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Hungary:
the home-made and the imported crisis

After years of lax fiscal policy from mid-2001 to mid-2006, a period of painful corrections has since set in. In the framework of an austerity package, the Hungarian general government deficit was reduced from over 10% of the GDP to below 4% by summer 2008. As a consequence of shrinking domestic demand, economic growth decelerated to about 1% in 2007; however, GDP data for the first two quarters of 2008 already hinted at an incipient upturn in growth. Those and other data suggested that the Hungarian economy had managed to pull through the most painful stage of fiscal adjustment. Recovery, however, was rudely interrupted by the international financial crisis last autumn. Despite the progress Hungary had achieved in curbing fiscal deficits in both 2007 and 2008, the country's image as one of the most vulnerable emerging market economies has persisted. In the middle of October 2008, amidst the enormous volatility surrounding the forint exchange rate, the market for Hungarian government bonds dried up despite the sky-rocketing yields offered. Sovereign CDS spreads rose sharply. Owing to the dependence of the Hungarian economy on external financing to rollover its huge debt (public and private external debt amounted to 114% of the GDP at end-September 2008), the threat of insolvency loomed large. It was only averted with the help of a EUR 20 billion financial package (EUR 12.5 billion stand-by agreement with the IMF, EUR 6.5 billion from the European Union (EU) and EUR 1 billion from the World Bank).

The main conditionality of the stand-by agreement is the reduction of the general government deficit from about 3.4% of GDP in 2008 to 2.6% in 2009. The assumptions in the stand-by agreement relating to the macroeconomic framework are: 0.9% contraction of the GDP, 4.5% annual average consumer price inflation and a decrease of more than 4 percentage points in the current account deficit compared to 2008. It is also assumed that both external borrowing by the government and external lending to the business sector will slow down appreciably.

In the four months since the stand-by agreement was concluded on 4 November 2008, external conditions have changed considerably. The growth prospects of Hungary's main export markets in the EU, both old and new members, have radically deteriorated. With falling energy prices and deflationary pressures in Europe, the Hungarian inflationary outlook had to be corrected downwards. Those two factors mean that the macro-economic framework envisaged in the assumptions for the 2009 budget and the IMF stand-by agreement are no longer valid. The recession will be deeper and inflation lower.

In assessing developments for 2009, it is expedient to review individual elements of the GDP. In 2009, household consumption will be affected by declining real wages in both the business and public sectors; unemployment will increase; and credit will become more expensive and less readily available. Households with foreign exchange loans will have to reckon with a higher debt service in forint terms on account of a weaker exchange rate. Given the bleak outlook, households' propensity to save will most likely increase. Cuts in some social transfers cannot be excluded either, further to which a possible increase in the VAT rate may discourage consumption. The outcome may be a decline in household consumption of the order of 3% and 4%.

The investment outlook is bleak as well. Domestic demand is shrinking; the development of export markets is uncertain. On the financing side of investments, liquidity in the economy has generally shrunk and foreign investors cannot be counted on to provide substantial additional impetus. Profits will be lower, credits will be more expensive and conditionality stricter than before the crisis. The only expanding segment will be investment financed by EU transfers. This will accelerate as more and more commitments arising out of the 2007-2013 financial framework enter the implementation phase (roads, railway lines, schools, waste water treatment, logistics and tourism). The government has begun rearranging spending targets both across and within the operational programmes of the New Hungary Development Plan co-financed by the EU. Authorization procedures will be simplified and accelerated.

Net exports have become an important contributor to Hungarian economic growth ever since 2004. This year, they will be the only component in the GDP to contribute positively to a change in the GDP. Owing to the international crisis, both exports and imports are likely to contract; nevertheless imports will decline more rapidly than exports, as a consequence of the drop in domestic demand and lower energy prices. Although imports will decline in the main Hungarian export markets, the shrinkage of Hungarian exports may be proportionally less steep than the decline in imports in those markets. Over the past few years, Hungary has regularly managed to achieve export growth rates in its main foreign markets that were higher than these markets' overall import growth rates. Hungarian exports will be supported by the secondary effects of the counter-cyclical economic policy in the EU, primarily in Germany. This applies primarily to the automotive cluster. Exporters of both assembled cars and car components (such as engines produced for Audi, VW, Skoda and Seat models) may profit indirectly from the subsidies that the old EU member states are granting on the purchase of new cars. The automotive cluster accounts for roughly 20% of Hungary's exports.

In summary, a decline in consumption of about 3.5%, a drop in investment of about 5% and a somewhat more pronounced decline in imports (3%) than in exports (2%) may add up to a fall in the GDP of about 3% in 2009. In growth rate terms, that is equivalent to a deterioration of more than 3 percentage points compared to the previous year. Owing to all those uncertainties, this forecast is to be seen as the median value within a wide band of possible growth rates. In the ultimate analysis, real developments may culminate in a decline in GDP of up to 5%.

The government faces a triple challenge: immediate measures must be taken to ensure that the fiscal deficit corresponds to that agreed with the IMF; a boost will have to be given to domestic economic activities in order to minimize the recession; and reforms will have to be initiated to ensure the sustainability of fiscal improvements and lessen the employment-related tax burden on the business sector. All these problems will have to be solved by a minority government struggling with a considerable credibility deficit.

On 16 February 2009 the government presented in broad strokes a major package of tax reform. *In toto*, the re-arrangement will have to be of the order of 1000 billion forint, amounting to some 4% of the GDP. On the one hand, the economy is to be stimulated by reducing employers' social security contributions from 32% to 27%, increasing the number of those taxed by the lower personal income tax rate (which in turn will be raised from 18% to 19%), as well as by scrapping the 4% so-called 'solidarity tax' on businesses and those individuals in the highest tax bracket. On the other hand, additional budget revenue will be generated by raising the VAT rate from 20% to 23% and slashing tax concessions. Corporate tax will be raised from 16% to 19%. Changes in government spending will impinge in part on social and welfare expenditure with the purpose to make them more focused on the really needy recipients. For the recipients, those transfers will be added to other income and taxed accordingly. In the course of this process, however, the position of those in the lowest income group will not worsen.

Besides curbing recession, the government will have other headaches this year. The IMF stand-by agreement expires in March 2010, by which time at the latest Hungary must have secured the external financing required to service the public debt. The question is when will the government be in a position to start issuing new government bonds once again – and on what terms. Another important issue is to ensure the continuous financing of the corporate sector. This will necessitate sufficient forex liquidity of the Hungarian banks. This will be largely determined by the behaviour of foreign mother companies (80% of the banks are foreign owned), availability of resources from other international creditors and the central bank's ability to set conditions which help ease the bottlenecks. A possible failure in this field poses one of the main risks for a deeper than the currently forecast recession.

In order to follow world-wide trends of low policy interest rates and depart from the currently very high real interest rates, the Monetary Council has already begun its cycle of interest rate cuts following the 300 basis point increase in October 2008. The prime rate, however, is still very high (9.5% in the third weak of February). In the very first days of February, the forint exchange rate dropped to 300 HUF/EUR, in concert with the weakening of the region's other currencies. A permanently weak forint might help the exporters of products with relatively low import content, yet it would impose inordinately on those households with foreign currency debts owing to the large debt-servicing burden in forint terms.

The forecasts for 2010 and even more so for 2011 are extremely uncertain. 2010 is an election year in Hungary; this usually bears detrimental consequences for the budget. This time, the conditions set by the IMF will hopefully not permit any new fiscal escapades. Under favourable external circumstances, modest economic growth may be recorded, based on a slight expansion in each of the main components of the GDP. Although it is assumed that growth will accelerate in 2011, the country will not return to the 4% growth path that it left in 2007 in that year either.

Table HU

Hungary: Selected Economic Indicators

	2003	2004	2005	2006	2007	2008 [1]	2009	2010 Forecast	2011
Population, th pers., average	10129.6	10107.1	10087.1	10071.4	10055.8	10037.6	.	.	.
Gross domestic product, HUF bn, nom. [2]	18914.9	20695.4	21997.4	23785.2	25419.2	26800	26400	27600	29300
annual change in % (real) [2]	4.2	4.8	4.0	4.1	1.1	0.3	-3	1.4	3
GDP/capita (EUR at exchange rate)	7400	8100	8800	8900	10100	10600	.	.	.
GDP/capita (EUR at PPP)	13100	13700	14200	15000	15600	15700	.	.	.
Consumption of households, HUF bn, nom. [2]	10232.2	10965.8	11764.0	12384.4	13263.7	.	.	.	.
annual change in % (real) [2]	8.3	2.5	3.4	1.9	0.7	0	-3.5	0.5	2
Gross fixed capital form., HUF bn, nom. [2]	4163.5	4649.4	5173.5	5130.8	5343.7	.	.	.	
annual change in % (real) [2]	2.2	7.9	8.5	-6.2	1.5	-2.5	-5	2	5
Gross industrial production									
annual change in % (real)	6.4	7.4	6.9	10.0	8.2	-1.1	-5	4	8
Gross agricultural production									
annual change in % (real)	-7.1	24.1	-7.1	-2.9	-11.3	26.2	-10	0	2
Construction industry (build.& civil engin.)									
annual change in % (real)	1.9	5.8	16.1	-1.5	-14.7	-5.1	0	4	10
Employed persons - LFS, th, average	3921.9	3900.4	3901.5	3930.0	3926.2	3879.4	.	.	.
annual change in %	1.3	-0.5	0.0	0.7	-0.1	-1.2	.	.	.
Unemployed persons - LFS, th, average	244.5	252.9	302.2	316.7	312.0	329.2	.	.	.
Unemployment rate - LFS, in %, average	5.9	6.1	7.2	7.5	7.4	7.8	9	8.8	8
Reg. unemployment rate, in %, end of period	8.3	9.1	9.3	9.1	10.1	10.2	.	.	.
Average gross monthly wages, HUF [3]	137187	145520	158343	171351	185017	200000	.	.	.
annual change in % (real, net)	9.2	-1.0	6.3	3.5	-4.6	1.0	.	.	.
Consumer prices (HICP), % p.a.	4.7	6.8	3.5	4.0	7.9	6.0	3	3	3
Producer prices in industry, % p.a.	2.4	3.5	4.7	6.5	1.9	5.6	.	.	.
General governm.budget, EU-def., % GDP [4]									
Revenues	42.0	42.6	42.3	42.6	44.9	45.8	.	.	.
Expenditures	49.1	48.9	50.1	51.9	49.8	48.9	.	.	.
Net lending (+) / net borrowing (-)	-7.2	-6.4	-7.8	-9.3	-4.9	-3.1	-2.9	-2.7	-2.3
Public debt, EU-def., in % of GDP [4]	58.0	59.4	61.7	65.6	65.8	.	.	.	.
Base rate of NB, % p.a., end of period	12.5	9.5	6.0	8.0	7.5	10.0	.	.	.
Current account, EUR mn [5]	-5933.0	-7078.0	-6655.0	-6857.0	-6307.0	-6500	-4500	-5500	-5700
Current account in % of GDP	-8.0	-8.6	-7.5	-7.6	-6.2	-6.1	-4.9	-5.5	-5.1
Exports of goods, BOP, EUR mn [5]	37906.9	44506.7	49672.3	58381.0	68371.0	72800	71300	74900	82400
annual growth rate in %	2.9	17.4	11.6	17.5	17.1	6.5	-2	5	10
Imports of goods, BOP, EUR mn [5]	40804.5	47369.2	51882.4	60433.0	68051.0	71790	69600	72700	80000
annual growth rate in %	4.6	16.1	9.5	16.5	12.6	5.5	-3	4.5	10
Exports of services, BOP, EUR mn [5]	8122.5	8671.5	10351.2	10626.0	12443.0	13640	13400	14100	15200
annual growth rate in %	3.9	6.8	19.4	2.7	17.1	9.6	-2	5	8
Imports of services, BOP, EUR mn [5]	8074.6	8187.7	9218.7	9376.0	11392.0	12540	12300	12900	13900
annual growth rate in %	11.6	1.4	12.6	1.7	21.5	10.1	-2	5	8
FDI inflow, EUR mn [5]	1887.5	3633.3	6172.1	15991.0	34515.0	.	.	.	.
FDI outflow, EUR mn [5]	1463.3	892.1	1755.5	15031.0	31254.0	.	.	.	.
FDI inflow, excl. SPE, EUR mn	1887.5	3633.3	6172.1	6024.0	4372.8	2500	1500	2500	3500
FDI outflow, excl. SPE, EUR mn	1463.4	892.1	1755.5	3126.3	2764.8	500	300	500	1000
Gross reserves of NB, excl. gold, EUR mn	10098.0	11669.0	15669.7	16383.5	16305.2	23979.0	.	.	.
Gross external debt, EUR mn	46041.1	55150.1	66607.8	81428.1	98265.9	122000	.	.	.
Gross external debt in % of GDP	63.9	65.5	76.6	86.2	98.1	120.7	.	.	.
Average exchange rate HUF/EUR	253.62	251.66	248.05	264.26	251.35	251.51	290	275	260
Purchasing power parity HUF/EUR	142.58	149.88	153.53	157.23	162.20	170.23	.	.	.

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

1) Preliminary and wiiw estimates. - 2) According to ESA'95 (FISIM adjusted and real change based on previous year prices). - 3) Enterprises with more than 5 employees. - 4) According to ESA'95, excessive deficit procedure. - 5) From 2006 including Special Purpose Entities (SPE).

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