DOCUMENT OF THE EUROPEAN BANK
FOR RECONSTRUCTION AND DEVELOPMENT

STRATEGY FOR HUNGARY

As approved by the Board of Directors at its meeting on 23 March 2016

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EXECUTIVE SUMMARY

Hungary is committed to and is applying the principles of multiparty democracy, pluralism and market economics in accordance with the conditions specified in Article 1 of the Agreement Establishing the Bank.

Hungary is a functioning multi-party parliamentary democracy that joined the European Union in 2004. Since the adoption of the last strategy, Hungary's governing coalition has relied on its two-thirds parliamentary majority to implement a significant transformation of its legal system and political institutions by adopting a new Fundamental Law (Constitution) and a number of cardinal laws. Some aspects of this transformation improved efficiency and helped to consolidate the political system. However, the European Union, the Council of Europe and the OSCE raised questions about their impact on the strength of checks and balances in the political system, the commitment to guarantee the freedom of expression and inclusive political decision-making. The Hungarian authorities have acknowledged these concerns by introducing multiple amendments to the Constitution and legislation.

The impact of the global financial crisis in 2008-2009 left deep scars on Hungary. It exposed the vulnerabilities of a country that, although well integrated within the European and global markets, evidenced persistent fiscal imbalances and high public debt coupled with an exceptionally elevated level of FX denominated commercial bank loans, particularly mortgages and consumer financing.

Adjustments started in late 2008 and 2009 and the new government, elected in 2010 and subsequently re-elected in 2014, has vigorously pursued significant economic and structural reforms. Among other things, the government has targeted further fiscal consolidation, although at times not in a fully business friendly manner, and has effected the winding up of the painful legacy of the FX mortgages and car loans. This has led to an overall strengthening of the role of the state and increasing domestic, including public, ownership in the real economy. The economy has stabilised and growth has picked up, albeit at a cost that may have hampered an inclusive and private sector led economic growth.

Hungary's strong growth rate in 2014 and continued growth in 2015, along with the Government's commitment to unwind state involvement in the banking sector, have given a welcome support to business confidence. Nevertheless, structural challenges remain significant in many sectors, particularly with respect to banking, energy and other public utilities, labour market policies as well as education.

Against this backdrop, the main objectives of the Bank's activities in the forthcoming period in Hungary, an advanced transition country, are defined against the remaining transition challenges and the potential scope for the Bank to help re-energise and support reforms in well-defined areas through investment and policy reform dialogue, and thus contribute to sustainable economic growth. The Bank's engagement must also be seen in light of the important commitments contained in the Memorandum of Understanding ('MoU') concluded between the Government of Hungary and the EBRD in February 2015. Full implementation, including the Government's commitment to creating a predictable and business-friendly tax and policy environment for the banking sector, will be critical.

The Hungarian authorities have reaffirmed their commitment to the principle of graduation. As per the Strategic and Capital Framework for 2016-2020, the main instrument for decision-making on graduation is the respective country strategies, jointly agreed by the Bank and country authorities. Hungary has confirmed that it will continue to keep the question of graduation under review and that the present strategy is consistent with a path towards graduation at the appropriate time.

In this context, the Bank will pursue the following strategic priorities:

- **Strengthening banking sector resilience and the capacity to lend.** The February 2015 MoU provides a clear basis for the improvement of the policy, regulatory and tax environment for banks, and states the Government's intention to divest its strategic stakes in the sector. To the extent that the agreed measures under the MoU are consistently implemented, the Bank will be able to support the financial sector in areas such as privatisation, and will also support sector consolidation and seek to help banks improve their asset/liability maturity profile by providing long term funding on sustainable and commercial terms. The Bank will also continue its cooperation with the Government and the Hungarian National Bank (MNB) as they take steps to enhance the legislative and institutional framework in support of NPL resolution. In this context, the Bank will continue to provide policy advice and technical assistance to enable faster and more efficient NPL resolution under the Vienna Initiative.

- **Improving further Hungary's energy security through strengthening market based regional interconnections, optimising the use of storage capacities and enhancing energy efficiency.** The Bank will seek to play a role in supporting the development of key energy infrastructure projects, including commercial gas interconnections to facilitate the two way flow of gas and to develop a more trusted and liquid Hungarian gas exchange. These projects are fundamental to enable Hungary to optimise and diversify its existing resources, most notably its significant storage capacity and indeed to support the broader goal of energy security on the basis of economically sustainable tools – both for Hungary and for the region as a whole. With regard to energy efficiency, significant challenges remain and consequently the potential exists for the Bank to be actively involved in energy savings projects.

- **Enhancing competitiveness and addressing innovation gaps.** The Bank will support well-selected local companies in catching up to the technological frontier, both directly and through private equity channels, and will also help them become more competitive by strengthening their operational efficiency and managerial capacity. The Bank will pay particular attention to companies operating in the less developed regions, and will generally look for equity investment opportunities where this can be used to underpin private sector balance sheets in companies which show real growth potential. The Bank will also look to build more commercial and competitive market structures in targeted sectors, such as municipal and inter-city transport, based on an analysis of the competitive environment and through a variety of channels. In so doing, the Bank will seek to address deep-rooted inefficiencies within these sectors stemming in part from a lack of competition, the inefficient use of energy, insufficient private sector participation and the need for financial and operational restructuring.

1 OVERVIEW OF THE BANK'S ACTIVITIES TO DATE

1.1 The Bank's current portfolio

Private sector portfolio ratio: 88.7 per cent, as of 31 January 2016

Sector Group	Sector Team	Portfolio no of operations	Portfolio (€m)	% Portfolio	Op Assets	% Op Assets
Energy	Natural Resources	3	119	23%	119	29%
	Power and Energy	2	51	10%	51	12%
		5	**169**	**33%**	**169**	**41%**
Financial Institutions	Depository Credit (banks)	2	1	0%	1	0%
	Insurance, Pension, Mutual Funds	0	0	0%	0	0%
	Leasing Finance	0	0	0%	0	0%
	Non-depository Credit (non-bank)	0	0	0%	0	0%
		2	**1**	**0%**	**1**	**0%**
Industry, Commerce & Agribusiness	Agribusiness	3	9	2%	3	1%
	Equity Funds	18	40	8%	18	4%
	ICT	1	0	0%	0	0%
	Manufacturing & Services	1	10	2%	0	0%
	Property and Tourism	3	49	10%	43	10%
		26	**108**	**21%**	**63**	**15%**
Infrastructure	Municipal & Env Inf	1	55	11%	7	2%
	Transport	6	174	34%	174	42%
		7	**228**	**45%**	**181**	**44%**
Summary		**40**	**507**	**100%**	**414**	**100%**

Source: EBRD Business Performance Navigator

1.2 Implementation of the previous strategy

The last Country Strategy for Hungary, which was developed and approved during the global financial crisis and the economic recession in the European Union (EU), set out four main strategic priorities: (i) strengthen financial sector resilience; (ii) address deep-rooted inefficiencies in the transport sector stemming in part from insufficient private sector participation and a lack of restructuring of transport companies; (iii) support diversification of Hungary's energy supply, and renewable energy and energy efficiency investments; and (iv) secure and expand the country's role as an export platform of technology and skills intensive products.

As the 2012 Country Strategy Update noted, without a clear, predictable framework for structural reforms, and in light of the economic policies chosen by the Hungarian government, the environment for the Bank's projects remained risky and constrained, and in particular financial sector projects to strengthen resilience and public sector projects to facilitate reforms were difficult to identify and structure.

As the government's economic policy continued to evolve, the 2013 Country Strategy Update changed the emphasis in the Bank's strategy towards the corporate sector, reflecting Hungary's impaired financial system and government priorities at the time. As part of this shift, the Bank focused on seeking to fund corporate investments, including restructuring, given the retrenchment in credit to the private sector.

Despite heightened additionality in these crisis conditions, and the adjustments made to the Bank's strategic priorities, the Bank's objectives have only been partially achieved, while a number of earlier transition achievements in the country have been reversed.

Specifically, over the last three years of the strategy period, the Bank assessed that Hungary's transition indicator ratings fell in eight sectors (natural resources, power, railways, water and wastewater, banking, insurance and other financial services, and capital markets and telecommunications). The government, re-elected in spring 2014, has sought, among others, to increase domestic ownership in the banking and energy sectors (including through increasing state ownership), and to centralise public utility service provision, with a view to achieving lower utility costs to customers, primarily households. It is also worth noting that Hungary's ratio of private capital formation to GDP is one of the lowest in the EU.

During the strategy period the Bank has invested EUR 351 million in 18 projects. In value terms, close to half of the investments were in the energy sector (3 transactions, including one major restructuring commitment), while the remaining investments were in the financial, corporate sector (including 7 investments into regional equity funds) as well as in municipal infrastructure.

In the **financial sector**, the Bank delivered a cross-currency swap programme to address the structural currency mismatches in the balance sheets of Hungarian banks, at a point when access to medium and long-term FX swaps was disrupted and while regulatory demand for banks to improve the diversification and independence of their liquidity management and funding was increased. In the strategy period, two banks joined the programme.

Apart from these, the Bank's activity in the financial sector was curtailed by the unpredictable government and central bank policies and subdued credit growth. Efforts to foster regulatory change that could have opened capital market funding for banks were stalled. Due to market and regulatory constraints, non-performing loan (NPL) resolution was also limited, as in many other countries in the region. Nonetheless, as NPL resolution was coming to the fore of the Hungarian National Bank (MNB)'s priorities, in 2014 the Bank assisted in conducting a review and analysis of the existing framework for enforcement, corporate restructuring and insolvency with the objective of addressing the high level of corporate NPLs. With MNB's leadership and in the context of the Vienna Initiative, the Bank has stepped up its policy advice to the relevant stakeholders, providing support to address the identified impediments to efficient NPL resolution.

Private corporates were supported directly as well as via regional equity funds, which invested EUR 35.5 million into Hungarian SMEs. The Bank supported a leading Spanish automotive component manufacturer's investment in Hungary, and provided debt and equity financing to the largest French grain collector and malt producer to fund working capital needs and the capex programme of its subsidiaries in Central Europe, including Hungary.

In the **infrastructure sector**, while the public sector (municipalities/state) state was buying out private shareholders/operators in municipal utility companies, the financing of the Budapest Automated Fare Collection (AFC) system is enabling the Bank to support private sector involvement in the delivery of public services in the urban transport sector. Disbursements began in 2015. Nevertheless, it may be possible to replicate the structure of the AFC project in several second-tier cities, which remains to be explored in the next strategy period. As the government has reviewed all PPP contracts signed under previous governments, the underlying structure and contracts for **concessional motorway** projects for which the Bank had previously provided financing stayed in place, and the Bank has supported the regular dialogue between its concessionaire clients and the relevant authorities. However to date, and despite a formal request by the government back in 2010-2011, the Bank has been unable to engage with the government on the **railways** company MAV, to address the deep rooted inefficiencies in this public transport sub-sector due to very slow and limited progress with railway restructuring.

In the **energy sector**, the Bank supported a cross-border investment by financing MOL, the leading Hungarian oil and gas group to implement energy efficiency and environmental improvements in their Slovak subsidiary. The Bank's participation in restructuring the debt of the underground strategic gas storage was critical in giving comfort to the commercial banks that support this transaction and in opening a dialogue with the authorities on gas sector regulation and standards. The Bank also commissioned a report on the gas market in Hungary and organised a workshop with the participation of the private sector and several authorities. The participating authorities have welcomed the report and have confirmed the importance they attach to adhering to the EU guidelines and to undertaking further investment to enable the country to optimise their gas storage resources and to enhance energy security. The Bank has not been able to identify new opportunities for investments in energy generation from renewable sources. According to the European Commission's latest Renewable Energy Progress report of June 2015 the achievement of the 2020 renewable energy targets in Hungary, as in the case of some other EU member states, is not certain and it is only under optimistic assumptions related to the future development of energy demand and country-specific financing conditions that the 2020 renewable energy targets appear achievable.

1.3 Lessons learnt

As mentioned above, despite the heightened additionality and adjustments made to its priorities during the last strategy period, the EBRD was hamstrung in fully pursuing the country strategy objectives on both the investment and policy dialogue fronts. The unpredictable policy changes and tax regime, the unstable regulatory framework, a growing government involvement in the real economy, particularly through concessional lending schemes that have distorted the market as well as the acquisition of banks, corporates and utility companies from private shareholders – have all contributed to making progress on the Bank's transition impact driven strategic agenda difficult.

Specifically, the challenging business climate constrained banking activity and made it difficult to achieve much in the financial sector due to: (1) high bank levy and other restitutionary charges related to past FX lending activity; (2) low loan demand due to the unwillingness of businesses to invest in the current climate, and (3) high NPLs, which remain at about 16 per cent of the loan portfolios, thus diverting management time as well as capital use. All this resulted in significant bank deleveraging.

In order to enhance the effectiveness of the Hungarian banking sector, in February 2015 the Government of Hungary and the EBRD signed, at the highest levels, a Memorandum of Understanding (MoU) for cooperation in support of the financial sector and real sector in Hungary. With the MoU, the signatories agreed that a sound banking sector represents a key foundation for long-term sustainable economic growth, and the Government of Hungary confirmed its intention to promote a stable and predictable policy and regulatory framework for the banking sector to support macroeconomic stability, including a reduction of the bank levy. The MoU set out the broad priorities for cooperation in support of the real economy. It specifically targets a reduction in the bank levy along a time-bound schedule, reducing state ownership in the sector, and to refrain from further measures that may adversely impact bank profitability. In June 2015 the Parliament adopted the Budget Act for 2016, which includes amendments to gradually reduce the bank levy in line with the MoU. However, the agreements reached within the MoU were jeopardised following the introduction of a new law passed by Parliament in April 2015 (the "Quaestor Act"), which required the banks to fund certain significant additional payments to compensate investors in the bankrupt Quaestor brokerage house. The banks challenged this new law on the basis they were not responsible for the actions of a fraudulent broker supervised by the National Bank of Hungary. Moreover the reasons for the new law were never explained and it was considered by the banks (and indeed the EBRD) to be a clear breach of the MoU in that this was a new law that directly impacted bank profitability. The matter was passed to the Constitutional Court which eventually concluded that the law was indeed unconstitutional. To address this, Parliament has subsequently amended the law in a manner that is considered by the Banking Association to be broadly acceptable and, consequently, in line with the MoU.

The challenging business environment also inhibited the development of the private sector. Following a period of low investment rates, companies will have to start investing to grow market position and competitiveness. Support for innovation and further development of export markets, including beyond the European Union, have been among the Government's priorities. To boost investments the Government and the National Bank of Hungary (MNB) have launched a number of lending initiatives channelling a significant amount of subsidised funding into the economy, directly or through the banks. This has made the offering of traditional commercial funding solutions by banks significantly less attractive both for the banks and the investors. Following the announcement of regulatory changes by MNB that will require banks to have initially at least 15 per cent of their mortgage book financed by long-term funding, there may be an opportunity for EBRD to support long-term funding through mortgage bonds. Although, Hungary has been regarded as an advanced private equity market in Central Europe and the JEREMIE supported equity funds have been successful, the overall supply of equity funding has been limited as private equity funds shifted their focus to more stable and faster growing economies in the region and the local capital market development has remained subdued. It is expected that the demand for the Bank's debt and equity funding will start growing over the strategy period as companies need to invest and strengthen their balance sheets.

Hungary has substantial gas storage and gas pipeline capacities, including interconnectors. However, in order to optimise their use and also enhance the country's (and indeed the region's) energy security further, reverse flow capacity would need to be developed. Further significant investments would be required to develop smart metering and smart grid as well. New, commercial solutions to increase energy efficiency could give additional boost to energy security. The Bank, having financed gas storage capacities and the first ESCOs in the country, should be well positioned to help address these energy security challenges and engage in related policy reform dialogue.

Hungary needs a significant amount of investment in the coming years to rehabilitate and modernise the existing public transport infrastructure and rolling stock, including in the metro, tram and the bus transport. This is particularly acute in the capital but also needed in the other secondary cities. The magnitude of these investments is such that it will require EU and IFI funding in particular for the larger infrastructure projects. The Bank will seek to take a lead in providing funding solutions on municipal or transport company level as opposed to the state driven funding solutions. Working together with the EIB could strengthen the Bank's position in achieving progress with policy dialogue initiatives to further promote commercialisation and private sector involvement in the provision of the urban transport services.

2 OPERATIONAL ENVIRONMENT

2.1 Political context

Hungary is a functioning democracy that joined the European Union in 2004. The current coalition government is formed by two centre-right parties, the Young Democrats' Alliance-Hungarian Civic Union (Fidesz), led by Prime Minister Viktor Orban, and its junior partner the Christian Democratic People's Party (KDNP). Together these two parties won two-thirds of the seats in parliament in the 2010 general elections and again in the 2014 elections in contests that were competitive and free. The coalition lost their constitutional majority after losing two seats in early by-elections.

The coalition, drawing on its two-thirds majority support in parliament, has overhauled Hungary's political institutions by adopting a new Constitution and passing over 500 laws and legal amendments since coming to power. The Constitution and many of the new laws were adopted without support from minority parties in the parliament.

According to the government, these reforms were intended, in part, to address longstanding issues related to the legacies of the communist system, the need to streamline the state bureaucracy and to reduce dependency on the state social security system. However, these changes also centralised political power, diminished democratic checks and balances in the system and introduced legal uncertainties due to the number of amendments introduced.

During the strategy period, questions have arisen with regard to the independence of the judiciary. The new Constitution and subsequent amendments established the National Judicial Office (OBH), increased the number of judges in the Constitutional Court, and modified the scope of its powers, including some limitations on its former role. At the same time, the integrity of Hungarian courts has been upheld and the authorities respect court orders.

The European Commission deemed some provisions of the new Constitution to be incompatible with EU laws and initiated several infringement cases in recent years, which resulted in adjustments to the Constitution and the relevant laws. The government, for example, reversed its decision to force judges to take early retirement after the European Court of Justice ruled that it was incompatible with EU law. The OSCE and the Council of Europe have also raised concerns over certain provisions of the new Constitution, media law and several laws relating to fundamental rights and freedoms. The Hungarian government responded by amending the relevant laws.

Many of the recent changes were enshrined in so called ‘cardinal laws’ which would require a two-thirds majority to amend. Although the popularity of the ruling coalition has declined after the 2014 elections, the only serious political challenge that it faces comes from the far right Jobbik party, which won the third largest number of votes on its party list and recently the first directly elected MP.

2.2 Macroeconomic context

Between 2006 and 2013 Hungary’s economy experienced two recessions and intermittent weak growth. This trend changed when a stronger recovery that was led by domestic demand began in 2014, when growth accelerated to 3.7 per cent, a pace that slowed down slightly in early 2015. Increased public sector investment expenditures in part reflected a better utilisation of EU grant disbursements. One-off factors such as the recovery of the agriculture sector also helped, as did terms of trade gains related to the oil price decline and more generally a sharp drop in inflation and its support to real household incomes. Even though Hungary is a highly open economy with a relatively advanced export structure, the net contribution of exports remained modest in the context of weak external demand from the eurozone, its main trading partner, and well below previous years.

Despite the positive recent growth picture, Hungary’s medium term growth fundamentals could be further strengthened. Capital formation suffered in the years following the European financial crisis, even though over the past two years there has been a welcome revival in private investment activity. FDI inflows, formerly a key support to capital formation, are lower than before the crisis, similarly to trends prevailing all over Europe. Consequently, the rate of productivity growth has been more modest. The contraction in the workforce has been arrested and the labour participation rate has returned to a steadily increasing path, in part due to public work schemes and the Job Protection Plan. However, some demographic trends (e.g. aging population) remain a concern.

The government has persevered with fiscal consolidation efforts. Redressing Hungary’s large fiscal shortfall was in large measure based on sector-based taxes. These so-called ‘crisis taxes’ distorted incentives, but the government in recent years began substituting these taxes with consumption taxes that are assessed on a wider base. In 2012 the budget deficit fell below EU threshold levels, which allowed for the long-awaited exit from the EU’s Excessive Deficit Procedure, to which the country had been subject since accession in 2004. This was a major milestone; since then a continuously decreasing fiscal deficit has been rigorously achieved.

In 2011, the government shifted nearly the entire stock of the mandatory, second pillar private pension savings into the state system. This measure was motivated both by concerns over the slow establishment of a budgetary funded pillar, as the budget deficit remained high, and over the management costs within the industry. Public debt and the ongoing dependence on foreign financing remain vulnerabilities. At the end of 2014 the general government debt still stood at 76.2 per cent of GDP, one of the highest among the new EU countries.

The National Bank of Hungary has loosened monetary policy in the context of very low inflation. For 2014 as a whole the consumer price index showed no increase over 2013, in part helped by three earlier across-the-board administrative cuts in utility tariffs. Since the second quarter of 2014 the price level intermittently fell in annual terms. This deflationary tendency, which is also evident in other economies in the region with independent exchange rates, has prompted the MNB to steadily reduce the key policy rate. The programme of quantitative easing by the European Central Bank has led to a brief period of appreciation of the forint, and prompted the central Bank to resume this easing policy.

The National Bank of Hungary has also implemented concessional lending schemes to incentivise credit recovery. It has sought to counteract the ongoing contraction in corporate credit through the 'Funding for Growth' scheme (FGS), which was initiated in 2013. Commercial banks obtain credit facilities at zero interest cost from the central bank for on-lending to the SMEs at a rate of no more than 2.5 per cent (the 2.5 per cent interest rate margin must include all fees and commissions as well as costs of potential credit guarantee). About HUF 1,325 billion, or roughly 4 per cent of GDP, was disbursed until early 2015. The second phase of the programme has met with only modest demand early on, although the deadline for drawing loans in the FGS I. pillar has been extended to the end of 2016. In the future, smaller and riskier SMEs will also benefit from the programme, and banks may be allowed to charge in excess of 2.5 per cent interest margin. While the programme has contributed to a modest revival in corporate credit, lending outside the programme remains hampered by risk aversion and tight credit conditions.

Overall, Hungary has benefitted from is trade and investment openness. At the same time the size of external debt and refinancing risks are vulnerabilities. The country remains exposed to a change in capital market conditions, in particular given the past large reduction in its policy interest rate.

2.3 Structural reform context

Structural challenges remain significant in many sectors, particularly with respect to banking, energy as well as labour market policies and education with focus on transition to labour market and the promotion of inclusive mainstream education for disadvantaged groups.

Overall, businesses are burdened by a relatively high level and number of taxes, though 'special taxation' is concentrated in a small number of non-tradable sectors. Uncertainty in the tax regime and regulatory changes, which were in the past often adopted speedily with limited consultation of the private sector, still have a lingering effect that dampen confidence of both domestic and foreign investors. Legal and institutional changes have strengthened overall government control over the economy.

The government announced plans already in 2010-2011 to take closer control over the country's energy sector with a view to lowering energy costs, particularly for households. The gas storage facilities - strategic and commercial - were transferred into majority state-ownership in 2013, as private investors, E.ON and MOL, sold their stake. A series of administratively decreed cuts to household utility tariffs since 2013 further underline the government's stated aim to reorganise the utility sector essentially as non-profit companies. A state-owned First National Public Utility Company was set up in early 2015 to take over the retail gas supply through Fogaz, which is majority owned by the state after RWE's exit, and plans to extend its services to power and district heating supply. The household tariff cuts, the introduction of 'infrastructure network tax' and the emergence of strong, state-owned energy utilities have materially impacted the investment environment, with several private investors divesting to the government or returning their retail supply licenses. The financial viability of the water and district heating sectors are similarly in doubt. The joint regulator for energy and other public utilities (water and solid waste) has limited commercial pricing in these sectors.

As noted, the banking sector has faced a number of challenges and burdens, including the financial sector levy introduced in 2010 and, as of 2013, the financial transaction tax. Restitution of certain loan charges made on foreign currency denominated retail loans further depressed the earnings outlook. At the same time, in December 2014 most foreign exchange denominated mortgages were fixed at then prevailing exchange rates, and subsequently converted into local currency. Banks were given access to MNB's liquidity to fund the resulting currency mismatch. Fixing the exchange rate fortuitously protected retail borrowers and the banking sector in Hungary from the fallout from the rapid appreciation of the Swiss Franc in early 2015, which has since plagued other banking systems and their retail borrowers. Overall the exposure and vulnerability of the households and of the banking sector as regards FX loans were practically eliminated.

The government has also pursued, and by the end of 2014, achieved its clearly stated objective to reduce the share of foreign-owned banks within the sector, and to expand the share and role of institutions in domestic, including state, ownership to above 50 per cent.

NPLs stand at about 16 per cent in both corporate and retail loans. Incentives for banks to divest of or restructure non-performing portfolios have been weak to date. Market transactions in distressed portfolios have been minimal, and the principles for out-of-court restructuring have been largely ineffectual. The programme of regulatory and legal reform, which has in part been supported through technical assistance provided by the EBRD, should help overcome certain obstacles. The establishment of an asset management company under the MNB, while unconventional, could further support the necessary process of balance sheet cleansing.

In this context, the MoU agreed between the EBRD and the Government in February 2015 indicated a welcome change of direction in policies towards the banking sector. The government committed to a reduction in the financial sector levy as it applies to banks, and for which the base on which the levy is calculated will be adjusted to the 2014 balance sheets. Moreover the government committed to refrain from further measures that may adversely impact bank profitability, ensure fair competition, adopt best practices in NPL resolution, and divest all majority equity stakes in banks back to the private sector (see section 3.2 below). The MoU was considered a major positive development in the sector and more generally in the business environment, and the Budget Act for 2016 adopted in June 2015 provided, amongst other things, for a gradual reduction in the bank levy in line with the MoU. However, during the year it became apparent that certain additional tax benefits, outside the scope of the MoU but nevertheless included in the Budget Act for 2016, were a point of contention with the European Commission, which cited a possible violation on the ban on state aid. To address this, in December 2015, Parliament amended the Budget Act for 2016 by reducing the rate of the bank levy for 2016 and at the same time reverting to the 2009 balance sheets as the basis for the underlying calculation. Although the net effect on individual banks varied, the net tax reduction across the industry as a whole remained at approximately the same level as that envisaged in the MoU. The government has indicated its commitment to enact further legislation during the first half of 2016 with regard to further tax reductions for 2017 and beyond, in line with the MoU.

2.4 Access to finance

Private sources of capital

Private sources of funding for Hungarian companies (unless they are among the few large local corporates) are limited. Companies rely predominantly on bank loans rather than on capital market financing. Particularly for mid-cap companies and SMEs, the access to finance is a challenge.

Over the strategy period, the Credit to Private Sector to GDP ratio dropped from 57.9 per cent in 2011 to 41.4 per cent at end 2014. Net corporate credit showed a further decline in the first half of 2014. Surveys continue to point towards risk aversion and restrictive conditions in terms of collateral requirements. As banks continue to be plagued by high taxes and recurring initiatives in household debt restructuring, and credit demand remains low, liquidity continues to flow out of the country.

The Hungarian capital market is relatively developed, but liquidity has suffered from the redressing of the mandatory private pension system and government measures negatively impacting financial institutions. Initial public offerings (IPOs) and corporate bond issues are rarely used to raise capital from institutional and private investors. The corporate bond market is still significantly underdeveloped compared to emerging markets globally. The majority of corporate bonds are fixed rate and the market is largely a buy-and hold market. Corporates have little direct access to the bond market, with FIs accounting for over 80% of local currency bond issuance by value. The outcome is similar in foreign currency bonds. In 2014, corporate bonds of an amount of €13.5 billion were issued, including €3.5 billion in local currency. Issuance cost is high with investment banks requiring arranging fees of between 2% to 3% for a three year corporate bond. Corporate cost of funds shows high variation. In 2014, the cash market capitalisation was €62.4 billion, of which equities accounted for €12 billion. Equity trading is highly concentrated in four blue-chips, with OTP accounting for a 58 per cent share in trading. The trading activity of Hungarian retail investors was around 20 per cent in the equities market, a slight decrease from 2013. However, the record amount of mutual fund assets under management, with a value of HUF 5,360 billion (about EUR 17 billion) in August 2014, shows that investors could be a strong base for the growth of the Hungarian private sector.

Private equity and venture capital investments in Hungary totalled EUR 183 million in 2014, according to the Hungarian Private Equity and Venture Capital Association (HVCA), with 107 investments in 96 companies. 73 per cent of such investments were in the business and industrial services sector as well as in energy and environmental operations related businesses. The 19 EU - JEREMIE funds in Hungary, also leveraging private capital, accounted for some 20 per cent of such investments.

Public sources of capital

There are three state-owned development financial institutions: (i) the Hungarian Development Bank (MFB); (ii) the Hungarian Export-Import Bank (Eximbank) and (iii) the Hungarian Export Credit Insurance (MEHIB).

MFB offers products to almost all actors in the Hungarian economy: (i) SMEs, which through their development activities, might increase their technological efficiency and create additional employment; (ii) municipalities, by providing development funding; (iii) the retail sector, primarily in the area of energy efficiency and environmental investments; and (iv) large enterprises by funding large-scale development projects. It has significantly expanded its operations, including an increased role in channeling the 2014-2020 EU funds to the real economy through debt, guarantee and equity products.

Eximbank and ***MEHIB*** offer products for direct export pre-financing and supply-chain financing facilities to SMEs, as well as investment financing for export oriented corporates, and loan guarantee products. Both institutions have materially stepped up their activities during the last 3-4 years.

To stimulate SME lending, the ***National Bank of Hungary*** introduced the "Funding for Growth Scheme" (FGS) in June 2013. FGS aims to support SMEs in accessing local currency loans, as mentioned above, by providing funding to participating commercial banks at a zero per cent interest rate with a maximum maturity of 10 years. Banks may on-lend FGS funding to corporate clients at the capped all-inclusive interest rate of 2.5 per cent.

The deadline for drawing loans in the FGS I. pillar has now been extended until the end of 2016. The extension was focused on new lending, as opposed to refinancing, and widening eligibility criteria. While these funds were almost fully allocated to commercial banks, disbursements to SMEs have been very slow. The fixed margin in the lending rate and a slow and cumbersome process in guaranteeing loans remain key impediments. Under the framework of the FGS, SMEs which fulfil the eligibility criteria can contract with credit institutions and financial enterprises participating in the programme until the end of December 2015. In case of new investment loans and loans providing pre-financing of EU grants in connection with investments and financial leasing, there is a possibility to disburse part of the loan in the first half of 2016 and in case of factoring to revolve until 31 December 2018.

The European Union and MDBs
The key and predominant provider of development funds to Hungary is the ***European Union (EU)***, which committed EUR 24.9 billion in the period 2007-2013 under the European Regional Development Fund (ERDF), European Social Fund (ESF) and the Cohesion Fund (CF). Hungary is placed in the middle range of EU countries in terms of fund absorption as by the end of 2014 Hungary disbursed close to 80% of the funds available for the budget period.

Based on the EU-funding plan presented in 2014, covering the 2014-2020 term, Hungary is planning to utilise funds of EUR 34.5 billion, comprising EUR 25.4 billion in EU funding, and EUR 9.1 billion of Hungary's own contribution. The Hungarian government's intention is to utilise 60 per cent of the funds to directly support economic development and employment and 40 per cent for infrastructure and human resource development. In this regard Hungary intends to implement, as agreed with the European Commission, the largest SME competitiveness programme in the European Union (EUR 9 billion) to enhance the capacity of SMEs for research, innovation and job creation. Financing under the JEREMIE programme (Joint European Resources for Micro to Medium Enterprises) has been available in Hungary with a good implementation track record of providing equity to SMEs. The new SME competitiveness programme will facilitate the use of financial instruments further. Hungary has indicated that it plans to access and leverage funds under the Juncker Plan for the development of digital technology as well as transport and energy infrastructure, including regional gas pipeline development.

The ***European Investment Bank (EIB)*** has continued to be a significant source of official co-financing in Hungary, including for co-financing with EU Structural Funds. EIB's primary focus in Hungary is on reducing disparities in regional development, strengthening economic competitiveness of mid-caps and SMEs and on improving transport and telecommunications.

In the period 2010-2014 EIB committed about EUR 6.14 billion to projects in Hungary. During the past five years EIB's funding was invested, among others, in industry, services and agriculture (20%), transport and telecommunications (20%), as well as several small and medium-scale projects (24%).

In 2014, EIB signed EUR 756 million in new financing, including credit lines to private and public financial institutions and several projects targeting infrastructure (rail developments and energy infrastructure in the public sector).

Hungary 'graduated' from the ***World Bank Group*** operations in 2007. It is not any longer under an ***IMF*** programme as in 2013 the country pre-paid its debt from the 2008 IMF programme. However, IMF provides advisory services as, for instance, has been requested by the Government in the context of NPL resolution.

2.5 Business environment and legal context

Business environment

Hungary has traditionally been an attractive base for multinational export-oriented companies. Nevertheless, since 2010 the government has pursued frequent legislative changes, tax initiatives and ownership acquisition by the state. The more uncertain regulatory and business environment is beginning to be reflected in international indicators.

Hungary's position in the World Bank's *Doing Business* in 2016 rankings, which introduced a new methodology in 2015, has been downgraded (by two places) compared to 2014 and it remains low compared to other advanced transition countries in the region (e.g. Poland, Slovakia or Romania), at 42nd out of 189 economies. The World Bank assessment downgraded Hungary in the following sub-categories: paying taxes, dealing with construction permits, getting electricity, registering property and resolving insolvency. Hungary's ratings for starting a new business have remained low (significantly better than some transition countries, e.g., Poland and Slovakia, but lower than those of the Baltic States or Romania), including due to a requirement for minimum paid-in capital that currently represents about 47.7 per cent of annual income per capita (compared to an OECD average of only 9.6 per cent). In the previous edition of the rankings, Hungary's overall index rating benefitted from some improvement in the component sub-index for credit information.

Business regulations have nevertheless been simplified in certain ways, including through the elimination in 2013 of dual regulations under the civil and commercial regulations.

In the 2012-13 EBRD/World Bank Business Environment and Enterprise Performance Survey (BEEPS), the top three obstacles identified by Hungarian companies were tax administration, practices of competitors in the informal sector and political instability.

According to the World Economic Forum's *Global Competitiveness Report* 2015-2016, Hungary is ranked 63rd out of 140 countries, down three notches since the previous edition of the publication. Government effectiveness was assessed as low and the country has consistently been ranked poorly in a number of indicators related to policy-making. Institutional factors such as burden of government regulation and efficiency of the legal framework in challenging regulations were other shortcomings, according to this report.

In Transparency International's Corruption Perception Index, Hungary ranked 47th globally in 2014, an improvement by seven places since 2011 when the government launched two large-scale initiatives aimed at reducing administrative burdens. In the area of e-government, Hungary still remains below the EU-wide average. However, several measures have been implemented over the last 4 years, such as the introduction of electronic systems for construction permissions or business tax payments.

Legal Context

In the past years, the administration of the judiciary has undergone significant changes, some of which have raised concerns of local and international observers, including the European Commission. These concerns relate predominantly to the excessive role of the President of the National Office for the Judiciary (NOJ), a presidential appointee, in appointing judges and concerns about infringements on judicial independence. Another particular concern raised by the attempt to lower the mandatory retirement age for judges was addressed when the Constitutional Court and the European Court of Justice ruled against it. Eventually, on the grounds of the decision of the Constitutional Court and the justification of the judgment of the Court of Justice, the Hungarian Parliament has adopted an amendment which introduces uniform regulations as regards judges, prosecutors and notaries by lowering the retirement age gradually. A number of measures have been taken to improve independence of the judiciary, including legislative amendments that require the National Judicial Council to publish an annual opinion on the role of the President of the NOJ in judicial appointments.

The government was criticised on several occasions by the European Central Bank, which raised questions about the changes in the laws undermining the independence of the central bank (MNB). At the same time, the merger of the Hungarian Financial Supervisory Authority into the MNB in October 2013 was welcomed by the ECB. After the integration of the two agencies in October 2013, the MNB supervises stock and commodity exchanges, brokers and financial institutions.

The primary legal framework for the renewable electricity sector is set out by the Act on Electricity (adopted in 2007 and subsequently amended), which regulates the broader energy sector.

Feed-in tariffs, priority grid connection and grid access are key support measures for renewable energy producers. Further improvements can be achieved through long-term, stable and efficient legal and administrative regulatory reform, maintenance development and improved availability of the grid network. In relation to energy efficiency, which is largely regulated by the Act on Energy Efficiency and implementing regulations, a number of programmes have been implemented, such as the energy certification of buildings, reducing energy use by enterprises and promoting energy efficiency improvement projects in residential buildings and multi-storey dwellings.

In relation to the PPP sector, there is no single-act specific PPP law in Hungary. A number of laws are applicable to PPPs and concessions, including the Concessions Act of 1991, which is an old and fairly basic, but flexible piece of legislation. However, in recent years there has been a fairly strong opposition to PPPs associated with the high public debt level and a few controversial projects, which has reduced political and public support for PPPs.

See Annex 4 for a more detailed assessment of the legal environment.

2.6 Social context

Despite slight improvements in competitiveness and increases in the flexibility of labour markets (specifically related to hiring and firing and wage setting) the unemployment rate in Hungary was above 10 per cent until October 2013; however, it decreased substantially and reached a pre-crisis level of 7.7 per cent in 2014. Within that, there are substantial regional variations, from 4.6 per cent in Western Transdanubia to 10.4 per cent in Northern Hungary, according to Eurostat.

The overall employment rate stood at 66.7 per cent in 2014, which, according to Eurostat, is low relative to the EU-wide target of 75 per cent. To increase labour force participation rates, the Government of Hungary has removed several transfer services in relation to light disability pensions and unemployment benefits as well as increasing the notional and effective retirement age over the last decade. The Government also introduced a public works scheme. However, further measures are needed to increase the scheme's effectiveness to facilitate the entry or return of people employed under the scheme to open labour market employment.

Youth unemployment (15 to 24 year olds) is persistently high at 20.4 per cent in 2014, in particular affecting young women and female graduates with high educational levels. The rate of young people who are not in education training or employment is 15.4 per cent, which is comparatively high for the region. At the same time, data on financial inclusion from the World Bank show that in the age group of 15 to 24 year olds, only just over half use banking services, a low ratio compared to other countries, and pointing at a greater prevalence of the informal employment in that age group.

According to an EBRD assessment in 2015, Hungary is amongst those countries with small and medium gender gaps. The labour force participation of women is low relative to men and women earned 18.4 per cent less than men in 2013 when average hourly earnings were considered (Eurostat data). According to the World Bank's Findex, men are twice as likely to lead a business than women and to hold a bank account that is used for business purposes. Women in Hungary tend to be clustered in lower paid sectors of the economy, such as health, education and social services while men dominate sectors such as construction, transportation or information and communications. Women take much longer maternity leave when they have children as compared to most other OECD countries, which is in part due to the country's parental leave regulations (which offer maternity leave of up to three years).

The large regional inclusion gaps in relation to (formal) employment are reflected in substantial regional variations in the poverty rate in Hungary, with over 30 per cent of the population at risk of poverty and social exclusion, above the EU average of 24 per cent (Eurostat). A third of the long-term poor are of Roma origin, even though this group accounts for only about 5.7 per cent of the Hungarian population. In north-eastern Hungary, Roma constitute up to 11-16 per cent of the population, while in the west they are as few as 5 per cent. It is estimated that about 59 per cent of Roma families have an income below the EU defined poverty line of less than 60% of the median. The Roma community in Hungary is characterised by considerably worse indicators on most crucial socio-economic, demographic and other key measures than the population at large. In 2011, 24 per cent of Roma men were unemployed, which is almost two and a half times that of non-Roma men (11.1 per cent). Roma women were affected less, with almost 19 per cent unable to find a job (compared to 11 per cent of non-Roma women). This is partly a result of lower school attendance rates of Roma compared to non-Roma, and poor educational performance of Roma students limiting their employment prospects and social mobility. For example, 94 per cent of 16 – 18 year old non-Roma youth were in school compared to 68 per cent for Roma youth, according to the UNDP/World Bank/EC Regional Roma Survey in 2011. This gap remains for 19 – 21 year olds (with 50 per cent of non-Roma compared to 15 per cent of Roma in school) and beyond (with respective rates of 24 per cent compared to 3 per cent). One third of Hungary's Roma population is under 18 years of age, which is double the national average, according to the 2011 census. Recognising this, the Hungarian government has outlined a National Social Inclusion Strategy for 2011- 2020, which focuses on discrimination as an area of concern but emphasises a lack of access to education, employment, healthcare, as well as the improvement of housing conditions, as the key areas.

2.7 Energy efficiency and climate change context

In Hungary, although per capita energy consumption is low, the energy intensity of the country is relatively high. In 2012 the use of energy per unit of GDP has been twice that of the EU-28 level (0.22 kg oil eq/USD of GDP vs 0.11 for EU-28 (IEA)) and energy use-related CO2 emissions per unit of GDP have been about 70% higher than the EU-28 average (0.4 kgCO2/USD of GDP vs 0.24 for EU-28 (IEA)). Energy production in Hungary has been continuously decreasing since the 1990's while energy imports have been increasing significantly. Indeed, the portion of gas coming from Russian has grown in recent years increasing Hungary's dependency on natural gas imports.

A more sustainable energy future for Hungary would improve the domestic security of supply, reduce the dependence on energy imports, and become a more competitive and environmentally sustainable economy. Apart from energy efficiency, there is a need to improve resource efficiency across the economy including waste management.

Supporting the diversification of energy supply, the development of renewable energy as well as energy efficiency investments and greater energy savings across all sectors is vital. However, currently the country has a low share of renewables, mainly biomass, and there is a need to increase domestic renewable energy sources. There is significant untapped potential for wind power, geothermal energy, waste-to-energy, and solar energy in order to meet energy demands in a low carbon emission and sustainable manner.

According to the National Energy Efficiency Action Plan (NEEAP), one of the key barriers to scaling up energy efficiency and renewable energy is the lack of dedicated financing. Great energy savings could also be made if the electricity generation, transmission and distribution systems were to be modernised. In addition the roll out of smart metering will enable consumers to optimise their energy consumption and thus waste fewer valuable resources (source: National Energy Strategy for 2030).

The building sector remains the largest energy consumer, accounting for 40% of all energy consumption; two-thirds of which goes to heating and cooling. Around 70% of Hungarian homes and public buildings do not currently meet modern technical and thermal engineering requirements; modernising community district heating as well as private heat generation is therefore needed. According to the National Energy Strategy of Hungary, the building sector could account for about 58% of the potential for total primary energy savings by 2030. Namely, there are significant savings opportunities in the domestic energy consumption regarding both heating and electricity consumption. Transport also accounts for a quarter of the total energy consumption and has potential to improve its efficiency and save energy.

As an EU member state, Hungary's energy policy should be aligned with the EU's energy strategy. Hungary has officially notified the transposition of the **Energy Efficiency Directive** into the national law at the end of May 2015, including ensuring the presence of targeted policy measures to drive energy efficiency improvements in households, buildings, and the industry and transport sectors. Under this directive, all EU member states must meet certain energy savings targets from 1 January 2014 until 31 December 2020. The amendment of sectoral laws and laws on implementation ensure the regulation in effect to be in line with the EU requirements. Besides this, due to the recognition of the single energy efficiency regulations transcending the frameworks for sectoral laws, it has become indispensable to draft the new law on energy efficiency as well. Act LVII of 2015 on Energy Efficiency has been announced in May 2015.

Hungary's Partnership Agreement with the European Commission and relevant operational programmes under the European Structural and Investment Funds (ESIF) constitute major policy instruments in 2014-2020 and contain actions on energy efficiency.

On the climate resilience front, Hungary will need to increase its activities of climate change adaptation as many communities have already been affected. Many were affected by the negative environment effects of climate change in rural areas such as in-land waters, floods, droughts, etc. The increasing frequency of extreme climate occurrences is likely to make economic forecasting obsolete and undermine crop security. Therefore greater emphasis needs to be put on preparation for the consequences of climate change and adaptation across sectors.

3 STRATEGIC ORIENTATIONS

3.1 Strategic Directions

While Hungary is an advanced transition country, transition challenges remain in some areas and, in certain sectors, transition gaps have widened over the last 4-5 years. The latter development is a result of policy and regulatory measures adopted by the Government, seeking to deal with the legacy of the financial crisis of 2008-2010 and asserting a stronger role of the state, particularly in the banking and the utility sectors, both as a regulator and owner of business entities. As indicated in the MoU signed with the Government of Hungary in February 2015, the Bank aims to increase its activities in Hungary in line with its transition impact driven strategic priorities outlined in this strategy. However, its ability to do so will be dependent upon the Government honouring the letter and spirit of the MoU and implementation of a stable policy environment.

The Hungarian authorities have reaffirmed their commitment to the principle of graduation. As per the Strategic and Capital Framework for 2016-2020, the main instrument for decision-making on graduation is the respective country strategies, jointly agreed by the Bank and country authorities. Hungary has confirmed that it will continue to keep the question of graduation under review and that the present strategy is consistent with a path towards graduation at the appropriate time.

In designing its support and related instruments, the Bank will tailor them to the advanced stage of transition of Hungary. This is also intended to enable the Bank to gather further experience and develop its knowledge in its advanced markets that it could share in other parts of the EBRD region.

Over the next strategy period, the Bank's engagement in Hungary will focus on the following **strategic priorities**:

- **Strengthening banking sector resilience and the capacity to lend.** The February 2015 MoU provides a clear basis for the improvement of the policy, regulatory and tax environment for banks, and states the Government's intention to divest its strategic stakes in the sector. To the extent that the agreed measures under the MoU are consistently implemented, the Bank will be able to support the financial sector in areas such as privatisation, and will also support sector consolidation and seek to help banks improve their asset/liability maturity profile by providing long term funding on sustainable and commercial terms. The Bank will also continue its cooperation with the Government and the MNB as they take steps to enhance the legislative and institutional framework in support of NPL resolution. In this context, the Bank will continue to provide policy advice and technical assistance to enable faster and more efficient NPL resolution under the Vienna Initiative.

- **Improving further Hungary's energy security through strengthening market-based regional interconnections, optimising the use of storage capacities and enhancing energy efficiency.** The Bank will seek to support the development of key energy infrastructure projects, with particular focus on commercial gas interconnections to facilitate the two way flow of gas and to develop a reliable and liquid Hungarian gas exchange. These projects are fundamental to enable Hungary to optimise its existing resources, most notably its significant storage capacity and indeed to support the broader goal of energy security on the basis of economically sustainable tools – both for Hungary and for the neighbouring region as a whole. Enhancing energy and resource efficiency is a medium priority for the country with specific objectives set for 2020 and consequently the potential exists for the Bank to engage actively in energy savings investments to contribute to achieving to such objectives.

- **Enhancing competitiveness and addressing innovation gaps.** The Bank will support well-selected local companies in catching up to the technological frontier, both directly and through private equity channels, and will also help them become more competitive by strengthening their operational efficiency and managerial capacity. The Bank will pay particular attention to companies operating in the less developed regions, and will look for equity investment opportunities where this can be used to underpin private sector balance sheets in companies which show real growth potential. The Bank will also look to build more commercial and competitive market structures in targeted sectors, such as municipal and inter-city transport, based on an analysis of the competitive environment and through a variety of channels. In so doing, the Bank will seek to address deep-rooted inefficiencies within these sectors stemming in part from a lack of competition, the inefficient use of energy, insufficient private sector participation and the need for financial and operational restructuring.

3.2 Key challenges and Bank activities

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

Transition challenges

- There has been a series of tax and regulatory measures, and restructuring of retail lending contracts over the past years. The capacity of private banks to ease lending standards and to resume their role in financial intermediation needs to be strengthened, including through a more predictable and supportive policy framework.
- Several state-backed institutions have gained market share, and the central bank's programme of subsidized lending has further challenged commercial pricing in the credit market. The role of foreign banks has been questioned by the authorities, even though these institutions have provided valuable access to capital and know-how, while at times engaging in risky lending practices. Eroded profitability, but also the Government's intention to divest its present majority holdings in the sector, underline the need for consolidation.
- Credit institutions are increasingly encumbered by an overhang of corporate NPLs. The legal framework and private sector capacity to deal with distressed corporate loans is inadequate. The MNB has established an asset management company for commercial real estate. Broader balance sheet cleansing will require a number of regulatory and tax reforms, including attracting outside investors in distressed portfolios.
- The market has been waiting for clarity regarding the final outcome in the Quaestor case. In November the Constitutional Court delivered a decision and concluded that the Quaestor Act, as drafted, was unconstitutional. As a result, Parliament adopted a new government proposal which addresses the issues raised by the Constitutional Court and which is considered by the banks to be broadly acceptable.
- Fresh lending will benefit from improvements in credit information shared within the sector. The credit bureau that is typically supported by the industry as a whole will need to be strengthened.
- The local financial system requires a strengthened participation of local institutional investors and development of funding structures and products appropriate for local currency lending and supporting the build-up of long-term funding base for mortgage lending, e.g. through mortgage bonds and other securitised products.

Operational response

- As the agreed measures under the MoU are consistently implemented, the Bank will consider participating in merger and acquisition transactions that will support market-based consolidation in the banking sector. The Bank will also seek to help Hungarian banks stabilise and strengthen their local currency liquidity by providing direct long-term funding through bond issuance, mortgage-backed lending and other securitised products.
- The Bank will seek opportunities to finance distressed assets across sectors to assist with NPL resolution and freeing up banks' capacity for new lending.

- The Bank will consider banks' demands for long-term funding for other purposes as well, mortgage bonds, residential energy efficiency and lending to smaller municipalities and utility companies.

Policy dialogue and capacity building

- As agreed under the MoU, the Bank will continue its engagement with the Hungarian authorities to promote a predictable policy environment conducive to investment and capitalisation in the banking sector. The Bank will continue its ongoing technical assistance, under which legal and financial obstacles to corporate restructuring and NPL resolution have already been diagnosed. Based on this work, the MNB has requested EBRD assistance on a new bankruptcy law, and on private out-of-court restructuring principles. Other work with the Hungarian authorities will draw on the recommendations made by the working group of public and private sector stakeholders, using the Vienna Initiative's platform.
- The asset management company ('AMC') established for the real estate and resolution of NPLs under the MNB could lend important support in the process of reducing the NPL overhang, provided concerns over its governance structure are removed, as it is already envisaged along the lines of a recent IMF report. The Bank will continue advising, as requested, on the governance of the AMC, and on portfolio sales and restructuring efforts by this entity. Advice would be clearly separated from any potential Bank interest in investment in portfolios sold by the AMC.
- The Bank, as requested by MNB, will assist with establishing a securitisation platform.

Results Framework for Theme 1: Strengthening banking sector resilience and the capacity to lend

	CHALLENGES	OBJECTIVES	ACTIVITIES	TRACKING INDICATORS
4.1	State involvement in the banking sector is substantial; the sector lacks resilience and further consolidation is necessary	**Development of sound, efficient, stable and adequately capitalised banking sector**	• As opportunities arise, participate in selected M&A transactions that support banking consolidation	• Evidence of successful M&A transactions or restructurings (number and qualitative account) *(Baseline – 0)*
4.2	Banking sector will require additional long-term investment and development of funding structures and products appropriate for local currency lending	**Bolster sustainability of banking sector through additional funding, expanded product range, including in local currency**	• Provide long-term funding including through debt / bond issuance, mortgage-backed lending and other securitised products, where possible in local currency • Assist with establishing a securitisation platform	• Volume or share of total local currency lending in client banks including due to funding products supported by the Bank (bonds, securitised products) *(Baseline – established at projects' approval)* • Share of long-term funding for mortgage lending at client banks *(Baseline – established at projects' approval)*
4.3	Bank lending is constrained by high NPLs	**Development of sound and efficient banking sector through effective restructuring and an adequate legal and tax frameworks to deal with distressed corporate loans**	• Seek opportunities to finance distressed assets across sectors • Continue ongoing policy advice and technical assistance on NPL resolution overall, and in particular provide technical assistance on new bankruptcy law and out of court restructuring principles and other impediments to efficient NPL resolution	• Evidence of improved laws regulating corporate restructuring and insolvency *(Baseline – N/A)* • Evidence of client banks' improvement in NPL ratios *(Baseline – established at projects' approval); and/or* • Evidence of investor participation in distressed asset sales (*Baseline – 0)*
	Context indicator: Δ in Banking ATC score			

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

Transition challenges

- In the past few years several studies and stress tests from European institutions, such as ENTSO-G Winter supply outlooks, have identified potential issues in Central and South-Eastern Europe in the event of disruptions in gas supplies coming via Ukraine. These have revealed a lack of market integration and cross border trading facilitation in several countries, including Hungary.
- Central and South-Eastern Europe needs to identify and jointly commit to priority infrastructure projects to support the demand driven integration of gas markets and competitive diversification of supply. These projects (such as new commercial interconnectors, competitive reverse flow capacities, gas hub developments) would deliver diversification and competition benefits in the short term. They would also support market development towards greater regional integration and with Western Europe considering the potential source of gas available in the mid to long term.
- New routes to the region should come within a comprehensive framework encompassing: sales agreements, volume and capacities, physical route and commercial contracts employing market based tools to improve the energy security of the region. These will build supply diversification with increased market competition.
- Within this regional goal and set of objectives, it will be important to foster regional trading between Hungary's gas system and neighbouring markets.
- Although per capita energy consumption is low in Hungary, the energy intensity of the country is relatively high and energy imports have been increasing significantly in recent years. A more sustainable energy future for Hungary would improve the domestic security of supply, reduce the dependence on energy imports, and help the country's economy become more competitive and environmentally sustainable.
- The residential sector remains the largest energy consumer, accounting for 40 per cent of all energy consumption; two-thirds of which goes to heating and cooling. Around 70 per cent of Hungarian homes and public buildings do not currently meet modern technical and thermal engineering requirements; modernising community district heating as well as private heat generation is therefore needed. While progress has been made during the last 4-5 years, in residential and municipal energy efficiency, there remains significant scope for investment in energy savings, particularly though the further development of the ESCO market.

Operational response

- The Bank will seek to support the development of key energy infrastructure projects with particular focus on commercial gas interconnections to facilitate the two way flow of gas and to develop a reliable and liquid Hungarian gas exchange.
- The Bank will support energy saving investments through direct investments in corporates and energy utilities to enhance energy efficiency and through intermediated financial products to boost energy efficiency in residential and public buildings.
- Building upon its track record of supporting the first ESCOs in Hungary, the Bank will seek out new opportunities to support municipal energy efficiency in particular through ESCOs.

Policy dialogue

- The Bank will promote and offer technical assistance to support regional integration and encourage cooperation between gas markets. In particular the EBRD can support with its knowledge and involvement in several projects in its portfolio that promote gas sector integration in the region.
- The Bank is already participating in the Central and South Eastern Europe Gas Connectivity-CESEC initiative promoted by the European Commission. The final objective of the working group is to prepare an Action Plan, which will identify specific technical, financial as well as regulatory measures addressing the regional need for market integration and diversification.

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

	CHALLENGES	OBJECTIVES	ACTIVITIES	TRACKING INDICATORS
3.1	Regional gas markets lack adequate integration and competitive diversification of supply	**Strengthen regional energy market integration and security through cross-border energy connections and gas pipelines, including increased usage of storage capacity**	• Boost regional transmission and storage capacity by financing commercial gas interconnections, linked, where feasible, to storage facilities • Policy dialogue, including technical assistance, to support regional integration and encourage cooperation between gas markets	• Evidence of increased regional interconnectivity of gas transmission, distribution or storage capacity as a result of the Bank's activities (TIMS/TCRF) *(Baseline – established at projects' approval)*
3.2	Hungary's energy intensity is high, and energy imports have been rising	**Improve energy efficiency**	• Direct/indirect financing to corporates and energy utilities to enhance energy efficiency in residential and public buildings • Support municipal energy efficiency, including through further development of the ESCO market	• Volume of energy savings achieved through Bank investments based on EBRD methodology in toe/year *(Baseline – 0)* • Number of energy efficiency investments successfully implemented or financed *(Baseline – 0)*
	Context indicator: Δ in Hungary's energy intensity *(Source: Eurostat (Baseline (2013) – 256.6 kg oil equivalent/€10000))*			

Theme 3: Enhancing competitiveness and addressing innovation gaps

Transition challenges

- Hungary has established an enviable position as a platform for export-oriented multinational companies, in particular in the manufacturing sector. However, in recent years FDI inflows have dropped substantially, with many companies electing to repatriate profits offshore rather than reinvest. At the same time, green field investments are also sharply lower. The country has lost in relative terms both in export market share and investment inflows, against its peers in central Europe. Securing and expanding the country's role as an export platform of technology and skills intensive products will require the adoption of a non-discriminatory tax policy and regulatory reforms.
- Enterprise development in Hungary has been highly skewed towards the west of the country. The four regions of eastern and southern Hungary, that are also important regions for agribusiness, have shown protracted gaps, e.g. in persistent income differential well below 50 per cent of the EU average.
- While Hungary scores as a 'Moderate Innovator' in EU-wide innovation assessments, domestic enterprises had only a relatively small share in this success. Beyond some issues with research and innovation policies and frameworks, the administrative burden imposed on enterprises and high and variable taxation could be particularly discouraging small and innovative firms. Venture capital funds are not well established.
- Management practices and skills need to be upgraded in order to accelerate growth and innovation, and enhance the local corporate's capacity for exporting and cross-border investment.
- Despite the generous provision of concessional credit through the MNB bank facility, corporate credit on commercial terms is still shrinking. The transition to a period beyond the MNB bank facility to commercial financing bears much uncertainty. Access to non-bank financing is limited.
- Lack of market discipline and commercial behaviour is a broader concern in the municipal utilities sector. . In municipal public transport, for instance, financial and environmental sustainability need to be enhanced. Among other aspects, inter-modal planning and regulation of the urban transport sector in larger cities need to be better integrated and Public Service Contracts implemented more effectively. Public and private service providers could also be better integrated, and private sector involvement and competition in bus services, both within and between larger cities, should be increased.

Operational response

- The EBRD will actively support Hungarian companies' investments that strengthen their competitiveness and thus their capacity for export and cross-border transactions. In so doing, the Bank will selectively consider engagement with local companies that have strong growth potential and a sound core business model, yet require financial and operational restructuring alongside other financiers, to unlock new investments. The Bank will also look for opportunities to integrate youth and gender inclusion components in these investments.

- The Bank will actively seek roles where it can provide equity/equity-like funding structures to help companies with good growth potential, to stabilize their balance sheet and attract commercial bank funding.
- The Bank will also support local corporates in their efforts to retool, improve operational efficiency, launch innovative products and introduce innovative technical solutions.
- The Bank will support foreign direct investors where such support provides the necessary comfort, to help Hungary enhance innovation and technology transfer and to contribute to local supply chain value enhancement.
- The Bank will explore ways, in consultation with the government and engaging the private sector, to help address youth, gender and regional inclusion gaps in relation to equal economic opportunities, in particular access to employment.
- In addition, on a selective basis and considering carefully the transition case, the Bank will look for opportunities to boost competition and commercial behaviour in targeted sectors where its involvement could improve operational efficiency and managerial capacity. For example, the Bank will look to leverage direct lending to municipalities, backed by technical assistance and possibly involving co-financing with EU funds, to finance urban transport infrastructure with particular regard to environmental sustainability and energy efficiency.
- The Bank will support privately and publicly owned transport companies in Budapest and the secondary cities seeking to operate more commercially, including through outsourcing some operations to the private sector on a sound regulatory basis.

Policy dialogue

- Success in relieving companies of excess debt will require upgraded restructuring principles, which the Bank is committed to support in coordination with MNB.
- Improved access to finance will require strengthened accounting and managerial practices at SMEs, which the Bank can support in coordination with the relevant public standards setting authorities and industry associations.

Results Framework for Theme 3: Enhancing competitiveness and addressing innovation gaps

	CHALLENGES	OBJECTIVES	ACTIVITIES	TRACKING INDICATORS
3.1	Regulatory environment inhibits development of innovative, export-oriented businesses, and local corporates lack access to finance and are hampered by weak management practices	**Support growth and development of innovative, export-oriented local corporates**	• Debt and equity financing (both direct/indirect) to select corporates with strong growth potential and sound business models, with particular emphasis on innovative technologies, cross-border transactions and local supply chain value enhancement. • Support for strengthened corporate governance and management practices through PD with relevant standard-setting bodies and industry associations • Support foreign investment as a source of high quality corporate governance and innovation, and as an anchor for development of local value chains	• Evidence of successful operation of export-oriented and/or innovative companies supported directly or indirectly by the Bank *(Baseline –N/A)* • TIMS indicators on client firms reporting growth, increased productivity and standards, including in under-served regions *(Baseline – N/A)* • Evidence of increased FDI in EBRD supported sectors that contributes to supply chain linkages and export channels for local enterprises (TIMS) *(Baseline – established at projects' approval)*
3.2	Poor technical state and inefficient operation of municipal service operators	**Support financial and operational improvement in targeted sectors, such as municipal urban transport, through commercialisation and restructuring**	• Leverage direct lending to municipalities to finance urban transport projects in Budapest and other larger cities • Support publicly owned transport companies seeking to operate more commercially, including through outsourcing operations to the private sector	• Improvements in operational practices and cost performance of municipal operators supported by the Bank (qualitative account) *(Baseline – N/A)* • Evidence of urban transport services successfully outsourced to private sector (number of successful projects and/or qualitative account) *(Baseline – 0)*
	Context indicator: Δ in Sub-indicator on Innovation systems from Adjusted Knowledge Economy Index *(Baseline (2013) – 5.73)*			

3.3 Potential risks to Country Strategy implementation

Successful implementation of the country strategy will necessarily depend on a number of factors, some of which are outside the Bank's control.

The implementation of **Theme 1 - Strengthening banking sector resilience and the capacity to lend** – is conditional on the Government creating a predictable and business-friendly tax and policy environment for the banking sector, as undertaken under the MoU signed with EBRD in February 2015, the full implementation of which will be critical. It will also depend on whether banking sector consolidation will happen and the market players driving it. While the Government has committed itself to implement a more favourable policy towards the sector, this cannot be done in isolation from a stable overall policy framework. Delivery under this theme is also dependent on the successful resolution of the corporate and mortgage NPL stock that will enable banks to focus on new lending and upon the fair and equitable resolution of the Quaestor issue in line with the spirit of the MoU.

The implementation of **Theme 2 – Improving Hungary's energy security through strengthening market-based regional interconnections, optimising the use of storage capacities and enhancing energy efficiency –** will essentially depend on the publicly owned utilities' appetite for investing in energy linkages with Hungary's neighbours against the backdrop of competing energy projects. Likewise, the extent to which Hungary's neighbours prioritise such inter-linkages will greatly affect the scope and pace of potential projects. In this respect the selection of Projects of Common Interest within the European Union is helpful to prioritise investments in the energy sector to enhance overall European energy security.

The implementation of **Theme 3** – **Enhancing competitiveness and addressing innovation gaps** – will depend on the investment appetite of local corporates, which, among other things, will also be determined by the business climate, the predictability and stability of tax and other sector specific policy measures. It will also depend upon whether sustainable commercial financing can gradually substitute the MNB's programme of subsidized lending (FGS). In addition, opportunities in the urban transport sector will largely depend on the willingness of relevant authorities to further private sector involvement in the provision of those services, as well as to engage in policy dialogue to address issues related to the commercialisation of urban transport operations.

3.4 Environmental and Social Implications of Bank Proposed Activities

As a European Union member, Hungary has adopted environmental and social legislation that meets EU requirements and is aligned with EBRD's Environmental and Social Policy and Performance Requirements.

The Bank's Environmental and Social Policy will apply to all projects in Hungary.

Hungary has a relatively high proportion of protected areas, with 21 per cent of the country designated as Natura 2000 sites. Infrastructure projects also have the potential to adversely impact biodiversity and sensitive habitats. Such projects in these areas may require detailed biodiversity impact assessments and the development of appropriate mitigation measures, in line with EBRD's Performance Requirement 6: Biodiversity Conservation and Sustainable Management of Living Natural Resources.

Health and safety is an important consideration for all EBRD projects, and is a particular issue with energy and transport infrastructure, both because of risks to worker safety during construction, and public safety once operational. The Bank will work with clients to minimise the risks of accidents and fatalities through good project design and best practice in safety management.

The Bank will agree appropriate reporting and monitoring arrangements with clients to provide it with adequate information on projects' environment and social performance and compliance with the Bank's Policy and Performance Requirements.

3.5 Cooperation with the EU and IFIs

The EBRD will continue its consultations with the EU on developments in the banking sector in Hungary and coordinate its policy advisory and technical assistance work on assisting NPL resolution with the IMF, World Bank and the EIB under the Vienna Initiative.

In the context of building a strategic relationship between the EU and EBRD, the Bank will explore further with the managing authorities in Hungary and the European Commission the possibility of leveraging EU grants with commercial financing and in the overall design of potential new financial instruments.

ANNEX 1 – POLITICAL ASSESSMENT

Hungary is committed to and applying principles of multiparty democracy and pluralism in accordance with Article 1 of the Agreement Establishing the Bank.

Hungary is a functioning multi-party parliamentary democracy that joined the European Union in 2004. Since the adoption of the last strategy, Hungary's governing coalition implemented significant changes to several political institutions, the judiciary and media oversight. Some aspects of these reforms raised questions in the international community regarding the strength of checks and balances in the political system, the commitment to guarantee the freedom of expression and inclusive political decision-making.

Free Elections and Representative Government

Hungary's ruling coalition scored resounding victories in two consecutive elections, gaining a two-thirds majority in the parliament. The Government interpreted these outcomes as a strong popular mandate for comprehensive political and economic reforms. Hungary's legal environment has undergone significant changes, with over 700 laws adopted and amended in just three years. A new Constitution, the first since the 1989 political transition, was adopted and then amended five times since it came into force in 2012. The approach of adopting the new Constitution enjoyed widespread public support, however, none of the opposition parties in the parliament voted in favour of the text provided by the governing coalition.

These modifications established a more centralised political system with diminished democratic checks and balances. Although Act CXXXI of 2010 on lawmaking stipulates that the widest possible scope of opinions are presented during negotiation procedures (general and direct), changes to laws were often adopted in a very short period of time as private members bills, which precluded thorough consultations with the opposition and civil society.

Free, fair and competitive elections

The new Constitution provides citizens of Hungary with the right to change their government peacefully and through free and competitive elections based on universal suffrage. General elections held in 2014 were free and offered voters a diverse choice amongst registered parties. However, the final report on the quality of the process by international monitors from the Organisation for Security and Cooperation in Europe / Office for Democratic Institutions and Human Rights (OSCE/ODIHR) raised concerns about the fairness of elections, noting that Fidesz "enjoyed an undue advantage because of restrictive campaign regulations, biased media coverage and campaign activities that blurred the separation between [the governing] political party and the State."[1]

Amendments to the electoral legislation, many of which were introduced without support of the opposition, reduced the number of parliamentary seats from 386 to 199, in line with the government's efforts to reduce public spending, necessitating alterations to constituency boundaries. The redrawing process was criticized by several international organisations for a lack of transparency, independence and consultation, and allegations of gerrymandering were

[1] http://www.osce.org/odihr/elections/hungary/121098?download=true

widespread.[2] At the same time, the new electoral legislation introduced several changes to the status of the National Election Office responsible for organising and holding elections, which is no longer a governmental body, but functions as an independent autonomous body of the state administration. New campaign finance laws were adopted in 2011 and 2012 which partly address previous OSCE/ODIHR recommendations to strengthen transparency and accountability, although deficiencies remain[3].

Changes to the electoral law also allowed citizens without permanent residence in Hungary to vote. According to the OSCE/ODIHR report, "different registration and voting procedures for voters abroad, which depended on whether they had permanent residence in Hungary, undermined the principle of equal suffrage and may be seen as an attempt to differentiate voting rights on partisan grounds."[4] The Constitutional Court assessed the registration requirement for Hungarian citizens living abroad, but did not deem this requirement anti-constitutional.

Separation of powers and effective checks and balances

Hungary is a parliamentary republic. The National Assembly is the main 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 has control over the nomination and appointment of public officials and may refer legislation to the parliament or the Constitutional Court before signing it into law, a power that has been exercised by the incumbent.[5]

The Prime Minister holds executive power and is elected by a majority of the unicameral National Assembly. The Prime Minister is responsible to the parliament and can be removed along with the cabinet of ministers through a no-confidence process, which requires a new Prime Minister to be endorsed in the same vote. The current Prime Minister Viktor Orban, who is the leader of the Fidesz party (Young Democrats' Alliance-Hungarian Civic Union) is serving his second consecutive term. His nomination was supported by a Fidesz-Christian Democratic People's Party (KDNP) coalition which won a two-thirds parliamentary majority in the 2010 and 2014 general elections. During this time many important draft laws were introduced by individual members of parliament and adopted without thorough consultation with public, opposition or civil society. This accelerated legislative procedure limited the scrutiny of the government's actions weakening political checks and balances[6].

The Constitutional Court has repeatedly demonstrated its independence by challenging decisions of the parliamentary majority. However, the new Constitution shifted certain powers from the Constitutional Court to the Parliament. The parliamentary majority has

[2] OSCE/ODIHR (2014): Limited Election Observation Mission Final Report, Hungary Parliamentary Elections 6 April 2014, p.1

[3] Hungary Page: 14 Parliamentary Elections, 6 April 2014 OSCE/ODIHR Limited Election Observation Mission Final Report p.16

[4] OSCE/ODIHR (2014): Limited Election Observation Mission Final Report, Hungary Parliamentary Elections 6 April 2014, p.2 Venice Commission of the Council of Europe and ODIHR Joint Opinion on the Act on the election of members of parliament of Hungary (1 June 2012) recommended that "the actual delimitations should be done by an independent commission". p.14

[5] Recently the President submitted a law on electoral procedures to the Constitutional Court. For the list of legislation sent back to the parliament for revision, see Office of the President of the Republic, news releases http://www.keh.hu/sajtokozlemenyek

[6] European Parliament Report on the situation of fundamental rights, standards and practices in Hungary p.22

overridden some decisions by the Constitutional Court by reintroducing annulled provisions as part of the Constitution and limiting possibilities of review by the Constitutional Court. According to the Venice Commission of the Council of Europe this amounts to an infringement of democratic checks and balances and the separation of powers[7].

Effective power to govern of elected officials

Elected officials have the effective power to govern. However, the extensive reliance on Cardinal Laws, which require a two-thirds majority to amend, risks insulating the policy preferences of the current government from review by a future government which may not enjoy a constitutional majority.

Civil Society, Media and Participation

Hungarian citizens participate in civil and political life. However, voter apathy towards electoral politics has been a long-term trend in Hungary. Moreover, trust in institutions and political parties is generally low. In addition to periodic voting, Hungarian citizens participate in political and public life through their membership in civil society organisations, as well as through participation in public demonstrations. Independent civil society organisations are facing challenges in influencing political decision-making and accessing non-state sources of funding. Hungary‘s media landscape is growing and now has over 11,000 providers. However, the media has become less pluralistic in so far is it provides less room for critical voices to be aired in the mainstream and public media.

Scale and independence of civil society

According to government sources, there are over 80,000 civil society organisations in Hungary effectively functioning freely and independent of the political power. This includes rights protection organisations, environmental protection organisations and cultural organisations, amongst others.

Hungary’s civil society organisations receive state funding, which has been declining in recent years, as well as private donations and foreign grants. Many independent watchdog organisations that provide critical oversight over government policies relied on funding from international donors. However, in 2014 the government questioned impartiality in awarding these grants and ordered the Government Control Office (KEHI) to audit 58 NGOs receiving funding through the Norwegian Civil Fund[8]. The Norwegian government has contested these claims and suspended funding[9]. The Council of Europe Commissioner for Human Rights expressed concerns over stigmatizing rhetoric used by Hungarian politicians who questioned the legitimacy of NGO’s work on political issues[10].

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[7] European Commission for democracy through law, Draft Opinion on the Fourth Amendment of the Fundamental Law of Hungary, May 29, 2012 p.22

[8] Norwegian Civil Fund was set up in Hungary and other EU states with the aim of strengthening civil sociality, with special focus on issues such as democratic values, rule of law, transparency, gender equality and vulnerable groups. It is managed by an independent consortium

[9] After a 19-month suspension, the Norwegian and Hungarian governments reached an agreement on distribution of funding and stopping tax evasion charges against NGOs. It has paved the way for a resumption of funding.

[10] https://wcd.coe.int/com.instranet.InstraServlet?command=com.instranet.CmdBlobGet&InstranetImage=2564455&SecMode=1&DocId=2164762&Usage=2

Independent pluralistic media that operates without censorship

The right to free speech is enshrined in the Constitution (Fundamental Law), however independence of the media is not fully observed in practice. The European Commission found that some provisions of the 2010 Media Law contradict the EU law, [11] the Commissioner for Human Rights of the Council of Europe expressed concerns over its effects on media pluralism and free speech[12] and the Hungarian Constitutional Court ruled that certain provisions of the media laws violated the Constitution. In response, the Parliament adopted an amendment to the regulation in 2011 and 2012. Some international and domestic observers were not satisfied with these reforms, claiming that "these amendments were fragmentary and not addressing the key problems identified earlier."[13] Despite these initial expectations, in practice there have been no precedents that reinforced these theoretical concerns. In fact, in 2013, the Council of Europe explicitly stated that there is "no need of further amendments of the regulation."[14] In June 2015 the Venice Commission of the Council of Europe undertook a comprehensive assessment of Hungary's media legislation. According to its assessment of Hungary's media laws, the Media Act does not secure a pluralistic composition of the bodies supervising the publicly owned media; its provisions enable the ruling coalition to ensure the loyalty of the Media Council, of the MTVA and of the Board of Trustees, which manage the public media sector, and, through them, to control finances and personnel of the public broadcasters.[15] At the same time, the Venice Commission report acknowledged the effort of the Hungarian government over the years to improve the original text of the two media laws in line with comments by various international observers, but suggested a list of further revisions to improve the situation of media freedom in Hungary.[16]

Media ownership is relatively diverse in Hungary. Since 2008 many independent media outlets have experienced a decline in public and private advertising revenue. They linked the cutting-off of government advertising to their critical stance towards the ruling coalition, although the Government links this to the impact of the financial crisis and competition from online producers.[17] In 2014 a new tax based on turnover was introduced, which affected companies with big advertisement revenues (Act XXII, hereinafter the Advertisement Tax

[11] UN Human Rights Council (2014): Report of the Working Group on Arbitrary Detention; Mission to Hungary, p.4f

[12] Commissioner for Human Rights of the Council of Europe (2014): Report following the visit to Hungary from 1 to 5 July 2015, p.9-17

[13] According to the OSCE Representative for the Freedom of the Media the amendments did not go far enough to safeguard the freedom of the press. The areas of concern include the methods of nomination and appointment of the President and members of the Media Authority and Media Council; their powers over content in the broadcast media; high fines that encourage self-censorship among journalists; and failure to guarantee the political independence of public service media. (http://www.osce.org/fom/75999) The UN Rapporteur on the promotion and protection of the right to freedom of opinion and expression has highlighted remaining concerns pertaining to "excessive fines and other administrative sanctions that can be imposed on media; broad scope of the law to regulate all types of media, including the press and the Internet; registration requirements for the operation of media service providers; and lack of sufficient protection of journalistic sources" (http://www.ohchr.org/en/NewsEvents/Pages/DisplayNews.aspx?NewsID=10916&LangID=E)

[14] http://mediamonitor.ceu.hu/2013/01/council-of-europe-and-hungarian-government-agree-on-changes-to-media-law/

[15] Venice Commission, Opinion on Media Legislation (ACT CLXXXV on Media Services and on the Mass Media, Act CIV on the Freedom of the Press, and the Legislation on Taxation of Advertisement Revenues of Mass Media) of Hungary, adopted by the Venice Commission at its 103rd Plenary Session (Venice, 19-20 June 2015)

[16] Venice Commission, Opinion on media legislation of Hungary (June 2015) p. 26-27

[17] Venice Commission Opinion on media legislation of Hungary (June 2015) p. 23-27

Act). Introduction of this new tax has been challenged by the RTL Group (a company heavily impacted by the tax) before the European Court of Human Rights (ECtHR) and the European Commission. There were no government restrictions on access to the internet in Hungary. According to the International Telecommunication Union approximately 72 per cent of the population have access to internet. In October 2014 the government proposed a tax on internet data traffic. However, it withdrew the proposal after protests broke out across the country opposing it.

Multiple channels of civic and political participation

Civil society can participate in political decision-making through a range of access points; however, apart from elections and protests, opportunities for influencing the legislative process remain limited. The new Constitution has curtailed the possibility of direct democracy by creating a high double threshold for a referendum. It also abolished the right of individual citizens to initiate constitutional review.

The public right to information is constitutionally guaranteed but its application remains uneven. Recent amendments to the law on freedom of information were passed in June 2013. These raised some additional concerns as regards the risks of too wide interpretation of provisions on abusive requests for information.[18] In April 2014 the European Court of Justice ruled that that the abrupt termination of the Hungarian Data Protection Commissioner's term in office by the government constitutes an infringement of the independence of the Hungarian Data Protection Authority and is hence in breach of EU law.[19] Hungary addressed some of the European Commission's concerns by amending its national legislation to make the new National Authority for Data Protection and Freedom of Information independent, in line with EU law, by publically apologising for the termination of the mandate of the former data protection commissioner and paying him compensation. Subsequently the EC infringement procedure was closed.

Freedom to form political parties and existence of organised opposition

Since 1990 Hungary has established a multi-party political system. Parties represent a wide range of views within the Hungarian society and opposition parties contest elections freely. The ruling coalition declared a clear preference to a majoritarian versus consensual democracy, and has made little practical effort to build consensus with the opposition over comprehensive political reforms since 2010. Despite their long existence, Hungary has failed to develop a transparent system of political party funding[20].

Rule of Law and Access to Justice

The new Constitution, which entered into force on 1 January 2012, has brought about significant changes to the judicial system. A number of its provisions have raised concerns

[18] European Commission (2014): EU Anti-Corruption Report, Annex 17 – National chapter on Hungary, p.11ff
[19] http://europa.eu/rapid/press-release_MEMO-14-267_en.htm
[20] In a recent report by the Council of Europe's Group of States against Corruption (GRECO) it was noted that positive steps were taken to ensure that the registries of political parties are transparent and up-to-date, but concluded that more needed to be done to ensure the transparency, accuracy and accountability of the accounts of political parties and their entities GRECO (2013): Third Evaluation Round, Compliance Report on Hungary, p.8

among the Constitutional Court, the Venice Commission of the Council of Europe and the EU. Subsequently the Constitution had been amended five times, increasing legal uncertainty.

Supremacy of the law

Citizens are equal before the law and the Constitution and other laws provide for a fair public trial within a reasonable period. Hungarian authorities generally respect court orders, although senior public officials occasionally criticized rulings issued by the Constitutional Court as well as those by ordinary courts. There are no political prisoners in Hungary.

Independence of the judiciary

Article 26 of the Fundamental Law of Hungary stipulates that judges shall be independent and only subordinated to the Acts; they shall not be instructed in relation to their judicial activities. Judges may only be removed from office for the reasons and in a procedure specified in a cardinal Act. Judges may not be members of political parties or engage in political activities. Apart from the Fundamental Law, the Act on the legal status of judges also stipulates that judges shall be independent in their administration of justice. In spite of an overall legislative and institutional framework that sets the main guarantees for the independence of the judiciary, alleged political ties of certain high-level officials within judiciary oversight institutions - such as the State Audit Office or the National Judicial Office - have raised a number of concerns in recent years.[21]

The Judiciary is organised in a four-tier system of local courts, county courts, high appeal courts and the Supreme Court (Kuria). The Constitutional Court has shaped the legal framework in Hungary since 1990 and its members are elected by the parliament. The governing coalition increased the number of Constitutional Court judges from 11 to 15 and abolished the requirement to reach agreement with the opposition regarding the election of constitutional judges. Judiciary posts are filled through an open tender process and the Fundamental Law stipulates that they shall be appointed the President. The ruling coalition has appointed the majority (8 out of a total of 15) of justices to the Constitutional Court. Despite the reorganisation of the judicial branch and allegations of government interference in judicial affairs,[22] the courts have safeguarded their integrity and professionalism. In 2012 the Constitutional Court struck down several laws, such as a law on early retirement of judges, legislation criminalising homelessness and provisions narrowing the definition of the family. In 2013 the Constitutional Court ruled some provisions of the new electoral legislation regarding compulsory voter registration to be unconstitutional.

In 2013 the parliament passed laws significantly constraining the Constitutional Court's power regarding constitutional reviews on the government's financial and tax measures. The parliamentary majority integrated some of the provisions, which were dismissed by prior Constitutional Court rulings, into the Constitution itself through the Fourth Amendment. The

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[21] European Commission Anti-Corruption report, Hungary Annex, February 2014 http://ec.europa.eu/dgs/home-affairs/what-we-do/policies/organized-crime-and-human-trafficking/corruption/anti-corruption-report/docs/2014_acr_hungary_chapter_en.pdf

[22] The European Court of Human Rights ruled on May 27, 2014 that the early termination of the mandate of the President of the Supreme Court was not the result of a justified restructuring of the supreme judicial authority in Hungary, but in fact was set up on account of the views and criticisms that he had publicly expressed in his professional capacity on the legislative reforms. See the full ECHR judgement in the Baka v. Hungary case http://hudoc.echr.coe.int/eng?i=001-144139#{"itemid":["001-144139"]}. The final judgment has not yet been delivered, as the case is under appeal at the Grand Chamber.

modified text also stated that Constitutional Court rulings given prior to the entry into force of the new Constitution are repealed. The Fourth Amendment was criticised by the Venice Commission of the Council of Europe and by the EU as threatening constitutional justice.[23] The Parliament subsequently adopted the Fifth Amendment to address some aspects of the Venice Commission recommendations.

Government and citizens equally subject to the law

The Government and citizens are equally subject to the law. The Government generally took steps to prosecute and punish officials who committed abuses, whether in the security sector or elsewhere in the government.

Effective policies and institutions to prevent corruption

Anti-corruption and integrity-related policies are enshrined in a wide range of legislation. An extensive criminal legal framework is in place, covering both public and private sector corruption. A new Criminal Code entered into force in July 2013, simplifying definitions of crimes and prescribing longer prison terms, while criminalising budget fraud and the provision of new aggravating circumstances for a range of corruption-related offences. The Council of Europe Group of States against Corruption (GRECO) noted that the new legislation met an acceptable level of compliance with its recommendations.[24]

In 2014 Hungary had a score of 54 (out of 100) in Transparency International's Corruption Perceptions Index (CPI), thus ranking 47th out of the 177 surveyed countries. This rating remained unchanged from 2013, leaving Hungary in the bottom third among all EU member states. According to the Hungarian authorities, in 2011 and 2012 there were over 700 detected corruption cases. However, there are few examples of high-profile cases that have reached the courts. Several measures were recently implemented to tackle corruption cases involving police officers, including the elimination of cash payments for fines and the introduction of integrity testing within the National Protection Service.[25]

Hungary adopted a National Anti-Corruption Programme (NACP) in 2013 as well as an Action Plan for 2015–2016. The European Commission concluded that the "NACP addresses insufficiently the risks associated with clientelism, favouritism and nepotism at high levels of public administration, or those arising from the interface between businesses and political actors."[26] In 2015, the EC Country Report for Hungary states that "recent legislative act lifts previously existing restrictions on access to public funding by politically affiliated organisations and eliminates rules against conflict of interests and transparency requirements".[27] The government announced measures to improve the anticorruption

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[23] European Commission for democracy through law, Draft Opinion on the Fourth Amendment of the Fundamental Law of Hungary, May 29, 2012

[24] http://www.coe.int/t/dghl/monitoring/greco/evaluations/round3/GrecoRC3(2012)3_Hungary_EN.pdf Third Evaluation Round, Compliance Report, June 2012

[25] European Commission (2014): EU Anti-Corruption Report, Annex 17 – National chapter on Hungary, p.3

[26] European Commission, Hungary Annex to the EU Anti-corruption Report 3.2.2014 http://ec.europa.eu/dgs/home-affairs/what-we-do/policies/organized-crime-and-human-trafficking/corruption/anti-corruption-report/docs/2014_acr_hungary_chapter_en.pdf

[27] European Commission; Country Report Hungary 2015 Including an In-Depth Review on the prevention and correction of macroeconomic imbalance 18 march 2015 http://ec.europa.eu/europe2020/pdf/csr2015/cr2015_hungary_en.pdf

framework introducing corruption risk assessments as part of mandatory impact assessments and an information campaign on corruption prevention for different target groups.

Civil and Political Rights

The new Constitution strengthened the protection of human rights inspired by the Charter of Fundamental Rights of the European Union and contained a more extensive list of rights than before. Most internationally established human rights norms are observed in practice. However, discriminatory practices against women, the LGBT community, and some religious groups continue to be reported.[28] Hungary's Roma minority are often a target for intimidation by extremist groups and anti-Roma hate speech is common.

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

The Constitution provides for freedom of peaceful assembly, and the Government generally respects this right. Opposition parties and civil activists are able to hold regular demonstrations against government policies, without major constraints. There are no restrictions on the freedom of association in Hungary. However, a comprehensive new law regulating the right of association and the functioning of NGOs entered into force in 2012. According to this law NGOs should specify their purpose in their statutes, have a listed membership and be registered by the court. It also requires NGOs to submit annual reports to the court or risk de-registration. According to the authorities this measure is needed to ensure the transparency of the operations of civil organisations, to avoid multiple registration of an organisation and to improve public access to information about NGO operations.

Freedom of religion has not been fully observed in Hungary. Under the 2011 Church Act, 90 per cent of the more than 300 legally operating religious groups lost their status as churches. The law was ruled unconstitutional in February 2013 but was then incorporated in the Constitution via the Fourth Amendment. The Venice Commission noted that it contradicts European standards because the criteria for the recognition of churches are vague and the parliament is not an independent arbiter on questions of religion. The Fifth Amendment to the Constitution responded to this criticism by changing the language on churches but retaining the essentially discriminatory regulation. Churches which were stripped of their status have appealed to the European Court of Human Rights. The ECtHR delivered a judgement on April 8 2014 recognising the Government's legitimate concern regarding the problems connected with the large number of churches formerly existing in the country, but determined that the Church Act violated applicant churches' members' rights to freedom of thought, conscience and religion and freedom of association protected by the European Convention on Human Rights.[29]

In February 2013 the Parliament adopted a new civil code constraining possibilities for the press to report on public figures' personal life, including topics which may expose corruption. The Ombudsman formally challenged the constitutionality of the provision that allowed the

[28] For examples see in the European Commission Against Racism and Intolerance, Report on Hungary (fifth monitoring cycle), adopted 19 March 2015 http://www.coe.int/t/dghl/monitoring/ecri/Country-by-country/Hungary/HUN-CbC-V-2015-19-ENG.pdf

[29] CASE OF MAGYAR KERESZTÉNY MENNONITA EGYHÁZ AND OTHERS v. HUNGARY, JUDGMENT STRASBOURG 8 April 2014 http://hudoc.echr.coe.int/sites/eng/pages/search.aspx?i=001-142196#{"itemid":["001-142196"]}

Media Authority to determine what constituted reasonable public interest, arguing that the provisions curbed free expression. Upon the subsequent decision of the Constitutional Court, the Civil Code was amended in regard to the protection of the personality rights of politically exposed persons.[30]

Political inclusiveness for women, ethnic and other minorities

The new Constitution prohibits discrimination on the grounds of race, colour, gender, disability, language, religion, political or other views, national or social origins, or financial, birth or other circumstances. The Hungarian Parliament has enacted legislation to combat racial incitement and hate speech. However, political inclusiveness of women and some ethnic minorities remain, and intolerance towards LGBT people is still evident.

Article 15 of the new Constitution on equality and non-discrimination does not expressly include sexual orientation as a ground for discrimination despite recommendations made in this sense by several international stakeholders, including the Venice Commission. While same-sex partnerships have been recognised since 1996 and registered partnerships granting same-sex couples rights similar to those of spouses have been in place since 2009, same-sex marriage is not legal and the provisions on registered partnerships were taken out from the Civil Code to become a separate piece of legislation in 2013. In addition, following several changes brought to the Constitution in 2012 and 2013, the Constitution defines family as "marriage and parent-child relationships", excluding cohabitants and same-sex couples.. The Hungarian authorities initiated a consultation with LGBT organisations regarding the implementation of the Council of Europe recommendations on combating discrimination on the grounds of sexual orientation.[31] .Despite legal protections, the LGBT community in Hungary continues to face intimidation.

The political representation of women and minorities remains low. The proportion of female MPs in the parliament stood at 9 per cent – the lowest in the EU – both after the 2010 and 2014 elections. According to an ODIHR report on the parliamentary 2014 elections, female candidates received limited media coverage during the campaign, and most candidates did not specifically address issues of gender equality in their programmes. There are no legal requirements aimed at enhancing the participation of women in political life. Only two political parties have internal policies to promote women candidates.[32]

Since the establishment of a democratic system, Hungary had been addressing 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. The new Civil Code provides for protection for members of ethnic minorities in Hungary, including Roma, against any false and malicious statement or conduct that could damage that community's reputation. Moreover, the government took steps to increase political participation among 13 recognized national minorities who could choose to register for 'minority elections' which would then exclude them from voting in the national, proportional list elections. The national minority lists enjoy a preferential threshold and receive a non-voting, parliamentary

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[30] "Section 2:44 now states that "Exercising the fundamental rights relating to the free debate of public affairs may diminish the protection of the personality rights of politically exposed persons, to the extent necessary and proportionate, without prejudice to human dignity."

[31] http://www.coe.int/t/dg4/lgbt/Source/RecCM2010_5_EN.pdf

[32] OSCE/ODIHR (2014): Limited Election Observation Mission Final Report, Hungary Parliamentary Elections 6 April 2014, p.2

spokesperson should they fail to win a seat. However, Romany civic organisations protested against the changes and chose not to register a minority list, arguing that the new system limited their choice and compromised the secrecy of the ballot. [33]

In the last five years in Hungary, the proliferation of vigilante groups and hate crimes against Roma and other minority groups has led to a climate of increasing social and economic exclusion. In several instances state officials and members of mainstream parties used racist language in public statements that incite hatred against the Roma and other minority groups. The scale of these attacks has decreased following the banning of the extremist paramilitary group 'Hungarian Guard' in 2011 and the perpetrators of hate crimes against the Roma community were prosecuted according to the law. The government took steps to combat hate crimes by setting up a specialised unit on hate crimes within the police, which maintains good contacts with civil society, Roma organisations and LGBT groups; an established National Professional Hate Crime Hotline to gather information about hate motivated crimes[34] and training sessions have been organised with the help of NGOs.

The extreme right Jobbik party has become the third largest group in the Hungarian Parliament for the second time after the 2014 elections. The Jobbik Party's anti-Roma and anti-Semitic rhetoric and actions have become increasingly virulent in recent years, bolstered by organized paramilitary groups, extremist organizations, and private individuals.

Freedom from harassment, intimidation and torture

Over the past three years the government took some steps to prevent ill-treatment by the police. In particular, access to legal representation has improved in practice. Efforts have been made to improve the situation of prisoners serving lengthy sentences who are subjected to a special regime at Szeged Prison. However, the Council of Europe Committee on Prevention of Torture noted a serious concern regarding the lack of effective action to combat prison overcrowding, which had a major impact on many aspects of life in prison, including increased staff-inmate tensions as well as overcrowding[35]. The Ministry of Justice adopted a special regulation on the implementation of sentences, certain coercive measures and confinement in jail for misdemeanours in light of prison overcrowding, which entered into force on 1 January 2015. The institution of reintegration was introduced with effect from 1 April 2015 to promote reintegration into society and to decrease the number of persons in custody.

[33] OSCE/ODIHR (2014): Limited Election Observation Mission Final Report, Hungary Parliamentary Elections 6 April 2014, p.2

[34] The European Commission against Racism and Intolerance (ECRI) Fifth Monitoring Report on Hungary, March 19, 2015

[35] European Committee for the Prevention of Torture and Inhuman or Degrading Treatment or Punishment (2014): Report to the Hungarian Government on the visit to Hungary by the Committee in April 2013, p.8

ANNEX 2 – SELECTED ECONOMIC INDICATORS

	2010	2011	2012	2013	2014	2015	2016
						Projection	
Output and expenditure				*(Percentage change in real terms)*			
GDP	0.7	1.8	-1.7	1.9	3.7	2.9	2.1
Private consumption (households)	-2.8	0.8	-2.0	0.1	1.7	na	na
Public consumption	-2.8	0.4	-2.6	1.5	1.3	na	na
Gross fixed capital formation	-9.5	-2.2	-4.2	5.2	11.7	na	na
Exports of goods and services	11.3	6.6	-1.5	5.9	8.7	na	na
Imports of goods and services	10.1	4.5	-3.3	5.9	10.0	na	na
Industrial gross output	10.6	5.6	-1.8	1.1	7.6	na	na
Labour Market[1]				*(Percentage change)*			
Gross average monthly earnings in economy (annual average)	9.6	7.9	5.3	5.9	4.3	na	na
Real LCU wage growth	4.7	3.8	-0.3	4.1	4.2	na	na
						na	na
Unemployment rate (end-year)	11.1	11.1	11.0	8.7	7.3	na	na
Prices				*(Percentage change)*			
Consumer prices (annual average)	4.7	3.9	5.7	1.7	0.0	-0.1	na
Fiscal Indicators				*(In per cent of GDP)*			
General government balance	-4.5	-5.5	-2.3	-2.5	-2.5	na	na
General government revenues	45.0	44.3	46.3	47.0	47.4	na	na
General government expenditure	49.6	49.7	48.6	49.5	49.9	na	na
General government debt	80.6	80.8	78.3	76.8	76.2	na	na
Monetary and financial sectors				*(Percentage change)*			
Broad money (M2, end-year)	3.0	5.9	-3.3	5.5	5.9	na	na
Credit to the private sector (end-year)	-3.0	-7.3	-9.1	-5.2	-3.7	na	na
				(in per cent of GDP)			
Broad money (M2, end-year in per cent of GDP)	61.0	62.1	59.0	59.5	59.0	na	na
				(In per cent of total)			
Non-performing loans ratio (end-year)	9.8	13.4	15.8	16.7	16.6	na	na
Interest and exchange rates				*(In per cent per annum, end-year)*			
Deposit rate	4.92	6.19	5.29	2.46	1.42	na	na
Lending rate	7.59	8.32	9.00	6.30	4.44	na	na
Refinance rate	5.75	7.00	5.75	3.00	2.10	na	na
Interbank interest rate (up to 30-day maturity)	4.50	7.52	5.49	3.00	2.08	na	na
				(Forints per Euro)			
Exchange rate (end-year)	278.75	311.13	291.29	296.91	314.89	na	na
External sector				*(in per cent of GDP)*			
Current account	0.3	0.8	1.8	4.0	4.1	na	na
Trade balance	2.7	2.9	3.0	3.5	2.6	na	na
Merchandise exports	67.6	71.6	71.0	72.0	72.9	na	na
Merchandise imports	65.0	68.7	68.0	68.5	70.3	na	na
Foreign direct investment, net	0.8	1.0	2.1	0.9	0.5	na	na
External debt stock	143.7	135.0	129.2	119.0	114.6	na	na
Gross reserves (end-year)	34.4	37.7	34.3	33.6	33.5	na	na
Previous year's gross reserves in months of imports of goods and services	4.9	5.0	5.7	5.0	4.7	na	na
Memorandum items				*(Denominations as indicated)*			
Population (end-year, million)	10.0	9.9	9.9	9.9	9.9	na	na
GDP (in billions of Forints)	27 051.7	28 133.8	28 627.9	30 065.0	32 179.7	33 112.9	33 808.2
GDP (in billions of Euro)	98.2	100.6	98.9	101.2	104.3	107.3	109.5
GDP per capita (in Euro)	9 830.7	10 130.6	9 983.1	10 245.7	10 579.9	na	na
Share of industry in GDP (in per cent, excl. construction)	25.7	25.5	25.6	25.4	25.8	na	na
Share of agriculture in GDP (in per cent)	3.0	3.9	3.8	3.7	3.7	na	na
FDI (In millions of Euro), net	761.7	971.7	2 087.4	921.9	479.2	na	na
External debt - reserves (in billions of Euro)	106.9	97.6	93.6	85.8	83.8	na	na
External debt/exports of goods and services (in per cent)	173.3	146.0	150.2	137.8	115.7	na	na

ANNEX 3 - ASSESSMENT OF TRANSITION CHALLENGES

Market Structure	Market Institutions	Key challenges:
CORPORATES		
Agribusiness		
Small	Small	• supporting land consolidation through further reform of the land market to facilitate economies of scale and foster productivity growth.
Manufacturing and Services		
Small	Small	• adopting a more consistent and predictable taxation policy and reforms to improve labour market flexibility; • supporting and improving an investor-friendly environment especially for investments in innovation by local SMEs to secure and expand the country's role as an export platform of technology and skills intensive products.
Real estate		
Small	Negligible	• although the sector is already well developed, further market penetration of innovative construction techniques and technologies (including those specific to energy efficiency).
ICT		
Small	Small	• further developing the telecommunications infrastructure (broadband internet); • further increasing competition in the wireline segment.
ENERGY		
Natural Resources		
Small	Small	• encouraging the entry of new participants in the downstream oil and gas markets respectively; • decreasing state ownership and influence in the gas sector; • fully liberalising end-user prices; • strengthening the independence of the regulator in energy tariffs setting; • fostering regional trading between Hungary's gas system and neighbouring markets
Sustainable Energy		
Medium	Small	• further deployment of renewable projects to improve renewable penetration; • strengthening capacity for supporting climate change initiatives.
Power		
Medium	Large	• reinvigorating the liberalisation process through the promotion of competition in the retail energy market; • removing price controls and adopting sustainable tariffs determined by the regulator; • improving the investment climate for generation capacity; • increasing trading through market coupling with

Market Structure	Market Institutions	Key challenges:
		regional partners.
INFRASTRUCTURE		
Water and wastewater		
Small	Medium	• improved regulation at the national level to ensure sustainable investments and tariff adjustments; • improved corporate governance and management standards in smaller utilities; • disclosure of service performance against targets; • greater private sector participation.
Urban Transport		
Medium	Small	• better integrated and inter-modal planning and regulation of the urban transport sector in the larger cities; • increased private sector involvement and competition in bus services in the capital; • adequate implementation of effective Public Service Contracts; • effective introduction of e-ticketing systems in the capital and some of the secondary cities.
Roads		
Small	Negligible	• reducing political fluctuations on PPP projects.
Railways		
Small	Small	• substantial corporate restructuring (including labour restructuring and line closures); • establishment of contractual arrangements (including improvements in the PSO and access charge regime); • developing new businesses, including commercial based property management.
FINANCIAL INSTITUTIONS		
Banking		
Small	Medium	• creating a policy environment conducive to investment in and capitalization of banking; • developing funding structures and products appropriate for local currency lending; • addressing stock of NPLs; • decreasing reliance on parent funding of the foreign-owned banks; • offering matching derivative products to cover outstanding FX mismatches at the banks.
Insurance and other financial services		
Small	Small	• bringing insurance legislation and regulation to IAIS standards; • re-establishing the basis for private pension funds; • re-establishing the mortgage market based on local currency instruments.
Micro, Small and Medium-sized enterprises		
Medium	Small	• increasing the range of bank specialised financial products available to SMEs; • developing venture capital firms providing finance to start-ups;

Market Structure	Market Institutions	Key challenges:
		• improving the institutional environment with measures targeted at improving the enforcement of creditor rights and increasing the scope of credit information available to lenders.
Private equity		
Medium	Small	• ensuring that uncertainties in the business environment do not have a negative effect on long term equity investment; • increasing participation by local institutional investors.
Capital Markets		
Medium	Small	• improving market liquidity; • improving access to capital market financing for SMEs; • developing issuer base for local currency capital market instruments, e.g., mortgage bonds issued by universal banks.

ECONOMIC INCLUSION[36] GAP RATINGS

Inclusion gap dimension	Inclusion gap	Key challenges
Regions		
Labour Markets	Large	▪ Improving access to local jobs in rural areas in sectors other than agriculture, where possible integrating a focus on Roma jobseekers, in line with the EU's recommendations on the Hungary's Roma Inclusion Strategy, i.e. strengthening measures to formalise employment, particularly to absorb job seekers from the Roma community.
Youth		
Labour Market Structure and Youth Employment	Medium	▪ Developing effective progression routes from training into employment through closer links between employers and education providers - such as work-based learning opportunities and career guidance (particularly at tertiary level).
Quality of Education and Skills Mismatch	Medium	▪ Ensure private sector participation in the introduction and development of new skill standards at national level in line with international best practice. ▪ Establishment of new cooperation programmes between clients and local universities or vocational technical schools which will facilitate new or substantially upgraded training offers for young people.
Financial Inclusion	Medium	▪ Supporting local start-ups and young entrepreneurs, including Roma youth, by encouraging financial institutions to consider and address the youth segment through tailored product packages (such as credit lines with adequate business development training).
Gender		
Labour Practices, Employment and Business	Medium	▪ Incentivise companies to introduce corporate policies in line with international best practice and adopt equal opportunities measures that enable women to access jobs and benefit from training and promotion opportunities.
Education and Training	Medium	▪ The creation and promotion of training programmes that take into account gender considerations in the design and implementation of such programmes. ▪ The creation and promotion of employment opportunities that encourage female participation in STEM (science, technology, engineering and mathematics) subjects.

[36] The EBRD Economic Inclusion gaps rate the institutions, markets and education systems across all of EBRD's countries of operation in terms of their capacity to extend economic opportunity to individuals regardless of their gender, age or place of birth. These gaps measure *differences* in opportunities – between 15 to 24-year-olds and older workers, and between women and men – rather than opportunity *levels*. Gaps are reported in this Country Strategy where there exists an Inclusion Gap above Small. Except for 'Regions', these gaps are consistent with the EBRD 2015 Inclusion Gap Assessment (Regional Inclusion Gaps were assessed in 2013 and will be updated in 2016 following the new *Life in Transition Survey*).

Access to finance	Medium	▪ Incentivising financial institutions to develop financial products and services specifically aimed at women-led SMEs and female entrepreneurs. ▪ Supporting women-led SMEs by developing business training opportunities.

ANNEX 4 – LEGAL TRANSITION

This annex offers critical analysis on selected legal topics relevant to the Bank's investment strategy in Hungary during the forthcoming period. It is based on the assessments of commercial laws conducted by EBRD Legal Transition Programme.[37]

Energy

Hungary seems to have made a satisfactory progress in introducing renewable energy, with its share of renewable energy sources above the interim target. At the same time, the government should focus on fully implementing the EU Third Energy Liberalisation Package, overcoming the current administrative and financing burdens, training respective professionals and adapting the regulatory regime to the technological developments in the renewable energy sector.

The primary legal framework for the renewable electricity sector is set out by the Act on Electricity (adopted in 2007 and subsequently amended), which regulates the broader energy sector. Feed-in tariffs, priority grid connection and grid access are key support measures for renewable energy producers. In the transportation sector, there is a quota system in place supplemented by tax reimbursement applicable to certain biofuels. The effect of incentive schemes is diminished by the insufficient grid capacity, high connection costs and complicated permitting process involving numerous authorities.

The National Renewable Energy Action Plan (the NREAP), adopted in December 2010 (as well as the National Energy Strategy 2030), identifies a number of objectives for development of renewable energy, including introducing sector-specific legislation and putting in place support financing schemes such as a new independent co-financing scheme with the participation of the EU. The revision of the Hungarian Renewable Energy Utilisation Action Plan is in progress. Other measures include further development of the feed-in tariffs, abolishment of the bureaucratic and uncoordinated system of licenses, grid development and carrying out targeted capacity building programmes. Further improvements can be achieved through long-term, stable and efficient legal and administrative regulatory reform, maintenance development and improved availability of the grid network.

Since 2014, one of the key resources of the support programmes enhancing the application of renewable energy sources has been the Green Economy Financing Scheme (GEFS), which is going to be financed by the quota revenue from the EU emission trade system. Discussions are in progress regarding potential introduction of new scheme of RES regulation.

The energy efficiency (EE) sector is largely regulated by the Act on Electricity supported by implementing regulations and furthermore by the recently adopted Act on Energy Efficiency (Act LVII of May 2015). To achieve the policy targets, a number of programmes have been implemented, with many still ongoing, such as energy certification of buildings, reducing energy use in enterprises and promoting energy efficiency improvement projects in residential buildings and multi-storey dwellings. Finalisation of the National Energy Efficiency Action Plan III (NEEAP) of Hungary was adopted by the Hungarian Government in in September 2015. The NEEAP summarises the prospective and achieved energy savings, and introduces the measures and control systems which guarantee the implementation of

[37] See www.ebrd.com/law

expected savings. Hungary has officially notified the transposition of the EU Energy Efficiency Directive into the national law at the end of May 2015.

In order to improve the energy efficiency in the residential sector, the National Building Energy Strategy was adopted on the basis of the Government decision of 18 February 2015. The Strategy has determined the objectives, requirements and the expected unit costs, the bases of which an extensive building modernisation programme can be launched.

Minimum performance standards and energy efficiency requirements for boilers have been introduced in the residential sector. Actions have been taken to transpose labelling requirements (Directive 2010/30/EU). There are certain training programmes but these do not comprehensively address the capacity needs of both public and private sectors. The efficiency of the power sector is poor, however over the years the electricity sector has improved its efficiency.

Strengthening of the policy/regulatory framework for appliances, improving energy efficiency performance in buildings and adopting detailed plans on their implementation is an important step towards a better energy efficiency framework in Hungary. The government should focus on development of energy performance contracting, especially in public buildings, and roll-out of ESCO-model financing. Establishment of a dedicated energy efficiency agency and establishment of an ESCO fund could be considered to support relevant financing operations. Attention should be given to introduction of modern innovative technologies as well as enhancing decentralised energy production. Training programmes, in particular with respect to innovative technologies, should be considered for public and private sectors in order to enhance technical capacity in all sectors. Public awareness campaigns should also be part of government's priorities.

Capital Markets

Hungary enjoys a relatively high technical level of capital markets infrastructure, and its laws are largely aligned on EU rules. The EBRD 2011 Local Capital Markets Development Legal and Regulatory Work Report (the "2011 Report") found that the laws on prohibiting insider dealing and market manipulation are working well, and the capital markets in Hungary benefit from strong corporate governance rules, as well as favourable passporting rules and accounting rules for repo transactions.

Among the more significant legal reforms affecting capital markets, in 2010 the Hungarian parliament cancelled mandatory contributions to private pension funds (pillar 2) and returned the assets from fund management to state handling. The decision (which was a reversal of an earlier pension reform) had a negative effect on the institutional investor base in Hungary, as pension funds were significant investors into equities and government securities. Over the three years, Hungary's transition indicator ratings fell in five sectors, including in insurance and other financial services and capital markets.

The government was criticised on several occasions by the ECB, which raised questions about the changes in the laws undermining the independence of the central bank (the MNB). At the same time, the merger of the HSFA into the MNB in October 2013 was welcomed by the ECB. After the integration of the two agencies in October 2013, the MNB supervises stock and commodity exchanges, brokers and financial institutions.

In terms of desirable reforms, it appears that the high cost for smaller businesses presents a barrier for local debt issuances. The government could be engaged in a dialogue on devising regulatory measures to facilitate access of such companies to capital markets, for example, through removing some of the regulatory requirements or creating an alternative issuing regime for SME issuances.

Insolvency

Various amendments have recently been made to the Bankruptcy Law (e.g. in 2009 and 2011) that have been aimed, inter alia, at strengthening the role of reorganisation proceedings. Nevertheless material gaps in the legislation still remain. Provisions relating to recovery of the assets belonging to the estate held by third parties, including the requirements for third parties to cooperate with the insolvency practitioner are weak. Creditors have limited rights in insolvency proceedings and their role is primarily of a supervisory nature. They cannot initiate bankruptcy proceedings and they have no influence over the appointment of the insolvency administrator, which is selected by an automatic system. Creditors cannot directly influence the sale (auction) or price of the assets to be sold by the administrator in liquidation either although they may comment on the auction price or turn to the Court for its revision. Another key area of weakness is cases under the Bankruptcy Law are decided by ordinary courts; there is no specialist bankruptcy or commercial court with jurisdiction over insolvency cases.

Despite the reforms to restructuring proceedings, the insolvency law framework continues to be liquidation-focused. Information gathered from key stakeholders, including banks, as part of the draft report prepared in the course of the EBRD TC Project 'Technical Cooperation Project in Support of Corporate Restructuring and Insolvency in Hungary' (the 'Draft Report') suggests that Hungary does not have a developed restructuring culture.[38] Although Hungary has a set of principles and guidelines for multi-creditor restructurings, the so-called 'Budapest Principles', implemented in 2010 and based on the London Approach and INSOL Principles, these are rarely used in practice. Restructuring or reorganisation within the context of bankruptcy proceedings is also weak. The Draft Report identifies the following issues with the bankruptcy legislation: (i) there is no substantive examination of the restructuring plan by the court as to fairness; (ii) creditors do not have the right to propose an alternative restructuring plan or to modify the plan submitted by the debtor; (iii) creditors' claims are not examined by the insolvency office holder before registration, meaning that false claims may be registered, which may, in turn, affect the outcome of the voting on the restructuring plan; (iv) insolvency office holders do not play a strong role in bankruptcy proceedings as management powers are shared with the debtor, which with the absence of creditor involvement creates an absence of incentives.

Amendments entered into force on 16 September 2014 to the Bankruptcy Law that will prioritise the claims of the mutual fund of the Cooperative Credit Union[39] ahead of unsecured creditors and remove the National Deposit Insurance Fund from the list of priority creditors. We also understand the Hungarian government is considering setting up a working group led by the Hungarian Association of Insolvency Practitioners and Asset Controllers for the formulation and adoption of amendments to the bankruptcy law.

[38] The ongoing EBRD 'Technical Cooperation Project in Support of Corporate Restructuring and Insolvency in Hungary' aims to provide the Central Bank of Hungary with a critical analysis of the existing framework in Hungary for out-of-Court restructuring and Court-led restructuring and liquidation under the Bankruptcy Law with a view to identifying potential areas for reform, focusing on corporate non-performing loans.

[39] A mutual fund for the purpose of securing the deposit held by cooperative credit institutions.

As confirmed by the Draft Report, further strengthening of the existing restructuring (bankruptcy) procedure is needed to ensure that this provides a viable alternative to liquidation. Creditors should be given greater rights in both bankruptcy and liquidation (including the right to initiate bankruptcy proceedings, influence the selection of the insolvency office holder and propose restructuring measures). The role of the insolvency office holder in bankruptcy and the content of the restructuring plan should be clearly defined (and strengthened) by law. In addition, the introduction of specialist bankruptcy or commercial courts with jurisdiction in insolvency cases would contribute to the better administration of insolvency cases and fostering of insolvency expertise.

Electronic Communications/Telecoms

The main legal basis for electronic communications regulation in Hungary is Act 100 of 2003 on Electronic Communications, as amended in 2007 and in July 2011 to transpose the EU 2009 regulatory framework. The National Media and Infocommunications Authority (NMHH) is a converged media and telecommunication regulator established following its integration with the media authority (ORTT) in 2010.

Hungary is a member state of the EU with fully liberalised electronic communications markets. The formal regulatory framework is well aligned with that of the EU and is largely seen as effectively regulated. However, some recent government policy approaches, particularly with respect to sector taxation, have been widely criticised. Although the government has replaced a so-called 'crisis tax' on telecoms from 2010 with a consumption-based telecom tax in 2013, this continued application of telecom specific taxation risks affecting both affordability for users and the incentives to invest for operators.[40]

Further, the willingness of the government to target the sector with specific taxes, has created uncertainty in the sector and has been used in the past to partly justify investment-rating downgrades.

This uncertainty has contributed to negative investor sentiment at a time when significant infrastructure investment is necessary for Hungary to achieve the EU wide Digital Agenda for Europe (DAE) targets. However, the government's recent commitment to stabilise tax policy has begun to reverse negative sentiment.

Hungary's plan for implementing DAE targets is contained in its 'Digital Hungary' strategy, launched in March 2015. The plan will benefit from the recent successful auction by NMHH of radio frequency spectrum in the 800MHz, 900MHz, 1,800MHz and 2,600MHz frequency bands. The three incumbent mobile operators all acquired spectrum, as well as a fourth player, new-entrant Digi Telecommunications. The frequencies will be used to provide 4G services throughout the country, with the 800MHz spectrum being particularly suited to expand mobile broadband coverage outside urban areas at a lower cost. The entry of a fourth mobile network operator (alongside three existing virtual operators) should also increase competitive pressure in the sector, ideally helping efficiencies and lowering prices. While the recent substantial decrease in mobile termination rates should allow a decrease in retail rates,

[40] When measuring level of taxation as a proportion of total cost of mobile ownership for 2014, the GSM Association recorded the level in Hungary as being more than 30 per cent, significantly above the global average of 20 per cent across 110 countries, which is in large part explained by the higher than average Hungarian VAT rate. http://www.gsma.com/mobilefordevelopment/wp-content/uploads/2015/06/Digital-Inclusion-Mobile-Sector-Taxation-2015.pdf.

the authorities should ensure that any accompanying decrease in operator revenues does not hamper their ability or willingness to re-invest in their networks.

While electronic communications is an important contributor to the Hungarian economy in itself, it is the sector's role as an engine of growth and development across all sectors of the economy that makes continued implementation of the ever evolving EU framework critical as a means of attracting the investment necessary to install next generation technologies. Though EBRD is currently without any direct investments in the electronic communications sector in Hungary it is nonetheless keen to see a transparent, investment friendly and fully EU-compliant regulatory regime maintained as a means to enhance the attractiveness of the sector to private investors and the security of their investments.

The main reform efforts are understood to be focussed on continuing vigorous implementation of the most recent EU framework (2009). Though the Hungarian electronic communications sector can be seen as performing better than the overall trends of the Hungarian economy, government policies over recent years have not proved particularly encouraging with respect to investment attractiveness. Though these policies have since been reversed, the authorities should now redouble efforts to ensure that their approach to next generation networks, regulatory or otherwise, should provide sufficient incentives to attract the investment necessary to achieve the DAE targets.

Public-Private Partnerships (PPP)/concessions

There is no single-act specific PPP law in Hungary. A number of laws are applicable to PPPs and concessions, including the Concessions Act of 1991, the Public Procurement Act applicable to concession award procedures as well as non-concession PPPs, the Public Finance Act and the Civil Code.

The Concession Act is an old and fairly basic piece of legislation that provides a good degree of flexibility in setting the terms for project documentation. In the absence of specific legal framework covering non-concession PPP, social infrastructure PPP projects in education, penitentiary system, culture, sports etc. has developed based on the Civil Code provisions using the principle of freedom of a contract. Hungary has become one of the first states in Central Europe to experiment with PPP starting as early as 1991 with the toll road concession projects.

There has been over a hundred PPP projects awarded and some are still under implementation/operation, ranging from road sector DBFO concessions to education, prisons, theatres, museums and sports facilities and other smaller-size municipal projects, while others have been cancelled.

For a few years now there has been a fairly strong opposition to PPP associated with high public debt level and a few controversial projects which results in a lack of political and public support for PPP. From 2009 the government started reviewing the ongoing PPP projects with a view to renegotiating and restructuring them. A PPP taskforce that used to perform a role of a PPP Unit was dissolved in 2009 too leaving a gap in the institutional PPP framework. Further private sector participation in the form of PPP remains to be heavily dependent on politics and public support.