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Hungary: healthy growth, sick budget and current account

The Hungarian GDP expanded by about 4% in 2004. The growth path differed significantly, to the better, from the one followed between mid-2001 and mid-2003. Excessive household consumption growth of the earlier years was curbed to 2.7-3% in 2004. A sharp upturn took place in investments; exports increased at a rapid pace. FDI inflow recovered, with the second highest annual inflow since transition began. Industry increased its output by about 8%, with much higher growth rates in engineering. After a transitional hike caused by changes in taxation upon accession to the EU, year-on-year inflation fell to 5.5% by December, a better record than expected by the market or the central bank. The bad news of 2004: all the above-outlined positive developments notwithstanding, the current account remained deeply in the red (8-9% of GDP) and the financing of the deficit took the form of a considerable increase in foreign debt (partly in forint-denominated securities). Failures in the fiscal area remained a sore spot; the budget deficit target for 2004 had to be revised upwards no less than three times within one year (from 3.8% to 4.6% and finally to 5-5.3% of GDP).

The state of the economy has been interpreted differently by the government and the central bank, respectively. In the central bank's view the 2004 growth path is unsustainable. It urges the government to introduce measures more resolute than those already taken to cut the budget deficit, pointing to the danger of recurrent inflation due to a possible sharp devaluation of the forint in case foreign financial investors should become reluctant to buy Hungarian government securities. The practical consequence of the central bank's evaluation has been to keep the prime rate high ever since the weakening of the forint in late 2003. Although that rate has been reduced, in small steps, by 425 basis points to 8.25% by the end of February 2005, it still remains the highest prime rate in the EU. The result is a strong forint, HUF 243 per EUR, in early 2005, close to the strong edge (HUF 240) of the intervention band. A further consequence of the strong forint and high interest rates is the rapid increase in lending in foreign currencies, both to the enterprise sector and to households, at substantially lower interest rates than with forint credits. Thus an increasing segment of the economy has become exposed to the risk of a possible devaluation.

The government is of the opinion that the current exchange rate of the forint is too strong, causing damage to import-competing firms and hindering the export activities of those small and medium-sized enterprises which rely primarily on domestic inputs in their production. (Hungary's export growth was slower than that of other new EU Member States in the region.) The government is convinced that lower inflation can be achieved and maintained at a lower prime rate and a weaker forint, which in turn would help to attain a more dynamic, export-driven growth that would also generate more budget revenues and support the consolidation of the budget. The high interest rates themselves increase the budget deficit due to the higher debt service burden.

Hungary has declared its intention to introduce the euro in 2010. However, the EU is not satisfied with the implementation of the Hungarian convergence programme. In January 2005 the ECOFIN decided to carry on the excessive deficit procedure against Hungary (while it was lifted in the case of all other new Member States) for the reason that the Hungarian government has been unable to observe its own fiscal deficit target. It is not so much the extent of the deficit that is at stake – in 2004 the fiscal deficit was lower (at about 5.2% of GDP) than in 2002 (9.3%) and in 2003 (6.2%). The real issue here is the shaken confidence in the Hungarian government's readiness to set realistic deficit targets and observe them.

Concerning the budget deficit, the EU has provided not only criticism but also some help recently. Eurostat agreed that payments to the private pension funds will not be included in the budget deficit. Calculated according to the new methodology, Hungary's 2004 fiscal deficit would only amount to about 4.5% of the GDP, and the original 2005 target deficit of 4.7% drops to 3.8%. Though the new methodology is no remedy to chronic fiscal problems, it may help to attain the 3% deficit/GDP ratio required by the Stability and Growth Pact earlier or with less pain than by the old methodology. The government, too, proved innovative concerning virtual deficit reduction. This year a substantial part of public investment (predominantly the expensive highway construction) will be implemented in a quasi-fiscal scheme. This solution helps to decrease public expenditures in the short run. With no major budgetary reforms in sight, but elections due in Spring 2006, the deficit target for 2005 is, despite all tricks, fairly ambitious. Observing it may require corrective measures in the course of the year.

Apart from the troublesome fiscal position the general outlook for 2005 is good. A decelerating expansion of external demand and an unchanged growth rate of domestic demand will keep the GDP growth rate at slightly below 4%. Both exports and imports will rise at a slower pace than in 2004; transactions with the new EU Member States and with the rapidly growing (mainly Asian) non-EU partners will, as in the past year, gain in importance. The extent of the current account deficit will remains at around EUR 7 billion (as in 2004), but its ratio to the GDP will probably fall below 8%. Non-debt generating financing will cover, as in 2004, about half of the current account deficit. With the successful deceleration of inflation, further cautious steps towards a lower prime rate may take most of the poignancy of the economic policy struggles which dominated 2004. On an annual average the forint will be slightly weaker (250-253 HUF/EUR) than in the last months of 2004. The risk of a currency crisis is substantially smaller than it was in 2003-2004.

Table HU

Hungary: Selected Economic Indicators

	1998	1999	2000	2001	2002	2003	2004 [1)]	2005	2006
								forecast	
Population, th pers., end of period	10253.4	10221.6	10200.3	10174.9	10142.4	10116.7	10097 [XI]	10065	10040
Gross domestic product, HUF bn, nom.	10087.4	11393.5	13150.8	14849.8	16740.4	18568.3	20700	22300	24000
annual change in % (real)	4.9	4.2	5.2	3.8	3.5	3.0	3.9	3.8	4.1
GDP/capita (EUR at exchange rate)	4077	4402	4953	5679	6782	7231	8150	.	.
GDP/capita (EUR at PPP - wiiw)	9120	9730	10550	11550	12400	12930	13890	.	.
Gross industrial production									
annual change in % (real)	12.5	10.4	18.1	3.6	2.8	6.4	8.4	7	10
Gross agricultural production									
annual change in % (real)	0.7	0.4	-6.5	15.8	-4.1	-4.5	.	.	.
Construction industry									
annual change in % (real)	15.3	9.0	7.9	7.7	17.5	2.2	6.8	.	.
Consumption of households, HUF bn, nom.	4994.2	5826.6	6689.2	7680.4	8767.2	9904.7	.	.	.
annual change in % (real)	4.8	5.4	4.4	5.7	10.3	8.1	2.9	3	3.3
Gross fixed capital form., HUF bn, nom.	2384.6	2724.5	3179.8	3493.0	3916.9	4141.3	.	.	.
annual change in % (real)	13.3	5.9	7.7	5.0	8.0	3.4	10	7	12
LFS - employed persons, th, avg. [2)]	3674.7	3809.3	3856.2	3868.3	3870.6	3921.9	3900.4	.	.
annual change in % [2)]	1.8	0.6	1.2	0.3	0.1	1.3	-0.5	.	.
Reg. employees in industry, th pers., avg. [3)]	795.9	834.0	844.8	833.9	817.9	801.8	785.3	.	.
annual change in %	1.6	0.8	1.3	-1.3	-1.9	-2.0	-2.1	.	.
LFS - unemployed, th pers., average	313.0	285.3	263.7	234.1	238.8	244.5	252.9	.	.
LFS - unemployment rate in %, average	7.8	7.0	6.4	5.7	5.8	5.9	6.1	6.1	6.1
Reg. unemployment rate in %, end of period	9.5	9.3	8.6	8.0	8.0	8.3	8.7 [XI]	8.5	8.5
Average gross monthly wages, HUF [3)]	67764	77187	87645	103553	122482	137193	145675	.	.
annual change in % (real, net)	3.6	2.5	1.5	6.4	13.6	9.2	-1.1	.	.
Consumer prices, % p.a.	14.3	10.0	9.8	9.2	5.3	4.7	6.8	3.9	3.2
Producer prices in industry, % p.a.	11.3	5.1	11.6	5.2	-1.8	2.4	3.5	.	.
General governm.budget, EU-def., % GDP [4)]									
Revenues	.	.	44.6	44.3	43.4	43.6	43.3	.	.
Expenditures	.	.	47.6	48.7	52.6	49.7	48.7	.	.
Deficit (-) / surplus (+) [5)]	.	.	-3.0	-4.4	-9.2	-6.2	-5.3	-4.8	-4.4
Public debt, EU-def., in % of GDP [4)5)]	61.6	60.9	55.4	53.5	57.2	59.1	59.7	.	.
Refinancing rate, % p.a., end of period	17.0	14.5	11.0	9.8	8.5	12.5	9.5	8	6.5
Current account, EUR mn	-3026.1	-3531.4	-4380.0	-3612.5	-4973.7	-6575.5	-7000	-7000	-7000
Current account in % of GDP	-7.2	-7.8	-8.7	-6.2	-7.2	-9.0	-8.5	-7.9	-7.4
Reserves total, excl. gold, EUR mn	7976.8	10845.3	12038.4	12163.7	9887.4	10108.3	11669.8	.	.
Gross external debt, EUR mn	23657.1	29230.9	32571.5	37387.0	38559.3	46504.4	52699.4 [IX]	.	.
FDI inflow, EUR mn	2988.1	3106.4	2998.4	4390.7	3185.1	2018.0	3200 [6)]	.	.
FDI outflow, EUR mn	245.2	234.7	664.4	398.5	295.7	1456.5	500 [6)]	.	.
Exports of goods, BOP, EUR mn	21056.7	24058.8	31277.5	34697.1	36820.7	38376.9	43750	48100	54400
annual growth rate in %	23.3	14.3	30.0	10.9	6.1	4.2	14	10	13
Imports of goods, BOP, EUR mn	22742.1	26102.4	34457.1	37192.8	39024.1	41274.5	46230	50400	55900
annual growth rate in %	24.6	14.8	32.0	7.9	4.9	5.8	12	9	11
Exports of services, BOP, EUR mn	4810.9	4910.2	6114.2	7434.5	7342.3	7082.0	7430	.	.
annual growth rate in %	-6.5	2.1	24.5	21.6	-1.2	-3.5	5	.	.
Imports of services, BOP, EUR mn	3735.5	4093.9	4907.4	5809.1	6799.9	7611.2	8220	.	.
annual growth rate in %	4.2	9.6	19.9	18.4	17.1	11.9	8	.	.
Average exchange rate HUF/USD	214.45	237.31	282.27	286.54	258.00	224.44	202.63	.	.
Average exchange rate HUF/EUR (ECU)	240.98	252.80	260.04	256.68	242.97	253.51	251.68	252	253
Purchasing power parity HUF/USD, wiiw	92.83	99.96	107.34	110.10	114.72	120.86	127.15	.	.
Purchasing power parity HUF/EUR, wiiw	107.78	114.35	122.11	126.21	132.87	141.78	147.57	.	.

Notes: 1) Preliminary. - 2) From 1999 according to census 2001. - 3) Enterprises with more than 5 employees. - 4) According to ESA'95, excessive deficit procedure. - 5) Without taking into consideration the payments to public pension funds. – 6) wiiw estimate.

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