Sándor Richter

Hungary:
little manoeuvring room to cope with the recession

In early summer 2009 Hungary features an economy sliding into recession, a new government with a rescue package for a period less than a year and minimum popular support and, finally, an extremely strong parliamentary opposition on the threshold of taking over the political power. The latter has no (revealed) idea how it wants to cope with the crisis once in office.

On 14 April the Hungarian parliament elected Gordon Bajnai for Prime Minister in the course of a constructive vote of no confidence against Ferenc Gyurcsány. Mr. Gyurcsány had to go because in the wake of the mounting economic difficulties related to the global financial crisis he did not manage to gain support in his own (Socialist) party for a second round of austerity measures, unavoidable for securing the support of the IMF (plus European Commission and World Bank). In the current situation the IMF stand-by credit is indispensable for rolling over the country's external debt and thus preserving Hungary's solvency.

Mr. Bajnai's main task is to accommodate the fiscal policy to the changed conditions. The stand-by agreement with the IMF signed last November still reckoned with a GDP decline of less than 1%. However, along with the continuous and increasing deterioration of the international environment and of the growth prospects of the main trading partners, first of all Germany, it has become obvious that Hungary with its shrinking domestic *and* external demand will suffer a much stronger GDP decline than previously assumed. With the recession-related decline of the general government revenues and the unchanged level of expenditures, the targeted deficit for 2009 (2.5% of GDP in the original stand-by agreement, later revised to 2.9%) proved impossible to be achieved without immediate fiscal policy steps.

The first set of measures was approved by the parliament on 11 May. These include, among others, the abolition of the 13th month pension, a pension indexation which follows only the inflation, and the gradual raising of the retirement age from 62 to 65 years. Sickness allowance is reduced from 70% to 60% of the salary. In the field of taxation the standard VAT rate will be increased, as of 1 July, from 20% to 25%. Social security contributions paid by employers are reduced by 5 percentage points. The personal income tax brackets are changed so that more people will be covered by the lowest (18%) tax rate. There are plans to introduce a tax on real estate from next year onwards. These measures are supplemented by government decisions to freeze nominal wages for two years and skip the 13th month salary in the public sector, simultaneously with the abolition of the preferential (state-supported) financing of housing credits.

These measures are primarily expected to decrease fiscal expenditures. The secondary goal is to increase revenues from taxes on consumption which ought to draw on the huge unreported personal incomes. At the same time reported personal incomes are relieved through widening the lower personal income tax bracket. The planned tax on real estate follows the same philosophy, as luxury housing is the most frequent spending target of owners of unreported incomes. A further goal is to maintain employment and thus stimulate economic growth (or at least diminish its decline) by reducing the tax burden on labour.

Given the latest official GDP forecast revisions (6.7% decline this year, 0.9% in 2010) the earlier set 2.9% deficit target became unrealistic. This was acknowledged by the IMF and the European Union in the course of the last review of the IMF stand-by agreement in mid-May. A raising of the general government deficit target from 2.9% to 3.9% of the GDP in 2009 was approved, next year the budget deficit is required to be diminished only by a symbolic 0.1 percentage point to 3.8% of the GDP. This means that the fiscal policy can be somewhat less pro-cyclical in 2009 and 2010 than it would have been in the case of the former deficit target.

Both the monetary authorities and the government made serious efforts to prevent financial intermediation from collapsing. Several measures were taken to ensure liquidity of the banking system. Of the funds provided by the IMF-led international consortium, more than EUR 2 billion was earmarked for actions to bail out the banking system (guarantees, recapitalization). Relying on this source, the government offered recapitalization for the Hungarian banks. Less than happy with allowing more state influence, the banks did not want to make use of this opportunity, except for one bank, FHB. Other banks (MKB, Raiffeisen) received capital injections from their mother companies, the only significant domestic-owned bank, OTP, is in negotiations about a capital injection in the form of a subordinated loan from the EBRD. The government has introduced four new programmes and has eased the conditions of some existing ones to provide additional funds for the banking system so that it can refinance corporate loans. Other measures, through providing subsidies on interest or guarantee schemes, turn the conditions on banks' existing offers more favourable. These programmes are focused on small and medium-sized enterprises. The new funds to refinance banks' corporate loans originate mainly from EU sources: Hungarian government budget financing is used for guarantees and interest subsidies. With the help of government guarantees the commercial banks may reschedule credits for selected households indebted either in forint or foreign exchange (eligible are debtors who have lost their job after 30 September 2008).

In order to stimulate investment the government initiated a programme for the construction industry. This consists primarily of EU Structural and Cohesion Fund co-financed projects whose implementation will be accelerated. The government provides advance payments for the investors between 25% and 40% of the investment value. Unjustified delay of due disbursements of EU funds for investors will be penalized. Lack of advance payments and delays in payments have both been important bottlenecks in the realization of EU co-financed projects, thus these measures will indeed create additional demand for this and the next year compared to the earlier situation.

The monetary policy has other considerations than boosting domestic demand. On 22 October last year the central bank raised the policy rate by 300 basis points to 11.50% as an immediate reaction to the weakening of the exchange rate and the drying out of the market for Hungarian government securities. More than half a year later the policy rate stands at 9.50%, still 100 basis points higher than before the upward jump in October 2008. This rate is exceptionally high in the NMS. With regard to the extreme volatility of the exchange rate[1] the policy rate will probably be cut only cautiously in the second half of the year, maintaining the exceptionally restrictive monetary environment for borrowers in forint. This is coupled with much stricter conditions for loans. It is not surprising then that banks' lending activity has dropped, simultaneously with the strong decline in demand for credits. The net change in loans for non-financial enterprises was negative in the last quarter of 2008 and the first quarter of this year. By denomination, lending in forint declined while in the case of loans denominated in foreign exchange only the increment became smaller. For households the net increase of loans decelerated to less than one third of the pace characterizing the first half of 2008. At the end of March 2009 the share of forex loans in total loans amounted to 68%, 10 percentage points more than last September.

In the first quarter of 2009 the GDP contracted by 6.7%. Contrary to 2007 and 2008 when Hungary's growth performance was substantially weaker than that of the other new EU member states, the county's 'contraction performance' is comparable to the respective indicators of Slovenia, Slovakia and Romania, the shooting stars of the region less than a year ago. With fiscal stabilization underway in Hungary also the gap in the general government deficit compared to other NMS will be closed by the end of the year.

First quarter data about the final use of the GDP show that the 6-7% decline was nearly uniform in household consumption and investment. There was a much stronger decline in inventories. Public consumption, however, remained unchanged. The gap between export and import growth rates widened to 3.4% percentage points, indicating a positive change in net exports. On the production side of the GDP the decline of value added in industry was strong, 20.5% in manufacturing. Construction and services contracted much less, by 4.2% and 3.2% respectively. Stagnating output in public services helped to dampen the overall decline.

Industrial sales declined at a substantially higher rate for exports than for the domestic markets (26.2% vs. 6.9%). The contraction was particularly strong (37.2%) in export sales of transport equipment. This industry alone has been providing more than a quarter of Hungarian industrial exports.

January-April foreign trade data reflect the shrinking foreign demand and the even more rapidly contracting demand for imports. In the first four months of 2009 exports declined by 29%, imports by 35%, the trade balance improved considerably (in euro terms, at current prices).

[1] In March the HUF/EUR rate weakened to a historical low of 316, then strengthened to below 290 by June.

The shrinking output is reflected in employment figures. In the first quarter of the year employment in the overall economy declined by 2.1%, in the business sector by 4.6%, in industry alone by 7.8%. The unemployment rate increased by 1.7 percentage points year on year, by the end of the year it may reach 10.5%.

Fiscal prudence, indispensable to restore the international investors' confidence, will diminish domestic demand both in 2009 and 2010. Foreign demand, assumed to bottom out in the second half of 2009 and to increase modestly in 2010, will thus determine the depth of the recession this and the next two years. Positive growth in Hungary can be expected only in 2011, when the fiscal consolidation has been completed and the world economy is assumed to have entered a new growth period. The downward growth risks are considerable yet. The output effects of the expenditure cuts may be larger than assumed, and foreign demand may remain depressed. Financial intermediation, though kept from collapsing, is far from functioning without frictions. Extremely high interest rates and surcharges related to the increased risks may block economic activities where short-term credits are of vital importance. In the worst-case scenario the GDP decline may be substantially stronger than the 6% to 7 % baseline scenario.

The IMF stand-by credit currently solves the rollover problem of public debt. Nevertheless, a return to market-based financing (issue of bonds denominated in forint and in foreign exchange) is a must. The government's austerity measures have prepared the ground for this and the first experimental placements are encouraging. Still, a resumption of full-scale market financing is dependent on external factors as well, such as the risk appetite of potential investors and yields on alternative investments. Last but not least the development of Hungarian domestic policy up to and after the general elections (to be held in Spring 2010 at the latest) is of critical importance.

Table HU

Hungary: Selected Economic Indicators

	2005	2006	2007	2008 1)	2008	2009	2009	2010	2011
					1st quarter		Forecast		
Population, th pers., average	10087.1	10071.4	10055.8	10037.6	10038	10023	.	.	.
Gross domestic product, HUF bn, nom. 2)	21993.1	23775.3	25479.4	26470.0	6102.7	5763.9	25900	26600	28200
annual change in % (real) 2)	3.9	4.0	1.2	0.5	1.8	-6.7	-6.5	-1.5	3
GDP/capita (EUR at exchange rate)	8800	8900	10100	10500	.	.	.	.	.
GDP/capita (EUR at PPP)	14200	15000	15600	15700	.	.	.	.	.
Consumption of households, HUF bn, nom. 2)	11764.0	12384.4	13225.9	13891.1	3351.8	3239.1	.	.	.
annual change in % (real) 2)	3.4	1.9	0.5	-0.5	0.6	-7.3	-7	-3.3	1
Gross fixed capital form., HUF bn, nom. 2)	5040.2	5130.8	5359.1	5343.1	936.1	904.7	.	.	
annual change in % (real) 2)	5.8	-3.7	1.8	-2.9	-5.1	-6.9	-9.5	-1	9
Gross industrial production 3)									
annual change in % (real)	6.9	10.0	8.2	-1.1	7.9	-22.4	-14	-2	10
Gross agricultural production									
annual change in % (real)	-7.1	-2.9	-11.3	27.3	.	.	.	.	.
Construction industry (build.& civil engin.) 3)									
annual change in % (real)	16.1	-1.5	-14.7	-5.2	-17.5	-4.5	-5	4	10
Employed persons - LFS, th, average	3901.5	3930.0	3926.2	3879.4	3844.2	3764.1	.	.	.
annual change in %	0.0	0.7	-0.1	-1.2	-1.6	-2.1	.	.	.
Unemployed persons - LFS, th, average	302.2	316.7	312.0	329.1	332.6	402.8	.	.	.
Unemployment rate - LFS, in %, average	7.2	7.5	7.4	7.8	8.0	9.7	10.5	11	10
Reg. unemployment rate, in %, end of period	9.3	9.1	10.1	10.8	10.5	12.8	.	.	.
Average gross monthly wages, HUF 4)	158343	171351	185017	198942	195331	195827	.	.	.
annual change in % (real, net)	6.3	3.5	-4.6	0.7	-1.1	-2.7	.	.	.
Consumer prices (HICP), % p.a.	3.5	4.0	7.9	6.0	6.9	2.7	4.7	4.3	3
Producer prices in industry, % p.a. 3)	4.7	6.5	1.9	5.6	4.5	7.6	.	.	.
General governm.budget, EU-def., % GDP 5)									
Revenues	42.3	42.7	44.8	46.5	.	.	.	.	.
Expenditures	50.1	51.9	49.7	49.8	.	.	.	.	.
Net lending (+) / net borrowing (-)	-7.8	-9.3	-4.9	-3.4	.	.	-4	-4	-3
Public debt, EU-def., in % of GDP 5)	61.7	65.6	65.8	73.0	.	.	.	.	.
Base rate of NB, % p.a., end of period	6.0	8.0	7.5	10.0	7.5	9.5	.	.	.
Current account, EUR mn 6)	-6655.0	-6857.0	-6511.0	-8865.0	-1602.9	-694.3	-3900	-3700	-4000
Current account in % of GDP	-7.5	-7.6	-6.4	-8.4	-6.8	-3.5	-4.4	-4.0	-3.9
Exports of goods, BOP, EUR mn 6)	49672.3	58381.0	68371.0	72259.0	18630.5	13682.3	61400	64800	71300
annual growth rate in %	11.6	17.5	17.1	5.7	15.1	-26.6	-15	5.5	10
Imports of goods, BOP, EUR mn 6)	51882.4	60433.0	68051.0	72159.0	18258.6	12997.3	60300	62700	69100
annual growth rate in %	9.5	16.5	12.6	6.0	12.7	-28.8	-16.5	4	10
Exports of services, BOP, EUR mn 6)	10351.2	10626.0	12443.0	13667.0	2838.2	2714.0	13000	13700	14800
annual growth rate in %	19.4	2.7	17.1	9.8	9.2	-4.4	-5	5	8
Imports of services, BOP, EUR mn 6)	9218.7	9376.0	11392.0	12755.0	2760.7	2576.7	11500	12100	13100
annual growth rate in %	12.6	1.7	21.5	12.0	13.5	-6.7	-10	5	8
FDI inflow, EUR mn 6)	6172.1	15991.0	52712.0	32869.0	6740.5	21.2	.	.	.
FDI outflow, EUR mn 6)	1755.5	15031.0	49248.0	30338.0	6794.2	411.6	.	.	.
FDI inflow, excl. SPE, EUR mn	6172.1	6024.0	4429.2	4405.5	822.3	535.7	2200	2500	4500
FDI outflow, excl. SPE, EUR mn	1755.5	3126.3	2728.8	1151.1	340.2	273.4	100	500	1000
Gross reserves of NB, excl. gold, EUR mn	15669.7	16383.5	16305.2	23806.5	16756.8	27821.2	.	.	.
Gross external debt, EUR mn 7)	66607.8	81428.1	98256.7	120858.2	103834.5	125388.8	.	.	.
Gross external debt in % of GDP 7)	76.6	86.2	97.8	121.8	104.6	142.8	.	.	.
Average exchange rate HUF/EUR	248.05	264.26	251.35	251.51	259.36	294.24	295	285	275
Purchasing power parity HUF/EUR	153.53	157.23	162.20	167.92	.	.	.	.	.

1) Preliminary. - 2) According to ESA'95 (FISIM adjusted and real change based on previous year prices). - 3) Quarterly data and forecasts according to NACE Rev. 2. - 4) Enterprises with more than 5 employees. - 5) According to ESA'95, excessive deficit procedure. - 6) From 2006 including Special Purpose Entities (SPE). - 7) Excluding SPE.

Source: wiiw Database incorporating Eurostat and national statistics. Forecasts by wiiw.