

Hungary: 2002 Article IV Consultation—Staff Report; Staff Statement; and Public Information Notice on the Executive Board Discussion

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2002 Article IV consultation with Hungary, the following documents have been released and are included in this package:

- the staff report for the 2002 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **March 7, 2002**, 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 April 26, 2002.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- a staff statement of **May 22, 2002** updating information on recent developments.
- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its May 22, 2002 discussion** of the staff report that concluded the Article IV consultation.

The document(s) listed below have been or will be separately released.

Selected Issues Paper
Report on Observance of Standards and Codes-Data Module: An Update
Report on Observance of Standards and Codes-Fiscal Transparency: An Update
Statistical Appendix

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

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INTERNATIONAL MONETARY FUND

HUNGARY

Staff Report for the 2002 Article IV Consultation

Prepared by the Staff Representatives for the 2002 Consultation with Hungary

Approved by Carlo Cottarelli and Liam P. Ebrill

April 26, 2002

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The 2002 Article IV consultation discussions were held in Budapest during February 21–March 7, 2002. The mission met with: President Járαι of the National Bank of Hungary (NBH); Finance Minister Varga; senior officials in the NBH, government ministries, and Parliament; trade unions; and representatives of financial and research institutions.

The staff team was headed by Mr. Feldman and included Ms. Wagner, and Messrs. Berger and Drummond (all EU1). A team headed by Mr. Quintyn (MAE) also visited Budapest during February 25–March 8 to update the 2001 Financial System Stability Assessment. The Regional Resident Representative, Mr. Nord, assisted both teams. Mr. Kiekens, Executive Director for Hungary, attended the concluding policy meeting.

Hungary participated this year in the preparation of updates of the Report on Standards and Codes (ROSC) modules on the financial and fiscal sectors, and on data dissemination. Hungary meets the Special Data Dissemination Standard (SDDS) specifications.

In concluding the last Article IV consultation on May 4, 2001, Directors commended Hungary on its impressive economic performance. This included remarkable export growth, strong external competitiveness, and a narrowing external current account deficit. They urged Hungary to maintain its track record of careful macroeconomic management, while pressing ahead with remaining structural reforms. They also welcomed the decision to widen the exchange rate band, and the room it would provide monetary policy to fight inflation. But Directors emphasized that monetary policy alone could not achieve both inflation and external objectives: support from appropriate fiscal adjustment would be needed.

Parliamentary elections were completed on April 21, 2002 and a center-left coalition led by the socialist party won by a narrow margin.

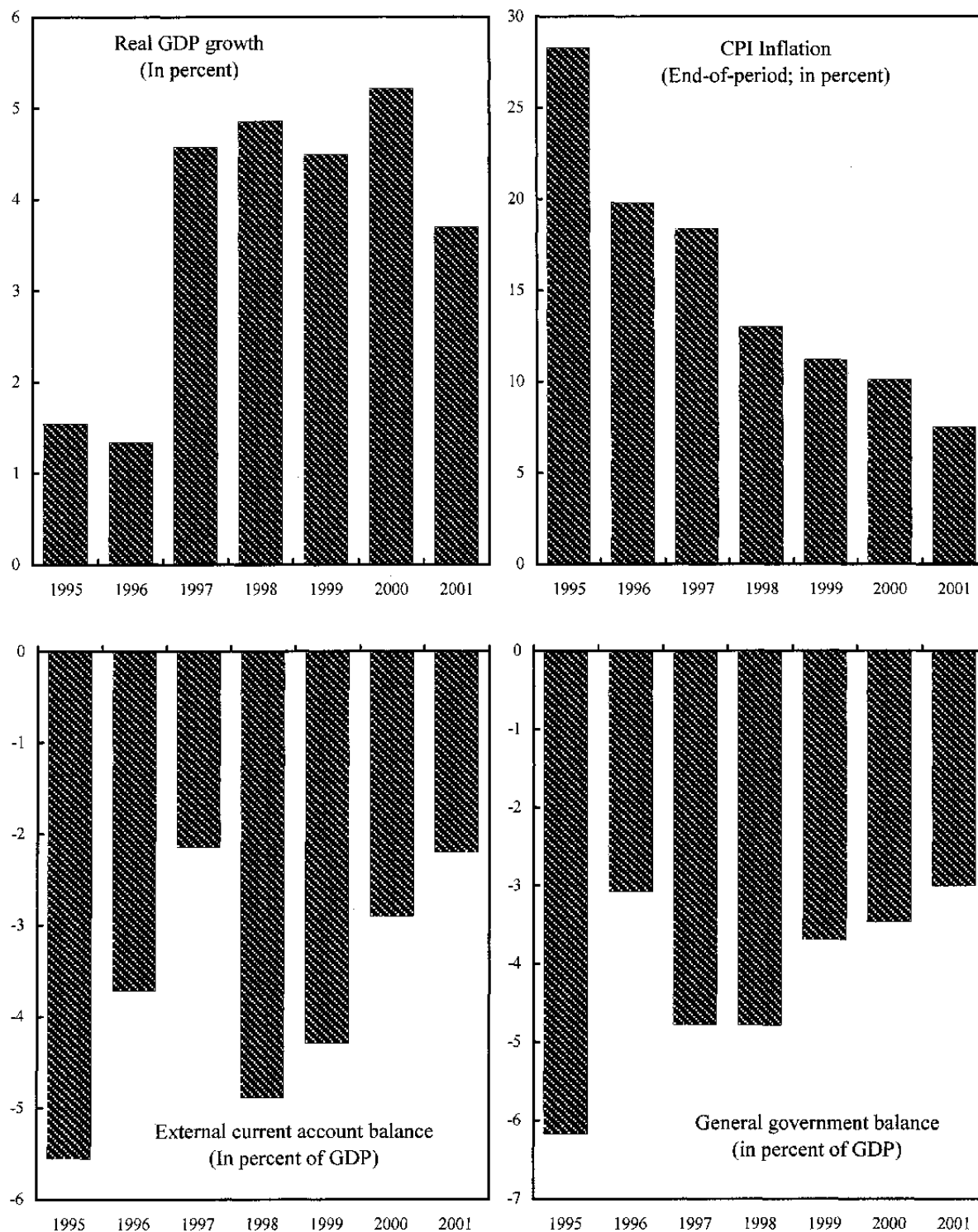
Hungary is among the most advanced EU accession countries. So far, 24 chapters of the *acquis communautaire* have been provisionally closed. In its last Regular Report, the European Commission concluded that Hungary is a functioning market economy and, provided that it fully maintains and implements its reform program in a consistent manner, should be able to cope with competitive pressure and market forces within the EU in the near term.

I. BACKGROUND

1. **Hungary achieved remarkable economic success in the four years to 2000.** The country maintained strong output growth, increased employment, raised the investment-to-GDP ratio, reduced inflation significantly, steadily narrowed the fiscal deficit, and lowered the current account deficit to a sustainable level (Table 1 and Figure 1). All this reflected careful macroeconomic management and significant structural reforms, including the lasting effects of the bold reform measures of the early and mid-1990s.

2. **Although economic growth slowed in 2001, the economy showed considerable resilience to the slowdown in the EU.** GDP growth was a still respectable 3.8 percent, down

Figure 1. Hungary: Selected Economic Indicators, 1995-2001



Sources: Hungarian authorities and staff estimates.

from 5.2 percent in 2000 but higher than in most other countries in the region.¹ While this reflected a deceleration in the growth of exports, they nevertheless outpaced growth in Hungary's export markets (Figure 2). Demand was partly supported by buoyant private consumption on the back of strong real wage gains. Meanwhile, the unemployment rate edged down to 5.6 percent by the start of 2002 and labor market conditions remained tight in some regions—though the number of employed dropped by 1 percent.

3. **With economic growth slowing and the political cycle in full swing, fiscal policy turned expansionary in 2001, also contributing to domestic demand.** The sizable fiscal stimulus, estimated at about 2 percent of GDP (see text table below), contributed to public investment and growth at a time when private investment was being scaled back. But the higher level of public spending—notably on wages and pensions—has increased the challenge of attaining needed medium-term fiscal adjustment. The deficit of the general government, on an SNA basis, almost reached an estimated 5 percent of GDP.

Consolidated General Government Balance (Official and SNA Basis)^{1/}

	2000	2001 Prel.	2002 Proj.
	(In percent of GDP)		
Overall balance, official (see Table 2a)	-3.7	-3.3	-3.2
Adjustments (see Table 2b)	0.2	-1.6	-2.5
Overall balance on an SNA basis	-3.5	-4.9	-5.7
<i>Memorandum item:</i>			
Fiscal impulse (+=fiscal stimulus) ^{2/}	-1.1	2.0	0.9

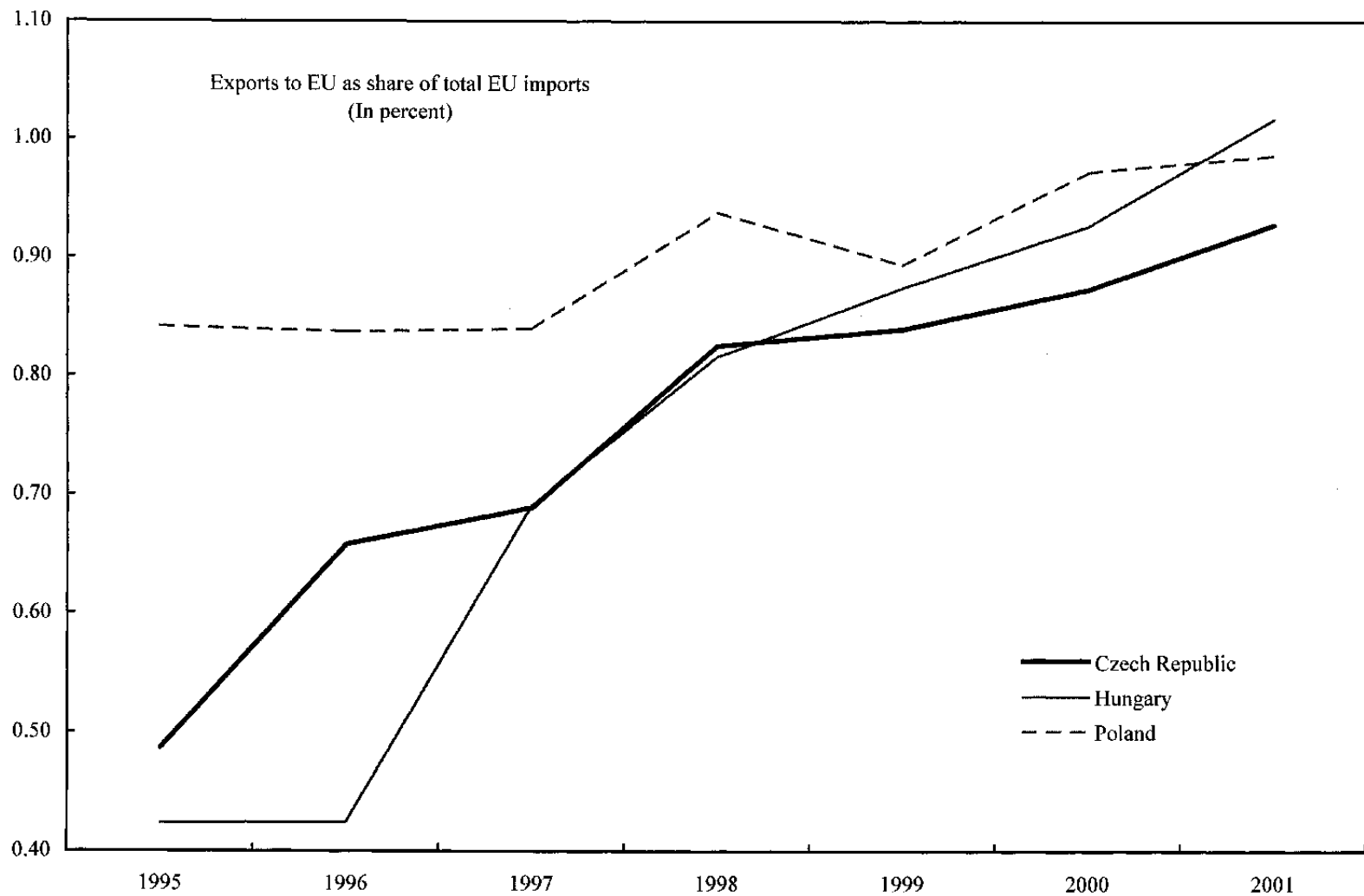
Sources: Ministry of Finance and preliminary staff estimates.

1/ As in the past, staff has made adjustments to include the fiscal activities of the privatization agency, the Hungarian Development Bank, and the motorway company, to measure more fully than the official statistics the impact of the operations of the general government.

2/ Measured by the change in the structural primary balance on an SNA basis, assuming potential GDP growth of 4.5 percent.

¹ Bearing in mind the difficulty in measuring potential output, the output gap in 2001 would be approximately -1 percent of GDP, assuming potential growth of about 4½ percent and a closed output gap in the preceding year.

Figure 2. Hungary: Export Performance, 1995-2001 1/



Sources: Direction of trade statistics, IMF.

1/ January through November data for 2001.

4. **The authorities successfully introduced a new monetary policy framework—widening the exchange rate band in May 2001 to ± 15 percent against the euro and adopting inflation targeting in June 2001.** Notwithstanding a string of interest rate cuts since the band widening, this led to a tightening of monetary conditions (Figure 3). With inflation expectations coming down—as indicated, for example, by the Reuters’ poll of financial analysts and the decline in long-term interest rates—real short-term interest rates have increased. The exchange rate is the more powerful channel of monetary policy transmission, and the forint has strengthened against the euro by some 10 percentage points since the band widening, to stand about 12 percent above its central rate.

5. **Inflation has come down.** After peaking at 10.8 percent in May 2001, year-on-year consumer price inflation declined steadily to 6.8 in December 2001 (somewhat under the NBH’s projection), falling further to 5.9 percent in March 2002 (Figure 4). This reflected moderating growth in tradable goods inflation owing largely to the appreciation of the forint; a drop in services sector inflation to single digits, attributed to greater competition; and a decline in food and fuel prices. Core inflation, which excludes certain fuel and food prices, and administrative prices, declined by 4.2 percentage points over the same period.

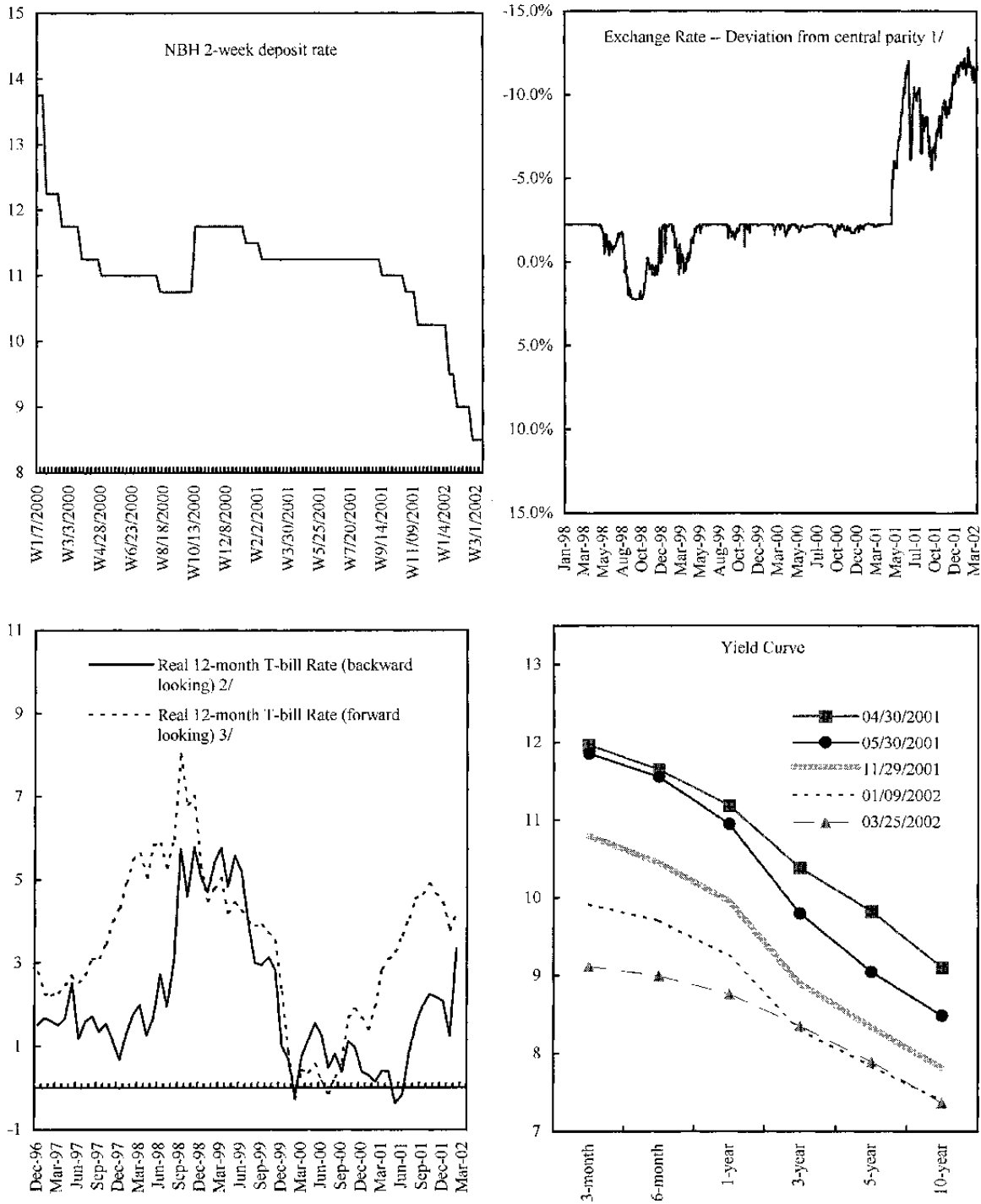
6. **Wage growth, though somewhat difficult to interpret, has accelerated.** Year-average economy-wide nominal wage growth reached 18 percent (16 percent in the private sector) in 2001, compared with headline inflation of 9.2 percent. In contrast to the preceding few years, real wage growth outpaced productivity gains, reflecting in part faster-than-anticipated disinflation. As shown in Figure 4, in contrast to a rapid acceleration in public sector wages, wage growth in the private sector has recently been much more moderate. Moreover, while a 57 percent increase in the minimum wage, introduced in January 2001, was a contributing factor to wage increases, some minimum wage workers actually receive higher but unrecorded pay. This implies that the minimum wage hike had the effect of raising measured wages more rapidly than actual wages.² In January 2002, the minimum wage was increased again by 25 percent: it now stands at almost 45 percent of average wages, compared with about 35 percent in Poland and the Czech Republic.

7. **The external current account deficit narrowed in 2001, and external financing was unaffected by emerging market tensions over the past year.** The deficit was 2.1 percent of GDP, down from 2.9 percent of GDP in 2000 (Table 3).³ In terms of the underlying current account flows: import growth moderated owing to the sharp drop in private investment growth and lower oil prices; exports, though slowing during the year,

² Estimates by the NBH—adjusted for the composition of employment and the number of working days, as well as removing the impact of the minimum wage—suggest that wage growth in the private sector, on a year-average basis, could have been as much as 3½ percentage points lower than the official data would indicate.

³ The deficit would be higher if retained earnings were included in the official statistics, but FDI would also be correspondingly higher. These earnings have been estimated in the range of 2 to 3 percent of GDP, but data are not yet officially available.

Figure 3. Hungary: Components of Monetary Conditions, 1996-2002



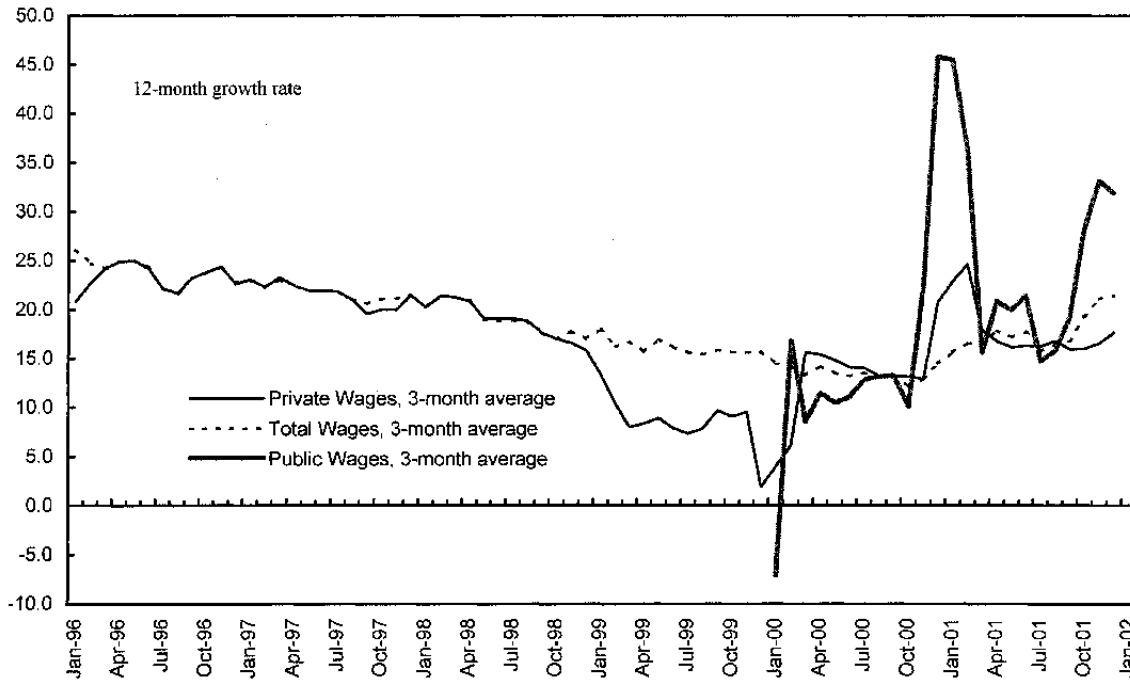
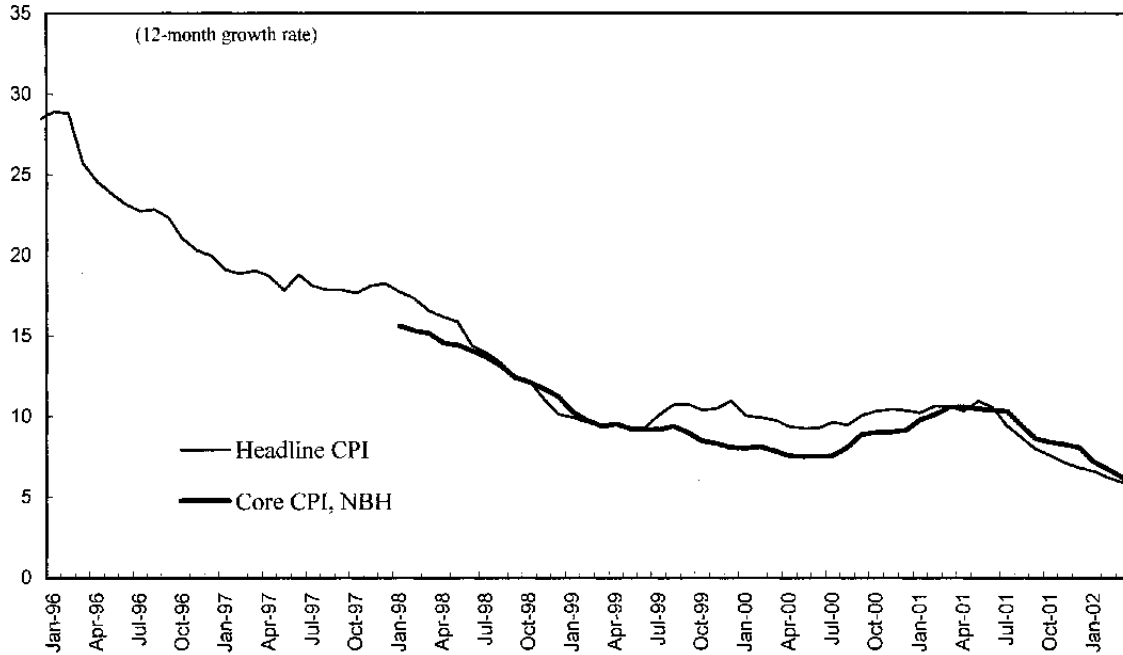
Sources: National Bank of Hungary and Bloomberg.

1/ A minus (-) sign means appreciation.

2/ Nominal 12-month T-bill rate adjusted for the ex-post 12-month CPI growth rate.

3/ Nominal rates deflated by one year ahead CPI.

Figure 4. Hungary: Consumer Prices and Wage Development, 1996-2002
(In percent)



Sources: Hungarian authorities.

were buoyant on a year-average basis; tourism receipts were strong; and profit repatriation at year-end was unexpectedly much less than in previous years. Access to international financial markets has remained on favorable terms, even amid emerging market turmoil,⁴ and there has reportedly been little indication of speculative inflows, even in the aftermath of full capital account liberalization in mid-2001. At this time, vulnerability is judged to be low, as indicated, for example, by a comfortable level of international reserves (measured in terms of import cover, short-term debt, or broad money) (Table 4).

II. REPORT ON THE DISCUSSIONS

8. **In addition to the short-term outlook, the discussions centered on the medium-term macroeconomic framework and related implications for policy.** With policy anchored on the overarching objective of early accession to the EU and adoption of the euro, consolidating the public finances and achieving EMU-compatible inflation were issues of particular focus. So was advancing the real convergence process through completing the structural reform agenda, maintaining growth-enhancing fiscal expenditure in the context of an appropriately restrained overall fiscal stance, and generally ensuring macroeconomic stability, including to encourage an environment conducive to investment.

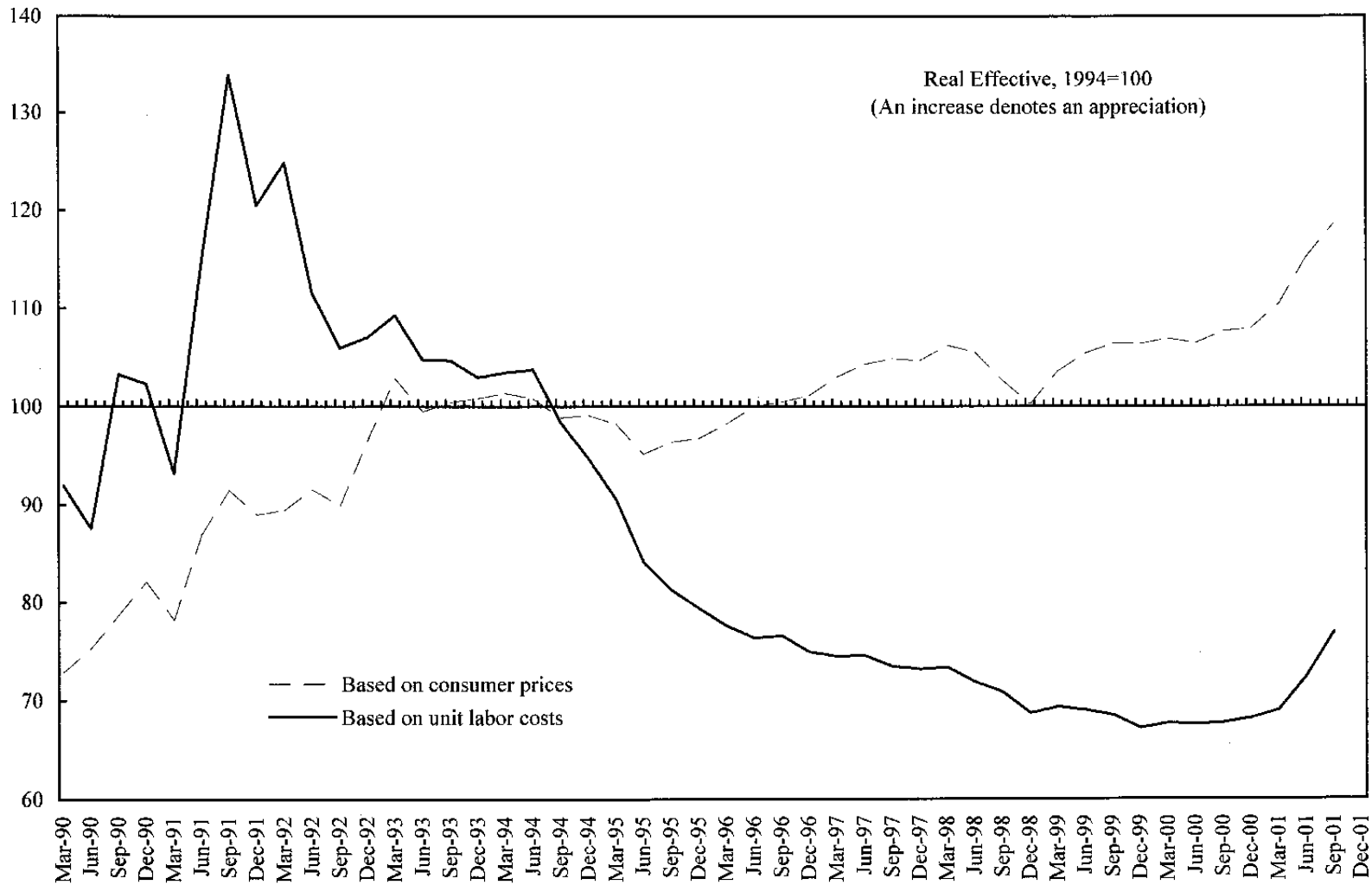
9. **Policies and related details will need to be fleshed out by the new government.** The political cycle has meant that the fiscal effort and progress on various structural reforms had to await the completion of parliamentary elections in April. The authorities stressed that the next two years are critical ones, with the first 12 months after the elections offering the best window of opportunity to initiate work and lay the economic and political groundwork on needed reforms.

A. Economic Outlook and Objectives

10. **The authorities expect economic growth to accelerate.** Underpinned by an improving external environment in the second half of this year, the authorities' baseline calls for export growth and private investment to pick up—resulting in a shift in the composition of growth away from other components of domestic demand. While, on a year-average basis, the pace of economic activity slows down modestly to about 3½ percent (notwithstanding the pick up as the year progresses), the economy is expected to gather pace in later years, with real GDP rising by about 4 percent in 2003, led by increasing export growth. The mission's projections were broadly in line with the authorities. Downside risks were recognized, reflecting uncertainties concerning wage growth, the lagged effects of an appreciating real effective exchange rate (Figure 5), and the timing of the upturn in western Europe. But the upside was also recognized, reflecting, for example, supply-side considerations related to

⁴ Interestingly, the government has changed its borrowing strategy for 2002 by shifting exclusively to forint-denominated bonds and lengthening the average maturity of its debt. The government floated its first 15-year bond last November at a heavily oversubscribed auction, which elicited strong investor interest.

Figure 5. Hungary: Exchange Rates, 1990-2001



Sources: Hungarian authorities.

generally strong competitiveness and shifts from other production sites to lower-cost Hungary.⁵

11. **Key medium-term macroeconomic targets have been set with a firm eye on early EU accession and adoption of the euro.** For Hungary, a small economy that is already highly integrated with the EU, adopting the common European currency has clear medium-term benefits. This is particularly true given the important role in Hungary of FDI and foreign-owned enterprises, and their orientation mainly toward EU markets. The commitment to early EU accession and adoption of the euro not only hardens the authorities' resolve to deliver the necessary fiscal discipline and structural reforms, but it can also serve to strengthen the credibility of the disinflation path and, by doing so, can also help to minimize short-run costs that might arise. The authorities have announced end-year targets (with tolerance bands of ± 1 percent) for headline inflation of 4.5 percent and 3.5 percent for 2002 and 2003, respectively; and the goal of narrowing the deficit of the general government (on an ESA-95 basis, consistent with the Maastricht fiscal criterion) to 2–3 percent of GDP by 2004.

B. Monetary and Exchange Rate Policy

12. **All agreed that maintaining the momentum of disinflation should be the primary objective of monetary policy.** The inflation targeting framework has served Hungary well in this regard.⁶ With the benefit of a stronger exchange rate since the widening of the band, the NBH has been successful in lowering its policy rates while maintaining broadly appropriate monetary conditions—and the fall in inflation expectations is evidence of the increasing credibility of the NBH's disinflation strategy. At the same time, in the context of their goal of early adoption of the euro, the authorities recognized that the objective of lowering inflation to EMU-compatible levels, while real convergence advances, presents challenges for the policy framework. In this connection, in light of the expected real appreciation of the exchange rate associated with real convergence—through, for example, the Balassa-Samuelson effect—the nominal exchange rate may have to appreciate if disinflation is to continue on the envisaged path.

13. **The inflation targets for both this year and next are within reach—but not without risks that inflation could be higher than targeted.** The NBH projects the continuation of rapid disinflation through the first half of 2002. Owing in part to an expected rise in the oil price, this is followed by a period of stable inflation until 2003 when disinflation is projected to resume. In the NBH's view, downside risks of lower inflation counterbalance the upside, particularly in 2002. Regarding possible downside risks, the NBH

⁵ Broadly speaking, staff believes that the appreciation of the forint so far has not compromised Hungary's external competitiveness in light of the substantial gains made earlier in reducing relative unit labor costs, as shown in Figure 5.

⁶ An accompanying Selected Issues paper discusses in more detail the inflation targeting framework.

has lowered the assumed exchange rate pass-through for its central forecast, but views a higher pass-through as a possibility. This could lead to lower-than-expected inflation. Upside risks to the central projection stem from uncertainty over regulated prices (especially in 2003) and wage behavior. While considerable uncertainty surrounds the impact of this year's minimum wage hike, the authorities clearly expected it to be more binding than last year's. They, nevertheless, were also hopeful that labor market flexibility would mitigate its impact and other wage pressures on inflation.⁷ Discussions with labor unions highlighted two concerns: they argued that containing wage increases following the rise in the minimum wage would prevent wage differentiation; moreover, they were skeptical about the NBH's inflation targets in light of the inflation overshooting in the past.

14. **Staff saw greater upside risks than the authorities.** In particular, staff expressed concern that private sector wages could increase by more than the NBH projected in formulating its inflation outlook.⁸ This was on account of the signaling effect of large wage increases for the public sector in 2001 and 2002, and the potential unwinding of wage compression caused by the increase in the minimum wage. In the staff's view, this could make it all the more difficult to meet the inflation targets, and could also weaken external competitiveness down the road.

15. **The authorities and staff agreed that labor market participants' expectations of future inflation will be heavily influenced by whether this year's target will be met.** By meeting it, monetary policy can reduce their expectations of inflation, thereby restraining future wage growth and lending strong support to meeting future inflation targets. Staff was of the view that the risk of higher inflation argued for a cautious approach in deciding on further interest rate cuts in the period ahead. In particular, with fiscal stimulus still in the works (see below) and disinflation widely expected to pause, or possibly reverse, in the second half of this year, there was considerable merit in at least maintaining the current degree of monetary tightness. The NBH saw the potential conflict between the current exchange rate band and meeting its inflation targets, but emphasized that it would stand ready to raise interest rates, if need be, to safeguard its inflation targets. More generally, the NBH has developed a broad-based communication strategy (including by providing a comprehensive and transparent assessment of inflation in its *Quarterly Report on Inflation* and direct outreach efforts with the social partners) to encourage more forward-oriented assessments of inflation in wage setting behavior.

16. **Monetary policy cannot do it alone—the policy mix will be key.** The authorities concurred with the staff's stress on the importance of support from fiscal consolidation, as this would help to keep monetary tightening as moderate as possible and avoid too strong an

⁷ Although too soon to form firm judgments, technical discussions at the NBH suggested that December 2001 data on private sector wages may be indicative of labor markets responding flexibly to the slowdown in growth and the appreciation of the forint.

⁸ The NBH forecasts private sector wage inflation, on a year-average basis, of 8 to 10½ percent for 2002 and 5 to 8 percent for 2003.

appreciation of the forint, which, *inter alia*, could have unwanted consequences on export performance. And a strong and visible commitment by fiscal policy to support monetary policy would add to the credibility of the disinflation path, help anchor inflation expectations, and thereby moderate wage growth. Such gains in credibility would help to minimize any real cost associated with significant disinflation.

C. Fiscal Policy

17. **The authorities saw several advantages of significant medium-term fiscal consolidation.** Although the authorities cannot establish precise medium-term targets for the fiscal deficit until a new government is in place, a deficit of the general government—on an SNA basis—in the range of 2 to 2½ percent of GDP by 2004 would be in line with the target outlined in the Pre-Accession Economic Program (prepared in the spring of 2001). As indicated by the authorities in broad terms and demonstrated by the staff's medium-term scenario (Table 5), a deficit of this size would contribute to meeting a number of goals: supporting the disinflation effort; raising national saving to support investment; safeguarding public debt and external sustainability;⁹ avoiding crowding out private sector investment; and leaving room for maneuver in conducting stabilization policies, while providing a safety margin for meeting the Maastricht fiscal criterion.

18. **Achieving the medium-term fiscal objective will not be easy.** Without adjustment, the fiscal stimulus this year could be about 1 percent of GDP and the deficit of the general government, on an SNA basis, could reach 5¾ percent of GDP. This would imply a narrowing of the deficit by about 3 percentage points of GDP to achieve the desired fiscal deficit by 2004. The authorities noted that roughly a percentage point of this adjustment is expected to come from lower interest payments. They also noted in other discussions that another ½ percent of GDP or so might come from net transfers from the EU (after membership in early 2004). But there would obviously be a need for greater expenditure restraint by the new government.

19. **Redirecting fiscal policy at the earliest opportunity would facilitate the task at hand.** Staff strongly recommended aiming for a broadly neutral fiscal stance in 2002 (implying a general government deficit of 4¾ percent of GDP on an SNA basis). This would avoid adding stimulus at a time when the economy is likely to gather steam, and would give an early start to achieving the medium-term targets. However, with only part of the year remaining to bring the 2002 fiscal deficit down to the level recommended by staff, the change in government near midyear, and local elections in October, fiscal adjustment could well get delayed into 2003. But, even in these circumstances, it would be crucial to initiate the needed work on reforms once a new government is formed, in anticipation of taking decisive actions next year.

⁹ This includes targeting an external current account deficit of under 4 percent of GDP, which would be sustainable in the staff's view. See "Sustainability in the Hungarian Balance of Payments," IMF Staff Country Report (SM/99/27).

20. **In a related vein, adopting medium-term expenditure limits would help secure the desired fiscal deficit targets.** A workshop on the medium-term fiscal framework pointed to the importance of calibrating discretionary, lower-priority, spending to safeguard the fiscal target, after taking into account expenditures that are precommitted and defining and protecting goals for other categories of priority spending (e.g., infrastructure and EU-accession related outlays). In all of this, it would be important to identify the impact of possible reforms—for instance, in the health care and pension systems, the civil service, and better targeting of other social benefits. In some key areas, such as health care, education, and other local services, reforms will require cooperation between central and local levels of governments to ensure local services are pooled to meet needs efficiently. The Ministry of Finance has started preparing a review of public expenditure—with a view to presenting options for containing spending to the new government. Making medium-term spending targets public—which would include providing them to Parliament during the budget cycle—would help establish the political commitment to, and credibility of, the specified expenditure ceilings, as well as the medium-term fiscal adjustment path.

D. Structural Reforms

21. **Critical structural reform priorities—needed to support the medium-term fiscal consolidation effort and Hungary’s long-term growth potential—remain outstanding.** The discussions raised a number of issues in four key areas, which would have implications for labor supply, investment, total factor productivity, and macroeconomic stability. But the specifics of reform plans and initiatives would have to await a new government.

22. **On pensions, recent changes have reversed some of the features of the earlier pension reform and the impact is yet uncertain.** The comprehensive reforms of 1997 substantially improved the viability of the pension system. These reforms included both far-reaching changes in the traditional PAYG scheme and the introduction of a second pillar (mandatory for new labor market entrants, but voluntary for others) based on private pension funds. Partly reflecting the surprisingly high number of workers choosing to switch to the multi-pillar system, the authorities adopted changes in November 2001. These included: (i) making the decision to join either the traditional PAYG plan and the two-pillar pension scheme voluntary; and (ii) abolition of the minimum benefit state-guarantee for privately funded pensions. In addition, the authorities maintained the decision made during the preparation of the 2001–2002 two-year budget not to increase financing of the second pillar from 6 percentage points of participants’ pension contributions to 8 percentage points, thus reducing the importance of the privately funded pillar relative to the reforms envisaged earlier. Some of the implications of these actions are discussed in the box below.

Altering the 2nd Pillar of the Pension System: What are the Implications?

The decision to allow voluntary participation in the two-pillar scheme, even for new labor market entrants, could lead to an increase in the unfunded liabilities of the overall pension system to the extent that workers choose to participate in the traditional PAYG plan. The fiscal deficit, all else equal, would be smaller in the near-term, but only as long as the temptation to spend the extra revenues from contributions are resisted (and at some cost to the intertemporal balance overall).

The abolition of the minimum benefit state-guarantee for privately funded pensions reduced the contingent liabilities stemming from the pension system. To the extent that the recent withdrawal of the guarantee does not lead to a significant backflow into the traditional PAYG plan—which so far it has not—the intertemporal balance of the pension system would be improved.

The decision not to proceed with the planned increase in the contribution rate to the private second pillar could have some disadvantages from a long-term perspective. While, in principle, both the private and the PAYG pillar of the pension system could be used to raise the actuarial fairness and, thus, the incentives to participate officially in the labor market, strengthening the private pillar might be a more effective way to achieve this goal from the standpoint of administrative costs. In this regard, meeting the informational requirements for converting the existing PAYG pillar, as in many European countries, into one with a transparent notional defined contributions system—a plan currently under review—may need to involve a substantial effort in terms of resources and staff.

23. In all, against the background of adverse demographic prospects, policy makers will be increasingly confronted with the need to address issues related to the unfunded future liabilities of the public pension system. This will require timely, consistent and transparent decisions on a range of policies that affect the viability of the pension system, with a view to increasing the effective supply of labor and keeping benefits within prudent limits.¹⁰

24. Tackling health care reform ranks very high on the agenda. Health care costs are likely to rise significantly over the longer term due to population ageing. However, while the Health Insurance Fund has experienced large spending overruns, comprehensive health care reform has been delayed. Plans now on the table, in addition to a number of ad hoc measures to control spending, include programs that aim to allow doctors to practice on a contractual basis outside the traditional health care system, and to set the stage for further private provision of health care services, especially in hospitals. If implemented consistently by the new government, these measures—along with others in the context of a comprehensive reform, possibly including expanding the range of co-payments and limiting the range of health services covered by the public system—could help to increase the efficiency of the public health care sector and lower its reliance on general government revenues.

25. Regulatory reform of the energy sector, aimed at reducing state ownership and ending subsidization of prices at the household level, is progressing slowly. The new Electricity Act approved this year allows for a gradual opening of the electricity market to

¹⁰ An accompanying Selected Issues paper discusses the impact of aging and pension reform.

private suppliers beginning in 2003—though with full liberalization by 2010. At the same time, privatization of MVM, the large wholesaler and network operator, has been postponed, and government still plays a decisive role in price-setting, sometimes overriding pre-agreed formulas if the resulting price increase is deemed too large. Similarly, liberalization of the natural gas market will only be gradual, state-ownership in the dominant supplier MOL is still substantial (and expected to grow with the prospective renationalization of the gas unit), and natural gas price regulation keeps household prices artificially low. The government has, at times, covered a significant part of the losses arising at the supplier level through ad hoc payments.

26. **The authorities noted that there is overstaffing in the public sector.** While acceding to the EU implies higher staff levels in some areas, they indicated that employment in health, education, and general administration needs to be better rationalized. A rationalization program, even when combined with higher wages to retain highly qualified staff, could contribute to scaling back the size of government and the public wage bill, in line with the authorities' objectives, help to increase labor force participation rates in the private sector of the economy, and contribute to the targeted fiscal adjustment. An assessment of public sector employment that could aid future rationalization efforts is underway.

E. Financial System Stability

27. **Against the backdrop of the international economic slowdown and slower growth domestically, the financial system demonstrated its resilience.** The update of the 2001 Financial System Stability Assessment revealed no serious threats to the stability of Hungary's financial system, a view shared by the NBH as indicated in its latest *Financial Stability Report*.¹¹ Banks remain adequately capitalized and liquid, and asset quality remains high. Bank profitability increased significantly in 2001, supported in particular by the fast growth in lending to small- and medium-size enterprises and the household sector, which more than offset the effects of narrowing interest rate margins. Mortgage lending continued to accelerate in 2001, driven by a generous home building subsidy plan; the authorities agreed with the staff's stress on careful monitoring of this rapid pace of growth to ensure that it not lead over time to a deterioration in the quality of banks' asset portfolios. Nonbank financial institutions continued to increase their market shares, from a very low base, within the financial system, without any systemic stability issues arising.

28. **The changes to the monetary and exchange regime framework in 2001—adoption of inflation targeting, widening of the exchange rate band, and removal of the remaining capital controls—have significantly altered the operating environment for the financial system.** Combined, these policy changes have stimulated the development of foreign exchange and forint money markets, facilitating risk management and, more broadly, a smoother operating environment for financial institutions. Trading volumes in both markets have grown significantly and maturities have lengthened, while interest and exchange rate

¹¹ More details are provided in the Financial System Stability Assessment (FSSA) follow-up, and related documentation, which accompany this Staff Report.

volatility have not increased dramatically. Nevertheless, in this new environment, staff reiterated the importance of strengthening monitoring of the financial sector's indirect exposure to exchange and interest rate movements (including through regular surveys of corporate exposures).

29. **The significant strengthening of the legal framework governing the financial system is an additional safeguard for the financial system's stability.** In the aftermath of the 2000 Financial System Assessment Program (FSAP) effort and in the run-up to EU accession, several new acts on the financial sector have been adopted. The new act on the National Bank of Hungary further enhances the transparency of the central bank's operations. The new credit institutions act sets the stage, among other improvements, for consolidated reporting and supervision—a most welcome enhancement of Hungary's supervisory framework. The new capital markets act strengthens the supervisors' enforcement power, further liberalizes the markets, and removes several legal uncertainties with respect to the use of repos and pledges. Finally, the autonomy and accountability of the Hungarian Financial Supervisory Authority (HFSA) have also been strengthened. These legal efforts bring Hungary close to international standards and practices, but fall short of granting full legislative independence for the HFSA. The mission also noted some other areas for further strengthening, including fit and proper testing (in particular, the power to remove board members or managers at later stages), and the mechanisms to instill principles of good corporate governance in the financial institutions. In addition, the lack of a gradual ladder of sanctions to address noncomplying financial institutions could hamper the effectiveness of supervisory action. New legislation for the insurance sector is still underway, which aims at EU compatibility.

30. **The mission commended the authorities for adopting stricter legislation aimed at combating money laundering and terrorist financing.** The assessment revealed that the new legal and regulatory framework, adopted in 2001, effectively addresses the two major issues that the Financial Action Task Force (FATF) raised regarding Hungary—the existence of anonymous savings deposits and the lack of information regarding beneficial ownership. Over the period ahead, the focus should be on taking steps to ensure robust implementation of the strengthened anti-money laundering legislation and improving the efficiency of the functioning of the Financial Intelligence Unit.

F. Transparency and International Standards

31. **Hungary has made further progress in the area of economic statistics.** As described in the statistical issues appendix, the authorities have addressed a number of issues of data quality noted in last year's report—though some problems remain within government finance statistics, reflecting the growing size of off-budget fiscal activities in recent years.

32. **Fiscal transparency should be strengthened.** While work to compute the fiscal accounts on an ESA95 basis has been proceeding, it will be important to reduce the growing discrepancy between the cash budget approved by Parliament and monitored by government, and the more inclusive measure of the general government that includes fiscal activities now treated off budget (notably the activities of the National Motorway Company, the Hungarian Development Bank, and the privatization agency). The first priority should be to scale back

off-budget fiscal spending (including by bringing such spending into the budgetary process). At the same time, a comprehensive and timely information system should be put in place, ensuring that the Ministry of Finance can keep up-to-date and accurate records of all fiscal spending, including by off-budget agencies.

III. STAFF APPRAISAL

33. **The performance of the Hungarian economy has been impressive.** This reflects careful macroeconomic management and far-reaching institutional and structural reforms, including the lasting effects of the bold measures of the early- and mid-1990s. Though growth slowed in 2001 from the fast pace of the previous year, the economy weathered the recent global economic slowdown well. As long as appropriate policy adjustments are made and EU demand picks up, economic growth can be expected to accelerate and gather pace in later years—with the external current account deficit staying within safe limits.

34. **The authorities' objective of seeking early EU accession and adoption of the euro provides a key anchor for the policy framework with clear benefits.** This is particularly the case as Hungary is already highly integrated with the EU. Moreover, the commitment to an early entry should underpin the authorities' resolve to deliver needed fiscal discipline and structural reforms, and therefore also serves to strengthen the credibility of the policy framework.

35. **Achieving this objective poses significant challenges.** Against the background of rapid growth in public sector wages, the large hike in the minimum wage, and still tight labor market conditions, achieving the targeted disinflation path is not yet assured. In addition, fiscal adjustment has been made all the more difficult by the significantly expansionary fiscal stance last year and into this year.

36. **The introduction of a new monetary policy framework—which was well managed both publicly and professionally—has contributed to putting inflation back on a downward track.** Widening the exchange rate band allowed the NBH to appropriately tighten monetary conditions. And the significant fall in inflation helped to foster the credibility of the new inflation targeting regime.

37. **Securing the targeted disinflation will require a determined effort.** Keeping monetary policy tight will be key, as an easing of monetary conditions would risk rekindling price pressures, not least in circumstances in which real growth is expected to pick up. Support from fiscal policy is also essential. This would help to keep monetary tightening as moderate as possible and avoid too strong an appreciation of the forint.

38. **It will be important to reverse the fiscal expansion underway at the earliest opportunity.** Achieving a broadly neutral fiscal stance in 2002, while challenging, would eschew adding stimulus at a time when the economy is likely to gather steam. Equally as important, it would facilitate meeting medium-term fiscal consolidation objectives and avoid crowding out private sector investment. In addition, a strong, early, and visible commitment by fiscal policy to support monetary policy would add to the credibility of the disinflation path—and help anchor inflation expectations more firmly, moderate wage growth, and

minimize real costs associated with disinflation. Initiating needed work on fiscal reforms as soon as a new government is formed would help to ensure that decisive fiscal actions are implemented next year.

39. **Meeting fiscal deficit targets will hinge on restraining spending, underscoring the need for a well fleshed-out medium-term expenditure framework.** In this context, the decision to start preparing a review of public expenditure, with a view to presenting options for greater expenditure restraint for the new government, is most welcome. Adopting medium-term expenditure ceilings and providing them to Parliament during the budget cycle would be another important step forward. This would add to the credibility of the fiscal adjustment path, including by strengthening the political commitment to the ceilings.

40. **Pressing ahead with remaining structural reforms would help support fiscal consolidation, increase policy flexibility, and improve the economy's resilience.** In addition to rationalizing public sector employment, pension and health care reforms are key in light of the ageing population. Tackling the unfunded future liabilities of the public pension system will require timely, transparent, and consistent decisions on a range of policies that affect the system's viability, with a view to increasing the effective supply of labor and keeping benefits within prudent limits. Health care reform is critical for strengthening expenditure control while delivering quality services. On public administration, the government faces the task of retaining high quality staff and expanding employment in some areas (for example, on activities related to EU accession), while raising the productivity of existing services and keeping the wage bill in check. This may require some adjustment to the wage structure, but, to be successful, it must be accompanied by strong and decisive efforts to rationalize and reduce public sector employment. Finally, moving forward with liberalizing the energy market should be a priority, and the government should refrain from ad hoc caps on regulated prices and from reversing earlier privatization.

41. **The Hungarian financial system remains fundamentally sound.** Hungary is at the forefront of financial sector reform among the accession countries and has one of the most developed financial systems in the region. As in the past, the continuous monitoring evident in the *Financial Stability Report*, and the efforts of the Hungarian Financial Supervisory Authority should help mitigate any future risks. While not an immediate concern, banks' rapidly increasing exposure to certain market segments deserves careful monitoring and attention. And, in the current environment of more volatile exchange rates, the authorities are also encouraged to closely monitor the foreign exchange exposure of banks' clients, with a view to ensuring that credit risks are well contained. The strengthening of the legal framework for the financial sector has continued at a significant pace, and the adoption of new legislation aimed at combating money laundering and terrorist financing is a welcome step. Over the period ahead, the emphasis should be on ensuring its robust implementation.

42. **With respect to economic statistics, transparency, and standards initiatives, Hungary should build on past successes.** This includes improvements in the national accounts, a recent agreement to place the balance of payments statistics on an internationally comparable basis by early 2003, and progress in computing the fiscal accounts on an ESA95 basis. In addition, the country's participation in updating the ROSC modules as part of this

year's Article IV consultation is evidence of the country's continued commitment to transparency and standards. Looking ahead, it will be important to reduce the discrepancy between the official fiscal accounts and a more inclusive measure of the general government that includes the fiscal activities of currently off-budget entities. In a related vein, a comprehensive and timely information system needs to be put in place to ensure that the Ministry of Finance can keep up-to-date and accurate records of all fiscal spending, and properly measure the activities of the general government.

43. The next Article IV consultation with Hungary should remain on the 12-month cycle.

Table 1. Hungary: Main Economic Indicators

	1998	1999	2000	2001 Preliminary	2002 Staff Proj. 1/
Real economy (change in percent)					
Real GDP	4.9	4.2	5.2	3.8	3.5
Real domestic demand	7.8	4.0	5.1	2.1	3.8
CPI (average)	14.3	10.0	9.8	9.2	5.4
CPI (end-year)	10.3	11.2	10.1	6.8	5.2
Unemployment rate, percent	7.8	7.0	6.4	5.7	5.5
Gross national saving (percent of GDP)	24.8	24.4	27.2	24.5	24.0
Gross domestic investment (percent of GDP)	29.7	28.7	30.1	26.6	26.8
General government (percent of GDP) 2/					
Official Balance (excl. privatization receipts)	-4.8	-3.7	-3.7	-3.3	-3.2
Official Primary balance 3/	1.6	2.7	1.5	0.8	0.8
Balance, SNA basis 4/	...	-6.0	-3.5	-4.9	-5.7
Primary balance, SNA basis	...	0.4	1.7	-0.7	-1.7
Fiscal Stimulus 5/	...	...	-1.1	2.0	0.9
Debt	61.1	60.0	55.3	52.1	51.4
Money and credit (end of year, percent change)					
M3	14.9	16.5	12.1	17.2	...
Credit to non-government	22.1	22.7	35.0	18.7	...
Interest rates (percent)					
T-bill (90-day, average)	17.8	14.6	10.8	10.7	...
Government bond yield (5-year, average)	15.7	11.8	9.1	8.5	...
Balance of payments					
Trade balance (percent of GDP)	-5.0	-4.6	-3.8	-3.9	-4.3
Current account (percent of GDP)	-4.8	-4.4	-2.9	-2.1	-2.9
Reserves in convertible currencies					
Billions of U.S. dollars	9.3	11.0	11.2	10.8	...
In months of imports of goods and services	4.1	4.7	4.2	3.7	...
Net external debt (percent of GDP) 6/	26.4	25.0	24.2	20.3	...
Exchange rate					
Exchange regime		Peg against euro, with band +/-15 percent			
Present exchange rate (April 25, 2002)		Forint 270.41 per US\$1			
Forint/euro rate (period average)	192.5	222.4	282.2	256.7	
Nominal effective rate (1990=100)	38.2	35.9	34.1	36.2	
Real effective rate, CPI basis (1990=100)	133.0	135.2	136.0	146.8	
Fund Relations					
Use of Fund Resources			0.0	0.0	
Fund holding of currency (in percent of quota)			83.0	81.0	
Holdings of SDRs (In percent of allocation)			...	...
Quota (SDR million)			1,038.4	1,038.4	
Memorandum items:					
Risk-weighted capital adequacy ratio	16.5	14.9	13.5	14.2	...
M3 to reserves	2.3	2.0	2.1	3.2	...
M3 to Monetary base	4.0	3.7	3.9	4.6	...

Sources: Data provided by the authorities; IFS; and staff estimates.

1/ These projections are based on the government's budget, and planned off-budget spending.

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

3/ This excludes net interest payments and central bank transfers from the government balance.

4/ SNA refers to System of National Accounts.

5/ Measured by the change in the structural primary balance.

6/ In convertible currencies, including inter-company loans, and non-resident holdings of forint denominated assets.

Table 2a. Hungary: Consolidated General Government, 1999-2002 1/
(Official account basis)

	1999	2000	2001 Prel.	2002 Proj.
(In billion of forint)				
Total revenues (ex. official privatization)	4,927	5,568	6,235	6,662
Interest and NBH receipts	129	123	118	80
Primary revenues	4,798	5,445	6,117	6,582
Central government taxes	4,068	4,704	5,266	5,656
VAT	942	1,154	1,244	1,343
Excises	464	506	540	583
Profit tax	262	293	352	380
Customs	140	137	123	132
Personal income tax	770	938	1,117	1,195
Social security contributions 2/	1,490	1,677	1,891	2,023
Local government and other 3/	730	741	851	926
Expenditure and net-lending	5,350	6,048	6,718	7,173
Interest and NBH expenditure	859	802	726	720
Primary expenditures	4,492	5,247	5,992	6,454
Current	4,113	4,849	5,548	6,013
Pensions and social transfers	1,069	1,200	1,398	1,531
Enterprise and household subsidies	521	561	645	612
Other current expenditure	2,523	3,087	3,505	3,870
Capital 4/	379	398	444	440
Net interest	-730	-678	-608	-640
Primary balance	306	198	125	128
Overall balance	-424	-480	-483	-512
(In percent of GDP)				
Total revenues	42.9	43.0	42.5	41.6
Primary revenues	41.8	42.0	41.7	41.1
Central government taxes	35.4	36.3	35.9	35.3
Local government and other	6.4	5.7	5.8	5.8
Expenditure and net lending	46.6	46.7	45.8	44.8
Primary expenditure	39.1	40.5	40.8	40.3
Current	35.8	37.4	37.8	37.5
Capital 4/	3.3	3.1	3.0	2.7
Net interest	-6.4	-5.2	-4.1	-4.0
Primary balance	2.7	1.5	0.8	0.8
Overall balance	-3.7	-3.7	-3.3	-3.2
Gross debt	60.0	55.3	52.1	51.4

Sources: Ministry of Finance, and staff estimates.

1/ Official consolidated data for central budget, social security funds, extra-budgetary funds, and local governments. While no detailed breakdown of net financing for the general government is available, the Government's Debt Management Agency is not planning any new net issuance of foreign exchange debt in 2002.

2/ Contributions to the Pension Insurance Fund, the National Health Fund, and the Labor Market Fund.

3/ Includes privatization revenues of the social security funds and proceeds from the sale of concessions.

4/ Central budget investment projects and local government capital expenditures.

Table 2b. Hungary: Adjusting the General Government Balance to an SNA Basis 1/

	2000	2001 Prel.	2002 Proj.
	(In billion of forint)		
A. Overall balance, official	-480	-483	-512
B. Adjustments to the official overall balance	20	-230	-395
Net lending and other financing 2/ 3/	-31	-29	-23
Off-budget spending 4/	-37	-249	-355
Accrual basis corrections	113	35	23
Concession receipts, net 5/	-25	13	-42
C. Overall balance on an SNA basis (A + B)	-460	-713	-907
	(In percent of GDP)		
A. Overall balance, official	-3.7	-3.3	-3.2
B. Adjustments to the official overall balance	0.2	-1.6	-2.5
Net lending and other financing 2/ 3/	-0.2	-0.2	-0.1
Off-budget spending 4/	-0.3	-1.7	-2.2
Accrual basis corrections	0.9	0.2	0.1
Concession receipts 5/	-0.2	0.1	-0.3
C. Overall balance on an SNA basis (A + B)	-3.5	-4.9	-5.7
<i>Memoranda items:</i>			
Primary balance, on an SNA basis	1.7	-0.7	-1.7
Structural primary balance	1.5	-0.5	-1.4
Fiscal impulse (+=fiscal stimulus) 6/	-1.1	2.0	0.9

Sources: Ministry of Finance and preliminary staff estimates.

1/ This table is based on available data through end-March 2002. While it aims to adjust the official fiscal accounts to make them consistent with the SNA system of accounts, there is insufficient data to ensure full consistency. The table draws on preliminary estimates of the Ministry of Finance for privatization items, net lending, accrual basis corrections, and off-budget items.

2/ Proceeds from the sale of shares and other financial assets by the Social Security Funds and other units of government.

3/ Net lending for non-policy purposes, principally related to Russian debt and other debt repayments in revenues.

Includes dividends paid by the NBH.

4/ Includes estimates of fiscal spending by the privatization agency, the Development Bank, debt assumption of public corporations, and road construction. The estimate for construction expenditure by the National Motorway Company exceeds central budget appropriations of Ft 35.2 and Ft 36 billion for 2001 and 2002 respectively. Includes Ft 10 billion for spending on road maintenance not covered by road tolls and fees.

5/ Proceeds from the sale of concessions, including 1800 MHz spectrum and mobile phone licenses (UMTS).

6/ Measured by the change in the structural primary balance on an SNA basis; assuming potential GDP growth of 4.5 percent.

Table 3. Hungary: Balance of Payments, 1999-2004

	1999	2000	2001 Prel.	2002 Proj. 1/	2003 Proj. 1/	2004 Proj. 1/
	(In billions of U.S. dollars)					
Current account balance	-2.1	-1.3	-1.1	-1.7	-2.2	-2.6
in percent of GDP	-4.4	-2.9	-2.1	-2.9	-3.5	-3.8
Merchandise trade balance	-2.2	-1.8	-2.0	-2.5	-3.0	-3.4
in percent of GDP	-4.6	-3.8	-3.9	-4.3	-4.7	-5.0
Exports goods	21.8	25.8	28.1	29.9	33.2	36.7
percentage change	5.3	17.9	9.2	6.4	10.9	10.6
Imports goods	24.0	27.5	30.2	32.4	36.1	40.1
percentage change	4.0	14.5	9.6	7.5	11.5	10.8
Services balance	1.4	1.8	2.2	2.3	2.3	2.3
Net income	-1.6	-1.6	-1.5	-2.0	-2.0	-2.0
Net transfers	0.3	0.2	0.2	0.5	0.5	0.5
Capital account, net	0.0	0.3	0.3	0.2	0.2	0.2
Financial account, net	4.7	2.4	0.8	1.9	3.2	3.3
Net direct investment	1.7	1.2	1.8	1.5	1.4	1.4
Portfolio investments, net	2.0	-0.4	1.9	1.9	1.9	1.9
of which equity securities, net	1.2	-0.4	0.1	0.4	0.5	0.5
Errors and omissions	-0.3	-0.1	-0.1	0.0	0.0	0.0
Overall balance	2.3	1.1	-0.1	0.4	1.2	0.9
Net reserves of the NBH	-2.3	-1.1	0.1	-0.4	-1.2	-0.9
Net credit from the IMF	0.0	0.0	0.0	0.0	0.0	0.0
Memo items: end of period						
Gross reserves of the NBH	11.0	11.2	11.5	12.2	13.6	15.0
in months of merchandise imports	5.5	4.9	4.6	4.5	4.5	4.5
Net foreign debt, in percent of GDP 2/	25.0	24.8	19.1	19.6	19.1	19.0

Sources: National Bank of Hungary, IFS, and staff estimates.

1/ These projections are based on the government's budget, and planned off-budget spending.

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

Table 4. Hungary: Frequently Used Indicators of Stability and Vulnerability in the Financial and External Sectors
(In percent of GDP, unless otherwise indicated)

	1998	1999	2000	2001
Financial indicators				
Public sector debt	61.1	60.0	55.3	52.3
Broad money (M3, percent change, 12-month basis)	14.9	16.5	12.1	17.2
Private sector credit (percent change, 12 month basis)	22.1	22.7	35.0	18.7
Domestic credit to GDP	58.0	52.0	53.5	50.6
3-month T-bill yield 1/	16.1	12.4	11.6	9.7
3-month T-bill yield (real) 2/	5.2	1.6	1.3	3.1
External Indicators				
Exports (percent change, 12-month basis in US\$) 3/	20.4	8.7	11.3	10.8
Imports (percent change, 12-month basis in US\$) 3/	21.1	9.0	13.5	7.0
Terms of Trade (percent change, 12 month basis)	2.2	0.6	-2.7	2.5
Current account balance	-4.8	-4.4	-2.9	-2.1
Capital and financial account balance	6.5	9.7	5.4	1.8
o/w: Inward portfolio investment (debt securities etc.)	4.0	2.4	-1.9	2.1
Other investment (loans, trade credits etc.)	-1.6	2.0	3.4	-5.9
Inward foreign direct investment in the form of debt or loans	1.1	0.6	0.6	2.9
Net Foreign Assets (NFA) of commercial banks (in US\$ billions)	0.1	0.2	0.1	1.0
Gross official reserves (in US\$ billions)	9.3	11.0	11.2	10.8
Central Bank foreign currency exposure (in US\$ billions) 4/	4.0	5.6	7.2	8.8
Official reserves in months of imports GS	4.1	4.7	4.2	3.7
Reserve money to reserves	1.0	0.9	0.7	0.6
Broad money to reserves	2.3	1.9	1.8	2.2
Total short term external debt to net reserves 5/	1.11	1.06	1.08	0.92
Total external debt 6/	55.8	64.5	66.8	65.1
o/w: Public sector debt	30.2	31.6	32.5	32.6
Total external debt 7/	50.7	58.0	59.9	56.1
Total external debt to exports GS (in percent) 7/	104.1	106.5	96.1	93.3
Exchange rate (per US\$, period average)	214.4	237.1	282.2	286.5
REER depreciation (-) (12 month basis; CPI-based)	-1.6	1.6	0.6	8.0
Financial Market Indicators				
Stock market index (end of period)	6,308	10,101	7,850	7,131
Foreign currency debt rating (Moody's)	Baa2	Baa1	A3	A3
Spread of dollar-denominated benchmark bond (basis points, end of period) 8/	155	107	116	78
Spread of DM-denominated benchmark bond (basis points, end of period) 9/	...	...	53	41

Sources: National Bank of Hungary, Ministry of Finance, Bloomberg and staff estimates.

1/ End-of-period.

2/ Backward-looking using actual CPI.

3/ Customs based data, in current U.S. dollar prices.

4/ Net foreign assets plus foreign exchange (FX) credit to government and banks less deposit money banks' FX deposits at NBH. Does not include FX position arising from off-balance sheet operations.

5/ Includes short-term loans (by remaining maturity), and nonresident holdings of domestic bonds. Reserves are net of resident foreign exchange deposits with the NBH.

6/ Including intercompany loans.

7/ Excluding intercompany loans.

8/ NBH bond maturing April 2003 (US\$-denominated) and a U.S. government bond with similar maturity.

9/ NBH bond maturing September 2003 (DM-denominated) and a German government bond with similar maturity.

Table 5. Hungary: Staff Illustrative Medium-term Scenario 1/

	2000 Actual	2001 Prel.	2002 Staff projections	2003 Staff projections
	(in percent)			
Real GDP growth	5.2	3.8	3.5	4.0
Inflation (CPI; year average basis)	9.8	9.2	5.4	3.8
Inflation (CPI; end-year basis)	10.1	6.8	5.2	3.5
	(annual percentage change, constant prices)			
Domestic Demand	5.1	2.1	3.8	4.2
Consumption	4.0	3.6	4.1	3.7
Gross fixed capital formation	7.7	3.1	4.5	5.7
Exports of GNFS	21.8	9.1	6.2	9.2
Imports of GNFS	21.1	6.3	6.6	9.4
	(In percent of GDP)			
External Current Account Deficit	2.9	2.1	2.5	3.3
Gross Private Savings	25.1	25.1	24.8	24.5
Fixed Investment	24.7	23.8	24.0	24.4
General Government				
Revenue, primary 2/	42.4	41.7	41.1	41.0
Expenditure, primary	40.9	40.8	39.3	39.8
<i>Memoranda items:</i>				
General Government Balance, on an SNA basis	-3.6	-4.9	-4.7	-3.7
Primary balance, on an SNA basis	1.7	-0.7	-0.7	0.0
Fiscal Impulse (+=fiscal stimulus)	-1.1	2.0	0.0	-0.5
Net interest	5.3	4.1	4.0	3.7
Public debt	55.3	52.1	49.9	48.7

Source: IMF staff estimates

1/ Incorporates staff's policy recommendations.

2/ Revenues are exclusive of EU transfers as expected preaccession transfers are netted against spending for accession purposes.

HUNGARY: FUND RELATIONS
(As of February 28, 2002)

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

II. General Resources Account:	SDR Million	Percent of Quota
Quota	1,038.40	100.0
Fund holdings of currency	716.45	69.0
Reserve position in Fund	321.95	31.0
Financial Transaction Plan transfers (net)	81.00	

III. SDR Department:	SDR Million	Allocation
Holdings	17.83	0

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	0.0
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:**

Between May 16, 1994 and January 1, 1997, the exchange rate of the forint was linked to a basket of the European Currency Unit (with a weight of 70 percent) and the U.S. dollar (with a weight of 30 percent). In January 1, 1997, the NBH changed the composition of its fixing basket to a combination of deutsche mark (with a weight of 70 percent) and the U.S. dollar (with a weight of 30 percent). Since January 1, 1997, the NBH has based its official rate on the interbank spot rates. Margins for the NBH's intervention band were widened to

±2.25 percent on December 23, 1994; and ±15 percent on May 4, 2001. Until March 13, 1995, the value of the peg to the basket was adjusted periodically, mainly on the basis of the difference between domestic and foreign inflation rates; since then and until October 1, 2001, the value of the peg was adjusted in accordance with a preannounced rate of crawl. Since then, the peg was set at 276.1 forint per euro. Between March 13 and June 30, 1995, the rate of devaluation against the basket was 1.9 percent per month; it was reduced to 1.3 percent per month as of July 1, 1995; to 1.2 percent per month as of January 1, 1996; to 1.1 percent per month from April 1, 1997; to 1.0 percent per month as of August 15, 1997; to 0.9 percent per month from Jan 1, 1998, to 0.8 percent per month from June 15, 1998; to 0.7 percent per month from October 1, 1998; to 0.6 percent per month from January 1, 1999; to 0.5 percent per month from July 1, 1999; to 0.4 percent per month from October 1, 1999; to 0.3 percent as of April 1, 2000; to 0.2 percent as of April 1, 2001; and eliminated effective October 1, 2001. As of January 1, 2000, the central parity of the intervention band has been defined solely in terms of the euro.

Hungary accepted the obligations of Article VIII as of January 1, 1996, and its exchange system is free of restrictions on payments and transfers of current international transactions. In accordance with UN Resolution 661 and Executive Board decision No. 144-(52/51), Hungary continues to maintain exchange restrictions against Iraq. The UN Security Council Resolution on food for oil was implemented in December 1996.

VIII. Article IV Consultations:

Hungary is on a 12-month consultation cycle.

The 2000 Article IV staff report was issued on April 13, 2001 (SM/01/109). The last Article IV Board discussion took place on May 4, 2001. The Public Information Notice No. 01/47 was released on May 18, 2001.

IX. Technical Assistance:

Year	Dept.	Purpose	Date
1991	FAD	Tax reform	April
1991	EU1/IMF Institute	Seminar on financial programming	May
1991	FAD	Budget reform	May
1991	FAD	Tax administration reform	June
1991	MAE/PDR	Development of a foreign exchange interbank market	September
1991	MAE/PDR	Development of a foreign exchange interbank market	October
1991	FAD	Budget reform	November

1991	FAD	Tax administration reform	November
1992	STA	Money and banking statistics seminar	March
1992	FAD	Design and implementation of a "flash" fiscal reporting system	May
1992	FAD	Revenue forecasting	June
1993	MAE/EU1/IBRD	Financial and enterprise restructuring	March
1993	MAE	Central bank reorganization	May
1994	FAD/EU1	Treasury/debt management	February
1994	FAD	Tax administration	March
1994	STA/PDR	International trade and balance of payments statistics	April
1994	FAD	Tax administration—follow-up	May
1994	FAD	Expenditure management	June
1994	FAD	Tax administration—long-term expert assignment (on-going)	July
1994	FAD	Local government	August
1994	FAD	Tax administration	November
1995	FAD	Tax administration	February
1995	FAD	Treasury	February
1995	FAD	Treasury	May
1995	FAD	Treasury	November
1995	FAD	Debt management	November
1995	MAE	Central bank internal auditing	November
1995	MAE	Monetary analysis and research	December
1996	FAD	Tax Policy	May
1996	MAE	Central bank accounts	September
1996	FAD	Subsidies	November
1997	FAD	Subsidies follow-up	May
2000	FAD	Tax legislation	June
2000	MAE	Money and banking statistics	October
2000	FAD	Tax legislation follow-up	November

X. Regional Resident Representative:

Mr. Roger Nord took office in Budapest in December 1998. It is expected that the regional office will be closed when Mr. Nord's term expires in July 2002.

HUNGARY: STATISTICAL ISSUES

1. Progress has been made in improving the timeliness, coverage, periodicity, and quality of Hungarian statistics. A number of issues of data quality, noted in the data dissemination module of the 2001 Report on the Observance of Standards and Codes, have been addressed, but some shortcomings remain.
2. Hungary has subscribed to the Special Data Dissemination Standard, and its metadata are posted on the Fund's Dissemination Standards Bulletin Board (<http://dsbb.imf.org>). Hungary meets the SDDS specifications for the coverage, periodicity, and timeliness of the data, and for the dissemination of advance release calendars.

A. Real Sector Issues

National accounts

3. A persistent national accounts residual appeared in 1997, and remained in subsequent years, reported as part of changes in inventories. In 2000, the Hungarian Central Statistical Office (HCSO) first published an estimate of the statistical discrepancy between the final version of GDP by production activities and GDP by expenditure components. The HCSO publishes estimates of quarterly GDP by type of economic activity and by expenditure components beginning with the first quarter of 1996. The benchmarking of the quarterly estimates to the annual estimates has been applied from 2000. Beginning in June 2002, the HCSO will begin releasing a seasonally adjusted series of quarterly national accounts. The national accounts are also undergoing revision to incorporate a more up-to-date estimate of imputed rents.

Other real sector issues

4. The authorities have improved the reliability of industrial sales data by broadening the sample of enterprises surveyed. In addition, a new methodology for seasonal adjustment was introduced in 1997.

B. Balance of Payments

5. The Statistics Department of the National Bank of Hungary (NBH) compiles the balance of payments and international investment position of Hungary in broad conformity with the conceptual framework of the fifth edition of the IMF's *Balance of Payments Manual (BPM5)*. However, transactions are recorded on a cash basis, rather than on the accrual-based accounting principles of the *BPM5*. While resident institutional units are in accord with the *BPM5*'s definition of center of economic interest, the exclusion of reinvested earnings and other transactions that have no payment counterpart or banking mediation, limits the scope of BOP statistics in their coverage of all resident-nonresident transactions. No adjustments for reinvested earnings are made in the current and financial accounts. As a result, while there is

no impact on the overall balance, the current account deficit has been underestimated by, perhaps, 2-3 percent of GDP in recent years.

6. In the BOP, trade data are recorded on a settlements basis, instead of using the more adequate customs data, which records the physical movement of goods across borders. Processing and repairs of goods are recorded as services (value added) in the BOP, instead of recording the gross value of exports and imports under goods as recommended in the *BMP5*.

7. Strengthened institutional cooperation between the NBH and the HCSO, covering methodological and technical issues, aims at replacing current ITRS goods data by customs statistics and incorporating reinvested earnings in foreign direct investment. Introducing accrual accounting for investment income also has high priority for the NBH. These steps, which are planned to be first introduced for the 2002 annual data (to be published in early 2003), will place the balance of payments statistics and Hungary's international investment position on an internationally comparable basis.

C. Monetary Sector

8. The *IFS* country page for Hungary now provides timely data for the monetary authorities, banking institutions, and the banking survey. In addition, the coverage of the NBH's analytical accounts has been extended, and Hungary now complies with the strengthened reserves standard. STA conducted a money and banking statistics mission in October 2000 to review progress in this area and to discuss recent methodological changes in the compilation of monetary statistics. The STA mission found that the framework for the compilation of monetary statistics in Hungary basically conforms to the Fund's current methodology. A ROSC data module mission in January 2001 recommended that securities recorded on the balance sheets of depository corporations should be valued at market prices, and deposit liabilities of credit institutions in the process of liquidation should be removed from the monetary aggregates and classified as restricted deposits. The value of deposits of a credit institution in the process of liquidation is zero from November 2000. Hence, from that date, monetary aggregates M1 through M4 do not include any deposits of credit institutions under liquidation. In the future, these kinds of deposits will be excluded from monetary aggregates and will be shown under "restricted deposits." The national definition of the monetary base still does include deposits of some credit institutions in the process of liquidation. This problem will be resolved in the first half of 2002. The introduction of new reporting forms based on the *System of National Accounts (1993 SNA)* in May 2001 also resolved the sectorization issues of nonprofit institutions.

D. Government Finance Statistics

9. The degree of decentralization of fiscal institutions hinders the full consolidation of government accounts, thereby leading to lags in availability of the data, possible overstatement of the size of the government in the economy, and complicating the estimation of the national accounts.

10. Significant progress in addressing several of these issues has been made with the establishment and subsequent expansion of the centralized Treasury and improved compilation of statistics at the Ministry of Finance. However, plans to report monthly expenditures classified on an economic basis have yet to come to fruition. Following a GFS mission in 1998, the authorities provided annual data for publication in the *GFS Yearbook* starting from 1991. The latest data published in the *GFS Yearbook* are for the year 2000. These data now cover the operations of the State Property Management and Privatization Company, since its inception in 1995. However, some other activities of a fiscal nature-taking place outside of the government budget, such as those of the National Motorway Company, are not included. The GFS Yearbook data, and the monthly data reported for *IFS*, still contain inconsistencies between the measures of the deficit and financing. The *GFS Yearbook* data contain significant adjustments to current expenditure in order to balance the deficit and financing.

11. Financing data provided for *IFS* are not published because of the significant differences between financing and the deficit. The Ministry of Finance, in cooperation with the Treasury and the Debt Management Office, is working to identify and eliminate these inconsistencies.

Hungary: Core Statistical Indicators

(As of April 15, 2002)

	Exchange Rates	International Reserves	Central Bank Balance Sheet	Reserve/ Base Money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	External Debt/ Debt Service	Consolidated Government Balance	GDP
Date of Latest Observation	April	March	March	March	March	March	March	February	February	February	February	2001Q4
Date Received	April	April	April	April	April	April	April	April	April	April	April	March
Frequency of Data	Daily	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Quarterly
Frequency of Reporting	Weekly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Quarterly
Source of Update	National Bank of Hungary	National Bank of Hungary	National Bank of Hungary	National Bank of Hungary	National Bank of Hungary	National Bank of Hungary	Central Statistical Office of Hungary	Ministry of Industry & Trade	National Bank of Hungary	National Bank of Hungary	Ministry of Finance	Central Statistical Office of Hungary
Mode of Reporting	e-mail	Internet	Internet	Internet	Internet	Internet	Internet	Internet	Internet	Internet	e-mail	Internet
Confidentiality	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public
Frequency of Publication	Daily	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Quarterly

HUNGARY: RELATIONS WITH THE WORLD BANK GROUP

1. Hungary joined the World Bank in 1982. Since then the Bank has committed about US\$4.0 billion for 40 projects and programs. During the 1980s, Bank assistance focused on liberalizing the economy and modernizing and expanding its productive capacity, and infrastructure. During the 1990s, support for macroeconomic and structural adjustment became a key element of the assistance program, including structural adjustment loans in the early 1990s, accompanied by Japan Exim co-financing and an IMF EFF Program, and sector adjustment loans in the mid-1990s supporting financial sector and pension reform. The Bank also provided support to help strengthen public institutions (e.g. in tax administration and public finance, health and social assistance).
2. Since the last Country Assistance Strategy, discussed by the Bank's Board on January 28, 1998, Hungary has continued to establish a sustainable and robust macroeconomic environment, complete the transformation agenda, and make progress towards meeting the requirements for EU accession. A new CAS Progress Report will be discussed by the Bank's Board on April 25, 2002. With moderate external deficits, good access to private capital and support from the EU and its financial institutions, Hungary does not envisage further borrowing from the Bank. Therefore, the Bank's assistance program for FY03-05 outlined in the CAS Progress Report is limited to a program of advisory and analytical support in selected areas and support for implementation of two remaining Bank-financed projects in the portfolio.
3. The two ongoing Bank-financed projects are for Municipal Wastewater Management and Public Finance Management, with an undisbursed balance of about US\$12.2 million as of April 1, 2002. With limited borrowing from the Bank in recent years, cancellation of portions of undisbursed loans, and pre-payment of some loans, Hungary's outstanding obligations to the Bank amounted to about US\$0.5 billion as of April 1, 2002. IFC and MIGA have not undertaken new investments and guarantees in Hungary in recent years.

Statement by the IMF Staff Representative
May 22, 2002

1. This statement reviews developments in Hungary since the preparation of the staff report for the 2002 Article IV consultation (SM/02/128, 4/30/02). This additional information does not change the broad thrust of the staff appraisal, although prospects for fiscal consolidation in the near term now appear less likely.
2. The parliamentary election in April 2002 resulted in a narrow majority (of 198 seats out of 386) for the center-left opposition (the Socialist party together with the Alliance of Free-Democrats). On May 15, President Mádl appointed Peter Medgyessy to form a new government. Indications are that a new cabinet will be in place by May 27.
3. Economic policy developments:
 - The National Bank of Hungary (NBH) has maintained its policy interest rate at 8.5 percent since the last official rate reduction on February 19. Meanwhile, the forint has continued to trade at around 12 percent above its central rate against the euro. In a statement on May 6, 2002, the Monetary Council noted that additional unfavorable developments for inflation might require a tightening of monetary conditions. On that date, the Monetary Council also discussed a draft of the NBH's *Quarterly Inflation Report* for May. That report, according to the Council's statement, revised upward the end-2002 central inflation forecast from 4.8 percent in the February report to 5.3 percent, close to the upper limit of the inflation target range. The latest report kept the central forecast for end-2003 close to the middle of the inflation target range, at 3.4 percent, but noted that existing risk factors could push the end-2003 inflation to 4 percent. These factors included wage pressures, a more expansionary fiscal policy, and potential hikes in regulated prices.
 - The candidate for Minister of Finance, Mr. Csaba Laszlo, indicated that the government intends to amend the 2002 budget to include plans for a spending package. Based on press reports, staff estimates that the additional spending could be in the range of Ft 220-270 billion (equivalent to about 1.4-1.7 percent of GDP). The additional spending would largely raise pensions, and public sector wages in education and health. The extent to which the additional spending might be accompanied by expenditure cuts in other areas is unclear. Mr. Laszlo has also suggested that the new government plans to reduce the deficit of the general government to 2.5 percent of GDP (on an ESA-95 basis) by 2006, with a view to adopting the euro in 2007. These plans are somewhat less ambitious than those indicated during the Article IV consultation discussions.

4. Other economic developments:

- The external current account was in surplus in March, bringing the rolling 12-month current account deficit down slightly to 2.7 percent of GDP, from 2.8 percent in February. Net FDI inflows over the latter period were 3.6 percent of GDP.
- Year-on-year industrial output growth was 3.1 percent in March, the strongest growth rate recorded since October 2001. The unemployment rate, meanwhile, stood at 5.8 percent in the first quarter of 2002, up slightly from 5.6 percent in the previous quarter.
- In the first two months of 2002, the average volume of retail sales was 12.1 percent higher than a year earlier, as consumer spending was boosted by a pick-up in year-on-year real wage growth to 12 percent.
- The official general government deficit reached 63 percent of the annual deficit target in the first four months of 2002, sharply up from 20 percent of the annual target in the same period last year. This reflected larger-than-targeted expenditures by both the central budget and social security administrations, mostly due to higher spending on health care, pensions, and public sector wages. The NBH has raised its estimate of the fiscal stimulus in 2002 from 0.8 percent of GDP to 1.3 percent of GDP.
- Year-on-year consumer price inflation was 6.1 percent in April, up from 5.9 percent in March, reflecting a rise in food and fuel price inflation. By comparison, year-on-year core inflation, which excludes certain fuel and food prices, declined by 0.2 percentage point to 6 percent in April.



INTERNATIONAL MONETARY FUND

Public Information Notice

EXTERNAL
RELATIONS
DEPARTMENT

Public Information Notice (PIN) No. 02/58
FOR IMMEDIATE RELEASE
June 5, 2002

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

IMF Concludes 2002 Article IV Consultation with Hungary

On May 22, 2002 the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Hungary.¹

Background

Hungary achieved remarkable economic success in the four years to 2000. The country maintained strong output growth, increased employment, raised the investment-to-GDP ratio, reduced inflation significantly, narrowed the fiscal deficit, and lowered the current account deficit to a sustainable level.

Although economic growth slowed in 2001, the economy showed considerable resilience to the weaker external environment. GDP growth was a still respectable 3.8 percent, down from 5.2 percent in 2000 but higher than most other countries in the region. While export growth decelerated as the year progressed, it nevertheless outpaced growth in Hungary's export markets. Domestic demand was partly supported by buoyant private consumption on the back of strong real wage gains. Meanwhile, the unemployment rate edged down to 5.6 percent by the start of 2002.

Fiscal policy turned expansionary in 2001, also contributing to domestic demand and economic growth in that year. The fiscal stimulus was sizable, estimated at about 2 percent of GDP. This contributed to public investment and growth at a time when private investment was being scaled

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. This PIN summarizes the views of the Executive Board as expressed during the May 22, 2002 Executive Board discussion based on the staff report.

back. But the higher level of public spending—notably on wages and pensions—has increased the challenge of attaining the government’s desired medium-term fiscal adjustment.

The authorities successfully introduced a new monetary policy framework—widening the exchange rate band in May 2001 to ± 15 percent against the euro and adopting inflation targeting in June 2001. Notwithstanding a string of interest rate cuts since the band widening, this led to a tightening of monetary conditions.² With inflation expectations falling faster than nominal interest rates, real short-term interest rates have increased modestly, and the forint has strengthened against the euro by some 10 percentage points since the band widening.

Inflation has come down markedly. After peaking at 10.8 percent in May 2001, year-on-year consumer price inflation declined steadily to 5.9 percent in March 2002. This reflected moderating growth in tradable goods inflation owing largely to the appreciation of the forint; a drop in services sector inflation to single digits, attributed to greater competition; and a decline in food and fuel prices. Core inflation, which excludes certain fuel and food prices and administrative prices, declined by 4.2 percentage points over the same period.

Amid tight labor market conditions, wage growth has picked up. Year-average economy-wide nominal wage growth reached 18 percent in 2001, compared with headline inflation of 9.2 percent. This rapid pace of growth reflected in part a 57 percent increase in the minimum wage, introduced in January 2001—although with some low wage workers actually receiving higher but unrecorded pay, the minimum wage hike had the effect of raising measured wages much more rapidly than actual wages paid in the private sector. The minimum wage was raised again by 25 percent in January 2002.

The external current account deficit narrowed in 2001, and external financing was unaffected by emerging market tensions over the past year. The deficit was 2.1 percent of GDP, down from 2.9 percent of GDP in 2000. Import growth moderated owing to the sharp drop in private investment growth and lower oil prices; exports, though slowing during the year, were buoyant on a year-average basis; and tourism receipts were strong. The capital account was fully liberalized in mid-2001. Access to international financial markets has remained on favorable terms, even amid emerging market turmoil.

Executive Board Assessment

Executive Directors commended the authorities for Hungary’s remarkable economic progress in recent years and its success in weathering the recent global economic slowdown. They attributed this result to generally sound macroeconomic management, far-reaching institutional and structural reforms, including the lasting effects of the bold reform measures of the early and mid-1990s, and Hungary’s integration with the EU. However, in spite of Hungary’s generally favorable economic outlook, Directors noted that there remain important areas where some weaknesses need to be addressed, most notably in the fiscal domain.

² Effective the day of the Board meeting the National Bank of Hungary also raised its policy interest rate by 50 basis points to 9 percent.

In light of Hungary's already high degree of integration with the EU, most Directors viewed the objective of early EU accession and timely adoption of the euro as appropriate and helpful for anchoring policy. But they stressed that achieving this objective would pose significant policy challenges, made all the more difficult by the expansionary fiscal stance last year and the continued significant fiscal stimulus that would occur this year without offsetting measures. Moreover, against the background of rapid growth in public sector wages, minimum wage hikes, and still tight labor market conditions, macroeconomic policy restraint would be essential to support the achievement of inflation objectives.

On the monetary front, Directors welcomed the firm downward track of inflation over the past year, attributed in large part to the well-managed introduction of the new monetary policy framework. Widening the exchange rate band allowed the National Bank of Hungary to appropriately tighten monetary conditions, and the successful resumption of disinflation helped to foster the credibility of the new inflation targeting regime.

Nevertheless, Directors considered that there exists an upside risk to inflation, and that securing the targeted degree of disinflation would require a determined effort. They recommended that monetary policy be kept tight to prevent a rekindling of inflationary pressures, particularly with economic activity expected to pick up. However, Directors noted that the appreciating currency and rising labor costs raised concerns about external competitiveness, and cautioned the authorities against excessive reliance on monetary policy. They stressed the importance of support from fiscal policy, emphasizing that a fiscal correction would moderate the necessary degree of monetary tightness and help avoid too strong an appreciation of the forint.

For this and other reasons, Directors emphasized the need to reverse the considerable fiscal expansion underway at the earliest opportunity. While acknowledging that in 2001 the fiscal expansion helped moderate the economic slowdown, they thought that a broadly neutral fiscal stance in 2002 would be appropriate. This would avoid adding stimulus as economic growth gathers pace, preclude the crowding out of private investment, and facilitate meeting medium-term fiscal consolidation objectives. As an additional benefit, it was observed that a strong, early, and visible commitment to rein in the fiscal deficit would add to the credibility of the targeted disinflation path—thereby anchoring inflation expectations more firmly, moderating wage growth, and, ultimately, minimizing the real costs of disinflation.

In the view of the Directors, spending restraint will be key for meeting fiscal deficit targets. They considered that adopting medium-term expenditure ceilings—within a well-developed medium-term fiscal framework—would help secure the desired fiscal adjustment path. A few Directors advocated making these expenditure ceilings public to enhance credibility, including by garnering political commitment. Directors strongly supported the ongoing preparation of a public expenditure review, and encouraged the authorities to complete the review as soon as possible, with the aim of presenting options for greater spending restraint.

To help support fiscal consolidation, as well as increase policy flexibility and improve the economy's resilience, Directors urged the government to press ahead with remaining structural reforms. In light of Hungary's rapidly aging population, they viewed pension and health care reforms as core. Further reforms to ensure the pension system's viability should aim, in part, to increase the effective supply of labor. Health care reform should focus on strengthening

expenditure control while delivering quality services. Directors also underscored the need to rationalize public sector employment, in order to reconcile the difficult task of retaining high quality staff while keeping the overall wage bill in check. In addition, they encouraged the government to move forward with liberalizing the energy market and to refrain from ad hoc caps on regulated prices.

Directors welcomed the findings of the update of the Financial System Stability Assessment, which confirmed that the financial system remains fundamentally sound. They commended the government for the further strengthening of the legal framework over the past year, including new legislation aimed at combating money laundering and terrorist financing. They stressed, nevertheless, the importance of ensuring robust implementation over the period ahead. In the current environment of more volatile exchange rates and an open capital account, a few Directors also encouraged the authorities to monitor closely the foreign exchange exposure of banks' clients.

Directors welcomed the authorities' intention to publish the staff report and associated documents, and observed that Hungary's participation in updating Report on the Observance of Standards and Codes modules represents a welcome commitment to transparency and standards. While commending ongoing efforts in several areas, including the recent agreement to place balance of payments statistics on an internationally comparable basis by early 2003, they observed that there was room for improvement with regard to fiscal transparency. In this regard, Directors urged the authorities to integrate all the fiscal activities of institutions currently outside the scope of the government budget into the regular budgetary process.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board. The Staff Report for the 2002 Article IV Consultation with Hungary is also available.

Hungary: Main Economic Indicators

	1998	1999	2000	2001	2002
Real economy (change in percent)					
Real GDP	4.9	4.2	5.2	3.8	3.5
CPI (average)	14.3	10.0	9.8	9.2	5.4
CPI (end-year)	10.3	11.2	10.1	6.8	5.2
Unemployment rate (percent)	7.8	7.0	6.4	5.7	5.5
Gross national saving (percent of GDP)	24.8	24.4	27.2	24.5	24.0
Gross domestic investment (percent of GDP)	29.7	28.7	30.1	26.6	26.8
General government (percent of GDP) 1/					
Official balance (excl. privatization receipts)	-4.8	-3.7	-3.7	-3.3	-3.2
Balance, estimated SNA basis 2/	...	-6.0	-3.5	-4.9	-5.7
Fiscal impulse (+ = fiscal stimulus) 3/	...	...	-1.1	2.0	0.9
Debt ..	61.1	60.0	55.3	52.1	51.4
Money and credit (end-year, percent change)					
M3	14.9	16.5	12.1	17.2	...
Credit to nongovernment	22.1	22.7	35.0	18.7	...
Interest rates (percent)					
T-bill (90-day, average)	17.8	14.6	10.8	10.7	...
Government bond yield (five-year, average)	15.7	11.8	9.1	8.5	...
Balance of payments					
Trade balance (percent of GDP)	-5.0	-4.6	-3.8	-3.9	-4.3
Current account (percent of GDP)	-4.8	-4.4	-2.9	-2.1	-2.9
Gross international reserves					
Billions of U.S. dollars	9.3	11.0	11.2	10.8	...
In months of imports of goods and services	4.1	4.7	4.2	3.7	...
Net external debt (percent of GDP) 4/	26.4	25.0	24.2	20.3	...
Fund position (February 28, 2002)					
Quota (SDR millions)				1,038.4	
Holdings of currency (in percent of quota)				81.0	
Holdings of SDRs (SDR millions)				...	
Exchange rate					
Exchange regime	peg against	euro, with	band, +/-15	percent	
		forint	270.4 per	US\$1	
Present exchange rate (April 25, 2002)					
Appreciation (+) of real effective exchange rate (relative CPIs, in percent)	-0.8	1.7	0.6	7.9	

Sources: Data provided by authorities; *IFS*; and IMF staff estimates.

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

2/ SNA refers to System of National Accounts and includes off-budget fiscal items.

3/ Measured by the change in the structural primary balance (on an SNA basis) and assuming potential GDP growth of 4.5 percent.

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