could be achieved by shifting resources from increasing the number of participants and the size of wage compensation toward higher spending on vocational training, with a focus on new skills development. Hungary is amongst the group of countries that have relatively high horizontal skills mismatch (a mismatch of field of education) and retraining workers would be a relevant area to focus on.

1/ Cross country studies are skeptical about the effects of such programs on employment; e.g., Berkhout and van den Berg (2010) "Bridging the Gap: International Database on Employment and Adaptable Labour", Randstad, Amsterdam, 2010.

Box 3. The Funding for Growth Scheme

The scheme

First phase: Under the first pillar, the MNB provided zero-interest funding to banks for on-lending to SMEs at a maximum rate of 2½ percent. The amount available to banks was initially set at HUF 250 billion, but it was later raised to HUF 425 billion (1½ percent of GDP). The maximum maturity of the loans is 10 years and participating banks fully bear credit risk. The second pillar of the scheme allocated HUF 325 billion to facilitate the conversion of SMEs' FX loans into forint at the same refinancing terms, but, given the high interest for the first pillar, the MNB enabled credit institutions to use their credit lines allocated under the second pillar for the first pillar. The scheme also established a third pillar (HUF 1,150 billion; equivalent to 4 percent of GDP) aimed at reducing foreign currency liabilities of banks and MNB's interest expenses by making foreign exchange available to banks that would like to reduce their holdings of MNB bills and repay external liabilities.

Second phase: This phase envisages an increase in the allocated amount up to HUF 2,000 billion (6.6 percent of GDP), though only HUF 500 billion were initially allocated, to be operational until end-2014. It has the same financing terms for banks, but 90 percent of the additional funds available are required to be used for new loans only. The remaining 10 percent is available for refinancing of the FX loans. More recently, participation requirements were relaxed to include real estate companies, individual farmers, leasing companies, and non-bank financial intermediaries, and the limit of financing for an individual borrower was raised to HUF 10 billion from HUF 3 billion.

Utilization

About 93½ percent of the overall amount (HUF 701 billion) was disbursed to credit institutions. The majority of the amount was disbursed to pillar I (HUF 472 billion), divided between new investment loans (41½ percent), loans for working capital (26½ percent), and refinancing (about 43 percent), while HUF 229 billion was disbursed under pillar II (Table). The scheme also facilitated a significant decline in the interest rate for new loans, and increased the average loan maturity.

Distribution of loans provided under the first phase of the FGS
(in HUF billion)

	Allocated amount	Number of contracts	Sum	Percent of the allocated amount*
Pillar I	425			
Investment loans		3,679	177	41.6
Working capital		2,285	113	26.6
Refinancing		2,167	182	42.8
Pillar II	325	1,713	229	70.5
Total	750	9,844	701	93.4

*As of August 1, 2013 credit institutions were allowed to use the allocation under pillar II within for pillar I.

Box 3. The Funding for Growth Scheme (concluded)

While the first phase was met by high interest by enterprises, the expansion of the FGS seems very ambitious and its full utilization during the envisaged period does not seem to be realistic for a number of reasons. First, the initial disbursement of FGS funds has already met a substantial part of the SMEs' demand for new credit. The lack of qualified borrowers makes the possibility of banks expanding their loans by around 30 percent during an 18-month period very distant. Related to this, Eximbank has been expanding its lending financed by issuance of external bonds, especially focusing on meeting demand by exporting SMEs which arguably are higher-quality borrowers. Second, many banks will not be able to substantially expand their lending under the FGS due to balance sheet constraints. Finally, the current maximum interest rate of 2½ percentage points may be attractive for lending to high-quality SMEs, but may be binding for more risky ones.[1/]

Therefore, it is highly unlikely that banks will manage to utilize the full amount of the second phase; and staff assumes that up to HUF 500 billion will be utilized. Indeed, central bank data indicate that the **utilization of the second phase in the first six months** (October, 2013–March, 2014) stood at about 18½ percent (HUF 92.7 billion), of which 11 percent of the allocated amount was utilized for new investment loans.

Potential growth impact

A model-based approach (using the GIMF), which is calibrated for the Hungarian economy, is employed to assess the potential impact of the FGS on economic growth.[2/] The provision of FGS funds is modeled as a temporary decrease in the riskiness of Hungarian corporate borrowers, which in turn reduces the external financing premium. Thus, as a result of the utilization of the first phase and assumed utilization of HUF 500 billion in the second phase, the cost of capital would decline and, therefore, corporate debt and business investment would increase. Real GDP would increase by approximately 0.1 percentage point compared to the baseline on impact because of the increase in domestic demand, particularly investment. In the next periods, real GDP would be higher by up to 0.2 percentage points.

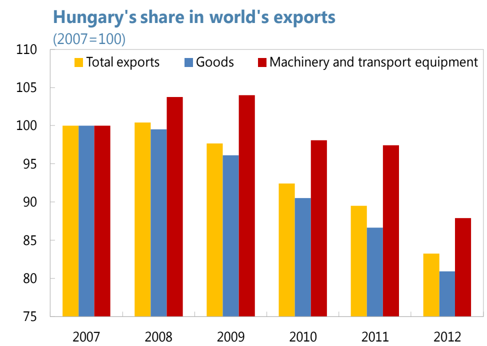
1/ The FGS follows the Bank of England's Funding for Lending Scheme (FLS), which also aims at boosting lending to SMEs. However, unlike the FGS, the FLS is based on collateral swap, with amounts depending on new lending. In addition, the FLS does not impose a cap on the lending rate.

2/ The GIMF is a multi-region, forward-looking, DSGE model developed by the IMF for policy analysis and international economic research. For details on GIMF, see Kumhof et al (2010) "The Global Integrated Monetary and Fiscal Model (GIMF)—Theoretical Structure" IMF Working Paper 10/34, Washington: International Monetary Fund.

Box 4. Export Developments and External Competitiveness

Hungary's integration into the German-Central European Supply Chain (GCESC) drove its impressive export performance until 2009.[1/] Starting in the mid-1990s, many German firms outsourced or relocated part of the production process to the CE4 countries, starting with Hungary, drawn to lower unit labor costs, high-quality human capital, and proximity to markets.[2/] This integration process led Hungary's export volume to quadruple during 1995–2009, while also raising intermediate goods imports, particularly in the knowledge-intensive sectors such as the automotive industry. Hungary also received substantial foreign direct investment from Germany during that period, which brought technology transfers, raised Hungary's external competitiveness in the knowledge-intensive sectors and its domestic value added, creating jobs and supporting income convergence.[3/] Moreover, close economic ties with Germany served as a shock absorber during the global financial crisis.

At the same time, the integration into the supply chain has posed challenges. The increased trade dependency on Germany has been reflected in higher business cycle co-movement and also contributed to increased exposure to global shocks. The Cluster Report's analysis indeed indicates that the CE4 countries are more exposed to spillovers from the rest of the world. This, together with the increased concentration of exports in the knowledge-intensive industries such as machinery and transport equipment, suggests that Hungary needs to maintain sufficient policy buffers to cope with external shocks.



Sources: WEO and ComTrade.

These challenges are further complicated by mounting competitiveness pressures. Since 2009, Hungary's export growth moderated significantly and its share in world exports has been declining. This may partly reflect peers' catching up, but with no strong evidence of exchange rate misalignment, it also reflects declining competitiveness. This is evidenced further in the recent sharp decline of investment from 23 percent of GDP in the late 1990s to a record-low 17 percent in 2012. Moreover, Hungary's ranking in the Global Competitiveness report slipping by 11 places in the past 3 years. As unit labor cost differentials with Germany narrow, Hungary may also face difficulties in sustaining its current role in the GCESC, particularly given that other CESEE countries are making strides in removing impediments to trade, thus becoming potential candidates for the GCESC.

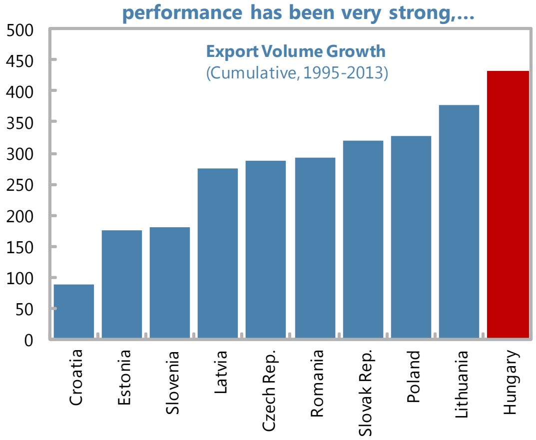
1/ See German-Central European Cluster Report, Country Report No. 13/263.

2/ The CE4 group comprises the Czech Republic, Hungary, Slovakia, and Poland.

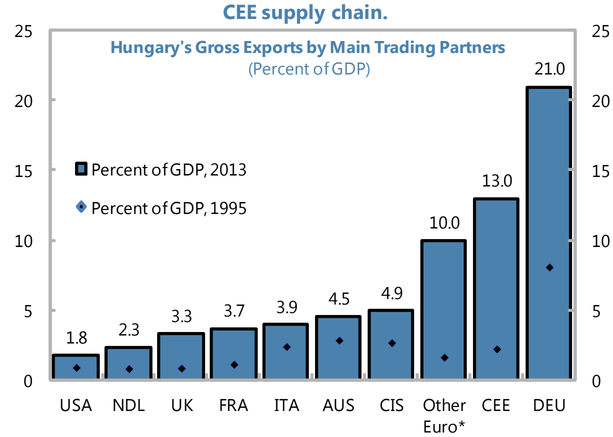
3/ During 1995–2009, domestic value added in Hungary's exports increased by 14 percent of GDP, most of this in the knowledge-intensive sectors.

Box 4. Export Developments and External Competitiveness (concluded)

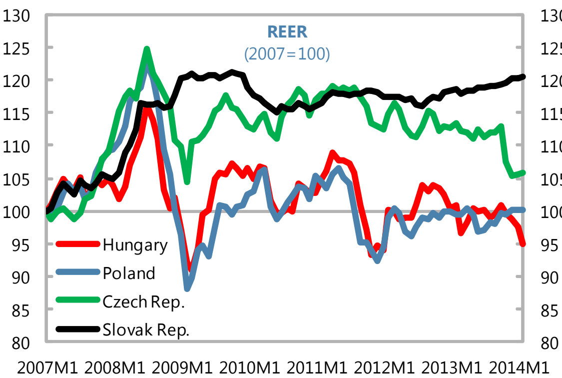
Over the last two decades Hungary's export performance has been very strong,...



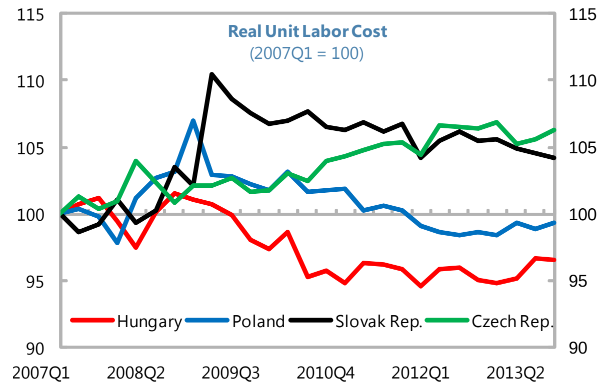
....reflecting in part its integration into the German-CEE supply chain.



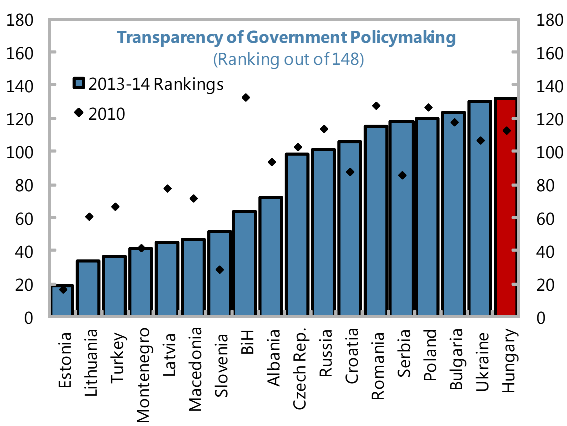
However, despite the forint's stability,...



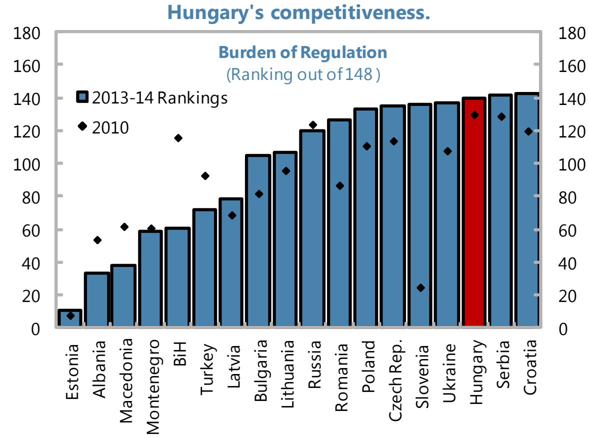
...and competitive unit labor costs,...



....lack of transparency in policy making...



...and heavy regulations could take a toll on Hungary's competitiveness.



Sources: Direction of Trade, World Economic Outlook, Hungarian Statistical Office, MNB, the Global Competitiveness Report. and IMF staff estimates,
*Excluding DEU, NDL, FRA, AUS, and ITA.

Box 5. Hungary's Linkages with Russia and Ukraine

The economic risks from developments in Russia and/or Ukraine, especially ones that lead to disruptions in energy trade, would affect Hungary through its impact on the other economies of the region and the global economy more than through direct linkages. Financial linkages may become more pronounced at times of market turbulence, but are less likely to have adverse spillover effects otherwise.

Russia is an important source of final demand for Hungarian goods, but mainly through indirect supply chain links. Hungary's direct export links with Russia and Ukraine are limited, as it exports just 2 and 1¾ percent of GDP to each one, respectively—a total of 3½ percent of Hungary's exports—largely concentrated in the "machinery and transport equipment" industries. However, final demand from Russia, in particular for automobiles produced in Hungary and supplied indirectly through the German supply chain, is an important driver of exports, and, thus, lower growth in Russia could lower Hungarian exports (see IMF European Department, Regional Economic Issues, Spring 2014.)

Hungary has a significant dependency on Russia and Ukraine for its energy imports. Hungary imports about 5½ percent of GDP from Russia and just below 1 percent of GDP from Ukraine, with the former supplying most of Hungary's imported gas and over 60 percent of its imported fuel. In addition, there is only limited possibility for re-routing gas imports through other countries. On the other hand, with seasonally-low demand and ample gas reserves (about 3 months of consumption), Hungary can overcome short-lived disruptions. At the same time, Hungary relies heavily on imported energy: 70 percent of the energy and 40 percent of the electricity it consumes in a year. Moreover, as the entire region is heavily dependent on energy imports from Russia, lengthy disruptions in gas supply would adversely affect production in Hungary also through the impact on other countries.

Direct financial channels are limited, but a marked deterioration in market sentiment could adversely affect Hungary. Hungary's banking system is directly exposed to Russia and Ukraine mostly through OTP's subsidiaries, which account for 9 percent and 6 percent of the group's total assets, respectively. A sustained deterioration in the operating environment in Russia/Ukraine would adversely affect OTP's profitability, but given its high capital buffers, it is unlikely to endanger the group's financial soundness or have a significant effect on its operations in Hungary. The market share of Sberbank, the only Russian bank operating in Hungary, is only 2 percent and the bank is not systemically important. That said, a broader re-pricing of emerging market risk in the region may have considerable repercussions for Hungary by reducing the appetite for Hungarian and/or other emerging market assets. This impact could be amplified if some investors that play a significant role in the Hungarian and Ukrainian markets decide to re-balance their portfolio and reconsider their exposure to the region.

FDI links are limited. Hungary's FDI positions in Russia and in Ukraine are 2.2 percent and 1.6 percent of total FDI abroad, respectively.

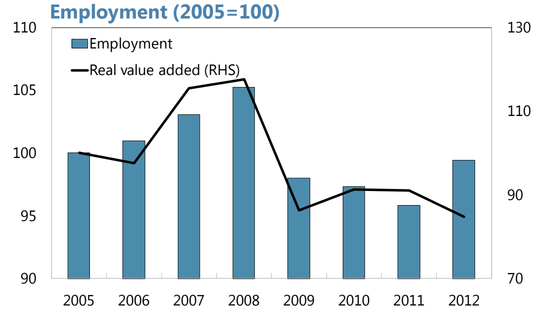
Box 6. The Role of SMEs

In Hungary, SMEs account for 53 percent of the business sector's value added (2012). While low compared to the EU median of 60 percent, it is broadly consistent with the share of other countries that have integrated into the German-Central European supply chain (e.g., Czech Republic, Poland, and Slovakia) where large multinational companies operate in the knowledge-intensive and high value added sectors. Moreover, SMEs' employment amounts to 71 percent of business sector's employment, which is significantly above the EU median of 67 percent, thus underscoring their pivotal role in job creation.

Performance

SMEs' real value added fell by 28 percent during 2009–12, more than offsetting the sharp increase in the pre-crisis period, while the decline in employment was more moderate (5½ percent). The subdued activity of the SMEs sector in this period was accompanied by tightening of lending conditions. The premium on risky loans, as reflected in the widening of interest rate spreads, has increased significantly. Moreover, MNB's lending survey indicates that lending standards to SMEs have been tightened significantly since 2008, as evidenced by the extension of smaller-size and lower-maturity credit lines, reflecting in part stricter collateral and higher credit scores requirements,. Overall, credit to SMEs contracted by 18 percent in 2012 relative to end-2008 and, although a sharp decline of credit also took place among large enterprises, estimations by the MNB suggest that supply-side factors mostly affected SMEs, while weak lending to large companies was mainly attributable to lack of demand.[1/]

Hungary. SMEs'Real Value added and Employment (2005=100)



Source: Annual report on Small and Medium Size Enterprises in the EU, 2011/12.

Impact on economic activity and policy response

A cross-country estimation is employed to study the impact of tight credit conditions faced by SMEs on economic activity in Hungary.[2/] The results suggest that a shock to lending standards that is similar in magnitude to the estimated "net tightening" in 2008 (average of 20 percent, "purged" of factors that also affect demand for credit) leads to a cumulative contraction of 1¾ percentage points of GDP in the following four quarters. This implies that nearly a quarter of the GDP contraction in 2009 (6¾ percent) can be attributed to the tight lending conditions that SMEs faced. As the adverse effect of the credit supply shock has a prolonged effect (estimated at an additional 1 percentage point in the subsequent four quarters), the drag on economic activity from the "net tightening" is likely to have persisted in subsequent years, particularly given that banks continued to tighten lending standards in 2010. In 2011–12, credit supply conditions remained broadly unchanged (on average); therefore, the adverse impact on economic activity is likely to have moderated.

1/ Report on Financial Stability, National Bank of Hungary, May 2013.

2/ Klein, N. (2014) "Small and Medium Size Enterprises, Credit Supply Shocks, and Economic Recovery in Europe", IMF Working Paper (forthcoming).

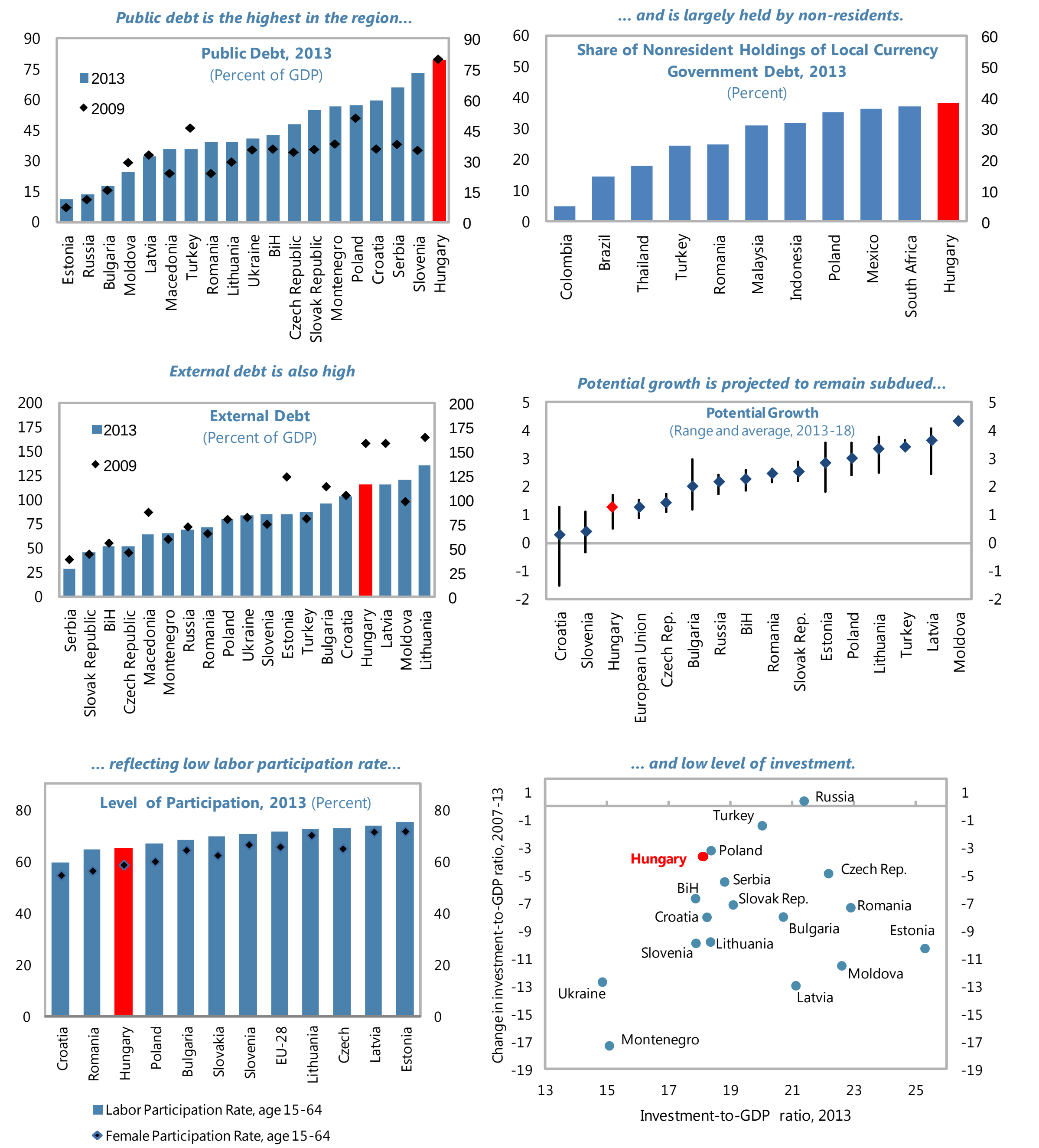
Box 6. The Role of SMEs (concluded)

Policy response

The MNB has responded to the tight credit conditions with both conventional and unconventional measures. In parallel to the gradual reduction of the policy interest rate to a record low level of 2.6 percent (as of March 2014), the MNB launched the Funding for Growth Scheme in June 2013, which, among others, aims to boost lending by providing loans to SMEs with preferential interest rate (Box 3).[3/] While the program has provided some relief and shifted credit growth to SMEs to a positive territory, it is likely to have a limited impact on growth, absent complementary measures to restore the banks' financial intermediation role, including through an improvement in the operational environment for banks. In this regard, steps to facilitate faster NPL resolution and to reduce the tax burden are imperative.

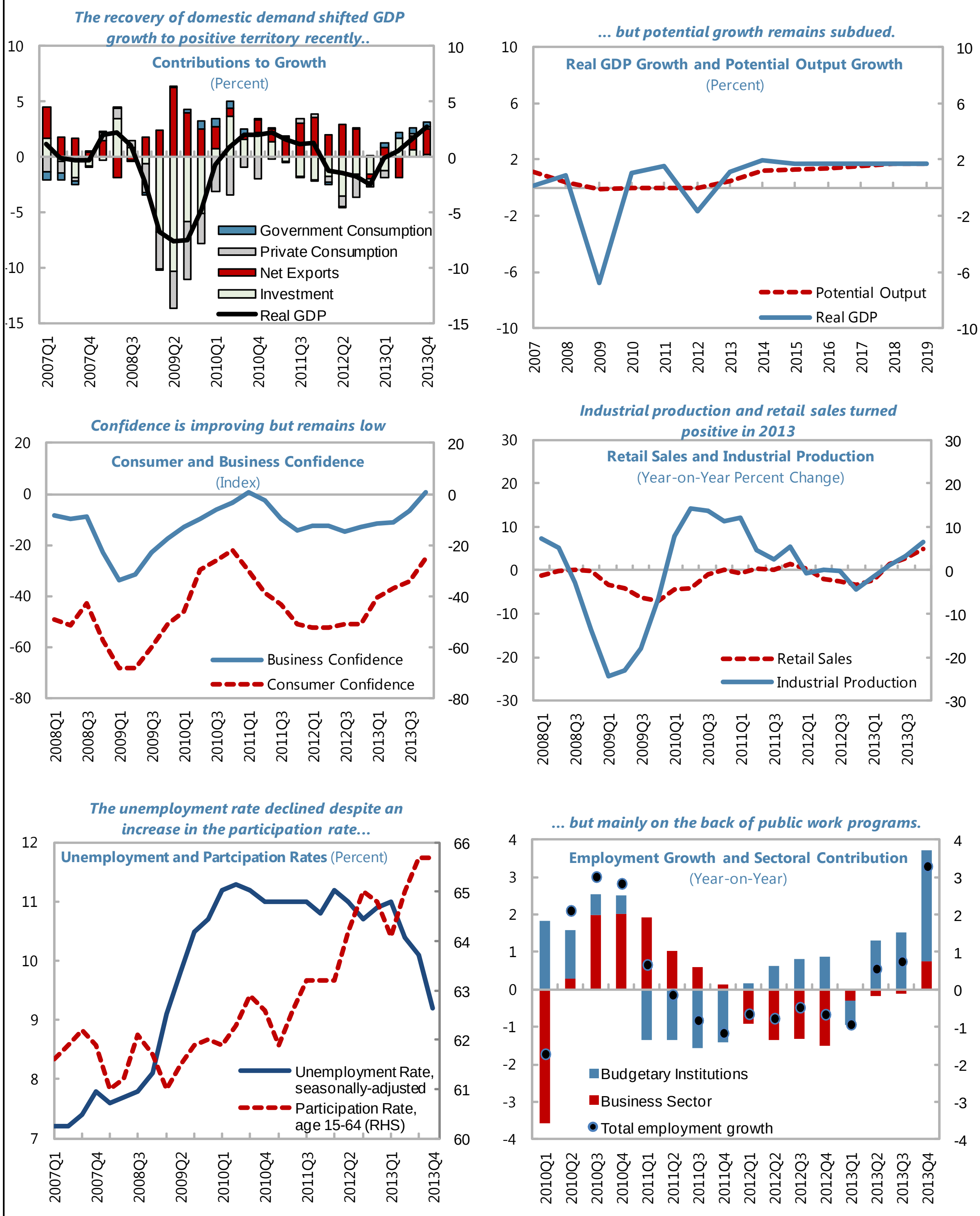
3/ Additional mechanisms are in place to support SMEs' access to financing. These include (i) state-owned guarantees provided by Garantiqa, (ii) guarantees and direct lending by the Hungarian Development Bank, and (iii) government's subsidized-short-term lending program ("Szechenyi Card").

Figure 1. Hungary and Peers



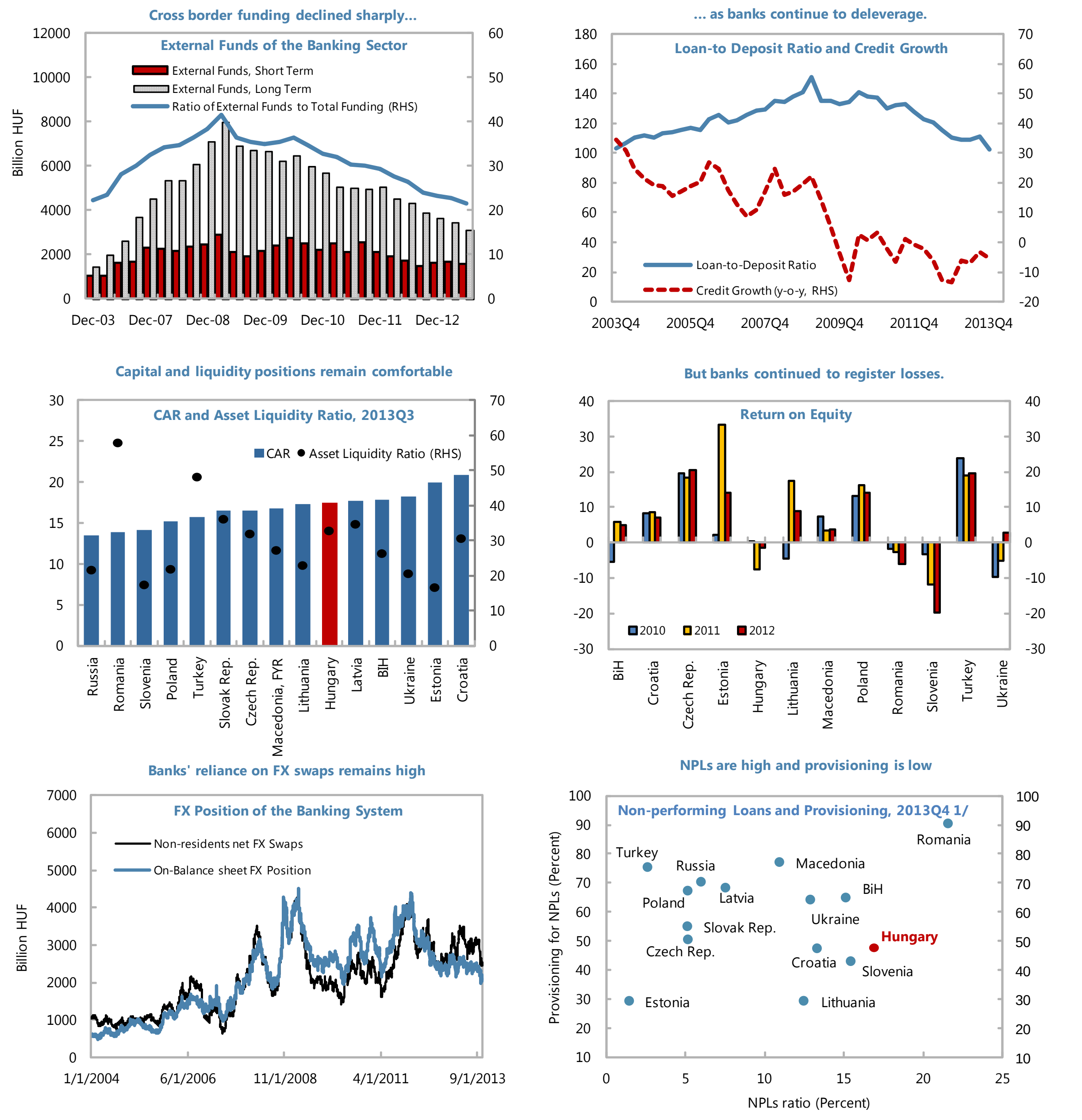
Sources: Eurostat, Hungarian Statistical Office, MNB, ILO, and IMF staff estimates.

Figure 2. Hungary: Real Sector



Sources: Eurostat, Hungarian Statistical Office; MNB and IMF staff estimates.

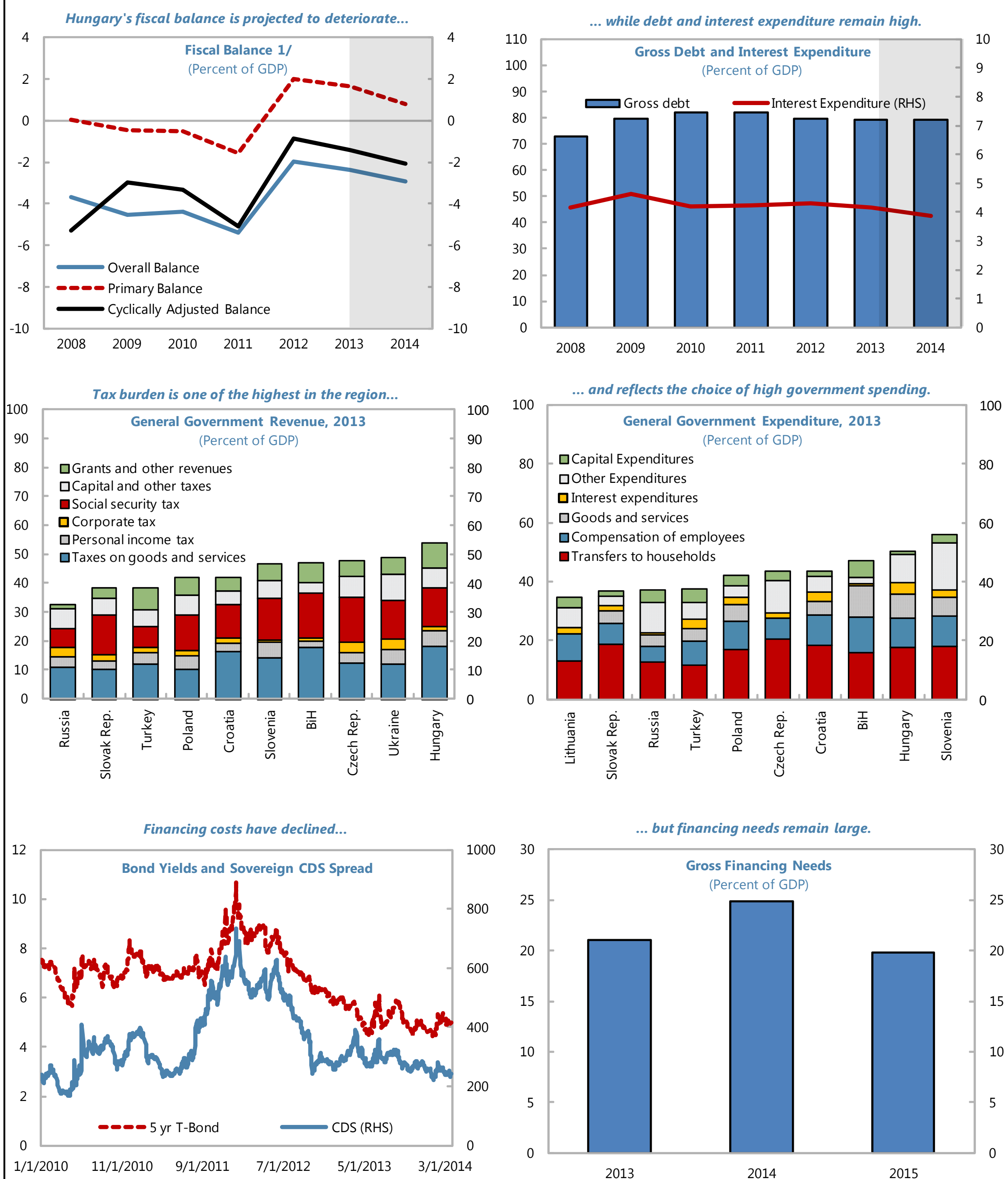
Figure 3. Hungary: Banking Sector



Sources: MNB, IFS, WEO and IMF staff estimates.

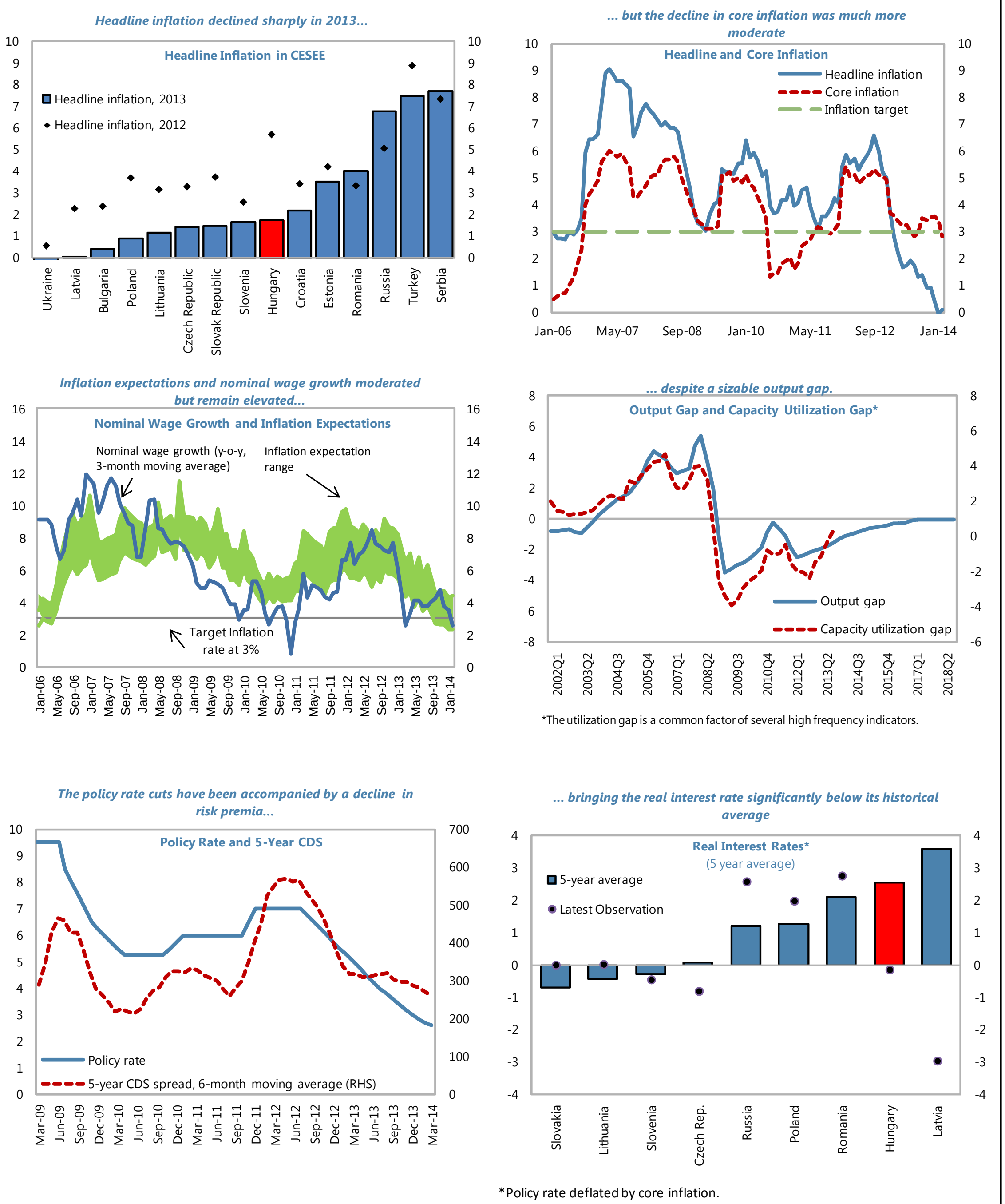
1/ For Czech Rep., Latvia, Lithuania, Romania, and Turkey data is for 2013Q3. For Poland, data is for 2013Q2.

Figure 4. Hungary: Fiscal Sector



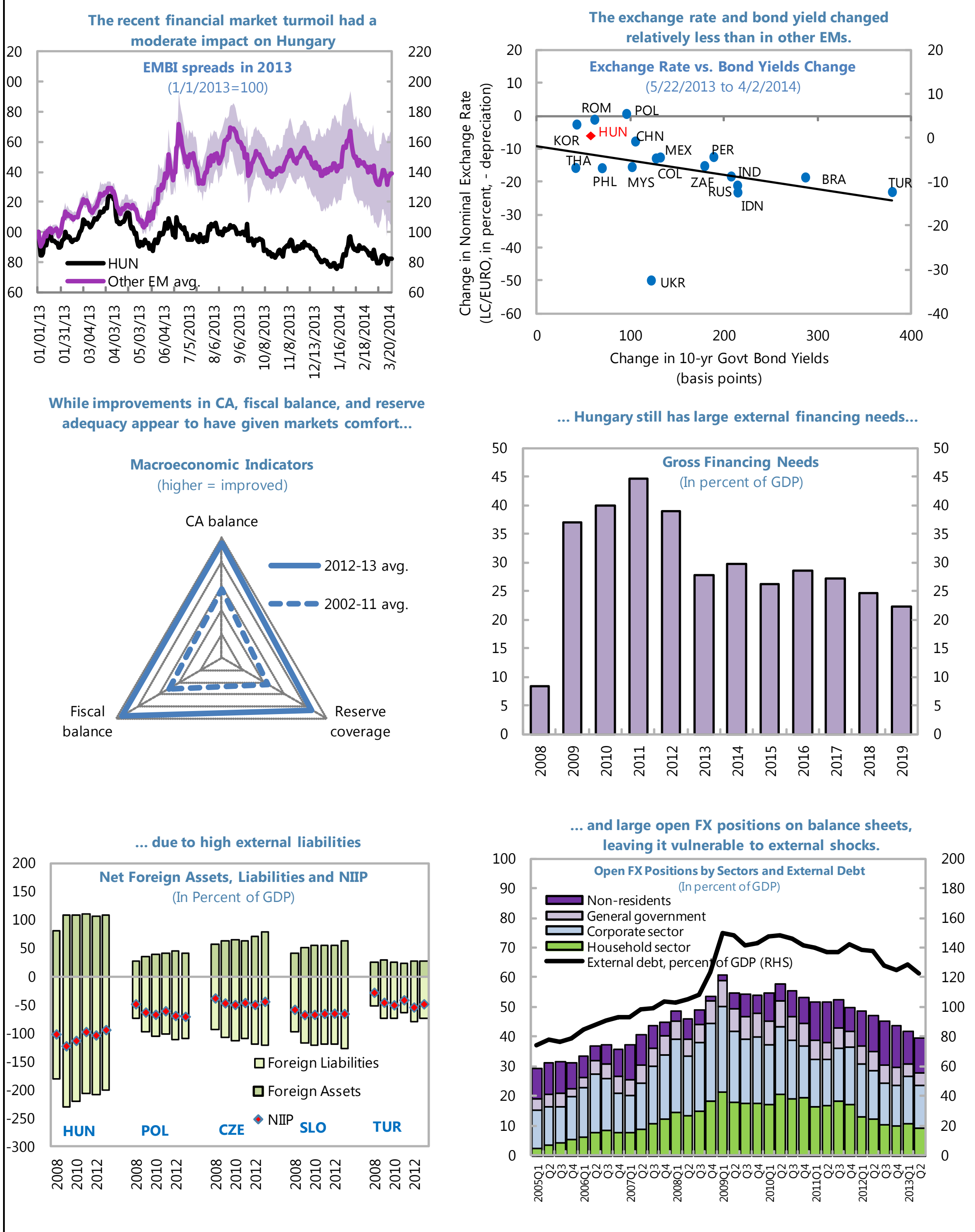
Sources: Hungarian Authorities, IMF staff estimates and projections .
1/ Excludes 9.6 percent of GDP in pension assets transfer to government in 2011.

Figure 5. Hungary: Inflation and Monetary Policy



Sources: MNB, Bloomberg, WEO and IMF staff estimates.

Figure 6. Hungary: External Vulnerabilities



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

Table 1. Hungary: Selected Economic Indicators, 2009–16

	2009	2010	2011	2012	2013	2014	2015	2016
					Prel.	Proj.	Proj.	Proj.
Real economy								
Real GDP (percentage change)	-6.8	1.1	1.6	-1.7	1.1	2.0	1.7	1.7
Total domestic demand (contribution to growth) 1/	-10.4	0.2	-0.5	-3.3	0.7	1.6	1.5	1.8
Private consumption 2/	-3.7	-2.4	0.2	-1.1	0.0	0.4	0.7	0.9
Government consumption	0.3	0.5	0.0	0.0	0.4	0.2	0.1	0.1
Gross fixed investment	-2.4	-1.8	-1.1	-0.7	1.0	1.0	0.8	0.8
Foreign balance (contribution to growth)	3.6	0.9	2.1	1.6	0.4	0.4	0.3	-0.1
Exports	-8.4	8.8	7.2	1.5	5.0	5.3	5.0	4.9
Imports	-12.0	7.9	5.1	-0.1	4.6	5.0	4.7	5.0
CPI inflation (average)	4.2	4.9	3.9	5.7	1.7	0.9	3.0	3.0
CPI inflation (end year)	5.6	4.7	4.1	5.0	0.4	2.9	3.0	3.0
Unemployment rate (average)	10.1	11.2	11.0	11.0	10.3	9.4	9.2	9.0
Gross domestic investment (percent of GDP) 3/	20.7	18.6	17.9	17.4	18.1	18.9	19.2	19.6
Gross national saving (percent of GDP, from BOP)	20.5	18.8	18.3	18.3	21.1	21.4	21.2	20.9
General government (GFSM 2001 basis) 4/								
Overall balance	-4.6	-4.4	4.2	-2.0	-2.3	-2.9	-2.9	-2.9
Primary balance	-0.5	-0.5	8.0	2.0	1.8	0.6	0.5	0.6
Primary structural balance, in percent of potential GDP	1.1	-1.1	-1.1	2.3	2.5	1.1	0.8	0.8
Gross debt	79.8	82.1	82.1	79.8	79.2	79.0	79.0	78.9
Money and credit (end-of-period)								
Broad money	4.4	3.0	5.9	-3.3	5.8	2.8	5.7	6.0
Lending to the private sector, flow-based	-2.3	-2.4	-6.9	-7.4	-3.2	0.0	3.0	3.5
Interest rates								
T-bill (90-day, End of Period)	6.1	5.7	7.2	5.6	4.1	...	...	...
Government bond yield (5-year, End of Period)	7.6	7.9	8.9	6.1	4.8	...	...	...
5-year sovereign CDS (Decemebr 31, 2013)	335	282	379	450	260	...	...	...
Balance of payments								
Goods and services trade balance	4.7	5.5	6.3	7.0	8.0	7.7	7.4	6.7
Current account	-0.2	0.2	0.4	0.9	3.0	2.5	2.0	1.2
Reserves (in billions of euros)	30.7	33.7	37.8	33.9	33.8	34.6	35.5	36.6
Gross external debt 5/	150.1	143.7	134.6	128.8	118.7	116.8	107.8	100.2
Gross official reserves (percent of short-term debt at remaining maturity)	83.6	74.9	88.9	96.0	98.3	117.2	116.0	126.2
Exchange rate								
Exchange regime			Floating					
Present rate (February 28, 2014)			Ft. 310 = €1; Ft. 256 = CHF1					
Nominal effective rate (2000=100, average)	102.6	102.7	104.2	109.0	110.3	...	...	...
Real effective rate, CPI basis (2000=100, average)	74.8	72.4	72.6	73.6	74.3	...	...	...
Quota at the Fund			SDR 1,038.4 million					
Memorandum Items								
Nominal GDP (billions of forints)	25,626	26,513	27,635	28,048	29,114	30,272	31,506	32,806

Sources: Hungarian authorities; IMF, International Financial Statistics; Bloomberg; and IMF staff estimates.
1/ Includes change in inventories.
2/ Actual final consumption of households.
3/ Excludes change in inventories.
4/ Consists of the central government budget, social security funds, extrabudgetary funds, and local governments. 2011 numbers reflect 9.6 percent of GDP transfer of pension assets to the state system.
5/ Excluding Special Purpose Entities. Including inter-company loans, and nonresident holdings of forint-denominated assets.

Table 2. Hungary: Medium-Term Scenario, 2009–19

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
							Projections				
Real GDP growth	-6.8	1.1	1.6	-1.7	1.1	2.0	1.7	1.7	1.7	1.7	1.7
Nominal GDP, forint billions	25,626	26,513	27,635	28,048	29,114	30,272	31,506	32,806	34,175	35,580	37,041
Inflation (CPI; year average basis)	4.2	4.9	3.9	5.7	1.7	0.9	3.0	3.0	3.0	3.0	3.0
Inflation (CPI; end-year basis)	5.6	4.7	4.1	5.0	0.4	2.9	3.0	3.0	3.0	3.0	3.0
Domestic demand	-10.7	0.2	-0.6	-3.5	0.8	1.8	1.6	1.9	2.0	2.1	2.1
Total consumption	-4.6	-2.5	0.3	-1.5	0.6	0.9	1.0	1.3	1.4	1.5	1.5
Gross fixed capital formation	-11.1	-8.5	-5.9	-3.7	5.9	5.5	4.0	4.0	4.0	4.0	4.0
Exports of GNFS	-10.2	11.3	8.4	1.7	5.3	5.6	5.1	5.0	5.0	5.0	5.0
Imports of GNFS	-14.8	10.9	6.4	-0.1	5.3	5.7	5.3	5.5	5.5	5.5	5.6
Lending to the private sector, flow-based (current prices, e.o.p.)	-2.3	-2.4	-6.9	-7.4	-3.2	0.0	3.0	3.5	4.0	4.0	4.0
Unemployment rate (percent of labor force, year average basis)	10.1	11.2	11.0	11.0	10.3	9.4	9.2	9.0	8.7	8.5	8.3
External current account balance	-0.2	0.2	0.4	0.9	3.0	2.5	2.0	1.2	0.4	-0.6	-1.7
Gross national saving	20.5	18.8	18.3	18.3	21.1	21.4	21.2	20.9	20.5	20.0	19.4
Gross domestic investment 1/	20.7	18.6	17.9	17.4	18.1	18.9	19.2	19.6	20.1	20.6	21.1
Capital account, net	1.2	1.8	2.3	2.7	3.5	3.6	3.1	2.8	2.5	2.3	2.0
Financial account, net	0.0	1.9	3.1	-4.6	-1.0	-3.2	-4.4	-1.7	-2.0	-0.8	0.5
Gross external debt 2/	150.1	143.7	134.6	128.8	118.7	116.8	107.8	100.2	94.2	89.9	87.1
General government (GFSM 2001)											
Revenue, total	46.9	45.6	54.3	46.9	47.6	47.9	48.2	46.3	46.7	47.7	48.5
Expenditure, primary	46.8	45.7	45.8	44.6	45.5	47.0	47.4	45.4	45.6	46.5	47.2
Primary balance 3/	-0.5	-0.5	8.0	2.0	1.8	0.6	0.5	0.6	0.9	1.0	1.1
General government overall balance	-4.6	-4.4	4.2	-2.0	-2.3	-2.9	-2.9	-2.9	-2.8	-2.8	-2.7
Interest expenditure	4.6	4.2	4.2	4.3	4.4	3.8	3.7	3.8	3.9	4.1	4.1
General government debt	79.8	82.1	82.1	79.8	79.2	79.0	79.0	78.9	78.7	78.6	78.4
Memorandum items											
Output gap	-3.3	-2.2	-0.7	-2.3	-1.7	-1.0	-0.6	-0.3	-0.1	0.0	0.0
Potential GDP growth	-0.1	0.0	0.0	0.0	0.5	1.2	1.3	1.4	1.5	1.7	1.7
Structural general government balance (in percent of potential GDP)	-2.8	-4.9	-4.9	-1.5	-1.6	-2.4	-2.7	-2.8	-2.8	-2.8	-2.7
Structural primary balance (in percent of potential GDP)	1.1	-1.1	-1.1	2.3	2.5	1.1	0.8	0.8	0.9	1.0	1.1
Gross official reserves (in percent of short-term debt at remaining maturity)	83.6	74.9	88.9	96.0	98.3	117.2	116.0	126.2	127.4	128.6	129.7

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.

Table 3. Hungary: Consolidated General Government, 2009-16 1/

(In percent of GDP, unless otherwise indicated)

	2009	2010	2011	2012	2013	2014	2015	2016
					Prel.		Proj.	
Revenue	46.9	45.6	54.3	46.9	47.6	47.9	48.2	46.3
Tax revenue	26.6	25.7	23.8	25.7	25.7	25.6	25.8	25.8
Taxes on goods and services	16.6	17.1	16.9	18.2	18.3	18.2	18.2	18.2
VAT	8.4	8.6	8.5	9.3	9.1	9.2	9.2	9.2
Excises and other 2/ 3/	8.2	8.4	8.4	8.9	9.2	9.0	9.0	9.0
Taxes on income, profits and capital gains	10.0	8.6	7.0	7.5	7.3	7.4	7.6	7.6
Personal income tax	7.4	6.5	4.9	5.4	5.2	5.2	5.3	5.3
Corporate taxes	2.3	1.2	1.3	1.3	1.4	1.5	1.6	1.6
Capital taxes 3/	0.1	0.5	0.5	0.6	0.5	0.5	0.5	0.4
Other 2/	0.3	0.3	0.2	0.3	0.3	0.3	0.3	0.3
Social contributions	13.3	12.2	13.3	13.3	13.4	13.4	13.5	13.5
Current non-tax revenue	4.3	4.0	3.8	3.8	3.9	4.0	3.6	3.6
o.w. interest revenue	0.5	0.3	0.4	0.3	0.2	0.2	0.2	0.2
Current grants	1.3	1.5	1.3	1.6	1.8	1.9	2.0	1.4
Capital revenues and grants 4/	1.4	2.2	12.0	2.5	2.8	3.1	3.4	2.0
Expenditure	51.4	49.9	50.0	48.9	49.8	50.8	51.1	49.2
Compensation of employees 5/	11.5	11.0	10.3	10.0	10.3	10.1	10.1	10.1
Goods and services	7.8	7.9	7.5	7.7	7.9	8.5	8.6	8.0
Interest	4.6	4.2	4.2	4.3	4.2	3.8	3.7	3.8
Subsidies	1.0	1.1	1.3	1.3	1.5	1.3	1.3	1.3
Current transfers to households	19.4	18.6	18.2	17.8	17.3	17.2	17.1	17.1
Social security	14.8	14.4	14.5	13.4	13.6	13.2	13.1	13.1
o.w. unemployment benefits	0.6	0.6	0.7	0.3	0.2	0.2	0.1	0.1
Other	4.6	4.1	3.7	4.3	3.7	4.0	4.0	3.9
Other current transfers 6/	2.6	2.4	2.6	3.1	3.1	3.3	3.3	3.3
Capital expenditures	3.1	3.4	3.0	3.0	3.9	4.9	5.4	4.0
Capital transfers 7/	1.3	1.3	2.8	1.8	1.4	1.7	1.7	1.7
Other	0.0	0.1	0.1	0.1	0.2	0.0	0.0	0.0
General government balance	-4.6	-4.4	4.2	-2.0	-2.2	-2.9	-2.9	-2.9
Primary balance	-0.5	-0.5	8.0	2.0	1.8	0.7	0.6	0.7
Memorandum items:								
Convergence program overall balance	..	..	..	..	-2.2	-2.9	-2.8	-2.5
Gap to convergence program	..	..	..	..	0.0	0.0	0.1	0.4
Transfer of pension assets to the state system	0.1	0.2	9.7	0.0	0.0	0.0	0.0	0.0
General government balance excl. pension assets	-4.7	-4.6	-5.5	-2.0	-2.2	-2.9	-2.9	-2.9
Cyclically-adj. balance (% of potential GDP)	-2.9	-3.3	4.5	-0.9	-1.2	-2.0	-2.6	-2.7
Annual change	2.6	-0.4	7.8	-5.4	-0.4	-0.8	-0.6	-0.1
One-off items (net)	0.0	1.6	9.4	0.7	0.2	0.4	0.0	0.0
Structural balance	-2.9	-5.0	-4.9	-1.6	-1.5	-2.4	-2.6	-2.8
Annual change	2.1	-2.1	0.1	3.3	0.1	-0.9	-0.2	-0.1
Structural balance (% of potential GDP)	-2.8	-4.9	-4.9	-1.5	-1.5	-2.4	-2.6	-2.7
Annual change	2.4	-2.1	0.0	3.3	0.1	-0.9	-0.2	-0.1
Structural primary balance	1.2	-1.1	-1.1	2.4	2.5	1.1	0.8	0.8
Annual change	2.5	-2.3	0.0	3.5	0.1	-1.3	-0.3	0.0
Structural primary balance (% of potential GDP)	1.1	-1.1	-1.1	2.3	2.4	1.1	0.8	0.8
Annual change	2.5	-2.2	0.0	3.4	0.1	-1.3	-0.3	0.0
Cyclically-adj. balance	-3.0	-3.3	4.5	-0.9	-1.3	-2.0	-2.6	-2.8
Annual change	2.3	-0.4	7.9	-5.4	-0.4	-0.8	-0.6	-0.1
Output gap	-3.3	-2.2	-0.7	-2.3	-1.7	-1.0	-0.6	-0.3
Gross public debt	79.8	82.1	82.1	79.8	79.2	78.9	78.9	78.8
In billions of HUF								
Revenue	12,018	12,079	14,996	13,160	13,860	14,506	15,191	15,187
Of which tax revenues	6,821	6,804	6,586	7,217	7,480	7,740	8,140	8,458
Expenditure	13,184	13,243	13,825	13,718	14,493	15,384	16,110	16,132
Transfer of pension assets	26	65	2,688	0	0	0	0	0
Primary balance	-120	-137	2,221	557	528	203	176	223
Overall balance	-1,166	-1,164	1,170	-558	-634	-877	-918	-944
GDP	25,626	26,513	27,635	28,048	29,114	30,272	31,506	32,806

Sources: Hungarian authorities; and staff estimates.

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

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

3/ Includes the levy on financial institutions.

4/ In 2011 and 2012 includes 9.6 and 0.2 percent of GDP, respectively, from the transfer of pension assets to the state system.

5/ Includes social security contributions.

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

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, 2010-16

(In percent of GDP)

	2010	2011	2012	2013	2014	2015	2016
				Prel.	Projections		
Gross financing needs	**16.7**	**19.6**	**16.3**	**20.9**	**24.9**	**19.8**	**24.8**
Central government cash deficit	3.3	1.7	1.9	2.6	3.1	2.9	2.9
Repayments	13.4	15.7	14.5	18.3	21.5	16.9	21.9
Domestic	12.0	11.2	9.0	12.8	15.8	15.0	16.4
Loans	0.0	0.3	0.1	0.1	0.4	0.3	0.1
LT bonds	5.8	5.4	3.4	6.2	9.1	8.4	10.0
T bills	6.2	5.5	5.5	6.5	6.3	6.3	6.3
External	1.3	4.5	5.4	5.5	5.7	1.9	5.5
Bonds	1.2	2.0	1.5	1.5	2.9	1.5	2.8
Loans	0.1	2.5	3.9	4.0	2.9	0.4	2.7
Of which : IMF	0.0	0.0	3.9	4.0	0.0	0.0	0.0
Gross financing sources	**16.7**	**19.6**	**16.3**	**20.9**	**24.9**	**19.8**	**24.8**
Domestic	15.1	13.6	15.3	14.7	18.4	16.9	18.3
Loans	0.3	0.0	0.0	0.0	0.0	0.0	0.0
LT bonds	8.8	7.6	8.6	8.1	11.8	10.3	11.7
T bills	6.1	6.0	6.7	6.6	6.6	6.6	6.6
External	1.7	4.6	1.0	5.1	5.9	2.9	6.5
Bonds	1.5	3.8	0.3	5.1	4.9	1.9	5.5
Loans	0.2	0.8	0.7	0.0	1.0	1.0	1.0
Deposit drawdown	-0.1	1.4	0.0	1.2	0.0	0.0	0.0
Memo items:							
Central Government deposits	4.1	5.0	4.9	4.4	...	...	...
Gross financing needs excl. short term debt	10.5	14.1	10.8	14.3	18.6	13.5	18.5
Gross financing requirements, in US$ bn.	16.1	19.4	15.8	20.8	23.9	19.7	25.6
o/w short term amortization	6.0	5.4	5.3	6.5	6.1	6.3	6.5

Sources: Hungarian authorities, and staff estimates and projections.

Table 5a. Hungary: General Government Operations (GFSM presentation), 2009-17 1/

In percent of GDP

	2009	2010	2011	2012	2013	Projection 2014	2015	2016	2017
Revenue	46.9	45.6	54.3	46.9	47.6	47.9	48.2	46.3	46.7
Taxes	26.6	25.7	23.8	25.7	25.7	25.6	25.8	25.8	25.9
Taxes on goods and services	16.6	17.1	16.9	18.2	18.3	18.2	18.2	18.2	18.3
VAT	8.4	8.6	8.5	9.3	9.1	9.2	9.2	9.2	9.2
Excises and other	8.2	8.4	8.4	8.9	9.2	9.0	9.0	9.0	9.1
Taxes on income, profits and capital gains	9.9	8.1	6.4	7.0	6.9	6.9	7.1	7.2	7.2
Personal income tax	7.4	6.5	4.9	5.4	5.2	5.2	5.3	5.3	5.3
Corporate income tax	2.3	1.2	1.3	1.3	1.4	1.5	1.6	1.6	1.6
Other	0.3	0.3	0.2	0.3	0.3	0.3	0.3	0.3	0.3
Capital taxes	0.1	0.5	0.5	0.6	0.5	0.5	0.5	0.4	0.4
Social contributions	13.3	12.2	13.3	13.3	13.4	13.4	13.5	13.5	13.6
Grants and other revenues	7.0	7.6	17.1	7.9	8.5	9.0	8.9	7.0	7.3
Current non-tax revenue	4.3	4.0	3.8	3.8	3.9	4.0	3.6	3.6	3.6
o.w. interest revenue	0.5	0.3	0.4	0.3	0.2	0.2	0.2	0.2	0.2
o.w. dividends	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Current transfers 2/	1.3	1.5	1.3	1.6	1.8	1.9	2.0	1.4	1.5
Capital transfers 2/	1.4	2.2	12.0	2.5	2.8	3.1	3.4	2.0	2.2
o.w. transfer of pension assets	0.1	0.2	9.7	0.0	0.0	0.0	0.0	0.0	0.0
Expenditure	51.4	49.9	50.0	48.9	49.8	50.8	51.1	49.2	49.5
Expense	51.7	49.9	50.3	48.7	49.5	49.2	49.0	48.4	48.5
Compensation of employees	11.5	11.0	10.3	10.1	10.3	10.1	10.1	10.1	10.0
Goods and services	7.8	7.9	7.5	7.5	7.9	8.5	8.6	8.0	8.0
Consumption of fixed capital	3.4	3.4	3.3	3.3	3.3	3.3	3.3	3.3	3.3
Interest	4.6	4.2	4.2	4.4	4.4	3.8	3.7	3.8	3.9
Subsidies	1.0	1.1	1.3	1.4	1.5	1.3	1.3	1.3	1.3
Social benefits	19.4	18.6	18.2	17.8	17.5	17.2	17.1	17.1	17.0
o.w. social security	14.8	14.4	14.5	13.4	13.6	13.2	13.1	13.1	13.1
Other expense	4.0	3.8	5.5	4.2	4.7	5.0	4.9	5.0	5.0
Net acquisition of nonfinancial assets	-0.3	0.0	-0.3	0.0	0.4	1.6	2.1	0.8	1.0
Gross fixed capital formation 3/	3.1	3.4	3.0	3.3	3.7	4.9	5.4	4.0	4.2
Consumption of fixed capital	3.4	3.4	3.3	3.3	3.3	3.3	3.3	3.3	3.3
Gross operating balance 4/	-1.4	-1.0	7.3	1.2	1.3	2.0	2.4	1.2	1.5
Net operating balance	-4.8	-4.4	4.0	-2.1	-1.9	-1.3	-0.8	-2.1	-1.8
Net lending (+) / borrowing (-)	-4.6	-4.4	4.2	-2.2	-2.4	-2.9	-2.9	-2.9	-2.8
Net acquisition of financial assets	-0.5	-1.7	4.1	-1.2	-1.0	0.0	0.0	0.0	0.0
Currency and deposits	-2.7	-0.8	0.5	0.3	-1.6	0.0	0.0	0.0	0.0
Securities other than shares	0.0	0.0	0.2	0.1	0.2	0.0	0.0	0.0	0.0
Loans	2.1	-0.7	-0.6	-0.4	0.1	-0.4	-0.4	-0.4	-0.3
Shares and other equity	0.1	0.0	4.4	-0.7	-0.4	0.0	0.0	0.0	0.0
Insurance technical reserves	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financial derivatives	-0.5	-0.3	-0.3	-0.5	-0.4	0.0	0.0	0.0	0.0
Other accounts receivable	0.5	0.1	-0.1	0.0	1.1	0.4	0.4	0.4	0.3
Monetary gold and SDRs	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net incurrence of liabilities	4.0	2.9	-0.1	1.0	1.4	2.2	3.1	3.1	2.9
Currency and deposits	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Securities other than shares	-3.1	1.8	-0.9	4.8	5.4	4.6	2.6	4.7	3.1
Loans	7.3	1.5	-0.7	-3.4	-3.8	-3.1	0.3	-1.8	-0.3
Shares and other equity	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Insurance technical reserves	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financial derivatives	-1.1	-0.1	-0.1	-0.1	-0.1	0.0	0.0	0.0	0.0
Other accounts payable	0.9	-0.3	1.6	-0.4	0.0	0.7	0.2	0.2	0.2
Statistical discrepancy	-0.1	0.2	0.0	0.0	0.1	-0.7	0.2	0.2	0.2
Memo:									
Nominal GDP, HUF bn.	25,626	26,513	27,635	28,048	29,114	30,272	31,506	32,806	34,175

Sources: Hungarian authorities, and IMF staff projections

1/ Subcategories within tax revenues follow the ESA95 presentation.

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

3/ Includes net acquisition of nonproduced nonfinancial assets.

4/ Excludes fixed capital consumption.

Table 5b. Hungary: General Government Stock Positions, 2009-15 1/

In percent of GDP

	2009	2010	2011	2012	2013	Projections 2014	2015
Net Financial Worth	-59.8	-61.8	-53.3	-61.2	-63.2	-60.2	-60.5
Financial Assets	27.0	26.2	33.8	28.9	26.7	26.9	25.9
Currency and deposits	6.8	6.2	6.9	6.9	5.2	6.1	5.9
Securities other than shares	0.0	0.0	0.2	0.3	0.6	0.3	0.3
Loans	2.5	1.8	1.2	0.7	0.7	0.7	0.3
Shares and other equity	11.9	11.8	18.2	14.6	13.7	13.5	12.9
Insurance technical reserves	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financial derivatives	0.4	1.1	2.2	1.4	0.5	1.3	1.3
Other accounts receivable	5.4	5.3	5.1	5.0	6.0	5.0	5.2
Monetary gold and SDRs	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Liabilities	86.8	88.0	87.1	90.1	89.9	87.1	86.4
Currency and deposits	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Securities other than shares	59.1	59.1	56.0	64.7	68.7	67.9	68.0
Loans	20.8	22.7	23.5	18.4	14.1	11.2	10.6
Shares and other equity	0.0	0.0	0.0	0.0	0.0	0.4	0.4
Insurance technical reserves	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financial derivatives	0.8	0.6	0.5	0.4	0.8	0.4	0.4
Other accounts payable	6.0	5.5	6.9	6.5	6.2	7.0	6.9
Gross debt at face value	85.8	87.7	89.1	86.1	86.3	85.4	85.9
Maastricht Debt	79.8	82.1	86.5	79.8	79.2	78.9	78.9
Memo Items:							
Foreign currency debt	37.0	38.6	42.6	34.4	33.8	33.4	33.1
Other economic flows	-1.7	0.5	1.8	-6.6	-1.8	-1.8	0.4

Sources: Hungarian authorities, and IMF staff projections

1/ GFSM 2001 presentation.

Table 6. Hungary: Balance Sheet of the Central Bank, 2009-2015

(In billions of forints)

	2009	2010	2011	2012	2013	2014	2015
						Proj.	Proj.
Net foreign assets	7,261	7,449	9,709	9,025	9,360	10,015	10,384
Foreign Assets	8,484	9,598	11,969	10,092	10,262	10,892	11,224
Foreign Liabilities	1,223	2,149	2,260	1,068	902	878	840
Net domestic assets	-4,460	-4,244	-5,836	-5,613	-5,564	-6,029	-6,199
Net claims on government	-709	-827	-1,215	-1,236	-614	-614	-614
Assets	279	249	169	142	138	138	138
Liabilities (Govt Deposits at MNB)	988	1,077	1,383	1,378	752	752	752
HUF	248	273	597	443	242	...	...
FX	741	804	786	935	510	...	...
Net claims on banks	-3,147	-2,565	-2,923	-3,404	-3,779	-4,098	-4,436
Assets	0	35	119	184	821	1,810	1,810
Liabilities	3,147	2,600	3,041	3,588	4,600	5,908	6,246
Two Week Deposit Facility	244	120	211	337	319	160	180
Securities Issued by MNB	2,903	2,480	2,830	3,251	4,281	5,748	6,066
Net claims on the economy	-197	-355	-163	-272	-598	-598	-598
Other items, net	-406	-496	-1,536	-701	-574	-720	-552
Base money (M0)	2,801	3,206	3,873	3,412	3,796	3,986	4,185
Currency in Circulation	2,268	2,464	2,766	2,740	3,251	3,413	3,584
Banks' Reserves	533	741	1,106	673	545	572	601
Current Account Balances	339	448	471	477	435	457	480
Overnight Deposits	194	293	635	195	110	116	121
Memorandum items :							
International Reserves (billions of euros)	30.7	33.7	37.8	33.9	33.8	34.6	35.5
Base Money (yoy percent change)	-23.2	14.4	20.8	-11.9	11.2	5.0	5.0
NFA (contribution to change)	34.9	6.7	70.5	-17.7	9.8	17.2	9.3
NDA (contribution to change)	-58.1	7.7	-49.7	5.8	1.4	-12.2	-4.3
Government Deposits at Central Bank (percent of GDP)	3.9	4.1	5.0	4.9	2.6	2.5	2.4
HUF	1.0	1.0	2.2	1.6	0.8	...	...
FX	2.9	3.0	2.8	3.3	1.8	...	...
Central Bank Bills Outstanding (percent of GDP)	11.3	9.4	10.2	11.8	15.5	20.5	21.6
Portion of CB Bills Owned by Non-Residents (percent	4.0	9.3	13.2	2.2	9.1	...	...
Reserve Requirement Ratio (percent of select liabilities)	2.0		2% to 5%				

Sources: Magyar Nemzeti Bank and IMF staff projections.

Table 7. Hungary: Monetary Survey, 2009-15

(In billions of forints, unless otherwise indicated)

	2009	2010	2011	2012	2013	2014 Proj.	2015 Proj.
Net foreign assets	568	1,242	4,167	5,062	6,175	7,099	7,565
Central Bank	7,261	7,449	9,709	9,025	9,360	10,015	10,384
Commercial Banks	-6,693	-6,207	-5,541	-3,963	-3,185	-2,915	-2,819
Net domestic assets	15,397	15,199	13,250	11,774	11,638	11,205	11,774
Domestic credit	20,303	21,135	20,806	18,611	18,259	18,541	19,110
Net claims on government	3,037	3,461	3,041	3,357	4,164	4,446	4,721
From Central Bank	-709	-827	-1,215	-1,236	-614	-614	-614
From Commercial Banks	3,747	4,288	4,256	4,593	4,778	5,060	5,335
Gross Credit to the economy	17,266	17,674	17,765	15,254	14,095	14,095	14,389
From Central Bank	-197	-355	-163	-272	-598	-598	-598
From Comercial Banks	17,462	18,029	17,927	15,525	14,693	14,693	14,987
Other items, net	-4,906	-5,936	-7,556	-6,837	-6,621	-7,337	-7,337
Broad money (M3)	15,964	16,441	17,418	16,837	17,813	18,304	19,339
M2	14,354	14,351	15,369	15,179	15,847	16,502	17,434
M1	6,122	6,635	7,343	7,297	8,899	7,933	8,381
Currency in circulation	2,039	2,218	2,551	2,554	3,001	2,776	2,933
Overnight Deposits	4,082	4,417	4,791	4,743	5,898	5,157	5,448
Deposits with Maturities up to 2 years	8,233	7,716	8,026	7,882	6,948	8,569	9,053
Repos	35	34	23	22	30	24	25
Money Market Fund Shares/Units	1,115	1,335	1,320	1,179	1,399	1,282	1,354
Debt Securities	460	721	706	457	538	496	524
Memorandum items :							
	(percentage change by contribution, y-o-y)						
Broad Money	4.4	3.0	5.9	-3.3	5.8	2.8	5.7
NFA	13.4	4.2	17.8	5.1	6.6	5.2	2.5
NDA	-9.0	-1.2	-11.9	-8.5	-0.8	-2.4	3.1
	(percentage change, y-o-y)						
Credit to Private Sector 1/ 2/	-2.3	-2.4	-6.9	-7.4	-3.3	0.0	2.0
HUF	0.4	5.2	3.5	5.7	5.7	...	...
FX	-4.0	-7.1	-13.0	-15.4	-10.4	...	...
Bank Deposits (% yoy)	2.1	0.0	6.2	0.1	2.5	12.3	18.1
Bank Holdings of Government Paper	15.3	15.5	14.0	14.6	14.2	14.6	14.9

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

Table 8. Hungary: Financial Soundness Indicators for the Banking Sector, 2009-13

(In percent, unless otherwise indicated, end of period)

	2009	2010	2011	2012	2013
Capital					
Regulatory capital to risk-weighted assets	13.9	13.9	13.8	16.3	17.4
Regulatory Tier1 capital to risk-weighted assets	11.7	11.4	11.4	13.4	14.7
Asset Quality					
NPLs net of provisions to capital	33.0	49.3	59.0	52.9	46.3
NPLs to gross loans	6.7	9.8	13.4	15.8	16.9
Distribution of Loans (Percent of Total)					
Firms	35.8	34.6	34.6	37.1	37.7
Households and Non-Profits	37.7	40.4	39.8	39.7	39.7
Non-Residents	11.8	10.3	9.8	8.4	7.2
Other	14.7	14.8	15.8	14.8	15.4
Profitability					
ROA	0.6	0.0	-0.7	-0.1	0.3
ROE	8.4	0.4	-7.7	-1.4	2.7
Net interest income to gross income	66.8	71.6	69.1	73.7	68.1
Noninterest expenses to gross income	48.8	48.5	47.6	51.8	47.4
Liquidity					
Liquid assets to total assets	23.5	22.3	24.7	30.8	32.8
Liquid assets to short term liabilities	45.3	42.8	45.6	55.2	57.5
Sensitivity to Market risk					
Net open FX position to Regulatory capital	17.8	15.9	23.9	20.5	15.5

Source: MNB.

Table 9. Hungary: Balance of Payments, 2009—19

(in millions of euros, unless otherwise indicated)

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
					Est.			Proj.			
Current Account	**-202**	**208**	**419**	**826**	**2,941**	**2,413**	**1,989**	**1,276**	**412**	**-639**	**-1,899**
Goods and service, net	4,328	5,320	6,284	6,832	7,811	7,399	7,336	6,949	6,431	5,736	4,846
Exports	70,667	81,511	90,281	91,585	94,039	97,990	102,233	107,315	113,233	119,677	126,359
Imports	-66,340	-76,190	-83,997	-84,753	-86,227	-90,591	-94,898	-100,366	-106,802	-113,941	-121,513
Income, net	-4,935	-5,489	-6,412	-6,408	-5,933	-5,786	-6,046	-6,373	-6,719	-7,075	-7,445
Current transfers, net	404	377	547	403	1,062	800	700	700	700	700	700
Capital Account	**1,071**	**1,737**	**2,285**	**2,575**	**3,392**	**3,446**	**3,118**	**2,918**	**2,718**	**2,518**	**2,318**
Net capital transfers	1,603	2,193	2,383	2,572	3,442	3,446	3,118	2,918	2,718	2,518	2,318
Financial Account	**-41**	**1,801**	**3,087**	**-4,437**	**-1,003**	**-3,106**	**-4,334**	**-1,741**	**-2,159**	**-858**	**572**
Direct investment, net	128	787	990	2,051	615	14	98	202	312	426	544
Portfolio investment, net 1/	-2,951	487	5,791	2,138	3,716	979	-708	1,740	-253	-501	-894
Other investment	2,781	527	-3,695	-8,626	-5,334	-4,071	-3,724	-3,683	-2,218	-782	922
Net errors and omissions	**-325**	**-728**	**-1,917**	**1,522**	**934**	**96**	**100**	**103**	**107**	**111**	**115**
Overall Balance	**502**	**3,018**	**3,874**	**487**	**6,264**	**2,850**	**873**	**2,557**	**1,079**	**1,133**	**1,106**
Official Financing (European Union)	**3,500**	**0**	**-2,000**	**0**	**0**	**-2,000**	**0**	**-1,500**	**0**	**0**	**0**
Net International Reserves (increase -)	**-4,002**	**-3,018**	**-1,874**	**-487**	**-6,264**	**-850**	**-873**	**-1,057**	**-1,079**	**-1,133**	**-1,106**
Gross Reserves	-8,986	-3,018	-1,874	3,350	-1,210	-850	-873	-1,057	-1,079	-1,133	-1,106
Reserve Liabilities	4,984	0	0	-3,837	-5,054	0	0	0	0	0	0
IMF	4,984	0	0	-3,837	-5,054	0	0	0	0	0	0
Memorandum Items:											
Current account (in percent of GDP)	-0.2	0.2	0.4	0.9	3.0	2.5	2.0	1.2	0.4	-0.6	-1.7
Exports, g&s (in percent of GDP)	77.4	84.7	91.2	94.5	95.9	101.8	102.6	103.9	105.7	107.8	110.0
Volume (percent change)	-10.2	11.3	8.4	1.7	5.3	5.6	5.1	5.0	5.0	5.0	5.0
Imports, g&s (in percent of GDP)	72.6	79.1	84.9	87.5	87.9	94.1	95.3	97.2	99.7	102.7	105.8
Volume (percent change)	-14.8	10.9	6.4	-0.1	5.3	5.7	5.3	5.5	5.5	5.5	5.6
Gross external debt (in percent of GDP) 2/	150.1	143.7	134.6	128.8	118.7	116.8	107.8	100.2	94.2	89.9	87.1
Gross official reserves	30,676	33,675	37,774	33,881	33,782	34,592	35,421	36,430	37,455	38,531	39,573
In percent of short-term debt at remaining maturity 3/	83.6	74.9	88.9	96.0	98.3	117.1	115.7	125.7	126.7	127.8	128.7
In months of next year's imports of good and services	4.8	4.8	5.3	4.7	4.5	4.4	4.2	4.1	3.9	3.8	3.7

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

Table 10. Hungary: External Financing Needs, 2010—19

(in millions of euros, unless otherwise indicated)

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
				Est.			Proj.			
Total financing requirements	**38,379**	**44,370**	**37,814**	**27,504**	**28,871**	**24,331**	**26,322**	**25,735**	**25,860**	**25,156**
Current account - Capital account	-1,946	-2,704	-3,401	-6,332	-5,859	-5,108	-4,194	-3,130	-1,880	-419
Current account	-208	-419	-826	-2,941	2,413	1,989	1,276	412	-639	-1,899
Capital account	1,737	2,285	2,575	3,392	3,446	3,118	2,918	2,718	2,518	2,318
Amortizations	39,596	45,157	42,737	34,771	34,826	29,538	30,620	28,972	27,851	25,690
FDI (incl. intra-company)	6,503	6,228	6,084	5,974	6,338	6,338	6,338	6,338	6,338	6,338
General government	4,686	7,682	10,707	11,116	9,494	4,139	5,658	5,121	5,059	3,967
Eurobonds	1,243	1,989	1,488	1,456	2,737	1,463	1,846	1,896	3,476	983
Loans and others	439	2,549	3,837	5,054	2,724	192	2,286	623	343	62
o/w: to IMF and EU	0	2,000	3,837	5,054	2,000	0	1,500	0	0	0
Non-resident holding of government securities	3,004	3,144	5,145	4,607	4,033	2,484	1,526	2,602	1,240	2,922
Central bank	2,241	5,035	4,877	1,934	1,998	2,037	1,998	1,998	1,998	1,998
Banks	20,062	18,465	14,431	10,012	9,886	10,046	9,637	8,915	9,333	8,750
Other investment (mainly corporate)	6,105	7,747	6,638	5,735	7,110	6,978	6,988	6,600	5,122	4,637
Net errors and omissions	728	1,917	-1,522	-934	-96	-100	-103	-107	-111	-115
Total financing sources	**38,379**	**44,370**	**37,813**	**27,504**	**28,871**	**24,331**	**26,322**	**25,735**	**25,860**	**25,156**
FDI net inflows (incl. intra-company)	7,290	7,219	8,135	6,590	6,324	6,436	6,540	6,650	6,764	6,882
Disbursements (debt)	30,554	29,807	22,789	20,340	20,692	16,226	18,553	18,113	18,411	17,749
General government 2/	5,293	10,424	9,336	8,889	8,543	4,183	6,488	5,782	5,916	4,838
Eurobonds	983	4,696	0	3,911	5,444	1,628	4,114	2,502	3,802	1,028
Loans and others	182	1,097	700	400	1,000	1,000	1,000	1,000	1,000	1,000
Non-resident holding of government securities	2,585	4,631	8,636	4,579	2,099	1,555	1,374	2,281	1,114	2,810
Central bank	4,258	4,552	1,294	1,934	1,921	1,921	1,921	1,921	1,921	1,960
Banks	18,158	12,612	8,111	6,235	8,261	8,112	8,267	8,339	7,877	8,283
Other investment (mainly corporate)	7,103	6,771	5,342	5,216	3,888	3,931	3,798	3,992	4,618	4,628
Other portfolio flows net	3,552	9,219	3,538	1,784	2,704	2,542	2,287	2,050	1,818	1,631
Drawdown in gross reserves	-3,018	-1,874	3,350	-1,210	-850	-873	-1,057	-1,079	-1,133	-1,106
Memo items										
Gross international reserves (level in Euro million)	33,675	37,774	33,881	33,782	34,592	35,421	36,430	37,455	38,531	39,573
In percent of short-term debt at remaining maturity	75	89	96	98	117	116	126	127	128	129
Government rollover rates (in percent)	113	136	87	80	90	101	115	113	117	122
Banks' rollover rates (in percent)	91	68	56	62	84	81	86	94	84	95
Corporate rollover rates (in percent)	116	87	80	91	55	56	54	60	90	100

Sources: Hungarian authorities; IMF staff estimates and projections.

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

2/ Excludes EU and IMF loans

Appendix I. Hungary: Debt Sustainability Analysis

Hungary's high public and external debt and financing needs remain important sources of vulnerability. Under the baseline scenario, public debt is projected to remain at around 80 percent of GDP while gross financing needs are forecast to hover above 20 percent of GDP. This exposes Hungary's public debt to considerable risks, particularly from lower GDP growth. External debt is expected to continue to decline, with all sectors except for the government continuing to make net repayments. The projected downward path is sensitive mainly to exchange rate shocks.

Under current policies, public debt is projected to remain at just under 80 percent of GDP over the medium term. This scenario is underpinned by a net lending/borrowing balance of near 3 percent of GDP; interest rates on sovereign bonds and loans gradually increasing in line with global WEO assumptions; and medium-term output growth of 1¾ percent. The scenario assumes that financial markets remain accessible and there are no significant interest rate spikes, with sovereign and maturity spreads remaining at near 2014 levels.

The baseline scenario is subject to considerable risks which, if materialized, would likely set public debt on an increasing trajectory. With public debt at around 80 percent of GDP, negative shocks, even of a relatively small size, may trigger adverse reactions from financial markets, especially considering that annual gross financing needs are hovering above 20 percent of GDP with large reliance on non-resident financing. Possible shocks include an increase in sovereign spreads through contagion effects from other emerging economies, depreciation pressure on the exchange rate, reduced appetite by international investors, and an increase in global interest rates in line with U.S. monetary policy normalization. On the domestic front, risks include possible shocks to the primary fiscal balance from long-standing fiscal vulnerabilities in the public sector, including recurrent needs to restore service provision by SOEs; public wage pressures; and revenue uncertainty driven by new tax schemes and volatile VAT and corporate tax collection.

Based on historical volatility, probabilistic analysis of debt dynamics indicates that public debt could enter an increasing trajectory with a probability of 50 percent. Moreover, assuming that policy rigidities do not allow improving the primary balance by more than 2 percent of GDP in a single year, the probability that public debt enters into an increasing trajectory increases to 75 percent. This constraint is driven by the already high tax burden that leaves virtually no room for significant revenue-raising measures, and also by the fact that expenditure-based consolidations typically take more time to design and implement.

Hungary's external debt has declined in recent years but remains high. Gross external debt has declined from its peak of about 150 percent of GDP in 2009 to 119 percent by end-2013. The improvement mainly reflects heavy bank deleveraging that began during the global financial crisis, although this was partly offset by higher external government debt. Intra-company loans related to FDI remain broadly stable, amounting to just above 20 percent of gross debt throughout this period. Going forward, external debt is expected to continue to decline, with all sectors except for the government continuing to make net repayments. External bond issuances and continued purchases of HUF-denominated securities by nonresidents are expected to keep government external debt elevated, albeit declining in percent of GDP over the medium term.

Shocks to the exchange rate in particular are the main source of risk to external debt dynamics, reflecting high external liabilities. External debt remains sustainable under a range of shocks. Staff analysis shows that external debt is particularly vulnerable to exchange rate shocks, and to a lesser extent, to growth or current account shocks. A one-time real depreciation of 30 percent would add nearly 35 percentage points of GDP to external debt. An adverse permanent growth or current account shock of ½ standard deviation of their historical variation would add about 12 to 15 percentage points of GDP to external debt, respectively.

Hungary Public DSA Risk Assessment

Heat Map

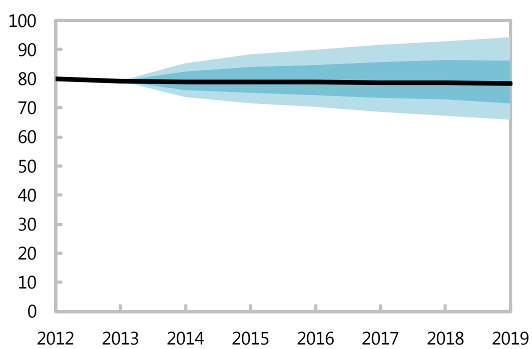
Debt level [1/]	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability shock
Gross financing needs [2/]	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability Shock
Debt profile [3/]	Market Perception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

Evolution of Predictive Densities of Gross Nominal Public Debt

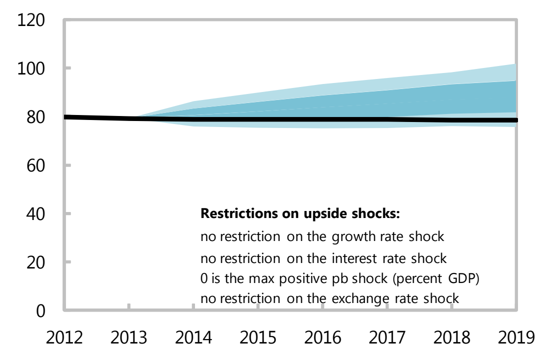
(in percent of GDP)

Baseline Percentiles: 10th-25th 25th-75th 75th-90th

Symmetric Distribution



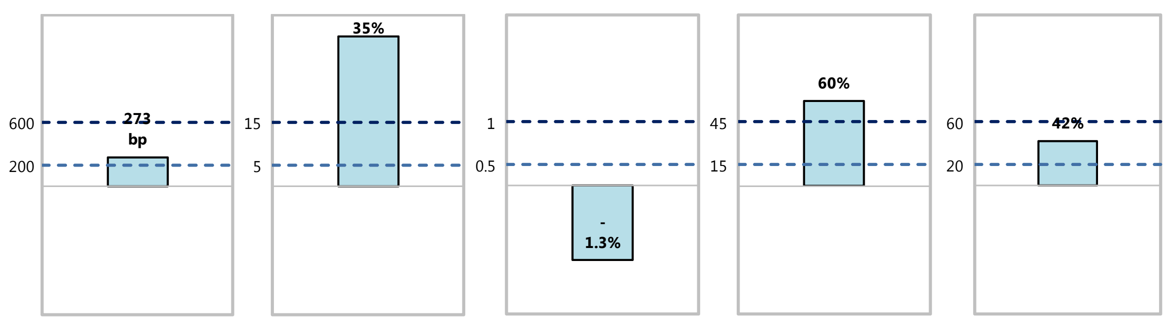
Restricted (Asymmetric) Distribution



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2013)

Hungary Lower early warning Upper early warning



EMBIG	**External Financing Requirement**	**Annual Change in Short-Term Public Debt**	**Public Debt Held by Non-Residents**	**Public Debt in Foreign Currency**
(in basis points) 4/	(in percent of GDP) 5/	(in percent of total)	(in percent of total)	(in percent of total)

Source: IMF staff.

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

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

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

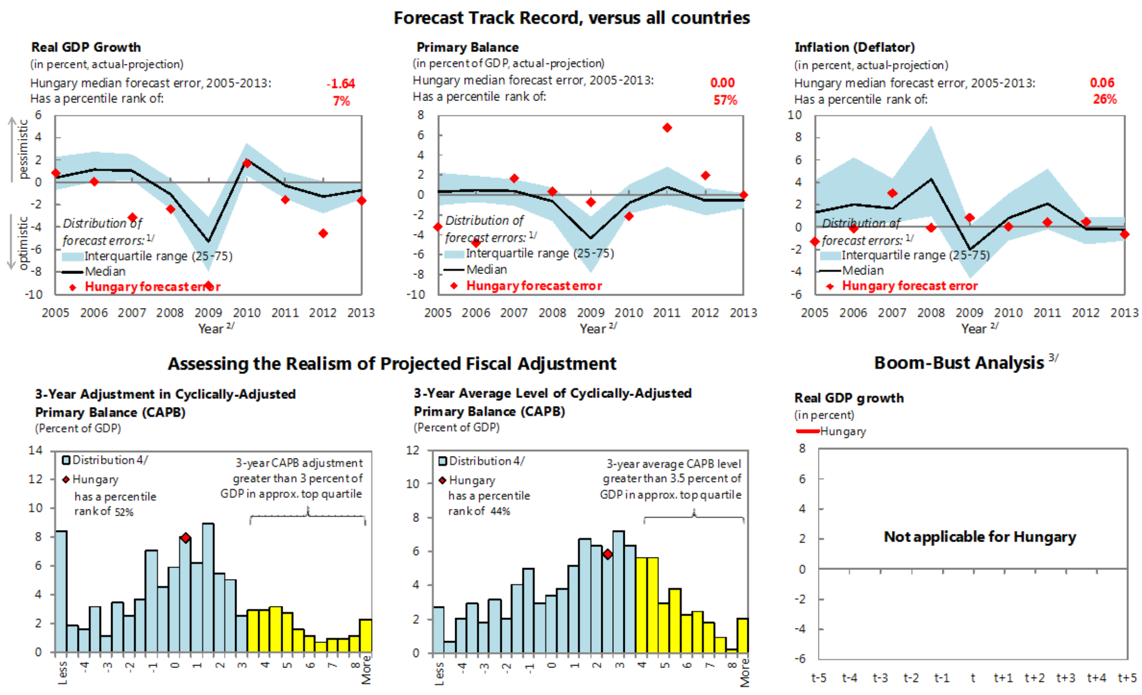
Lower and upper risk-assessment benchmarks are:

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

4/ EMBIG, an average over the last 3 months, 16-Jan-14 through 16-Apr-14.

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

Hungary Public DSA - Realism of Baseline Assumptions



Source : IMF Staff.

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

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

3/ Not applicable for Hungary, as it meets neither the positive output gap criterion nor the private credit growth criterion.

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

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

(in percent of GDP unless otherwise indicated)

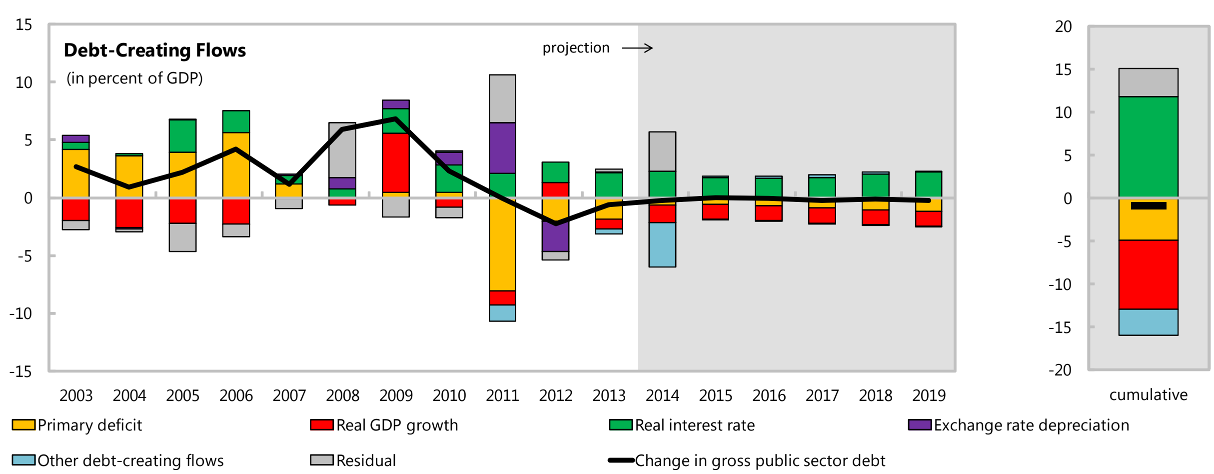
Debt, Economic and Market Indicators [1/]

	Actual			Projections					
	2003-2011 [2/]	2012	2013	2014	2015	2016	2017	2018	2019
Nominal gross public debt	70.0	79.8	79.2	79.0	79.0	78.9	78.7	78.6	78.4
Public gross financing needs	23.2	16.5	20.1	24.5	16.3	22.0	23.1	23.5	24.4
Real GDP growth (in percent)	1.5	-1.7	1.1	2.0	1.7	1.7	1.7	1.7	1.7
Inflation (GDP deflator, in percent)	4.0	3.2	2.7	2.0	2.3	2.4	2.5	2.4	2.4
Nominal GDP growth (in percent)	5.5	1.5	3.8	4.0	4.1	4.1	4.2	4.1	4.1
Effective interest rate (in percent) [4/]	6.3	5.3	5.5	5.0	4.7	4.7	4.9	5.2	5.4

As of April 16, 2014		
Sovereign Spreads		
EMBIG (bp) 3/		269
5Y CDS (bp)		269
Ratings	Foreign	Local
Moody's	Ba1	Ba1
S&Ps	BB	BB
Fitch	BB+	BBB-

Contribution to Changes in Public Debt

	Actual			Projections							
	2003-2011	2012	2013	2014	2015	2016	2017	2018	2019	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	2.9	-2.3	-0.6	-0.3	0.0	-0.1	-0.2	-0.1	-0.2	-0.9	
Identified debt-creating flows	2.8	-1.6	-0.9	-3.7	0.0	0.0	-0.2	-0.1	-0.2	-4.1	
Primary deficit	1.3	-2.0	-1.8	-0.6	-0.5	-0.6	-0.9	-1.0	-1.1	-4.8	1.0
Primary (noninterest) revenue and grants	44.9	46.6	47.4	47.6	47.9	46.0	46.5	47.5	48.3	283.9	
Primary (noninterest) expenditure	46.2	44.6	45.5	47.0	47.4	45.4	45.6	46.5	47.2	279.1	
Automatic debt dynamics [5/]	1.6	0.4	1.4	0.8	0.5	0.4	0.5	0.8	0.9	3.9	
Interest rate/growth differential [6/]	0.8	3.1	1.3	0.8	0.5	0.4	0.5	0.8	0.9	3.9	
Of which: real interest rate	1.5	1.7	2.2	2.3	1.8	1.7	1.8	2.1	2.2	11.9	
Of which: real GDP growth	-0.7	1.3	-0.9	-1.5	-1.3	-1.3	-1.3	-1.3	-1.3	-8.0	
Exchange rate depreciation [7/]	0.9	-2.7	0.1	…	…	…	…	…	…	…	
Other identified debt-creating flows	-0.1	0.0	-0.4	-3.8	0.1	0.2	0.2	0.2	0.0	-3.1	
Privatization/Drawdown of deposits (negative)	-0.1	0.0	-1.2	-0.5	0.0	0.0	0.0	0.0	0.0	-0.5	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other debt-creating flows and adjustments	0.0	0.0	0.7	-3.3	0.1	0.2	0.2	0.2	0.0	-2.6	
Residual, including asset changes [8/]	0.1	-0.7	0.3	3.4	0.0	0.0	0.0	0.0	0.0	3.2	



Source: IMF staff.

1/ Public sector is defined as general government.

2/ Based on available data.

3/ EMBIG.

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

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

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

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

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

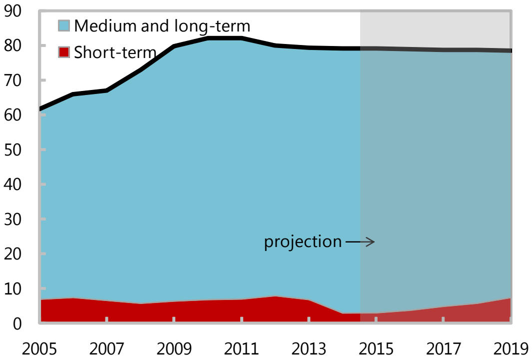
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Hungary Public DSA - Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

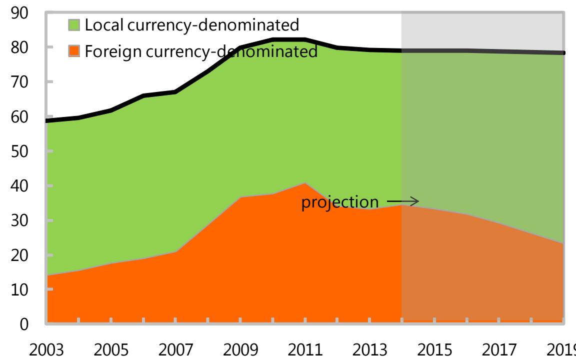
By Maturity

(in percent of GDP)



By Currency

(in percent of GDP)

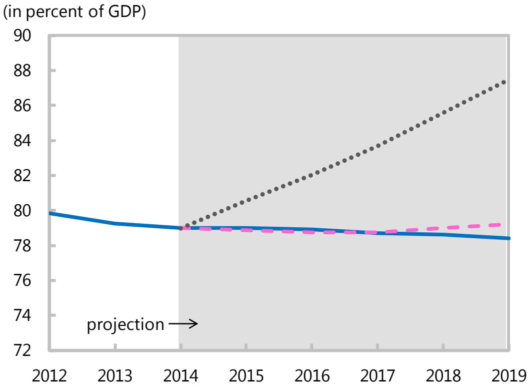


Alternative Scenarios

Baseline　　Historical　　Constant Primary Balance

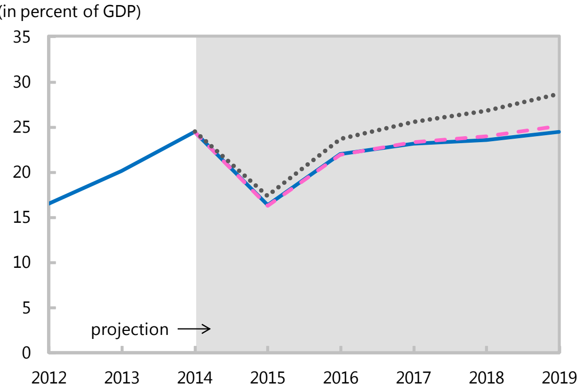
Gross Nominal Public Debt

(in percent of GDP)



Public Gross Financing Needs

(in percent of GDP)



Underlying Assumptions

(in percent)

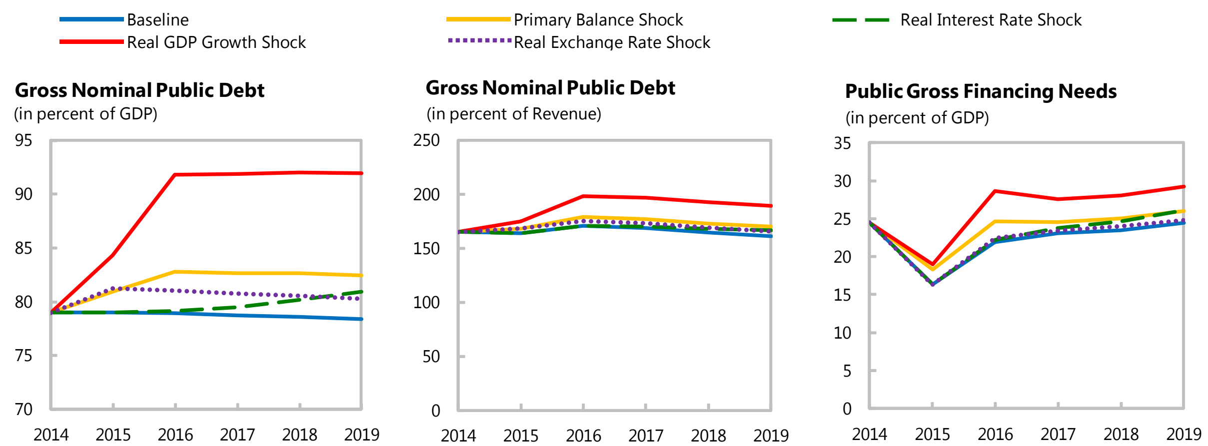
Baseline Scenario	2014	2015	2016	2017	2018	2019
Real GDP growth	2.0	1.7	1.7	1.7	1.7	1.7
Inflation	2.0	2.3	2.4	2.5	2.4	2.4
Primary Balance	0.6	0.5	0.6	0.9	1.0	1.1
Effective interest rate	5.0	4.7	4.7	4.9	5.2	5.4
Constant Primary Balance Scenario						
Real GDP growth	2.0	1.7	1.7	1.7	1.7	1.7
Inflation	2.0	2.3	2.4	2.5	2.4	2.4
Primary Balance	0.6	0.6	0.6	0.6	0.6	0.6
Effective interest rate	5.0	4.7	4.7	4.9	5.2	5.4

Historical Scenario	2014	2015	2016	2017	2018	2019
Real GDP growth	2.0	0.9	0.9	0.9	0.9	0.9
Inflation	2.0	2.3	2.4	2.5	2.4	2.4
Primary Balance	0.6	-0.4	-0.4	-0.4	-0.4	-0.4
Effective interest rate	5.0	4.7	4.7	4.8	5.1	5.2

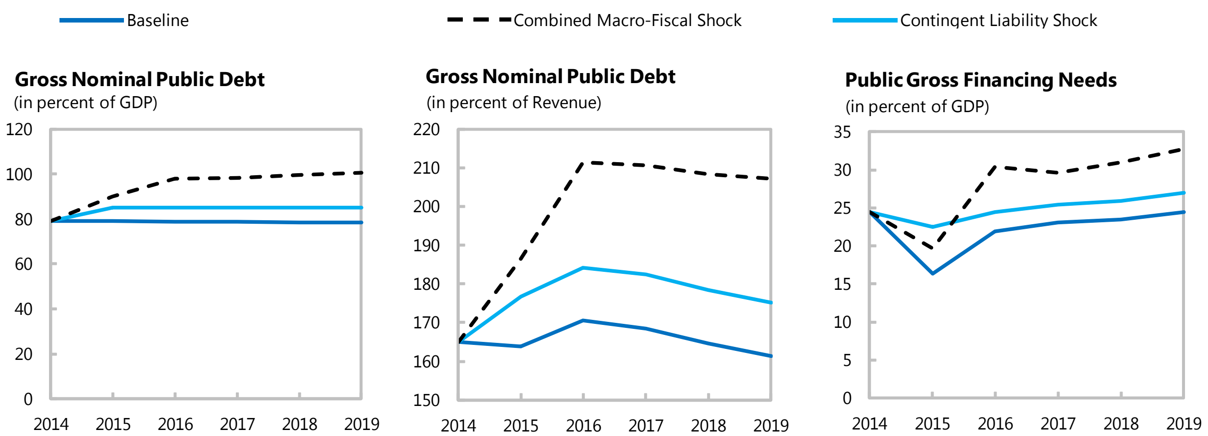
Source: IMF staff.

Hungary Public DSA - Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions

(in percent)

Primary Balance Shock	2014	2015	2016	2017	2018	2019
Real GDP growth	2.0	1.7	1.7	1.7	1.7	1.7
Inflation	2.0	2.3	2.4	2.5	2.4	2.4
Primary balance	0.6	-1.4	-1.3	0.9	1.0	1.1
Effective interest rate	5.0	4.7	4.8	5.0	5.3	5.4
Real Interest Rate Shock						
Real GDP growth	2.0	1.7	1.7	1.7	1.7	1.7
Inflation	2.0	2.3	2.4	2.5	2.4	2.4
Primary balance	0.6	0.5	0.6	0.9	1.0	1.1
Effective interest rate	5.0	4.7	5.1	5.7	6.3	6.7
Combined Shock						
Real GDP growth	2.0	-1.6	-1.7	1.7	1.7	1.7
Inflation	2.0	1.5	1.6	2.5	2.4	2.4
Primary balance	0.6	-1.5	-3.2	0.9	1.0	1.1
Effective interest rate	5.0	4.9	5.0	5.6	6.2	6.6

Real GDP Growth Shock	2014	2015	2016	2017	2018	2019
Real GDP growth	2.0	-1.6	-1.7	1.7	1.7	1.7
Inflation	2.0	1.5	1.6	2.5	2.4	2.4
Primary balance	0.6	-1.5	-3.2	0.9	1.0	1.1
Effective interest rate	5.0	4.7	4.8	5.1	5.3	5.5
Real Exchange Rate Shock						
Real GDP growth	2.0	1.7	1.7	1.7	1.7	1.7
Inflation	2.0	6.2	2.4	2.5	2.4	2.4
Primary balance	0.6	0.5	0.6	0.9	1.0	1.1
Effective interest rate	5.0	4.9	4.6	4.8	5.1	5.3
Contingent Liability Shock						
Real GDP growth	2.0	1.7	1.7	1.7	1.7	1.7
Inflation	2.0	2.3	2.4	2.5	2.4	2.4
Primary balance	0.6	-5.4	0.6	0.9	1.0	1.1
Effective interest rate	5.0	5.0	4.9	5.1	5.3	5.4

Source: IMF staff.

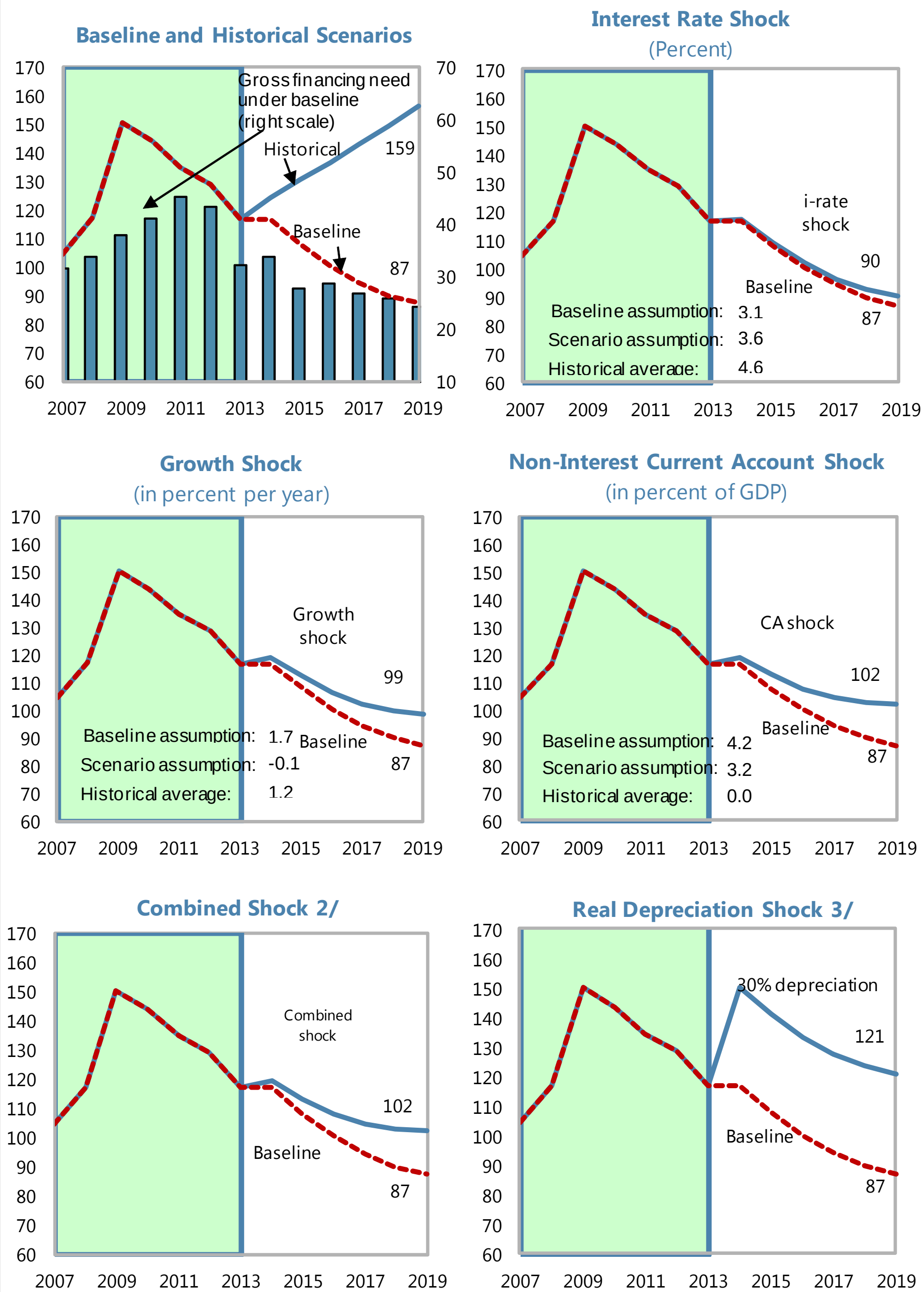
Hungary: External Debt Sustainability Framework, 2007-19

(In percent of GDP, unless otherwise indicated) 1/

	Actual						Projections							
	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	Debt-stabilizing non-interest current account 7/
Baseline: External debt	104.6	116.9	150.1	143.7	134.6	128.8	**118.7**	**116.8**	**107.8**	**100.2**	**94.2**	**89.9**	**87.1**	**-4.2**
Change in external debt	7.8	12.3	33.3	-6.4	-9.1	-5.8	-10.1	-1.9	-9.0	-7.6	-6.0	-4.3	-2.8	
Identified external debt-creating flows (4+8+9)	7.4	4.5	23.2	-10.2	-8.0	-8.7	-9.7	-11.0	-9.6	-7.9	-6.6	-5.2	-3.7	
Current account deficit, excluding interest payments	3.5	1.9	-5.2	-5.2	-5.7	-7.0	-6.3	-5.8	-5.2	-4.4	-3.6	-2.5	-1.3	
Deficit in balance of goods and services	-0.7	-0.3	-4.7	-5.5	-6.3	-7.0	-7.8	-7.7	-7.4	-6.7	-6.0	-5.1	-4.2	
Exports	80.8	81.3	77.4	84.7	91.2	94.5	94.3	101.4	102.1	103.4	105.2	107.3	109.3	
Imports	80.2	81.0	72.6	79.1	84.9	87.5	86.5	93.7	94.8	96.7	99.2	102.1	105.1	
Net non-debt creating capital inflows (negative) 2/	8.1	3.3	7.7	-2.9	-3.2	-9.5	-5.3	-6.1	-5.6	-4.9	-4.6	-4.2	-3.9	
Automatic debt dynamics 3/	-4.2	-0.7	20.8	-2.1	0.9	7.8	2.0	0.9	1.3	1.4	1.6	1.5	1.5	
Contribution from nominal interest rate	3.8	5.4	5.5	5.0	5.2	6.2	3.4	3.3	3.3	3.2	3.3	3.1	3.0	
Contribution from real GDP growth	-0.1	-0.9	9.1	-1.5	-2.2	2.3	-1.4	-2.4	-2.0	-1.7	-1.7	-1.6	-1.5	
Contribution from price and exchange rate changes 4/	-7.9	-5.3	6.1	-5.6	-2.2	-0.6	...	...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 5/	0.4	7.8	10.0	3.8	-1.1	2.9	-0.4	9.1	0.6	0.3	0.6	0.9	0.9	
External debt-to-exports ratio (in percent)	129.3	143.7	194.0	169.7	147.6	136.3	125.9	115.1	105.5	96.9	89.6	83.8	79.7	
Gross external financing need (in billions of euros) 6/	31.1	35.5	34.5	39.4	44.5	41.7	31.8	32.4	27.6	29.4	28.6	28.5	27.6	
in percent of GDP	31.3	33.6	37.8	40.9	45.0	43.0	31.9	33.7	27.6	28.4	26.7	25.7	24.0	
Scenario with key variables at their historical averages 7/							**118.7**	**124.2**	**130.3**	**136.3**	**142.7**	**149.3**	**156.4**	**4.0**
Key Macroeconomic Assumptions Underlying Baseline 8/														
Real GDP growth (in percent)	0.1	0.9	-6.8	1.1	1.6	-1.7	1.1	2.0	1.7	1.7	1.7	1.7	1.7	
GDP deflator in euros (change in percent)	10.9	5.3	-7.3	4.3	1.2	-0.4	1.8	-5.3	1.8	2.0	2.0	1.9	1.9	
Nominal external interest rate (in percent)	4.3	5.5	4.0	3.5	3.7	4.5	2.7	2.7	2.9	3.1	3.4	3.4	3.5	
Growth of exports (euro terms, in percent)	16.1	6.9	-17.7	15.3	10.8	1.4	2.7	3.8	4.3	5.0	5.5	5.7	5.6	
Growth of imports (euro terms, in percent)	13.5	7.4	-22.5	14.8	10.2	0.9	1.7	4.6	4.8	5.8	6.4	6.7	6.7	
Current account balance, excluding interest payments	-3.5	-1.9	5.2	5.2	5.7	7.0	6.3	5.8	5.2	4.4	3.6	2.5	1.3	
Net non-debt creating capital inflows	-8.1	-3.3	-7.7	2.9	3.2	9.5	5.3	6.1	5.6	4.9	4.6	4.2	3.9	

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.

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 2014.

INTERNATIONAL MONETARY FUND

HUNGARY

May 8, 2014

STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Prepared By

European Department
(In Consultation with Other Departments)

CONTENTS

FUND RELATIONS

(As of March 30, 2014)

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

General Resources Account:

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

SDR Department:

	SDR Million	Percent Allocation
Net cumulative allocation	991.05	100.00
Holdings	13.49	1.36

Outstanding Purchases and Loans: None

Latest Financial Arrangements:

Type	Date of Arrangement	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
Stand-by	Nov 6, 2008	Oct 5, 2010	10,537.50	7,637.00
Stand-By	March 15, 1996	Feb 14, 1998	264.18	0.00
Stand-By	Sep 15, 1993	Dec 14, 1994	340	56.70

Projected Payments to Fund:

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

	Forthcoming				
	2014	2015	2016	2017	2018
Principal					
Charges/Interest	0.94	1.28	1.28	1.28	1.28
Total	0.94	1.28	1.28	1.28	1.28

Current Status of Safeguards Assessment:

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

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

Article IV Consultation:
Hungary is on a 12-month consultation cycle. The last Article IV Board discussion took place on March 18, 2013. The associated Executive Board assessment is available at http://www.imf.org/external/np/sec/pn/2013/pn1338.htm and the staff report at http://www.imf.org/external/pubs/cat/longres.aspx?sk=40438.0

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

HUNGARY: TECHNICAL ASSISTANCE FROM THE FUND, FY2010–2014

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

Resident Representative: The resident representative office closed on December 31, 2013.

STATISTICAL ISSUES

Assessment of Data Adequacy for Surveillance

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

- **Government Finance Statistics**: Data reporting on fiscal accounting needs to be improved further. The monthly cash-basis accounts of the central government prepared by the Ministry of National Economy do not reflect the GFS presentation and provide no information on financing. This complicates staff's ability to analyze trends and to appropriately anticipate the impact on general government accounts. Data on revenue and expenditure arrears has been readily provided by the authorities upon request, but provision of this data on an automatic basis would facilitate the monitoring of obligations on an accrual basis. Similarly, automatic provision of local government revenues and expenditures, as well as of financial statements of state-owned enterprises (an important source of contingent liabilities), would allow for closer regular monitoring of the general government.

Data Standards and Quality

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

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

HUNGARY: TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE

(AS OF APRIL 30, 2014)

	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	4/30/2014	4/30/2014	D and M	D and M	D and M		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	March 2014	4/18/2014	M	M	M		
Reserve/Base Money	March 2014	4/14/2014	M	M	M	O,O,LO,LO	O,O,O,O,LO
Broad Money	March 2014	4/30/2014	M	M	M		
Central Bank Balance Sheet	March 2014	4/14/2014	M	M	M		
Consolidated Balance Sheet of the Banking System	March 2014	4/30/2014	M	M	M		
Interest Rates[2]	Mar-14	4/7/2014	M	M	M		
Consumer Price Index	Mar-14	4/11/2014	M	M	M	O,O,O,O	O,O,O,O,NA
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	2013	4/1/2014	Q	Q	Q	O,LNO,LO,O	LO,O,O,O,NA
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	Apr-14	5/6/2014	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Mar-14	4/20/2014	M	M	M		
External Current Account Balance	Q4 2013	3/31/2014	Q	Q	Q	O,LO,LO,LO	O,O,O,O,NA
Exports and Imports of Goods and Services	Q4 2013	3/31/2014	Q	Q	Q		
GDP/GNP	Q4 2013	3/5/2014	Q	Q	Q	O,O,O,LO	O,LO,O,O,NA
Gross External Debt	Q4 2013	3/31/2014	Q	Q	Q		
International investment Position[6]	Q4 2013	3/31/2014	Q	Q	Q		

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

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

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

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

[5] Including currency and maturity composition.

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

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

[8] Reflects the assessment provided in the data ROSC and Substantive Update published in May 2001and July 2004, respectively, and based on the findings of the respective missions that took place during January 2001and 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

COMMUNICATIONS DEPARTMENT

Press Release No. 14/268
FOR IMMEDIATE RELEASE
June 6, 2014

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Concludes 2014 Article IV Consultation with Hungary

On May 23, 2014, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Hungary.[1]

Hungary's economy emerged from the 2012 recession and posted 1.1 percent growth last year, mainly driven by government investment and consumption, and also net exports. Private demand—although strengthening on the back of accommodative monetary conditions and improved market confidence—remained weak, and credit to the retail and corporate sectors continued to contract, albeit at a slowing pace. Output growth is projected to pick-up to 2 percent this year as investment and private consumption continue to improve, while exports expand further. Underlying inflationary pressures have eased, and inflation expectations have come down to around the National Bank of Hungary's (MNB) inflation target. Unemployment declined despite the increase in the participation rate, mainly due to the expansion of public works programs; but labor market conditions remain weak.

Hungary has experienced a welcome reduction in its vulnerabilities thanks to a persistent current account surplus, low headline inflation, and a significant fiscal consolidation. These developments helped Hungary withstand various bouts of emerging market turmoil over the past year relatively well. However, still-high public and external financing needs, heavy reliance on nonresident funding, uncertainty regarding advanced economies' monetary policies, and the potential reemergence of financial stress in emerging markets pose risks. The government has secured financing for most of its maturing external debt in 2014 with the recent Eurobond placements.

Hungary has demonstrated a strong commitment to keeping the fiscal deficit within the EU limit. The 2013 deficit is estimated at 2.2 percent of GDP, over-performing the 2.7 percent target, as lower tax revenues were more than offset by prudent expenditure control. Public debt declined only slightly to just above 79 percent of GDP. For 2014, the deficit target of

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

2.9 percent of GDP implies a structural relaxation of about one percent of GDP leaving public debt broadly unchanged at about 79 percent of GDP.

Comforted by decelerating inflation, low risk premia, and a negative output gap, the MNB reduced the policy rate to a record-low level of 2.5 percent (as of April 2014). Furthermore, the MNB introduced the Funding for Growth Scheme with the aim of easing access to finance for SMEs and improving their credit conditions through the provision of subsidized lending interest rate.

Hungary's medium-term growth prospects remain subdued, as private consumption is still hampered by the ongoing repair of households' balance sheets; while the weak business environment continues to weigh on private investment. Banks remain under stress, reflecting the heavy tax burden, high non-performing loans, and a weak growth outlook. Labor participation, while somewhat increasing, remains low. These challenges are further compounded by rising competitiveness pressures, as reflected in the loss of export market share, owing to the deterioration in the business climate, particularly the institutional framework and tax policy.

Executive Board Assessment[2]

Executive Directors welcomed Hungary's economic recovery, supported by accommodative policies, but noted that the economy continues to face significant risks arising from an uncertain global environment, the still high public debt, large financing needs, and extensive reliance on non-resident funding.

Against this background, Directors underscored the need for a recalibration of macroeconomic policies to rebuild policy buffers and ambitious structural reforms to improve medium-term growth prospects. Priorities include strengthening institutions, increasing policy predictability, and promoting private sector participation in the economy.

Directors welcomed the authorities' commitment to fiscal prudence and sustainable debt reduction. They encouraged the authorities to implement a durable adjustment strategy, focusing on expenditure retrenchment and elimination of distortionary taxes. Continued efforts are also needed to reduce tax exemptions and address VAT fraud. Directors noted that these steps should be complemented by growth-friendly fiscal reforms, which could entail better targeting of social benefits, restructuring the remaining loss-making SOEs, and streamlining public sector employment. Directors welcomed the authorities' intention to introduce a multi-year budget framework and underscored the importance of an independent and adequately-resourced fiscal council.

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

Directors observed that, while inflationary pressures have eased and inflation expectations have come down, there remains uncertainty surrounding the external environment, which calls for caution in monetary conduct. Directors saw merit in halting the monetary easing cycle as long as there are no evident signs of inflationary pressures, noting that the current accommodative stance can continue to support economic activity. They also emphasized that adequate international reserves would help mitigate exchange rate volatility and support financial stability.

Directors called for further steps to restore financial intermediation and facilitate the resolution of non-performing loans, including by reducing taxes on banks and removing legal and regulatory impediments to a clean-up of banks' portfolios. They saw scope for further refining the modalities of the Funding for Growth Scheme to improve the targeting and effectiveness of its lending.

Directors welcomed progress in improving the functioning of the labor market. They stressed that broad-based structural reforms are essential to boost potential growth and support Hungary's advancement in the regional supply chain. They also recommended improving the business climate, including by reducing the regulatory burden and rationalizing taxes.

Hungary: Selected Economic Indicators, 2009–16

	2009	2010	2011	2012	2013	2014	2015	2016
					Prel.	Proj.	Proj.	Proj.
Real economy								
Real GDP (percentage change)	-6.8	1.1	1.6	-1.7	1.1	2.0	1.7	1.7
Total domestic demand (contribution to growth) 1/	-10.4	0.2	-0.5	-3.3	0.7	1.6	1.5	1.8
Private consumption 2/	-3.7	-2.4	0.2	-1.1	0.0	0.4	0.7	0.9
Government consumption	0.3	0.5	0.0	0.0	0.4	0.2	0.1	0.1
Gross fixed investment	-2.4	-1.8	-1.1	-0.7	1.0	1.0	0.8	0.8
Foreign balance (contribution to growth)	3.6	0.9	2.1	1.6	0.4	0.4	0.3	-0.1
Exports	-8.4	8.8	7.2	1.5	5.0	5.3	5.0	4.9
Imports	-12.0	7.9	5.1	-0.1	4.6	5.0	4.7	5.0
CPI inflation (average)	4.2	4.9	3.9	5.7	1.7	0.9	3.0	3.0
CPI inflation (end year)	5.6	4.7	4.1	5.0	0.4	2.9	3.0	3.0
Unemployment rate (average)	10.1	11.2	11.0	11.0	10.3	9.4	9.2	9.0
Gross domestic investment (percent of GDP) 3/	20.7	18.6	17.9	17.4	18.1	18.9	19.2	19.6
Gross national saving (percent of GDP, from BOP)	20.5	18.8	18.3	18.3	21.1	21.4	21.2	20.9
General government (GFSM 2001 basis) 4/								
Overall balance	-4.6	-4.4	4.2	-2.0	-2.3	-2.9	-2.9	-2.9
Primary balance	-0.5	-0.5	8.0	2.0	1.8	0.6	0.5	0.6
Primary structural balance, in percent of potential GDP	1.1	-1.1	-1.1	2.3	2.5	1.1	0.8	0.8
Gross debt	79.8	82.1	82.1	79.8	79.2	79.0	79.0	78.9
Money and credit (end-of-period)								
Broad money	4.4	3.0	5.9	-3.3	5.8	2.8	5.7	6.0
Lending to the private sector, flow-based	-2.3	-2.4	-6.9	-7.4	-3.2	0.0	3.0	3.5
Interest rates								
T-bill (90-day, End of Period)	6.1	5.7	7.2	5.6	4.1	...	...	...
Government bond yield (5-year, End of Period)	7.6	7.9	8.9	6.1	4.8	...	...	...
5-year sovereign CDS (December 31, 2013)	335	282	379	450	260	...	...	...
Balance of payments								
Goods and services trade balance	4.7	5.5	6.3	7.0	8.0	7.7	7.4	6.7
Current account	-0.2	0.2	0.4	0.9	3.0	2.5	2.0	1.2
Reserves (in billions of euros)	30.7	33.7	37.8	33.9	33.8	34.6	35.5	36.6
Gross external debt 5/	150.1	143.7	134.6	128.8	118.7	116.8	107.8	100.2
Gross official reserves (percent of short-term debt at remaining	83.6	74.9	88.9	96.0	98.3	117.2	116.0	126.2
Exchange rate								
Exchange regime					Floating			
Present rate (February 28, 2014)					Ft. 310 = €1; Ft. 256 = CHF1			
Nominal effective rate (2000=100, average)	102.6	102.7	104.2	109.0	110.3	...	...	...
Real effective rate, CPI basis (2000=100, average)	74.8	72.4	72.6	73.6	74.3	...	...	...
Quota at the Fund					SDR 1,038.4 million			
Memorandum Items								
Nominal GDP (billions of forints)	25,626	26,513	27,635	28,048	29,114	30,272	31,506	32,806

Sources: Hungarian authorities; IMF, International Financial Statistics; Bloomberg; and IMF staff estimates.
1/ Includes change in inventories.
2/ Actual final consumption of households.
3/ Excludes change in inventories.
4/ Consists of the central government budget, social security funds, extrabudgetary funds, and local governments. 2011
5/ Excluding Special Purpose Entities. Including inter-company loans, and nonresident holdings of forint-denominated assets.

Statement by Mr. Prader and Mr. Benk on Hungary
May 23, 2014

Since the last Article IV consultation Hungary has achieved a remarkable reduction in vulnerabilities despite the volatile external environment. Economic activity picked up in the past one and a half year, driven both by internal demand and net exports. The external balance has been strengthening, backed by the current account surplus and continuous reduction in external debt. Disciplined fiscal policy preserved a stable fiscal balance and moderately declining public debt.

That being said, the authorities are aware of the surrounding risks and remaining vulnerabilities, stemming primarily from the volatile external environment and the still elevated financing needs. They remain committed to prudent macroeconomic policies, focusing their strategy on sustainable debt reduction, increasing labor participation, improving competitiveness, and reducing financial vulnerabilities. The authorities thank staff for the thorough and constructive discussions during the Article IV mission and for their valuable advice on macroeconomic policies.

Economic developments and outlook

The economy strengthened in 2013, with output growth reaching 3.5 percent in the first quarter of 2014. The composition of growth shifted towards a more balanced structure, where the pick-up in external demand has been complemented by the recovery of internal demand, backed by reviving public and private investment and consumption. The accelerating growth is coupled with a rising current account surplus. Headline inflation decelerated sharply driven by the still-existing spare capacities in the economy and one-off price cuts in regulated utility prices.

Going forward, growth momentum is expected to persist over the forecast horizon. Against the background of the latest incoming data the authorities are more optimistic than staff about the growth prospects, expecting GDP growth rates exceeding 2.5 percent both for the current and for next year. Rising exports will remain an important driver of growth, supported by increasing FDI in the manufacturing sector and the new production capacities brought into the automobile industry, in addition to the strengthening of external demand. Investment is likely to pick up further, as the easing of credit constraints and the increased use of EU funding add to the improved outlook for activity. Nevertheless, consumption recovers only gradually despite the improved disposable income, as deleveraging continues to act as a drag on households. Inflation is expected to rise back into the price stability range of 3 percent as the output gap narrows and the one-off effects phase out. Labor market conditions remain loose, with moderate wage conditions coupled with gradually improving private sector employment.

Fiscal Policy and Consolidation

The authorities are fully committed to conduct prudent fiscal policies compatible with sustainable debt reduction, and building buffers which allow for countercyclical policy. The key building blocks of fiscal policymaking have been expenditure reductions through structural measures, fair tax burden-sharing among various economic players in accordance with their capacity, and employment-friendly taxation which shifts the burden from labor to consumption and turnover taxes (growth-oriented reform).

Fiscal discipline and prudence helped the government to keep the deficit comfortably within EU limits and exit the Excessive Deficit Procedure. Rigorous budget execution and corrective actions, where needed, ensured that both the 2012 and 2013 deficits overperformed the initial target. Going forward, fiscal policy seeks to support economic recovery while complying with the requirements of the fiscal framework, which in turn is based on keeping the deficit below 3 percent, complying with the medium-term fiscal plan regarding the structural balance, and preserving the declining debt ratio.

In this vein, the 2014 budget allows for a countercyclical structural impulse of about 1 percentage point, while a broadly neutral fiscal stance is envisaged for the subsequent years. Budgeted contingency reserves for 2014 provide sufficient buffers to address unforeseen risks and meet the 2.9 percent deficit target at a comfortable margin. Corrective actions and potential savings have already been identified in order to offset the underperforming revenues due to lower than expected inflation.

The authorities appreciate staff's constructive policy recommendation on the medium-term fiscal adjustment strategy. Many of them, where feasible, are already under implementation, or given due consideration for the 2015-17 fiscal plan. Several measures have been implemented to address tax compliance and VAT fraud: reverse charge VAT mechanism in the agricultural sector, connection of cash registers to the tax authority and limitation of cash payments between firms, the effect of these showing already early results in the 2014 VAT revenues. Streamlining the range of VAT preferential rates, while consistent with the government's general policy, should be evaluated against equity, inequality, social, and tax efficiency considerations. Spending on non-EU related goods and services will remain under strict nominal control and decline as a share of GDP, while public nominal wages remain frozen except in the education and healthcare sectors. Social transfers will also decline substantially as a share of GDP, as pensions are indexed to inflation, while other benefits remain frozen. Sector specific taxes, except the bank levy, were replaced by consumption and turnover type taxes (financial transaction levy, telecommunication tax) based on a "broad base - low rate" approach. The centralization of the local government's finances gives the government stricter control over spending and contracting new local debt. The reorganization of public transportation companies is ongoing.

Monetary Policy and Financial System

The Magyar Nemzeti Bank (MNB) launched an easing cycle in August 2012 in association with the improving market sentiment vis-à-vis Hungary and the strong global risk appetite. The subdued inflationary pressures, the still negative output gap, and the supportive risk perception associated with the economy allowed the continuous lowering of the policy rate to 2.5 percent. Going forward, a cautious approach to policy is needed due to uncertainty in the global financial environment. However, a tightening bias would be warranted only if risk perception shifts and global volatility increases.

The current level of international reserves is adequate by a variety of metrics, and there is no compelling evidence showing that the exchange rate is misaligned.

The monetary toolkit has been complemented by new elements. The MNB announced the Funding for Growth Scheme in April 2013, aiming at providing liquidity to credit institutions to alleviate disruptions in lending to SMEs, reinforce financial stability, reduce the external vulnerability of the Hungarian economy, and ultimately revert the vicious credit squeeze - low growth cycle. The first phase of the program (June-September 2013), with a disbursed amount of about 2.5 percent of GDP, strengthened competition in the SME credit market and substantially alleviated the interest burden of firms. The second phase, running until the end of 2014, puts greater emphasis on the stimulation of economic growth by focusing on the supply of new loans to finance new investments. Although the utilization of the second phase evolves gradually owing to the time lag needed for the implementation of new projects, 60 percent of the 126 bn HUF (about 0.4 percent of GDP) of the already contracted loans as of April were new investment loans.

From August 2014 on, the MNB’s main policy instrument will change: the two-week MNB bill will be replaced by a two-week deposit facility, which only counterparties will be allowed to hold with the Bank, and will be excluded from the range of eligible collateral for the Bank’s lending operations. This will provide an incentive to the banking sector to contribute to the reduction of the country’s external vulnerability by shifting the Hungarian economy’s debt structure towards dominantly domestic financing sources. Other changes, like the introduction of interest rate swap, long-term repo operation and asset swap can encourage banks to buy long-term HUF government bonds and improve the maturity profile of the public debt financing.

The integration of the financial supervisory authority into the central bank has been an important improvement in the financial stability framework. The established Financial Stability Board ensures the coordination between micro-prudential regulatory supervision of the individual risks of institutions and macro-prudential regulatory oversight. The revision of the Act on Credit Institutions – transposing the EU rules based on Basel III (CRD IV directive) at the end of 2013 – has also strengthened the supervisory toolbox and financial stability.

Debt and Financing Vulnerabilities

The public debt-to-GDP ratio has been on a declining path since 2010, dropping 3 percentage points by the end of 2013. The share of FX-denominated debt declined by more than 10 percentage points during the past three years, thanks to the financing strategy of covering the new financing needs by issuing domestic currency denominated papers, while FX denominated bonds were issued only to cover rollover needs. The nonresident holdings share, though still elevated, has turned to a declining trend during the past year, and there is also evidence that the composition of the foreign investor base shifted towards more stable, real money players. The retail bond program, started in 2012, has been highly successful and as a result, domestic households are currently holding 10 percent of total government securities stock. Additionally, domestic institutional investors increased their demand for government securities, and, following some changes in monetary policy instruments, demand from banks is expected to rise even more in the near future.

These developments, coupled with other improving external indicators, determined that Hungary experienced lower volatility than other emerging markets during the market turmoil over the past year.

Structural Reforms

Structural transformations and supply-side measures, intended to address structural bottlenecks and raise Hungary's medium-term growth prospects, are underway. Diversification of export destinations, and gaining new markets are supported by the provision of effective financing and insurance facilities for exporters by the operation of Eximbank. Efforts are stepped up to develop a non-profit energy sector and reduce high energy costs for investors to international levels.

Labor market conditions have been substantially reformed to boost both labor supply and labor demand. On the demand side, changes to the Labor Code facilitated the shift towards more flexible employment types. The Job Protection Act in 2013 reduced the tax wedge (typically though allowances in social contribution tax) for disadvantaged groups with perhaps the lowest productivity, but with the highest responsiveness to incentives to join the workforce, such as low-income, low-skilled, young, old, long-term unemployed, returning mothers, career starters. The Act covered more than half of low-wage earners. More recently, the extension of the family tax allowance decreased further the tax wedge for families in the lower income brackets. Nevertheless, measures based on reported income are not preferred by the authorities due to the severe underreporting of income. However, differentiating the minimum wage based on geographic regions or employee groups may be feasible. On the supply side, the transformation of the unemployment and disability benefits and the early retirement system, encouraged the return to the job market of the groups concerned. Mobility benefits should alleviate geographical mismatches. Overall, the labor market reforms, aiming at a workfare state and work-based social-security system, are already reflected by the continuously rising labor force participation, private employment and public work scheme employment, and declining unemployment.