GOVERNMENT OF THE REPUBLIC OF HUNGARY

# CONVERGENCE PROGRAMME OF HUNGARY

## 2011 – 2015

## BASED ON THE SZÉLL KÁLMÁN PLAN

Budapest, April 2011

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# Preface

On 17 June 2010, heads of states and governments of the Member States of the European Union agreed on the orientation that "from 2011 onwards, in the context of a 'European semester,' presenting to the Commission in the spring Stability and Convergence Programmes for the upcoming years, taking account of national budgetary procedures," would be obligatory.

The shift to the European Semester in 2011 gives a clear ex-ante dimension to economic policy coordination at EU level and provides the framework for aligning the Stability and Convergence Programmes on medium-term fiscal plans with the National Reform Programmes on the progress towards the Europe 2020 targets. This enables the programmes to be consistent and based on the same macroeconomic and fiscal assumptions and structural measures, in addition to the fact that overlapping of programmes with different focuses can be avoided.

Against this background, the Government adopted the Convergence Programme for the years 2011 to 2015 together with the 2011 national reform programme on 13 April 2011. The Convergence Programme sets forth in detail the medium-term macroeconomic, budgetary and debt outlook and includes in this context the underpinning measures. The National Reform Programme presents in detail the measures taken and planned in order to attain the goals laid out in the framework of the Europe 2020 Strategy.

# 1. Economic Policy Objectives

The new government formed in 2010 inherited an economic pitfall. As a result of the irresponsible economic policy that was conducted since 2002, public debt has increased from 53 percent of GDP to above 80 percent. The initial budgetary expansion and the subsequent austerity measures were carried out in a structure that decreased the growth potential of the economy. Thus, the catching-up process of the Hungarian economy has come to a halt, and our economic arrears compared to developed countries have not diminished, rather our regional peers have outperformed the Hungarian economy. As a result of increased fiscal risks, the denomination structure of the country's external debt has also become unfavourable. Households were pushed towards Swiss franc denominated (mortgage) loans by high domestic interest rates, which made them extremely vulnerable to the global financial crisis that started in 2008. The increased risk of these loans continues to be a key bottleneck to the revival of domestic demand.

After it took office in May 2010, the new government faced several unexpected challenges. Serious measures had to be undertaken to control the slippage in the 2010 budget. Several expenditures that were not taken into account in the 2010 budget by the previous government (e.g. expenditures related to the EU presidency, state subsidies to churches etc.), natural disasters (inland waters, the red sludge catastrophe) and planned but eventually not realized revenues (e.g. the abolition of real estate taxes by the Constitutional Court) put further pressure on the 2010 budget. Without these and the better than expected growth for 2010, the budget deficit would have been as high as 7 percent of GDP.

At the same time, the government launched its supply-side oriented growth strategy, an important pillar of its debt reduction plan. A decrease in the corporate profit tax rate and the abolition of certain minor taxes support the economic recovery by nearing the tax wedge to the regional average, thus making the economy more competitive.

Addressing the key bottlenecks to growth by lowering the tax rates that are the most distortionary to economic decisions (i.e. personal income tax and corporate profit tax), led to an immediate revenue shortfall in the budget. Nevertheless, these measures were inevitable in order to increase the labour supply, to boost employment and thus to increase long term growth. The preceding governments missed the opportunities to engage in these growth friendly policies, thus were not able to break the trap of slow growth and high public debt, and rather contributed to the worsening of the situation. The case for making the tax system less distortive is undisputable but, in the short term, this contributed to the deterioration of the budget balance.

In order to address the acute problems in the 2010 budget, the Government announced its First and, somewhat later, its Second Action Plan, which were based on non-orthodox stabilization measures. It must be emphasized that, following slippages at the beginning of the year, the room for manoeuvre to rebalance the 2010 budget was very limited. An adjustment of that magnitude in such a short time could only be achieved by extraordinary measures. It was a key priority of the government that the budgetary adjustment shall not put more burden on those participants of the economy that had already been suffering the most from the credit crunch and deleveraging cycle (households and SMEs).

The two action plans and further government measures included important expenditure cuts, inter alia a restructuring of the public sector compensation scheme (e.g. elimination of bonuses), cost cutting and efficiency increasing steps in state-owned enterprises and a revision of outsourced activities. The reform of the pension system (as part of the second action plan), in addition to the large one-off revenue in 2011 to be used for debt reduction, has been significantly improving the structural balance from 2010 onwards, thus improves the sustainability of the social security pension system over the long term by permanently rechanneling future pension contributions to the social security pillar.

In addition to the expenditure cuts in 2010 and the pension system reform, the temporary crisis taxes had the most significant and immediate fiscal impact. These taxes were levied on those sectors that weathered the crisis most successfully, thus still had enough buffers and the capacity to handle an additional burden and, thereby, their temporary taxation should not effect long term growth potential.

The initial measures were aimed at ensuring the stable financing of the 2010 budget without further increasing public debt, and were inevitable due to the imbalances built up by former irresponsible policies and mistakes. By ensuring the sustainability of the 2010 budget, the Government gained some time work out the structural reforms that would set the budget straight over the long term. Without further (mainly expenditure side) reforms budget deficit could not have been set on a declining path. That would have hindered the reduction of public debt and thus jeopardized investments and job creation. The Government decided that it would not risk deepening the crisis and, therefore, prepared a structural reform programme that can simultaneously achieve the quick decrease of public debt and address the chronic problems of the economy.

According to the Structural Reform Programme (Széll Kálmán Plan) announced in March 2011, the temporary, mostly revenue-side measures will be replaced in the next years by structural, expenditure-side measures that will support higher potential growth already in the medium term.

The aim of the Structural Reform Programme is to reduce public debt by boosting economic growth and employment. Without such a heavy and comprehensive reform plan the Hungarian economy would not be able to escape from the pitfall that was created by the previous governments' irresponsible policies. The Structural Reform Programme thus minimizes the risk of a potential subsequent devastating financial crisis by ensuring that the following three principles are fulfilled: (i) the (nominal) amount of public debt has to be decreased, (ii) the highest possible rate of economic growth has to be attained and, (iii) future debt accumulation needs to be avoided. The Structural Reform Programme includes a simultaneous decrease of public debt, the reorganization of those economic and social areas that are inefficiently organized and therefore continuously contribute to the rising of public debt and, at the same time, also helps increasing long term economic growth. The budgetary deficit is planned to be reduced through measures – primarily on the expenditures side – that also address the most important structural problems of the economy.

The Government has received unprecedented authority to implement these objectives. It enjoys a 2/3 majority in Parliament, which is held by one united party alliance. Furthermore, according to latest surveys, the majority of people agree with the objectives of the Structural Reform Programme, which clearly contributes to its successful implementation.

The Structural Reform Programme focuses on the following areas: labour market, pension system, public transport, higher education, pharmaceutical subsidy system, local governments, and the administrative burden on businesses. The implementation of the Programme will yield a significant decrease in the redistribution rate, and the structure of state expenditures will become growth-friendly.

Decreasing debt cannot be sustained in the long term without increasing growth. A number of measures that have already been implemented, as well as the majority of the objectives of the Structural Reform Programme are aimed at stimulating all three sources of long term growth. The rise in the labour market participation rate, which is extremely low in international comparison, will be supported by eliminating disincentives to work and by the reduction of the personal income tax rate. The dynamics of the investments will be increased by the cuts in corporate tax rate and personal income tax rate, strengthening labour supply, and risk premia that are expected to decrease. A simpler and less progressive tax system, the modernization of the vocational training system, and the support of science and engineering programs in higher education can lead to faster development of human capital. Decreasing red tape also stimulates technological developments and fixed capital investment.

The Government has developed and will implement a comprehensive scheme in mid-2011 that will reduce the financial vulnerability of households with foreign currency debt and the financial stability risks that stem from it. The core principle of the concept is a fair burden sharing between the affected households, the banking system, and the state in bearing the incurred losses and thus minimizing potential future losses. However, the Government will not assume implicit or explicit liabilities that would endanger its key priority of debt reduction as set forth by the Structural Reform Programme. In addition, financial stability risks will be further reduced by maintained enhanced Government oversight of the financial intermediary system.

The structural reforms will also decrease the financial vulnerability of the economy via indirect channels. As a result of the economic policies that undermined its credibility in the past decade, the risk premia of Hungary were higher in 2010 than that of several countries with much worse debt histories. These developments have significantly contributed to the rises in the (debt service) instalments of foreign currency indebted households in the past years. Thus far, in 2010, the government mainly targeted to strengthen investor's confidence by strictly aiming at fulfilling of the deficit target. Going forward, the Structural Reform Programme defines the details of the a policy mix that will lead to declining risk premia by keeping the budget deficit along the announced path and by setting the economy on a growth path that supports credible and sustainable debt reduction. Already since the Structural Reform Programme has been announced, Hungary's credibility as seen by the markets has gradually increased, and these favourable developments are expected to continue as implementation is carried out. This will strengthen financial stability and the non-Keynesian channels of the reforms. Thus, although the growth effects of the reforms will only unfold in the medium to longer term, the regaining of the trust of the players of the economy in the state will have positive effects already in the short term (i.e. decreases in yields will have a favourable effect on economic activities even in the short term).

As it is very difficult to estimate the exact effects the structural reforms on growth, the Convergence Programme calculates its debt path based on a conservative macroeconomic scenario. This ensures that the deficit targets will be attainable even if the supply side stimuli expected from the Structural Reform Programme and the New Széchenyi Plan would unfold with a longer lag. Furthermore, the Government reiterates its commitment to achieve the deficit path set forth herein and is ready to implement further measures if necessary.

## 2. Macroeconomic Outlook

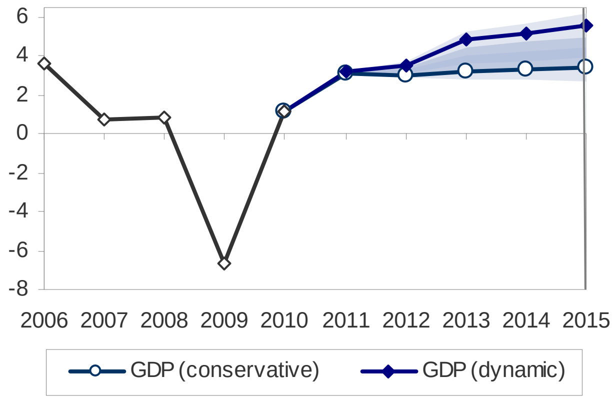
In order to provide for the successful implementation of the Structural Reform Programme those bottlenecks have been identified that, if handled effectively, will ensure the attainability of economic policy objectives. The Convergence Programme identifies two such bottlenecks: one is the present low level of employment and the other is financial risks.

As with all future processes, the implementation of the Structural Reform Programme and the successful handling of the bottlenecks is also shrouded in uncertainty; therefore the possible methods of implementing the Plan are described in a probability distribution by Figure 1, in which the coloured part cover the 90% probability area. Within the above, the Convergence Programme identifies two scenarios: one is a cautious and conservative path in which the positive effects of the Structural Reform Programme are manifest late and not with full effect. The other is a dynamic path of growth that assumes the successful handling and management of existing bottlenecks. The probability that the actual implementation of the plan resides somewhere between these two paths is 80%.[1]

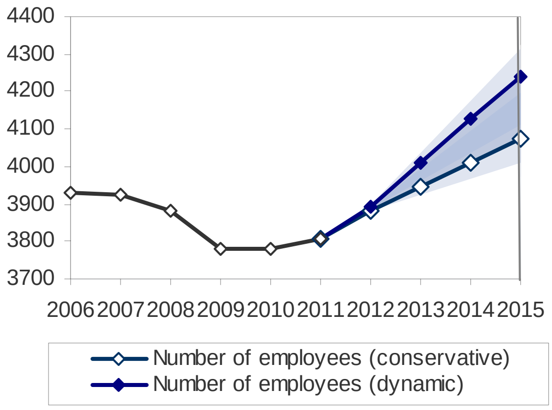
[1] The probability intervals included in the fan chart as well as the probability and direction of the various risks occurring has been developed on the basis of professional estimates, in accordance with the fan chart methods applied in international professional literature.

**Figure 1 The conservative and the dynamic path of growth**

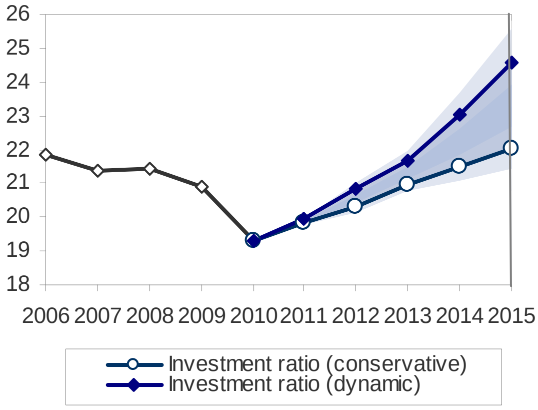
**GDP**
(annual growth rate, percent)




**Number of employees**
(thousand people)




**Investment ratio**
(percent)




The conservative macroeconomic scenario assumes a moderate increase in employment and restrained investment activity. On the basis of the above, a GDP growth of 3-3.5 percent can be expected in the medium term. The dynamic scenario assumes a significant increase in employment, 400,000 jobs in 5 years if the Structural Reform Programme and further government measures are successfully implemented. It furthermore assumes that the increase of credibility and the decrease of the country risk premium resulting from the successful implementation of the plan can provide for a greater rate of investment expansion and the new production capacities thus created will provide jobs for the increased labour force supply. As a result of all of the above, a GDP growth between 4% and 6% can be attained in the medium term.

In accordance with the Annual Growth Survey that started the European Semester and the conclusions issued at the ECOFIN Council meeting held on 15 February, the Convergence Programme is built on conservative macroeconomic forecasts. This ensures that the goals set for the deficit and the public debt path will be met even in the framework of the conservative macroeconomic scenario.

## 2.1. External conditions

Following the global economic crisis, the period of recovery in 2010 was characterized by fast global trade growth. The growth was partly fuelled by the internal demand of developing countries, budgetary stimulus and positive inventory cycle in developed countries also contributed to it in the first half of the year. Although the rate of growth slowed in the second half of 2010, global economic activity remained favourable. As a result, the GDP growth of both the EU-27 and the Eurozone was around 1.8%.

The necessary data for providing an accurate forecast of the international environment are only available in the European Commission's autumn 2010 forecast with sufficient detail; the changes published in the interim forecast in February 2011 are taken into account by the programme as positive risks. Following the period of recovery, 2011-2012 can promise a slightly slower rate of world GDP growth at approximately 4.6% with a continued divergence in the rate of growth experienced by developed and developing countries. These developments can have a significant affect on Hungarian growth, especially if we take into account the fact that Hungary is a small and open economy where growth is largely dependant on the development of net exports. The economic performance of the years to come is thus strongly defined by how the risks that are becoming presently apparent are realized.

The slow increase in domestic demand in European countries and the United States will continue to be determined by how the income of households and the deteriorated prospects of the labour-market can be improved. The large increase of public debt during the crisis forced the development of medium term budgetary adjustments in the majority of European countries, which negatively impacts their internal demand for the respective period. On the other hand, the international economic activity, that turned out to be more favourable than expected, has a positive affect on the performance of the corporate sector and the increase of business confidence. Overheating in developing countries from significant capital inflows can prove to be problematic in the future, especially taking into account the fact that their export performance is strongly dependant on the recovery of internal demand in developed countries.

According to the Commission's interim report, the EU-27 will continue to grow in 2011 at a slightly faster pace (1.8%) than forecast in autumn. Recovery in the EU is driven by exports, but the increase in the components of internal demand is gradually gaining more importance. Favourable export prospects and improving corporate profit can result in the expansion of investments in manufacturing. The consumption of households continues to be held back by high levels of inflation, low disposable income, deleveraging, and deteriorated consumer confidence. An important element of the Commission's forecast for Hungary's export outlook is that the growth of Hungary's most important export partner, Germany, is expected to exceed the level of the EU average as a result of both the external demand from developing countries and above average internal demand and increased competitiveness.

## 2.2. Cyclical developments

In the period between 1997 and 2006, the Hungarian economy experienced growth in excess of its potential, by a rate over 4%, which resulted in a positive output gap. The positive output gap after 2001 can be aligned with the strong fiscal expansion that characterized the period. As a result of the accumulated public debt and decreasing competitiveness, economic growth began to slow from 2007, and, due to the impact of the global economic crisis at the end of 2008, it fell below the potential growth and the positive output gap started to decrease. Nevertheless, the level of output fell below the potential level only in 2009, thus the output gap turned negative.

Although actual economic growth is expected to exceed the potential one in 2011, the actual output level will remain below the potential level until the end of the forecast period, and, according to the calculations of the Convergence Programme, the output gap will only close in 2015 (Table 1).

The global crisis made it necessary to re-estimate not only the actual but also the potential growth. Between 2009 and 2011, potential growth is on average 1 percentage point less than those in the periods prior to and following the crisis.. These changes are reflected also in the estimated contribution of the main factors to potential growth (labour, capital, and total factor productivity). Taking into account the fact that growth prior to the crisis was also fuelled by the granting of loans and considering the present balance adjustments, the economy - given the present structure of fixed assets and technical development - can only be capable of a slower sustainable growth in the coming years than previously assumed. Thus, the previously estimated potential growth rate of 2.5 – 3% or higher cannot be achieved without structural reforms.

**Table 1 Cyclical developments, *conservative path*** %

| | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 |
|---|---|---|---|---|---|---|---|---|
| GDP growth | 0.8 | -6.7 | 1.2 | 3.1 | 3.0 | 3.2 | 3.3 | 3.5 |
| Potential growth | 2.0 | 1.3 | 1.1 | 1.3 | 2.3 | 2.4 | 2.4 | 2.6 |
| Contributions: | | | | | | | | |
| Labour | -0.1 | -0.1 | 0.0 | 0.2 | 0.3 | 0.4 | 0.5 | 0.5 |
| Capital | 1.5 | 1.0 | 0.8 | 0.9 | 1.8 | 1.7 | 1.6 | 1.8 |
| Total factor productivity | 0.6 | 0.4 | 0.3 | 0.2 | 0.2 | 0.2 | 0.3 | 0.3 |
| *Output gap* | *3.1* | *-5.1* | *-5.0* | *-3.4* | *-2.7* | *-1.9* | *-1.0* | *-0.1* |

Due to the rounding of data some aggregate figures could differ from the sum of detailed data.

Table 2 presents the estimate of the output gap based on the *dynamic* path of growth. For better understanding the data, it is important to note that for methodological reasons, the estimated values of past potential growth and output gap can change as the future forecast changes.[2] This is why some historical values in the table can differ from those in the table presenting conservative growth.

**Table 2 Cyclical developments, *dynamic path*** %

| | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 |
|---|---|---|---|---|---|---|---|---|
| GDP growth | 0.8 | -6.7 | 1.2 | 3.2 | 3.6 | 4.8 | 5.2 | 5.5 |
| Potential growth | 2.2 | 1.5 | 1.4 | 1.7 | 2.9 | 3.2 | 3.6 | 4.2 |
| Contributions: | | | | | | | | |
| Labour | 0.0 | 0.0 | 0.1 | 0.3 | 0.6 | 0.8 | 0.9 | 0.9 |
| Capital | 1.5 | 1.0 | 0.8 | 0.9 | 1.9 | 1.9 | 2.1 | 2.7 |
| Total factor productivity | 0.7 | 0.5 | 0.5 | 0.4 | 0.4 | 0.5 | 0.5 | 0.6 |
| *Output gap* | *2.8* | *-5.5* | *-5.7* | *-4.3* | *-3.7* | *-2.2* | *-0.7* | *0.5* |

Due to the rounding of data some aggregate figures could differ from the sum of detailed data.

It is important to stress that the structural measures most of all increase potential growth. As a result of the measures, the labour and capital components of potential growth will quickly exceed even those prior to the crisis. However, total factor productivity will only increase very slowly, reflecting that R+D developments and education have their effects with some lag. By the end of the period, the three factors will result in a 3-4% increase of potential growth. At the same time, the output gap shows a similar tendency as in the case of the conservative path and will only close at the end of the forecast period.

[2] In accordance with the recommendations of the European Commission, some smoothing filters are used.

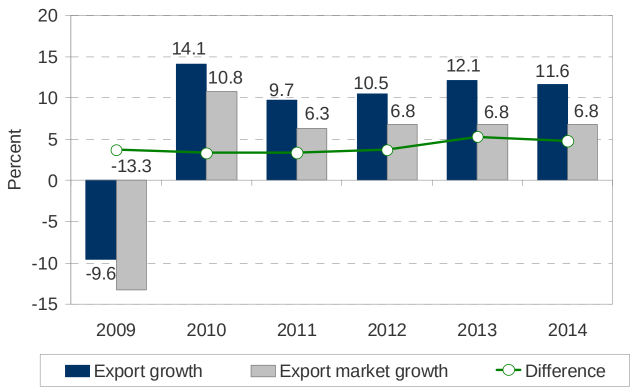
## 2.3. Foreign trade

To forecast the demand for Hungarian exports, the import demand of Hungary's major export markets has been taken into account, relying on the European Commission's 2010 Autumn Forecast. Accordingly, Hungary's export markets increased significantly, by 10.8% in 2010, on the back of the European recovery. In the following years, the rate of growth is expected to moderate somewhat and to result in a growth rate of the demand of Hungarian exports of 6.3% in 2011 and of 6.8% from 2012 on.

The growth rate of Hungarian exports has exceeded that of its export markets for several years. In 2010, the expansion of Hungarian exports even exceeded the outstanding growth of external demand by 3.3%. The increasing competitiveness of the Hungarian export sector is also reflected in the development of the ULC-based real effective exchange rate, which increased by more than 20% since the start of the crisis. The gap between the two indices may continue to widen, as large-scale investments in the car industry that are presently under way contribute to the build-up of capacities that will commence production and export sales in 2012-2013.

In 2009, the global economic crisis led to a shift in the export structure towards the members of the EU-15, despite the fact that previous years had shown an opposite tendency. The foreign trade of goods and in the year 2010 reverted to its previous trend: the share of the EU-15 in exports once again decreased and thus fell to 57.2%, while the share of the new Member States increased slightly, to 20.2%, and the share of non-EU countries showed a stronger increase, to 22.7%.

**Figure 2 Export volumes and the growth of export markets**
(percent)




Source: European Commission, NGM calculation

Recovery from the economic crisis in 2010 was accompanied by a quick expansion of global trade; in addition to the intensive import demand by developing countries, the fiscal spending by developed countries, and their positive inventory cycle in the first half of the year also helped Hungarian exports. Meanwhile, domestic demand – though in a smaller degree than in the previous year – continued to decrease. The growth of exports exceeded that of imports by 2.1 percentage points, resulting in a 2.2% growth contribution of net exports. The positive balance of goods and services continued to increase, and showed a record surplus of EUR 6.8 billion.

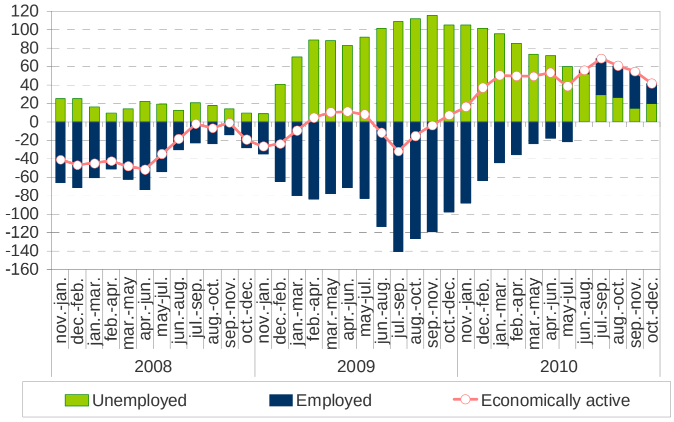
Despite oil price increases, the terms of trade improved by 0.1 percentage point, which can be attributed on the one hand to the improvement in the terms of trade in machinery and transport equipment, as well as processed goods and, on the other hand, to the improvement in the terms of trade in services. From 2011, the improvement in manufacturing is not expected to counter the detrimental effects the continued increase in oil prices have on the terms of trade, since the planned large scale car industry investments will result in a significant amount of machinery imports until 2013. As the individual effects are fading, the decline in the terms of trade is expected to slowly diminish over the forecast horizon.

The increase in global trade that characterized the recovery period following the crisis, will slow in 2011; and exports are expected to increase by 9.7%. The additional production of the new car industry capacities will be reflected in the data as from 2012, resulting in an expected export growth of about 12% in 2013 and somewhat below that in 2014 and 2015. The growth of domestic demand will become more robust from 2011 on, thus the gap between the growth rate of exports and imports will narrow and from 2013 onwards, the growth of imports will exceed that of exports. In addition these developments, the downward level shift in domestic demand caused by the crisis is expected to be sustained, thus its import demand is also lower, as a result of which the foreign trade surplus will remain significant in the subsequent years as well.

## 2.4. Employment

Following the bottom of the economic recession in 2010, corporate profitability slowly and gradually normalized. Accordingly, in comparison with the negative spike in September 2009, the decrease of the labour force demand slowed down and a turning point was measurable from August 2010 (on an annual basis) in the number of employed (Figure 3).

**Figure 3 Labour market activity**
(changes in three month average of the number of employees compared to the same period of the previous year, thousand people)

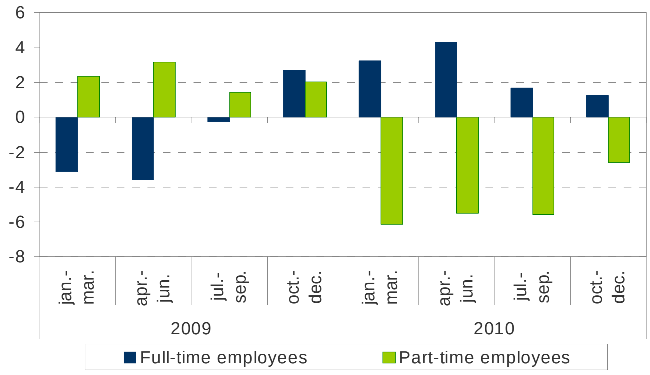



Source: KSH

This is a result of several parallel developments. The development of the number of employees in the private sector was also characterized by the duality that was apparent in the economic growth. In the export-oriented (tradable) sectors, the number of full time employees started to increase in 2010 due to the more beneficial external environment (meaning high export demands) (Figure 4). However, the sectors based on the still weak internal demand (non-tradable sectors, services) were rather characterized by labour hoarding and increases in the number of part time employees. It was also manifested in the number of working hours. In the tradable sector, the average number of working hours per month of full time employees reached the pre-crisis level in the second half of the year; however, the ratio of part time employees in the non-tradable sectors was still higher at the end of 2010 than before the crisis.

This indicates that the benign environment in the tradable sector and the increasing profitability did not make it necessary to adjust the number of working hours, while companies in the non-tradable sectors intended to maintain the smallest possible number of full time employees in order to cut their costs. In summary, the number of employees in the private sector increased slightly, by 0.3%, in 2010 on the basis of the institutional labour statistics (at enterprises with more than four employed persons) while according to the data of the labour force survey, which includes small and micro enterprises that typically sell their products to the internal market decreased by 1%.

**Figure 4 Number of working hours by full time and part time employees in the tradable sector**
(compared to the same period of the previous year, %)




Source: KSH

The number of economically active persons rose continuously during the financial and economic crisis. It can be attributed to the fact that fewer people who became recently unemployed exited the labour market than in the previous years. Furthermore, an increasingly higher number of inactive people could have entered the labour market as job seekers, which coulc be a result of the fact that in many cases, besides the primary earners having lost their jobs, the secondary earners of the family were forced to seek jobs. Since on the demand side no expansion with a similar rate took place during 2010, the unemployment rate stabilized at a high percentage over 10% (the unemployment rate increased to 11.2% in 2010). The hysteresis effect (the eroding human capital and the decreasing intensity of job seeking increases the ratio of those who are unemployed for longer time) can also result in the rising of the unemployment rate, which seems to be verified by the continuous increase in the number of those people who are unemployed for a long time (more than 12 months).

The decrease in private sector employment was counterbalanced by the significant, 2.9% rise in the number of employees in the public sector in 2010, which was mostly due to the high number of participants (85-90 thousand people on an annual average) in the so-called Pathway to Work public employment programme.

The gradual recovery of the profitability of companies could continue in 2011, which is however somewhat negatively influenced by the crisis taxes affecting the various sectors. The rationalizing of the number of employees in the public sector (decreasing bureaucracy) also contributes to the fact that employment is only expected to show a moderate increase until 2013. Conservatively estimating the positive effects of the Structural Reform Plan on the labour market, a more significant rise exceeding 1.5% in employment can be expected from 2014. On the basis of the dynamic path of the economic growth the number of employed people may increase by 2% from 2012 and it could reach approximately 3% by 2015. Accordingly employment is expected to increase by 300 thousands people until 2014 and on the whole by 400 thousands people by 2015.

**Table 3 Employment** changes in %

| | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 |
|---|---|---|---|---|---|---|
| **Conservative path of growth** | | | | | | |
| Number of employed (aged 15-64) | 0.0 | 0.7 | 2.0 | 1.7 | 1.6 | 1.5 |
| Unemployment rate (%) | 11.2 | 10.9 | 10.5 | 9.9 | 9.3 | 8.7 |
| Participation rate (%) | 62.4 | 62.8 | 64.0 | 65.1 | 66.1 | 67.2 |
| GDP growth | 1.2 | 3.1 | 3.0 | 3.2 | 3.3 | 3.5 |
| **Dynamic path of growth** | | | | | | |
| Number of employed (aged 15-64) | 0,0 | 0,7 | 2,3 | 3,0 | 2,9 | 2,8 |
| Unemployment rate (%) | 11,2 | 10,9 | 10,4 | 8,8 | 7,3 | 5,9 |
| Participation rate (%) | 62,4 | 62,8 | 64,2 | 65,3 | 66,6 | 68,0 |
| GDP growth | 1,2 | 3,2 | 3,6 | 4,8 | 5,2 | 5,5 |

### The Effects of the Structural Reform Programme on the labour market

The Government presented Hungary's structural reform programme at the beginning of March, 2011 (Structural Reform Plan), in which it identified three main policies and objectives: implementation of a high level and sustainable economic growth by increasing employment, decreasing the fiscal deficit, and significantly and permanently decreasing the public debt. In order to achieve these objectives, the Government announced reform measures that influence, among others, employment, the pension system, and education, which can have a significant positive effect on labour market developments.

Hungary's employment rate is extremely low (55.4%) it is one of the lowest in the European Union. One of the sources of the problem is that there are many people who would like to work but do not have the opportunity to do so because of the loose labour market conditions (or perhaps because of disadvantages or low level of education). It is primarily not the age group of 25-45 year olds in which employment is troubling (although the respective ratio is also low in international comparisons), but the people entering the labour market under 25 or those who are above 45 and generally have low levels of education. The other source of the problem is posed by that part of the working age population which makes use of the relatively generous social benefits and the disabled pension system, or which does not work at all, or makes use of the above benefits and has a job that is not registered at the authorities (or only registered at minimum wage) such as undeclared or grey employment.

The Government has announced such measures among others that would improve the employment of disadvantaged groups. The objective of the renewed and redeveloped public employment programme the so-called National Public Employment Programme is to increase the employment rate of the low-skilled, raise job seeking activities, and aid returning to (or entering into) the private sector, into the primary labour market. In order to achieve this latter goal, we also wish to motivate local companies to participate in the programme. Due to the new system of the public employment, it is expected that an even higher number of people of working age can be legally employed and can receive permanent salaries that are sufficient for their subsistence (in an annual average, 80-85 thousand people participated in the public employment programmes in 2010).

An important element of the motivational system established by the Structural Reform Plan is that the amount of social benefits available to a citizen of working age could not reach the income from the public employment, and the latter should remain under the effective minimum wage.

In order to improve the chances of finding work for fresh graduates, the Government plans to develop a higher education and quota system that better conforms to the needs of the labour market. It will enable them to find work in their respective fields in accordance with their qualification. This makes it possible to decrease the time and costs spent on their training, which makes it more beneficial for companies to employ them.

On the other hand the measures included in the Structural Reform Plan also intend to prevent the abuse of social benefits and pensions and to lessen the counterproductive effect of these benefits on the labour supply. The redefining of the sick–pay (decreasing its upper limit to half of the present amount), the maximising (at a level lower than the minimum wage) of the total amount of social transfers given by various legal grounds, the nominal fixation of the family allowances and benefits, the decreasing of the passive labour market benefits, and the planned reform of the pension system serve the mentioned goals. Restraining passive labour market benefits results in the decreasing of the maximum time for which the various unemployment benefits are provided. Therefore, the maximum time for which the jobseeker's allowance is provided will be decreased from 270 days to 90 days; the unemployment benefit, which provided benefits for a further period of 90 days, will be eliminated; and the system of the wage supplement benefit will be changed (the latter benefit can currently be received by persons participating in the public employment programme until the time they find work in the framework of the programme).

With these measures, the Government motivates more effective and more intensive job seeking and would also like to decrease the duration of unemployment, and therefore the number of persons unemployed for a long time.

The measures mentioned above have a positive effect on the activity of the labour market and the whitening of the economy; however, the number of unemployed people may even rise in the short run. It is caused by the fact that the present loose labour market cannot immediately accommodate the increased labour supply: following the crisis, the demand side of the labour market can grow at a slower pace and only gradually, with the increase of productivity.

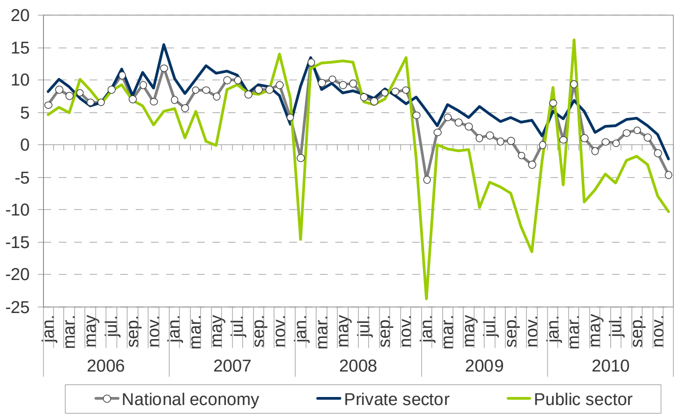
However, the announced measures can be expected to result in the expansion of employment in the long run and will thus manifest their effects on the growth of the economy.

## 2.5. Income policy and consumption

The developments in private sector's income growth were characterized by the duality that was also apparent in economic growth and employment in 2010: while average gross incomes in the tradable sector displayed relatively dynamic growth (at around 5%), no clear tendency could be seen in the non-tradable sectors. However, the slowing of income growth in the fourth quarter of 2010 characterized the whole business sector which can be mainly attributed to the reform of the personal income tax system. Making use of the more favourable tax system, a number of companies deferred premium payments to 2011. Sharper increases in incomes at the beginning of 2011 also seem to confirm this. Similarly to the number of employees, developments in gross average earnings of the public sector were also driven by government measures in 2010. As a result of the cost cutting measures taken during the year (maintaining the wage freeze, the implementation of the HUF 2 million income ceiling in the public sector, the revision of bonuses, benefits, and severance payments) and the typically low incomes of the participants in the Pathway to Work programme, gross average wages decreased by 2.7% in 2010 (Figure 5).

As a result of the loose labour market conditions and the decreasing tax wedge due to the new, flat rate personal income tax (PIT) system, only moderate dynamics of the earnings in the private sector are expected in 2011 and the subsequent years. Due to the lowered rate of PIT in effect from 2011, even a smaller income increase is enough to maintain (or increase) the net income of employees. The development of the earnings in the public sector will continue to be strongly influenced by government decisions and the planned increase in the number of participants in the renewed public employment programme (National Public Employment Programme), and thus by the increasing share lower income public sector employees.

**Figure 5 Gross average wages**
(compared to the same period of the previous year, %)



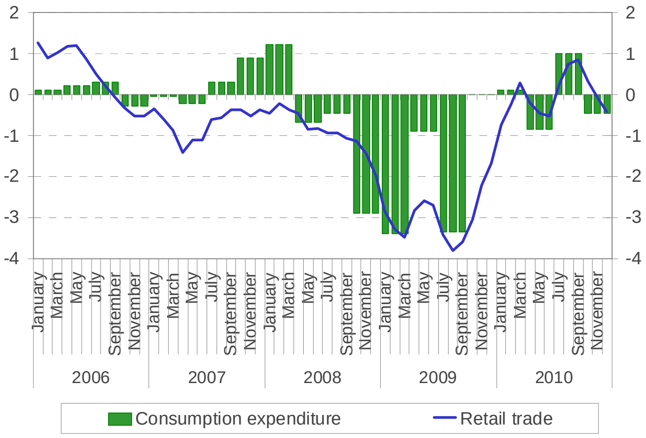

Source: KSH

The trends experienced in gross incomes in the fourth quarter of 2010 were also clearly visible in retail trade volumes. The trend of retail trade that turned positive over the summer – for the first time in 39 months – showed some correction towards the end of 2010. Thus, the 1% growth experienced in the volume of household consumer expenditure during the third quarter was followed by a weaker figure in the fourth quarter of 2010. On an annual average, the amount of household consumption expenditure decreased by 2.2% in 2010 compared to the previous year. In addition to low income growth, the reason for the above is the permanently low consumption rate exhibited since the crisis, the accelerated inflation in the fourth quarter, the increase in mortgage instalments resulting from the strong Swiss franc, and the cancellation of bonus payments regularly due in the last months of the year.

However, the expected above 5% increase in net incomes which increase is in large part due to the restructuring of the PIT system, gives reason for optimism regarding household consumption expenditure in 2011. In the first quarter, the amount of household consumption expenditure is expected to further increase as a result of the payment of the bonuses that are expected to be rescheduled for this year as well as the disbursements of the real yields on private pension funds and voluntary membership payments due to the pension reform. It can, nevertheless, be assumed that precautionary motives may strengthen further and that households will continue their balance sheet adjustment, leading to only a small portion of the disbursement, which could amount to HUF 250 billion being consumed. Households are expected to use this amount mainly either to increase their savings (i.e. transfers to voluntary pension fund accounts) or to pay their debt in 2011. Also taking into account the planned tightening of the eligibility rules for disability pensions, downside risks (relating to further increase in food and fuel prices, tight credit conditions), the convergence programme forecasts a gradual growth of 3.1% for 2011, following the significant decline experienced in previous years.

At the end of the forecast period, household consumption expenditure is expected to increase between 2.2 and 2.7% following 2011. This can be explained by the decrease of social benefits paid out in cash, the slower than expected normalization of the savings rate, and labour market conditions that improve only gradually.

**Figure 6 Household consumption expenditure* and retail trade volume**
(compared to the same period of the previous year, %)




Source: KSH
*/: quarterly data

## 2.6. Investments

During the period between 2005 and 2010, the gross fixed capital formed by the household sector, the government and the private sector showed a strong decline. This unfavourable tendency is primarily attributable to a decrease in internal and external demand and to a tightening in credit conditions. As a result of the dismal circumstances, the investment rate continued to weaken; although the decrease cannot be considered extraordinary compared to other regional competitors, its level is the lowest among them.

The decrease in gross fixed capital formation was the strongest in the private sector. As a result of the weak demand stemming from the global crisis, companies continuously decreased the utilization rate of their capacities in several sectors This made it superfluous to expand their gross fixed capital formations. The companies' disadvantageous liquidity conditions that developed as a result of decreasing sales and the rising costs of funding resulting from the uncertain macroeconomic assessment of Hungary prompted even profitable companies to delay their investments.

In order to address risks stemming from household lending, the Government made lending conditions of and credit quality assessment more stringent in the course of 2009. The loan-to-value ratio was maximized by a government decree and stricter requirements regarding income were also defined, which further strengthened the processes already under way and decreased the willingness to invest. Businesses' burdens were also increased with the introduction solidarity tax and the minimum tax during 2009. As a consequence of detrimental internal and external effects, the largest recession took place in the construction and manufacturing sectors.

At the end of the forecast period, continuously increasing external demand will motivate the domestic manufacturing industry to increase capacities and permanent positive export possibilities can boost investment demand. This process is also aided by the improved liquidity conditions and solvency of companies stemming from the increase of their sales.

Significant large investments will be implemented in coming years. Of these, the largest will be carried out by Audi, which will result in a capital inflow of HUF 247 billion between 2010 and 2013. General Motors will commence the expansion of its manufacturing line in 2011 and will invest HUF 137 billion in Hungary by 2012. Mercedes will invest HUF 220 billion in its plants in Kecskemét until the manufacturing process starts in 2012. Hankook will also expand its factories, thus resulting in an inflow of HUF 63 billion in Hungary between 2010 and 2011. These are expected to commence or expand their production in 2012, adding to the long term dynamic expansion of the manufacturing industry and export.

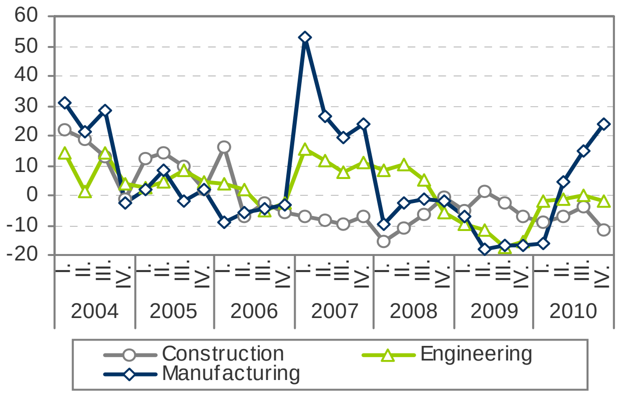
The commenced positive tendencies can be strengthened in the long term by measures aiming at increasing competitiveness. With the introduction of the flat rate PIT system, tax burdens on labour that are considered high in the region will be decreased. The restraining of passive labour market benefits, the supervision of the disabled pension system, freezing the minimum pension amount, and increasing the retirement age increases the labour supply, which can improve the competitiveness and the country's capital attracting capabilities.

As a result of tight credit conditions and uncertain labour market prospects, household sector and construction investments showed a strong decrease. Unfortunately this process could continue in 2011 and 2012; however, from 2013 the Home Creation Programme of the New Széchenyi Plan is expected to result in a pickup in household sector investments. With the increase of the labour activity, the income position of households could improve, which in turn could increase their credit rating as well as their willingness to invest. Fostering macroeconomic stability by the continually decreasing public debt ratio can improve Hungary's risk assessment and external financing can become cheaper.

Utilization of the EU funds is expected to improve further in 2011-2012. These subsidies form a basis for infrastructure investments and provide companies with non-refundable sources, thus boosting their investment demand. The level of public investments is expected to decrease by 2011 as a result of structural reforms and is then expected to approximately stagnate at that level.

In summary, following the unfavourable international and domestic economic and financial processes of the previous years, as of 2011, as a result of increasing external demand and the announced measures, the annual level of gross fixed capital formation is expected to increase at a rate of approximately 6% in the long run. As a result of the increase in competitiveness, the investment ratio (measured at current prices) could increase from the present level of about 19% to in excess of 22% even according to the conservative path.

**Figure 7 Investment by sectors**
(compared to the same period of the previous year, %)




Source: KSH

## 2.7. Components of growth

As a result of the global economic crisis Hungary is struggling with a large fiscal deficit and public debt and has felt the crisis more than its regional competitors. The Hungarian economy was characterized by a low growth rate over the long term even in the period before the crisis; this unfavourable performance was attributed to the high rate of public debt and decreasing competitiveness. The stringent fiscal measures that aimed at providing a solution to structural problems and slowing the rate of the accumulation of public debt was not growth-incentivising and as a result Hungary's growth rate was pushed lower than it's competitors. Partly as a result of these processes, the employment rate is among the lowest in the European Union and the investment rate is also significantly behind that of its regional competitors.

Due to increasing external demand the recovery started gradually and in 2010 the Hungarian economy experienced a 1.2% GDP growth. The export oriented manufacturing industry increased by 10.6% in 2010, contributing to an extraordinary degree to economic growth. From the aspect of the development of the Hungarian economy, external demand still plays an important role: the economic activity of Germany is of primary importance, but the growth of Asian countries – which affects the Hungarian economy indirectly through the developed manufacturing countries – is also having greater significance.

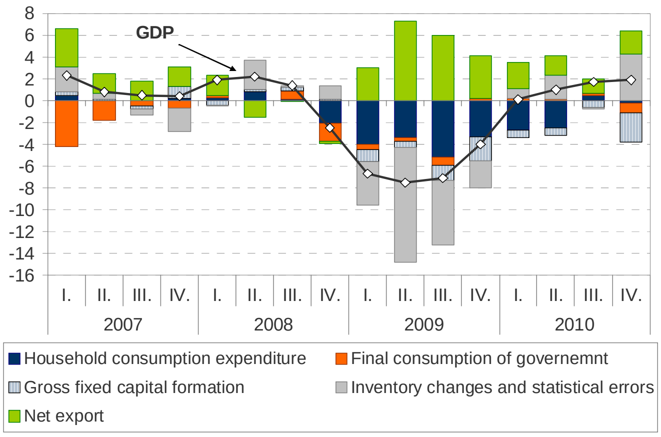
The measures announced by the Government in its Structural Reform Programme are continuously being implemented in the next period. These measures simultaneously decrease public debt and establish a growth-incentive macroeconomic environment utilizing the stimulating effect these two have on each other. The Structural Reform Programme puts a great deal of emphasis on the gradual augmentation of the low level of employment, two of the main goals are the restricting of passive labour market benefits and the restructuring of the pension system. These measures can increase the labour supply and improve the competitiveness of the Hungarian economy enhancing the country's capital influx in the long term. All these will aid growth, strengthen internal demand, and raise the level of consumption. On the basis of the conservative path, the Hungarian economy may expand by 3.1% in 2011 following the slight degree of growth experienced in 2010, growth may remain at over 3% in subsequent years. In the dynamic scenario the risk premium will decrease in the long term and due to the incentives of the New Széchenyi Plan investment will grow at a higher level than in the conservative approach. These effects enhance capital accumulation and labour demand at the same time, improving the household's disposable income and domestic demand. Under these favourable circumstances the Hungarian economy can grow at 4,8-5,5% in the period of 2013-2015.

### Table 4 Components of GDP %

| | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 |
|---|---|---|---|---|---|---|
| **Conservative path** | | | | | | |
| Household final consumption expenditure | -2.1 | 3.1 | 2.2 | 2.4 | 2.5 | 2.7 |
| Government consumption | -0.6 | -4.9 | 0.3 | 0.5 | 0.5 | 0.6 |
| Social transfers in kind | -2.5 | -0.5 | -0.7 | -0.8 | -0.1 | -0.1 |
| Gross fixed capital formation | -5.6 | 5.7 | 5.3 | 6.0 | 5.7 | 5.8 |
| Export | 14.1 | 9.7 | 10.5 | 12.1 | 11.6 | 11.7 |
| Import | 12.0 | 9.7 | 10.4 | 12.2 | 11.8 | 11.8 |
| *GDP* | *1.2* | *3.1* | *3.0* | *3.2* | *3.3* | *3.5* |
| **Dynamic path** | | | | | | |
| Household final consumption expenditure | -2.1 | 3.2 | 2.6 | 4.9 | 4.2 | 4.2 |
| Government consumption | -0.6 | -4.9 | 0.3 | 0.4 | 0.5 | 0.6 |
| Social transfers in kind | -2.5 | -0.5 | -0.7 | -0.8 | -0.1 | -0.1 |
| Gross fixed capital formation | -5.6 | 6.4 | 8.0 | 8.4 | 11.4 | 11.9 |
| Export | 14.1 | 9.7 | 10.8 | 12.3 | 12.5 | 12.5 |
| Import | 12.0 | 9.8 | 10.9 | 12.6 | 13.0 | 12.9 |
| *GDP* | *1.2* | *3.2* | *3.6* | *4.8* | *5.2* | *5.5* |

Source: KSH (Hungarian Central Statistical Office) and NGM (Ministry for National Economy) estimates

### Figure 8 Contribution to GDP growth




Source: KSH

## 2.8. External position

In 2010 the external position of Hungary increased as a result of the significant amount of real economic surplus and the influx of EU transfers. While real economic surplus accounted for 5.1% of GDP in 2009, which increased to 7.2% in 2010. The significant improvement of the balance of goods and services was also seen in the current account balance, as a 2.1% surplus developed in 2010 following a surplus of 0.4% in 2009. As a result of expanding capital transfers, the external financing capacity grew at a faster pace than the current balance and accounted for 3.9% of GDP in 2010.

The improvement of the real economic balance can be explained by the decrease in domestic demand, which in turn led to a lower level of imports required by domestic use. Although both household consumption and gross fixed capital formation is expected to significantly increase from 2011, the recession in internal demand that caused a drop in levels will lower import rates for the whole period of the medium term. Therefore, the real economic balance will continue to produce a surplus of around 7.5% of GDP for the whole duration of the forecast.

Since Hungary will be in a net financing position from 2010, the stock of external debt can start to continuously decrease. The interest payment will therefore gradually decrease in the balance of incomes. Changes in income on equity are expected to be defined mainly by unique factors until 2014. On the one hand, the car industry investments planned between 2012 and 2013 will presumably be carried out with the use of internal cash pool and, on the other hand, the commencement of production in 2012-2013 will draw a part of the revenue generated by other production units of these companies. Therefore, both profit transfers directed towards foreign countries and reinvested earnings are expected to remain at low levels in 2012-2013. However, profit derived from surplus production will be available after 2014; therefore the deficit of income on equity can increase at a faster rate.

Since the annual rate of use of current EU transfers will continue to somewhat increase until 2013, the surplus of the current account balance in 2012-2013 will be around 2.7-2.8% of GDP. Resulting from the increased income outflow in 2014 and the smaller planned amounts of EU transfers, the current account balance is expected to be about 1.9% of GDP. The EU transfers in the capital account will also increase until the end of 2013, which is why external financing capacity in 2012-2013 can reach 5.6-5.8% of GDP. Positive net financing can also be expected in 2014, but its rate is estimated to be around 4.4% of GDP.

Foreign direct investment inflow will also be defined by the unique factors set forth in the incomes section. Although the rate of reinvested earnings could increase in 2011 as compared to 2010, this rate will decrease in 2012-2013 due to the above unique factors and will once again show a significant increase in 2014; meanwhile, equity inflow will remain about average. Because of the car industry investments financed from internal cash pool, other capital inflows could exceed the average rate in the period between 2011 and 2013.

**Table 5 External financing** in percent of GDP

| | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 |
|---|---|---|---|---|---|---|
| Balance of goods and services | 7.2 | 7.2 | 7.6 | 7.7 | 7.8 | 8.0 |
| Current account balance | 2.1 | 1.6 | 2.8 | 2.7 | 1.9 | 2.0 |
| Capital account including EU transfers | 1.8 | 2.6 | 2.8 | 3.1 | 2.5 | 2.4 |
| External financing need(-)/capacity(+) | 3.9 | 4.2 | 5.6 | 5.8 | 4.4 | 4.4 |
| Debt-creating financing*,** | -3.9 | -5.6 | -6.2 | -6.3 | -5.3 | -5.3 |
| Non-debt-creating financing | 0.0 | 1.4 | 0.5 | 0.6 | 0.9 | 0.9 |
| of which: net foreign direct investment | 1.5 | 2.0 | 1.1 | 1.3 | 1.7 | 1.7 |
| of which: net reinvested earnings | 0.3 | 1.0 | 0.3 | 0.5 | 0.9 | 0.9 |

*/without other capital
**/negative amounts decrease the stock of external debt
Due to the rounding of data some aggregate figures could differ from the sum of detailed data.
Source: KSH (Hungarian Central Statistical Office) and NGM (Ministry for National Economy) estimates

## 2.9. Inflation dynamics

At 4.9 % in 2010, the Hungarian inflation rate was higher than expected (by the November 2010 report). The most significant role in this process was played by the drastic increase in the price of fuels (annual average of 21%), which is due to two factors: the depreciation of the HUF-USD exchange rate (by 12% on an annual level) and the increase in the price of oil on the global market (by 21% on an annual level). It must be noted, in connection with the latter, that the pace of the price increase was fastest in the last quarter of 2010 and it seems that it will have an even stronger influence on the consumer price index's dynamics in 2011.

In addition to fuel prices, attention must also be paid to the food price developments. Although the annual price index was lower (3.2%) in 2010 than in 2009 (4.4%), in the second half of the last year a significant increase commenced among unprocessed foods. The first effects could already be seen in the soaring prices of processed foods in the last months of 2010 but these will be more apparent in the inflation rates for 2011.

Oil and food price developments will have the greatest effect on the consumer price index in 2011. The oil price shock experienced in the beginning of 2011 has not yet materialised in the most recent inflation figures, but its effect has to be taken into account from March on. The increase in food prices was already reflected in the developments of the price index in the very first months of the year and this will continue to be an inflationary pressure for the rest of the year, too.

While global raw material and food price increases put upward pressure on inflation, from the cost side, core inflation decreased to a rate between 1 and 2% during the past year. All the above mentioned factors can be attributed to the fact that output is persistently below its potential level, and to the weak internal demand, which is due to loose labour market conditions. A further proof of the moderate income increases are the low levels of premium payments (one should also take into account that in certain cases payments were just delayed due to changes in the tax system). The main reason for the decrease in premiums is weak internal economic activity and that the sectors subject to crisis taxes might have tried to reduce their operating costs by decreasing the amounts of bonuses and benefits. To sum up, income developments lead to weak inflationary pressure on both the demand (consumption) and the supply (labour costs) sides.

No inflationary pressures can be seen on this year's core inflation rate because of the gradually improving domestic demand. The effect of increased raw material prices on consumer prices might be mitigated by companies attempting to counterbalance their rising non-labour related costs by lowering wages and salaries. In total, a 4.0% rate of inflation is expected for this year, which, after the cost shocks are over, could decelerate to 3.4% in 2012. In the long run, a 3% increase in prices can be expected, which is in line with the inflation target.

No significant inflationary pressure can be expected from the side of regulated prices in 2011. The Government is committed to keeping the costs of living low, especially in the case of utility bills, thus helping people living in dire circumstances to make ends meet. As regards the prices set by local governments, the majority of price increases have already taken place at the beginning of the year and their rate did not exceed the expected rate of inflation, thus they do not put further pressure on inflation.

**Table 6 Changes in consumer prices** %

| | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 |
|---|---|---|---|---|---|---|
| Consumer prices | 4.9 | 4.0 | 3.4 | 3.0 | 3.0 | 3.0 |

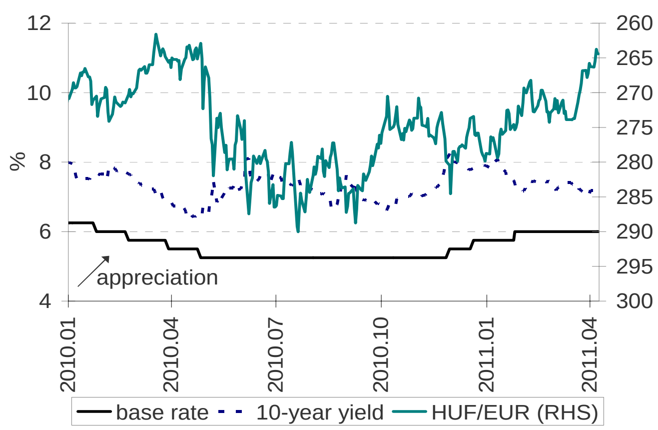
Source: KSH (Hungarian Central Statistical Office) and NGM (Ministry for National Economy) estimates

## 2.10. Monetary and exchange rate policy

Pursuant to the Act on MNB, the central bank's primary objective is to achieve and maintain price stability. Since 2001, monetary policy has been operating within the inflation targeting framework. In this framework, the Monetary Council defines a numerical inflation goal that corresponds to price stability, which presently – as a continuous goal – is 3%. The floating exchange rate applied since February 2008 ensures conditions that are more beneficial to the MNB for the attaining of the inflationary goal than those previously present, since the edge of the exchange rate band does not pose a limit to exchange rate developments in harmony with the inflationary goal.

The nominal exchange rate of the forint compared to the euro was significantly more stable than in the previous period: with the exception of a few transitional periods, the Hungarian currency remained in the 265-280 HUF/EUR band. In March 2011, the yields on Hungarian government securities were basically at the same level as at the beginning of 2010. However, all this developed through significant fluctuations: the yields (spreads) were greatly influenced by the expectations of the new government's programme and the reception by the market of the individual measures. In summary – amongst ever newer chapters of the debt crisis of the Eurozone – the Hungarian CDS spread also increased and even attained extraordinarily high levels in certain periods.

**Figure 9 Yields and exchange rates**




Monetary conditions mitigated in 2010. On the one hand, the ex ante real interest rate decreased to 2% from its 2009 level of 4-5%, as a result of a lower base rate and higher inflationary expectations. On the other hand, the real exchange rate based on unit labour costs weakened due to restrained wage evolution during the past year.

The majority of the temporary monetary policy instruments introduced due to the financial and economic crisis were phased out in 2010. Thus, the MNB does not continue its mortgage bond purchasing programme in 2011 but, in the case of advantageous conditions, will remain open to commencing similar programmes. The flexible minimum reserve system that can be changed every six months entered into effect at the end of 2010. The banking sector continues to make use of the central bank's euro liquidity providing three-month EUR/HUF FX swap instrument.

The Hungarian banking sector came through the period of the crisis without any serious trouble, but the worsening of the quality of the loan portfolio is significant; the ratio of late or non-performing loans increased significantly in 2010 among both companies and households. However, the deterioration of the operating environment of the domestic banking sector that was apparent in the past period does not endanger financial stability due to a strong proprietary background and the high level of capital domestic banks have.

Hungary does not have a target date for the introduction of the euro. Practical preparation is accordingly focused on the necessary tasks that can be presently fulfilled. The structure of the consulting body that manages practical preparation, the National Euro Coordination Committee has conformed to the new government structure in order to ensure that any arising tasks can be carried out by the Committee without delay.

# 3. General government balance and debt

## 3.1. Fiscal policy objectives

In Hungary the outbreak of the global financial and economic crisis was not followed by a significant rise of the general government deficit. The severe financial market crisis which reached the country in the autumn of 2008, did not allow the mitigation of recession by fiscal stimulus measures. In order to strengthen financial market confidence and stability, expenditure cutting measures were introduced primarily to hold back social transfers and public sector wages offsetting the revenue shortfalls, triggered by the decline in economic activity and employment. As a result of consolidation measures, the general government primary balance in percent of GDP deteriorated only by less than half a percentage point in 2009, and by only 0.2 percentage point in 2010. The general government deficit rose from 3.7% in 2008 to 4.5% of GDP in 2009, and then dropped to 4.2% in 2010.

Pursuant to the Council Recommendation of July 2009, Hungary should correct its excessive deficit by 2011. Since 97% of the former private pension fund members returned into the state pension pillar within the framework of the pension system reform, the transfer of their assets, accumulated in the funds so far will generate a general government surplus in 2011.

The Government, which took office in May 2010, is committed to the reduction of the public debt and continuation of the fiscal consolidation. Structural reforms and the maintenance of fiscal discipline will assure that the general government deficit will be kept below 3% of GDP from 2011 even according to prudent macro-economic assumptions. According to the fiscal path decided by the Government and stated in the Structural Reform Programme, the deficit may drop to 2.5% of GDP in 2012, and then it will gradually decline year by year to 1.5% by the end of the programme horizon.

A considerable part of the revenues from the asset transfer related to the pension reform will decrease the public debt and thus the gross public debt to GDP ratio will fall already in the short-term. In addition, the improving balance, forecast in the mid-term fiscal path, will also contribute to the reduction of the debt ratio from the 80.2% peak recorded in 2010 to below 65% of GDP by 2015.

**Table 7 Medium-term fiscal path** in percent of GDP

| | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 |
|---|---|---|---|---|---|---|---|---|
| General government balance* | -3.7 | -4.5 | -4.2 | 2.0 | -2.5 | -2.2 | -1.9 | -1.5 |
| Primary balance | 0.5 | 0.1 | -0.1 | 5.9 | 1.2 | 1.5 | 1.7 | 1.8 |
| Gross public debt | 72.3 | 78.4 | 80.2 | 75.5 | 72.1 | 69.7 | 66.7 | 64.1 |

*: According to EDP methodology

The Government's economic policy focuses on fiscal consolidation, as well as on the improvement of competitiveness, employment incentives and strengthening the growth potential of the economy. The simplification and complex restructuring of the tax system are important instruments in achieving these objectives. Several, so-called small taxes were abolished, the corporate income tax rate was reduced from 19% to 10% on up to HUF 500 million profit from the second half of 2010. In January 2011, a 16% flat rate personal income tax was introduced, coupled with a considerable family tax base allowance in order to increase the number of births, to recognise the costs of raising children, thus improving the demographic structure in the long run. The super grossing principle (i.e. including the social security contribution paid by the employer in the tax base) will be gradually phased out by 2013 and the current tax credit system will also be gradually reduced. The budgetary impacts of the restructuring of the tax system are offset with the revenues from the special taxes introduced on a temporary basis (extra tax imposed on financial organisations and certain sectors) and the pension system reform in the short term. The private pension fund members pay pension contributions into the state pension pillar from November 2010 to the end of 2011 instead of paying membership fees, but at the beginning of 2011 they also had an opportunity to return to the state pension scheme. Owing to the large number of people returning to the pay-as-you-go pillar, contribution revenues of the social security system will increase by more than 1% of GDP on a permanent basis.

Apart from the restructuring of the revenue side, the Government also adopted a large scale of expenditure-cutting measures in 2010 and 2011 (blocking of appropriations, freezing of public sector wages, launching the restructuring of public work schemes, etc.). However, these measures are not sufficient to keeping the general government deficit below the 3% threshold even in the medium term. With the application of conservative macroeconomic assumptions and without any change in the fiscal policy, the deficit would rise to approximately 4.5-5% of GDP and the debt ratio would not decrease once the special taxes are phased out. Therefore the Government launched the Structural Reform Programme (based on the Széll Kálmán Plan), focusing primarily on the expenditure side and aiming at the restructuring of areas where expenditures are significantly higher than in other countries with similar level of GDP per capita. The envisaged reform measures make the structure of public expenditures much more 'growth friendly', and improve employment by stimulating labour supply, and decrease the general government deficit by 1.8% of GDP in 2012 and by 2.8% of GDP from 2013 compared to the no-policy-change scenario. In addition to the impact of structural reforms, continued fiscal discipline will result in savings in the operational expenditures of the public sector (wages, purchase of goods and services), and will also help achieve the deficit targets in the following years.

**Figure 10 Deficit reducing impact of the measures** (in percent of GDP)

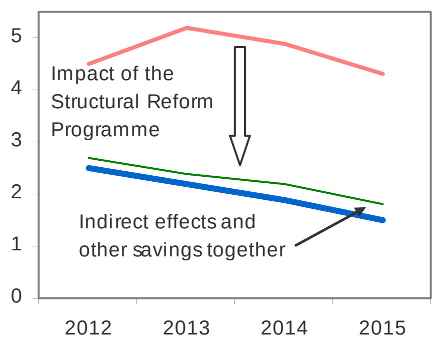
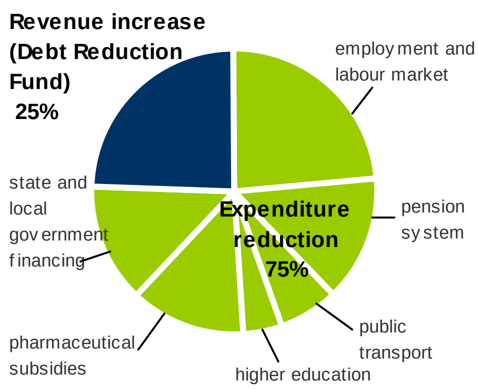



**Figure 11 Breakdown of the Structural Reform Programme measures** (%)




## 3.2. Budgetary developments in 2010

The first notification of the Hungarian Central Statistical Office (KSH) to Eurostat registered a slight overrun of the 3.8% deficit target: the general government balance according to the EDP methodology was -4.2% of GDP in 2010. In the central budgetary sub-systems, where the Government has a direct impact on the budgetary developments, the cash-based deficit was in line with the appropriation (compared to GDP, it turned out to be even slightly more favourable owing to the higher nominal GDP). However, the local governments closed the year with a worse than projected balance, generating an additional deficit of 0.2% of GDP.

Apart from the higher deficit of local governments, the changes in the 'bridge' between the cash and accrual-based figures caused the rest of the discrepancy. In the latter figures, the January 2011 tax revenues were the main factor, which were still included in the 2010 accrual-based accounts.

**Table 8 Development of the 2010 balances** in percent of GDP

| | 2010 January Convergence Programme | 2011 spring notification |
|---|---|---|
| Cash-based balance of the central sub-systems | -3.3 | -3.2 |
| Cash-based balance of local governments | -0.7 | -0.9 |
| EDP balance of the central sub-systems | -3.1 | -3.3 |
| EDP balance of the local governments | -0.7 | -0.9 |
| *EDP balance of the general government* | *-3.8* | *-4.2* |

The shortfall of tax revenues characterised the whole of 2010. Even the introduction of special taxes could only dampen the shortfall, and finally in total the actual revenues collected were by close to 1% of GDP lower than projected in the Convergence Programme of January 2010. Although instead of the previously expected slight decline the economy grew by more than 1% in 2010, the positive growth surprise was mainly export-driven, thus not reflected in stronger tax revenues. The shortfall of revenues was especially large in income taxes, primarily in the corporate income tax, partly due to the base effects and the write-off of higher losses incurred during the crisis, and also partly to the lower tax rate, introduced in the second half of the year.

The unfavourable revenue developments were indicated already in the interim figures, and some of the cost savings, originally planned in the budget in the first half of the year, could not be maintained either (support to transport companies, support to local governments due to the higher cost of public work). This is why, after taking office, the Government launched two economic actions plans, containing competitiveness boosting tax changes, measures assisting small and medium-sized enterprises as well as temporary revenue measures (introduction of special taxes, re-direction of private pension fund contributions from November 2010 to December 2011), and introduced also strict saving measures in order to constrain expenditure growth (freezing of appropriations, reduction of staff costs and purchase of goods and services).

Owing to these measures, the accrual-based deficit dropped by 50% between the first and the second half of the year. Finally, over the entire year, wage-related expenditures and social benefits were in line with the projections of the Convergence Programme of January 2010, but capital expenditures and intermediate consumption were slightly higher than forecast (however, approximately 50% of this increase was related to the higher absorption of EU transfers).

**Table 9 Changes in the year 2010 general government figures** in percent of GDP

| | 2010 January Convergence Programme | Preliminary fact | Difference | Of which | |
|---|---|---|---|---|---|
| | | | | surplus / shortfall | GDP effect* |
| Tax and contribution revenues | 38.9 | 37.1 | -1.8 | -0.8 | -1.0 |
| Other revenues | 6.1 | 7.5 | 1.4 | 1.6 | -0.2 |
| *Total revenues* | *45.0* | *44.6* | *-0.4* | *0.7* | *-1.1* |
| Compensation of employees | 11.0 | 10.7 | -0.3 | 0 | -0.3 |
| Intermediate consumption | 7.1 | 7.7 | 0.6 | 0.8 | -0.2 |
| Social transfers | 18.8 | 18.3 | -0.5 | 0 | -0.5 |
| Investments | 2.8 | 3.2 | 0.4 | 0.5 | -0.1 |
| Other expenditures | 9.1 | 8.8 | -0.3 | -0.1 | -0.2 |
| *Total expenditures* | *48.8* | *48.8* | *0* | *1.2* | *-1.2* |

*/: Impact of higher nominal GDP on the GDP-based indicators
The total figures may not reconcile with the total of the components due to rounding.

## 3.3. Budgetary developments in 2011

In line with the Council Recommendation, the 2011 budget set a deficit target below the 3% threshold, at 2.9% of GDP. In order to improve the balance, the number of employees was limited and wages were frozen in the public sector (a wage supplement compensates for the impact of the change in the tax credit for employees earning low wages), there were significant cuts in extra-wage benefits and the transformation of the public work system also began. In compliance with the effective laws and regulations, 80% of the forecast inflation and 20% of the estimated wages were taken into account in the pension increase, and there was no change in the nominal value of family support and social transfers.

According to another assumption used in the budget, the assets of individuals returning from the private pension funds into the state pension pillar would have improved the general government balance by nearly 2% of GDP in 2011 and close to another 1% in 2012. However, the return process closed at the beginning of 2011, and thus the total assets transferred into the Pension Reform and Debt Reduction Fund will improve this year's balance according to accrual accounting. Of the approximately 3 million fund members, 97% returned to the state pension scheme, and thus the asset portfolio will improve the balance much more significantly in 2011 (the difference is approximately 7% of GDP): even following the payment of the real earnings and employer supplementary contribution to the former fund members returning to the state pension scheme, the impact is estimated at 9% of GDP.

With this one-off effect of the asset transfer, the general government balance would show 4% surplus. However, in order to improve the efficiency of public transport, which is an objective of the Széll Kálmán Plan, the Government decided that a considerable portion of the MÁV and BKV debt would be assumed by the budget. In addition, in order to ease the future burden, a decision was also adopted on the replacement of certain PPP projects. These one-off items reduce this year's estimated surplus by 2% of GDP, so the 2011 general government balance could equal +2% of GDP.

The extraordinary items will not change the key figures of the originally approved budget though: the Government intends to achieve the deficit target net of one-off impacts. This is why it established a stabilisation reserve of close to 1% of GDP (HUF 250 billion). The February Government resolution ordered freezing in the appropriations of budget chapters, obligatory contributions from certain budgetary agencies, the improvement of the balances of the extra-budgetary funds and reductions in consumer price subsidies, and also set an obligation to maintain the unspent appropriations, carried over from the previous year.

The stabilisation reserve created in order to manage any unfavourable development of the external environment could offset the risks, emerging primarily on the revenue side. As the 2010 tax revenues were lower than calculated in the course of budget planning, mainly because of the base effects, the tax and contribution revenues could be by 0.7% of GDP lower than set in the budget. The largest revenue loss could be recorded in the corporate profit tax also this year. Taking also into account other, less significant risks, the Convergence Programme assumes that the stabilisation reserve will not be released.

## 3.4. Main objectives of the 2012 budget

The Government intends to keep the general government deficit below 3% of GDP on a permanent basis and to reduce it gradually year by year. Thus next year's budget will be planned with a deficit target, set at 2.5% of GDP.

The savings expected from the structural reforms will already be integrated into the expenditure appropriations in 2012, but the balance improvement still calls for economical budget planning. For this reason

- The wages will not increase in the public sector, but a wage supplement, compensating for the gradual reduction of the tax credit will remain in place for employees with low salaries.

The gradual phasing out of the so-called super grossing principle will result in higher net wages;

- With the start of the new public work system, estimating also a rising number of participants in the new programmes, expenditures on compensation of employees in percent of GDP could drop by approximately half a percentage point compared to 2011;
- The purchases of goods and services will not change in the central budget chapters, while they could increase by the estimated inflation rate at local governments;
- The budget chapters may plan their expenditure appropriations on a base, reduced with the majority of the 2011 stabilisation reserve;
- The new pension scheme will take effect, and pensions will preserve their real value with the help of the indexation rules;
- As a result of the review and restructuring of disability benefits, the expenditures related to disability pensions will decrease;
- There will be no rise in social transfers and family support; the budget will recognise the costs of child raising through the tax system;
- The labour market benefits will be restructured in accordance with the Széll Kálmán Plan;
- Expenditures on price subsidies will decrease: pharmaceutical subsidies will be cut significantly, and there will also be only a minimum rise in consumer price subsidies over the 2011 reduced base. The former gas and district heating subsidy will be transformed into an extended housing maintenance subsidy, keeping its targeted nature;
- As the efficiency of public transport improves, lower amounts should be spent from the budget on supporting transport companies;
- The systemic transformation of higher education will start;
- Local government administration will be restructured along the principle of the economies of scale and the central administration will also be streamlined.

With all these targets on board, the Convergence Programme assumes a nearly one percentage point GDP-proportionate cut in the current operational expenditures of the public sector over 2011 (compensation of employees and intermediate consumption). The transformed structure of social transfers will contribute to the reduction of the redistribution rate by a further one-and-a-half percentage points.

On the revenue side, personal income tax revenues will be reduced by the 'halving' of super grossing, yet the continued limitations in tax credit will have a contrary effect. Within the framework of the EU law approximation process, the excise duty on tobacco products will be higher and the transformation of the product fee in order to enhance environmental protection will also generate additional revenues for the budget. Restrictions are expected in corporate taxation in regard to the write-off of losses of previous years. Assuming the unchanged amount of the special tax on financial institutions planned in the Structural Reform Programme, the tax and contribution revenues will drop as a percentage of GDP in only a negligible extent in 2012.

## 3.5. Budgetary developments in 2013-2015

The 2013-2015 budgetary forecast is determined by an improving macro-economic outlook, the extension of the impacts of structural reforms and the continued fiscal savings.

In line with the Structural Reform Programme, the Convergence Programme assumes that

- the special taxes imposed on certain sectors ('crisis taxes') will be abolished in 2013;
- Assuming that in the next few years a harmonised bank tax will be introduced in Europe, which will continue to raise budgetary revenues also from 2013, although their amount will drop by approximately 50% compared to what is collected currently under the title of special tax on financial institutions;
- The general corporate income tax rate cut will be postponed;
- The use-proportionate electronic toll, introduced in 2013, will produce revenues equalling 0.3% of GDP.

With the assumptions indicated above, revenues will grow at a lower rate than the GDP, and therefore stronger spending cuts are required in order to improve the balance. The deficit path set out in the programme facilitates a fall in GDP-proportionate interest expenditures, but the primary expenditures will also shrink by approximately 3.5 percentage points in the last three years of the programme horizon. This is based on the following assumptions:

- Public sector net wages will rise even without any wage increase in 2013, when the so-called super gross principle will no longer apply. In the subsequent two years the wage bill (without public work programmes) will remain unchanged. Taking into account the expansion of public work programmes, the GDP-proportionate expenditures on compensation of employees could diminish by one-and-a-half percentage points between 2012 and 2015;

- Owing to the economical fiscal management, the rise of the intermediate consumption expenditures will also be lower than the GDP growth;
- The pensions will preserve their value in real terms. The process of transformation of the disability pension scheme will continue. As a result of the reform of the pension system and the social benefits, social transfers will decline by more than one-and-a-half percentage points as a percentage of GDP in the last three years of the programme horizon;
- The restructuring and efficiency improvement of the public transport system will cut the respective expenditures by approximately 0.2% of GDP;
- The higher economies of scale in the local government system, the review of its tasks and limitations of its borrowing will generate considerable savings;
- The structure of expenditures will change favourably in terms of economic growth: among the largest items of the expenditure side, only investment expenses could rise more than GDP.

## 3.6. Structural balance and one-off items

According to the calculations of the Convergence Programme the sensitivity coefficient is 0.28, i.e., the balance of the general government changes by 0.28 percentage point upon a 1% change in GDP (assuming no change in the composition of GDP).

The strongly negative output gap, which developed during the economic crisis, will gradually narrow over the time horizon of the programme and will be practically closed in 2015. GDP growth is already expected to be higher than the potential growth rate in 2011, but the closing of the large negative output gap, which developed between 2008 and 2010, will take a longer time. Because of the negative output gap, prevailing through the time horizon of the programme, the cyclically adjusted balance stays more favourable than the actual EDP balance until 2014, and will be identical with it in 2015.

Between 2010 and 2012, the revenues and expenditures of the government sector will include one-off items with considerable balance improving effects. In 2010, the Malév capital injection was a one-off item increasing expenditures, while the one-off items that increased the revenues included the revenue from the settlement of the VAT refund between 2009 and 2010 based on the decision of the European Court (0.1% of GDP), the one-off MOL contribution, also made pursuant to a European Court decision (0.1%), the transfer related to the return of the private pension fund members into the state pension scheme based on an age limit (0.2%), part of the temporary special tax on the financial sector that exceeds the expected harmonised European rate (0.3%), and the temporary special tax imposed on certain sectors (0.6%). The Convergence Programme reckons with the last two revenue increasing one-off items also in 2011 and 2012. Another considerable one-off revenue item in 2011 is the revenue from the transfer, within the framework of the pension reform, of the assets accumulated earlier in the private pension funds (9%). The programme includes the following expenditure-increasing one-off items: assumption of the MÁV and BKV debts and the buyout of the investments made in the previous period based on PPP projects (in total 2%), the expenses of the census (0.1%), the EU presidency (0.1%) and the loss compensation to the central bank (0.1%). In 2012, the programme contains no longer one-off items apart from the sector-specific taxes (in relation to the financial sector, half of the total amount is regarded as one-off). There are no one-off items at all in the programme between 2013 and 2015.

The structural balance will improve gradually from 2012, and will only be slightly below the medium-term budgetary objective (MTO) in 2013, finally reaching it at the end of the programme period. Although some deterioration can be observed in 2011, it must be taken into account that Hungary is one of the few Member States where the structural balance improved even during the recession triggered by the global economic crisis compared to what it was in the last year before its outbreak (compared to 2007, the structural balance shows approximately 0.5 percentage point improvement in 2011).

**Table 10 Structural balance** in percent of GDP

| | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 |
|---|---|---|---|---|---|---|
| Output gap | -5.0 | -3.4 | -2.7 | -1.9 | -1.0 | -0.1 |
| General government balance | -4.2 | 2.0 | -2.5 | -2.2 | -1.9 | -1.5 |
| Cyclically adjusted balance | -2.8 | 3.0 | -1.8 | -1.7 | -1.6 | -1.5 |
| One-off items* | 1.3 | 7.7 | 0.9 | 0.0 | 0.0 | 0.0 |
| *Structural balance* | *-4.0* | *-4.7* | *-2.6* | *-1.7* | *-1.6* | *-1.5* |

*The positive figure reflects a balance improving effect.
Any discrepancy among the data of the table is the result of rounding.

## 3.7. Public debt

At the end of 2009, public debt was 78.4% of GDP, significantly higher than the 72.9% at the end of 2008. In 2010, public debt reached 80.2% of GDP as a result of the weaker exchange rate and the slightly higher budget deficit than forecast in the January 2010 Convergence Programme.

Parallel with the dampening of the effects of the economic crisis, global risk aversion also eased and confidence began to return to the international markets in 2010. However, deteriorating debt problems of the euro zone also had an impact on the judgement of the Hungarian public debt, reflected in the higher yields on government securities. Nevertheless, apart from some minor market turbulence, government bond market remained stable throughout the year. The coverage of HUF government securities auctions was 200-250% on average, and following a volatile year, the mid- and long-term yields shrank compared to the beginning of 2010, while there was no major change in short-term yields. The country's largest and longest-tenored issuance of FX-denominated bonds in March 2011 reflects the increasing confidence of the market in the country.

As the Government Debt Management Agency could satisfy the financing needs from the market, no new loan was drawn in 2010 from the approximately EUR 20 billion facility provided by the European Union, the International Monetary Fund and the World Bank. Thus the debt of the central government to these institutions is close to EUR 13 billion, and the Government will begin reimburse it in December 2011, in accordance with the repayment schedule stated in the contract.

Ever since its establishment, the Government taking office in spring 2010 considered the issue of public debt a priority. The Government committed itself to a strict budgetary policy in order to be able to reduce the public debt continuously and sustainably, in relation to which it introduced measures to fulfil the 2011 deficit target and reduce the budget deficit to 1.5% of GDP by 2015.

Apart from its commitment to deficit reduction, the Government is also reducing the public debt by reforming the pension system, as contrary to the gradual debt reducing effects of a conservative deficit policy, the assumption of the public pension funds' assets brings forth a single and large cut in the debt. Almost 97% of the private pension fund members decided to return to the state pension system, which has a significant impact on public finances:

- The assets of private pension funds, accumulated by the returning fund members, will be transferred into the Pension Reform and Debt Reduction Fund (hereinafter: Fund) established specifically for such purposes, in June 2011. The exact size and composition of the transferred portfolio becomes final on 31 May 2011, until then it can only be estimated based on the figures of 31 December 2010. According to those figures, the size of the total portfolio to be returned to the state is close to 10% of GDP.
- Of the portfolio returning to the Government,

- the Fund will pay out the accumulated real earnings and supplementary contributions, representing approximately 0.9% of GDP, to the private pension fund members returning to the state pension pillar by 31 August 2011 in compliance with the approved legal provisions,
- an amount equalling 1.8% of GDP will be used to finance pension and pension-type expenses in 2011,
- the Hungarian government securities make up approximately 4.7% of GDP, the immediate neutralisation of which will reduce the debt ratio by the same rate,
- securities worth approximately 2.4% of GDP will be sold in 2012-2013 depending on the market conditions, for the purpose of debt reduction.

As indicated above, the pension reform will reduce the debt ratio by approximately 4.7% of GDP in 2011, and a further 2.4% of GDP in 2012-2013.

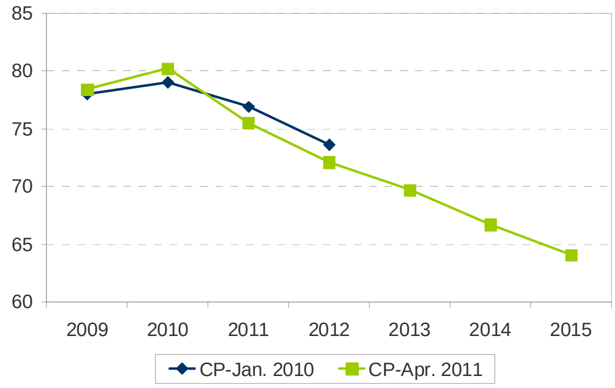
Pursuant to its decision, the Government assumes part of the MÁV and BKV debt, accumulated in the previous years. Another Government decision was made on the revision of some PPP contracts. These one-off items represent in total 2% of GDP.

As a result of the pension reform, debt assumption and PPP replacement, the debt ratio will be approximately one-and-half percentage point lower than forecast in the Convergence Programme in January 2010. In the following years, the debt ratio will shrink gradually to below 65% by 2015 owing to the conservative deficit policy and the decrease in the currency deposit (accumulated from the IMF loans and held at the MNB) parallel to the repayment of the international loans.

**Table 11 Main assumptions in the Convergence Programmes** in percent of GDP

| | | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 |
|---|---|---|---|---|---|---|---|---|
| Nominal GDP growth (%) | CP-2010 January | -2.3 | 2.0 | 5.6 | 6.5 | | | |
| | CP-2011 April | -2.6 | 4.1 | 6.1 | 5.8 | 5.4 | 5.6 | 5.8 |
| General government balance | CP-2010 January | -3.9 | -3.8 | -2.8 | -2.5 | | | |
| | CP-2011 April | -4.4 | -4.2 | +2.0 | -2.5 | -2.2 | -1.9 | -1.5 |
| Debt ratio | CP-2010 January | 78.0 | 79.0 | 76.9 | 73.6 | | | |
| | CP-2011 April | 78.4 | 80.2 | 75.5 | 72.1 | 69.7 | 66.7 | 64.1 |

**Figure 12 Debt ratio in the January 2010 and the current Convergence Programme**




Factors of the change of the public debt path:

- The main factor in the deviation from the 2010 programme is the effect of the pension reform. The cancellation of government bonds and the sale of other securities will reduce the debt already in 2011, and subsequent sales will have similar effect in the forthcoming years. These items were not taken into account in the 2010 Convergence Programme.
- Interest expenditures as a percentage of GDP are currently forecast higher than in the previous programme, which - despite the lower debt - is caused by the higher assumed yields.
- In terms of nominal GDP, slightly higher growth was assumed for 2011 followed by slightly lower growth in 2012, which is explained by the rise in our inflation forecast for 2011 and the decline in the 2012 GDP forecast. In line with this development, as a result of the change of the nominal GDP path itself, the debt ratio would rise less than forecast in 2011 and more in 2012 than in the 2010 forecast.
- Similarly to the 2010 Convergence Programme, – among the other items – no considerable privatisation revenues can be expected over the time horizon of the Programme. The technical exchange rate assumption used in the debt forecast is based on more than 1% weaker HUF exchange rate, which results in a slightly higher debt path than contained in the 2010 outlook. In addition, a different path is projected for the reduction of the FX deposits generated from the IMF-EU loans.

The future debt ratio is sensitive to the changes in the following main factors (ceteris paribus):

- Primary balance: a permanent 1 percentage point annual change of the primary balance, effective until the end of the path, will induce cca. 1% stock change in the first year and a change of 5% by 2015.
- Exchange rate: the share of the FX-denominated debt within the gross debt grew to 45% by the end of 2010 although, as a result of the increasing HUF weight in debt financing in the forecast horizon, it will fall to below 40% by 2015. Consequently, a 10% change in the exchange rate will modify the gross debt ratio by 3.2-2.6 percentage points between 2011 and 2015.
- Yield curve: the yield fluctuation is gradually reflected in the interest expenditure through the renewed instruments. The cumulated impact of the changed interest expenditure on the debt ratio in the individual years between 2010 and 2015 in case of a 100 basis point yield change is 0; 0.2; 0.5 0.8, 1.2 percentage points (change in interest expenditure as a percentage of GDP: 0; 0.2; 0.3; 0.4; 0.4 percentage point).
- Economic growth: a permanent 1 percentage point deviation of the nominal GDP from 2011 throughout the path would change the gross debt ratio by 0.7 percentage point in 2011, and the discrepancy would gradually expand to 3 percentage points by 2015.

### Limitation of indebtedness in the Constitution

In order to make the results of the implementation of the public debt reduction programme sustainable in the long term, over political cycles, pursuant to the Bill under discussion by the Parliament, the new Constitution will contain a provision on public debt. According to this provision, the public debt cannot be higher than 50% of the gross domestic product. The purpose of this provision is to prevent, also with constitutional means, the repetition of reaching the currently outstandingly high public debt in the future. However, in case of significant and long-term economic recession, the draft Bill shows an appropriate degree of flexibility. The draft Constitution Bill also contains provisions limiting the indebtedness of local governments, which is also one of the key points of the Széll Kálmán Plan.

# 4. Alternative scenarios and sensitivity analyses

## 4.1. The dynamic growth path

The Convergence Programme is based on a conservative macroeconomic scenario, in which the positive affects of the Structural Reform Programme are only felt to a small degree. However, a more dynamic path of growth can be attained with the termination of the identified bottlenecks.

The alternative scenario included in Table 13 assumes that the increase in credibility resulting from the successful implementation of the plan leads to a decrease in the country's risk premium, which in turn will result in the lessening of the required return on capital investments. All the above, as well as the successful motivational effect of the New Széchenyi Plan, can result in a more pronounced expansion in investment, by which the investment rate can reach 24.5% by the end of the forecast period.

The new production capacities to be built generate additional labour force demand that raise the level of employment. Simultaneously, the measures of the Structural Reform Programme that motivate work contribute in large part to the increase in employment, which generate a surplus labour force supply by making it increasingly worthwhile for people to find work instead of choosing passive benefits.

Incomes in the private sector will partially accommodate the increase in productivity, which – also as a result of the increased number of employees – will lead to a more pronounced growth of incomes, resulting in the more dynamic increase in household consumption. More advantageous loan conditions also significantly contribute to the increase in consumption, as a result of which the population will use increasing amounts of its disposable income. Stronger domestic demand than in the conservative growth path implies higher growth rates of imports, thus the net external financing capacity, though still maintained, is somewhat lower, particularly in the outer years of the programme horizon.

**Table 12 Dynamic growth path** %

| | 2011 | 2012 | 2013 | 2014 | 2015 |
|---|---|---|---|---|---|
| GDP | 3.2 | 3.6 | 4.8 | 5.2 | 5.5 |
| Household consumption expenditure | 3,2 | 2,6 | 4,9 | 4,2 | 4,2 |
| Gross fixed capital formation | 6.4 | 8.0 | 8.4 | 11.4 | 11.9 |
| Export | 9.7 | 10.8 | 12.3 | 12.5 | 12.5 |
| Import | 9.8 | 10.9 | 12.6 | 13.0 | 12.9 |
| Inflation | 4.0 | 3.4 | 3.1 | 3.0 | 3.0 |
| Employment in the business sector | 1.2 | 2.1 | 3.3 | 3.3 | 3.3 |
| External financing need (-)/capacity (+) | 4.1 | 5.4 | 4.9 | 3.1 | 2.6 |

## 4.2. Sensitivity analyses

Besides the two presented scenarios, it is also worthwhile examining and attaching a number to certain risk factors. Table 14 presents the effects of changes in external demand and of more lenient loan conditions.

The slower than anticipated growth of our main export partners could result in a decrease in the demand for Hungarian exports. A half percent decrease compared to the baseline scenario would result in a decrease of more than half a percent in exports – which is a result of the Hungarian economy's export elasticity being greater than one. All of the above decreases the profitability of companies that manufacture exports, which therefore lessen their capacities by reducing their investments and employment. In 2011, GDP could be lower by 0.2 percent as a result of decreased net exports and because of internal use (investment and consumption), but the effects also spread into other areas and decrease the amount of growth experienced in 2012. The balance of public finances could fall by 0.2 percentage points by 2013 as a result of more disadvantageous real economic development, but the budgetary reserve will provide funding.

The conservative scenario is calculated with very slowly improving credit conditions. If credits constraints loosen faster, that would stimulate activities of both households and companies. In this latter case, the willingness of households to consume (the ratio of consumption to income) can be higher since households will be able to fund increasing amounts of their consumption from loans. However, the more beneficial credit conditions can also lead to a rise in residential investments. Willingness to invest can also increase in the corporate sector, partly because of the more advantageous loan conditions and partly as a result of the population's increased demand. Increased domestic demand will somewhat increase employment and the incomes in the business sector. In summary, this scenario includes a half a percent additional consumption and more than one percent more investments. As a result of the increased tax and contribution revenue, the fiscal deficit could be 0.4 percentage points less than the baseline scenario by 2013.

**Table 13 Deviations from the baseline scenario** percentage points

| | 2011 | 2012 | 2013 |
|---|---|---|---|
| **Decrease in external demand** | | | |
| GDP | -0.2 | -0.1 | -0.0 |
| Household consumption expenditures | -0.1 | -0.1 | 0.0 |
| Gross fixed capital formation | -0.2 | -0.1 | -0.0 |
| Export | -0.6 | -0.3 | 0.0 |
| Import | -0.3 | -0.2 | -0.0 |
| Inflation | 0.0 | -0.1 | 0.0 |
| Employment in the business sector | -0.1 | -0.1 | 0.0 |
| General government balance (in percent of GDP) | -0.1 | -0.1 | -0.2 |
| **Increases in loans** | | | |
| GDP | 0.3 | 0.2 | 0.1 |
| Household consumption expenditures | 0.5 | 0.3 | 0.1 |
| Gross fixed capital formation | 1.3 | 0.6 | 0.0 |
| Export | 0.0 | 0.1 | 0.2 |
| Import | 0.3 | 0.2 | 0.2 |
| Inflation | 0.1 | 0.1 | 0.1 |
| Employment in the business sector | 0.0 | 0.2 | 0.2 |
| General government balance (in percent of GDP) | 0.1 | 0.3 | 0.4 |

*: The difference in the growth of macroeconomic variables compared to the baseline scenario, in percentage points

# 5. Sustainability of public finances

Expenditures related to long term sustainability are determined by the pension, health care, old-age care and education systems as well as the unemployment benefit system and long-term demographic trends. As a result of demographic developments, without reforming the pension and health care systems, expenditures are set to increase with the ageing of society, inducing the growth of public debt in the long term. The level of government debt calculated for 2060 is determined by the current position of the general government (budget balance, current government debt) and the size of ageing-related budgetary expenditures, which would grow in the future.

The significant parametric measures introduced in the years 2006-2007 and 2009 have significantly reduced the growth of pension-related expenditures incurred in the long run, by approximately 4.2% of GDP. This also means that a decrease also took place between 2007 and 2060 in the projected pension expenditures.

According to the Government's evaluation, the second pension pillar introduced in 1998 did not lead to the desired results; it therefore made it possible for members of the compulsory private pension scheme to return to the solely state operated pension system in 2010. 97% of members made use of this possibility. This influences the long term sustainability of public finances through several channels: on the one hand, explicit public debt immediately and significantly decreases and the payments of those members who rejoin the state pension system improve the balance of the pay-as-you-go system[3] and, on the other hand, future payments made from the pay-as-you-go system also would have the effect of increasing long term state pension expenditures in the long term.

The Government therefore decided to implement several measures in order to improve the long term sustainability of the pension system (see Chapter 6.1.2). As a result of these measures, pension expenditures on the whole will decrease and the pension system will become balanced in the medium and long term, as the effective retirement age will significantly increase. This results in a smaller number of people utilising benefits under the statutory retirement age, thus reducing public expenditures.

[3] The payment of contributions to private pension funds reduced the social security contribution revenues of the government sector by almost 1.5% of GDP per annum.

In the long term projections of the convergence programme, it is assumed that pension expenditures will be streamlined from 2012 on. Pension benefits provided before the retirement age limit is reached will be converted to other benefits. The transparency of benefits provided before the retirement age limit is reached creates an opportunity to redefine every single element and to develop a cleansed system. As a result of the streamlining, pensions paid before the retirement age limit is reached and the various benefits will be removed from the pension system, thus decreasing pension expenditures.

Taking into account only the benefits provided from the Pension Insurance Fund to people above the retirement age, the balance of the Pension Insurance Fund is balanced and shows a surplus in 2060. This provides an important reserve for new benefits to be provided (survivor benefits, retiring women who have worked for 40 years). The projection assumes that people who have not reached the retirement age will gradually return to work. This will result in a continuous decrease in pre-retirement benefits. Thus, taking into account the benefits provided to those who have not yet reached the retirement age, a higher expenditure is apparent – on a public finance level – but significant savings can be attained in the long term by the pre-retirement age system not providing automatic pensions, but rather benefits linked to certain conditions. In sum, these measures will contribute to the long term sustainability of the pension system.

According to the preliminary calculations of the Ministry for National Economy, pension expenditures will decrease from 10.9% of GDP to 7.8% between 2007 and 2060.

The figures concerning other expenditure areas related to long term sustainability are provided in the Report of the Economic Policy Committee (EPC) of the European Union published in 2009 (Ageing Report 2009). According to the Report, between 2007 and 2060 the health expenditures to GDP ratio will increase from 5.8% to 7.1%, the old age care from 0.3% to 0.6%, while education expenditures will decline from 4.4% to 4%.

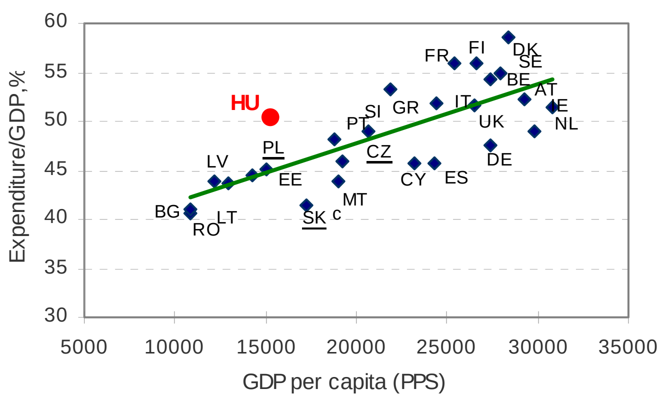
# 6. Quality of public finances

## 6.1. Public expenditures

### 6.1.1. Fiscal effects of the Structural Reform Programme

Until 2008, the Hungarian redistribution rate was significantly, in some years by more than 10 percentage points, higher than the average of other Member States with similar level of GDP per capita and was even a few percentage points higher than the average of more advanced Member States. As a result of the different crisis management strategies, this difference fell in 2009, when in most countries the fiscal stimulating measures temporarily raised the expenditure-to-GDP ratio, while in Hungary the redistribution rate grew much more moderately because of the cost cutting measures. In 2009, the size of the Hungarian general government sector was slightly smaller the EU-27 and the EU-15 average, but it was still by approximately 6 percentage points larger than the average of countries with similar level of GDP per capita or the other Visegrád countries.

**Figure 13 Redistribution rate and GDP per capita in 2009**




Source: Eurostat
Due to the outstandingly high GDP/capita, Luxembourg is not included in the figure.

Some half of the difference is attributable to the much higher interest expenditure, but the Hungarian primary expenditures-to-GDP ratio was also higher than in other Member States with similar level of GDP per capita, although this previously prevailing difference shrank significantly in 2009. In addition, the structure of public expenditures is not favourable for the growth potential of the economy: the share of investment expenditures is relatively low, while the share of current expenditures (including social transfers) is high.

Compared to its degree of development, in functional distribution Hungary spends more than average on general public services and social protection, and although health expenditures are somewhat below average, pharmaceutical expenditures are high in international comparison.

The Structural Reform Programme identifies six critical areas where public expenditure is higher than what could be justified based on the economic development, social structure and institutional framework of the country. The aim of the structural reforms is to reduce the general government deficit in a sustainable structure, which is indispensable for a sustainable public debt reduction.[4]

| **1. Employment and labour market** | **fiscal effect in percent of GDP** | |
|---|---|---|
| | **2012** | **2013** |
| Reduction of passive labour market benefits | | |
| Termination of the job search benefit, transformation of the wage substitute benefit | 0.2 | 0.2 |
| Reduction of the maximum disbursement period of the job search allowance | 0.1 | 0.1 |
| Financing of active labour market policies and vocational trainings from EU funds | 0.1 | 0.1 |
| Transformation of the sick pay benefit system | 0.03 | 0.03 |
| Maximisation of the social transfers available under several titles | 0.05 | 0.05 |
| Fixing of the nominal level of family allowance | 0.06 | 0.1 |
| **Total** | **0.6** | **0.7** |

The purpose of the measures is to help inactive groups return to the labour market, which can also be facilitated by participation in the new public work schemes.

Timing:

1 July 2011: Drafting of the new legislation for the National Employment Programme

1 January 2012: Launch of the new public work scheme

1 July 2011: Review of the sick pay benefit system, limitation of potential abuses

[4] The measures of the Széll Kálmán Plan were quantified compared to a no policy change scenario based on measures and rules in effect in December 2010.

### 2. Pension system — fiscal effect in percent of GDP

| | 2011 | 2012 | 2013 |
|---|---|---|---|
| Shift to purely inflation-based indexation | | 0.01 | 0.02 |
| Review of early retirement schemes | | 0.01 | 0.02 |
| Review of the approval of disability pensions | 0.04 | 0.3 | 0.4 |
| **Total** | **0.04** | **0.3** | **0.4** |

The purpose of the measures is to increase the effective retirement age and to enhance sustainability of the pension system. Within the framework of the pension reform, a transparent old-age pension scheme filtered from social components will be established on the basis of the insurance principle, ensuring the sustainability of the balance of the Pension Fund.

Timing:

1 July 2011: Legislation laying down the basis of the new disability pension system

By 1 January 2012: Review of previously approved disability pensions

1 July 2011: Proposal on the revision of early retirement schemes

1 July 2011: Preparation of new public service career models

31 December 2011: Legislation required for the functioning of the new pension system

1 January 2012: Entry into force of the new pension system

### 3. Public transport — fiscal effect in percent of GDP

| | 2012 | 2013 |
|---|---|---|
| Integration of MÁV and VOLÁN | 0.02 | 0.05% |
| Improvement of MÁV's cost efficiency, reduction of cost refunds and price subsidies | 0.1 | 0.1 |
| **Total** | **0.1** | **0.2** |

The purpose of the measures is to eliminate redundancies in public transport, to improve the efficiency of the organisations and to limit the scope of travel discounts with the exception of travel discount granted to individuals aged over 65 years.

Timing:

31 December 2011: Completion of restructuring plans

1 January 2012: Setting up the National Transport Company, start of organisational consolidation, followed by the entry into force of the new system of fees and discounts

### 4. Higher education — fiscal effect in percent of GDP

| | 2012 | 2013 |
|---|---|---|
| Changing the composition of the number of state subsidised students, increase of the ratio of graduates in technical and sciences studies, elimination of unused capacities | 0.04 | 0.1 |
| **Total** | **0.04** | **0.1** |

The purpose of the measures is to adjust the training and education system to the requirements of the labour market

Timing:

September 2011: New legislation on public and higher education

1 September 2012: The new higher education system begins its operation

### 5. Pharmaceutical subsidies — fiscal effect in percent of GDP

| | 2012 | 2013 |
|---|---|---|
| Generic programme, therapy review procedures, a new system evaluating the co-operation of patients, international reference pricing, revision of subsidies, increase of contributions | 0.3 | 0.4 |
| **Total** | **0.3** | **0.4** |

The purpose of the measures is to cut back on pharmaceutical expenses, which are high in international comparison.

Timing:

From 1 April 2011: Consultations for the establishment of a new, more effective financing system

1 July 2011: Legislation required for the operation of the new system

### 6. Public and local government financing — fiscal effect in percent of GDP

| | 2012 | 2013 |
|---|---|---|
| Restructuring of local government tasks based on the economies of scale, limitation of borrowing | 0.05 | 0.3 |
| Strengthening of the tax authority and simplification of tax procedures | 0.02 | 0.03 |
| Rationalisation of central administration, ban on outsourcing | 0.04 | 0.04 |
| **Total** | **0.1** | **0.4** |

The purpose of the measures is to make the functioning of the public sector more efficient, to reduce bureaucracy and to enhance transparency.

Timing:

1 July 2011: new Public Procurement Act

Entry into force of the new Constitution: introduction of the 'debt brake' concept

Freezing of support to political parties at the 2011 level

Besides the significant expenditure cuts, only a quarter of the planned measures are revenue increasing:

**7. Revenues: Public Debt Reduction Fund** **fiscal effect in percent of GDP**

| | 2012 | 2013 |
|---|---|---|
| Introduction of use-proportionate electronic road toll | - | 0.3 |
| The full amount of the special tax on financial institutions will still be kept in 2012 | 0.3 | -[5] |
| Postponement of the general reduction of the corporate income tax | - | 0.4 |
| **Total** | **0.3** | **0.7** |

### 6.1.2. Structural spending cuts

## Central administration

The general objective of the so-called Magyary Programme, the Government's programme on the renewal of public administration, is to create efficient national public services. Since the Government took office, the first efficiency improving measures have been taken in all four components of the Magyary Programme: tasks, organisation, procedures and human resources, and further steps are to follow.

#### *Renewal of the tasks*

With regard to the restructuring of public administration, first the tasks of the government at national level and in relation to international undertakings are identified. This review will result in a complex register of public tasks.

This is followed by an analysis to identify the level of public administration at which the specific public tasks can be performed most efficiently (central or local administration, ministries or background institutions). On the basis of this analysis the adequate organisational framework can be established, registered in the public institution cadastre.

In the central administration, the administrative procedures allocated to ministers are being reviewed and eliminated to the extent possible, while at local level the main objective is to remove public administration tasks from local governments that are resource intensive and do

[5] The outlook chapter of the 2011 Budget assumed the introduction of a harmonised European bank levy from 2012, therefore the measure does not imply additional revenues in 2013 compared to the original assumptions.

not necessarily require local government competency and to transfer them partly to government agencies and partly to regional centres to be established from 2013.

### *Efficient functioning of the institutional framework*

The organisational restructuring has two main directions: the transformation of the institutional framework and the renewal of the internal operation of the public administration agencies.

The former fragmented regional administration agencies have been integrated by 1 January 2011. As a result of the integration, the regional public administration tasks can be performed with more co-ordination, control and more cost efficiently in the future. The county and central government agencies will operate integrated offices where different administrative procedures can be managed at one place.

The primary task in 2011 is to connect the integrated sub-systems and to launch the development of a standardised citizen centre system. At the same time, at the lower mid-level of regional public administration the current micro-regional associations will be transformed from 2013, when districts will be re-introduced. As a result a more integrated and better co-ordinated administration structure may be established, coupled with a complex and standardised citizen centre system.

The National Public Administration Centre opened on 1 January 2011 to coordinate the financial and other material conditions required for the performance of the basic professional tasks of government agencies and controlling the operation of the integrated citizen centre system of government agencies.

### *Review of procedures*

A modern planning system, based on a standardised methodology, will be introduced in the whole public administration system to assist a more effective achievement of the government objectives. Ministries will have policy strategies, elaborated with a standardised methodology and action plans describing the execution of the strategies.

The objective is to create a multi-channel (personal, electronic and phone-based) government citizen centre system between the state and clients, enabling clients to use single-window services. The first 29 offices of the new citizen centre system, the so-called 'government windows', opened on 3 January 2011. Government windows will be established in each district by 2013, providing equal access to advanced single-window services.

### *Staff renewal*

A new public administration career model will be elaborated, offering a predictable, safe and projectable future vision to civil servants. The career model will be based on a clear description of activities, in which the objectives, main responsibilities, performance indicators, the required knowledge, experience, and competencies will be determined for each position. In this career model, a further training and exam system, teaching and measuring the actually required knowledge and skills will be formed, providing opportunities for lifelong learning and mobility within public administration. Pursuant to the Act on the establishment of the University of National Public Services, from 2012 public administration, military and police training and education will be provided by one single institution.

The new career model will be launched on 1 June 2011, and its components will be implemented gradually by 1 January 2012.

## Local governments

In the local government sub-system, the objective is to restructure operation in order to provide high-quality, professionally effective and economically optimised public services.

As a result of the efficient organisation of local government tasks, economies of scale will be enhanced and expenditure will decrease.

In the public services, the roles of the Government and local governments will be re-regulated.

Public administration tasks will need to be divided into local government and central administration tasks. The majority of the tasks falling within the competence of the clerk (e.g., official documentation bureau, construction authority, aid, custodianship cases) should be concentrated at the new district government offices.

The state will have a more important role in public education, thus the institutions can be organised more rationally. The objective is to strengthen state control in the regulation of the standard contents of education and the elaboration of the nationwide professional quality control systems. This will make the quality of education independent from the financial position of local governments.

In school-based vocational training, the training period and the professional content will be revised in line with the necessary and sufficient principle, as well as with the actual requirements of the economy and changes in the labour market.

With the strengthening of task financing and a local revenue structure adjusted to it, there can no longer be any shortfall of funding in current operation for the mandatory local government tasks, and thus borrowing for operational purposes can be prohibited.

Concerning development, local governments will have to comply with two types of conditions. On the one hand, all development actions have to aim at ensuring that public services are evenly provided at national level and, on the other hand, local governments can only borrow for development purposes, controlled by the Government, and only if the investment is expected to have positive rate of return.

## Changes in the labour market regulations

As one of the main elements of the Convergence Programme, the legislation package on labour market – which is expected to contribute to fostering employment – is currently being drafted and is to be adopted by Parliament in spring 2011 .

The legislation package contains proposals for *more flexible employment regulation* :

- possibility for 6-month trial period,
- finalisation of the rule, which was originally defined temporarily until end 2011, in view of the crisis, whereby unused working hours resulting from the temporary reduction of the ordinary working hours (due to lack of orders) can be rearranged for a longer period, so employees may work up to 44 hours a week for wages payable for 40 hours,
- reduction from the first year to the first six months of eligibility for unpaid holiday granted for caring for and nursing children among the cases of absence from work based on the right to ordinary holidays,
- issue of holidays in more than two periods also in case the employer has important economic interests to do so;
- granting part of the holidays in the form of a payment upon return from childcare allowance (unpaid holiday granted for caring for or nursing children) based on the employee's acceptance,
- requirement set for employees who intend to return from a longer period of unpaid holidays granted for caring for or nursing children to indicate their intention to the employer in due time (30-60 days in advance),
- free time instead of supplements, granted to reward overtime work based on a unilateral decision of the employer.

Further easing of *simplified employment* fosters employment as well. According to the plans:

- the new simplified employment introduced in summer 2010 will become more easily available for associations formed by agricultural producers for specific work processes (e.g. packaging).
- The provision on seasonal agricultural work will become clearer.
- In order to reduce administration, a written contract prepared upon the employee's request may cover only the basic issues (names of the parties, work to be performed, wages) until the start of the actual employment, while the sections containing other information could be completed by the end of the day.
- According to a draft bill, the obligation to issue separate working hour and payroll accounting records in case of short-term employment would be replaced with a written employment contract.

### Public work schemes

The purpose of the measures revising public work schemes is to make the consumption of the limited public funds more efficient and to increase job search activities, helping transition into the private sector and, through value creating employment, to contribute to the preservation of working capacity of disadvantaged groups, giving them a better chance to return to the primary labour market. As a result of the measures, more work could be offered to individuals of active working age in need of social assistance, capable of, and willing to work, in the new public work schemes.

The public work programme, regulated in Act III of 1993 on Social Administration and Social Services and the work in the interest of the public, specified in Act IV of 1991 on the Promotion of Employment and Unemployment Services were terminated on 1 January 2011. They were replaced by a standard public work scheme.

Under the new regulations, more support is available for public works. Individuals in need of social assistance with low education, receiving wage supplement benefit, are involved in short-term public work schemes run by local governments (local, minority), churches and civil organisations. This can help the long term unemployed to return to the labour market through primarily short-term employment, working 4 hours daily. Support can be granted up to 95% of the wage (time proportionate amount of minimum wages) and contributions, which can be supplemented with cost refunds.

The longer-term public work schemes run by local governments and institutions, churches and civil organisations help matching local public tasks, the provision of services important for and in the interests of the local community. Value creating works, also requiring professional qualifications, may be performed in the framework of this type of support, therefore this employment involves 6-8 hours of work each day and their wider range of purchases can also be supported (e.g., cost of materials, cost of tools). The total support can be 70 to 100% of the wages of employees and the related contributions, reduced by allowances.

National public work schemes can offer effective solutions for managing changes in the economy, in the labour market and potential vis maior situations. Programmes covering entire sectors and generating considerable profits for the economy at national level can be implemented within the framework of the national public work schemes. In addition to flood and inland water protection, public roads, railways and national forests, public work schemes can also be introduced in relation to renewable energy sources and energy efficiency. In these programmes, the wages and contributions are financed from the employment support system. The support may reach 100% of the wages and contributions, with regard to costs, 20% of this support and 3% of the costs of organisation in case of one hundred or more employed people. The support may be granted for up to 12 months.

The standard public work schemes are organised by the employment offices. As part of the system of government agencies, these offices perform important tasks both in matching the workforce and in the supply of support.

### *The 2011 public work programme*

The financing of the 2011 public work programme is different from the past in two important aspects. The funds allocated to public work and social benefits were not defined in a single uncapped appropriation. HUF 64 billion has been allocated from the Labour Market Fund to support public work and in total HUF 88.5 billion has been approved for social benefits, including the wage supplement benefit. In addition, the employment of wage supplement benefit recipients at entrepreneurs is supported from EU sources within the SROP 1.1.3. scheme.

According to preliminary calculations, approximately 190,000 individuals may be employed for short-term public work and 15,000-20,000 for longer-term from the available sources this year.

The further restructuring of the public work scheme will take place in the context of the Government's Structural Reform Programme by July 2011. The new framework will become effective as of January 2012. The components of the three-level model implemented at national level will assist investments requiring the work of many people including construction of dams and reservoirs, construction and maintenance of inland water collection canals, etc. The programmes implemented at local and regional level will continue to support short-term public work schemes run by local governments (local and minority), churches and civil organisations. The concept of the public work scheme implemented at the third level is currently being elaborated. The restructuring of unemployment benefits, maximisation of social subsidies, review of eligibility for disability benefits may lead to an increase in the number of participants in public work schemes. Thus instead of social benefits, the individuals concerned may earn income from work.

## Changes in social benefits

In international comparison, Hungary spends rather a lot on welfare benefits while analysts claim that the benefits are not necessarily targeted to the individuals in need. The purpose of the adopted and planned measures is to change this situation, to improve the targeting of the system already in the short term and to encourage and support economic activity and taking up employment. The most important measures in this area:

- transformation and preservation of the nominal value of social benefits
- changes in the family support system,
- restructuring of the system of health damage allowances

### *Transformation and preservation of the nominal value of social benefits*

Pursuant to the amendment of Act III of 1993 on Social Administration and Social Benefits, the availability allowance (RÁT) was replaced by the so-called wage supplement benefit (BPJ), which may be disbursed only to individuals who can certify at least 30 days of employment each year (participation in a public work scheme, seasonal work performed in the framework of simplified employment or work performed in any other form) and satisfy the other requirements of local governments specified in local bylaws, e.g., keeping the direct residential environment in order. The wage supplement benefit equals the lowest amount of old-age pension. The local governments fund 20% of the wage supplement benefit. The eligibility to benefit will still be established by the local government and remains means-tested, but the individuals concerned have to take part in job search more actively, co-operating with the competent employment office as job seekers.

The mandatory 30 days of work, required for the eligibility to the wage supplement benefit may also be performed with public work, seasonal work and other voluntary work in the interest of the public parallel to other earning activity. This enables anyone who intends to fulfil the eligibility criteria to do so in a year.

It is a major change compared to the previous practice that in the new public work system anyone capable of working has to perform some work in one form or another, otherwise they will lose eligibility to the wage supplement allowance.

### *Changes in the family support system*

In the case of family support, pursuant to the 2011 Budget, the amount of the family allowance, maternity support, child care allowance, child raising support, life-start support and the in-cash child protection benefit does not increase in 2011. The nominal value of the support needs to be preserved. It is a change in the system that pursuant to the amendment of the Act on Family Support, effective as from 1 January 2011, the childcare allowance (GYES) is payable again until the child reaches three years of age instead of two. In line with the amendment of GYES, the rules of child raising support (GYET) have also changed. GYET is again available as soon as the youngest child reaches three years of age, since the GYES expires then. The rules of employment during receiving GYES have also been amended. From 1 January 2011, part-time employment may be taken for 30 hours a week parallel with GYES once the child has reached one year of age. The Act provides for a transition period of adjustment to the changed rules by 31 March 2011 for those parents who were in full-time employment on 1 January 2011 according to the old rules, after their child reached one year of age. After this deadline, employment can only be taken for no more than 30 hours a week and the eligibility to GYES of those who are employed over this limit was terminated on 31 March.

### *Transformation of the system of health damage benefits*

With the planned measure, the transformation of the system of health damage allowances affects recipients of temporary allowance, health damage allowance of miners and regular social allowance. The main element of the restructuring is the review of the degree of the health damage of each individual eligible for the allowance; if during the review the health damaged individual proves to be capable of working, then the further disbursement of the allowance in its current form is no longer justified. This change may also lead to an amendment of the Government Decree on the Social Benefits of Health Damaged Persons and the support system of persons with altered working ability. The stressed objective of this change is to increase the employment rate among the individuals concerned.

## Higher education

The restructuring of higher education is based on a new Higher Education Act. The main objective of the restructuring is to improve the competitiveness of the sector, to reflect the requirements of the economy and the labour market, to give preference to education in sciences and technical studies, to improve the training structure and to ensure the return of the cost of training.

Certain rules applicable to higher education were modified already in 2010, including the new admittance procedure contributing to the improvement of the quality of training on the input side (from 2013, the number of faculties where enhanced GCSE is a mandatory requirement of admission will increase).

The Government's Structural Reform Programme describes the need for careful and planned decisions and argues for the reconsideration, and in some cases, strengthening, of the role of the state. The Government pays outstanding attention to the determination of the number of state financed students and the composition of their faculties in line with changes in the economy, which will imply decrease in the total number in the forthcoming period (e.g. in order to reduce excessive unemployment of graduates in some faculties). From 2012, the quota of students that can be admitted to state-financed education will decrease gradually from 53,450 students in 2011 to approximately 30,000 by 2014, while further admitted students can study in other, not financed forms. This step is also explained by public education and demographic developments (continuous decline of the number of students). The structure of training will also be transformed by introducing more courses in sciences and technical faculties.

Significant changes can be expected in the method, beneficiaries, titles and other conditions of financing (e.g., normative support), ensuring that state support secures the performance of the state tasks. Financial instruments will also be used for imposing limitations on the role of the state. The organisational and institutional structure of higher education will be revised, rationalised and the efficiency of operation will be improved in the same context.

## Pharmaceutical subsidy system

The following components of the pharmaceutical subsidy system were defined at the beginning of 2011 in order to achieve the desired savings:

- encouraging prescriptions and expediation to pharmacies of active substances and drugs, more favourable for the Health Insurance Fund,

- revision of the rules of ex officio review by defining in advance the relevant therapy fields, preparing adequate cost efficiency analyses and taking into account the financing protocol of the specific field,
- elaboration of the detailed rules of acceptance of combined product and their support,
- modification of the application form in the acceptance of new pharmaceuticals in order to ensure the lowest European Union price level.

Furthermore, the preservation of the level of 2011 of pharmaceutical subsidies and the HUF 83 billion savings forecast for 2012 followed by further savings in 2013 partly resulting from pharmaceutical policy measures and partly from the increase of the payments of manufacturers are key points of the Structural Reform Programme, approved by the Government.

The 12% payment of producers, the increase of medical sales representative fees and the revision of the support volume contracts are the most important among the revenue-related measures.

In terms of expenditures, the Plan takes into account the effect of the following measures: establishment of a therapy review procedure, development of a complex system evaluating efficiency of therapies, patient co-operation and preferring the generic programme, elaboration of a bio-similar support procedure, introduction of international reference prices and other measures enhancing system transparency, including the transformation of pharmaceutical acceptance, special pharmaceutical public subsidy system and its means-tests.

## Pension reform

The new legislation related to the pension reform will be completed by 31 December 2011. Based on the concept, the objective is to create a new financing system and a transparent pension scheme. Given the objective to achieve a balance of the Pension Fund, no services can be financed that are not aimed at old-age security, which is the basic purpose of the pension. The early retirement schemes and other allowances will be treated separately from the pension system. The objective is to redirect as many people receiving pension below the retirement age into the labour market as possible.

The purpose of this transformation is to ensure the provision of pension entitlements for every insured person in the pay–as-you-go system and to form a structure where the value of pensions can be preserved in the long term.

The pension system will have a transparent, clear profile in its funding components, with pension entitlements based on various risk profiles. Within the managed risks, insurance, solidarity and social components will be identified and, to the extent possible, separated and entitlements not or only partly justified by insurance performance will be gradually phased out and transformed into social benefits.

As a result of the transformation of the financing system, existing benefits provided below the retirement age will be converted into social benefits. The review of the benefits can result in the redefinition of every element and ultimately in a clear system. The possibility for women with 40 years of service to retire will remain part of the pension system and will not be reviewed.

The termination of early pensions encompasses two main areas the early disability pension scheme and the early retirement scheme. In the disability system, the objective is to redirect disabled individuals who are capable of performing certain jobs into employment. The early retirement scheme also needs to be reviewed in order to form a balanced and transparent state pension system. In order to do so, all titles (early retirement) will be eliminated, which permit individuals with working capacity to retire before the official retirement age.

In the disability pension scheme, the review system has to be made more efficient and more operational. The purpose of the review is not only to assess the degree and possible rehabilitation of the disability, but also to identify the specific jobs and conditions under which the individual subject to the review may be employed. The currently applied health status focused review system would be replaced by an employment focused system. The purpose of this review is to conclude, whether or not the individual is able to work and to identify the employment criteria based on which he/she may be returned into active employment. If a disabled cannot find a job in the open labour market, the person can be employed at a social rehabilitation workplace within the framework of a public work scheme, naturally if there are no such opportunities provision is still performed.

A standard pension calculation method will also be introduced. Retirement age and pension entitlements will be determined according to the same standard principles and method. New career models need to be developed for those occupational groups, to which more favourable retirement rules have been applied, and the specificities of the work performed by them should be rewarded with other instruments than early retirement.

As a result of these measures, pension expenditures may decrease, the pension system may be balanced in the medium and long term and the effective retirement age may rise significantly. The application of standardised, more transparent rules will create a clearer scheme, with a view only the to old-age risk, in which pension will be granted only to those who have reached the retirement age. The benefits below retirement age will not be provided automatically, as the objective is to keep those in the labour market under the retirement age with working capacity.

In the longer term, employment is expected to grow and thereby revenues from contributions are expected to rise as well. As fewer people will use benefits below the retirement age, pension expenditures will decrease. As an overall effect, not only expenditures of the Pension Fund will fall significantly, but total pension expenditures are expected to decrease.

### Public transport

In the framework of the Structural Reform Programme the Government announced the basic principles to guide the implementation of the reorganisation of public transport. The actions in the Plan are as follows:

- By 31 December 2011 the Ministry of National Development will work out the plan for the clearing of debt and reorganisation of the railway company (MÁV). The present form of the operation of MÁV needs to be changed to enable it to become a railway company that provides competitive, efficient and high standard services.
- As of 1 January 2012, through the integration of MÁV and Volán (coach company), the National Transport Holding will be set up and the organisational consolidation of public transport will be launched. Through harmonising activities and rationalising functions more efficient fulfilment of functions will be implemented and redundant schedules of railway and coach companies providing public transport services will be terminated.
- The new system of discounts and fees of public transport: currently, persons who use public transport can obtain discounts under approximately fifty legal titles. This scheme cannot be sustained in the future; therefore, all existing discounts have to be reviewed. As a result of the steps, it will be possible to attain savings on the expenditure side of the central budget.
- As of 1 January 2013, the use-proportionate electronic road toll system will be applied. The currently effective (e-sticker) tariff system does not allow to charge road users fees covering the cost of maintenance actually caused. As a result of introducing a system of tariffs in proportion to covered mileage the costs of use of the clearway network will become proportionate by the usage. By introducing the use-proportionate electronic road toll system, the advantage of road transport to rail transport can be decreased and thereby generating significant additional budgetary revenues on the central level from 2013.

## 6.2. Tax policy

In order to implement a new economic system, the Government adopted its first economic action plan already in mid-2010. As part of that, in addition to CIT reduction, it introduced several simplifications: ten minor taxes were abolished, among others tourist industry tax on buildings, communal tax payable by entrepreneurs, tax on high capacity passenger cars, vessels, aircraft, operating fee of television sets, contribution payable on water management, tax on spirits on distillation for hire, and duties on inheritance and gift for heirs of line. These steps not only ease the tax burden on business but also reduce administrative burdens. Altogether, these measures have a positive effect on whitening the economy, by creating sound legal framework for economic activities and stimulate business investments.

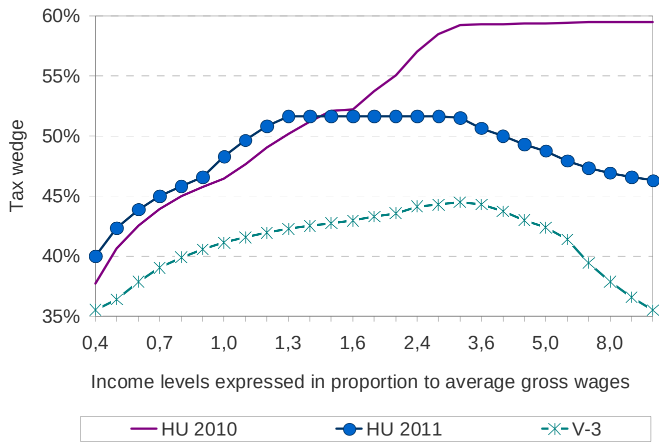
Further changes implemented during 2010 include the introduction of the term of income not subject to taxation in the legal system (in relation to duties of the household or around the house), and the simplification of the conditions of ad hoc employment.

As from 2011, structural changes have been made in the PIT regime. Accordingly, the former tax bracket regime has been replaced by a flat rate tax regime that implements proportional taxation operated by a 16% rate, while the institution of super grossing-up (under which the social security contribution paid by the employer is included in calculating the tax base) will be phased out by 2013. Simultaneously, the tax credit has been modified: as from 2011, its monthly ceiling has been reduced to 12 100 HUF, whereas the income limit belonging to full enforcement has decreased to 2 750 000 HUF per annum. In order to ensure neutral taxation across various incomes, the tax rates applied to fringe benefits were transformed. Furthermore, the tax rate of separately taxable income (presumptive tax for sole proprietors and agricultural small producers, taxes on dividends, life annuities, capital gains, incomes from transfer of real and movable property and from renting out real estate, and on incomes subject to withholding tax) has also changed, to 16%.

The new PIT regime pays special attention to mitigating burdens related to child raising. In this context, the construction of family allowance has been transformed and extended; accordingly, as of 2011 families raising one or two children are also entitled to the allowance reserved for families (the allowance can be divided between the parents in 2011 too). It is a further change that, instead of the former allowance deductible from tax, as of 2011 persons concerned can reduce their tax base by the acknowledged costs of child raising. Persons with one or two children can reduce their tax base by 62 500 HUF per child per month, while persons who care for a minimum of three children by 216 250 HUF per child per month. Upon the effect of family allowance, in 2011 taxpayers with one child up to gross earnings of approx. 109 thousand HUF per month, taxpayers with two children up to gross earnings of approx. 158 thousand HUF per month, while taxpayers raising three children up to gross earnings of approx. 487 thousand HUF per month will not pay PIT.

The new tax regime has significant direct and indirect positive macroeconomic effects. Repayment capacity of households with higher income, which have higher loans outstanding as a result of their higher borrowing capacity, will improve owing to their additional net income arising from tax reduction. Thereby the portfolio deterioration of the financial system will lessen, reducing risks to financial stability. The marginal tax wedge, which is outstandingly high among taxpayers with high income compared to the rest of the countries in the region, will be narrowed as a result of modifications, producing favourable impact on the whitening of incomes. Experience shows that the impact produced by the marginal tax wedge on tax returns is the most significant among taxpayers with high income.

**Figure 14 Changes in tax wedge**




The new family tax base allowance indirectly influences consumption and employment positively. On the one hand, as the allowance can be used only by families that have taxable income, it encourages parents to return to work. On the other hand, it increases a family's available income, which can be spent on consumption or the above-mentioned loan repayment purposes.

With respect to changes in the PIT from 2012, it should be highlighted that in the autumn of 2010 the Parliament enacted a law phasing out super grossing up, as a result of which this element of the tax regime will terminate by 2013. The above-mentioned modification is followed by the reduction of the tax credit commenced from 2011 and to be continued in the coming years: according to the relevant proposal as of 2012 transformation of tax credit will generate approx. 180 billion HUF, while in 2013 approx. 230 billion HUF savings.

As of August 2010 the CIT regime was also modified, its core element was to raise the threshold of the tax base allocated to the preferential rate from 50 million HUF to 500 million HUF. As the legislative amendment entered into force during the year, to determine the CIT liability calculated for 2010, businesses had to divide their annual tax base: while the preferential 10% tax rate could be applied in the first half of 2010 according to the former regime, that is, up to 50 million HUF limit, in the second half of the year already up to 250 million HUF taking modifications and time proportioning into account. As of 2011 the threshold of the tax base of the preferential rate – as now the new tax regime applies to the entire year – has increased to 500 million HUF. In the autumn of 2010 the Parliament enacted that as of 2013 the general rate of CIT will be lowered to 10%. At the same time, upon acceptance of the Széll Kálmán Plan that has laid down the foundations of reduction of public debt, a decision was adopted that the uniform 10% CIT rate will not be implemented in the period 2013-2014. In view of the indulgence of present regulation applying to the option to write off accrued loss of former years, from 2012 the regulation will presumably become more stringent (e.g., it can be enforced up to 50% of profit before tax only; 3-5 year limitation of usability; it can be used only for activities where loss was incurred in former years).

In order to improve the balance of public finances, taxpayers capable of burden sharing exceeding general tax payment are obliged to pay special tax in the three years of the period 2010-2012. The special tax must be paid by businesses that belong to the financial sector, energy suppliers, companies that deal with telecommunication or perform retail trade activity. Here it is necessary to underline the point of the Structural Reform Programme that states that financial organisations will have to pay special tax in 2012 in the amount paid in the two years preceding it.

Businesses concerned must reckon with the income tax payable by energy suppliers also in the period 2011-2012 (in accordance with the previously effective Act this tax type would have terminated from 2011).

From among the changes in consumption-type taxes it should be underlined that from 2011 for VAT the scope of application of reverse taxation has extended. As regards excise tax regulation, arising from the law approximation obligation, as from 2011 excise taxes imposed on tobacco products have increased: for cigarettes (applying to average retail cigarette prices) the excise tax burden has increased by somewhat more than 4%, while for smoking tobacco the tax minimum has increased by 8%. In order to support R&D activity, as from 2011 the tax allowance of experimental engine development enables to reclaim excise tax on use of fuel in experimental projects to develop environment friendly engines. Excise tax will be increased in July 2011 and evenly in the coming years – as part of EU law approximation measures to be completed by 1 January 2018.

In social security it is an important change that as from 2011 the rule of payment of contribution on income characteristic of the activity, governing full-time sole proprietors has terminated; instead, for full-time sole proprietors or members of partnerships the new minimum contribution base valid as from 2011 will be the amount of the minimum wage, and, in case of main activity requiring secondary school qualifications / vocational qualification, the amount of guaranteed minimum wages. The pension contribution rate payable by the employees was increased from 9.5% in 2010 to 10%, effective from the beginning of 2011.

In order to ensure uniform records, collection and control of budget revenues as well as to enhance efficiency and simplify taxation related procedures, on 1 January 2011 the integration of the Tax and Fiscal Control Office and the Customs and Excise Guard was launched, and the National Tax and Customs Administration of Hungary was set up.

It is a further goal in relation to the transformation of the tax regime, set forth in the Structural Reform Programme, that a new regulation will enter into force regarding local taxes as part of the overall reform of local government financing.

# 7. Institutional features of public finances

## 7.1. Public finance governance

The public finance and fiscal system will be renewed on the basis of the new Constitution and the fundamental laws, taking also into account the requirements of the legislative package on strengthening economic and fiscal governance in the European Union..

In this context, the Government's objectives are as follows:

- strengthening the credibility of the medium term fiscal framework by extending the forecast horizon;
- in addition to more detailed planning with a transparent explanation of the underlying assumptions, the annual budget accepted by Parliament should not be amended during its implementation process; developing a system of measures and rules that ensure the adherence of the adopted budget;
- reducing the overabundant administration regarding the operation and business activities of fiscal organs;
- including elements in the process of public spending that guarantee the protection of public property and curb corruption.

### *The public finance recommendations included in the new Constitution*

On 14 March 2011, a proposal for the new Constitution (hereinafter referred to as: the Proposal) was submitted to Parliament.

The Proposal sets forth that balanced, transparent, and sustainable fiscal management is obligatory. It provides for the public availability of data pertaining to both national public property and public finances by holding such data to be of public interest.

The Proposal has a separate chapter that deals with public finances, in which the Proposal sets strict requirements to fiscal management in order to ensure that excessive emphasis on current needs or interests do not impose an unbearable burden on future generations. It declares the permanent reduction of public debt as a fundamental value; accordingly, it defines a ceiling for the public debt ratio at 50% of GDP, a threshold below the reference value of the Treaty.

Since the present level of public debt is significantly higher than the target of 50%, the Proposal sets forth that Parliament and the Government, primarily responsible for the implementation of the budget, are to decrease public debt until the target level is attained.

The Government is only authorised to refrain from adhering to the above fiscal rules if special circumstances arise and in a degree in line with such circumstances. Since it is necessary to unequivocally define both public debt and the gross domestic product, the Proposal sets forth that the methods for calculating these figures is to be included in law.

On the basis of the Proposal, the consent of the government (or governing body) can be required for the borrowing or other undertaking of obligations on behalf of local governments, as defined in relevant legislation.

The Proposal also includes the fundamental provisions in regard to Magyar Nemzeti Bank the State Audit Office] and the Fiscal Council, including their tasks, competences, and the rules pertaining to the election of their members. According to relevant regulations as included in legislation (see below) and the planned constitutional provisions, the members of the Fiscal Council are the President of the Fiscal Council (who is appointed by the President of the Republic), the President of Magyar Nemzeti Bank and the President of the State Audit Office. On the basis of the Proposal, the Fiscal Council will preliminarily inspect the well founded nature of the fiscal regulations for the given year and whether it is in accordance with the fiscal rules to be included in the Constitution.

In addition to the above, the Proposal also includes the fundamental principles pertaining to the protection of public finances and national public assets. The Proposal also sets requirements for the sale of public property by setting forth that such can only be carried out in the interests set forth by law and declares that – with the exceptions defined by law – the transactions should be based on the principle of fair value. It would only be possible to conclude agreements regarding the transfer or utilisation of national public property with organisations whose proprietary background and activities are transparent.

### *The renewed Fiscal Council*

According to relevant regulations, the Fiscal Council continues to carry out its activities based on the Act on economical government management and fiscal responsibility, the rules of which have been amended in several places by Act CLIII of 2010 on the amendment of the various acts that form the basis for the 2011 budget of the Republic of Hungary.

Within the meaning of the amendments, the members of the Council are the respective Presidents of Magyar Nemzeti Bank and the State Audit Office as well as one person appointed by the President of the Republic. The mandate of the pervious members has been cancelled. On the basis of the amended Act, the members of the Fiscal Council do not receive remuneration for their activity. The organisation that assisted the Council's work, the Secretariat of the Fiscal Council, was also terminated. The Council can rely on the available work organisations of the Presidents of Magyar Nemzeti Bank and the State Audit Office in fulfilling of its tasks.

According to the new rules, the sole task of the Fiscal Council is to formulate an opinion regarding the respective draft annual budget and its competence has been augmented in this respect. The draft budget is to be sent to the Fiscal Council prior to being submitted to Parliament, and the Fiscal Council will, if the draft budget has fundamental deficiencies, also be granted the right to formulate a second opinion. In such a case the Government is obliged to once again debate the draft budget and can only submit it to Parliament if the new opinion has been received or the deadline for providing such has been passed.

### *Elements of regulation aiming at aiding the tenability of the 2011 budget*

The amendment of the act on public finances adopted on 16 March 2011 provides for the legal possibility for, during the implementation of the 2011 budget, procuring sources for additional costs incurred during the year from the own budgets of portfolios instead of from the extraordinary government central budget appropriation or by using the "stability reserve" created during the year. This ensures that no situation can arise in which providing for the issues of various sectoral cases burdens the sources of the central reserves even though sources are available in the respective portfolio's own budget.

### *Operation of the fiscal inspectorate system*

The legal framework for the operation of a fiscal inspectorate and supervision system was established on 15 August 2010. The objective of the new setup was to provide for continuous control of the undertakings of obligations taken on by the central fiscal portfolios that fall under Government control as well as the fiscal bodies that fall under its supervision and separate extra-budgetary funds. The basis of the system is that at the very beginning of the process of expenditures, the required level of control is established, which will greatly decrease the risks incurred later on. Within the meaning of the rules, the Government can decide on how many (inspectors or) supervisors it wishes to assign to the various portfolios, on the basis of which the Minister for National Economy will designate and appoint the persons. Since the act has entered into force, fiscal (inspectors or) supervisors have been designated to numerous positions. Initial experiences show that the appointments have brought positive results regarding both the quality of the management rules of the fiscal bodies and the well founded nature of the undertaking of obligations. Maintaining and expanding this system is among the Government's important objectives.

## 7.2. The governance of public finance statistics

The Hungarian Central Statistical Office (KSH) and the central bank (Magyar Nemzeti Bank, MNB) compile the statistics on the government sector in Hungary. In the current division of labour, the KSH is responsible for non-financial accounts, the MNB for financial accounts. The above-mentioned division of labour applies to the compilation of data up to the (t-1) period within the Excessive Deficit Procedure (EDP Notification), while the expected deficit and debt of the current (t) period are calculated by the Ministry for National Economy (NGM). Previously, the deficit for the (t-1) period was also calculated by the NGM, but since 2006, when the Notification deadlines were changed, the KSH has been able to take on this task, which assures consistency with the national accounts. The statistical working group comprised of the representatives of the KSH, the MNB and the NGM operates on the management and expert levels, and a co-operation agreement regulates procedural issues of data flow, division of labour and methodological treatment.

Key data sources of the statistics of the government sector include the general government information system, the annual and interim reports of the units of the legal government, statistical data collection from corporations and non-profit entities classified within the general government sector as well as the statistical collection of banking and securities data for the entire government sector. The EDP Notification report is published on the KSH website when it sends the data to Eurostat, after which follows a three week period of harmonization with Eurostat. Eurostat then also publishes the approved EDP Notification tables as well as their time series and the detailed description of its compilation methodology as updated by Hungarian authorities from time to time ("EDP Inventory"), simultaneously with the press release of Eurostat. According to current practice, the Ministry for National Economy dedicates a separate chapter to the explanation of the difference between the official national and the Maastricht deficit and debt indicators, as part of the general explanation attached to the annual budget and the final accounts submitted to Parliament. As from 2008, the KSH discloses quarterly data of the general government sector in its publications on national account statistics.

During its latest visit (in July 2010), Eurostat reviewed the institutional background of data reporting related to the Excessive Deficit Procedure, the cooperation of peer authorities, the data sources, the applied methodology and procedure as well as the disclosure policy.

| | | Measures of the Structural Reform Programme | 2011 | 2012 | 2013 |
|---|---|---|---|---|---|
| | **TOTAL** | | **15** | **550** | **902** |
| | **1. EMPLOYMENT AND LABOUR MARKET** | | **3** | **195** | **213** |
| 1 | | Termination of job seeking assistance | 0.0 | 27.2 | 27.2 |
| 2 | **Reduction of passive labour market provisions** | Overhaul of the wage supplement system | 0.0 | 41.0 | 41.0 |
| 3 | | Tightening the conditions of job seeking benefits (reduction of the time period covered and the amount granted) | 0.0 | 42.9 | 42.9 |
| 4 | **Reduction of active labour market and vocational training provisions** | Replacement of part of the active labour market and vocational training provisions by EU funds serving the same purpose | 0.0 | 40.5 | 40.5 |
| 5 | **Reduction of sick pay expenditures** | Review and modification of the conditions of granting sick pay | 3.0 | 10.0 | 10.0 |
| 6 | **Capping social benefits** | Capping the total amount of social and family benefits which can be granted on various grounds | 0.0 | 15.0 | 15.0 |
| 7 | **Family benefits** | Nominal freeze of family benefits | 0.0 | 18.0 | 36.0 |
| | **2. PENSION SYSTEM REFORM** | | **12** | **93** | **129** |
| 8 | | Changing the rules of the pension increase at the beginning of the year, pension increase based on CPI | 0.0 | 3.0 | 6.0 |
| 9 | **Pension system** | Review of the schedule of professions eligible for retirement earlier than the statutory retirement age | 0.0 | 0.0 | 2.5 |
| 10 | | Termination of special pension rules for members of the armed forces | 0.0 | 1.5 | 3.0 |
| 11 | **Overhaul of the allowances related to disability status and health status** | Review of the qualification conditions of granting disability pensions, overhaul of the allowances | 12.0 | 88.0 | 117.0 |
| | **3. PUBLIC TRANSPORT** | | **0** | **45** | **60** |
| 12 | **Setting-up of the National Transport Holding Company** | Integration of MÁV and Volán, setting-up of an integrated management company, more efficient governance structure (e. g., lower management fee), thus reducing the reimbursement related to passenger transport | 0.0 | 5.0 | 15.0 |
| 13 | **Re-structuring of MÁV and improvement of its cost-efficiency** | Improving the operational conditions of MÁV (debt assumption, re-structuring, cost-efficient functioning), thus reducing the reimbursement related to passenger transport | 0.0 | 30.0 | 35.0 |
| 14 | **Review of the the preferential tariff system** | Reduction of price subsidies | 0.0 | 10.0 | 10.0 |

| | | Measures of the Structural Reform Programme | 2011 | 2012 | 2013 |
|---|---|---|---|---|---|
| | **4. HIGHER EDUCATION** | | **0** | **12** | **38** |
| **15** | **Reduction of the number of students** | Reducing the enrolment in both state-subsidised and tuition fee based higher education, changing the composition of curricula by giving preference to natural sciences | 0.0 | 5.4 | 15.5 |
| **16** | **Structural measures: reduction of institutional and other organisational capacities and determinations** | Elimination of capacities not utilised, termination of statutory financing needs | 0.0 | 6.6 | 22.5 |
| | **5. PRESCRIPTION DRUG SUBSIDY SYSTEM** | | **0** | **83** | **120** |
| **17** | | Revenue increase: raising the payment by pharmaceutical companies (lifting the current 12% rate, increasing the fee paid on promotion (medical representative), re-negotiating contracts) | 0.0 | 16.0 | 15.0 |
| | | Expenditure cuts: | | | |
| **18** | | Generic program (system of preferred reference price range, encouraging the use of generic products) | 0.0 | 20.0 | 21.0 |
| **19** | | a) in case of expired patents - replacement by generic products and b) encouraging the use of first generics | 0.0 | 4.0 | 6.0 |
| **20** | | a) subsidy scheme for bio-like drugs and b) subsidies based on therapy results | 0.0 | 5.0 | 6.0 |
| **21** | | Revision of the therapies | 0.0 | 8.0 | 8.0 |
| **22** | | Subsidies conditional on the cooperative behaviour of patients | 0.0 | 3.0 | 4.0 |
| **23** | | a) international reference pricing and b) review and price fixing of composite drugs | 0.0 | 4.0 | 4.0 |
| **24** | | Reduction of subsidies on drugs which decrease the level of cholesterol | 0.0 | 14.0 | 19.0 |
| **25** | | Savings through re-shuffling of financing (the financing of certain infusion, injection and oncology type drugs will be hospital-based) | 0.0 | 5.0 | 5.0 |
| **26** | | Overhaul of the principles applied for equity consideration in individual cases | 0.0 | 2.0 | 5.0 |
| **27** | | Overhaul of the special public subsidy system for the poor | 0.0 | 2.0 | 2.0 |
| **28** | | Further long-term measures regarding the enhancement of the effectiveness of the subsidy system and — if necessary — increase of the burden on pharmaceutical market partners | 0.0 | 0.0 | 25.0 |

| | Measures of the Structural Reform Programme | | 2011 | 2012 | 2013 |
|---|---|---|---|---|---|
| | **6. STATE AND MUNICIPAL FINANCING** | | **0** | **32** | **122** |
| 29 | **Organisational development of local governments** | Re-shuffling compulsory tasks performed by local government based on economies of scale | 0.0 | 15.0 | 100.0 |
| 30 | | Prohibition of taking loans for current operations, introducing Government control on taking loans for investments | | | |
| 31 | **Strengthening the tax authority** | Strengthening the tax authority, simplification of taxation procedures | 0.0 | 5.0 | 10.0 |
| 32 | **Rationalisation in central public administration** | Rationalisation of the functioning of central and background institutions, prohibition of outsourcing | 0.0 | 12.0 | 12.0 |
| | **CONTRIBUTIONS TO THE FUND ESTABLISHED TO REDUCE PUBLIC DEBT** | | **0** | **90** | **220** |
| 33 | **Electronic toll system** | Immediate launch of the establishment of a usage-based electronic toll system | 0.0 | 0.0 | 100.0 |
| 34 | **Bank tax** | The size of the bank tax will not change in 2012. (Compared to the baseline - calculating with half of the bank tax from 2012 -, this generates additional revenue of HUF 90 billion in 2012). From 2013 onwards, the bank tax will be levied at the level harmonised within the European Union. | 0.0 | 90.0 | 0.0 |
| 35 | **Corporate income tax** | The standard corporate income tax rate will not be reduced to 10% from 2013. | 0.0 | 0.0 | 120.0 |

# TABLES

## Table 1a Macroeconomic prospects

| | ESA Code | 2010 HUF bn | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 |
|---|---|---|---|---|---|---|---|---|
| | | | Percentage change | | | | | |
| 1. Real GDP (at constant prices) | B1g | 26359.8 | 1.2 | 3.1 | 3.0 | 3.2 | 3.3 | 3.5 |
| 2. Nominal GDP | B1g | 27119.8 | 4.1 | 6.1 | 5.8 | 5.4 | 5.6 | 5.8 |
| **Components of real GDP** | | | | | | | | |
| 3. Private consumption expenditure | P.3 | 13208.7 | -2.1 | 3.1 | 2.2 | 2.4 | 2.5 | 2.7 |
| 4. Government consumption expenditure* | P.3 | 6101.5 | -1.7 | -2.4 | -0.3 | -0.2 | 0.2 | 0.2 |
| 5. Gross fixed capital formation | P.51 | 5135.8 | -5.6 | 5.7 | 5.3 | 6.0 | 5.7 | 5.8 |
| 6. Changes in inventories and net acquisition of valuables (percent of GDP) | P.52+ P.53 | -29.7 | -0.1 | -0.6 | -0.6 | -0.6 | -0.5 | -0.5 |
| 7. Exports of goods and services | P.6 | 23020.5 | 14.1 | 9.7 | 10.5 | 12.1 | 11.6 | 11.7 |
| 8. Imports of goods and services | P.7 | 21077.0 | 12.0 | 9.7 | 10.4 | 12.2 | 11.8 | 11.8 |
| **Contribution to real GDP growth** | | | | | | | | |
| 9. Final domestic demand | | - | -2.6 | 2.2 | 2.2 | 2.4 | 2.6 | 2.7 |
| 10. Changes in inventories and net acquisition of valuables | P.52+ P.53 | - | 1.6 | 0.2 | 0.0 | 0.0 | 0.0 | 0.0 |
| 11. External balance of goods and services | B.11 | - | 2.2 | 0.7 | 0.8 | 0.8 | 0.7 | 0.8 |

*/: Including government and NPISHs as well

## Table 1b Price developments

| | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 |
|---|---|---|---|---|---|---|
| | Percentage change | | | | | |
| 12. GDP deflator | 2.9 | 2.9 | 2.7 | 2.1 | 2.2 | 2.2 |
| 13. Private consumption deflator | 5.1 | 4.0 | 3.4 | 3.0 | 3.0 | 3.0 |
| 14. HICP | 4.7 | 4.0 | 3.4 | 3.0 | 3.0 | 3.0 |
| 15. Public consumption deflator | 2.4 | 1.2 | 2.3 | 1.3 | 2.0 | 1.9 |
| 16. Investment deflator | 2.0 | 3.0 | 2.8 | 2.6 | 2.6 | 2.6 |
| 17. Export price deflator (goods and services) | 1.9 | 4.1 | 2.1 | 1.0 | 0.9 | 0.9 |
| 18. Import price deflator (goods and services) | 1.8 | 4.5 | 2.3 | 1.3 | 1.2 | 1.2 |

## Table 1c Labour market developments

| | ESA Code | 2010 Level | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 |
|---|---|---|---|---|---|---|---|---|
| | | | Percentage change | | | | | |
| 19. Employment ('000;15-64) | | 3750.1 | 0.0 | 0.7 | 2.0 | 1.7 | 1.6 | 1.5 |
| 20. Unemployment rate (%) | | - | 11.2 | 10.9 | 10.5 | 9.9 | 9.3 | 8.7 |
| 21. Labour productivity, persons | | - | 1.2 | 2.4 | 1.0 | 1.5 | 1.7 | 1.9 |
| 22. Compensation of employees (HUF bn) | D.1 | 11462.6 | -4.9 | 2.4 | 3.9 | 5.7 | 4.7 | 4.9 |
| 22a. Compensation per employees (HUF million) | | 4.2 | -4.8 | 1.7 | 1.9 | 4.0 | 3.1 | 2.9 |

## Table 1d. Sectoral balances

| | ESA Code | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 |
|---|---|---|---|---|---|---|---|
| | | Percent of GDP | | | | | |
| 23. Net lending / borrowing vis-á-vis the rest of the world | B9. | 3.9 | 4.2 | 5.6 | 5.8 | 4.4 | 4.4 |
| of which:<br>- Balance of goods and services | | 7.2 | 7.2 | 7.6 | 7.7 | 7.8 | 8.0 |
| - Balance of primary incomes and transfers | | -5.1 | -5.6 | -4.7 | -5.0 | -5.9 | -6.0 |
| - Capital account | | 1.8 | 2.6 | 2.8 | 3.1 | 2.5 | 2.4 |
| 24. Net lending / borrowing of the private sector | B9. | 8.1 | 2.2 | 8.1 | 8.0 | 6.3 | 5.9 |
| 25. Net lending / borrowing of general government | EDP B9. | -4.2 | 2.0 | -2.5 | -2.2 | -1.9 | -1.5 |

## Table 2 General government budgetary prospects

| | ESA Code | 2010 HUF bn | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 |
|---|---|---|---|---|---|---|---|---|
| | | | Percent of GDP | | | | | |
| **Net lending (EDP B.9.) by sub-sector** | | | | | | | | |
| 1. General government | S.13 | -1132.0 | -4.2 | 2.0 | -2.5 | -2.2 | -1.9 | -1.5 |
| 2. Central government | S.1311 | -925.2 | -3.4 | 2.4 | -2.1 | -1.9 | -1.7 | -1.3 |
| 3. State government | S.1312 | - | - | - | - | - | - | - |
| 4. Local government | S.1313 | -242.5 | -0.9 | -0.5 | -0.4 | -0.3 | -0.3 | -0.2 |
| 5. Social security funds | S.1314 | 35.7 | 0.1 | 0.1 | 0.0 | 0.0 | 0.0 | 0.0 |
| **General government (S.13)** | | | | | | | | |
| 6. Total revenue | TR | 12095.1 | 44.6 | 51.7 | 41.6 | 40.3 | 39.4 | 38.7 |
| 7. Total expenditure | TE[1] | 13227.1 | 48.8 | 49.7 | 44.1 | 42.5 | 41.3 | 40.3 |
| 8. Net lending / borrowing | EDP B.9 | -1132.0 | -4.2 | 2.0 | -2.5 | -2.2 | -1.9 | -1.5 |
| 9. Interest expenditure | EDP D.41 | 1098.0 | 4.0 | 3.9 | 3.8 | 3.7 | 3.6 | 3.4 |
| 10. Primary balance | | -34.0 | -0.1 | 5.9 | 1.2 | 1.5 | 1.7 | 1.8 |
| 11. One-off and other temporary items[2] | | 343.3 | 1.3 | 7.7 | 0.9 | 0.0 | 0.0 | 0.0 |
| **Selected components of revenues** | | | | | | | | |
| 12. Total taxes (12=12a+12b+12c) | | 6807.0 | 25.1 | 23.2 | 23.2 | 21.8 | 21.6 | 21.3 |
| 12a. Taxes on production and imports | D.2 | 4527.9 | 16.7 | 16.7 | 16.5 | 15.7 | 15.6 | 15.4 |
| 12b. Current taxes on income, wealth, etc. | D.5 | 2133.2 | 7.9 | 6.0 | 6.3 | 5.8 | 5.8 | 5.7 |
| 12c. Capital taxes | D.91 | 145.9 | 0.5 | 0.5 | 0.5 | 0.2 | 0.2 | 0.2 |
| 13. Social contributions | D.61 | 3245.8 | 12.0 | 12.5 | 12.3 | 12.2 | 12.1 | 11.9 |
| 14. Property income | D.4 | 293.5 | 1.1 | 0.8 | 0.6 | 0.5 | 0.5 | 0.4 |
| 15. Others | | 1748.8 | 6.4 | 15.3 | 5.4 | 5.7 | 5.2 | 5.0 |
| 16=6. Total revenue | TR | 12095.1 | 44.6 | 51.7 | 41.6 | 40.3 | 39.4 | 38.7 |
| Tax burden[3] (D.2+D.5+D.61+D.91-D.995) | | 10119.8 | 37.3 | 35.9 | 35.8 | 34.3 | 33.9 | 33.6 |
| **Selected components of expenditures** | | | | | | | | |
| 17. Compensation of employees + intermediate consumption | D.1+P.2 | 5004.4 | 18.5 | 17.1 | 16.3 | 15.4 | 14.7 | 14.1 |
| 17a. Compensation of employees | D.1 | 2906.6 | 10.7 | 10.1 | 9.5 | 8.9 | 8.4 | 8.0 |
| 17b. Intermediate consumption | P.2 | 2097.8 | 7.7 | 7.0 | 6.8 | 6.6 | 6.3 | 6.1 |
| 18. Social payments (18=18a+18b) | | 4968.1 | 18.3 | 17.7 | 16.2 | 15.5 | 15.0 | 14.6 |
| 18a. Social payments in kind via market producers | D.6311, D.63121, D.63131 | 734.0 | 2.7 | 2.5 | 2.1 | 1.9 | 1.8 | 1.8 |
| 18b. Social transfers other than in kind | D.62 | 4234.1 | 15.6 | 15.1 | 14.0 | 13.6 | 13.2 | 12.8 |
| 19.=9. Interest expenditure | EDP D.41 | 1098.0 | 4.0 | 3.9 | 3.8 | 3.7 | 3.6 | 3.4 |
| 20. Subsidies | D.3 | 256.2 | 0.9 | 0.9 | 0.8 | 0.8 | 0.7 | 0.7 |
| 21. Gross fixed capital formation | P.51 | 879.4 | 3.2 | 3.9 | 3.4 | 3.4 | 3.8 | 3.8 |
| 22. Other | | 1021.0 | 3.8 | 6.2 | 3.6 | 3.7 | 3.4 | 3.7 |
| 23.=7. Total expenditure | TE[1] | 13227.1 | 48.8 | 49.7 | 44.1 | 42.5 | 41.3 | 40.3 |

Due to the rounding the sum data could differ from the sum of the detailed data.
[1]: corrected with the net effect of swap transactions, TR-TE=EDP B.9.
[2]: a plus sign means deficit-reducing one-off item
[3]: including revenues entitled to the European Union

## Table 3 General government debt developments

| | ESA Code | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 |
|---|---|---|---|---|---|---|---|
| | | Percent of GDP | | | | | |
| 1. Gross debt | | 80.2 | 75.5 | 72.1 | 69.7 | 66.7 | 64.1 |
| 2. Change in gross debt ratio | | 1.8 | -4.7 | -3.3 | -2.4 | -3.0 | -2.6 |
| **Contribution to changes in gross debt** | | | | | | | |
| 3. Primary balance | | 0.1 | -5.9 | -1.2 | -1.5 | -1.7 | -1.8 |
| 4. Interest expenditure | EDP D.41 | 4.0 | 3.9 | 3.8 | 3.7 | 3.6 | 3.4 |
| 5. Stock-flow adjustment | | 0.7 | 1.9 | -1.7 | -0.9 | -1.3 | -0.5 |
| of which: - privatization receipts | | -0.1 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| - international institutions stand-by credits not used for financing purpose | | -0.6 | -0.1 | -0.4 | -1.3 | -1.2 | 0.0 |
| Implicit interest rate on debt (%) | | 5.2 | 5.1 | 5.3 | 5.4 | 5.5 | 5.4 |

## Table 4 Cyclical developments

| | ESA Code | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 |
|---|---|---|---|---|---|---|---|
| | | Percent of GDP | | | | | |
| 1. Real GDP growth (%, at constant prices) | | 1.2 | 3.1 | 3.0 | 3.2 | 3.3 | 3.5 |
| 2. Net lending of general government | EDP B.9 | -4.2 | 2.0 | -2.5 | -2.2 | -1.9 | -1.5 |
| 3. Interest expenditure | EDP D.41 | 4.0 | 3.9 | 3.8 | 3.7 | 3.6 | 3.4 |
| 4. One-off and other temporary items[1] | | 1.3 | 7.7 | 0.9 | 0.0 | 0.0 | 0.0 |
| 5. Potential GDP (%) | | 1.1 | 1.3 | 2.3 | 2.4 | 2.4 | 2.6 |
| contributions: - labour | | 0.0 | 0.2 | 0.3 | 0.4 | 0.5 | 0.5 |
| - capital | | 0.8 | 0.9 | 1.8 | 1.7 | 1.6 | 1.8 |
| - total factor productivity (TFP) | | 0.3 | 0.2 | 0.2 | 0.2 | 0.3 | 0.3 |
| 6. Output gap | | -5.0 | -3.4 | -2.7 | -1.9 | -1.0 | -0.1 |
| 7. Cyclical budgetary component | | -1.4 | -0.9 | -0.8 | -0.5 | -0.3 | 0.0 |
| 8. Cyclically-adjusted balance (2-7) | | -2.8 | 3.0 | -1.8 | -1.7 | -1.6 | -1.5 |
| 9. Cyclically-adjusted primary balance (8+3) | | 1.3 | 6.9 | 2.0 | 2.0 | 2.0 | 1.8 |
| 10. Structural balance (8-4) | | -4.0 | -4.7 | -2.6 | -1.7 | -1.6 | -1.5 |

Due to the rounding the sum data could differ from the sum of the detailed data.
[1]: a plus sign means deficit-reducing one-off item

## Table 5 Divergence from previous update

| | ESA Code | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 |
|---|---|---|---|---|---|---|---|
| **Real GDP growth (%)** | | | | | | | |
| 1. CP – January 2010 | | -0.3 | 3.7 | 3.8 | | | |
| 2. CP – 2011 | | 1.2 | 3.1 | 3.0 | 3.2 | 3.3 | 3.5 |
| 3. Difference | | 1.5 | -0.6 | -0.8 | | | |
| **General government net lending (percent of GDP)** | | | | | | | |
| 1. CP – January 2010 | EDP B.9 | -3.8 | -2.8 | -2.5 | | | |
| 2. CP – 2011 | EDP B.9 | -4.2 | 2.0 | -2.5 | -2.2 | -1.9 | -1.5 |
| 3. Difference | | -0.4 | 4.8 | 0.0 | | | |
| **General government gross debt (percent of GDP)** | | | | | | | |
| 1. CP – January 2010 | | 79.0 | 76.9 | 73.6 | | | |
| 2. CP – 2011 | | 80.2 | 75.5 | 72.1 | 69.7 | 66.7 | 64.1 |
| 3. Difference | | 1.2 | -1.4 | -1.5 | | | |

## Table 6 Long-term sustainability of public finances

| | 2007 | 2015 | 2020 | 2030 | 2040 | 2060 |
|---|---|---|---|---|---|---|
| | Percent of GDP | | | | | |
| Pension expenditure (net)[1] | 10.9 | 9.6 | 8.7 | 7.8 | 7.7 | 7.8 |
| Old-age and early pensions | 9.0 | 8.7 | 8.1 | 7.2 | 7.2 | 7.3 |
| Other pensions (disability, survivors) | 1.9 | 0.9 | 0.7 | 0.7 | 0.6 | 0.6 |
| Health care, education and other age-related expenditure[2] | 10.7 | 10.3 | 10.3 | 10.7 | 11.0 | 11.5 |
| Health care expenditures | 5.8 | 5.9 | 6.0 | 6.4 | 6.7 | 6.9 |
| Long-term care expenditures | 0.3 | 0.3 | 0.3 | 0.4 | 0.4 | 0.5 |
| Education expenditures | 4.4 | 3.8 | 3.8 | 3.7 | 3.7 | 3.8 |
| Other age-related expenditures | 0.3 | 0.3 | 0.2 | 0.2 | 0.2 | 0.2 |
| Pension contribution revenue[3] | 8.6 | 8.8 | 8.3 | 7.7 | 7.5 | 7.5 |
| **Assumptions**[4] | | | | | | |
| Labour productivity growth | 1.1 | 1.8 | 2.1 | 2.5 | 2.3 | 1.6 |
| Real GDP growth | 0.8 | 3.5 | 2.6 | 2.1 | 1.1 | 0.9 |
| Participation rate, males (15-64) | 68.9 | 70.8 | 75.8 | 74.6 | 73.6 | 73.7 |
| Participation rate, females (15-64) | 55.2 | 63.6 | 68.0 | 67.0 | 66.1 | 66.2 |
| Total participation rate (15-64) | 61.9 | 67.2 | 71.9 | 70.8 | 69.9 | 70.0 |
| Unemployment rate | 7.4 | 8.7 | 8.7 | 7.7 | 7.5 | 7.3 |
| Population aged 65 + over / total population | 14.8 | 17.7 | 19.8 | 22.0 | 25.0 | 31.9 |

[1]: Projection of the Ministry for National Economy.
[2]: Data from the 'AWG reference scenario' and 'Baseline scenario' of the 2009 EPC (Economic Policy Committee) projections.
[3]: Projection of the Ministry for National Economy.
[4]: Data are based partly on the 2009 forecast of the Economic Policy Committee (population, participation rate, capital), partly on the present recommendations of Ageing Working Group (unemployment) and on a Hungarian modification proposal (TFP).

## Table 7 Basic assumptions

| | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 |
|---|---|---|---|---|---|---|
| Hungary: short-term interest rate (annual average,%) | 5.4 | 5.9 | 5.7 | 5.1 | 4.4 | 4.0 |
| Hungary: long-term interest rate (annual average,%) | 7.3 | 7.5 | 7.0 | 5.9 | 5.1 | 4.6 |
| Nominal effective exchange rate (% change) | -1.1 | -1.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| HUF/EUR exchange rate | 275.4 | 274.6 | 274.8 | 274.8 | 274.8 | 274.8 |
| World (excluding EU) GDP growth (%) | 5.6 | 4.6 | 4.6 | 4.6 | 4.6 | 4.6 |
| EU-27 GDP growth (%) | 1.8 | 1.8 | 1.9 | 1.9 | 1.9 | 1.9 |
| Growth of foreign markets of Hungary | 10.8 | 6.3 | 6.8 | 6.8 | 6.8 | 6.8 |
| World import volumes (excluding EU) | 13.8 | 8.2 | 8.0 | 8.0 | 8.0 | 8.0 |
| Oil prices (Brent – USD / barrel) | 80.1 | 104.7 | 104.3 | 103.3 | 102.7 | 102.7 |