HUNGARY

Highlights

- **Hungary's GDP growth rate in 2014 was among the highest in the European Union (EU).** The rebound in growth was primarily driven by strong investment, supported by easing monetary policy and financing conditions. Utility price cuts and the improvement of labour market conditions provided a boost to private consumption after two consecutive years of contraction.
- **Financial stability has been strengthened.** The financial sector was helped by a fortuitously timed decision to convert outstanding foreign currency-denominated mortgages into local currency in late 2014. In addition, the central bank also progressed with the agenda on clearing banks' delinquent commercial real estate and other non-performing loans (NPLs).
- **Hungary secured gas flows from Western Europe thanks to a new bi-directional gas pipeline with the Slovak Republic.** Also, the EC's Euratom Supply Agency has approved the fuel supply agreement of the capacity maintenance project of the Paks nuclear power plant, after competition concerns over fuel supply arrangements from the Russian supplier were resolved.

Key priorities for 2016

- **Hungary will need to further develop the use of EU Structural Funds through commercially managed financial instruments.** Establishing such institutions and governance for attracting and sustaining private investor participation in publicly led projects will be crucial to sustain growth.
- **The government should provide a more predictable framework for the banking sector.** This is the intention expressed in a Memorandum of Understanding (MoU) signed with the EBRD in February 2015, which has been welcomed by local and foreign institutions alike. As the central bank will unwind extraordinary measures of support to the real economy, commercial banks will need to rebuild capital cushions and resume lending to sustain economic growth at present rates. At the end of 2014, the capital adequacy ratio stood at 16.8 per cent whereas the common equity Tier 1 ratio was 13.1 per cent.
- **Special taxes adopted in recent years need to be further unwound.** This would be vital for expanding the country's role as an export platform of technology and skills-intensive products.

Main macroeconomic indicators %

	2011	2012	2013	2014	2015 proj.
GDP growth	1.8	-1.7	1.9	3.7	2.9
Inflation (average)	3.9	5.7	1.7	0.0	-0.1
Government balance/GDP	-5.5	-2.3	-2.5	-2.5	-2.6
Current account balance/GDP	0.8	1.8	4.0	2.3	4.0
Net FDI/GDP [neg. sign = inflows]	-1.6	-2.1	0.1	-2.6	-1.3
External debt/GDP	127.9	131.9	122.8	106.8	n.a.
Gross reserves/GDP	35.0	35.2	34.8	30.7	n.a.
Credit to private sector/GDP	51.5	49.1	45.4	41.5	n.a.

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Macroeconomic performance

In 2014 growth accelerated to 3.7 per cent and this pace was sustained in the first half of 2015. Increased public sector investment expenditure in part reflected a better utilisation of EU grant disbursements. One-off factors such as the further improvement of the agricultural sector also supported growth, as did terms-of-trade gains related to the commodity price decline and the drop in inflation, which supported real household incomes. Investment increased by 14 per cent and was the main contributor to growth in 2014. The surge in both private and public investments was driven by accelerated absorption of EU grants as well as the scheme of subsidised loans extended by the National Bank of Hungary (NBH). Despite strong export growth of 7.6 per cent in 2014, the net contribution of foreign trade to GDP was negative. The rapid growth of imports mirrors the acceleration in domestic investment and household consumption.

The unemployment rate declined to 6.7 per cent in August 2015. This represents a substantial improvement from the peaks of above 11 per cent in 2012. Employment (in the 20 to 64 age group) growth of 3.1 per cent was the second highest in the EU in 2014, according to Eurostat data, although at the level of 67.3 per cent in the first quarter of 2015 it still remains below the EU average of 69.2 per cent. While the public employment scheme was the main driving force in jobs creation from mid-2012, it has contributed less than 20 per cent in additional employment in the first half of 2015. A recent EU assessment suggests that this scheme does not sufficiently sustain the integration of participants into the open labour market.

The general budget deficit remained below the EU threshold at 2.5 per cent of GDP in 2014. Tax and social security receipts were backed by robust GDP growth, and also some improvements in tax administration. Taxes on specific sectors, such as those imposed on financial institutions, represent a significant source of government revenues and were estimated by the International Monetary Fund (IMF) at 1.9 per cent of GDP for 2015. Public debt remains high, at 76.2 per cent in 2014, and according to the EC it is forecast to decrease only moderately over the medium term.

Growth is expected to decelerate over the medium term. A continued slackening in growth is expected from the high 3.7 per cent rate achieved last year, to around a still-respectable 2.5 per cent on average in 2015 and 2016. Temporary factors, such as the accelerated absorption of EU funds towards the end of their availability, no longer boost growth. Given the long history of weak investment, these rates are still in excess of estimates for trend growth.

Major structural reform developments

Hungary has improved energy security and expanded its share in regional energy trade. A new gas pipeline between Hungary and the Slovak Republic started operations in July 2015. It will supply gas in both directions and allow access to the Western European gas network. In April 2015 the EC approved the extension of the Paks nuclear power plant, following a compromise under which the monopoly supply by Rusatom will be in effect for 10, rather than 20, years.

The government has approved a bill that transposes the EU energy efficiency directive into national law. Under the new law, approved in May 2015, the authorities aim to reduce energy consumption in Hungary by 18 per cent by 2020, which is in line with the EU directive. The government also launched tenders for a residential heat insulation programme, which will begin in spring 2016. On the path to the EU's 2020 energy efficiency targets, Hungary reached interim milestones in 2010, although the share of renewable energy consumption has not increased substantially since then. The share of 9.8 per cent in total energy consumption still constitutes a wide gap relative to the Europe 2020 target of 14.65 per cent. Similarly, energy intensity continues to exceed the average level observed in the EU.

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A smart specialisation strategy has been adopted. The new strategy, adopted in November 2014, is expected to result in more effective public funding for innovative enterprises and provide a better exchange between business and academia. This would be welcome because innovation finance vehicles, such as private equity and venture capital, are poorly developed. Hungary is ranked 20th in the EU-wide innovation assessments published in the EC's 2015 *Innovation Union Scoreboard*. Its innovation performance relative to the EU average increased to only 67 per cent in 2014, from around 65 per cent in 2007.

Substantial EU funds are earmarked for development. All seven operational programmes under the EU's Structural and Investment Funds were approved by the EC by July 2015. Hungary will utilise an allocation over €21.5 billion in 2014-2020, which is equivalent to 3 per cent of GDP in average annual inflows. Sixty per cent of the funds, including the domestic contribution, will support economic development and employment, and 40 per cent will support infrastructure and human resource development. Hungary plans to implement the largest small and medium-sized enterprise (SME) competitiveness programme in the European Union (amounting to €9 billion). This will enhance the capacity of SMEs for research, innovation and job creation. The new programme will further facilitate the use of financial instruments (commercially based funding supported by EU structural funds). Hungary also plans to access the European Fund for Strategic Investments (also known as the "Juncker Plan") for the development of digital technology as well as transport and energy infrastructure, including regional gas pipeline development.

The government has clarified its intentions for the regulatory framework in the banking sector. In the MoU signed with the EBRD in February 2015, the government confirmed that it seeks a stable and predictable regulatory framework in support of macroeconomic stability. In line with this announcement from 2016 the financial sector levy applicable to banks will be substantially reduced, and will be based on more recent balance sheet data. The ultimate form of this tax will be aligned with European norms. The MoU also stated that the government would not implement new laws or measures that would have a negative impact on the profitability of the banking sector. A subsequent decision in April 2015 to seek a substantial contribution from the banking sector for the insolvency of a local fund management company remains under judicial review. As regards state participations in the sector, in June 2015 state-owned development bank MFB purchased all equity in Budapest Bank from GE Capital. This followed the acquisition of the insolvent MKB Bank in September 2014. The MoU clarified that the government will seek to divest all majority stakes in local banks within three years.

The central bank's Funding for Growth Scheme (FGS) has been extended to 2016. The extension encouraged lending to new projects, as opposed to refinancing, and widened the scope of eligible SMEs. By the end of August 2015 the funds of this third extension were almost fully allocated to the participating commercial banks, although disbursements to beneficiary SMEs have been slow. The fixed margin in the lending rate and complications in approvals of public guarantees slowed the process of disbursement. Total corporate credit declined between 2009 and mid-2014, and has expanded modestly since then, in part due to the central bank's programme.

The NBH progressed with regulatory reforms to encourage NPL resolution. A re-organisation of asset management company MARK aims to cleanse bank balance sheets of delinquent real estate exposures. The initial capital of the "bad bank" will be Ft 300 billion (about €1 billion), provided by the NBH, but the institution may also seek market funding. Following the 2009-10 financial crisis, sluggish lending activities have been stymied by the high level of NPLs, which reached an average of 16 per cent of total loans in mid-2015.