HUNGARY

Highlights

- **Recovering investment is boosting growth amid strong private consumption.** Following a slow-down of GDP growth in 2016, growth is accelerating again in 2017, underpinned by rising investment and private consumption and a resumption of positive credit growth to the private sector.
- **Measures to enhance competitiveness are being introduced.** Among other things, in November 2016, the government and the trade unions reached a long-term agreement on significant changes in taxation. Further, a Competitiveness Council was established in March 2017, which has issued recommendations for improvements in areas such as construction, utility services, tax compliance and ease of doing business.
- **Cooperation with China has strengthened.** Hungary joined the Asian Infrastructure Investment Bank in June 2017. The country is also becoming an important partner in China's Belt and Road Initiative.

Key priorities for 2018

- **Addressing labour shortages will be critical for higher productivity.** Further measures to improve labour skills, such as through job training programmes, are necessary, and efforts should continue to support the transition of workers from public work schemes to the primary labour market.
- **Banking sector recovery should be sustained.** Following some positive regulatory and tax environment changes in 2016, including the reduction of the bank levy, the banking sector returned to profitability last year. Efforts to clean up the banks' loan portfolios should be continued, and this is expected to be further supported by the recovering local real estate market and strong economic growth.
- **Market-friendly financing instruments should be further promoted.** As the European Union (EU) funds available after 2020 may decline, a wider usage of repayable instruments would allow for their recirculation afterwards, in contrast to pure grant financing.

Main macroeconomic indicators %

	2013	2014	2015	2016	2017 proj.
GDP growth	2.1	4.0	3.1	2.2	3.8
Inflation (average)	1.7	0.0	0.1	0.4	2.6
Government balance/GDP	-2.6	-2.7	-2.0	-1.9	-2.3
Current account balance/GDP	3.8	1.5	3.4	6.1	4.2
Net FDI/GDP [neg. sign = inflows]	-1.1	-2.8	-1.0	-1.7	-1.8
External debt/GDP	118.2	117.7	109.2	97.2	n.a.
Gross reserves/GDP	34.5	30.2	27.2	20.8	n.a.
Credit to private sector/GDP	69.5	68.8	70.1	72.1	n.a.

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Macroeconomic performance

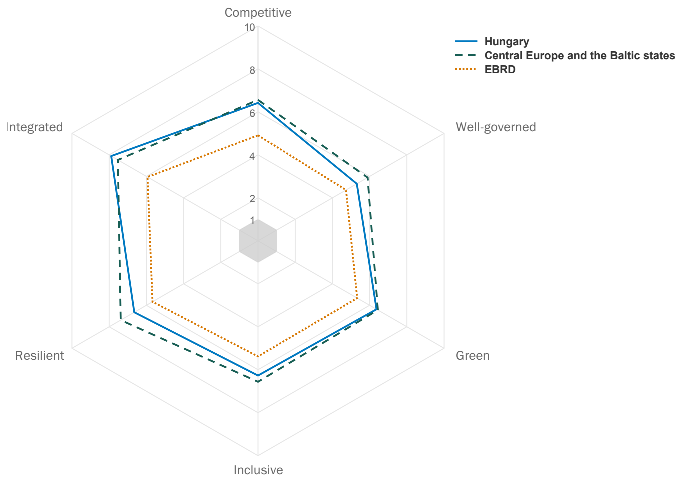
Robust private consumption has supported recent growth. GDP growth slowed to 2.2 per cent in 2016 as investment decreased by 10.6 per cent, mostly explained by the low utilisation of EU funds. In contrast, private consumption remained strong, underpinned by rising employment and wages. Household disposable incomes were driven by rising real wages and falling unemployment. In the first half of 2017, GDP growth accelerated to 3.6 per cent year-on-year, driven by a solid rebound in investment and robust private consumption. Investment is up by 24.1 per cent year-on-year in the first half of 2017, backed by accelerated EU fund transfers as well as a return to positive credit growth (after seven years of negative credit growth) to the private sector.

Labour market shortages started weighing on growth. The unemployment rate dropped to its lowest rate since transition began: 4.4 per cent, in December 2016, and has decreased slightly further during the first half of 2017. As the labour market is tightening, employment growth has slowed and companies have started experiencing shortages of qualified labour. As a result, wage pressures are mounting, increasing unit labour costs and reducing Hungary's international competitiveness. Compared with the other EU new member states, Hungary has experienced the lowest cumulated productivity growth per person, of less than 1.0 per cent, since 2010. At the same time, nominal unit labour costs have gone up by almost 15.0 per cent until 2016, substantially above the regional average of 10.5 per cent.

High revenues and weak public investment have kept the fiscal deficit at a low level. The fiscal deficit in 2016 saw a slight improvement to 1.9 per cent of GDP relative to the previous year. Last year's budget benefited substantially from some temporary factors such as the improved tax collection and the accumulated savings from unrealised EU co-financed investments. The 2017 fiscal deficit, however, is expected to widen somewhat. According to the European Commission's (EC's) autumn estimates, the public debt is estimated to fall from 73.9 per cent in 2016 to 72.6 per cent of GDP in 2017.

Investment and consumption are expected to drive robust GDP growth. Accelerated EU funds absorption and recovering credit to the private sector are set to support growth over the short term. The expected increases in wages, driven by agreements with the state-owned companies and car manufacturers; and a higher minimum wage and social security contribution cuts, will further support strong consumption, despite rising inflation. On balance, GDP growth is expected to accelerate to 3.8 this year and 3.4 in 2018. Weaker-than-anticipated private sector investment and sluggish recovery of the eurozone are key risks to this scenario.

Assessment of transition qualities (1-10)



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Major structural reform developments

The government is taking measures to improve competitiveness. In May 2017, the Competitiveness Council, which was established in March 2017, submitted to the parliament the first package of measures aimed at improving Hungary's competitiveness. The proposed measures target improvements in areas such as construction, utility services, tax compliance and ease of doing business. Another package is expected to be ready by the end of 2017 and will be related to education, employment and digitalisation. These new policy measures follow a tax package, adopted by the parliament in November 2016, which targeted excessive "red tape", higher small and medium-sized enterprise (SME) tax breaks and a reduction of the "grey" economy. In the World Bank *Doing Business in the European Union 2017* report, which assessed the ease of doing business in seven cities in the country, business start-up costs, access to power and construction permits came behind the EU average. In the overall Doing Business ranking, Hungary scores 48th (out of 190 countries) in 2018.

The government launched several measures to ease the lack of qualified workers. In order to provide immediate relief to the mounting problem of qualified labour shortages, the government has taken measures to facilitate the hiring of non-EU workers. Up to mid-2017, more than 10,000 foreign workers had been granted work permits, mostly from Serbia and Ukraine. In addition, for those sectors urgently lacking a qualified labour force, employers can hire foreign workers for 90 days without a work permit. Other measures include launching an employment rehabilitation programme, announced by the government in May 2017, targeted at people with disabilities who find it difficult to find jobs on the open labour market and may require skills requalification. Moreover, beyond the existing subsidy for municipalities that create additional accommodation for incoming workers, a tax package adopted by the parliament in June 2017 also envisages some relief on employers' costs for employee resettlement, which is expected to improve labour mobility in the country.

Additional gas delivery routes are being created. In July 2017, Hungary signed an agreement with Gazprom for constructing a new gas pipeline for gas delivery from Russia, to be finalised by the end of 2019. The new connection would be an extension of the Turkish Stream project, which is already under construction and will run partly along the route of the suspended South Stream gas pipeline. In addition, Hungary is expected to be able to buy gas from Croatia from the first quarter of 2019. The two governments signed a letter of understanding in June 2017 to construct a bi-directional gas interconnection, which will allow for a reverse flow of gas to Hungary from Croatia.

A new railway will be constructed as part of China's Silk Road project. Work on a 350-km long railway connecting Budapest with the Serbian capital, Belgrade, will start in November 2017. The railroad will become part of the Pan-European Corridor X, facilitating the central and south-eastern Europe (CSEE) region's access to Asia by sea. For the time being, however, the project remains subject to an EC investigation on state aid rules. Under China's Silk Road project launched in 2013, known officially as the Belt and Road Initiative (BRI), China's attention has increasingly focused on the CESEE region, launching the 16+1 framework for Chinese cooperation with 16 of the CESEE countries. As a member of the 16+1 framework, Hungary can also access the China-Central and Eastern Europe Investment Cooperation Fund that has been set up to support infrastructure, high-tech and green investments in the 16 member countries. In June 2017 Hungary joined the Asian Infrastructure Investment Bank (AIIB), which is headquartered in Beijing.

New regulations have been adopted on the sale of foreclosed houses. In March 2017, the parliament approved an amendment to the law on the sale of foreclosed houses. The amendment specifies that repossessed homes are sold at no less than 100 per cent of their market value during the first year after foreclosure. The floor would be reduced to 90 per cent if not sold in the first year. Earlier, foreclosed homes could be sold at 70 per cent of market value. According to the authorities, selling the foreclosed homes at higher prices would allow for a greater reduction in household indebtedness, which ultimately would support about 150,000 households that are at risk of foreclosure. The EBRD initiated the creation of a Working Group along with the Ministry of National Economy and the National Bank of Hungary to assess the impact of the amendment. The Working Group has subsequently solicited feedback from the Banking Association and the discussion is ongoing.