HUNGARY

Highlights

- **Investment has been the key driver of recent gross domestic product (GDP) growth.** Strong credit growth, substantial foreign direct investment (FDI) and funds inflows from the European Union (EU) are supporting investment, while household consumption also remains strong, boosted by sharp wage growth and increased government spending.
- **An economic protection programme has been introduced.** According to the authorities, this programme aims to increase the GDP growth rate by an additional two percentage points above the EU average in the coming years.
- **The cost of funding for eligible corporates has decreased.** The National Bank of Hungary (NBH) has launched a new scheme for corporate bond purchases. While the scheme provided liquidity to the market, it remains to be seen whether it will be able to trigger new private investment flows to the market.

Key priorities for 2020

- **Market-based non-bank financial instruments and a wider investor base should be further developed.** The capital market remains shallow and reliant on stimulus measures by the NBH. A greater availability of modern alternative sources of finance from the private sector would enhance investment and productivity.
- **Transparency and governance of EU funds' absorption need to improve.** In its annual report, the European Anti-Fraud Office concluded 52 probes into misuse of EU funds and recommended to the European Commission (EC) to recover 3.8 per cent of payments. This is the highest proportion within the EU.
- **More domestic enterprises should be integrated into global value chains.** Despite the great openness of the economy, domestic small and medium-sized enterprises (SMEs) are largely excluded from international value chains and do not benefit from technology and international skills diffusion.

Main macroeconomic indicators %

	2015	2016	2017	2018	2019 proj.
GDP growth	3.8	2.2	4.3	5.1	4.6
Inflation (average)	0.1	0.4	2.4	2.9	3.4
Government balance/GDP	-2.0	-1.8	-2.4	-2.3	-1.9
Current account balance/GDP	2.4	4.5	2.3	-0.5	-0.8
Net FDI/GDP [neg. sign = inflows]	-1.3	-2.2	-1.6	-2.1	-2.5
External debt/GDP	107.4	96.1	84.3	80.8	n.a.
Gross reserves/GDP	26.6	20.3	19.7	19.9	n.a.
Credit to private sector/GDP	68.6	70.2	64.5	62.1	n.a.

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Macroeconomic performance

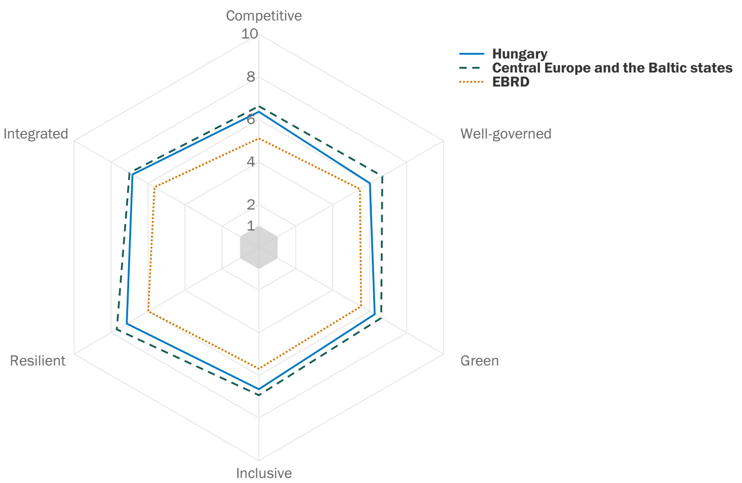
Investment and consumption are boosting GDP growth. Following the 5.1 per cent GDP growth in 2018, the economy continued to grow at the same pace in the first half of 2019. A substantial hike in investment and continuously strong household consumption were the key drivers of the strong GDP performance. Consumption was fuelled by strong gross nominal wage growth (above 10.0 per cent in annual terms) in both the private and public sectors. Salaries of employees in the central public administration were raised on average by 30.0 per cent from January 2019.

Investment growth has been impressive. Since 2017, investment has registered an average annual growth rate of more than 17.1 per cent and accelerated further to 20.6 per cent in the first half of 2019, the highest among the economies in central Europe and the Baltic states. In June 2019, the corporate loan stock increased by almost 15.0 per cent, supported by new subsidised lending by the NBH. Moreover, amid greater EU fund inflows, FDI inflows reached 6.3 per cent of GDP in 2018 but slowed down somewhat in the first half of 2019. Relatively strong FDI inflows are expected to continue as foreign companies, mainly in the automotive and aviation industries, and have already announced further greenfield and capacity expansion investments in the coming years.

Pro-cyclical government policies are preventing a greater budget deficit reduction. In 2018, the general government deficit narrowed slightly to 2.3 per cent of GDP, in a favourable macroeconomic environment. The government is planning both a 2.5 percentage point cut in employers' social contribution rates and higher expenditures related to various development programmes, such as family support or village development schemes. Despite this, the headline deficit is expected to fall to 1.9 per cent of GDP in 2019. According to EC estimates, the public debt is projected to fall below 70.0 per cent of GDP by the end of 2019, with a targeted reduction to 60.0 per cent of GDP by 2022.

Economic expansion is expected to decelerate, mainly due to weakening external demand. The stronger-than-expected performance of the economy in the first half of 2019 will help ensure continued strong growth of 4.6 per cent in 2019, but in 2020, we anticipate GDP growth to moderate to 3.1 per cent. This slowdown will be partially offset by domestic demand, powered by a double-digit recovery in corporate credit and still-strong wage hikes. The latter is largely a result of the tightening labour market, caused by the falling working-age population and mounting skill-mismatches. EU funds absorption will likely further underpin investment in 2019, but reduced EU fund inflows will constitute a drag on public investment from 2020 onwards. Trade disputes and the economic performance of Hungary's main trading partners, such as Germany, constitute negative risks to that scenario.

Assessment of transition qualities (1-10)



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Major structural reform developments

State withdrawal from the banking sector remains slow. The planned sale of Budapest Bank, acquired by the state in 2015, is on hold, as government plans and the timeline remain unclear. In January 2019 a minister without portfolio in charge of state assets was mandated to hold talks with potential investors regarding a potential sale of the bank.

The corporate bond market lacks a wider investor base. Currently, the corporate bond market represents around 1.6 per cent of GDP, below that of 6.0 to 7.0 per cent in peer countries such as Poland or the Czech Republic. In July 2019, the NBH launched a new HUF 300 billion (€930 million) scheme for corporate bond purchases (up to 70.0 per cent of a series). While the scheme provided liquidity to the market, it remains unclear whether this will introduce new private investors to the market.

An economic protection programme has been announced. The programme, initially announced by the Finance Ministry in May 2019, contains 16 economic support measures to counteract the negative impact of the economic slowdown in the eurozone. The measures include a reduction of social contributions by two percentage points, various tax changes and simplifications, more loan guarantees and research and development funding, assistance to companies for providing worker accommodation facilities and support for irrigation in agriculture. The authorities claim that this programme will boost the GDP growth rate by an additional two percentage points above the EU average in the coming years.

The government is taking measures to improve competitiveness. In June 2019, the NBH, at the government's request, unveiled 330 proposals in 12 areas for reforms to make the economy more competitive. The goal is to achieve higher productivity growth, driven by improvements in efficiency and export capacity of SMEs, reduced state bureaucracy and a renewal of the financial model (for example, through a prudent increase in lending, by strengthening alternative forms of financing or by promoting digital solutions). The NBH report also proposed reforms in healthcare. The report echoes largely the recommendations of the Competitiveness Council, a consultative body at the Finance Ministry, from November 2018.

The government has introduced measures to alleviate labour market shortages. In December 2018 the President signed an amendment to the labour code, raising the annual ceiling on working overtime from 250 to 400 hours. The amendment triggered a number of street protests and strike threats by trade unions. However, the Constitutional Court found the new law to be valid, noting that proposed overtime hours are still below some other EU countries.

A generous family support scheme aims to address demographic challenges. In order to enhance greater birth rates, the parliament approved new demographic and family support measures in April 2019, taking effect in July 2019. Measures in the adopted legislation include interest-free loans for married couples, grants for family purchases of seven-seated vehicles, write-offs of mortgage loans depending on the number of children in a family, and permanent income tax reliefs to women with at least four children. The anticipated cost of this family support is expected to add 0.1 per cent and 0.5 per cent of GDP to the budget deficit in 2019 and 2020, respectively. According to the EC 2018 Ageing report, the share of the working-age population in Hungary will fall by more than 11 percentage points in the next 50 years.

The EC has referred Hungary to the European Court of Justice for non-compliance with EU law for its asylum-and-return legislation with the EU. In September 2018 the European Parliament adopted a resolution proposing that the Council determine whether there is a risk of a serious breach of the values on which the Union is founded.