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Macroeconomic imbalances - Hungary



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Macroeconomic imbalances – Hungary

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EXECUTIVE SUMMARY AND CONCLUSIONS

This in-depth review takes a broad view of the Hungarian economy in order to identify actual or potential imbalances and the possible macroeconomic risks which they may entail. Following the rapid increase in both public and private debt a primarily crisis-induced adjustment is taking place since late 2008 to correct the accumulated stock imbalances. However, the associated external exposure is expected to remain outstandingly large and a factor of fragility in the foreseeable future. The main observations from this review are:

- **Hungary's economy built up sizeable external and internal imbalances in the years leading up to 2009 and it now faces a continued adjustment challenge.** The high public debt stock and high negative Net International Investment Position (NIIP) are primarily the result of the continuous twin deficits (budget and current account) recorded in the years before the global economic and financial crisis (fiscal adjustment was initiated in mid-2006, but from a very high deficit level). Notwithstanding some improvements in the trade and transfer balances since 2004, these were not sufficient to counterbalance the widening factor income deficit that had reached around 7% of GDP over the period in question and was a result of the strong and sustained FDI inflows, especially during the 1990s. Hungary's relative cost competitiveness deteriorated in particular vis-à-vis regional peers as nominal ULC has increased by close to 55% between 2000 and 2010.
- **With the deep crisis, a sharp adjustment has taken place with the country's net external balances, but important vulnerabilities remain.** Starting from late 2008, the current account rebounded into a surplus as domestic demand collapsed and corrective steps were taken also in the context of a EUR 20 bn EU-IMF financial assistance programme (expired in late 2010). It was also supported by the significant improvement in cost competitiveness through the depreciation of the forint and a decline in real wages, amounting to some 20% decrease in the REER compared to the pre-crisis period. The projections contained in the Commission services' 2012 Spring Forecast point to a further steep reduction in the (negative) NIIP to well below 90% of GDP by the end of 2013 (compared to -112.5% of GDP in 2010). Public debt sustainability calculations prepared by the Commission services on the basis of the usual no-policy change assumption and of broadly stable and then declining interest rates show that a firm decreasing path for public debt is attainable in the coming decade, but continued tension in the financial markets could relatively easily reverse this trend. The resolute decrease in public indebtedness is all the more important as the accumulated level of both external and internal stock imbalances is still substantial and requires further adjustment as rolling over such a high gross debt stock always implies increased vulnerabilities. The associated risks, and in particular the possibility of refinancing difficulties with government debt in the context of looming sovereign downgrades has prompted the national authorities to seek precautionary financial assistance from the EU and the IMF.
- **At the same time, Hungary's medium-term growth outlook is modest at best, partly as a consequence of policy uncertainty.** The potential growth is currently estimated to be very low: in the range of 0.2-0.4% for the 2011-2013 period, which is considerably lower than what is expected for neighbouring countries, and real GDP growth may trend to around 1.5% on the medium-term forecast horizon. The persisting concerns over the country's long-term potential growth are to a large extent due to labour market weaknesses, which are also reflected by the stubbornly low employment rate (currently around 56.5% in the 15-64 age group). Additionally, potential growth is likely to have suffered from the fact that gross fixed capital formation has declined for 12 out of the most recent 14 quarters while the investment ratio is the lowest since 1997. These bottlenecks to growth are also linked to the significant decrease in FDI inflows starting from 2009, which are to a considerable extent explained by the dramatic fall in the ratio of reinvested profits in 2009 and 2010. The low level of economic confidence is explained first by the crisis but more recently by significant (and often controversial) changes in the policy environment and in the legal and institutional system. This is also shown by various surveys, which consistently rank Hungary far behind its regional peers in terms of business environment.
- **The high stock of private debt stands out among catching-up economies.** The private debt-to-GDP ratio, at 155%, was just below the indicative threshold in 2010 (according to financial accounts data over 60% is denominated in foreign currency). Despite the recent rapid deleveraging, accentuated further at the end of 2011 by the early repayment scheme of foreign

currency (FX) denominated mortgages, its currency composition is still a source of concern, which in turn contributes to the important strains on Hungary's strongly interconnected banking sector. The recently experienced high CDS sovereign spreads and long-term bond yields has a host of negative implications for economic prospects and contributed to the increasingly high financing costs of the real sector.

In this context, **the in-depth review concludes that Hungary is experiencing serious macroeconomic imbalances, which are not excessive but need to be addressed.** In particular, certain macroeconomic developments such as the highly negative size of the net international investment position and public debt deserve very close attention so as to reduce the important risks of adverse effects on the functioning of the economy.

The policy response could usefully include creating the conditions for sustained macroeconomic growth as well as a gradual but sustained deleveraging of both private and public agents. This should also make the country less vulnerable to changes in market sentiment and restore its attractiveness for foreign direct investment. Policy initiatives could therefore target the creation of a predictable policy environment and well-functioning institutional system, which should be conducive to the sustained reduction in stock vulnerabilities. In addition, structural reforms in both labour and product markets are worth pursuing in order to lift the country's potential growth.

1. INTRODUCTION

On 14 February 2012, the European Commission presented its first 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” 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 and what type of policy follow-up it will recommend to the Council.

The AMR scoreboard showed that Hungary exceeded the indicative threshold in the case of two out of ten indicators in 2010. Specifically, the public debt ratio and the net international investment position (NIIP) stood at 81.3% of GDP and -112.5% of GDP, respectively, as a result of continuous twin deficits recorded in the years before the crisis. The AMR recalled that in the context of the crisis *"a sharp adjustment has taken place as domestic demand collapsed but the NIIP deficit remains large even if a substantial part is financed by FDI...The accumulation of external financial exposure in the private sector has taken place in a context of high and increasing public debt levels also financed in foreign currency."* In line with the conclusion of the AMR, Hungary is subject to an in-depth review.

Against this background, Section 2 of this review looks more in detail into these developments covering both the external and internal dimensions, followed by specific focus sections on the current account developments and outlook as well as on the sustainability of the country's debt position in Section 3. Section 4 presents possible policy considerations.

2. MACROECONOMIC SITUATION AND POTENTIAL IMBALANCES

Since Hungary had built up over many years a rather high external financial exposure and debt stock its economy was already fragile when the global economic and financial crisis erupted in 2008 and was hit harder than other countries. Potential output had started to decelerate some years earlier while the external financial exposure was rapidly growing, also as a reflection of high current account deficits. The vulnerabilities were aggravated by the fact that compared to regional peers, both private and public debt were outstandingly high. In this context, economic activity declined by around 6¾% in 2009, chiefly on the account of a sudden collapse in external demand and industrial production. Moreover, credit conditions tightened significantly, as banks struggled to deleverage in the context of a sell-off of government securities by non-residents and sharp exchange rate depreciation. The much weaker forint magnified the vulnerabilities posed by the high stock of foreign currency denominated mortgage debt held by households and limited the manoeuvring room of the monetary policy. Given the lack of fiscal space and investors' concerns, the Government had to continue to implement its fiscal consolidation policy.

The economic recovery from recession proved to be moderate. In 2010 and 2011, GDP grew by around 1.5% on average and growth was driven exclusively by the external balance, with the export sector performing well and domestic demand remaining firmly in negative territory, although its pace of contraction slowed. Looking further, the Commission services' 2012 Spring Forecast projects GDP to contract by 0.3% in 2012, and to resume growing at a moderate rate of 1% in 2013. The lacklustre outlook is chiefly explained by the fact that there is no recovery in sight for domestic demand over the forecast horizon. Real disposable income is expected to fall in 2012 and investment is projected to continue to decrease, the latter being also due to biting credit supply constraints. After rising sharply from below 8% (pre-crisis level) to around 12% at the beginning of 2010, unemployment is currently hovering around 11% and expected to fall again below 10% only in the second half of 2013. In a longer-term perspective, low potential growth is currently expected to present a risk of protracted real economic convergence to the European average.

2.1. SUSTAINABILITY OF EXTERNAL IMBALANCES

Hungary's external imbalances are stemming from the accumulation of external financial exposure both by the public and private sector until the eruption of the global crisis. Hungary's negative NIIP steadily grew over the pre-crisis period, reflecting chiefly developments in the current account balance, with the country registering cumulative current account deficits of 75% of GDP over the ten years between 1999 and 2008. Hungary's NIIP, which already exceeded by far the -35% of GDP scoreboard threshold in the early years of the 2000s (hovering around -70% of GDP), further deteriorated until its peak in 2009 and set a negative European record of -118% of GDP (the increase in the ratio in 2009 was exclusively due to valuation changes and negative growth in nominal GDP). Since 2005, the negative NIIP of Hungary has constantly been the most significant in the EU¹.

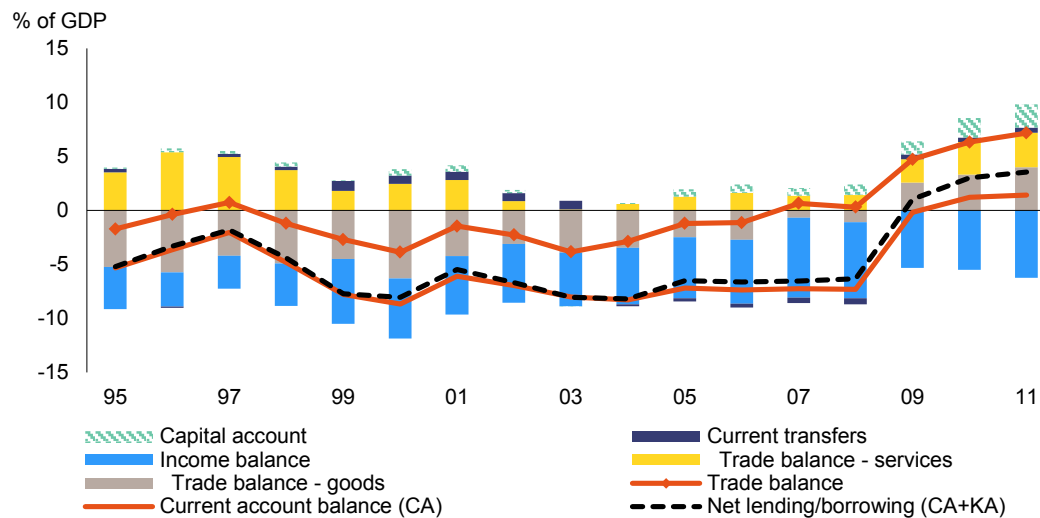
Gradual improvements in the trade balance from 2004 could not stop the steady increase in the negative NIIP. During the early years of 2000s, substantial increases in social transfers and public wages spurred domestic demand and hence imports, sending the trade deficit to its all-time low of close to 4% of GDP in 2003. The trade balance has continuously improved since then (see Graph 1), and the services sub-balance has recorded (in some years quite significant) surpluses throughout the entire period despite the fact that the country repeatedly had one of the highest trade deficits of energy products (hovering in the range of -4 and -6% of GDP over the second half of the last decade).

Financial flows from the EU contributed to mitigating the current account deficit as well as to improving the net external financing capacity. Current EU transfers (chiefly direct agricultural payments) improved the current account, by over 1% of GDP in recent years, while structural funds flows (registered in the capital account) followed a constant increase after EU entry in 2004 to around 2% of GDP in 2010. These trends progressively contributed to the increase in the net lending of the country (and before 2009, the smoother financing of the current account deficit).

¹ For an assessment on the sustainability of Hungary's large current account deficits in this period, see Oblath, G. (2006).

Despite these moderating developments in the trade and transfer balances, the current account deficit exceeded 7% of GDP between 2004 and 2008 on the account of a widening factor income deficit. In parallel with the improvements in the trade and transfer balances, the factor income balance deficit was steadily growing, peaking at close to 7.5% of GDP in 2007. The increasing amount of public and private foreign debt-related interest expenditure strongly contributed to the expanding factor income deficit. Overall, the current account deficits were substantial in many years (averaging 7.5% of GDP in the 2000-2008 period), since the gradual improvements in the trade and transfer balance could not counterbalance the structurally high factor income deficit.

Graph 1: Components of the current account balance (BOP definition)

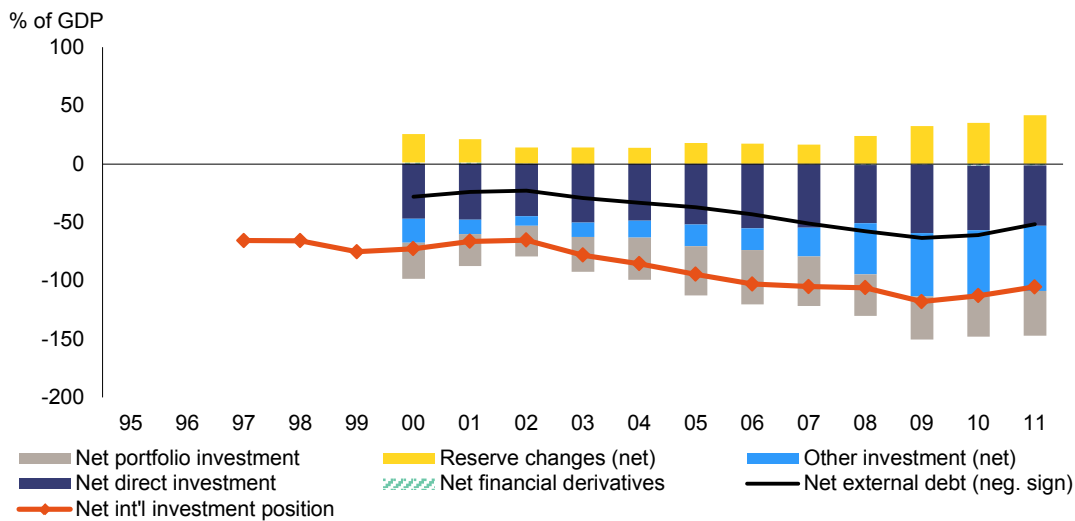


Source: Commission services

In the context of a sharp real GDP contraction of 6.7% in 2009, the current account balance turned positive from that year onwards, reaching a surplus of over 1% of GDP in 2010. This turnaround was chiefly driven by a relatively resilient export performance throughout the crisis, while domestic demand contracted sharply, compressing imports. The current account surplus is estimated to have stabilised in 2011 at the level observed in the previous year, at +1.4% of GDP, and projected in the Commission services' 2012 Spring Forecast to reach around 2% of GDP in 2012 and close to 4% of GDP in 2013. This is notably due to the fact that (i) net exports should be further boosted by car industry investments; and (ii) EU current transfers are on a rising trend. These improvements will only be partly counterbalanced by the projected increase in the factor income deficit as dividend-type income should return to their pre-crisis level as the economy recovers. Given that EU structural fund inflows should further increase the surplus in the capital account (from around 2% of GDP in 2011 to over 3% of GDP in 2013), the net external lending could reach around 7% of GDP in 2013 (for a more detailed discussion on the outlook for the external balances, see subchapter 3.1.4.).

Despite its ongoing adjustment, the negative NIIP position is expected to remain outstandingly large and a factor of fragility in the foreseeable future. The continuously high current account deficits resulted in a very high negative NIIP, peaking at around -118% of GDP in 2009 and thereafter decreasing to around -105% by the end of 2011 (see Graph 2). It is worth distinguishing between liabilities that require payments of principal and/or interest by the home country at some point in the future and non-debt-generating type of external liabilities. Without the net stock of foreign direct investment, Hungary's net external debt level was around 60% of GDP in 2010 (for a detailed discussion on the respective roles of debt-creating and non-debt-creating financial flows in the Hungarian balance of payment, see subchapter 3.1.3.).

Graph 2: Components of NIIP (BOP definition)



Source: Commission services

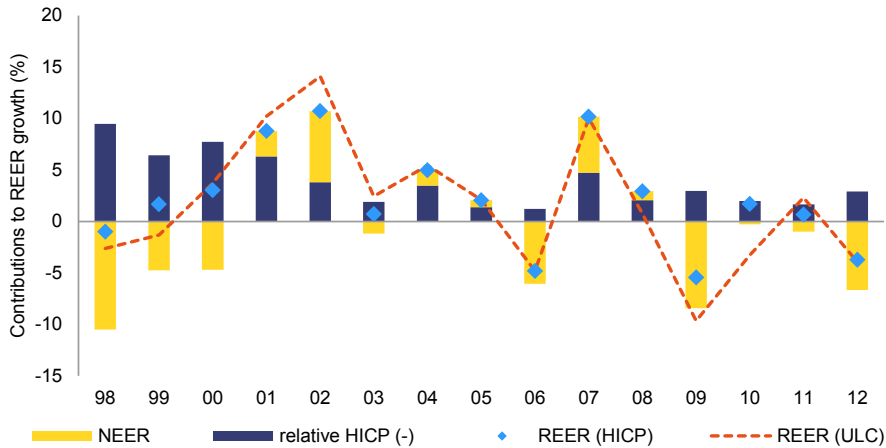
On the financing side, following strong FDI inflows (the FDI stock amounted to 69% of GDP in 2010), there was a marked decline of inward direct investment in the context of the crisis. In the years after 2004, annual FDI inflows were significant (up to 6-7% of GDP) and on average the ratio of FDI inflows to GDP was above the EU27 average, suggesting that the country was at the time relatively attractive to foreign investors². But more recently the inflows have been significantly lower, amounting to around 1.5% of GDP in 2009 and 2010, and picking up somewhat to close to 3% of GDP in 2011. However, as FDI outflows were in the same order of magnitude, the total stock of net direct investment was stagnating over these years.

Although the scoreboard indicator on nominal unit labour costs (ULC) is not above the benchmark for 2010 (+3.9), it was quite high for most of the last decade. Nominal ULC rose especially strongly in the early years of the 2000s with y-o-y growth hovering around +10% between 2000 and 2002, motivated also by the spill-over from generous public wage increase to the private sector wage. Indeed, Hungary's relative cost competitiveness has been deteriorating, as nominal ULC has increased by close to 55% between 2000 and 2010, compared to an average of 20% for the euro area and even to the increases registered for regional peers (Czech Republic, Slovakia and Poland, all below +35%). This development was particularly strong in the traditionally non-tradable market services sectors (annual average ULC increase of 5.4 %), where in the above period Hungary experienced the seventh highest increase in ULC among 26 Member States with data available.

The increases in nominal ULC have aggravated the deterioration of the cost competitiveness position of Hungary, as reflected in the increase of the real effective exchange rate (REER). This trend was also more pronounced at the beginning of the last decade (see Graph 3), depicting similar paths both for HICP-based and ULC-based REERs). In 2009 and 2010, the crisis brought about a sharp adjustment in the ULC-based REER due to the nominal depreciation of the forint (in 2009) as well as the successive declines in real compensation per employee (close to -5% in each year in question). In 2010, cost competitiveness as measured by the improved further as real work income declined yet again by 5%. Indeed, based on updated estimates using DG ECFIN's fundamental exchange rate equilibrium method, the Hungarian REER in 2011 appears to be somewhat undervalued (by roughly 3.5-5.5%). On the other hand, the strong hike in the minimum wage by 19% in January 2012 is a risk to competitiveness, in particular if it has spill-over effects to the whole wage structure. It will, *ceteris paribus*, also increase inflationary pressures.

² See e.g. Allard, C. (2009).

Graph 3: Changes in the Real Effective Exchange Rates and Components

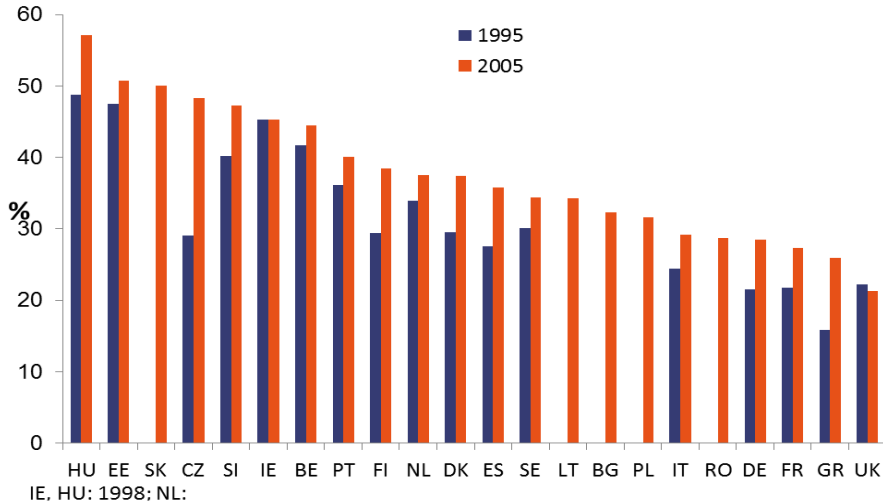


Source: Commission services

Note: The REER is calculated as a deflated weighted average of the bilateral exchange rates with a group of 36 industrial countries (IC36).

Despite the erosion in cost competitiveness described above, Hungary's export performance proved to be resilient. The country continuously gained market shares up until 2008, and the registered y-o-y declines in 2009 and 2010 were less pronounced than for the majority of the EU MSs (the related scoreboard indicator – measuring 5 year periods – remained positive during the crisis). However, compared to its regional peers, the overall 1.4 percentage change growth of Hungarian export market shares in the five years up to 2010 seems very low (CZ: 12.3%, LV: 14%, LT: 13.9%, PL: 20.1%, SK: 32.6%). Furthermore, the import content of Hungarian exports was very high in EU comparison – see Graph 4 below. This seems to indicate that compared to other countries Hungarian exports contain relatively little domestic value added.

Graph 4: Import content of exports in 1995 and in 2005



Source: Commission services

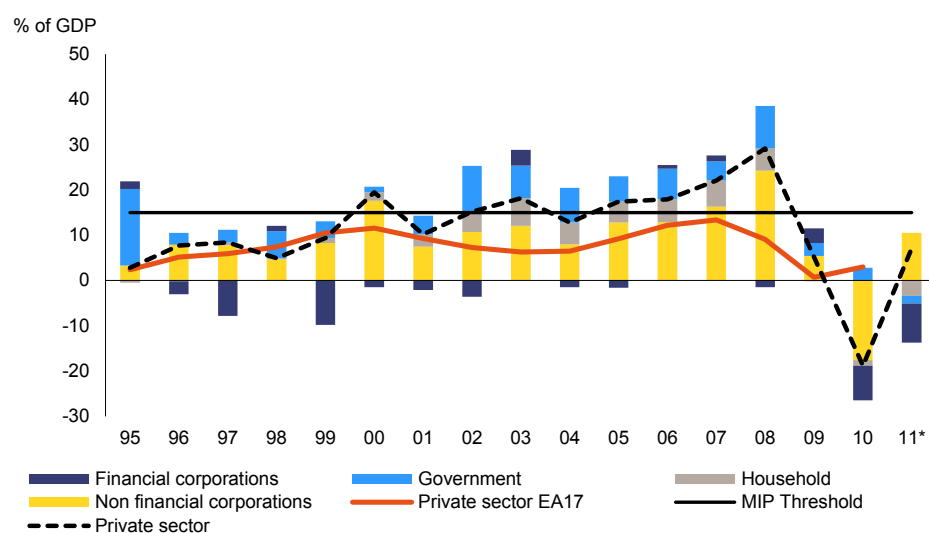
2.2. SUSTAINABILITY OF INTERNAL IMBALANCES

The stock of private sector debt, at 155% of GDP, was just below the indicative threshold in 2010 and stands out among catching-up economies. Private sector debt almost tripled from 2000 to 2009 (when it culminated at 170% of GDP), before it declined markedly in 2010 in the context of strong deleveraging. The increase in households' debt was kicked off at early years of the last decade by the easing of liquidity constraints in the context of a rapid development of the Hungarian financial sector. In this period, the operation of a number of universal housing subsidy schemes also contributed to the substantial pick-up in mortgage lending (at the time, it was overwhelmingly denominated in forint).

It is not only the total stock of private debt, but also its composition that is a source of concern, specifically the build-up of households' almost fully un-hedged foreign currency liabilities. The stock of households' mortgage loans increased from its end-2004 level of close to 9% of GDP to over 22% of GDP by end-2008, also as reflection of increasingly loosened lending standards. Over the same period, the FX share in these loans increased from less than 10% to over 75% (overwhelmingly in Swiss franc), which exposes households to a large extent to foreign exchange rate fluctuations. There has practically been no new FX lending to households since mid-2009, chiefly due to the introduction of very strict regulatory regimes, and forint-denominated lending remained subdued. Still, the ensuing vulnerabilities were amply illustrated in recurring episodes over recent years when the Hungarian financial markets came under stress. Most notably, over the summer of 2011, when the Swiss franc reached all-time highs versus the euro, the HUF depreciated against the CHF by ca. 30% compared with the yearly average in 2010, with a corresponding increase in the monthly mortgage instalments. By early 2012, also linked to the establishment of an exchange rate floor for the CHF against the euro by the SNB, the HUF/CHF parity reverted back to around 240, still representing a large loss for debtors, who took out the loans at an average rate of 160 CHF/HUF.

Primarily due to the sharp contraction in credit to non-financial corporations, the net private sector credit flow has become sharply negative (posting a -18.7 percent drop in 2010). The increasing pressure on the European banking sector coupled with domestic policy uncertainty in Hungary and weak loan demand has led most banks to deleverage their balance sheets (the retail loan-to-deposit ratio was 131% at end-2011 down from 170% in 2009), which also induced a decrease in net foreign liabilities (mainly parent funding) by EUR 5bn since end-2009. These trends suggest that the balance sheet adjustment is proving to be quite disruptive from an economic point of view and the recovery was also slowed down by the constrained access to credit.

Graph 5: Sectoral decomposition of credit flows



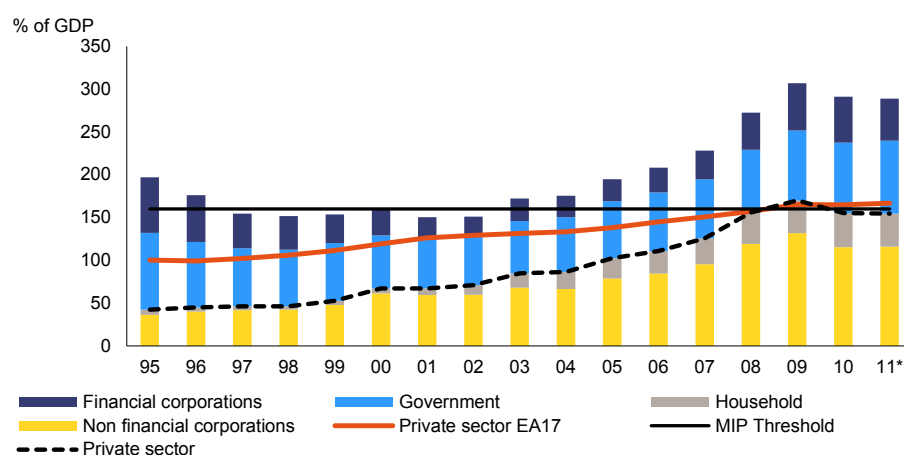
Source: Commission services

Close to one-fifth of non-financial enterprises' debt is owed to parent companies, which generally provides for relatively stable financing conditions. The consolidated debt stock of the private sector was thus around 135% of GDP in 2010 (i.e. 20 pps smaller than the non-consolidated measure). Looking further, as a consequence of the severe deleveraging described above, the outstanding stock was lowered to around 145% by Q2 2011. In addition, asset quality is in general deteriorating: the non-

performing loan ratio (NPL) is growing for both the corporate (above 16%) and household (above 13%) segments and is expected to worsen throughout 2012 due chiefly to the sluggish economy.

The early repayment scheme put in place by the authorities implied a further decline in the private sector's debt stock, but it endangered financial stability. The Parliament adopted in September 2011 a controversial scheme allowing (until end-February 2012) for the early repayment of households' FX mortgages at a fixed exchange rate well below the current market rate by 25-30%. . Based on final data, given that less than one-third of the repayments were financed from HUF loans, household debt was reduced by around 4% of GDP in Q4 2011-Q1 2012. However, this was done at the expense of triggering a net loss of close to 1% of GDP for the sector and more generally of deteriorating the business environment and the economic recovery. In mid-December 2011 an agreement was concluded, which included steps towards a more balanced burden-sharing between the banking sector and the government (originally all related costs were legislated to be borne by the banks). However, the announcement in the 2012 convergence programme of a new financial transaction duty, covering also households' and corporations' daily transactions, is likely to raise further doubts in this respect. Albeit the agreed schemes should help to arrest the further increase in NPL ratios, they are not sufficiently targeted and imply important budgetary costs.

Graph 6: Sectoral decomposition of debt



Source: Commission services

The rapid increase in private sector indebtedness in the Hungarian economy has taken place in a context of increasing public debt levels. High fiscal deficits were registered especially in the 2002-2006 period, which caused the debt-to-GDP ratio to increase from 53% to around 66% by 2007. Despite the important fiscal consolidation steps of permanent nature implemented in the context of the EU-IMF financial support programme, the debt ratio further increased to above 81% in 2010 chiefly on account of an adverse denominator effect linked to low nominal GDP growth during the crisis but also due to the need to increase the official reserve position of the central bank. In 2011, gross public debt declined slightly to 80.6% of GDP. This small improvement is the result of a sizeable primary surplus of 7½% of GDP (generated mainly by one-off revenues), which is to a large extent offset by the significant depreciation of the forint by over 10% compared to its end-2010 level, which gave rise to an unfavourable valuation effect of government debt denominated in foreign currency.

Not only the high level of public debt is a potential source of financial stress, but also its structure and financing given that close to half of it is denominated in FX. In addition, over 70% of the public debt is owned by non-residents which play a very significant role in the domestic bond market: at the end of Q1 2012 their holdings set an all-time record of HUF 4200 bn, or more than 40% market share (while around 7% of forint-denominated government securities is owned currently directly by Hungarian households, compared to a share of around 15% in the first half of the last decade). This means that there is a danger that if foreigners lose trust in Hungary, the share to be taken up by domestic investors is so large that even domestic refinancing of maturing forint-denominated debt could become difficult (as happened for instance in January 2012 after the pre-discussions on an EU-IMF precautionary assistance were interrupted and the Hungarian sovereign rating was unanimously downgraded to non-investment status by the largest agencies).

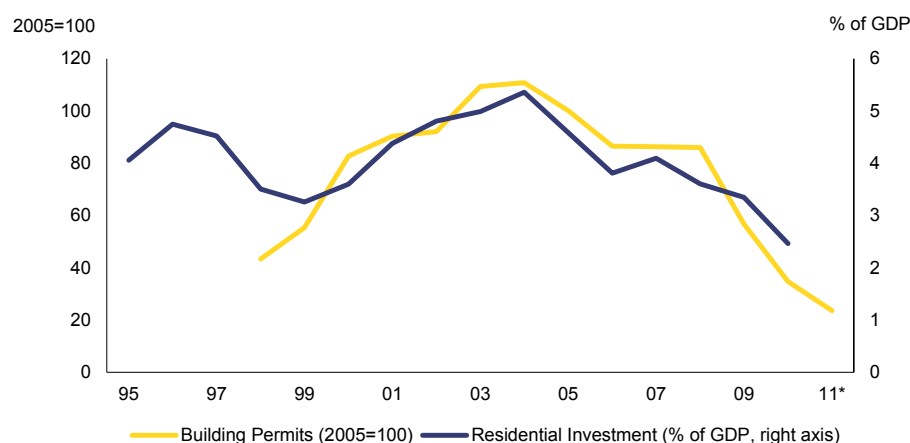
While the unemployment figure *per se* is not excessively high, there are important structural weaknesses in the Hungarian labour market. In 2010, the unemployment rate of 9.7% was slightly

below the threshold value of 10%. However, this gives a somewhat too positive picture as the unemployment rate was held down by high numbers of disability benefit recipients and early retirees. This practice also added to the budgetary woes. A related labour market problem is the low employment rate, which is persistently among the lowest in the EU. While some of the recently launched measures of the authorities' structural reform programme are expected to raise the participation rate, activation could be further facilitated by strengthening measures to increase participation rate of women and disadvantaged groups, as well as by reinforcing the capacity of the Public Employment Service. In contrast, the abolishment of the employment tax credit as of 2012 has increased taxation of low-income earners substantially, calling for adjustments in this area. In addition, better tax enforcement would allow for lower tax rates on labour supporting employment growth.

As regards potential further bottlenecks to growth, there seems to be scope to further increasing competition in industry and services on the product market front. Average mark-ups in the industrial sectors with 10.5% were the eighth-highest among 26 Member States between 2008 and 2009. This may be partly explained by high demand for exported products, but may also indicate weak competition in these sectors³. Furthermore, internal imbalances are aggravated by an excessive burden of government regulation, which places Hungary 135th out of 142 countries surveyed on the related indicator of the World Economic Forum⁴. The overall administrative burden on firms is estimated to remain over 10% of GDP. The complexity of tax rules affects firms of various sizes differently: the government estimates that larger firms devote on average 1% of their turnover to the administration of taxes, while the same figure is near 10% for small enterprises.

As regards the housing sector, the pre-crisis period was not characterised by an asset price bubble in the Hungarian real estate market. Indeed, Hungary registered one of the lowest rates of house price growth in the EU from the latest trough to the latest peak, and the decline in house prices was on average 4%, while in the Baltic states and some other new member states this average is well over 10%. A gradual but protracted unwinding is still taking place: based on FHB House Price Index⁵ data, the decline in real prices was on average 1% over the 2005-2008 period. From mid-2008, there has been a continuous (quarter-on-quarter) nominal decrease in house prices: by Q3 2011, the size of this price reduction reached 15%. The monotonous diminution in house prices is strongly linked to the drastic fall in mortgage lending since late 2008. The decrease in residential investment had already started from 2005, and it was more than halved by 2010 measured from its peak in 2004 at 5.4% of GDP. Before the crisis, the share of the real estate sector's value added was around 8-8.5%, which was lower by one-third than the EU average. Since there has been a continued steep reduction in the number of building permits (leading indicator for dwellings), a quick turnaround should not be expected.

Graph 7: Housing supply indicators



Source: Commission services (figures for 2011* are based on the first three quarters)

³ Mark-ups are measured by the gross operating rate, calculated as (gross operating surplus/turnover)*100.

⁴ World Economic Forum (2011-12) Global Competitiveness Report

⁵ For details see: <http://www.fhbindex.com/FHB-Index/FHB-House-Price-Index>

3. IN-DEPTH ANALYSIS OF SELECTED TOPICS

3.1. A CLOSER LOOK AT CURRENT ACCOUNT DEVELOPMENTS AND OUTLOOK

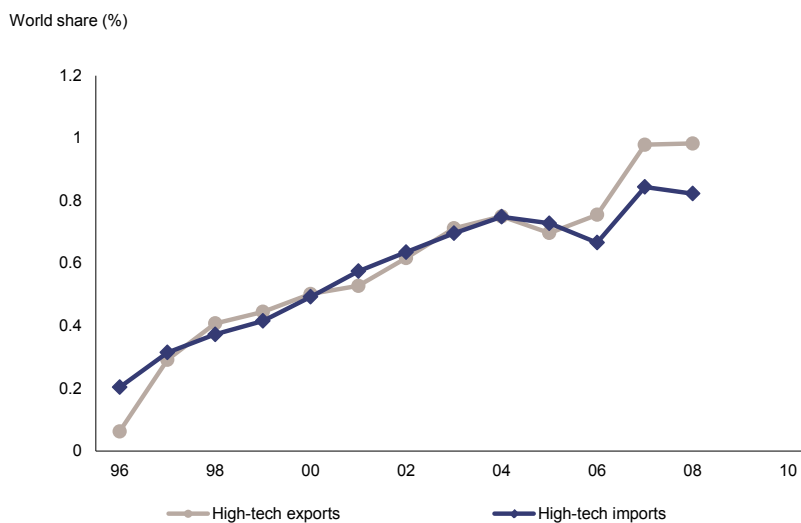
Up until the global crisis in 2008, Hungary's progressively increasing integration into the global supply chains and the easing in liquidity constraints on financial markets made it easier to finance its current account deficits. While the economic convergence process often causes savings to fall and investment to rise in converging economies, which, in turn, leads to a rise in their external liabilities⁶, the accumulated magnitude of Hungary's external imbalances clearly stands out in regional comparison and its sheer size has become a source of vulnerability. Some further analysis of the sources of these excessive external deficits, of their financing and of the medium-term prospects therefore appears to be warranted.

Against this backdrop, the first question addressed shortly in this subchapter is what could explain the country's relatively resilient export performance before the crisis. Second, it is discussed how the various economic sectors contributed to the accumulation of external imbalances. This is followed by a closer look to the financing side, and in particular the respective roles and significance of debt-creating and non-debt creating financial flows (in particular FDI). In conclusion, the short and medium-term outlook for the evolution of the external imbalances will be discussed.

3.1.1. The role of non-price factors behind the export performance

The improving trade balance between 2004 and 2008 in the context of deteriorating cost competitiveness highlight the importance of non-cost-related determinants of the country's exports. The relative resilience of the export sector may be linked to the very significant share of high-technology goods (over 22% of total exports, which is one of the highest in the EU-27). Starting from 1995, and over the next 15 years or so, Hungary has successfully multiplied by 10 its share in global high-tech exports (see Graph below). Indeed, based on revealed comparative advantages in the manufacturing sector, there was a gradual shift in Hungary's exports over the last decade from low technology exports (e.g. wood and textile products) to medium-to-high technology exports, such as rubber products, motor vehicles and electrical and optical equipments. The strength of high technology production is confirmed by the progressively increasing revealed comparative advantage vis-à-vis the euro area in products such as electrical machinery as well as radio, television and communication equipment. A related unique strength in comparison to regional peers is that the technological trade sub-balance entered positive territory in 2006 and the surplus has been gradually increasing since then; however, its size of around 1.5%-2% of GDP per se was sufficient to offset only to a small extent the deficit registered in the other sub-balances until 2008.

Graph 8: Hungary's share in high-tech world trade



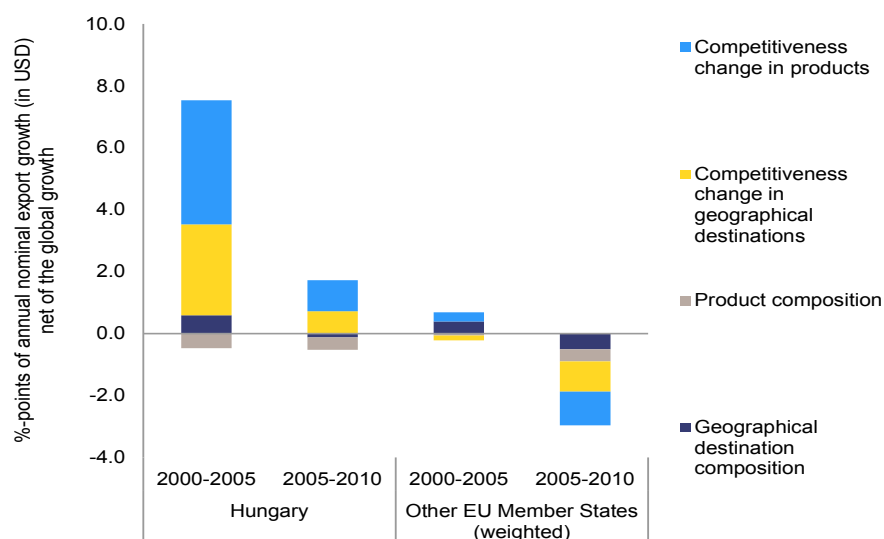
Source: Commission services

⁶ For a detailed discussion of these arguments, see Koroknai, P. (2008)

The geographical structure of exports does not explain the gain in export market share, i.e. the country's performance was not boosted automatically by growth of destination markets. In terms of geographical orientation, the EU-27 dominates both directions of trade (based on 2010 figures, it accounts for 77% of Hungary's exports and 68% of its imports). Germany continues to be the most important trading partner, absorbing almost one-fourth of Hungary's total external trade, while Italy, France, and Austria each have an export share of around 5%. Thus the country's orientation towards less dynamic export markets is quite significant, albeit in parallel there has recently been a steady extension of export markets to the fast growing economies of Eastern Europe and Asia (e.g. new Member States account for 20½% of exports and 16½% of imports, while these figures stood at 18% and 13½% in 2006, respectively).

The graph below also reveals that the rather good export performance between 2000 and 2005 was thanks to the fact that Hungary has increased its market share in both the geographical locations and product categories in which it was present at the beginning of the period under observation. Originally Hungary was not specialised in relative terms in geographical destinations and sectors that were characterised by a particularly dynamic import demand. The much less dynamic export growth in the second 5-year sub-period can also be explained by the lagged impact of deteriorating cost competitiveness as described above. This being said, if one compares the Hungarian performance with regional peers with broadly similar production structure (e.g. CZ, PL, SK, the other Visegrad countries), their additional export growth due to competitiveness gains were markedly stronger in both periods.

Graph 9: Decomposition of nominal export growth (net of the global trade growth)



Source: Commission services

3.1.2. The anatomy of the external deficits: sectoral decomposition

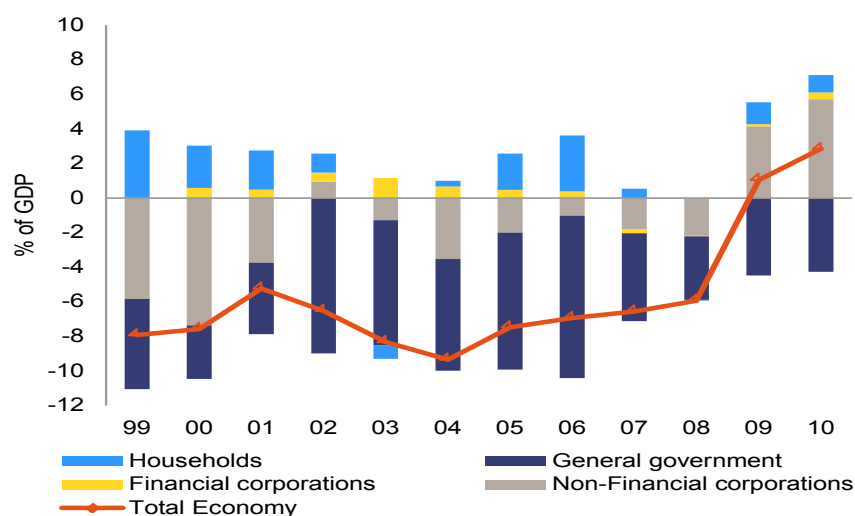
The sectoral decomposition of the net lending figures confirms the importance of the twin-deficit causality for Hungary. Following a budget consolidation period in the second half of the 1990s, resulting in a significant drop in the public debt-to-GDP ratio from a peak of close to 90% of GDP in 1994-95 to around 52% in 2001, the orientation of fiscal policy was sharply reversed in Hungary. Structural adjustment efforts were replaced by controversial accounting practices and optimistic budgetary planning. The track-record of fiscal policy between 2001 and 2006 was poor, as budgetary targets were regularly missed by wide margins.

Significantly increased social transfers and large public wage increases resulted in budget deficits well over 6% of GDP in each year in the 2002-2006 period, persistently among the highest in the European Union. A number of tax cuts, carried out in the context of the high nominal and structural deficit, exacerbated the growing macroeconomic imbalances. Indeed, model simulations by MNB

experts⁷ showed that domestic demand-driven solid GDP growth rates in the range of 4-5% were to an important extent explained by the large fiscal impulse. For example, in case of a "neutral fiscal path" counterfactual scenario, the growth rate of consumer spending was estimated to have been on average close to 2% lower in each year between 2001 and 2003. This moderation in consumption would have occurred because of less generous social transfers in cash to households and slower growth in net income. Thus, in the period in question, the unsustainable fiscal expansion created a significant "artificial" consumer demand, which led to a deterioration of the current account through higher import flows than otherwise would have been the case.

The successive high budget deficits contributed to a sharp increase in the net external debt. It was more than doubled in the 5 years following 2002 when it stood at around 23% of GDP. The increase in the foreign debt stock was primarily due to a policy-induced move in the sectoral composition of the country's net financing requirement from corporate financing to the financing of the general government (see Graph 10). Indeed, the corporate financing requirement, which had been basically covered by non-debt-generating capital inflows (largely FDI) in the second half of the 1990, dropped to substantially lower levels after 2000 compared to previous years. At the same time, starting from 2001, the persistently loose fiscal policy absorbed a considerable part of domestic savings⁸. The resulting uncertainty and recurring market doubts about the sustainability of public finances played an important role in keeping the risk premium and therefore domestic interest at an elevated level. This has increased the private sector's dependence on external funds, and thus motivated the practice of lending in foreign currency to households and SMEs in a period when FX rates were much lower, relevant macro-prudential regulations were weak and some aspects of lending behaviour on the part of banks as a whole were not prudent. Moreover, even the financing position of the government could not be covered fully from internal resources given the household sector's relatively low savings rate.

Graph 10: Net lending/borrowing by sectors



Source: Commission services

An important fiscal consolidation effort carried out after the peak deficit of over 9% of GDP in 2006⁹ reduced the government's financing need prior to the global crisis. Despite the major contraction of the economy in 2009, the fiscal adjustment programme supported by EU-IMF financial assistance resulted in the stabilisation of the headline fiscal deficit at around 4-4.5% of GDP between 2008 and 2010 as well as to improve the structural balance in 2009 by more than 2% of GDP. The crisis brought about sharp adjustments as the household savings rate started to increase, chiefly due to precautionary considerations, while the corporate sector established a net savings position.

3.1.3 The structure of the financing of external deficits

Apart from the rapidly increasing level of external indebtedness, starting from 2003, there was also a marked shift in the structure on the financing side. The first period lasting to the early 2000s was characterised by high non-debt creating capital inflows and practically insignificant outflows.

⁷ Hornok, C. et al (2008)

⁸ See for example Antal, J. (2006)

⁹ The level of the 2006 deficit was to some extent pushed up by one-off expenditure.

Relatively early and large-scale privatisation played an essential role in the strong FDI and portfolio investment inflow throughout the 1990s, as economic policies that were designed to encourage foreign investment, in particular, by granting significant (tax) allowances made Hungary an attractive investment destination¹⁰. On the other hand, both the direct capital export of resident companies and the level of foreign equity investment were low, reflecting the nascent state of the Hungarian corporate and institutional investor sectors. As a general feature of the period in question, the net volume of non-debt creating financing recurrently exceeded the external financing requirement.

Starting from 2003, however, there was a parallel increase in the non-debt-creating capital export undertaken by domestic agents and in the share of debt-creating financing. It is important to highlight that until the eruption of the crisis in 2008, there was no significant decrease in the gross inflow of FDI, especially if privatisation revenues are excluded from the time series. The major part of the direct capital outflow FDI in that period could be attributed to a few large and very profitable resident companies on the way to becoming "regional" multinationals (e.g. MOL). As regards industries, the banking sector played a particularly important role in the process through acquisitions (e.g. OTP, MKB - subsidiary of Bayerische Landesbank). The domestic market proved to be saturated for these business organisations, and therefore the access to new market opportunities was the main motivation behind their regional expansion. There had been a parallel rise in capital outflow in the form of portfolio equities, which was primarily explained by the growing international activity of domestic institutional investors (geographical diversification). Non-bank saving alternatives became increasingly accepted among households, and legislative changes (e.g. the complete liberalisation of the financial accounts and revised regulation for private pension funds' investment benchmarks) also supported the increasing outward activities of the sector. As a consequence, the outflow of equity capital also reduced the net amount of non-debt-creating financing.

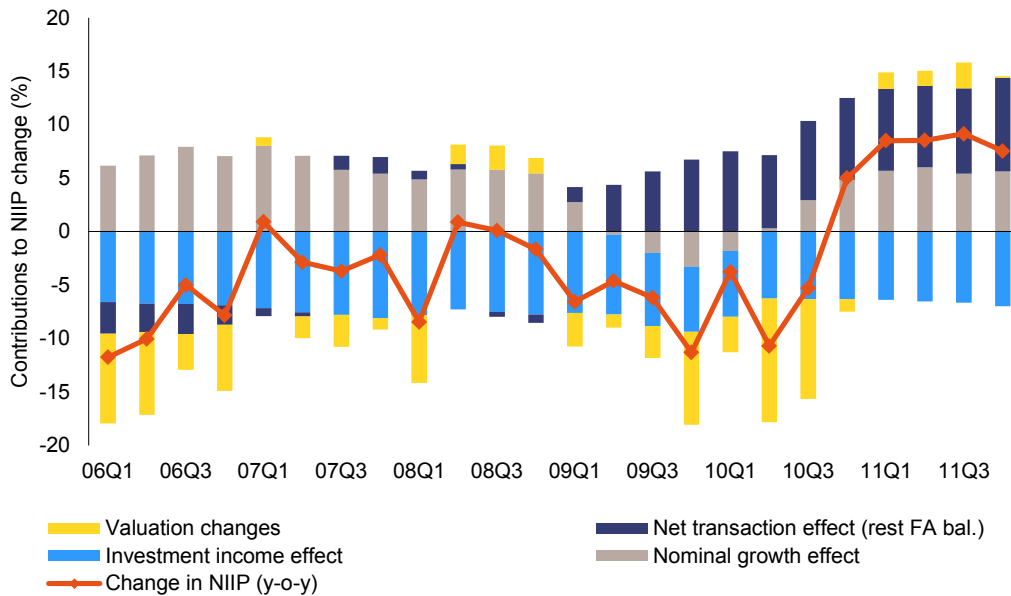
It is conventional wisdom that non-debt-creating forms of financing are linked to a number of positive features. Non-debt-creating resources – particularly in the form of FDI – are often thought to be a less liquid and therefore more stable form of financing than debt type investments, especially during "sudden stop" periods. In addition, FDI can accelerate economic growth in the host country through the associated positive externalities (technological upgrade, managerial skills, access to new markets, etc.). FDI is therefore also associated with an almost automatic increase in corporate investment expenditure, as corporations are capable of raising non-debt-creating resources by issuing shares or using FDI to satisfy their financial needs, while the general government and households typically rely on debt-creating foreign financing. However, it is important to recognise that most of the above described advantages attributed to FDI are linked to the activities of foreign-owned companies rather than the concrete means of financing (direct capital is only one of the possible ways to finance the operation of a company)¹¹.

The strong and sustained FDI inflows during the 1990s had created a large structural deficit of the income balance of around 5-6% of GDP already by 2000 (see Graph 11 below). This would have implied the need for strong structural surpluses in other sub-balances such as trade in goods in order to avoid permanent external imbalances, pointing to the importance of a robust competitiveness position of the country. It is important to emphasise that already before the crisis (from 2007) the net transaction effect (i.e. the balance of real economy transactions between residents and non-residents) linked to the functioning of the economy contributed to a slight reduction in external liabilities. Thus, the increase in Hungary's external liabilities between 2007 and 2008 was due in large part to the high initial liabilities related to the outflow of factor income. Given the already high level of debt, the net outflow of investment income is likely to continue to be significant in the foreseeable future.

¹⁰ Given that privatisation to foreign strategic investors in the neighbouring countries was started at a later phase of the transition process, based on the FDI inflow-to-GDP ratio, Hungary had continuously been the "number one" in the region until the end of the 1990s (and in a number of years, Hungary led the regional league also based on absolute amounts).

¹¹ For a review of the related literature, see Komáromi, A. (2008)

Graph 11: Decomposition of Net IIP Changes



Source: Commission services

An undisputed advantage of FDI-based financing over debt-creation is that dividend-type payments are pro-cyclical. In parallel with the economic downturn, therefore, the associated financing requirement may also decline. Indeed, in 2009 and 2010, the Hungarian balance of payment registered a roughly 25% decline in income realised on foreign direct investments compared to the average of the pre-crisis years. By contrast, servicing debt-type liabilities could become risky (renewal risks) and expensive (increase in interest premiums) in the context of an economic crisis.

Moreover, a recent empirical study found that if one compares the income-generating impact of FDI-type financing that arrived in Hungary between 1995 and 2010 with alternative ways of external financing (portfolio investments and foreign loans), FDI proved to be more beneficial as it led to a higher GNI level by 6-14%. This calculation has already taken into account that the expected return on direct investment proved to be higher compared to all possible other forms of financing¹². These findings also support the need to regain as swiftly as possible the confidence of direct capital investors in order to move FDI inflows close back to the levels experienced over the pre-crisis period.

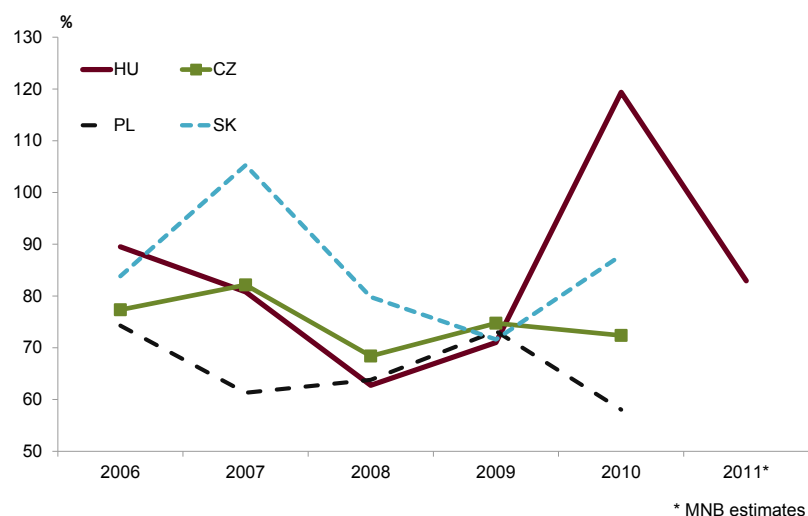
The recent decline in FDI inflows is partly explained by the dramatic fall in the ratio of reinvested profits over 2009 and 2010. While before 2009, this ratio was in the range of 20% to 40%, it became actually negative in both 2009 and 2010, i.e. the amount of repatriated profit (through dividends) was higher than the sum of total profits in that year, implying some recourse to the accumulated profit reserve. This decline does not seem to be a mechanical consequence of the crisis; at least in some other countries in the region (e.g. Czech Republic, Slovakia) the ratio of reinvested profits (hovering in comparable range as the Hungarian figures before the crisis) remained stable, or even increased.

The low level of economic confidence is also linked to a number of considerable (and often controversial) changes in the policy environment and legal and institutional system. This is also shown by the World Bank 2012 Doing Business indicator for the category “protecting investors”, which ranked Hungary far behind its regional peers (and at the position of 122nd globally). A further important indication can be found in the survey published in the 2012 annual report of German-Hungarian Chamber of Industry and Commerce, which showed that 87% of the respondents were unsatisfied with the unpredictable Hungarian economic environment (the worst result in years). Moreover, despite recent progress in some areas (e.g. start-up costs) the burden of government regulation places Hungary on one of the last places. Originally promising reform efforts to reduce the administrative burden on enterprises seem also to have slowed down. More recently, in 2011, there was a pick-up in the reinvested profit ratio when it is estimated to have reached again over 25%. However,

¹² See Balatoni A. - Pitz M. (2012)

the recent deterioration in the investment climate linked to frequent changes in legislation and policy decisions that may hamper growth does not bode well for a continuation of this trend.

Graph 12: Ratio of dividend payments to profits in selected new Member States

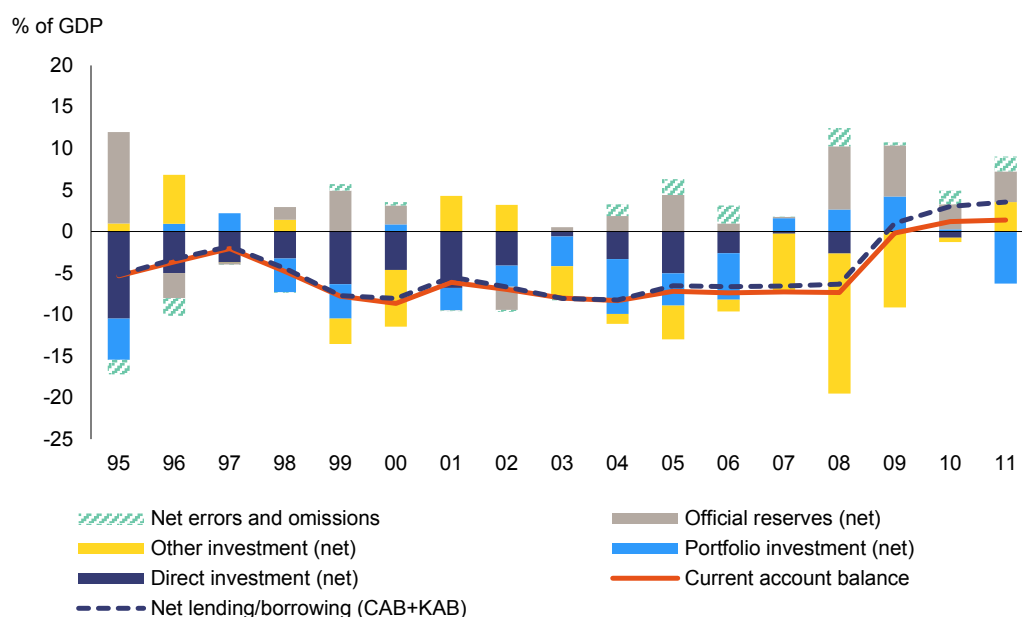


Source: National Bank of Hungary (Magyar Nemzeti Bank, MNB)

Note: The repatriated profit ratio can be derived from deducting the dividend payout ratio (shown in the graph) from 100. If dividend payments in year T were to be compared in profits realised in year T-1, similar patterns would be shown.

As regards the sectoral composition of FDI, around one-fourth of inflows went to the manufacturing sector – and an increasing share to the automobile industry –, which suggests that direct investments play a pivotal role in enhancing Hungary’s export capacity, and thereby its growth potential. FDI inflows also significantly contribute to the integration of Hungary’s financial system and product markets with that of the EU as both financial intermediation and the retail sector make up close to 15% of the total inflow. Both administrative and support activities (through the establishment of shared-service centres) and information and telecommunication services account for roughly 10% of the total FDI stock.

Graph 13: Financing of net external lending/borrowing



Source: Commission services

In the framework of the EU-IMF loan, Hungary's international reserves increased sharply from around EUR 17 bn in October 2008 to above EUR 30 bn in summer 2009. This increase reflected

successive disbursements of balance of payments assistance from international institutions as well as quantitative targets under the programme; during the same period, the reserve coverage of the short-term debt moved from 60% to around 100% (excluding intercompany debt liabilities related to FDI). International reserves continued to follow an upward trend until late 2011 benefiting chiefly from the increased inflow of EU structural funds (which are normally converted by the central bank into the local currency). International reserves peaked at above EUR 38bn in October 2011 before sovereign external debt redemptions and accelerated deleveraging in the banking sector linked to the scheme allowing for the early repayment of foreign exchange denominated mortgages at preferential rates induced a decline in the reserve level by some EUR 2.5 bn. At the end of 2011, international reserves covered 90% of short-term external debt at original maturity.

3.1.4. Longer term outlook for external imbalances

There is a wide consensus among the national authorities and international organisations that the current account surplus would be on an increasing path in the short- and medium term. Specifically, it could be in the range of 4% of GDP in 2013, also on the back of favourable EU inflows, while domestic demand is still expected to be depressed.

Looking further ahead, the question arises to what extent the recently experienced rebound in the current account from high deficits to an increasing surplus in the context of the crisis is cyclical, and to what extent it is structural. As regards the sectoral composition, the adjustment in the household's savings rate appears to be largely a structural phenomenon. First, also based on the recent credit demand surveys, it is reasonable to assume that there have been lasting behavioural changes for households to be more prudent when taking out loans. Second, in view of a number of regulatory changes concerning responsible lending by commercial banks (e.g. substantially tightened access FX loans) as well as financial market trends (elevated level of CDS spreads are expected to be maintained in the longer-term compared to its pre-crisis level of around 60 bps) the credit-fuelled consumption boom is not likely to re-appear again. In contrast, non-financial corporations should start to return to a net borrowing position again, despite the disappearance of cheap external financing. In the short-run, however, the deleveraging process will continue in the corporate sector albeit with a decelerated pace (a negative credit growth of 3% is expected for 2012 by the MNB based on market intelligence) and the most recent Senior Loan Officers' surveys also show that banks are tightening credit conditions, also on the account of liquidity and capital constraints.

The corporate sector should become again a net borrower. Empirical findings show that the indebtedness of the Hungarian corporate sector should not be regarded excessive in international comparison (based on both the overall level of financial liabilities and net financial assets, non-financial corporations in Hungary are among the least indebted in the EU). Therefore, the positive savings rate of the non-financial corporations should eventually be reversed as a reflection of a return to normal investment activities. The associated increase in the imports of investment goods should preferably be accommodated by improvements in the net lending position for other economic sectors; thus a further rise in the negative NIIP position would be avoided. In turn, a sort of modernisation deficit is considered to be a typical feature of a converging country.

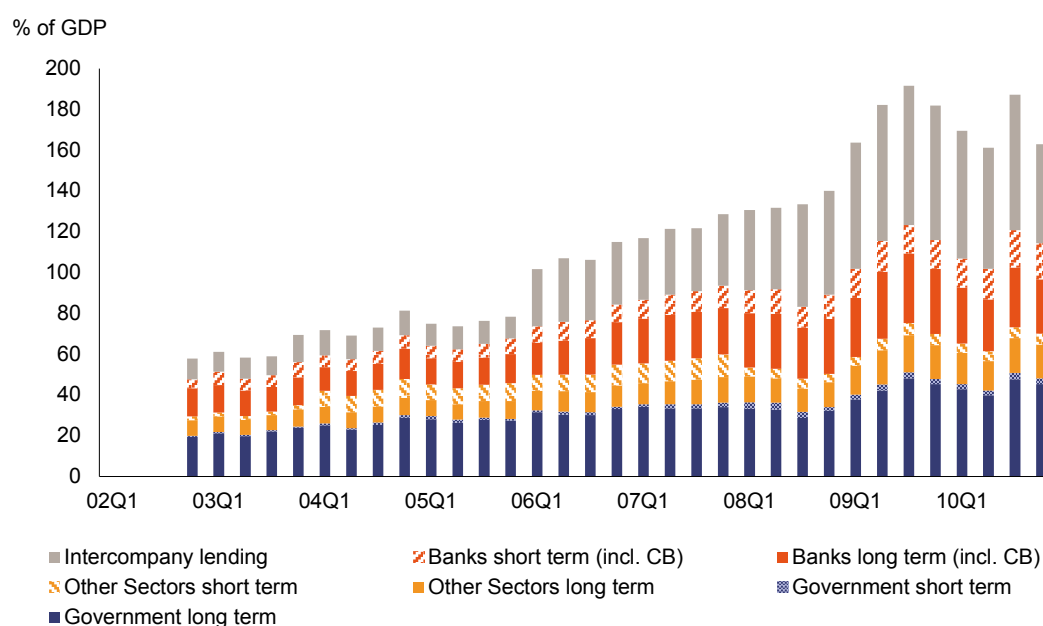
Based on current information, the NIIP position is anticipated to improve markedly in the coming period. Regarding this year and next, assuming no other changes, the current and capital account projections of the Commission services' 2012 Spring Forecast, *ceteris paribus*, would imply a further steep reduction in the NIIP to well below 90% of GDP by the end of 2013. Looking even further, Commission services' illustrative calculations on the basis of a number of simplified assumptions for growth, inflation and external yields show that Hungary would need to achieve a current account surplus of over 3% of GDP on average over the 2012-2020 period in order to halve its negative NIIP by 2020 (to around -53% of GDP, which would be still above the indicative threshold). For Hungary, based on estimates regarding the potential EU structural fund inflows in the present and the forthcoming financial perspectives, the capital account could plausibly be projected to be in a surplus in the magnitude of 2% of GDP in the coming decade. Also taking into account this positive factor, the necessary current account surplus to be sustained in order to halve the NIIP ratio is still over 1% of GDP.

3.2. SUSTAINABILITY OF DEBT DEVELOPMENTS

From its peak of around 63% of GDP in 2009, net external debt declined a couple of percentage points by Q3 2011, but its level remains high in regional comparison. The second highest level in the Visegrad countries can be found in Poland with a ratio of somewhat over 30%. As regards the

distribution of the high external debt burden in gross terms, especially the state and the banking sector account for significant shares in the external debt.

Graph 14: Gross external debt and its structure

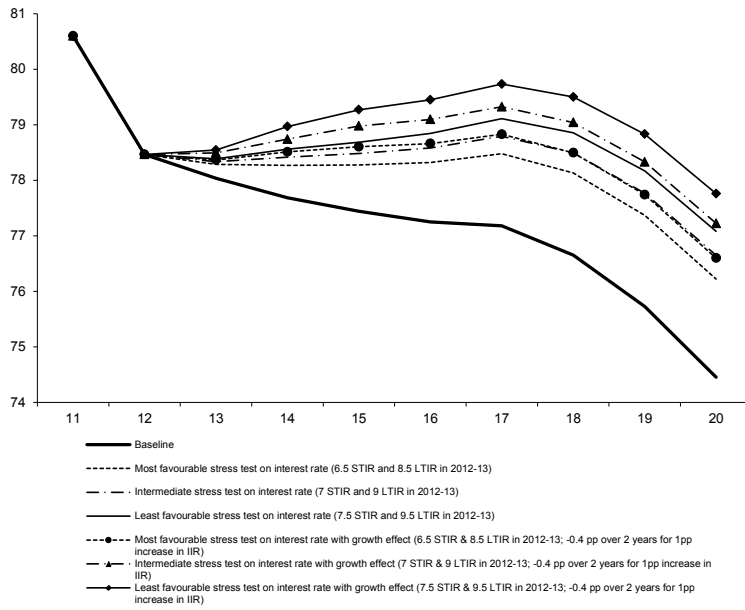


Source: World Bank's SDDS external debt database

The rapid adjustment in the annual external financing requirement between late 2008 and 2010 occurred in parallel with significant outflows of debt-type liabilities, related to the recessionary economic environment. The ongoing balance sheet adjustment of the private sector primarily took place through a substantial decline in borrowing. The sharp fall in the growth rate of private sector credit (flow) in 2010 (-18%), was expected to be followed by another important decline (-6 by Q3 2011) as the private sector has become net loan re-payer. The deteriorating economy corroded loan quality and reduced loan demand, which have led most banks to deleverage their balance sheets (the retail loan-to-deposit ratio was 131% at end-2011 down from 170% in 2009), which also induced a decrease in net foreign liabilities (mainly parent funding) by EUR 5bn since end 2009. In contrast, the FX share in public debt (currently at around 46-47%) is expected to remain unusually high in the coming period (compared to the pre-crisis benchmark range of 27-32%). As long as there are no significant capital inflows an accelerated pace of reduction in the FX share would imply a corresponding depletion in official reserves and there are prospective important demand constraints in local market financing.

Debt sustainability calculations show a mixed picture. The following graph presents illustrative projections for the debt-to-GDP ratio up to 2020. The baseline scenario assumes that the 2013 structural primary balance (a surplus of 2.3% of GDP as projected in the Commission services' spring 2012 Spring Forecast) is kept constant thereafter in line with the usual no-policy-change assumption – except that changes in the cost of ageing are accounted for. This scenario shows that the debt ratio will gradually but monotonically decrease to around 74% of GDP in 2020. An important caveat related to the interpretation of these results is that implicit interest rates are assumed to broadly stabilise at current levels and then gradually decline from their peak of around 5.6% in 2015 throughout the simulation horizon. Further results are provided in the debt sustainability analysis below with three sensitivity tests implying temporarily higher (200-400 bps for two years relative to the baseline) interest rates due to financial market pressure. All of these scenarios would revert the baseline's downward-sloping trend over 2012-17, leading instead to a broad stabilisation or slight increase in the debt ratio over the aforementioned time period. Only after 2017 the debt ratio would start decreasing again under the stress-test scenarios as in the baseline. Adding some estimated negative feedback effect on growth to the increase in interest rates makes this path in the evolution of the debt ratio even more pronounced (approaching 80% in the least favourable scenario).

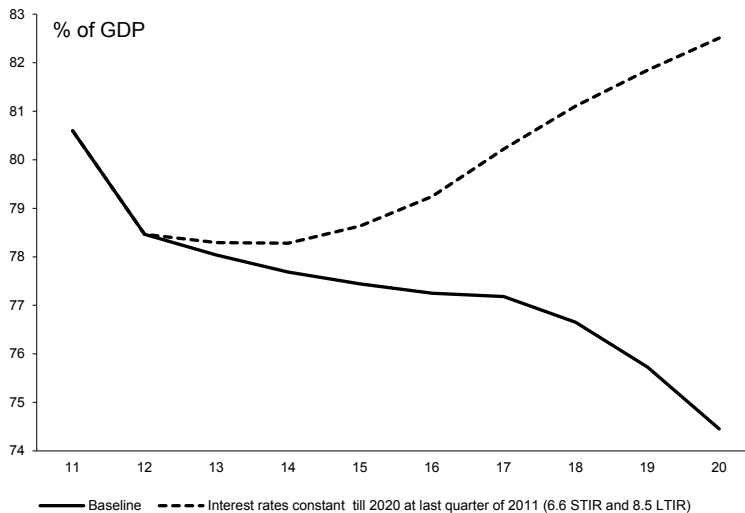
Graph 15: Medium-term public debt dynamics in Hungary



Source: Commission services' calculations on the basis of the 2012 Spring Forecast

Should the yields stabilise at the level recently observed, it would trigger explosive debt dynamics. This additional scenario assumes that interest rates, both short- and long-term, remain for a longer time interval (from 2012 till 2020) at the higher values observed at the end of 2011 (6.6% for short-term and 8.5% for long-term interest rates, as in last quarter of 2011 based on OECD data). The resulting path is displayed in Graph 16, showing that this type of continued financial market stress implies the broad stabilisation of the debt-to-GDP ratio between 2012-14, followed by an increase to around 82.5% in 2020 (above the level recorded for 2011 (80.6%), and significantly above the value of 74.5% that would be reached in 2020 in the baseline scenario).

Graph 16: The evolution of debt over GDP in case of interest rates constant until 2020 at the levels of 2011 last quarter

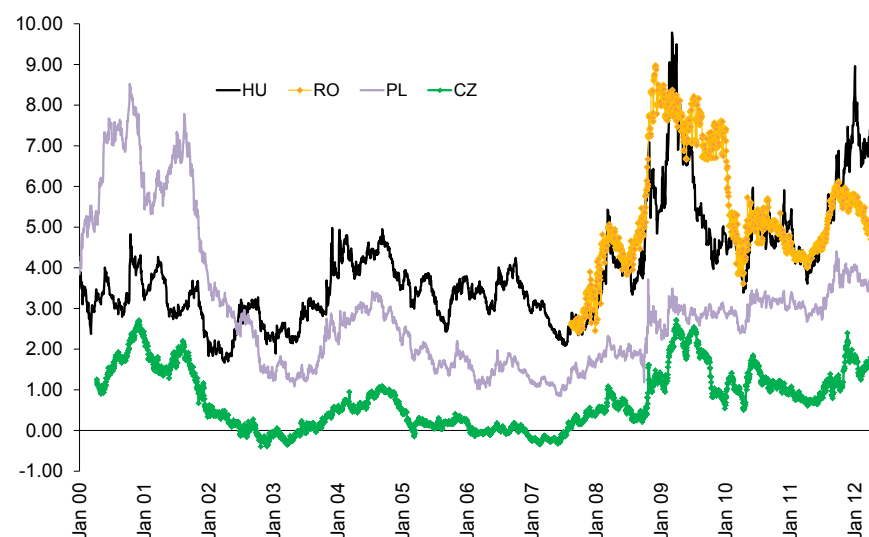


Source: Commission services' calculations on the basis of the 2012 Spring Forecast

Apart from sustainability concerns, the current high level of public debt in Hungary may impact negatively on growth prospects and competitiveness. One of the traditional channels is the crowding out of private investment, with public debt competing with private debt for the allocation of savings. Other channels are that the high debt burden entails a comparatively high debt service (as a share of GDP, it is at least double of regional peers) and thereby drives out more productive government expenditure but also tends to increase the tax burden, which is a drag on competitiveness and growth. Since late 2008, these phenomena have become even more pronounced given that even in periods of

relative stability Hungarian sovereign spreads tend to be higher compared to the pre-crisis period (see graph above). In addition, since the autumn of 2011, the spreads have become substantially larger compared to regional peers, demonstrating the erosion of investors' confidence vis-à-vis the country (also shown by the fact that between November 2011 and early January 2012 Hungarian sovereign credit rating was downgraded to the speculative level by Fitch Ratings, Moody's and S&P).

Graph 17: Spreads on long-term government bonds vis-à-vis German bunds (10 years)



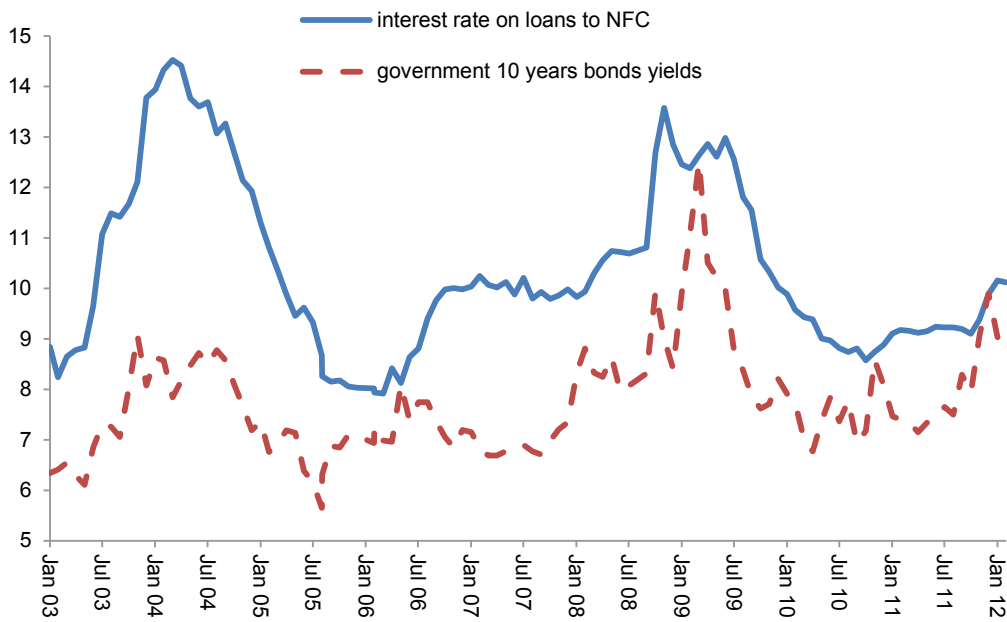
Source: Commission services (Ecowin database)

One particular consequence of high public debt could be the negative feedback effects from sovereign yields to corporate financing costs. Investors generally apply the “sovereign ceiling” when financing corporations (i.e. no firm is considered to be more creditworthy than its government)¹³. Given that the financing of the corporations in Hungary is carried out predominantly through bank loans, it would be warranted to monitor the link between sovereign and corporate yields (see Graph 17). Since October 2008, loans to the corporate sector have fallen by over 15%. According to the MNB, the decline in corporate lending is both a supply and a demand issue, whereby the two accounted for the drop by a ratio of around 2/3-1/3. Furthermore, market intelligence confirms that starting especially from 2010, the sovereign CDS swaps played an increasing role in determining the funding costs of Hungarian banks¹⁴. This was attributable to the fact that some foreign parent banks started to introduce CDS-based pricing within the group's fund allocations, in particular for maturities of over one year. Indeed, the positive correlation between the two set of interest rates increased recently, showing a coefficient of 0.88 in 2011, compared to 0.65 in the five years leading up to the crisis.

¹³ There are a number of channels through the creditworthiness of the government may affect that of the private sector. First of all, there are a host of potential negative impacts that a situation of near-default or a sovereign default has on the domestic economy on the whole, which undermines the financial strength of the private sector. The second channel is the “spillover” effect stemming from the insolvency of the sovereign as it may undertake measures that directly affect the private sector’s ability to repay, such as resorting to inflationary financing, large tax increases or the imposition of direct capital controls.

¹⁴ See for details Páles, J. – Homolya, D. (2011)

Graph 18: Long-term government bond yields and corporate interest rates



Source: Commission services, MNB

Note: Interest rates on HUF-denominated loans for over 1 year, weighted by the amount of outstanding loans

However, a few important specificities of the Hungarian banking sector should also be taken into account which cautions against an extrapolation of this trend. Firstly, 70% of the Hungarian financial sector is foreign owned. In December 2008, the leverage ratio (loan-to-deposit) of the foreign subsidiaries was an average of 180%, which implies that a large portion of lending in Hungary was financed through parent bank funding. Though banks have meanwhile strongly deleveraged, parent bank funding still accounts for an important share of subsidiaries' funding. As a result, parent banks' funding difficulties negatively impact both the funding and the capital position of the Hungarian subsidiaries even in periods when Hungarian sovereign yields drop. Parent banks are heavily reliant on wholesale funding with still 1/3 of their funds raised from the capital market where investors require notoriously high yields, especially from weaker parent banks. In that respect, the ECB's 3-year long-term refinancing operations has had a beneficial effect on parent bank funding since parent banks participated in the ECB's operation.

Secondly, though banks' capital buffers are still comfortable, the NPL ratio and more importantly, the pipeline of previously restructured loans that generally have a high probability of becoming non-performing, increasingly dominate banks' ability to extend new loans. It can be argued that up till now it was the willingness or rather unwillingness to lend that played a key role in tightening the credit supply, also influenced by the uncertain regulatory environment and weak growth prospects in Hungary. Looking ahead, however, the lower ability to lend is linked to the anticipated declining capital buffers independently of the sovereign's rating and yield spread.

4. POLICY CHALLENGES

The preceding analysis has shown that Hungary is experiencing serious macroeconomic imbalances, which are not excessive but need to be addressed. In particular, certain macroeconomic developments such as the highly negative size of the net international investment position and public debt deserve very close attention so as to reduce the important risks of adverse effects on the functioning of the economy.

Faced with a deteriorating financial market situation and an emerging confidence crisis, Hungary asked for precautionary balance of payments assistance by the EU and the IMF in November 2011. Agreement on a possible assistance programme was not reached by the cut-off date of this in-depth review as some conditions inter alia related to central bank independence were not yet fulfilled. Irrespective of whether an international financial safety net would be secured or not, the risks stemming from the remaining external financing exposure, and more generally, from the stock problems described in this study can best be remedied through sustained macroeconomic stability, i.e. low inflation and sound fiscal position. Such a stable economic policy environment should also be conducive to ensuring a gradual deleveraging process (i.e. in the medium to long run) of both private and public agents and could be usefully supported by structural reforms.

Hungary would benefit from the creation of a stable policy environment and well-functioning institutional system. Investors currently regard Hungary as a volatile country where the institutional and policy framework for corporations and in particular for banks is unpredictable. This is reflected in the Hungarian sovereign yield and CDS spreads, the highest in the Central European region. To address the current shortcomings in the stability and transparency of the system, several changes may be useful. First, the independence of the central bank (MNB), notably including the independent fulfilment of its tasks and mandate would need to be fully ensured. Second, economic governance could be enhanced by strengthening legal and economic watchdogs, including the restoration of the Constitutional Court's remit in the budgetary field and endowing the Fiscal Council with the necessary resources to fulfil its role effectively. Finally, also with a view to improving the predictability of the economic and policy environment, consultation with private and official partners is worth reinforcing. In this context, it would be beneficial if the speed of lawmaking was reduced and the extensive practice of not respecting the requirement of preparing proper impact assessments ended.

The firm reduction of the public debt should help reduce external exposure of the country. Measures underpinning the attainment of the deficit targets laid down in the Council EDP recommendation of 6 March under Article 126(7) would best be of a permanent and structural nature. These steps could include the full implementation of the Széll Kálmán Plan as recommended by the Council in March 2012 and the additional measures announced in the April 2012 convergence programme, most notably savings achieved by reviewing the disability benefits, pharmaceutical subsidies, efficiency gains in the in the local government sector and in the public transport sector as well as the introduction of the electronic road toll system. Hungary would also benefit from better targeting the universal child benefit (possibly in connection with the recently introduced generous family tax allowances), introducing a centralised, value-based property tax and from enhancing the progressive nature of the flat income tax scheme.

The sustained reduction in stock vulnerabilities would necessitate raising the growth potential through structural reforms. With a view to steadily increasing the employment rate, employment friendly taxation for the low-wage workers could be adopted to support labour demand without endangering the attainment of fiscal targets. In the current context, it appears to be warranted to avoid further increases in the minimum wage and to discourage excessive contractual wage growth. Participation in the labour market may usefully be further facilitated by tailor-made measures for disadvantaged groups. In addition, activation should be improved through a review of the public works scheme and by reinforcing the capacity of the Public Employment Service. Furthermore, fostering competition in product markets could stimulate growth by creating incentives for firms to use their resources most efficiently. These may include steps to strengthen the functioning of competition enforcement institutions and the public procurement rules. Finally, the rigorous implementation of all the measures envisaged by the Hungarian authorities for regulatory reform and lowering administrative burden should help growth.

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