



HUNGARY: The growth engine kicked in – what next?

SÁNDOR RICHTER

Even though Hungary has left recession behind, it has not yet embarked on a sustainable growth path. The strong external stimulus to growth lent by the EU helped to resuscitate private investment and employment. With the stimulus from the EU cohesion policy weakening as of the current year, it is expected that other private (domestic and external) factors will drive recovery; however, the conditions conducive to that happening are far from favourable. Medium-term growth is unlikely to reach more than 2% in the biennium 2016-2017.

According to preliminary data the Hungarian GDP may have expanded by 3.5% in 2014, the best result since 2006. Does this impressive performance mark the beginning of a new era, characterised by stronger and more sustainable economic growth, or is 2014 to be seen as an anomaly within a lasting low-growth period characterised by meagre investment propensity, unsolved structural problems in public finance and spreading pauperisation¹ of wide strata of the population?

Without any doubt, one-off factors played a very important role in the improvement of the growth performance last year. Cohesion policy related payments from the EU budget steeply increased over 2013 and 2014, reaching a climax at about 6% of the GDP last year. This huge injection into aggregate demand was reflected in the strong upturn in investment (over 14%) and, indirectly, in elevated household consumption relative to the previous year as well. It may have contributed to higher fiscal revenues by over 2 percentage points of the GDP, i.e. without these transfers the fiscal deficit may have attained more than 4% of GDP, surpassing the 3% threshold prescribed in the Stability and Growth Pact. Another one-off effect is that 2014 was a super-election year (general, EU parliament and municipal elections) with the consequence of long-pending large investment projects being completed to impress the electorate. Household consumption may have increased by more than 2% last year, an important expansion after several years of negative or only marginal positive growth. The upturn in household consumption was triggered by an exceptionally strong, 5.3% increase in employment and a 3% expansion of real net wages last year. The former was related to the mentioned investment boom as well as to a substantial enlargement of public workfare programmes and that part of migration abroad which is registered as domestic employment. Real wages may have grown partly unplanned, due to stronger than expected disinflation. Retail trade turnover increased by more than 5%.

¹ http://www.ksh.hu/docs/eng/xstadat/xstadat_annual/i_zhc013.html

What remains of all these growth-fostering effects for this year? 2015 is the last year of payments from the 2007-2013 Multiannual Financial Framework of the EU. A complete disbursement of outstanding resources would ensure a magnitude of inflows similar to that registered last year. However, often the difficult projects remain to be completed in the very last stage. Hungary is one of the most problematic Member States in terms of deficient projects; there are problems with transparency, reliability of data supply and public procurement.² This makes it likely that the contribution of EU transfers to economic growth will lag behind the peak attained last year. The 5% increase in employment cannot be repeated this year as investment growth has been decelerating since the summer of 2014. Inflation is making a comeback this year, even if it remains low. That means that no surprise effect in real wages can be expected as in the previous year. To partly counterbalance these effects, household consumption may be fostered this year through more disposable income of those households where monthly amortisation of mortgage loans will be diminished due to the stipulations of the 'fair banking' law. This law obliges banks to compensate their clients for arbitrary modifications of interest rates charged and too high a margin between bid and ask rates for currency conversion applied in the case of foreign exchange loans for households in the past years.

Thus, one-off factors will wane this year as drivers of growth. This leaves the traditional growth engines of the Hungarian economy, FDI and foreign trade. FDI inflow data must be split into two parts. On the one hand, there is a substantial inflow for the recapitalisation of ailing foreign-owned banks by their mother companies: from 2008 to end of 2014 the accumulated inflow to this purpose amounted to EUR 5 billion.³ On the other hand, in the non-financial business sector the FDI outflow has been surpassing the inflow for two years.⁴ With regard to the outstanding role foreign-owned enterprises play in the modernisation of industrial capacities and services, employment and exports, this has become one of the crucial obstacles to attaining a higher growth path of the economy. Foreign trade, i.e. net export, had made an important contribution to GDP growth from the 2009 crisis up to 2013. This contribution diminished already in 2013 and is assumed to have turned negative in 2014. With less import for investment and consumption and lower import value of energy due to falling prices, net export may again positively contribute to GDP growth this year, even if less than in the pre-2013 years.

While the fiscal balance safely remained below 3% of GDP in 2014, the public debt to GDP ratio most probably stayed at the level of the previous year. Though the main figures hint at a consolidated fiscal stance, the critical state of affairs in public health, education, culture and local governments coupled with the persisting existence of growth-constraining sector-specific taxes point to outstanding structural reforms.

An enhancement of financial transmission would be of critical importance for improving Hungary's growth performance. Recent data show that, except for the SME segment where the Credit for Growth Programme, a preferential credit line subsidised by the central bank, brought about positive changes, the stock of loans presumably declined further in 2014. The financial sector has become a battlefield in the past five years. An exceptionally high bank tax and a financial transaction tax, together with other smaller charges, have become the main pillar of fiscal consolidation. Squeezing the banks had also the purpose to diminish the foreign presence in the sector. In early 2015 this goal seems to have been

² B. Jávör, 'Veszélyben vannak a regionális pénzek?', http://javorbenedek.blog.hu/2014/12/29/veszelyben_vannak_a_regionalis_penzek

³ National Bank of Hungary, 'Fizetési Mérleg Jelentés', January 2015.

⁴ Világ gazdaság Online, www.vg.hu/gazdasag/menekul-a-toke-magyarorszagrol-441127 and National Bank of Hungary, 'Fizetési Mérleg Jelentés', January 2015.

achieved with the state having bought MKB and the Budapest Bank and having agreed with Erste Bank to purchase a 15% participation in that bank. The Russian-owned Sberbank may also go over to Hungarian state ownership. The further faith of majority state-owned banks is unclear. Both lasting state ownership and early reprivatisation to Hungarian owners are possible, both solutions bearing the danger of immediate political interference, a guarantee of inefficiency under the current political constellation in Hungary. Nevertheless, in its most recent information on this issue the government declared its intention to reprivatise the banks concerned within three years.

This year foreign exchange mortgage loans of households will be converted into forint-denominated loans. The conversion will take place at the daily rate of 7 November 2014 (256 HUF/CHF and 309 HUF/EUR). This is much more favourable for the banks (and worse for the households involved) than the conversion rate of 180 HUF/CHF and 250 HUF/EUR applied in a 2011 campaign designed for the richest segment of the forex debtors. Still the 'fair banking' law mentioned above will cost the banks an equivalent of 2% of GDP, and in this context forex debtor households come off better. The average monthly amortisation of the involved households' loans is assumed to shrink by 20% to 30% after being converted into Hungarian forint. All in all, the exit of forex mortgage loans (their value corresponds to 10% of the GDP) is a painful but necessary step to defuse a dangerous time bomb.

On 9 February 2015 the Hungarian government announced a U-turn in its policy towards the financial sector. In a Memorandum of Understanding with the EBRD the government promised to cut the rate of the bank tax (projected on the balance sheets of individual banks) from the current 0.53% to 0.31% in 2016 and to 0.21% in 2017. From 2019 the tax rate is planned to be adjusted to EU norms. The tax amounts to HUF 144 billion this year, and delivers about 0.9% of total fiscal revenues (all special taxes combined about 5.5%)⁵. It remains to be seen whether this turn in policy will hold (originally the government had announced to phase out the tax by 2014 and that promise was broken). The change, if realised, may help the revitalisation of the ailing financial intermediation, but it also raises the necessity to find an alternative source of revenues for the budget to make up for the losses due to the elimination of the bank tax.

Summarising, though Hungary has left behind recession, it has not entered a sustainable growth path yet. The strong external stimulus to growth received from the EU in the last one and a half years helped reanimate, to some extent, private investment and employment in the business sector. The growth-enhancing impact of these one-off effects made us to revise upwards our forecast for 2014. Once this extraordinary addition to domestic demand gets weaker from this year onwards, other, private domestic and external factors should carry on the recovery. It is doubtful whether this will occur. FDI inflows have ebbed out and financial transmission is yet far from fulfilling its due role in the economy, to mention only the two most important obstacles to sustained recovery. In addition to these, there are the evergreen issues of the past five years: the uncertainty of the legal environment, the extreme centralisation of government decisions and cronyism, pointless confrontations with the EU and the United States, the Prime Minister's attraction to Putin's Russia and dubious autocratic regimes such as that in Azerbaijan. In these circumstances, economic growth is assumed to reach not more than 2% in the medium run, leaving the hope for catching up with the core EU countries or the Visegrad peers frustrated.

⁵ Own calculation based on Portfolio, 'Orbán megint megígérte a kölönadók csökkentését', 15 January 2014.

Table 1 / Hungary: Selected Economic Indicators

	2010	2011	2012	2013	2014 ¹⁾	2015	2016	2017
						Forecast		
Population, th pers., average ²⁾	10,000	9,948	9,920	9,894	9,850	9,830	9,810	9,800
Gross domestic product, HUF bn, nom. ³⁾	26,946	28,035	28,549	29,846	31,570	33,000	34,500	36,200
annual change in % (real) ³⁾	0.8	1.8	-1.5	1.5	3.5	2.3	2.0	2.0
GDP/capita (EUR at exchange rate)	9,800	10,100	9,900	10,200	10,400	.	.	.
GDP/capita (EUR at PPP)	16,400	17,100	17,300	17,600	18,400	.	.	.
Consumption of households, HUF bn, nom. ³⁾	13,679	14,292	14,880	15,254	15,960	.	.	.
annual change in % (real) ³⁾	-2.8	0.8	-2.0	0.1	2.4	2.0	1.4	1.4
Gross fixed capital form., HUF bn, nom. ³⁾	5,492	5,552	5,458	5,949	6,930	.	.	.
annual change in % (real) ³⁾	-9.5	-2.2	-4.2	5.2	14.0	5.0	3.0	3.5
Gross industrial production								
annual change in % (real)	10.5	5.6	-1.8	1.1	7.5	6.0	5.0	4.0
Gross agricultural production								
annual change in % (real)	-11.1	11.1	-10.0	12.2	9.2	.	.	.
Construction industry								
annual change in % (real)	-10.4	-8.0	-6.7	8.5	14.3	5.0	3.0	3.0
Employed persons, LFS, th, average ⁴⁾	3,781	3,812	3,827	3,893	4,101	4,120	4,140	4,150
annual change in %	0.0	0.8	1.8	1.7	5.3	0.5	0.5	0.2
Unemployed persons, LFS, th, average ⁴⁾	475	468	473	441	343	.	.	.
Unemployment rate, LFS, in %, average ⁴⁾	11.2	10.9	11.0	10.2	7.7	7.5	7.3	7.2
Reg. unemployment rate, in %, end of period	13.3	12.4	12.8	9.3	8.9	.	.	.
Average monthly gross wages, HUF ⁵⁾	202,525	213,094	223,060	230,664	237,100	.	.	.
annual change in % (real, gross)	-3.4	1.3	-0.9	1.7	3.0	.	.	.
Average monthly net wages, HUF ⁵⁾	132,604	141,151	144,085	151,085	155,300	.	.	.
annual change in % (real, net)	1.8	2.4	-3.4	3.1	3.0	.	.	.
Consumer prices (HICP), % p.a.	4.7	3.9	5.7	1.7	0.0	1.5	2.5	3.0
Producer prices in industry, % p.a.	4.0	4.1	4.1	0.6	-0.4	.	.	.
General governm.budget, EU-def., % of GDP								
Revenues	45.2	44.4	46.4	47.3	48.0	.	.	.
Expenditures	49.7	49.9	48.7	49.7	50.2	.	.	.
Net lending (+) / net borrowing (-)	-4.5	-5.5	-2.3	-2.4	-2.2	-2.8	-2.9	-2.9
Public debt, EU-def., % of GDP	80.9	81.0	78.5	77.3	77.3	77.5	77.0	76.8
Central bank policy rate, % p.a., end of period ⁶⁾	5.75	7.00	5.75	3.00	2.10	.	.	.
Current account, EUR mn ⁷⁾	274	754	1,873	4,162	4,495	4,000	3,700	3,500
Current account, % of GDP	0.3	0.8	1.9	4.1	4.4	3.8	3.4	3.0
Exports of goods, BOP, EUR mn ⁷⁾	66,130	71,793	70,299	72,409	76,527	81,700	87,400	92,600
annual change in %	16.4	8.6	-2.1	3.0	5.7	6.8	7.0	6.0
Imports of goods, BOP, EUR mn ⁷⁾	63,514	68,868	67,261	68,822	73,384	78,500	83,600	88,600
annual change in %	17.2	8.4	-2.3	2.3	6.6	7.0	6.5	6.0
Exports of services, BOP, EUR mn ⁷⁾	14,650	16,039	16,125	16,788	17,452	18,500	19,400	20,200
annual change in %	10.1	9.5	0.5	4.1	4.0	6.0	5.0	4.0
Imports of services, BOP, EUR mn ⁷⁾	12,005	12,752	12,327	12,751	12,875	13,400	13,800	14,200
annual change in %	-1.0	6.2	-3.3	3.4	1.0	4.0	3.0	3.0
FDI inflow (liabilities), EUR mn ⁷⁾	1,358	4,430	4,366	4,063	3,040	.	.	.
FDI outflow (assets), EUR mn ⁷⁾	597	3,458	2,345	3,689	2,695	.	.	.
Gross reserves of NB, excl. gold, EUR mn	33,667	37,242	33,757	33,696	34,481	.	.	.
Gross external debt, EUR mn ⁷⁾	140,558	135,351	127,230	119,148	120,000	.	.	.
Gross external debt, % of GDP	143.7	134.9	128.9	118.5	117.6	.	.	.
Average exchange rate HUF/EUR	275.48	279.37	289.25	296.87	308.71	315	315	315
Purchasing power parity HUF/EUR	164.54	164.39	166.35	171.01	173.74	.	.	.

1) Preliminary and wiiw estimates. - 2) From 2011 according to census October 2011. - 3) According to ESA 2010. - 4) From 2012 according to census 2011. - 5) Enterprises with 5 and more employees. - 6) Base rate (two-week NB bill). - 7) BOP 6th edition.
Source: wiiw Databases incorporating Eurostat and national statistics.