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EU BALANCE OF PAYMENTS ASSISTANCE TO HUNGARY

SIXTH REVIEW UNDER POST-PROGRAMME SURVEILLANCE

EXECUTIVE SUMMARY

From 25 to 28 November 2014, Commission staff carried out the sixth post-programme surveillance (PPS) mission to Hungary linked to EU balance of payments assistance between 2008 and 2010.[1] *The Commission team followed up on commitments and policy measures agreed during the programme and monitored that the country's fundamentals remain sufficiently solid in order to ensure continued debt servicing. Furthermore, the team also discussed with the authorities the 2014 MIP-related Country-Specific Recommendations (CSRs). As this is the final report under the PPS framework (see below), it briefly recalls the developments and policy steps over the concerned 2011-2014 time horizon for each discussed policy area. The cut-off date of this report was 15 January 2015 (i.e. well before the finalisation of the 2015 winter forecast).*

Hungary is experiencing high growth, boosted by several one-offs and stimulus measures: in the first three quarters of 2014 GDP grew by 3.6%, but growth started to decelerate in Q3. *According to the Commission's 2014 autumn forecast, GDP growth is expected to reach 3.2% in 2014 before slowing down to 2.5% and 2.0% in 2015 and 2016, respectively. Domestic demand is the main driver of growth (mostly gross fixed capital formation and secondly household consumption). Short-term stimulus measures (increased absorption of EU funds, the central bank's Funding for Growth Scheme, regulated utility price cuts, and expansion of the Public Works Scheme) are partly behind the current high growth. Nevertheless, the underlying economic situation has also improved. The authorities' assessment of the growth profile and its main drivers is in line with the autumn forecast. Although increasing slowly, the growth potential of the country has limited space to improve further in the medium term (around 1.5%) and is still below most regional peers, reflecting a low level of productivity growth, which can be partially explained by problems with financial intermediation.*

Employment now exceeds the level of the pre-crisis period, inflation has been subdued in 2014 and the current account surplus is stable above 4% of GDP. *Employment has been increasing since 2012 Q4 from 3.86 million to 4.15 million in Q3 2014, mainly thanks to private sector employment growth but subsidised job creation through the Public Works Scheme has also played a significant role, and the unemployment rate is forecast to decline further. Inflation has been decreasing since end-2012 and Hungary has experienced very low external and internal inflationary pressures in 2014. The inflation index was -0.2% in 2014 and will only pick up from 2015 according to the Commission's 2014 autumn forecast, but might not reach the central bank's 3% target over the forecast horizon. According to the Commission forecast, the net external lending position will be above 8% of GDP in 2014 but is foreseen to gradually decrease also linked to the decrease in EU fund inflows over the forecast horizon while the current account surplus is forecast to remain stable above 4% of GDP.*

Following fiscal loosening in 2014, the Commission expects a gradually decreasing deficit trajectory. *The mission concurred with the authorities that the budgetary situation has noticeably improved over the recent months reflecting the pick-up in economic growth. The*

[1] Among others, meetings were held with G. Orbán, State Secretary for Economic Policy and other senior officials in the Ministry for National Economy; Á. Balog, deputy governor and other senior officials in the central bank; the President of the Fiscal Council; research institutes; representatives of the Banking Association and several major banks. A Commission press statement was released at the end of the mission (see Annex 1).

size of the deficit reduction could potentially increase as the newly enacted budget targets a deficit of 2.4% of GDP in 2015, which is considerably lower than planned in the latest Convergence programme. However, the achievement of this deficit target is subject to significant negative risks as the realisation of some of the budgeted revenues appears to be highly uncertain. Nevertheless, the authorities expressed their confidence to have the sufficient means at their disposal to contain these risks. The debt-to-GDP ratio is projected to remain overall on a decreasing path, but the speed of debt reduction is expected to be still contained over the forecast horizon and important vulnerabilities remain.

Further efforts are needed to ensure compliance with the requirements of the preventive arm of the Stability and Growth Pact as well as the debt reduction benchmark of the transition period. *The Commission's autumn forecast still indicates a risk of a significant deviation from the MTO of -1.7%, both in 2014 and 2015 with a structural balance of around -2¾% of GDP. Moreover, the absolute distance from the MTO increased since the last Commission assessment in the spring, reflecting the better-than-previously estimated cyclical position of the economy. Despite the improvement in the projected debt trajectory, Hungary is forecast to remain non-compliant with the minimum linear structural adjustment (MLSA) required for the debt reduction benchmark over the transition period in 2014. The country is already expected to be compliant with the transitory debt rule in 2015, but only thanks to the allowed margin of deviation. Thus the government's decision to lower the deficit target in 2015 is a step in the right direction, which could allow a greater pace of debt reduction. However, it is planned to be achieved with the help of substantial one-off revenues, implying that the improvement of the structural balance is not yet on a firm footing. Based on their different interpretation of the underlying cyclical situation, the authorities held a more optimistic view about the outlook of the structural budgetary position.*

The Hungarian central bank (MNB) ended its rate cutting cycle in July 2014 and expects the policy rate to remain at the current level of 2.1% for an extended period. *On the other hand, the MNB continued with its efforts to provide additional monetary stimulus to the real economy. The utilisation of the second phase of the Funding for Growth Scheme (FGS) has gradually picked up, as some of its conditions were loosened, the allocated amount was raised by HUF 500 bn (to HUF 1000 bn) and the programme was extended to 2015. Forint sovereign yields were lowered by the MNB's self-financing programme and the 10-year yield fell to around 3.6% by early December. Hungarian financial market conditions have been adjusting to the low interest rate environment, supported by a moderation in the perceived country-specific risks. In the third quarter of 2014, the forint was about 5% weaker against the euro than a year earlier, but it appreciated by about 2% in October and slightly more in November, partly as a reaction to the announcement of the MNB's new FX liquidity-providing facilities, some stabilization of the situation in Ukraine and further policy easing in the region. International reserve coverage of short-term external debt remains adequate, thanks to the high external financing capacity of the Hungarian economy. Following the adoption of its 'Statute' by its management in May 2014, the MNB has launched a large social responsibility programme, so far donating around 0.85% of GDP to its new foundations and the MNB also purchased some real estate.*

Past months continued to be very volatile for the Hungarian banking sector. *In 2014, banks faced further difficulties in operating in Hungary. Their profitability remains heavily affected by the highest tax burden in the EU while their balance sheets are affected by elevated levels of bad or restructured debt. The weak level of economic activity over the past years and the less appealing, and more volatile operating environment have induced foreign parent banks to curtail funding to their local Hungarian subsidiaries. Despite temporary rebounds in net*

lending in some quarters in 2013 and 2014 mainly due to the Funding for Growth Scheme, restoring financial intermediation in a sustainable manner clearly requires a better operating environment for the sector. The ongoing settlement scheme in the retail segment is expected to end up costing the financial system about EUR 3 billion in gross terms (or about one third of the capital base), although capital injections by parent banks have almost neutralized this effect on capital adequacy. Nevertheless, the latest major initiative to convert FX loans at market prices could lay the groundwork for the government and the banks to start a more constructive relationship going forward. Meanwhile, the rapidly growing size of the state-owned banking sector presents a contingent liability for the State finances. Also, the initiative to establish and fund an Asset Management Company (AMC) directly under the central bank raises legal concerns and presents a potential risk for the budget and the central bank's credibility. While, the modalities of the AMC are still not final and operations have not yet started, the Central Bank has already advanced with the full set-up of the legal company and management in place. The European Central Bank and the Commission are in discussion with the Hungarian Central Bank in order to avoid the potential breach of relevant Treaty provisions. Moreover, since the AMC would purchase highly illiquid and highly impaired assets from the banks' balance sheets at above market prices, the Commission (DG Competition) is currently examining the identified concerns regarding the AMC from state the aid point of view, similarly to other EU countries that set up such an institution.

Sovereign financing conditions remained stable, but risks remain linked to the high level gross external financing needs. *The current level of foreign-exchange reserves should help guard against liquidity shocks despite a still challenging debt repayment schedule in 2015-16 (close to 20% of GDP in 2015-2016). The current level of financial buffers appears adequate, while the declining share of the FX component mirrors the sovereign funding strategy (supported by the MNB's self-financing programme) with stronger emphasis on increasing the role of domestic investors. Further risks are related to the still high level of net external and short-term gross external debt: below 60% of GDP (as measured by the MIP scoreboard indicator) and around 26% of GDP, respectively. While net external debt is projected to decline in the medium term, Hungary is particularly exposed to the Ukrainian-Russian crisis through its high dependence on energy imports and the high exposure of OTP, Hungary's biggest bank, without a parent bank.*

Taking into account the results of the 6th PPS mission as laid out in this report, and in particular the fact that Hungary's refinancing capacity appears to be on solid grounds, the Commission proposed to end the Post-Programme Surveillance. *The BoP "Green file"[2] states that "the end of post-programme surveillance would normally be decided by the Commission, after having consulted the EFC, but not before 70% of the loan has been repaid." With the reimbursement of the second tranche (EUR 2 bn) in early November, the remaining outstanding debt fell below 30% threshold of the originally disbursed amount; thereby the legal obligation to maintain PPS for Hungary no longer applies. It is true that given the high gross refinancing needs, partly in FX, Hungary remains vulnerable to a reversal in the global risk appetite. However, since mid-2012, the refinancing of government debt has proceeded smoothly with continued access to international bond markets and the country weathered the episodes of market turbulences (announcement of FED tapering) relatively well. Overall, based on current and prospective developments, there seem to be no*

[2] "EU procedure for providing financial assistance for non-euro area EU Member States" Ref. Ares 21/1/2011, revised version of 3 February 2011.

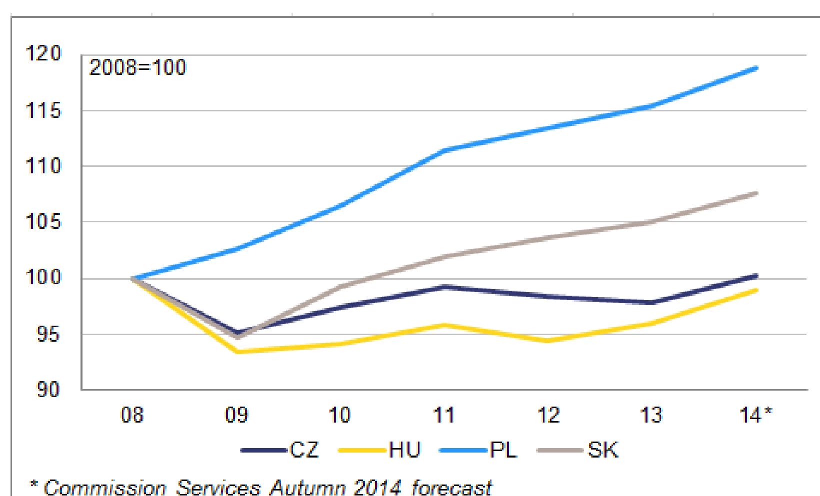
major risks with repayment capacity provided determined implementation of structural reforms and further fiscal consolidation. Following the end of PPS, these policies will be closely monitored under the regular EU surveillance procedures, especially the SGP, MIP and EU Semester. The Economic and Financial Committee at its meeting of 15 January 2015 agreed to end the post-programme surveillance for Hungary.

1. MACROECONOMIC SCENE-SETTER

1.1. Macroeconomic developments

Throughout the post-programme surveillance period, Hungary's economic growth was weak, with one year of recession in 2012 and significant acceleration only in 2014. After the crisis Hungary experienced a moderate recovery in 2010 and 2011 (0.8% and 1.8% respectively), before the country fell back into recession in 2012 with a negative 1.5% GDP growth. In 2013, economic activity revived again with a moderate 1.5%. After five years of continuous decline, this was the first year gross fixed capital formation turned around. Growth is expected to be 3.2% in 2014, according to the Commission's 2014 autumn forecast, but the level of GDP will barely reach the pre-crisis level and still lags behind regional peers.

Graph 1: GDP in 2010 constant prices amongst the Visegrád (V4) countries[3]



Source: Eurostat, Commission Services Autumn 2014 forecast

Inflation was relatively high during the first part of the post-programme surveillance period, around the 5% average of the previous ten years, but it has started to decrease from 2013. Yearly inflation was 4.7%, 3.9% and 5.7% respectively between 2010 and 2012. Since January 2013, on the back of the fading-out of earlier indirect tax hikes, inflation started to decrease. Three waves of cuts in regulated energy and other utility prices introduced as of January, August, and November 2013 contributed to the disinflation and inflation reached a historically low rate of 1.7% in 2013.

Between 2010 and 2013 labour market conditions improved, partly linked to the increasing reliance on public works. Following the 1 pp. drop from 2008 to 2009 in the

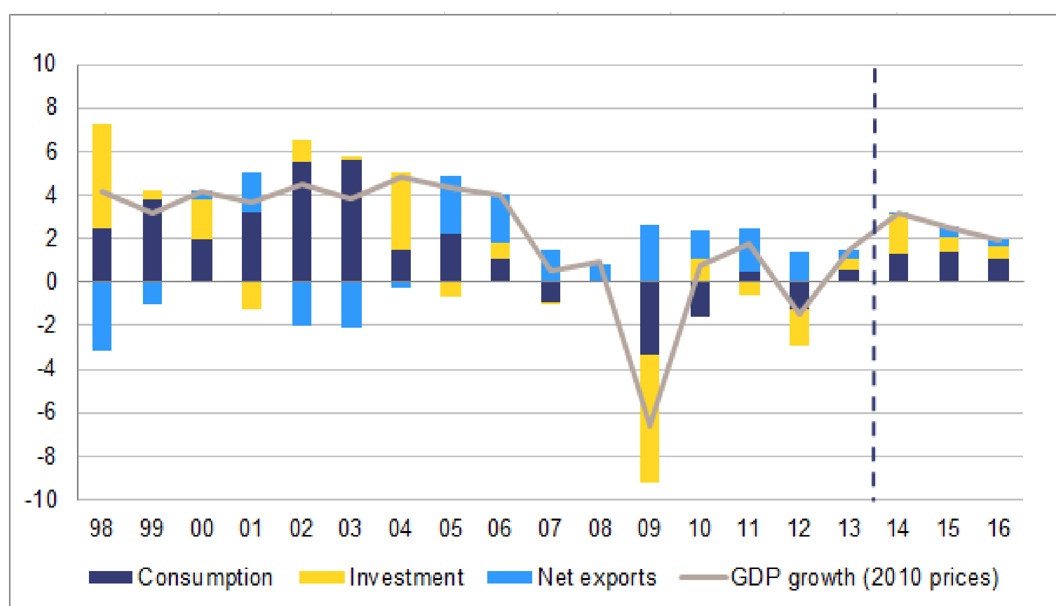
[3] It is common to compare the so-called Visegrád (V4) countries (namely, Poland, the Czech Republic, Slovakia and Hungary) to each other.

employment rate, both the employment rate and the activity rate have been increasing since 2009, and reached 58.1% and 64.7% respectively in 2013, but both still low in international comparison. The unemployment rate peaked at 11.2% in 2010. In 2011, the government reformed the system of the public works, and started to rely more and more on subsidised job creation through the Public Works Scheme. According to the institutional statistics from a monthly average of 87 300 participants in public works in 2010, their number grew to 129 170 in 2013. As a result, the unemployment rate decreased to 10.2% in 2013. The overall employment gain between Q1 2010 and Q4 2013 (296 000) is due to i) private sector employment (128 000); ii) public works (116 000); and iii) frontier workers (52 000) according to the Labour Force Survey based statistics.

In 2014 so far, Hungary has experienced relatively strong growth, boosted by several one-offs and stimulus measures: in the first three quarters GDP grew by 3.6%, but started to decelerate in Q3. The composition of the recovery shifted as domestic demand has become the main driver of growth already in 2013. Investment growth accelerated to an outstanding 16.5% so far in 2014. Although corporate investment also started to increase, this was mainly the result of public investment supported by an inflow of EU funds and the central bank's Funding for Growth Scheme. Household final consumption expenditure grew by 1.6% so far, because of lower than expected inflation and strengthening employment growth. On the production side in 2014 so far, all sectors contributed positively, construction rose by 17.8% - again mainly on the back of increased EU fund absorption - but manufacturing and retail sales also grew by 7.4% and 1.9% respectively. Nevertheless the Q3 data shows a deceleration in the growth momentum of every sector, especially in construction (H1: 22.7%; Q3: 11.6%) and also in manufacturing (H1: 8.1%; Q3: 6.2%). The only positive surprise is in the agricultural sector, so far growing by 7.7% in 2014.

According to the Commission's 2014 autumn forecast, GDP growth is expected to reach 3.2% in 2014 before slowing down to 2.5% and 2.0% in 2015 and 2016, respectively. Domestic demand will remain the main driver of growth over the forecast horizon, with net exports contributing marginally. Within domestic demand, a shift is expected from gross fixed capital formation to household consumption expenditure. The growth of the former shall lose its momentum as 2014 was a peak in EU fund absorption and also a year with three elections (national, EU, local). The latter will gain extra strength temporarily in 2015, because following the settlement of household mortgage loans (see section 4 for details), real disposable income is expected to increase, increasing ceteris paribus household consumption by approximately 1 pp.

Graph 2: Contributions to economic growth by external and domestic demand (pps.)



Source: KSH, Commission services (for the 2014-16 period, based on the 2014 autumn forecast).
Note: Investment contains the changes in inventories.

The authorities' assessment of the growth profile, its drivers and of other macroeconomic indicators is in line with the autumn forecast. Comparing the official macro path underlying the 2015 budget, and the central bank's most recent quarterly forecast, there seems to be a convergence of views that there will be a slowdown of investment and a pick-up in private consumption, hence domestic demand will remain the main growth driver, and the overall contribution of net exports will be limited. Potential growth estimations of the Commission are slightly below the government's projections over the 2014-2016 period. Net lending and borrowing projections are broadly similar, although the 2015 budget foresees a larger current account surplus than Commission forecast, due to a better trade balance forecast and a more optimistic EU fund inflow assumption.

Table 1: Comparison of GDP growth forecasts

%	2014	2015	2016
Commission, 2014 autumn forecast	3.2	2.5	2.0
HU government 2015 budget	3.2	2.5	2.1
MNB Inflation Report, December 2014	3.3	2.3	2.1

Source: Commission, MfNE, MNB

The ongoing employment increase in 2014 is mostly due to the private sector employment, but the subsidised job creation through the Public Works Scheme also added to the increase in the first three quarters of 2014. Despite a continuing improvement in the participation rate, unemployment decreased further to 7.8% in 2014 as the employment rate kept on increasing. Employment rate and the activity rate reached 61.8% and 67% respectively in 2014 and the number of employed reached, and even exceeded the pre-crisis level. In line with the economic uptake, private sector employment also picked up, growing by 2.5% y-o-y in the first three quarters of 2014. Moreover, the extension of the public works is ongoing, reaching on average a monthly 181 000 persons in 2014, around 4.5% of all employed. In mid-2014 extra budgetary sources were devoted to keep the number

of employees at 200 000 on average throughout the year. Furthermore, the 2015 budget allocates 0.9% of GDP for this scheme, 0.1 pp. above the amount expected to be spent in 2014. This will translate into a further increase in the average number of public workers by 44 500 both in 2015 and 2016 – which means a lower unemployment rate compared to the autumn forecast.

Inflation was -0.2% in 2014 against the backdrop of very low external and internal inflationary pressures, and will only pick up moderately from 2015. Consumer prices in the first nine months of 2014 remained broadly unchanged due to subdued imported inflation, low food prices, regulated energy price cuts and declining inflation expectations. The effect of domestic demand picking up has not yet passed through to monthly data of price developments and a fourth wave of regulated price cuts, spread out in 2014 also pushed prices down, thus inflation turned out to be -0.2% for last year.The Commission's autumn forecast foresees 2.5% inflation for 2015, but downward risks considerably increased recently. In November, the Ministry already decreased its inflation forecast for 2015 (1.8%) and so did the central bank in December (0.9%). The main reasons for these revisions were: i) recent fall in the oil price; ii) the exchange rate pass-through to inflation is lower than it used to be; iii) lower than expected price dynamics in the case of non-durable products; iv) a downward surprise element in regulated prices of textbooks.

The Commission's autumn forecast projects net external lending to reach 8.3% of GDP in 2014 and to decrease gradually to 7.7% by 2016, also linked to the decrease in EU fund inflows. In 2013-2014 the trade balance was boosted by an increased production of newly installed capacities in the car industry, while higher current transfers were recorded due to the elevated absorption of EU funds related to the end of the 2007-2013 cycle. Throughout the forecast horizon the trade surplus is expected to increase slightly further, mainly because of a pick-up in external demand. The transfer account will start to shrink from 2015 with lower EU funds flowing into the country. The current account surplus is expected to be stable, above four percent of GDP.

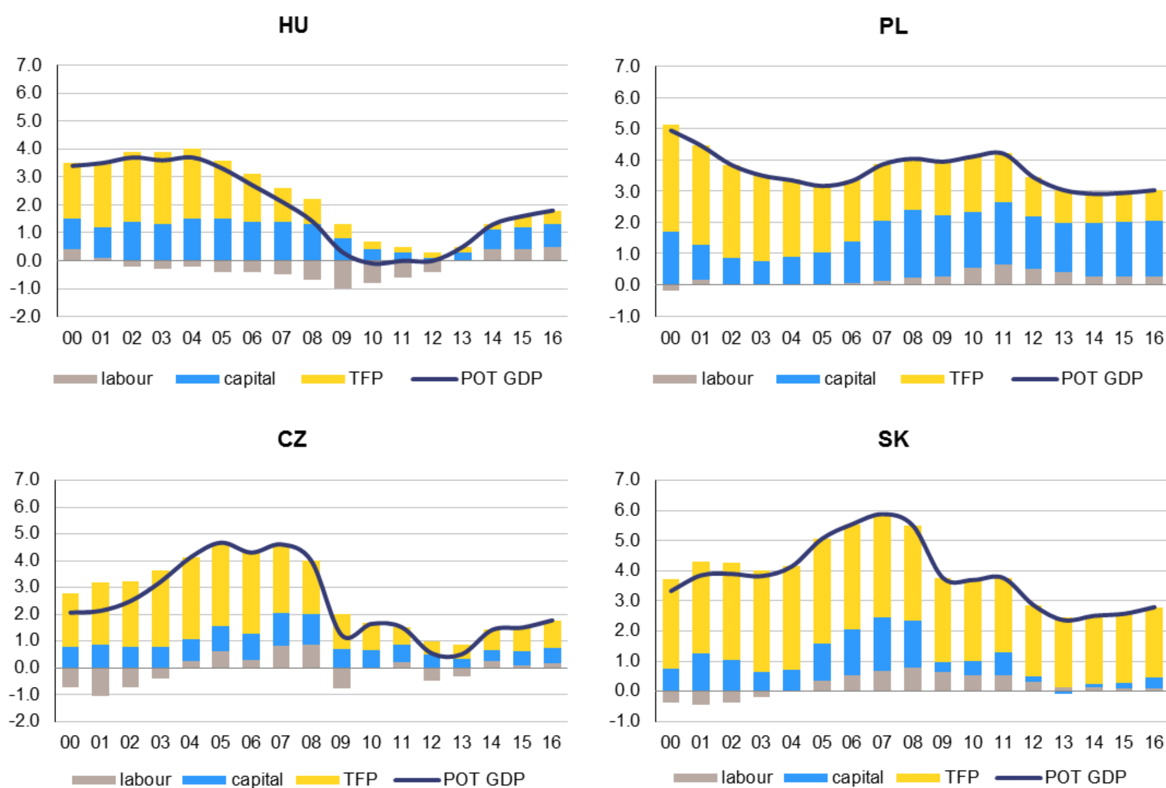
1.2. Hungary's growth potential and state-of-play with structural reforms

Hungary's potential growth was around zero in the period of 2010-2012 and only started to increase in 2013. Regarding the components of potential growth, the low level of total factor productivity (TFP) seems to be the main reason for Hungary's low performance. The weak TFP could stem from both sub-optimal investment activity and a low level of innovation. Capital accumulation is also affected by the quality of financial intermediation and by the uncertainty in the business environment. The overall contribution of labour to potential GDP has improved. This improvement can be attributed to structural reforms in the labour market − namely the abolishment of early retirement schemes, the phasing-in of the increase in the statutory retirement age, tightening the conditions of unemployment benefits, and the restricted eligibility to disability pensions − as well as to the extensive usage of the Public Works Scheme.

According to the Commission's autumn forecast, potential growth is projected to reach 1.3% in 2014 but with only limited room to further improve in the medium term. Until 2016 potential growth would reach 1.8% according to the Commission's autumn forecast. Based on the long-term projections of the Commission it would decelerate back to 1.5% on

average in the subsequent period.[4] The Ministry estimates potential growth between 1.6% and 2% in the period 2014-2016, while the central bank's forecast is between 1.2% and 1.5%. Among the Visegrád countries, only the Czech Republic has such a low growth potential, while both Poland's and Slovakia's potential growth is more than 1 pp. higher. The TFP contribution to potential growth is the lowest in Hungary.

Graph 3: Potential GDP growth and its components in the Visegrád countries



Source: Commission's 2014 autumn forecast

Policies that could lift the potential growth of the Hungarian economy are listed and detailed amongst the country-specific recommendations (CSRs) adopted by the Council on 8 July 2014.[5] First of all, as recommended in CSR 2, it would be important to facilitate the restoration of normal lending in the economy. This is all the more important as when the stimulating effects of FGS will fade out in 2016, then banks will need to find fresh resources to support economic growth and this is currently still hampered by a difficult operating environment. Restoring normal lending to the economy requires lowering the regulatory burden on the financial sector and accelerating portfolio cleaning (see also section 4 for a detailed discussion). Second, as stated in CSR 3, distortive sector-specific taxes, with a burden of around 2% of GDP, should be gradually phased out. These taxes, which partly targeting services that are instrumental in the production chain of other companies, may have exacerbated the productivity problems as they are distorting resource allocation across sectors, and increasing running costs for other companies (see also discussion in section 2.3).

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[4] This is explained by the fact that the estimation is sensitive to the pick-up in real growth in 2014.

[5] See Box 1 for the 2014 CSRs. A summary assessment of the implementation of the 2014 CSRs is provided in Annex 3.

BOX 1: The MIP relevant 2014 country-specific recommendations for Hungary

CSR1: Fiscal policy

Reinforce the budgetary measures for 2014 in the light of the emerging gap relative to the Stability and Growth Pact requirements, namely the debt reduction rule, based on the Commission 2014 spring forecast. In 2015, and thereafter significantly strengthen the budgetary strategy to ensure reaching the medium-term objective and compliance with the debt reduction requirements in order to keep the general government debt ratio on a sustained downward path. Further enhance the binding nature of the medium-term budgetary framework through systematic ex-post monitoring of compliance with numerical fiscal rules and the use of corrective mechanisms. Improve the transparency of public finances, including through broadening the mandatory remit of the Fiscal Council, by requiring the preparation of regular macro-fiscal forecasts and budgetary impact assessments of major policy proposals.

CSR2: Financial sector policy

Help restore normal lending flows to the economy, inter alia by improving the design of and reducing the burden of taxes imposed on financial institutions. Adjust the financial transaction duty in order to avoid diverting savings from the banking sector and enhance incentives for using electronic payments. Investigate and remove obstacles to portfolio cleaning inter alia by tightening provisioning rules for restructured loans, removing obstacles to collateral foreclosure as well as increasing the speed and efficiency of insolvency proceedings. In this respect, closely consult stakeholders on new policy initiatives and ensure that these are well-targeted and do not increase moral hazard for borrowers. Further enhance financial regulation and supervision.

CSR3: Taxation

Ensure a stable, more balanced and streamlined corporate tax system, including by phasing out distortive sector-specific taxes. Reduce the tax wedge for low-income earners, inter alia by improving the efficiency of environmental taxes. Step up measures to improve tax compliance – in particular to reduce VAT fraud – and reduce its overall costs.

CSR5: Business environment

Stabilise the regulatory framework and foster market competition, inter alia by removing barriers in the services sector. Take more ambitious steps to increase competition and transparency in public procurement, including better use of e-procurement and further reduce corruption and the overall administrative burden.

The policy advice on business environment (CSR5) points out that the regulatory framework also could be enhanced to become more stable and competitiveness oriented. Since mid-2010, there have been a number of measures with potential detrimental impacts on the business environment. In particular, the introduction of new barriers in previously open markets has artificially reduced the number of suppliers and active economic actors, most likely to the detriment of overall competitiveness. Prime examples are the authorisation requirement of medium and large retail outlets (introduced from 2012 and initially supposed to elapse in 2014) as well as tightened regulations in waste management, meal vouchers, textbooks, pharmacy ownerships and tobacco retail. Moreover, Hungary adopted an amendment to its completion law in 2012, which essentially prevents the Hungarian competition authority from sanctioning cartels on agricultural products. Subsequently, a new provision was introduced in late 2013, according to which mergers regarded as of ‘strategic

national interest' are exempt from scrutiny by the competition authority. A large number of the above-mentioned cases are subject to ongoing infringement procedures.

The progressively increasing restrictions to entry in certain service sectors hamper an efficient allocation of economic resources and increase uncertainty for investors. The former is also shown by the limited allocative efficiency for wholesale and retail trade, which is among the lowest in the EU.[6] In addition, the repeated interventions by the government and their unpredictability have increased uncertainty for investors in the past years. The regulatory framework still lacks transparency: stakeholder consultations are not systematically carried out and evidence-based impact assessments are often not available. Accordingly, recent international competitiveness surveys rank Hungary as having the least transparent policy making in the region; the weakest insolvency framework (i.e. the lowest level of investors' protection) and the highest legal barriers to entry.[7] The measures suggested in the CSRs would elevate potential growth, through a better functioning of financial intermediation, capital accumulation, higher efficiency in production, more resources on research, and with a more predictive functioning of the economy.

2. FISCAL POLICY

2.1. Budgetary developments and outlook

Hungary could clearly be credited for keeping the general government deficit below the 3% Treaty threshold following the exit from the EDP, but concerns remain regarding the quality of fiscal adjustment both in terms of its durability and growth-friendliness. After reaching 5.5% of GDP in 2011, the deficit was sharply reduced to around 2.3-2.4% in 2012 and 2013. With a deficit target set close to 3%, however, the election year of 2014 saw a loosening of the budgetary stance. Nevertheless, the magnitude of fiscal easing (1% of GDP in terms of change in the primary balance) appears to be relatively moderate at least compared to the historic pattern of Hungarian electoral cycles, whereas quasi-fiscal stimulus measures not affecting the deficit directly (at least in the short term) seemed to gain a more important role this time (including the cuts in regulated energy prices or the Central Bank's Funding for Growth Scheme). Fiscal consolidation efforts were geared both at the revenue and expenditure sides. Yet, the achieved containment of primary expenditures as a whole looks rather modest at best,[8] while Hungary's expenditure-to-GDP ratio still remains by far the highest in a regional comparison.[9] The reduction of social benefits featured strongly amongst cost saving measures, including the parametric pension reforms that could also facilitate debt reduction in the longer term. While benefit cuts contributed to an increased labour supply, it proved to be more difficult to ensure a matching labour demand by the private sector partly as a consequence of tax measures creating new economic bottlenecks

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[6] See European Commission (2013) and the related discussion in European Commission (2014a).

[7] See, inter alia, the World Economic Forum "Global Competitiveness Report 2014-2015", the World Bank "Doing Business 2015" and OECD 2013 PMR.

[8] The primary expenditure-to-GDP ratio corrected for the impact of EU funds fully matched by government spending is estimated to have decreased overall only by around ¾ pp. between 2010 and 2014, while it did not shrink at all in cyclically adjusted terms. Nevertheless, caution is warranted when interpreting these estimates as they also reflect the election-year effect at the end of the period and the budgetary data are not fully comparable across years due to methodological changes.

[9] Hungarian expenditure-to-GDP ratio was close to 50% in 2013, whereas the average of the other three Visegrad-group countries was less than 42%.

(inter alia, with the increasing reliance on sector-specific taxes) as well as of the often unpredictable nature of fiscal and regulatory policies.

Despite a deficit below the 3% threshold, the high level of government debt somewhat below 80% of GDP remains an important vulnerability and the pace of debt reduction could have been quicker. The reduction of the debt ratio achieved between 2010 and 2013 – 3.6 pps. over the three years – may appear impressive at first sight. However, it should be seen against the sizeable capital transfer of around 10% of GDP from the takeover of second-pillar private pension assets by the state during the same period.[10] This outcome reflects the combined effect of low growth, relatively high financing costs and the depreciation of the exchange rate. Also, the government's apparent preference for company acquisitions seems to have gained precedence over debt reduction.

Table 2: Overview of fiscal developments and outlook (as a % of GDP)

Outturn and forecast	2010	2011	2012	2013	2014	2015	2016
General government	-4.5	-5.5	-2.3	-2.4	-2.9	-2.8	-2.5
- Total revenues	45.2	44.4	46.4	47.3	47.3	46.4	43.9
- Total expenditure	49.7	49.9	48.7	49.7	50.2	49.2	46.4
- Tax burden	37.6	36.9	38.6	38.4	38.6	38.0	37.4
Primary balance	-0.4	-1.3	2.3	2.2	1.2	1.1	1.4
Structural balance	-3.3	-4.2	-1.3	-1.3	-2.7	-2.8	-2.6
Government gross debt	80.9	81.0	78.5	77.3	76.9	76.4	75.2

Source: Commission's 2014 autumn forecast

Turning to recent developments, the Commission's 2014 autumn forecast projects a deficit for 2014 fully in line with the official target of 2.9% of GDP, with a positive risk of potentially overachieving it. The switch to ESA2010 and other statistical revisions deteriorated the headline figure by 0.2 % of GDP. Filtering this out, however, the budgetary situation has improved considerably since the Commission's spring forecast. This is mainly thanks to the significantly better revenue outlook as the projected tax and social security receipts as a whole are already forecast to exceed the originally budgeted number. In addition, the government adopted expenditure freezes in mid-July (with a budgetary effect close to 0.3 pp.). These positive developments are estimated to more than counterbalance the deficit-increasing impact of expenditure slippages, reflecting the increased appropriations for the Public Works Scheme and education as well as the higher-than-planned domestic co-financing needs of EU funded projects. Thus the government is projected to have a leeway in terms of spending part of the extraordinary reserve (some two-thirds out of the budgeted 0.3 % of GDP).[11] As learned during the PPS mission, the November amendment of the 2014 budget (consisting mostly of capital expenditures and additional corporate subsidies) and other smaller expenditure items would increase the deficit by 0.2% of GDP, but the

[10] Out of the transferred assets, only about 70% (some 7 pps of GDP) was used for debt reduction in a narrow sense over the 2011-2013 period, if also deducing the part (around 1.5% of GDP) absorbed by the increased deficit in 2011 besides assets incorporated in the permanent state portfolio.

[11] According the budget law, the extraordinary reserve can be spent if this does not endanger the achievement of the deficit target.

authorities expect that it will be offset by additional revenues, which seems to be supported by the most recent outturn data. Taken together, the deficit target could be potentially overachieved provided that no further spending would be made from the extraordinary reserve and there would be no negative surprises regarding the balance of local governments.

Looking ahead, the Commission projects a gradually deficit-improving trajectory, which is based on the no-policy-change assumption and the credible commitments made in the 2014 Convergence programme.[12] The deficit targets of 2.8% and 2.5% of GDP set in the latest Convergence programme for 2015 and 2016 are expected to be achieved, but only under the assumption that the extraordinary reserve will not be spent at all in 2016. Expenditures are projected to grow below the rate of nominal GDP growth taking into account *inter alia* (i) public wage restraint except for the effect of the gradually phased-in compensation scheme for teachers; (ii) the restricted spending on social transfers due to the indexation of pensions linked only to CPI, the gradually increasing statutory retirement age and the nominal freeze of most of other cash benefits; and (iii) the fall in public investment following the election year. However, the pace of the balance improvement is expected to be hindered in 2015 by the fading of factors which just temporarily contained the deficit in 2014, most importantly the one-off receipts from the sale of telecom spectrum licenses. In 2016, a similar effect is expected to stem from the projected fall of EU funds matched by expenditures, which would negatively affect tax receipts.

The subsequently released draft budget, which was approved by Parliament on 15 December, aims at reaching a deficit of 2.4% of GDP in 2015, tightening the target by 0.4 pp. compared to the plan laid down in the latest Convergence programme. On the revenue side, the budget incorporates an extra amount of around 1% of GDP on the top of what is assumed in the autumn forecast. The tax package underpinning the budget is estimated to generate +0.1% of GDP (see the details in section 2.3) and additional receipts of a similar magnitude are planned from road tolls. Counting on further expected yields from measures enhancing tax collection efficiency and combatting tax fraud, the budgeted VAT revenues are assumed to increase by 0.3% of GDP. In addition, the budget assumes receipts of around 0.5% of GDP from selling (yet unspecified) assets, in essence replacing the one-off revenues from telecom licences in the previous year. These extra revenues are just partly turned to the reduction of the deficit as they are to a large extent absorbed by additional spending. The planned expenditure increases include: (i) a new wage compensation scheme for the police and military service; (ii) further extension of the Public Works Scheme; (iii) extra appropriations for health care and public transport; and (iv) considerably higher-than-expected spending on investment linked to the rolling over of the Investment Fund set up in 2014 and the assumed expansion of EU co-financed projects. Regarding expenditure savings, ministry officials highlighted that the public wage bill is assumed to be cut by some 0.1% of GDP due to rationalization steps in public administration under the new state reform programme. Finally, the extraordinary reserve (providing a buffer against unforeseen adverse developments on the top of the standard general reserve) was reduced to a marginal level of 0.1% of GDP.

While the government's intention to tighten the deficit trajectory is commendable, the achievement of the lowered 2015 deficit target remains uncertain in light of the

[12] Note that the 2015 draft budget was not released by the cut-off date of the autumn forecast.

considerable identifiable risks. These negative risks pertain mostly to the revenue side. In particular, the realisation of sizeable one-off receipts from asset sales is rather doubtful given the lack of any detail on the potential sources. Implementation risks also arise concerning the planned revenue gains from the envisaged further improvement of VAT compliance as well the intended increase of road toll revenues (even though the initially planned amount was reduced). In addition, the financial corrections of EU funds – related to the pending case of irregularities of asphalt tenders in road construction projects – may eventually well exceed the provision set aside in the budget (0.1% of GDP). Although the risks surrounding most of the budgeted expenditure items appear to be relatively balanced, the public wage bill is exposed to potential spending overruns to a notable degree.[13] The authorities did not share these concerns by the Commission, arguing that the government has the sufficient means to contain potential risks. While specific details could not be disclosed on the budgeted asset sales for reasons of market sensitivity, it was pointed out that the minister of finance is authorized to stop projects of the Investment Fund should the actual receipts fall short of plans, albeit admitting that this link is not a fully automatic one.

The government debt-to-GDP ratio is not yet on a firm downward path over the forecast horizon. The debt trajectory has overall improved since the Commission's Spring forecast. However, the debt ratio is projected now by the Commission to decrease only slightly in 2014, by 0.4 pp. to 76.9% reflecting a relatively high deficit figure as well as the adverse impacts of the weakening exchange rate and corporate takeovers, which are assumed to be largely offset by the planned other stock-flow operations (including the end-of-year reduction of state deposits). In 2015, the ratio is also forecast to decrease moderately by around 0.5 pp. as the further decline is set to be contained by the need to provide domestic advance payments for the closing of EU co-financed projects. The debt-to-GDP ratio is already foreseen to decline more rapidly in 2016, decreasing by more than 1 pp. to a level somewhat above 75%. In the light of the recently increased prospect of delays in the reimbursement of EU funded projects from the EU budget,[14] the authorities expressed their reduced confidence in achieving the planned reduction in the debt ratio in 2014. At the same time, the 2015 budget targets a larger decrease of the debt ratio in 2015 (0.9 pp.), which appears to be consistent with the lowered deficit target assuming unchanged exchange rate.

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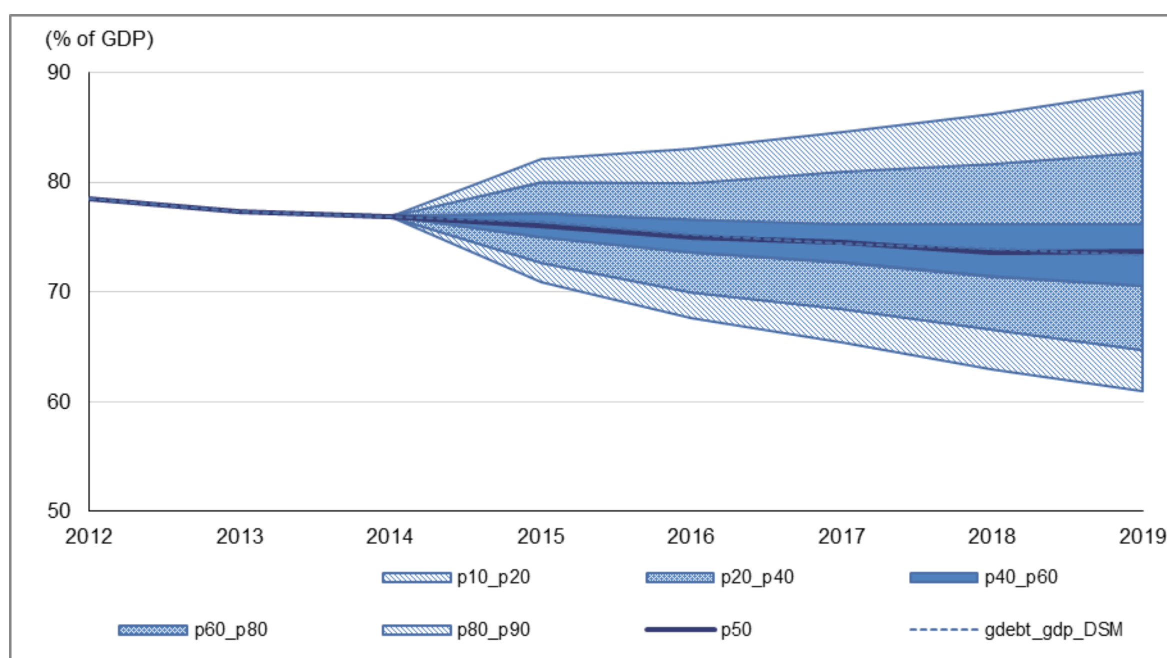
[13] While the planned savings to be generated by the new state reform initiative are apparently uncertain given the current rudimentary shape of the programme, wage pressures in the public sector are likely to intensify as apart from certain selected sub-sectors salary scales are set to remain nominally frozen for the majority of public employees (practically since 2008).

[14] Due to the uncertainties and liquidity problems of the EU budget, there is an increasing risk that a significant amount of EU funds (potentially 1% of GDP) may need to be pre-financed in cash-flow terms by the Hungarian budget at the end of the year.

Graph 4: Stochastic debt projections for Hungary



Source: Commission services

Stochastic debt simulations reveal that the government debt reduction path is not robust enough to show resilience against adverse shocks. In the medium-term baseline scenario, assuming a constant structural primary balance after 2016 and using the medium-term macroeconomic projections of the Commission,[15] the debt is expected to decline slowly to about 73% of GDP by 2019. However, stochastic debt simulations based on historical macroeconomic shocks (to the interest rate, the exchange rate, GDP and inflation) [16] indicate that there is slightly more than a 40% probability that debt will exceed 76% of GDP by 2019. Therefore it can be concluded that the debt reduction path is not robust enough to show resilience against adverse scenarios. This indicates an important remaining vulnerability of the Hungarian economy. In this context, the government's plan to reduce the share of foreign currency-denominated debt to the pre-crisis levels would certainly reduce the exposure to exchange rate developments, but at a potential price of freezing the effect of the prevailing low exchange rate on the level of debt.

The Commission's autumn forecast indicates that more effort is needed to make adequate progress towards the country's medium-term-objective. Starting from a position well above the MTO (-1.7% of GDP), the structural balance is forecast to deteriorate by 1.4 pp to -2.7% of GDP in 2014, and to decrease slightly further in 2015. This results in a risk of significant deviation from the MTO both in 2014 and 2015, which is confirmed on the basis of the expenditure benchmark as well. Thus the recent assessment shows no progress regarding compliance with the preventive arm of the SGP. Moreover, the estimated distance from the MTO has widened since the Commission's assessment in the spring due to the output gap closing faster than previously assumed. This reinforces the conclusion that the cyclical position of the economy would call for a more ambitious deficit path. Therefore, the

[15] The details of the debt sustainability analysis can be found in Annex 2.

[16] For more methodological details, see Berti K. (2013).

government's decision to lower the deficit target is a step in the right direction. However, it appears that the 2015 budget plans to achieve this on the back of substantial one-off revenues (i.e. asset sales) which would not contribute to the improvement of the structural balance. In response, the authorities highlighted that according to their own calculations the structural balance is kept above the MTO, which reflects mainly diverging views regarding the estimated size of the output gap and the country's growth potential as well as some differences in the interpretation of one-off effects.

Despite an improvement in the debt trajectory, compliance with the transitory debt rule of the SGP is not ensured yet. Hungary is expected to still be non-compliant with the required minimum linear structural adjustment (MLSA) in 2014, and only with a slightly lowered gap than estimated on the basis of the spring forecast (0.9% of GDP vs. 0.7% of GDP). However, the country is forecast to comply with the MLSA requirement in 2015, but only thanks to the allowed margin of deviation (0.25% of GDP). A greater-than-projected improvement of the debt ratio due the lowered 2015 deficit target, if achieved, could ensure a more secure positive outcome. Finally, after the end of the transition period, Hungary is estimated to comply with the debt rule as the debt ratio is projected to be below the debt benchmark in 2016. The authorities reiterated their concerns about the way how the debt reduction requirement is assessed during the transitory period, notably the MLSA rule intended to ease fiscal adjustment following the exit from an EDP. In this respect, they found it paradoxical that the country appears to comply with the standard debt rule (which would be applicable only after the transition, i.e. as of 2016) in 2014, while it is expected to breach significantly the required MLSA in the same year. The Commission team responded by pointing out that contrary to what is the case in 2014, Hungary does no longer comply with the standard debt rule (in any of its configurations) in 2015, while it is expected to be compliant again with the MLSA. Moreover, it was highlighted that the SGP does not allow an optional (*à la carte*) application of different debt reduction rules relevant for the transitory period and for the years following the transition.[17]

2.2. Fiscal governance

In the framework of the balance of payment assistance programme, Hungary started to comprehensively reinforce its fiscal framework between 2008 and 2010, which was, however, fundamentally revamped by the new government starting from late 2010. The promising reform as endorsed by the EU and the IMF included new procedural and accounting rules, prescription of new numerical rules of a multi-annual nature as well as the establishment of an independent Fiscal Council (FC), supported by a 30-strong analytical staff. With the adoption of the new Base Law and subsequent laws in 2011 (the cardinal Law on Economic Stability and the new Public Finance Act), virtually all elements of domestic fiscal governance system were replaced.[18] This re-regulation has weakened some aspects of the efficiency of its operation (notably, replacing the forward looking real debt rule with a

[17] By construction, the MLSA requires compliance with a certain path for the structural balance as defined in the Code of Conduct. In the case of Hungary, while the MLSA allowed for a certain deterioration of the structural balance in 2014, the projected deterioration is far above the allowed one, which explains the non-compliance with the MLSA requirements for that year. However, the role of the MLSA to smooth the adjustment over the transition period remains valid, as shown by the projected compliance with the MLSA in 2015, compared to the foreseen non-compliance with the standard debt benchmark in that year.

[18] For a description of the previous system and the new constitutional provisions, see European Commission (2012).

pro-cyclical debt ceiling and dismantling the autonomous analytical capacity of the FC, but at the same time granting it with a veto right over the budget), while strengthening others (inter alia, providing a commendable strong Constitutional basis for the new set-up).

In order to improve the new system's credibility and its effectiveness in guiding fiscal expectations, the Council repeatedly called for introducing a more binding medium-term budgetary framework (MTBF), an increased transparency of public finances as well as for broadening the analytical remit of the Fiscal Council. The 2011 revamp has not touched the existing MTBF, so it remained purely indicative. As to institutional aspects, also due to the peer pressure under the European Semester and the EDP, the FC received some reinforcement in 2012 both in terms of optional tasks and resources. Notably, a small dedicated analytical team was set up within the Office of the Parliament and informal expert networks were established. However, further improvements were deemed necessary to ensure that the FC's analytical underpinnings are commensurate with its unprecedented veto competence over the annual budget bill, in particular the mandatory assignment to issue macro-fiscal baseline projections and impact assessments on major policy proposals. The advocated broadening of the mandatory mandate would be conducive to ensuring that the FC's work and decisions are based on detailed and quantified calculations and not on a qualitative risk assessments (as has been the case so far).

The long overdue strengthening of the medium-term budgetary framework (MTBF) was legislated in December 2013[19], but its test of effectiveness in genuinely lengthening the planning horizon appears to have been postponed until the deliberation and adoption of the 2016 budget. The main novelty of the new regulation is that differences between the medium-term budgetary framework (laid down in a government resolution with three-year expenditure and revenue plans) and the draft budget bill for any given year must be fully justified by changes falling outside the scope of the government (i.e. 'comply or explain'). Somewhat worryingly, the obligation to issue such a resolution (foreseen to take place by 30 April in each year, the first of such a deadline was end-April 2014) was missed in 2014. Ministry staff argued that some delay was inevitable due to the national election and the subsequent formation of the new (re-elected) government (completed in early June), but acknowledged that this issue has subsequently not been rectified. Consequently, the 2015 budget was prepared in the traditional way: neither the indicative 3-year plans contained in the justification of the previous year's budget, nor the Convergence Programme plans played a meaningful guiding role in the derivation of budgetary appropriations. In turn, government representatives announced that the issuance of the next resolution containing medium-term plans for the 2016-2018 period could be advanced from April 2016 possibly by several months.

Further reinforcements (de jure or de facto) of the Fiscal Council are still needed to transform it into a body with a strong and unbiased analytical basis, in light of its uniquely strong veto power. Despite the existing broad optional mandate to comment on any relevant public finance issues, the Council has not published any own analysis or opinion

[19] This amendment to the fiscal framework was approved in the context of the transposition of the six-pack's Directive. The package also included most notably the regular publication of fiscal data at both the central and local government levels, the accessibility of planning documents, as well as the incorporation of the 3% of GDP treaty reference value and the maintenance of the medium-term objective in the domestic legislation as numerical rules.

beyond what was strictly required by law over the last (close to) 3 years. The Commission staff argued that broadening the FC's mandatory remit would transform it into an active watchdog, scrutinising fiscal policy in a systematic way throughout the entire year and thus would ensure that its decisions are based on publicly accessible detailed calculations.[20] The President of the Fiscal Council explained that they have started to increase the number of commissioned external studies (both short-term forecasts and analytical papers from external partners). In addition, there is a new initiative to commission a medium- to long-term macro-fiscal baseline (concept papers have already been received from five research institutes). As a response, Commission staff reiterated its position that these undertakings (even the interesting and insightful papers) could not replace the function of a genuine quantitative analysis of the official macro-fiscal projections and the FC's standing would be enhanced by basing its opinion on the basis of a clear numerical benchmark: its own forecast. Indeed, it was a telling sign that the Fiscal Council announced an affirmative opinion on the 2015 draft budget plan on 27 October, while at the same time admitting that it could not put a price tag for the budgetary costs of the new tax package (see next section for details).[21]

2.3. Tax policy

Hungary's tax burden is the highest among regional peers and ranks as the 10th highest in the EU with a considerable reliance on taxation of some selected sectors (finance, energy, telecom).[22] Over the 2010-2014 period, the tax burden increased by 1 pps, which is fully explained by the permanent diversion of employees' social security contributions from private pension funds to the central budget,, but there were important changes in the tax structure. The revenue losses in income taxes, chiefly driven by the phase-in of a flat personal income tax regime by 2013, were offset by the increase in indirect taxes. However, the compensating tax increases were only partly related to standard type of consumption taxes, the bulk of these additional revenues have stemmed from the introduction of turnover, asset, or profit-linked sector-specific taxes (such as the bank levy, the financial transaction duty, the surcharge on energy companies or the pipeline tax). The Commission has recurrently criticised these extra taxes on account of the unpredictability of their introduction, the harmful choice of tax bases and the arbitrary way surtaxes affect the allocation of resources across industries. Despite the government efforts to decrease the tax burden on labour, − and for high-income earners it was indeed substantially decreased −, the tax wedge on low-wage earners (particularly on single wage earners without a family) is still very high in the regional context and impedes job creation, even after accounting for the effect of the Job Protection Act.[23] Against this background, the country-specific recommendations repeatedly called for a

[20] A reinforced Fiscal Council could subsequently also be tasked with evaluating the completeness and validity of the government's justifications when the differences between the medium-term plans and the actual budget figures would be explained. In this regard, the regular preparation of fully-fledged macro-fiscal forecasts, as specifically recommended by the Council, would help the Fiscal Council verify the government's explanations for possible deviations vis-à-vis the medium-term plans, which could considerably enhance the integrity and predictability of the entire medium-term framework.

[21] See Fiscal Council (2014).

[22] In 2013, the tax-to-GDP ratio in Hungary was 38.4 %, compared with 34.9 % in the Czech Republic, 32.7 % in Poland and 30.4 % in the Slovak Republic. In 2013, sector-specific taxes stood close to 2% of GDP (OECD, 2014).

[23] The Job Protection scheme provides targeted reductions in the employers' social security contributions for certain categories, based on educational levels, age and other social factors. This scheme currently costs

more balanced corporate tax system, also through minimising distortions caused by sector-specific taxes, as well as reducing the tax on low-wage earners.

Official efforts to reduce the administrative burden linked to taxation and tackle tax fraud are commendable, but more needs to be done. The 'Cutting Red Tape Programme' launched in 2011 included a number of measures to reduce the complexity of the Hungarian tax system (such as simpler electronic filing for tax returns and extending online services for taxpayers). However, according to the World Bank's Paying Taxes 2014 report, the time needed to comply with tax obligations for Hungarian businesses is still the 4th longest in the EU.. Hungary still suffers from widespread tax non-compliance with an elevated level of undeclared work. With the standard VAT rate at 27 %, i.e. the highest in the EU, the exposure of Hungary to non-compliance is particularly high. In a recent CASE-CPB (2014) study, the VAT gap (i.e. revenue shortfall compared to the theoretical tax liability) is estimated at around 25% of the total tax liabilityor around 3% of GDP) for 2011 and 2012 (clearly above the EU average, but broadly in line with regional peers). According to the IMF (2013), VAT fraud amounts to 1¾% of GDP.

Recent tax measures as well as the package of tax amendments adopted in November have reinforced the overall design of the tax policy carried out since mid-2010. The authorities confirmed again to the Commission mission team that sector-specific taxes are to be considered as a permanent feature of the Hungarian revenue structure and on the account that many of them are in reality consumption taxes, they downplayed their negative effects on investors' perceptions and on the business environment. Already in June, a new progressive tax on advertisement revenue was adopted with a revenue impact of less than 0.05% of GDP.[24] In September, the law on mortgage settlements offered a small compensation for banks: some 0.05% of GDP a year could be recouped from their corporate taxes from 2015 for several years (while the related losses are estimated to be over 3% of GDP, see section 4 for details). Subsequently, revenue side steps adopted in late 2014 brought about new sector-specific burdens (increase in the retail supervisory fee, healthcare contribution of tobacco manufacturers). It was difficult to argue against the fact that these measures may deteriorate further perceptions regarding the business environment.

The recently adopted revenue increases are estimated both by the Commission and the government to altogether yield to around 0.1% of GDP in 2015. It includes the following main elements: (i) a very substantial increase in the supervision fee paid by the retail companies[25]; (ii) the tax on unhealthy products was extended to alcoholic goods; (iii) the coverage of environmental product fees was broadened; (iv) introduction of a new one-off extra tax on tobacco producers with a steep progressive schedule. It is worth recalling that the original proposal tabled to the Parliament targeted higher revenue increases by around 0.2% of GDP. [26] However, first, following strong protests, the foreseen extension of the telecom tax

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0.45% of GDP and covers close to 900 000 employees; the largest subgroup is the one with people over the age of 55 with a share of around 40%.

24 A recent amendment increased the top rate of this tax from 40% to 50% from 2015. It is reported that only one taxpayer belongs to this category, RTL, the largest television channel in the country.

25 It should be noted that the full-year effect of this measure (around 0.1% of GDP) will be realized only starting from 2016 as the first half-a-year instalment of the fee in 2015 still will be paid on the basis of the previous lower rate.

26 It should also be highlighted that the planned doubling of the family tax allowance in case of two children will be phased in in four linear steps between 2016 and 2019 (with a total cost of 0.15% of GDP), and not immediately from 2015 as was previously contemplated.

to online data traffic (with an originally planned yield of some 0.05% of GDP) was withdrawn. Second, the proposed tax increase for the benefits in kind was significantly watered down during the legislative debate. As regards the financial transaction duty, the taxation of credit cards was changed into a flat annual fee, which is to be welcomed as it would help the further spread of electronic payments.

Tax compliance is improving mainly thanks to the online connection of cash registers. By end-August 20014, the introduction of online cash registers was basically completed with some 180 000 units. Based on the cash-flow VAT receipts, it appears that starting from this year around 0.3% of GDP additional revenues could materialise linked to the new system and to its whitening effects (based on VAT declarations, revenues from the most affected sectors were increased by ca. 15%-20% year-on-year in the first half of the year). During the mission, the authorities explained that further measures are foreseen to combat tax fraud and to increase VAT compliance. In particular, this includes (i) a new real-time monitoring system of the transport of VAT liable goods; (ii) the extension of the requirement for online cashiers to a number of market services, including e.g. health-care, and hairdressing; (iii) the changes of the reporting system of VAT tax returns making it more frequent. Altogether the 2015 budget incorporates an extra revenue of 0.3% of GDP due to these measures, which assumption was, however, highlighted to be a risky one by Commission officials.

3. FINANCIAL MARKETS AND MONETARY POLICY

Financial market conditions deteriorated during the first phase of the PPS (in 2011), but have gradually improved since 2012. The entire PPS period (2011-2014) was characterized by very benign liquidity conditions in international financial markets and Hungary benefitted from a global search for yields. However, the perception of Hungary's country risk initially deteriorated, partly due to the country's accumulated imbalances, its unorthodox policy responses and the sovereign debt crisis in the EA. The mix of these factors led to high financial market stress in late 2011 and the situation was brought under control by requesting (a precautionary) EU/IMF assistance. While the programme negotiations dragged on, both the external and domestic environment stabilized and no new programme was finally agreed. The forint's exchange rate and yield spreads to the EA broadly reflected these developments, also influenced by MNB's policy easing from mid-2012 and by rising geopolitical tensions in the region from late 2013. International reserves peaked close to EUR 39 bn in late 2011 and have hovered broadly around EUR 35bn since early 2012, at a level two times higher than the average of the 2006-2008 pre-crisis period. Fluctuations were mainly due to major sovereign debt management steps, including the early repayment in 2013 of the IMF loans from the previous programme, and to the uneven payments of EU funds.

Monetary policy, conducted within an inflation targeting framework, has been loosened significantly since 2012, in view of weak underlying inflation pressures and a negative output gap. Monetary policy was relatively tight in the early PPS period, mainly to contain excessive financial market volatility. Faced with accelerating energy and food price inflation, the MNB then increased its main policy rate in three successive 25 bps steps to 6% by January 2011. Thereafter, it kept the main policy rate on hold until late 2011 when in view of escalating financial market tensions, the monetary policy stance was further tightened by two successive 50 basis point hikes in November and December, bringing the policy rate to 7%. Starting from this level in August 2012, the base rate was reduced to 2.1% in 24 steps by July

2014. The long rate cutting cycle was supported by falling headline and underlying inflation, improving financial market conditions and monetary easing by other central banks. In addition to the base rate reductions, the MNB further loosened the monetary policy stance through its Funding for Growth Scheme (FGS), which was introduced as a new instrument, primarily to foster lending to SMEs. MNB, under its new management since March 2013, has become more active in supporting growth and the government's economic policy by designing new instruments, in an environment also characterized by significant undershooting of the MNB's inflation target and by historically low inflation expectations in Hungary.

International reserve coverage of short-term external debt[27] stood at 136% at end-Q2 2014, a considerable increase from the level a year earlier (121%). International reserves were increased by EU transfers and by a public USD bond issuance in early 2014, reaching EUR 34.1 bn at end-November (covering broadly around 60% of M3). As a key part of its 'self-financing programme' announced in April 2014, the MNB transformed its two-week bills into a deposit facility from August 2014.[28] As further elements of the self-financing programme, the MNB also announced a new forint interest rate swap (IRS) facility and the possibility of other liquidity-providing measures to encourage banks to buy more government securities.[29] The self-financing programme was successful in encouraging banks to invest more in government securities and thereby reducing reliance on external funding. Following the Hungarian Supreme Court's FX ruling of 16 June 2014 and the legislated conversion of households' FX loans (mainly in CHF),[30] the MNB decided to provide the necessary FX liquidity to the banking sector, in order to ensure that the phasing-out of FX loans can occur in a rapid and orderly way, without threatening the stability of the financial system and without significantly affecting the exchange rate of the forint.[31] Looking forward, the economy's strong net external lending position and the conditions of the MNB's new FX liquidity-providing facilities should ensure that international reserves remain at an adequate level, but domestic and external risks should not be underestimated.

As indicated by yields and CDS spreads, the risk perception of Hungary improved from 2013, but the forint was about 6% weaker in December than a year earlier, reflecting the lower MNB policy rate and international tensions in the region. In the first half of 2014, the forint was on average about 3.5% weaker against the euro than a year earlier, amidst the continuation of monetary loosening and uncertainties around the geopolitical crisis in Ukraine. In the third quarter of 2014, the forint was about 5% weaker than a year earlier, but it appreciated by about 2% in October and slightly more in November, partly as a reaction to the MNB's new FX liquidity-providing facilities, some stabilization of the situation in Ukraine and further policy easing in the region (e.g. by the ECB and the NBP). Accordingly,

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[27] At remaining maturity and without intercompany debt − this is arguably the most relevant measure of reserve coverage for Hungary.

[28] Accordingly, the MNB no longer accepts funds from non-residents and does not provide overnight liquidity to banks against their two-week claims.

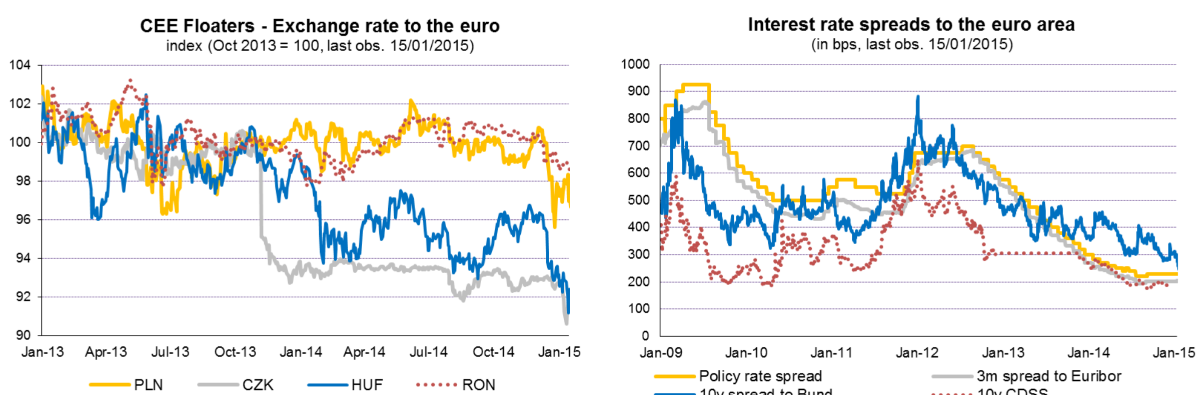
[29] The IRS tenders started in June and the programme size reached some HUF 383 bn by November 2014.

[30] For details, see next section on the financial sector.

[31] The instruments were announced on 24 September 2014 and the tenders took place shortly thereafter. The instruments combine spot and swap transactions thus the foreign currency remains part of foreign exchange reserves until the maturity of swaps. The programme ensures that banks get the FX broadly when they reduce their external liabilities, and as the majority of the new FX instruments has a long-term maturity, the level of reserves reduces only gradually.

the international environment remained supportive for low interest rates in Hungary, despite signs in the autumn that the FED will tighten earlier than expected. Following the ECB's rate cut in September, the short-term interest rate differential vis-à-vis the euro area increased to 230 bps. The 10-year government bond yield declined from 5.6% at end-2013 to 3.3% by early 2015, while the spread to the Bund fell by about 80 bps from end-2013. The MNB's self-financing programme lowered forint yields by channelling funds from the 2-week MNB bill to government paper. After Moody's outlook change in November 2014, Hungary's sovereign credit rating has a stable outlook with all three major credit rating agencies (but the ratings remain below investment grade by one to two steps). The 5-year CDS spread declined from around 255 bps at end-2013 to around 180 bps by early 2015. At mid-January 2015, the Budapest stock market index was some 19% below its level of a year earlier.

Graph 5: Exchange and interest rate developments



** An increase indicates an appreciation of the currency against the euro.*

Source: Bloomberg, Datastream and Eurostat

The MNB completed the rate-cutting cycle started in August 2012 in July, following a cumulative cut in its policy rate by 490 bps to 2.1% in 24 steps. The Monetary Council (MC) scaled back the pace of successive monthly reductions in August 2013 from 25 bps to 20 bps and then to 15 bps in January 2014 and to 10 bps in March. It cut the base rate by 20 bps in July, before announcing the end of the easing cycle. At its November rate setting meeting, the MC reiterated that achieving the medium-term inflation target points in the direction of maintaining current loose monetary conditions for an extended period. The indirect-tax-adjusted core inflation rate reached 1.1% in October 2014 and inflation expectations stabilized at low levels. Markets expect the base rate to remain around its current level till end-2016. Cash in circulation increased by 18% in a year to end-October 2014, partly due to the low inflation environment and to the financial transaction duty which burdens bank transfers. The annual growth rate of M3 rose to 6% in October, while domestic credit to the private sector contracted at a pace of 3% y-o-y.

The take-up of the second phase of the Funding for Growth Scheme (FGS)[32] is gradually picking up and in late October the MNB extended the deadline for signing

[32] In April 2013, the MNB approved the FGS which was built around three pillars. Pillar 1: granting new loans to SMEs — the MNB offers commercial banks funds at 0 % interest rate, which banks can lend to SMEs at a maximum of 2.5 %. Pillar 2: refinancing of existing loans with forint loans, with interest rates capped at

contracts under the programme until end-2015. In January 2014, leases were added to the FGS and the maximum lending limit was raised from HUF 3 bn to 10 bn. From May 2014, the modalities of the FGS were modified in three respects: (i) to provide longer-term working capital financing (up to 3 years), (ii) the introduction of the possibility of buying out non-performing commercial real estate loans from FGS loans, and (iii) the extension of the deadline for the disbursement of investment loans to mid-2015. In September, financial leases and loans for pre-financing EU-funded projects were also added to the latter group and in October the draw-down period for these loans was extended to mid-2016. The total amount of contracts submitted to the MNB from the second phase of the FGS reached about HUF 509 bn (1.6% of GDP) by end-November 2014. In response to the recent acceleration in its take-up, the Monetary Council decided on 2 September to increase the size of the second phase of FGS by another HUF 500 bn to HUF 1000 bn.

Following the adoption of its 'Statute' by its management in May 2014, the MNB has launched alarge social responsibility programme, so far donating about 0.85% of GDP to its new foundations. These six foundations deal mainly with economic and financial research and education, including the development and support of the Hungarian economic science. According to a press interview with Governor Matolcsy[33], the MNB required that over the long-term, the foundations invest the donated funds into Hungarian government bonds and they use only the proceeds to finance their activities. The MNB may also buy art, as part of its social responsibility strategy. In addition, the MNB has purchased some real estate to ensure its medium-term accommodation and for the purposes of education, training and welfare services. According to the same interview, the MNB's Board approved a total amount of HUF 90 bn (about 0.3% of GDP) for buying and renovating such real estate, but the Governor has also mentioned that the recently bought office building was a 'business investment'. The Commission mission team cautioned that these activities may raise concerns regarding their consistency with the MNB's monetary policy mandate. The financing of the foundations without generating a loss in the short term is made possible inter alia by realizing FX gains on the international reserves. The Commission mission team also pointed to potential future impact on the general government budget.[34] The well over HUF 100 bn FX gains related to the household FX loan conversion[35] in late-2014 made it possible to switch

2.5 %. Pillar 3: decreasing the outstanding amount of two-week MNB bills by 20 % to reduce Hungary's gross external debt. In the first phase of the FGS, HUF 701 bn were utilised (of a total available of HUF 750 bn), out of which HUF 290 bn (1 % of GDP) was recorded as new credit; the rest was used to refinance debt (of which HUF 229 bn was denominated in foreign currency). After the first phase, the FGS was expanded to a maximum potential size of HUF 2.75 trillion (i.e. close to 10 % of GDP or two thirds of the 2012 SME loan stock) running until end-2014. However, as a first step a HUF 500 bn envelope was announced in the second phase, where only 10 % of loans could be used for refinancing. After the announcement of swap tenders related to the new two-week deposit instrument, from 1 July 2014 the central bank finally closed the third pillar of the FGS.

[33] See: http://vs.hu/gazdasag/gazdasagpolitika/matolcsy-elarulta-sajat-kozgazkepzest-epit-az-mnb-200-milliardbol-0828

[34] According to the MNB law, the central budget is obliged to recapitalize the MNB in the following year, if it has a negative equity (including equalisation reserves, if their balance is negative). On the other hand, in the new 'Statute' the MNB management made an explicit commitment that it aims to operate the MNB without a need for budgetary recapitalisation.

[35] On 9 December, Governor Matolcsy announced that the precise number of the concerned FX gains was HUF 136 bn.

the MNB's international reserve accounting into a fully accrual-based one without creating a massive one-time loss.

4. FINANCIAL SECTOR POLICIES

The Hungarian banking sector faced heavy headwinds during the entire post-programme surveillance period. The sector's profitability was on average negative though noteworthy polarization among banks could be observed. The level of profitability is significantly affected by the highest tax burden in the EU (mainly the levy on financial institutions based on their 2009 balance sheet in place since 2010 and the financial transactions duty introduced from 2013), a number of government support schemes aimed at foreign currency borrowers and high and worsening levels of non-performing loans (NPLs). The weak level of economic activity over the past 4 years, the less appealing and more volatile operating environment and in general low profitability compared to neighbouring countries (the average ROE in the sector is close to nil in Hungary in contrast to double-digit in Poland) have encouraged foreign parent banks to curtail funding (mostly deposits, loans and securities) to their local Hungarian subsidiaries. And while the same parent banks have abundantly provided capital (over EUR 2.4 billion since 2009) to keep their Hungarian business in line with local and international capital and liquidity rules, they have deleveraged from Hungary at a heavy and sustained pace (almost 6% per year on average). The current loan-to-deposits ratio is now approaching 100%, down from a peak of 155% in December 2008. The impression persists that the Hungarian financial sector is increasingly difficult for foreign lenders and that the authorities welcome either the exit or a major consolidation between some of the foreign-owned banks. Over the length of the post-programme surveillance period, two foreign groups have indeed sold their local Hungarian franchise or stakes in local banks to the State, which has now become the most active buyer in that business segment as it is targeting a dominant, over 50% domestic ownership in the sector. Nonetheless, the default strategy for most foreign lenders is to remain invested in Hungary as their group strategy attaches great importance to broad presence in the region. As to the progress made with financial regulation, Hungary swiftly implemented Directive 2014/59/EU on the resolution of credit institutions and investment firms, thus increasing the prudential adequacy and guaranteeing the safe functionning of the banking sector This law provides for early intervention and resolution tools for use by the MNB as the resolution authority designated to manage credit institutions and investment firms that are failing or likely to fail.

The conversion of foreign exchange-denominated (FX) loans to forint may mark the end of a difficult period in the recent history of Hungarian banking, although the related settlement process will entail sizeable costs. Over the entire duration of the post-programme surveillance, the authorities and banks struggled to find a common base of understanding on some of the key issues pertaining to the financial stability of the local banking system, one of them being the problem of the stock of FX loans. The recent conversion of FX loans is a follow-up to a long series of initiatives pursued by the authorities to ease the burden on concerned loan holders. FX loans were the flagship product of many Hungarian banks during the pre-crisis boom years benefitting from low interest rates compared to HUF denominated loans. When the financial crisis hit Hungary in Q4 2008, almost 70% of the retail loan portfolio was already denominated in Swiss francs, euro or Japanese yen, the highest percentage in central Europe. Since 2011, the government has launched several FX support schemes. While almost all these initiatives were directed to FX loan holders, they failed to target fully the most vulnerable debtors and dramatically increased moral hazard among retail borrowers expecting a better and more generous scheme

to come. Moreover, the moratorium on residential evictions and foreclosures, practically permanent since summer 2010, has been another source of moral hazard and increased the burden of NPLs in banks' balance sheet. The latest initiative to convert literally all FX loans in the retail segment - using the central bank's official exchange rate on 7 November - coupled with a settlement scheme is the opportunity for the government and the banks to start a more constructive relationship going forward. The settlement scheme follows the June 2014 uniformity decision of the Supreme Court and requires banks to compensate borrowers for abusive terms of their loan contracts – mainly unilateral interest increases and abusive margins on FX denominated loans. The scope of the Supreme Court ruling was extended in the government legislation to cover all retail loans, denominated both in local and foreign currency and includes claims by borrowers for the past ten years. The related gross costs estimated by the MNB to be between HUF 900-1000 bn, the equivalent of about 3% of GDP or about one third of the capital base of the sector. (Provisioning for the major part of losses were provided for already in 2014.) In addition, both these initiatives represent a major organisational and IT challenge[36] for Hungarian banks.

Net lending flows to the corporate sector turned positive in some quarters in 2013 and 2014, but market-based corporate lending is still not improving. Lending to non-financial corporations showed signs of revival in the second half of 2013, and again in Q2 and Q3 2014, following the allocations of the Funding for Growth Scheme (FGS). During the third quarter of 2014, the utilisation of the second FGS phase increased to nearly HUF 400 bn bringing the total value of loans under the scheme to HUF 1,140 bn in over 16, 000 loan contracts. However, market-based corporate lending still does not show any significant improvement as unaudited Q3 figures confirmed a negative (2% y-o-y) growth of the corporate loan stock. The extension till end-2015 and increase of the FGS credit facility is expected to further support lending to the SME sector. From a financial stability perspective the lending rate should be tightly linked to the policy rate increased by the risk premium to curb excessive risk-taking by banks and to reduce misallocation of capital. While targeted support schemes are being promoted in many countries across the EU, mostly to address market failures, it is important to keep the current scheme time bound and well-targeted, and to recognise its embedded fiscal cost.

Portfolio quality remains a problem for most banks. At the end of June 2014, 22.3% of the loan portfolio was past due (compared to 23.9% at the end-June 2013). The ratio of loans past due by over 90 days to the total of credit of institutions operating as joint-stock companies was 14.4% while that of cooperative credit institutions was 16.2%. The NPL indicator (90 days plus) in the household sector stood at 18.8%, while this ratio in the corporate sector dropped to 16.8% from around 19% a year earlier. The coverage ratio of non-performing loans remains relatively high (close to 60%) in international comparison. Nevertheless, the high share of restructured loans (at 17% of the total portfolio in Q2 2014) raises questions regarding the true quality of the loan portfolio, especially given that over 44% of restructured loans become problematic again. Given that provisioning rules remain relatively loose, the coverage ratio behind restructured loans is relatively low[37]. Efficient

[36] The complicated calculation method prescribed by the MNB also entails further significant IT costs for banks as they need to recalculate loan values and payments for some 1.3 million borrowers.

[37] International best practices call for the restructured loans to continue to be classified and provisioned as non-performing and a NPL should be restored to performing status after all arrears are settled and the borrower is expected to be able to service all future principal and interest payments on the loan. In Hungary most NPLs

portfolio cleaning is hindered by the lack of a market for purchasing receivables, particularly in the case of project loans, the virtual lack of foreclosures and weak efficiency of in-court and out-of-court resolution proceedings: the average time to settle disputes is high in international comparison, while the expected recovery is low. Corporate and retail loans have a similar weighting in the banks' aggregated balance sheet accounting for about 45% and 47% of the banks' total loan portfolio, respectively. However, banks, on average, have a relatively high exposure to the commercial real-estate and construction sectors, as well as trade and manufacturing segments, which account for close to 70% of all corporate loans or 30% of total loans. The commercial real estate part of the loan book accounts in total for nearly half of all distressed corporate loans. Foreign-exchange indebtedness of households is still the major reason behind the high share of non-performing credit. This reflects the weak economic situation of the country since the start of the financial crisis, as well as the fact that most of the FX relief schemes adopted so far have not been targeted towards distressed borrowers. The practice of repeated introduction of new foreign exchange relief schemes deteriorated the payment culture[38] among Hungarian borrowers in the recent past. The only programme targeted to distressed borrowers was the National Asset Management Fund, which aims to purchase around 25 000 dwellings owned by distressed borrowers. However, the scheme's target falls short of the number of flats owned by problematic borrowers, which is assessed at about 150 000. The above mentioned FX scheme will reduce total debt of FX borrowers by an approximate 16% on average, which according to most banks will not restore the solvency of most FX and forint loan holders. The problem of NPLs will therefore most probably remain unresolved.

The recently launched plan of the MNB to establish an Asset Management Company (AMC) requires careful consideration and raises a number of concerns. More specifically, establishing an AMC within the perimeter of a central bank would be a unique format within the EU, as central banks usually refrain from directly financing 'bad banks' or AMCs tasked with managing non-performing, highly illiquid and impaired loan portfolios and foreclosed collaterals. This calls for a cautious approach considering that similar structures were created in other EU countries with the participation of the governments and private investors. To this end, the European Central Bank and the European Commission are in discussion with the Hungarian Central Bank in order to avoid the potential breach of relevant Treaty provisions. The pricing of the assets could involve a state aid element for the participating banks which would then require an examination and approval process by DG Competition. Despite the ongoing discussions with EU institutions and open concerns, the Central Bank has already set-up a corporate entity with management and identified the desired portfolio. While bad banks can contribute to portfolio cleaning and credit growth, the benefits need to be clear for all stakeholders and fair terms should be offered for all banks under a very transparent process. In addition, potential fiscal risks of state-financed schemes, even if executed within the MNB, should be duly taken into account. Removing the various impediments hindering portfolio cleaning, along with the introduction of a an appropriately designed personal insolvency framework that avoid creating moral hazard would help accelerate the clean-up of banks' distressed assets portfolios and curb the evergreening of loans.

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are restructured several times (a process called evergreening) and most provisions are released once the NPL has been restructured. See also IMF (2014) on best practices in loan loss provisioning.

[38] Based on MNB (2013), some 25% of the respondents who did not apply for the exchange rate cap system said that they are waiting for a new and better scheme.

High system-wide capital buffer will come under pressure from compensation charges to borrowers. Banks have maintained and built up a considerable capital buffer. Due mostly to repeated capital increases of foreign banks (EUR 4.6 bn since 2009), the aggregate levels of capital have reached a record high level of 19.5% in Q1 2014. The ratio deteriorated in the second quarter mainly as a result of the inclusion of negative interim results in own funds. The average capital adequacy ratio by the end of June was 17.4% with all banks registering values above the minimum 9% as most banks accumulated high levels of own funds expecting losses associated with the high compensation payments to retail borrowers and FX conversion. In addition, Pillar II supervisory requirements related to individual risks of banks also called for high capitalisation level of banks. Banks' short-term liquidity (mainly available in forints) is also adequate at more than twice the regulatory requirement. Under stressed conditions the liquidity surplus of banks also exceeds the regulatory minimum, while capital needs are very limited. However, the persistence of banks' negative profits represents a risk to financial stability. The banking sector's total loss for the first half of 2014 amounted to HUF 278.8 bn, including a profit of HUF 76.8 bn for Q1 2014. This is a major setback compared to H1 2013 when the sector registered a profit of HUF 57.2 billion. Losses are mainly generated through provisions set aside for expected losses due to the ongoing settlements with borrowers. Hungarian banks remain persistently the worst performers in the region, which heavily impacts the ability of the sector to attract foreign capital and funding, while the capacity to generate capital on domestic business is nil. The focus of some lenders is shifting towards cost savings measures, which can be achieved through cutting operating costs.

The State has extended its direct ownership in the Hungarian banking sector, which is not without some inherent risks. Following the acquisition of minority stakes in two minor lenders (Széchenyi bank and Gránit Bank) in 2013, the State purchased MKB from Bayerische Landesbank in July 2014 and recently signed a pre-agreement with GE Capital to purchase Budapest Bank, the smallest of the top eight Hungarian banks (the latter transaction is foreseen to be completed by mid-January 2015). MKB is one of the largest commercial banks (the fifth largest in total assets) in the country exposed to significant losses originating mainly from the real estate (RE) and commercial RE loan portfolio. Recently, in September 2014, the State, through the Hungarian Post, also purchased 49% in FHB Commercial bank. In the medium run, the state-owned financial institutions would comprise the Hungarian Post with its 2700 outlets, the restructured system of savings associations with 1600 branches and the Hungarian Development Bank Group (HDB). Although the government's strategy is to sell its stake in the newly nationalised institutions, this increasingly large ownership in the banking sector has the potential to expose public finances to a contingent liability as evidenced in many countries during the recent financial crisis. This risk was underlined by the early December 2014 bankruptcy of Szechenyi Bank, whose credit stock has reportedly close to tripled over the last 18 months (i.e. following the state purchase of a minority stake) but operated with serious irregularities. The State has probably lost all of its capital injection of HUF 3 bn in about 1.5 years, already putting some strain on public finances. MKB, which was acquisition by the State was officially completed in September 2014, was placed under resolution in just three months' time, on 18 December 2014.

5. ASSESSMENT OF REPAYMENT CAPACITY

The sovereign bond market proved rather resilient amid heightened economic and geopolitical risks. Sovereign financing conditions remained relatively stable during the recent months despite a worsening global outlook and intensified geopolitical tensions,

allowing for larger issuances, especially for longer maturities, at historically low yields. Debt managers emphasised that the central bank's self-financing programme contributed to an important extent to this healthy situation: since its April 2014 announcement the local banking sector increased its holdings by ca. HUF 700 bn (well over 2% of GDP), while the amount of securities held by foreign investors is roughly at the same level, which was observed at the beginning of the year (for the most part of the year, it was below that level by around HUF 200 bn).While yields on the longer end remained broadly stable (average yields for 10Y paper stood at 4.4% in October 2014), the shorter end yields decreased by on average 110 basis points compared to July 2014 (3Y domestic T-bonds are at 3.0% in October 2014). Even though S&P and Fitch changed their respective outlook from negative to stable over the recent months on the back of better growth prospects, fiscal discipline and decreasing external vulnerabilities, all three big rating agencies (S&P's/Moody's/Fitch) confirmed the non-investment grade (speculative) for the country, both for foreign currency debt (Ba1/BB/BB) and domestic currency debt (Ba1/BB/BBB-) respectively[39], citing, inter alia, the government's policy mix, the relatively high public and external indebtedness as well as the FX exposure of the country as constraining factors for medium-term prospects.

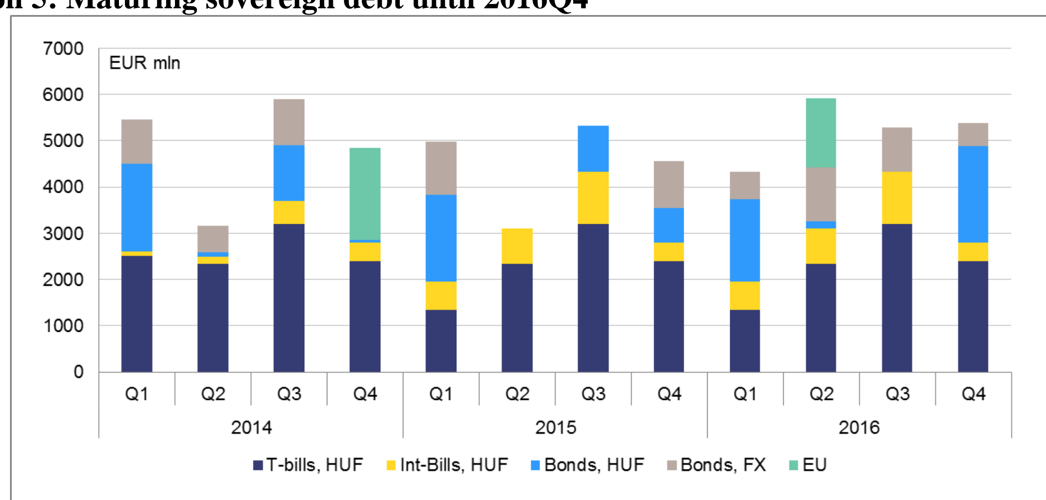
Based on the revised 2014 financing plan (AKK, 2014), the total gross HUF issuance of government debt is set to total HUF 7,920 bn (EUR 25.7 bn) and exceeds the original yearly plan by over HUF 1,000 bn (EUR 2.5 bn). In its updated financing plan for 2014, the State Debt Management Agency pencilled in FX issuance of EUR 3.6 bn, of which Hungary has raised only some EUR 2.1 bn (with an USD 3.0 bn benchmark dollar bonds in March). The difference was made up by decreasing the size of the state FX buffers as well as increased HUF issuance. This accelerates the realisation of AKK's funding strategy, which aims at replacing FX debt by domestic currency issuances if market conditions permit, and thus reducing the still high share of FX sovereign debt. In the last quarter of 2014, however, the State Debt Management Agency already cut back the size of primary auctions, leading to an overall reduction in net issuances on the domestic market. In this context, the authorities confirmed their intention to decrease the debt ratio through a reduction in the end-year cash-buffer (by some 0.7-0.8% of GDP), which would imply considerably lower total gross issuance than contained in the revised financing plan (see also the discussion on debt developments in Section 2.1.)

Hungary faces declining but still substantial financing needs which are expected to amount to18.6% (EUR 19.7 bn) in 2015 and 18.5% (EUR 20.6 bn) in 2016. This poses demanding challenges in international comparison: according to the IMF (2014), Hungary has the third highest sovereign financing need among the surveyed emerging and middle income economies. The above estimates are based on cash deficit projections derived from the Commission's 2014 Autumn forecast and the assumption of a complete roll-over of short-term debt. These gross figures include total FX repayment needs of around 2.2% and 5.0% of GDP (ca. EUR 2.3 bn and EUR 5.6 bn) in 2015 and 2016, respectively. A noteworthy item is the repayment of the last instalment of the EU balance of payment assistance (EUR 1.5 bn) in Q2 2016.

[39] The only exception is Fitch's rating for domestic currency debt.

The tentative annual financing plan for 2015 does not foresee any tapping of international private markets in 2015.[40] It implies that around EUR 1.9 bn maturing FX debt out of the total EUR 2.4 bn will be refinanced fully from HUF sources, as around EUR 0.5 bn could plausibly be expected from the sale of euro-denominated special securities (PEMÁK and residence bonds). Following three successive years of stepping up the retail securities programme (this stock more than tripled from around HUF 750 at end-2011 bn to HUF 2350 bn by end-October 2014), some moderate net increase could still reasonably be expected from this channel for 2015. Overall, debt managers were confident that based on the further roll-out of the self-financing programme, the foreseen switch to HUF issuances was feasible, barring a major turbulence in market conditions. It will lead to an accelerated reduction of the FX share in public debt (potentially close to a pre-crisis level of around 30% by 2016), but as a trade-off, the exchange rate loss linked to the recent years of depreciation of the forint will be realised. Looking ahead, AKK officials saw no meaningful risk over the horizon around the above-mentioned repayment of the final instalment to the EU due in April 2016.

Graph 5: Maturing sovereign debt until 2016Q4



Source: Bloomberg, European Commission

In the third quarter of 2014, financial buffers of the government stood at a comfortably high level, currently at 7.4% of GDP (2013 average: 6% of GDP). Starting in 2013Q3, the FX component has been substantially reduced, while the HUF component has been more than doubled. In addition, the high level of FX reserves of the central bank provides an additional safeguard against liquidity shocks and other funding risks. Moreover, the lower share of the FX buffer partly results from the modified funding strategy of the government which aims to replace FX funding with HUF issuances. However, the government targets to reduce sovereign debt with an end-of-year cut in state cash deposits.

[40] Indeed, the preliminary 2015 financing plan published on 18 December 2014 confirmed these intentions: no FX bond transaction is foreseen for 2015, while the bulk of the net issuance would come from long tenure HUF bonds (HUF 1126 bn, or ca. EUR 3.6 bn).

Table 3: Financial buffers of the government

	EUR bn (end of period)			% of GDP		
	2013Q3	2014Q2	2014Q3	2013Q3	2014Q2	2014Q3
MNB depo	3.1	7.3	6.5	3.1	7.2	6.4
-of which FX	1.2	0.8	1.0	1.2	0.8	0.9
pension fund (less liquid)	0.6	0.0	0.0	0.6	0.0	0.0
Total buffers (narrow)	3.7	7.3	6.5	3.7	7.2	6.4
MOL (less liquid)	1.4	1.0	1.0	1.4	1.0	1.0
Total buffers	5.1	8.3	7.5	5.1	8.2	7.4

Source: MNB, AKK, MOL

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Annex 1: Commission press statement (issued on 2 December 2014)

Commission staff concludes the sixth Post-Programme Surveillance mission to Hungary

Following the conclusion of the 2008-2010 EU balance of payments assistance programme in November 2010, European Commission staff conducted a sixth and possibly final post-programme surveillance mission to Hungary from 25 to 28 November 2014 to review recent economic and financial developments and policy initiatives.

The mission welcomed the fact that on the back of a strong economic recovery, Hungary recorded one of the highest GDP growth rates in the EU over recent quarters (well over 3% year-on-year). Nevertheless, the high growth is partly due to the substantially increased absorption of EU funds at the end of the seven-year programming cycle. In addition, other short-term stimulus measures (such as the Hungarian Central Bank's Funding for Growth Scheme, cuts in regulated utility prices as well as the continued expansion of the Public Works Scheme) also contributed to the growth performance. The expected abatement of the bulk of these stimulus measures is reflected in the projected decelerating growth path included in the Commission's 2014 autumn forecast for the years beyond 2014.

The mission concurred with the authorities that Hungary was on track to achieve this year's deficit target of 2.9% of GDP. Nevertheless, it stressed that government debt is not yet on a firm downward path and that based on the Commission's 2014 autumn forecast, the projected pace of debt reduction appears at risk of breaching the requirements of the Stability and Growth Pact. Looking ahead, while the government's decision to lower the deficit target for 2015 is welcomed, the mission emphasised that there were important concerns regarding the substantiation of a number of revenue-increasing measures contained in the 2015 draft budget. The sustainability of the fiscal adjustment would benefit from the further reinforcement of fiscal governance, as recommended by the Council, most notably through the decisive introduction of the already legislated medium-term budgetary framework.

Restoring a normal operation of financial intermediation is essential to revive growth in a sustainable manner. This requires improving banks' capital accumulation capacity along with an enhanced portfolio-cleaning effort. In the light of the progressively increased tax and regulatory burden on the financial sector, the advocated policy adjustment should include a reduction in this burden to bring it more in line with the European average. The mission took note of the recent series of laws on the settlement and subsequent phasing-out of foreign-currency mortgages, and in that respect emphasised the importance of a consultative approach and of an appropriate burden sharing for the final phases of the process, also with a view to mitigating moral hazard. In that respect, measures that hinder the resolution of long-term non-performing loans, such as the moratorium on foreclosures, could be gradually lifted in parallel with government assistance to the most distressed borrowers. The mission also strongly invited the MNB (Magyar Nemzeti Bank), the Hungarian Central Bank, to ensure that its recently launched asset management company initiative will be in full compliance with EU Treaties. Furthermore, it was highlighted that a substantial state ownership in the banking sector has the potential to expose public finances to a contingent liability, as evidenced during the recent financial crisis.

More generally, the mission underlined that the current cyclical upturn should be seized as an opportunity to pursue structural reforms along the lines of the 2014 country-specific recommendations, in order to lift Hungary's still relatively low growth potential. In this context, the mission called for ensuring a stable and more balanced corporate tax system, and regretted that the reliance on sector-specific corporate taxation had even been further increased with the recent adoption of new targeted taxes. Moreover, the mission identified a clear need for more predictable and competitiveness-oriented policies, in particular by removing entry barriers in the service sector.

In the context of rapid improvements in external indebtedness, albeit declining from a very high level, financing of the sovereign has been smoothly ensured as the local bond market was characterised by healthy demand and historically low yields. With the EUR 2 billion repayment of the second tranche of the EU balance of payments loan in early November, Hungary has repaid over 70% of the originally disbursed amount; the legal requirement to automatically continue with post-programme surveillance has thus expired. Therefore, the Commission, after having consulted the Member States, will decide in the coming weeks about the possible end of its post-programme surveillance. After the post-programme surveillance process, it will nonetheless be essential to continue with the implementation of structural reforms and achieve fiscal and financial prudence, elements which will be monitored through the European Semester framework.

Annex 2: Debt sustainability analysis: Methodology and assumptions underpinning debt scenarios and sensitivity tests

Deterministic debt projections are run in the debt sustainability analysis (DSA) under the following scenarios:[41]

1) A baseline no-fiscal policy change scenario, relying on Commission forecasts, the EPC agreed long-run convergence assumptions of underlying macroeconomic variables (real interest rate, real GDP growth,[42] inflation rate) and the assumption of constant fiscal policy (i.e. constant structural primary balance, SPB, at last forecast value) beyond the forecast horizon. The cyclical component of the balance is calculated using standard country-specific semi-elasticity parameters,[43] and the stock-flow adjustment is set to zero beyond forecasts. This scenario incorporates implicit liabilities related to ageing.

2) A no-fiscal policy change scenario without ageing costs, which differs from the baseline no-fiscal policy change scenario only for the exclusion of age-related implicit liabilities (the comparison between the two scenarios allows assessing the impact of the cost of ageing on projected debt developments).

3) Historical scenarios (which incorporate age-related costs) consisting of:

    i. A historical SPB scenario relying on Commission forecasts and the assumption of gradual (3-year) convergence of the SPB to last 10-year historical average beyond the forecast horizon, while all other macroeconomic assumptions remain as in baseline scenario (1);

    ii. A combined historical scenario relying on Commission forecasts and the assumption of gradual (3-year) convergence of the main underlying macroeconomic variables (SPB, implicit interest rate, real GDP growth) to last 10-year historical averages beyond the forecast horizon.

4) A Commission Stability and Growth Pact (SGP) institutional scenario, where for countries under excessive deficit procedure (EDP) a structural adjustment path in compliance with the fiscal effort recommended by the Council is maintained until the excessive deficit is corrected, and thereafter an annual structural consolidation effort of 0.5 p.p. of GDP (or 0.6 p.p. if public debt exceeds 60% of GDP) is maintained until the MTO is reached. For the other countries, the consolidation effort to reach the MTO is centred on an annual improvement in the SPB by 0.5/0.6 p.p. of GDP as of 2014. In this scenario, the usual feedback effect used in the European Commission's Debt Sustainability Monitor's model (a 1 p.p. consolidation effort reducing baseline GDP growth by 0.5 p.p. in the same year) is applied (in the forecast years, this applies to the difference between the forecasted fiscal effort - change in the structural balance - and the assumed fiscal effort - EDP structural adjustment path or benchmark fiscal effort of 0.5/0.6 p.p. of GDP).[44]

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[41] For more details, see European Commission (2014b).

[42] The output gap is assumed to close in T+5.

[43] Estimated semi-elasticity parameters are taken from Mourre G. et al. (2013).

[44] Age-related costs are incorporated also in the SGP institutional scenario.

5) A Stability and Convergence Programme (SCP) scenario, relying on SCPs' macro-fiscal assumptions over the programme horizon and constant fiscal policy assumption (constant SPB at last programme year value) beyond the programme horizon. [45]

Standardized sensitivity tests are run around the baseline no-fiscal policy change scenario to assess the magnitude of the effects that changes in underlying macroeconomic conditions would have on debt dynamics. Sensitivity tests are designed as follows:

1) Standardized (permanent) negative and positive shocks (-1 p.p./ +1 p.p.) to the short- and long-term interest rates *on newly issued and rolled over debt* applied starting from the year following the one of last actual data available till the end of the projection horizon (in the Debt Sustainability Monitor model, these shocks feed into changes in the overall implicit interest rate (IIR), with the size of the change in the IIR depending on the structure of public debt in terms of short- and long-term debt, maturing and non-maturing debt);
2) Standardized (permanent) negative and positive shocks (-0.5 p.p./ +0.5 p.p.) on GDP growth applied from the year following the one of last actual data available till the end of the projection horizon;[46]
3) Standardized negative and positive (permanent) shocks on the inflation rate (-0.5 p.p./ +0.5 p.p.) applied from the year following the one of last actual data available till the end of the projection horizon;
4) A standardized (permanent) negative shock on the primary balance equal to 50% of the forecasted cumulative change over the two forecast years[47] (the structural primary balance is then kept constant for the remaining of the projection horizon at the lower level obtained for the last forecast year after applying the shock of the indicated size);
5) An additional sensitivity test on the exchange rate. The test is run by applying a shock (*for two years* from the year following the one of last actual data available) identical to the maximum historical change occurred in the exchange rate over the last ten years.

Assessment of debt sustainability

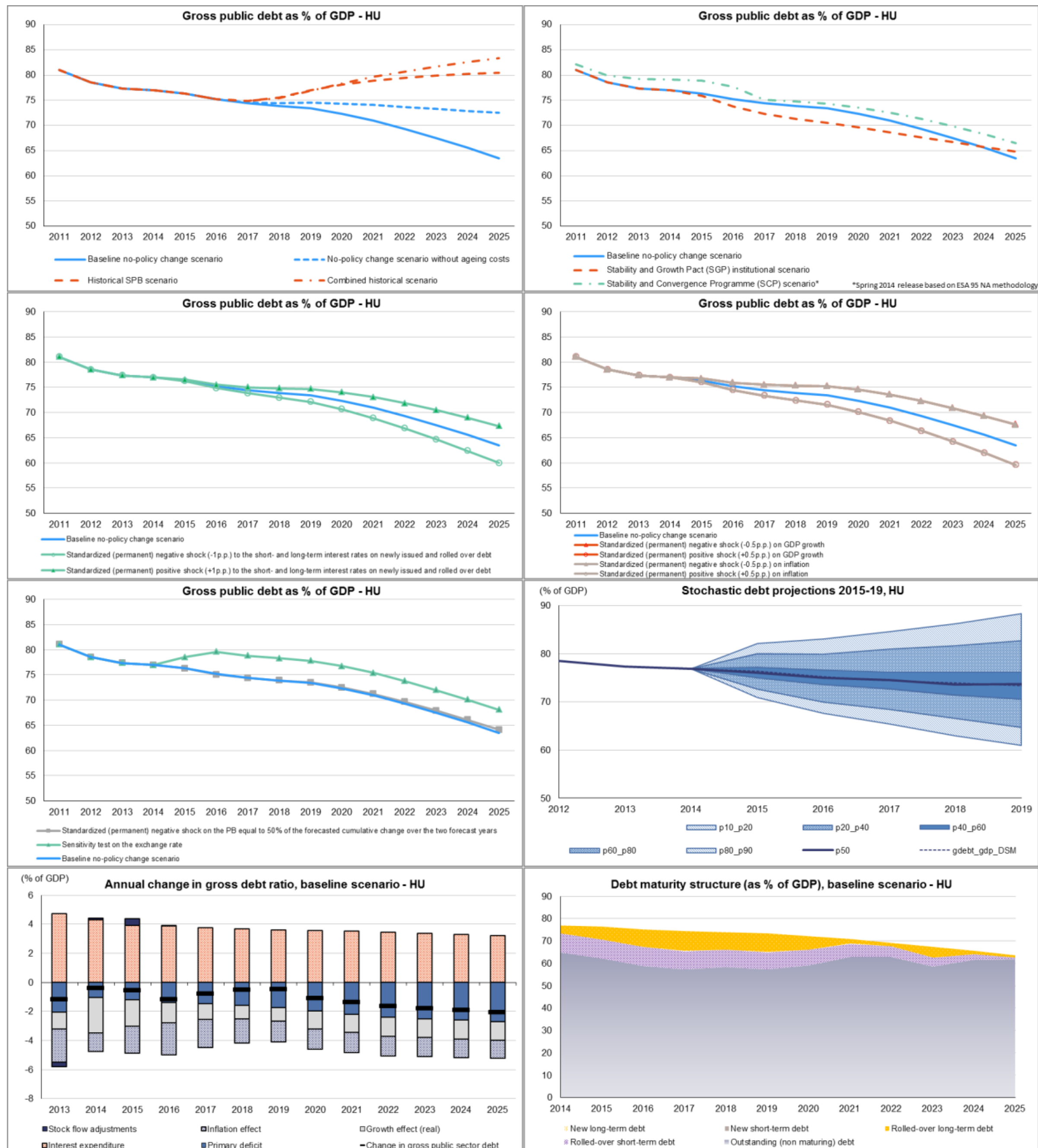
In the baseline scenario Hungary's debt is expected to decline to around 64% of GDP over the next ten years. The improvement is largely driven by saving related to aging (as in recent years several restrictive steps were introduced in the pension system). Nevertheless debt would start to increase if the economy would revert to a historical primary balance or historical scenario. Overall, although keeping the structural primary balance would ensure a steady debt reduction, the pace of this is not robust enough against adverse historical shocks. This is also reflected in the fan chart, which shows a probability greater than 40% that the

[45] Debt projections under the SCP scenario are based on ESA95, given that the SCPs date back to spring 2014.

[46] The shock is symmetrically applied to actual and potential GDP growth, so that the output gap remains unchanged. The cyclical component of the balance is therefore not affected by these shocks to growth.

[47] The usual feedback effect on growth applies in this case (-1 p.p. fiscal consolidation leading to +0.5 p.p. in GDP growth in the same year).

debt will remain above 76% of GDP in 2019. The debt reduction path is particularly sensitive to exchange rate movements as more than 40% of debt is in FX.[48]



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48 Importantly, the debt sustainability calculations do not take into account the recently adopted long-term financial agreement with Russia to fund the construction of a new nuclear power plant. The overall cost of the project is officially estimated to be around EUR 12.5 bn (over 12% of GDP), the realisation is planned to start with a gradually increasing pace from the end of this decade.

Annex 3: Assessment on MIP-related Country-Specific Recommendations

In general terms, Hungary has implemented only limited parts of what has been recommended by the Council in the first years of the EU semester exercise, apart from fiscal consolidation advices. Besides, it has been very vocal in challenging recommendations in areas that it considers falling under its exclusive responsibility (e.g. taxation issues).

During the 2012 EU Semester, the Hungarian tax system was revamped. The tax changes decided in 2011 have negatively impacted low earners and subsequent recommendations to decrease their tax burden (among the highest in the EU) have been completely dismissed. Moreover, the reduced PIT revenues were among the factors inducing the government to raise CIT on a restricted number of sectors, e.g. financial, energy, telecommunications. This distorted allocation of resources and impacted on the overall HU economy competitiveness; repeated Council recommendations to revise the taxation structure of the economy have been outrightly dismissed by the government. At that time, Hungary adopted a cardinal law on economic stability that did not include a binding medium-term budgetary framework (MTBF). Despite further recent regulatory improvements in this field, as of today a binding MTBF is not in place yet.

During the 2013 EU semester, despite substantial progress on fiscal consolidation that allowed a closure of the Hungarian EDP, serious concerns on economic policy prevailed due to a hectic business environment with focus on the efficiency of financial intermediation and on the service sector more in general. Government policies hit the latter especially by restraining competition in certain areas (e.g. waste management, meal vouchers, retail) and by the introducing sector-specific surtaxes (which hit the financial and energy sectors particularly hard). High surtaxes in the financial sector and the high level of non-performing loans in banks' balance sheets made more difficult to accumulate internal capital and hindered incentives to provide credit. During the year, the government had introduced a sizeable new duty on bank transactions (around 0.6% of GDP) adding to the permanent bank levy (0.5% of GDP), i.e. already the biggest tax of this kind in Europe. Government's measures contributed to policy uncertainty and a quick pace of banking sector deleveraging resulting in a historic low investment rate, which have eroded the country's weak growth potential, despite a substantial inflow of EU funds.

Last year EU semester showed, once again, limited progress in addressing the previous country-specific recommendations. In particular, despite the central bank's subsidy scheme for small and medium enterprises, normal (i.e. non-subsidised) lending in the economy has not yet returned. The regulatory burden on the financial sector has further increased contrary to Council earlier recommendations. Household portfolios have continued deteriorating, partly due to the government's continuous communication in the recent past on new foreign currency mortgage relief schemes that contributed to a weakening of the payment culture and to increased moral hazard. There has been only limited progress in reducing the tax burden on low-income earners, as measures only targeted low-income families with children. However, some progress could be observed with tax compliance. Overall, there was limited observable progress in improving the business environment. Although the government has addressed the recommendation on strengthening the judiciary and made strides to reduce administrative burdens, entry costs have further increased in several market segments, particularly in the service sector, where restrictions to competition have increased yet again.

2014 MIP-related CSRs	Plans and Progress
Fiscal policy CSR (CSR1) Reinforce the budgetary measures for 2014 in the light of the emerging gap relative to the Stability and Growth Pact requirements, namely the debt reduction rule, based on the Commission 2014 spring forecast. In 2015, and thereafter significantly strengthen the budgetary strategy to ensure reaching the medium-term objective and compliance with the debt reduction requirements in order to keep the general government debt ratio on a sustained downward path. Ensure the binding nature of the medium-term budgetary framework through systematic ex-post monitoring of compliance with numerical fiscal rules and the use of corrective mechanisms. Improve the transparency of public finances, including through broadening the mandatory remit of the Fiscal Council, by requiring the preparation of regular macro-fiscal forecasts and budgetary impact assessments of major policy proposals.	• Despite a noticeable improvement of the projected debt trajectory since the spring projections, the autumn forecast indicates that the minimal linear adjustment (MLSA) requirement is still expected to be breached in 2014. It should be noted, however, that Hungary would be compliant with the standard debt rule applicable after transition in 2014. The country is already expected to be compliant with the required MLSA in 2015, but only thanks to the allowed margin of deviation. • The autumn forecast shows no improvement in terms of making an adequate progress towards the medium-term objective (MTO) as Hungary is found to be at risk of significantly deviating from its MTO both in 2014 and 2015. While the headline deficit somewhat improved over the forecast horizon, in structural terms this was offset by the faster closing of the output gap than previously estimated. • The adopted 2015 budget (submitted after the autumn forecast) tightens the deficit target for 2015 (by 0.4% of GDP), which in principle could allow an improvement in the structural balance as well as a more secure compliance with the debt reduction rule. However, it is planned to be achieved with the help of significant (and yet to be substantiated) one-off revenues, so that the structural improvement remains in doubt. • The first application of the recently established medium-term planning framework has been repeatedly delayed. No new plans to improve the budgetary framework and to broaden the mandatory remit of the Fiscal Council.
Financial sector CSR (CSR2) Help restore normal lending flows to the economy, inter alia by improving the design of and reducing the burden of taxes imposed on financial institutions. Adjust the financial transaction duty in order to avoid diverting savings from the banking sector and enhance incentives for using electronic payments. Investigate and remove obstacles to portfolio cleaning inter alia by tightening provisioning rules for restructured loans, removing obstacles to collateral foreclosure as well as increasing the speed and efficiency of insolvency proceedings. In this respect, closely consult stakeholders on new policy initiatives and ensure that these are well-targeted and do not increase moral hazard for borrowers. Further enhance financial regulation and supervision.	• Normal lending is still to be restored. Since mid-2013, lending has mainly relied on the MNB Funding for Growth Scheme, which has managed to loosen lending constraints, but cannot substitute for a sound operating environment for banks on a permanent basis. Risks in term of future fiscal costs should be considered when extending the programme further. • The government has not reduced nor permanently modified any surcharges on the financial sector tax. The law on mortgage settlements adopted in September offers a small compensation for banks: some 0.05% of GDP a year could be recouped from their corporate taxes from 2015 for several years. The tax package introduced a flat annual fee for the financial transaction duty on card payments from 2015, thereby contributing to the increased use electronic payment means. • To facilitate portfolio cleaning, the National Asset Management Agency has contracted the purchase of close to its target of 25 000 real estates until end-2014 used as collateral to non-performing loans. For non-financial corporations, the MNB set up an asset management company, primarily aimed at commercial real estates. However, such an initiative needs be in full compliance with relevant Treaty provisions. • Consultation with stakeholders on new policy initiatives has been at best patchy, for example on the recent law implementing a decision of the Supreme Court on FX loans. The ensuing settlements are estimated to result in substantial losses (over 3% of GDP) for the banking sector, that adds up to an already high sector-specific fiscal burden. • The government has already transposed the EU directive on bank resolution, hence responding to this part of the CSR. • The law on fair banking includes relevant prudential tools, however, a careful assessment is granted to evaluate its effect on bank's activities (e.g. the effect of interest rate margins on new loans).
Taxation CSR (CSR3) Ensure a stable, more balanced and streamlined tax system for companies, including by phasing out distortive sector-	• No progress in ensuring a more normative corporate tax regime. In contrast, a number of new sector-specific taxes were introduced with a steep progressive schedule or existing ones were increased.

2014 MIP-related CSRs	Plans and Progress
specific taxes. Reduce the tax wedge for low-income earners, inter alia by improving the efficiency of environmental taxes. Step up measures to improve tax compliance – in particular to reduce VAT fraud – and reduce its overall costs.	• The tax wedge for low-income earners has not been reduced yet and the Job Protection Act eligibility criteria were not revised to specifically address low-wage earners. A doubling in the family tax allowance after two children is proposed to be introduced in four linear steps way between 2016 and 2019 (with a total cost of 0.15% of GDP). • Some steps were made to increase environmental taxes: fuel excises and the energy tax have been raised but the adopted changes to the environmental product fee are questionable in view of green economy goals. The establishment of on-line links to cash-registers for retail outlets has been completed with commendable results in terms of VAT revenues. The authorities are planning to extend the requirement of online registers to a number of market services. A new surveillance system is scheduled to be established from January 2015, which will permit the real-time monitoring of the transport of VAT-liable goods.
Business environment CSR (CSR5) Stabilise the regulatory framework and foster market competition, inter alia by removing barriers in the services sector. Take more ambitious steps to increase competition and transparency in public procurement, including better use of e-procurement and further reduce corruption and the overall administrative burden.	• No barrier in the service sector existing at the time of the 2014 CSR adoption has been removed (e.g. meal voucher, retail, waste management, pharmacies, tobacco, school textbook, mobile payments). • The so-called "plaza stop" law (prescribing ex-ante central authorisation for the construction of retail outlets above 300 sq. m) was de facto prevented the establishment of discount shops until its expiry at the end of 2014. From 2015, this restriction has been made permanent, while only some elements of the legislation were adjusted (most notably, increasing the size of concerned shops to 400 sq. m). • The new legislation on closing down retail companies from 2017 over a set threshold for annual turnover that fail to make profits for two consecutive years is another example for the unpredictability of the regulatory framework. As most domestic-owned chains are structured in a number of smaller (franchising) shops, the regulation does not apply to them and may push out of the market big foreign groups. • A number of measures of the Cutting Red Tape programme were introduced, but the desired impact is – as evidenced by relevant surveys - yet to be felt by businesses. The launch of a new simplification and deregulation programme (State Reform 2) has been announced for 2016. • Low level of competition, transparency problems and direct awards in public procurement persist. E-submission of tenders is possible but hardly used in practice.