CONCLUDING STATEMENT

Hungary: Staff Concluding Statement of the 2021 Article IV Mission

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Hungary's economy entered the COVID-19 pandemic on a strong footing and the authorities responded swiftly and strongly to the crisis it triggered. While the lockdowns have been weighing heavily on activity, the fast vaccination pace may allow for an earlier reopening than in most other EU countries. Continued fiscal support, well targeted, will be needed as long as the recovery is not well entrenched, while any revenue windfall from a faster-than-expected rebound should be saved. Monetary policy should stay tuned to the inflationary pressures, which could increase as the recovery develops. Over the medium term, improvements in competitiveness are now more necessary than before the crisis, as the economy needs to make up the lost ground, face potential structural transformation, and address demographic and climate challenges.

The economy suffered a deep shock in 2020 but is expected to rebound this year. After an output contraction of 5 percent, significant policy support, rapid vaccinations, trade recovery, and the disbursement of the EU funds are expected to lift activity. Staff expects growth to exceed 4 percent in 2021 and accelerate further in 2022. Yet, the uncertainty is significant. Downward risks remain important, as the recovery depends on the race between the virus and vaccination, domestically and globally.

The authorities' policy response was large and timely. They sought to contain the pandemic and support the economy through a loan moratorium, tax holidays, increase and reprioritization of spending, and EU-financed programs. Fiscal spending focused on purchases of medical supplies, bonuses and wage increases to healthcare staff, wage support for reduced working hours, investment support, and direct transfers to affected sectors. As a result, the fiscal deficit increased to 8.1 percent of GDP and public debt, which had been on a declining path for a decade, rose above 80 percent of GDP. The MNB also swiftly reacted to market pressures. It provided ample liquidity through a variety of policy tools, including FX liquidity swaps, enhanced lending facility, the expansion of its asset purchase programs (APPs), which includes government, corporate and mortgage bonds, and the adjustment of the policy rate. Like other EU banking regulators, the MNB allowed temporary easing and deferment of some capital requirements and took other micro and macro prudential measures.

Fiscal policy needs to balance providing sufficient support for the recovery in the short run and gradually rebuilding room for fiscal policy maneuver in the medium run. If the recovery turns out faster than expected, buffers should be rebuilt more rapidly by saving the tax windfall from higher growth. Conversely, a further setback to the recovery may warrant additional support for households and firms. Accordingly, fiscal targets and budget composition beyond this year will need to be regularly reassessed and flexibly adjusted. Given high gross financing needs, it would also be important to continue lengthening public debt maturity, as started in 2020. Considering the magnitude of the fiscal response, it will be even more important ensure the transparency of spending. Information on related procurement contracts, including beneficial ownerships, should be publicly available.

- *The continued, significant economic support embedded in the revised 2021 budget appears justified considering the severity of the third wave of the pandemic*. Beyond the immediate emergency response, fiscal policy will need to focus on minimizing scarring from the crisis, including through targeted support to the corporate sector, especially small and medium-sized enterprises (SMEs), and supporting the transition to a more resilient economy, as discussed below. Fiscal measures that could accelerate recovery and reallocation in the short run include temporary incentives to hiring or investment (e.g., temporary investment tax credits) or favorable financing conditions (including equity funding, approved under the EU guidelines for state support).

- *Some fiscal space can be gradually created by implementing IMF's long-standing recommendations to enhance revenue and lower current spending*. Regarding spending, consideration could be given to further reducing the public wage bill as a share of GDP, by rationalizing employment in the public sector. With respect to revenues, measures include continuing to improve tax collection, reducing exemptions and preferential regimes, and broadening the tax base. In this regard, the reintroduction of a temporary low preferential VAT rate on new home purchases may not have been needed given the strength of this market and other incentives to increase supply. Also, increasing labor market participation of the youth under 25 could be better addressed through active labor market policies, training, and hiring subsidies rather than the planned blanket income tax exemption.

The monetary policy response to the crisis was appropriate and no significant policy action appears necessary in the short term. The MNB successfully kept inflation broadly within its 2–4 percent tolerance band. Some overshooting of the inflation band due to temporary shocks—as expected in the near term—should be acceptable. Looking ahead, there are upward and downward risks to inflation that monetary policy will need to consider.

Thus far, the adaption of monetary operations has effectively provided needed liquidity and addressed market dysfunction. As conditions normalize, the MNB should continue to review the effectiveness of its unconventional tools, including the size of its still-growing APP.

Prudential policies should continue to focus on mitigating immediate vulnerabilities. As the recovery takes hold, withdrawal of support measures will need to be gradual. Aggregate buffers of the banking system are comfortable. But since they are somewhat unevenly distributed, continued supervisory vigilance is warranted. The anti-money laundering framework should continue to follow the latest international standards; thus, the recent revisions of the legislative framework, creation of databases on beneficial owners and bank accounts, are welcome.

The structural reform agenda should support the recovery and facilitate the transformation toward a more resilient economy post-pandemic. Over the medium term, accelerated shift to e-commerce, teleworking, the likely reshaping of global value chains and, possibly, less travel will likely require economic transformation and labor reskilling. Managing these changes successfully, together with other measures to green the economy, could greatly limit output losses relative to pre-pandemic medium-term projections.

- *The authorities' efforts to strengthen Hungary's competitiveness are welcome*. Over the past decades, the authorities' strategy has focused on attracting investment from large multinationals, especially in the automotive and electronics industry. Recent priorities have appropriately aimed at enhancing SMEs' productivity, improving the business environment and procurement system, increasing labor participation, and fostering digitalization and greater government services' efficiency.

- *The crisis also underscored the need to support an efficient reallocation of resources*. In that respect, strengthening the insolvency and debt recovery frameworks is important. The recently proposed revisions to the bankruptcy law aim to support more orderly corporate restructuring. Furthermore, labor reallocation across sectors need to be supported by a strengthened social safety net, including unemployment benefits, and higher investment in human capital, including life-long (re)training, with spending on these categories historically below the EU average.

- *Greening the economy, to which the authorities are strongly committed, is necessary for the sustainability of growth and should be supported by higher carbon pricing*. Hungary aims to reach climate neutrality by 2050, relying on renewable and nuclear energy production, recycling, and energy conservation. Higher carbon pricing would foster energy efficiency and innovation and bring revenue that could help finance green investment and compensate the most vulnerable users for higher energy costs. Given the evolving EU framework, it may be preferable at this stage to incentivize green investment through transparent fiscal subsidies, applying equally to self- and credit-financed investment, rather than through bank capital relief in the MNB's prudential framework.

The EU Recovery and Resilience Funds can play a key role in supporting the recovery and economic transformation. The timely implementation of the above reform package, with a focus on leveling the playing field for SMEs and improving governance and transparency, will be crucial for a strong recovery and to set the economy on a more sustainable path. A judicious, transparent use of EU funds, supported by a strong recovery and resilience plan, could greatly help progress on all these fronts.

An IMF team led by Jean-François Dauphin conducted virtual meetings during April 20-30, 2021. The mission met with State Secretaries Banai and Gion, Deputy MNB Governors Kandrács, Patai and Virág, various other government officials, and representatives from banks, trade chambers, unions, and academia. The mission thanks its counterparts for the close collaboration and the candid and insightful discussions.