HUNGARY

Highlights

- **Robust growth is being driven by investment recovery and household consumption.** Investment grew at double-digit levels in 2017 and the first half of 2018, driven by rising credit to the private sector and accelerated European Union (EU) funds absorption.
- **The state is gradually reducing its ownership in the banking sector.** Following a successful sale of its stake in the small-sized Granit Bank, the government has committed to privatising the Budapest Bank, but the procedure has been delayed.
- **The tax wedge has been gradually reduced.** New measures are being introduced to continue with cuts to employers' social security contributions, helping to bring down the tax wedge which is among the highest in the OECD.

Key priorities for 2019

- **Labour reserves should be released through higher-quality active labour market policies.** In light of increasing labour shortages, new active labour market policies are needed because the current public work scheme has had limited success in bringing labour force participants back to regular employment.
- **Improving education and healthcare systems would increase Hungary's competitiveness.** Education and health outcomes remain below the EU average, reflecting the limited effectiveness of their provision by the state. A more active role for the Competitiveness Council in addressing these two areas would be welcome.
- **Productivity of SMEs should be improved.** Measures should focus on boosting innovation and value added, because despite the preferential lending schemes targeting small and medium-sized enterprises (SMEs), the productivity difference between large firms and SMEs still remains higher than in other EU countries.

Main macroeconomic indicators %

	2014	2015	2016	2017	2018 proj.
GDP growth	4.2	3.5	2.3	4.1	4.3
Inflation (average)	0.0	0.1	0.4	2.4	2.8
Government balance/GDP	-2.6	-1.9	-1.7	-2.4	-2.3
Current account balance/GDP	1.5	2.8	6.2	3.2	2.4
Net FDI/GDP [neg. sign = inflows]	-2.8	-1.1	-2.0	-1.3	-2.1
External debt/GDP	117.1	108.7	97.0	84.9	n.a.
Gross reserves/GDP	30.0	26.9	20.5	19.9	n.a.
Credit to private sector/GDP	67.8	69.1	70.2	65.0	n.a.

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Macroeconomic performance

Domestic demand is underpinning strong GDP growth. Household consumption has continued to strengthen since 2014, reaching 4.8 per cent growth in 2017. The key growth contributor in 2017, however, was investment, which increased by 18.2 per cent, lifting the overall GDP growth in 2017 to 4.1 per cent. In the first half of 2018, economic expansion accelerated further to 4.7 per cent year-on-year, fuelled by the continuously strong domestic demand. Despite strong exports, the net contribution of trade has been negative, as the recovered investment has required a major increase in imports.

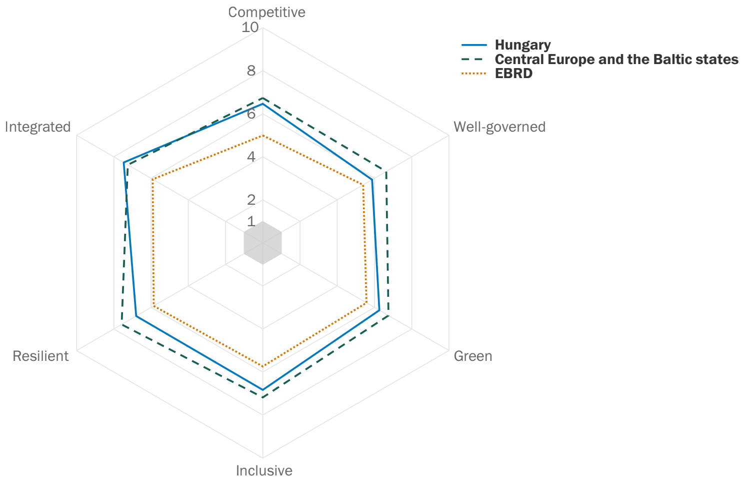
Banks' willingness to lend has improved, in particular to corporates. Following almost eight years of contraction, credit growth to the private sector started to recover in mid-2017. In the first half of 2018, corporate credit grew on average by 10 per cent year-on-year. At the same time, household borrowing also went up, although by just 1.0 per cent. Profitability of the banking sector has improved, while non-performing loans further declined from 7.4 per cent at the end of 2016 to 4.2 per cent by the end of 2017, below the central Europe and the Baltic states' average.

Labour shortages are among the most severe in the EU. According to the third quarter of the 2018 European Commission business survey, nine out of 10 companies in Hungary cite labour shortages as the key factor limiting industrial production. With unemployment rates at an historical low (3.9 per cent in June 2018), and employment rates at a peak of 74.4 per cent in the first quarter of 2018, the squeeze on the labour supply pool is negatively affecting companies' expansion plans and constitutes a threat to future economic growth. The government's gradual withdrawal from the public works scheme is expected to shift more workers towards the private sector, although more active labour market policies are required to bring more disabled, Roma and elderly people back to employment.

Fiscal policy remains pro-cyclical. Although fiscal policy has been pro-cyclical, the growing economy contributed to a government deficit of just 2.0 per cent of GDP in 2017, better than initially forecast. This was despite the reduction of the corporate income tax to 9.0 per cent, the lowest rate in the EU, and cuts to social security contributions. Public debt dropped in 2017 from 76.0 per cent to 73.6 per cent of GDP.

Economic growth is forecast to moderate. GDP growth in 2018 is expected to reach 4.3 per cent, before it slows down to 3.3 per cent in 2019. Strengthening credit to the private sector will further boost investment over the forecast horizon. Household consumption will also remain strong, although a rise in inflation may somewhat offset the ongoing increase in disposable incomes. The shrinking labour supply and potential turmoil in global trade constitute the main risks to the outlook, especially in the automotive industry.

Assessment of transition qualities (1-10)



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Major structural reform developments

Tax changes have been introduced. In July 2018, the parliament approved a package of tax changes for 2019. Among other things, the package includes the following: first, a reduction in social contributions by two percentage points to 17.5 per cent as of the second half of 2019, if private sector wages increase by more than 6.0 per cent in the first quarter of 2019. Second, tax relief will be eliminated for almost all kinds of fringe benefits although health insurance and pension saving may be left in the fringe benefit system (the so-called "cafeteria"). Third, a 25 per cent tax is being introduced on the revenues of non-governmental organisations (NGOs) that materially support the immigration of non-EU nationals without proper residency permits. The reduction in social contributions will help reduce Hungary's tax wedge, which is one of the highest among the OECD countries. However, the introduction of the tax on NGOs has led to the launch by the European Commission of an infringement procedure against Hungary in July 2018.

Steps to boosting the innovation and productivity of SMEs are being taken. In May 2018 the government established an innovation and technology ministry. The new ministry is expected to streamline the government's efforts to promote higher value-added creation among Hungarian corporates, including SMEs. A recent study by the National Bank of Hungary (NBH) showed that SMEs' productivity is on average only about a third of that in large companies.

New incentives for investment are being introduced. In April 2018, the government awarded HUF 17 billion (€53 million) of investment incentives for industrial development. A total of 65 companies will benefit from these incentives, supporting new investments worth more than HUF 38 billion (€118 million), mainly in new capacities and efficiency and technological improvements.

The government is gradually reducing its ownership in the banking sector. In December 2017, the state sold a 36.5 per cent stake in the small-sized Granit Bank for HUF 4.5 billion (€14 million). The state entered Granit Bank in mid-2013, acquiring a 49.9 per cent stake in the bank, which was diluted in late 2015 but without the state's participation. The government has committed to sell its stake in Budapest Bank but the procedure has been repeatedly delayed so far.

EU funds utilisation has been impressive. In the 2014-20 budget, Hungary was allocated €25 billion of EU funds, which represent about 3 per cent of GDP annually. By the end of 2017, about 94 per cent of the funds were already allocated to projects on the ground, and more than half was already disbursed.

The construction of the Budapest-Belgrade railway line has advanced. First applications for the tender were submitted in June 2018, which will be followed by negotiations, and a contract with the winning bidder should be signed by the end of 2018. The costs on the Hungarian side are estimated at €1.6 billion, and a part of that is expected to be financed through a loan from China. The connection is expected to be the fastest overland route from Greece to central Europe and is scheduled to be finalised by the end of 2023.