



EUROPEAN COMMISSION

DIRECTORATE GENERAL
ECONOMIC AND FINANCIAL AFFAIRS

Brussels, 18 February 2014

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

1. Executive Summary

From 4 to 10 December 2013, Commission services carried out the fourth post-programme surveillance (PPS) mission to Hungary linked to EU balance of payments assistance between 2008 and 2010.¹ The Commission team followed up on commitments and policy measures agreed during the programme and monitored that the country's fundamentals remain sufficiently solid in order to ensure continued debt servicing.²

Hungary's economic growth has been improving significantly since the beginning of 2013, partly on account of 'indirect' fiscal stimulus measures³. After a fall by 1.7% in 2012, real GDP growth was projected to reach 0.7% in the Commission services' 2013 autumn forecast. Recent economic developments point to upside risks to this forecast, with growth now expected to reach over 1% in 2013. The recovery has become broader-based as the contribution from domestic demand turned positive, albeit partly on account of 'indirect' fiscal stimulus measures (notably, cuts in regulated utility prices, stepped-up absorption of EU funds and the central bank's extended Funding for Growth Scheme), but the country's underlying growth dynamics has also been improving. A gradual pick-up in economic growth is expected in the range of 2% in both 2014 and 2015. However, in a context of relatively high private and public indebtedness, the country's growth potential is still weak, which has recently been exacerbated by a series of unpredictable and contentious policy measures (such as the composition of the fiscal adjustment). While there was a broadly shared view between the Commission staff and the authorities regarding the improving macroeconomic outlook, the Hungarian authorities were more optimistic regarding the underlying situation of the economy, which is also reflected in somewhat higher potential growth figures over the forecast horizon.

The budget deficit path projected in the Commission services' 2013 autumn forecast is still broadly valid, although recent data suggest a better outturn for 2013. While the Commission services projected an increase of the general government deficit to 2.9% of GDP in 2013 in the autumn forecast, the cash-flow data published in early January 2014 could point to a 2013 deficit outcome close to or below the government target of 2.7% of GDP.⁴ Based on the adopted 2014 budget, the 2014 deficit could be around 3.0% of GDP. This assessment is subject to both significant deficit-decreasing risks (in particular related to the shift of the calculation method for national co-payments for EU funds from public to total cost) and deficit-increasing risks. In 2015, the deficit may stay below the Treaty reference value. The government reiterated its commitment to maintain the deficit below 3% of GDP (2.7% and 2.9% of GDP in 2013 and 2014, respectively). Following the overachievement of the MTO in both 2012 and 2013, the structural deficit will exceed the MTO in 2014 and 2015 due to the deterioration of the structural balance of around 1% of GDP in 2014 followed by a slight

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

² The cut-off date of this report was 9 January 2014.

³ The eventual fiscal costs of these measures may appear only in a longer-term horizon (e.g. a fiscal transfer to cover a potential loss of the central bank resulting from subsidised lending schemes).

⁴ However, based on a preliminary analysis, even if this better-than-expected deficit outcome for 2013 is confirmed by the 2014 spring fiscal notification, it would imply a negligible base effect for 2014 and beyond.

improvement in 2015. Government debt is projected in the Commission services' 2013 autumn forecast to increase to slightly over 80% of GDP in 2013, before decreasing by a cumulative 1½ pp in 2014 and 2015. If the current macro-fiscal outlook is confirmed by actual data, based on validated 2014 outturns, there could be a significant breach of the minimum linear structural adjustment (i.e. the debt reduction requirement) to be assessed in 2015

While the fiscal adjustment seems to have reduced the deficit to close to or just below the Treaty reference value, its composition hampered further the growth outlook, contrary to the Council's Recommendation of 9 July 2013. Specifically, compared to the 2012 outcomes, the tax burden on the corporate sector was further increased in 2013 (partly explained by within-the-year tax changes). In addition, the 2014 budget contains a higher expenditure ratio than envisaged in the 2013 convergence programme, which is planned to be counterbalanced partly by further revenue-increasing measures.

In the context of the transposition of the six-pack's Directive on minimum requirements for national budgetary frameworks, a number of amendments were approved to the fiscal framework legislation. These cover notably the availability of fiscal data and planning documents, numerical rules and the medium-term budgetary framework. Most notably, newly introduced fiscal rules are meant to ensure the consistency of the Hungarian fiscal policy with the requirement of the Stability and Growth Pact. In addition, the long overdue strengthening of medium-term budgetary planning was legislated. This opportunity was, however, not seized by the authorities to further reinforce the Fiscal Council by broadening its mandatory remit, as advocated by the Council.

Monetary easing continued in 2013 via further policy rate reductions and by the launch of the Funding for Growth Scheme to foster lending to SMEs. Excess forint liquidity in the financial system has increased rapidly. International reserve coverage of short-term external debt remained adequate despite the early repayment of the IMF, supported by EU fund inflows and a global search for yields. The forint has usually been traded in a rather narrow range to the euro since February 2013, with temporary deviations driven both by domestic and external factors. In a similar vein, Hungary's CDS spreads and long-term government bond yields fluctuated without a clear trend and were influenced by the same factors as the exchange rate. Discussions during the mission were centred around the sensitivity of the Hungarian financial markets towards possible adverse shocks. The Commission staff pointed to the vulnerabilities of the Hungarian economy, due to high short-term rollover needs and an unusually low short-term interest rate differential of Hungarian assets vis-à-vis euro area benchmarks. While the Hungarian authorities acknowledged that policies should be pursued in a cautious manner, they perceived economic vulnerabilities to be on a smaller scale.

Although the Hungarian banking sector is considered as broadly stable with adequate liquidity and solvency levels, it has not contributed to economic growth since the outbreak of the financial crisis in late 2008. Lending has remained sluggish, partly hindered on the demand side by the ongoing deleveraging of households and corporates, and on the supply side by banks' little appetite to increase credit exposure, most notably towards the corporate sector. In the last few quarters, lending conditions have somewhat eased and credit demand has also slightly improved. However, both factors still stand very far from their pre-crisis levels. In the Commission staff's assessment, a sustainable return of lending would require first and foremost a better operational environment for banks, as advocated by the Council in the country-specific recommendations addressed to Hungary. The current combination of an

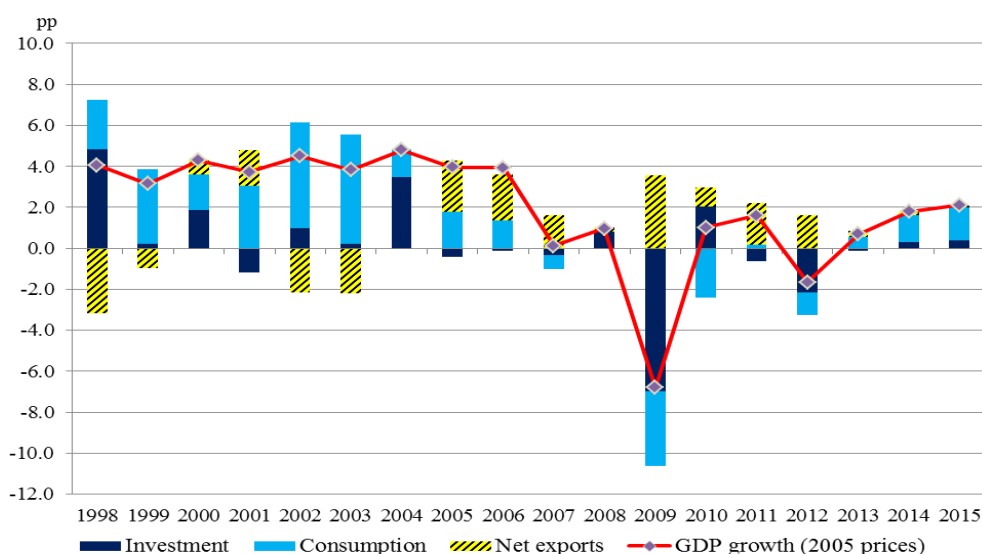
excessive tax burden imposed on banks and a high percentage of bad debt is unsustainable in the long term. Consequently, policies should be adjusted in order to improve current conditions. The next few years will most likely lead to a restructuring in the sector where most foreign-owned banks will probably continue deleveraging, while the market share of the savings banks sector and small domestic banks will gradually increase. However, before reaching this new equilibrium, lending could remain a drag on economic growth whereas the central bank's subsidised programmes and various forms of government interventions (such as increased state ownership in the banking sector) could imply medium-term risks. The integration of the Hungarian Financial Supervisory Authority into the central bank may lead to synergies in the oversight of the financial sector. Both enhanced macro-prudential supervision and the plan to establish an EU-conform bank resolution regime was welcomed by the Commission staff. The Hungarian authorities shared the Commission staff's view regarding the importance of enhanced portfolio cleaning and of improved resolution and supervisory mechanisms. However, views differed as to whether sustainable lending could be restored without reducing the current burdens on the sector, and also as regards the long-term potential fiscal risks inherent to the extended Funding for Growth Scheme.

Given relatively favourable financing conditions on sovereign debt markets, a persistent current account surplus, huge inflows of EU transfers and decreasing short-term debts, Hungary has been successful in rolling over its maturing international obligations, while keeping FX reserves at an adequate level. Hungary faces increasing gross financing needs in 2014 and 2015 at around 23% and 19% of GDP, up from 18% in 2013, including a spike in FX rollover needs of around 5.3% of GDP in 2014 (before it would fall to 2% of GDP in 2015). The international bond issuance of USD 2 bn in November replenished the level of available financial buffers. It should be recalled that the presence of foreign investors is dominant in public debt financing (with a 40% share of HUF-denominated papers and close to two-thirds of the total debt stock). Overall, the Commission team agreed with the Hungarian authorities that Hungary will be able to continue servicing its debt obligations. However, views differed (i) in terms of the vulnerability to adverse changes in the international financial environment and (ii) the potential unfavourable effect of a new FX mortgage relief scheme on financing conditions.

2. Macroeconomic developments and outlook

The Commission services' 2013 autumn forecast projects moderate real GDP growth of 0.7% in 2013, partly on account of indirect fiscal stimulus measures. After a 1.7% fall in GDP growth in 2012, the first quarters of 2013 brought a turnaround in economic activity, mostly in agricultural production (which went back to normal following a sizeable drop in 2012 linked to extreme weather conditions), but other sectors of the economy (i.e. construction, manufacturing and retail) have also started to gradually recover. Exports are projected to speed up partly on account of improving external demand, but also due to increasing export market shares linked to new production capacity in the machinery sector. Domestic demand is expected to be the main driver of growth. The increase in real disposable income, partly due to significant cuts in administrative prices introduced in three successive waves (January, August and November 2013), is expected to turn private consumption growth into slightly positive territory although high unemployment and ongoing deleveraging will keep household spending contained. The sharp fall in investment is forecast to stop on account of a strong increase in government investment due to an increased absorption of EU funds. Despite the boost to SME lending provided by the central bank's extended Funding for Growth Scheme (FGS), private investment is expected to remain negative in 2013, reflecting inter alia a weak housing market.

Graph 1: External and domestic demand contributions to economic growth



Source: Commission services (for the 2013-15 period, based on the 2013 autumn forecast)

The upward revision of the data for the first half of the year points to upside risks for the growth forecast. In the third quarter of 2013, GDP grew by 0.9% in line with expectations, but the significant upward revision of data for the first two quarters (+0.3 pp for each quarter) implies a significant upside risk to the Commission services' autumn forecast. Based on most recent estimates, real GDP growth is now expected to reach over 1% in 2013. Compared to the 2013 Convergence Programme, the draft budget revised up the official growth forecast to 0.9%

and 2.0% for 2013 and 2014, respectively, which seems to be realistic. The IMF projections⁵ are more pessimistic than the Commission services' autumn forecast (Table 1). Overall, there is a broadly shared view between the Commission staff and the authorities regarding short-term economic prospects.

According to the Commission services' autumn forecast, real GDP growth is expected to reach around 2% in 2014 and 2015. Exports are forecast to gain impetus in tandem with improving external demand. Domestic demand will be still partly supported by quasi-fiscal measures: investment is helped by the FGS's subsidized lending to SMEs and the strengthening of household consumption will in part stem from the improvement in real disposable income due to the regulated price cuts and increasing public sector wages.

Table 1: Comparison of GDP growth forecasts

%	2013	2014	2015
Commission services, autumn forecast, November 2013	0.7	1.8	2.1
HU government in Draft 2014 Budget, September 2013	0.9	2.0	2.3
MNB Inflation Report, December 2013	1.1	2.1	2.4
IMF WEO, October 2013	0.2	1.3	1.5

While unemployment has decreased in recent quarters, employment statistics show a contradictory picture. Despite a weak economy, based on the Labour Force Survey, employment expanded by 1.2% in the first three quarters of 2013 on a year-on-year basis and outperformed its pre-crisis level. Employment gains are chiefly occurring due to the extension of the Public Work Scheme, the increasing number of frontier workers as well as possibly to the whitening of the economy. The latter two factors could have a substantial effect, as based on the GDP-consistent data, employment grew at a much slower pace (0.1% y-o-y in Q1-Q3 2013).⁶ Despite a continuous increase in the participation rate on account of a tightening of social transfers, the unemployment rate decreased to close to 10% in Q3 2013. Based on the autumn forecast, employment is projected to increase in parallel with resuming economic growth, while unemployment is projected to remain around 10% by 2015, due to further increasing participation.

Inflation has declined to a low level, on account of cuts in administrative prices, low imported inflation and a negative output gap. Inflation fell to a low rate of 1.7% in Q3 2013. This decline has occurred mostly on account of two waves of cuts in regulated energy and other utility prices introduced as of January and August (with an overall effect of around - 1 pp for 2013) and a third cut effective from 1 November (implying a reduction in the inflation rate of around 1 pp for 2014). Underlying inflation has been declining too, due to the negative output gap and a drop in imported inflation. After an inflation rate well below the 3% target in 2013 and 2014, the MNB expects CPI to stabilise around 3% in the medium term. Although

⁵ The cut-off date of the IMF WEO was 23 September 2013 against 22 October for the Commission services' 2013 autumn forecast.

⁶ The main differences between the domestic (GDP-consistent) employment data and the Labour Force Survey data are that the former contains estimations of the grey economy done by the Hungarian Statistical Office, while the latter also captures changes in the number of frontier workers.

the autumn forecast contains somewhat higher figures than the MNB's projection⁷, there was a broadly shared assessment of the inflation trends over the forecast horizon between the Commission staff and the authorities.

While the economic projections of the Commission services and those of the authorities are relatively close to each other, there is a significant divergence in the assessment of the growth potential. Based on the Commission staff's assessment, the improving growth outlook is to a large extent a cyclical correction, mostly driven by indirect government stimulus to the economy, while potential GDP growth remains quite contained between 0% and 1%.⁸ During the discussions, the Commission staff stressed that Hungary's potential growth seems to lag behind regional competitors, with TFP and capital accumulation as the main factors behind the low potential growth. The Commission staff argued that the deterioration of the business environment and the related policy uncertainty adversely affect Hungary's competitiveness, private sector investment and the country's attractiveness to FDI. Therefore, they underlined the importance of policy adjustments to restore the country as an attractive environment for foreign direct investors, inter alia, by making the regulatory framework more stable, fostering market competition and removing recently introduced barriers in the services sector, along the lines advocated in the Council's country-specific recommendations. While the authorities shared the Commission staff's view of a currently relatively low potential growth of Hungary (the Ministry for National Economy's estimate of potential growth is 0.5 pp higher than that of the Commission staff), they stressed the importance of the improving outlook as well as the general uncertainties with potential output calculations. Also, the authorities had a different, more optimistic view on the effect of recent policies on medium-term potential growth.

3. Fiscal policy

3.1. Recent budgetary developments and outlook

According to the Commission services' 2013 autumn forecast, the general government deficit is expected to increase to 2.9% in 2013, following a deficit of 2.0% of GDP in 2012. However, the annual cash-flow data published in early January 2014 may signal a better deficit outcome. Compared to the budgeted figures, tax revenues could be lower by close to 1% of GDP, even after including the impact of the June 2013 tax-increasing measures of 0.4% of GDP, such as higher financial transaction duties and sectoral taxes on the energy and telecommunication companies. The lower tax revenues partly stem from lower-than-expected inflation and wages but are also linked to the overestimation of the budgetary impact of selected tax measures (e.g. the introduction of the financial transaction duty) and to the delay in the implementation of actions aimed at enhancing the tax administration (notably the on-line connection of cash registers with the Tax Authority).

Higher expenditures of close to 1% of GDP are expected in the 2013 autumn forecast compared to the budget. Expenditure slippages include higher wages in the public sector

⁷ In its recently published December Inflation Report, the MNB revised significantly down its inflation forecast for 2014 from 2.2% (September Inflation Report) to 1.3%, while the projected inflation rate of 2.8% for 2015 is close to the Commission services' 3% forecast. The downward revision is partly explained by recent measures (e.g. effect of the two free cash withdrawals per month – see Section 5).

⁸ Potential growth estimates over the horizon of the Commission services' autumn forecast (2013-2015)

related to the brought-forward introduction of a new compensation scheme in the education sector, the extension of the Public Work Scheme and the payment of premia to the staff of the Tax Authority. Moreover, higher-than-budgeted expenditures are expected on account of higher co-payments for EU funds mainly due to the financial correction approved in September⁹ and to the lack of agreement with the EU on a new financial assistance programme¹⁰, further subsidies to public transport companies and to the higher education sector as well as flood protection. Also, the Treasury's costs related to its financial transaction duty payment will highly exceed the initial expectations. These slippages were only partly counterbalanced by the May 2013 expenditure cuts of 0.25% of GDP related to the line ministries and some savings related to housing grants and pensions. Overall, according to the autumn forecast, the above-mentioned revenue shortfalls and expenditure slippages amounting altogether to close to 2% of GDP were assumed to be broadly offset by the budgetary reserve buffer of 1.6% of GDP¹¹, the higher revenues from the sale of broadcasting frequencies of close to 0.2% of GDP and the better-than-targeted balance of the local government sector.

Since the cut-off date of the 2013 autumn forecast deficit-decreasing developments have taken place, which could be partly offset by further deficit-increasing factors. According to recent cash-flow data, VAT revenues and social security contributions could be higher than expected in the 2013 autumn forecast, but this could be partly counterbalanced by lower excise duty revenues. Moreover, expenditure overruns could be contained by new savings by the budgetary institutions and chapters, lower housing subsidies as well as spending by extra-budgetary funds, altogether amounting to over ¼% of GDP. In addition, a one-off revenue could result from the shift of the accounting method from public to total cost for national co-

⁹ Due to deficiencies in management verifications in a number of EU co-funded projects, the Commission (DG REGIO) decided in July 2013 to apply a financial correction, i.e. a retroactive decrease of co-payments. In parallel, the Commission has temporarily put on hold payments to Hungary under 10 out of 15 national Operational Programmes (OPs) for around 1.6% of GDP (EUR 1.5 bn) until all requested remedial actions are undertaken. Final agreement on a flat 5% financial correction for all OPs in question was reached in September. Since then Hungary submitted the corrected payment claims to the Commission, and all withheld reimbursements were paid out.

¹⁰ Under Regulation No 1311/2011, the EU co-financing rates for EU funds can be increased by up to 10 percentage points in countries benefiting from financial assistance, meaning that the EU could cover up to a maximum of 95% of programme costs, if requested by the Member States concerned. See: http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/126789.pdf.

¹¹ The budgeted reserve buffer of 1.6% of GDP includes an extraordinary reserve of 1.3% of GDP (the so-called Country Protection Fund) and the general reserve of 0.3% of GDP. While the general reserve of 0.3% of GDP only slightly exceeds the level that is set as a minimum by the Public Finance Act, the extraordinary reserve buffer could be assessed as exceptionally high and aimed at counterbalancing risks stemming from, inter alia, the introduction of new taxes and the budgeted increase in tax revenues due to the enhancement of tax collection. However, already in the 2012 autumn forecast, the Commission services forecast that the deficit target of 2.7% of GDP would not be attained without further corrective measures since the revenue shortfalls and expenditure slippages were expected to exceed the budgeted reserves.

payments for EU funds.¹² On the other hand, deficit-increasing factors are related notably to the one-off outlay of 0.1% of GDP due to the recent decision of the European Court of Justice¹³ and the slightly higher operational costs of the Hungarian debt management agency. Overall, based notably on the annual cash-flow figures published in early January, the 2013 deficit could be close to or even below the government target of 2.7% of GDP.

However, the achievement of the official deficit target of 2.7% of GDP is still subject to upside and downside risks. The main deficit-decreasing risk is related to the possibly higher surplus of the local government sector linked also to the favourable preliminary cash-flow data in the first three quarters of 2013, which could partly reflect the impact of the strengthened control of the central government on taking loans by the local governments. On the other hand, the budgetary transfer of 0.4% of GDP into the central body of the savings co-operatives paid out in December 2013 might increase the deficit in ESA terms, depending on the outcome of the ongoing consultations between Eurostat and Hungary. In addition, the end-year savings by budgetary chapters and institutions stemming from increasing carry-over balances could be offset by increased arrears in accrual terms (to be validated at the time of the spring 2014 fiscal notification).

The 2014 deficit is projected to be 3.0% of GDP in the Commission services' 2013 autumn forecast, i.e. slightly beyond the recently revised target of 2.9% of GDP. Based on the latest information available and taking into account the final numbers of the 2014 budget as adopted by Parliament on 17 December, this assessment of the deficit outlook still remains valid. In particular, based on a preliminary analysis, the better-than-expected 2013 cash-flow figures published in early January seem to have only a marginal base effect for the deficit outcomes in 2014 and beyond. The higher deficit in 2014 compared to 2013 reflects the planned increase of wages in the public education sector, the increasing fiscal costs of the previously introduced simplified business taxes as well as the extension of the family tax allowances. These elements are projected to be partly offset by a nominal freeze of public wages in most areas of the public sector, additional revenues from the new distance-based road toll system, the enhancement of the tax administration and the effect of economic recovery. In addition, the implementation of specific investment projects is announced to be conditional on the realisation of one-off revenues from the sale of telecommunication licences. The Commission services' assessment is based on the important assumption that the totality of the extraordinary reserve (0.3% of GDP) and part of the general reserve (i.e. close to 0.1% of GDP) will not be spent. Compared to the Commission services' 2013 autumn forecast, the only non-negligible difference in the Commission services' current assessment for 2014 is the extension of selected family benefits of 0.05% of GDP, which was not sufficiently

¹² Shifting the calculation method for national co-payments for EU funds from the public to the total cost approach means that while previously the 85% EU co-financing rate was complemented by a national public contribution of 15%, this latter national contribution could be covered by private sources for relevant interventions too. Essentially, the effect would be to replace the national public funds invested in those interventions by private funds. This would apply retroactively as well. As these private funds would then count as part of the overall financing provided and the national public resources would be taken out of the projects concerned, the overall volume of investments linked to the OPs would decrease. The actual amount of the decrease would be reimbursed to the Hungarian budget. Also, given that the EU funds would replace 15% national co-financing for the intervention areas in question, correspondingly less EU funds would be available for other/future projects.

¹³ On 12 November 2013, the European Court of Justice overturned a 2010 European Commission decision ordering MOL, a Hungary-based oil and gas company, to pay the national government EUR 122 million, which was the estimated value of discounted fees for mining.

substantiated at the time of the finalisation of the 2013 autumn forecast. However, this deficit-increasing development is offset by the improving macroeconomic outlook.

Importantly, the structure of the planned 2014 budget has changed compared to the one included in the 2013 convergence programme, with an increased reliance on revenue measures, running counter to the Council's policy advice. Contrary to the commitment in the convergence programme, the nominal freeze of the purchase of goods and services has not been kept. Overall, according to the 2014 budget, the expenditure-to-GDP ratio would be higher than expected in the 2013 convergence programme by around 1½ pps, but this is primarily due to the downward revision in the projected nominal GDP trajectory. This anticipated increase would take place even though a number of factors would suggest strict expenditure restraints: (i) the base effect of ¼% of GDP of the May 2013 expenditure cuts, (ii) the lower than originally planned cost of the next step of the new compensation scheme in the public sector amounting to 0.2% of GDP, and (iii) the lower extraordinary reserve of 0.2% of GDP. The projected higher expenditures are planned to be counterbalanced by (i) tax revenue-increasing measures of 0.3% of GDP as announced in June 2013, (ii) higher than earlier estimated revenues due to the enhancement of tax administration of around 0.2% of GDP, and (iii) the sale of telecommunication frequencies of 0.4% of GDP (recorded as non-tax revenues). However, further revenue-side measures and developments decreasing tax receipts (in particular, the extension of family tax allowance and increased take-up for the simplified new SME tax schemes,) partly counterbalance this revenue increase. Overall, the tax-to-GDP ratio is expected to remain at around 39¼% if we compare the officially budgeted 2014 figures with preliminary estimates for the 2013 outturns. Finally, the fiscal room for manoeuvre has also been widened by the increase of the deficit target from 2.7% to 2.9% of GDP, i.e. just below the Treaty reference value. It should be recalled that the direction of these changes was against the policy advice contained in the Council recommendations, which called for a more growth-friendly composition of fiscal adjustment.

Differences between the 2014 budgetary plan and the Commission services' forecast mainly pertain to the revenue side, which is only partly related to the assumed slower economic recovery. Specifically, the Commission foresees significantly lower VAT and CIT revenues, although higher revenues of 0.2% of GDP due to the enhancement of the tax administration were taken into account. On the expenditure side, the Commission forecast factors in somewhat higher expenditures related to the higher wage compensation in the Tax Authority and slightly higher net interest expenditures. All in all, according to the Commission services' updated assessment, the 2014 deficit would be just at the Treaty reference value.

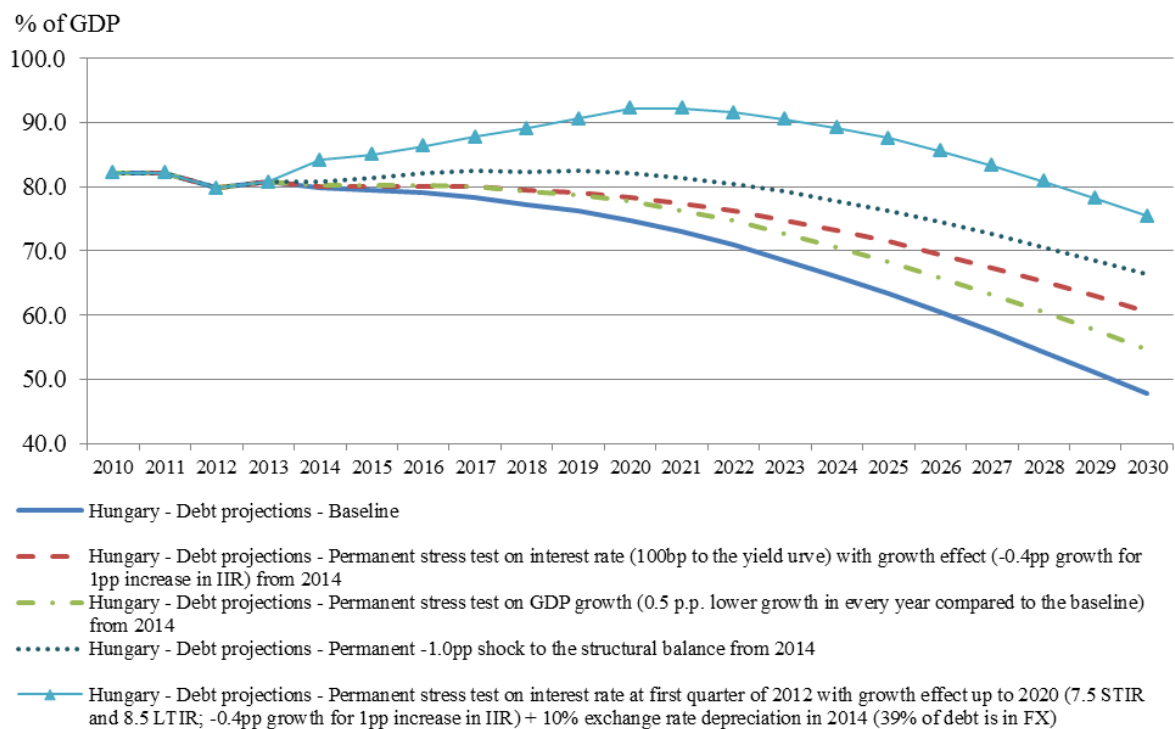
For 2015 the Commission services' 2013 autumn forecast projects the deficit to decrease to 2.7% of GDP. This projection is mainly based on the usual no-policy-change assumption (e.g. it factors in the already adopted steps of the new wage compensation scheme in the public education sector), but also takes into account the credible commitments of the convergence programme (e.g. the nominal freeze of wages in the public sector and selected family benefits, which has been respected for many years in a row), and assumes a fall in public investment linked to the electoral cycle. Importantly, this forecast does not factor in any loss of the MNB and the related capital transfer need.

Accounting issues pose upside and downside risks to the 2014 and 2015 deficit. The change of method for the calculation of national co-payments for EU funds from public to total cost may result in significant one-off revenues in the year when it is approved by the

Commission if it is accounted as revenue in ESA terms. Specifically, Hungary would receive EU co-payments of around ½% of GDP in one step (likely to take place in 2014), corresponding to payments that were provided earlier from the Hungarian budget to those projects where the final beneficiaries were private sector agents. On the other hand, higher public domestic investment expenditures may become necessary later on linked to this shift of the accounting method unless the original investment projects are reviewed – due to the fact that the accelerated absorption of the EU funds in 2013 and 2014 will result in lower available EU funds in 2015. With regard to the exact accounting of the methodological shift, frequent technical discussions between the Hungarian authorities and Eurostat have taken place and the final decision is expected shortly.

The structural balance is forecast to deteriorate in 2013 and 2014 by around 1½% of GDP in cumulative terms and to improve slightly in 2015. This should be seen against the background that the MTO (a structural deficit of 1.7% of GDP) was considerably overachieved in 2012 and the 2013 structural deficit is projected to be closer but still below the MTO. The currently projected 2014 and 2015 structural deficits would exceed the MTO by ½% and ¼% of GDP respectively, but it alone could not trigger any formal surveillance step for HU, whose currency is not the euro and that chose not to be bound by the Fiscal Compact. In addition, the deterioration of the structural balance amounting to around 1% of GDP in 2014 would significantly exceed the minimum linear structural adjustment requirement that would allow, according to preliminary calculations, a maximum deterioration of 0.4% of GDP for that year. This would imply a significant breach of the debt-reduction requirement to be assessed in 2015, based on the validated 2014 budgetary outcome, unless further structural efforts are made.

Graph 2: Government debt sensitivity analysis



Source: Eurostat and Commission services' calculations

According to the Commission services' 2013 autumn forecast, government debt is forecast to increase to close to 81% of GDP in 2013, before decreasing by around a cumulative 1½ pp in 2014 and 2015. This also reflects financial transactions made in 2013, notably capital transfers to buy out the E.ON gas storage units and to reorganise the savings cooperative sector. Looking ahead, debt sustainability calculations show a mixed picture. Graph 2 presents illustrative projections for the debt-to-GDP ratio up to 2030. In the baseline scenario government debt can slowly decline to around 75% of GDP by 2020. However, sensitivity analysis indicates that the foreseen pace of debt reduction will not be sufficiently robust against adverse shocks. Small negative shocks to the interest rate, economic growth or the budget balance can lead to a stagnating debt ratio in the medium term. In case of a strongly adverse scenario (assuming interest rates would return to the level prevailing in Q1 2012 and a 10% permanent exchange rate depreciation), debt could start increasing towards 90% by 2020. During discussions, the Commission staff drew the authorities' attention to the potential breach of the debt-reduction requirement and the risks revealed by the debt sustainability calculations and hence stressed the need to put the public debt on a firm downward path through growth-enhancing consolidation measures.

3.2. Fiscal governance

The promising fiscal governance framework, adopted and phased in between 2008 and 2010 in the context of the financial assistance programme, was fundamentally revamped in 2011. The new set-up has a commendable strong constitutional basis, but suffers from a number of weaknesses, which the Council asked to address in subsequent EDP and country-specific recommendations. The medium-term budgetary framework (MTBF) remains purely indicative. In addition, the debt growth rule (laid down in the Economic Stability Act adopted in December 2011) has a number of design flaws (narrow focus on the annual cycle, lenient escape clause, insufficient monitoring and correction mechanism in case of deviation), and it will be in effect only from 2016. On the institutional side, further reinforcements for the Fiscal Council (FC) are still needed to ensure that its analytical underpinnings are commensurate with its unprecedented veto right over the annual budget bill. The broadening of the FC's mandatory mandate advocated by the Council would be conducive to ensuring that its work and decisions are based on detailed and quantified calculations and not on qualitative risk assessments, as has been the case so far.

Discussions with the authorities centred on the amendments introduced to the fiscal framework legislation in the context of transposing Council Directive 2011/85 on the requirements for national budgetary frameworks. The amendments, which were approved by Parliament soon after the mission ended, cover inter alia the availability of fiscal data and planning documents, numerical rules and a revamped medium-term budgetary framework. The exchange of views during the mission was not meant to pre-judge the result of the compliance assessment to be carried out by the Commission in a horizontally consistent way later on the basis of Hungary's expected notification, but just to collect preliminary information. In this respect, the authorities emphasised that many requirements of the Directive were already fulfilled by the existing Hungarian legislation. As regards the public availability of budgetary data on the central and local level as well as the public nature of the government's regularly updated forecasts, the new provisions seem to include a comprehensive regulation.

New numerical rules are introduced to ensure compliance with the Stability and Growth Pact requirements, but existing design flaws are not corrected. Beyond the constitutionally

defined requirement to have a declining debt path, it is now stipulated that the deficit target of the planned budget shall be in accordance with the 3% of GDP deficit threshold as well as with Hungary's medium-term objective (MTO). The escape clause is defined in such a way that any officially projected negative GDP growth rate would exempt the country from fulfilling the 3% threshold (without, however, delineating the level of permissible deviation or establishing a correction mechanism in the event of a deviation, while the structural balance shall ex ante still be in line with the MTO). In this context, it was clarified that after long consideration, the government decided not to repeal the debt growth rule. Thus, from 2016, a relatively complex set of domestic fiscal rules will be in place in Hungary and the identified weaknesses in the design of this rule (see above) will not be addressed.

The new medium-term budgetary framework should help to improve the planning horizon, which has so far been narrowly focusing only on the actual budget year. The amendments prescribe that 3-year expenditure and revenue plans (decomposed into a no-policy-change baseline and the estimated impact of new discretionary measures) would be defined in a separate government resolution by 30 April of each year (the structure will be similar to the one used in the annual budget law).¹⁴ Adjusting the plans would require an official justification by the government in the relevant resolution. Differences between the MTBF and the actual budget law for a given year must be fully justified by changes in the macroeconomic scenario or other events falling outside the scope of the government. This 'comply or explain' type of rule would exercise constraint only on the government when preparing the draft budget but would not put a limit on the powers of the Parliament.

The authorities expressed no intention to change the rules governing the Fiscal Council, and thus no follow-up to the Council recommendation, which advocated the broadening of the body's mandatory remit, is expected. Government representatives argued that the FC has already got a very wide optional mandate to comment on any relevant public finance issues. The Commission staff responded that over the last 24 months – the Economic Stability Act setting up the FC entered into force on 1 January 2012 –, the FC has not really utilised this manoeuvring room (notably, it did not publish any analysis/opinion beyond what was strictly required by law). As regards the observed way of performing existing tasks, the Commission staff highlighted that the FC's opinion on whether or not the draft budget is considered to fulfil the debt reduction rule (i.e. exercise its veto right) should preferably be based on publicly accessible detailed calculations/projections, which would enhance the credibility and accountability of the institution. In relation to the new MTBF provisions, the authorities acknowledged that it would be up to the discretion of the FC to decide whether it would endeavour to evaluate the completeness and validity of the government's justifications when the differences between the medium-term plans and the actual budget figures would be explained.¹⁵

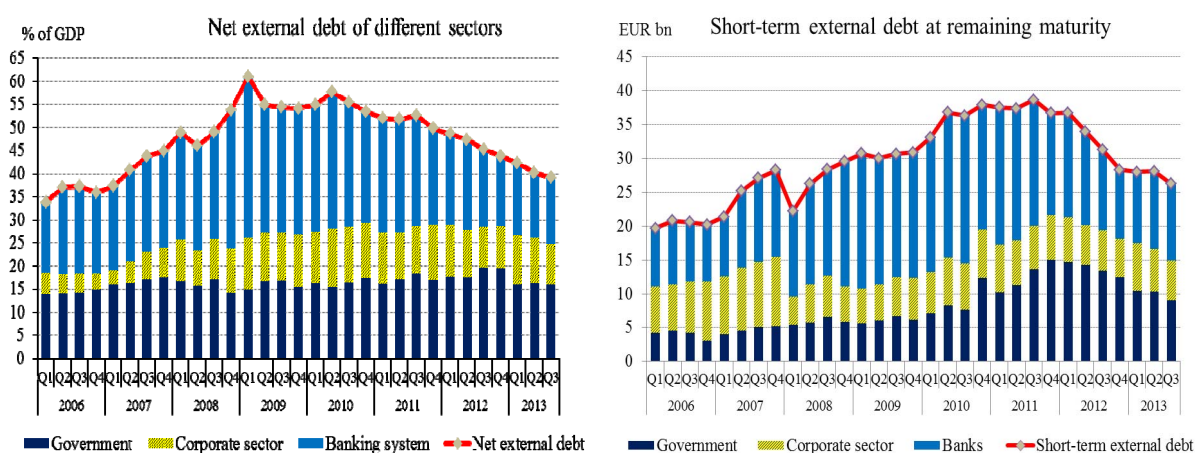
¹⁴ A very similar planning procedure would be implemented in the local government sector (where medium-term planning was completely non-existent so far).

¹⁵ In this regard, the regular preparation of macro-fiscal forecasts, as recommended by the Council, would help the FC verify the government's explanations for possible deviations vis-à-vis the medium-term plans, which could considerably enhance the integrity and predictability of the entire medium-term framework.

4. Financial markets and monetary policy

During the first three quarters of 2013, the large net outflow in the financial account (EUR 7.2 bn) was partly covered by the robust surplus of the combined current and capital account (EUR 4.4 bn). Financial account outflows were driven largely by "other investment" (about EUR 8.7 bn), which was the result of the repayment of IMF assistance loans (about EUR 5.1 bn in Q1-Q3 2013) and the protracted deleveraging in the financial sector. Direct investments were also contributing negatively (EUR 1.1 bn). These were partially offset by the net positive balance of portfolio investment (EUR 1.8 bn in Q1-Q3 2013), which reflected in particular the issuance of FX bonds in February (amounting to USD 3.25 bn). In line with the general trend in the region, there was no major setback in portfolio capital flows after the start of the Fed tapering discussion in May 2013. Non-resident holdings of HUF-denominated Hungarian government securities declined from June to September, but recovered to about HUF 4.9 tn by November 2013 (vs. about 4.8 tn in February 2013). Hungary's gross external debt fell to some 90% of GDP by Q3 2013 and net external debt to below 40% of GDP (down from 48% of Q1 2012).¹⁶ Short-term external debt has also declined by EUR 10.5 bn since Q1 2012 due to both declining banking sector and government debt.

Graph 3: Evolution of external debt



Source: Commission services

International reserve coverage of short-term external debt¹⁷ increased to 117% by the end of Q3 2013 from 110% a year earlier. The improvement was due to a significant decline in short-term debt (EUR 5.1 bn in a year). Hungarian authorities decided in July 2013 to early repay the remaining programme-related IMF debt by August 2013.¹⁸ After these repayments, international reserves fell to around EUR 31 bn in August and September, but continued to cover well over 50% of broad money (M3). International reserves were replenished to EUR

¹⁶ Reported external debt figures exclude intercompany loans.

¹⁷ At remaining maturity, including the effect of accrual accounting of EU transfers (EUR 0.6 bn in Q3 2013) – this is arguably the most relevant measure of reserve coverage for HU.

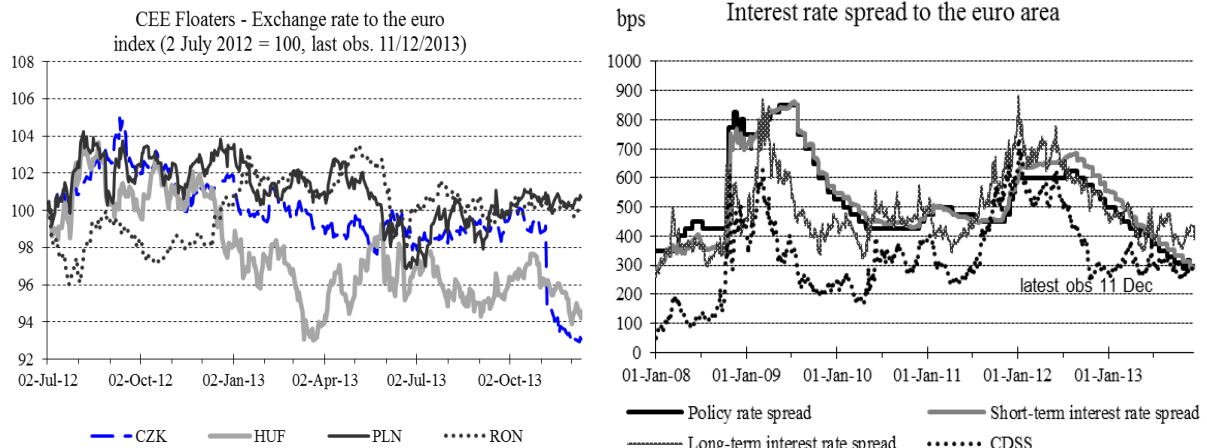
¹⁸ In July-August 2013, about EUR 2.9 bn was repaid early to the IMF (including also repayment of EUR 0.7 bn by the MNB), on top of the EUR 2.2 bn repaid in H1 2013.

34.7 bn by end-November, by large EU-fund transfers and a USD-issue by the government.¹⁹ Looking forward, the economy's strong net external lending position should ensure that international reserves remain at adequate levels, but vigilance is needed as (i) a possible new FX mortgage scheme might require the use of MNB reserves to avoid pressure on the exchange rate, and (ii) monetary conditions are easing in Hungary and the international monetary environment may get less favourable, and hence the interest rate differentials become less supportive for the forint.

Financial market sentiment has been driven primarily by expectations about the continuation of ultra-easy monetary conditions in advanced economies and by further monetary easing in Hungary. The forint weakened to 303 HUF/EUR on average in March 2013, with uncertainties around the Cyprus programme and the appointment of the new MNB governor, former Finance Minister Matolcsy. Benefitting from a global search for yields, the forint strengthened to around 293 on average in May and has remained relatively stable in the range of 290-300 since then, except for some days ahead of the Fed's September meeting and more recently in December. Between February and early December 2013, Hungary's 5-year CDS spread fluctuated around 300 bps, with two peaks to over 360 bps in late-March and June, both triggered mainly by external factors (Cyprus and Fed tapering fear). The 10-year government bond yield declined to below 5% in May, but edged up to around 5.8% by early December, with two significant bouts in June and September. Sovereign HUF-denominated primary market access was relatively smooth, although demand for longer maturities was volatile and the government's yield curve has steepened. The Budapest stock market index has broadly stagnated this year, partly due to unfavourable news about its two biggest companies. Discussions during the mission centred around the consequences to Hungarian financial markets of the low interest rate environment and sensitivities towards possible adverse shocks. The Commission staff pointed to the vulnerabilities of the Hungarian economy, due to a high short term rollover need and an unusually low short term interest rate differential of Hungarian assets vis-à-vis euro area benchmarks. While the Hungarian authorities agreed that policies should be pursued in a cautious manner, they perceived economic vulnerabilities to be on a smaller scale.

¹⁹ It should be added that in September 2013, MNB signed a CNY 10 billion (about EUR 1.2 bn) renminbi-forint swap agreement with the People's Bank of China to support trade and investment relations.

Graph 4: Exchange and interest rate developments



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

Source: Bloomberg and Eurostat

The MNB continued the rate-cutting cycle started in August 2012 and by mid December 2013 it had reduced its policy rate by 400 bps to 3.0% in 17 steps. As an intended sign of precaution, the Monetary Council (MPC) scaled back the pace of successive monthly reductions in August from 25 bp to 20 bp and hinted that future steps may be calibrated further. In the MPC's assessment, the December cut was necessary for reaching the 3% inflation target over the medium term, against the background of low inflationary pressures and sizeable unutilised capacities in the economy. The MPC also indicated that there may be further – although potentially smaller – rate reductions ahead, barring unfavourable country risk developments. The MNB-calculated core inflation excluding indirect taxes reached 1.2% in November 2013 and inflation expectations are also low and declining. Interbank market rates and the implied HUF yields on the FX-swap market followed the path of the policy rate. Markets expect the policy rate at around 3% in early 2014, before it starts rising with the awaited Fed tightening thereafter.

In June 2013, the MNB launched a Funding for Growth Scheme (FGS) as a new monetary policy instrument, in order to foster lending to SMEs. The programme was recently extended and expanded in size (more details on this scheme are provided in the next section). The MPC's stated goals with the FGS, beyond mitigating the disorders observed in lending to SMEs, were to strengthen financial stability and reduce the external vulnerability of the country. The FGS is also regarded as an additional and more rapid instrument for implementing monetary easing than the traditional policy rate channel, in a situation when inflation is undershooting the target. The FGS contributed to a significant rise in the liquidity surplus, with the 2-week MNB-bill stock reaching nearly HUF 5 tn by end-November 2013 (up by about HUF 532 bn from end-June).²⁰ Cash in circulation increased by 18.7% in the year to end-November, due to higher duties on banking transactions and lower opportunity cost of holding cash. The FGS may constrain the MPC in setting the policy rate in the future due to the negative impact higher rates would have on the MNB's profit (given the fixed 0% long-term refinancing rate of the scheme). On the other hand, the MNB downplayed this risk with

²⁰ While the conversion of EU funds has also added to forint liquidity, the increase was partly drained by the MNB with FX-swaps (under the 3rd pillar of FGS).

the arguments that (i) the FGS was targeted to SMEs, (2) its volume was limited, (3) the central bank law did not put any constraint on MNB's profits.

5. Financial sector policies

The aggregated balance sheet of the Hungarian commercial banking sector continued to shrink throughout the year (decreasing by 1.3% y-o-y in September). The deleveraging of the sector has been on-going since mid-2010. However, it is clearly becoming segmented and while big banks, mostly foreign-owned, continue to deleverage, the medium and small institutions including the cooperative sector are growing and increasing their loan stock between 5 to 15% per year. Net lending flows turned positive in Q3 2013 primarily on account of the central bank's Funding for Growth Scheme (FGS). The scheme, which is targeted towards SMEs contributed to a net increase in lending flows of around 1% of GDP or close to 5% of the outstanding corporate lending stock in Q3 2013. Banks welcomed the introduction of the FGS and noted that it was essential to revive the SME lending market. The authorities stressed that it loosened financial constraints and increased competition in lending. In the second stage it is expected that around HUF 600-900 bn will be allocated out of a potential total envelope of HUF 2000 bn or 7% of GDP. While the Commission staff acknowledged the importance of existing financing constraints in the SME segment, it warned against potential fiscal costs related to the scheme (the central bank refinances banks at zero interest rate) and the risk of leading to unsustainable price competition (due to a fixed interest rate margin at 2,5%), which risks are correspondingly more pronounced if the programme is applied on a large scale (potentially up to HUF 2750 bn, which is close to 60% of the 2012 SME loan stock or 10% of GDP).

Box 1: The Funding for Growth Scheme

In April 2013, the MNB's Monetary Policy Council approved the Funding for Growth Scheme (FGS) which is built around 3 pillars:

1st Pillar - New loans to SMEs. The MNB offers commercial banks funds at 0% interest rate, which banks can lend to SMEs at maximum 2.5%. The preferential rate loans can be used only to finance investments and working capital, contribute to EU financial support and redeem loans.

2nd Pillar - Conversion of existing FX loans of SMEs into forint loans, also based on zero cost funding to banks and capped interest rates at 2.5%. Simultaneously, the MNB has planned to decrease international reserves by the same amount and to make them available to banks to repay short-term foreign liabilities. As a result, the net FX exposure of Hungary would remain unaffected.

3rd Pillar - Planned decrease of the outstanding amount of two-week MNB bills by 20% (HUF 900 bn) to reduce Hungary's gross external debt. An equivalent amount of international reserves has been planned to be made available (in the form of swaps) to banks to help them repay their short-term foreign liabilities. As a consequence, the net FX exposure of the country is unaffected.

In the first phase of the FGS, HUF 701 bn were utilised in the first two pillars (out of a total envelope of HUF 750 bn), out of which HUF 290 bn (1% of GDP) was recorded as new credit and the rest was used to refinance debt (of which HUF 229 bn was FX debt). As regards the third pillar there was a relatively moderate demand (by end-2013, it exceeded HUF 150 bn or some EUR 0.5 bn) compared to the original plans. After the first phase, the FGS was expanded

in September to a maximum potential size of HUF 2.75 tn (close to 10% of GDP) running till end-2014, out of which HUF 500 bn became immediately available. The conditions attached to the second envelope are stricter than for the first one as 90% of the disbursements must be related to new loans.

Portfolio quality has declined in both the corporate and household segments. The banking sector's balance sheet is heavily burdened with non-performing credit representing one of the main risks for financial stability in Hungary. One in five corporate loans are classified as delinquent and although the MNB's expectations is that it reached a plateau, the corporate sector NPL ratio is not expected to decrease until 2015. Performing restructured loans also stand relatively high at 7.5% of the portfolio. In the case of households the non-performing credit was close to 18% in Q3 2013 and is expected by the central bank to stabilize around the current levels. However, shorter maturity delinquencies (below 90 days) also stand at 15% of the portfolio and around 23% of the household loan portfolio is restructured (NPL excluded), mostly through the exchange rate cap scheme. Therefore, overall more than one third of the banking sector's household portfolio can be considered as problematic. Nevertheless, the coverage ratio of NPLs is relatively high at 55% in both segments, although it is much lower for restructured loans at 20%. Any major improvement in terms of portfolio quality would require much faster portfolio cleaning. Discussions during the mission revealed that this is hindered on the one hand by the more generous provisioning rules for restructured loans and on the other hand by inefficiencies in the resolution procedures. The Commission staff also argued that policy uncertainty and a weak operational environment – contributing to increased uncertainty on potential losses – are also obstacles. The Commission staff welcomed plans of the Financial Stability Council to investigate potential ways of enhancing portfolio cleaning.

Against the background of a high tax burden and non-performing assets the banking sector has been loss-making since Q3 2011. The return on assets (ROE) stood at -2% in Q2 2013, slightly higher than in previous years. The average figures hide a severe dispersion between individual banks with the biggest bank generating substantial profits²¹ while other banks record either a small profit or loss. Banks have been trying to pass through their increasing tax burden to their customers by increasing the already high level of interest rate margins on existing FX loans and raising fees for financial intermediation. As a consequence of increasing service fees, the government imposed on banks to grant customers two free cash withdrawals per month starting from February 2014. This recent measure will cost the financial sector around 0.1% of GDP. The low level of profitability among large foreign-owned banks is not sustainable and there is a risk that some actors may decide to leave the market in the next few years.²² While the authorities justified their policies towards the banking sector by the low level of competition and equal burden sharing, the situation seems to have turned into a negative feedback loop between banks and the government. Banks are cautious not to expand lending in a volatile operational environment, but try to pass through to customers any extra burden. This leads to new measures from the government's side, further deteriorating the general operational environment. While the authorities think that the expansion of the savings bank sector and other domestic banks (helped by the FGS) can

²¹ A certain portion originates outside Hungary.

²² However, leaving the Hungarian market is not easy due to the high level of foreign funding in the sector, which should be taken over by potential buyers. This originates in the persistently high loan-to-deposit ratios among foreign subsidiaries in Hungary averaging ca. 140% against a total average of some 110%. Also, presence in Hungary for the foreign banking groups is part of their regional strategy. Hence, fixed costs of leaving the Hungarian market are also relatively high in terms of reputation and/or market access.

contribute to an increase in lending, the Commission staff stressed, recalling the relevant country-specific recommendations, that a sustainable return to lending would require a better operational environment for banks and improved capacities for capital accumulation.

Despite a problematic situation the banking sector would remain liquid and solvent under a stress scenario. Regular stress tests carried out by the central bank require a global capital adequacy ratio of 8% under the stress scenario. The latest stress test indicates capital needs in two banks in the range of HUF 116 bn (0.4% of GDP) under the stress scenario. In terms of liquidity, the sector remains above the regulatory requirement of 10% 30-day liquidity to total assets even under the stress scenario. However, as there is a major shortfall of FX liquidity, the smooth functioning of swap markets (supported by the MNB), especially in the stress case, remains paramount to the proper functioning of the banking sector.

Assisting insolvent debtors is an urgent and major social challenge but a new FX relief scheme could endanger financial stability. FX indebtedness is one of the most serious social challenges facing Hungary.²³ The government has tried so far to address the problem with a series of measures (early repayment scheme, exchange rate cap scheme, and the creation of the National Asset Management Agency), but most of these measures did not target the most problematic debtors. The recent extension of the exchange rate cap scheme towards delinquent borrowers (over 90 days) is a step in the right direction, which could give some relief for tens of thousands of households. The exact design of the announced new FX relief scheme is still uncertain, as the government has decided to wait for a clear legal picture before adopting any further decision. Therefore, in parallel to the legal deliberations of the Supreme Court (Curia) in this area, it submitted a request to the Constitutional Court on the issue of FX loans.²⁴ The Courts' legal opinions and the possible ensuing government decision could have a major impact on the banking sector's capital position. This impact will depend on: (i) whether there is a direct consequence for the entire sector or only general guidance for individual legal cases, (ii) whether the decisions can have retroactive effects, and (iii) whether the potential costs are shared with other stakeholders.²⁵ During discussions, the MNB stressed that it was in favour of a gradual solution to the problem so as not to jeopardize financial stability. The Commission staff welcomed this approach and emphasised the need to combine a potential new relief scheme with a decrease in the tax burden on the sector. As NPL ratios are equally high among

²³ Among the half million families (over 20% of the total number) who have FX debt, half of them have some problems with timely and regular repayments. However it should be noted that while the stock of non-performing HUF loans is around 20% of that of FX loans (0.6% of GDP as opposed to 2¼% of GDP), the NPL ratio is equally high in the non-subsidized HUF segment as in the FX (around 20%). Therefore the problem of insolvent debtors is not restricted only to FX loans.

²⁴ Two major issues are discussed: (i) whether it is justifiable that the exchange rate risks are borne by households, and (ii) whether interest rate changes and the application of high bid-ask spreads (during loan disbursement and redemption) were in line with a fair contract of two equal parties. The Supreme Court's goal of a uniformity decision is to give guidance to lower level courts on FX loan contracts. The submission of the government to the Constitutional Court asked whether the invalidity of FX loans can be derived from the Constitution (due to infringing fair competition and human dignity).

²⁵ The Supreme Court issued a uniformity decision on 16 December. According to this, courts alone cannot be expected to single-handedly address the problems related to FX loans, and its own role is limited to the interpretation of the law. No decision was made on the most critical point, i.e. banks' unilateral changes to contracts, as the Curia is waiting for the decision of the European Court of Justice (ECJ) expected in February-March 2014. Therefore the Curia's decision per se should not lead to a radical change in the FX problem. As a response to this decision, the Hungarian authorities indicated that they would wait for the ECJ ruling before announcing a new FX scheme. However, a clear legal situation would also require having the decision of the Constitutional Court, which will take some time, as the Court will only start addressing the issue in 2014.

non-subsidized HUF mortgage loans, the Commission staff also emphasised the importance of targeted measures towards all insolvent borrowers. In this manner potential costs could be distributed in a sustainable manner among banks, households and the government.

The integration of the supervisor into the central bank could have a positive impact on financial supervision. The Hungarian Financial Supervisory Authority (HFSA) was integrated into the central bank structure on 1 October 2013. There are many examples of central banks that have successfully incorporated supervision and monetary functions also because of the synergies created within the institution. The ECB expressed, however, some concerns in its opinion issued in mid-October about the way the new integrated supervisory framework was implemented. The critical opinion was driven by the insufficient time allowed to the ECB to examine the draft legislative provisions and by the lack of time for the transfer of supervisory tasks from the HFSA. The ECB also raised its concerns about the central bank's independence after its integration of the HFSA.²⁶ The new Financial Stability Council plans a series of initiatives, which were welcomed by the Commission staff. In addition to a new project on portfolio cleaning (see above), new macro-prudential tools are foreseen in line with the new Capital Requirements Directive (CRD IV). Furthermore, a new bank resolution regime is likely to be adopted in early 2014.

6. Assessment of repayment capacity

In 2013, FX issuance turned out to be somewhat lower than planned with some EUR 3.9 bn international bonds issued in February and November, as opposed to a yearly target of EUR 4.5 bn. Funds from the February issuance were primarily used for the early August ahead of schedule repayment of outstanding IMF obligations (EUR 2.15 bn for the state part). In addition, FX redemptions were partly covered from stepped-up domestic HUF issuance, in particular a much larger than planned retail programme. The mid-November USD 2 bn issuance will be to a large extent used to repay a maturing EUR 1 bn bond in January 2014. This latest tapping of the market with a 10-year USD bond was completed in the context of robust demand (it was oversubscribed more than five times).²⁷ The authorities clarified that when deciding on the size of the transaction, they considered carefully the trade-off between capitalising as much as possible on the still good ("pre Fed-tapering") international financial environment and jeopardising the decline in the public debt ratio from 2012 to 2013 (as the entire sum of this issuance will be used only in 2014).

Favourable conditions characterised the local bond market over 2013 as there has been a healthy demand for primary auctions and yields of practically all maturities have been at or near their historically low level. More recently, as the MNB continued to cut its base rate, the steepness of the yield curve has become historically high. This was explained by the debt managers by two main factors. First, steepening yield curves are global trends, reflecting the

²⁶ The concerns over central bank independence partly came from the fact that with the integration of the HFSA to the MNB, previous HFSA decrees were planned to be repealed, meaning that (i) it was not clear how the MNB will collect the supervisory fees, and (ii) the operational environment was assumed to become non-transparent for a temporary period. These concerns were eventually partly remedied as the HFSA decrees remained effective.

²⁷ The premium over US Treasury bonds was 325 bps, which is 20 bps less than the February transaction. In contrast, the nominal interest rate of the November transaction is close to 6% versus the February 2013 nominal rate of around 5.4%, but this increase is fully due to the jump in the 10-year US bond yields in the meantime (from around 2% to 2.7%).

market expectation that ultra-loose monetary policy could not be sustained in the longer term. Second, taking into account the entire year, the presence of foreign investors in the domestic bond market remained constant in terms of absolute figures (the stock of HUF-denominated government papers held by non-residents is currently just below HUF 5000 bn, which is identical to the end-2012 figure) and given that foreign investors are traditionally overrepresented in the long-term segments, a relative shift towards domestic investors (both institutional and households) tend to steepen the yield curve.

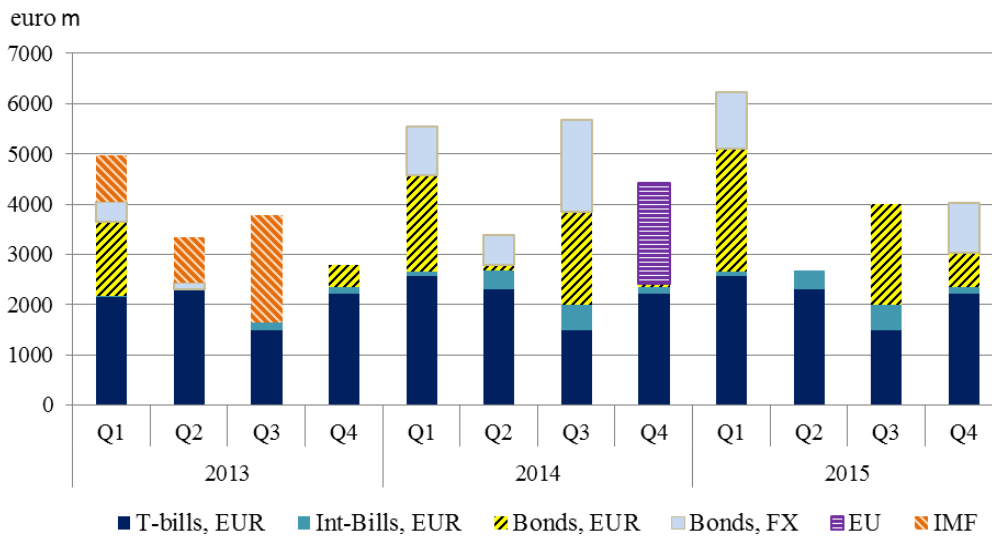
The retail programme is set to play an ever increasing role in the Hungarian sovereign debt financing, but it has some costs in terms of shortening the average duration. The programme's overall size continued to increase rapidly throughout 2013 and recently exceeded HUF 1600 bn (i.e. 12.5% of the entire HUF-denominated public debt stock). The authorities highlighted that the increase from the beginning of 2013 was over HUF 600 bn, which means that some two-thirds of the 2013 cash-flow deficit are financed by households. The exemption of government securities from the extra 6% interest income tax (legislated as part of the June tax package, and effective from 1 August 2013) could provide a further demand pull to the retail programme, notably through accelerating the on-going shift from bank deposits to government papers. At the same time, the authorities acknowledged that the average maturity of retail papers is too short (around 14 months vs the average maturity of marketable HUF-bonds of over 3 years). Given this potential drawback with the current structure of retail securities, the State Debt Management Agency was reported to be in the process of launching and designing new products in order to lengthen the maturity (notably, revamping the 'baby bonds' scheme and the introduction of inflation-linked type of retail bonds, which would be accessible through the banking distribution channel as well).

Assuming a complete roll-over of short-term debt²⁸, Hungary faces increasing total gross financing needs of around EUR 22.1 bn (some 22% of GDP) in 2014 compared to EUR 18.3 bn (19% of GDP) in 2013. This increase is partly due to the increase in FX rollover needs from EUR 4.5 bn (4.6% of GDP) in 2013 to around EUR 5.3 bn in 2014 (5.2% of GDP). One noteworthy item is the repayment of the second instalment of the EU balance of payment assistance (EUR 2 bn) in Q4 2014.²⁹ The central government deficit (approximately a net financing requirement of above EUR 2 bn) is planned to be financed from domestic papers. The total gross financing need is expected to decline to around EUR 19.9 bn (close to 19% of GDP) in 2015, while the FX financing need will see a much sharper fall in that year to EUR 2.1 bn (ca. 2% of GDP).

²⁸ Technical assumption: the T-bill stock in 2014-15 equals the stock of T-bill issuances in 2013.

²⁹ The repayment of the final instalment (EUR 1.5 bn) is due in Q2 2016.

Graph 5: Maturing sovereign debt until Q4 2015



Source: State Debt Management Agency

The Hungarian government still has a considerable amount of financial buffers to cover redemption needs. Available buffers consist of cash deposits at the MNB, which based on end-November preliminary data stood at 5.6% of GDP (including an over 2% of GDP FX deposit). There are also less liquid buffers, namely the still remaining assets from the abolition of the mandatory private pension pillars (slightly over 0.5% of GDP), as well as the ca. 25% ownership in MOL³⁰ assets (worth around 1.2% of GDP based on current stock exchange valuation). Therefore, the financing buffers altogether amount to some 7¼ % of GDP or ca. EUR 7 bn.

In view of the high gross rollover needs, including a sizeable FX portion, Hungary remains vulnerable to financial market shocks. Currently, Hungary benefits from relatively benign financial market conditions due to decreasing short-term debt and an increasing reserve coverage ratio. However, sudden changes in market sentiment can lead to quick tensions on different markets in parallel, as the exposure of government bond and interbank swap markets to foreign investors remains very high. Specifically, the share of foreign investors in the HUF bond market has recently been in the range of 41-43% and overall over 60% of the government debt is in the hands of foreigners. Sudden turbulences may originate from either domestic or external sources. Possible further non-market friendly measures (e.g. a new FX relief scheme that would affect banks' balance sheets heavily) from the domestic side or tightening steps of larger central banks (notably, the Fed tapering) from the international side could imply a decreasing search for yields of international investors, which would have negative consequences for Hungary.

³⁰ Hungary-based multinational company in the energy industry.

Commission staff conclude fourth Post-Programme Surveillance mission to Hungary

European Commission officials conducted a mission to Hungary from 4 to 10 December 2013 to review recent developments and policy initiatives in the context of post-programme surveillance linked to EU balance of payments assistance between 2008 and 2010. This has been the fourth such surveillance visit since the expiry of the financial assistance programme in November 2010.

The mission welcomed the recent improvements in the macroeconomic situation. In addition to net exports, domestic demand has also started to contribute to the recovery, albeit partly on account of indirect fiscal stimulus measures. Looking ahead, economic growth is expected to pick up gradually, supported, by stepped-up absorption of EU funds. The continued current and capital account surpluses decreased external debt and the market-based financing of the public debt was smoothly ensured. At the same time, important vulnerabilities remain, characterised notably by still high private and public debt levels, high financing costs, and a low growth potential, linked also to persistently weak lending and a series of non-market friendly policy measures.

Following the abrogation of the excessive deficit procedure in June 2013, the government's commitment to fiscal discipline appears to be broadly maintained. However, there is no margin for possible slippages in the 2014 budget; any further deficit-increasing measures or negative developments, unless they are fully offset by compensatory measures, would increase the deficit above the 3% of GDP threshold. Furthermore, the mission stressed the need to pursue growth-friendly fiscal consolidation, focusing on expenditure savings, and to preserve a sound fiscal position in compliance with Hungary's medium-term objective. Also, the sustainability of the fiscal correction would be enhanced by improving the transparency and the predictability of the budgetary planning. The mission took note of the recent amendments introduced to improve the fiscal framework in the context of transposing Council Directive 2011/85/EU on minimum requirements for national budgetary frameworks.

The mission expressed concern about continued obstacles to the banking sector to contribute to economic growth. Bank lending continues to be hindered by excessive and further increasing burdens on banks and a high share of non-performing and restructured loans. The mission welcomed the central bank's intention to ease financing conditions for small and medium-sized enterprises. In this regard the Funding for Growth Scheme can provide a temporary improvement in access to credit, but raises concerns about potential fiscal costs and the risk of unsustainable price competition. Restoring normal lending to the economy in a sustainable manner would require an improved and predictable operational environment for the financial sector, conducive to enhanced portfolio cleaning as well as capital accumulation.

The mission highlighted that reinforcing the medium-term growth prospects, also with a view to putting the public debt-to-GDP ratio on a firm downward path, would necessitate significant improvements in the business environment. Barriers to entry and limited competition in several segments of the service sector put a drag on productivity and foreign direct investment. The mission discussed with the Hungarian authorities possible structural reform steps to stimulate growth, notably in the financial sector, labour and product markets, in line with the Council's Recommendation of 9 July 2013 addressed to Hungary in the context of the European Semester.