Sándor Richter

Hungary:
One-sided growth – only exports matter

Post-crisis growth has been driven solely by external demand. Investment and consumption are suffering on account of legal uncertainties and impaired financial intermediation. For 2011, nationalizing the assets of private pension funds will secure a one-off fiscal surplus. International investors have demonstrated their appreciation of the Government's fiscal plans. The slow export-based recovery is expected to continue in 2011.

The Hungarian economy has been leaving recession behind. Economic growth amounted to 2.5% in the first quarter of 2011, the best quarterly result since late 2006. The post-crisis growth has been noticeably one-sided, driven almost exclusively by external demand. Both fixed investment and consumption suffer from legal uncertainties and decelerated financial transmission provided by a distressed banking system.

According to provisional national accounts data, industry and agriculture recorded positive contributions to GDP change in the first quarter; construction declined while the sector with the biggest weight, services, stagnated. Concerning the use of the GDP, final consumption of households was still declining slightly. Gross capital formation expanded by over 8%, but this figure conceals the completely diverging developments in gross fixed investment and inventories. The former declined again (by 1.6%), while the change in inventories (plus statistical discrepancy) contributed to GDP growth by no less than plus 1.7 percentage points. Finally, net exports, as was the case in each quarter since early 2009, contributed positively to the GDP change (by plus 1.2% percentage points) in the first quarter of 2011.

Industrial production expanded by 12% in the first quarter. The two dominating clusters (computers, electronic and optical products; the automotive industry) producing close to 40% of the industrial output fared well with 18% and 13% expansion, respectively, with products placed predominantly on foreign markets. Mainly the domestic market oriented food industry, with about one tenth of total industrial output, practically stagnated. Altogether in industry foreign sales increased by 17% while the more than 5% drop in domestic sales clearly shows the prevailing miserable state of domestic demand. New orders point to a further upturn, this time in domestic sales as well. The good news is that approximately half of the output expansion in industry came from increased employment and the rest from productivity growth, thus at least in this segment of the economy the period of jobless growth has come to an end.

Contrary to industry, construction is still in crisis. Output declined by 7% in the first quarter, the sector's current performance is as low as it was a decade ago. The reason for this is, first, shrinking housing construction (one third drop in the first quarter) partly due to missing readiness to provide or raise credits, respectively, for housing projects. Second, there are further cutbacks in public investment and a slowdown of EU co-financed projects' implementation related to the change of government a year ago.

Though investment declined in the first quarter, there are diverging tendencies here as well. A robust, close to 40% expansion was recorded in manufacturing and the energy supply, as opposed to a strong decline in transport and storage, real estate activities and public administration. Concerning the type of investment, construction dropped by 8% while machinery investment expanded by 4.2%.

Retail trade turnover has been stagnating as households refrained from buying durable consumer goods, clothing and shoes, travelled less by car and purchased less new and used cars than in the first three months of 2010.

Lively foreign demand has been the main facilitator of economic growth: exports (in current euro terms) increased by 23.5%, imports by 21.7% in the first quarter of 2011. With this dynamic growth Hungary's foreign trade performance reached again the pre-crisis level. Deliveries to each immediate neighbouring country of Hungary and also to the Czech Republic, Poland and Bulgaria recorded remarkably strong growth (30-40%), while the expansion of exports to Hungary's main export market Germany was high but remained below the average.

A radical upturn in employment (1 million new jobs within ten years, 400,000 new jobs in this four-year election period) was a central issue in Prime Minster Orbán's election programme. The achieved results are modest yet: in January-April the participation rate, compared to the respective period of 2010, stagnated, the employment rate improved by just 0.3 percentage points. The unemployment rate declined modestly. A key question of the coming years is how and to what extent the government will manage to realize its ambitious intentions for re-launching public work programmes after eliminating the respective schemes launched by the previous government.

A critical issue in the revitalization of domestic demand is the reanimation of financial intermediation. In the first quarter of 2011 net lending both for households and businesses declined, a phenomenon that has been prevailing for more than one and a half years. Conditions for lending were deteriorating both for the business sector and households (for the purchase of consumer goods) in the first quarter of the year while they remained strict for housing. Demand for housing credits further declined. Banks are in a squeeze: they are charged with a sectoral tax for the second year now, with a rate substantially higher than anywhere in the EU, and the share of non-performing loans is on the rise. An especially critical segment is that of mortgage credits based on the Swiss franc (CHF) which is now substantially stronger (relative to the forint) than it was in the period when most of those credits were raised; this has markedly increased the involved households' debt service burden, which is to be paid in forint. This and the new government's promise to help households coping with this problem led to an ever increasing part of clients who either cannot or, counting on the promised bailout, do not wish to service their debt. The government announced a relief scheme at the end of May 2011. Up to the end of 2014 households indebted in foreign exchange (predominantly in CHF) may opt for a lower HUF/foreign exchange rate (in the case of the CHF 180 instead of the current market rate 210-220) to calculate their actual debt service. The difference will be accumulated on a special account and will have to be paid back later topped by the interest charged for the set-aside part. However, this will only be a genuine relief if the HUF/CHF rate returns to its earlier 'normal' level. If not, debtors will have to face an increased debt service after 2014 and carry the burden of exchange rate risk. The relief scheme was approved simultaneously with the partial lifting of a moratorium on the eviction of dwellers and allowing again foreclosure. These are measures that may help resolve the current stalemate in the area of housing credits.

Nearly one year after its inauguration the Orbán government dropped its philosophy 'first economic growth and then the consolidation of the budget' and with an overnight turn declared the war on public debt. This is more than mere rhetoric: the scapegoats for high public debt have been named (key figures of the previous government) and their criminalization has been initiated. The fight for reducing public debt has the features of a patriotic movement, private persons and firms are encouraged voluntarily to contribute to a fund created for diminishing public debt. Beyond these spectacular elements and more importantly, the respective government measures bear the features of a (non-existent) emergency situation. Government decisions of far-reaching consequences for those involved have been announced in various segments of the pension system, social welfare system, education and culture without preliminary consultation with stakeholders or using the long-established institutions of interest reconciliation. As experts have been typically excluded from the preparatory work, most measures are mere improvizations full of contradictions, and are followed by similarly improvized and hasty corrections.

Whether this (in post-transition Central Europe) unprecedented concentration of executive power will help decrease public debt is highly uncertain. For 2011 the nationalized assets of the private pension funds will ensure a 2% (relative to the GDP) fiscal surplus – technically. Without this one- off item the deficit would be higher than 3% of the GDP. For the years 2012 and 2013 and beyond, the uncertainties are mounting. While the 16% flat personal income tax rate – as the central achievement of the Orbán government – will probably prevail, the sectoral taxes were promised to be phased out by 2013, just as the current excessively high charge on financial institutions are expected to be significantly lowered. The recently approved measures of the government concerning unemployment benefits cuts, the compulsory re-activation of army officers, members of the police and fire brigades involved in early retirement systems, the plans to diminish the number of universities, etc. are restrictions and not genuine reforms. These latter are still to be elaborated. The reform-bashing rhetoric of Fidesz in its eight-year opposition, the lack of readiness on the part of the government to use the fora of interest reconciliation and, last but not least, the government's hesitation to rely on expert support in the elaboration of policy measures hint at difficult times to come. A clear sign of that is the current wave of embittered protests against the fiscal restrictions by various involved occupation groups of the society, from members of the police and the fire brigades to young medical doctors.

Despite all the above-listed problems the government has met with no difficulties in rolling over the public debt. The placement of newly issued government bonds has been a success story even if the yields were fairly high. Hungary's sovereign CDS spreads have been sinking (to about 250) compared to late 2010 (around 400) but they are still higher than they were (around 200) in the previous government's last months in office. This may be explained, apart from the favourable investment climate in emerging Europe in general, by the favourable reception of the government's Széll Kálmán Plan and the updated convergence programme. International investors may have appreciated the government's spectacular turn towards fighting the country's fiscal problems and pay, as for now, less attention to the risks of realization.

All in all, the slow recovery is expected to continue and the annual GDP growth will amount to about 2.5% in 2011. Domestic demand will be sluggish with some acceleration possible towards the end of the year. The principally export-based character of the recovery will prevail, however, in 2012 and probably 2013 as well it will be accompanied by a sluggish recovery of domestic demand, mainly of household consumption. Accordingly the current account balance will pose no problems in the medium run while public finance (debt, deficits, reforms) remain in the focus of international markets.

Table HU

Hungary: Selected Economic Indicators

	2007	2008	2009	2010 [1]	2010 1st quarter	2011 1st quarter	2011 Forecast	2012 Forecast	2013 Forecast
Population, th pers., average	10056	10038	10023	10004	10010	9978	10002	10000	9998
Gross domestic product, HUF bn, nom.	25321.5	26753.9	26054.3	27119.8	6016.3	6302.9	28600	30300	31900
annual change in % (real)	0.7	0.9	-6.7	1.2	0.1	2.5	2.5	3	3
GDP/capita (EUR at exchange rate)	10000	10600	9300	9800	.	.	.	.	.
GDP/capita (EUR at PPP)	15600	16100	15300	15700	.	.	.	.	.
Consumption of households, HUF bn, nom.	13306.0	14091.9	13487.9	13879.7	3270.2	3390.2	.	.	.
annual change in % (real)	0.2	0.5	-8.1	-2.0	-3.7	-0.8	0.5	1.5	2.5
Gross fixed capital form., HUF bn, nom.	5408.3	5727.3	5441.6	5239.3	915.7	924.2	.	.	.
annual change in % (real)	3.7	3.2	-9.3	-6.9	-4.8	-1.6	3	7	8
Gross industrial production									
annual change in % (real)	7.9	-0.2	-17.6	10.4	5.2	12.2	10	12	12
Gross agricultural production									
annual change in % (real)	-12.5	27.7	-10.1	-6.0	.		.	.	.
Construction industry									
annual change in % (real)	-14.0	-5.2	-4.4	-10.1	-10.9	-7.0	0	10	10
Employed persons - LFS, th, average	3926.2	3879.4	3781.8	3781.2	3719.3	3732.5	3820	3860	3900
annual change in %	-0.1	-1.2	-2.5	0.0	-1.2	0.4	1	1	1
Unemployed persons - LFS, th, average	312.0	329.1	420.7	474.8	497.8	489.8	.	.	.
Unemployment rate - LFS, in %, average	7.4	7.8	10.0	11.2	11.8	11.6	11	9.5	8.5
Reg. unemployment rate, in %, end of period	10.1	10.9	13.6	13.3	14.5	14.7	.	.	.
Average gross monthly wages, HUF [2]	185018	198741	199837	202576	206860	210036	.	.	.
annual change in % (real, net)	-4.6	0.8	-2.3	1.9	5.6	-1.0	.	.	.
Consumer prices (HICP), % p.a.	7.9	6.0	4.0	4.7	5.8	4.3	4.2	3.5	3.5
Producer prices in industry, % p.a.	0.3	4.6	4.5	6.3	-0.9	5.2	.	.	.
General governm.budget, EU-def., % GDP									
Revenues	45.0	45.2	46.1	44.6	.	.	.	.	.
Expenditures	50.0	48.8	50.5	48.9	.	.	.	.	.
Net lending (+) / net borrowing (-)	-5.0	-3.6	-4.5	-4.3	.	.	2 [3]	-3	-3
Public debt, EU-def., in % of GDP	66.1	72.3	78.4	80.2	.	.	74	73	72
Central bank policy rate, % p.a., end of period [4]	7.50	10.00	6.25	5.75	5.50	6.00	.	.	.
Current account, EUR mn	-6965	-7749	361	2029	597	.	1000	500	0
Current account in % of GDP	-6.9	-7.3	0.4	2.1	2.7	.	0.9	0.5	0.0
Exports of goods, BOP, EUR mn	68362	72684	58428	70359	16005	.	77700	85500	94100
annual growth rate in %	17.1	6.3	-19.6	20.4	17.6	.	11	10	10
Imports of goods, BOP, EUR mn	68500	73233	55028	65688	14755	.	72200	78800	86400
annual growth rate in %	12.6	6.9	-24.9	19.4	12.3	.	10	9	10
Exports of services, BOP, EUR mn	12574	13804	13305	14384	3309	.	15500	17100	18800
annual growth rate in %	15.6	9.8	-3.6	8.1	12.5	.	8	10	10
Imports of services, BOP, EUR mn	11524	12843	11956	11980	2697	.	12900	14200	15600
annual growth rate in %	19.5	11.4	-6.9	0.2	-5.5	.	8	10	10
FDI inflow, EUR mn	2861	4926	1498	1202	421	.	600	.	.
FDI outflow, EUR mn	2646	2076	1956	625	807	.	.	.	.
Gross reserves of NB, excl. gold, EUR mn	16305	23807	30648	33667	33852	35601	.	.	.
Gross external debt, EUR mn	103988	123536	136133	136928	140937	.	.	.	.
Gross external debt in % of GDP	103.2	116.1	146.5	139.1	143.2	.	.	.	.
Average exchange rate HUF/EUR	251.35	251.51	280.33	275.48	268.68	272.46	270	275	275
Purchasing power parity HUF/EUR	161.73	165.03	170.18	172.99	.	.	.	.	.

Note: Gross industrial production, construction output and producer prices refer to NACE Rev. 2.
1) Preliminary. - 2) Enterprises with 5 and more employees. - 3) Including the one-off effect of nationalization of the private pension funds' assets. Without that effect the general government balance is forecasted to attain -3.5% of GDP. - 4) Base rate (two-week NB bill).

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