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Hungary: deficit reduction plan topped, economy supercooled

In 2007 the central government deficit amounted to only 77% of the planned target. Thus, despite GDP growth being substantially lower than envisaged (about 1.3% vs. 2.2%), the most important indicator of the Hungarian convergence programme – the general government balance/GDP ratio – turned out much better than expected. It amounted to 5.7% of the GDP, as compared to the original target of 6.8% or the latest government forecast in December, 6.2%. That means that in 2007, the budget deficit/GDP ratio fell by about 3.5 percentage points of the GDP year on year. The main explanatory factors for the smaller deficit are the lower than previously assessed interest payments on public debt and the substantially higher than expected revenues from taxes and charges. The bigger part of the additional budget revenues came from higher than planned tax revenues related to higher inflation, a smaller part from 'whitening' of the economy, i.e. the shift of activities from the shadow economy to the taxed one.

Austerity package *cum* bad weather

One reason for the slower than planned growth performance of the economy was the dramatic, about 16%, drop in agricultural output caused by bad weather. The cuts in government expenditures for the ambitious highway construction programme resulted in a strong decline in construction activities. By contrast, the dynamism of industry remained unbroken. Growth here, and especially in manufacturing, relied on rapidly increasing productivity and export sales. Engineering remained the driving force in industry, in particular electrical machinery, telecommunication equipment and computers. Output of the services sector increased at a slower pace than GDP: first, because of the declining performance in public administration, education, health and social services, which in turn was part of the austerity package; and second, due to the only marginal increase in services delivered by trade, hotels and restaurants, a consequence of falling household consumption, a 'collateral damage' of the stabilization programme.

Data on the final use of GDP display that growth in 2007 was virtually entirely attributable to foreign trade. Household consumption has probably declined by 1.2% to 1.5%; within this, social transfers in kind from the government fell much more strongly than household consumption expenditures. Government consumption decreased to a substantially larger extent. Gross fixed capital formation practically stagnated last year, with sharply diverging tendencies in the individual segments of the economy. Due to the fiscal consolidation measures, investment declined by one third in public administration, by about 15% in education and by 7-8% in health care. By contrast, manufacturing investment expanded by about 30%.

Improving foreign trade balance

Rapidly expanding industrial exports coupled with declining consumption and stagnating investment resulted in a remarkable improvement in foreign trade balances.

According to the customs statistics on commodity trade, exports rose by 16% and imports by 12% in 2007, and the trade balance improved by nearly EUR 2 billion compared to 2006. Commodity trade according to the balance of payments statistics is estimated to have turned into a surplus of EUR 1 billion last year, as against a deficit of the same magnitude in 2006. The current account deficit has probably declined as well, to an estimated EUR 4.5 billion. This deficit, combined with the capital account balance, constitutes the net external financing capacity of the economy, which may have remained well below EUR 4 billion, or 4% of the GDP.

Inflation accelerated in 2007. The annual average was 8%, with a 9% monthly inflation peak in March and decline thereafter until September, associated with the rise in regulated prices at the beginning of the year. From October inflation accelerated again, primarily as a consequence of higher food prices and fuel prices for motor vehicles.

Unemployment remained at the previous year's level, despite declining employment (by close to 5%) in public administration and services. This is due to more jobs in the private sector and the already mentioned 'whitening' of economic activities.

Recovery begins in 2008

In 2008 economic growth will accelerate to about 3%. This will result from a moderate upturn in household consumption and a considerable expansion of investments, related partly to a substantial increase in EU co-financed projects both from the outgoing 2000-2006 and the incoming 2007-2013 EU financial framework. Public consumption will still decline, but less steeply than in 2007. The gap between export and import growth rates will be much smaller, as imports will grow more dynamically than in the previous year due to the expected lively investment activities and the recovery of household consumption. Industrial growth will continue its longer-term trend. Agriculture and construction will attain high growth rates after the strong decline in both branches last year. Unemployment will remain unchanged, although jobs will be lost in the public sector.

The updated convergence programme of the Hungarian government reckons with 2.8% GDP growth and a 4% public deficit/GDP ratio for 2008. The primary deficit of the general government is expected to turn into a small surplus. (Starting from 2008, the draft budget submitted to the parliament may not assume a primary deficit.) Public debt is expected to grow marginally, reaching 65.8% of the GDP. The targets envisaged by the government for the public finances are realistic, the general government deficit will probably be even slightly smaller than planned. Accelerating economic growth, continued ‘whitening’ of economic activities, and also the somewhat higher inflation than planned by the government will ensure sufficient revenues from taxes and charges. On the expenditure side, some one-off items which burdened the budget last year will not pop up in 2008. Hungary’s fiscal stance will not be essentially affected by the likely approval of the opposition’s request, to be put to referendum in early March, to abolish the hospital and doctor visit fees which were introduced as part of the budget consolidation package, and the university fees set to be introduced from September 2008. The items that will probably be lost on the revenue side can relatively easily be compensated for either on the revenue or the expenditure side of the budget. The real significance of the referendum, however, is not related to the budget. The opposition party FIDESZ, standing head and shoulders above the government parties in public opinion polls, views the referendum as a vote of confidence and puts the legitimacy of the government in question should the proposals be approved. That raises the danger of political turbulence in spring.

Unpopular reforms and reformers

While structural reforms in the health care and pension systems, in education and concerning local governments are of vital importance to ensure the consolidation of the budget in the medium and long run, major changes have been initiated in the health care system only. But, the reformed system (to be introduced in 2009), with intended partial involvement of private capital, is an unfortunate compromise reflecting the fundamental division between the governing socialists and the liberals as concerns the ideas about the role of the state and the private sector, respectively, in the reformed health care system. The government’s communication of the reform has been very poor as yet. The opposition attacks the reform with mostly populist criticism, without presenting a convincing alternative remedy. The government’s incapability to convince the population and the interest groups involved of the merits of the new system coupled with the opposition’s fruitless populism have created an embittered political climate in Hungary which threatens to block any further steps towards modernizing public finances.

The turmoil in international finances has had no considerable impact on the Hungarian economy. The absorption of the home-made shock created by the austerity package has as yet been a bigger challenge than facing the external effects. Hungary’s development in 2009 and 2010 will be strongly influenced by the general elections in spring 2010. The main (optimistic) scenario reckons with a return to higher growth and Maastricht-compatible fiscal and inflation indicators, as envisaged by the convergence programme. Alternatively, however, a pessimistic scenario may be looming: a return of populist economic policy measures and irresponsible promises prior to the elections and, thereafter, a new government in office being hostage to its own promises.

Table HU

Hungary: Selected economic indicators

	2002	2003	2004	2005	2006	2007 [1]	2008	2009	2010
								Forecast	
Population, th pers., end of period	10,142	10,117	10,098	10,077	10,066	10,046	.	.	.
Gross domestic product, HUF bn, nom. [2]	17,181	18,941	20,717	22,055	23,757	25,600	27,500	29,500	31,700
annual change in % (real) [2]	4.4	4.2	4.8	4.1	3.9	1.3	3.0	4.1	4.3
GDP/capita (EUR at exchange rate)	6,961	7,376	8,144	8,815	8,926	10,130	.	.	.
GDP/capita (EUR at PPP - wiiw)	12,580	13,110	13,670	14,390	15,260	15,870	.	.	.
Gross industrial production									
annual change in % (real)	2.8	6.4	7.4	7.0	9.9	8.1	8	10	12
Gross agricultural production									
annual change in % (real)	-4.1	-4.1	22.6	-9.5	-3.8	-16	16	5	5
Construction industry									
annual change in % (real)	17.5	2.2	6.8	18.8	-0.7	-10	10	5	10
Actual final consump.of househ,HUF bn,nom.[2]	11,348	12,920	13,863	14,911	15,743	16,700	.	.	.
annual change in % (real) [2]	9.9	7.9	2.8	3.6	2.0	-1.3	1	4	4
Gross fixed capital form., HUF bn, nom. [2]	3,958	4,177	4,651	5,017	5,155	5,460	.	.	.
annual change in % (real) [2]	10.2	2.2	7.6	5.3	-2.8	0.9	6.5	10	10
LFS - employed persons, th, avg.	3,871	3,922	3,900	3,902	3,930	3,926	.	.	.
annual change in %	0.1	1.3	-0.5	0.0	0.7	-0.1	.	.	.
Reg. employees in industry, th pers., avg. [3]	817.9	801.8	785.4	762.9	752.5	745	.	.	.
annual change in %	-1.9	-2.0	-2.0	-2.9	-1.4	-1.0	.	.	.
LFS - unemployed, th pers., average	238.8	244.5	252.9	303.9	316.8	312.0	.	.	.
LFS - unemployment rate in %, average	5.8	5.9	6.1	7.2	7.5	7.4	7.5	7.5	7.5
Reg. unemployment rate in %, end of period	8.0	8.3	9.1	9.3	9.1	9.5	.	.	.
Average gross monthly wages, HUF [3]	122,482	137,187	145,520	158,343	171,351	185,600	.	.	.
annual change in % (real, net)	13.6	9.2	-1.0	6.3	3.5	-5.5	.	.	.
Consumer prices, % p.a.	5.3	4.7	6.8	3.6	3.9	8.0	5.5	3.2	2.9
Producer prices in industry, % p.a.	-1.8	2.4	3.5	4.3	6.5	0.2	.	.	.
General governm.budget, EU-def., % GDP [4]									
Revenues	42.4	41.9	42.4	42.1	42.6	44.5	.	.	.
Expenditures	51.3	49.1	48.9	49.9	51.9	50.2	.	.	.
Net lending (+) / net borrowing (-)	-8.9	-7.2	-6.4	-7.8	-9.3	-5.7	-3.9	-3.0	-3.0
Public debt, EU-def., in % of GDP [4]	55.6	58.0	59.4	61.6	65.6	.	.	.	.
Base rate of NB, % p.a., end of period	8.5	12.5	9.5	6.0	8.0	7.5	.	.	.
Current account, EUR mn	-4,929	-5,933	-6,916	-6,013	-5,835	-4,700	-4,600	-4,500	-4,500
Current account in % of GDP	-7.0	-7.9	-8.4	-6.8	-6.5	-4.6	-4.2	-3.8	-3.5
Reserves total, excl. gold, EUR mn	9,887	10,108	11,671	15,678	16,349	16,330	.	.	.
Gross external debt, EUR mn	38,559	46,041	55,150	66,608	82,926	94,581 [IX]	.	.	.
Gross external debt in % of GDP	52.9	63.7	65.5	76.3	88.1	.	.	.	.
FDI inflow, EUR mn	3,185	1,888	3,633	6,172	5,680	3,000	4,000	5,000	5,000
FDI outflow, EUR mn	296	1,463	892	1,777	2,913	2,200	1,500	1,500	2,000
Exports of goods, BOP, EUR mn	36,821	37,907	44,779	50,120	59,079	68,530	76,800	86,000	96,300
annual growth rate in %	6.1	2.9	18.1	11.9	17.9	16	12	12	12
Imports of goods, BOP, EUR mn	39,024	40,805	47,232	51,610	60,001	67,200	74,600	82,800	91,900
annual growth rate in %	4.9	4.6	15.8	9.3	16.3	12	11	11	11
Exports of services, BOP, EUR mn	7,820	8,123	8,770	10,287	10,549	12,340	14,200	16,300	18,700
annual growth rate in %	-0.6	3.9	8.0	17.3	2.5	17	15	15	15
Imports of services, BOP, EUR mn	7,233	8,075	8,533	9,233	9,281	10,950	12,600	14,500	16,700
annual growth rate in %	16.6	11.6	5.7	8.2	0.5	18	15	15	15
Average exchange rate HUF/USD	258.00	224.44	202.63	199.66	210.51	183.83	.	.	.
Average exchange rate HUF/EUR (ECU)	242.97	253.51	251.68	248.05	264.27	251.31	252	251	250
Purchasing power parity HUF/USD	114.88	120.44	126.13	128.51	129.19	134.23	.	.	.
Purchasing power parity HUF/EUR	134.43	142.58	149.91	151.91	154.55	160.42	.	.	.

Note: The term "industry" refers to NACE classification C+D+E.

1) Preliminary and wiiw estimates. - 2) According to ESA'95 (from 2001 FISIM adjustment, estimate of illegal economy, real change based on previous year prices etc.) - 3) Enterprises with more than 5 employees. - 4) According to ESA'95, excessive deficit procedure.

Source: wiiw Database incorporating national statistics; Eurostat; wiiw forecasts.