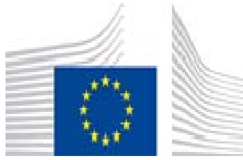

EUROPEAN COMMISSION

DIRECTORATE GENERAL
ECONOMIC AND FINANCIAL AFFAIRS

Brussels, 30 September 2014

# EU BALANCE OF PAYMENTS ASSISTANCE TO HUNGARY

## FIFTH REVIEW UNDER POST-PROGRAMME SURVEILLANCE

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## 1. Executive Summary

***From 24 to 27 June 2014, Commission staff carried out the fifth 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. In addition, the team also discussed with the authorities the 2014 MIP-related Country-Specific Recommendations (CSRs).*[2]

***The economic situation has continued improving in recent quarters. GDP grew by 3.7% and 3.9% year-on-year in Q1 and Q2 2014, respectively, so the risks to the Commission spring forecast's growth projections of 2.3% and 2.1% for 2014 and 2015 are clearly tilted to the upside in the short term.*** *The recovery has become more balanced, with domestic demand becoming the main driver of growth, but it is also largely driven by short-term stimulus measures (increasing absorption of EU funds, the central bank's Funding for Growth Scheme (FGS), regulated utility price cuts, and expansion of the Public Works Scheme (PWS)). Nevertheless, the underlying economic situation has also improved, as reflected by the strong growth of manufacturing industry (around 9½% year-on-year in H1). Although improving slowly, the growth potential of the country is still contained and lagging behind the level of most regional peers, and reflects a low level of productivity growth. This in turn can be partially explained by problems with financial intermediation.*

***The authorities see major upside risks compared to the Commission's Spring forecast and indicated that economic growth could be close to 3% in both 2014 and 2015.*** *Although there was a broad agreement on the growth drivers of the economy, the authorities estimate that one-off effects could have a smaller role in the current recovery. Their more optimistic view on the underlying economic situation is also reflected in somewhat higher potential growth estimates than those of the Commission (1.5-2% as opposed to around 1% in 2014-2015).*

***Based on the Commission's Spring forecast, beyond the medium-term plans set out in the 2014 Convergence Programme, further structural efforts are needed in order to ensure compliance with the requirements of the Stability and Growth Pact under the preventive arm as well as with the debt reduction benchmark.*** *The headline deficit as projected in the Commission 2014 spring forecast is identical to the official deficit target for both 2014 and 2015 (2.9% and 2.8% of GDP, respectively). Nevertheless, the Commission's forecast points to a risk of a significant and persistent deviation from the medium-term objective (MTO) of -1.7%, with a structural balance of around -2¼% in 2014 and 2015. Moreover, based on the Commission's forecast, the minimum linear structural adjustment (MLSA) required for the debt reduction benchmark over the transition period will not be respected in 2014 and in 2015. This would imply a significant breach of the debt reduction requirement to be assessed in 2015, based on the validated 2014 budgetary outturn data. Should the Commission forecast prove to be in line with the outturn data, a re-opening of the EDP could become possible, unless further structural efforts are made. The eventual size of the additional effort needed was estimated at*

[1] Among others, meetings were held with G. Orbán, State Secretary for Economic Policy, and other senior officials in the Ministry for National Economy, the executive directors and 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 4 September 2014.

*0.9% of GDP based on the Spring forecast. This being said, the size of the additional structural improvement will depend to an important degree also on other factors influencing the debt-to-GDP ratio, including nominal GDP growth, the exchange rate on the last day of 2014 and other stock-flow adjustment operations.*

***After the mission the authorities adopted a corrective package and updated their stock flow adjustment plans, both steps which could mitigate the risk of non-compliance with the debt reduction benchmark.*** *During the discussions, the authorities emphasised that the MTO could still be achieved over the forecast horizon under a no-policy-change scenario, while in the case of the debt reduction benchmark they stressed that factors other than the structural efforts could also play a role. The authorities' more optimistic view on the MTO primarily reflects a better potential GDP outlook than in the Commission's Spring forecast (where the latter estimate is based on the commonly agreed methodology). They also highlighted that the MLSA requirement is subject to a great deal of uncertainty and also depends on nominal GDP growth and the stock-flow adjustment. In this regard, on 17 July the authorities adopted an expenditure freeze (amounting to 0.25- 0.3% of GDP in net terms) and updated their stock-flow adjustment projection for 2014, targeting a declining debt ratio also through the end-of year reduction of state cash deposits. Both steps could mitigate the risk of non-compliance with the debt reduction benchmark. Nevertheless they cannot be a substitute for genuine fiscal consolidation efforts in order to put government debt on a firm downward path.*

***In the area of taxation, the authorities do not plan any major change in response to the CSRs*** *(e.g. phasing out of sector-specific taxes, lower tax wedge on low income earners). The authorities underscored that sector-specific taxes will remain a permanent feature of the tax system, and since many of them are turnover taxes, these are not considered distortive or particularly harmful for potential growth. On the tax burden of low-wage earners, there is work underway to assess ex post the efficiency of existing personal income tax and social security contribution allowances. As regards tax compliance, the authorities argued that the online connection of cash registers is near completion and has already brought noticeable results in terms of VAT revenues this year.*

***Following the reform of the fiscal framework adopted in December 2013, the mission followed up on the recently enacted provisions and advocated further improvements****. The long overdue strengthening of the medium-term budgetary framework (MTBF) was legislated, but its capacity to effectively and genuinely lengthen the planning horizon appears to be postponed until the adoption of the 2016 budget. This is because the recently established obligation to issue a government resolution with three-year expenditure and revenue plans (foreseen to take place by 30 April in each year) has so far been delayed and there is still no clarity on the timing and the exact content of the first such resolution. Although it is advocated in the CSRs to ensure the effectiveness of the existing set of numerical fiscal rules, the authorities do not see the need for the establishment of a dedicated ex-post correction mechanism. As to the broadening of the Fiscal Council's mandatory remit to rebalance its analytical role with its strong veto competence, the authorities responded that on the basis of its optional mandate in place, this body will progressively become a more active institution.*

***Monetary easing continued until July 2014 via further policy rate reductions, supported by falling inflation and by some improvement in the sovereign risk of Hungary.*** *Although starting from a low level, the utilisation of the second phase of the Funding for Growth Scheme (FGS) has gradually picked up (by August HUF 337 bn have been contracted out of the total allocated amount of HUF 500 bn) and some of its conditions were loosened to encourage a*

*higher take-up. On 2 September, the Monetary Council increased the available funds in the FGS by an additional HUF 500 bn. International reserve coverage of short-term external debt remains adequate, thanks to EU funds payments and the government's USD-denominated bond issuance. In the first half of 2014, the forint was on average about 3.5% weaker vis-à-vis the euro than in the second half of 2013, partly due to continued loosening of the monetary policy stance and to the political crisis in Ukraine. Since the last PPS review, Hungary's 5-year CDS spread fell by about 80 bps to near 150 bps. The forint yield curve was flattened in part due to the MNB's self-financing programme, while the 10-year yield declined to around 4.4%-4.5% over the summer.*

***Despite a temporary rebound in net lending flows thanks to the Funding for Growth Scheme, restoring financial intermediation in a sustainable manner would require a better operating environment for the financial sector.*** *Although the central bank's stress tests indicate an adequate level of capital and liquidity, a return to normal lending would require a lower tax and regulatory burden and enhanced portfolio cleaning, as recommended in the CSRs. While there is no intention from the authorities' side to reduce the tax burden on the sector, the MNB is investigating how to foster portfolio cleaning in the banking sector, through the possibility of setting up a bad bank (or a national asset management company). A proposal is scheduled to be adopted by the end of 2014 by the Financial Stability Council. The mission welcomed the authorities' efforts to enhance portfolio cleaning, but stressed that the creation of a bad bank should duly take into account EU state aid rules and be developed in consultation with stakeholders.*

***As a major step towards addressing the problem of households' foreign currency (FX) loans, Parliament adopted a law implementing the recent ruling of the Supreme Court on household loans, and further steps are foreseen in the coming months, including the conversion of FX mortgage loans.*** *The main purpose of the law adopted on 4 July is to avoid massive court cases following the uniformity decision of the Supreme Court. The law on the one hand declares the use of bid-ask spread in FX loan disbursements and reimbursements illegal, while in the case of unilateral interest rate changes, it puts the burden of proof on banks to prove the legality of changes for all loan contracts. Estimates of potential losses for the banking sector vary widely from HUF 700 to 900 bn (2¼-3% of GDP, or around 25 to 30% of banks existing capital). The exact amount of losses for the sector will be clarified by the autumn, when the corresponding lawsuits are closed. However, it is likely that some banks, mostly foreign-owned banks active in FX lending and with a lower capital adequacy ratio, will face recapitalisation needs (the parents of Erste Bank and CIB have already announced that they will inject capital, and other parent banks are expected to follow suit). In addition, the government intends to convert FX mortgage loans into HUF loans, with details to be disclosed this autumn. The mission took note of the government's efforts to address the issue of foreign currency mortgage loans, but insisted on the need for a consultative approach and for appropriate burden sharing between stakeholders on any government's decision, in order to avoid moral hazard and endangering financial stability. Similar policy advice was provided in the ECB's legal opinion issued in late July.*

***Hungary is among the first Member States that transposed and put in force the Bank Recovery and Resolution Directive (BRRD).*** *This step is in line with the financial sector CSR, which calls for a further enhancement of financial regulation and supervision. Most of the provisions of the law adopted on 4 July 2014 entered into force after 60 days, while the provisions on valuators entered into force immediately in order to allow a timely public*

*procurement process. The bail-in power is also immediately available for the resolution authority, much earlier than the deadline foreseen in the relevant EU Directive (2016).*

***The refinancing of external debt has proceeded smoothly (with one international FX debt issuance of EUR 2.1 bn already in March).*** *Further issuances are not planned for this year, and the increased cash-flow deficit and the remaining FX redemptions of EUR 3 bn will mainly be covered through the reduction of deposits of the government as well as stepped-up sale of HUF securities. As regards the following years, the government strategy remains not to fully cover FX redemptions with new FX issuances. The planned FX redemption from HUF sources will not endanger the financial sustainability of the country as international reserves are expected to remain at least at the current level due to the continuous inflow of EU funds (in the magnitude of EUR 5 bn annually). This refinancing strategy can contribute to a more accelerated decline in the share of FX debt, which is currently around 40% of total government debt. Nevertheless, it is unclear to what extent the phasing-out of FX mortgage loans will require the use of the MNB's FX reserves.*

***Although fragilities have declined, Hungary is still a vulnerable economy due to its still high level of indebtedness.*** *Both, the net external and gross short-term external debt (slightly below 35% of GDP and around 28% of GDP, respectively) as well as the refinancing needs of the government sector (around 21% of GDP in 2015-2016) stand at a rather elevated level. While net external debt is projected to decline in the medium term, the decrease in government debt is much less clear-cut. Under less favourable macroeconomic scenarios it would start increasing again, above 80% of GDP. Finally, Hungary is particularly exposed to the Ukrainian-Russian crisis through its high dependence on energy imports and through the high exposure in these countries of the biggest Hungarian bank, i.e. OTP.*

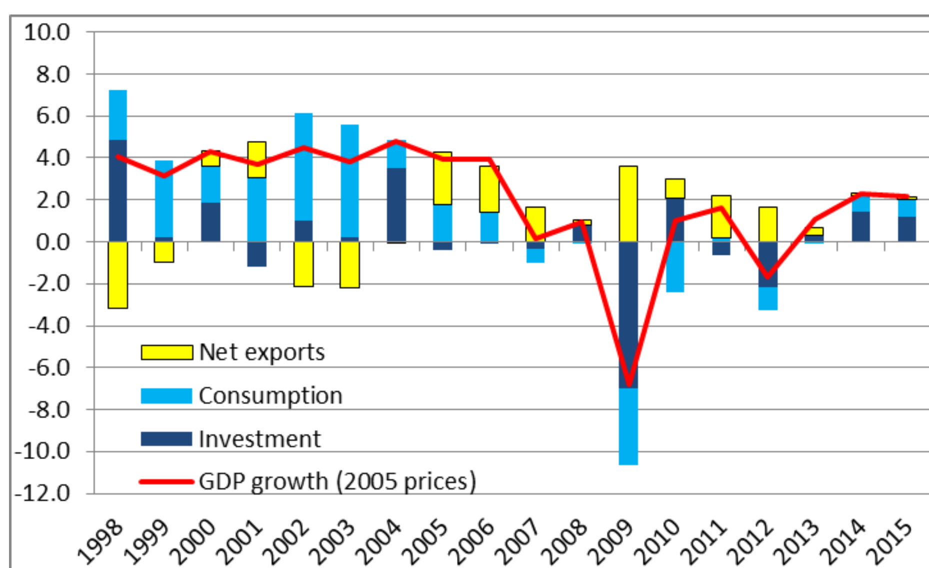
***A further risk is related to the heavy losses that the banking sector could incur due the new FX scheme and the potential use of the central bank's FX reserves in the context of the phasing-out of FX mortgage loans****. Although the sector is currently adequately capitalised (with a capital adequacy ratio at 17.4%), a capital loss ranging between 25% and 30% could put some banks below the regulatory threshold. However, in the case of some foreign-owned banks, where the risk of capital loss might be the most significant, the parent banks always recapitalised their subsidiaries in the past. As regards the conversion of FX mortgage loans, a one-off conversion would require a substantial amount of the Central Bank's FX reserves (up to EUR 11 bn, or close to one-third of the total reserves).*

## 2. Macroeconomic developments and outlook

**Hungary is on a recovery path: after a 1.7% drop in GDP in 2012, growth reached 1.1% in 2013 but was to a large extent driven by stimulus measures and one-off factors, including the central bank's Funding for Growth Scheme (FGS), regulated utility price cuts, an increasing absorption of EU funds, the extension of the Public Works Scheme, as well as a strong rebound in agriculture.** Without these factors, the economy would have remained in recession. Growth in 2013 became more balanced, with domestic demand becoming the main driver of the economy. Overall investments turned positive for the first time since 2008, recording a 5.9 % increase, mainly as a result of public investment supported by EU funds, but corporate investment also started to accelerate, in part reflecting the positive effect of the Central Bank's Funding for Growth Scheme. Public consumption grew by 1.3%, also reflecting the expansion of the Public Works Scheme (PWS). Household consumption increased only by a meagre 0.2%, despite a visible increase in real disposable income (above 1%), partly on account of regulated utility price cuts. On the production, side, after an unusually weak performance in 2012, the agricultural sector posted the strongest real growth (22%) (following a drought in 2012), while the second biggest real growth was recorded by the construction sector (7.4%), again mainly on the back of increased EU fund absorption. Industry as a whole contracted by 0.2%, but within the sector, manufacturing grew by 0.8%, whereas overall services showed a slight positive yearly growth too. Nevertheless, the economy was still characterised by a deleveraging of domestic sectors and tight lending conditions.

**According to the Commission's 2014 spring forecast, GDP growth is expected to accelerate to 2.3% in 2014 and to slightly slow down to 2.1% in 2015.** Based on the Commission's spring forecast, domestic demand is set to be the main driver of growth in 2014 and 2015, as despite robust export growth (around 6%), the contribution of net exports is forecast to be small. Investment is expected to pick up strongly to 7% this year but to decelerate to around 4.2% in 2015 as the effect of increased EU fund absorption is expected to fade away with the end of the 2007-2013 programming period. At the same time, private consumption is forecast to grow by around 1.5 % in both years, reflecting increasing real disposable income due to lower inflation (partly reflecting regulated utility price cuts) and improving employment prospects.

**Graph 1: Contributions to economic growth by external and domestic demand (pps)**




*Source: Commission services (for the 2014-15 period, based on the 2014 spring forecast)*
*Note: Investment contains the changes in inventories.*

**Incoming data point to considerable upside risks to the Commission's spring forecast.** In Q1 2014 GDP growth reached 3.7% year-on-year (1.1% quarter-on-quarter as opposed to 0.7% in the spring forecast) and in Q2 3.9% year-on-year (0.8% quarter-on-quarter as opposed to 0.6% projected in the spring forecast). Although the effect of the above-mentioned one-off factors is still present in the economy (e.g. construction output grew by 24% in Q1 and 19% in Q2, mostly boosted by EU funds)[3], the underlying economic situation has clearly improved, as suggested by the robust growth in manufacturing (9.7% in Q1 and 9.0% in Q2). Household final consumption grew by 1.7% in Q1 and 2.4% in Q2 and gross fixed capital formation by 13.9% in Q1 and 18.7% in Q2 (all year-on-year figures). The carry-over from 2013 also increased slightly due to data revisions. Overall, real GDP growth is now expected to reach around 3% this year.

**While the authorities and the Commission staff agreed on the short-term economic prospects, views were somewhat divergent on the 2015 outlook.** According to both the Ministry of National Economy (MFNE) and the MNB, economic prospects have significantly improved since the end of 2013. Indeed, on 18 August Minister Varga announced that the government revised upwards its growth projection for 2014 to 3.1%. The Central Bank projects growth at close to 3% in 2014, followed by a slowdown in 2015.[4] Similarly, despite the obviously improving short-term outlook, the Commission staff concurred that growth will slow down in 2015 as the effect of one-off factors fades away.[5]

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[3] Moreover, the Q1 GDP data could also have been visibly influenced (close to 0.2-0.3 pp of GDP) by the winter expansion of the Public Works Scheme as real government consumption figures are calculated on the basis of public sector employment.

[4] The IMF projections are more pessimistic than the Commission's 2014 spring forecast. The cut-off date of the spring forecast was 24 April, while that of the IMF Article IV report was 12 May.

[5] An updated Commission assessment will be provided with the autumn forecast in early November.

**Table 1: Comparison of GDP growth forecasts**

| % | 2014 | 2015 |
|---|---|---|
| Commission, 2014 spring forecast | 2.3 | 2.1 |
| HU government (April 2014 Convergence Programme) | 2.3 | 2.5 |
| HU government (August) | 3.1 | 2.5 |
| MNB Inflation Report, June 2014 | 2.9 | 2.5 |
| IMF Article IV report, June 2014 | 2.0 | 1.7 |

*Source: Commission, MfNE, MNB, IMF*

**In parallel with the ongoing recovery, labour market conditions continued improving, although this occurred to a significant extent due to the heavy reliance on subsidised job creation through the Public Works Scheme.** In 2013 employment increased by 1.6% and the unemployment rate stood at 10.2%. Despite a continuing improvement in the participation rate, unemployment dropped to 8.4% in Q1 and to 8.0% in Q2 2014 as employment kept on increasing. The winter expansion of the Public Works Scheme brought in 200 000 public employees per month during the winter period, which offset the end-year seasonal fall of employment. Since 1 August 2014 the government has devoted additional budgetary resources (up to around 0.2% of GDP)[6] to keep the number of people in the scheme constantly above 200 000.

**Nevertheless, private sector employment has also gained momentum.** This primarily reflects an increasing number of frontier workers and the whitening of the economy. As the economy recovered, employment in the domestic private sector also picked up in the latest quarters (growing by 2.5% in year-on-year terms in Q1 2014). According to the Commission's spring forecast the unemployment rate is projected to decrease only slightly (9.0% in 2014 and 8.9% in 2015) due to a steady increase in the participation rate, but incoming data and the government's intention to further extend the Public Works Scheme, as well as the upside risks to the economic recovery all point to downside risks regarding the unemployment rate.

**In 2013 inflation dropped to 1.7%, a historical low for Hungary as a market economy, and is expected to decrease further in 2014 before rebounding towards the Central Bank's 3% target by 2015**. Inflation has started to fall sharply since January 2013, with the fading-out effect of earlier indirect tax hikes and due three successive waves of regulated cuts in energy and other utility prices. The effect of these cuts temporarily decreased inflation in 2013 and early 2014, with administered price inflation running well below the headline level. A decline in market energy and food prices also supported disinflation in late 2013, as did weak domestic demand and historically low inflation expectations. On the other hand, excise duty increases and some other government measures (most notably the introduction of the financial transaction duty) had an upward effect. As a consequence, HICP inflation reached 0.4% in Q1 and -0.2% in Q2 2014. Core inflation has also decreased but remained above 2%, which can be regarded as price stability among products whose price is determined by market processes. The Commission spring forecast projects the 2014 yearly inflation at 1%, but this is now subject to substantial downside risks. Looking ahead, in 2015 the influence of the above-mentioned factors will gradually diminish and as the output gap closes, inflation is forecast to increase to 2.8%. In light of the new incoming data, the central bank's most recent inflation forecast projects inflation to be at zero in 2014, before gradually converging to the 3% target by the second half of 2015.

[6] See Section 3.1.

**The Commission forecast projects the net external position to gradually decrease from 6.6% of GDP in 2013 to 5.7% by 2015.** In 2013, the trade surplus was boosted by an increased production in the car industry due to newly installed capacities, while higher current and capital transfers were recorded due to the accelerated absorption of EU funds related to the end of the 2007-2013 multiannual financial cycle. Looking ahead, the net external position surplus is expected to slowly start to decrease from 6.6% of GDP in 2013 to 5.7% in 2015**.** Despite an improving domestic demand the trade surplus is expected to remain stable due to dynamic exports supported by the gradual pick-up in the production capacities of the automobile industry. At the same time a decrease in the income balance is forecast as the ongoing recovery results in higher profit rates of foreign-owned companies. Furthermore, a lower level of EU transfers will result in a decrease in the net current transfers and capital account surplus.

**While the short-term economic assessment of the Commission and that of the authorities are relatively close to each other, there is a divergence in views in the assessment of the medium-term growth potential.** Based on the Commission staff's assessment, the improving growth outlook is to a significant extent a cyclical correction, partly driven by stimulus measures, while potential GDP growth remains quite contained, at 0.9% in 2014 and reaching only 1.1% in 2015. In the authorities' view, potential output could be higher, around 2% this year and 1.5% in 2015. The Central Bank's estimates potential growth to be around 1.5% in both years. To enhance potential growth, the Commission staff underlined the need for policy adjustments aimed at restoring financial intermediation, making the regulatory framework more stable, fostering market competition and removing barriers in the services sector, as advocated in the 2014 country-specific recommendations (see also Annex 3).

**Geopolitical tensions between Russia and Ukraine represent an important risk to the macroeconomic outlook.** Hungary has a high-to-medium level of exposure to Russia in an EU level comparison. Overall, sensitivity to natural gas and oil imports (over 64% and 91% of the consumption in natural gas and oil comes from Russia) as well as the exposure of OTP bank (with the bank's balance sheet in Russia and Ukraine together amounting to 5% of the Hungarian GDP) could be the most important channel of transmission. In addition, the country has a non-negligible export share to Russia and Ukraine (5% and 2%). Finally, Hungary's trade comes mostly from countries that have relatively strong trade linkages with Russia and Ukraine (Germany and Central and Eastern European Countries). Based on the Commission's assessment, depending on the severity of the economic sanctions against Russia, Hungary could experience substantial growth effects.

## 3. Fiscal policy

### 3.1. Recent budgetary developments and outlook

**In 2013, the general government deficit reached 2.2% of GDP, well below the official deficit target of 2.7% of GDP for 2013.** The revenue shortfalls and expenditure overruns at the central government level were more than offset by the activation of the sizeable extraordinary budgetary reserve buffer, the extra one-off receipts from the sale of telecom frequency licences as well as the cost savings by local governments.

**The 2014 budget targets a deficit of 2.9% of GDP, implying a loosening of the fiscal stance compared to the previous year.** On the revenue side, the budget contains notably the extension of the family tax allowances (-0.15% of GDP) as well as the expected increases due to the enhancement of tax administration (0.5%) and the full-year impact of the distance-based road-toll (0.2% of GDP) introduced from mid-2013. Primary expenditures are set to expand by more than 1% of GDP with further wage increases in the education sector, increased spending on healthcare, higher appropriations at line ministries and rising public investment. In order to counterbalance potential unforeseen adverse developments, an extraordinary budgetary reserve of over 0.3% of GDP was established, on top of the standard general reserve.

**While the Commission's spring forecast is in line with the 2014 deficit target[7], this similarity masks some important differences regarding the underlying developments.** Compared to the budgeted figures, tax and social contribution receipts as a whole are projected to be lower by around 0.3% of GDP despite the estimated positive revenue impact of the lower-than-planned participation in the Job Protection Act's simplified tax schemes. The identified revenue shortfall is partly related to the estimated negative base effect of the meagre outturn of consumption taxes in the previous year in accrual terms, but also reflects a more cautious assessment of measures aiming to enhance tax administration. Overall, the forecast expenditure is in line with the budgeted figures, the estimated slippages in public wages being compensated by savings in social transfers. However, the projected achievement of the official deficit target of 2.9% of GDP is based on the important assumption that the extraordinary reserve buffer (0.3% of GDP) will not be spent.

**The incoming data and the information collected during the mission suggest that the underlying budgetary position has improved since the spring forecast.** This is due to the better revenue outlook reflecting the upturn of economic activity and possibly also whitening effects (i.e. increasing tax compliance) as well as due to decreasing interest outlays against the backdrop of lower-than-expected sovereign yields. Indeed, the strong revenue dynamics observed in the first eight months of the year (wage-related taxes and contributions in particular) indicates that the revenue shortfall projected in the spring forecast could be fully reversed and tax and social security receipts as a whole may even turn out to be somewhat higher than the budgetary target. These favourable developments are likely to more than compensate for the deficit-increasing impact resulting from expenditure overruns, mainly related to the further expansion of the Public Works Scheme (0.2% of GDP) as well as from the revised estimates for the financial correction of EU funds (0.2% of GDP). Moreover, following the mission, on 17 July, the government decided to freeze appropriations for an amount of HUF 110 bn or close to 0.4% of GDP, which has an estimated net budgetary effect of 0.25%-0.3% of GDP based on the Commission's preliminary assessment. Taking into account this subsequently announced step as well, the updated 2014 deficit projection of the Commission would be slightly below the target, with the full amount of the extraordinary reserve remaining at the government's disposal.[8] This may allow the achievement of an even lower deficit if this reserve (0.3% of GDP) is not spent.

[7] The fiscal forecast figures presented in this note still refer to ESA-95 data (unless indicated otherwise).

[8] According to the Budget Act, the extraordinary reserve can be spent subject to a government decision in the last quarter of the year if this does not endanger the achievement of the 2.9% of GDP deficit target based on the Autumn fiscal notification. It seems now that this condition will be met, and thus in principle the reserve could be used.

**For 2015, the Commission's spring forecast based on the no-policy-change assumption projects only a marginal deficit improvement to 2.8% of GDP, which is identical to the official target of the Convergence Programme.** It is projected that the positive effects of the closing output gap, wage restraint in most of the public sector and declining public investment following the election year will be largely counterbalanced by deficit-increasing measures (i.e. further wage compensation of teachers and the gradually increasing participation in simplified tax schemes) and a fall in one-off receipts from the sale of frequency licenses. The Commission's spring forecast yet again makes the assumption that the extraordinary reserve will not be spent. However, it seems now that the base effect of the recently improving revenue prospects in 2014 would allow some leeway for the government in terms of using the reserve buffer, and the deficit could even end up below target, if the recently announced freezes of appropriations would be incorporated into the 2015 budget and underpinned by lasting measures.[9]

**Table 2: Overview of fiscal developments and outlook**

| Outturn and forecast | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 |
|---|---|---|---|---|---|---|
| **General government balance** | -4.3 | 4.3 | -2.1 | -2.2 | -2.9 | -2.8 |
| ***- Total revenues*** | *45.6* | *54.3* | *46.6* | *47.6* | *47.3* | *46.5* |
| ***- Total expenditure*** | *49.9* | *50.0* | *48.6* | *49.8* | *50.2* | *49.3* |
| ***p.m.: Tax burden*** | *38.2* | *37.4* | *39.3* | *39.4* | *39.2* | *38.6* |
| **Primary balance** | -0.2 | 8.5 | 2.2 | 2.1 | 0.9 | 1.0 |
| **Structural balance** | -3.2 | -4.0 | -0.8 | -0.8 | -2.2 | -2.3 |
| **Government gross debt** | 82.2 | 82.1 | 79.8 | 79.2 | 80.3 | 79.5 |

*Source: Commission's 2014 spring forecast*

**The forecast deficit trajectory is subject to both upside and downside risks.** On the deficit-improving side, the promising macroeconomic developments contribute to a positive risk concerning tax receipts, and the new system of on-line cash registers to enhance tax compliance could also generate higher revenues than estimated by the Commission (0.2% of GDP).[10] On the deficit-increasing side, the financial tensions in the public education and health care sectors could result in expenditure slippages, while the public wage dynamics revealed by recent statistical figures point to the risk of overruns in the public wage bill even though the authorities were confident in their capacity to maintain spending controls. Implementation risks are also emerging in particular in 2015 as the bulk of the planned expenditure reduction is to be achieved through a nominal freeze for wages in most parts of the public sector (in place since 2008) and a stringent expenditure restraint for the operational costs of budgetary institutions. Further uncertainties (two-sided risks) stem from the balance of local governments as well as from the direct and indirect budgetary effects of the new measures to tackle the problem of FX loans (including the possibility of a burden-sharing arrangement between the government and banks).[11]

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[9] Nevertheless so far the government communicated that the measures of 17 July concern only 2014, without an immediate effect on the 2015 budgetary plans.

[10] The first results are claimed to be impressive by the authorities. See section 3.2.for more details.

[11] See Section 5.

**In addition, the shift to ESA 2010 is likely to affect adversely the calculated headline deficit.** The methodological change with the main impact on the deficit would be linked to the exclusion of proceeds from interest rate swaps and forward transactions amounting to around 0.2% of GDP over the forecast horizon. The full impact of the changed accounting methodology will be assessed in the Commission's 2014 autumn forecast, but the government's own calculations seem to confirm the above-mentioned preliminary estimate. In this respect, the authorities expressed their preference for keeping the headline figure below the threshold not least for reputational reasons, even though the Commission would not propose to launch a new EDP if the breach of the 3% of GDP reference value would be exclusively due to the shift to ESA 2010 this year.

**Despite a small reduction last year, the government debt-to-GDP ratio is not yet on a firm downward path.** The debt ratio decreased from 79.8% of GDP in 2012 to 79.3% in 2013, mainly on account of the end-year reduction in the state cash deposits as well as the accelerated utilisation of the transferred pension assets for refinancing debt obligations, while the weakening HUF/EUR exchange rate and the pre-financing of EU funds had an opposite effect. According to the Commission's spring forecast, the ratio is expected to increase again to over 80% in 2014 reflecting the depreciation of the forint as well as the planned acquisition of company assets (0.4% of GDP).[12] Thereafter, it is projected to decrease to 79.5% of GDP in 2015. For the same period the Convergence Programme plans only a very gradual decrease in the debt ratio.

**The authorities admitted that the expected pace of debt reduction is likely to be rather modest in the short term partly due to the recently announced takeovers in the corporate sector and is subject to significant risks related to exchange rate movements.** The planned stock-flow operations, shared with the Commission after the mission, reveal that the government intends to ensure the reduction in the debt ratio in 2014 partly with the help of an end-of-year reduction of state deposits. Nevertheless, according to the authorities, end-year deposits would still be held at a satisfactory level so that they can serve as liquidity buffer. Although this seems to be technically feasible, it can work only in the short term as similar steps in the future will be increasingly constrained by the liquidity management requirements of the state.

**Stochastic debt simulations indicate that the government debt reduction path is not robust enough to show resilience against adverse shocks.** In the medium-term baseline scenario, assuming a constant structural primary balance after 2015 and using the medium-term macroeconomic projection of the Commission,[13] the debt is expected to decline slowly to 77% of GDP by 2018. However, stochastic debt simulations based on historical macroeconomic shocks (to the interest rate, the exchange rate, GDP and inflation) indicate that there is a slightly more than 40% probability that debt will exceed 80% of GDP by 2018. Therefore it can be concluded that the debt reduction path is not robust enough to show resilience against adverse scenarios. This indicates an important remaining vulnerability of the Hungarian economy.

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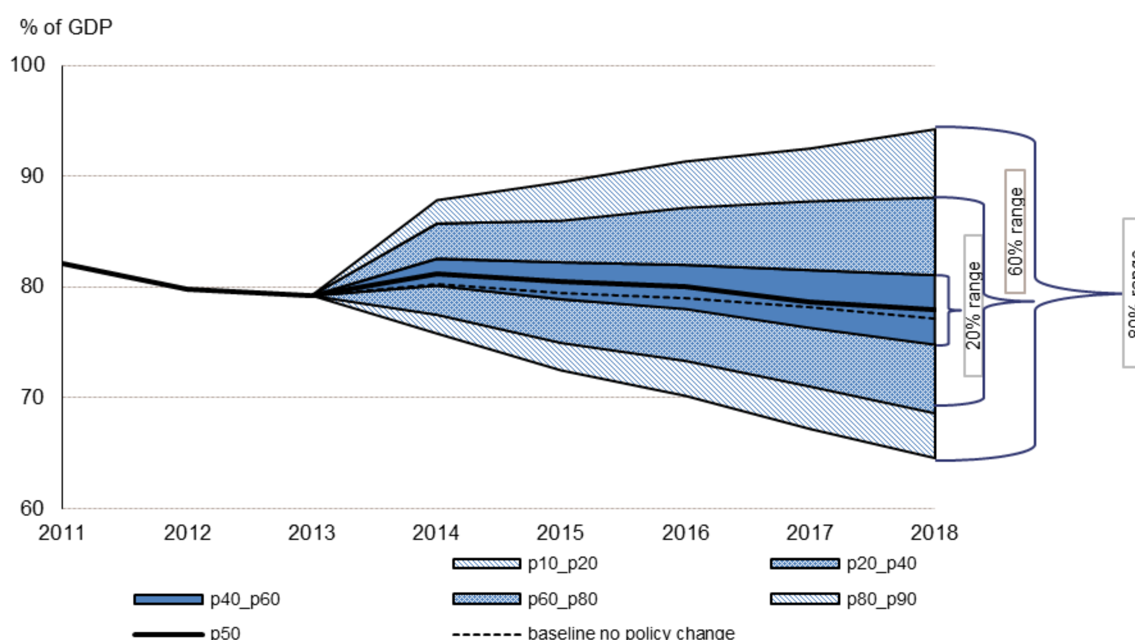
[12] It includes the recently decided corporate takeovers, most notably the purchases of the Budapest gas provider Főgáz and the broadcasting company Antenna Hungária.

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

**Graph 2: Stochastic debt projections for Hungary**




*Source: Commission services*

**The Commission's spring forecast indicates that the country is at a considerable risk of breaching both the requirement of making adequate progress towards its medium-term objective (MTO) as well as the debt reduction benchmark.** The deficit path laid down in the Convergence Programme is not ambitious enough to avert these risks. In 2013, Hungary`s structural balance significantly overachieved its MTO (-0.8% vs.-1.7% of GDP). However, with the output gap closing and the headline deficit moving up close to 3% of GDP, the recalculated structural balance is forecast to deteriorate by 1.4% of GDP to -2.2% in 2014 and to stabilise at a level considerably below the MTO in 2015. Consequently, the Commission's assessment of the Convergence Programme points to a risk of significant deviation from the MTO over the forecast horizon. This risk of non-compliance with the requirements of the preventive arm of the Stability and Growth Pact is also confirmed based on the expenditure benchmark. Moreover, the Commission spring forecast also points to non-compliance with the debt reduction benchmark in 2014 and 2015. In 2014, the projected deterioration in the structural balance (-1.4 pp) is larger than the minimum linear structural adjustment (MLSA) required to comply with the debt rule (-0.5 pp). In 2015, based on the no-policy change assumption, Hungary is also forecast not to comply with the MLSA (gap of 0.5% of GDP). As a result, if this ex ante assessment is confirmed in spring 2015 based on the validated 2014 outturn data, and unless further structural efforts are made this year compared to the spring forecast, this would lead to a significant breach of the debt reduction requirement and possibly the re-opening of the EDP. In light of this, the 2014 country-specific recommendations addressed to Hungary call for the reinforcement of the budgetary measures for 2014 in order to close the emerging gap relative to the Stability and Growth Pact requirements.

**The authorities raised their concerns with regard to the Commission's assessment.** They pointed out that the MTO will be met according to the government's figures, while the MLSA requirement is subject to a great deal of uncertainty and thus the compliance with the debt reduction benchmark depends not only on the structural efforts made. The Commission staff stressed that the evaluation of progress towards the MTO should be based on the commonly

agreed methodology, which points to the need for additional structural efforts even if the government's own calculations based on a different methodology do not indicate a deviation from the MTO. At the same time, there was an agreement that in addition to the actual structural effort, the ex post compliance with the debt reduction benchmark could also depend on other factors influencing the debt-to-GDP ratio, including nominal GDP growth and stock-flow adjustments. Given that around 40% of Hungary's government debt is denominated in foreign currency, the MLSA calculation is also particularly sensitive to exchange rate movements. To further reduce the risk of non-compliance, the authorities were urged to strengthen the budgetary stance, inter alia, by fully cancelling the extraordinary reserve, and offsetting the newly announced extra spending on the Public Works Scheme with equivalent expenditure cuts as well as carefully examining the impact of company asset acquisitions on the debt level.

**The spending freeze adopted by the government after the mission, together with the updated stock-flow adjustment plans, seem to mitigate the risk of breaching the debt-reduction benchmark.** However, this preliminary assessment needs to be validated on the basis of the Commission's autumn forecast. It should also be noted, that both the freezing of appropriations and the planned stock-flow adjustment operation of reducing the state deposits constitute only temporary solutions, and thus should be complemented by a reinforced budgetary strategy for the years beyond 2014.

### 3.2. Taxation

**Hungary's tax burden ranks as the 10th highest in the EU and as the highest among countries in the region with a heavy reliance on taxation of some selected sectors (finance, energy, telecom)**.[14] Despite the governement efforts to decrease the tax wedge, the tax burden on low-wage earners (particularly on single wage earners without a family) is still very high in the regional context and impedes job creation, even after accounting for the effect of the Job Protection Act.[15] According to the World Bank's Paying Taxes 2014 report, the time needed to comply with tax obligations for Hungarian businesses is the 4th longest in the EU. The multitude of corporate tax regimes and rates in force also adds to the complexity of business taxation. Hungary still suffers from widespread tax non-compliance with an elevated level of undeclared work. With the standard VAT rate at 27 %, i.e. the highest in the EU, the exposure of Hungary to non-compliance in the VAT area is particularly high. According to the IMF, VAT fraud amounts to 1.75 % of GDP.[16] Therefore, the 2014 country-specific recommendations call for a stable corporate tax system and for minimising distortions caused by sector-specific taxes, reducing the tax on low wage earners as well as stepping up efforts to improve tax compliance.

**While the authorities confirmed that no phasing out of sector-specific taxes is currently planned, they emphasised the need for a differentiation among these taxes.** It was explained that some of these taxes are indeed capital taxes (e.g. bank levy, extra surcharge on energy companies, tax on public utilities), but others in this category (financial transaction duty, telecom tax, insurance tax) are very close to consumption taxes (i.e. turnover taxes), with much less distortive effects. Regarding the recently adopted advertisement tax, the authorities

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14 In 2013, the tax-to-GDP ratio in Hungary was 38.9 %, compared with 35.4 % in the Czech Republic, 32 % in Poland and 29.2 % in the Slovak Republic. In 2013, sector-specific taxes stood close to 2% of GDP (OECD, 2014).

15 The scheme provides targeted social security contribution reductions among others for low wage earners.

16 IMF (2013).

stressed that it could yield only HUF 10 bn (less than 0.05% of GDP) extra revenues annually (without the impact of possible one-off exemptions for 2014), and hence they did not believe that this additional sector-specific tax would carry a serious risk of affecting negatively investors' perception of the business environment.[17]

**Regarding labour taxation, the authorities outlined the principles that could guide future measures in this area.** On the tax burden of low-wage earners, there is work underway to assess ex post the efficiency of existing personal income tax and social security contribution allowances. It was clarified that no specific measure was currently on the agenda, but the authorities outlined the principles that would guide future initiatives. In this respect only the enhanced use of targeted allowances will be seriously considered as the government's view is that the income-related general tax credits (such as a zero rate tax bracket) would incentivise wage under-reporting. At the same time, the authorities noted that a further reduction of the personal income tax rate to a single digit level (as recently announced by the Prime Minister) could be envisaged if GDP growth and government revenue receipts allow for it without breaching the 3% of GDP deficit threshold.

**Tax compliance is improving thanks to the online connection of cash registers.** According to the authorities, the implementation of the introduction of online cash registers is already at an advanced stage.[18] The first results are claimed to be impressive: based on VAT declarations, VAT revenues in ESA terms from the most affected sectors were increased by ca. 15% in Q1 2014 year-on-year. A dedicated task force was set up in the Tax Authority to analyse the incoming data, and an action plan to revamp and inform the tax audit system is currently under preparation.

### 3.3. 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. In late December 2013, a number of amendments to the fiscal framework legislation were approved in the context of the transposition of the six-pack's Directive. These cover notably the regular publication of fiscal data at both the central and local government levels, the accessibility of planning documents, the introduction of new numerical rules and the enhancement of the medium-term budgetary framework. The authorities did not seize this opportunity, however, to further reinforce the Fiscal Council by broadening its mandatory remit.

**The long overdue strengthening of the medium-term budgetary framework (MTBF) was legislated, but its test of effectiveness in genuinely lengthening the planning horizon appears to be postponed until the adoption of the 2016 budget.** The recently established obligation to issue a government resolution with three-year expenditure and revenue plans

[17] On the interpretation of the provision in the Economic Stability Act stipulating a flat rate regime for the corporate income tax from 2015, it was explained that so far there was no political decision how to follow up on this issue, namely, whether to unify the two current rates (10% and 19%) at around 13-14% or to amend the concerned requirement in the Act.

[18] The full renewal of computer-based cash registers (used in the big retail chains) will be completed by end-2014.

(foreseen to take place by 30 April in each year) has so far been delayed linked to the formation of the new government. The authorities informed the Commission team that there was still no clarity on the timing and targeted content of the first such resolution (there was notably even an option to defer it until the end of the year). Given that differences between the medium-term budgetary framework and the draft budget bill for any given year must be fully justified by changes falling outside the scope of the government (i.e. 'comply or explain'), it follows that the closer the publication date is to the submission of the draft budget, the less influence the MBTF procedure exercises on the annual plans.

**Although it is advocated in the country-specific recommendations, the authorities do not see the need for the establishment of a dedicated ex-post correction mechanism.** Ensuring the effectiveness of the numerical fiscal rules, including the revamped MTBF, would be facilitated by stipulating a sound correction mechanism to be activated in case of deviation from the rules (preferably in conjunction with a systematic ex-post monitoring of compliance to be put under the aegis of a reinforced Fiscal Council). The authorities argued that the Hungarian Public Finance Act provides many opportunities to intervene within the year if a slippage starts to emerge, notably the obligatory mid-year review of the government[19] as well as the possible freeze or reduction of budgetary appropriations. Moreover, it is prescribed in the Public Finance Act that each draft budget shall be prepared by the government to respect the country's MTO. However, the current regulation does not foresee the activation of an ex-post correction mechanism in case the target is eventually not met.

**As to the advocated broadening of the Fiscal Council's mandatory remit, the authorities responded that on the basis of its optional mandate in place, this body will progressively become a more active institution.** Commission staff reiterated its long-held position that further reinforcements of the Fiscal Council would still be needed, in light of its uniquely strong veto power. Despite the existing broad optional mandate to comment on any relevant public finance issues, the Council has not published any own analysis or opinion beyond what was strictly required by law over the last 30 months. Broadening its mandatory remit as repeatedly recommended in the country-specific recommendations would transform this body into an active watchdog, scrutinising fiscal policy in a systematic way throughout the entire year and thus would ensure that its decisions are based on publicly accessible detailed calculations and not only on qualitative risk assessments, as it has been the case so far. [20] Discussions with the President of the Fiscal Council revealed that while it was indeed foreseen to increase the number of commissioned studies in the near future (notably, economic papers focusing on disadvantaged groups on the labour market and competitiveness issues have recently been published), these undertakings could not replace the function of a genuine quantitative analysis of the official macro-fiscal projections.

[19] It is a non-public document to be prepared from 2012 (even the summary of the assessment has never been published) and it was confirmed during the discussions that it was not planned to be made available in the future as this analysis is considered to be a preparatory study for decision-making.

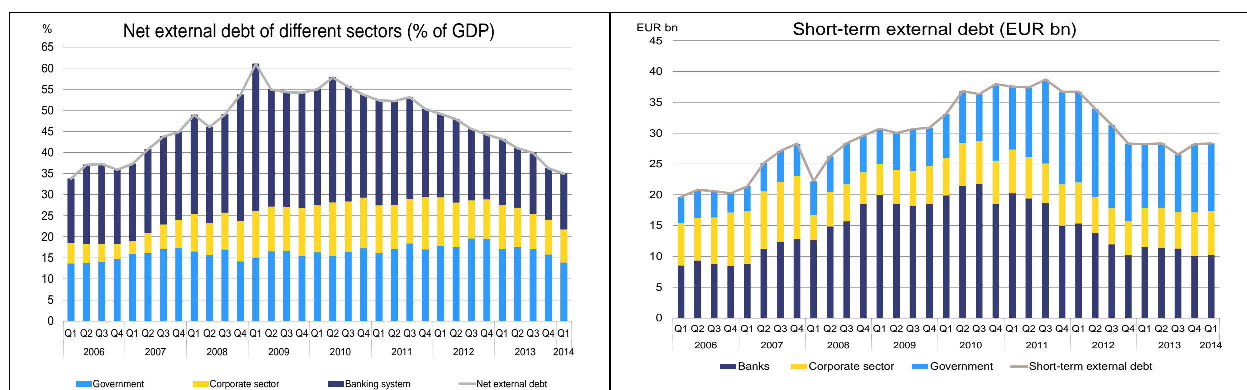
[20] A reinforced Fiscal Council could subsequently also tasked with evaluating the completeness and validity of the government's justifications when the differences between the medium-term plans and the actual budget figures would be explained. In this regard, the regular preparation of fully-fledged macro-fiscal forecasts, as specifically recommended by the Council, would help the 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

**In 2013, the net outflows in the financial account amounted to EUR 7.2 bn, while the combined current and capital account reached a surplus of EUR 6.6 bn.** Financial account outflows were driven mainly by other investments (EUR 10.1 bn). This also includes the full repayment of the IMF assistance loan (about EUR 5.1 bn in 2013) and the protracted deleveraging in the financial sector. These were partially offset by the net positive balance of portfolio investments (EUR 3.1 bn) and net direct investment inflows were also slightly positive (EUR 0.4 bn). Hungary's gross external debt fell from EUR 94.9 bn (97.9% of GDP) in 2012 to EUR 87.8 bn (88% of GDP) in 2013[21] and net external debt also decreased from 44.2% of GDP in 2012 to 36.2% by end 2013. Gross short-term external debt has been decreasing since early 2012, bottoming out at around EUR 28 bn (28% of GDP) in mid-2013 and remaining stable since then.

**In Q1 2014, the previous trends broadly continued, both the four-quarter rolling sum of Hungary's current and capital account surplus as well as the net outflows on the financial account rose to EUR 7.1 bn**. In line with the trend observed in previous quarters, the contraction of external debt continued, which primarily reflected the general government's reduction of its net external debt. As opposed to previous trends, however, the external debt of the banking sector increased somewhat, possibly related to the fact that households have increasingly shifted their focus from deposits to other securities. Hungary's gross external debt slightly exceeded EUR 88 bn (89 % of GDP) in Q1 2014, while net external debt declined to EUR 34 bn (34½% of GDP).

**Graph 3: Evolution of external debt**




*Source: MNB*

**International reserve coverage of short-term external debt[22] stood at 129% in Q2 2014, broadly at the same level as a year earlier (126%)**. International reserves declined in summer 2013 (to around EUR 31 bn in August), following the early repayment of the

[21] In July 2014, the MNB revised its methodology on Balance of Payments based on the Balance of Payments Manual 6 (BMP6) methodology, therefore the 2014 data are not fully comparable with those for the years before 2013.

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

remaining programme-related IMF debt.[23] Reserves were replenished by large EU funds transfers and a USD bond issuance and by end-2013 they amounted altogether to EUR 33.8 bn. Reserves were increased further by EU transfers and by another public USD bond issuance in early 2014 and reached EUR 36.1 bn by end-June (covering broadly around 60% of M3). As a key part of its 'self-financing programme' announced in April 2014, the MNB transformed its two-week bills into a deposit facility from August 2014 (thereby it will not be accessible for non-residents and will not provide overnight liquidity to banks against their two-week claims).[24] The self-financing programme aims to increase reliance on domestic financing and thereby reduce gross external debt. However, the programme can also have some downward effects on FX reserves[25] therefore the effect on net external debt is more uncertain. Given the increased reliance on banks in the HUF government bond market (as they will use only government bonds as collateral instead of the former two-week bill instrument), the share of FX government debt can also decline. At the same time, the MNB has also decided to gradually tighten its liquidity requirements for banks in order to achieve a more stable FX funding structure in the years ahead and to thereby reduce the future needs for FX reserves. Looking forward, the economy's strong net external lending position should continue to ensure that international reserves remain at an adequate level. Nevertheless, strong vigilance is warranted in view of the upcoming new FX mortgage scheme and Hungary's remaining vulnerability to exchange rate risk, due to its decreasing, but still significant external debt.

**Looking at yields, it seems that financial market sentiment has generally improved towards Hungary, against the background of ultra-easy monetary conditions in advanced economies, but the exchange rate reached very weak levels around 315 HUF/EUR against the background of successive rate cuts and the geopolitical crisis in Ukraine.** The forint weakened in early 2014, reaching 311 HUF/EUR at end-January, amidst uncertainties around the political crisis in Ukraine and the continuation of monetary loosening. It has remained mostly around 310 HUF/EUR until July, except for a period in May, when it appreciated to around 303 HUF/EUR. The exchange rate has weakened further to around 315 HUF/EUR in August, largely on account of the deepening of the Ukrainian crisis. In the first half of 2014, the forint was on average about 3.5% weaker to the euro than a year earlier. Reflecting the decrease in the policy rate, short-term interest rate differentials vis-à-vis the euro area fell to 210 bps by August. The 10-year government bond yield declined from around 5.8% in early December 2013 to around 4.4% by end-June and remained broadly there over the summer. The MNB's self-financing programme contributed to a flattening of the yield curve by channelling funds from the 2-week MNB bill market to the government bond market. The expected forward-looking real interest rates of forint fixed-income assets fell, but they remain relatively high in international comparison. Following the government's USD 3 bn bond issuance in mid-March 2014, S&P changed its outlook on Hungary's BB sovereign rating from negative to stable. At the same time Fitch kept its BB+ assessment and left also the outlook unchanged at stable. The 5-year CDS spread gradually declined from around 230 bps at end-2013 to around 170 bps by August. At early August 2014, the Budapest stock market index was somewhat below its end-2013 level, slightly underperforming most of its regional peers.

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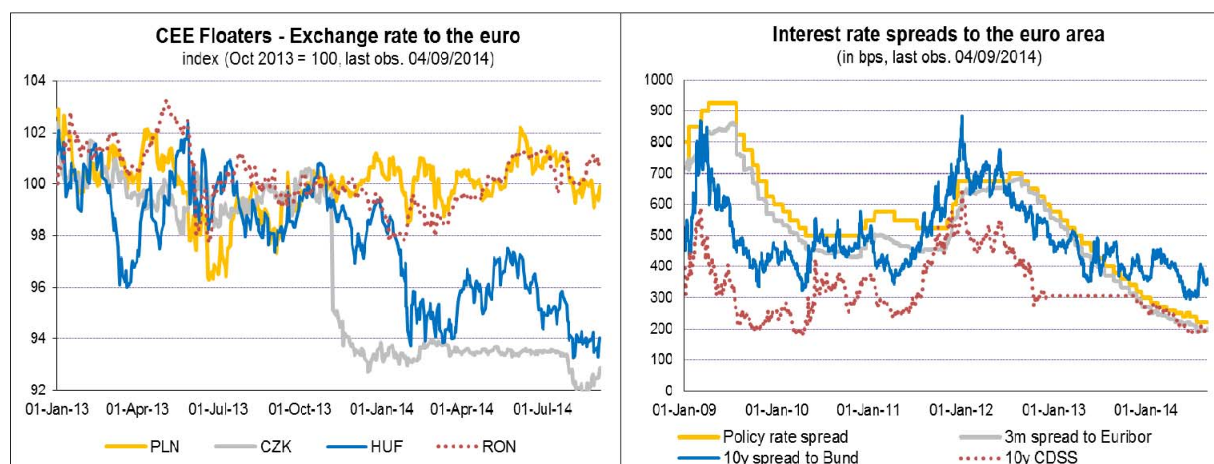
[23] In July-August 2013, about EUR 2.9 bn was repaid early to the IMF (including also a repayment of EUR 0.7 bn by the MNB), on top of the EUR 2.2 bn repaid in H1 2013.

[24] As further elements of the self-financing programme, the MNB has also announced a new forint interest rate swap facility (starting from late June 2014) and new potential liquidity-providing measures to encourage banks to buy more government securities, with a view to reducing external funding of the government.

[25] These could materialise via potential FX interventions related to outflows of non-residents from the two-week bill market, and via lower FX debt issuance by AKK.

**Graph 4: Exchange and interest rate developments**




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

*Source: Bloomberg, Datastream and Eurostat*

**The MNB completed the rate-cutting cycle started in August 2012 in July, following a cumulative cut in its policy rate by 490 bps to 2.1% in 24 steps.** The Monetary Council (MC) scaled back the pace of successive monthly reductions in August 2013 from 25 bps to 20 bps and then to 15 bps in January 2014 and to 10 bps in March. In the MC's judgement, monetary easing was necessary to achieve price stability over the medium term, also taking into account the gradual closing of the output gap. In July, the MC announced the end of rate cuts as the base rate had reached a level which ensures the medium-term achievement of price stability and underlined that the macroeconomic outlook pointed in the direction of persistently loose monetary conditions for the coming period. The indirect-tax-adjusted core inflation reached 1.5% in August 2014 and inflation expectations are at their historical lows. Interbank rates followed the path of the policy rate and markets expect the base rate to remain around its current level till 2016. Cash in circulation increased by 18% in August 2014, partly due to the low inflation environment, but also due to government measures affecting the banking sector (the financial transaction duty and the introduction of two free cash withdrawals per month). On the other hand, M3 grew by 5% y-o-y, while domestic credit to the private economy declined by 3% y-o-y in July, with a close to 5% positive growth rate within its forint-denominated segment.

**Since the last PPS review, the MNB extended its Funding for Growth Scheme (FGS)** [26]**, but take-up of funds under the programme's second phase only picked up slowly**. In January 2014, leases were added to the FGS and the maximum lending limit was raised from HUF 3 bn to 10 bn. From May 2014, the modalities of the FGS were changed again in three respects: (i) to provide longer-term working capital financing (up to 3 years), (ii) the introduction of the possibility of buying out non-performing commercial real estate loans from FGS loans, and (iii) the extension of the deadline for the disbursement of investment loans to mid-2015. The total amount of contracts submitted to the MNB from the second phase of the FGS reached HUF 337 bn (1.1% of GDP) by August 2014, and the recent acceleration in the take-up makes it likely that by end 2014the total allocated amount of HUF 500 bn will be used. Indeed, on 2 September the MC decided to increase the size of the FGS envelope by another HUF 500 bn.

**In May 2014, the MNB's management adopted a 'Statute' of the MNB, which was not intended to be a new legal document, but rather a summary of the existing material already made public.** It includes the following main elements: (i) as a baseline the MNB refrains from influencing the exchange rate (i.e. no change in the previous approach), (ii) without jeopardizing price stability, the MNB supports economic growth, also possibly by unconventional measures like the FGS, (iii) the MNB has a social responsibility programme, and (iv) the MNB aims to operate without a need for budgetary recapitalisation. During discussions, the MNB officials confirmed that the Statute does not represent a change in the existing monetary policy framework and its content is not legally binding for the MC. They also explained that most central banks have similar social responsibility programmes, which are not a cause for concern as long as their size remains small relative to the overall balance sheet and operational budget of the institution.

## 5. Financial sector policies

**The aggregated balance sheet of the Hungarian commercial banking sector has been shrinking since mid-2010, and while the process has slowed down in late 2013, Q1 2014 data still indicated a close to 4% decline in year-on-year terms.** This slowdown in the pace of deleveraging reflects to some extent the impact of the FGS, but also possibly the effect of more structural factors: with a loan-to-deposit ratio around 102 % (down from 160 % in early 2009) banks could naturally slow down their deleveraging. However, the aggregate picture masks huge differences in the characteristics of individual banks, namely a decreasing market share and low profitability for most foreign-owned big banks, compared with an increasing market share and better rates of return for the rest of the sector. This pattern reflects differences in portfolio quality, especially as most foreign-owned big banks were among the

[26] In April 2013, the Hungarian National Bank (MNB) approved the Funding for Growth scheme (FGS) which is built around three pillars. Pillar 1: granting new loans to SMEs — the MNB offers commercial banks funds at 0 % interest rate, which banks can lend to SMEs at a maximum of 2.5 %. Pillar 2: conversion of existing foreign currency loans into forint loans, with interest rates capped at 2.5 %. Pillar 3: decreasing the outstanding amount of two-week MNB bills by 20 % to reduce Hungary's gross external debt. In the first phase of the FGS, HUF 701 bn were utilised (of a total available of HUF 750 bn), out of which HUF 290 bn (1 % of GDP) was recorded as new credit; the rest was used to refinance debt (of which HUF 229 bn was denominated in foreign currency). After the first phase, the FGS was expanded to a maximum potential size of HUF 2.75 trillion (i.e. close to 10 % of GDP or two thirds of the 2012 SME loan stock) running until end-2014. However, as a first step a HUF 500 bn envelope was announced in the second phase, where only 10 % of loans could be used for refinancing. After the announcement of swap tenders related to the new two-week deposit instrument, from 1 July 2014 the central bank finally closed the third pillar of the FGS.

most active in FX lending as well as in commercial real estate lending (the two most problematic loan types during the crisis). Foreign-owned big banks still have a dominant market share in private sector lending (at 62 % in Q1 2013).[27]

**Net lending flows in the corporate sector turned temporarily positive in Q3 2013 following the first allocation of the FGS, but returned to negative values thereafter. In Q2 2014 corporate lending turned to a slightly positive territory due to the second allocation of the FGS scheme.** Nevertheless, without the FGS (currently with an allocated amount of around HUF 930 bn, i.e. more than 3% of GDP in total), net lending flows would have remained significantly negative. In addition to a decreasing risk tolerance, the combination of a heavy tax and regulatory burden and an increasing share of problematic loans are hindering a return to normal lending. Therefore, the 2014 country-specific recommendations stress the importance of decreasing the tax and regulatory burden on the sector as well as of enhancing portfolio cleaning.

**Despite the extension of housing subsidy schemes and a low interest rate environment, lending to households has continued to shrink without interruption.** The stock of household loans to GDP declined by 22% in Q4 2013 compared to its pre-crisis level. By contrast with the corporate sector, the declining lending stock primarily reflects a low level of credit demand due to the high share of distressed borrowers, a still high repayment burden and a depressed housing market.

**Portfolio quality has improved slightly in the corporate sector, while it has deteriorated further in the household segment over the past year.** The non-performing loans (NPL) indicator increased further in the household sector to 19% in Q4 2013 compared to 16% a year earlier, while it slightly declined to 18% from 19% in the corporate sector over the same period. On a positive note, the coverage ratio of non-performing loans is relatively high in international comparison (close to 60%). Nevertheless, the high share of restructured loans (at 16% of the total portfolio in Q4 2013) raises some questions regarding the true quality of the loan portfolio, especially given that on average 43% of restructured loans become problematic again. Given that provisioning rules are relatively loose[28] for restructured loans, the coverage ratio is relatively low (at 20%). In general, portfolio cleaning is also hindered by the weak efficiency of in-court and out-of-court resolution proceedings: the average time to settle disputes is high in international comparison, while the expected recovery is relatively low.[29] As a response to the high share of problematic loans in the corporate sector, the central bank has opened, in the Funding for Growth Scheme, the possibility for SMEs to buy commercial real estates that served as collateral of non-performing loans.

**During discussions, the MNB staff agreed that portfolio cleaning in the corporate segment is an important priority to revive lending in a sustainable manner.** The MNB is currently investigating obstacles to portfolio cleaning in the sector, and a proposal is planned to be adopted by the Financial Stability Council by the end of 2014. The main option currently considered is the creation of a bad bank.[30] Details of the proposal are not yet available, but most likely a new national assets management company, which would buy out banks' bad debt in the commercial real estate loan segment, would be set up. The MNB staff indicated that EU legislation and EU best practices will be duly taken into account. The mission warned that while bad banks can contribute to portfolio cleaning and credit growth, the benefits need to be

[27] Unfortunately more recent data are not available for this decomposition. See MNB (2013).
[28] See Box 6 in MNB (2011).
[29] See Box 8 in MNB (2012).
[30] See MNB (2014).

clear for all stakeholders and fair terms should be offered to banks to incentivise them to participate. In addition, potential fiscal risks of state-financed schemes need to be taken into account.

**Capital accumulation of the banking sector is hampered by a heavy tax and regulatory burden and a high share of non-performing loans.** After recording negative values in 2011 and 2012, the return on equity of banks re-entered positive territory in 2013 (around 2 %), but this improvement largely reflects the effect of one specific transaction.[31] Without this one-off effect, the banking sector would have posted a slightly negative return on equity yet again. During discussions, the authorities indicated that there are currently no plans to decrease the regulatory burden on banks, while the new FX scheme (see below) will rather result into further substantial losses for the sector.

**There is currently no financial stability risk in Hungary, given that banks are well capitalised and their liquidity position is strong, but the new FX debt scheme could lead to recapitalisation needs for some financial institutions (see below).** The aggregate levels of capital have further improved in 2013 (capital adequacy ratio of 17.4% in end-2013, with all banks registering values above 9%) and indicate a strong shock absorption capacity for the sector due to substantial recapitalisations. Banks' short-term liquidity (mainly available in forints) is also adequate at more than twice the regulatory requirement. Under the Central Bank's stressed tests the liquidity surplus of banks also exceeds the regulatory minimum. The swap exposure of the banking sector remained in the range of EUR 9–10 bn in 2013, similarly to 2012, but the share of swaps with a maturity of over a year has increased significantly since end-2012.

**Although household indebtedness and the share of FX debt have declined, FX indebtedness of households is still the major reason behind the continued increase in non-performing loans.** This reflects the weak economic situation of the country since the start of the financial crisis, as well as the fact that most of the foreign exchange relief schemes adopted so far have not been targeted towards distressed borrowers. At the same time, the practice of the repeated introduction of new foreign exchange relief schemes has deteriorated the payment culture.[32] One programme targeted to distressed borrowers is the setting-up of the National Asset Management Company, which is allowed to purchase around 25 000 flats owned by distressed borrowers. However, this falls short of the number of flats owned by problematic borrowers, which is in the magnitude of 150 000. In November 2013, the government extended the exchange rate cap scheme to delinquent borrowers.[33] In addition, the government has insisted on the need for a final solution to the foreign exchange loan problem, but waited for a clear legal picture before adopting any new package.

**On 16 June 2014 the Supreme Court adopted a uniformity[34] decision on FX loans.** The Supreme Court ruling contains three main elements: (i) it declares the use of bid-ask spreads for the disbursement and reimbursement of FX loans as illegal, and recommends instead the use of the MNB central parity in all FX contracts; (ii) it specifies strict conditions under which

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31 This one-off effect is related to one bank, which has converted parent bank funding into equity. http://www.portfolio.hu/vallalatok/penzugy/titokzatos_akcio_miatt_taltosodott_meg_a_magyar_bankszektor.195773.html.

32 For example, based on MNB (2013), 25 % of the respondents who did not apply for the exchange rate cap system said that they are waiting for a new and better scheme.

33 Before that date only the debtors who were not in the non-performing category could enter into the scheme.

34 A Supreme Court's ruling, which is binding for all related individual Court cases.

unilateral interest rate increases can be considered as justified[35]; and (iii) it stresses that in general, the fact that the FX risk has been borne by households cannot be considered as illegal, unless debtors were not properly informed, but this should be proved by debtors.

**Following the Supreme Court's decision, the government adopted a draft law in late June in order to avoid massive court cases.** The law, adopted by Parliament on 4 July, covers all FX and HUF loans, including financial lease contracts, not yet closed in the last 5 years. It will not apply to debtors who already benefited from the early repayment scheme and those whose flats were bought out by the National Asset Management Company. According to the law, banks should calculate within 90 days the exact amount they owe to debtors due to the use of bid-ask spreads instead of the MNB central parity. The MNB is in charge of issuing a decree on the methodology for these calculations. As regards unilateral interest rate modifications, the law states that as a baseline any increase in the interest rate is illegal and banks can file lawsuits within 30 days to prove that the changes were fair. After these steps, if needed, the government might adopt further measures by the autumn to clarify what amounts the banks need to repay to their debtors.[36] According to the MNB, estimates of potential losses for banks vary widely between HUF 700 bn and 900 bn (2¼-3% of GDP and from 25% to 30% of banks' existing capital) if all potential contracts are included.

**Therefore, it is likely that some banks (mostly foreign-owned banks very active in FX lending and with a lower capital adequacy ratio) will face recapitalisation needs.** Although NPLs could improve in the household segment (due to lower repayment burdens), this would come at a huge cost in terms of banks' lending capacity, given that lending activity is strongly correlated with return on equity.[37] In addition to the above-mentioned law, the government intends to convert FX mortgage loans into HUF loans at a certain point in time, but details will be revealed this autumn. This conversion, if done in one step, could require a substantial use of central bank reserves (up to around EUR 11 bn, i.e. close to one-third of total reserves). Furthermore, if the conversion is done at a stronger HUF rate than the market rate, this could trigger further losses for the banking sector, which could potentially be shared with the government. The mission team took note of the government's proposals to address the issue of FX loans, and in line with the 2014 country-specific recommendation on the financial sector, insisted on the need for a consultative approach and appropriate burden sharing between stakeholders on any government decision, in order to avoid moral hazard and endangering financial stability.

**The persistence of banks' anaemic profitability also represents a risk over the long term.** Barely breaking even Hungarian banks are the worst performers in the region, which heavily impacts on the ability of the sector to attract foreign capital and funding, while the capacity to generate capital on domestic business is very low. The focus of some lenders is shifting towards cost savings measures, which can be achieved through cutting operating costs, and to a larger extent, by exploiting synergies from potential mergers and/or acquisitions. Nevertheless, the consolidation that the authorities seem to be advocating could also have negative consequences by impairing market-based lending as the gaps left by banks downsizing their

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[35] Contracts should include a detailed list of reasons for interest rate changes, which should be understandable and could be calculated by borrowers. Possible changes in the interest rate should be symmetric and changes should be compatible with shocks faced by banks. The list should be objective in the sense that the changes to the listed conditions should be outside the control of banks.

[36] This will depend on three conditions: (i) in how many cases banks can prove that interest rate changes were justified; (ii) on the exact calculation formula of the bid-ask spread and interest rate changes; and (iii) how banks have to refund their clients.

[37] See MNB (2014).

operations or exiting the market may prove to be too large to be rapidly filled by those market players remaining in business.

**Cash in circulation has increased substantially over the past six months, which could be due to the Financial Transaction Duty (FTD) as well as the two free monthly cash withdrawals.** While cash in circulation in real terms increased by around 4% in 2012 and by 6.5 % in 2013, it increased by 20.5% in Q1 2014 in year on year terms. The mission investigated whether this tendency could be attributed to the introduction of the financial transaction duty (and most recently the related two free cash withdrawals), as discussed in the 2014 country-specific recommendations. The authorities admitted that this was possible, although they also pointed to the ultra-low interest rate environment, and the pick-up in retail sales as further potential reasons. In addition, they did not indicate any plans to adjust the FTD to incentivise more the use of electronic payments.

**Hungary is among the first Member States that transposed and put in force the Bank Recovery and Resolution Directive (BRRD).** This step is in line with the financial sector country-specific recommendation, which calls for a further enhancement of financial regulation and supervision. The law was adopted on 4 July 2014. Most of the law's provisions entered into force after 60 days, while the provisions on valuators entered into force immediately in order to allow a timely public procurement process. The bail-in power is also immediately available for the resolution authority, much earlier than the deadline foreseen in the relevant EU Directive (2016). The national law contains all the provisions of the BRRD except those referring to early intervention and special administration[38], which will be transposed in the autumn as part of the new banking law. The law will be complemented by Government and Central bank decrees in order to provide specific regulations on several issues.[39] A Resolution fund with a target amount of HUF 80bn will be set up and filled up by 2024, which will be a separate fund but to be administered by the national Deposit Guarantee Scheme. The resolution college of OTP bank (national banking group) will be set up by next year. Resolution colleges of other foreign-owned banks will be set up when the home authorities transpose the BRRD and set up the colleges. The Hungarian Central Bank has been chosen as Resolution Authority in Hungary. In order to ensure functional separation (as the MNB is responsible for bank supervision as well), the bank resolution department will be placed under a vice president or the president. With this law and the set-up of the resolution authority and fund, Hungary will have a fully-fledged resolution framework available for banks, which fulfils part of the financial sector country-specific recommendation. Work should continue to expand the framework for non-bank financial institutions.

## 6. Assessment of repayment capacity

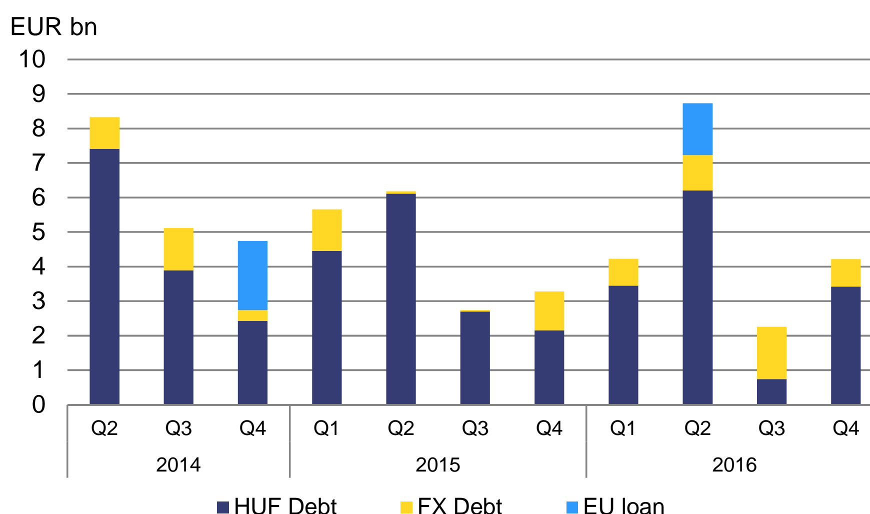
**The gross sovereign refinancing needs are projected to be around 21.8%, 20.6% and 21.2% of GDP in the 2014-2016 period, respectively.** Out of these amounts, EUR 4.4 bn

[38] The early intervention and special administration tools aim to increase the enforcement power of the supervisor and not the resolution authority in order to avoid that the evolution of problems in a bank's operation lead to more severe financial stability problems. The tools include obligation to implement recovery measures, convene shareholders' meeting, removal of management, change the business strategy. The special administration would entail that the bank's management is replaced by a special manager appointed by the relevant authority.

[39] Although the transposition deadline of the Directive is end of 2014, the Parliament did not wait for the opinion of the ECB on the law, which will be published only in a few weeks' time due to some modifications to the draft law that were added in the final stage of the process. The MFNE insisted that the ECB's opinion will be taken into consideration and the law will be modified if needed in the fall.

(4.5% of GDP), EUR 2.4 bn (2.3% of GDP), EUR 5.6 bn (5.1% of GDP) are maturing foreign currency denominated obligations.[40] The higher FX redemption needs in 2014 and 2016 are linked to the repayment of the EU financial assistance, namely EUR 2 bn in November 2014 and EUR 1.5 bn in April 2016.

**Graph 5: Quarterly profile of redemptions of government debt**




*Note: The calculation assumes a complete roll-over of Treasury bills (all maturities).*
*Source: ÁKK, Commission services*

**According to the revised financing plan of the debt management agency (ÁKK)[41], FX redemptions will only be partially covered from new FX issuances in the future, as there is a deliberate strategy to decrease the share of FX debt.** In the original 2014 financing plan, it was envisaged that FX redemptions will to a large extent be financed from tapping the international financial markets, which approach – given that the net financing need (annual cash-flow deficit) is traditionally financed from HUF sources – would have implied a gradual decline in the FX share of government debt. However, in May (after the MNB's announcement of the self-financing programme[42]), the AKK modified its financing plan: no new FX bond issuance is planned for this year[43], and the increased cash-flow deficit (linked mainly to corporate buyouts by the state) will be covered by additional HUF securities. As a result, the FX share of public debt is expected to decrease to 35% by end 2014 from 41% in 2013 (assuming unchanged exchange rate). It is worth recalling that prior to the crisis the FX share was consistently kept below 30% (and it peaked over 50% in 2011).

**The stepped-up HUF issuances are made possible by the favourable conditions in the local bond market as there has been a healthy demand for primary auctions and yields of all maturities have arrived to historically low levels in the last half year.** During the discussions, debt managers highlighted the clear improvements in market sentiment as was

[40] The 2014 figure only refers to the period Q2-Q4.

[41] See ÁKK (2014a) and ÁKK (2014b).

[42] This notably included a change in the monetary instrument from two-week bills to deposits, which has already led to higher demand for government bonds from the domestic banking sector. See Section 4 for details.

[43] In March 2014, Hungary completed 5-year and 10-year USD bond issuances with an overall amount of USD 3 bn (EUR 2.1 bn). In the case of the 10-year bond (USD 2 bn) the premium over US Treasuries was 287.5 bps, which is 37.5 bps lower compared to a very similar November 2013 USD-denominated transaction (and represents a 57.5 bps decrease in the premium if compared to the February 2013 tapping of the USD markets).

demonstrated by the sharp fall in the country's CDS spread (the 5-year CDS spread has practically halved over the last 12 months to around 150 bps by end-June). Over Q2 2014, the amount of non-resident holdings returned to the level observed at the beginning of the year (close to HUF 5000 bn), following a massive decline in January-February 2014 in the context of the emerging market turbulence. The announcement of the self-financing programme has accelerated the positive trends since late April: long-term yields have dropped to historic lows with some flattening of the curve, and demand at the primary market has strengthened. As a result, since April the bid/cover ratio for bond auctions has increased to over 3 (from below 2.5 observed in the first months of this year).

**The financial buffers of the government stand at a steadily high level, currently at over 8.0% of GDP, which decreases vulnerabilities.** FX deposits decreased to EUR 0.8 bn in May (HUF 255 bn) from a much higher level of up to 3-3.5% of GDP throughout 2012-2013 (see Table 3). However, due to the high level of FX reserves of the central bank, HUF deposits of over HUF 2100 bn can also be considered as secure buffers.

**Table 3: Financial buffers available for the government (% of GDP)**

| | **May 2014** | **2013 Q3** | **2012 Q4** |
|---|---|---|---|
| MNB deposit | **7.0** | **4.7** | **4.9** |
| -of which FX | 0.8 | 2.8 | 3.3 |
| Pension fund (less liquid) | **0.0** | **0.7** | **1.6** |
| MOL (less liquid) | **1.1** | **1.3** | **1.7** |
| Financial buffers in total | **8.1** | **6.7** | **8.2** |

*Source: Commission, MNB, ÁKK, MOL*

**Debt managers communicated to the mission team that the repayment of the second EU instalment of EUR 2 bn due in November has already been pre-financed.**

**Even with the revised debt management strategy, international reserves could remain broadly stable at around EUR 36 bn, unless they are used for the conversion of FX loans.** The potential decline due to remaining FX redemptions of EUR 3 bn in 2014 could be more than offset by the expected inflow of EU funds in the total magnitude of EUR 5 bn for 2014. However, a one-off conversion of FX mortgage loans may potentially require close to one-third of the total reserves.[44] Although with the repayment of FX loans, banks' short-term FX debt would also decline, such a step could potentially endanger reserve adequacy. Nevertheless, senior central bank officials have already indicated that the level of FX reserves seems to be on the high side and could be decreased slowly and gradually.[45]

**Overall, as evidenced by its smooth financing operations, Hungary's vulnerabilities have substantially declined, although the economy remains fragile.** In particular, the country's net external debt (at 35% of GDP) and the short-term external debt (at 28% of GDP) can be still considered as relatively high in international comparison. The IMF's common methodology on external refinancing needs shows that Hungary has the highest value (at 30%

[44] See Section 5, page 23 for more details.
[45] See Nagy and Palotai (2014).

of GDP) among the 9 emerging markets considered.[46] The share of foreign residents in the government bond market also remains relatively high, at around 60%. Furthermore, the country is particularly exposed to the Ukrainian-Russian crisis due to high energy dependence as well as with the significant exposure of OTP, Hungary's biggest bank, to the two countries. Therefore, economic policies need to be carefully designed in order to avoid that a sudden change in market sentiment leads to refinancing problems.

[46] See IMF (2014). The countries, which Hungary is compared to, are Romania, Turkey, Poland, South Africa, Indonesia, India, Mexico and Brazil.

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## Annex 1: Commission press statement issued after the mission (1 July 2014)

# Commission staff conclude the fifth Post-Programme Surveillance mission to Hungary

European Commission officials conducted a mission to Hungary from 24 to 27 June 2014 to review recent economic developments and policy initiatives in the context of post-programme surveillance linked to EU balance of payments assistance provided between 2008 and 2010. This was the fifth surveillance visit since the expiry of the financial assistance programme in November 2010.

The mission welcomed recent improvements in the macroeconomic situation as both exports and domestic demand have strengthened over the last half year. While the recent expansion of newly installed capacities in the automobile sector is boosting exports and industrial output, the economic recovery is also to a large extent driven by stimulus measures (the central bank's Funding for Growth Scheme, cuts in regulated utility prices, the expansion of the Public Works Scheme and the increased absorption of EU funds). This calls for caution when assessing the underlying economic situation. Economic growth is projected to slow down somewhat in 2015, as the effect of these stimulus measures fades away.

The continuous current and capital account surpluses have decreased external debt and the sovereign financing has been smoothly ensured in a context of strong demand for government securities and record-low yields. At the same time, the still high public and external debt levels, the high rollover needs and low growth potential remain important vulnerabilities.

There was a wide agreement with the authorities that the 2014 and 2015 general government deficit targets were within reach. At the same time, the mission highlighted that although the general government deficit has been kept below the 3% of GDP threshold, government debt is not yet on a firm downward path. Furthermore, it warned that based on the Commission’s 2014 spring forecast, the country appears at risk of breaching the requirements of the Stability and Growth Pact. In particular, compliance with the debt reduction benchmark would likely require additional fiscal consolidation efforts, in order to avoid that an inadequate pace of debt reduction could trigger the re-opening of an excessive deficit procedure in spring 2015. Moreover, the mission underlined the benefits of pursuing growth-friendly fiscal consolidation in a further enhanced fiscal governance framework.

The mission also stressed the need to strengthen Hungary's medium-term growth prospects by giving a strong impetus to structural reforms along the lines of the 2014 country-specific recommendations endorsed by the European Council on 27 June. In this context, the mission called for ensuring a stable and more balanced corporate tax system, including by phasing out distortive sector-specific taxes, and for reducing the tax wedge on low-income earners in order to foster employment. Restoring normal lending to the economy is essential to stimulate economic growth in a sustainable manner and requires accelerating the clean-up of banks' asset portfolios and improving banks' operating environment, including through a reduction in their tax burden. In this respect, while the mission welcomed the authorities' intention to incentivise portfolio cleaning, it warned that any initiative on setting up a bad bank should duly take into account EU state aid rules for banks. The mission took note of the government's efforts to address the issue of foreign currency mortgage loans, but insisted on the need for a consultative approach and appropriate burden sharing between stakeholders on any

government decision, in order to avoid moral hazard and endangering financial stability. Finally, the mission called for improving the business environment and emphasised the need to stabilise the regulatory framework and foster market competition, in particular by removing entry barriers in the service sector.

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

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

1) A Commission baseline no-policy change scenario, relying on Commission forecasts, the EPC agreed long-run convergence assumptions of underlying macroeconomic variables (real interest rate, real GDP growth,[47] inflation rate) and the assumption of constant fiscal policy (i.e. constant structural primary balance, SPB, at last forecast value) beyond the forecast horizon. The cyclical component of the balance is calculated using standard country-specific semi-elasticity parameters,[48] and the stock-flow adjustment is set to zero beyond forecasts. This scenario incorporates implicit liabilities related to ageing.
2) A Commission no-policy change scenario without ageing costs, which differs from the Commission baseline no-policy change scenario only for the exclusion of age-related implicit liabilities (the comparison between the two scenarios allows assessing the impact of the cost of ageing on projected debt developments).
3) Commission historical scenarios (which incorporate age-related costs) consisting of:
    i. A Commission historical SPB scenario relying on Commission forecasts and the assumption of gradual (3-year) convergence of the SPB to last 10-year historical average beyond the forecast horizon, while all other macroeconomic assumptions remain as in baseline scenario (1);
    ii. A combined Commission historical scenario relying on Commission forecasts and the assumption of gradual (3-year) convergence of the main underlying macroeconomic variables (SPB, real implicit interest rate, real GDP growth) to last 10-year historical averages beyond the forecast horizon.
4) A Commission Stability and Growth Pact (SGP) institutional scenario, where for countries under excessive deficit procedure (EDP) a structural adjustment path in compliance with the fiscal effort recommended by the Council is maintained until the excessive deficit is corrected, and thereafter an annual structural consolidation effort of 0.5 p.p. of GDP (or 0.6 p.p. if public debt exceeds 60% of GDP) is maintained until the MTO is reached. For the other countries, the consolidation effort to reach the MTO is centred on an annual improvement in the SPB by 0.5/0.6 p.p. of GDP as of 2014. In this scenario, the usual feedback effect used in the DSM model (a 1 p.p. consolidation effort reducing baseline GDP growth by 0.5 p.p. in the same year)[49] is applied (in the years 2014-15, this applies to the difference between the forecasted fiscal effort - change in the structural balance - and the assumed fiscal effort - EDP structural adjustment path or benchmark fiscal effort of 0.5/0.6 p.p. of GDP).[50]

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

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

[49] In the next issue of the DSM, projections would additionally be run under the assumption of a greater (than the standard 0.5 p.p.) feedback effect of fiscal consolidation on growth and under the assumption of lagged effects on growth (protracted over the year immediately following the one in which the fiscal consolidation effort takes place).

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

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

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

1) Standardized (permanent) negative and positive shocks (-1 p.p./ +1 p.p.) to the short- and long-term interest rates *on newly issued and rolled over debt* applied starting from the year following the one of last actual data available till the end of the projection horizon (in the DSM model, these shocks feed into changes in the overall implicit interest rate (IIR), with the size of the change in the IIR depending on the structure of public debt in terms of short- and long-term debt, maturing and non-maturing debt);[51]
2) Standardized (permanent) negative and positive shocks (-0.5 p.p./ +0.5 p.p.) on GDP growth applied from the year following the one of last actual data available till the end of the projection horizon;[52]
3) Standardized negative and positive (permanent) shocks on the inflation rate (-0.5 p.p./ +0.5 p.p.) applied from the year following the one of last actual data available till the end of the projection horizon (this sensitivity test will allow capturing the impact that changes in inflation possibly have on debt dynamics through a relatively more sluggish adjustment in the nominal implicit interest rate on government bonds, relative to the adjustment in nominal GDP, accounting for the structure of public debt in terms of short- and long-term debt and maturing/non-maturing debt);
4) A standardized (permanent) negative shock on the primary balance equal to 50% of the forecasted cumulative change over the two forecast years[53] (the structural primary balance is then kept constant for the remaining of the projection horizon at the lower level obtained for the last forecast year after applying the shock of the indicated size).
5) An additional sensitivity test on the exchange rate. The test is run by applying a shock (*for two years* from the year following the one of last actual data available) identical to the maximum historical change occurred in the exchange rate over the last ten years.

**Assessment of debt sustainability**

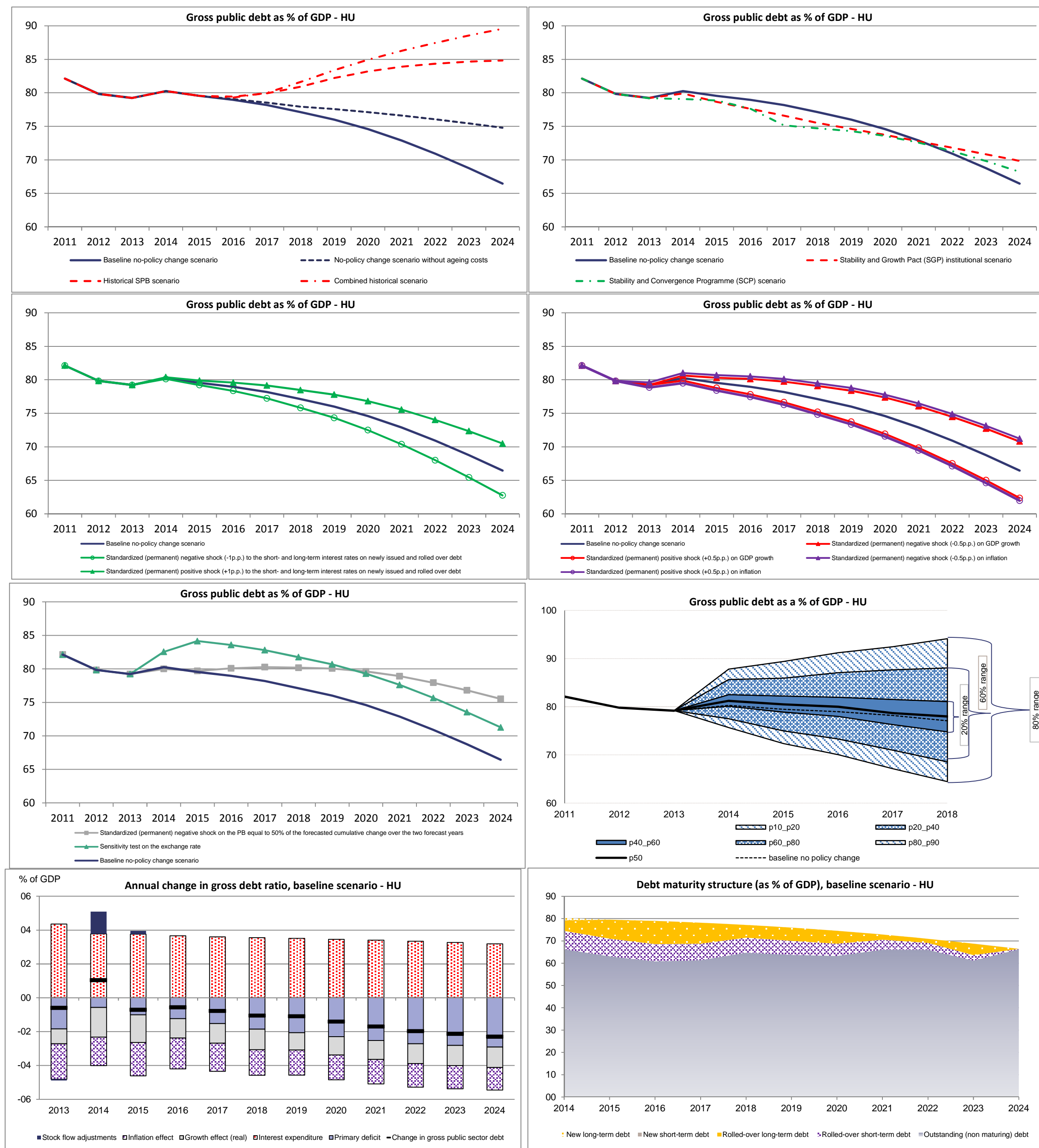
In the baseline scenario Hungary's debt is expected to decline 66% of GDP in the next ten years. The improvement is largely driven by saving related to aging (as in recent years several restrictive steps were introduced in the pension system). Nevertheless debt would start to increase if the economy would revert to a historical primary balance or historical scenario. Overall, although keeping the structural primary balance would ensure a continuous debt reduction, however the pace of this is not robust enough against adverse historical shocks. This

[51] For more details on how the structure of public debt (short-term versus long-term; maturing versus non-maturing) has been incorporated in the DSM model, see the internal note by ECFIN/C2 "Enriching long-term debt projections with sovereign debt maturity structure and refinancing needs" ref. Ares(2011)1082356.

[52] The shock is symmetrically applied to actual and potential GDP growth, so that the output gap remains unchanged. The cyclical component of the balance (calculated using standard semi-elasticity parameters, taken from Mourre G. et. al. (2013) is therefore not affected by these shocks to growth.

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

is also reflected in the fan chart, which shows an over 40% probability that the debt will remain above 80% of GDP by 2018. The debt reduction path is particularly sensitive to exchange rate movements as close 40% of debt is in FX.[54]




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

# Annex 3: Government plans on the 2014 Country-Specific Recommendations (CSRs)

| 2014 MIP-related CSRs | Plans and Progress |
|---|---|
| **Fiscal CSR**<br><br>Reinforce the budgetary measures for 2014 in the light of the emerging gap relative to the Stability and Growth Pact requirements, namely the debt reduction rule, based on the Commission 2014 spring forecast. In 2015, and thereafter significantly strengthen the budgetary strategy to ensure reaching the medium-term objective and compliance with the debt reduction requirements in order to keep the general government debt ratio on a sustained downward path. Ensure the binding nature of the medium-term budgetary framework through systematic ex-post monitoring of compliance with numerical fiscal rules and the use of corrective mechanisms. Improve the transparency of public finances, including through broadening the mandatory remit of the Fiscal Council, by requiring the preparation of regular macro-fiscal forecasts and budgetary impact assessments of major policy proposals. | • The government adopted a spending freeze amounting to close to 0.4% of GDP (0.25-0.3% of GDP in net terms according to Commission), This could lead to a lower deficit than the government 2.9% of GDP target even if the extraordinary reserves are spent.<br><br>• This corrective step together with the updated stock-flow adjustment plans for 2014 could mitigate the risk of non-compliance with the debt reduction benchmark.<br><br>• The first application of the recently established medium-term planning framework has been delayed. No new plans to improve the budgetary framework and to broaden the mandatory remit of the Fiscal Council. |
| **Financial sector CSR**<br><br>Help restore normal lending flows to the economy, inter alia by improving the design of and reducing the burden of taxes imposed on financial institutions. Adjust the financial transaction duty in order to avoid diverting savings from the banking sector and enhance incentives for using electronic payments. Investigate and remove obstacles to portfolio cleaning inter alia by tightening provisioning rules for restructured loans, removing obstacles to collateral foreclosure as well as increasing the speed and efficiency of insolvency proceedings. In this respect, closely consult stakeholders on new policy initiatives and ensure that these are well-targeted and do not increase moral hazard for borrowers. Further enhance financial regulation and supervision. | • No concrete plans to decrease the tax and regulatory burden on the banking sector. In fact, the recent law (see below) could cost banks around 25% to 30% of their capital.<br><br>• No plans to adjust the financial transaction duty.<br><br>• After the uniformity decision of the Supreme Court, the government adopted a draft law which requests banks to reimburse the costs of using bid-ask spreads in loan reimbursements and disbursements, as well as declares any unilateral rate increase as illegal, unless banks can prove the opposite in court. A FX conversion scheme is foreseen to be announced in the autumn. These steps can improve the NPL rate but at a huge cost of capital.<br><br>• The central bank is planning to adopt a bad bank proposal by the end of 2014.<br><br>• The EU conform law on bank resolution was adopted by Parliament on 4 July. |
| **Taxation CSR**<br><br>Ensure a stable, more balanced and streamlined tax system for companies, including by phasing out distortive sector-specific taxes. Reduce the tax wedge for low-income earners, inter alia by improving the efficiency of environmental taxes. Step up measures to improve tax compliance – in particular to reduce VAT fraud – and reduce its overall costs. | • Sector-specific taxes are declared to be a permanent feature of the Hungarian tax system. Most recently (July 2014) a new tax on advertisement was adopted.<br><br>• Ways of reducing the tax wedge are investigated but the government strongly opposes the use of income-related tax credit schemes.<br><br>• The lowering of the PIT flat rate to a single digit is deemed to be possible once there is fiscal space in the budget.<br><br>• Efforts to link online cash registers are near to completion with significant results in terms of VAT tax receipts. |

| 2014 MIP-related CSRs | Plans and Progress |
|---|---|
| **Business environment CSR**<br>Stabilise the regulatory framework and foster market competition, inter alia by removing barriers in the services sector. Take more ambitious steps to increase competition and transparency in public procurement, including better use of e-procurement and further reduce corruption and the overall administrative burden. | • No plans to decrease entry barriers in the service sector.<br>• According to the government, the increasing use of e-procurement should be promoted, but no new measures were mentioned. |