

The Hungarian Government's statement on the economy's current status

Recent data testifies to an improvement in the macroeconomic environment in Hungary. Positive movement can be seen primarily within the field of economic financing. First of all, this is the third year that the budget deficit has remained below three percent, and the government debt to GDP ratio has also begun to decrease. Secondly, similarly to the state, the private sector has also begun to downsize its sizeable debt. Public savings are increasing, and the balance of payments is permanently in the positive range. In addition, the number of employed has again reached the pre-crisis level and the employment rate has increased significantly. The increase in the number of jobs is helped by the fact that a significant increase in production capacities may be observed, especially thanks to large automotive industry projects. Although the economy showed a slight slump in 2012 due to unique factors, growth potential may rise above 2 percent in the mid term as a result of structural reorganisation and macroeconomic stability.

The State of the Budget

1. The excessive deficit procedure against Hungary may be lifted for the first time since the country's accession to the European Union in 2004. International organisations acknowledge the Government's firm commitment to perpetually decreasing the budget deficit. As acknowledged by the European Commission, the deficit fell to below the 3 percent Maastricht level in 2012 and 2013. The deficit rate decreased, with Hungary achieving the third highest decrease among EU member states in 2012. With regard to the budget deficit, according to the 2013 forecast – similarly to the past two years – Hungary is among the ten countries with the smallest deficit. However, the international environment remains fragile, and the Government is prepared to introduce further measures if necessary. We should also keep in mind that while decreasing high levels of debt is a global problem, Hungary achieved the highest reduction in government debt within the European Union during the period 2010-2012.

2. The better than expected budget position significantly decreased the economy's vulnerability to external factors. The 5-year CDS price has fallen to a sustained level of under 300 base points. Government bond issues were characterised by oversubscription and gradually decreasing yields. The secondary market's reference yield for all expiries fell to around or under 6 percent. In addition, the Hungarian Government was able to repay the current instalment of its IMF loan ahead of time. The favourable fiscal and money market trends have provided increased room for monetary easing, enabling the National Bank of Hungary (MNB) to decrease the prime interest rate by a total of 125 base points in 5 steps to under 6%.

Prospects for the Real Economy

3. Positive tendencies may primarily be observed on the job market. In 2012, the number of people in employment again reached the pre-crisis level and the number of workplaces will continue to increase in the coming period. The expansion of public employment programmes, the newly developed Job Protection Action Plan and

changes in the system of tools for encouraging job access have all contributed significantly to the encouraging trends. In addition to the number in employment, the active population has also increased significantly, and accordingly the unemployment rate dropped at a more moderate pace from the 11.8 percent record level to 10.4 percent.

4. Despite this, the economy was unable to avoid recession in 2012, a result of the simultaneous effect of several factors. Firstly, strong export orientation means that a drop in external demand itself (recession within the eurozone) brought with it a narrowing in export sales opportunities. Secondly, agriculture contributed almost 1 percentage point to a drop in GDP as a result of the extremely dry weather. Thirdly, the market positions of several large international corporations with subsidiaries in Hungary (e.g. Nokia, Flextronics) worsened against global competition, leading to a partial reduction in domestic production capacities.

5. The economy will begin gradually growing in 2013. Assuming average weather condition with regard to agriculture, a significant correction can be expected. Car manufacturing plants that are replacing the lost production capacity will begin or increase their production this year. In addition, the economic downturn in Europe is expected to slacken, which should improve export sales opportunities for the whole processing industry. Parallel to this, internal demand will be positively affected primarily by an increase in household income in real terms resulting from drops in energy prices. In the processing industry, the expansion of production capacities will continue thanks to large automotive industry projects.

6. In the mid term, growth may be facilitated by achieving and maintaining macroeconomic stability, and through structural reorganisation. The low budget deficit, the positive balance of payments, decreasing debt and the low inflation environment all serve to restore investor confidence and reduce the costs of financing. In addition, several structural measures have been introduced that increase the activity of economic operators. Retirement regulations have been tightened, the vocational and higher education systems have been restructured, access to social benefits has been made stricter, more flexible employment regulations have been introduced, and the Job Protection Action Plan has helped increase job access for disadvantaged groups. Furthermore, significant steps have been taken in the interests of whitening the economy and increasing the efficiency of tax collection. These factors may all contribute to increasing the economy's growth potential, based on which a 2 percent increase in GDP is expected.

Structural Reorganisation

7. The Government has fundamentally changed the tax system, significantly reducing the tax burden on work-related income. During first half of the government's term in office, the tax system was transformed significantly as a result of structural reorganisation and according to principles of economic philosophy. The emphasis was moved from tax on income to consumer-type taxes. The simple, transparent and low (16 percent) single rate income tax system came into force from 2013. Within the framework of the Job Protection Action Plan, targeted tax reductions and the introduction of forms of taxation that favour the creation and preservation of

jobs ("small taxpayers' itemised lump sum tax" [kata] and "small business tax" [kiva]) were also introduced. However, to keep the budget deficit in check, corporations that operated with higher profits in the past must also undertake part of the tax burden – the taxes in question are primarily linked to turnover, such as the financial transaction tax, the telecom tax and the special energy sector tax. In the interests of whitening the economy and increasing the efficiency of tax collection, cash registers will be linked online to the National Tax and Customs Administration in 2013. According to international experience, this significantly increased tax morale. In Bulgaria, where a similar online cash register system has also been introduced, the budget's income from VAT increased by EUR 1 billion in 2012. Strict restrictions will also come into force with regard to the transfer of monies between enterprises; from 2013 a maximum of HUF 1.5 million may be paid out in cash each month per contract.

8. Sustainability elements and conforming to market demand played a significant role in decisions concerning education. Despite limited resources, the education system continues to provide a high level of training. However, intervention was essential with regard to several fields: (1) significant regional differences have developed in the field of public education, (2) the quantity and quality of vocational training did not correspond to market requirements, and (3) severe tension was caused in higher education by the fact that many students chose non-marketable courses that they subsequently failed to complete within the allotted time. The most important measure with regard to balancing regional inequalities was placing local government primary and secondary schools and colleges under state control. The state-run Klebelsberg Institution Maintenance Centre (KIK) has been performing the professional management of public education through 198 education districts since January 2013. The other important measure was the introduction of the Teacher Career Model, as a result of which teaching will be performed by professionals who are more motivated. The most significant move within the field of vocational training is the introduction of the dual vocational training system based on the German model, in which emphasis is shifted from theoretical training to the completion of training through professional experience at corporations. The Government has restructured the higher education system so that it better conforms to market expectation, providing more places within the fields of engineering, natural sciences and information technology.

9. Within the field of public healthcare, lack of financing and overspending both posed serious problems. Viewing the whole healthcare system in general, a lack of funds and significant debts endangered the safety of services, and in order to correct this, the salaries of healthcare workers were resolved and supplier debts were reduced (the Government earmarked some HUF 30bn for this purpose at the end of 2012). In the past, the field of state subsidies on pharmaceuticals was, in contrast, characterised by overly high levels of state funding. In accordance with the objectives of the Széll Kálmán Plan, 2011 expenditure levels were successfully reduced by almost HUF 100bn by 2012, and the current level of funding will remain stable in 2013. Putting institutions under state maintenance may be regarded as a further efficiency-increasing measure. This also enables more cost-effective operation through joint public procurement tenders. All things considered, savings of up to HUF 10bn per year may be achieved through joint public procurements.

10. By 2010, the pensions system was on an unsustainable course due to unnecessary expenditure and demographic trends. Within the framework of the system's restructuring, disability pensions and early retirement will be reviewed; the state has overspent severely in these areas in international comparison. The retirement age will gradually increase to 65 years. In place of the private pension funds (Pillar II), which operated wastefully and generated significant government deficit (HUF 360bn per year), the Government is shifting emphasis to supporting self-provision (primarily through supporting Pillar III, voluntary insurance companies). The transparency of the pensions system is significantly increased by the system of individual accounts, which will be developed in future. A new regulation that comes into force from 31 January 2013 states that those working in the public sector may not receive a salary and a pension concurrently. As a result of these measures, the Pension Insurance Fund is in balance such that the purchasing power of pensions has been retained throughout the government term.

11. Public transport posed a significant burden on public spending, but positive developments have begun in all areas. Significant restructuring became necessary within the public transport sector, with regard the heavily indebted MÁV (rail transport) and BKV (Budapest public transport system) corporations and the maintenance of the public road network. In the interests of sorting out public transport, the reorganisation of MÁV has begun (the separation of public transport and infrastructure management, encouraging the use of the rail system as opposed to freight transport by road). Significant savings of up to HUF 20bn may be realised through the reviewing of travel benefits (60 million of the current total of 140 million passengers travel using some form of discount, while 30 million use public transport free of charge). With regard to the public road network the most significant measure has been the introduction and expansion of the electronic road toll system. It is in development and should begin operations in mid 2013. The expected additional income will contribute to maintaining the fiscal balance.

12. The management of local government debt is another significant step towards the sustainable decreasing of government debt. The system of local governments was experiencing sever difficulties when the government came to power in 2010; the total debt exceeded HUF 1200bn. The greatest challenge was posed by debt that had accumulated as a result of a continuous lack of financing. Measures were introduced in several phases to combat debt and provide sustainability. The first important measure declared that local authorities could only take on loans within a certain limit and for development purposes. The financing system will also be significantly transformed. Local governments will receive task-based funding from 2013. Several responsibilities – within the fields of education, healthcare and the social benefits system – have been passed on to the state, so decreasing the burden on local authorities and increasing efficiency. This is followed by the two-step consolidation of local government debts. In 2012, the debts of all local governments with populations of under 5000 were transferred to the Government. Then is 2013, 40-70 percent of the debts of local governments with populations exceeding 5000 will be consolidated according to a predetermined formula. These measures significantly improve long-term sustainability while not damaging the state's debt index (calculated according to European Union methodology).

13. The Hungarian financial vehicle system has stood the test of the financial crisis and its status is stable. The financial crisis also had a serious effect on the Hungarian banking system. The extremely high ratio of foreign currency loans became a systematic risk as the crisis deepened. However, in contrast to other countries there were no bank bankruptcies and no need for bank bailouts in the classical sense. The increasing level of non-performing loans raised questions of both social and financial stability. State-organised early repayment attempted to provide a solution to a serious economic and social problem. Households who chose early repayment have the opportunity to increase their consumption or make new investments in future, which has a positive effect on economic growth and through that on the banking system. In addition, the Government also introduced several measures to reinforce the stability of the banking system, such as the temporary suspension of foreign currency loans and regulations to increase transparency (e.g. positive debtor list). The banking system's supply of capital and stability are significantly increased by disciplined fiscal policy and decreasing government debt.

Summary

14. The Government is open to further consultation. Following the conclusion of talks, it may be determined that the standpoints of the Government and the IMF converged on several issues, such as improving deficit indices the need for structural reorganisation. However, the parties placed varying levels of emphasis on several issue. While the International Monetary Fund places too high an emphasis on the state of the banking system, the Hungarian Government feels it would be worth evaluating the working of the whole economy, including positive employment trends and the significant excess in the balance of payments. Nevertheless, the Government will consider the organisation's recommendations, of which several – such as the further rationalisation of central expenditure, increasing the targeted nature of social benefits and the development of VAT regulations – are already in process. The Government is open to further consultations in the spirit of constructive cooperation.