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## **Hungary: shrinking deficits, lower growth**

Amidst the austerity measures introduced in the second half of 2006 and early 2007, economic growth continued its gradual deceleration that had started already in the first quarter of last year. The 2.7% expansion in the first quarter of 2007 is the weakest among the NMS-10. That growth slowdown represents the 'collateral damage' of the economic policy measures aimed at diverting Hungary from its mid-2001 to mid-2006 growth path that has led to unsustainable fiscal imbalances. Signs of a transition to a more balanced growth path are clearly visible: both the foreign trade and the budget deficits have been shrinking, and the HUF/EUR exchange rate, after volatilities and depreciation in 2006, returned to its longer-run level of 245-250 by April-May this year.

Taking advantage of the favourable external environment due to more robust EU growth in general and the upturn in Germany in particular, the highly specialized Hungarian industry managed to maintain its dynamic expansion. The 8.8% growth rate of industrial output in the first quarter disguises a stagnation of domestic sales and a 17% expansion of sales on foreign markets.

Exports have been the main engine of growth. In the first quarter of 2007 they expanded by 18.2%, in euro terms, 3.5 percentage points more rapidly than imports (customs statistics). The foreign trade deficit more than halved compared to the respective period of 2006.

According to investment statistics, in the first quarter investment in new assets recovered from the decline in the previous year, even if growth was marginal compared to the respective period in 2006 (gross fixed capital formation, a broader category used in national accounts, slightly declined). Due to the decelerating pace of highway construction and the decline in outlays for housing, construction-related investments dropped by 7.3% while investment in machinery and equipment increased by a spectacular 15.5%. The over 50% expansion of manufacturing sector investments is promising for the future.

As envisaged in the convergence programme, government consumption declined strongly, and consumption of households hardly changed in the first quarter, resulting in a 1.7% drop in total consumption.

Indicators for employment and wages reflect the impact of the government's efforts to reduce the fiscal deficit. The number of employed in the whole economy remained almost unchanged, with employment in the business sector increasing by 1.5% and that in the public sector (employing 27% of all employees in Hungary) declining by 4.2% in the first quarter. The gap between the incomes earned in the two sectors has been growing as

well. In the first quarter net earnings in the public sector decreased by 1.2%, while in the business sector they expanded by 2.6%. With unemployment unchanged, labour shortage in certain branches has become a problem. According to a recent survey 21% of firms employing more than 250 persons report difficulties in meeting their demand for labour. Skilled workers and engineers with foreign language skills are the most demanded professions.

Inflation accelerated in early 2007 and reached its climax in March with 9% (month to month) following considerable price rises for household energy, public transport and pharmaceutical products as a consequence of abolished or redesigned price subsidies for the products concerned. Price rises for food products were unexpectedly high. All in all consumer price inflation proved to be higher than envisaged in the convergence programme. The higher than expected CPI inflation along with a stronger than projected exchange rate allowed the Monetary Council to leave the base rate unchanged until 26 June, when it was reduced from 8% to 7.75%.

As a consequence of the first wave of austerity measures in the second half of 2006, the fiscal balance began to improve and the 2006 general government deficit/GDP ratio turned out to be less (9.2%) than predicted in the government's convergence programme (10.1%). That was the result of the strict observation of expenditure plans coupled with higher than forecasted revenues from various (partly new, partly raised) taxes and fees. As a result of more rigorous regulations and control a certain 'whitening' of the shadow economy has begun. In the first four months of 2007 the fiscal deficit continued to turn out better than planned. Helped by the somewhat higher than envisaged inflation, revenues from fees, indirect taxes and personal income taxes have been continuously higher than originally planned. Moreover, this year even expenditures (in healthcare) have so far been lower than foreseen in the convergence programme.

The fiscal deficit remains the key question of any forecast for Hungary in 2007. In earlier reports wiiw reckoned with a lower (6.5%) general government deficit/GDP ratio for this year than the government's target in the convergence programme (6.8%). In May the government revised its 2007 forecast for some macroeconomic indicators, among others for the fiscal deficit as well. The most recent target figure for the general government deficit/GDP ratio is 6.4%. Considering the higher inflation as well as the strong exchange rate and the lower yields that are expected to diminish interest expenditures, wiiw has marginally revised its forecast for the deficit/GDP ratio to 6.3%.

The decline in household consumption is expected to be smaller (wiiw forecast: 0.2%) than that foreseen in the May forecast of the government (0.6%). Though real household incomes will fall this year, we expect that households will response by 'smoothing' their consumption expenditures. This assumption is supported by the strong increase in

household credits in 2006 and in the first months of 2007. In the business sector an upturn in long-term credits in late 2006 hints at a turnaround in investments. High capacity utilization and lively foreign demand also support a moderate recovery of investment after the decline in 2006. The government's May forecast reckons with more dynamic growth of exports than that of imports, with the difference in the growth rates amounting to 2.6 percentage points. The wiiw forecast predicts that the gap between export and import growth rates will be bigger, 3.4 p.p., and as a consequence the balance of trade and services is assumed to close with a surplus this year. The wiiw sticks to its earlier GDP growth forecast of 2.7% for this year, that is 0.5 p.p. higher than the May forecast of the government (this target remained as originally set out in the convergence programme).

While meeting the 2007 general government deficit target seems to be secured, the consistent implementation of the government programme to reduce the deficit below 3% by 2009 is far from certain. The attainment of the deficit level needed to introduce the euro requires a series of structural reforms in the public sector. But in the past twelve months the popularity of the socialist-liberal government has dropped to a historical low, with all reforms, whether implemented or still in their planning stage, being in the continuous political crossfire of the opposition. Nevertheless, the main opposition party FIDESZ has cautiously avoided the presentation of an alternative programme for addressing the chronic ills of the public sector yet and sticks to its view that Hungary's problems can be solved without austerity measures. As the progress of reforms is slower than planned, the government tries to set limits to its own inclination to excessive spending. From 2008 no budget draft can be submitted to the parliament stipulating a primary deficit. Regulations still to be introduced will put a cap on ministerial expenditures for three years and ban the financing of the municipalities' operational costs from credit.

There is no new official target date for the introduction of the euro but the target itself has remained an anchor of economic policy for the medium run. There is a consensus among the political parties that Hungary needs the euro and that it should be introduced as soon as possible. A more exact schedule for the euro introduction will probably not be announced before 2008.

Table HU

## Hungary: Selected Economic Indicators

	2002	2003	2004	2005	2006 <sup>1)</sup>	2006	2007	2007	2008
						1st quarter		forecast	
Population, th pers., end of period	10142.4	10116.7	10097.5	10076.6	10064.0	10072	10059	10060	10060
Gross domestic product, HUF bn, nom. <sup>2)</sup>	17180.6	18940.7	20717.1	22055.1	23752.7	5143.2	5750.8	25800	27500
annual change in % (real) <sup>2)</sup>	4.4	4.2	4.8	4.1	3.9	4.9	2.7	2.7	3.1
GDP/capita (EUR at exchange rate) <sup>2)</sup>	6961	7376	8144	8815	8925	.	.	.	.
GDP/capita (EUR at PPP - wiiw) <sup>2)</sup>	12710	13230	13930	14690	16040	.	.	.	.
Gross industrial production									
annual change in % (real)	2.8	6.4	7.4	7.0	10.1	13.3	8.8	8	9
Gross agricultural production									
annual change in % (real)	-4.1	-4.5	22.9	-8.5	-2.9	.	.	.	.
Construction industry									
annual change in % (real)	17.5	2.2	6.8	18.8	-1.6	8.6	3.3	.	.
Consumption of households, HUF bn, nom. <sup>2)</sup>	9078.8	10232.2	11006.5	11835.6	12394.9	2872.9	3087.2	.	.
annual change in % (real) <sup>2)</sup>	10.6	8.3	2.9	3.7	1.4	2.6	0.6	-0.3	1
Gross fixed capital form., HUF bn, nom. <sup>2)</sup>	3958.3	4177.3	4650.7	5016.7	5185.8	897.4	957.0	.	.
annual change in % (real) <sup>2)</sup>	10.2	2.2	7.6	5.3	-2.1	9.9	-2.3	3	4
LFS - employed persons, th, avg.	3870.6	3921.9	3900.4	3901.5	3930.1	3885.3	3905.5	.	.
annual change in %	0.1	1.3	-0.5	0.0	0.7	0.4	0.5	.	.
Reg. employees in industry, th pers., avg. <sup>3)</sup>	817.9	801.8	785.4	762.9	752.2	751.9	748.4	.	.
annual change in %	-1.9	-2.0	-2.0	-2.9	-1.4	-2.6	-0.5	.	.
LFS - unemployed, th pers., average	238.8	244.5	252.9	303.9	316.8	323.6	316.3	.	.
LFS - unemployment rate in %, average	5.8	5.9	6.1	7.2	7.5	7.7	7.5	7.7	7.7
Reg. unemployment rate in %, end of period	8.0	8.3	9.1	9.3	9.2	9.6	10.3	.	.
Average gross monthly wages, HUF <sup>3)</sup>	122482	137187	145520	158343	171239	171796	183960	.	.
annual change in % (real, net)	13.6	9.2	-1.0	6.3	3.5	5.7	-7.0	-3	1
Consumer prices, % p.a.	5.3	4.7	6.8	3.6	3.9	2.5	8.5	7.0	3.5
Producer prices in industry, % p.a.	-1.8	2.4	3.5	4.3	6.5	4.7	3.5	5	4.5
General governm.budget, EU-def., % GDP <sup>4)</sup>									
Revenues	42.3	41.9	42.5	42.2	43.7	.	.	.	.
Expenditures	51.2	49.1	48.9	50.0	53.0	.	.	.	.
Deficit (-) / surplus (+)	-8.9	-7.2	-6.4	-7.8	-9.2	.	.	-6.3	-4.0
Public debt, EU-def., in % of GDP <sup>4)</sup>	54.0	58.0	59.4	61.7	66.0	.	.	.	.
Base rate of NB, % p.a., end of period	8.5	12.5	9.5	6.0	8.0	6.0	8.0	.	.
Current account, EUR mn	-4929.2	-5933.0	-6915.5	-6090.6	-5196.9	-1455.3	-1101.9	-4700	-4200
Current account in % of GDP	-7.0	-7.9	-8.4	-6.9	-5.8	-7.2	-4.8	-4.6	-3.8
Reserves total, excl. gold, EUR mn	9887.4	10108.3	11670.9	15678.4	16349.2	17781.0	16949.7	.	.
Gross external debt, EUR mn	38559.3	46041.1	55150.1	66239.6	82104.5	72395.7	86111.1	.	.
Gross external debt in % of GDP	54.5	61.6	67.0	74.6	91.3	.	.	.	.
FDI inflow, EUR mn	3185.1	1887.5	3633.3	6099.4	4874.2	2230.4	481.4	.	.
FDI outflow, EUR mn	295.7	1463.4	892.1	1874.5	2442.4	461.2	511.2	.	.
Exports of goods, BOP, EUR mn	36820.7	37906.9	44779.1	50119.9	58415.9	13474.4	16060.4	66300	74300
annual growth rate in %	6.1	2.9	18.1	11.9	16.6	19.3	19.2	13.5	12
Imports of goods, BOP, EUR mn	39024.1	40804.5	47232.3	51579.9	58833.1	13764.4	15932.1	64700	71200
annual growth rate in %	4.9	4.6	15.8	9.2	14.1	20.0	15.7	10	10
Exports of services, BOP, EUR mn	7820.0	8122.5	8769.5	10313.0	10676.3	2112.1	2539.3	11960	13400
annual growth rate in %	-0.6	3.9	8.0	17.6	3.5	-8.0	20.2	12	12
Imports of services, BOP, EUR mn	7233.1	8074.6	8532.5	9584.5	9657.7	2073.5	2399.2	10400	11200
annual growth rate in %	16.6	11.6	5.7	12.3	0.8	-3.7	15.7	8	8
Average exchange rate HUF/USD	258.00	224.44	202.63	199.66	210.51	211.53	192.61	.	.
Average exchange rate HUF/EUR (ECU)	242.97	253.51	251.68	248.05	264.27	254.40	252.35	251	250
Purchasing power parity HUF/USD	114.72	119.60	124.05	124.90	127.83	.	.	.	.
Purchasing power parity HUF/EUR	133.11	141.31	147.12	148.89	147.09	.	.	.	.

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

1) Preliminary. - 2) According to ESA'95 ( from 2001 FISIM adjustment, estimate of illegal economy, real change based on previous year prices etc.) - 3) Enterprises with more than 5 employees. - 4) According to ESA'95, excessive deficit procedure.

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