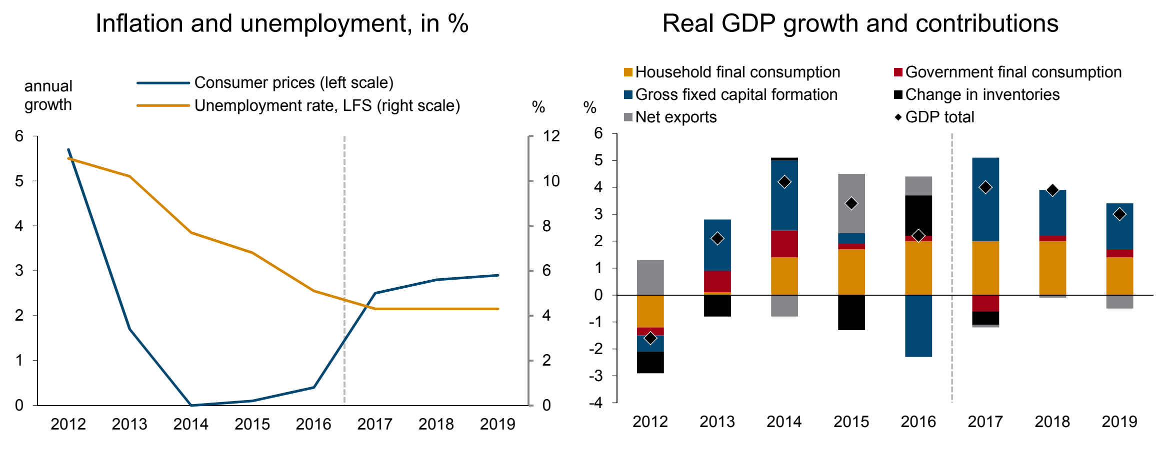
HUNGARY: Euro introduction is far far away

SÁNDOR RICHTER

Economic growth has accelerated compared to the previous year. The main drivers are investment and household consumption. The foreign trade balance started to deteriorate, but the trade surplus is still significant and will remain so over the forecast horizon. The sharp increase in wages will stimulate domestic demand, but productivity growth is lagging and may increasingly become a problem for firms, primarily for small and medium-sized enterprises. According to the Hungarian Central Bank, introduction of the euro will only be feasible if Hungary's per capita GDP and wages attain 90% of the EU average; this rules out euro adoption, even in the medium term.

Figure 37 / Hungary: Main macroeconomic indicators



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

Economic growth in the first half of 2017 has been substantially stronger than in the previous year, driven both by investment and consumption. Gross fixed capital formation shot up by 24.1%. This is primarily due to the boost in EU co-financed projects, more exactly the disbursement of advance payments from the central government budget for such projects. While this practice helped to revive investments from the 2016 depression caused by the cyclicality of the 2014-2020 financial framework of EU cohesion policy transfers, it may become a double-edged weapon. In the remaining part of the current seven-year financial framework, the 'cold turkey' effect may turn out to be much more severe than it was in 2016, diminishing aggregate demand in 2020-2022. Good news, however, is that not only

EU co-financed, mainly infrastructure projects thrive; investment in manufacturing increased by 16.6%, mainly in the computer and automobile clusters but also in nearly all sub-branches. New facilities for border protection and defence contributed to the investment boom as well. Despite the very strong expansion of gross fixed capital formation the investment rate (share in GDP) has just surpassed 20%, and is far below the 25% share which ensures sustainable longer-term economic growth. Due to a drop in inventories, gross capital formation expanded at a much slower pace than investments. Though the expansion of household consumption was also impressive, 4.1% in the first half of the year, it remained far below the growth rate of average real wages (10%). Government consumption declined, thus moderating the contribution of final consumption to growth.

The strong growth of investment and household consumption has been reflected in the foreign trade data. The gap between export and import growth rates (the latter being higher) increased to about two percentage points. That means that the trade surplus has begun to shrink; in January-July it was about one billion euro smaller than a year earlier (according to customs statistics). Even so it amounted to over EUR 5 billion. The current account surplus has diminished to a considerable extent as well. All in all, the contribution of net exports to growth was slightly negative.

After years of silence on the subject, the introduction of the euro has finally been addressed by the central bank. The Maastricht criteria are considered to be obsolete by the central bank, which elaborated its own system of criteria. According to this the Hungarian per capita GDP should first reach 90% of the EU level; the same applies to the level of wages. Currently per capita GDP is at 70% of the average EU level, according to wiiw, and the lag is even larger in the case of wages. Further, total liabilities & equity of the financial sector should approach 250% of the GDP, far beyond the current 90% level. Real-economy and financial cycles should move in a harmonised way with that of the eurozone. The efficiency of the SME sector, now at one third of the level of large enterprises, should improve to 50%. The participation rate should reach 65%, the unemployment rate should be around 4%. (This latter has already been achieved.) Concerning the fiscal stance, the structural balance should be around zero and the public debt to GDP proportion below 50%. Here there is still room for improvement. Thus, while some of the mentioned preconditions are not far from being met, the first two targets – per capita GDP and wages at 90% of the EU average – are set so high that euro introduction will be impossible even in the medium and long run, even if the pace of convergence to the core EU were to speed up to some extent. Meanwhile Slovakia, a country being a comparable regional peer to Hungary, performed spectacularly better than Hungary in terms of convergence despite having introduced the euro already in 2009 and not fulfilling many of Hungary's self-imposed conditions either currently or in the year of the euro introduction. These economic arguments, together with the political conflicts of the Hungarian government with the EU concerning its policy towards refugees and the rule of law, make it probable that Hungary will not join the group of the core EU Member States which endeavour a qualitatively closer cooperation following a series of recently proposed reforms.

Economic developments in this and the next year will be determined by the forthcoming elections and the accelerated investment activity financed to a large extent by EU transfers. The government will do everything possible to mobilise its potential voters and may go to the limits in government-financed projects, yet remaining within the 3% fiscal deficit/GDP threshold. That means that long-neglected areas like health and education may receive additional resources, beyond pointless prestige investments. A recovery of lending activity, both to households and the business sector, helps maintain the growth momentum.

The increasingly acute shortage of labour will drive the expansion of wages ways beyond the pace of GDP or productivity growth. This will maintain the dynamic increase of household consumption, but may increase inflationary pressure and adversely affect competitiveness. Investment, bouncing back in 2017 after a deep fall in the previous year, will level out at a relatively high level. In the medium term, beginning in 2019, the limits of the current growth path will be felt. Extremely rapid wage growth, which is partly driven by labour shortage, will prevail; however, profitability of the business sector will deteriorate as productivity cannot keep pace with that rate of wage growth, at least not in the SME sector and in most of the services sector. Labour shortages will continue to be a major obstacle to growth. According to official data there are 65,000 vacancies currently; according to expert estimations this number may be substantially higher. One of the solutions – to rely on imported labour – is no longer viable, at least in the short run, following the poisonous political campaign of the government against migrants. Programmes launched to encourage the return of recent Hungarian emigrants have had limited results as yet. In the medium term investments will be negatively affected by the artificially reinforced cyclicality described above. Uncertainties related to Brexit and consequently a possible reduction of cohesion policy related transfers add a new dimension to the existing problems. Last but not least, the growing isolation of Hungary (together with that of Poland) following from PM Orbán’s unstoppable inclination to provoke the EU delivers an additional element of risk related to the longer-term availability of EU support.

Table 12 / Hungary: Selected economic indicators

	2013	2014	2015	2016 1)	2016	2017	2017	2018	2019
					January-June			Forecast	
Population, th pers., average	9,893	9,866	9,843	9,814	.	.	9,780	9,750	9,720
Gross domestic product, HUF bn, nom. 2)	30,247	32,592	34,324	35,420	16,405	17,600	37,900	40,700	43,300
annual change in % (real)	2.1	4.2	3.4	2.2	2.0	3.6	4.0	3.9	3.0
GDP/capita (EUR at PPP)	18,000	18,800	19,900	19,800	.	.	.	.	.
Consumption of households, HUF bn, nom. 2)	15,311	15,874	16,377	17,020	8,316	8,856	.	.	.
annual change in % (real)	0.2	2.8	3.6	4.2	5.0	4.1	4.2	4.2	3.0
Gross fixed capital form., HUF bn, nom. 2)	6,308	7,223	7,525	6,812	2,541	3,273	.	.	.
annual change in % (real)	9.8	12.3	1.9	-10.6	-15.8	24.1	16.0	9.0	8.7
Gross industrial production									
annual change in % (real)	1.1	7.7	7.4	1.0	2.0	5.6	6.0	7.0	6.0
Gross agricultural production									
annual change in % (real)	12.5	11.4	-2.3	8.7	.	.	.	.	.
Construction industry									
annual change in % (real)	8.4	13.5	3.0	-18.8	-25.4	26.9	.	.	.
Employed persons, LFS, th, average	3,893	4,101	4,211	4,352	4,302	4,394	4,440	4,460	4,460
annual change in %	1.7	5.3	2.7	3.4	3.5	2.1	2.0	0.5	0.0
Unemployed persons, LFS, th, average	441	343	308	235	253	202	200	200	200
Unemployment rate, LFS, in %, average	10.2	7.7	6.8	5.1	5.6	4.4	4.3	4.3	4.3
Reg. unemployment rate, in %, eop	9.3	8.9	7.6	6.1	6.5	6.1	.	.	.
Average monthly gross wages, HUF 3)	230,714	237,695	247,924	263,171	258,003	290,344	288,600	314,500	333,300
annual change in % (real, gross)	1.7	3.2	4.4	5.7	5.7	7.4	7.0	6.0	3.0
Average monthly net wages, HUF 3)	151,118	155,690	162,391	175,009	171,573	193,078	195,500	217,100	232,300
annual change in % (real, net)	3.1	3.2	4.4	7.4	7.5	10.0	9.0	8.0	4.0
Consumer prices (HICP), % p.a.	1.7	0.0	0.1	0.4	0.2	2.4	2.5	2.8	2.9
Producer prices in industry, % p.a.	0.6	-0.4	-0.9	-1.7	-1.8	3.1	3.0	3.0	3.0
General governm.budget, EU-def., % of GDP									
Revenues	46.6	46.7	48.0	45.1	.	.	47.9	47.5	47.7
Expenditures	49.1	48.7	49.6	46.9	.	.	50.4	50.4	50.4
Net lending (+) / net borrowing (-)	-2.5	-2.1	-1.5	-1.8	.	.	-2.5	-2.9	-2.7
Public debt, EU-def., % of GDP	76.3	75.2	74.0	73.2	.	.	72.9	71.9	70.9
Stock of loans of non-fin.private sector, % p.a.	-4.4	-0.3	-12.3	-1.3	-5.8	2.3	.	.	.
Non-performing loans (NPL), in %, eop	18.1	17.4	13.6	8.9	.	.	.	.	.
Central bank policy rate, % p.a., eop 4)	3.00	2.10	1.35	0.90	0.90	0.90	0.90	1.30	1.50
Current account, EUR mn 5)	3,892	1,587	3,838	6,967	4,039	2,703	5,300	5,200	4,400
Current account, % of GDP 5)	3.8	1.5	3.5	6.1	7.7	4.8	4.3	4.0	3.2
Exports of goods, BOP, EUR mn 5)	70,243	73,826	79,638	80,188	40,002	44,696	88,200	97,000	104,800
annual change in %	0.4	5.1	7.9	0.7	1.9	11.7	10.0	10.0	8.0
Imports of goods, BOP, EUR mn 5)	66,912	71,701	75,236	75,482	37,060	42,503	84,500	94,600	104,100
annual change in %	-0.2	7.2	4.9	0.3	0.0	14.7	12.0	12.0	10.0
Exports of services, BOP, EUR mn 5)	16,993	18,727	20,289	21,659	10,242	10,741	23,300	25,000	26,500
annual change in %	5.8	10.2	8.3	6.8	7.2	4.9	7.5	7.5	6.0
Imports of services, BOP, EUR mn 5)	13,232	14,120	14,885	14,892	7,076	7,564	15,600	16,400	17,100
annual change in %	7.9	6.7	5.4	0.0	3.2	6.9	5.0	5.0	4.0
FDI liabilities, EUR mn 5)	4,986	7,134	6,667	-7,140	-8,622	3,168	5,000	.	.
FDI assets, EUR mn 5)	3,848	4,186	5,574	-9,052	-8,175	3,509	5,000	.	.
Gross reserves of NB excl. gold, EUR mn	33,696	34,481	30,226	24,384	24,668	23,353	.	.	.
Gross external debt, EUR mn 5)	119,963	121,129	118,613	109,411	116,536	109,435	107,000	105,000	103,000
Gross external debt, % of GDP 5)	117.7	114.7	107.1	96.2	102.5	89.2	87.2	80.7	75.4
Average exchange rate HUF/EUR	296.87	308.71	310.00	311.44	312.70	309.47	309	313	317

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

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