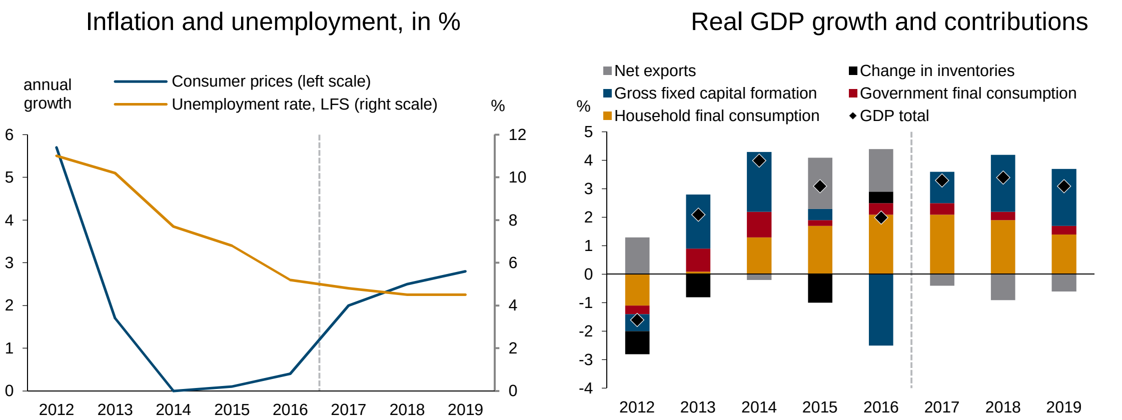
HUNGARY: Thriving household consumption pushes the economy onto a higher growth path

SÁNDOR RICHTER

Over the next three years, economic growth is forecast to remain above 3%. In 2016, the expansion of household consumption was the main driver of growth, and that will remain the case, at least until the election year 2018. A deterioration will begin in the external balances; there is expected to be a recovery in investment, largely financed by EU funds.

Figure 40 / Hungary: Main macroeconomic indicators



Source: wiiw Annual Database incorporating national and Eurostat statistics, own calculation. Forecasts by wiiw.

In 2016, economic growth slowed considerably (2%) compared to 2014-2015. The main driver of growth in 2014-2015, the EU co-financed investments, experienced a deep (albeit temporary) decline, as a consequence of a flaw in the construction of the Multiannual Financial Framework (MFF) of the EU, which allowed for considerable fluctuation in the funds disbursed at the interface of the two seven-year planning periods. Last year, household consumption growth replaced investment as the driver of expansion; it will continue to fulfil that function at least until the election year 2018.

Government attempts to counter the EU funds-related temporary investment decline had only limited success. The Hungarian government had promised an early mobilisation of cohesion policy-related EU resources from the 2014-2020 MFF to curb the anticipated decline in investment last year. There was to be an extended advance payment from the budget to the widest possible circle of beneficiary firms and institutions; the respective EU funds would have been collected later. But this plan could be implemented only partially: fixed capital formation generally – and within that, public investment in particular – declined sharply. The main contribution to growth came from consumption and, to a nearly equal extent, from net exports. The former is explained by a rapid rise in net real wages (7-8%); the latter by improved terms of trade and damped import demand due to the low tide of investment.

Wage increases have been accelerating since 2015, with a sudden jump last year. The explanation for this phenomenon is multi-faceted. A considerable push for wage rises resulted from the tightening labour market.

Employment expanded dynamically, while the unemployment rate declined, but the number of persons involved in public works schemes matches the number of those reported unemployed. Outward migration has also reduced the supply of skilled labour in an increasing number of areas of the economy. Some 75% of manufacturing firms already report shortage of labour as an obstacle to production. The figure is over 30% in the services sector with tourism, the retail trade, IT and the health sector affected the most. Both in manufacturing and the services sector the Hungarian indicator for shortage of labour is roughly double that reported by the country's regional peers. All in all, strong wage rises are supported by labour market developments. This push will be further strengthened by a big increase in the statutory minimum wage in 2017: 15% for unskilled and 25% for skilled employees. A change in taxation is trying to counterbalance the negative impact of wage increases on employers: social security contribution payed by employers (as a percentage of gross wages) were reduced from 27% to 22%, and it is envisaged that they will be cut by another 2 percentage points in 2018. There are further employment-fostering taxation changes in the pipeline for 2018 and beyond.

Both market forces and government initiatives will promote wage rises and a corresponding increase in household consumption in the coming years. An important question is how the subsystems of the economy will respond. Increased consumption will, without doubt, induce a surge in imports. In the short run, this should not be a problem because of the huge foreign trade surplus. Wage rises in the public sector will place an increased burden on the budget, but again there is no cause for concern in the short run, as there is room for greater expenditure without danger of the 3% deficit/GDP ratio being surpassed. Strong wage growth may, however, be problematic for firms. Multinational companies (which in any case pay higher wages than Hungarian-owned ones) can adapt more easily to the new situation than domestically owned small and medium-sized firms with a much lower productivity level. This latter group of firms will have to cope with increased labour costs. A positive outcome to this would see efforts being made to improve productivity; a negative outcome would see an increase in illegal employment, the postponement of company expansion – or even bankruptcy.

Fiscal policy is expected to be growth supportive in view of the forthcoming elections. Up until the last few days of 2016, the record of expenditure and revenue meant that the general government deficit for that year could have been very low. But then the government introduced a huge 'last-minute' increase in expenditure across a wide range of areas: e.g. advance payments for EU projects, being under the control of individual ministries, the health sector, etc.). Certainly this expenditure will have an impact on the real economy only this year. The general government deficit may after all have exceeded 2% of GDP. The government will most probably use the room opened up for deficit spending without endangering fiscal stability in the next two years, as prescribed in the Maastricht criteria. As for the fiscal steps to be taken in the run-up to the elections in spring 2018, these are expected to involve mostly 'mood-improving' measures: a reduction in some centrally regulated prices, a cut in tax rates, wage increases in the public sector.

The foreign exposure of Hungarian public finance has decreased considerably in recent years. Purchases of government securities by the banking sector and by households enabled the public sector to refinance the maturing foreign exchange debt without major foreign exchange bond issuance. The share of foreign currency-denominated debt in the government's total external debt dropped to the level observed pre-crisis. As for monetary policy, it remains relaxed and the policy rate is expected to stay relatively low this year and next, despite recurring inflation. The financial sector shows encouraging signs of recovery, with lending starting to grow for both the business and the household sectors.

Over the medium term, the country's massive trade surplus will shrink. The Hungarian current account displayed huge surpluses in 2013-2016, ranging from 2% to more than 4% of GDP. This came from a surplus in trade in goods and services (7-10% of GDP) and the large net inflow of EU transfers (3-5%), while the income balance (4-6% of GDP in the last six years) reduced the current account surplus in the years concerned. The improvement in the terms of trade due to low prices for imported energy has been considerable in the past four years. Meanwhile 2017 is expected to bring about a turn in foreign trade. The improvement in the terms of trade will cease, while a strong rise in household consumption and an upturn in investment will push the growth rate of imports above that of exports. On the forecast horizon, the surpluses in the trade and current account balances will diminish; but because of the huge surpluses, this will not impose any constraint on the new, mainly consumption-driven growth in the short run.

Together with the revival of EU co-financed investment projects, dynamically increasing consumption will be the Hungarian growth driver over the next couple of years. However, these developments will place the Hungarian economy at a crossroads:

› In an *optimistic scenario*, additional demand via a strong expansion in consumption will be met by an appropriate expansion of domestic supply in goods and services, and thus will not generate unsustainable import growth in the medium term. Firms that are domestically owned and that supply the domestic market will start modernising via revived investment activities; export-oriented foreign-owned firms will absorb the increased labour costs. This new dynamism in the economy will be maintained *despite* the current unfavourable political environment, characterised by lack of transparency and extreme centralisation of government decision making; the incalculable, abruptly changing legal regulations; and the widespread cronyism and corruption.

› In a *pessimistic scenario*, the pattern of 2002-2006 will recur: strong consumption growth will lead to a resurgence in unsustainable foreign trade and public finance deficits in just a few years; investment will remain heavily dependent on EU transfers and foreign direct investment; and modernisation across most of the economy will get further bogged down. Rapidly increasing wages will force an increasing number of foreign-owned manufacturing companies to relocate their activities to other countries, and the fact that after 2020 EU transfers will most probably decline substantially will bring the Hungarian economy to near stagnation. Certainly the unfavourable political environment described above will be of no help in avoiding this scenario.

In this and the next two years, economic growth is forecast to remain above 3%, with an expected peak of 3.4% in the election year 2018. A deterioration in the external balances will begin. Investment – carried mainly by EU transfers and supported by a reduction in the corporate income tax rate to 9% (from 19% in general and from 10% in the case of small enterprises) – may recover by 2018.

Meanwhile 2019 may be a year of consolidation, with already less-dynamic wage rises. While consumer price inflation will return to 'normal', general government deficit is expected to remain below the 3% of GDP threshold, with public debt slowly shrinking. The fiscal room is available now to improve the financial position of the long-neglected health and education sectors and to ease the extreme poverty of distinct social groups. It remains to be seen, however, whether this will happen or whether further prestige sports investments will steal the show.

Table 11 / Hungary: Selected economic indicators

	2012	2013	2014	2015	2016 [1)]	2017	2018 Forecast	2019
Population, th pers., average	9,920	9,893	9,866	9,843	9,810	9,780	9,750	9,720
Gross domestic product, HUF bn, nom.	28,661	30,127	32,400	33,999	35,500	37,700	40,200	42,600
annual change in % (real)	-1.6	2.1	4.0	3.1	2.0	3.3	3.4	3.1
GDP/capita (EUR at PPP)	17,400	17,900	18,700	19,700	20,300	.	.	.
Consumption of households, HUF bn, nom.	14,922	15,207	15,730	16,205	17,300	.	.	.
annual change in % (real)	-2.2	0.2	2.5	3.4	4.5	4.5	4.0	3.0
Gross fixed capital form., HUF bn, nom.	5,548	6,308	7,064	7,367	6,700	.	.	.
annual change in % (real)	-3.0	9.8	9.9	1.9	-11.5	5.0	9.0	9.0
Gross industrial production								
annual change in % (real)	-1.8	1.1	7.7	7.4	1.0	6.0	7.0	6.0
Gross agricultural production								
annual change in % (real)	-10.0	12.5	11.4	-2.3	8.5	.	.	.
Construction industry								
annual change in % (real)	-6.5	8.4	13.5	3.0	-18.8	.	.	.
Employed persons, LFS, th, average	3,827	3,893	4,101	4,211	4,350	4,370	4,390	4,390
annual change in %	1.8	1.7	5.3	2.7	3.3	0.5	0.5	0.0
Unemployed persons, LFS, th, average	473	441	343	308	237	220	210	210
Unemployment rate, LFS, in %, average	11.0	10.2	7.7	6.8	5.2	4.8	4.5	4.5
Reg. unemployment rate, in %, end of period	12.7	9.3	8.9	7.6	6.1	.	.	.
Average monthly gross wages, HUF [2)]	223,060	230,714	237,695	247,924	263,600	281,000	299,500	316,800
annual change in % (real, gross)	-0.9	1.7	3.2	4.4	5.9	4.5	4.0	2.9
Average monthly net wages, HUF [2)]	144,085	151,118	155,690	162,391	175,300	186,900	199,200	210,700
annual change in % (real, net)	-3.4	3.1	3.2	4.4	7.5	4.5	4.0	2.9
Consumer prices (HICP), % p.a.	5.7	1.7	0.0	0.1	0.4	2.0	2.5	2.8
Producer prices in industry, % p.a.	4.1	0.6	-0.4	-0.9	-1.7	1.0	2.0	2.3
General governm.budget, EU-def., % of GDP								
Revenues	46.2	46.8	46.9	48.5	47.5	47.5	47.5	47.5
Expenditures	48.6	49.3	49.0	50.0	49.8	50.4	50.4	50.4
Net lending (+) / net borrowing (-)	-2.3	-2.6	-2.1	-1.6	-2.3	-2.9	-2.9	-2.9
Public debt, EU-def., % of GDP	78.2	76.6	75.7	74.7	73.9	72.9	71.9	70.9
Stock of loans of non-fin.private sector, % p.a.	-12.8	-4.4	-0.3	-12.3	-1.8	.	.	.
Non-performing loans (NPL), in %, Dec	17.6	18.1	17.4	13.6	11.9	.	.	.
Central bank policy rate, % p.a., end of period [3)]	5.75	3.00	2.10	1.35	0.90	1.00	1.30	1.50
Current account, EUR mn [4)]	1,752	3,892	2,181	3,714	4,910	5,000	4,300	3,400
Current account, % of GDP [4)]	1.8	3.8	2.1	3.4	4.3	4.2	3.4	2.5
Exports of goods, BOP, EUR mn [4)]	69,961	70,243	74,423	79,604	82,613	86,700	91,900	98,100
annual change in %	-2.6	0.4	6.0	7.0	3.8	5.0	6.0	6.7
Imports of goods, BOP, EUR mn [4)]	67,028	66,912	72,051	75,237	77,632	82,300	88,600	95,900
annual change in %	-2.7	-0.2	7.7	4.4	3.2	6.0	7.7	8.2
Exports of services, BOP, EUR mn [4)]	16,060	16,993	18,640	19,957	20,853	22,100	23,600	25,200
annual change in %	0.1	5.8	9.7	7.1	4.5	6.0	6.9	6.7
Imports of services, BOP, EUR mn [4)]	12,263	13,232	13,732	14,562	14,789	15,800	17,100	18,500
annual change in %	-3.8	7.9	3.8	6.0	1.6	6.6	8.4	8.2
FDI liabilities, EUR mn [4)]	4,405	4,986	6,868	5,964	-8,129	.	.	.
FDI assets, EUR mn [4)]	2,310	3,848	4,035	5,565	-12,217	.	.	.
Gross reserves of NB excl. gold, EUR mn	33,757	33,696	34,481	30,226	24,384	.	.	.
Gross external debt, EUR mn [4)]	127,667	119,963	120,077	116,937	113,400	112,500	111,200	108,200
Gross external debt, % of GDP [4)]	128.8	118.2	114.4	106.6	99.5	93.4	87.1	81.0
Average exchange rate HUF/EUR	289.25	296.87	308.71	310.00	311.44	313	315	319

1) Preliminary and wiiw estimates. - 2) Enterprises with 5 and more employees. - 3) Base rate (two-week NB bill). - 4) Excluding SPE.

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