Hungary: 2013 Article IV Consultation and Third Post Program Monitoring Discussions—Staff Report; Informational Annex; Public Information Notice; and Statement by the Executive Director

The following documents have been released and are included in this package:

- The staff report, prepared by a staff team of the IMF, following discussions that ended on January 26, 2013 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 March 5, 2013. 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.

- An informational annex to the staff report.

- A Public Information Notice (PIN).

- A statement by the Executive Director for Hungary.

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

    Selected Issues Paper

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

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HUNGARY

STAFF REPORT FOR THE 2013 ARTICLE IV CONSULTATION AND THIRD POST PROGRAM MONITORING DISCUSSIONS

March 5, 2013

KEY ISSUES

Overview: The government has continued to pursue an unconventional strategy for economic recovery. Despite improved market sentiment which has eased financing constraints, the economic outlook remains difficult and large external and public financing needs leave Hungary exposed to risks. Maintaining market confidence and reviving growth are the most pressing priorities for which decisive action to improve policies is needed.

Fiscal policy: The government is determined to exit the EU's Excessive Deficit Procedure (EDP), but the adjustment relies excessively on controversial tax measures which have increased uncertainty and hurt the business climate. The key challenge is to achieve the needed deficit reduction with more growth-friendly and sustainable measures. This will require a rebalancing of the adjustment toward durable spending consolidation and rationalization of the tax system, including a gradual elimination of sectoral taxes.

Monetary policy: While the output gap remains sizable, inflation expectations are not well anchored and after seven consecutive policy rate cuts a pause seems prudent. Further monetary policy easing can be supported by stronger macroeconomic policies. In this regard, safeguarding the Central Bank's (MNB) operational and legal independence is critical.

Financial Sector: An adverse environment, including a heavy tax burden and rising NPLs, have increased bank losses and contributed to sharp external and domestic deleveraging. Restoring financial intermediation is essential to support economic growth. This would require a better operational environment for banks and measures to facilitate faster clean up of NPLs while ensuring adequate provisioning.

Structural reforms: Some efforts have been made to improve labor participation, but potential growth remains far too low for a country that should converge faster to EU-average incomes. Productivity, labor demand, and competition in product markets need to improve, for which a more business friendly policy environment is a key prerequisite.

Approved By
**Aasim M. Husain and
Lorenzo Giorgianni**

Discussions took place in Budapest during January 16–26, 2013. The mission met with Minister without portfolio Varga, Central Bank Governor Simor, Minister for National Development Németh, Secretary of State for National Economy Pleschinger, President of Financial Supervisory Authority Szász, and other senior officials, members of Parliament, and representatives of the private sector and diplomatic delegations. The staff comprised Messrs. Arvanitis (Head), Hajdenberg, Klein, and Stepanyan (all EUR), Montes-Negret (MCM), Guerson (FAD), Esposito (LEG), and Ms. Oner (SPR). Ms. Ivaschenko (Resident Representative) assisted the mission, and Messrs. Prader, Benk (OED), and Husain (EUR), attended some of the meetings. Hungary is an Article VIII country (Informational Annex: Fund Relations). Data provision is adequate for surveillance (Informational Annex: Statistical Issues).

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CONTEXT

1.   Hungary has been plagued by low growth and high debt for much of the last decade. Growth performance has been one of the weakest in the region, and real GDP in 2012 was about 6 percent below the 2008 level. At the same time, public and external debt and currency mismatches in the economy have been very high (Figure 1).

Real GDP Growth
(Percent)

Source: WEO.

2.   The recent weak growth performance has been due to structural factors as well as domestic policy missteps. More than four years since the onset of the financial crisis, the economy is undergoing a difficult period of balance sheet adjustment which inevitably exerts a negative impact on growth. And although the imbalances have improved, the adjustment process is still not complete. Government policies have sought to cushion the impact of the downturn on households, rein in fiscal deficits, and boost employment. However, increased state interference in the economy including through frequent and unpredictable policy changes (e.g., sectoral taxes, pension nationalization, mortgage pre-payment schemes, utility tariff cuts) and the weakening of institutions (e.g., diminished role of the Fiscal Council and the Constitutional Court) have hurt the investment climate, undercutting prospects for recovery (Box 1).

3.   Despite considerable headwinds, financial stability was broadly maintained in 2012.
With large vulnerabilities and limited space to absorb shocks, financial pressures rose sharply in late 2011–early 2012, in the wake of growth and financial spillovers from the eurozone crisis, which exacerbated existing strains on the domestic economy. However, despite these pressures, the authorities managed to navigate a challenging year and maintain macroeconomic stability. The external financial environment has improved considerably in recent months, but this has not translated into benefits for the broader economy.
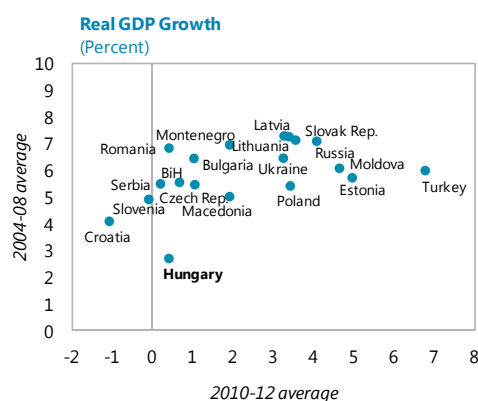
Box 1. Implementation of Past IMF Recommendations

During the last Article IV consultation, Directors underscored the need for a different policy mix to restore confidence in economic governance, anchor the ongoing adjustment, and strengthen economic institutions. Overall, there was no major change in policy direction in 2012, and several policies deviated from past Fund advice.

Key recommendations	Implemented policies
Ensure fiscal sustainability through a coherent tax and expenditure policy mix.	A large fiscal adjustment was implemented and the deficit target was met. However, the adjustment relied heavily on ad-hoc tax measures.
Strengthen the Fiscal Council.	No significant measures were taken to strengthen the Fiscal Council's independence and mandate.
Contain financial sector risks and finalize the bank resolution framework.	Several initiatives were implemented to provide debt relief for households, often with little prior consultation with banks. Plans to reduce bank taxes were reversed; the levy became permanent and a new tax on bank transactions was introduced. The bank resolution framework is still under discussion.
Pursue structural reforms to improve the business environment, competitiveness, and labor supply.	No major structural reforms were advanced in 2012, but some measures were taken to increase labor participation including through tightening unemployment benefits and launching the Job Protection Plan (effective in 2013).

RECENT ECONOMIC DEVELOPMENTS

4.   The economic environment deteriorated markedly in 2012. Against strong headwinds from a challenging environment, strained balance sheets, and a drag from the significant fiscal adjustment, the economy slipped into a second recession in four years, with real GDP estimated to have declined by 1.7 percent (Figure 2).

- Consumption resumed its trend decline (about -2½ percent in 2012) despite several initiatives to support household incomes and improve labor market conditions. In particular, the minimum wage was increased by 18 percent in 2012; the public works program was extended to cover over 100,000 workers; and various mortgage restructuring schemes were implemented (Box 2). Nonetheless, consumer confidence remained depressed and household consumption continued

Household Indebtdedness and Real Disposable Income

Households' indebtedness (as a share of disposable income)
Real disposable income (2000=100, RHS)
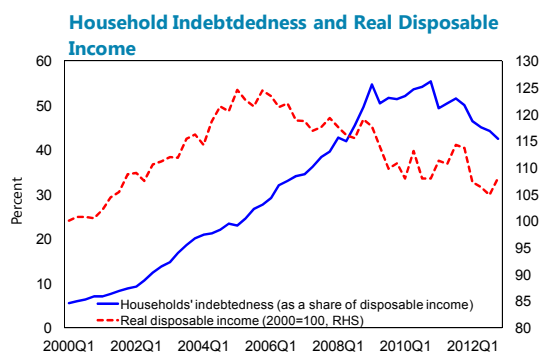
Sources: MNB and IMF staff estimates.

to decline reflecting the elevated debt service burden, erosion of real disposable income due to high inflation, and heavier tax burden on low income workers from the regressive flat personal income tax. Unemployment stayed flat at around 10.7 percent (e-o-p), near post crisis high levels, as demand for labor from the private sector remained subdued.

- Investment dropped to the lowest levels in 10 years (and at around 16 percent of GDP is below normal amortization levels), reflecting, inter alia, the weak business environment. This decline goes beyond the depressed construction sector, and structural problems in the corporate sector are increasingly coming to the fore. Manufacturing output declined in most sectors in 2012 and is now about 13 percent below the 2008 peak. A notable exception is the auto industry that continues to benefit from its close links to the German supply chain and past investment decisions.

Domestic Investment
(Percent of GDP)

Source: Hungarian Statistical Office and IMF staff estimates.

- Net exports remained the only source of growth, on the back of continued import compression and the expansion of the auto industry. Although the recent weakening in the pace of exports can be attributed to a worsened external environment, the decline in export market shares in recent years indicates that Hungary may be losing ground compared to peers (Box 3).

Hungarian and German Exports Real Growth
(YOY Percentage Change)
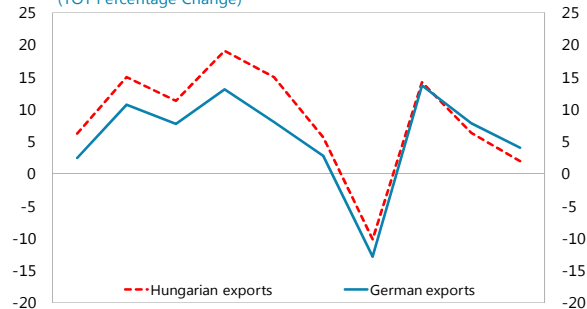
Source: Eurostat.

5.   Financial intermediation declined sharply. Banks have continued to scale down their operations under pressure from heavy taxation, losses from government mortgage relief schemes, and rising NPLs (Figure 3). The reduction in external funding accelerated beyond the pace seen in peer countries, and the loan-to-deposits ratio dropped sharply to 111 percent at end-2012. Most of this reflects reduced lending as the deposit base has remained broadly stable. Banks have tightened their lending standards and are less willing to expand in the corporate sector, particularly to small and medium enterprises (SMEs). Demand for new loans, especially from households, is also very weak. Non-performing loans (NPLs) continued to increase in both the retail and corporate segments (reaching 15 percent and 21 percent, respectively).[1] Restructured loans are on the rise (11 percent of all loans), reflecting the implicit incentive by the absence of penalties in the form of provisions.

External and Internal Deleveraging

Sources: IFS and MNB

Credit Growth
(YOY, Exchange rate Adjusted)

Source: MNB.
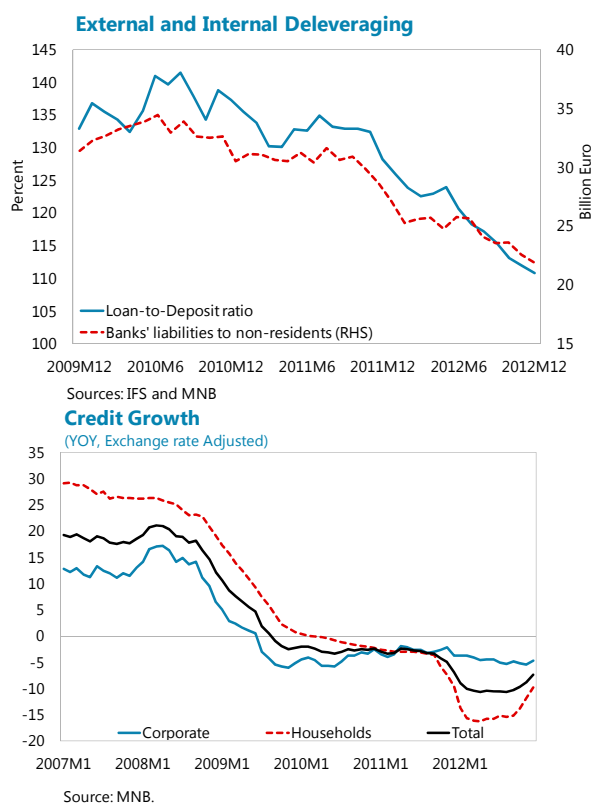
6.   The fiscal deficit declined below 3 percent of GDP. After nine years under the excessive deficit procedure (EDP) and to avoid the suspension of cohesion funds, the government embarked on a sizable consolidation (Figure 4). The 2012 deficit is estimated at 2½ percent of GDP, implying a structural adjustment of 2¾ percent of GDP. This required the adoption of several fiscal packages during the year as the budget faced pressure from revenue shortfalls from a weakening economy and expenditure slippages. Overall, around two thirds of the announced measures were revenue based, including the increase in the standard VAT rate from 25 to 27 percent (the highest rate in Europe), hikes in excise taxes, and increases in health care contributions. In addition, the budget continued to rely on

Main Fiscal Measures in 2012

	Staff est.	
	HUF bn.	% of GDP
Revenue increases	445	1.6
A. Original budget	410	1.4
PIT changes, net	90	0.3
Tax credit elimination	370	1.3
Partial elimination of supergrossing	-280	-1.0
Cuts in SSC to compensate for wage increases	-150	-0.5
VAT rate hike	160	0.6
Excise tax hikes and other fees	150	0.5
Health care contribution increases	112	0.4
Redirection of private pension fund members' contributions	48	0.2
B. Supplementary measures (April and October 2012)	35	0.1
New tax on telecom	25	0.1
Reverse VAT on agriculture	10	0.0
Expenditure cuts	280	1.0
A. Original budget	100	0.4
B. Supplementary measures (April and October 2012)	180	0.6

Source: IMF staff estimates.

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[1] Part of the increase in household NPLs reflects the impact from the mortgage pre-payment scheme which reduced the total value of loans.

existing and new special taxes levied on bank, retail, telecom, and energy sectors. Some efforts were made at reducing spending on goods and services and capital transfers.

7.   After a difficult first part of 2012, sovereign financing conditions improved considerably in recent months on the back of improved risk appetite globally. Hungary came under severe financial stress starting in late 2011 with sovereign spreads reaching 650 bps and the forint hitting 320 per euro. Conditions started to ease in the summer following actions by major central banks and the authorities' commitment to keep the fiscal deficit under control. Flows into government domestic debt surged, particularly in the second half of the year, and, by end 2012, about 45 percent of the stock of domestic government bonds (about €17 billion) was held by non-residents. Taking advantage of the favorable environment, in February 2013, the government returned to the external markets (the first time since May 2011) with a US$3.25 billion bond placement.

5-year Sovereign CDS Spreads

Source: Datastream
*Poland, Czech Rep., Slovak Rep., Romania, Bulgaria, Ukraine, Estonia, Latvia, Lithuania, Croatia, and Slovenia.
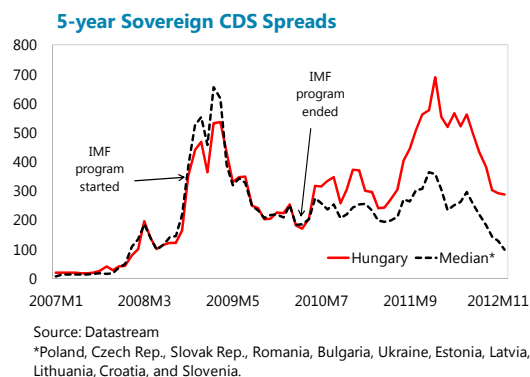
8.   Against a decline in risk premia and a weak economic outlook, the MNB started to ease monetary policy in the second half of 2012 (Figure 5). The policy stance was kept tight during the first seven months of the year as financial conditions were unsettled and inflation remained stubbornly above 5 percent. Since August, policy rates have been cut by 175 basis points in seven successive steps. These were split vote decisions, with the monetary council's (MPC) external members outvoting MNB's management. The majority considered that the effects of cost-push factors (energy prices and indirect tax rate hikes) that kept inflation above the central bank's 3 percent target were waning, and the pull from weak demand conditions was sufficient to steer inflation towards the target by mid-2014. The exchange rate closed at HUF291 per euro at end 2012, appreciating by 6½ percent during the year, but suffering bouts of volatility.

OUTLOOK AND RISKS

9.   Staff expects weak growth conditions to continue. Real GDP is projected to remain broadly flat in 2013 as the negative carry over from 2012 and persistently weak domestic demand are expected to offset a modest contribution from net exports. Consumption is likely to remain depressed despite a small increase in disposable income as households continue to repair their balance sheets. Similarly, amid a generally unfriendly environment weak, investment and bank deleveraging are expected to continue (Box 4). A mild recovery is expected in 2014 and thereafter as domestic demand bottoms out.

Real Potential Output Growth In Hungary and Regional Peers 1/
(Percent)
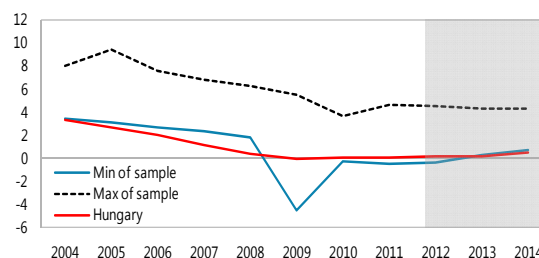
Source: IMF staff estimates.
1/ The sample includes Bulgaria, Croatia, Czech Republic, Estonia, Lithuania, Poland, Romania, Russia, Slovak Republic, Slovenia, Turkey and Ukraine.

Yet weak policies, low labor participation, and the poor investment climate are likely to keep growth subdued in the medium term.[2] Current account surpluses are projected for 2013–14, which would gradually narrow as domestic demand and imports recover. Absent new tax hikes and administrative price adjustment, inflation will moderate in 2013–14.

10.   Downside risks to the baseline outlook are considerable. On the domestic side, the recession could prove more persistent prolonged by weaker than expected private consumption and business confidence. On the external side, the reemergence of pressures in the euro area could be particularly destabilizing for Hungary given its strong regional trade and financial linkages leading to sharper credit crunch and economic slowdown. In addition, a reversal of capital flows, including markedly diminished non-residents' participation in Hungarian securities, prompted by either an intensification of the euro area crisis or domestic policies could cause severe funding pressures and an abrupt depreciation. In turn, this would further impair balance sheets given the still sizable foreign currency exposures (Box 5) and undermine external sustainability (Appendix).[3] On the upside, sustained capital inflows could lead to an exchange rate appreciation and improved balance sheets, providing a boost to domestic demand**.**

Authorities' views

11.   The government was generally sanguine about the outlook and confident that current policies will support economic recovery. It viewed the 2012 contraction as the result of external headwinds, the poor agricultural harvest, and the drag from fiscal adjustment. It

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[2] Citing the weak and uncertain economic outlook, S&P downgraded Hungary's rating by one notch to BB in November 2012.

[3] External and public financing needs amount to 38 and 20 percent of GDP, respectively.

expected real GDP to grow by 0.9 percent in 2013 and 2 percent in 2014, as external conditions improve, the drag from the fiscal stance is lifted, targeted measures increase household disposable income, and the absorption of EU funds is accelerated. The MNB was less upbeat. It expressed serious concerns about the worsened growth outlook. It estimated that potential growth declined to around 0–½ percent in 2012 (in line with staff's assessment), and expected it to rise to a modest 1 percent in 2013–14.

POLICY DISCUSSIONS

Discussions centered on the viability and challenges of the current economic strategy, the sustainability of the fiscal adjustment, the need to repair bank and household balance sheets, and structural reforms to support investment and job creation.

A. Ensuring Fiscal Sustainability: Quality Matters

12.   The authorities are determined to exit the EDP as soon as possible. Following the sharp adjustment last year, the 2013 budget targets a slight increase in the headline deficit to 2¾ percent of GDP, implying a broadly cyclically neutral stance. The broader direction of policies in the 2013 budget remains unchanged. Tax revenue is expected to increase by more than 1 percent of GDP, mainly on the back of sectoral taxes, most of which were revised and became permanent in 2013, and a new tax on bank transactions (BTT). The latter was introduced to fund the implementation of the Job Protection Plan which reduces social security contributions for companies employing specific groups of workers.[4,5] Overall, revenues in the form of sectoral taxes are expected to rise to around 2½ percent of GDP in 2013. Total spending is expected to exceed 50 percent of GDP.

Main fiscal measures for 2013

	Staff est.	
	HUF bn.	% of GDP
Revenues	378	1.3
Taxes on banks (BTT and bank levy)	302	1.0
Job protection plan	-190	-0.7
Tax on Treasury transactions	80	0.3
Tax on utility companies (tax on wires and pipelines)	60	0.2
Elimination of the cap on employee pension contribution	51	0.2
Increase in the rate of the tax on energy suppliers	40	0.1
Limitation of expense deductibility for the local business tax	35	0.1
Expenditures	91	0.3
Postponement of wage hikes in education	73	0.2
Savings from public sector wage bill and cap on social benefits	18	0.1

Source:IMF staff estimates.

13.   Based on current policies, the 2013 target is expected to be missed. Staff supported the slightly looser 2013 target (relative to the 2.2 percent target under the convergence plan), given the weak state of the economy, but expressed deep concern about the composition and adequacy of measures underpinning the budget. Absent new measures, the deficit is likely to reach 4½ percent of GDP with the overrun mainly caused by overestimation of revenue

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[4] This program covers long-term unemployed, workers below the age of 25 and over the age of 55, and women receiving maternity benefits.

[5] The tax base is the value of various bank transactions. The rate is set at 0.2 percent on all non-cash transactions and at 0.3 percent on cash withdrawals, with a cap of HUF 6,000 per transaction.

including from optimistic macro projections, unsubstantiated tax administration gains and the BTT, delays in launching the electronic toll system, higher spending on education, and copayments to EU funded projects. While the budget includes a buffer of about 1¼ percent of GDP in the form of contingency reserves, this is insufficient to cover the projected shortfall. Assuming these contingency reserves are not spent, the deficit would be limited to 3¼ percent of GDP in 2013. In this regard, staff called for additional measures to reach the deficit target.

General Government Overall Deficit
(Percent of GDP)

Source: Hungarian authorities and IMF staff estimates.
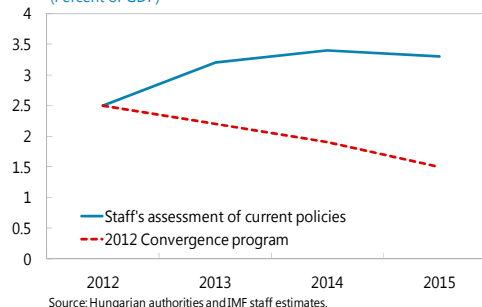
14.   Staff recommended a stronger medium-term adjustment. On current plans, the fiscal deficit will remain above 3 percent of GDP over the medium-term, keeping public debt close to 80 percent of GDP. This would be some 10 percentage points higher than its pre-crisis level—despite the one-off effect from the transfer of assets from private pension funds in 2011. This high level of debt, and the corresponding large financing needs, would keep Hungary vulnerable to shocks and swings in market sentiment (Table 4 and Appendix I). In this regard, staff called for stronger action to bring the deficit sustainably well below 2 percent of GDP by 2015 to support decisive debt reduction.

Public Debt and the Structural Fiscal Balance
(Percent of GDP)

Sources: Hungarian authorities and IMF staff estimates.
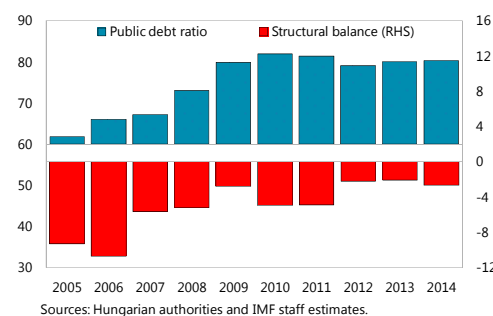
15.   Importantly, staff called for a significantly different composition of fiscal policy to improve growth prospects and ensure the sustainability of the fiscal adjustment. The tax burden on several economic sectors has increased, undermining investment, employment, and growth. At the same time, public expenditure is among the highest in the region (Box 6). Staff argued for a medium-term plan to streamline spending while protecting the most vulnerable, which would open room for the needed rationalization of the tax system.[6] Possible actions include : (i) reducing the cost of the central government bureaucracy and containing spending at the local government level, where savings can be found after the centralization of health and education spending; (ii) restructuring loss making transport state-owned enterprises (SOE)s to reduce state transfers; (iii) better targeting social benefits to vulnerable groups; (iv) gradually eliminating sectoral taxes while streamlining the corporate tax regime; (v) reducing disincentives

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[6] Staff's analysis suggests that consolidation based on current expenditures cuts yields the smallest GDP contraction in the short term and can increase output in the long term by stimulating labor participation and private investment. See Selected Issues Paper: "The Composition of Fiscal Consolidation Matters: Policy Simulations for Hungary".

to work embedded in the personal income tax; and (vi) reducing tax expenditures and adopting a more comprehensive approach to tackle VAT fraud, particularly in the basic food sector (Box 7).[7]

16.   Staff underscored the need to move ahead with the structural fiscal reform agenda and strengthen fiscal institutions. Enhancing fiscal institutions would better support macroeconomic and fiscal performance. In this regard, staff recommended: (i) introducing a medium-term budget framework that will support the targets under the Convergence plan and EU fiscal rules; and (ii) strengthening the fiscal council by enhancing its independence, providing it with sufficient resources, and broadening its mandate to effectively assess budgetary objectives and risks.

Authorities' views

17.   The government was confident that the 2013–14 deficits will remain below 3 percent of GDP. It argued that despite some possible slippages, the contingency reserves are sufficient to meet the deficit target. The government saw no room to change the current tax system, which in its view, balances appropriately the tax burden among the various sectors of the economy. In this respect, they also saw no need for sizable reduction in spending, although they noted plans to reduce the cost of public administration. They also noted their plans to strengthen the budgetary framework by introducing the European Structural Balance rule for the general government by end-2013.

B.   Monetary Policy—A Difficult Balancing Act

18.   The recent monetary policy easing was supported by favorable external conditions, yet inflation is not well anchored. Headline inflation is projected to decline in 2013 on the back of a one off (10 percent) adjustment in regulated energy prices for households, but, as this impact wears off, inflation is expected to increase before the pull from the output gap brings it close to the target by end-2014. Core inflation is set to decelerate at a more gradual pace. However, upside risks are considerable, stemming from the uncertainty about the degree to which spare capacity in the economy will restrain rising production costs, including from higher taxes and nominal wage increases.

Inflation (yoy)

Source: IMF staff's estimates.
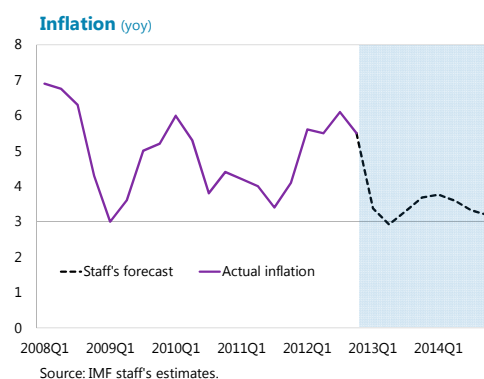
19.   Staff argued that a pause in the easing cycle seems prudent and further cuts should be considered only in the context of strengthened macro policies and improved market conditions. Beyond the uncertainty surrounding the inflation trajectory, staff cautioned that

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[7] The authorities estimate VAT losses at around HUF 500 billion (about 1¾ percent of GDP). The agricultural and food sectors appear to be particularly affected.

policy rate cuts cannot substitute for other policies to jump-start growth, particularly when the credit channel is impaired. In fact, with fickle market confidence, deep policy rate cuts could lead to currency depreciation and could risk de-stabilizing the financial system, given the sizable FX exposures in private balance sheets. Stronger policies (including fiscal), moderation of inflation expectations, and low risk premia would facilitate further policy rate cuts. In this regard, maintaining the legal and operational independence of the MNB is critical.

20. **Although there is no compelling evidence that the forint is considerably misaligned, structural factors may be eroding competitiveness (Box 3)**. Standard methodologies find only weak evidence for overvaluation. Nonetheless, Hungary has been gradually losing export market share and lagging labor productivity has raised unit labor costs relative to peers due mostly to structural factors rather than exchange rate developments. Considering the balance sheet exposure to exchange rate movements, improving competitiveness should be based on removing the impediments that hamper investment and hold back private activity, and advancing structural reforms. This would help to maintain a strong current account and improve the large negative net international investment position over time.

21. **An adequate reserve position would help provide strong buffers against shocks**.
Reserves are currently within the IMF adequacy range. However, given the still high short-term external debt and FX exposure of Hungary's economy, reserves should be maintained at levels sufficient to provide foreign currency liquidity to markets under adverse external shocks. Periods of continued capital inflows can provide an opportunity to build reserves within the current exchange rate regime.

Reserve Adequacy

Source: IMF staff estimates.
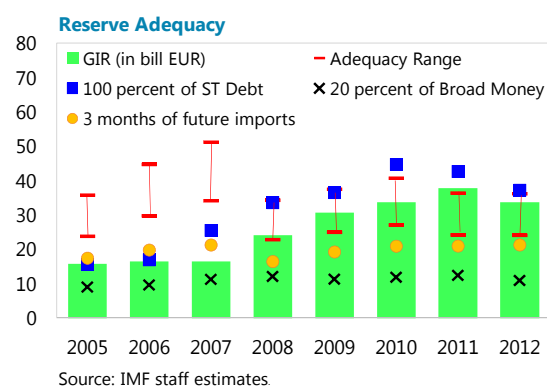
Authorities' view

22. **Views within the MNB were divided**. The MNB management favored a tighter monetary stance. They expressed concern that the higher production costs and possible over-estimation of the output gap may lead to higher inflationary pressures in the period ahead. They also doubted the effectiveness of monetary easing to spur growth in the current juncture, given the impaired credit channel and the adverse balance sheet effects of a weaker currency that may be associated with further cuts. The external MPC members were more sanguine about the inflation outlook, arguing that higher production costs will not result in inflationary pressures as the output gap remains sizable. In this regard, they were convinced that the improved external environment creates room for monetary policy easing and that policy rate cuts could contribute to credit growth. The MPC members assessed the level of reserves as adequate by a variety of indicators. The MNB did not see the forint as overvalued, but shared staff's concerns that Hungary's international competitiveness may have started to weaken recently.

C. Financial Sector—Restore Conditions for Financial Intermediation

23.   While the banking system is generally stable, important vulnerabilities remain.
Banks' average capital adequacy ratio (CAR) as of end-2012 (15 percent) appears adequate and
stress tests conducted by the Central Bank indicate an improvement in the shock-absorbing
capacity of the banking sector as a whole. However, with subdued economic activity, rising non-
performing and restructured loans, possibly over-stated collateral, and a heavy tax burden,[8]
banks' profitability is projected to remain low. In this difficult landscape, banks are planning to
further scale down their operations. Credit growth is projected to remain negative in 2013 on the
back of weak household demand and banks' limited appetite to lend. Reduction of parent banks'
cross-border exposure (including to their subsidiaries) is likely to continue, albeit at a more
gradual pace, and thus contribute to the negative credit growth and weak economic activity in
the period ahead.[9]

**24.   Higher bank provisioning is needed in view of the worsening asset quality and
weak collateral.** Rising corporate and household NPLs point to the risk of further losses,[10]

particularly given the relatively low provisioning (47
percent), and the high level of restructured and ever-
greened loans.[11] Staff underscored that adequate
provisioning, including through more frequent and
realistic appraisals of collateral, would help minimize
uncertainty regarding future losses and assist with the
cleanup of balance sheets.[12] In addition, staff stressed
the need for closer monitoring of repeated loan
restructurings to ensure that non-performing loans
are adequately reported and provisioned for.

**Hungary: Non-Performing Loans in the Private
Sector** (Percent of Total Loans)
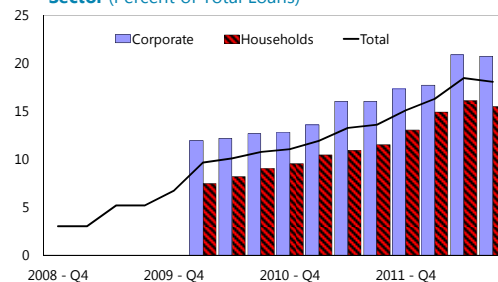
Source: MNB.

**25.   Speeding up portfolio cleaning is desirable but banks' capacity to absorb further
losses is limited.** Portfolio cleaning remains sluggish. Staff concurred with the authorities that
resolution of NPLs should be led by banks in a cooperative fashion, yet noted that a more
proactive approach, which would provide incentives for the banks to clean up their portfolios, is
warranted. In this regard, staff stressed the need to remove legal, tax and regulatory

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[8] The levy imposed on banks has a fixed base reflecting the size of the banks' balance sheets in 2009. However,
since then, some banks' balance sheets have contracted by as much as 20 percent, resulting in a rising tax
burden.

[9] See Selected Issues Paper "NPLs in CESEE: Determinants and Impact on Macroeconomic Performance".

[10] The recent rise in NPL ratio in the household segment is in part due to the early mortgage repayment scheme,
which reduced the stock of outstanding household loans by 12 percent.

[11] This in part reflects banks' reluctance to realize losses in the face of a frozen real estate market.

[12] Adequate provisioning would reduce the system-wide capital adequacy ratio but would still leave it above the
minimum requirement.

impediments to facilitate speedy liquidation of collateral while keeping an adequate balance between creditors and debtors rights.[13] Establishing a personal insolvency framework would also help expedite the portfolio cleaning process. Staff noted that developing an *out-of-court* debt restructuring framework would reduce present delays and high collection costs while further alleviating the pressure on the judicial system. Staff welcomed the establishment of the National Asset Management Agency (NAMA), though saw room to relax the participation requirements and change its financing structure to reduce the burden on the treasury.[14]

26.   Banks need more stable sources of external funding to reduce reliance on FX swaps. The stock of FX swaps (used to hedge on-balance sheet open FX positions) declined in 2012, in tandem with the reduction in banks' FX assets. But at a level of €10 billion (about 10 percent of GDP) and with relatively short maturity (on average 1½ years), FX swaps represent a significant vulnerability to the financial system as they can amplify the negative effects of external shocks on the exchange rate. Staff noted the recent improvements in the macro-prudential regulatory framework, including the introduction of the FX Funding Adequacy Ratio (FFAR),[15] and stressed that, as the reduction of banks' FX assets continues, banks should be encouraged to turn to more stable sources of external financing. In this regard, staff also welcomed the authorities' efforts to reduce the rollover and liquidity risks associated with FX swaps by negotiating with the banks to voluntarily limit their off-balance sheet net FX position to below 15 percent of total assets.

27.   Hungarian banks' regional operations should continue to be monitored to minimize the risk of potential adverse outward spillovers. The largest domestic bank has several subsidiaries in the region accounting for about 40 percent of its total assets. While these subsidiaries are mostly small, they are relatively large in Bulgaria and Montenegro (among the top three banks by bank assets).[16] The HFSA is in regular contact with host country supervisors and staff does not see an imminent risk of systemic spillovers in the host countries from the activities of this bank. Continued effective supervision of banking group's and enhanced cooperation with host country supervisory agencies will be critical to ensure the stability and soundness of host country financial systems.

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[13] For instance, by reconsidering the regulations for debt cancellation, such that under certain conditions it would not result in income for debtors (i.e. no tax consequence), and could be booked as cost by banks (i.e. tax shield effect).

[14] NAMA started to operate in the summer of 2012 with the objective of helping lower income families who are unable to repay their loans by purchasing their properties and renting them back at a price determined by law. It is not clear, however, whether NAMA would be able to purchase the full 25,000 properties allowed by the law by 2014 given the strict requirements (for example, only those that have at least one child and receive some sort of social benefits are eligible to participate).

[15] The liquidity buffer has to exceed 20 percent of corporate and retail deposits and/or exceed 10 percent of total assets (January 2012). Under FFAR, the ratio of stable FX funding (including FX swaps above one year) to FX assets needs to exceed 65 percent.

[16] Other subsidiaries are located in Russia, Ukraine, Croatia, Romania, Slovakia, and Serbia, and make up between 1 and 7 percent of total banking group assets each. They are increasingly locally funded and are more active in retail banking, though some specialize in corporate lending.

28.   Staff warned against an increased role of the government in providing credit to the economy, particularly given the limited fiscal space. The government's efforts to facilitate lending to SMEs through tax incentives, refinancing, and direct lending by the state-controlled banks has had little success so far, and further efforts to expand the government's involvement in lending to the private sector are underway. Staff argued that the most efficient way to restore credit growth is through improving the broader policy framework and its predictability, including by abolishing the bank levy, which is delinked from banks' current size and performance. Staff, in this regard, welcomed the governments' intent to re-engage with banks in an effort to establish a better operational environment.

Authorities' views

29.   The authorities agreed that the lack of financial intermediation undermines economic activity. They concurred that credit is likely to continue to contract in 2013 due to both demand and supply factors. They saw a role for government action, including through credit guarantees and mortgage rate subsidies, to improve SMEs' access to credit and reduce the cost of borrowing to households. While agreeing that the high share of NPLs and restructured loans burdens banks' balance sheets, the authorities expressed concern that forcing banks to move faster with portfolio cleaning would amplify their losses, particularly given the weak real estate market. The MNB agreed that the regulatory framework could be strengthened to ensure adequate provisioning. However, the financial supervision authority (HFSA) was more optimistic arguing that loan-loss provisioning is adequate and the recent improvement in the banks' capital position would be sufficient to withstand possible losses. The HFSA noted its intent to issue guidelines to banks within the first half of 2013, requiring additional provisions for loans that have been restructured multiple times. They also stressed their plans to enforce stricter collateral valuation for real estate, and harmonize appraisal methods across banks. The authorities are working on a bank resolution framework, including with IMF technical assistance, aiming to submit legislation for parliamentary approval by June-2013.

D.   Structural Issues—Raising Potential Growth

30.   Hungary's growth prospects have deteriorated in recent years. Unconventional policies, high and uneven tax rates, and heavy regulatory burden have eroded investors' confidence and contributed to a sharp decline in investment, undermining growth and aggravating the ongoing balance sheet adjustment in the economy. While estimates are subject to considerable uncertainty, Hungary's potential GDP growth over the medium-term (around 1½ percent) is significantly below its peers and well below the level needed to bring the high unemployment back to its pre-crisis levels.

Burden of Government Regulations

Source: Global Competitiveness report 2012-13, WEF.
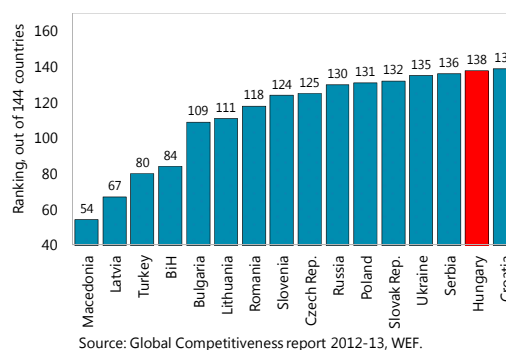
31.   The gains to potential growth from comprehensive efforts to raise productivity and labor participation could be substantial. In this regard, measures are needed to:

- **Improve the business climate.** Hungary's ranking (54) in the World Bank's *Doing Business Report* continued to deteriorate in 2013 after falling both in 2012 and 2011 (by 5 and 8 places, respectively), primarily due to worsening perceptions about investors' protection, institutions, and tax burden. A level playing field for all business, a stronger investor protection framework, and a more predictable policy framework, including through more balanced fiscal consolidation and a better operational environment for banks would help support investment and economic activity.

- **Raise the exceptionally low labor participation rate.** The authorities have placed job creation as a key policy objective and have adopted measures to stimulate employment, including by tightening unemployment and welfare benefits, expanding the public works program, and reducing tax rates and social contributions for some segments of the labor force. Staff argued for (i) a more employment-friendly taxation for low income earners, including by introducing a basic allowance in the personal income tax to increase labor supply; (ii) upgrading the public works program by significantly scaling up training and skill-enhancing services; and (iii) raising women's participation in the labor market by reorienting public spending from cash benefits, including overly long post-maternity parental leave benefits, towards the development of high quality early childhood education and day care centers.

- **Strengthen competition**. Possible measures in this area include the reduction of unnecessary regulations and entry barriers that continue to pose obstacles to entrepreneurship, and enhancing the operation, effectiveness, and role of the Competition Authority.[17] In addition, increasing competition in the services sectors can raise productivity. This includes the utility sector, where reforms to allow for more competition is a more sustainable way to help drive down utility tariffs than administrative measures.

- **Enhance the efficiency of SOEs.** The restructuring of loss making transport SOEs is long overdue and could help improve services and resource reallocation while phasing out a persistent drain on the budget.

Authorities' views

32.   While agreeing on the need to remove structural bottlenecks to growth, the authorities envisage a more favorable growth outlook based on ongoing initiatives. In their view, the fiscal adjustment in 2012 and the commitment to fiscal prudence constitutes a solid

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[17] On January 1st and March 1st 2012, the government introduced new requirements for company registration to better protect the interests of creditors. The changes are expected to significantly lengthen company-registration procedures and increase the costs of establishing new firms.

base to jumpstart the economy. Private investment would be supported by strategic agreements with large manufacturing companies and more targeted use of EU transfers. They pointed out that Hungary's labor market regulations ensure a high degree of flexibility, and labor participation will continue to increase thanks to recent changes to early pension requirements and unemployment and disability benefits. Labor demand will strengthen on account of the targeted relief afforded by the Job Protection Plan. Finally, they noted that exports could be supported by expanding the role of the Eximbank and by efforts to strengthen trade links with non-EU partners such as China, Russia, and the Arab countries.

POST PROGRAM MONITORING

33.   In the current favorable market environment no official financing is envisaged. Outstanding Fund credit to Hungary is projected to fall below 200 percent of quota in August 2013, and be mostly eliminated by mid-2014 (Table 11). Hungary's capacity to repay the Fund is expected to remain adequate, assuming continued access to international capital markets and/or continued strong nonresident participation in the domestic government debt market. However, downside risks (as described in paragraph 10) remain sizable and should they materialize meeting the debt payments could become challenging.

STAFF APPRAISAL

34.   Hungary managed to navigate a challenging year. Despite the strong headwinds from the external and domestic environment, financial stability was maintained. However, vulnerabilities are still high and leave Hungary exposed to considerable risks. In this environment, external shocks and policy missteps could threaten financial stability. The main challenge is to strengthen policies to maintain confidence, reduce vulnerabilities, and generate robust and sustainable economic growth.

35.   A change in policy direction would help revive growth, improve competitiveness, and support the orderly unwinding of imbalances. The output decline in recent years has been deeper than in peer countries, and the economic outlook is clouded by unconventional policies that are steadily eroding confidence, undercutting investment and growth. Competitiveness has been declining despite no strong evidence of exchange rate misalignment. Priority should be placed on strengthening policy credibility, delivering the fiscal adjustment in a more growth-friendly way, and restoring bank intermediation. The pace of structural reforms, which has lost steam recently, should be accelerated. In this regard, efforts are needed to improve the poor business climate, address the persistent weak conditions of state-owned enterprises (especially in the transportation sector), and increase competition in product markets. These efforts should be combined with further measures to raise labor participation, including by enhancing vocational training and introducing a basic allowance in the personal income tax to make the taxation of labor more employment-friendly for low earners.

36.   The commitment to fiscal consolidation is welcome but the composition of the adjustment needs to improve to support growth. Transient sectoral surcharges have now become a permanent feature of the tax system and new taxes, like the bank transaction tax, have been introduced to support an unsustainably high level of public spending. The authorities are encouraged to focus their efforts on achieving a durable spending reduction that will pave the way to reduce the tax burden and improve the efficiency of the tax system over time. In addition, decisive steps should be taken to strengthen revenue administration, in particular to combat VAT fraud.

37.   Strong discipline and additional efforts are necessary to put public debt firmly on a downward path. Public debt has stabilized but remains high and its financing poses considerable risks. This leaves no space to loosen the fiscal stance in 2013 or to pause the fiscal consolidation in 2014. Additional efforts are needed to ensure that public debt and financing needs are reduced to more manageable levels.

38.   Restoring financial intermediation is critical for economic recovery. A turnaround in bank lending requires improving the banking system's operational environment. Key steps include scaling down the tax burden on the financial sector and facilitating conditions to help banks clean up their asset portfolio from rising NPLs, including by removing tax, legal, and regulatory obstacles that hamper the resolution of impaired assets. This would be a more effective and less costly way to support credit growth than resorting to ad-hoc initiatives involving tax incentives, credit guarantees, and on-lending by state-controlled banks. At the same time, the authorities should step up the monitoring of NPL classification and provisioning, including for repeatedly restructured loans.

39.   While the recent monetary policy easing was appropriate, a pause in the easing cycle seems prudent at this point. The challenge ahead is to guide inflation sustainably to lower levels while striking the right balance between supporting economic activity and financial stability. Inflation is still not well anchored and is projected to decelerate in 2013 mainly on the back of lower administered utility tariffs. Further monetary easing should proceed only as inflation expectations and risk premia moderate and pressures on the forint do not emerge. A strong policy framework, including maintaining the operational and legal independence of the MNB, will be critical for the credibility of the inflation targeting regime.

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

Box 2. Household Indebtedness

Buoyant credit growth in the pre-crisis years left the household sector heavily indebted. Comprising mostly mortgages, debt grew rapidly before the crisis, reaching 42 percent of GDP by mid 2008. As two-thirds of the debt was in FX, particularly in Swiss francs, the stock ballooned to 55 percent of GDP in early 2009 due to the sharp depreciation of the forint.

Household Debt Service
(Percent of Disposable Income)

☒ Principal payment/disposable income ■ Interest payment/disposable income

Source: MNB.

When the crisis hit, servicing the debt became increasingly burdensome. The rising share of debt payments in income and the decline in asset prices led to a steep increase in default rates. To alleviate the pressure, the government introduced several measures in 2011–12, including:

- *Early FX mortgage repayment scheme (September 2011).* Households with FX-denominated mortgages were allowed to pay off their loans at a preferential exchange rate (around 25 percent below the market rate). The cost arising from the exchange rate difference was initially to be borne by the banks, though the scheme was later modified to allow banks to deduct 30 percent of the losses from the 2011 bank levy.

- *Locking in preferential exchange rates for a five-year period ("exchange rate cap").* Eligible borrowers can lock their amortization payments at a preferential rate through June 30, 2017. The difference with the originally scheduled principal payments is accumulated in the form of separate HUF loan to be repaid by the debtor after five years. The cost arising from the interest rate differential will be split between the state and the banks.

- *Conversion of non-performing FX mortgage loans into forints.* Borrowers of FX mortgage loans with at least 90-day overdue payments of over HUF 78,000 at end-September 2011 were entitled to convert their loans to forints at the average exchange rate prevailing between May 15 and June 15, 2012. Banks had to cancel 25 percent of the debt converted to forints, but were allowed to deduct 30 percent of the resulting loss from the bank levy.

	Restructured foreign currency loans			
	FX mortgage loans benefited (in HUF billion)	In percent of total FX mortgage loans at end-2011	Participation rate of eligible borrowers	Estimated transfer to Households (in HUF billion)
Early repayment scheme	1354	29.6	24.1	356
Exchange rate cap	948.3*	20.7	26	67**
Conversion of FX NPLs into forints	23	0.5	na	9

* As of end-2013
** Including the 5-year grace period
Source: HFSA and MNB's Financial Stability Reports.

Box 2. Household Indebtedness (continued)

The mortgage relief programs have so far had a modest impact on the debt stock. The participation rate was relatively low – in part due to the complex design of the programs. In particular, the early repayment scheme mostly favored borrowers in good standing who could afford to pay off their loans. The participation in the conversion scheme of non-performing FX mortgages was hindered by the collateral requirement which specified that the value of the borrower's real estate could not exceed HUF 20 million and by the fact that part of the savings were offset by the higher interest rate of new forint loans. Finally, the registration (one third of eligible debtors) in the "exchange rate cap" program (open until March 2013) has undershot expectations due to the complexity of program and the uncertainty that it envisages after the 5-year grace period.

But the cost has been sizable. The programs have so far resulted in a net transfer of about 1½ percent of GDP to households, of which two-thirds was borne by banks and one-third by the government.

Box 3. External Sustainability and Competitiveness Assessment

While there is no clear evidence of a real exchange rate misalignment, there are signs that international competitiveness may have been eroded recently.

Estimates of standard methodologies vary considerably with no clear evidence of misalignment. CGER estimates point to a small overvaluation as does the EBA ES estimate, while the two other EBA methodologies find deviations in opposite direction.[18] Staff's estimates find large standard errors that render two of the three methodologies statistically insignificant, while the ES method points to a small undervaluation.

Hungary: Summary of REER Assessment 1/

1/ + (-) is over(under)valuation. Range around desk estimates indicate the 95 percent confidence interval.
2/ Shows the current account gap where +(-) is under(over)valuation.

These metrics notwithstanding, Hungary's international competitiveness may be weakening (panel chart). Compared to regional peers, labor productivity has remained broadly flat since 2009, making unit labor costs relatively high in Hungary. Along with the deteriorating business climate, this may be contributing to Hungary gradually losing export market share, receiving less FDI than it did in the pre-crisis years, and having a lower share of profits generated by nonresident-owned corporates reinvested in Hungary.

An improvement in international competitiveness will facilitate the reduction in Hungary's large net foreign liabilities while helping to rekindle growth. At 100 percent of GDP, Hungary's net foreign liability position is higher than in regional peers, and around levels seen in Greece, Ireland and Portugal. While the ongoing external deleveraging has contributed to an improvement in the net position, foreign liabilities are high and pose a risk to external stability. A weaker REER could help maintain a strong current account balance necessary to reduce Hungary's large negative net IIP position over the medium-term, while supporting growth and job creation.

Net Foreign Assets, Liabilities and NIIP
(In Percent of GDP)

Sources: Haver Analytics.

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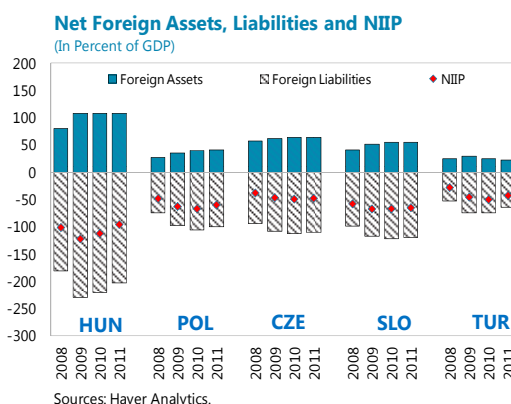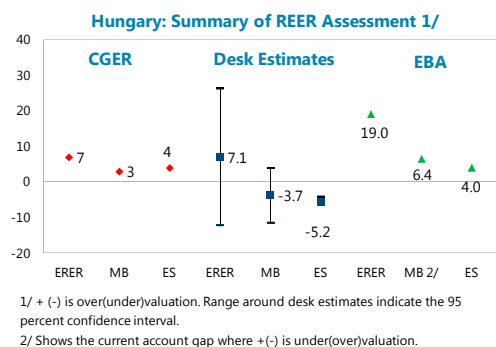
[18] The EBA MB estimate may not be relevant for Hungary, as the EBA method has certain limitations in assessing countries with NFA positions that are highly negative and need to strengthen considerably.

Box 3. External Sustainability and Competitiveness Assessment (continued)

Like in regional peers, export growth has slowed since the global financial crisis...

Average Export Growth
(Geometric Mean, Percent)

■ Average 2000-08
▨ Average 2010-12
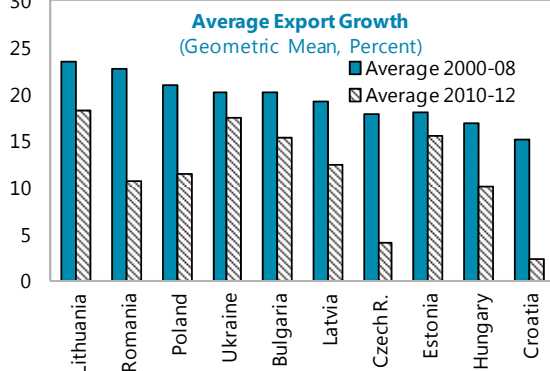
...but Hungary appears to be losing some market share.

World Market Share
(Index, 2007 Q1 = 100)

- Hungary
- Czech Republic
- Poland
- Slovak Republic
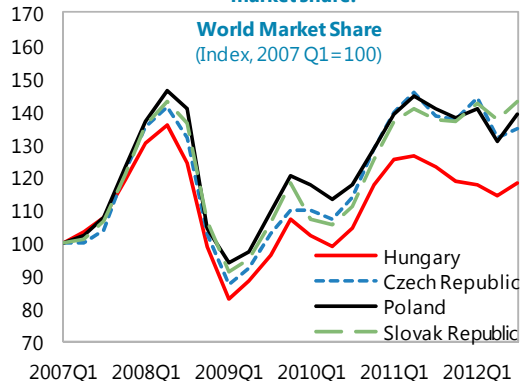
Notwithstanding some volatility over the last two years, the real exchange rate has gradually appreciated.

REER, Nominal Exchange Rate
(Index, 2007Q1 = 100)

- REER
- HUF/Euro (RHS)
- Linear (REER)
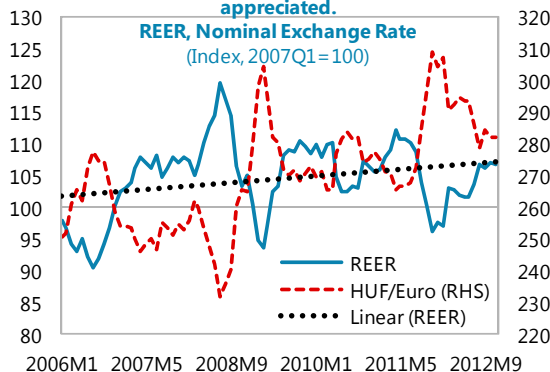
Real wages have grown somewhat less than in peer countries...

Real Hourly Earnings
(2002 Q1 = 100)

- Hungary
- Czech Republic
- Poland
- Slovak Republic
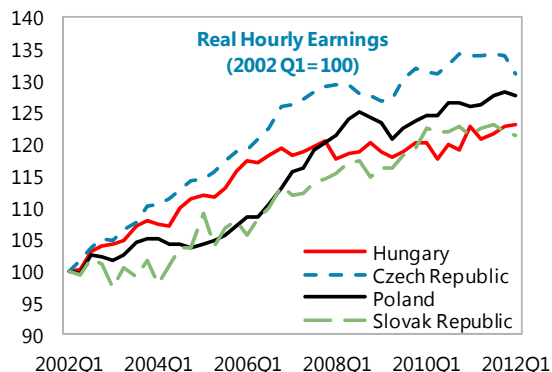
... but labor productivity growth has not recovered since the crisis...

Labor Productivity
(Index, 2002Q1 = 100)

- Hungary
- Czech Republic
- Poland
- Slovak Republic
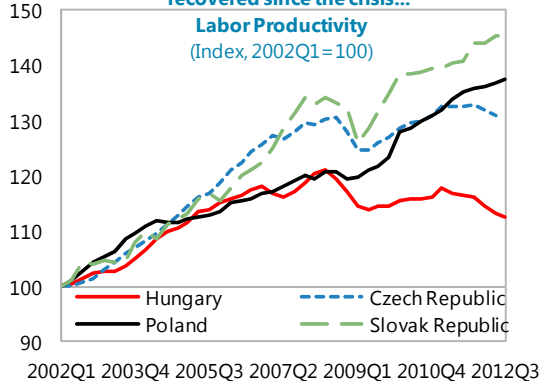
...resulting in a relative increase in unit labor costs in Hungary.

Unit Labor Cost
(Index, 2002 = 100)

- Hungary
- Czech Republic
- Poland
- Slovak Republic
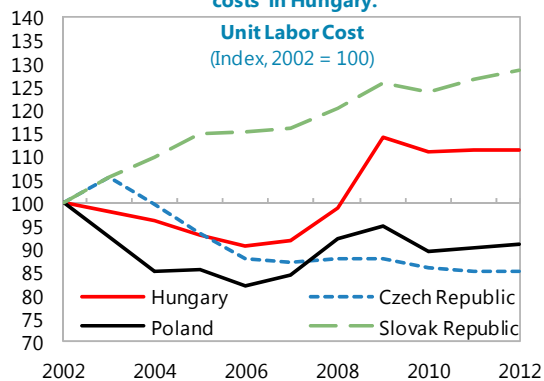
Source: Hungarian Statistical Office, MNB, and IMF staff estimates.

Box 4. External Deleveraging and Economic Growth

Since 2008, the reduction in cross-border exposures to Central Eastern and Southeastern Europe (CESEE) has been sizable reaching an average of 4¾ percent of GDP.[1] The strong positive correlation between banks' external funding and credit growth (Figure 1) suggests that the outflows may be associated with a weak pace of economic recovery, particularly in economies that face difficulties in substituting external resources with domestic ones.

Figure 1. Banks' Liabilities to Non-Residents and Credit to the Private Sector (Real Growth, YoY)

Sources: IFS and IMF staff's calculations

To study the impact of the reduction in cross border funding on economic activity, a panel VAR was estimated using quarterly data from 2001q1 to 2012q2 for 12 CESEE economies. The VAR includes three endogenous variables: the real GDP growth, the real growth of banks' credit to the private sector, and the real change in banks' liabilities to non-residents (yoy). The results confirm that there is a positive and significant link between cross-border financial flows and economic growth and that the causality runs both ways. In particular:

- A positive shock of one standard deviation (17 percent, yoy) to the banks' external liabilities leads to an increase of 3.3 percent in real credit growth and 0.6 percentage point in real GDP growth (after four quarters, yoy basis) (Figure 2).

- A positive shock of one standard deviation (2.5 percent, yoy) to real GDP growth leads, on average, to a real growth in banks' external liabilities of about 4.7 percent (after four quarters, yoy basis) (Figure 3).

Figure 2. Response of Real GDP Growth to a Shock in Banks' Liabilities to Non-Residents

Sources: IMF Staff's estimates.

Figure 3. Response of Banks' Liabilities to Non-Residents to a Shock in Real GDP Growth
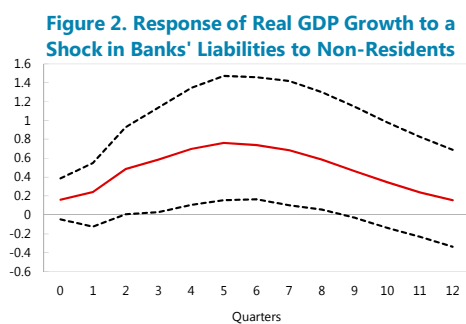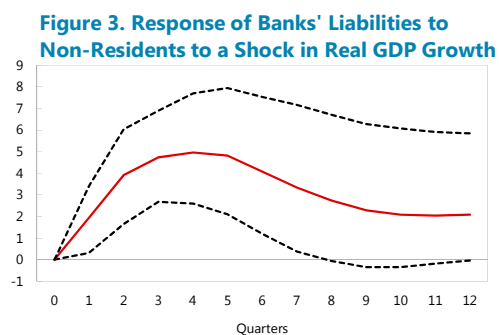
Sources: IMF Staff's estimates.

Implications for Hungary: The sharp decline in banks' external funding observed in Q2:2012 (12 percent) is likely to induce further credit contraction and subdued GDP growth in the year ahead. Other things being equal, the estimation suggests that it could contribute to the contraction of lending to the private sector (of about 2.3 percent in the real terms), and to shave about 0.4 percentage points off real GDP growth in the next four quarters. This magnitude is about twice the size of the impact that would have been if external deleveraging in Hungary was in line with the median size of deleveraging among CESEE economies.

[1] Bulgaria, Croatia, Czech Rep., Hungary, Latvia, Lithuania, Poland, Romania, Russia, Serbia, Turkey, and Ukraine.
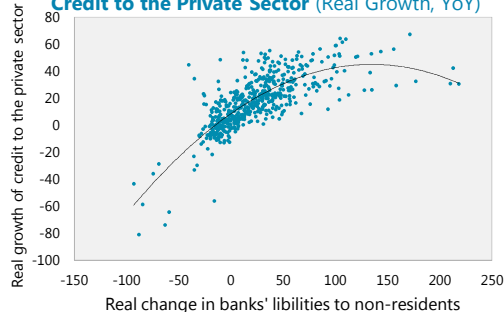
Box 5. Sectoral Balance Sheets—FX Exposure

The currency exposure of the economy has diminished recently. This reflects the ongoing balance sheet adjustment in the economy as well as the small exchange rate appreciation in 2012. However, at close to 130 percent of GDP, Hungary's external debt remains among the highest in the region.

- **Government**. Foreign currency denominated public debt stands at 34 percent of GDP about (40 percent of total public debt). Its decline in 2012 reflects a small currency appreciation and the lack of external placements since 2011. However, non-resident holdings of HUF government bonds have increased considerably to 45 percent of the stock (18 percent of GDP).

- **Banks**. The banks' open FX position has declined from a peak of over 15 percent of GDP in 2011 to 8 percent in 2012. This reflects a very large contraction in FX assets (including due to the early mortgage repayment and the ban on new FX household loans), partly offset by the sharp reduction in cross border funding.

- **Non-financial enterprises.** The stock of FX debt has moderated since 2009, due to the repayment of maturing loans and the weak issuance of new loans.

- **Households**. The stock of FX debt, consisting mostly of mortgages, has declined considerably since its peak in 2010 but still represents close to 25 percent of GDP. To a large extent, the decline reflects the impact of the early repayment schemes launched in recent years.

Government Debt

Legend:
- Forint debt (% of GDP)
- FX debt (% of GDP)
- FX/Total debt (Percent, right axis)

FX Exposure of the Banking System (Percent of GDP)

Legend:
- On-balance FX position adjusted with non-residents' net FX swaps
- On-balance FX position
- Total open FX position
- Non-residents' net FX swaps

Debt of Non-Financial Enterprises (Percent of GDP)

Legend:
- Loans from abroad
- Domestic loans
- FX loans (right axis)

Household Debt

Legend:
- HUF denominated loans (% of GDP)
- FX loans (% of GDP)
- FX loans to total loans (percent, right axis)

Source: MNB.

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Box 6. Fiscal Policy During 2010–13

Several fiscal policy measures have been adopted since 2010. The analysis below focuses on structural changes by excluding the largest transitory factors, such as the nationalization of the pension system, EU transfers, and the payment of overdue VAT refunds. The main conclusions are the following:

- The large fiscal adjustment in 2012-13 is to a large extent a reversal of the structural loosening in the previous two years.

- The adjustment between 2011 and 2013 reflects higher revenue collections. Specifically, revenue in 2013 is expected to be 2½ percent of GDP higher than in 2011, most of which is due to higher taxes. By contrast, primary spending has been broadly flat as savings associated with the implementation of the Szell-Kalman plan have been largely offset by other discretionary increases.

- The structure of the tax system has changed significantly compared to 2010. The current system involves a shift away from direct taxes towards consumption taxes and special levies. This is mainly the result of the introduction of the flat PIT and a lower corporate tax (CIT) rate combined with higher VAT and excise tax rates. At the same time, the tax system now relies significantly (2 ½ percent of GDP) on sectoral taxes.

Consolidated General Government Excluding EU Transfers

	2010	2011 1/	2012	2013
In percent of GDP				
Revenue	43.1	41.7	44.3	44.2
Tax revenue	25.6	23.6	25.0	26.2
Expenditure	47.4	46.4	46.8	47.3
Primary expenditure	43.2	42.2	42.6	43.1
Change in the structural primary balance	-2.6	-0.1	3.0	0.2
In percent of potential GDP				
Revenue	42.2	41.6	43.5	43.2
Tax revenue	25.1	23.5	24.5	25.6
Expenditure	46.5	46.9	45.9	46.3
Primary expenditure	42.4	42.7	41.8	42.2

Source: Hungarian authorities and IMF staff estimates.

1/ 2011 figures exclude revenue related to the asset transfer from the pension funds (9.6 percent of GDP) and expenditure corresponding to overdue VAT refunds (0.7 percent of GDP).

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Box 7. Tackling VAT Fraud

The level of VAT fraud in Hungary is high. The authorities' conservative estimates place it at 1¾ percent of GDP. The problem in the agricultural and food sectors is particularly pervasive, with losses of ½ a percent of GDP in the food sector alone, according to private sector organizations), but other sectors (e.g. construction) are affected too. VAT frauds amount to 20 percent of all the tax violations detected by the National Tax and Customs Administration in 2011.

Beyond the fiscal implications, VAT fraud results in an unfair playing field for companies and might be detrimental to employment and investment. The main types of VAT-related fraud are fictitious invoicing and missing trader or carousel fraud. The profits made by fraudulent companies in the VAT "chain" enable them to sell products at a reduced price to retailers who, in turn, are able to sell products at a reduced price to consumers. This generates unfair competition and pushes down the profit margin of "lawful" companies, some of which may have difficulties to survive in these market conditions.

A comprehensive approach is needed to tackle VAT fraud, notably carousel fraud. The authorities have introduced, among other measures, reverse VAT charging for certain products, but this is only a stop-gap measure. A comprehensive plan with measures to prevent, detect and disrupt the fraud can help with VAT administration. Specific goals should be to: (i) stop the fraud before it begins by identifying "fraudulent" companies at the registration stage; (ii) enhance risk management of the verification of VAT returns and proactively target audits to missing trader fraud-related cases; and (iii) make greater use of the anti-money laundering (AML) framework to tackle missing trader fraud.

Figure 1. Hungary and Peers

High external debt...

External Debt
(Percent of GDP)

■ 2012   ◆ 2008

[Bar chart showing external debt as percent of GDP for: Russia, Turkey, Czech Republic, BiH, Macedonia, Slovak Republic, Romania, Moldova, Ukraine, Poland, Lithuania, Slovenia, Serbia, Bulgaria, Estonia, Croatia, Montenegro, Hungary, Latvia]

...and high public debt are major sources of vulnerability.

Public Debt
(Percent of GDP)

■ 2012   ◆ 2008

[Bar chart showing public debt as percent of GDP for: Estonia, Russia, Bulgaria, Moldova, Macedonia, Romania, Ukraine, Latvia, Turkey, Lithuania, Czech Republic, BiH, Slovak Republic, Slovenia, Montenegro, Croatia, Poland, Serbia, Hungary]

The share of FX loans in banks' portfolio remains elevated.

Foreign Currency Loans as a Share of Private Sector Credit

[Bar chart showing FX loans as share of private sector credit for: Slovak Republic, Czech Republic, Russia, Turkey, Poland, Belarus, Ukraine, Moldova, Macedonia, FYR, Hungary, Albania, Bulgaria, Romania, Lithuania, Serbia, Croatia, Latvia]

Economic recovery is modest compared to regional peers.

Real GDP Growth
(2008Q1=100)

[Line chart showing Real GDP Growth from 2008Q1 to 2012Q1 for: Hungary, Poland, Czech Rep., Slovak Rep.]

Low labor participation rate...

Level of Participation, 2010
(Percent)

[Bar chart showing participation levels for: Moldova, BiH, Turkey, Hungary, Croatia, Bulgaria, Macedonia, Poland, Romania, Lithuania, Czech Rep., Serbia, Slovenia, Ukraine, Slovak Rep., Latvia, Estonia, Russia]

...and low level of investment undermine potential growth.

Investment

[Scatter plot: 2007-12 change, in percent of GDP (y-axis) vs Percent of GDP, 2012 (x-axis), showing: Russia, Poland, Turkey, Slovak Rep., Czech Rep., Serbia, Romania, Hungary, Bosnia and Herzegovina, Bulgaria, Croatia, Ukraine, Latvia, Slovenia, Lithuania, Moldova, Estonia, Montenegro]

Source: Hungarian Statistical Office, MNB, World Bank, and IMF staff estimates.

Figure 2. Hungary: Real Sector

Hungary slid back into recession in 2012.

Contributions to Growth
(Percent)

- Net Exports
- Investment
- Private Consumption
- Government Consumption
- Real GDP

Industrial production and retail sales are weak.

Retail Sales and Industrial Production
(Year-on-Year Percentage Change)

- Retail Sales
- Industrial Production

Market confidence is still low.

Consumer and Business Confidence
(Index)

- Business Confidence
- Consumer Confidence

Net capital accumulation reached negative territory...

Capital Formation
(Percent of GDP)

- Gross fixed capital formation
- Consumption of fixed capital

...and the labor market remains weak...

Employment
(Percent)

- Unemployment Rate
- Employment Rate (RHS)

...undermining the prospects for recovery.

Real GDP Growth and Potential Output Growth
(Percent)

- Potential Output
- Real GDP

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

Figure 3. Hungary: Banking Sector Developments

External deleveraging is among the highest in CESEE...

Cumulative Change in Banks' External Liabilities to Non-Residents, 2010Q1-2012Q2

Percent of 2012 GDP / Billion USD

Legend: Percent of 2012 GDP / Bln USD

Countries: Lithuania, Hungary, BiH, Bulgaria, Latvia, Serbia, Ukraine, Romania, Slovenia, Slovak Rep., Croatia, Poland, Czech Rep., Macedonia, Russia, Turkey

..and is accompanied by a rapid adjustment in banks' balance sheets.

Change in Banks' Balance Sheet and Loan-to-Deposit Ratio

- Change in external liabilities (percent of GDP)
- Change in deposits (percent of GDP)
- Loan-to-deposit ratio (RHS)

2010Q1, 2010Q3, 2011Q1, 2011Q3, 2012Q1, 2012Q3

Banks' profits turn negative...

Return to Equity

- Hungary
- Bulgaria
- Croatia
- Poland
- Czech Republic
- Romania

2001 2002 2003 2004 2005 2006 2007 2008 2009 2010 2011

...but capital and liquidity levels remains comfortable.

CAR and Asset Liquidity, 2012Q2

- CAR
- Asset liquidity ratio (RHS)

Countries: Slovenia, Poland, Russia, Romania, Lithuania, Hungary, Slovak Rep., Czech Rep., Turkey, BiH, Latvia*, Macedonia, Ukraine, Estonia*, Croatia

*2012q1.

Although declining, currency mismatches and the heavy reliance on FX swaps pose vulnerabilities...

Banks Open FX Position and FX Swaps

Forint Bln / EUR Bln

- On-balance sheet FX position
- Net FX swap stock (RHS)

Dec-09, Mar, Jun, Sep, Dec-10, Mar, Jun, Sep, Dec-11, Mar, Jun

Non-performing loans ratio is high but provisioning is relatively low.

NPLs ratio (per cent) vs Provisioning of NPLs (per cent)

Serbia (1), Lithuania (3), Hungary (3), Bulgaria (1), Romania (2), Croatia (3), Slovenia (2), Ukraine (3), BiH (3), Latvia (2), Macedonia (2), Slovakia (2), Czech Rep. (2), Poland (1), Estonia (2)

Numbers in brackets denote the reference periods of NPLs:
(1)=2011 Q4, (2)=2012 Q1, (3)=2012 Q2. Data on loan loss coverage refer to 2012 Q2 in the case of Hungary and the latest data for 2011-12 in the case of other countries, based on the EBCI Report.

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

Figure 4. Hungary: Fiscal Sector

Hungary's fiscal balance has improved recently...

Fiscal Balance 1/
(Percent of GDP)

- Overall Balance
- Primary Balance
- Cyclically Adjusted Balance

...but debt remains high.

Gross Debt and Interest Expenditure
(Percent of GDP)

- Gross debt
- Interest Expenditure (RHS)

The adjustment relies mostly on revenue measures, including significant ad-hoc taxes...

"Sectoral" Taxes in 2013 (Percent of GDP)

- Banks transactions tax
- Telecom tax
- Tax on wires and pipelines (for utility providers)
- Tax on energy suppliers
- Tax on insurance companies
- Levy on banks
- Payments by pharmaceutical companies
- Tax on gambling
- Energy tax

Total: 2.5% of GDP

...while public spending is still high compared to peers.

General Government Total Expenditure, 2012
(Percent of GDP)

Macedonia, FYR; Romania; Slovak Republic; Turkey; Russia; Lithuania; Latvia; Croatia; Poland; Estonia; Czech Republic; Slovenia; Ukraine; Hungary; BiH

Financing costs declined in 2012...

Bond Yields and Sovereign CDS Spread

- 5 yr T-Bond
- CDS (RHS)

1/1/2010 1/1/2011 1/1/2012 1/1/2013

...but financing needs remain large.

Gross Financing Needs
(Percent of GDP)

2012 2013 2014

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

Figure 5. Hungary: Inflation and Monetary Policy

Headline and core inflation are elevated due to cost-push factors, including tax increases...

Headline and Core Inflation

Headline inflation has been high from a regional perspective.

Headline Inflation in CESEE

Second round effects are a risk...

Nominal Wage Growth and Inflation Expectations

...despite a sizable output gap.

Output Gap and Capacity Utilization Gap

The recent policy rate cuts were facilitated by the decline in risk premia.

Policy Rate and 5-Year CDS

Credit growth remains significantly below that in regional peers.

Credit to the Private Sector

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

Table 1. Hungary: Selected Economic Indicators, 2008–14

	2008	2009	2010	2011	2012	2013	2014
					Est.	Proj.	Proj.
	(Percentage change, unless otherwise noted)						
Real economy							
Real GDP (percentage change)	0.9	-6.8	1.3	1.6	-1.7	0.0	1.2
Total domestic demand (contribution to growth) 1/	0.7	-10.4	-0.4	0.1	-3.0	-1.0	0.4
Private consumption 2/	-0.2	-5.6	-3.3	0.4	-2.9	-0.9	0.5
Government consumption	-0.2	2.6	3.8	-0.3	-2.0	-0.7	0.5
Gross fixed investment	2.9	-11.1	-9.5	-3.6	-5.5	-2.5	0.5
Foreign balance (contribution to growth)	0.2	3.6	1.8	1.5	1.4	1.0	0.7
Exports	5.7	-10.2	14.2	6.3	1.7	2.9	3.5
Imports	5.5	-14.8	12.7	5.0	0.2	2.0	3.0
	(Percent)						
CPI inflation (average)	6.1	4.2	4.9	3.9	5.7	3.2	3.5
CPI inflation (end year)	3.5	5.6	4.7	4.1	5.0	4.0	3.3
Unemployment rate (average)	7.9	10.1	11.2	11.0	11.0	11.1	10.9
	(Percent of GDP)						
Gross domestic investment (percent of GDP) 3/	21.7	20.7	18.3	17.9	17.1	16.5	16.3
Gross national saving (percent of GDP, from BOP)	14.4	20.5	19.4	18.8	18.8	18.6	18.1
General government (GFSM 2001 basis) 4/							
Overall balance	-3.7	-4.5	-4.5	4.3	-2.5	-3.2	-3.4
Primary balance	0.0	-0.2	-0.6	7.9	1.5	0.9	0.5
Primary structural balance, in percent of potential GDP	-1.4	1.3	-1.2	-1.3	1.7	1.9	1.2
Gross debt	73.0	79.8	81.8	81.4	79.0	79.9	80.3
	(Percentage change)						
Money and credit (end-of-period)							
Broad money	7.7	4.4	3.0	5.9	-8.8	7.2	6.0
Lending to the private sector, flow-based	12.2	-2.3	-2.4	-6.9	-7.4	-3.0	3.0
	(Percent)						
Interest rates							
T-bill (90-day, average)	8.9	8.2	5.4	6.0	6.9	...	...
Government bond yield (5-year, average)	9.4	7.6	7.9	8.9	7.8	...	...
5-year sovereign CDS (average in bps; for 2013, as of as of January 29)	196	335	282	379	450	276	
	(Percent of GDP, unless otherwise noted)						
Balance of payments							
Goods and services trade balance	0.3	4.7	6.4	6.6	7.8	8.2	8.1
Current account	-7.3	-0.2	1.1	0.9	1.7	2.1	1.8
Reserves (in billions of euros)	24.0	30.7	33.7	37.8	33.9	33.9	35.0
Gross external debt 5/	116.9	150.1	143.1	132.1	126.4	121.0	112.6
Gross official reserves (percent of short-term debt at remaining maturity)	71.3	83.6	75.0	88.2	90.7	86.8	105.8
Exchange rate							
Exchange regime				Floating			
Present rate (January 29, 2013)				Ft. 297 = €1; Ft. 238 = CHF1			
Nominal effective rate (2000=100, average)	93.3	102.6	102.7	104.2	...	...	
Real effective rate, CPI basis (2000=100, average)	70.4	74.8	72.4	72.6	...	...	
Quota at the Fund				SDR 1,038.4 million			
Memorandum Items							
Nominal GDP (billions of forints)	26,543	25,626	26,607	27,886	28,549	29,228	30,402

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

1/ Includes change in inventories.

2/ Actual final consumption of households.

3/ Excludes change in inventories.

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

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

Table 2. Hungary: Medium-Term Scenario, 2008–18

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
								Projections			
(In percent, unless otherwise indicated)											
Real GDP growth	0.9	-6.8	1.3	1.6	-1.7	0.0	1.2	1.5	1.6	1.6	1.6
Nominal GDP, forint billions	26,543	25,626	26,607	27,886	28,549	29,228	30,402	31,669	33,042	34,516	36,049
Inflation (CPI; year average basis)	6.1	4.2	4.9	3.9	5.7	3.2	3.5	3.0	3.0	3.0	3.0
Inflation (CPI; end-year basis)	3.5	5.6	4.7	4.1	5.0	4.0	3.3	3.0	3.0	3.0	3.0
(Annual percentage change, constant prices)											
Domestic demand	0.7	-10.5	-0.5	0.1	-3.4	-1.2	0.5	2.1	2.0	2.3	2.3
Total consumption	-0.2	-4.5	-2.3	0.3	-2.8	-0.8	0.5	1.7	1.9	1.9	1.9
Gross fixed capital formation	2.9	-11.1	-9.5	-3.6	-5.5	-2.5	0.5	3.0	3.3	3.3	3.2
Exports of GNFS	5.7	-10.2	14.2	6.3	1.7	2.9	3.5	3.9	4.4	4.6	4.7
Imports of GNFS	5.5	-14.8	12.7	5.0	0.2	2.0	3.0	4.6	5.2	5.4	5.5
Lending to the private sector, flow-based (current prices, e.o.p.)	12.2	-2.3	-2.4	-6.9	-7.4	-3.0	3.0	3.0	3.5	4.0	4.0
Unemployment rate (percent of labor force, year average basis)	7.9	10.1	10.5	11.0	11.0	11.1	10.9	10.8	10.6	10.3	10.0
(In percent of GDP, unless otherwise indicated)											
External current account balance	-7.3	-0.2	1.1	0.9	1.7	2.1	1.8	1.1	0.3	-0.6	-1.8
Gross national saving	14.4	20.5	19.4	18.8	18.8	18.6	18.1	17.5	17.0	16.3	15.3
Gross domestic investment 1/	21.7	20.7	18.3	17.9	17.1	16.5	16.3	16.5	16.7	16.9	17.0
Capital account, net	1.0	1.2	1.8	2.4	2.3	3.3	3.1	2.8	2.5	2.2	1.9
Financial account, net	11.1	0.0	1.9	2.2	-2.5	-0.4	-0.9	-2.5	-0.2	-0.2	1.2
Gross external debt 2/	116.9	150.1	143.1	132.1	126.4	121.0	112.6	106.2	100.9	96.1	93.0
General government (GFSM 2001)											
Revenue, total	45.5	46.9	45.4	53.9	46.5	47.4	48.3	48.2	48.2	48.3	48.2
Expenditure, primary	45.1	46.8	45.6	45.4	44.8	46.3	47.6	47.4	47.4	47.4	47.3
Primary balance 3/	0.0	-0.2	-0.6	7.9	1.5	0.9	0.5	0.6	0.7	0.8	0.7
General government overall balance	-3.7	-4.5	-4.5	4.3	-2.5	-3.2	-3.4	-3.3	-3.2	-3.1	-3.0
Interest expenditure	4.1	4.6	4.2	4.2	4.2	4.2	4.2	4.1	4.1	4.1	3.9
General government debt	73.0	79.8	81.8	81.4	79.0	79.9	80.3	80.3	80.2	79.8	79.2
Memorandum items											
Output gap	3.7	-3.2	-2.0	-0.3	-2.2	-2.4	-1.7	-1.1	-0.6	-0.2	-0.1
Potential GDP growth	0.4	-0.1	0.0	0.0	0.2	0.2	0.5	0.9	1.1	1.3	1.5
Structural general government balance (in percent of potential GDP)	-5.2	-2.8	-4.9	-4.9	-2.2	-2.1	-2.6	-2.8	-3.1	-3.1	-3.0
Structural primary balance (in percent of potential GDP)	-1.4	1.3	-1.2	-1.3	1.7	1.9	1.2	1.1	0.8	0.8	0.7
Gross official reserves (in percent of short-term debt at remaining maturity)	71.3	83.6	75.0	88.2	90.7	86.8	105.8	102.2	106.9	107.9	108.7

Sources: Hungarian authorities; and IMF staff estimates.

1/ Excludes change in inventories.
2/ Excluding Special Purpose Entities. Including inter-company loans, and nonresident holdings of forint-denominated assets.
3/ Includes interest revenue.

Table 3. Hungary: Consolidated General Government, 2008-14 1/

(In percent of GDP, unless otherwise indicated)

	2008	2009	2010	2011	Est. 2012	Proj. 2013	2014
Revenue	45.5	46.9	45.4	53.9	46.5	47.4	48.3
Tax revenue	26.3	26.6	25.6	23.6	25.0	26.2	26.1
Taxes on goods and services	15.6	16.6	17.0	16.7	17.6	18.4	18.2
VAT	7.6	8.4	8.6	8.4	9.1	9.3	9.3
Excises and other 2/ 3/	8.0	8.2	8.4	8.3	8.6	9.1	8.9
Taxes on income, profits and capital gains	10.6	10.0	8.6	6.9	7.4	7.8	7.9
Personal income tax	7.7	7.4	6.5	4.9	5.3	5.1	5.2
Corporate taxes	2.6	2.3	1.2	1.3	1.3	1.7	1.7
Capital taxes 3/	0.1	0.1	0.5	0.5	0.5	0.5	0.5
Other 2/	0.3	0.3	0.3	0.2	0.3	0.5	0.5
Social contributions	13.8	13.3	12.2	13.2	13.7	13.4	14.1
Current non-tax revenue	4.1	4.3	4.0	3.7	3.9	3.7	4.1
o.w. interest revenue	0.4	0.3	0.3	0.5	0.2	0.2	0.2
Current grants	0.8	1.3	1.5	1.3	1.4	1.4	1.4
Capital revenues and grants 4/	0.6	1.4	2.1	12.0	2.4	2.6	2.6
Expenditure 5/	49.2	51.4	49.8	49.6	48.9	50.5	51.7
Compensation of employees 6/	11.6	11.5	11.0	10.2	10.4	10.4	11.4
Goods and services	7.2	7.8	7.8	7.4	7.1	7.5	7.6
Interest	4.1	4.6	4.2	4.2	4.2	4.2	4.2
Subsidies	1.1	1.0	1.1	1.2	1.2	1.3	1.3
Current transfers to households	18.7	19.4	18.6	18.0	17.7	17.8	17.8
Social security	14.3	14.8	14.4	14.4	13.8	13.6	13.6
o.w. unemployment benefits	0.4	0.6	0.6	0.7	0.4	0.4	0.4
Other	4.4	4.6	4.2	3.6	3.9	4.2	4.2
Other current transfers 7/	2.3	2.6	2.4	2.6	2.9	3.4	3.3
Capital expenditures	2.7	3.1	3.4	3.0	4.0	4.6	4.5
Capital transfers 8/	1.4	1.3	1.2	2.8	1.5	1.3	1.5
Other	0.0	0.0	0.1	0.1	0.0	0.0	0.0
General government balance	-3.7	-4.5	-4.5	4.3	-2.5	-3.2	-3.4
Primary balance	0.0	-0.2	-0.6	7.9	1.5	0.9	0.5
Memorandum items:							
Convergence program overall balance	..	..	..	2.0	-2.7	-2.7	-2.2
Gap to convergence program	..	..	..	-2.3	-0.2	0.5	1.2
Transfer of pension assets to the state system	0.0	0.1	0.2	9.6	0.0	0.0	0.0
General government balance excl. pension assets	-3.7	-4.6	-4.6	-5.4	-2.5	-3.2	-3.4
Cyclically-adj. balance (% of potential GDP)	-5.5	-2.9	-3.3	4.4	-1.6	-2.1	-2.6
Annual change	1.3	2.6	-0.5	7.7	-5.9	-0.5	-0.6
One-off items (net)	-0.3	0.0	1.6	9.3	0.7	0.0	0.0
Structural balance (% of potential GDP)	-5.2	-2.8	-4.9	-4.9	-2.2	-2.1	-2.6
Annual change	0.5	2.4	-2.1	0.0	2.7	0.1	-0.6
Structural primary balance (% of potential GDP)	-1.4	1.3	-1.2	-1.3	1.7	1.9	1.2
Annual change	0.4	2.7	-2.5	-0.1	3.0	0.1	-0.6
Cyclically-adj. balance	-5.3	-3.0	-3.4	4.4	-1.6	-2.1	-2.7
Annual change	1.2	2.3	-0.4	7.8	-6.0	-0.5	-0.6
Output gap	3.7	-3.2	-2.0	-0.3	-1.9	-2.1	-1.5
Gross public debt	73.0	79.8	81.8	81.4	79.0	79.9	80.3
In billions of HUF							
Revenue	12,090	12,018	12,068	15,022	13,264	13,841	14,685
Of which tax revenues	6,972	6,821	6,804	6,586	7,143	7,653	7,931
Expenditure	13,070	13,179	13,253	13,835	13,970	14,763	15,721
Transfer of pension assets	0	26	65	2,688	0	0	0
Primary balance	7	-56	-124	2,214	439	256	164
Overall balance	-980	-1,161	-1,185	1,187	-707	-922	-1,036
GDP	26,543	25,626	26,607	27,886	28,549	29,228	30,403

Sources: Hungarian authorities; and Fund staff estimates.

1/ Data are classified following the ESA'95 methodology.
2/ Includes sectoral levies. Also, starting 2013 includes revenues from the financial transaction levy.
3/ Includes the levy on financial institutions.
4/ In 2011 and 2012 includes 9.6 and 0.2 percent of GDP, respectively, from the transfer of pension assets to the state system.
5/ For 2014, all non-interest expenditure categories are projected according to the nominal GDP growth rate.
6/ Includes social security contributions.
7/ Different from 2011 Article IV Report assumption, Staff now assumes that the extraordinary reserves, included under this spending category, will not be spent, to reach the deficit targets.
8/ In 2011 includes debt takeover of the transport sector company MAV (0.2 percent of GDP) and the capitalization of the National Development Bank (0.1 percent of GDP).

Table 4. Hungary: Central Government Financing, 2010-14 1/					
(In percent of GDP)					
	2010	2011	2012	2013	2014
Gross financing needs	**16.7**	**19.4**	**16.6**	**20.8**	**20.1**
Central government cash deficit	3.3	1.7	2.3	2.9	3.2
Repayments	13.4	15.5	14.2	17.9	16.9
Domestic	12.0	11.1	8.9	12.8	11.3
Loans	0.0	0.2	0.1	0.1	0.3
LT bonds	5.8	5.4	3.4	6.2	4.6
T bills	6.2	5.4	5.4	6.5	6.4
External	1.3	4.5	5.3	5.1	5.6
Bonds	1.2	2.0	1.5	1.5	2.6
Loans	0.1	2.5	3.8	3.7	3.0
Of which : IMF	0.0	0.0	3.8	3.7	0.6
Gross financing sources	**16.7**	**19.4**	**16.6**	**20.8**	**20.1**
Domestic	15.1	13.5	15.8	15.5	13.6
Loans	0.3	0.0	0.0	0.0	0.0
LT bonds	8.7	7.5	9.2	8.9	7.0
T bills	6.1	6.0	6.6	6.6	6.5
External	1.7	4.6	0.7	5.3	6.6
Bonds	1.5	3.8	0.0	4.9	5.6
Loans	0.2	0.8	0.7	0.4	1.0
Deposit drawdown	-0.1	1.4	0.0	0.0	0.0
Memo items:					
Central Government deposits	4.0	5.0	...	...	...
Gross financing needs excl. short term debt	10.5	14.0	11.2	14.3	13.8
Gross financing requirements, in bn Euros	16.1	19.4	16.3	20.8	21.2
o/w short term amortization	6.0	5.4	5.3	6.5	6.7
Source: Hungarian authorities and Fund staff estimates.					
1/ Cash deficit as reported by the authorities is adjusted for the below-the-line transactions. For 2011, gross financing needs also include the purchase of MOL company shares and the recapitalization of the MFB bank.					

Table 5a. Hungary: General Government Operations (GFSM presentation), 2008-14 1/						
(In percent of GDP)						
					Est.	Projection	
	2008	2009	2010	2011	2012	2013	2014
Revenue	45.5	46.9	45.4	53.9	46.5	47.4	48.3
Taxes	26.3	26.6	25.6	23.6	25.0	26.2	26.1
Taxes on goods and services	15.6	16.6	17.0	16.7	17.6	18.4	18.2
VAT	7.6	8.4	8.6	8.4	9.1	9.3	9.3
Excises and other	8.0	8.2	8.4	8.3	8.6	9.1	8.9
Taxes on income, profits and capital gains	10.6	9.9	8.0	6.4	6.9	7.3	7.4
Personal income tax	7.7	7.4	6.5	4.9	5.3	5.1	5.2
Corporate income tax	2.6	2.3	1.2	1.3	1.3	1.7	1.7
Other	0.3	0.3	0.3	0.2	0.3	0.5	0.5
Capital taxes	0.1	0.1	0.5	0.5	0.5	0.5	0.5
Social contributions	13.8	13.3	12.2	13.2	13.7	13.4	14.1
Grants and other revenues	5.4	7.0	7.6	17.0	7.7	7.8	8.1
Current non-tax revenue	4.1	4.3	4.0	3.7	3.9	3.7	4.1
o.w. interest revenue	0.4	0.3	0.3	0.5	0.2	0.2	0.2
o.w. dividends	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Current transfers 2/	0.8	1.3	1.5	1.3	1.4	1.4	1.4
Capital transfers 2/	0.6	1.4	2.1	12.0	2.4	2.6	2.6
o.w. transfer of pension assets	0.0	0.1	0.2	9.6	0.0	0.0	0.0
Expenditure	49.2	51.4	49.8	49.6	48.9	50.5	51.7
Expense	49.7	51.7	49.8	49.8	48.3	49.2	50.5
Compensation of employees	11.6	11.5	11.0	10.2	10.4	10.4	11.4
Goods and services	7.2	7.8	7.8	7.4	7.1	7.5	7.6
Consumption of fixed capital	3.2	3.4	3.4	3.3	3.3	3.3	3.3
Interest	4.1	4.6	4.2	4.2	4.2	4.2	4.2
Subsidies	1.1	1.0	1.1	1.2	1.2	1.3	1.3
Social benefits	18.6	19.4	18.6	18.0	17.7	17.8	17.8
o.w. social security	14.3	14.8	14.4	14.4	13.8	13.6	13.6
Other expense	3.8	3.9	3.8	5.5	4.4	4.7	4.8
Net acquisition of nonfinancial assets	-0.5	-0.3	-0.1	-0.2	0.6	1.3	1.2
Gross fixed capital formation 3/	2.7	3.1	3.4	3.0	4.0	4.6	4.5
Consumption of fixed capital	3.2	3.4	3.4	3.3	3.3	3.3	3.3
Gross operating balance 4/	-1.0	-1.4	-1.0	7.3	1.5	1.4	1.1
Net operating balance	-4.2	-4.8	-4.4	4.0	-1.8	-1.9	-2.2
Net lending (+) / borrowing (-)	-3.7	-4.5	-4.5	4.3	-2.5	-3.2	-3.4
Net acquisition of financial assets	5.0	-0.5	-1.8	4.1	0.0	0.0	0.0
Currency and deposits	6.0	-2.7	-0.8	0.5	0.0	0.0	0.0
Securities other than shares	0.0	0.0	0.0	0.2	0.0	0.0	0.0
Loans	-0.4	2.1	-0.7	-0.6	0.1	0.1	0.1
Shares and other equity	-0.6	0.1	0.0	4.4	0.0	0.0	0.0
Insurance technical reserves	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financial derivatives	0.0	-0.5	-0.3	-0.3	0.0	0.0	0.0
Other accounts receivable	0.1	0.5	0.0	-0.1	-0.1	-0.1	-0.1
Monetary gold and SDRs	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net incurrence of liabilities	8.6	4.0	2.9	-0.1	2.5	3.2	3.4
Currency and deposits	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Securities other than shares	1.9	-3.1	1.8	-0.9	5.7	6.4	5.8
Loans	7.0	7.3	1.5	-0.7	-3.0	-3.1	-2.0
Shares and other equity	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Insurance technical reserves	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financial derivatives	-0.1	-1.1	-0.1	-0.1	0.0	0.0	0.0
Other accounts payable	-0.2	0.9	-0.3	1.6	-0.3	-0.1	-0.3
Statistical discrepancy	0.0	0.0	0.3	0.1	0.0	0.0	0.0
Memo:							
Nominal GDP, HUF bn.	26,543	25,626	26,607	27,886	28,549	29,228	30,403

Sources: Hungarian authorities and IMF staff estimates.
1/ Subcategories within tax revenues follow the ESA95 presentation.
2/ The distinction between grants and other transfers is not available in the ESA95 main tables which are the source of data for this table.
3/ Includes net acquisition of nonproduced nonfinancial assets.
4/ Excludes fixed capital consumption.

Table 5b. Hungary: General Government Stock Positions, 2008-14 1/						
(In percent of GDP)						
					Est.	Projections
	2008	2009	2010	2011	2012	2013	2014
Net Financial Worth	-51.7	-59.7	-61.5	-52.7	-52.0	-53.5	-54.6
Financial Assets	25.4	27.0	26.0	33.5	32.7	31.9	30.7
Currency and deposits	8.9	6.8	6.1	6.8	6.7	6.5	6.3
Securities other than shares	0.0	0.0	0.0	0.2	0.2	0.2	0.2
Loans	0.6	2.5	1.7	1.2	1.2	1.3	1.4
Shares and other equity	11.0	11.9	11.8	18.1	17.7	17.3	16.6
Insurance technical reserves	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financial derivatives	0.3	0.4	1.0	2.2	2.1	2.1	2.0
Other accounts receivable	4.6	5.4	5.2	5.0	4.7	4.5	4.2
Monetary gold and SDRs	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Liabilities	77.1	86.7	87.5	86.2	84.7	85.4	85.3
Currency and deposits	0.0	0.1	0.1	0.1	0.1	0.1	0.1
Securities other than shares	58.2	59.1	58.9	55.5	59.2	64.3	67.3
Loans	13.3	20.8	22.6	23.3	18.5	14.4	11.8
Shares and other equity	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Insurance technical reserves	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financial derivatives	0.7	0.8	0.6	0.5	0.5	0.5	0.5
Other accounts payable	4.8	6.0	5.4	6.8	6.3	6.1	5.6
Gross debt at market value	76.3	85.8	86.8	..	..	..	..
Gross debt at face value	77.8	85.8	87.3	88.1	85.3	86.0	85.9
Maastricht Debt	73.0	79.8	81.8	81.4	79.0	79.9	80.3
Memo Items:							
Foreign currency debt	29.2	37.0	38.5	42.2	34.3	33.4	33.1
Other economic flows	2.5	-1.7	0.6	1.8	1.9	0.5	0.3
Sources: Hungarian authorities and IMF staff estimates.							
1/ GFSM 2001 presentation.							

Table 6. Hungary: Balance Sheet of the Central Bank, 2007-2013 (In billions of forints)							
	2007	2008	2009	2010	2011	2012	2013
						Proj.	Proj.
Net foreign assets	3,941	5,988	7,261	7,449	9,709	8,490	8,341
Foreign Assets	4,359	6,584	8,484	9,598	11,969	9,470	9,556
Foreign Liabilities	418	596	1,223	2,149	2,260	980	1,216
Net domestic assets	-890	-2,340	-4,460	-4,244	-5,836	-5,314	-5,038
Net claims on government	-108	-1,286	-709	-827	-1,215	-1,043	-1,043
Assets	147	360	279	249	169	140	140
Securities	147	360	279	249	169		
Liabilities (Govt Deposits at MNB)	255	1,646	988	1,077	1,383	1,183	1,183
HUF	197	128	248	273	597	...	...
FX	58	1,518	741	804	786	...	...
Net claims on banks	-706	-910	-3,147	-2,565	-2,923	-2,572	-2,296
Assets	0	177	0	35	119	119	119
Liabilities	706	1,087	3,147	2,600	3,041	2,691	2,415
Two Week Deposit Facility	270	-114	244	120	211	211	0
Securities Issued by MNB	436	1,201	2,903	2,480	2,830	2,480	2,415
Net claims on the economy	-118	-50	-197	-355	-163	-163	-163
Other items, net	42	-95	-406	-496	-1,536	-1,536	-1,536
Base money (M0)	3,051	3,647	2,801	3,206	3,873	3,176	3,303
Currency in Circulation	2,258	2,404	2,268	2,464	2,766	2,268	2,359
Banks' Reserves	793	1,243	533	741	1,106	907	944
Current Account Balances	683	328	339	448	471	386	402
Overnight Deposits	110	915	194	293	635	521	542
Memorandum items:							
International Reserves (billions of euros)	16.4	24.0	30.7	33.7	37.8	33.8	34.1
Base Money (yoy percent change)	11.4	19.5	-23.2	14.4	20.8	-18.0	4.0
NFA (contribution to change)	3.8	67.1	34.9	6.7	70.5	-31.5	-4.7
NDA (contribution to change)	7.7	-47.5	-58.1	7.7	-49.7	13.5	8.7
Government Deposits at Central Bank (percent of GDP)	1.0	6.2	3.9	4.0	5.0	4.1	4.0
HUF	0.8	0.5	1.0	1.0	...	...	...
FX	0.2	5.7	2.9	3.0	...	...	...
Central Bank Bills Outstanding (percent of GDP)	1.7	4.5	11.3	9.3	10.1	8.7	8.4
Portion of CB Bills Owned by Non-Residents (percent)	15.2	7.2	4.0	9.3	...	...	...
Reserve Requirement Ratio (percent of select liabilities)	5.0	2.0	2.0		2% to 5%		

Sources: Magyar Nemzeti Bank and IMF staff calculation.

Table 7. Hungary: Monetary Survey, 2008-14
(In billions of forints)

	2008	2009	2010	2011	2012	2013 Proj.	2014 Proj.
Net foreign assets	-1,486	568	1,244	4,167	5,051	5,744	6,577
Central Bank	5,988	7,261	7,449	9,709	9,031	8,850	9,115
Commercial Banks	-7,474	-6,693	-6,205	-5,541	-3,980	-3,106	-2,538
Net domestic assets	16,779	15,397	15,197	13,250	11,784	11,785	11,934
Domestic credit	21,002	20,303	21,135	20,806	18,608	18,609	18,758
Net claims on government	2,953	3,037	3,461	3,041	3,362	3,687	3,969
From Central Bank	-1,286	-709	-827	-1,215	-1,236	-1,236	-1,236
From Commercial Banks	4,239	3,747	4,288	4,256	4,598	4,923	5,205
Gross Credit to the economy	18,049	17,266	17,674	17,765	15,246	14,922	14,788
From Central Bank	-50	-197	-355	-163	-279	-279	-279
From Comercial Banks	18,099	17,462	18,029	17,927	15,524	15,058	15,058
Other items, net	-4,223	-4,906	-5,938	-7,556	-6,824	-6,824	-6,824
Broad money (M3)	15,292	15,964	16,441	17,418	16,835	17,529	18,510
M2	14,097	14,354	14,351	15,369	15,177	15,803	16,688
M1	6,162	6,122	6,635	7,343	7,289	7,589	8,014
Currency in circulation	2,137	2,039	2,218	2,551	2,553	2,658	2,807
Overnight Deposits	4,025	4,082	4,417	4,791	4,736	4,932	5,208
Deposits with Maturities up to 2 years	7,935	8,233	7,716	8,026	7,888	8,213	8,673
Repos	22	35	34	23	22	23	24
Money Market Fund Shares/Units	858	1,115	1,335	1,320	1,179	1,228	1,297
Debt Securities	316	460	721	706	457	475	502
Memorandum items:							
	(percentage change by contribution, y-o-y)						
Broad Money	7.7	4.4	3.0	5.9	-3.3	4.1	5.6
NFA	-3.8	13.4	4.2	17.8	5.1	4.1	4.8
NDA	11.5	-9.0	-1.3	-11.8	-8.4	0.0	0.8
	(percentage change, y-o-y)						
Credit to Private Sector 1/ 2/	12.2	-2.3	-2.4	-6.9	-7.4	-3.0	0.0
HUF	-3.1	0.4	5.2	3.5	5.7	...	...
FX	25.6	-4.0	-7.1	-13.0	-15.4	...	...
Bank Deposits (% yoy)	9.8	2.1	0.0	6.2	0.1	1.8	3.2
Bank Holdings of Government Paper	14.9	15.3	15.5	13.9	14.4	15.2	15.5

Sources: MNB and IMF staff estimates.
1/ Adjusted for changes in exchange rate
2/ Only credit to households and firms

| Table 8. Hungary: Financial Soundness Indicators for the Banking Sector, 2008-12 | | | | | |
| (In percent unless otherwise indicated, end of period) | | | | | |
	2008	2009	2010	2011	June 2012
Capital					
Regulatory capital to risk-weighted assets	12.3	13.9	13.9	14.2	15.1
Regulatory Tier1 capital to risk-weighted assets	10.3	11.7	11.4	11.7	12.5
Asset Quality					
NPLs net of provisions to capital	15.6	33.0	49.3	59.0	58.3
NPLs to gross loans	3.0	6.7	9.8	13.4	15.8
Distribution of Loans (Percent of Total)					
Firms	36.0	35.9	34.6	34.6	35.7
Households and Non-Profits	36.7	37.7	40.4	39.8	38.9
Non-Residents	11.6	11.8	10.3	9.8	8.9
Other	15.7	14.7	14.8	15.8	16.5
Profitability					
ROA	1.2	0.6	0.0	-0.4	0.3
ROE	16.4	8.3	0.4	-4.0	3.1
Net interest income to gross income	65.4	66.8	71.6	69.1	73.4
Noninterest expenses to gross income	59.3	48.9	48.5	47.4	50.6
Liquidity					
Liquid assets to total assets	23.2	31.3	27.7	29.4	33.1
Liquid assets to short term liabilities	45.4	60.3	53.2	54.3	60.9
Sensitivity to Market risk					
Net open FX position to Regulatory capital	15.3	17.8	15.9	23.9	20.7

Source: MNB.

Table 9. Hungary: Balance of Payments, 2008—18										
(in millions of euros)										
	2008	2009	2010	2011	2012 Est.	2013 Proj.	2014 Proj.	2015 Proj.	2016 Proj.	2017 Proj.	2018 Proj.
Current Account	**-7,752**	**-202**	**1,033**	**910**	**1,680**	**2,149**	**1,864**	**1,203**	**403**	**-711**	**-2,266**
Goods and service, net	309	4,328	6,147	6,585	7,660	8,175	8,572	8,273	7,939	7,328	6,298
Exports	85,915	70,667	83,620	90,820	92,026	93,816	96,524	100,265	104,706	109,823	114,993
Imports	-85,606	-66,340	-77,473	-84,235	-84,365	-85,641	-87,952	-91,993	-96,767	-102,495	-108,695
Income, net	-7,481	-4,935	-5,459	-6,155	-6,241	-6,395	-6,786	-7,170	-7,635	-8,139	-8,664
Current transfers, net	-579	404	345	480	260	370	78	100	100	100	100
Capital Account	**1,016**	**1,071**	**1,691**	**2,348**	**2,304**	**3,265**	**3,265**	**3,065**	**2,865**	**2,665**	**2,465**
Net capital transfers	919	1,669	1,973	2,443	2,304	3,265	3,265	3,065	2,865	2,665	2,465
Financial Account	**11,771**	**-41**	**1,842**	**2,196**	**-2,433**	**-425**	**-895**	**-2,716**	**-181**	**-249**	**1,463**
Direct investment, net	2,677	128	725	119	1,117	124	-155	-247	-296	-395	-501
Portfolio investment, net 1/	-3,202	-2,951	487	5,786	1,476	4,265	1,171	577	1,508	549	1,070
Other investment	12,297	2,781	630	-3,708	-5,027	-4,814	-1,911	-3,046	-1,392	-403	893
Net errors and omissions	**-2,283**	**-325**	**-1,548**	**-1,581**	**561**	**-500**	**-526**	**-551**	**-577**	**-605**	**-633**
Overall Balance	**2,753**	**502**	**3,018**	**3,874**	**2,112**	**4,489**	**3,708**	**1,001**	**2,511**	**1,100**	**1,028**
Official Financing (European Union)	**2,000**	**3,500**	**0**	**-2,000**	**0**	**0**	**-2,000**	**0**	**-1,500**	**0**	**0**
European Union	2,000	3,500	0	-2,000	0	0	-2,000	0	-1,500	0	0
Net International Reserves (increase -)	**-4,753**	**-4,002**	**-3,018**	**-1,874**	**-2,112**	**-4,489**	**-1,708**	**-1,001**	**-1,011**	**-1,100**	**-1,028**
Gross Reserves	-9,676	-8,986	-3,018	-1,874	1,723	-62	-1,011	-1,001	-1,011	-1,100	-1,028
Reserve Liabilities	4,923	4,984	0	0	-3,835	-4,427	-696	0	0	0	0
IMF	4,923	4,984	0	0	-3,835	-4,427	-696	0	0	0	0
Memorandum Items:											
Current account (in percent of GDP)	-7.3	-0.2	1.1	0.9	1.7	2.1	1.8	1.1	0.3	-0.6	-1.8
Exports, g&s (in percent of GDP)	81.3	77.4	86.6	90.9	93.3	93.7	91.7	91.1	90.8	90.8	90.8
Volume (percent change)	4.2	-12.7	17.0	9.9	2.6	2.9	3.5	3.9	4.3	4.6	4.7
Imports, g&s (in percent of GDP)	81.0	72.6	80.2	84.3	85.5	85.6	83.6	83.5	83.9	84.7	85.8
Volume (percent change)	4.3	-17.1	15.2	6.8	1.6	2.0	3.0	4.5	5.1	5.4	5.5
Gross external debt (in percent of GDP) 2/	116.9	150.1	143.1	132.1	126.4	121.0	112.6	106.2	100.9	96.1	93.0
Gross official reserves	24,040	30,676	33,675	37,774	33,881	33,943	34,954	35,956	36,967	38,067	39,095
In percent of short-term debt at remaining maturity 3/	71.3	83.6	75.0	88.2	90.7	86.8	105.8	102.2	106.9	107.9	108.7
In months of next year's imports of good and services	4.3	4.8	4.8	5.4	4.7	4.6	4.6	4.5	4.3	4.2	4.1

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

	2010	2011	2012 Proj.	2013 Proj.	2014 Proj.	2015 Proj.	2016 Proj.	2017 Proj.	2018 Proj.
Table 10. Hungary: External Financing Needs, 2010—18									
(in millions of euros)									
Total financing requirements	**38,374**	**43,412**	**38,525**	**30,703**	**34,514**	**29,315**	**32,498**	**33,225**	**29,965**
Current account - Capital account	-2,724	-3,258	-3,984	-5,414	-5,129	-4,268	-3,268	-1,954	-199
Current account	-1,033	-910	-1,680	-2,149	-1,864	-1,203	-403	711	2,266
Capital account	1,691	2,348	2,304	3,265	3,265	3,065	2,865	2,665	2,465
Amortizations	39,550	45,089	43,070	35,617	39,117	33,032	35,189	34,574	29,530
FDI (inter company)	6,487	6,201	5,876	6,134	6,508	6,508	6,508	6,508	6,508
General government	4,686	7,682	10,705	12,016	13,962	8,562	10,567	10,508	6,692
Eurobonds	1,243	1,989	1,488	1,456	2,737	1,463	1,846	1,896	1,501
Loans and others	439	2,549	3,835	4,427	3,218	290	2,484	636	496
o/w: to IMF and EU	0	2,000	3,835	4,427	2,696	0	1,500	0	0
Non-resident holding of government securities	3,004	3,144	5,145	6,134	8,008	6,810	6,237	7,976	4,695
MFB external funds need 1/			237						
Central bank	2,240	5,035	4,884	871	528	242	200	222	222
Banks	20,062	18,465	14,848	14,382	12,336	10,650	10,506	10,314	10,412
Other investment (mainly corporate)	6,075	7,705	6,757	2,214	5,783	7,071	7,408	7,022	5,696
Net errors and omissions	1,548	1,581	-561	500	526	551	577	605	633
Total financing sources	**38,374**	**43,412**	**38,525**	**30,703**	**34,514**	**29,315**	**32,498**	**33,225**	**29,965**
FDI net inflows (incl. inter-company)	7,212	6,320	6,993	6,258	6,353	6,261	6,212	6,113	6,007
Disbursements (debt)	30,524	32,575	13,555	24,897	29,719	24,863	27,892	27,731	24,413
General government 2/	5,293	10,428	9,233	13,467	13,724	9,321	11,394	11,160	7,904
Eurobonds	983	4,696	0	4,900	5,936	1,723	4,311	2,512	1,974
Loans and others	182	1,100	600	600	1,000	1,000	1,000	1,000	1,000
Non-resident holding of government securities	2,585	4,631	8,633	7,967	6,788	6,598	6,083	7,648	4,930
Central bank	4,102	4,552	3,419	871	266	123	181	200	211
Banks	18,158	15,702	2,970	9,588	10,356	9,997	9,882	10,244	10,534
Other investment (mainly corporate)	7,073	6,446	1,351	1,843	5,639	5,545	6,617	6,327	5,975
Other portfolio flows net	3,655	6,390	16,254	-390	-547	-808	-595	481	573
Drawdown in gross reserves	-3,018	-1,874	1,723	-62	-1,011	-1,001	-1,011	-1,100	-1,028
Memo items									
Gross international reserves (level in Euro million)	33,675	37,774	33,881	33,943	34,954	35,956	36,967	38,067	39,095
In percent of short-term debt at remaining maturity	75	88	91	87	106	102	107	108	109
Government rollover rates (in percent)	113	136	86	112	98	109	108	106	118
Banks' rollover rates (in percent)	91	85	20	67	84	94	94	99	101
Corporate rollover rates (in percent)	116	84	20	83	98	78	89	90	105

Sources: Hungarian authorities and IMF staff estimates.

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

2/ Excludes EU and IMF loans

Table 11. Hungary: Indicators of Fund Credit, 2008-15

(In millions of SDR)

	2008	2009	2010	2011	2012	2013	2014	2015
Existing and prospective Fund credit								
Disbursement	4,215	3,422	0	0	0	0	0	0
Stock 1/	4,215	7,637	7,637	7,637	4,417	598	0	0
Obligations	0	148	186	201	3,391	3,897	604	0
Repurchase	0	0	0	0	3,220	3,819	598	0
Charges	0	148	186	201	171	79	6	0
Stock of existing and prospective Fund credit								
In percent of quota	405.9	735.5	735.5	735.5	425.3	57.6	0	0
In percent of GDP	4.3	9.3	9.1	8.7	5.3	0.7	0	0
In percent of exports of goods and services	5.3	12.0	10.5	9.5	5.7	0.7	0	0
In percent of gross reserves	18.8	27.6	26.1	22.9	15.5	2.0	0	0
Obligations to the Fund from existing and prospective Fund arrangements								
In percent of quota	0.0	14.2	17.9	19.4	326.5	375.3	58.2	0
In percent of GDP	0.0	0.2	0.2	0.2	4.1	4.5	0.7	0
In percent of exports of goods and services	0.0	0.2	0.3	0.3	4.4	4.8	0.7	0
In percent of gross reserves	0.0	0.5	0.6	0.6	11.9	13.3	2.0	0

Source: IMF staff estimates.

1/ End of period. Calculated based on proposed extension and rephasing of purchases.

APPENDIX

Hungary: Debt Sustainability Analysis

Hungary's high public and external debt and financing needs remain important sources of vulnerability. Although liquidity pressures have diminished on the back of improved market conditions and the recent Eurobond issuance, rollover risks remain high. Stress tests indicate that shocks to growth and the exchange rate could make debt unsustainable.

1.   **Under the baseline scenario, public debt is projected to remain broadly flat but at an already high level**. The baseline scenario assumes no policy changes, and therefore the fiscal deficit is expected to deviate from the convergence program targets. Under this scenario, debt would remain at around 80 percent of GDP as the small projected primary surpluses are almost entirely offset by an unfavorable interest rate/growth differential. Due to the high level of debt Hungary is susceptible to sudden changes in investor sentiment and, although financing pressures have subsided, rollover needs remain high. In staff's view, sustained primary surpluses above 2 percent of GDP are needed to put debt firmly on a downward trajectory.

2.   **A number of plausible shocks could threaten Hungary's public debt sustainability (Figure 1).** The main risks to the baseline stem from weaker than expected growth and a depreciation of the forint. The former, which could result from a continued weak external environment, could lead to an increase in the public debt ratio to above 100 percent of GDP by 2018. Similarly, a depreciation of a magnitude comparable to historical episodes as a result of a sizable reversal of capital flows would have an immediate and substantial impact on the public debt ratio due to the still significant share of foreign currency denominated debt. In particular, 30 percent depreciation would raise public debt to close to 100 percent of GDP.
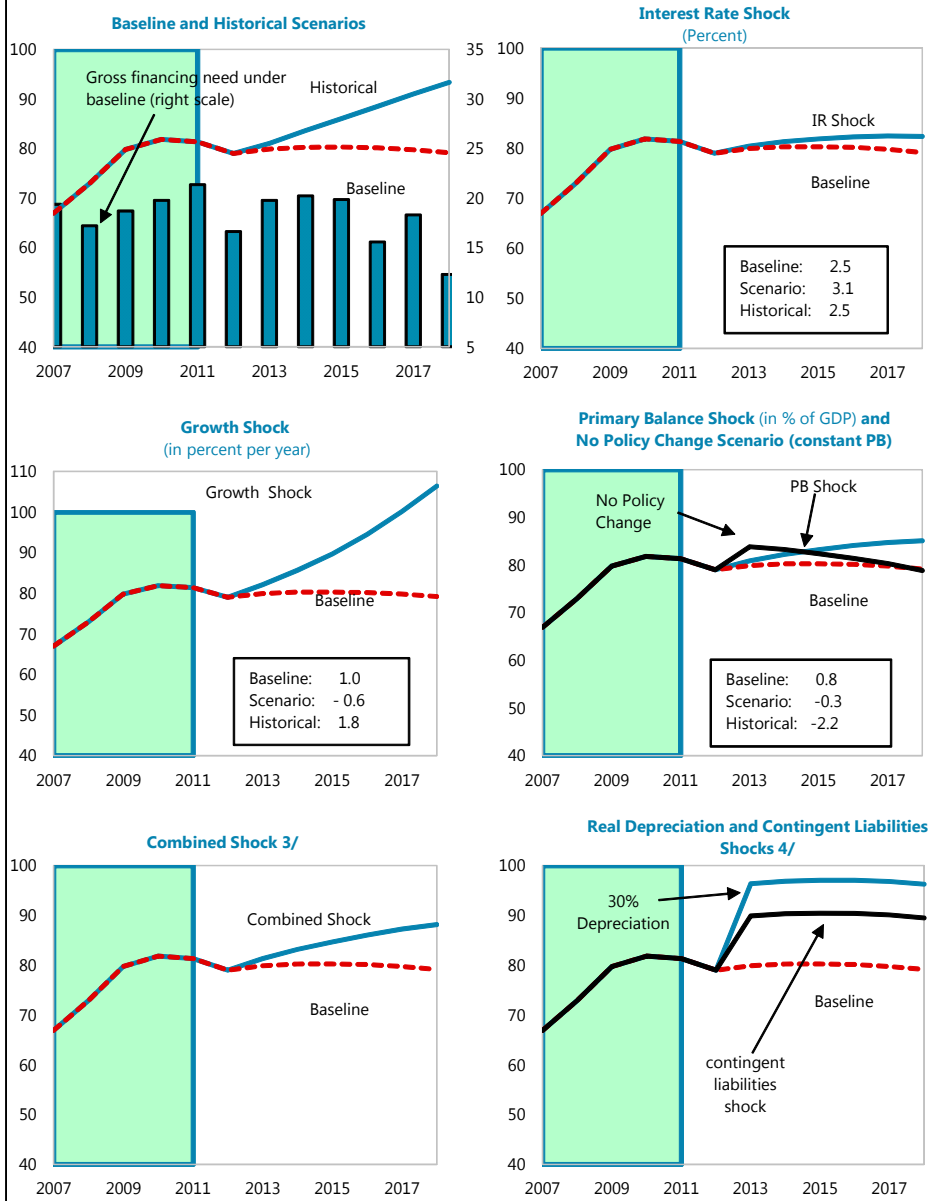
3.   **Hungary's external debt has declined in recent years but remains high** (Table 2, Figure 2). Gross external debt has declined from its peak of about 150 percent of GDP in early 2010 to 129 percent of GDP at end-September 2012. The improvement mainly reflects the heavy deleveraging by the banking sector that began during the global financial crisis, although this was partly offset by higher external government debt. Intra-company loans related to FDI remain broadly stable, amounting to just above 20 percent of gross debt throughout this period. Going forward, external debt is expected to continue to decline, with all sectors except for the government continuing to make net repayments. External bond issuances and continued purchases of HUF-denominated securities by nonresidents are expected to keep government external debt elevated, albeit declining in percent of GDP over the medium term.

4.   **As with public debt, shocks to growth and the exchange rate are the main sources of risk to external debt sustainability**. An adverse permanent growth shock of ½ standard deviation of the historical variation in growth (about 4 percentage points) would put external debt dynamics on an unsustainable path. Similarly, a one-time real depreciation of 30 percent would add about 40 percentage points to external debt.

Table 1. Hungary: Public Sector Debt Sustainability Framework, 2007-2018

(In percent of GDP, unless otherwise indicated)

	Actual 10/					Projections							Debt-stabilizing primary balance 9/
	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	
Baseline: Public sector debt 1/	67.0	73.0	79.8	81.8	81.4	**79.0**	**79.9**	**80.3**	**80.3**	**80.2**	**79.8**	**79.2**	0.4
o/w foreign-currency denominated	21.2	29.2	37.0	38.5	42.2	34.3	33.4	33.1	32.7	32.3	31.8	31.1	
Change in public sector debt	1.1	6.0	6.8	2.0	-0.5	-2.4	0.9	0.4	0.0	-0.1	-0.4	-0.6	
Identified debt-creating flows (4+7+12)	0.5	1.0	8.2	2.8	6.5	0.8	1.5	0.5	0.3	0.1	-0.1	-0.2	
Primary deficit	0.9	0.0	0.2	0.5	1.7	-1.5	-0.9	-0.5	-0.6	-0.7	-0.8	-0.7	
Revenue and grants	45.6	45.1	46.5	45.1	42.8	46.3	47.1	48.1	48.0	48.0	48.1	48.1	
Primary (noninterest) expenditure	46.5	45.1	46.8	45.5	44.5	44.8	46.3	47.6	47.4	47.4	47.4	47.3	
Automatic debt dynamics 2/	0.7	1.0	7.9	2.3	4.8	2.3	2.4	1.1	0.9	0.8	0.6	0.5	
Contribution from interest rate/growth differential 3/	0.7	0.2	7.2	1.2	0.4	2.3	2.4	1.1	0.9	0.8	0.6	0.5	
Of which contribution from real interest rate	0.7	0.8	2.2	2.2	1.7	1.2	2.4	2.0	2.1	2.0	1.9	1.7	
Of which contribution from real GDP growth	-0.1	-0.6	5.1	-1.0	-1.3	1.1	0.0	-0.9	-1.2	-1.3	-1.3	-1.2	
Contribution from exchange rate depreciation 4/	0.1	0.8	0.7	1.1	4.4	-2.7	...	...	...	...	...	...	
Other identified debt-creating flows	-1.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Privatization receipts (negative)	-1.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes (2-3) 5/	0.6	5.0	-1.3	-0.7	-7.0	-0.4	-0.6	-0.2	-0.3	-0.2	-0.2	-0.4	
Public sector debt-to-revenue ratio 1/	146.9	161.8	171.5	181.6	190.1	170.7	169.5	166.9	167.2	166.8	165.8	164.7	
Gross financing need 6/	19.4	17.2	18.7	19.8	21.4	16.6	19.8	20.2	19.9	15.6	18.3	12.3	
in billions of U.S. dollars	19.3	18.2	17.1	19.1	21.3	16.4	19.8	21.3	21.9	18.0	22.1	15.6	
Scenario with key variables at their historical averages 7/						**79.0**	**81.1**	**83.6**	**86.0**	**88.5**	**91.0**	**93.4**	0.4
Scenario with no policy change (constant primary balance) in 2012-2018						**79.0**	**83.9**	**83.3**	**82.4**	**81.4**	**80.3**	**78.9**	0.4
Key Macroeconomic and Fiscal Assumptions Underlying Baseline													
Real GDP growth (in percent)	0.1	0.9	-6.7	1.2	1.7	-1.4	0.0	1.2	1.5	1.6	1.6	1.6	
Average nominal interest rate on public debt (in percent) 8/	6.6	6.6	6.1	5.4	5.4	5.3	5.5	5.4	5.4	5.3	5.3	5.1	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	1.2	1.3	2.6	2.9	2.3	1.4	3.1	2.6	2.7	2.7	2.5	2.3	
Nominal appreciation (increase in US dollar value of local currency, in percent)	-0.4	-4.3	-2.2	-2.8	-10.4	...	...	...	...	...	...	...	
Inflation rate (GDP deflator, in percent)	5.5	5.3	3.5	2.6	3.1	3.8	2.4	2.8	2.6	2.7	2.8	2.8	
Growth of real primary spending (deflated by GDP deflator, in percent)	-3.4	-2.2	-3.2	-1.4	-0.7	-0.8	3.3	4.0	1.2	1.6	1.6	1.6	
Primary deficit	0.9	0.0	0.2	0.5	1.7	-1.5	-0.9	-0.5	-0.6	-0.7	-0.8	-0.7	

1/ General government gross debt. Estimates based on government debt agency (AKK) data.
2/ Derived as [(r - p(1+g) - g + ae(1+r))/(1+g+p+gp)] times previous period debt ratio, with r = interest rate; p = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).
3/ The real interest rate contribution is derived from the denominator in footnote 2/ as r - π (1+g) and the real growth contribution as -g.
4/ The exchange rate contribution is derived from the numerator in footnote 2/ as ae(1+r).
5/ For projections, this line includes exchange rate changes. For 2011, largely reflects the effect of the pension assets transfer to government.
6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.
8/ Derived as nominal interest expenditure divided by previous period debt stock.
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.
10/ 2011 calculations exclude the effect of the pension asset transfer to government on revenues.

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

Baseline and Historical Scenarios

Gross financing need under baseline (right scale)

Historical

Baseline

Interest Rate Shock
(Percent)

IR Shock

Baseline

Baseline:	2.5
Scenario:	3.1
Historical:	2.5

Growth Shock
(in percent per year)

Growth Shock

Baseline

Baseline:	1.0
Scenario:	- 0.6
Historical:	1.8

Primary Balance Shock (in % of GDP) and
No Policy Change Scenario (constant PB)

No Policy Change

PB Shock

Baseline

Baseline:	0.8
Scenario:	-0.3
Historical:	-2.2

Combined Shock 3/

Combined Shock

Baseline

Real Depreciation and Contingent Liabilities
Shocks 4/

30% Depreciation

contingent liabilities shock

Baseline

Sources: International Monetary Fund, country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.
3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.
4/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2013, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Table 2. Hungary: External Debt Sustainability Framework, 2007-18
(In percent of GDP, unless otherwise indicated) 1/

	Actual												Debt-stabilizing
	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	non-interest current account 7/
Baseline: External debt	104.6	116.9	150.1	143.1	132.1	**126.4**	**121.0**	**112.6**	**106.2**	**100.9**	**96.1**	**93.0**	**-5.0**
Change in external debt	7.8	12.3	33.3	-7.0	-11.0	-5.7	-5.4	-8.4	-6.4	-5.3	-4.8	-3.1	
Identified external debt-creating flows (4+8+9)	3.2	1.2	13.7	-10.7	-11.1	-5.8	-10.8	-9.8	-8.9	-6.3	-4.7	-2.7	
Current account deficit, excluding interest payments	3.5	1.9	-5.2	-6.1	-7.5	-7.2	-5.6	-4.6	-3.6	-2.8	-1.8	-0.5	
Deficit in balance of goods and services	-0.7	-0.3	-4.7	-6.4	-6.6	-7.8	-8.2	-8.1	-7.5	-6.9	-6.1	-5.0	
Exports	80.8	81.3	77.4	86.6	90.9	93.3	93.7	91.7	91.1	90.8	90.8	90.8	
Imports	80.2	81.0	72.6	80.2	84.3	85.5	85.6	83.6	83.5	83.9	84.7	85.8	
Net non-debt creating capital inflows (negative) 2/	3.9	0.0	-1.8	-2.0	-5.1	-6.0	-8.7	-6.7	-6.1	-4.3	-3.7	-3.1	
Automatic debt dynamics 3/	-4.2	-0.7	20.8	-2.6	1.5	7.4	3.5	1.5	0.9	0.8	0.7	0.9	
Contribution from nominal interest rate	3.8	5.4	5.5	5.0	6.6	5.5	3.4	2.8	2.5	2.4	2.3	2.3	
Contribution from real GDP growth	-0.1	-0.7	9.0	-1.8	-2.3	1.9	0.0	-1.4	-1.6	-1.7	-1.6	-1.4	
Contribution from price and exchange rate changes 4/	-7.8	-5.4	6.2	-5.9	-2.8	...	...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 5/	4.6	11.1	19.6	3.6	0.1	0.1	5.4	1.4	2.5	1.0	-0.1	-0.4	
External debt-to-exports ratio (in percent)	129.3	143.7	194.0	165.3	145.3	135.5	129.1	122.8	116.7	111.1	105.8	102.5	
Gross external financing need (in billions of euros) 6/	31.1	35.5	34.5	38.5	44.0	41.2	33.5	37.3	31.8	34.8	35.3	31.8	
in percent of GDP	31.3	33.6	37.8	39.9	44.0	41.7	33.4	35.4	28.9	30.2	29.2	25.1	
Scenario with key variables at their historical averages 7/						126.4	128.2	128.7	128.8	127.3	124.8	122.0	-5.7
Key Macroeconomic Assumptions Underlying Baseline 8/													
Real GDP growth (in percent)	0.1	0.7	-6.7	1.2	1.7	-1.4	0.0	1.2	1.5	1.6	1.7	1.6	
GDP deflator in euros (change in percent)	10.9	5.5	-7.3	4.5	1.7	0.2	1.5	3.9	3.1	3.1	3.1	3.1	
Nominal external interest rate (in percent)	4.3	5.5	4.0	3.5	4.8	4.1	2.8	2.5	2.4	2.4	2.4	2.5	
Growth of exports (euro terms, in percent)	16.1	6.9	-17.7	18.3	8.6	1.3	1.9	2.9	3.9	4.4	4.9	4.7	
Growth of imports (euro terms, in percent)	13.5	7.4	-22.5	16.8	8.7	0.2	1.5	2.7	4.6	5.2	5.9	6.0	
Current account balance, excluding interest payments	-3.5	-1.9	5.2	6.1	7.5	7.2	5.6	4.6	3.6	2.8	1.8	0.5	
Net non-debt creating capital inflows	-3.9	0.0	1.8	2.0	5.1	6.0	8.7	6.7	6.1	4.3	3.7	3.1	

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

2/ Includes EU capital transfers.

3/ Derived as $[r - g - r(1+g) + ea(1+r)]/(1+g+r+gr)$ times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in euro terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

4/ The contribution from price and exchange rate changes is defined as $[-r(1+g) + ea(1+r)]/(1+g+r+gr)$ times previous period debt stock. r increases with an appreciating domestic currency (e > 0) and rising inflation (based on GDP deflator).
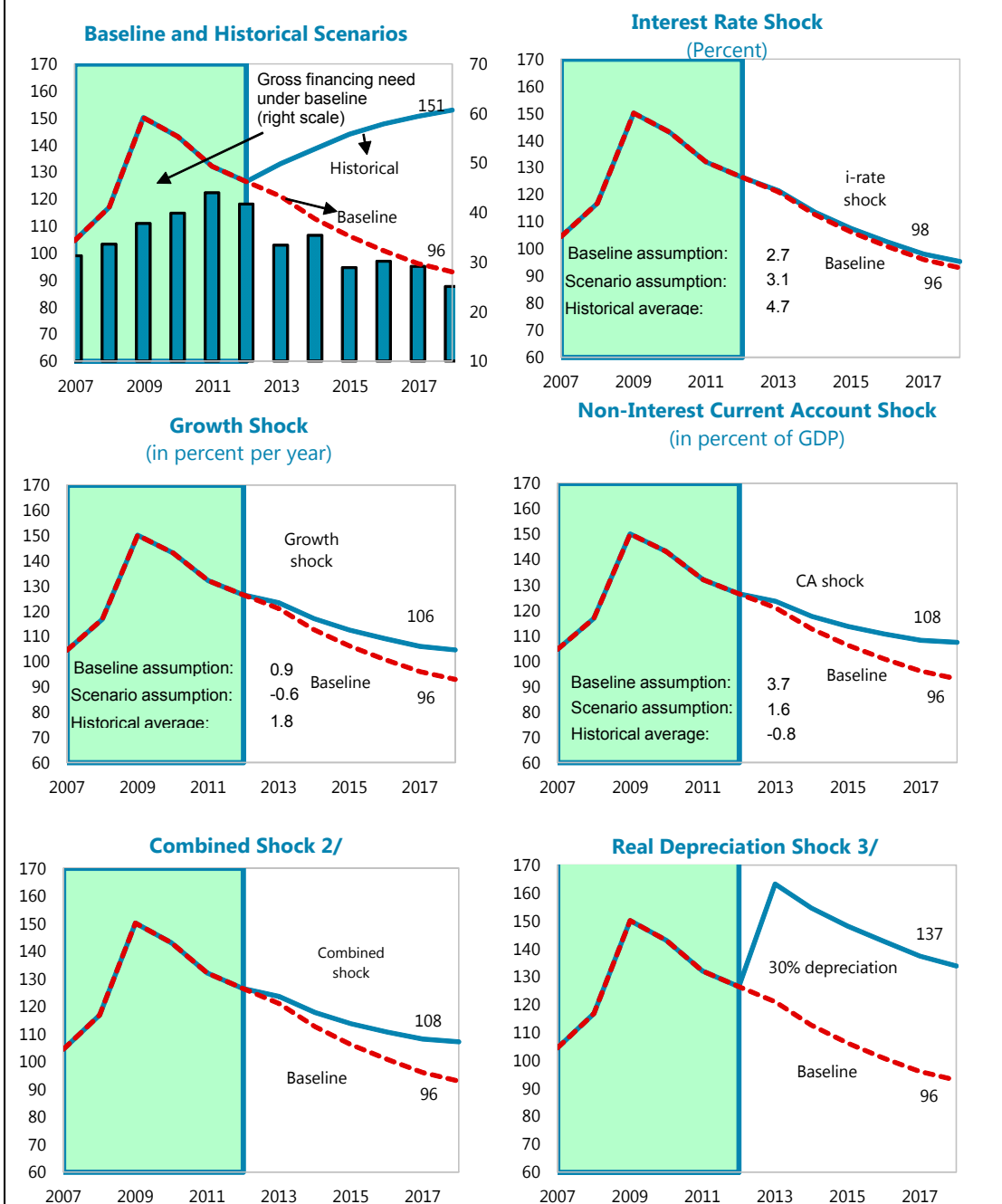
5/ For projection, line includes the impact of price and exchange rate changes.

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

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

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

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

Baseline and Historical Scenarios

Gross financing need under baseline (right scale)

151

Historical

Baseline

96

Interest Rate Shock
(Percent)

i-rate shock

Baseline assumption:	2.7
Scenario assumption:	3.1
Historical average:	4.7

Baseline

98

96

Growth Shock
(in percent per year)

Growth shock

106

Baseline assumption:	0.9
Scenario assumption:	-0.6
Historical average:	1.8

Baseline

96

Non-Interest Current Account Shock
(in percent of GDP)

CA shock

108

Baseline assumption:	3.7
Scenario assumption:	1.6
Historical average:	-0.8

Baseline

96

Combined Shock 2/

Combined shock

108

Baseline

96

Real Depreciation Shock 3/

30% depreciation

137

Baseline

96

Sources: International Monetary Fund, Country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks.
Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
3/ One-time real depreciation of 30 percent occurs in 2013.

INTERNATIONAL MONETARY FUND

HUNGARY

STAFF REPORT FOR THE 2013 ARTICLE IV CONSULTATION AND THIRD POST-PROGRAM MONITORING DISCUSSIONS—INFORMATIONAL ANNEX

March 1, 2013

Prepared By | European Department
(In Consultation with Other Departments)

CONTENTS

FUND RELATIONS

(As of January 31, 2013)

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

General Resources Account:

	SDR Million	Percent Quota
Quota	1,038.40	100.00
Fund holdings of currency	4,854.51	467.50
Reserve position in Fund	73.83	7.11

SDR Department:

	SDR Million	Percent Allocation
Net cumulative allocation	991.05	100.00
Holdings	237.21	23.94

Outstanding Purchases and Loans:

	SDR Million	Percent of Quota
Stand-By Arrangements	3,889.94	374.61

Latest Financial Arrangements:

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

Projected Payments to Fund:

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

	Forthcoming				
	2013	2014	2015	2016	2017
Principal	3,291.63	598.31			
Charges/Interest	52.62	4.62	0.61	0.61	0.61
Total	3,344.25	602.93	0.61	0.61	0.61

Current Status of Safeguards Assessment:
The safeguards assessment of the Magyar Nemzeti Bank (MNB) was finalized on January 28, 2009. The assessment found that the central bank had a relatively strong safeguards framework in place. The MNB's control environment was well established, and the audit and financial reporting practices adhered to international standards. The assessment recommended measures to improve the process of program data reporting to the Fund and to strengthen audit oversight, especially over the central bank's basic tasks. In recent years the central bank law was subject to numerous changes. Going

forward, it is critical to avoid undue changes to the MNB's legal framework and to ensure that the law continues to support MNB's operational and legal independence.

Exchange Rate Arrangements:

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

Article IV Consultation:

Hungary is on a 12-month consultation cycle. The last Article IV Board discussion took place on January 18, 2012. The associated Executive Board assessment is available at http://www.imf.org/external/np/sec/pn/2012/pn1204.htm and the staff report at http://www.imf.org/external/pubs/cat/longres.aspx?sk=25673.0.

Technical Assistance:

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

HUNGARY: TECHNICAL ASSISTANCE FROM THE FUND, FY2010–2013

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

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

STATISTICAL ISSUES

Assessment of Data Adequacy for Surveillance

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

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

Data Standards and Quality

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

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

	Date of latest observation	Date received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of publication[7]	Memo Items:	
						Data Quality – Methodological soundness[8]	Data Quality Accuracy and reliability[9]
Exchange Rates	2/14/2013	2/14/2013	D and M	D and M	D and M		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Jan 2013	2/7/2013	M	M	M		
Reserve/Base Money	Jan 2013	2/12/2013	M	M	M	O,O,LO,LO	O,O,O,O,LO
Broad Money	Dec 2012	1/31/2013	M	M	M		
Central Bank Balance Sheet	Jan 2013	2/12/2013	M	M	M		
Consolidated Balance Sheet of the Banking System	Dec 2012	1/31/2013	M	M	M		
Interest Rates[2]	Jan 2013	2/5/2013	M	M	M		
Consumer Price Index	Jan 2013	2/14/2013	M	M	M	O,O,O,O	O,O,O,O,NA
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	2011	9/28/2012	A	A	A	O,LNO,LO,O	LO,O,O,O,NA
Revenue, Expenditure, Balance and Composition of Financing[3] – Central Government	Jan 2013	2/7/2013	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Q3 2012	1/2/2013	Q	Q	Q		
External Current Account Balance	Q3 2012	12/28/2012	Q	Q	Q	O,LO,LO,LO	O,O,O,O,NA
Exports and Imports of Goods and Services	Q3 2012	12/28/2012	Q	Q	Q		
GDP/GNP	Q3 2012	12/7/2012	Q	Q	Q	O,O,O,LO	O,LO,O,O,NA
Gross External Debt	Q3 2012	12/28/2012	Q	Q	Q		
International investment Position[6]	Q3 2012	12/28/2012	Q	Q	Q		

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

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

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

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

[5] Including currency and maturity composition.

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

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

[8] Reflects the assessment provided in the data ROSC and Substantive Update published in May 2001 and July 2004, respectively, and based on the findings of the respective missions that took place during January 2001 and January 2004 for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning (respectively) concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O), largely observed (LO), largely not observed (LNO), or not observed (NO).

[9] Same as footnote 8, except referring to international standards concerning (respectively) source data, statistical techniques, assessment and validation of source data, assessment and validation of intermediate data and statistical outputs, and revision studies

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International Monetary Fund
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IMF Executive Board Concludes 2013 Article IV Consultation and Third Post-Program Monitoring Discussions with Hungary

On March 18, 2013 the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation and Third Post-Program Monitoring discussions with Hungary.[1]

Background

Hungary's economy has not yet recovered to pre-crisis levels. After a modest recovery in 2011, real GDP is estimated to have contracted by 1.7 percent in 2012. Continued weakness in private consumption and investment, compounded by a sizable fiscal consolidation, contributed to the downturn. Net exports, buoyed by the expansion of the car industry, were a key source of growth.

The outlook remains challenging. The economy is projected to stagnate in 2013 amid continued weakness in domestic demand and only a mild improvement of external conditions. Consumption is still hampered by the ongoing repair of households' balance sheets and the business climate and investment have weakened. Banks remain under stress, reflecting the heavy tax burden, high Non-Performing Loans (NPLs), and weak growth outlook. Labor participation, while somewhat increasing, remains low. In this context, the economy's growth potential is subdued, thus, amplifying the cost and risks related to the large imbalances in the economy.

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

With regard to policies, significant strides were made toward fiscal consolidation in 2012, with the general government deficit declining to around 2½ percent of GDP. Some two-thirds of the adjustment was due to revenue measures, including unconventional taxes on the banking, telecom, electricity, and retail sectors. The government is aiming for a fiscal deficit of 2¾ percent of GDP in 2013, maintaining a broadly neutral cyclical stance.

In line with global trends, market sentiment toward Hungary improved markedly in recent months. After spiking near the end of 2011, risk spreads narrowed and the exchange rate strengthened during 2012. Taking advantage of the situation, Hungary's National Bank (MNB) started a monetary policy easing cycle in the second half of 2012.

While financing constraints have eased, Hungary's economy remains vulnerable. Strong non-resident investor appetite for domestically issued government securities and the recent bond placement in international capital markets have helped cover a large part of this year's foreign exchange financing requirement. However, with still large external and public financing needs, continued access to the markets remains critical. In addition, currency mismatches in the economy remain sizable and leave balance sheets exposed to exchange rate volatility.

Executive Board Assessment

Executive Directors noted that Hungary has preserved financial stability despite challenging domestic and external environments, and has successfully returned to the international bond market. However, high public and external financing needs leave the economy exposed to shifts in market sentiment, while weak investment and low labor participation undermine long-term prospects. Accordingly, Directors agreed that robust and credible policies are needed to support confidence, reduce uncertainty, improve competitiveness, and raise potential growth.

Directors welcomed the authorities' commitment to fiscal consolidation. They noted, however, that additional efforts are needed to durably reduce the high public debt-to-GDP ratio. To make the adjustment more balanced and growth-friendly, these efforts should focus on streamlining expenditure, which could pave the way to lower taxes and a rationalization of the tax system. In addition, Directors saw room to improve tax collection by strengthening revenue administration, particularly the VAT system. Many Directors noted that strengthening the fiscal framework, including by enhancing the resources and independence of the Fiscal Council, would help improve fiscal policy credibility.

Directors agreed that improved external financial conditions have supported the recent monetary loosening, but a pause to the easing cycle would now be prudent. In this regard, they noted that inflation is not well anchored and the projected deceleration in 2013 mainly reflects administrative price cuts. Directors underscored the importance of preserving the legal and operational independence of the central bank, which is crucial for price and financial stability and the credibility of the inflation targeting regime.

Directors noted that weak financial intermediation remains an obstacle to economic recovery. They called for improving the operational environment for banks, including by gradually cutting back the heavy tax burden and putting in place the necessary conditions to facilitate an orderly clean up of banks' and households' balance sheets. Ad hoc initiatives to stimulate lending, including by state-owned banks, are less likely to be effective in reviving credit and may have undesired effects on credit quality.

Directors welcomed recent steps to improve labor participation, but encouraged the authorities to pursue a broader structural reform agenda. In particular, they saw the need to promote competition and a level playing field in product markets. Further advances in restructuring of loss-making state-owned enterprises should also remain a priority.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The staff report (use the free Adobe Acrobat Reader to view this pdf file) for the 2013 Article IV Consultation with Hungary is also available.

Hungary: Selected Economic Indicators, 2008–14

	2008	2009	2010	2011	2012 Est.	2013 Proj.	2014 Proj.
	(Percentage change, unless otherwise noted)						
Real economy							
Real GDP (percentage change)	0.9	-6.8	1.3	1.6	-1.7	0.0	1.2
Total domestic demand (contribution to growth) 1/	0.7	-10.4	-0.4	0.1	-3.0	-1.0	0.4
Private consumption 2/	-0.2	-5.6	-3.3	0.4	-2.9	-0.9	0.5
Government consumption	-0.2	2.6	3.8	-0.3	-2.0	-0.7	0.5
Gross fixed investment	2.9	-11.1	-9.5	-3.6	-5.5	-2.5	0.5
Foreign balance (contribution to growth)	0.2	3.6	1.8	1.5	1.4	1.0	0.7
Exports	5.7	-10.2	14.2	6.3	1.7	2.9	3.5
Imports	5.5	-14.8	12.7	5.0	0.2	2.0	3.0
	(Percent)						
CPI inflation (average)	6.1	4.2	4.9	3.9	5.7	3.2	3.5
CPI inflation (end year)	3.5	5.6	4.7	4.1	5.0	4.0	3.3
Unemployment rate (average)	7.9	10.1	11.2	11.0	11.0	11.1	10.9
	(Percent of GDP)						
Gross domestic investment (percent of GDP) 3/	21.7	20.7	18.3	17.9	17.1	16.5	16.3
Gross national saving (percent of GDP, from BOP)	14.4	20.5	19.4	18.8	18.8	18.6	18.1
General government (GFSM 2001 basis) 4/							
Overall balance	-3.7	-4.5	-4.5	4.3	-2.5	-3.2	-3.4
Primary balance	0.0	-0.2	-0.6	7.9	1.5	0.9	0.5
Primary structural balance, in percent of potential GDP	-1.4	1.3	-1.2	-1.3	1.7	1.9	1.2
Gross debt	73.0	79.8	81.8	81.4	79.0	79.9	80.3
	(Percentage change)						
Money and credit (end-of-period)							
Broad money	7.7	4.4	3.0	5.9	-8.8	7.2	6.0
Lending to the private sector, flow-based	12.2	-2.3	-2.4	-6.9	-7.4	-3.0	3.0
	(Percent)						
Interest rates							
T-bill (90-day, average)	8.9	8.2	5.4	6.0	6.9	...	...
Government bond yield (5-year, average)	9.4	7.6	7.9	8.9	7.8	...	...
5-year sovereign CDS (average in bps; for 2013, as of as of January 29)	196	335	282	379	450	276	
	(Percent of GDP, unless otherwise noted)						
Balance of payments							
Goods and services trade balance	0.3	4.7	6.4	6.6	7.8	8.2	8.1
Current account	-7.3	-0.2	1.1	0.9	1.7	2.1	1.8
Reserves (in billions of euros)	24.0	30.7	33.7	37.8	33.9	33.9	35.0
Gross external debt 5/	116.9	150.1	143.1	132.1	126.4	121.0	112.6
Gross official reserves (percent of short-term debt at remaining maturity)	71.3	83.6	75.0	88.2	90.7	86.8	105.8
Exchange rate							
Exchange regime				Floating			
Present rate (January 29, 2013)			Ft. 297 = €1; Ft. 238 = CHF1				
Nominal effective rate (2000=100, average)	93.3	102.6	102.7	104.2	...	...	
Real effective rate, CPI basis (2000=100, average)	70.4	74.8	72.4	72.6	...	...	
Quota at the Fund			SDR 1,038.4 million				
Memorandum Items							
Nominal GDP (billions of forints)							

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

Statement by Mr. Prader and Mr. Benk on Hungary
March 18, 2013

The authorities thank staff for the thorough and constructive discussions during the Article IV mission and for their valuable advice on macroeconomic policies. The authorities remain committed to prudent macroeconomic policies, focusing their strategy on sustainable debt reduction, increasing labor participation, improving competitiveness, and reducing financial vulnerabilities.

Economic developments and outlook

2012 was a challenging year for Hungary. Real GDP declined by 1.7 percent in the face of a worsening external environment, weak domestic demand reflecting the ongoing deleveraging process and significant fiscal consolidation effort, as well as a sharp fall in agricultural production caused by severe weather conditions.

The authorities expect that growth will resume in the course of 2013, backed by net exports and stabilizing domestic demand. The manufacturing sector is gaining momentum, supporting export growth and continuing attracting investments. While overall investment contracted in 2012 amid tight credit conditions, investment in manufacturing increased by 4.9 percent and is likely to remain at high levels in 2013, increasing productivity and potential output. Several significant FDI projects will be implemented in the course of 2013, which, through the vertical supply chains, will add momentum to the domestic SME sector. The strategic partnership agreements which the government has signed with a wide number of large manufacturing and other companies will further contribute to job creation and investment in R&D. Public investment will be supported by the continuous absorption of EU funds.

Private consumption growth is expected to gradually resume by 2014. The still-ongoing deleveraging in the household sector will be offset by the gradual recovery of real disposable income, supported by rising real wages, increasing labor participation, and a decelerating inflation. Inflation is expected to slow to around 3 percent, due to weak domestic demand and contained regulated energy prices.

Fiscal Policy and Consolidation

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

strategy aims to permanently keep the fiscal deficit comfortably below 3 percent of GDP, which allows an exit from the EU's Excessive Deficit Procedure.

In 2012, the government achieved a structural consolidation of around 2.5 percentage points of GDP, based on measures announced in the multi-annual Széll Kálmán Plan I and II, the implementation of which is continuing, implying further spending cuts in the 2013 budget. A number of further corrective actions throughout the year ensured that the 2012 fiscal deficit stood at around 2.5 percent, in spite of the worse-than-expected macroeconomic environment.

Going forward, the Hungarian government is committed to fully implement the measures underpinning the 2013 budget which will ensure the safe attainment of the deficit target. With respect to the items on which Fund staff identified a risk of slippages, the authorities assure that the necessary measures will be implemented timely (e.g. launching the electronic toll system and the connection of cash registers to the tax authority). Furthermore, the substantially increased contingency reserves (1 1/3 percent of GDP) provide sufficient buffers to address unforeseen risks, including any that surround the macroeconomic outlook. The centralization of the local government's finances gives the government stricter control over spending, and contracting new local debt. The legally binding framework on debt reduction along with the government's solid track record in terms of strictly fulfilling the planned deficit targets since 2010, are further factors to be considered in this context.

The power of the Fiscal Council has been strengthened by a number of measures: (i) It has been entrusted with a veto right in the adoption of the annual budget. (ii) It evaluates the budget execution twice a year on its consistency with the debt reduction goal. (iii) It has the right to evaluate any bill that has budgetary implications, or express its opinion on any other issue that has implications on budget planning, its execution, or the use of public money. In fulfilling its tasks, the Fiscal Council can rely on the expertise of the staff of the State Audit Office and the Magyar Nemzeti Bank, whose presidents are also members of the Fiscal Council. Moreover, the Council has been endowed with a small professional staff team and its own appropriation.

Taxation. Tax policy aims at creating incentives for labor participation and SME development, at the same time securing the revenues needed to pursue the structural transformations while containing the fiscal deficit. The tax burden was gradually shifted away from labor income, leaving the overall burden on capital income unchanged at an already low level. Revenues were replaced by VAT hikes, excise duties, new consumption and turnover taxes based on a "broad base – low rate" approach (financial transaction levy, telecommunication tax), taxes on negative externalities (tax on unhealthy food products, product fees, car accident tax), several tax base broadening measures (improving tax compliance, deleting tax reliefs, tax hikes on fringe benefits, stricter loss carry-forward rules) and the introduction/increase of taxes on businesses with excess market power (bank levy, tax on energy companies). Hence, funding has been secured for the launch of the Job Protection Action Plan, intended to reduce the tax burden on the

most vulnerable groups of the labor market, targeting those with the highest responsiveness to incentives to join the workforce: unskilled, young and elderly workers, and those returning to the labor market after a long period of inactivity. The lump sum tax for small entrepreneurs may significantly improve compliance among the self-employed, while the small business tax provides a simple and transparent framework to promote both employment and investment among small enterprises.

Debt and Financing

The public debt-to-GDP ratio has been continuously declining since 2010. The government was also able to reduce the share of FX-denominated debt, as it completed the 2012 FX redemptions by issuing domestic currency denominated papers while maintaining the level of official reserves through the continuous inflow of EU funds. As for 2013, the government has already secured the bulk of the 2013 FX financing need by a USD 3.25 bn bond issuance in international markets in mid-February, and a EUR 1.5 bn retail euro-denominated bond sale in the domestic market during November - January.

Monetary Policy and Reserves

The Magyar Nemzeti Bank launched a rate-cutting cycle in August 2012, lowering the policy rate by a cumulative 175 basis points in seven successive steps to 5.25 percent. The monetary easing has occurred in association with the improving market sentiment vis-à-vis Hungary and the strong global risk appetite. The central bank may consider a further reduction in the policy rate if the medium-term outlook for inflation remains consistent with the 3 percent target, and the improvement in financial market sentiment is sustained.

The central bank has been continuously accumulating international reserves over the past few years. The current level of reserves is adequate by a variety of metrics. The authorities share staff's assessment that there is no compelling evidence showing that the exchange rate is misaligned.

Financial Sector

The resilience of the Hungarian financial system in terms of capital and liquidity is adequate, and has improved markedly over the last year. Capital adequacy exceeds 15 percent supported by ongoing deleveraging and capital injections by parent banks. Liquidity risks have abated due to the appreciation of the forint, the drop in CDS spreads, a decrease in the net FX swap exposure, and the longer maturities of swaps.

The excessive FX lending practices pursued before the onset of the global financial and economic crisis led to a relatively high and still increasing share of NPLs. Nevertheless, in the view of the supervision authority, the provisioning of NPLs is adequate, exceeding 100 percent if

collaterals are taken into account. While the deleveraging is still ongoing, the government has supported the so-called managed deleveraging through various measures (e.g. fixed exchange rate repayment schemes, interest subsidy on FX loans converted into HUF, etc.). The functioning of the National Asset Management Agency is conducive to the portfolio cleaning process, which, amid weak real estate market conditions, offers targeted support to low income families by purchasing their homes.

The Financial Stability Board has started elaborating on the legislative proposal regarding crisis management and the resolution framework, with the aim of submitting it to Parliament during the Spring 2013 session.

To facilitate the restoration of lending, an agreement with the Hungarian Banking Association has been concluded, with special focus on providing credit to the SME sector. A surge of lending to exporting SMEs can be expected also from the expanding role of the Eximbank, which has recently attracted substantial resources through international bond issuance and refinancing operations.

Structural Reforms

The implementation of growth-enhancing structural reforms, including the measures of the Széll Kálmán Plan I-II is underway. The reform of the local government sub-system (including administrative tasks, public education, health care, and social services) is at an advanced stage and will continue in 2013 as well, and the reform of the higher education system is progressing. The reorganization of the MÁV group is ongoing, aiming to create an independent track operator and an integrated passenger transport company, in parallel with the divestment of assets not required for railway operations.

Labor market reforms, aiming at a workfare state, and work-based social-security system, are already reflected by the rising labor force participation and employment (both growing by 1.7 percent in 2012, leaving the unemployment rate broadly unchanged). These figures comprise employment growth in small enterprises and the extension of the public work scheme. The government views the public work programs as a temporary measure until the business sector becomes capable of absorbing those involved now in public work. Nevertheless, regular public employment continues to decline, a trend supported by some of the public administration's recent streamlining measures (e.g. compulsory retirement at the retirement age, abandoning the practice to receive salary and pension simultaneously).