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Hungary: switching to lower gear

Economic growth in Hungary decelerated in the first quarter of the year, from 4.5% in the respective period of 2004 to 2.9%, reflecting the trend in the European Union. The trade deficit has become smaller, and inflation has bottomed out after the hike related to the country's entry into the EU. Although the persisting budget deficit threatens to cause a delay in Hungary's accession to the euro-zone, the demand generated by government-initiated programmes and spending has been lending a boost to investments and thus prevented an even stronger deceleration of GDP growth.

Gross value added rose by 1.5% in the primary and secondary sectors combined; in services the expansion amounted to 3.6%. The former was substantially less, the latter somewhat more than the respective rate of expansion in the first quarter of 2004. The slowdown was particularly strong in industry. The growth rate of gross output fell from 10.4% in the first four months of 2004 to 3.6% in the respective period of 2005. Construction performed better; being the main beneficiary of state-initiated highway constructions, it recorded an expansion of more than 10% in the first quarter.

Investment increased by close to 7% in the first quarter, with construction investment expanding by over 12% due to the highway projects, while machinery investment was up by 2.7% only. An important development is the revival of investment in agriculture following the record (20%) gross output expansion in the sector last year.

Household consumption, rising by 2.2% in the first quarter, lagged 0.7 percentage points behind the GDP's expansion. This may be surprising in the wake of the 9.7% real wage growth in the first quarter. The reason is the postponement, to January 2005, of the paying and accounting of the 13th month salary of 2004 for public servants, which has resulted in a distortion of real wage data in both years. Real wages in March, cleared of those distorting effects, were 4.4% higher than in the respective month of 2004. Household consumption expanded at a slower pace, to some extent attributable to households' increasing savings/income ratio.

In the first quarter of the year employment in the business sector increased by 0.6%, while in the public sector it decreased by 1.4%. In sum the number of employed persons declined marginally while unemployment rose by one percentage point to 7.1%. Several factors account for that increase: the impact of the shift from a conscription army to a professional one, the higher pension entry age according to the reformed pension system, and the increasing number of university graduates with skills not in demand on the labour market.

According to foreign trade statistics, in the first four months of the year the expansion of exports was twice as large as that of imports (12% and 6%, respectively). The gap between export and import growth rates was particularly wide in April, reflecting the high basis in the case of imports due to last hasty import purchases in 2004 immediately prior to Hungary's accession to the EU on 1 May. The balance of payments data of the first quarter of 2005 show that the deficit in trade of goods halved as compared to the respective period of the previous year. However, due to a deterioration of the balance in services trade and income and in current transfers, the current account deficit was 14% higher than in the first quarter of 2004. Though Hungary's external financing requirement (combined current and capital account deficit) deteriorated only marginally as against the first quarter of 2004, non-debt creating financing covered only 16% of it, a coverage substantially less than a year earlier.

The budget deficit has remained the most critical issue. Due to various accounting manoeuvres of the government it is very difficult to get a clear picture about developments in this field. Last year's 13th month wages for public servants were paid in January 2005, disbursements of the value added tax rebate due in 2004 were partly brought forward to this year. Further tricks related to the off-budgetary financing of the highway construction projects will make the picture even more blurred. Although the development so far makes it likely that the fiscal deficit will come close to the envisaged year-end level already in early summer, the Ministry of Finance reckons with an improvement in the second half of the year and has not been ready as yet to revise its 3.6% (relative to GDP) deficit target. However, without intervention the deficit will most probably surpass 4% of the GDP by the end of the year. With regard to the approaching elections (spring 2006) it is not likely that radical expenditure cuts will be risked in the near future. Considering the discouraging record of election-related deficit spending cycles in Hungary, even the resistance to the temptation to buying votes with costly 'election sweeteners' will have to be appreciated. As a prologue to the election campaign, prime minister Gyurcsány announced a new government project labelled '100 steps'. The project initiates a series of small reform measures in health care, education, family allowance, labour market regulation, etc. Though these measures represent primarily a re-design of existing programmes within their pre-set financial framework, their overall impact on the fiscal balances is not yet clear.

Inflation (CPI) has been decreasing spectacularly (from 6.8% in January-May 2004 to 3.6% in the respective period of this year) as one-time effects related to EU accession are bottoming out. The monetary authorities continued with the cautious, stepwise reduction of the prime rate, which dropped to 7% by the end of June (from 11.5% a year earlier), leaving the real interest rate still remarkably high. Until mid-April the forint/euro rate was fairly close to the stronger edge of the intervention band, ranging between 241-248; since then it has turned somewhat weaker (248-255).

In 2005 economic growth will be less dynamic (about 3.3 to 3.5%) than it was last year, and for 2006 only a marginal acceleration can be expected. Inflation will remain low, the current account deficit to GDP ratio will improve moderately in both 2005 and 2006. In the coming several months the Hungarian political elite will be preoccupied with the preparations for the next elections. Although a longer-term consolidation of the budget – a precondition for accession to the euro-zone – requires fundamental reforms in sub-systems of the general government finances, these will not be launched before the inauguration of the new government. The latter, no matter of which political bent, will have to start its legislative period with unpopular measures or postpone the euro introduction beyond 2010.

After the editorial deadline for this report, the government announced a five-year tax package as a first milestone in a far-reaching reform of the public sector. The package is meant to positively affect economic growth through expected supply-side effects in the corporate sector and higher demand generated in the household sector. The highlights of the programme are: reducing the highest VAT rate to 20% (from currently 25%) from January 2006, gradual elimination of the municipal tax on sales, lowering the personal income tax rate, reducing the social security contributions, lowering the corporate tax rate that benefits primarily small and medium-size companies and, finally, the introduction of a luxury tax on real estates with a value of over EUR 400,000 (annually 0.5% of the value). These steps and the increase and differentiation of the minimum wage by education will have a negative primary net effect on the revenues of the budget, equalling about 0.8% of the GDP in 2006 and in 2007 as well. The government claims that the envisaged – but in detail still unknown – cuts in the budget expenditures to the same magnitude will ensure that the convergence targets concerning the budget will be observed. As a side effect of the lowering of the upper VAT rate, CPI inflation may be substantially lower than envisaged by the monetary authorities (possibly below 2%).

Table HU

Hungary: Selected Economic Indicators

	2000	2001	2002	2003	2004 ¹⁾	2004 1st quarter	2005 1st quarter	2005 forecast	2006 forecast
Population, th pers., end of period	10200.3	10174.9	10142.4	10116.7	10096.0	10110	10093	10065	10040
Gross domestic product, HUF bn, nom.	13150.8	14849.8	16740.4	18408.8	20338.2	4686	4865.1	21800	23300
annual change in % (real)	5.2	3.8	3.5	2.9	4.2	4.5	2.9	3.4	3.7
GDP/capita (EUR at exchange rate)	4953	5679	6782	7169	7996	.	.	.	.
GDP/capita (EUR at PPP - wiiw)	10510	11500	12350	12770	13620	.	.	.	.
Gross industrial production									
annual change in % (real)	18.1	3.6	2.8	6.4	8.3	10.4	1.7	5	7
Construction industry									
annual change in % (real)	7.9	7.7	17.5	2.2	6.8	15.5	11.7	.	.
Consumption of households, HUF bn, nom.	6689.2	7671.3	8756.3	9855.8	10925.5	2573.3	2716.5	.	.
annual change in % (real)	4.4	5.8	10.4	7.8	3.1	2.0	2.0	2.8	3.2
Gross fixed capital form., HUF bn, nom.	3179.8	3493.0	3916.9	4141.3	4598.9	731.4	792.8	.	.
annual change in % (real)	7.7	5.9	9.3	2.5	7.9	18.4	6.8	7	12
LFS - employed persons, th, avg.	3856.2	3868.3	3870.6	3921.9	3900.4	3891.5	3870.6	.	.
annual change in % ²⁾	1.2	0.3	0.1	1.3	-0.5	0.8	-0.5	.	.
Reg. employees in industry, th pers., avg. ²⁾	844.8	833.9	817.9	801.8	785.2	789.2	771.9	.	.
annual change in %	1.3	-1.3	-1.9	-2.0	-2.1	-2.2	-2.2	.	.
LFS - unemployed, th pers., average	263.7	234.1	238.8	244.5	252.9	252.2	297.4	.	.
LFS - unemployment rate in %, average	6.4	5.7	5.8	5.9	6.1	6.1	7.1	6.6	6.5
Reg. unemployment rate in %, end of period	8.6	8.0	8.0	8.3	9.2	9.1	10.0	8.5	8.5
Average gross monthly wages, HUF ²³⁾	87645	103553	122482	137193	145675	140719	160028	.	.
annual change in % (real, net)	1.5	6.4	13.6	9.2	-1.1	1.1	9.7	.	.
Consumer prices, % p.a.	9.8	9.2	5.3	4.7	6.8	6.8	3.6	3.6	3.3
Producer prices in industry, % p.a.	11.6	5.2	-1.8	2.4	3.5	4.3	4.0	4	.
General governm.budget, EU-def., % GDP ⁴⁾	-2.3	-3.7	-8.5	-6.2	-4.5	.	.	.	.
Revenues	45.3	45.0	44.1	44.5	47.5	.	.	.	.
Expenditures	47.6	48.7	52.6	50.7	52.0	.	.	.	.
Deficit (-) / surplus (+) ⁵⁾	-2.3	-3.7	-8.5	-6.2	-4.5	.	.	-4.1	-3.9
Public debt, EU-def., in % of GDP ⁴⁵⁾	55.4	52.2	55.5	56.9	57.6	.	.	.	.
Refinancing rate, % p.a., end of period	11.0	9.8	8.5	12.5	9.5	12.3	7.8	7.0	6.5
Current account, EUR mn	-4352.4	-3576.5	-4929.2	-6363.9	-7123.2	-1307.9	-1496.6	-7000	-7100
Current account in % of GDP	-8.6	-6.2	-7.2	-8.8	-8.8	-7.3	-7.5	-8.1	-7.7
Reserves total, excl. gold, EUR mn	12038.4	12163.7	9887.4	10108.3	11670.9	10156.5	13222.7	.	.
Gross external debt, EUR mn	32571.5	37387.0	38559.3	46035.6	54927.5	47929.1	58426.3	.	.
FDI inflow, EUR mn	2998.4	4390.7	3185.1	1909.0	3364.6	661.4	1091.1	.	.
FDI outflow, EUR mn	664.4	398.5	295.7	1465.6	424.2	252.2	376.7	.	.
Exports of goods, BOP, EUR mn	31277.5	34697.1	36820.7	38376.9	44515.8	10277.2	11425.4	49000	55400
annual growth rate in %	30.0	10.9	6.1	4.2	16.0	14.3	11.2	10	13
Imports of goods, BOP, EUR mn	34457.1	37192.8	39024.1	41274.5	46906.6	10679.4	11614.0	50700	56300
annual growth rate in %	32.0	7.9	4.9	5.8	13.6	11.3	8.8	8	11
Exports of services, BOP, EUR mn	6429.2	7864.7	7820.0	7665.6	8132.1	1874.2	2035.4	.	.
annual growth rate in %	30.9	22.3	-0.6	-2.0	6.1	16.7	8.6	.	.
Imports of services, BOP, EUR mn	5194.8	6203.3	7233.1	8043.1	8141.7	1851.9	2057.8	.	.
annual growth rate in %	26.9	19.4	16.6	11.2	1.2	-1.0	11.1	.	.
Average exchange rate HUF/USD	282.27	286.54	258.00	224.44	202.63	208.09	186.98	.	.
Average exchange rate HUF/EUR (ECU)	260.04	256.68	242.97	253.51	251.68	260.31	245.10	252	253
Purchasing power parity HUF/USD	107.34	110.10	114.72	120.50	125.22	.	.	.	.
Purchasing power parity HUF/EUR	122.57	126.74	133.44	142.34	147.73	.	.	.	.

Notes: 1) Preliminary. - 2) Enterprises with more than 5 employees. - 3) The high growth in the first quarter 2005 results from the one month extra salary paid out in January instead of December. - 4) According to ESA95, excessive deficit procedure. - 5) After corrections related to the pension reform.

Source: wiiw Database incorporating national statistics; Eurostat; EU Economic Forecasts, Spring 2005; wiiw forecasts.