May 19, 2020
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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 19/95-1

9:30 a.m., November 27, 2019

1. Hungary—2019 Article IV Consultation

Documents: SM/19/250 and Correction 1; and Supplement 1; SM/19/251; and Correction 1

Staff: Sakr, EUR; Sommer, SPR

Length: 50 minutes

Executive Board Attendance

T. Zhang, Acting Chair

Executive Directors	Alternate Executive Directors
	A. Tivane (AE), Temporary
	E. Boukpessi (AF), Temporary
	J. Di Tata (AG)
	N. Heo (AP)
	F. Fuentes (BR), Temporary
	Z. Huang (CC), Temporary
	P. Moreno (CE)
L. Levonian (CO)	
	S. Benk (EC)
	P. Rozan (FF)
	K. Merk (GR)
	R. Goyal (IN), Temporary
	M. Psalidopoulos (IT)
	H. Mori (JA), Temporary
	M. El Qorchi (MD)
	P. Al-Riffai (MI), Temporary
	R. Doornbosch (NE)
T. Ostros (NO)	
	A. Biriukv (RU), Temporary
	R. Alkhareif (SA)
	K.Tan (ST)
	P. Trabinski (SZ)
	D. Andreicut (UK), Temporary
	P. Pollard (US), Temporary

C. McDonald, Acting Secretary
A. Bala, Summing Up Officer
D. Jiang, Board Operations Officer
L. Nagy-Baker, Verbatim Reporting Officer

Also Present
Communications Department: G. Vilkas. European Central Bank: K. Nikolaou, D. Rakitzis, R. Rueffer. European Department: E. Detragiache, K. Dybczak, T. Lybek, K. Sakr, S. Vtyurina. Fiscal Affairs Department: A. Zdzienicka. Independent Evaluation Office: C. Rustomjee. Legal Department: D. McDonnell. Office of Executive Directors: M. El Qorchi OEDMD AT TABLE. Strategy, Policy, and Review Department: D. Hart, M. Sommer.

Senior Advisors to Executive Directors: M.Gilliot (FF), N. Jost (NE), L. Marek (EC), C. Quaglierini (IT), M. Tabora (CE). Advisors to Executive Directors: K. Badsi (MD), O. Bayar (EC), K. Carvalho da Silveira (AF), G. Khurelbaatar (AP), H. Koh (GR), M. Mehmedi (EC), P. Mooney (CO), N. Shenai (US), I. Skrivere (NO), S. Yoe (ST), A. Zaborovskiy (EC), J. Montero (CE), A. Tola (SZ).

1. HUNGARY—2019 ARTICLE IV CONSULTATION

Mr. Benk submitted the following statement:

My Hungarian authorities thank staff for the candid discussion and their report, which presents the economic developments and policy challenges in a very balanced way. The authorities broadly agree with staff's assessment of Hungary's economic and financial position and appreciate the thorough and constructive policy dialogue and policy recommendations.

Economic growth remains strong, supporting economic convergence and building resilience amid a gloomy global outlook. Hungary has been one of the fastest growing economies in Europe, registering 5.1 percent growth in 2018, and similar performance is expected to be achieved in 2019. Unemployment is at historic low levels at close to 3 percent and the employment rate exceeds EU average. The growth momentum has been preserved despite the significant deterioration of the global economic outlook and the slowdown in Hungary's main trading partners, with strong signs of a decoupling from the German business cycle. Growth has primarily been driven by strong domestic demand, while the external balance has been maintained. Investment has been buoyant in recent years, with a steadily rising investment rate exceeding 26 percent by 2019.

Although growth is expected to decelerate in the medium term, the authorities intend to maintain a 2-percentage point growth surplus over the euro area which would continue to support convergence. The authorities broadly share staff's assessment on the sources of global risks and plan to preemptively implement a series of measures to preserve Hungary's economic results and further build resilience. Hence, the government decided in May on the Economy Protection Action Plan, which is now in the course of legislation, and includes several tax cuts, simplification of tax administration, various supportive measures for SMEs, and increased spending on R&D. Additional impetus would also come from the implementation of the competitiveness reform, outlined in this buff statement.

Fiscal performance remains strong with prudent fiscal planning and execution, and a steadily declining debt trajectory. The public debt-to-GDP ratio has decreased from above 80 percent in 2011, to around 68 percent by the end of 2019, and is expected to decline further in the coming years. External debt has declined significantly too. The composition of the debt has shifted to a healthier and less vulnerable structure as a result of the debt management strategy to reduce the share of foreign debt and replace it by domestic debt on one hand, and refinance maturing FX debt with domestic currency-denominated debt on the other hand. The central bank's self-financing program, and the domestic wholesale bond and retail bond issuances were helpful in this respect. In addition, the new domestic retail bond (MAP+) is instrumental in lengthening maturities, reducing external vulnerabilities, building a stable domestic investor base, and not least in alleviating pressure in the real estate market.

The budgetary balance is expected to decrease to historically low levels in 2020 and 2021. After a 1.8 percent deficit in 2019, the 2020 budget foresees a further reduction in the overall deficit to 1 percent. In addition, exceptionally high contingency reserves of about 1 percent of GDP are budgeted, as a buffer that would allow for the operation of the automatic stabilizers, should the downside risks to the economy materialize. The budget is built on a rigorous expenditure control resulting in a countercyclic fiscal stance, in line with the IMF staff's previous recommendations. In the medium term, the authorities aim for a zero overall deficit, which is in line with staff's proposed medium-term target, and attainable under realistic macro assumptions.

On the revenue side, the continuously improving efficiency in tax collection and the whitening of the economy has been crucial for the fiscal performance in recent years. Owing to the installation of the on-line cash registers and the electronic billing system, the VAT-gap has decreased significantly in recent years, and is now well below the EU average. The previously imposed taxes to mitigate the impact of the global financial crisis, directly affecting certain sectors, have been mostly phased out. Some of them were replaced with consumption-turnover type taxes having a less distortive effect on investment and growth. The bank levy has been significantly reduced.

Having said this, and given staff's overall positive assessment of the fiscal developments, we are puzzled by staff's categorization in the context of the pilot Fiscal Space Assessment Framework, that fiscal space is "at risk". Within this framework we would deem more appropriate the usage of the term "some fiscal space".

Monetary policy has been accommodative and continues to be data driven. The central bank of Hungary (MNB) has kept the policy rate unchanged at 0.9 percent since 2016, with some minor tightening of the interest rate corridor in March. Monetary conditions have been further fine-tuned by using the crowded-out liquidity target and FX-swaps. The MNB cautiously monitors international monetary policy developments as well as domestic inflation developments and stands ready to fine-tune monetary conditions as deemed necessary. Domestic inflation has been fluctuating within the MNB's tolerance band, at levels somewhat lower than the earlier forecasts. A dichotomy remains between the factors determining domestic inflation, as domestic demand remained buoyant, while external activity is restraining inflation, along with global monetary policy turning dovish. Nonetheless, the MNB assesses that the previously symmetric risks to inflation became asymmetric in the second half of the year, with downside risks having strengthened further reflecting the economic slowdown in Europe.

The MNB has launched two new instruments recently: The Funding for Growth Scheme Fix (FGSfix) was launched at the beginning of 2019, targeting SMEs, in order to increase the share of predictable, fixed rate loan products within the financing of investments of SMEs. The Bond Funding for Growth Scheme (BGS) was launched in July, targeting larger enterprises, with the aim to purchase bonds issued by domestic non-financial corporations with an at least B+ rating, to promote the diversification of funding to the domestic corporate sector and develop the corporate bond market.

The financial sector is overall healthy and resilient. The shock-absorbing capacity of the Hungarian banking system continues to be robust. Banks' capital adequacy ratios indicate strong solvency, while the liquidity coverage ratio is also well above the regulatory requirements. Banks continued to expand their balance sheet, especially their outstanding loans vis-à-vis the private sector.

In order to foster the mitig' interest rate risk, the MNB issued a recommendation to financial institutions, advising banks to offer customers with variable-rate mortgage loans the option of transition to a fixed-rate scheme. In the corporate loan segment, the share of fixed-rate loans increased for longer maturities, thanks to the FGSfix. Further improvement in the corporate sector's resilience to crises as well as opportunities for diversifying funding may be fostered by the BGS.

Beside its regulatory mandate, the MNB is committed to tackle the existing inefficiencies in the banking and the broader financial sector, enhance competition and support the consolidation of the sector, while paying attention also to consumer protection. The launch of the frameworks for "Certified Consumer Friendly Housing Loans" and "Certified Consumer Friendly House Insurance" point into this direction.

The MNB has just published in October its FinTech strategy, which provides a comprehensive framework for the MNB's digitalization efforts in the financial system and sets out 24 specific initiatives and proposals.

Further structural reforms aimed at enhancing competitiveness and potential growth are high on the authorities' agenda. The government's Program for a More Competitive Hungary, prepared under the guidance of the National Competitiveness Board, and relying on proposals from the MNB, the Hungarian Chamber of Commerce and other independent bodies, sets out the structural reform agenda in six areas: employment, business environment, taxation, public sector, education and healthcare. With its main objective to improve medium- and long-term growth prospects and competitiveness of the economy, the program targets key areas and bottlenecks where reforms can lead to substantial productivity gains. Measures include facilitating widespread access to quality health care and education, decreasing administrative burdens, improving the competitiveness of the tax system and promoting digitalization. Special attention is given to labor market reforms, facilitation of mobility, the employment of mothers with small children and retired persons. The government just published its new SME strategy with the aim to improve access to finance, reduce administrative burdens and provide targeted support in various fields including innovation, management practices, business transfers and access to export markets and to global value chains. The support of SMEs is a priority of the authorities, as SMEs employ the largest share of the work force, while their productivity and competitiveness lag behind the bigger enterprises.

The MNB has also published a 330-point proposal with measures intended to unlock the growth potential and secure convergence to the most developed economies. These were also taken into account during the formulation of the government's Program for a More Competitive Hungary. The Competitiveness Mirror launched recently assesses the extent of the implementation of this agenda. Since the publication of the 330-points agenda in February, there has been progress in 165 points, out of which 33 have been partially or fully completed.

Final remarks

The Hungarian authorities are grateful for the meaningful and constructive discussions. They appreciate the staff's recommendations which they are planning to accommodate to the extent possible. They remain committed to prudent policies, focusing their strategy on promoting growth, sustainable debt reduction, improving competitiveness, and reducing financial vulnerabilities.

Mr. Di Tata and Mr. Corvalan Mendoza submitted the following statement:

We thank staff for the well-written and informative report and selected issues paper, and Mr. Benk for his helpful buff Statement.

Hungary has experienced a strong recovery since the global financial crisis. Real GDP growth reached 5.1 percent in 2018, supported by record EU funds-related investment, with the growth momentum continuing in the first two quarters of 2019 notwithstanding the weaker global economic outlook. Unemployment has declined to historic lows and wage growth has been strong in 2018-19. Inflation remains within the tolerance band of 3+-1 percent, the country's external position is estimated to be moderately stronger than medium-term fundamentals, and international reserves adequacy indicators have improved. Income convergence continues successfully, and the country has attained an upgrade by the rating agencies. At the same time, although on a downward path, public debt remains elevated at above 70 percent of GDP and the financing needs are considerable.

Economic growth is projected to decelerate in the coming years owing to slower global activity and declining EU funds-related investment. Real GDP growth is expected by staff to remain in the 3.5-2.0 percent range in the medium term. Main external downside risks include deteriorating global growth prospects and trade tensions, while domestic risks are on the upside and include possible stronger labor force participation. We appreciate Box 1 on global developments in the automotive industry and their possible effects on Hungary's production. Could staff elaborate on the possible impact of demographics on medium to long-term growth?

Although the recent economic performance is commendable, we concur with staff on the need to address structural distortions and vulnerabilities to achieve higher sustainable growth over the medium to long-term in order to facilitate further income convergence to the most developed economies. Given Hungary's favorable position in the cycle, there is also a window of opportunity for further fiscal consolidation to help ease demand pressures and facilitate a gradual normalization of monetary policy. At the same time, it is important to improve the quality and efficiency of spending.

We welcome the authorities' plan to reduce the fiscal deficit to 1.8 percent of GDP in 2018 and 1 percent in 2020, and to achieve a balanced fiscal position over the medium term. This would help strengthen buffers and lower the public debt to about 50 percent of GDP by 2024. At the same time, we agree with staff on the need to better specify the measures underlying the planned fiscal consolidation effort. In addition to improving tax collections, consideration should be given to broadening the tax base while phasing out sector-specific taxes, as well as to lowering spending, including by further reducing public sector employment and rationalizing subsidies. Could staff comment on the magnitude of total tax expenditures in Hungary?

We concur with staff that the public debt strategy should continue to focus on lengthening maturities while balancing the objectives of reducing foreign exposure and containing interest expenditures. In this regard, we find the SIP analysis of Hungary's public debt strategy timely and appropriate. Regarding the Government Security Plus Scheme (MÁP+) for physical persons introduced recently, which seeks to reduce refinancing risks and promote household's high savings, we agree on the need to pay due attention to costs and to anchor the interest rate of future offerings closer to the government bond market yield curve.

On monetary policy, we share the view that the central bank can afford to be more patient with removing accommodation, especially given global financial uncertainties and downside risks and a lessening of inflationary pressures since May 2019. In any case, the MNB should continue to monitor international monetary developments and domestic inflation closely to fine-tune monetary conditions as necessary. We also encourage the authorities to follow-up the implications of the schemes introduced recently to encourage lending to SMEs and develop the corporate bond market in order to minimize market distortions.

The banking system remains on average well-capitalized, profitable, and liquid, and the NPL ratio continues to decline. We welcome the authorities' intention to review the legislative and institutional framework for bankruptcy and liquidation procedures in 2020. We also encourage the authorities to review the fiscal incentives for house purchases and address supply constraints to reduce market pressures. In addition, there is a need to continue with the AML/CFT efforts under way, including by monitoring large purchases of luxury real estate. Could staff provide an update on the privatization of Budapest Bank?

On the structural front, the key challenge is improving competitiveness. Wages have been rising at a faster pace than labor productivity and further efforts are necessary to address shortcomings in the business environment, particularly in the areas of paying taxes, protecting minority investors, and accessing electricity. In this regard, we welcome the roll-out of the government's "Program for a More Competitive Hungary", which sets out the structural reform agenda. We support the authorities' efforts at streamlining the procurement process and enhancing the efficiency of SOEs, as well as the focus on enhancing the productivity of SMEs and reducing the risk of contingent liabilities, simplifying the tax system, and implementing a modern competition policy. Further progress is also necessary in adult education, vocational training, and the provision of childcare services to raise labor force participation, especially among the female population. More generally, strengthening policy frameworks, governance, transparency, and data are crucial to attract investment and support decision making.

With these comments, we wish the Hungarian authorities every success in their future endeavors.

Ms. Pollard and Mr. Shenai submitted the following statement:

We thank staff for the well-written Article IV Staff Report and Selected Issues Paper, as well as Mr. Benk for his helpful buff Statement. We agree with the thrust of staff's analysis and policy and offer the following remarks for additional emphasis.

While we agree that debt sustainability should be safeguarded, recent data indicate better-than-projected budget performance. Sustained improvements in revenue collection and expenditure controls may give the authorities room for counter-cyclical fiscal policy in the event of a downturn.

We found the Selected Issues Paper section on public debt management to be particularly illuminating and urge the authorities to continue to enhance debt management to lengthen the maturity profile of the debt stock and reduce gross financing needs, in line with staff recommendations. While the MAP+ issuance can broaden the pool of debt holders, harmonizing the interest expense of these securities can help to mitigate potential spillover risks to bank funding and the fiscal accounts.

Monetary policy has room to remain accommodative, though the authorities should remain vigilant and data-driven about upside inflation risks posed by the tight labor market. Although labor market tightness has not spilled over into general prices, price pressures could emerge suddenly and thus could justify a more cautious approach.

Financial sector risks should be closely monitored given the rapid growth in housing prices. Recent measures to reduce housing risk, including increasing the length of fixed interest rate terms on new mortgages and raising the risk weight on unhedged but performing construction loans, are welcome. Still, we wonder about risks posed to the housing market by a decline in wage inflation, given the degree to which home purchases are investments that generate rental income. Could staff provide additional information on the link between labor market developments and the housing market, including vulnerabilities to a decline in wage growth? We also encourage sustained attention to AML/CFT risks in the real estate sector, in line with the enhanced follow-up from Moneyval's 2016 assessment.

The leveling off of growth and investment-related imports, coupled with a recovery in global automobile markets, will likely improve Hungary's external position over the medium term. Yet the external sector assessment indicates that the external position is moderately stronger than medium-term fundamentals and desired policy settings. Thus, we would argue a high current account balance as staff projects would not be an improvement but a worsening of the external position. We would urge staff to use more neutral language, e.g. "the current account deficit will shrink over the medium-term," which does not imply deficits and surpluses are good or bad.

Continued structural reforms can boost potential growth and enhance competitiveness. Transparent procurement processes, in line with EC recommendations, can reduce the scope for graft and promote the business climate. An orderly wind down of the PWS can release workers into the tight labor market and mitigate wage pressures while boosting competitiveness.

Mr. Doornbosch submitted the following statement:

We thank staff for their insightful report and selected issues paper in the context of Hungary's Article IV consultation. We also thank Mr. Benk for his informative buff statement.

The remarkable recovery after the global financial crisis has revived Hungary's economic convergence to advanced Europe. We welcome the positive developments in the labor market with increasing participation and employment rates, as well as unemployment at historic lows. At the same time, we believe that further efforts remain necessary to promote inclusiveness. While debt levels have been decreasing, we agree with staff on the need to build fiscal buffers and to improve the quality of expenditure. The high share of public investment and the high utilization of EU Funds are welcome, but they should be assessed in view of their impact on labor productivity, that has been stagnating until 2017. We support the call for specifying the measures to reverse the procyclical fiscal stance. We encourage the continuation of structural reforms to improve competitiveness, strengthen labor productivity and boost potential output.

Macroeconomic developments

Economic growth has been particularly robust and led to falling unemployment, without de-anchoring inflation. Moreover, the economy has so far proved resilient to the global slowdown, thanks to domestic tailwinds in 2019. These include a major expansion in the construction sector, driven by both public and private investment; and the introduction of new models to major automotive factories operating in the premium segment, which shielded the sector in Hungary from declining global auto sales. Domestic demand was also bolstered by a tight labor market and rapidly rising wages. In 2020, however, these supporting factors should wane and the economy is poised for a slowdown. Despite the considerable deleveraging process, debt levels remain substantial and Hungary faces risks stemming from the external sector as it remains vulnerable to a worsening global outlook, the potential escalation of trade tensions, and abrupt changes in international investor sentiment towards emerging economies.

Fiscal policies

Given the high structural deficit and the financing need of the government, delivering on the authorities' fiscal consolidation plan is important. The fiscal target for 2019 is expected to be met and the government is planning further reductions in the nominal deficit. A fiscal consolidation is indeed appropriate given that the structural deficit has stayed in the range of 2.5-3 percent of GDP since 2017 and that the public debt is around 70 percent of GDP with high yearly financing needs. IMF staff's analysis on the public debt strategy demonstrates the need for sustained vigilance on external vulnerability and interest cost risks, including those relating to the recently introduced retail bond (which may also be associated with potential crowding out effects). We note that past years' strong economic performance has not been used to make headways in reducing the structural deficit but, on the contrary, it was coupled with a pro-cyclical fiscal policy. We therefore encourage the authorities to implement the 2019 convergence program.

Hungary needs to improve the structure and efficiency of public spending. The 2019 budget included several stimulus measures aimed at improving demographics and to cushion the expected economic slowdown. There is also a tendency to use the funds in general reserves for recurrent low-quality spending at the end of fiscal years. It is hence important that the consolidation plans are delivered in conjunction with a significant improvement in the efficiency of public spending. We note, in this context, staff's recommendation that savings in the medium term can be used to boost infrastructure investment to compensate for the projected decline in EU funds. In the context of already high public investment, we would like to encourage the authorities to consider greater use of private investment and to increase the quality of public expenditure.

Financial sector

The banking system is healthy overall; nevertheless, credit developments, on the back of a major expansion in the construction sector, need to be closely monitored. Efforts to strengthen resilience in the banking system in the past years have borne fruit; yet, risks remain. Most banks appear to display sound capital positions, sufficient liquidity buffers, and the ratio of non-performing loans declined further. Profitability has also improved; however, markedly low cost-efficiency in the sector continue to raise concerns about long-term profitability. The lending cycle is in full swing but lending standards have remained prudent and household debt levels are low. Foreign exchange exposure has been eliminated administratively from households' balance sheets, but it has been steadily increasing and persists in the commercial real estate sector. We also share staff's concerns regarding house prices and the signs of overvaluation, especially in Budapest. However, with low household debt levels and the gradual increase of new supply, this need not become a serious stability risk. Close monitoring is nonetheless warranted.

Structural policies

Labor market developments have improved markedly; however, a larger boost to labor productivity would be necessary. The rapid growth of per capita GDP since 2014 is encouraging but, viewed against labor productivity that is still at around 2008 levels and quickly rising labor costs, there is a risk that growth could slow substantially if global demand moderates further. We therefore agree with staff that boosting productivity should be made a priority. We share staff's analysis and recommendation regarding the business environment, the legal and regulatory framework, and the need to improve the access to quality education and health care for disadvantaged groups. Moreover, we encourage the authorities to increase fiscal transparency and introduce a competitive procurement process in line with recent EU recommendations.

Mr. Mouminah, Mr. Alkhareif and Mr. Keshava submitted the following statement:

We thank staff for the well-written set of reports and Mr. Benk for his informative buff statement. We are in broad agreement with the staff's analysis and policy recommendations and would limit our remarks to the following issues.

We welcome the continued strong economic performance, with Hungary being one of the fastest growing economies in Europe. Indeed, growth in 2018 was considerably higher-than-projected, inflation was within the tolerance band, and unemployment reached historic lows. We are also encouraged that the authorities are determined to keep GDP growth 2 percentage points above the average of advanced EU countries by further advancing reforms, which would continue to support income convergence. In this connection, we echo staff's recommendation on the need to utilize the current upswing to further strengthen resilience and boost potential growth.

The authorities should build on the strong fiscal performance. We are in particular encouraged to note that public debt is on a downward path and expected to decline from slightly above 70 percent of GDP in 2018 to around 56 percent of GDP in 2024 under the baseline scenario. In this context, it is important that the authorities pursue a mix of growth-friendly revenue and expenditure measures, as recommended by staff. We found the Selected Issues paper on public debt strategy to be very informative and we encourage the authorities to continuously monitor the financial implications of the new retail bond (MAP+) to help strike the right balance between limiting vulnerabilities and containing the interest expenditure. Given the overall positive fiscal assessment and medium-term outlook, we would welcome further elaboration on the staff's assessment in paragraph 13 that Hungary's fiscal space is at risk.

Efforts to strengthen financial sector resilience should continue. We are reassured to note that the banking system remains, on average, well-capitalized, profitable, and liquid and that the NPL ratio continues to decline. In this connection, we take positive note of the initiatives to reduce the mortgage interest rate risk, as underlined in the buff statement. On AML/CFT, we join staff in encouraging the authorities to continue their efforts, including by monitoring the real estate sector, against the background of enhanced follow-up based on Moneyval's 2016 assessment.

Finally, we welcome the emphasis on further structural reforms aimed at enhancing competitiveness and potential growth. The authorities' reform agenda is far-reaching covering employment, business environment, taxation, public sector, education, and healthcare. In particular, we welcome the increased focus on enhancing productivity of SMEs, including through supporting innovation, as SMEs contribute significantly to Hungary's non-financial business economy. We also encourage the authorities to continue their efforts to scale down the public works scheme (PWS) amid a tight labor market while being mindful of social impact.

With these remarks, we wish the authorities further success.

Mr. Moreno and Mr. Montero submitted the following statement:

We thank staff for its set of well-written reports and Mr. Benk for his useful buff statement. We broadly agree with staff's appraisal and associate ourselves with Mr. Doornbosch's statement. We would like to offer the following comments for emphasis.

Hungary continued to sustain an elevated growth rate, supported by expansionary policies and robust domestic demand, including record-high EU fund-related investment, in a context of contained inflationary pressures, despite strong wage growth and tight labor markets. Moreover, vulnerabilities associated with the high levels of public debt and NPLs have declined substantially, although in the former case remain elevated. The outlook continues to be broadly positive, despite (mostly external) risks. This environment is highly conducive to enhance resilience, especially in the fiscal front, and, above all, to address long-standing structural challenges, in particular very low productivity growth (as illustrated in Fig. 2) and insufficient real income convergence with EU peers (still at about 44 percent of the EU-28 average).

We note that staff assesses Hungary's fiscal space to be at risk based on the relatively high levels of public debt and gross financing needs. However, at the same time, it acknowledges that both variables are projected to notably decline over the medium term, with fan charts showing moderate uncertainty around the baseline and available cash buffers of about 5 percent of GDP. We wonder whether it would be more appropriate to consider that there is some fiscal space, instead. Staff's comments are welcome. In any case, we call on authorities to implement a more growth-friendly consolidation strategy than currently envisaged with a focus on improving business confidence, social inclusion and labor force participation. To this end, we believe that staff's proposals are a good starting point.

We welcome the analysis on retail bonds in the SIP, which the authorities are using to lengthen maturities, reduce external vulnerabilities, and encourage household savings away from the real estate market. As staff rightly points out, this strategy is not without risks. These bonds are tax-exempted and offer a yield about 4 percentage points higher than the typical 5-year bond, which make them an expensive funding source. This is creating several other distortions that must be considered, such as its negative redistributive impact, non-neutral asset reallocations, and inconsistencies with the monetary policy stance.

Low labor productivity and demographic challenges call for a renewed impetus to the structural reform agenda, where priorities should focus on improving the business environment and enhancing labor participation and human capital, with a view to also tackle social inclusion issues. Over the past few years, the authorities have been adopting measures to strengthen the business climate, but important challenges persist. In order to level the playing field and foster a more dynamic private sector, it is important to modernize the competition policy framework, streamline regulations, ensure transparent and competitive procurement processes, forcefully fight against corruption and address governance issues in SOEs.

Labor supply could be boosted by further increasing participation rates, scaling down the Public Work Scheme (PWS) and facilitating immigration. The authorities are pursuing a determined policy to stimulate fertility, though as staff suggests, it could be complemented with additional measures such as increasing the number of daycare centers. However, the impact of such policies, if successful, will only be felt over the long run. Thus, it would be desirable to adopt policies to augment labor supply over a shorter time horizon. To this end, we welcome the authorities' numerous efforts to increase participation as well as their intention to scale down the PWS—which could also be improved as suggested in Box 2—as it will release workers to the very tight primary labor market. However, we missed some discussion in the report regarding the potential role that immigration could play to ease pressures in this market. We expect that this topic will be covered in future Art. IV consultations. Staff's comments are welcome.

Mr. Ostros and Ms. Skrivere submitted the following statement:

We thank staff for the comprehensive set of reports and Mr. Benk for the helpful buff statement. We broadly share staff's appraisal and agree that the Hungarian economy has registered an impressive recovery from the global financial crisis. Nevertheless, amid risks of a worsening global growth outlook and increased trade tensions, a comprehensive reform agenda coupled with a growth-friendly fiscal adjustment will be needed to sustain the growth momentum and lift the potential growth. We associate ourselves with the statement by Mr. Doornbosch and offer the followings points on fiscal policy, the structural reform agenda, and the financial sector developments for emphasis.

The authorities should identify growth-friendly measures to deliver on their fiscal consolidation plans and build fiscal buffers as the growth decelerates. Despite improvements over the past years, we note with concern that Hungary's public debt level and gross financing needs remain high. While the economic growth has been very favorable, the fiscal position has been procyclical. We share staff's call for further fiscal consolidation to increase buffers and reduce debt vulnerabilities, and we agree that the fiscal adjustment should consist of both revenue and expenditure measures. Particularly, we would like to emphasize the need to broaden the tax base by removing the distortive tax exemptions and allowances, as well as the importance of improving the structure and efficiency of public spending. We note that such reforms can help alleviate pressures in other parts of the economy, as for example rationalizing public sector employment would not only reduce public expenditures, but also release labor force to the private sector.

A comprehensive structural reform agenda can help sustain Hungary's growth momentum and lead to substantial productivity gains. We welcome the authorities' priorities in this area, as laid out in the government's Program for a More Competitive Hungary. We highlight the importance of strengthening institutional frameworks and promoting good governance practices. In particular, we encourage the authorities to address the perceived corruption, strengthen public procurement practices, and improve SOE oversight.

While the banking system remains healthy, developments in the housing market require close monitoring. While the authorities have strengthened the resilience of the financial sector, we share staff's assessment that in some areas, particularly regarding insolvency procedures, further reform efforts are needed. We agree with staff that the double-digit housing price growth calls for close monitoring. We also encourage the authorities to assess the various fiscal incentives for house purchases.

Mr. Merk and Mrs. Koh submitted the following statement:

We thank staff for its well-written set of reports and Mr. Benk for the buff statement. We associate ourselves with the statement issued by Mr. Doornbosch. In addition, we offer the following comments and questions for emphasis.

Hungary's current favorable situation offers a good opportunity to address long-standing structural challenges. We encourage authorities to undertake structural reform efforts, e.g. regarding promoting productivity growth, increasing competitiveness and addressing present shortcomings in the environment for SMEs to enhance Hungary's positioning in international value chains.

We echo staff's call for a prudent public debt strategy. In that context, we take note that staff does not elaborate on Hungary being subject to a significant deviation procedure under the EU fiscal framework. Notwithstanding the benefits of the recently introduced retail bond (MÁP+), we are concerned about potential high opportunity costs as well as the risk of arbitrage. We therefore encourage the authorities to take advantage of the strong economic conditions to pursue a growth-friendly fiscal consolidation and, while doing so, contain the risks arising from high interest expenditure.

Monetary policy should firmly focus on price stability and be mindful of possible market distortions from unconventional arrangements. In this context, we take note that the report mentions the Central Bank's "extensive agenda to improve competitiveness" as well as policies to reduce interest rate risk for SMEs and develop the corporate bond market. We would welcome additional staff comments and assessment of these policies.

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

We thank staff for the insightful Article IV report and Mr. Benk for his comprehensive buff statement. We broadly share staff's policy recommendations and would like to make the following comments for emphasis.

Hungary has been one of the European growth champions, but outlook weakens. GDP growth made up 5.1 percent in 2018 and remained flat in the first half of 2019, above Hungary's potential. Booming domestic demand, notably investments, more than offset the negative effect of the external slowdown. However, the economy is approaching the peak of its strong cyclical recovery and will embark on a slowing cycle in the coming years. Economic activity will be adversely affected by sluggish GDP growth in Hungary's export markets in the euro zone, not least owing to the US trade disputes with the EU and China. Investments growth will moderate in 2020 as a bulk of EU-financed investment projects have been completed. In addition, the European Commission's plans for its 2021-27 budget will result in reduced EU transfers to Hungary from 2021, further affecting fixed investment growth.

Fiscal policy turned pro-cyclical in recent years, however, more forward-looking approach should be implemented. Staff anticipates the structural deficit would deteriorate by almost half a percentage point to around 0.8 percent in 2019, still constituting a procyclical impulse. Against this background, we encourage the authorities to accelerate growth-friendly fiscal consolidation and build finance reserves for bad times. Revenue augmentation could be underpinned by further reduction of exemptions and preferential regimes. On expenditure side, the authorities could rationalize public employment, while ensuring adequate provision of quality public services. Public sector employment is substantially higher in Hungary than in its regional peers.

Credible fiscal consolidation would help bring down Hungary's elevated public debt. The public debt-to-GDP ratio has decreased from above 80 percent in 2011, to a bit less than 70 percent by the end of 2019, and is expected to decline further in the coming years. The public debt strategy, focusing on lengthening maturities and striking balance between further foreign exposure and containing interest exposure, remains appropriate. We agree with staff that the size of the total new retail bond (MAP+) offering should be capped and the interest rate for future offerings should be anchored closure to the government market yield curve. We also note that population aging is accelerating, boosting ageing related spending pressures. Could staff elaborate on fiscal implications of ageing and policy recommendations in this respect?

Monetary policy remains appropriately accommodative. Inflationary pressures have abated, while global outlook remains weak. Reduced social security contributions contained pressure from strong wage growth amid tight labor market. Chipper imports because of the price dynamics in the European trading partners helped to offset the pro-inflationary impact of the positive of the output gap. We acknowledge the unconventional arrangements "Funding for Growth Scheme Fix" and "Bond Funding for Growth" target enhancing of financial stability and developing the corporate bond market. However, close monitoring of both arrangements is warranted to minimize market distortions.

Financial sector remains heathy, yet vulnerabilities could be further reduced. Stability of the sector has improved markedly. Banks' capital adequacy ratio remains close to 18 percent. Liquidity coverage is high as well, providing banks with adequate shock absorbing capacity in line with Basel and national regulatory requirements. Other indicators also point to good health. Return on assets (ROA) and equity (ROE) were around 1.8 percent and 18 percent respectively by mid-summer 2019, close to historical highs, reflecting solid profitability. In addition, banks have continued to reduce their share of non-performing loans (NPLs). We commend the government efforts to further spur competition in the sector through privatization of the remaining state-owned banks, in particular, the Budapest Bank. Developments on the local housing market should remain in focus after double digit prices growth last year. Efforts should be taken to discourage current house purchase incentives, including the ones on the fiscal side. Launch of several initiatives to reduce the mortgage interest rate risk, i.e. increase the portion of existing housing loans with fixed rates, has been a step in the right direction.

On the structural side, improved labor resource allocation is becoming more important to sustain growth. Shortages could be addressed by further increasing participation rates. The female labor market situation has improved significantly, in many ways restoring the pre-transition situation of high female labor force participation and gender equality, yet remains below best performers. At the same time, productivity growth remains modest. The reallocation of resources towards more efficient firms slowed down persistently, hindering aggregate productivity growth. In this respect, strengthening of institutional governance remains crucial to booster productivity growth.

Mr. El Qorchi and Mr. Badsi submitted the following statement:

We thank staff for the informative set of reports and Mr. Benk for his insightful buff statement. We welcome Hungary's economic growth performance, reaching a peak of 5.1 percent in 2018 and bringing unemployment down to historically low levels. Although on an upward trend, inflation remains within the band, reflecting an increased demand pressure. Against a backdrop of a declining public debt and adequate international reserves, internal and external imbalances remain contained. Going forward, we are pleased to note the shared views between the authorities and staff on the balance of risks, thus suggesting a favorable domestic outlook, due to the potential impact of continued demand pressures on growth. However, downside risks persist, mainly driven by a sharp tightening of global financial conditions, rising protectionism and retreat from multilateralism, and weaker than expected global growth. We broadly concur with the thrust of the staff appraisal and limit our comments to the following points for emphasis.

We commend the authorities for their fiscal consolidation plan which aims to achieve to balance the fiscal position by 2023. While concrete measures are still needed, the efforts made by the authorities in formalizing the grey economy are encouraging which should strengthen the pace of fiscal consolidation by broadening the tax base. Although the spillover from wage growth into inflation has been contained, we encourage the authorities to rationalize further public sector employment and rein in the wage bill. Based on the staff assessment, the GFN are projected to decline in the short and medium term, can staff give us more explanation on the drivers behind this shift along with the level expected to be reached over this period.

The banking sector appears to be robust, as demonstrated by the central bank's stress test and the low level of non-performing loans. On monetary policy, the MNB should stand ready to counter any upward inflationary pressures, including through a fine-tuning of the monetary conditions as mentioned by Mr. Benk in his statement. We look forward to the implementation of the new legislative and institutional framework for bankruptcy. We take positive note of the upcoming introduction of a new instant retail payment system which would help to attenuate cash usage, against a backdrop of declining but still present grey economy. We encourage the authorities to implement the necessary corrective measures to address housing market pressures.

We welcome the steps taken to improve competitiveness. The expected slowdown in growth over the medium term call for critical structural reforms to promote productivity, exports, and business climate. We welcome stepped up efforts to enhance productivity of SMEs and support ongoing efforts to simplify the tax system for SMEs. We encourage the authorities to remove the sectoral exemptions and embark on the modernization of the competition policy framework. We also encourage the authorities to continue to improve the business environment and address the impediments that stifle the entrepreneurial risk-taking, which increase the cost of doing business. We welcome the recent introduction of the digital land registry map and data service, as well as the new procurement system, which should, respectively, help improve construction permit procedures and reduce administrative burdens.

Mr. Heo, Mr. Tan, Mr. Harada, Mr. Khurelbaatar, Ms. Mori and Ms. Yoe submitted the following joint statement:

> We thank staff for the report and the Selected Issues paper and Mr. Benk for his informative buff statement. We would like to commend the Hungarian authorities for their robust policies, which have helped to reduce macroeconomic vulnerabilities substantially, increase foreign reserves to comfortable levels, lower the public debt and reduce unemployment significantly. Hungary was one of the fastest growing economies in the Euro area in 2018, and continues to demonstrate solid growth. Going forward, we would encourage the authorities to use the favorable conditions to step up their structural reform efforts, and to strengthen the resilience of the economy. We see the need to reduce procyclicality of fiscal policy and to enhance competitiveness of the economy as important priorities. We broadly agree with the staff report and have the following comments.
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> Growth-friendly fiscal consolidation should continue in the current upswing to build buffers and to help ease demand pressures. Structural fiscal position is still procyclical, even with an overall reduction of the fiscal deficit. With unemployment at historic low and the economy growing above potential, we agree with staff that a procyclical fiscal policy stance may risk overheating the economy and jeopardizing debt sustainability. In this regard, we welcome the authorities' medium-term plan towards fiscal consolidation, and commend the authorities' success in reducing the public wage bill to reduce inefficiencies. We would encourage the authorities to use the current favorable environment to undertake further growth-friendly fiscal adjustments and to create fiscal space by enhancing revenue collection and rationalizing the expenditure. We note the differences in views between staff and the authorities on the phasing out of sectoral taxes, and seek staff's comment on how much impact would this measure contribute to fiscal consolidation.
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> While the public debt is on a declining path, further efforts are required to improve debt sustainability amid the still elevated public debt. The authority's public debt strategy has paid off, with the general government debt declining by around 10 percent of GDP over the last decade, and external vulnerability of public debt has been substantially reduced. The profile of the public debt has also improved, with a more balanced mix between domestic and foreign currency denominated debt, and a further lengthening of maturities of the public debt. However, as the level of the public debt remains elevated, further efforts are required to improve debt sustainability.

The long-term implications of the retail MAP+ bond needs to be examined. Households are incentivized by very attractive features of the MAP+ retail bond as shown by the strong demand and oversubscription of the bond. We note the authorities' view that this retail bond has supported the debt strategy in lengthening maturities, containing consumption and imports, as well as to stabilize housing market prices. However, the MAP+ bond appears to be a more expensive source of funding than other government bonds. We would call on the authorities to carefully evaluate the MAP+ bond scheme to ensure that the fiscal implications would not outweigh the benefits of this scheme and the possibility of negative effects on the domestic financial market.

The authorities must remain vigilant to inflationary pressures in the economy and the housing market to safeguard macroeconomic and financial stability. While downside risks to inflation have increased on the back of weaker prospects for global demand, the authorities should continue to monitor domestic price pressures closely and adjust its monetary policy accordingly. We note the authorities' view that the new unconventional tools such as "Bond Funding for Growth" and the "Funding for Growth Scheme Fix" are not intended for immediate monetary policy objectives. Can staff elaborate on the schemes and outline how they could lead to negative market distortions? We also welcome staff's comment on whether any negative market distortions have been observed since the roll out of the schemes? The elevated housing prices relative to fundamentals raises concerns, and we note that further tightening of macro prudential measures is expected to have limited impact on containing price increase, and housing supply (especially in Budapest) is difficult to increase in a short period of time. It seems that the strong housing price growth has been driven in a large part by house purchases for investment purpose, and the authorities have proposed to tighten rules on investment purchase. In this regard, we wonder whether staff's advice to scale back fiscal incentives for house purchases would appropriately target the root cause of the housing price increase. Can staff elaborate on whether the fiscal incentives apply to investment purchase and suggest alternative policies for the authorities to mitigate the housing price growth.

Improving productivity and competitiveness are needed to boost the economy's potential output. It is encouraging that the authorities rolled out a comprehensive competitiveness agenda and strengthened the monitoring of reform implementation to ensure timely progress. We encourage the authorities to continue their efforts for enhancing productivity of SMEs, increasing labor participation and improving the business environment. In this regard, we note the proactive role played by the MNB but wonder why the

MNB and not the government is responsible for monitoring the implementation of competitiveness recommendations and whether it would be in line with the autonomy or mandate of MNB. On the SOE and Fiscal Policy Interactions shown in Figure 7, we note that Hungary is ranked worst among peer countries, especially the evaluation of explicit non-commercial SOE mandates and fiscal risk assessment. If the SOEs are lacking clear public purpose and crowding-out private companies or become a source of contingent liabilities, should the authorities consider a strategy to privatize them? Staff comments are welcome.

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

We commend the authorities for the prudent policies that have reduced vulnerabilities as shown in the comprehensive staff report. This has led to an upgrade by rating agencies and allowed Hungary to achieve one of the highest rates of growth in Europe in 2019, as well as a historically low unemployment rate. Staff points to rapid wage growth, low labor participation, and rigidities in the business environment as constraints on future growth. The government's "Program for a More Competitive Hungary" aims to address some of this, as also elaborated in the informative buff statement of Mr. Benk.

We welcome the continued decline in public debt to 70 percent of GDP at end 2018 (or around 68 percent by the end of 2019), the steady fiscal deficit reduction, and budget over-performance of the 2.4 percent of GDP target. Nevertheless, staff sees scope for further changes to the structure of expenditure and a less pro-cyclical stance, pointing to the high gross financing needs of close to 20 percent of GDP, although these are projected to decline. We agree that it would be prudent to safeguard fiscal space and welcome the authorities' medium term targets and consolidation plan. We note that while some measures are not yet specified, the authorities have already overachieved their targets and have reduced staff positions in the public sector by over 20 percent in 2018-2019. We would like to ask staff about the gains in VAT collection related to efforts made to reduce the gray economy, and whether these can be relevant for other countries.

Monetary policy continues to be well managed, balancing domestic demand pressures with worsened global prospects. With regard to the unconventional schemes, we note that their size is small, and their liquidity impact is being sterilized. We agree on the need to continuously assess their effectiveness in achieving their objective of further enhancing financial stability by reducing interest rates risk for SMEs and developing the corporate bond market.

Financial sector indicators are sound, with robust credit growth and continued decline in NPLs. The rapid growth in housing loans and in Budapest house prices should be monitored.

We note that macroprudential measures are not likely to be effective as most purchases are for investment purposes and by foreign citizens and using own private savings. Could staff therefore clarify how their proposal to review various fiscal incentives for house purchases, basing them on means testing, would lead to a significant scale back of house purchases?

We thank Mr. Benk for the elaborations on the competitiveness reforms and the recent launch of the Competitiveness Mirror. This sounds like a promising and well coordinated national initiative. We look forward to future updates by staff, and to lessons to be learned and implemented by other countries. In view of the reliance on various third-party indicators in Figure 7, we would be interested to see if implementation of these reforms in the coming months will be rightly reflected in these same indicators. We look forward to a more favorable assessment next year.

Mr. Psalidopoulos and Ms. Quaglierini submitted the following statement:

We thank Mr. Benk for his helpful buff statement and staff for an interesting set of papers. We associate ourselves with the statement by Mr. Doornbosch and broadly share the staff’s appraisal. We see merit in focusing on the challenges related to medium-term growth prospects and, hence, on structural reforms. We would like to make the following points for emphasis.

The Hungarian economy continues to perform very strongly, though the growth potential is expected to be much more moderate in the medium-term, according to staff’s estimates. We would like more analysis by staff on this issue, given the moderate productivity growth despite a very strong economic performance in recent years and the specialization of the Hungarian economy in high-technology sectors, like the auto industry. We would like further elaborations by staff on the structural reforms needed to spur productivity and competitiveness in the economy

We would encourage monitoring closely the developments in certain segments of the housing market, given the sharp rise in real estate prices, together with the assessment of the effectiveness of the policy measures taken by the authorities to moderate those trends.

We welcome the reduction in external vulnerabilities of the Hungarian economy. At the same time, we noted the very large range that characterizes the current account norms estimated by staff based on the different methods in the external sustainability framework and would encourage more work on that.

We appreciate the interesting SIP on currency in circulation and the peculiar trends that emerged in the study.

Ms. Levonian, Ms. McKiernan and Mr. Williams submitted the following statement:

We thank staff for their comprehensive set of papers and Mr. Benk for his helpful buff statement. Hungary's robust growth against the backdrop of heightened global economic uncertainty is laudable. In this context, the authorities are advised to utilize the opportunity provided by the current vibrant economic setting to expedite supply-side reforms and build fiscal buffers to mitigate the anticipated slowdown. We broadly concur with staff's assessments and recommendations and offer the following remarks for emphasis.

Efforts to improve the fiscal position should continue unabatedly. We see merit in staff's recommended fiscal stance that calls for a congruent mix of measures to mobilize revenue and curtail spending. This can be done in a manner that facilitates growth and improves the quality of public services. A comprehensive reform that reduces tax exemptions and phases out distortionary sectoral taxes will help to level the playing field while generating additional revenue. Furthermore, rationalizing public employment - which is high compared to peers - seems socially and politically feasible amid the labor shortages that plague the private sector. The resulting improvement in the fiscal balance would lower the financing needs and help to improve the debt dynamics. It would also provide scope for a scaling back of the generous interest terms offered on the recently introduced retail bond (MAP +), which has the potential to crowd out private investment. We look forward to a deeper analysis from staff on the net economic benefits of the MAP+ in future work.

The accommodative monetary stance appears broadly appropriate. The planned strengthening of fiscal policy and expected economic slowdown should ease inflationary pressures. At the same time, the central bank of Hungary (MNB) must remain vigilant to market developments and be prepared to tighten the policy stance if upside risks to inflation materialize.

We urge the authorities to sustain progress achieved with financial system stability. We take positive note of the general health of the banking system, including low and declining NPLs, and welcome the favorable results of the most recent stress tests. Nevertheless, like staff, we are concerned about a likely overpricing of houses, particularly in the capital city. While low household debt will help to assuage stability risks, close monitoring of housing prices is warranted, and efforts to increase supply should be a top priority for the authorities. We welcome staff's further comment on steps to expand housing construction.

Deeper structural reforms will be integral to improving competitiveness and sustaining the growth momentum. In this regard, we appreciate staff's focus on actions to strengthen the legal and regulatory framework and to enhance the business environment. Relatedly, we welcome Hungary's progress in improving labor force participation rates and we encourage continued efforts to this end, especially for women. Going forward, curtailing corruption and improving governance, including strengthening oversight of SOEs, will be crucial to enhancing the business environment and raising potential growth. Can staff comment on the efficacy of the authorities' new procurement system?

Mr. Rozan and Ms. Gilliot submitted the following statement:

We thank staff for this insightful set of documents and Mr. Benk for his informative buff Statement. We share the thrust of staff's assessment regarding the strong performance of the Hungarian economy on the back of a dynamic private consumption, rising employment and rebounding investment. Strong public policies, including the planned fiscal consolidation, an adequate public debt strategy and sound financial sector policies have served the country well. We encourage authorities to increase fiscal space, in line with the good efforts already delivered, and to take measures to intensify the productivity of both SMEs and SOEs, at a time when Hungary's favorable position in the economic cycle allows it. We associate ourselves with Mr. Doornbosch' statement and wish to provide the following complementary remarks.

Outlook and risks

Although slightly decelerating in 2019 and thereafter, growth remains strong, driven by households' consumption and by investment in a context of a fiscal stimulus and buoyant credit growth. Domestic risks will weigh on the outlook, with for instance labor shortages, and uncertainties regarding the evolution of the public sector wage bill. This could hamper stronger growth and may affect private consumption. On the external front, Hungary’s specialization in high-end vehicles, and FDI in the manufacturing sector should continue to shield the country from Germany’s slowdown to a certain extent. Regarding growth projections, we would appreciate more details on the underlying factors behind the repeated under-estimation of projected growth and potential output. Could staff clarify their assessment on this regard and the consequences for the conduct of fiscal policy (e.g structural primary balance)?

Fiscal policy

High public debt and financing needs as well as risks and uncertainty over the favorable outlook make the case for less procyclical fiscal policy, more sustainable tax revenues and spending efficiency. The steady decrease since 2017 in the overall fiscal deficit is noteworthy and the authorities’ public debt strategy to reduce debt and curb the share of FX denominated debt is encouraging. More could be done to streamline VAT rates, reduce exemptions, contain the public wage bill and rationalize spending while protecting the poorest as well as public investment projects. In this regard, investment in infrastructure including in digitalization may be hindered by the decline in EU-funds inflows and their absorption given the growing capacity constraints. Given the willingness of the authorities to reduce public investment “as needed”, what is staff’s appraisal of Hungary’s infrastructure needs and their financing in the medium term? We appreciate the SIP on the public debt strategy, which highlighted the useful steps taken by the authorities to reduce and prevent public debt’s vulnerability to FX shocks or sudden stop episodes. The new MAP+ bond’s attractive design could however lead to opportunity cost, potential arbitrage opportunities, other funding costs increase and potential negative on budget deficit and wealth inequality. We encourage the authorities to reconsider the design of this program, by carefully balancing the various objectives of opportunity cost of reducing external vulnerabilities, refinancing risks, maintaining a high savings rate of households, reducing cash hoarding, and budgetary resources redistribution.

Structural agenda

Structural weaknesses should be addressed to boost potential growth and promote income convergence. Efforts need to be ramped up to address the many challenges the economy is coping with including an ageing population, regional disparities, underperforming education and vocational training, low innovation and R&D and to remove impediments to doing business, especially regarding SMEs. Progress is warranted to improve public sector governance and transparency in procurement, and we support the recent measures adopted to promote a more business-friendly environment. Labor productivity should be supported through increased older female workers participation as well as the reduction of labor from Public Works Scheme. Stepping up technical innovation effort while aligning wage growth with productivity gains would certainly be helpful to reach higher competitiveness levels. Accordingly, we welcome the government' Program for a More Competitive Hungary and encourage them to capitalize on the current favorable growth and financing conditions to accelerate reforms.

Lastly on the financial sector, we encourage the authorities to strengthen further the AML-CFT framework and enhance supervision of luxury real estate transactions.

Mr. Sun and Mr. Huang submitted the following statement:

We thank staff for the concise reports and Mr. Benk for the informative buff statement. After an impressive recovery from the global financial crisis, Hungary continues to be one of the fastest growing countries in Europe. Going forward, efforts are needed to preserve the hard-earned macroeconomic stability and to promote medium-term growth potential. We agree with the thrust of staff's appraisal and limit ourselves to the following comments for emphasis.

We agree with staff that the authorities' envisaged fiscal consolidation would allow monetary policy to remain accommodative for a longer period. The authorities are encouraged to take advantage of the current cyclical upswing to create more room for future fiscal policy maneuvers. This can allow monetary policy to better coordinate with fiscal policy to support growth in times of increasing external uncertainties. We support staff's recommendation of a growth-friendly revenue and expenditure policy mix, including further streamlining tax exemptions, broadening the tax base, and rationalizing poor-targeted subsidies. We take note of the divergent views on the fiscal space between staff and the authorities. Could staff comment on the authorities' view that Hungary has "some fiscal space"?

Thanks to robust economic growth and continuous fiscal consolidation, the public debt to GDP ratio is on a downward trend. However, the gross financing needs (GFN) stands at 20 percent of GDP, one of the highest in the EU. In this regard, we support the authorities' efforts in strengthening public debt management, to shift the public debt from short-term, foreign currency-denominated, and non-residents held to long-term, domestic currency-denominated, and residents-held. We welcome staff's analysis of the potential implications of the newly-introduced retail bond (MÁP+). The authorities are encouraged to closely monitor its impact and calibrate the size of issuance if needed.

We concur with staff that the central bank can slow down its pace of removing accommodation, given the increasing external uncertainties and abating inflation pressure. We support the authorities' effort to facilitate SMEs' access to financing and to promote corporate bond market development. We encourage staff to do a granular analysis on the potential implications of the two initiatives, Funding for Growth Scheme and Bond Funding for Growth, to ensure that they achieve their intended objectives with minimal market distortions. The banking sector is well-capitalized, profitable, and liquid, and we commend the authorities' efforts in bringing down the NPL ratio to a historic low. Regarding the housing market, we echo staff's advice to review the fiscal incentives for house purchasing and to increase housing supply.

Structural reforms are essential to boost growth potential and competitiveness. We agree with staff's suggestions on improving the business environment, including leveling the playing field for SMEs, ensuring competitive neutrality for SOEs, and improving governance and transparency. Further increasing labor participation rates and attracting inward migration of ethnic Hungarians are steps in the right direction to address the demographic challenges.

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

Mr. Trabinski and Mr. Tola submitted the following statement:

We thank staff for their report and selected issues paper and Mr. Benk for the helpful buff statement. We welcome the positive developments in the Hungarian economy. Strong domestic demand and investment growth have underpinned the high growth rates and the historically low unemployment. Looking forward, the authorities need to take actions to address challenges linked to the less positive external outlook, tight labor market, and slowing inflows of EU funds after 2020.

Fiscal policy should aim at creating space for counter-cyclical measures and to ensure that public debt stays firmly on a downward path. The current favorable economic situation presents a good opportunity to reverse the procyclical fiscal stance and to address the persisting structural deficit, as well as the high public debt and gross financing needs. According to staff's DSA baseline projections, the public debt-to- GDP ratio is expected to decline significantly during the next five years. Real GDP growth, which is expected to remain higher than the effective interest rates on public debt, will be the main contributor to this dynamic. However, the contribution of the primary balance to the projected decline in public debt will be small. Considering the impact that an adverse shock on growth would have on public debt and gross financing needs, would it be advisable to aim at a higher primary surplus to counteract the potential fallout from lower growth rates? Staff's comments would be welcome. In this context, we agree with staff on the need to cap the size of the total MAP+ offering and to align the interest rate of future offerings with the government bond market yield curve. This would also ensure that the growth-interest rate differential, the main contributor to the debt reduction, remains positive.

Slower global economic momentum and trade tensions justify the current stance of monetary policy, but due attention should be paid to the emerging inflationary pressures. The slowdown in Hungary's main trading partners justifies the current dovish stance of the MNB. At the same time, the tight labor market and the forint depreciation could lead to higher core and imported inflation, and we share staff's call for the central bank to be ready to adapt its stance if the emerging inflationary pressures persist.

We share staff's view that structural reforms are needed to support the growth momentum. Despite the progress achieved in certain areas, such as female participation in the workforce, more could be done to address labor supply scarcity. Labor shortages could else translate into higher wages and constitute a major impediment to future growth. In this context, we would like to know the staff's view on the effectiveness of the authorities' polices to address labor shortages in the short and long-term, such as the financial incentives aimed at increasing birth rates and the likelihood of employment of PWS participants.

Mr. Bhalla and Mr. Goyal submitted the following statement:

We thank staff for the informative report and selected issues paper, and Mr. Benk for the helpful buff statement.

Hungary registered the highest growth rate in Europe during 2018 and it has been growing at 5.1 percent on average during the first two quarters of 2019. Significantly, growth has been above its capacity and wages are rising rapidly against labour shortage and with historically low unemployment. Both headline and core inflation also rose though remained within the tolerance band. External balance is stronger than the estimated current account norm. Banking sector is healthy and NPL are declining with booming economic conditions. Notwithstanding the global slowdown, higher growth was largely driven by domestic demand and was supported by procyclical fiscal policy and accommodative monetary stance. However, Staff expects some slowdown going forward due to global slowdown and weakening of exports.

In the wake of apparent demand pressures, Staff has suggested more aggressive fiscal consolidation using cut in expenditure and enhancing revenue efforts particularly as authorities have not spelt out any specific measures to bring about fiscal consolidation. We agree with Staff's suggestions to reduce exemptions and subsidies and, broaden the tax base.

We note that Hungarian Central Bank has actively pursued the objective of reducing external vulnerability and has worked to increase the domestic holdings of government debt. By issuing MAP+ domestic subscription of government debt has gone up sharply. While it is helping in raising the saving rate and reducing external vulnerability there are implications in terms of higher cost of public debt leading to rise in fiscal deficit and potential crowding out effects. So we agree with Staff suggestion that offerings under MAP+ may be capped. Notwithstanding several positives like, a fast-growing economy, international investment position expected to turn positive in near future, authorities appears over-cautious about tapping external financing. This sounds a bit surprising, Staff may like to comment and elaborate on these concerns about external financing.

One of the concerns about Hungarian economy is sharp increase in wages unrelated to movement in productivity. Productivity levels are lagging particularly in SOEs. Low productivity may eventually impact inflation, exports and growth in an already weak global demand scenario. We agree with Staff suggestion that authorities may focus on reducing the impediments to doing business, simplifying regulations to provide level playing field for SMEs and enhancing education and vocational training. Also need to increase labour participation rate to address labour scarcity pushing up wages.

Notwithstanding global slowdown and downside risks, strong domestic demand is sustaining the economic growth and is exceeding its potential level. Demand pressures are quite evident particularly in rising wages and real estate prices. It appears that Hungarian economy is on the path of excess demand and is probably over-heated. In this backdrop, Staff may like to elaborate on its suggestion that it is appropriate for the monetary stance to remain accommodative.

We wish the authorities every success in future endeavors.

The representative from the European Central Bank submitted the following statement:

We would like to thank Mr. Benk for his buff statement and Staff for their report. We associate ourselves with the statement by Mr Doornbosch and would like to further highlight a few issues.

We broadly share staff's assessment of the generally positive macroeconomic outlook for Hungary, with risks being substantial and tilted to the downside. Economic growth has been particularly robust and led to falling unemployment, without de-anchoring inflation. Moreover, the economy has so far proved resilient to the global slowdown, thanks to domestic tailwinds in 2019, including dynamic exports on account of the automotive sector. Domestic demand was bolstered by a very tight labour market and rapidly rising wages. The Hungarian economy continues to operate above potential, while there are signs that the output gap is shrinking. As such, the very strong growth is expected to gradually moderate in the coming years. Moreover, despite the considerable deleveraging process, debt levels remain substantial and Hungary faces significant risks stemming from the external sector as it remains vulnerable to a worsening global outlook, the potential escalation of trade tensions, and abrupt changes in international investor sentiment.

Delivering on the authorities' fiscal consolidation plan is important for ensuring medium-term sustainability and further refinements appear needed for the government's targets to be met. In more detail, like IMF Staff, we believe that the fiscal strategy should consist of a mix of revenue and expenditure measures. On the revenue side, further reforms could be considered in order to simplify and unify the tax system. On the spending side, we also share the IMF Staff's assessment that a further reduction of spending on goods and services and compensation of public sector employees could help to meet the Medium-Term Objective (MTO) under the Stability and Growth Pact.

The analysis done by IMF staff on the public debt strategy demonstrates the need for sustained vigilance on external vulnerability and interest cost risks. Hungary’s external vulnerability has significantly declined since 2011 owing to the active public debt management, and it is projected to further decline in the coming years. The recently introduced new retail bond (MAP+) should contribute to further reductions in rollover of FX risks and growth in household savings. However, the relative generosity of the terms governing debt issued under this programme and its popularity could result in increased interest expenditure. In the context of these risks, we agree with the assessment by IMF Staff that some refinements to the projects should be considered. These refinements could take the form of anchoring of future interest rate offerings closer to the government bond market yield curve in order to prevent excessive growth in interest costs.

Regarding the banking sector, we find that efforts to strengthen resilience in the banking system in the past years have borne fruit; yet, remaining risks require caution. Most banks appear to display sound capital positions and sufficient liquidity buffers, while at the same time, profitability has improved and the ratio of non-performing loans declined further. However, there remain significant risks to long-term profitability stemming from the markedly low cost-efficiency displayed by the Hungarian banking sector. Moreover, credit growth to both non-financial corporations and households remains strong on the back of the booming housing market and solid household income growth and corporate real estate lending in foreign currency has been increasing steadily, which, going forward, may lead to significant currency mismatches and increased foreign exchange risk of credit institutions. Hence, it will be important to closely monitor developments and further enhance macroprudential policies as well as supervisory practices.

We agree that there is a need for implementing structural policies aimed at raising productivity growth and potential output. In this respect, the core policy issues relate to challenges stemming from demographic trends, addressing the labour market tightness inter alia by implementing effective active labour market policies and pursuing reforms in the areas of product market policies and the institutional framework.

The Acting Chair (Mr. Zhang) made the following statement:

As you know, Hungary's economic performance has been strong since the crisis. Particularly in 2018, it was one of the fastest growing economies in Europe. You also recognized in your grays that the country can do more to utilize the current upswing to further strengthening the resilience and potential growth. I also take note of the authorities' extensive structural reform agenda that aims to increase labor participation, improve the business environment, and enhance productivity.

The staff representative from the European Department (Mr. Sakr) made the following statement:

Thank you, Mr. Chairman. Maybe it would be useful at this point to quickly elaborate on the assessment of the fiscal space and on government financing, as requested by a few Directors. As you noted, Mr. Chairman, Hungary has made substantial progress in reducing vulnerabilities. Over the past decade, external debt came down from almost 115 percent of GDP to about 80 percent of GDP. Public debt also declined, but at a lesser speed. It declined from 85 percent of GDP to slightly above 70 percent of GDP. However, in its effort to reduce foreign borrowing, the government increased the issuance of treasury bills over the past couple of years. This was motivated by the preference to reduce foreign exposure given Hungary's experience during the global financial crisis. Nonetheless, this led to a shortening in maturity, which drove the gross financing needs up from less than 15 percent of GDP a few years ago to close to 20 percent of GDP in 2018.

In addition, Hungary's fiscal position remains vulnerable to various possible shocks. This is reflected in the Debt Sustainability Analysis (DSA), in which the heatmap remains mostly red, similar to last year. All the aforementioned factors are consistent with staff's assessment of Hungary's fiscal space being at risk. In view of this, staff has been recommending measures to advance fiscal consolidation in order to further reduce vulnerabilities and to build space that can be used in future downturns. I would note that this assessment will likely improve in the coming years, given the projected fiscal path and the transitory nature of the short-term maturity of public debt with the projected increase in the share of longer-term domestic bonds.

Mr. Fuentes made the following statement:

Thank you, Mr. Chairman. We would like to thank Mr. Benk for his insightful statement and staff for the well-written reports. In particular, we appreciate the focus on Hungary's public debt strategy and the discussion of the recently introduced domestic retail bond in the selected issues paper. Our chair did not issue a gray statement, but we would like to commend the Hungarian authorities for the strong economic performance and the rapid income convergence in recent years, along with the efforts to boost resilience amid a complex external environment and the downshift in Hungary's main trading partners.

Prudent fiscal management has supported macroeconomic resilience in Hungary, sustaining a steady decline in public debt along with a substantial deleveraging process to reduce external exposure and limit potential spillovers. In addition, we welcome the persistent efforts to tackle tax evasion and improve revenue collection, allowing for a transition towards a more efficient tax structure.

Finally, we believe the assessment of Hungary's fiscal space should more appropriately reflect staff's overall positive appraisal of the country's fiscal performance and the projected decline in public debt and financing needs even under stress scenarios. With that, we wish the authorities continued success.

Mr. Andreicut made the following statement:

We support staff's analysis and did not issue a gray statement. We would like to share a few remarks and ask two questions. We welcome Hungary's strong economic performance and the historically low unemployment. We support staff's recommendations, including those related to improving Hungary's competitiveness with a view to sustaining rapid income convergence and addressing demographic challenges. In this context, the authorities' initiative to promote a more business-friendly environment through the Program for a More Competitive Hungary is a step in the right direction. We welcome the further context on the program set out by Mr. Benk in his buff statement. Could staff provide more information on the timelines of the different program objectives?

Finally, the report highlights perceived corruption as one of the impediments to doing business. This is reinforced by Figure 7 of the staff report, where Hungary scores low relative to the euro area average in terms of control of corruption. Could staff comment on the measures the authorities are taking to address this?

Mr. Doornbosch made the following statement:

I think it is fair to say, and you alluded to that Mr. Chairman, in your opening remarks, that Hungary's recovery after the global financial crisis has been remarkable, indicated, for instance, by the rapid growth of per capita GDP since 2014. In particular, we very much welcome the positive developments in the labor market illustrated by increasing participation in employment rates and unemployment levels at historic lows. We believe that further efforts remain necessary to share the benefits of the economic success more broadly across the society and promote inclusiveness. We believe that further efforts remain necessary to improve the access to quality education and healthcare for disadvantaged groups.

Regarding fiscal policy, we welcome the continued reduction in debt levels and encourage the authorities to address the procyclical fiscal stance. Despite the considerable deleveraging process, we encourage Hungary to use the favorable economic environment to continue building up adequate policy buffers as external risks continue to exist. More specifically and in line with IMF staff's analysis of the public debt strategy, we see the need for sustained vigilance on external vulnerability and interest cost risks, including those related to the recently introduced retail bonds. We encourage the authorities to implement the priorities set out in the 2019 Convergence Report.

We generally welcome public investment when it contributes to boosting potential growth and preparing the economy for future challenges. We would like to stress that it is vital to make sure that public funds are used efficiently and to design investment policies in a way in which they do not crowd out private investors. In the same vein, we encourage the authorities to further improve the business environment to introduce more competitive procurement processes and to increase fiscal transparency.

With these remarks, we wish the authorities all the best in their endeavors.

Mr. Trabinski made the following statement:

We commend the Hungarian authorities for their continuous commitment to the reform agenda. The strong policy framework, greater social inclusion, and further income convergence have helped Hungary to become one of the European Union's growth leaders. Going forward, it will be important for the authorities to further reduce public debt, improve tax system efficiency, and introduce well-designed and targeted structural reforms to address potential downside risks and strengthen the overall resilience of the economy.

First, I think that from the long-term perspective, the most pressing issue for Hungary, as well as for other countries in the region, including my own, are the demographic pressures. No other economic issues present a greater challenge for the region. We thank for staff's reference both in the report and in the answers to our questions to the IMF departmental paper titled Demographic Headwinds in Central and Eastern Europe. We found it very timely and helpful both in terms of quality of analysis as well as in terms of the policy recommendations that point to the need for a more comprehensive set of measures that should be introduced to tackle this problem.

We welcome the authorities' demographic measures in this regard, but we would be interested in hearing from staff what other measures to tackle population aging could be introduced by the authorities. In the context of the demographic challenges, we would also like to ask staff about migration dynamics in Hungary, both in terms of outflows and inflows, as well as foreign migration to the country. Could staff comment on this?

Second, as other Directors, we share staff's view that there is scope for introducing a mix of growth-friendly fiscal measures both on the expenditure and revenue sides to help the authorities in achieving their medium-term fiscal targets. This could help to further reduce high public debt, while strengthening fiscal buffers and preserving necessary space for important infrastructure investments. Could staff comment on the size of basic infrastructure investment needs in Hungary and on whether there are any data available for staff in this regard?

Let me wish the authorities all success in their future endeavors.

Mr. Montero made the following statement:

I associate myself with Mr. Doornbosch's oral statement. We issued a comprehensive gray, and I was going to focus on the more structural issues. I think I have to chip in also on the debate regarding the fiscal space, because I do not remain fully convinced by the explanations provided by staff. I join Mr. Fuentes in his call to reflect better the fiscal position in Hungary. As we explain in our statement, both public debt and gross financing needs are projected to decline over the medium term. Fund charts show moderate uncertainty around the baseline scenario, and staff acknowledges that there are available cash buffers of about 5 percent of GDP. We wonder whether it would be more appropriate to consider that there is some fiscal space instead of the assessment of Hungary's fiscal space at risk.

Coming back to what would be my main points for today, two of them have already been raised by Mr. Trabinski, so I may be brief. The first is to raise awareness regarding this policy paper, Demographic Headwinds in Central and Eastern Europe. I think it is a must-read paper for the authorities in this region, precisely because it addresses not only the demographics, but also the low labor productivity that are somehow connected between themselves. It contains a lot of useful policy recommendations.

Second, in order to boost productivity, we believe that it is crucial to strengthen the business climate by inter alia modernizing the competition and policy framework, streamlining regulations, and ensuring transparency and competitive procurement processes, and fighting against corruption more forcefully.

Third, this is also related to Mr. Trabinski's comments. Given the extremely adverse demographic scenario going forward, we would like to encourage the authorities to continue boosting labor supply using a variety of policy tools. This cannot be done just by using a single bullet, because it does not exist. We would like to call attention to the issue of developing a more liberal immigration policy to increase labor supply and also to bring in new skills.

Mr. Alkhareif made the following statement:

We would like to take this opportunity to commend the authorities for the strong economic performance. GDP growth has been overachieving the estimates. Inflation has been stable. Unemployment has been at record low. We are encouraged that the authorities are determined to achieve the income convergence target. We echo staff's recommendation that the current upswing environment should be an opportunity to strengthen resilience and boost potential growth.

On fiscal policy, we are encouraged to note that the public debt is on a downward path, and we encourage the authorities to build on the strong economic and fiscal performance. Like Mr. Trabinski, we encourage the authorities to pursue a mix of growth-friendly revenue and expenditure measures. We found the selected issues paper on debt strategy very informative, and we encourage the authorities to continuously monitor the financial implications of the new retail bond MÁP+.

On the financial sector, we welcome the authorities' efforts to strengthen the resilience of the sector. We note that the banking sector is well capitalized, profitable, and liquid. The NPL ratio is also declining, and this is a very encouraging sign. Like staff, we encourage the authorities to focus their reforms on the AML/CFT side and to continue their reform to monitor risks stemming from the real estate sector.

Finally, we welcome the authorities' efforts to carry on structural reforms. We note that it is broad-based reforms and covers many sectors. We particularly welcome the focus on enhancing productivity in the small and medium-size enterprises (SME) sector, which will have a positive impact on employment and potential growth.

With these remarks, we wish the authorities a continued success.

Mr. Heo made the following statement:

The Hungarian economy looks solid, one of the highest growth rates in Europe, running above its capacity while its public debt is on a declining path. We can also share staff's view that monetary policy can afford to stay on hold, given the contained inflation and weak external outlook.

There is one thing that bothers me. It is not easy to understand why the central bank of Hungary (MNB) introduced bond funding for growth scheme last July. It noted then that the purchase of corporate bonds is a practice of leading European central banks, such as ECB and the Bank of England, but I am not sure the Hungarian economies are facing a credit crunch. The bond purchase scheme will involve the purchase of bonds issued by domestic nonfinancial corporations with at least B+ rating, which is four notches under the investment-grade threshold. That means MNB can embrace a low-quality credit risk, which can negatively impact the central banks' balance sheets when the risk materializes. I understand that the size of the program is limited to 300 billion Hungarian Forints, which is about 0.7 percent of GDP. However, as staff answered to our technical questions, it also raises concerns on how the risk of various companies is assessed. In contrast to the authorities' intention of developing the corporate bond market, I am worried that it may delay the development of the domestic capital market, as it can boost higher risk taking by unsound companies with a moral hazard. So I would like to encourage staff to continue candid consultations with the authorities on this issue. With this, I wish the authorities every success.

Mr. Merk made the following statement:

We associate ourselves with the statement of Mr. Doornbosch. We recognize Hungary's overall favorable economic situation marked by high growth, low unemployment, and on average, well-capitalized financial sector. Nonetheless, we take note that vulnerabilities remain. The fiscal position appears to be procyclical, and public debt is still well above 60 percent of GDP. We echo staff's call for a prudent public debt strategy. We take note that the public debt ratio has declined further but that the underlying structural fiscal balance has deteriorated. As rightly pointed out by staff, we encourage the authorities to take advantage of the strong economic conditions to pursue growth-friendly fiscal consolidation, to lengthen maturities, and to reduce rollover risk, while at the same time containing interest expenditure.

Ms. Pollard made the following statement:

I just want to touch on two points. The first is this issue of fiscal space that was raised by Mr. Fuentes and Mr. Montero. I note that in paragraph 9 of the report, staff indicates that they have underestimated both growth and potential growth, which seems to me to indicate that there may be more fiscal space than is accounted for in the report. In this regard, the question that Mr. Trabinski has raised about the size of the infrastructure needs is important, because the idea is that you should not just use fiscal space to spend the money. If there are needs and there is available fiscal space, then efficient investment can actually be helpful to the economy.

Secondly, I just want to echo a point that we made in our gray on the use of qualifiers when talking about the external sector balance. In Hungary's case, staff note that the current account norm is negative, and yet they talk about movement of the current account in the future likely moving back into surplus as an improvement. We would actually say that is not an improvement. It is moving further away from the norm, so we need to be cautious in indicating that surpluses are good and deficits are always bad.

Mr. El Qorchi made the following statement:

We issued a gray, and our questions were answered by staff, and I have only one additional question, which could be answered bilaterally if needed. The use of cash is persistent in Hungary, despite the development of more efficient alternative payment instruments. What else could the authorities do? What policies could staff recommend to reduce cash payment and promote no cash? I would like to wish the authorities every success.

The staff representative from the European Department (Mr. Sakr), in response to questions and comments from Executive Directors, made the following statement:[1]

Let me start with a little bit more on the fiscal space. There are various factors that we take into consideration in that assessment, and two important factors for Hungary are that according to the most recent information for end last year, end-2018, public debt is about 70 percent of GDP, and the gross financing needs are well above 15 percent of GDP. These are two important benchmarks that play a role in the assessment. They are not the only factors in the process, but they are important factors. For cross-country comparability, we have to basically abide by the methodology. That assessment was given very careful consideration. We are comfortable that if the fiscal projections materialize, the situation will be different in the near future.

Directors raised a few other points that are partly related to the fiscal space. There was a recommendation that any additional savings should be spent on infrastructure. I think this is a very good point. On the assessment of the infrastructure in the country, basically it varies among regions. There are some assessments that indicate that the quality of infrastructure in Hungary is at par with the average in the EU. Others point to some weaknesses, especially in roads and transportation. This is particularly relevant for inclusiveness and also for the severity of the labor shortages and for the real estate sector. Unemployment tends to be more concentrated in certain regions, while other regions have very severe labor shortages. That would be a good thing to pay attention to. However, public investment is already high at the moment, so we basically agree with the government that with the pressure on the capacity, especially in the construction sector, they could reduce public investment a little bit in the short run, but in the medium run there will be a need to increase it.

With regard to the Competitiveness Program, it includes a comprehensive structural reform agenda and contains 330 competitiveness recommendations in different areas. The focus is on addressing the labor shortages and on SMEs. Hence the government focuses on SMEs including by trying to improve the availability of financing. It is true that the domestic

[1]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.

capital market is underdeveloped, and it is a matter of priority for the authorities. They are more focused now on growth. Developing the capital market would take time. They want to sustain their high growth rates, and hence they are looking at ways to encourage SMEs, including by providing financing. It is well taken that there are risks associated with that, and the program is still new. It was introduced three months ago, but we will keep a close eye on it and make sure that we assess it as it evolves.

Corruption was one of the structural reform agenda elements. Immediate gains have been made in improving the procurement system, but it is important that its implementation also meets the high standards. Another element is reducing tax evasion. This also is something that we see happening already. Good success there. The agenda includes long-term issues, and the authorities are putting in place a system to monitor progress in these areas.

Tax evasion and also the financial transaction tax are elements that could hinder a reduction in the grey economy.So one of the selected issues papers is looking at the impact of the financial transaction tax. We recommend the authorities to phase it out along with other structural taxes. The continued use of cash registers and the real time monitoring captures more of the transactions in the economy and reduces the size of the gray economy and would help reduce the cash transactions.

On population aging, the authorities have already taken some good steps in the pension system in particular, and that has helped moderate its impact to about 2 to 3 percent of GDP going forward. It is pretty moderate, but it is still one risk that highlights the need to improve the fiscal situation.

On immigration, Hungary has a unique culture and unique language, and the preference the country has at this point is to deal with labor shortages by encouraging Hungarians—and there are a large number of Hungarians abroad—to come back and work in the country. There has been some progress in this regard, but the results have been mixed because of the wage difference between Hungary and some of the, higher-income Western European countries. Some come back and then actually leave again. Some come from the East and stay in Hungary for a while and then move to the West. So the authorities are actually keen on having higher wages domestically, because they feel that this will help deal with the labor shortages. Staff's advice is to facilitate that in a sustainable way, by increasing emphasis on raising productivity. That is an important element of our recommendations.

Mr. Benk made the following concluding remarks:

I thank the mission chief, Mr. Sakr, and his team for their valuable work and recommendations. My authorities and I highly appreciate the constructive and open discussions during the Article IV missions and the staff's advice on macroeconomic policies. We also thank Directors for their helpful comments expressed in their statements today.

I believe Mr. Sakr has already provided very comprehensive answers to the relevant questions, which hopefully clarified many issues, so I will make only a few additional remarks.

Hungary's economic performance has been strong, which supports convergence and resilience building. However, in order to fully understand and assess these achievements, we need to look a bit back at the developments over the past decade. Ten years ago, Hungary was under a Fund program after several years of irresponsible fiscal policies, not to mention other policy mistakes. Then when the crisis hit, the economy had already been in a weak position with depleted fiscal reserves, soaring debts, and stagnating growth. After 2010, the economy experienced a major turnaround. The new government implemented bold and some unconventional measures which were effective in restoring macro stability and relaunching growth. These policies are now bearing fruits.

The vulnerability has decreased significantly. That is on a steady downward trend. Fiscal deficit is shrinking, the country is approaching a balanced budget in the medium term, and the income convergence is ongoing. However, I still feel from some of the grays that some minor concerns remain regarding the fiscal performance going forward. Let me just again assure Directors, as I did for many years, let me assure Directors about the authorities' commitment to prudent fiscal policies, prudent policies in general, and focusing their strategy on promoting growth, improving competitiveness, and reducing vulnerabilities.

Another note on the undue concerns. In his gray, Mr. Rosen and today Ms. Pollard rightly pointed out the continuous underestimation of projected growth. This is not a Fund-specific issue. I think the Fund staff did a great job, but this kind of underestimation of not only the growth performance but also the fiscal performance has been prevalent both among other international organizations like the European Commission (EC) and market analysts, so I think there are some lessons to be learned here.

There are two further issues raised by some Directors that I would like to elaborate on. First, on the fiscal space, Mr. Sakr has explained the rationale behind the staff assessment, and I can broadly agree with his reasoning, given the institutional methodological constraints. However, maybe on a more general note, and not only relating to Hungary, I believe that the terminology of the pilot fiscal space assessment framework, that fiscal space could be at risk in some cases. I think this term is somehow misleading, and maybe it would be better to revert to the old language used before that of limited fiscal space or some fiscal space, because this term of risk could generate different reactions. Stating that fiscal space is at risk while public finances are sustainable and buffers exist, that could confuse the markets, which are unaware of the Fund's methodology. Markets are also unaware of the fact that only a small group of countries are part of these pilot projects, and some of these countries could be qualified as being at risk, while those who are not part of the pilot, on those countries the Fund is just silent. How would the market differentiate between these two assessments?

Finally, I noticed the interest of Directors in the new Hungarian domestic retail bond and its relatively generous terms, which obviously comes at some costs. This bond is an instrument of the debt management strategy and intended to reduce external vulnerabilities, but we all know that insurance is always costly, so there is no free lunch. Staff actually has rightly pointed out in the paper that it is kind of a political decision of how to raise the opportunity costs of reducing external vulnerabilities, the finance risks, maintaining the high savings rate of the households, reducing cash holdings, and so on. The authorities' view is that the costs they face with this instrument will be well compensated by secondary benefits, like lengthening maturities, building a stable domestic investor space, encouraging savings, or even stimulating the internal demands through the interest income benefitting households and alleviating pressures in the real estate market.

A final point responding to Mr. Montero's question on the immigration policy. As Mr. Sakr mentioned, the general policy is to discourage illegal immigration. There are legal challenges. To give an example, Hungary has just developed a program for hosting refugees from Venezuela. They are hosting about 1,000 people so far, and probably the program is ongoing.

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

Directors have had the opportunity previously to engage a couple of times on the fiscal space analysis. The last such discussion was last year, and there was subsequently a follow-up by staff in the form of written communication, in which staff explained to the Directors some of the methodological enhancements. In terms of the actual definition of what the “fiscal space at risk” means, it implies that there are clear, but not imminent, risks to fiscal sustainability and at most marginal fiscal loosening is possible compared to the baseline. As the mission chief explained, there is a variety of factors at play that reflects this assessment. Again, the debt ratios are still at rather elevated levels. The gross financing needs are very high, and the overall assessment of the fiscal space reflects not only historical data, but there is also a number of detailed scenarios by staff underpinning this assessment. There are also stress tests. So in sum, staff applied the technological toolkit and considered other factors when arriving at the overall risk assessment. The rating that has been assigned by staff is not set in stone. I am sure that staff will want to address this again in future consultations.

In terms of the overall tone of the report, I think it would be fair to say that there is a number of positive statements about the overall policy plans of the authorities, so I would think that the observers will be interpreting the statements as a package.

Mr. Doornbosch made the following statement:

Staff is referring that we had an opportunity to discuss the fiscal space framework, and we did discuss this. At the time, 14 Directors did not like it and thought it was implemented too early. I think it may be a good opportunity to get back to the fact that there is still a lot of concerns from several Directors about the new fiscal space framework. This is really something we need to look at more carefully, because the language is confusing and it raises often concerns.

The Acting Chair (Mr. Zhang). I think that is a very good, important point, and we will take note and find a good opportunity to review it, particularly in terms of the communication and sending a clear message to both the authorities concerned and to the market. I think that is very important.

The following summing up was issued:

Executive Directors agreed with the thrust of the staff appraisal. They commended Hungary’s continued strong economic performance, which has led to faster income convergence towards the European Union average and reduction of vulnerabilities. Directors noted that growth has been underpinned by strong domestic consumption and investment. However, given the increased external uncertainty and Hungary's still high public debt and gross financing needs, Directors encouraged continued fiscal consolidation and supply-side reforms, to further build resilience and sustain the growth momentum.

Directors were reassured by the government's medium-term fiscal targets, which will help reverse the procyclical fiscal stance, alleviate demand pressures, and increase the available fiscal space that can be used in future downturns. In this context, Directors encouraged specific growth-friendly revenue and expenditure measures, including reducing exemptions, broadening the tax base, phasing out sectoral taxes, moderately reducing spending on goods and services, containing the public wage bill and rationalizing generalized subsidies. Directors saw merit in a public debt management strategy that reduces rollover and foreign exchange rate risks, while avoiding large increases in domestic interest costs. It will also be important to implement the government's plan to enhance the monitoring of state-owned enterprises to improve efficiency and reduce the risk of contingent liabilities.

Directors supported the current monetary policy stance and acknowledged the challenges posed by divergent domestic and external conditions. Since risks to inflation from domestic conditions appear to be on the upside, they encouraged the Central Bank of Hungary (MNB) to be attentive to demand pressures. In this respect, Directors noted that close monitoring of the housing market is warranted, and consideration should be given to reducing housing bottlenecks and scaling down existing incentives that stimulate demand. Directors also recommended continued assessment of new and existing unconventional arrangements to reduce the risk of market distortions. Clear and timely communication will remain essential for effective forward guidance.

Directors emphasized that rapidly rising wages relative to productivity, decelerated export growth, and remaining shortcomings in the business environment underline the need to invigorate supply-side reforms. Accordingly, they welcomed the authorities' extensive agenda to improve competitiveness and to help address demographic challenges. Directors called for timely implementation of prioritized reform measures that focus on reducing impediments to doing business. Such prioritization should focus on leveling the playing field for small and medium-sized enterprises, improving governance and transparency, increasing labor force participation, particularly of women, and enhancing education and vocational training.

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

APPROVAL: May 27, 2020

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/Risks

1. Could staff elaborate on the possible impact of demographics on medium to long-term growth?

- Hungary's aging and declining population contributes to the severe labor shortages and to lower productivity, which in turn have negative implications for growth. This is a challenge that is also faced by other countries in the region (https://www.imf.org/en/Publications/Departmental-Papers-Policy-Papers/Issues/2019/07/11/Demographic-Headwinds-in-Central-and-Eastern-Europe-46992). The Hungarian government has introduced targeted demographic measures to encourage families to grow with the aim of increasing domestic labor supply over the longer term. The authorities also intend to improve the availability of daycare options in order to increase the participation of younger women in the labor market. It is, however, important to ensure that the fiscal cost of such measures remains contained and that they are complemented by labor market, education, and other structural reforms to improve productivity.

2. We would appreciate more details on the underlying factors behind the repeated under-estimation of projected growth and potential output. Could staff clarify their assessment on this regard and the consequences for the conduct of fiscal policy (e.g structural primary balance).

- Hungary's growth rate has exceeded most projections, including those of the authorities and the EC over the past few years. A key factor that has contributed to strong growth was the higher-than-expected absorption of the EU funds, not least due to the authorities' pre-financing the projects. Private consumption has also contributed at a higher rate than envisaged spurred by the reduction in tax rates and very high wage growth. Another possible factor is the impressive success in formalizing part of the grey economy and the likelihood that the slack in the economy has been underestimated.
- Estimation of potential output is challenging, especially in rapidly transitioning emerging economies. Staff's estimate of Hungary's potential output is moderately smaller than the authorities' estimate, but higher than the EC's estimate. However, all three estimates indicate that the output gap has closed or about to close. Had the potential output been estimated higher, the estimated primary structural balance would have of course been smaller. Nonetheless, the very strong growth and the

increasing pressure on resources, as manifested in the severe labor shortages highlight the need for fiscal consolidation to reduce remaining vulnerabilities and build fiscal space that can be used in future downturns.

3. We missed some discussion in the report regarding the potential role that immigration could play to ease pressures in this market.

And

4. We would like to know the staff's view on the effectiveness of the authorities' polices to address labor shortages in the short and long-term, such as the financial incentives aimed at increasing birth rates and the likelihood of employment of PWS participants.

- The Hungarian authorities has been focused on unlocking the labor reserve available domestically by rolling out measures to increase participation rate and release more participants from the Public Works Scheme. Staff believes that there is still scope to tap these reserves, especially in view the still large size of the Public Works Scheme (about 2.5 percent of the labor force), the relatively large size of the civil service, and the small female participation rate (about 50 percent compared to the national rate of about 70 percent). More recently, the authorities are considering measure to attract Hungarians living and working abroad. The success of the latter objective will likely increase as domestic wages continue to increase. To facilitate a sustainable increase in wages, it would be important to improve productivity through enhancing education, training, and the business environment.

Fiscal Policy

5. Considering the impact that an adverse shock on growth would have on public debt and gross financing needs, would it be advisable to aim at a higher primary surplus to counteract the potential fallout from lower growth rates?

- Under staff's baseline scenario (which is more conservative than the authorities' projections), the public debt-to-GDP ratio is forecast to decline from 70.2 percent in 2018 to about 56 percent by 2024. While the cumulative contribution of higher growth is projected to be about 11 percentage points, the improvement in the primary balance will contribute only by 2.7 percentage points. Consequently, Staff recommended a mix of growth-friendly revenue and expenditure measures that would lead to public debt falling to 50 percent of GDP by 2024, which is consistent with the authorities' objectives.

6**.** ***Could staff comment on the magnitude of total tax expenditures in Hungary?***

- According to the information provided by the authorities, tax expenditure is estimated at about 4.2 percent of GDP, which points to some scope for reducing exemptions. Implementation of the adjustment measures recommended by staff would help reduce this amount.

7. We would like to ask staff about the gains in VAT collection related to efforts made to reduce the gray economy, and whether these can be relevant for other countries.

- Hungary has introduced several measures to improve VAT collection over the past few years. The introduction of online cash registers and the online invoice system seem to have had the largest impact. Consequently, according to the latest estimates by the EC, the VAT tax gap has declined from about 20 percent of the overall VAT total tax liability in 2013 to about 10 percent in 2018. These measures are also expected to contribute to further formalizing the grey economy.

8. We note the differences in views between staff and the authorities on the phasing out of sectoral taxes, and seek staff's comment on how much impact would this measure contribute to fiscal consolidation.

- The overall size of sectoral taxes in Hungary is estimated at 1.2 percent of GDP in 2019. The bulk of sectoral taxes (0.8 percent of GDP) are taxes in the financial sector (Financial Transaction Tax, Bank Levy, and the Tax on Insurance Companies). In the adjustment scenario, staff proposes to reduce the size of sectoral taxes by 1 percentage point of GDP over 2020-24.

9. Given the overall positive fiscal assessment and medium-term outlook, we would welcome further elaboration on the staff's assessment in paragraph 13 that Hungary's fiscal space is at risk. Could staff comment on the authorities' view that Hungary has "some fiscal space"?

10. Staff may like to comment and elaborate on these concerns about external financing.

- Staff will address the above two question in its oral intervention at the Board.

11. Could staff elaborate on fiscal implications of ageing and policy recommendations in this respect?

- As in other European countries, long-term demographic trends can have major fiscal implications over the long-term. In view of this, Hungary introduced a number of parametric changes to reduce the long-term pension expenditures and other age-related public spending. The main focus of these parametric reforms has been on increasing the effective retirement age in line with the rising life expectancy and changing the pension indexation rules. Due to these reforms, the remaining increase in age-related expenditure is expected to be moderate. According to the authorities' most recent projections, which are peer-reviewed within the EU, age-related spending is projected to increase from 19 percent of GDP in 2016 to 22 percent of GDP in 2070.

12. Based on the staff assessment, the GFN are projected to decline in the short and medium term, can staff give us more explanation on the drivers behind this shift along with the level expected to be reached over this period.

- The projected substantial improvement in the gross financing needs corresponds to the intended extension of public debt maturity. Following the authorities' decision from mid-2019 to extend the average maturity of public debt and the most recent public debt management practices, staff projects that the share of short-term financing to decline from 12 percent of GDP to about 5 percent of GDP. This will be achieved through replacing the stock of short-term T-bills, with a maturity of one year and less, by sovereign bonds with maturity of 5 years and above.

13. Can staff comment on the efficacy of the authorities' new procurement system?

- The design of the new procurement strategy was given high marks by the OECD. In particular, the introduction of the central electronic public procurement system is a step in the right direction. While staff understands that the new system is guided by best international principles and is in line with the EU Public Procurement Directive, it would be important to address any remaining concerns, including by ensuring transparent and competitive procurement processes, in line with EC recommendations. The key to its success would be its strict implementation.

14. Given the willingness of the authorities to reduce public investment "as needed", what is staff's appraisal of Hungary's infrastructure needs and their financing in the medium term?

- In 2018, the stock of public capital in Hungary was slightly below the average of EU and OECD countries. Nonetheless, in the same year, capital spending in Hungary reached almost 6 percent GDP, which is among the highest in the EU. Furthermore, according to the World Economic Forum, the overall quality of Hungarian infrastructure is at the level of other EU countries. However, the quality of roads and air transportation is below the EU and OECD average. Given the severe shortages of labor, especially in the construction sector, the authorities plan to moderate public investment in the near term. Staff agrees with the need to contain expenditure, and at the same time recommends that any additional savings can be used to boost infrastructure investment over the medium term to compensate for the projected decline in EU funds.

15. If the SOEs are lacking clear public purpose and crowding-out private companies or become a source of contingent liabilities, should the authorities consider a strategy to privatize them?

- The authorities believe that SOEs play a strategic role, especially in the energy and utilities sectors, and their current strategy is to continue to improve their efficiency. With regards to the financial sector, the state-owned bank (Budapest Bank) is currently being privatized.

Monetary Policy

16. Staff may like to elaborate on its suggestion that it is appropriate for the monetary stance to remain accommodative.

- The weaker global outlook point to downside risks that may later calm the currently strong domestic demand. It is nonetheless important to monitor developments closely as prompt action may be needed, given transmission lags, should inflation pressures build. Headline inflation in October was 2.9 percent (target is 3.0 percent, with a +/-1 percent tolerance band).

17. In this context, we take note that the report mentions the Central Bank's "extensive agenda to improve competitiveness" as well as policies to reduce interest rate risk for SMEs and develop the corporate bond market. We would welcome additional staff comments and assessment of these policies.

- The MNB's Competitiveness Programme in 330 Points (https://www.mnb.hu/en/publications/reports/competitiveness-programme) covers a broad range of measures, generally aiming at making the economy more dynamic by easing capacity constraints and reducing vulnerabilities. While there are many measures, they vary in extent of impact. Staff has encouraged the authorities to prioritize the implementation of the competitiveness agenda in general and monitor progress. As noted in the staff report, staff welcomes the forthcoming publication of the MNB, Competitiveness Mirror, which aims to report on progress to date.

18. In this regard, we note the proactive role played by the MNB but wonder why the MNB and not the government is responsible for monitoring the implementation of competitiveness recommendations and whether it would be in line with the autonomy or mandate of MNB.

- The MNB closely monitors trends in competitiveness and is an active member of the Competitiveness Council, which is headed by the deputy prime minister and minister of finance. The MNB contributes with suggestions and follow-up on the status of its recommendations (the forthcoming MNB publication titled Competitiveness Mirror), which will serve as further input for the Competitiveness Council.

19. Can staff elaborate on the schemes and outline how they could lead to negative market distortions? We also welcome staff's comment on whether any negative market distortions have been observed since the roll out of the schemes?

- Potential distortions from the two new schemes include affecting the pricing of interest risk (Funding for Growth Fix) for SMEs as market conditions evolve, and concerns about how the risk of various companies is assessed (Bond Funding for Growth). The two schemes can be useful in enhancing financial stability and develop the commercial bond market, but as noted in the staff report, their implications should be monitored closely. Past experience with unconventional initiatives suggests that the MNB will discontinue their use once their objectives have been achieved or they turn out to be less effective than envisaged.

Financial/housing

20. Could staff provide an update on the privatization of Budapest Bank?

- Budapest Bank has been put up for sale. Several Hungarian banks have expressed interest in acquiring the Bank. The decision is pending.

21. Could staff provide additional information on the link between labor market developments and the housing market, including vulnerabilities to a decline in wage growth?

- Housing prices in the capital area now exceed "fundamentals," which mainly include wage income but do not include income from short-term rentals. According to Box 2 in the MNB's November 2019 Housing Market Report (https://www.mnb.hu/en/publications/reports/housing-market-report), the number of years of annual income a median apartment costs ranges from about 7 years for an average income in the country side to 13 years for an average income in the inner districts of Budapest. Macro-prudential measures, like loan-to-value and debt-service-to-income ratios should help contain financial stability risks in the unlikely event of major reduction of wages.

- We welcome staff's further comment on steps to expand housing construction. The main constraints to expanding housing supply are labor shortages in the construction sector and delays in obtaining permits and utilities connections. The MNB's Competitiveness Programme in 330 Points include three specific points to support the construction capacities. Point 37: Increase the construction workforce by supporting educational and training programs, including to increase the number of workers qualified to implement the new energy requirements. Point 38: Better scheduling of public investments, which can help facilitate contra-cyclical public construction. Point 39: Ease administrative barriers to home construction related to permits and registration procedures, including by digitalization these procedures, which should shorten the procedural times.

22. Could the staff clarify how their proposal to review various fiscal incentives for house purchases, basing them on means testing, would lead to a significant scale back of house purchases?

- Means testing of various housing incentives could potentially reduce some of the demand for dwellings, including for investment purposes. However, this alone would not have a significant impact and should be accompanied by other measures as outlined above.

23. Can staff elaborate on whether the fiscal incentives apply to investment purchase and suggest alternative policies for the authorities to mitigate the housing price growth.

- There are several initiatives to support housing that have been adjusted in recent years. It is our understanding that some of these schemes may also be used to purchase second homes. Staff did suggest making a clearer distinction between homes for primary residence and for investments.