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Hungary:
New government's visions cut to size

After the deep recession in 2009 the signs of a beginning recovery have been becoming stronger in the first months of this year. Industrial production expanded by 5.7% in January-April compared to the respective period last year. This upturn is the result of growing foreign demand: export sales of industry increased by close to 13% while still shrinking domestic markets absorbed nearly 10% less industrial products in the first quarter of this year as compared to the first quarter of 2009. The two most important branches of Hungarian industry – production of road vehicles and of computers, electronic and optical devices – registered a particularly strong expansion, but their output lags far behind the pre-crisis levels yet. In foreign trade, decline turned into growth at the end of 2009 (exports) and in January 2010 (imports) respectively. Reflecting the effect of the still hibernating domestic market, the gap between export and import growth rates remained large: it amounted to 5 percentage points in the first quarter of the year, resulting in a more than doubling of the trade surplus (to EUR 1.3 billion) compared the respective period of 2009. Other segments of the economy present a mixed picture: output indicators of transport have improved, but construction and retail trade sales have been further declining. This mixed performance is mirrored in the GDP growth rates: data suggest that the GDP decline experienced in the preceding five consecutive quarters came to halt in the first quarter of 2010. Net exports and public consumption contributed positively to the marginally small (+0.1%) GDP change in the first quarter, while consumption of households and gross fixed capital formation were further declining and yielded a negative contribution to the GDP change.

The impact of the crisis appears with a time lag in employment. There has been a dramatic, 24% increase in the number of unemployed persons compared to the first quarter of 2009, resulting in a nearly 2 percentage point increase in the unemployment rate. Employment decreased by 1.3% in the overall economy, with significant differences by sector: employment in the public sector rose by over 5% (due to temporary public employment programmes) but in the private sector it decreased by more than 5%. The deteriorating situation on the labour market is in contradiction to the developments of net wages: the latter increased by 5.6% in real terms in the first quarter. This unusual

combination is the result of changes in the rules of personal income taxation (moving upwards the tax brackets for the lower tax rate). Changes in taxation (the one-off effect of the higher VAT rate) also explain the noticeably high consumer price inflation, an outlier in the current deflationary international environment.

After a landslide victory in the recent elections the Fidesz party, obtaining more than two thirds of the seats in the parliament, took over the government on 29 May with Viktor Orbán as new Prime Minister. Fidesz is now empowered to change any law including the constitution. The Number One challenge faced by the new government without delay is that of the budget for the current and the next year.

What can be expected from the new government? Fidesz's vision of solving Hungary's economic problems has been elaborated and represented by György Matolcsy, the newly appointed Minister of Economy (responsible also for fiscal affairs as there is no longer an independent ministry of finance). The core idea is that Hungary should be catapulted to a higher growth path with the help of ample fiscal spending combined with low interest rates on loans. Dynamic growth is thought to automatically increase tax revenues and thus the problem of the budget deficit and eventually that of the public debt will be 'grown out'. Economic growth in this concept relies more than the current practice on domestic consumption, which in turn would rely more than currently on goods and services produced by domestic SMEs, a sector with firms being predominantly in Hungarian ownership.

This vision had a dramatic confrontation with reality on 4 and 5 June when high-ranking Fidesz officials announced that the Hungarian economy is on the verge of collapse and the country's fiscal stance is hardly better than that of Greece. The original purpose of this irresponsible announcement was to sell the idea that Hungary will not be able to observe the 3.8% GDP proportional general government deficit target agreed upon with the IMF and the European Commission and that the deficit may go up to 7% or more this year. The higher deficit would have created room for at least a part of the ambitious spending programmes. However, not only would the mentioned 7% deficit be far behind the 12.2% Greek deficit (EU Commission Spring Forecast), but the actual fiscal situation in Hungary is much less dramatic than indicated by the 7% deficit proposed by Fidesz. The 2010 budget, approved still under the previous government, foresaw a 3.8% (relative to the GDP) general government deficit. This figure has been coordinated with the IMF and the European Commission, the providers of the currently unused stand-by package for Hungary.[1] The outgoing minister of finance, just as the recently established independent

[1] Last summer Hungary managed to return to market-based financing of its public debt.

Fiscal Council, have been warning several times that the target deficit cannot be achieved without additional budget consolidation measures corresponding to approximately 1 percentage point of GDP. But even without these measures the deficit would not be higher than about 5% of GDP.

Only a few months ago the wiiw still saw room for manoeuvre opening up for the new government to surpass the 3.8% deficit target so that at least a tiny part of pre-election Fidesz promises (withdrawal of the most unpopular measures of the previous government's crisis management package, further immediate radical tax cuts, no budgetary restrictions of any kind any longer) can be realized. This belief was based, first, on the assumed initial confidence towards the incoming government (no bad track record as yet), second, on the acceptance of government-initiated demand management in a series of countries under IMF surveillance in the crisis year 2009 and, last but not least, the 5-6% general government deficit assumed to emerge in other Central European countries in 2010. However, the recent dramatic developments in Greece and the menace of fiscal collapse in Portugal, Spain, Italy and Ireland have rewritten the previous assumptions concerning the receptivity of the international environment in this respect. One by one, EU member states are announcing economic policy measures aimed at decreasing their fiscal deficits in order to preserve international financial investors' confidence.

The unfortunate communication of Fidesz officials about Hungary's fiscal difficulties, comparing them to those of Greece, pushed the country suddenly into the limelight of the international media and triggered a significant weakening of the Hungarian currency and that of the euro vis-à-vis the US dollar as well as drops in the stock exchanges all over the world. The immediate consequence was that the anyhow narrow room for attaining a higher than originally planned budget deficit through clever negotiations with the IMF and the EU shrank, within hours, to zero.

Three days after the communication debacle and the sudden weakening of the forint, the Prime Minister announced in the parliament a 29 points action plan for the economy. It consists of two strong restrictive elements with the purpose of securing the deficit target. Banks, insurance and leasing companies will be charged a new special tax this and the next two years, with the aim to collect HUF 200 billion (about EUR 750 million) revenue per annum.[2] The other measure is a 15% reduction of the wage bill in certain segments of the public sector, to be achieved either by wage cuts or lay-offs.

2 Though no details have been made public, the tax will most probably be charged on financial institutions' profits.

Other components of the package will come into force next year and these measures are in line with the pre-election Fidesz promises for tax reductions. The personal income tax will be 16% instead of 17% and 32%; on the other hand, currently untaxed minimum wages will be taxed as well. Although details are not yet known, this change will unambiguously re-arrange the tax burden to the detriment of low-income taxpayers. As opposed to this planned rearrangement, which will only benefit the affluent upper middle class but not the economy, a positive change was initiated for SMEs. These (up to an annual turnover of EUR 1.8 million) will have to pay only 10% corporate income tax, instead of the 19% charge on all other companies. Several so-called ‘small taxes’ with limited macroeconomic significance will also be abolished. As many important details of the planned measures are unclear as yet, it is too early to judge whether the package will be able to secure the achievement of the 2010 and the even more ambitious 2011 fiscal deficit target (below 3% relative to the GDP).

Other effects can be assessed more easily. The banks will face a serious challenge if the new tax is really introduced. Moreover, the new government prolonged a moratorium on the eviction of non-performing debtors with a mortgage on their real estate and prohibited providing foreign exchange-denominated mortgage loans. That will, without doubt, put a brake on financial intermediation and make loans more expensive than they currently are. While the exchange rate risk is missing in the case of forint-denominated loans, a possible hike in the central bank’s policy rate – as a reaction to a fiscal policy evaluated as too relaxed and/or as an attempt to strengthen the exchange rate of the forint – may push up interest rates of forint-denominated loans, dragging on the upturn of the economy. Restrictions in the public sector may push up unemployment and/or make the best experts leave for the private sector, while the indeed low efficiency of the sector would remain unchanged. All in all, this seemingly improvised bunch of measures cannot replace a well-prepared economic strategy which reconciles the original Fidesz targets with the requirements of real life.

Nevertheless, the growth of the Hungarian economy will slowly accelerate over the next couple of years, first driven by net exports, from the next year onwards also by a modest expansion of consumption. Fiscal consolidation and the related slow growth of import demand in Hungary’s main export markets Germany, Austria and Italy may drag, while rapid recovery in some extra-EU export markets may to some extent support export-driven growth. It is an important but yet unanswered question whether the new government’s efforts to facilitate a boom in domestic SME activities will yield results. While tax allowances for this segment of the economy may become helpful in this respect, the special tax on domestic financial institutions may make loans, also for SMEs, more

expensive. The biggest uncertainty is the effect of the planned special tax on financial intermediation, in an environment characterized by still shrinking financing for the business sector in the first quarter of the year. The current account will deteriorate over the next few years as compared to 2009 with domestic consumption slowly gaining momentum but it will remain substantially better than before the crisis. The exchange rate of the forint will slowly appreciate to the pre-elections 265-270 HUF/EUR level, in line with the new government's assumed readiness to accept reality and follow the down-to-earth economic policy of the previous caretaker government.

Table HU

Hungary: Selected Economic Indicators

	2006	2007	2008	2009 1)	2009	2010	2010	2011	2012
					1st quarter			Forecast	
Population, th pers., average	10071.4	10055.8	10038.2	10022.3	10022	10007	10011	10005	10000
Gross domestic product, HUF bn, nom.	23755.5	25408.1	26543.3	26094.8	5948.6	6018.4	27000	28200	29600
annual change in % (real)	4.0	1.0	0.6	-6.3	-6.7	0.1	0.8	2.5	3
GDP/capita (EUR at exchange rate)	8900	10100	10500	9300	.	.	.	.	.
GDP/capita (EUR at PPP)	15000	15600	16100	14900	.	.	.	.	.
Consumption of households, HUF bn, nom.	12436.5	13254.9	13919.4	13409.3	3222.1	3200.7	.	.	.
annual change in % (real)	1.9	0.3	-0.5	-7.6	-7.2	-4.7	-0.7	1.3	2
Gross fixed capital form., HUF bn, nom.	5161.3	5380.5	5559.1	5225.3	938.6	875.1	.	.	.
annual change in % (real)	-3.6	1.6	0.4	-6.5	-7.0	-4.4	3	9	10
Gross industrial production									
annual change in % (real)	9.9	7.9	-0.2	-17.5	-22.3	4.5	6	10	10
Gross agricultural production									
annual change in % (real)	-2.9	-11.6	27.6	-9.9	.	.	.	.	.
Construction industry									
annual change in % (real)	-0.7	-14.0	-5.2	-4.3	-5.0	-10.3	1	5	10
Employed persons - LFS, th, average	3930.0	3926.2	3879.4	3781.8	3764.1	3719.3	3760	3800	3840
annual change in %	0.7	-0.1	-1.2	-2.5	-2.1	-1.2	-0.5	1	1
Unemployed persons - LFS, th, average	316.7	312.0	329.1	420.7	402.8	497.8	.	.	.
Unemployment rate - LFS, in %, average	7.5	7.4	7.8	10.0	9.7	11.8	11.5	10.5	9.3
Reg. unemployment rate, in %, end of period	9.1	10.1	10.9	13.8	12.9	14.7	.	.	.
Average gross monthly wages, HUF 2)	171351	185017	198964	199775	195842	206913	.	.	.
annual change in % (real, net)	3.6	-4.6	0.8	-2.6	-2.7	5.6	.	.	.
Consumer prices (HICP), % p.a.	4.0	7.9	6.0	4.0	2.7	5.8	4.4	3.5	3
Producer prices in industry, % p.a.	6.6	0.3	4.6	4.5	7.6	-0.9	.	.	.
General governm.budget, EU-def., % GDP									
Revenues	42.6	44.8	45.4	45.8	.	.	.	.	.
Expenditures	52.0	49.8	49.2	49.8	.	.	.	.	.
Net lending (+) / net borrowing (-)	-9.4	-5.0	-3.8	-4.0	.	.	-4.0	-4.0	-3.5
Public debt, EU-def., in % of GDP	65.6	65.9	72.9	78.3	.	.	78	79	78
Base rate of NB, % p.a., end of period	8.0	7.5	10.0	6.3	9.5	5.5	.	.	.
Current account, EUR mn 3)	-6472	-6631	-7409	222	-601	102	-1200	-2300	-2600
Current account in % of GDP	-7.2	-6.6	-7.0	0.2	-3.0	0.5	-1.2	-2.2	-2.3
Exports of goods, BOP, EUR mn 3)	58380	68178	72686	58806	13636	15979	64700	71200	78300
annual growth rate in %	17.5	16.8	6.6	-19.1	-27.0	17.2	10	10	10
Imports of goods, BOP, EUR mn 3)	60433	67987	72735	54763	13031	14754	59700	65100	71000
annual growth rate in %	16.5	12.5	7.0	-24.7	-28.9	13.2	9	9	9
Exports of services, BOP, EUR mn 3)	10876	12574	13804	13061	2891	3188	13700	14800	16300
annual growth rate in %	5.1	15.6	9.8	-5.4	1.4	10.3	5	8	10
Imports of services, BOP, EUR mn 3)	9643	11524	12843	11586	2780	2667	12200	13200	14500
annual growth rate in %	4.6	19.5	11.4	-9.8	-0.04	-4.1	5	8	10
FDI inflow, EUR mn 3)	15809	52328	43239	-4052	-101	-4104	.	.	.
FDI outflow, EUR mn 3)	14846	48915	41794	-5059	-814	-2803	.	.	.
FDI inflow, excl. SPE, EUR mn	5609	3956	4752	1021	750	163	1500	2500	3500
FDI outflow, excl. SPE, EUR mn	3127	2643	2020	1228	183	840	1000	1200	1500
Gross reserves of NB, excl. gold, EUR mn	16384	16305	23807	30601	27915	33771	.	.	.
Gross external debt, EUR mn	81205	98841	122898	130661	128783	135492	.	.	.
Gross external debt in % of GDP	86.1	98.7	123.5	135.4	133.5	138.0	.	.	.
Average exchange rate HUF/EUR	264.26	251.35	251.51	280.33	294.10	268.68	275	270	265
Purchasing power parity HUF/EUR	157.74	161.97	163.81	174.56	.	.	.	.	.

Note: Gross industrial production, construction output and producer price index refer to NACE Rev. 2.

1) Preliminary . - 2) Enterprises with 5 and more employees. - 3) From 2006 including Special Purpose Entities (SPEs), 2010-2012 data are estimated excluding SPEs.

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