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Hungary: in need of credibility

A weakening of the forint in the last weeks of 2003 clearly signalled that the populist economic policy introduced by the previous conservative government in 2001 and continued by the incoming socialist-liberal government after the 2002 elections has arrived at a critical point: without a credible turn, the results achieved following the painful stabilization in 1995 are endangered.

The 2003 volatility of the forint/euro exchange rate originates in the interplay of three factors: specific structural features of the Hungarian public debt, policy mistakes resulting in loss of confidence and, finally, the deterioration of some (but not all) key macroeconomic indicators.

At the end of 2003 public debt amounted to 56.6% of the GDP. Government securities denominated in forint made up 76% of the public debt; the rest was denominated in foreign currencies. Of the forint-denominated government securities, 34% was in foreign ownership. The foreign ownership structure is highly centralized; transactions of a small number of big investors have decisive influence on the market and on the exchange rate.

The problems over the weak forint in the second half of 2003 were in sharp contrast to the concerns of economic policy in the first half of the year, when the forint was too strong. In January 2003 the central bank had to intervene through purchasing EUR 5 billion within a few days, in order to ease the revaluation pressure on the Hungarian currency. The first weakening of the forint in June 2003 unfortunately coincided with the devaluation of the middle of the intervention band. The decision on the latter had been made prior to the forint's weakening, and was then thought to be a prophylactic measure against the strong forint problem that was extrapolated to remain a concern for a longer period.

The second weakening of the forint started at the end of November 2003. A fraction of the stock of the foreign-owned, forint-denominated government securities were sold, and these transactions pushed the forint from the central bank's informally set target band of 250-260 HUF/EUR. In reaction to the forint's weakening the Monetary Council raised the prime rate of the central bank from 9.5% to 12.5%. This measure was the beginning of a series of unsuccessful steps to get the exchange rate back below 260 HUF/EUR. Later on, the government announced that the state support on housing credits would be reduced and measures would be taken to ensure that the targeted improvement in the budget in 2004 would really be achieved. In the first days of 2004 the Minister of Finance was sacked because the 2003 general government deficit had amounted to 5.6% of GDP, instead of 5.2% as predicted by the minister only a few weeks earlier. The new Minister of Finance announced that the planned date for introducing the euro (2008) would be reconsidered and initiated a further cut in government expenditures to regain credibility of the economic policy. This latter cut, together with those announced in December, amounts to HUF 155 billion, equalling 0.7% of the GDP. The continued weakness of the forint (ranging between 261 and 272 HUF/EUR in December and January) signals that no remedy has been found as yet to the shaken confidence of the markets.

The failure to stabilize the exchange rate with the above measures hints at a dual crisis of credibility in Hungary – that of the economic policy in general and that of the monetary policy in particular.

As described in earlier wiiw reports[1], the populist policy before and after the 2002 elections derailed the Hungarian economy from its earlier export-led growth path. In 2001-2003 household consumption expanded by 25% while GDP increased by 10% only. The consequences were a 9% budget (general government) deficit in 2002, failure in observing the 4.5% budget deficit target in 2003 and a serious deterioration of the current account (6.6% of the GDP) in 2003.

Although last year the government made some half-hearted attempts at improving fiscal balances, it stuck to the fiction of its main election campaign message: if elected, the socialist-liberal government's mission would fundamentally change the Hungarian welfare system to the better. Also, the government has remained hostage to another promise. In the 2002 election campaign, the conservative parties had demonized the 'Bokros package' (the 1995 austerity programme introduced by the socialist-liberal government in office then) claiming that if the socialists and the liberals were to win the elections, they would introduce a new edition of the Bokros package. The socialists, instead of proudly taking over the responsibility for the then unavoidable stabilization measures which cleared the way for the highly successful growth performance in the second half of the 1990s, chose the tactic of endlessly repeating that there would be no second 'Bokros package' should they return to government. This is the political background to the persistent denial of the need for action in the economic policy and the hesitation to address the towering problems by otherwise excellent economists such as Prime Minister Peter Medgyessy and former Minister of Finance Csaba László. A radical turn in the economic policy would have been seen as a break of the election promises. Accordingly, the government's strategy was to initiate small corrective measures thought to have a less devastating PR effect than one resolute adjustment. These corrective measures were insufficient to solve the problems but left the impression of weakness and indecision in foreign and domestic observers.

[1] S. Richter, 'Hungary: the election year is over, repair of damages may begin', in L. Podkaminer et al., 'Transition Countries Resist Global Slowdown: Productivity Gains Offset Effects of Appreciation', *wiiw Research Reports*, No. 293, February 2003. pp. 70-74; S. Richter, 'Hungary: corrective measures to stop drifting', in P. Havlik et al., 'Transition Economies in 2003: Reforms and Restructuring Keep Global Economic Slowdown at Bay', *wiiw Research Reports*, No. 297, July 2003, pp. 61-64.

The other scenery of the credibility crisis is the monetary policy. Since 2001 the monetary policy has followed inflation targeting. The HUF/EUR exchange rate has an allowed volatility of ± 15% within the 240-325 HUF/EUR band. Within this band the central bank has had a much narrower informally targeted band for the forint (most recently 250-260 HUF/EUR). This 'wishful' rate appears again and again in the central bank's communications, leaving no doubt that the central bank would intervene through changing the interest rates if the exchange rate were to get out of the informally targeted narrow band. International experience shows that this practically dual targeting (inflation and exchange rate) with principally one instrument applied (interest rate) makes the system an attractive target for speculation. In the wake of the previous episode of forint weakening in June 2003 the government, in agreement with the central bank, announced the planned date (2008) of the euro's introduction in Hungary. This step, in other circumstances, could have been an important confidence-raising event. In this particular case however the government made this announcement instead of undertaking the badly needed measures to consolidate the budget, with exactly the opposite outcome on confidence. The monetary policy did not meet its primary target, the CPI inflation, either. At the end of 2003 the latter amounted to 5.7%, well beyond the targeted range of 3.5 ± 1%.

What is the relation between the forint's weakening and the macroeconomic 'fundamentals'? The populist economic policy, the fragility of the fiscal policy targets and the deterioration of the current account were well known in the first half of 2003 when the main concern was still about the strength of the forint. In the days of the critical weakening of the forint at the end of 2003, news about the accelerating growth and improving export performance should have had the opposite effect on the exchange rate. All in all, the 'fundamentals' alone do not serve as an explanation to the exchange rate development in Hungary in the past 14 months.

Recent data on the state of the economy are encouraging. The third-quarter GDP in 2003 increased by 2.9%, more rapidly than in the first and second quarters. Output of the manufacturing industry expanded by 5.9% year on year in the first eleven months of 2003. The expansion of the most modern sectors of industry, machinery and equipment, amounted to 14.7% in the same period. Growth in industry is nearly fully export-driven, export sales of industry increased by 9.5% in January-November. New orders in October 2003 were 22.8% higher, of which export orders 26.6% higher than in the respective month of 2002. Investment in the manufacturing industry increased by 12.7% in January-October. Employment may have increased by about 1% in 2003.

The record deficit of the current account in 2003 (about EUR 4.8 billion) reflects two tendencies: first, the 'outphasing' consumer rush triggered by the hike in real earnings related to the 2002 elections and second, the growing import-sucking effect due to the economy's take-off. Lower incomes from tourism also contributed to the deterioration of the current account balance. Exceptionally unfavourable was the balance of non-debt generating financing. In earlier years a considerable surplus of this position had been able to partly compensate the current account deficit, keeping the economy's external position sustainable. In 2003 this positive effect was missing because outward FDI from Hungary (according to data of the first eleven months) was higher than the amount of inward FDI; this was primarily due to two major Hungarian acquisitions abroad: INA in Croatia (acquired by the national oil and gas company MOL) and the second largest Bulgarian commercial bank, DSK (acquired by OTP Bank).

The general government deficit, as already mentioned, was substantially higher than planned. The government has contradicting aims for 2004: The deficit target (4.6% of GDP) should be observed to regain the confidence of the international markets; the programmes to stimulate the economy, primarily those in highway construction, should be continued or stepped up; co-financing for projects supported by the EU Structural Actions will have to be provided; further, the election promise 'there will be no "Bokros package" again' should not be broken. As of the beginning of the year, it is yet unclear which of these aims will be dropped, or which mix with what weights of these aims will be opted for.

The most likely scenario for 2004 foresees a modest acceleration of economic growth, based on an expansion of industrial exports. The forint/euro exchange rate will remain moderately volatile around 260 HUF/EUR, which will please exporters, but less so central bankers. As real earnings of households will hardly increase this year, the current account will slightly improve and fall below 6% of the GDP. CPI inflation will be between 6% and 7% due to price changes related to the EU accession. The latter will have no immediate impact on the economy except for the budget where the uncertainty due to major changes related to the in- and outflow of transfers will be much higher than in earlier years. It is assumed that the consolidation of the budget will begin, and the deficit/GDP ratio might be brought down below 5%. The financing of the budget will be restructured, with a considerably increasing share of euro-denominated bonds relative to forint-denominated government securities. As of now, no predictions can be made on the monetary policy. Giving up the exchange rate targeting parallel to the inflation targeting would allow for a lowering of the prime rate. Should the dual targeting prevail, this would probably leave interest rates high for a longer period and put a brake on the beginning recovery. Postponing the date of entry of the ERM II (which is planned to occur immediately upon Hungary's accession to the EU in May) by at least half a year would provide more manoeuvring room for the government and the central bank to regain confidence through a newly designed coherent economic and monetary policy.

Table HU

Hungary: Selected Economic Indicators

	1997	1998	1999	2000	2001	2002	2003 [1]	2004 forecast	2005 forecast
Population, th pers., end of period	10280	10253	10222	10200	10175	10142	10115	10085	10065
Gross domestic product, HUF bn, nom. [2]	8540.7	10087.4	11393.5	13150.8	14849.6	16743.7	18300	21000	21900
annual change in % (real) [2]	4.6	4.9	4.2	5.2	3.8	3.5	2.9	3.3	3.9
GDP/capita (EUR at exchange rate)	3935	4077	4402	4953	5679	6784	7140	.	.
GDP/capita (EUR at PPP - wiiw)	8930	9550	10200	11030	12020	12840	13420	.	.
Gross industrial production									
annual change in % (real)	11.1	12.5	10.4	18.1	3.6	2.7	6.4	8.5	10
Gross agricultural production									
annual change in % (real)	-3.3	0.7	0.4	-6.5	15.8	-4.1	.	.	.
Goods transport, mn t-kms [3]	24789	27144	26339	26399	26240	25816	19159 I-IX	.	.
annual change in %	-0.3	9.5	-3.0	0.2	-0.6	-1.6	5.9 I-IX	.	.
Gross fixed capital form., HUF bn, nom.	1898.9	2384.6	2724.5	3179.8	3508.4	3844.5	.	.	.
annual change in % (real)	9.2	13.3	5.9	7.7	3.5	7.2	3.5	5	6
Construction industry									
annual change in % (real)	8.1	15.3	9.0	7.9	7.7	17.5	0.1 I-XI	.	.
Dwellings completed, units	28130	20323	19287	21583	28054	31511	15408 I-IX	.	.
annual change in %	-0.4	-27.8	-5.1	11.9	30.0	12.3	-2.1 I-IX	.	.
Employed persons total - LFS, th, avg [4]	3646.3	3697.7	3811.5	3849.1	3859.5	3870.6	3922.0	.	.
annual change in % [4]	0.0	0.7	3.1	1.0	0.3	0.1	1.3	0	.
Reg. employees in industry, th pers., avg [5]	783.5	795.9	834.0	844.8	833.9	817.9	801.2 I-XI	.	.
annual change in %	-0.7	1.6	0.8	1.3	-1.3	-1.9	-2.2 I-XI	.	.
Reg. unemployed pers, th, end of period	464.0	404.1	404.5	372.4	342.8	344.9	339.6 Oct	.	.
Reg. unemployment rate in %, end of period [6]	11.0	9.6	9.4	8.6	8.0	8.0	7.9 Oct	8	8
LFS - unemployment rate in %, average	8.7	7.8	7.0	6.4	5.7	5.8	5.9	6	6
Average gross monthly wages, HUF [5]	57270	67764	77187	87645	103553	122482	133660 I-XI	.	.
annual change in % (real, net)	4.9	3.6	2.5	1.5	6.4	13.6	10.1 I-XI	.	.
Retail trade turnover, HUF bn [7]	2949.1	3682.8	4329.7	4822.0	5396.1	6108.5	4260.3 I-XI	.	.
annual change in % (real) [7]	-1.6	12.3	7.9	2.0	5.4	10.7	8.4 I-XI	.	.
Consumer prices, % p.a.	18.3	14.3	10.0	9.8	9.2	5.3	4.7	6.5	5
Producer prices in industry, % p.a.	20.4	11.3	5.1	11.6	5.2	-1.8	2.4	.	.
Central government budget, HUF bn [8]									
Revenues	2364.6	2624.4	3227.6	3681.0	4068.0	4357.3	4939.5	.	.
Expenditures	2703.1	3176.6	3565.8	4049.7	4470.9	5826.9	5667.4	.	.
Deficit (-) / surplus (+)	-338.5	-552.2	-338.1	-368.7	-402.9	-1469.6	-728.0	.	.
Deficit (-) / surplus (+), % GDP	-4.0	-5.5	-3.0	-2.8	-2.7	-8.8	-4.0	.	.
Money supply, HUF bn, end of period [9]									
M1, Money	1528.4	1991.4	2362.1	2653.9	3113.3	3655.0	4028.5	.	.
Broad money	4036.3	4590.4	5192.4	6129.6	7177.7	7858.5	8782.7	.	.
Refinancing rate, % p.a., end of period	20.5	17.0	14.5	11.0	9.8	8.5	12.5	.	.
Current account, EUR mn	-578.5	-1976.6	-2301.2	-3151.5	-1966.9	-2770.8	-4800	-4600	-4500
Current account in % of GDP	-1.4	-4.7	-5.1	-6.2	-3.4	-4.0	-6.6	-5.7	-5.3
Reserves total, excl. gold, EUR mn	7613.1	7976.8	10845.3	12038.4	12163.7	9887.4	10108.9	.	.
Gross external debt, EUR mn	22108.9	23368.1	28915.0	32513.5	37568.4	38578.6	42998 Sept	.	.
Exports total, fob, EUR mn [10]	16910.1	20476.8	23491.0	30544.5	34082.0	36522.9	37070	39700	43300
annual growth rate in %	35.1	21.1	14.7	30.0	11.6	7.2	1.5	7	9
Imports total, cif, EUR mn [10]	18779.5	22871.2	26287.8	34856.3	37654.1	39939.5	41860	44400	47900
annual growth rate in %	29.9	21.8	14.9	32.6	8.0	6.1	4.8	6	8
Average exchange rate HUF/USD	186.75	214.45	237.31	282.27	286.54	258.00	224.44	.	.
Average exchange rate HUF/EUR (ECU)	210.93	240.98	252.80	260.04	256.68	242.97	253.51	262	260
Purchasing power parity HUF/USD, wiiw	83.39	92.76	99.85	108.60	111.76	118.63	124.24	.	.
Purchasing power parity HUF/EUR, wiiw	92.93	102.93	109.11	116.74	121.29	128.32	134.78	.	.

Notes: 1) Preliminary. - 2) Methodological break 2000/2001. - 3) From 2002 methodological break in road transport. - 4) From 1998 new sample; from 2002 according to census 2001 and excluding conscripts. - 5) Enterprises with more than 10, from 1999 more than 5 employees. - 6) From 2001 wiiw estimate. - 7) From 2003 excluding sale, maintenance and repair of motor vehicles (NACE 52). - 8) Excluding privatization revenues. - 9) From 1998 revised data according to ECB methodology. - 10) Converted from the national currency to EUR at the official exchange rate.

Source: wiiw Database incorporating national statistics; wiiw forecasts.