GOVERNMENT OF HUNGARY

CONVERGENCE PROGRAMME

OF HUNGARY

2015 – 2018

April 2015

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1. Economic policy objectives

In 2010 the Government implemented a radical turnaround in economic policy in order to stabilising financial situation of Hungary and setting it on a catching-up growth path. In the period before 2010 the Hungarian economy accumulated significant private and public debts – mainly in foreign currency – which constrained growth and led to significant vulnerability. At the beginning of the 2010s both the legacy of the former years and the debt crisis in the euro area created a difficult initial condition to restart of the economy. In this challenging environment the Government had to rectify public finances, set public debt on a downward path and implement the necessary reforms that had not been undertaken up to that point.

In the spring of 2015 the Convergence Programme can already present favourable developments. Last year GDP grew by 3.6%, which was the second highest growth rate in the European Union. Employment reached record high levels not experienced for decades: at the end of 2014 the number of persons employed was above 4 million, while participation and unemployment indicators are also improving continuously. The debt-to-GDP ratio is reduced year by year, and the budgetary deficit has been sustainably and significantly below 3% for years. The country's external financing capacity has become positive, and presently the surplus is above 8% of GDP. All the above developments contributed to reducing the vulnerability of the country and strengthening confidence in Hungarian economic policy. The latter is indicated by the low interest rate environment and by that international institutions and market analysts are continuously revising their growth projections upwards.

Due to dynamic growth, the output of the Hungarian economy reached pre-crisis levels at the end of last year. The structure of growth has become healthier and more balanced; besides exports the contribution of domestic demand has increased since 2014. The record expansion of investment must be emphasised, which outstandingly contributed to growth in 2014 and continue to strengthen the potential growth for the future. The increase in consumption was supported by the improving income situation of the households, which is related to the fact that an increasing number of people have the opportunity to work, wages are increasing, inflation is low and the conditions of access to credit have improved because of the declining interest rates. The income situation of the households is also supported by the fact that due to the conversion of foreign currency denominated loans into forints and the settlement of unfair additional burdens households have got rid of the risks deriving from foreign currency loans. Furthermore, wage developments linked to the career models introduced in the government sector may also promote consumption.

In 2015 economic growth will remain high, which will have a favourable effect on the labour market, and via the expansion of income it will also increase consumption. Further expansion of investment can be expected, due to the increased absorption of EU funds, the loan programmes supporting SMEs and the low yield environment. One of the main factors of growth is that significant production capacities have evolved, especially in the automotive industry, where significant companies operating on the global market have created manufacturing capacities and jobs. Also, growth in the following years will be ensured by the continuous improvement of the balance indicators, the results of the growth-enhancing reforms implemented in the preceding years, and the firmly low budgetary deficit. Over the period of the Convergence Programme GDP will grow vigorously, which will contribute to Hungary's rapid catching up with the average level of development in the EU.

Another significant achievement of Hungarian economy is that thanks to the measures implemented on the labour market, by the end of 2014 the employment rate rose to record high levels. On the one hand, by reforming the tax system, the Government provided incentives for creating more jobs, while on the other hand it enabled that people who can and want to work do enter the labour market. This purpose was served by the significant reduction of taxes on labour, the preferential social-security contributions available for disadvantaged groups on the labour market within the framework of the Job Protection Action Plan, raising the effective retirement age as a result of the pension reforms, and changes in unemployment benefit system. The Government modified the social subsidy system along the principles that more people be motivated to undertake jobs and more people do have the opportunity to work. The extended public work schemes play a central role in this. At the same time, in 2014 about two-thirds of all new jobs were created by the private sector.

Last year the Government also took several measures in order to set the Hungarian economy on a sustainable growth path and to reduce its vulnerability. The measures that need to be highlighted involve the agreement concluded with the EBRD to improve the performance of the banking system and the final settlement of the situation of households with foreign currency loans. Hungarian economy has carried the burdens of retail foreign currency denominated loans since 2008. The loans mainly denominated in Swiss francs imposed increasing burdens on households and also deteriorated the quality of the banking system's balance sheet, while representing an overall social problem due to their size. The Government started early to deal with the problem, in 2011, but due to the complexity of the problem and the clarification of the related legal issues, it took a long time to handle. Finally, at the end of 2014 a final settlement of the problem was reached, and foreign currency denominated loans were converted into Hungarian forints, which took a great burden off the shoulders of both the households and the banking system. In the interest of an efficiently operating and actively lending banking system which can promotes the growth potential of the Hungarian economy, the Government, on the basis of the agreement concluded with the EBRD, committed to reduce the bank levy gradually and significantly. This is to considerably improve the banking system's prospects of lending and profitability.

Further important changes took place in the field of taxation. The Government still considers the reduction of taxes on labour as a priority. In the scope of this, personal income tax will be reduced, tax allowances for families with two children will be increased, and the benefits offered by the Job Protection Action Plan can be used by further groups of employees. Furthermore, the VAT-rate on a group of food products is reduced. All the above is expected to give another boost to increasing employment and the income of households. Business environment and the predictability of budget revenues are supported by measures aimed at the whitening of the economy, which improve tax compliance by reducing tax avoidance opportunities. The tax authority is becoming more client friendly, which is indicated by taking off the administrative burdens of submitting tax returns from the taxpayers, it distinguishes bad and good taxpayers, and it reduces fines due to errors. In recent years, the introduction of online cash registers connected to the tax authority proved to be a successful initiative. Based on the reforms, further measures have been introduced, such as the Electronic Trade and Transport Control System, or the extension of the use of online cash registers to further area in service sector.

Stability is strengthened by a budget deficit permanently below 3% in recent years, and reducing it further continuously. An important result is that due to budgetary discipline, the excessive deficit procedure launched at EU accession was abrogated in the summer of 2013. Last year's deficit-to-GDP ratio was 2.6%, more favourable than the 2.9% deficit target. The achievement of the 2.4% deficit target planned in 2015 is ensured by the growth prospects being more favourable than expected. The deficit targets determined by the Government for the years between 2016 and 2018 are 2.0%, 1.7% and 1.6%, respectively, which complies with the rules laid down in the fiscal framework and envisages a reduction in the debt ratio at a satisfactory pace. In 2016 the Government will use the room for manoeuvre created by the additional revenues deriving from growth, the low yield environment, the results of the structural reforms of the Széll Kálmán Plan and the lower domestic co-financing expenditure partly for reducing taxes and partly for reducing the deficit. Besides the continuously declining deficit due to budgetary discipline, the accelerating growth also perceivably contributes to the continued reduction of the debt-to-GDP ratio, so in 2018, based on the Convergence Programme, the debt ratio will decrease to below 70%. In addition, the Government finds it important to change the structure of public debt. On the one hand, it tries to reduce the country's exposure to external influences and broaden the investor base by encouraging domestic involvement in debt financing, while on the other hand the Government seeks to continue to reduce the foreign currency proportion of the debt. The reduction of the foreign exchange rate risk of the public debt results in lower vulnerability, and the future debt burden can be planned more reliably.

Besides the favourable macroeconomic and budgetary developments, the long-term sustainability of public finances is also exceptionally good when compared to other Member States of the EU. This is due first of all to the pension reforms implemented in recent years, the reduction of the debt ratio and the improving demographic developments. Furthermore, parallel to the accelerating growth, the potential growth rate is also gradually increasing. This is supported by the spectacularly improving situation of the labour market, the capacity expansions of foreign manufacturers representing cutting-edge technologies, which also facilitate the improvement of the technical standard of domestic suppliers. The prospects are further improved by measures taken in order to restore the profitable and healthy operation of the banking system and the function of the financial intermediary system supporting economic growth.

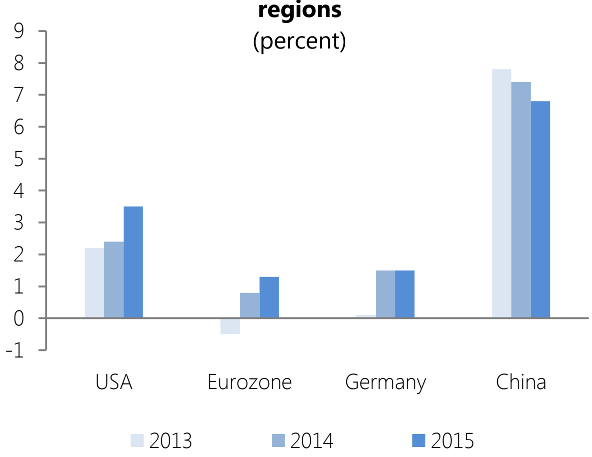
Overall, it can be established that by 2015 the Hungarian economy has reached a balanced position with strong macroeconomic indicators. The fiscal path and the structural measures presented in the programme support the further improvement of macroeconomic fundamentals and the sustainability of the growth results.

2. MACROECONOMIC DEVELOPMENTS AND OUTLOOK

2.1. GLOBAL DEVELOPMENTS

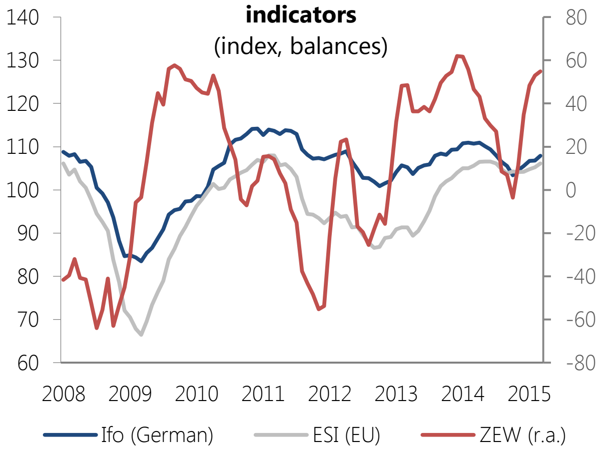
Overall, in the past quarters global economic prospects improved, but there are still significant differences between the performance of individual countries. The growth of the world economy is further on powered by the USA, the economy of which expanded dynamically last year thanks to improving labour market processes and rising domestic demand. This year's prospects for the US economy are also favourable, although this may be slightly restrained by the appreciation of the US dollar. The countries of Asia also did well in 2014, but the growth dynamics show a slowdown. The intensive investment activity observed in Chinese economy in the recent period bears significant risks, as well as the excessive expansion of the stock of loans (Chart 2.1.).

Chart 2.1: GDP growth in the main regions
(percent)



Source: European Commission, IMF

Chart 2.2: Eurpoean economic sentiment indicators
(index, balances)



Source: Cesifo, European Commission, ZEW

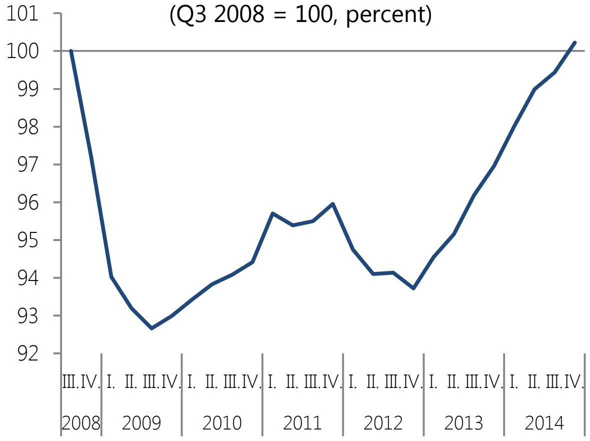
The growth of the euro area is still subdued, while the performance of Germany was more favourable than expected in the last quarter of 2014, due to increasing investments and the growth in private consumption. Although the currency area, which plays a decisive role from the aspect of Hungarian economy, still struggles with structural problems, high debt and unemployment rates, the prospects improved in the recent quarters overall, which is also demonstrated by the improving confidence indexes (Chart 2.2.). In the following period the performance of the economies of the European Union may be encouraged by the low oil price level on the one hand, while on the other hand, although earlier the strong euro hindered growth, the current weakening of the common currency may improve the competitiveness of European enterprises. Finally, European economy may be stimulated by the bond purchase programme launched by the European Central Bank (ECB) on 9 March 2015. In the scope of this, the ECB purchases bonds of a value of EUR 60 billion every month, counterbalancing by this the effects caused by the completion of the Fed's quantitative easing, which lasted for nearly six years, and by the approaching increase of the US base rate. So on the whole, there will still be ample liquidity on the European financial markets, which, according to our expectations, may lead to a further decline in government bond yields or at least to their stabilisation at a low level. At the same time, geopolitical tensions continue to carry risks (possible escalation of the Russian-Ukrainian conflict, the Islamic State), as well as the financing problems of Greece within the euro area.

2.2. COMPONENTS OF GROWTH

Hungary presented outstanding economic performance in 2014, the rate of growth accelerated to 3.6%. With this result Hungary came second in the European Union and first among the Visegrad countries. It is also worth pointing out that due to this high growth rate the economy reached pre-crisis levels (chart 2.3.). As a result of the growth lasting for two years now, Hungary converges again towards the EU's average level of development (chart 2.4.).

Chart 2.3: Hungarian GDP growth taking 2008 as a reference period *

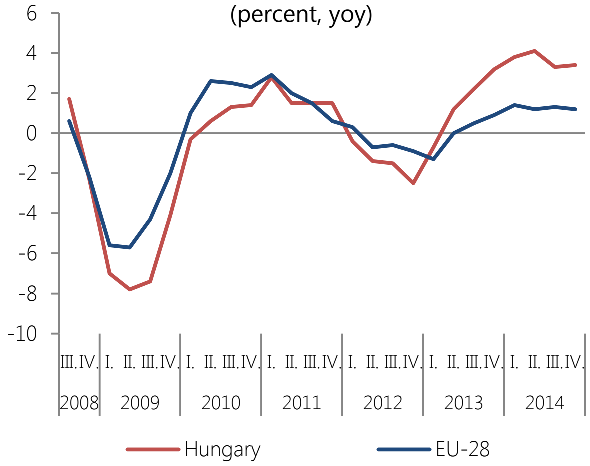
(Q3 2008 = 100, percent)



Source: HCSO, MfNE calculations

Chart 2.4: GDP growth in Hungary and in the EU

(percent, yoy)



Source: HCSO, MfNE calculations

** During the crisis, the GDP volume decreased on a quarterly base first in the third quarter of 2008, so this point in time was regarded as the reference base.*

Since 2013 Hungarian economy has been progressing towards a healthier and more balanced growth structure. Actual data show that by now this positive tendency has become permanent and sustainable in the long term. It is important to emphasise that the growth well above 3% was achieved such a way that the balance indicators were also favourable, which means that the growth did not derive from indebtedness. Last year the balance of payments reached a massive surplus, and the general government deficit remained significantly below 3%. Furthermore, the external vulnerability of the country was reduced by the settlement of the foreign currency denominated loans of the households, and by the fact that Hungarian economy is now financed increasingly more from domestic sources.

In line with the improvement of the balanced position, growth is now resting on multiple pillars. While till 2013 GDP on the expenditure side was typically and mainly driven by exports, by now the role of investments and consumption has also become dominant. The strengthening of investment dynamics was facilitated, inter alia, by the EU transfers, the funding programs supporting the SME sector and by the low yield environment, while the expansion of consumption was driven by that real incomes increased due to the reduction of prices and to the favourable labour market processes. Despite the excellent export dynamics, due to the import increasing as a result of recovering domestic demand, the net export volume was lower than in the years before.

In 2014 growth showed a stable structure on the production side of GDP, as well. It was the producer branches (primary and secondary sectors) again that contributed to economic performance the most. Despite the high reference period, the output of agriculture increased by about 13%, of which a significant expansion could be observed in plant production and livestock farming. Industrial production increased by 5.3% due to, inter alia, automobile industry developments and the expansion of the supplier industries. This can be explained partly by that despite weak European growth, the external demand of the automobile sector remained high. As a result of the outstanding investment dynamics, and especially infrastructure developments, construction output expanded by nearly 14%. Among the services, tourism and retail sales presented outstanding performance in line with the accelerating growth of domestic demand, and the financial sector also improved.

Box 1: Hungarian growth on the income side

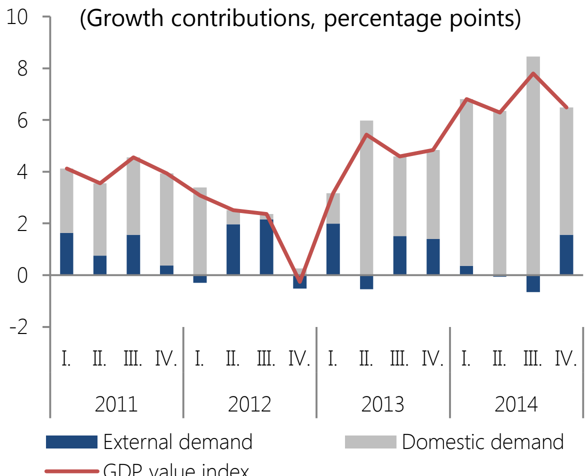
Usually, GDP growth is analysed on the basis of the expenditure and production side. Thus, the third approach to GDP, the so-called income approach, is analysed much less in practice. This approach is especially important, because it gives us a better understanding of the behaviour of the corporate sector.

Changes of GDP on the income side indicates the revenue of individual economic agents gained from production factors (capital, labour force); i.e. the relationship between profit and labour costs. In the case of the corporation sector this approach shows that the profitability of companies can improve, if their production output increases and/or their labour costs decrease. In national accounts profit is an indicator similar to operating profit or loss, but there are several differences between these items, for example: the former one also contains consumption of fixed capital. Wage costs include gross wages and salaries. Theoretically speaking, certain further tax items - e.g. VAT, financial transaction tax, employers' social security contributions – are also parts of GDP.

In the recent period the structure of Hungarian growth became balanced on the production and expenditure side (charts 2.5. and 2.6.), and also on the income side (chart 2.7.). The latter is demonstrated by that the distribution of capital and labour income is relatively stable, which is in line with international comparisons.

Chart 2.5: Decompositon of GDP growth at current prices, expenditure side *

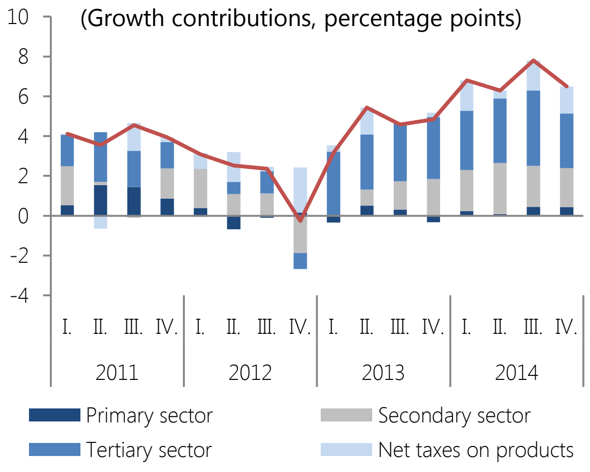
(Growth contributions, percentage points)



Source: HCSO, MfNE calculations

Chart 2.6: Decompositon of GDP growth at current prices, production side *

(Growth contributions, percentage points)



Source: HCSO, MfNE calculations

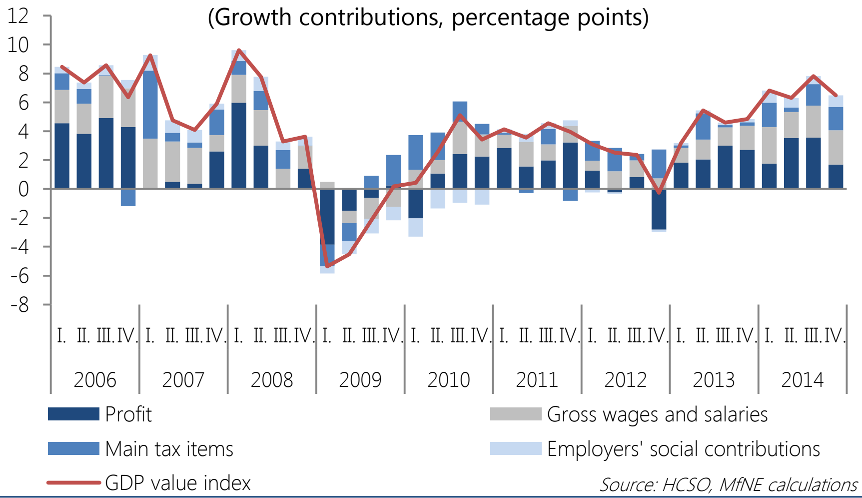
** As on the income side there are no available volume data measured at constant prices, the changes of GDP at current prices was broken down on all three sides.*

During the crisis - in line with the model calculations - the distribution of the production factors shifted only temporarily. First, profitability deteriorated in the recession environment, i.e. the ratio of capital incomes declined. Employers responded to this shock a few quarters later by labour market adjustments, so as a result of the lay-offs the labour to income ratio also declined. However, in line with emerging from the crisis, profitability improved again, which resulted in an increase in labour demand a few quarters later. Corporations responded to the continuous recovery of domestic demand by increasing their production capacities, and the improvement of the growth prospects was followed by an increase of both capital and labour to income ratios. The positive labour market trend is demonstrated by the significant increase of gross wages and the number of people employed in 2014, which was also substantially supported by the private sector. The relatively higher share of taxes can also be explained partly by the recovery of domestic demand.

It is important to point out that the distribution of the individual income items is not completely constant, as the income structure is significantly influenced by the changes of the prices of production factors, i.e. real wages and real yields. And these cost items do not necessarily change at the same rate. From this it also follows that the role of taxation is also relevant: the increase of labour share is supported by the reduction of taxes levied on labour, while the future reduction of the bank tax will improve profitability. In the short term, technical factors (seasonality, lagged adjustment) also partly explain the differences. It should also be taken into account that the distribution of factor incomes is not the same when broken down by branches, either. In the recent past, an improvement in profitability could be observed first of all in the industrial and in certain service branches, while the increasing share of wages can be illustrated in numerous sectors.

Chart 2.7: Decompositon of GDP growth at current prices, income side *

(Growth contributions, percentage points)



Source: HCSO, MfNE calculations

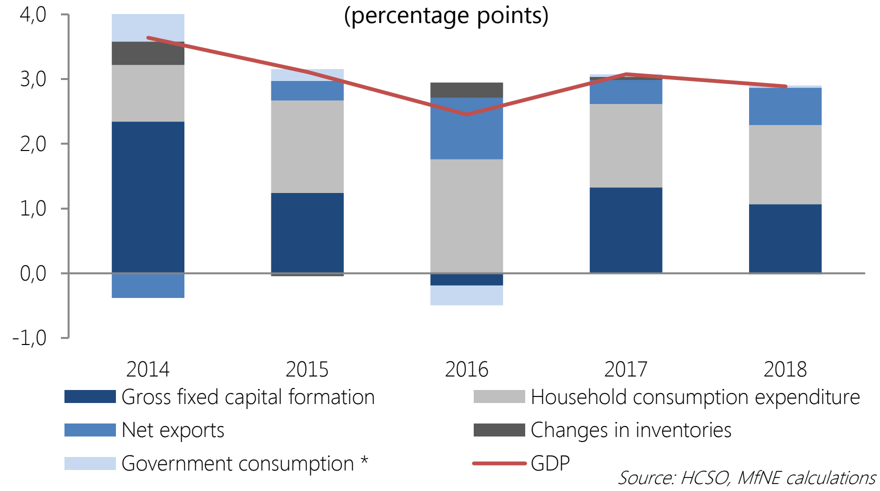
Note: Profit refers to the gross operating surplus, while main tax items refer to net taxes on products and production.

Overall, the analysis of GDP on the income side also confirms that the structure of growth is balanced in Hungary, which also supports future outlook. Primarily this is due to the fact that in a wide variety of branches the compensation of employees and profitability increased. The favourable trend is supported by the fact that in line with the recovery of domestic demand, corporations produce more output, which improves profitability and also generates additional labour demand. This means that the corporations, the households and the general government all benefit from the growth of the Hungarian economy and from the incomes generated additionally.

As compared to the autumn 2014 projection (2.5%), this year the performance of the Hungarian economy may increase at a significantly faster pace, by 3.1%. The revision of the projection is based first of all on last year's actual data, which were significantly more favourable than expected, and the high carry-over effect related to this. When preparing the projections, both positive effects and negative risks were taken into consideration, and the former ones are more dominant altogether. Further growth in the consumption of households is driven by low oil prices, the low inflationary environment, the favourable labour market trends and the settlement of foreign currency denominated loans. Following last year's record performance, this year investments may continue to expand, which is due to the increased withdrawal of EU funds, the loan programmes supporting SMEs and the favourable yield environment. The quantitative easing by the ECB may improve the prospects for exports. At the same time, the dynamics of government consumption may remain moderate, in line with the tight fiscal constraints. The possible escalation of geopolitical tensions and the recurrence of the debt crisis in the euro area can be identified as risks (chart 2.8.).

Chart 2.8: GDP growth and contributions by expenditure components

(percentage points)



Source: HCSO, MfNE calculations

** Together with the social benefits in kind provided by the non-profit sector supporting households.*

In 2016, the expected slowdown of growth will be caused by the natural cyclic nature of EU transfers. This is due to the fact that while this year funds provided both in the previous programming period of 2007-2013 and in the new programming period starting in 2014 can be used, next year only the transfers granted in the new cycle can be withdrawn. Because of this, in 2016 the volume of investments may be below the level observed in 2015. Despite this a higher growth rate can be projected compared to earlier expectations. The substantially improving outlook, together with the tax reductions and tax allowances (first of all the reduction of personal income tax, bank tax, VAT rate of pork products, and increasing family tax allowances) result in a higher income position of households and enterprises, supporting the further recovery of domestic demand. Following the fade-out of the one-off effect (resulting from the cyclic nature of EU transfers), from 2017 the GDP growth will return to a rate around 3%.

Table 2.1.: GDP components (annual growth, %)

	2014	2015	2016	2017	2018
GDP	**3.6**	**3.1**	**2.5**	**3.1**	**2.9**
Consumption expenditure of households	1.7	2.9	3.6	2.7	2.5
Social benefits in kind	0.8	0.3	-0.1	0.1	0.1
Collective consumption	3.4	1.5	-3.0	0.3	0.2
Gross fixed capital formation	11.7	5.8	-0.9	6.4	5.1
Exports	8.7	7.5	7.4	7.1	7.0
Imports	10.0	7.7	7.1	7.5	7.1

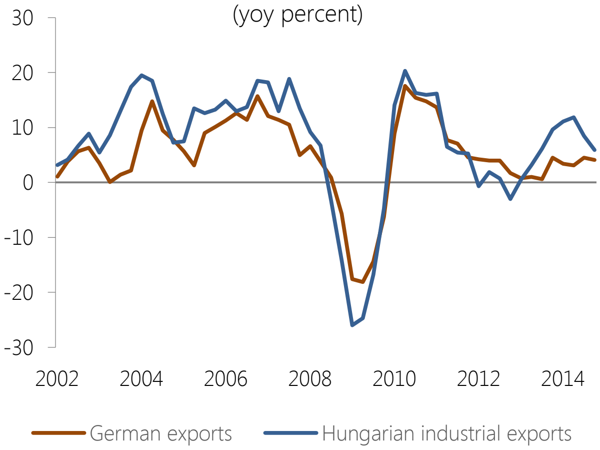
Source: HCSO, MfNE calculations

2.2.1. EXTERNAL TRADE

Despite the overall weak performance of our external markets, Hungary's foreign trade turnover developed favourably in 2014. Demand remained high in the automobile industry, which boosted domestic vehicle manufacturing significantly, while the negative effects of the Russian embargo on the export of Hungarian food products could hardly be detected in the total export growth (Chart 2.9.). Besides trade, the export of services also developed favourably, in which the expansion of tourism played an important role. Last year tourism increased by more than 10% and reached record levels, which was due to the continuously improving touristic offers and the depreciating exchange rate.

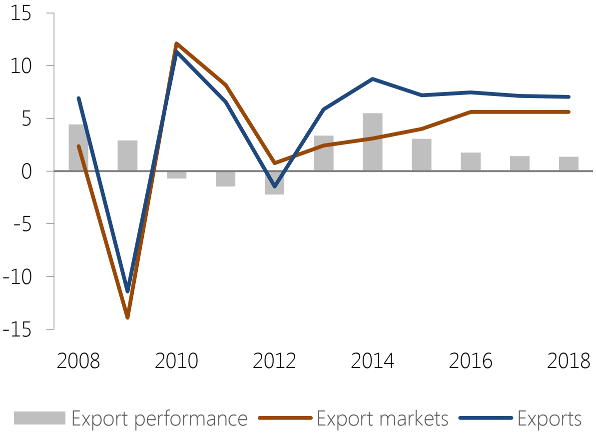
At the same time, in line with the excellent export processes, imports significantly increased in 2014, in which the soaring of investments all through the year played a dominant role. Although overall net exports showed a slight decrease, Hungary's external trade surplus amounted to EUR 6.4 billion. This was also due to terms of trade improvements, since the price level of exports denominated in HUF has also elevated because of the increasing share of higher value added products.

Chart 2.9.: German exports and Hungarian industrial export sales
(yoy percent)



Source: Eurostat, HCSO

Chart 2.10: Hungarian exports
(yoy percent)



Source: HCSO, MfNE calculations

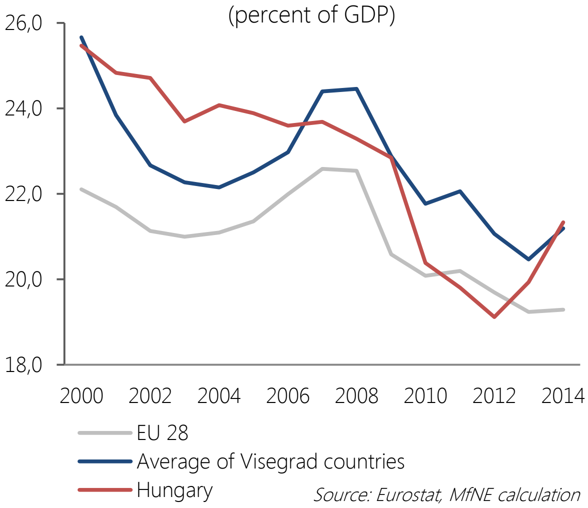
Despite the risks related to the international environment, Hungary's external demand may increase this year, supporting Hungary's export opportunities (Chart 2.10.). At the same time it is important to emphasise that although nearly three-quarters of Hungarian export flows to the European Union, a significant part of it is sold in countries beyond the EU, in the form of re-export. This slightly reduces Hungary's direct exposure to the business cycles of the euro area. Consequently, it can be expected that the favourable foreign trade processes will persist next year, which is supported by several factors. On the one hand, the economic outlook in the euro area including Germany, the main foreign trade partner of Hungary, improved in the past period. On the other hand, capacity building in the automobile industry and the increase in the related supplier network project further expansion of industrial production and exports. This expectation is also justified by the permanently high stock of manufacturing export orders. In the following years Hungarian export will be further supported by the financing programmes for the SME sector, which help an increasing number of small and medium-sized Hungarian enterprises to appear on foreign markets.

In line with accelerating domestic demand and the impressive performance of exports, the volume of imports may increase again in the following period because of the rising import demand of expenditure side items. At the same time, in 2015, mainly due to the recovery of external demand, net exports may make a positive contribution to increase again. Partly due to this and partly due to the improved terms of trade (which mainly derive from the low oil price level), the external trade surplus may continue to grow. In 2016, due to the specific cycle of EU transfers, the volume of investments and imports may show a slight increase, so besides permanently high exports, net exports may increase significantly, and their contribution to growth may remain positive in the following years too.

2.2.2. INVESTMENT

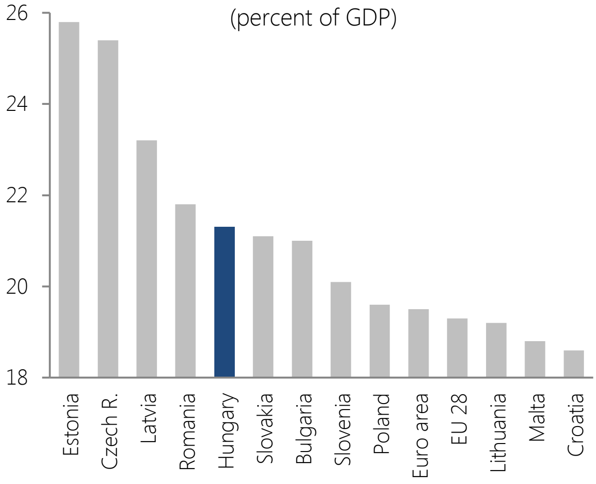
Following the turn in investments in 2013, since 2014 developments of a total value of over HUF 5 200 billion have been realised in the economy. As a result of this, investments increased at a record rate by 14% and contributed to the 3.6% economic growth by 2.3 percentage points. As a result of the favourable processes, Hungary's investment rate reached 21.3% of GDP, which was above the average ratio observed both in the European Union and in the Visegrad countries. Within this, the investment rate of enterprises increased markedly, and at the same time in the household sector a positive turn was experienced as well after the drastic decrease since 2009. Furthermore, as a result of the accelerating absorption of EU funds, the general government investment rate rose to 5.2%.

Chart 2.11: Investment rate of Hungary in international comparison
(percent of GDP)



Source: Eurostat, MfNE calculation

Chart 2.12: Investment rate in 2014 in countries that joined the EU since 2004
(percent of GDP)



Source: Eurostat

Last year's massive increase in investments was not simply due to the outstanding performance of a few sectors, as significant expansion was recorded in 17 out of the 19 sectors. It is due to the combined effect of numerous factors, such as continuously implemented investments and capacity expansions in the manufacturing industry, the targeted and efficient absorption of EU funds, loan programmes supporting developments made by SMEs, and the permanently low interest rate environment.

Primarily due to the developments made by the automotive supplier sectors, the investments of the manufacturing industry, representing one-third of general investments, increased by 12.7% in 2014. This is important, because through the increase of the production sector performance the new capacities will provide a stable foundation for economic growth in the forthcoming period. It is especially favourable that the successful large investments made by Audi, Mercedes, Opel and Suzuki, some of the key players in the automotive industry, may have an incentive effect on the capacity expansions of significant suppliers such as Alpine, Apollo Tyres, Autoliv, Bridgestone, Denso, Hankook, Harman, Michelin or Takata. As a result of this it can be stated that 15 out of the 20 largest first-round automotive suppliers of the world now have substantial production capacities in Hungary too. It is essential that an increasing number of domestic automotive SMEs are joining the production of large international enterprises.

The data of the Hungarian Investment Promotion Agency (HIPA) also demonstrate further strengthening of Hungary's ability to attract capital. In 2014 the HIPA participated in launching 60 new investment projects involving a total amount of EUR 1.6 billion. The investments handled by them indicate a two-way strengthening of investor confidence, as among the enterprises announcing new developments, those showing confidence in Hungary for the first time as well as enterprises already operating in Hungary are represented by nearly equivalent proportions. The HIPA currently handles more than 100 - mostly automotive - projects, through which, in the case of a positive decision, investments amounting to a total of EUR 2.5 billion may arrive to Hungary in the next period. As a result of the above, on the forecast horizon the automotive industry and its supplier network are expected to be the most important driving forces of investments. This trend is further confirmed by the rising trend of the capacity utilization in the manufacturing industry which reflects future investments of the corporate sector.

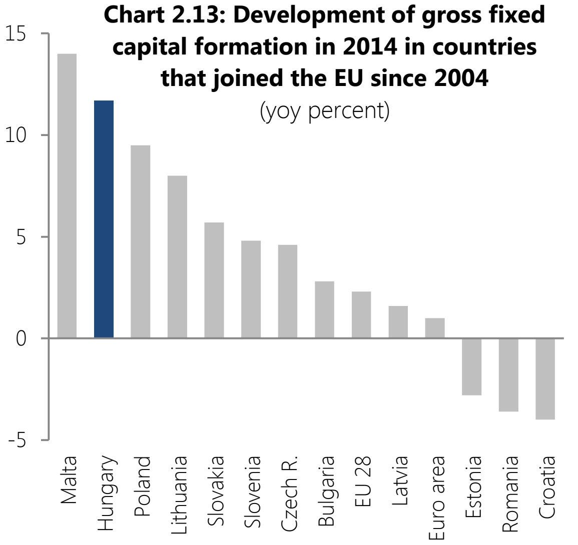


Chart 2.13: Development of gross fixed capital formation in 2014 in countries that joined the EU since 2004
(yoy percent)

Source: Eurostat

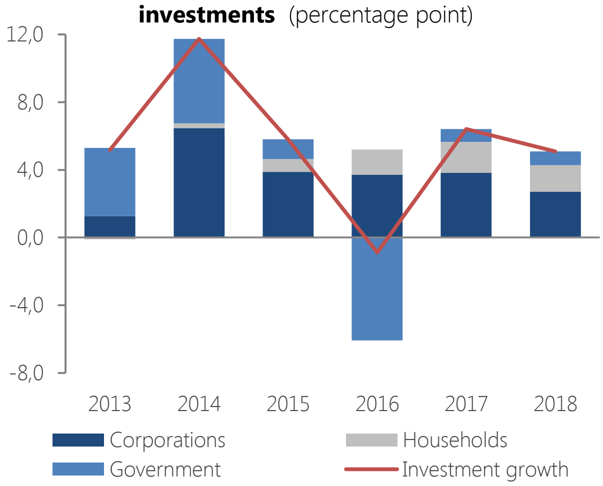


Chart 2.14: Contribution of sectors to the development of gross fixed investments (percentage point)

Source: MfNE calculation, HCSO

Although enterprises are facing only gradually easing credit conditions, in 2015 the investment activity of SMEs is encouraged partly by the Funding for Growth Scheme (FGS), the budget of which has been expanded to HUF 1 000 billion, and partly by the Funding for Growth Scheme Plus (FGS+), which mainly target medium-risk SMEs. As in the interest of the implementation and financial viability of the time-consuming investments the National Bank of Hungary postponed the deadline available for withdrawing the disbursed loans until the end of the following year, the positive impact of the schemes on real economy will be probably felt during 2016 too. In connection with this it is especially important that 90% of the currently accessible budget of the FGS can be applied for the placement of new loans, which can be used for investment and for the financing of current assets, while in the case of FGS+ at least 70% of the loan taken up by an enterprise must be an investment loan.

Furthermore, the dynamic growth of corporate investments is also supported by the funds arriving from the new seven-year EU programming period of 2014-2020, as based on the commitment made by the Government, 60% of the EU funds available between 2014 and 2020 must be used directly for economic development, and the remaining 40% must be allocated between the target areas of HR development, infrastructure development, environmental protection and energy efficiency. It is of outstanding importance that in Hungary the EU transfer per capita has never been as high as in the currently started new programming period. A considerable increase of corporate investments realised from the new EU transfers can be expected from 2017, in line with the progressing of the disbursements.

In 2014 too, the development of public investments was determined by the accelerated use of the funds provided during the already completed 2007-2013 EU programming period, as these funds can still be withdrawn in 2014 and 2015. The large-scale infrastructure investments realised from EU funds supplied construction enterprises with continuous orders on the one hand, and strengthened the country's capital attracting ability on the other hand. The continuous infrastructure developments are also indicated by the data, as in 2014 the investment performance of the transport and storage sector increased outstandingly, by 28%.

The absorption of EU funds may continue to increase in 2015 and exceed last year's record amount of HUF 2,2000 billion. As a result of this, further public developments involving significant amounts are expected to be realised in economy. In 2016 a temporary loss in the dynamics of investments can be expected, as next year exclusively the funds of the new seven-year cycle can be withdrawn, which will result in a significant decrease of EU transfer compared to 2015. This temporary setback will be corrected in 2017, which will also contribute to a more intensive increase in the withdrawal of funds - also due to phased projects - in the case of the new operative programmes of the period between 2014-2020, as compared to the payment rate observed in the former seven-year cycle.

The contraction on the housing market lasting since 2009 ended in 2014, as the number of housing constructions increased by 15% and the number of building permits issued rose by 28%. The outstanding increase in the number of building permits is essential, because it projects the housing constructions that will take place in the following period. Furthermore, the estimates made by real estate agencies also confirm that last year the real estate market returned to an increasing trend, and 2014 was the first year following the crisis, when the number of housing sales could rise above 100 thousand. On the one hand this is due to the fact that housing purchases delayed in the past years are starting to appear on the market, while on the other hand the low interest rate environment and the increasing real wages also encourage the investment decisions of households. Starting from the second half of 2015, the recovering housing market will get a boost from the introduction of non-refundable grants, which can also be used for purchasing second hand housing within the frames of the Family Housing Allowance.

Due to the above, following last year's record increase, investments can be expected to expand by a further 5.8% in 2015. Furthermore, on the forecast horizon, first of all as a result of the private sector's investment activity, Hungary's investment rate may permanently and significantly exceed 20%, which will have a favourable effect on potential economic output.

2.2.3. CONSUMPTION

Following the year 2013, the real income of households continued to increase dynamically in 2014 too, hence consumption has gradually increased. In addition to the actual data, confidence indicators also show that the purchasing intentions of families have returned as they judge their own income prospects more favourable. Thanks to the positive trends, consumption has increasingly contributed to the growth of the Hungarian economy in the recent period. On the one hand, the significant increase of real wages played an important role in this which was supported by the low inflation rate as well as nominal wage growth. On the other hand, dynamically increasing employment also had a positive impact on the consumption of households. It is important to emphasise that the dynamic expansion of real income is also supported by several government measures, such as the utility price cuts implemented in several rounds, the extension of family tax allowance, the introduction of flexible maternity leave and the wage increase linked to career model for teachers as well as armed and law enforcement workers.

Although the processes clearly indicate an improvement, the growth of consumption expenditure remained at a slower pace than the increase in real income observed last year. This is because the reduction of debt accumulated before the crisis, precautionary savings and the slowly easing lending conditions still play a decisive role in the consumption decisions of households. As a result of this the household savings ratio continued to increase, the households' net financial saving of an average of 5.2% characteristic of previous years grew to 5.9% of GDP within a period of one year. The household loan portfolio continued to decline, but this is due to the continuous reduction of foreign currency denominated loans. At the same time, the signs of recovery can be detected in forint loans. It is especially favourable that in line with the increasing real wages and falling lending rates - based on the increase in the number of new loan placements - the demand for housing loans has increased considerably. Banks participating in the Lending Survey conducted by the Magyar Nemzeti Bank have also indicated the easing of credit conditions, which is mainly due to the low base rate.

From this year the settlement of foreign currency denominated loans will also contribute to the increase of consumption. In accordance with the decision of the Curia and the legislation based on it, during the process of holding the banks to account households will be returned the interests and charges unfairly deducted from them, and the holders of foreign currency denominated loans will be paid back the amount of the rate spread. As a result of this process of holding the banks to account, the remaining principal debt of the families is reduced, which leads to lower debt payments. In this way, significantly more money remains at the households, and the families' disposable income increases. Furthermore, the conversion of foreign currency denominated loans into forints bears outstanding significance also because it reduces the exchange rate sensitivity of private consumption. The latter facilitates and accelerates the moderation of precautionary considerations and also the reduction of the savings rate.

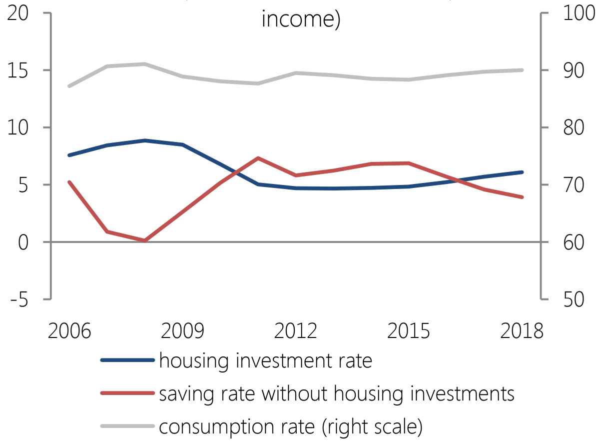
All in all, in the following years the dynamics of household consumption may continue to accelerate, due to the settlement of foreign currency denominated loans and also due to rising real incomes, the record levels of employment and measures such as increasing the tax allowance for families with two children and the tax allowance for first married couples. The Government's outstanding aim is to support the increase of consumption through labour market processes too. So it is important that an increasingly wider range of society earn their living from work on the one hand, and that the taxes imposed on labour be reduced even further on the other hand. This will be facilitated by the planned reduction of the personal income tax too in 2016.

Chart 2.15: Evolution of retail sales, consumer confidence index and consumption expenditure (percent)

Source: HCSO, GKI, MfNE

Chart 2.16: Households' consumption, saving and investment rate

(rates as a percent of households' disposable income)

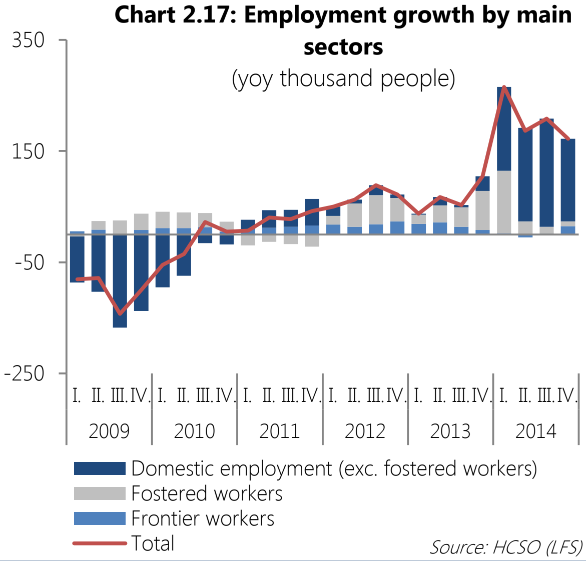


Source: HCSO, MfNE calculations

2.3. LABOUR MARKET

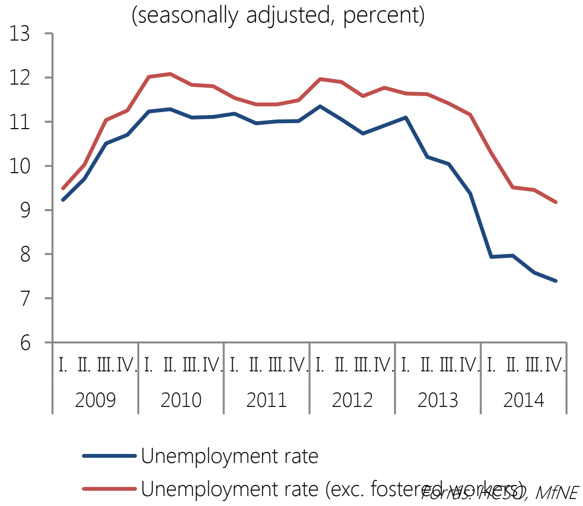
Employment growth that started during the previous years continued in 2014 at a faster pace, and due to a more than 200,000 increase of employed persons, employment reached a multi-annual record, exceeding 4 million. In the expansion of employment the private sector played a decisive role, while public works contributed to a much lesser extent than in the previous year (chart 2.17.).

Chart 2.17: Employment growth by main sectors
(yoy thousand people)



Source: HCSO (LFS)

Chart 2.18: Unemployment rate
(seasonally adjusted, percent)



Forrás: HCSO, MfNE calculations

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

From the aspect of labour demand, the extension of public works contributed to growth on the one hand, and the amendments to the Labour Code also promoted the progress towards more flexible forms of employment on the other. The Job Protection Action Plan encouraged employers to employ disadvantaged groups and groups with high labour supply elasticity, such as people below 25 and above 55, people with low qualifications, permanently unemployed and mothers returning from maternity leave. From 1st July this year the Government will extend the relief from social-security contributions to agricultural workers between the age of 25 and 55, which may affect a further 30,000-35,000 employees and may even facilitate the whitening of agriculture sector.

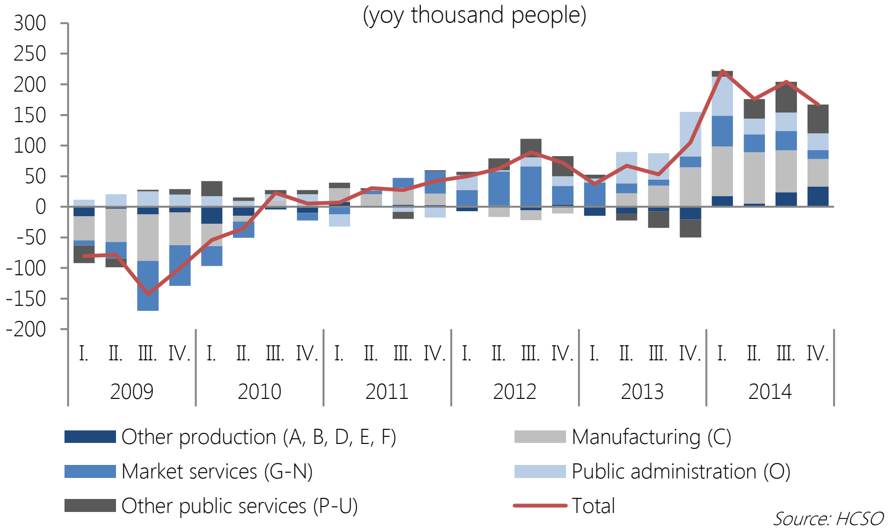
As a result of the government measures the participation rate continued to increase in 2014, and it nearly reached 59% in the 15-74 age group. Along with the increase of participation, employment also rose while unemployment declined. Mainly thanks to the expansion of manufacturing and service sector employment, employment at the national level increased by 5.3% in 2014, resulting in an employment rate of 54.1%. Among manufacturing branches the transport equipment and related branches, and food processing – as the largest employer – contributed to this to the greatest extent.

Improving employment of the transport equipment branch was due to the set-up of new capacities as well as the settling down of supplier companies.

Thanks to the more favourable labour market environment, the employment level of women continued to rise in 2014, and due to a 2.6 percentage point increase it reached 48% in the 15-74 age group. Meanwhile following a 0.7 percentage point increase the EU average the rate has risen to 52.3%.

Chart 2.19: Employment growth by economic branches

(yoy thousand people)



Source: HCSO

Public sector employment also increased in 2014 of which two-thirds is due to the extension of public works. Based on the data of the Hungarian Central Statistical Office public works provided temporary employment for more than 180,000 job seekers on average, and until the end of 2014 26,000 people were involved in the 2014/2015 winter training programmes. The aim of the training programmes – promoting the maintenance and improvement of employee competences – is to enable participants to find a job on the primary labour market.

Overall, the increasing labour demand of the private sector and, to a smaller extent, the extension of the public works significantly reduced unemployment. As a result the unemployment rate dropped to 7.1% by the end of 2014, while the annual average unemployment rate decreased to 7.7% following a 2.5 percentage point reduction (chart 2.18.).

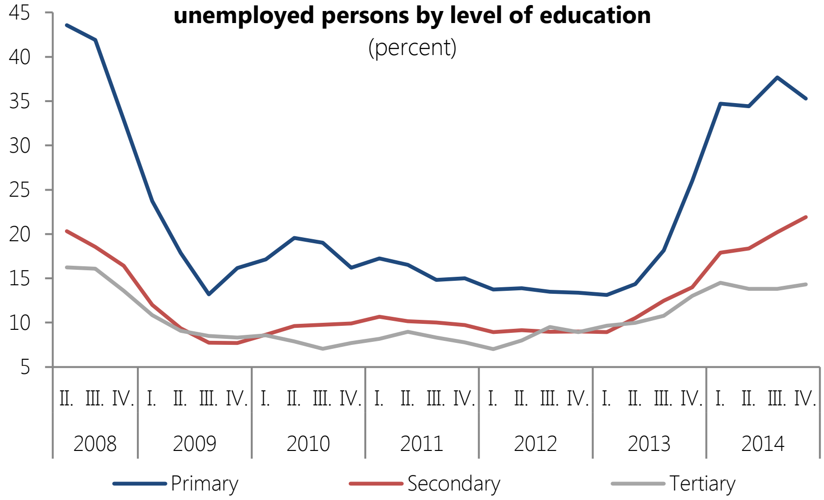
The favourable labour market trends are expected to continue on the forecast horizon due to which further employment increase and lower than 7% unemployment rate can be projected. Further increase in employment may take place as a result of increasing labour demand in the private sector - in line with the economic recovery - on the one hand, and as a result of the further expansion of the public work schemes on the other hand.

The government's aim is to increase the proportion of people returning to the primary labour market from public works. In 2013 slightly more than 13% of the public workers leaving the programme found employment on the primary labour market after 6 months. As people with elementary qualifications have a low chance of finding employment, training seems to be the most efficient way of improving the participants' chances to find a job on the primary labour market and willingness to work. The objective of the Youth Guarantee programme launched during the 2014-2020 EU financial framework is to provide further support for the employment of people below the age of 25.

Last year, as a result of the increasing labour demand of the private sector and lower unemployment, labour market conditions became tighter, especially in case of people with elementary and secondary qualifications. In case of the least qualified workers this is explained to a large extent by the increase in the number of non-subsidised job vacancies, while for those with intermediate level of education, the decrease of the number of unemployed also significantly contributed to it. Compared to 2013, the number of job vacancies for highly qualified workers showed only a slight increase, whereas the number of the unemployed in this group was significantly lower.

Chart 2.20: Unsubsidised job vacancies as a percent of unemployed persons by level of education

(percent)



Source HCSO, MfNE

From the second half of 2015 the Government will implement a number of changes in the vocational training system in order to meet the demand for skilled workers with an intermediate level of education. From September 2015 vocational training centres will be established in the framework of the major vocational training institutions of the counties and the capital. Secondary vocational schools will be transformed into vocational grammar schools and vocational schools into secondary vocational schools as of September 2016. The career scheme for teachers in vocational education may make teaching in educational institutions attractive for engineers as well. Budgetary resources allocated for study grants will increase and obtaining a second vocational qualification in the national system will also become free of charge. The purpose of the transformations is to increase the number of students in the area of marketable professions and to increase the number of apprenticeships to 70,000 from the current 50,000 by 2018. A further aim is – in order to enable students to acquire a higher level of professional competence – to include 20,000, instead of the current 7000–8000, businesses into practical training with a high degree of participation of small and medium-sized enterprises. Businesses would be encouraged to participate by tax concessions. Entering the system of full-time vocational school training is now possible up to the age of 25, instead of 21.

Tighter labour market conditions have contributed to increasing wage pressures, which may explain the faster than expected increase of private sector wages in 2014. Net real wages has grown by 3.2%

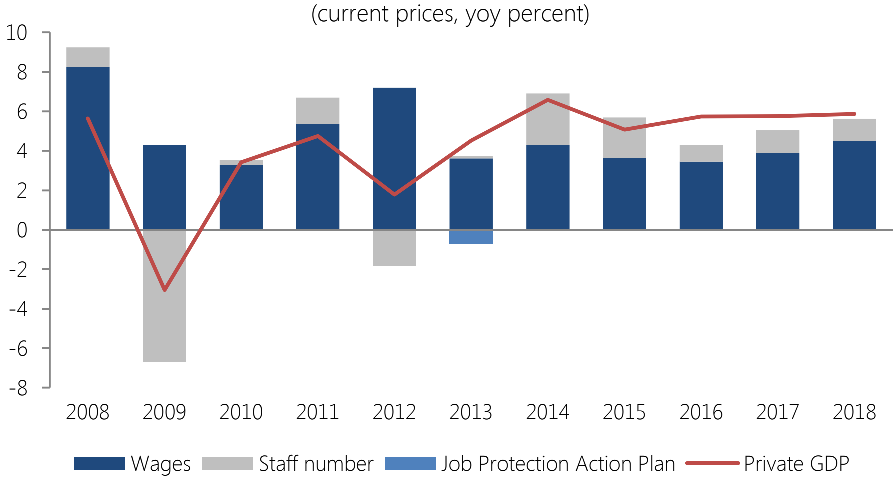
partly due to the low inflation environment, exceeding the moderate real wage dynamics since the onset of the crisis. However, the 3.4% increase of the minimum wage and the 3.5% increase of the guaranteed wage minimum for highly skilled workers at the beginning of the year was lower than the growth rate of private sector wages.

Public sector wage dynamics were influenced mostly by the teachers' career scheme last year, however, the carry-over effect of the wage hike of health workers has also contributed to a smaller extent. At the same time, the composition effect arising from the increasing number of fostered workers with relatively low wages and the low level, i.e. 2.4% increase of the wage of fostered workers drew down the gross average wages in the public sector.

Lower inflation expectations of employers along with tightening labour market conditions have opposing effects on wages in the private sector this year, so wages are forecast to increase at a lower rate than last year. The unit labour cost of the private sector, taking into account productivity, may show a modest increase as a result of which corporate profitability may improve (chart 2.21).

Chart 2.21: Private GDP and labour costs

(current prices, yoy percent)



Source HCSO, MfNE calculations

On the forecast horizon gross wages in the private sector are projected to increase by 3.5–4.5%. It should be stressed that the expanding public works program will draw down average wages in the public sector significantly, which will have a particularly strong effect in 2016 when it will also significantly reduce the average wage index of the national economy. The increase of the minimum wage and guaranteed wage minimum is not expected to cause any significant wage shifts as the rate of which is expected to be similar to the national wage index excluding fostered workers. Besides, in 2015, wage increases will continue in the education sector, the career model for armed and law enforcement workers will be launched, while the career scheme of government officials will start in 2016.

On the whole, increasing labour demand among relatively tight labour market conditions contributes to wage increases, however, the low inflation environment, reduced inflation expectations and the potential expansion of labour market capacities may cushion it to a certain extent.

2.4. INFLATION

2014 saw excessively low price dynamics throughout the whole year, mainly as a result of the low inflationary environment seen all over Europe, decreasing food prices related to favourable agricultural yields and the government regulations. Although the second utility price cut faded out by the end of the year, this was compensated by the reduction of fuel prices stemming from the global oil price drop. Energy prices are expected to remain below recent years' high level, which significantly decrease domestic consumer prices in the forthcoming period.

The low rate of core inflation also suggests, were the impacts of utility price cuts and the oil price fall excluded, price dynamics would remain low as well. A reason for this is that while the data suggest a gradual increase in internal demand, economic performance still lags behind its potential level, and thus the increased consumption does not result in a substantive rise in prices. On the other hand, the disinflationary pressure from the European Union affects a wide range of goods, and reduces particularly the prices of industrial products and food. Apart from this the Russian import ban imposed on diary and meat products, vegetables and fruits as of 8 August 2014 further contributes to the decrease in food prices. Restrictions most significantly affect dairy products where the embargo further increased the already existing global oversupply and the related price reduction.

So far the external disinflationary factors have been, at least partly, mitigated by the depreciation of the Hungarian forint against the euro. This effect however may become much more moderate, due to the monetary easing of the European Central Bank that resulted in the global depreciation of the euro. Besides, the favourable growth data along with growing investor confidence further support the appreciation of the forint. Price increase is thus mostly expected for alcohol and tobacco products, and market services, which are less affected by external pressures. As a result inflation may be expected to be around 0% in 2015.

The asset purchase program announced by the ECB in January is expected to boost European demand in the long run, which may, though with delay, materialise in Hungarian prices as well. Furthermore futures quotes suggest moderate increase in oil prices. Consequently, along with the decrease of external disinflationary pressure and the boost of internal demand, the pace of price increase may reach higher level in 2016. At the same time, the decrease of the value added tax on pork to 5% and the reduction of duties will somewhat curb price increase. After 2016 price dynamics are expected to accelerate further, as a result the rate of inflation may reach the medium-term target of the MNB (Central Bank of Hungary) defined at 3% by the end of 2017.

Table 2.2.: Inflation (%)

	2014	2015	2016	2017	2018
Inflation	-0.2	0.0	1.6	2.5	3.0

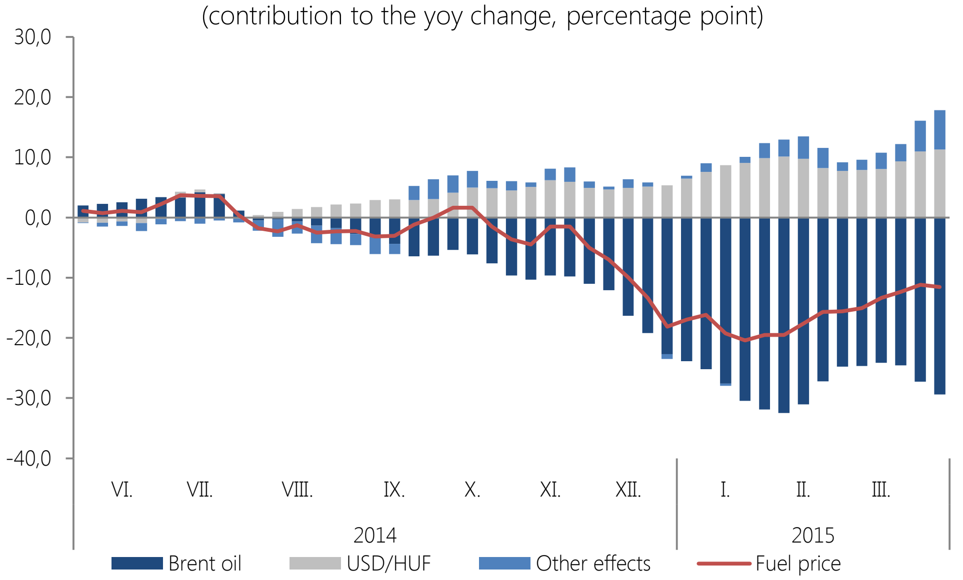
Box 2: Macro-economic Impact of the Oil Prices Fall

A significant decline in oil prices were experienced in recent period, from USD 110 seen in July below USD 50 by January 2015. The primary reason behind the price fall is the increasing supply arising from the exploitation of shale oil fields, followed by a decline in global demand. Although the low point of January was followed by the oil price approaching USD 60 due to market corrections, the current price level is by far lagging behind the predictions of our previous forecast published in autumn 2014, thus has a favourable impact on growth prospects.

In the assessment of the impact the oil price fall exercised on Hungary, it should be taken into account that while the price of oil per barrel decreased by 40%, at the same time, US dollar appreciated by 20% against the forint at the FX market. The Brent oil denominated in Hungarian forint thus became cheaper by 30%, which, due to the tax content and the refinement costs, became apparent at the service stations with delay and only to a limited extent. Even considering these mitigating factors fuel prices has dropped significantly since the end of 2014, which, because of its high weight, also determined consumer price index development (Chart 2.22.).

Chart 2.22: Effect of external factors on fuel prices

(contribution to the yoy change, percentage point)



Forrás: MfNE calculations

In addition, the positive impact of oil price fall on the real economy has already been expressed in the latest industrial production data. However, the question is, for how long the current lower price level may be expected to persist, that is, whether it is a temporary or permanent phenomenon. Since price falls partly stemmed from a technological factor and the OPEC determining global supply had not cut back on exploitation so far, it can be reasonably assumed that the price of oil is to remain below the previous levels, which is also reflected in futures quotes.

We expect that a permanent oil price level of USD 60–70 has a positive impact on the economy as a whole. The decreasing inflation is elevating the purchasing power of incomes, thus households will be able to buy more with the same amount of money. In other words, families have to spend less on fuels due to lower prices, and can spend the remaining amounts on other products or savings.

The corporate sector responds to the increasing internal demand by enhancing capacities, increasing investment activity and hiring more workers, which is fostered by the profitability gains stemming from lower costs. However, the unpredictability of prices may make both households and business sector delay the increase of consumption or their capacities. Consequently, while the oil price fall drastically and immediately reduces inflation, its impact on the economy as a whole generally becomes evident only with a delay, though with still considerable extents this year and next year as well.

On the basis of the sensitivity analysis conducted, a 10% oil price fall in Hungarian forints – taking the dollar exchange rate also into consideration – leads to a 0.35 percentage point decline in inflation; at the same time, GDP increases by 0.15 percentage points per annum, ceteris paribus. On the whole, we can establish that the low oil price in itself reduces the inflation rate by 1.1 percentage points, while it increases economic growth by 0.5 percentage points in 2015.

2.5. CYCLICAL DEVELOPMENTS

The output gap in Hungary, similarly to the whole European Union, remained positive throughout the decade preceding the crisis, whilst in 2009 the global financial crisis suddenly pushed the economic performance below its potential level. It is evident by now that the financial crisis did not only influence growth temporarily, but – mainly due to the decrease in capital accumulation and the devaluation of the competencies of those losing their job – it also affected long-term growth potential. Therefore it is a very important result that the potential growth of Hungary showed considerable acceleration in 2014, to which both the capital accumulation gaining momentum after several years and the economic policy of the Government contributed significantly.

Following the outstanding increase of 2014 the level of investments is expected to be lower but still showing a rising trend, partly as a result of programmes supporting SMEs and the historically low interest rate environment, partly due to the foreign direct investments in manufacturing and the absorption of EU funds. Therefore capital accumulation provides a substantial contribution to growth potential over the forecast horizon. The exploitation of new capacities entails a growth in employment, whereas the active labour market policy of the Government may substantially improve employment and long run growth potential as well by reducing structural unemployment and increasing the participation rate.

Although the additional growth stemming from productivity gains showed a continuous increase over the past years, it still lags behind its pre-crisis levels and the rates of regional peers. Nevertheless, foreign direct investments and the considerable openness of the Hungarian economy, the active participation in global value chains, along with the competition stemming from this may significantly improve efficiency in the future. The capacity expansions of foreign manufacturers representing cutting-edge technologies help to improve the technical standards of domestic suppliers as well, making a positive impact on the economy as a whole over time. Furthermore international corporations play an increasing role in education too, improving the modernity of equipment and training itself. As a result, the upcoming years are expected to see an increase in productivity.

The stronger than expected GDP growth of 2014 would in theory induce a faster closure of the output gap. However, since the unforeseen rate of growth is explained mostly by fundamental factors, the growth potential of the Hungarian economy also shifted to a higher level. Nevertheless actual growth is assumed to exceed the potential GDP growth in the upcoming years as well, meaning that the output gap may close by the end of the forecast horizon.

Table 2.4.: Cyclical developments (%)

	2014	2015	2016	2017	2018
Actual GDP growth	3.6	3.1	2.5	3.1	2.9
Potential growth	1.6	1.9	2.2	2.3	2.5
Factors					
Labour	0.3	0.5	0.7	0.7	0.7
Capital	0.4	0.5	0.4	0.6	0.7
Total factor productivity	0.9	0.9	1.0	1.0	1.1
Output gap	-2.8	-1.7	-1.4	-0.6	-0.2

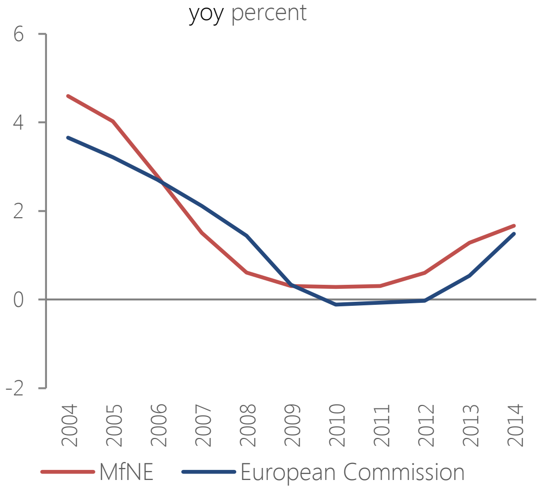
Box 3: Assessment of the Cyclical Position of the Hungarian Economy in 2014

In 2014 Hungary managed to reach the pre-crisis GDP level thanks to the favourable economic processes. However, economic performance still remains below its potential, although the European Commission and the Government of Hungary have different view about the openness of the output gap. It is for the economic policy to moderate the fluctuations of the economy, which implies an awareness of the current cyclical position. This is why such discrepancies need to be clarified.

The Government and the European Commission[1] have similar estimates on the potential growth rate and output gap, that meet the general view according to which the previously overheated economy declined in 2009 and has been below its potential level since then (Charts 2.23, 2.24). Additionally, the pace of the recovery process is not even, but shows a "W"-like output gap, which might be explained by the renewal of the European downturn and the weaker agricultural performance in 2012.

Chart 2.23: Potential growth

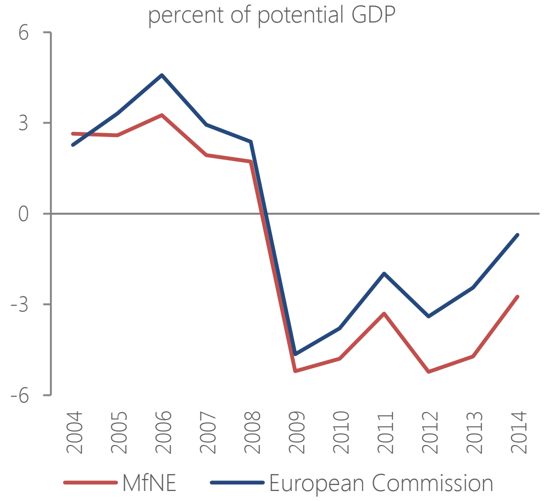
yoy percent



Source: MfNE calculations, European Commission

Chart 2.24: Output gap

percent of potential GDP



Source: MfNE calculations, European Commission

[1] Source: European Commission, Winter 2015 Forecast

However, with regard to the period between 2010 and 2014, the Commission and the Government have substantially different estimations. Since no general procedure is in place for determining the potential output, it is natural that the various organizations have different output gap results.

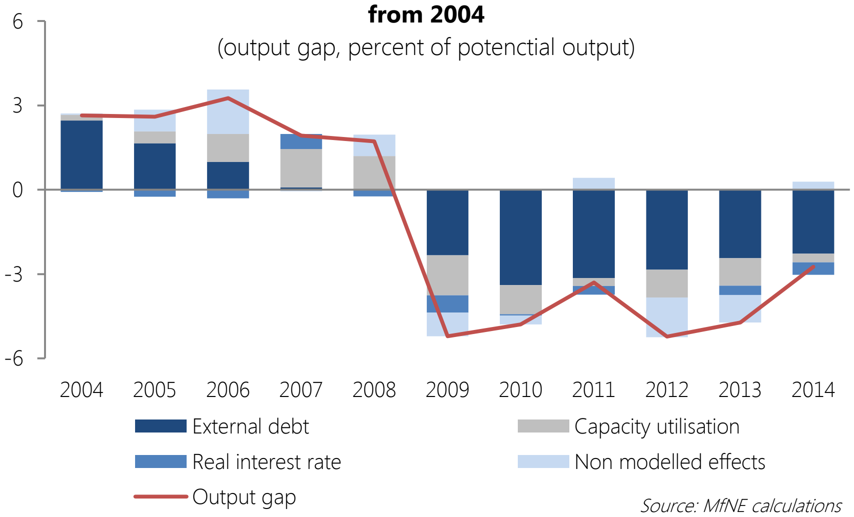
The European Commission applies a so-called "production function" based methodology, a benefit of which is that it provides results comparable across several member states, but basically builds on a neo-classical, real economic relation.

In contrast to this, the crisis in 2008 has served the following lesson: the financial and capital markets are an inherent part of the economy, so the financial and real economic cycles are interrelated. This idea provides the basis for a model developed by experts of the Bank for International Settlements[2] that incorporates the financial cycle. Since the finance neutral output gap that takes into account the lessons of the 2008 crisis provides better real-time performance, the Ministry for National Economy, starting from 2014, applies this model for measuring the potential output and the output gap.[3]

Due to the high degree of openness of Hungary, we took into consideration the funding position vis-à-vis the rest of the world and the level of foreign debt when presenting the financial cycles. In our view, the net borrowing position and the accumulation of high amounts of foreign debt is not sustainable in the long run, thus results in an overheated economy. In contrast to this, excessive surpluses result in the reduction of debts and lower consumption activity as well as economic growth, which may also be regarded as cyclical. In this context, the massive financing surpluses currently present in the economy of Hungary shows that the economic actors continue to spend substantial parts of their resources to deleveraging. Consequently, the current performance of the economy lags behind its potential level induced by the fundamental factors, thus the output gap (Chart 2.25) is negative.

Chart 2.25: Cyclical position of the Hungarian economy from 2004

(output gap, percent of potenctial output)



Source: MfNE calculations

The estimates diverging from those of the European Commission are explained by methodological differences; the model applied by the Government also takes the financial cycles and the impacts of foreign debt reduction into consideration. At the same time, we assume with higher industrial capacity utilisation simultaneously to economic recovery, the output may gradually reach its potential

[2] BORIO, C. – DISYATAT, P. – JUSELIUS, M. (2013): Rethinking potential output: Embedding information about the financial cycle. BIS Working Papers No. 404

[3] The model is described in details in the 2014 Convergence Programme.

level.

To sum up, the various methods of output gap calculation are obviously different from each other, which means, that the assessment of the cyclical position of the economy provided by the European Commission and the Government are similar but not identical. As we have seen, the economic slowdowns after 2009 were cyclical, as a result of which the output gap remained fairly negative in 2014 as well. By contrast, the results of the European Commission are more pro-cyclical, and thus the output gap is less open.

2.6. External position

The post-crisis period saw drastic changes in the external balance developments, Hungary's net financing capacity turned positive and even exceeded 8% of the GDP in 2014. With this rate Hungary was outstanding among the Visegrád countries, and took the second place after the Netherlands in an EU-wide comparison. The developments of EU transfers and net exports also benefited the balance of current account.

The excess surplus was still explained by the considerable export performance of the automotive industry, on the one hand, which was moderated by the Russian-Ukrainian conflict and the lower than expected European growth only to a certain extent. On the other hand, income outflows were reduced further, which was a result of remittances of Hungarian workers abroad and the decrease of interest burden related to shrinking external debt. The value of EU transfers increased further in 2014 with EU fund absorption reaching a record amount of EUR 6 billion.

The favourable trends are expected to continue in 2015 as well, and the euro interest rates may, along with the income outflow, continue to decrease as a result of increasing investor confidence and the monetary easing of the ECB. Furthermore, in 2015 Hungary may use the funds of both the previous and the new programming cycle, thus EU transfer inflow is expected to exceed even last year's record values. Parallel to the boost in European demand, external trade may also increase further. Although yields are anticipated to increase in 2016, the rate of income outflow may further decrease due to debt reduction. However, the transfer inflow may fall temporarily, which might reduce net lending.

Overall, in the upcoming years the external financing capacity may stabilize around 8% of the GDP as in 2014. The current account balance is projected to show permanent growth reaching a surplus above 6% by 2017. As a result of these favourable developments external debt may decrease at a pace faster than previously expected, which could significantly reduce the vulnerability of the economy.

Table 2.5.: External Financing (% of GDP)

	2014	2015	2016	2017	2018
Balance of goods and services	7.5	8.3	9.3	9.5	9.9
Balance of current account	4.1	5.4	5.9	6.2	6.7
Balance of capital account	4.1	4.0	2.0	2.3	2.2
Net external financing capacity	8.3	9.3	7.9	8.5	8.9

Source: MNB, MfNE calculations

The totals and the sum of subtotals may differ due to rounding.

Box 4: The Settlement of the Situation of FX Borrowers Enhances Economic Performance

Starting with 2005, the proportion of foreign exchange-based loans (FX loans) , mostly of those in Swiss francs, has significantly increased in Hungary. Between 2006 and 2008, loans to households were almost exclusively foreign exchange based with favourable interest rates and seemingly low risk, the stock of which peaked at 28% of the GDP in 2009. FX loans implied risks both for the banking system and for households, and though national regulatory bodies of that time did perceive it, no substantial measures were taken to prevent indebtedness in foreign currencies.

The Swiss currency became a safe-haven currency after the outbreak of the financial crisis, which ended up, both directly and through the cross-currency exchange rate, in the depreciation of forint. Due to this, households faced increasing instalments, as a result of which more and more people have become unable to meet their loan obligations from 2010, and the higher proportion of non-performing loans caused serious problems to the banking sector, as well. At the same time, household consumption showed a drastic decrease, considerably contributing to a worsening economic performance.

With a view to halting this trend, the Government took a series of measures starting from 2011 in order to improve the situation of FX borrowers (exchange rate cap, early repayment scheme, National Asset Management Company). Mostly as a result of these measures, the stock of households' FX loans decreased by 45% from its peak in 2009 by the end of 2014, however, households' exposure to FX risk was still too high. The worsening situation of FX borrowers did not only create economic problems, but also led to social difficulties. It became apparent that economic policy makers needed to find a solution. The unfavourable situation could be settled in a satisfactory manner by phasing out mortgage-backed FX loans, which imposed a large burden on households and on the performance of economy. However, conversion of FX loans could only become a subject of consideration within the frameworks of a healthier banking sector, stable macro-economic fundamentals and with an interest rate environment significantly lower than at the time of the loan disbursements, since a settlement and phasing-out with a wrong timing could have been harmful to the economy, as well.

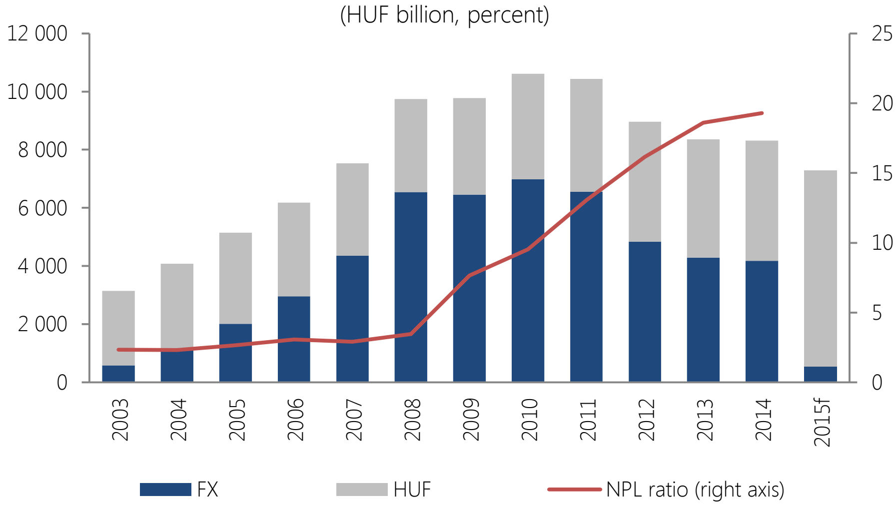
A turning point was marked by the decisions of the Constitutional Court of 28 February 2013 and 24 March 2014, on the basis of which the Hungarian Parliament has been entitled to exceptionally alter the terms of bilateral civil law contracts, providing that the housing of families is at risk, or an abuse of a dominant position by a credit institution emerges. In addition, based on the European Court of Justice decision of 30 April 2014, the Hungarian Court was entitled to examine the unfairness of FX loan contracts. This was followed by the Curia's decision of 16 June 2014, according to which spreads on FX loans were deemed to be unfair, and it was stated that the contractual amendments of household loans do not comply with law until the opposite is proven.

Under the laws adopted after the above decision of the Curia, the amounts charged in an unfair manner were to be repaid, imposing approximately HUF 600-700 billion net burden on financial institutions, while decreasing the outstanding debt of Hungarian families by a total of cca. HUF 1,000 billion. On average, instalments are to fall by 20-25%. An average borrower used to pay approximately HUF 75,000 per month to cover the capital and interest payments due, while this amount is to be around HUF 55,000 as a result of settlements. Due to the lower instalments, households' disposable income will be higher hence consumption is forecast to increase by 0.5-0.5% this year and next year. Besides this, households' savings are also expected to increase. Taking the import content of consumption into consideration, model calculations by the MfNE suggest that the stimulation of demand results in a 0.4% percentage points faster GDP growth by the end of 2016.

The actual phasing-out of FX loans could only take place in case sufficient levels of MNB's international reserves to ensure that FX loans' conversion will not threaten the compliance level of MNB's reserves. The only possible way for converting an amount of EUR 9 billion, equivalent to 9% of the GDP, was using international reserves. This solution being the right choice was also confirmed by market reactions.

Chart 2.26: FX exposure of households

(HUF billion, percent)



Source: MNB, MfNE forecast

The Parliament of Hungary adopted a law on FX loans' conversion on 25 November 2014, as a result of which households' mortgage-backed FX loans were transformed into HUF-based loans in a total amount of approximately HUF 3,600 billion at specified market rates (Swiss francs: 256.5 HUF/CHF, euro: 309 HUF/EUR, Japanese yen: 2.16 HUF/JPY). In technical terms, conversions take place simultaneously with the settlements. As a result, households could finally dispose of exchange rate risk, thus the conversion of FX loans can prevent further increase in the burdens of Hungarian families. While 50% of the household loans was FX-based in 2014, this rate may fall below 10% after the conversion.

The conversion of FX loans is expected to have a positive impact on the banking system, too. FX ratio in the balance sheets of banks will become considerably lower, both on the assets and liabilities side. According to our expectations, NPL ratio diminishes, as well, due to the reduced instalments.

External debt of Hungary will become significantly lower due to the settlements and the conversion of FX loans, moderating the vulnerability of the economy both in the medium and in the long term. The effect of global market turbulences will be slighter, the risk related to Hungarian forint will be lower, resulting in a less volatile exchange rate. The market perception of Hungary is also to improve, an evidence of which is, in addition to the positive feedbacks provided by international institutions, credit rating agencies and researchers that the country risk indicator, i.e. the 5-year CDS spread of Hungary fell below 140 base points, which was experienced only before the outbreak of the financial crisis in 2008. The improved perceptions will result in lower yields, and decreasing costs of debt financing.

The benefits of conversions are already apparent in the short term: having fixed the applicable exchange rate beforehand, the drastic weakening of the Hungarian forint against the Swiss francs in mid-January 2015 did not lead to larger burdens for households and greater risk for banks, hence, the previously considerable risks related to households' FX loans could not materialise. A few countries, for example, Croatia, Romania, and Poland were not in such a favourable position: indebtedness in foreign currencies, particularly in Swiss francs, has led to difficulties as settling the situation of FX borrowers in these countries has not yet reached such an advanced phase as Hungary has.

The settlement and phasing-out of FX loans represent a milestone for households, for the Hungarian financial system, and for the economy as a whole. The increasing consumption of the families will have a stimulating impact on economic performance. Furthermore, the reduced external exposure results in a more favourable country risk profile with a more stable market environment and lower financing costs. To sum up, FX loans related measures help ensuring a sustainable and balanced growth in the long run, and making Hungarian economy resilient to global market shocks.

2.7. ECONOMIC IMPLICATIONS OF STRUCTURAL MEASURES

The macroeconomic impacts of the most important economic policy measures of the Government were estimated by the DINAMO[4] model of the Ministry for National Economy. The model is suitable for such assessments because it consistently reflects the sufficiently detailed connections between the national accounts and the financial accounts of the government. Additionally, multiple transmission channels were integrated into the model through which fiscal variables can exert their effect on the economy. The structure of the DINAMO model is based on neoclassical growth assumptions on the long run, but in the short term the adjustment is slowed by nominal rigidities.

Impacts of certain government measures (which have been announced after the Convergence Programme of 2014) were estimated. The overall impact of the following major measures and changes in the tax system were analysed (Table 2.6):

- Career models in the public sector.
- The Start work programme: the benefits of public employment programs compared to the Convergence Programme for 2014.
- Reducing bank levy.
- Reducing personal income tax rate from 16% to 15%.
- Increasing tax allowances of families with two children.
- Reducing the value added tax on pork products from 27% to 5%.
- Reducing or abolition of certain public services fees and duties.

[4] The methodology of the Dynamic National Accounts Based Model (DINAMO) is available in the following link: http://www.kormany.hu/download/9/97/10000/El%C5%91rejelz%C3%A9si%20m%C3%B3dszertan_angol.pdf

Table 2.6.: The Impact of the modelled measures on the general government balance (% of GDP)

	2015	2016	2017	2018
Measures increasing expenditure	**-0.25**	**-0.53**	**-0.71**	**-0.80**
Career models	-0.08	-0.24	-0.34	-0.36
Start work programme	-0.17	-0.28	-0.37	-0.44
Measures decreasing revenues		**-0.62**	**-0.69**	**-0.69**
Bank levy reduction		-0.17	-0.22	-0.21
Personal income tax reduction		-0.31	-0.30	-0.28
Increasing family allowances		-0.04	-0.08	-0.11
VAT reduction (on pork products)		-0.07	-0.07	-0.06
Reduction or abolition of fees and duties		-0.03	-0.03	-0.03
In total	**-0.25**	**-1.15**	**-1.40**	**-1.49**

Source: MfNE calculations

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

Growth stimulating measures can be introduced, which is based on several factors. On the one hand, the improvement of growth prospects higher than expected lead to a further increase in government revenues, whereas the low-yield environment and the appreciation of the HUF leads to lower government expenditures, also supporting predictability of the budget. On the other hand, the structural reforms implemented in the framework of the Széll Kálmán Plan generate savings for the budget. Additionally, less EU funds will be withdrawn next year due to the cyclic nature of EU transfers, meaning that the expected co-financing expenditures are lower, as well. Finally, the higher level of the Gross Domestic Product results in a lower government deficit to GDP ratio and debt level. On the whole, the favourable developments of the macroeconomic fundamentals support the introduction of specific fiscal stimulators, whereas, in accordance with the strict fiscal policy, the government deficit decreases in the forecast horizon.

The simulation results show the percentage changes of each macroeconomic indicator cumulatively due to the government measures compared to the scenario without fiscal measures. According to the model calculations, the GDP volume is gradually increasing, as a result of which the level of the Gross Domestic Product may be 1.4% higher in 2018 (Table 2.7.).

Table 2.7.: The cumulative macroeconomic impacts of the structural measures (% difference in levels relative to the baseline scenario)

	2015	2016	2017	2018
GDP	**0.28**	**0.87**	**1.19**	**1.41**
Households' consumption expenditure	0.40	1.75	2.19	2.52
Investments	0.00	0.71	1.09	1.18
Exports	0.00	0.00	-0.01	-0.01
Imports	0.23	0.69	0.90	1.06
Inflation	-0.01	0.15	0.19	0.21
Private sector employment	-0.04	0.39	0.46	0.51
Gross wages in the private sector	-0.02	0.24	0.33	0.38
General government deficit (% of the GDP*)	-0.21	-0.87	-1.13	-1.29

Source: MfNE calculations

**Change in percentage points*

The majority of government measures lead to the increase of the household's disposable income levels, which further enhances consumption expenditures. This is true for the following measures: the introduction of career models, the reduction of value added taxes (VAT on pork products, duties) and personal income tax, as well as the increase in family tax allowances.

The cut of bank levy improves the profitability of the financial sector, and it also stimulates willingness to lend and credit supply by reducing the additional burden of the sector. In addition to this, both actual and potential growth is supported through accelerating investment dynamics. The positive aggregate impact of domestic demand is, at the same time, slightly dampened by the high import content. On the whole, government measures have a stimulating impact on economic growth and also boost labour demand.

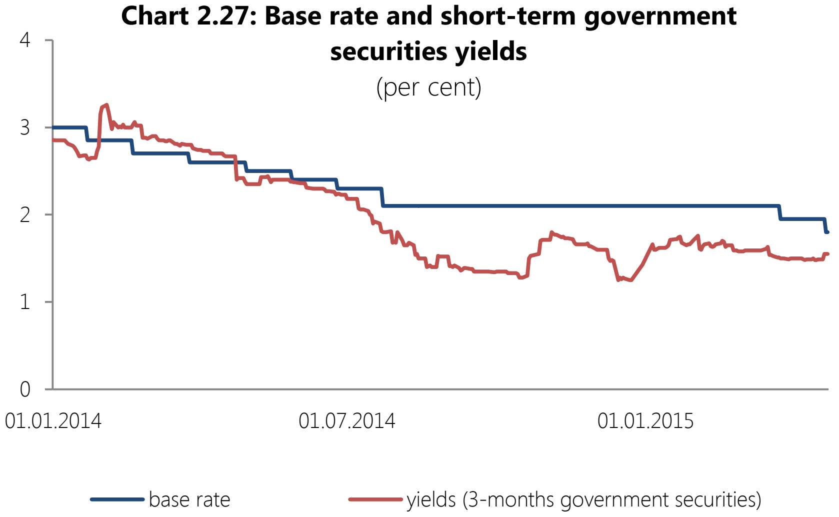
2.8. MONETARY AND EXCHANGE RATE POLICY

The law on the Central Bank of Hungary (MNB) sets out achieving price stability as the primary objective of the Central Bank. Since 2001, the MNB followed inflation targeting policy with a 3% mid-term target. However, in March 2015, Monetary Council switched to a 3% inflation target with a tolerance band of ±1 percentage point.

Inflation targeting is implemented through changing the level of the base rate with the help of the flexibility provided by the floating exchange rate system.

Recent favourable market developments have left more room for monetary policy manoeuvre. The 2.6% base rate of April 2014 has been cut incrementally to 1.8% by April 2015, which is a new historically record low rate. Base rate reduction was supported by the weak inflationary trends, by the Government's sustained commitment to meet the deficit target, and a globally positive investor sentiment. These were incorporated into investor expectations through the interest rate reductions of the Central Bank, and led to a further decline in the short-term government securities yields, as well. The 3-month yield, having followed the reduction in the policy rate, diminished from 2.9% as of early 2014 to 1.6% by April 2015. (Chart 2.27)

Chart 2.27: Base rate and short-term government securities yields
(per cent)



Source:: MNB, ÁKK

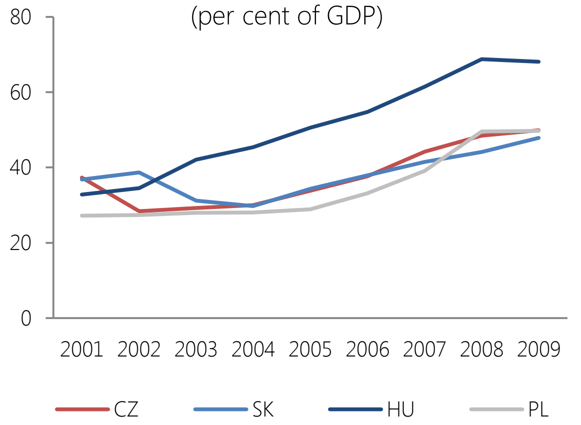
Several changes were made to the monetary policy instruments of the Central Bank last year. In April 2014, Central Bank announced its self-financing programme. In this programme, its main instrument, the two-week MNB-bills were replaced by a two-week deposit, and introduced an interest rate swap facility. These MNB measures were targeted to shift liquidity excess of the institutional investors to the government securities market with a view to supporting the predictability of debt financing and the reduction of financing costs through the increased demand.

The Central Bank further expanded its alternative toolset for stimulating the economy. Having seen the developments of the FGS (Funding for Growth Scheme), originally set to close by end-2014, and the latest challenges in SME lending, the Central Bank decided, on the one hand, to extend the programme with unchanged conditions, and, on the other hand, to introduce a new scheme supplementing the FGS (FGS+). The Central Bank reserves a total of HUF 2,000 billion for the FGS and FGS+ programmes, out of which HUF 1,300 billion have already been drawn down by financial institutions within the framework of the first programme, while HUF 500 billion of this financial envelope have been allocated for the FGS+ by the Monetary Council. The purpose of the new scheme is to improve lending conditions for riskier SMEs which were previously excluded from FGS and expand their access to finance, as well. MNB expects that with the help of these programmes, lending activity gradually recovers parallel to becoming market-based again, and financial intermediation can be more efficient from 2016.

Box 5: Improving operating environment of the bank system

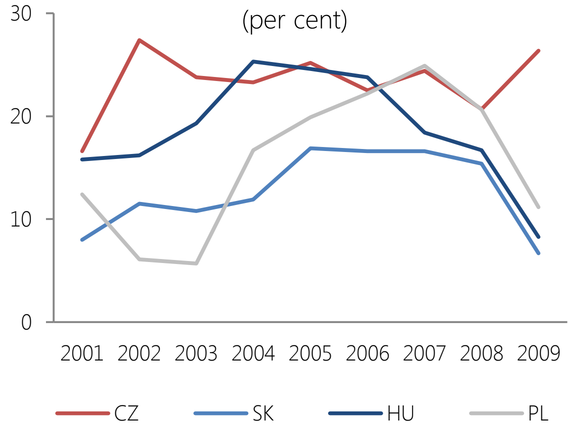
The healthy operation of the banking sector is vital for economic performance. Before the financial crisis of 2008, the Hungarian banking system was characterized by high profits and a dynamic lending activity : loans to the private sector was outstandingly expanding, even in a regional comparison, and the profitability of Hungarian banks was, for a long period, only exceeded by Czech banks. (Charts 2.28-29) While the banking system’s contribution n to economic growth was positive before the financial crisis, it began to have a contracting effect on the economy since 2009, and was not able to duly help Hungary to recover from the crisis at a faster pace.

Chart 2.28: Loans of domestic private sector
(per cent of GDP)



Source: World Bank

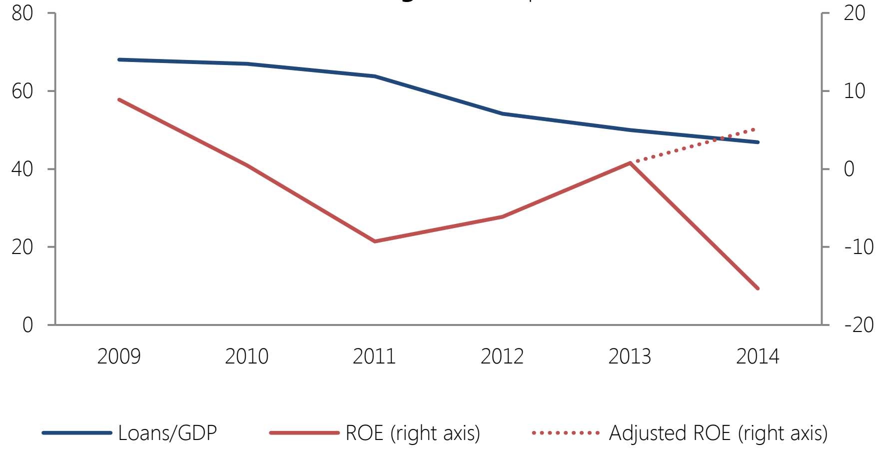
Chart 2.29: ROE of the banking sector
(per cent)



Source: MNB

As a result of the crisis, the profitability of banks, similarly to regional countries, began to fall, and while the decreasing tendency of the return on equity (ROE) reached to a turning point in 2011, it remained negative. In 2014, ROE dropped to historical lows, which was mostly the result of provisioning of approximately HUF 600 billion, related to the unfair contractual amendments and pricing. Excluding the impact of settlements, the profitability of the banking sector would have turned positive in 2014. (Chart 2.30) Nevertheless, this loss means a one-off factor suffered by the banks, which, on the other hand, will provide ground for a new era considering the operating environment of the banking system. Due to the elimination of the exchange rate risk, favourable changes are expected to start in the poorly structured and low quality portfolios of the banks.

Chart 2.30: Loans of the private sector and ROE of the banking sector* (per cent)



** credit institutions operating as a joint-stock company*

Source: MNB, ECB, MfNE calculations

However, the recovery of the profitability of the banking system, has not come to an end yet, so it is getting even more focus from the Government as the state needs to play an essential role in recovering the growth-supporting function of the financial system. With a view to promoting a prosperous banking sector in Hungary in the upcoming years, the Government has taken a number of actions.

The Government intends to improve the excessively fragmented structure of the banking system by the acquisition of several banks, which it aims to privatise again after certain efficiency enhancing reorganizational measures, pursuant to the agreement between the European Bank for Reconstruction and Development ("EBRD") and the Hungarian Government. The Takarékbank (the umbrella entity of Hungary's savings bank sector) was a good example to this, which is privately run again after thorough reorganization of the system of savings banks. The state has acquired ownership in the Hungarian Foreign Trade Bank (MKB) and in Budapest Bank. With these transactions, the ratio of banks with domestic ownership has exceeded 50%, which, as a result, will be less exposed to the business decisions of foreign parent banks which often tend to put more priorities on the parent country's interests, particularly in a period of crisis.

The Government has expressed its intentions of further acquisitions. On 9 February 2015, the EBRD and the Hungarian Government signed a Memorandum of Understanding ("MoU"), and at the same time, the parties announced they are to gain 15-15% shares in the Hungarian Erste Bank, with the consent of the Erste Bank Group.

The Government pointed out that it will refrain from taking further stakes in systemically important local banks in the future, and that it is committed to transferring all direct and indirect majority equity stakes in local banks to the private sector within the next three years.

The MoU largely contributes to better investor perceptions and implies a strengthened and more balanced relationship between the Government and the banking sector. Moreover, it will also improve the operating environment of banks. The Government expressed its intention to

- adjust the banking tax so that it is calculated based on the banks' balance sheets as of end-2014, and by 2019 the degree of the levy will be gradually reduced to a level which meets EU standards;
- impose no further burdens on the banking sector;
- refrain from further restrictions on foreclosures and moratorium on evictions and forced sales quotas will not be extended, while the real estate purchase activity of the National Asset Management Agency will be extended and conditions of it eased;
- make decisions on the introduction of private bankruptcy and the retrospective modification of contracts with the involvement of the Association of Banks;
- refrain from adopting laws or regulations which can adversely influence the profitability of the banking sector;
- secure free competition and equal treatment among financial institutions on the Hungarian market.

The EBRD agreed in the MoU to take part in dealing with the problem of non-performing loans, in the transactions needed for the private consolidation of the banking sector, and to provide technical assistance in the tools supporting business and corporate crediting.

The MoU not only creates a new ground for the relationship between the Government and the Hungarian banking sector, but has several other benefits for the financial sector, as well. First, pursuant to the MoU, the bank levy is to decrease in two steps in 2016 and in 2017. Second, due to the more predictable economic environment and the ongoing reorganization of banks, from 2015 onwards, the financial sector will operate more efficiently, which is substantially backed by the considerable cost reduction of the last few years, and by the future increase of their lending activity. Finally, as instalments are becoming lower, due to the ongoing settlements, and more predictable in the long run, due to the fair banking regulation, a larger proportion of debtors will be able to duly meet their loan obligations. These developments may contribute to a better performance of the banking system.

On the whole, we project that the profitability of the banking sector will substantially improve by 2017, in particular as a result of a lowering NPL ratio, and of the reduced level of bank levy. The Government is committed to promote these objectives, since it took a clear position in the MoU with EBRD that Hungary needs efficiently, transparently and prudentially operating banks, whose lending activity supports growth, capital adequacy is proper, and whose profitability is secured in the long run.

3. GENERAL GOVERNMENT DEFICIT AND DEBT

3.1. FISCAL POLICY OBJECTIVES

As a result of the successful fiscal consolidation implemented after 2010, the general government deficit has been under 3% of GDP for the 4th consecutive years. In 2014, the deficit was 2.6% of GDP contrary to the planned 2.9%. As macro-economic and fiscal trends suggest, the 2.4% deficit target set for 2015 is safely attainable. This rate is lower than it was projected in the previous Convergence Programme.

Taking into consideration the stronger than expected upturn of the economy, the better prospects and the favourable fiscal trends, the Government revised the fiscal path set in April 2014 and determined the deficit targets at much lower rates. The additional revenues from growth, the low-yield environment, the results of structural reforms of the Széll Kálmán Plan, and, from 2016 on, the smaller amount of the national co-financing as the EU transfers are only gradually increasing in the first half of the new EU programming period create room for manoeuvre for the Government to reduce taxes and to make up for certain outstanding expenditures, on the one hand, and to reduce the deficit, on the other hand.

The new medium-term fiscal path is to secure the reduction of public debt required in the Constitution, as well as the fulfilment of the debt rule set out in the Stability and Growth Pact. The structural deficit, the revised potential output level also taken into account (see Chapter 2.5), is to remain below the medium-term budgetary objective in the programming period, apart from one conditional temporary increase in 2015. This potential increase may be the consequence of certain investments enhancing the state wealth, which may take place subject to the receipt of revenues from the sales and use of state property. This year the structural deficit may temporarily increase to some extent as a result of the one-off nature of the corresponding revenues.

With the stabilisation of the budget, the debt ratio is now on a downward path, the gross public debt to GDP ratio fell from 81% of 2011 to 76.9% by the end of 2014. With the targeted deficit path the debt ratio may fall by a further 8 percentage points, i.e. below 70% in the time horizon for the Convergence Programme.

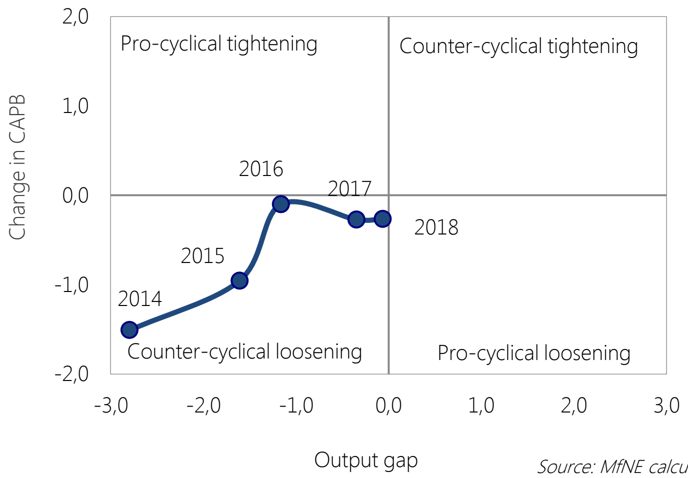
Table 3.1.: The Medium-term fiscal path (% of GDP)

	2014	2015	2016	2017	2018
General government balance	-2.6	-2.4	-2.0	-1.7	-1.6
Structural balance	-1.5	-2.1 (-1.6)	-1.6	-1.4	-1.6
Gross public debt	76.9	74.9	73.9	71.3	68.9

Source: HCSO, MNB, MfNE calculations

Relying on the results of consolidation, fiscal policy could already take supporting economic growth into account, however, in line with the improved growth fundamentals the role of fiscal stimulation can decrease. On the basis of the changes in the cyclically adjusted primary balance, the fiscal impulse of 2014 is followed by a more modest stimulus of the aggregate demand in 2015, and the demand effect of fiscal policy is expected to be close to neutral from 2016.

Chart 3.1: Fiscal stance (+ tightening, - loosening)
(percentage point)



Source: MfNE calculations

3.2. THE 2014 BUDGETARY OUTCOME

Similarly to the previous 2 years, in 2014 the general government deficit based on EU methodology turned out to be lower than the target. The first disclosure provided by the Hungarian Central Statistical Office to Eurostat shows that the deficit was 2.6% of the GDP instead of the targeted 2.9%, even though the different accounting of swap transactions itself increased the deficit by 0.3% percentage points (see Box 6). However, in contrast to the years 2012-2013, in 2014 the better budgetary outcome was mostly due to the considerably better than expected economic growth and the additional revenues from the whitening of the economy. The improvement occurred at the level of central subsystems (central government and social security), where both the cash flow deficit and the ESA 2010 deficit figures fell below the ones expected in the previous Convergence Programme.

In 2014 the cash flow balance of the central government also included items which did not affect the balance calculated by the EU methodology, particularly the expenses of strategic corporate share acquisitions in the areas of telecommunication, energy, and waste management. Among the items not included in the cash flow balance but included in the accrued accounting, the most significant one, this year again, is related to the debt consolidation of local governments. In the last phase of the consolidation the central government assumed a debt of exceeding HUF 400 billion from the municipalities. This transaction modified the balance of only the sub-systems, its effect was neutral at the level of the general government as a whole.

Table 3.2.: The Balances of 2014 (% of GDP)

	2014 Convergence Programme	Notification of Spring 2015
Cash flow balance of the central sub-systems	-3.5	-2.6
Cash flow balance of local governments	0.3	0.3
EDP balance of the central sub-systems	-4.4 (-3.1)*	-4.0 (-2.7)*
EDP balance of local governments	1.5 (0.2)*	1.4 (0.1)*
EDP balance of the general government	**-2.9**	**-2.6**

Source: HCSO, MfNE

**In brackets: without assume of municipalities debts*

In order to safely reach the deficit target in the course of budget implementation and taking into account country-specific recommendation No. 1 of 2014, the Government decided in July to reduce the expenditures by HUF 110 billion (i.e. 0.3% of GDP) (freezes on the appropriations for expenditure in the central budgetary chapters and on the reserve for exceptional government measures, balance improvement at the extra budgetary funds, reducing the expenditures of the Investment Fund). With regard to the economic growth stronger than expected and the resulting additional revenues, HUF 60 billion could be released in the last two months of the year.

The Parliament approved HUF 160 billion additional expenditure when amending the budget to cover the expenses of strategic corporate share acquisitions, which, however, did not by their nature deteriorate the government balance calculated according to the EU methodology. The amendment also provided a few additional resources of smaller amounts also affecting the ESA 2010 expenditures (appr. HUF 55 billion) for example for the following: the capital increase of Eximbank Zrt., the developments required for the introduction of the Electronic Trade and Transport Control System ("EKÁER"), the improvement of standards of the sustainability of transport infrastructure, etc.; however, these expenditures were covered by the reduction of extra risk reserve (Country Protection Fund). In addition, in the middle of the year the Government decided to extend public work scheme, and increased the appropriation for expenditure of the START working programme by 25%. Besides public employment, more expenditure than planned was spent also on health care, however, these additional expenses were widely compensated by the savings on pension expenditure, disability and rehabilitation benefits, and from housing, family and social subsidies.

On the revenue side, both the income and turnover type taxes overperformed, compared not only to the appropriations but to the expectations of the previous Convergence Programme too, mainly due to the surpluses from corporate income tax, personal income tax and value added tax. Despite the decline of consumer prices, the accrual-based VAT revenue increased by 11.8% compared to the base year, in which, in addition to the increased consumption, the whitening effect of the online cash registers also materialised. The surplus from social contributions was, apart from the improvements in employment, further enhanced by the lower than expected number of those choosing the preferential taxation schemes (small business tax, lump-sum tax for small tax payers). The ESA-based revenues were further increased by that EU funds were used by general government to an extent greater than estimated in the previous Convergence Programme.

The expenditure side also shows essential changes: more money was spent by the government to the compensation of employees and, also due to the EU funds of greater amounts, to investments, while savings were generated in the areas of social cash benefits and the expenses spent on purchasing goods and services.

Compared to the forecast of the previous Convergence Programme, the switch to the ESA 2010 methodology also modified the level and structure of revenues and expenditures, in addition to the fiscal trend (see Box 6). Furthermore, the GDP-based indicators were heavily influenced by the fact that the GDP in current prices increased by HUF 1,400 billion, which resulted partly from the revision of the base data due to the switch to ESA 2010, and partly from economic growth being stronger than expected.

Table 3.3.: Changes in the general government data of 2014 (% of GDP)

	2014 Convergence Programme (ESA95)	Preliminary fact (ESA 2010)	From deviations	
			surplus/shortfall	GDP effect
Tax revenues	25.8	25.4	0.7	-1.1
Social contributions	13.4	13.2	0.4	-0.6
Other	8.1	9.0	1.3	-0.3
Total revenue	**47.2**	**47.6**	**2.4**	**-2.1**
Compensation of employees	10.4	10.6	0.7	-0.4
Intermediate consumption	8.4	7.8	-0.2	-0.4
Social transfers	17.0	16.0	-0.2	-0.7
Gross fixed capital formation	4.5	5.2	0.9	-0.2
Other	9.9	10.5	1.0	-0.4
Total expenditure	**50.1**	**50.1**	**2.2**	**-2.2**
BALANCE	**-2.9**	**-2.6**	**0.2**	**0.1**

Source: HCSO, MfNE calculations

Any deviations in the table are due to rounding.

Box 6: The Impact of the switch to ESA 2010 on general government data

In autumn 2014, the switch to ESA 2010 having taken place, the major impact on general government data was made by the change in accounting the takeover of the mandatory private pension assets by the Government. While previously the assets of appr. HUF 2,700 billion (9.6% of the GDP) improved the 2011 balance in one sum (resulting in a significant surplus), the revenue according to the new methodology compensates the future pension payments divided in a long term. A takeover of mandatory private pension assets of a much smaller extent (0.2% of the GDP) also took place in 2010 and in 2012, when the balance impact was many times lower than that of 2011.

Other changes related to the introduction of ESA 2010 (the modified classification methodology of the government sector and the accounting of standardized guarantees) had only a negligible impact on the general government balance.

Simultaneously with the switch, the difference between the methodologies of the EDP Notifications and national accounts was eliminated in swap accounting. The impact on the balance was -(0.1–0.2%) of the GDP between 2010 and 2013.

Finally, the changes of methodology resulted in a considerable upward correction in the level of the nominal GDP, which further influenced the government balance to GDP ratio.

Table 3.4.: Change of the general government balance (% of GDP)

	2010	2011	2012	2013
EDP balance (Notification of Spring 2014)	**-4.3**	**4.3**	**-2.1**	**-2.2**
Change in the GDP	0.1	-0.1	0.0	0.1
Change in swap accounting	-0.1	-0.1	-0.1	-0.2
Impact of the switch to ESA 2010	-0.2	-9.6	-0.2	0.0
Data revision	0.0	0.0	0.0	-0.1
ESA 2010 balance (Notification of Autumn 2014)	**-4.5**	**-5.5**	**-2.3**	**-2.4**
ESA 2010 balance (Notification of Spring 2015)		**-5.5**	**-2.3**	**-2.5**

Source: HCSO, Eurostat

Any deviations in the table are due to rounding.

The new methodology has modified not only the balance but also the level and structure of revenues and expenditures. A major change was that R&D activity should no longer be regarded as a current expenditure but as fixed capital formation. Investment expenditures and other revenues along with this (output for own final use) have increased. Some of the military expenditures, subject to their nature, were moved from the intermediate consumption to the gross fixed capital formation.

According to ESA 2010 the VAT due to be paid to the EU is also part of the tax revenues, parallel to which the current transfer expenditures are to increase. In relation to the takeover of the mandatory private pension assets, an imputed interest expenditure further increases the expenditures and the other current transfer revenues.

Finally, the level of revenues and expenditure has further changes due to the organisations newly classified into general government sector.

3.3. THE 2015 BUDGET

With regard to the reduction of government debt required by Hungarian and EU laws and targeted by the Hungarian economic policy, and to the favourable macro-economic and fiscal trends already on the horizon in 2014, in the budget for 2015 the Government changed the deficit path set out in the previous Convergence Programme downward and set the deficit target at 2.4% for this year. The major elements to determine the budget are the following:

- No general increase in salary took place in the public sector in 2015. The gradual introduction of the teachers' career model is going as planned, however, from 2015 the change of the so-called basic salary, a central element of the remuneration system, will not follow the collective agreement of the private sector for teachers, but the general budget framework conditions instead.

- The introduction of the career model will also begin for armed forces and law enforcement workers, with a 30% salary increase from July 2015 (the net fiscal impact of the measure is HUF 27 billion).
- In June 2014 the Government decided to further extend the scope of public work schemes. The aim of the Government is to better implement the principle of "job instead of social transfer" and that more and more of those receiving employment substitute benefit move to the labour market – first into the public work scheme, then to the primary labour market. The START Work Programme has an appropriation of HUF 270 billion for 2015, which is almost 20% more than the amount spent for this purpose in 2014. In 2015 the remuneration of those in public work schemes increased by 2.4%, but the considerably higher financial framework enables an increase of the number of those participating in this scheme of public work by tens of thousands from the second half of the year.
- The assistance provided to physicians is to rise by HUF 10 billion, and the budget has among the provisions HUF 60 billion available for the debt consolidation of health institutions.
- The assistance provided to long-distance transport services is to rise, whereas the consumer price subsidy (social policy fare subsidy) is to remain at the increased level of last year.
- The budget provides a considerably increasing amount of assistance to extend the export stimulating lending activity of Eximbank Zrt. which also improves international competitiveness.
- Pensions and pension-like benefits have increased at the inflation rate projected in the budget (1.8%), in accordance with laws. Some changes have been made in the division of tasks between the central government and the local governments in the area of certain social benefits, although it is basically the number of beneficiaries that determines the expenditure on family and social benefits at the level of general government as a whole.
- The year of 2015 is the last when the resources of the EU programming period of 2007–2013 are available for use, while the resource for the new programmes of the period of 2014–2020 are already stared to be paid. The budget is to provide the necessary national resources to the EU funds exceeding even last year's high level.
- The budget expected a saving of HUF 20 billion to gain through bureaucracy reduction implemented within the frameworks of "State Reform 2".
- In 2015 again, certain investments, mostly of cultural and sports nature, are recognised by the budget in a so-called Investment Fund, and are covered by the revenue generated from the sale and use of state property. The appropriations in the Fund are only to be committed with the prior consent of the minister for public finance, who will approve such action only if the deficit target is safely achievable.
- The budgetary revenue accruing from road network users is expected to increase in 2015. In case of the time-based charges, the range of road network elements liable to charges has extended since the beginning of the year, the tariff scheme has been modified by the introduction of a new fee category, and, at the same time, the annual regional vignette has been introduced for road network users with favourable terms. In case of the distance based fee, the range of road network elements liable to charges has been further extended, and a general increase in the level of the fee has also taken place. The Government has committed itself to ensure long term sustainable financing of road traffic infrastructure. With the introduction of the distance-based

tariff scheme, i.e. by putting the principle of "the user pays" in place, the range of resources for transportation has also widened along with the increasing revenues generated from road users. As a result, funds are being generated for the operation, maintenance and renovation of the national road network financed from the budget, as well as for further transportation related purposes. The widening resources available brought a favourable turn in the fiscal funding of road infrastructure, which we intend to further enhance in the future. The aim is to secure the stable maintenance of an appr. 32,000 km long road network, ensuring a safe and secure transport in the long term, as well as to boost public satisfaction by increasing the rate of EU standard road surfaces. In 2015 an additional HUF 10 billion are allocated for such purposes compared to the previous years.

- No material change has taken place in the tax system, apart from a few slight modifications or refinements, however, the range of tools for economy whitening has widened (for example, the launch of EKÁER, extending the use of online cash registers, etc.).
- The Job Protection Action Plan has been further extended: in order to improve the labour-market situation of parents with young children, allowance may be used after such parents in part-time employment from 2015 up to a ceiling of HUF 100 thousand gross, without regards to the length of working time.
- The reserves incorporated in the budget for covering unpredictable expenditures and neutralising the risks amount to 0.4% of the GDP.

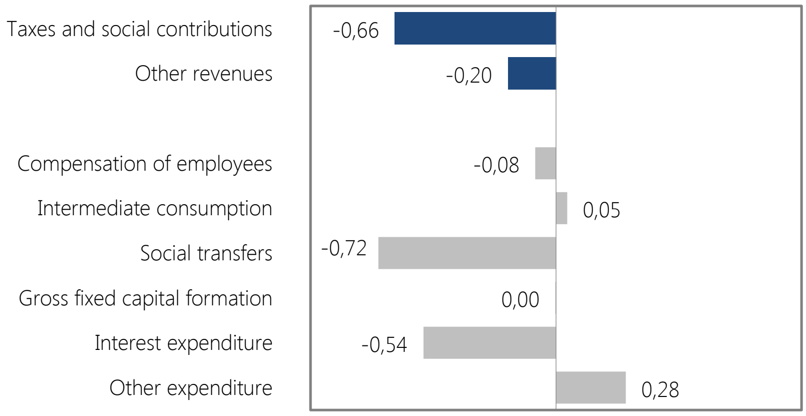
On the basis of the cash flow data of the first three months, the Convergence Programme envisages that the 2.4% deficit target is sustainable. The aggregate deficit of the central budget, the social security funds and the extra-budgetary funds amounted to 61% of the annual appropriation by the end of March, which is considerably lower than last year's quarter/year ratio, even though the January-March balance was also affected by transitory effects in 2015. Due to Easter holidays, the family and social benefits due in April were advanced at the end of March, and the advance payment of the expenses of EU programs from national resources has reached again a considerable level; these will be reimbursed during the year. The balance being favourable is mainly due to the increase of the tax and social contribution revenues. Despite the fact that in 2015 the inflation rate may go much below again the rate estimated at the time of preparing the budget (0% instead of 1.8%), there are several factors to support that the amount of tax and contribution revenues may go above the budgetary appropriations this year again. Tax revenues in 2014, particularly in case of corporate income tax and value added tax, but, to a smaller extent, also in case of other taxes, exceeded the amounts foreseen when preparing the budget, leading to a favourable base effect. Furthermore, the improvement of employment is more dynamic than expected in the macro-economic prognosis the budget is based on, and the household consumption growth also may accelerate. Taking all this into consideration, the prognosis of the Convergence Programme envisages a surplus of tax and contribution revenues amounting to 0.4% of GDP.

The revenue surplus and the fact that the improving yield environment may bring the accrual-based interest expenditure by 0.1% of GDP below the amount expected in the budget, may cover the surpluses explained mainly by base effects in case of compensations of employees and investments, the additional expenditures approved in the budget amendment as well as the assumption of the debt of the community transport company of Budapest. The intermediate consumption expenditures may, at the same time, lag behind the budgetary expectations of 2015, mainly as a result of the base effect again. As for social transfers, the expected savings (pensions, disability and rehabilitation benefits, employment benefits) may overcompensate the slight slippages (support on medicines and therapeutic appliances, sick pensions).

Despite the projected surplus, the tax and contribution revenue to GDP ratio is to fall compared to the rate of 2014. Although the structure of economic growth has become much more balanced than it was before, the growth contribution of tax-poor components (investments, net export) remains to be significant. With the falling centralisation rate, the balance improvement may be achieved by the more pronounced decline of the expenditure/GDP ratio. As a result of the structural reforms of the Széll Kálmán Plan, social transfers increase far behind the GDP, and interest expenditure shows a nominal decrease compared to 2014. In the development of intermediate consumption expenditure balance-neutral effects are also reflected: the expected EU funds exceeding last year's levels lead to increase, whereas the narrowed range of the Treasury transaction levy[5] leads to decrease.

Chart 3.2: Expenditure and revenue changes 2015-2014

(% of GDP, percentage point)



3.4. Budgetary developments from 2016 to 2018

In order to enhance predictability the Government is to submit the budget for 2016 to Parliament much sooner than required by law, i.e. in the first half of 2015. The budget builds on conservative assumptions (2.5% economic growth, 1.6% inflation rate), and is planned to contain reserves amounting to 0.5% of GDP, a rate slightly higher than it was in 2015.

The room for manoeuvre in the 2016 budget is widened by both transitory and long-term effects. On the one hand, after the phasing out of the projects of the previous EU programming period, only the new 7-year framework will be available from 2016. Since the absorption of EU funds is expected to increase gradually in the first half of the new cycle, much lower EU transfers compared to 2015 will be accompanied by around 20% lower national co-financing expenditures next year. On the other hand, interest expenditures are projected to decrease even nominally due to the lower deficit and low yields. In addition, the results of the structural reforms of the Széll Kálmán Plan further widen

[5] Due to the gross accounting, transaction levy built into the fee for Treasury services increases both the intermediate consumption expenditure of budgetary institutions and the revenue of Treasury. However, as of 2015, out of the budgetary institutions, the Government Debt Management Agency is no longer liable to pay transaction duty.

the room for manoeuvre, and expenditures on social transfers will increase well below GDP growth also in 2016. Finally, the increase of tax and social contribution revenues as a result of the favourable macroeconomic developments also facilitate the achievement of the fiscal targets.

The room for manoeuvre will be used by the Government to reduce taxes, to make up for certain outstanding expenditures as well as to cut the deficit. In addition to continuing on-going measures the draft budget also contains new elements:

- Pursuant to the agreement with the EBRD, the rate of levy imposed on credit institutions will be significantly reduced from 2016, and the base of the tax will change.
- The personal income tax rate will be reduced by 1 percentage point, i.e. from 16% to 15%, and tax allowances will be higher for families with two children, as announced earlier.
- The VAT on pork carcass will be reduced to 5%.
- Certain administration fees and procedure duties will be cut or phased out.
- No other major changes are envisaged for the tax system, the flat rate corporate tax will not be implemented in 2016 yet.
- The budget contains revenues from the sale and use of state property next year again, however, the amount of this is hardly more than half of the appropriation of 2015.
- A general wage increase in the public sector will not be possible in 2016 either, although a certain part of outstanding payments accumulated throughout several years will be compensated. The gradual introduction of the teachers' career model and the implementation of the career model for the armed forces and law enforcement employees will continue as planned. Besides, only the career model of government officials, making up slightly more than 10% of public sector employees, may be launched in the second half of 2016. The rules of career models focus on the enhancement of performance criteria instead of automatic promotions.
- Public work schemes will be further extended. The aim of the Government is to gradually achieve full employment by 2018, and to provide valuable job opportunities to citizens able and willing to work instead of benefits. To this end, further tens of thousands of persons will be involved in 2016 in public work schemes. The budgetary appropriation of the START Work Programme will be increased by 25%.
- Investment expenditures in the 2016 budget are more focused with high weight of big large projects. The biggest one is the acceleration of priority road investments determined by the Government, funded from the budget. The aim of the Government is to connect each city with county rights into the national highway network by 2018 and to have cross-border interconnectedness to promote development. To supplement EU funds, considerable national budgetary resources are also allocated for this purpose. In addition to providing the necessary financing, a number of measures (e.g. concerning permits, construction and official duties) are also being drawn up to enable a quick completion of the projects.
- Concerning expenditures on goods and services, the principle of cost-efficient planning remains.
- Pension expenditures making two-third of the social transfers secure that the real value of pensions is maintained. The family and social benefits are still determined by the number of users, interest rate subsidies for housing purposes are moderated by the changes in yields and the decline resulting from the repaid loans. The sum of the social policy fare subsidies will remain the same, however, for the pharmaceutical subsidies and subsidies for therapeutic equipment, the amount planned in the budget is somewhat higher than the appropriation for this year. On

the whole, social transfers in kind provided by market producers may increase by 2% compared to 2015, and social transfers other than in kind will remain stable.

Table 3.5.: New measures in the 2016 budget (% of GDP)

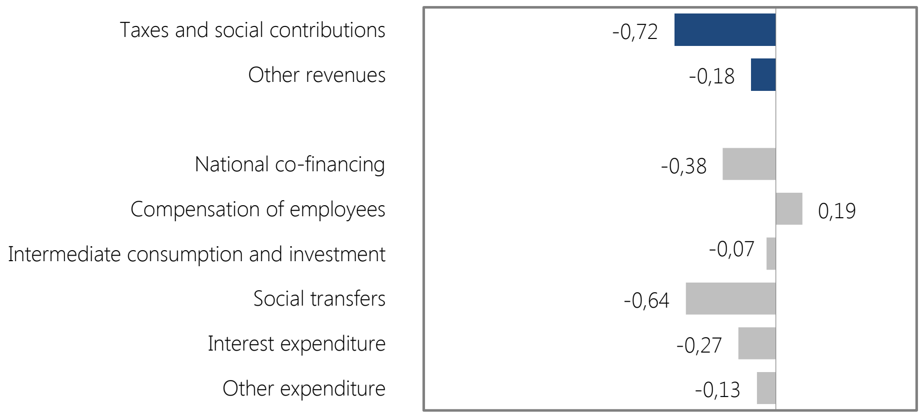
	2016
Cut in the levy on credit institutions	0.17
Decrease of PIT rate, extension of family allowance	0.35
VAT reduction	0.07
Duty reduction	0.03
Government officials' career model (net impact)	0.07
Acceleration of major investment projects	0.72
New measures in total	**1.41**

Source: MfNE calculation

Compared to 2015, the tax and contribution revenues to GDP ratio may, due partly to tax reduction, partly to the structure of economic growth, continue to fall by 0.7 percentage points, however, 90% of the decline in the tax centralisation is offset by the lower interest expenditures and the balance improving impact of the national co-financing supplementing EU funds. The revenues from the sale and use of state property are recognised in the ESA accounting as an expenditure reducing item. Expenditures on social transfers and the purchases of goods and services covered solely from national budget change little in nominal terms compared to last year, showing a decrease as a percentage of GDP, thereby improving the balance. The additional expenditure on career models, along with the extension of public work schemes, lead to the compensation of employees growing faster than the GDP, nevertheless, overall developments of total revenues and expenditures, result in a deficit-to-GDP ratio falling by 0.4 percentage points.

Chart 3.3: Expenditure and revenue changes 2016-2015 (EU-transfers excluded)

(% of GDP, percentage point)



No new measures are included in the calculations of the Convergence Programme for the last two years of the forecast horizon. However, projected macroeconomic developments may imply additional room for manoeuvre reaching 0.4% of GDP in 2017 and 0.5% of GDP in 2018, which, subject to future decisions, may also be used for further tax reductions or for further developments. This buffer appears in the calculations as "Tax Reduction and Development Fund".

The tax and contribution revenues will grow slower than GDP in 2017 and in 2018, too, and taking into account the agreement with the EBRD and the already announced gradual extension of the family tax allowance, tax centralization is expected to decrease to below 36% by 2018. Considering that after 2016 only the gradually increasing absorption of funds of the new, 2014-2020 EU programming period is expected, and taking into account the growing ratio of non-public sector beneficiaries, the total general government revenues to GDP ratio is envisaged to decrease by a further 1.5 percentage points in the last two years.

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

	2015	2016	2017	2018
Taxes and contributions	37.9	37.2	36.4	35.9
Other revenues without EU transfers	5.4	5.2	5.0	4.8
Total revenue without EU transfers	43.3	42.4	41.4	40.6
EU transfers	3.4	1.9	1.9	1.9
Total revenue	**46.7**	**44.3**	**43.3**	**42.5**

Source: MfNE calculation

Any deviations in the table are due to rounding.

Besides the decreasing centralisation rate, the deficit targets can be achieved by significant expenditure restraint. The balance is further improved by the lower interest expenditures, however, social transfers can contribute most to the reduction of the re-distribution.

Table 3.7.: Main expenditures of the general government (% of GDP)

	2015	2016	2017	2018
Balance	-2.4	-2.0	-1.7	-1.6
Total revenue without EU transfers	43.3	42.4	41.4	40.6
Total expenditure without EU transfers	45.7	44.4	43.1	42.2
of which:				
social transfers	15.3	14.7	14.1	13.6
interest expenditure	3.6	3.3	3.1	2.9

Source: MfNE calculation

In the last two years of the programme horizon

- the development of social transfers are still influenced by the implemented structural reforms. The increase in the cash benefits reflects in particular the preservation of the real value of pensions, and the in-kind transfers provided through market producers may show an increase below the projected inflation rate. Between 2016 and 2018 the total expenditure on social transfers as a percentage of the growing GDP is projected to decrease by slightly above 1 percentage point.
- Apart from the EU transfers and related national co-financing, intermediate consumption expenditures are expected to grow only in 2018, when the requirement to reduce the deficit becomes less stringent.

- The development of investment expenditures is mainly determined by EU transfers and the major projects in progress.
- The expenditure on compensation of employees as a percentage of GDP may show a slight increase in 2017 as a result of the career models and the ongoing extension of public work schemes, however, it is projected to moderate afterwards.

3.5. Structural balance

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 the potential growth rate over the forecast horizon, gradually closing the negative output gap, and bringing the actual output close to its potential level by 2018 (see chapter 2.5). As a consequence of the negative output gap characterising the whole forecast horizon, the cyclically-adjusted balance is more favourable than the actual balance in each year.

In 2014 the major one-off item was the concession revenues from the extended frequency usage rights. In 2015 certain investments enhancing the state wealth may take place subject to the receipt of revenues from the sale of state property. The corresponding revenues are of one-off nature. In 2016, similarly to 2015, one-off revenues are expected from asset sales, though in smaller amount. For 2017 and 2018, the programme contains only the sale of CO_2 quota of insignificant amounts, no other one-off item is accounted for.

The structural deficit, i.e. the cyclically adjusted balance net of one-off and temporary items, has been significantly better than the medium-term objective (MTO), defined as structural deficit equivalent to 1.7% of the GDP, since 2012, and will remain below the MTO throughout the programming period. In 2015 certain investments enhancing the state wealth may take place subject to the receipt of revenues from the sale of state property. In case of their materialisation, given the one-off nature of the corresponding revenues, the structural deficit may temporarily increase somewhat.

Table 3.8.: Structural Balance (in % of the GDP)

	2014	2015	2016	2017	2018
Output gap	-2.8	-1.7	-1.4	-0.6	-0.2
Balance of the government sector	-2.6	-2.4	-2.0	-1.7	-1.6
Cyclically adjusted balance	-1.2	-1.6	-1.3	-1.4	-1.5
Net one-time items*	0.3	0.5 (0.0)	0.3	0.0	0.1
Structural balance	-1.5	-2.1 (-1.6)	-1.6	-1.4	-1.6

**The positive number refers to an item improving the headline balance.*
Source: MfNE calculations

As the structural deficit is expected to overachieve the MTO during the programme period, the expenditure aggregate (primary expenditures net of EU transfers) may increase at a rate in excess of the reference benchmark.

3.6. GENERAL GOVERNMENT DEBT

In 2010, the Government set one of its main economic policy objectives to put a halt to the rising trend of public debt-to-GDP ratio and to define a sustainable downward path to it. The Government is committed to a disciplined and sustainable fiscal policy and a growth-friendly economic policy. The public debt–to-GDP ratio was brought down from 81% to 76.9% by the end of 2014, with a parallel increase in state properties.

Besides curbing the debt ratio, the Government also intends to reach a more favourable structure of debt, with the attempt to enhance domestic participation in debt financing and to reduce foreign exchange risk of the public debt.

More than half of the public debt is financed by non-residents, what makes the country vulnerable and poses refinancing risks, as in case of market turbulences, foreign investors tend to liquidate their positions in greater volumes and in a shorter period of time than domestic actors. In order to mitigate this, a priority objective of debt management strategy is to encourage domestic sectors to invest in government securities. As a positive impact, in addition to a more stable debt financing, interest payments are earned within the country. Several new types of retail securities were introduced during the last two years, which were developed with the aim of responding to different preferences of retail investors. As a result of the retail programme launched in 2012, the share of government securities held by households rose from 5% to 10%, and has remained at this level since then. In 2014, the Central Bank of Hungary launched its self-financing programme with a view to shifting liquidity surplus of institutional investors to the government securities' market. In order to absorb the extra demand, the Government Debt Management Agency increased HUF issuances and introduced a new type of government bond with variable interest rate and a 3-year maturity period, which appeared to be a product of outstanding success.

Since March 2014, due to the massive net HUF issuances, no FX-denominated bonds have been issued in the international markets, and the Debt Management Agency does not have the intention to do so in 2015 either. These developments have contributed to a faster decrease in the FX ratio of public debt, which was brought down from above 50% to below 40% by the end of 2014. The exchange rate risk will be further reduced by the continued decrease in the foreign exchange ratio, making the future debt path more predictable.

Country risk and yields have continued to follow their downward trend in the last year, as well. We have seen a basically balanced and stable period on the government securities' market.

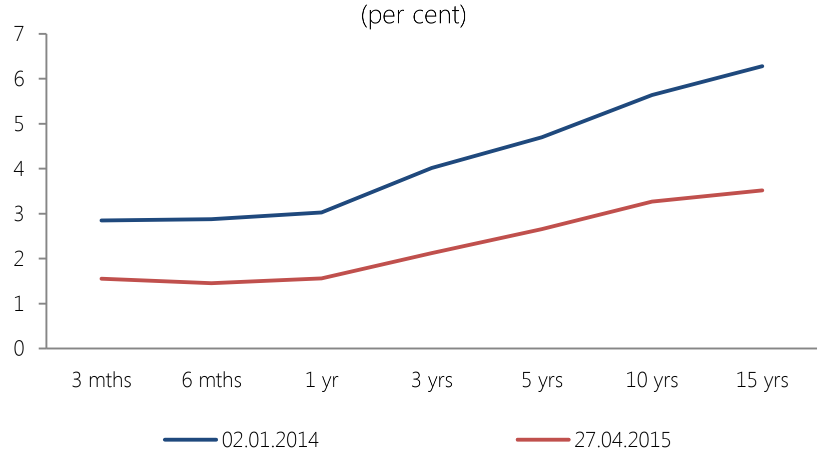
The Hungarian 5-year CDS spread opened the year close to 250 bps and closed it, after a gradual moderation, below 180 bps. The spread, which provides a good indication of country risk, showed a fast decline in a short period of time in the first months of 2015, and went below 140 bps, a level last seen in 2008, before the outbreak of the financial crisis. The decrease can be explained by two main factors. On the one hand, external indebtedness of the country has been gradually and substantially moderating due to the settlements and the conversion of FX mortgage loans, and, on the other hand, the agreement between the Government and the EBRD projects a growth-supporting financial environment.

The yield curve, reflecting to some extent the impact of the above, has showed a significant downward shift. 5-year yields have declined from 4.7% to 2.7%, whereas 10-year yields reduced from 5.6% to 3.3% since the beginning of 2014, mostly due to the better country risk profile and to the lower inflation expectations. The yield curve has become less steep due to the considerable decrease in the long-term yields (Chart 3.4). 3-month yields, following the base rate, diminished from the 2.9% of early 2014 to 1.6%.

Primary market yields became lower, as well. Yields on T-bill auctions decreased from 3% to 1.6%, while that of bonds declined from 4.3%-5.7% to 2.1%-3.3%. HUF bond auctions had an average bid-to-cover ratio of 2.7, and total bids accepted exceeded more than 21% the total volumes offered since the beginning of 2014.

Chart 3.4: Yield curve

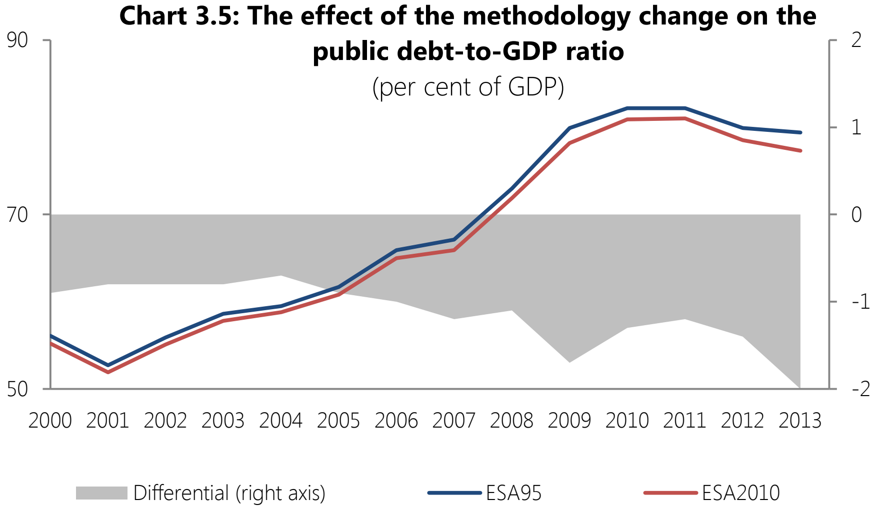
(per cent)



Source: ÁKK

Recent prognoses indicate a downward shift of the debt path compared to the one in the Convergence Programme for 2014. One reason for this is that the new ESA 2010 GDP data in current prices are higher than those compiled with the previous methodology. (Chart 3.5) The other main reason for a diminishing debt ratio is more fundamental and policy related as responsible fiscal policy and growth-friendly economic policy has made a substantial contribution to make a more steeply declining debt-to-GDP ratio possible. Therefore, the ratio is expected to fall from 76.9% of 2014 to below 70% by 2018.

Chart 3.5: The effect of the methodology change on the public debt-to-GDP ratio
(per cent of GDP)



Source: MNB, HCSO, MfNE calculations

With regard to the fact that there is no data adjusted for the impact of the methodological change on the nominal GDP levels, we refrain from quantifying the factors behind the deviations between the debt paths in the Convergence Programmes of 2014 and 2015.

(1) Nominal GDP: The Convergence Programme of 2015 projects a nominal GDP higher than that of 2014. Besides the improved growth prospects and the higher GDP deflator, the lower debt path is explained by the shift from ESA 95 to ESA 2010 methodology.

(2) Government deficit: Government securities yields have significantly decreased since the Convergence Programme of 2014, causing lower interest expenditure projections with a decreasing trend in the forecast horizon. Better macroeconomic indicators and disciplined fiscal policy has led to better perceptions of the country by investors and credit rating agencies, what is reflected in the lower risk premia and spreads. The cost of debt financing is becoming lower, so the Government is expecting a gradual decrease in the interest expenditures. A deficit path lower than previous year's projection and still meeting the 3% EU reference value will significantly contribute to debt rate reduction in the future, as well.

(3) Stock-flow adjustments: Apart from the above, the debt path is further modified by stock-flow adjustment items.

- The technical assumption for exchange rate used for debt prediction is somewhat stronger than the 307.9 HUF/EUR rate of the Convergence Programme of 2014. The Programme of 2015 projects a rate of 304.7 HUF/EUR this year, and 303.7 HUF/EUR from 2016 onwards.
- The prognosis on the change in government reserves (Standard Treasury Account and the foreign deposit with the Central Bank of Hungary), the pre-financing of EU transfers, and the difference between the cash based and the accrual budget balance are also different from the projections of the previous Convergence Programme.

Table 3.8.: Main assumptions in the Convergence Programmes

		2014	2015	2016	2017	2018
Nominal GDP growth (%)	CP - April 2014	4.8	5.3	5.1	6.0	-
	CP - April 2015	6.8	5.5	4.6	5.8	5.8
General government net lending (GDP%)	CP - April 2014	-2.9	-2.8	-2.5	-1.9	-
	CP - April 2015	-2.6	-2.4	-2.0	-1.7	-1.6
Public debt (GDP%)	CP - April 2014	79.1	78.9	77.5	74.7	-
	CP - April 2015	76.9	74.9	73.9	71.3	68.9

Source: Calculation by KSH, MNB and NGM

The future developments of the public debt-to-GDP ratio are determined by changes in the following major factors, with everything else remaining unchanged:

(1) Primary balance: A 1 percentage point upward shift in the primary balance in terms of GDP from 2014 until the end of the horizon would reduce the debt-to-GDP ratio by 1 percentage point in 2015 and by 3.7 percentage points by 2018.

(2) Exchange rate: The share of foreign currency debt within gross debt was approximately 40% at the end of 2014, and, as a result of the Government's endeavours, should decline to almost 22% by 2018. In view of this, a 1% appreciation of the nominal exchange rate (301.7 and 300.7 HUF/EUR, respectively, in 2015 and in subsequent years), compared to the technical exchange rate in the Convergence Programme, would result in a 0.3 percentage point lower gross debt ratio in each year over the projection horizon.

(3) Economic growth: Should nominal GDP growth end up 1 percentage point higher in 2015, debt path would see a 0.7 percentage point downward shift.

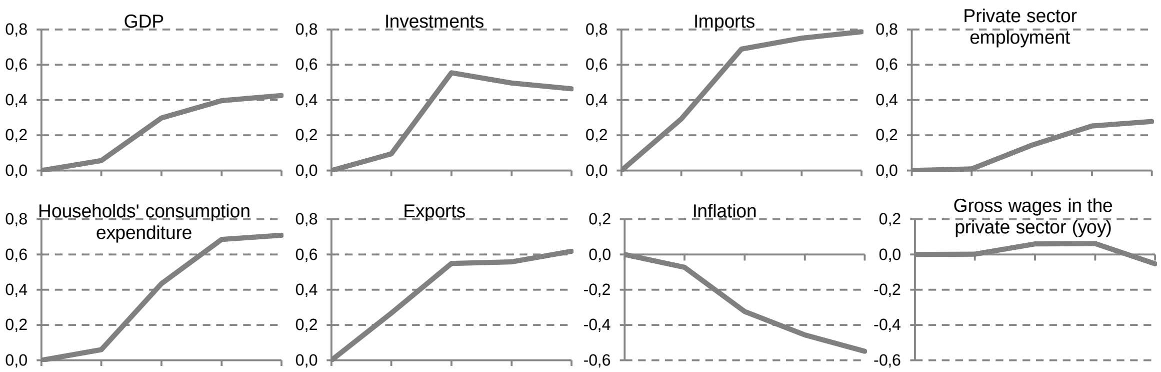
4. SENSITIVITY ANALYSIS

The macroeconomic baseline scenario of the Convergence Programme is subject to both positive and negative risks, of which the sensitivity analysis of two alternative scenarios was performed. In the positive scenario, we estimated the impact of persistently low level of oil prices, while the subject of the negative scenario was the deteriorating external environment. Similarly to the impact assessment of government measures, calculations were based on the DINAMO model of the Ministry for National Economy. Table 4.1. shows the cumulated difference of major macroeconomic variables from the baseline scenario due to various shocks.

Recently world market prices of crude oil have dropped significantly, reflecting both demand and supply factors (as described in Box 2). Due to the more moderate imported inflationary pressure, the cost-side process supports the growth of domestic demand. The significant decline in oil prices also means that changes of future oil prices are uncertain. Indeed, in the long run futures quotes (which reflect market expectations) do not necessarily capture the exact development of prices. For this reason, the first scenario is based on the assumption that oil prices will remain persistently low: 10% lower than the assumed price level in the baseline scenario.

The lower oil price dynamics on the one hand means that consumers spend less from their disposable income on fuel, resulting in the purchasing of other consumer goods and higher savings. On the other hand, this leads to lower expenses and higher profitability for the corporate sector. The improvement of profitability will also lead to the increase of production capacities, resulting in higher investments and number of employees. Not only Hungary, but as an importer of oil, also its major foreign trade partners benefit from the persistently low oil prices. Consequently, external demand may increase which also supports the strengthening of Hungarian exports. Assuming an endogenous interest rate path, the disinflationary shock also supports domestic demand and improves the general government balance by nominal interest rate cuts.

Chart 4.1.: Persistently Low Oil Prices*



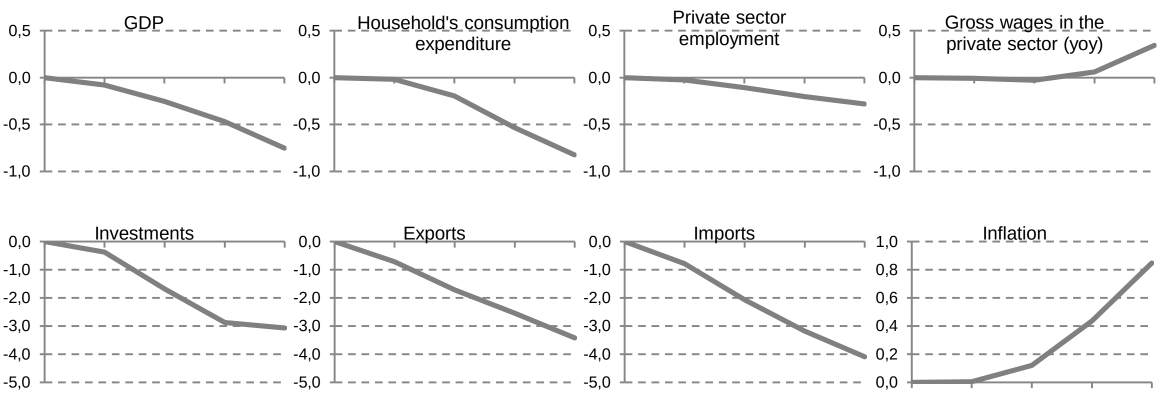
Source: MfNE calculation

**The charts represent the percentage difference of the level of variables from the baseline scenario. The grades of the horizontal axis represent years: the first grade is for 2014, the last one for 2018.*

In the second half of 2014, global economic activity picked up despite a number of external risk factors. The possible escalation of geopolitical tensions and the financing problems of Greece within the euro area continue to pose a considerable external risk, which could lead to the deterioration of the growth outlook. In some ways the two shocks are not fully comparable, because while through shrinking external demand the former affects mostly the real economy, through the loss of confidence the latter has impact on money and capital markets. In the simulation tests of the negative scenario these three effects are grasped by three assumptions. First, the exchange rate of HUF weakens, then stabilizes at a level higher than at present (320 HUF/EUR). Second, in order to stop the outflow of capital, the MNB is forced to raise the interest rate, and due to the increase in risk premiums the yields of sovereign debt also surge (by an average of 100 basis points). Third, the external demand will be at a lower level by 1 percentage point than previously expected.

Due to lower external demand the country's export growth will slow down. However this impact is dampened by two factors. Firstly, import growth will also be reduced because of the high import content of exports. On the other hand, the weakening of the HUF improves competitiveness, that is, Hungary's exports. To a large extent, the positive macroeconomic impact of the weakening HUF is due to the conversion of household of foreign currency denominated loans to HUF, by which household balance sheets were cleaned up, and the external exposure of households decreased significantly. In the case of companies shocks do not pose an overall risk, as the external exposure of the majority of the sector is already covered (because both their revenue and their import purchases are denominated in euros). However, due to the weaker exchange rate and as a result of the imported inflationary pressure, the changes of the price level may end up a few tenths of a percentage point higher. This impact, however, will remain gradual and moderate. At the same time the rise of the nominal yields will render the acquisition of external resources more expensive, and thus has a negative effect on domestic demand. Overall, the volume of GDP will end up at a level lower than presumed in the baseline scenario. General government deficit will increase slightly, which is basically caused by the increase in interest expenses.

Chart 4.2.: Deterioration of the External Environment*



Source: MfNE calculation

**The charts represent the percentage difference of the level of variables from the baseline scenario. The grades of the horizontal axis represent years: the first grade is for 2014, the last one for 2018.*

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

Positive scenario: persistently low oil prices	2015	2016	2017	2018
GDP	0.12	0.40	0.51	0.53
Households' consumption expenditure	0.06	0.43	0.68	0.71
Gross fixed capital formation	0.09	0.55	0.50	0.46
Exports	0.27	0.55	0.56	0.62
Imports	0.23	0.59	0.64	0.68
Inflation	-0.07	-0.32	-0.46	-0.55
Private sector employment	0.01	0.14	0.25	0.28
Gross average wages in the private sector	0.00	0.06	0.06	-0.05
Income taxes *	0.00	0.02	0.02	0.02
Employer contributions*	0.00	0.01	0.02	0.01
Turnover taxes*	0.00	0.01	0.02	0.02
Taxes levied on companies*	0.02	0.05	0.00	0.00
Interest expenditure of the general government*, **	0.11	0.22	0.21	0.20
General government balance*	0.13	0.30	0.28	0.25
Negative scenario: deterioration of the external environment	**2015**	**2016**	**2017**	**2018**
GDP	-0.08	-0.25	-0.47	-0.75
Households' consumption expenditure	-0.02	-0.20	-0.53	-0.82
Gross fixed capital formation	-0.37	-1.68	-2.88	-3.06
Exports	-0.71	-1.72	-2.55	-3.42
Imports	-0.78	-2.07	-3.19	-4.09
Inflation	0.00	0.12	0.44	0.85
Private sector employment	-0.02	-0.11	-0.20	-0.28
Gross average wages in the private sector	-0.01	-0.03	0.06	0.34
Income taxes *	0.00	-0.01	-0.01	0.01
Employer contributions*	0.00	-0.01	-0.01	0.01
Turnover taxes*	0.00	-0.01	-0.01	0.01
Taxes levied on companies*	-0.01	0.01	0.06	0.08
Interest expenditure of the general government*, **	-0.75	-0.74	-0.72	-0.70
General government balance*	-0.77	-0.75	-0.71	-0.64

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. SUSTAINABILITY OF PUBLIC FINANCES

The sustainability of public finances is primarily determined by the current fiscal stance (budgetary position, public debt, also as a percentage of GDP), the amount of future budgetary expenditure related to 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 scheme 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 Hungarian society through demographic changes.

The Fundamental Law, effective as of 1 January 2012, 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, composed of a compulsory, fully funded private pension fund pillar and a state-run, social-security-based, pay-as-you-go pillar introduced in 1998. This affects the sustainability of the state budget 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 been unable to compensate for the lost social-security-based pensions.

Owing to the parametric changes, which were implemented in several phases, future public pension expenditures were significantly reduced. 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 new 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. In addition to the parametric changes, further measures fostered transparency and ease of presentation in the budget of the pension system and other age-related provisions.

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 long term. One of the main reasons behind the unfavourable demographic process is the low fertility rate. Despite a slight increase in recent years, in 2015 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. 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% in per cent 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 calculations of the Economic Policy Committee for 2015, 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.

6. Quality of Public Finances

6.1. Structure and Efficiency of Expenditure

Local Governments

As a result of the restructuring of their tasks, local governments have kept those tasks where local decision-making is indispensable and for which the required funds are available. Parallel to the reorganisation of tasks, the financing system of local governments has become task-based. Previously, state financing of local governments took place on a revenue-oriented basis, while local governments conducted an expenditure-driven budget planning. An essential element of the new task-based financing in the four priority areas of local government tasks (management, nursery care, social care, and as of 2014 children's meals too) is to determine the number of employees in a given area, acknowledged by the central budget. "Acknowledged number" is a measurement based on statutory calculations, on the basis of which wage expenses for a given task at the local government are financed by the central budget, in line with certain professional criteria. Funding of wages is complemented by a separate grant linked to other operational expenditures of the given sector.

Bringing in line the financing and the related tasks of local governments put an end to the main source of generation of municipal debts, and this has allowed the state to take over the debts accumulated by local governments in the past years.

Within the framework of the debt consolidation, local governments were relieved of HUF 1,369.1 billion debt between 2011 and 2014, of which HUF 178.6 billion was redeemed through repayment subsidies and the remaining HUF 1,190.5 billion was taken over and transferred to the central government sector. The consolidation affected 2,058 local governments and 24 local government associations.

The regulations introduced in 2012 pertaining to new debts were also made stricter in 2013: since the middle of 2013 any local government guarantee and surety requires the government's prior consent, while from 1 January 2014 the preliminary data supply obligation has been extended to numerous transactions not requiring a government approval, and from 1 January 2015 an approval will also be required for loans taken to fund own resources of developments financed from EU-funds. Also as of 1 January 2015, the generation of debt by 100% local government-owned companies also became subject to approval.

On this basis, after the completion of consolidation, overall debt of local governments and their 100%-owned companies is expected to remain low also in the long run, given the government consent necessary for any new debt and the change in the borrowing practices of local governments.

The local governments' cash balance net of lending and securities transactions shows a positive balance of about HUF 90 billion according to the 2014 preliminary performance data; which corresponds to HUF 21.1 billion without the debt consolidation of HUF 68.9 billion classified as state aid. The cash balance of local governments net of the large positive impact of the debt consolidation has also shown a positive trend in the past few years: it was HUF 1.2 billion in 2011, HUF 16.6 billion in 2012, and HUF 85 billion in 2013.

The positive balance is due to several factors. On the one hand, the gradual takeover in 2012 and 2013 of the institutions operated by the county and local governments that created a considerable financing gap at the municipalities took a great burden off the shoulders of the subsystem of municipalities. The full debt consolidation of local governments significantly reduces the interest expenditures of municipalities. The enforcement of the regulations of the Stability Act also has a positive effect on the balance since, due to the requirement of approval by the Government, only loans that are absolutely necessary will be taken up and spent. Consequently, it is unlikely that any new freely disposable funds would appear in the subsystem, with a negative effect on the local government balance. Fourth, as of 2013, local governments are not allowed to plan their annual budget with an operating deficit. Consequently, as a result of the measures exerting their effects each year after their implementation, the cash balance of local governments is likely to become predictable on a continuous basis free of any major negative swings.

TRANSFORMING THE SOCIAL SUBSIDY SYSTEM

Thanks to the changes introduced, the new social assistance system has become fairer and more transparent, and it also prevents the formerly often-experienced misuse of aids. Thus, only those in real need will receive assistance. Apart from the forms of assistance provided by the state, it is the task of local governments to provide social assistance as local communities have a real knowledge on the basis of which they can make informed decision on eligibility. Local governments have more freedom to decide on the volume and form of assistance. In this new scheme no one will be left without care, because local governments that do not have the appropriate resources can apply for funds from the central budget.

The system of in-cash and in-kind social benefits has changed significantly from 1 March 2015. In the new scheme, the responsibilities of the state and of local governments in the field of social assistance are sharply separated. Assistance under state responsibility is transferred to the competence of district government offices, while assistance provided by local governments is transferred to the competence of municipal councils. The responsibility of local authorities to strengthen social security and provide social welfare will increase. The eligibility for compulsory care (care provided to working-age population, allowances of the elderly, care allowance (basic, increased and extraordinary amounts), free public healthcare (automatic and normative forms), eligibility for health service) is established by district offices as of 1 March 2015.

Therefore, the change of competence affects only assistance provided for working-age population, as the above-mentioned forms of assistance had already been established by district offices. Local governments are in charge of providing any other assistance. The uniform name for assistance granted by local governments is municipal assistance, for which eligibility criteria and types are determined by the local governments themselves. There are two types of care provided to working-age population, now under the competence of district offices: employment substitution support, and the health detriment and childcare support[6], a new type of assistance, available to some people formerly eligible for regular social assistance.

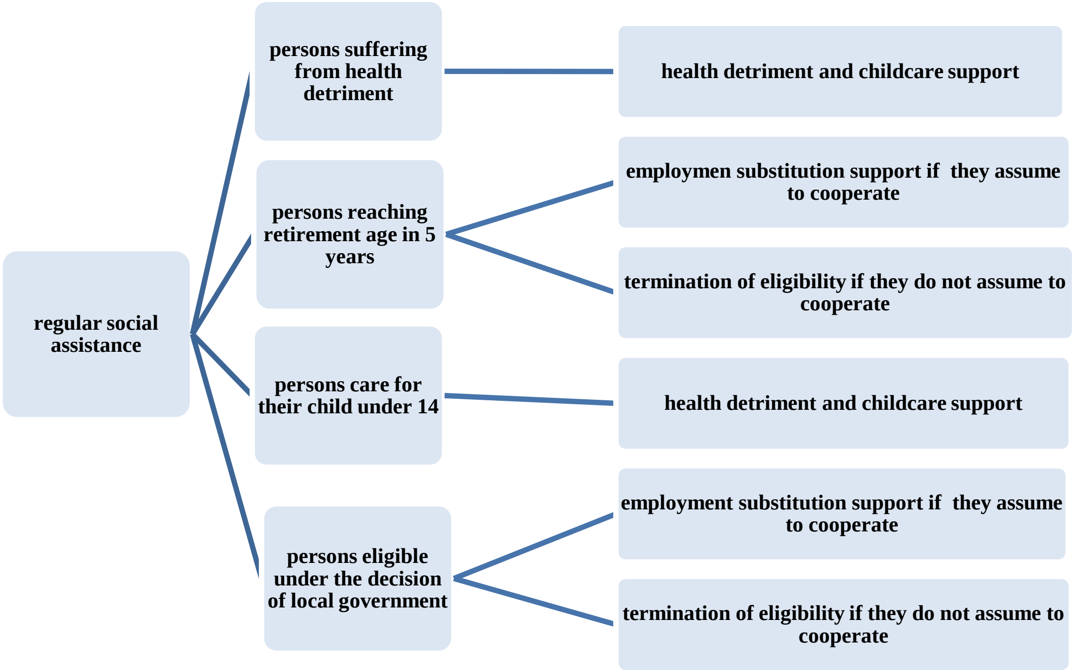
No changes were introduced in the rules on employment substitution support, apart from the changes in the competence for the provision of support. The so-called regular social assistance has been eliminated as of 1 March 2015. Persons formerly eligible to this type of assistance are entitled to other types of assistance.

The steps for the introduction of this new scheme are as follows:

- The eligibility for assistance of persons entitled to regular social assistance was reviewed by the notary between 1 January 2015 and 28 February 2015.
- As a result of this review, in his/her decision the notary established the type of assistance the client would be entitled to after 1 March 2015.
- Persons now automatically eligible for the new health detriment and childcare support are those who were entitled to the regular social assistance due to their health detriment or because otherwise they were unable to care for their child under 14.
- Persons reaching retirement age in 5 years are entitled to employment substitution support if they are willing to assume the corresponding obligation to cooperate (to be registered as a job seeker, to cooperate with the employment centre), and also those persons who previously were entitled to regular social assistance, under the conditions specified by the decision of the local government.

[6] The amount of the newly introduced health detriment and childcare support (EGYT) shall be calculated on the basis of the rules on the amount of regular social assistance, only the upper limit of family income changes: the monthly amount of EGYT is the difference between the upper limit of family income and the total monthly income of the eligible family, but it cannot exceed 90% of the net public employment wage. (In 2015 90% of the net public employment wage that is the maximum amount of EGYT is HUF 46,662.) If a family member of the person entitled to EGYT is entitled to an employment substitution support, the amount of EGYT shall not exceed the difference between 90% of the net public employment wage and the amount of the employment substitution support. (In this case the maximum amount of EGYT is HUF 23,862.) The amount of the upper limit of family income equals the sum of ratios for each consumption unit of the family, multiplied by 92% of the current minimum old age pension. It should be noted that until 28 February 2015 family income had to be topped up to 90% of the minimum old age pension.

- If the person reaching retirement age in 5 years or the person entitled to regular social assistance under the conditions specified by the local government decision did not assume the obligation to cooperate, he/she is no longer eligible for assistance provided to persons of working age.



Public Education

Fundamental changes were launched to modify the content and structure of public education when the Parliament adopted the new Act on National Public Education (hereinafter: Nkt.) at end-2011. The Act defines certain services in public education as a public service provided by the central government, that was previously shared with and the maintenance was actually assigned to local governments. The new regulation created the foundations of an institutional system, a curriculum and a quality assurance system managed, designed, financed and controlled by the state in line with the national interests.

Except for kindergartens, the entire, previously municipal, network of public education institutions was transferred to central level. Its maintainer is the Klebersberg Intézményfenntartó Központ (Klebersberg Institution Maintenance Centre; hereinafter: KLIK) founded in autumn 2012 and disposing of the whole range of the institutions concerned as of 2013.

During the phasing in of certain provisions of the Act, one of the first measures was the introduction of decent financial remuneration of teachers, through the codification of a career path model. The amendment of Nkt. and the codification of the government decree governing its implementation resulted in an arrangement whereby those concerned can see their potential professional career and the associated scheduled wage increase five years ahead. The first phase of the career path model was introduced together with the academic year of 2013/2014. At that time, the central budget provided already for 60% of the costs of the envisaged full-scale introduction, and the Government guaranteed a further 10-10% extra costs and the introduction of the items guaranteed by the career path model accordingly, from one academic year to the next, up to the academic year of 2017/2018.

In 2014 (test) qualifications of teachers began, as well as the training of experts needed for the launching of a nation-wide professional verification system, funded by the EU. Thanks to this training programme the Master Teacher expert capacity needed for the first qualification of 150,000 teachers to be completed until the academic year of 2017/2018 is already available, which can perform the qualification of around 30,000 teachers a year. Through qualifications teachers can access a higher salary grade, and thus receive higher remuneration, in line with their career path model. The central budget contains the appropriations required for the planned qualifications.

As of 1 January 2015, advancement along the career path is no longer linked to the current minimum wage, but to the salary according to the Act on the central budget, which is a fixed amount. The basis of the wage calculation for 2015 is equal to the minimum wage in 2014. This ensures that, under the conditions and within the framework provided by the central budget, the Parliament makes a uniform decision on the career opportunities of those working in the public sector as well as of those working in public education.

Organization, management and coordination of the ongoing nation-wide professional verification of teachers, heads of educational institutions and institutions is carried out by the Oktatási Hivatal (Educational Authority, hereinafter referred to as: the Authority). Tasks related to the provision of pedagogical professional services have also been transferred to the Authority, in order to meet the uniform public professional policy and quality assurance requirements.

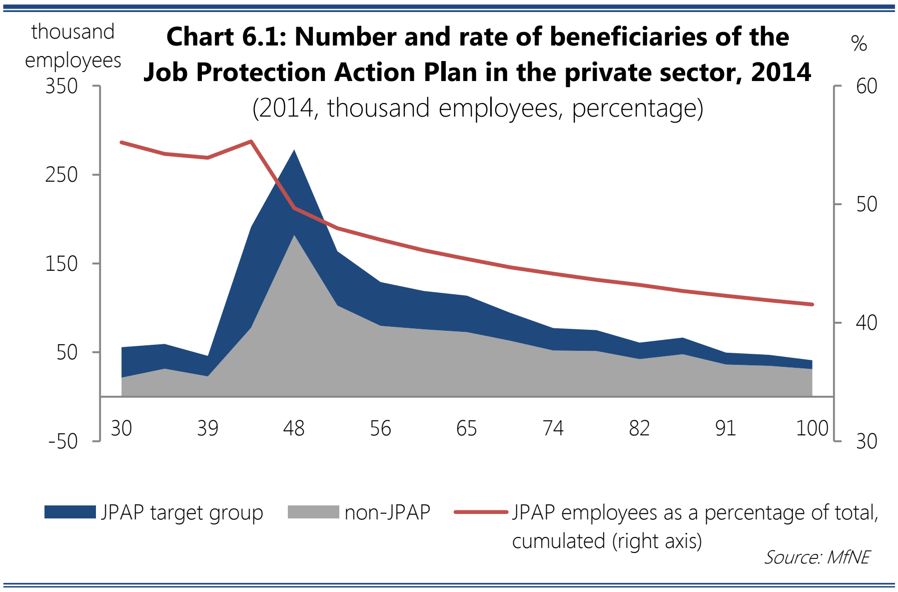
The delivery of school textbooks was reformed as of 1 January 2014, in order to ensure, through the unification of the delivery of textbooks, that the selection and ordering of textbooks takes place only on educational and professional grounds, to increase the transparency of textbook purchasing, and to reduce the expenses of parents and the budget related to textbook purchases. To achieve this, a State-owned textbook publisher was founded. The central budget provided the resources necessary for its operation: the launching of the academic year of 2014/2015, delivering the necessary school textbooks, purchasing publishing rights, and other property, personal and material expenditure. Furthermore, in line with the increasing resources in the budget the introduction of free school textbooks in primary schools has been phased in as of the academic year of 2013/2014. The introduction in grades 1 to 8 will be completed by the academic year of 2016/2017. The textbooks are used by pupils for their advancement to complete compulsory education, then the supply of school textbooks will be ensured also for the next generation of pupils, in several grades. This will reduce the financial burden on parents, while by using durable textbooks the supply of school textbooks will become more rational and economical.

By transferring public education institutions into maintenance by the state, KLIK is now in charge of the extremely heterogeneous tasks related to almost 3,000 institutions, the training, education and care provided for about 1,100,000 students participating in education, the employment of more than 100,000 teachers and about 40,000 other employees in the field of general education and vocational training. Due to the professional and structural specificities of the professional management of vocational training, and to the need for having an institutional system that is more flexible in adapting to labour market needs, from 1 July 2015 vocational training institutions will exit KLIK and, integrated in vocational training centres, will continue to operate under the responsibility of the Ministry for National Economy. The Government’s initiative of "Vocational training in the service of economy" contains proposals to reform vocational training. One of the fundamental objectives of the concept is to reduce early school leaving, to increase students' interest in vocational training, so that a larger number of skilled workers can enter the labour market. One of the most important means for achieving that goal is strengthening dual training, with the growing involvement of market participants. This can be promoted through the vocational training contribution fund, with differentiated subsidies.

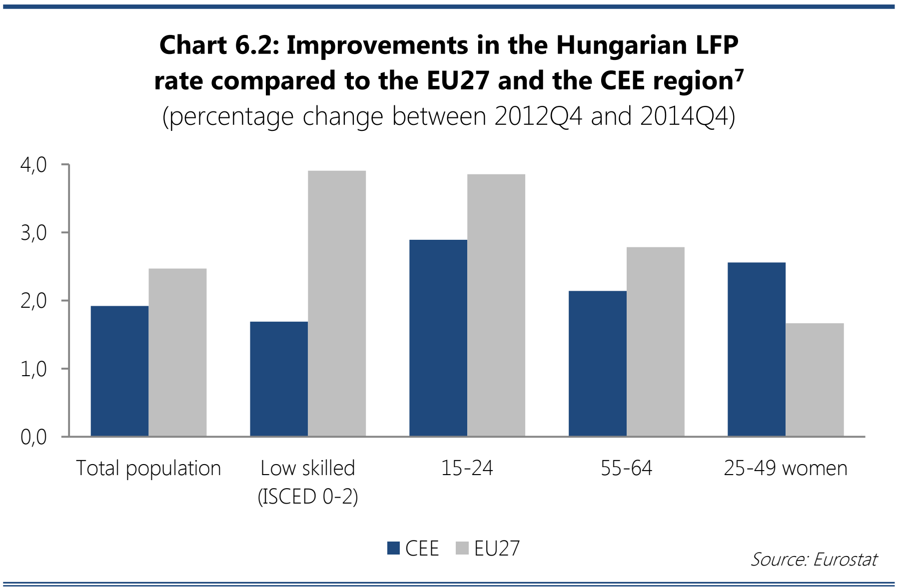
6.2. STRUCTURE AND EFFICIENCY OF REVENUES

Over the previous years, the Government pursued the consolidation of the budget in a way that the total taxes and contributions imposed on the economy decreased to around 39%, from 41% of GDP prevailing in the pre-crisis years. This value continues to decrease gradually on our forecast horizon, partly due to the already announced tax cut measures, partly due to the structure of growth. The most important elements in the restructuring of the tax system which took place in parallel with the reduction of the overall tax burden are reducing taxes on labour, increasing the taxes on consumption, turnover and negative externalities, as well as enhancing the efficiency of tax collection. The most important restructuring measures necessary to achieve the above targets were implemented in the previous years. In the coming years, the Government's tax policy will focus mainly on the further reduction of income taxes, simplification of the tax system and increasing efficiency. These efforts are reflected in the measures to be implemented in 2016, particularly the reduction of the personal income tax rate to 15% and the gradual increase of the tax allowance for families with two children, that will double by 2019. In the coming years, the Government's key objective will be the further reduction of personal income tax, in order to achieve a single-digit personal income tax rate.

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 cancellation of the pension contribution ceiling, a completely linear tax and contribution system came into effect as the main rule. With the introduction of the family tax allowance in 2011, on the other hand, the tax system now takes into consideration also the number of dependent persons in the household. From 2014 on, the family tax allowance can be deducted also from the employees' social security contributions, so taxes on labour of families in the lower income brackets have decreased further. From 2015, the Government introduced the tax benefit for those wedded for the first time. The employment of the most vulnerable employees and the preservation of their jobs, on the other hand, were promoted by the introduction in 2013 of the Job Protection Action Plan that encourages employment and boosts labour force participation more cost-effectively than the in-work tax credit phased out in 2011-2012.

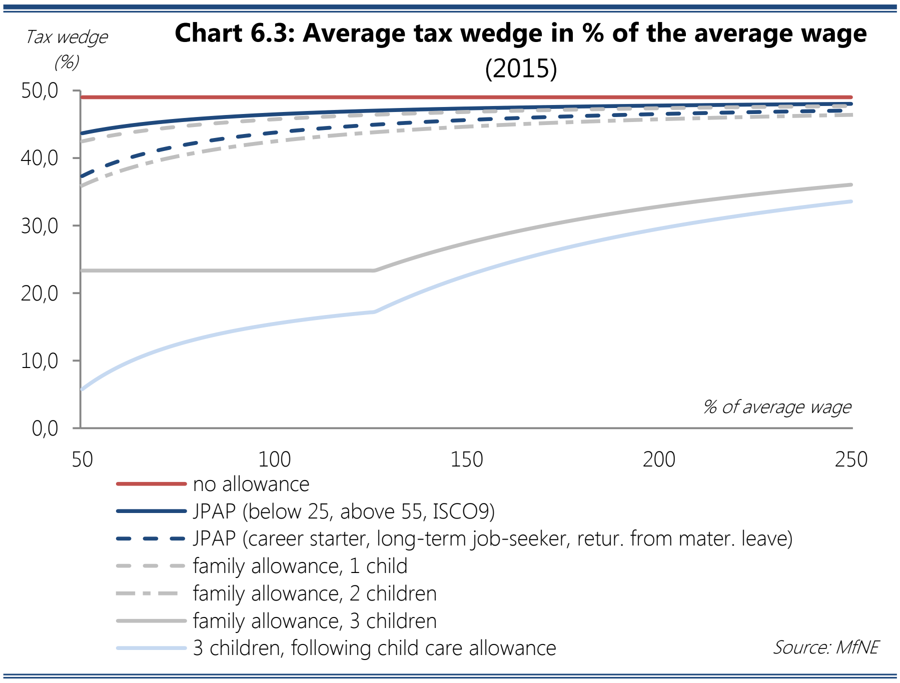


The Job Protection Action Plan is aimed at the employment of groups whose labour force participation is low in regional comparison, and based on the available Hungarian and international empirical literature are usually more responsive to various tax incentives. The minimisation of administrative burdens has also been an important aspect in designing the targeting criteria. The range of eligible workers is very extensive in international comparison. Currently targeted allowances are applied to almost 800,000 employees in the private sector, and these allowances reduced the wage costs by around HUF 125 billion in 2014.



Since 2012 the growth of the participation rate in the major target groups of allowances in Hungary exceeded the average growth in the European Union and in Central and Eastern Europe, so the previous disadvantage has decreased. Although apart from the Job Protection Action Plan there were a number of other government measures aimed at increasing the participation rate of these groups, the targeted tax benefits are thought to have contributed to this favourable trend.

[7] Bulgaria, the Czech Republic, Estonia, Poland, Lithuania, Latvia, Hungary, Romania, Slovakia, Slovenia



As a result of the restructuring of the tax system, in each income category the employer and employee taxes and other contributions imposed on marginal income fell under 50%, and due to family and targeted tax benefits, in some groups it dropped to even lower levels.

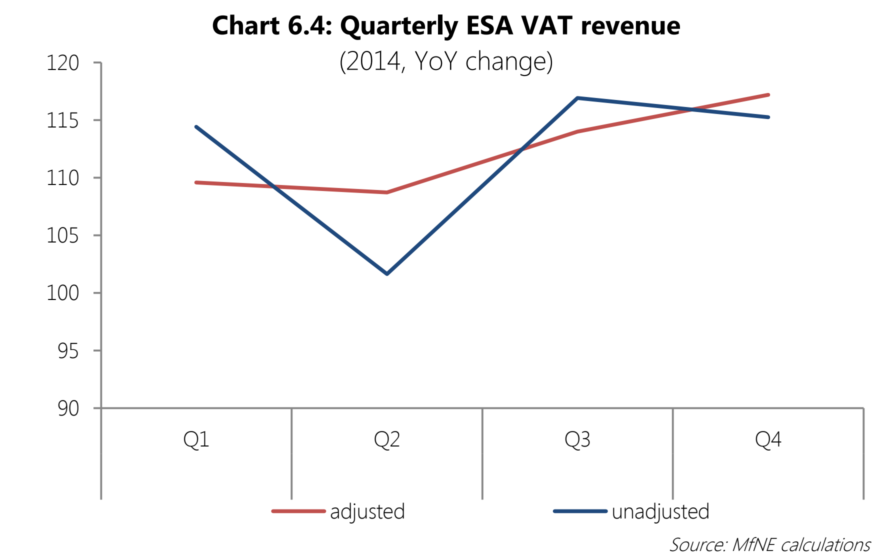
The tax burden of SMEs dropped substantially when the upper limit of the 10% corporate tax rate bracket was raised from HUF 50 million to HUF 500 million, and when two new optional simplified tax types (KATA, the lump-sum tax for self-employed, and KIVA, the small business tax) were also introduced under the Job Protection Action Plan to assist small businesses. Around 105,000 enterprises have chosen the latter tax types until the end of 2014.

Meanwhile, in 2010 the Government found itself in a position in which it was forced to introduce sector-specific taxes in order to mitigate the effects of the crisis, most of which have been abolished in recent years. 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.

The weight of consumption-turnover type taxes was also increased by the rise of the standard VAT rate in 2012, and the increased importance of environmental protection/healthcare aspects in the tax system. In this framework changes affecting the excise duty and some product fees were made, the company car tax was modified in order to take into consideration environmental aspects, and the public health product tax and accident tax have been introduced.

In past years several measures were implemented to combat the shadow economy and tax evasion associated with business-to-consumer (B2C) and business-to-business (B2B) sales transactions. These measures are expected to lead not only to the decline of VAT fraud, but indirectly they also contribute to the decline of other forms of fraud (profit and wage concealment). To lower the rate of fraud related to retail sales, based on positive international examples, online supervision of cash registers by the Tax Authority (NAV) started in 2013 and was completed in 2014, which allowed NAV to monitor the turnover of the cash registers on a real-time basis and detect fraud more efficiently. As a result, by the end of 2014 about 184,000 online cash registers were operating.

The primary impact of the online connection of cash registers on the black economy can be observed in the retail sector. Based on data collected by NAV for 2014, in retail segments in which there has been substantial shadow economy going on in the past decades according to the tax authority (e.g. in food and clothes shops, or in the trading in second-hand products), an outstanding increase in turnover can be observed. VAT liability increased by 21.9% from the base year, while a 13.7% increase took place in the entire trade sector. Rules requiring the exchange of cash registers, the new equipment installed, and favourable economic trends, such as improved labour market situation and the increase of real wages also contributed to the increase of declared VAT liability. The 2014 ESA approach shows a 11.8% (HUF 318 billion) rise in VAT revenue from the same period in the base year. Growth adjusted by one-off items (such as one-off payments, carry-over effects of payment obligations) affecting ESA revenues in the current and base year reached almost 12.4%. In terms of year-on year growth, average (adjusted) growth reached 9.1% in the 1st half of 2014, and 15.6% in the 2nd half of 2014.



In 2015 the Government continued its fight against the shadow economy in the framework of which reverse charge VAT was extended, the Electronic Public Road Trade Control System (EKÁER) was launched, VAT rate of other large livestock (cattle, sheep and goat) and carcasses was reduced to 5%, the application of domestic VAT recapitulative statements was extended, also from 2015 the compulsory use of online cash registers is to be introduced in the majority of the services sector. From 2016 VAT for carcasses of pork will be reduced to 5%.

After solving the problem of foreign currency loans, the Government decided to cut the bank levy. According to the agreement concluded between EBRD and the Government in February 2015, the rate of the levy imposed on credit institutions will shrink from the current 0.53% to 0.31% in 2016, and the tax base will change to the balance sheet of the year 2014 . From 2017 the rate will decrease further to 0.21%, and from 2019 it will move closer to the EU average. As a result of this measure the expected lending activity and the job and investment growth will have a positive effect on economic growth.

In the coming years, the main objective of the tax policy will be maintaining the framework developed over the past years, as well as the further reduction of taxes on labour and tax burden of businesses, and to make the tax system even more employment and business-friendly. In the years to come the Government will seek to curb shadow economy through a more efficient utilisation of the tools available and the introduction of new instruments. Due to the fiscal consolidation and the sustainable growth path in the coming years further tax cuts will be possible. To continue with the reduction of the personal income tax rate in 2016, the Government's key objective for the years to come will be the further reduction of personal income tax, in order to achieve a single-digit personal income tax rate. A further objective is to create a flat-rate corporate tax.

Reduction of Tax Administration

In order to reduce the tax administration burden, fees and charges for several public services will be reduced as of 2016, and some of them will be eliminated.

With the introduction of a new act on the rules of taxation, the relationship between taxpayers and the tax authority will change radically as of 2016. Although in the past decade there has been a positive shift in this area both for individuals and businesses, further measures are needed. This is justified also by the need to improve the competitiveness of the country. Priority is given to interventions that act as incentives in terms of economic development and everyday life. Increasing efficiency must be promoted both with regard to the tax authority and to taxpayers, with the widest possible support to voluntary compliance. The objective is that by the end of the decade the tax system be able to catch up with the best practices in Western Europe. The disciplined budget management and the technological development have made this possible.

Problems related to the rules of taxation and the most important measures to be taken

Problems	Timeframe	Actions
Tax inspections	2016-2018	Gradual reduction of the deadline for tax inspections Increasing sanctions imposed on tax authorities Combating shadow economy
Tax return	2017	Preparation of tax returns by the authority
Services related to tax administration	2016-2018	Distinguishing between good and bad taxpayers Creating the opportunity for voluntary tax inspection Lowering of fines due to errors More effective use of communication channels

The set of measures aimed at achieving real improvement shall be focused on areas of the rules of taxation where problems identified by individuals or businesses are the most serious, taking into account fiscal policy aspects too. The complexity of cases and the duration of tax inspections increased significantly since the 2004 EU accession. At the same time the more intense exchange of information between tax authorities paves the way for procedures to become less time-consuming.

The tightening of sanctions is required in case of late tax refunds by the tax authority, that will act as an incentive for the timely settlement of cases.

However, it is of key importance that all members of the Hungarian society understand that paying taxes and charges is an obligation, and that the effectiveness of tax collection should improve. In order to improve tax-paying morals and to promote the interests of taxpayers acting in good faith the customer-friendly, service providing feature of NAV shall be emphasised, thus developing a relationship of trust with taxpayers. Incentives shall be found in a broader range of economic policy solutions, otherwise measures to be introduced in the individual subsectors will necessarily be one-sided.

The well-defined objectives of tax policy need to be supported by proper measures in the tax procedure. The involvement of the authorities in the area of personal income tax returns has increased significantly in recent years, which, however, was associated with an increased complexity of the system. In order for this measure to reach the widest possible scope and to considerably reduce the administrative burden for the population, from 2017 the tax authority should be able to prepare tax returns for individuals, and such returns will be sent out to individuals only for review. In addition to the modifications described above, further progress is needed in four areas:

1. Distinguishing between good and bad taxpayers: The positive attitude of persistently law-abiding taxpayers shall be rewarded and encouraged by an enhanced service-providing character of the tax authority. Conversely, if the authority considers the taxpayer risky due to its earlier history, more stringent conditions would be applied to them.
2. Creating the opportunity for voluntary tax inspection: Larger businesses could conclude long-term agreements with the tax authority, based on mutual trust. In this context, the company could also initiate tax inspections, or could even apply for ongoing control by the tax authority. An intentional misuse of this possibility would entail losing the status of trusted taxpayer, as well as applying strict additional sanctions.
3. Lowering of fines due to errors: The system of fines shall be transformed in a way that the tax authority does not impose an unreasonably high fine for unintentional errors.
4. More effective use of communication channels: Communication activities of NAV and other government organizations shall be extended, through thematic information booklets, personal media presence and better use of new technologies. As a result, those concerned could receive more information on each measure.

These changes will contribute to an easier and faster administration for individuals and businesses, as well as to a culture of compliance.

7. INSTITUTIONAL FEATURES OF PUBLIC FINANCES

7.1. BUDGETARY FRAMEWORK

In accordance with Council Directive 2011/85/EU and with Act CXCV of 2011 on Public Finance and Government Decree No. 368/2011. (XII. 31.) on its execution, budgetary planning shall be based on the macroeconomic and budgetary forecasts built upon the most likely scenario, using the latest available information. Under the current legislation, the minister responsible for public finances makes regular macroeconomic and budgetary forecasts twice a year for the given year and for the next three years. The forecasts present the differences relative to the latest forecasts of the European Commission, explain the reasons of any major deviation, and also comprise sensitivity analyses. Once a year, the forecasts must be evaluated comprehensively on the basis of objective criteria, and the evaluation methodology, procedure, timing and outcome must be published. The publication of the forecasts is linked to that of the medium-term and the annual budget.

The methodology developed in 2013 and applied fully from 2014 (DINAMO model) allows not only simulations and sensitivity tests, but also government projections to be based on the appropriate modelling techniques. A reliable and realistic macroeconomic and budgetary path not only helps to prepare a credible budget, but also orients economic players: it contains important information about the economic environment to be expected in the coming period for their business-related, economic and consumer decision-making process.

The Fiscal Council, continuing the work launched in 2013 and developed further in 2014, in order to draft professional, duly supported analyses and opinions, such as the ability to make own projections for the macroeconomic baseline scenario needed for budget assessment, will make use of not only the analyses of the State Audit Office and the Magyar Nemzeti Bank, but the work by external experts, analysts, professional research institutions and advisory boards. In 2013 three, in 2014 six studies were prepared by external research institutions that contained medium-term outlook, and these were published on the Fiscal Council's website. These studies have effectively contributed to the assessment of the macroeconomic scenario expected in 2014 and used as a basis for 2015, and served as a basis for the opinion on the 2015 draft budget.

In addition the Fiscal Council commissioned a study by five external research institutions to lay the methodological foundations for future forecasts, titled "Preliminary study on the methodology for medium-term macroeconomic, budgetary (fiscal) forecasting". These studies prepared by external research institutions will contribute greatly to strengthening the analysing ability of the Fiscal Council, and to the preparation of the forward-looking analyses, projections, baseline scenarios and alternative scenarios.

7.2. GOVERNANCE OF GOVERNMENT FINANCE STATISTICS

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 (MfNE). 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. 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 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. It publishes the EDP Notification report on its website following approval, simultaneously with Eurostat.

As from 2008, the HCSO discloses quarterly data of the general government sector in its publications on national account statistics.

On the occasion of its latest bi-annual visit (in July 2014), Eurostat reviewed with the Hungarian statistical authorities the topics also examined in other countries, namely: the progress made with regard to the findings of its previous visit, the institutional background of data provision related to the EDP, the cooperation of peer authorities, the data sources, the applied methodology and procedures, and the disclosure policy. Consultations on the methodology issues referred to general topics, with the most important issues being the following: transition to the rules of ESA2010, a general consultation on the contents and consequences (effect) of the new rules (new rules on sector classification, treatment of standardized guarantees, and the new treatment of lump-sum payments to social security funds(in case of those returning to social security system)) and specific examples (MFB Zrt., Eximbank Zrt., Magyar Követeléskezelő Zrt., Széchenyi Tőkealapkezelő Zrt., MIFIN Mikrofinanszírozó Zrt., Malév Vagyonkezelő Zrt.); the classification of new taxes introduced after the visit of July 2012 and the means for their accrual accounting, treatment of EU transfers, accounting of capital injections and acquisition of equity (Eximbank, Főgáz, AVE Magyarország Hulladékgazdálkodási Kft., Antenna Hungária, capital injections by local governments), the relationship between BKV Zrt. and BKK Zrt. and their public service contract, accounting of PPPs, accounting of CO2 emission quota sales, accounting of frequency sales, accounting of transactions in the energy sector, overview of the budgetary sector accounting reform, creation of the Savings Cooperatives Integration Unit and accounting of the budgetary contribution granted to it. Eurostat welcomed the work done so far in connection with the compilation of the financial accounts from direct data sources, the recasting of the cooperation agreement and the updating of the EDP Inventory.

With a view to debt reduction, as of 2012 the Government controls debt generation by local governments and non-budgetary entities classified in the general government sector through a monitoring and authorising system.

Hungary fully complies with the requirement to publish data, laid down by Directive 2011/85/EU on the budgetary frameworks. The legal background of data publications is provided by Government decree 368/2011 (XII.31.) on the implementation of the Act on public finance. Data reports are published on the website of the Hungarian State Treasury, tables are produced by Hungarian State Treasury, the Ministry for National Economy, the National Bank and the Hungarian Central Statistical Office, on the basis of a predefined division of tasks.

The budgetary sector accounting system has been modified as of 2014. Budgetary appropriations, their fulfilment and the relevant commitments are recorded in the entire budgetary sector in a standardised, so-called budgetary accounting register, whereas in the so-called financial accounting, accrual-based accounting according to the GAAP standards takes place. Besides the relevant regulation, the change-over to the new accounting system is supported by methodological guides, manuals, accounting examples and correlation tables facilitating the change-over to the concepts of the new system, that are regularly updated to include questions that arise through practical application. According to the new order of data reporting, from 2014 budgetary entities shall produce a monthly budgetary report that has become part of the budget monitoring system both for supervisory authorities and for the financial governance. The new infrastructure of data reporting contributes to the simplification of data reporting, as well as to the monitoring of the status of data reporting, facilitates the uniform application of year-on-year assessments, as well as the inclusion of additional verification and consultation opportunities in order to improve data quality.

The data source of the monthly and quarterly publications related to the general government sector required by the EU directives on the budgetary framework is provided by the standardised economic classification regime according to the budgetary accounting system. Concerning non-budgetary entities classified in the general government sector, state-owned companies and extra-budgetary funds report on the development of their business management in the form of monthly data supply.

TABLES

Table 1a. Macroeconomic prospects

	ESA Code	2014 HUF bn	2014	2015	2016	2017	2018
			percentage change				
1. Real GDP (at constant prices)	**B1g**	**30,931.3**	**3.6**	**3.1**	**2.5**	**3.1**	**2.9**
2. Nominal GDP	B1g	31,890.6	6.8	5.5	4.6	5.8	5.8
Components of real GDP							
3. Private consumption expenditure	P.3	15,516.0	1.7	2.9	3.6	2.7	2.5
4. Government consumption expenditure*	P.3	6,539.3	2.0	0.9	-1.4	0.2	0.2
5. Gross fixed capital formation	P.51	6,647.7	11.7	5.8	-0.9	6.4	5.1
6. Changes in inventories and net acquisition of valuables (per cent of GDP)	P.52+ P.53	75.9	0.4	0.0	0.2	0.0	0.0
7. Exports of goods and services	P.6	28,805.7	8.7	7.5	7.4	7.1	7.0
8. Imports of goods and services	P.7	26,653.2	10.0	7.7	7.1	7.5	7.2
Contribution to real GDP growth							
9. Final domestic demand		28,703.0	3.7	2.9	1.3	2.7	2.3
10. Changes in inventories and net acquisition of valuables	P.52+ P.53	75.9	0.4	0.0	0.2	0.0	0.0
11. External balance of goods and services	B.11	2,152.4	-0.4	0.3	0.9	0.4	0.6

*/: Including government and NPISHs

Table 1b. Price developments

	2014	2015	2016	2017	2018
	percentage change				
1. GDP deflator	3.1	2.3	2.1	2.7	2.8
2. Private consumption deflator	0.7	1.0	1.6	2.5	3.0
3. HICP	-0.2	0.0	1.6	2.5	3.0
4. Public consumption deflator	5.5	3.5	2.1	3.9	2.8
5. Investment deflator	2.4	0.6	1.1	1.5	2.1
6. Export price deflator (goods and services)	0.9	-0.4	0.3	1.0	1.5
7. Import price deflator (goods and services)	0.2	-1.6	-0.2	0.8	1.3

Table 1c. Labour market developments

	ESA Code	2014 level	2014	2015	2016	2017	2018
			percentage change				
1. Employment, persons ('000;15-64)		4,069.9	5.4	2.1	2.1	1.8	1.7
2. Unemployment rate (%)		-	7.8	6.9	6.2	5.8	5.5
3. Labour productivity, persons		-	-1.7	1.0	0.3	1.3	1.1
4. Compensation of employees (HUF bn)	D.1	14,640	6.6	5.6	5.2	5.0	5.0
5. Compensation per employee (HUF million)		3.6	1.1	3.3	3.1	3.2	3.2

Table 1d. Sectoral balances

	ESA Code	2014	2015	2016	2017	2018
		per cent of GDP				
1. Net lending/borrowing vis-à-vis the rest of the world	B9.	8.3	9.3	7.9	8.5	8.9
of which:						
- Balance of goods and services		7.5	8.3	9.3	9.5	9.9
- Balance of primary incomes and transfers		-2.6	-2.3	-2.7	-2.6	-2.6
- Capital account		4.1	4.0	2.0	2.3	2.2
2. Net lending/borrowing of the private sector including statistical discrepancy	B9.	10.9	11.7	9.9	10.2	10.5
3. Net lending/borrowing of general government	B9.	-2.6	-2.4	-2.0	-1.7	-1.6

Table 2a. General government budgetary prospects

	ESA Code	2014 HUF bn	2014	2015	2016	2017	2018
			per cent of GDP				
Net lending (EDP B.9.) by sub-sector							
1. General government	S.13	-817.6	-2.6	-2.4	-2.0	-1.7	-1.6
2. Central government	S.1311	-1,293.1	-4.1	-2.6	-2.0	-1.9	-1.9
3. State government	S.1312	-	-	-	-	-	-
4. Local government	S.1313	444.8	1.4	0.0	-0.1	0.0	0.0
5. Social security funds	S.1314	30.6	0.1	0.2	0.1	0.2	0.3
General government (S.13)							
6. Total revenue	TR	15,168.1	47.6	46.7	44.3	43.3	42.5
7. Total expenditure	TE	15,985.8	50.1	49.1	46.3	44.9	44.1
8. Net lending/borrowing	B.9	-817.6	-2.6	-2.4	-2.0	-1.7	-1.6
9. Interest expenditure	D.41	1,310.0	4.1	3.6	3.3	3.1	2.9
10. Primary balance		492.4	1.5	1.2	1.3	1.4	1.3
11. One-off and other temporary measures[1]		99.0	0.3	0.5	0.3	0.0	0.1
Selected components of revenues							
12. Total taxes (12=12a+12b+12c)		8,097.9	25.4	24.7	24.0	23.4	23.0
12a. Taxes on production and imports	D.2	5940.4	18.6	18.2	17.8	17.4	17.1
12b. Current taxes on income. wealth, etc.	D.5	2,146.8	6.7	6.5	6.2	6.0	6.0
12c. Capital taxes	D.91	10.7	0.0	0.0	0.0	0.0	0.0
13. Social contributions	D.61	4,198.7	13.2	13.2	13.2	13.0	12.8
14. Property income	D.4	194.7	0.6	0.5	0.5	0.5	0.5
15. Other		2,676.8	8.4	8.3	6.6	6.4	6.2
16.=6. Total revenue	TR	15,168.1	47.6	46.7	44.3	43.3	42.5
Tax burden[2] (D.2+D.5+D.61+D.91-D.995)		12,340.4	38.7	38.1	37.3	36.5	36.0
Selected components of expenditure							
17. Compensation of employees + intermediate consumption	D.1+P.2	5,875.5	18.4	18.4	17.8	17.4	17.1
17.a. Compensation of employees	D.1	3,372.1	10.6	10.5	10.7	10.8	10.6
17.b. Intermediate consumption	P.2	2,503.4	7.8	7.9	7.1	6.6	6.5
18. Social payments (18=18.a+18.b)		5,116.8	16.0	15.3	14.7	14.1	13.6
of which: Unemployment benefits[3]		66.4	0.2	0.2	0.2	0.2	0.1
18.a. Social transfers in kind supplied via market producers	D.6311, D.63121, D.63131	662.4	2.1	2.0	1.9	1.8	1.7
18.b. Social transfers other than in kind	D.62	4,454.3	14.0	13.3	12.7	12.2	11.9
19.=9. Interest expenditure	D.41	1,310.0	4.1	3.6	3.3	3.1	2.9
20. Subsidies	D.3	419.6	1.3	1.3	1.3	1.3	1.2
21. Gross fixed capital formation	P.51	1,655.6	5.2	5.2	4.3	4.2	4.5
22. Capital transfers	D.9	572.2	1.8	1.9	1.5	1.3	1.3
23. Other		1,036.0	3.2	3.4	3.5	3.6	3.5
24.=7. Total expenditure	TE	15,985.8	50.1	49.1	46.3	44.9	44.1

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

		2014	2014	2015	2016	2017	2018
		HUF bn	per cent of GDP				
1. Total revenue at unchanged policies		15,168.1	47.6	46.7	44.3	43.3	42.5

The table contains revenue projections based on measures till 30 April 2015.

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

		2014	2014	2015	2016	2017	2018
		HUF bn	per cent of GDP				
1. Expenditure on EU programmes fully matched by EU funds revenue		1,083.9	3.4	3.4	1.9	1.9	1.9
2. Cyclical unemployment benefit expenditure							
3. Effects of discretionary revenue measures		82.1	0.3	0.1	-0.7	-0.2	0.0
4. Revenue increases mandated by law							

Table 3. General government debt developments

	ESA Code	2014	2015	2016	2017	2018
		per cent of GDP				
1. Gross debt		76.9	74.9	73.9	71.3	68.9
2. Change in gross debt ratio		-0.4	-2.0	-1.0	-2.5	-2.4
Contribution to changes in gross debt						
3. Primary balance		-1.5	-1.2	-1.3	-1.4	-1.3
4. Interest expenditure	D.41	4.1	3.6	3.3	3.1	2.9
5. Stock-flow adjustment		2.0	-0.4	0.2	-0.2	-0.1
Implicit interest rate on debt (%)		5.5	4.8	4.5	4.4	4.3

Table 4. Cyclical developments

	ESA Code	2014	2015	2016	2017	2018
		per cent of GDP				
1. Real GDP growth (%. at constant prices)		3.6	3.1	2.5	3.1	2.9
2. Net lending of general government	B.9	-2.6	-2.4	-2.0	-1.7	-1.6
3. Interest expenditure	D.41	4.1	3.6	3.3	3.1	2.9
4. One-off and other temporary measures[1]		0.3	0.5 (0.0)	0.3	0.0	0.1
5. Potential GDP (%)		1.6	1.9	2.2	2.3	2.5
contributions: - labour		0.3	0.5	0.7	0.7	0.7
- capital		0.4	0.5	0.4	0.6	0.7
- total factor productivity (TFP)		0.9	0.9	1.0	1.0	1.1
6. Output gap		-2.8	-1.7	-1.4	-0.6	-0.2
7. Cyclical budgetary component		-1.4	-0.8	-0.7	-0.3	-0.1
8. Cyclically-adjusted balance (2-7)		-1.2	-1.6	-1.3	-1.4	-1.5
9. Cyclically-adjusted primary balance (8+3)		2.9	2.0	2.0	1.7	1.4
10. Structural balance (8-4)		-1.5	-2.1 (-1.6)	-1.6	-1.4	-1.6

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	2014	2015	2016	2017	2018
Real GDP growth (%)						
1. April 2014 Convergence Programme		2.3	2.5	2.1	3.1	-
2. April 2015 Convergence Programme		3.6	3.1	2.5	3.1	2.9
3. Difference		1.3	0.6	0.4	0.0	-
General government net lending (per cent of GDP)						
1. April 2014 Convergence Programme	EDP B.9	-2.9	-2.8	-2.5	-1.9	-
2. April 2015 Convergence Programme	B.9	-2.6	-2.4	-2.0	-1.7	-1.6
3. Difference		0.3	0.4	0.5	0.2	-
General government gross debt (per cent of GDP)						
1. April 2014 Convergence Programme		79.1	78.9	77.5	74.7	-
2. April 2015 Convergence Programme		76.9	74.9	73.9	71.3	68.9
3. Difference		-2.2	-4.0	-3.6	-3.4	-

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]: Projections adopted by the EPC (Economic Policy Committee) in October 2012

Table 6a. Contingent liabilities

per cent of GDP	2014
Public guarantees	7.7

Table 7. Basic assumptions

	2014	2015	2016	2017	2018
Hungary: Short-term interest rate (annual average)	2.1	1.5	1.7	1.9	2.4
Hungary: Long-term interest rate (annual average)	4.8	3.0	3.2	3.7	4.1
HUF/EUR	308.7	304.7	303.7	303.7	303.7
World excluding EU, GDP growth	3.9	4.5	4.6	4.7	4.6
EU28 GDP growth	1.3	1.7	2.1	2.1	2.1
Growth of relevant foreign markets	3.1	4.0	5.6	5.6	5.6
World import volumes, excluding EU	4.1	5.2	5.6	5.7	5.7
Oil prices (Brent, USD/barrel)	99.4	61.5	68.8	70.0	72.8