HUNGARY: IMF Staff Concluding Statement of the 2017 Article IV Mission

March 9, 2017

Hungary has succeeded in achieving several consecutive years of high economic growth and debt reduction. Despite robust private sector consumption, GDP growth temporarily slowed in 2016 to an estimated 2 percent, mainly as a result of a decline in investment. This was mostly due to subdued absorption of EU funds, related to the beginning of a new program period. Growth is projected to reach about 3 percent this year, driven by a recovery in EU funds' absorption (and thus investment) and continued strong consumption as wage increases boost disposable income. Employment is projected to further grow and the economy may begin to operate at full capacity in the course of 2017. With higher wages and commodity prices, inflation is likely to gradually pick up, reaching its 3 percent target by early 2018.

The medium-term outlook remains favorable but is subject to risks. A weakening in the still-fragile euro area recovery or further slowdown in global trade on the back of higher trade barriers could dampen exports. Normalization of monetary policy in the U.S. and the euro area could lead to an increase in financing costs and volatility of capital flows. Domestically, stable macroeconomic policies are necessary to maintain investor confidence. Rising demand and the expansion of the housing scheme could inflate asset prices. On the other hand, these risks would be mitigated by the improvement in the current account and international investment position over the past years and by the enhanced market sentiment towards Hungary. Policies that set public debt firmly on a downward path and accelerate structural reforms would further boost confidence and resilience of the economy, while supporting both short-term and potential growth.

Hungary's economic strength provides an opportunity to advance growth-friendly fiscal consolidation. Such consolidation would focus on enhancing the quality of expenditure and composition of revenue, while gradually improving the cyclically-adjusted fiscal balance. Such a strategy would enable monetary policy to stay accommodative for a longer time. It would thereby foster growth, while building fiscal buffers against downside surprises to global activity. These elements and other measures to increase competitiveness would help realize the authorities' dual objective of achieving sustainable growth and boosting the economy's medium term potential.

In support of the above strategy, fiscal policy should continue to aim at achieving a marked reduction in public debt over the medium term. Preliminary data indicate that the authorities have likely over-performed their 2016 target for the general government deficit. The slowdown in EU funds disbursement coincided with an impressive improvement in the collection of social security contributions and corporate income tax, driven by the increase in wage earnings and exceptional tax collection from corporates. Interest and EU funds-related outlays declined, but other expenditures increased, including on the wage bill. Staff preliminarily estimates that the general government deficit has declined to about 1.8 percent of GDP in 2016. However, the above expenditure increases have likely contributed to a worsening of the cyclically-adjusted fiscal balance.

The 2017 budget target of 2.4 percent of GDP would imply a further decline in the cyclical-adjusted structural fiscal balance. In view of current information, staff projects the overall deficit at about 2.6 percent of GDP. This is slightly larger than the budget target on account of staff's more conservative estimate for the revenue impact of the tax package and for GDP growth. However, in times when the economy is expected to improve significantly and operate at or even beyond full capacity, it is preferable to improve the fiscal balance. The higher deficit relative to 2016 will provide a boost to the economy. However, it will also mean that monetary policy may have to normalize at a faster pace, and the Hungarian economy would stay more exposed to new shocks because of the still-limited room for fiscal policy maneuver. Staff therefore recommends the adoption of additional fiscal measures that would yield annual improvements in the cyclically-adjusted fiscal balance consistent with a reduction of public debt to about 60 percent of GDP over the projection period. For 2017, this would imply an overall deficit of 2.2 percent of GDP, which is slightly below the budget target, and for 2018 and beyond appreciable annual reductions in the fiscal deficit.

It is critical to ensure that the fiscal reform be growth friendly. It should, therefore, aim at rationalizing current expenditures and improving the tax system. For example, implementing administrative reforms would help gradually reduce the elevated wage bill, while allowing a competitive scale of public salaries and improving performance and the provision of public services. This would also help increase labor supply to ease the severe shortage in various segments of the private sector. In addition, reducing and better targeting generalized subsidies would help decrease their cost while protecting the poor more efficiently. It would also be beneficial to further enhance revenue mobilization by reducing exemptions and continuing to build on the commendable success in improving tax administration. Staff welcomes the reduction in the tax wedge and in some distortive sectoral taxes. Staff encourages the authorities to continue reducing such taxes and streamlining multiple VAT rates and exemptions for fuel and tobacco excises.

The Magyar Nemzeti Bank (the central bank of Hungary - MNB) has appropriately continued to ease monetary policy in 2016, as inflation was subdued during most of the year and growth was less than initially projected. The MNB continued to adjust its unconventional monetary policy instruments. For instance, staff welcomes the decision to let the Funding for Growth Scheme expire by end-March 2017. The impact this may have on some SMEs could be mitigated partially by the existing Market-Based Lending Scheme of the MNB and EU-funded schemes. Deleveraging seems to be gradually coming to an end, and new lending, albeit still tepid, is beginning to pick up. The macroprudential rules introduced and strengthened in recent years have been a prudent pre-emptive measure to improve lending practices. In view of these factors, as well as the increased global risks, the monetary stance can remain accommodative in the near term. However, it will be important to monitor the situation and be ready to remove some of the stimulus as underlying inflationary pressure picks up.

On average, banks are liquid and well capitalized. In 2016, bank profitability improved significantly. A large part of the substantial increase in profits was, however, due to revoked provisions and one-off factors. Staff welcomes the MNB's intention to continue to enhance supervisory practices and guidelines, including in view of the large write-back of provisions and rapid increase in real estate prices. The substantial reduction of the bank levy has also helped after-tax revenue and likely contributed to the increased willingness to lend. Banks continued to deleverage and increase their placements in government securities.

Advancing structural reforms would boost productivity, thereby supporting growth and broadening its base to the benefits of all sectors and segments of the population. Ensuring effective utilization of EU funds, including by further enhancing the procurement process is key in this regard. In addition, it would be important to build on past efforts to continue to upgrade vocational training and enhance the public works scheme to improve the skills and productivity of participants and gradually move them to the primary labor market. Furthermore, boosting activity rates, particularly for women including through affordable childcare, would also help increase employment and output. Finally, it would be essential to enhance the business environment by addressing perceived corruption through improved transparency, enhancing policy predictability, continuing to improve the ease of paying taxes, and streamlining regulations.

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A staff team led by Khaled Sakr visited Budapest during February 23 – March 8 2017. The mission met with H.E. Mihály Varga Minister for National Economy, the Honorable György Matolcsy Governor of the National Bank, other senior officials, and representatives of the private sector and think tanks. Staff is grateful to the authorities for their excellent collaboration and kind hospitality.