GOVERNMENT OF HUNGARY

CONVERGENCE PROGRAMME

OF HUNGARY

2016 – 2020

April 2016

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1. ECONOMIC POLICY OBJECTIVES

The beginning of the 2010s was dominated by crisis management. The financial stability of Hungary had to be restored, external vulnerabilities had to be significantly reduced and the economy had to be set on a sustainable growth path. By 2016, the results are clearly visible. The debt ratio is on a steadily declining path and the fiscal deficit has been below 3% of GDP for several years. The external debt has dramatically decreased and foreign currency mortgage loans of households have essentially been eliminated. The financing of the country has become more stable with an increasing share of domestic financing. As a result of tax measures and other structural reforms, the Government managed to significantly raise employment and economic growth has also been resumed while the structure of growth has become more balanced.

The improving performance of the Hungarian economy has been recognised by the markets and an increasing number of international organisations. In 2013, the excessive deficit procedure related to Hungary was abrogated, and the European Commission concluded in early 2016 that there were no macro-economic imbalances in the economy. Moreover, the latest Sustainability Report by the Commission shows that the long-term sustainability of public finances is at low risk and, according to its calculation, the debt ratio will drop to 60% of GDP over the next 10 years. The Hungarian debt ratio has been steadily decreasing since 2011, while this ratio has increased in the majority of EU countries over this period.

The Government intends to build on these achievements and further foster positive developments. The encouraging results notwithstanding, it is clear that there is still room for further improvement in the economic and fiscal performance and the already increasing employment can be stepped up. The reduction of public debt continues to be a top priority. This is assisted by rapid economic growth supported by rising employment and sustained fiscal discipline.

Maintaining the strong performance of the economy is important. In 2016, the growth rate is primarily determined by the cyclical nature of EU funds, resulting in temporarily slower GDP growth. From 2017, growth will return to levels significantly above the EU average, thus ensuring rapid catch-up. In order to mitigate the temporary negative impact in 2016, the Government will increase public investment, promote the access to funds available in the new EU financial programming period, carry out long due wage increases in a number of areas related to the performance of public duties (such as health, education, the social domain and public administration), and will cut taxes where it is feasible and most urgently needed.

As last year, the 2017 budget bill has been prepared and submitted to Parliament in the spring. The early submission provides economic actors with timely information on fiscal developments and prospects, as well as changes in the tax system expected for 2017 and facilitates a better preparation and planning of their business decisions. While maintaining the decreasing trend of the debt-to-GDP ratio in 2016 and 2017, the Government uses the room for manoeuvre for smoothing economic growth. The deficit will be well below from the 3% reference value in each year, and gradually decline after 2017. The planned deficit path brings about a substantial reduction in the debt-to-GDP ratio.

The Government has taken significant steps to whiten the economy in recent years. As a continuation of the already implemented successful measures, the use of online cash registers will be extended, online invoicing will be introduced, and a programme to promote electronic payment will be launched. The tax authority will become more client friendly, taking over tax payers' administrative burdens related to the submission of tax returns, and distinguishing between bad and good taxpayers as well as reducing the fines imposed because of unintended mistakes.

The accomplishments achieved so far have created the opportunity to initiate tax cuts in some areas. From 2017, the VAT rate of several foodstuffs will decrease, the family tax allowance will be gradually extended to families with two children and the bank levy will continue to decrease in line with the earlier commitment of the Government in the context of the MoU with the EBRD signed in early 2015. The tax cuts will leave more money with households and help to maintain economic growth at a high level.

External vulnerabilities have decreased and financial stability of the country has improved as a result of Government measures and the programmes of the Magyar Nemzeti Bank related to the conversion of FX denominated residential loans to domestic currency loans, reducing the burdens of instalments. Bank lending to the non-financial corporate sector is still hindered by a high level of non-performing loans, even though significant improvement took place also in this area in 2015. Improvement in the banking sector performance is clearly indicated by the fact that the banking sector as a whole has registered profits last year, and several major banks' individual profits became profitable in 2015 after several years of losses.

Employment reached a record level as a result of Government measures facilitating access to work, which involves cutting taxes on labour, the revision of unemployment benefit, pension and disability pension systems, as well as the introduction of the flexible maternity benefit. Public work schemes also played significant role in the improvement on the labour market. Further improvement in employment can be achieved by moving public workers into the primary labour market and ensuring that the skills of job seekers better match the needs of the employers. The Government has taken steps in both areas. It facilitates to leave public work by financial incentives, trainings and other tools and transforms the system of vocational training.

Overall, significant improvement has taken place in the main macro-financial indicators of the Hungarian economy in recent years. Building on the results achieved and the measures outlined in the programme, further improvement in macroeconomic fundamentals is expected.

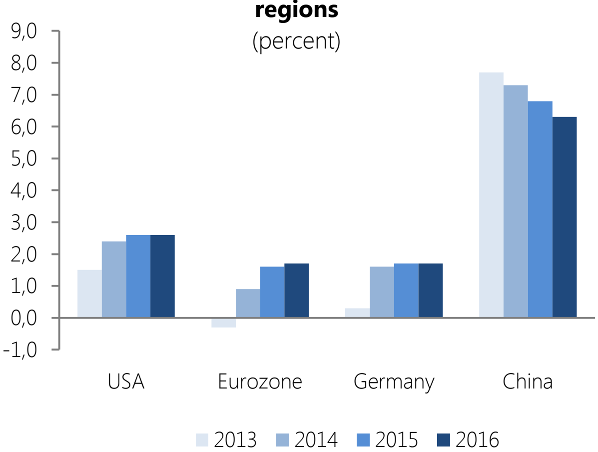
2. MACROECONOMIC DEVELOPMENT AND OUTLOOK

2.1. DEVELOPMENT OF GLOBAL ECONOMY

The world economy showed more subdued growth in 2015 than previously expected. While the majority of countries were in the phase of recovery at the beginning of last year, a number of economies are now on the downward side of the growth cycle and their prospects have become gloomier. This is properly reflected in the downward revision of the growth forecasts for 2016 that are surrounded by negative risks mainly. On the one hand, the sharp fall in commodity prices has adversely affected exporting countries, which manifested partly in the depreciation of currencies and partly in the development of budget imbalances and, ultimately, led to a reduction in their demand for import. On the other hand, supportive monetary policy instruments have reached their limits in developed countries, while the financing conditions have become typically more stringent in emerging countries. However, the low inflation rate and interest rate environment, as well as the improvement of lending activity in European Union countries should be mentioned among the factors positively influencing the global economic outlook. Since the fall in commodity prices caused a significant cost reduction for importers, it supported the growth in commodity importing countries.

Chart 2.1.: GDP growth in the main regions

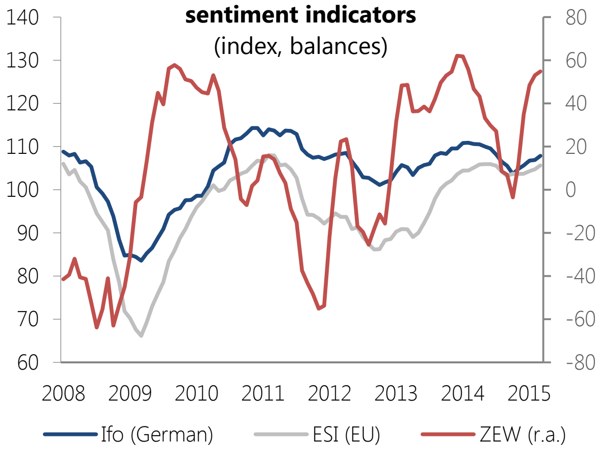
(percent)



Source: European Comission, IMF

Chart 2.2.: Eurpoean economic sentiment indicators

(index, balances)



Source: Cesifo, European Comission, ZEW

It is expected that the declining import demand of emerging countries will be in the background of the slowdown of world trade over the coming quarters. China's economic structure is undergoing significant changes, with the focus shifting from investments and export to consumption, and from industrial production to services. All this can lead to a sustainable growth path in the long term, but, in the medium term, it may involve economic loss, the degree of which is surrounded by great uncertainty. As a result of that country's wide-ranging trading relations, the slowdown in growth will continue to exercise a considerable influence on the world economy, especially the performance of emerging countries. It is important to point out that Russia has recently been one of the biggest losers in the fall of oil prices. In addition, geopolitical tensions and trade sanctions have also contributed to the country's recession during the year 2015. The growth of the United States, which has a central role in the evolution of the world economy, is slightly below last year's expectations, as the stronger dollar and weak external demand resulted in a negative growth contribution of net export. Nevertheless, favourable labour market developments are expected to continue to support the growth of domestic demand in the coming periods as well.

Although the growth of the Eurozone has accelerated in recent years, it has remained subdued. The growth was primarily due to the strengthening of domestic demand, particularly the decline of consumer prices and, linked to that, loose monetary conditions. Germany, which is considered to be Hungary's most important trading partner, showed a long-term stable performance, however, a decrease in exports to China was already evident last year and the economic indicators also projected further deceleration in industrial output (Chart 2.2).

From 2013 onwards, Central and Eastern European countries had the highest growth rates in the European Union. The European Commission forecasts that the region's countries expect an annual GDP growth between 2.5-3.5% in the next two years. This scenario is supported in that several credit rating agencies and analysts interested in international investments also suggest that the favourable economic trend will continue in the coming years and the countries in the region will demonstrate growth rates above the EU average.

The overall conclusion is that the world economic outlook is less favourable than previously expected, so it is becoming increasingly important for Hungary to mitigate the risks arising from external exposure. Therefore, the Government's economic policy should aim to promote the diversification of the export structure that softens the spill-over effects of the weaker economic performance of certain sectors or partner countries.

2.2. THE COMPONENTS OF GROWTH

Since 2013 the Hungarian economy has been progressing towards a stable and dynamic growth structure, which is clearly demonstrated by the fact that the GDP growth has been stabilised at a sustained high rate of around 3% for ten quarters now. Thus, GDP increased by 3.7% in 2014 and by 2.9% last year. Due to these developments, GDP growth data recorded in Hungary over the past years were much higher than the average in the European Union or that of Germany (Chart 2.3).

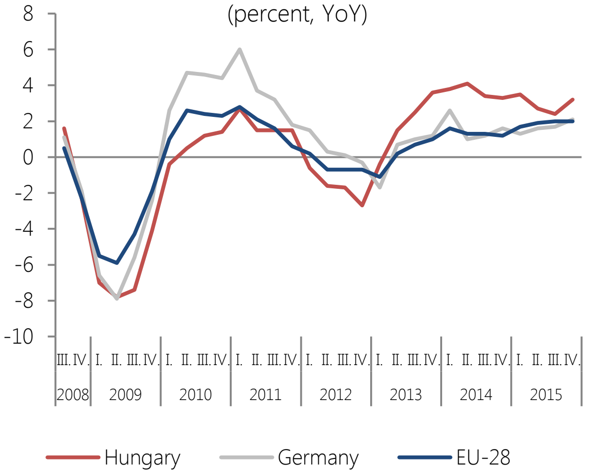
Apart from the fact that Hungarian GDP has grown dynamically since 2013, its structure became balanced and sustainable, which is underpinned by several factors. On the one hand, most sectors show favourable and stable performance. On the other hand, the GDP growth was not accompanied by building up external and internal imbalances, meaning, that the catch-up of the Hungarian economy was not fuelled by indebtedness. This balanced structure is well illustrated by the fact that the foreign trade surplus reached EUR 8.1 billion last year, which is a substantial improvement compared to the 2014 level. In parallel, the general government deficit to GDP ratio amounted to 2% in 2015, which also shows the stabilization of internal balance.

In parallel with this positive trend, Hungary once again converged to the European Union's level of development (Chart 2.4), which is shown by the fact that Hungary performed the fastest average per capita GDP growth in the sample analysed (after Latvia and Ireland) between 2013 and 2015. The performance of these three economies was well above the average speed of convergence in the EU, which shows a rate of around 2%, in line with international comparisons.

Based on GDP data we can conclude that the newly acceded Member States typically grew at higher pace than the old Member States. Among them, the role of the Visegrád countries is remarkable. However, the external environment has not always supported the GDP growth, so the role of domestic demand has become more important for the region's economies. In particular, investment activity should be highlighted, which significantly contributed to the convergence process between 2013 and 2015, which is favourable because investments support growth potential over the longer horizon.

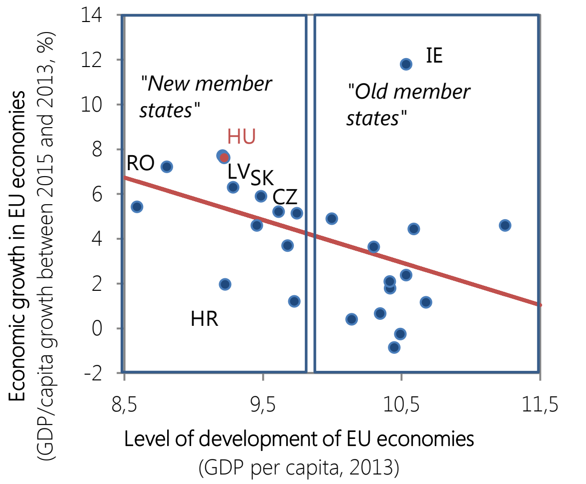
Chart 2.3: GDP growth in Hungary, Germany and in the EU

(percent, YoY)



Source: HCSO, Eurostat

Chart 2.4: Development and growth in the EU



Source: HCSO, Eurostat, MfNE calculation

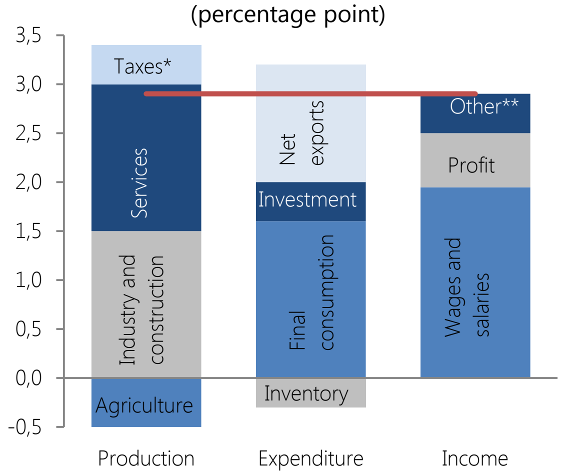
** The red curve represents the average speed of catching up in the EU. The Hungarian, Latvian and Polish data are almost identical. The volumes (which are based on per capita, euro data) are in logarithms in accordance with the common practice. Data of Cyprus and Malta are not taken into account because of their different economic structure. The country groups are in the general the newly and previously acceded Member States, but some outliers exist.*

As for the structure of the Hungarian GDP, the contribution of industrial production was the highest among the supply side GDP items in 2015, which is explained, amongst others, by the new vehicle manufacturing capacities. Simultaneously, however, a substantial upturn in services can be observed, which reflects a significant increase of output in tourism and retail trade, in line with the acceleration of domestic demand. This resulted in the gradual acceleration of growth contribution of services: while the growth contribution amounted to nearly one-fifth in 2014, it was about one half last year. However, agricultural output declined due to unfavourable weather conditions. Excluding the direct impact of the gross value added of the agricultural sector, the GDP growth of Hungary was close to 3.5% in 2015.

On the demand side, growth was also balanced last year. Before 2013, GDP was essentially driven by net exports. However, the catch-up of domestic demand has been observed since then. The recovery of domestic demand, however, could have been stronger than preliminary planned by companies, to which the economic agents adapted by downsizing their inventories. In line with substantially high industrial production and tourism, the country's export surplus increased significantly during 2015, as well.

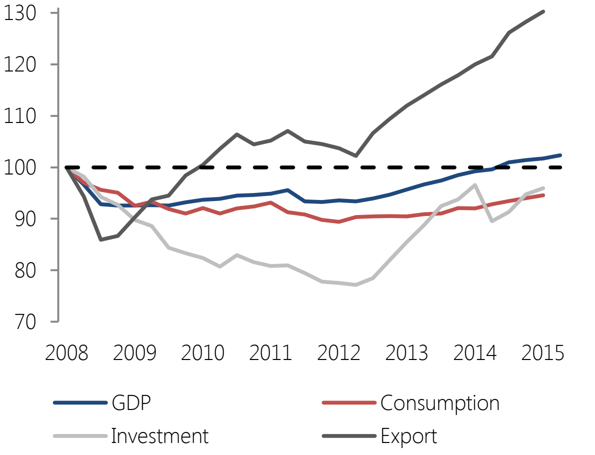
GDP can also be decomposed based on how much income of the economic agents is generated from each production factor. During last year, a significant wage surplus was generated in the Hungarian economy, which is due to two main factors. First, favourable labour market trends and, second, the near-zero inflation environment (which, in a large part, is due to low oil prices) should be highlighted.

Chart 2.5: Decomposition of 2,9% GDP growth in 2015
(percentage point)



Source: HCSO, Eurostat, MfNE calculation

Chart 2.6: GDP growth since the crisis
(2008 third quarter = 100)



Source: HCSO, Eurostat, MfNE calculation

** Net taxes on products ** Net taxes on products and production.*

When assessing the growth outlook, several factors should be considered. On the one hand, while the EU funds provided both in the previous programming period of 2007-2013 and in the new programming period starting in 2014 could be used last year, only the transfers granted in the new cycle can be withdrawn this year. So, due to the cyclical nature of EU funds, investments might decrease this year.

On the other hand, when estimating the growth prospects, it should be noted that the Hungarian GDP reached the pre-crisis level last year, which is largely due to the dynamic export growth. Domestic demand, however, has not been caught up completely (Chart 2.6), so there exists a strong potential of recovery, which supports the growth outlook of both consumption and investment. In addition, the decline in agricultural production last year can be adjusted this year due to the low basis in the one hand and last year's capacity expansions on the other hand.

Third, the external demand can be negatively affected by certain factors, such as the slowdown of the Chinese economy, the Volkswagen scandal and the fiscal and real economic difficulties surrounding oil-exporting countries.

Finally, on the forecast horizon, the outlook can also be strengthened by fundamental factors and fiscal incentives. In the longer run, demand is supported, amongst others, by favourable labour market trends and persistently low oil prices. In addition, the earlier and recent Government measures taken to support growth, such as the reduction of personal income tax and the bank tax, as well as the stimulation of new dwellings construction, may significantly dampen the slowdown due to the cyclical nature of EU transfers.

Overall, taking into account all these factors, the growth rate in 2016 may be lower compared to 2015, mainly due to the cyclical nature of EU transfers. After the fading of the one-off effect, however, the volume of gross domestic product can grow again at around 3% from 2017 onwards, which is supported by the sustained and dynamic GDP growth data of the recent period. Due to government measures, the robust growth is expected to surpass even the 3% rate in the forthcoming years.

External trade

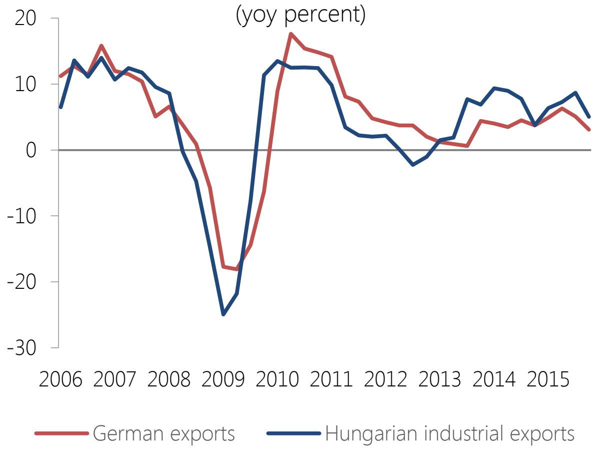
Hungary's foreign trade grew significantly in 2015, as the volume of exports and imports increased by 8.4% and by 7.7%, respectively. Due to the global market environment, external demand also showed a sustained upturn last year, which supported the export opportunities of Hungarian companies. In addition, the Euro, which devalued against the dollar, and the improving domestic terms of trade also contributed to export performance. The recovery of global demand in the automotive industry had a positive impact on vehicle sales and, thus, the domestic automotive sector and its exports. This positive development could not be broken even by the negative reverberations caused by the Volkswagen scandal and can only have a role in realignment the market during the coming period, which will not be meaningful to the diversified domestic automotive industry. Audi, a member of the Volkswagen Group, has a small share in the respect of the diesel engines in its plant at Győr. In fact, the environmental pollution involved older engines are not included in the products of the Audi factory. Introduced in the second half of 2014, the Russian embargo was not lifted after the planned one year, however, its negative impact on Hungary was moderate. This is mainly explained by the low direct exposure of Hungary, and that economic actors also adapted to the restrictions quickly.

The structure of foreign trade developed in a balanced way in 2015. First, over and above vehicle manufacturing and the associated supply sectors, the pharmaceutical industry could substantively contribute to the dynamic increase of trade during the last year. On the other hand, services, including in particular tourist activities, expanded significantly in tune with the quickening of domestic demand and favourable labour market trends.

After last year's outstanding export performance, high growth around 7% is projected with respect to exports during 2016 as well, which is supported by the high level of industrial export orders. From 2017 on, new capacities to be developed in the framework of the new industrial strategy will give more boost to foreign trade, which in turn is expected to make the export of priority sectors other than automotive manufacturing more dynamic. As a result, the country's foreign trade can become diversified. A major expansion in the exports of services is expected in tune with the recovery of internal demand.

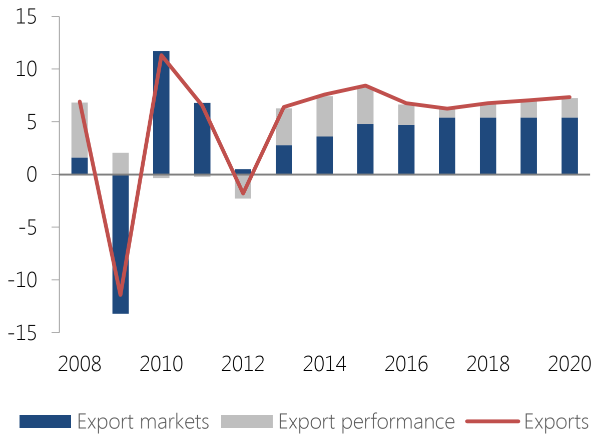
The development of the absorption of EU funds will play a decisive role in the growth of imports over the next few years. Due to the cyclical nature of EU funds, the import implication of growing demand is expected to be more moderate in 2016, but will become more dynamic in parallel with the upturn of the transfers starting from 2017. As a result, and due to the favourable terms of trade by reason of cheap crude oil, net exports can strongly contribute to GDP growth once again after last year, however, the level of contribution may decrease from 2017. In light of these, the foreign trade surplus is projected to significantly rise further in 2016, surpassing the record surplus of last year.

Chart 2.7.: German exports and Hungarian industrial export sales
(yoy percent)



Source: Eurostat, HCSO

Chart 2.8: Hungarian exports
(yoy percent)



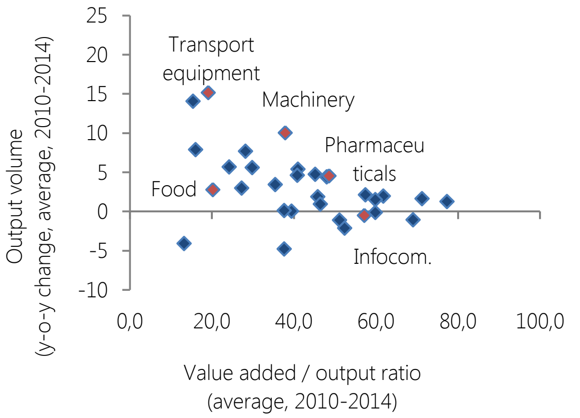
Source: HCSO, MfNE calculations

Box 2.1: Industrial strategy for a more diversified economic structure

The manufacturing industry is one of the main leading sectors in the Hungarian economy, and within this the performance of vehicle industry is outstanding. This is illustrated in that the automotive industry provided about 4% of gross domestic product in 2014, which places Hungary in the leading group of EU in this respect. In addition, this subsector has shown the most dynamic growth in the Hungarian economy since 2012, as investment and production activities of enterprises operating in this industry during the recent period made Hungary a dominant player in the European automotive industry. Automotive products also have significant weight in terms of foreign trade, since the vehicle industry provides nearly 20% of Hungary's total exports. However, the significant growth of the sector coupled with a relatively low expansion of value added in the recent past, as production only slightly enhanced the value of vehicles produced in Hungary. On the other hand, the high degree of specialisation of the country in the automotive industry also poses risks, which was highlighted by recent incidents, notably the Volkswagen scandal and uncertainty surrounding Chinese growth. Therefore, the Government decided to support certain industrial sectors in order to reduce this exposure, as well as to create a growth structure with higher value added and productivity.

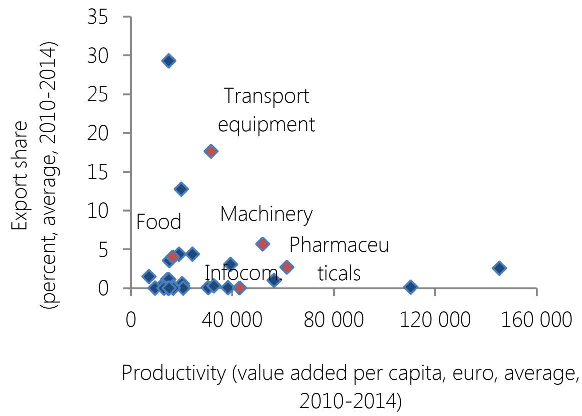
The macroeconomic significance of various sectors can be compared on the basis of several indicators. First, the level of relative value added produced by the sector in Hungary is a priority. In this respect, infocommunication within services and the pharmaceutical industry from the industrial subsectors can be considered outstanding. Second, the volume increase of certain sectors is a good indicator regarding economic growth. Since 2010, the average annual growth rate of machinery production was second behind the automotive industry and the food and pharmaceutical industries also delivered great performance (Chart 2.9). In addition, regarding the value added per capita, which shows the productivity of sectors, petroleum production and real estate transactions are followed by the pharmaceutical industry in third place, but machinery production and infocommunication are also in the leading group. Taking into account the future trends and how much a sector is technologically driven or how capital intensive the production is becomes increasingly important, among domestic sectors the machinery production, pharmaceutical and automotive industry are considered to be highly capital intensive. Finally, in terms of foreign trade, over and above the automotive industry and electronics, the machinery production, the food industry and pharmaceutical industry is outstanding, as the ratio of exported products is significant within the total exports (Chart 2.10).

Chart 2.9: Relation between the gross value added and output volume of each branches of national economy



Source: Eurostat

Chart 2.10: Relation between the productivity and export share of each branches of national economy



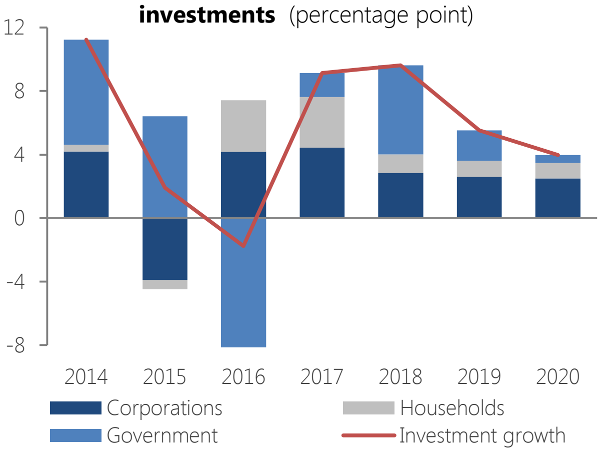
Source: Eurostat, HCSO

The Government elaborated and laid down the new industrial strategy in the Irinyi Plan, which seeks to increase the share of industrial production to 30% within gross domestic product by 2020. The indicators above show the specific industrial subsectors that should be supported to achieve this target and, in parallel, mitigate external exposure. In addition, ceasing dependence on imports was a priority aspect in selecting the areas to be developed in order to maintain the country's defence potential. The priority areas include the automotive industry, specialised machinery and vehicle production, the "health industry", food industry, "green industry", infocommunication and defence industry. The importance of listed sectors is illustrated also in that, on average more than one-tenth of all employed people worked in one of these sectors between 2010 and 2015. In 2015, the food industry employed 140,000 (just behind the automotive industry), and the infocommunication sector employed 102,000 people. In the medium term, additional capacities developed through the increase of government subsidies and provided in the framework of the industrial strategy will generate more significant labour force demand. In order to maintain the competitiveness of the country, it is important to support these industries, as similar sectors were placed in the focus of growth promotion in the case of regional competitors as well.

Investment

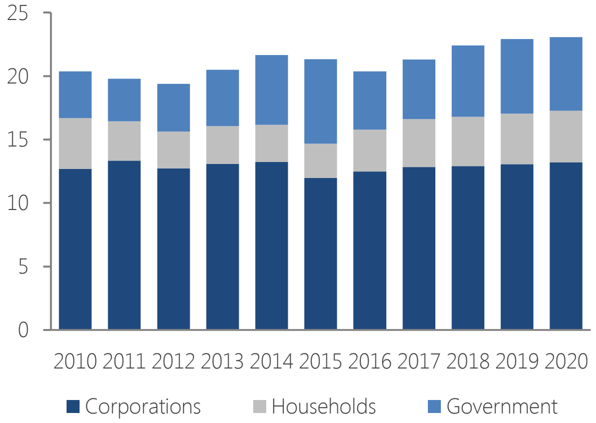
After the record year of 2014, investment activities increased further in 2015. Last year, developments worth nearly HUF 5,600 billion were realised in the economy, thus investments again contributed positively to economic growth. Thanks to this performance, Hungary's GDP proportional investment rate of 21.3% surpassed substantially the average of European Union and was close to the average rate of Visegrád countries. However, certain temporary shifts in the structure of investment could be observed in 2015. On the one hand, the accelerated absorption of EU co-financed projects was reflected by an upsurge in government investments. On the other hand, developments in private sector declined as a result of the moderate performance of both companies and households.

Chart 2.11.: Contribution of sectors to the development of gross fixed investments (percentage point)



Source: MfNE calculation, HCSO

Chart 2.12.: Contribution of sectors to the investment rate (percent)



Source: MfNE calculations, HCSO

The decrease in manufacturing investments, which has the largest weight in the corporate sector, can be explained by the phase-out of previous large scale developments and also several new projects launched in 2015 were still only in the initial stage, and will expand only gradually. The recovery expected in the coming quarters is supported by the permanently high level of capacity utilisation in manufacturing industry, which anticipates further developments. It is important to emphasize that already announced developments also include capacity extensions by automotive flagships like Audi and Mercedes, which have already attracted significant investments into the country through their supplier chain.

The continuous strengthening of Hungary's ability to attract capital is illustrated by the projects managed by the Hungarian Investment Promotion Agency (HIPA). Based on their data, investment decisions amounted to EUR 1.4 billion in 2015, thus 13,000 new jobs will be created in the country, of which nearly one-third are linked to the developments of German companies. Over and above the automotive industry, most of the new jobs are created in the business service sector and food industry. If the ongoing decisions are closed positively, another EUR 4.6 billion would be invested in Hungary, which would create 27,000 additional new jobs.

The investment activity of small- and medium-sized enterprises will be further encouraged by the low yield environment and the favourable business climate. Also, SMEs' access to resources is supported by the particularly investment-focused loan programme, which was announced for 2016 by Central Bank of Hungary (MNB). The positive impact of programme on real economy may be noticeable during this year. In addition, the disbursements from EU funds will also promote the investment activity of SMEs in the coming years, since they can be primarily used for economic development.

Developments in housing market were characterised by a duality in 2015. On the one hand, the recovery of market demand materialised with the continued dynamic increase in dwelling sales last year. According to the estimations of real estate agencies, the number of transactions could reach 135,000, which was a 20% year-over-year increase. On the other hand, despite the number of dwelling permits increased rapidly by 30%, the number of housing constructions decreased by nearly

9% last year. This can be explained by the degraded capacities of construction sector due to the crisis and the restrained demand for new houses.

Looking ahead, in the coming years several factors will contribute to an expected significant recovery regarding the propensity of households to invest. Over and above the stable low interest conditions and rising real incomes, increasing demand is expressly supported by the extended Family Housing Subsidy Programme (CSOK) as well. Although there are specific regions in the country, such as the environs of Budapest, Győr and Kecskemét, where stable demand in housing market has already attracted several real estate investors, the reduced 5% VAT on housing construction between 2016 and 2019 is expected to play a significant role in the recovery of construction sector and the supply side in the rest of the country as well. In addition, the effect of continuous and dynamic increase in the number of issued construction permits of past two years is also expected to appear in the increasing number of new dwellings in the coming quarters.

In 2015, the developments of investment in the public sector were typically determined by the accelerated use of remaining 2007-2013 EU funds. Mainly thanks to the EU transfers, the investment performance of government-related sectors, such as public administration, education and health care, taken together increased by about 40%. In addition, dynamic infrastructure improvements continued despite a record expansion of over 40% being observed in the sector in 2014. The implemented road and railway developments are important in terms of economic growth because they significantly enhance the country's ability to attract capital.

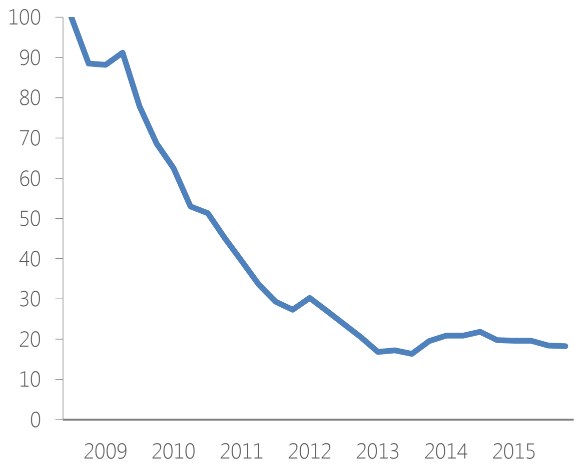
During the 2007-2013 EU financial framework, Hungary had access to funds of EUR 24.9 billion, which is the highest amount relative to GDP in the Central and Eastern European region. The funds significantly contributed to the economic growth and employment developments all over the country, especially in the eastern counties. In the coming years, Hungary will receive EUR 21.9 billion funds in the framework of 2014-2020 EU budgetary period. In terms of using these funds, the priorities will significantly shift towards economic development. The proportion of funds spent on employment and the development of labour market will increase at an outstanding rate, while transport projects will have less emphasis compared to the previous period. If, in accordance with the Government's objectives, all 2014-2020 EU funds will be used by no later than the end of 2018 or early 2019, it would significantly assist Hungary's more dynamic catch-up to EU through the faster building of capacities.

Overall, it is expected that the developments of private sector will contribute positively to the evolution of investments in 2016, while the phase-out of EU co-financed public projects will appear in the reduction of government investments. It is envisaged that growing investment activity of companies and households will not be able to compensate for the temporary recoiling of the public developments, so the growth figure may temporarily turn negative in 2016. However, the joint effect of accelerated EU fund absorption and the upturn of Home-creating Programme will thereafter forecast a strong upsurge of investments in 2017 and 2018, to which all three sectors will contribute. Accordingly, Hungary's investment rate is expected to rise steadily over the entire forecast horizon and will be above 20%, which is favourable also because the developments will support economic growth after the capacities have been built and production has started.

Box 2.2: The impact of the Family Housing Subsidy Scheme (CSOK) and the reduced VAT on housing construction as the accelerators of dwelling market recovery

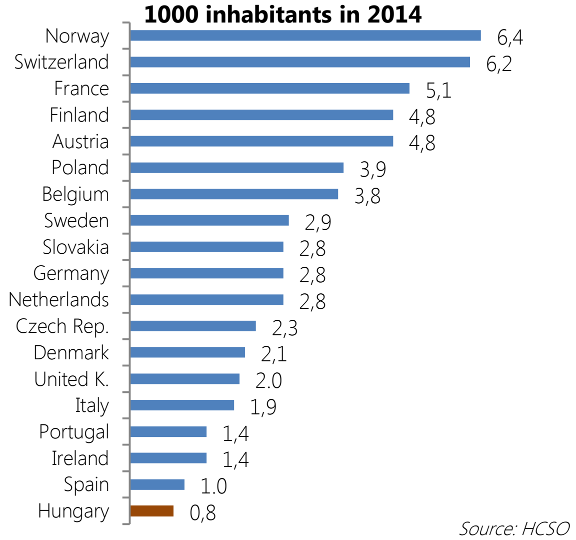
As a result of the degraded capacities of construction sector due to the crisis and the restrained demand for new houses, home building has decreased continuously over the past years. In the middle of 2000s, approximately 35-40,000 dwellings were built annually, which corresponded to 1% of the Hungarian housing stock of 4.2 million at that time. Had this trend continued, it would have ensured the renewal of housing stock in approximately 100 years. By contrast, the housing market started to decline due to the crisis and home building stagnated at around just 8-10,000 after 2010, which is very low in international comparison (Chart 2.14). In 2015, the number of newly built dwellings just exceeded 7,500, which is only one-sixth of the necessary quantity to replace the current housing stock. As a consequence of subdued demand in housing market, mostly renovation and modernisation works kept construction companies alive in recent times, who tried to survive in the market by continuously reducing their capacities and human resources. This is apparently reflected in the number of persons employed in construction industry, as more than 100,000 fewer people were working in the sector by early 2012 compared to the 340,000 in 2007.

Chart 2.13.: Number of dwelling construction
(Q3 2008=100)



Source, MfNE calculation, HCSO

Chart 2.14: Number of newly built dwellings per 1000 inhabitants in 2014



Source: HCSO

Examining the current situation of housing market, it was obvious that a catalyst was needed, which would trigger the processes of real estate market. The measures introduced in this context are particularly favourable because while the Family Housing Subsidy (CSOK) stimulates the demand side of the market, cutting the VAT on dwelling construction to 5% may give a boost to the supply side and also it has a significant whitening effect on tax revenues. Boosting the construction industry is peculiarly important because it is typically categorised as a labour-intensive sector and has a high value added due to the low import content. Consequently, the budgetary expenditure linked to these measures will be partly offset by related revenue gains. It is important to point out that the Home-creating Programme is an economic and demographic programme at the same time because, in addition to encouraging growth, it also alleviates the risks associated with an ageing society by providing support for families to have children.

Given that there are supply barriers in the market due to the capacities of construction industry have gradually decreased since 2008, individual home building by families may initially show a larger share. The supply of new dwellings by businesses is likely to gradually catch up with the increased market demand; however, the situation is complicated because of the serious skills shortfalls in construction industry. With regard to all of this, the number of dwellings is expected to rise to 13,000 in 2016, which means building of one and a half times more homes with a 0.2-0.3% GDP impact compared to the baseline scenario. Looking ahead, the number of newly built homes can exceed 25,000 annually by the end of forecast horizon in parallel with the rebuilding of capacities. Also, as a spill-over effect, certain manufacturing supplier subsectors can also benefit from the positive developments. Overall, the budgetary resources allocated to the Home-creating Programme accelerate the recovery of degraded capacities due to the crisis in order to support and facilitate that the performance of construction industry permanently supports economic growth in the coming period.

Consumption

It is particularly important from the aspect of a balanced growth structure that, since 2013, consumption supports the economic recovery at an increasingly pronounced way. Thanks to the improving employment indicators, the labour market has become tighter in recent years, as a result, the wages increased considerably. The low inflation environment further increased the purchasing power of income. The recovery in consumption expenditure is illustrated in that it amounted to nearly one-fourth of the economic growth in 2014, but it was more than half of the 2.9% growth in the whole of the year 2015.

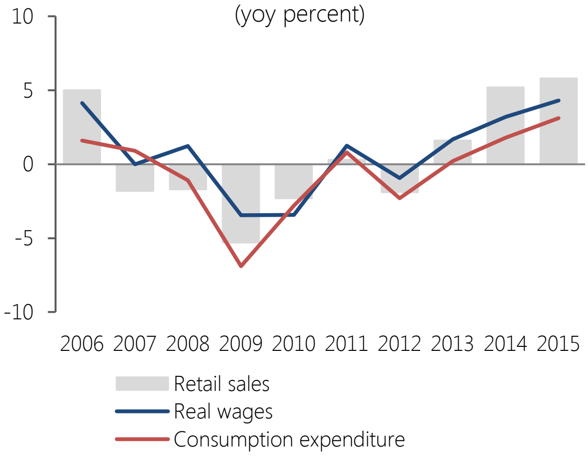
Although, last year, consumption increased at rates not seen since 2006, the pace of expansion still lags behind the increase of real income. This is because the precautionary motive still plays a decisive role in the consumption decisions of households. Households consider their employment and income prospects more uncertain since the crisis, so they increase savings. This is particularly illustrated that the households' net financial saving amounted to 8% of GDP in 2015.

At the same time, several factors show an easing towards the precautionary motives. On the one hand, the conversion of foreign currency loans into domestic currency, the accounting of unfairly increased interest rates by credit institutions and unlawful costs resulting from the application of the exchange margins, as well as the Act on fair banks tempered the external exposure of families and the risks arising from exchange fluctuations. The alleviation of uncertainty encourages households to increase their consumption, and the remaining principal debt and instalments of the families have decreased as a result of the settlement, which results in a better income position. On the other hand, the signs of recovery can be detected in lending, as the volume of new housing loans increased significantly in 2015. It is particularly favourable that, in parallel with increasing real wages and decreasing lending rates, the strengthening of the demand for housing loans is expected in the coming quarters, which will be significantly complemented by the Family Housing Subsidy.

A further increase in the households' consumption is expected in the following years, which beyond precautionary motives supported by several factors. On the one hand, the income situation of families continues to improve in tune with the labour market trends. On the other hand, the low inflationary environment increases the real value of wages. Third, the measures taken by the Government also support the recovery of consumption. Thanks to the 1 percentage point reduction in personal income tax, more than HUF 100 billion will remain in households. In addition, the gradual increase of the family tax allowance for families with two children and cutting the value added tax on basic food products and the internet also stimulates the consumption.

Chart 2.15: Evolution of retail sales, real wages and consumption expenditure

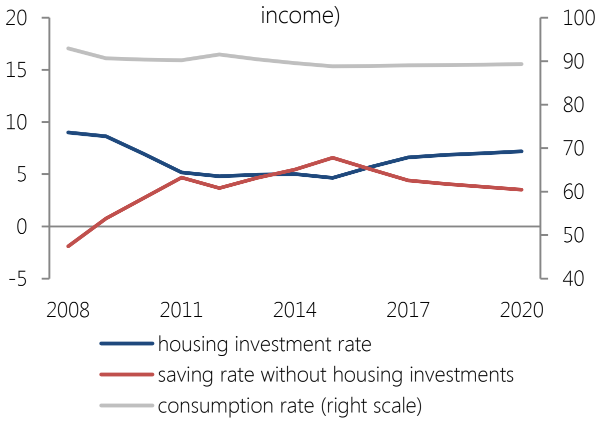
(yoy percent)



Source: MfNE calculation, HCSO

Chart 2.16: Households' consumption, saving and investment rate

(rates as a percent of households' disposable income)



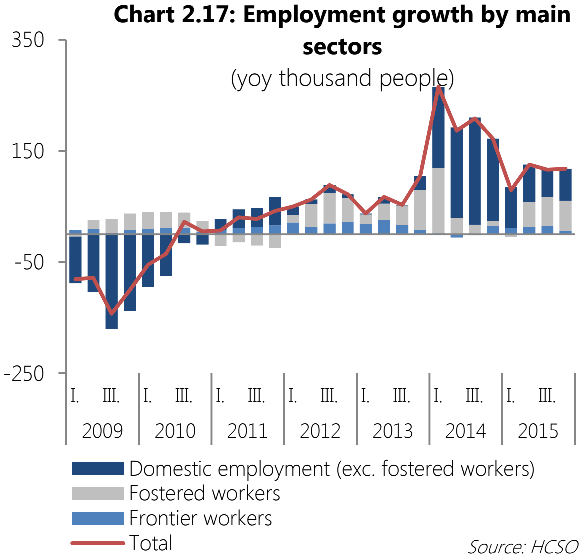
Source: MfNE calculation, HCSO

2.3. Labour market

The dynamic expansion that started during the previous years has continued, so the number of employees increased by 110 thousand in 2015, and exceeded 4.2 million, which is a level not seen since the transition to market economy. Private sector played the most important role in the expansion of employment, while public works contributed to a lesser extent than in the previous year (Chart 2.17).

Chart 2.17: Employment growth by main sectors

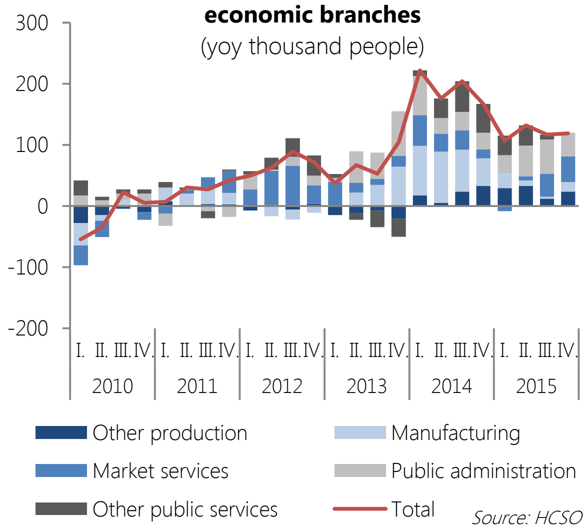
(yoy thousand people)



Source: HCSO

Chart 2.18: Employment growth by economic branches

(yoy thousand people)



Source: HCSO

Labour market trends were significantly influenced by government measures encouraging labour market participation. The increase in labour supply and the return of the affected groups to the labour market were significantly advanced by tightening the conditions to receive unemployment benefits, the changes in conditions of old-age and disability pensions and the introduction of flexible parental benefits.

The labour demand of the private sector increased further as a result of continuing economic growth. Several government measures contributed to the return of hard-to-employ groups to the primary labour market (for a more detailed description of these see Chapter 6). The key objective of the public work scheme is to prevent the long-term unemployed becoming discouraged and leave the labour market, which contributes to their re-introduction to the primary labour market in a more favourable labour market environment. In order to achieve the latter goal, the government supports public workers' entry to the primary labour market by the means of a one-time subsidy in the context of the “From Public Works to the Private Sector” programme, and district offices provide labour market information and labour mediation to ensure the most optimal employment. The programme could help the employment of around 20 thousand fostered workers in the private sector. The profiling system of job seekers was launched at the beginning of this year to determine to whom is it appropriate to offer the possibility of fostered employment and who should rather be assisted to find a job on the primary labour market.

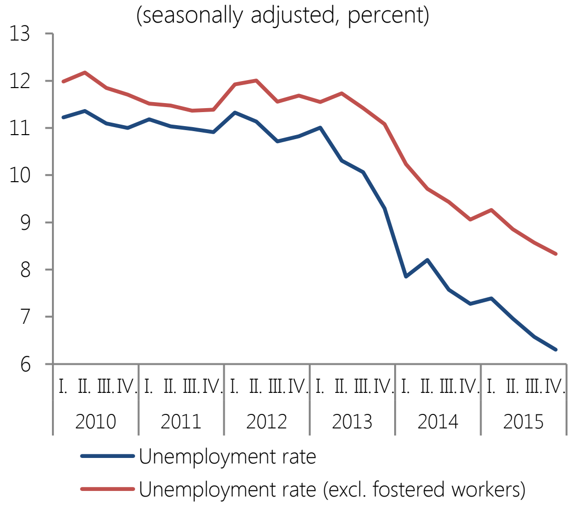
The government uses several active labour market policies to help disadvantaged groups with a high labour supply elasticity to find jobs directly in the private sector. Of these, the employees most affected by the Job Protection Act which supports the employment of people below 25 and above 55, people with low qualifications, permanently unemployed and mothers returning from maternity leave. From 1st July 2015, the government extended the relief from social-security contributions to agricultural workers as well, which affected a further 20,000 employees and facilitated the whitening of the agriculture sector at the same time. According to the data of the Ministry for National Economy, tax exemptions offered by the Job Protection Act helped the employment of nearly 900,000 workers in 2015. Social security contributions left with employers amounted to approximately HUF 136 billion, equivalent to 0.4% of the GDP. (For a detailed analysis of the effects of the Job Protection Act see Box 6.1). For people under 25 years of age, the Youth Guarantee Programme offers additional support and employment opportunities, so persons under 25 may be mediated into public employment in exceptional cases only. The launch of other active labour market programmes expanding employment is expected in 2016, using EU and Hungarian budget funds. Those include the expansion of the apprenticeship programme and a programme to spread flexible forms of employment, as well as the Women 40+ programme to support the employment of women above 55 years of age who face retirement; and a programme to promote the development of social enterprises which have both social and business purposes. Starting from the second half of 2015, the government has implemented several changes in the system of vocational training in order to meet the demand for skilled workers with secondary education. Vocational training centres have been established in the counties and the capital in September 2015 in cooperation with major vocational training institutions. From this fall, these vocational training centres will become training and service centres where new opportunities will be offered to acquire professional knowledge and enhance foreign language and computer skills. In addition, adults will be assisted by training and career counselling so they can get a better understanding of professional development and progress opportunities. As of September 2016, vocational schools will be named vocational secondary schools extended to five grades. The legislative preparations have been completed in order to introduce the so-called vocational high school as well, which is a new type of school.

As a result of Government measures the participation rate has reached 68.6% in 2015, while the expansion of employment and the decline of the unemployment rate have continued. The service sector played a major role in the revival of employment, with arts-recreation, accommodation, public administration and transportation services boosting most of the growth. Within manufacturing transportation equipment and textiles contributed significantly to the expansion of employment (Chart 2.18). Mainly due to the expansion in the sectors listed above and agriculture, employment at the national level increased by 2.7% in 2015, resulting in a nearly 64% employment rate. Overall, the increasing labour demand of the private sector and, to a smaller extent, the extension of the public works, the unemployment rate dropped to 6.2% in the last quarter of 2015. Following a decrease of 0.9% over one year, the annual average unemployment rate moderated to 6.8% (Chart 2.19).

Thanks to the more favourable labour market environment, women's employment rate also continued to rise in 2015, and following a 1.9 percentage point increase it approached 58% in the 15-64 age group and it is considerably higher than the EU average.

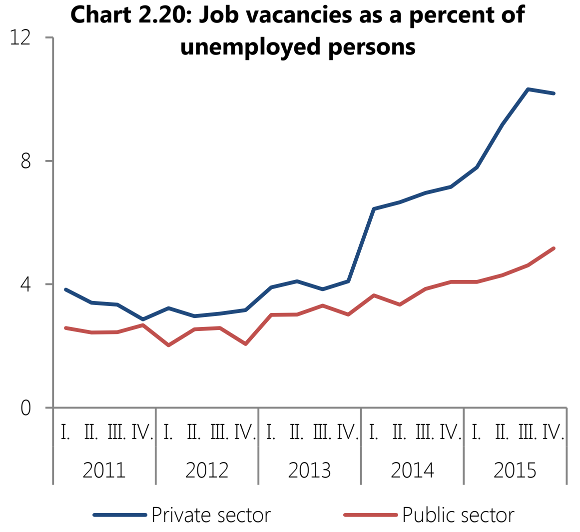
Chart 2.19: Unemployment rate[1]

(seasonally adjusted, percent)



Forrás: HCSO, MfNE calculations

Chart 2.20: Job vacancies as a percent of unemployed persons



Source: HCSO

[1] Provided that in absence of the Public Works Scheme half of the fostered workers would be unemployed and the other half would be inactive

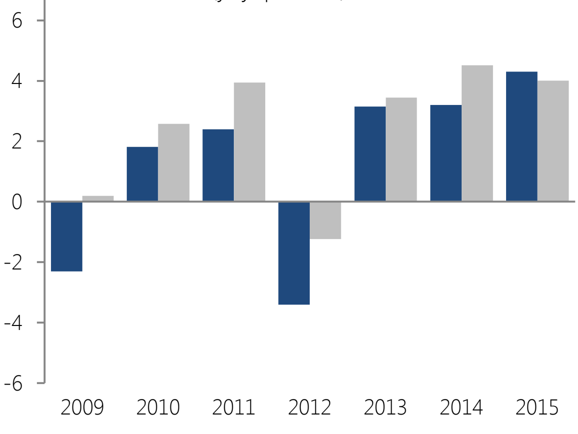
Public sector employment increased mostly as a result of the expansion of the number of fostered workers in 2015. According to institutional data collection of the Hungarian Central Statistical Office, the public works scheme ensured the temporary employment of an average of nearly 192,000 job seekers during the year.

As a result of the improving labour demand of the private sector and lower unemployment, labour market conditions became tighter last year, as a result signs of labour shortage could be observed in certain regions and professions. This is indicated by the increasing number of vacancies and lower unemployment in the private sector which resulted in tighter labour market conditions (Chart 2.20). Meanwhile, more and more employers reported having difficulty finding properly trained and experienced workforce to fill certain positions. Labour shortage is the most typical in the counties along the north-western border where a cross-border regional labour market has emerged. In these regions companies have to attract workers from competitors by offering higher wages.

The tighter labour market did not influence the growth of private sector wages significantly in 2015 (Chart 2.21). The 3.4% increase of the minimum wage and the guaranteed wage minimum fell short of the 4.2% growth rate of gross nominal average earnings.

Chart 2. 21: Net real wages

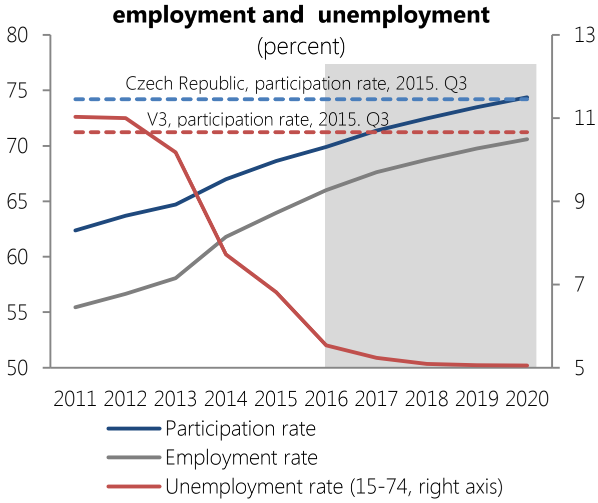
(yoy, percent)



Source: HCSO

Chart 2.22: Labour market participation, employment and unemployment

(percent)



Source: HCSO, MfNE

Public sector wages increased faster than expected. This is due to the fact that in addition to the wage hike of armed and law enforcement workers and the teachers' career model, unscheduled measures such as the additional allowance paid to social sector workers also had an impact on wage growth. At the same time, the composition effect arising from the increasing number of fostered workers and the relatively low, 2.1% increase of fostered worker's wages has dragged down public sector gross average wages, although to a lower degree than in the previous year.

As a result of labour market conditions becoming tighter, private sector wages may grow faster this year than the year before, which can be cushioned by increasing labour supply due to higher labour market participation. In the forecast horizon, a 4.6-5.0% increase of gross private sector wages can be anticipated. The increase in net wages will be supported by lower personal income tax rate which was cut from 16% to 15% as of January 2016. The expansion of the public work scheme is expected to have lower impact on the average wage dynamics of the public sector, however, the announced career models may significantly increase public sector wages, especially in 2017. The increase of the minimum wage and guaranteed wage minimum is expected to be similar to the increase in the previous years.

As an impact of past and current Government measures to stimulate employment, increasing participation may persist over the forecast horizon (Chart 2.22). In parallel with the continuing trend, as a result of the strong labour demand by the private sector, the growth of employment and the decrease of unemployment may continue, which leads to an unemployment rate close to 5% projected by the end of the forecast period.

2.4. INFLATION

Domestic inflation trends have changed radically in recent years. In contrast to the typical yearly price increases of around 4-5% earlier, the Hungarian economy is characterised by historically low price dynamics since 2013, which is has become entrenched into expectations as well. As a result a record low inflation rate close to zero was recorded over the past two years. This favourable change was first clearly related to the reduction of overhead costs implemented by the Government in several stages. After the phase-out thereof, the major role in 2015 was played by external factors such as low oil prices and disinflationary pressure from Europe. Nonetheless, the devaluation of the HUF in the FX market, in particular against the US dollar, offset the price-reducing effects. Thus, although inflation evolved essentially in line with the expectations of the Convergence Programme last year both positive and negative surprises occurred in respect of certain effects, of which the downside factors will continue to prevail in 2016 as well.

As regards the imported effects, the further decline in oil prices is the most significant, which is expected to mitigate the increase in prices in a decisive extent this year as it did last year. Another downside factor is that despite the efforts of the ECB inflation was stuck at historically low levels in the Eurozone. In addition, domestic factors also affect low price dynamics, thanks to the fact that companies are able to meet the recovering demand by using their existing capacities, so it does not appear as a substantial factor in pushing up prices. The price decrease is also supported by the value added tax cut on pork. Overall, inflation may be around zero per cent in 2016 as in previous years.

In 2017, the price dynamics is expected to accelerate significantly as the effect of low energy prices fades out. In addition, although the impact of the ECB's monetary easing appears in Hungary with a significant delay only, the inflation coming from Europe may overall converge to its normal rate. Regarding domestic factors, the value added tax reduction on certain staple foods and services will at the same time have a significant impact. Another downward factor is the pass through of low fuel prices into other goods and services. Overall, although the external disinflationary effects may decline this is offset by domestic factors therefore inflation may remain low in 2017 as well.

Although VAT reduction affects subsequent years, too, inflation is expected to approach the 3 % mid-term target of the MNB by late 2018 in parallel with the phase-out of the disinflationary pressure from abroad and the gradual closing of the output gap. Nevertheless, based on recent years it can be declared that the Hungarian economy is characterised by moderate inflationary environment that built into expectations establishes the conditions for long-term price stability.

Box 2.3: Favourable macro-economic impact of the fall in oil prices

In recent years, inflation forecasts were characterised by high downward revisions, which was mainly due to the decrease of the world oil price that surpassed all expectations. Initially, the futures market counted upon the retreat of shale oil and, in parallel, a sharp rise in prices, which was reflected in the forecast of the 2015 year Convergence Programme as well. In line with expectations black gold became considerably more expensive in the first half of the year , reaching a level of USD 65 in May. However, the quotes did not reflect the fundamentals, as American producers were able to maintain their output by means of financial and technological solutions, so the market remained oversupplied: the daily demand of 95 million barrels was coupled with production above 97 million barrels, and the surplus resulted in stocks rising to record high levels.

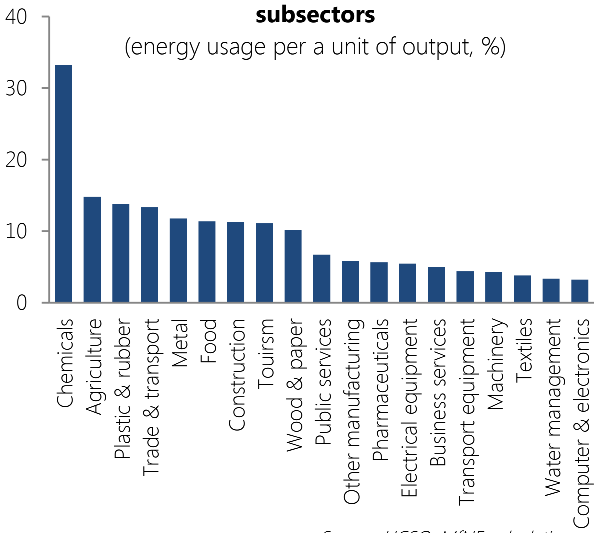
Finally, in late summer, a significant price fall unfolded as a result of the slowdown of the Chinese economy and the renminbi crisis, resulting in lower quotations by approximately 40% compared to June. Taking into account the continuing significant oversupply and the accumulated stocks, the market is currently counting on more moderate oil prices than expected, both in terms of level and dynamics. Lower energy prices appear as a positive factor in the economy as a whole. The purpose of this box is to present and quantify it.

In a global context, the oil price decline might be interpreted as a kind of income reallocation from net producer countries to net users. Since Hungary and the Eurozone are a part of the latter group, as a first approximation, Hungary is clearly a beneficiary of the current situation. Nevertheless, it is important to take into account the indirect effects stemming from the openness of the global economy. The oil price decline is detrimental to the producers including OPEC countries, as well as Russia and due to the spread of non-conventional technologies the United States as well. Thus, the European export loses important markets concurrently with the oil price decline, which indirectly affects Hungary as well. These indirect effects, however, are difficult to quantify, so we focus on the domestic developments in the analysis.

As regards the domestic economy, the expenses of the corporate sector declined considerably due to lower energy prices and further reduction may occur in the coming period. About two-thirds of the oil price change appears in production costs through domestic energy prices. This allowed the firms to save about HUF 300 billion on an annual basis in 2015, which, after taking into account the reduction of output prices as well, could contribute to GDP growth by 0.5 percentage points. Examining the structure of production, the main beneficiary is industry, including, in particular the manufacturing of chemicals but agriculture construction and the services linked to transport and travel also realise meaningful profit from cheaper energy.

Chart 2.23.: Energy intensity by subsectors

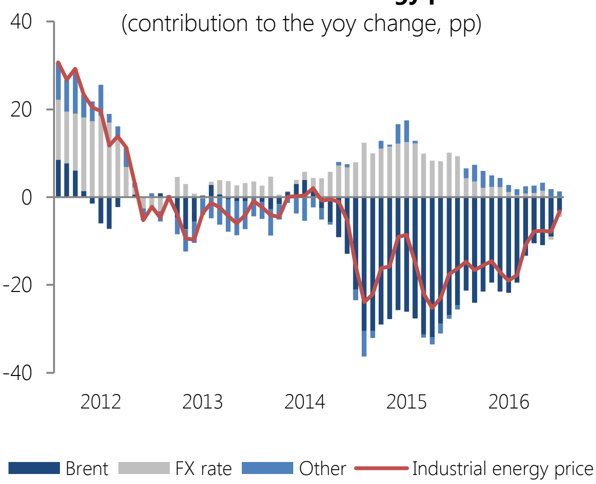
(energy usage per a unit of output, %)



Source: HCSO, MfNE calculations

Chart 2.24.: The effect of oil price decline on industrial energy prices

(contribution to the yoy change, pp)



Source: HCSO, Thosmson Reuters, MfNE calculations

Part of the extra income gain appears as corporate profit while another part thereof finally improves the financial position of households in the form of dividends and wages. From the households' point of view low oil prices manifest in an increase of real wages through the decrease of consumer prices, meaning that consumers may spend more from the same salary. Calculations suggest that the oil price drop in 2015 and 2016 resulted in a one-off real wage increase of HUF 220, 200 billion for households respectively, a major part of which is probably used for consumption. The savings and profits left with firms gives room to finance extra investments, which contributes to long-term growth.

In summary, the positive impact of low oil prices affects the economy as a whole. The income produced by the economy increases through the decreased production costs, and its benefits are experienced by households and firms alike. Thanks to the decrease of energy prices, both consumption and investments may be higher in 2015 and 2016. Although the oil price measured in HUF may constantly rise with the conditions of supply and demand returning to normal, it may in the medium term be about 40% below the level seen between 2010 and 2014. Therefore, the positive effects may prove to be basically of long lasting nature, which may result in about a 1% higher GDP.

2.5. CYCLICAL POSITION

Basically, the performance of the Hungarian economy in the late 1990s and the first half of the 2000s fluctuated around its potential level. Nonetheless, the growth in this era was marked by excessive lending and rapid external deleveraging prior to the crisis which turned unsustainable. With the outbreak of the global financial crisis in 2009, lending took a turn and the focus shifted to debt repayment in parallel with a drop in the performance of the economy well below its potential level. In the following years, the cyclical position started to improve, which has accelerated since 2013 in parallel with favourable structural developments. Nonetheless, owing to the high level of debts accumulated during the period of boom the economy's performance may fall short of the level induced by structural factors in the coming years as well. In summary, in accordance with the financial cycle and basically due to the absence of domestic demand, the output gap may remain in the negative range over the forecast horizon and close by 2020.

The financial position vis-à-vis the rest of the world suggests that basically the Hungarian economy still places the emphasis on debt repayment. The high stock of credits reduces domestic demand and therefore investment and consumption levels are still below the pre-crisis level. In addition, given that the output gap of major trading partners is negative, there is still some room for cyclical growth stemming from foreign demand.

Nonetheless, the capacity utilisation of manufacturing companies and confidence indicators are also at a high level, which suggests production is on the verge of possibilities. The appropriate evaluation of these indicators is difficult though, since a higher level of equilibrium seems to emerge after the drastic downturn experienced during the crisis. Thanks to additional investments and flexible workforce management methods, firms are able to adequately meet the emerging extra demand, which is reflected in low inflation.

In 2016, due to the temporal slowdown in economic growth, the cyclical position of the economy may remain essentially unchanged. In the following years however, expansion supported by the Government's growth-stimulating measures may already exceed potential growth, meaning, that the output gap is expected to close gradually. In addition, the ever-tightening labour market, favourable commodity prices and the accelerated absorption of EU transfers are all factors pointing towards the closure of the current cycle.

Box 2.4: Factors behind the acceleration of potential growth

Although the methods of various institutions show differences[1] as to the merits, the estimates of both the European Commission and the Government suggest that potential growth developed similarly in recent years, and could have reached 2% by 2015 as opposed to 0% in 2014. The drastic improvement means that the recovery of the economy is not merely cyclical, but also structural in nature, that is, economic growth is sustainable in the long term. This box is intended to describe which factors and reforms could lead to the acceleration of potential growth and the possible continuation of positive developments.

The question is answered by breaking down potential growth to three factors of production, namely the amount of hours worked, stock of capital and efficiency. The results clearly show that the change in the labour market trend had a key role in the turning of 2010-2011. (Chart 2.25) Employment switched from earlier decline to steep ascent, in which the Government's policy targeted at the appreciation of work had an explicit role. On the one hand, the tax system has been transformed towards taxes on consumption, which may certainly have a positive impact in the long run. On the other hand, the revision of early retirement regulations and active labour market policies produced meaningful results in driving down unemployment in the short term as well.

In addition, capital accumulation could also contribute to potential growth at an increasing rate from 2013 onwards, thanks to investments in manufacturing and the accelerated absorption of EU funds. Over the forecast horizon, the change in capital stock and its potential contribution to growth gradually approaches the level experienced in the early 2000s, which is supported by the investments of foreign companies, the proper use of EU funds and the new industrial strategy of the Government as well.

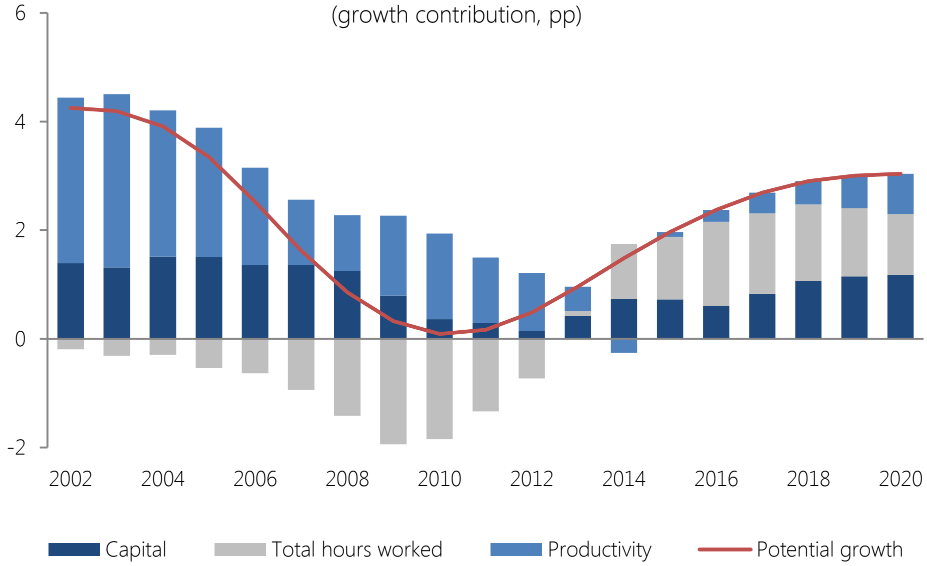
Nevertheless, the implemented reforms inevitably involve a sacrifice of efficiency in the short term. Expanding employment basically affected the low-skilled workforce, which appeared as a negative composition effect in terms of efficiency. As a result, the improvement of productivity substantially decreased in the post-2010 period in the context of favourable labour market developments. The trade-off between employment and efficiency is observed for a wide range of countries and is a phenomenon prevailing in the longer term[2], which in itself does not cause sustainability problems. On the other hand, although the latest results[3] confirm that the involvement of low-skilled workforce in the labour market brings about the decrease of productivity, they also point out that it leads to an increases in per capita income and decreases income inequality. In addition, the productivity of these groups also improves over time, thanks to the skills acquired during work which results in efficiency gains in the longer term.

[1] The comparison of the results of the Government and the European Commission was presented in a separate box in 2014 and 2015 Convergence Programmes, respectively.

[2] Michelis, A., Estevao, M, Wilson B.A. [2013]: "Productivity or Employment: Is It a Choice?" IMF Working Paper WP/13/97

[3] Sanches-Roehn [2016]: "The distributional impact of pro-growth reforms", OECD preliminary working paper, ECO/CPE/WP1(2016)2

Chart 2.25: Components of potenctial growth
(growth contribution, pp)



Source: MfNE calculation

In conclusion, fundamental changes took place in terms of potential output in recent years, which ensure sustainable growth in the long run. The improvement may be linked to the expansion of investments on the one hand and the favourable labour market outturn on the other. The most important result is that, due to the Government's economic policy, the declining trend of employment since the beginning of the 2000s was changed into steep growth. Although it caused lower level of aggregate efficiency, this effect is only temporary and furthermore the involvement of low-skilled groups in production has many other social benefits.

2.6. External balance

Hungary's net lending reached 8.8% of the GDP in 2015, which is outstanding both historically and in an international comparison. This is a result of that foreign trade has increased year after year due to dynamically expanding exports on the one hand, and income outflows decreased due to the declining external debt on the other hand, while an increasing inflow of sources from the European Union was recorded.

The favourable process was a joint result of the improvement of the current account and the capital account. Net exports, which have dynamically expanded for years, could continue to rise in 2015, and were also supported by the excellent performance of the service sector mainly due to tourism and transport. The lack of income continued to moderate, which is due to EU transfers on the one hand and, on the other hand, decreasing interest expenditures resulting from the combined effects of declining debts and low yield conditions. The improvement of the capital balance was brought about mainly by EU transfers linked to infrastructural developments and renovations. At the same time the huge levels of resources used in 2014-2015 was a one-off phenomenon given that even transfers from the previous programming period could also be called.

High financing capacity coupled with the decrease of external debt in recent years. Accordingly, the GDP-proportionate gross foreign debt of the national economy was reduced to 75.6% by the end of

2015 from 112.7%, measured in late 2010. The trend accelerated significantly during 2015. Basically, the population and non-financial corporations are paying their debts back and, in the case of public finances, the process was assisted the most by the regrouping of debt between foreign and domestic actors. The background of the latter phenomenon is that Hungary is characterised by improving fundamentals and a low yield environment, which results in that some foreign fund managers downsize their Hungarian Government securities positions. In contrast with previous experience, capital withdrawal did not cause turbulence on the money market, thanks to the revival of government securities purchases by domestic households and banks, in which the MNBs Self-financing Programme had a featured role.

In the coming period, the manufacturing industry and, in the long run, the Government's industrial strategy will continue to contribute to the upswing of foreign trade. In addition, the absorption of EU funds for economic development will particularly improve the possibilities of Hungarian exports. As regards the income balance, earlier trends may continue and outflows may further abate as a result of the dynamic decrease of debt. However, the above effects are offset in that, from 2016 on, Hungary can call on only the transfers of the current EU cycle, so this year a more moderate inflow of EU funds is expected than last year. Although the structural reforms carried out in recent years promote the faster use of the resources of the new programming period, the overall net financing capacity may temporarily decrease this year.

The net lending may stabilise at an invariably high rate around 8% in the coming years. As a result of the massive surplus and dynamic economic growth, the gross foreign debt of the national economy may significantly decrease and even drop below 60% of the GDP, which further reduces the vulnerability of the country.

Box 2.5: Sustainable current account surplus in the long-term

It is a basic economic process that the higher the income that can be achieved in convergence countries attracts foreign capital and technology, which appears as a financing need in the current account deficit. This is underpinned by the data of Hungary and the countries in the region from the 90s and then the first half of the 2000s. However, the process suddenly changed in 2009. The current account deficit has declined dramatically concurrently with the crisis and, in the following years, even had a surplus, which significantly expanded later. Although the trend is similar in regional countries as well, the rate of improvement in the financing position apparently falls short of that experienced in Hungary.

The evolution of the current account deficit is basically explained either by structural factors[4], such as demographic conditions, economic development, claims towards foreign countries, budget deficit, or cyclical effects, such as the output gap, the change of exchange ratio or the global risk appetite of investors. However, there are no factors that justify such a deviation from neighbouring countries, so there must be some country-specific feature in the background.

In recent years, Hungary has gained a significant competitive advantage, on the one side due to its real exchange rate devalued by nearly 10% since 2009 and on the other side non-price-based factors could also contribute to positive processes. Examining the details of the current account, the balance

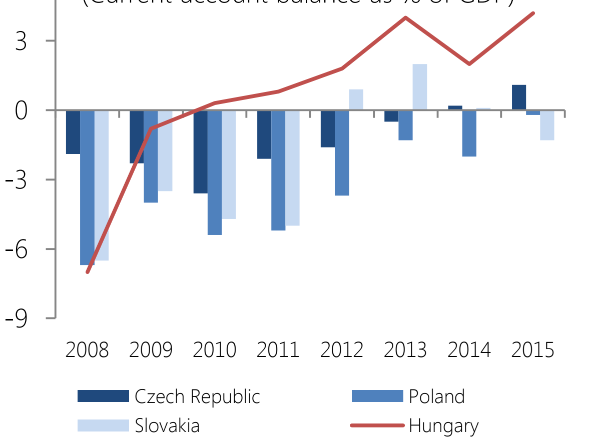
[4] See, for example, Phillips et al. [2013]: The External Balance Assessment Methodology, IMF Working Paper WP13/272

of incomes shows a moderate deficit in accordance with the regional trend, while the surplus of the commodity balance, although high, is around the level that can be observed in the Czech Republic and Slovakia as well, so they do not provide an explanation for the difference.

In terms of services, however, Hungary clearly stands out in the region. Over and above processing fees related to the manufacturing industry, the significant surplus is due to the spread of service centres, trade and transport activities, as well as tourism. The value of the latter is high also in a historical context, which is likely to be caused by country-specific factors, such as the capital being popular among tourists. The balance of transport and commercial services has been rising since the accession to the EU, and amounted to nearly 6 per cent of the GDP in 2014. The significant surplus is given by road and air transport, which can be linked to the favourable geographical location, the motorway network that is outstanding by regional comparison, as well as, to some extent, individual company performances.

Chart 2.26: Current account developments in the region

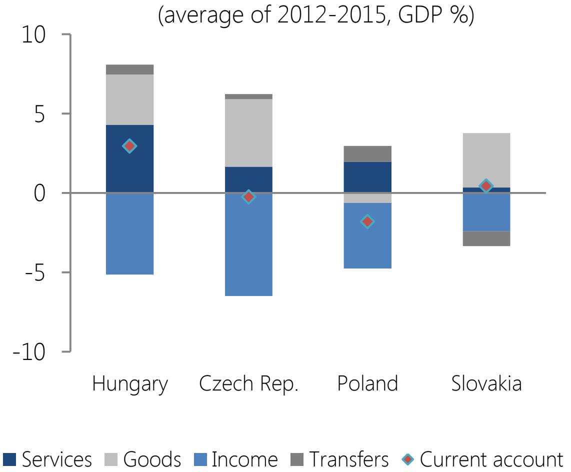
(Current account balance as % of GDP)



Source: Eurostat

Chart 2.27: Current account balance decomposition in a regional comparison

(average of 2012-2015, GDP %)



Source: Eurostat

Overall, the surplus of the current account measured in recent years, which is higher than that of regional peers, is basically country-specific and a result of corporate factors. It was an important basis for the circumstances that the Forint devalued by nearly 30% in the foreign currency market since 2008, which greatly improved the country's price-based competitiveness. These factors are expected to continue over a longer term, as opposed to regional peers, as there is no reason to justify any change thereof, so a current account surplus amounting to 4-5% of the GDP may characterise the Hungarian economy in the period ahead.

2.7. Economic implications of structural reforms

This chapter sets out the macroeconomic impact assessment of key Government measures issued since the publication of the 2015 Convergence Programme by using the DINAMO [5]model of the Ministry for National Development. The structure of the DINAMO model rests on neo-classical growth relationships in the long term, however, adjustment to this is slowed down by various

[5] The description of the Dynamic National Accounts Based Model (DINAMO) is available here: http://2010-2014.kormany.hu/download/5/34/41000/Dinamo%20NGM%20El%C5%91rejelz%C3%A9si%20M%C3%B3dszertan.pdf

frictions in the short term. First, the model is suitable for impact assessments because it reflects complex relationships between the macroeconomic variables. Second, it is consistent representation of relations between the national accounts and the financial accounts of public finances. Third, several transmission channels have been incorporated in the model through which the fiscal variables exert their effects on the economy.

The impact assessment addressed the following Government actions (Table 2.1):

- Wage increases and introduction of career model in the public sector: wage developments of workers in the health and social sectors, tax authority career, and other sectoral wage increases.
- Programmes supporting the stimulation of investment: housing, housing subsidy, Modern Cities Programme (MVP).
- VAT reductions for certain products and services: some basic food products, Internet services, restaurant meals.

Table 2.1 Impact of the Government measures on the general government balance (% of GDP)

	2016	2017	2018	2019	2020
Measures increasing expenditure	**-0,42**	**-1,06**	**-1,24**	**-1,08**	**-0,83**
Wage increases, career models	-0,09	-0,43	-0,58	-0,67	-0,64
Housing subsidy	-0,20	-0,22	-0,22	-0,22	-0,19
Modern Cities Programme (MVP)	-0,13	-0,41	-0,44	-0,19	0,00
Measures decreasing revenues	**0,00**	**-0,19**	**-0,22**	**-0,22**	**-0,22**
VAT reductions	0,00	-0,19	-0,22	-0,22	-0,22
Total	**-0,42**	**-1,25**	**-1,46**	**-1,31**	**-1,05**

Source: MfNE calculations

Remark: The items do not necessarily make up the total due to rounding

The positive developments of macroeconomic fundamentals allow the introduction of the above Government measures. In parallel, the balance of the budget evolves in accordance with EU requirements, meaning, that the deficit of public finances will remain significantly below 3% of the GDP in the coming years. It is also important to point out that, according to the information received recently, the Hungarian economy produces growth of around 3%, which Government measures are expected to further strengthen over the forecast horizon.

The simulation results show the cumulated effects of baseline scenario with Government measures compared to a scenario without fiscal measures in terms of percentage points.. According to the model calculations, GDP volume is gradually increasing, as a result of which the level of the GDP may be 1% higher in 2020 compared to the baseline projections (Table 2.2). Since this overall growth effect is realized in 5 years, Government measures may result in an 0.2 percentage points higher annual GDP growth on the average. In some years, the estimated effect is somewhat even higher.

Table 2.2 The cumulative macroeconomic impacts of the structural measures (% difference in levels relative to the baseline scenario)

	2016	2017	2018	2019	2020
GDP	**0,38**	**1,24**	**1,57**	**1,28**	**1,03**
Households' consumption expenditure	0,25	1,71	2,30	2,31	2,19
Investments	2,24	5,61	6,39	4,24	2,62
Net export	-0,17	-0,73	-0,94	-0,82	-0,70
Inflation	0,01	0,25	0,53	0,61	0,60
Private sector employment	0,11	1,04	1,40	1,33	1,30
Gross wages in the private sector	0,05	0,67	1,26	1,27	1,07
General government deficit (% of the GDP*)	-0,07	-0,62	-0,74	-0,75	-0,83

Source: MfNE calculations based on DINAMO model

**Change in percentage points*

A set of economic policy steps (wage increases, VAT cuts) brings along the increase of disposable income of the households, which directly contributes to the strengthening of consumption. And another set thereof (housing subsidy, MVP) envisages a large-scale investment growth partly by households and partly by companies and by the Government. The measures indirectly support the growth of the export capacities as well.

Through the recovery of internal demand, Government measures also generate a demand for labour and induce wage growth in the Hungarian economy. However, the expansion of domestic consumption generates mild inflationary pressure. Simultaneously, higher tax revenues from the GDP growth partly offset the negative impact of the additional expenditure on the budget balance.

2.8. MONETARY AND EXCHANGE RATE POLICY

Following the previous regulation, the current Act on the Magyar Nemzeti Bank (MNB) sets out to achieve and preserve price stability as the primary objective of the Central Bank. Since 2001 the MNB has been following an inflation-targeting monetary policy. Within the framework of this, the Monetary Council set a 3% mid-term inflation target, however, in March 2015, it defined a tolerance range of ±1 percentage point around this value.

Monetary policy ensures inflation targeting by changing the base rate and exploiting the flexibility provided by the floating exchange rate.

The MNB continued to reduce the base rate last year as well: from 1.95% on 22 April 2015, it cut the applicable interest rate to 1.05% in late April 2016, as a result of six steps of 0.15 percentage points reduction each. In addition, it changed the monetary policy tools on several occasions during the year.

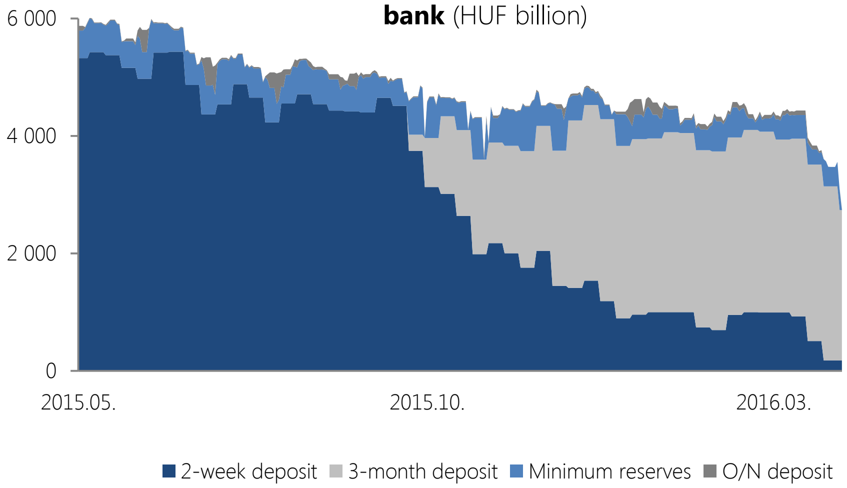
First, the interest rate corridor was changed on two occasions. While from November 2009 to September 2015 the interest rates of overnight standing facilities of the Central Bank were ±1 percentage point from the prevailing base rate, the MNB made the interest rate corridor asymmetric from 25 September 2015, while keeping the width of the band. From then on, the overnight deposit rate is 1.25 percentage points lower, and the overnight collateralised loan rate is 0.75 percentage points higher than the policy rate. As the next move, the Central Bank narrowed the band to a width of 1.5 percentage points on 23 March 2016. It is now paying an interest of only 25 basis points higher than the base rate for overnight lending, but did not change the lower width of the marginal interest rate. The overnight deposit rate became negative in March 2016, for the first time in the history of the Central Bank. (Chart 2.29)

Second, MNB reduced, from 1 December 2015, the minimum reserve requirements ratio for credit institutions uniformly to 2% instead of the freely electable rate of 2% to 5%, in force since 2010. The other aspects of the minimum reserve requirements did not change, e. g. the MNB continues to review compliance with them on a monthly average, and the MNB pays the base rate for the reserves deposited, as it has done since the country's accession to the European Union in 2004.

Third, the fact that the relevant instrument has been modified in several steps brought along a significant change in money markets and fundamentally affected the banks' liquidity management. On 3 June 2015, the MNB announced that the previous policy instrument, which was changed from the two-week MNB bill to the two-week Central Bank deposit in 2014, would be available only subject to a quantitative limit in the future. Instead, the MNB declared that its new policy instrument would be the three-month fixed-rate deposit from 23 September 2015. The two-week deposit would still be available to the credit institutions at auctions by the end of 2015 in a way that its stock may not exceed the limit of HUF 1,000 billion. On 12 January 2016, the MNB decided to completely phase this instrument out by the end of April 2016. These steps are organically linked to the implementation of the MNB's self-financing programme, an important element of which was the introduction of interest swap tenders as well.

As one of the pillars of the adaptation of the banks to the changed environment, the stock of the three-month deposit was gradually built up following its introduction in September 2015, mainly in the last three months of the year, taking the place of the two-week deposits. The other pillar of adaptation, that is, the shift of a part of the banks' liquidity from the Central Bank, took place already following the announcement in June 2015: the average stock of the relevant instrument dropped from HUF 5,000 billion in June 2015 to HUF 4,300 billion in September 2015, and reached HUF 3,600 billion on average in March 2016. (Chart 2.28) A significant part of the liquidity moved towards the government securities market, so the share of the credit institutions in the debt market increased to 28% after a growth of over HUF 1,400 billion compared to June 2015.

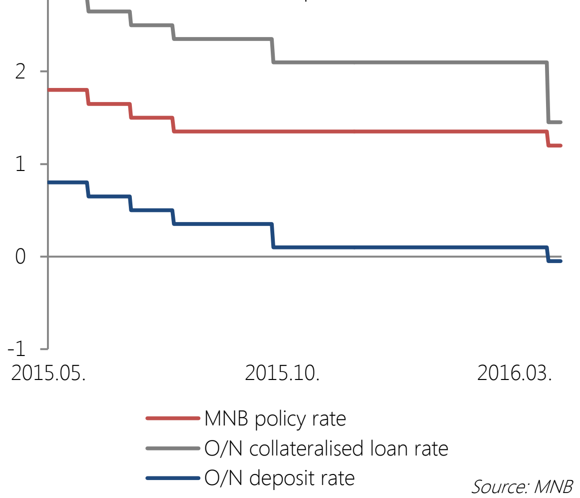
Chart 2.28.: Credit institutions' liquidity at the central bank (HUF billion)



Source: MNB

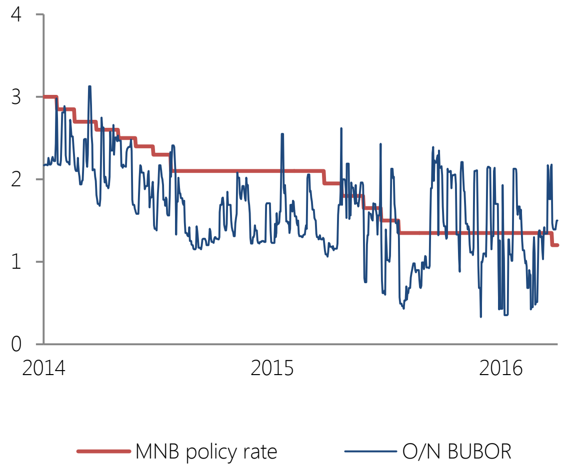
However, another part of the banks' liquidity emerged on the interbank market, which resulted in the greater volatility of the interbank overnight interest rate since September 2015. (Chart 2.30) By increasing the maturity of the relevant instrument to three months, liquidity management has become more difficult for banks. As a result of the policy rate cuts and of the interest rate corridor changes, the Central Bank pays an interest below 0% for the deposits placed at it, causing the credit institutions to implement a part of their liquidity management on the interbank market, where higher demand and supply volumes appeared thereafter.

Chart 2.29.: Policy rate and interest rate corridor (percent)



Source: MNB

Chart 2.30.: Interbank rate and policy rate (percent)



Source: MNB

Foreign reserves and the balance of the MNB were not sufficiently high to cover the short-term external debt during the crisis. The loans drawn from international organizations and the global excess liquidity owing to the quantitative easing of the leading central banks increased the MNB's balance sheet, the high level of which, together with the moderation of the economy's external exposure, is no longer justified. Overall, a consolidation period has started and, in accordance with the new era, the MNB has begun to decrease its balance sheet, which improves the profit of the Central Bank through the decrease of sterilisation costs on the one hand, and contributes to strengthening the domestic pillar of debt financing on the other.

2.9. Financial sector

The year 2015 was a great turning point for the domestic financial sector in more ways. Earlier that year, in order to lay down the basis for the consolidating relationship of the Government and the banking system, an agreement was made between the Government and EBRD. The cornerstones envisaged therein involved a number of issues, most of which have been resolved by the Government since then, including the extension of the National Asset Management Company, the abolition of the extraordinary eviction moratorium and the mitigation of the banking tax. Although the latter is in force since 2016 only, the domestic banking system became profit-making already last year amid great transformations, and closed the year 2015 with a pre-tax profit of HUF 30 billion. In particular, a major part of the large banks dominant at the system level had a considerable profit-making capability already in 2015. The conversion of FX loans into Forint, the macro prudential regulatory instruments introduced and other measures of the Central Bank, such as the modification of monetary policy tools or the implementation of the Growth Supporting Programme, established the basis of a renewed banking system.

Amid the above developments, the shock-resistance capability of the banks has remained strong. Solvency is around 20 per cent at the level of the banking system, while liquidity has remained ample even together with the impact of Central Bank measures, which is illustrated by the persistently high LCR ratio of over 150%.

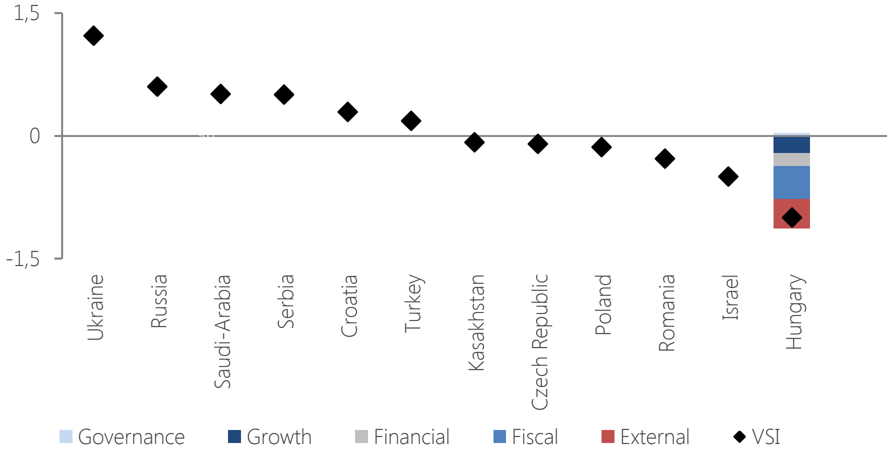
In 2015, the credit trends were mainly characterised by the disposal of a part of a difficult legacy and the consolidation of the relationship between the banks and the authorities. An important framework has been established, which lays the foundations for a lending turn and serves the prudent operation of banks in the long term, as well as creates a sharper and more predictable vision of the future.

The evolution and the structure of households' debt was largely defined by two main decisions in 2015, which the Government took in the spirit of settling accounts with the past, also having regard to the decisions of the Curia and the Constitutional Court. First, credit institutions were obliged to refund the unlawful costs incurred due to the application of unfairly increased interest rates and the exchange rate spread to debtors in the total amount of HUF 735 billion, of which HUF 550 billion reduced the existing loan portfolio, and a further HUF 185 billion were paid to the former debtors for their loans that had already matured. So the main reason for the decrease of households' loan portfolio by HUF 1,000 billion in 2015, shrinking by 15% compared to 2014, was the settlement implemented in the first half of 2015. Second, as a result of the conversion of foreign currency loans into Forint, a significant change took place in the structure of retail loans in 2015, as the portfolio of foreign currency loans fell by HUF 4,272 billion, while that of Forint loans increased by HUF 3,099 billion. The conversion of mortgage loans took place on 1 February 2015, and that of the vehicle and personal loans occurred on 1 December 2015. Thus, the share of foreign currency-denominated loans shrank to only 1% of households' loan portfolio and the exchange rate risk, which was previously burdening on the population, practically disappeared.

It should be discussed at this point that the positive effects of the conversion of the mortgage loans into Forint could already be felt in the short term. Owing to the fixing of the exchange rate in late December 2014, which was the "hallway" to the conversion into the Forint, the sharp weakening of the Forint against the Swiss Franc in mid-January 2015 after the exchange rate cap on CHF has been eliminated, did not worsen the debt burden of mortgage debtors or the risk exposure of banks. So the previously significant risks in the national economy linked to residential loans did not materialise. Due to good timing, households were saved from an increase of their debts in the magnitude of several hundred billions of Forints, which would have further push upwards the non-performing ratio of the banking sector.

Hungary's vulnerability decreased as a result of the strengthening macroeconomic fundamentals and the lower external exposure largely attributable to the FX-loan conversion into Forint. The favourable developments are well reflected in the change of the index calculated by Morgan Stanley (Vulnerability Scoring Indicator, VSI), which produced the biggest improvement in Hungary between 2008 and 2015 among the selected emerging market countries. (Chart 2.31)

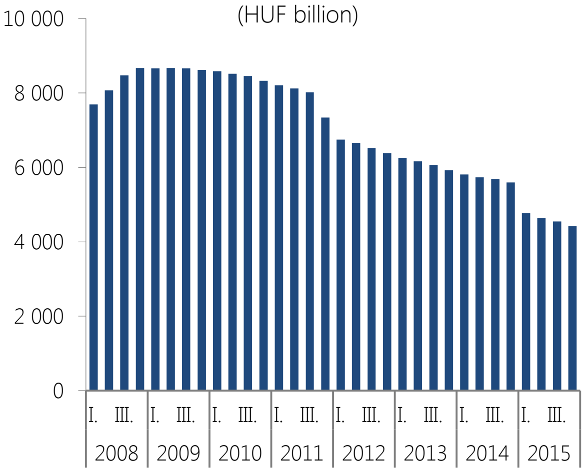
Chart 2.31.: Change in Morgan Stanley Vulnerability Scoring Indicator (2008Q3-2015Q3)



Source: Morgan Stanley

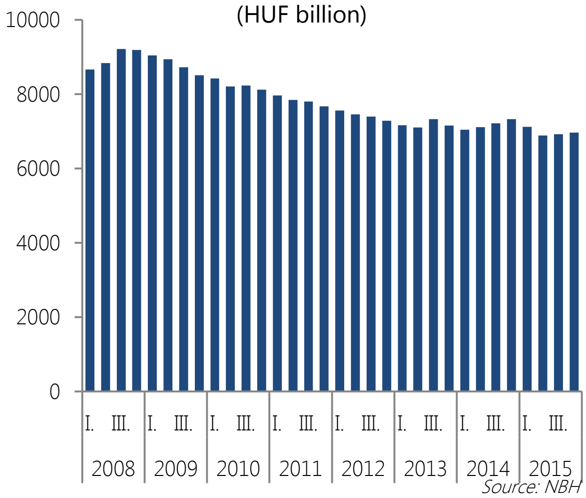
Following the FX-loan conversion into Forint, and the settlement, in a nowadays more balanced economic situation, the precautionary motif is gradually moderating and consumer confidence seems to return, which is reflected by a rise of new retail loans as well. In 2015, the credit institutions disbursed HUF 690 billion in new loans to households, which is 34% more than the HUF 510 billion in 2014. Around 75% of the growth is due to the expansion of housing loans. Moreover, a further rise in housing loans is expected in the coming years due to the favourable housing market developments on the one hand, and the Government's programme motivating new family homes buying on the other hand.

Chart 2.32.: Transaction-based development of households loans (HUF billion)



Source: NBH

Chart 2.33.: Transaction-based development of corporate loans (HUF billion)



Source: NBH

Corporate lending was characterised by divergence by corporate size in 2015 as well. Overall, loans provided by domestic financial intermediaries decreased by HUF 365 billion or 55% to HUF 6,964 billion in 2015, which follows the trend that commenced in 2009. This is largely due to the contraction of foreign currency loans by HUF 441 billion, as a part of companies (mostly from among large companies) switched to foreign funding. SME loans showed a 3.6% increase compared with the end of the previous year in which the Funding for Growth Scheme had a crucial role. In the first and second phases of the programme, a total of nearly 31,000 Hungarian companies received favourable financing in the amount of over HUF 2,100 billion.

Considering the banking sector, one of the key problems to be solved in the near future is the cleaning of the non-performing portfolio which has already been targeted by the Government and by the Central Bank through several measures over the past period as well. The ratio of household loans overdue for more than 90 days decreased from 19% in 2014 to 17.6% in 2015. In particular, the NPL ratio was mitigated by 3.6 percentage points with the decline of the stock of non-performing loans itself, but the decrease of the total loan portfolio partly offset this positive impact and increased the index by 2.2 percentage points. The ratio of the loans of the corporate sector overdue for more than 90 days has shown an improvement since 2012. The rate fell by 4 percentage points to 9.8% last year as the amount of the overdue loans of companies decreased by about HUF 350 billion to HUF 580 billion. This is partly due to the cleaning of the non-performing project loan portfolio, whose default rate dropped below 20% in 2015.

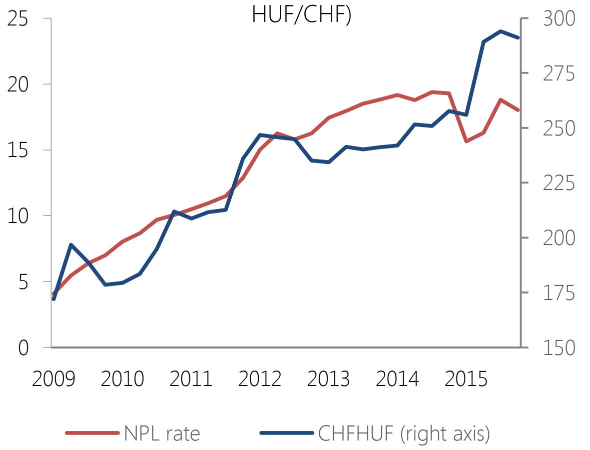
The above indicates that important steps are still taking place in the financial intermediary system, which are largely related to the further cleaning of the balance sheets: in addition to the stabilising measures of the Central Bank under the supervision of the European Commission, the non-performing (primarily project) loans market seems to have been shaken up. All of these are much needed, as the biggest obstacle to the lending turn is the huge stock of non-performing loans. In addition, banks will need to carefully reconsider their future strategy: besides increasing operating costs, regulatory actions and the negative interest rate environment may limit interest income in the future. Overall, financial stability is strengthening, and the sector is expected to become enduringly profitable in the forthcoming years through the intensification of business activity and portfolio cleaning, however, greater emphasis should be put on cost-effectiveness and competitive solutions in the next few years. Thanks to these projects, a banking system which operates customer-friendly, functions prudently, produces capital, hence as a proper financial intermediary, serves economic growth significantly.

Box 2.6: By eliminating the exchange rate risk and through Government measures, the NPL ratio of households' loans is on a downward path

2015 was the "year of FX-loan conversion", and the exchange rate risk of the household sector could be almost completely eliminated. In 2016, one of the biggest challenges of economic policy makers is to reduce the still high stock of non-performing loans. In most cases, complex macroeconomic relationships can be observed behind the increase in non-performing loans ratio. Unemployment typically begins to increase when certain countries enter recession, which to many debtors is the synonym for exorbitant instalments. The situation is exacerbated if the decline of the economy goes hand in hand with the decrease of the value of homes and, thus, loan coverage, which may cause the value of mortgaged real estates to fall below the amount of the outstanding loan. In addition, households typically became debtors in foreign currencies in the years immediately before the outbreak of a crisis, so the significant weakening of the Forint experienced during the crisis sharply increased the amount of the instalments due expressed in Forint. As a result of the combined negative impact of the weakening Forint on instalments and loan amounts, there is a significantly increasing chance that debtors become insolvent and lose the motivation to pay their loans.

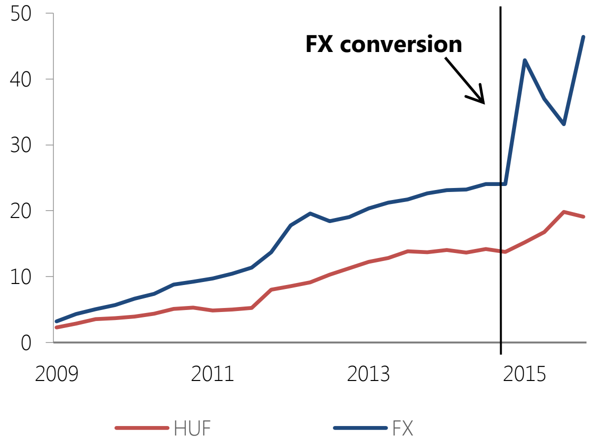
This factor had an undisputed role in that the stock of non-performing retail loans increased to a critically high level. A strong correlation of the ratio of loans overdue for more than 90 days and the exchange rate of the Swiss Franc against the Forint could be observed. The exchange rate effect is well illustrated in that the non-performing ratio of HUF loans increased to a much lesser extent than of foreign currency loans. (Chart 2.34-2.35)

Chart 2.34.: NPL ratio of household loans and the CHFHUF exchange rate (%, HUF/CHF)



Source: NBH

Chart 2.35.: NPL ratio of mortgage loans
(percent)



Source: NBH

In addition to the depreciation of the Forint, owing to the former deficiencies of the domestic legal system, the concluded loan contracts provided excessive dominance to banks concerning the subsequent and unilateral modifications of pricing and loan conditions, so they were practically enabled to offset their decreasing profitability by increasing the interest rates of foreign currency loans. Therefore, for Hungarian debtors the downturn of the real economy was coupled with increasing interest rates and exchange rates, while in other countries the typical relaxing of monetary conditions rather supported the position of the borrowers.

In an effort to prevent the accumulation of non-performing loans and to manage existing bad loans, the Government started to take a series of measures in 2011 to improve the situation of foreign currency borrowers (exchange rate cap scheme, early preferential repayment, National Asset Management Company). Although the ratio of foreign currency loans had significantly decreased until 2014, the ratio of non-performing debtors continued to rise.

At the beginning of 2015, financial institutions compensated the debtors for the previously unfair interest rate increases and the use of the large exchange rate spreads. At the same time, the conversion of foreign currency-based mortgage loans into Forint also took place, then in December 2015 consumer foreign currency loans i.e. vehicle and personal loans were also converted into Forint. This practically eliminated the exchange rate risk of debtors, hence the risk of becoming a non-performing debtor also fell significantly.

The Government currently has several programs running intended to improve the situation of non-performing debtors. The National Asset Management Company currently continues to operate and purchases the properties of debtors in the worst financial position, the former owners are allowed to stay in their homes as tenants. By increasing the quota of the National Asset Management Company by 10,000 debtors, the Government will provide assistance to and assure the housing of a total of 35,000 debtors by the end of 2017. In addition, from September 2015 non-performing debtors also have the option of using the institution of personal bankruptcy. The system of bankruptcy protection for families has been developed for those who are not able to pay even their current instalments, however, with the help of an administrator their homes could still be saved and within the foreseeable future they are able to repay all or a significant part of their overdue debts.

In March 2011 an extraordinary moratorium was announced for evictions, in order to protect residents. Over a period of 5 years that has elapsed since then, evictions of the non-paying debtors were only allowed during less than two years. In accordance with the agreement concluded with EBRD at the beginning of 2015, the Government lifted the restriction, which means that after the end of the regular eviction moratorium in winter, i.e. from the end of March 2016, the collateral of non-performing debtors may be sold, which is expected to improve the payment discipline of also those debtors who are able to pay, but have not been willing to do so up to now.

In total it can be stated that the handling of the non-performing portfolio is an important priority of economic policy, and the portfolio cleaning that has been initiated from several sides may significantly improve the financial position of the banking system in the near future, which could give new impetus to domestic lending.

3. General government deficit and debt

3.1. Fiscal policy objectives

The budget consolidation implemented in the first half of the 2010s proved to be stable, the general government deficit has been significantly below 3% of the GDP for the fifth year now and the government debt-to-GDP ratio is constantly decreasing. Owing to the improvement of macro-economic trends and the measures aimed at the whitening of the economy, the deficit successively turned out to be lower than the target over recent years, and the budgetary developments indicate in 2016 as well the safe attainment or even a small overachievement of the target.

Relying on the results of the stabilisation, the Government revised the deficit targets set in the previous convergence programme and determined the new medium-term budgetary path in such a manner that while maintaining the deficit that ensures the continued reduction of public debt, still remaining well below 3% of the GDP, support to economic growth should be more in focus and the economic and social policy priorities of the Government should be implemented more powerfully. Aiming at the smoothing of macroeconomic effects of the natural cyclical characteristics of EU transfers, the Government announced an accelerated absorption of the resources available in the 2014 – 2020 EU financial framework on the one hand, , and proposed to Parliament a small increase of the deficit in the 2017 draft budget, on the other hand. The enhanced growth fundamentals could decrease the role of fiscal stimulation, the general government deficit will once again be placed on a downward path from 2018, by 2020 it will be reduced to nearly 1% of the GDP. The structural deficit is expected to increase above the medium-term budgetary objective (MTO) in 2016 and 2017 temporarily, but in the medium term it will once again return to the target value and in 2020 it could even drop below the MTO.

The deficit path ensures the continued reduction of the debt ratio. The gross government debt-to-GDP ratio dropped to 75.3% by the end of 2015, from 80.8% in 2011. The debt ratio may fall by a further 11 percentage points, i.e. below 65% in the time horizon for the convergence programme.

Table 3.1.: The medium-term fiscal path (% of GDP)

	2015	2016	2017	2018	2019	2020
General government balance	-2.0	-1.9	-2.4	-1.8	-1.5	-1.2
Structural balance	-1.4	-2.1	-2.1	-1.7	-1.5	-1.2
Gross public debt	75.3	74.5	73.6	72.4	68.4	64.6

Source: HCSO, MNB, MfNE calculations

3.2. THE 2015 BUDGETARY OUTCOME

Similarly to previous years, in 2015 fiscal developments once again were better than planned. The fiscal notification provided by the Hungarian Central Statistical Office to Eurostat shows that the general government deficit calculated according to ESA2010 amounted to 2% of the GDP, as opposed to 2.4% set as the target, which is the lowest value ever registered in the timeline available since 1995. Although expenditures were increased by the fact that the Government accelerated the EU-funded projects with regard to the closing of the 2007 – 2013 programming period, this was overcompensated by additional revenues from powerfully expanding consumption, improving employment, and the whitening of the economy.

As opposed to accrual-based accounting, the cash flow balance of the central government closed with a deficit that was significantly higher than planned, primarily owing to the fact that by the end of the year 2015 about one-third of the EU transfers planned in the budget for this year had not yet been transferred. The "slip" of the revenues coming from the EU funds and the advance payment of the expenses of EU projects from national resources increased only the cash flow deficit, in the ESA2010 data the EU transfers are recorded as revenues of the relevant period of the year 2015, regardless of when they were actually received.

Table 3.2.: The balances of 2015 (% of GDP)

	2015 Convergence Programme	Preliminary fact
Cash flow balance of the central sub-systems	-1.9	-3.6
Cash flow balance of local governments	-0.1	0.0
EDP balance of the central sub-systems	-2.4	-2.0
EDP balance of local governments	0.0	0.0
EDP balance of the general government	**-2.4**	**-2.0**
Growth of *households consumption expenditure*	*2.9*	*3.1*
Employment growth	*2.1*	*2.7*

Source: HCSO, MfNE

During the year Parliament modified the cash flow-based budget appropriations twice. It allocated funds to meet the needs for additional expenses that were incurred in the meantime (preparation for the purchase of a minority share in Erste Bank[6], highlighted public road and other construction projects, support to local governments, commitment to military involvement in Kurdistan, handling of the refugee crisis, etc.) and to increasing the general reserve set aside to support extraordinary governmental measures. The increase of the expenditure appropriations was largely offset by the raising of the appropriation for interest revenues and consumption taxes, the planned value for the cash flow-based deficit only went up by HUF 15 billion. In addition, besides the assumption of the debts of the railway transport company (MÁV Zrt.) that had been planned originally, in order to stabilise the financial situation of community transport in the capital and to expand the services of public media, Parliament also resolved that the debts of the transport company of Budapest (BKV Zrt) and those of the Media Service Supporting and Asset Management Fund (MTVA) are to be assumed by the State. The assumption of these debts is not registered in the cash flow balance, but the transactions related to the assumption of the debts of the transport companies caused a deterioration in the accrual-based balance by 0.2% of the GDP.[7]

Owing to the macro-economic processes and the measures aimed at the whitening of the economy, tax and contribution revenues finally exceeded the original cash flow-based appropriations by approximately HUF 550 billion. The convergence programme last year already anticipated the expected overachievement of appropriations, however, finally the surplus of the accrual-based tax and contribution revenues even exceeded the expectations formulated at that time by over HUF 450 billion, i.e. 1.4% of the GDP. The majority of the surplus was registered in the category of turnover-type taxes, where the impact of the measures aimed at the whitening of the economy was also powerful (introduction of online cash registers and the Electronic Trade and Transport Control System). In the category of other revenues, payments related to the assets of the State showed a non-negligible backlog, since the sale of assets amounting to 0.5% of the GDP, originally planned in the budget, only takes place in 2016. At the same time, owing to the acceleration of projects co-financed by the EU, the EU transfers that can be assigned to these significantly exceeded the expectation of the previous convergence programme.

The acceleration of EU projects was also manifested in the largest change registered on the expenditure side, in investment expenditures higher by 1.5% of the GDP. At the same time, the budget spent significantly less amounts than expected on purchasing goods and services. Increased expenditure on compensation of employees was influenced, among others, by the effect of the supplementary allowance introduced from the second half of 2015 for persons employed in the social sector. The slight overspending of social transfers resulted from the savings in cash benefits (pensions, housing subsidies) and additional expenditures of in-kind benefits (pharmaceutical subsidies and subsidies for therapeutic equipment). Regarding other expenditures, interest expenditure developed according to the forecast, however, debt assumptions resolved during the year were registered as additional expenses.

This year the impact of the change in nominal GDP only modified the GDP-based indicators to a minimum extent.

[6] This transaction was not registered in the balance according to ESA2010.
[7] The media company is part of the general government sector in national accounts, therefore the assumption of its debts is not registered in the consolidated data.

Table 3.3.: Changes in the general government data of 2015 (ESA2010, % of GDP)

	2015 Convergence Programme	Preliminary fact	From deviations surplus/shortfall	GDP effect
Taxes and social contributions	37.9	39.2	1.4	-0.1
of which: taxes on production and imports	*18.2*	*19.0*	*0.8*	*0.0*
current taxes on income and wealth	*6.5*	*6.9*	*0.5*	*0.0*
Other	8.8	9.5	0.7	0.0
Total revenue	**46.7**	**48.7**	**2.1**	**-0.1**
Compensation of employees	10.5	10.7	0.2	0.0
Intermediate consumption	7.9	7.1	-0.7	0.0
Social transfers	15.3	15.4	0.1	0.0
Gross fixed capital formation	5.2	6.7	1.5	0.0
Other	10.2	10.8	0.7	0.0
Total expenditure	**49.1**	**50.7**	**1.7**	**-0.1**
BALANCE	**-2.4**	**-2.0**	**0.4**	**0.0**

Source: HCSO, MfNE calculations. Any deviations in the table are due to rounding.

3.3. THE 2016 BUDGET

In the budget for the year 2016, Parliament set the deficit target in accordance with the deficit path set in the previous convergence programme, at 2.0% of the GDP. The most important priorities defined in the budget are, on the one hand, tax reduction (reduction of the personal income tax rate from 16% to 15%, increase of the tax benefit for families, reduction of the bank tax and VAT), on the other hand, increasing certain spending items, which have been lagged behind due to the the crisis and the robust fiscal consolidation (wage raises in certain areas of the public sector, extension of public work schemes or the launch of large construction projects).

The cash flow figures for the first three months are extremely favourable, the aggregate deficit of the central budget, the social security funds and the extra-budgetary funds amounted to only 16.5% of the annual appropriation by the end of March. Such a low level of deficit in the first quarter has been unprecedented for over 10 years. Thanks to macroeconomic development and last year's budgetary outcome the room for manoeuvre for the fiscal policy has been extended. The programmes and investment projects announced by the Government supporting economic growth can be implemented while safely attaining the deficit target, and even a small improvement is possible. With regard to the amendment of the budget currently in progress, the forecast of the convergence programme takes into account the following major new elements:

- In an effort to revert the adverse demographic trend and to keep the qualified labour force at home, the Government has announced a major home-creation programme, which promotes the economic upturn while accomplishing social policy objectives. Components of the program include reduction of the VAT rate on the sale of new apartments from 27% to 5%, support in the form of a tax return for families building a home on their own, introduction of the Family Home Building Benefit (non-refundable support and the related loan with supported interests) and state aid provided for the scheme of the National Home Building Community. The amount allocated to housing subsidies may be HUF 100 billion higher than had been planned originally, it could be almost doubled compared to 2015.

- The Government has decided on the acceleration of the absorption of funds available in the 2014-2020 EU programming period, in an effort to avoid the former practice under which the drawdown of the majority of the available resources was focused on the end of the financial cycle of the EU. In 2016 half of the funds available in the period between 2014 and 2020 will be announced, while the remaining part of the resources will be open for applications from the beginning of 2017. The accrual-based forecast of the convergence programme expects the utilisation of over one and a half times more EU transfers than had been planned originally within the government sector too, which results in the increase of investment expenditures and, to a smaller extent, of the payments made on the purchase of goods and services.
- The amendment of the budget will provide additional resources for projects financed from purely domestic sources as well. Of these, those with the highest volume are the "Complex road renewal program" enabling the renewal of the national public road network and the “Modern cities programme.” In the first stage of the "Modern cities programme," during the year 2015 the Government concluded cooperation agreements with the local governments of 13 cities with county rights on the implementation of development aims and programmes affecting the city and its surroundings. Together with minor investment surpluses, investments implemented purely from domestic resources could be higher by about one-fourth than had been planned originally.
- The expenditure on compensation of employees is mainly increased by the additional resources necessary in public education. In addition, the forecast of the convergence programme also takes into account other changes of minor magnitude, primarily attributable to the base effect, for example, expenditures on public work schemes could be somewhat lower and the costs of pharmaceutical subsidies somewhat higher than planned originally. However, these shifts amount to less than 0.1% of the GDP.
- The expected revenue surplus will cover the additional expenditures and the increase of the reserves built into the budget. On the one hand, the sale of assets originally planned for 2015 shifted to 2016, therefore the budget can expect from the sale and utilisation of assets of the State, through the sale of land owned by the State, revenues of 0.7% of the GDP, as opposed to the originally planned figure of 0.4%. On the other hand, the expected surplus of tax and contribution revenues is very significant, it may be as high as 1.5% of the GDP. This year, in addition to the base effect, the more dynamic increase of consumption, better employment figures than expected at the time of planning the budget, plus other tax measures implemented in the meantime (for example the institution of the growth tax credit implemented in the corporate tax system) are all factors to be taken into account.

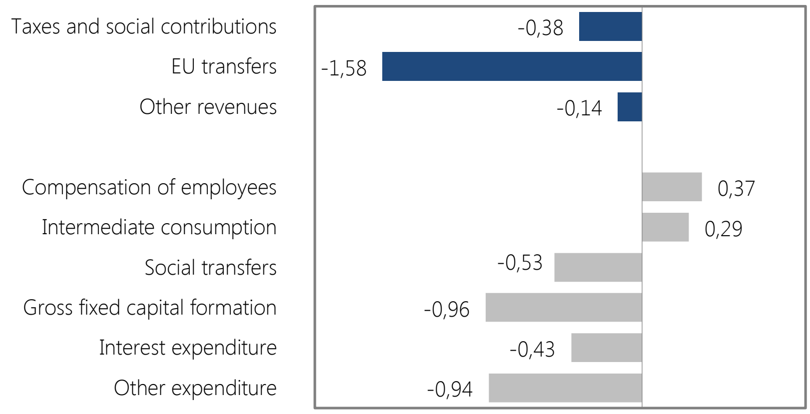
Table 3.4.: Changes in the general government data of 2015 (ESA2010, % of GDP)

	Appropriation	Forecast
Taxes and social contributions	37.3	38.8
of which: taxes on production and imports	*17.9*	*18.2*
current taxes on income and wealth	*6.2*	*7.2*
social contributions	*13.2*	*13.4*
Other	7.0	7.8
of which: EU-transfer	*1.9*	*2.9*
Total revenue	**44.3**	**46.6**
Compensation of employees	10.6	11.0
Intermediate consumption	7.0	7.4
Social transfers	14.8	14.9
Gross fixed capital formation	4.4	5.7
Interests	3.3	3.2
Other	6.1	6.3
Total expenditure	**46.3**	**48.5**
BALANCE	**-2.0**	**-1.9**
Growth of *households consumption expenditure*	*3.6*	*3.9*
Employment growth	*2.1*	*2.5*

Source: MfNE. Any deviations in the table are due to rounding.

Compared to 2015, the decrease of the ratio of tax and contribution revenues compared to the GDP may be more moderate than expected in the previous convergence programme. Despite the acceleration of the programmes, the utilisation of the EU transfers available in the 2014-2020 financial cycle falls behind the outstanding rate of last year, and investments do not yet reach the peak of the year 2015, even together with additional expenditures. Among the large items of the expenditure side, only compensation of employees and the purchase of goods and services could grow somewhat faster than the GDP. The expenditure on compensation of employees could be increased by the additional funds incorporated in the budget for career models (teachers, employees of law enforcement, government employees of district offices) and other wage raises (health care, social sector) and the higher amounts allocated to the public work schemes. As the combined impact of changes in revenues and expenditures, compared to the previous year the deficit/GDP ratio could decrease slightly.

Chart 3.1: Expenditure and revenue changes 2016-2015
(% of GDP, percentage point)



3.4. THE 2017 BUDGET

In order to enhance predictability, which is extremely important for economic actors, similarly to the budget of last year, the budget of 2017 will be also adopted already in the first half of 2016. The Government developed the draft law in such a manner that while maintaining the deficit that ensures the continued reduction of public debt, still remaining well below 3% of the GDP, the budget should support economic growth, and economic and social policy priorities of the Government should be implemented more powerfully. Accordingly, it set the deficit target according to the methodology of the European Union at 2.4% of the GDP and proposes to the Parliament the implementation of the following major priorities:

- *The initiated tax reduction should continue, changes in the system of taxation should support families, enhance the upswing in lending, the simplification of taxation and the whitening of the economy.*

In the case of families with two children, in accordance with formerly announced plans, the tax benefit for families continues to increase, in the tax allowance for first married couples the former restrictive conditions are relaxed. The VAT rate applying to milk, eggs and poultry is reduced to 5%, while the VAT rate of Internet access and catering in restaurants is reduced to 18%. The special tax of financial organizations being further reduced in accordance with the EBRD agreement could contribute to a surge in lending. Together with other changes of minor magnitude, the impact of the tax reductions on the budget may be set at 0.3% of the GDP. At the same time, the macroeconomic processes, the measures aimed at the whitening of the economy (extension of the application of online cash registers, implementation of online billing systems, optimisation of the operation of the tax office, etc.) and former tax measures increase revenues, as the outcome of the effects of opposing directions, tax centralisation will slightly increase compared to 2016.

- *The budget should provide coverage for the announced home building programme.*

The amount allocated to housing subsidies enables the continuation of the home building program, compared to the significantly raised expenditure of 2016, it will grow by an additional 4%.

- *In the public sector the gradual narrowing of formerly accumulated wage gaps should continue, but the operation of the State should be more efficient.*

In addition to continuing the already launched career models for teachers and law enforcement employees, the career model for government employees to be implemented in the district offices from the second half of 2016 will be extended in 2017 to employees of county level government offices, and the rise of the wages of employees of the National Tax and Customs Administration of Hungary will also begin. Under the draft budget wages will be raised in the field of healthcare, social services, higher education and culture as well. In 2017, in total the budget impact of the career models and other wage raises will be almost HUF 200 billion, i.e. 0.5% of the GDP. Considering the costs of public work schemes and the savings expected from reorganizations affecting central official agencies (over half of the currently operating 90 relevant institutes will be terminated or merged), the expenditures on compensation of employees could increase slightly less than the growth of nominal GDP, but even so the raise could be 4% compared to 2016.

- *There should be sufficient resources for high quality healthcare.*

The budget allocates significant additional resources to the healthcare sector. In addition to the resources assured by the targeted reserve of the budget for the wage raises, the appropriation for curative-preventive care could further increase by almost 6%.

- *The budget should ensure the co-financing necessary for the accelerated utilisation of EU transfers.*

The impact of the accelerating measures implemented in 2016 also determines later years of the period. A surge in the utilisation of Union resources is expected from 2016 and could reach the maximum level in 2018. The budget expects that after the large-scale launch of developments this year, 2017 will already be one of the strongest years in terms of disbursements. The accrual-based forecast of the convergence programme assumes a growth in EU transfers and domestic co-financing expenditures that will exceed the expansion of GDP within the government sector as well.

- *The budget should contribute to the support of economic growth by announced large investment projects as well.*

Owing to the start or continuation of large infrastructure projects announced by the Government (for example, expansion of the Nuclear Power Plant of Paks, the Budapest Park project, developments in prison facilities, Modern Cities Programme, highlighted public road investments, preparations for key traffic developments related to the Olympics in Budapest, etc.), the weight of investment expenditures in the budget for 2017 will further increase. These projects will be mostly implemented from domestic budgetary resources. Total investment expenditures will increase by 0.5% percentage points as a ratio of GDP, within that expenditures on projects financed purely from domestic sources will increase by 0.4 percentage points compared to 2016.

- *The principle of "work instead of unemployment benefit" should be implemented in 2017 as well, and public work programmes should continue.*

The budget allocates a significant amount to the Start Work Programme in 2017 as well.

- *Enough resources should be available for preserving the real value of pensions and other income replacement allowances.*

Pensions and pension-like benefits will increase following the inflation rate projected in the budget (0.9%). Primarily, pension expenditures denote the largest item which determines the development of social cash benefits, and since the preservation of real value means an increase falling short of

GDP, the total amount of cash social benefits as a ratio of GDP could be reduced by 0.6 percentage points.

- *The budget should provide sufficient reserves for protection against unforeseeable risks.*

According to the draft, the amount of the (general) reserve allocated for the purpose of implementing extraordinary government measures and the extra reserve (Country Protection Fund) incorporated for the purpose of neutralising stability risks is close to 0.5% of the GDP. In addition, a so-called stability reserve will also be incorporated into the appropriations of the individual budgetary chapters also in 2017, the utilisation of which is only allowed in the last quarter according to the decision of the Government.

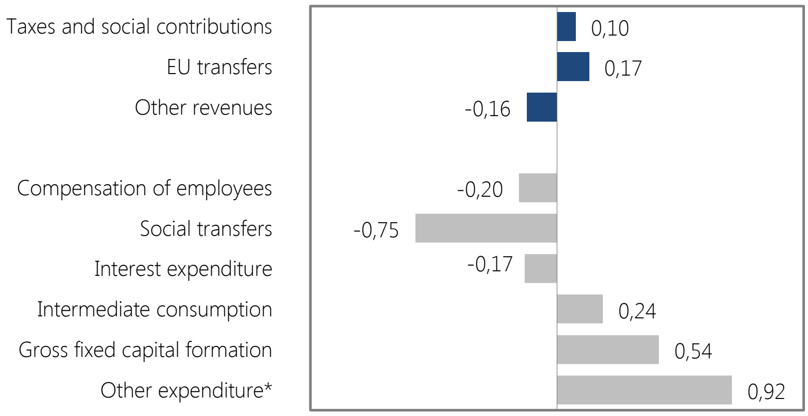
- *The budget of 2017 should take the first step towards the aim set by the Government, a balanced budget.*

As the first step, the goal of the Government is to operate the state without deficit, the operating revenues should fully fund the current operating costs of public services. The budget for 2017 complies with this requirement, the cash flow-based appropriations ensure the balance of the domestic operating budget, the deficit is created in the domestic investment budget and the budget of EU projects supporting economic growth.

According to the accrual-based forecast, in 2017 the ratio of the total revenues of general government to GDP will slightly increase compared to the previous year, within that tax and contribution revenues and even more the amount of EU transfers used in government sector could grow faster than the GDP. Among expenditures, the ratio of compensation of employees, interest expenditures and to the highest extent, that of social transfers compared to GDP could be reduced.

Chart 3.2: Expenditure and revenue changes 2017-2016

(% of GDP, percentage point)



*Increase of other expenditures is inflluenced also by reserves.

3.5. Budgetary developments from 2018 to 2020

In the last three years of the programming period the forecast of the convergence programme does not assume any new measures, only the carry-over effects of decisions already made into the subsequent years have been incorporated in the calculations.

The decisive elements of the revenue side are tax and contribution revenues and the development of EU transfers. Considering the gradual widening of the tax benefit for families and assuming that no more whitening measures will be implemented, tax centralisation could be reduced by over 2 percentage points between 2017 and 2020. As a result of the acceleration of absorption of EU transfers, the overwhelming majority of the funds available for the 2014-2020 EU programming period will have been utilized by 2018, which will also be shown in the development of EU transfers remaining within the government sector. After the peak of 2018 in the last two years much lower amounts should be anticipated in the calculation. In 2018 EU transfers will still somewhat offset the impact of tax revenues increasing at a pace falling short of GDP, but from 2019 they will already be strengthening the reduction of the centralisation ratio. The total revenue-to-GDP ratio could be reduced in the last three years by close to 5 percentage points and could drop under 42%.

Table 3.5.: Main revenues of the general government (% of GDP)

	2017	2018	2019	2020
Taxes and social contributions	38.9	37.8	37.2	36.7
Other revenues without EU transfers	4.7	4.6	4.4	4.2
Total revenue without EU transfers	43.7	42.4	41.6	40.8
EU transfers	3.0	3.6	1.8	1.0
Total revenue	**46.7**	**45.9**	**43.4**	**41.8**

Source: MfNE calculation

Any deviations in the table are due to rounding.

Besides the decreasing centralisation ratio, the deficit targets can be achieved by an expenditure restraint. Without EU transfers revenue-to-GDP ratio could be reduced by almost 3 percentage points, however, expenditures could be decreased even more powerfully, by 4 percentage points, because any rise exceeding the GDP growth can only be expected in the case of investments funded purely from domestic resources. The forecast takes into account the following

- The wage increasing effect of the career models implemented in the public sector will have gradually worn off until 2020, the additional expenses compared to the previous year will be reduced year by year, the increase of expenditures spent on the compensation of employees will fall short of the GDP.
- The expenditures on the purchase of goods and services purely financed from domestic resources could also be increasing at a pace falling short of the GDP.
- The development of social benefits is still influenced by the structural reforms implemented earlier. In accordance with the assumption of the previous convergence programme, the increase in cash benefits reflects in particular the preservation of the real value, and the in-kind transfers provided through market producers may show an increase below the projected inflation rate. Between 2017 and 2020 total social transfers as a percentage of the growing GDP could decrease by 1.5 percentage points, by which they will contribute in the highest ratio to the reduction of the redistribution ratio.
- With a deficit decreasing year by year, interest expenditures could drop even in nominal terms.

- The launched large investment projects mean a determination affecting several years, therefore the expenditures as a ratio to GDP of investments financed from purely domestic resources could increase by 2 percentage points in the last three years of the programming period. However, this rise is offset by the much more moderate expansion of the other items of the expenditure side, falling short of GDP.

Table 3.6.: Main expenditures of the general government (% of GDP)

	2017	2018	2019	2020
Balance	-2.4	-1.8	-1.5	-1.2
Total revenue	46.7	45.9	43.4	41.8
Total expenditure	49.1	47.7	44.9	43.0
Total expenditure without EU transfers	46.1	44.2	43.1	42.0
of which:				
Compensation of employees	10.8	10.5	10.2	9.7
Intermediate consumption financed from domestic resources	6.4	6.2	5.9	5.7
Investments financed from domestic resources	3.7	3.7	4.6	5.7
Social transfers	14.1	13.5	13.0	12.6
Interest expenditure	3.0	2.8	2.5	2.3

Source: MfNE calculation

3.6. Structural balance

To gauge the structural balance, as a first step, the Convergence Programme uses a semi-elasticity coefficient of 0.49 for the calculation of the cyclically adjusted balance, which is in line with the methodology adopted by the Output Gap Working Group of the EU. This means that the general government balance changes by 0.49 percentage points as a result of a 1% difference between actual and potential GDP (assuming no change in its composition).

It is assumed in the Convergence Programme that actual GDP growth exceeds the potential growth rate over the forecast horizon, gradually closing the negative output gap (see chapter 2.5). As a consequence, the cyclically-adjusted balance is more favourable than the actual balance from year to year, gradually approaching and then reaching it in 2019. Balance improving one-off items of 0.7% of GDP are expected in 2016 related to asset sales.

Due to developments outside the scope of the Government, expenditures linked to the management of the influx of migrants increased significantly in 2015, also affecting the 2016 budget (see Annex, Table 8-9). The expenditures were necessary to ensure the respect of Hungarian and EU legislation and the Government sought the most cost effective solutions. The bulk of the spending related to the influx of migrants in 2015 is of one-off nature.

The objective of the Government was to prevent uncontrolled free movement of illegal migrants into Hungary and within the Schengen area. Real refugees naturally received the necessary provisions and care. In the context of the migrant crisis that hit Europe and in order to tackle illegal immigration, Hungary, with a view to controlling the influx, resorted to new tools such as the physical border barrier, which by their nature required sizeable expenditures. These items are one-offs in economic terms, thus when assessing compliance with the Stability and Growth Pact, they shall be duly taken into account. The physical barrier, that is to help directing the influx towards legal and controllable ports of entry, is a significantly more cost effective solution than protecting the border by the police and the army necessitating extra personnel. For a whole year, the physical barrier results in notable savings and, from an economic point of view, does not differ at all from the situation where the same protection is provided by human resources. This latter solution would bring about permanent and not one-off expenditure increasing items with multiple times higher costs in each year.

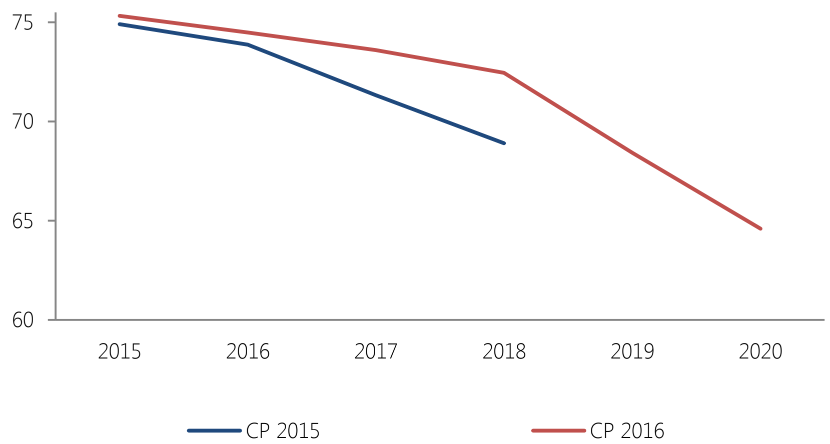
The structural deficit, i.e. the cyclically adjusted balance net of one-off and temporary items that has been significantly better than the medium term objective (MTO) of -1.7% of GDP since 2012 is expected to increase temporarily in 2016 before returning to the MTO in the medium term.

The medium term objective is defined as a structural deficit of 1.7% of GDP till 2016. In the context of the actual revision and in line with the methodology included in the Code of Conduct[8], from 2017 the Government sets the MTO as a structural deficit of 1.5% of GDP. The expenditure aggregate is expected to rise above the reference benchmark in 2017 and remain at a lower level afterwards.

3.7. General government debt

The public debt-to-GDP ratio has been decreasing consistently since 2011. At the end of 2015 the debt ratio stood at 75.3% with an exchange rate of 313.12 HUF/EUR. It is expected to fall to 74.5% by 2016 and under 65% by 2020. (Chart 3.3.)

Chart 3.3.: Public debt ratio in the Convergence Programs for 2015 and 2016 (the percentage of GDP)



Source: MfNE calculation

While maintaining the decreasing trend, the current Convergence Programme anticipates a debt path that will be running somewhat higher than last year. The two main reasons behind this are the higher deficit figure for 2017 and an exchange rate that is weaker than last year.

(1) Nominal GDP: The nominal GDP values that are somewhat higher than the figures of the Convergence Programme for 2015 have a restraining effect on the debt path, although it is not

[8] http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/coc/code_of_conduct_en.pdf

significant until 2017: this factor pushed down the debt ratio between 2016 and 2018 by 0.01, 0.08 and 0.4 percentage points respectively, compared to the forecasts of last year.

(2) Numerator effect: The upward shift between 2016 and 2018 of the public debt stock forecasts compared to the Convergence Programme for 2015 in itself raises the debt path by 0.6, 2.4, and 3.9 percentage points respectively. This is attributable to the lower primary balance and to other items (so-called SFA items) that are higher than last year. This cannot be offset by interest expenditures that are lower on the entire forecast horizon than expected earlier. This reflects a yield environment reaching record low levels as a result of decreasing external vulnerability of the country and the policy rate cuts of the MNB.

(2a) Net interest expenditures and primary deficit: Owing to the yield curve that continued to decrease in 2015 as well, the forecast on the interest expenditures of the general government was pushed somewhat lower compared to the forecast for 2015. At the end of the forecast horizon, in 2020 the interest expenditures of the budget can amount to 2.3% of the GDP, while until 2014 expenditures were above 4%. From this year the continuously decreasing yield environment since the middle of 2012 has been powerfully reflected in accrual-based interest expenditures as well. One of the underlying factors of the diminishing interest expenditures is that, as a result of the constantly improving investor perception of the country reflected in decreasing of risk premia, yields and therefore debt financing costs will continue to lower in the future. However, the primary balance will be lower compared to the forecast of the Convergence Programme for 2015 owing to the growth-stimulating actions of the Government (including Family Housing programme (CSOK) and tax cuts). In total, the effect of a higher-than-earlier deficit path – which still meets the 3% Maastricht requirement of the EU – results in a slower pace of debt reduction, at the same time, it also reflects a somewhat more relaxed fiscal policy that supports growth. Ultimately, this contributes to debt reduction through the higher nominal GDP.

(2b) Other Items: Furthermore, the change of the debt path is also caused by the balance of other items (the so-called SFA, stock-flow adjustments).

- The technical assumption for the exchange rate used for debt prediction is 2.6% weaker than the exchange rate of 304.2 HUF/EUR in the Convergence Programme for 2015 (i.e. HUF/EUR 312). Although the exchange rate sensitivity of public debt has decreased with the drop in foreign currency denominated debt ratio, however, one unit of shift in the exchange rate will still change the public debt ratio by approximately 0.1 percentage points, therefore an assumed exchange rate that is 8 units weaker than last year's assumption in itself leads to a 0.6-0.8 percentage points higher debt path.
- In addition, a major deviation from the projections of the previous Convergence Programme is caused by the change in cash reserves (Single Treasury Account and the foreign currency deposit at the MNB), along with the advance payment of EU transfers, and different values for the difference between cash flow and ESA balance of the budget.

The future development of the debt rate is sensitive to changes in the following major factors, ceteris paribus:

(1) Primary balance: A 1 percentage point upward shift in the primary balance in terms of GDP from 2016 until the end of the horizon would reduce the debt-to-GDP ratio by 1 percentage point in 2016 and by 5.5 percentage points by 2020.

(2) Exchange rate: The share of foreign currency denominated debt within gross public debt was 35% at the end of 2015, which, as a result of the Government's endeavours, is expected to decline to almost 20% by 2020. Owing to a foreign currency ratio that keeps decreasing, the exchange rate exposure of the debt keeps falling, which is well reflected by the fact that a nominal exchange rate that is 1% stronger compared to the exchange rate assumption included in the Convergence Programme (308.9 HUF/EUR) would induce a 0.2 percentage points lower gross debt ratio in 2016 and 2017, but from 2018 it would be only 0.1 percentage points lower.

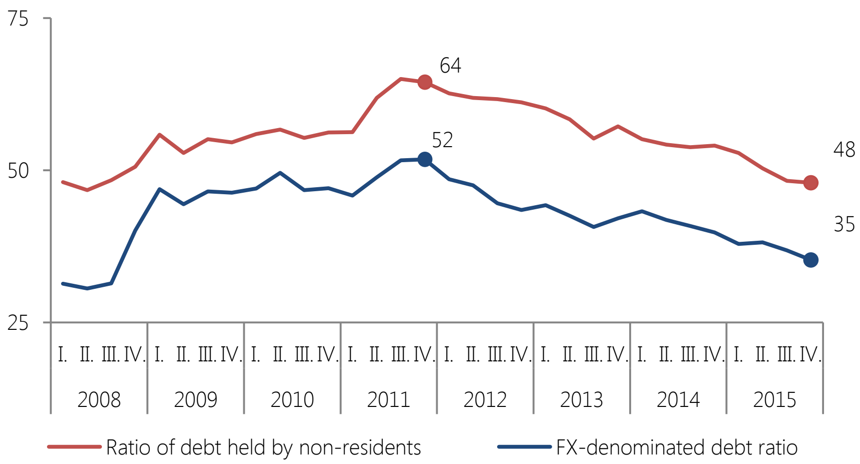
(3) Economic growth: Should nominal GDP growth end up 1 percentage point higher in 2016, the debt path would see a 0.6-0.7 percentage point downward shift.

Box 3.1: The debt structure is persistently moving in a favourable direction

In the spring of 2016 Hungary repaid the last instalment of foreign currency loans borrowed from international institutions in 2008 and 2009, thereby shifting debt financing from international loans to primarily market-based financing. This is reflected by the fact that by the end of 2015, 89% per cent of the public debt existed in the form of government securities, while at the end of 2009 this ratio stood at only 73%. In the meantime, both the share of foreign currency denominated debt and the share of foreign investors have shown a significant decrease from 2012 on. The share of FX-debt had dropped from 52% to 35% by the end of 2015, and the share of non-resident investors from 64% to 48%. (Chart 3.4) It is important to note that the two sets partially overlap, since government securities denominated in foreign currency are also sold to Hungarian residents (for example P€MÁK), while HUF-denominated securities are also available for non-residents.

The favourable developments have significantly contributed to the mitigation of foreign currency exposure and external vulnerability of the country. The impact of the adjustment is also reflected in the substantial drop of the country risk premium, since compared to a level of 600 basis points at the beginning of 2012, the five-year CDS spread is currently around 150 basis points. Owing to the favourable developments, the State finances its operations at a lower price than ever before, in fact, since 2012 both short and long term yields have decreased significantly, by approximately 7 percentage points. (3-month yields dropped from 7.5% to under 1%, while five- and ten-year yields from 10% to 2-3%).

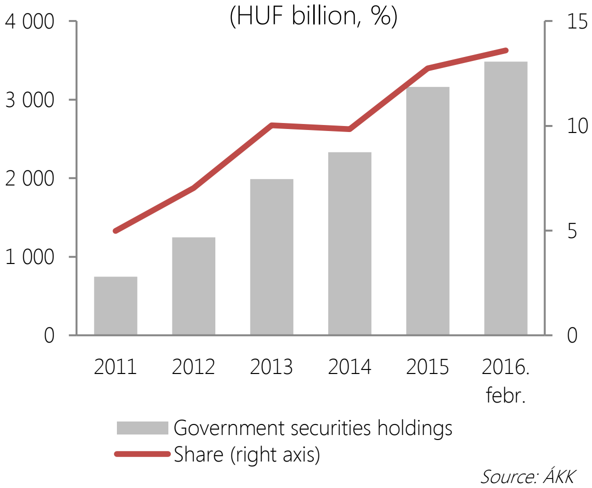
Chart 3.4.: Public debt held by non-residents and the FX ratio of debt (%)



Source: MNB

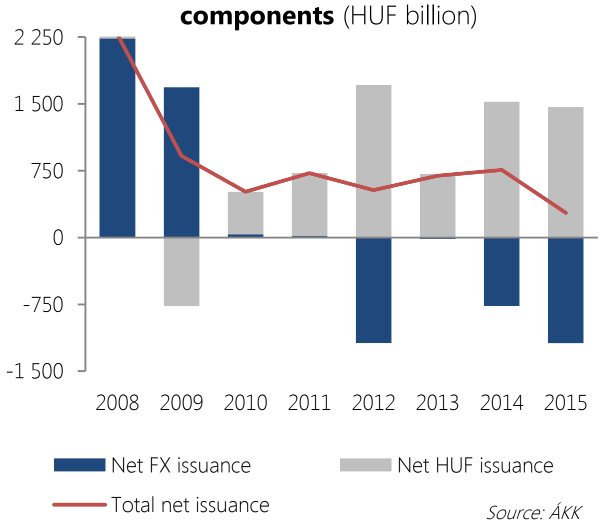
The Hungarian Debt Management Agency supported the efforts of the Government aiming at the reduction of the foreign currency ratio by negative net foreign currency issuance in several years, i.e. by refinancing a significant part of the maturing foreign currency debt via HUF-denominated instruments. (Chart 3.4) The shift in the structure of investors towards domestic sectors could take place as the combined result of two initiatives. As a result of the Self-Financing Programme, the share of banks in the sovereign debt market has increased after a significant expansion to 28% according to latest data. In addition, the retail programme of the Government also played an important role, the aim of which was to encourage households' purchases of government securities. In that framework, on the one hand, the availability of government securities has improved through the opening of a high number of new points of sale (at present government securities are sold by the Treasury in almost 80 places). As the second pillar of this effort, the range of government securities aimed at households has been widened by five new types of government securities over the last four years, which have been developed matching the preferences of various household groups. Premium Euro Hungarian Government Bond (P€MÁK) caters for the needs of retail customers intending to put their savings in Euro, Half-year Interest-Bearing Treasury Bills (FKJ) are for customers preferring shorter-term savings, while the renewed Baby Bond offers a solution for families intending to accumulate savings for securing the future of their children. The novelty of the Bonus Hungarian Government Bond (BMÁK) is that its interest rate is tied to government securities yields, while with the introduction of the Treasury Savings Bills Plus (KTJ Plusz) the palette of government securities available at Hungarian Post Ltd. has been extended. Third, it is a significant appeal that government securities with their favourable interest rates offer a significant premium despite the generally decreasing market yields.

Chart 3.5.: Government securities' market share of households (HUF billion, %)



Source: ÁKK

Chart 3.6.: Total net issuance and its components (HUF billion)



Source: ÁKK

The effectiveness of the retail programme is reflected well in the fact that the portfolio of government securities held by retail customers has been constantly increasing over the last four years, by over HUF 2,700 billion until February 2016, by which the share of the households in the sovereign debt market increased from 5% to 14%. This means that retail customers not only renew their maturing investments in government securities, but also increase their holdings. The impact of these developments is also reflected in the fact that within the savings of households the ratio of government securities had increased by the end of 2015 to 7.4%, compared to 2.4% at the beginning of 2012. What is more, it is safe to say that in 2015 essentially the retail sector financed the deficit of the budget, since households purchased government securities on every second Forint they saved. Owing to the constant success of the retail programme, debt financing became more stable, since the household sector is a reliable type of investor, one that typically does not want to get rid of its government securities holdings abruptly, as do foreign investors in the case of market turbulence. Moreover, it is also an important aspect that interests paid on the securities are spent in Hungary and therefore strengthen the domestic economy.

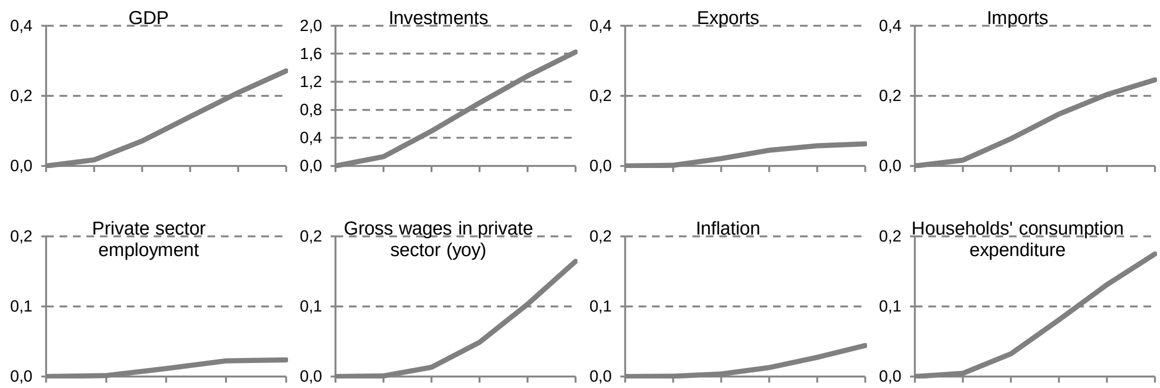
4. SENSITIVITY ANALYSIS

The macroeconomic baseline scenario of the Convergence Programme is subject to both positive and negative risk factors. Of these, two current, alternative scenarios have been selected. The positive scenario is based on the strengthening of consumer and business confidence, while the negative scenario on a slower upsurge of external demand. The sensitivity analyses show the extent by which the level of the major macro-economic variables would deviate from the baseline scenario. Charts 4.1–4.2. and table 4.1. illustrate the estimates made using the DINAMO model of the Ministry for National Economy.

The positive scenario is based on the assumption that due to more favourable growth outlook, lending activity could be boosted at a pace faster than estimated in the baseline scenario. This is explained in the scenario, among others by the long run equilibrium level of corporate investment rising persistently by 2 percentage points on the forecast horizon owing to more moderate risk premium and lower interest environment.

As a result of the strengthening confidence in the improvement of the business environment, the demand of firms also increases for factors of production. In other words, the shock effect generates additional employment and investment. The improvement of economic outlook also fosters wage dynamics further, which results in a significant expansion of consumption. Consequently, in the case of both households and firms the improving confidence is accompanied by the attenuation of precautionary motivations and the decrease of savings, and thus with the increase of expenditures by economic actors. Although the imports generated by domestic demand are coupled with additional imports, established extra capacities also support the continued growth of exports. In addition, the upsurge in aggregate demand generates slight inflationary pressure on the one hand, on the other hand, it is also coupled with increasing tax revenues, thereby improving the general government balance.

Chart 4.1.: Strengthening confidence*



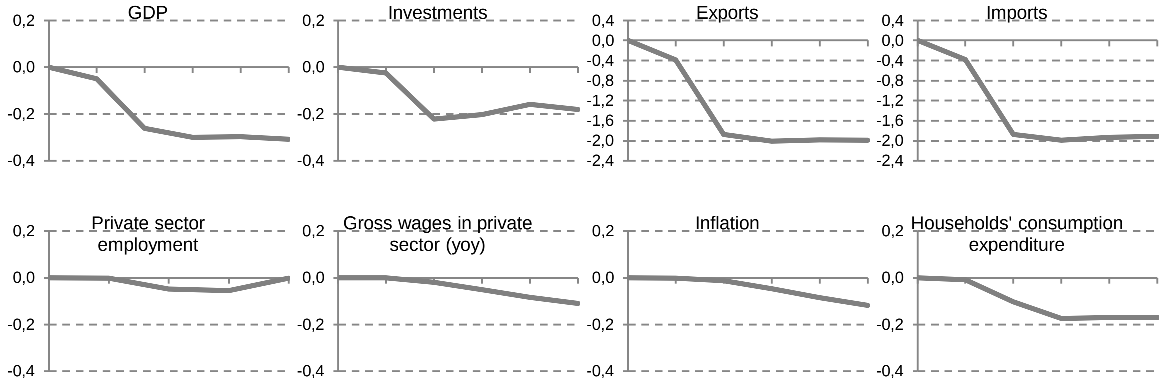
Source: MfNE's calculations based on DINAMO model

**Charts demonstrate the deviation of variables in percent compared to the baseline scenario. The horizontal line represents years from 2015 to 2020.*

The negative scenario contains slower than anticipated external demand, since recent experience imply negative risks around external conditions. On the one hand, the slowdown of the Chinese economy carries risks through the exposure of Hungary to the automotive industry. On the other hand, the exit of the United Kingdom from the European Union could lead to a slowdown of the Eurozone and would also jeopardize the revenue side of the EU budget. In addition, the escalation of geopolitical tensions could also result in deteriorating global growth figures. Since the impact mechanism of these factors is varied and diverse, in the sensitivity analyses only the central channel was assessed: the alternative scenario is based on the deterioration of external demand by 2 percentage points, temporarily (lasting for one year).

As a result of the slower than expected growth on external markets, the growth of exports would also decelerate, which would also result in a more moderate expansion of domestic production capacities than anticipated. In other words, the dynamics of both employment and investment, and thereby that of exports would fall short of the level assumed in the baseline scenario. At the same time, the shock effect would be significantly mitigated by the fact that the import contents of exports are high, therefore imports would also be lower compared to the baseline scenario. The slower expansion of demand would result in lower inflation and consequently slightly more moderate wage increases in the private sector. In summary, the general government balance would also somewhat deteriorate as a result of the weakening of external demand.

Chart 4.2.: Deterioration of the external environment*



Source: MfNE's calculations based on DINAMO model

**Charts demonstrate the deviation of variables in percent compared to the baseline scenario. The horizontal line represents years from 2015 to 2020.*

Table 4.1.: Risk scenarios (Cumulative difference from the baseline scenario of the growth rate of macroeconomic variables, expressed in percentages)

Positive scenario: Strengthening of the trust	2015	2016	2017	2018	2019	2020
GDP	0.00	0.02	0.07	0.14	0.21	0.27
Households' consumption expenditure	0.00	0.00	0.03	0.08	0.13	0.18
Gross fixed capital formation	0.00	0.13	0.50	0.90	1.28	1.62
Exports	0.00	0.00	0.02	0.05	0.06	0.06
Imports	0.00	0.02	0.08	0.15	0.20	0.25
Inflation	0.00	0.00	0.00	0.01	0.03	0.04
Private sector employment	0.00	0.00	0.01	0.02	0.02	0.02
Gross average wages in the private sector	0.00	0.00	0.01	0.05	0.10	0.16
Income taxes *	0.00	0.01	0.06	0.12	0.19	0.25
Employer contributions*	0.00	0.01	0.06	0.13	0.20	0.27
Turnover taxes*	0.00	0.00	0.03	0.07	0.12	0.17
Taxes levied on companies*	0.00	0.03	0.10	0.20	0.29	0.37
Interest expenditure of the general gov.*, **	0.00	0.00	0.01	0.05	0.11	0.22
General government balance*	0.00	0.02	0.08	0.19	0.30	0.39
Negative scenario: deterioration of the external environment	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**
GDP	0.00	-0.05	-0.26	-0.30	-0.30	-0.31
Households' consumption expenditure	0.00	-0.01	-0.10	-0.17	-0.17	-0.17
Gross fixed capital formation	0.00	-0.02	-0.22	-0.20	-0.16	-0.18
Exports	0.00	-0.39	-1.88	-2.01	-1.98	-1.99
Imports	0.00	-0.38	-1.88	-1.99	-1.93	-1.91
Inflation	0.00	0.00	-0.01	-0.05	-0.08	-0.12
Private sector employment	0.00	0.00	-0.05	-0.06	0.00	0.01
Gross average wages in the private sector	0.00	0.00	-0.02	-0.05	-0.08	-0.11
Income taxes *	0.00	-0.02	-0.19	-0.26	-0.30	-0.35
Employer contributions*	0.00	-0.02	-0.17	-0.24	-0.27	-0.32
Turnover taxes*	0.00	-0.01	-0.08	-0.16	-0.20	-0.24
Taxes levied on companies*	0.00	-0.07	-0.32	-0.38	-0.43	-0.49
Interest expenditure of the general gov.*, **	0.00	0.00	-0.03	-0.12	-0.25	-0.39
General government balance*	0.00	-0.04	-0.26	-0.40	-0.45	-0.52

Source: MfNE calculations

** In % of GDP; changes of key fiscal items in percentage points.*

*** A plus sign means a decrease in interest expenditures, while the minus sign shows increase.*

Remark: the items do not necessarily make up the total, which is the result of rounding.

5. Long term sustainability of public finances

The sustainability of public finances is basically determined by the current fiscal stance (budget balance, public debt and debt-to-GDP ratio), the size of future budgetary expenditures associated with ageing and demographic trends.

The Government fosters the improvement of long-term sustainability of public finances through several channels with complex and targeted measures. One component of such measures is that the Government has set the reduction of debt ratio as a key objective. A lowed public debt creates favourable conditions to tackle the challenges of an ageing population in the long run. The other element of the above mentioned measures is that the Government has introduced a number of parametric changes in the pension system which have considerably reduced long-term pension expenditures and the cost of other age-related spending. The third element of the measures is that the Government has introduced family-friendly incentives which could mitigate budgetary consequences of the projected ageing of the Hungarian society through demographic changes.

The Fundamental Law stipulates that the public-debt-to-GDP ratio shall be constantly reduced until it reaches 50%. The achievement of this target was significantly facilitated by the termination of the mixed system introduced in 1998, composed of a compulsory, fully funded private pension fund pillar and a state-run, social-security-based, pay-as-you-go pillar. This affects the sustainability of public finances in many ways. On the one hand, the public debt was immediately and significantly cut due to the assets transferred from the private pension funds and, on the other hand, the contributions paid by members switching back into the public pillar are now paid to the budget, thereby permanently improving the fiscal position. In addition to the need for reducing public debt, there were also further arguments for the termination of the mixed system. With the high expenditure and low yields, the second pillar of the pension system, introduced in 1998, would have supposedly been unable to compensate for the lost social-security-based pensions.

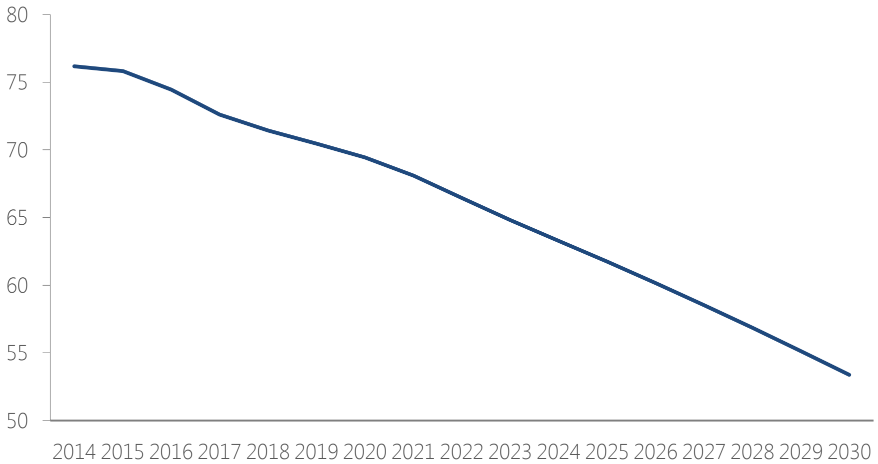
As a result of the parametric changes implemented in several steps, future pension expenditures were reduced significantly. In conformity with best international practices, the main direction of the measures is to raise retirement age in line with rising life expectancy, a significant increase in effective retirement age and change of indexation. The statutory retirement age will be gradually raised to 65 years by 2022 and the actual retirement age will also be much higher as a result of the regulations adopted in 2011, which transformed the benefits below retirement age. All these measures have a beneficial effect not only on the pension system but also on employment.

Long-term demographic trends have a major impact on expenditures relating to long-term sustainability. The demographic trends forecast the ageing of the population. The ageing of the population increases age-related expenditure, which has an upward pressure on public debt on the long term. One of the main reasons behind the unfavourable demographic process is the low fertility rate. Despite a slight increase in recent years, the fertility rate in Hungary is one of the lowest in Europe, standing at 1.4 according to the latest statistics (Europop2013), while the EU average is 1.6. In order to encourage families to have children, the government strengthened the family incentive system and Parliament approved the Act on Family Protection. The main elements of the measures included various forms of pecuniary support to families, such as family allowance, maternity support, child-care allowance, child raising support, life-starting support, child protection benefit, gas price subsidy for families with three or more children, and the family tax relief introduced in 2011. New measures were introduced on 1 January 2014 (new GYED extra) aimed at improving the conditions of having and raising children and of returning to the labour market for parents with small children. The measures include child-care and child raising benefits, better conditions of employment, parallel disbursement of benefits for families with several children, eligibility for child-care support for students studying in higher education and graduates at the beginning of their career, as well as the extension of the term of tax allowance available for parents with three or more children intending to return to employment after using child-care benefits. At the end of 2015 the Family Home Building Benefit (CSOK) was introduced at a higher amount, which also grants more support to families having or raising several children. All of these measures are expected to mitigate the projected ageing of the Hungarian population. It should be noted however that the natural decline rate is decreasing.

In the long run, pension expenditures are expected to increase at a much slower pace due to the measures implemented in the pension system. According to calculations approved by the European Commission and the EU Economic Policy Committee, pension expenditures are expected to drop between 2013 and 2060 from 11.5% only to 11.4% of GDP, which is considered a good result in the evolution of long-term pension expenditure in the European Union. Further expenditure figures with relevance to long-term sustainability are taken from 2015 Ageing Report, according to which health expenditure will increase from 4.7% of GDP to 5.4%, long-term care expenditure will rise from 0.8% of GDP to 1.3% and expenditures on education will shrink from 3.6% to 3.4% of GDP between 2013 and 2060 in Hungary.

According to the most recent calculations of the European Commission, included in its Sustainability Report published at the beginning of 2016, the Hungarian debt rate is projected to decrease at a rapid pace in the upcoming period. As is reflected by the chart, 10 years from now the public debt ratio will stand at 60% of GDP and will continue to decrease after that.

Chart 5.1.: Development of debt ratio till 2030
(% of GDP)



Source: EU Commission, MfNE calculation

Box 5.1: Sustainably declining path of the public debt

The European Commission published its Sustainability Report in January 2016. In the opinion of the Commission the dynamically declining path of the Hungarian public debt will continue in the medium-term in the upcoming 10-15 years as well. The report also states that the sustainability of Hungarian public finances is subject to a low risk. The report has developed a system of indicators for the measurement of short, medium and long-term risks. According to the indicators, Hungary is a country with low risk and the rate of the public debt will also decline significantly on the horizon of the upcoming 10 years.

The Commission also acknowledges the fact that the share of foreign currency denominated public debt has decreased over the recent years, and the share of domestic actors has increased among creditors of the public debt, significantly reducing the vulnerability of the country in the short term and improving the risk sentiment. Also in the medium term favourable developments are expected. The value of the S1 indicator calculated for Hungary is -0.6, which continues to represent a low risk. Based on that, the debt rate will decrease to 60% of the GDP until 2030, even if a relaxation of 0.6% of GDP takes place in the primary balance. The model of the Commission shows that on a time horizon of 10 years, i.e. by 2026, the debt ratio will decrease from 72.6% to 60.1%. The decrease of 12.5 percentage points occurring over the next 10 years can be considered substantial, both in absolute terms and in comparison to other EU countries. It can be seen (chart 5.2) that the Commission predicts the third largest debt reduction for Hungary 2017-2026. According to the actual figures, Hungary has been one of the best-performing countries in reduction of the debt ratio so far. Most countries increased or significantly increased their debt ratios 2009-2015, while the Hungarian figure dropped, and the country showed the second largest reduction in the EU (Chart 5.3).

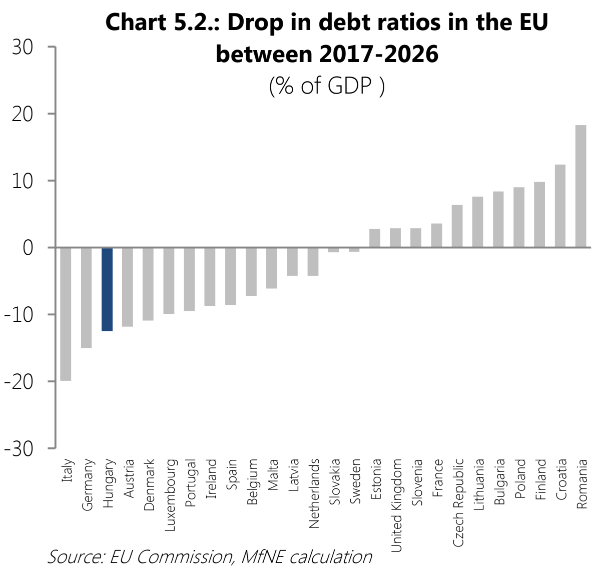


Chart 5.2.: Drop in debt ratios in the EU between 2017-2026
(% of GDP)

Source: EU Commission, MfNE calculation

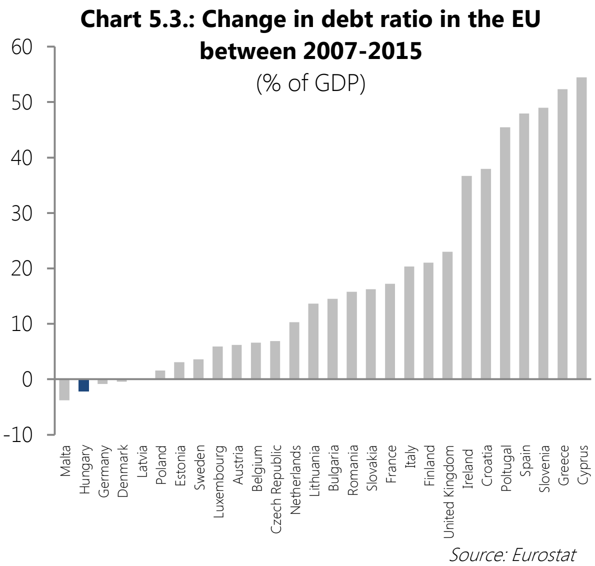


Chart 5.3.: Change in debt ratio in the EU between 2007-2015
(% of GDP)

Source: Eurostat

Hungary is still considered a country with low risk concerning the long-term sustainability of public finances. The reason for the favourable assessment is that over recent years the Government has implemented pension reforms constraining long-term expenditures. The Hungarian indicator measuring long-term sustainability (the so-called S2 indicator) stands at 1.5, which means that if the structural primary balance of the budget improves by 1.5% of GDP and does not change in the 50 years following that, then the public debt-to-GDP ratio will stabilise in the long term.

6. QUALITY OF PUBLIC FINANCES

As a result of the fiscal consolidation implemented in recent years, the general government deficit dropped well below 3% of GDP in a sustainable manner. While ensuring the sustainability of public finances, the Government builds on accomplishments so far and continues the improvement of the structure of government expenditures and revenues, in order to provide the best possible support to one of its most important economic policy objectives, i.e. sustained, job-creating economic growth.

The streamlining of expenditures makes it possible to preserve the accomplished favourable fiscal position while giving additional budgetary resources to those areas that can contribute the most in the medium and long-term to the competitiveness of the economy and to raising the growth potential.

In order to ensure the efficiency of the collection of revenues, one important objective is to make as many taxpayers as possible pay taxes as enshrined in the tax legislation. The measures aimed at continuing the whitening of the economy play an important role in this. The other important aim is to support employment also by refining the amount and structure of revenues.

6.1. STRUCTURE AND EFFICIENCY OF EXPENDITURE

As part of the efforts aimed at improving the quality of expenditures, several labour market measures support the expansion of activity, and thereby growth. Furthermore, the reorganisation of public administration serves the rationalisation of expenditures.

LABOUR MARKET MEASURES

One of the priorities of the economic policy of the Government is the support of expansion of employment. To that end, several actions have been and are being implemented, which have already delivered remarkable results in the improvement of the situation of the labour market. The increase in labour supply and the return of the affected groups to the labour market were significantly advanced by the tightening of transfers paid to the unemployed, the changes in the conditions of old-age and disability pensions and the introduction of flexible maternity leave. As part of public employment, those persons who had not been active in the labour market earlier also received an opportunity to work.

In addition to the positive developments thus far, the Government plans to take further steps. In the field of public employment, at present the main challenge is to provide assistance to the persons participating in the public work schemes so that they can be employed in the primary labour market. In addition, in order to increase the flexibility of the labour market and to reduce the mismatch between qualifications and the needs of the labour market, reforms are implemented in the field of vocational training as well.

In 2016 further programmes aimed at the promotion of employment are expected to be launched, with the utilisation of budgetary and EU funds. The program called Women 40+ will be providing wage and social contribution subsidy from January to those employers who employ women over the age of 55 facing retirement. Plans of the Government also include the extension of the trainee program, in order to support career starters with no qualification. This programme with a budget appropriation of some HUF 15 billion will accept grant applications from micro, small and medium-sized enterprises that commit to employing young people under the age of 25 with no qualifications. Furthermore, in 2016 a programme aimed at the dissemination of flexible forms of employment will also be started: a budget appropriation of HUF 5 billion will support the creation of jobs in about 500 enterprises. Furthermore a grant designed for the development of the so-called social enterprises with both social and business objectives will also be announced, with a budget appropriation of HUF 6 billion.

Public employment

In an effort to increase employment for the long term, it is justified to promote employment in the primary labour market. The promotion of employment in a way that is sustainable in the long term is possible if the business sector represents the highest possible ratio, and as many new, tax-paying jobs will be created as possible, and if those who are able and willing to work according to the conditions of the open labour market receive appropriate assistance in finding jobs for themselves. The government's aim is to increase the proportion of people returning to the primary labour market from public works.

The programme called "From public employment to the competitive sector" was launched on 1 February 2016. In that programme those in public employment receive an employment benefit if they find a job before the expiry of the term of the legal relationship of public employment. This program is financed from the National Employment Fund.

In addition to this, from 1 January 2016 a system for the profiling of job-seekers has been developed, in order to determine who should be offered the option of public employment and who should receive assistance with finding a job in the open labour market, with the appropriate incentives, support and services. In profiling a basic principle that must be implemented is that public employment is only warranted for those who cannot be helped in getting employment by any other means. At the same time, the opportunity for public employment must be guaranteed for those clients who are most exposed to the danger of persistent unemployment, i.e. who cannot find jobs in the open labour market even with support.

In the case of young persons under the age of 25 public employment is not considered an appropriate job opportunity. They can receive favourable support and employment opportunities from the Youth Guarantee Programme, and therefore persons under the age of 25 may only be referred to public employment in exceptional, well-justified cases.

Vocational training

In order to implement a vocational training system that is capable of serving the needs of the labour market flexibly, in the first half of 2015 the Government decided on the strategic concept necessary for the reorganisation of the sector. The changes focused on serving the expected needs of the economy in such a manner that the training and educational systems should be able to train and release more professionals than at present.

The feedback received from employers shows that there is an increasing need for a highly trained labour force. Therefore the current changes in the vocational training system significantly enhance the chances of students obtaining a school leaving certificate at the end of each vocational training path, which will enable them to enter tertiary education from September 2016. As an element of the vocational training reform, as of 1 July 2015 several vocational schools and vocational secondary schools were transferred from Klebelsberg Institution Maintenance Centre to the Ministry of National Economy as the operator. These institutions were re-organized into 44 vocational training centres at the national level. As part of the institutional reorganisation, from the academic year of 2016/2017 vocational schools are converted into vocational secondary schools, in which the students may obtain a trade together with their school leaving certificate. Furthermore, if they complete one more year of training, they will also obtain a technician qualification. At the same time, current vocational schools will be converted into vocational secondary schools, and after completing three years of training necessary for learning a trade, students will also have the option of obtaining a school leaving certificate in the span of two years. In the case of the institutional reorganisation it is registered as a highlighted aim to have vocational training centres converted into service centres, where clients of any generation may receive career consulting, proposals for adult education courses, training courses and survey of abilities.

The opportunity of a second vocational qualification, assured by the Government from the second half of 2015 and obtainable free of charge in the system run by the State, significantly contributes to increasing the number of students involved in vocational training. This impact can be mainly registered in adult education, where a sharp increase is expected in the number of students.

The Hungarian Chamber of Commerce and Industry has a significant responsibility in the operation of dual training, in the dissemination of practical training at companies and in quality assurance. With the amendment of the law on vocational training in 2015, the institution of the “chambers’ guarantee” was introduced, which increases the number of students involved in dual training by placing students during their practice in a real business working environment, thereby promoting the training of professionals in order to meet the needs of the labour market. The implementation of the “chambers guarantee” contributes to the increase of the number of student contracts to 70,000 by 2018, i.e. about 50% of the number of students. In order to ensure the enhanced participation of enterprises in the dual training system in the future as well, the Government continues to provide individual company support in dual vocational training by supporting the establishment of training workshops and the training of the company's own workers.

STREAMLINING OF THE INSTITUTIONAL SYSTEM OF STATE ADMINISTRATION

Since 2010 the reorganisation of ministries and territorial agencies of state administration has been completed in several steps, which has led to a more efficient structure. At the same time, no changes have been introduced in the system of central budgetary institutions. The organisational and operational layout of central offices and background institutions is not uniform, which makes the transparency and supervision of the activities of the agencies, as well as their operation more difficult. Thus, a high number of separate organisations perform parallel supporting functions, such as human resource management, IT and internal financial operations.

In order to improve efficiency, the Government plans to reduce the number of central offices and background institutions of budgetary organisations significantly. With this measure a total of 50 budgetary organisations will be terminated. This may result in significant savings in operational expenditures (wages and the purchase of goods and services). Furthermore, this measure improves the transparency of the institutional system. As a main rule, central offices will be terminated as of 1 July 2016. The functions of the outgoing central offices have been assigned to ministries, economic associations, and the territorial organisations of central offices being integrated into the organisation of the government offices in Budapest and in the counties.

6.2. STRUCTURE AND EFFICIENCY OF REVENUES

Measures aimed at further decreasing the shadow economy play an important role in the more efficient collection of revenues of the budget. In addition, a quality change takes place in the relationship between the tax authority and the taxpayers. Aspects of promoting employment are also implemented in the planned restructuring of the revenue structure.

Owing to the tax measures of previous years, the total taxes and contributions imposed on economy was about 39 per cent of the GDP, which means a decrease of approximately 2 percentage points compared to the pre-crisis years. This value continues to decrease gradually on the forecast horizon, partly due to the already announced tax cut measures, partly due to the structure of growth. The most important elements of the restructuring of the tax system were the reduction of taxes on labour, increasing the importance of taxes on consumption, turnover and negative externalities, as well as enhancing the efficiency of tax collection in previous years. The most important restructuring measures necessary to achieve the above targets were implemented in the period between 2010 and 2014. In the upcoming years, the reduction of taxes on labour and the tax burden of enterprises remain highlighted objectives, furthermore, the tax system is designed to be made even more employment- and business-friendly. In addition, in upcoming years the Government will continue to make efforts to combat the shadow economy by more efficient operation of tools available and the implementation of new instruments, and the tax policy will focus more and more on curbing the tax avoidance practice of large corporations as well. A significant step implemented in order to increase the efficiency of tax collection is that from 2016, the National Tax and Customs Administration (NAV) of Hungary has been reorganised.

Due to fiscal consolidation and the sustainable growth path in the upcoming years further tax cuts will become possible.

STEPS TAKEN TO COMBAT SHADOW ECONOMY

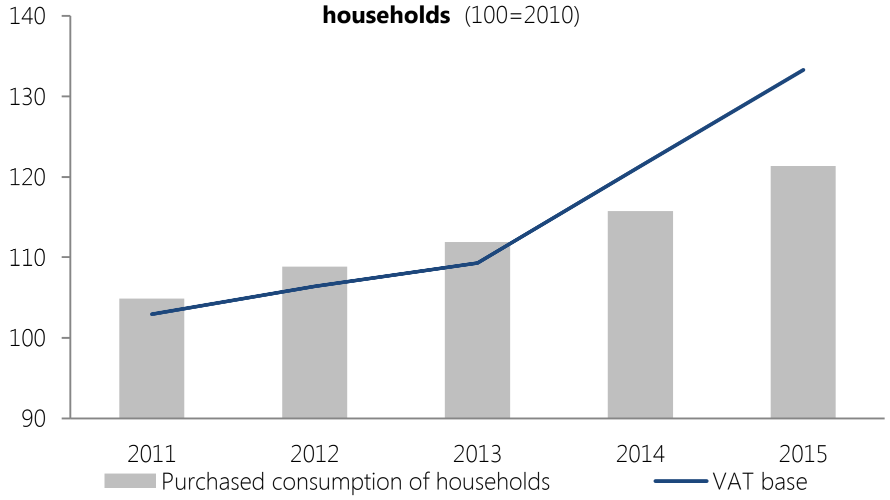
The measures taken against the shadow economy have played an important role in the increase of tax revenues in recent years. The aim of the Government's tax policy is to create the opportunity, with continued powerful actions against tax fraud, to carry out the tax cuts implemented in recent years.

Concerning the favourable impact on tax revenues, the electronic connection of cash registers to the tax authority (NAV) and the Electronic Trade and Transport Control System (EKAER) played an outstanding role. The number of cash registers connected to the tax authority had increased to some 217,000 by March 2016, which allows NAV to monitor the turnover of the cash registers on a real-time basis and thereby detect fraud more efficiently. EKAER, the system set up in an effort to curb VAT fraud, enables the monitoring of the road transport of goods movement. The purpose of EKAER is the strengthening of law-abiding market actors, assurance of the transparency of goods traffic, the exclusion of frauds with foods that often jeopardise human health, and not least, screening tax evaders. Until the end of February 2016 53,000 taxpayers and 6,000 transporters registered on the interface of EKAER. But EKAER does not only support instant, real-time control, it also provides excellent information for subsequent audits.

Concerning budgetary impacts, in 2014, mainly as a result of the introduction of online cash registers, the increase of VAT revenues already significantly exceeded the increment justified by the macro-economic parameters (households' consumption, households' investments, purchases by the State). In 2015 the development of revenues was also determined by the positive impact of carry-over effect of the cash registers from 2014, furthermore, the live operation of the EKAER from March 2015, following test operation. VAT revenue in ESA terms shows a 11.8% (HUF 318 billion) rise in 2014, while according to the preliminary figures of 2015 there is an increase of 9.8% (HUF 269 billion) compared to the corresponding period of the previous year. From the increased VAT revenues calculated according to the ESA terms, in 2014 approximately 0.6% of the GDP, in 2015 an additional 0.2 – 0.3% of the GDP is the part that cannot be explained by the development of the preliminary macro-economic parameters, therefore this amount is likely largely attributable to the decrease of the shadow economy.

The purchased consumption of households and the increase of the VAT base estimated according to the revenues of the budget in ESA terms had been moving on a similar path of growth from 2011 until 2013. In 2014 and in 2015 the growth of the estimated net VAT base significantly exceeded the growth index of purchased consumption calculated at current prices.

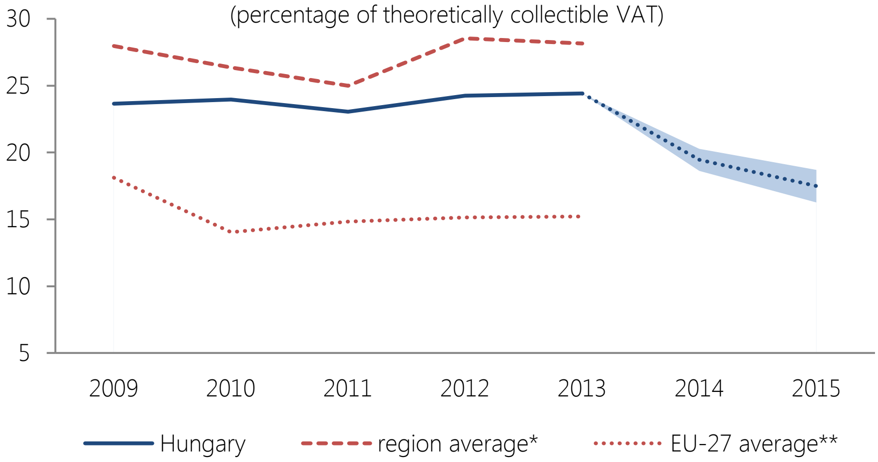
Chart 6.1. Estimated VAT base and purchased consumption of households (100=2010)



Source: HCSO, MfNE calculations

Case (2015)[9] estimates that the level of VAT gap (the difference between the theoretical and the actual VAT revenue) was 23-24% in 2009-2013 as a ratio of theoretical VAT revenue in Hungary (chart 6.2). According to the estimation of recent years based on VAT revenue figures, in 2014 the level of the VAT gap was expected to drop below 20%, which decrease continued into 2015, and although the development of other items affecting the VAT base (such as residential investments, purchases by the State) did play a role in it, the majority of this change was a result of the actions aimed at decreasing the shadow economy.

Chart 6.2. Value added tax gap
(percentage of theoretically collectible VAT)



*Czech Republic, Poland, Slovakia, Slovenia, Romania, Bulgaria
**excl. Cyprus

Source: CASE (2015), MfNE calculations

Based on the successes attained thus far, in 2016 and 2017 the Government will continue the extension of the obligation to use online cash registers to additional branches of the economy. From 30 September 2016 some parts of the service sector that provides the repair and maintenance of vehicles, retail of vehicle parts, repair of motorcycles and trade in motorcycle parts, performing cosmetic surgery activities, operating discos and dance halls, performing cleaning of clothing and providing various services improving physical well-being and exercise will be obliged to use online cash registers. From 1 January 2017 money changers and taxi services will join the online system provide online data to NAV. Owing to the extension of the online data reporting obligation, the monitoring option of NAV will be further widened, which may result in an additional revenue increase by several tens of billions of Forints through the more efficient detection of tax evasion.

The aim of the Government is to introduce a system of online invoicing from 2017, in addition to the extension of the use of online cash registers, which could make the fight against tax evasion committed by failing to record revenues more efficient, by making the data reporting on the issue of invoices a real-time process. In an effort to make the collection of overdue tax liabilities more efficient, the real-time tax audit practice may be enhanced by the screening out of risky taxpayers, the rules of the collection of public debts to be collected as taxes, in order to ensure more efficient resource allocation and to streamline collection activity. Furthermore, a toolset suitable for the analysis of network connections of taxpayers will also be developed.

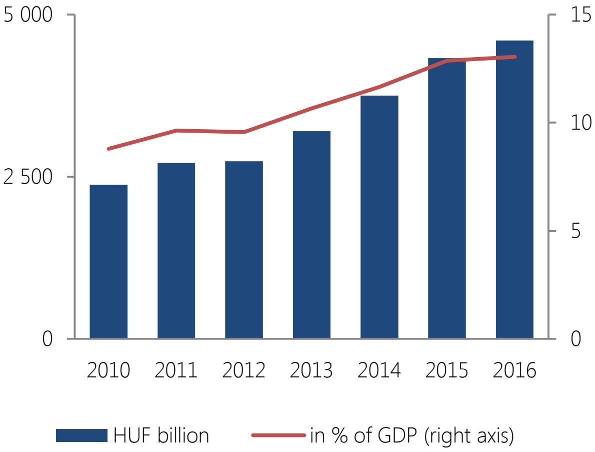
[9] Case (2015): Study to quantify and analyse the VAT Gap in the EU Member States (Report 2015). Warsaw, May 2015

Measures to promote electronic payment

In international comparison the cash in hand is high in Hungary. This especially applies to the household sector, where this ratio is significantly higher than in the other Visegrád countries. There are several factors underlying this phenomenon, of which two are highlighted here. One important reason is the low level of deposit interests, which have significantly decreased as from 2012, as a consequence of the reduction of the base rate. As a result, economic actors prefer to keep money in cash, rather than in deposits at low interest rates. Another factor that may explain the high level of cash in hand is the connection between cash and the hidden economy, owing to its anonymity, cash is ideal for financial settlements of illegal transactions and for the accumulation of income from the hidden economy.

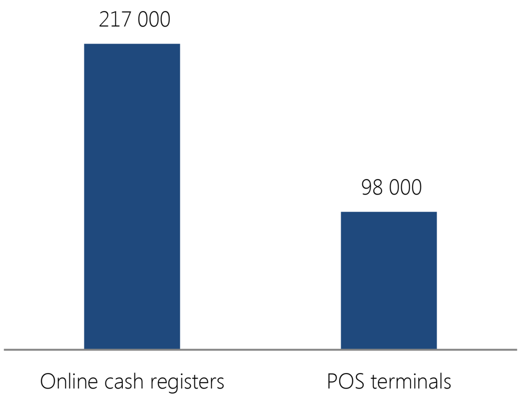
In an effort to combat the hidden economy, the Government has implemented several measures. The efficiency of the efforts to whiten the economy can nonetheless still be improved: raising the ratio of electronic transactions further would contribute to the whitening effect. This factor would also improve the efficiency of online cash registers. Furthermore, an increase in the number of POS terminals would curtail the need of the economy for cash, which would also reduce the costs related to the use of cash at national level.

Chart 6.3.: Currency in circulation
(HUF billion, in % of GDP)



Source: MNB

Chart 6.4.: Number of online cash registers and of bank card acceptance points



Source: NTCA, MNB

Despite the advantages at national level outlined above, the ratio of electronic transactions in Hungary falls significantly below the European average[10], and the number POS terminals is lower than that of online cash registers. The main reason is the high installation costs of POS terminals; currently the installation of such instrument is too costly for most market participants and thus it is not an attractive option. The programme under preparation designed to encourage the installation of POS terminals is to remedy these problems, and following a one-off investment the entire economy can reap the benefits of the upgraded payment system, which are as follows:

(1) whiter, more transparent economy (generating more tax revenues);
(2) with the moderation of the costs of cash transactions, costs also decrease at national level, fostering competitiveness;

[10] European Commission (2015) Survey on merchants' costs of processing cash and card payments, Luxembourg, Publications Office of the European Union

(3) part of the savings held in cash earlier appears in the economy.

REDUCTION OF TAX ADMINISTRATION

In order to reduce the administration burdens and to speed up processing, fees and charges for several public services were reduced from 2016, and some items were eliminated, furthermore, the processing deadlines will be shortened further. Under this measure fees and charges have been reduced by a total of HUF 10 billion, the issue of several documents (e.g. personal ID card, student card) is now free of charge, in the area of construction affairs several deadlines have been shortened and construction and occupancy permits under an area of 160 m2 have been made exempt from duties. The burdens of enterprises have also been alleviated through the deletion of several duties and fees, for example, certificates issued by the tax authority and the publication of the annual financial report of companies are now free of charge. It has also been made possible from 2016 that the tax authority may prepare the personal income tax returns of persons who only have received income from their employers. Furthermore, the taxpayer rating system has been introduced as an effort to encourage the law-abiding practice of taxpayers.

The Government set it as an objective that in the upcoming years the system of relations between the taxpayers and the tax authority should be reorganised substantially, through the change of the regime of taxation and the restructuring of the tax authority. The objective is that by the end of the decade the tax system will be able to catch up with the best practices in Western Europe.

The set of measures concerning the realm of taxation shall be focused on areas where backlog or problems identified by individuals or businesses are the most serious, also taking into account tax policy aspects. The changes planned in addition to the above will primarily contribute to an easier and faster administration for individuals and businesses, as well as to a culture of compliance. Accordingly, the most important aims include mitigation of the audit, authority type activity, dominance of the tax authority, i.e. the change of the approach that primarily imposes obligations and does not assign rights to the taxpayers. As a part of these efforts, such a regulation will be developed that provides institutionalised support to voluntarily law-abiding persons with the fulfilment of their obligations, and which has a system of sanctions with no excessive or unjustified penalties. In addition, the new regulation focuses more on the principle of professional and efficient process, i.e. that the tax authority organises its activity in such a way that the process can be closed as fast as possible, incurring the least costs for the persons involved in the process, as well as on the principle of clarity, under which in the tax procedure the language of maintaining connection with the taxpayers should be simple and understandable.

In an effort to make tax collection more efficient, the activity of the National Tax and Customs Administration of Hungary, established on 1 January 2011, has been reviewed; as a result, the organisation was restructured as of 1 January 2016. The restructuring applied, among others, to the governance, organisational set-up and system of legal remedies of NAV.

TAX-REDUCING STEPS

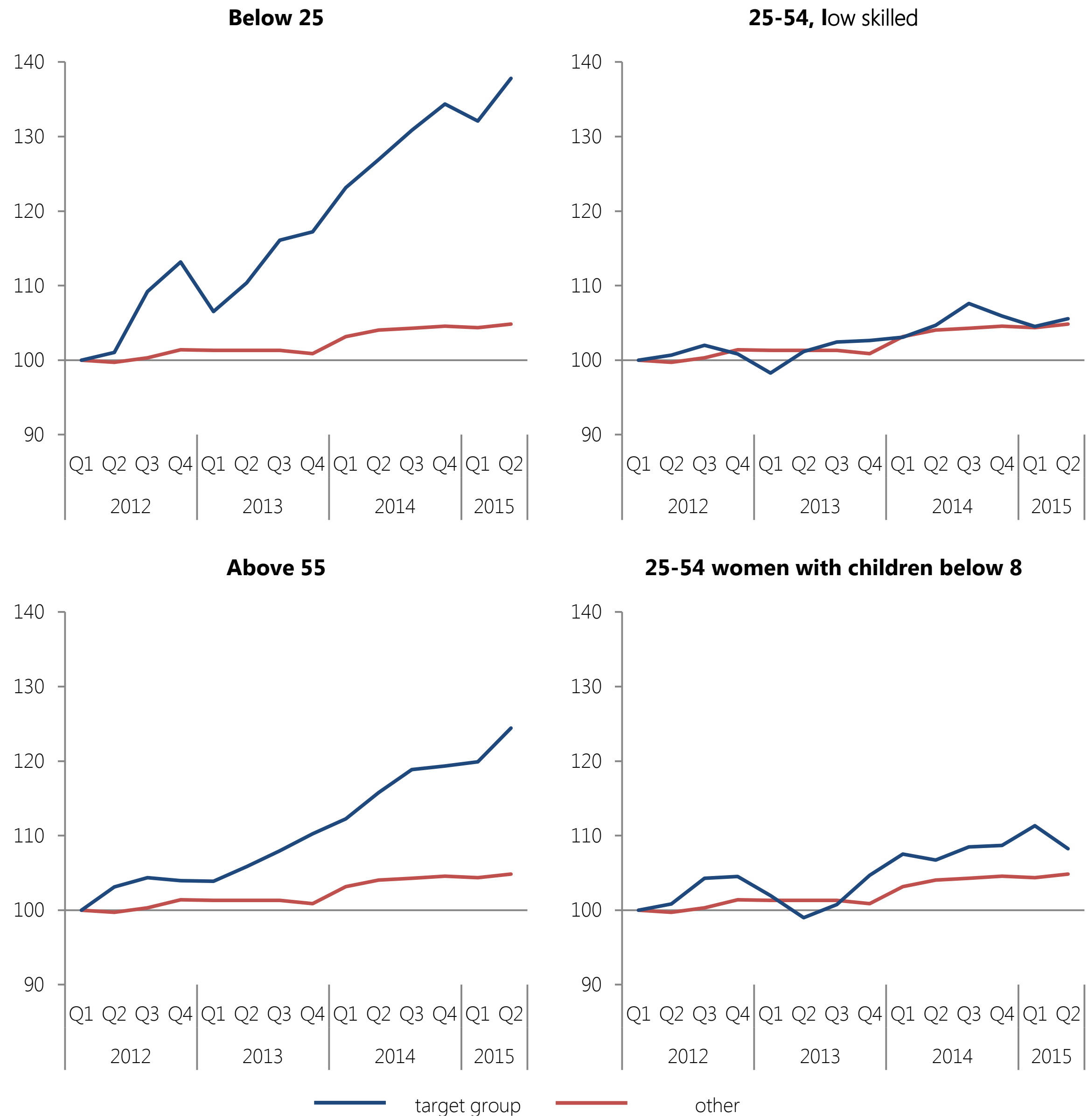
Taxes on labour

During the restructuring of taxes on labour the Government's aim was to create a tax system that provides the least possible disincentive to work, while also ensuring better conditions for those in the most disadvantageous labour market situation. As a result of the flat-rate personal income taxation, introduced in several stages between 2010 and 2013, and the abolition of the pension contribution ceiling, a completely linear tax and contribution system came into being. On the other hand, with the introduction of the family tax allowance in 2011, the tax system now also takes into consideration the number of dependent persons in the household. In order to promote the employment of the most disadvantaged groups, in 2013 the targeted social contribution tax benefits of the Job Protection Act were introduced, which have the potential of providing much more efficient incentives for the employment of people in real need, compared to the earlier personal income tax credit.

The Job Protection Act is aimed at the employment of groups whose labour force participation is low in regional comparison, and based on the available Hungarian and international empirical literature are usually more responsive to various tax incentives. The scope of beneficiary employees (those under the age of 25, over the age of 55, persons returning from home child care allowance, long-term unemployed persons, career starters and persons working in elementary occupations) can be considered extremely broad in international comparison. Currently, targeted allowances are applied by the employers to 880,000 employees in the private sector, and these allowances reduced the wage costs by around HUF 136 billion in 2015. The favourable labour market trends that have improved in recent years can also be observed in groups in disadvantaged positions targeted by the Job Protection Act. In the two largest target groups of the benefits, i.e. those under 25 and those above 55, the change in the employment rate compared to the first quarter of 2012 continuously exceeded the corresponding rates of those who are not affected by the Job Protection Act. The employment of unskilled workers did not fall behind either, compared to that of employees between the age of 25 and 54, having at least a secondary school qualification and not belonging to either of the target groups. In addition to the Job Protection Act, several other governmental measures contributed to these processes, however, according to the analyses of the Ministry for National Economy a significant part of this increment can be explained by the impact of the benefits (see Box 6.1).

Chart 6.5.: Changes in employment rate without public work schemes by the tartget groups of the Job Protection Act

((2012Q1 = 100)



Sources: LFS, MfNE calculation

From 2014, the family tax allowance may also be deducted from the employees' social security contributions, so taxes on labour for families in lower income brackets have decreased further. From 2015 the Government introduced the tax benefit for those married for the first time, which means an option to reduce the income tax base.

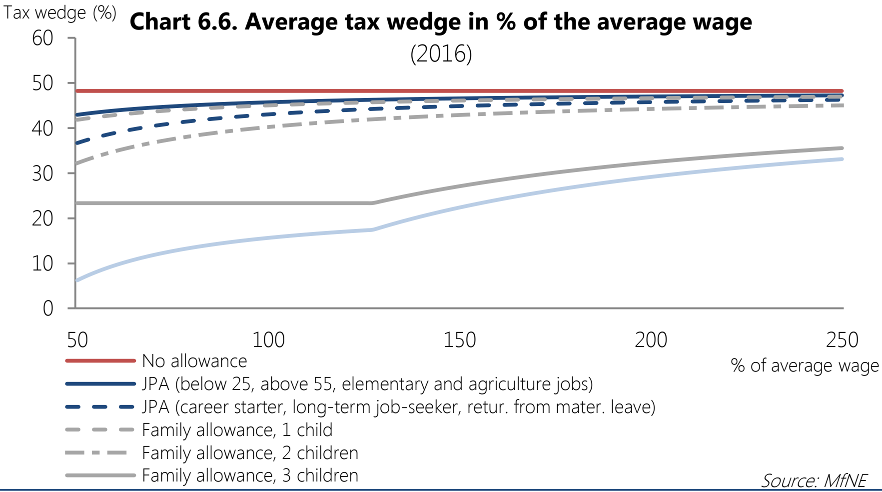
The economic growth of recent years and the successes in the fight against the shadow economy enabled the continued reduction of taxes on labour. In 2016 the personal income tax rate was reduced to 15% and the family tax allowance for families with two children also increased. The reduction of the personal income tax rate to 15% alleviates the tax burden of employees by HUF 120 billion annually. In the future the aim of the Government is the continued reduction of the personal income tax rate, in order to achieve a single-digit personal income tax rate.

Box 6.1: The impacts of targeted tax benefits by the Job Protection Act on employment and redistribution

Having been introduced in 2013, the Job Protection Act is aimed at the employment of those disadvantaged and low productivity groups whose labour force participation rate is low in Hungary in regional comparison, and based on the available empirical research are usually very responsive to various tax incentives. The scope of beneficiary employees is broad in international comparison, covering one third of the private sector at present, and owing to the benefits the tax burden of the target groups decreased substantially, by approximately HUF 136 billion in 2015.

Chart 6.6. Average tax wedge in % of the average wage

(2016)

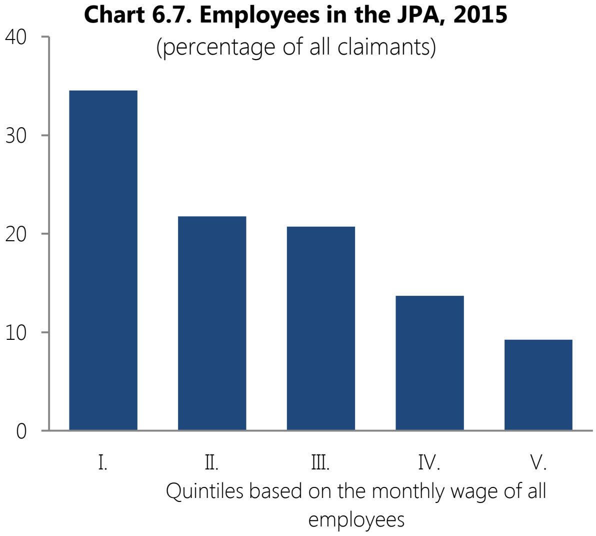


Source: MfNE

Although the benefits available under the Job Protection Act are not phased out even in the case of high incomes, Chart 6.6 illustrates it well that in lower income categories – primarily around the minimum wage – they substantially reduce labour costs.

Chart 6.7. Employees in the JPA, 2015

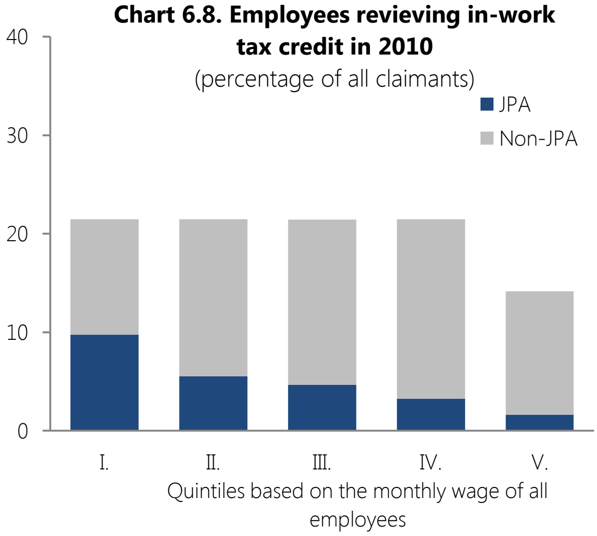
(percentage of all claimants)



Source: NTCA, MfNE calculations

Chart 6.8. Employees revieving in-work tax credit in 2010

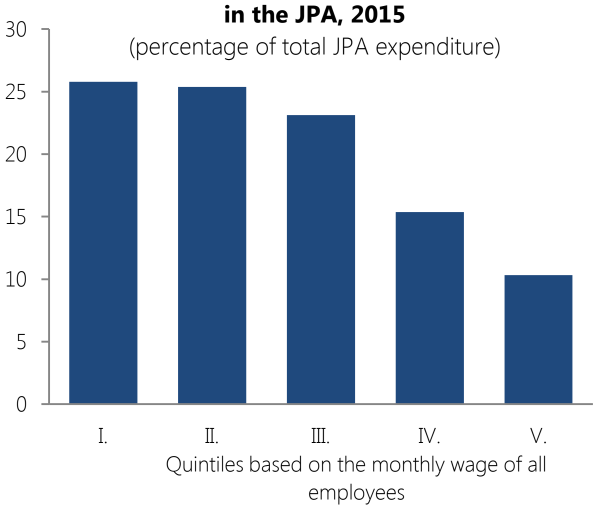
(percentage of all claimants)



Source: NTCA, MfNE calculations

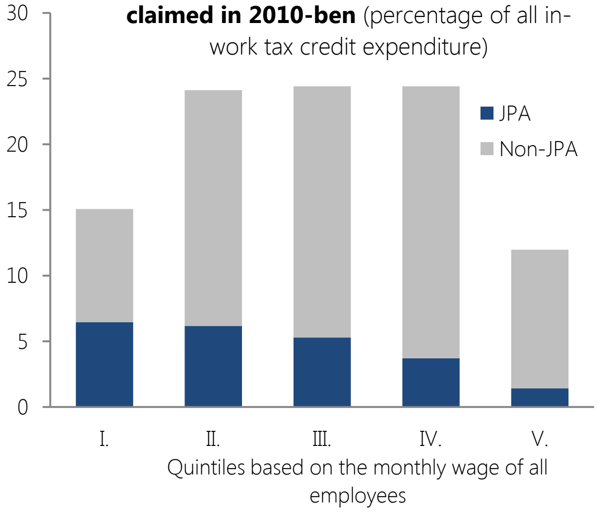
Although the benefits of the Job Protection Act are taken by a smaller group of beneficiaries than that of the tax credit that had operated prior to 2010, at the level of labour cost their role is similar and their targeting according to income category is more favourable (Chart 6.7), while they are free of the high marginal burdens caused by the phasing out of the tax credit (Chart 6.8). In terms of redistribution more efficient targeting is accomplished in terms of the structure of the amount of benefits (Charts 6.9.-6.10), since the higher amount of the benefit taken reduces the employment burdens of that group of employees who earn less.

Chart 6.9. Amount of tax relief claimed in the JPA, 2015
(percentage of total JPA expenditure)



Source: NTCA, MfNE calculations

Chart 6.10. Amount of in-work tax credit claimed in 2010-ben (percentage of all in-work tax credit expenditure)



Source: NTCA, MfNE calculations

Over recent years, in the target groups of the Job Protection Act a stronger expansion of employment has evolved than the generally registered level, first of all among young employees and those about to retire. Naturally, the change reflects the simultaneous impacts of several governmental measures, according to research on the anonymous, administrative micro databases of the National Tax and Customs Administration of Hungary and the National Labour Office, the benefits of the Job Protection Act themselves significantly increased the employment of the target groups .

According to the econometric analysis of the Ministry for National Economy, in the private sector for those under the age of 25 the benefit facilitated entry in the labour market, which raised the employment level of age groups 22 and 23, close to the age of eligibility, by 2-3 percentage points between 2013 and 2015. In the category of those above 55 years, this measure contributed to preventing their exit from the labour market, or to postponing the exit. In the demographic of those aged 56-57 under examination, the benefit raised employment by 0.5-1 percentage point, which is primarily focused on those with low qualification. The benefit of long-term job-seekers increased the exit from registered unemployed status and entering into jobs in the private sector by 1 percentage point and also contributed to retention of the job after the termination of unemployed status.

As a result of the restructuring of the tax system, in each income category employer and employee taxes and other contributions imposed on income fell under 48.3%, and due to family tax allowance and targeted tax benefits, in some groups it dropped to even lower levels. One of the aims for the following years is that until 2019 the family tax allowance for families with two children should be double the corresponding value of 2015, which will improve the income position of the relevant 380-390,000 taxpayers by almost HUF 15 billion annually.

Corporate taxes

The tax burden of SMEs has dropped substantially over recent years through the widening of the corporate tax rate of 10% and through the introduction of two new optional simplified tax types (KATA, the lump-sum tax for self-employed, and KIVA, the small business tax). The lump-sum tax for self-employed alleviates the administrative burdens for micro enterprises and thanks to the favourable tax burden, contributes to the decrease of the shadow economy, the small business tax is favourable for those SMEs that take on a significant role in employment or implement major investments. A total of some 138,000 enterprises had chosen the two new tax types by the end of 2015.

Over recent years most of the taxes introduced earlier in an effort to mitigate the impacts of the crisis and directly burden enterprises operating in certain sectors have been phased out. They were replaced by new consumption-turnover type taxes such as the tax on insurance premiums, the levy on financial transactions and the telecommunications tax. These taxes have a less distorting effect on investments and economic growth, because they are imposed on the services provided by companies and not on their profits, furthermore, they are introduced on a wide tax base, at a low tax rate. In the meantime, the system of remaining sector-specific tax types resulting in a direct burden has been amended for the benefit of taxpayers. In the tax on public utility systems, in order to promote the infrastructural expansions of companies and their market entry, in 2015 new lines and replacement of cables used for communication were made tax exempt in a term of 5 years, and from 2014 enterprises making capital investments are entitled to a development tax benefit from the income tax on energy suppliers as well. After the resolution of the problem of foreign currency loans, it is no longer justified to maintain the surtax on financial credit institutions; therefore from 2017 this tax will be abolished. In addition, in its agreement concluded with EBRD in February 2015, the Government committed to reduce the surtax on financial institutions. Accordingly, the upper bracket of this tax type applying to financial institutions was reduced from the former 0.53% to 0.24% in 2016, and from 2017 the tax rate will continue to decrease in accordance with the EBRD agreement. This measure is expected to trigger a surge in lending activity, which will have a favourable impact on economic growth.

In the field of taxing corporate income, the tax policy focuses more and more on curbing the tax avoidance practice of large corporations as well. It poses great challenges for the tax administrations of several states in those multinational companies apply complex tax structures to deflect income from the location of value creation, thereby evading taxes in those locations. Hungary intends to create a regulatory environment that implements the effort to tax income at the point of value creation, and ensures that multinational companies pay tax on incomes generated by them. Concerning that, in recent years the rules of corporate income tax have been amended on several points and the proposals finalised by the OECD working groups on base erosion and profit shifting (BEPS) and supported by G20 countries, are also assessed. As a result of the changes in regulation implemented in 2015 and 2016, the application of transfer price rules and the concept of affiliated enterprise are subject to more stringent conditions, and the utilisation of loss carried forward has also been restricted. From 1 July 2016 the tax base benefits related to royalty and other intangible assets are available according to a methodology (the so-called nexus method) developed by the OECD, approved by the ECOFIN Council, which is much more stringent than the previous Hungarian regulation. This methodology tightens the scope of intangible assets qualifying for tax benefits, and the base of the benefit has been restricted from revenue to profit.

In the field of corporate taxation, plans by the Government for the upcoming years include the further alleviation of administrative burdens of enterprises, as well as implementation of the flat-rate corporate income tax, if the situation of the budget enables these measures.

Consumption and turnover taxes

The weight of consumption-turnover type taxes was also increased by the restructuring of sectoral taxes, rise of the standard VAT rate in 2012, and the increased importance of environmental protection/healthcare aspects in the tax system. It was along these latter aspects that changes affecting the excise duty and some product taxes have been introduced in recent years, as well as the introduction of the public health product tax and the accident tax and the transformation of the company car tax, taking into account aspects of environment protection. Under the Jedlik Ányos Plan, from 2016 preferences in keeping environment-friendly vehicles as opposed to vehicles with a stronger environmentally damaging effect have been implemented in every tax type related to the acquisition and owning of vehicles.

Measures implemented in recent years aimed at increasing the legitimate sector of the economy and to combat the shadow economy have played an important role in increasing revenues from consumption type taxes. Nevertheless, these measures could not only lead to the decline of VAT fraud, but they are also expected to indirectly contribute to the decline of other forms of fraud (profit and wage concealment). In an effort to curb fraud related to retail sales, in 2014 the electronic connection of cash registers to NAV was implemented, in 2015 the number of connected cash registers further increased and in the subsequent years the scope of enterprises obliged to use online cash registers will be extended continuously. In addition, in 2015 reverse charge VAT was extended, the Electronic Trade and Transport Control System was launched, the VAT rate of other large livestock and carcasses was reduced to 5%, furthermore, the scope of taxpayers mandated for domestic VAT recapitulative statements was expanded. From 2016 VAT for pork has been reduced to 5%. As a further measure, from 2017 the VAT rate applying to Internet access and catering in restaurants will be reduced from 27% to 18%, and the VAT rate applying to fresh milk, eggs and poultry will be reduced to 5%.

7. INSTITUTIONAL FEATURES OF PUBLIC FINANCES

7.1. BUDGETARY FRAMEWORK

The framework rules of the preparation of the budget are included in Act CXCIV of 2011 on the economic stability of Hungary (Gst.), Act CXCV of 211 on public finances and Government Decree 368/2011 (XII.31.) on the implementation thereof, in accordance with Directive 2011/85/EU of the Council.

From 18 June 2015, based on the rules of Gst. on debt, the balance of the budget shall be planned in such a manner that if both the rate of inflation predicted for the budget year and the pace of growth of the gross domestic product exceeds 3%, then the annual growth rate of public debt shall not exceed the difference between the expected inflation and the half of the real growth of the gross domestic product. If at least either of the inflation predicted for the budget year or the real growth rate of the gross domestic product does not exceed 3%, then the public debt ratio shall decrease by at least 0.1 percentage points.

Therefore there are no budgetary requirements under adverse circumstances (low growth) or low inflation that would unjustifiably restrict the performance of the national economy, and would result in other negative consequences, while the reduction of the public debt is guaranteed in accordance with the Fundamental Law.

7.2. PUBLIC FINANCE STATISTICAL GOVERNANCE

In Hungary, general government sector related statistics are prepared by the Hungarian Central Statistical Office (HCSO) and by the Hungarian Central Bank (Magyar Nemzeti Bank, MNB). According to the current division of tasks, the HCSO is responsible for non-financial accounts and the MNB for financial accounts. Concerning the provision of data in the context of the Excessive Deficit Procedure (EDP Notification), the above division of tasks prevails in compiling the actual figures up to the period before the reported year, whereas the calculation of government balance and debt envisaged for the reported year is the task of the Ministry for National Economy. A statistics working committee consisting of delegates of the HCSO, the MNB and the Ministry for National Economy operates at the level of executives and experts; data flow, division of work and procedural questions of methodological treatment are set out in a cooperation agreement which was updated in 2015. Key data sources of government finance statistics is the public finance information system, the annual and interim reports of budgetary entities, supplemented by statistical data collected from corporations and non-profit entities classified within the general government sector, as well as bank and securities data for the entire government sector. The EDP Notification Report is published on the HCSO website as soon as it has submitted the report to Eurostat. After the three-week consultation period with Eurostat, the HCSO also publishes, together and simultaneously with the Eurostat press release, the approved EDP Notification tables. Moreover, it publishes the description of the methodology related to the compilation of the report, regularly updated and extended in 2016 by the Hungarian statistical authorities ("EDP Inventory"). In accordance with the established practice, the Ministry for National Economy dedicates a separate chapter to the explanation of the difference between the official national and the Maastricht deficit and debt indicators, as part of the general explanation attached to the annual budget and the final accounts submitted to Parliament.

TABLES

Table 1a. Macroeconomic prospects

	ESA code	2015 HUF bn	2015	2016	2017	2018	2019	2020
			percentage change					
1. Real GDP (at constant prices)	**B1g**	**33,125.4**	**2.9**	**2.5**	**3.1**	**3.4**	**3.1**	**3.2**
2. Nominal GDP	B1g	33,711.8	4.8	4.4	5.9	6.3	5.8	5.7
Components of real GDP								
3. Private consumption expenditure	P.3	16,137.2	3.1	3.9	3.7	2.8	2.7	2.7
4. Government consumption expenditure*	P.3	7,082.8	0.6	0.4	0.9	0.7	-0.7	-0.4
5. Gross fixed capital formation	P.51	7,105.0	1.9	-1.8	9.1	9.6	5.5	4.0
6. Changes in inventories and net acquisition of valuables (per cent of GDP)	P.52+ P.53	82.4	-0.3	0.0	-0.2	0.0	0.0	0.1
7. Exports of goods and services	P.6	31,147.0	8.4	6.7	6.3	6.8	7.0	7.3
8. Imports of goods and services	P.7	28,428.9	7.8	6.4	7.4	7.6	7.0	7.1
Contribution to real GDP growth								
9. Final domestic demand		30,325.0	1.8	1.6	3.6	3.5	2.4	2.2
10. Changes in inventories and net acquisition of valuables	P.52+ P.53	82.4	-0.3	0.0	-0.2	0.0	0.0	0.1
11. External balance of goods and services	B.11	2,718.0	1.2	0.9	-0.4	-0.1	0.7	0.9

*/: Including government and NPISHs as well

Table 1b. Price developments

	2015	2016	2017	2018	2019	2020
	percentage change					
1. GDP deflator	1.8	1.8	2.7	2.8	2.6	2.5
2. Private consumption deflator	0.0	0.4	0.9	2.4	3.0	3.0
3. HICP	-0.1	0.4	0.9	2.4	3.0	3.0
4. Public consumption deflator	2.6	4.2	4.9	3.6	1.7	0.6
5. Investment deflator	1.2	1.4	1.5	2.1	2.4	2.4
6. Export price deflator (goods and services)	-0.3	0.0	0.5	1.9	2.0	2.0
7. Import price deflator (goods and services)	-1.0	-0.5	0.3	1.8	2.0	2.0

Table 1c. Labour market developments

	ESA code	2015 level	2015	2016	2017	2018	2019	2020
			percentage change					
1. Employment, persons ('000;15-74)		4,210.5	2.7	2.5	1.7	1.0	0.8	0.5
2. Unemployment rate (%; 15-74)		-	6.8	5.5	5.2	5.1	5.1	5.1
3. Labour productivity, persons		-	0.3	0.0	1.4	2.3	2.3	2.6
4. Compensation of employees (HUF bn)	D.1	14,976	6.1	7.1	6.8	5.4	4.8	4.0
5. Compensation per employee (HUF million)		3.6	3.4	4.5	5.0	4.4	4.0	3.4

Table 1d. Sectoral balances

	ESA code	2015	2016	2017	2018	2019	2020
		per cent of GDP					
1. Net lending/borrowing vis-à-vis the rest of the world	B9.	8.8	8.4	8.3	9.3	8.6	7.8
of which:							
- Balance of goods and services		8.6	9.5	8.9	8.5	8.8	9.4
- Balance of primary incomes and transfers		-4.2	-4.0	-3.7	-3.4	-3.4	-3.4
- Capital account		4.4	2.9	3.1	4.2	3.2	1.9
2. Net lending/borrowing of the private sector including statistical discrepancy	B9.	10.8	10.4	10.7	11.1	10.1	9.0
3. Net lending/borrowing of general government	B9.	-2.0	-2.0	-2.4	-1.8	-1.5	-1.2

Table 2a. General government budgetary prospects

	ESA code	2015 HUF bn	2015	2016	2017	2018	2019	2020
			per cent of GDP					
Net lending (EDP B.9.) by sub-sector								
1. General government	S.13	-679.7	-2.0	-1.9	-2.4	-1.8	-1.5	-1.2
2. Central government	S.1311	-684.2	-2.0	-2.1	-2.4	-2.1	-1.9	-1.7
3. State government	S.1312	-	-	-	-	-	-	-
4. Local government	S.1313	0.4	0.0	0.0	0.0	0.0	0.0	0.0
5. Social security funds	S.1314	4.1	0.0	0.2	0.1	0.3	0.4	0.5
General government (S.13)								
6. Total revenue	TR	16,417.5	48.7	46.6	46.7	45.9	43.4	41.8
7. Total expenditure	TE	17,097.2	50.7	48.5	49.1	47.7	44.9	43.0
8. Net lending/borrowing	B.9	-679.7	-2.0	-1.9	-2.4	-1.8	-1.5	-1.2
9. Interest expenditure	D.41	1,209.5	3.6	3.2	3.0	2.8	2.5	2.3
10. Primary balance		529.8	1.6	1.2	0.6	1.0	1.0	1.1
11. One-off and other temporary measures[1]		0.0	0.0	0.7	0.0	0.0	0.0	0.0
Selected components of revenues								
12. Total taxes (12=12a+12b+12c)		8,738.1	25.9	25.4	25.3	24.3	24.0	23.6
12a. Taxes on production and imports	D.2	6,393.5	19.0	18.2	18.1	17.8	17.5	17.2
12b. Current taxes on income. wealth, etc.	D.5	2,332.6	6.9	7.2	7.2	6.5	6.4	6.4
12c. Capital taxes	D.91	12.0	0.0	0.0	0.0	0.0	0.0	0.0
13. Social contributions	D.61	4,482.7	13.3	13.4	13.6	13.5	13.3	13.1
14. Property income	D.4	132.6	0.4	0.5	0.4	0.4	0.4	0.3
15. Other		3,064.1	9.1	7.3	7.3	7.8	5.8	4.8
16.=6. Total revenue	TR	16,417.5	48.7	46.6	46.7	45.9	43.4	41.8
Tax burden[2] (D.2+D.5+D.61+D.91-D.995)		13,273.9	39.4	39.0	39.1	37.9	37.4	36.8
Selected components of expenditure								
17. Compensation of employees + intermediate consumption	D.1+P.2	6,004.8	17.8	18.5	18.5	18.2	16.9	15.8
17.a. Compensation of employees	D.1	3,595.2	10.7	11.0	10.8	10.5	10.2	9.7
17.b. Intermediate consumption	P.2	2,409.6	7.1	7.4	7.7	7.6	6.7	6.1
18. Social payments (18=18.a+18.b)		5,190.4	15.4	14.9	14.1	13.5	13.0	12.6
of which: Unemployment benefits[3]		60.1	0.2	0.2	0.2	0.1	0.1	0.1
18.a. Social transfers in kind supplied via market producers	D.6311, D.63121, D.63131	718.8	2.1	2.1	1.9	1.8	1.7	1.6
18.b. Social transfers other than in kind	D.62	4,471.5	13.3	12.8	12.2	11.7	11.3	11.0
19.=9. Interest expenditure	D.41	1,209.5	3.6	3.2	3.0	2.8	2.5	2.3
20. Subsidies	D.3	421.4	1.3	1.3	1.2	1.2	1.1	1.0
21. Gross fixed capital formation	P.51	2,245.3	6.7	5.7	6.2	6.5	6.1	6.5
22. Capital transfers	D.9	913.8	2.7	2.4	2.3	2.2	2.0	1.8
23. Other		1,112.1	3.3	2.6	3.8	3.5	3.2	2.9
24.=7. Total expenditure	TE	17,097.2	50.7	48.5	49.1	47.7	44.9	43.0

Due to rounding the sum data could differ from the sum of the detailed data.
1: A plus sign means deficit-reducing one-off measures.
2: Including revenues collected by the EU
3: Cash benefits of National Employment Fund and financing of certain trainings

Table 2b. No-policy change projections

	2015	2015	2016	2017	2018	2019	2020
	HUF bn	per cent of GDP					
1. Total revenue at unchanged policies	16,417.5	48.7	46.6	46.7	45.9	43.4	41.8

The table contains revenue projections based on measures till 30 April 2016.

Table 2c. Amounts to be excluded from the expenditure benchmark

	2015	2015	2016	2017	2018	2019	2020
	HUF bn	per cent of GDP					
1. Expenditure on EU programmes fully matched by EU funds revenue	1503.0	4.5	2.9	3.0	3.6	1.8	1.0
1.a. of which investment fully matched by EU funds revenue	1281.6	3.8	2.0	2.0	2.4	1.2	0.6
2. Cyclical unemployment benefit expenditure	-13.5	0.0	-0.1	0.0	0.0	0.0	0.0
3. Effects of discretionary revenue measures	0.0	0.0	-0.7	0.2	0.0	0.0	0.0
4. Revenue increases mandated by law							

Table 3. General government debt developments

	ESA code	2015	2016	2017	2018	2019	2020
		per cent of GDP					
1. Gross debt		75.3	74.5	73.6	72.4	68.4	64.6
2. Change in gross debt ratio		-0.9	-0.8	-0.9	-1.1	-4.0	-3.8
Contribution to changes in gross debt							
3. Primary balance		-1.6	-1.2	-0.6	-1.0	-1.0	-1.1
4. Interest expenditure	D.41	3.6	3.2	3.0	2.8	2.5	2.3
5. Stock-flow adjustment		0.8	0.4	0.9	1.4	-1.6	-1.3
Implicit interest rate on debt (%)		4.8	4.3	4.1	3.9	3.7	3.6

Table 4. Cyclical developments

	ESA code	2015	2016	2017	2018	2019	2020
		per cent of GDP					
1. Real GDP growth (%. at constant prices)		2.9	2.5	3.1	3.4	3.1	3.2
2. Net lending of general government	B.9	-2.0	-1.9	-2.4	-1.8	-1.5	-1.2
3. Interest expenditure	D.41	3.6	3.2	3.0	2.8	2.5	2.3
4. One-off and other temporary measures[1]		0.0	0.7	0.0	0.0	0.0	0.0
5. Potential GDP (%)		2.0	2.4	2.7	2.9	3.0	3.0
contributions: - labour		1.2	1.6	1.5	1.4	1.3	1.1
- capital		0.7	0.6	0.8	1.1	1.1	1.2
- total factor productivity (TFP)		0.1	0.2	0.4	0.4	0.6	0.7
6. Output gap		-1.2	-1.0	-0.6	-0.1	-0.1	0.1
7. Cyclical budgetary component		-0.6	-0.5	-0.3	-0.1	0.0	0.0
8. Cyclically-adjusted balance (2-7)		-1.3	-1.5	-2.1	-1.7	-1.5	-1.2
9. Cyclically-adjusted primary balance (8+3)		2.1	1.7	0.9	1.0	1.1	1.1
10. Structural balance (8-4)		-1.4	-2.1	-2.1	-1.7	-1.5	-1.2

Due to rounding the sum data could differ from the sum of the detailed data.
1: a plus sign means one-off item improving the EDP balance.

Table 5. Divergence from previous update

	ESA code	2015	2016	2017	2018	2019	2020
Real GDP growth (%)							
1. April 2015 Convergence Programme		3.1	2.5	3.1	2.9	-	-
2. April 2016 Convergence Programme		2.9	2.5	3.1	3.4	3.1	3.2
3. Difference		-0.2	0.0	0.0	0.5	-	-
General government net lending (per cent of GDP)							
1. April 2015 Convergence Programme	EDP B.9	-2.4	-2.0	-1.7	-1.6	-	
2. April 2016 Convergence Programme	B.9	-2.0	-1.9	-2.4	-1.8	-1.5	-1.2
3. Difference		0.4	0.1	-0.7	-0.2	-	-
General government gross debt (per cent of GDP)							
1. April 2015 Convergence Programme		74.9	73.9	71.3	68.9	-	-
2. April 2016 Convergence Programme		75.3	74.5	73.6	72.4	68.4	64.6
3. Difference		0.4	0.6	2.4	3.6	-	-

Table 6. Long-term sustainability of public finances[1]

	2013	2020	2030	2040	2050	2060
	per cent of GDP					
Pension expenditure	11.5	9.8	8.9	9.6	10.7	11.4
Old-age and early pensions	9.1	7.9	7.2	8.0	8.9	9.7
Other pensions (disability, survivors)	2.3	1.8	1.7	1.6	1.7	1.7
Health care, education and other age-related expenditure	9.3	8.9	9.1	9.5	9.9	10.2
Health care expenditures	4.7	4.8	5.1	5.3	5.4	5.4
Long-term care expenditures	0.8	0.8	0.8	0.9	1.1	1.2
Education expenditures	3.6	3.1	3.0	3.1	3.2	3.4
Other age-related expenditures	0.3	0.2	0.2	0.2	0.2	0.2
Pension contribution revenue	10.5	10.5	10.4	10.2	10.2	10.2
Assumptions						
Labour productivity growth	0.3	1.4	2.2	2.1	1.9	1.5
Real GDP growth	0.4	1.9	2.0	1.2	1.4	1.0
Participation rate, males (20-64)	77.1	82.6	84.7	84.3	84.4	84.5
Participation rate, females (20-64)	63.3	72.3	75.2	74.6	74.8	74.7
Total participation rate (20-64)	70.1	77.4	79.9	79.5	79.7	79.6
Unemployment rate	10.0	8.4	7.4	7.3	7.3	7.3
Population aged 65 + over / total population	14.0	17.0	23.0	25.0	25.0	23.0

[1]: Ageing Report 2015

Table 6a. Contingent liabilities

per cent of GDP	2015
Public guarantees	9.2

Table 7. Basic assumptions

	2015	2016	2017	2018	2019	2020
Hungary: Short-term interest rate (annual average)	1.1	1.2	1.6	1.8	2.0	2.1
Hungary: Long-term interest rate (annual average)	3.4	3.8	4.4	4.5	4.6	4.7
HUF/EUR	309.9	312.0	312.0	312.0	312.0	312.0
World excluding EU, GDP growth	3.4	3.5	4.0	4.1	4.3	4.3
EU28 GDP growth	1.9	1.9	2.0	2.0	2.0	2.0
Growth of relevant foreign markets	4.8	4.7	5.4	5.4	5.4	5.4
World import volumes, excluding EU	2.1	2.7	3.5	3.9	4.1	4.2
Oil prices (Brent, USD/barrel)	53.6	39.6	42.6	46.3	48.8	50.7

Table 8. Impact of refugee crisis on the headline balance – – breakdown by functional categories

	2014	2015	2016
		HUF bn	
1. Initial reception costs	2.4	6.9	7.3
2. Transport (including rescue operations)	0.0	2.4	0.1
3. Health-care	0.1	0.2	0.1
4. Administrative costs (incl. processing applications for asylum)	0.3	1.0	0.9
5. Contributions to Turkey Facility (excluding through EU Budget)	0.0	0.0	0.0
6. Other costs and measures	0.1	38.5	41.8
Judiciary activity	0.0	0.5	0.5
Communication	0.0	0.5	0.8
Other additional administrative expenditure	0.0	0.0	0.0
Border control	0.1	20.6	23.8
Temporary security barrier	0.0	16.9	16.5
International assistance	0.0	0.0	0.2
7. Total impact on headline deficit (7) = Σ(1..6)	**2.9**	**49.0**	**50.2**

Table 9. Impact of refugee crisis on the headline balance – – breakdown by ESA categories

	ESA-code	2014	2015	2016
			HUF bn	
1. Compensation of employees	D.1	0.8	14.8	6.1
2. Intermediate consumption	P.2	1.5	14.4	12.7
3. Social payments	D.62, D.63	0.2	0.3	0.3
4. Subsidies	D.3	0.0	0.0	0.0
5. Gross fixed capital formation	P.51	0.2	6.6	19.9
6. Capital transfers	D.9	0.0	0.0	0.1
7. Other	D.7	0.2	12.9	11.1
8. Total impact on headline deficit (8) = Σ(1..7)		**2.9**	**49.0**	**50.2**
9. Compensation from EU		-	-	-
10. Total impact on headline deficit net of EU contributions (10) = (8) - (9)		**2.9**	**49.0**	**50.2**
11. Total impact on headline deficit net of EU contributions (per cent of GDP)		**0.0**	**0.1**	**0.1**

Table 10. Additional country-specific information on costs

	2014	2015	2016
		persons	
1. Arrivals (total no of persons, incl. transiting refugees)	42,777	177,135	12,994
2. Arrivals who are transiting refugees	22,024	149,091	5,934
3. First time applicants	41,301	174,434	12,517
4. Positive decisions	483	508	197