MISSION CONCLUDING STATEMENT

Hungary: Article IV Consultation Concluding Statement of the IMF Mission

February 16, 2016

A Concluding Statement describes the preliminary findings of IMF staff at the end of an official staff visit (or 'mission'), in most cases to a member country. Missions are undertaken as part of regular (usually annual) consultations under Article IV (/external/pubs/ft/aa/aa04.htm) of the IMF's Articles of Agreement, in the context of a request to use IMF resources (borrow from the IMF), as part of discussions of staff monitored programs, or as part of other staff monitoring of economic developments.

The authorities have consented to the publication of this statement. The views expressed in this statement are those of the IMF staff and do not necessarily represent the views of the IMF's Executive Board. Based on the preliminary findings of this mission, staff will prepare a report that, subject to management approval, will be presented to the IMF Executive Board for discussion and decision.

February 15, 2016

The Hungarian economy is performing very well and its vulnerability to shocks has declined substantially, although debt levels and financing needs remain high. Solid growth and a sharp reduction in unemployment are largely due to supportive macroeconomic policies, a favorable external environment, and high utilization of EU funds. While accommodative fiscal and monetary policies have been helping on the growth front, they have at the same time expanded the state's role in the economy and shifted risks to the public sector. In the mission's view, more needs to be done to further reduce vulnerabilities, especially given the fragile external environment, and to transition to growth driven by a vibrant private sector. Growth-friendly fiscal consolidation would help build buffers, while more ambitious structural reforms aimed at improving the business environment, enhancing competitiveness, and addressing labor market weaknesses would boost the economy's growth potential.

Economic outlook and risks

1. The economy is growing at a robust pace and vulnerabilities have declined. Supportive macroeconomic policies along with a favorable external environment—low global interest rates and low commodity prices—and significant utilization of EU funds have contributed to a strong growth performance over the past two years. Solid employment growth—led by the private sector, but also the continued expansion of public works—has helped reduce the unemployment rate to below pre-crisis levels. Output growth is projected to moderate slightly this year owing to the (expected) deceleration in the utilization of EU funds. Headline inflation would remain low on account of low import prices, and slowly reach the 3 percent target as food and energy prices recover, and the labor market tightens. The current account has been in record surplus, while external debt, especially FX-denominated, and gross public debt have continued their downward path.

2. The balance of risks is tilted to the downside. Hungary is now less vulnerable to external shocks and has weathered recent bouts of financial market volatility well. However, financing needs remain high, and an abrupt sharp deterioration in global or emerging market risk perception could lead to capital outflows. Further, an escalation of the refugee crisis in Europe could weigh on trade, while weak external demand would put pressure on exports. On the upside, persistently lower energy prices would reduce production costs and increase purchasing power, while initiatives to boost housing construction and stimulate credit demand could increase short-term growth.

Fiscal policy

3. Better-than-budgeted fiscal performance last year helped reduce public debt. The general government deficit is currently estimated at close to 2 percent of GDP against the 2.4 percent target,

as revenue over-performance—mainly due to improvements in tax administration but also owing to a strong macro performance—and savings in the interest bill were only partially offset by higher expenditures. This contributed to a slight narrowing in the structural deficit and a moderate reduction in the public debt-to-GDP ratio.

4. However, fiscal policy is turning expansionary. The mission projects the 2016 headline deficit at 2.1 percent of GDP, implying a structural fiscal relaxation of about ⅔ percentage points of GDP (due to sizeable one-off revenues), and a moderate decline in public debt. The reduction in the bank levy (along with the commitment to further reduce it) and continued efforts to improve tax administration are welcome. However, the continued shifting of items to the lower VAT rate complicates tax administration and introduces distortions in the tax system, which remains burdened by sectoral taxes. At the same time, the budget relies on sizeable one-off revenues, while a number of new initiatives, most importantly the housing support scheme, although expected to have a positive impact on growth, could become an open-ended drag on the budget.

5. Decisive fiscal action is needed to put public debt on a firmly downward path and help reduce fiscal risks. In the mission's baseline scenario, current fiscal plans imply a structural fiscal deficit of 1¾ percent of GDP over the medium term and a moderate reduction in the public debt ratio to around 70 percent by 2021 thus leaving Hungary vulnerable to shocks. The mission urges the authorities to embark on a moderate structural fiscal tightening beginning this year, consistent with gradually reducing the structural deficit to zero by 2021. This would entail an average annual consolidation of about ⅓ percent of GDP, and would result in public debt below 60 percent of GDP over the medium term.

6. This adjustment should be accompanied by a budget rebalancing to help boost long-term growth. On the revenue side, this should encompass steps to broaden the tax base by reducing exemptions and preferential regimes; a gradual reduction in distortionary sectoral taxes; and continued efforts to improve tax administration. As for expenditure, there is a need to eliminate generalized subsidies, improve the efficiency of SOEs, increase the efficiency of public spending in health and education, and rationalize the relatively-high and increasing wage bill. In this vein, the authorities' intention to downsize the public sector is welcome but needs to be complemented by a public expenditure review clearly identifying the government's priorities regarding the provision of public services.

Monetary policy

7. Monetary policy has been appropriately accommodative, but may have to ease further, if downside risks to activity and inflation materialize. There is currently no evidence of inflationary pressures, inflation expectations remain stable, and the estimated output gap is still negative, although closing. On the other hand, fiscal policy is loosening and labor market conditions are tightening. In the mission's baseline scenario, inflation would reach the target only in late-2018, while external developments continue to pose downside risks. These considerations argue for continued accommodation at the current policy rate level. Should inflation fail to pick up as projected or downside risks to activity threaten to materialize, further monetary easing should be considered. If there is a sharp deterioration in risk perception that results in capital outflows, monetary tightening could be necessary to support financial stability. To this end, the Central Bank's (MNB) commitment to maintain adequate international reserves is welcome.

Financial sector policies

8. Financial sector indicators have been improving, but the stock of bank lending to the private sector has continued to contract. Banks' capital positions are on average strong, profitability is recovering, and liquidity positions are ample. The elimination of FX-denominated household loans following their conversion to local currency contributed to a sharp decline in household risk, and the Settlement Act and Fair Banking legislation combined with the ongoing deleveraging have reduced household indebtedness. The self-financing program contributed to a significant reduction in the exposure of the economy to exchange rate risk. Nevertheless, and despite an increase in bank lending to SMEs through the Funding for Growth Scheme (FGS), the private sector continues to deleverage. Finally, while many of these operations have reduced vulnerabilities, they have also shifted risk, including to the MNB.

9. Efforts to promote lending should properly consider the risks and be time bound. While supply-side factors are important, there is a widespread conviction in the market that the adverse business climate and sudden regulatory changes have curtailed credit demand. Going forward, the MNB should not share credit risk from banks' lending, and in this regard, the mission welcomes the expiration of FGS+. Looking ahead, the recently-introduced measures try to incentivize banks to lend more to the private sector, in part by moving interest rate risk from the private sector to the MNB. Improvements in business climate indicators and enhanced economic policy predictability, however, will be critical for increasing the demand for credit.

10. While supporting the authorities' efforts to resolve legacy non-performing loans, the mission emphasizes the need to keep the operations of the asset management company for commercial real estate (MARK) fully transparent. The envisaged transfer of assets on a voluntary basis and at market-related prices, as noted by the Directorate-General for Competition of the European Commission, is welcome. Moreover, further strengthening of the governance structure would make MARK less vulnerable to market speculation about potential conflict of interests, in line with IMF technical assistance recommendations. It is thus encouraging that considerations are already been given to transition to private sector funding and later, when a track record has been established, also to revisit the ownership structure.

11. Steps to improve financial intermediation should also entail lower state presence in the banking sector. To this end, the mission welcomes steps to privatize MKB in a transparent manner.

Structural reforms

12. Structural reforms, with an increased role for the private sector, remain essential to enhance Hungary's growth potential. In the mission's view, medium-term growth is constrained by low productivity, a challenging business environment, continued weaknesses in the labor market, and demographic headwinds. Moreover, the expanding role of the state in the economy could crowd out private sector investment, weighing on productivity and growth. Consideration should be given to the following set of measures:

• Business climate: Easing the regulatory burden, enhancing policy predictability, and limiting state involvement in the economy would improve the environment for private sector-led growth. Enhancing the ease of paying taxes, further whitening of the economy, and continued strong actions to tackle VAT fraud would also be important.

• Competitiveness: Improving competitiveness would entail moving up in the value chain, and enhancing productivity in the labor and services markets, including by upgrading skills. Focus should be on boosting innovation and R&D, further strengthening vocational training, and promoting entrepreneurship. Efficient EU fund utilization is important to maximize their growth impact.

• Labor market: Progress has been made in increasing labor participation of the young and the older workers. However, there is a need to upgrade labor force skills, address skills mismatches, and further boost the employment of low-skilled. Active labor market policies should entail strengthened training and enhanced job-matching services, while tax-benefit systems should aim at boosting the supply of and demand for low-skilled. Further steps to increase female labor force participation should also be considered.

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