HUNGARY: At the turning point of the business cycle

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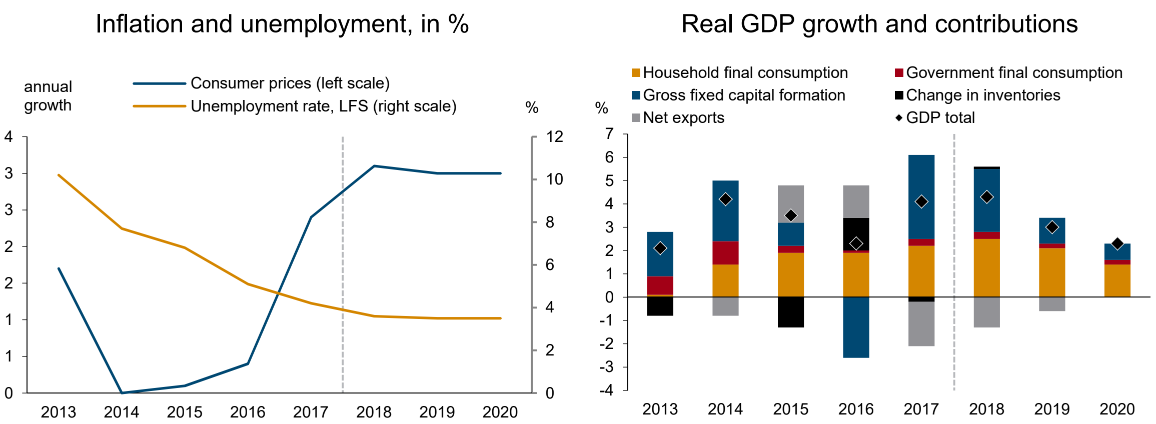
The Hungarian economy expanded by 4.8% in Q2 of 2018, reaching the zenith of the current business cycle. Growth has been driven by the extraordinarily rapid utilisation of EU cohesion policy resources. This high growth rate cannot be sustained in the next three years. A sharp decrease in EU transfers from next year on will remove an important driver of growth and there is no comparable substitute for that in sight.

Figure 43 / Hungary: Main macroeconomic indicators



Source: wiiw Annual Database incorporating national and Eurostat statistics, own calculation. Forecasts by wiiw.

The Hungarian economy expanded by 4.8% in the second quarter of 2018, probably reaching the zenith of the current business cycle. GDP growth in the first half-year was 4.6% higher than in the respective period of the previous year. GDP production-side data show how tightly the growth has been related with the extraordinarily rapid utilisation of EU cohesion policy resources. Value added increased by a moderate 3.5% in industry and 3.2% in agriculture but by 24% in the construction industry, a sector closely related to EU co-financed projects. Services became a major driver of growth (4.3%) with retail trade, tourism and catering as top performers. Characteristically, value added in public administration, education, health and social services stagnated. On the utilisation side of the GDP, household consumption expanded dynamically by 5.6% in the first half-year and gross fixed capital formation by 15.8%. Nevertheless a slowdown of expansion can be observed both in consumption and investment in the second quarter compared to the first. The same is true for public consumption.

The one-sidedness due to accelerated utilisation of EU financing is clearly visible from detailed investment data. While investment slightly decreased in manufacturing and agriculture in the first half-year, it increased by 76% in public administration and defence and compulsory social security. Investment in transportation and storage also increased by above-average rates. Business sector investment expanded by 10% in Q2 while the respective growth rate was 44% in the public sector.

The growth rate of exports has lagged behind that of imports. The volume of export sales in industry (64% of all sales) increased by 1.9% while that of domestic sales (36% of all sales) grew by 6.1%. These data reflect the fact that the strongly export oriented automotive sector is experiencing a temporary slowdown, related to model changes. The labour productivity of industrial enterprises with 5 or more employees rose by 0.2% along with a 3.6% increase in the number of employees.

The central bank reckons on reaching the medium-term inflation target (3% +/- 1pp tolerance band) in a sustainable manner from mid-2019. September inflation amounted to 3.6% with the core inflation being lower at 2.4%. The relatively high growth of the consumer price index (CPI) was caused primarily by high fuel and unprocessed food prices. Inflationary pressure from wages was found by the central bank to be moderate. True, part of the increased household earnings was already paid before but was not reported (‘whitening’ of the economy) and an increasing share of household incomes finances housing expenditures which are not included in the price index calculations. The central bank wishes to maintain loose monetary conditions for some time yet. The main risks are a weakening exchange rate and an unfavourable change in the international environment.

Hungarian Prime Minister Viktor Orbán’s conflict with the EU reached a new level on 12 September. The European Parliament (EP) voted to initiate disciplinary action against Hungary over alleged breaches of the EU's core values, including the rule of law and freedom of the media and NGOs, as well as an insufficient fight against corruption. This is a first step in a lengthy process which may lead, if approved unanimously by the European Council (which seems highly unlikely at present) to the suspension of the voting rights of Hungary.

The EP decision may have far reaching consequences for the country. Hungary, a major beneficiary of the EU’s cohesion policy transfers, has already allocated nearly all of its available resources from the 2014-2020 financial framework. It paid enormous sums in the form of advance payments to recipients of such transfers in forint, financed from the central government budget. The underlying concept has been that transfers from the EU budget will arrive sooner or later and will counterbalance the huge (cash based) budget deficit that has been accumulated due to the accelerated advance payments. However, the respective transfers from the EU budget have already been delayed with the consequence that, as at the end of August, only 13% of the already disbursed advance payments from the national budget had been covered by transfers from the EU budget. After the EP approval of the Sargentini report, where corruption is one of the major issues, the resolution of pending cohesion policy transfer cases, which are frequently caused by irregularities being found, may become even slower. This is an additional problem for the anyhow strained (cash based) budget. Related to the increasing tension in the budget, the government ordered an immediate reduction in the rate of advanced payment from 50% to 25% for beneficiaries in the business sector and local government sector. Public sector (central government) beneficiaries still receive 50% advanced payment.

Increased conditionality in the EU budget beyond 2020 may see Hungary receive less money. In the initial discussion on the next 2021-2027 multiannual financial framework of the EU, the European Commission proposed the introduction of a new conditionality for the availability of cohesion policy transfers related to the rule of law in the individual Member States. From the first appearance of the proposal a fierce debate has raged over how non-compliance with the rule of law can be 'measured'. The decision of the European Parliament has now delivered a precedent for identifying such non-compliance in a Member State. The loss of all or a substantial part of its cohesion policy resources may seriously curb economic growth in Hungary as these resources are estimated to have amounted to 3-4.5% of Hungarian GDP in recent years and they have had a decisive influence on investment activities in general, and on public investment in particular.

The Hungarian government also received a warning from the EU recently. On 18 September the European Commission (EC) warned the government for the second time to 'correct the significant observed deviation from the adjustment path toward the medium-term budgetary objective'. The medium-term budgetary objective (MTO) is tied to the structural budget deficit (it is the difference between government revenues and expenditures corrected by the effects that could be attributed to the economic cycle and one-off events). The structural balance in 2017 deteriorated to -3.1% of the GDP from -1.8% in 2016. Hungary is now expected to implement changes in order to comply with the MTO, i.e. achieving, in the medium term, a structural deficit amounting to a maximum of -1.5% of GDP. The extent of the adjustment suggested in 2018 was originally set by the EC at 1.5pp of GDP, but then lowered to 1 percentage point.

The high rate of economic growth (4.3%) forecast for this year will most probably not be attained in the next three years. A sharp decrease of available EU financing from next year on and the uncertainties about the next MFF will remove an important driver of growth for a relatively long period, and there is no comparable substitute for this chunk of aggregate demand in sight. Monetary policy cannot be looser than it is now and fiscal policy has no reserves for jumping in to fill the gap. Concerning investment, the EUR 1 billion greenfield FDI initiated by the German car manufacturer BMW to build a new plant in Debrecen will give a boost to the economy, but in general FDI's role in the economy remains far away from earlier peaks. An upturn in corporate lending is encouraging but that too still remains far from its potential. Labour shortage will not ease and imported labour from abroad is blocked by ideological reasons. Raising wages will become increasingly difficult to cope with primarily by small and medium-sized Hungarian-owned firms.

Table 18 / Hungary: Selected economic indicators

	2014	2015	2016	2017 [1]	2017	2018	2018	2019	2020
					January-June		Forecast		
Population, th pers., average	9,866	9,843	9,814	9,784	.	.	9,750	9,720	9,700
Gross domestic product, HUF bn, nom.	32,583	34,379	35,474	38,355	17,853	19,506	41,300	43,900	46,400
annual change in % (real)	4.2	3.5	2.3	4.1	4.0	4.7	4.3	3.0	2.3
GDP/capita (EUR at PPP)	18,800	19,800	19,700	20,500	.	.	.	.	.
Consumption of households, HUF bn, nom.	15,875	16,428	17,033	18,281	8,887	9,636	.	.	.
annual change in % (real)	2.8	3.9	4.0	4.7	4.3	5.6	5.2	4.5	3.0
Gross fixed capital form., HUF bn, nom.	7,223	7,744	6,961	8,528	3,626	4,420	.	.	.
annual change in % (real)	12.3	4.7	-11.7	18.2	22.6	15.8	12.0	5.0	3.0
Gross industrial production									
annual change in % (real)	7.6	7.4	0.9	4.7	5.3	3.5	4.0	5.0	6.0
Gross agricultural production									
annual change in % (real)	11.4	-2.4	9.3	-5.2	.	.	.	.	.
Construction industry									
annual change in % (real)	13.6	3.0	-18.9	29.7	27.7	19.1	.	.	.
Employed persons, LFS, th, average	4,101	4,211	4,352	4,421	4,394	4,455	4,470	4,490	4,490
annual change in %	5.3	2.7	3.4	1.6	2.1	1.4	1.2	0.5	0.1
Unemployed persons, LFS, th, average	343	308	235	192	202	172	170	160	160
Unemployment rate, LFS, in %, average	7.7	6.8	5.1	4.2	4.4	3.8	3.6	3.5	3.5
Reg. unemployment rate, in %, eop	8.9	7.6	6.1	5.6	6.1	5.2	.	.	.
Average monthly gross wages, HUF [2]	237,695	247,924	263,171	297,017	290,344	324,408	332,300	359,400	381,300
annual change in % (real, gross)	3.2	4.4	5.7	10.3	10.0	9.2	8.5	5.0	3.0
Average monthly net wages, HUF [2]	155,690	162,391	175,009	197,516	193,078	215,731	220,900	238,900	253,400
annual change in % (real, net)	3.2	4.4	7.4	10.3	10.0	9.2	8.5	5.0	3.0
Consumer prices (HICP), % p.a.	0.0	0.1	0.4	2.4	2.4	2.4	3.1	3.0	3.0
Producer prices in industry, % p.a.	-0.3	-1.1	-1.7	3.3	3.2	4.4	4.2	3.0	3.0
General governm.budget, EU-def., % of GDP									
Revenues	46.8	48.1	44.8	44.3	.	.	47.5	47.7	47.7
Expenditures	49.4	50.0	46.5	46.3	.	.	49.5	50.0	50.4
Net lending (+) / net borrowing (-)	-2.6	-1.9	-1.7	-1.9	.	.	-2.0	-2.3	-2.7
General gov.gross debt, EU def., % of GDP	76.6	76.6	75.9	73.3	.	.	73.3	71.5	71.0
Stock of loans of non-fin.private sector, % p.a.	-0.3	-12.3	-1.3	5.5	2.3	8.6	.	.	.
Non-performing loans (NPL), in %, eop	16.7	13.6	9.3	5.3	6.7	4.1	.	.	.
Central bank policy rate, % p.a., eop [3]	2.10	1.35	0.90	0.90	0.90	0.90	1.00	1.50	2.00
Current account, EUR mn [4]	1,587	3,127	7,071	3,947	2,401	1,613	3,200	3,600	3,900
Current account, % of GDP [4]	1.5	2.8	6.2	3.2	4.2	2.6	2.5	2.7	2.8
Exports of goods, BOP, EUR mn [4]	73,826	78,477	80,106	85,566	43,089	45,719	89,400	93,900	98,600
annual change in %	5.1	6.3	2.1	6.8	8.0	6.1	4.5	5.0	5.0
Imports of goods, BOP, EUR mn [4]	71,701	74,425	75,482	83,662	41,623	45,108	88,700	94,000	99,000
annual change in %	7.2	3.8	1.4	10.8	12.3	8.4	6.0	6.0	5.3
Exports of services, BOP, EUR mn [4]	18,727	20,229	22,114	23,746	11,278	11,788	24,600	25,800	27,300
annual change in %	10.2	8.0	9.3	7.4	9.2	4.5	3.5	5.0	6.0
Imports of services, BOP, EUR mn [4]	14,120	15,302	15,338	16,394	7,919	7,927	16,400	17,100	18,000
annual change in %	6.7	8.4	0.2	6.9	8.9	0.1	0.1	4.0	5.0
FDI liabilities, EUR mn [4]	7,134	6,966	-6,158	6,546	3,488	2,248	5,000	.	.
FDI assets, EUR mn [4]	4,186	5,753	-8,467	4,911	3,804	1,972	5,000	.	.
Gross reserves of NB excl. gold, EUR mn	34,481	30,226	24,384	23,261	23,353	23,955	.	.	.
Gross external debt, EUR mn [4]	121,129	119,339	110,637	104,941	111,139	105,322	107,000	105,000	101,000
Gross external debt, % of GDP [4]	114.8	107.6	97.1	84.6	89.6	81.6	82.9	78.2	71.8
Average exchange rate HUF/EUR	308.71	310.00	311.44	309.19	309.47	314.09	320	327	330

1) Preliminary. - 2) Enterprises with 5 and more employees. - 3) Base rate (two-week NB bill). - 4) Excluding SPE.

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