HUNGARY: Formidable take-off with limited expiration date

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Economic growth in Hungary accelerated still more in the second quarter of 2014, driven by a robust take-off in investment and an increase in household consumption for the first time in many years. However, the looming scarcity of EU-financed projects, the prevailing legal uncertainties and an ailing financial system may well render the current boom unsustainable.

With economic growth further accelerating in the second quarter of 2014, Hungary's GDP expanded by 3.8% in the first half of the year. The take-off spread to nearly each sector of the economy, even if the rate of expansion varied substantially. Construction increased by over 20%, industry over 9%, and despite the high basis due to the good harvest in the previous year, the expansion was considerable in agriculture as well. Growth has been substantially weaker in services, the largest sector of the economy. Within services, real estate and financial and insurance services continued to decline.

On the demand side of the GDP, the biggest item, household consumption, increased by 2%, but the really positive news has been the robust, 17% take-off in gross fixed capital formation. A decomposition of GDP growth displays the positive contributions of consumption and gross capital formation in the proportion 1:3. Accelerating consumption and especially investment have taken their toll in the foreign trade flows (as registered in the national account statistics). For the first time in years net export had only a marginal positive contribution to GDP growth.

The accelerating economic growth is partly explained by one-off factors. 2014, the last but one year for payments out of the 2007-2014 Multiannual Financial Framework of the EU, brought a real bonanza in EU co-financed investments. In the first half of the year the forint equivalent of EUR 3 billion was paid from this pot, and approximately as much will still be paid until the end of this year. That means that EU resources, primarily for investment, will amount to 5% to 6% of the GDP, about twice as much as the average in the period 2007-2013. That is a huge invigorating injection into domestic demand. 2014 has also been a year of three elections: parliamentary elections, those for the European Parliament, and municipal ones. The election campaign-related acceleration of long neglected projects explains the boom in several spectacular public investment projects (in nearly all cases EU-co-financed), implemented both by the central and by the local governments.

The National Bank's preferential credit line opened for SMEs also made a positive contribution to the upturn of investments. Still, the lending activity of the financial sector is further on fairly restrained, and without the preferential credit line the figures would be even worse. Deleveraging has been continuing, and the credit/deposit ratio may soon reach 100%.

The Hungarian financial sector has remained in poor shape, with gigantic losses foreseen for this and the next year. In the framework of a 'compensation for unfair contractual terms' banks will have to refund clients (a) for too large exchange rate bid-ask spreads calculated in foreign exchange credit transactions and (b) for unilateral contract modifications (typically higher interest rates charged without the client's consent). Total costs of the reparation to be paid by the banks may amount to HUF 900 billion, 3% of the GDP according to the estimation of the central bank. The government also announced that foreign exchange credits will have to be converted to HUF credits next year, but here the details are not known yet. That will hit the financial sector hard as well. Of the eight large banks in Hungary with an altogether 80% market share, three (Erste, Raiffeisen, CIB) will need considerable capital injections from their foreign parent banks in order to further on maintain the required capital adequacy ratio. The government makes no secret of its intention to reach a higher share of domestic (private or state) ownership in the financial sector even if this is achieved via the exit of foreign-owned banks. The government's recent purchase of MKB, one of the eight large banks, from the Bayerische Landesbank should be seen as been part of this process.

The expansion of the economy has had a positive impact on the labour market – even if public work schemes and tricks with calculating part of the outward migrants as domestic employment help inflate employment data. The unemployment rate declined to a six-year low, and jobs have been added in the business sector as well. Rocketing public investments have obviously had their secondary positive impact on sub-contractors in the business sector, generating additional employment. Due to the unexpectedly low CPI inflation real wages increased by over 3% in the first six months, more than double the rate in the previous year. The 2% expansion of household consumption reflects both the improved employment situation and the increase in real wages.

The escalating conflict in Hungary's eastern neighbourhood, the already introduced and potential further EU sanctions and counter-sanctions by Russia raise the question of possible effects on the Hungarian economy. The structure of Hungarian exports to and imports from Russia display completely different features. In exports, the share of machinery and transport equipment is 45%, that of manufactured products 44%. Food and beverages make up somewhat less than 10%. In imports, fuels account for 90% while other commodity groups are of limited relative importance.

The strongest impact of the counter-sanctions introduced by Russia may appear in the agricultural sector. Hungary's agricultural exports to Russia are relatively modest, amounting to EUR 266 million in 2013, about 4% of total Hungarian exports of this commodity group. The really sensitive exports are those of meat (pork and poultry) and fruits and vegetables (mainly apples). Losses in the pork sector will be minimal as exports have already been prohibited by Russia earlier, with reference to the pig pest. The fruit and vegetable sector will be the real concern. The main problem is not so much the loss of revenues from exports to Russia, but the indirect impact. Other traditional EU suppliers of Russia (Polish, Baltic and German exporters) will appear with their now superfluous produce as strong competitors to Hungarian fruits and vegetables in Hungary's traditional export markets for this commodity group. Another, even if limited, indirect negative impact on domestic producers may be the imports of cheap grain from Ukraine, due to the loss of Ukraine's export market in Russia.

Another impacted sector may be car manufacturing where Russia may introduce import restrictions. Magyar Suzuki, Audi Hungaria in the first line, but also Opel and Mercedes deliver to the Russian market partly from Hungary. Smaller difficulties have already emerged, and there is a fear that other difficulties may follow if the EU bans exports of automobile components with dual (civil and military) use to Russia. That may hurt a couple of important Hungarian car component producers (e.g. Knorr-Bremse, Rába).

Nevertheless, the really big issue of the Hungarian-Russian economic relations is the reconstruction and enlargement of the nuclear power station Paks. Hungary agreed to raise a credit from Russia in the value of EUR 10 billion to finance this project. The details of the agreement are confidential, but allegedly it ensures that a substantial part of the construction activities will be implemented by Russian firms. This giant project will further increase Hungary's long-term dependence on Russia in the field of electricity generation, beyond the already existing dependence on Russian gas and oil deliveries. It is still an open question how the EU will judge these plans in the current circumstances. A critical point is not only the growing physical, and through the giant credit also financial, dependence on Russia but the non-transparent credit agreement and the related public procurement procedures as well.

How lasting may the current take-off in the Hungarian economy be? The public investment bonanza will fade away in the next and the following year as the EU-related inflows from the 2007-2013 financial framework runs out and those from the 2014-2020 financial framework will still be relatively moderate. The compensation of banks' clients for 'unfair practices', as mentioned above, may create additional purchasing power for the households involved, thus supporting domestic demand. The key issue, however, is the prospective behaviour of domestic and foreign investors in the business sector. In this respect optimism is not really justified. Legal uncertainty, arbitrary changes in taxation, and hardly disguised cronyism in public procurement have all become chronic problems under the Orbán government. Though Hungary was ranked 63rd in the World Economic Forum's ranking of 148 countries by international competitiveness, in areas such as the burden of government regulation, efficiency of the legal framework challenging regulations, and transparency of government policy-making, Hungary's ranking proved to be disastrous: 140th, 138th, and 132nd respectively. These figures do not predict a massive future inflow of foreign direct investment, nor vigorous domestic investment activities. A well-functioning, growth-friendly financial system is not in sight either. Foreign-owned banks struggle for survival, and the government-promoted extension of a half market-based, half politically dominated Hungarian-owned segment is everything but a guarantee for an early consolidation in the financial transmission. For all these reasons, wiiw regards the current acceleration of economic growth as temporary and forecasts a return to lower GDP growth rates (2.2% and 2.0%) in 2015 and 2016.

Table 1 / Hungary: Selected Economic Indicators

	2010	2011	2012	2013 1)	2013	2014	2014	2015	2016
					January-June		Forecast		
Population, th pers., average 2)	10,000	9,948	9,920	9,894	.	.	9,850	9,830	9,810
Gross domestic product, HUF bn, nom. 3)	26,946	28,035	28,549	29,846	13,661	14,506	31,400	32,900	34,400
annual change in % (real) 3)	0.8	1.8	-1.5	1.5	-0.2	3.8	3.0	2.2	2.0
GDP/capita (EUR at exchange rate)	9,800	10,100	9,900	10,200	.	.	.	.	.
GDP/capita (EUR at PPP)	16,400	17,100	17,300	17,800	.	.	.	.	.
Consumption of households, HUF bn, nom. 3)	13,679	14,292	14,880	15,254	7,339	7,533	.	.	.
annual change in % (real) 3)	-2.8	0.8	-2.0	0.1	-0.3	2.0	2.3	1.8	1.3
Gross fixed capital form., HUF bn, nom. 3)	5,492	5,552	5,458	5,949	2,082	2,450	.	.	.
annual change in % (real) 3)	-9.5	-2.2	-4.2	5.2	0.7	16.8	10.0	6.0	5.0
Gross industrial production									
annual change in % (real)	10.5	5.6	-1.8	1.1	-1.7	9.4	7.5	6.0	6.0
Gross agricultural production									
annual change in % (real)	-11.1	11.1	-9.8	12.4	.	.	.	.	.
Construction industry									
annual change in % (real)	-10.4	-8.0	-6.7	8.5	6.0	22.8	14.0	8.0	7.0
Employed persons, LFS, th, average	3,781	3,812	3,878	3,938	3,875	4,100	3,980	4,020	4,060
annual change in %	0.0	0.8	1.7	1.6	1.1	5.8	1.0	1.0	1.0
Unemployed persons, LFS, th, average	475	468	476	449	479	364	.	.	.
Unemployment rate, LFS, in %, average	11.2	10.9	10.9	10.2	11.1	8.2	8.5	8.3	8.0
Reg. unemployment rate, in %, end of period	13.3	12.4	12.8	9.3	11.2	10.0	.	.	.
Average monthly gross wages, HUF 4)	202,525	213,094	223,060	230,664	228,063	235,040	.	.	.
annual change in % (real, gross)	-3.4	1.3	-0.9	1.7	1.1	3.2	.	.	.
Average monthly net wages, HUF 4)	132,604	141,151	144,085	151,085	149,381	153,951	.	.	.
annual change in % (real, net)	1.8	2.4	-3.4	3.1	2.4	3.2	.	.	.
Consumer prices (HICP), % p.a.	4.7	3.9	5.7	1.7	2.3	0.2	0.3	2.0	3.0
Producer prices in industry, % p.a.	4.0	4.1	4.1	0.6	0.2	-0.8	.	.	.
General governm.budget, EU-def., % of GDP									
Revenues	44.8	53.5	45.8	46.4	.	.	.	.	.
Expenditures	49.2	49.3	47.9	48.7	.	.	.	.	.
Net lending (+) / net borrowing (-) 5)	-4.3	4.2	-2.1	-2.3	.	.	-3.0	-3.0	-3.0
Public debt, EU-def., % of GDP	80.8	81.0	78.4	77.3	.	.	78.0	77.5	77.0
Central bank policy rate, % p.a., end of period 6)	5.75	7.00	5.75	3.00	4.3	2.3	.	.	.
Current account, EUR mn 7)	274	754	1,873	4,162	1,681	1,876	3,600	3,300	3,100
Current account, % of GDP	0.3	0.8	1.9	4.1	3.6	4.0	3.6	3.2	2.8
Exports of goods, BOP, EUR mn 7)	66,130	71,793	70,299	72,409	35,562	37,600	76,200	81,400	87,100
annual change in %	16.4	8.6	-2.1	3.0	1.2	5.7	5.3	6.8	7.0
Imports of goods, BOP, EUR mn 7)	63,514	68,868	67,261	68,822	33,884	36,051	73,000	78,100	83,200
annual change in %	17.2	8.4	-2.3	2.3	1.0	6.4	6.1	7.0	6.5
Exports of services, BOP, EUR mn 7)	14,650	16,039	16,125	16,788	8,008	8,176	17,600	18,700	19,600
annual change in %	10.1	9.5	0.5	4.1	4.8	2.1	5.0	6.0	5.0
Imports of services, BOP, EUR mn 7)	12,005	12,752	12,327	12,751	6,052	6,149	13,100	13,600	14,000
annual change in %	-1.0	6.2	-3.3	3.4	3.8	1.6	3.0	4.0	3.0
FDI inflow (liabilities), EUR mn 7)	1,358	4,429	4,366	4,063	2,219	219	.	.	.
FDI outflow (assets), EUR mn 7)	597	3,458	2,345	3,689	2,688	1,542	.	.	.
Gross reserves of NB, excl. gold, EUR mn	33,667	37,242	33,783	33,696	34,238	35,985	.	.	.
Gross external debt, EUR mn 7)	140,558	135,351	127,230	119,148	126,693	121,294	.	.	.
Gross external debt, % of GDP	143.7	134.9	128.9	118.5	125.7	118.6	.	.	.
Average exchange rate HUF/EUR	275.48	279.37	289.25	296.87	296	307	315	315	315
Purchasing power parity HUF/EUR	164.54	164.39	166.35	171.01	.	.	.	.	.

1) Preliminary. - 2) From 2011 according to census October 2011. - 3) Annual data based on ESA 2010, quarterly data still on ESA 1995. - 4) Enterprises with 5 and more employees. - 5) 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). - 6) Base rate (two-week NB bill). - 7) BOP 6th edition.

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