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Hungary:
Efforts to get released from the excessive deficit procedure

The Hungarian economy re-entered recession in 2012; the vision to put the economy to a new growth path with a growth rate of 5% to 7% has given way to a bitter struggle to keep the general government deficit below 3% of the GDP in order to get released from the excessive deficit procedure. Despite an improvement in important fiscal indicators, Hungary's position has remained fragile, as an important part of the improvement is due to temporary consolidation measures and not to genuine reforms.

The Hungarian economy re-entered recession in 2012: the GDP declined by 1.7%. Data from the past five years show that Hungary cannot close the gap that opened up in the wake of the crisis. Compared to the levels in the last pre-crisis year (2008), household consumption was by 11%, investment by 27% lower in 2012. The Visegrad region peers performed much better in the period concerned (see Table 1).

Table 1

Comparison of pre-crisis and 2012 consumption and investment levels of the Visegrad countries

	Consumption		Investment	
	2008	**2012**	**2008**	**2012**
Hungary	100	89	100	73
Czech Republic	100	99	100	88
Poland	100	109	100	108
Slovakia	100	98	100	95

Source: wiiw Database.

The vision to turn the Hungarian economy into a 'fairy tale' (a formulation invented by the Minister of Economy, György Matolcsy) with a growth rate of 5% to 7% coupled with a high degree of independence from multilateral institutions (EU, IMF) and foreign capital (except for investors operating in manufacturing) has given way to a bitter struggle to keep the general government deficit below 3% of the GDP in order to get released from the excessive deficit procedure in June this year. This is indispensable for securing the continuous flow of Cohesion Fund transfers from the EU budget, a vital source of investment amidst scarce alternative sources.

In 2012 household consumption decreased in accord with the pace of GDP decline. This is no surprise in view of the real wage drop of 3.4% and the high debt service payments of households indebted in foreign exchange (forex). The strong decline in investment is explained by 'hibernated' financial transmission in the country and diminishing opportunities for public investment as a consequence of successive waves of fiscal consolidation. For the business sector the uncertainties due to erratically changing regulatory environment and taxation rules in the past two years along with depressed domestic demand and, finally, the slowdown in export expansion gave enough reason for caution concerning investment decisions. The share of gross fixed investment in the GDP fell below

17%. Net exports still provided a positive contribution to GDP change, just as in the previous years, but that was insufficient to compensate the decline in other components of the GDP.

The sunny side of the Hungarian economy, the good export performance, has been waning: exports sales of industry slightly decreased in 2012. While exports of the automotive cluster, providing one third of manufacturing exports, sustained their momentum with an 11% expansion, foreign sales of the other 'flagship cluster' – that of computer, electronic and optical equipment delivering traditionally about one fifth of manufacturing exports – dropped by 17%. Two other major branches of the economy performed poorly as well: Agriculture suffered a severe double-digit decline, and the performance of the construction sector dropped by 6%. The former was related mostly to unfavourable weather, the latter to falling investments.

The unemployment rate has hardly changed while significant rearrangement has taken place in the labour market. The employment rate increased last year, but this is principally due to an upturn in public work. Employment dropped both in the business sector and in the public sector without the so-called public workers – those who are obliged to participate in public work programmes in order to remain eligible for the welfare transfers (the provision of unemployment benefits was cut to 3 months).

In early 2012 the weak exchange rate of the forint, high CDS spreads and yields on government bonds put an agreement with the EU/IMF tandem about a financial assistance programme on the agenda. Through postponing the start of the negotiations again and again the government managed to preserve its prioritized independence from external influence on its economic policy. By the end of 2012 ample liquidity on the international markets and the increased risk appetite of international investors resulted in lower yields on HUF-denominated government bonds and in a stronger forint. This situation allowed the revolving of public debt, primarily through issuing forint-denominated bonds (about 44% of forint-denominated bonds are held by non-residents). In early 2013 first attempts to return to the international markets with forex-denominated bonds via the state-owned Eximbank proved to be successful. On 12 February the Government Debt Management Agency successfully placed 5- and 10-year USD-denominated government bonds in the value of EUR 2.5 billion. The yield on the 5-year bond was by 335 basis points over the corresponding US Treasury yields, that on the 10-year bond by 345 basis points. Direct sale of forex-denominated bonds to residents (EUR 1 billion, for institutional investors and households) started with remarkable success. These steps were sufficient to cover more than half of the sum to be raised in 2013 to ensure the refinancing of mature foreign exchange-denominated public debt.

In 2013 the general government balance remains in the focus of the economic policy. At least until the decision on whether Hungary will be released from the excessive deficit procedure, the government must maintain the impression that the 3% deficit threshold will be observed this and in the coming two years as well. That will not be easy with regard to the several uncertainties in the 2013 budget. The hoped-for revenues from the electronic road toll and from measures to diminish tax evasion may be significantly delayed or may not materialize at all. The sector-specific tax imposed on the telecom sector may be qualified as invalid by the European Court of Justice and the government may be compelled to pay back the whole sum collected up until now. These factors and a substantially slower GDP growth rate than the assumed 0.9% used while planning the budget create risks on the revenue side of the budget, amounting to more than 1% of the GDP. That means that on top of the 2012 restrictions, additional measures may become necessary later this year to observe the 3% deficit target. These considerations are also reflected in the most recent forecast of the European Commission on Hungary's budget deficit (3.4% of GDP this and the next year).

All that must be seen in the context of the forthcoming elections in early 2014. The government has already began with 'mood improving' steps: gas, electricity and district heating prices were reduced by 10% for households. Further similar steps to diminish various public utilies prices for households were mentioned as being under consideration. Though the government expects that the distributor companies will bear the burdens of this decision, the secondary exposure of non-household customers is unclear. Election cookies were promised for the single biggest block of voters, the pensioners, too. With regard to these uncertainties, improvised and poorly planned and implemented fiscal measures will most probably figure as key features of the 2013 economic policy.

In March this year the mandate of András Simor, the governor of the National Bank of Hungary, will end. The successor is unknown as yet, but no doubt a person loyal to the government will follow Mr. Simor. This, coupled with a Monetary Council where government loyalists constitute the majority, poses the risk of precipitate cuts of the policy rate and quantitative easing of the monetary policy, steps which may seriously weaken the forint. The growth stimulating effect of such measures anticipated by the government seems to be negligible in the current circumstances.

The predominantly foreign-owned financial sector has remained in disfavour with the government. Banks must bear a disproportionately large burden of the fiscal consolidation. The special tax levied on the financial sector has not been halved in 2013 and will not be levelled in 2014 with taxes imposed on banks in other EU countries as had been promised by the government. Additionally a new tax on financial transactions, hitting the banks hard, was introduced on 1 January this year. While parent banks inject capital from abroad into their affiliates in Hungary to avoid the latter's undercapitalization, liquidity made available by parent banks for their Hungarian affiliates has substantially diminished and that partly explains the further shrinkage of lending. As external sources of liquidity turned meagre, the government's successful attempt to sell both forint- and forex-denominated bonds for resident investors has the potential to crowd out bank deposits from households' saving instruments. No wonder that lending activities both to the corporate sector and households have further decreased. Deleveraging in the corporate and the household sectors carries on, the credit/deposit ratio has dropped to 110 and is sinking further. Insufficient financial intermediation is not solely a supply-side issue however; demand for credits is extreme weak as well, due to shrinking investment, stagnating consumption and diminished export opportunities.

Under the current relaxed mood in the financial markets, an agreement with the IMF may seem unnecessary. Despite an improvement in important fiscal indicators, Hungary's position has remained fragile, as an important part of the improvement is due to temporary consolidation measures and not to genuine reforms. Should the currently favourable investment climate for the emerging markets change to the worse, Hungary may easily become one of the countries being hit first and the hardest. Without a major policy change aimed at the restoration of investors' confidence, both domestic and foreign ones, without a return to established forms of interest reconciliation with social partners, a reconciliation with the banking sector based on observed agreements and fair and feasible burden sharing and, last but not least, without an easing of the extreme centralization of decisions in the hands of the Prime Minister, a real improvement in the economy cannot be started. In our baseline scenario, this turn will only take place if and when a clear victory of the alliance of the political parties of the current democratic opposition occurs. This scenario envisages a political and legal consolidation period in the second half of 2014 and a gradual return to a higher, investment- and export-driven growth path from 2015 onwards. An alternative scenario assumes the prolongation of the current ‘unorthodox’ economic policy for several more years and consequently a protracted crisis of confidence and marginal economic growth in a depressed society.

Table HU

Hungary: Selected Economic Indicators

	2008	2009	2010	2011	2012 1)	2013	2014 Forecast	2015
Population, th pers., average	10038	10023	10000	9972	9940	9920	9900	9880
Gross domestic product, HUF bn, nom.	26543	25626	26607	27886	28600	29800	31300	33200
annual change in % (real)	0.9	-6.8	1.3	1.6	-1.7	0.0	1.2	2.5
GDP/capita (EUR at exchange rate)	10500	9100	9700	10000	10000	.	.	.
GDP/capita (EUR at PPP)	16000	15300	15900	16500	16500	.	.	.
Consumption of households, HUF bn, nom.	13985	13551	13665	14360	14800	.	.	.
annual change in % (real) 2)	-0.5	-6.8	-3.0	0.5	-1.5	0.0	0.0	0.0
Gross fixed capital form., HUF bn, nom.	5760	5302	4867	4987	4880	.	.	.
annual change in % (real)	2.9	-11.1	-9.6	-3.6	-6.0	-2.0	0.0	5.0
Gross industrial production								
annual change in % (real)	-0.2	-17.6	10.5	5.5	-1.7	1.0	3.0	5.0
Gross agricultural production (EAA)								
annual change in % (real)	27.4	-10.6	-11.1	10.7	-11.0	.	.	.
Construction industry								
annual change in % (real)	-5.2	-4.4	-10.4	-7.8	-5.9	0.0	2.0	5.0
Employed persons, LFS, th, average	3879.4	3781.8	3781.2	3811.9	3870.0	3880	3890	3910
annual change in %	-1.2	-2.5	0.0	0.8	1.5	0.2	0.2	0.5
Unemployed persons, LFS, th, average	329.1	420.7	474.8	467.9	475.6	.	.	.
Unemployment rate, LFS, in %, average	7.8	10.0	11.2	10.9	10.9	10.9	10.8	10.6
Reg. unemployment rate, in %, end of period	10.9	13.6	13.3	12.5	12.8	.	.	.
Average gross monthly wages, HUF 3)	198741	199837	202525	213094	223100	.	.	.
annual change in % (real, net)	0.8	-2.3	1.8	2.4	-3.5	.	.	.
Consumer prices (HICP), % p.a.	6.0	4.0	4.7	3.9	5.7	4.0	3.5	3.5
Producer prices in industry, % p.a.	4.6	4.5	6.3	2.5	3.8	.	.	.
General governm.budget, EU-def., % of GDP								
Revenues	45.5	46.9	45.4	53.9	46.4	.	.	.
Expenditures	49.2	51.4	49.8	49.6	49.2	.	.	.
Net lending (+) / net borrowing (-) 4)	-3.7	-4.5	-4.5	4.3	-2.8	-3.0	-3.0	-3.0
Public debt, EU-def., % of GDP	73.0	79.8	81.8	81.4	78.5	78.0	77.5	77.0
Central bank policy rate, % p.a., end of period 5)	10.00	6.25	5.75	7.00	5.75	.	.	.
Current account, EUR mn	-7728	-176	1030	917	1100	1000	1100	600
Current account, % of GDP	-7.3	-0.2	1.1	0.9	1.1	1.0	1.0	0.5
Exports of goods, BOP, EUR mn	72043	57397	68964	75238	77100	81000	89900	99800
annual growth rate in %	6.2	-20.3	20.2	9.1	2.5	5.0	11.0	11.0
Imports of goods, BOP, EUR mn	73233	55028	65749	71871	72600	75500	83700	92900
annual growth rate in %	6.9	-24.9	19.5	9.3	1.0	4.0	10.8	11.0
Exports of services, BOP, EUR mn	13804	13305	14634	15578	15270	16000	17600	19500
annual growth rate in %	9.8	-3.6	10.0	6.5	-2.0	5.0	10.0	11.0
Imports of services, BOP, EUR mn	12287	11319	11704	12355	12050	12500	13500	15000
annual growth rate in %	9.4	-7.9	3.4	5.6	-2.5	4.0	8.0	11.0
FDI inflow, EUR mn	4225	1475	1662	3325	7000	.	.	.
FDI outflow, EUR mn	1503	1365	949	3153	6000	.	.	.
Gross reserves of NB, excl. gold, EUR mn	23807	30648	33667	37242	33757	.	.	.
Gross external debt, EUR mn	123454	137120	138228	131944	126200	.	.	.
Gross external debt, % of GDP	117.0	150.0	143.1	132.2	127.6	.	.	.
Average exchange rate HUF/EUR	251.51	280.33	275.48	279.37	289.25	290	290	275
Purchasing power parity HUF/EUR	165.55	166.78	167.48	169.65	174.23	.	.	.

Note: Gross industrial production, construction output and producer prices refer to NACE Rev. 2. Gross agricultural production refers to Economic Accounts for Agriculture (EAA).

1) Preliminary and wiiw estimates. - 2) From 2012 including government financed transfers in kind. - 3) Enterprises with 5 and more employees. - 4) In 2011 including one-off effects. Without those effects general government budget balance is estimated to have attained -4.6% of GDP (Source: Portfolio.hu). - 5) Base rate (two-week NB bill).

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