MINISTRY
FOR NATIONAL ECONOMY

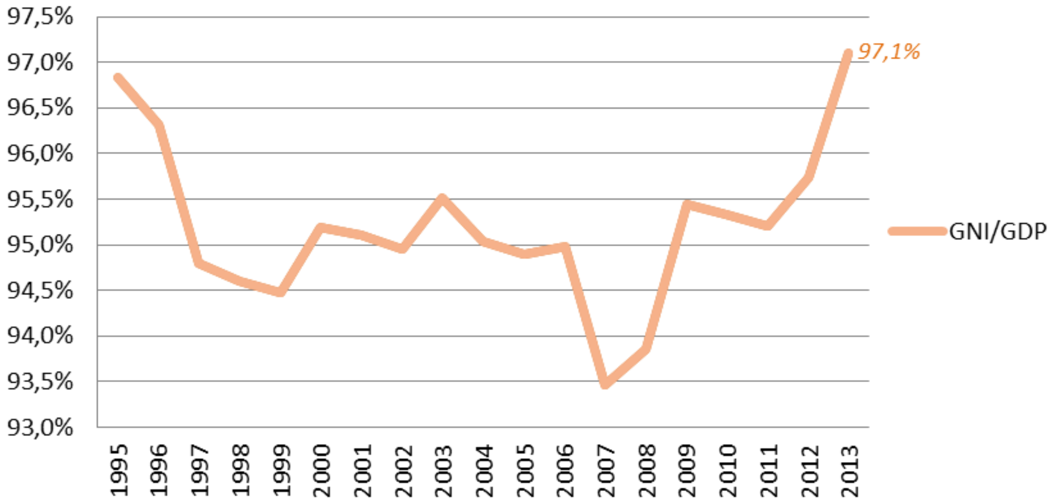
Hungarian economy's GNI/GDP hit 97.1 percent, up by more than 4 percent since 2007

The medium- and long-term development path and opportunities of the Hungarian economy are determined by three major fundamentals. First, it is a medium-sized economy (with GDP of USD 255.3bn ranked as 54th largest out of the 188 economies observed by the IMF); second, it is an open economy in terms of foreign trade (exports/GDP, imports/GDP ratios); third, due to the lack of competitive, large domestic corporations the private sector is missing a key pillar. This latter factor had adversely affected Hungary's GNI-to-GDP ratio for decades which trend could only be reversed by direct measures in the past four years.

The openness of an economy enables -- on the one hand -- prompt adjustment to international markets through the inflow of knowledge and the re-location of know-how from developed regions. On the other hand, openness is also characterized by massive capital outflows: some estimates put the national economy's shortfall at between HUF 7000bn and HUF 8500bn per year.[1] This imbalance clearly shows as only one-sixth of total annual income transfers are reimbursed to Hungary in the form EU funding. According to certain estimates, net contributors to the EU budget regain as much as 30 percent of GDP per year, while EU transfers to Hungary account for only 2-4 percent of GDP each year and re-investments constitute only 1.2 percent of GDP. Around 2008, the largest outflow (of HUF 3000bn) was the result of income transfers of foreign monopolies. Therefore, it has become a primary Hungarian economic policy goal to reduce that amount. Among major policy instruments, sectoral extra taxes and the market overhaul brought about by public utility price cuts deserve attention. These measures have in recent years managed to reverse the negative trend and narrow the GNI/GDP gap to the level prevalent prior to Hungary's EU accession. Currently, Hungary's per capita GNI is USD 23 800 (at PPP), which figure places Hungary on a par with Poland and the Baltic states.[2]

[1] (Pavics, 2011 and Matolcsy, 2012)
[2] WB WDI, 2014: GNI per capita, current international $, PPP

GNI/GDP in Hungary, 1995-2013



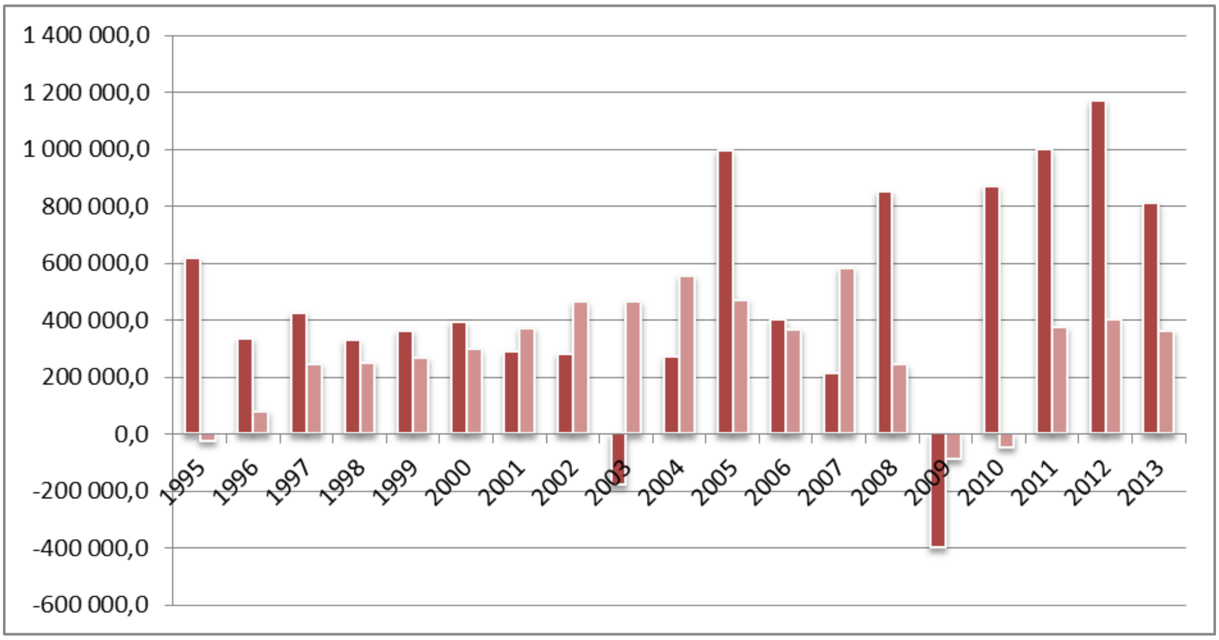
Source: Hungarian Central Statistical Office (KSH)

The economic policy measures of recent years, such as the phasing-out of forex loans, the increasing of the share of domestic investors in central government debt financing and new bank sector regulations have left the Hungarian economy more resilient against external shocks. Hungary's economic policy has managed to curb income outflow through the redirecting of profits to state coffers (i.e. sectoral extra taxes) and the partial strengthening of domestic large enterprises. As far as foreign-owned companies are concerned, the country has prioritized the re-investment of a part of income outflows in the domestic economy. To this end, the Government has been concluding strategic cooperation agreements with high-tech enterprises which are open to relocating an increasing number of supply chain components to Hungary and the number of Hungarian suppliers. As a medium- and long term goal, Hungarian economic policy aims to stimulate large enterprises active in Hungary to boost investment in R&D&I capacities through tax incentives and a cost-competitive environment.[3] In Hungary, every second researcher is employed by a Hungarian subsidiary of a foreign enterprise, in the research centre of which the number of researchers is on average six times higher than at a Hungarian company. These statistics, however, must be further improved and the Government incentivizes foreign

[3] Compared to 2005, Hungary has steadily maintained its cost-competitiveness in comparison to several EU countries (Eurostat, 2015 REER data code: tsdec300). While this is a major precondition for exiting the so-called „middle-income trap", it is hard to keep it.

enterprises to bring more of research capacities to Hungary and utilize avaialable domestic human and material resources.

Current account balance adjusted for reinvested income. Dark columns: capital investment minus outflows; light columns: amount of re-investment (million HUF)



Source: Central Bank of Hungary (MNB, 2014)

Two factors determine the medium-term outlook of Hungary's economy: domestic demand and the utilization of EU funding. Domestic demand growth[4] generates inflationary pressure which requires monetary policy adjustment, but the base rate must be kept low until higher inflation returns to the world economy and to Europe. Another key safeguard for the efficiency of monetary policy is ensuring that forint-dominance returns to the domestic financial sector: this is a prerequisite for the MNB' interest rate policy that ensures full effect on economic cycles. The other major determinant of medium-term growth outlook is the allocation of EU funding. Hungary's high growth rate in 2013-2015 was also the period of the best EU absorption data: EU funding accounted for as much as 4 percent of GDP; accordingly, these resources significantly contributed to economic expansion. However, a lower figure is expected in the next two-three years. In order to fully exploit growth potential, the share of EU funding earmarked for the private sector must be increased to a level higher than ever before. Over the past two years, the steady but slow depreciation of the forint has also driven economic growth. This trend has also

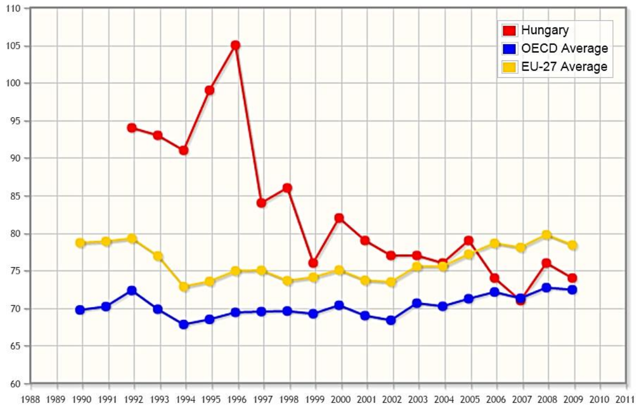
[4] National Bank of Hungary (MNB) Inflation Report, March 2015

been in line with Hungarian economic goals and monetary policy purposes and it is expected to remain in place in the medium term. The Government must -- and it also wants – to stimulate domestic consumption growth, along with implementing long-term infrastructure development projects and boosting corporate capacities. However, as durable consumer goods are typically imported, steady economic expansion cannot be based solely on domestic consumption growth. Accordingly, **the primary priority must be to bolster the export capacity of domestic-owned private sector enterprises**. A key element of this policy may be to facilitate the creation of a more compact market structure instead of the current, highly fragmented one and thus help enterprises with the highest export potential to maximize competitiveness on international markets.[5]

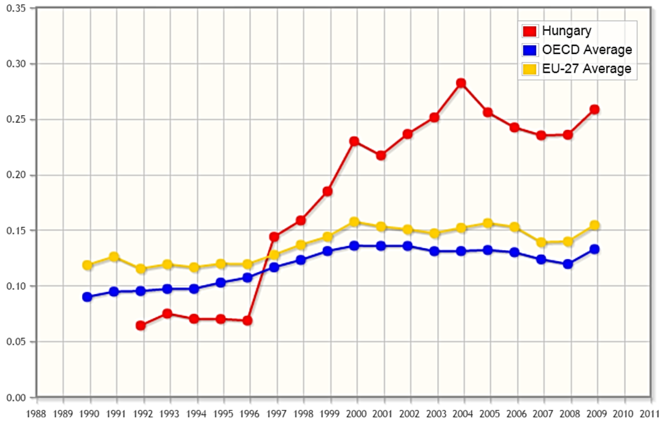
In order to assist the utilization of growth potentials, Hungarian economic policy focuses on improving two other structural factors. First, although Hungary – similarly to the other Visegrád Four members – is increasingly competitive on foreign markets, final economic statistics are marred by two significant factors. **In spite of the fact that Hungary's foreign trade keeps posting stable surpluses, these are increasingly the result of an ever falling number of competitive products**. The share of high-tech products has increased significantly within the export basket which has made the export sector more profitable but this profitability – outstanding even from a global perspective – **has failed to exert a ripple effect on the real economy**. This justifies the introduction of some low-scale Government measures aiming to enhance this situation.

[5] Policy tools in this regard are limited by EU regulations on state support. Economic policy must support some flagship companies capable of underpinning the national economy in multiple ways.

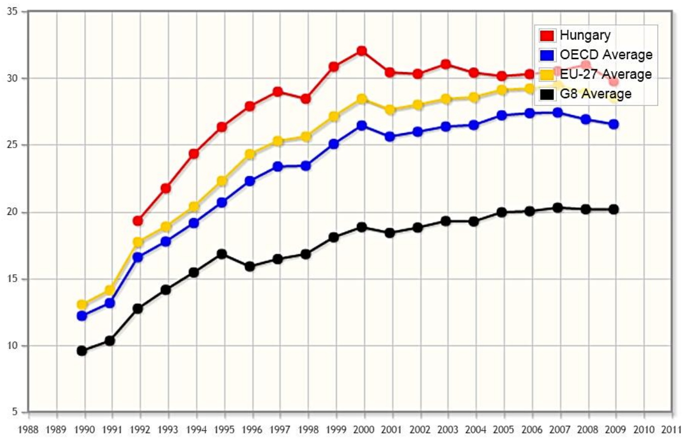
Hungary's foreign trade diversity (RCA index) (1992-2009). Source: Sabanci Univ. (2013)



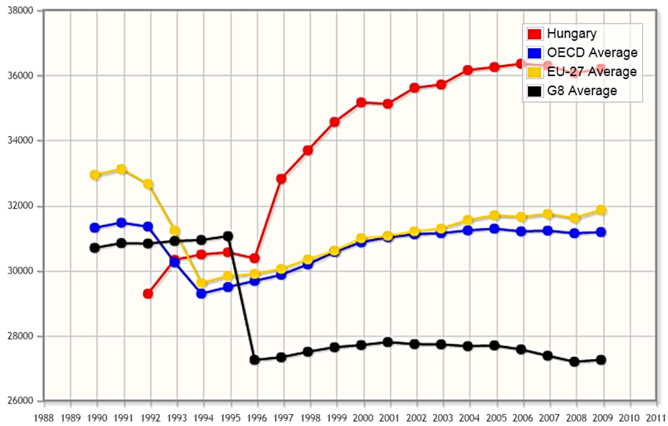
Revealed Trade Advantage (RTA) for high-tech products within Hungarian exports (1992-2009). Higher indicators signal higher competitiveness.



Ubiquity index, showing the diversification of exports compared to global averages. Higher indicators signal less diverse composition of exports (1992-2009). Source: Sabanci Univ. (2013)



ESI (Export Sophistication Index), showing export profitability (1992-2009). Source: Sabanci Univ. (2013)



Due to the openness of the economy, **Hungary produces foreign trade data that paint the picture of a country at a much higher stage of development than it actually is.** The bulk of the domestic economy and the majority of domestic economic stakeholders do not profit from massive trade surpluses. Export performance can and must be improved by the development of existing, endogenous potentials. The objective to restore growth potential requires the building of an innovation eco-system which for the time being is lacking several vital components.

The large amount of general government debt also significantly dents the country's growth potential: despite the successful shift towards the issuance of more forint-denominated state debt and a higher share of domestic bondholders, the persistently high level of general government debt remains an obstacle in the way of improving the country's international credit position. Further improvement hinges mainly on enhancing foreign trade composition and external demand growth. External debt rates, which are critical in terms of economic vulnerability, are expected to continue to fall. In the medium term, gross state debt is also seen more resilient to external shocks, thanks to the MNB's self-financing programme and the expected drop in the external debt of the bank sector due to the conversion of forex household loans.[6] In the long term, **the strengthening of the domestic credit market** is another key pillar of reducing general government debt, as the financial and insurance sector is one of the largest retailer and holder of government securities as well as the main catalyst of private sector investment.

To sum it up, Hungarian economic policy will carry out structural corrections and implement a focused, well-defined development policy. The current EU fiscal period coupled with potent measures is expected to facilitate a more stable economic growth path.

[6] National Bank of Hungary Inflation Report, March 2015