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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 15/30-2

10:10 a.m., March 27, 2015

**2. Hungary—2015 Article IV Consultation**

Documents: SM/15/66 and Correction 1, and Correction 2, and Supplement 1, and Supplement 1, Correction 1; SM/15/67 and Correction 1, and Correction 2

Staff: Christou, EUR; Flanagan, SPR

Length: 37 minutes

## Executive Board Attendance

M. Furusawa, Acting Chair

### Executive Directors

H. de Villeroché (FF)

M. Snel (NE)

### Alternate Executive Directors

M. Mkwezalamba (AE)  
 P. Ayissi-Etoh (AF), Temporary  
 D. Vogel (AG), Temporary  
 K. Choi (AP)  
 W. Orie (BR), Temporary  
 X. Li (CC), Temporary  
 F. Lopez (CE), Temporary  
 M. McGrath (CO)  
 S. Benk (EC)

S. Meyer (GR)  
 M. Govil (IN), Temporary  
 T. Catsambas (IT)  
 M. Matsutani (JA), Temporary  
 M. Daïri (MD)  
 M. Merhi (MI), Temporary

M. Lindpere (NO), Temporary  
 M. Atamanchuk (RU), Temporary  
 H. Alogeel (SA)  
 P. Tangcharoenmonkong (ST)  
 M. Radziwill (SZ)  
 J. Gruber (US), Temporary  
 T. Duggan (UK), Temporary

A. Zanello, Acting Secretary

H. Malothra, Summing Up Officer

D. Kovacevic, Board Operations Officer

### Also Present

African Department: D. Robinson. Asia and Pacific Department: D. Cowen.  
 Communications Department: W. Amr, R. Anspach, P. Walker. European Department:  
 K. Christou, J. Decressin, A. ElGanainy, J. Franks, N. Klein. Finance Department:  
 B. Hacibedel, H. Hatanpaa, H. Imamura, T. Krueger, A. Tweedie, R. Zhang. Legal  
 Department: W. Bergthaler, K. Kwak, R. Leckow, B. Steinki, J. Swanepoel. Middle East and  
 Central Asia Department: H. Finger, D. Gressani, A. Shahmoradi. Monetary and Capital  
 Markets Department: K. AlSaeed. Office of Budget and Planning: D. Citrin. Strategy, Policy,  
 and Review Department: B. Baltabaev, M. Flanagan, A. Kammer, S. Tiwari, C. Tovar Mora.  
 Western Hemisphere Department: J. Roldos. Executive Director: F. Alshathri (SA),  
 C. Cottarelli (IT), S. Field (UK), R. Mohan (IN), J. Mojarrad (MD), H. Temmeyer (GR).  
 Alternate Executive Director: M. Arbelaez (CE), S. Geadah (MI), C. Just (EC), W. Kiekens

(NE), I. Oliveira Lima (BR), O. Petryk (NE), V. Plater (AP), C. Yeates (UK). Senior Advisors to Executive Directors: W. Abdelati (MI), M. Farnoux (FF), M. Haarsager (US), A. Jbili (MD), A. Landbeck (GR), T. Lessard (CO), B. Lischinsky (AG), A. Marcussen (NO), A. Monajemi (MD), R. N'Sonde (AF), N. Parent (CO), J. Raj (IN), U. Rutkaste (NO), M. Sidi Bouna (AF), D. Stenzel (GR), K. Watanabe (JA), G. Zuniga-Villasenor (CE). Advisors to Executive Directors: K. Badsı (MD), W. Choi (AP), J. Clicq (NE), J. Corvalan (AG), V. De la Barra (AG), F. Dlamini-Kunene (AE), G. Gasasira-Manzi (AE), V. Gibbs (UK), C. Gokcen (EC), M. Hough (CO), S. Keshava (SA), I. Lopes (IT), T. Manchev (NE), K. Masuhara (JA), N. Meredov (SZ), P. Miettinen (NO), G. Nadali (MD), E. Ondo Bile (AF), J. Osinska (SZ), L. Piana (FF), B. Repansek (EC), X. Shi (CC), M. Spinella (IT), A. Tivane (AE), T. Tlelima (AE), D. Togmid (AP), D. Vasilyev (RU), A. Weller (US), H. Zavarce (CE), F. Najjarian (BR), S. Bor (UK).

## 2. HUNGARY—2015 ARTICLE IV CONSULTATION

The staff representatives from the European Department submitted the following statement:

This statement provides information that has become available since the issuance of the staff report on March 13, 2015. This information does not alter the thrust of the staff appraisal.

On March 24, the Monetary Council lowered the policy rate. On the back of continued disinflationary pressures and as recommended by staff, the council reduced its policy rate by 15 basis points from 2.10 percent to 1.95 percent. This cut was slightly smaller than market expectations for a 20 basis points cut. In its communication following the meeting, the council noted that cautious easing of monetary conditions may continue as long as it supports the achievement of the medium-term inflation target.

At the same time, the Monetary Council confirmed its 3 percent inflation target and introduced a  $\pm 1$  percent ex-ante band around it. The introduction of the band is a change from the previous framework whereby the central bank adhered to a continuous 3 percent point target with a tolerance band of  $\pm 1$  percent which was used to evaluate ex post the attainment of price stability. Confirmation of the 3 percent inflation target helps reaffirm the central bank's (MNB) intentions at a point of deflationary risk, and the introduction of the ex ante band is in line with practices of other inflation targeting central banks. It will be important for the MNB to continue anchoring inflation expectations around the mid-point of the band.

Standard and Poor's (S&P) upgraded Hungary's rating, but it still remains non-investment grade. On March 20, S&P raised its long-term foreign and local currency sovereign credit ratings to BB+ from BB and affirmed the short-term foreign and local currency sovereign credit ratings at B. S&P noted that the upgrade mainly reflects the improvement in Hungary's external vulnerability and growth outlook, as well as the positive impact of the FX mortgage conversion.

Mr. Benk submitted the following statement:

Since the last Article IV consultation, Hungary has continued to improve its macroeconomic fundamentals. Economic activity remained strong while vulnerabilities declined, backed by prudent and supportive policies. The external balance continued to strengthen, while disciplined fiscal policy

preserved a stable fiscal balance and a gradually declining public debt. On March 20, Standard & Poor's raised Hungary's credit rating by one notch, citing the reduced vulnerability to external shocks and a pickup in economic growth. The authorities expect a further upgrade in the near future on the basis of Hungary's strengthening macroeconomic fundamentals.

### Economic Developments and Outlook

The economy has continued to grow at a strong pace, reaching an annual rate of 3.6 percent in 2014 on the back of improving domestic demand. Unemployment continued to decline, reaching its pre-crisis level, on the account of accelerating private sector job creation and persisting public work programs. Notwithstanding the accelerating growth, the current account has remained in a substantial surplus. Headline inflation decelerated sharply, reflecting the still negative output gap, the decline in import prices, and one-off effects from regulated utility price cuts.

The growth momentum is expected to persist over the forecast horizon. Against the background of the latest incoming data and supportive policies, the authorities are more optimistic than staff about the growth prospects, expecting GDP to grow at a rate close to 3 percent in 2015, while in the medium- and long-run, GDP is expected to remain dynamic, driven mainly by the underlying factors which also boost potential GDP growth. The extended and prolonged Funding for Growth Scheme (FGS) is likely to promote corporate, in particular SME, investment, while the cyclical nature of the EU funding receipts is likely to work in the opposite manner in 2016, acting as a temporary drag on growth. Households' investment activity is expected to rise gradually as consumer confidence, labor conditions, and real income recover. The improving household balance sheets resulting from the settlement and conversion of FX mortgages, and the consequent removal of uncertainties, would further support the revival of private consumption.

The authorities assess the risks around the outlook as more balanced than in staff's view. External vulnerabilities, though still important, are gradually lessening as the share of the nonresident holdings of public debt turned to a firmly declining trend during the past years; the composition of the foreign investor base shifted towards more stable, real money players; and the foreign liabilities of the banks have been reduced substantially by the conversion of the Swiss franc-dominated FX loans.

## Fiscal Policy and Debt

The public debt-to-GDP ratio has been on a declining path since 2011, moderating to 76.9 percent by the end of 2014, notwithstanding a weaker exchange rate. The financing strategy allowed for the composition of the debt to shift to a more healthy structure, with a firmly declining share of FX-denominated securities. In addition, the central bank's self-financing scheme shifted the incentive of holding government securities from the foreign banks to the domestic banks, thus aiding the decline of nonresident holdings of public debt. Domestic households continued to increase their bond holdings as well.

The authorities are fully committed to conducting prudent fiscal policies compatible with sustainable debt reduction, and building buffers which allow for countercyclical policies. Fiscal discipline and prudence helped the government to keep the deficit comfortably within EU limits, and rigorous budget execution and corrective actions, where needed, ensured that the 2012, 2013, and also the 2014 deficits over-performed relative to the initial target. The 2014 deficit is estimated at 2.6 percent on the background of an accelerating economy and significant improvements in tax administration, especially in increasing VAT collection and tackling fraud. The installation of online cash registers was especially helpful in this regard, and the recent implementation of the Electronic Trade and Transport Control System is expected to yield similar positive results.

The 2015 budget targets a 2.4 percent deficit, planning a broadly neutral fiscal stance for the current and the subsequent years. This would allow a convergence to the medium-term structural deficit target of 1.7 percent and a steadily declining public debt trajectory.

The government plans a number of changes to the fiscal framework. The intended early adoption of the 2016 budget would enhance predictability, while harmonizing the budgeting process with the European Semester. A new Tax Code is under preparation, with the intention to develop a more customer-friendly system and ease the taxpayers' administrative burden.

The authorities appreciate staff's constructive policy recommendations on the medium-term fiscal adjustment strategy. Some of them, where feasible, are already under implementation, or given due consideration for the fiscal plan of the coming years. For example, some measures to address VAT compliance and fraud are already yielding promising results (online cash registers) or are in the early implementation phase (road control system).

Spending on non-EU related goods and services will remain under close monitoring. The government has committed to substantially lower the bank levy starting from 2016. Nevertheless, the authorities wish to keep the public work programs in operation as an important element for integrating inactive groups into the active labor force.

### Monetary Policy

The central bank (MNB) cut the policy rate by 15 basis points to 1.95 percent in its March meeting, re-launching its easing cycle after an eight-month stall, and is committed to maintaining accommodative monetary conditions for an extended period. This reflects the authorities' assessment—in agreement with Fund staff—that inflationary pressures continue to stay moderate in the medium term, supported by both domestic and international factors. Headline inflation stayed in the negative territory in the past months, while households' inflation expectations adjusted and declined continuously during the last year. Going forward, this may help align the price- and wage-setting decisions of economic agents with the inflation target over the medium term, despite the pickup in domestic demand. The launch of the ECB's asset purchase program and the ongoing monetary easing in the region also point to easier monetary conditions.

The current level of international reserves is adequate by a variety of metrics, and is expected to stay within a comfortable range even after supplying the banking sector with the necessary foreign exchange for the conversion of mortgage loans. There is no compelling evidence showing that the exchange rate is misaligned.

### Financial System

The aggregate capital and liquidity positions of the banking system are adequate, though most banks' balance sheets have continued to shrink and their profitability has remained curtailed. Nonperforming loans, although stabilized, remained high both in the corporate and in the household segments. To repair the financial intermediation and enable the banking system to be more supportive of economic growth, the authorities have taken a series of measures, as follows:

The MNB launched the Funding for Growth Scheme (FGS) in 2013, aiming at providing liquidity to credit institutions at a preferential rate to alleviate disruptions in lending to SMEs and to reverse the vicious credit squeeze/low growth cycle. The first and second phase of the program

provided financing to more than twenty-thousand SMEs, amounting to about HUF 1325 billion (over 4 percent of GDP), predominantly new investment loans. Notwithstanding the FGS' beneficial effects, lending outside of the FGS has yet to recover, as excessive risk aversion by banks and tight credit conditions have remained present in the riskier but viable SME segment. As a response, the MNB just launched in March the FGS+ scheme, targeting SMEs with medium risk spreads that exceed the FGS' 2.5 percent cap. Under the FGS+, the MNB will assume 50 percent of the credit risk from credit institutions, but limited to only up to a five-year period, and capped at a maximum of 2.5 percent of the outstanding FGS+ loan stock of the individual credit institution.

To clean the nonperforming commercial real estate loan portfolio, the MNB established an asset management company (MARK) with the aim of serving as a voluntary option for the banks for removing distressed assets from their balance sheets, hence catalyzing the market. Following consultations with the European Commission and the ECB, and building on the Fund's TA recommendations, the MNB has improved the market-based characteristics of the vehicle and shifted to market pricing, and is examining the implementation of further safeguards to ensure the financial independence of the central bank. The MNB pursues its macroprudential mandate with MARK, namely, to achieve a well-functioning banking sector which sufficiently supports economic growth. MARK is expected to begin operations in the second half of 2015. The MNB highly appreciates the prompt technical assistance provided by the Fund in the set-up of the MARK.

A number of decisive steps have been taken to address the longstanding issue of foreign exchange-denominated (mostly Swiss franc) mortgages. First, the Settlement Act ensured the settlement of the non-justified interest rate, fee increases, and exchange rate spreads, setting the stage for the transition to a "fair banking system." The Conversion Act stipulated the conversion of the FX-denominated mortgage stock at the market exchange rate. Lastly, the Fair Banking Act will ensure the transparency in pricing going forward, fostering competition. The immediate effect of these measures will reduce the profitability of the banking sector for this year; however, in the longer term, the return to fair interest margins will increase households' repayment ability, ease their balance sheet pressures, and increase predictability. Not least, these measures will reduce banks' exposure to foreign funding. The MNB is playing an active role in this process, both in terms of macroprudential regulation and consumer protection, and in supplying the foreign exchange for the conversion.



In order to increase the profitability and lending capacity of the banking sector, the government signed a memorandum of understanding with the EBRD, opening a new chapter with the banking sector, committing to: (i) create a framework that ensures the long-term sustainability of a stable and predictable economic policy; (ii) decrease the bank tax to the EU standards by 2019, starting in 2016; (iii) refrain from any measure that may have a negative impact on the profitability of the banking sector; and (iv) transfer all direct and indirect majority equity stakes it currently holds in local banks to the private sector within the next three years.

### Structural Reforms

The authorities are continuing with the structural transformations and supply-side measures, intended to address structural bottlenecks and raise Hungary's medium-term growth prospects. A series of regulatory and administrative changes have been implemented with an impact on the business environment, such as: a new Labor Code facilitating the shift towards more flexible employment types; a new Civil Code with reforms in the field of corporate law and contract law; the implementation of the Cutting Red Tape program, aiming to reduce entrepreneurial administrative burdens, reduce the timeframe for administrative procedures, and simplify the tax system by abolishing several minor taxes; and the one-stop-shop government windows for administrative matters. A new Tax Code is under preparation, intended to develop a more customer-friendly system with less administrative burden.

Labor market reforms are aimed at creating a workfare state, a work-based social security system where the long-term unemployed have access to public work, facilitating their return to the primary labor market. The Job Protection Act reduced the tax wedge for disadvantaged groups with the lowest productivity but with the highest responsiveness to incentives to join the workforce, such as the low-skilled, young, old, long-term unemployed, returning mothers, and career starters. Its results are already reflected in the continuously rising labor force participation alongside the declining unemployment. Several measures aimed to transform primary and higher education, as well as vocational training, serve the enhancement of human capital.

Efforts have been stepped up to diversify export destinations. The energy strategy is focused on developing a non-profit energy sector to reduce high energy costs for investors to international levels, which is key to enhancing the economy's competitiveness.

## Final Remarks

The authorities thank staff for the thorough and constructive discussions during the Article IV mission, and for their valuable advice on macroeconomic policies. They remain committed to prudent policies, focusing their strategy on sustainable debt reduction, increasing labor participation, improving competitiveness, and reducing financial vulnerabilities.

Mr. Chodos and Mr. Vogel submitted the following statement:

Hungary's economy is exhibiting an interesting recovery, with a real GDP growth in 2014 more than twice the rate of the previous year; and a large part of vulnerabilities seems to have declined, which was translated in the recent improvement of the country's credit rating. It is interesting to note that in Box 1 of the staff report ("Response to Past Fund Policy Advice") the staff underscores that "the authorities have actively engaged in a policy dialogue with the Fund, but some policies deviated from previous IMF advice." For instance, we note some deviation from the Fund's policy advice. It seems that the authorities' policies were successful in encouraging economic activity, which enhanced confidence, promoting a virtuous cycle. We also observe some differences between the authorities and the staff with the policies and results looking forward. Thus, some issues could rise: how sustainable are the authorities' policies? Market reaction and the credit rating agencies seem to have a favorable view. Even though we do not have a counterfactual, we could ask what would happen with Hungary's economy if it were to implement previous IMF advice.

We welcome the authorities' commitment to conducting prudent fiscal policies. We observe that the 2015 budget implies a broadly neutral fiscal stance. The staff is right in underlining the relatively high gross public debt-to-GDP ratio; however, once again, we have to take into account that the ratio could raise because of a growing numerator and/or a decreasing denominator. Furthermore, while the staff considers in its analysis the gross public debt, as in other cases, we consider important to observe the net public debt and, in this regard, we note from the staff report that Hungary's level of reserves is estimated at slightly above the upper limit of the Fund's adequacy range. Having said this, the staff in their report made important points in underscoring the importance of enhancing the efficiency of the tax system, while in the selected issues paper it clearly depicts the necessity of increasing the level and the efficiency of public spending, particularly education and health.

We shared the concerns expressed in the staff report on the banking sector and the consequent need of repairing financial intermediation and addressing the high level of non-performing loans. We note the authorities' optimism on the measures to stimulate credit, but dealing with the above-referred issues it seems to be a pre-condition for a banking system that could support higher and sustainable growth conditions.

With these comments, we thank Mr. Benk for his informative buff statement and we wish Hungary and its people every success in their future endeavors.

Mr. Daïri and Mr. Monajemi submitted the following statement:

Hungary's recovery is strengthening, supported by accommodative policies and improved market sentiment, with GDP in 2014 close to its pre-crisis level. The current account has remained in surplus, inflation decelerated further to a very low level, and unemployment has fallen significantly. However, public debt-to-GDP ratio remained elevated, and the economy continues to face significant risks arising from an uncertain global environment and large financing needs, with extensive reliance on non-resident funding. There is a need to strengthen fundamentals, further reduce vulnerabilities and comprehensively tackle impediments to strong, private sector-led growth. We broadly concur with the thrust of the staff appraisal.

The sharp decline in unemployment over the past 2 years was driven to a large extent by public works programs. This raises the question of the sustainability of this decline. While we note the authorities' intention to expand public works programs, we would welcome staff clarification on how this higher spending is captured in the fiscal accounts, in view of the significant reduction in capital spending projected over the medium term in the context of a less supportive fiscal policy and lower EU funds.

We share staff view on the need for growth-friendly fiscal consolidation, including broadening the tax base and improving compliance, and for strengthening expenditure composition and quality to achieve faster debt reduction. The staff has expressed concern that distortionary sectoral taxes undermine investment and long-term growth. The authorities however see limited scope to reduce these taxes beyond the announced reduction in the bank levy over 2016–19. The staff's further comments on the issue, with particular reference to global trends toward taxation of the financial system and energy, would be appreciated.

Monetary conditions have been appropriately eased and have supported the strong recovery. We agree that there is scope for further cautious monetary easing in view of subdued inflationary pressures, a weak external environment, falling commodity prices, a negative output gap, and the recent quantitative easing by the ECB, with possible pressures on capital inflows. However, in the event of a sharp increase in U.S. long term interest rates or a deterioration in market sentiment, monetary tightening would be necessary to mitigate capital outflows and support financial stability. We welcome the MNB's intention to maintain an adequate level of international reserves as a buffer against shocks. Could staff indicate whether the toolkit of instruments to mitigate potential capital flow volatility includes CFMs?

Repairing financial intermediation is essential to boost lending and support economic growth. Although the Funding for Growth Scheme has improved SMEs' access to finance, reduced borrowing costs, and increased loan maturity, high NPLs and loan-loss provisioning and a heavy tax burden have eroded bank profitability. We are pleased to note from Mr. Benk's informative buff statement that the authorities have signed a memorandum of understanding with the EBRD to address these concerns. We also welcome the establishment of an Asset Management Company, and encourage the authorities to protect its independence and ensure transparency.

Continued structural reforms are needed to put Hungary on a higher growth trajectory. While the introduction of new Labor and Civil Codes are commendable, further labor market reforms aimed at upgrading labor skills and reducing skill mismatches, and enhancing labor participation, in particular for women, are critical. Improving the business climate, including by increasing policy predictability and transparency and reducing the regulatory burden, would go a long way in supporting investment and growth. Strong efforts would be needed to improve productivity, increase export diversification, and move up in the value chain.

Mr. Gruber and Mr. Haarsager submitted the following statement:

Hungary's main economic indicators were strong in 2014, with real GDP increasing 3½ percent, supported by a robust increase in investment, bringing the level of output back to its pre-crisis level. What explains the sharp flattening out of investment in the staff forecast for 2015, which in turn is pulling down headline growth? The unemployment rate fell, partly in response to an expanded "workfare" program which increased public sector employment. The current account was in surplus, Hungary's external debt

level declined and, as noted in Mr. Benk's informative buff statement, Hungary's credit rating has recently been revised up. However, imbalances continue to present risks to Hungary's economy. Absent significant reforms, Hungary's medium-term growth prospects will remain subdued, with potential growth hampered by lack of competitiveness and an unpredictable regulatory environment. Moreover, Hungary's external and public debt levels remain elevated, and gross financing needs are very high as a proportion of GDP. Hungary's reliance on nonresident financing and a large open FX position increase the vulnerability of the economy to shocks. We broadly agree with the staff's policy recommendations to help mitigate risks and lay the foundation for more robust growth.

Fiscal policy was broadly accommodative in 2014, with a positive fiscal impulse of  $1\frac{1}{3}$  percent of GDP. The document refers to a pro-cyclical increase in spending, but Hungary is estimated to have a negative output gap, so in what sense was the increased spending pro-cyclical? The public deficit is projected to be 2.7 percent of GDP in 2015. Can the staff offer any further information on the unidentified revenue sources included in the budget, including an estimate of their size? Public debt, at 72 percent of GDP in the baseline macro scenario, is among the highest in the region. Going forward, authorities will require more ambitious fiscal tightening in order to put public debt on a sustainable trajectory. This point is underscored by the DSA, which assigns a high probability of debt entering an increasing trajectory under current policy assumptions. Given already high revenues as a percent of GDP, fiscal consolidation will likely involve reduced expenditure, particularly in public investment. On the revenue side, we would encourage authorities to consider increased tax progressivity.

Monetary policy remains accommodative as inflation runs far below the MNB's inflation target. We support the staff's call for additional monetary easing, but highlight the need for the MNB to remain vigilant and to respond aggressively to sudden shifts and in risk perception and capital flows. Can the staff provide an update on the impact of ECB monetary easing on financial conditions in Hungary? The MNB plans to double the size of its Funding for Growth Scheme (FGS). It is important in implementing the FGS that the MNB plan be a limited duration program in order to minimize distortions in credit allocation.

The banking sector in Hungary is weighed down by high levels of NPLs and FX exposure. A more robust economic recovery in Hungary will require measures to improve the performance of the banking sector. Authorities are setting up an asset management company to remove distressed

commercial real estate loans from bank balance sheets. In setting up this company, we endorse the staff's recommendation that its operations be independent and transparent.

Hungary's banking sector has also been negatively affected by an increased tax burden and a number of government interventions which have unsettled the regulatory environment. We endorse the staff's recommendations for the removal of impediments to the cleanup of bank portfolios and also for reducing the tax burden on the sector. As in other sectors of the economy, we would urge authorities to minimize state intervention in the interest of promoting a robust and dynamic private sector.

Although Hungary has been running a current account surplus, it remains vulnerable to external shocks on account of its elevated external debt and large open FX position. The external sustainability assessment in Box 2 was ambiguous. Could the staff be more precise about the model-implied current account norm for Hungary and what sort of ad hoc upward adjustment they had in mind in order to capture Hungary's need to reduce its external liabilities? Why is it that the need to reduce external liabilities (which would seem to be a primary mechanism of current account determination) requires an ad hoc approach? The staff also assesses Hungary's competitiveness to have stagnated in recent years, noting a sharp moderation in export growth since 2009. How has the depreciation of the Russian ruble impacted Hungary?

In order to strengthen the underlying pace of growth Hungary must engage in structural reform. We encourage an enhanced anti-corruption effort on the part of authorities as well as greater policy predictability and coherence. We are particularly supportive of staff recommendations for an ambitious structural reform agenda including boosting incentives for women to enter the labor market. In the RAM, the staff highlights the risks of "unconventional policies" on the part of the authorities. Could the staff be more specific about what policies they are referring to and what impact they might have on the economic environment?

Mr. Alshathri and Mr. Abdel-Rahman submitted the following statement:

We thank staff for a set of informative reports and Mr. Benk for his helpful buff statement. While we welcome the steady economic recovery over the last two years, we note that it has been achieved on the back of expansionary policies and increasing role of the public sector in the economy. In view of the significant downside risks to the outlook, sustaining robust economic growth over the medium term would hinge on efforts to address

remaining fiscal and external vulnerabilities while creating conducive environment for private investment. We broadly agree with the thrust of staff appraisal and would like to offer a few remarks.

Fiscal reforms to improve the allocation of fiscal resources and enhance the efficiency of public spending to create more value for the money will be vital to ensure that fiscal consolidation required over the medium term to put the public debt ratio on a firm downward path is growth-friendly. Toward that goal, reforms on the revenue side to enhance the efficiency of the tax system and improve compliance should also be considered. While the authorities are committed to fiscal consolidation, the difference in views with staff on how to achieve it is notable. The authorities are more upbeat on the impact of past adjustment to the social transfer system and ongoing reforms to enhance the efficiency of spending. Could staff elaborate on these measures and why staff thinks it will not be adequate?

We note that the high level of NPLs continues to weigh on banks' balance sheets, which is contributing in impeding private credit growth. In this context, could staff clarify what are the implications on monetary policy transmission? The Funding for Growth Scheme should be viewed as a short term measure to improve SMEs access to credit and efforts going forward should focus on facilitating balance sheet repair and promoting efficient and market-oriented financial intermediation. While we welcome the establishment of an asset management company (MARK), a more fundamental legal and regulatory reform should also be considered in order to facilitate the resolution of impaired loans. Could staff clarify what are the fiscal implications of their recommendation to provide tax incentives for write offs given the size of the impaired loans and taking into consideration the authorities' plan to reduce bank taxes starting in 2016?

Structural reforms are essential to boost confidence in the economy's medium term prospects and promote potential growth. Efforts should focus on enhancing labor force skills and creating the enabling environment for a competitive private sector in order to boost export performance and move-up the value chain.

With these remarks, we wish the authorities well in their future endeavors.

Mr. Jimenez Latorre and Mr. Lopez submitted the following statement:

We thank staff for the comprehensive set of reports and Mr. Benk for his helpful buff statement. Hungarian economic indicators have recently improved with activity growing at a strong pace and market sentiment increasing. Nevertheless, growth prospects still face significant challenges. On the one hand, the increasing role of the public sector in the economy is eroding business environment and competition, curbing medium-term prospects; on the other, although thanks to some policy actions and a persistent external surplus vulnerabilities have declined, their magnitude still poses a risk. By and large, we agree with staff's appraisal and main recommendations. We associate ourselves to Mr. Snel's statement and would like to add the following comments for emphasis.

We note that economic growth has peaked up and unemployment has declined in 2014 supported by expansionary macroeconomic policies and the increased use of EU funds to finance investment projects. Nevertheless, economic output will significantly slow down during the projection period since potential growth remains subdued. The current account maintains a large surplus in terms of GDP, with high export dynamism, in line with the reported increased in price competitiveness; but at the same time, staff's report shows a sharp reduction in export market share. We would appreciate staff's comments on this apparent contradiction.

On the fiscal front, we welcome authorities' commitment to fiscal consolidation and encourage them to strengthen the fiscal budgetary framework and design a comprehensive growth-friendly fiscal strategy to put public debt on a sustainable path in the medium term. This strategy should be clear and predictable in order to avoid undesirable effects on business confidence and foreign investment. A special focus should be devoted to improving tax efficiency and progressivity—e.g. eliminating distortionary sectoral taxes and excessive exceptions—reducing current expenditures and enhancing efficiency in health and education spending.

The current accommodative stance of monetary policy seems appropriate, since disinflationary pressures persist, monetary conditions in the euro zone have eased and households' FX exposure has been reduced. Additionally, monetary loosening may support the economy in a context of necessary fiscal adjustment. The extra allocation of resources of the Funding for Growth Scheme is welcome, although it is not clear if the program has been successful so far in increasing the volume of credit. The staff's comments are welcome.



Fragilities in the banking sector remain a concern and the increasing role of the state in the banking system does not help to clarify the landscape. Some policy measures, as the conversion of FX mortgage loans to forints, have reduced vulnerabilities. However, high tax and regulatory burdens, and the significant level of NPL are eroding banks' profitability and constraining credit creation. In this regard, we welcome the set-up of the Asset Management Company as part of the strategy to cleanup banks' balance sheets. Nevertheless, the current management of the company by the central bank (MNB), with no private sector involvement, does not seem to be efficient and may bring about an unnecessary risk exposure to the MNB.

In order to facilitate a robust private-led economic growth and spur potential output, we encourage authorities to advance in measures to reduce economic imbalances, de-regulate markets, improve business sentiment, increase competition—specially in the non-tradable sector—and reduce administrative burdens. We share staff's call for an ambitious structural reform agenda that should also address weaknesses in the labor market, reduce the labor tax wedge, increase efficiency in the health and educational systems, and promote internationalization of SMEs. We kindly ask staff to specify if such policy measures are included in the current policy agenda.

Mr. Hishikawa and Mr. Matsutani submitted the following statement:

We welcome the fact that Hungary has witnessed a restart of a strong growth driven by domestic demand. We also note positively that the vulnerabilities have declined, as can be seen in the recent action by S&P raising the country's rating by one notch. Nonetheless, challenges still remain, including a high debt level, balance sheet clean-up of the banking sector, and the country's structural bottlenecks.

Since we agree with the thrust of the staff appraisal, we will limit our comments to the following points:

#### Fiscal Policy and Debt Issues

We welcome the authorities' continued commitment to fiscal consolidation. Meanwhile, continued high debt level remains an issue of concern, although we are encouraged by Mr. Benk's statement which explained that the share of the public debt held by nonresidents has declined. We encourage the authorities to continue their efforts to maintain a prudent fiscal policy and put the public debt on the downward trend at a steady pace.

### Financial Sector Improvement

Giving the pressure the banking sector has been facing, we agree with staff that improving the bank operating environment is crucial. On this note, we welcome various initiatives by the authorities to strengthen the financial system and repair the financial intermediation capabilities.

We particularly commend the authorities for their decisive actions on the issue of FX-denominated mortgages. We believe that effectively addressing the issue benefits both households and banks in the long run, through improved price transparency and reduction of currency and funding risks.

Concerning the increasing state intervention in the banking sector, we can understand the authorities' rationale for actions in the midst of difficult circumstances. However, these actions should be regarded as temporary remedies, and we urge the authorities to plan a medium-term strategy, including an effective exit policy, sufficiently in advance.

### Structural Reform

We echo staff that ambitious structural reforms are warranted to solve structural impediments and strengthen the country's medium-term growth potential. In particular, given the country's aging and shrinking population, the labor market reform is crucial. In this regard, we are encouraged by Mr. Benk's statement, which mentioned various measures taken so far, and hope that the momentum could be maintained in this critical juncture. We would appreciate if staff could update us concerning the population outlook and its impact to the economy in the medium to long term.

Mr. Mohan and Mr. Govil submitted the following statement:

We thank staff for a comprehensive set of reports on the Article IV consultations and Mr. Benk for his insightful buff statement. We generally agree with the staff assessment and have the following comments:

### Macroeconomic Outlook

In 2014, the Hungarian economy recovered strongly. Led by higher domestic demand and domestic investment, the economy grew by 3.6 percent; the growth is projected to remain above 2 percent during the next few years.

Inflation reached a low of (minus) -0.9 percent by end-Dec 2014. The average unemployment rate dipped by 2.4 percent to reach a multi-year low of 7.8 percent. The labor participation rate increased to around 68 percent. The fiscal deficit was restrained at 2.6 percent of GDP, against an initial target of 2.9 percent, which is well under the EU norms. The current account surplus went up to 4.2 percent of GDP. Reserves remained adequate, and as a percentage of short-term debt at remaining maturity reached 107 percent, up from 62 percent five years earlier. The authorities are to be commended for their strong policy actions that have revived growth and reduced external vulnerabilities.

The report states (ref: paragraph 28) that the potential growth is estimated at about 1 percent, and as investment increases, it is projected to increase to around 2 percent in the medium term. However, we notice that Hungary's gross domestic investment rate has been and is projected to be around 20 percent of GDP for the period 2010-2017. With such a healthy investment rate, why is the potential growth estimated to be so low? The staff is requested to elaborate.

### Fiscal Policy

Public debt remains high at around 77 percent of GDP; however, it is encouraging to note that it is on a declining trend over the past few years. We welcome the better than targeted performance on fiscal deficit during each of the past three years. Given this background, staff's recommendation to take further action towards structural fiscal tightening to reduce this ratio to 60 percent by 2022 is well supported. Unlike staff, we are, however, not pessimistic about the slow pace of improvement in the public debt ratio, given the difficult environment prevailing over the past few years which has resulted in a significant increase in the debt to GDP ratios in most advanced countries, as also in most of the countries in the region. We think the authorities have done well in maintaining a decline in the debt burden. The quality of fiscal consolidation is also important, and the increase in investment during 2014 aided by better utilization of the EU funds is especially welcome. On account of the improvement in sovereign debt profile, S&P recently raised Hungary's long-term sovereign debt rating from BB to BB+.

While the gross financing needs of the government (ref: Table 4), estimated at 23.3 percent of GDP during 2014, appear on a higher side, the authorities' plan to increase the sourcing of funding from domestic sources, reduce foreign funding and develop local currency bond markets would assist in reducing external vulnerabilities.

## External Vulnerability

It is encouraging to note that gross external debt has declined significantly from around 150 percent of GDP in 2009 to 115.8 percent in 2014 (preliminary estimate), and is further projected to decline to around 63.5 percent by 2020. The current account surplus is around 4.2 percent in 2014 and is expected to be around this level in the next few years. Further, the gross external financing need has declined significantly from 68.5 percent of GDP in 2011 to 39.9 percent in 2014, and is projected to be around 15 percent by 2018. The foreign currency public debt has also decreased from 42 percent of GDP in 2011 to 30.5 percent in 2014. All these factors point to a major reduction in the external vulnerability.

In view of the above, the heat map of Hungary's public DSA risk assessment (on page 48) seems unduly pessimistic. While we agree that external financing requirements (around 25 percent) and public debt held by non-residents (60 percent) are high and constitute a significant vulnerability, the steps being taken by the authorities—such as the FX mortgage conversion, tapping domestic sources of financing for raising public debt, widening of investor base etc.—are likely to significantly decrease the external sector vulnerability. At the same time, we agree with authorities that deterioration of external environment could be a key downside risk and would urge them to maintain healthy foreign exchange reserves to mitigate the impact of any adverse external sector developments, including possible volatility in international financial markets.

## Financial Sector

In our statement last year, we had noted the high level of restructured loans (around 18 percent of total loans) and agreed with staff regarding faster cleanup of banks' asset portfolios. The NPLs are still high at around 16 percent, and the bank profitability remains low. A major worry is that credit growth has been negative for the past few years. We welcome the authorities' announcement that they would decrease the bank tax to the level of EU standards by 2019. Other positive indicators for the sector include: the FX mortgage conversion scheme which has reduced the external sector vulnerability of the banking sector; and, the setting up of an asset management company (MARK) by the central bank (MNB) which is expected to clean up the balance-sheets of banks. Here, we would agree with staff and caution that MARK's operations should be kept fully independent and transparent to avoid potential conflict with the MNB's price and stability objectives.

The authorities launched a Funding for Growth Scheme (FGS) in 2013 to encourage banks to provide subsidized loans to the SME sector. In last year's Article IV report, staff had cautioned that lending under the FGS should be limited to SMEs, be well-targeted, and kept time-bound; moreover, the fiscal costs should be recognized. However, Mr. Benk mentions in his statement that in March 2015, the MNB has launched the FGS+ scheme, targeting SMEs with profiles riskier than was permitted under the FGS. In addition, under the FGS+ the MNB will assume 50 percent of the credit risk from credit institutions limited up to a five-year period. It appears that the FGS and FGS+ could stay for substantial time, at least until credit growth in the banking sector picks up. An updated analysis of risks and benefits of the FGS and staff's views on the newly launched FGS+ would be appreciated.

In 2013, the Hungarian authorities integrated the financial supervisory authority into the MNB. We would welcome staff's comments on the structure/organization and the mandate of the integrated authority. What has been the experience so far about the work done by the authority?

With these comments, we wish the Hungarian authorities all success in their development endeavors.

Mr. Mkwezalamba and Ms. Gasasira-Manzi submitted the following statement:

The Hungarian economy has registered a steady recovery in economic growth, supported by accommodative macroeconomic policies and improved market sentiment. The current account surplus and the improvement in fiscal balance and reserve adequacy appeared to have reduced vulnerabilities and improved market sentiment. However, Hungary still has large financing needs due to high external liabilities and large open FX positions, leaving it vulnerable to external shocks. This is further exacerbated by the subdued medium term growth prospects. Rigidities in the labor market and weaknesses in the business environment are key factors in Hungary's structural problems. With risks to the outlook on the downside, we broadly agree with staff's appraisal and urge the authorities to take timely policy adjustments and structural reforms to reduce vulnerabilities and secure the gains made towards a sustained economic growth.

We acknowledge the authorities' commitment to fiscal consolidation and welcome the conversion of foreign currency-denominated household mortgage debt into local currency. This combined with government's policy of borrowing primarily in local currency has contributed further to a reduction

in Hungary's vulnerability to potential external shocks. In this regard, we appreciate that some of staff's proposals for a growth-friendly fiscal consolidation strategy to reduce debt are already under implementation or being given due consideration, as mentioned in the buff statement by Mr. Benk. However, government spending of 50 percent of GDP, the highest in the region, calls for the close examination of government spending, its composition and financing. Also, in addition to improvement in tax administration and compliance measures to improve revenues, the tax system should be made more efficient by gradually eliminating distortionary sectoral taxes and exemptions so as to improve the simplicity and predictability of tax policies.

A strong regulatory and supervisory framework and a reduction of the vulnerabilities in the banking sector are necessary to safeguard financial stability. In this regard, we welcome the authorities' effort to strengthen the regulatory framework, including the introduction of the new macroprudential regulation to prevent excessive household indebtedness. On the other hand, the high levels of NPLs continue to weigh on banks' balance sheets and constrain lending, underscoring the need for a faster clean-up of banks' asset portfolio, as well as removal of legal, tax and regulatory impediments.

Decisive implementation of structural reforms aimed at improving the business climate, raising productivity and unleashing Hungary's growth potential is key. Hungary has low labor participation and productivity compared to its peers and has seen a decline in its competitiveness, export market share and attractiveness for FDI. To boost investment and strong, private sector-led growth, emphasis should be on policy predictability as well as reducing the regulatory and tax burden, enhancing competitiveness and reforming the labor market. We also encourage the authorities to continue to refine the modalities in the access to finance for SMEs under the Funding for Growth Scheme (FGS) to ensure a more effective monetary policy transmission mechanism and a higher impact on economic activity. Finally, the increasing role of the state in the economy should be managed to minimize uncertainty and avoid crowding out the private sector.

Mr. Mozhin and Mr. Palei submitted the following statement:

We thank staff for an interesting report on Hungary supported by the selected issues paper. However, while reading the staff report, on a few occasions we felt that staff did not fully appreciate the magnitude of past policy challenges in Hungary and, therefore, the authorities' achievements in strengthening economic fundamentals, improving policy frameworks, and

advancing structural reforms. Mr. Benk in his insightful buff statement highlighted many additional points, which put recent developments in proper perspective.

Since the beginning of the global financial crisis the Hungarian authorities have been facing major policy challenges. Substantial vulnerabilities of the Hungarian economy were further aggravated by the deep institutional crisis and slow recovery in the euro area. According to Laeven and Valencia (2013), in 2008-2011, Hungary was already classified as a “borderline case” for the systemic banking crisis. Taking into account subsequent bank nationalizations, the FX mortgage conversion, and creation of an asset management company (MARK) as an option to address high level of NPLs, one could probably argue that there was a full-blown systemic banking crisis, which had to affect in a very profound way the authorities’ policies as well as general economic performance.

After several years of painful adjustment and as a result of deep structural changes stronger growth rebound and higher potential growth in Hungary cannot be ruled out. In this respect, we note that last year the Hungarian economy surprised many observers. In the October 2014 WEO, staff projected 2014 GDP growth of only 2.8 percent, while the outcome was much better at 3.6 percent. In the new report staff have already revised upwards Hungary’s medium-term growth projections. In 2015 staff now expect growth of about 2.7 percent, which is slightly above consensus. However, Mr. Benk explained that the authorities have reasons to believe that even the revised growth projection is excessively cautious. For example, the Hungarian National Bank now forecasts 3.2 percent growth in 2015. Overall, we agree with the authorities that upside risks to the economic outlook may still be underappreciated by most analysts.

Economic fundamentals are improving in Hungary. Unemployment rate declined from 11.1 percent in 2011 to 7.8 percent last year. External debt is rapidly declining. Current account shows a strong surplus, which points to a competitive exchange rate. Foreign exchange reserves are sufficiently large. The economy is now much less vulnerable to foreign exchange risks. Public debt is on a downward path, while fiscal deficits are relatively low. It is not surprising that financial market indicators react positively to rapidly improving fundamentals. Spreads on sovereign bonds and CDS are declining. Recent increase in sovereign credit rating by the Standard and Poor’s was another sign of growing market confidence in Hungary.

Recent positive developments should not distract the authorities from the remaining serious policy challenges. It seems to us, however, that some of these challenges are exaggerated by staff. In the fiscal area, staff recommend to the authorities to embark in 2015 on a medium-term fiscal consolidation of about 0.5 percent of GDP annually. Given the declining public debt and upside risks to the economic outlook, we doubt that such a substantial consolidation is imperative at this stage. Its benefits for confidence building are doubtful, while the risks of choking off nascent economic recovery are non-negligible. While we recognize that the level of fiscal expenditures is high in Hungary, the case for a major reduction of expenditures is not clear. It would be more important for the Hungarian authorities to make public expenditures more efficient and to make the tax structure more growth-friendly. To this effect, we welcome the list of specific measures proposed by staff in the text table on page 9, and we encourage the Hungarian authorities to make them a part of the domestic policy discussions.

In the monetary policy area, the inflation targeting regime seems to work well in Hungary. Due to powerful and unexpected shocks the headline inflation numbers are negative, and the core inflation is below the central bank's tolerance band of 3 +/-1 percent. However, inflation expectations appear to be anchored, as they currently point to a reversal of inflation towards the authorities' target range. We welcome the MNB's recent decision to reduce policy rate, which was in line with staff recommendations.

In their analysis of the external sector (Box 2) staff explained that the EBA methodology was not very useful in identifying possible misalignment of the forint exchange rate, similar to the situations in many other countries. At this stage, strong current account surplus does not point to any problems with competitiveness. Hungary's share in world exports is not a good indicator of non-price factors. Due to the growing role of China and other dynamic economies, almost all other countries are experiencing a declining share of exports.

Finally, staff's arguments about competitiveness erosion based on their references to the Global Competitiveness Report should also be seen with a grain of salt. For example, we could point to Hungary's increase in ranking from 58 to 54 in the Doing Business database, which points to improving business environment in the country. Despite these caveats, we agree with staff that the Hungarian authorities should remain vigilant and apprehensive to maintaining competitiveness in the future. We also agree with the authorities and staff that additional accumulation of foreign exchange reserves may be beneficial for further strengthening of the external position.



Mr. Snel submitted the following statement:

We thank staff for their candid assessment of the economic and financial developments in Hungary and Mr. Benk for his interesting buff statement. We broadly share the thrust of the staff's appraisal. We welcome the broad-based improvements in the economic indicators. Economic activity beat expectations in 2014 and unemployment decreased substantially. Rebalancing of the economy has been on-going since the crisis, driven by sustained current and capital account surpluses. We strongly encourage the authorities to take advantage of the cyclical upturn to strengthen fiscal consolidation and pursue structural reforms. Improvements in the business environment would be particularly important to raise Hungary's medium-term growth prospect. With this as background, we are concerned about the increasing role of the state in the economy, the continuous prominence of sectoral taxes, and the governance arrangements of the asset management company (MARK).

#### Macroeconomic Outlook

We share staff's macroeconomic projections. The dynamic growth seen in 2014 is expected to gradually slow down as the impact of one-offs, such as accelerated absorption of EU funds, dissipates. However, recent data releases and the extension of the Funding for Growth Scheme constitute upward risks. As the weaker exchange rate passes through to prices, inflation is expected to bounce back gradually.

#### Fiscal Policy

We are happy to read in Mr. Benk's buff statement that the authorities are strongly committed to conducting prudent fiscal policies compatible with sustainable debt reduction. However, despite the successful reduction of fiscal deficits over the last years, the general government debt is predicted to remain at relatively high levels in the medium term as a result of the current fiscal stance. We therefore strongly encourage the authorities to identify measures as part of an ambitious and well-specified growth-friendly consolidation strategy, seeking compliance with all the requirements of the Stability and Growth Pact to secure public debt levels on a firmly downward path.

We see scope for reducing non-productive expenditures on the basis of well-specified reform objectives while protecting spending in health and education sectors. Growth-friendly consolidation should be combined with

efforts to improve the efficiency of the tax system and to eliminate excessive sectoral taxes. We concur with the authorities that the early adoption of the 2016 budget would enhance predictability and welcome their intention to harmonize the budgetary process with the European Semester. We invite the authorities to implement the legislated strengthening of the medium-term budgetary framework. Further steps to improve the governing arrangements of the Fiscal Council as well as the transparency of public finances would help supporting the necessary fiscal adjustment.

### Financial Sector

We are pleased that the authorities are devoting increasing attention to the need to address non-performing loans and to restore the lending capacity. We concur with staff that the authorities' recent initiatives are likely to improve private sector balance sheets and could help re-invigorate credit growth. Enhancing banks' governance and operating environment, and restoring their lending capacity is crucial to support growth opportunities. We thus support the measures announced in the Memorandum of Understanding with the EBRD. We also welcome the authorities' commitment to strengthen the regulatory and supervisory framework and the introduction of macro-prudential regulation on FX loans. The authorities' decision to re-denominate the bulk of FX mortgage loans has significantly reduced the exposure of households to currency risk. However, like staff, we caution against an increasing role of the state in the banking system and invite the authorities to pursue their intention to disinvest. We also note that the ECB and the European Commission are currently discussing with the Hungarian National Bank (MNB) concerns about the set-up of MARK under the central bank, also in light of the risk of possible lack of compliance with EU Treaty provisions.

### Structural Policies

Medium-term growth potential remains subdued. Like staff, we call upon the authorities to develop a comprehensive strategy to boost the growth potential and medium-term growth. Such a strategy would also positively contribute to the confidence of foreign investors, which remains essential given the considerable external debt rollover needs.

Improving policy predictability and transparency in decision making procedures is essential. The increasing role of the state in several sectors as well as the entry restrictions in certain service sectors are significant impediments for competition, investment and attracting foreign investors.

Labor market reforms should aim at increasing labor participation further and addressing skill mismatches. In this respect, we also see scope for further reducing the high tax wedge for low-income workers.

Mr. Catsambas and Ms. Spinella submitted the following statement:

We thank staff for their candid set of papers and Mr. Benk for his informative buff statement. We broadly concur with the staff appraisal and associate ourselves with Mr. Snel's statement. In addition, we would like to offer the following comments.

#### Macroeconomic Outlook

We welcome the recent improvements in the Hungarian economy: the 2014 growth was recorded at an encouraging 3.6 percent, unemployment was reduced to 7.8 percent and vulnerabilities to external shocks were significantly reduced too, which in turn improved market sentiment. At the same time, the transitory nature of the authorities' measures is a source of concern, many of which could dissolve without a structural impact on economic fundamentals other than bringing about an increased role of the state in the economy. As a result, we agree with staff that Hungary continues to face considerable risks in the medium-term, as public debt is still very high, medium term growth prospects are subdued, and foreign investment prospects have deteriorated. The increasing role of the state in the economy, either by means of direct intervention and business nationalizations or by the introduction of ad hoc taxes on domestically operating foreign enterprises, could prove highly detrimental to the development of the country in the long-term, provoking the retrenchment of foreign direct investment. Several Italian companies were forced to leave Hungary after suffering high losses, especially in the energy, banking, telecommunication and agricultural sectors, while others face disproportionate tax and administrative burdens that could make them unprofitable and ultimately unviable.

#### Fiscal Policy

We commend the authorities for their commitment to fiscal consolidation, but concur with staff that a more decisive action is warranted to ensure the medium term reduction of public debt below 60 percent of GDP in line with the IMF recommendation and the EU Stability and Growth Pact requirements. The consolidation strategy should be based on both expenditures and revenues, remaining growth friendly and aiming at increasing the quality and efficiency of health and education spending.

Moreover, we see scope for a far-reaching reform of the tax system, by improving its efficiency, limiting fraud and lack of compliance, reducing exemptions and, especially by eliminating the distortionary sectoral taxes imposed on financial institutions, energy providers, telecommunications and other companies.

### Banking Sector

Despite increasing efforts by the authorities to tackle the high NPLs and the long-lasting credit crunch, the banking sector still remains vulnerable. Many banks are not adequately provisioned to face a negative shock and balance sheets continue to shrink. On the other hand, we commend the authorities for the substantial improvement of the supervisory and regulatory framework, now enriched by macro-prudential regulations, and remain confident that the institutional framework of the asset management company (MARK) will follow best international practice and compliance with the EU Treaty provisions.

### Structural Reforms

We concur with staff that Hungary needs to promote a fully-fledged structural reform agenda and stimulate growth by removing obstacles to competitiveness, improving productivity and encouraging SME internationalization. We are pleased to note that Hungary did quite well in the Doing Business 2015 World Bank review, gaining 4 positions from 58 to 54. When looking into the index composition in detail though, we are confronted with the (sometimes significant) deterioration of a series of indicators related to the business environment, such as starting a business, getting electricity, and registering property, to name a few. We therefore strongly encourage the authorities to tackle these weaknesses by reducing the regulatory burden, while at the same time promoting innovation and investing in vocational training.

Finally, we would like to encourage the authorities to try increasing female labor force participation and reducing gender inequalities, especially in political representation, as analyzed in the interesting SIP.

Mr. Santoso, Mr. Marcelo and Mrs. Waqabaca submitted the following statement:

We welcome the steady growth of Hungary and the reduction in vulnerabilities in the economy, supported by accommodative macroeconomic policies and better market sentiment. While macroeconomic fundamentals

have improved, there remain underlying challenges associated with reducing the public debt, reviving financial intermediation, and improving the business environment, which need to be addressed through growth-friendly policies and wide ranging reforms. As such, we broadly support the recommendations by staff and thank Mr. Benk for his helpful buff statement, adding a few comments only for emphasis.

Appropriate fiscal consolidation is vital to support growth while helping to lower debt. Improving expenditure efficiencies in key sectors such as public works, education and health and reducing discretionary spending will create space for more quality spending that will strengthen the fiscal position and positively impact the economy. At the same time, simplification and rationalization of the tax system may be warranted in light of the budget reliance on special taxes, the substantial tax burden on certain sectors, and the need to improve policy predictability and the business environment. In this regard, we welcome the progress towards a new customer-friendly Tax Code that should improve tax administration and compliance.

Financial reforms are essential to strengthen bank performance and support financial stability. Despite the adequacy of banks' aggregate capital and liquidity positions, their lack of profitability and high NPLs need to be addressed. We welcome the recent steps taken including the Funding for Growth Scheme, the asset management company (MARK) and measures to tackle the longstanding issue of foreign currency-denominated mortgages, aimed at improving banks' health and reviving credit growth. The subsidized lending programs have provided temporary relief in improving SME access to credit but these may entail significant fiscal risks. As mentioned in the buff statement, the Magyar Nemzeti Bank has expanded the SME scope of the lending program and introduced a time-bound and capped loan guarantee mechanism. The staff's comments are appreciated on the recent program modifications. Moreover, in light of challenges posed by increased state role in the banking system, strengthening the regulatory and supervisory framework is vital to reinforce adherence to international prudential standards, which support financial stability.

Pursuing reforms to alleviate structural rigidities in the economy and lift medium term growth prospects is vital. We note the positive results of some recent measures on the business environment and labor market. Nevertheless, persistent and timely implementation of coherent policies needs to continue to enhance the country's competitiveness, diversify the economy and bring about durable and sustainable growth.

Ms. Meyersson and Mr. Lindpere submitted the following statement:

We thank staff for the comprehensive reports and Mr. Benk for his helpful buff statement. We associate ourselves with the views expressed by Mr. Snel and offer the following remarks for emphasis.

The Hungarian economy has settled on a growth path, which was last year one of the highest among the EU countries. Economic growth has been driven by a few favorable factors, some of which are temporary in nature, and by accommodative policies. However, there has been limited success in a number of policy areas. Therefore, renewing the reform momentum that reduces the role of the state in the economy, restores fiscal sector sustainability, and revives credit sector support to the economy has high importance for maintaining growth and continuing income level convergence. Unlocking the growth potential prescribes stepping up with structural reforms in a number of areas. High public debt and substantial financing needs make the Hungarian economy still vulnerable to changes in global market sentiment.

The Hungarian economy needs an urgent restart in the fiscal policy performance and strengthening of the fiscal framework. Persistent budget deficit, which has deteriorated recently in both structural and nominal terms, high public debt to GDP ratio and public expenditure close to 50 percent of GDP are considerable sources of risk, calling for decisive fiscal repair. In our view, current economic conditions and medium term outlook with nominal GDP growing at around 5 percent annual rate provide a favorable environment for fiscal rebalancing. Speeding up with reforms that improve tax compliance and increase efficiency of spending would make consolidation efforts easier.

There is a need for further analysis of the tax system to make it more efficient. We subscribe to the view that the tax system should be kept simple, predictable, growth friendly, and without distortions.

Developments in the financial sector have been a drag to the economy in recent years. Therefore, the banks' operating environment needs to be improved and the cleanup of banks' portfolios undertaken in a transparent and steadfast manner. Following the baseline, we note that the Hungarian economy switches from 5 percent private sector credit deleveraging in 2015 to 3 percent releveraging in 2016, which should provide some stimulus but this is not apparent in the growth forecast. We would appreciate if staff could comment on their assessment of how much credit deleveraging has so far been

supply versus demand driven and how much deleveraging may have affected GDP growth.

Hungary would benefit from a number of reforms that improve functioning of the real economy and make the business environment more attractive to foreign investors. In this regard, a determined action plan is needed. Stronger lending activity and the implementation of structural reforms would elevate the level of investment and accelerate medium term growth. Previous shocks to economic policy predictability take a toll on growth that needs to be reduced as well.

Mr. Meyer and Mrs. Brabender submitted the following statement:

We thank staff for the insightful analyses and the recommendations which we broadly share, and Mr. Benk for his informative buff statement.

The macroeconomic setting in Hungary appears somewhat split up: While the Hungarian economy continues to recover with a strong domestic demand and external position, falling unemployment rates and a tendency towards receding vulnerabilities in the short-term, outlook in the medium-term is less promising as some down-side risks and distortionary policies deem to hamper the current track. The recent pick-up in economic growth is largely driven by expansionary economic policies as staff rightly accentuates. The strong current account surplus benefits from improved terms of trade-effects, partially obscuring significant internal and external risks due to still elevated (external) debt levels. Increasing governmental intervention and participation, and persistent structural weaknesses are limiting factors to sustained flexibility and competitiveness of the economy, and thereby, to strong sustained growth. Against this backdrop, we join staff in its pledge to further strengthen policy buffers through increased fiscal restraint, to remove persistent impediments to financial intermediation and to deliberately pursue structural reforms conducive to potential growth.

We associate ourselves with Mr. Snel's statement and would like to add the following comments:

We welcome the authorities' renewed commitment to fiscal consolidation. However, despite the successful reduction of fiscal deficits over the last years, even below the target, the general government debt is predicted to remain at relatively high levels in the medium-term as a result of the current fiscal stance. We therefore strongly encourage the authorities, as Mr. Snel pointed out his statement, to identify measures as part of an ambitious and

well-specified growth-friendly consolidation strategy, to secure public debt levels on a firmly downward path while seeking compliance with the requirements of the preventive arm of the Stability and Growth Pact (SGP). In this context, we see great merit in increasing the quality and efficiency of public spending, i.a. by avoiding discretionary budget measures on a large scale, rationalizing local governmental employment and streamlining the tax system, including measures to prevent fraud. The abolition of discretionary sectoral taxes and tax exemptions should also contribute to a better business environment and increased private sector-led economic growth.

With likely continued downward pressures on prices through a persistent negative output gap and possibly increased fiscal restraint in the future, we deem Magyar Nemzeti Bank's (MNB) present accommodative stance as appropriate. However, even with negative headline inflation and expectations now slightly below the central bank's target of 3 percent, the authorities should remain cautious regarding further steps of monetary easing as long as there is no indication of a deflationary feedback loop. The current disinflationary environment is significantly influenced by one-off effects of recently administered price cuts and the decline of the oil price. In a scenario of waning temporary price effects and possibly recovering oil prices, the inflation rate may soon rebound. Maintaining the current policy rate premium against most major economies should also enhance external resiliency.

In light of the banks' continued sluggish deleveraging process with a still high stock of NPLs, there is an urgent need for improving banks' operating environment and removing existing impediments to financial intermediation. Against this background, we support staff in its call to implement the conditions for a comprehensive, orderly and timely cleanup of bank balance sheets as further hesitation risks to increase economic costs. Moreover, the operating environment of banks has to be improved by reducing bank taxes and regulatory, legal and tax impediments to NPL resolution. We take note of the increasing role of the government adopted in the restructuring and consolidation process in the financial sector. We are worried about the potential contingent liabilities emerging from this engagement and stress the transitory character it should have. We fully share the concerns about the set-up of the Asset Management Company (MARK) in the MNB with regard to potential conflicts of interests, the MNB's independence and the prohibition of monetary financing.

External vulnerabilities have diminished somewhat, but risks from heavily reliance on external financing remain. The recent foreign exchange mortgage conversion, together with MNB's MARK initiative, have—to a



certain extent—eased the significant risks to Hungary’s external position. We welcome the authorities’ recent efforts to strengthen micro- and macroprudential supervision, especially concerning now stricter loan-to-value and payment-to-income ratios for foreign exchange loans. In the future, a fundamentally stronger regulatory framework will help to contain the excessive buildup of foreign currency denominated debt and the need for costly and distortionary government intervention.

We concur with staff that structural reforms are key to raising potential growth and strengthening the country’s competitiveness. We are concerned about the introduction of a series of anti-competitive barriers in previously open markets, and encourage the authorities for their removal. More predictable and sustained policy efforts towards improving the business climate will raise the country’s attractiveness to (foreign) investors. In this regard, it will be of the essence that government interventions into the market do not crowd out or discourage private entrepreneurship and innovation.

Mr. Dupont and Mr. Hough submitted the following statement:

We thank staff for their comprehensive set of reports and Mr. Benk for his informative buff statement. Hungary’s recent economic performance has been strong, with improvements in the fiscal position, increases in employment, and reductions in external vulnerabilities all notable. The challenge for the authorities will be to maintain this positive momentum in a fiscally sustainable way. In addition, while it has had some positive effects, we share staff’s concerns that continued state intervention in the economy can reduce predictability, worsen the climate for investment and thus affect growth prospects. As we agree with the thrust of the staff’s appraisal, we will limit ourselves to the following remarks.

We encourage the authorities to take advantage of the current cyclical upturn to strengthen fiscal consolidation. Although improving, Hungary’s debt levels remain high, and staff’s suggestion of moderate structural fiscal tightening appears appropriate. We welcome the authorities’ commitment to EU fiscal targets, but urge them to better specify what measures they will undertake to achieve them. We note differences between staff and the authorities about the usefulness of the public works programs and the Job Protection Act. Can staff quantify the fiscal cost of these programs and elaborate on what benefits they provide, such as increasing labor market participation or achieving social/economic goals?

Given the low inflation environment, monetary policy should remain accommodative. In addition, while reserves appear adequate for now, they should be carefully monitored, as the exposure of both the state's and the banks' balance sheets to foreign currency movements, despite recent improvements, remains elevated.

Further work is needed to strengthen the financial system, while the level of state intervention should be reassessed. The high levels of NPLs are a concern, and while appreciating that it can be a lengthy process, the authorities should undertake the necessary reforms to remove any legal, tax, or regulatory impediments to their resolution. The governance arrangements of and potential fiscal risks from (i) the asset management company (MARK) and (ii) the funding guarantee scheme (FGS) for SMEs should be closely monitored.

We note that the FX mortgage conversion measure was carried out at market exchange rates, supported by the central bank, and has had beneficial effects for financial stability and reduced FX risks for borrowers. Nevertheless, there have been other government interventions which have changed contracts retroactively and affected negatively bank profitability. Combined with the disproportionately heavy tax burden on the banking system, as well as increased state ownership, these measures reduce predictability and could constrain the ability of the banking sector to support the real economy.

Therefore, we urge the authorities to implement their agreement with the EBRD as described in the buff to, inter alia, withdraw from the banking sector over the next 3 years and refrain from further such interventions that affect bank profitability.

The authorities need to improve the business climate to boost growth potential. Reducing state intervention in the economy and increasing policy predictability to improve the investment environment are important steps. Measures to increase the internationalization of SMEs, as outlined in the selected issues paper, would also be beneficial. Finally, we note the authorities' intention to establish a state-owned energy company, which they consider would improve competitiveness. We are unconvinced. Can staff elaborate on the reasons behind this strategy and how it is intended to operate?

Finally, we note the use of OECD indicators on the efficiency of health and education spending, which have also been used in other Article IV reviews. While cross-country comparisons can be interesting, we note the caveats regarding the sensitivity to sample selection and measurement error.

In addition, placing important weight on specific outcomes, such as life expectancy or PISA test scores, may miss other elements of the system. Therefore, while we agree the OECD indicators can be interesting as a basis for discussion, we would caution against using them as basis for making specific estimates of potential fiscal savings.

Mr. Sun and Ms. Li submitted the following statement:

Supportive macroeconomic policies, improved terms-of-trade, and enhanced market confidence have paved the way for Hungary's economic recovery. Real GDP is poised to return to its pre-crisis level, and unemployment has declined. Nevertheless, the economy continues to face vulnerabilities including the high debt level and heavy reliance on nonresident financing. Over the medium term, the economic recovery is expected to maintain its momentum on the back of continued private consumption and favorable financing conditions. Measures to promote private sector economic activities would be crucial to sustain growth in the long run. We broadly agree with staff's recommendations and would like to make the following remarks.

Growth-friendly fiscal consolidation is needed to put the public debt onto a sustainable downward path, while maintaining sufficient fiscal support for economic growth. We welcome the authorities' firm commitment to fiscal consolidation and the better-than-planned fiscal performance in 2014. That said, with the public debt-to-GDP ratio projected to remain above 70 percent by 2017, more efforts are perhaps needed to significantly reduce public debt over the medium term. We encourage the authorities to mobilize more fiscal revenue by enhancing the efficiency of the tax system and addressing tax compliance issues, while ensuring adequate capital investments.

An accommodative monetary policy stance is warranted, given the extended disinflationary pressure. Inflation rate is projected to remain below the 3 percent target by 2016, with weak external environment and lower international oil prices posing downside pressure. In this context, we see merit in keeping the monetary policy stance to better anchor inflation expectations and support economic activities. However, considering the country's high external vulnerabilities, the authorities should stand ready to reverse such policy stance to safeguard macroeconomic stability, should international financing conditions change significantly and large capital outflows materialize.

Further policy measures are needed to promote credit to private sector in order to help sustain growth. While liquidity is adequate, the banks'

willingness to lend remains low, limited by the deleveraging process and high NPLs in the banking sector. We encourage the authorities to make further progress in accelerating NPL resolution, with technical support from the Fund, the EBRD, and other development partners. The establishment of the Asset Management Company is a critical move to resolve the distressed commercial real estate loans in the banking sector. Extending the Funding for Growth Scheme to provide continued lending to SMEs is crucial for inclusive growth.

Structural reforms should be accelerated to improve the business environment and address the weaknesses in the labor market. Scope exists for increasing policy predictability and transparency, as well as reducing the regulatory burden, in order to foster an environment conducive to private sector-led economic growth. Policy measures should also be geared toward further improving labor productivity and reducing skill mismatches.

Mr. Beblawi and Ms. Merhi submitted the following statement:

The Hungarian economy grew at a strong pace in 2014, helped by accommodating macroeconomic policies, higher investment due to increased utilization of EU funds, and improved market confidence. With growth gaining momentum, inflation decelerated, and unemployment was reduced to pre-crisis level. Notwithstanding these positive developments, some vulnerabilities remain, including high external and public debt levels and the heavy reliance on non-resident funding. Discussions rightly focused on a comprehensive strategy to support growth, including through the implementation of structural reform agenda, reducing the public and external debt, and improving the resilience of the financial sector. We agree with the thrust of the staff appraisal and would like to raise the following points:

Further efforts are needed to put the public debt on a downward path while supporting growth. As noted in Mr. Benk's helpful buff, public debt declined moderately and rigorous budget execution ensured that the 2012, 2013, and 2014 deficits over-performed relative to the initial target. While we welcome the authorities' commitment to conduct prudent fiscal policies, we see merit in staff's recommendation for additional adjustment in order to rein in spending and further reduce public debt. As elaborated in the interesting SIP, there might be a scope for improving the efficiency of public spending on health and education, without sacrificing current outcomes.

We welcome the measures taken to enhance financial stability, strengthen the regulatory and supervisory framework and repair financial intermediation. While the capital and liquidity positions remain comfortable in

the banking sector, banks are under pressure, as their profitability is declining and NPLs still at a high level. We look forward to the start of the clean-up of nonperforming commercial real estate loan portfolio by the asset management company MARK which was set up by the MNB. However, we concur with staff that it is important to keep MARK's operations fully independent and transparent to avoid a potential conflict with MNB's objectives. Lending under the "Funding for Growth Scheme (FGS)" has helped improve credit conditions for SMEs, nevertheless, excessive risk aversion by banks and tight credit conditions have remained present in the riskier SME segment. We welcome in this regard the launching of the FGS+ scheme in March which targets SMEs with medium risks spreads.

Structural reforms are needed to improve the business environment and boost the economy's growth potential. We welcome in this regard the implementation of the Cutting Red Tape Program which aims to create a one-stop-shop government window for administrative matters. Priority should also be given to increase competitiveness and diversify exports destinations, as well as reform the labor market in order to attract more investments.

Mr. Radziwill and Ms. Osinska submitted the following statement:

We welcome Hungary's strong growth performance. This notwithstanding, while the outlook has improved, vulnerabilities remain elevated and medium-term growth prospects seem rather subdued. A comprehensive strategy is needed to achieve a dual objective of sustainable growth over the medium-term and steady reduction of public debt. This should be accompanied by a prudent monetary policy, while stability of the banking sector should be strengthened and its intermediation function improved. We broadly share staff's assessment and policy recommendations and limit ourselves to the comments below.

Despite the improved stance of the economy, significant risks are still in place. Increased utilization of the EU-funds as well as expansionary policies prompted a strong upturn in growth in 2014. External vulnerabilities decreased. The current account surplus remained large in 2014 and thanks to lower oil prices and improved terms-of-trade may increase even further this year. At the same time, high public and external debt, associated with heavy reliance on external funding, continue to pose risks. The banking sector remains under pressure, including due to high level of non-performing loans and a high tax burden. More generally, increased policy uncertainty and distortionary taxes weigh on the business climate and cloud the growth outlook.

Against this background, Hungary needs a comprehensive strategy to support growth and further reduce vulnerabilities. A prudent and growth-friendly fiscal policy remains key to bring the public debt ratio firmly on a downward path. This should be pursued in line with the EU commitments. In our view, at least a moderate fiscal tightening in 2015 would be advisable. Further, we call for fiscal reforms to increase efficiency and reduce spending. This is crucial, since the government expenditure-to-GDP ratio is high and the overall tax burden is one of the highest in the region. Simultaneously, reforms aimed at boosting private sector-led growth are needed, including improvements in the business climate and measures to enhance productivity. However, the recent increase of the state's involvement in the economy through the acquisitions of banks and energy companies has the potential to have the contrary effect.

Monetary policy should remain circumspect amid uncertainty about future developments in the global financial environment. We see merit in the recommended cautious easing bias to counter the disinflationary pressures, in particular given the continuously falling inflation expectations, which are already below the central bank's inflation target. In this context, we take note of the recent policy rate cut. At the same time, it is warranted for the central bank to remain vigilant and stand ready to tighten if external pressures materialize. Also, it is crucial to maintain sufficient reserves as a buffer to support financial stability.

Priorities in the financial sector include repairing banks' intermediation function and safeguarding financial stability. First, more predictable banking sector policies and lower bank levies are important to improve the operating environment for banks. Second, to support a faster NPL cleanup, the authorities should consider the elimination of certain legal, tax and regulatory impediments along the lines suggested by staff. The establishment of the asset management company (MARK) can be helpful for NPL resolution, but it is important to give the scheme a clear objective of maximizing the value of purchased assets. Finally, we are concerned about the increased role of the state in the banking sector. This involvement entails the risk that lending will not be based on adequate risk considerations.

With these comments, we wish Hungary and its people all success in their challenging future reform endeavors.

Mr. Yambaye and Mr. Sembene submitted the following statement:

Hungary has recently enjoyed lower vulnerabilities along with a noticeable improvement in economic fundamentals. GDP grew strongly last year, largely driven by expansionary macroeconomic policies. At the same time, the external position remained sound amid strong export performance and better terms of trade. As a result of these positive developments, the country has enjoyed renewed market confidence. Yet risks to the economic outlook remain serious, notably those arising from the potential deterioration in the external environment, weakening of the reform momentum, and other unfavorable domestic conditions. In addition, public debt continues to be large, necessitating sustained consolidation efforts in the face of weaker growth prospects. There is also ample scope for boosting the country's growth potential, notably through increased labor participation which remains relatively low despite the significant job creation.

Against this background, we echo staff's call for continued growth-friendly fiscal consolidation. We note staff's concerns over the moderate impact of the projected deficit on the reduction of public debt. In this connection and in view the large output share of public spending, there is merit in considering additional adjustment measures that aim at enhancing the composition of public expenditure and improving the targeting of welfare programs. On the revenue side, we encourage the authorities to keep up with their efforts to improve the efficiency of the tax system and to enhance fiscal transparency.

The projected low level of inflation provides significant room for further loosening the stance of monetary policy with a view to supporting growth. The authorities are also appropriately standing ready to take necessary steps in this direction in the event disinflationary pressures were to persist and the exchange rate to come under pressure. However, they will also need to remain vigilant and stand ready to reverse course, should external sector developments so dictate. In any event, caution will need to be exercised to preserve reserve adequacy, particularly in the process of converting FX mortgage loans into local currency.

We note that the Settlement Act and Fair Banking Act provide a welcome relief to FX mortgage borrowers, while FX mortgage conversions mitigate households' debt exposure to exchange rate risks. At the same time these various legislative measures along with the heavy tax burden borne by banks are poised to affect adversely profitability in the banking system. In this connection, the authorities are well-advised to have committed to reducing the

levy on banks from 2016, as noted in Mr. Benk's helpful buff statement. The adverse impact of tax policies on the resolution of nonperforming loans should be also addressed, as it contributes to further constraining private sector credit. The staff underscores the need to limit government ownership in the banking sector. Could staff comment on the fiscal risks associated with increased state involvement in this sector?

The already large output gap is yet projected to increase over the medium term. This reinforces the need for the authorities to make inroads toward increasing the country's growth potential. To this end, staff rightly emphasizes the importance of improving the business environment and competitiveness. In the latter respect, the staff report underscores the steps being taken by the authorities to acquire energy companies, with a view to securing and diversifying energy supply. We encourage the authorities to exercise prudence in advancing their energy sector strategy with a view to containing related contingent liabilities. Finally, we see merit in addressing distortions in the labor market, notably by implementing productivity-enhancing measures and facilitating increased labor participation, as recommended in the selected issues paper.

Mr. K. Choi and Mr. W. Choi submitted the following statement:

We thank staff for the well-prepared set of papers and Mr. Benk for his informative buff statement.

We generally agree with the thrust of staff appraisal and policy advice: The staff rightly highlighted the importance of a growth-friendly fiscal consolidation strategy; desirability of well-functioning financial intermediation; and urgency of structural reform to lift growth potential. We also consider the authorities' policy responses generally in a right direction. However, we see scope for the authorities' further policy responses and staff's closer attention to following three points.

First, we urge that more focus should be placed on policy response to risk from disorderly deleveraging. Fast and disorderly deleveraging by household and banks may have an adverse impact on consumption and investment, resulting in withering growth momentum and aggravating disinflation. The staff's advice is not clear in the staff report concerning how to manage deleveraging, merely guiding the authorities to maintain accommodative monetary policy. However, it is well known that monetary easing may not be effective during a deleveraging process. We invite staff's



view on available options for the authorities to prevent possible disorderly deleveraging.

Second, we are concerned about Hungary's heavy reliance on non-resident funding. As rightly mentioned in the recent speech by Madam Lagarde in India, reducing short-term external debt is a key policy in the emerging economies against spillovers from unconventional monetary policy as witnessed in the Korean case. We note with concern the lack of staff's clear policy advice on this issue, and encourage staff to provide the authorities with concrete options on possible macro-prudential measures to make the composition of external borrowings more prudent. Further improvement would also benefit from more fundamental approach such as domestic capital market development.

Lastly, we believe that shrinking population of Hungary, although barely touched on in the staff report, significantly weigh on growth potential in Hungary. Hungarian population has decreased for last 30 years. As a common issue in transition economies, shrinking population, together with aging, could hamper the longer-term sustainability and prosperity of Hungarian economy. As a macro-critical structural issue, we urge the Fund to pay an adequate attention to this issue to provide more targeted policy advice, based on identification of a root cause. The staff's view on this issue would be welcome.

Mr. Oliveira Lima and Mr. Orie submitted the following statement:

We thank staff for the reports and for the well-researched selected issues paper and Mr. Benk for the informative buff statement. We take positive note of the ongoing improvement of the Hungarian economy. Nonetheless, vigilance is still warranted given large external financing needs and high public and external debt levels, which leave Hungary susceptible to shifts in market sentiment and external shocks. Furthermore, credit market and labor market reforms as well as improvements of the business climate are warranted to foster the growth potential of the economy.

The Hungarian economy has not only weathered well recent market volatility but is also recovering from the 2012 recession. The economy registered 1.5 percent and 3.6 percent growth in 2013 and 2014 respectively. According to staff, the high growth in the latter year was a result of expansionary policies and improved market sentiments. Going forward, growth is expected to slow to 2.7 percent in 2015 and gradually converge to

2.1 percent in 2018. Structural reforms are needed to enhance the growth potential of the country.

The staff continues to be uneasy with what it labels “the authorities’ increasing role in the economy.” According to staff, such a policy course is detrimental to private sector growth. We think that staff should have provided a more substantive justification to this position, and would like to ask whether the authorities’ increasing role in the economy is at odds with the European Union (EU) rules.

We commend the authorities for keeping the fiscal deficit under control. However, given that gross public debt stood at 76.9 percent of GDP in 2014 and is expected to decline gradually to 71.8 percent of GDP in 2020, we encourage the authorities to adopt a growth-friendly fiscal consolidation strategy. Based on the findings in the selected issues paper, the authorities could focus on the potential efficiency gains in public spending in the education and health sectors.

Private sector credit continues to contract. Therefore, we can understand why the authorities persevere with the Funding for Growth Scheme (FGS). We reiterate our view in last year’s statement on Hungary that, unlike staff, we favor keeping this arrangement available for small and medium enterprises on a more permanent basis, probably through a development bank. At the same time, we would support a faster cleanup of banks’ asset portfolios and removal of tax impediments to enhance bank lending capacity to the private sector.

Hungary’s external position remained within the Fund’s adequacy range in 2014. The authorities’ pragmatic approach to convert the FX mortgage stock to local currency will further reduce Hungary’s exposure to FX volatility. Nonetheless, high gross external financing needs and open FX position on private balance sheets, weak international investment position, and heavy reliance on non-resident funding of public debt, warrant vigilance. Given those circumstances, having sufficient reserves at any time seems to be imperative to maintain confidence and guarantee financial stability. While staff is recommending tightening the monetary stance and using FX intervention to smooth excessive exchange rate volatility in episodes of a sharp deterioration in risk perception and large capital outflows, surprisingly no reference is made to discussions on capital flow measures. We also note a divergence in the behavior of the gross reserves to short-term debt ratio and the import cover ratio (Table 9 of the staff report) and would appreciate staff’s comments on this issue.

From the selected issues paper, we note that formal as well as informal institutions result in a significantly lower labor market participation rate for women. While we see the merits of staff's recommendations aimed at reforming the formal institutions (i.e. government policies), including the generous parental leave, the availability and affordability of childcare and the gender wage gap, we would like to know staff's views on how effective government policies can be given the widely-held preference for traditional gender roles.

Mr. de Villeroché submitted the following statement:

We thank staff for a candid report and interesting selected issues papers as well as Mr. Benk for his detailed buff statement. The macroeconomic outlook has continued to improve in Hungary, with growth expanding to 3½ percent in 2014, spurred by increasing gains in real disposable income associated with a reduction in administered prices, public works programs, an improvement in EU structural funds, and accommodative monetary conditions. In particular, the surge in investments is supported to a large extent by structural funds. These positive factors must trigger a self-sustained impetus for private investment, which would pave the way for higher and sustained potential growth. We associate ourselves with the views expressed by Mr. Snel and we would like to offer the following comments.

We have some doubts on the efficiency of the Public Works Scheme. The improvement in the Hungarian labor market is to a certain extent the result of the increased reliance on subsidized job creation in the public sector. The Public Works Scheme is costly for public finances, while not allowing for a durable return of participants to the labor market. In view of staff's opinion that this program should be scaled down, we invite the authorities to weigh its effectiveness with its negative side-effects.

We support staff's recommendation for stepping up the efforts to reduce the high public debt ratio. With a large negative external position, Hungary's external vulnerability to shocks is sizeable. Continued public debt reduction would therefore be welcome and is required under the rules of the Stability and Growth Pact. We also concur with staff that the fiscal consolidation should focus on public spending and the improvement of the tax system. In particular, we consider the introduction of new taxes (in particular in the retail trade sector) since last year's Article IV consultation as unwarranted.

The accommodative stance of the monetary policy should be maintained. A strengthening of the fiscal stance would allow for the easing stance of the monetary policy to continue, which we consider, like staff, as justified in the context of a negative inflation and a still negative output gap. Having said that, the central bank should remain alert and prepared to review this stance in case the current risk appetite environment reverses.

We strongly welcome the agreement between Hungary and the EBRD. It will help with expediting and cleaning-up of banks' balance sheets, enhance the resilience of the financial sector, and will allow banks to play a greater role in the financing of the economy, while allowing temporary nationalized banks to return to the private sector. The creation of a bad bank could also help address the high level of NPLs, but its institutional setting must be carefully designed.

Lifting Hungary's growth potential through a comprehensive structural reforms program is key. We fully concur with staff that the business environment should be reformed to enhance investors' confidence and help to attract more FDI. The authorities should be mindful that unpredictable decisions in the regulatory and tax framework may have detrimental effects on Hungary's level of attractiveness for foreign investors.

The representative from the European Central Bank (Mr. Pineau) submitted the following statement:

We thank staff for their insightful report and Mr. Benk for his informative buff statement. We support the views expressed by Mr. Snel in his gray statement and we would like to make the following points for emphasis.

At this stage of the recovery, the economic activity is expected to gradually slow down as the impact of past policy steps dissipates. Moreover, risks to the economic outlook are tilted to the downside. Hence, we fully support the call for decisive economic policy actions, as Hungary continues to experience macroeconomic imbalances. In recent years, the Hungarian government has only partially implemented key country-specific recommendations agreed by the EU Council. Their full implementation and the reversal of some distortionary policy measures currently in place would contribute to increasing potential output growth.

In line with the staff, we consider promoting economic activity led by the private sector as a crucial element of the macroeconomic strategy to strengthen the medium-term prospects for the Hungarian economy. Private

sector-led growth hinges on (i) a stable and business-friendly regulatory environment; (ii) a reduction in excessive tax burden in selected sectors of the economy; (iii) enhanced functioning of the institutions and rules on competition and public procurement; and (iv) reform of the transport and energy industries, including price deregulation.

On financial sector policies, we broadly agree with the staff analysis and recommendations. The banking sector continues to be loss-making amid high regulatory costs and tax burden, which limits banks' capital generation and growth opportunities. This, coupled with the large stock of non-performing loans, weakens banks' capacity to lend to the economy. Therefore, policies should aim at improving the operating environment for banks and the long-lasting restoration of their lending capacity. Furthermore, the increased state ownership of the banking sector—even if temporary—strengthens the links between banks and the sovereign and can create contingent liabilities for the government. As concerns the asset management company (MARK) created under the central bank to address NPLs issue, we would like to stress that in addition to the concerns raised by staff, the governance of MARK raises issues about its compliance with the Treaty provisions, namely with the prohibition of monetary financing and financial independence of the central bank.

Regarding fiscal policy, the government should adopt a growth-friendly fiscal consolidation mix coupled with structural reforms to put the high sovereign debt ratio on a firmly declining path and comply with the SGP commitments. The medium-term fiscal strategy should be primarily anchored by further reducing non-productive expenditure on the basis of well-specified reform objectives, while avoiding as much as possible ad-hoc, discretionary cuts in spending. On the revenue side, the government should aim at eliminating the excessive sectoral taxes and further reducing the high tax wedge for low-income workers, in a deficit-neutral way. Overall, budget targets should be set in a prudent way and incorporate a reasonable safety margin to comply with the SGP commitments.

Mr. Choi highlighted the issue of the shrinking population, which posed a threat to the Hungarian economy, particularly in terms of sustainable growth, and placed a financial burden on that society. He noted that other countries, including South Korea, had similar concerns. He requested that the Fund take a closer look at that issue, with a more systematic approach.

Mr. Daïri made the following statement:

I appreciate the staff's comprehensive responses to our questions. I have only one problem, which is related to the treatment of the public work programs. It is not obvious that they should be treated as expenditures on wages. Most of the time, these projects are contributing to the maintenance of infrastructure or even small irrigation or rural road network. We have an extensive such a program in Morocco, and it seems like a large part of these projects could well be classified as capital expenditure.

It is true that sometimes some of these workers may be involved in activities that do not have such characteristics, but it is a worthwhile exercise to have a discussion with the authorities to delineate between what can be classified as maintenance or capital spending and what should be treated as wages under current expenditures.

The staff representative from the European Department (Mr. Christou), in response to questions and comments from Executive Directors, made the following statement:<sup>1</sup>

I would like to address a few broader issues that came out in Directors' gray statements, and I will also respond to the follow-up questions raised in the Board.

There was an overarching theme in all the gray statements, and that was the role of the state in the economy. Many Directors had views about that. There was also a question on whether all these policies and interventions comply with EU rules. I want to make an important distinction between EU rules and the economics of this intervention and how those affect Hungary's growth prospects in general.

Regarding the EU rules, the authorities are discussing all the policies that they are undertaking as part of normal discussions with EU institutions; and yes, in some cases they have had to modify certain policies to make them in line with EU rules and norms.

Turning to the economic rationale of the state's role in the economy, the staff's main concern is that this role has been increasing over the past few years. Because of the nature of the intervention, that could have adverse implications for Hungary's growth prospects, fiscal picture, and also financial

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<sup>1</sup> Prior to the Board meeting, SEC circulated the staff's additional responses by email. For information, these are included in an annex to these minutes.

intermediation. As Directors noted in their gray statements, the state has increased its influence throughout the economy by buying certain companies, including banks, increasing the scope of distortionary taxes, expanding public works, and reducing administered prices.

Most of these initiatives have been crowding out private sector activity and the business climate has been worsening. One can see it through various indicators that we present in the report, but also one can get that sense after talking to private sector participants during the mission.

Moreover, FDI prospects are pretty poor. A significant amount of FDI went into Hungary about 10 years ago, but recently that has stagnated. Hungary has fierce competition with its neighbors in attracting FDI. That is one of the main reasons why the staff is concerned.

When it comes to distortionary taxes, the majority of those taxes, mainly on the banks, were introduced at the beginning of the crisis, and the idea was to address the fiscal situation. However, the fiscal situation has since improved substantially. It is encouraging that the authorities are now recognizing the need to reduce the bank levy, and we hope that they will stick to their commitment in that regard.

But we also believe that they should go one step further. They should reconsider their policies toward taxation of other sectors—telecoms, energy, the retail sector, and others. This will result in some revenue loss, so it should be dealt with carefully. That also underscores the importance for the authorities to have a strong medium-term framework that would include such tax reductions, but at the same time, have the objective of consolidating the fiscal position. The staff has outlined a number of concerns in that regard, with the objective to increase fiscal buffers, which are now weak.

Another concern regarding the state's role in the economy relates to the fact that the acquisitions of companies increase the contingent liabilities of the state. There was a question about the size of contingent liabilities. We have only information that was provided by the authorities for 2013, and that number, which is about 10 percent of GDP, is not very high. But many acquisitions have taken place since then, and we need to dig into this issue a bit more.

For example, the acquisition of banks, even if it is temporary, could add to the contingent liabilities of the state. That has to do with increased fiscal risks given that non-performing loans have still not been resolved,

which could have implications for potential capital injections into those banks. Similar considerations apply for acquisitions in the energy sector.

Turning to financial intermediation, Directors had a number of questions regarding the authorities' policies. One policy that I mentioned earlier was the heavy tax burden on banks, which has impeded financial intermediation. In that sense, it is encouraging that the authorities now plan to not only reduce the bank levy, but also to create a good environment for banks to operate and to abstain from measures that would hurt banks' profitability. This is encouraging.

However, restoring financial intermediation also hinges on cleaning up the banks' portfolios. This is another initiative that is high on the authorities' agenda, and it was mentioned in many of the gray statements. That has to do with the establishment of the asset management company. Clearly there is a market failure in that there is no private sector demand for these distressed commercial real estate assets, so it is our hope that the creation of this company will help to resolve this issue.

However, there are a number of concerns that were also highlighted in the gray statements, and those have to do with the institutional and operational risks surrounding the establishment of this institution. We have been closely engaged with the authorities through a technical assistance mission earlier this year. Based on the discussions during the mission and follow-up discussions with the authorities, it seems that they are open to incorporating our advice about the modalities of this company—the governance, the structure and so on—into the operational framework of the company.

The European Central Bank's (ECB) statement added a few concerns in addition to the ones that we have highlighted in the report. Those were concerns of the European institutions about rules that relate to the funding of the company and also to the pricing of the assets. As far as we know, there have been ongoing discussions between the ECB, the European Commission and the authorities, and it is our hope that these issues are resolved and the company operates in line with international best practice.

As part of this engagement on the establishment of an asset management company, which is an important endeavor by the authorities, we have participated in a workshop that the European Bank for Reconstruction and Development (EBRD) organized with the authorities in Budapest about a month ago, and there was a good discussion on the asset management company itself. Even from those discussions, it seems that the authorities are



open-minded about addressing the modalities of the company. Needless to say, we will be following up on all of these issues.

Regarding the question about the public works, there is a difference between economic and functional classification. I do not want to go into the details of the accounting issue and how it has been classified since 2010, but spending has been mainly on wages. Beyond that, our concern is not only about the size of the program per se, but also the fact that this program will be increasing. There might be some rationale for the public works program during the economic downturn—one wants to keep workers employed—but when the economy is starting to grow and the government has a plan to almost double these public works programs, that raises questions.

The authorities link it to the social reform program, and in their view it is better to have all these people at work and doing something rather than being on unemployment benefits or social welfare. As we mentioned in our written responses, there is mixed international evidence about the effectiveness of such programs. This is on our agenda, and we will be following up on it in the context of our upcoming discussions, either in a staff visit or in the next Article IV consultation, but we need more detailed information from the authorities on what these people are doing.

The staff representative from the Strategy, Policy, and Review Department (Mr. Flanagan), in response to questions and comments from Executive Directors, made the following statement:

There was a question about why the staff has said that an ad hoc approach is required to correct the high level of external debt and the highly negative net international investment position. We try to be as specific as possible in each case, but across countries and even across time, there are a number of factors that affect the desirable speed of adjustment that suggest that some discretion is useful.

For instance, external financing conditions can change, arguing for more speed if for the worse; improvements in debt structure can allow a country to tolerate a higher external debt level, for example, if a greater portion of the debt becomes intercompany loans; and changing domestic balance sheet exposures may affect the desirable speed, since movements in the effective exchange rate would affect balance sheets. The level of buffers across countries, and over time the level of foreign exchange reserves, may change. This is an issue we need to carefully consider in a country context, but the answer is likely to be different across countries and even across time.

Turning to this issue of aging, a Director urged that we pay adequate attention to the issue of a shrinking population and provide more targeted policy advice. We have been paying a good deal of attention to this issue. The Fiscal Monitor regularly updates its projections on the impact of aging for all countries. There has been work done in the Fiscal Affairs Department (FAD) on pension and health care issues, including the challenge of public pension reform in advanced and emerging economies, which was a Board paper in 2011, and the economics of public health care reform in advanced and emerging economies, which was a book published in 2012.

When we consider the medium-term macro and fiscal projections, the staff does consider this issue of how demographics may affect issues like labor supply and social spending. But having said all that, we agree that the Fund needs to look carefully at this issue across countries and in specific country contexts, and we need to derive the right advice for each country due to these factors.

Mr. Daïri made the following statement:

On the issue of taxation of the financial sector, I agree on the importance of reducing excessive taxation, but advocating complete elimination of sectoral taxation may be going too far. Some sectoral taxation is justified for different reasons, for example, when one is pursuing some global public good, like the environment, or the stability of the financial system. It is also justified when one has a social purpose, for example, when agriculture is taxed differently from other activities for social reasons. In addition, depletable resources may be subject to a specific taxation system.

While we would agree on the need for reducing distortions, the call for the complete elimination of sectoral taxation may not be justified.

Mr. Benk made the following concluding statement:

I thank the staff for their invaluable work, and Mr. Christou for providing comprehensive answers to the relevant questions in writing. My authorities highly appreciate the thorough and constructive discussions during the Article IV mission and the staff's advice on macroeconomic policies.

We also appreciate Mr. Christou's initiative to organize a one-day workshop on specific issues relevant to the Hungarian economy. This is already the second session of the workshop series that he started last year.

This created a special opportunity for technical discussions between the authorities and the staff and allowed young researchers to exchange their views and discuss their research with experienced economists at the Fund. This initiative was a good example of cooperation and fruitful discussion, and it would serve as a model for other countries, and I would highly recommend it for other countries.

I thank Directors for their constructive comments, and I will convey the Board's message to my Hungarian authorities.

I would like to comment on a few of the specific points Directors have raised in their gray statements, starting with the vulnerabilities. When reading Hungary's Article IV report from the previous years, one will note that there are some recurring elements: the elevated public debt, high external debt, high share of non-resident financing, and large open foreign exchange positions. I am glad to say that these vulnerabilities have lessened and are continuously decreasing. For example, the share of non-resident holdings of public debt turned to a declining trend. The composition of the foreign investor base shifted towards more stable real money players, and the foreign liabilities of the banks have been substantially reduced by the conversion of the Swiss franc-denominated loans.

This conversion, which took place at market exchange rate, shields the banking sector from the households' exchange rate risk that otherwise would have exposed the banks to an additional credit through the balance sheet of the households. The importance of this protection had already been revealed on January 15, on the occasion of the liberalization of the Swiss franc exchange rate.

Regarding public debt, which was often cited, I can confirm that the public debt ratio has been on a declining path since 2011. I noted Directors' concern and their encouragement to continue with fiscal consolidation, and let me stress the authorities' full commitment to conduct prudent fiscal policies compatible with sustainable debt reduction and building buffers that allow for countercyclical policies.

My second point is on the financial sector, which has been extensively discussed. Many Directors also underscored—and my authorities agree—that it is important to repair the financial intermediation. For this reason, the authorities have taken a number of steps: first, the conversion of foreign exchange mortgages; second, the boosting of lending to small- and medium-sized enterprises (SMEs). Two years ago, the central bank launched

the so-called funding for growth scheme to accelerate lending to SMEs and to reverse the vicious credit squeeze, low-growth cycle. Most recently, they extended this program, intending to increase the access of more risky, but creditworthy SMEs to bank funding.

The third issue with the financial sector, which was also mentioned by Mr. Christou, is the cleaning of the nonperforming loans in the commercial real estate segment. The central bank established an asset management company, but I note that there are some concerns from some Directors regarding the governance and the financial independence of the central bank and possible conflicts of interest.

These concerns remind me of the discussions we had on the merger of the financial supervisory authority with the central bank. At that time, Directors also expressed similar concerns about that arrangement, but the staff's written responses today indicate that this merger reinforced the central bank's macroprudential toolkit, and improved the ability to react to the buildup of the systemic financial crisis. We also learned that the merger went smoothly, and the staff does not see any impediments for the central bank's operation.

These concerns have been dispelled, and I believe that it will be the same for the asset management company. It is important to be open-minded and to encourage the authorities' efforts to complete this project. The authorities appreciate any constructive comments and suggestions, and they are also consulting with the European Commission and the ECB on improving the characteristics of this vehicle and on implementing the necessary safeguards. Most importantly, the setup of this vehicle builds strongly on the Fund's technical assistance recommendations.

I thank the Fund, and in particular the Monetary and Capital Markets Department, for their invaluable technical assistance, and also for their prompt reply and availability to address the authorities' requests.

I also noted the concern from Directors about the operating environment of the banking sector. I would like to highlight the Memorandum of Understanding that the government signed with the EBRD, which opens a new chapter for the banking sector. The government commenced to create a framework for a stable and productive economic policy. The government has committed to substantially decrease the banking tax. It has committed to refrain from any other measure that may have a negative impact on the profitability of the banking sector. The government is committed to

transferring all of the major equity stakes it currently holds in local banks to the private sector within the next three years.

I would like to focus on an issue that was also mentioned by Mr. Daïri and many other Directors. Directors showed some interest in the public works program. Mr. Christou explained the nature of this program, which aims at a work-based social security system, where the long-term unemployed have access to public work instead of passive unemployment benefits, while also facilitating their return to the primary labor market.

I emphasize the long-term unemployed because there is another motivation behind this program that has not been mentioned before. It is the long-term impact on the work attitude of the younger generation. Many children grow up in families where their parents are long-term unemployed, sometimes for 5 or 10 years. These children grow up seeing their fathers staying at home for years and not seeing their fathers leave for work in the morning. I believe such experience is detrimental for the development of the younger generation and is something that we cannot quantify among the immediate fiscal costs or benefits, but it will have a long-term impact on the labor participation rate and the work attitude of future generations.

The Acting Chair (Mr. Furusawa) noted that Hungary is an Article VIII member, and no decision was proposed.

The following summing up was issued:

Executive Directors agreed with the thrust of the staff appraisal. They welcomed Hungary's strong economic rebound, which has been underpinned by supportive policies and improved market sentiment. However, they noted that medium-term prospects appear subdued, and the economy continues to face risks arising from high debt levels and heavy reliance on non-resident funding. Against this background, Directors agreed that policies in the period ahead should focus on further reducing vulnerabilities and boosting medium-term growth, while enhancing policy predictability and limiting the role of the state in the economy.

Directors welcomed the authorities' continued commitment to fiscal discipline. Given the favorable near-term outlook, most Directors encouraged more ambitious efforts to curb the public debt ratio. They recommended pushing ahead with growth-friendly consolidation centered on improving the efficiency and composition of public spending, and rationalizing the tax

system, including by gradually reducing sectoral taxes. Continued efforts are also needed to tackle VAT fraud and improve the targeting of social benefits.

Directors concurred that monetary conditions have supported the recovery. They agreed that persistent disinflation warrants further cautious easing of monetary policy, particularly in light of the improved resilience of households' balance sheets to exchange rate risk and the weak external demand. Directors noted, however, that the central bank should stand ready to tighten the policy stance if external financing conditions deteriorate sharply. They also underscored the need to maintain adequate foreign exchange reserves to mitigate excessive exchange rate volatility and support financial stability.

Directors emphasized the importance of improving financial intermediation to sustain the recovery. In this regard, they welcomed the government's commitment to gradually reduce the tax burden on banks. Noting that the recent establishment of a national asset management company would help clean up bank balance sheets, Directors stressed the need for transparency and good governance and called on the authorities to mitigate financial and operational risks that might be associated with the new institution. More broadly, Directors cautioned against the increasing role of the state in the banking sector.

Directors stressed that sustained progress on wide-ranging structural reforms is essential to boost Hungary's growth potential. Noting progress in improving the labor market, Directors saw scope for additional reforms to increase labor participation, particularly among women and older workers, and address skill mismatches. Directors agreed that these steps, together with measures to enhance competitiveness and strengthen the business climate, would stimulate higher investment and strong private-sector-led growth.

It is expected that the next Article IV consultation with Hungary will be held on the standard 12-month cycle.

APPROVAL: September 18, 2015

JIANHAI LIN  
Secretary

## Annex

The staff circulated the following written answers, in response to technical and factual questions from Executive Directors, prior to the Executive Board meeting:

### Outlook and Risks

1. ***What explains the sharp flattening out of investment in the staff forecast for 2015, which in turn is pulling down headline growth?***
  - The sharp flattening out of investment growth reflects the fall in EU funds starting in 2015, due to the cyclical nature of these funds—as the previous programming period (2007-13) ends, while the pace of fund utilization under the new programming period (2014-20) gathers momentum. It also reflects base effects from the strong growth of investment in 2014, due in large part to the accelerated absorption of EU funds.
2. ***In the RAM, staff highlights the risks of “unconventional policies” on the part of the authorities. Could staff be more specific about what policies they are referring to and what impact they might have on the economic environment?***
  - Those could be policies that may affect the business climate, raise uncertainty, and undermine private sector investment and growth. In the past, they included an expansion of the scope of distortionary sectoral taxes and/or frequent changes to the tax code; measures that affect banks’ profitability negatively; and state interference in the economy, including in the retail, advertising, energy, and banking sectors.
3. ***The report states (ref: paragraph 28) that the potential growth is estimated at about 1 percent, and as investment increases, it is projected to increase to around 2 percent in the medium term. However, we notice that Hungary’s gross domestic investment rate has been and is projected to be around 20 percent of GDP for the period 2010-2017. With such a healthy investment rate, why is the potential growth estimated to be so low?***
  - In the 2014 SIP, staff identified factors behind the decline in potential growth since the onset of the crisis, which were largely due to the sharp decline in total factor productivity. Using a model-based approach, staff estimated the impact of structural reforms on potential growth, and found that a comprehensive strategy focused on increasing labor participation; improving the quality and composition of fiscal policy; and enhancing the business climate, including through strengthening the institutional and policy framework (by improving transparency and predictability), could increase potential growth to pre-crisis levels (3½ percent) over the medium-term.
  - The staff raised its estimates for potential growth over the medium-term from 1.7 (in last year’s report) to 2.1 percent to reflect the strong growth in investment in 2014. However, lifting potential growth further would require addressing other structural

impediments to growth, including in the labor markets and the business environment; as well as enhancing competitiveness and repairing financial intermediation.

## **Fiscal Policy**

4. *While we note the authorities' intention to expand public works programs, we would welcome staff clarification on how this higher spending is captured in the fiscal accounts, in view of the significant reduction in capital spending projected over the medium term in the context of a less supportive fiscal policy and lower EU funds.*
  - The authorities' intention is to move towards a work-based welfare system with participation in public works programs substituting for "passive" unemployment benefits. By 2018, they intend to cover 378,000 workers—or all able-bodied potential welfare recipients.
  - The 2015 budget includes HUF 270 billion for the public works program. Roughly 80 percent are being spent on wages and 20 percent on goods and services. These are fully accounted for. Wage spending is moreover on a gross basis, i.e., it includes a significant tax component of about one-third.
  - In light of limited evidence with regard to the program's effectiveness in terms of helping participants re-enter the primary job market (please see also below), it may be considered a relatively costly alternative to targeted social transfers and/or other active labor market programs.
5. *We note differences between staff and the authorities about the usefulness of the public works programs and the Job Protection Act. Can staff quantify the fiscal cost of these programs and elaborate on what benefits they provide, such as increasing labor market participation or achieving social/economic goals?*
  - This is the fiscal cost of these programs for 2014-15 (in HUF billion):

|                                       | 2014 (prel.) | 2015 (proj.) |
|---------------------------------------|--------------|--------------|
| Public works program                  | 225.5        | 270          |
| JPA (static, excluding public sector) | 125          | 128          |

## **Public Works:**

- There is limited evidence with regard to the program's effectiveness in terms of helping participants re-enter the primary job market (see for example the OECD's 2014 Economic Survey for Hungary). The authorities report that only about 11-13 percent of participants find employment in the primary labor market 180 days after leaving the program.



- Indeed it is increasingly being characterized by the authorities as a “workfare” program (rather than an active labor market instrument); and they report that it has replaced regular municipal employment in a number of cases (wages are below minimum wage). Its scope is to be almost doubled by 2018 (to cover 378,000 participants, compared to 200,000 in 2014).
- As such, it may be considered a relatively costly alternative to targeted social transfers and/or other active labor market programs that may be more effective in helping participants return to the primary labor market.
- To our knowledge, there is no thorough evaluation of the program, but we would welcome that going forward.

### **Job Protection Act (JPA):**

- Ex-ante assessments of the JPA based on micro-models predicted it to have less of an impact on employment than the employment tax credit (ETC) that was in effect until 2010; however, it carries a much lower budgetary cost (Benedek et al., 2013).<sup>2</sup>
- There are no rigorous assessments yet of the JPA’s impact on employment (the majority of its targeted benefits were only introduced in 2013).
- However, based on past estimations of labor supply elasticities at the extensive margin, the increase in the tax wedge as a result of the abolition of the ETC should elicit a negative response in participation.
- In light of the relatively high tax wedge for low income earners, staff has recommended to reinstate a more limited and targeted ETC that would be credited only against labor income and phased out rapidly after the minimum wage.
- Alternatively, the targeting of the JPA could be improved in light of some leakage to higher-income earners.
- More generally, staff believes that there are a number of additional obstacles to employment-creation and participation that should be tackled (ranging from the business climate to better provision of child-care, see SIPs in 2014 and 2015).

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<sup>2</sup> Benedek, D., G. Kátay and Á. Kiss (2013), “Microsimulation as a Tool for Assessing the Impact of Tax Changes,” in K. Fazekas et al. (eds.) (2013), *The Hungarian Labour Market, 2013*, Centre for Economic and Regional Studies, Hungarian Academy of Sciences and National Employment.

**6. *The authorities are more upbeat on the impact of past adjustment to the social transfer system and ongoing reforms to enhance the efficiency of spending. Could staff elaborate on these measures and why staff thinks it will not be adequate?***

- The authorities indeed implemented important reforms to the social protection system that have resulted in significant fiscal savings: in particular, the tightening of eligibility for disability benefits and the phasing out of most early retirement schemes. On a smaller scale, savings will continue on the basis of frozen benefit levels and the “devolution” of responsibility for means-tested benefits to the local government level.
- However, the authorities’ intention to move towards a work-based welfare system with participation in public works programs substituting for “passive” unemployment benefits is not motivated by fiscal savings. By 2018, they intend to cover all able-bodied potential welfare recipients; and budget allocations for the public works program are projected to increase accordingly. In light of limited evidence on the program’s effectiveness in terms of helping participants re-enter the primary job market, it can therefore be considered a relatively costly alternative to targeted social transfers and/or other active labor market programs that can help beneficiaries back into economic independence.
- With regard to the medium-term outlook more generally, staff is less upbeat for the following reasons: first, staff has a less optimistic growth outlook. Second, staff also attaches a higher probability to the accommodation of future spending pressures, e.g., on public sector wages that have been frozen and/or political prestige projects that have been allocated in the investment fund. Third, staff takes a more conservative view on revenue gains on the basis of administrative improvements; and is reluctant to include revenues that have not been substantiated (such as the HUF 169 billion (0.5 percent of GDP) in sales of state assets in 2015).

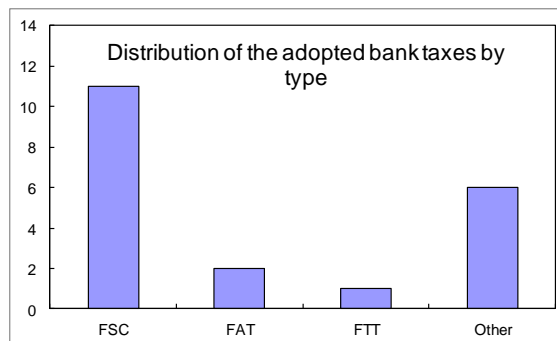
**7. *The document refers to a pro-cyclical increase in spending, but Hungary is estimated to have a negative output gap, so in what sense was the increased spending pro-cyclical?***

- The structural fiscal balance widened considerably in 2014, leading to an estimated fiscal impulse close to 1½ percent of potential GDP. This impulse largely resulted from higher public spending (especially on wages and goods and services) financed in part by one-off revenues (equivalent to 0.4 percent of GDP).
- Can staff offer any further information on the unidentified revenue sources included in the budget, including an estimate of their size?
- The 2015 budget includes HUF 169 billion in revenues from the sale of unidentified state assets.

8. *The staff has expressed concern that distortionary sectoral taxes undermine investment and long-term growth. The authorities however see limited scope to reduce these taxes beyond the announced reduction in the bank levy over 2016–19. Could staff further comment on the issue, with particular reference to global trends toward taxation of the financial system and energy?*

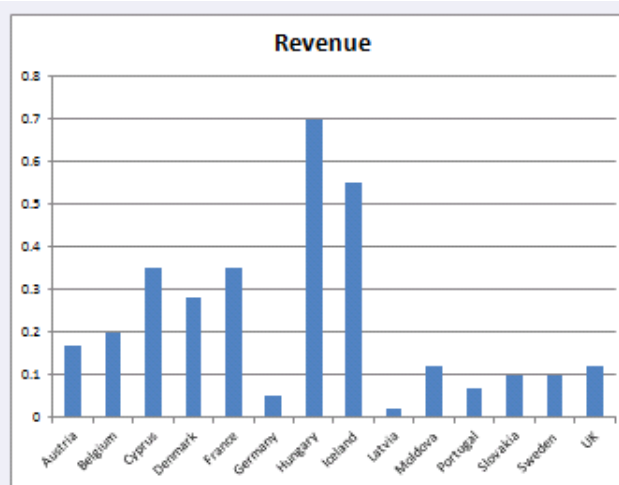
- With regard to **financial sector taxation**, the 2015 budget includes HUF 344 billion in revenues from three separate taxes:

- Since 2007 credit institutions have had to pay a special tax (the extra tax on selected financial institutions) on interest income from state-subsidized loans.



- In 2010 taxes on the financial sector were expanded with the introduction of the levy on financial institutions, or banking tax, falling on the adjusted balance sheet amount at end-2009. A 0.15 percent rate is applied up to HUF 50 billion, beyond which the marginal rate rises to 0.53 percent.

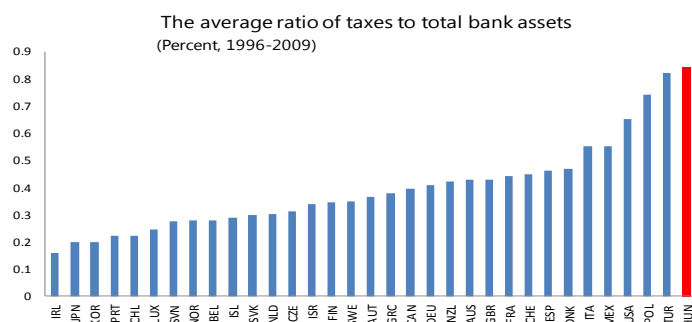
- The financial transaction tax (FTT), in force since 2013, is levied on most transactions of financial institutions and the treasury, including money transfers, cash withdrawals and amortization of loans, among others. The FTT was initially supposed to replace the levy on financial institutions, and the law creating it (July 2012) set a rate of 0.1 percent. In the autumn, however, the general rate was increased to 0.2 percent, with a higher rate (0.3 percent) charged on cash withdrawals. A ceiling of HUF 6,000 per transaction generally applied. Because of large revenue shortfalls, the authorities increased rates again to 0.3 percent (0.6 percent on cash withdrawals), effective from August 2013, and abolished the ceiling for cash withdrawals.



- As for global trends, a number of countries implemented new financial sector levies in the aftermath of the Great Recession. For example, a 2012 EUR desk survey reported that 14 European countries had some form of levy; with a Financial Stability Contribution (FSC) being in effect in 11 countries. Something similar to a Financial

Transactions Tax could only be found in Belgium at the time—subsequently, FTTs were introduced in Italy, France, and Hungary.

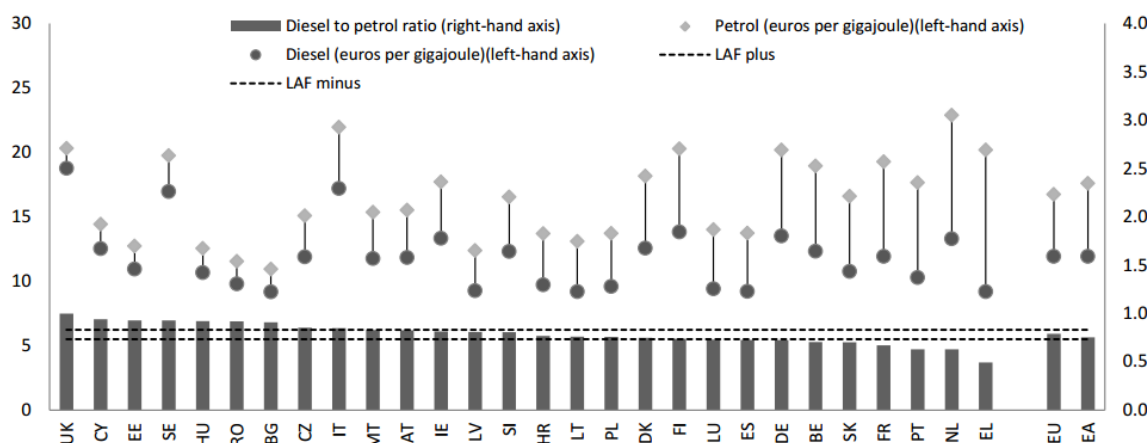
- The total tax burden and structure of taxation of the financial sector in Hungary has been exceptional, however, both in its design (banking tax on total assets) and its quantitative impact (relatively high rates). Financial sector revenues in Hungary were the highest in the EU even before the introduction of the FTT in 2013. An earlier comparison with OECD countries also shows a similar picture.



- On February 9, the government signed a memorandum of understanding with the EBRD that stipulates a plan to adjust the banking tax from 2016 onwards so that it is calculated based on banks' balance sheets as of end-2014 (and not as of end-2009), with the rate being reduced to 31 bps in 2016 and to 21 bps in 2017. From 2019, the government intends to align the level of the banking tax with prevailing EU norms.
- In addition, more European countries are pushing for a coordinated FTT: as per Council Directive 2013/0045 (CNS), a proposal on enhanced cooperation to establish a common FTT was tabled in February 2013. This was supported by 11 member states: Belgium, Germany, Estonia, Greece, Spain, France, Italy, Austria, Portugal, Slovenia and Slovakia.
- FAD has not endorsed the FTT, however, and would advocate for Financial Activities Taxes (FAT) or a reform of corporate income taxes to reduce debt bias in financing.
- As for **energy taxation**, special taxes on the energy sector are lower, but nonetheless significant. The 2015 budget includes HUF 95 billion in revenues from two main taxes, of which one only partially includes the energy sector:
- The income tax on energy service providers was introduced in 2009 as a temporary tax to last for two years (2009-10). It fell on pre-tax profit at a rate of percent. The tax has stayed on after 2010 and was raised to 31 percent in November 2012 (with an up to 50 percent deduction for certain types of job creating investments). Since 2013, the range of companies liable to pay this tax has also been broadened with the inclusion of electricity and natural gas distribution system operators and universal service providers.
- A tax on wires and pipelines, falling on the owners of utility networks, came into force in January 2013, set at a rate of HUF 125 per meter of ducts providing for electricity, natural gas, heating, water, and wastewater services.

- From an environmental point of view, Hungary has one of the highest ratios of tax rates on diesel to tax rates on petrol—in line with EC recommendations (see graph taken from *Tax Reforms in EU Member States 2014*).

Graph 4.2: Marginal tax rates on petrol and diesel when used as propellants, 2014 (euros per gigajoule)



Source: Commission services and Eurostat.

Sources: EC; OECD; Hungarian authorities; staff estimates

## Monetary Policy and Financial Sector

### 9. Could staff indicate whether the toolkit of instruments to mitigate potential capital flow volatility includes CFMs?

- While there are no capital controls or any type of restrictions on cross-border financial activity that discriminate non-residents, the Hungarian National Bank (MNB) has several options to reduce capital flows volatility:
- On the one hand, MNB has different swap instruments (3 month and O/N) which can ease the pressure on the banking system in case of money market turbulence. On the other hand, it can introduce casual swap instruments if the money market environment gives reason for that (in the past, MNB has already applied this type of instruments at the end of the years effectively, when window dressing of the banking sector caused money market tensions).
- If money market tensions were to hit the forint, MNB has sufficient room for maneuver to reduce exchange rate volatility and hence capital flow volatility. The level of FX reserves (34.6 EUR billion compared to short-term external debt at EUR 21 billion at the end of 2014) provides excess buffer for FX transactions. The excess buffer remains still significant even after the conversion of FX loans. Capital flow volatility can be eased even by interest rate hikes, too.

- In addition, there are macro prudential tools in effect (e.g. foreign fund adequacy ratio) which already contributed strongly to shifting short-term capital flows of banks to long-term foreign funding. This impact of these instruments can also mitigate the capital flow volatility.

**10. *Can the staff provide an update on the impact of ECB monetary easing on financial conditions in Hungary?***

- The QE announcement by the ECB on January 22nd did not have a significant impact on Hungary's financial conditions. Non-residents' holding of government bonds has remain broadly stable, while yields on government bonds have not shown a clear trend. The forint has somewhat appreciated against the euro, though part was recorded following the recent policy rate cut by the MNB.

**11. *We note that the high level of NPLs continues to weigh on banks' balance sheets, which is contributing in impeding private credit growth. In this context, could staff clarify what are the implications on monetary policy transmission?***

- The high level of NPLs continues to impose uncertainty regarding banks' capital and liquidity positions, leading to tight credit conditions despite the accommodative monetary stance. Therefore, staff believes that NPL resolution is imperative to improve the effectiveness of monetary policy easing on economic activity.

**12. *In 2013, the Hungarian authorities integrated the financial supervisory authority into the MNB. We would welcome staff's comments on the structure/organization and the mandate of the integrated authority. What has been the experience so far about the work done by the authority?***

- As mentioned in the staff report, the merger of the HFSA with the MNB (October 2013) has reinforced the MNB's macro-prudential toolkit and has improved its ability to react to buildup of systemic financial risks (under its role as the macro-prudential authority). The merger was accompanied with the adoption of a new MNB Act, which places greater emphasis on the financial stability objective while keeping price stability as the primary objective. The merger went smooth, and staff does not see any impediments for the MNB's operations going forward.

**13. *Could staff clarify what are the fiscal implications of their recommendation to provide tax incentives for write offs given the size of the impaired loans and taking into consideration the authorities' plan to reduce bank taxes starting in 2016?***

- At this juncture staff does not have estimates for the fiscal implication of the tax incentives for write offs as the authorities are in the process of designing the incentives together with the EBRD. As for the banking tax, the reduction is estimated to cost HUF 60 billion in 2016 and HUF 22 billion in 2017 and has been fully reflected in our baseline projections.

**14. *Could staff comment on the fiscal risks associated with increased state involvement in the banking sector?***

- The total contingent liabilities reported by the authorities are relatively low (8.3 percent of GDP in 2013). However, the increased public ownership in the banking sector has increased fiscal risks significantly given the uncertainty that surrounds the NPL resolution and the potential need for capital injections if banks continue to register loss over the medium term.

**15. *What is staff's view on available options for the authorities to prevent possible disorderly deleveraging?***

- Indeed, the effectiveness of monetary policy during episodes of deleveraging is lower than otherwise given that the credit channel is impaired. Going forward, staff expects that deleveraging will be at a more moderate pace given the effects of the recent Settlement Act on households' indebtedness, the reduction of unemployment, and the government's commitment to improve the operating environment for banks. As a result, staff expects that following a technical decline of the credit stock in 2015 (due to the effects of the Settlement Act), credit growth will resume from 2016 onwards.

**16. *The extra allocation of resources of the Funding for Growth Scheme (FGS) is welcome, although it is not clear if the program has been successful so far in increasing the volume of credit. Could staff comment?***

**17. *As mentioned in the buff statement, the Magyar Nemzeti Bank has expanded the SME scope of the lending program and introduced a time-bound and capped loan guarantee mechanism. Could staff comment on the recent program modifications?***

**18. *It appears that the FGS and FGS+ could stay for substantial time, at least until credit growth in the banking sector picks up. An updated analysis of risks and benefits of the FGS and staff's views on the newly launched FGS+ would be appreciated.***

***Combined response to questions related to FGS:***

- The first and second phases of the FGS provided financing to more than 20,000 SMEs with a total amount of 4 percent of GDP, with the outstanding amount of new investment loans in the second phase significantly exceeding the amount lent in the first phase. Consequently, credit for the SME sector registered a modest positive growth in 2014 following a continuous contraction since 2009, while credit to large firms continued to contract. However, and as also acknowledged by the MNB (see link below), the FGS was accessible only to a small portion of SMEs that are more credit worthy, and thus led to a strong polarization of the credit market both in terms of interest rate and maturities. The more risky SMEs were excluded from the program, particularly given that the lending cap of 2½ percent was not sufficient to compensate banks for the risk.

([http://english.mnb.hu/Root/Dokumentumtar/ENMNB/Monetaris\\_politika/fgs/2015/Hatterelemzes\\_final\\_ENG.pdf](http://english.mnb.hu/Root/Dokumentumtar/ENMNB/Monetaris_politika/fgs/2015/Hatterelemzes_final_ENG.pdf))

- The FGS+ was launched very recently and staff is still assessing its modalities and potential impact. While the risk sharing mechanism is likely to increase the access of more risky SMEs to bank funding and thus support investment and growth, staff believes that the cap on the lending rate should be removed to allow banks to better price the credit risk. Furthermore, the removal of the cap on the lending rate would better support monetary transmission and eliminate the easing bias that results from sterilization costs.

**19. *Could staff comment on their assessment of how much credit deleveraging has so far been supply versus demand driven and how much deleveraging may have affected GDP growth?***

- Please note that the projected credit contraction of 5 percent in 2015 is in part due to the effects of the Settlement Act on the credit stock, and some recovery is projected going forward, in particular given the authorities' commitment to improve the operating environment for banks. Although it is difficult to disentangle supply and demand factors, in staff's assessment, the contraction of credit in recent years was a combination of both. Households' deleveraging, for example, led to weak demand for credit and resulted also in subdued private consumption, while supply constraints mainly affected SMEs and thus held back investment.

**External Sector and Competitiveness**

**20. *We note a divergence in the behavior of the gross reserves to short-term debt ratio and the import cover ratio (Table 9 of the staff report) and would appreciate staff's comments on this issue.***

- Short-term external debt is projected to decline significantly (more than imports) in the medium term due to the impact of the authorities' self financing program and the FX mortgage conversion during 2015-17. Imports remain dynamic on account of strong investment in 2014-15, slightly higher commodity prices in the medium term as well as increased household consumption.

**21. *The external sustainability assessment in Box 2 was ambiguous. Could staff be more precise about the model-implied current account norm for Hungary and what sort of ad hoc upward adjustment they had in mind in order to capture Hungary's need to reduce its external liabilities? Why is it that the need to reduce external liabilities (which would seem to be a primary mechanism of current account determination) requires an ad hoc approach?***

- The recent EBA estimate of Hungary's current account norm is about -2 percent of GDP. However, as in previous rounds of the exercise, the unexplained residual



(6.5 percent) remains sizeable suggesting sizable uncertainty about these estimates. The staff projects a gradual decline in the current account balance over the medium term (with the current account remaining in a small surplus) consistent with the need to reduce external vulnerabilities and improve the large and negative IIP position.

**22. *The current account maintains a large surplus in terms of GDP, with high export dynamism, in line with the reported increased in price competitiveness; but at the same time, staff's report shows a sharp reduction in export market share. Could staff comment on this apparent contradiction?***

- The large current account surpluses in recent years reflected in part the significant import compression in the early stage of the crisis due to the collapse of domestic demand. Since 2008, the average import growth stood at about 2 percent per annum compared to an average export growth of about 4 percent per annum. As domestic demand is set to gradually recover over the medium term, the current account surplus is projected to decline. The reduction in export market share is in part due to the fact that Hungary is now well integrated into the German supply chain and unless it seeks to diversify into other markets and/or products it is unlikely to retain its export share on the world market. That said, export shares are declining in most other European countries due to global factors (in particular weak demand from Europe) and the growing role of China and other economies during the commodities boom.

**23. *How has the depreciation of the Russian ruble impacted Hungary?***

- At this juncture, it is difficult to assess the full and direct impact of the Russian ruble depreciation mainly due to the lack of bilateral trade data. While the depreciation itself may have contributed to an improvement in Hungary's trade balance, lower demand from Russia, in particular for automobiles produced in Hungary and supplied indirectly through the German supply chain, may have offset this positive impact.

## **Structural Reforms**

**24. *We share staff's call for an ambitious structural reform agenda that should also address weaknesses in the labor market, reduce the labor tax wedge, increase efficiency in the health and educational systems, and promote internationalization of SMEs. Could staff specify if such policy measures are included in the current policy agenda?***

- The authorities' reform agenda includes some of these measures. With regard to the labor market, the authorities' main interventions have focused on dismantling work disincentives inherent in the benefit system, providing targeted tax incentives to employers under the JPA, and launching a broad-scale public works program. The staff believes that further efforts are needed to reduce the high tax wedge (especially for low wage earners), address skill mismatches, and eliminate other obstacles to higher participation and employment on the supply side (e.g. providing better child care options; reforming parental leave benefits) and the demand side (improving the business environment). Moreover, several steps are under way to improve the

efficiency of spending on health and education; (e.g. the launch of the health sector structural transformation that includes the recentralization of hospitals from the local to the central government; and the introduction of the new teacher career model, which emphasizes teachers' remuneration, career path and qualifications). However, greater efforts are necessary to improve the performance of these sectors and improve outcomes. Finally, to facilitate internationalization of SMEs, steps were taken to improve SMEs' access to finance (including through the FGS and the FGS+); but greater focus should be placed on developing stronger infrastructure to improve SMEs' exporting capacity and supporting higher degree of cooperation between SMEs and large multi-national companies.

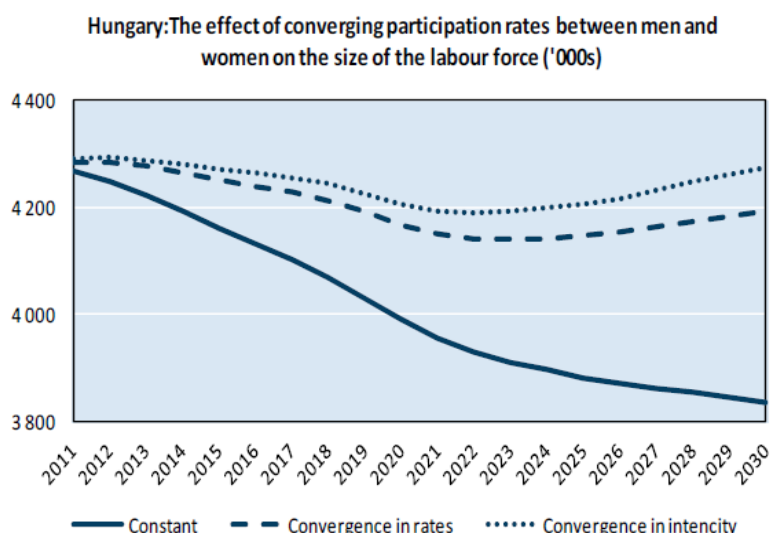
**25. Could staff provide an update on the population outlook and its impact to the economy in the medium to long term?**

- Demographic trends in Hungary are unfavorable and thus will likely have adverse effects on its growth potential over the medium-to-long term. As such, it is important to address structural impediments in the labor markets, with a view to enhancing labor participation, particularly among women, low-skilled workers, youth, and the long-term unemployed (please refer to the answer to the next question) and tackling skill-mismatches—the latter would be through strengthening the training component of active labor market policies—while strengthening higher education to enhance productivity.

**26. As a macro-critical structural issue, we urge the Fund to pay an adequate attention to the issue of shrinking population and to provide more targeted policy advice, based on identification of a root cause. The staff's view on this issue would be welcome.**

- We agree that unfavorable demographic trends would weigh on labor markets and potential growth. To this end, staff stressed the importance of addressing structural impediments in the labor markets, particularly with respect to obstacles to female labor force participation (FLFP) and skill-mismatches (including through strengthening the training component of active labor market policies).

- As Box 4 of the staff report illustrates, taking into account current trends, Hungary's labor force will shrink by around 10 percent by 2030. Increasing FLFP will be necessary to help offset these adverse trends and boost long-term growth. The OECD estimates that



full convergence in participation rates by 2030 can stabilize the size of the work force and increase annual per capita growth rates in Hungary by 0.6 percent, on average.

- The staff provides concrete recommendations on measures to encourage higher FLFP (Box 4; SIP), including providing more affordable childcare options, reforming parental leave benefits, and tackling discriminatory work place practices (such as pay inequities).
- With regard to productive employment of low-skilled workers, youth, or the long-term unemployed, staff recommends replacing the public works program with active labor market programs that provide individualized training and job-search assistance. These will have to be complemented by efforts to increase private sector job-creation.

**27. We note the authorities' intention to establish a state-owned energy company, which they consider would improve competitiveness. We are unconvinced. Can staff elaborate on the reasons behind this strategy and how it is intended to operate?**

- The broad strategy aims at securing and diversifying energy supply, while providing cheap energy to the population (both households and businesses), including through creating a non-profit energy sector. The latter would be achieved through the acquisition of energy companies and the establishment of a state-owned energy company. Providing cheap energy to businesses would help reduce production costs and thus enhance competitiveness.
- Specifically, the government recently launched a national non-profit utility company which will act as a holding company that will act as an “efficient, predictable and cheap” utilities provider. It announced that the aim of the company would be to make energy available at fair prices and increase security of energy supply. A number of acquisitions have already been made and the government intends to make further acquisitions in the energy sector (which it considers a strategic one).

**28. We note that formal as well as informal institutions result in a significantly lower labor market participation rate for women. While we see the merits of staff's recommendations aimed at reforming the formal institutions (i.e. government policies), including the generous parental leave, the availability and affordability of childcare and the gender wage gap, we would like to know staff's views on how effective government policies can be given the widely-held preference for traditional gender roles.**

- It is true that ingrained attitudes and behaviors can permeate gender inequities even where policy changes open a window of opportunity. However, there is some room for optimism. For example, eliminating the pay gap will have an impact on how women's work is valued (and put it on par with male income earners). Likewise, helping women stay connected to the labor market will also help them have more continuous, fulfilling and financially rewarding careers—and help boost their

participation. Evidence quoted in the SIP shows that countries that provided incentives for fathers to take paternity leave could achieve up to 25 percent take-up rates. In turn, other evidence indicates that fathers that bond with the children from a young age are also more likely to stay engaged in child care responsibilities. In sum, policies can still make a huge difference in eliminating biases against female participation (e.g. the design of leave policies in Hungary) and creating a more level playing field.