HUNGARY

Highlights

- **Economic growth has decelerated in the past year.** Following an impressive performance in 2014, GDP growth has since slowed considerably. Private consumption contributed the most to GDP growth in 2015 and the beginning of 2016, but investment registered a substantial drop in the first half of 2016.
- **Several regulatory changes have been introduced for the banking sector in recent years.** These changes include the conversion of foreign currency mortgages as well as the establishment of a new asset management company to deal with non-performing loans (NPLs). A reduction in bank taxes was approved by the government, which was one of the key commitments included in the memorandum signed with the EBRD in early 2015.
- **A number of measures to reduce red tape were adopted.** Parliament approved a tax package which includes various measures for facilitating and simplifying tax procedures for individuals and companies.

Key priorities for 2017

- **Obstacles to bank credit growth should be addressed.** The capacity of private banks to relax lending standards and to resume their role in financial intermediation needs to be strengthened, including through a more predictable and supportive policy framework.
- **Capacity for innovation and cross-border investment should be strengthened among local companies.** There remains considerable potential to improve competitiveness in Hungary by developing a knowledge-based economy and enhancing the growth potential of locally owned companies. OECD indicators suggest that only a very small share of local small and medium-sized enterprises (SMEs) invest in innovation and research and development, and productivity growth generally remains constrained by the still low investment rate.
- **A more inclusive regional policy would support higher growth potential.** Enterprise development in Hungary has been highly skewed towards the west of the country. The four regions of eastern and southern Hungary, which are important for agribusiness, have income levels well below 50 per cent of the EU average.

Main macroeconomic indicators %

	2012	2013	2014	2015	2016 proj.
GDP growth	-1.6	2.1	4.0	3.1	2.0
Inflation (average)	5.7	1.7	0.0	0.1	0.4
Government balance/GDP	-2.3	-2.6	-2.1	-1.6	-1.5
Current account balance/GDP	1.8	3.8	2.0	3.2	4.0
Net FDI/GDP [neg. sign = inflows]	-2.1	0.0	-2.7	-1.6	-1.5
External debt/GDP	131.7	122.2	106.7	106.8	n.a.
Gross reserves/GDP	35.1	34.6	30.4	27.5	n.a.
Credit to private sector/GDP	48.9	45.0	41.1	34.5	n.a.

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Macroeconomic performance

GDP growth has slowed in the past year. In the first half of 2016, GDP grew by 1.9 per cent year-on-year, which represents a significant deceleration compared with the previous two years. In 2015, with a growth rate of 3.1 per cent, Hungary's real GDP markedly surpassed its pre-crisis peak of 2008. Domestic demand continued to be the principal driver of growth, underpinned by strong increases in household disposable income. However, private investment has continued to shrink. Compared with its pre-crisis level of about 20 per cent of GDP, its share went down to only 15 per cent in 2015, below the average for the new EU member states. Despite several central bank initiatives, including the provision of subsidised credit to SMEs, the corporate credit contraction continued in the first half of 2016. Given the slow-down in EU funds absorption in 2016, public investment will likely rebound in 2017. Among other things, such a scenario would be underpinned by the government's large road infrastructure projects, which will cost about 1.5 per cent of GDP in the coming years.

Export growth remains the strongest in central Europe and the Baltic states (CEB). In 2015, export volumes increased by almost 8 per cent, and this pace of growth was roughly sustained in the first half of 2016. At the same time, exports to Russia decreased by almost 30 per cent, mainly due to the Russian trade embargo that affected mostly food products. Net foreign direct investment (FDI) flows reversed in the third quarter of 2015 and remained negative during the first quarter of 2016. Many companies have elected to repatriate profits offshore rather than reinvest. At the same time, greenfield investments are also sharply lower.

Growth will strengthen next year. The current forecast is 2.0 per cent growth for 2016 and 2.4 per cent in 2017, supported by higher exports and investment. The latter will be underpinned by government fiscal stimuli, higher-than-expected FDI inflows (partially linked to the factory expansion projects of Audi and Mercedes) and accelerated disbursement of EU funds.

Major structural reform developments

The regulatory and tax environment for the banking sector has improved. In May 2016 the government submitted to parliament a draft law for reducing the bank tax. The normalisation of the tax regime is in line with the Memorandum of Understanding agreed between the government and the EBRD in February 2015. Crucially, these amendments set the base for the tax calculation as the average asset base over the previous two years, thereby moving beyond the outdated tax base of 2009. These changes were implemented following the final conversion of foreign currency mortgages in late 2014, and the establishment of a new asset management company to deal with non-performing real estate loans in 2015. The pace of contraction in the outstanding credit volumes has declined somewhat. The central bank's Funding for Growth scheme, which made interest-free loans available to the banking sector for on-lending to SMEs with a minimal credit guarantee, has been concluded after four years. The sector will therefore move to a more market-oriented functioning.

The government is aiming for a modest simplification of the tax regime. Following numerous additional tax measures over recent years, parliament in November 2015 passed a package of measures aimed at simplifying tax procedures for individuals and companies. The key change applies to the role of the tax administration office. Companies will be audited based on the risk of tax evasion. The package also included the elimination of several taxes, such as on electric cars and tax benefits for domestic transport companies. The European Commission (EC) has acknowledged improvements in policy and tax administration, but at the same time pointed out that continued reliance on numerous sector-specific taxes constitutes a potential barrier to investment.

Another package to support companies' research and development activities through tax preferences was approved by parliament in June 2016. While Hungary is ranked as a "Moderate Innovator" in EU-wide innovation assessments, domestic enterprises had only a relatively small share in this success. Due to the country's substantial presence in the global value chains, total research and development expenditures (1.5 per cent of GDP) as well as the relatively significant share of high-tech exports in total exports (15.2 per cent) help the country stand out in central Europe. However, labour productivity has remained stagnant since 2015.

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The Paks nuclear power plant expansion project may contradict EU regulations. Since November 2015 the EC launched several investigations into the project due to suspected non-compliance with EU competition and state aid rules. In 2014 Hungary and the Russian state company Rosatom signed a contract to build two more reactors at Paks, an investment estimated at €12 billion. In return, Russia agreed to provide a loan of €10 billion to partly finance the project. The EC's final position is expected to be announced in the autumn of 2016.

The central bank's stake in the domestic stock exchange has risen to over 75 per cent, following the acquisition of another investor's shares. A plan announced in March 2016 aims to increase market capitalisation and encourage additional listings. To achieve these goals, parliament adopted a package of measures in May 2016 aimed at broadening the competence of the exchange and reducing companies' initial public offering (IPO) costs. By implementing the approved measures and introducing a multi-tier market structure the government can create a revitalised Hungarian capital market with a sufficient level of liquidity. In addition, vertical integration of the capital market infrastructure should be considered.

EU funds were fully used up in the previous budget. The EU 2007-13 structural and cohesion funds, totalling almost €25 billion, were successfully utilised by the end of 2015, which was the final year to draw down the EU funds from the previous budget. The authorities managed to utilise the highest amount of grants paid per capita in the region. Through nine national and regional programmes, Hungary is expected to utilise an additional €25 billion from the new 2014-2020 budget of the European Structural and Investment Funds (ESIF). More emphasis is to be placed on repayable instruments.