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Assessment and recommendations

Hungary is facing one of the most severe recessions among OECD countries

Hungary has been in one of the most severe recessions among OECD countries, with the projected fall in real gross domestic product (GDP) in 2009 being double the OECD average. Hungary's economy suffered from a trade collapse just like other transition economies in the region, but the global crisis has been compounded by a collapse in investor confidence in forint-denominated assets. This triggered a steep depreciation of the exchange rate in October 2008 and led the authorities to request financial assistance from international organisations. A combined credit package of EUR 20 billion was granted in November 2008 by the International Monetary Fund (IMF), the European Union (EU) and the World Bank.

High foreign currency indebtedness and weak fiscal sustainability were at the root of the loss in confidence of foreign investors. Foreign exchange lending became a common practice due to the interaction of several factors, reinforcing each other. On the credit demand side, lenders were encouraged to borrow by the persistently wide spread between interest rates in Hungary and western-European countries, a relatively stable currency, and the expectation of convergence. On the credit supply side, banks favoured foreign currency lending owing to the lack of domestic forint savings and also over-optimistic assumption on convergence. As a result, households and enterprises have become increasingly indebted in foreign currency, especially in Swiss francs. Total external debt reached about 120% of GDP at the end of 2008, compared to less than 50% in Poland and 40% in the Czech Republic. At the climax of the financial crisis (October 2008), gross international reserves fell short of covering short-term foreign currency debt at remaining maturity. At the same time, the capacity of the government to bail out private investors appeared limited owing to the high public debt and the still significant fiscal deficit.

Restoring market confidence has required tight macroeconomic policies…

Unlike most other OECD countries, macroeconomic policies could not afford to support the economy and had to remain tight to avoid further depreciation of the exchange rate. For the central bank, defending the forint had at times to take precedence over inflation targeting. On the fiscal side, spending was cut significantly to reinforce confidence, including nominal cuts in public wages and pensions. The pro-cyclical stance was similar to policies followed by other emerging countries with foreign currency debt overhangs. In those countries, the positive impact of reversing capital flows proved to outweigh the negative impact of tight macroeconomic policies: the restoration of market confidence

eventually led to currency appreciation and interest rate declines, which lightened the private sector debt burden, stimulating activity. In the meantime, transitory high domestic interest rates had limited pass-through to the economy since most indebtedness is in foreign currency. In Hungary also, tight macroeconomic policies, together with international support, have been successful in stabilising the currency, allowing the central bank to resume interest rate cuts in mid-2009 and the government to let automatic stabilisers work in part.

… while the crisis acted as a trigger for long-overdue reforms

The need to restore foreign investor confidence also acted as a trigger to implement long-overdue structural reforms. Improving fiscal sustainability required going beyond short-term expenditure cuts. Hungary has made significant progress in reducing the cyclically-adjusted fiscal deficit over the past years. In particular, the government has improved the targeting of social transfers and has reduced inefficient subsidies. In May 2009, the government adopted a new pension reform that should significantly mitigate the rise in ageing costs. This reform, which increases the retirement age, will also favour labour supply, thereby supporting potential growth. Moreover, on 1 July 2009, the government implemented a far-reaching tax reform that switches the tax burden from labour to consumption: an increase in the value added tax rate by 5 percentage points (together with a rise in excise taxes and the creation of a wealth tax) allowed significant cuts in employer social contributions and the personal income tax. This reform should support potential growth and employment by reducing economic distortions.

Restoring sustainable growth will require further structural reforms and an enhanced policy mix

Before the crisis, Hungary's productivity gap *vis-à-vis* the OECD average was already large. Real income convergence came close to a halt in 2007-08 and is likely to have been reversed in 2009. The depth of this recession is bound to leave deep marks in productive capacity. Consequently, boosting potential growth calls for continued structural reforms encompassing labour market, education, entrepreneurship and innovation. In particular, *active labour market policies should be better targeted at the unskilled*. For the recent reduction in maternity leave to lead to a significant increase in female participation, it is essential that public support for childcare (*e.g.* part-time work, working from home, nursery services) is expanded. *The still generous maternity leave provisions should be reduced further, while public support for childcare should be expanded in parallel*. Regarding product market policies, *barriers to firm creation should continue to be reduced*. *The share of research and development in GDP should increase and collaborative links between research institutions, universities and the business community should be strengthened*.

A well-balanced policy mix is the key to maintaining a sustainable growth path in Hungary. Fiscal consolidation is a pre-requisite since market confidence is needed to allow the central bank to base its policy stance solely on inflation targeting. Hence, *fiscal consolidation, through structural reforms, should continue, while avoiding excessive pro-cyclicality if the economy deteriorates beyond anticipation*. As the economy recovers and monetary policy shifts emphasis from financial stability to inflation targeting, *the central bank should continue to carefully communicate*

to financial markets so as to avoid financial stability concerns in case of sudden changes in market confidence, as has happened in the past. *Continued in-depth analysis of the impact of the recession on potential output should help guide monetary policy* within the inflation targeting framework, given the difficulty of interpreting inflation shifts in Hungary.

The fiscal responsibility framework needs to be fostered

A major step toward fiscal sustainability has been taken with the adoption of the Fiscal Responsibility Law that introduced strict fiscal rules and established a non-partisan fiscal council to oversee implementation. The new fiscal council holds the potential to raise public awareness about the need for fiscal consolidation and to ensure "checks and balances" for fiscal policy implementation. Hence, it is of utmost importance that the fiscal council benefits from broad political acceptance. The new fiscal rules aim at lowering the debt-to-GDP ratio over time and introduce annual spending targets for each of the next three years. By focusing on the debt ratio and moving towards a medium-term expenditure setting, the framework deals appropriately with Hungary's sustainability challenge given politicians' proclivity to overspending during election years. The Fiscal Responsibility Law has just begun to be implemented and, with two major elections taking place in 2010, it would be best to *allow some experience to accumulate before considering substantial changes*. However, the operational framework of the rules appears to be somewhat complex. To increase public ownership of the rules, *the fiscal council should prepare, as soon as possible, an operational manual describing the step-by-step process for implementing the rules, including key budgetary variables, dates and responsible governmental and parliamentary units*.

Further tax reforms and enhanced public expenditure efficiency should support growth

As mentioned above, the recent changes in the tax system, by switching from labour to consumption taxes, are steps in the right direction. However, at a constant level of taxation, economic distortions could be reduced by *considering further cuts in labour taxes, financed through higher property taxes (accompanied by improved property registry) and/or emissions taxation*. Further tax cuts would also increase welfare gains since marginal tax rates are high, with negative impacts on growth and employment. However, this would require first to reduce the size of the government – which is very large in Hungary, especially in comparison to countries with similar living standards – so as not to deteriorate fiscal sustainability. A striking feature in Hungary is the large share of public service expenditure, suggesting inefficient public administration. Another feature is the comparatively high level of outlays on social protection, reflecting generous social transfers and attractive incentives for early retirement, despite recent measures taken by the government. Finally, health-care spending, while not dramatically different from most OECD members, does not deliver adequate outcomes by international standards. While some improvement has been made, further efforts are needed to increase efficiency.

Reducing the level of general public services expenditure is the key

Hungary's public administration is one of the least efficient among OECD and accession countries, pointing to potentially large efficiency gains. One potential source of savings appears to lie in reduced staffing; central and sub-national workers account for almost 20% of total domestic employment, which is high in comparison with other OECD countries, although it reflects low total activity ratio as well. Hence, *the government should continue to streamline public sector employment*. Another source of saving could be outsourcing, given that the degree of outsourcing is rather low in Hungary at the central government level compared to other countries. *Greater use of outsourcing for public services could raise efficiency of service provision, but care would have to be taken to ensure transparent and competitive contracting*, to reduce the risk of corruption. This would require the government to *strengthen public procurement monitoring capacity and the State Audit Office, and enhance the political will in support of the Office's enforcement*. The recent legislation enhancing the control mechanism of the Public Procurement Office is a step in the right direction. More generally, to help maintain the momentum of public administration reform, *the government should establish a unit with a mandate to both promote and assess reform progress*. It should also *revisit and pursue recommendations of the 2006 State Reform Council's comprehensive stocktaking of overlapping tasks in government agencies.*

Slowing the growth of expenditure related to ageing is also crucial

A major challenge for public expenditure reduction is the anticipated rise in public expenditure related to ageing. Past and recent reforms of the pension system – in 1998, 2007 and May 2009 – should lead to a slower increase in pension costs. In the future, the government should *increase the statutory retirement age in line with increases in life expectancy.*

The health status of the Hungarian population is among the poorest in the OECD; in particular, male life expectancy at birth is the lowest, while that of women is the second lowest. Despite multi-casual factors, one of the most important determinants is the health-care delivery system. Although Hungary's public expenditure on health care is below OECD and EU15 averages, the share of private spending on health (including the traditional under-the-table payments) is estimated to be the highest in the EU, at around 30% of total spending on health. There is thus an obvious need to raise "value for money" in the health sector, all the more so in light of impending ageing-related growth in demand for health services.

Recently, the government has achieved some successful reforms, principally in reforming the pharmaceutical market, but the reform agenda spelled out in previous OECD *Surveys* remains mostly valid. Efforts to tackle the thorny issues of formal patient co-payments and devolution of the payer function from the Social Security Fund to a mix of private/public insurance schemes have encountered strong political resistance. The authorities should seek consensus toward the goal of *introducing patient co-payment to instil some cost-consciousness and help eliminate under-the-table payments. The authorities should also continue to strengthen the gate-keeping role of general practitioners*. Reform is also crucial for the government to be in a position to manage the financial impact of ageing-related increases

in health-care spending. Based solely on ageing, Hungary's public spending on health care is projected to increase relatively modestly, but the government should *plan for possible long-term budgetary impacts of rising demand, and especially the likely greater use of more costly improved medical technologies*.

Reshaping financial regulatory approaches

A major lesson learnt from the crisis in Hungary is that the approach towards household lending needs to change: stronger protection for borrowers needs to be combined with tighter regulation of lenders. The right balance needs to be struck in both directions, as neither the over-protection of households nor the over-regulation of banks would be desirable. The former can lead to moral hazard and boost the pool of "subprime" borrowers, while the latter can hurt the efficient functioning of the financial system and hence of the whole economy.

Limiting borrowers' risk taking

Household debt as a percentage of GDP, at less than 40% in 2009 is much lower than that in more developed countries, but most debt is floating-rate and a large share of the debt is in foreign currency. This exposes borrowers to interest rate and exchange rate risks that increase their solvency risks. In view of the risks that high household debt-service ratios pose for financial stability, in accordance with the already effective Code of Conduct, *the share of income that can be used for debt servicing should be capped. To ensure that the ceilings on debt-service ratios are observed, a comprehensive credit registry is needed, which goes beyond the existing negative list. Borrowers' incomes should be better documented to ensure ability to repay.* This measure would also help "whiten" the economy.

To mitigate solvency risks for households, the supply of mortgage insurance-type financial products (for instance, in the case of unemployment or sickness of the borrower) should be reinforced, and the practise by banks to use these products as a loan security should be fostered. Financial education at the stage of formal studies is widespread and covers major issues. But financial education in general should be bolstered at all life stages and targeted programmes for vulnerable groups such as the elderly and the less educated should be introduced.

Containing financial market and credit risks

Major sources of risk for financial stability have been borrowing in foreign currency and inadequate liquidity management with a mismatch of maturities between assets and liabilities. Exposure of banks in foreign currency, in particular Swiss francs, is large, while the scope for the authorities to provide emergency liquidity in this currency is limited. Hence, liquidity regulation and oversight of the largest institutions needs to be given high priority to avoid a future currency crisis. Although capital requirements have so far been adequate, better preparation for a rise in non-performing loans is needed. *Liquidity conditions in foreign currency should be more closely followed. Banks should be subject to higher costs for risky lending in the form of higher capital requirements, although this would be more*

effective if enacted at the regional (even global) level. Dynamic provisioning should be introduced once the economy recovers to provide a buffer for banks during economic downturns.

Strengthening consumer protection

A source of risk for borrowers has been the arbitrary cost increases passed on by banks without much restriction until very recently. Inadequate disclosure of the conditions of loan products, in particular unilateral change of contract by banks, resulted in soaring instalments, payment difficulties, defaults and sometimes evictions. Unfair conditions, unilateral changes of contract and other abusive practices in the recent past call for vigilant consumer protection. *All conditions of financial products should be disclosed in a transparent way before signing the contract.* More recently, the instances where banks can transfer increased costs to households have been limited with the signature of banks, the regulator and the government of a "Code of Conduct" effective from December 2009. *However, related clauses in lending contracts should be generally condemned and declared non-binding. As a second-best option for existing contracts, lenders should be encouraged to engage in restructuring of loans if borrowers' defaults result from a unilateral contract change.*

Fostering competition to enhance efficiency in the banking market

There are serious obstacles to effective competition. One relates to the lack of information on borrowers, which implies higher credit risk for banks and hence less likelihood for reducing margins. Another very important obstacle is high switching costs, amounting to 1-2% for housing loans and 3-5% for loans for other purposes. Increased competition should help reduce switching costs but *capping of pre-payment costs by a recent legislation is a welcome step, even though the cap may be somewhat high. Also, portability for housing loan subsidies across properties and across financial institutions should be introduced, as recommended by the competition authority. Independent agents should be required to offer several options to customers for a fixed fee, which should only be paid if one of the options is chosen by the customer, and these agents should be prohibited from accepting commissions from financial institutions. Agents working for or on behalf of banks should disclose their remuneration scheme and amount to the borrower.*

Strengthening the supervisory framework

The crisis exposed weaknesses in the supervisory framework, such as inadequate monitoring and risk assessment of the financial system, and insufficient co-operation among institutions in charge of financial stability. The financial supervisory authority had not been entrusted with stopping unfair commercial practices and protecting consumer interests until very recently. The supervisory authority has been made independent from the Ministry of Finance and responsible directly to Parliament. To better identify and assess systemic risks, *co-operation between the central bank and other institutions in charge of financial stability should be strengthened further. A more formal Financial Stability Council should play a prominent role in detecting risks and making recommendations to mitigate them. The financial market supervisor should be granted wider scope to issue regulation, although care should be taken to avoid overlap with the central bank. The supervisory authority should not be held liable for the*

damages its regulations may cause to regulated institutions, otherwise the new powers to charge higher fines cannot be effective.

Improving education outcomes to raise productivity performance

Hungarian educational policies and institutions are capable of combining good educational outcomes and a relatively efficient use of resources. Costs relative to GDP are at about the OECD average, while younger school pupils perform above average in internationally comparable assessments. But 15 year-olds register only average performance in the Programme for international student assessments (PISA), and the proportion of adults with tertiary qualifications, though rising, is still low. More worryingly, the school system does not adequately prepare vocational school leavers for the labour market. Hence, the government should be ready to reform the system to further improve educational outcomes and cost efficiency.

Education efficiency at the school level can be improved

The Hungarian school system possesses features usually associated with good outcomes, notably a high degree of local autonomy. However, many municipalities are too small to provide good educational facilities for all students in their district, and the government actively encourages small municipalities to form associations with each other so as to share facilities and/or combine kindergartens, primary and secondary schools. *Scope remains for further mergers/associations among municipalities to improve education efficiency.* The "National Assessment of Basic Competencies" provides a benchmark for individual school performance, but the supervision of the tests and their dissemination leave something to be desired. *To improve their reliability, the proportion of national assessments invigilated by independent inspectors should increase and, to improve their utility, a higher proportion of individual school results, preferably adjusted for the socio-economic background of the students, should be coded and disseminated in a timely fashion.*

Teacher quality is an important factor influencing educational achievement. In Hungary, the quality of incoming teachers appears to be lower than those in other professions. Recent reforms require new entrants to spend up to three years acquiring knowledge in their specific topic area, followed by up to two years studying teaching-related issues and as trainee teachers. *Entry criteria and courses taught in teacher training institutions should be independently assessed.* Hungarian teachers are paid less than teachers in most other countries, even allowing for lower per capita GDP, but they also have a lower teaching burden. *In the longer term, the ratio of actual teaching relative to the total statutory working time should be raised. The resulting gains in efficiency could be used either to reduce the number of teachers or increase the relatively low salaries of teachers, or a combination of both.*

Improving the quality and relevance of vocational training

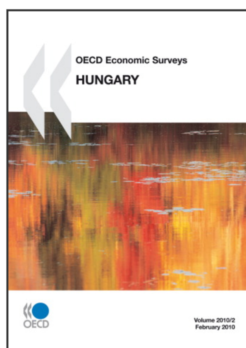
The employment rate for youth (age 15-19) was the lowest in the OECD area in 2008, which is in part explained by the longer compulsory schooling period (gradually increased to the age of 18). Some 60% of vocationally trained workers are either not in employment, or in fields that do not correspond to their professional qualifications. *To improve the usefulness of the courses taught, school leavers should be traced in their first years after school to gain feedback on the relevance of their vocational training.*

A high proportion of Hungarian students are enrolled in two types of vocational schools after the end of the 8th grade. The OECD recently published an in-depth analysis of the vocational education and training system in Hungary. *The government should implement the policy recommendations of the OECD report.* As practical training provided on school premises is of uncertain quality as well as limited in quantity, *the policy to favour practical vocational training in regional integrated vocational training centres and in workplaces (apprenticeship system), rather than in the vocational schools should be continued.* In addition, given the poor record of the vocational training schools in preparing students for the labour market, *the government should strengthen them, for example by offering a similar education standard as in vocational secondary schools in order to offer all vocational students the same teaching resources, and adequately prepare all interested students to sit for the matura examination.*

Ensuring a better integration of students from disadvantaged background, especially the Roma

Tracking (*i.e.* selecting students into different types of school on the basis of their assessed performance and expressed preferences) is widely believed to lead to greater efficiency in teaching, despite lack of evidence. Several OECD countries have moved away from early tracking in recent decades, and no country has moved in the opposite direction. The movement towards de-tracking was influenced by the finding that early tracking tended to perpetuate existing socio-economic differentials. In Hungary, tracking can occur at age 14. *As in most OECD countries, tracking should start at the earliest at age 15.*

Many Roma adults have low educational attainment – some did not even complete primary education – and on average, systematically lower achievement than the rest of the population. Policies have moved away from concentrating Roma students in "gypsy schools" towards encouraging Roma integration with the rest of society from the earliest possible age. Research shows that integrating young children from different ethnic backgrounds in pre-school raises the probability that they will remain longer in education after the minimum age limit, and reduces social prejudices in both directions. *It is therefore desirable to encourage Roma parents, for example through financial incentives, to send their children to pre-school for longer than the compulsory period.* The special pre-schooling support for disadvantaged parents introduced by the government in January 2009 is a positive step in this direction.



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