GOVERNMENT OF HUNGARY

CONVERGENCE PROGRAMME

OF HUNGARY

2014 – 2017

April 2014

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1. ECONOMIC POLICY OBJECTIVES

With a view to stabilising the economic and financial position of the country, the Government, which took office in 2010, implemented radical changes in the following areas:

- the upward trend of the public debt-to-GDP ratio prevailing in the last decade has been reversed and put on a durably declining path;
- the high debt compared to GDP denominated foreign currency, a major factor behind the financial vulnerability of Hungary has been reduced significantly, in particular through the moderation of the FX denominated public debt;
- a marked turning point in employment and steady enhancement of labour market activity have been achieved;
- the economy has been put on a sustainable growth path with balanced composition.

Both the international organisations and the investors have recognised the achievements of the economic policy and disciplined fiscal policy pursued so far. This was indicated in summer 2013 by the abrogation of the excessive deficit procedure by the Council of the European Union, which had been in effect since the country's accession to the Union, and the by early repayment of the IMF loan drawn in 2008 necessary due to the vulnerability of the country that time. The international bond auctions were extremely successful and their pricing also showed that investors were expecting a lower yield premium in exchange for the sovereign risk. The clear message is that the country can successfully finance its debt from the market, under favourable conditions, without any support from international institutions.

The party coalition in office so far, that was granted two-thirds majority in Parliament once again at the April 2014 parliamentary elections, building on its achievements, continues to establish the conditions of an accelerating and balanced economic growth while preserving the disciplined fiscal policy thereby assuring the reduction of the public debt ratio and the external indebtedness of the country.

According to the calculations of the Convergence Programme, economic growth is expected to accelerate in 2014; that will have a beneficial impact on the labour market and raise the level of consumption through the expansion of incomes. Parallel to the acceleration of GDP growth, its composition may become even more balanced. On the one hand, external demand is projected to pick up gradually, suggesting dynamic export expansion. On the other hand, the gradual growth of domestic consumption will be promoted by an increase in disposable incomes, deleveraging and the moderation of precautionary motives. Growth will also be supported by EU funds and the financial instruments made available under the EXIM programmes and the second phase of the Funding for Growth Scheme of MNB. In concert with the further upsurge in external and domestic demand, dynamic investment growth in the corporate sector is expected to continue over the forecast horizon. Although lending conditions ease slowly for companies, moderating lending costs due to the low yield environment have a stimulating effect on investment activity. Real GDP growth may exceed 3% by the end of the programme horizon.

Besides the steadily decreasing budget deficit, accelerating economic growth contributes visibly to the further reduction of the public debt-to-GDP ratio that is expected to drop to around 75% by 2017.

Further to the reduction of the public debt ratio a change in its financing structure is another priority of the Government, in order to encourage the active participation of the domestic sectors in debt financing; to moderate the foreign exposure of the country and to extend the investor base. Moreover, it strives to further moderate the ratio of the debt denominated in foreign currency. By filtering out the risk of the variation of public debt driven by exchange rate fluctuation, future debt service burden becomes more predictable.

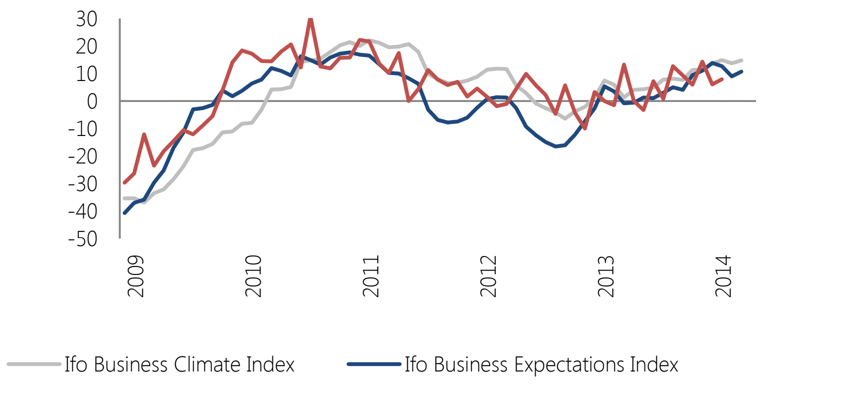
2. MACROECONOMIC DEVELOPMENTS AND OUTLOOK

2.1. EXTERNAL CONDITIONS

There have been signs of an upturn in Europe and also in Hungary in the past year. However, the rate and structure of growth was different by region. While growth picked up also in Europe, the main driving forces have been the United States and the emerging countries in recent years.

In 2013, the economic performance of the European Union grew by 0.1%, with expansion unfolding from the second quarter on. Since the economic sentiment indicators project continuing recovery, growth may accelerate further in the years to come. Among other things, the business confidence index of the euro zone has been improving steadily, the German Ifo Business Climate Index for industry and trade has shown an upward trend, and German business expectations are also positive. Real economic performance has gained momentum and, at the same time, the financial sector is stabilising, the balance sheets of the banks became healthier. However, there remain risks around the accelerating growth in the European countries: significant public debts, high unemployment rates especially in periphery countries, and the risk of deflation in the euro zone. Tight lending conditions prevailing in Southern Europe constitute further risks. Considering these developments, according to the forecast of the European Commission, GDP expansion in the EU may accelerate to 1.5% in 2014.

Chart 2.1: Confidence indicators in Germany and Hungarian exports of goods



Source: Cesifo, CSO

In particular, Germany, Hungary's most important foreign trade partner and export market, showed mild growth last year due to the weak trade balance and the shortfall in investment. This year, however, the surge in domestic demand is expected to intensify growth and that, in turn, will have a positive impact on both foreign trade and growth in Hungary.

Economic expansion in the new Member States of the EU has exceeded that of the euro zone for years. This is one of the reasons why the foreign trade position of Hungary may improve due to an opening of Hungarian economic policy towards these countries in the field of foreign trade relations. The same applies to growth of emerging economies, being faster than global growth. Hungary launched its strategy of opening up towards the East (the so called Go East program) in order to enhance its presence in the countries that have become the engines of global economic growth in the past years.

The global environment is gradually improving, not only within, but also outside Europe. The fact that the economies are set on a growth path constitutes favourable external conditions for Hungary. Hungary intends to exploit these opportunities and to take part in the unfolding global upswing through the reinforcement of its foreign trade relations.

2.2. COMPOSITION OF GROWTH

From Q2 2013 on, the Hungarian economy showed firm growth: the volume of GDP increased from quarter to quarter. Consequently, gross domestic product increased by 2.7% in Q4, faster than in the other Visegrad Countries. Annual GDP was 1.1% higher than in the previous year, due mainly to the negative carry-over effect. Several factors supported the Hungarian economic growth, in particular the take-off of investment, the dynamic performance of agriculture, the external economic upswing and government measures. The long-term sustainability of economic growth is underpinned by the fact that the expansion of the country is no longer fed by foreign loans: the external balance has shown a massive surplus and the budget deficit has also remained well below 3%.

In the past years, net exports have had the biggest positive contribution to the Hungarian GDP. Nevertheless, the structure of growth became more balanced in 2013, since domestic demand also expanded besides net exports and even contributed more to GDP. In line with the gradual external economic upswing and the expansion of the transport equipment production capacities, the dynamism of Hungarian exports strengthened substantially and hence the trade balance showed a record surplus – of more than EUR 7 billion – in 2013. The import of goods and services grew at the same rate as exports (5.3%), due to the import content of improving exports and picking up domestic demand.

Within domestic demand both fixed investment and consumption expenditure of households grew, by 5.9% and 0.2%, respectively, so the structure of domestic demand has stabilised as well. The surge in consumption was promoted by several factors. Both the increase in real incomes due to the cuts of utility prices and the record expansion of employment, and the improvement of consumer confidence boosted the development of the GDP. The slight decline in social transfers in kind was due to the savings implemented under the Széll Kálmán Plan; its effect, however, was dampened by the increase of transfers provided by the non-profit sector. Public consumption rose by 4.3%, partly due to the increasing absorption of EU funds. The expansion of the other main component of domestic demand, i.e. investment, was assisted by government and private development projects, thanks among other things to the absorption of EU transfers and the Funding for Growth Scheme.

Growth was balanced also on the production side of the GDP, as most branches contributed to the expansion in 2013. The 22% growth of the agricultural output is explained mainly by the weak basis, i.e., due to the drought of 2012. Owing to the upswing of the external demand and the substantial automotive manufacturing capacities, manufacturing output growth accelerated gradually to 5.1% in Q4 2013. In accordance with the development of investment, the construction sector experienced dynamic growth as well: the output of the branch grew at the fastest pace since 2002. The performance of most of the services branches has also improved. Developments in some of them were supported by the upsurge in consumption and domestic tourism, transportation expanded in line with the strengthening performance of the manufacturing industry. Financial activities have shown moderate decline but the profitability of the sector has improved.

Box 1: The automotive industry leads manufacturing growth

Within the domestic manufacturing industry, the output of the transport equipment branch grew at an extraordinary rate of 18.9% in 2013 and, consequently, its share has also increased substantially. In the meantime, the decrease of the output of the second most important branch, i.e., electronic industry, continued. That is, a spectacular shift, beneficial for the domestic industrial structure in several aspects, has started. Value added content of transport equipment exceeds by far that of the domestic electronic industry that is based mainly on assembly work. Within automotive industry rather complex production processes were allocated to Hungary and it can generate further investments through its extensive supplier-chain network. The exports of premium category products comprising higher value added, raise the price level of exports and hence improves the terms of trade of the country. Moreover, capacity growth gives Hungary a chance to catch up with other countries of the region in the field of transport equipment manufacturing, the success story of the region.

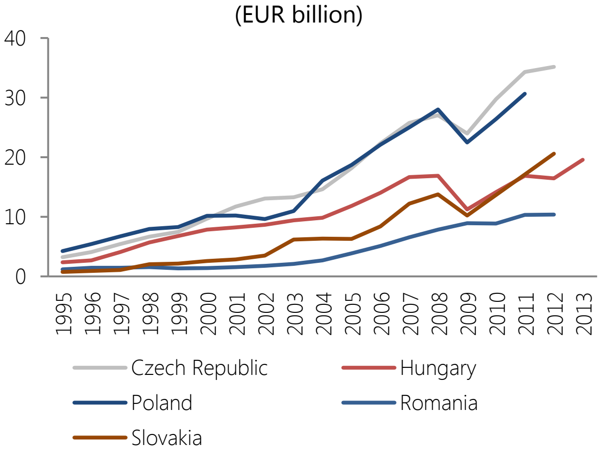
Although the automotive industry is traditionally cyclical, products of German brands manufactured in Hungary belong to the premium segment where demand is less sensitive to the short-term fluctuations of consumer demand. Besides the high proportion of high-end products, another key feature of the domestic automotive industry is that it produces a significant amount of vehicle components (e.g. engine, clutch, tires), and hence the number of vehicles manufactured is far from drawing a comprehensive picture of automotive industry’s output.

With investments, launched in the previous years, entering the production phase, continued growth of both output and the number of vehicles produced is expected, which should be supported by the growing demand for cars experienced in Europe since Autumn 2013. Further capacity enhancements are also expected in the years to come, so the output may keep growing in the longer term as well. Audi plans to more than double the number of cars manufactured in Hungary, and the capacities deployed by Mercedes also provide for a much higher output than the current one. Moreover, Mercedes will start a third shift from May 2014 to match increased demand. The Hungarian vehicle production capacities are not excessive in regional comparison, so there is a potential for growth also in that regard (Chart 2.2). The Government designated several priority automotive industrial centres to spur automotive investment and help companies to integrate into the European automotive manufacturing networks as deeply as possible.

As a positive yield of the increasing dynamism of the transport equipment industry, several suppliers have also installed manufacturing capacities in Hungary (e.g. Bosch, Continental, Rehau, LUK, ZF, Knorr-Bremse), and the expansion produced a market also for domestic suppliers (e.g. Csaba Metál, Dension, NNG). The automotive companies allocate not only production, but also part of their research activities to Hungary which represent significant value added. Moreover, they co-operate with higher education institutions, contributing thereby to the long-term integration of the production structure of the automotive industry into the Hungarian economy. For example, co-operation schemes were established with the higher education institutions of Győr, Veszprém and Miskolc.

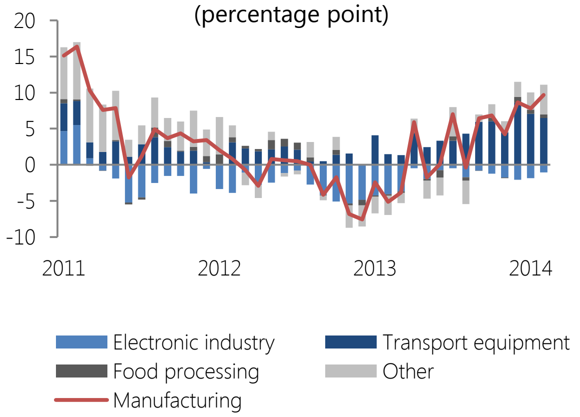
Transport equipment branch showed outstanding growth in 2013 relative to other manufacturing industries. Six out of the thirteen manufacturing branches, including transport equipment, recorded growth for the whole year, whereas the others stagnated or declined last year. As for regional data, only the counties with significant automotive exposure produced substantive output growth. These facts reinforce that the automotive industry has become the flagship of the manufacturing industry. (Chart 2.3)

Chart 2.2: Transport equipment output
(EUR billion)



Source:: CSO

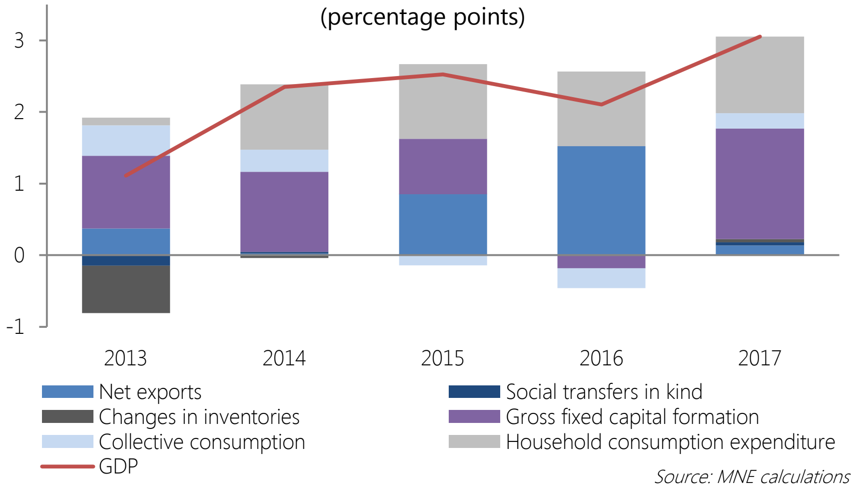
Chart 2.3: Contribution of main sub-sections to manufacturing growth
(percentage point)



Source: CSO, MNE calculations

The expected further acceleration of economic growth in 2014 will have a positive effect on the labour market and, through the expansion of disposable incomes, it will also raise consumption level. Parallel to the accelerating GDP growth, the structure of growth may also become more balanced. On the one hand, according to the forecast, external demand will pick up gradually yielding dynamic export expansion. On the other hand, the gradual growth of domestic consumption will be promoted by the increase of disposable incomes and the moderation of deleveraging and precautionary motives. Developments of social transfers in kind will mostly be driven by the public education reform. In line with the expansion of domestic demand, the contribution of net exports to GDP growth may be more moderate than the rate observed in the past years. Growth will also be supported by the absorption of EU funds and the financial instruments made available under the EXIM programmes and the second phase of the Funding for Growth Scheme launched by the Magyar Nemzeti Bank.

Chart 2.4: GDP growth and contributions by expenditure components
(percentage points)



Source: MNE calculations

Funds from the 2007-2013 EU programming period can still be used in 2014 and 2015, while in 2016 only the funds of the new 2014-2020 programming period will be available. Consequently, the projects to be implemented in 2016-2017 will not be able to attain the level of the significant investments completed in 2015 financed from EU funds. Hence public investment will necessarily drop. The pattern of the utilisation of the EU funds will also affect the evolution of public consumption. However, due, inter alia, to accelerating EU transfer utilisation in 2017, the GDP may expand at a faster rate than experienced in the past years, slightly faster than 3%.

Table 2.1: Components of GDP (annual growth, %)

	2013	2014	2015	2016	2017
GDP	**1.1**	**2.3**	**2.5**	**2.1**	**3.1**
Household consumption expenditure	0.2	1.8	2.0	2.0	2.1
Public consumption	4.3	3.1	-1.5	-3.0	0.0
Social transfers in kind	-1.2	0.2	0.0	0.0	0.3
Gross fixed capital formation	5.9	6.2	4.1	-0.9	9.9
Exports	5.3	5.8	6.8	6.7	6.6
Imports	5.3	6.2	6.5	5.8	7.2

Source: CSO, MNE calculations

2.2.1. Foreign trade

The international institutions projected substantial growth on the main export markets of Hungary for 2013 but, contrary to their expectations, the upswing remained moderate. Nevertheless, Hungarian foreign trade showed dynamic growth and the export performance surged, driven to a large extent by the spectacular production take-off of the recently deployed automotive industrial capacities. Consequently, in 2016 the volume of exports exceeded the pre-crisis level by as many as 16%. Despite the dynamic increase of import-intensive investments in 2013, the growth contribution of foreign trade has remained substantial (0.4 percentage point). The services turnover has also developed favourably, thanks to the positive impact of the revival of tourism after several years.

The forecasts of international organisations project the gradual acceleration of external demand in 2014 and in the following years, which is underpinned by the trade data of past periods and the development of export orders. Export growth may remain permanently faster than the rise of the external demand in the years to come, thanks to vehicle manufacture, with significant weight in exports that may profit from the uplift of European car sales. Similarly, the continuing growth of the market share of Hungarian exports will be ensured by the expansion of FDI inflow and the expansion of investment, stimulated by the low yield environment, the profitability-improving effect of picking-up demand and the targeted programmes (Funding for Growth Scheme, EXIM funds) as well as the Go East program.

Besides the increasing export dynamic, the strengthening domestic demand also contributes to import growth. On the forecast horizon, export growth is estimated at 6-7% on average, and taking account of underlying processes exceeds the growth of imports. In 2014 and in 2017, ad hoc effects will cause a reversal. First in 2014, due to the surge in domestic demand and, second, in 2017, due to absorption pattern of EU transfers, imports may grow slightly faster than exports. Consequently, net exports may remain massively positive on the whole forecast horizon.

Chart 2.5: Hungarian exports
(% change, year-on-year)

Source: CSO, MNE calculations

2.2.2. INVESTMENT

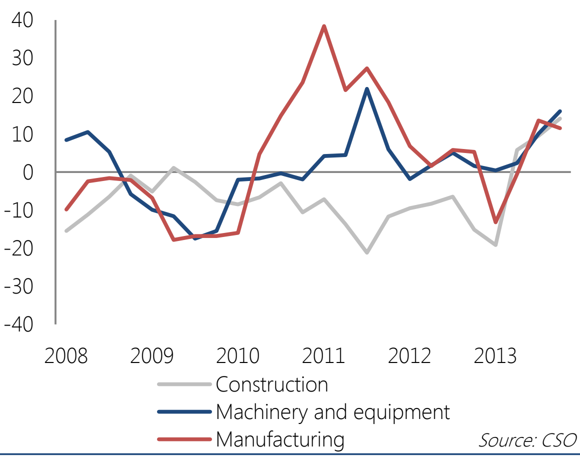
The decline since 2008 gave way to a sharp positive turn in investment in 2013. Investment expanded by a decade record 7.2% in 2013. Thanks to this outstanding growth, the Hungarian investment rate is once again higher than the corresponding EU average. Dynamic investment growth in a wide range of industries was driven by the continuous expansion of manufacturing capacities, the efficient utilisation of EU funds, the low yield environment, projects realised under the first phase of the Funding for Growth Scheme and improving business confidence.

Most favourably, the distribution of investments was also more balanced than before: besides the continuing expansion of machinery investments, construction investments have also set out on a path of dynamic growth after a long time. Lasting investment expansion is projected over and beyond the export-oriented branches. The projection is supported by the facts that the volume of projects implemented by companies producing/offering services for the domestic market also grew substantially last year and, given the predicted revival of domestic demand, this trend may well continue in the years to come.

Manufacturing investment, with the largest weight within investment overall, picked up further in 2013; its growth of 4.9% contributed to the reversal of the investment trend. Besides the capacity expansions realised by companies in the vanguard of international vehicle manufacture, relocated to Hungary, investments of their supplier industries have also contributed significantly to the expansion of this sector. This proves that flagship manufacturers of vehicle industry can generate further marked growth via their supplier chains.

Chart 2.6: Investment structure

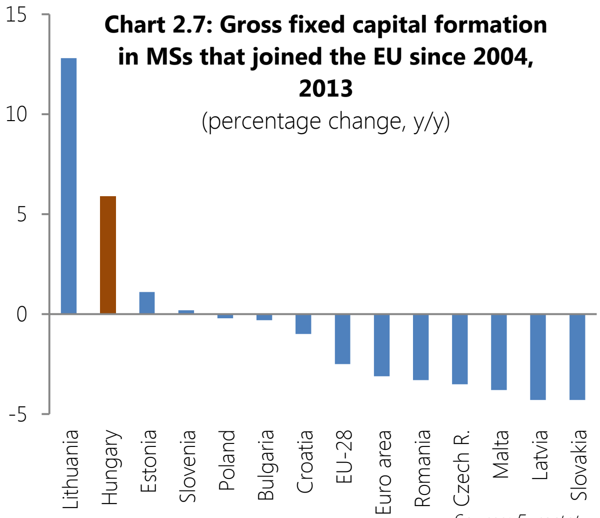
(percentage change, y/y)



Source: CSO

Chart 2.7: Gross fixed capital formation in MSs that joined the EU since 2004, 2013

(percentage change, y/y)



Source: Eurostat

Parallel to the further upsurge in external and domestic demand, investment growth in the corporate sector is expected to continue dynamically over the forecast horizon until 2017. Although lending conditions ease slowly for companies moderating lending costs due to the low yield environment have a stimulating effect on investment activity.

The vehicle industry and its supplier network are expected to remain the main driver of corporate investment. As a consequence of the successful large investment projects of the automotive industry, Hungary's capital attracting capacity intensified even further, as confirmed by the data recorded by the Hungarian Investment and Trade Agency: in 2013, a total of EUR 1.2 billion FDI flowed into the country, and in case of a positive decision, another EUR 3 billion FDI may follow in the coming years via the currently managed investment portfolios. The growth of manufacturing capacity utilisation that can be interpreted as an indicator of future investments also projects the further expansion of the production capacities, and the consequent growth of the potential output.

Investments by small and medium-sized enterprises will be boosted in 2014 and 2015 by the second phase of the Funding for Growth Scheme, as 90% of the currently available HUF 500 billion tranche can only be used for extending new credits, and the approved loans must be used for investment or for current asset financing. Consequently, the projects to be implemented as the investment-focused second phase gains momentum will, in the months to come, exert an intensifying effect on investment and on economic growth of the coming years.

EU transfers in the next seven-year programming period of the EU will also contribute substantially to the expansion of corporate investment. The Hungarian Government committed itself to "allocating 60% of the EU development funds available in 2014-2020 directly to economic development, and dividing the remaining 40% between the target areas of human resources development, infrastructure development, environmental protection and energy efficiency".[1] As payments under the new EU programming period gain momentum, a significant increase is expected in the number of corporate projects realised from EU funds as of 2017.

Funds allocated to the state in the 2007-2013 programming period yielded dynamic infrastructure developments that contribute most significantly to the investment attracting capacity of the country. Moreover, many public transport vehicles were procured from these payments, and various public buildings and community spaces were renewed. The remaining funds of the 2007-2013 programming period may still be used in 2014 and 2015, so public projects will produce a further significant investment surplus in these years.

In 2016, however, only the funds of the new programming period can be drawn, and that will result in a lower absorption of EU funds than in 2015. Consequently, investment will lose some momentum in 2016 and that will have a major impact on economic growth in the same year. The temporary decline is expected to give way to marked expansion in 2017 in investment and hence in GDP growth, due, inter alia, to the contribution of the corporate and public projects implemented through faster absorption in the new programming period.

Deleveraging of households is expected to continue this year, albeit at a moderating pace. Several signs suggest the easing of the wait-and-see attitude regarding housing investment: the number of issued new construction permits on residential buildings rose substantially in the first months of 2014, and the number of housing transactions also reflects growth relative to the previous year. People contemplating housing investments are typically as cautious as before, but the low interest rate environment and the relatively low real estate prices, at around the real value of 1999, may boost property purchases as well. Consequently, the declining trend in household investment since the crisis may come to an end in 2014, and housing market demand is projected to recover as of 2015.

Box 2: Effect of EU funds on investment development

Pursuant to its accession to the EU in 2004, Hungary keeps receiving substantial EU funds. Already in the period of 2004-2006 HUF 670 billion was put at its disposal to implement various development programmes, and in the programming period of 2007-2013 it had a budget of HUF 8200 billion to realise its operational programmes. Tendering for the EU funds will start again in the second half of this year as a further cohesion fund budget of HUF 7500 billion will be made available to Hungary in the programming period of 2014-2020.

The macroeconomic effect of these EU funds depends significantly on the nature of the transfers, hence it is particularly favourable that around 70% of the resources of the period of 2007-2013 were allocated to capital expenditures boosting corporate and public investment. Around two thirds of the capital transfers remained in the public sector yielding dynamic infrastructure development projects throughout the country in the past period. Return on such projects is significant in catching up

[1] Decree No. 1600/2012. (XII. 17.) of the Government on the topical tasks related to planning the utilisation of EU development funds provided between 2014–2020 and the establishment of the relevant institution system

countries in terms of infrastructure and, moreover, they attract further private investments.

Under the n+2 rule, the resources made available for the period of 2007-2013 can be used up to the end of 2015. EU funds granted for the ending programming period have not been paid out evenly: the slowly accelerating pace observed in the initial years peaks in the years 2013-2015. Consequently, projects implemented under the two overlapping seven-year programming periods will take place simultaneously in 2014 and 2015.

Although the tendering procedure for the funds of the 2014-2020 programming period will start in the second half of this year, investments realised from payments under the new cycle in 2016 will probably not attain the combined growth effect of projects terminating in 2015, implemented from EU funds of the previous cycle and of projects started under the new one. Thus investment will definitely show a drop in 2016 relative to the high base of 2015. In respect of the EU development funds, the international experience (data for EU15) confirms that payment levels are the lowest in a new programming period in its third year, since the resources of the previous cycle dry out by that time.

In accordance with the above, the expenditure structure of the new programming period will become the rule as of 2016, that is, 60% of expenditure co-financed by the EU will be channelled to economic development and mainly to the business sector, and the share of infrastructure investments will shrink. Nevertheless, several environmental and public road investments launched from the funds of the period of 2007-2013 need to and can be terminated in the first half of the 2014-2020 cycle.

Another important structural change is the growing share of financial instruments to be refunded that could boost private investments through their higher leverage, but this will make its effects felt primarily towards the end of the programming period. Thus the shift in public/corporate payments is expected to manifest itself in the distribution of EU payments only in the second half of the cycle.

2.2.3. CONSUMPTION

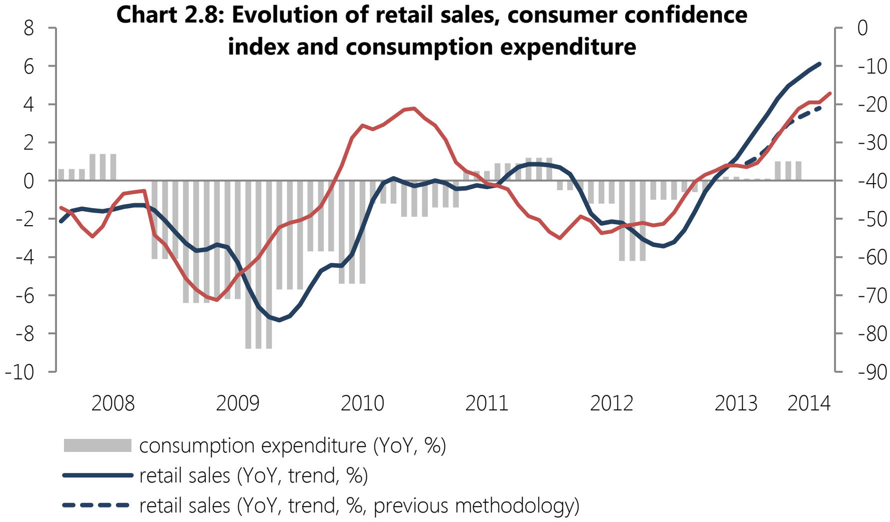
After the drop in 2012, the real income of households increased substantially in 2013, according to the consumer confidence indices, the propensity to buy revived and consumers judged their income prospects favourable. However, the reduction of debt accumulated before the crisis, as well as precautionary savings and tight lending conditions have kept playing a decisive part in consumption decisions. Consequently, household saving rate rose in 2013, and hence consumption expenditure increased slightly.

The expansion of the real income of households was promoted by several government measures. On the one hand, the Government achieved substantial results in reducing the burdens of borrowers in foreign currency. With the help of the options of early repayment, the exchange rate cap, the conversion of loans to Hungarian forint at a favourable exchange rate and the contribution of the National Asset Management Agency, the Government helped a total of 360 thousand foreign currency borrower households. On the other hand, government measures increasing household disposable income, such as the utility price cuts, wage increase related to the career path model for teachers and in the healthcare sector, the Job Protection Action Plan and record level employment have also played a major role.

In household borrowing, the credit stock continued to decline. However, new lending recovered somewhat from its earlier trough, in which the interest rate subsidy scheme played an increasing role. Banks participating in the Lending Survey conducted by the Magyar Nemzeti Bank have also indicated the easing of credit conditions, in which the effect of the declining base rate may also have been reflected. On the demand side, households remained cautious, but major upturn in household lending is expected in the medium term.

As for the future, it is a positive development that household consumption expenditure increased in 2013 from quarter to quarter. Consumption may gather significant momentum in 2014, since real income is expected to rise faster than in 2013. Real income growth is attributable on the one hand to minimum wages increasing in excess of the inflation rate (furthermore, these groups concerned have a higher-than-average marginal propensity to consume) and to the increase in salaries realised in the defence, policing and social branches and, on the other, to low inflation due partly to the lowering of regulated prices. Thirdly, government measures (e.g. expanding tax exemption for families, upgrading the financial aid for mothers on maternity leave this year) are expected to further increase disposable income. As a result of the above, household consumption may increase in 2014 by 1.4%. From 2015 on, the recovery of lending and further increase in real incomes and the record rate of employment, household consumption growth may accelerate even further.

Chart 2.8: Evolution of retail sales, consumer confidence index and consumption expenditure



Source: CSO, GKI, MNE calculations

In 2013, the slight decline in social transfers in kind was due to the savings implemented under the Széll Kálmán Plan; its effect, however, was dampened by the increase of transfers provided by the non-profit sector. From 2014 on, the course of social transfers in kind will be determined by the efficiency improvement measures taken in education and healthcare sector. The other part of government consumption, namely public consumption, grew by 4.3% in 2013, due probably to the increasing absorption of EU funds. The prospective temporary shrinking of public consumption as of 2015 is explained by the dynamic utilisation of the current EU transfers.

Box 3: Effect of utility price cuts on household consumption

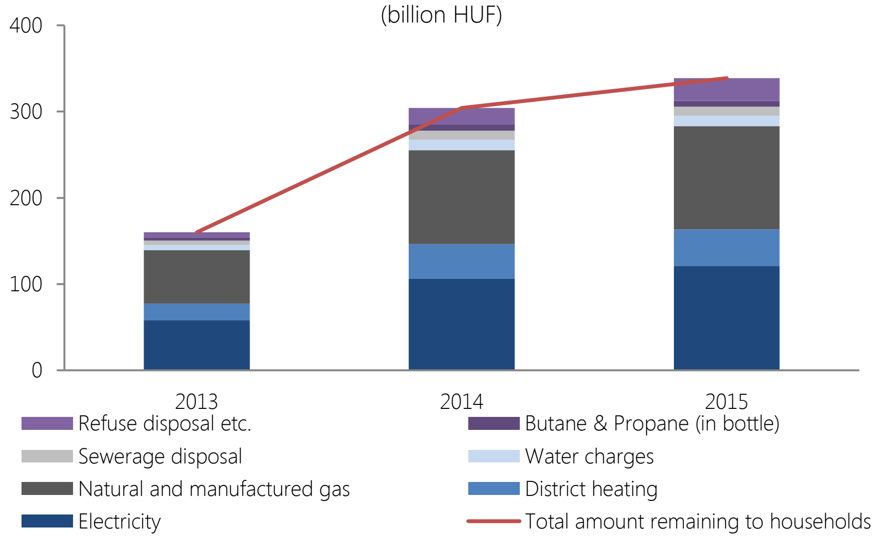
An international comparison of utility costs reveals that, before the administrative price cuts, household energy was relatively expensive in Hungary. Utility price cuts started in January 2013, for the purpose, inter alia, of converging the Hungarian energy prices to the European average. In July 2013, of the European capitals under study, only the residents of Bucharest spent larger part of their income on utility costs than those of Budapest.

The Government of Hungary considers improving the income position of Hungarian families as a priority by moderating the utility costs. Hence it set out to reduce the household energy prices in several steps to achieve it. In that context, gas, electricity, district heating price level is lower by 10% since January 2013, then refuse collection, water / sewage charges and Butane & Propane gas have become cheaper since July, followed by a further energy price cut of 11.1% in November. The third utility rate cut will reduce the gas, electricity and district heating prices in three steps (April September, October) in 2014.

As a result of the utility price cuts, the share of expenditures allocated to routine household maintenance and to paying the household energy bills decreased for the first time in a long while. In international comparison, by March 2014, in addition to the residents of Bucharest, those of Bratislava, Warsaw and Lisbon had also been obliged to spend a larger part of their income on electricity and natural gas than their Hungarian peers. From an macroeconomic point of view, it is especially favourable that the reduction of household energy prices exempted the families of HUF 300 billion expenditure in 2014, and almost HUF 340 billion annually as of 2015, to boost consumption. As a result of the government measures to moderate the burden on population, domestic consumption will continue to increase in the proceeding period, underpinned by further government measures to improve the income position of households (extension of the family tax allowances, introduction of the so-called flexible child-care allowance).

Chart 2.9. : Effects of utility price cuts on households' disposable income

(billion HUF)



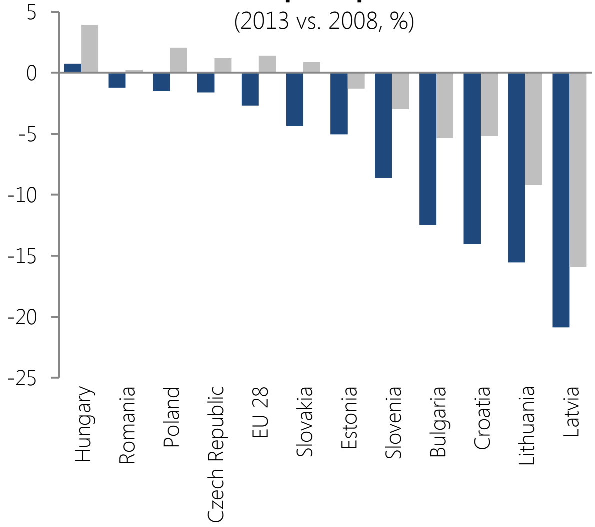
Source: MNE calculations

2.3. LABOUR MARKET

The labour market exhibited positive developments in the past years. By 2013, both employment and labour force participation exceeded their respective pre-crisis levels and reached record levels in a multiyear perspective. Developments are also favourable in international comparison: Hungary was the only country where the number of employed exceeded the corresponding level in 2008 while rise in labour force participation was the highest in this country.

Chart 2.10: Employment and labour force participation

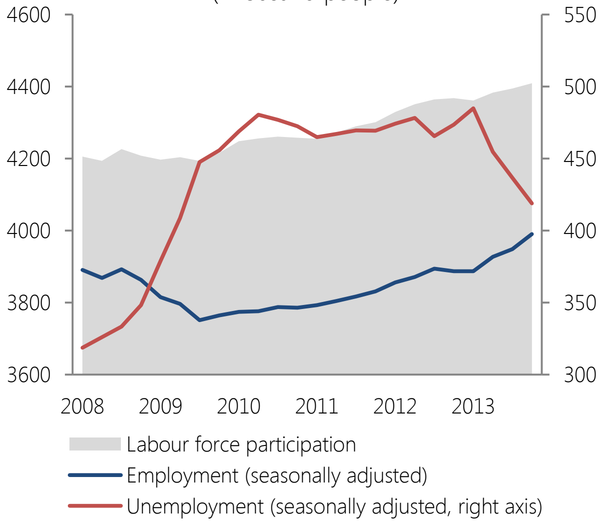
(2013 vs. 2008, %)



Source: Eurostat

Chart 2.11: Labour force participation

(Thousand people)



Source: CSO, MNE calculations

Supply and demand side incentives exerted a major impact on labour market trends. The expansion of the labour supply was supported by government measures enhancing labour force participation such as the tightening of unemployment benefits, the alteration of the eligibility criteria of old-age and disability pension that helped the concerned groups to return to the labour market.

On the demand side, the extension of the public work schemes fostered employment growth on the one hand, while the shift in favour of flexible forms of employment facilitated by the amendments of the Labour Code and the Job Protection Action Plan supporting employers employing the most disadvantaged groups characterised by high labour supply flexibility (persons below 25, above 55, the low-skilled, the long-term unemployed and mothers returning from maternity leave) also contributed.

Due to the impact of labour market incentives, the participation rate continued to increase, and attained 57.5% in 2013. The rise was accompanied by the expansion of employment and the moderation of unemployment.

In 2013, the number of employed grew by 1.6% (corresponding to 60.6 thousand persons) overall, resulting in an employment rate of 51.6%. From the second half of 2013 on, the private sector also contributed to the increase.

In the private sector, employment expansion followed the economic trend more dynamically than experienced before, due to the more extensive spread of flexible forms of employment such as part-time employment. Companies striving to restore their profitability during the recovery from the crisis adhered to hold reserve labour to save hiring and training costs and enjoy favourable conditions during the upswing. Intensive labour market adaptation was encouraged by the amendments of the Labour Code and was more popular in the services sector. The increase of the newly announced non-subsidised vacancies compared to 2012 indicated the hiring intentions in the private sector.

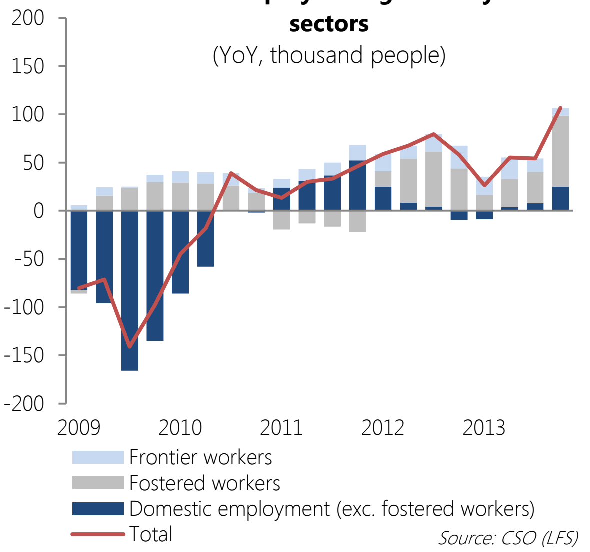
Among the main branches, employment expanded the fastest in manufacturing. In parallel with the dynamic increase in production, the branch managed to raise the number of employees. The prominent growth was associated mainly with vehicle production and the related supplier industries.

The growth of public sector employment is attributable primarily to the public work schemes expanded at the end of the year. Winter public works announced until the end of April 2014 provided temporary employment for almost 200 thousand underprivileged job-seekers. The training programmes promoting the preservation and development of employee skills target the re-employment of the participants in the primary labour market.

The shift in favour of full-time employment as the trend of previous years, continued. Although no further expansion of the programmes is expected, potential participants in the winter public work schemes will be characterised to a growing extent by employment in 8 hours a day.

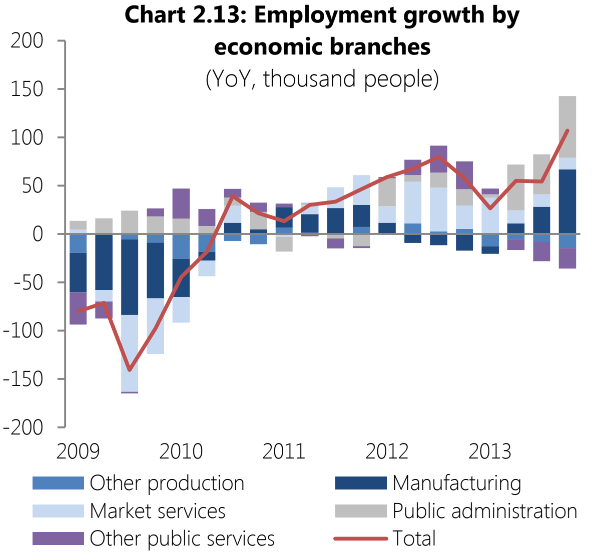
Apart from public workers, the public sector experienced slight increase due to the government measures to restrain staff number (mandatory retirement of persons above the retirement age, exclusion of combined extension of pensions and earnings, and the saving motive of the administration), and to the reclassification of employees from the non-profit health care sector to the public sector in April 2013.

Chart 2.12: Employment growth by main sectors
(YoY, thousand people)



Source: CSO (LFS)

Chart 2.13: Employment growth by economic branches
(YoY, thousand people)



Source: CSO (LFS)

The growing labour demand of the private sector and the expansion of public works have led to a marked drop in unemployment, hence the unemployment rate moderated to 9.1% by Q4 2013. The rate dropped the fastest in the regions characterised typically by high unemployment (Southern Transdanubia, Northern Hungary).

In line with recent labour market developments, employment permanently exceeding 4 million persons accompanied by an unemployment rate well below 10% is projected over the forecast horizon. The growing number of employed might occur partly due to the increase in private sector labour demand in parallel with the economic uptrend, and partly to the slightly expanding public work schemes. Public work programmes may contribute to the growth of employment more moderately than in 2013.

Box 4: Participation rate implications of the changes in the pension system

Following the outbreak of the crisis, Hungarian governments took several measures to ensure the long-term sustainability of the pension system. The box below describes a simulation to assess the expected implications of the implemented measures on the labour force participation rate of the 15-74 year age group. The simulation is based on individual data from the CSO labour force survey (LFS) that may deviate to some extent from those of the Central Administration of National Pension Insurance.

Chart 2.14 shows the breakdown of developments of the participation rate in the past.[2] The distribution of the population by age, sex and educational attainment and the proportion of students and beneficiaries of the most important transfers within these groups provides a rather plausible explanation for changes in the activity rate in the past years. Another striking feature is the significant contribution of the changes of the pensions and pension-type benefits – by more than 4 percentage points altogether in the period from 1999 to 2013 – to the growth of the participation rate.

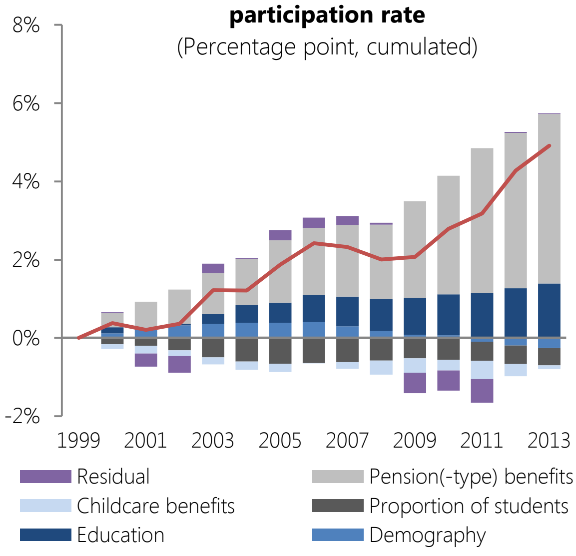
The model assumes that the participation rate will keep developing in the future in line with the

[2] For a description of the methodology applied for the breakdown, see: Kátay, G. – Nobilis, B. (2009): Driving Forces Behind Changes in the Aggregate Labour Force Participation in Hungary, CBH WP 2009/5.

changes in the composition of the population explained by the factors mentioned above. This implies that employees excluded from the benefits as a consequence of the measures will appear in the labour market later on in a proportion similar to that of employees characterised by the same traits (age, sex, education) receiving no support.

Chart 2.14: Decomposition of participation rate

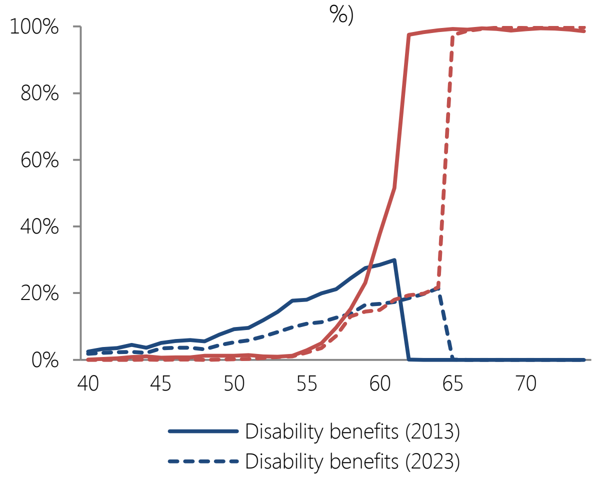
(Percentage point, cumulated)



Source: MNE calculations

Chart 2.15: Age profile of beneficiaries of pension and disability benefits

(Proportion of beneficiaries within the cohorts, %)



Source: MNE calculations

Pursuant to the effective regulations, full retirement age will be raised gradually to 65 years of age by 2022. The age limit increases by 6 months by date of birth, that is, the members of the generation born in 1952 may retire at the age of 62 and a half and those born in 1957 at the age of 65.

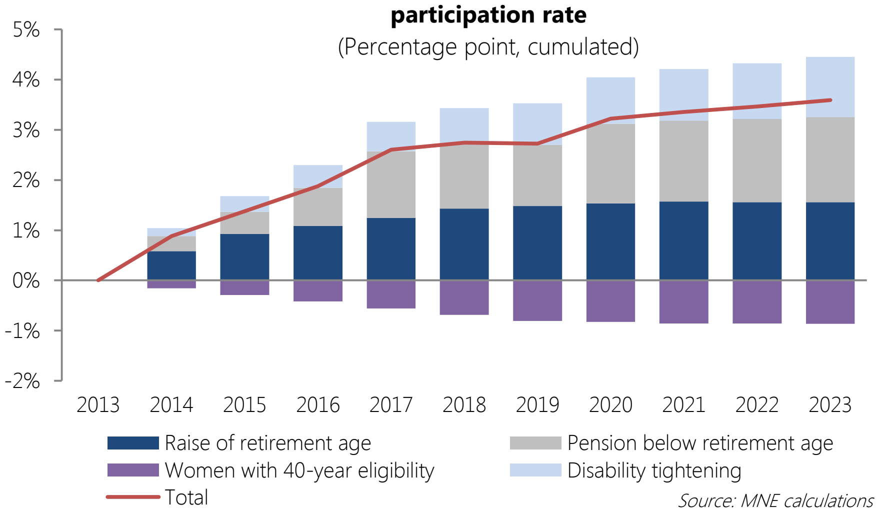
The system of early retirement was transformed as of January 1, 2012; accordingly, no old-age pension may be granted below the retirement age. Following the reform, early retirement pensions already granted are transformed into benefits before retirement age or into service allowance, and new benefits may only be granted to persons fulfilling the statutory eligibility conditions, e.g., acquiring eligibility no later than 31 December 2014. Furthermore, the Government provided the option of retirement below retirement age as of 2011 to women with an eligibility period of at least 40 years.

Severe tightening transformations took place in the system of disability pensions over the past years. As a result, the number of new entrants to the benefit system decreased by almost half of the value prevailing in the mid-2000s. Moreover, as a consequence of the alteration of the eligibility criteria and medical reviews, the rate of terminated benefits has also increased.

The simulation is based on the further assumption that, essentially due to the decrease in the number of new entrants, the proportion of the beneficiaries within the groups defined by age, sex and education may drop in the long run to half of the current levels, representing the slow-down of the pace of moderation prevailing in the past years. The decrease, however, is partly offset by the elevation of the retirement age, beneficiaries will retire and be granted old-age pension later. Chart 2.15 shows the expected development in the period between 2013 and 2023 of the age profile of beneficiaries of old-age pension and disability and rehabilitation benefits, respectively.

Chart 2.16: Expected impact of the modelled measures on the participation rate

(Percentage point, cumulated)



Source: MNE calculations

To break down the effects on the participation rate of specific measures, a technical assumption was applied that the elevation of the retirement age would have been concurrent with a parallel increase in age limits applicable to early pensions, and the effects of the total cancellation of early pension were assessed relative to this scenario.

As can be seen in Chart 2.16, the modelled measures raise the participation rate by further 3.6 percentage points altogether by 2023. The increase in the retirement age implies a further increase of 1.6 percentage points and that of the cancellation of the possibility of early retirement an increase of 1.7 percentage points. The retirement of women with an eligibility period of 40 years, on the other hand, implies a decline of 0.9 percentage points, while tightening measures introduced in the disability benefit system increases labour force participation growth by 1.2 percentage points.

Labour market conditions are regarded as being loose, although the number of newly announced non-subsidised vacancies showed slight increase and the number of the registered job-seekers moderated over one year. Despite the improvement, there are relatively more job-seekers per newly announced vacancies (outside the public work schemes), which lags behind the period before the crisis. Moderate wage pressure was indicated by the loose labour market and supported by the low inflationary environment and the corresponding inflation expectations.

Wage increases was stimulated by a 5.4% increase of minimum wages along with a 5.6% increase of the guaranteed wage minimum early this year, declining inflation expectations throughout the year resulted low wage dynamics. Gross wages increased overall by 3.5% on average over the past year.

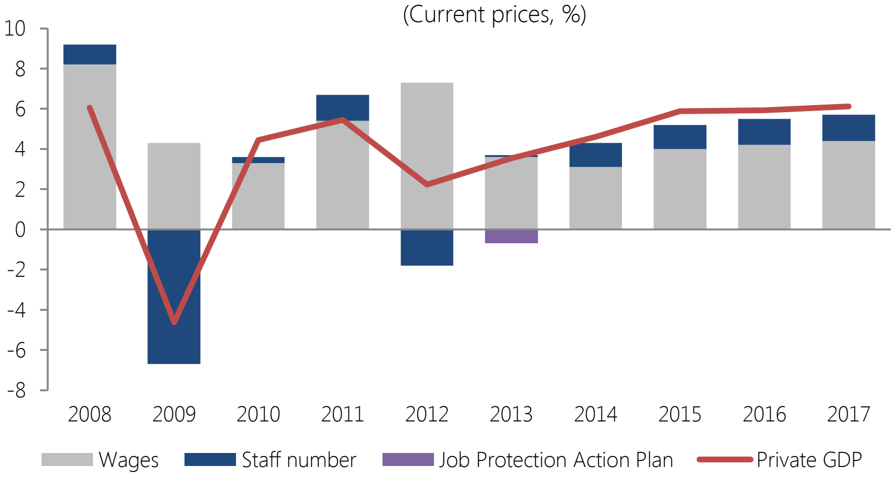
Enterprises determined to improve their profitability reacted to the limited price increase options due to the weak domestic demand primarily by containing their production costs, whereas the wage index of the public sector was raised by the wage settlement of healthcare workers and the introduction of the career path model for teachers. The distribution effect owing to the growing number of relatively low-paid public workers reduced gross average wages in the public sector despite the 5.1% increase of their wages.

The effects of the flat-rate personal income tax system manifested themselves clearly for the first year in 2013, with the phasing out of half super-grossing, which caused an increase of the net wage bill. Net average wages calculated by taking into consideration the family tax base allowance rose by 4.4%. As a result of the low inflationary environment, the real value of net wages increased by 2.6%, which exceeds the moderate average real wage dynamics of the years since the crisis.

Given the loose labour market conditions in 2013, companies of the private sector faced moderate labour cost pressure relative to the average of the previous year. The development was underpinned by restrained wages and by cost-mitigating allowances under the Job Protection Action Plan. In regional comparison, relatively low real labour costs indicate favourable competitiveness within the group of the Visegrad Countries.

Chart 2.17: Private GDP and labour costs

(Current prices, %)



Source: CSO, MNE estimations

Expectations adjusting to the low inflationary environment and the loose labour market conditions point towards moderate nominal wages that may rise gradually with the strengthening domestic demand. Private sector unit labour cost may show only moderate growth, so corporate profitability can improve in line with accelerating wages and staff number.

An expansion of 3-4% of gross average wages is projected over the forecast period. The extension of the family tax allowance to employee contributions in 2014 projects a more dynamic increase of net wages, whereas minimum wage and guaranteed wage minimum growth hardly exceeding the general wage increase is expected to bring no significant wage shifts. On the basis of the projection, wage settlement of education will continue in the public sector under the career path model for teachers.

2.4. Inflation developments

In 2013, Hungary registered a low average price increase rate of 1.7%, unprecedented in decades. This value, substantially lower than that of the previous year, is the result of several effects. On the one hand, price growth decelerated due to global oil and food price decrease and low external inflationary pressure. On the other hand, utility price cuts introduced in several steps reduced the price level substantively. At the same time, a wide range of products in the consumers' basket was characterised by moderate price growth. Although the core inflation rate excluding articles with more volatile prices as well as administratively priced ones was raised by temporary effects (e.g. the increase of the retail trade margins of tobacco articles, partial shift of the duty on financial transactions), after adjustment for these effects, it was a mere 1.5% in 2013. Owing to the factors listed above, a low inflationary environment has formed in Hungary.

Inflation in 2014 is moderated substantially by the second 11% utility price cut implemented in December 2013, and the third administrative price cut that is to take place in several steps in 2014. Overall, restrained price increase is projected for regulated priced products. The price of market goods and services is subject to several conflicting factors. On the one hand, the performance of the economy will lag behind its potential level (negative output gap) over the entire forecast horizon, and thus low inflationary pressure is to be presumed on the demand side, as is confirmed by the restrained inflation expectations. The spill over effects of fuel prices that are lower than those in the previous year and cash withdrawals free of charge will keep reducing the pace of price increase. On the other hand, the fact that the exchange rate is weaker than before acts in favour of price increase especially in the groups of industrial and food products.

Low inflation measured in early 2014 will increase moderately during the year, and the inflation-curbing effect of the second utility price cut will fade out by the end of this year. In addition, based on the grains futures quotes, food prices may also be higher than the favourable level experienced in H2 2013. Thus in the last months of the year, the annual index will exceed the average value for the whole of 2014. In 2015, besides the carry-over effects of the third utility price cut and of the option of cash withdrawals free of charge, weak external pressure due to the low inflationary environment experienced all over Europe will partly offset the price increase resulting from the depreciation of the Hungarian forint. Consequently, the average inflation rate will remain somewhat below the 3% level. Low inflation expectations, however, support the attainment of long-term price stability, thus in the period after 2015, a 3% inflationary rate is to be expected, in line with the inflation target of the central bank.

Table 2.2: Inflation (%)

	2013	2014	2015	2016	2017
Inflation	1.7	0.8	2.9	3.0	3.0

2.5. CYCLICAL DEVELOPMENTS

New methodology was applied for the calculation of potential growth and output gap described in Box 5. Calculations show that in the decade preceding the crisis, the output gap was permanently in the positive range in Hungary, but in 2009 economic performance dropped below the potential level. After 2006, potential growth also decreased substantially, but since 2010 it has been increasing again at an accelerating pace.

Potential growth has three components that are also fostered by the economic policy of the Government. Labour market reforms aim at reducing imbalances, improving potential growth also in the long term by decreasing equilibrium unemployment and raising the activity rate. The growth of the capital stock available for production is the result of corporate investment showing marked expansion over the forecast horizon. The improvement of total factor productivity is backed by the vehicle production capacity expansions in the vanguard of the relevant technology that may bring a rise in the technical standards of companies active in other sectors as well, and the reforms implemented in education and vocational training.

The potential output accelerates over the entire forecast horizon. Initially, as a result of labour market reforms, labour will contribute the most to potential growth. This will be complemented by the increasingly marked growth contribution of productivity due to productive capital backed by increasing investment and the related innovation and efficiency gains content.

Actual growth exceeds the pace of potential growth over the forecast horizon, so the negative output gap will gradually close. Consequently, by 2018, the output level may reach its potential level. Parallel to the closing of the output gap, inflationary pressure originating from the domestic demand side will also become more tangible.

Table 2.3: Cyclical developments (%)

	2011	2012	2013	2014	2015	2016	2017
GDP growth	1.6	-1.7	1.1	2.3	2.5	2.1	3.1
Potential growth	0.4	0.7	0.9	1.2	1.3	1.5	1.9
Growth Contributions:							
Labour	0.3	0.4	0.6	0.8	0.7	0.7	0.7
Capital	0.2	0.1	0.2	0.4	0.4	0.4	0.6
Total factor productivity	-0.1	0.1	0.1	0.1	0.2	0.4	0.6
Output gap	-2.6	-4.8	-4.6	-3.6	-2.5	-2.0	-0.9

Source: MNE calculations

"Total data" may differ from the sum of partial data due to rounding.

Box 5: Real-time measurement of the cyclical position of the Hungarian economy

Potential output indicates the level of economic performance attainable with the available resources that is sustainable in the long run. Since it cannot be observed directly, it may be quantified by estimation procedures based on different methodologies. The existing literature usually presents two main groups of estimation techniques. Beyond the purely statistical smoothing algorithms, structural approaches that incorporate economic relations in the estimation of the variable are also popular.

End-point uncertainty is the common problem of the various methods. After receiving new information, the filtered cyclical position of the economy also changes substantially having the consequence that the most important information for economic policy making – i.e. the ones pertaining to the actual period – is the least reliable.

The Commonly agreed methodology for measuring the cyclical position used to rely on a statistical approach: it was based on the Hodrick-Prescott (HP) filter. To address the end-point problem, the European Commission switched in 2002 to the so-called production-function-based methodology[3]. In the new model, equilibrium values were calculated separately for each factor, although the HP filter

[3] D'Auria, F. – Denis, C. – Havik, K. – Mc Morrow, K. – Planas, C. – Raciborski, R. – Röger, W. – Rossi, A. (2010): The Production Function Methodology for Calculating Potential Growth & Output Gaps. ECFIN Economic Papers 420

was retained to smooth the productivity indicator.

The 2008 crisis highlighted the end-point uncertainty. Experts agreed in retrospect that the advanced economies had been overheated in the period before the crisis, although the contemporary models projected a different view for decision-makers. Therefore, in 2010 the Commission has changed to the more complex, so-called state-space models for smoothening productivity.[4] Better real-time performance was again one of the decisive arguments in favour of the improvement.

The Commission’s model controls only the development of the real economy, whereas in connection with the global economic crisis, the literature quoted much evidence concerning the relation of financial and real economic cycles. Therefore, the proposal of Borio et al. (2013), presenting the improvement of potential GDP estimation through the implementation of financial cycles seems plausible.[5]

The model extends the HP filter with variables that describe the development of the financial cycle adequately. Real-interest rate, the real price of property and the real value of loans are the concerned variables. The method has the advantage that, it is possible to take into consideration several effects simultaneously, while keeping the number of parameters to be estimated low, with favourable statistical properties.

Estimations conducted on US data can be interpreted as a finance-neutral output gap (hereinafter: FNOG). The FNOG method has a property that is highly advantageous for economic policymaking, namely that its real-time performance is substantively more reliable than that of the estimates published by international organisations (IMF, OECD).

Based on its reliability, the FNOG method is worth being adapted also in Hungary. However, it should be applied to Hungarian data with prudence. On the one hand, the available observations cover a relatively short period from 1997 to 2013, embracing a single economic cycle comprising period of growth in the second half of the 1990s, gradual loss of impetus after the early 2000s, turning into a crisis in 2008 and the recovery from it. On the other hand – contrary to the USA – Hungary is a small open economy, hence its business cycle is greatly affected by the development of external demand.

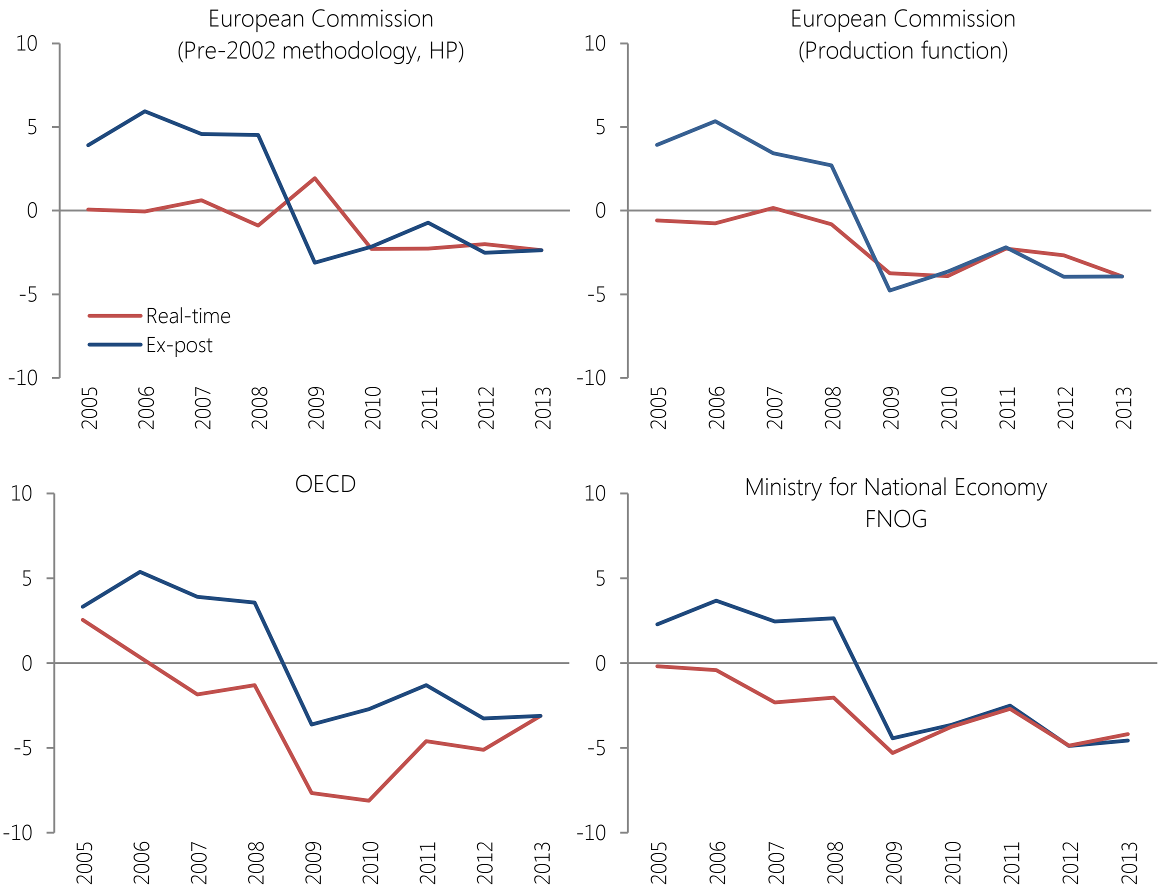
In consideration of the country- and sample-specific features, the range of variables included in the analysis was extended relative to the paper referred above. In addition to the financial cycle (real-interest rate), the changes in the external balance (net financial capacity, capital account balance) and overall macroeconomic performance (industrial capacity utilisation) has been embedded as well. Regarding the latter, Borio et al. (2014) also proposed to take into account the general stance of the economy.

[4] Borio, C. – Disyatat, P. – Juselius, M. (2013): Rethinking potential output: Embedding information about the financial cycle. BIS Working papers 404

[5] [5] Borio, C. – Disyatat, P. – Juselius, M. (2014): A parsimonious approach to incorporating economic information in measures of potential output. BIS Working papers 442

Chart 2.18: Real-time and ex-post output gaps of Hungary

(in % of potential output)

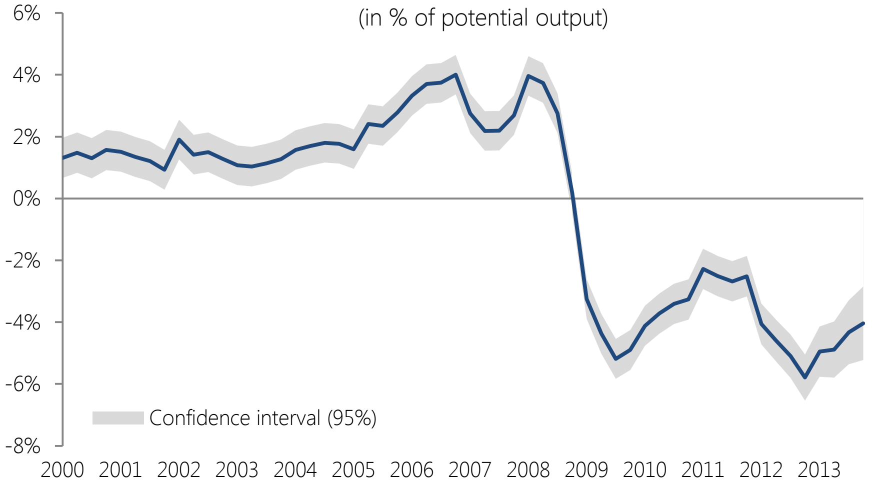


Source: European Commission, OECD, MNE calculations

To evaluate the estimations for Hungary, it is important to note that the FNOG method works reliably if there are business cycles that can be recognised in the data. As for Hungary, it can be detected simultaneously with the outbreak of the financial crisis, so the FNOG method becomes reliable also in real-time after the year of 2009. In addition, the ex-post output gap results are significant throughout the whole time horizon, meaning that a more accurate view becomes discernible regarding the business cycle. The period preceding the crisis is characterised by a clearly positive, and the one after 2009 by a negative output gap (Chart 2.19). Applying the generally used HP filter, not even the sign of the output gap is certain in the major part of the estimation period.

Chart 2.19: Finance neutral output gap (FNOG)

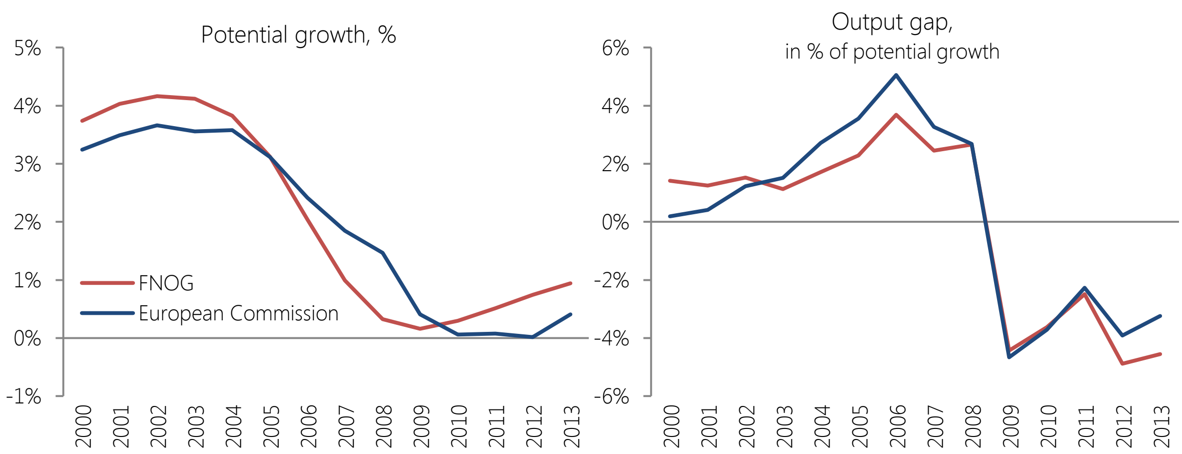
(in % of potential output)



Source: MNE calculations

The reduction of uncertainty – i.e. the conclusions of the finance-neutral output gap model – is of primary relevance for economic policy. By taking into consideration cyclicality due to the financial and external processes, observable cyclicality in potential growth will be moderated. Consequently, the calculation suggests that for the period 2010-2013 the potential growth is higher and the output gap is more negative than the European Commission and OECD estimations. Hence the results imply more favourable cyclically adjusted fiscal balance and lower inflationary pressure for the recent period, knowing these carries relevant real time information for both the fiscal and monetary policy decision makers.

Chart 2.20: Potential output and output gap



Source: MNE calculations

From the perspective of economic policymaking, the reliability of the output gap estimation is of great importance. The finance-neutral output gap model taking into consideration the country-specific characteristics as well as the lessons of the crisis of 2008 yields reliable real-time estimates about the cyclical position of economy. Therefore, as of 2014, the Ministry for National Economy applies this model to measure potential output and the output gap.

2.6. EXTERNAL POSITION

The net external position of the country has shown increasing surplus since 2009, which almost doubled from 2012 to 2013 and reached a record high figure of 6.5% relative to the GDP. Within the current account balance the major rise in the trade balance was the result of the export surplus, stemming from new automotive industrial capacities. In terms of income, the lower interest liabilities, and in terms of current transfers, the accelerated use of EU transfers improved the current account balance. The better shape of the capital account was due to an increase in EU support provided for economy and infrastructure development. It was favourable from external balance perspective that in 2013 Hungary received in total EUR 5.4 billion Community funds in the form of current transfers.

The trends observed in 2013 are likely to continue over the forecast horizon. Although parallel to the picking up in domestic demand imports may rise intensively, the balance of goods and services as a percentage of GDP might improve gradually, reaching 10.8% by 2017. The funds received from the European Union may decline temporarily in 2016 due to the n+2 rule, tempering the financial capacity.

Some moderation may be expected in the income outflow experienced over the last few years as a result of several contrary effects. On the one hand, parallel to the reduction of external debt, the outflow of interest type income will decrease, as the interest income will remain in the country with strengthening domestic financing. On the other hand, as the economic output rises and foreign investment inflow reinforces, non-debt type income will also be higher. Furthermore, parallel to the European upturn, investors also likely to expect higher returns, which may also be reflected in an increasing income outflow.

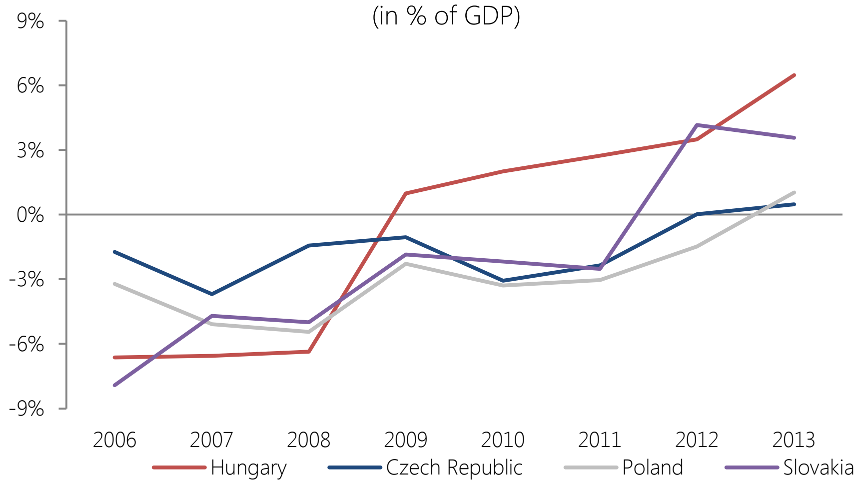
All in all, the current account surplus to GDP ratio will exceed 3% over the forecast horizon. Owing to the sound external financing position, the country is gradually repaying its external debt. Between 2010 and 2013 the gross external debt (without other capital) to GDP ratio fell from 114.4% to 88.3%, while the net external debt shrank from 53% to 35.2%. The net financial capacity remains steady at around 6-7% of GDP, therefore the pace of debt reduction may also accelerate in the forthcoming period. As a result, by 2017, gross external debt may fall to around 60% of GDP.

Table 2.4.: External financing (in % of GDP)

	2013	2014	2015	2016	2017
Balance of goods and services	8.0	8.3	8.9	10.8	10.8
Current account	3.0	3.6	3.7	4.9	5.4
Capital account	3.5	3.7	2.3	1.2	2.1
External net lending/borrowing	6.5	7.2	6.0	6.1	7.5

Source: MNB, MNE calculations
"Total data" may differ from the sum of partial data due to rounding.

Chart 2.21: Net financial capacity in the region
(in % of GDP)



Source: Eurostat

2.7. ECONOMIC EFFECTS OF GOVERNMENT MEASURES

The macroeconomic impacts of the main economic policy measures of the Government were estimated by the DINAMO model of the Ministry for National Economy. The model is suitable for such impact assessment because it consistently reflects the sufficiently detailed connections between the national accounts and the financial accounts of the government and because numerous transmission channels were integrated into the model through which fiscal variables can exert their effect on the economy. The structure of the DINAMO model is based on neoclassical growth assumptions on the long run, but in the short term the adjustment is slowed by nominal rigidities. During the simulations, the impacts of the government measures implemented since the publication of the 2013 Convergence Programme were analysed.

The overall impact of the following major reforms and changes in the tax system were analysed:

- The Start work programme, that is, the surplus of public work programmes since the 2013 Convergence Programme.
- Introduction of the career path model for teachers.
- Increase of the levy on financial transactions from 3‰ to 6‰ and cancellation of the HUF 6,000 upper limit for cash withdrawal.
- One-off collection of the levy on financial transactions on banks in 2013.
- Extension of 6% health contribution on interest income.
- Raising the telecommunications tax paid by companies from HUF 2 to HUF 3 and increase of the upper limit to HUF 5,000.
- Increase of the mining fees from 12% to 16%.
- Extension of the family tax allowance to employer contributions.
- Introduction of flexible GYES, GYED (child-care support, child-care allowance), as a result of which from January 2014 mothers can engage in employment without any limitation while

receiving GYES or GYED, if the child is older than one year, and the Government also took measures to support university students to have children.

- Freezing of certain general government expenditures.

Table 2.5.: Impact of modelled measures on general government balance (% of GDP)

	2013	2014	2015	2016	2017
Start work programme	-0.06%	-0.10%	-0.09%	-0.09%	-0.09%
Career path model for teachers	-0.14%	-0.52%	-0.68%	-0.83%	-0.85%
Financial transaction duty: rate increase	0.10%	0.23%	0.23%	0.23%	0.23%
One-off financial transaction duty	0.26%				
Health contribution on interest income	0.02%	0.07%	0.06%	0.06%	0.06%
Telecommunications tax increase	0.02%	0.04%	0.04%	0.04%	0.04%
Mining fees	0.02%	0.03%	0.02%	0.02%	0.02%
Family tax allowance		-0.16%	-0.16%	-0.16%	-0.16%
Flexible child-care support and child-care allowance (GYES, GYED)		-0.05%	-0.05%	-0.05%	-0.05%
Freezing of certain general government expenditures	0.27%	0.30%	0.29%	0.28%	0.26%
Total:	0.49%	-0.16%	-0.34%	-0.50%	-0.54%

Source: MNE calculations

Remark: The items do not necessarily make up the total due to rounding

Table 2.6 shows the results of the simulations in percentage differences compared to the baseline scenario. On the basis of the simulation the GDP volume is expected to increase gradually: in 2013 the output grew by more than a half of one tenth percentage point. However, in the subsequent periods, the economic growth will be higher: the measures will lead to 0.5% higher GDP volume by 2017.

The disposable income of households was increased by Government measures; consequently a considerable rise is expected in consumption over the forecast horizon. This impact will offset the additional import demand, driven by the growing consumption and the decrease of investment, which is due to the additional expenditures of corporations and freezing of certain expenditures of the Government. Although these additional liabilities slightly held back employment in 2013, in parallel with the acceleration of economic growth, the measures will boost the labour demand across the forecast horizon.

Although the measures have a slightly negative impact on the general government balance from 2014, the higher tax revenues projected from the accelerating growth will dampen that effect. Overall, therefore, the Hungarian economy will set out on a higher growth path as a result of the introduced measures, which expand households' consumption.

Table 2.6.: Macroeconomic impacts of measures (% difference in levels relative to the baseline scenario)

	2013	2014	2015	2016	2017
GDP	0.06	0.24	0.33	0.43	0.51
Household consumption expenditure	0.23	1.14	1.29	1.48	1.65
Investment	-0.23	-0.75	-0.46	-0.25	-0.19
Exports	0.00	0.00	0.00	-0.01	-0.01
Import	0.07	0.27	0.33	0.39	0.45
Inflation	0.00	0.01	0.06	0.09	0.11
Private sector employment	-0.01	0.04	0.13	0.20	0.27
Gross wages in the private sector	-0.01	-0.01	0.03	0.06	0.07
General government deficit (% of the GDP)	0.32	-0.04	-0.19	-0.29	-0.38

Source: MNE calculations

2.8. MONETARY AND EXCHANGE RATE POLICY

The Act on the MNB stipulates, similarly to its predecessor, that the primary objective of the MNB is to achieve and maintain price stability. Since 2001 the MNB has defined monetary policy within the regime of inflation targeting. Under this framework the Monetary Council sets a medium-term inflation target in line with price stability, which is currently 3% as a continuous target.

A floating exchange rate regime has been in place since early 2008, allowing the central bank to resort to foreign exchange intervention operations. The floating exchange rate proved to be successful also during the crisis, offering sufficient flexibility; therefore, no change in the regime is envisaged. In the period since the Convergence Programme of 2013, the HUF/EUR exchange rate has fluctuated between 288 and 313.

Since April 2013, the market interest rates have been rather variable, yet the declining trend of the country risk and the reference yield has continued. The globally deteriorating investment environment and a yield increase, observed on the capital markets, affected also the market of Hungarian government securities in the summer of 2013. The yield of the 10-year government bonds temporarily rose to 6.5% by the end of August. In June the Hungarian CDS spread also became higher temporarily as a consequence of the concerns that accompanied the phasing out of the quantitative easing applied by the Fed. However, as a result of the improved market perception due to the fiscal discipline and the falling public debt, both the reference yield and the 5-year CDS spread, which quantifies the risk of default of a country, sank significantly again: the 10-year Hungarian government securities yields stabilised around 5.5% over the previous period, corresponding to a lower range than the one recorded one year before. The Hungarian 5-year CDS is now around 230 basis points, after having left the 300 basis point band which prevailed in April 2013. The lower risk premium resulting from individual country-specific factors, based on the CDS decomposition, was another positive sign.

Over the last year the central bank base rate was lowered in phases from a previous all-time low of 5% in April 2013 to reach another historic low of 2.5%. That process was the result of the Government measures and the fact that the Government is committed to achieving the deficit target and that the base rate could be cut further gradually during the year amidst the globally favourable investment climatemode.

In April 2013 the MNB expanded its monetary policy toolkit to support the Government's measures to stimulate lending without jeopardising the independence of the central bank and its primary objective of achieving and maintaining price stability. The objective of the first two pillars of the three-pillar scheme was to help micro, small and medium-sized enterprises (hereinafter: SMEs) which struggle with a shortage of funds have access to HUF-denominated loans and strengthen their position with the help of a HUF 500 billion facility created by the MNB. The first phase of the Funding for Growth Scheme (FGS) ended on 30 September 2013 and consisted of the following main parts:

Pillar 1: Preferential central bank refinancing for forint-based lending to SMEs

The MNB will provide refinancing loans with a preferential interest rate to commercial banks for a temporary period. The total initial amount of the programme is HUF 250 billion; the interest rate on the central bank loan is 0%. Credit institutions wishing to participate in the scheme will have to lend on the central bank loan to SMEs at a preferential interest rate with a maximised premium. That premium, including also the costs of the guarantee schemes, used as required, could not exceed 2.5 percentage points. The MNB organised regular consultations with the credit institutions to discuss the experiences of the scheme.

Pillar 2: Preferential central bank refinancing for converting SME foreign currency loans into forints

The MNB intends to provide, also with the involvement of credit institutions and on a temporary basis, preferential refinancing loans for the conversion of SME's outstanding foreign currency loans into forints. The total initial amount of the programme is HUF 250 billion; the interest rate on the central bank loan is 0%. The other conditions of the programme (total amount, interest rate, size of the premium and targeting) are also identical with those of the previous programme point. The maximum volume of the low-interest-rate refinancing that can be provided under the scheme is limited again: it may not exceed 15% of domestic banks' total foreign currency loans to SMEs. In order to ensure that the conversion of the foreign currency loans into HUF loans does not result in any exchange rate volatility, the MNB supplied foreign exchange to credit institutions from its foreign exchange reserves at market rates for the currency conversion of the loans on condition that credit institutions undertake to use it for repaying their short-term external liabilities.

Pillar 3: Reducing the vulnerability of the economy and the related interest expenditures

This programme aimed to reduce the country's short-term external debt, which also lowers the foreign exchange reserve requirement of the central bank. The central bank provided foreign exchange to financial institutions involved in the scheme, in exchange for HUF, to help them repay their short-term external debts.

Companies showed intensive interest in the available preferential loans after the scheme has been announced and, therefore, the Monetary Council raised the amount available in the first two pillars by 50%, i.e. to HUF 750 million, prior to the launch of the scheme on 1 June. Consequently, credit institutions entered into contracts for HUF 472 billion under Pillar 1 and for almost HUF 229 billion under Pillar 2, which represented 70 % utilisation. In total, within the framework of Pillars I and II advertised to companies, credit institutions provided almost HUF 701 billion loans, which equalled 93.5%% utilisation of the total available facility.

On 11 September 2013 the MNB Monetary Council decided to continue the scheme (FGS II). The main achievement of the first phase was a boost to the SME credit market, hence in the second phase the MNB intends to focus on new loans and on encouraging economic growth even more. In order to facilitate growth, in the continued phase of the scheme, 90% of the total HUF 2,000 billion facility (of which MNB allocated HUF 500 billion for the first phase) may be used only for new loans under Pillar 1, while the remaining 10% is available for refinancing HUF loans and currency loans, taken previously with a higher interest rate. The lending started on 15 November 2013. The scheme will be closed on 31 December 2014.

Hungary has not yet set the date for the introduction of the euro. The convergence criteria should be met while also promoting economic growth to the maximum extent possible.

3. General government balance and debt

3.1. Fiscal policy objectives

Owing to the successful fiscal consolidation implemented since 2010, Hungary has managed to terminate the excessive budget deficit by 2012, complying with the March 2012 Council Recommendation. Following the 4.3% deficit in 2010 and the 4.3% surplus, resulting also from a one-off item in 2011, the general government showed only 2.1% deficit, i.e. much lower than the 3% reference value, in 2012. As a token of recognition of the disciplined fiscal policy, in June 2013 the Council closed the Excessive Deficit Procedure against Hungary, which had been in effect since Hungary's accession to the EU in 2004.

In 2013, the general government deficit remained low at 2.2% of GDP. Simultaneously with the stabilisation of the budget, the debt ratio has also declined. The gross public debt as a ratio of GDP contracted from 82.2% in 2010 to 79.2% by the end of 2013.

Backed by the results of consolidation, the fiscal policy can now concentrate also on supporting and maintaining economic growth. Consequently, the Government designed a reviewed mid-term fiscal path which does not hamper economic recovery by fiscal demand restriction and fulfils the following requirements:

- the deficit must remain below the 3% reference value,
- in line with the Fundamental Law, the deficit path must ensure the reduction of the public debt,
- in line with the new Public Finance Act, the structural balance, i.e. the cyclically adjusted balance net of one-off and temporary items, must be consistent with the medium-term budgetary objective (MTO) defined as a structural deficit of 1.7% of GDP.

Following the years of the crisis, the Hungarian economy began to pick up against from Q2 2013. In view of the importance of supporting the started upturn, the 2014 annual budget contains a deficit target of 2.9% of GDP but, parallel with the strengthening of the economy, the deficit may fall again subsequently. Thus, taking into account the revised potential output of the economy as well (see Chapter 2.5), the structural deficit will remain below the medium-term budgetary objective throughout the programme horizon, apart from one conditional one-off increase in 2015. This potential rise would be a technical one: similarly to 2014, certain investments to expand state property may be implemented depending on the revenues from the sale and utilisation of state property also in 2015. Considering that the income that forms the basis of funding will originate from one-off items, the structural deficit may be a bit higher temporarily.

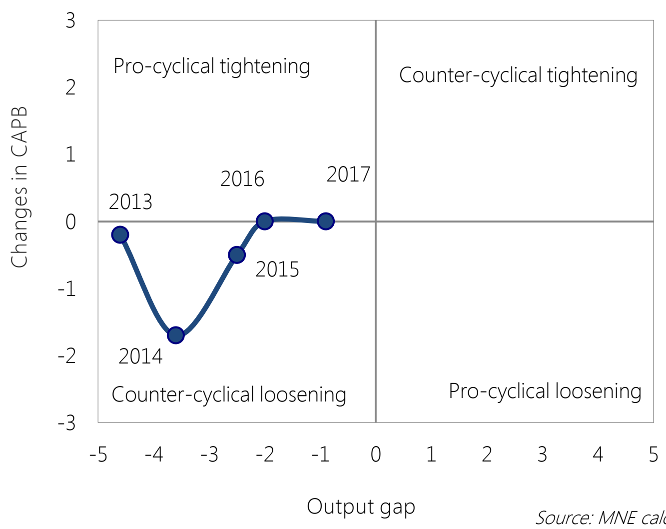
Table 3.1.: Medium-term fiscal path (% of GDP)

	2013	2014	2015	2016	2017
EDP-balance of the government sector	-2.2	-2,9	-2,8	-2.5	-1,9
Structural balance	-0.3	-1.6	-1.6 (-2.0)	-1.6	-1.6
Gross public debt	79.2	79.1	78.9	77.5	74.7

Source: CSO, MNB, MNE calculations

Based on the changes of the cyclically adjusted primary balance, following the fiscal impulse in 2014, the aggregate demand will be stimulated much more moderately in 2015 against a background of a narrowing but still negative output gap, while from 2016 on the fiscal policy will be neutral in terms of an effect on demand along with the medium-term fiscal path, set out in the Convergence Programme.

Chart 3.1: Fiscal stance (+ tightening, - loosening)
(percentage point)



Source: MNE calculations

3.2. THE 2013 BUDGETARY OUTCOME

Similarly to 2012, the general government deficit according to the EDP methodology turned out to be much below the target also in 2013. According to the data provided by the Hungarian Central Statistical Office to Eurostat, the deficit made up 2.2% of GDP last year instead of the 2.7% target. The favourable balance was the result of four main factors. Firstly, the Government applied disciplined fiscal management and controlled the expenditures during the year. Secondly, 80% of the outstandingly high risk reserve integrated into the budget (HUF 400 billion Country Protection Fund, making up 1.4% of GDP) were not spent. Thirdly, the Government introduced balance-improving measures in May and June 2013 in order to close the Excessive Deficit Procedure. And, finally, the local governments and other classified organisations (i.e. business associations not belonging to the Hungarian budget, but classified in the general government sector according to the EU methodology) closed the year with a surplus, higher than forecast, also in 2013. Partly owing to more disciplined fund management and partly due to the strict government control over borrowing, the position of the local governments turned out to be more favourable than forecast in the third year in a row.

During the interim modifications of the budget, some items appeared in the cash-based balance of the central government that did not affect the actual balance according to the EU methodology, yet led to a greater cash-based deficit than originally planned. Such items included a capital increase in MVM Zrt. to partially finance the acquisition of the E.ON gas business line in Hungary, or the state capital injection into the Savings Cooperatives Integration Unit. The Integration Unit was classified into the general government sector in the ESA accounting, and therefore that transaction did not deteriorate the EDP balance.

Of the items not included in the cash-based balance of the sub-systems, but included in accrual-based accounting, the largest one was the partial assumption by the state of the debt of the local governments operating in settlements with more than 5,000 residents. This transaction amounting to 2% of GDP was neutral on the balance of the general government sector.

Table 3.2.: Balances in 2013 (% of GDP)

	2013 Convergence Programme	Spring 2014 notification
Cash-based balance of the central budgetary sub-systems	-2.8	-3.2
Cash-based balance of local governments	0.1	0.4
Central government and SS EDP balance	-5.1 (-3.1)*	-4.8 (-2.8)*
EDP balance of local governments	2.4 (0.4)*	2.6 (0.6)*
EDP balance of the general government	**-2.7**	**-2.2**

Source: CSO, MNE

**in brackets: not including local government debt assumption*

During the implementation of the budget, both positive and negative risks affecting the balance emerged in the first half of the year. Thus e.g., the overall fiscal position improved because fewer than projected opted for the two new tax types introduced in January 2013 (KATA, KIVA), hence some surplus was generated primarily in the social contribution tax; at the same time, the unfavourable effects of the much-lower-than-expected inflation rate were also reflected in the tax revenues, more specifically and primarily revenues from turnover-type taxes. Having studied the projection of the European Commission that was different from those of the Hungarian Government and taking into account the above-mentioned risks as well, the Government decided to introduce, despite professional opinions to the contrary, balance improving measures in order to achieve the abrogation of the Excessive Deficit Procedure. The measures introduced in May and June aimed at expenditure cuts, equivalent to 0.3% of GDP (primarily freezes on the expenditure appropriations of the central budget chapters), as well as revenue increase equalling 0.4% of GDP (increase in the financial transaction levy, telecommunications tax, mining fees, introduction of health contribution on interest income and a mandatory one-off additional financial transaction levy payment to offset the shortfall that occurred in the first half of the year).

In the second half of the year it became obvious that the deficit target was feasible owing to the introduced measures, the upturn in the economy, some savings on certain expenditures (housing subsidies, benefits below retirement age), as well as concession revenues received for the extension of frequency usage rights. Some measures affecting the expenditure side could be partially abolished due to the more favourable fiscal processes and the record high risk reserve. Additional resources could be provided in several fields as required (launch of the career path model for teachers in September, extra expenditures relating to the flood, Own Resource Fund which helps obtaining EU funds, additional support to higher education, extension of the public work programme to the winter months, reduction of hospital debts). The risk reserve was reduced by 20% to cover part of the additional expenditures, but the Government did not spend the rest. Consequently, the cash-based deficit of the central government turned out to be approximately HUF 200 billion lower than stated in the amended statutory projection, and the deficit, calculated according to the EU methodology, was also lower by almost the same amount than the target set in the previous Convergence Programme.

Regarding the structure of the budget, the shortfall of tax revenues turned out to be greater than expected when the Convergence Programme was prepared in April 2013, primarily due to the underperformance of the turnover-type taxes, which could not be offset by the surplus achieved in social security contributions but, owing to the non-tax-type revenues, the total government revenues turned out to be slightly higher than forecast. At the same time, the expenditures were lower because the cancellation of the free risk reserve accounted among the other expenditures overcompensated for the slight surplus achieved on the other items. The GDP-based indicators were also affected by the more than HUF 350 billion lower nominal GDP effect, resulting partly from the revision of the base figures and partly from a moderate price increase.

Table 3.3.: Changes in the general government figures for the year 2013 (% of GDP)

	2013 Convergence Programme	Preliminary fact	discrepancy	
			overrun / shortfall	GDP effect
Tax revenues	26.3	25.7	-0.9	0.3
Social security contributions	12.8	13.4	0.5	0.2
Other revenue	7.9	8.5	0.5	0.1
Total revenue	**46.9**	**47.6**	**0.1**	**0.6**
Compensation of employees	9.6	10.3	0.5	0.1
Intermediate consumption	7.7	7.9	0.1	0.1
Social transfers	17.5	17.5	-0.2	0.2
Gross fixed capital formation	4.0	3.9	-0.2	0.1
Other expenditure*	10.8	10,2	-0,7	0.1
Total expenditure	**49.6**	**49.8**	**-0.4**	**0.6**

Source: CSO, MNE calculations

**: The revenues from the sale of frequencies reduced the other expenditure in the ESA accounting.*

The differences in the table are due to rounding.

3.3. THE 2014 BUDGET

In view of the importance of support of the economic upturn and having taken into account the effect on the tax revenues of the evolving lower inflation path, in the 2014 budget the Government raised the deficit target to 2.9% of GDP from 2.7%, defined in the previous Convergence Programme. Further decisions also had an impact on the planned revenues and expenditures:

- Last year's fiscal processes facilitated the launch of the career path model for teachers in public education in September 2013 but, contrary to the assumptions used in the Convergence Programme prepared in 2013, the remuneration will be increased gradually, in 5 phases instead of one, by 2017;
- The extension of the public work programme will also continue in 2014. As the respective budgetary appropriation for this year is 7.4% higher than the annual expenditures in 2013 increased by the introduction of the winter public work, apart from the inflation-adjusted wage increase of public work scheme participants, the number of employees may also go up;
- Certain, mainly cultural and sports, investments are managed separately in an Investment Fund within the budget. Those expenses are funded from the proceeds of the sale of state property (mainly frequency usage right). More than HUF 100 billion revenues are projected for the budget from the sale of frequencies also in 2014;
- The freezes ordered in 2013 were integrated into the base figures used in the course of planning, yet in certain fields additional needs were also recognised. Such examples include increases in the social policy fare subsidies in public transport and an increase in health expenditures. The 2014 expenditure appropriation of medical and preventive care is nearly 6% higher than the previous year's appropriation, and reflects also a slight increase in real terms compared to last year's expenditures, which expanded as a result of the additional support provided at the end of 2013 for the reduction of hospital debts. Any further acceleration in the absorption of the EU transfers and the required higher amount of national co-financing will also give a boost to expenditures compared to what was planned in the previous Convergence Programme;
- In order to enable employees earning low wages to claim the full family tax allowance, it has also been extended to employee's social contributions. The effect of the measure on the budget is approximately HUF 50 billion;
- The more flexible support to parents with young children, and within this the improvement of the conditions of returning to the labour market aim to incite having children. The introduction of "GYED-extra" will have an estimated HUF 15 billion effect on the budget.
- The debt consolidation of local governments will be completed in 2014. The central government will assume the total outstanding debt of the local governments or in the case of debt below a specific limit, will provide a support for debt repayment. (In the concluding phase of consolidation, HUF 68 billion support was provided for repayment, and almost HUF 404 billion debt was assumed.)
- The risk reserve, equivalent to 0.3% of the GDP, has been integrated into the budget in order to eliminate macroeconomic risks (Country Protection Fund, HUF 100 billion). Together with the reserve set aside for unexpected expenditures and/or losses in revenue and the specific reserve for the wage compensation of low income earners in the public sector, the total reserves make up almost 1% of GDP.

In line with the previous assumptions, the wages in the public sector did not increase, with the exception of public education. With the gradual implementation of the career path model for teachers, expenditures for compensation of employees will increase less in 2014 than calculated in the previous Convergence Programme. However, higher amounts will be spent from the budget than calculated earlier for the purchase of goods and services, owing to an increase in EU transfers and other expenditure surplus. The data, calculated according to ESA, are raised not only by the actual surpluses, but also as a result of a balance-neutral change in methodology, which relates to the accounting of the Treasury transaction levy[6]. The development of social transfers is determined by the largest item, i.e. pensions and pension-type benefits, where the increase, required to maintain their real value was adjusted to the 2.4% estimated inflation, which is lower than expected in the previous Convergence Programme.

Having taken into account lower inflation, the base effects of the previous year's processes, the extension of the family tax allowance, and the revenue-boosting measures of 2013, the tax and contribution revenues calculated in the budget were below the expectations of the 2013 Convergence Programme by 0.3% of GDP. However, the significantly lower nominal GDP, resulting from the revision of the data of the former years and a moderate price increase, will raise the GDP-proportionate indicator also in 2014. The changes in other revenue reflect the change in the methodology of accounting of the Treasury transaction levy.

Table 3.4.: The 2014 budget (% of GDP)

	2013 Convergence Programme	2014 budget	discrepancy	
			overrun / shortfall	GDP effect
Tax and contribution revenues	38.8	39.0	-0.3	0.5
Other revenue	8.3	8,7	0.3	0.1
Total revenue	**47.1**	**47.7**	**-0.1**	**0,7**
Compensation of employees	10.2	9.9	-0,4	0.1
Intermediate consumption	7.7	8,7	0.8	0.1
Social transfers	17.0	17.0	-0.2	0.2
Gross fixed capital formation	4.8	4.8	0.0	0.1
Other expenditure*	10.2	10.2	-0.1	0.1
Total expenditure	**49.8**	**50.6**	**0.1**	**0.7**
EDP BALANCE	**-2.7**	**-2,9**	**-0,2**	**0,0**

Source: MNE calculations

**: The revenues from the sale of frequencies reduced the other expenditures in the ESA accounting.*

The differences in the table are due to rounding.

On the basis of the cash-based figures of the first three months, the Convergence Programme assumes that the 2.9% deficit target may be achieved. In the first quarter the aggregate deficit of the central government, the social security funds and the extra-budgetary funds amounted to 71% of the annual appropriation which, considering that, due to the customary seasonality, the distribution of the cash-based deficit within the year is typically front-loaded, may not be deemed outstandingly high. Similar quarter/year ratios could be observed on several occasions in the former years and the January-March balance was also affected by one-off impacts, including the transfer of the repayment

[6] Due to the gross accounting, transaction levy built into the fee for Treasury services increases both the intermediate consumption expenditure of budgetary institutions and the revenue of Treasury.

support to local governments, or resources advanced from national resources to cover the expenditure of the EU programmes, to be recovered during the year.

The structure of the 2014 budget, however, may vary from the original plans. Despite the fact that this year's rate of inflation is likely to be much lower (0.8%) than the 2.4% estimated at the time of the preparation of the budget, no shortfall is expected in the total tax and contribution revenues. The shortfall of value added tax and excise duty will be counterbalanced, because in 2014, like in 2013, fewer taxpayers opted for the two new preferential taxation schemes (small business tax, lump-sum tax for small taxpayers) introduced in 2013, hence significant surpluses may be projected in the simplified entrepreneurial tax and even more in the social contribution tax. As2013 purchases of goods and services were much below the forecast made in the course of planning the 2014 budget, while compensation of employees was significantly higher, the base effect may trigger significant changes in the structure of the expenditure side. At the beginning of 2014, a decision was made to increase the financial remuneration of employees working in the defence, law enforcement and social sectors, respectively. This increase will be funded from the savings in the specific reserve for wage compensation, hence those decisions may be implemented with a neutral effect on the balance. The absorption of EU transfers is likely to be higher than originally planned in the private sector and lower in the general government reducing the level of expenditures and revenues in a balance-neutral manner. At the same time, the savings expected in housing subsidies and in certain social transfers together with the more favourable position of local governments will improve the balance. Taking into account the last three years and in particular the 2013 developments, the balance of local governments without the effect of debt assumption and the budget transfer provided for the repayment of debt below a specific limit, as a conservative estimate, may be approximately zero instead of the slight deficit planned in the budget. A more favourable local government balance is to be considered an upward risk in the forecast.

Table 3.5.: Expected general government development (% **of GDP)**

	2014
Targeted balance of the 2014 budget	**-2.9**
Shortfall of tax revenues	-0.4
Surplus in social contribution revenues	+0.4
Expenditure overrun relating to compensation of employees	-0.4
Savings in the intermediate consumption	+0.1
Improvement in the balance of local governments	+0.1
Social transfers, housing subsidy	+0.1
Total other items, net	+0.1
Expected balance in 2014	**-2.9**

Source: MNE calculations

3.4. BUDGETARY DEVELOPMENTS IN 2015-17

REVENUES

In the forthcoming years the tax and contribution revenues, as well as the non-tax-type revenues (property income, market revenues, transfers) are likely to increase at a pace lower than the GDP growth. The Convergence Programme does not contain any further major modifications in the tax system after the completion of the structural changes. Although the structure of economic growth is more balanced than in the previous years, the tax centralisation may drop by 2 percentage points to close to 37% by the end of 2017 from the slightly more than 39% registered in 2014, including also the effect of the slower-than-originally-projected, but still steady increase in the number of taxpayers opting for the two preferential tax types (small business tax, lump sum tax of small taxpayers).

In the two years that follow the 2007-2013 programming period of the EU, EU transfers used within the government sector may similarly boost the revenues than in 2013. However, following the phasing out the n+2 rule, from 2016 on, only the amounts available from the frameworks established in the new seven-year period may be used for the calculations. For that reason and also as a result of an increase in the ratio of beneficiaries outside the general government, the centralisation ratio may drop below 43% by 2017.

Table 3.6.: Main revenues of the general government (% of GDP)

	2014	2015	2016	2017
Tax and contribution revenues	39.2	38.4	37.8	37.2
Other revenue without EU transfers	5.,0	4.7	4.5	4.3
Total revenue without EU transfers	44.1	43.1	42.3	41.5
EU transfers	3.1	3.0	1.2	1,4
Total revenue	**47.2**	**46.1**	**43.6**	**42.9**

Source: MNE calculations
The differences in the table are due to rounding.

EXPENDITURES

With the falling revenue/GDP ratio, the deficit targets may be achieved with stronger cuts in expenditures. Apart from EU transfers, social transfers can contribute most to the reduction of the re-distribution rate, but disciplined fiscal management and national co-financing complementing the lower EU transfers available for absorption by the government and private sector may also reduce the expenditure/GDP ratio in the last two years of the programming period.

Table 3.7.: Main expenditures of the general government (% of GDP)

	2014	2015	2016	2017
Balance	-2.9	-2.8	-2.5	-1.9
Total revenue without EU transfers	44.1	43.1	42.3	41.5
Total expenditure without EU transfers	47.0	45.9	44.8	43.3
of which:				
compensation of employees	10.4	10.0	9.7	9.4
social transfers	17.0	16.4	16.1	15.6
intermediate consumption and gross fixed capital formation without EU transfers	9.8	9.3	9,0	8.9
other expenditure	9.9	10.2	10.0	9.5

Source: MNE calculations

The differences in the table are due to rounding.

The disciplined fiscal management will affect all major types of expenditures:

- with the exception of public education, at present the Convergence Programme does not project any general wage increase and does not forecast any further considerable extension of the public work schemes in view of the improved economic environment. The gradual introduction of the career path model for teachers that began in September 2013 raised the level of expenditures most in 2014, after which the increase of compensation of employees in the government sector will be lower than the GDP growth rate;
- apart from the EU transfers and the related national co-financing, the outlays of central budgetary institutions for the purchase of goods and services cannot increase, especially at the beginning of the period and local governments may increase their spending only at a rate below the expected inflation;
- similarly to 2014, investments aimed at the expansion of state property (primarily in culture and sports) financed from resources other than EU funds may also be implemented in 2015, depending on the proceeds received from the sale of state property (mainly frequency usage rights). Throughout the period, investments will be determined by the EU funds, resulting in an approximately 1.5 percentage points decline in the GDP-proportionate expenditures following the completion of the projects launched in the 2007-2013 period, although thereby fulfilling the pledges made under the Agreement on additionality relating to the EU funds in this programming period.
- the social transfers reflect the results of restructuring under the Széll Kálmán Plan. Pensions and pension-type benefits retain their real value, while the family and social benefits are fundamentally determined by the number of the applicants. The growth of pharmaceutical subsidies and subsidies for therapeutic equipment and of expenditures on free medication to the needy will be below the expected inflation rate and the social policy fare subsidies will be fixed at the level increased in 2014. As a percentage of the growing GDP, the in-cash social transfers may be reduced by more than 1 percentage point, and the in-kind benefits provided by market producers could also fall by a few decimals of a percentage point between 2014 and 2017;

- the Convergence Programme assumes some reduction in the expenditures associated with state property and, owing to the restructuring and the completed debt consolidation, stabilisation of the balance of the local governments.

Although the macroeconomic risks have been mitigated extensively since the former years, some risk, as well as restructuring and development, reserves, equivalent to 0.3 to 0.4% of the GDP, should still be integrated into the yearly budgets even in the medium term in order to safely achieve the deficit targets.

3.5. STRUCTURAL BALANCE

The Convergence Programme uses a semi-elasticity of 0.47 for the calculation of the cyclically adjusted balance, which is in line with the methodology adopted by the Output Gap Working Group of the EU. This means that the general government balance changes by 0.47 percentage points as a result of a 1% difference between actual and potential GDP (assuming no change in its composition).

It is assumed in the Convergence Programme that the actual growth will be greater than the potential growth rate over the forecast horizon, thus the negative output gap will gradually disappear, and the output of the economy may be close to its potential again by 2018 (see Chapter 2.5). As a consequence of the negative output gap characterising the whole forecast horizon, the cyclically-adjusted balance is more favourable than the actual balance in each year.

In 2013 the net effect of the one-off items working in contrary directions improved the ESA balance slightly. In 2014 the one-off items include the expenditures of the elections and the concession revenues from sale of CO2 quota and from the extended frequency usage rights, which will also improve the balance. Similarly to 2014, in 2015, too, certain investments aimed at the expansion of state property may be implemented depending on the actual proceeds from the sale of state property. The revenues funding the investments are one-off fiscal items.

The structural deficit, i.e. the cyclically adjusted balance net of one-off and temporary items, has been significantly better than the medium-term objective (MTO) defined as structural deficit equivalent to 1.7% of the GDP since 2012, and will remain below the MTO during the programming period.

Table 3.8.: Structural balance (% of the GDP)

	2013	2014	2015	2016	2017
Output gap	-4.6	-3.6	-2.5	-2.0	-0.9
General government balance	-2.2	-2.9	-2.8	-2.5	-1.9
Cyclically adjusted balance	0.0	-1.2	-1.6	-1.6	-1.6
Net one-off items*	0.2	0.4	0.0 (0.4)	0.0	0.0
Structural balance	-0.2	-1.6	-1.6 (-2.0)	-1.6	-1.6

** Positive number refers to an item improving the headline balance.*

Source: MNE calculations

As the structural deficit will overachieve the MTO during the programme period, the expenditure aggregate (primary expenditures net of EU transfers) may increase at a rate in excess of the reference benchmark.

3.6. General government debt

The Government defined putting a stop to the rising trend of the public debt-to-GDP ratio, inherited from the preceding period and the reduction of this ratio on a continuous basis as one of the most important objectives of its economic policy in 2010. By the end of 2013 the public debt-to-GDP ratio dropped to 79.2%, while the Government even expanded the state property at the same time.

The debt ratio is fundamentally affected in the long run by the economic growth and the fiscal deficit. It is also important to bear in mind that, because of the natural mechanisms of debt origination, the nominal public debt is rising from year to year as a result of the budget financing needs. The Government may improve the structure of the debt, but the debt ratio can be significantly reduced only with a disciplined fiscal policy and with strong economic growth. The Government has been giving great importance to these factors and considers them to be priorities.

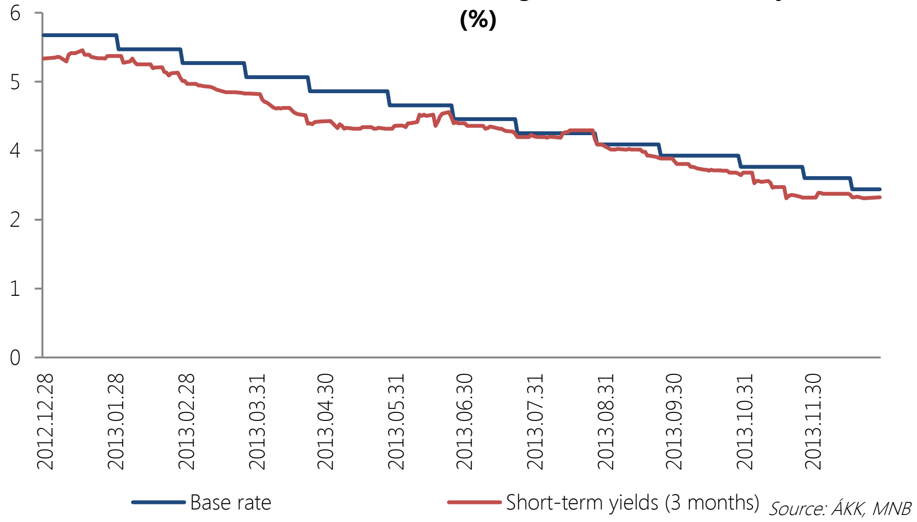
Apart from controlling the debt ratio, favourable changes in the debt structure are also important to the Government. In that regard numerous new measures were implemented. The most important among them enhances the participation of domestic sectors in debt financing, thus reducing the external exposure of the country and widening the investor base. An extensive role of foreign investors (whose total HUF and FX holdings equal approximately 60% of the public debt) makes the country vulnerable and imposes a threat on the financing of the public debt. Foreigners are more likely to close their position in a shorter time in case of market turbulences than residents. In order to mitigate that risk, encouraging the purchase of government securities by domestic actors is an important element of debt strategy. Its positive impacts will not only be a more stable debt financing, but also the realisation of interest income by domestic actors. Over the last one-and-a-half year, several new retail securities have been introduced, which were designed to suit the preferences of various groups of retail investors. The Premium Euro Hungarian Government Bond (PEMÁK) offers a solution to residents intending to save in euro, the Six-Monthly Treasury Bill (FKJ) is an ideal solution for those who prefer shorter-term savings, while the new Baby Bond has been designed for families intending to save up for the future of their children. The Bonus Hungarian Government Bond (BMÁK) has a new feature – its interest rate is tied to the wholesale government securities, while with the introduction of the Treasury Savings Bond Plus (KTJ Plus) the government securities available at Magyar Posta Zrt. were extended to dematerialised securities. While in 2011 the stock of government securities held by the households remained below HUF 500 billion, the stock increased gradually and expanded to HUF 1,900 billion by the end of 2013, which reflects the success of the household programme launched in 2012.

The Government is trying to reduce the FX denominated debt within public debt. By the end of 2013 the Government managed to reduce to 42% the share of FX denominated debt within total public debt, which surged from around 30% to almost 50% with the IMF/EU loan. Nonetheless, a large part of the debt is still denominated in foreign currency, due to which public debt is heavily exposed to exchange rate fluctuation. The exchange rate risk may be mitigated by accelerating the process of reducing the FX denominated share of public debt. Once that risk is diminishing, the future burden of public debt may be projected with greater certainty.

The repayment of the loan taken from the European Union and the International Monetary Fund in 2008-2009 started in December 2011. In 2013 Hungary repaid its total debt to the IMF, and it will repay the outstanding principal of EUR 3.5 billion owed to the EU in two instalments, in 2014 and in 2016. In terms of the composition of FX denominated debt, it was an important change that, following the prepayment of the IMF loan and the USD bond issues in February and November 2013 and March 2014, the structure of FX denominated debt shifted towards market financing. The international bond auctions were extremely successful, and their pricing showed that investors were expecting a lower yield premium in exchange for the sovereign risk. There is a clear message from those transactions suggesting that the country can successfully finance its debt from the market, under favourable conditions, without any support from international institutions.

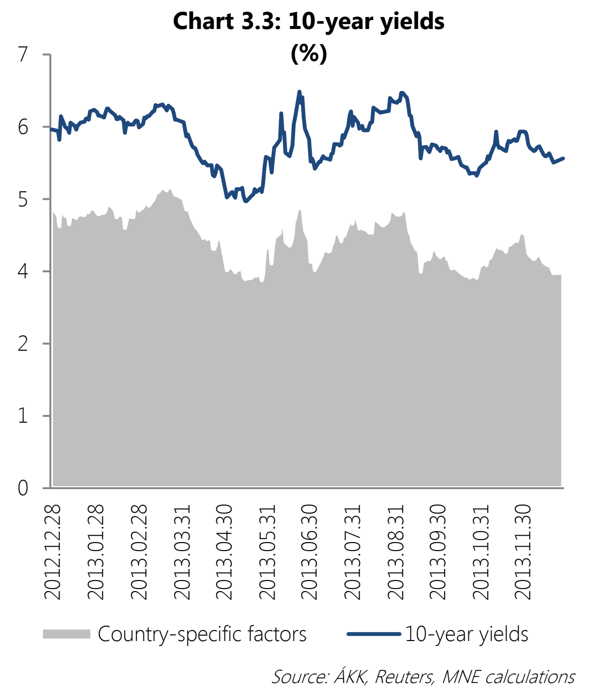
2013 was a predominantly balanced and stable year in the Hungarian government securities market. The year was opened and closed with an approximately 250 basis points Hungarian 5-year CDS spread. As a result of an increase in Q1, it exceeded 400 basis points for a short period, but in the rest of the year it gradually dropped back to 250 basis points. The favourable fiscal and capital market developments left more room for manoeuvre for monetary policy and let the MNB cut its base rate. Simultaneously, improved investor perceptions have led to lower short-term government securities yields. The short-term government securities yields followed the decline in the base rate and fell from 5.4% at the beginning of the year to 2.9% till the end of the year. (Chart 3.2)

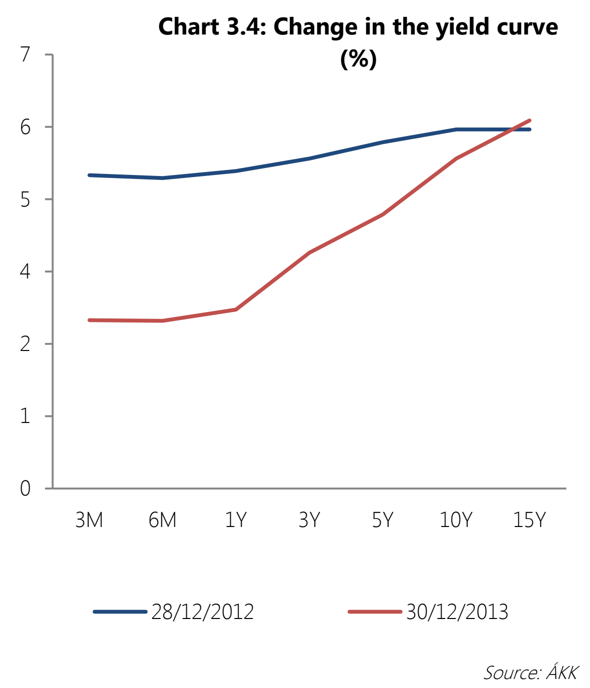
Chart 3.2: Base rate and short-term government securities yields (%)



Source: ÁKK, MNB

The long-term yields were also following a diminishing trend with minor fluctuations. Five-year yields dropped from 5.9% to 4.7%, while ten-year yields contracted from 6.1% to 5.6% during the year (Chart 3.3). Besides international liquidity abundance, declining yields were mainly due to country specific factors (i.e. lower sovereign risk, liquidity and exchange rate risk premia). The yield curve became steeper during the year as a result of a greater decline in short-term yield than in long-term yields (Chart 3.4.).





Primary market yields followed the secondary market yields: in the shorter maturities they fell from 5.5% to 2.9%, while the auction yields of medium and longer term maturities fell from almost 6% to 4.8-5.8% by the end of the year. The average bid-to-cover ratio of HUF government bond auctions was 2.8. In response to the high demand, the value of government bonds issued in HUF by the Debt Management Agency exceeded the originally planned amount by almost 50% in 2013.

On the basis of the latest projections, even though the falling trend has continued, the debt path has been shifted slightly upwards compared to what is contained in the 2013 Convergence Programme. This change is the combined result of the following factors.

(1) General government deficit: The projected net interest expenditures are only slightly higher than last year's forecast, primarily because of the greater-than-expected success of retail securities sales with attractive interest rates. However, the trend of interest expenditures continues to be reducing, which is the result of the lower yield curve. Improving macroeconomic indicators and disciplined fiscal policy may improve investors' and credit rating agencies' perception about the country, which may be reflected in lower risk premia. Financing costs of the public debt will be lower and therefore the Government expects a gradual decrease in interest expenditures. In total, the higher deficit path will still comply with the EU requirement of 3%, and will contribute to a slower reduction of the debt, yet implies a slightly more relaxed, growth-supporting fiscal policy. That, ultimately, will reduce the debt ratio through a higher nominal GDP.

(2) Nominal GDP: The 2014 Convergence Programme reckons with lower nominal GDP than the 2013 Programme, mainly due to the revised CSO figures. A lower nominal GDP projection on its own will rise the debt trajectory by 1, 1.4, 0.9 and 0.6 percentage points between 2013 and 2016.

(3) Stock-flow adjustments: The debt path was also modified by stock-flow adjustments.

- The technical exchange rate assumption used for the debt projection implies 307 HUF/EUR rate between 2014 and 2017, which is around 5 percentage points weaker than the 293.1 HUF/EUR rate used in the 2013 Convergence Programme.
- The debt was reduced by approximately HUF 200 billion more than projected in the Convergence Programme of April 2013, from the revenues of the Pension Reform and Debt Reduction Fund (PRDRF). The components of the portfolio of PRDRF, requiring active asset management, were transferred to Hungarian National Asset Management Inc. in 2012-2013.
- In terms of special transactions, it should be noted that the bonds issued in 2011 by MÁV with a state guarantee must be accounted among the debt of the general government sector pursuant to the ESA'95 rules, as it constituted an imputed debt assumption. As included in the assumptions of the 2013 Convergence Programme, the assumed debt will be repaid in 2014 also according to the assumptions used in the 2014 Convergence Programme.
- The projections for the changes in the liquid assets of the budget (Single Treasury Account and foreign currency deposits at the MNB), advances on EU transfers as well as the difference between the cash-based and accrual-based balance of the budget have been modified since the forecast used in the previous Convergence Programme.

As the local government debt also constitutes part of the Maastricht debt, the takeover of local government debt has no effect on the public debt, as it merely involves some debt restructuring between the sub-systems.

Table 3.8.: Main assumptions in the Convergence Programmes

		2013	2014	2015	2016	2017
Nominal GDP growth (%)	CP-2013 April	4.3	5.3	4,6	4.7	-
	CP-2014 April	3.8	4.8	5.3	5,1	6.0
General government balance (% of GDP)	CP-2013 April	-2.7	-2.7	-2.2	-1.3	-
	CP-2014 April	-2.2	-2.9	-2.8	-2.5	-1.9
Public debt ratio (% of GDP)	CP-2013 April	78.1	77.2	76.1	73.4	-
	CP-2014 April	79.2	79.1	78.9	77.5	74.7

Source: CSO, MNB, MNE calculations

The future debt ratio is sensitive to the following major factors (ceteris paribus):

(1) Primary balance: A 1 percentage point upward shift in the primary balance in terms of GDP from 2014 until the end of the horizon would reduce the debt-to-GDP ratio by 1 percentage point in 2014 and by 3.7 percentage points in 2017.

(2) Exchange rate: The share of foreign currency debt within gross debt was approximately 42% at the end of 2013, which is expected to decline to almost 26% by 2017. In view of this, a nominal exchange rate appreciation of 1% (HUF/EUR rate of 304.8 rather than 307.9) would reduce the debt-to-GDP ratio by 0.3 percentage points between 2014 and 2017.

(3) Economic growth: If the nominal GDP growth rate were increased permanently across the horizon, starting in 2014, by 1 percentage point, the debt-to-GDP ratio would decline by 0.7 percentage point in 2014 and the impact would gradually climb to 2.8 percentage points by 2017.

4. SENSITIVITY ANALYSIS

The macroeconomic baseline scenario of the Convergence Programme is subject to both positive and negative risks. Out of these the sensitivity analysis investigates two alternative scenarios, one positive and one negative, the impacts of which were estimated compared to the baseline scenario. The simulation focused on a lower level of the credit risk premium and a slower-than-expected upswing in external demand. Similarly to the impact assessment of government measures, the calculations were made with the DINAMO model of the Ministry for National Economy.

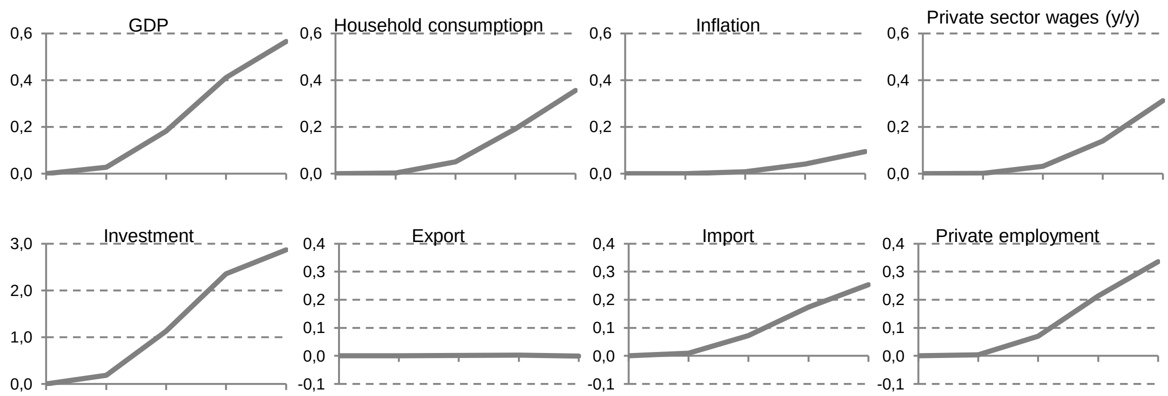
Table 4.1 illustrates the results of the simulation, i.e. the impact of the various shocks on the main macroeconomic and fiscal variables.

In the first scenario, the markets are assumed to recognise the success of the Hungarian economic policy, the sustainable low fiscal deficit and diminishing debt, the successfully achieved turnaround towards the economic growth path, as a result of which the country risk premium will drop by 100 basis points and, consequently, the yields will also persistently fall by 100 basis points. As the country risk premium and the yields decrease by exactly the same magnitude in this scenario, the HUF exchange rate is expected to remain unchanged.

As direct effects of lower yields, the funding cost becomes cheaper for investment activities of companies leading to the increase of the labour market demand. This positive impact is reflected in a rise in employment and wages, and consequently in the consumption expenditures of households. However, as the domestic demand picks up, inflation will also be slightly higher. The growing import demand of investments and consumption will have a negative impact on the trade balance. All in all, persistent GDP growth is assumed.

At the same time, interest expenses of the general government sector will decline and due to the upswing tax revenues will increase as well, i.e. the fiscal balance may improve considerably.

Chart 4.1.: More favourable country risk rating*



Source: MNE calculations

** Difference of the growth rates from the baseline scenario of indicators in percentage points. The horizontal axis divisions represent years after the shock, in this case, the first division represents the year 2013, the last represents the year 2017.*

Table 4.1.: Risk scenarios (Difference of the growth rates from the baseline scenario of macroeconomic indicators, in per cent)

Positive scenario: more favourable country risk rating	2014	2015	2016	2017
GDP	0.03	0,18	0,41	0,57
Household consumption expenditure	0.00	0.05	0.19	0,36
Gross fixed capital formation	0.19	1.13	2.36	2.87
Exports	0.00	0.00	0.00	0.00
Imports	0.01	0.07	0.17	0.25
Inflation	0.00	0.01	0.04	0.09
Private sector employment	0.00	0.07	0,21	0,34
Private sector gross average wages	0.00	0.03	0.14	0.31
Income taxes*	0.00	0.01	0.03	0.05
Employer contributions*	0.00	0.01	0.02	0.04
Turnover taxes*	0.00	0.01	0.02	0.04
Taxes levied on companies*	0.00	0.02	0.04	0.04
Interest expenditure of the general government*	0.75	0.72	0.69	0.66
General government balance*	0.76	0.76	0.78	0.80
Negative scenario: lower than expected external demand	**2014**	**2015**	**2016**	**2017**
GDP	-0.09	-0.29	-0.50	-0.67
Household consumption expenditure	-0.01	-0.11	-0.26	-0,39
Gross fixed capital formation	-0.18	-0.62	-0.94	-1.11
Exports	-0.72	-1.85	-2.97	-4.07
Imports	-0,73	-1.88	-3.00	-4,01
Inflation	0.00	-0.03	-0.08	-0.16
Private sector employment	-0.02	-0.15	-0.31	-0.46
Private sector gross average wages	-0.01	-0.07	-0.19	-0,32
Income taxes*	0.00	-0.02	-0.04	-0,06
Employer contributions*	0.00	-0.01	-0.03	-0,05
Turnover taxes*	0.00	-0.01	-0.03	-0,05
Taxes levied on companies*	-0.02	-0.04	-0,05	-0,06
Interest expenditure of the general government*	0.00	0.00	0.00	-0.01
General government balance*	-0.02	-0.07	-0.13	-0.17

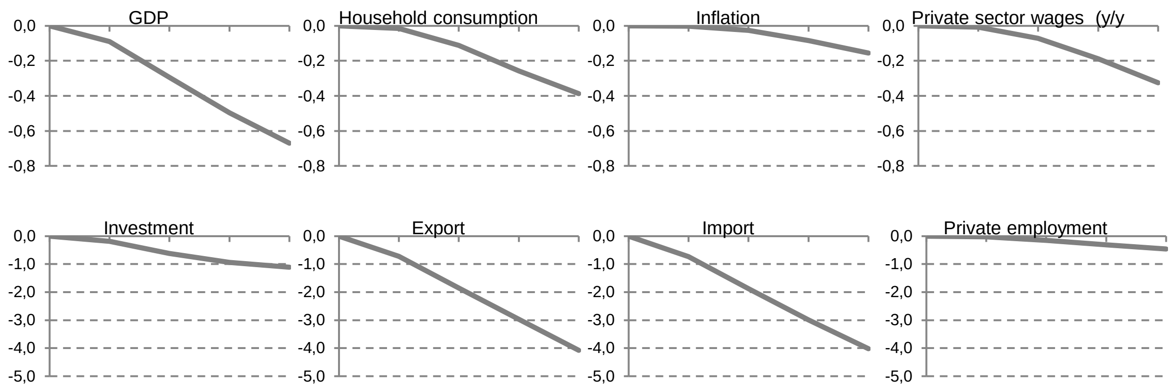
Source: MNE calculations
**% of the GDP; the changes in percentage points refer to the main fiscal items.*
Remark: the items do not necessarily make up the total, which is the result of rounding.

In the second scenario, the simulation is based on a more moderate increase of external demand. In 2013 an economic upswing could have been observed in the European Union. The leading European indices imply a further increase in external demand, which may yet be lower than projected due to the geopolitical risks that have been evolved in our eastern neighbouring country recently. Thus, in the second scenario is based on the assumption that the dynamics of the external demand will be persistently 1 percentage point lower than assumed in the baseline between 2014 and 2017.

Weaker external demand has a negative impact on export outlook and, therefore, Hungary's exports will decline. As the export has high import shares, imports will also considerably shrink as a result of the shock. Thus, due to the more moderate economic outlook, profit expectations will also be more moderate and, in turn, companies will be inspired to gradually cut down production factors. As a consequence, the labour demand of the corporate sector will decrease, leading to a decline in employment and wages. Investment activities of the companies will also held back. Lower real wages will lead to decreasing consumption, as well. All in all, due to a weaker external demand, the GDP volume and inflation will decline persistently.

The fiscal deficit will be higher as tax revenues fall due to the shrink of tax base, caused by the economic downturn.

Chart 4.2.: Lower external demand for four years*



Source: MNE calculations

** Difference of the growth rates from the baseline scenario of indicators in percentage points. The horizontal axis divisions represent years after the shock, in this case, the first division represents the year 2013, the last represents the year 2017.*

5. SUSTAINABILITY OF PUBLIC FINANCES

The sustainability of public finances is primarily determined by the current fiscal stance (budgetary position, public debt, also as a percentage of GDP), the amount of future budgetary expenditure related to ageing and demographic trends.

The Government fosters the improvement of long-term sustainability of public finances through several channels with complex and targeted measures. Its priority is to significantly reduce the debt ratio. (A lowed public debt creates favourable conditions to tackle the challenges of an ageing population in the long run.) In this context, the Government has implemented numerous parametric changes to the pension system which have considerably reduced long-term pension expenditures and the cost of other age-related spending. The Government has introduced family-friendly incentives which could mitigate budgetary consequences of the projected ageing of Hungarian society through demographic changes.

The Fundamental Law, effective as of 1 January 2012, stipulates that the public-debt-to-GDP ratio shall be constantly reduced until it reaches 50%. The achievement of this target was significantly facilitated by the termination of the mixed system, composed of a compulsory, fully funded private pension fund pillar and a state-run, social-security-based, pay-as-you-go pillar introduced in 1998. This affects the sustainability of the state budget in many ways. On the one hand, the public debt was immediately and significantly cut due to the assets transferred from the private pension funds and, on the other hand, the contributions paid by members switching back into the public pillar are now paid to the budget, thereby permanently improving the fiscal position. In addition to the need for reducing public debt, there were also further arguments for the termination of the mixed system. With the high expenditure and low yields, the second pillar of the pension system, introduced in 1998, would have been unable to compensate for the lost social-security-based pensions.

Owing to the parametric changes, which were implemented in several phases, future public pension expenditures were significantly reduced. In conformity with best international practices, the main direction of the measures is to raise retirement age in line with rising life expectancy, a significant increase in effective retirement age and change of indexation. The statutory retirement age will be gradually raised to 65 years by 2022 and the actual retirement age will also be much higher as a result of the new regulations adopted in 2011, which transformed the benefits below retirement age. All these measures have a beneficial effect not only on the pension system but also on employment. In addition to the parametric changes, further measures fostered transparency and ease of presentation in the budget of the pension system and other age-related provisions.

Long-term demographic trends have a major impact on expenditures relating to long-term sustainability. The demographic trends forecast the ageing of the population. The ageing of the population increases age-related expenditure, which has an upward pressure on public debt on long term. One of the main reasons behind the unfavourable demographic process is the low fertility rate. The fertility rate in Hungary is one of the lowest in Europe, accounting for only 1.3% compared to a 1.6% EU average. In order to encourage families to have children, the government strengthened the family incentive system and Parliament approved the Act on Family Protection. The main elements of the measures included various forms of pecuniary support to families, such as family allowance, maternity support, child-care allowance, child raising support, life-starting support, child protection benefit, gas price subsidy for families with three or more children, and the family tax relief introduced in 2011. New measures were introduced on 1 January 2014 (new GYED extra) aimed at improving the conditions of having and raising children and of returning to the labour market for parents with small children. The measures include child-care and child raising benefits, better conditions of employment, parallel disbursement of benefits for families with several children, eligibility for child-care support for students studying in higher education and graduates at the beginning of their career, as well as the extension of the term of tax allowance available for parents with three or more children intending to return to employment after using child-care benefits. All of these measures are expected to mitigate the projected ageing of the Hungarian population.

In the long run, pension expenditures are expected to increase at a much slower pace due to the measures implemented in the pension system. According to calculations approved by the European Commission and the EU Economic Policy Committee, pension expenditures are expected to grow between 2010 and 2060 from 11.9% only to 12.4% in per cent of GDP, which is one of the best results in the European Union as regards the rise in pension expenditures. The positive results of the Government's measures are also confirmed by the most recent Sustainability Report prepared by the

European Commission in December 2012. In its report, the European Commission states that Hungary is a low-risk country regarding the sustainability of the public finances in the short, medium and long term alike. Only 4 other countries received such a favourable rating. Apart from that, the European Commission also claims that the debt ratio will decrease well below 60% of GDP by 2030, provided that the Government maintains the level of structural primary balance planned for 2014.

The figures concerning other expenditure areas significant for long-term sustainability are disclosed in the Report of the Economic Policy Committee of the European Union published in 2012. According to these calculations, health expenditures will grow from 4.9% to 6.1%, expenditures for long term care will rise from 0.8% to 1.4% and education costs will shrink from 4.3% to 3.7% of GDP between 2010 and 2060 in Hungary

6. QUALITY OF PUBLIC FINANCES

6.1. STRUCTURE AND EFFICIENCY OF EXPENDITURES

Structural measures implemented over the last few years enable a more efficient use of public expenditures. The changes made in the local government sector brought the tasks and their financing in line with each other and made local government borrowing better regulated. The measures improved the budget management in the local government sub-sector, which was clearly indicated by the surplus achieved in the sub-sector both in 2012 and 2013, improving the general government balance. Structural changes were also introduced in public education to provide consistently higher quality education to students and ensure better recognition of the activities of the teachers. The impact of the changes may be felt gradually, because they are being introduced progressively. The structural changes leading to cost efficiency were made in public transport as scheduled, resulting in a more predictable financing.

LOCAL GOVERNMENTS

As a result of the restructuring of their tasks, local governments have kept those tasks where local decision-making is indispensable and for which the required funds are available. Further to the reorganisation of tasks, the financing system has also been reformed with task-based financing becoming an essential element. The Act on the local governments of Hungary, the Budget Act, and other legislation on the state budget were all created along the principle that the new type of financing should be aligned with the responsibilities. Simultaneously, the assumption by the state of the debt accumulated by the local governments over the previous years also became necessary.

Within the framework of the debt consolidation, local governments were relieved of HUF 1,368.9 billion debt between 2011 and 2014, of which HUF 178.4 billion was redeemed through aimed subsidies and the remaining HUF 1,190.5 billion was taken over and transferred to the central government sector. The consolidation affected 2,056 local governments and 24 local government associations. The regulations introduced in 2012 pertaining to new debts were also made stricter in 2013: since the middle of 2013 any local government guarantee and surety requires the government's prior consent, while from 1 January 2014 the preliminary data supply obligation has been extended to numerous transactions not requiring a government approval, and from 1 January

2015 an approval will also be required for loans taken to fund own resources of developments financed from EU-funds.

Those measures will ensure that, after the completion of consolidation, the overall debt of the local governments would remain low also in the long term, in view of the required government consent for any new debt and the reserved borrowing practices observed in the local government sector since 2012.

The 2013 balance of local governments is estimated to have shown a surplus of approximately HUF 120 billion. The balance data net of the significant positive effect of the debt consolidation on cash based figures also reflect a favourable trend: HUF 1.2 billion in 2011, HUF 16.6 billion in 2012 and approximately HUF 85 billion in 2013.

The cash balance of local governments net of debt consolidation is influenced by the following factors:

- The gradual takeover in 2012 and 2013 of local institutions operated by county and local governments, that caused significant financing shortfalls for the local governments, took off a lot of burden from the whole local government sector.
- The full consolidation of the debt of local governments significantly reduces the interest expenditures of municipalities.
- The enforcement of the regulations of the Stability Act also has a positive effect on the balance because, due to the requirement of approval by the Government, only loans that are absolutely necessary will be taken up and spent. Consequently, it is unlikely that any new freely disposable cash would appear with a negative effect on the local government balance.
- As of 2013, local governments are not allowed to plan their annual budget with an operating deficit.

Consequently, as a result of the measures exerting their effects each year, the cash balance of local governments is likely to become predictable on a continuous basis free of any major negative swings.

PUBLIC EDUCATION

Fundamental changes were launched to modify the content and structure of public education; Parliament passed the new Act on National Public Education (hereinafter: Nkt.) at end-2011. The Act defines public education as a public service provided by the central government, that was previously shared with and the maintenance was actually assigned to local governments. Thus the former, fragmented education system, driven by local interests and characterised by major differences in quality due to the variance of the local financial and economic endowments, and by indefinite content and requirements, was replaced by an institution system, a curriculum and a quality assurance system managed, designed, financed and controlled by the state in line with the national interests. Except for kindergartens, the entire, previously municipal, network of public education institutions was transferred to state operation. Its maintainer is the Klebersberg Intézményfenntartó Központ (Klebersberg Institution Maintenance Centre; hereinafter: KLIK) founded in autumn 2012 and disposing of the whole range of the institutions concerned as of 2013.

The enactment of the career path model for teachers opened the way to the more decent financial remuneration of educators. The amendment of Nkt. and the codification of the government decree governing its execution resulted in an arrangement whereby those concerned can see their potential professional career and the associated scheduled wage increase five years ahead. The first phase of the career path model was introduced together with the academic year of 2013/2014. At that time, the central budget provided already for 60% of the costs of the envisaged full-scale introduction, and the Government guaranteed a further 10-10% extra costs and the introduction of the items guaranteed by the career path model accordingly, from one year to the next, up to the academic year of 2017/2018.

To standardise the quality of education, reduce early school-leaving, help children in a disadvantageous situation catch up, extend talent education and teach the generations being brought up to lead a healthy life, investment programmes started as of 2014 for all-day primary school activities, the reduction of school age, the introduction of daily physical education and in particular swimming lessons and mandatory pre-schooling from the age of 3. Decisions on investments financed from the relevant appropriation of this year's budget have already been made. Professional developments are also supported by substantial EU funds and domestic projects. The most significant components are the support schemes, dominated by EU transfers, related to early school-leaving, and the schemes related to the Arany János programmes and to integrated education that have been supported by domestic central budgetary funds for several years.

The transformation of the whole system will take years, since the requirements applicable to the teaching profession and to the content of education can only be introduced gradually. Some new functions started only in 2014, so their specific and long-term professional and financial impacts are not discernible yet. One of these functions is the introduction and operation of the teacher qualification system for which qualification procedures must be conducted for around 30 thousand teachers annually. Currently, the training of the qualifiers is underway. National professional control, i.e. the restoration of the school inspection system, is indispensable to implement higher quality standards in education and to reverse the deteriorating performance of school pupils demonstrated by the international measurement surveys in recent years.

TRANSPORT

In the framework of internal restructuring announced to improve the cost efficiency of the MÁV Group, traction (Trakció) and maintenance (Gépészet) were integrated into MÁV-Start Zrt., and hence the integrated passenger transport branch has been established. The preparation of the transfer of the railway track operation activity to a separate entity was terminated (the activity will be transferred after the relevant decision is taken). As a result of the steps taken so far, budget appropriations designed for the passenger rail transport public service can be put on a declining course. This is further helped by the rationalisation and coordination of timetables.

Organisational restructuring at the Volán companies is in an advanced stage: instead of the earlier twenty-four firms, seven regional companies have been established, leading to cost reductions in terms of centralised procurement, maintenance, operational management and control and hence more moderate public reimbursement.

Based on the railway track operation contracts concluded in 2011, the railway track operators (MÁV Zrt., GySEV Zrt.) are entitled to a reimbursement of justified costs not covered by revenues. Following increases realised in several steps, the appropriation in the budget since the past few years provides full coverage for the justified costs making the funding of both companies predictable.

6.2. STRUCTURE AND EFFICIENCY OF REVENUES

Owing to the tax measures of the Government taken in the past years, total taxes and contributions imposed on the economy decreased to around 39% from 41% of GDP prevailing in pre-crisis years. The reduction of the tax burden was concurrent with the restructuring of the tax system, focusing as before on reducing taxes imposed on labour and on small and medium-sized enterprises. In that context, the focus of taxation shifted from income taxes to taxes imposed on consumption, turnover and negative externalities. The Government considers it a priority objective to enhance the efficiency of tax collection and to expand the toolset for combating the shadow economy.

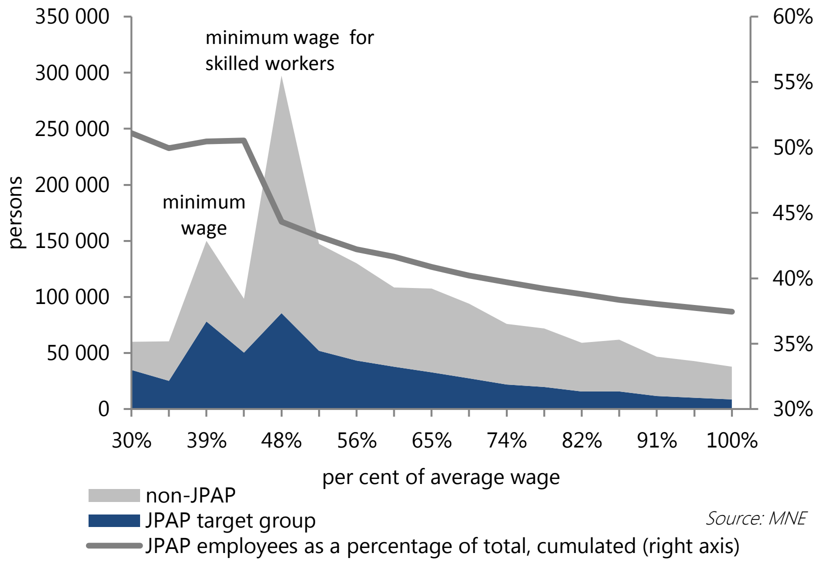
The most important restructuring measures necessary to achieve the above targets were implemented in the past years. However, the changing economic environment, the need for eliminating problems in the implementation of the law and compliance with EU directives may warrant the amendment of taxation rules. Provided that the budgetary position in light of accelerating economic growth make it possible in the years to come, the tax policy of the Government will focus on the further reduction of labour taxes.

Between 2011 and 2014, the Government implemented a fundamental restructuring of taxes on labour so that the tax system provide the least disincentive to work possible, while also providing better conditions for those in the most disadvantageous labour market situation. The introduction of the flat-rate personal income taxation, the elimination of in-work tax credits and the cancellation of the pension contribution ceiling resulted as a general rule in a completely linear tax and contribution system. With the introduction of the family tax allowance in 2011, on the other hand, the tax system now takes into consideration also the number of dependent persons in the household. From 2014 on, the family tax allowance can be deducted also from the employees' social security contributions, so the tax rates of families in the lower income brackets have decreased further. The employment of the most vulnerable employees and the preservation of their jobs, on the other hand, was promoted by the introduction in 2013 of the Job Protection Action Plan that encourages employment and boosts labour force participation more cost-effectively than the in-work tax credit phased out in 2011-2012.

The Hungarian labour force participation is low in regional comparison. The gap is attributable mainly to the low participation rate of low-skilled workers, the elderly, the youth and women of child-bearing age. Based on the available Hungarian and international empirical literature it can be established that the participation and employment rates of the above groups are usually more responsive to various tax incentives. The earnings of workers in elementary occupations, of young employees, and of those returning to work after a longer period of time are typically lower; consequently, the probability of tax evasion associated with low reported wages is lower in these groups. Against this backdrop, the targeted tax allowances of the Job Protection Action Plan aim primarily at helping these employees find employment. Since the allowances in social contribution tax and vocational training contribution payable by employers, introduced by the Job Protection

Action Plan, are not phased out even for higher wages, they encourage wage concealment less than the previous in-work tax credits. The minimisation of administrative burdens has also been an important aspect in designing the targeting criteria. Although the Job Protection Action Plan targets the groups in the most disadvantageous labour market situation, an extensive range of employees is eligible for the allowances. By the end of 2013, the deductions were applied to almost 740 thousand employees, and the Job Protection Action Plan reduced the labour costs of the target groups by a total of HUF 115 billion (of which HUF 97 billion in the private sector) during the year.

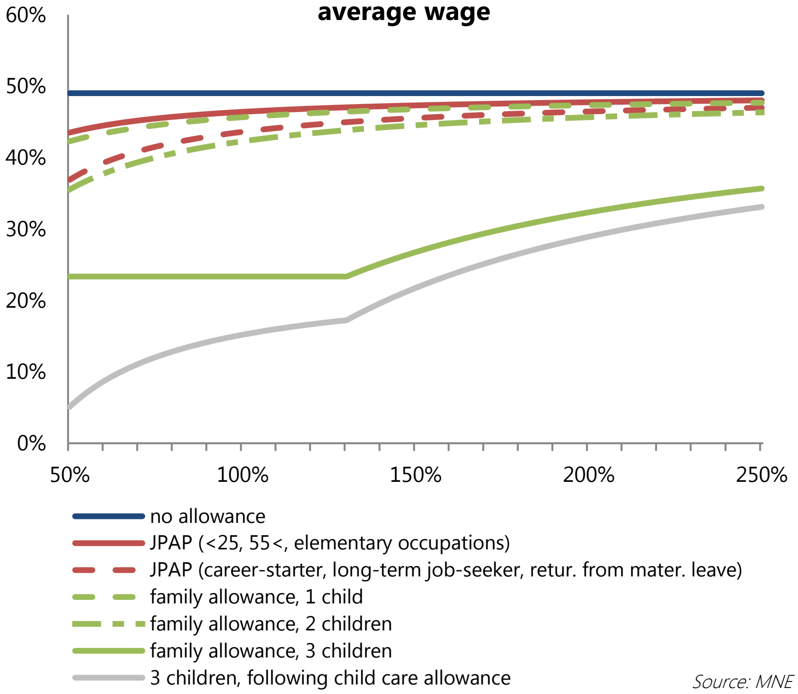
Chart 6.1: Number and rate of beneficiaries of the Job Protection Action Plan in the private sector, 2013



Source: MNE

As a result of the flat-rate tax, the marginal tax wedge fell below 50% in every income category, and to even significantly lower levels in certain groups owing to the family and targeted allowances. Moreover, the tax base was also broadened due to the elimination of certain allowances and the reduction of the difference between tax burden on fringe benefits and wage income.

Chart 6.2: Average tax wedge, 2014, in % of the average wage



Source: MNE

In addition, two new optional tax types (KATA, the lump-sum tax for self-employed, and KIVA, the small business tax) were also introduced in 2013 under the Job Protection Action Plan to assist small businesses. Enterprises have been opting for the new tax types gradually. In the years to come, the current expansion rate is expected to prevail for KATA, and the number of small businesses choosing KIVA is also expected to increase.

In accordance with the dual structure of the Hungarian corporate sector, the tax burden of SMEs, with typically smaller weight in the economy, but employing almost 2/3 of the workforce, dropped substantially when the upper limit of the 10% corporate tax rate bracket was raised from HUF 50 million to HUF 500 million in 2010.

As for the services sectors, in certain cases dominated by companies possessing significant power in domestic markets, the Government has made efforts to involve them more in the contributions to public burdens, thus the tax burden of the financial institutions and some other services sectors increased. Nevertheless, the Government abolished as of 1 January 2013 the special tax on the retail, energy and telecommunications sectors (introduced temporarily for 2010-2012 in view of the economic crisis) and insurance companies were taken out from the scope of the special tax on financial organisations. Concurrently, the income tax of energy providers was raised from 8% to 31%, the weight of consumption-turnover taxes increased and new consumption-turnover type taxes were introduced in order to help the fiscal consolidation process.

The new consumption-turnover type taxes replacing the sector-specific special taxes have a smaller distorting effect on economic growth, because instead of corporate profits, they are imposed on the services provided; furthermore, they are introduced on a wide tax base, at a low tax rate. Consequently, they hinder investment and potential economic growth to a lesser extent. Such tax types include the telecommunications tax and the tax on insurance premiums – replacing also the repealed fire protection contribution –, as well as the levy on financial transactions.

The weight of consumption-turnover type taxes was also increased by the rise of the standard VAT rate in 2012. To increase budgetary revenues and to enable a further reduction of taxes on labour, a VAT that is imposed on a wide tax base and providing for a relatively narrow range of benefits is still necessary.

The weight of taxes (mostly on consumption) promoting environmental protection/healthcare has increased in recent years. For example, the excise duty and environmental protection fees were raised; the public health product tax and accident tax have been introduced, and the company car tax and the car registration tax have been modified, taking into consideration the environmental aspects. In the coming years, regulations on excise duty will have to legislate its gradual increase until 2018 ensuring catching-up with the EU minimum rates according to the EU Directive on Tobacco Products. In regard of the most important environmental type tax, the excise tax on fuels, taxation may have to be reviewed following the amendment of the EU Directive on Energy Taxation.

The Government implemented several measures in the past years to combat the shadow economy, and it will continue to do so in the future as well. Apart from the expansion of the toolset of the tax authority, the measures will focus on fighting the concealment of revenues realised through inter-company sales or sales to final consumers; this is also expected to lead to the decline of other forms of fraud (profit and wage concealment).

The formation of the National Tax and Customs Administration (NAV) through organisational integration, the filtering mechanisms (e.g. tax registration procedure) assisting the national tax authority, the introduction of new tools and tighter sanctions on tax evasion have enabled the tax authority to address tax fraud effectively and quickly. The Government kept on enhancing the tools to combat the shadow economy in 2013. In the field of inter-enterprise sales, the tighter limit (HUF 1.5 million/month) imposed on cash transactions between businesses, as well as the introduction of the reverse charge VAT in some agricultural sectors highly affected by VAT fraud and the introduction of invoice-level VAT declaration for transactions with VAT content exceeding HUF 2 million will help repress the shadow economy.

To lower the rate of fraud related to retail sales, based on positive international examples, online supervision of cash registers by the Tax Authority (NAV) started in 2013 and will be completed in 2014; this will let NAV monitor the turnover of the cash registers on a real-time basis and detect fraud more efficiently.

7. INSTITUTIONAL FEATURES OF PUBLIC FINANCES

7.1. BUDGETARY FRAMEWORK

As of 01 January 2014, new components were added to the budgetary framework.

Council Directive 2011/85/EU on the requirements for budgetary frameworks of the Member States has been transposed into national law. The Directive is part of a legislative package, the so-called six-pack, on strengthening economic governance which aims at strengthening economic policy coordination in the Union. It offers the European Union the option to set minimum requirements for the budgetary frameworks of the Member States for the first time.

Pursuant to the effective regulation, the transparency and predictability of budgetary planning has strengthened and, in addition, new numerical fiscal rules have appeared. The medium-term approach to budgetary planning became more emphatic and transparency has been facilitated by the fact that the Government publishes the macroeconomic and budgetary forecasts used for planning and their methodology. The publication of the public accounting and of the fiscal statistics has also changed. All of these rules contribute to the setting and realisation of sustainable budget balances supporting the economy in the short, medium and long term, and they help reduce the general government debt ratio. Moreover, by applying this set of rules, the fiscal rules of the Union are also met.

The revamped rules of budgetary planning are contained in Act CXCV of 2011 on Public Finance and Government Decree No. 368/2011. (XII. 31.) on its execution.

The credibility of budgetary planning is enhanced by making the forecasts and their underlying calculations public and accessible. Enhanced transparency makes it possible for the economic actors to assess the forecast and hence it raises their confidence. Pursuant to the new rules, the minister responsible for public finances makes regular macroeconomic and budgetary forecasts two times a year for the given year and for the next three years. The forecasts present the differences relative to the latest forecasts of the European Commission, they explain the reasons of any major deviation, and they also comprise sensitivity analysis. The forecasts must be evaluated comprehensively on the bases of objective criteria once a year, and the methodology, procedure, timing and result of the evaluation must be published. The publication of the forecasts is linked to that of the medium-term and the annual budget.

The rules so far have been complemented with new numerical fiscal rules focusing on the general government balance. The existing and the new rules together ensure the fulfilment of the EU requirements and the provisions of the Fundamental Law concerning the reduction of public debt. The new, numerical fiscal rules have two components: On the one hand, the general government deficit must not exceed 3% of the gross domestic product and, on the other hand, the structural balance must not exceed the medium-term objective (MTO) defined under the Convergence Programme. The Act introduces the concept of structural balance, i.e. the general government budget balance net of the cyclical component and of one-off and other temporary measures.

The rules are accompanied by an escape clause. Accordingly, the debt ratio does not have to be reduced and the budget deficit may also exceed 3% of the GDP in any year when the real value of the GDP decreases. This escape clause gives the budget the possibility, under adverse economic circumstances, to offset the negative effects of an economic downturn by increasing the deficit. The escape clause does not apply to the medium-term structural balance rule. As a matter of fact, this is what prevents, despite exemption from the other rules, the indefinite rise of the budget deficit and the debt ratio, threatening long term sustainability.

Numerical fiscal rules

Rule	Legislative act	Escape clause	Entitlements of the Fiscal Council
The debt ratio must decrease year on year.	Fundamental Law	yes	right to veto, Parliament cannot pass the budget bill unless it is met
The nominal public debt defined under the Stability Act may increase at inflation–real GPP/2*	Stability Act	none**	may express its opinion
The budget balance must be set so that the general government debt ratio defined under the Stability Act should diminish	Act on Public Finances	yes	may express its opinion
The budget balance must be consistent with the achievement of the medium-term budgetary objective	Act on Public Finances	none	may express its opinion
The deficit shall not exceed 3% of the GDP	Act on Public Finances	yes	may express its opinion

*Effective as of 2015; the deficit shall remain below 3% until then.

**If the real value of the GDP decreases, the debt ratio will automatically increase, so the escape clause is not needed.

The application of the budgetary rule is associated with rules ensuring transparency that facilitate the monitoring of the execution and application of the rules. The calculation of the structural deficit of the general government entails many uncertainties. In order to reduce these uncertainties, the calculation methodology of the balance resulting from the Fundamental Law and the law of the European Union and the parameters needed for it must be published.

7.2. Public finance statistical governance

In Hungary, public sector related statistics are prepared by the Hungarian Central Statistical Office (CSO) and by the Magyar Nemzeti Bank (MNB). According to the current division of tasks, the CSO is responsible for non-financial accounts and the MNB for financial accounts. Concerning the provision of data in the context of the Excessive Deficit Procedure (EDP Notification), the above division of work prevails in compiling the actual figures up to the period before the reported year, whereas the calculation of the balance and the deficit envisaged by the Government for the reported year is the task of the Ministry for National Economy. A statistics working committee consisting of delegates of the CSO, the MNB and the Ministry for National Economy operates at the level of executives and experts; data flow, division of work and procedural questions of methodological treatment are set out in a cooperation agreement. Key sources of the statistics of the government sector is the general government information system, the annual and interim reports of budgetary entities, supplemented by statistical data collected from corporations and non-profit entities classified within the general government sector, as well as bank and securities data for the entire government sector. The EDP Notification Report is published on the CSO website when it sends the data to Eurostat. After the three-week reconciliation period with Eurostat, the CSO also publishes, together and simultaneously with Eurostat's press release, the approved Notification tables. Moreover, it publishes the description of the methodology related to the compilation, regularly updated by the Hungarian statistical authorities ("EDP Inventory"). In accordance with the established 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. It publishes the EDP Notification report on its website following approval, simultaneously with Eurostat.

As from 2008, the CSO discloses quarterly data of the general government sector in its publications on national account statistics.

On the occasion of its last visit (in July 2012), Eurostat reviewed with the domestic statistical authorities the topics also examined in other countries: it examined progress regarding its findings expressed upon its previous visit, the institutional background of data provision related to the EDP, the cooperation of peer authorities, the data sources, the applied methodology and procedures, and the disclosure policy. Consultations on the methodological issues took place by general topics, the most important issues being the following: classification of new tax types and method for applying them on accrual basis, accounting of the Hungarian Development Bank's equity increase, public transactions related to Malév and accounting of Diákhitel II. Eurostat welcomed the work done so far in connection with the compilation of the financial accounts from direct data sources and the system developed for PPP project monitoring. On the occasion of its visit, it proposed to rework the cooperation agreement, to update slightly the EDP Inventory, to use the budgetary data more extensively in the financial accounts to reduce/eliminate statistical discrepancy, to understand the content of the other financing items more thoroughly and to renew the methodology applied for accounting the EU transfers in ESA'95 terms.

With a view to debt reduction, as of 2012 the Government controls debt generation by local governments and non-budgetary entities through a monitoring and authorising system.

The general government accounting system has been modified as of 2014. Budgetary appropriations, their fulfilment and the relevant commitments are recorded in the entire general government sector in a standardised, so-called budgetary accounting register, whereas in the so-called financial accounting, accrual-based accounting according to the GAAP standards takes place. Besides the relevant regulation, the change-over to the new accounting system is supported by methodological guides, aids, accounting examples and reconciliation tables facilitating the change-over to the concepts of the new system. The data source of the monthly and quarterly publications related to the general government sector required under the EU directives on the budgetary frameworks is provided by the standardised economic classification regime according to the budgetary accounting system. Concerning non-public entities belonging to the general government sector, state-owned companies and extra-budgetary funds report on the development of their business management in the form of monthly data supply.

TABLES

Table 1a. Macroeconomic prospects

	ESA code	2013 HUF bn	2013	2014	2015	2016	2017
			percentage change				
1. Real GDP (at constant prices)	B1*g	28,360.2	1.1	2.3	2.5	2.1	3.1
2. Nominal GDP	B1*g	29,114.4	3.8	4.8	5.3	5.1	6.0
Components of real GDP							
3. Private consumption expenditure	P.3	14,932.8	0.2	1.8	2.0	2.0	2.1
4. Government consumption expenditure*	P.3	6,267.1	1.3	1.5	-0.6	-1.3	1.2
5. Gross fixed capital formation	P.51	5,166.4	5.9	6.2	4.1	-0.9	8.5
6. Changes in inventories and net acquisition of valuables (per cent of GDP)	P.52+ P.53	-171.0	-0.7	0.0	0.0	0.0	0.0
7. Exports of goods and services	P.6	27,950.7	5.3	5.8	6.8	6.7	6.6
8. Imports of goods and services	P.7	25,785.9	5.3	6.2	6.5	5.8	7.2
Contribution to real GDP growth							
9. Final domestic demand		26,366.3	1.4	2.4	1.7	0.6	2.9
10. Changes in inventories and net acquisition of valuables	P.52+ P.53	-171.0	-0.7	0.0	0.0	0.0	0.0
11. External balance of goods and services	B.11	2,164.9	0.4	0.0	0.9	1.5	0.1

*/: Including government and NPISHs as well

Table 1b. Price developments

	2013	2014	2015	2016	2017
	percentage change				
1. GDP deflator	2.7	2.4	2.7	2.9	2.9
2. Private consumption deflator	1.6	0.8	2.9	3.0	2.9
3. HICP	1.7	0.8	2.9	3.0	3.0
4. Public consumption deflator	3.5	3.7	1.8	1.9	2.4
5. Investment deflator	2.2	1.8	1.9	2.0	2.2
6. Export price deflator (goods and services)	0.0	2.6	1.5	1.8	2.0
7. Import price deflator (goods and services)	-0.6	2.1	1.4	1.6	1.9

Table 1c. Labour market developments

	ESA code	2013 level	2013	2014	2015	2016	2017
			percentage change				
1. Employment, persons ('000;15-64)		3,904.5	1.6	1.2	0.9	0.9	0.9
2. Unemployment rate (%)		-	10.2	9.1	8.8	8.5	8.2
3. Labour productivity, persons		-	-0.4	1.2	1.7	1.2	2.1
4. Compensation of employees (HUF bn)	D.1	13,362.0	4.4	4.8	4.7	5.0	5.1
5. Compensation per employee (HUF million)		5.0	3.5	3.6	3.8	4.0	4.2

Table 1d. Sectoral balances

	ESA code	2013	2014	2015	2016	2017
		per cent of GDP				
1. Net lending/borrowing vis-à-vis the rest of the world	B9.	6.5	7.2	6.0	6.1	7.4
of which:						
- Balance of goods and services		8.0	8.3	8.9	10.8	10.7
- Balance of primary incomes and transfers		-5.0	-4.7	-5.1	-5.9	-5.4
- Capital account		3.5	3.7	2.3	1.2	2.1
2. Net lending/borrowing of the private sector including statistical discrepancy	B9.	8.7	10.1	8.8	8.6	9.3
3. Net lending/borrowing of general government	EDP B9.	-2.2	-2.9	-2.8	-2.5	-1.9

Table 2a. General government budgetary prospects

	ESA code	2013 HUF bn	2013	2014	2015*	2016	2017
			per cent of GDP				
Net lending (EDP B.9.) by sub-sector							
1. General government	S.13	-633.6	-2.2	-2.9	-2.8	-2.5	-1.9
2. Central government	S.1311	-1,540.6	-5.3	-4.8	-3.2	-2.8	-2.1
3. State government	S.1312	-	-	-	-	-	-
4. Local government	S.1313	766.4	2.6	1.5	0.0	0.0	0.0
5. Social security funds	S.1314	140.6	0.5	0.3	0.4	0.3	0.2
General government (S.13)							
6. Total revenue	TR	13,859.6	47.6	47.2	46.1	43.6	42.9
7. Total expenditure	TE[1]	14,493.2	49.8	50.1	48.9	46.1	44.8
8. Net lending/borrowing	EDP B.9	-633.6	-2.2	-2.9	-2.8	-2.5	-1.9
9. Interest expenditure	EDP D.41	1,233.6	4.2	3.7	3.6	3.6	3.6
10. Primary balance		600.0	2.1	0.8	0.8	1.1	1.8
11. One-off and other temporary measures[2]			0.2	0.4	0.0	0.0	0.0
Selected components of revenues							
12. Total taxes (12=12a+12b+12c)		7,479.9	25.7	25.8	25.2	24.8	24.4
12a. Taxes on production and imports	D.2	5,342.2	18.3	18.4	18.1	17.7	17.4
12b. Current taxes on income. wealth, etc.	D.5	1,996.9	6.9	6.9	6.7	6.7	6.7
12c. Capital taxes	D.91	140.8	0.5	0.5	0.4	0.4	0.4
13. Social contributions	D.61	3,907.1	13.4	13.4	13.2	13.0	12.8
14. Property income	D.4	212.4	0.7	0.6	0.5	0.5	0.5
15. Other		2,260.3	7.8	7.4	7.2	5.3	5.3
16.=6. Total revenue	TR	13,859.6	47.6	47.2	46.1	43.6	42.9
Tax burden[3] (D.2+D.5+D.61+D.91-D.995)		11,456.2	39.3	39.4	38.6	38.0	37.4
Selected components of expenditure							
17. Compensation of employees + intermediate consumption	D.1+P.2	5,287.4	18.2	18.8	18.0	17.2	16.9
17.a. Compensation of employees	D.1	2,985.8	10.3	10.4	10.0	9.7	9.4
17.b. Intermediate consumption	P.2	2,301.6	7.9	8.4	8.1	7.5	7.5
18. Social payments (18=18.a+18.b)		5,085.8	17.5	17.0	16.4	16.1	15.6
of which: Unemployment benefits[4]		50.8	0.2	0.2	0.2	0.2	0.2
18.a. Social transfers in kind supplied via market producers	D.6311, D.63121, D.63131	635.7	2.2	2.2	2.1	2.0	1.9
18.b. Social transfers other than in kind	D.62	4,450.1	15.3	14.8	14.3	14.1	13.7
19.=9. Interest expenditure	EDP D.41	1233.6	4.2	3.7	3.6	3.6	3.6
20. Subsidies	D.3	425.9	1.5	1.4	1.3	1.3	1.2
21. Gross fixed capital formation	P.51	1,139.6	3.9	4.5	3.9	2.8	2.8
22. Capital transfers	D.9	421.6	1.4	1.4	1.8	1.5	1.3
23. Other		899.3	3.1	3.3	3.9	3.6	3.3
24.=7. Total expenditure	TE[1]	14,493.2	49.8	50.1	48.9	46.1	44.8

*: Assuming that there will be no one-off revenues from sales of state property.
Due to rounding the sum data could differ from the sum of the detailed data.
[1]: Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.
[2]: A plus sign means deficit-reducing one-off measures.
[3]: Including revenues collected by the EU
[4]: Cash benefits of National Employment Fund

Table 2b. No-policy change projections

		2013	2013	2014	2015	2016	2017
		HUF bn	per cent of GDP				
1. Total revenue at unchanged policies		13,859.6	47.6	47.2	46.1	43.6	42.9

The table contains revenue projections based on measures till 30 April 2014.

Table 2c. Amounts to be excluded from the expenditure benchmark

		2013	2013	2014	2015	2016	2017
		HUF bn	per cent of GDP				
1. Expenditure on EU programmes fully matched by EU funds revenue		923.2	3.2	3.1	3.0	1.2	1.4
2. Cyclical unemployment benefit expenditure							
3. Effects of discretionary revenue measures		286.6	1.0	0.3	0.0	0.0	0.0
4. Revenue increases mandated by law							

Table 3. General government debt developments

	ESA code	2013	2014	2015	2016	2017
		per cent of GDP				
1. Gross debt		79.2	79.1	78.9	77.5	74.7
2. Change in gross debt ratio		-0.6	-0.1	-0.2	-1.4	-2.8
Contribution to changes in gross debt						
3. Primary balance		-2.1	-0.8	-0.8	-1.1	-1.8
4. Interest expenditure	EDP D.41	4.2	3.7	3.6	3.6	3.6
5. Stock-flow adjustment		0.1	0.6	1.0	-0.1	-0.3
Implicit interest rate on debt (%)		5.4	4.8	4.7	4.7	4.9

Table 4. Cyclical developments

	ESA code	2013	2014	2015	2016	2017
		per cent of GDP				
1. Real GDP growth (%. at constant prices)		1.1	2.3	2.5	2.1	3.1
2. Net lending of general government	EDP B.9	-2.2	-2.9	-2.8	-2.5	-1.9
3. Interest expenditure	EDP D.41	4.2	3.7	3.6	3.6	3.6
4. One-off and other temporary measures[1]		0.2	0.4	0.0 (0.4)	0.0	0.0
5. Potential GDP (%)		0.9	1.2	1.3	1.5	1.9
contributions: - labour		0.6	0.8	0.7	0.7	0.7
- capital		0.2	0.4	0.4	0.4	0.6
- total factor productivity (TFP)		0.1	0.1	0.2	0.4	0.6
6. Output gap		-4.6	-3.6	-2.5	-2.0	-0.9
7. Cyclical budgetary component		-2.1	-1.7	-1.2	-1.0	-0.4
8. Cyclically-adjusted balance (2-7)		0.0	-1.2	-1.6	-1.6	-1.6
9. Cyclically-adjusted primary balance (8+3)		4.2	2.5	2.0	2.0	2.1
10. Structural balance (8-4)		-0.2	-1.6	-1.6 (-2.0)	-1.6	-1.6

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

Table 5. Divergence from previous update

	ESA code	2013	2014	2015	2016	2017
Real GDP growth (%)						
1. April 2013 Convergence Programme		0.7	1.9	2.3	2.5	-
2. April 2014 Convergence Programme		1.1	2.3	2.5	2.1	3.1
3. Difference		0.4	0.4	0.2	-0.4	-
General government net lending (per cent of GDP)						
1. April 2013 Convergence Programme	EDP B.9	-2.7	-2.7	-2.2	-1.3	-
2. April 2014 Convergence Programme	EDP B.9	-2.2	-2.9	-2.8	-2.5	-1.9
3. Difference		0.5	-0.2	-0.6	-1.2	-
General government gross debt (per cent of GDP)						
1. April 2013 Convergence Programme		78.1	77.2	76.1	73.4	-
2. April 2014 Convergence Programme		79.2	79.1	78.9	77.5	74.7
3. Difference		1.1	1.9	2.8	4.1	-

Table 6. Long-term sustainability of public finances[1]

	2007	2010	2020	2030	2040	2050	2060
	per cent of GDP						
Pension expenditure		11.9	10.5	9.3	9.8	11.2	12.4
Old-age and early pensions		10.1	9.3	8.1	8.6	9.9	11.1
Other pensions (disability, survivors)		1.8	1.2	1.1	1.0	1.0	1.0
Health care, education and other age-related expenditure		10.4	10.4	10.4	10.7	11.2	11.6
Health care expenditures		4.9	5.1	5.4	5.7	6.0	6.1
Long-term care expenditures		0.8	0.9	1.0	1.1	1.3	1.4
Education expenditures		4.3	3.9	3.5	3.5	3.7	3.8
Other age-related expenditures		0.4	0.4	0.3	0.3	0.3	0.3
Pension contribution revenue		8.3	10.2	10.1	10.1	10.0	10.0
Assumptions							
Labour productivity growth		1.3	0.9	2.1	2.1	1.8	1.5
Real GDP growth		1.3	1.5	1.9	1.2	0.9	0.8
Participation rate, males (20-64)		74.7	79.5	80.2	79.0	79.1	79.2
Participation rate, females (20-64)		61.4	68.6	70.0	68.8	68.9	69.1
Total participation rate (20-64)		68.0	74.0	75.1	73.9	74.0	74.2
Unemployment rate	7.4	11.1	11.2	7.7	7.3	7.2	7.2
Population aged 65 + over / total population	15.9	16.7	20.0	21.8	25.1	29.4	32.2

[1]: Projections adopted by the EPC (Economic Policy Committee) in October 2012

Table 6a. Contingent liabilities

per cent of GDP	2013
Public guarantees	8.2

Table 7. Basic assumptions

	2013	2014	2015	2016	2017
Hungary: Short-term interest rate (annual average)	4.0	3.1	3.2	3.3	3.4
Hungary: Long-term interest rate (annual average)	6.0	6.1	6.2	6.0	5.5
HUF/EUR	296.9	307.9	307.9	307.9	307.9
World excluding EU, GDP growth	3.9	4.2	4.5	4.6	4.6
EU28 GDP growth	0.2	1.6	1.8	1.9	1.9
Growth of relevant foreign markets	1.3	4.7	6.1	6.1	6.1
World import volumes, excluding EU	3.7	4.2	5.4	5.7	5.6
Oil prices (Brent, USD/barrel)	108.7	108.0	108.0	108.0	108.0