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Macroeconomic Imbalances

Hungary 2014

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Results of in-depth reviews under Regulation (EU) No 1176/2011 on the prevention and correction of macroeconomic imbalances

Hungary continues to experience *macroeconomic imbalances, which require monitoring and decisive policy action*. In particular, the ongoing adjustment of the highly negative net international position, the high level of public and private debt in the context of a fragile financial sector and deteriorating export performance continue to deserve very close attention so as to reduce the important risks of adverse effects on the functioning of the economy.

More specifically, despite a lacklustre export performance, the NIIP has been improving, reflecting primarily private sector deleveraging. Although there have recently been some encouraging signs in manufacturing, it will not be enough to bring out by itself a marked turnaround in export performance. While the debt level has declined, the imbalance and risks related to private debt remain, as deleveraging has been hindered by a high share of distressed borrowers, a depressed housing market, a fragile financial sector, a substantial share of loans in foreign currency as well as prevailing business uncertainty. Restoring normal lending to the economy in a sustainable manner would require improving the operating environment for banks. A high government debt is another important source of concern. Despite substantial improvements in the structural fiscal balance, a weakened exchange rate, a poor growth potential and elevated financing costs have kept the debt from declining. Hungary is not expected to meet its medium-term objective and its structural balance is projected to deteriorate in 2014.

Excerpt of country-specific findings on Hungary, COM(2014) 150 final, 5.3.2014

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EXECUTIVE SUMMARY AND CONCLUSIONS

In April 2013, the Commission concluded that Hungary was experiencing macroeconomic imbalances and indicated the necessity of adopting decisive policy actions. The very negative net international investment position (NIIP), in particular, raised concerns. In the Alert Mechanism Report (AMR) published on 13 November 2013, the Commission found it useful, also taking into account the identification of imbalances in April, to examine further the risks involved in the persistence of imbalances. To this end this In-Depth Review (IDR) provides an economic analysis of the Hungarian economy in line with the scope of the surveillance under the Macroeconomic Imbalance Procedure (MIP). The main observations and findings from this analysis are:

- **Although a continuous improvement is projected, the NIIP remains a major source of concern, due to its still highly negative level and high short-term external rollover needs.** The NIIP has been improving steadily since 2009 due to a favourable external financing position reflecting a current and capital account surplus. This is primarily the result of suppressed domestic demand and an increasing inflow of EU funds, while the growth of export market shares (with a 16% cumulative fall in the 2008-2013 period) has been well below that of regional peers. Recent large FDI investments in the automobile industry might improve somewhat Hungary's lacklustre export performance, but these new capacities will not suffice to turn it around in a sustainable manner.
- **Despite a recent slowdown in deleveraging, indebtedness of households and non-financial corporations also remains a key vulnerability.** The improvement of the NIIP partly reflects private sector deleveraging, which has been ongoing for the fifth year in a row, reflecting several factors related to both the demand and supply of credit. On the demand side deleveraging is the result of the high level of household and to some extent corporate debt accumulated before the financial crisis. On the supply side, a decreasing risk tolerance, a high level of external financing as well as the deterioration in the operating environment of banks can be mentioned. The repair of balance sheets is hindered by a high share of distressed borrowers, a depressed housing market, a fragile financial sector as well as prevailing business uncertainty.
- **The situation in the financial sector continues to raise concerns.** Although the sector seems to be adequately capitalised and its liquidity position is relatively strong, the combination of a high level of tax and regulatory burdens as well as a high share of problematic loans does not provide the right incentives for banks to increase their lending activity. While the central bank's subsidized lending scheme (Funding for Growth Scheme) gave some temporary relief in access to credit for SMEs, financial intermediation conditions have not improved in a sustainable manner.
- **Government debt has remained steadily at a high level, which is forecast to be corrected only at a very slow pace.** Despite one-off capital transfers that decreased public debt by around 7% of GDP, and a substantial improvement in the structural balance, government debt has been broadly stable around 80% of GDP since 2009. The short-term rollover needs and the interest rate burden on debt are still at elevated levels (respectively 22% and 4% of GDP in 2014), contributing to vulnerabilities. While in the baseline scenario the debt to GDP ratio is forecast to decline slowly, in case of a more negative external environment or a negative shock to domestic confidence, it will start increasing again.
- **Overall, a faster decline of Hungary's imbalances is hindered by a relatively low growth potential.** As in countries with high debt levels, financing costs and the growth outlook can be strongly correlated, an improved potential growth would help to decrease imbalances also through indirect channels. The low growth potential of recent years has been partly the consequence of debt overhang and deleveraging, but economic growth has also been hindered by the deterioration in the business environment, due to the introduction of excessive taxes in some sectors and increasing entry costs in certain service sector segments.

The IDR also discusses the policy challenges stemming from these imbalances and what could be possible policy avenues for the way forward. A number of elements can be considered:

- **Improving the export performance would require more FDI inflows as well as a broadening of the value chain in the export sector.** The latter seems to be particularly challenging for catching-up economies, where there is a substantial gap in terms of productivity between foreign and domestic companies. This is also related to the problem of relatively low value added content of exports and a low level of domestically driven innovation. This would probably require increasing support to research and development as well as better cooperation of businesses and universities. In addition, improving financing conditions for SMEs would be also beneficial.
- **The negative feedback loop between households, banks and the housing market could possibly be tackled by a final debt relief scheme targeted to insolvent borrowers, while mitigating risks of moral hazard and limiting the additional tax burden on the financial sector.** The targeted nature of the scheme together with a clear commitment to end the practice of adopting new measures would keep moral hazard risks contained. In order not to endanger financial stability the scheme would need to be accompanied by a reduction of the current tax burden on the financial sector. At the same time, given a high non-performing loan (NPL) ratio also in the non-subsidized HUF loan segment, a possible programme would also have to target this share of indebted households, not only FX debtors. The programme would help to improve the banking sector's portfolio and decreasing excess housing supply, which ultimately could contribute to better lending conditions both in terms of loan demand and supply.
- **Improving capital accumulation possibilities as well as incentives to portfolio cleaning are essential to ease supply-side conditions in bank lending.** The central bank's Funding for Growth Scheme (FGS) is currently the main policy tool used to revive corporate lending. Although subsidized schemes can be useful to tackle negative externalities (e.g. the prohibitively high risk aversion of banks towards the SME sector) they cannot be a substitute for a normal operating environment for the banking sector. A large share of subsidized lending could also entail potentially high fiscal costs and distort price signals. In order to improve banks' operating environment, the current level of the banking sector's taxation could be reconsidered, while legal obstacles and impediments to portfolio cleaning could be investigated and properly tackled.
- **In addition to a better operating environment for the financial sector, a more predictable and competitiveness-oriented policy and regulatory framework would be warranted.** An improvement in the business environment can also be facilitated by compulsory stakeholder consultation before any major policy initiative. Also, the role of the competition authority in the assessment of legislative changes could be enhanced. The corporate tax system could be simplified and entry costs in service sector segments could be decreased. Finally, labour market reforms and a more sustainable energy price system could also boost competitiveness.
- **Continued fiscal consolidation efforts combined with a more growth-friendly structure of the adjustment would also be warranted.** This would require relying less on revenue measures (most notably by lowering the excessive taxation of selected sectors) and more on expenditure restraints. This restructuring of fiscal policy could possibly lead not only to higher potential growth but also lower financing costs.

1. INTRODUCTION

On 13 November 2013, the European Commission presented its second Alert Mechanism Report (AMR), prepared in accordance with Article 3 of Regulation (EU) No. 1176/2011 on the prevention and correction of macroeconomic imbalances. The AMR serves as an initial screening device helping to identify Member States that warrant further in depth analysis to determine whether imbalances exist or risk emerging. According to Article 5 of Regulation No. 1176/2011, these country-specific “in-depth reviews” (IDR) should examine the nature, origin and severity of macroeconomic developments in the Member State concerned, which constitute, or could lead to, imbalances. On the basis of this analysis, the Commission will establish whether it considers that an imbalance exists in the sense of the legislation and what type of follow-up in terms it will recommend to the Council.

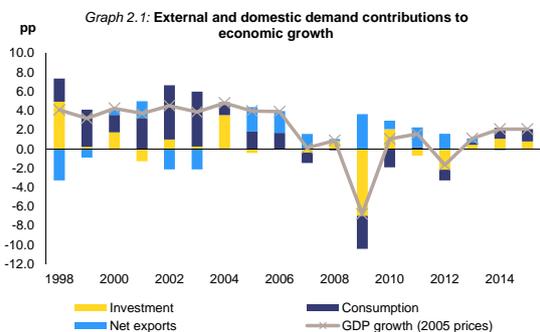
This is the third IDR for Hungary. The previous IDR was published on 10 April 2013 on the basis of which the Commission concluded that Hungary was experiencing macroeconomic imbalances and indicated the necessity of adopting decisive policy actions. In particular, the very negative NIIP raised concerns. Overall, the Commission finds it useful, also taking into account the identification of imbalances in April, to examine further the risks involved in the persistence of imbalances. To this end this IDR provides an economic analysis of the Hungarian economy in line with the scope of the surveillance under the Macroeconomic Imbalance Procedure (MIP).

Against this background, Section 2 reviews the general macroeconomic developments, Section 3 looks more in detail into the main imbalances and risks and Section 4 analyses recent developments in Hungary's business environment based on international competitiveness surveys. Finally, Section 5 discusses policy challenges.

2. MACROECONOMIC DEVELOPMENTS

The macroeconomic outlook improves partly on account of indirect fiscal stimulus measures

Following a double dip recession in 2012, GDP growth has returned to positive territory since the first quarter of 2013. Real GDP growth stood at 1.1% in 2013, and based on the Commission services' winter 2014 forecast is projected to accelerate to around 2% in 2014-15. An increase in exports is expected to be driven by a gradual recovery in external demand, while export performance could also improve somewhat due to an increase in newly installed capacities in the automobile industry. An improvement in domestic demand is foreseen on account of improving investment and consumption, which is partly driven by indirect government stimulus to the economy, including (i) an acceleration in the absorption of EU funds, (ii) cuts in household utility prices, and (iii) the central bank's subsidized lending scheme (Funding for Growth Scheme (FGS) ⁽¹⁾).



Source: Commission services

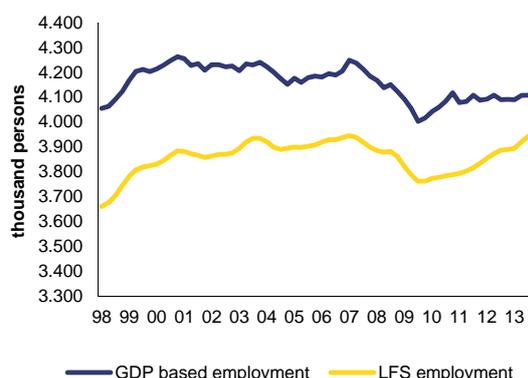
After staying around 4-5% even during the crisis years (2009-2012), annual consumer price inflation declined to a historically low level in 2013. Inflation fell below 1% in the last months of 2013, partly due to three waves of cuts in regulated energy and other utility prices introduced as of January, August and November. ⁽²⁾ Underlying inflation has been declining too, due to the negative output gap, a drop in imported inflation and decreasing inflation expectations. After staying in the range of 1-2% in 2013 and 2014,

⁽¹⁾ On the FGS scheme, see more details in section 3.2.2.

⁽²⁾ These measures had an overall effect on the inflation rate of over -1 pp for 2013 and entail - as a full -year effect - an additional reduction in the inflation rate of around 1 pp for 2014.

inflation is expected to return to close to the central bank's 3% target over the medium term.

Graph 2.2: GDP based and LFS employment



Source: Eurostat, KSH

Even though at first sight, the Hungarian labour market seems to have been relatively resilient to the financial crisis, employment statistics provide a contradictory picture. Although GDP fell close to 4% between 2007 and 2013, employment based on the Labour Force Survey (LFS) increased around ½% in the same period. The latter increased by close to 5% between Q3 2009 - Q3 2013 (i.e. since the lowest point in the crisis) and the improving trend has been uninterrupted. By contrast, GDP-based employment increased by around 2½% in the same period, and more importantly it has been broadly stagnant in the last three years. Therefore, while a turnaround in the labour market from 2009 to H2 2010 seems to be evidenced by both statistics, uncertainties regarding the exact state of the labour market have increased recently. Substantial employment gains have occurred in the public sector, due to the extensions of the Public Work Scheme (PWS), which contributed a 1¼ pps increase in the LFS employment in the Q3 2010-Q3 2013 period. However, excluding the effect of this scheme, GDP-based employment declined slightly (by ½ pps). Therefore the improvement in private sector employment based on the LFS statistics in the last three years could reflect the net increase in frontier workers, but also the whitening of the economy. ⁽³⁾ These latter two factors explain

⁽³⁾ In addition to some methodological differences, the statistical discrepancy between the LFS and GDP

3½ pps. out of the total improvement of 4¼ pps. in the LFS statistics between Q3 2010 and Q3 2013.

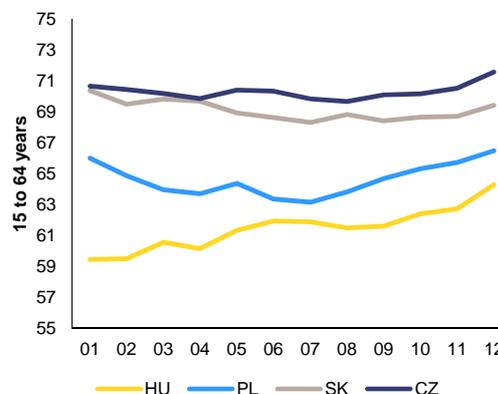
The relatively low level of newly created private sector jobs reflects the constraint from the labour demand side, linked to the low level of investment and productivity. The slightly declining GDP-based employment without the effect of PWS is a sign for the weakness of labour demand in the private sector, as labour participation has been increasing continuously even after controlling for the effect of public works. This latter phenomenon is related to the successive tightening of social transfers (including increases in the retirement age, tightening eligibility conditions for early retirement and unemployment benefits), but the Job Protection Act could also have incentivised participation and employment for certain groups.⁽⁴⁾

By Q3 2013, the employment rate in Hungary has almost reached the level of most regional peers. The seasonally adjusted employment rate reached 58.5% of the active age population, which is only slightly lower than the corresponding level of the Slovak Republic or Poland. The Czech Republic has by far the highest employment rate in the region, close to 68%. Despite similarities in the employment rate of three Visegrád countries, unemployment rates vary much more reflecting differences in participation.

consistent employment figures primarily arise from two sources. On the one hand the LFS statistics counts the number of Hungarian nationals employed (who have a Hungarian residence), while the latter estimates the number of persons used for the production of the Hungarian GDP, i.e. residents and non-residents working in Hungary. Also, in the case of GDP-based employment, the CSO estimates the number of home and grey economy workers.

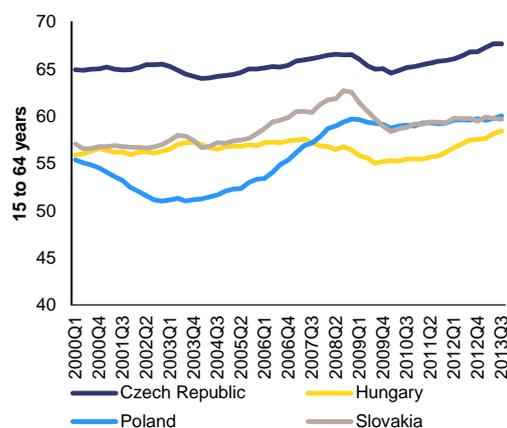
⁽⁴⁾ The Job Protection Act was introduced as of January 2013, and provides reduced social security contributions for targeted groups (e.g. low skilled, young and elderly employees, long term unemployed and women returning from maternity leave.)

Graph 2.3: Participation rate in the region



Source: Eurostat

Graph 2.4: Employment rates in the region



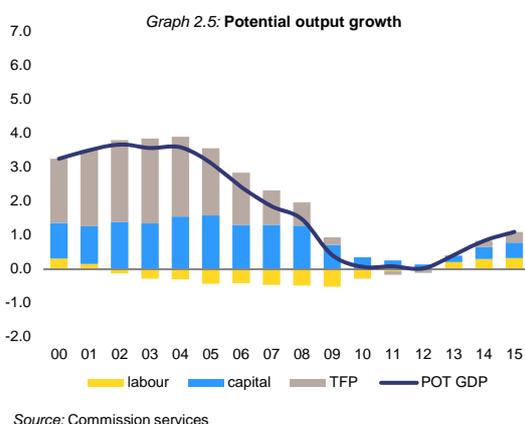
Source: Eurostat, Commission services

The medium-term growth outlook remains weak

Potential output growth remains quite low at 0-1%, close to the EU average but well below the level of regional peers. Hungary's potential growth was already quite modest compared to Visegrád countries before the financial crisis and it practically came to a halt in recent years. TFP and capital accumulation are the main factors behind the weak growth potential. By contrast, there have been some improvements compared to pre-crisis trends as regards the labour market, linked to several structural reforms, mentioned above.

Both credit demand and supply factors have hindered capital accumulation, as discussed in the 2013 IDR. In addition to the unavoidable deleveraging among households and in the corporate sector, deterioration in the business environment could have hindered investment decisions. ⁽⁵⁾

The lack of TFP growth could be linked to problems with financial disintermediation but also to a low level of innovation in general. In the process of continuous deleveraging, innovative firms have less access to capital, hence tight financing constraints could have hindered productivity. At the same time a weak innovation capacity has been a feature of the Hungarian economy even before the crisis. The country has been lagging behind in terms of new FDI inflows in the last decade compared to regional peers, while domestic innovation capacity has also stood well below the level of EU15 countries, although this latter phenomenon is also true for other Visegrád countries (see section 3.1.1.).

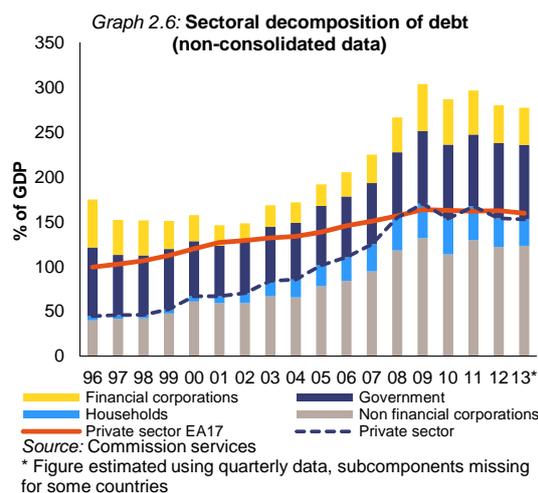


A clear end of deleveraging is not yet foreseen

Deleveraging has been ongoing since the start of the financial crisis in all private sectors of the economy. The decline in debt levels has been hindered by the high share of FX debt due to a weakened exchange rate compared to pre-crisis levels. Deleveraging has been driven by both credit demand and supply factors. From the demand side, debt overhang was observable in the household

⁽⁵⁾ A more detailed assessment of recent trends in the business environment can be found in section 4.

and to some extent the corporate sectors. From the credit supply side banking sector's decreasing risk tolerance and a deterioration in its operating environment has contributed to a tightening of credit supply.



As recently net lending flows turned positive in the non-financial corporate sector only due to the effect of one-off factors, it might be premature to refer to a turning point in debt reduction. Supply conditions have been eased by the central bank's FGS, and investment has also been fuelled by an increasing inflow of EU funds. However, without the FGS, net lending flows are still in the negative territory. ⁽⁶⁾ Given a still high total debt level compared to regional peers (as opposed to a much more moderate level of loans from domestic banks ⁽⁷⁾) and prevailing business uncertainties, recent developments cannot be considered as reflecting a turning point in debt reduction.

While demand for credit is expected to increase in the household sector, the still high monthly repayment burden of debtors, and the high share of distressed borrowers hinder a recovery. Household debt level declined by 10 pps. since the 2010 peak and reached the level of

⁽⁶⁾ It should be stressed that a ceteris paribus calculation of deducting the amount of new loans allocated in the first phase of the FGS underestimates the potential magnitude of net lending without the programme, as some of the loans disbursed in the scheme would have been granted anyway. However at least it helps to present that FGS had a huge effect on lending statistics in Q3.

⁽⁷⁾ See section 3.2.2 for more details.

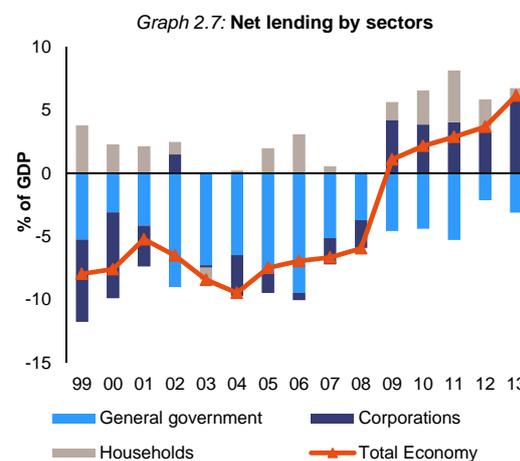
other Visegrád countries. At the same time, the monthly repayment burden of households remains unchanged (due to a weakened HUF/CHF exchange rate and a lower disposable income compared to pre-crisis levels) and the share of distressed borrowers has increased.

A return to normal lending is also constrained by banks' weak incentives to lending activity. Although the FGS scheme could temporarily ease financing conditions in the corporate sector and the decreased interest rate level (passed through from a lowered base rate) helps to stimulate credit demand in general, a return of normal lending to the economy is hindered by a difficult operating environment for the financial sector, most notably a high level of burdens combined with an elevated ratio of non-performing loans (NPLs).

Government debt has stagnated since 2009, but is forecast to decline very slowly to slightly below 70% of GDP by 2023. Despite one-off capital transfers, which contributed to reduce debt by close to 7% of GDP, and significant improvements in the structural balance, government debt has remained stable at around 80% of GDP in the last few years. This reflects the effect of a weakened exchange rate, a low growth performance and high financing costs. In the baseline scenario government debt is projected to decrease slowly. However, this path is very sensitive to the growth outlook, the potential financing costs and the level of the exchange rate. Under unfavourable scenarios, debt can start increasing again. ⁽⁸⁾

Private sector deleveraging has been mirrored in a surplus of the external balance, despite a weak export performance. Export market shares fell by a cumulative 16% between 2008 and 2013, one of the highest falls in CEE comparison. Despite this negative tendency, the net lending/borrowing position of the whole economy was in surplus, driven mainly by the adjustment of the private sector, i.e. a substantial decline in the investment rate. ⁽⁹⁾ However, this is primarily considered rather cyclical, especially in the case of corporations. At the same time the widened output gap masks a substantial improvement in the structural balance of the general government by

over 6 pps. if the 2013 figure is compared to pre-crisis years.



Source: Eurostat

NIIP is expected to continue improving in the medium term, despite a weak export performance. The improvement in the NIIP is foreseen to prevail in the medium term, primarily reflecting an increased fiscal discipline compared to pre-crisis trends. Sticking to the MTO could help Hungary to avoid the twin deficit problem, which was typical in the pre-crisis decade. ⁽¹⁰⁾

The crisis has had long lasting social consequences

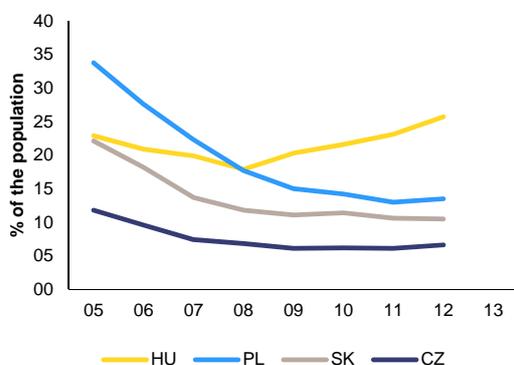
All indicators on poverty have been deteriorating since the start of the crisis, and most of them stand at a higher level than that of other Visegrád countries. In particular youth unemployment, the severe material deprivation rate has increased substantially since the start of the financial crisis (both by around 8 pps.). At the same time the severe material deprivation rate and the share of low work intensity households stand above the level of regional peers and the difference even increased in the last years.

⁽⁹⁾ The investment rate has declined from a pre-crisis level around 22% to 17½% of GDP by 2012.

⁽¹⁰⁾ See details on the external sustainability analysis in section 3.1.2.

⁽⁸⁾ See section 3.3 for more details.

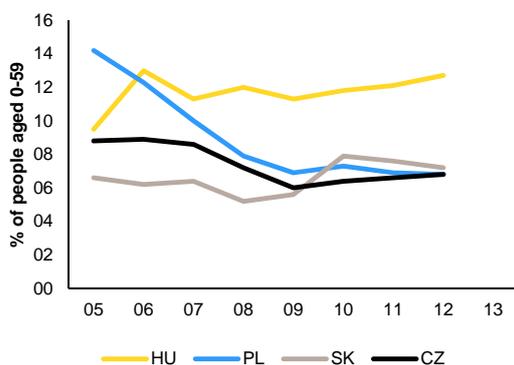
Graph 2.8: The severe material deprivation rate in the region



Source: Eurostat

countries. It is also possible that the particular policy responses chosen (e.g. cutting the length of unemployment and tightening the availability of other social benefits, while also decreasing both in size; steps towards a more regressive taxation system) could have had a negative effect on poverty indicators.

Graph 2.9: The share of people living in low work intensity households



Source: Eurostat

The weaker social position of Hungary compared to regional peers probably reflects the deeper negative economic effects of the financial crisis since 2008. Hungary has undergone a severe external adjustment after the start of the financial crisis, contributing to a deep recession and increasing unemployment. The high share of FX loans, combined with an over 40% weakening of the HUF/CHF exchange rate and declining employment increased the share of insolvent debtors and could have contributed to the deterioration of poverty indicators. Given the high level of government debt, and a budget deficit above the Treaty threshold before the crisis, the government was hindered to pursue countercyclical fiscal policy contrary to most EU

Table 2.1:

Key economic, financial and social indicators - Hungary	2007	2008	2009	2010	2011	2012	Forecast		
							2013	2014	2015
Real GDP (yoy)	0.1	0.9	-6.8	1.1	1.6	-1.7	1.1	2.1	2.1
Private consumption (yoy)	1.1	-0.7	-6.6	-3.0	0.4	-1.6	0.0	1.5	1.6
Public consumption (yoy)	-7.2	1.1	0.7	-1.2	0.0	-1.2	1.1	1.5	2.0
Gross fixed capital formation (yoy)	3.8	2.9	-11.1	-8.5	-5.9	-3.7	3.2	6.0	4.4
Exports of goods and services (yoy)	15.0	5.7	-10.2	11.3	8.4	1.7	5.1	5.3	6.1
Imports of goods and services (yoy)	12.8	5.5	-14.8	10.9	6.4	-0.1	5.0	5.9	6.6
Output gap	3.3	2.7	-4.7	-3.7	-2.3	-3.9	-3.2	-2.0	-1.1
Contribution to GDP growth:									
Domestic demand (yoy)	-0.2	0.5	-5.9	-3.7	-0.9	-1.8	0.8	2.2	2.1
Inventories (yoy)	-1.2	0.2	-4.6	3.8	0.4	-1.5	-0.1	0.0	0.0
Net exports (yoy)	1.6	0.2	3.6	0.9	2.1	1.6	0.4	-0.1	0.0
Current account balance BoP (% of GDP)	-7.3	-7.3	-0.2	0.2	0.4	1.0	.	.	.
Trade balance (% of GDP), BoP	0.7	0.3	4.7	5.5	6.3	7.2	.	.	.
Terms of trade of goods and services (yoy)	0.4	-0.7	0.7	0.0	-1.4	-1.0	0.3	0.1	0.1
Net international investment position (% of GDP)	-105.1	-106.0	-117.2	-113.3	-106.9	-103.1	.	.	.
Net external debt (% of GDP)	50.9	57.5	63.4	61.4	53.5	57.1	.	.	.
Gross external debt (% of GDP)	105.4	123.2	144.9	145.4	149.3	128.9	.	.	.
Export performance vs. advanced countries (5 years % change)	.	.	.	.	.	.	.	.	.
Export market share, goods and services (%)	.	.	.	.	.	.	.	.	.
Savings rate of households (Net saving as percentage of net disposable income)	3.3	2.7	4.8	5.4	5.4	1.9	.	.	.
Private credit flow (consolidated, % of GDP)	20.3	30.0	1.1	-20.6	7.7	-6.1	.	.	.
Private sector debt, consolidated (% of GDP)	111.0	139.9	149.2	133.3	147.1	131.0	.	.	.
Deflated house price index (yoy)	.	-2.7	-8.8	-6.2	-7.4	-9.2	.	.	.
Residential investment (% of GDP)	4.1	4.2	4.3	3.2	2.3	2.1	.	.	.
Total Financial Sector Liabilities, non-consolidated (yoy)	13.4	14.6	8.2	3.2	-2.6	-8.3	.	.	.
Tier 1 ratio (1)	.	13.5	13.1	14.1	13.8	16.0	.	.	.
Overall solvency ratio (2)	.	12.9	14.4	14.1	13.8	16.3	.	.	.
Gross total doubtful and non-performing loans (% of total debt instruments and total loans and advances) (2)	.	3.7	7.7	10.9	12.8	14.1	.	.	.
Employment, persons (yoy)	-0.1	-1.2	-2.5	0.0	0.8	1.7	1.6	1.3	0.9
Unemployment rate	7.4	7.8	10.0	11.2	10.9	10.9	10.2	9.6	9.3
Long-term unemployment rate (% of active population)	3.4	3.6	4.2	5.5	5.2	4.9	.	.	.
Youth unemployment rate (% of active population in the same age group)	18.1	19.9	26.5	26.6	26.1	28.1	.	.	.
Activity rate (15-64 years)	61.9	61.5	61.6	62.4	62.7	64.3	.	.	.
Young people not in employment, education or training (% of total population)	11.3	11.5	13.4	12.4	13.3	14.7	.	.	.
People at-risk poverty or social exclusion (% total population)	29.4	28.2	29.6	29.9	31.0	32.4	.	.	.
At-risk poverty rate (% of total population)	12.3	12.4	12.4	12.3	13.8	14.0	.	.	.
Severe material deprivation rate (% of total population)	19.9	17.9	20.3	21.6	23.1	25.7	.	.	.
Persons living in households with very low work intensity (% of total population)	11.3	12.0	11.3	11.9	12.2	12.8	.	.	.
GDP deflator (yoy)	5.4	5.3	3.6	2.4	2.6	3.2	2.2	2.1	2.3
Harmonised index of consumer prices (yoy)	7.9	6.0	4.0	4.7	3.9	5.7	1.7	1.2	2.8
Compensation of employees/head (yoy)	5.5	7.2	-1.7	-0.5	3.6	0.8	2.4	3.5	3.2
Labour Productivity (yoy)	-0.6	2.7	-4.4	0.2	1.3	-1.8	.	.	.
Unit labour costs (whole economy, yoy)	6.2	4.4	2.8	-0.7	2.3	2.7	1.6	2.0	1.7
Real unit labour costs (yoy)	0.7	-0.9	-0.7	-3.0	-0.3	-0.5	-0.5	-0.1	-0.6
REER (ULC, yoy)	9.9	0.8	-9.7	-0.4	0.8	-4.5	-0.7	-2.1	0.1
REER (HICP, yoy)	10.9	2.7	-5.3	1.6	-0.4	-2.3	-1.3	-3.1	0.6
General government balance (% of GDP)	-5.1	-3.7	-4.6	-4.3	4.3	-2.0	-2.4	-3.0	-2.9
Structural budget balance (% of GDP)	-5.8	-4.6	-2.4	-3.3	-4.1	-0.9	-1.1	-2.4	-2.3
General government gross debt (% of GDP)	67.0	73.0	79.8	82.2	82.1	79.8	77.8	79.1	78.9

(1) domestic banking groups and stand-alone banks.

(2) domestic banking groups and stand alone banks, foreign (EU and non-EU) controlled subsidiaries and foreign (EU and non-EU) controlled branches.

Source: Eurostat, ECB, AMECO.

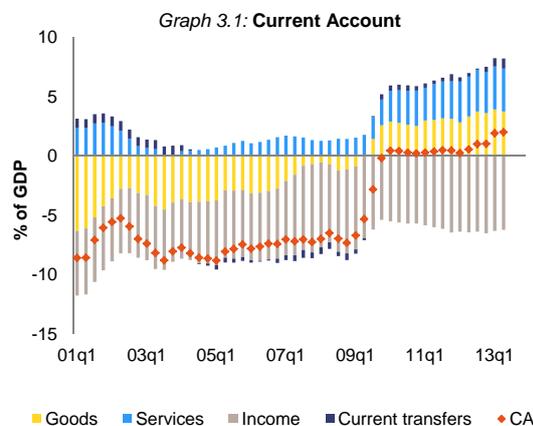
3. IMBALANCES AND RISKS

The Hungarian economy has been suffering from a number of imbalances: a highly negative NIIP and an elevated level of external debt, which stems from a high level of public and private sector indebtedness, accumulated before the financial crisis. The decline in the NIIP has been accompanied by a gradual deterioration of the export performance, which has become particularly pronounced in the last years. The reassessment of risks in the financial crisis led to the deleveraging of previous excessive debt levels, which depressed further an already declining housing market.

3.1. DESPITE A WEAK EXPORT PERFORMANCE THE NIIP IS EXPECTED TO CONTINUE IMPROVING

After persistent current account deficits contributing to a rapidly deteriorating NIIP position, the crisis brought about a sharp improvement in the external balance mostly on account of increased net savings of households and corporations. The collapse of domestic demand turned the current account into a surplus, despite a lacklustre export performance. The improvement of the external balance (by around 7 pps. between 2008 and 2009) primarily reflected the adjustment of the private sector, although the structural budget balance has also improved (by around 2 pps.). The adjustment was smoothed by a Balance of Payments assistance programme of the EU and IMF⁽¹⁾.

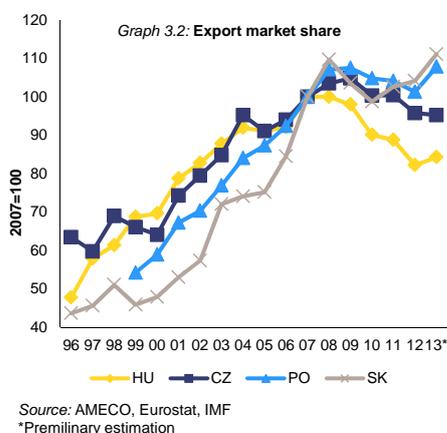
⁽¹⁾ See details at http://ec.europa.eu/economy_finance/assistance_eu_ms/hungary/index_en.



Source: Eurostat
Note: Four quarter moving sum

Although the export performance has weakened, Hungary has recorded a net lending surplus that has contributed to a declining NIIP and external debt since 2009. While it has been the most dynamic compared to the other three Visegrád (V3) countries in the early 2000s, export growth has slowed down gradually later, culminating in a sharp fall in export market shares since the financial crisis. While the fall of country exports compared to world exports is a general European phenomenon, contrary to other V3 countries, Hungary has been in the group of the worst performing Member States in the region, with a 16% fall in export market shares in the 2008-2013 period. With an openness ratio⁽¹²⁾ of close to 160% of GDP (among the highest in the world) a slowdown in export performance could seem partly inevitable at some point. However, the fact that the other V3 countries have a similar openness ratio suggests that a better export performance is still possible. As the highly negative NIIP and the high level of external debt are among the main sources of Hungary's vulnerabilities, it seems warranted to ask whether the improvement is expected to continue in the coming years, especially in view of a deteriorating export performance.

⁽¹²⁾ The openness ratio is defined as the sum of exports plus imports over GDP.



The analysis presented below suggests that the NIIP will likely improve in the medium term. This improvement is driven by a more contained domestic demand compared to pre-crisis levels due to improved fiscal discipline and a substantial inflow of EU funds.

The current highly negative level of the NIIP, combined with high external rollover needs in the absence of an obvious improvement in the export performance, keep the economy vulnerable, and should still be considered as an imbalance. The extent of vulnerability also depends on whether the future path of the NIIP will be financed mainly from FDI or debt sources. If the country is able to at least maintain the current net stock of FDI (as a percentage of GDP) in the next ten years, the NIIP would be almost fully financed from FDI flows in the baseline scenario. Under less favourable macroeconomic scenarios, debt type financing will very likely prevail, therefore keeping vulnerabilities at a higher level for a prolonged period.

3.1.1. Why has the Hungarian export performance deteriorated in the last decade?

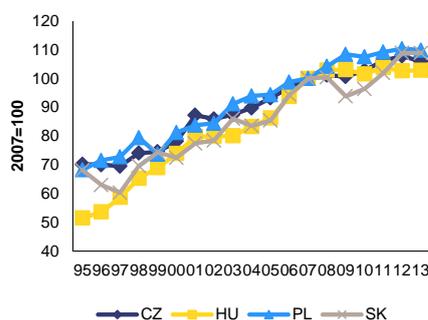
A detailed analysis of the Hungarian export performance suggests that the deterioration is primarily related to tightening supply constraints. This is partly linked to the inability to attract new FDI inflows but also to the weak spillover linkages between multinationals and domestic companies. Although recently there have been some large investment projects in the automobile industry, a marked improvement in the export sector is not expected. This latter would

require reliance on a broader set of export segments and also improved performance in terms of the value chain breadth.

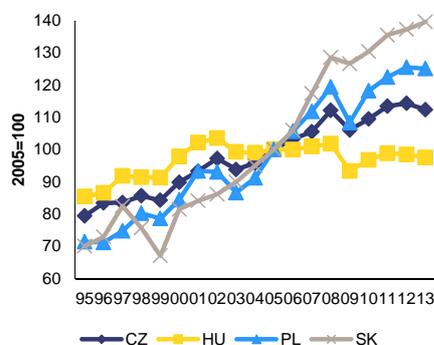
Some detailed stylised facts

The underperformance of Hungarian exports is primarily related to goods, while services exports broadly grew in line with the regional average. At the same time it is also important to stress that Hungary only slightly underperformed vis-à-vis other V3 countries in terms of volumes. Therefore export price developments are the main reason behind the differences in export performance. While the Hungarian export deflators have broadly stagnated since 2000 the other V3 countries were able to increase their deflators by around 30 to 70%.

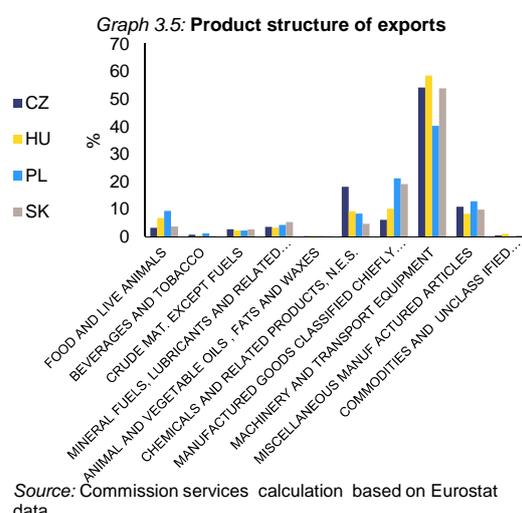
Graph 3.3: Export performance in volumes



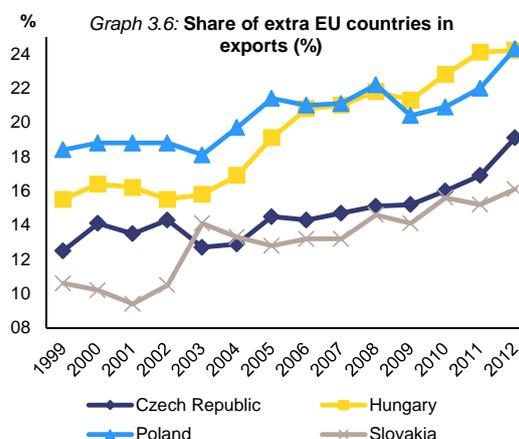
Graph 3.4: Export Deflators



The four Visegrád (V4) countries have a broadly similar product structure, but Hungary experienced some unfavourable one-off shocks during the crisis, which affected the export performance significantly. All V4 countries are primarily involved in producing machinery and transport equipment products for exports, with Poland having a somewhat less concentrated structure compared to the other V3 countries. Nevertheless, Hungary has experienced significant plant closures in the export sector in the last few years due to global decisions of multinational firms mostly in the electronic equipment subsector⁽¹³⁾. However, it is not clear if these decisions are already related to Hungary's loss of competitiveness, as no comparable data is available for other countries in the region. Also, as in terms of export performance the country has lagged behind continuously since the early 2000s vis-à-vis regional peers, these one-off shocks cannot be the sole explaining factor behind the deterioration.



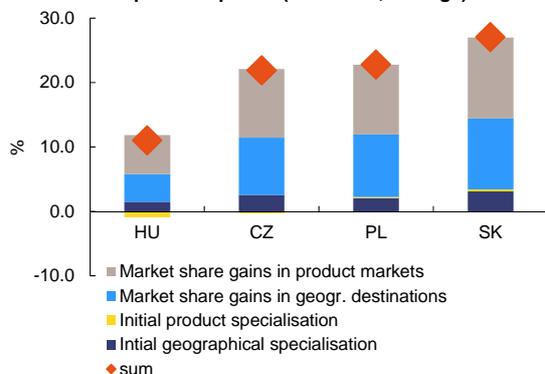
In terms of the country structure of exports, V4 countries can be split into two subgroups. EU countries are accounting for around 75% of exports for Hungary and Poland, while this share is higher at 85% for Slovakia and the Czech Republic. Nevertheless all countries have reoriented to some extent their trade towards non-EU countries in recent years.



The shift share analysis suggests that differences in export developments are not attributable to the initial product or geographical distribution, but to market share gains in individual product or country markets. In this respect Hungary has been the least successful among the Visegrád countries before, as well as after the financial crisis (see graph 3.7 and 3.8).

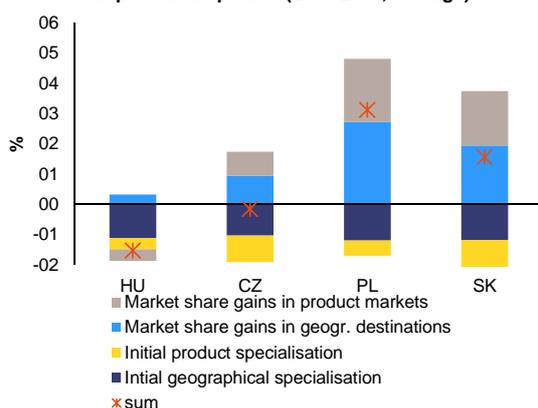
⁽¹³⁾ Among others these included the closure of the following plants or companies: Elcoteq, Flextronics, Nokia and Sony. The central bank estimates that these shocks could have resulted in a 5% fall in exports in the last few years.

Graph 3.7: A decomposition of export growth in the precrisis period (2000-2007, average)



Source: Commission services calculation based on Eurostat data

Graph 3.8: A decomposition of export growth in the post-crisis period (2007-2010, average)

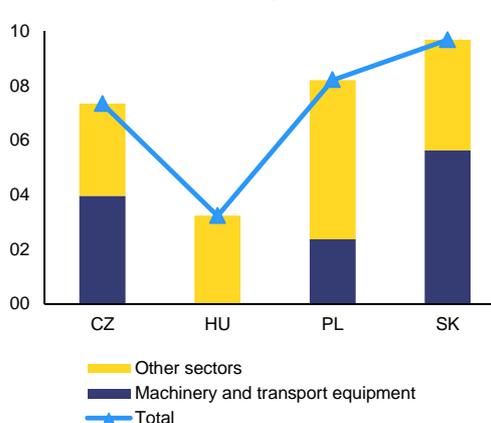


Source: Commission services calculation based on Eurostat data

The deterioration of Hungary's competitiveness in the export sector is primarily related to the machinery and transport equipment subsector.

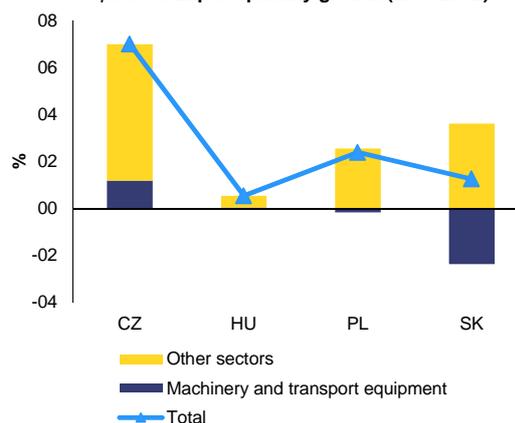
It is important to stress, that – as is the case with total goods and services exports – this tendency is not visible in terms of volumes, but reflects differences in export unit values. In terms of volumes, other sectors than machinery explain the lower performance of Hungary although the general difference compared to regional peers is smaller (except compared to the Czech Republic)⁽¹⁴⁾.

Graph 3.9: Export value growth (2007-2012)



Source: Commission services calculation based on Eurostat data

Graph 3.10: Export quantity growth (2007-2012)

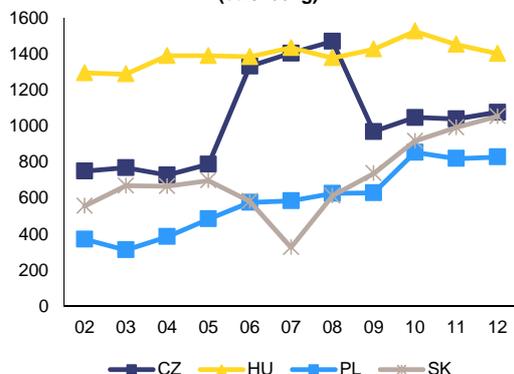


Source: Commission services calculation based on Eurostat data

Hungary's underperformance in terms of prices is a consequence of an initially very high level of unit values, which the country was unable to increase further in the last decade. The unit values of other V3 countries increased, probably reflecting the effect of product upgrading. The differences in the level of total export unit values is a consequence of the different pattern of the machinery and transport equipment sector, while the price trends of other sectors seems broadly similar.

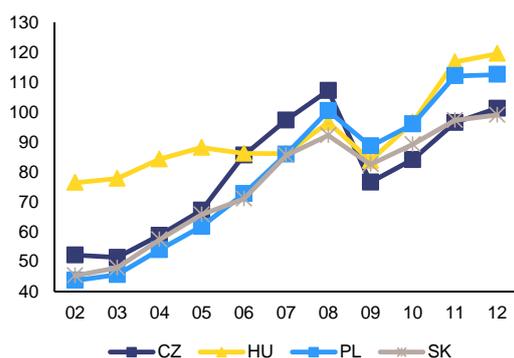
⁽¹⁴⁾ It should be noted that export unit values are not price levels per se, therefore the problem of different product composition can hinder international comparison of unit values much more than the comparison of export deflators.

Graph 3.11: Export good unit value levels in machinery and transport equipment sector (eur/100kg)



Source: Commission services calculation based on Eurostat data

Graph 3.12: Export good unit value levels in other sectors (eur/100kg)



Source: Commission services calculation based on Eurostat data

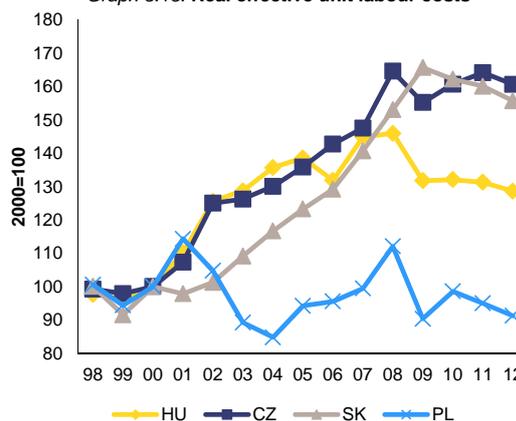
Overall, Hungary's weak export performance compared to regional peers is primarily attributable to a weaker price/value performance of the machinery and transport equipment sector. Hungary has also been slightly lagging behind in terms of volumes, although this occurred in other export sectors than machinery. Nevertheless, the country continues to have the highest level of export unit values, which could reflect a still competitive product quality in regional comparison.

Drivers behind the weak export competitiveness

Price competitiveness

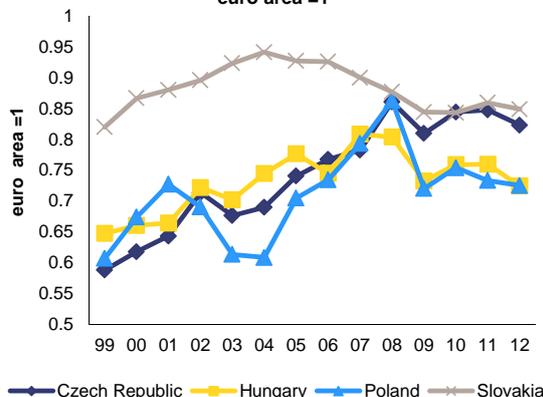
While there was no substantial difference in the pre-crisis years, the Hungarian price and cost competitiveness improved substantially after the financial crisis if compared to the Czech Republic and Slovakia. In terms of unit labour costs based real exchange rate, all countries but Poland had a similar real appreciating trend until 2007, while both Hungary and Poland gained competitiveness due to the depreciation of the nominal exchange rate in 2009. A comparison of goods price levels also point to Hungary and Poland having the lowest prices among the V4 countries after the start of the financial crisis.

Graph 3.13: Real effective unit labour costs



Source: Commission services calculation based on Eurostat data

Graph 3.14: Comparative goods level prices, euro area =1



Source: Commission services calculation based on Eurostat data

Product quality

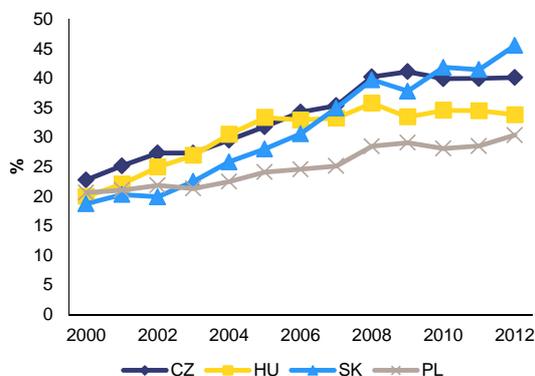
The worse performance of Hungarian export deflators compared to other V3 countries might point to differences in product upgrading.

Benkovskis and Worter (2012) estimate the effect of product quality for different EU countries including the V4 countries. After estimating quality, they produce quality-adjusted price competitiveness measures. Their results show that while other V3 countries' export deflators increased substantially in the last decade, after adjusting for quality they showed a steep declining trend. At the same time, while Hungarian export prices remained stable, this is also true for quality-adjusted prices. This suggests that Hungary has become less competitive due to its inability to improve the quality of its products.

Productivity, FDI and the value added content of exports

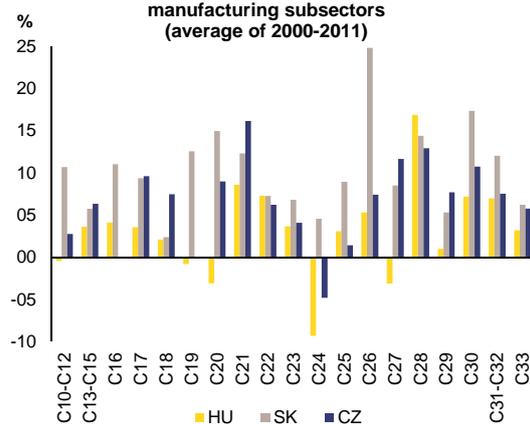
Hungary's manufacturing productivity growth has also been lagging behind compared to regional peers, i.e. the export performance could have been hindered by supply side constraints. The slower productivity growth of Hungary is broadly valid across all subsectors, therefore it cannot be considered as the result of some idiosyncratic shock. Somewhat similarly to the case of exports, the relative productivity improvements of other V3 countries reflect a catching-up process. While Hungary had one of the highest levels of manufacturing productivity among V4 countries in the first half of the decade, currently it has the third lowest figure, well below the level of the Czech Republic and Slovakia.

Graph 3.15: Manufacturing productivity levels vis-a-vis EU15 countries



Source: Eurostat

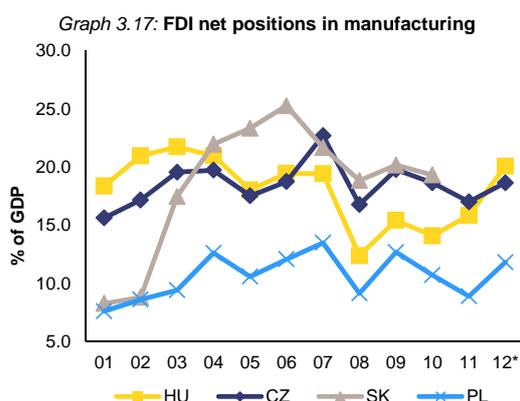
Graph 3.16: Growth of productivity in manufacturing subsectors (average of 2000-2011)



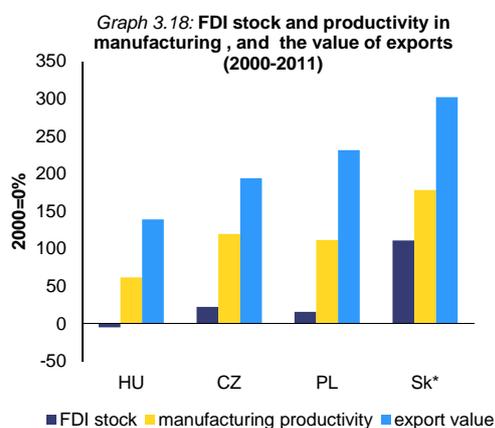
Source: Commission services calculation based on Eurostat data

V4 countries lag well behind the EU average in terms of innovation capacity, and FDI inflows are one of the most important sources of productivity and product quality improvements. Earlier research (Oblath, 2009) concluded that Hungary's export structure contained a large share of high quality products in the early 2000s in manufacturing, similarly to the most developed EU countries. This conclusion is reinforced by the initial high level of export prices. The advanced level of product quality was accompanied by a very high level of FDI in Hungarian manufacturing compared to other V3 countries.

While the other V3 countries increased the stock of FDI in manufacturing, Hungary's stock even declined until 2011, as practically no new production capacities were installed.⁽¹⁵⁾ Indeed it seems that productivity and export performance are strongly related to FDI, a relationship which has been confirmed by several empirical studies.⁽¹⁶⁾



Source: Commission services calculation based on OECD and IMF data
2012 data are based on national data sources, in case of HU the net FDI inflow is added to the 2011 stock



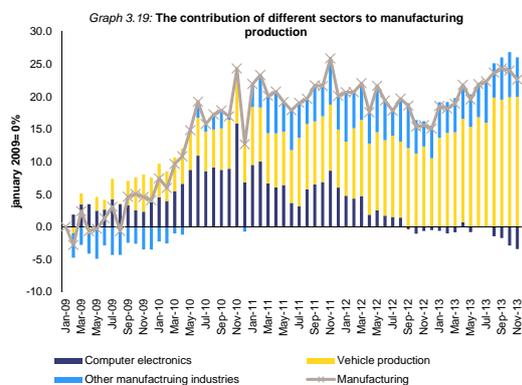
*FDI data refers to the 2000-2010 period.
Source: Commission services calculation based on OECD and Eurostat data

While there was an upswing of FDI in manufacturing in 2011-2012, it is not obvious whether this represents a marked turnaround

⁽¹⁵⁾ We discuss net FDI inflows so as to avoid that capital in transit distorts the picture. Nevertheless, in case of the manufacturing sector the use of inward FDI stock data would have given a broadly similar picture.

⁽¹⁶⁾ See for example Pain-Wakelin (1998), Damjan et. al. (2013) or Rahmaddi and Ichiasi (2012).

compared to past tendencies. These increased flows are mostly related to the automobile sub sector, where business plans suggest that the number of produced cars can almost double between 2012-2014.⁽¹⁷⁾ The MNB estimated that new investments in the automobile industry could contribute to increasing exports in cumulative terms by around 6.5%, although the exact time profile of production pick-up is uncertain. Indeed, data for 2013 already show an improvement in the export market share compared to 2012, and a quick pick up in the industrial production of the automobile sector. However it is questionable whether the automobile sector is enough in itself to turn around the past deterioration in export competitiveness, especially due to the fact that the negative trend in the electronic equipment subsector has remained uninterrupted. Also it is not obvious whether these new investments represent a turnaround in FDI trends compared to past tendencies as the general business environment in Hungary has remained problematic.



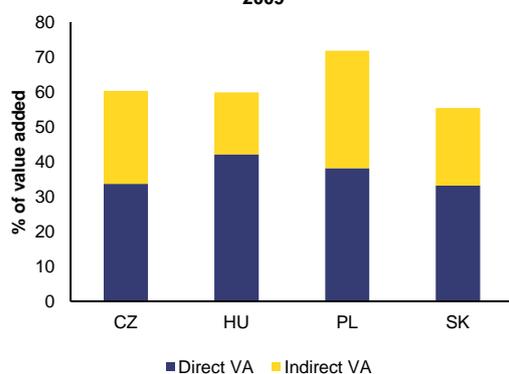
Source: Commission services calculation based on CSO data

As Hungary is already highly integrated into the world economy, further trade gains would also require increasing the importance of domestic value chains. However, both the domestic value added content of exports and particularly the domestic innovation activity seems to be low compared to more developed EU countries (although this latter is also true for all V4 countries). While three Visegrád countries (Czech Republic, Slovakia, and Hungary) have a broadly similar value added content of exports of around 60%, this figure is somewhat higher for Poland

⁽¹⁷⁾ E.g. see Napi (2013) "Robbanás várható a magyar autógyártásban hamarosan" 25, November 2013.

(around 70%). This 60% level is relatively low compared to an average of 72.5% for the 58 countries (mostly OECD members) in the OECD-WTO database. Although the direct value added content is somewhat higher than at other V3 countries, the indirect value added (spillover) effects of exports Hungary at 18% is one of the lowest among the countries surveyed, which is also lower than the value of regional peers. As around 75% of exports are produced by foreign-owned companies and close to 50% by big foreign-owned corporates, the low spillover possibly indicates difficulties in connecting the SME sector to the multinational export sector. The relatively low value added content of exports is also reflected in international competitiveness indicators, which point toward a substantial deterioration in the value chain breadth and cluster developments in the last 7-8 years.⁽¹⁸⁾

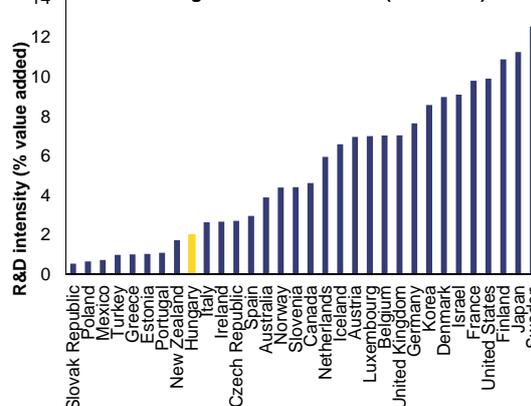
Graph 3.20: Direct and indirect value added content of exports among OECD countries in 2009



Source: OECD-WTO database

⁽¹⁸⁾ See section 4 for more detail.

Graph 3.21: The R&D intensity of manufacturing in OECD countries (2005-2009)



Source: OECD

Export performance could benefit from further FDI inflows, but also higher spillovers from multinationals to domestic companies as well as a higher share of domestically-driven innovation. An improvement in the business environment would help attracting more FDI. While the Hungarian government considers manufacturing as a priority sector in terms of foreign capital, the risk of spillovers of a deteriorating investor sentiment from services to manufacturing cannot be excluded. Positive spillovers to domestic companies could be boosted by increasing the availability of SME export financing.⁽¹⁹⁾ but also possibly an improved vocational education system.⁽²⁰⁾ Domestic innovation could be enhanced by improving the research infrastructure as well as enhancing the cooperation among businesses and universities.

3.1.2. External sustainability

External imbalances have been declining steadily as the NIIP improved from the lowest level in the EU in 2009 (-117%) to -99% of GDP by 2013. Roughly half of the NIIP consists of debt securities and another half could be considered as FDI or portfolio investment. The improvement in the NIIP primarily reflects a declining external debt of the banking sector.

⁽¹⁹⁾ The Hungarian EXIM bank's facilities has been recently extended and upgraded to support export and export supplier financing.

⁽²⁰⁾ A recent survey of the German-Hungarian trade and industrial chamber indicates that only every sixth company leader is satisfied with the vocational training system, while over 40% have serious reservations.

Box 3.1: Details of the external sustainability calculations

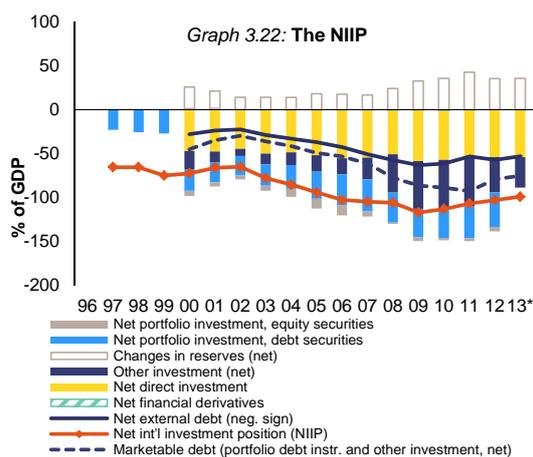
Table 1:
Main features of the external sustainability calculations

average 2014-2023	Baseline	Favourable scenario	Unfavourable scenario	Unfavourable scenario+no capital account surplus	
GDP growth		1.3	1.8	0.8	0.8
GDP deflator, change		2.2	2.7	1.7	1.7
Domestic yields		5.4	4.9	5.9	5.9
Trade+ current transfer balar		5.2	6.0	4.4	4.4
Current account		0.7	2.3	-1.2	-1.9
Capital account		2.0	2.0	2.0	0.0
Net lending		2.6	4.3	0.8	-1.9
NIIP in 2023		-48.7	-29.0	-71.9	-95.5

Source: Commission services

The starting point of the calculation is ECFIN staff computations of the underlying current account, based on Salto-Turini (2010). This shows for Hungary an underlying current account position (after adjusting for the cyclical position) of close to -1% of GDP as an average of the 2009-2013 period. ⁽¹⁾ In the baseline scenario it was assumed that the underlying current account position is achieved by 2017, when the output gap is already closed. The current account is assumed to be fixed thereafter. The baseline scenario is based on ECFIN autumn 2013 forecast, while the long term projection is on the 2012 Fiscal Sustainability Report. Projections on the capital account balance are based on EU fund projections until 2020, while these converge to zero linearly by 2025. Importantly, based on past relationships, it is not assumed that with the increasing inflow of EU funds the investment rate will also increase. Therefore, as in the past few years EU funds seem to be an important source of external financing. The favourable scenario assumes a combined 1 pps GDP shock to the trade balance, 0.5 pps extra GDP growth and inflation and lower domestic yields by 0.5 pps. The unfavourable scenario assumes 1 pps of GDP lower trade balance combined with 0.5 pps lower growth and inflation and 0.5 pps higher domestic yields.

⁽¹⁾ As the estimates of underlying current account varied between -2 to +1% after the substantial correction in 2009, it seemed reasonable to use an average value, instead of using the estimate for a particular year.

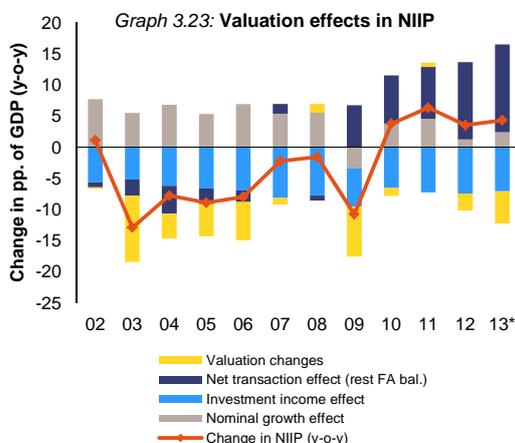


Source: Eurostat
*Estimated from quarterly data

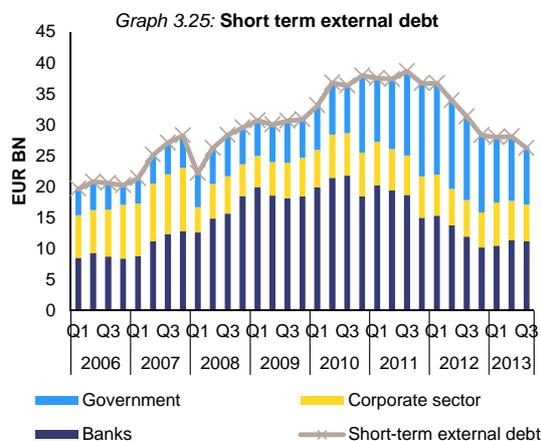
and an exchange rate depreciation. Since 2009, a continuous decline in external imbalances has been recorded, mostly on account of a trade surplus of around 5-7% of GDP and persistent inflows of EU funds, which ceteris paribus have improved the external balance in the magnitude of around 2-4% of GDP.⁽²¹⁾

⁽²¹⁾ Assuming EU funds do not generate additional investments at the macro level, it can be considered as a source of financing. This seems to be the correct assumption, as despite an inflow of EU funds by around EUR 3 bn annually, the investment rate declined by over 4 pps. between 2007-2012. At the same time, recently, the effect of EU funds on investment activity could have increased. (see box 3.3).

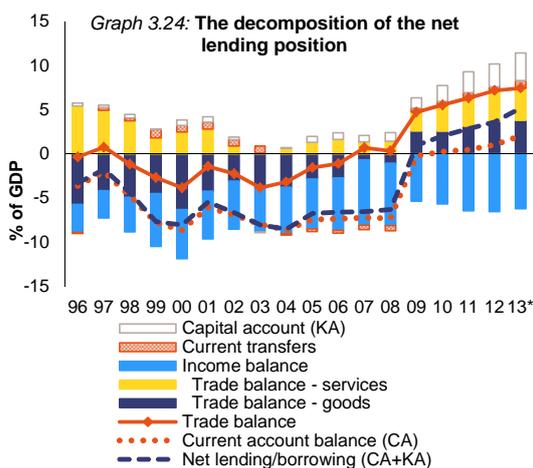
Despite a sizeable correction of the previous current account deficits already in 2009, the NIIP has started to decline only since 2010 due to revaluation effects. The deterioration in the NIIP from 2008 to 2009 occurred on account of the combined negative effect of a sharp recession



Source: Eurostat
*Estimated from quarterly data



Source: MNB

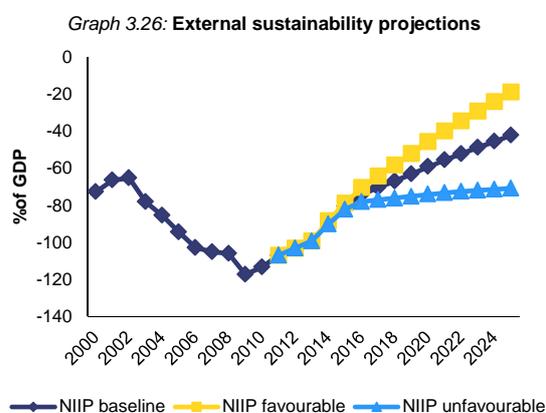


Source: Eurostat
*Estimated from quarterly data

Although the short term external debt has also declined by around EUR 10 bn (10% of GDP) from its 2011 peak, it is still high at around EUR 25 bn (25% of GDP). While currently a combined current and capital account in the range of 6% of GDP eases refinancing tensions, Hungary still needs to attract foreign investors in order to rollover maturing debt.

Sustainability calculations for the next decade suggest that the improvement of the NIIP will most likely continue as the economy recovers. As the actual external balance of the economy is well above the NIIP stabilising net lending position (6.1% as opposed to -3,5% of GDP), the starting situation of the economy suggests continuing NIIP improvement. Given an underlying current account⁽²²⁾ which is only slightly negative (at around -1% of GDP) and a capital account in surplus due to the expected inflow of EU funds, the NIIP could be projected to improve even in the medium term. Indeed, based on different macroeconomic scenarios, this picture seems to be robust, although the exact pace of improvement is sensitive to macroeconomic assumptions (see Box 3.1). In the baseline scenario the NIIP could increase above -50% of GDP by 2023. In an unfavourable scenario, it could be around -70% of GDP by 2023, which is still relatively high in international comparison. However, without the help of a persistent surplus in the capital account the NIIP position under more negative circumstances would remain broadly unchanged (at around -95% by 2023).

⁽²²⁾ The current account adjusted for cyclical and possibly for past real exchange rate effects. Given the volatility of the exchange rate and the uncertainty in the elasticities, in the calculations we use the underlying current account which is only corrected for cyclical effects.



Source: Commission services calculation

Compared to pre-crisis trends, the improving NIIP position is primarily driven by a stronger fiscal discipline. To understand NIIP trends it is also crucial to see whether the behaviour of different sectors has changed persistently. As before the crisis Hungary had a persistent twin deficit, assuming that its structural balance will now stick to the country's MTO of a 1.7% of GDP government deficit, such a scenario would improve ceteris paribus the external position by around 6 pps.⁽²³⁾

3.2. ALTHOUGH PRIVATE SECTOR DELEVERAGING HAS SLOWED DOWN RECENTLY, SEVERAL FRAGILITIES REMAIN

The high level of private sector indebtedness is considered as a major imbalance of the Hungarian economy. Before the financial crisis, private sector debt increased well above the level of regional peers, and the debt structure became particularly fragile due to a high share of FX loans. The financial crisis has triggered a 5-year spell of deleveraging in the country, starting in 2009, with dire consequences for economic growth and the housing market.

While debt levels have declined substantially, private sector indebtedness in the context of a fragile financial sector should be considered as an important source of imbalance. Deleveraging

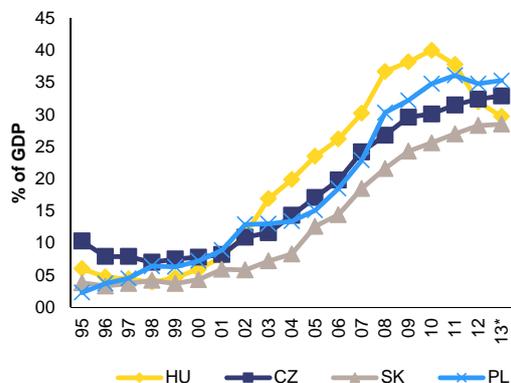
has halted in the non-financial corporate sector, where investment has been recovering, albeit on account of some stimulus measures (the increasing absorption of EU funds and the central bank's subsidized lending scheme (Funding for Growth (FGS))). However, as the general business environment remained problematic and also total corporate debt stands well above the level of other V3 countries, it is too early to conclude that the sector has already reached a sustainable position. A turning point is even more uncertain in the household sector, where despite increasing real disposable income since 2013 and some slightly improving signs in credit demand the high share of distressed borrowers and a depressed housing market hamper achieving the endpoint of debt reduction. With a loan-to-deposit ratio of around 110%, there are also signs of a slowdown in the banking sector's deleveraging process, which in principle could support the easing of credit conditions. However, at the current juncture a problematic and uncertain operating environment does not give the right incentives for banks to expand credit flows.

3.2.1. Household indebtedness

Household indebtedness quadrupled during the decade before the financial crisis and exceeded by far the level of regional peers by 2008. Despite a weakening economic performance, this process has been driven by optimistic expectations about income convergence to EU15 levels and the prospects of EMU membership, but also by ample liquidity and high risk tolerance of the banking sector. Mortgage indebtedness was first driven by a general housing subsidy scheme in the early 2000s, which ended in late 2003. After the restriction of subsidized HUF lending, the widespread expansion of FX loans has been driven by the high interest rate differential of HUF loans compared to CHF ones in a generally risk prone environment.

⁽²³⁾ Comparing the pre-crisis average structural government deficit of around 8% of GDP with Hungary's MTO of a deficit of 1.7% of GDP.

Graph 3.27: Household debt



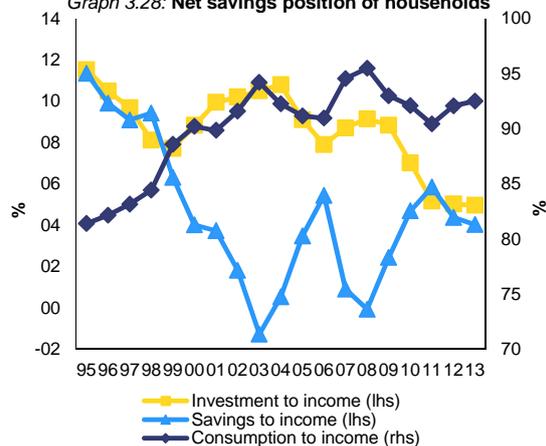
Source: Eurostat
*Estimated from quarterly data

The crisis brought a sharp adjustment among households, banks and on the housing market through a combination of demand and supply factors. On the demand side, increasing economic uncertainty and increasing unemployment decreased the demand for credit. At the same time, decreasing external funding and risk tolerance of banks tightened credit supply conditions. Excess housing supply was also increased by the negative feedback loops between the housing market and the financial sector. On the one hand the fall in real estate prices (even combined with a fall in the HUF/CHF rate) contributed to huge increases in the loan-to-value ratios among household mortgages. This made it more difficult for households to repay the debt burden, increasing the share of those households who are non-performing. In addition, a depressed housing market made it difficult for banks to sell the collateral in the case of these non-performing loans. This hampers a cleaning-up of banks' balance sheets and restoring normal lending to the economy.

The household sector has cut back its expenditure mostly related to housing investment since 2009 which has contributed to a continuous surplus of net savings. However due to revaluation effects (on account of a 40% weakening of HUF/CHF exchange rate, which repriced existing FX debt amounting to over 2/3 of

total household debt in Q4 2008), household debt only started to decline in 2011. ⁽²⁴⁾

Graph 3.28: Net savings position of households



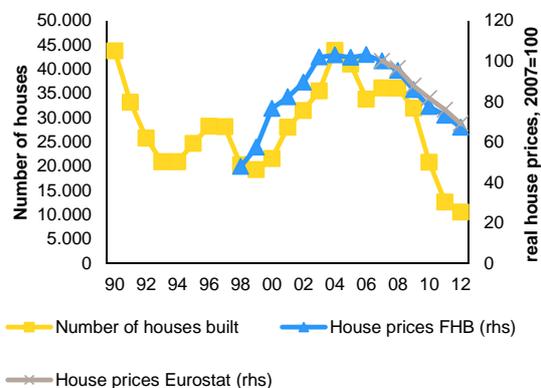
Source: AMECO

Consequently, the deleveraging process had sharp consequences on the housing market. Overall, Hungary's housing prices have fallen by close to a cumulative 35% since the latest peak in 2004, while the number of houses built has dropped by around 75%. ⁽²⁵⁾The decline in housing prices was not preceded by a real estate boom before the crisis, in fact real house prices have been declining slowly since 2004. As a declining housing market has wide-ranging spillovers to the economy (from the negative effects on housing investment rate to the banking sector's cautious behaviour towards lending), it is important to understand to what extent the fall should be seen as a cyclical or rather a more structural phenomenon.

⁽²⁴⁾ The decline in household FX debt since 2011 has also reflected the controversial scheme put in place by the authorities allowing for an early repayment of households' FX mortgages at a fixed exchange rate well below the relevant market rate. This was one in a series of economic policy measures targeted toward FX borrowers. While it helped to decrease FX debt by around 24%, it triggered substantial losses for the banking sector and contributed to an increase in the NPL ratio (see Box 3.2).

⁽²⁵⁾ The decline in housing prices has marked regional disparities. Larger price declines since 2008 have been observed in those regions where the starting price levels were initially lower, also the proportion of forced sales were most relevant in these areas. The worse performing regions in terms of prices were also those which experienced the biggest increase in unemployment rates. Therefore the housing regional market situation has mirrored regional disparities of economic performance.

Graph 3.29: Number of houses built and real house prices

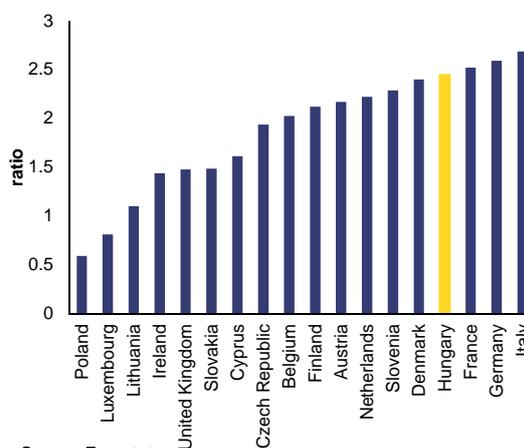


Source: KSH, Eurostat, FHB

A number of factors suggest a structural oversupply in the housing market, which would possibly require several years to be reduced in case of no policy change. First, as a result of increasing NPLs, the financial sector has accumulated a non-negligible amount of housing stock. According to the central bank's estimates, financial institutions own around 150000 dwellings in their portfolios, a number which is approximately 15 times the current annual amount of houses built in the country (at 10000), but even stand around 3¾ times of the pre-crisis investment level (40000 houses per annum). As the sector waits for a better market environment to clean up portfolios, once a recovery has started, this supply would also appear in the market. Second, the utilisation rate of the available housing stock is still at a historically low level (below 90%). Third, housing wealth is still relatively high in international comparison (measured as a share of GDP), even higher than in some developed countries.⁽²⁶⁾

⁽²⁶⁾ As housing is primarily a non-tradable good among other factors (like demography and institutional determinants) its consumption should be driven by economic developments. Given Hungary's high level of housing stock compared to its development level, it is possible that the country will continue to suffer from an excess supply in the medium term. The high level of housing stock probably also comes from the special circumstances of Hungary before the transition where in a relatively liberal economy with suppressed financial intermediation, the only way to accumulate household wealth was housing. See e.g. Zsoldos (1997).

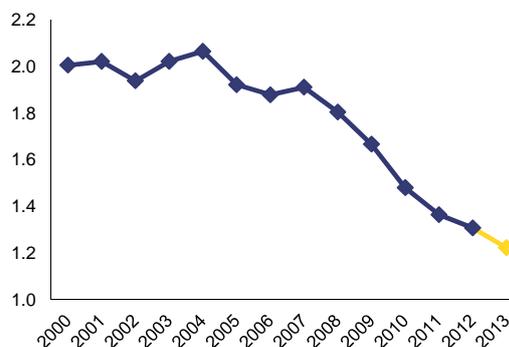
Graph 3.30: Dwelling assets to GDP in 2011



Source: Eurostat

Finally the weak potential growth performance of Hungary⁽²⁷⁾ means that household disposable income is not expected to generate dynamic housing demand in the future. However, given the relatively high stock of housing, quality upgrading could be the main factor driving housing investments in the future.⁽²⁸⁾

Graph 3.31: Housing affordability*



Source: ELTINGA

*The number of monthly average wages needed to buy 1 m² of an average flat

⁽²⁷⁾ See section 2 for more details.

⁽²⁸⁾ I.e. assuming an initial housing stock of 250% of GDP and a 100 year life span, the amount of investment which recovers amortisation could add around 2.5% to residential investment which stood at only 2% of GDP in 2012.

Box 3.2: The FX debt problem and government intervention

FX indebtedness is one of the most serious social challenges facing Hungary. The combination of declining employment, an over 40% depreciation of the HUF/CHF exchange rate compared to precrisis levels and an increasing interest rate burden contributed to increasing insolvencies in the household debt market. The NPL ratio of FX loans increased to 18% by 2013 from a level around 7,5% in early 2010.

The government has tried so far to address the problem with a series of measures. *The early repayment scheme* (introduced in September 2011 and open until December 2011) made possible for households to repay their existing FX mortgage debt well below the market exchange rate. However most of these repayments (around 2/3rd) were possible from own savings of households, which meant that primarily better off households were able to redeem existing FX debt.⁽¹⁾ While the scheme helped decreasing FX exposure of households (the FX debt stock declined by around 24% between 2011-Q1 2012 filtering out the exchange rate effects), it triggered a net loss of close to 1% of GDP for the financial sector (taking into account some burden-sharing between the banking sector and the government laid down in the mid-December 2011 agreement). Also, since the scheme helped primarily the most solvent debtors, the share of the problematic ones has increased in banks' portfolios, reflecting a substantially increased NPL rate (from 13% to 16% between q4 2011 and q2 2012).

⁽¹⁾ More accurately, according to financial statistics, around 1/3 of the repayment was made from HUF loans. As regards the rest, apart from own financial savings, possibly other sources could have been selling dwelling assets as well as family or private loans etc.

The *exchange rate cap scheme* (first introduced in August 2011 but extended for a longer relief period in the December 2011 agreement between the government and the banking sector) for non-distressed borrowers allows them to pay their monthly installment for a certain period at a fixed exchange rate level (also well below the market rate), but contrary to the early repayment scheme it does not give a relief on the principal.⁽²⁾ A further measure converted nonperforming foreign exchange (FX) mortgages to HUF loans with 25% debt relief. Finally, the National Asset Management Company was set up to purchase flats owned by distressed borrowers who met certain eligibility conditions.⁽³⁾

It is important to stress that in several cases (e.g. in case of the early repayment scheme and the exchange rate cap scheme) these programmes did not target the most problematic debtors or the ones which targeted the most problematic ones has not been successful in giving substantial relief to the most distressed debtors.⁽⁴⁾ The recent extension (in November 2013) of the exchange rate cap scheme towards delinquent borrowers (over 90 days) could be a step in the right direction, which could give some relief for tens of thousands of households, but it is still not expected to tackle the problem of distressed households on a larger scale, as banks already tried to restructure the loans of problematic debtors on an individual basis. At the same time, the adoption of newer and newer relief

⁽²⁾ The debt resulting from the difference between this fixed exchange rate and the market rate is accumulated on a separate account to be repayed at the latest starting from June 2017. At the same time this latter debt becomes interest free as the interest expense is covered by the government and banks.

⁽³⁾ See net <http://www.netzrt.hu/>

⁽⁴⁾ E.g. in case of the exchange rate conversion of FX loans to HUF loans with a 25% debt relief, the monthly instalment only decreased slightly due to the higher HUF rates compared to FX rates (see MNB (2012)). With the potential purchase of 25000 flats, the coverage of the National Asset Management company is rather small to tackle the problem of distressed debtors on a larger scale. In 2013 based on the MNB estimation around 150000 flats are in the portfolio of the financial sector due to NPLs.

(Continued on the next page)

Box (continued)

measures contributed to the perception of forever ongoing government help, which increased moral hazard and deteriorated the payment culture.⁽⁵⁾

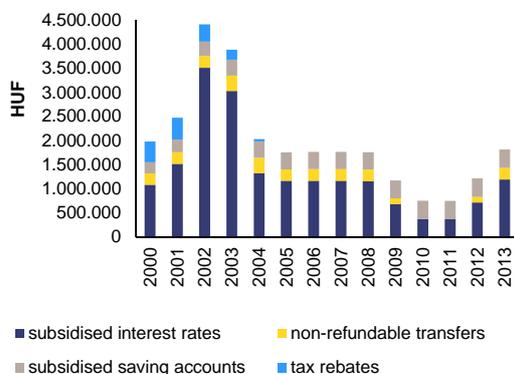
Since August 2013, the government has continuously communicated the need for a final solution of the FX problem. The exact design of the possible new FX relief scheme is still uncertain, as the government has decided to wait for a clear legal picture before adopting any further decision. Therefore, in parallel to the legal deliberations of the Supreme Court in this area, it submitted a request to the Constitutional Court on the issue of FX loans. Two major issues are discussed: (i) whether it is justifiable that the exchange rate risks are borne by households, and (ii) whether interest rate changes and the application of high bid-ask spreads (during loan disbursement and redemption) were in line with a fair contract of two equal parties. The Courts' legal opinions and the possible ensuing government decision could have a major impact on the banking sector's capital position. This impact will depend on: (i) whether there is a direct consequence for the entire sector or only general guidance for individual legal cases, (ii) whether the decisions can have retroactive effects, and (iii) whether the potential costs are shared with other stakeholders.⁽⁶⁾

While FX indebtedness still seems to be a major social and economic policy issue, the NPL rate among non-subsidized HUF loans is equally high, at 20%. On the other hand as shown by these experiences non-targeted measures incur unnecessary costs on the banking sector, which can hinder economic growth. Therefore it would be advisable to target a possible relief scheme toward insolvent borrowers. However in order to decrease financial stability risks, it is particularly important that any new relief scheme is accompanied by decreased burdens for the financial sector as well as a clear government communication on closing the practice of newer and newer relief schemes.

⁽⁵⁾ For example, based on a recent survey carried out by MNB, 25% of the respondents who did not apply for the exchange rate cap system said that they are waiting for a newer and better scheme. (Close to 50% of those who are eligible has not yet applied to the scheme until end of 2013.)

⁽⁶⁾ The Supreme Court issued a uniformity decision on 16 December. According to this, courts alone cannot be expected to single-handedly address the problems related to FX loans, and its own role is limited to the interpretation of the law. No decision was made on the most critical point, i.e. banks' unilateral changes to contracts, as the Curia is waiting for the decision of the European Court of Justice (ECJ, expected around May-June 2014). Therefore the Curia's decision per se should not lead to a radical change in the FX problem. As a response to this decision, the Hungarian authorities indicated that they would wait for the ECJ ruling before announcing a new FX scheme. A clear legal situation would also require having the decision of the Constitutional Court, which will take some time, as the Court will only start addressing the issue in 2014.

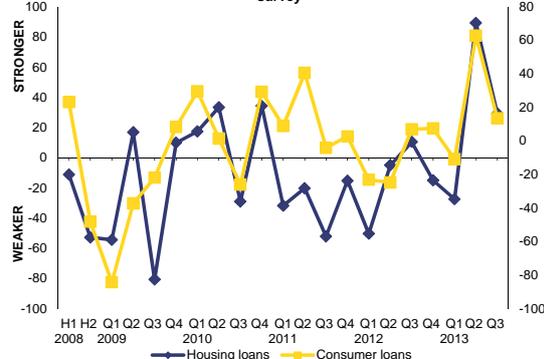
Graph 3.32: Available housing subsidies on a median flat



Source: ELTINGA

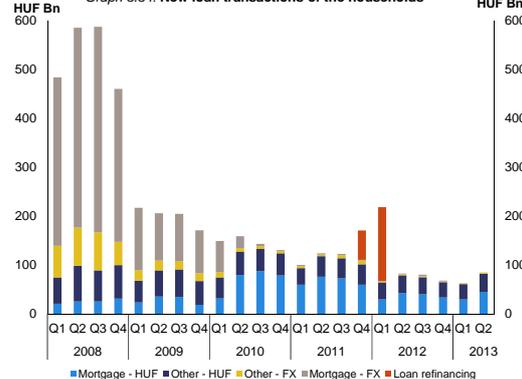
A sharply reduced debt level and improved housing affordability might suggest a turning point in household deleveraging. On a positive note several factors indicate the possibility of an endpoint to household debt reduction. First, the level of household debt has declined (by 10% of GDP between 2010 and 2013) to those recorded in the other V3 countries and the share of FX debt has also fallen (from 70% in 2009 to 53% in 2013), lowering financial fragilities. Second, housing affordability indicators point to an improving entry point for housing investment. House price-to-income ratios have declined by 40% compared to the 2004 peak, and the amount of housing subsidies has more than doubled for a median flat in the last two years. Third, the lower interest rate environment also supports household borrowing. Finally, banks are also slightly easing credit conditions, although from a very tight level in a historical perspective, and report an increasing credit demand in the Loan Officer's Survey for the second consecutive quarter.

Graph 3.33: Credit demand of households based on the SLO survey



Source: MNB

Graph 3.34: New loan transactions of the households

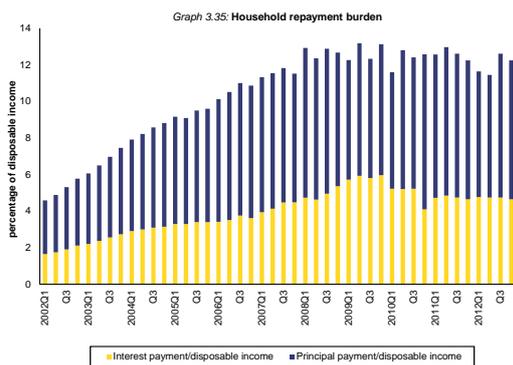


Source: MNB

However the high monthly repayment burden, a high share of distressed borrowers as well as a weak housing market still hinder a possible recovery. Notwithstanding a declining debt level, the monthly repayment burden of households has remained unchanged since 2008 due to the weakening of the HUF/CHF exchange rate and deteriorating disposable income. In addition, despite a series of measures, the problem of distressed borrowers has not been resolved yet, as reflected in a household NPL ratio in the banking sector's balance sheet close to 20%.⁽²⁹⁾ Finally, it should also be noted that, as the primary type of household lending is mortgage backed, a recovery in household lending would first appear as a recovery in the mortgage market. However, as

⁽²⁹⁾ This partially reflects the weak economic situation in the country, but also the fact that several measures were not particularly targeted towards problematic borrowers and created moral hazard which damaged the payment culture by creating expectations for further favourable debt relief schemes (see Box (3.2))

discussed above, the housing sector still shows signs of oversupply. Therefore overall it is not surprising that gross lending flows still stood below 20% of their pre-crisis levels in Q2 2013.



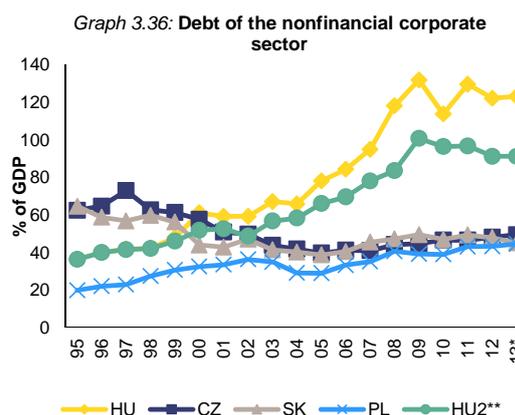
3.2.2. Non-financial corporate sector

Compared to households, it is more difficult to gauge whether the non-financial corporate sector was suffering from a debt overhang at the start of the financial crisis. The comparison of corporate indebtedness is hindered by several methodological caveats including companies' tax optimisation activities.⁽³⁰⁾ Pre-crisis corporate sector indebtedness among SMEs has been driven by similar factors as among households (e.g. optimistic expectations on convergence, low real interest rate on CHF loans assuming exchange rate stability), while the determining factors for larger companies usually differed. Given the better financing opportunities of the latter, their level of indebtedness is more linked to the potential profitability of individual projects. The funding of this latter group is to large extent linked to foreign bank or intercompany loans.⁽³¹⁾

While corporate sector debt data still indicates a significant difference, outstanding loans from domestic banks show that the indebtedness of

the Hungarian corporate sector is already close to the level of regional peers. Although domestic loan data would not suggest debt overhang for the non-financial corporate sector even at the start of the financial crisis, total debt data still indicates an over-indebtedness of the sector. The fact that the two data sources present a very different picture of the non-financial corporate sector in international comparison increases the uncertainties as to what extent past deleveraging has been warranted from the credit demand side and whether further debt reduction efforts are necessary.

Despite this caveat, several studies indicate that the fall in domestic lending since the start of the financial crisis should be seen as somewhat excessive and not fully warranted by the high level of loans in the sector. First MNB (2010) estimated that contrary to the household sector, corporate level indebtedness did not exceed the estimated equilibrium level by 2008. Second, Hosszú et. al. (2013) suggests that in the last years between half and two-thirds of the decline in corporate lending has been attributable to tight credit supply factors. Finally, based on the analysis of Cuerdo et al (2013) it can be concluded that loan supply pressures were one of the highest in Hungary among EU countries, while loan demand pressures stood at the average in 2012.⁽³²⁾

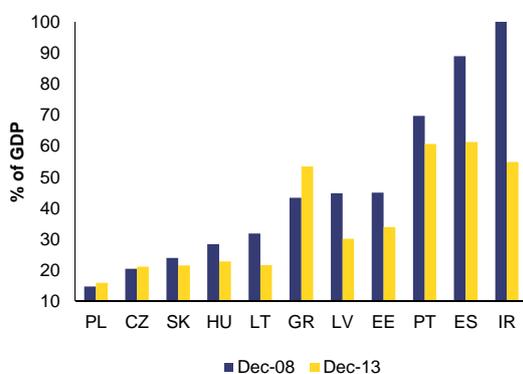


⁽³⁰⁾ This includes the existence of Special Purpose Entities (as discussed in last year's IDR), but also the fact that "normal multinationals" can restructure their activity in a way so as to report their profit in the lowest tax environment.

⁽³¹⁾ Financial accounts data suggests that roughly 60% of corporate loans are foreign loans.

⁽³²⁾ See Kovács (2013).

Graph 3.37: Domestic banks' loans to the non-financial corporate sector



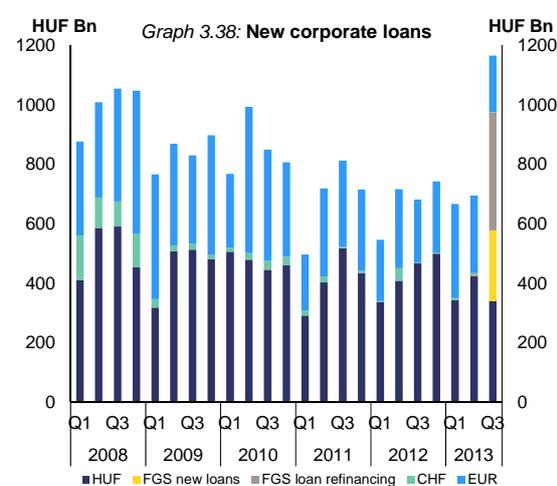
Source: Commission services calculation based on ECB and Eurostat data

Deleveraging has stopped in Q3 2013 in the corporate sector on account of the central bank's FGS scheme. ⁽³³⁾ Both credit demand and supply factors have been improving, but the increase in lending is attributable to the first allocation of funds under the central bank's FGS. Without this latter, net lending flows would have remained negative. ⁽³⁴⁾ The scheme, which is

⁽³³⁾ In April 2013, the MNB Monetary Council approved the FGS which is built around 3 pillars: The 1st pillar is based on granting new loans to SMEs - The MNB offers commercial banks funds at 0% interest rate, which banks can lend to SMEs at max. 2.5%. The preferential rate loans could be used only to finance investments, working capital, contribute to EU financial support and to redeem loans. The 2nd Pillar is based on the conversion of existing foreign currency (FX) loans of SMEs into forint loans, based also on zero cost funding to banks and capped interest rates at 2.5%. Simultaneously, MNB planned to decrease international reserves by the same amount and to make them available to banks to repay short-term foreign liabilities. As a result, the net FX exposure of Hungary would remain unaffected. The 3rd Pillar has been planned decrease of the outstanding amount of two-week MNB bills by 20% (HUF 900 bn) to reduce Hungary's gross external debt. In the first phase of the FGS, HUF 701 bn were utilised (from HUF 750 bn), out of which 290 bn (1% of GDP) was recorded as new credit and the rest was used to refinance debt (of which HUF 229 bn was FX). Due to the first allocation of the scheme, the share of FX debt among SME-s has declined from 52 to 44% of their loan stock. After the first phase, the FGS was expanded in September to a max. potential size of HUF 2.75tn (~close to 10% of GDP or 2/3 of the 2012 SME loan stock) running till end-2014, out of which HUF500bn became immediately available. As regards the third pillar there was a relatively moderate demand (by end-2013, it exceeded HUF 150 bn or some EUR 0.5 bn) compared to the planned amount.

⁽³⁴⁾ It should be stressed that a ceteris paribus calculation deducting the amount of new loans allocated in the first phase of the FGS underestimates the potential magnitude of net lending without the programme, as some of the loans

targeted towards SMEs contributed to a net increase in lending flows of around 0.8% of GDP in Q3 2013 or around 3½% of the outstanding corporate lending stock granted by domestic banks. Corporate sector demand for long-term loans is also gaining momentum, and in parallel investment has picked up recently, both factors pointing to a turning point in deleveraging.



Source: MNB

disbursed in the scheme would have been granted anyway. However at least it helps to show that the FGS had a huge effect on lending statistics in Q3 2013.

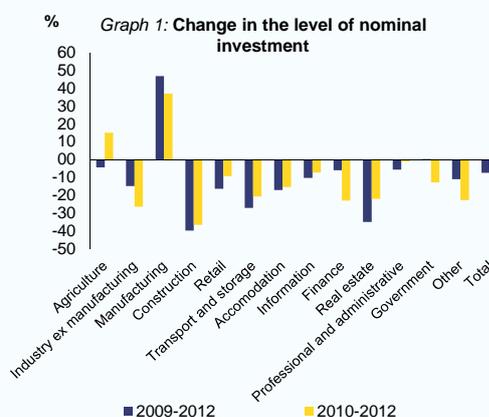
Box 3.3: Which sectors are responsible for the decline in the investment rate?

The investment rate in Hungary has declined from a precrisis level around 22% to 17½% of GDP by 2012. Since 2009, the drop in investment has been observable in all subsectors of the economy but in manufacturing. As discussed before, in this latter case, a turnaround in the investment activity was observable in 2011-2012. This occurred primarily on account of big investment projects in the automobile industry, where the decision was already made several years before the actual investments. ⁽¹⁾ At the same time, the fall in investment has been particularly pronounced in those subsectors, where sizeable extra burdens have been introduced in the last years (e.g. energy or finance with -40% and -23% fall in nominal investments in the 2010-2012 period). ⁽²⁾

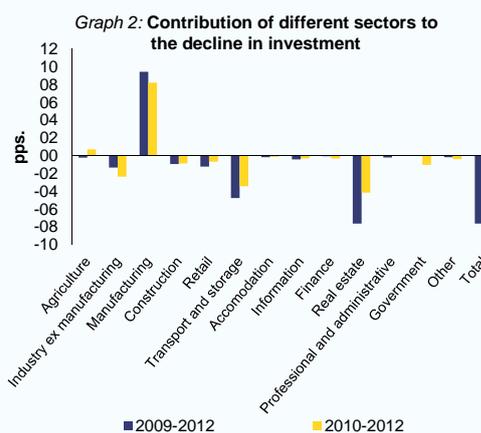
As regards the contributions to the decline in the investment, the biggest negative effect comes from real estate (due to its high share in total investment), which is linked to the collapse in the real estate market of both housing and professional rental services, while manufacturing (also a relatively large sector) had a significant positive effect.

⁽¹⁾ I.e. in the 2008-2010 period.

⁽²⁾ Two comparisons (from 2009 and 2010) are presented on the graphs. The first period refers to the earliest availability of data with a sectoral breakdown, while the second period is useful to see possible changes in investment since the introduction of sectoral taxes.



Source: Commission Services calculations based on KSH data

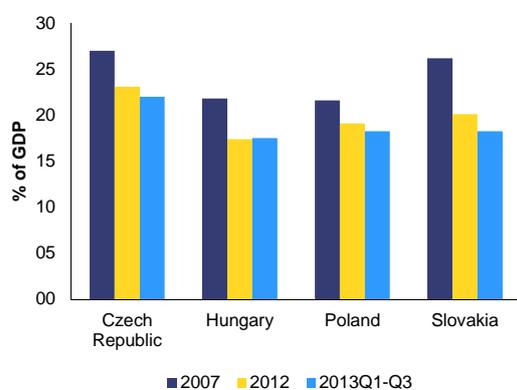


Source: Commission Services calculations based on KSH data

The Q3 2013 data brought a turnaround in the investment activity with the volume of investment increasing by 9.8% in yoy terms. The increase was relatively broad-based, however it seems quite likely that one-off factors like the increasing absorption of EU funds at the end of the 2007-2013 cycle and partly the first allocation in the FGS are responsible for this improvement. As regards EU funds to Hungary, they have increased in 2013 by close to EUR 1¼ bn or 7¾% of the total investment level if compared to the previous year. Therefore they could have substantially contributed to the improved investment figures. As regards the FGS scheme, MNB (2013a) assesses that part of the significant improvements occurred in subsectors, where FGS was allocated in large amounts compared to the existing stock of loans (like agriculture construction or professional services).

However, it is yet too early to conclude that recent improvements can be sustained, as they also reflect the effect of one-off factors. As regards the supply side, although the central bank can temporarily ease supply side conditions with the FGS, persistently better conditions would require an improvement in the operating environment of banks. On the demand side, improved demand for investment would also require better growth prospects and decreased business uncertainty. While the fall in investment has also stopped in the latest quarters, it seems that the figures could have been substantially influenced by the increased inflow of EU funds, and to a smaller extent, the first allocation of the FGS scheme (see Box 3.3). Despite all these caveats, recent data presents Hungary in a slightly better relative position in regional comparison than before, although the relative improvement is also linked to the declining investment rate of other countries in the region.

Graph 3.39: Investment rates in V4 countries

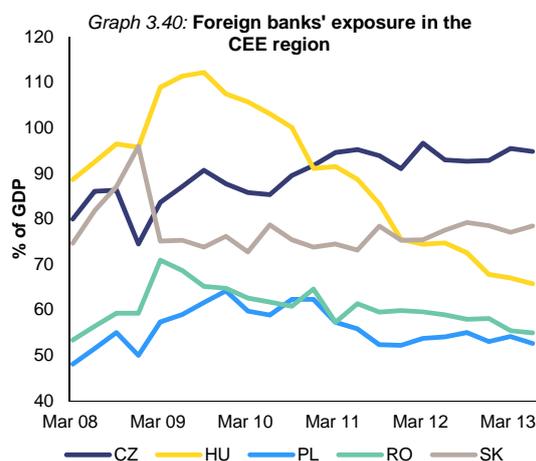


Source: Eurostat

3.2.3. Financial sector

The aggregated balance sheet of the Hungarian commercial banking sector had been shrinking since mid-2010, but the process halted by the end of 2013. This reflects on the one hand the allocation of the FGS, but possibly also the effect of more structural factors: with a loan to deposit ratio around 110% (down from 160% in early 2009) banks could naturally slow down their deleveraging. The halt in the process has been also

reflected in a slowdown in the withdrawal of foreign banks' external funding from the country.



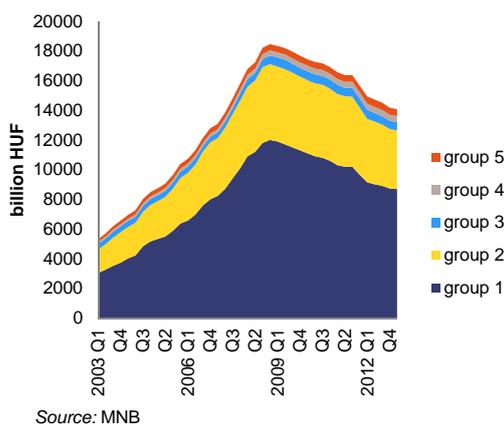
Source: BIS

However, the aggregate picture masks huge differences in the characteristics of individual banks. In this regard, MNB (2013b) identified 5 groups of banks. These are (i) foreign owned large banks, (ii) mainly domestic-owned large and medium-sized banks active in foreign currency lending to households, (iii) smaller banks with less activity in foreign currency lending and moderate overall lending activity prior to the crisis, (iv) larger cooperative credit institutions that have access to interbank funds and also participate in foreign currency lending, (v) other cooperative credit institutions. Despite a decline around 3% since the pre-crisis peak, foreign-owned big banks still have a dominant market share in private sector lending (at 62% in Q1 2013). However they perform worse in terms of profitability in the last years than others and still possess the highest loan-to-deposit ratios (around 140% in Q1 2013). Therefore deleveraging will probably continue for this group. While other actors have partially compensated for the market share loss, given the dominance of foreign owned banks, so far this restructuring has been accompanied with a significant fall in total lending volumes. Although the activity of the savings banks sector⁽³⁵⁾ and

⁽³⁵⁾ In July 2013, a new law was adopted for the cooperative sector. In the new system a unified institutional fund (where the government injected HUF 136 bn (around 0.35% of GDP) from the budget in December 2013) together with the already existing Takarékbank (central bank of the savings bank sector) are the key participants in the sector. Takarékbank does unified liquidity

possibly that of some domestic banks can increase, it is not clear whether it can be enough to offset the shrinking asset side of the foreign-owned commercial banking sector, especially after the expiry of the effects of FGS.

Graph 3.41: The composition of private sector loans based on different banking groups



Despite some improvements in net lending flows the general operating environment of the banking sector has remained particularly problematic due to a combination of high taxes and regulatory burdens and a high share of problematic portfolios. Portfolio quality declined in both the corporate and household segments since the start of the financial crisis. The banking sector's balance sheet is heavily burdened with non-performing credit representing one of the main

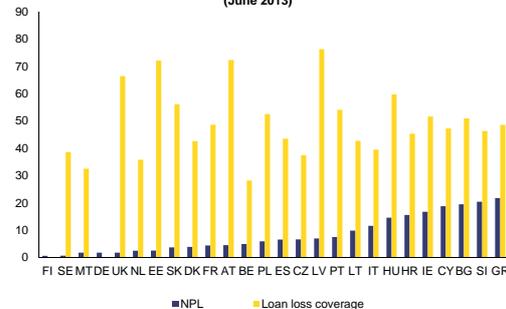
management, and supplies the financial infrastructure of the sector, while the new Institutional Fund will be a supervisory authority and the lender of last resort. Additionally the law allowed the State to gain majority ownership in Takarékbank via the Hungarian Post and the development bank (MFB). This measure has been controversial and criticised by many local stakeholders and several lawsuits are currently in the court process.

Equipped with an adequate level of capital the sector has a sizeable lending potential. While it collects over 10% of deposits of the banking sector it only has 6% of the assets with a loan-to-deposit ratio of around 50%. In terms of future plans it is expected by the management that the sector can double or triple its size. However this strategy is expected to be completed by the end of the decade and not in the very short term, as currently the sector focuses on restructuring and would like to achieve a sustainable expansion.

In January 2014, after just a few months of gaining a majority stake in Takarékbank, the government launched an open, international tender to sell its majority stake in Takarékbank, foreseen to be concluded by end-March 2014.

risks for financial stability in Hungary. One in five corporate loans are classified as delinquent (based on MNB data) and although it has reached a plateau, it is not expected to decrease visibly until 2015. In case of households, the non-performing credit was close to 18% in Q3 2013. However, shorter maturity delinquencies (below 90 days) also stand at 15% of the portfolio. Therefore, overall more than one third of the banking sector's household portfolio presents some problems. Nevertheless, the coverage ratio of NPLs is relatively high in international comparison at close to 60% of the total portfolio, although it is much lower for restructured loans at 20%.

Graph 3.42: NPL and loan loss coverage on total banking sector assets (June 2013)



Any major improvement in terms of portfolio quality would require much faster portfolio cleaning. This is hindered on the one hand by the more generous provisioning rules for restructured loans and on the other hand by the inefficiencies in the resolution procedures. In addition, policy uncertainty and a weak operating environment - contributing to increased uncertainty on potential losses - are also obstacles.

Starting from an already excessive level, extra taxes and regulatory burdens⁽³⁶⁾ on the sector have increased further. These have been imposed on the sector through successive steps in the last years. The magnitude of them stands in the range of 1¼-1½% of GDP on a sector which has a value added of less than 4% of GDP.⁽³⁷⁾ Against the background of high levels of tax burdens and non-performing assets the banking sector has been loss-

⁽³⁶⁾ By extra taxes and regulatory burdens we refer to sectoral taxes and other regulatory burdens that are specific for the financial sector.(see table 3.1.)

⁽³⁷⁾ Based on Havrylchik (2012), bank taxes as a percentage of assets stood the highest level among OECD countries after taking into account the bank levy.

making since Q4 2011. The return on equity (ROE) stood at -2% in Q2 2013, slightly higher than in previous years. As mentioned previously, the average figures mask a severe dispersion between individual banks with the biggest bank generating substantial profits (to a large extent from activities outside Hungary) while mostly foreign-owned banks produce either a small profit or larger losses. The low level of profitability among the latter group is probably not sustainable and there is a risk that some actors may decide to leave the market in the next few years.

Table 3.1:
Extra taxes and regulatory burdens on the financial sector since 2010

Policy measure	Details of the measure	Effect on the financial sector
Bank levy	<p>•0.53% of 2009 assets above HUF 50bn, 0.15% of 2009 assets up to HUF 50 bn. First planned for 2 years and decreased significantly from 2012, to be later kept at the EU average level.</p> <p>•Finally the bank levy is kept as a permanent tax measure with the original parameters (adopted 11/12/2012)</p>	0.5% of GDP from 2010 onwards (reduced to 0.3% of GDP in 2011 and 2012, see below)
Early repayment scheme	Household mortgage debtors were allowed to repay early their FX debt at a non-market exchange rate from cash or HUF loans if applied for the scheme in the period from 29/09/2012 up to 29/02/2012. Banks were allowed to decrease the bank levy by 30% of the losses from the scheme.	0.9% of GDP in 2011
Financial transaction duty	Introduced from 2013 (latest version adopted on 26/06/2013 and effective from August), 0.3% on bank transactions with a ceiling of HUF 6000 (and to 0.6% without a ceiling in case of cash withdrawal). For the last four months of 2013, one-off payments were levied (adopted on 26/06/2013 and totalling to 0.25% of GDP), to compensate for lower than expected revenues in the first half of 2013 from this duty.	0.75% of GDP in 2013 and 0.7% of GDP in 2014 (duties paid by the Treasury and the State Debt Management Agency are not included)
Two free cash withdrawals	Banks are obliged to service 2 free cash withdrawals per month up to a maximum of up to 150000 HUF since 1 February 2014	up to 0.1% of GDP from 2014

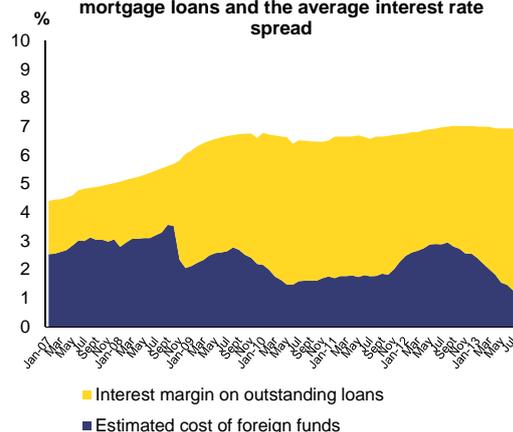
Source: Commission services

The government justified the introduction of extra taxes and regulatory burdens as an endeavour to address the problem of insufficient competition due to market power in the sector. Indeed, there seem to be competitiveness problems particularly in the retail segment⁽³⁸⁾ as banks were able to increase their interest margin well above the change in funding costs. However, it is doubtful whether the policy

⁽³⁸⁾ See also Havrylchuk (2012).

steps taken so far solves the issue of monopoly pricing, while decreasing banks' market power without restoring a normal taxation environment for them could endanger financial stability.

Graph 3.43: Cost of CHF foreign funding of mortgage loans and the average interest rate spread



Source: MNB

Extra taxes and regulatory burdens on banks triggered a negative feedback loop for the economy. Banks have been trying to pass through their increasing tax burdens to their customers by increasing the high level of interest rate margins on existing FX loans and raising fees for financial intermediation. These steps have triggered new government measures, i.e. most recently the introduction of two free cash withdrawals per month.

With high burdens on the sector, banks welcomed the introduction of the FGS, which contains an implicit capital transfer. The attempt of the central bank to ease financing constraints in the SME segment should be acknowledged and the programme also helped to decrease the share of FX loans in the SME segment (from 52% to 44%).

However, it cannot be considered a substitute for a better operating environment for banks, which would be essential to revive lending in a sustainable manner, and can also entail non-negligible risks if applied on an extended scale.⁽³⁹⁾ The FGS has a potential total size of HUF 2750 bn, which is close to 10% of GDP.

⁽³⁹⁾ Estimates whether the programme can be successful on a larger scale varied markedly among experts. The median expectation is that around HUF 800-900 bn could be allocated in the second stage from the total envelope of HUF 2000 bn.

Subsidized lending of this size can entail significant risks. The potential costs are related to the zero cost refinancing of the central bank (which triggers *ceteris paribus* losses at the MNB) and there are risks of possibly unsustainable competition due to a fixed interest rate margin at 2.5%. As regards the latter, it is questionable whether this margin is high enough in an emerging country like Hungary (with a financing cost of the sovereign at 6%) to potentially cover around two-thirds of the 2012 SME loan stock. The application of this very low margin on a large scale can trigger potential fiscal costs (if it potentially leads to imprudent lending partly covered by state guarantees) or can have spillover effects to lending rates of the non-SME segment.⁽⁴⁰⁾

Based on the MNB's calculation the banking sector would manage to remain liquid and solvent under a stress scenario due to an initial high level of liquidity and capital and an adequate level of loan loss coverage, but also due to foreign banks' commitment to their subsidiaries. Regular stress tests led by the central bank require a global capital adequacy ratio of 8% under the stress scenario. The latest stress tests indicate capital needs at two banks in the range of HUF 116 bn (0.4% of GDP) under the stress scenario. Given that foreign owners recapitalised their subsidiaries several times (altogether by around 3½% of GDP since the start of the crisis) this risk seems to be manageable. In terms of liquidity, the sector remains above the regulatory requirement of 10% 30-day liquidity to total assets even in the stress scenario. However, as there is a major shortfall of FX liquidity, the smooth functioning of swap markets (supported by the MNB), especially in the stressed case, remains paramount to the proper functioning of the banking sector.

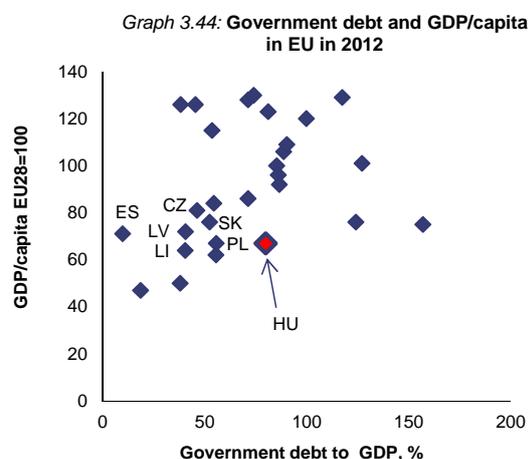
There have been important regulatory changes in the supervisory environment. The Hungarian Financial Supervisory Authority (HFSA) was integrated into the central bank structure on 1 October, which can lead to positive synergies. This is especially so as the MNB has been equipped with the right to use macroprudential tools and has

⁽⁴⁰⁾ As banks receive an implicit capital transfer under FGS (due to the zero cost financing), while lending rates are artificially low for SME-s it cannot be excluded that banks try to lower rates below prudent levels in the non-SME segment so as to avoid losing their clients.

become the dedicated authority responsible for macroprudential oversight. As one of the major reasons behind the widespread increase in FX lending was the inefficient macroprudential set-up this seems to be a step in the right direction.^{(41) (42)}

3.3. THE HIGH AND STAGNATING LEVEL OF GOVERNMENT DEBT REMAINS A KEY SOURCE OF CONCERN

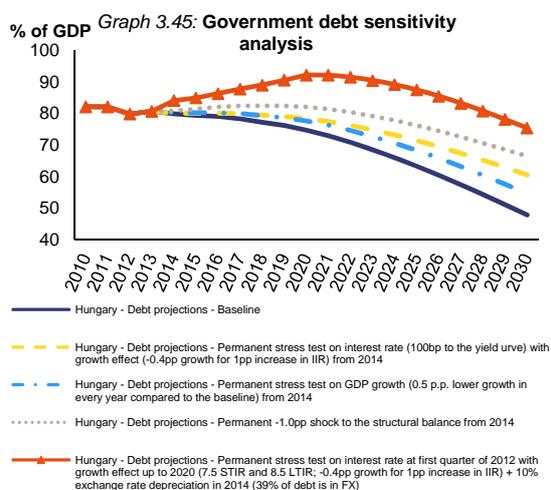
While standing below the EU average, Hungary's government debt is still well above the level of regional peers and hence remains an important imbalance. The debt level is high compared to the country's economic development and taxing capacity. This problem is also reflected in the fact that the interest expenditure on government debt is the upper edge of EU countries (at 4% of GDP as opposed to the EU average of 3% of GDP). Also, the short-term rollover need at 20% of GDP should be considered as relatively high. As close to two-thirds of the debt stock is held by foreign investors, this remains an important source of fragility.



⁽⁴¹⁾ See e.g. MNB (2013a).

⁽⁴²⁾ While generally being supportive of a unified macro- and microprudential authority, the ECB expressed some concerns about the way the new integrated supervisory framework was implemented. The critical opinion was driven by the insufficient time allowed to the ECB to examine the draft legislative provisions and by the lack of time for the transfer of supervisory tasks for the HFSA. The ECB also raised its concerns about the central bank's independence after its merger with the HFSA.

Debt is projected to only decrease very slowly to below 70% of GDP by 2023 in the baseline scenario, however this path is very sensitive to assumptions on the interest rate, growth and exchange rate. ⁽⁴³⁾ Under unfavourable scenarios, the debt can start to increase again. A more robust debt reduction strategy would require a higher growth potential, which would have favourable spillover effects also on financing costs.



⁽⁴³⁾ The baseline scenario takes as point of departure the Commission's Autumn 2013 forecast. The long-term budgetary projections released with the 2012 Ageing Report have been incorporated in the simulations, including the long-term fiscal impact of the pension reforms. Available figures on debt maturity structure (Bloomberg) and share of short and long-term debt (Eurostat) have been used.

4. SPECIFIC TOPICS

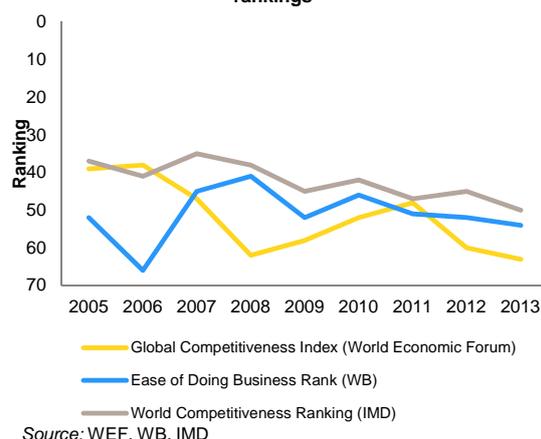
4.1. THE BUSINESS ENVIRONMENT: AN ANALYSIS BASED ON INTERNATIONAL COMPETITIVENESS INDICATORS

As highlighted in 2013 IDR and in section 2, Hungary suffers from a low GDP growth potential, mostly linked to a very low TFP contribution and reduced availability of capital. Recent developments and shortcomings in the Hungarian business environment shed some light on how this is happening, as evidenced in international business environment indicators. ⁽⁴⁴⁾

International competitiveness indicators point to a deterioration in the Hungarian business environment during the last decade. Although international indicators diverge in terms of the exact time when Hungary relative position has started worsening, all of them identify the peak in Hungarian competitiveness before or at the outset of the international financial crisis and point to deterioration since then. In the period under examination, ⁽⁴⁵⁾ this is particularly clear for the Global Competitiveness Index (GCI) and World

Competitiveness Scoreboard that have recorded their worst ranking for Hungary in their latest publications, while according to the World Bank Doing Business Report (DBR) the bottom was reached in 2006. ⁽⁴⁶⁾

Graph 4.1: The Hungarian business environment according to main international rankings



Hungary has lost its frontrunner position among Visegrád (V4) countries in terms of international competitiveness. Moreover, while Hungary was the best among the V4 until 2004 according to the Global Competitiveness Report (GCR) and the World Competitiveness Yearbook (WCY), both studies classified it as the least competitive economy in 2009. However, since then the situation has improved again and Hungary has gained some ground on the Czech and Slovak Republics. ⁽⁴⁷⁾

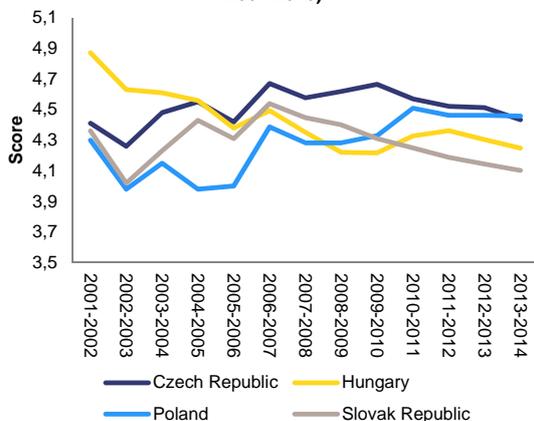
⁽⁴⁴⁾ Several International Organisations and think tanks have long been assessing the degree of competitiveness of world's economies. The most cited ones being probably the World Bank's Doing Business Report (DBR) and the World Economic Forum's Global Competitiveness Report (GCR). One practical difference among the two researches is that the DBR does not provide a cumulative score of a certain country's competitiveness, nor it does that for the 10 sub-set of indicators contributing to the overall score, but only provides the ranking which is heavily affected by the overall number of assessed countries (i.e. DBR covered only 155 countries in 2006, it has 189 this year). This is why the use of rankings has been kept to the minimum and wherever possible absolute scores and updated consolidated data published by the International Organisations have been used instead. On top of these two researches, the IMD World Competitiveness Yearbook (WCY) is also considered among reliable sources of country competitiveness analysis. Given that it would be questionable to single out one research method as the best one, a comparative analysis of all studies is warranted in this IDR. In addition, results from the survey of the German-Hungarian Chamber of Industry and Commerce are also presented, as German companies are the biggest foreign investors in Hungary. Finally, OECD product market regulation (PMR) indicators for 2013 have been used in this paper. (See OECD (2013). The reported PMR indicators for Poland are based on preliminary estimates as some of the underlying data has not been validated with national authorities. Subsequent data validation may lead to revisions to the indicators for the country.

⁽⁴⁵⁾ This paper is based on GCR from 2001-2002 to 2013-2014; Doing Business Reports from DBR2006 to DBR 2014; and WCY from 2003 to 2012.

⁽⁴⁶⁾ Then Hungary was ranked 66th in the world, while it reached its best performance in DBR 2009, when it ranked 41st.

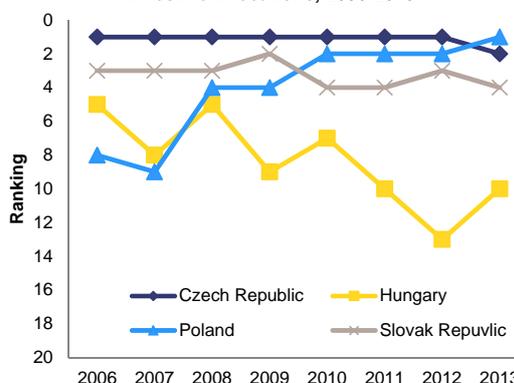
⁽⁴⁷⁾ Since the GCR 2009-2010, the Global Competitiveness Index for both the Czech and the Slovak Republics have decreased by about 5%, while the Hungarian one has slightly improved. The same trend has been observable in the WCY: the Czech and the Slovak Republics have lost in terms of competitiveness from the 2009 edition, while Hungary has improved.

Graph 4.2: Global Competitiveness Index (WEF, 2001-2013)



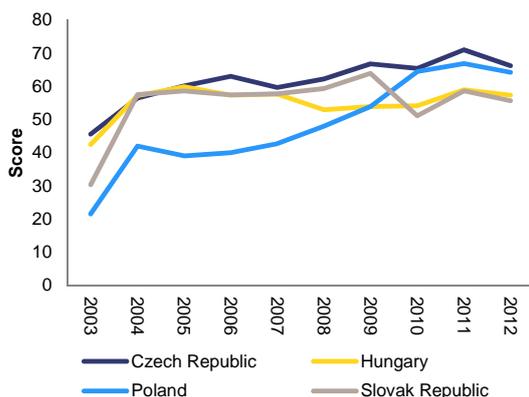
Source: WEF, GCR

Graph 4.4: Attractiveness of V4 countries as investment locations, 2006-2013



Source: German-Hungarian Chamber of Industry and Commerce, annual business surveys

Graph 4.3: World Competitiveness of Economies

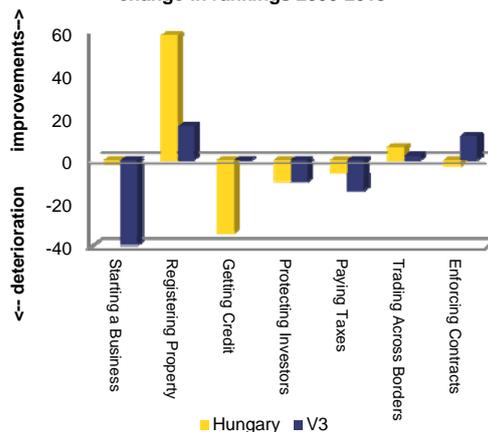


Source: IMD, WCY

The deterioration in Hungary's relative position is particularly pronounced according to the surveys of the German-Hungarian Chamber of Industry and Commerce (DUIHK). The country has become the least attractive among the V4 countries, given that the other three Visegrád countries (V3) have broadly kept or improved their positions over recent years. As a result, in 2013 Hungary is only the 10th country in terms of preferred investment location among the listed 20 CEE countries, while the other V3 countries occupy the first places. This helps explain why Hungary has now the lowest investment rate among V4 countries (see Graph 3.39).

According to the DBR, the area which has weakened the most in comparative terms is *Getting Credit*, while Hungary remains the worst performer in regional terms in *Investors' Protection and Paying Taxes*. Whilst Hungary used to rank second in *Getting Credit* in 2006 after the Slovak Republic, it is now the fourth one among V4 countries. In the meantime, there was a further deterioration in the Hungarian rankings for *Investors' Protection and Paying Taxes*,⁽⁴⁸⁾ so it remained the least performing among Visegrád countries for these indicators.

Graph 4.5: World Bank Doing Business - change in rankings 2006-2013

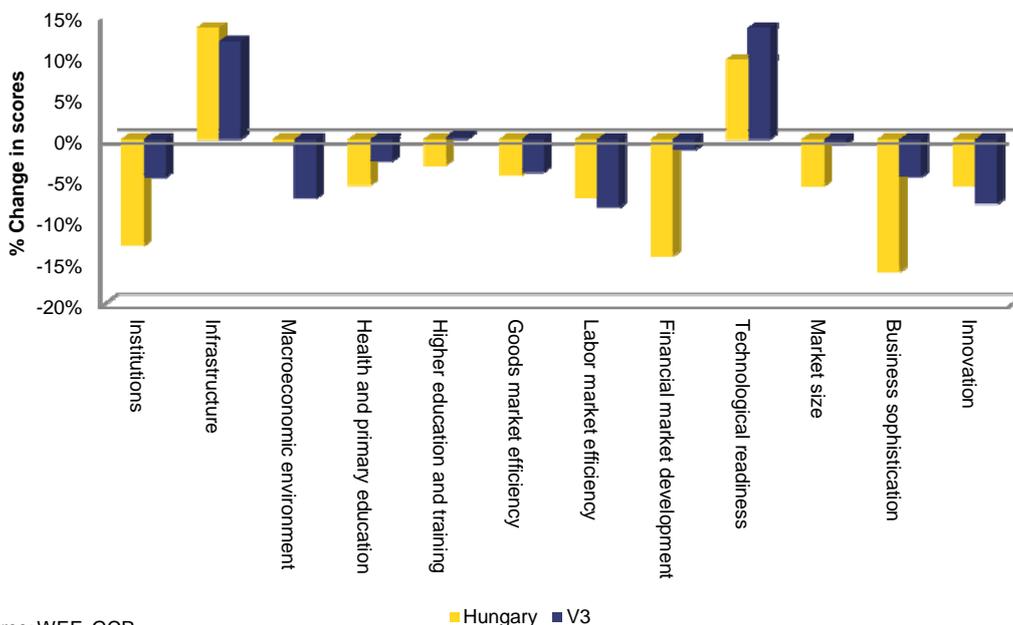


Source: WB, DBR

According to the GCR, the deterioration of Hungary's relative position has happened because since 2006 most competitiveness sub-

⁽⁴⁸⁾ From 118th in 2006 to 128th and from 118th to 124th respectively.

Graph 4.6: Global Competitiveness Reports (2006-2013) 12 Pillars of Competitiveness



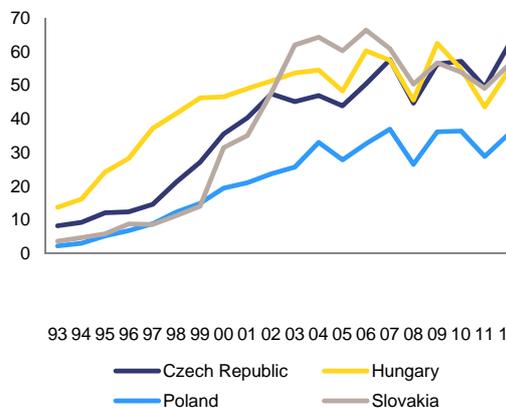
Source: WEF, GCR

indicators have deteriorated. In fact, 10 out of the so called 12 "pillars of competitiveness" have worsened whilst only the *Infrastructure* and the *Technological Readiness* ones have improved. Although a similar trend was recorded also for the other V3 countries, the Hungarian deterioration has been quicker, in particular in the areas of *Financial Market*, which is now considered as the least efficient and trustworthy in the region, *Institutional Environment*, and *Business Sophistication*.

A deteriorating competitiveness could also explain the fact that since the early 2000s, Hungary has been unable to attract substantial additional FDI flows as opposed to the other V3 countries.⁽⁴⁹⁾

⁽⁴⁹⁾ We use net FDI stock data in the analysis so as to avoid that capital in transit distorts the underlying picture. Nevertheless this method also has its own weakness as "true" FDI outflows could also speed up after a certain level of integration into the world economy. See also section 3.1.1.2.

Graph 4.7: Net FDI stocks as % of GDP

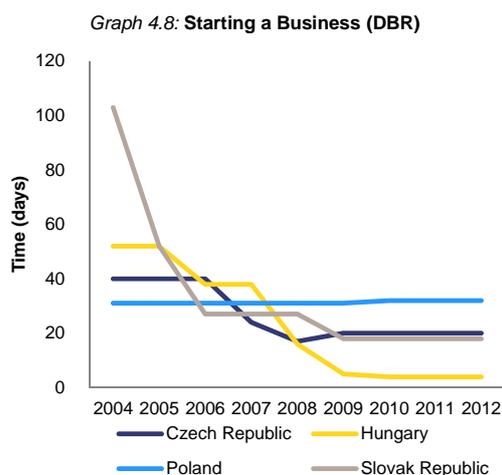


Source: Commission Services calculation based on UNCTAD data

4.1.1. What are Hungary's main strengths?

According to the DBR overall ranking, before the crisis the Hungarian economy had a good starting position, also thanks to a number of reforms in business regulation that had made Hungary an attractive investment target. These reform steps were successful in making easier: i) *Registering Properties*, ii) *Dealing with Construction Permits*, and iii) *Starting a*

Business.⁽⁵⁰⁾ Despite the deterioration observed since the crisis, Hungary still has a number of strengths. For example, reforms introduced in *Starting a Business* still make it the quickest among V4 and the second cheapest to start a business in, while Hungary is still the 15th easiest country worldwide to *Enforce Contracts* in.



Source: WB, Doing Business

More recently, the implementation of the *Magyary* and *Simple State* programmes⁽⁵¹⁾ has reduced the complexity of regulatory processes. The effects of the programmes are already reflected in the 2013 OECD Product Market Regulation (PMR) overall indicator, which has improved compared to 2008.⁽⁵²⁾ However, the same study shows that despite the improvements brought about by these reform efforts in terms of simplification of regulatory procedures and of

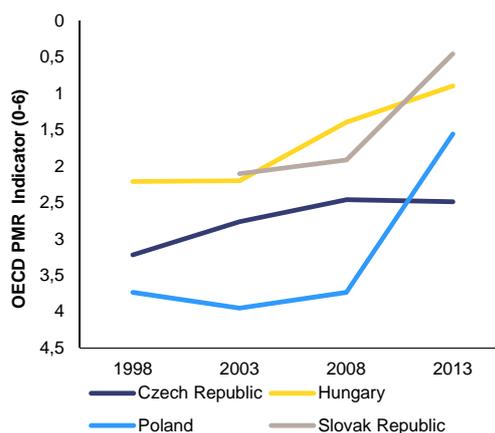
⁽⁵⁰⁾ Specifically: the time to register a property decreased from 78 to 17 days and the relevant ranking in DBR improved from 103rd in 2007 to 57th in 2009; the cost to obtain a building permit went down to just 10.3% of annual income per capita, making Hungary the 6th cheapest in the world in relative terms at that time; and the capital to start a business was cut by about 80% making Hungary the 27th easiest country to start a business in, up from the 87th position it occupied in 2007. The paid-in minimum capital requirement (i.e. the amount that an entrepreneur needs to deposit before registration and/or up to 3 months following incorporation) is recorded by the DBR as a percentage of the economy's income per capita. In Hungary, the paid-in minimum capital was reduced to just 10.8% in 2009, down from 65.1% of income per capita one year before.

⁽⁵¹⁾ See Box 4.1.

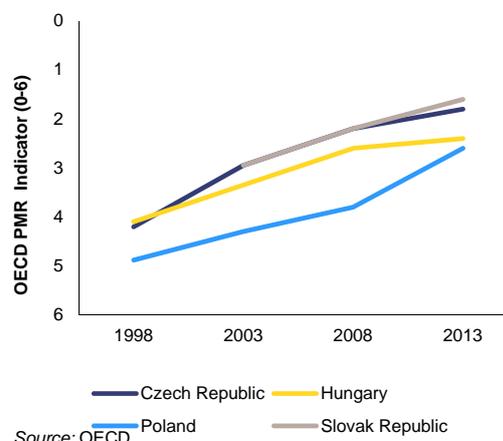
⁽⁵²⁾ The overall Product Market Regulation indicator for Hungary has improved from 1.40 to 1.31. A progress of a similar magnitude was achieved in the Czech Republic (from 1.50 to 1.39), while in the Slovak Republic the improvement was even better (from 1.57 to 1.31).

reduction of the administrative burden for corporations, the latter remains heavy in regional comparison.

Graph 4.9a: Complexity of regulatory procedures



Graph 4.9b: Administrative burdens for corporations



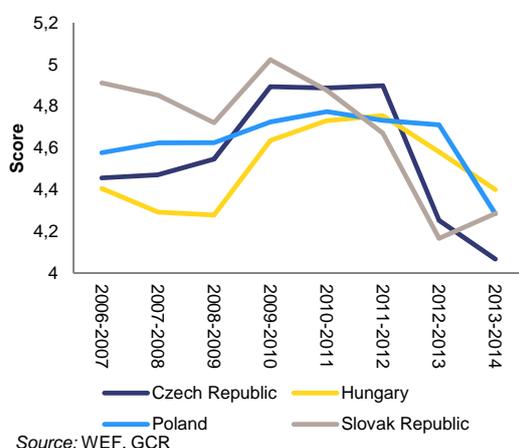
Source: OECD

Hungarian infrastructures are assessed as the second best in the region and broadband penetration is well above the regional average. Namely, the quality of Hungarian roads is now considered the best one in the region (according to both the GCR and the DUHIK respondents),⁽⁵³⁾ while the number of fixed broadband internet subscriptions per capita has grown more than threefold in the last six years. This explains why the *Technological Readiness* indicator in GCR has increased well above the regional average.

⁽⁵³⁾ See: World Economic Forum (2013) and German-Hungarian Chamber of Industry and Commerce (2013)

In addition, the new labour code introduced in 2011 is starting to deliver in terms of increased flexibility. Namely, hiring and firing practices have been made easier and now Hungary is ranked as the most flexible labour market in the region according to GCR, while it was the least one as early as 2010. In spite of this, the perception of *Labour Flexibility* in GCR has started decreasing again since the 2011 report, mainly on account of reduced cooperation between workers and their employers and of a reported diminished flexibility in wage determination.

Graph 4.10: Labour Flexibility



4.1.2. What is behind the observed downward trend?

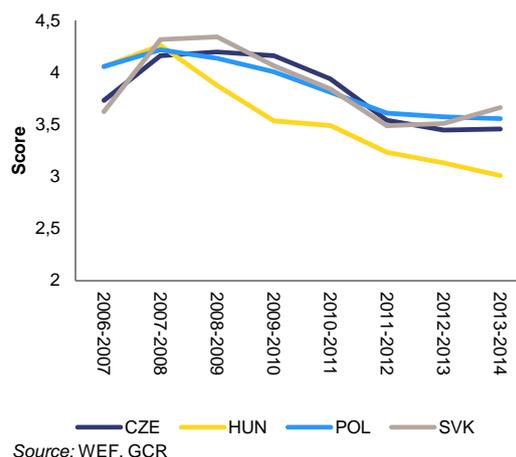
Financial intermediation

The DBR and GCR indicators complement each other in explaining why the Hungarian financial market is perceived as not functioning well and the reasons behind a prolonged credit shortage in the economy. The Hungarian ranking in *Getting Credit* under the DBR is modest mainly due to the absence of a public registry covering borrowers and despite the introduction in 2012 of the first credit bureau law mandating the creation of a database with positive credit information on individuals. This is confirmed by the Commission's report on European SMEs, which shows that in the area of access to finance, there has been deterioration since 2008 and that the Hungarian financial market still performs worse than the EU average one. ⁽⁵⁴⁾ Also, The GCR pillar

⁽⁵⁴⁾ European Commission (2013c).

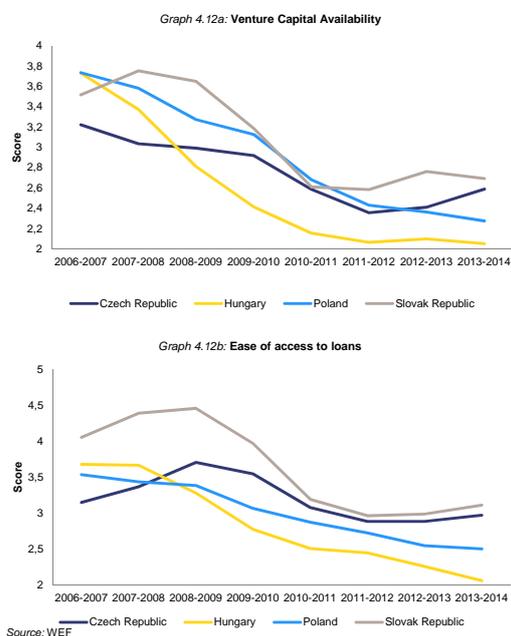
of *Financial Market Development* has steadily deteriorated since 2006 due to a limited *Availability of Venture Capital, Financing through Equity Markets, and Financial Services and Loans.*

Graph 4.11: Financial Market Efficiency



In addition to the unavoidable deleveraging of households and corporates, the observed financial disintermediation could be partially explained by a problematic operating environment for the financial sector (see section 3.2.3). In fact, the severe deterioration in the Hungarian financial market has continued, and sometimes even accelerated, in the last three years. *Venture Capital Availability* was severely affected by the international financial crisis and Hungary, which used to be the best regional performer in the GCR, is now the least successful. ⁽⁵⁵⁾ Problems in financial intermediation are also confirmed by reported difficulties to *Access Loans* for companies, which the National Bank of Hungary is now trying to curb through the Funding for Growth Scheme, whose impact on business confidence indicators will only be observable as from next year's GCR.

⁽⁵⁵⁾ However, there are some contradictions according to different sources of statistics. Based on European Commission (2013c), access to venture capital improved substantially in 2011 over the previous year, having swung from being considerably below the EU average to slightly above. This was mainly on account of specific allocations for venture capital made available under the EU financed JEREMIE programme as from December 2010.



Investors protection and Institutions

Policy unpredictability and high taxes are also reflected in a low degree of investors' protection. On the one hand, the GCR makes evident the very negative effect of the Hungarian tax system: only 13 tax systems among the countries covered provide fewer incentives to invest. Besides, "policy instability" was the second most cited obstacle to doing business in their latest report. ⁽⁵⁶⁾ On the other hand, DBR confirms that Hungary has still one of the weakest frameworks to *Protect Investors*, ⁽⁵⁷⁾ as no single reform has been introduced in this area in the period under examination, and given that company management is not obliged to disclose transactions affected by conflicts of interest to minority stakeholders yet.

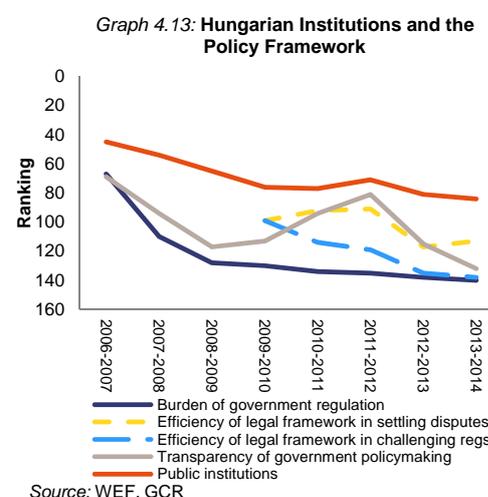
An analysis of the causes behind the marked deterioration in the Institutional set up indicator in the GCR ⁽⁵⁸⁾ shows that the loss in competitiveness has taken place mainly until 2009-2010 and that it was to a large extent driven by the deterioration in the policy-environment-related indicators (see Graph 4.13). As a

⁽⁵⁶⁾ 15.9% of respondents have indicated it, preceded only by "access to finance", which was cited by 16.3% of surveyed business executives.

⁽⁵⁷⁾ Hungary is now ranked 128th out of 189 countries in the DBR.

⁽⁵⁸⁾ It moved from the 45th position worldwide in 2006 to the 84th in 2013.

consequence, in the GCR Hungary currently ranks in the lowest quartile among EU Member States in terms of: *Burden of Government Regulation* (25th in the EU), *Efficiency of Legal Framework In Challenging Regulations* (27th) and *Transparency of Policy Making* (27th). The latter has particularly weakened in the last two years, showing that the lack of consultations of stakeholders on new policy measures by the government may have had already an effect on the perception of business executives.



This is confirmed by respondents to the DUIHK survey ⁽⁵⁹⁾, who mention *Legal Stability* as well as the *Predictability of Economic Policy* as primary weaknesses in the economic framework. These weaknesses and their recent aggravation are probably linked also to a series of policy measures that have been introduced in the last years (increasing number of extra taxes on some sectors and increasing entry costs and barriers in certain service sector segments, see Box 4.1).

Further analysis of GCR *Institutions* indicators confirms an unfavourable picture of government transparency as well. Many respondents highlighted the *Lack of Trust in Politicians* (Hungary ranks 129th out of 148 countries) and in the government, hinting that there is *Favouritism in Decision of Government's Officials* (116th), *Wastefulness of Government Spending* (110th) and *Diversion of Public Funds* (110th). It should be highlighted that most of the

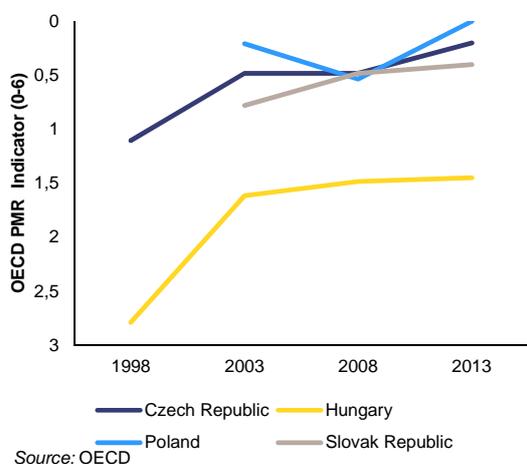
⁽⁵⁹⁾ German-Hungarian Chamber of Industry and Commerce (2013)

deterioration in this respect took place until 2009, while since then the indicators have remained broadly stable.

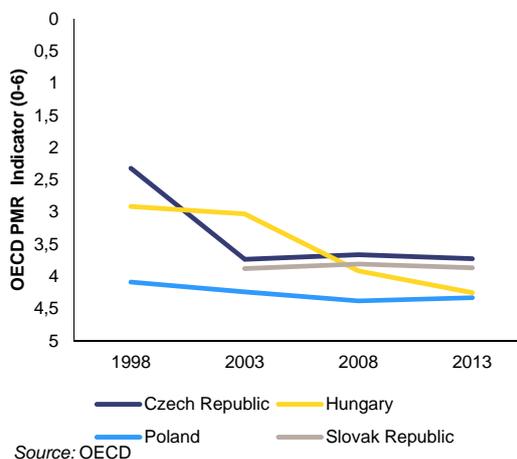
Barriers to competition

Restrictions to entry in certain service sectors have reduced the number of suppliers, excluded new entrants and reduced competition. As shown by PMR indicators, *Barriers in the Service Sector* have substantially increased in the last ten years, contrary to what has happened in the other V3 countries, and *Legal Barriers to Entry* have become by far the highest in the region. In this respect, recent government policies played a decisive role for the current state of play, as the introduction of: the Plaza Stop Law, regulations in the district heating, waste management, meal vouchers, tobacco retail and pharmaceutical retail sectors (see Box 4.1) have reduced the number of economic actors present in the market.

Graph 4.14: Legal barriers to entry



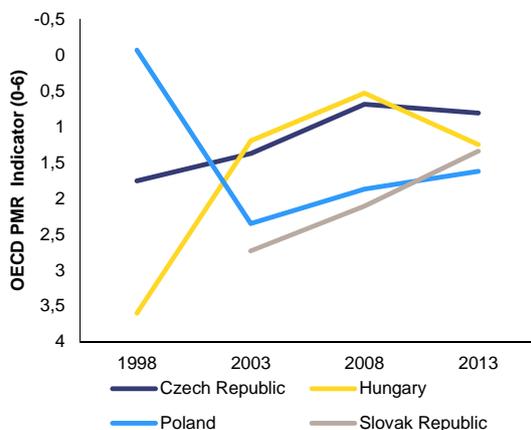
Graph 4.15: Barriers in the Service Sector



Price Controls also represent a drag on competition. As reflected in the PMR indicators, substantial efforts in the reduction of regulated prices are visible only until 2008. Then the trend has reversed in Hungary and, to a smaller extent, in the Czech Republic. This could be linked to the existence of regulated energy (electricity and gas) prices for universal services and to the utility price cuts that have been decided by the government since 2013 (see Box 4.1).

As a first consequence, in recent years investment in those sectors has substantially decreased (see Box 3.3). If this tendency is continued over time it could weaken network infrastructures, with negative spill-over effects on all other sectors. In fact, these policies do not only distort resource allocation across sectors, but also increase running costs for all companies, given that network industries are instrumental in the production chain of all companies.

Graph 4.16: Price Controls



Source: OECD

Taxation

In spite of the substantial reform efforts made on taxation, the overall country assessment has slightly deteriorated and remained the worst performing among other V3 countries (see Graph 4.18). Recent reforms included a reduction in the corporate income tax rate and the introduction of simplified forms of tax payments for small and micro enterprises which, between 2006 and 2013, have substantially reduced the total tax rate for companies and hours needed to pay taxes, as reported by DBR. ⁽⁶⁰⁾

Reverse developments have curbed the potential of those earlier reforms; hence Hungary is still the 3rd most difficult country to Pay Taxes in the EU according to DBR. ⁽⁶¹⁾ In particular, the government has adopted a number of sector-specific taxes (e.g. in the telecom, financial and energy sectors) and increased the health insurance contribution. The DUIHK acknowledges the complexity of the domestic taxation system as one of the main constraints to doing business as well ⁽⁶²⁾.

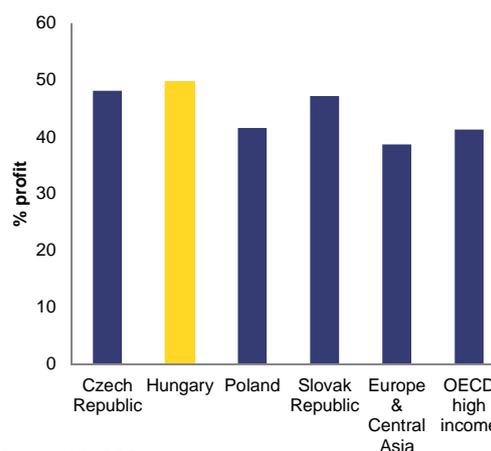
⁽⁶⁰⁾ The total tax rate was cut by 7 percentage points, while hours needed to pay taxes were reduced by nearly 20%. See <http://www.doingbusiness.org/data>.

⁽⁶¹⁾ Italy and Romania being worse. Under the category *Paying Taxes* Doing Business brings together: the amount of taxes and mandatory contributions that a medium-size company must pay in a given year and the administrative burden of paying taxes and contributions (i.e. number of payments required and time needed).

⁽⁶²⁾ German-Hungarian Chamber of Industry and Commerce (2013)

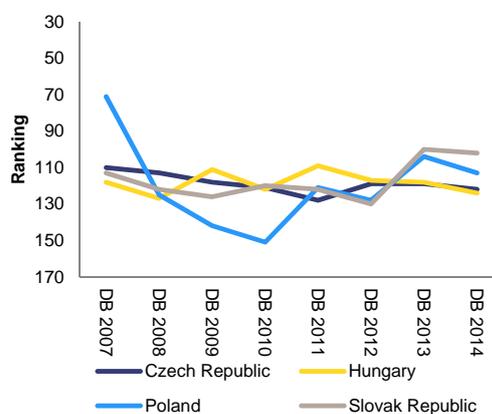
Moreover, Hungary is well above the OECD and regional averages in terms of Total Company Tax Rate as computed in DBR. ⁽⁶³⁾ This happens despite a very low profit tax and mainly on account of high rates for labour taxes and social security contributions.

Graph 4.17: Total tax rate



Source: WB, DBR

Graph 4.18: Paying Taxes in the Visegrad Countries



Source: WB, DBR

⁽⁶³⁾ The Total Tax Rate in Doing Business reports measures the amount of taxes and mandatory contributions borne by the business in the second year of operation, expressed as a share of commercial profit. It includes the profit or corporate income tax, social contributions and labour taxes paid by the employer, property taxes, property transfer taxes, dividend tax, capital gains tax, financial transactions tax, waste collection taxes, vehicle and road taxes, and any other small taxes or fees. DBR 2014 reports the total tax rate for calendar year 2012.

Business sophistication and innovation

Finally, *Business Sophistication* has also deteriorated markedly. The latter is clearly the area where the situation has deteriorated the most in absolute terms, as Hungary has fallen 60 places back in the relevant ranking between the GCR 2006-2007 and the latest release. This occurred mainly on account of a severe deterioration in terms of integration of local companies into the international value added chain and cluster development. The Hungarian value chain breadth⁽⁶⁴⁾ was deemed to be good by most respondents (GCR ranking was 27th worldwide in 2007 and 32nd in 2008) and actually Hungary was the second best among V4 countries in this respect. Since then, the country has experienced a severe deterioration in both indicators⁽⁶⁵⁾ which has not taken place in the other V3 countries, showing that such a development cannot be attributed to the international crisis alone. As regards cluster development, until 2008 Hungary was the 6th best performing countries worldwide, while recently it fell back to 111th in the GCR.⁽⁶⁶⁾

This means that spill-over effects from large manufacturing companies operating in Hungary are limited (see also section 3.1.2) and that the situation is not improving over time. Despite the initiation of tailor-made activities, such as the supplier programme coordinated by the Hungarian Investment and Trade Agency, Hungarian companies cannot properly integrate within the international value chain yet. This has severe consequences, as close integration with large multinationals is particularly important, as most Research and Development (R&D) worldwide happens at the frontier. In fact, domestically driven innovation is very limited in Hungary, as the number of companies doing R&D is about half the EU average while those producing patents is about a third of it.⁽⁶⁷⁾

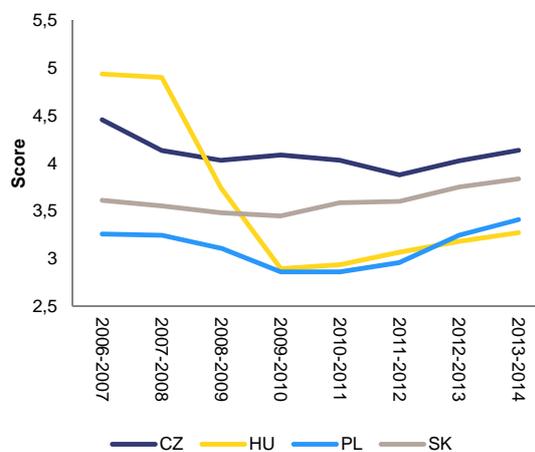
⁽⁶⁴⁾ Assessed by the question: "In your country, do companies have a narrow or broad presence in the value chain?"

⁽⁶⁵⁾ Losing 105 and 74 ranking positions from their respective peaks.

⁽⁶⁶⁾ Assessed by replies to the following question: "In your country, how widespread are well-developed and deep clusters (geographic concentrations of firms, suppliers, producers of related products and services, and specialized institutions in a particular field)?"

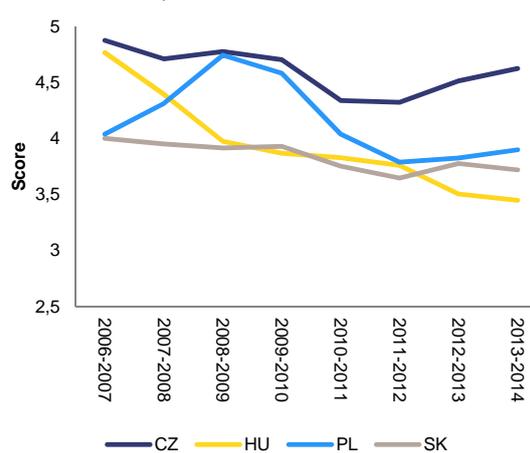
⁽⁶⁷⁾ European Commission (2013d).

Graph 4.19: State of cluster development



Source: WEF, GCR

Graph 4.20: Value chain breadth



Source: WEF, GCR

Box 4.1: Recent policy steps affecting the business environment

Contradictory policy steps have been taken in recent years by the government; on one hand, the Széll Kálmán reform programme has helped reducing the administrative burden on businesses, but on the other hand a number of steps with a deteriorating effect on the Hungarian business environment have been adopted.

On a positive note, in the framework of the Széll Kálmán reform programme, there had been a number of business-friendly steps. These include, notably, the increased flexibility in labour regulation and significant reduction in the administrative burden. Regarding the latter, the government recently announced its estimation that an overall reduction of 25% in red tape (or savings by HUF 210 bn) was achieved since 2009. The implemented measures focused mainly on simplifying tax and accounting procedures as well as easing the burden on application for EU funds and other budget support schemes.

However, since mid-2010 there have a number of measures with potential detrimental impacts on the business environment. First and foremost, as discussed in the 2013 IDR, the role of sectoral taxes was enlarged to a significant degree with revenues from these that have increased from 0.5% to 2.5% of GDP between 2009 and 2013.¹

In 2012, the Parliament limited the powers of the National Competition Authority (NCA) to impose sanctions for competition law infringements in case of agricultural products. Now, if NCA finds an infringement in this field, it must suspend sanctions and give parties a deadline to correct their behaviour. Such an arrangement provides incentives to operators to try anti-competitive behaviours, since they do not risk until they are proven to be behaving illegally.

In 2013, two energy prices cuts were introduced, with a total size of 20%, to all universal services (households, public bodies, hospitals, etc.). On the contrary, unit energy costs in manufacturing have

increased during the last decade (as opposed to the regional peers) on the backdrop of increasing real energy prices and small improvements in energy intensity. Even before the price cuts were introduced, the average ratio of industrial to household prices for gas was the highest in the EU, and for electricity, among the highest ones⁽²⁾. These point to a cross-subsidisation from industries to households which could indicate that retail companies recuperate their losses from selling gas and electricity under regulated prices on the account of industries. Recent regulated price cuts could have strengthened further this tendency.

In addition, legislative changes approved in recent years have substantially revamped certain market segments by restricting the number of players in the service sector, often without proper consultation or compensation of the affected stakeholders. These changes seem to go against the spirit of the single market. Some notable examples are summarised below:

- In the retail sector the so-called "Plaza Stop Law" constrains the building of new commercial premises above 300 m² until the end of 2014. More recently, the government repealed and redistributed licenses for selling tobacco to dedicated "tobacco stores" under very restrictive conditions and with non-transparent authorisation procedures.
- In 2010, amendments were introduced to the Pharmacy law to: i) mandatory raise over 25% by 2014 (and over 50% by 2017) the shares held in each pharmacy by pharmacists; ii) limit to 4 the number of pharmacies per each shareholder. These amendments may cause the end of pharmacy chains in Hungary. Non-pharmacist investors are obliged to sell their shares in a very weak bargaining position.
- In 2010, Hungary amended its legislation on the issuance of vouchers granted to employees for meals, leisure & holidays, creating a monopoly for a public foundation responsible for issuing cold meal vouchers, and significantly

¹ In 2010, the government introduced a set of "crisis taxes" for the telecom, energy and retail sectors which were phased out by 2013, but new surcharges were introduced meanwhile in the public utilities sectors and reinstated on the telecom and energy ones. Moreover, the crisis tax on banks (the bank levy) has become permanent (contrary to an earlier agreement with the banking sector to halve it in 2013 and to further reduce it to the level of the European average in 2014). In 2013, a financial transaction duty was introduced on all cash and bank transfer transactions at a rate of 0.2% (0.3% in case of cash withdrawals), but tax rates were raised to 0.3% and 0.6% as from August 2013.

⁽²⁾ See Energy Economic Development in Europe, DG ECFIN, January 2014.

(Continued on the next page)

Box (continued)

strengthening the conditions for issuing hot meal vouchers. This limits competition through a reduction of possible substitute products and also through a reduction in the number of competitors. Many foreign-owned issuers have already been squeezed out of the market. The Commission has decided to refer this case to the Court of Justice of the European Union.

- In 2011, in a very short timeline the organization of waste management has been allocated to the state and the collection and recycling of households' wastes given to companies majority-owned by the state or its communities.

5. POLICY CHALLENGES

The analysis found several specific aspects contributing to macroeconomic imbalances in Hungary: a highly negative NIIP and a high level of private and public debt in the context of a fragile financial sector and weakening export performance. The incidence of several of these factors has diminished in the last years but important vulnerabilities remain. Decreasing them would require decisive policy action.

The NIIP has been improving, and sustainability calculations suggest that this tendency will prevail; nevertheless it will remain a key source of concern due to the current still highly negative level and high level of short term rollover needs. The degree of fragility also depends on to what extent the external position will be financed from FDI or debt flows. Due to the high short-term external rollover needs the country still has to rely to a large extent on foreign investors' confidence. Therefore a business-friendly environment would be needed.

While there are some signs that deleveraging is about to be completed in the private sector, important fragilities persist. These are primarily linked to the high share of insolvent debtors and the high monthly repayment burden among households, as well as a depressed housing market and the high level of business uncertainty. A turning point in deleveraging is also not yet justified from the credit supply point of view. While lending conditions were eased slightly in the last quarters, on account of the central bank's Funding for Growth Scheme (FGS), non-subsidized net lending flows have remained negative for the fifth consecutive year. The high ratio of non-performing loans (NPLs) and the high tax and regulatory burdens on the banking sector do not provide banks with the right incentives to increase their lending activities.

A high level of government debt remains a key source of fragility, as it is forecast to decline only at a very slow pace. Despite one-off capital transfers, which contributed to reducing debt by around 7% of GDP, and a substantial improvement in the structural balance, government debt has been broadly stable since 2009, around 80% of GDP, reflecting a weakened exchange rate, low economic growth and high financing costs. Also, the high short-term rollover needs, the interest rate

burden, as well as a high share of foreign investors in the government bond market are important sources of vulnerabilities.

Behind the imbalances mentioned above, there is the general problem of the low growth potential of Hungary. As in countries with high debt levels, the financing costs and the growth outlook tend to be strongly negatively correlated, an improved potential growth outlook would help decrease imbalances also through indirect channels. The low growth potential of recent years has been partly the consequence of debt overhang and deleveraging, but economic growth has also been hindered by the deterioration in the business environment, due to excessive taxation of selected sectors and increasing entry costs in certain service sector segments.

These fragilities were broadly identified and discussed in the first and second editions of the IDR and relevant policy responses were reflected and integrated in the country-specific recommendations addressed to Hungary in July 2013. The assessment of progress in the implementation of these recommendations will take place in the context of the assessment of the National Reform Programme and Stability Programme under the European Semester. Against this background, this section also discusses different policy avenues that could be envisaged to address the above-mentioned challenges.

Export competitiveness

The export performance could be enhanced by further FDI inflows into export-oriented industries, which would require a more predictable policy environment. Although Hungary is already highly integrated into the world economy in terms of the FDI stock, this reflects a rapid pace of integration until the early 2000s, while the FDI stock to GDP in manufacturing has broadly stagnated in the last decade. The lack of new FDI investments in manufacturing has contributed to the fact that the country was unable to upgrade its product quality and to increase productivity on a sufficient scale. At the same time, the recent increase in FDI in the automobile sector does not seem sufficient in itself to boost competitiveness substantially as the improvement in the export sector is not broad-based enough.

Broadening the value chain is also essential to promote exports. This seems to be particularly challenging for catching-up economies, where there is a substantial gap in terms of productivity between foreign and domestic companies. The problem is also reflected in the relatively low value added content of exports. Increasing the value added content would require a higher level of economic spillovers from multinationals to domestic companies, but also more genuine innovation in the country. This could require increased support to research and development, enhanced cooperation between business and universities, as well as better financing conditions for SMEs.

Private sector indebtedness

The negative feedback loop between households, banks and the housing market could possibly be tackled by a comprehensive package, based on a final debt relief programme targeted to insolvent borrowers, while mitigating the risk of moral hazard and limiting the additional tax burden on banks. The targeted nature of the programme would ensure that only unavoidable costs are borne by the financial sector and the government. This can be accompanied by a clear commitment to refrain from adopting further measures in order to minimize the risk of moral hazard. At the same time, given the high NPL ratio also in the non-subsidized HUF loans segment, a possible programme would also have to target this share of indebted households, and not only FX debtors. The programme would help to improve the banking sector's portfolio, which ultimately would contribute to improving lending conditions. However, costs from a new scheme cannot be imposed on banks without a corresponding reduction in their tax burden.

Additional targeted measures to stabilise the housing market might also be considered. Supporting energy efficient building and renovation of the amortised housing stock could also contribute to a revival of the housing market. However, instead of general subsidies for lending, the programmes could be targeted to those who are financially constrained.

Improving capital accumulation possibilities as well as incentives to portfolio cleaning are

essential to ease credit supply side conditions. Recent measures targeted towards the SME sector, most notably the FGS, aim to revive corporate lending. Although subsidized schemes can be useful to tackle negative externalities (e.g. the prohibitively high risk aversion of banks towards the SME sector) they cannot be a substitute for a normal operating environment for the banking sector. A large share of subsidized lending could also lead to potentially high fiscal costs and distort price signals. In order to improve banks' operating environment, the current tax level on the sector could be lowered, while legal obstacles and impediments to portfolio cleaning could be investigated and properly tackled.

Public sector indebtedness

A marked decline in government debt could result from a more growth-friendly fiscal consolidation strategy. Although the structural balance improved substantially compared to pre-crisis levels, the composition of the adjustment was repeatedly skewed towards the revenue side. Despite recent cuts in labour taxes, the fiscal consolidation episodes between mid-2006 and 2008 and from 2010 have been characterised by a reliance on tax increases, in the latter case consisting of to a large extent an increase in various corporate surcharges with detrimental effects on growth. Overall, Hungary's general government expenditure (hovering around 50% of GDP) in relative terms is considerably higher than in the other Visegrád countries, which implies that the public sector must claim a large share of resources to maintain a sound fiscal stance, in compliance with EU rules. In addition, also in view of the relatively sizeable assets of the Hungarian government, some parts of this portfolio could be considered to be sold in order to support sovereign funding needs and accelerate debt reduction.

Potential growth

Improving the growth potential of Hungary would require improving the operating environment for the financial sector and a more stable regulatory framework in general. A more predictable policy environment could be facilitated by compulsory stakeholder consultation before any major policy initiative, as well as an enhanced role of the competition authority in the assessment of

legislative changes. The corporate tax system could be simplified and entry costs in service sector segments could be decreased. Finally, labour market reforms and a more sustainable energy price system could also boost competitiveness.

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