Sándor Richter

Hungary:
Gradual recovery amidst persistent uncertainties

The Hungarian economy shows clear signs of a modest recovery from the severe recession. In 2010 GDP growth accelerated from quarter to quarter, the annual growth rate is estimated to have surpassed 1%, a result which compares positively with the country's past performance but lags behind both the EU-15 average and the performance of Hungary's peers in the region.

The recovery has been driven by the robust export-based expansion of the manufacturing industry. Agriculture and construction still reported declines last year, services must have closed with zero growth. In manufacturing domestic sales still declined in 2010 while sales abroad increased by about 16%. The 'flagship' industrial clusters – computers, electronic and optical equipment and transport equipment – have been the engine of the expansion. The recovery has been 'jobless' so far, employment in industry even dropped last year while productivity improved considerably.

Prime Minister Orbán outlined ambitious goals for the economy when he took over office nine months ago: stimulation of growth through radical tax cuts, more and cheaper credits, focused national and EU co-financed support for the predominantly domestic-owned SME sector. The government reckons with 1 million new jobs within ten years, an accordingly elevated wage bill and consequently additional tax revenues. A new growth path (5-7% annually), substantially higher than the one that characterized the last decade, a reinforced middle class and a handful well-positioned Fidesz-friendly industrialists and bankers as well as a substantial reduction of the number of social transfer recipients would be the outcome of this policy. Yet the key problem of the Hungarian economy beyond the slow growth, namely the outstanding reforms of the inefficient and wasteful redistribution systems in the public sector, the main cause of the country's structural fiscal deficit, was completely ignored in the original programme.

A precondition for the good start of a programme such as this is the existence of a leeway in fiscal policy, since the initial budget deficit will grow due to tax reduction. The hoped-for positive impact on growth with newly generated additional revenues for the budget appears only with a time lag. Right after its inauguration the Orbán government made serious efforts to sell the idea of a 6-7% fiscal deficit (relative to the GDP) for 2010 instead of a less than 4% one as prescribed in the country's convergence programme and the stand-by agreement with the IMF and the EU. This attempt, with regard to Hungary's miserable pre-2006 track record concerning fiscal deficits, coupled with the Europe-wide panic last summer caused by the developments in Greece, did not have the smallest chance to come through with the EU or the IMF. At that point the government had two options: (a) either to retreat from the central element of its programme, postpone the radical tax reduction plans and focus the efforts on other components of the programme while continuing the fiscal consolidation launched by the previous governments in 2006-2009; or (b) to push through the tax reduction while observing the deficit targets of the convergence programme. This option necessitates the raising of new resources to make up for the gap emerging on the revenue side of the budget due to the radical tax reduction. Orbán's government decided for option (b); this decision has determined the developments since then.

In early 2011 the radical tax reduction is reality: the personal income tax with its 16% rate became 'flat' (earlier there had been two rates, 17% and 32%). The corporate tax rate for the SME sector was cut from 19% to 10%. Some other minor taxes were reduced as well. The other side of the coin: first, financial institutions were charged with a temporary levy, then specific temporary taxes were introduced for the largest (predominantly foreign-owned) firms of the energy, telecommunications and retail trade sectors. As a next step, 14 months' employee contributions to private pension funds (the second pillar of the pension system) were re-channelled to the central budget in order to cover current expenditures. Finally, the quasi nationalization of the accumulated private pension fund savings (about EUR 11 billion) was announced, with 26% of this sum to finance current budget expenditures this and the next year.

Leaving aside all the political and legal (Hungarian and EU) concerns – which are far from irrelevant – the main economic problem of this construction is that these elements of the fiscal revenues all are temporary. The taxes on the financial institutions and the other three sectors were promised to phase out from 2013 onwards. That part of the savings accumulated in the private pension funds which will not be re-channelled to the budget is planned to be used for the reduction of the public debt, therefore no further resources will be available from this segment. In contrast, the revenue-diminishing effects of the tax reduction remain, raising the danger of severe fiscal imbalances in the medium run.

The uncertainties about the medium-run fiscal outlook resulted in a downgrading of Hungary's sovereign debt to a level that is just one category better than 'junk'. The abolishment of the independent Fiscal Council critical to the government's fiscal policy did not reinforce confidence either. As a successful rolling-over of public debt is highly dependent on the sufficient purchase of government securities by international financial investors and the interest paid on public debt is of macroeconomic magnitude, it is no wonder that the government announced the elaboration of a fiscal consolidation programme to be presented in March this year. (See a first review of the programme at the end of this country report.) Should this programme leave the rating agencies and potential foreign buyers of Hungarian bonds unsatisfied, a major disruption in external financing of the public debt cannot be excluded.

The other pillar of Orbán's new economic policy, namely providing cheap and abundant credits for firms and households, faces resistance on the part of the (still) independent central bank. The Monetary Council, after a two-year long interest cutting cycle, raised the policy rate in three steps from 5.25% to 6% within a two-month interval (between 30 November 2010 and 25 January 2011). These decisions were explained by the higher than targeted inflation in 2010 (4.9%) caused by cost shocks through high prices of unprocessed food and oil, respectively, and the risk that inflationary expectations remain unanchored due to a prolonged period of above-target inflation. In March 2011 four of the currently seven members of the Monetary Council will be replaced by persons delegated by the Fidesz-dominated parliament. After this change, supporters of a cautious monetary policy may become a minority and, theoretically, this opens up the way for a monetary policy less dismissive towards the government's effort to enforce lower interest rates.

In recent months the forint has remained weaker as compared to the pre-crisis level. The real problem, however, is the appreciation of the Swiss franc, as in December 2010 over 60% of the foreign currency housing and consumer loans (stocks) was denominated in CHF. This is a serious concern for the households involved, as servicing of the debt requires a remarkably higher share of disposable incomes than before. Delayed payment and non-performance have been on the rise, causing problems both for the households which are in ever growing numbers qualified as not creditworthy and the lending financial institutions which face the challenge of a deteriorating quality of their credit portfolio.

In 2011 the Hungarian economy will finally leave recession behind. Household consumption will increase at a very moderate pace as the income tax reduction favours primarily well-to-do families whose motivation to increase consumption is limited, and about 60% of the households will have equal or less net income as compared to the situation prior to the tax reform. Further, higher debt service obligations of households indebted in foreign currency will pose a drag on the recovery of consumption. Investment will recover at a faster pace than consumption but from very low levels. This will be partly the result of huge investment projects in the automotive sectors, as Daimler-Benz, Audi and Opel are in the process of a remarkable extension of their production capacities in Hungary. However, FDI inflows this year will substantially lag behind the pre-crisis level and, more importantly, the respective figures in the Czech Republic, Poland and Slovakia. This relatively poor performance is, without doubt, at least partly the consequence of the new specific taxes. These policies, together with the related rhetoric, as well as the uncertainties concerning the phasing-out of these taxes, may all have played a role. It must be added that the treatment of the private pension funds, the curtailment of rights of the Constitutional Court with regard to public finance, how severance payments in the public sector were retroactively taxed, have all weakened confidence in the legal stability. Another channel for foreign resources will, however, gain importance: increased (compared to 2010) transfers from the budget of the European Union will help fixed investment recovery.

The highest contribution to GDP growth will again come from net exports in 2011. The extent of this contribution will be smaller than in the past two years as the gap between export and import growth rates has started to close in the wake of gradually recovering investment and, to a smaller extent, consumption. As a consequence, the exceptional situation in 2010 when Hungary closed the year with a current account surplus will not be repeated in the coming years. The outlook for 2012 and 2013 is extremely uncertain. While inertia alone would help the economy achieve a gradual acceleration of the current export-driven growth, uncertainties concerning the medium-run fiscal sustainability, the future monetary policy, and the country's attractiveness for foreign investors make the baseline scenario (displayed in detail in the country table) less robust than it usually is.

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On 1 March the Hungarian government announced its long-awaited plan for the fiscal consolidation in 2012-2013. This programme is a radical departure from the original Fidesz credo for an acceleration of economic growth without any regard to its price in terms of fiscal deficit and debt. From now on the new 'enemy of the people' is high public debt and the programme is set out to radically reduce it in the coming years.[1]

One component of the programme is a retreat from earlier planned measures: the extension of the 10% preferential corporate income tax rate for large enterprises was

[1] This approach is practically identical with that of the second Gyurcsány and the Bajnai governments (summer 2006 to spring 2010) mercilessly attacked by the then opposition Fidesz.

discarded, the phasing-out of the bank levy in 2012 was postponed. A central element of the programme is to decrease the number of social transfer recipients: unemployment benefits will be provided for a shorter period, disability qualifications will be revised, access to early retirement will be abolished. The people dropping out from the here mentioned social transfer schemes are intended to be absorbed by public works programmes – whose details have yet to be elaborated. State support for pharmaceutical products will be cut, but it is not clear how the increased burdens will be shared between producers and consumers. The Hungarian Railway Company's debt will be consolidated and the company reorganized so that it can cope without subsidies in the future; the details are nevertheless again unknown. Further elements of the programme are merely vague plans: freezing overhead charges of households, cost reduction coupled with reforms in the education system, cuts in various segments of public expenditures. Compared with the baseline 2011 budget, the country's fiscal stance is envisaged to improve by 2% of GDP in 2012 and by an additional 1% in 2013. Public debt is expected to drop from around 80% in 2010 to around 69% by the end of 2013.[2]

All in all, the government programme is a resolute step towards addressing Hungary's medium-run fiscal problems. Despite its many unclear details it will be sufficient to maintain a central government deficit of around 3% of GDP in 2012 and 2013. The government's goal for those years (2.5% and 2.2% deficit, respectively) seems overambitious, as the underlying assumption of a GDP growth rate of 4% or more is unrealistic. The current state of the economy and the unavoidable fiscal consolidation will probably not allow for GDP growth higher than 3% in any of the two years.

[2] According to the Hungarian methodology, which is not identical with the Eurostat methodology used in the country table attached to this report.

Table HU

Hungary: Selected Economic Indicators

	2005	2006	2007	2008	2009	2010 [1]	2011	2012	2013
								Forecast	
Population, th pers., average	10087.1	10071.4	10055.8	10038.2	10022.0	10003	10002	10000	9998
Gross domestic product, HUF bn, nom.	21970.8	23730.0	25321.5	26753.9	26054.3	27400	28900	30700	32600
annual change in % (real)	3.1	3.6	0.7	0.9	-6.7	1.2	2.5	3	3
GDP/capita (EUR at exchange rate)	8800	8900	10000	10600	9300	9900	.	.	.
GDP/capita (EUR at PPP)	14200	14900	15500	16200	15300	15600	.	.	.
Consumption of households, HUF bn, nom.	11825.2	12495.5	13306.0	14091.9	13487.9	13700	.	.	.
annual change in % (real)	3.2	2.1	0.2	0.5	-8.1	-2	0.5	1.5	2.5
Gross fixed capital form., HUF bn, nom.	5065.9	5182.9	5408.3	5727.3	5441.6	5500	.	.	.
annual change in % (real)	6.5	-3.5	3.7	3.2	-9.3	-3	5	7	8
Gross industrial production									
annual change in % (real)	6.8	9.9	7.9	-0.2	-17.6	10.4	12	12	12
Gross agricultural production									
annual change in % (real)	-7.3	-3.0	-12.5	27.7	-10.1	-5.6	.	.	.
Construction industry									
annual change in % (real)	15.7	-0.7	-14.0	-5.2	-4.3	-8	5	10	10
Employed persons - LFS, th, average	3901.5	3930.0	3926.2	3879.4	3781.8	3780	3820	3860	3900
annual change in %	0.0	0.7	-0.1	-1.2	-2.5	0	1	1	1
Unemployed persons - LFS, th, average	302.2	316.7	312.0	329.1	420.7	480	.	.	.
Unemployment rate - LFS, in %, average	7.2	7.5	7.4	7.8	10.0	11	10.5	9.3	8.5
Reg. unemployment rate, in %, end of period	9.3	9.1	10.1	10.9	13.6	13.3	.	.	.
Average gross monthly wages, HUF [2]	158343	171351	185018	198741	199837	204000	.	.	.
annual change in % (real, net)	6.3	3.6	-4.6	0.8	-2.3	2.5	.	.	.
Consumer prices (HICP), % p.a.	3.5	4.0	7.9	6.0	4.0	4.7	3.9	3.5	3.5
Producer prices in industry, % p.a.	3.1	6.6	0.3	4.6	4.5	6.3	.	.	.
General governm.budget, EU-def., % GDP									
Revenues	42.3	42.6	45.0	45.1	46.1	46	.	.	.
Expenditures	50.2	52.0	50.0	48.8	50.5	50	.	.	.
Net lending (+) / net borrowing (-)	-7.9	-9.4	-5.0	-3.7	-4.4	-4	-3	-3	-3
Public debt, EU-def., in % of GDP	61.8	65.7	66.1	72.3	78.4	78.5	74	73	72
Central bank policy rate, % p.a., end of period [3]	6.00	8.00	7.50	10.00	6.25	5.75	.	.	.
Current account, EUR mn	-6710	-6829	-6965	-7747	-404	800	-1700	-2400	-2800
Current account in % of GDP	-7.6	-7.6	-6.9	-7.3	-0.4	0.8	-1.6	-2.1	-2.4
Exports of goods, BOP, EUR mn	49671	58378	68362	72684	58414	70700	78100	85900	94500
annual growth rate in %	11.6	17.5	17.1	6.3	-19.6	21	10.5	10	10
Imports of goods, BOP, EUR mn	52212	60840	68500	73233	55033	65500	71900	78400	85800
annual growth rate in %	9.6	16.5	12.6	6.9	-24.9	19	9.7	9	9.5
Exports of services, BOP, EUR mn	10351	10876	12574	13804	13285	14200	15300	16800	18500
annual growth rate in %	19.4	5.1	15.6	9.8	-3.8	7	8	10	10
Imports of services, BOP, EUR mn	9219	9643	11524	12843	11920	11900	12900	14200	15600
annual growth rate in %	12.6	4.6	19.5	11.4	-7.2	0	8	10	10
FDI inflow, EUR mn	6172	5468	2861	4926	1549	600	2000	.	.
FDI outflow, EUR mn	1756	3118	2646	2084	1726	800	1500	.	.
Gross reserves of NB, excl. gold, EUR mn	15670	16384	16305	23807	30648	33570	.	.	.
Gross external debt, EUR mn	71770	86681	103988	123537	135802	136000	.	.	.
Gross external debt, in % of GDP	82.6	92.0	104.2	123.1	140.9	138.0	.	.	.
Average exchange rate HUF/EUR	248.05	264.26	251.35	251.51	280.33	275.48	280	275	275
Purchasing power parity HUF/EUR	153.56	157.75	161.71	165.00	170.11	175.13	.	.	.

Note: Gross industrial production, construction output and producer prices refer to NACE Rev. 2.

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

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