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Hungary: beginning of budget consolidation

On 10 June Ferenc Gyurcsány, the prime minister of the re-elected socialist liberal government, announced a package of measures in order to curb the fiscal deficit and restore the credibility of Hungarian economic policy. The measures are intended to put an end to the irresponsible economic policy that has been pursued since 2000. Over one and a half election cycles (2000-2006), public finances have been misused for political purposes through excessive public spending.

Between 2000 and 2005 the debt of the general government increased by 87%, while the (nominal) GDP grew by 66% only, and the gap may have widened further in the first half of 2006. Close to two thirds of the debt increment are explained by central government deficits; deficits of the social security funds account for one quarter, while the rest is explained by other factors, such as taking over credits from off-budgetary institutions or handing over government securities without being paid for them. This is partly related to investments in the state railway company and highway construction. Although only a small portion of public debt falls on local governments (2.2% of the GDP in 2005), the increase of that debt has been huge (187%) since 2000. The reliability of fiscal planning in the period concerned was extremely weak. The law on the annual budget was amended several times in each year between 2000 and 2005. The responsibility for the fiscal mismanagement is shared by all political parties which participated in both the conservative (Orbán) and the socialist-liberal (Medgyessy and Gyurcsány) governments in office in the past six years.

The prelude to the 10 June announcement of the package of measures had been the prime minister's confession a few days earlier that the 2006 general government deficit target (4.7% of the GDP) could not be attained. Without immediate measures it would amount to 9.5%, with the help of the correction announced it will make up 8% of the GDP in 2006. This is in sharp contradiction to the repeated declarations of the minister of finance – prior to the elections – about the sustainability of the original deficit.

The government's package envisages an improvement by HUF 350 billion in the fiscal balance this year and an additional HUF 1000 billion in 2007 and 2008 each. This should help cut the general government deficit from 8% of the GDP in 2006 to about 5% in 2007 and somewhat below 3% by the end of 2008. The announced measures refer to the remaining months of 2006 and to 2007; those planned for 2008 have not been announced. Half of the deficit reduction in 2006 is intended to be attained through more revenue, the other half via less expenditure, while in 2007 the increase in revenue should make up 60%, expenditure cuts only 40% of the balance improvement.

The proposed corrective measures will affect three groups. First, as part of the political marketing, the government starts saving in its own ranks. The staff of the ministries will be reduced by a quarter, their operational costs will be cut, reserves of the budget will be frozen. The 19 traditional regional administrative units (counties) are planned to be replaced by 7 regions, which also are better compatible with EU financing for regional policy. Local governments' activities will be streamlined.

The second group targeted consists of the business sector and well-to-do strata of the population. All firms and entrepreneurs will pay a 4% solidarity tax levied on pre-tax profit, de facto raising the corporate income tax rate to 20% from the current 16%. Employees with more than about EUR 2000 monthly gross earnings will also have to pay the 4% solidarity tax on that part of their earnings that exceeds EUR 2000, topping the 36% personal income tax rate. The rate of the simplified entrepreneurial tax for small enterprises will be raised to 25% from the current 15%. The abolishment of the health care contribution paid by the employers will be postponed. Cash held at firms will be taxed. Interest income and stock exchange gains will be taxed with a 20% rate except for long-term government securities. Fringe benefits in kind for managers will be taxed with a higher rate than currently. A tax on real estate of higher than 'average' value is planned, without closer specification so far. A special sub-package will address undeclared incomes. Loss-reporting firms avoiding the payment of corporate income tax will have to pay a tax charged on 2% of their net turnover, according to the corporate income tax rate. Assets held illegally abroad may be repatriated at a preferential tax rate. Finally, simultaneously with an amnesty for tax evasion in the case of voluntary reporting up to the end of 2006, a much stricter control over personal incomes was announced, which will be implemented through the comparison of reported incomes with accumulated wealth.

The bulk of the burden, however, will fall on the broader public, the third group targeted. The 15% VAT key will be raised to 20%, leading to price rises primarily of food, public transport, utilities and energy. Subsidies on gas and electricity prices will be radically cut, with partial compensation for the most needy households. Due to changes in the regulation of the sale of pharmaceutical products, prices of the latter will go up as well. Individual and employees' social security contributions will be raised. The excise tax on alcoholic beverages, except for wine, will be raised.

The programme is hardly more than a collection of restrictive measures, except for the changes in the field of regional and local governance. The promised fundamental reforms in health care, education and the amendment of the recently introduced pension reform are not addressed in the announced programme, but later in June elements of the higher education reform were made public and reconciliation on scenarios for the health care reforms began. Nevertheless, the changes in the decision-making structure of the government may be regarded as preparatory steps for far-reaching reforms. First, the

number of ministries was reduced from 17 to 12; at the same time the ministerial competencies were curtailed. Public investment strategic concepts, primarily those related to EU financing, will be elaborated by the National Development Council, decisions will be implemented by the Development Cabinet, both institutions newly established in Hungary. The management and financing of several operational activities of the ministries were taken over by the third new institution, the Centre of Government Services. Finally, a fourth new institution, the State Reform Committee, was called into being as a think tank for the preparation of reforms in the public sector. The changes represent an unprecedented centralization of the executive power in the hands of the prime minister. These steps may be seen as an attempt by prime minister Gyurcsány to minimize the ministries' ability to resist reforms and to increase efficiency in the utilization of resources from the EU, which has been low as a consequence of the permanent struggle among the various ministries for more influence and resources.

The most important question in the short run is whether the measures are sufficient to restore fiscal policy credibility. The reception has been mixed so far with criticism from the market that the government should have put more emphasis on expenditure cuts and less on revenue increases, as the latter decrease competitiveness and the balance improving effects may not prove lasting. No panic sales of the Hungarian currency occurred, but the forint/euro rate weakened, in several stages, to over 284 by the end of June from a range of 260-265 in April and May and 250-255 in the first quarter of this year.

The announced economic policy measures will put the Hungarian economy on a lower growth path. Domestic demand will decline sharply; as a consequence, the GDP growth rate, a healthy 4.6% in the first quarter of this year, will fall below 4% by the last quarter of 2006. The real impact will be felt in 2007. The government reckons with a growth rate of about 2.5% for 2007 and with a return to higher (4%) growth in 2008. The programme foresees that CPI inflation (2.8% in May 2006, year-on-year) will rise to 5% in 2007 (annual average) and that real wages, growing by 5.7% in the first quarter of this year, will stagnate in both 2007 and 2008.

There are significant uncertainties regarding the future (short-term) path of the economy. The extent of the contraction of domestic demand cannot be exactly predicted. The tax burden on enterprises will grow, the cost of labour will rise, the room for 'creative book-keeping' will become narrower. Household consumption may be affected not only due to stagnating real wages but also due to the probably increasing propensity to save. However, a substantial jump in EU transfers from 2007 on will inject additional demand corresponding to 1-1.5 percentage points of the GDP, softening the demand-side shock to some extent. The range for our GDP growth rate forecast for 2007 is wider than in other years and can be put between 1.5% and 3%. Inflation will strongly depend on how the forint/euro rate will develop. By the end of 2006, year-on-year inflation may go up to 4%,

and the officially expected 5% inflation in 2007 should be seen as the lower end of a 5-7% range. Should the market find the government programme credible and the international environment develop favourably for emerging markets, the forint/euro exchange rate may range around 275 in the second half of 2006 and in 2007. Limited credibility plus a continuation of the deterioration in the international environment for emerging markets may lead to stronger depreciation of the forint.

The impact on the external equilibrium will result from contradicting forces. As concerns trade, the growth of imports will be slowed down due to hardly expanding consumption and the weaker forint. In January-April 2006 exports increased more dynamically (15.5%) than imports (14.1%), despite the 3% deterioration of the terms of trade. On the one hand, the weaker forint will support, at least in the short run, a further expansion of exports; on the other hand, it is an open question to what extent higher tax burdens and rising labour costs will impede export growth. The income components of the current account may not improve in the short term. Altogether, in 2006 the current account deficit may remain at the level of the previous year. In 2007 it may decrease by close to one billion euro.

The schedule for the introduction of the euro has remained a key issue in restoring credibility. The government is planning to cut the fiscal deficit to the level corresponding to the Maastricht criterion by 2008, but – apart from the feasibility of that target itself – the fulfilment of the inflation criterion by that time is highly questionable. Prime minister Gyurcsány has hinted at a possible postponement of the current 2010 target date by one year to 2011, but the decision is still pending. This question will have to be answered, at the latest, by September 2006, when the revised convergence programme must be presented to the EU. Nevertheless, the credibility of the correction measures would require a clear statement about the government's intentions much earlier than that.

All in all, the new Hungarian government got down to work to break the vicious circle of 'political' economy determined by populism and election cycles in Hungary. However, there is still a long way to go to restored credibility and a properly functioning system of public finances and it is an open question whether the international environment, currently changing to the worse, will allow a 'soft landing' for Hungary.

Table HU

Hungary: Selected economic indicators

	2001	2002	2003	2004	2005 ¹⁾	2005 1st quarter	2006	2006 forecast	2007
Population, th pers., end of period	10174.9	10142.4	10116.7	10097.5	10077.0	10089	10074	10060	10040
Gross domestic product, HUF bn, nom. ²⁾	14989.8	16915.3	18650.7	20429.5	21802.6	4968.6	5198.8	23500	25500
annual change in % (real) ²⁾	4.3	3.8	3.4	5.2	4.1	3.2	4.6	4.0	2.3
GDP/capita (EUR at exchange rate) ²⁾	5732	6853	7263	8031	8714	.	.	.	.
GDP/capita (EUR at PPP - wiiw) ²⁾	11640	12510	12890	13630	14260	.	.	.	.
Gross industrial production									
annual change in % (real)	3.6	2.8	6.4	7.4	7.3	1.9	12.9	9	8
Gross agricultural production									
annual change in % (real)	15.8	-4.1	-4.5	22.8	.	.	.	.	.
Construction industry									
annual change in % (real)	7.7	17.5	2.2	6.8	16.6	9.1	7.9	.	.
Consumption of households, HUF bn, nom. ²⁾	7816.9	8904.2	10066.3	10814.6	11676.7	2702.5	2842.3	.	.
annual change in % (real) ²⁾	6.1	11.0	8.4	3.6	1.7	0.5	2.6	1.9	0.5
Gross fixed capital form., HUF bn, nom. ²⁾	3499.7	3941.5	4156.0	4631.2	5057.0	798.3	904.6	.	.
annual change in % (real) ²⁾	6.0	10.2	2.9	8.0	6.6	6.8	9.7	9	5
LFS - employed persons, th, avg.	3868.3	3870.6	3921.9	3900.4	3901.5	3870.6	3885.3	.	.
annual change in %	0.3	0.1	1.3	-0.5	0.0	-0.5	0.4	.	.
Reg. employees in industry, th pers., avg. ³⁾	833.9	817.9	801.8	785.4	762.7	772.1	751.9	.	.
annual change in %	-1.3	-1.9	-2.0	-2.0	-2.9	-2.2	-2.6	.	.
LFS - unemployed, th pers., average	234.1	238.8	244.5	252.9	303.9	297.4	323.6	.	.
LFS - unemployment rate in %, average	5.7	5.8	5.9	6.1	7.2	7.1	7.7	7.9	8.5
Reg. unemployment rate in %, end of period	8.0	8.0	8.3	9.1	9.4	10.0	9.6	.	.
Average gross monthly wages, HUF ³⁾	103553	122482	137193	145521	158315	160014	171723	.	.
annual change in % (real, net)	6.4	13.6	9.2	-0.7	6.2	9.8	5.7	.	.
Consumer prices, % p.a.	9.2	5.3	4.7	6.8	3.6	3.6	2.5	3.5	6
Producer prices in industry, % p.a.	5.2	-1.8	2.4	3.5	4.3	4.0	4.7	5.7	7
General governm.budget, EU-def., % GDP ⁴⁾									
Revenues	44.7	43.7	43.4	44.1	44.5	.	.	.	.
Expenditures	48.2	52.0	49.8	49.5	50.7	.	.	.	.
Deficit (-) / surplus (+) ⁴⁾	-3.5	-8.4	-6.4	-5.4	-6.2	.	.	-8	-5
Public debt, EU-def., in % of GDP ⁴⁾⁵⁾	52.2	55.0	56.7	57.1	58.4	.	.	.	.
Refinancing rate, % p.a., end of period	9.8	8.5	12.5	9.5	6.0	7.8	6.0	.	.
Current account, EUR mn	-3576.5	-4929.2	-6381.7	-6975.7	-6524.9	-1461.7	1442.4	-6400	-5600
Current account in % of GDP	-6.1	-7.1	-8.7	-8.6	-7.4	-7.2	7.1	-7.4	-6.0
Reserves total, excl. gold, EUR mn	12163.7	9887.4	10108.3	11670.9	15678.4	13222.7	17781.0	.	.
Gross external debt, EUR mn	37387.0	38559.3	46041.1	55062.4	66259.3	58613.2	72089.5	.	.
FDI inflow, EUR mn	4390.7	3185.1	1887.5	3754.0	5214.7	1042.5	2009.7	4000	4000
FDI outflow, EUR mn	398.5	295.7	1463.4	894.4	1031.0	411.0	320.5	1000	1000
Exports of goods, BOP, EUR mn	34697.1	36820.7	38376.9	45083.0	49805.0	11126.5	13297.9	57300	65900
annual growth rate in %	10.9	6.1	4.2	17.5	10.4	8.3	19.5	15	15
Imports of goods, BOP, EUR mn	37192.8	39024.1	41274.5	47536.2	51414.5	11405.1	13600.3	58600	66500
annual growth rate in %	7.9	4.9	5.8	15.2	8.2	6.7	19.2	14	13.5
Exports of services, BOP, EUR mn	7864.7	7820.0	7673.8	8659.8	9921.1	2180.5	2116.7	11100	12430
annual growth rate in %	22.3	-0.6	-1.9	12.8	14.6	11.7	-2.9	12	12
Imports of services, BOP, EUR mn	6203.3	7233.1	8074.7	8532.5	9473.5	2079.8	2089.8	10230	11000
annual growth rate in %	19.4	16.6	11.6	5.7	11.0	7.8	0.5	8	8
Average exchange rate HUF/USD	286.54	258.00	224.44	202.63	199.66	186.98	211.53	.	.
Average exchange rate HUF/EUR (ECU)	256.68	242.97	253.51	251.68	248.05	245.10	254.40	270	275
Purchasing power parity HUF/USD	110.13	114.72	121.84	126.65	125.82	.	.	.	.
Purchasing power parity HUF/EUR	126.46	133.14	142.85	148.28	151.57	.	.	.	.

Notes: 1) Preliminary. - 2) From 2001 revised GDP data (FISIM adjustment). - 3) Enterprises with more than 5 employees. - 4) According to ESA'95, excessive deficit procedure. - 5) After corrections related to the pension reform.

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