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**In-depth review for HUNGARY**

**in accordance with Article 5 of Regulation (EU) No 1176/2011 on the prevention and correction of macroeconomic imbalances**

*Accompanying the document*

**COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN  
PARLIAMENT AND THE COUNCIL AND TO THE EUROGROUP**

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

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## EXECUTIVE SUMMARY AND CONCLUSIONS

In May 2012, the Commission concluded that Hungary was experiencing serious imbalances, in particular as regards developments related to the net international investment position and implications of high government debt. In the Alert Mechanism Report (AMR) published on 28 November 2012, the Commission found useful, also taking into account the identification of a serious imbalance in May, to examine further the risks involved and progress in the unwinding of imbalances in an in-depth analysis. To this end this In-Depth Review (IDR) takes a broad view 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:

- **Hungary has been experiencing imbalances, in particular as regards developments related to the net international investment position (NIIP) and public debt as mentioned in last year's IDR. External imbalances have decreased as the current account is in surplus for the third year in a row and the NIIP has been improving steadily (from -117% in 2009 to above -103% in 2012), but it remains significantly more negative than the threshold. This is expected to be the case also in the years to come.** The current account turnaround that started in 2009 was mainly the result of a fall in domestic demand amidst a sharp recession; export competitiveness has rather deteriorated somewhat. After a marked decline during the 2009 recession, the deficit in the factor income has started to widen again, though it remains below pre-crisis levels. Both elements suggest that the external correction is partly cyclical.
- **Most of the recent external adjustment reflects the deleveraging of the private sector.** Private sector deleveraging is necessary to correct imbalances most notably in the household sector. While this has been happening, the rapid fall in corporate credit, against the background of policy uncertainty and sectoral surtaxes most notably on the financial sector, has contributed to historically low investment and productivity growth rates and therefore eroded the country's growth potential, which is very low.
- **Public debt, which was reduced from 82% to below 79% in the 2010-2012 period thanks to one-off capital transfers from the abolition of the mandatory private pension scheme as well as some consolidation measures, is still very high compared to the country's GDP per capita level and regional peers.** Given the combination of a weak growth potential, high debt level and financing costs, a very high share of foreign ownership of public debt securities and the relatively high gross financing needs, public sector deleveraging is a vulnerable process.
- **At first sight, the relatively high level of the unemployment rate (persistently above 10% since the start of the crisis) seems less of a concern as it mainly reflects an increased participation rate, while employment returned to pre-crisis**

**levels.** While private sector employment has also improved in the SME sector, recent increases in employment are strongly linked to public work schemes, and there are no visible signs of movements from public work to the open labour market. Part of the problem can be the insufficient training elements in the scheme. While its social policy advantages should be acknowledged, the public work scheme is unlikely to contribute in a sustainable manner to GDP growth. The sustainability of the increase in private sector employment is questionable due to a low level of investment and productivity.

The IDR also discusses the policy challenges stemming from these developments and possible policy responses. A number of elements can be considered:

**In this context, the in-depth review concludes that though the adjustment process is ongoing and there have been improvements most notably in the external imbalances, a number of policies that cannot be considered market friendly have contributed to losses in the country's growth potential. The combination of high level of debt stocks and low growth keeps the country vulnerable and exposed to sudden adverse changes in market sentiment.** Therefore, in addition to flashing indicators of the scoreboard such as the highly negative size of the net international investment position, public and private sector debt and high unemployment rate, the business friendliness of the economic environment deserves very close attention so as to reduce the important risks of adverse effects on the functioning of the economy.

**While continuing on the path of fiscal consolidation to create the basis for sustainable growth, the policy response could usefully include a revision of the tax system by lowering surtaxes on certain sectors (most notably on the financial sector), and more generally creating a more business friendly environment.** These steps should also make the country less vulnerable to changes in market sentiment and restore its attractiveness for foreign direct investment and bank funding which would result in improved lending, investment and economic growth. In addition, structural reforms in both labour and product markets are worth pursuing in order to lift the country's potential growth. These may include steps toward more efficient active labour market policies, including a thorough review of the Public Works Scheme with respect to training elements and by reinforcing the capacity of the Public Employment Service. In addition, a strengthened functioning of competition enforcement, public procurement rules could be suggested. The on-going efforts to implement measures that lower the administrative burden is commendable and could be continued and plans envisaged in the National Reform Programme fully implemented. Improving educational outcomes can also positively affect growth. Finally a reform of the transport and energy systems toward more sustainable levels is necessary from both the point of view of fiscal sustainability and economic efficiency.

## 1. INTRODUCTION

**On 28 November 2012, the European Commission published 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.<sup>1</sup>** 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.

This is the second IDR for Hungary. The previous IDR was published on 30 May 2012 on the basis of which the Commission concluded that Hungary was experiencing serious imbalances, in particular as regards developments related to the net international investment position and implications of the high government debt.

**The updated AMR scoreboard showed that Hungary exceeded the indicative threshold in the case of four out of ten indicators in 2011.** In addition to the public debt ratio and the net international investment position (NIIP) standing at 81% of GDP and -105.9% of GDP, respectively, the private sector debt and the unemployment rate were also registered above the thresholds (with values of 167% and 10.7%, respectively). In line with the conclusion of the AMR, Hungary is subject to an in-depth review. To this end this IDR takes a broad view of the Hungarian economy in line with the scope of the surveillance under the Macroeconomic Imbalance Procedure (MIP).

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 country's growth potential in Section 3. Section 4 presents possible policy considerations.

## 2. MACROECONOMIC SITUATION AND POTENTIAL IMBALANCES

### 2.1. Macroeconomic scene setter

**Since Hungary had a high external financial exposure and a weak growth potential in the pre-crisis years, it was among the first economies to experience a sudden stop in 2008.** On the account of a sharp collapse in external and domestic demand, economic activity

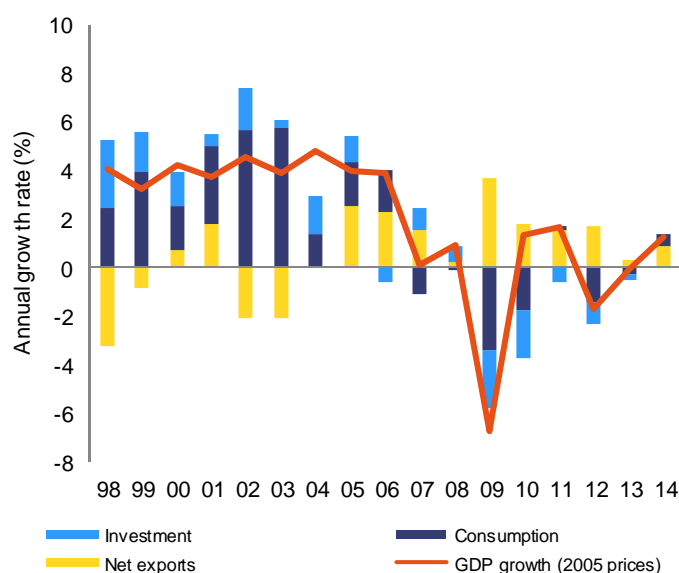
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<sup>1</sup> See European Commission (2013)

declined by around 6¾% in 2009. Following a macroeconomic adjustment programme agreed with the EU and IMF in the context of a EUR 20 bn financial assistance envelope, the situation stabilized and growth resumed in the second half of 2009. In 2010 and 2011, GDP grew at a modest rate of 1.3% and 1.6%, respectively. Growth was driven exclusively by the external balance, with the export sector performing well while domestic demand remained firmly in negative territory.

**The economic recovery was moderate and short lived with Hungary experiencing recession again in 2012 by -1.7% of GDP according to the Commission services' 2013 Winter forecast.** The negative GDP growth rate was mainly caused by a large drop in domestic demand, with all components (private and government consumption, investment and inventories) contributing negatively. On the production side, GDP was dragged down by a historically weak agricultural output due to a drought.

**Graph 1: External and domestic demand contributions to economic growth**



Source: AMECO

**A small decline in GDP (0.1%) is projected for 2013 by the Commission services, with a return to growth in 2014 by 1.3%.** While domestic demand is still expected to fall slightly this year, growth in 2014 is expected to be more broadly based. An improvement in export markets and a strengthened capacity of newly installed car production facilities contribute to a pick-up in exports, while domestic demand (including inventories) is expected to recover slowly to around 0.7% in 2014. Looser lending conditions are expected to help investment somewhat at the end of the forecast horizon, while moderating inflation is likely to support consumption growth.

**Hungary's recovery has been the weakest among Visegrád countries since the 2009 recession. This can be linked to the country's particularly weak growth potential showing a persistent stagnation since the start of the crisis.** Among the factors of potential

growth the contributions from productivity and capital accumulation seem to be particularly low. Productivity growth has been in the negative territory in recent years, while investment stands at historically low levels, just compensating for net amortisation.<sup>2</sup>

## 2.2. Sustainability of external positions

**After the NIIP of Hungary had risen persistently to exceptionally high levels (-117% of GDP) by 2009, it declined steadily (to around -106% of GDP in 2011) and is expected to come close to -103% by the end of 2012 (compared to a threshold of -35%).** Net external debt was around 52% of GDP in 2011, and is expected to remain close to half of the NIIP also in 2012.<sup>3</sup> The accumulation of the strongly negative NIIP until 2009 was primarily explained by the substantial current account deficits in many years prior to the crisis (averaging 7.5% of GDP in the 2000-2008 period), when the gradual improvements in the trade and transfer balances were not sufficient to counterbalance the structurally high factor income deficit (as explained in last year's IDR study).<sup>4</sup> Besides, the dividend-type income linked to the relatively large FDI stock (the latter amounting to 67% of GDP in 2011) the increasing interest expenditure related to both public and private foreign debt also contributed to the steadily growing factor income deficit, which peaked at close to 7.5% of GDP in 2007. Nevertheless, the high share of FDI in the NIIP position might alleviate somewhat the short- to medium-term sustainability concerns.

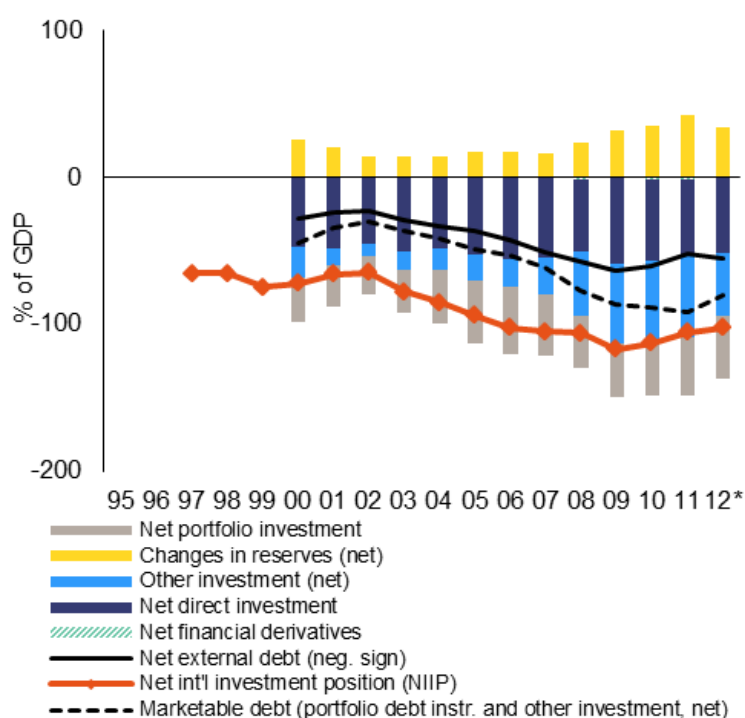
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<sup>2</sup> More details on potential growth can be found in section 3.1.

<sup>3</sup> It is worth distinguishing between liabilities that require the repayment of the principal by the home country in the foreseeable future and non-debt-generating (FDI) type of external liabilities. Due to its shorter term repayment profile and counter-cyclical interest payments, the increase in debt-generating financing brings higher vulnerabilities. Furthermore, FDI type financing is also associated with an increase in technology transfers. However, it is also important to stress that the rate of return on FDI is on average higher than the rate of interest on external debt, contributing *ceteris paribus* to a more negative income balance in the current account.

<sup>4</sup> European Commission (2012): Macroeconomic Imbalances – Hungary. European Economy, Occasional Papers. No. 106., Directorate General for Economic and Financial Affairs, Brussels

**Graph 2: Components of NIIP (BOP definition, % of GDP)**



Source: Eurostat, \*2012 is based on latest available quarterly data

**In the context of a sharp drop in real GDP in 2009 and the following lacklustre recovery, the current account balance turned positive.** The current account surplus stood around 1% of GDP in the 2010-2012 period. The turnaround from high deficits to a moderate surplus was partly driven by the rapidly contracting domestic demand, compressing imports, while export competitiveness rather deteriorated somewhat (for details see the next section). The recent current account surpluses are partly linked to the historically low investment rate in the corporate sector, but also factors like the increased precautionary savings of households, both of which are also to some extent structural phenomenon. Increased precautionary savings of households is linked to the increasing income uncertainty, most notably stemming from the high share of FX loans in lending to households and the possible impact of exchange rate fluctuations. Despite a declining share of FX debt by 23% after the early repayment scheme,<sup>5</sup> its share in outstanding household loans is still well above 50%. A 10% permanent depreciation of the HUF ceteris paribus increases household debt by close to 2 pp of GDP and the monthly debt service burden by close to 1 pp of disposable income.

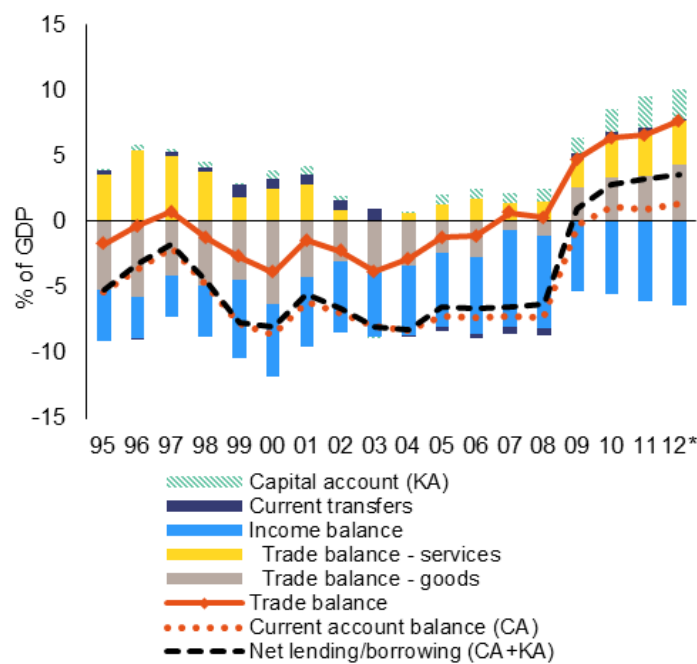
**The current account surplus is estimated in the Commission services' 2013 Winter forecast to have increased in 2012 to 2.3% of GDP. Moreover, it is projected to reach 3.3% and 3.6% of GDP in 2013 and 2014, respectively.** This is partly due a recovery in

<sup>5</sup> See more details on the scheme in section 3.3.



external demand, but also to the fact that exports should be further boosted by car industry investments. Finally it also shows that the weakness of domestic demand is expected to persist. Overall, the trade balance in goods and services is expected to reach 9% of GDP by 2013. This improvement will be to some extent counterbalanced by the projected increase in the factor income deficit as dividend-type income should move towards its pre-crisis level as the economy slowly recovers (increasing from the low point of 5.4% of GDP in 2009 to 6% of GDP in 2014). Given that EU structural fund inflows should further increase the surplus in the capital account (from 2.4% of GDP in 2011 to around 4% of GDP in 2014) net external lending could reach some 7.3% of GDP in 2014, compared to the level of 7.1% of GDP in 2013.

**Graph 3: Components of the current account balance (BOP definition, % of GDP)**

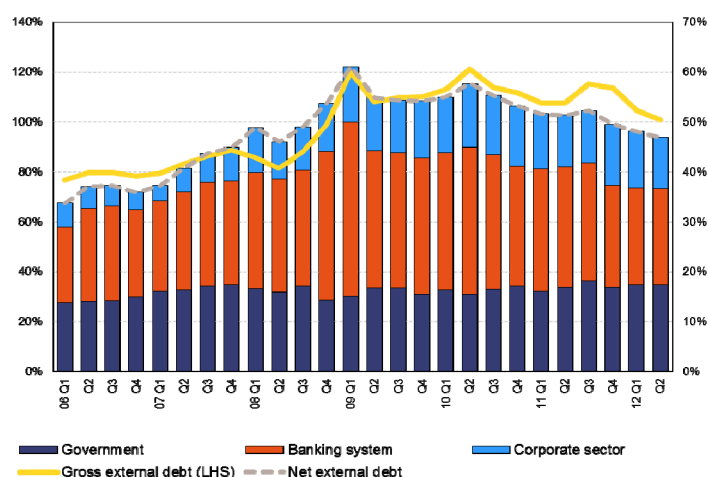


*Source: Eurostat, 2012 is based on latest available quarterly data*

**Despite the expectation that the negative NIIP will continue to decline swiftly, it is expected to remain at exceptional high levels in the next few years.** Assuming no other changes, the current and capital account projections of the Commission services' 2013 Winter forecast for the 2012-2014 period would imply a level of -88% of GDP by the end of 2014 from an expected level of around -102.5% of GDP in 2012. Nevertheless the high gross external borrowing requirement of the whole economy albeit decreasing, will remain a factor of fragility in the foreseeable future. Focusing on short-term external debt, EUR 30 bn per year will need to be rolled over by economic sectors in the coming years,<sup>6</sup> a magnitude that implies potentially important vulnerabilities in case of turbulent market conditions.

<sup>6</sup> Koroknai, P.– Lénárt-Odorán, R. (2012)

**Graph 4: Sectoral decomposition of net external debt (% of GDP)**



Source: MNB

Looking even further, the level of NIIP is currently anticipated to continue improving due to sustained trade surpluses, capital inflows from EU funds and somewhat improving growth dynamics. However, given the very negative starting position reaching the MIP indicative threshold of -35% of NIIP would require a decade. The Commission services' calculations on the basis of a number of simplified but plausible assumptions<sup>7</sup> for GDP growth and inflation show that Hungary would need to achieve a net lending surplus of around 4% of GDP on average over the 2012-2022 period in order bring its NIIP to below the MIP indicative threshold (-35% of GDP). Assuming that the net EU fund inflow to the country will slightly decline from levels foreseen in 2013-2014, the capital account could plausibly be projected to be in a surplus of around 2% of GDP in the coming decade (from a level of 3-4% of GDP foreseen for 2013-2014). Also taking into account this positive contribution, the necessary current account surplus to be sustained in the coming decade to bring the NIIP ratio to the much safer territory mentioned above is around 2% of GDP i.e. comparable to current levels.

**Risk scenarios regarding the evolution of the NIIP present a more nuanced picture.** Once the recovery in the economy is associated with a weaker competitiveness and a smaller trade balance (by 2 pp of GDP) compared to the economic assumptions contained in the above scenario (i.e. reaching the -35% NIIP threshold by 2022), this would, *ceteris paribus*, still point to a massive improvement in the negative NIIP by roughly halving it from its 2011 level to somewhat below -60% of GDP by 2022. In turn, a sustained lower economic growth by 1 pp would result in a more negative NIIP in 2022 by some 10 pp compared to the baseline scenario. Finally, if interest rates would remain at an elevated level by 200 bps

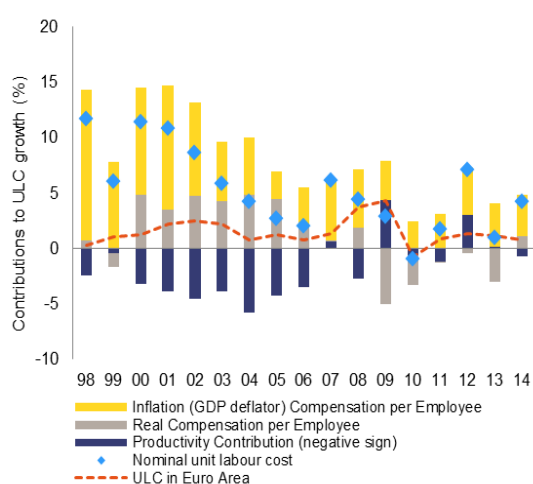
<sup>7</sup> See 2012 Fiscal sustainability report

compared to the baseline (a stronger hike was observable at the beginning of 2012), the NIIP would turn out to be in the neighbourhood of -55% of GDP at the end of the reference period.

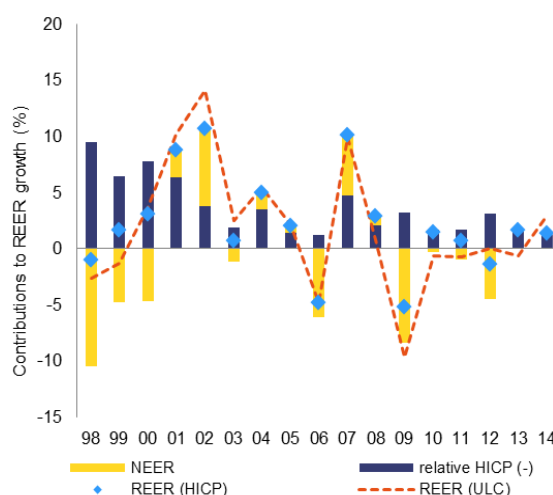
### 2.3. Competitiveness and trade performance

**The continuous rapid increase in the surplus of the trade balance in goods and services (from 0.3% of GDP in 2008 to an expected 9.6% of GDP in 2014) also reflects weaknesses in the economy.** An unsustainably low corporate investment rate and weak consumption keep domestic demand contained, while, as was argued above, export competitiveness did not change substantially, or even deteriorated as a result of counteracting forces.

Graph 5a: Decomposition of developments in ULCs



Graph 5b: Decomposition of REER\*



Source: AMECO

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

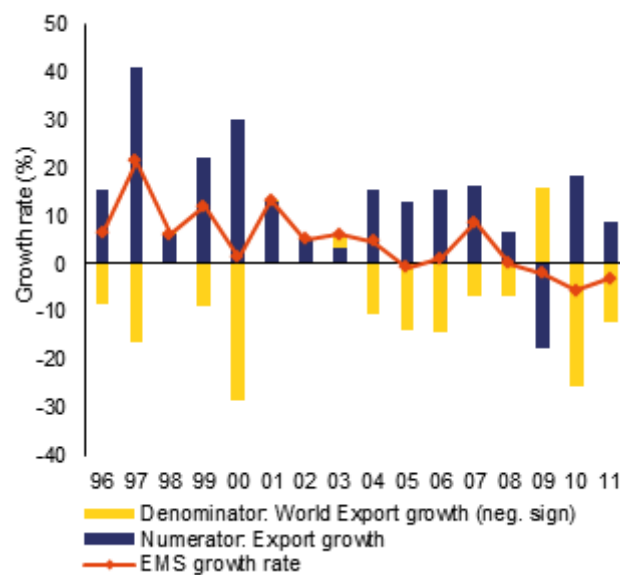
**Price competitiveness improved compared to pre-crisis levels mainly due to a substantial weakening of the exchange rate. However, despite the government's compensation scheme,<sup>8</sup> the substantial minimum wage hike in 2012 (19%) could have eroded these competitiveness gains somewhat due to spillover effects of minimum wage increases.** Although the scoreboard indicator on nominal unit labour costs (ULC) is not above the benchmark for 2011 (+3.7), it was quite high for most of the last decade, in

<sup>8</sup> In order to compensate employers for the labour cost increase resulting from the minimum wage increase and to ensure that the nominal net wages are maintained while the employment tax credit scheme is eliminated, the government introduced substantial wage subsidies to firms, most likely temporary and certainly decreasing over time.

particular for the traditionally non-tradable market services sectors (see also last year's IDR in this respect). The increases in nominal ULC had aggravated the deterioration of the cost competitiveness position of Hungary, as reflected in the increase of the real effective exchange rate (REER), which was also more pronounced at the beginning of the last decade. The crisis brought about a sharp depreciation in the ULC-based REER due to the nominal depreciation of the forint (mostly in 2009) as well as the successive declines in real compensation per employee and the decline in private sector employment in 2009 and 2010. Since then, cost competitiveness as measured by REERs broadly stagnated and has remained broadly unchanged also in 2012. Based on updated estimates using DG ECFIN's fundamental exchange rate equilibrium method,<sup>9</sup> the Hungarian REER in 2012 appears to be somewhat undervalued (by some 5%).

**Despite the improvement in price competitiveness, Hungary's recent export performance is weakening partly due to cyclical but also to structural non-price competitiveness factors.** This is demonstrated by the fact that Hungary's export market share turned into negative territory since 2009 after a period of virtually uninterrupted growth in the 1995-2008 period. In view of the high elasticity of Hungarian exports to world demand a falling market share could have been seen as cyclical in the early crisis years, but the negative tendency in the last years seems to be in part structural.

**Graph 6: Export market share growth (% y-o-y)**



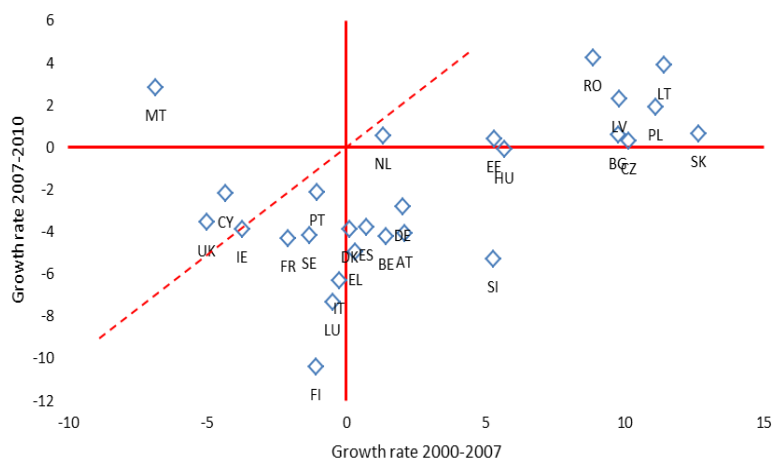
Source: Eurostat

<sup>9</sup> For the methodological approach see Salto and Turrini (2010).

**The marked decline of inward direct investment over the recent years contributed to a stagnating total stock of net foreign direct investment.** This also reflected relocation decisions of a number of multinational manufacturing companies, triggering the loss of productive capacities most notably in the electronic equipment sector. As was set out in detail in last year's IDR, this decline in FDI inflows is partly mirrored in the fall in the ratio of reinvested profits. However, there have also been counteracting tendencies; in particular, very substantial FDI investments (around 2% of GDP) into the automobile industry to some extent already increased or will increase in the coming years productive capacities in the automobile sector (by some 50%). Furthermore, the government has been signing strategic agreements with large multinationals, mostly in the manufacturing sector.<sup>10</sup> It is yet to be seen whether these latter trends will turn around the above described negative tendency in export performance.

**While the Hungarian export performance has been much better than the European average it has been lagging behind compared to that of regional peers.** In particular, the increase in Hungary's export market share has been weaker in the goods category, while the service sector was among the best performers in Europe. Nevertheless, even the service sector could only experience moderate increases in the export performance since the start of the financial crisis.

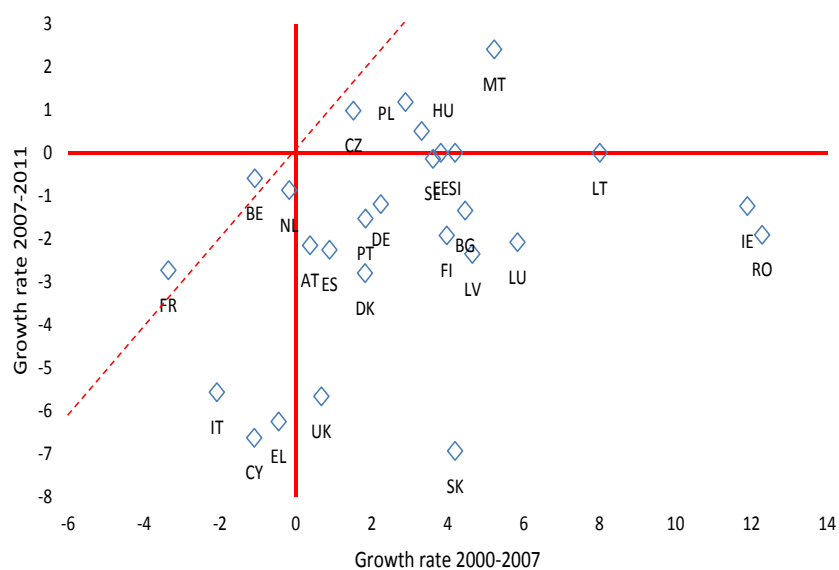
**Graph 7: World market share in goods (annual growth): before and during the crisis**



Source: Commission services' calculations based on UN COMTRADE data

<sup>10</sup> As of mid-February 2013, 15 strategic agreements were concluded (covering in total over 50 000 employees, or close to 3% of the headcount of the private corporations with more than 4 employees), and according to media information, the number of such agreements can even reach 40 over time. There is no uniform content of these deals, but mostly in exchange for the promise to expand investment and employment the government commits to cooperate closely with these companies.

**Graph 8: World market share in services (annual growth): before and during the crisis**



Source: Commission services' calculations based on UN COMTRADE data

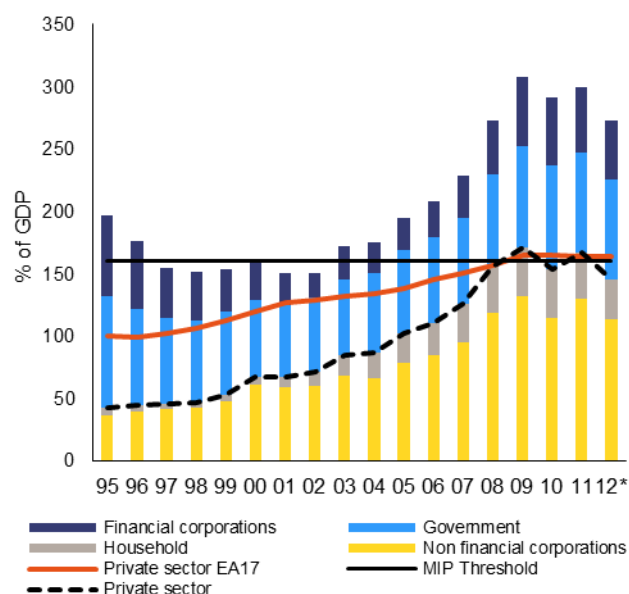
## 2.4. Private sector indebtedness

While private sector debt (167% of GDP) entered into the flashing territory again in 2011, this reflects the revaluation effect of a substantially weakened exchange rate. However, some statistical accounting differences in the non-financial sector debt data make a precise international comparison more difficult.<sup>11</sup> Private sector debt had almost tripled from 2000 to 2009 (when it peaked at 170% of GDP and thereby stood out among catching-up economies as discussed in last year's IDR). It then declined markedly in 2010 in the context of strong deleveraging (net private sector credit flow recorded a sharply negative -18.7% in that year). As regards 2011 and 2012, when looking at transaction based data for these years, the deleveraging continued as credits declined rapidly for both the household (7% and 14%, respectively) and corporate sectors (around 5% for both years). However, given the large share of FX denominated loans, especially in household mortgages (still close

<sup>11</sup> The non-financial private sector debt of Hungary is distorted by the different accounting practice of special purpose entities (SPEs) in the Hungarian statistics compared to other Member States. According to current practice, SPEs are classified as non-financial corporations in the Hungarian statistics. This practice deviates from that of other Member States in which SPEs and other SPE-type units engaged in financial intermediation are usually classified as being part of the financial corporations sector. For this reason, the non-financial private sector debt of Hungary in the EIP Scoreboard indicator is not comparable to the figures of many other Member States concerned. Debts of SPEs amounted to 17-34% of GDP in the last years, substantially increasing the indicator for Hungary. As these corporates are set-up for tax optimization purposes and do not have real economic relationship with residents, they should be distinguished from other companies. This comparability issue is being addressed by a Task Force at European level.

to 55%), in 2011, this effect could have been more than offset by the 12% depreciation of the forint compared to its end-2010 level.

**Graph 9: Decomposition of debt (% of GDP)**



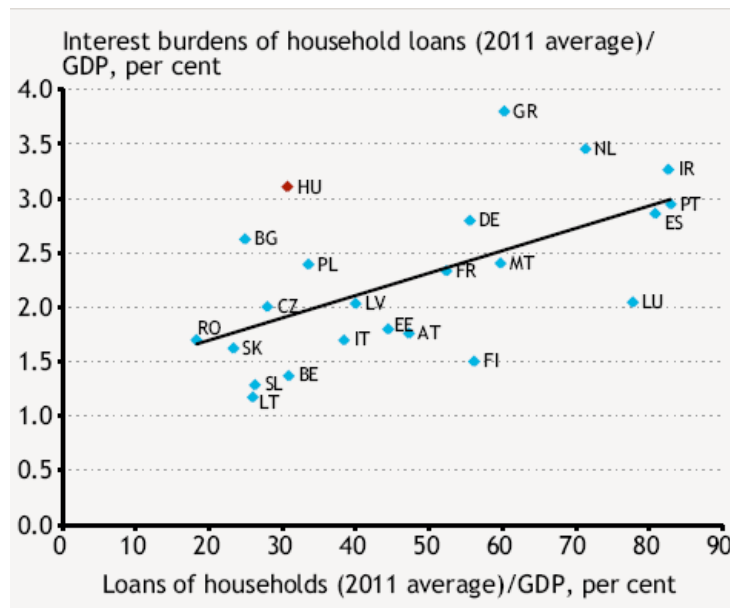
Source: Eurostat

While a meaningful degree of deleveraging has been inevitable especially in the household sector,<sup>12</sup> it is rather the monthly repayment burden than the level of debt, which seems to be particularly high. The monthly debt service is particularly elevated (especially compared to regional peers) due to the high interest rate burden.<sup>13</sup> The high interest rate burden is primarily linked to the high sovereign cost of the country, but interest rate margins in the household sector also stand out in international comparison. The latter can partially be explained by the quality of the bank's loan portfolio, but some competitiveness problems in the financial sector could also be highlighted. The latter is also reflected in the fact that despite recent decline in funding costs, the interest rate burden of households did not decline.

<sup>12</sup> Deleveraging pressures are discussed in more detail in section 3.3.

<sup>13</sup> See MNB's "Analysis of the convergence process, 2010."

**Graph 10: Interest burden and loan exposure of households**



Source: Fáykiss-Szigel (2012)

**The decline in household debt reflects to some extent 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.<sup>14</sup>** While this helped decreasing FX exposure of households, 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) and since the scheme helped primarily the most solvent debtors, the share of the problematic ones has increased in banks' portfolios. This is also reflected in the high household NPL rate of 16% in the first half of 2012. Based on final transaction based data, given that less than one-third of the repayments were financed from HUF loans, household debt was reduced by around 3.6% of GDP in Q4 2011-Q1 2012 (filtering out the exchange rate effect).

**Regarding corporate debt, the rapid decline not only reflects weaker and more uncertain growth prospects, but also extremely tight lending conditions of the banking sector, partly a result of policy uncertainty and permanent extra burdens on the financial sector (currently around 1½% of GDP).** The consequences of these policies on the country's growth potential and investment dynamics are analysed in detail in the next section of the study.

<sup>14</sup> See more details on this topic in the first IDR on Hungary published in May 2012.



## 2.5. Public sector indebtedness

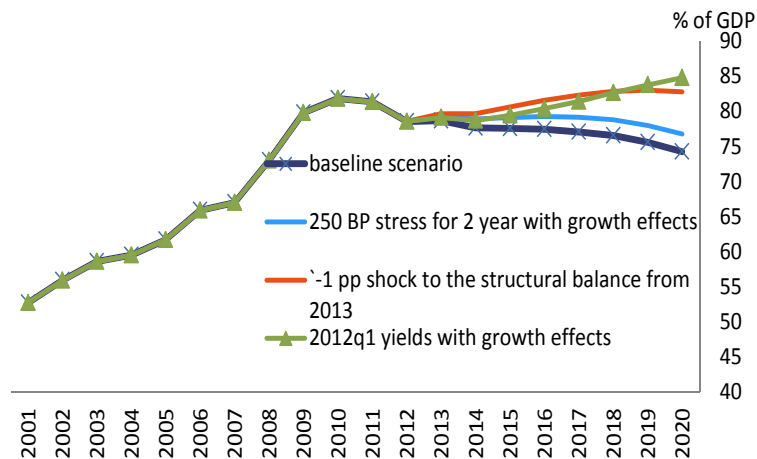
**The deleveraging in the private sector takes place in a context of efforts to reduce the high public debt level.** In 2011, gross public debt declined only slightly by less than half a percentage point to 81.4% of GDP. This small improvement is even linked to the huge one-off revenues from the abolition of the mandatory private pension scheme (9½% of GDP), a large part of which has already been used for debt reduction. However, this was almost fully 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. In 2012, after significant fiscal efforts (the structural balance improved by over 2½% of GDP) and some helpful revaluation effects as well as further debt repayments from the transferred pension assets, the debt-to-GDP ratio is estimated in the Commission services' 2013 Winter forecast to have declined by some 3 pps to 78.6%, and it is forecast to gradually decrease further to below 78% by 2014.

**While in the baseline scenario debt is expected to broadly stabilize at the current level, debt sustainability calculations show that it can turn to an increasing path if financing conditions deteriorate.** In the baseline scenario of the Commission services' medium-term projections<sup>15</sup> the debt-to-GDP ratio is expected to decline very slowly to around 74% until 2020. However, a detailed sensitivity analysis on alternative interest rate and growth assumptions compared to the baseline scenario reveals the vulnerability of the Hungarian situation. For instance if long-term interest rates would permanently stay at around 8.5% (a level comparable to the severe financial market stress in Q1 2012), debt would start to increase rapidly already from 2014 onwards, to reach 85% of GDP in 2020. A somewhat similar debt-increasing path could be the outcome of a one percentage point permanent deterioration in the structural balance. Therefore, although the assumed primary surpluses over the projection horizon help the decrease of public debt, the outlook is sensitive to alternative interest rate and growth scenarios, due to the combination of weak growth potential and relatively high financing costs and high starting debt level. In addition, as around 40% of the central government debt is denominated in foreign currency, a 10% permanent depreciation of the HUF ceteris paribus increases debt by 3 pp of GDP. Adverse market conditions might cause a combined negative shock to debt sustainability, e.g. increasing yields and a weaker exchange rate in parallel. Under these circumstances even worse outturns are imaginable compared to those presented on graph 11 as negative scenarios, with possible spillovers to private sector debt refinancing.

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<sup>15</sup> Using the projections for growth, real interest rates and the structural balance for 2013 and 2014 of the Commission services' Winter 2013 forecast, while keeping the structural balance constant and using the assumptions of the 2012 Ageing report with a real interest rate around 3-3.5%, and growth rates of around 1% thereafter.

**Graph 11: Public debt scenarios**



*Source: Commission services*

**Unfavourable alternative scenarios are not highly unlikely given the possibility of negative market reactions if foreign investors' risk appetite decreases in general and for Hungary in particular, as the high share of FX and foreign ownership in public debt and also the high gross annual public refinancing needs (close to 20% of GDP for 2013) are important sources of concerns.** In the context of favourable global market conditions for most of 2012, maturing FX public debt (notably over EUR 3.5 bn of IMF repayments) was renewed from stepped up issuance of HUF-denominated bills and bonds (including also the doubling of retail securities over the course of 2012) and existing liquid reserves. This coupled with the marked appreciation of the forint compared to the early 2012 levels (close to 10%) reduced the FX share of public debt from around 50% to just below 40% at the end of the year. However, non-residents play an increasingly significant role in the domestic bond market: throughout 2012 their holdings set successive all-time records and by end-year they owned slightly over HUF 5000 bn of papers, or close to 44% in terms of market share. In sum, some two-thirds of the public debt is owned by non-residents. This means that the country is highly exposed to sudden changes in market sentiment, as it happened in October 2008 when the first EU and IMF support programme was requested and provided.<sup>16</sup>

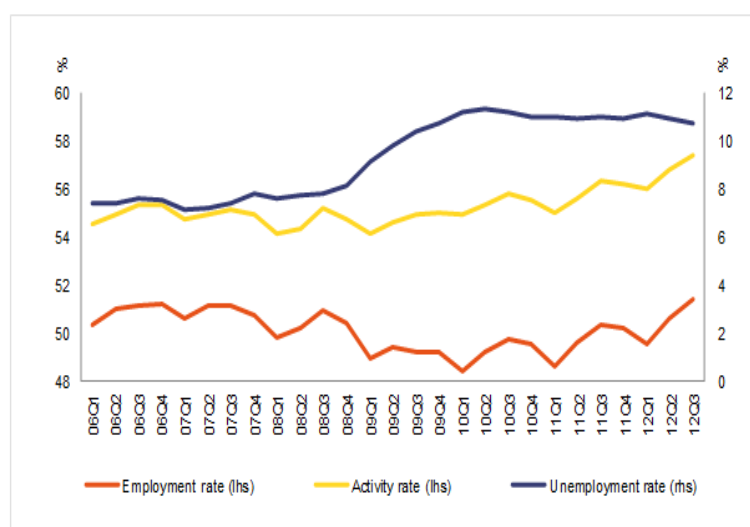
## 2.6. Labour market developments

**Although the indicator on unemployment (3-year average) has exceeded the MIP indicator threshold in 2011 (10.7% against 10%), there have been moderate improvements in the area of the labour markets.** In particular, most recent figures indicate that the employment rate reached its pre-crisis level (at 51%, see graph below). This occurred

<sup>16</sup> On the first BoP assistance programme see the following link:  
[http://ec.europa.eu/economy\\_finance/assistance\\_eu\\_ms/hungary/index\\_en.htm](http://ec.europa.eu/economy_finance/assistance_eu_ms/hungary/index_en.htm)

in parallel with a steadily increasing activity rate (some 2 pps to 57% from pre-crisis levels). Over the last two years, the government introduced numerous reforms to stimulate labour market supply, including notably a massive tightening in social benefits and the elimination of early retirement schemes from 1 January 2012. The drastic cut in unemployment benefits has been rather controversial, notably from an efficiency point of view.<sup>17</sup> Therefore, in spite of its recent decline, unemployment remained relatively high basically due to increasing participation rather than to a loss in employment. In the Commission services' 2013 Winter Forecast, the unemployment rate is projected to remain in double digits (i.e. implying that the 3-year average would remain somewhat above the indicative threshold) over the entire forecast horizon.

**Graph 12: Key labour market statistics in Hungary (age group 15-74)**



Source: Eurostat

**While it is important to recognise Hungary's achievements in increasing the supply side of the labour market as part of its structural reform programme, a few caveats remain.** First, close to half of the recent increase is linked to the stepping up of Public Work Schemes (PWS) and so far there is no tangible sign of transition from public employment to the private sector.<sup>18</sup> Based on empirical studies, there is a clear risk that participants will remain in the circle of public work-benefit-public work for a long period, especially in those parts of the country where the open labour market is unable to offer real possibilities. Second, it is questionable whether there can be a sustainable increase in private sector employment as long as the growth potential is weak and there is a lack of investment. Third, as the public work

<sup>17</sup> Shortening the unemployment benefits to three months might result in increasing skill mismatches as this period is unusually short on average to find a new job for skilled labour. See MNB (2011) on this subject.

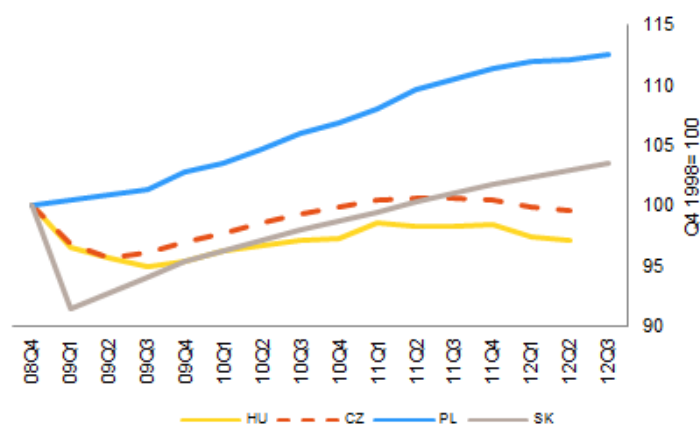
<sup>18</sup> See for example Fazekas-Kézdi (2012). Improving the training element of the PWSs would be especially warranted as proposed in CSR 4.

wage is lower than the minimum wage, in some low wage non-government dominated sectors that are also covered by public work programmes (like agriculture, construction), there is an increasing risk that the latter can crowd out private sector companies. Overall, it is yet to be seen whether the recently adopted Job Protection Act, which contains sizeable cuts in social security contributions for certain target groups (and can be considered a step towards improving labour tax incentives) can counterbalance the negative labour supply effects of the full abolishment of the employment tax credit, which increased taxation of low-income earners substantially as of 2012.

### 3. IN-DEPTH ANALYSIS OF SELECTED TOPICS: THE UNDERLYING REASONS OF HUNGARY'S LOW GROWTH POTENTIAL

After a weak recovery from the sharp recession in 2009, Hungary was the first among central and eastern European (CEE) countries to enter into a recession again this year. Although on the one hand, macroeconomic imbalances are declining as persistent current and capital account surpluses decrease the NIIP ratio, high debt levels combined with high financing costs and a weak growth outlook keep the country vulnerable. This section investigates the underlying reasons of the weak growth potential of the country. In the first section existing results on potential output calculations are reviewed, including the role of different inputs. The second section discusses the possible behavioural effect of recent tax developments, most notably in light of sectoral taxes introduced in the country. Finally, the impact of financial sector deleveraging is discussed.

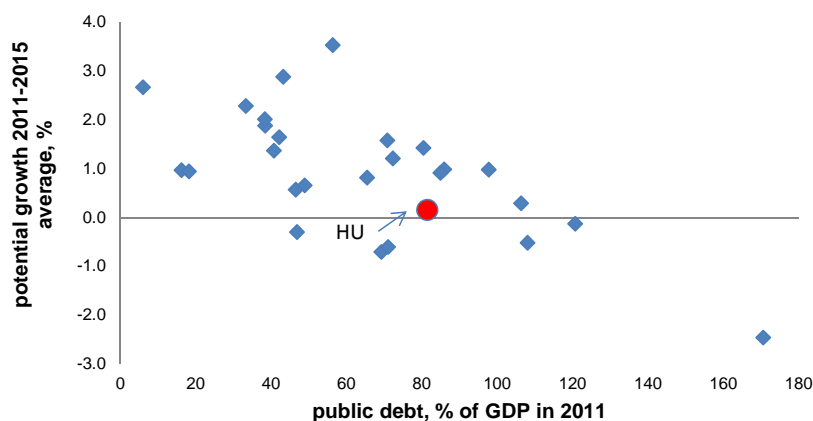
Graph 13: GDP in Hungary and Visegrád countries<sup>19</sup>



Source: Eurostat

<sup>19</sup> Visegrád countries are the Czech Republic, Hungary, Poland and Slovakia.

Graph 14: Public debt and potential GDP growth



Source: Eurostat and Commission services

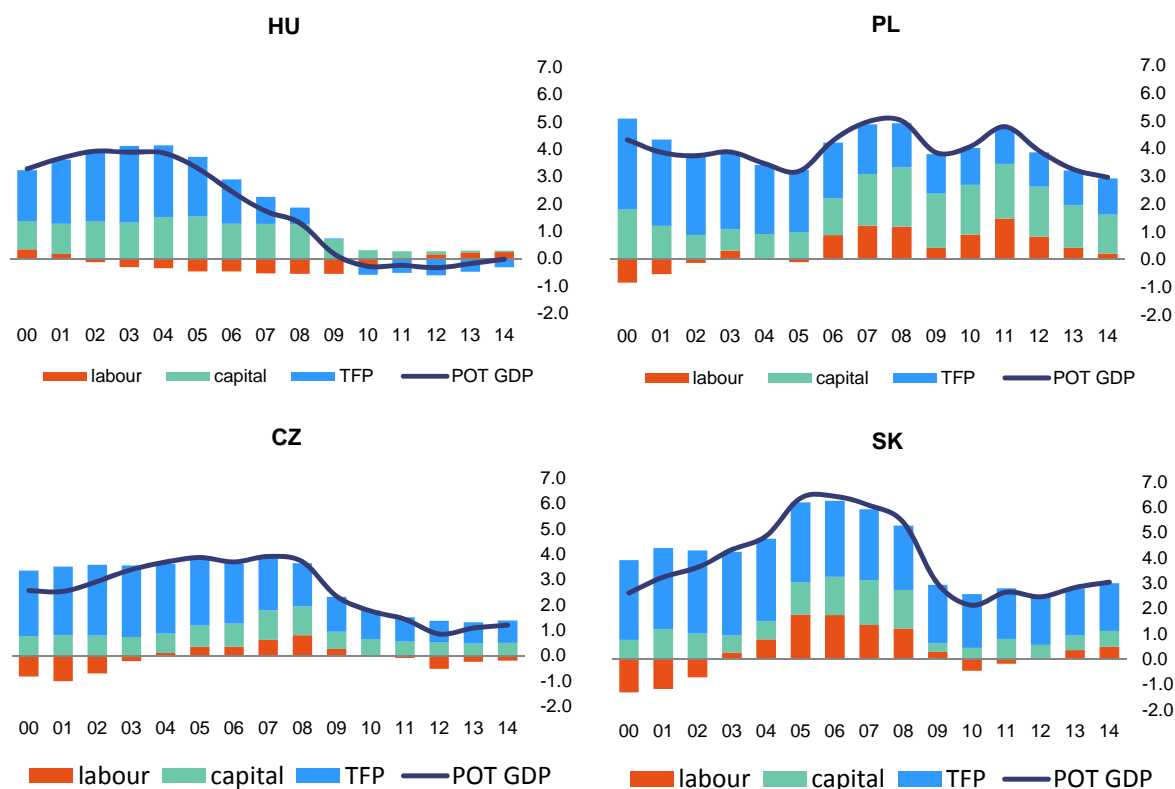
### 3.1. An analysis of potential growth: past tendencies and prospects

Hungary's potential growth seems to lag behind regional competitors. While in the case of the country a gradual slowdown was observable in the second part of the last decade, potential growth for the Czech Republic, Poland and Slovakia remained stable or even increased.<sup>20</sup> The crisis has contributed to a sizeable slowdown in all countries, but given its unfavourable starting position, potential growth came practically to a halt in Hungary.

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<sup>20</sup> A detailed description of the calculation of the Commission's potential growth methodology can be found in D'Auria et. al. (2010).

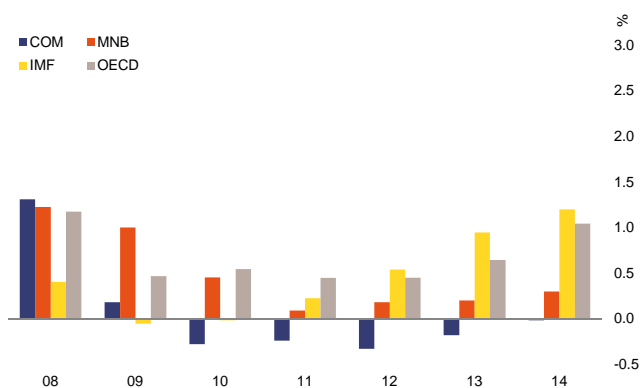
**Graph 15: Potential output based on the Commission's methodology in Hungary and Visegrád countries**



Source: Commission services

It should be also noted that the current assessment of a relatively low potential growth rate in Hungary is broadly shared among other institutions (IMF, OECD).

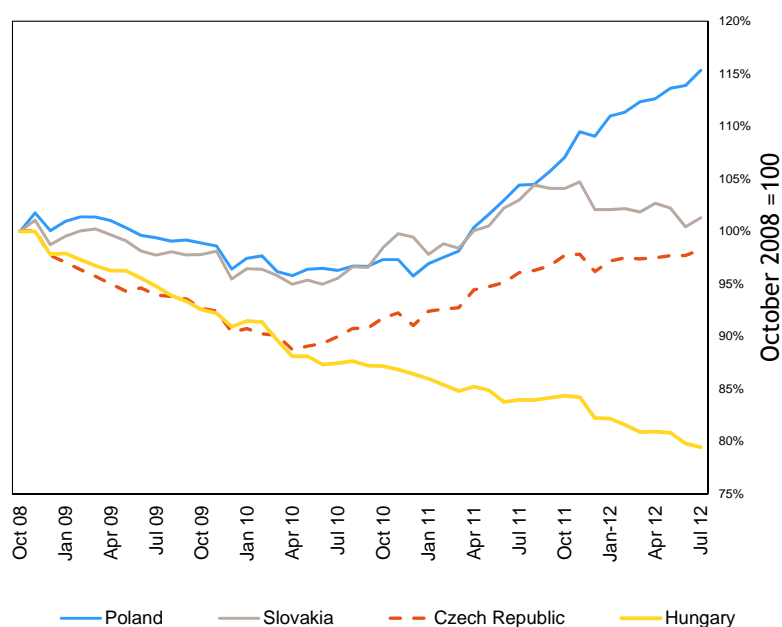
**Graph 16: Potential growth outlook of Hungary according to different institutions**



Source: Commission's services Winter Forecast, OECD iLibrary, December 2012, IMF WEO 2012, MNB, Quarterly Report on Inflation, September 2012

Looking at the factors behind potential growth reveals that it is TFP and capital accumulation where the country clearly lags behind compared to regional peers. By contrast, there have been some improvements compared to pre-crisis trends as regards the labour market. According to the current assessment contained in the Commission services' Winter 2013 forecast, capital and labour are making a moderately positive contribution to growth while TFP is making a negative one.<sup>21</sup> In a financial crisis, opposing factors are at work on TFP.<sup>22</sup> On the one hand, problems with financial intermediation can decrease TFP, while increased competitive pressure and the closure of inefficient plants can increase it. As discussed in chapter 2 and also in more detail in chapter 3.3, since the start of the crisis lending to both the corporate and household sectors has been declining. The scale of the decline in the corporate sector is exceptionally high when compared internationally.

Graph 17: Corporate sector lending in Visegrád countries



Source: MNB (2012)

A possible reason behind the very low and recently even negative TFP is the problem with financial intermediation. In countries with extremely high loan supply pressures, productive companies can fall out of business easily.<sup>23</sup> This seems all the more likely as TFP growth before the crisis was solid and comparable to other Visegrád countries. As there

<sup>21</sup> TFP reflects the efficiency in the use of inputs, which are combined during the production process. This efficiency depends on a couple of factors including management capabilities, educational experience, skill level of the staff, the competition environment and also financial conditions.

<sup>22</sup> See for example D'Auria et. al. (2010).

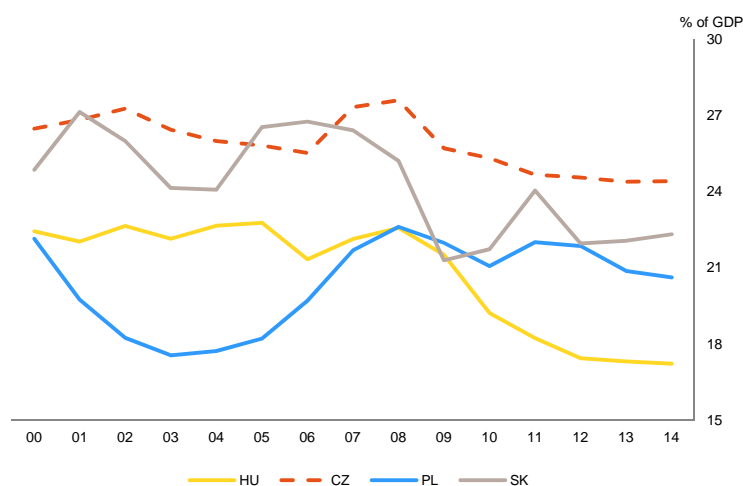
<sup>23</sup> Negative TFP growth rates are observable also in Greece and Cyprus, countries with loan supply pressures similar to Hungary. See also section 3.3. on this subject.



has been some back-ward steps in terms of service sector competitiveness,<sup>24</sup> this can also justify the decrease in productivity.

**The declining contribution of capital is a reflection of a historically low investment rate in the economy.** This latter was above 20% in the decade prior to the financial crisis, comparable to other countries in the region. Since then, it has decreased to around 17% of GDP while remaining at their pre-crisis level in Visegrád countries. It is not clear to what extent this decline reflects demand or supply factors. On the one hand, from the demand side, increased economic uncertainty during the crisis, with an increasing share of sectoral surtaxes on the corporate sector could have contributed to lower investment incentives for firms. In addition, a natural deleveraging process has taken place most notably in the household sector. On the other hand, financial sector deleveraging, which has also been triggered by extra burdens on the sector, caused tight credit supply that has been also detrimental to investment (see also 3.3. on this subject).

**Graph 18: Investment rate (investment/GDP) in Hungary and Visegrád countries**

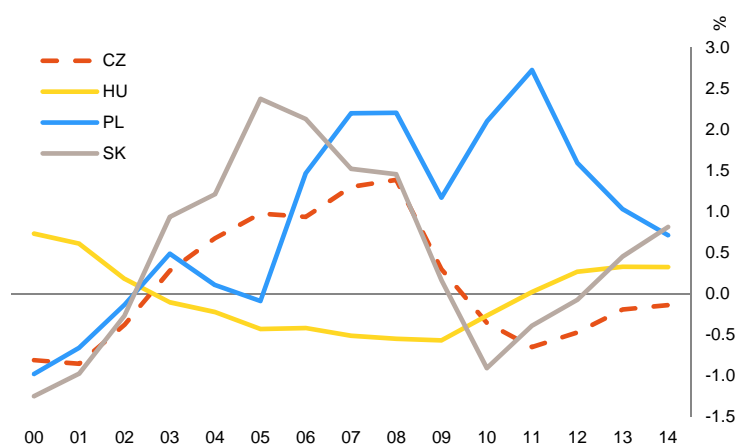


Source: Eurostat

<sup>24</sup> In addition to increasing burdens of the financial sector, corporate tax burden on several other service sector segments have been increased (e.g. telecom, energy, retail). See also chapter 3.2 on this subject. Furthermore, recent steps to increase entry costs in certain service sector segments (e.g. plaza stop, ownership and corporate governance restrictions in the pharmaceutical sectors) are also not helpful from the point of view of medium term productivity growth.

**Finally, the contribution of employment to potential growth has improved recently, and it is comparable to other countries in the region.** This tendency is largely linked to policy measures designed to increase the participation rate (that lowered the replacement ratio and tightened eligibility conditions for pensions as well as other social transfers). However, the persistent rise in the participation rate has not been accompanied by a proportional increase in employment. Therefore unemployment rose persistently above 10%. After a marked fall of above 5% (from Q3 2008 to Q1 2010), employment gradually returned to pre-crisis levels this year. However close to half of the employment increase can be linked to the Public Work Schemes, while the sustainability of an increase in private sector employment is questionable given the low level of investment and the lack of productivity growth.

**Graph 19: Growth of trend employment rate in Hungary and Visegrád countries**



*Source: Commission services*

### 3.2. Recent changes in the corporate tax system and their potential behavioural effects

In 2010 the incoming government set itself the goal to reduce the overall corporate income tax rate by introducing a fully flat rate of 10% by 2013.<sup>25</sup> While this ambition has been reviewed in the Széll Kálmán reform programme, which postponed the elimination of the higher corporate income tax rate, special tax regimes for corporations have been created for small and medium-sized companies both in the form of an effective preferential corporate income tax rate (already in 2010) and through targeted tax schemes (from 2013). In parallel, surtaxes<sup>26</sup> on corporations in specific sectors have been applied and extended to raise revenues to counterbalance costs of preferential corporate tax regimes for SMEs and cuts in labour taxes, several rising expenditure items, the phasing out of temporary tax elements in order to keep fiscal consolidation on track. Importantly, only selected sectors face a higher tax burden, while small and medium-sized companies are eligible for preferential corporate income tax rates as well as targeted tax schemes.<sup>27</sup>

**Revenues from sectoral taxes have gradually increased from ½% to 2½% of GDP from 2009 to 2013** (see graph 20). This comes in addition to the revenues of around 1% of GDP from the standard corporate income taxes and 1½% of GDP from the local business tax. Although some sectoral surtaxes were introduced already before 2010 (such as those on credit institutions, pharmaceutical companies and energy service providers), their magnitude was minor compared to the overall size of the budget and was also limited compared to the profits in the sectors concerned. In 2010, as part of budgetary corrective measures, further significant (above 1% of GDP) but temporary surtaxes were introduced in the financial, energy, telecom and retail sectors. In 2011, the tax burden on the pharmaceutical companies was close to doubled. In 2012, the government announced the replacement of temporary surtaxes by permanent taxes. In particular, a new permanent tax based on minutes of phone calls and the number of short messages sent was introduced in the telecom sector already in mid-2012, while other permanent sectoral taxes in the utilities

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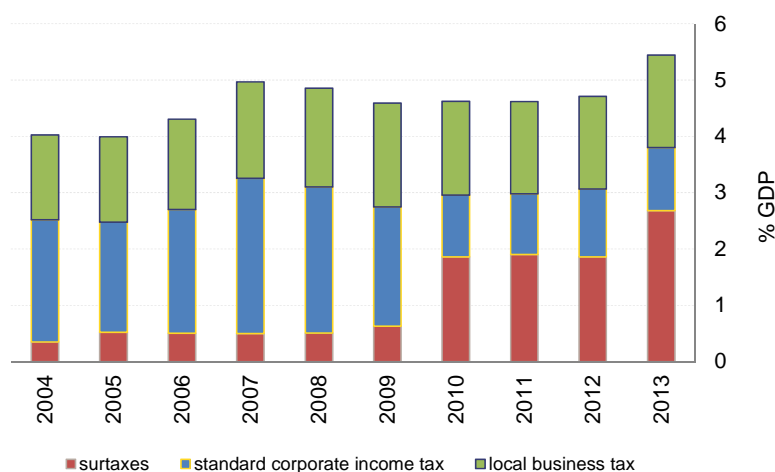
<sup>25</sup> In this section we use the term of "Taxes on Corporations" to refer to all taxes that targets the corporate sector, including corporate income taxes, taxes on stocks of capital owned by the corporate sector and other surtaxes on corporations.

<sup>26</sup> Surtaxes are levied in specifically on activities in given sectors in addition to the general corporate income taxes.

<sup>27</sup> The design of some of the sectoral taxes may also discriminate against foreign-owned operators. The sectoral taxes on retail and on telecommunications sectors have been subject to infringement procedures as the progressivity of the taxes – uniquely tailored and applicable to the respective sectors – were found to be disproportionately falling on foreign-owned operators.

sector were launched in 2013.<sup>28</sup> In addition, the progressive surtax on the financial sector whose base is the 2009 balance sheet was announced to be maintained as a permanent tax contrary to an earlier agreement with the banking sector (to be halved in 2013 and further lowered from 2014). Furthermore, a consumption-type insurance tax was introduced as of 2013. Finally, a new financial transaction duty was introduced from 2013, and after the exclusion of central bank transactions from the tax base<sup>29</sup> its rate was increased from 0.1% to 0.2% (and to 0.3% in case of cash withdrawal).<sup>30</sup>

**Graph 20: Hungary: Taxes on corporations as a % of GDP**



Source: Commission services' calculations

**It should be stressed that (sur)taxes on corporations may have negative incentive effects, especially when inputs to production are not exempted. In particular, they may impact on economic growth via several channels, notably through their potential distortionary impact on investment and productivity.<sup>31</sup>** In the current Hungarian case investment may be reduced not only due to diminishing after-tax return but also in light of the fast deleveraging process in the financial sector, which could also reflect the impact of the very high surtaxes on financial institutions (see details in 3.3.). Besides, frequent changes of taxes may also have

<sup>28</sup> The 8% surtax introduced in 2009 on the (adjusted) pre-tax profit of energy suppliers was extended to other utilities in 2013 and the rate was increased to 31 %, i.e. the de facto corporate income tax rate of subjected companies increased to 50 %. Additionally, pipelines and other utility networks bear an extra tax as of 2013.

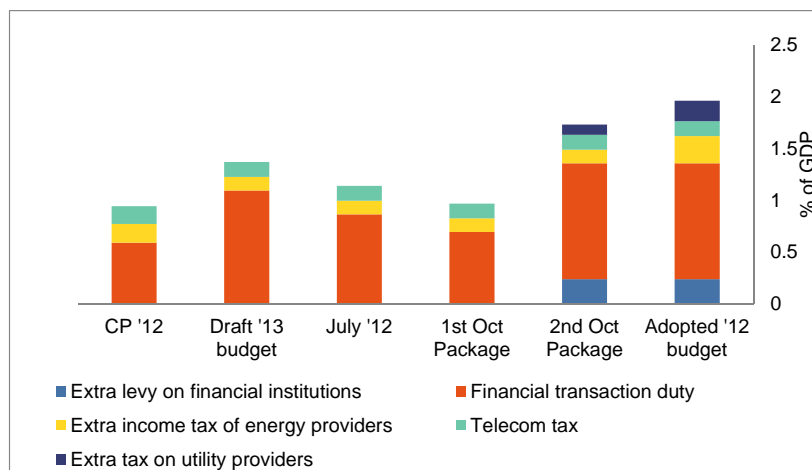
<sup>29</sup> The first version of the act on the financial transaction duty (adopted on 9 July 2012) seemed to breach the independence of the central bank and the prohibition of monetary financing. After several rounds of modifications, the final law (adopted on 19 November 2012) exempted central bank transactions from the duty.

<sup>30</sup> It is worth mentioning that in the case of the local business tax the full deductibility of intermediate goods and services from the turnover has been eliminated for bigger firms, which is expected to affect mostly those companies that have high intermediate costs while their profit margins are limited, namely the retail and energy companies.

<sup>31</sup> See Johanson et. al. (2008) and Mirrlees et. al (2011).

a negative impact on investment by creating an uncertain business environment. Recent changes in the design and rates of the Hungarian corporate taxation, a growing number of sectors subject to surtaxes and the replacement of temporary sectoral taxes with permanent ones even against earlier agreements could have such an effect (see graph 21).

**Graph 21: Size of the new surtaxes on corporations in 2013 as a % of GDP**



*Source: Commission services' calculations*

**From the point of view of a catching-up country, it is also important that high taxes on corporations may also discourage inbound foreign direct investment.** In addition, to the extent that taxes on corporations reduce FDI and the presence of foreign multinational enterprises they can hinder technology transfers and knowledge spill-overs to domestic firms.

**The introduction of specific sectoral taxes also tends to artificially reallocate capital inputs between sectors, creating economic inefficiencies.** This is particularly true when those specific surcharges cannot be justified by the exemption to other taxes<sup>32</sup> or by the existence of sector-specific rents. However, in these latter cases sectoral taxes should be designed in a way that they respectively mimic the exempted base or capture the rent and also do not have a detrimental effect on investment incentives due to an excessive size.

**The investment ratio has declined to its historical low level (17%) and investment is most subdued in sectors particularly hit by surtaxes.** Moreover, the reinvested earnings of foreign companies fell to their historically lowest level. A possible sign of the worsening of the business environment is the deterioration of Hungary's position in selected competitiveness surveys, like the Global Competitiveness Report, where the country has lost 12 places compared to the previous year.

<sup>32</sup> The exemption of the financial sector to VAT could call for compensatory taxes.

### 3.3 Credit market conditions' impact on deleveraging

**As discussed in section 2, private sector debt rose somewhat above the threshold level of 155% of GDP in 2011, although already declined slightly below to around 152% in 2012, based on quarterly data. While the current level ( level is not especially high compared to the European average, private sector debt is well above that of regional peers and also taking into account Hungary's development level. Further fragility comes from the high repayment burden, due to the relatively high interest rates compared to developed countries.<sup>33</sup> Therefore the need for private sector deleveraging has been evident since the start of the crisis.**

**There is also a deleveraging pressure from the credit supply point of view.** The need for banks to roll over high levels of external funding and their decreasing risk tolerance have also contributed to a tendency to decrease loan-to-value ratios, partly through the tightening of lending conditions.

**The deleveraging pressure has been also incentivised by government policies in the recent past, which contributed to a fast decline in external debt and a continuous fall in both corporate and household credit.** On the credit demand side, the early repayment scheme of the government, introduced in late 2011 and which allowed households to repay their FX debt at a predetermined exchange rate level much stronger than the market rate should be mentioned. On the one hand this measure contributed to a fall by 23% in outstanding household FX loans and decreasing the FX exposure. However, the scheme also had a negative effect on banking sector profitability of around 0.9% of GDP, contributing to sizeable losses in 2011 (a return on equity of -3.9%).<sup>34</sup> The low level of profitability may have contributed to the decline in funds allocated to the country, and consequently may have had a negative effect on credit supply. Credit supply pressures have been further exaggerated by the extra tax burden on the financial sector, which gradually increased from 0.03% to 1½% of GDP from 2009 to 2013 (as indicated in the previous sub-section).

**In addition to lower risk tolerance after the financial crisis, high sovereign spreads and increasing non-performing loan (NPL) rates have also increased banks' risk aversion. As foreign funding of the banking sector is closely linked to the sovereign's funding cost, sovereign risks and the banking sector's credit supply behaviour are strongly connected through this channel.** In a recent paper<sup>35</sup> loan supply pressures among Hungarian banks were identified as one of the strongest in Europe. These pressures have a clear linkage with the pace of adjustment in the banking sector. The presence of international banks in Hungary has been declining steadily, while these banks broadly kept their position in other Visegrád countries.

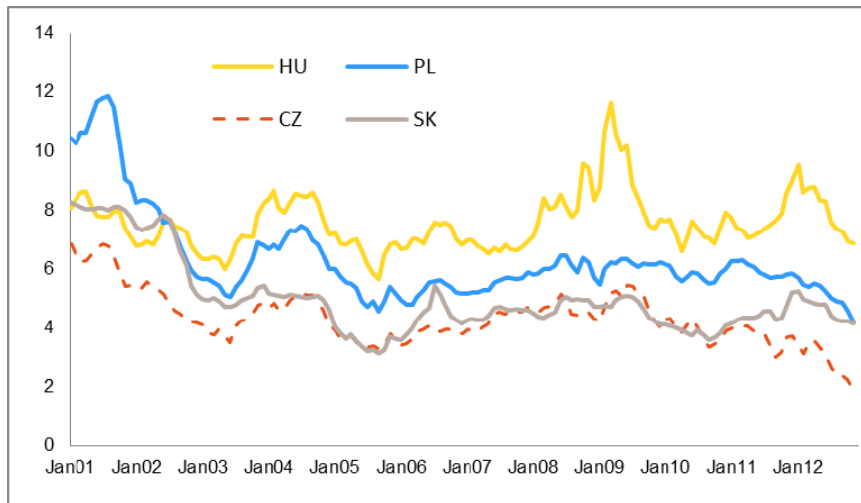
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<sup>33</sup> See MNB (2010) on this issue.

<sup>34</sup> See HFSA (2012).

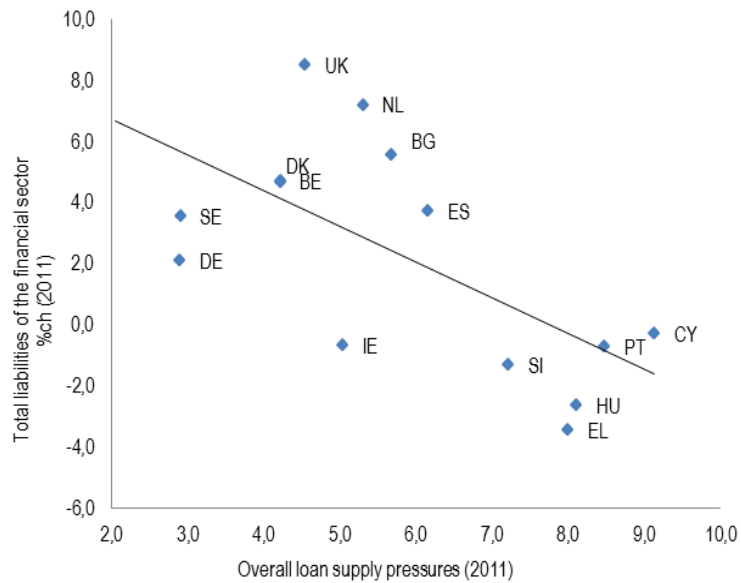
<sup>35</sup> See ECFIN (2012).

**Graph 22: 10 year government bond yields in Visegrád countries (monthly average)**



Source: Eurostat

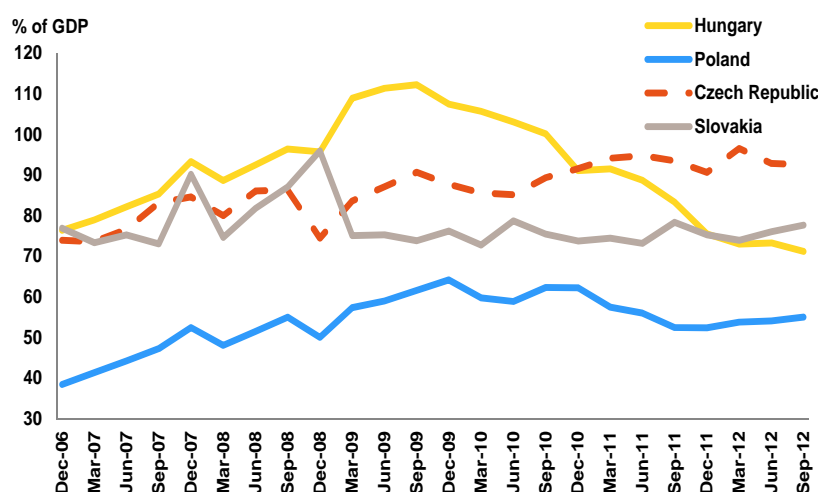
**Graph 23: Loan supply pressures and the liabilities of the banking sector\***



Source: Commission services

\*Loan supply pressure is a composite indicator of banks' financial conditions bounded between 0 and 10. This contains the NPL rate, banks profitability, capital adequacy, sovereign CDS and results from lending surveys. See more detail in ECFIN (2012)

Graph 24: Foreign banks' exposure in Visegrád Countries



\*Source: BIS

While the Hungarian banking sector seems to be well capitalised (with capital adequacy ratios around 15%), bank lending surveys for the corporate sector in Hungary show a persistent tightening of lending conditions, mentioning a decreasing willingness to lend as the primary reason. This means that currently the financial sector has a very negative contribution to economic growth in Hungary. Though deleveraging can be considered as an equilibrium phenomenon due to the high level of private sector debt, high share of nonperforming assets in their portfolio, government measures contributed to supply pressures that are among the highest in Europe. Based on most recent calculations of the Hungarian central bank the contribution of the financial sector to economic growth (the new financial condition index) has been highly negative since the start of the crisis and has been even increasing recently, to around -2% annually.<sup>36</sup>

Overall it seems that household deleveraging is primarily demand driven, while corporate sector deleveraging is rather supply driven.<sup>37</sup> An updated estimate of Kiss et. al. (2006) on a large panel of countries indicates<sup>38</sup> that household debt to GDP reached or even exceeded its equilibrium level by 2008, but this was not the case in the corporate sector. The possibility of decreasing demand in corporate credit is also less likely from the point of view of loan duration. Since the crisis due to increased economic uncertainty, long-term loans decreased more than short-term ones in most countries. As long-term loans are more dominant in the household sector, decreasing credit demand should be more obvious in this

<sup>36</sup> See MNB (2012).

<sup>37</sup> See also MNB (2012) "Report on Financial Stability", November.

<sup>38</sup> See MNB (2010).



case.<sup>39</sup> In either case, the exact size of pressure is uncertain, as the debt level is subject to uncertainty since the part that is denominated in FX (around 55% in both the household and corporate sector) is subject to exchange rate fluctuations and therefore also to market sentiment.

#### 4. POLICY CHALLENGES

**The analysis in sections 2 and 3 indicates that macroeconomic developments in the areas of net international investment position (NIIP), public and private debt are the main challenges for Hungary, together with the need to improve the business environment and competitiveness in order to increase the country's growth potential and employment opportunities.** It should be recalled that these challenges were identified under the MIP in the first IDR and relevant policy responses were reflected and integrated in the country-specific recommendations issued for Hungary in July 2012. The assessment of progress in the implementation of those recommendations will take place in the context of the assessment of the Hungarian National Reform Programme and Stability programme under the European Semester. Against this background, this section discusses different avenues that could be envisaged to address the challenges identified in this IDR

**Last year's IDR already showed that Hungary was experiencing macroeconomic imbalances, most notably in the form of a highly negative NIIP and a high public debt. This updated assessment has come to the conclusion that since last year, an adjustment of these macroeconomic imbalances is on-going. However, there some caveats in the process.** First of all, the current account surplus and steadily declining NIIP primarily reflects private sector adjustment, although there has been a structural adjustment in the public sector of close to 3% between 2008 and 2012. While private sector deleveraging is necessary to correct imbalances most notably in the household sector, the rapid fall in corporate credit, against the background of policy uncertainty and extra burdens on the financial sector, has contributed to historically low investment rates. This, in turn, has eroded the country's growth potential. At the same time the reduction of public sector debt in 2011, which is also high compared to regional peers, decreased only slightly mainly on account of one-off capital transfers. In 2012, after significant fiscal efforts (2½% of GDP in structural terms), a further sale of pension assets and some helpful revaluation effects, public debt declined further. However the current account surplus still reflects high private sector savings and the lack of investment, rather than a substantially increased net savings in the public sector.

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<sup>39</sup>On the contrary, recent analysis of the Commission services has concluded that there were demand side deleveraging pressures in the corporate sector, but not in the household sector. Part of the difference can come from the fact that the latter analysis includes special purpose entities in the corporate sector which distorts the Hungarian figures upwards. On the other hand, the high monthly repayment burden in the household is not included in the analysis. See ECFIN (2012)

Overall, Hungary is facing the following policy challenges.

**The most important policy challenge is to create a more business friendly environment.**

The reliability and stability of the institutional framework is very important in this respect. During the last year several steps (including the adoption of the amended central bank law, an increase in the analytical remit of the Fiscal Council) were taken, which should be welcomed. However, the predictability of economic policies, including tax changes is also an important element of business conditions. Recent tax policy changes have not improved the operational environment, most notably for large firms in the service sector. Ensuring a stable regulatory and business-friendly environment for financial and non-financial enterprises, including foreign direct investors, was also recommended by the Council under the European Semester in 2012. Economic convergence to EU-15 member states would require lifting the investment rate and raising productivity. Given Hungary's lower GDP per capita and its distance from the technological frontier, a successful catch-up strategy cannot be expected without the continuing reliance on foreign capital and funding. This would necessitate increased policy predictability and a revision of the corporate tax system, where the high reliance of corporate surtaxes on some certain sectors most notably on the financial sector should be decreased. However this should be done without endangering the achievement of the fiscal targets. Therefore a broad revision of the budget both on the revenue and expenditure side may be necessary.

**A related challenge is to restore normal lending in the economy, most notably for the corporate sector.**

Persistent productivity increases and a higher investment rate cannot be expected without efficient financial intermediation. In addition to decreasing the tax burden on the financial sector, this would require an agreement between the government and commercial banks that would give the right incentives for both parties keeping the financial sector profitable but also taking into consideration pressing fiscal consolidation needs. This could among others include some further tax incentives to increase lending in the economy.

**Fiscal consolidation should be continued in line with the Council recommendations both under the European Semester and the Excessive Deficit Procedure.**

This will also facilitate the sustainable improvement of the negative NIIP, without putting all the burden of adjustment on the private sector. While public debt is still outstanding compared to the country's development level and regional peers, the efforts of the government to keep the budget deficit permanently below 3% of GDP should be acknowledged. Given the combination of a weak growth potential, high debt levels and financing costs, a very high share of foreign ownership of public debt securities and the relatively high gross financing needs, public sector deleveraging is a very vulnerable process. Therefore fiscal consolidation measures should be carefully selected in order not to hamper economic growth in the medium term. In this context, a loan agreement with international organisations (even if treated as precautionary in line with official plans) would also contribute to stabilizing the situation. However, the latter would require a change toward more growth friendly policies. In addition, steps could include the full implementation of the Széll Kálmán Plan as recommended by the

Council in March 2012 and the additional expenditure side measures announced in the April 2012 convergence programme.

**The sustained reduction in stock vulnerabilities would necessitate raising the growth potential and the employment rate through further structural reforms.** In addition to the ones mentioned above, further measures might need to be considered along the 2012 Council recommendations under the European Semester. While the government's efforts to increase the participation rate and also SME employment should be welcomed, a more careful approach might be needed in order to be able to increase the employment rate in a sustainable manner. Steps toward a more business friendly environment would help to improve private sector labour demand. In addition, as recent improvements in employment are strongly linked to public employment without visible signs of movements from the Public Work Scheme to the open labour market, more efficient active labour market policies are essential. These might include a thorough review of the Public Works Scheme with respect to training elements 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 more efficiently, responding also to the 2012 Council recommendations.** These may include steps to strengthen the functioning of competition enforcement institutions and the public procurement rules, but also reconsidering increasing entry costs in certain service sector segments. The on-going efforts to implement measures that lower the administrative burden is commendable and could be continued and plans envisaged in the National Reform Programme fully implemented. Improving educational outcomes can also positively affect growth. Finally a reform of the transport and energy systems toward more sustainable levels is necessary from both the point of view of fiscal sustainability and economic efficiency.

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