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Assessment of the 2018 Convergence Programme for

HUNGARY

(Note prepared by DG ECFIN staff)

CONTENTS

1. INTRODUCTION

On 30 April 2018[1], Hungary's 2018 submitted its 2018 Convergence Programme (hereafter called Convergence Programme or Programme), covering the period 2017-2022. The convergence programme was approved by the Government.

Hungary is currently subject to the preventive arm of the the Stability and Growth Pact (SGP) and should ensure sufficient progress towards its medium-term objective (MTO). preserve a sound fiscal position which ensures compliance with the medium-term objective (MTO). As the debt ratio reached 73.6% of GDP in 2017, exceeding the 60% of GDP reference value, Hungary is also subject to the debt reduction benchmark.

This document complements the Country Report published on 7 March 2018 and updates it with the information included in the Programme.

Section 2 presents the macroeconomic outlook of the Programme and provides an assessment based on the Commission 2018 spring forecast. The following section presents the recent and planned budgetary developments, according to the Programme. In particular, it includes an overview on the medium term budgetary plans, an assessment of the measures underpinning the Programme and a risk analysis of the budgetary plans based on Commission forecast. Section 4 assesses compliance with the rules of the Stability and Growth Pact, including on the basis of the Commission forecast. Section 5 provides an overview of long term sustainability risks, Section 6 of recent developments and plans regarding the fiscal framework. Section 7 concludes.

2. MACROECONOMIC DEVELOPMENTS

Economic growth recovered in 2017 to 4.0%, up from 2.2% in 2016. The rebound was largely due to the strong growth of public investment. The macroeconomic scenario underlying the Programme expects that GDP growth will accelerate to 4.3% in 2018 before moderating slightly to 4.1% in 2019. In the subsequent years, growth is projected to remain close to 4%. Private consumption contributes strongly to growth in the projection, driven by the continuing rise of employment and real wages. Investment growth remains rapid in 2018, and then it gradually decelerates. Export growth remains close to 7%, as the export market share is projected to rise due to new manufacturing capacities.

Compared to the previous Programme, the 2018 GDP growth projection was left unchanged; the growth forecast for 2019-2020 was raised by 0.3 percentage points, while the 2021 forecast was increased by 0.6 percentage points, due to higher consumption and export growth. New fiscal measures incorporated in the current Programme include an additional 0.5 percentage point cut to employers' social contributions in 2018 as well as a higher level of public investments. The Programme also takes into account new major manufacturing investments announced since the latest Programme, amounting to 2.3% of GDP over the planning horizon.

[1] The English version of the Convergence Programme was not yet submitted at the time of publication of this assessment.

Table 1: Comparison of macroeconomic developments and forecasts

	2017		2018		2019		2020	2021	2022
	COM	CP	COM	CP	COM	CP	CP	CP	CP
Real GDP (% change)	4.0	4.0	4.0	4.3	3.2	4.1	4.0	4.2	4.1
Private consumption (% change)	4.7	4.7	4.9	5.2	3.3	4.8	4.7	4.6	4.5
Gross fixed capital formation (% change)	16.8	16.8	12.5	12.8	8.8	7.5	3.8	5.7	5.1
Exports of goods and services (% change)	7.1	7.1	7.0	7.2	6.5	6.9	6.7	7.3	7.1
Imports of goods and services (% change)	9.7	9.7	9.5	9.2	8.0	7.4	6.3	7.1	6.9
Contributions to real GDP growth:									
- Final domestic demand	5.7	5.7	5.2	5.5	4.1	4.2	3.3	3.7	3.5
- Change in inventories	-0.3	-0.3	0.4	0.0	0.0	0.0	0.0	0.0	0.0
- Net exports	-1.4	-1.4	-1.5	-1.1	-0.9	0.0	0.7	0.5	0.6
Output gap[1]	1.6	1.4	2.4	1.7	2.3	1.5	1.1	0.8	0.4
Employment (% change)	2.0	1.6	0.9	1.5	0.5	1.5	1.3	1.1	0.9
Unemployment rate (%)	4.2	4.2	3.7	3.4	3.6	2.7	2.0	1.6	1.3
Labour productivity (% change)	2.0	2.3	3.1	2.8	2.7	2.6	2.7	3.1	3.2
HICP inflation (%)	2.4	2.4	2.3	2.5	3.0	2.7	2.9	3.0	3.0
GDP deflator (% change)	3.7	3.7	2.8	2.7	3.0	3.1	3.0	3.0	3.0
Comp. of employees (per head, % change)	7.9	9.2	7.4	9.1	5.6	7.9	6.3	5.9	6.2
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	4.2	4.1	4.1	5.9	3.8	5.9	4.1	3.1	3.0

Note:

[1]In % of potential GDP, with potential GDP growth recalculated by Commission services on the basis of the programme scenario using the commonly agreed methodology.

Source :

Commission 2018 spring forecast (COM); Convergence Programme (CP).

The GDP growth forecast of the Programme is higher than the 2018 spring Commission forecast, by 0.3 percentage points in 2018 and by 0.9 percentage points in 2019. The difference is mainly due to private consumption, which is driven by different projections for labour market developments. The convergence Programme forecasts notably higher employment and wage growth than the Commission. As a result, the growth rate of total wages and salaries is higher than in the Commission forecast, by 2.4 percentage points in 2018 and by 3.3 percentage points in 2019. Despite a higher path for unit labour costs, the Programme expects lower inflation in 2019 than the Commission. The nominal growth rate of household consumption expenditure is 0.3 and 1.2 percentage points higher than the Commission forecast in 2018 and 2019, respectively.

The output gap as recalculated by the Commission based on the information in the Programme, following the commonly agreed methodology, is estimated to be 1.4% of GDP in 2017. The recalculated output gap widens to 1.7% in 2018, and then gradually narrows to 0.4% by 2022. The Commission 2018 spring forecast calculates a wider positive output gap in 2018 and 2019. Taken at face value, the Programme estimates that the output gap was -1.2% of GDP in 2017, which was outside the range suggested by the plausibility tool estimates by the Commission.

Compared to the Commission 2018 spring forecast, the Programme assumes a considerably higher potential growth. The recalculated potential growth rate is 4.0%, in 2018, rising to

4.5% by 2022. By contrast, the potential growth rate consistent with the Commission 2018 spring forecast is 3.2% in 2018 and projected to gradually decline to 2.7% by 2022. The path of potential growth in the Programme does not appear to be sufficiently underpinned by structural measures.

The Programme's macroeconomic assumptions are markedly more favourable than the Commission forecast.

3. RECENT AND PLANNED BUDGETARY DEVELOPMENTS

3.1. Deficit developments in 2017 and 2018

In 2017, the general government deficit rose to 2.0% of GDP, from 1.7% of GDP in 2016. Based on the Commission forecast, the structural balance is estimated to have deteriorated sharply, by around 1.4 percentage points after adjusting for the effect of one-off measures (i.e. receipts from agricultural land sales amounting to 0.4% of GDP, recorded as negative expenditure). The tax-to-GDP ratio dropped by 0.9% of GDP as a result of sizeable tax and social contribution cuts. The effect of tax reductions was partly compensated by extra income-related tax receipts due to accelerating wage increases induced by a minimum wage hike. In parallel, government spending rose strongly. Aside from the increased spending from EU funds, primary expenditure grew just slightly below nominal GDP. At the same time, interest outlays declined, even in nominal terms, providing a substantial deficit-moderating effect.

The 2017 deficit outturn remained below the official target of 2.4% of GDP. Whereas EU fund absorption fell short of planned, revenues from taxes and other sources exceeded the targets. On the expenditure side, spending on goods and services turned out to be significantly lower than expected. These favourable effects were partially absorbed by higher-than-planned capital expenditure and extra spending on public wages and social transfers.

For 2018, the Convergence Programme targets the headline deficit to increase to 2.4% of GDP. The fiscal stance continues to loosen with the structural balance estimated to deteriorate further. EU fund absorption is planned to expand by nearly 2% of GDP. Without EU funds, however, both total revenue and expenditure are projected to decrease as a share of GDP, with revenues declining to a greater extent (by 0.8 and 0.4 percentage points, respectively). The tax-to-GDP ratio is set to be negatively affected by further tax and social contribution cuts as well as by the phasing-out of a temporary extra corporate income tax payment, which benefited the budget in 2016 and 2017. The projected robust growth of major tax bases, particularly wages and salaries, is expected to dampen the fall in the tax ratio. In addition, the drop-out of one-off receipts from land sales conveys a significant adverse budgetary impact. At the same time, overall primary expenditure is planned to increase moderately compared to the forecast high nominal GDP growth, albeit comfortably above inflation. Thus the targeted slowdown in spending growth partly offsets the impact of the above-mentioned deficit-increasing developments.

The 2018 deficit target remains the same as planned in the previous convergence Programme. However, the current Programme counts on significantly higher revenues. The amount of tax receipts exceeds the previously planned level by 0.8% of GDP. This reflects favourable base effects and a more optimistic macroeconomic scenario of the updated Programme. The extra revenues are planned to be fully spent, most notably on capital expenditure.

3.2. Medium-term strategy and targets

Over the medium term, the Convergence Programme plans to bring down the headline deficit from 2.4% of GDP in 2018 to 0.5% by 2022. The MTO set in the Programme, a structural deficit of 1.5% of GDP, reflects the objectives of the Pact. According to the authorities, the planned reduction in the headline deficit would ensure that the structural balance reaches the country's MTO by 2020. However, the structural balance recalculated by the Commission[2] would reach the country's MTO only by 2022.

Table 2: Composition of the budgetary adjustment

(% of GDP)	2017	2018		2019		2020	2021	2022	Change: 2017-2022
	COM	COM	CP	COM	CP	CP	CP	CP	CP
Revenue	**44.5**	**44.7**	**45.5**	**45.0**	**45.1**	**42.9**	**41.0**	**39.9**	**-4.6**
of which:									
- Taxes on production and imports	18.0	18.0	18.1	17.8	17.9	17.6	17.4	17.0	-1.0
- Current taxes on income, wealth, etc.	7.4	6.8	6.9	6.9	7.0	7.1	7.2	7.2	-0.2
- Social contributions	12.8	12.4	12.7	12.5	12.6	12.2	11.6	11.2	-1.6
- Other (residual)	6.2	7.4	7.8	7.7	7.6	6.0	4.8	4.5	-1.7
Expenditure	**46.5**	**47.1**	**47.9**	**47.1**	**46.9**	**44.4**	**42.2**	**40.5**	**-6.0**
of which:									
- Primary expenditure	43.7	44.5	45.3	44.6	44.5	42.1	40.0	38.4	-5.3
of which:									
Compensation of employees	10.8	10.6	10.5	10.5	9.9	9.3	8.5	7.9	-2.9
Intermediate consumption	7.1	7.1	7.3	7.3	7.1	6.4	6.0	5.7	-1.4
Social payments	14.2	13.7	13.8	13.2	13.1	12.7	12.3	11.8	-2.4
Subsidies	1.3	1.4	1.4	1.4	1.4	1.3	1.2	1.1	-0.2
Gross fixed capital formation	4.4	5.5	6.0	5.8	7.0	6.5	5.8	5.5	1.1
Other (residual)	5.8	6.2	6.3	6.5	6.0	6.0	6.3	6.2	0.4
- Interest expenditure	2.8	2.6	2.6	2.5	2.4	2.3	2.2	2.1	-0.7
General government balance (GGB)	**-2.0**	**-2.4**	**-2.4**	**-2.1**	**-1.8**	**-1.5**	**-1.2**	**-0.5**	**1.5**
Primary balance	**0.8**	**0.1**	**0.2**	**0.3**	**0.6**	**0.8**	**1.0**	**1.6**	**0.8**
One-off and other temporary measures	0.4	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-0.4
GGB excl. one-offs	**-2.3**	**-2.4**	**-2.4**	**-2.1**	**-1.8**	**-1.5**	**-1.2**	**-0.5**	**1.8**
Output gap[1]	1.6	2.4	1.7	2.3	1.5	1.1	0.8	0.4	-1.2
Cyclically-adjusted balance[1]	-2.8	-3.6	-3.2	-3.3	-2.6	-2.1	-1.6	-0.7	2.1
Structural balance[2]	**-3.1**	**-3.6**	**-3.2**	**-3.3**	**-2.6**	**-2.1**	**-1.6**	**-0.7**	**2.4**
Structural primary balance[2]	-0.3	-1.0	-0.6	-0.8	-0.2	0.2	0.6	1.4	**1.7**

Notes*:*

[1]Output gap (in % of potential GDP) and cyclically-adjusted balance according to the programme as recalculated by Commission on the basis of the programme scenario using the commonly agreed methodology.

[2]Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.

Source :

Convergence Programme (CP); Commission 2018 spring forecasts (COM); Commission calculations.

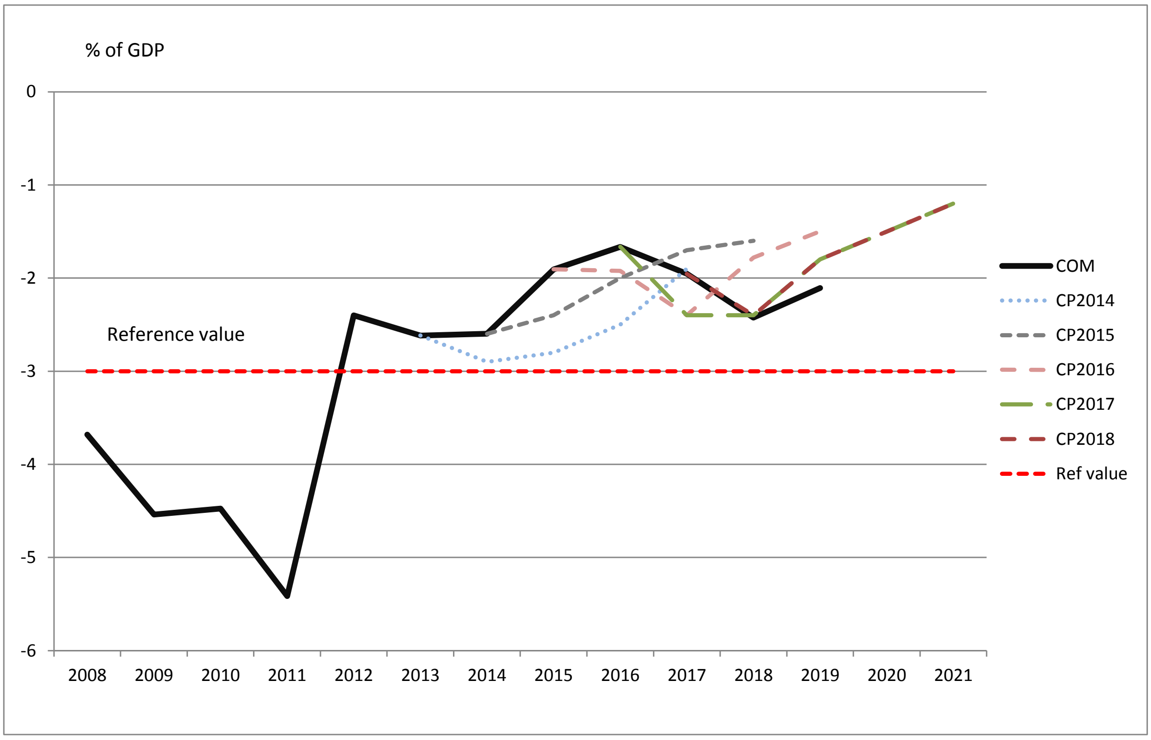
The Programme shows an uneven pattern of budgetary adjustment (see Table 2). The headline deficit is set to decline by some 0.6% of GDP in 2019, then decreasing further at a slower speed, by 0.3% annually in 2020-2021, and finally falling by 0.7% in 2022. The medium-term

[2] Cyclically-adjusted balance net of one-off and temporary measures, recalculated by the Commission on the basis of the information provided in the Programme, using the agreed methodology.

fiscal strategy is driven by expenditure restrains, while helped by a projected robust GDP growth and decreases in interest spending. The level of EU fund absorption is assumed to peak in 2019 and to decline considerably thereafter. Therefore the decreasing national co-financing costs also facilitate the improvement of the budget balance. Nevertheless, the further planned tax cuts adversely affect the pace of deficit-reduction.

The Programme plans that the total revenue-to-GDP ratio will decline from 45.5% in 2018 to slightly below 40% by 2022. Filtering out the impact of EU funds, revenues are estimated to decrease by around 3.2 percentage points in the same period (by 0.4% of GDP in 2019 and by a further 2.8% of GDP during 2020-2022). Besides the impact of tax cuts, the projected decline in revenue is also attributable to the shrinking expenditure ratio (i.e. the decreasing tax content of government spending) and the assumed low GDP-elasticity of non-tax revenues. Nevertheless, tax revenues, particularly consumption and production tax receipts, appear to be projected rather conservatively in the light of the parameters of the macroeconomic scenario. The primary expenditure-to-GDP ratio without EU funds is set to fall even more than revenues, overall by 4.6 percentage points of GDP (by 0.8% of GDP in 2019 and by 3.8% of GDP over the following three years). The steady decrease of social payments relative to the GDP plays a major role in the planned fiscal adjustment. This reflects the impact of previous parametric pension reforms and nominal freezes of several cash benefits. Current expenditure other than social transfers is also set to grow well below the nominal GDP, increasing even slower than inflation. However, the effect of spending restraints is planned to be partly offset by capital expenditure financed from national sources, which would rise dynamically throughout the Programme period even as a share of GDP. Meanwhile, the primary surplus is foreseen to recover from 0.2% of GDP in 2018 to 1.6% by 2022 (i.e. returning to the level seen in 2016). The headline deficit is expected to benefit also from a continued decline of interest spending, overall by 0.5% of GDP during the period 2019-2022.

Figure 1: Government balance projections in successive programmes (% of GDP)



Source: Commission 2018 spring forecast; Convergence Programmes

Compared to 2017 Convergence Programme, the planned deficit trajectory did not change for the 2018-2021 period. It is noteworthy that past deficit outcomes (including the 2017 deficit) turned out to be notably lower than the targets set by earlier convergence programmes (see Figure 1). This suggests a conservative approach in budgetary planning.

The Commission 2018 spring forecast projects a government deficit at 2.4% of GDP for 2018, which is in line with projection by the authorities. However, both total revenue and total expenditure planned by the authorities for 2018 are higher than in the Commission forecast. The difference in expected revenues is linked to a higher level of EU fund absorption and a more optimistic macroeconomic scenario projected by the Programme. On the expenditure side, the planned spending on public investment is notably higher. The lower level of public investment in the Commission forecast is based on assuming a slower-than-planned implementation of projects due to capacity constraints in construction. For 2019, the Commission forecast, which is based on a no-policy-change assumption, expects a somewhat higher deficit than the target (2.1% of GDP vs. 1.8%), mainly on account of a lower economic growth path projected by the Commission.

3.3. Measures underpinning the Programme

On the revenue side, the updated budgetary plans for 2018 incorporate measures with an estimated overall negative effect amounting to around 0.7% of GDP. In particular, the tax cuts involve (i) 2.5 percentage points reduction of the employer social security contribution rate from 22% to 19.5%; and (ii) the lowering of VAT rates on selected items such as internet, restaurant meals and fish. The impact of reduced taxes is somewhat reduced by the introduction of a new tourism tax and measures aimed at increasing the efficiency of tax collection. Beyond 2018, the Programme entails further employer social security contribution cuts in four consecutive steps, involving additional 2 percentage point rate reduction in each phase. The estimated cumulative impact of the scheduled social contribution reductions is around 2% of GDP on revenues and 1.5% on the deficit (netting out expenditure savings) in 2019-2022.

On the expenditure side, the convergence Programme most notably includes (i) the impact of decreasing social contributions on the gross public wage bill (i.e. the lower tax content of expenditure); (ii) the ongoing and planned pay raises in the public sector; (iii) extra spending on nationally financed investment projects as well as (iv) the additional budgetary costs of the new housing support scheme introduced in 2016. The implementation of large-scale investment projects and measures pertaining to the public sector wage bill are two key elements. While EU-funded projects fall after 2019, expenditure on nationally funded infrastructure developments (including investments linked to the "Modern cities" and "Healthy Budapest" programmes and the Paks-2 nuclear power plant project) is foreseen to expand continuously. Regarding the wage bill, the majority of public sector workers are to be affected by pay increases in 2018 under the ongoing career-path schemes. The budgetary costs are expected to be partly offset by wage restrains in other branches of general government. As the impact of the selective schemes fades, the growth of the public wage bill is set to slow down, even below inflation as of 2019. Additional budgetary savings are projected due to the planned reduction of participants in public works scheme. Nevertheless, measures underpinning the planned expenditure containment after 2018 are not spelled out in sufficient detail.

Main budgetary measures

Revenue	Expenditure
2017	
• Reduction of employer social security contributions from 27% to 22% (-1.4% of GDP) • Cutting the corporate income tax rate (-0.4% of GDP) • Additional selective VAT rate cuts on poultry, eggs, milk, internet and restaurant meals (-0.2% of GDP) • Other smaller tax measures, including the second step in increasing family allowances after two children (-0.1% of GDP) • Further increases in the efficiency of tax collection (+0.1% of GDP)	• Gross wage bill: the effect of reduced employer social security contribution (-0.4% of GDP) • Gross wage bill: effect of career paths/selective pay rises, minimum wage increases and offsetting wage restraints in other branches (+1% of GDP) • Public works scheme: gradual reduction of enrolment (-0.1% of GDP) • Nationally funded investment projects (including capital transfers, +1% of GDP) • Increased take up of the housing grant scheme (+0.1% of GDP) • Increase of certain social benefits due to minimum wage increases (+0.1% of GDP) • One-year extra benefit and "growth premium" for pensioners (+0.15% of GDP) • Phasing in the increase in mandatory retirement age from 62 to 65 by 2022 (not specified) • One-off receipts from asset sales (recorded as negative expenditure, -0.4% of GDP)
2018	
• Further cut of employer social security contributions to 19.5% (-0.65% of GDP) • Additional selective VAT rate cuts on restaurant meal, internet, fish and pork offal (-0.1% of GDP) • Other smaller tax measures, including the third step in increasing family allowances after two children (-0.1% of GDP) • Further increases in the efficiency of tax collection (+0.1% of GDP) • Introduction of a new tourism tax (+0.05% of GDP)	• Gross wage bill: the effect of a further employer social security contribution cut (-0.2% of GDP) • Gross wage bill: the effect of career paths/selective pay rises, minimum wage increases and offsetting wage restraints in other branches (+0.4% of GDP) • Public works scheme: further reduction of enrolment (-0.1% of GDP) • Nationally funded investment projects (including capital transfers, +0.2% of GDP) • Increased take up of the housing grant scheme (+0.1% of GDP, some uncertainty) • One-year extra benefit and "growth premium" for pensioners (+0.15% of GDP) • Phasing in the increase in mandatory retirement age from 62 to 65 by 2022 (not specified)
2019	
• Further cut of employer social security contribution to 17.5% as of 1st July (-0.3% of GDP) • Other smaller tax measures, including the final step in increasing family allowances after two children (-0.1% of GDP)	• Gross wage bill: the effect of a further employer social security contribution cut (-0.1% of GDP) • Gross wage bill: effect of career paths/selective wage increases and offsetting wage restraints in other branches (-0.05% of GDP)) • Public works scheme: further reduction of enrolment (-0.05% of GDP) • Nationally funded investment projects (including capital transfers, +0.7% of GDP) • Increased take up of the housing grant scheme (+0.1% of GDP, some uncertainty) • One-year "growth premium" for pensioners

Revenue	Expenditure
	(+0.05% of GDP) • Phasing in the increase in mandatory retirement age from 62 to 65 by 2022 (not specified)
2020	
• Full year effect and further cut of employer social security contribution to 15.5% as of 1st July (-0.6% of GDP) • Phasing out VAT reduction on newly built houses (+0.15% of GDP)	• Gross wage bill: the effect of the reduced employer social security contribution (-0.15% of GDP) • Gross wage bill: effect of career paths/selective wage increases and offsetting wage restraints in other branches of the public sector (-0.05% of GDP) • Public works scheme: further reduction of enrolment (-0.05% of GDP) • Nationally funded investment projects (including capital transfers, +0.6% of GDP) • Phasing out VAT rebate for self-built family houses (-0.05%) • One-year "growth premium" for pensioners (+0.05% of GDP) • Phasing in the increase in mandatory retirement age from 62 to 65 by 2022 (not specified)
2021	
• Full year effect and further cut of employer social security contribution to 13.5% as of 1st July (-0.6% of GDP)	• Gross wage bill: the effect of the reduced employer social security contribution (-0.15% of GDP) • Gross wage bill: effect of career paths/selective wage increases and offsetting wage restraints in other branches of the public sector (-0.2% of GDP) • Nationally funded investment projects (including capital transfers, +0.3% of GDP) • One-year "growth premium" for pensioners (+0.05% of GDP) • Phasing in the increase in mandatory retirement age from 62 to 65 by 2022 (not specified)
2022	
• Full year effect and further cut of employer social security contribution to 11.5% as of 1st October (-0.5% of GDP)	• Gross wage bill: the effect of the reduced employer social security contribution (-0.1% of GDP) • Gross wage bill: effect of career paths/selective wage increases and offsetting wage restraints in other branches of the public sector (-0.2% of GDP) • One-year "growth premium" for pensioners (+0.05% of GDP) • Phasing in the increase in mandatory retirement age from 62 to 65 by 2022 (not specified)
Note: The budgetary impact in the table is the impact reported in the Programme, i.e. by the national authorities. A positive sign implies that revenue / expenditure increases as a consequence of this measure.	

3.4. Debt developments

In 2017, the government debt-to-GDP ratio decreased by 2.4 percentage points reaching 73.6% of GDP. This decrease was mainly driven by a favourable snow-ball effect reflecting the acceleration of nominal GDP growth and helped also by the primary surplus, while it was adversely affected by below-the-line developments (i.e. stock-flow adjustments) mainly linked to the pre-financing needs of EU funds.

Table 2: Debt developments

(% of GDP)	Average 2012-2016	2017	2018		2019		2020	2021	2022
			COM	CP	COM	CP	CP	CP	CP
Gross debt ratio[1]	**77.0**	**73.6**	**73.3**	**73.2**	**71.0**	**69.6**	**66.7**	**63.4**	**59.7**
Change in the ratio	-0.9	-2.4	-0.3	-0.4	-2.3	-3.6	-2.9	-3.3	-3.7
Contributions[2] :									
1. Primary balance	**-1.7**	**-0.8**	**-0.1**	**-0.2**	**-0.3**	**-0.6**	**-0.8**	**-1.0**	**-1.6**
2. "Snow-ball" effect	**0.6**	**-2.6**	**-2.1**	**-2.2**	**-1.8**	**-2.6**	**-2.3**	**-2.3**	**-2.1**
Of which:									
Interest expenditure	4.0	2.8	2.6	2.6	2.5	2.4	2.3	2.2	2.1
Growth effect	-1.5	-2.8	-2.8	-3.0	-2.2	-2.8	-2.6	-2.6	-2.4
Inflation effect	-1.9	-2.6	-1.9	-1.8	-2.1	-2.2	-2.0	-1.9	-1.8
3. Stock-flow adjustment	**0.2**	**1.1**	**2.0**	**2.1**	**-0.1**	**-0.4**	**0.3**	**0.1**	**0.1**

Notes:

[1] End of period.

[2] The snow-ball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator). The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other residual effects.

Source :

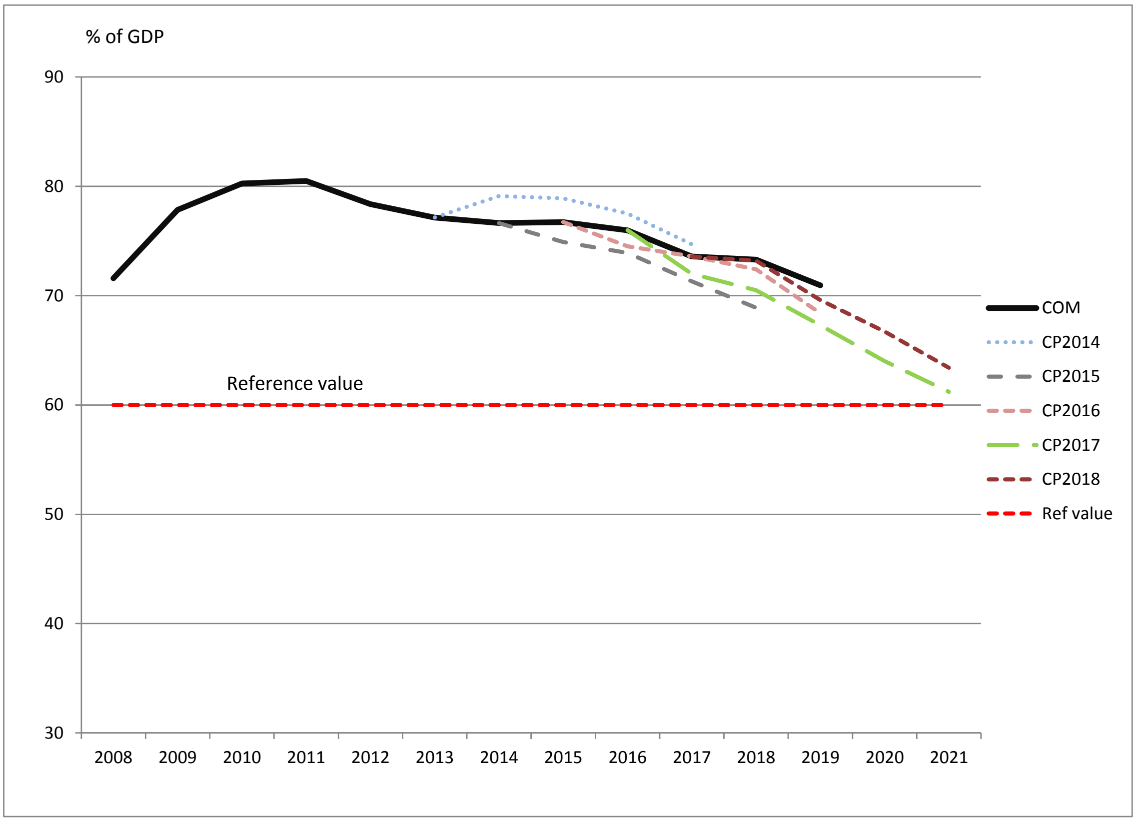
Commission 2018 spring forecast (COM); Convergence Programme (CP), Comission calculations.

The Convergence Programme projects a steeply decreasing public debt path. The debt ratio is expected to decline to slightly below 60% by the end 2022. It is equivalent with an average annual debt reduction of more than 2.5% of GDP over the planning horizon. The snowball effect remains a strong supporting factor due to a projected high nominal GDP growth and continuing decreases in interest outlays. As the primary balance is projected to improve from its low level in 2018, it also increasingly contributes to the debt-reduction path. The Convergence Programme foresees unfavourable stock-flow adjustment effects in each year, except in 2019. A sizable debt-increasing stock-flow adjustment is projected for 2018, mainly on account of the planned readjustment of government deposits. From 2019, the cash-flow effect of EU fund reimbursement is expected to incur a debt-reducing impact, which amounted to 1% of GDP in 2019-2021 in the previous Programme. By contrast, projected stock-flow adjustments have overall a neutral effect during the same period in the updated plans, reflecting below-the-line items, which are not spelled out in detail in the Programme.

Compared to the previous plan, the level of public debt has notably shifted up (by some 2% of GDP) due to the reclassification of Eximbank (i.e. a state owned export-import bank) into the government sector. At the same time, the shape of the debt-reduction path remained similar (see Figure 2). The updated Programme projects higher nominal growth rates and lower interest expenditure compared with the previous plans, which would imply a faster decline in public debt. However, this is fully offset by a weaker contribution of primary balance and stock-flow adjustment developments to the reduction of debt.

The Commission 2018 spring forecast projects a debt reduction path, which is broadly similar to the debt dynamics in the Programme. The debt-to-GDP ratio is forecast to decrease to 73.3% of GDP in 2018 and to 71% of GDP by the end of 2019, somewhat more slowly than in the official plans, reflecting mainly a less optimistic GDP growth projection by the Commission.

Figure 2: Debt projections in successive programmes (% of GDP)



Source: Commission 2018 spring forecast; Convergence Programmes

3.5. Risk assessment

Overall, the risks to the planned fiscal adjustment are to the downside pointing to potentially higher-than-projected deficit outcomes. In the light of the Commission forecast, the negative budgetary risks related to the macroeconomic scenario of the Programme are notable. The GDP growth projected by the authorities is already considerably higher in 2019 than forecast by the Commission and remains more than 1 percentage point above the Commission's potential growth estimate. Thus the economic growth path may turn out markedly less favourable than planned, which would result in an increasing deficit gap due to accumulating revenue shortfalls. Assuming a GDP growth in line with the Commission forecast in 2018-2019 and then 1 percentage point lower than projected in the Programme as well as unchanged policies, the headline deficit could end up exceeding the target by some 1.5% of GDP in the final year (i.e. with a deficit of 2% of GDP in 2022 compared to the planned 0.5%). The relatively strong reliance of the fiscal strategy on savings in interest outlays is also a vulnerability factor. The loose stance of global monetary policies may be reversed faster or more abruptly than anticipated, posing a risk to the assumed low implicit interest rates on public debt.

At the same time, conditional fiscal measures incorporated in the Programme can offer some buffer against adverse macroeconomic risks. The agreement between the government and social partners signed in 2016, set conditions for reducing social contributions after 2018. Accordingly, further cuts in the employer social security contribution rate should be implemented amounting to 2 percentage points on each occasion (and involving not more than four steps), when *real* wages in the private sector increase by at least 6% compared to a reference period (i.e. the first quarter of 2018 in the first instance and thereafter the quarter when a preceding cut was phased in). As each step involves an estimated annual budgetary cost of around 0.45% of GDP, the postponement of further social contribution cuts can provide a non-negligible risk-mitigating effect. Under a less favourable macroeconomic scenario, the agreed conditions pertaining to the real wage growth are likely to be met in a more protracted manner than foreseen in the Programme. Pension growth-premiums (which are triggered if the actual real GDP growth exceeds 3.5%) represent a similar conditional measure, albeit offering a relatively modest saving in the case of a lower-than-planned GDP growth (less than 0.1% of GDP).

Regarding other key measures, the budgetary risks appear to be positive in the short term, whereas they are increasingly tilted towards a higher deficit in the medium term. Positive risks arise from the ambitious investment targets (including both nationally and EU funded projects), which are set to rise at a very high speed during the first two years of Programme with expenditure peaking at a historic high of 7% of GDP in 2019. Given the tight capacity constraints in construction, the implementation of projects may turn out to be slower than planned. However, budgetary savings may be reversed in later years as the backlog is gradually reduced. Looking ahead, the construction of the Paks-2 nuclear power plant is an additional source of investment-related risks. The construction is scheduled for 2020-2027 involving total estimated costs at around 9.5% of GDP, which are to be funded by the budget. Although the Programme entails increasing spending on capital transfers as of 2020 (the heading under which the project is recorded), the adequacy of the planned increases cannot be assessed with confidence since the timeline of the construction expenses is not publicly available information. The achievement of the medium-term deficit targets is also exposed to risks linked to the execution of the planned significant spending restraints affecting current expenditure. The implementation risks are particularly notable with regard to the foreseen subdued pay raises in the public sector amid the projected fast growth of real wages in the private sector.

The risks to the planned debt-reduction are largely similar to those impacting the deficit target. However, adverse macroeconomic risks can affect the debt-to-GDP ratio in an amplified manner simultaneously through a higher-than-planned deficit and a lower denominator (i.e. a weaker "snow-ball" effect). Further risks stem from the sensitivity of the debt ratio to exchange rate developments, as still around 25% of government debt is denominated in foreign currency. However, the proportion of debt held in foreign currency is planned to be reduced to 15% by 2022, resulting in a progressively diminishing exposure to revaluation effects. The debt trajectory is also shaped by the cash-flow effects of EU transfers, which has been a source of uncertainty for debt management.

4. COMPLIANCE WITH THE PROVISIONS OF THE STABILITY AND GROWTH PACT

Box 1. Council recommendations addressed to Hungary

On 11 July 2017, the Council addressed recommendations to Hungary in the context of the European Semester. In particular, in the area of public finances the Council recommended to Hungary to pursue a substantial fiscal effort in 2018 in line with the requirements of the preventive arm of the Stability and Growth Pact, taking into account the need to strengthen the ongoing recovery and to ensure the sustainability of Hungary's public finances.

The Council noted that in 2018, in light of its fiscal situation and, in particular, of its debt level, Hungary is expected to further adjust towards its medium-term budgetary objective of a structural deficit of 1,5 % of GDP. According to the commonly agreed adjustment matrix under the Stability and Growth Pact, that adjustment translates into a requirement of a nominal growth rate of net primary government expenditure, which does not exceed 2.8 % in 2018. This would correspond to a structural adjustment of 1.0 % of GDP. As recalled in the Commission communication accompanying these country-specific recommendations, the assessment of 2018 budget outcomes will need to take due account of the goal of achieving a fiscal stance that contributes to both strengthening the ongoing recovery and ensuring the sustainability of Hungary's public finances.

4.1. Compliance with the debt criterion

As the debt ratio exceeds the 60% of GDP reference value, Hungary is subject to the debt reduction benchmark of the Stability and Growth Pact.

Table 4: Compliance with the debt criterion

	2017	2018		2019	
		CP	COM	CP	COM
Gross debt ratio	**73.6**	**73.2**	**73.3**	**69.6**	**71.0**
Gap to the debt benchmark [1]	-1.9	-4.2	-1.3	-5.4	-1.9

Notes:

[1] Shows the difference between the debt-to-GDP ratio and the debt benchmark. If positive, projected gross debt-to-GDP ratio does not comply with the debt reduction benchmark.

Source :

Commission 2018 spring forecast (COM); Convergence Programme (CP), Comission calculations.

In 2017, Hungary complied with the debt reduction benchmark as the notified debt-to-GDP ratio remained below the debt reduction benchmark. Therefore, according to the Commission's assessment based on notified data, Hungary is compliant with the debt criterion in 2017. According to information provided in the Programme, Hungary is expected to meet the debt reduction benchmark in 2018 and 2019, since the debt-to-GDP ratio is planned to remain below the debt reduction benchmark throughout the programme horizon. The same conclusion is reached on the basis of the Commission 2018 spring forecast for 2018 and under a no-policy-change scenario for 2019.

4.2. Compliance with the required adjustment path towards the MTO

Hungary is subject to the preventive arm of the Stability and Growth Pact.

Assessment of requests for deviating from SGP requirements

The Programme indicates that the budgetary impact of the security-related measures in 2017 is significant, and provides adequate evidence of the scope and nature of these additional budgetary costs. The additional expenditure on security-related measures amounted to 0.17% of GDP. The provisions set out in Articles 5(1) and 6(3) of Regulation (EC) No 1466/97 cater for this additional expenditure, in that the severity of a terrorist threat is an unusual event, the impact of which on Hungary's public finances is significant. Therefore, the required adjustment towards the medium-term budgetary objective for 2017 has been reduced to take into account the additional costs. Adding also the three-year carry-forward of the allowance for refugee and security related incremental costs granted in 2015 and 2016, implies that Hungary is eligible for a temporary deviation under the unusual event clause amounting to 0.25% of GDP from the required adjustment path in 2017.

Adjustment towards the MTO in 2017-2019

In 2017, taking into account the distance from the MTO in the initial position as well as the allowance based on the unusual event clause, Hungary was required to maintain its structural deficit position vis-a-vis 2016. This corresponds to a requirement to ensure a growth of government expenditure, net of discretionary revenue measures and one-offs, not higher than 1.5% in real terms. Based on outturn data, the growth of net primary government expenditure was well above the applicable expenditure benchmark rate (deviation of 2.4% of GDP), pointing to a significant deviation. As the structural balance deteriorated by 1.4% of GDP, while the requirement was to maintain the initial position, the structural balance pillar also clearly points towards that conclusion (deviation of 1.4% of GDP).

The overall assessment shows that the expenditure benchmark is negatively affected by three elements. First, the medium-term growth rate underlying the expenditure benchmark is negatively impacted by the low potential growth rate estimates in the aftermath of the crisis. As a result, the currently calculated 10-year average potential growth rate is considerably higher (2% vs. 1.5%). Second, the use of a higher deflator than the frozen ex-ante estimate is justified to account better for cost pressures affecting government expenditure.[3] Third, the expenditure benchmark appears to underestimate the fiscal effort because some of the revenue windfalls could be considered permanent. This permanent effect is linked to extra tax revenues generated by the ripple effect of significant minimum wage increases on earnings above the statutory minimum as the wage-cost share in the economy was recovering towards its historic average. After taking into account these factors, the expenditure benchmark appears to adequately reflect the fiscal effort and still points to a significant deviation by a wide margin. This is confirmed by the reading of the structural balance, which after adjusting for the impacts of decreasing interest expenditure, investment volatility and a revenue windfall (filtering out the above mentioned permanent effect) also points to a risk of significant deviation. Therefore, based on outturn data for 2017 and the Commission 2018 spring forecast, the ex-post assessment indicates that Hungary has significantly deviated from the adjustment path towards the MTO in 2017.

[3] The actual deflator in 2017 was 1.1 percentage points higher than the ex-ante projection used in the assessment, albeit it also reflected an inventory effect.

For 2018, Hungary was recommended to adjust towards the MTO. This adjustment translates into a requirement of a nominal growth rate of net primary government expenditure that does not exceed 2.8%[4] in 2018. This would correspond to a structural adjustment of 1% of GDP. Based on plans set out in the Programme, the growth of net expenditure is expected to considerably exceed the applicable reference rate in 2018, leading to a negative impact of 2% of GDP on the underlying fiscal position. This implies a risk of significant deviation. At the same time, according to the Programme, the recalculated structural balance is set to deteriorate by 0.2% of GDP, providing a similar reading (deviation of 1.2% of GDP). The assessment of the planned fiscal adjustment over the years 2017 and 2018 taken together also points to a risk of significant deviation based on both pillars. Therefore, according to information provided in the Programme, there is a risk of significant deviation from the required adjustment towards the MTO in 2018.

The assessment based on the Commission 2018 spring forecast leads to a similar conclusion. The growth of net primary government expenditure is projected to be well above the reference rate in 2018 (deviation of 1.8 % of GDP). At the same time, the structural balance is estimated to deteriorate by 0.5% of GDP in 2018, pointing also to a risk of significant deviation (deviation of 1.5% of GDP). Moreover, based on the Commission forecast, both pillars point to a risk of significant deviation taking 2017 and 2018 together. As was the case in 2017, fiscal effort as estimated by the expenditure benchmark appears to be adversely impacted by a lower benchmark growth than the currently estimated medium-term potential growth (2.3% vs. 1.8%) as well as by a permanent effect linked to extra revenues due to continued minimum wage increases. On the other hand, the deflator used for assessing net expenditure growth seems to overestimate cost pressures affecting general government. After correcting for these factors, the expenditure benchmark appears to adequately reflect fiscal effort and still points to a risk of significant deviation. The analysis of the structural balance pillar also confirms this. The reading of fiscal effort by the structural balance is negatively biased by a revenue shortfall, but it is offset by an opposite effect due to declining interest spending and investment volatility. Therefore, following an overall assessment, a significant deviation is expected in 2018, putting at risk compliance with the requirements of the Pact.

In 2019, in view of Hungary's general government debt ratio above 60% of GDP, a projected output gap of 2.3% and an actual GDP growth below potential, the commonly agreed adjustment matrix under the Stability and Growth Pact requires that the nominal growth rate of net primary government expenditure does not exceed 3.8%, corresponding to an annual structural adjustment of 0.75% of GDP. Based on the convergence Programme, the planned growth of net primary expenditure is calculated to exceed the applicable reference rate in 2019, pointing to a risk of some deviation (deviation of 0.3% of GDP). As the recalculated structural balance is set to improve by slightly less than 0.7% of GDP, the structural balance pillar also indicates some deviation (deviation of 0.1% of GDP). Taking 2018 and 2019 together, however, both the expenditure benchmark and the structural balance pillars point to a significant deviation based on the Convergence Programme (i.e. with a two-year average deviation of 1.1% and 0.6% of GDP for the expenditure benchmark and structural balance

[4] As part of the agreement on the EFC Opinion on "*Improving the predictability and transparency the SGP: a stronger focus on the expenditure benchmark in the preventive arm*", which was adopted by the Economic and Financial Committee on 29 November 2016, the expenditure benchmark, that is the maximum allowable growth rate of expenditure net of discretionary revenue measures, is expressed in nominal terms as from 2018.

pillars, respectively). Therefore, based on information provided in the Programme, there is a risk of significant deviation from the required adjustment in 2019.

Overall, the assessment based on the Commission 2018 spring forecast has a similar implication for 2019. According to the Commission forecast, which follows a no-policy-change assumption, the growth of net primary expenditure is projected to be well above the applicable reference rate in 2019, indicating a risk of significant deviation over one year (deviation of 0.7% of GDP). At the same time, the structural balance pillar points to a risk of some deviation over one year as the structural balance is forecast to improve by some 0.4% of GDP in 2019 (deviation of 0.4% of GDP). The difference in the reading between the two indicators mainly linked to decreasing interest spending and investment volatility, which are filtered-out by the expenditure benchmark. This implies that the expenditure benchmark adequately reflects fiscal effort as forecast by the Commission, pointing to a risk of significant deviation over one year. The difference between the calculations based on the Commission forecast and the convergence Programme results from the fact that the Commission forecast is based on a no-policy-change scenario, while the convergence Programme plans a strong fiscal adjustment in 2019 affecting government expenditure *other than investments*.[5] Considering the two-year averages, both the expenditure benchmark and the structural balance pillars point to a risk of significant deviation taking 2018 and 2019 together on the basis of the Commission forecast. Overall, following an overall assessment a significant deviation from the adjustment path towards the MTO is expected in 2019 putting at risk compliance with the requirements of the preventive arm of the Pact.

The country-specific recommendation adopted by the Council on 11 July 2017 mentioned that the assessment of 2018 budget outcomes will need to take due account of the goal of achieving a fiscal stance that contributes to both strengthening the ongoing recovery and ensuring the sustainability of public finances.

The Commission has carried out a qualitative assessment of the strength of the recovery in Hungary while giving due consideration to its sustainability challenges. Hungary does not face short-term sustainability challenges. However, government debt is at around 73% of GDP in 2017 and the structural primary balance is low. Therefore, sustainability risks are considered to be high in the medium term. GDP rose by 4% in 2017 and is projected to grow by 4% in 2018. The output gap is estimated to be positive; several indicators confirm that spare capacity is disappearing. Capacity utilisation in manufacturing rose above 84% by the first half of 2018, exceeding its long-term average. The labour market is tight: unemployment is at a record low level; more than 80% of managers in manufacturing firms reported labour as a factor limiting production in 2017. Capacity shortages are gradually feeding into costs and prices. Wages increased by double digits in 2017 and are expected to increase at a fast pace in 2018 as well. House prices rose by 8.5% in 2017 after recording growth above 13% in the two previous years. Core inflation has started to pick up in 2017 and it is expected to remain above 2% in 2018. HICP inflation is forecast to rise to the 3% target of the central bank by 2019. Overall, the framework indicates that the recovery in 2018 does not appear to

[5] In fact, the projected growth rates of primary expenditure without EU funds in 2019 are practically identical in the Commission forecast and the Programme. However, the composition is markedly different. The growth of current spending is considerably higher in the Commission forecast, which is compensated by a significantly higher growth of nationally financed investments in the Programme. This difference in composition has ramifications for the expenditure benchmark, which is calculated on the basis of smoothed investment series.

be fragile. On that basis, it is concluded that no additional elements in that regard need to be taken into account.

Table 5: Compliance with the requirements under the preventive arm

(% of GDP)	2017	2018		2019	
Initial position[1]					
Medium-term objective (MTO)	-1.5	-1.5		-1.5	
Structural balance[2] (COM)	-3.1	-3.6		-3.3	
Structural balance based on freezing (COM)	-3.2	-3.6		-	
Position vis-a -vis the MTO[3]	Not at MTO	Not at MTO		Not at MTO	
(% of GDP)	**2017**	**2018**		**2019**	
	COM	**CP**	**COM**	**CP**	**COM**
Structural balance pillar					
Required adjustment[4]	0.3	1.0		0.8	
Required adjustment corrected[5]	0.0	1.0		0.8	
Change in structural balance[6]	-1.4	-0.2	-0.5	0.7	0.4
One-year deviation from the required adjustment [7]	-1.4	-1.2	-1.5	-0.1	-0.4
Two-year average deviation from the required adjustment [7]	-0.7	-1.3	-1.4	-0.6	-0.9
Expenditure benchmark pillar					
Applicable reference rate[8]	1.5	2.8		3.9	
One-year deviation adjusted for one-offs[9]	-2.4	-2.0	-1.8	-0.3	-0.7
Two-year deviation adjusted for one-offs[9]	-1.9	-2.2	-2.1	-1.1	-1.2
PER MEMORIAM: One-year deviation [10]	-2.0	-2.3	-2.1	-0.3	-0.7
PER MEMORIAM: Two-year average deviation [10]	-1.7	-2.2	-2.1	-1.3	-1.4

Notes

[1] The most favourable level of the structural balance, measured as a percentage of GDP reached at the end of year t-1, between spring forecast (t-1) and the latest forecast, determines whether there is a need to adjust towards the MTO or not in year t. A margin of 0.25 percentage points (p.p.) is allowed in order to be evaluated as having reached the MTO.

[2] Structural balance = cyclically-adjusted government balance excluding one-off measures.

[3] Based on the relevant structural balance at year t-1.

[4] Based on the position vis-à-vis the MTO, the cyclical position and the debt level (See European Commission: Vade mecum on the Stability and Growth Pact, page 38.).

[5] Required adjustment corrected for the clauses, the possible margin to the MTO and the allowed deviation in case of overachievers.

[6] Change in the structural balance compared to year t-1. Ex post assessment (for 2017) is carried out on the basis of Commission 2018 spring forecast.

[7] The difference of the change in the structural balance and the corrected required adjustment.

[8] Reference medium-term rate of potential GDP growth. The (standard) reference rate applies from year t+1, if the country has reached its MTO in year t. A corrected rate applies as long as the country is adjusting towards its MTO, including in year t.

[9] Deviation of the growth rate of public expenditure net of discretionary revenue measures, revenue increases mandated by law and one-offs from the applicable reference rate in terms of the effect on the structural balance. The expenditure aggregate used for the expenditure benchmark is obtained following the commonly agreed methodology. A negative sign implies that expenditure growth exceeds the applicable reference rate.

[10] Deviation of the growth rate of public expenditure net of discretionary revenue measures and revenue increases mandated by law from the applicable reference rate in terms of the effect on the structural balance. The expenditure aggregate used for the expenditure benchmark is obtained following the commonly agreed methodology. A negative sign implies that expenditure growth exceeds the applicable reference rate.

Source :

Convergence Programme (CP); Commission 2018 spring forecast (COM); Commission calculations.

5. LONG-TERM SUSTAINABILITY

Hungary does not appear to face fiscal sustainability risks in the short run, as measured by the S0 indicator. Nonetheless, there are some indications that the fiscal side of the economy poses potential challenges (see Table 6).

Government debt stood at 73.6% of GDP in 2017. Based on the Commission 2018 spring forecast and under a no-policy-change scenario beyond forecasts, it is projected to decline to 72.9% in 2028, remaining above the 60% of GDP Treaty threshold. The full implementation of the Programme would put debt on a steeper decreasing path by 2028, leading to a debt ratio well below the 60% of GDP reference value in 2028. However, sensitivity tests (related to interest and growth shocks) suggest that the country's debt-reduction path displays considerable fragility to potential adverse macroeconomic developments. This highlights high risks for the country from debt sustainability analysis in the medium term.

Based on the Commission 2018 spring forecast and no-policy change scenario, the medium-term fiscal sustainability risk indicator S1 is at 1.5% of GDP. This is mainly due to the estimated initial budgetary position (the estimated primary structural deficit in 2019), the still high level of debt and the offsetting effect of the projected medium-term savings in age-related budgetary costs (which are estimated to reduce the additional required effort by 0.2% of GDP). This indicates medium risk in the medium term. Taking also into account the revealed fragility of the projected debt-reduction path, risks to fiscal sustainability over the medium term are overall high. The full implementation of the Convergence Programme would put the sustainability risk indicator S1 at -2.2% of GDP leading to low medium-term risks.

Based on the Commission 2018 forecast and debt projection, the long-term sustainability risk indicator S2 (which shows the adjustment effort needed to ensure that the debt-to-GDP ratio is not on an ever-increasing path) is at 4.4% of GDP. In the longer term, Hungary therefore appears to face medium fiscal sustainability risks, related to the initial budgetary position and the projected ageing costs contributing with 1.7% and 2.6% of GDP, respectively, to the sustainability gap over the very long run. On the other hand, full implementation of the Programme would put the S2 indicator at 2.2% of GDP, leading to a somewhat lower long-term risk, but leaving the risk classification unchanged.

Table 6: Sustainability indicators

Time horizon			Commission Scenario		Stability / Convergence Programme Scenario	
Short Term			**LOW risk**			
S0 indicator [1]			0.4			
Fiscal subindex			0.6	HIGH risk		
Financial & competitiveness subindex			0.3	LOW risk		
Medium Term			**HIGH risk**			
DSA [2]			HIGH risk			
S1 indicator [3]			1.5	MEDIUM risk	-2.2	LOW risk
of which						
	Initial Budgetary Position		0.9		-2.0	
	Debt Requirement		0.8		0.0	
	Cost of Ageing		-0.2		-0.2	
	of which					
		Pensions	-0.3		-0.3	
		Health-care	0.2		0.2	
		Long-term care	0.1		0.0	
		Other	-0.1		0.0	
Long Term			**MEDIUM risk**		**MEDIUM risk**	
S2 indicator [4]			4.4		2.2	
of which						
	Initial Budgetary Position		1.7		-0.6	
	Cost of Ageing		2.6		2.8	
	of which					
		Pensions	1.4		1.6	
		Health-care	0.6		0.6	
		Long-term care	0.3		0.3	
		Other	0.3		0.3	

Source: Commission services; 2018 stability/convergence programme.

Note: the 'Commission' scenario depicts the sustainability gap under the assumption that the structural primary balance position evolves according to the Commissions' spring 2018 forecast covering until 2019 included. The 'stability/convergence programme' scenario depicts the sustainability gap under the assumption that the budgetary plans in the programme are fully implemented over the period covered by the programme. Age-related expenditure as given in the 2018 Ageing Report.

[1] The S0 indicator of short term fiscal challenges informs the early detection of fiscal stress associated to fiscal risks within a one-year horizon. To estimate these risks S0 uses a set of fiscal, financial and competitiveness indicators selected and weighted according to their signalling power. S0 is therefore a composite indicator whose methodology is fundamentally different from the S1 and S2 indicators, which quantify fiscal adjustment efforts. The critical threshold for the overall S0 indicator is 0.46. For the fiscal and the financial-competitiveness sub-indexes, thresholds are respectively at 0.36 and 0.49*.

[2] Debt Sustainability Analysis (DSA) is performed around the no fiscal policy change scenario in a manner that tests the response of this scenario to different shocks presented as sensitivity tests and stochastic projections*.

[3] The S1 indicator is a medium-term sustainability gap; it measures the upfront fiscal adjustment effort required to bring the debt-to-GDP ratio to 60 % by 2032. This adjustment effort corresponds to a cumulated improvement in the structural primary balance over the 5 years following the forecast horizon (i.e. from 2020 for Commission scenario and from last available year for the SCP scenario); it must be then sustained, including financing for any additional expenditure until the target date, arising from an ageing population. The critical thresholds for S1 are 0 and 2.5, between which S1 indicates medium risk. If S1 is below 0 or above 2.5, it indicates low or high risk, respectively*.

[4] The S2 indicator is a long-term sustainability gap; it shows the upfront and permanent fiscal adjustment required to stabilise the debt-to-GDP ratio over the infinite horizon, including the costs of ageing. The critical thresholds for S2 are 2 and 6, between which S2 indicates medium risk. If S2 is below 2 or above 6, it indicates low or high risk, respectively*.

* For more information see Fiscal Sustainability Report 2015 and Debt Sustainability Monitor 2017.

6. FISCAL FRAMEWORK

Based on the 2017 budgetary outcomes, the constitutional debt rule, which stipulates a continuous reduction in the public debt-to-GDP ratio until the 50% national threshold is achieved, is very likely to have been fulfilled. The delineation of debt set out in the Hungarian legislation somewhat differs from the Maastricht concept.[6] Nonetheless, in the light of the notified decrease of the Maastricht debt ratio by more than 2 percentage point in 2017, it can be concluded that the conclusion that the prescribed reduction had indeed taken place. The escape clause defined for the debt reduction formula was invoked again for 2017, which led to a requirement to achieve at least a 0.1% of GDP reduction in the adjusted debt-to-GDP ratio.[7] Unfortunately, neither the authorities nor the Fiscal Council published the outcome for the 2017 adjusted debt ratio. This lack of formal ex post assessments risks to eroding the credibility of the Hungarian debt rules. The Convergence Programme, based on an unchanged exchange rate assumption, envisages a steadily decreasing trajectory with a fall in the debt ratio by nearly 14 percentage points between 2017 and 2022. Therefore the official plans are in accordance with the requirements of the domestic debt rules.

As to the nominal budget balance rule (prescribing conformity with the 3% of GDP reference value), the 2017 budgetary developments complied with this rule. Based on the headline deficit targets for years 2018-2022 contained in the Programme, the 3% of threshold is planned to be respected with an increasing margin. However, the structural budget balance rule (prescribing conformity with the MTO in each year) was breached in 2017 both ex ante and ex post, in a second year in a row. The adopted budget for that year was based on a structural deficit of 2.1% of GDP as estimated by the authorities, well above the country's MTO. The ex post breach is estimated to be smaller thanks to the overachievement of the deficit target. Moreover, the fiscal plan for 2018 breaches the structural balance rule again, as – according to the calculations of the government – the planned structural deficit was 2.5% of GDP at the time of the budget adoption. This was revised downwards in the Programme to 2.1%, still clearly worse than the MTO. Looking ahead, the structural balance trajectory set in the Programme will comply with the domestic requirement only from 2020, taking the plans at a face value as estimated by the authorities.

Based on the information provided in the Convergence Programme and in budget documents, the past and planned fiscal performance in Hungary appears to comply only partially with the requirements of the national fiscal rules. The Fiscal Council has not been involved in the endorsement or assessment of the macroeconomic scenario underpinning the Programme.

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[6] The domestic debt rule filters out (i) the revaluation effects of foreign currency debt and (ii) the stock-flow adjustment effects related to the pre-financing of EU funds.

[7] The legal base of this formula incorporates a very loose escape clause: if the official growth or inflation projection for year t+1 as included in the draft budget bill does not exceed 3%, the rule is suspended for that year. Based on the macroeconomic projection laid down in the Programme, the escape clause remains in force over its entire horizon.

7. SUMMARY

Based on the Commission 2018 spring forecast and the 2017 outturn data validated by Eurostat, the growth of government expenditure, net of discretionary revenue measures and one-offs, was well above the applicable expenditure benchmark rate in 2017, pointing to a significant deviation from the required structural adjustment (deviation of 2.4% of GDP). In 2017, from a position of -1.8% of GDP in 2016, the structural balance deteriorated to -3.1% of GDP, also pointing to a significant deviation (deviation of 1.4% of GDP). After taking into account factors that can potentially underestimate the fiscal effort measured by the growth of net primary government expenditure, the expenditure benchmark appears to adequately reflect the fiscal effort and still points to a significant deviation by a wide margin. This conclusion is also confirmed by the assessment of the structural balance pillar. The ex-post assessment therefore leads to the conclusion that the observed deviation from the MTO is significant in 2017.

Hungary complied with the debt rule in 2017. Both on the basis of the debt-reduction path of the Convergence Programme and the Commission 2018 spring forecast, Hungary's debt-to-GDP ratio is expected to remain below the debt reduction benchmark in 2018 and 2019, implying compliance with the debt rule.

The Convergence Programme assumes that the MTO will be reached by 2020. Based on the Programme's data recalculated by the Commission, however, the structural balance would reach the MTO in 2022, by the end of the planning period. According to the Commission 2018 spring forecast, the structural balance is expected to deteriorate further in 2018 and remains 1.8% of GDP away from the MTO in 2019. Overall, the adjustment path planned in the Programme is not in line with the requirement of the preventive arm of the Stability and Growth Pact with a risk of a significant deviation in 2018 and 2019. The net expenditure growth and structural balance based on the Commission 2018 spring forecast also point to a risk of a significant deviation from the required adjustment path towards the MTO in 2018 and 2019.

ANNEX

Table I. Macroeconomic indicators

	2000-2004	2005-2009	2010-2014	2015	2016	2017	2018	2019
Core indicators								
GDP growth rate	4.3	0.6	1.4	3.4	2.2	4.0	4.0	3.2
Output gap [1]	0.2	1.4	-2.5	0.3	0.3	1.6	2.4	2.3
HICP (annual % change)	7.1	5.1	3.2	0.1	0.4	2.4	2.3	3.0
Domestic demand (annual % change) [2]	4.6	-1.4	0.7	1.2	1.6	6.0	6.0	4.3
Unemployment rate (% of labour force) [3]	5.9	8.0	10.2	6.8	5.1	4.2	3.7	3.6
Gross fixed capital formation (% of GDP)	24.5	23.3	20.4	21.9	19.2	21.5	23.6	24.9
Gross national saving (% of GDP)	18.8	17.9	22.6	25.2	25.9	25.5	26.1	26.9
General Government (% of GDP)								
Net lending (+) or net borrowing (-)	**-5.9**	**-6.1**	**-3.5**	**-1.9**	**-1.7**	**-2.0**	**-2.4**	**-2.1**
Gross debt	**55.8**	**68.0**	**78.6**	**76.7**	**76.0**	**73.6**	**73.3**	**71.0**
Net financial assets	**-36.0**	**-51.4**	**-66.6**	**-67.2**	**-66.1**	**-63.2**	**n.a**	**n.a**
Total revenue	42.6	43.9	45.7	48.2	44.9	44.5	44.7	45.0
Total expenditure	48.5	49.9	49.2	50.1	46.5	46.5	47.1	47.1
of which: Interest	4.5	4.1	4.3	3.5	3.2	2.8	2.6	2.5
Corporations (% of GDP)								
Net lending (+) or net borrowing (-)	**-1.8**	**0.2**	**4.7**	**4.1**	**5.0**	**3.6**	**4.3**	**4.6**
Net financial assets; non-financial corporations	**-103.9**	**-114.6**	**-117.4**	**-102.6**	**-107.7**	**-104.0**	**n.a**	**n.a**
Net financial assets; financial corporations	**-2.3**	**-1.2**	**11.2**	**3.0**	**9.3**	**6.5**	**n.a**	**n.a**
Gross capital formation	16.3	14.9	13.5	12.2	13.3	14.3	15.2	15.9
Gross operating surplus	21.7	24.1	25.2	26.4	26.0	25.8	26.0	26.7
Households and NPISH (% of GDP)								
Net lending (+) or net borrowing (-)	**0.2**	**0.7**	**3.2**	**5.2**	**2.6**	**2.2**	**1.9**	**1.0**
Net financial assets	**64.6**	**65.4**	**79.7**	**98.4**	**104.5**	**105.9**	**n.a**	**n.a**
Gross wages and salaries	33.9	34.7	35.3	35.1	34.7	36.5	37.6	37.9
Net property income	4.4	3.8	3.4	3.4	2.8	2.4	1.7	2.3
Current transfers received	17.2	19.0	18.5	16.7	16.5	16.2	15.6	14.9
Gross saving	5.6	5.3	5.5	5.2	4.6	5.6	5.4	4.7
Rest of the world (% of GDP)								
Net lending (+) or net borrowing (-)	**-7.4**	**-5.2**	**4.4**	**8.0**	**6.0**	**4.2**	**4.1**	**3.8**
Net financial assets	**77.6**	**101.8**	**93.2**	**68.4**	**60.0**	**54.8**	**n.a**	**n.a**
Net exports of goods and services	-2.9	0.4	6.3	8.9	10.1	7.8	5.6	4.4
Net primary income from the rest of the world	-4.9	-5.5	-4.0	-4.5	-2.5	-4.3	-3.8	-3.0
Net capital transactions	0.2	1.0	2.8	4.7	-0.1	1.3	2.8	3.0
Tradable sector	46.0	45.3	45.4	46.5	46.1	45.4	n.a	n.a
Non tradable sector	40.1	40.7	39.1	37.5	38.5	39.2	n.a	n.a
of which: Building and construction sector	4.7	4.4	3.5	3.5	3.1	4.1	n.a	n.a
Real effective exchange rate (index, 2000=100)	93.0	106.6	97.0	87.7	90.3	95.6	98.2	99.1
Terms of trade goods and services (index, 2000=100)	102.3	99.7	98.8	100.0	101.1	100.7	100.3	100.2
Market performance of exports (index, 2000=100)	68.7	91.9	100.9	107.3	106.3	107.8	109.0	110.6

Notes:

[1] The output gap constitutes the gap between the actual and potential gross domestic product at 2005 market prices.

[2] The indicator on domestic demand includes stocks.

[3] Unemployed persons are all persons who were not employed, had actively sought work and were ready to begin working immediately or within two weeks. The labour force is the total number of people employed and unemployed. The unemployment rate covers the age group 15-74.

Source :
AMECO data, Commission 2018 spring forecast