



Hungary Country Strategy

2021-2026

Approved by the Board of Directors on 10 March 2021



European Bank
for Reconstruction and Development

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Glossary of Key Terms

| | | | |
|----------------|--|----------------|--|
| ABI | Annual Business Investment | ICA | Industry, Commerce & Agribusiness |
| ASB | Advisory for Small Businesses | ICT | Information and Communication Technologies |
| BEEPS | Business Environment and Enterprise Performance Survey | IDLO | International Development Law Organization |
| CEB | Central Europe and Baltics | IFC | International Finance Corporation |
| CEE | Central and Eastern Europe | IFI | International Financial Institution |
| CIT | Corporate Income Tax | ILO | International Labour Organization |
| CVM | Cooperation and Verification Mechanism | MFF | Multiannual Financial Framework |
| E&S | Environmental and Social | MREL | Minimum requirement for own funds and eligible liabilities |
| EBRD | European Bank for Reconstruction and Development | MSME | Micro, Small and Medium Enterprise |
| EC | European Commission | NBH | National Bank of Hungary (Magyar Nemzeti Bank) |
| EE | Energy Efficiency | NPL | Non-Performing Loans |
| EIA | Environmental Impact Assessments | ODA | Official Development Assistance |
| EIB | European Investment Bank | PPP | Private-Public Partnership |
| EIF | European Investment Fund | PR | Performance Requirements |
| ESCO | Energy service companies | PTI | Portfolio Transition Impact |
| ESIA | Environmental and Social Impact Assessment | R&D | Research and Development |
| ESIF | European Structural and Investment Fund | SEE | South-Eastern Europe |
| ETI | Expected Transition Impact | SME | Small and Medium Enterprise |
| EU | European Union | SOE | State-Owned Enterprise |
| FDI | Foreign Direct Investment | SRSS | Structural Reform Support Service |
| FI | Financial Institution | TC | Technical Cooperation |
| FX | Foreign Exchange | TFP | Trade Finance Project |
| GDP | Gross Domestic Product | TPES | Total primary energy supply |
| GET | Green Economy Transition | VCIP | Venture Capital Investment Program |
| H&S | Health & Safety | WB | World Bank |
| HR | Human Resources | WEF | World Economic Forum |
| KPI | Key Performance Indicator | | |

Hungary's commitment to and application of principles set out in Article 1 of the Agreement Establishing the Bank continued over the period since the previous Country Strategy approval, although some challenges remain. The latter include certain areas of governance and business environment. Judicial independence in Hungary has been raised by EU institutions as a source of concern, including in the Article 7 (1) Treaty on European Union procedure initiated by the European Parliament.

Hungary is a country advanced in transition reforms, with a robust economy and shrinking transition gaps until early 2020. The country has benefited from considerable EU funding, an active EIB presence, soft loans, a highly liquid / competitive banking sector and a National Bank that is active in seeking to diversify sources of financing by developing local capital markets. In such an environment, it has become increasingly difficult for the Bank to remain additional and play a meaningful role in addressing primary challenges that limit the competitiveness of Hungarian businesses.

Hungary is highly integrated into global value chains, and has been significantly impacted by COVID-19. The Bank will provide support for the recovery from COVID-19 crisis as needed, as this may temporarily increase EBRD's additionality during the strategy period, to be reviewed as a part of an extended Country Strategy Delivery Review for 2023.

The Hungarian economy has demonstrated strong economic growth with substantial inward investment, record low borrowing costs and a growth in credit, which has supported private sector employment and consumption until Covid-19 caused deep recession in the second quarter of 2020. The economy is also strongly exposed to the economic outlook of the eurozone as the country has pursued an export led growth model dominated by the automobile industry. Tight labour market and significant real wage growth – both positive by themselves - may start to pose a challenge to cost competitiveness of the Hungarian economy. This challenge, acknowledged by the Government, needs to be met with further growth of productivity and improving resource allocation, lest it curtails the return to strong GDP growth experienced over recent years after the recovery from Covid-19 crisis.

Hungary has been a significant beneficiary of EU Structural funds (EUR 25 bn over the 2014-20 period), which have undoubtedly played an important part in boosting the economy. Government debt has been steadily decreasing until the Covid-19 outbreak in mid-March 2020, which abruptly induced higher expenditures amid falling tax revenues, in 2019, it stood at 66.34% of GDP. In the coming period, it will be important for the Government to leverage EU funding more effectively, especially that linked to EU Post-Covid-19 Recovery Fund, and engage in co-financing with IFIs and the private sector.

In view of the above, the EBRD's approach during the next period will focus on those select areas where transition gaps remain and where the Bank can be additional, including in the efforts to overcome the impact of Covid-19. The Bank will continue to focus on developing capital markets and on opportunities to deploy equity and innovative investment products, and where appropriate seek to address inclusion and governance issues. There will be a clear focus on supporting projects in the areas of resource and energy efficiency, decarbonisation and renewable energy. The Bank will continue pursue cooperation with the authorities, including with the Ministry of Innovation & Technology on energy efficiency and the National Bank on green bonds and other green financial products, to identify projects of mutual interest where government support and co-financing (to the extent required) could be made available.

The Bank will pursue the following strategic priority in Hungary during 2021-2026:

- *Support Productivity Improvements through Innovative Financing and Green Investments*

Hungary - EBRD Snapshot

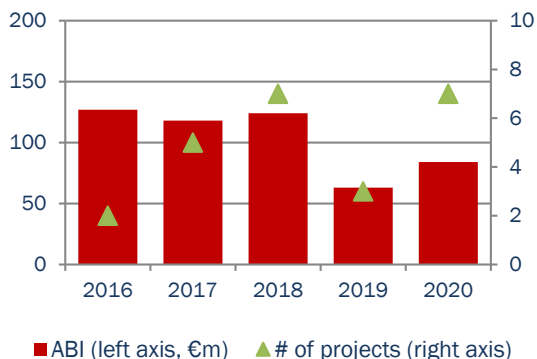


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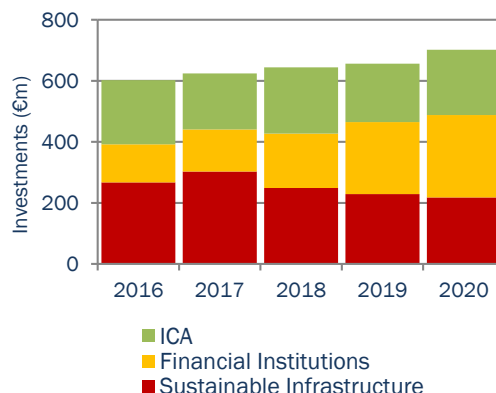
EBRD Investment Activities in Country (as of year-end 2020)

| | | | |
|----------------------------|-------|---------------------|---------|
| Portfolio | €702m | Active projects | 48 |
| Equity share | 34% | Operating assets | €670m |
| Private Share ¹ | 100% | Net cum. investment | €3,203m |

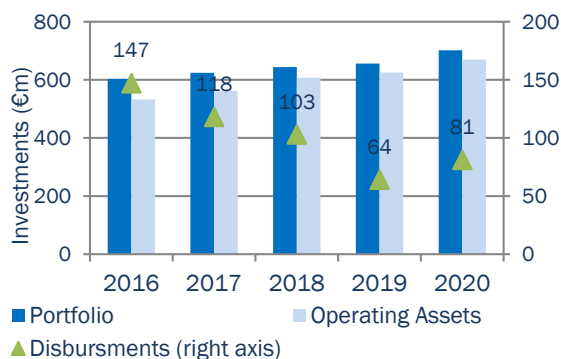
ABI and Operations



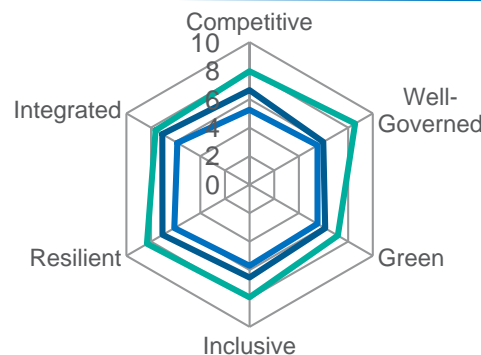
Portfolio Composition



Portfolio Dynamics



Transition Gaps²



Country Context Figures

| | Hungary | Comparators |
|---|---------|--|
| Population (million) ³ (2019) | 9.8 | Czech Republic (10.7), Poland (38.0), Slovak Republic (5.5) |
| GDP per capita (PPP, USD) ³ (2019) | 33,979 | Czech Republic (42,575), Poland (34,217), Slovak Republic (34,177) |
| Global Competitiveness Index (WEF) (2019) (out of 141 economies) | 47 | Czech Republic (32), Poland (37), Slovak Republic (42) |
| Unemployment (% , 15-64) ⁴ (2019) | 3.5 | Czech Republic (2.1), Poland (3.3), Slovak Republic (5.8) |
| Youth unemployment (% , LFS) ⁴ (2019) share of youth not in employment, education or training (NEET) | 11.0 | Czech Republic (5.7), Poland (8.1), Slovak Republic (10.3) |
| Female labour force participation (% , LFS, 25-54) ⁴ (2019) | 80.6 | Czech Republic (81.8), Poland (79.0), Slovak Republic (79.6) |
| Energy intensity (TPES/GDP) ⁵ (2017) | 0.2 | Czech Republic (0.2), Poland (0.2), Slovak Republic (0.2) |
| Emission intensity/GDP (kgCO2/10'\$) ⁵ (2017) | 0.3 | Czech Republic (0.4), Poland (0.5), Slovak Republic (0.3) |

¹ Cumulative Bank Investment: 5 year rolling basis on portfolio.

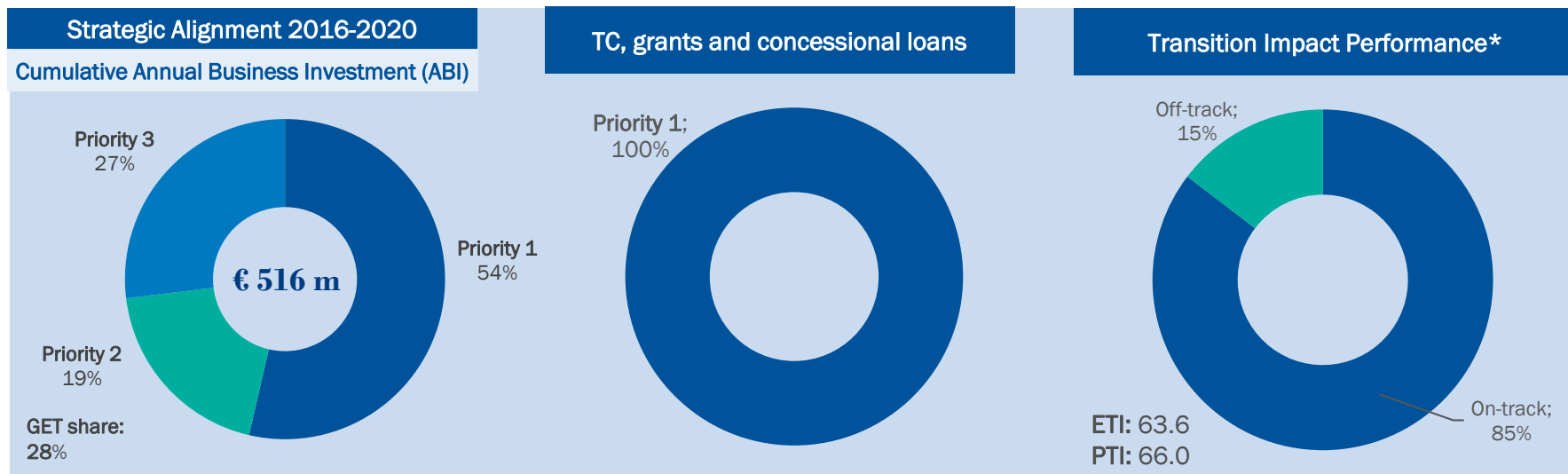
² Cf. EBRD Transition Report 2017-2018. ³ World Bank WDI. ⁴ International Labour Organisation. ⁵ IEA's Energy Atlas.

1. Implementation of Previous Strategy (2016-2020)



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1.1. Key Transition Results achieved under previous Country Strategy



Priority 1: Strengthening banking sector resilience and the capacity to lend

Key Results

- Facilitated reduction in the Banking Tax in January 2016, broadly recognized to have played an important role in bringing increased stability to banking sector and supporting a return to profitability of main banks. Further organised training on Debt Restructuring/Distressed Debt Sales for Budapest Institute of Banking.
- Completed a large equity investment in Erste Bank Hungary for €125m (15% stake) in 2016 to support financial sector restructuring.
- Signed €60m investment in OTP's €500m benchmark 10 year subordinated bond, the first issue of subordinated debt since the implementation of the EU's Bank Recovery and Resolution Directive and the first compliant issue by a CEE borrower.
- Helped Hungarian banks strengthen their local currency liquidity and provide long-term funding through mortgage backed bond issuances, supplying local banks with a total of up to €210m in framework facilities to facilitate sale of mortgage-backed covered bonds in support of new legislation by the Central Bank to address balance sheet mismatch of local mortgage banks. Discussed additional covered mortgage bond lines for local banks, MREL and the potential to develop new risk sharing products.
- Worked with Central Bank on a new template to support local banks in addressing the out-of-court settlement of multi-creditor NPLs (Vienna Initiative). Worked with the Ministry of Justice to amend the Insolvency Law and bring it in line with the new EU Directive
- Made progress with the first SRSS project approved to support Hungarian Central Securities depository (KELER CSD) establish cross-border clearing and settlement links and build direct links to CSD's in selected member states in accordance with the EU regulations.
- Working with the NHB on an SRSS proposal to fund a Detailed Assessment Report on Green Bonds benchmarking the relevant legal framework in Hungary.

1. Implementation of Previous Strategy (2016-2020)

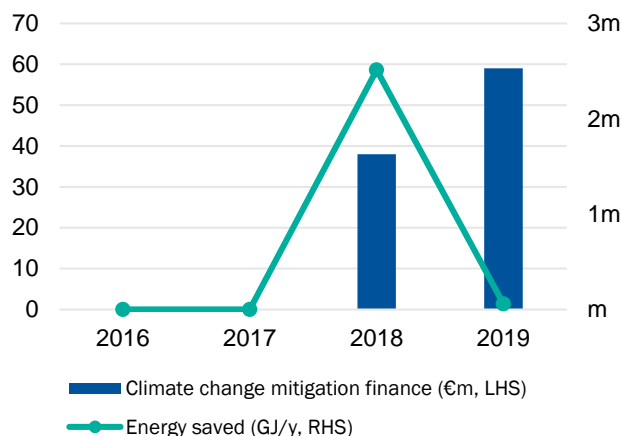


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1.1. Key Transition Results achieved under previous Country Strategy

Priority 2: Improving further Hungary's energy security through strengthening market-based regional interconnections, optimising the use of storage capacities and enhancing energy efficiency

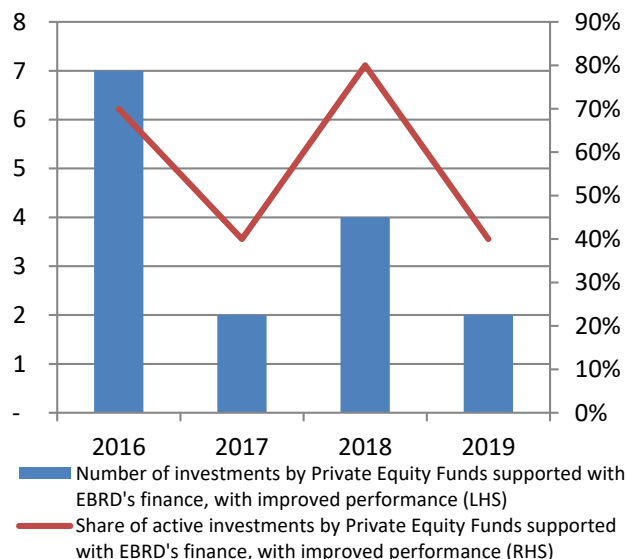
Green Economy Transition



Key Results

- Completed restructuring of existing loan to the Hungarian strategic gas storage company where the storage volume has now been maximised.
- Regular approaches to support funding of regional energy connection projects.
- Actively developing leads to support renewable energy projects, particularly in solar and geothermal.
- Embarked on discussions with the Government to seek their direct support (or potentially via the use of EU Funds) for TC for GET projects.
- Work ongoing with the Ministry of Innovation and Technology on an SRSS funded project to assess both the energy efficiency needs in residential and public buildings and the optimal funding vehicles needed to deliver such a programme.
- Raised awareness about possible EE funding structures (incl. green bonds) with commercial banks, the Ministry of Industry and Trade and the Central Bank.

Priority 3: Enhancing competitiveness and addressing innovation gaps



Key Results

- Supported regional venture capital funds, namely Almaz Capital and the Innovation Nest Fund.
- Continued to support FDI: a loan for a greenfield galvanising plant compliant with EU Best Available Techniques has helped attract over €101m in FDI. The plant utilises cost-competitive design and serves new Eastern European customers, and was successfully completed and reached full capacity in H2 2017.
- Provided €25m (equivalent) in debt financing to a local export oriented fertiliser producer (100% GET), provided €20.1m in finance to a regional export oriented bottling company. Invested €24.9m in a regional property company with significant activity in Hungary (13% GET), and a further €14.1m in one regional fund (active in Hungary) and one Hungarian equity fund.
- Closed a €100m transaction with Budapest Airport, via a capital market framework, leveraging the airport's improved operational and financial performance, thus supporting a secondary PPP market, which should facilitate attracting private operators in the infrastructure sector as a whole.
- Undertook extensive review of the equity market.
- Extensive work to help BKK restructure the Budapest Automated Fare Collection project in a challenging environment but due to lack of progress by the Sponsor, reluctantly terminated the loan in December 2018.

1. Implementation of Previous Strategy (2016-2020)



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1.2. Implementation Challenges and Key Lessons

Context for Implementation

Coinciding with the 2016-2020 strategic period, an economic protection programme has been introduced with the aim to increase the GDP growth rate by an additional two percentage points above the EU average in the coming years. Banking sector has rebounded and was lending aggressively alongside significant EU and EIB funding, while the cost of funding for eligible corporates has decreased. Therefore the EBRD has focused on the niche areas where it remained additional, including through capital markets development. In 2018 a new Innovation and Technology Ministry was established to streamline government efforts to promote higher value-added creation among Hungarian corporates, including SMEs, becoming an important local counterparty for policy engagement for the EBRD. During the previous strategy period, the NBH delivered the Funding for Growth scheme that provided soft loans to support SME's and soft loans to promote energy efficiency lending, and launched a new scheme for corporate bond purchases to provide liquidity to the market, aiming to trigger new private investment flows to the market. In addition, a generous family support scheme was approved by the parliament to address demographic challenges. The past strategy period was also characterised by the political rift between the Government and the EU.

Implementation Challenges

- Underdeveloped investor base for HUF denominated bonds
- Lack of internal/external appetite for energy links, although increasing demand for Green investments
- Focus on leveraging EU funds through subsidised / soft loans and grant distribution
- Increasing concentration of ownership and tender allocation within a select group of larger Hungarian companies

Key Lessons & Way Forward

- Continued dialogue and support for the development and implementation of new tailored products
- Policy engagement on EE in buildings and potential for financing of renewables
- Potential co-financing and better leverage for EU funding, that is expected to reduce gradually
- Strong focus on integrity checks required

2. Economic Context

2.1 . Macroeconomic Context and Outlook for Strategy Period



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Hungary - Main macroeconomic indicators

| | 2015 | 2016 | 2017 | 2018 | 2019 |
|--|-------|-------|-------|-------|-------|
| GDP growth (% y-o-y) | 3.8 | 2.2 | 4.3 | 5.4 | 4.6 |
| HICP inflation (% avg.) | 0.1 | 0.4 | 2.4 | 2.9 | 3.4 |
| Government balance (% of GDP) | -2.0 | -1.8 | -2.5 | -2.1 | -2.0 |
| Current account balance (% of GDP) | 2.4 | 4.5 | 2.0 | 0.3 | -0.2 |
| Net FDI (% of GDP) | -1.3 | -2.2 | -1.5 | -2.0 | 0.1 |
| External debt (% of GDP) | 107.0 | 95.4 | 83.5 | 80.1 | 73.6 |
| Gross reserves (% of GDP) | 26.5 | 20.1 | 19.5 | 19.6 | 19.5 |
| General government gross debt (% of GDP) | 76.2 | 75.5 | 72.9 | 70.2 | 66.3 |
| Unemployment (% , 15-64, 2019) | 6.8 | 5.1 | 4.2 | 3.7 | 3.5 |
| Nominal € GDP (bn) | 112.7 | 116.2 | 126.9 | 135.8 | 145.9 |

The average per capita income level converges with the EU average, although it still remains below Hungary's regional peers. Over the past ten year, GDP per capita increased by 10.5 percentage points, to 70.7% of the EU average in 2018. At the same time, average incomes in CEE3 (the Czech Republic, Poland and the Slovak Republic) reached almost 80% of the EU-average, with the Czech Republic exceeding 90% or 75% in the other CEB economies.

GDP growth in Hungary was the strongest among its peers over the past five years. Between 2014 and 2019, the average GDP growth rate reached 4.1% in Hungary, significantly above the average growth rate of 3.3% seen in the other CEB economies.

Investment has seen the most vibrant recovery in both public and private sectors. Similar to other EU member states, the cycle of public investment in Hungary is highly dependent on the EU transfers. Following a deceleration in the EU funds absorption in 2016, due to a shift towards the next EU budgetary period and a change in disbursement criteria, public as well as private sector investment soared above levels seen in CEE3. According to EC's estimates, public and private investment reached 6.0% and 22.6% of GDP in 2019, respectively. The impressive increase in private sector investment is also attributed to the recovery of corporate credit, of which growth turned positive only in late 2016. Overall, investment level was the highest in the region in 2019, at 28.6% of GDP, substantially above the CEB average of 21.5% of GDP.

Public debt in Hungary has been declining and its external macro vulnerabilities have been substantially reduced. Following a peak of 80.8% of GDP in 2011, Hungarian general government debt has been continuously falling thanks to lower overall deficits and the negative differential between real interest and GDP growth rates. However, the high importance of the economic cycle in that method of deficit reductions might result in a substantial worsening of the fiscal position in case of a slowdown. The share of FX-denominated central government debt fell from 48.5% to 17.3% between the end of 2011 and September 2019. In this period, the share of government securities held by non-residents dropped from 56.6% to 31.1%, and has been replaced by an increasing share of residents' holding, especially the retail government securities held domestically by households and banks.

Coronavirus crisis pushed Hungary into recession in 2020. Hungary registered the strongest GDP growth in the CEB region, at 4.6 per cent in 2019. Despite the recently rising importance of domestic consumption, a massive exposure of the economy to global trade (more than 190% of GDP) aggravates its vulnerability to disruptions to global supply chains from the coronavirus crisis. The manufacturing sector, especially automotive industry (28% of manufacturing output), is the main driver behind the country's high GVC integration.

2. Economic Context

2.2 . Key Transition Challenges



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Competitive (6.64)

- **The business and regulatory environment**, as measured by the ease of doing business indicator in 2019, is slightly above the EBRD average and lags behind the average for CEB countries.
- **Starting a business**, as measured both by the density of business entries and the ease of starting a business, is more difficult than in other CEB countries, and in particular the Baltic countries.
- **Hungary is a top performer among the CEB countries in terms of availability of sophisticated services**, including for instance finance, accounting. Exports of these services also reflect their availability domestically. SMEs seem to be a large contributor to services exports.
- **Many companies are highly integrated into global value chains**, thanks to Hungary's geographical location and open trade policy, relatively low labour costs and advanced logistics and infrastructure.
- **Hungary has potential to further strengthen its capacity to innovate and become a more solid knowledge economy**. As measured by the EBRD adjusted Knowledge Economy Index in 2019, the country attains a score (5.64) that is below the average of the CEB (6.41) and the OECD (8.55).

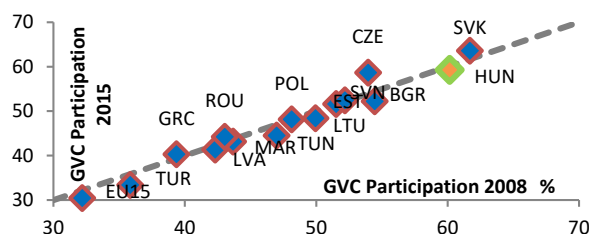
Well-governed (5.98)

- **Hungary has made important reforms in transition to a market economy.**
- **Index of Economic Freedom 2019** (The Heritage Foundation) ranks Hungary 64th out of 180 economies, with low scores in judicial effectiveness, government integrity and government spending. The country's overall score is below the regional but above the world average.
- **Tax administration has improved substantially though relative to CEB peers, there is room to improve further.** According to the latest round of EBRD's Business Environment and Enterprise Performance Survey (BEEPS VI, 2018-2020), almost 10% of companies claim that tax administration is the biggest obstacle for doing business, above CEB average of less than 6%. In BEEPS IV (2006-2009), the share was above 14%.

Green (6.14)

- **Hungary scores above average on most green indicators in the EBRD region**, but low in comparison to EU countries.
- **Hungary's green economy transition** will need to focus on investing in sound waste and material management, and managing transition away from carbon intensive sectors.
- **Hungary needs to improve the energy efficiency of its buildings.** Hungary has one of the most energy intensive residential sectors in the EBRD region. Nearly 80% of Hungarian homes fail to meet modern functional technical and thermal engineering requirements, and the ratio is similar in public buildings (OECD).
- **While Hungary has made progress in waste recycling and recovery**, more than half of the country's waste is deposited in landfills, a higher proportion than its EU neighbours.
- **Nuclear energy plays a significant role in electricity generation.** Hungary has decided to proceed with the intergovernmental agreement with Russia on the expansion of the Paks project with two new units (2,400 MW).

60% of exports are integrated into global value chains



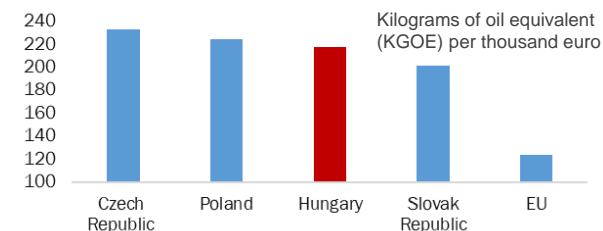
Source: OECD, EBRD's calculations.

National-level governance quality has deteriorated



Source: World Bank.

Overall energy intensity remains above EU-average



Source: Eurostat.

2. Economic Context

2.2 . Key Transition Challenges

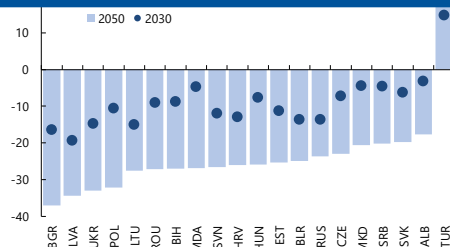


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Inclusive (6.53)

- Hungary scores above average on most inclusive indicators. Total unemployment is very low, at only 4.1% for men and 4.6% for women in November 2020 (Eurostat). The labour force participation for women is 67.2% against 83.2% for men in Q3 2020 (Eurostat).
- Policies should increase the availability of public child-care institutions in conjunction with child-care allowance for paternal leave, tax relieves for both dual-earners and single parents, in order to benefit from steadily higher labour force participation rates for women.
- Employers in Hungary experience significant labour shortages. 51% of all employers report having difficulties filling jobs.
- More than half of Roma households in Hungary suffer from economic, social and spatial exclusion. Residential disadvantage intersect with low to no access to employment and education. Most companies do not employ Roma based on lack of training and prejudices, at most employment is offered for seasonal work.
- UN ranks Hungary among the top 10 fastest shrinking countries in the world. At the same time, the population is aging. The proportion of people over 65 years old increased from 13% in 1990 to almost 20% in 2019 and it is expected to reach 29% in 2060. .

Labour force is projected to decline drastically by 2050

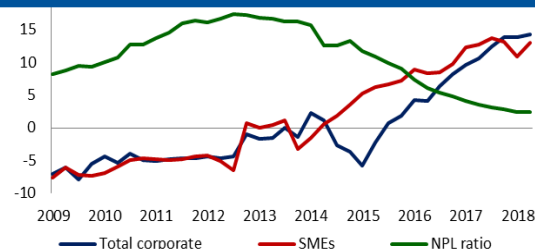


Source: IMF 2019.

Resilient (7.06)

- The stability of the Hungarian banking sector has seen notable improvements over the past years, as reflected in asset quality, capital adequacy and profitability. NPLs' share of total gross loans decreased significantly, from over 15% in 2014, to 1.2% in Q3 2020.
- The banking sector is resilient but it still falls behind comparable CEB countries in several areas. Capital adequacy, although improving, is still one of the lowest out of EU11 countries (capital adequacy ratio, CET1/RWA: 17.9% in Q3 2020), suggesting slightly lower levels of capital buffers.
- Credit to private corporates turned positive only in late 2016, boosted by strong domestic demand, reflecting high business confidence and a variety of initiatives to support credit penetration. Banks' credit to the private sector stood at 33% of GDP as of 2019, the lowest in CEB.
- Hungary has limited indigenous fossil-fuel resources with declining domestic production. As a result, it imports around 90% of its oil and natural gas from other countries, most of it from Russia.
- Although the Hungarian energy sector is liberalised, the market in electricity and natural gas remains concentrated with dominant players having over 50% of the market share.

Growth rate of corporate loans and NPL ratios have improved

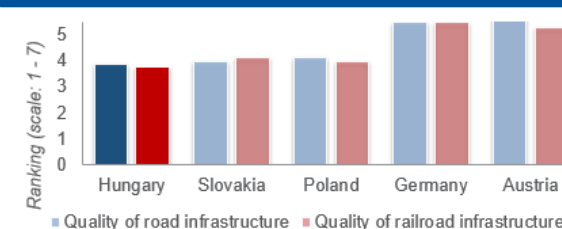


Source: NBH and IMF 2019.

Integrated (7.08)

- The share of exports and imports of goods and services in GDP is higher than that of many other CEB countries. Due to its EU membership, Hungary is involved in 41 regional trade agreements (EBRD average: 18), and enjoys a number of non-tariff trade-boosting measures.
- Hungary is part of 109 bilateral investment treaties with investment provisions put into force (CEB average: 102, EBRD average: 65). Hungary has also been benefitting from relatively few statutory FDI restrictions.
- The quality of the roads and railroads infrastructure in Hungary remains relatively weak, compared with CEB peers and OECD comparators.
- International transport is one of Hungary's strengths. The cost of trading across borders (measured as the time and cost associated with the logistical process of exporting and importing goods) is among the lowest the EBRD region.
- Hungary has a relatively poor energy infrastructure and comparatively better ICT infrastructure. The quality of the electricity supply in Hungary is below the CEB average, while the time required to obtain a permanent electricity connection is among the longest out of all EBRD countries.

Quality of road and railroad infrastructure remains poor



Source: WEF Global Competitiveness Report 2018.

3. Government Priorities and Stakeholder Engagement

3.1. Government Reform Priorities

The Government's 'For a More Competitive Hungary Programme' outlined six structural areas for action:

- **Employment** - incentivising students and mothers with smaller children to work, bringing inactive people back to the labour market, fostering mobility, reducing red tape regarding subsidised trainings, and reducing the number of health insurance frauds.
- **Corporate environment** - focusing on efficiency regarding innovation and research, increasing productivity and added value in the corporate production, modernizing education to better serve labour market needs, modernizing the construction sector and increasing efficiency, creating an AI strategy, integrating different transport systems, introducing new (autonomous) transport methods, and strengthening energy security (new power plants, stable energy production).
- **Taxation** - decreasing burdens on labour, supporting domestic SME's, invigorating corporate investments, simplifying the tax system, reducing red tape, reducing tax avoidance and developing digitalization.
- **Public sector** - increasing the efficiency of the public sector (digitalization, performance based compensation, accountability), and increasing the quality of business regulations (such as reforming the insolvency law).
- **Education** - *Primary education*: focusing on ability-focused education, sustainable and developable education system, measuring, analysing and supporting performance, and strengthening equal opportunities. *Higher education*: serving the needs of the labour market, focusing on more efficient teaching, and learning of languages.
- **Healthcare** - preventing illnesses, improving primary care and strengthening its gatekeeper position, creating new funding system that takes into account the real costs of the service, focusing on cost efficiency of healthcare treatments such as the use of short-term types of care, introducing KPI's.

3.2. EBRD Reform Areas Broadly Agreed with Authorities

- Although Hungary is a country advanced in transition, it is still facing transition gaps.
- Financing for solar energy capacity building, in particular to support projects under the recently introduced open tendering platform for solar power generation.
- Continued work with the Ministry of Innovation & Technology on defining funding needs and creating financing programmes to support energy efficiency needs and green transport development.
- Co-financing for the developers of geothermal district heating capacity, subject to the necessary regulation on municipal district heating tariffs is implemented.
- Continued work with the National Bank to develop the regulatory environment relevant for the green bond ecosystem necessary for incentivising the use of such financial instruments. Later, the EBRD may act as an anchor investor in initial corporate green bond issuances.
- Continued contribution to capital market development under the EBRD's covered bond program, and support for banks to meet MREL requirements.
- Continued search for opportunities for equity investments focusing on Hungarian growth companies active in innovative and high impact sectors.

3.3. Key Messages from Civil Society to EBRD

- Green economy transition is necessary but remains challenging. There is need for affordable and accessible renewable energy sources in synergy with energy efficiency improvements.
- Improving energy efficiency in residential buildings is the most needed and effective way to reach climate goals. Investments in residential sector as well as energy obligation schemes are crucial to reach the sufficient level of refurbishment in the sector.
- CSO representatives noted their concern with perceived increase in incidents of lack of transparency, corruption and breaches of human rights, which they claim are negatively affecting the economic transition. (Hungarian government strongly disagrees with this statement, finding it unfounded.) The EBRD should continue focusing on the support for the private sector.
- Considering Hungary as an "advanced transition economy" may cause misunderstanding as further reforms of the business environment are needed.



4. Defining EBRD Country Strategy Priorities

What needs to change ? (Country Diagnostic)

- Insufficient availability of modern and alternative sources of finance limits economic resilience and encumbers broader productivity growth.
- Capital market funding for private sector is marginal and there is no funding ecosystem to manage the rising wave of corporate succession. Also, Hungary ranks in the lower tier of the EU in terms of digital banking.
- Ensuring adequate financing is a key issue for the development of the green economy and for promoting environmental sustainability. A key component will be the availability of grants to incentivise end beneficiaries.
- Hungary is one of the most climate-vulnerable countries in Europe. Green financial products are only just being introduced.

Can it be changed ? (Political Economy)

- A wider use of alternative sources of finance, such as private equity and capital markets, could support companies that struggle to access bank finance / want to invest more in innovation, green solutions or expand abroad.
- The NBH's Fintech Strategy includes 24 recommendations for the development of Fintech sector, such as fostering services built on instant payments, fast track in licensing, regulatory sandboxes and tax incentives.
- National Climate Change Strategy designates the decarbonisation roadmap, and the NBH already launched Green Program, including Green Capital Market Strategy.
- The demand side interest for green products is low but growing.

What can the Bank do ? (Institutional Capabilities)

- The Bank assists broadening and diversifying the financial sector through supporting underdeveloped and innovative financial services and products, as well as developing deeper and more liquid capital and local currency markets.
- The development of green finance is promoted by scaling up existing activity as well as enlarging the suite of products, including risk sharing, green bonds and, where appropriate, equity.
- Mainstreaming inclusion and governance issues in equity transactions.
- Assisting the private sector to enhance its competitiveness and productivity levels through the provision of targeted debt and equity products.
- Green low-carbon transition is supported through investment in the necessary technological upgrades for scaled-up renewable energy supply, including smart grids and enhanced energy storage, together with increased investment in energy efficiency including geothermal district heating capacity.

Strategic Priorities (2021-2026)

**Support Productivity
Improvements
through Innovative
Financing and Green
Investments**

What We Want to see (Key Objectives)

Support for Covid-19 recovery

Diversify and deepen financial system products, including the introduction of green financial products

Resource and energy efficiency / Decarbonisation; Renewables

5. Activities and Results Framework



European Bank
for Reconstruction and Development

Priority: Support Productivity Improvements through Innovative Financing and Green Investments

| Key Objectives | Activities | Tracking Indicators (Outcomes) |
|--|---|---|
| Support for Covid-19 recovery | <ul style="list-style-type: none"> Deploy equity, debt and risk sharing products focused on Covid-19 recovery, both directly and through intermediaries (including financial intermediaries and equity funds) to Build Back Better. Focus on improved productivity, resilience and competitiveness, especially for innovative companies. In doing so, support digitalisation, automation, skills upgrades and, where appropriate, seek to address inclusion and governance issues. Target both local companies (active in Hungary and looking to expand overseas) and foreign investors into Hungary. Work with the authorities to support private sector investment in infrastructure projects which address remaining transition gaps. | <ul style="list-style-type: none"> New instruments introduced or existing ones tailored to support resilience and Covid-19 recovery |
| Diversify and deepen financial system products, including the introduction of green financial products | <ul style="list-style-type: none"> Continue to develop capital markets products that contribute to diversification of investment base and / or support financial institutions' loss absorption buffers and stable funding base, including relevant policy engagement both on capital markets and related issues. Work with the NBH on Green Bond introduction, including advancing incentives and potentially supporting initial issuances. Pursue innovative transactions that are compliant with the Taxonomy Regulation, including greening financial system and supporting both environmentally sustainable products and digitalization. | <ul style="list-style-type: none"> Volume of capital market transactions facilitated New financial instruments introduced or existing ones tailored to include facilitating competitiveness |

Impact Indicator: Economic Complexity Index (Harvard CID, baseline: 1.66 score);
Energy intensity TPES/GDP (IEA, baseline: 4.2 MJ/USD PPP);
Stock market capitalisation (WDI, baseline: 25% of GDP)

PUBLIC

Competitive



Green



Resilient



5. Activities and Results Framework



European Bank
for Reconstruction and Development

Priority: Support Productivity Improvements through Innovative Financing and Green Investments

| Key Objectives | Activities | Tracking Indicators (Outcomes) |
|--|--|---|
| Resource and energy efficiency / Decarbonisation; Renewables | <ul style="list-style-type: none"> Support Hungary's green transition, including achieving its nationally determined contributions, implementing its National Energy and Climate Plan and long-term renovation strategy, involving the renovation of building stock and support of circular economy business models. Work with authorities, private sector investors and developers to define energy efficiency needs in residential and public buildings and the necessary support for e-mobility. Identify optimal funding structures to deliver sustainable financing, including through financial intermediaries and potentially involving co-financing alongside public / EU funds. Support municipalities as a co-financing partner (including using public support structures such as Invest EU) to deliver innovative funding structures involving the private sector that deliver measurable and sustainable green projects (European Green Deal). Finance and promote resource and energy efficiency investments, including product and process innovation (such as emission free hydrogen production), compliant with the Taxonomy Regulation on green products. Support green skills development. Consider financing for green and climate resilient transport (including with Invest EU), subject to availability of necessary donor / TC support. Finance new renewable energy (e.g., PV generation, geothermal) and related infrastructure (e.g., storage, connectivity). | <ul style="list-style-type: none"> Energy saved (GJ/y) CO2 emissions reduced (ton/yr) Renewable Energy capacity installed (MW) |



6. Mapping of International Partners' Complementarity in EBRD Business Areas



European Bank
for Reconstruction and Development

| EBRD BUSINESS AREAS | | | | | | | | | | | | | | |
|---|-------|-----------------------------------|-----|--------------------------|-------------------|--------------------|----------------------------|----------------|------------------------|---------------------------------|-----------------------|----------------------|------------------------------------|----------------|
| | | Sectors | | | | | | | | | Cross-cutting Themes | | | |
| | | Industry, Commerce & Agribusiness | | | | | Sustainable Infrastructure | | Financial Institutions | | Strategic Initiatives | | | |
| Indicative annual investment/ grants (€m, 2016-2019 average unless otherwise specified) | | Agribusiness | ICT | Manufacturing & Services | Natural resources | Property & Tourism | Energy | Infrastructure | Banking | Non-bank Financial Institutions | Green Economy | Inclusion and Gender | Local Currency and Capital Markets | Small Business |
| EU (ESIF)* | 4,234 | € | € | € | | € | € | € | | | € | € | | € |
| EIB | 708 | € | € | € | | | € | € | € | | | € | | |
| EIF | 67 | | | | | | | | € | € | | | | € |
| CEB** | 58 | € | | | | | € | | | | € | € | | € |
| EBRD | 106 | | | € | | € | € | € | € | € | € | | € | |

€ Area of significant investments ● Focus mostly on private sector
 P Area of significant policy engagement ○ Focus mostly on public sector

Potential Areas of Cooperation



Green:

Working with the Ministry for Innovation and Technology on an EU (SRSS) funded project to assess the energy efficiency needs and funding options of Hungarian buildings. Potential financing of sustainable green projects via InvestEU.



Resilient:

Working with the NBH on an EU (SRSS) funded project to assess the potential of Green Bonds



Well-governed

Working with the Ministry of Justice and the NBH on an EU (SRSS) funded project to amend the Insolvency Law and bring it in line with EU directives

Note: IFI activity mapping based on publicly available information.

Significant IFI investment defined as projects exceeding 5% of annual investment and signed from 2016 to 2020.

*Based on the EU contributions to the Hungary Country Budget for 2014 - 2020. ** Council of Europe Development Bank

7. Implementation Risks

| Risks to the Strategy Implementation | Probability | Effect | Environmental and Social Implications |
|---|----------------------------|----------------------------|--|
| <ul style="list-style-type: none"> Adverse impact of COVID-19 on the ability to introduce innovative products and progress with greening transition Effective collaboration with the authorities to both define areas of need and source necessary grant funding is fundamental to the delivery of Green Investments. The preponderance of soft loans and grants (especially for municipal infrastructure projects) needs to be controlled and used more efficiently to leverage debt finance. | <p>●</p> <p>●</p> <p>●</p> | <p>●</p> <p>●</p> <p>●</p> | <ul style="list-style-type: none"> Assessment and Management of E&S Impacts: Ensure that direct, indirect and cumulative E&S impacts of projects are appropriately assessed and mitigated, especially for renewable energy projects. Labour and Working Conditions: Ensure that clients' HR policies and labour practices include workers' organisations, grievance mechanism and non-discrimination on the grounds of gender, age, disability or nationality and promote equal opportunities. Ensure Clients consider all possibilities to protect workers against the economic impact of Covid-19. Resource Efficiency and Pollution Prevention and Control: Ensure that alternatives are considered to identify investments that support transition to a low carbon and resource efficient economy, strengthen its resilience to climate change and promote circular economy Health and Safety: Assist in improvement of occupational and community health and safety in projects. Land Acquisition, Involuntary Resettlement and Economic Displacement: Renewable energy projects may require acquisition of land and properties and compensation and livelihood restoration in accordance with the Bank's requirements. Special attention will be paid to resettlement of informal land users and Roma communities Biodiversity Conservation and Sustainable Management of Living Natural Resources: Ensure robust biodiversity assessments of projects in sensitive locations are carried out to avoid encroaching or fragmenting sensitive habitats, and Natura 2000 sites and minimise impacts to, valuable biodiversity. Cultural Heritage: Ensure appropriate assessment processes to identify and consult with key stakeholders to protect cultural heritage Financial Intermediaries: Ensure that FI partners have adequate E&S capacity and risk management procedures in place Stakeholder Engagement: Promote meaningful stakeholder engagement with project-affected people and interested parties to ensure the participation of groups who might otherwise might not have a voice. |

8. Donor Co-Financing Assessment

8.1. Needs Assessment for the New Country Strategy Period

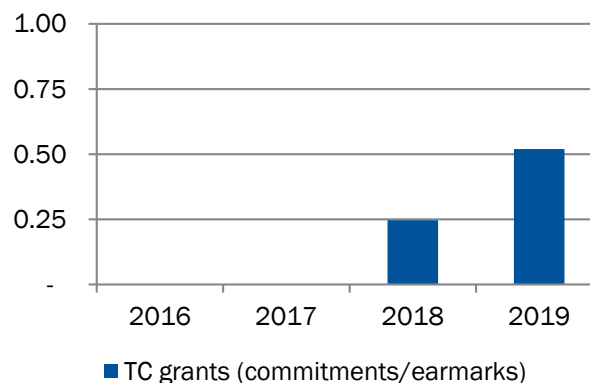
Funding will be needed to achieve the strategic objectives of the Country Strategy, including for:

- Policy dialogue and reforms which improve the investment climate, including through further developing and expanding capital markets products.
- Project preparation and policy engagement in support of investments in resource and energy efficiency. Co-financing structures with donors may also be explored.

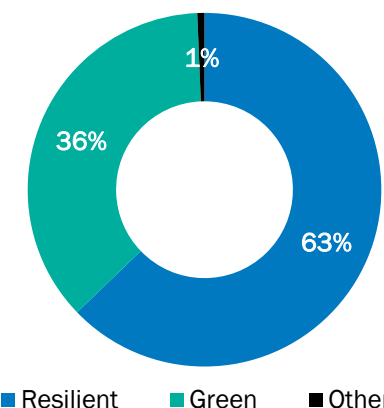
Selected Affordability Indicators

| | | EBRD regional percentile rank ¹ |
|--|--------|---|
| GDP per capita (PPP, current. \$) ² | 33,979 | 81 st |
| ODA Country ³ | No | N/A |

Donor finance during last strategy (€m)⁴



Use of grants in 2018-19⁵



*The "Other" category includes cross-sectoral programme implementation support

1. Simple percentile rank reported as the share of EBRD economies that are represented below Hungary.
2. Source: WDI (2019 or most recent)
3. Source: OECD (2018)
4. 2016-2019 TC data is based on earmarks at the project level.
5. Based on the primary Transition Quality of TC grants earmarked in 2018 and 2019.

Annexes



European Bank
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Annex 1 – Political Assessment in the Context of Article 1

Hungary's commitment to and application of principles set out in Article 1 has continued over the period since the previous Country Strategy approval, although some challenges remain. The latter include, in particular, certain areas of governance and business environment.

The constitutional and legislative framework for a pluralistic parliamentary democracy is in place. The guarantees for fundamental rights and for a meaningful role for civil society are largely in line with international and European standards. Hungary has been a member of the European Union since 2004.

The parliamentary elections in April 2018 gave a third consecutive term, with a two-thirds parliamentary majority, to Fidesz and the Christian Democratic People's party (KDNP).

The governing coalition continued implementing noticeable changes to several political institutions, to the judiciary and media oversight, drawing on a strong popular mandate. Between 2012 and 2018 around half of the laws in force have been amended, partly by use of fast-track legislation and omnibus laws ¹. Many important laws were adopted without thorough public consultation.

Some of the initiatives, such as measures supporting families and tackling demographic challenges in a number of areas, were broadly welcomed. Some other changes raised questions in parts of the international community over the government's commitment to guaranteeing freedom of expression and inclusive policy making. Since the adoption of the previous Strategy, judicial independence in Hungary has been raised by EU institutions as a source of concern, including in the Article 7(1) TEU procedure initiated by the European Parliament.

Free Elections and Representative Government

Free, fair and competitive elections

The Hungarian legal framework provides a sound basis for democratic elections. The last general election took place in April 2018. The OSCE/ODIHR Election Assessment Mission concluded that “fundamental rights and freedoms were respected overall” and that “the election administration fulfilled its mandate efficiently, enjoyed overall confidence among stakeholders and was generally perceived as impartial”. However, they noted that the elections were „...a missed opportunity to hold inclusive consultations and address prior ODIHR recommendations, including with respect to suffrage rights, a level playing field for campaigning, the freedom of the media, and citizen observation” ².

Separation of powers and effective checks and balances

Hungary is a parliamentary republic. The Fundamental Law provides for the separation of powers and institutional checks and balances within the political system. The National Assembly is the unicameral legislative organ and has the power to pass laws and elect the President of the Republic for up to two five-year terms. The President plays mostly a ceremonial role but he has a power of veto on acts of parliament and may send laws to the constitutional court for control of constitutionality. The current President of the Republic first took office on 10 May 2012 and is serving his second term. The Prime Minister holds executive power and is elected by a majority of the National Assembly.

Effective power to govern of elected officials

Elected officials have effective power to govern.

1. European Commission, Country report on Hungary, European Semester 2020, 26.6.2020.

2. OSCE, ODIHR Limited Election Observation Mission Final Report, Hungary parliamentary elections on 8 April 2018, 10 June 2018.

Annex 1 – Political Assessment in the Context of Article 1

Civil Society, Media and Participation

Scale and independence of civil society

Hungary's civil society organisations (CSOs) sector is diverse and vibrant. While there are over 60,000 CSOs registered, most are small. They span broad areas of activities and policy sectors. Act CLXXV of 2011 on association law, public benefit status and the operation and support of NGOs, which has been in force since 2011 and has been amended several times, continues to provide an appropriate framework for the development of the operating and support environment for NGOs. New laws and modifications in 2017 and 2018 challenged some aspects of the way CSOs' rights are protected.³ Uncertainty as to the legal and regulatory framework under which foreign funded CSOs function coupled with blurred boundaries between the civil and public spheres have further impacted the sector.⁴ Some new laws have been left in place despite continued domestic and international criticism.⁵ According to Hungarian authorities, consultations with the European Commission are ongoing in order to comply with respective ECJ rulings.

Independence and pluralism of media operating without censorship

The right to free speech is enshrined in the Constitution (Fundamental law). The legal framework for the media is largely in place and in line with international standards.

Since the last country strategy, significant changes have been made to the ownership structure of the Hungarian media. In 2018, control of more than 470 privately owned media outlets was transferred to a new group, the Central European Press and Media Foundation (KESMA). The authorities declared the merger to be of strategic national importance and in the public interest. KESMA's mission is to shape a public discourse rooted in national values and educate a new generation that identifies with national values. Some international and domestic media freedom organisations claimed the foundation's creation had increased the influence of government over independent media and put the plurality of the media market in Hungary at risk.⁶ On 25 June 2020, the Constitutional Court found that the government's decree on KESMA was within its prerogative and did not threaten media pluralism.

Internet penetration is 89 per cent. Online channels remain the predominant source of public information. Social media (Facebook use in particular is high) are the most significant news source, closely followed by television.

Multiple channels of civic and political participation

Multiple channels of civic and political participation are in place. The government regularly holds national consultations on issues of special interest to the public. The system of public consultations is largely in place, although its rules are not always enforced. The public right to information is constitutionally guaranteed but its application remains uneven.

Freedom to form political parties and existence of organised opposition

The freedom to form political parties is guaranteed by the Constitution and implemented in practice. Parties represent a wide range of views within Hungarian society and opposition parties contest elections freely.

3. Such as the 2017 Act on the transparency of organisations receiving foreign funding, the 2018 Act VI package and the 2018 Act on special immigration tax Act LXXVI.

4. European Union Agency for Fundamental Rights, Standing and operational space of non-governmental organisations in contributing to respecting and promoting fundamental rights in EU Member States, Hungary 2017.

5. Court of Justice of the European Union; The restrictions imposed by Hungary on the financing of civil organisations by persons established outside that Member State do not comply with EU law, 16.6.2020,

Court of Justice of the European Union; The placing of asylum seekers or third-country nationals who are the subject of a return decision in the Röszke transit zone at the Serbian-Hungarian border must be classified as

'detention', 14.4.2020, European Commission for democracy through law and OSCE Office for democratic institutions and human rights, joint opinion on the provisions of the so-called "stop Soros" draft legislative package which directly affect NGOs, 25.6.2018.

6. Council of Europe, Alert no 133 created on 29.11.2018.; UN International Covenant on Civil and Political Rights, Human Rights Committee, Concluding observations on the sixth periodic report of Hungary, 9.5.2018.

Annex 1 – Political Assessment in the Context of Article 1

Rule of Law and Access to Justice

Supremacy of the law

Necessary legislative and institutional safeguards for the supremacy of the law are in place. Citizens are equal before the law, have the right to a free and fair trial, and are free from arbitrary arrest or detention. Hungarian authorities generally respect court orders.

Independence of the judiciary

The independence of the judiciary is guaranteed by the Fundamental Law and key safeguards are in place to ensure its impartiality. Judges can be removed only for reasons and by procedures prescribed by the law.

Since the adoption of the previous Strategy, judicial independence in Hungary has been raised by EU institutions as a source of concern, including in the Article 7(1) TEU procedure initiated by the European Parliament.⁷ On 27 February 2019, the European Commission noted increasing concerns as regards judicial independence⁸. The level of independence of courts and judges is perceived as average by the general population, but low by companies. However, in 2020 both indicators have improved, changing a negative trend observed for a number of years.⁹

Government and citizens equally subject to the law

The Fundamental Law guarantees the equality of all citizens before the law and it is generally upheld in practice.

Effective policies and institutions to prevent corruption

Hungary is a signatory to the relevant multilateral anticorruption instruments, such as the UNCAC and the OECD's Anti-Bribery Convention. Although the legal framework can be considered satisfactory, and a comprehensive anti-corruption strategy is in place, enforcement in practice could be further strengthened.

New measures have been adopted, such as assigning the Minister of Interior as the minister responsible for co-ordinating the government's anti-corruption activities. A specialised department, the Corruption Prevention Department (CPD), has been established. Hungary has taken steps to make the national reports prepared for the Council of Europe's Group of States against corruption (GRECO) public. The UN Convention against Corruption's recent Article 7 report noted that measures taken by the Hungarian authorities to prevent and manage conflicts of interests are regulated to a high level. Furthermore, measures taken in the field of developing, implementing, monitoring and evaluating anti-corruption strategies, under Article 5 of the convention, have the proper regime in place ¹⁰.

According to the European Commission 2020 Country report on Hungary, corruption and anti-competitive practice remain an area of concern, particularly in public procurement.¹¹ The report also noted that determined systematic action to prosecute high-level corruption is lacking. The latest (2020) Transparency International Corruption Perception Index (CPI) ranked Hungary 69th out of 180 countries.¹² According to the authorities, public perception of corruption is higher than its actual occurrence.

7. European Commission, Rule of Law 2020, Country Chapter on the rule of law situation in Hungary, 30.9.2020

8. European Commission, 2019 European Semester: Assessment of progress on structural reforms, prevention and correction of macroeconomic imbalances, and results of in-depth reviews under Regulation (EU) No 1176/2011 (COM(2019) 150 final), Brussels, 27.2.2019

9. European Commission, Flash European barometer 484 and 483, Reports on perceived independence of the national justice systems in the EU among companies and among the general public, July 2020.

10. UNCAC, thematic compilation of relevant information submitted by Hungary, Article 7, paragraph 4 on conflict of interest and Article 5 on preventive anti-corruption policies and practices.

11. Ibid.

12. Transparency international, Corruption Perception Index 2020, January 2021.

Annex 1 – Political Assessment in the Context of Article 1

Civil and Political Rights

Freedom of speech, information, religion, conscience, movement, association, assembly and private property

Overall, civil and political rights continue to be respected in Hungary. The Constitution contains a comprehensive catalogue of fundamental human rights, including the rights to freedom of association and freedom of expression. Civil rights are legally codified and protected and the right to a fair and public trial is guaranteed.

Hungary is a signatory to major international human rights instruments. The Constitution guarantees basic freedoms and rights of citizens recognised in international law. Freedom of speech, information, religion and conscience, movement, association and assembly are therefore fully guaranteed. Property rights are generally respected and protected.

The last assessment of Hungary's track record in the area of human rights in the framework of the United Nations Universal Periodic Review (UPR) was adopted in 2016. The top three recommendations covered racial discrimination, international institution and women's rights. Hungary supported 85.2 per cent of the recommendations made in the course of the review process. Next review is scheduled in 2021.

Political inclusiveness for women, ethnic and other minorities

The Constitution prohibits discrimination on the grounds of race, colour, gender, disability, language, religion, political or other views, national or social origins, or other circumstances. Legislation is in place to combat racial incitement and hate speech. The newly adopted family protection plan highlights women's role in raising children within a family.

In terms of women's employment in the economy, Hungary performs better than the OECD average. According to the OECD, the gender wage gap is 9.4 percent (OECD average 13.2 percent).¹³

However, political inclusion of women remains relatively low and there are no legal requirements to promote gender equality in elections. The government has three women in the 14-member cabinet. The UN Human Rights Committee recommended in May 2018 that Hungary should adopt specific measures to increase representation of women in decision making positions.¹⁴ The proportion of female MPs in parliament is slightly higher than in 2014, but, at 12.06 percent, female representation remains among the lowest in the EU. The share of female representation in the European Parliament (EP) stands at 38 percent.

The authorities have continued their efforts to address the special situation of Roma through laws and other measures to improve their socioeconomic situation while remaining committed to the elimination of discrimination against them. An updated national Strategy 2011-2020 on social inclusion of all vulnerable groups is in place with an aim to combat poverty. Roma minority benefits from large scale horizontal programs for education and employment.¹⁵ Involving Roma is a crucial part of the strategy, as are raising general awareness and fighting discrimination. According to a report by the European Commission, Roma in Hungary continue to face various problems and their general living conditions and level of inclusion are low compared with the rest of the country.¹⁶ Hungary has the first Roma Vice president of the EP.

Freedom from harassment, intimidation and torture

Constitutional guarantees against harassment, intimidation, and torture are in place and are largely upheld in practice. A report by the European Committee for the Prevention of Torture and Inhuman or Degrading Treatment or Punishment (CPT), following a visit in 2018, acknowledged improvements made by the Hungarian authorities since its previous visit and made some additional recommendations on safeguards against ill-treatment in detention facilities.¹⁷

13. OECD gender wage gap, 2019.

14. United Nations, International Covenant on Civil and Political Rights, Human Rights Committee, Concluding observations on the sixth periodic report of Hungary, 9 May 2018.

15. European Agency for Fundamental Rights, Fundamental Rights Report 2020.

16. European Commission, Civil society monitoring report on implementation of the national Roma integration strategy in Hungary, October 2019.

17. Council of Europe, Report to the Hungarian Government on the visit to Hungary carried out by the European Committee for the Prevention of Torture and Inhuman or Degrading Treatment or Punishment (CPT) from 20 to 29 November 2018, 17 March 2020.