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Hungary: 2007 Article IV Consultation—Staff Report; and Public Information Notice on the Executive Board Discussion

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2007 Article IV consultation with Hungary, the following documents have been released and are included in this package.

- The staff report for the 2007 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on May 7, 2007, 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 June 22, 2007. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- A Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its July 18, 2007 discussion of the staff report that concluded the Article IV consultation.

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

Selected Issues Paper

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HUNGARY

Staff Report for the 2007 Article IV Consultation

Prepared by the Staff Representatives for the 2007 Consultation with Hungary

Approved by Susan Schadler and Adnan Mazarei

June 22, 2007

EXECUTIVE SUMMARY

Challenges. With fiscal consolidation on track for 2007 and 2008, short-term risks have receded, especially due to the favorable international financial environment. Nevertheless, vulnerabilities remain since, even with the ongoing efforts, the debt levels will stay elevated. Ensuring that the current economic slowdown does not translate into a prolonged period of low growth is important both for raising standards of living and for containing vulnerabilities.

Staff views. The ongoing fiscal consolidation should be used to fundamentally reorient fiscal affairs. Putting the debt on a sustainable downward trend will also require a substantial decrease in the size of government expenditure in relation to GDP. As structural reforms enter their more difficult phase, the momentum of change could slow down. With inflation set to decline, an easing cycle could bring policy rates closer to regional levels. Staff continues to recommend a shift from the current band to a floating exchange rate regime. Despite new strains, the financial sector remains sound. Measures to improve the regulatory environment and ensure productive use of EU funds should help raise potential growth.

Authorities' views. The authorities are less concerned than is staff about short-term vulnerabilities but do share concerns about medium-term growth prospects. The needed ambitious fiscal consolidation measures to continue the process beyond 2008 are under discussion. The short-term risks of currency appreciation, if the band were removed, constrain their willingness to change to a floating regime. Views on interest rate policy, the financial sector, and structural reforms largely coincide with those of staff.

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I. Introduction

1. **The resolute fiscal policy measures renew the prospects of stepped-up gains from integration into Europe.** Such integration has fostered enduring income growth through trade, foreign direct investment, and access to financial markets. Also, financial markets have forgiven policy errors and tolerated policy uncertainties. But, with elevated debt levels, vulnerabilities remain and markets' latitude carries risks if pressing policy decisions are deferred. The cost is borne not as visible financial crises but in a more insidious loss of international competitiveness. The erosion of Hungary's growth potential coincides with its fiscal deterioration—and recent European history cautions that low-growth traps are a real possibility. To realize the continuing potential of integration, pushing ahead with ongoing efforts to restore public finances and create a favorable business environment will pay early dividends and allow competitive entry into the eurozone.

II. Recent Economic Developments

2. **In mid-2006, the authorities put a brake on the runaway fiscal deficit.** From 7.8 percent of GDP in 2005, the fiscal deficit rose to 9.1 percent of GDP in 2006, as against the budget target of 6.4 percent of GDP (Tables 1 and 2). The end-year public debt rose by nearly 4 percentage points to about 66 percent of GDP. In mid-year, the deficit threatened to run away to 11 percent of GDP when a revised Convergence Programme (CP) announced emergency measures (Box 1). Since then, the consolidation has proceeded faster than promised. The "overperformance" has been due mainly to higher-than-expected revenues, reflecting, in turn, improvements in the tax administration.[1]

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[1] Collections of social security contributions and income taxes have been particularly strong. Excises and VAT have also performed better than expected.

Box 1. Surveillance and Policies

Fiscal Policy: The authorities' fiscal consolidation plan in 2006 relied to a greater extent on tax increases than advised by the Fund. However, expenditure measures with a longer-term view have been undertaken and others are under discussion. Consistent with the Fund's recommendations, the authorities have advanced fiscal transparency and accountability, including of public-private partnerships, and are exploring new fiscal rules and further external scrutiny of fiscal policy by an independent council.

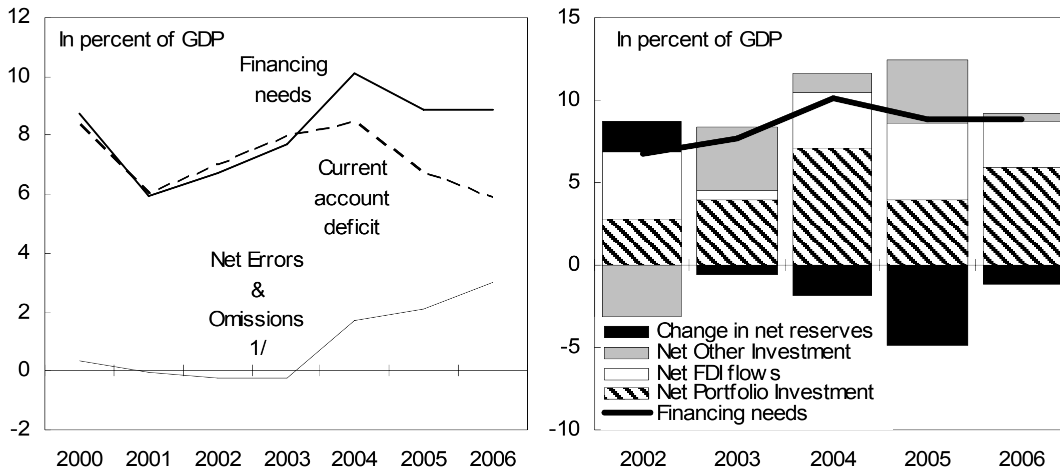
Monetary Policy: The increase in policy rates in the second half of 2006 was at the higher end of the range recommended by the Fund. The authorities do not view the shift to a floating exchange rate regime as necessary at present.

Financial Sector: In line with Fund's advice, the authorities have made appreciable progress in conducting stress tests and have undertaken more proactive banking supervision.

Labor Market: The government is tightening the disability pension and the early retirement program and is considering a gradual increase in the retirement age.

3. **The current account deficit has been falling, but external financing requirements remain high.** From 8.4 percent of GDP in 2004, the current account deficit fell to 5.8 percent of GDP in 2006 (Table 3 and Figure 1). However, with net errors and omissions widening to 3 percent of GDP, net financing needs remained at about 9 percent of

Financing Needs are Still Large, 2000-06

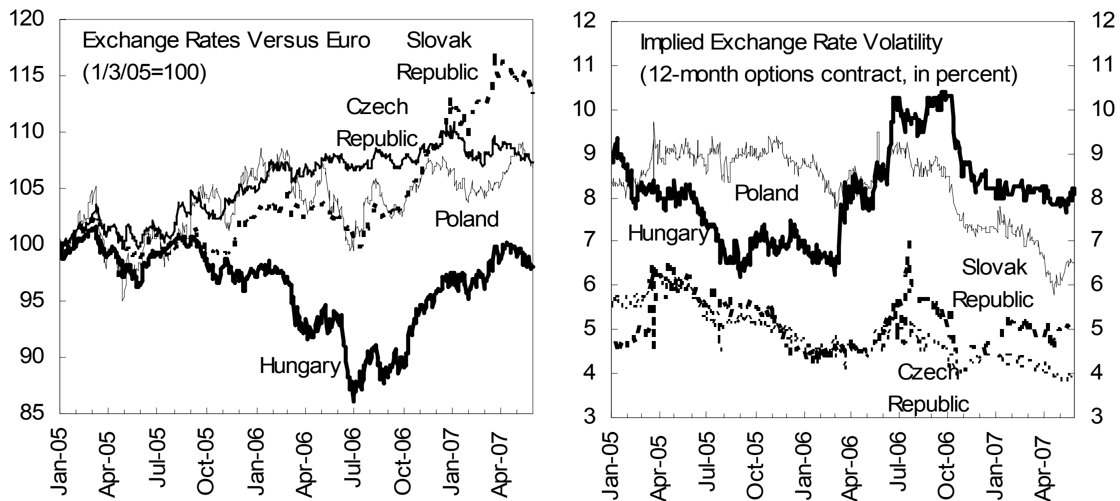


Source: Magyar Nemzeti Bank.
1/ A positive figure denotes an outflow.

GDP (figure below). Of these, debt-creating flows were about 5½ percent of GDP in 2006, raising the end-year external debt to 91 percent of GDP.

4. **Investor sentiment towards Hungary has improved.** In mid-2006, fiscal uncertainties placed Hungarian financial assets under intense pressure. The exchange rate fell to a low of F285/euro (Figure 2). It has since appreciated and its volatility has come down (figure below). About one-half of the appreciation reflects renewed bullishness for central European economies (Box 2). The other half, attributable to a more benign view of Hungary, has been helped by the fiscal policy efforts and, in part, by short-term weakness in domestic demand. Domestic weakness has contained import growth, helping currency appreciation.

Markets Have Been Kind to Hungary, 2005-07

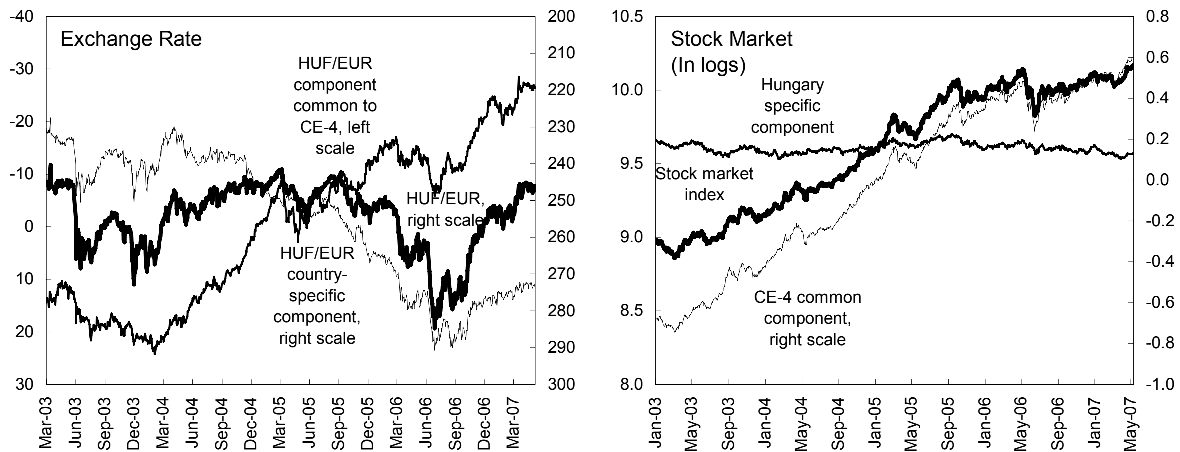


Source: Bloomberg.

Box 2. Regional Influences on Asset Prices

Common regional factors have dominated asset price movements in Hungary, Poland, Czech Republic, the Slovak Republic, and Slovenia (the CE-4).[1/] From its most depreciated level in June 2006, about 55 percent of the forint's 12 percent appreciation reflects the CE-4 common component (table and figure). The 24 percent increase in the stock price index over the same period was overwhelmingly led by positive regional investor sentiment; the Hungary-specific component actually fell after the start of the year (table and figure).

Asset Prices were Strengthened by Forces Beyond Hungary, 2003-07



Sources: Bloomberg; and IMF staff calculations.

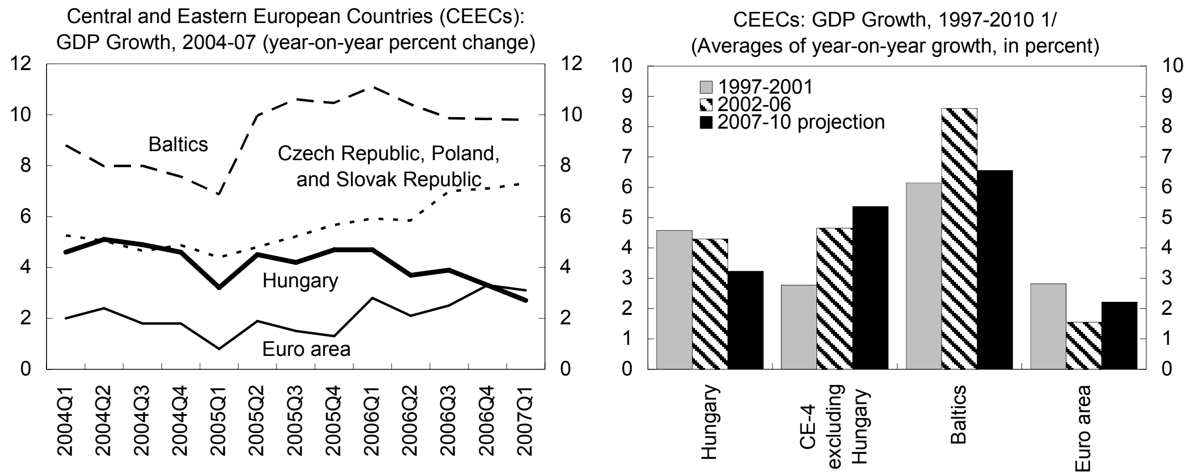
1/ Details of the decomposition methodology are in Country Report No. 06/367.

Contributions of the CE-4 common and Hungary-specific components to growth in asset prices 2/

	June 29, 2006 - Dec 31, 2006			Jan 1, 2007 - May 9, 2007			Jun 29, 2006 - May 9, 2007		
	Common	Specific	Total	Common	Specific	Total	Common	Specific	Total
Exchange rate (HUF/EUR)	-6.5	-5.2	-11.7	-0.8	-0.8	-1.7	-7.3	-5.9	-13.2
Stock price (BUX)	16.2	3.5	19.8	9.6	-5.6	3.9	25.8	-2.1	23.7

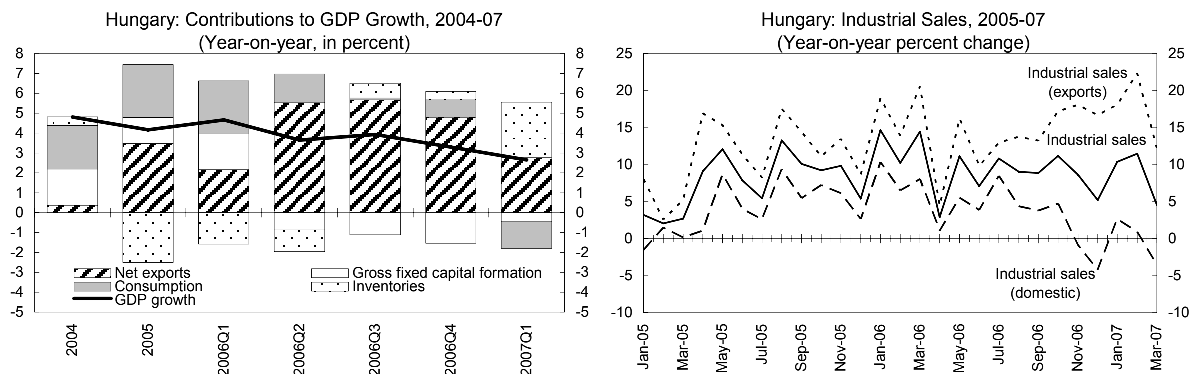
2/ The stock price decomposition is done in logarithms, so the growth in respective components is additive. The exchange rate decomposition is done in levels, and the two components are calculated as contributions to the growth rate.

5. **With crisis risk alleviated, Hungary's growth performance has moved into the spotlight.** GDP growth deteriorated relative to the rest of Europe starting early 2005 (figure below). The divergence was accentuated in 2006, when GDP growth declined to 3.9 percent just when much of Europe accelerated. Since the last quarter of 2006, GDP growth rate, at around 3 percent, has been below that of the euro zone. Hungary risks falling further behind.



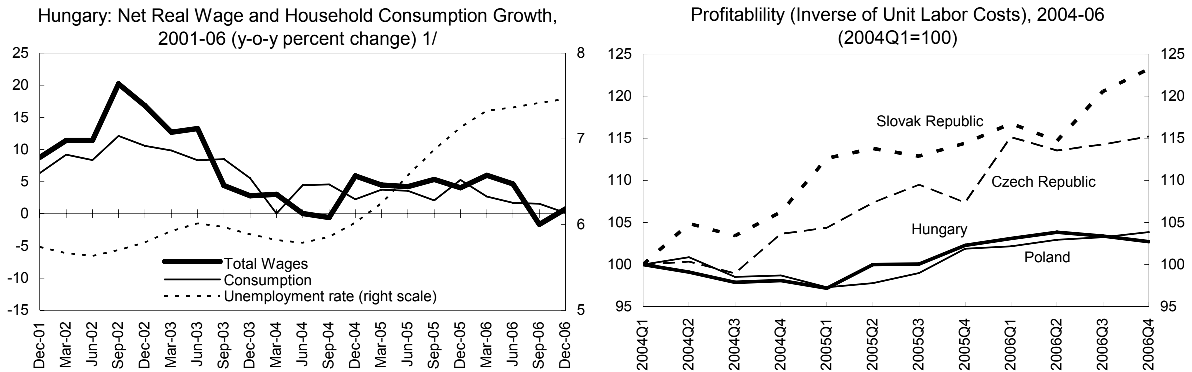
Sources: Eurostat; IMF, World Economic Outlook; and IMF staff calculations.
1/ The CEECs include the Central European 4 (CE-4) and Baltics. The CE-4 comprise the Czech Republic, Hungary, Poland, and the Slovak Republic. The Baltics comprise Estonia, Latvia, and Lithuania.

6. **Consumption growth and, especially, investment have weakened.** Private consumption had started to decelerate even before the announcement of the fiscal consolidation package, with soft employment conditions and moderating net real wages in early 2006 (figure below). Since then, the higher taxes and regulated prices have further dampened consumption growth (figure below). The investment decline since the second quarter of 2006 also predates the fiscal package. In the absence of direct profitability estimates, proximate measures suggest a fall in Hungarian relative profitability (figure below).[2] The gross national investment fell to 23 percent of GDP in 2006, while outward FDI increased to 2.7 percent of GDP (Figure 1 and Table 1).



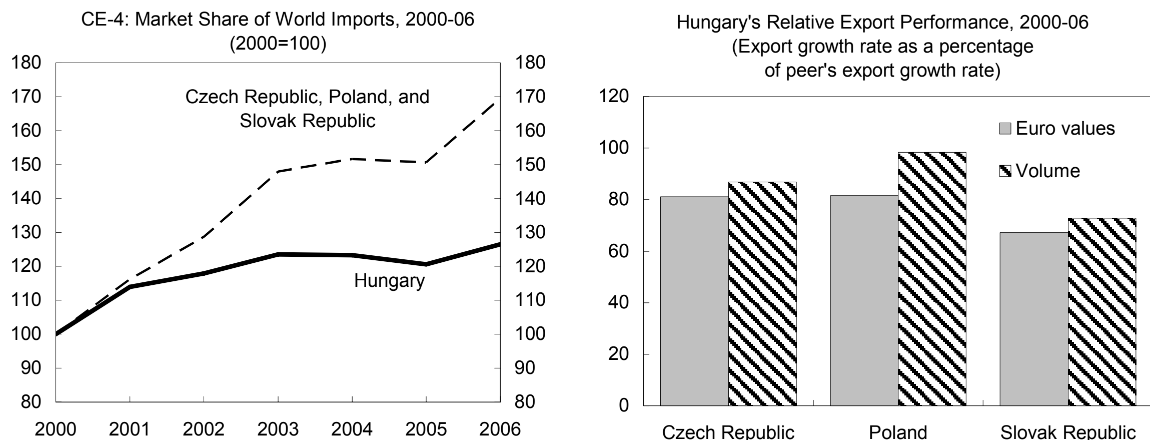
Sources: Hungarian Central Statistical Office; and IMF staff calculations.

[2] Almost 2 percent of the enterprises went into liquidation in 2006 against a prior high rate of 1.8 percent in 2003. The absence of Hungary-specific forces in stock market indices also indicates weak investment sentiment.



Sources: Hungarian Central Statistical Office; and IMF staff calculations.
1/ Wages are net of taxes and bonus payments at the end of the year.

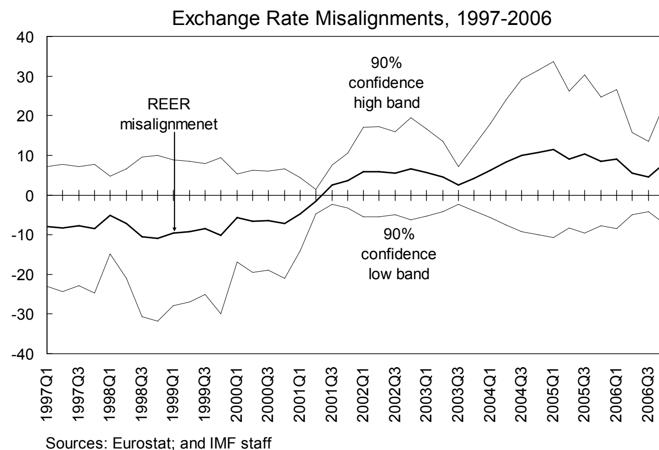
7. **The continued success of exports remains crucial, but the signals on competitiveness are mixed.** Strong export growth in the past three years has been sustained by a shift from European and U.S. markets to fast-growing emerging markets (Figure 3). However, Hungary has underperformed relative to the other CE-4 over 2000-06, especially in the value of exports (figure below). The technological upgrading of exports has slowed (Figure 3), and Hungary's share of world markets has stabilized (figure below). The unit labor cost-based real exchange rate depreciated with the nominal exchange rate in mid-2006 (Figure 3), and has appreciated since then. As Box 3 explains, measures of the equilibrium exchange rate are highly uncertain in short periods with significant structural changes. As of end-2006, the trade-weighted exchange rate was possibly overvalued by 8-10 percent. This, however, is not a serious concern, given the buoyant external environment.



Sources: IMF, Direction of Trade Statistics; IMF, World Economic Outlook; and IMF staff calculations.

Box 3. Is the Exchange Rate Overvalued? Maybe

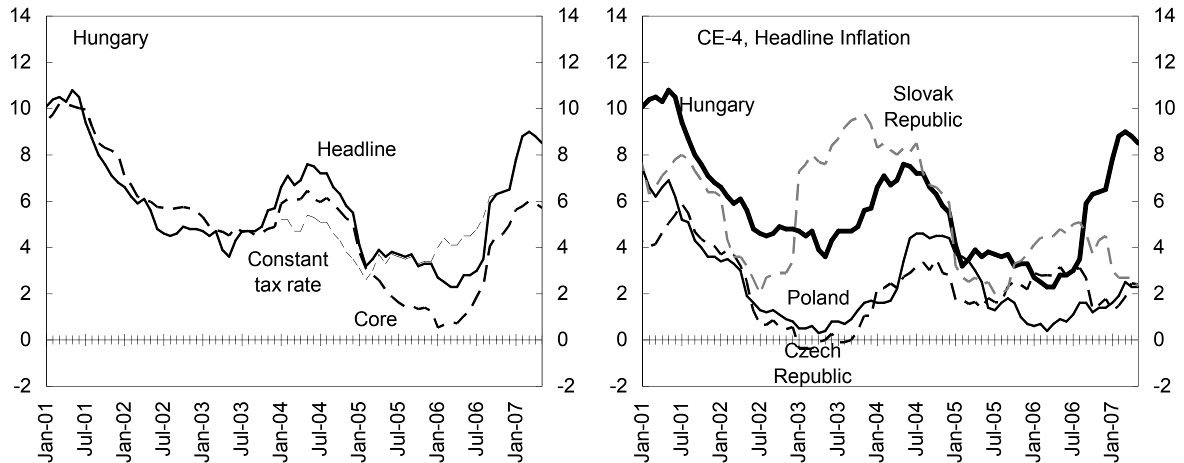
Between the mid-1990s and now, Hungary seems to have been in two regimes. Before 2002, larger external financial liabilities were associated with a depreciated equilibrium exchange rate, necessary to repay the liabilities. If that environment had continued, Hungary's exchange rate at end-2006 would have been about 8 percent overvalued, though with considerable statistical uncertainty (figure).[1/] The prospect of and subsequent entry into the European Union allowed the equilibrium exchange rate to appreciate even as external liabilities increased. If this improved market access persists, then there may currently be no overvaluation.



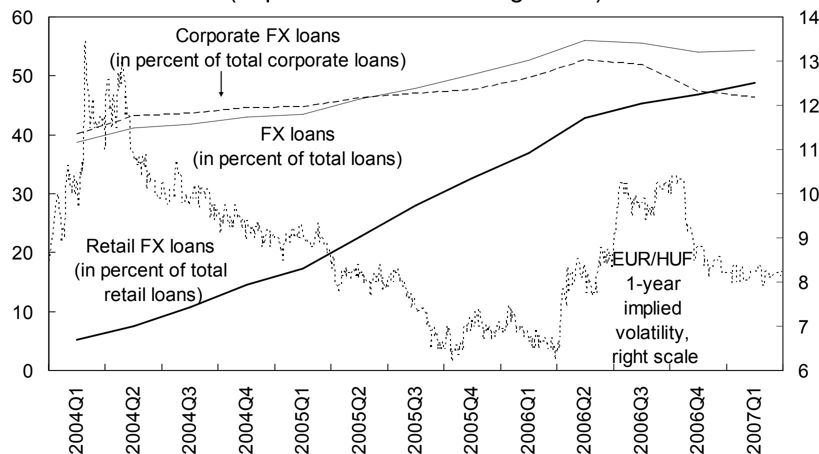
Sources: Eurostat; and IMF staff

1/ The methodology is detailed in Country Report No. 04/146.

8. **The inflation surge in 2006 was primarily due to one-off factors.** In 2006, average headline and core inflation were 3.9 and 2.3 percent, respectively (figure below). Inflation rates were headed down in early 2006, with year-on-year headline inflation reaching a low of 2.7 percent in the second quarter. However, the hikes in indirect tax rates and regulated prices to support fiscal consolidation pushed the headline inflation rate up to 6.5 percent in the last quarter. After reaching 9 percent in March 2007, inflation fell to 8.5 percent in May.



9. **Bank lending—especially in foreign currencies—has decelerated with weakening domestic demand.** Corporate borrowing actually fell in the first quarter of 2007 with a sharp decline in foreign currency-denominated borrowing (table and figure below). The heightened exchange rate volatility in mid- and late-2006 may have helped reduce the demand for foreign currency-denominated loans (figure below). Households, however, continued to borrow in foreign currencies. The share of foreign currency loans stabilized in the second half of 2006 at about 54 percent of all loans.



Hungary: Contributions of Forint and Foreign Currency Loans to Loan Growth, 2005–07 1/
(In percent, quarter on quarter)

	2005Q4	2006Q1	2006Q2	2006Q3	2006Q4	2007Q1
Growth in total loans	7.2	2.5	4.2	5.9	4.7	2.1
Contribution of FX loans	5.0	3.0	4.4	4.1	2.3	1.9
Contribution of forint loans	2.2	-0.5	-0.2	1.8	2.4	0.2
Growth in total corporate loans	7.3	1.2	2.2	5.1	2.7	0.1
Contribution of FX corporate loans	4.0	1.7	2.6	2.5	-1.2	-0.4
Contribution of forint loans	3.3	-0.5	-0.3	2.6	3.9	0.5
Growth in total household loans	7.1	4.5	7.3	7.1	7.6	5.0
Contribution of FX retail loans	6.6	5.0	7.2	6.5	7.3	5.2
Contribution of forint loans	0.5	-0.5	0.1	0.7	0.3	-0.2

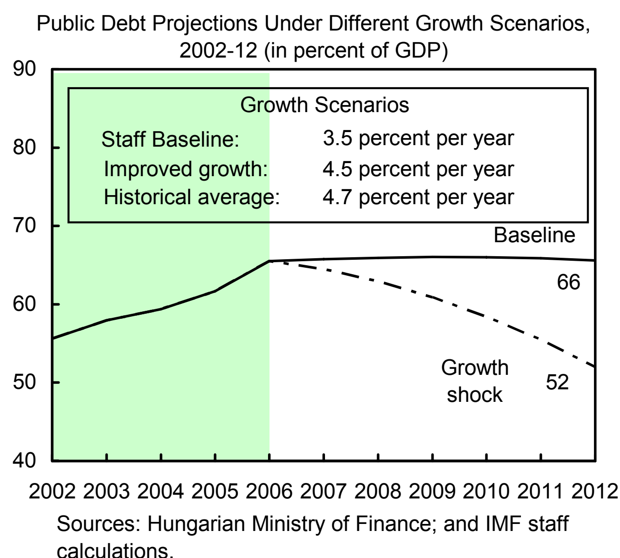
Sources: Magyar Nemzeti Bank; and IMF staff calculations.

1/ Adjusted for valuation effect of exchange rates movements on foreign exchange loans.

III. Policy Discussion

10. **The authorities are focused on establishing a sustainable fiscal outlook, crucial to maintaining stability and promoting growth.** Dealing with the still formidable fiscal challenges remains the central policy task. Reduction of the sizeable public debt requires dealing directly with the fiscal balance but also stepping-up the growth rate. If the growth rate were a percentage point higher, the public debt-to-GDP ratio would decline rapidly (figure). However, growth itself is stymied by fiscal imbalances: recent academic studies caution that large fiscal deficits, high public debt, and fiscal uncertainty (table below), which have been endemic in Hungary, can dampen growth.[3] The authorities recognize that fiscal stability will also help create greater predictability in monetary policy, which can further benefit from adjustments to the practice of inflation targeting. In addition, discussions dealt with measures to ensure banking sector soundness during the ongoing downturn and acceleration of structural reforms.

Public Debt Projections Under Different Growth Scenarios, 2002-12 (in percent of GDP)



Sources: Hungarian Ministry of Finance; and IMF staff calculations.

[3] Christopher Adams and David Bevan, "Fiscal Deficits and Growth in Developing Countries," 2005, *Journal of Public Economics*, Vol. 89, pp. 571-97.

Fiscal Uncertainty in the New Member States of the European Union, 2002–06

	Average Divergence 1/	Average Absolute Divergence 1/	Standard Deviation Around Target 2/
Czech Republic	1.3	1.5	1.7
Estonia	2.1	2.1	2.3
Hungary	**-3.1**	**3.1**	**3.2**
Latvia	0.8	1.3	1.4
Lithuania	0.9	1.0	1.2
Poland	-0.4	1.4	1.8
Slovak Republic	0.5	1.4	1.5
Slovenia	-0.5	0.8	1.0

Sources: Eurostat; Pre-Accession Economic Programs; Convergence Reports; and IMF staff calculations.

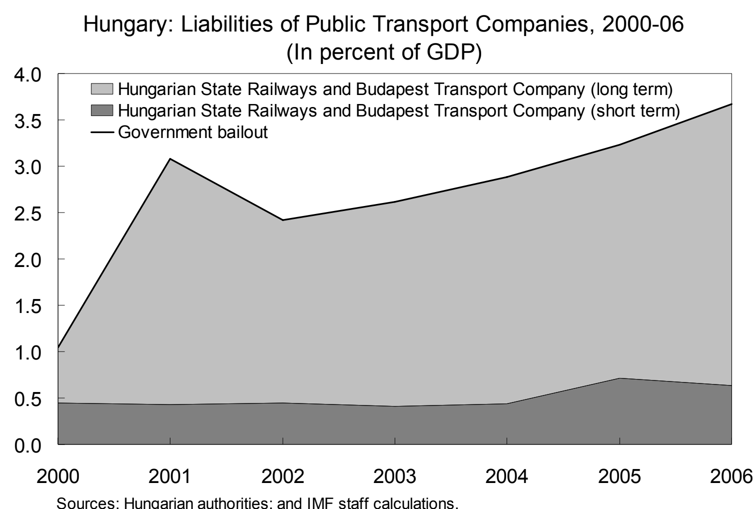
1/ Defined as the difference between actual outcome and target for the general government budget.

2/ Defined as squared absolute divergence divided by five (years).

A. Outlook and Risks

11. **The authorities were pleased that market pressures had subsided, but staff cautioned that the risks remain significant.** The fiscal deficit is on a downward trend but, besides short-term uncertainties, measures for a further reduction of the deficit beyond 2008 have not yet been outlined. On current policies, staff projects the 2009 deficit to be 4 percentof GDP, while the authorities are expecting it to be 3¼ percent of GDP. The task ahead remains formidable also because of the government's contingent liabilities arising from loss-making public enterprises (figure below) and increasing pressures from age-related expenditures (table below).[4] Public debt is expected to remain at about 66 percent of GDP for the next few years (Table 5 and Figure 4).

Hungary: Liabilities of Public Transport Companies, 2000-06
(In percent of GDP)



Sources: Hungarian authorities; and IMF staff calculations.

[4] A selected issues paper discusses fiscal risks from public transport companies.

Pension-Related Public Expenditure in the New Member States
(in percent of GDP)

	Estimates by European Commission (2006)			Estimates by Standard and Poor's (2006)		
		Change from 2004 to:			Change from 2005 to:	
	2004	2030	2050	2005	2030	2050
Hungary	10.4	3.1	6.7	10.7	2.8	6.4
Czech Republic	8.5	1.1	5.5	8.5	1.1	5.5
Estonia	6.7	-1.9	-2.5	7.1	0.8	1.8
Latvia	6.8	-1.2	-1.2	6.4	0.8	1.8
Lithuania	6.7	1.2	1.8	6.7	1.2	1.9
Poland	13.9	-4.7	-5.9	13.7	1.0	0.0
Slovak Republic	7.2	0.5	1.8	7.4	0.3	1.6
Slovenia	11.0	3.4	7.3	11.0	3.7	8.3
EU8	8.9	0.2	1.7	8.9	1.5	3.4
EU12	11.5	1.6	2.6	10.6	3.0	4.7

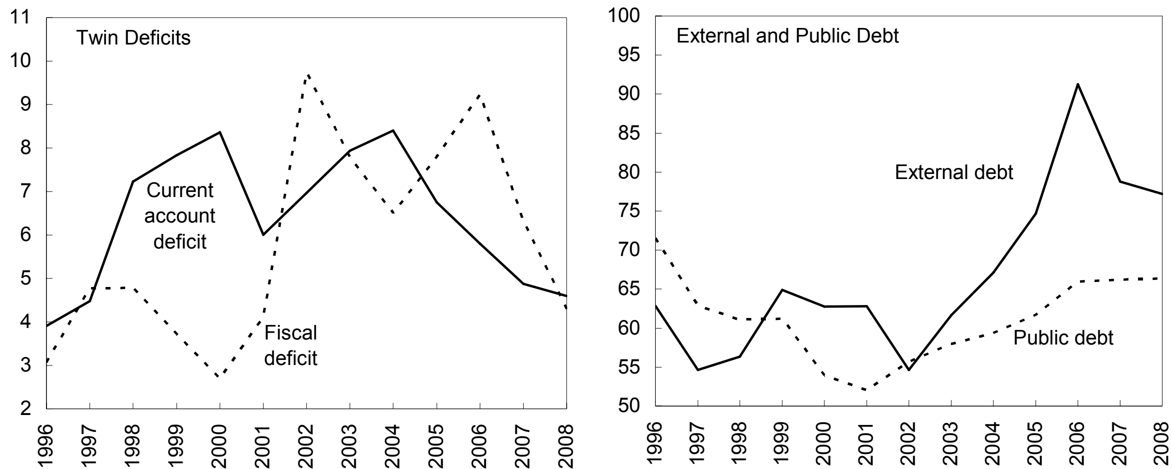
Sources: European Commission (2006); and Standard and Poor's (2006).

12. **External vulnerabilities also remain worrisome.** The current account deficit is expected to fall, with the staff and Magyar Nemzeti Bank (MNB) projecting about 5 percent of GDP in 2007 and the Ministry of Finance (MoF) projecting an even lower deficit. However, the financing requirement remains uncertain on account of the unclear causes of the net errors and omissions and could remain 2-3 percentage points higher than the current account deficit. The external debt-to-GDP ratio is expected to decline in 2007 to about 79 percent because of the forint's appreciation relative to 2006 (figure below, Figure 5, and Table 6).[5] However, policy slippages and deterioration in international market sentiment could weaken the forint, raising the debt ratio.[6] The ratio of reserves to external short-term debt of about 100 percent provides a good short-term buffer.

[5] A 3 percent appreciation of the forint is assumed in 2007.

[6] A 10 percent nominal depreciation would raise the debt-to-GDP ratio by about 10 percentage points.

Hungary: Public and External Deficits and Debt, 1996-2008
(In percent of GDP)



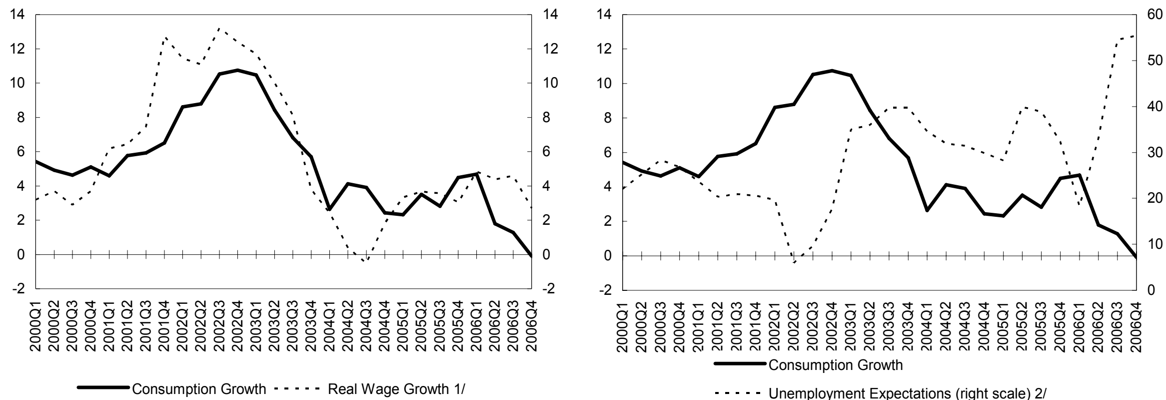
Sources: Magyar Nemzeti Bank; Hungarian Ministry of Finance; and IMF staff projections.

13. **A strong growth recovery after the ongoing fiscal adjustment is not assured.** GDP growth is projected to fall to 2.7 percent in 2007 (Table 4). The recent increase in unemployment expectations is likely to keep consumption growth low (figure below). Recent investment trends have not been favorable, and the virtual standstill in corporate borrowing implies that investment is likely to remain weak. The weakness in investment could prove self-reinforcing in the current policy context.[7] The MoF takes the view that Hungary is in a temporary adjustment phase, and growth, consistent with a potential rate of between 4 and 5 percent a year, will resume once this phase is over. However, the MNB's view is closer to that of staff. Together with the deceleration in GDP growth since early 2005, recent developments suggest that growth may stay in a range of 3-3½ percent a year over the next few years. Absent vigorous policy efforts, recovery to 4 percent growth may well occur only gradually.

14. **The MNB projects inflation to decline to within the 3 ±1 percent target range in the 18-month forecasting horizon**. The MoF emphasized that recent wage increases partly reflect advances in bonus payments and higher reported earnings because of stronger tax compliance. The MNB, however, expressed concern that the currently high inflation could persist in the short term if negotiated wages were to compensate for higher prices. Staff noted that there is yet no clear evidence of labor market tightening. Given its flexibility, the labor market is unlikely to create inflationary pressures. Also, as discussed below, following the introduction of inflation targeting, inflation persistence has declined.

[7] A selected issues paper suggests that negative economic shocks in Hungary cannot be presumed to self-correct and will persist without policy initiatives to reverse them.

Determinants of Consumption Growth



1/ Annual percent change in gross real wage.
2/ Consumers' expectations about unemployment in the next 12 months indicates the difference, in percentage points, between the percent of survey responders who expect unemployment rate to increase and those who expect it to decrease in the next 12 months.

Ordinary Least Squares estimates, 1999Q2—2006Q4, with Newey-West standard errors, ** (+) implies significance at 1 percent (10 percent).

	Constant	Consumption growth $_{t-1}$	Consumption growth $_{t-2}$	Real wage growth $_{t-1}$	Unemployment expectations$_t$	R^2
Estimates	3.47**	0.36+	0.13	0.27**	-0.08**	0.89
(Standard errors)	(0.70)	(0.15)	(0.15)	(0.05)	(0.02)	

B. Public Finances

15. **The 2007 and 2008 fiscal deficit targets are within reach, but risks need attention.** The government has lowered its 2007 fiscal deficit forecast from 6.8 to 6.6 percent of GDP, while staff projects a deficit closer to 6¼ percent of GDP, given the faster than promised consolidation in 2006 and continued strong revenues (table below and Table 2). Staff emphasized that if revenues overperform, the authorities should aim at further lowering the deficit. For 2008, the authorities' deficit target of 4.3 percent of GDP appears within reach with the expenditure measures in the pipeline and the expiration of certain one-off obligations. Upside risks are related to the future of wage freezes and the unclear nature of certain expenditure overruns in 2006 (worth about ¾ percent of GDP).

Key Fiscal Indicators, 2007-10
(In percent of GDP)

	2007	2008	2009	2010
	Projections			
Fiscal Deficit (ESA 95)				
Convergence Program	6.8	4.3	3.2	2.7
Authorities' revised targets	6.6	4.3	3.2	2.7
Staff's Projections	6.3	4.3	4.0	4.0
Public Debt				
Convergence Program	70.1	71.3	69.3	67.5
Authorities' revised targets	66.2	66.3	…	…
Staff's Projections	65.8	65.9	66.0	66.0

Sources: Hungarian authorities; and IMF staff estimates.

16. **Staff congratulated the authorities on tangible expenditure measures, and the discussions centered on consolidation needs beyond the CP targets.** Important measures have been taken including in reducing public employment, instituting co-payments by patients, rationalizing hospital beds, and scaling back pharmaceutical subsidies (Table 7).[8] However, the authorities recognize that continued consolidation beyond the targets set in the CP is needed. Even if the CP is fully implemented, the sizable 2009 fiscal deficit, the high public debt-to-GDP ratio, and a large government and tax wedge would continue to undermine stability and growth. Staff pressed for further action now, since reforms would bring savings only over time. Continued consolidation in 2009 and beyond—relying on durable expenditure restraint and broadening of the tax base—would put the debt-to-GDP ratio on a sustainable downward trend, raise potential growth, and help adopt the euro early in the next decade.

17. **Implicit in the ongoing debate on fiscal reform is the future role of the state in delivering public services and social security.** The authorities and staff agreed that much can be gained from greater efficiency and better targeting of expenditures (table below). The more far-reaching measures being contemplated require that the goal of solidarity—or shared commitment—be preserved in the context of greater private responsibility. Staff suggested that a benchmark would be to achieve an expenditure-to-GDP ratio of between 40 and 45 percent from the current 53 percent (figure below). The authorities saw value in such a benchmark but noted that it was not yet a focal point of the reform strategy.

[8] The Health Insurance Fund posted a surplus in March.

Efficiency in Public Education Spending in the New Member States 1/

	Country Rankings			
	Primary education 2/	Secondary education 3/	PISA test scores	Tertiary education 4/
Bulgaria	19	7	...	33
Czech Republic	17	29	15	29
Estonia	22	15	...	15
Hungary	**27**	**8**	**20**	**21**
Latvia	28	13	13	11
Lithuania	11	1	...	9
Poland	24	4	10	23
Romania	23	10	...	31
Slovak Republic	13	16	5	34
Slovenia	12	19	...	7
NMS-10 average	20	12	13	21
EU-15 average	16	20	15	15
Sample size 7/	36	36	27	35

Source: IMF staff calculations

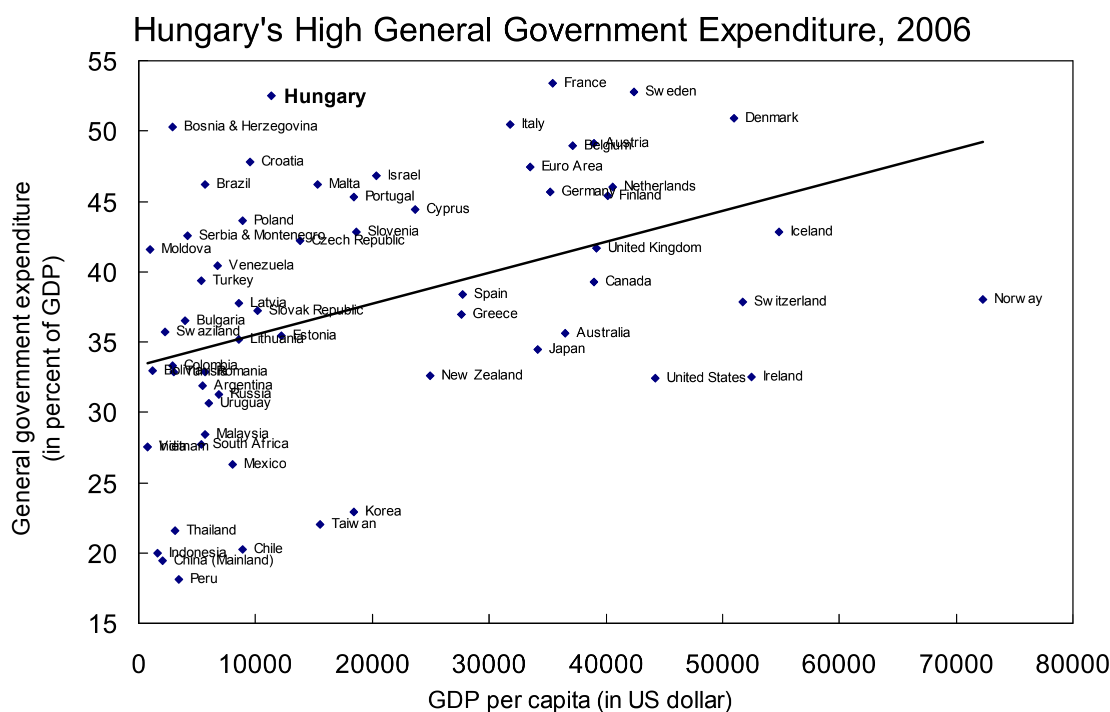
1/ Country rankings of spending efficiency using Data Envelope Analysis with rank 1 representing the country with the highest efficiency (see Clements, Faircloth, and Verhoeven, 2007, "Spending in Latin America: Trends and Key Issues," IMF Working Paper 07/21). The rankings reflect the extent to which countries can improve outcomes in education by enhancing efficiency based on the maximum efficiency achieved by other countries in the sample. The rankings should be interpreted with caution and reflect policy and government factors, as well as environment variables outside the control of policy makers.

2/ Based on primary expenditure efficiency in producing primary enrollment, primary pupil-teacher ratio, primary completion rates, and advancement to secondary.

3/ Based on secondary expenditure efficiency in producing secondary enrollment, and upper secondary graduation rates.

4/ Based on tertiary expenditure efficiency in producing tertiary enrollment.

5/ Sample includes OECD and NMS-13 countries.



Sources: IMF, World Economic Outlook (Winter 2007); and IMF staff calculations.

18. **The authorities described the scope for broader changes, but emphasized political limitations.** In health care, the policy debates have focused on competition in the

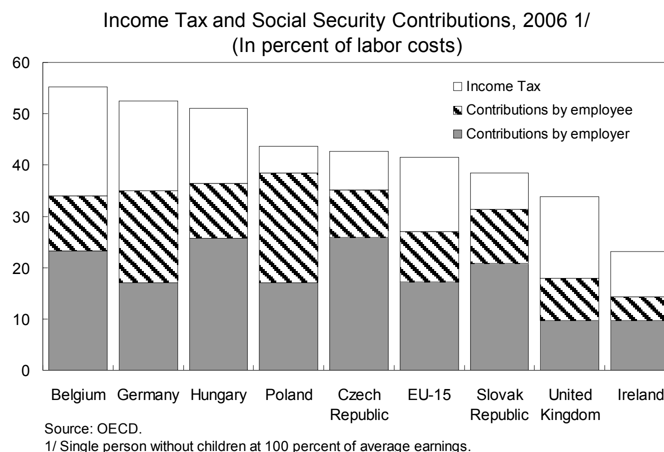
supply of health insurance. Staff argued for a broader discussion on competition in health services' provision. The restructuring and corporate governance of hospitals are, therefore, crucial to further progress. The authorities noted that such reforms were politically difficult, given needed parliamentary support for constitutional changes. Reforms of subsidies and of disability and early retirement pensions, reductions in the replacement rate of pensions for new retirees, and restructuring of central public administration are under way (Table 7). Under discussion are the changes to indexation of pension benefits and a gradual increase in the retirement age, which are crucial to improve the long-term sustainability of public finances. Also under discussion are more far-reaching reforms of pensions and education through the consensus-seeking "roundtables." Staff welcomed these proposals and encouraged their early implementation. Reforms of budget support to families, housing subsidies, and, importantly, local governments are not in the authorities' plans, but remain key for efficiency and equity.

19. **The authorities are exploring the scope for improving the tax system while maintaining revenue neutrality.** They agreed with staff that tax reform should not endanger the fiscal adjustment path and aim, for now, to increase efficiency, fairness, and stability. Staff welcomed efforts to institute a property tax but noted the importance of early measures to establish a property registry based on market valuation and simple rate structures. Based on recent technical assistance by the Fund, staff highlighted other priorities, including streamlining the personal income tax (while maintaining the principle of progressivity) and broadening the base of the corporate income tax by phasing out exemptions and simplifying deductions. Given the importance of raising employment rates (table below), and bearing revenue objectives in mind, a measured reduction in high labor tax costs (figure below) could be achieved in tandem with benefit consolidation. Also, consumption taxes may need to be increased to reduce labor taxes. These efforts could be a prelude to reducing the tax wedge once the fiscal space has been created through expenditure rationalization.

Labor Force Participation and Employment Rates, 2006

	Labor Force Participation Rate Ages 15 to 64	Employment Rate Ages 15 to 64
Hungary	**62.0**	**57.3**
Poland	63.4	54.5
Lithuania	67.4	63.6
Slovak Republic	68.6	59.4
Czech Republic	70.3	65.3
Slovenia	70.9	66.6
Latvia	71.3	66.3
Estonia	72.4	68.1
CEEC average	68.3	62.6
EU-15 average	72.3	67.4

Source: Eurostat.



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

20. **The authorities intend to institute stronger defenses against fiscal indiscipline.** They are considering implementing new fiscal rules, a medium-term expenditure targeting framework, and stricter budget monitoring.[9] Absent concerted leadership to establish self-discipline, Hungary could be stuck in a loop of high deficits and debt with weak and opaque budgetary processes.[10] Staff also emphasized that the new fiscal rules should be suitably ambitious to place public debt on a sustainable downward path. Appropriately sequenced complementary reforms in public financial management systems and budget processes (an area on ongoing technical assistance by the Fund) are also needed to credibly deliver on fiscal goals. Also, strengthening the external scrutiny of fiscal policy by an independent council would promote transparency and accountability. Staff was encouraged by the authorities' consideration of such reform.

C. Monetary and Exchange Rate Policies

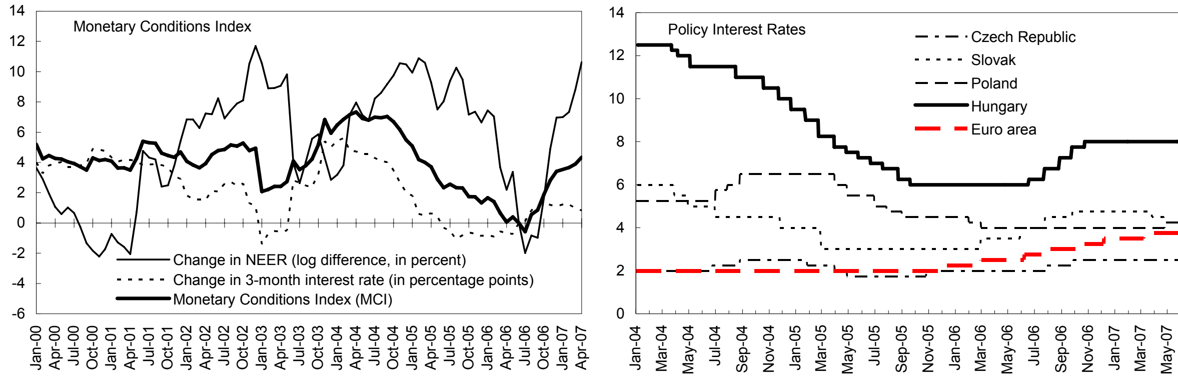
21. **With inflation projected to decline, the authorities and staff agreed that an easing interest rate cycle could commence once inflation has turned.** Market participants are beginning to anticipate policy rate reductions. Factors favoring a rate cut include tighter monetary conditions (figure below), the economic slowdown, and no evident signs of inflation being embedded in wage contracts. The inflation rate has fallen slowly but steadily since March, indicating the possibility that inflation may have peaked. Short-term (month-on-month) inflation trends indicate that the effects of the fiscal measures have decayed (figure below). These developments are consistent with the evidence that inflation persistence to shocks has declined over time (Box 4). Nevertheless, MNB is not yet persuaded that inflation persistence can be ruled out in the current circumstances. In

[9] New regulations on public-private partnerships now allow the MoF to exercise veto power over projects that are not fiscally affordable or do not deliver value for money.

[10] A selected issues paper discusses the European evidence.

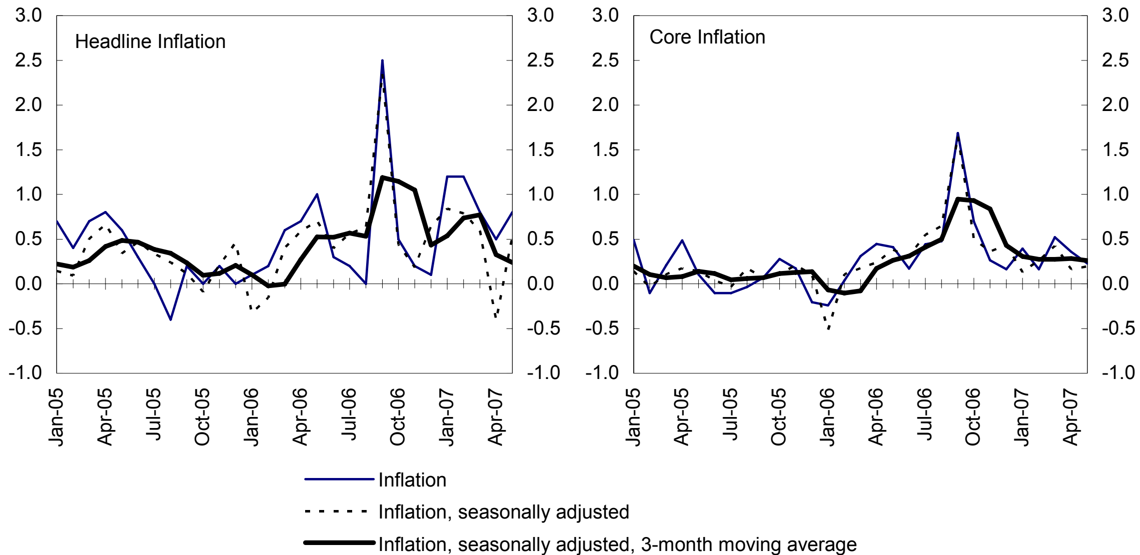
particular, they read the wage data as giving ambiguous signals. Staff is somewhat less concerned about wage pressures than is the MNB, but agreed that caution is justified.

Monetary Conditions, 2000-07 1/



Sources: Magyar Nemzeti Bank; and Bloomberg.
1/ The monetary conditions index is calculated by taking a weighted sum of the interest rate change and NEER change with a weight of one and one-third respectively. The changes are calculated from a base date of June 2006. An increase in the NEER implies an appreciation.

Hungary: Short-term Inflation Dynamics, 2005-07
(Month-on-month percent change)



Sources: Magyar Nemzeti Bank; and IMF staff calculations.

Box 4. How Persistent Are Inflation Shocks?

Following the adoption of inflation targeting in mid-2001, Hungary's inflation persistence has declined considerably (table). Using monthly consumer price data, a vector autoregression of inflation with four lags is estimated. "Persistence" is measured as the half life of a shock, i.e. the number of months for a one-unit inflation impulse to subside to half its value. A lower half-life reduces concerns about temporary shifts in inflation.

Inflation Persistence: Half-life (in months)

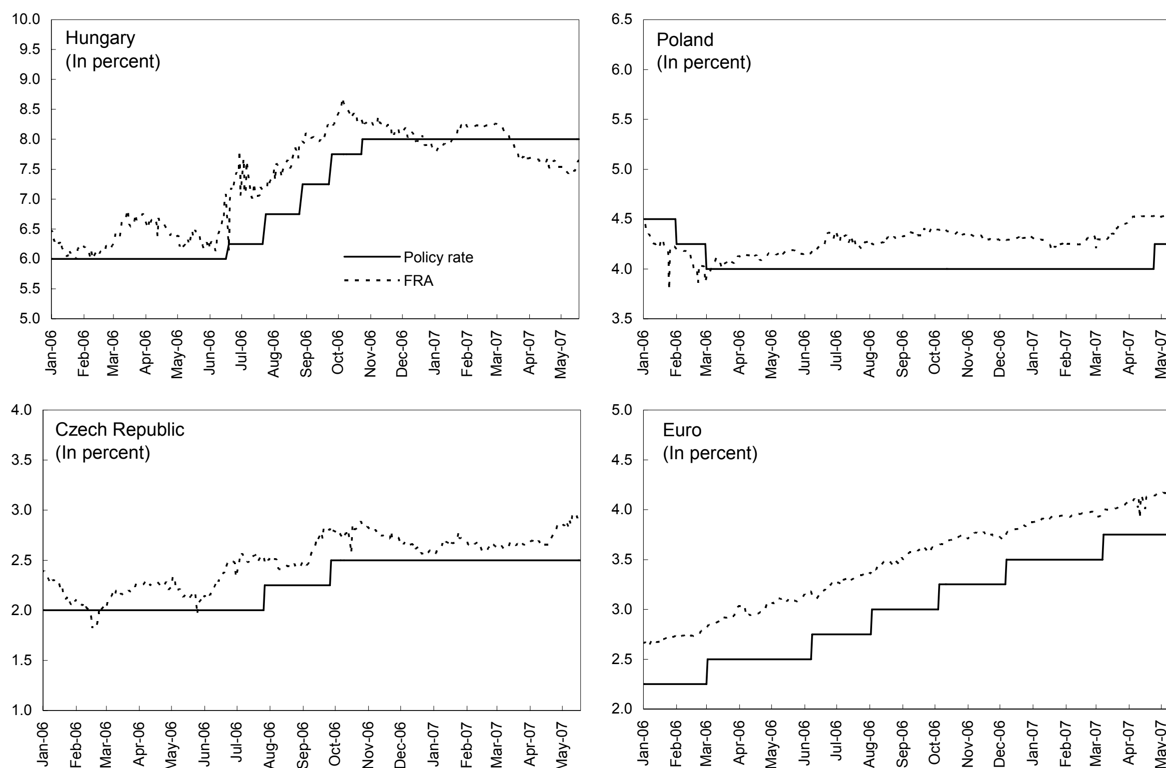
	Jan 1996-Jun 2001	Jul 2001-Dec 2006
Hungary	30	9
Czech Republic	20	9
Poland	37	12
Slovak Republic	10	12

Sources: Eurostat; and IMF staff calculations.

22. **Once an easing cycle commences, and if inflation expectations permit, there may be room for sizeable interest rate reduction.** In June 2006, the policy rate was 6 percent with moderating inflation; the rate was then hiked to 8 percent in response to accelerating inflation. Forward rates now suggest that markets expect Hungarian policy rates to decline, as rates rise in the region (figure below). This convergence, in staff's view, will encourage borrowing in forints and, hence, render monetary policy more relevant and effective. The authorities expect that greater reliance on statements of policy inclinations could partially substitute for the sharp changes in policy rates; and the effectiveness of the inflation targeting framework would be helped by endogenous interest rate forecasting—projecting an interest rate path consistent with the desired changes in inflation.

23. **With euro adoption some years away, staff reiterated the recommendation of moving to a floating rate regime.** Even though the exchange rate band is wide (±15 percent), it has occasionally constrained policymaking. Also, markets can have received unclear signals about whether rate decisions are oriented toward inflation targets or exchange rate bands. From a risk-management perspective, therefore, eliminating the band would be desirable. Hungary possesses the necessary prerequisites—a well-functioning foreign exchange interbank market and a credible monetary policy framework—for such a move. The authorities, however, remain unpersuaded owing to fears of short-term appreciation of the currency. While such a risk does exist, a more medium-term perspective should guide the decision and its timing.

Policy Rates and Forward Rate Agreements, 2006-07 1/



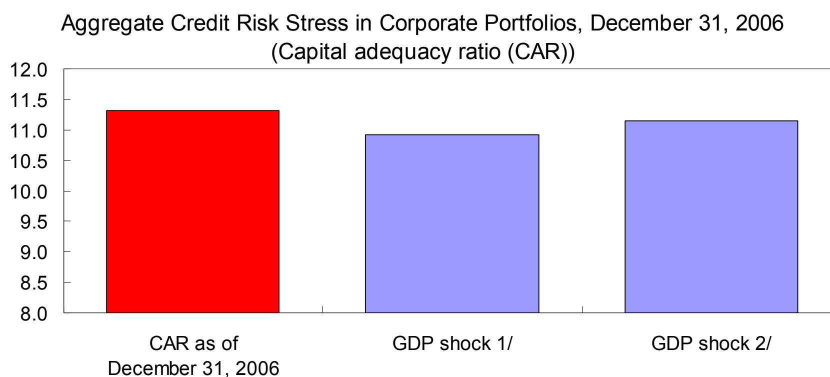
Source: Bloomberg.
1/ The forward rate agreement (FRA) are over the counter interest rate agreements for the 3 month interest rate, 2 months in the future. FRA's are used as a leading indicator of future monetary policy decisions.

D. Financial Sector

24. **The authorities and staff agreed that key trends in the banking sector need close monitoring.** First, with intense competition, banks are financing riskier activities (Figure 6). Moreover, bankruptcies and liquidations are up, and the macroeconomic adjustment could further strain parts of the banking system. Second, though the share of foreign currency loans extended by banks stabilized in the second half of 2006, the unhedged exposure of households to foreign currency loans has continued to rise, creating credit risks for banks. Finally, to fund credit growth, banks are relying on foreign interbank deposits and debt securities, some of which are subject to greater liquidity risks than traditional deposits.

25. **However, banks have significant financial buffers, and the supervisory authority has responded appropriately to cautionary signals.** The capital adequacy ratio remains at a relatively healthy 11 percent (Table 8). Profitability is high, although it could come under pressure with higher funding costs and decreasing interest margins. The MNB's aggregate stress tests indicate that the banking sector is resilient to GDP shocks (figure below). The Hungarian Financial Supervisory Authority (HFSA) has started conducting bottom-up market-risk stress tests, which have been used to induce higher capitalization and

strengthened risk management practices. The banks themselves are lengthening the maturity of foreign funds and extending more variable-rate long-term loans, which mitigates interest risk (though may raise credit risk). The HFSA and MNB are planning needed collaboration on credit risk stress tests. The authorities expect that Basel II rules will be in place by January 2008.



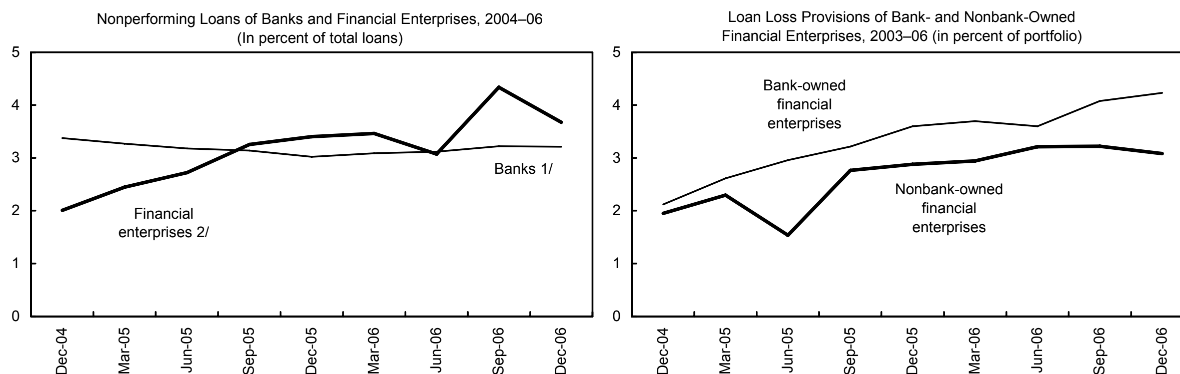
Sources: Magyar Nemzeti Bank; and IMF staff calculations.
Impact on CAR on a one-year horizon within industry-specific model (for model description, see Magyar Nemzeti Bank's Report of Financial Stability April 2007).
1/ A negative shock that reduces the difference between output and its potential level by 2 percentage points in 2 consecutive quarters.
2/ A negative shock that reduces the difference between output and its potential level by 1 percentage point in 2 consecutive quarters.

26. **Among new challenges is the rapid growth of the non-bank financial sector.** "Non-bank" financial intermediaries, especially investment and pension funds, have grown in importance (table). Their distressed loans have grown faster than those of banks (figure below). Moreover, within the non-bank sector, those belonging to banking groups have had to provision at a higher rate. While diversification benefits deserve to be preserved, concentration risks and regulatory arbitrage are a concern. The authorities recognize that risk-based consolidated supervision across financial institutions will need to keep pace with these developments.

Structure of Financial Sector, 2003–06
(In percent of total assets in intermediation)

	2003	2004	2005	2006
Banks 1/	71.8	69.7	67.2	67.1
Investment funds 2/	6.7	6.4	8.5	9.6
Leasing companies 3/	6.4	7.1	7.1	6.6
Insurance companies	5.5	6.1	6.0	5.8
Pension funds	5.1	6.1	6.7	6.9
Cooperative credit institutions	4.5	4.6	4.5	4.0
Total assets in intermediation	100.0	100.0	100.0	100.0
(In percent of GDP)	106	113	129	144

Sources: Hungarian Financial Supervisory Authority; and IMF staff calculations.
1/ Including specialized credit institutions; total assets and assets in management.
2/ Including investment companies; assets in management excluding assets in custody and net asset value at market value for investment companies.
3/ Including health care funds; asset value at market value.



Sources: Magyar Nemzeti Bank; Hungarian Financial Supervisory Authority; and IMF staff calculations.
1/ Include substandard, doubtful, and bad retail. and corporate loans.
2/ Include loans overdue by more than 90 days.

E. Structural Reforms

27. **Hungary, the authorities recognize, may be falling behind regional peers in maintaining its overall business climate.** Within central and eastern Europe, Hungary has been at the lower end of the competitiveness rankings (table below). While the labor market is flexible, the administrative costs of setting up a business are relatively high (Figure 7). Hungarian business indicators are not necessarily becoming worse; other countries have been more proactive in improving business operating conditions. In this context, the government's recent initiative, "In tune with business," takes the right steps, consistent with the OECD's recent Economic Survey. These steps include the simplification of regulatory requirements and public procurement procedures.

International Competitiveness Rankings, 2005-06

	World Economic Forum		International Institute for Management Development		World Bank's "Doing Business"	
	2005	2006	2005	2006	2005	2006
Hungary	**35**	**41**	**37**	**41**	**60**	**66**
Estonia	26	25	26	20	17	17
Lithuania	34	40	...	...	15	16
Latvia	39	36	...	...	31	24
Slovenia	30	33	52	45	56	61
Slovak Republic	36	37	40	39	34	36
Poland	43	48	57	58	74	75
Czech Republic	29	29	36	31	50	52
United Kingdom	9	10	22	21	5	6
Chile	27	27	19	24	24	28
Korea	19	24	29	38	23	23

Sources: World Economic Forum; International Institute for Management Development; and World Bank.

28. **Following rapid absorption of EU funds, their effective deployment would help raise productivity and growth.** Expenditures financed from the EU budget are to reach 2.7 percent of GDP this year and almost 5 percent of GDP during 2011–13 (table below).

Hungary: EU Transfers, 2004-13
(National fiscal methodology)

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
					(in billions of forints)					
EU refundable spending:	114	402	454	690	877	1,087	1,306	1,546	1,687	1,764
Budget items	92	204	310	465	626	802	986	1,193	1,297	1,336
Off-budget items	22	199	143	226	251	285	320	353	390	428
Contribution to the EU budget	120	187	186	192	232	223	241	241	257	261
National co-financing	35	89	168	166	185	203	207	226	246	253
Memorandum item: GDP in HUF million 1/	20,712	22,027	23,640	25,300	26,580	28,520	30,600	32,832	35,226	37,795
					(in percent of GDP)					
EU refundable spending	0.6	1.8	1.9	2.7	3.3	3.8	4.3	4.7	4.8	4.7
Budget items	0.4	0.9	1.3	1.8	2.4	2.8	3.2	3.6	3.7	3.5
Off-budget items	0.1	0.9	0.6	0.9	0.9	1.0	1.0	1.1	1.1	1.1
Contribution to EU	0.6	0.8	0.8	0.8	0.9	0.8	0.8	0.7	0.7	0.7
National co-financing	0.2	0.4	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7

Sources: Ministry of Finance; and IMF staff estimates.
1/ Convergence Program projections until 2010; a 7.3 percent nominal increase in 2011-13.

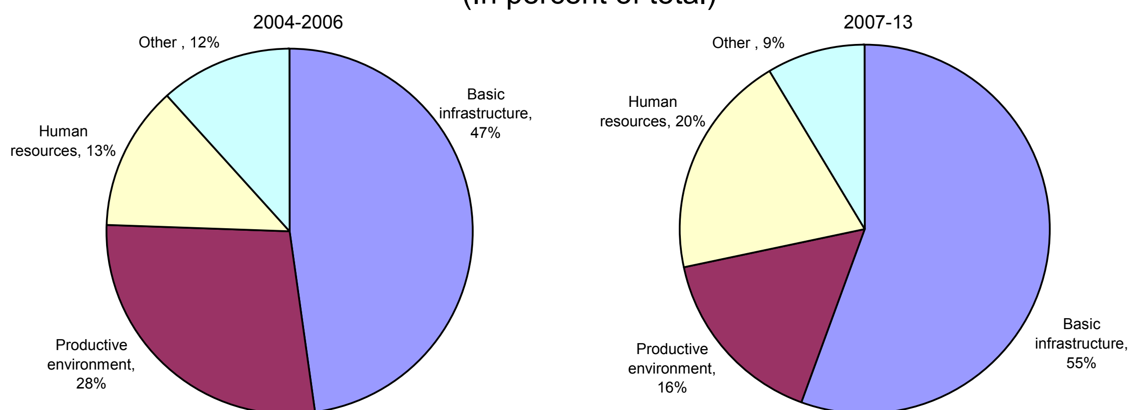
The authorities emphasized the important coordinating role of the National Development Agency, which appears well positioned to organize the utilization of structural and cohesion funds. The spending priorities (figure below) create the possibility of productivity gains through strengthening basic infrastructure, human capital, and the innovation system, an area in which Hungary has ceded its traditional lead in terms of patenting rates (table). The authorities agreed on the importance of coordinating the use of EU money with ongoing structural reforms and on ensuring, especially for private sector development, transparency and competition in the award of grants.

Innovation Trends: Patents Granted per GDP per Capita in Thousands of Euros, 2001-05

	2001	2002	2003	2004	2005
Czech Republic	1.2	1.8	2.3	2.9	2.7
Estonia	0.4	0.2	0.3	0.1	0.4
Hungary	4.4	6.6	8.4	4.7	3.6
Latvia	0.0	0.5	0.2	0.0	0.0
Lithuania	0.0	0.0	0.2	0.0	0.2
Poland	1.3	1.8	2.4	2.6	2.3
Slovak	3.4	1.2	1.5	0.5	1.4
Slovenia	0.2	1.3	1.6	1.8	1.7

Sources: European Patent Office; Eurostat; and IMF staff calculations.

Hungary: Shift in Spending Priorities of EU Funds
(In percent of total)



Sources: Hungarian authorities; and IMF staff calculations.

IV. STAFF APPRAISAL

29. **Fiscal credibility has been partially regained with the ongoing consolidation, but vulnerabilities remain**. Markets have responded favorably to the deficit reduction measures. Also, the favorable international financial environment has eased the access to funds. But the still high fiscal and external deficits are likely to keep public and external debt ratios at elevated levels. And market sentiment could reverse, especially if accompanied by negative surprises in fiscal and external accounts.

30. **The spotlight is now on the economic slowdown, which comes on top of earlier signs of weakness, raising the concern of prolonged low growth.** Hungary's growth, which stalled in early 2005, could remain in the 3–3½ percent range in the coming few years. With fiscal consolidation, the decline in consumption growth was expected. Investment weakness predates the fiscal consolidation and appears set to continue as corporate borrowing has slowed sharply. Despite mixed signals on exchange rate valuation, staff does not view the level of the exchange rate as a concern for competitiveness. Rather, competition from economies with lower wage costs and improving business environments poses a threat to foreign direct investment inflows and buoyancy of exports.

31. **Continued actions to retain the confidence of markets will also counteract a low growth trap.** Access to Europe's product, financial, and labor markets has created the foundation for rapid growth with stability, a process from which Hungary has already achieved substantial gains. But realizing the full potential of this opportunity requires continued pursuit of sound public finances and a business environment for firms to operate competitively in the euro zone. It remains imperative to take advantage of the current political window—and of the space provided by the markets' goodwill—to fundamentally reorient fiscal affairs and ensure continued competitiveness.

32. **Alongside ad hoc emergency measures in 2006, initiatives with a long-term view are helping to lower the fiscal deficit**. Contributing to the expected sizeable reduction in the deficit is the strengthened tax administration, the sizing down of public employment, and savings from measures in the health sector. Further measures in the pipeline, relating to disability pensions and early retirement, move in the right direction and should help the consolidation.

33. **However, challenges remain.** Besides short-term risks to the budget, measures for a further reduction of the deficit beyond 2009 have not yet been outlined. The task ahead remains formidable also because of the government's contingent liabilities arising from loss-making public enterprises and pressures from age-related expenditures. Reforms of budget support to families, housing subsidies, and, in particular, local governments have not advanced but remain key for equity and efficiency. A revenue neutral tax reform that simplifies and rebalances from labor and capital to consumption taxes, plus budget rules and procedures that counteract fiscal indiscipline are other major items on the fiscal agenda.

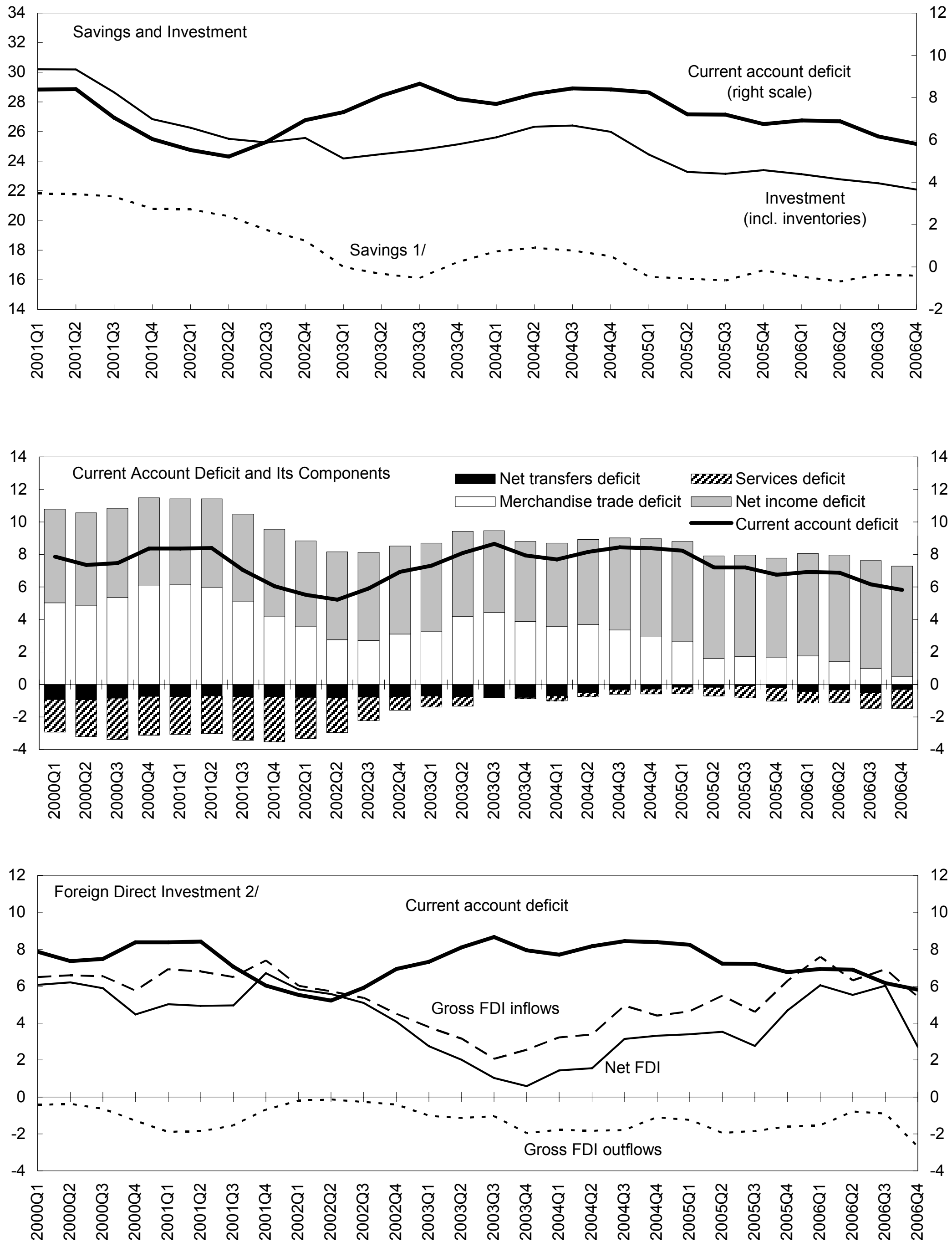
34. **Inflation seems likely to return to the target range over the forecasting horizon, and an easing interest rate cycle can commence once inflation is on a downward trend**. An initial policy rate cut could be followed by further easing if inflation expectations permit. With this gradual approach, the cumulative reduction during the forthcoming easing cycle could bring real short-term rates substantially lower. Greater fiscal policy credibility should help dampen pronounced swings in the policy interest rate, as would increased reliance on statements of monetary policy inclinations. Also, despite short-term concerns that speculative pressure may cause an unwarranted appreciation of the Hungarian forint, a move to a floating exchange rate regime remains desirable from a medium-term perspective.

35. **The financial sector, despite cautionary signals, appears generally sound.** Both long-term financial deepening and cyclical developments are creating new risks and stresses. With increased competition, loan officers are lending to riskier clients and projects. The ongoing downturn has raised the number of bankruptcies and liquidations. Banking sector profitability remains strong, however. The supervisor has responded to recent risks, including to those arising from foreign currency lending, by requiring some banks to strengthen their risk-management procedures and capitalization. Ensuring that Basel II regulations are put in place and strengthening consolidated regulation and supervision should be priorities.

36. **Accelerated improvements in the business climate and effective deployment of EU funds would help raise productivity and growth.** Recent steps including the simplification of regulatory requirements and public procurement procedures will help address the gap between Hungary and regional competitors in indicators of the business climate. The increased EU funds should be dovetailed with ongoing structural reforms, including strengthening infrastructure, human capital, and the innovation system, while ensuring, especially for private sector development, transparency and competition in the award of grants.

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

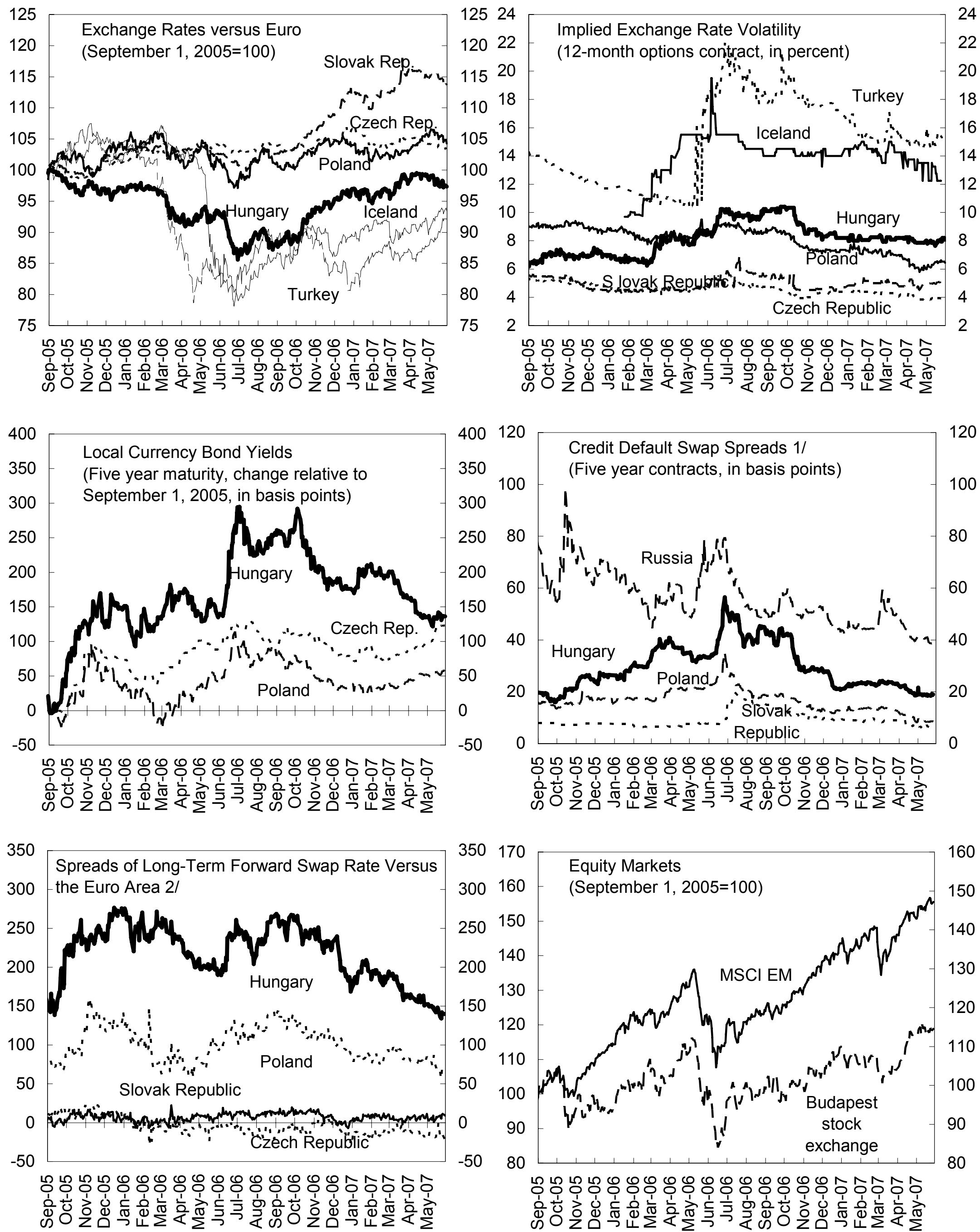
Figure 1. Hungary: External Sector Indicators, 2000-06
(In percent of GDP, four-quarter rolling basis)



Sources: Magyar National Bank; Hungary Statistical Office; and staff estimates.

1/ Derived from balance of payments statistics as investment plus the current account deficit.
2/ 2005 FDI includes privatization receipts from the sale of Budapest Airport (about 2 percentage points of GDP).

Figure 2. Selected Financial Indicators, 2005-07

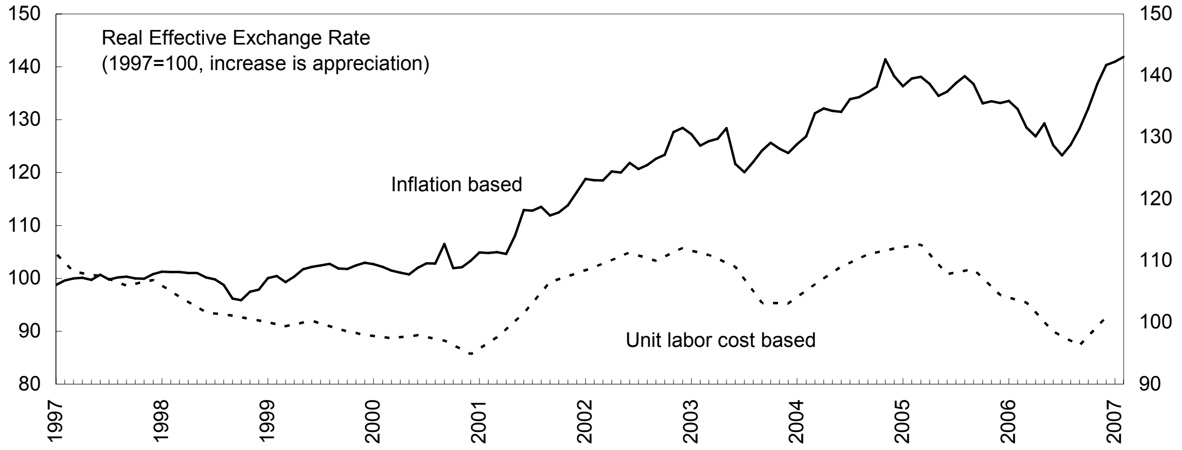


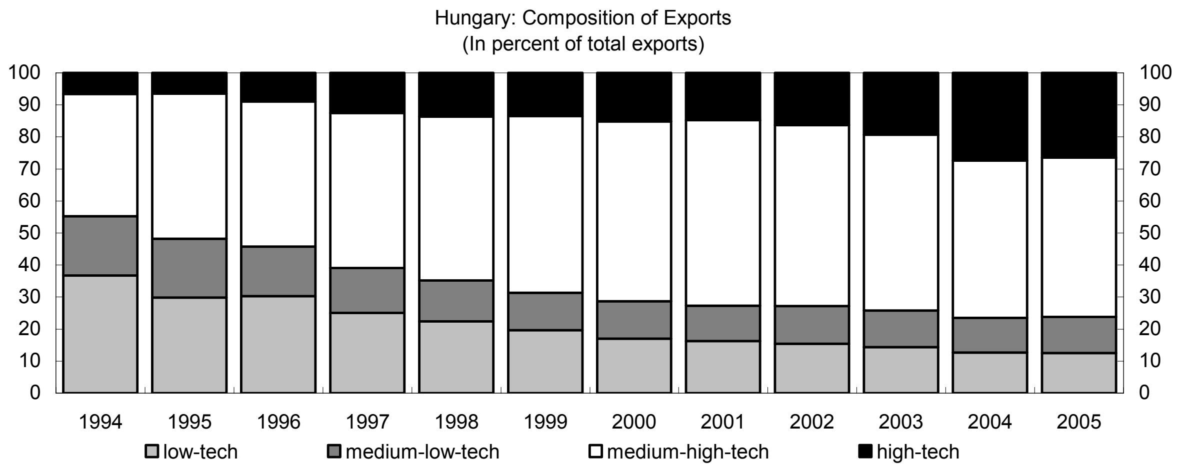
Sources: Bloomberg; and JP Morgan.

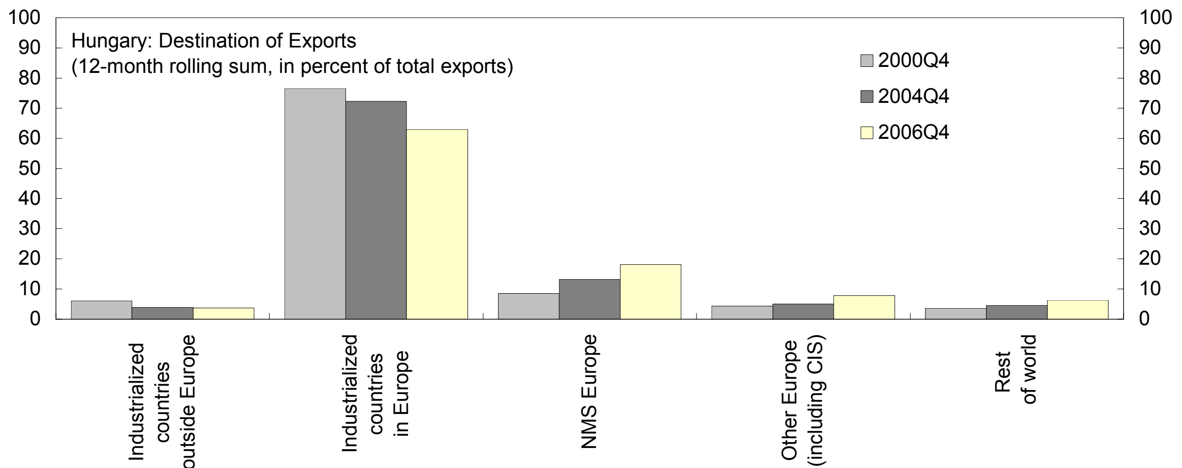
1/ The credit default swap (CDS) is an over-the-counter contract whereby the buyer pays the seller a periodic fee in return for a contingent payment by the seller upon default of the issuer of a credit instrument. Spreads are calculated versus the U.S.

2/ Five-year interest rate, in five years time, in basis points.

Figure 3. Hungary: Selected Competitiveness Indicators, 1994-2006

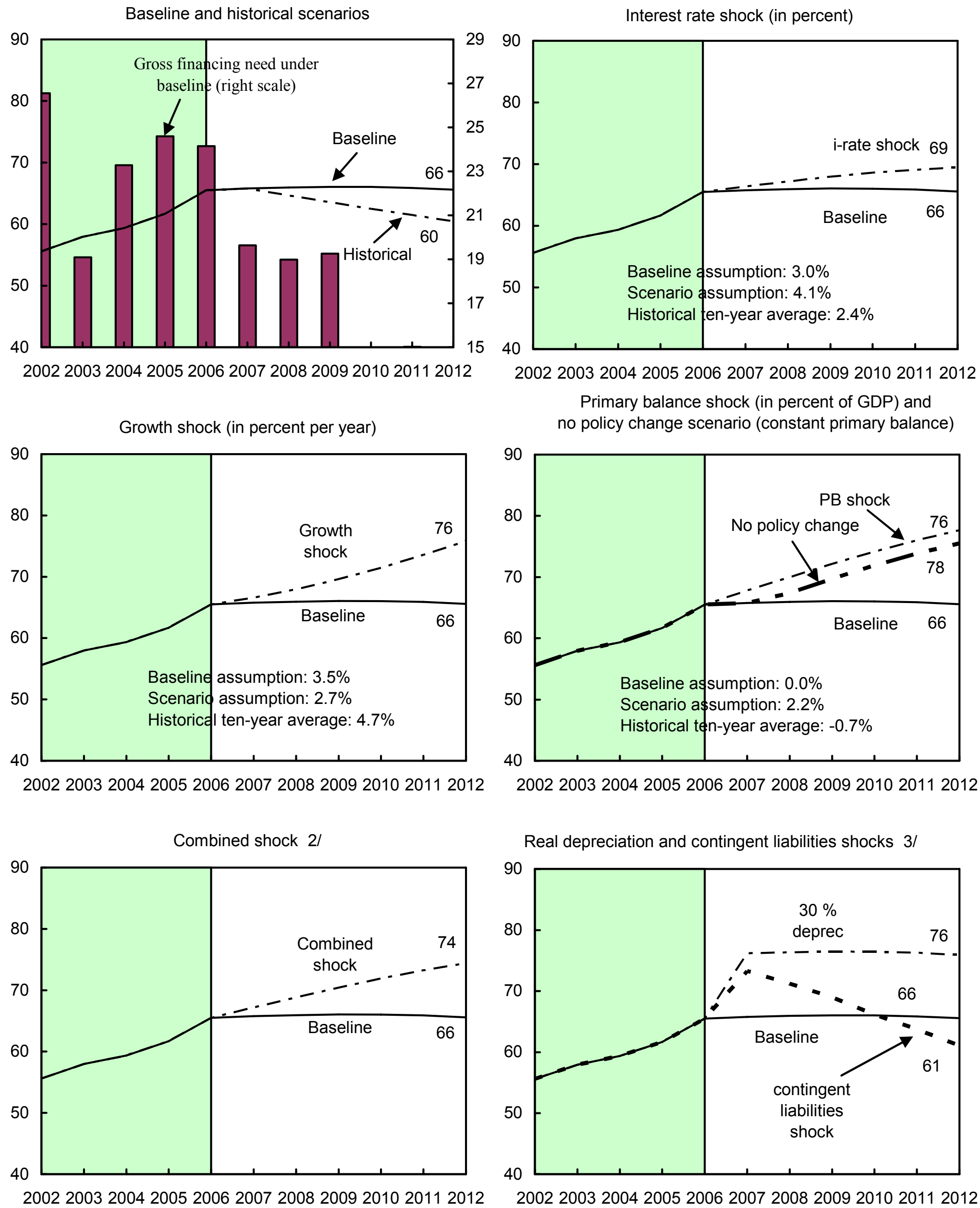






Sources: MNB; UN COMTRADE database; Hungarian Statistical Office; and IMF staff calculations.

Figure 4. Hungary: Public Debt Sustainability: Bound Tests, 2002-12 1/
(General government debt in percent of GDP)



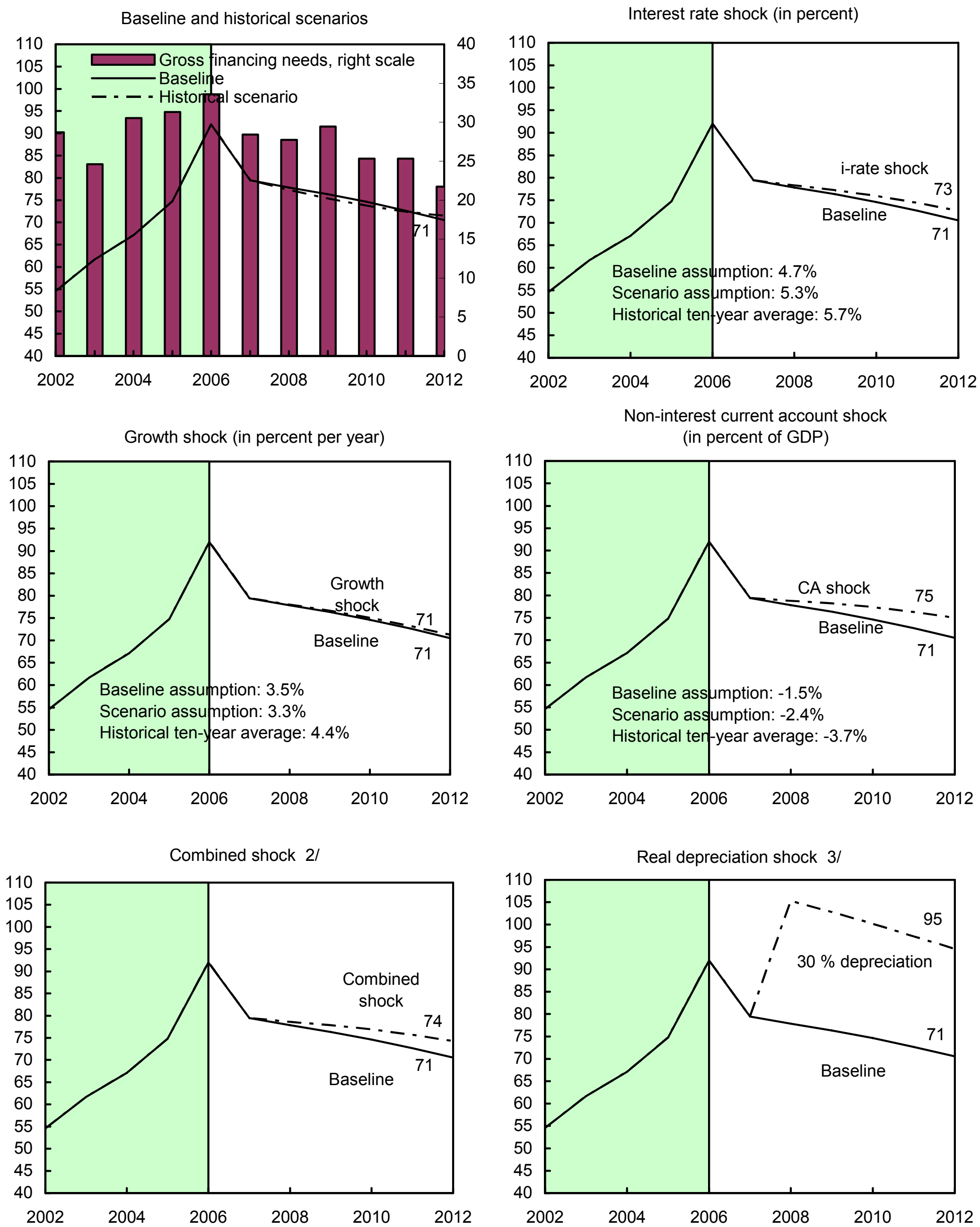
Sources: International Monetary Fund, Country desk data, and staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks (one standard deviation shock for growth). 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 primary balance.

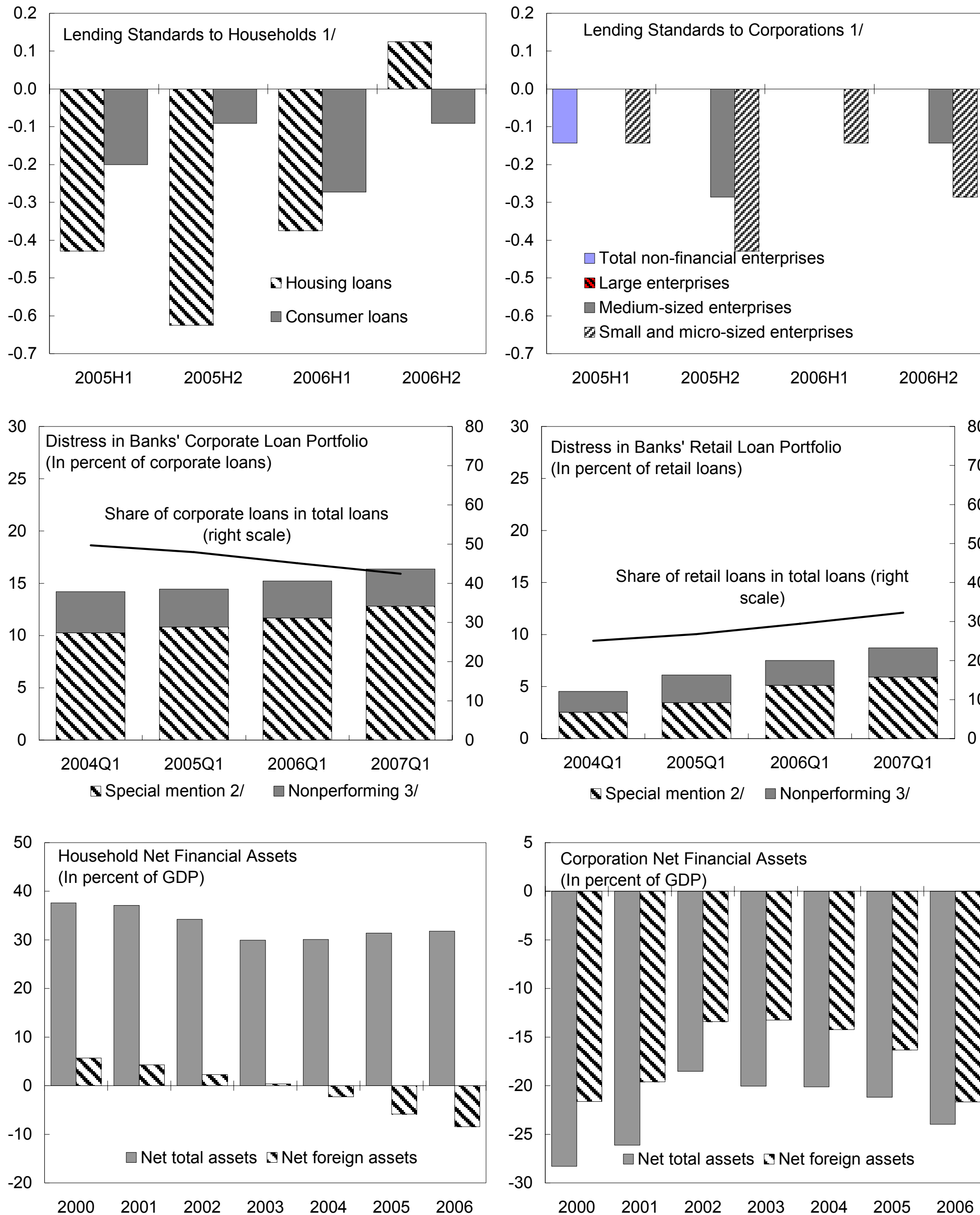
3/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2007, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Figure 5. Hungary: External Debt Sustainability: Bound Tests, 2002-12 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 2008.

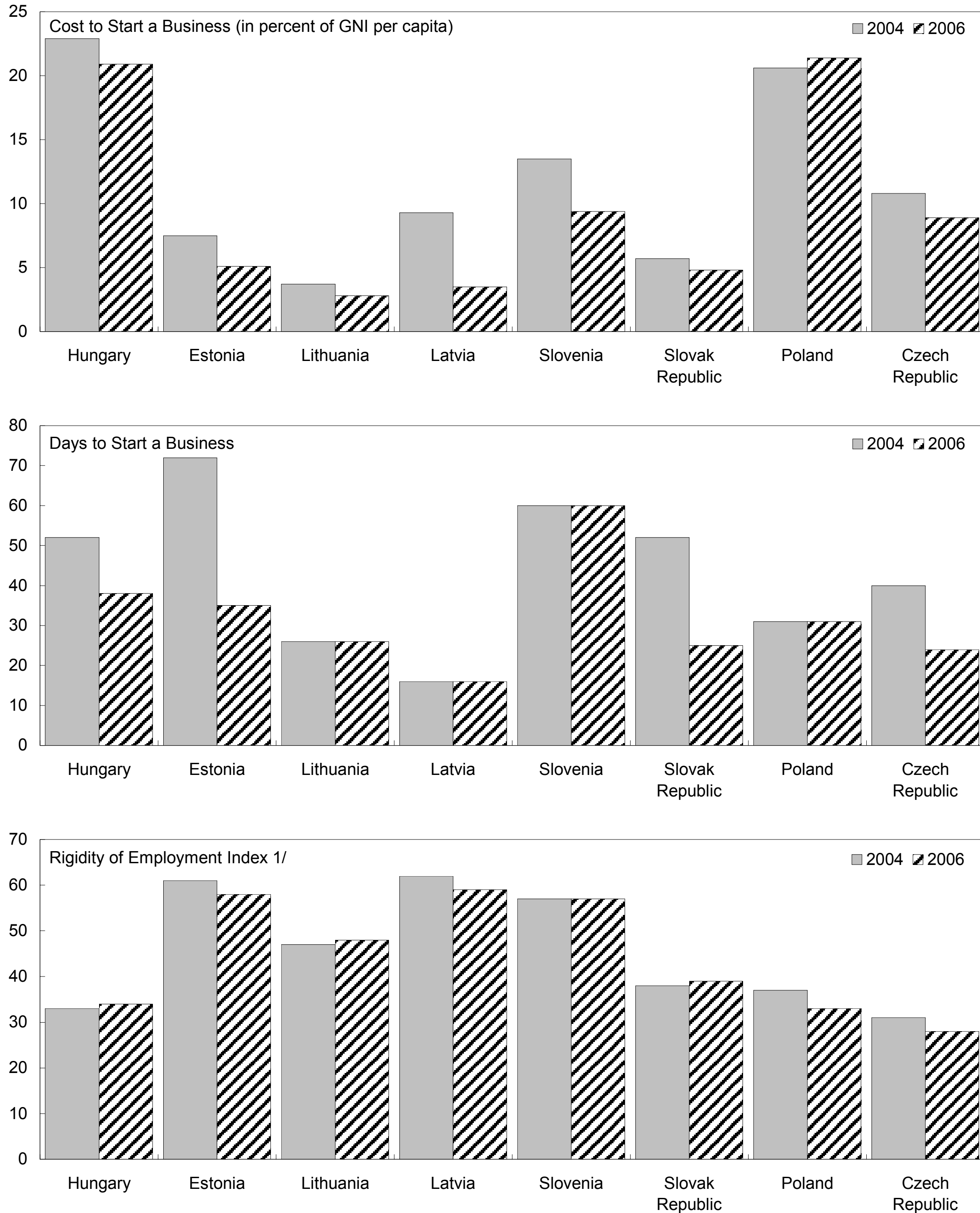
Figure 6. Hungary: Selected Financial Sector Developments, 2000-07



Sources: Magyar National Bank; and IMF staff calculations.

1/ Ratio of banks reporting tightening minus banks reporting easing of credit standards over total banks. A positive number indicates tightening, and a negative number indicates easing, and a missing bar indicates no change.
2/ Special mention loans are "watch-listed" loans, which are in a risk of (but are not yet) nonperforming.
3/ Nonperforming loans comprise bad, doubtful, and substandard loans.

Figure 7. Doing Business in the CEEC, 2004–06



Source: World Bank, Doing Business Database.

1/ The Rigidity of Employment Index captures the difficulty of hiring a new worker, restrictions on expanding or contracting the number of working hours, and the difficulty and expense of dismissing a redundant worker.

Table 1. Hungary: Main Economic Indicators, 2002–07

	2002	2003	2004	2005	2006	2007
						Proj.
Real economy (change in percent)						
Real GDP	4.4	4.2	4.8	4.2	3.9	2.7
Private consumption	9.9	7.8	3.2	3.9	1.8	-0.2
Gross fixed investment	10.2	2.2	7.6	5.3	-2.0	2.1
Exports	3.9	6.2	15.7	11.5	17.9	12.8
Imports 1/	6.8	9.3	14.1	6.9	12.4	8.7
CPI (end year)	4.8	5.7	5.5	3.3	6.5	5.0
CPI (average)	5.3	4.6	6.8	3.6	3.9	7.3
Unemployment rate (in percent)	5.8	5.9	6.1	7.2	7.5	8.0
Gross domestic investment (percent of GDP) 2/	25.5	25.2	26.1	23.7	23.0	21.8
Gross national saving (percent of GDP, from BOP)	18.6	17.3	17.7	16.9	17.2	16.9
General government (percent of GDP), ESA-95 basis 3/						
Overall balance	-8.9	-7.2	-6.5	-7.8	-9.1	-6.3
Primary balance	-5.3	-3.4	-2.4	-3.9	-5.4	-2.3
Debt	55.6	58.0	59.4	61.7	65.5	65.8
Money and credit (end-of-period, percent change)						
M3	9.3	12.0	11.6	14.5	13.9	…
Credit to nongovernment	21.9	34.4	19.2	18.8	17.3	...
Interest rates (percent)						
T-bill (90-day, average)	8.9	8.2	11.1	6.8	7.0	...
Government bond yield (5-year, average)	7.1	6.4	9.7	8.0	6.9	...
Balance of payments						
Trade balance (percent of GDP) 1/	-3.1	-3.9	-3.0	-1.6	-0.5	1.4
Current account (percent of GDP) 1/	-7.0	-7.9	-8.4	-6.7	-5.8	-4.9
Reserves (in billions of US dollars)	10.4	12.8	16.0	18.6	21.6	23.8
Gross external debt (percent of GDP) 4/	54.7	61.7	67.1	74.7	91.3	78.8
Net external debt (percent of GDP) 4/	22.9	28.7	32.2	34.3	42.7	39.0
Exchange rate						
Exchange regime	Peg against euro, with band +/-15 percent					
Present rate (May 30, 2007)	Ft 185.8 = US$1					
Nominal effective rate (1990=100)	38.9	38.8	39.6	39.2	37.1	...
Real effective rate, CPI basis (1990=100)	166.2	170.1	181.3	182.8	176.0	...

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

1/ The central bank believes that due to methodological changes, 2005-06 trade balance may be overstated by more than 2 percentage points of GDP.
2/ Includes change in inventories.
3/ Consists of the central budget, social security funds, extrabudgetary funds, and local governments, as well as motorway investments previously expected to be recorded off-budget in 2006-07.
4/ Including inter-company loans, and nonresident holdings of forint-denominated assets.

Table 2. Hungary: Consolidated General Government, 2003-07 1/
(In percent of GDP, unless otherwise indicated)

	2003	2004	2005	2006			2007		
				Budget	Rev. CP	Prelim.	Budget	Proj. Auth.	Proj. Staff
Total revenues	41.9	42.6	42.2	42.2	41.9	43.4	43.1	43.8	44.1
Current revenues and current grants	41.5	42.0	41.6	40.9	40.9	42.4	41.9	42.5	42.8
Tax revenues total	37.7	37.5	37.2	36.2	36.5	37.1	38.1	38.6	38.9
Taxes on income	9.3	8.7	8.7	8.9	9.1	9.2	9.7	9.6	9.7
Personal income tax	7.1	6.6	6.6	6.8	6.8	6.8	7.0	7.1	7.1
Corporate income tax	2.2	2.1	2.1	2.1	2.2	2.3	2.7	2.5	2.6
Other income tax	0.0	0.0	0.0	0.0	0.1	0.1	0.0	0.0	0.0
Social security contributions	12.5	12.3	12.6	12.6	12.4	12.7	13.1	13.2	13.2
Taxes on production and imports	15.5	16.0	15.5	14.3	14.8	14.9	15.0	15.5	15.6
Of which : VAT	8.1	8.7	8.3	7.6	7.5	7.5	7.5	7.6	7.7
Property taxes	0.3	0.4	0.3	0.3	0.2	0.2	0.2	0.2	0.2
Other taxes	0.1	0.1	0.1	0.1	0.0	0.1	0.1	0.1	0.1
Current non tax revenues total	3.6	4.2	4.0	3.1	3.8	4.3	2.9	2.7	2.7
Of which : interest	0.3	0.3	0.2	0.2	0.2	0.2	0.1	0.1	0.1
Current grants	0.2	0.3	0.4	1.6	0.6	1.0	0.9	1.2	1.2
Capital revenues and capital grants	0.4	0.5	0.6	1.3	1.0	1.0	1.2	1.3	1.3
Total expenditures	49.1	48.9	50.0	48.6	52.0	52.5	49.9	50.4	50.4
Current expenditures and current transfers	43.6	44.1	44.7	42.1	45.3	46.1	43.9	43.8	43.8
Goods and services	19.7	19.0	19.0	16.9	19.1	18.5	17.4	17.4	17.4
Of which : wages and salaries 2/	13.1	12.6	12.6	11.6	12.0	12.0	11.4	11.3	11.3
Transfers	19.8	20.7	21.6	21.7	22.3	23.7	22.1	22.3	22.3
Of which : to households	16.6	17.1	17.8	16.2	18.8	18.6	18.1	18.3	18.3
Interest payments	4.1	4.4	4.1	3.5	3.9	3.9	4.4	4.1	4.1
Capital expenditures and capital transfers	5.5	4.8	5.3	5.9	6.7	6.4	6.0	6.0	6.0
Capital expenditures 3/	3.3	3.3	3.9	3.1	4.8	4.2	3.5	3.5	3.5
Capital transfers	2.3	1.5	1.4	2.8	1.9	2.2	2.5	2.5	2.5
Other net expenditure	0.0	0.0	0.0	0.6	0.0	0.0	0.0	0.6	0.6
General government balance	-7.2	-6.5	-7.8	-6.4	-10.1	-9.1	-6.8	-6.6	-6.3
Net interest	-3.8	-4.1	-3.9	-3.3	-3.8	-3.7	-4.3	-4.0	-4.0
Primary balance	-3.4	-2.4	-3.9	-3.1	-6.3	-5.4	-2.5	-2.6	-2.3
General government balance (excluding the costs of pension reform)	-6.3	-5.3	-6.5	-5.1	-8.8	-7.7	...	...	...
Memorandum items:									
GDP, in current prices (forint billions)	18,941	20,717	22,055	23,270	23,562	23,753	25,500	25,500	26,175
Gross debt (including the costs of pension reform)	58.0	59.4	61.7	63.2	67.5	65.5	70.1	66.2	65.8
Gross debt (excluding the costs of pension reform)	55.8	57.1	57.7	58.5	62.9	61.2	64.9	...	...

Sources: Hungarian authorities; and staff estimates.

1/ Data are classified following the ESA'95 methodology, as reported to the European Commission.
2/ Including social security contributions.
3/ Including the cost of aircraft lease (0.3 percent of GDP in 2006), and motorway investments that were previously expected to be classified off budget under a PPP (0.6 percent of GDP in 2006).

Table 3. Hungary: Balance of Payments, 2002-10

	2002	2003	2004	2005	2006	2007	2008	2009	2010
							Projections		
				(In billions of U.S. dollars)					
Current account balance	-4.6	-6.7	-8.6	-7.5	-6.5	-6.5	-6.5	-6.6	-6.4
In percent of GDP	-7.0	-7.9	-8.4	-6.7	-5.8	-4.9	-4.6	-4.3	-4.0
Merchandise trade balance	-2.1	-3.3	-3.0	-1.8	-0.5	1.8	3.0	3.9	4.3
In percent of GDP	-3.1	-3.9	-3.0	-1.6	-0.5	1.4	2.1	2.6	2.7
Exports of goods	34.7	42.8	55.6	62.3	73.6	86.8	97.9	108.2	119.7
Percentage change in volume	5.9	9.1	18.4	11.5	16.7	13.3	13.3	11.0	10.5
Imports of goods 1/	36.7	46.1	58.7	64.1	74.1	84.9	94.9	104.3	115.4
Percentage change in volume	5.0	10.2	15.3	6.1	12.5	11.1	11.9	10.6	10.7
Services balance	0.6	0.1	0.3	0.9	1.3	1.9	2.3	2.7	2.9
In percent of GDP	0.8	0.1	0.3	0.8	1.1	1.4	1.6	1.7	1.8
Net income	-3.6	-4.2	-6.1	-6.8	-7.7	-10.6	-12.3	-13.6	-14.2
In percent of GDP	-5.4	-4.9	-6.0	-6.1	-6.8	-8.0	-8.6	-8.9	-8.7
Net transfers	0.5	0.7	0.3	0.2	0.4	0.4	0.4	0.5	0.5
In percent of GDP	0.7	0.8	0.3	0.2	0.3	0.3	0.3	0.3	0.3
Capital account, net	0.2	0.0	0.3	0.9	0.9	1.8	2.4	3.0	1.9
In percent of GDP	0.3	0.0	0.3	0.8	0.8	1.4	1.7	2.0	1.1
Financial account, net	2.5	7.1	11.9	13.8	10.2	9.5	8.5	7.9	7.5
In percent of GDP	3.7	8.4	11.7	12.4	9.1	7.1	6.0	5.2	4.6
Net direct investment	2.7	0.5	3.4	5.1	3.1	3.9	4.1	4.3	4.5
In percent of GDP	4.1	0.6	3.3	4.7	2.7	2.9	2.9	2.8	2.8
Net portfolio investment	1.9	3.3	7.3	4.4	6.7	6.7	6.9	7.1	7.3
In percent of GDP	2.8	3.9	7.1	3.9	5.9	5.0	4.9	4.7	4.5
Net other investment	-2.1	3.3	1.3	4.3	0.5	-1.1	-2.5	-3.5	-4.4
In percent of GDP	-3.2	3.9	1.2	3.9	0.5	-0.8	-1.7	-2.3	-2.7
Errors and omissions	0.1	0.2	-1.8	-2.3	-3.4	-2.6	-2.0	-1.4	-1.2
In percent of GDP	0.2	0.3	-1.7	-2.1	-3.0	-2.0	-1.4	-0.9	-0.8
Overall balance	-1.9	0.6	1.9	4.9	1.2	2.2	2.4	3.0	1.7
Net reserves (change; - = increase)	1.9	-0.6	-1.9	-4.9	-1.2	-2.2	-2.4	-3.0	-1.7
Memorandum of items (end of period):									
Gross reserves	10.4	12.8	16.0	18.6	21.6	23.8	26.2	29.2	30.9
In months of goods and services imports	2.9	2.8	2.8	2.9	3.0	2.9	2.8	2.9	2.8
Gross foreign debt, in percent of GDP 2/	54.7	61.7	67.1	74.7	91.3	78.8	77.2	75.7	74.0
Net foreign debt, in percent of GDP 3/	22.9	28.7	32.2	34.3	42.7	39.0	39.3	39.3	40.2

Sources: Magyar Nemzeti Bank; and IMF staff estimates.

1/ The central bank believes that due to methodological changes, 2005 imports may be understated by up to 2 percentage points of GDP.

2/ Including intercompany loans.

3/ Foreign liabilities net of foreign assets, excluding equity but including intercompany loans.

Table 4. Hungary: Staff's Illustrative Medium-Term Scenario, 2002-12

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
						Staff projections					
	(In percent, unless otherwise indicated)										
Real GDP growth	4.4	4.2	4.8	4.2	3.9	2.7	3.0	3.3	3.5	3.7	4.0
Nominal GDP, forint billions	17,181	18,941	20,717	22,055	23,753	26,175	27,931	29,660	31,558	33,642	35,967
Inflation (CPI; year average basis)	5.3	4.6	6.8	3.6	3.9	7.3	3.6	2.8	2.8	2.8	2.8
Inflation (CPI; end-year basis)	4.8	5.7	5.5	3.3	6.5	5.0	3.4	2.8	2.8	2.8	2.8
	(Annual percentage change, constant prices)										
Domestic demand	6.6	6.6	4.2	0.6	-0.7	-1.7	0.7	3.0	3.7	4.5	4.6
Consumption	9.3	7.5	2.8	3.4	1.6	-0.3	1.8	2.7	3.5	3.7	3.9
Gross fixed capital formation	10.2	2.2	7.6	5.3	-2.0	2.1	3.5	4.2	4.7	4.8	4.8
Exports of GNFS	3.9	6.2	15.7	11.5	17.9	12.8	13.3	11.0	10.5	10.4	9.6
Imports of GNFS	6.8	9.3	14.1	6.9	12.4	8.7	11.9	11.4	11.2	11.5	10.3
	(In percent of GDP)										
External current account balance	-7.0	-7.9	-8.4	-6.7	-5.8	-4.9	-4.6	-4.3	-4.0	-3.7	-3.2
Gross national saving	18.6	17.3	17.7	16.9	17.2	16.9	17.0	17.6	18.1	18.7	19.4
Gross national investment 1/	25.5	25.2	26.1	23.7	23.0	21.8	21.6	21.9	22.1	22.4	22.6
Gross external debt 2/	54.7	61.7	67.1	74.7	91.3	78.8	77.2	75.7	74.0	72.1	70.0
Private sector savings-investment balance 3/	-1.8	-1.2	-1.9	1.1	3.3	1.4	-0.3	-0.4	0.0	0.2	1.8
Gross private savings	20.4	19.2	20.9	20.8	22.0	19.7	18.5	18.5	19.1	19.6	20.4
Gross private investment	22.1	20.5	22.8	19.8	18.7	18.3	18.8	18.9	19.1	19.4	18.6
General government (ESA-95)											
Revenue, primary	42.0	41.7	42.3	41.8	43.4	44.0	44.0	44.3	44.3	44.3	44.3
Expenditure, primary	47.3	45.1	44.7	45.7	48.8	46.3	44.3	44.4	44.4	44.5	44.5
Primary balance	-5.3	-3.4	-2.4	-3.9	-5.4	-2.3	-0.3	-0.1	-0.2	-0.2	-0.3
General government balance (including the costs of pension reform) 4/	-8.9	-7.2	-6.5	-7.8	-9.1	-6.3	-4.3	-4.0	-4.0	-4.0	-4.0
General government balance (excluding the costs of pension reform) 4/ 5/	-8.2	-6.3	-5.3	-6.5	...	...	...	...	...	...	...
Net interest	3.6	3.8	4.0	3.7	3.7	4.0	4.0	3.9	3.8	3.8	3.7
General government debt	55.7	58.0	59.4	61.7	65.5	65.8	65.9	66.0	66.0	65.9	65.6
General government debt (excluding the costs of pension reform) 5/	55.0	55.8	57.1	57.7	61.7	...	...	...	...	...	...
Memorandum items											
Output gap	-0.4	-0.9	-0.3	-0.2	-0.2	-1.0	-1.5	-1.7	-1.7	-1.5	-1.0
Structural general government balance	-8.8	-6.9	-6.4	-7.7	-9.0	-6.0	-3.9	-3.4	-3.4	-3.5	-3.7
Structural primary balance	-5.2	-3.1	-2.4	-4.0	-5.3	-2.0	0.2	0.4	0.4	0.3	0.0

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

Table 5. Hungary: Public Sector Debt Sustainability Framework, 2002-12
(In percent of GDP, unless otherwise indicated)

	Actual					Projections					
	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Baseline: Public sector debt 1/	55.6	58.0	59.4	61.7	65.5	**65.8**	**65.9**	**66.0**	**66.0**	**65.9**	**65.6**
o/w foreign-currency denominated	13.7	14.1	15.3	17.5	18.5	18.6	18.7	18.7	18.7	18.6	18.6
Change in public sector debt	2.5	2.4	1.4	2.3	3.8	0.3	0.2	0.1	0.0	-0.1	-0.3
Identified debt-creating flows (4+7+12)	0.2	3.6	0.2	2.9	3.6	0.4	0.3	0.2	0.1	0.0	-0.2
Primary deficit	5.3	3.4	2.4	3.9	5.4	2.3	0.3	0.1	0.2	0.2	0.3
Revenue and grants	41.9	41.6	42.2	42.0	43.2	44.0	44.0	44.3	44.3	44.3	44.3
Primary (noninterest) expenditure	47.2	45.0	44.7	45.9	48.6	46.3	44.3	44.4	44.4	44.5	44.5
Automatic debt dynamics 2/	-5.1	0.5	-1.4	1.0	-0.6	-2.0	0.0	0.1	-0.1	-0.2	-0.5
Contribution from interest rate/growth differential 3/	-2.8	-1.0	-0.6	0.6	-0.6	-2.0	0.0	0.1	-0.1	-0.2	-0.5
Of which contribution from real interest rate	0.0	1.1	2.0	2.9	1.6	-0.4	1.8	2.2	2.1	2.1	2.0
Of which contribution from real GDP growth	-2.8	-2.1	-2.6	-2.4	-2.2	-1.6	-1.8	-2.0	-2.2	-2.3	-2.5
Contribution from exchange rate depreciation 4/	-2.3	1.5	-0.9	0.4	0.0	...	...	...	...	...	...
Other identified debt-creating flows	0.0	-0.2	-0.8	-1.9	-1.1	0.0	0.0	0.0	0.0	0.0	0.0
Privatization receipts (negative)	0.0	-0.2	-0.8	-1.9	-1.1	0.0	0.0	0.0	0.0	0.0	0.0
Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Residual, including asset changes (2-3) 5/	2.4	-1.3	1.2	-0.6	0.2	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Public sector debt-to-revenue ratio 1/	132.5	139.2	140.6	146.9	151.6	149.6	149.9	149.1	149.1	148.8	148.1
Gross financing need 6/	26.5	19.1	23.3	24.6	24.1	19.6	19.0	19.3	14.8	15.0	13.0
in billions of U.S. dollars	18.8	14.3	19.2	21.9	21.7	20.1	20.7	22.3	18.3	19.7	18.2
Scenario with key variables at their historical averages 7/						**65.8**	**64.7**	**63.6**	**62.5**	**61.5**	**60.5**
Scenario with no policy change (constant primary balance) in 2007-2010						**65.8**	**67.4**	**69.7**	**71.9**	**73.8**	**75.5**
Key Macroeconomic and Fiscal Assumptions Underlying Baseline											
Real GDP growth (in percent)	6.1	4.1	4.9	4.2	3.9	2.7	3.0	3.3	3.5	3.7	4.0
Average nominal interest rate on public debt (in percent) 8/	8.7	8.1	8.3	7.4	6.9	6.9	6.7	6.4	6.3	6.2	6.2
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	0.6	2.4	4.0	5.3	3.0	-0.4	3.1	3.6	3.5	3.4	3.4
Nominal appreciation (increase in US dollar value of local currency, in percent)	18.3	-10.0	6.6	-2.7	0.2	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	8.1	5.7	4.3	2.0	3.9	7.3	3.6	2.8	2.8	2.8	2.8
Growth of real primary spending (deflated by GDP deflator, in percent)	15.7	-0.6	4.1	7.2	9.8	-2.2	-1.5	3.5	3.6	3.8	4.1
Primary deficit	5.3	3.4	2.4	3.9	5.4	2.3	0.3	0.1	0.2	0.2	0.3

1/ General government gross debt.
2/ Derived as [(r - p(1+g) - g + ae(1+r)]/(1+g+p+gp)) times previous period debt ratio, with r = interest rate; p = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).
3/ The real interest rate contribution is derived from the denominator in footnote 2/ as r - π (1+g) and the real growth contribution as -g.
4/ The exchange rate contribution is derived from the numerator in footnote 2/ as ae(1+r).
5/ For projections, this line includes exchange rate changes.
6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.
8/ Derived as nominal interest expenditure divided by previous period debt stock.

Table 6. Hungary: External Debt Sustainability Framework, 2002-12
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	**Debt-stabilizing non-interest current account 6/**
Baseline: External debt	54.6	61.7	67.1	74.8	92.0	**79.4**	**77.8**	**76.3**	**74.6**	**72.7**	**70.5**	**-5.9**
Change in external debt	-8.2	7.1	5.4	7.6	17.2	-12.6	-1.6	-1.5	-1.7	-2.0	-2.1	
Identified external debt-creating flows (4+8+9)	-8.9	-3.6	-6.0	-3.9	-0.5	-0.9	-1.3	-2.1	-2.6	-2.9	-3.7	
Current account deficit, excluding interest payments	4.4	5.7	5.8	3.9	2.6	1.2	1.2	0.9	0.6	0.3	-0.2	
Deficit in balance of goods and services	2.3	3.8	2.7	0.8	-0.7	-2.8	-3.8	-4.4	-4.6	-4.5	-4.6	
Exports	63.0	61.6	65.1	68.0	77.7	77.8	82.0	85.0	87.8	91.2	93.8	
Imports	65.3	65.4	67.8	68.8	77.1	75.0	78.2	80.6	83.2	86.7	89.2	
Net non-debt creating capital inflows (negative)	-4.2	-1.9	-5.5	-6.0	-3.4	-3.8	-3.7	-4.0	-4.0	-4.0	-3.9	
Automatic debt dynamics 1/	-9.1	-7.4	-6.4	-1.8	0.4	1.6	1.2	1.0	0.8	0.7	0.4	
Contribution from nominal interest rate	2.5	2.3	2.6	2.8	3.3	3.7	3.5	3.4	3.3	3.2	3.1	
Contribution from real GDP growth	-2.2	-1.8	-2.5	-2.6	-2.9	-2.1	-2.2	-2.4	-2.5	-2.6	-2.7	
Contribution from price and exchange rate changes 2/	-9.5	-7.9	-6.5	-2.0	0.0	...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	0.6	10.6	11.5	11.5	17.7	-11.6	-0.3	0.6	0.9	1.0	1.6	
External debt-to-exports ratio (in percent)	86.6	100.1	103.1	109.9	118.4	102.1	95.0	89.8	84.9	79.7	75.2	
Gross external financing need (in billions of US dollars) 4/	19.2	20.8	31.2	34.5	37.6	37.5	39.2	44.4	40.8	43.9	40.6	
in percent of GDP	28.7	24.6	30.5	31.3	33.6	28.4	27.7	29.5	25.3	25.3	21.7	
Scenario with key variables at their historical averages 5/						**79.4**	**77.3**	**75.4**	**73.8**	**72.4**	**71.5**	**-8.1**
Key Macroeconomic Assumptions Underlying Baseline												
Real GDP growth (in percent)	4.3	4.1	4.9	4.2	3.9	2.7	3.0	3.3	3.5	3.7	4.0	
GDP deflator in US dollars (change in percent)	19.9	21.5	15.4	3.6	-1.5	14.6	4.0	3.2	3.4	3.6	3.7	
Nominal external interest rate (in percent)	5.0	5.2	5.1	4.5	4.5	4.7	4.7	4.7	4.7	4.7	4.7	
Growth of exports (US dollar terms, in percent)	10.3	23.7	27.9	12.9	16.0	17.9	12.9	10.5	10.6	11.6	10.9	
Growth of imports (US dollar terms, in percent)	12.1	26.7	25.5	9.7	13.6	14.6	11.7	9.8	10.5	12.0	10.9	
Current account balance, excluding interest payments	-4.4	-5.7	-5.8	-3.9	-2.6	-1.2	-1.2	-0.9	-0.6	-0.3	0.2	
Net non-debt creating capital inflows	4.2	1.9	5.5	6.0	3.4	3.8	3.7	4.0	4.0	4.0	3.9	

1/ Derived as $[r - g - \rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, ε = nominal appreciation (increase in dollar value of domestic currency), and α = share of domestic-currency denominated debt in total external debt.

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

3/ For projection, line includes the impact of price and exchange rate changes.

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

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

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

Table 7. Hungary: Key Fiscal Measures and Implementation Status

Reform Options	Implementation Status	Issues/Concerns	Recommended by Staff
Expenditure Reforms			
Health Care			
Help finance non-basic health care services by co-payments	Implemented	Large exemptions	Yes
Reform pharmaceutical subsidies	Implemented	Large exemptions	Yes
Reform of inpatient care	Ongoing	Unclear support from local governments; agreement on large Budapest hospital pending	Hospital privatization and governance restructuring critical
Implement multi-insurance health care model	Pending	Difficult political debate	Separation of health care and social insurance
Education			
Increase number of teaching hours	Implemented	Effect on employment and support from local governments unclear	No, but no objection raised
Increase private contributions to higher education	Implemented	Revenues to be reinvested	Yes
Change the structure of higher education	Ongoing	Slow progress	Yes
Merge underutilized schools	No direct action		Yes
Reduce employment	No direct action		Yes
Government Employment and Wages; and Public Administration			
Temporary wage freeze	Implemented	End-year bonuses brought forward; may not be sustainable	No
Restrictions on operating costs of budget institutions	Consistent with 2007 budget	Reserves and quarterly reporting appear effective	No, but supported by staff
Implement a temporary hiring freeze and layoffs	Ongoing	Limited to central administration	Yes
Abolish unusual benefits and bonuses, such as for meals, transportation, clothing	Pending		Yes
Provide incentives for intergovernmental cooperation and privatization at the local level	2006 reform did not pass	Critical for civil service, education, and health reform	Yes
Pensions			
Gradually raise the early retirement age	Implemented		Yes
Tighten eligibility for disability pensions	Parliamentary approval pending		Yes
Gradually move toward full price indexation of pensions	Under discussion		Yes
Phase out thirteenth month pension	Lower replacement rate		Yes
Paradigmatic reforms of pension system	Under discussion		Yes
Social Benefits			
Abolish tax deduction for children and introduce means-testing for family allowance	No direct action	Poor targeting	Yes
Government Subsidies			
Reform electricity and gas tariffs	Gas price increases effective	Electricity price increases to be determined	Yes
Reform transport subsidies	Price increases effective	Tariffs still lag cost-recovery levels	Yes
Reform of state support for public transport	Ongoing	Slow progress; significant fiscal risks	Yes
Reform housing subsidies	No direct action	Poor targeting	Yes
PPPs			
Implement medium-term budget framework	Under discussion		Yes
Strengthen economic analysis of investment projects and VfM assessments for PPPs	Guidelines being developed		Yes
Establish gateway process for PPPs within the MoF	Veto power granted to MoF		Yes
Strengthen capacity in MoF and line ministries	Ongoing		Yes
Implement more transparent accounting and reporting for PPPs	Some steps; see below		Yes
Implement techniques for risk assessment of PPP projects	Initial steps		Yes
Tax Reforms			
Delay pending items of 2005 tax relief plan	Implemented		Yes
Tax pensions under the PIT	Implemented	Pensions included under the base of the PIT	Yes
Tax interest income and capital gains without exemption threshold	Implemented		Yes
Increase 15 VAT rate to 20 percent	Implemented		Yes
Increase in health care and social security contributions	Implemented		No
Solidarity tax on corporate income	Implemented		No
Solidarity tax on personal income	Implemented		No
Increase tax rate on small businesses regime	Implemented		No
Minimum expected corporate tax	Overruled by Constitutional Court		No
Tax on excess cash position of enterprises	Overruled by Constitutional Court		No
Strengthen real estate tax	Under discussion	Should be backed by registry based on market valuation and simple rate structures	Yes
Eliminate tax exemptions; simplify deductions under corporate income tax	Tax strategy to be defined	Likely significant scope to broaden the tax base	Yes
Simplify personal income tax	Tax strategy to be defined		Yes
Rebalance tax composition away from labor and capital towards consumption	Tax strategy to be defined		Yes

Table 7. Hungary: Key Fiscal Measures and Implementation Status (Continued)

Reform Options	Implementation Status	Issues/Concerns	Recommended by Staff
Public Financial Management and Fiscal Transparency			
Recognize motorway investment attempted via a PPP with AAK on budget	Implemented		Yes
Develop a medium-term budget framework	Under discussion		Yes
Restrict use of carryover funds to finance additional expenditures	Some steps		Yes
Improve fiscal risk analysis (inc. QFAs and PPPs)	No direct action		Yes
Strengthen independent scrutiny of fiscal policy	Under discussion		Yes
Move towards performance budgeting	Under discussion		Yes
Extend coverage of the budget to ESA95	No direct action		Yes
Undertake quarterly reviews	Ongoing		Yes
Eliminate budget provisions allowing expenditure overruns without supplementary budget	Under discussion		Yes
Implement fiscal rules	Under discussion	Fiscal rules should be ambitious to place public debt on a sustainable downward path	Yes

Sources: Hungarian authorities; FAD Technical Assistance; and IMF staff reports.

Table 8. Financial Soundness Indicators for the Banking Sector, 2001-06
(In percent unless otherwise indicated, end of period)

	2001	2002	2003	2004	2005	2006
Capital adequacy						
Regulatory capital to risk-weighted assets	13.9	13.0	11.8	12.4	11.6	11.0
Capital (net worth) to assets	8.5	8.7	8.3	8.5	8.2	8.3
Asset composition and quality						
Annual growth of bank loans	17.2	23.7	33.2	16.9	19.8	18.4
Sectoral distribution of bank loans (in % of total)						
Corporates	65.3	53.7	49.5	48.4	45.7	43.2
o/w in foreign currency	22.3	18.9	20.2	21.6	21.8	20.3
Households	14.1	19.3	24.3	27.0	29.2	31.5
o/w in foreign currency	0.4	0.8	1.2	3.9	9.5	14.8
Other loans	20.7	27.0	26.2	24.6	25.0	25.3
o/w in foreign currency	14.3	16.9	18.3	17.4	18.8	19.1
Financial institutions	7.1	9.7	11.6	12.5	12.3	11.3
Central government	1.1	5.0	1.5	1.1	0.6	0.5
Nonresidents	8.8	6.9	6.5	4.5	5.1	6.2
Other	3.7	5.4	6.6	6.5	7.0	7.2
Denomination of FX loans to corporates						
EUR	69.5	77.6	84.8	79.3	74.8	70.7
USD	27.8	19.3	9.8	6.7	5.7	4.7
CHF	2.6	2.8	5.3	13.9	19.3	24.6
Other	0.2	0.3	0.1	0.1	0.2	0.0
NPLs to gross loans	2.7	2.9	2.6	2.7	2.5	2.5
Provisions to NPLs	57.9	50.8	47.3	51.3	54.4	53.9
NPLs net of provisions to capital	7.3	10.0	10.7	10.0	9.0	9.2
Earnings and profitability						
ROA (after tax)	1.3	1.4	1.5	2.0	2.0	1.8
ROE (after tax)	15.8	16.2	19.3	25.3	24.7	24.0
Net interest income to gross income	67.9	68.1	65.5	65.9	64.4	64.7
Noninterest expenses to gross income	61.8	60.4	56.4	50.1	48.6	48.7
Personnel expenses to noninterest expenses	41.2	42.9	43.4	45.7	47.2	48.3
Trading and fee income to total income	31.2	30.4	31.4	32.3	33.8	32.3
Spread between loan and deposit rates	3.9	4.0	3.7	3.6	3.7	3.5
Liquidity						
Liquid assets to total assets	29.9	24.3	19.5	21.1	21.0	20.0
Liquid assets to short term liabilities	43.7	36.0	31.4	35.6	35.7	36.8
Loans to deposits	77.0	84.6	99.7	103.7	107.7	109.9
FX liabilities(own capital is excluded) to total liabilities(own capital is excluded)	36.7	29.4	30.5	30.0	34.4	39.3
Sensitivity to market risk						
Net open position in FX to capital	6.9	2.1	2.1	6.0	3.5	7.2

Source: Magyar Nemzeti Bank.

Table 9. Selected Vulnerability Indicators, 2002-06
(In percent of GDP, unless otherwise indicated)

	2002	2003	2004	2005	2006
Current account balance					
Hungary	-7.1	-7.9	-8.4	-6.8	-5.8
Argentina	9.0	6.3	2.1	1.9	2.0
Brazil	-1.6	0.8	2.0	1.8	1.6
Latvia	-6.4	-7.7	-12.4	-13.4	-20.5
Poland	-2.5	-2.1	-4.2	-1.7	-1.9
Slovak Republic	-7.9	-0.8	-3.6	-8.6	-7.8
Turkey	-0.8	-3.3	-5.2	-6.4	-8.8
GIR to short-term debt 1/					
Hungary	116	106	85	89	99
Argentina	45	26	38	59	73
Brazil	56	59	84	69	82
Latvia	35	27	23	24	27
Poland	123	106	106	102	98
Slovak Republic	95	129	115	107	93
Turkey	51	76	77	62	76
External debt					
Hungary	55	62	67	75	91
Argentina	160	129	113	74	63
Brazil	46	43	33	21	17
Latvia	73	79	93	101	115
Poland	43	49	51	44	47
Slovak Republic	54	55	57	57	55
Turkey	71	60	54	47	50
REER (2000=100)					
Hungary	119	122	130	133	127
Argentina	46	48	46	46	45
Brazil	82	77	81	100	113
Latvia	96	91	92	90	93
Poland	108	96	96	107	110
Slovak Republic	105	119	130	134	143
Turkey	85	92	95	106	106
Fiscal balance					
Hungary	-8.9	-7.2	-6.5	-7.8	-9.1
Argentina	-1.5	1.3	3.8	2.4	2.0
Brazil	-4.6	-5.2	-2.8	-3.3	-2.8
Latvia	-2.3	-1.6	-1.1	-1.2	-0.9
Poland	-6.1	-5.6	-5.0	-2.1	-0.9
Slovak Republic	-7.7	-3.7	-3.9	-3.1	-3.3
Turkey	-14.4	-11.2	-7.0	-2.0	-1.4

Sources: National authorities; and IMF staff calculations.
1/ GIR are stocks at end of previous year; the denominators are current-year data.

INTERNATIONAL MONETARY FUND

HUNGARY

Staff Report for the 2007 Article IV Consultation—Informational Annexes

Prepared by the European Department

June 22, 2007

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ANNEX I. HUNGARY: FUND RELATIONS
(As of May 31, 2007)

Mission: April 25-May 7, 2007. The concluding statement of the mission is available at http://www.imf.org/external/np/ms/2007/050707.htm.

Staff team: Mr. Mody (head), Ms. Fabrizio, Ms Mitra, and Ms. Stolz (all EUR), and Mr. Corbacho (FAD). Mr. Sierhej, Regional Representative Office, Warsaw, joined the mission during April 25-26. Mr. Abel from the Executive Director's office also joined the mission.

Country interlocutors: Minister of Finance, Governor of Magyar Nemzeti Bank, and Minister of Health. Officials at the Ministry of Finance, the Magyar Nenzeti Bank, the Ministry of Education, Ministry of Economy, Ministry of Labor, the State Reform Committee, the Hungarian Financial Supervisory Authority, Representatives of Parliament, commercial banks, the academy, investors, asset management companies, private sector, the Central European Management Intelligence (CEMI), and the diplomatic community.

Fund relations: The previous consultation took place in June, 2006. The associated Executive Board assessment is available at http://www.imf.org/external/np/sec/pn/2006/pn06118.htm and the staff report and other mission documents at http://www.imf.org/external/pubs/cat/longres.cfm?sk=20035.0 and http://www.imf.org/external/pubs/cat/longres.cfm?sk=20019.0. Hungary has accepted the obligations of Article VIII and maintains an exchange rate system free of restrictions on the making of payments and transfers on current international transactions except for those maintained solely for the preservation of national or international security and that have been notified to the Fund pursuant to Executive Board Decision No. 144-(52/51).

Data: Hungary subscribes to the Fund's Special Data Dissemination Standard. Data provision is, in general, timely and facilitates effective surveillance (Appendix II).

Anti-money laundering and combating financing of terrorism: In 2005, a Fund assessment was conducted of Hungary's anti-money laundering (AML) and combating the financing of terrorism (CFT) [1/] system and concluded that the authorities had made significant progress in strengthening their AML/CFT regime since the previous assessment in 2001. The legislative framework for AML was in place and had been extended to nonfinancial business and professions. Financial institutions' compliance with the AML requirements was well-supervised. However, the report indicated that some gaps remained in the legislative framework for CFT and the implementation of AML measures needed to be improved. Since 2005, further progress has been made, and the authorities are currently working on the implementation of the Third EU AML/CFT Directive.

1/ The result report was adopted at plenary by MONEYVAL, the FATF-style regional body for Europe, to serve as tis third round evaluation of Hungary.

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

II. **General Resources Account**:

	SDR Million	Percent of Quota
Quota	1,038.40	100.00
Fund holdings of currency	962.31	92.67
Reserve position in Fund	76.09	7.33

III. **SDR Department**

	SDR Million	Allocation
Holdings	50.24	N/A

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

V. **Financial Arrangements**:

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

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

VII. **Exchange Rate Arrangement**:

The Hungarian forint is pegged to the euro with an horizontal band of +/- 15 percent around the central parity (Ft. 282.36 per euro) effective June 4, 2003.

VIII. **Article IV Consultations**:

Hungary is on a 12-month consultation cycle. The last Article IV Board discussion took place on October 11, 2006.

IX. Technical Assistance:

Year	Department.	Purpose	Date
1995	FAD	Tax administration	February
1995	FAD	Treasury	February
1995	FAD	Treasury	May
1995	FAD	Treasury	November
1995	FAD	Debt management	November
1995	MAE	Central bank internal auditing	November
1995	MAE	Monetary analysis and research	December
1996	FAD	Tax policy	May
1996	MAE	Central bank accounts	September
1996	FAD	Subsidies	November
1997	FAD	Subsidies follow-up	May
2000	FAD	FSAP	February
2000	FAD	Tax legislation	June
2000	STA	Money and banking statistics	October
2000	FAD	Tax legislation follow-up	November
2002	FAD	Expenditure rationalization	November
2004	STA	ROSC update of the fiscal sector	January
2005	FAD	FSAP update	February
2005	FAD	Tax policy and administration	October
2006	FAD	Fiscal ROSC	May
2006	FAD	Public-private partnership	September
2007	FAD	Tax policy	April

X. Regional Resident Representative for Central And Eastern Europe:

Mr. Christoph Rosenberg, Senior Regional Resident Representative for central and eastern Europe, took up his duties in Warsaw in February 2005.

ANNEX II. HUNGARY—STATISTICAL ISSUES

1. Data provision is, in general, timely and facilitates effective surveillance. Significant progress has been made in improving the coverage, periodicity, and other aspects of quality of the economic and financial statistics. Most data quality issues noted in the data module of the 2001 Report on the Observance of Standards and Codes (ROSC) have been satisfactorily addressed, but some still remain.[11]

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

A. Real Sector Issues

3. To incorporate EUROSTAT regulations, the Hungarian Central Statistical Office (HCSO) started to use chain-linked indices in September 2006. Another important methodological change concerns the GDP compilation by production approach. Until 2006, the GDP estimation by production approach was based on volume indices for industries. To measure changes in the sum of gross value added, the volume indices of production were weighted on the 2000 proportions of GDP. Since the third quarter of 2006, the HCSO has been using current price estimations. In addition, as of September 2006, the HCSO introduced direct output volume measurement for some government services (education and healthcare). Furthermore, the HCSO refined its method to indirectly measure financial intermediation services by introducing two separate reference rates for transaction in local and in foreign currencies. Also, the HCSO started to include illegal activities into the national accounts.

4. The consumer price index (CPI) is compiled as an annual chained Laspeyres index using expenditure patterns for weights two years prior to the current period. The computation of imputed rent for owner-occupied housing is based on the average price changes of different repair items and does not cover all elements of costs to the user.

B. Balance of Payments

5. In 2005, the MNB launched a project to set up a new data collection system for balance of payments and IIP statistics, with a view to replace the international transaction reporting system with direct reporting of respondents by 2008. In addition, the MNB and the

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

Hungarian Central Statistical Office (KSH) have established a new data collection system for international trade in services. As a result, from 2005, data are compiled from KSH surveys in the areas of travel and business services. For the remaining service items (i.e., transportation, insurance, financial and government services), the new data reporting system is currently being developed. These new statistics on trade in services are to supplement the statistics on trade in goods, which have used the KSH's foreign trade data since 2003.

6. Furthermore, the MNB changed the reporting of stock and flow data of special-purpose entities (SPE) as of January 1, 2006. According to the international statistical standards, an offshore firm is resident of the country in which it is registered. The off-shore status of SPEs ceased to exist on December 31, 2005. From January 2006, the MNB has been compiling the BOP including data on SPEs. The MNB continues to treat the statistics that exclude the flow and stock data of SPEs, as readily interpretable in economic terms. In defining the range of SPEs, the MNB cooperates with the CSO.

C. Monetary Sector

7. Starting with the release of data for January 2003, the MNB has been compiling and publishing data based on a new methodology consistent with the European Central Bank's framework for monetary statistics using the national residency approach. In addition to the central bank and credit institutions, monetary statistics now also cover money market funds (MMFs).

8. Following Statistics Department (STA) recommendation that securities on the balance sheets of depository corporations be valued at market prices; the authorities have pursued improvement. From 2004, depository corporations were encouraged to use market valuation for securities in their trading portfolio. From 2005, this requirement was made compulsory for those depository corporations that are listed on the stock exchange.

D. Government Finance Statistics (GFS)

9. In January 2004, STA conducted a substantive update of the GFS dataset using the July 2003 Data Quality Assessment Framework. The mission reported that, overall, significant progress has been made in addressing the shortcomings of budget execution data and GFS identified in the 2001 ROSC Data Module. These improvements relate mainly to institutional coverage of general government, consolidation of data and reconciliation of deficit and financing. However, plans to report monthly expenditures classified on an economic basis have yet to come to fruition.

10. The latest data reported for publication in the 2006 GFS Yearbook are for 2005. These data now cover the operations of the consolidated central government and consolidated general government sectors, as well as their corresponding subsectors. The data for 2000 onwards have been compiled on an accrual basis and reported in the Government Finance Statistics Manual 2001 format.

Hungary: Table of Common Indicators Required for Surveillance
AS OF JUNE 11, 2007

	Date of latest observation	Date received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of publication[6]	Memo Items:	
						Data Quality – Methodological soundness[7]	Data Quality Accuracy and reliability[8]
Exchange Rates	6/11/2007	611/2007	D and M	D and M	D and M		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	May 2007	6/8/2007	M	M	M		
Reserve/Base Money	Apr 2007	5/14/2007	M	M	M	O,O,LO,LO	O,O,O,O,LO
Broad Money	Apr 2007	5/14/2007	M	M	M		
Central Bank Balance Sheet	Apr 2007	5/14/2007	M	M	M		
Consolidated Balance Sheet of the Banking System	Apr 2007	5/31/2007	M	M	M		
Interest Rates[2]	May 2007	6/5/2007	M	M	M		
Consumer Price Index	Apr 2007	5/11/2007	M	M	M	O,O,O,O	O,O,O,O,NA
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	2005	4/1/2006	A	A	A	O,LNO,LO,O	LO,O,O,O,NA
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	Apr 2007	5/20/2007	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Q4 2006	1/29/2007	Q	Q	Q		
External Current Account Balance	Q4 2006	3/30/2007	Q	Q	Q	O,LO,LO,LO	O,O,O,O,NA
Exports and Imports of Goods and Services	Q4 2006	3/30/2007	Q	Q	Q		
GDP/GNP	Q1 2007	6/8/2007	Q	Q	Q	O,O,O,LO	O,LO,O,O,NA
Gross External Debt	Q4 2006	4/2/2007	Q	Q	Q		

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

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Public Information Notice

EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 07/87
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IMF Executive Board Concludes 2007 Article IV Consultation with Hungary

On July 18, 2007, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Hungary.[1]

Background

Investor sentiment towards Hungary improved after intense financial market pressure in mid-2006. The improvement was helped by the government's announcement of a fiscal consolidation package to contain the runaway fiscal deficit. The measures helped contain the 2006 fiscal deficit, which rose to 9.1 percent of GDP. Since mid-2006, the exchange rate, which had weakened to a low of F285 per euro in June, has appreciated and its volatility has come down. About one-half of the appreciation reflected renewed bullishness for central European economies, while the other half was attributable to a more benign view of Hungary.

However, vulnerabilities remain. The public debt is about 66 percent of GDP. Although the current account deficit fell to 5.8 percent of GDP in 2006, net financing needs remained at about 9 percent of GDP and the external debt reached 91 percent of GDP.

Growth deceleration from early 2005 brought GDP growth to 3.9 percent in 2006 and 2.7 percent in the first quarter of 2007. Consumption growth weakened further after the announcement of the fiscal consolidation package in mid-2006; gross domestic capital

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

formation has fallen in the past year. Export growth, which has maintained its strength, was sustained by a shift from European and U.S. markets to fast-growing emerging European markets. Inflation surged to 6.5 percent year-on-year in the last quarter of 2006 primarily owing to the one-off effects of the hikes in taxes and regulated prices to support fiscal consolidation. After reaching 9 percent in March 2007, inflation fell to 8.5 percent in May, as the one-off effects apparently peaked.

Bank borrowing, especially in foreign currencies, decelerated in 2006 with the weakening domestic demand. Although the unhedged exposure of borrowers to foreign currency loans generates credit risks for banks, the share of foreign currency loans in total loans stabilized in the second half of 2006 at 54 percent of all loans. Banks appear capable of managing new stresses and challenges with significant financial buffers, as capital adequacy ratio is at a healthy level and profitability remains high. Furthermore, the Financial Supervisory Authority has used its market-risk stress tests to require strengthened capitalization and risk management practices in major banks.

Executive Board Assessment

Executive Directors congratulated the Hungarian authorities for their resolute efforts to rein in the budget deficit and rebuild fiscal credibility. Markets have responded favorably to the deficit-reduction measures and access to funds has eased.

Directors stressed, however, that the task ahead is formidable and that vulnerabilities remain. Fiscal and external deficits are still large, and public and external debt ratios are likely to remain high. Favorable market sentiment could reverse, especially if fiscal and external accounts deteriorate.

Directors noted that Hungary's GDP growth performance has deteriorated relative to the rest of Europe since early 2005, and more since the onset of the fiscal package in mid-2006. Domestic consumption and investment are expected to recover only gradually. Directors encouraged the authorities to continue to persevere with structural reforms to improve competitiveness and spur growth.

Directors cautioned that prolonged low growth would set back income convergence and aggravate vulnerabilities. While the easy access to Europe's product, financial, and labor markets provides the basis for a return to rapid growth with stability, realizing the full potential of that opportunity will require continued pursuit of sound public finances and a competitive business environment.

Directors welcomed the structural content of some of the fiscal consolidation measures, and urged the authorities to outline further such measures so as to extend deficit reduction beyond 2009. They welcomed the measures to strengthen tax administration, to downsize public employment, to increase efficiency in health and education, and to reform the disability and early retirement schemes. However, much remains to be done, particularly in light of the

government's contingent liabilities from loss-making public enterprises and pressures from age-related expenditures. Directors recommended further rationalization of budget support to families, housing subsidies, and local governments. A revenue-neutral tax reform that simplifies and rebalances direct and indirect taxes, and budget rules and procedures that promote fiscal discipline, should also be priorities.

Directors saw the recent easing of the policy interest rate as appropriate, with inflation having apparently peaked and likely to return to the target range over the forecast horizon. They encouraged the authorities to undertake further policy rate reductions gradually, mindful of inflation expectations. Following such an approach, they envisaged a cumulative reduction of the policy rate that could bring greater convergence with rates in the region. They highlighted that enhanced fiscal policy credibility would help dampen pronounced swings in the policy interest rate, as would increased reliance on statements of monetary policy inclinations.

In view of the wide exchange rate band for the forint, many Directors supported the current exchange rate regime, which was working well and seemed not to constrain monetary policy. Other Directors, however, considered that an eventual move to a more flexible system would be desirable, as it would be more consistent with the inflation targeting framework. The reconsideration of the exchange rate framework should take place in the context of the medium-term strategy concerning fiscal policy and euro adoption. Directors viewed the exchange rate as falling within a broadly acceptable range, but cautioned that competition from economies with lower wages and better business environments poses a threat to foreign direct investment inflows and export buoyancy, which are needed to support growth.

Directors stressed the need to improve the business climate and increase productivity to enhance economic growth. They therefore welcomed the simplification of regulatory requirements and public procurement procedures. Effective deployment of European Union funds in infrastructure, human capital, and the innovation system would also help raise productivity and growth.

Directors noted that the financial sector appears generally sound, with banks profitable and well capitalized. At the same time, with financial deepening, banks are financing riskier activities, the ongoing economic slowdown is creating more corporate distress, and foreign currency borrowing (especially by households) remains a source of balance sheet risk. Directors therefore welcomed the recent measures to contain risks by requiring some banks to strengthen their risk management procedures and capitalization. In this context, Basel II regulations should be put in place, and risk-based consolidated supervision across financial institutions should keep pace with ongoing developments.

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

Hungary: Main Economic Indicators, 2003–07

	2003	2004	2005	2006	2007
					Proj.
Real economy (change in percent)					
Real GDP	4.2	4.8	4.2	3.9	2.7
CPI (end year)	5.7	5.5	3.3	6.5	5.0
CPI (average)	4.6	6.8	3.6	3.9	7.3
Unemployment rate (in percent)	5.9	6.1	7.2	7.5	8.0
Gross domestic investment (percent of GDP) 1/	25.2	26.1	23.7	23.0	21.8
Gross national saving (percent of GDP, from BOP)	17.3	17.7	16.9	17.2	16.9
General government (percent of GDP), ESA-95 basis 2/					
Overall balance	-7.2	-6.5	-7.8	-9.1	-6.3
Debt	58.0	59.4	61.7	65.5	66.2
Money and credit (end-of-period, percent change)					
M3	12.0	11.6	14.5	13.9	…
Credit to nongovernment	34.4	19.2	18.8	17.3	...
Interest rates (percent)					
T-bill (90-day, average)	8.2	11.1	6.8	7.0	...
Government bond yield (5-year, average)	6.4	9.7	8.0	6.9	...
Balance of payments					
Trade balance (percent of GDP) 3/	-3.9	-3.0	-1.6	-0.5	1.4
Current account (percent of GDP) 3/	-7.9	-8.4	-6.7	-5.8	-4.9
Reserves (in billions of US dollars)	12.8	16.0	18.6	21.6	23.8
Gross external debt (percent of GDP) 4/	61.7	67.1	74.7	91.3	78.8
Exchange rate					
Exchange regime		Peg against euro, with band +/-15 percent			
Present rate (May 30, 2007)		Ft 185.8 = US$1			
Nominal effective rate (1990=100)	38.8	39.6	39.2	37.1	...
Real effective rate, CPI basis (1990=100)	170.1	181.3	182.8	176.0	...

Sources: Hungarian authorities; Bloomberg; and IMF staff estimates.

1/ Includes change in inventories.

2/ Consists of the central budget, social security funds, extrabudgetary funds, and local governments, as well as motorway investments previously expected to be recorded off-budget in 2006-07.

3/ The central bank believes that due to methodological changes, 2005-06 trade balance may be overstated by more than 2 percentage points of GDP.

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