

16. HUNGARY

On its way towards a sustainable growth path?

Worrying signals before the crisis

Hungary was in a fragile economic condition when the financial crisis broke out in autumn 2008. Labour productivity and thus potential output had started to decelerate some years earlier, while lax fiscal policy and growing private sector indebtedness had sustained domestic demand at elevated levels. Moreover, from 2004 onwards, the share of foreign-exchange-denominated debt also increased quickly. Despite the fiscal expansion that raised the general government deficit to 9.3% of GDP in 2006, GDP grew by only 4% in that year, still lower than the average of the preceding years. The mid-2006 fiscal policy reversal, which was aimed at correcting the existing economic imbalances and restraining the accumulation of the public debt, successfully reduced the budget deficit to 3.8% of GDP by 2008. However, these corrective fiscal measures mainly focused on achieving higher revenues and not sufficiently on expenditure cuts based on structural reforms.

The crisis and short-term remedies

In autumn 2008, in a context of reduced risk appetite linked to the global financial crisis, financial market conditions in Hungary rapidly deteriorated to the extent that the external financing needs of the government could no longer be met through market channels. Moreover, due to a sudden decline in external demand and high uncertainty regarding the severity and duration of the crisis, both exports and industrial production dropped at double digit rates in the fourth quarter of 2008. In the context of an absence of fiscal space and financing difficulties, the policy response consisted of continued fiscal consolidation and measures to support the financial sector. In November 2008, acknowledging the government's commitment to maintain the fiscal consolidation process and to prevent a more severe financial market crash, joint financial assistance of up to EUR 20 bn was provided to Hungary by the EU, the IMF and the World Bank subject to certain policy conditions. In order to counteract the decreasing revenues caused by declining output, the government implemented a mix of structural and temporary expenditure saving measures.

The storm continued during 2009

In a controlled deleveraging process, financial institutions tightened credit conditions, which led to a decline in corporate lending and a negligible net flow to households in 2009, also in line with limited demand for credit. Nevertheless, financial market conditions have started to improve over the forecast horizon as uncertainty about the recovery subsides and investor confidence picks up.

Economic activity declined by around 6¼% in 2009 exclusively due to a sharp contraction of domestic demand. Private consumption dropped in 2009 by 7½%, based on diminishing real wages, increasing unemployment and a rising saving ratio. Concomitantly, fixed capital formation also retreated by 6½%, undermined by financing difficulties and low capacity utilisation linked to lack of demand. Additionally, the depletion of inventories was extremely strong during the first half of the year. However, positive net exports almost fully offset the negative impact of inventories and, all in all, the negative contribution of domestic demand (excluding inventories) broadly explains the overall GDP growth rate.

Regaining a positive growth path

In 2010, GDP is projected to stagnate. Given the pronounced activity decline in 2009, this implies that the economy will regain a rather strong growth path measured in quarterly terms, in particular in the second half of 2010, compensating for the negative carry-over. Specifically, GDP growth is projected to accelerate over the year to reach ¾% q-o-q at the end of the year. On the basis of the economic recovery in the EU and the rest of the world, the output of export-driven industries is expected to accelerate faster than that of domestic-driven sectors especially as the latter are heavily affected by the ongoing fiscal adjustment. This duality is expected to be reflected in labour-market developments as well, with labour demand being more elastic in the manufacturing sector, than in services where labour shedding is likely to continue.

In 2011, the country is expected to enter a more sustainable growth path with GDP increasing by 2¾% based on domestic demand. Private consumption is set to become the major

contributing factor to economic expansion, once real disposable income starts rising again, mirroring better employment growth prospects. In parallel, investment should also grow strongly, even above GDP growth, reflecting better prospects for both households and companies. Additionally, as the effect of the indirect taxes on prices will cease in 2011, they are expected to increase only by below 3% compared to 4½% in 2010.

There are risks to this scenario. On the one hand, private consumption could turn out to be more dynamic than projected on the basis of increasing consumer confidence coupled with a decline of the savings rate. Exports could also accelerate further supported by higher external demand. On the other hand, insufficient credit could put a brake on the recovery of domestic demand and exports might grow less than projected in case global downward risks materialize.

Sharp adjustment of external imbalances

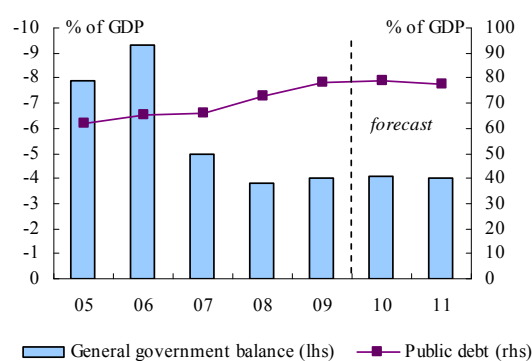
The rapid adjustment in consumption and thus imports led to a remarkable turnaround in the current-account balance in 2009, which improved from a deficit of 7.2% of GDP in 2008 to around a surplus of ½% last year. It is expected to remain at around that level in 2010 and 2011. It is worth mentioning some developments underlying this. Although constrained by worsening labour-market conditions, net financial savings of households reached 4.5% of GDP in the third quarter of 2009. The corporate sector also strongly improved its financial position in 2009. Overall, this led to the above-mentioned strong improvement in the current-account balance, a surplus in 2009 for the first time in over 15 years (the period for which data are available).

Focus on consolidation of public finances

The deficit target of 3.9% of in 2009 GDP is estimated to have been almost met (4.0% in the April EDP notification). Although the central government cash deficit of 3.5% of GDP is better than expected, this largely reflects factors, such as the advance payments of dividends and late payments of certain tax refunds, which have no impact in national-accounts terms. Additionally, the deficit of the local authorities is expected to be in line with the earlier estimations. Although some negative risks materialised (e.g. the revenue shortfall in income taxes and the expenditure

overrun at the budget chapters), their magnitude was limited and some other factors (e.g. higher-than-expected VAT, interest revenues as well as one-off revenues from the switch from the private pillars of the pension system to the public "pay-as-you-go" system) broadly offset them. Additionally, higher revenues stemming from the advance purchase of excise stamps by the tobacco companies should contribute to the achievement of the deficit target. Finally, the dividend revenue from the state-owned enterprises significantly exceeded the budgeted level, which may affect their capital level unfavourably and thereby also their future profitability.

Graph II.16.1: Hungary - General government balance and public debt



For 2010, Parliament adopted on 30 November a budget in compliance with the general government deficit target of 3.8% of GDP, underpinned by a number of legal decisions on the specific announced measures, which include a freeze of the public sector wage bill, the reform in the pension system, saving measures in the area of social benefits as well as reduction in the level of housing subsidies and gas- and district- heating supports. It also encompasses reserves amounting to HUF 206 bn (0.8% of GDP). The budget also aims at respecting the strict management of central budget chapters (notably thanks to the newly established Treasurers system) and lower expenditures of the local governments, reflecting reduced transfers from the central budget as well as the more efficient operation of the long-distance public transport system.

The Convergence programme (confirming the fiscal target of 3.8% of GDP) already incorporated that revenue could turn out lower than expected in the budget by ½% of GDP as implied by last year's worst outcome. It also foresaw higher-than-budgeted expenditure of 0.1% of GDP linked to

the additional subsidy to the Budapest transport company. This was compensated by (i) lower-than-budgeted net interest expenditures of 0.15% of GDP, (ii) a one-off revenue of ¼% of GDP from the shift of the eligible employees and pensioners from the private pillar to the public pension system, and (iii) a freezing of 0.2% of budgetary reserves.

This forecast projects a deficit that is 0.3 pp. higher than the deficit target in the budget and the convergence programme for the following reasons: On the one hand, further expenditure slippages are likely to occur linked to the currently re-nationalized airline company MALEV and the fact that the planned reduction of the subsidy for the long-distance public transport system is not fully underpinned by structural measures; furthermore, further slippages are expected as the new Treasurers' system may not be sufficient to fully ensure the control of the expenditures by line ministries against the background of substantial cuts in the past. Revenue shortfalls are expected due to the Constitutional Court's decision of revoking the general value-based property tax adopted by the Parliament and due to the fact that the projected income from the sale of (mobile-telephone) licences seems to be overestimated. On the other hand, budgetary reserves of around ½% of GDP are still available and could be frozen.

The government also announced that it could make contingency expenditure cuts of 0.2% of GDP to at least partly compensate for adverse developments, but based on the no-policy-change assumption this has not been incorporated in the forecast.

All in all, the 2010 the forecast projects a general budget deficit of 4.1% of GDP, which in structural terms can be characterised as broadly neutral.

Hungary has to put an end to its excessive deficit by 2011 at the latest, which implies a need for further deficit-reducing measures at the latest next year of more than 1% of GDP. These measures are necessary not only to reduce the deficit compared to 2010 but also to compensate the deficit-increasing effect of the already adopted personal income tax decrease (½% of GDP) as of 2011 and the highly probable accumulated loss as of the central bank.

Regarding the implementation of the new fiscal framework adopted in November 2008, the 2010 budget has already been prepared broadly in line with this. To ensure the success of the implementation phase, 2011 will be crucial as next year's budget must be fully in compliance with all the elements of the fiscal framework.

Table II.16.1:

Main features of country forecast - HUNGARY

	2008		92-05	Annual percentage change						
	bn HUF	Curr. prices		% GDP	2006	2007	2008	2009	2010	2011
GDP	26543.3		100.0	3.0	4.0	1.0	0.6	-6.3	0.0	2.8
Private consumption	14331.8		54.0	-	1.7	0.4	-0.5	-7.5	-3.2	2.6
Public consumption	5743.1		21.6	1.2	3.8	-7.4	-0.8	-1.1	-0.4	1.8
Gross fixed capital formation	5559.1		20.9	5.7	-3.6	1.6	0.4	-6.5	1.0	3.6
of which : equipment	2231.2		8.4	-	-	-	-	-3.8	3.1	4.5
Exports (goods and services)	21804.9		82.1	12.5	18.6	16.2	5.6	-9.1	6.6	8.7
Imports (goods and services)	21545.5		81.2	12.9	14.8	13.3	5.7	-15.4	5.4	9.1
GNI (GDP deflator)	24761.6		93.3	-	3.6	-0.4	1.1	-5.5	-0.7	2.8
Contribution to GDP growth :										
Domestic demand				3.1	0.9	-1.1	-0.4	-5.7	-1.6	2.5
Inventories				0.2	0.8	0.0	1.0	-5.7	0.2	0.0
Net exports				-0.3	2.3	2.2	0.0	5.1	1.4	0.3
Employment				-	0.6	-0.3	-1.3	-3.6	-0.9	0.8
Unemployment rate (a)				-	7.5	7.4	7.8	10.0	10.8	10.1
Compensation of employees/f.t.e.				-	5.3	6.7	6.5	-0.2	-0.3	3.7
Unit labour costs whole economy				-	1.9	5.4	4.5	2.7	-1.2	1.7
Real unit labour costs				-	-1.9	-0.5	0.7	-2.2	-3.6	-0.6
Savings rate of households (b)				-	-	-	-	-	-	-
GDP deflator				13.2	3.9	5.9	3.8	4.9	2.6	2.2
Harmonised index of consumer prices				-	4.0	7.9	6.0	4.0	4.6	2.8
Terms of trade of goods				-	-1.4	-0.1	-1.4	1.8	-0.5	-0.4
Trade balance (c)				-4.5	-2.3	0.2	-0.1	4.9	5.7	5.7
Current account balance (c)				-	-7.5	-6.5	-7.2	0.4	-0.2	-0.3
Net lending(+) or borrowing(-) vis-à-vis ROW (c)				-	-6.9	-5.5	-5.9	1.8	1.4	1.5
General government balance (c)				-	-9.3	-5.0	-3.8	-4.0	-4.1	-4.0
Cyclically-adjusted budget balance (c)				-	-10.9	-6.4	-5.1	-2.2	-2.1	-3.0
Structural budget balance (c)				-	-10.6	-5.5	-4.7	-2.2	-2.3	-3.0
General government gross debt (c)				-	65.6	65.9	72.9	78.3	78.9	77.8

(a) Eurostat definition. (b) gross saving divided by gross disposable income. (c) as a percentage of GDP.