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EU BALANCE-OF-PAYMENTS ASSISTANCE TO HUNGARY: THIRD REVIEW UNDER POST-PROGRAMME SURVEILLANCE

Executive summary

On 16-28 January 2013, the Commission services carried out the the third Post Programme Surveillance (PPS) mission jointly with the IMF staff (and with participation of ECB observers). *The discussions during the mission were overall smooth and the purpose of the mission was well acknowledged.*[1] *A precautionary programme (supported by an IMF stand-by and an EU medium term financial assistance) was not the subject of the mission and therefore not discussed. The Commission services encouraged a more pro-active consultation in advance of major policy decisions, in line with the PPS agreement, as well as a positive response to policy advice.*

After a short-lived economic recovery, GDP declined again in 2012 by 1.7%. Stagnation is projected for 2013 followed by a mild recovery with economic growth of above 1% in 2014. *Potential growth seems to markedly lag behind regional competitors and is estimated to barely exceed 0% in the medium term, partly due to a historically low investment ratio (16%) and low productivity. Both institutions expressed concern that potential growth could undermine the sustainable correction of the excessive deficit and the persistent reduction of public debt and that the combination of low growth and high debt keeps the country vulnerable. Economic policies would become more supportive of growth by implementing structural measures along the lines of CSRs.*

The Hungarian authorities explained that fiscal consolidation, decreasing FX exposure and increasing employment had been the key priorities of the government since it entered into power in 2010 and that they had been successful in achieving these targets. *Despite a recession, the fiscal deficit was kept safely below 3% in 2012, FX indebtness of households had been decreased, and employment was increasing by close to 2% in 2012, which was outstanding in a European context. They also stressed that EDP abrogation this year was a top priority of the Hungarian government. Further measures would be announced in the convergence programme if proven to be necessary.*

The Commission services welcomed the recent reduction of the budget deficit and explained that EDP abrogation can only be considered after the spring 2013 forecast based on actual and validated data. *This would require a sustainable correction of the excessive deficit, i.e. a deficit forecast well below 3% for both 2013 and 2014. Moreover, the quality of adjustment was important and should be improved as the sectoral taxes and the uncertainty linked to these and other consolidation measures had a negative impact on growth. On the design of fiscal policy, the Hungarian counterparts justified the very steep increase in sectoral taxes since mid-2010 by the excessive profitability of the targeted sectors before the crisis. At the same time, there was some acknowledgement that the relatively low growth potential required action.*[2]

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[1] Among others, meetings were held with Minister Varga - Minister without portfolio, responsible for contacts with international organisations, Mr. Rogán - head of the ruling parliamentary group, Mr. Pleschinger - State Secretary for Economic Policy in the Ministry of National Economy, Mrs Németh - the Minister of National Development, Governor Simor, the President of the Fiscal Council, the head of the financial supervisory agency (HFSA), the Banking Association and representatives of several major banks.

[2] These might include (1) improving the business environment by strategic alliances with large FDI providers and a new agreement with the banking sector (2) improved SME financing by increasing the activity of Eximbank (3) a reduction of bureaucracy, and (4) new initiatives on the labour market. However, no further details were mentioned regarding these steps and notably how to win over the banking sector after recently reversing the commitment to lowering the burden on it.

In 2012, the State Debt Management Agency (ÁKK) was successful in issuing HUF debt. Total gross sovereign issuance exceeded the original yearly plan by over HUF 1500 bn (around EUR 5 bn). *Despite the lack of progress on a BOP loan programme and of international FX debt issuance, the government was able to redeem its FX obligations by issuing HUF denominated papers and exchanging HUF into FX at the central bank while the level of international reserves only slightly decreased due to a surplus on the current account and EU funds inflows. The global liquidity situation provided a benign environment.*

The refinancing need of the government for the next years is relatively high, at close to 19% of GDP in 2013 and above 20% of GDP for 2014. *This includes FX repayment needs of around 5% of GDP for both 2013 (EUR 3.6 bn or 3½% of GDP of the IMF loan is maturing in 2013 after which the overwhelming part will have been repaid) and 2014 (including the repayment of the second EU loan instalment of EUR 2 bn). The government plans to issue international FX bonds of around EUR 4.5 bn to cover FX redemption needs in 2013. In February the AKK already successfully issued USD 3.25 bn (around EUR 2.4 bn). Stepped up issuance of retail FX bonds (currently close to EUR 1.5 bn) could also be used in FX financing as done for the January 2013 IMF EUR 0.6 bn loan redemption (a few days earlier than due). In addition, as the available financial buffers of the government are relatively high (more liquid assets are around EUR 3.5 billion, but taking also into account less liquid ones close to EUR 7 bn), no major re-financing problems are foreseen barring major adverse shocks in market sentiment.*

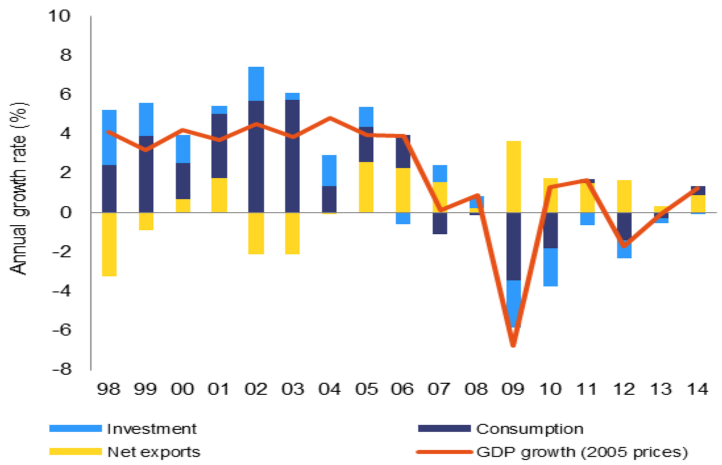
While the financing situation has improved in the second half of 2012, it is still fragile and could be de-stabilised by international or domestic factors. *The presence of foreign investors is dominant in certain market segments, most notably in public debt financing (with a 45% share of HUF-denominated papers and close to two-thirds of the total debt stock). Therefore, a sudden change in market sentiment could not only lead to tensions on government financing, but also to problems on interbank swap markets. In the medium term, the combination of high debt levels, high financing costs and low growth can also be problematic.*

The PPS mission was closed by a press release of the Commission, containing the key messages on the assessment of the economic situation. *It welcomed the government's efforts on fiscal consolidation, but stressed the importance of quality of the fiscal adjustment and the need to lift the growth potential (see Annex 1). The IMF issued a concluding statement with the agreement of the government.*

1. MACROECONOMIC DEVELOPMENTS AND OUTLOOK

After growing by 1.6% in 2011, Hungary's GDP declined by 1.7% in 2012 (with a sharper-than-expected contraction of 0.9% in Q4). The recovery this year is expected to be very contained. GDP is forecast to stagnate in 2013 and to grow around 1 ¼% in 2014, surrounded by balanced risks. The contraction of GDP in 2012 is primarily caused by a large drop in domestic demand, but a substantial slowdown in exports due to a weakening external environment also contributed. Agricultural output was particularly weak due to a drought in 2012, which could point to upward base effects.

Graph 1: External and domestic demand contributions to economic growth



Source: Commission services.

Weak domestic demand is expected to remain the major drag on growth in the next years. Tight lending conditions, economic uncertainty and the ongoing debt reduction efforts of domestic sectors. will hold back investments and consumption, while households' real disposable income is expected to only stabilize in 2013. Although the official growth projections were recently revised down to 0.9% for 2013 and 2% for 2014 (from 1.6% and 2.5% in the 2012 Convergence Programme (CP)), the updated outlook still appears to be too optimistic. The IMF in its concluding statement of the Article IV mission to Hungary (28 January2013) expected stagnation in 2013.[3] The authorities explained that there would be no official growth update before the 2013 Convergence Programme.

[3] See Table 1 for a comparison of available forecasts.

Table 1: GDP growth forecasts

%	2013	2014
Commission, autumn forecast	0.3	1.3
HU government in EDP Progress Report and 2013 Budget	0.9	2.0
Commission, current assessment	*Around 0*	*around 1¼*

Source: Commission services.

Labour market conditions are expected to timidly improve and will remain weak. Final unemployment figures from 2012 show that unemployment remained unchanged in the latest quarters standing at 10.7% in the fourth quarter. The increase in participation is a result of the implementation of several measures adopted earlier such as extending the retirement age, strengthening early retirement conditions, the review of disability pensions and tightening unemployment benefits. While the participation rate is projected to rise further, only a small increase in employment is expected and therefore unemployment might stagnate at two digit levels. One factor behind the weak employment is that firms are assumed to adjust to weaker profitability conditions partly through layoffs. Close to half of the employment increase (80 000 persons in Q3 2012 compared to Q3 2011) might be linked to the government-sponsored public work programme (accounting for an increase in employment by 35 000 persons in Q3 2012 compared to Q3 2011), while the rest is employment gains in the private sector. Employment for firms above 5 employees has been declining, while SME employment improved somewhat. However, based on the Labour Force Survey data, it is not possible to exactly disentangle the evolution of private and public employment as non-profit companies (also partly covered by the Public Work Scheme (PWS)) are also present in non-government sectors such as agriculture or construction.[4] This renders the assessment particularly difficult. Looking ahead, while measures continuously increase the labour supply pool, labour demand is held back by a low level of investment and productivity.

The authorities have a more benign view of the employment outlook compared to international organisations. During discussions, they argued that a large share of the recent employment increase occurred in the private sector (around 1% in 2012) and that this could also broadly be the case in the next years. Despite the assumption of continuous employment increase, even the government's forecasts project unemployment to remain above 10% throughout the forecast horizon due to increasing participation.

A drop in inflation is forecast for 2013 compared to 2012. On top of statistical factors, this drop is due to the cut in regulated energy prices introduced from January 2013 resulting in a 10% price decrease. In addition, inflation figures have been decreased due to a lower and rescheduled timing of excise duty hikes on alcohol and tobacco. Consequently, inflation is expected to slow to below 4% in 2013. Effects of new sectoral taxes are likely to cause spill-over price effects (firms adjusting by changing prices) but to some extent this could be offset by the disinflation effect of the still weak domestic demand and of the phasing out of temporary extraordinary taxes introduced in 2010 (on the retail, telecom and energy sectors).

[4] See section 6.1.2 in the December 2012 issue of Quarterly Inflation Report on this topic.

The current account surplus is estimated to have increased in 2012 to 2% of GDP and is projected to reach around 3% of GDP in both 2013 and 2014. This is partly due to the fact that exports should be further boosted by car industry investments, but it also shows the persistent weakness of domestic demand. Overall, the trade in goods and services balance is improving (and expected to reach above 9% of GDP by 2014). This improvement will be to some extent counterbalanced by the projected increase in the factor income deficit as dividend-type income should move towards its pre-crisis level as the economy slowly recovers. Given that EU structural fund inflows should further increase the surplus in the capital account, net external lending could reach close to 7% of GDP in 2014, compared to the current level of 4% of GDP in 2012.

2. Fiscal developments

In autumn 2012, the Hungarian government renewed its commitment to correct its excessive deficit by the new deadline of 2012. Just after the Council decision of June 2012, the government had presented in its draft 2013 budget deficit-increasing stimulus measures. On account of the fiscal corrective packages announced by the government in two steps in October 2012, the Commission services' 2012 autumn forecast showed the deficit below the Treaty reference value both in 2012 and 2013 but above 3% of GDP in 2014.

Table 2 : 2013 budget forecast of the Commission services (% of GDP)

2011 autumn forecast	3.7
Commission recommendation for a Council decision establishing inadequate action (January 2012)	3.3
Commission recommendation for a Council recommendation to end the excessive deficit situation (March 2012)	3.6
2012 spring forecast	2.9
Commission communication to the Council on action taken (May 2012)	2.7
July mission on a potential new programme	4.5
2012 autumn forecast	2.9

Source: Commission services.

Based on current information, notably gathered during the January mission to Budapest, the current assessment points to somewhat worse budget deficits in 2013 and 2014 than projected in the 2012 Autumn Forecast. This assessment takes into consideration all new developments since the 2012 autumn forecast, including further corrective measures announced in November (further sectoral levies, e.g. maintaining the level of the extraordinary tax on the financial institutions as a permanent element of the tax system rather than reducing it as announced, and increasing the taxation of the energy sector and network industries).

The increasing deficit in 2013 to somewhat above 3% of GDP compared to the 2012 deficit of around 2½% of GDP can mainly be attributed to the phasing out of temporary extraordinary taxes introduced in 2010 (on the retail, telecom and energy sectors) and

other one-off revenues of altogether 1% of GDP, the revenue-reducing stimulus measures of above ½% of GDP as well as the reduction of the personal income tax for higher-income earners (over ¼% of GDP). Some other smaller elements (e.g. extended public work scheme, extraordinary support of the higher education sector, fiscal impact of the lower than budgeted inflation) will also increase the deficit altogether by around ¾% of GDP.

These deficit-increasing developments will be partly offset by the corrective measures announced in autumn 2012, which may reduce the 2013 deficit by close to 1¼% of GDP, according to the Commission services. In addition, corrective measures announced in the context of the 2011 and 2012 Convergence Programmes will improve the deficit by around ¾% of GDP in 2013 compared to 2012, although the implementation of these saving measures in general lag behind compared to the original plans in selected areas (e.g. disability pension, public transport, pharmaceutical subsidies, and expenditures of the line ministries).

The 2014 deficit, based on the usual no policy change assumption is projected to remain close to 3½% of GDP. The planned wage compensation scheme in the public education sector, the foreseen need of capital transfer to the central bank and the increasing interest expenditures will deteriorate the fiscal balance. These effects will be compensated mainly by the economic recovery and further revenues related to the implementation of selected reform measures (e.g. distance-based road toll, enhancement of the tax administration).

Consequently, this budgetary assessment includes higher deficit figures than targeted by the government (2.7% of GDP in 2013 and 2.2% of GDP in 2014). Compared to the government, this assessment of the expected 2013 budgetary developments includes expenditure slippages of around ½% of GDP (e.g. higher co-payments related to the absorption of the EU funds, further financing for the higher education sector) and revenue shortfalls beyond 1¼% of GDP (e.g. lower than budgeted impact of the efforts aiming at enhancing tax administration, worse macroeconomic outlook), altogether amounting to close to 2% of GDP.

The expenditure slippages and revenue shortfalls foreseen by the Commission services could be partly counterbalanced by the budgeted reserves of 1.3% of GDP in 2013. The remaining difference (more than ½% of GDP in 2013) explains the Commission services' higher deficit outlook compared to that of the government. It also means that, according to our calculations, the 2013 budget does not contain any available extra reserve (besides the reserve of 0.3% of GDP specified by the organic law).

The estimated structural effort of 2½% of GDP in 2012 more than offsets the cumulative deterioration of 2% of GDP in 2010 and 2011. However, the structural balance is projected by the Commission services to deteriorate again in 2013 and 2014 by ¼% and ½% of GDP, respectively. Overall, the government has fulfilled several recommendations on the size of the fiscal correction but some further efforts seem to be necessary in the near future.

EDP abrogation seems to be the top priority of the Hungarian government. According to the authorities, further measures will be announced in the 2013 Convergence Programme if proven to be necessary. However, recent announcements by Members of Parliament on extending the family tax allowance and starting the new wage compensation scheme in the public education sector already as of September 2013 instead of January 2014 might point to renewed fiscal loosening, which should be avoided. The abrogation of the EDP could be proposed by the Commission following the 2013 spring forecast at the earliest, assuming that the 2012 deficit published by Eurostat without reservation is clearly below the reference value in the Treaty of 3% of GDP and the Commission services' deficit forecasts are well below the threshold both for 2013 and 2014.

The Commission services expressed concerns about the quality of the implemented measures. Notably, in 2013 close to 80% and in 2014 beyond 90% of the deficit-improving impact of the corrective measures announced in Autumn 2012 stem from tax increases, instead of reducing public spending on bureaucracy, untargeted social benefits and transfers to loss-making state-owned enterprises as well as reshuffling the tax system to gain more revenues as suggested. The Commission services (as well as the IMF team) considered that the current tax system (most notably surtaxes on the corporate sector) is likely to discourage economic growth, which can ultimately undermine the sustainability of the fiscal correction.

The Hungarian authorities acknowledged that the recent fiscal consolidation efforts contained mainly tax increases but claimed that taking into account all corrective measures since 2010 the composition would show a larger share on the expenditure side. In addition, in their opinion changes in the tax system were broadly revenue neutral, i.e. tax increases were entirely compensated by tax cuts during the 2010-2013 period. Furthermore, the Hungarian authorities expected strong positive labour supply and consumption effects as a result of the introduction of the fully flat personal income tax system and the Job Protection Act[5]. At the same time, they argued that there was little risk from the introduction of sectoral taxes as those sectors produced extra profits in recent years.

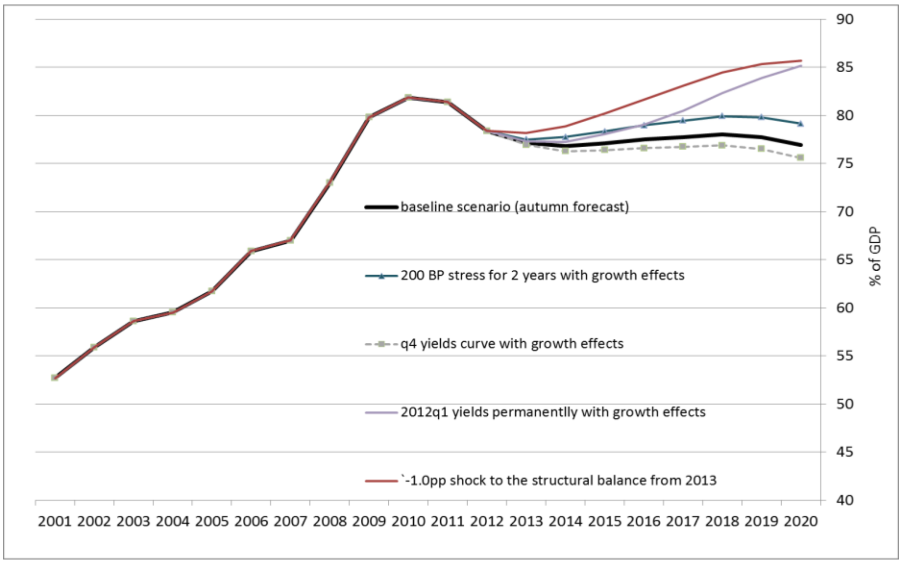
After declining below 80% of GDP in 2011 thanks to large one off revenues linked to the de facto elimination of the second pension reform pillar, the public debt declined by some 3 pps to around 78% at end 2012 thanks to the consolidation efforts and some helpful revaluation effects. In the Commission services' 2012 autumn forecast, the debt-to-GDP ratio is forecast to gradually decrease further in 2013 and 2014, to around 77%.

While in the baseline scenario debt is expected to stabilize at around 77% until 2020, debt sustainability calculations show that it can turn to an increasing path if financing conditions deteriorate.[6] A detailed sensitivity analysis on alternative interest rate and growth assumptions compared to the baseline scenario reveals the vulnerability of the Hungarian situation. For instance if long-term interest rates would permanently stay at around 8.5% (a level comparable to the severe financial market stress in Q1 2012), debt would start to increase rapidly already from 2014 onwards, by achieving 85% of GDP in 2020.

5 Targeted social security contribution cuts for certain employment groups, see also section 6 on the subject.

6 In the baseline scenario of the Commission services' illustrative medium-term projections (assuming a real interest rate of around 3-3.5%, growth rates of around 1% in line with the 2012 Ageing report as well as structural surpluses for both 2013 and 2014 as projected in the Commission services' autumn 2012 forecast and kept constant thereafter) the debt-to-GDP ratio is expected to remain broadly stable around 77% until 2020.

Graph 2: Public debt scenarios



Source: Commission services.

A similarly debt-increasing path could be the outcome of a one percentage point permanent decrease in the structural balance. Therefore, although the assumed primary surpluses over the forecast horizon help the decrease of public debt, the outlook is sensitive to alternative interest rate and growth scenarios, due to the combination of weak growth potential and relatively high financing costs and a high starting debt level. In addition, as around 40% of the central government debt is denominated in foreign currency, a 10% permanent depreciation of the HUF ceteris paribus increases debt by 3 pp of GDP.

As regards fiscal governance, the recently introduced prior central authorisation of local governments' loan agreements proved to be an effective constraint as the nominal increase in the total debt stock of the sector was minimal in 2012. Moreover, at the end of 2012, the government started the procedure of assuming roughly half of the municipalities' debt. As to the current plans on the transposition of the Directive on the minimum requirements of national budgetary frameworks, the introduction of a structural balance rule to define the adjustment path to the MTO and complemented by a correction mechanism is currently considered, possibly as part of a more binding medium-term budgetary framework. Compliance with the numerical rules would be monitored and supervised by the Fiscal Council. It remains to be verified whether the ongoing reinforcement of the Fiscal Council by 8-10 permanent staff and informal expert networks will transform it into an institution with a strong analytical basis. All necessary legislative amendments are planned to be submitted to Parliament before the autumn session.

3. FINANCIAL ACCOUNT DYNAMICS; RESERVE ADEQUACY, RESERVE POLICY

Hungary recorded substantial net outflows of foreign funding on the financial account of its balance of payments during the first three quarters of 2012, largely driven by massive (EUR 8.7bn) outflows of other investment, which were only partially offset by net inflows of direct and portfolio investment. As a result of the rapid deleveraging in the banking sector, gross external debt declined to below 100% of GDP in Q3-2012, with short-term external debt (at original maturity) falling to some 15% of GDP. At the same time, non-resident holdings of HUF-denominated Hungarian government securities continued to increase throughout 2012, reaching a record high of HUF 5,000 bn (EUR 17 bn, some 45% of the total outstanding amount) in December 2012.

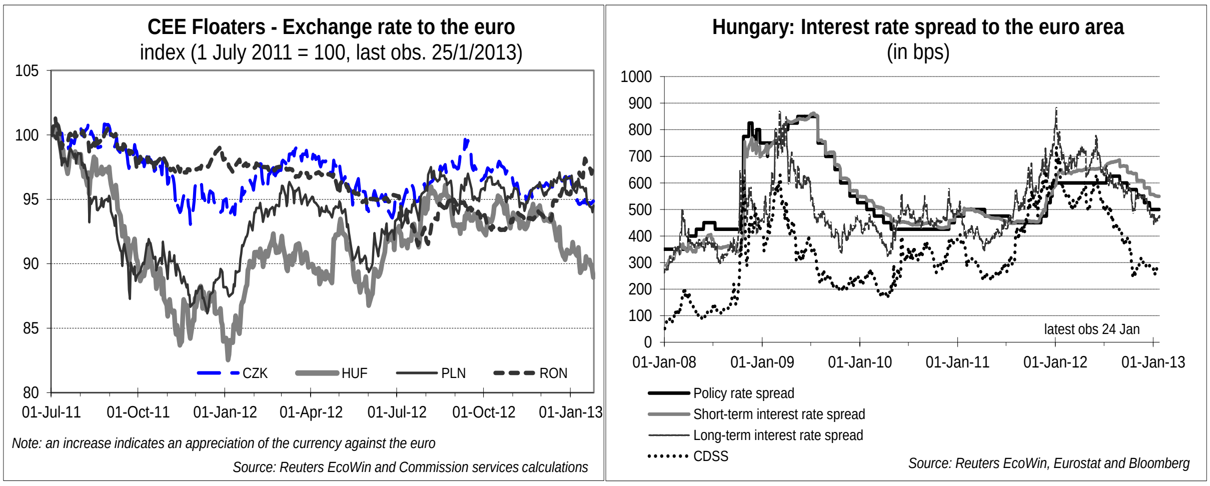
International reserves currently cover more than 100% of short-term external debt at remaining maturity (excluding intra-company debt liabilities, which are a stable source of funding). From late February until October 2012, international reserves of the MNB hovered around EUR 35bn, despite gradual redemptions of the IMF credit. They declined to some EUR 34bn during November (as the redemption of a EUR 1bn sovereign FX bond supplemented IMF loan repayments) and then remained broadly stable until mid-January 2013. International reserves are expected to increase to above EUR 37bn throughout 2013 if the government treasury (AKK) manages to fulfil its international bond issuance plan of EUR 4.5bn, which appears possible in view of the recent placement of the FX bond, which is expected to raise the reserve level considerably. Government FX debt redemptions of close to EUR 5 bn will again be the main driver of reserve outflows in 2013. At the same time, as deleveraging in the banking sector is expected to continue throughout 2013, a further decline in the estimated minimum reserve adequacy benchmarks is forecasted.

4. MONETARY POLICY DEVELOPMENTS, RECENT DEVELOPMENTS OF FINANCIAL MARKETS

Financial market sentiment vis-à-vis Hungary improved considerably in the second half of 2012, reflecting the gradual financial market stabilisation in the euro area as well as intensified search for yield induced by further monetary policy easing by major central banks. The forint remained relatively stable against the euro between end-July and mid-December, mostly trading in the rather narrow range of 275-285 HUF/EUR, although it depreciated to above 290 HUF/EUR in late December 2012 as concerns about the future course of monetary policy (the new MNB Governor to be elected in March) started to increase. In January, the exchange rate stabilised somewhat above 290 HUF/EUR, while it strengthened somewhat most recently after the successful FX debt issuance. Long-term yields have declined by some 280bp since early June, with 10-year government bonds yielding 6.3% in mid-February 2013, while CDS spreads dropped by almost 350 bp to below 290bp. The primary market has been functioning smoothly, with most of the auctions strongly oversubscribed.

The Monetary Council of the MNB launched a rate-cutting cycle in August 2012, lowering the main policy rate to 5.5% in late January 2012 through six successive 25bp steps. Money market rates declined in line with the main policy rate, with 3-month rates falling from 7.1% in late August to 5.4% in late-January 2013. Market prices currently assume a further decline in the policy rate by some 50bp until the end of Q1-2013 and bottoming of the cycle at 4.5% in Q4-2013. As the easing has so far largely coincided with a period of declining risk premia, it does not seem to have had a significantly negative impact on the attractiveness of HUF-denominated assets for non-resident investors. According to the MNB's Quarterly Report on Inflation from December 2012 factors pointing in the direction of tightening and easing of monetary policy were expected to broadly cancel each other out in 2013.

Graph 3: Exchange rates and interest rate spreads in the CEE region



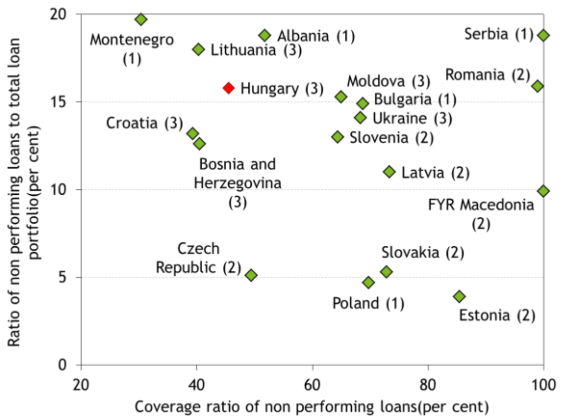
5. FINANCIAL SECTOR POLICIES

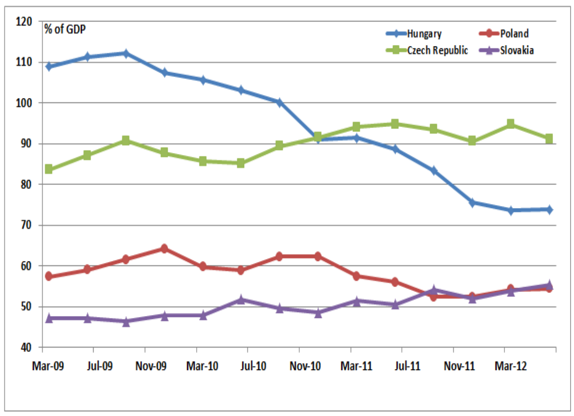
The high capital adequacy ratio in the banking system ensures resilience against adverse shocks. At 15.2% the capitalisation of Hungarian banks has reached unprecedented levels of almost double the regulatory minimum of 8%. Three main drivers lead to this record high capital adequacy ratio: the capital injections by parent banks, their unwillingness to extend loans and the appreciation of the forint on the back of an improved global investor sentiment. Capital buffers place banks in their comfort zone when it comes to withstanding even an extremely adverse shock and digesting the mounting pile of non-performing credit (ca. 14%) trapped on their balance sheets. The liquidity data for the system has improved alongside the better performance and outlook in financial markets. Banks' liquidity buffers are in line with both the short-term regulatory liquidity rule and the 65% regulatory requirement of the foreign exchange funding adequacy ratio in effect since mid-2012.

Banks do not support growth through lending. Lending has dropped on average by almost 20% from October 2008 levels. Based on the central bank's analysis, the contraction in lending to the corporate sector seems to be mostly driven by supply factors. Amidst a general climate of uncertainty banks also cite high credit risk, their negative internal capital generation capacity (parly linked to high tax burdens and loan loss provisioning) and recessionary pressures as the main reasons for tightening conditions on new lending. Foreign banks are more bearish on Hungary and plan to further deleverage from their Hungarian subsidiaries, while the local OTP and small domestic banks plan to somewhat increase their share in corporate lending. In contrast to the corporate segment, households are simply not willing to borrow while the economic environment is steadily deteriorating. The credit demand is negatively impacted by the decline in real wages, the uncertain income outlook and the resulting strengthening of precautionary considerations. Going forward, the government subsidised mortgage facilities (bearing a 4-5% percentage points interest cost lower than the market rate) should have some positive impact on mortgage demand.

The loan loss coverage is low compared to regional peers and evergreening is becoming a way to avoid further provisioning. Managing the deteriorating portfolio quality represents the biggest challenge so far. Non-performing loans (NPLs) have been on an upward trend since 2009. The rise slowed in Q3 2012, when household NPLs stood at 15.6% and corporate NPLs at 20.8% versus 11.5% and 16% a year earlier, respectively. However, asset quality is likely to further weaken throughout 2013 due to weak economic activity. While in case of corporate loans the portfolio has genuinely worsened, households' bad loans have remained stable and the increase in the NPL ratio is mainly attributable to the contraction in the outstanding loan stock. Meanwhile, the risk of insufficient loan loss coverage is becoming an issue as banks are unwilling to recognise the full extent of potential losses in capital. The loan loss coverage is low compared to regional peers and restructuring loans is becoming a way to avoid further provisioning. 12% of all corporate loans have been already restructured, while in the household segment this ratio is already equal to almost one third. Portfolio cleaning is extremely low as the mortgage market is literally frozen.

Graph 4: Coverage ratio of non-performing loans in regional comparison (left) and exposure of international banks among Visegrad countries (right)





Source: MNB.

Note: Numbers in brackets denote the reference periods of NPLs: (1)=2011 Q4, (2)=2012 Q1, (3)=2012 Q2

Source: BIS.

The impact of government measures had a strong negative impact on bank's profitability. The government has pushed through several high-impact measures that had a major influence both on banks' profits as well as on the relations between the legislator and the banking sector, and ultimately on foreign investors' perception of Hungary. The bank levy remains the biggest tax of that kind in Europe. The tax has now become an integral part of the Hungarian banking sector's taxation and continues to be levied on 0.53% of banks' assets over HUF 50bn based on the 2009 balance sheets. With business volumes shrinking on average by 12% since 2009 and for some banks by as much as 25% the levy is indeed an extreme and damaging tax. The FX mortgage early repayment scheme together with the scheme freezing FX rates for mortgage customers for five years cost the banking system over EUR 1 billion. The financial transaction duty (FTD) adopted in July 2012, which unlike the EU FTT project targets all corporate and household financial and banking transactions (e.g. cash payments, bank transfers etc.) puts additional strains on banks profitability, although probably most of them pass onthis cost to customers. The banking sector is likely to record a loss in 2012 (following a negative result in 2011) as loan loss provisioning, one-off losses from the early repayment scheme and the bank levy weigh heavily on the profitability of the sector (12-month return on assets (ROA) at around -1.3% for large banks in November 2012). The weak profitability of Hungarian banks puts them at a competitive disadvantage in the regional allocation of parent funds, which in turn contributes to a low willingness to lend.

The key policy challenge would be to restore normal lending to the economy. In order to achieve this, taxation of the financial sector should be decreased, and a new agreement between banks and the government would need to be set up. This might also usefully contain foreign bank's commitments to keep their exposures in the country, or at least decrease the pace of deleveraging. However to set-up such an agreement seems particularly difficult after former agreements between the banking sector and the government (e.g. regarding the phasing out of the extraordinary bank levy) were reconsidered by the latter. At the same time, given the high level of NPL, enhancing the effectiveness a portfolio cleaning should also be a priority.

Though both central bank and the Hungarian Financial Supervisory Authority (HFSA) stressed the strong liquidity and capital position of the financial sector, they had different views to what extent government measures of last years have contributed to financial disintermediation and also on the problem of underprovisioning in the sectors. While the central bank mostly shared the international organisations' concerns on these subjects, the HFSA generally defended government policies.

6. STRUCTURAL REFORMS

A gradual weakening of potential growth has taken place in Hungary since 2004, a trend which was amplified during the crisis since late 2008. A decline of potential growth was also observed among regional peers, but it started from higher levels and was generally less pronounced. This development can be attributed to a declining contribution of all production factors, except the labour component in the case of Hungary. The contribution of the TFP, capital accumulation and labour components to the slowdown varied from one country to another.

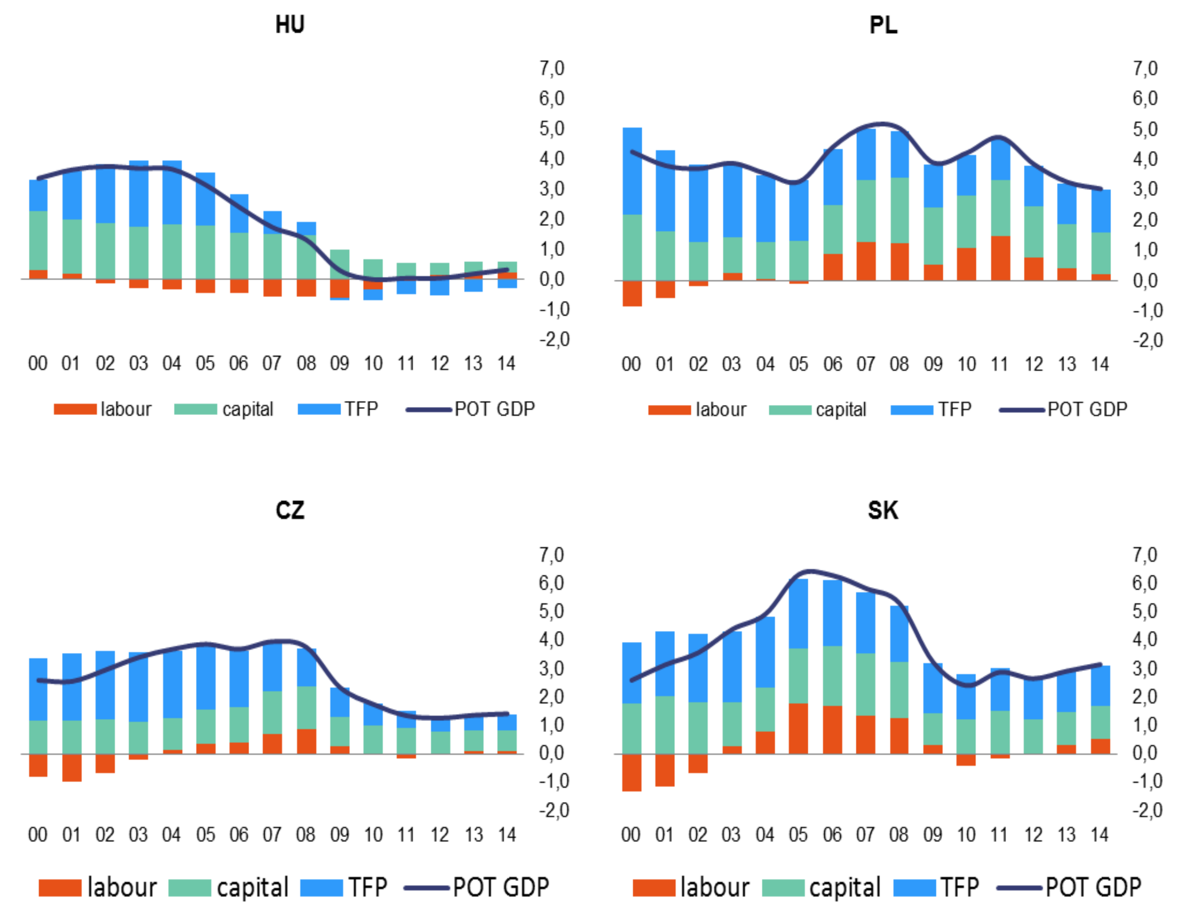
The weak potential growth in Hungary is also linked to the deterioration of the business environment, **which is related to policy uncertainty and increasing surtaxes on selected corporate sectors.**[7] Hungary's position has deteriorated on competitiveness rankings. In the Global Competitiveness Report the country has lost 12, while 5 places on the World Bank's doing business indicator compared to the previous year. Both the investment ratio and the reinvested earnings of foreign companies fell to their historically lowest level. Investment is very subdued in sectors particularly hit by sectoral surtaxes[8] which are expected to counterbalance several rising expenditure items, cuts in labour taxes and the phasing out of temporary tax elements. Importantly, only selected (often foreign-owned) companies operating in selected sectors (notably the financial, energy and telecom sectors) face a higher tax burden, while small and medium-sized companies are eligible for preferential corporate

[7] Despite the fact that the investment rate and the pace of total factor productivity growth rate stood below that of regional peers already in the 2010, the Hungarian trend labour productivity component (the sum of capital accumulation and total factor productivity growth rate) has been revised downwards to the largest extent among Visegrád countries in the Commission services' common methodology for potential output calculation between 2010-2012. This further decline in the pace of capital accumulation and TFP growth rates from already very low levels is in strong contradiction with the general economic potential of the country (related to the level of human capital, initial development level etc.) which is comparable to other Visegrád countries.

[8] Surtaxes are levied specifically on activities in given sectors in addition to the general corporate income taxes.

income tax rates as well as targeted tax schemes.[9] The size of these sectoral taxes has gradually increased from ½% to 2½% of GDP from 2009 to 2013.

Graph 5: Potential output in Hungary and Visegrád countries*



*Based on the Commission's services methodology.

Source: Commission services.

The Hungarian government has been successful in raising the participation rate. Over the last two years, the government introduced numerous reforms to stimulate labour market supply, including notably a massive tightening in social benefits (where the country was well above regional peers) including the elimination of early retirement schemes, but also from an efficiency point of view, the more controversial measure of a drastic cut in the unemployment benefits.

It is important to recognise Hungary's achievements in increasing the supply side of the labour market as part of their structural reform programme, but the private sector's labour demand falls short of labour supply. The recent increase in employment is to a large extent linked to the stepping up of Public Work Schemes (PWS). Although its social policy advantages should be acknowledged, it seems problematic that no tangible sign of transition from public employment to the private sector is discernible yet. Based on empirical studies,

[9] The crisis taxes on retail and on telecommunications sectors have been subject to infringement procedures as the progressivity of the taxes – uniquely tailored and applicable to the respective sectors – were found to be disproportionally falling on foreign-owned operators.

there is a clear risk that participants will be caught in the vicious circle of public work-benefit-public work for a long period, especially in those parts of the country where the open labour market is weak to offer real possibilities. While labour taxation has become more employment friendly, it is yet to be seen whether the recently adopted Job Protection Act, which contains sizeable cuts in social security contributions for certain target groups can counterbalance the negative labour supply effects of the full abolishment of the employment tax credit, which increased taxation of low-income earners substantially as of 2012. However, overall it is questionable whether there can be a sustainable increase in private sector employment with the weak growth potential and the lack of investment.

To raise the growth potential of the country one of the most important policy challenges appears to be to create a more business friendly environment and an equal level of playing field for domestic and foreign companies. Possible measures might include the reconsideration of sectoral corporate taxes. In addition public work programmes should be targeted to contain stronger training elements so as to increase participants' job finding probabilities Moreover, fostering competition in product markets could stimulate growth by creating incentives for firms to use their resources most efficiently, responding also to the 2012 Council recommendations. These may comprise steps to strengthen the functioning of competition enforcement institutions and the public procurement rules, but also reconsidering increasing entry costs in certain service sector segments. The on-going efforts to implement measures that lower the administrative burden are commendable and could be continued and plans envisaged in the 2012 National Reform Programme fully implemented. Improving educational outcomes can also positively affect growth. Finally a reform of the transport and energy systems toward more sustainable levels is necessary from both the point of view of fiscal sustainability and economic efficiency.

The Hungarian authorities explained their policy agenda and mentioned that fiscal consolidation, decreasing FX exposure and increasing employment have been the key priorities of the government since it entered into power in 2010. At the same time, there was some acknowledgement that the relatively low growth potential required action. These might include: (i) improving the business environment by strategic alliances with large FDI providers and a new agreement with the banking sector, (ii) improved SME financing by increasing the activity of Eximbank, (iii) a reduction of bureaucracy, and (iv) new initiatives on the labour market. However, no further details were mentioned regarding these steps.

7. REPAYMENT CAPACITY

Debt financing in 2012

In 2012, the total gross HUF issuance of government debt exceeded the original yearly plan by over HUF 1500 bn (around EUR 5 bn). Despite the financing plan of EUR 4 bn FX bond issuance in 2012, international FX bond issuance did not occur, but the government was able to complete FX redemption primarily with the strategy of issuing HUF denominated papers and paying back FX debt by exchanging HUF deposits to FX at the central bank (altogether EUR4.2 bn).[10] Though this strategy *ceteris paribus* decreased FX reserves, due to the continuous inflow of net EU funds (EUR 4 bn in 2012) official reserves remained at around 34 bn EUR, an amount comparable to maturing short-term debt.

[10] In addition, around EUR 0.7 bn retail and IFI project financing related FX bond issuance also occurred.

Gross financing needs, repayment schedule in 2013 and 2014

Hungary's gross financing needs of 2013 amount to almost EUR 19 bn, i.e. around 19% of GDP, of which EUR 4.9 bn have already been financed by debt issuances up to mid-February.[11] Redemptions due on financial markets amount to EUR 12 bn, of which around EUR 1.1 is denominated in foreign currency. Another EUR 3.6 bn is due for repayment of principal to the IMF (EUR 0.6 bn was already repayed in January) while the deficit financing need will be more than EUR 3 bn.

The gross financing need is projected to increase to around EUR 22 bn in 2014. On top of the deficit financing need of around EUR 3.5 bn, it includes the roll-over of the T-bills (which can be estimated above EUR 6 bn) and the redemptions of bonds and retail securities of around EUR 9 bn and repayment of principal of loans amounting to EUR 3 bn, including repayment of EUR 2 bn to the EU. About one quarter of the gross financing need (EUR 5.5 bn) will be denominated in foreign currency. [12]

Financial buffers of the government

According to information from the debt management agency (AKK) received during the mission, the liquid financial buffers of the government amounts to around EUR 3.5 bn (before latest issuance of FX bond). However taking into account less liquid assets, the available buffers are around EUR 7 bn. Financial buffers contain the cash buffer of the government included domestic deposits of EUR 1.5 bn and foreign exchange of EUR 2 bn in the middle of January. In addition, the pension fund portfolio (without cash) was worth HUF 433 bn (EUR 1.5 bn) at the end of November 2012 when latest data were available. The assets of the energy company MOL, where the government has a 22% share, are not considered as part of the buffer in a narrow sense, but they might serve as collateral or be liquidated. At present, its market value amounts to around HUF 427 bn or EUR 1.5 bn. In addition, the government has assets in a publicly listed pharmaceutical company around EUR 0.5 bn.

Issuance plans

According to the debt management outlook of AKK, total gross issuance is planned at HUF 5896 bn in 2013 (above 19% of GDP), i.e. slightly higher than the gross financing need. 75% of it will be in the domestic currency and the remainder (EUR 5.3 bn) in foreign exchange. Overall EUR 4.5 bn was planned to be issued in international markets. The first auction successfully completed in February raised USD 3.25 bn (around EUR 2.4 bn). After AKK launched in late November 2012 the retail sale of euro dominated bonds with a 3-year maturity, collecting EUR 1 bn from the domestic market, a second issue on 17 January 2013 delivered another EUR 0.5 bn. The total volume of retail issues in foreign currency is not fixed; demand is mainly stemming from resident corporates. The outstanding stock of T-bills is EUR 7.2 bn i.e. HUF 2120 bn, amounting to about 6.7% of GDP. No serious refinancing risk

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[11] In addition to international FX bonds around EUR 2.4 bn, retail FX bonds around EUR 0.5 bn, HUF T-bills with 6- and 12-month maturity, and 5-year and 10-year bonds (HUF securities altogether around EUR 2 bn) were also issued.

[12] The takeover of local government debt totalling about HUF 600 bn by the central government is scheduled to take place around mid-2013. Most of local government debt is in long-term loans and securities with maturities of 10 to 20 years in domestic currency and will thereby not affect the repayment schedule of the forthcoming two years.

is seen to be involved as such paper is mainly kept by local banks and pension funds for liquidity purposes.

Assessment of repayment capacity

Meeting financing requirements of Hungary has been smooth recently, also evidenced by the repayment of principal to the IMF due on 12 February a few days ahead of schedule (EUR 0.6 bn). If implemented according to plans, financing sources in 2013 will exceed redemptions by EUR 2 bn. This will be useful to handle the peak in redemptions in Q1 2014 specifically, where repayments scheduled to date amount to EUR 4.2 bn, to which a new stock of T-bills rolled over will be added.

Despite the ongoing rollover and the government financial buffers, the overall situation is still fragile as sudden changes in market sentiments can lead to quick tensions on different markets in parallel, as exposure of government bond and interbank swap markets to foreign investors is very high. The share of foreign investors on the HUF bond market is around 45%. Altogether around two-thirds of the government debt is in the hands of foreigners. Sudden changes can easily originate from either domestic or foreign sources.

8. CONSULTATION REQUIREMENT

Quite a number of measures that the government undertook since the last formal PPS review mission were not consulted in advance as suggested by the PPS framework or did not follow the policy advice received. The adoption of a new law in July 2012, which levied the financial transaction duty also on central bank operations infringed central bank independence (right after closing a previous infringement procedure on the subject), but were later remedied. Despite the Commission's advice to close budgetary gap by further expenditure cuts and a reshuffling of the personal income and corporate tax systems in a more efficient manner, recent fiscal consolidation measures primarily relied on increasing the number and coverage of sectoral taxes (e.g. crisis taxes were replaced by permanent sectoral taxes) though the role of indirect taxation has also gained importance. The Commission services encouraged a more pro-active consultation in advance of major policy decisions as well as a positive response to policy advice.

ANNEX

<u>Commission press release after the mission</u>

Commission's mission to Hungary encourages continued progress in fiscal consolidation while paying more attention to raising growth potential

European Commission officials, in close cooperation with International Monetary Fund staff and observers from the European Central Bank (ECB), conducted a mission to Hungary from 16 and 28 January. Its purpose was to review recent developments and policy initiatives in the context of post-programme surveillance linked to the EU balance of payments assistance provided over 2008-2010. The mission also used the opportunity to gain insights in view of the Commission's Winter 2013 forecast to be published on 22 February and its In-Depth Review of Hungary to be published in the Spring, in the context of the Macroeconomic Imbalances Procedure.

The mission welcomed the fiscal consolidation achieved so far and the commitment of the government to continue its efforts to keep the deficit well below 3% of GDP. At the same time, it encouraged the government to pay close attention to the quality of the adjustment measures so as to ensure a sustainable correction that supports growth and confidence. In view of the challenging external financing needs that Hungary faces in 2013 and 2014, decisive structural reforms as well as a stable and credible institutional policy framework will also play an important role.

The mission reviewed the economic situation and noted that Hungary entered into recession in the first half of 2012 and that GDP is expected to have declined by 1½% in 2012. Growth is expected to resume only slowly from 2013 since economic prospects are lacklustre, also in view of the historically low investment ratio and a further shrinkage in financial intermediation. The current account continues to be in surplus but it partly reflects the compression in domestic demand.

The Hungarian Government's commitment to further fiscal consolidation with a view to ending the excessive deficit procedure and bringing down government debt is to be welcomed. The first results are visible in the fiscal data for 2012. At the same time, keeping the deficit below the 3% of GDP Treaty reference value in a durable and balanced manner, as recommended by the Council, will require additional steps. These should preferably be on the expenditure side. An improved fiscal governance framework as recommended by the Council will facilitate the envisaged fiscal adjustment.

The Commission staff expressed concerns about Hungary’s low potential growth in a regional context. Against this background, the government was encouraged to review the increased reliance on revenue side measures (mostly sectoral taxes), which are likely to be harmful for business confidence, economic growth and employment, not just in the short run, but even more so in the medium and longer term. Also in this context, the mission stressed the importance of improving the conditions for banks to resume lending and thereby supporting much needed investment.

The mission also had discussions with the Hungarian authorities on progress in implementing the structural reform agenda and on how to stimulate further growth-enhancing structural changes – notably in the financial sector and in the areas of tax policy, labour and product markets, and public transport, as also recommended by the Council’s Country Specific Recommendations to Hungary in the context of the European Semester.