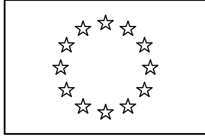

COMMISSION OF THE EUROPEAN COMMUNITIES

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REPORT FROM THE COMMISSION

Hungary

Report prepared in accordance with Article 104(3) of the Treaty

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1. INTRODUCTION AND JUSTIFICATION OF THE REPORT

On 7 April 2004, the Commission published its Spring 2004 forecasts. According to these forecasts, which took into consideration data reported by Hungary and validated by Eurostat in March 2004, the general government deficit in Hungary reached 5.9% of GDP in 2003, thus exceeding the 3% of GDP Treaty reference value.

Table 1: General government balance and debt (% of GDP)

	1998	1999	2000	2001	2002	2003	2004	2005
General government balance	-8.0	-5.6	-3.0	-4.4	-9.3	-5.9	-4.9	-4.3
General government gross debt	61.9	61.2	55.4	53.5	57.1	59.0	58.7	58.0

Source: Eurostat and Commission Spring 2004 forecasts.

At this stage, the estimated figure for the 2003 deficit provides evidence on the existence of an excessive deficit in Hungary, in the sense of the Treaty and the Stability and Growth Pact. The Commission therefore has decided to initiate the excessive deficit procedure (EDP) for Hungary.

The application of the EDP is governed by Article 104 of the Treaty and Council Regulation (EC) No 1467/97 "on speeding up and clarifying the implementation of the excessive deficit procedure", which is part of the Stability and Growth Pact (SGP).

Article 104(3) of the Treaty stipulates that "if a Member State does not fulfil the requirements under one or both of these criteria[1], the Commission shall prepare a report. The report of the Commission shall also take into account whether the government deficit exceeds government investment expenditure and take into account all other relevant factors, including the medium-term economic and budgetary position of the Member State…".

[1] The criteria are (a) whether the ratio of the planned or actual government deficit to gross domestic product exceeds the reference value of 3 %, unless: either the ratio has declined substantially and continuously and reached a level that comes close to the reference value; or, alternatively, the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value; (b) whether the ratio of government debt to gross domestic product exceeds the reference value of 60 %, unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace.

The present report prepared by the Commission according to Article 104(3) assesses recent and current budgetary developments in Hungary and reviews the short-term prospects in the light of overall economic conditions and policy action taken by the government.

2. RECENT MACROECONOMIC DEVELOPMENTS AND PROSPECTS

In the second half of the nineties, Hungary experienced steady real GDP growth of about 4 to 5%. This was supported by a combination of fiscal and monetary stabilisation policies and the implementation of appropriate market-oriented structural reforms. However, since 2001, real GDP growth slowed gradually, reaching 3.5% in 2002 and 2.9% in 2003. Per capita income in purchasing power standards as a percentage of the EU15 average has constantly increased since the second half of the nineties and stands at about 55% in 2003.

While the economic slowdown of the years 2001-2003 took place against the background of a weakening external environment, it also coincided with a significant increase in macroeconomic imbalances. This was the result of an easing in wage and fiscal policies as of 2001. The minimum wage almost doubled over the period 2001-2002 and wages of most public sector employees were increased by about 50% in Autumn 2002. These expansionary policies, together with a widening of the fluctuation bands in Spring 2001[2] and the unexpected subsequent devaluation of the central parity in June 2003[3], led to turbulences in the exchange rate market. As a measure of crisis prevention, and against the background of increasing inflation and a widening current account, the central bank's main refinancing rate was raised in two steps by 600 basis points to 12.5%.

The depreciation of the forint of about 4% in the second half of 2003, together with a deceleration of wages led to some improvement in the competitiveness of the Hungarian economy towards the 4th quarter of 2003. In such a context, the economy should benefit from the ongoing improvement in the global economy. Recently released figures suggest that economic fundamentals are indeed improving. The Commission in its Spring forecast expects a rebalancing of the sources of growth, and projects real GDP growth to accelerate moderately to 3.2% in 2004 and 3.5% in 2005 (see Table 2). After relying mainly on private and public consumption in 2002 and 2003, real GDP growth is projected to be driven by investment together with a clear improvement in the contribution of net exports to growth, which would turn positive.

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[2] From +/-2.25% to +/-15%.

[3] Following some weakening of the currency in Spring 2003, the government decided, with the consent of the Magyar Nemzeti Bank, to devaluate the central parity of the forint vis-à-vis the euro by 2.26% in June 2003. This move, which aimed at preventing further losses in competitiveness, surprised the markets. They interpreted this as a shift in policy from inflation targeting to competition support.

Table 2: Macroeconomic developments and outlook

	1998	1999	2000	2001	2002	2003	2004	2005
Real GDP (% change)	4.9	4.2	5.2	3.8	3.5	2.9	3.2	3.4
Contribution: Domestic demand	5.8	4.5	5.0	4.6	8.2	6.5	2.7	3.5
Change in inventories	2.5	0.5	-0.3	-2.9	-1.8	-0.3	0.3	-0.4
External trade	-3.4	-0.9	0.5	2.1	-2.0	-3.3	0.2	0.3
Unemployment rate (% of labour force)	8.4	6.9	6.3	5.6	5.6	5.8	5.7	5.6
Unit labour costs (% change)	10.5	4.3	10.9	11.7	8.3	10.3	5.3	3.8
HICP (% change)	14.2	10.0	10.0	9.1	5.2	4.7	6.9	4.6
External account[a b] (% of GDP)	(-4.7) -7.2	(-5.1) -7.8	(-6.2) -8.6	(-3.4) -6.2	(-4.0) -7.1	(-5.6) -8.9	(-5.4)	(-5.1)
GDP/capita, PPS (% of EU-15 avg.)	46.8	47.8	48.8	51.5	53.4	55.3		

[a] Net lending/borrowing vis-à-vis the rest of the world = current account + capital account.
[b] Figures according to the old balance of payment methodology in brackets, new methodology published in April 2004. The differences mainly result from the inclusion of reinvested earnings of direct investment enterprises.

Source: Eurostat and Commission Spring 2004 forecasts, Magyar Nemzeti Bank.

The steady decline in the unemployment rate observed since the mid-nineties came to a halt in 2002-2003 mostly due to lower economic growth. The unemployment rate is forecast by the Commission to remain roughly constant in 2004 and 2005 at 5.7% and 5.6%, respectively. This low level reflects, to a large extent, the substantial withdrawal of people from the labour market. The participation rate in the 15-64 year age-bracket in 2002 is at 59.7%, particularly low compared to the EU 15 average of 69.6%. This is due to some structural shortcomings of the Hungarian labour market, notably a lack of regional mobility, disincentives generated by the structure of the tax and benefit systems and a mismatch between labour supply and demand.

The appreciation of the exchange rate after the widening of the fluctuation bands, together with the postponement of the deregulation of several administered prices[4] led to a significant decline in inflation from about 9% in 2000 to below 4% year-on-year in the first half of 2003. This movement was interrupted in the course of 2003: the pass-through of the expansionary policies, the depreciation of the currency and the unforeseen hikes in unprocessed food prices[5] led to a gradual rebound in inflation during the second half of 2003. This movement was amplified in the beginning of

[4] The pace of the gradual increase of several regulated prices (notably gas, electricity, drugs and public transportation) to the market price level was reduced between 2000 and 2002.
[5] This increase is mostly due to unfavourable weather conditions.

2004 by the implementation of increases in indirect taxes (VAT, excise duties) which pushed the inflation rate to 7% in February 2004. Assuming no second-round effects of the tax hikes, no significant weakening of the currency from the present level and taking into account that a significant tightening of the policy-mix is currently taking place, the Commission projects in its Spring 2004 forecasts a gradual decline in inflation to below 5% in 2005.

3. THE SITUATION OF GOVERNMENT FINANCES

Since the year 2000, when it declined to 3.0% of GDP, the general government deficit has every year exceeded the 3% of GDP reference value. The deficit ratio is also expected to stay well above this value in 2004. Following two years of rapid increase, the debt-to-GDP ratio remained below, but came close to the 60% Treaty reference value in 2003.

The analysis of budgetary developments is hampered by the general lack of ESA95 data on general government revenues and expenditures. The lack of ESA95 data concerns both the functional sub-components of revenues and expenditures and the institutional sub-components of the general government.

3.1. Recent budgetary developments until 2002

The general government deficit has shown large fluctuations since 1998, particularly in the last three years. It increased from 3.0% of GDP in 2000 to 4.4% of GDP in 2001. In 2002, the deficit reached the high level of 9.3% of GDP, partly due to statistical operations which implied a one-off increase in the deficit by about 3 percentage points of GDP[6].

Beyond the pronounced year-to-year fluctuations, the general picture is that of a large deterioration in the situation of government finances between 2000 and 2002. The worsening in the primary deficit was even larger, since interest expenditure fell from 5.7% of GDP in 2000 to 4.2% in 2002 due to lower interest rates. The large deterioration in Hungarian government finances after 2000 can be attributed partly to the slowdown in economic activity observed in the years 2001 to 2003 and partly to the implementation of an expansionary fiscal policy from 2001 until 2003. In particular, there was a significant increase in the current expenditure to GDP ratio, driven by a generous wage policy in the public sector and sharp increases in social transfers and in subsidies. Between 2001 and 2003, the ratio of the public wage bill to GDP increased by 2 percentage points; over the same period, the ratio of social transfers to GDP increased by 1½ percentage point.

[6] This includes a widening of the coverage of the general government, e.g. the full integration of the motorway construction programme into the central budget, the elimination of some important quasi-fiscal activities of government institutions and the limitations of the use of the reserves of the privatisation agency.

Table 3: GDP growth and general government balance and debt

(% of GDP, unless otherwise indicated)	1998	1999	2000	2001	2002	2003	2004	2005
Real GDP (% change)	4.9	4.2	5.2	3.8	3.5	2.9	3.2	3.4
General government balance	-8.0	-5.6	-3.0	-4.4	-9.3	-5.9	-4.9	-4.3
Primary balance	n.a.	n.a.	1.8	-0.5	-5.6	-1.9	-0.9	-0.5
Total expenditures	n.a.	n.a.	49.4	50.1	54.0	49.6	52.0	51.1
of which: gross public investment	n.a.	n.a.	n.a.	3.8	4.9	3.1	4.5	4.6
Total revenues	n.a.	n.a.	46.4	45.4	44.7	43.7	47.1	46.8
General government gross debt	61.9	61.2	55.4	53.5	57.1	59.0	58.7	58.0

Source: Eurostat and Commission Spring 2004 forecasts.

3.2. Budgetary developments in 2003

The 2003 budget presented in October 2002 targeted a reduction in the general government deficit from about 9% of GDP in 2002 to 4.5% of GDP in 2003, under the assumption of an increase in real GDP by 4.4% in 2003. The large reduction in the general government deficit was planned to result from (i) the disappearing of the one-off effects which contributed to the increase in the 2002 deficit to the tune of 3 percentage points of GDP and (ii) a tight control over government expenditure, to be achieved notably through lower investment spending. On the revenue side, the budget foresaw the implementation of cuts in personal income tax (tax exemptions for people at the minimum wage and lower tax brackets) and in social security contributions.

In the course of the year 2003, risks appeared that the 2003 deficit target could be missed. In an attempt to reach the official target, the government decided in June 2003 to implement a correction package of about 0.5% of GDP[7]. This was however not enough to meet the initial deficit target, which was subsequently revised upward twice: first to 4.8% of GDP in the framework of the Pre-accession Economic Programme (PEP) in August 2003; second to 5.2% of GDP in December 2003. At that time, it was expected that a large budget surplus would be recorded for the month of December 2003. However, the December surplus turned out to be significantly smaller than expected and even the revised budget target was missed. The latest official figures show a deficit of 5.9% of GDP in 2003. The initial 2003 deficit target was therefore exceeded by a large margin (about 1½% of GDP).

[7] This package consisted of cuts in ministries' operational spending, the cancellation of 'unused appropriations' for previously planned projects that were not implemented in time, further cuts in drug subsidies, and a first reduction of the generous housing grants that had fuelled the private housing boom (as well as consumer credit). This package was adopted in the context of the devaluation of the central parity of the forint against the euro by 2.26%.

Table 4: Successive targets for the 2003 general government deficit and estimated outcome

	Real GDP growth assumption (%)	General government balance (% of GDP)
August 2002: 2002 pre-accession economic programme	4 – 4.5	-4.5
December 2002: budget for 2003	4.4	-4.5
August 2003: 2003 pre-accession economic programme	3.5	-4.8
December 2003: budget for 2004	3.5	-4.8
April 2004: Commission Spring 2004 forecasts	2.9	-5.9

Source: Commission Services

The slippage in the 2003 deficit compared to initial budget plans can be attributed to an overrun in general government expenditures. This overrun is primarily due to (i) higher-than-planned increases in social benefits, mainly in the areas of supplementary pension payments and in the contribution to the cost of child care (ii) a large increase in subsidies notably for housing[8] and prescribed medicines and (iii) the higher-than-forecast interest rate payments on short-term debt following the interest rate hikes by a cumulated 600 basis points since June 2003.

Despite real GDP growth being lower than projected in the budget (growth reached 2.9% in 2003, instead of 4.4% forecast in the budget), developments in overall tax revenues turned out to be better than expected. This is mostly due to the dynamism of VAT and excise tax revenues (reflecting higher-than-forecast consumption growth) and higher revenues from the simplified corporate tax scheme, which more than compensated the shortfall in personal income tax[9], corporate profit taxes[10] and social security contributions.

3.3. Prospects for 2004

The budget for 2004, adopted by Parliament in December 2003, targeted a reduction of the general government deficit to 3.8% of GDP from 5% of GDP in 2003, under the assumption of an increase in real GDP by 3.5%. Most of the deficit reduction targeted in the budget was planned to be achieved through a tight control of expenditure. The budget included notably real wage freezes in the public sector, which, together with the ongoing reduction of the number of public employees, was

[8] A significant tightening of the eligibility criteria of the previously very generous housing subsidy policy was decided in December 2003. This resulted from mid- to end-December 2003 in an unexpected run for housing loans, still according to the old rules. As the rights on these loans are claimed by the households only in 2004, the restrictive fiscal effect of this change of eligibility can only be expected from 2005.

[9] This is despite higher than predicted nominal wage increase in 2003 (13%). The main reason for the shortfall is the stronger use of tax exemptions than foreseen in the budget.

[10] This is due to the change to the more popular than expected alternative simplified entrepreneurial tax scheme for small businesses, with a very low flat tax rate.

planned to trigger a significant deceleration in the increase of the public wage bill. On the revenue side, the 2004 budget incorporated a comprehensive tax reform which came into effect at the beginning of 2004. While direct tax rates (both personal income and corporate taxes) were lowered[11], numerous tax allowances and credits were eliminated to compensate for the loss of fiscal revenues and to increase the transparency in the tax system. Furthermore, lower VAT rates were raised.

In January 2004, after re-assessing the risks on the expenditure and revenue sides, the 2004 deficit target was revised upward to 4.6% of GDP. At the same time, the government adopted a series of expenditure freezes of 1.1% of GDP relative to the budget baseline and decided to postpone several public investment projects. Since then, the government has taken further measures aimed at supporting its expenditure control strategy. In particular, in March 2004, the government decided a freeze of subsidies for prescribed pharmaceutical products.

The corrective measures will contribute to ensuring a better control of government expenditures in 2004. Nevertheless, the risk of an overrun cannot be excluded. A specific risk is that housing subsidies continue increasing at a very rapid pace in 2004, despite the substantial tightening of the eligibility criteria decided end-2003; such a decision may not have a substantial saving effect before 2005. Developments in expenditure will also depend on interest rate movements which may occur in the course of 2004. Risks of slippage also exist on the revenue side. The budget projects an increase by 0.5 percentage point in the revenue-to-GDP ratio. In view of the revenue shortfall of the personal income and corporate profit taxes observed in 2003, such a projection might well turn out to be overly optimistic.

Against this background, the Commission 2004 Spring forecast projects a general government deficit of 4.9% of GDP in 2004, i.e. slightly above the revised official projection of a deficit of 4.6% of GDP, under the assumption of an increase in real GDP by 3.2% (3.5% in the budget). The general government deficit would therefore remain at a level well above the 3% of GDP reference value.

3.4. Recent debt developments and prospects

Between 1998 and 2001, the debt-to-GDP ratio declined steadily from almost 62% of GDP to 53.5% of GDP. This decline was driven by sound budgetary policy and relatively dynamic GDP growth. In 2002 and 2003, this trend was reversed. Major privatisation operations slowed down significantly between 2000 and 2002, but were resumed in 2003. The debt ratio increased sharply in 2002 to over 57% of GDP, due to the very high fiscal deficit in that year, and to 59% of GDP in 2003, thus approaching the 60% of GDP reference value. Beside the high deficit level, the depreciation of the forint contributed to the increase in the debt ratio in 2003, since around a quarter of the public debt is denominated in foreign currencies.

The debt-to-GDP ratio is projected by the Commission to decline to 58.7% of GDP in 2004, slightly below the reference value of the Treaty. Such a decline reflects budgetary consolidation efforts, the slight acceleration of GDP growth and stock-

[11] The marginal rates for personal income taxes have been reduced and bands been increased. The rate of corporate taxes has been reduced from 18% to 16%.

flow adjustments. The lower cash than accrual deficit, however, which is due to a delay in the collection of value-added and excise taxes on imports from other EU Member States resulting from changed administrative procedures upon accession delays this adjustment.

Table 5: Debt dynamics

	1998	1999	2000	2001	2002	2003	2004	2005
Government gross debt	61.9	61.2	55.4	53.5	57.1	59.0	58.7	58.0
Change in debt ratio (1=-2+3+6)	-2.3	-0.7	-5.8	-1.9	3.6	1.9	-0.3	-0.7
Primary balance (2)	n.a.	n.a.	2.7	0.4	-5.1	-1.8	-0.9	-0.5
Snow-ball effect (3=4+5)	n.a.	n.a.	-2.6	-1.5	-1.9	-1.5	0.0	-1.0
Interest expenditure (4)	n.a.	n.a.	5.7	4.8	4.2	4.1	4.0	3.8
Contribution of nominal GDP growth (5)	n.a.	n.a.	-8.3	-6.3	-6.1	-5.6	-4.0	-4.8
Stock-flow adjustment (6)	n.a.	n.a.	-0.5	0.0	0.4	1.6	-1.2	-0.2

Source: Eurostat and Commission Spring 2004 forecasts.

4. OTHER RELEVANT FACTORS

4.1. Medium-term prospects

According to Hungary's pre-accession economic programme submitted in August 2003, the government planned to reduce the general government deficit to below the Treaty reference value of 3% of GDP by 2006. However, in the light of the revision of the 2004 target from 3.8% to 4.6% and the revision of the underlying macroeconomic data since the submission of the pre-accession economic programme, the realisation of these ambitious plans have become more unlikely.

4.2. Investment

Article 104(3) of the Treaty foresees that the present Commission report "shall also take into account whether the government deficit exceeds government investment expenditure". Since 2001, the general government deficit of Hungary consistently exceeded general government gross fixed capital formation (see table 3), which has shown relatively large fluctuations between 3% and 5% of GDP. Given its catching up status in terms of infrastructure compared to the EU average, Hungary should a priori have a high public investment rate. However, as the government strives to control the public sector deficit, several public infrastructure investment projects planned for 2004 have been announced to be postponed (with some exceptions, such as motorway construction). Nevertheless, as the government is likely to make commitments related to co-financing of EU-financed investments, increased public investment is likely to emerge particularly from 2005 onwards.

4.3. External account

The external position of Hungary deteriorated in 2003, with a widening of the external account[12] deficit to 8.9% of GDP from 6.2% of GDP in 2001[13]. The figures reflect a negative contribution from net exports due to strong, consumption-driven import growth, the slowdown in EU demand and the appreciation of the exchange rate by about 10% since 2001. For the next two years, the Commission expects a rebalancing of the sources of growth and therefore a slight narrowing of the external account deficit. This is also linked to the expected recovery in external demand and is expected to be supported by the reduction of the general government deficit in 2004 and 2005.

5. CONCLUSIONS

In 2003, the general government deficit in Hungary decreased to 5.9% of GDP, but cannot be considered close to the 3% reference value, in the sense of the Treaty. The excess of the general government deficit over the 3% of GDP reference value does not result, in the sense of the Stability and Growth Pact, from an unusual event outside the control of the Hungarian authorities, nor is it the result of a severe economic downturn. Following two years of rapid increase, the debt-to-GDP ratio in 2003 came close to the 60% reference value of the Treaty at 59.0%.

According to the Commission Spring 2004 forecasts as well as the Hungarian authorities, the general government deficit will remain above 4% of GDP in 2004. According to the Spring 2004 Commission forecasts, the debt-to-GDP ratio will decline moderately in 2004, and will therefore remain below 60% of GDP.

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[12] Net lending/borrowing vis-à-vis the rest of the world = current account + capital account. In the current system of national accounts, this is what corresponds to the concept of the "balances of payments on current account" mentioned in Article 121(1) of the Treaty.

[13] With a view to harmonising the Hungarian balance of payment statistics, external account figures were substantially revised end-March 2004 and are now published according to a new methodology. This implied an upward revision by about 3 percentage points to the previously published external deficit figures, mainly resulting from the inclusion of reinvested earnings of direct investment enterprises.