MINISTRY FOR NATIONAL ECONOMY

MACROECONOMIC AND BUDGET OUTLOOK

2017-2021

December 2017

SUMMARY

The Hungarian economy has been growing dynamically on a balanced and sustainable path since 2013. In the second half of 2017 GDP growth accelerates again to over 4%. This increase is broad-based as almost every sector contributes to the favourable performance. In addition, the sound structure and sustainability of growth are underpinned by the fact that Hungary's indicators of external and internal balances show a positive picture.

Investment is one of the main driving forces for growth in 2017 thanks to the Home Creating Programme that stimulates housing construction, the gradual acceleration of EU fund absorption and capacity expansions of large companies. The latter was encouraged by the reduction of the corporate income tax rate to 9% from 2017, becoming the lowest rate in EU. This tax reduction is part of the six-year wage and tax agreement. Also, consumption contributes considerably to GDP growth in parallel with the sustained improvement in households' income position and favourable labour market trends. On the production side, market services support growth to the largest extent, mainly due to the vivid domestic demand, namely tourism and the real estate market, but production braches are also contributing significantly to the growth performance. The boom in construction is a combined result of rebound in housing construction and EU co-financed infrastructure developments, while the accelerated growth rate of industrial production stems among others from the recent capacity expansions. Impressive growth processes are supported significantly by the new records that have been achieved in the labour market thanks to the strong labour demand of private sector. According to the latest data, more than 4.4 million people work in Hungary, which is unprecedented, and the unemployment rate has never been more favourable than the current level of 4.0%.

The sustainability of GDP growth is also underpinned by the fact that the inflation has remained moderate and financial stability is also favourable along with the dynamic economic performance. As in recent years, net financing capacity vis-à-vis the rest of the world shows a massive surplus resulting in a continuous decrease in external debt, further reducing Hungary's external vulnerability. General government deficit is contained and the public debt is on a declining path. Regarding the financing of general government, it is also a positive sign that in parallel with the role of non-residents, foreign currency exposure also diminishes. Due to the persistently disciplined fiscal policy and the further improving economic performance, Hungary's market perception has continued to improve. Two out of the three leading credit rating agencies have revised the outlook on Hungary's sovereign rating from stable to positive, which had a positive impact on debt financing costs through the further decreasing country risk premium.

Looking ahead, Hungary's economic growth is expected to accelerate to 4.1% in 2017 and to 4.3% in 2018 thanks, among others, to strong increase in domestic demand, accelerating EU fund absorption, Home Creating Programme, the growth-stimulating effect of the six-year wage and tax agreement, as well as the favourable fundamentals. The GDP growth forecast of the Government for 2017 and subsequent years has already remained unchanged for one year, as the fact data available so far have confirmed that the performance of the Hungarian economy is in line with the growth path projected in December 2016. The budget has been constructed by the Government in a way that supports GDP growth and its economic and social priorities while the deficit remains well below 3% of GDP and the public debt continues to decline.

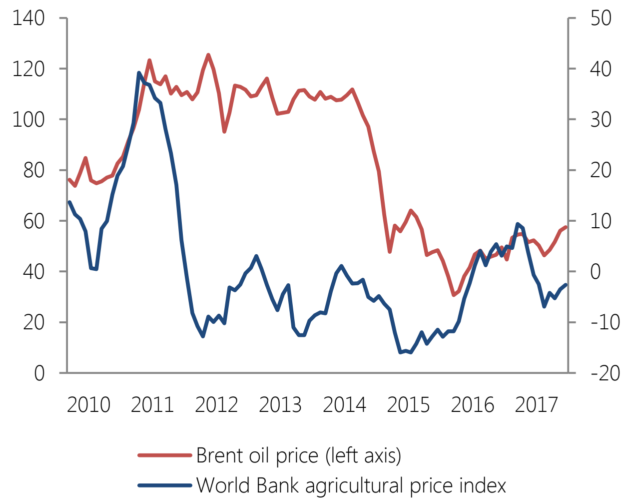
1. MACROECONOMIC DEVELOPMENT AND FORECAST

1.1 External Environment

Global economic growth gained momentum in the second half of last year and it carried on in the first three quarters of 2017. The favourable developments of this year were greatly influenced, in the first place, by the ten-year high GDP growth of the euro zone. The economic growth within the euro area was supported mainly by the internal demand, where not only the rising consumption, but also investments contributed remarkably to growth. In addition, due to rebounding external demand, net exports had a slight, but positive contribution to the growth of the EA member states.

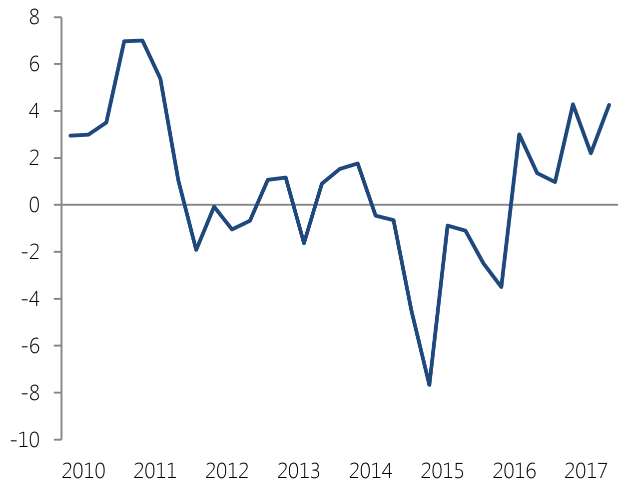
Secondly, the United States and Japan have also surpassed remarkably their performance in the previous year. Thirdly, thanks to the rising oil, raw material and agricultural product prices, in parallel with improving financial conditions, many emerging market economies have stabilised (*Chart 1*). The favourable global economic developments gave new impetus to world trade which is reflected in the import growth of G20 countries that hit a six-year high this year (*Chart 2*).

Chart 1.: Oil price and agricultural price index
(USD, yoy %)



Source: Thomson Reuters, World Bank

Chart 2.: Imports of G20 countries
(qoq, %)

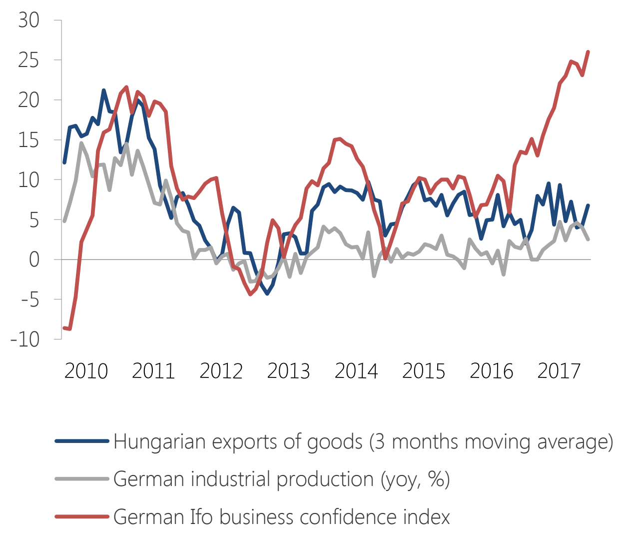


Source: OECD

Looking forward the favourable external environment is expected to persist. Business confidence indices have been at their highest levels during the last months (*Chart 3*). Besides the solid macroeconomic fundaments signalling an upswing in real terms, financial conditions are also in favour of global economic growth. In the coming period monetary policies worldwide are anticipated to remain supportive or they are going to ease at a slowing pace. The performance of raw material exporter countries will be boosted thanks to the agreement between the OPEC and Russia on reducing their oil production in order to stabilise oil prices. Taking all these factors into account the Hungarian external trade is projected to remain buoyant while export performance is expected to improve further in the upcoming period.

Overall the global economic growth is surrounded by risks. On the upside, the US tax reform passed in December can be the first essential element of the expansionary fiscal policy announced after the US elections last year. Furthermore, with respect to Europe it is also favourable that the free trade agreement with Canada has taken into effect since September and it can be followed by additional treaties with other countries which could potentially open up new export markets for Hungarian commodities. Downside risks are, on the one hand, coming from the uncertainties evolved around the United Kingdom leaving the European Union. On the other hand, risks to the Chinese economy are still apparent due to the challenges related to the rebalancing of activity towards services and consumption and the high loan-to-GDP ratio. If these negative risks were to realize they could harm the external trade of Hungary.

Chart 3.: Ifo index and Hungarian exports of goods



Source: HCSO, CESifo, Eurostat

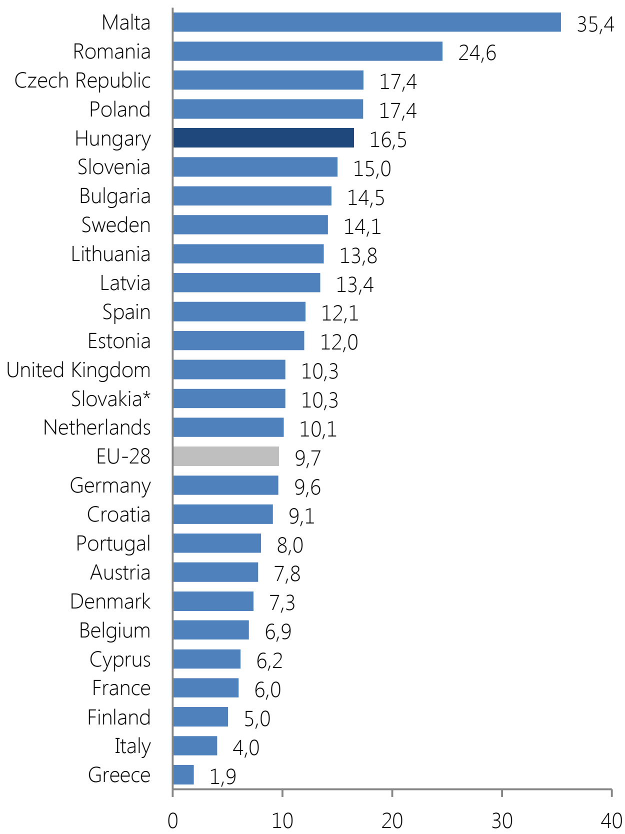
1.2 Recent Macroeconomic Developments

GDP and growth components

In 2013 Hungarian GDP growth became balanced, hence, the economy expanded by 4.2% in 2014, which was followed by a rate of 3.4% in 2015 and – due to the cyclical nature of EU fund absorption – by 2.2% in 2016. This year, the Hungarian economy again showed accelerating growth pattern: GDP grew by 3.8% and by adjusting data with calendar effect by 4.0% in the first three quarters of 2017.

In international comparison, Hungary's growth – also in 2017 – was above the EU average, so the convergence of the Hungarian economy to the EU average continued. Based on the current Q3 2017 data, the Hungarian economy showed the eighth and compared to the first quarter of 2013 the fifth fastest growth in the EU (*Chart 4*). The growth path remains stable and sustainable. This is confirmed by the dynamic growth in several sectors, on the one hand, and on the other hand, by favourable financing positions, which has led to a persistent decline in previously accumulated debt.

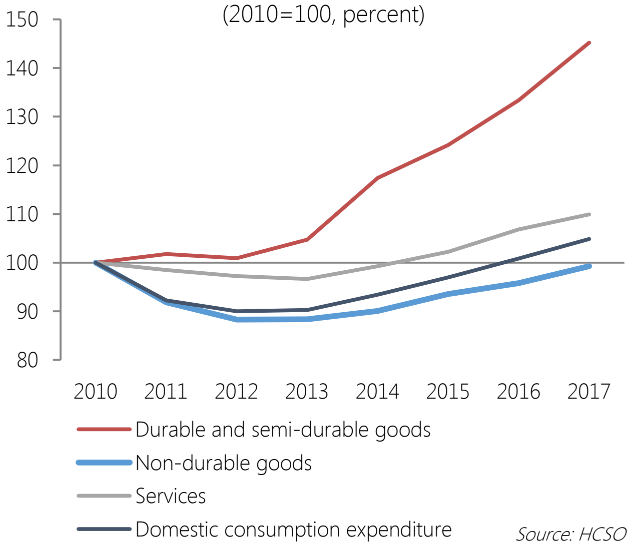
Chart 4.: GDP growth between 2013 and Q3 2017
(percent, adjusted by seasonality and working days)



Source: Eurostat, MfNE calculation

Considering the expenditure components of GDP, consumption growth has been primarily driven by the dynamic rise in households' disposable income. This is partly attributable to last year's six-year wage and tax agreement – which resulted in a continuous employment and an outstanding wage growth – and partly to moderate inflation. Strong consumer confidence is underpinned by the considerable rise in expenditures spent on durable and semi-durable goods *(Chart 5)*. Nevertheless, households are still characterized by their high propensity to save, although household debt – especially consumer loans – have been accumulating in recent months, which implies a steady easing of the sector's precautionary motives.

Chart 5.: Disaggregation of domestic consumption expenditure by durability
(2010=100, percent)

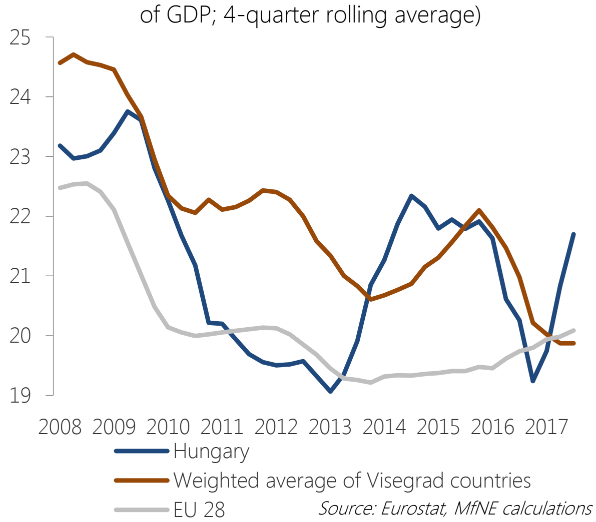


Source: HCSO

Looking forward, households' disposable income is expected to rise further thanks to favourable labour market developments and the repeated, significant increase in minimal wages. The sector's purchasing power is further enhanced by the gradual increase of tax allowance for families with two children and by the VAT rate cuts on basic food, internet and certain restaurant services. As a result, consumption growth is projected to continue, while precautionary motives are expected to ease further, which is corroborated by the recent rise in household debt.

In the first three quarters of 2017 overall investment of nearly HUF 6,000 billion has been realized in Hungary, thus investment activity increased by 23% year-on-year. This sharp pick-up is attributable to all the three sectors resulting in a 21.7% investment rate outperforming significantly both the average rate of Visegrad countries of 19.9% and the EU average (*Chart 6*).

Chart 6.: Investment rate in international comparison (gross fixed investments in percentage of GDP; 4-quarter rolling average)

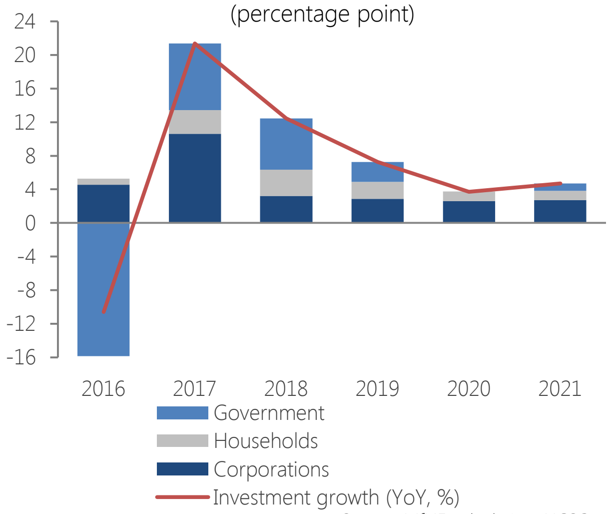


Source: Eurostat, MfNE calculations

In the dynamic upswing, corporate developments with two-thirds share in total investments played a key role. These capacity expansions are fundamentally supported by the corporate tax rate reduction to 9% from 2017 in the framework of the six-year wage and tax agreement concluded in November 2016. This agreement supports the investment activity of companies and strengthens Hungary's ability to attract capital. It contributed to the expansion of manufacturing investments that have increased by 16% in Q1-Q3 2017. Also, investment activity of households has gained momentum thanks to the Family Housing Subsidy Programme. Consequently, dwelling construction increased by 52% in the first three quarters of 2017. Moreover, the acceleration of investment projects co-financed by EU transfers under the 2014-2020 budgetary period or financed by domestic budget sources played also an important role in the investment boom. By the end of November 2017, more than HUF 3,200 billion was paid from the funds available in the new EU budget cycle contributing to a nominal increase of nearly 80% in government gross fixed investments.

The significant investment increase of 23% in Q1-Q3 2017 is favourable in terms of this year and in mid-term as well, since the developments will support the economic growth also after the capacities have been built and the production has started. Strong growth is expected to remain for the rest of 2017 supported by the developments of both private and government sector (*Chart 7*).

Chart 7.: Contribution of sectors to the development of gross fixed investments (percentage point)

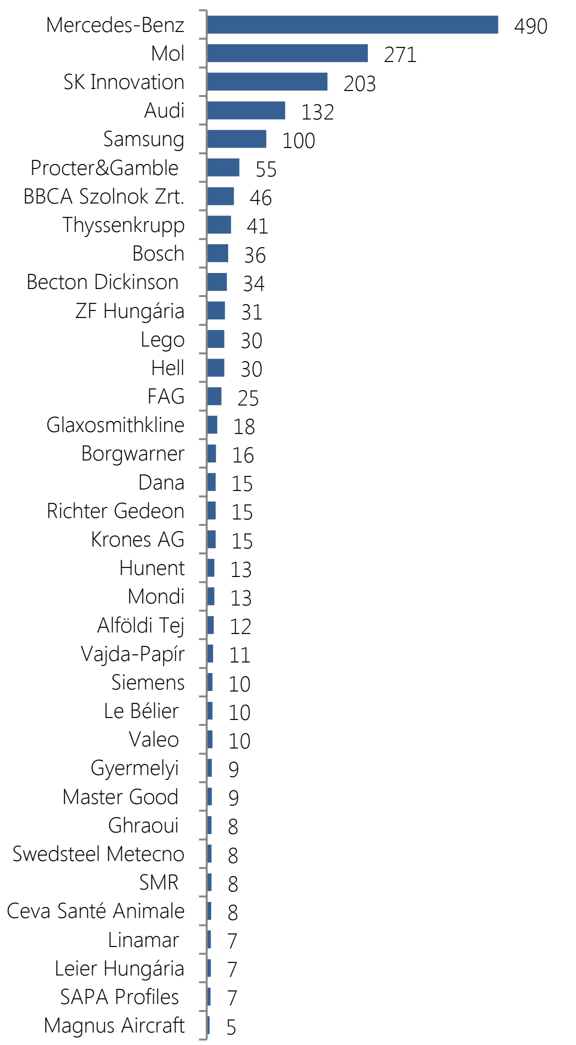


Source: MfNE calculation, HCSO

Numerous large investment projects announced recently primarily in the automotive industry and its supply chain are projected to boost the activity of large companies. In case of small and medium-sized enterprises, investment activity will be supported not only by the low yields and favourable business climate but also the accelerated allocation of EU funds dedicated to economic development. Furthermore, Hungary's investment attracting capability will become stronger, as the corporate income tax rate was reduced to 9% as from 2017, which is the lowest rate in EU comparison. It provides an incentive for both new companies to invest in Hungary and the incumbent companies to expand their already existing capacities (Chart 8).

In the coming quarters, the favourable tendencies in the housing market are expected to be further strengthened due to government measures, increasing real income and low interest rate environment. As a result, the number of newly built dwellings will continue to rise in 2018, in parallel with the continuous recovery of construction capacities. On the forecast horizon, the dynamics of government investments is also significantly determined by the allocation of funds under the EU budget cycle for 2014-2020. It is particularly favourable that every EU tender has been announced by the end of March 2017, and the full amount will be contracted until 31 March 2018. As the larger share of allocated amounts is still advance payments, the EU co-financed projects will strengthen gradually the investment performance in the next quarters.

Chart 8.: Main investment decisions of recent period (HUF billion)

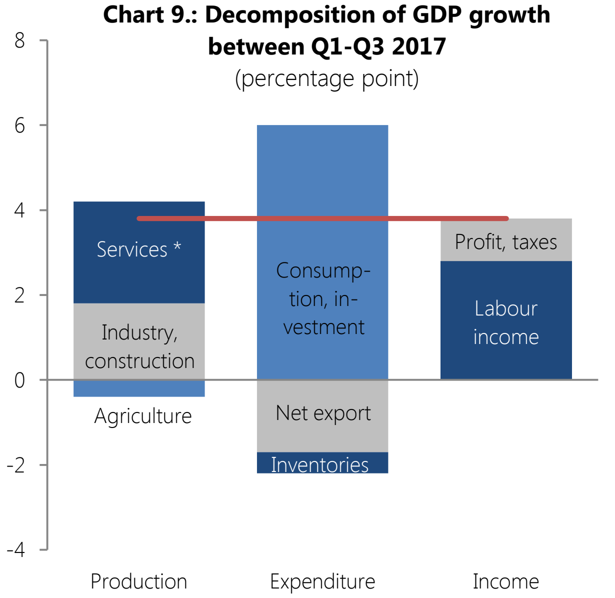


Source: HIPA, Press information

Regarding external trade of Hungary, in parallel with favourable industrial production, exports of goods and services rose by 6.5% in the first three quarters of this year. Looking forward, based on new export orders and double-digit growth of investments in manufacturing, steadily rising export is projected which also supports the trade balance to remain massively positive. In the long run, additional export capacity expansions are also encouraged by the corporate tax rate reduction to 9% from 2017 in the framework of six-year wage and tax agreement. In case of import, due to strong domestic demand and its import content, imports of goods and services increased outstandingly, by 9.5% in the first three quarter of 2017, surpassing the growth rate of exports. The increase of imports was mainly driven by the accelerating absorption of EU transfers, strengthening import demand of the supplier networks and buoyantly expanding consumption of households. As a result of these, the contribution of external trade to the GDP growth temporarily shifted to the negative range. Therefore the trade balance, after hitting record surplus last year, moderated, however it is still high in international comparison.

As for the production side, it can be concluded that in parallel with the exceptionally high growth of domestic demand, the branches of market services continued to grow: in 2017 approximately half of the growth was generated by these activities (*Chart 9*). On the one hand, the six-year wage and tax agreement boosts demand, resulting in additional income not only for households but also for the private sector; the private sector's profit (gross operating surplus) grew by 6.6% in the third quarter. On the other hand, in parallel with the Family Housing Subsidy Scheme, the upswing of real estate market should be highlighted, which contributed significantly to the expansion of construction of ca. 30%. Furthermore, the new production capacities and the recovery of external demand supported the acceleration of industrial production. At the same time, mainly due to the droughts in summer, average output was produced in agriculture, i.e. the sector did not contribute positively to growth.

Chart 9.: Decomposition of GDP growth between Q1-Q3 2017
(percentage point)

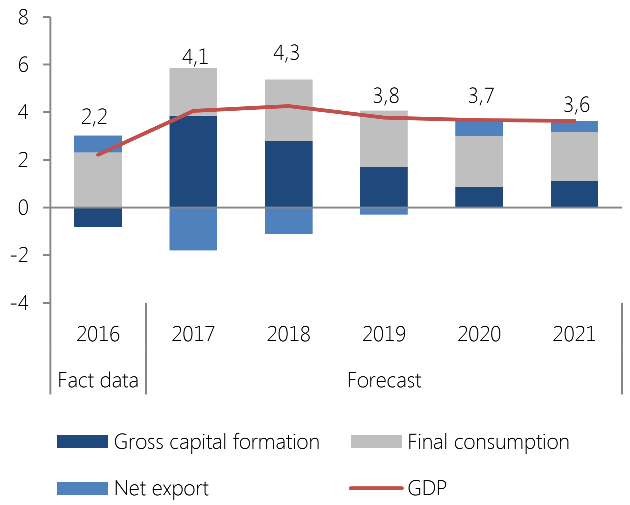


** Net taxes on products*

Source: HCSO, MfNE calculation

Growth is expected to accelerate in the fourth quarter of 2017, which is confirmed by the favourable statistical data of October. Hence, GDP is expected to increase by 4.1% in 2017 as a whole. Next year, GDP is assumed to rise by 4.3%, which will be supported by the strong domestic demand, in parallel with the increasing absorption of EU funds, the persistent growth stimulating effect of the six-year wage and tax agreement. Capacity expansions including the large, already announced projects (*Chart 10*) will also boost the export performance. In the forecast horizon, in parallel with rising consumption, market services and also the active capacity expansions of companies are expected to support GDP growth on the production side.

Chart 10.: GDP growth: demand side
(percentage point)

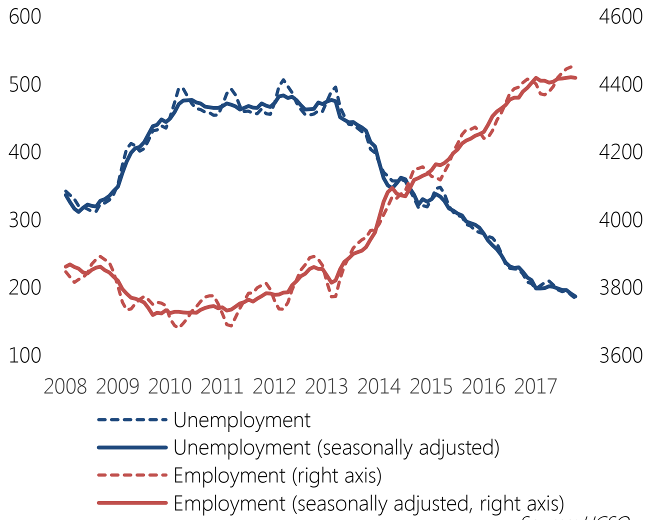


Source: Eurostat, MfNE calculation

Labour Market

The favourable labour market trends continued this year. The number of employees exceeded 4 451 thousand after a 1.9% increase in the first three quarters (*Chart 11*), which was primarily due to a 2.7% (+108,000) employment growth on the domestic primary labour market.

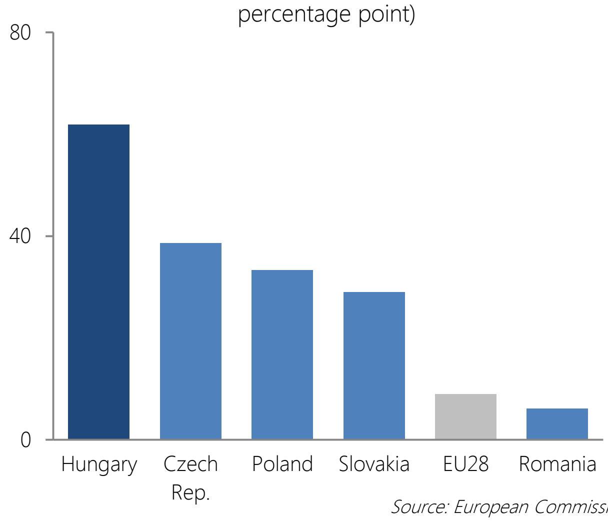
Chart 11: Unemployment and employment
(seasonally adjusted, thousands of pepole)



Source: HCSO

As a result of strong labour demand from the private sector, more and more public workers could find jobs on the primary labour market, so their number decreased by 47,000 in September, compared to a year earlier, based on the institutional statistics of Hungarian Central Statistical Office. The number of active persons on the labour market increased by 0.7% (34 thousand) in the first nine months. The shrinking of labour market reserves is indicated by the increase in the number of enterprises that mention labour shortages as a constraint on production (*Chart 12*) and the increase in vacancy rates. The latter is most typical in manufacturing, construction, healthcare and some market services sectors. At the same time the increase of the proportion of overtime hours showed the intensive labour market adaption of the private sector. In parallel with the growing employment of the private sector, the unemployment rate fell to 4.0% by the end of October. The minimum wage and the guaranteed wage minimum were raised under the six-year wage and tax agreement concluded at the initiative of the Government and, in parallel, the positive effect of the substantial reduction in the employer's tax burden is reflected in a rising wages. In the first nine months of 2017 average gross monthly earnings per employee in the private sector increased by 11.3%, net real monthly earnings increased by 8.7% accompanied by a moderate inflation.

Chart 12.: Labour as a limiting factor for production in the industry
(Change in the ratio of positive answers since Q1 2013, percentage point)



Source: European Commission

The labour market reforms implemented since 2010 have successfully stimulated the expansion of employment and labour market participation. Further strengthening the growth potential of the Hungarian economy after the increase of employment to an adequate level can be primarily achieved through the increase of labour productivity for which not only technology improvements and better work organization but also a high quality and well-motivated labour force is needed. To reach the above goals, based on the proposals by the Ministry for National Economy, participants in the Permanent Consultation Forum of the Private Sector and the Government agreed in November 2016 on a six-year wage and tax agreement (*Table 1*). This includes raising the minimum wage, the guaranteed wage minimum and real wages, and simultaneously the substantial reduction of corporate tax rates and employer tax burdens, partly depending on the rate of wage increases. The aim of the agreement is to boost employment in high value-added jobs by stimulating companies' efficiency-enhancing aspirations and strengthening the competitiveness of the Hungarian economy. Nearly one year after the agreement has come into effect its positive impact can be observed. Thanks to wage increases in the lower wage categories, regional and sectoral wage differences have also decreased.

Table 1: Elements of the six-year wage and tax agreement

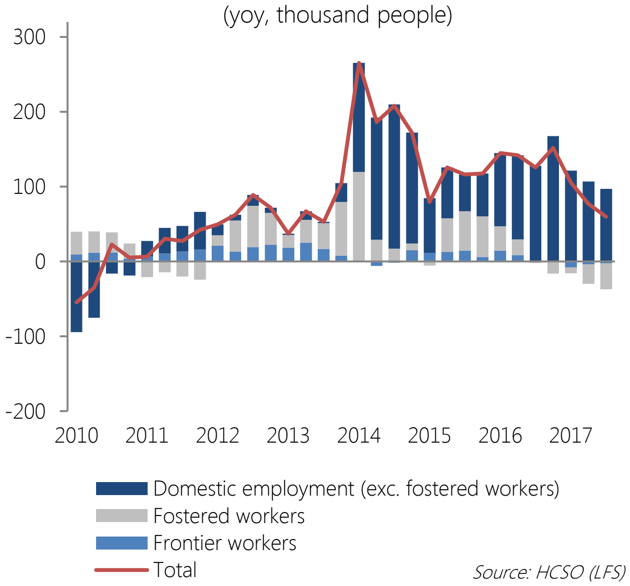
	2016	2017	2018
Minimum wage	111 000 Ft	+15%	+8%
Minimum wage for skilled persons	129 000 Ft	+25%	+12%
Social contribution tax	27%	22%	19.5%
Corporate income tax	10%	9%	
	19%	9%	
Social contribution tax after 2019	Further 4x2 percentage point reduction depending on the evolution of real wages		

The rising income also had a positive impact on consumption and thus on GDP growth. Favourable economic impacts have also been reflected by the increasing willingness of the private sector to invest in the growing number of operating companies. The reduction of the corporation tax and social contributions rate has largely offset the extra burden of companies resulting from wage increases, which is also proved by the growth in gross operating income of the private sector. Overall, the minimum wage hike offset by corporate tax and social contribution tax reductions did not lead to the deterioration of profitability and competitiveness.

Thanks to the favourable economic situation, the labour demand of the private sector remained strong, so the number of people on the primary labour market continued to increase (*Chart 13*). In line with the wage agreement, due to the sharp wage convergence experienced during the first nine months of this year, the social contribution tax will be reduced by 2.5% from 1 January 2018.

Chart 13.: Employment growth by main sectors

(yoy, thousand people)

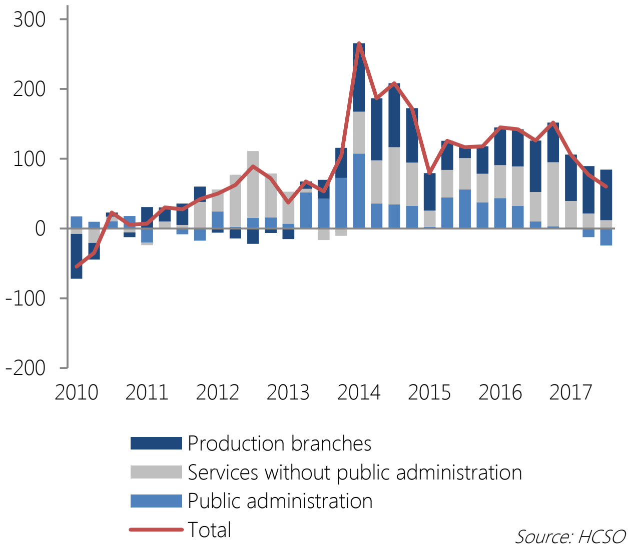


Source: HCSO (LFS)

Due to the upward trend and the six-year wage and tax agreement, the labour demand of the private sector should remain strong. The slowing increase of labour market participation on the forecast horizon reduces employment growth and at the same time leads to increasing wages (*Chart 14*). Higher wages also have a positive impact on labour market participation, and a decline in the number of fostered and frontier workers also contribute to domestic labour supply. Thus employment on the primary labour market may increase further. In addition, the decline in the unemployment rate, which is already historically low, may continue.

Chart 14.: Employment growth by main branches

(yoy, thousand people)



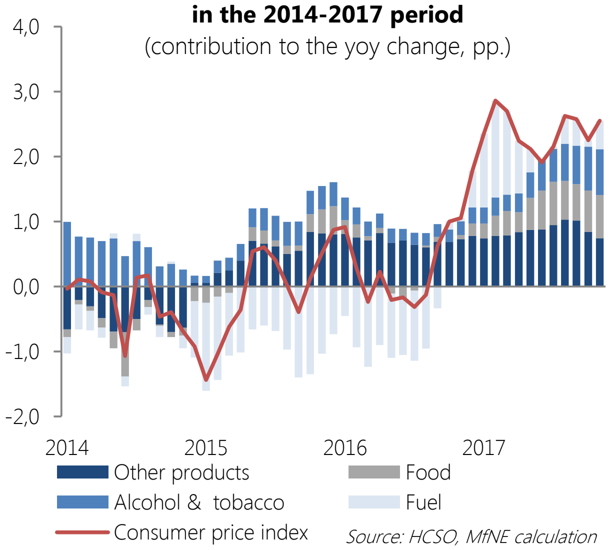
Source: HCSO

Inflation

Following the near zero inflation experienced in recent years prices increased moderately this year. At the beginning of 2017 the price index was pushed upward due to the low base of fuel prices, although this effect faded by summer. Nevertheless, after the VAT cut had fed into the price of food, it crept higher in the second half of the year mostly in connection with global meat and dairy product market developments, while the price elevation of pastries is related to increasing labour costs. Furthermore, the excise duty increase on tobacco products effective from summer also supported the surge in inflation. However, the extension of the free textbook scheme and the VAT cut of catering and internet services on inflation decreased prices considerably. Overall the data show no sign of underlying price pressures in 2017. So far, domestic demand has not appeared as a significant inflationary factor, which might be related to the historically low level of inflation expectations.

Looking ahead the one-off inflationary factors (food and energy prices, excise duty increase) of 2017 might carry over to 2018 as well. Furthermore, price pressure stemming from the ongoing economic pick up across Europe might become a more relevant factor too. Lastly, the boost in domestic demand supported by the six year wage agreement will definitely become a key inflationary factor. In the beginning of the year certain services might be exposed to significant price adjustment mirroring massive wage dynamics, however it might be partially mitigated by the further VAT cut of catering and internet services. In parallel with the closure of the output gap inflation is expected to be 3% from 2019 onwards which is in line with the medium term target of the MNB.

Chart 15.: Main factors affecting inflation in the 2014-2017 period
(contribution to the yoy change, pp.)

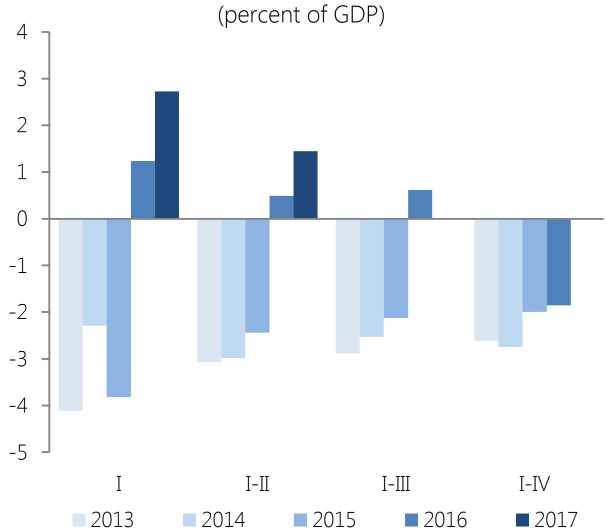


Source: HCSO, MfNE calculation

General government balance

In the first half of 2017 – based on accrual data – surplus was recorded in the balance of the general government sector (*Chart 16*). On the revenue side, in parallel with the persistently favourable labour market trends, income taxes, and – despite the tax cuts of the wage agreement – social contributions increased substantially, similarly to the rise of value added taxes in connection with increase in consumption. On the expenditure side, government investments grew dynamically and wages also increased substantially due to the career schemes introduced in the public sector.

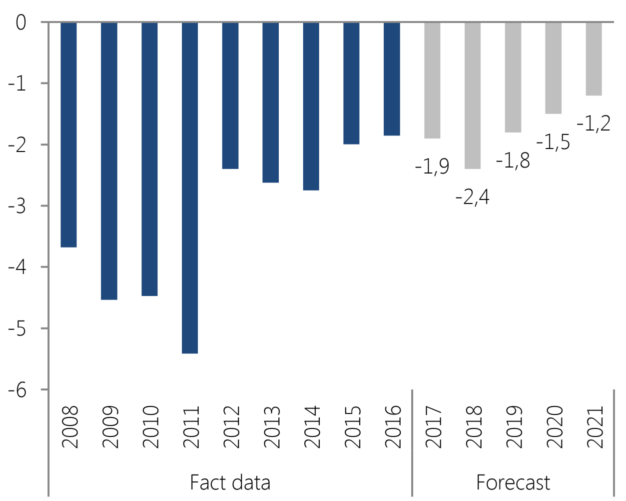
Chart 16.: General Government balance
(percent of GDP)



Source: HCSO, Eurostat, MfNE calculation

In the forecast horizon, the budget deficit remains persistently and substantially below 3% of GDP (*Chart 17*). At the same time, fiscal policy substantially supports aggregate demand. On the one hand, measures affecting the revenue side, e.g. the corporate income tax rate of 9% (decreased from January 2017), and also the social contribution tax cut (depending on the average gross real wage dynamics based on the six year wage agreement of 2016) in several steps from 27% to 11.5% improve profitability, stimulate companies' investments and households' employment, and also boosts labour income, which supports consumption. On the other hand, a number of measures, such as the Modern Cities Program, road construction, Housing Subsidy Scheme and career schemes introduced in the public sector supports economic outlook.

Chart 17.: General Government balance
(percent of GDP)

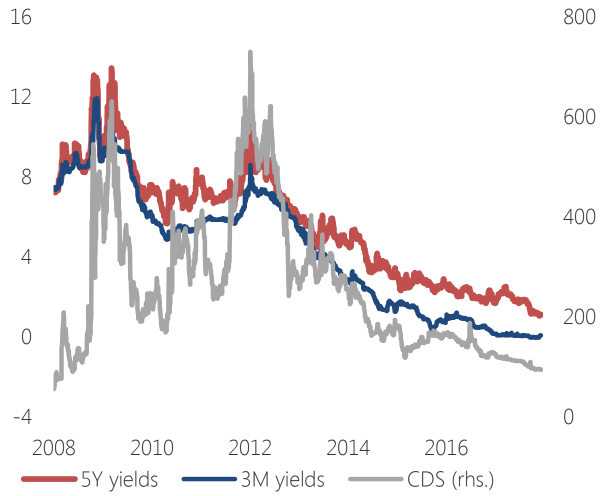


Source: HCSO, MfNE calculation

Financial markets

Due to the persistently disciplined fiscal policy and the further improving economic performance, Hungary's market perception has continued to improve. Two out of the three leading credit rating agencies have revised the outlook on Hungary's sovereign rating from stable to positive, which had a positive impact on debt financing costs through the further decreasing country risk premium.

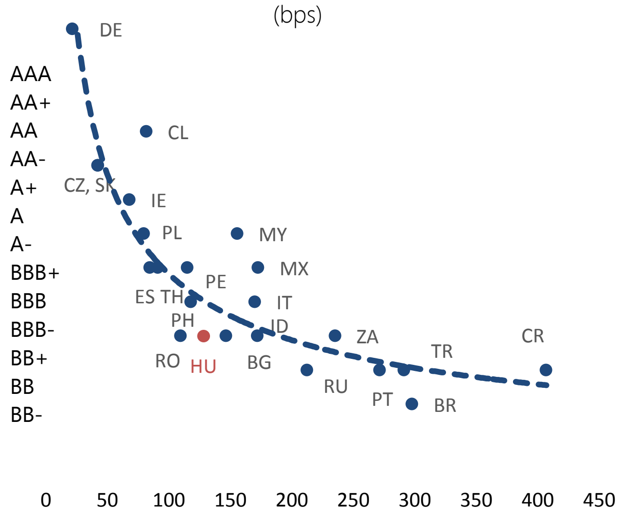
Chart 18.: Yields and 5-year CDS premium
(%, bps)



Source: Reuters, ÁKK

First S&P in August and then Fitch in November decided to revise the outlook of Hungary's sovereign credit rating. In this regard and based on the favourable market perception, further upgrade in credit rating is expected.

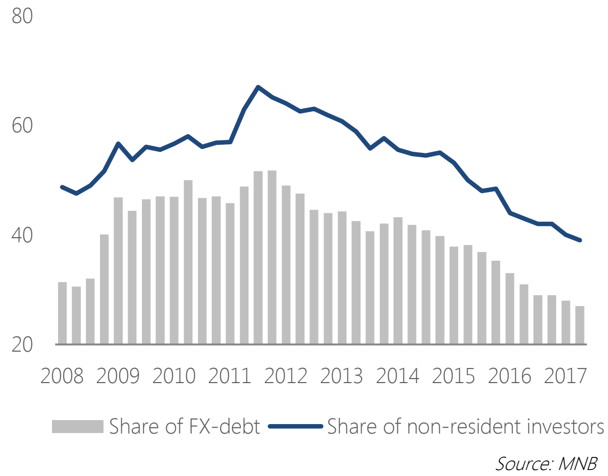
Chart 19.: Relationship between average credit rating and 5 year CDS spread
(bps)



Source: Reuters, Trading Economics

Public debt structure continued to improve further in 2017, contributing to the mitigation of foreign currency exposure and to the decrease of external vulnerability. The share of foreign currency debt dropped by 3 pps to 39% in 2017. Meanwhile, the share of non-resident investors decreased by 2 pps to 27%. *(Chart 20).* Due to the further improved situation in external exposure and credit ratings, yields have lowered significantly through decreasing country risk premium. Short-term yields decreased by 6-12 bps, while long-term ones by 25-80 bps.

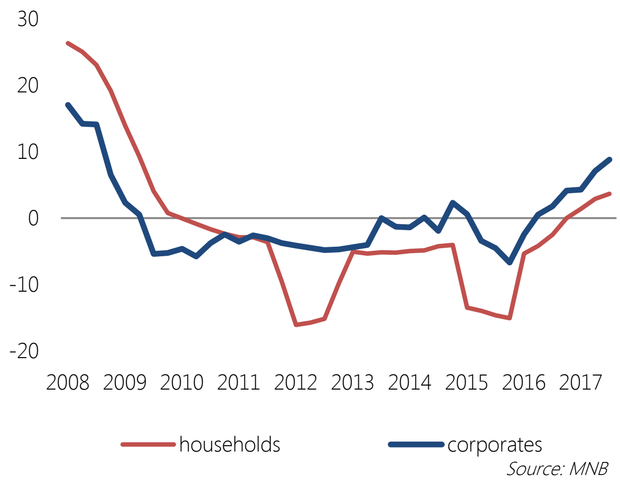
Chart 20.: Public debt held by non-residents and the FX ratio of public debt
(%)



Due to the favourable business and financing environment as well as to the intensifying banking competition, trends in lending took a positive turn in 2017.

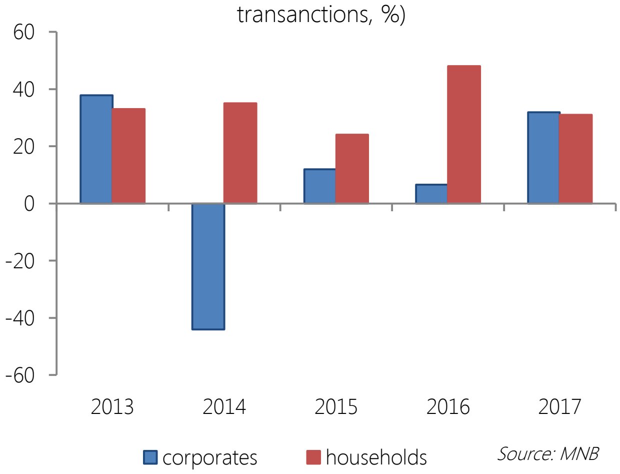
Household lending showed positive developments. In the first three quarters of 2017, new loans grew by 31% compared to the same period last year. By the end of the third quarter, household loans increased by 3.0% compared to the end of 2016. The non-performing loan ratio decreased by 4.3 pps to 12.4% in 2017. Household lending is expected to be further boosted by consumption, a buoyant real estate market, rising real estate prices and the Family Housing Subsidy Programme. However, a cca. 60% share of floating rate mortgages might pose a risk in the future.

Chart 21.: The yearly credit growth rate of the household and the corporate sector
(%)



The volume of new loans provided by credit institutions has increased by 32% on a year on year basis. Based on the balanced increase observed in corporate lending, lasting for more than a year, 2017 can be regarded as a turnaround year. The growth rate of corporate lending was in the 5-10% range considered as sustainable by the MNB. Thanks to the SMEs' increasingly active role in borrowing, SME loans outstanding have increased by 6.2% on year-on-year basis. The credit institutions' portfolio of non-performing corporate loans has decreased by 5 percentage points to 7.9% due to active portfolio cleanings. As a result of the Market-based Lending Scheme of MNB and the increasing demand in the real estate market, corporate lending is expected to further expand and experience a stable growth. However, in favour of sustainability, further expansion of long-term loans will be necessary.

Chart 22.: New corporate and household loans
(yoy growth of 3-quarterly cumulated transanctions, %)



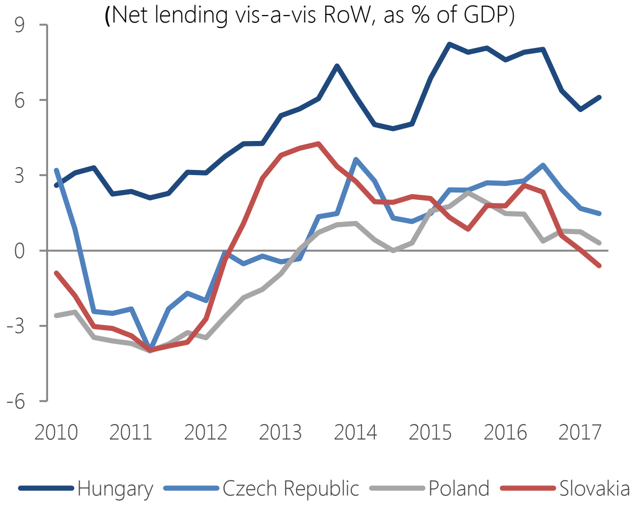
External balance

Following the record surplus of 2016 the trade balance decreased in 2017 partly due to less favourable terms of trade developments and partly as a result of increasing domestic demand especially the pick-up in investments. Nevertheless, trade balance is expected to remain high in international comparison mostly thanks to the outstanding performance of services. The income balance might show larger outflow compared to 2016 as a result of more effective activity of foreign owned firms. Thus the surplus of the current account might be lower compared to the record high figures of last year. Nevertheless, thanks to significantly higher transfer flows from the EU net lending might exceed that of last year, which is still outstanding in regional comparison.

In the forthcoming period, in parallel with increasing domestic demand the surplus of external trade is expected to shrink, however the capacity expansion of export oriented firms might mitigate this effect. Decreasing debt level on the one hand and increasing profit of foreign owned firms on the other hand leads to stable income balance, while transfer flows from the EU remain high throughout the whole forecast horizon. In conclusion thanks to the vast surplus of the trade balance and significant transfer inflow net financing capacity vis-à-vis the rest of the world is expected to show massive surplus resulting in a further decrease of external vulnerability. As a result and following fifty years of debtor’s position, Hungary may become a net lender by the end of the forecast horizon.

Chart 23.: External developments in regional comparison

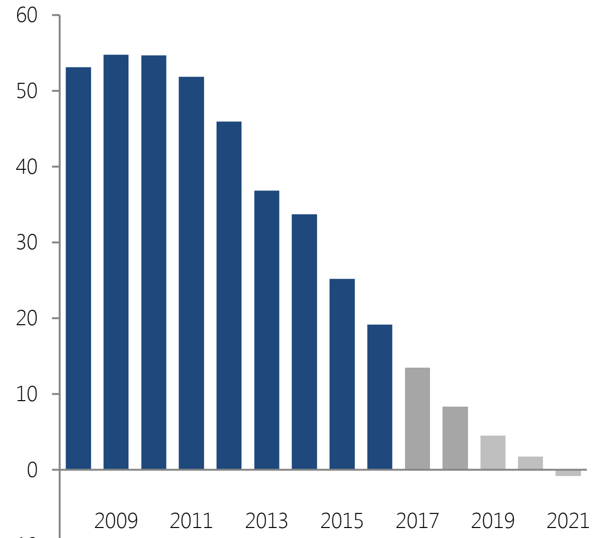
(Net lending vis-a-vis RoW, as % of GDP)



Source: Eurostat, MfNE calculation

Chart 24.: Net external debt

(as % of GDP)



Source: MNB, MfNE calculation

2. BUDGET OUTLOOK

2.1 Deficit Path

The budget for 2017 was approved by the Parliament with 3.1% economic growth and 0.9% inflation, and the deficit target was 2.4% of GDP. The budget was prepared by the Government in order to support economic growth, economic and social policy priorities, while the deficit remains well below 3% of GDP and public debt continues to decline.

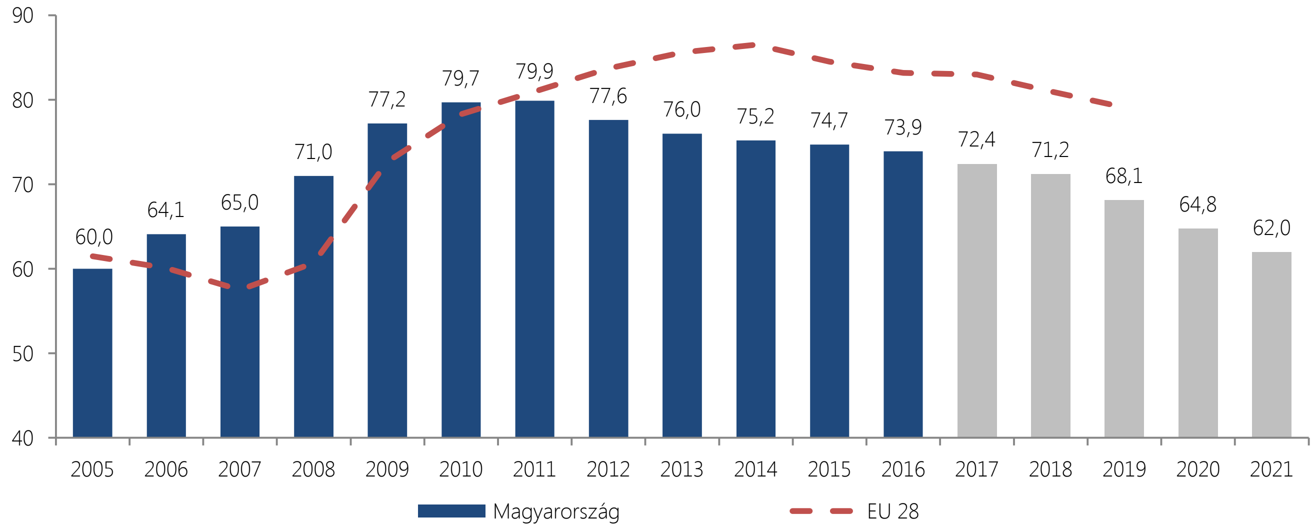
Since 2011 only Hungary has been able to reduce the public debt ratio each year among the EU Member States which highlights the success of disciplined fiscal policy.

The Government proposed an amendment of the 2017 budget, in order to follow the economic effects of the six-year wage and taxation agreement of November 2016, partly to speed up the economy, whilst keeping the deficit target.

- As a result of favourable budgetary developments (revenue surpluses, expenditure savings), in May, the Parliament provided a total of HUF 176 billion additional expenditures in the following areas:
- renewal and modernization of the national road network,
- economic development programs (supplier action plan, railway development),
- social goals (Hungarian Interchurch Aid, development of day-nurseries),
- health care (hospital development projects and infrastructure development),
- strengthen the country's defense capability (helicopter renewal),
- some local government development projects,
- church, cultural and educational programs,
- Investment Preparation Fund was set up in order to finance preparation costs of government investments.

The budgetary effects of the six-year wage agreement (reduction of the social contribution tax, raising minimum wage, guaranteed wage minimum), related to effects of the agreement on labour market had been projected to be budget-neutral at the time of the agreement in November 2016. All the effects were passed in the amendment of the Budget Act in Spring 2017. According to our current forecast, the budgetary impact in general is slightly positive in 2017, with a surplus of about HUF 20 billion more than originally expected. This effect does not include the negative budgetary impact of corporate tax cuts.

Chart 25.: The evolution of the debt ratio in Hungary and in the European Union
(% of GDP)



Source: Hungarian Central Statistical Office, Eurostat, European Commission, Autumn Forecast 2017

Table 2.: The budgetary impact of six-year wage agreement
(HUF billion)

The budgetary impact of the six-year wage agreement* (billion forints)	2017	2018
Reduction of social contributions tax by 5 and 2.5 percentage points	-414	-584
Increase of minimum wage 15%/8% and guaranteed wage minimum 25%/12% (private sector)	243	333
Public sector wage measures due to increased minimum wage and guaranteed wage minimum	-56	-66
Spillover effect of minimum wage increase on average wage level	217	313
Increase in minimum wage-related benefits (sick pay, child benefit)	-27	-32
Increased consumer tax revenues (VAT, excise duty, etc.)	8	32
Amount saved from public employment expenditure	49	64
Overall budgetary impact	**20**	**60**

** Budgetary impact compared to the state without measures*
Source: Ministry for National Economy calculation

According to preliminary data, the government sector had surplus in ESA terms in the first half of 2017. At the same time, however, there was a significant cash deficit in the central subsystem, which amounted to HUF 1,639 billion at the end of November.

The difference between the cash deficit and the favourable ESA balance is mainly due to the difference between the cash and the accrual accounting of EU transfers. The government advances grants to beneficiaries of EU programs, while related revenue comes from Brussels with a time lag (when the advance payment is effectively spent by the beneficiary), which temporarily worsens the cash flow balance. However, pre-payments do not affect the ESA balance, since - according to the EU methodology - the EU co-financing can be set as an expenditure offsetting revenue item regardless of the actual arrival of the cash transfer. (This difference in accounting will result in a reverse situation in those years when the domestic budget does no longer pay pre-payments to the beneficiaries, but EU money will arrive after the submitted invoices.)

As for EU programs, full scale use of resources is a priority given their favourable growth and employment effects. EU payments amounted to HUF 1,925 billion by the end of November 2017, while in the same period of 2016 this amount was about HUF 1,406 billion. Expenditures for EU-funded projects can well exceed the amount projected in the spring forecast. The difference represents advance payments in a significant proportion, however, these advances ensure the liquidity of the projects, which will help the scheduled progress.

Normative grants and migration related spending may be higher than the figures of the amended appropriations. Some development projects (e.g. road and railway developments) are progressing slower than expected, which brings savings in the budget. Nonetheless, public investments overall contributes significantly to GDP growth this year.

In 2017, the renewal of the national road network continued. Compared to the period up to 2014, the structure of funding has changed: the majority of large-scale asphalting and coating reinforcement works is paid no longer from EU sources but from domestic sources. 2017 year's budget included HUF 60 billion for this purpose.

The career models introduced in the public sector continue, as well as other wage increases for target groups. In addition, during the year, there were additional favourable decisions on the wages of the public sector which resulted in positive effect on economic growth and consumption. The average wage of those without qualification or degree, who directly help the educational work has risen due to the increase of the minimum wage/guaranteed wage minimum, and as a result of the wage increase of 10% from 1 January 2017 according to the decision of the

Government. From 1 November 2017, nurses employed in basic health service receive HUF 33,000 monthly wage surcharges. In connection with raising the minimum wage and the guaranteed wage minimum in the public sector, wage increases in state-owned companies and some sectoral wage measures (e.g. wage increase for judicial staff), the budget outlook projects higher realisation by HUF 114 billion compared to the original plan.

The use of new housing subsidies is growing dynamically (compared to the previous year, it is expected to increase by 25%).

Due to favourable labour market trends, expenditures on public work programs may be smaller by HUF 88 billion than the original appropriation, however, expenditure on active labour market measures increases compared to plans.

In parallel with its inflation forecast, the government decided to increase pension entitlements by 1.6% instead of the originally planned 0.9%. Until the end of 2017 every person entitled to pension and pension-like benefits received an additional 0.8% supplementary pension retroactively from January. The related budget expenditure exceeds HUF 27 billion. The supplement will be built into the level of pensions and pension-like benefits from January 2018.

Thanks to the Government's successful economic policy, the real value of pension benefits increased by 10.1% between 2011 and 2017. In addition to pension increases, due to the GDP growth rate of over 3.5% in 2017 elderly people will also receive pension premium. Based on the decision of the Government, at the same time as the pension premium was paid, the beneficiaries of the old-age pension under the age limit and those receiving pension-like benefits received a one-off benefit equal to the amount of the pension premium. Nearly 30 billion forints were allocated in the budget for the pension premium for the beneficiaries of old-age retirement and pension-like benefits.

Also according to the decision of the Government, similarly to the previous year, at the end of 2017 a voucher of HUF 10,000 was given to all recipients of pension and pension-like benefits.

According to the EU methodology, net interest expenditures can be estimated at around 70 billion forints lower compared to the initial appropriation despite the much higher cash deficit as planned. All this is due to Hungary's credit rating changed from speculative to investment grade, and partly in connection with, decreasing government securities yields.

Budget outlook for 2018 - 2021

Still low budget deficit, continuing debt reduction

In the coming years, the Government's budgetary priority will be to reduce the deficit ratio further and keep it permanently below 3% of GDP, to gradually decrease public debt in line with domestic and EU fiscal rules, and to ensure a balanced economic growth, boost employment and improve competitiveness. Keeping these goals in mind, the outlook forecasts the same deficit path that was set out in the Convergence Programme Spring 2017: 1.8% of GDP for 2019, 1.5% for 2020 and 1.2% for 2021, using EU methodology. The budget balance will probably not be affected by one-off items since 2018, temporary revenues such as revenues from land sale programme ("Land for Farmers") in 2016 and 2017 are not expected.

In addition to the low budget deficit of the central government, the balance of the local governments also shows a favourable picture due to rising tax revenues and the prudent fiscal rules that allow debt issuing only for investment purposes. In 2016 and 2017 the municipalities had a significant positive cash balance due to EU-related prepayments from the central budget. This surplus is expected to turn into deficit after 2018 by using up these resources. The high local government deficits in cash terms in years after 2019 correspond to only 0.1-0.2% of GDP according to EU methodology which reflects real economic developments better.

The sustainability of the medium-term budgetary path is ensured after 2018, similarly to the present situation, by the availability of central reserves, the Country Protection Fund, and the general reserve for extraordinary governmental measures. The system of reserves is supported by the stability reserve created for each budgetary chapter. From 2020, the calculations will include the Tax Reduction and Development Fund, which primarily serves as a source for governmental. If the Government uses the fund partly or fully for tax deduction, the redistribution rate and tax centralization may shrink more dynamically than it is shown in the balance sheet.

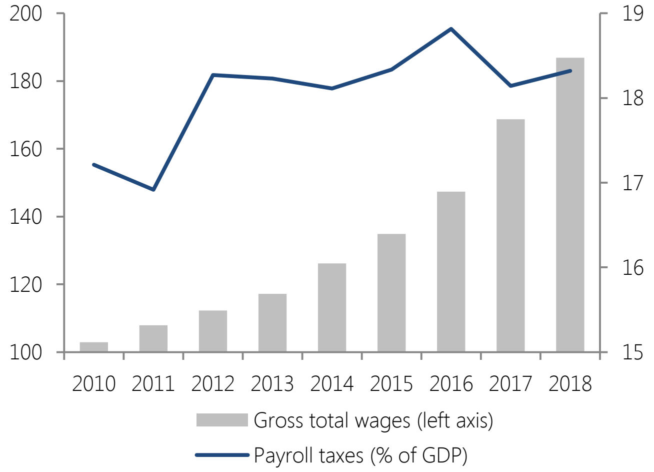
The net interest expense decreases also in nominal terms by 2021 compared to 2017 level, thanks to the successful, deficit reducing fiscal policy of recent years and to the falling deficits and debt in the years ahead. Although the deficit for 2017 in cash term is expected to be higher than planned in the budget, the debt renewal and the financing of the deficit can take place at record-low interest rate due to decreasing yields, and it affects the interest expense of the coming years favourably. The effect of declining yields will materialise over several years as financial instruments with higher interest rates will be replaced gradually. Net GDP-proportionate cash-based interest expenses will gradually decrease to 1.8% by 2021 from 2.6% in 2017.

The budget projection takes into consideration the government measures taken so far. In cases where there is no parliamentary or governmental decision, the calculation takes into account the rules in force, the relevant public policy, assuming the so-called "unchanged fiscal policy" scenario.

Budget and employment

In recent years, one of the milestones of fiscal policy has been to increase employment, which is based on the recognition that lasting budgetary balance can only be achieved through this, since nearly half of the tax revenues of the budget are directly linked to revenues related to work.

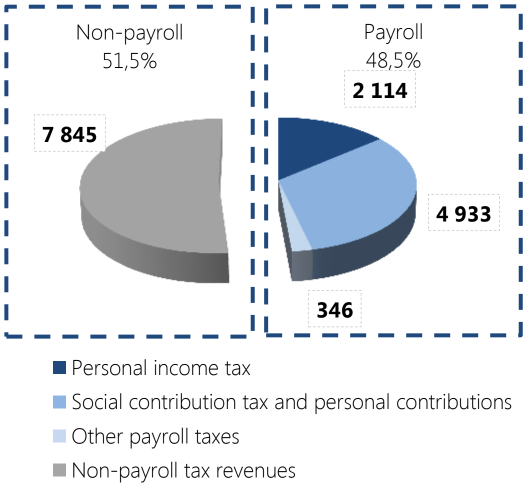
Chart 26.: The evolution of wages and salaries, payroll taxes
(2009 = 100)



Note: income in 2010 has been adjusted with private pension fund membership fees

Source: MfNE

Chart 27.: The proportion of payroll taxes in government tax revenues
(in 2018, HUF bn)



Source: MfNE

In this spirit, a number of important measures with significant budgetary implications have been taken earlier. The six-year wage and taxation agreement concluded by the Permanent Consultation Forum of the Private Sector and the Government in November 2016 fits in this line. According to the agreement, from 1 January 2018 the minimum wage increases by another 8% and the wage minimum by 12%. The cut in the social contribution tax is 2.5% instead of 2% in January 2018, as the gross wage increase in the private sector exceeded 11% in the first three quarters of 2017. Taking into account the favourable macroeconomic developments (especially the wage growth in the private sector, which is more dynamic than it was projected in November 2016), the total budgetary effects of the six-year wage agreement is even more favourable in 2018 than in this year.

Table 3.: Minimum wage and guaranteed minimum wage rise support in 2018

	Minimal wage increase
Budgetary bodies State-owned enterprises	87.8% from 2010
Total number of people affected (thousand)	**392.1**

Source: MfNE calculations

As a part of the wage agreement of November 2016, corporate income tax was uniformly reduced to 9% from the previous 19 and 10% from 2017. However, the loss of tax revenue is expected to be lower in the coming years, because the impact of the reduction in the tax rate can be partially offset by favourable economic developments and the responses of corporations.

By transforming the small business tax ('kiva'), after 2017 the tax system creates an even more favourable tax environment for small and medium-sized enterprises which play an important role in employment. Given that the 'kiva' replaces social contributions and corporation tax, the tax rate of kiva falls to 13% in 2018 in line with the measures affecting the social contributions and corporate income tax.

The Job Protection Action (JPA) continues. The increase in the number of recipients for JPA social contribution tax allowance is expected to be lower than the increase in the total number of employees.

Expenditure on public works scheme will fall steadily over the forecast horizon, by HUF 20 billion in 2019, and further by HUF 7 billion in 2020 compared to HUF 225 billion for 2018. This is partly due to improving labour market conditions, partly to making the system of public works more efficient and to widening other active labour market programs. In addition to the tight labour market and incentives introduced by the government, the active labour market subsidies can lead to a much larger number of public workers entering the primary labour market than earlier.

To increase the participation of women on the labour market, for the period 2018-2021 the budget provides increasing resources to fund a new, flexible and multi-level system of nurseries. In order to alleviate the lack of workforce in the growing number of professions, it has become possible to establish cooperatives of retired people from 1 July 1 2017, which is encouraged by the government with tax and contribution allowance.

Improving life standards

Significant minimum wage increases and guaranteed minimum wage increases started in 2017, as well as the wage increase programme announced by public companies, are resulting now in a substantial wage increase both in the public sector and public companies. All of these have a fiscal impact of HUF 166 billion for the gross wage bill in 2018 and 87 billion for net wages. The necessary resources for this will be provided by the budget in the years after 2018, as well.

Table 4.: The rates of increases in connection with career models and other wage measures between 2010 and 2018

Career models and wage measures	Rate between 2010 and 2018
Teachers' career model	38%
Health care wage settlement	90% - 110%
Social sector wage measure	62%
Law enforcement career model	45%
State officials' career model	42%
NAV employees' career model	50%
Cultural wage increase	15%
National defense career model	45%
Higher education teachers', reseachers' and teachers' wage settlement	25%
Total number of people affected (thousand)	**603.1**

Source: MfNE calculations

In addition to the continuation of the teacher, armed-forces and other career models, as well as the significant increases of salaries in health sector, the budget path also calculates that increase of salaries of those who have not received it yet – e.g. public officials – will take place from 2019 on. The budgetary impact of all these measures in 2018 is HUF 950 billion in gross wage bill and HUF 497 billion in net wages compared to the 2010 level. In the next few years, pensions and income replacement benefits will retain their real value; they will be increased in line with inflation. Pensioners will be able to benefit from rapid economic growth over the projection horizon, since in the forthcoming years, a minimum of 3.5% economic growth seems to be realistic which serves a primer condition for paying pension premiums.

Next year, VAT-rate reduction on food started in 2014 will be continued. Thus, from January 1 2018, the VAT rate for fish will be reduced from 27% to 5%. Likewise, the VAT rate for restaurant meals and internet is reduced to 5% from 2018.

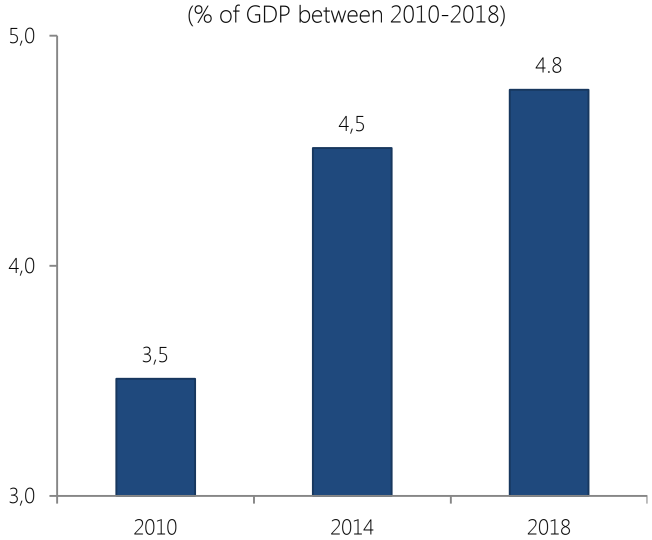
The increase of the Ministry of Defense's budget in line with the financing rules on GDP-proportional-funding serves the increase of the country's security level. The surplus also includes expenses related to the rising wages resulting from armed-forces career program.

Measures to improve the demographic situation

In addition to increasing employment, the Government's another important strategic goal is to support the child-raising families. Expenditure in connection with family support will reach 4.8% of GDP in 2018.

Chart 28.: Total expenditures affecting families

(% of GDP between 2010-2018)

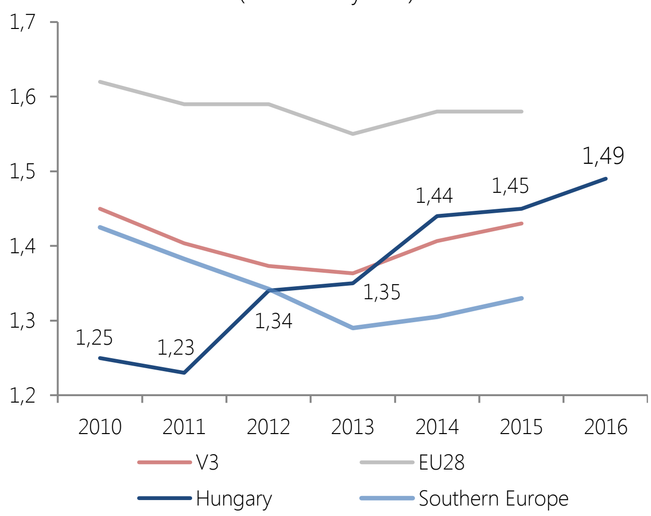


Source: Ministry of Human Capacities, HCSO, Eurostat

Wages are taxed by one of the lowest personal income tax rates in Europe (15%) and children's upbringing is supported by both personal income tax and social contribution allowances.

Chart 29.: Propensity to bear children in Hungary and some selected regions

(total fertility rate)



Source: Ministry of Human Capacities, HCSO, Eurostat

In case of families with two children, the amount of monthly tax benefit increases to HUF 17 500 per child. The amount of the tax benefit for the newly married spouses will also increase in 2018.

In 2018, increasing funds will be allocated for housing transfers. Therefore, the forecast calculates with the continuation of the Family Housing Subsidy Programme and the rise of the number of the National Housing Communities, as well as the expansion of the allowances given by the Housing Savings Trusts.

From 2018 on, we have budgeted resources for the implementation of the "Family Action Plan" adopted by the Government. In order to strengthen the favourable demographic processes, a significant nursery development begins. For three or more children, full student loan debt will be released, in case of 2 children, half of the debt is assumed by the state. Families with a mortgage loan can write down one million forints if the third child is born. As a fourth element of the action plan, baby bonds and maternity support will also be available for families staying or living abroad.

Development programmes

In the structure of the budget, the favourable change since the announcement of the Széll Kálmán Plan will continue in the forthcoming years, that is the share of growth-enhancing development-related expenditures is growing. Large-scale investment in infrastructure development can contribute to the outbreak from "medium income trap". The Hungarian budget provides thousands of billion forints for such investments in the period 2017-2021.

The road development plan totals to about HUF 2,500 billion, for which the total amount of available EU funds for road development will be spent, and a total of HUF 1,300 billion domestic budgetary resources will be allocated in seven years. In 2018, the renovation and upgrading of the national road network will continue. With the aim of strengthening the domestic industry, the budget contributes to the renewal of the bus fleet of passenger transportation public companies on the basis of national bus production and to the development and investment activities of the companies identified as a priority sector in the Irinyi Plan, to the Supplier Development Programme and to the improvements of the Industry 4.0 digitalization program. In addition to the EU subsidies, the budget supports with hundreds of billions of HUF to implement the investments in the Modern Cities Programme, most of which are with direct economic development purposes. Under this programme, the Government has signed a cooperation agreement with each of the county-level cities for development in the scope of economic development, tourism, education, culture and sport with a total value of over HUF 3000 billion.

In case of the EU funds, the primary objective is to allocate all the resources in 2018 in order to make the development resources available to beneficiaries as soon as possible. The size of payments in 2018 is expected to be close to the high levels of the previous years, supporting elevated economic growth, as the Government invests 60% of its resources in economic development plans which are based on increasing employment and competitiveness, in line with the EU objectives. A large part of the funds is paid as advance payments to the beneficiaries, with the favourable economic effects on the economy spreading in the medium term.

In addition to the non-refundable subsidies, there will be also financial instruments announced in significantly higher share than it was in the previous financial period, which, by means of multiple out-placements, will provide a stable source of financing for the future development of the underlying companies, gaining strength in the long run.

TABLES

1. MACROECONOMIC FORECAST 2017-2021

(year-on-year, percent)

	Fact	Forecast				
	2016	2017	2018	2019	2020	2021
Growth and structure of GDP						
GDP	2.2	4.1	4.3	3.8	3.7	3.6
Domestic demand	1.6	6.5	5.8	4.3	3.2	3.4
Household's consumption, of which:	3.8	3.6	4.0	3.9	3.5	3.4
Consumption expenditure	4.2	4.5	4.9	4.7	4.4	4.2
Social transfers in kind	2.2	0.0	0.6	0.6	0.0	0.0
Collective consumption	0.6	-1.7	1.6	0.5	0.0	0.0
Gross fixed investment	-10.6	21.4	12.5	7.3	3.7	4.7
Export of goods and services	3.4	6.6	6.8	6.1	6.3	6.9
Import of goods and services	2.9	9.8	8.8	6.9	6.0	6.8
Labour market indicators						
Gross wages and salaries	9.1	14.8	10.8	8.8	7.6	6.4
Average gross nominal wages	6.1	13.1	9.4	7.7	6.7	6.0
Average net nominal wages	7.8	13.1	9.4	7.7	6.7	6.0
Average net real wages	7.4	10.4	6.5	4.6	3.7	2.9
Employment [1]	3.4	1.6	1.3	1.2	1.0	0.4
Productivity [1]	-1.1	2.4	3.0	2.5	2.7	3.2
Inflation	0.4	2.4	2.7	3.0	3.0	3.0

[1] Based on the Labour Force Survey Data.

2. BUDGET OUTLOOK 2017-2021

Table 2. a.: REVENUE SIDE

(HUF billion)

	Actual data 2016	Forecast 2017 expected	2018[2] expected	2019 target	2020 target	2021 target
Payment by economic units	1 593.2	1 550.4	1 354.4	1 432.4	1 510.7	1 585.6
Taxes on consumption	4 610.4	4 828.0	5 239.9	5 711.9	6 041.0	6 401.1
Payments of household	1 922.3	2 148.1	2 349.5	2 533.5	2 718.6	2 872.8
Central budgetary institutions and chapter administered appropriations	3 507.4	3 709.0	1 350.0	1 350.0	1 350.0	1 350.0
Payments from central budgetary institutions	27.4	46.8	30.0	40.3	66.2	91.0
Payments of social security funds	4.6	12.8	0.0	10.9	0.0	0.0
Payments of local governments	15.3	36.9	39.0	39.0	39.0	39.0
Incomes of extrabudgetary funds	20.0	17.0	13.3	13.3	13.3	13.3
Incomes related to state property	205.7	256.1	96.1	95.2	95.2	95.2
Other revenues	68.3	26.1	7.2	6.8	6.8	6.8
Incomes of EU programmes	0.0	0.0	1 911.2	1 952.1	1 316.6	847.6
Reimbursement of EU financial supports	344.0	100.4	63.2	120.0	71.9	0.0
Reimbursement of customs' and sugar levies' collection costs	13.2	12.2	12.6	13.2	13.6	14.2
Revenue	**12 331.8**	**12 743.7**	**12 466.3**	**13 318.5**	**13 242.9**	**13 316.6**
Interest revenues	148.6	108.5	73.5	32.0	35.4	34.3
Total revenue	**12 480.4**	**12 852.2**	**12 539.8**	**13 350.6**	**13 278.3**	**13 350.9**

[2] The figures for 2018 are, in general, the same as the statutory appropriation for the central budgetary sub-system and the general government cash balance, however social contributions tax is calculated with 0,5% lower tax rate, and savings in interest rates and macroeconomic changes are also taken into account.

Table 2. b.: EXPENDITURE SIDE

(HUF billion)

	Actual data	Forecast				
	2016	2017 expected	2018 expected	2019 target	2020 target	2021 target
Subsidies to economic units	333.6	326.3	372.8	400.9	396.8	392.3
Support to the media	69.9	70.2	71.3	73.2	75.4	77.6
Social fare contribution	97.9	94.3	97.5	94.5	94.5	94.5
Housing grants	148.2	185.0	236.3	248.0	244.9	239.9
National family and social fund	672.2	656.7	644.6	644.1	641.0	639.7
Government agencies and chapter-administered appropriations	8 732.5	10 253.8	9 086.7	8 873.1	8 209.1	7 785.4
Support to civil society associations	3.8	3.8	9.8	3.8	3.8	3.8
Social security funds	409.7	623.9	617.8	500.6	567.8	659.4
Transfer to local governments	675.4	703.2	705.4	710.1	695.1	693.8
Transfer to extrabudgetary funds	155.0	53.0	61.9	57.6	56.8	56.9
Expenditure arising from international financial relations	6.3	4.0	2.8	3.0	2.8	2.6
Debt-servicing related expenditures	47.1	52.0	51.5	52.0	54.8	51.5
Other expenditures	59.3	51.8	31.7	29.8	30.6	31.8
Exceptional government measures	0.0	0.0	110.0	110.0	110.0	110.0
Extraordinary provision	0.0	0.0	90.6	180.3	182.5	182.5
Country Protection / Tax Reduction and Development Fund	0.0	0.0	60.0	60.0	440.0	710.0
Governmental extraordinary expenses	3.6	3.2	2.9	2.7	2.4	2.1
Validation of state guarantees	12.4	17.6	22.1	22.0	23.0	23.0
Expenditures related to state property	387.0	460.0	322.2	364.6	588.4	670.6
Contribution to EU budget	295.3	260.4	309.9	329.7	346.0	333.9
Expenditures	**12 109.2**	**13 819.2**	**12 907.9**	**12 760.0**	**12 765.6**	**12 761.4**
Debt-servicing related interest expenditures	1 118.2	1 090.5	943.3	957.0	940.8	921.0
Total expenditures	**13 227.4**	**14 909.7**	**13 851.2**	**13 717.0**	**13 706.5**	**13 682.3**

Table 2. c.: BALANCE AND OTHER INDICATORS

(HUF billion)

	Actual data	Forecast				
	2016	2017 expected	2018 expected	2019 target	2020 target	2021 target
Central government primary balance	222.6	-1 075.5	-441.6	558.5	477.2	555.2
Central government primary balance in % of GDP	0.6	-2.8	-1.1	1.3	1.0	1.1
Central government balance	-747.0	-2 057.5	-1 311.4	-366.5	-428.2	-331.5
Balance of pension insurance fund	12.8	-7.3	0.0	0.0	0.0	0.0
Balance of health insurance fund	-89.7	-146.0	0.0	0.0	0.0	0.0
Balance of extrabudgetary funds	-1.1	99.7	-49.3	-27.3	-1.7	16.7
Balance of central budgetary sub-system	-825.0	-2 111.0	-1 360.7	-393.8	-429.9	-314.8
Balance of local governments	285.0	618.2	203.1	-355.8	-147.8	-109.3
General government balance	-540.0	-1 492.8	-1 157.6	-749.6	-577.8	-424.1
ESA bridge	-116.5	758.8	175.6	-35.2	-120.7	-171.5
ESA balance of general government sector	-656.5	-734.0	-981.9	-784.8	-698.5	-595.6
ESA balance of general government sector in GDP %	**-1.9**	**-1.9**	**-2.4**	**-1.8**	**-1.5**	**-1.2**