

16. HUNGARY

Bumpy ride ahead

Net exports again pull growth into positive territory

The Hungarian economy entered 2011 amidst a number of indicators pointing towards accelerating growth, supported by a slow rebalancing in the economy and a positive contribution from domestic demand. Developments over the course of the year have led to a significant revision of this picture.

The gloomier outlook stems from the deterioration of the external environment which played out through several channels, as well as an acute domestic perception of squeezed demand and policy uncertainties. The slowdown of global (and German) growth as well as the sovereign-debt crisis have implied a decline in external demand: the export sector showed a stellar performance in the first quarter (4.8% quarter-on-quarter), but unfavourable external developments prevented this pace of expansion from being sustained. Banks have also been facing higher funding costs and tighter liquidity, squeezing credit for the economy further. Finally, instalment payments on foreign currency-denominated (FX) loans surged as the forint depreciated, depressing consumption: around 65% of household loans from banks are denominated in FX, overwhelmingly in Swiss franc.

Domestically, uncertainties about further austerity measures to come (new measures were announced in September) have directly affected consumption expenditure and enterprises, and weighed on investment beyond an already sluggish demand and extraordinary sectoral taxes. Contrary to earlier official expectations, the large overall personal income tax cut appears not to have succeeded in lifting domestic demand, although it has cushioned the impact of negative developments. On the other hand, the payout of the real yield achieved on private pension fund investments repatriated into the state pension pillar was larger than estimated in the spring due to the favourable timing of the stock market, which may have delivered some boost to consumption (assuming a degree of myopic behaviour).

Overall, domestic demand will once again contribute negatively to growth in 2011, from an already weak base. According to preliminary

annual data from the national accounts, the contraction of domestic demand in 2010 was more pronounced than previously thought: excluding inventories, it fell by 3.7% as opposed to 2.8% in previous notifications. The difference is largely attributable to a much steeper decline in gross fixed capital formation, although private and public consumption expenditure were also revised downwards. GDP is projected to grow by 1.4% in 2011, marginally higher than the revised figure of 1.3% growth in 2010.

Clouds on the horizon

In 2012 export capacity will increase as new plants are set to start production (Mercedes and Hankook). But uncertainty surrounding global economic activity will be an important factor in determining growth in the small, open Hungarian economy, although its impact in either direction is mediated by the high import content of exports.

Fiscal policy is also weighing on growth prospects. The additional fiscal measures planned in the context of the 2012 budget update (much of which is correcting a substantial fiscal loosening in 2010 and 2011) will further subdue economic activity through a variety of channels, including a broadly budget neutral tax reshuffle that again increases the burden on the poorest households, which also have the greatest propensity to consume. This comes on top of the significant cuts in social transfers, some of which (e.g. the reduction of unemployment benefits to at most three months) are already operational and others will come into effect in 2012.

The law adopted in a surprise move in September 2011 allowing the early repayment of FX mortgages at a discount to the prevailing exchange rates appears to intend to reduce the drag on household consumption. However, the households that are most likely to be able to participate in the scheme are the ones that have been relatively better able to weather the hike in FX loan repayments. Those who will be putting their savings towards repayment may then focus on rebuilding precautionary savings in the shorter term, even though their net asset position will not change dramatically. Households with longer than average FX loan maturities could face higher instalment payments for the duration of the new

loans, since their maturity may need to be shorter in order to make the switch financially attractive. The full magnitude of the effect of the scheme will depend on the eventual participation rate, but its net impact on consumption among participants is ambiguous at best.

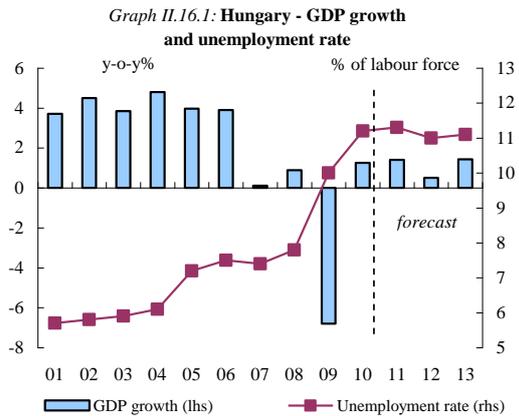
Furthermore, households in the greatest predicament are the where jobs have been lost or are at risk. The measure will have a negative impact on their consumption through: (i) further increasing the loan repayment burden in the case of households ineligible to participate in the scheme thanks to the depreciation of the forint; (ii) tightening credit to enterprises due to the resulting losses for the banking sector and hence endangering employment and, more generally, the investment climate.

Expanding labour supply

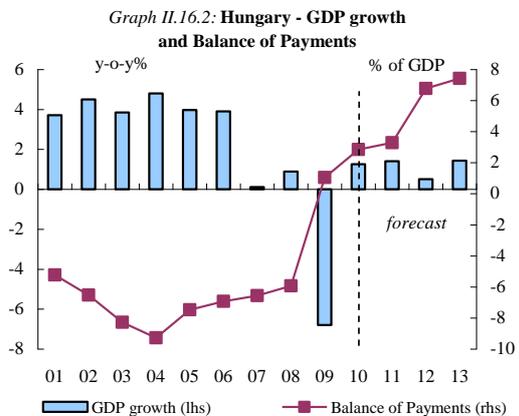
In a positive development, labour supply has been expanding (which contributes to the unemployment rate projections). Increasing the very low activity rate has been one of Hungary's key structural bottlenecks to growth, and a series of policy decisions are now bearing fruit. Translating this into job creation, however, remains a challenge especially in the shorter term. The main source of new employment is set to remain the public works scheme. However, public works have so far not contributed to increasing participants' chances of finding subsequent employment in the private market.⁽⁶⁴⁾ The drastic cut in the duration of unemployment benefits further exacerbates the difficulties of finding another job in the available time frame before public works (which pay below the minimum wage) would become the main income source.

The plan to increase the minimum wage by 18% will further hit labour demand exactly in the segment where employment challenges are the most acute. This may also pose a serious threat to the viability of many small businesses that are already struggling and are facing serious liquidity constraints. The government intends to compensate the affected enterprises but the form this may take is unclear at the time of publication, and may not arrive in time to tide over the hardest-hit SMEs.

⁽⁶⁴⁾ Scharle et al (2011) A közcélú foglalkoztatás kibővülésének célzottsága, igénybevétele és hatása a tartós munkanélküliségre (Budapest Institute)



The current account is expected to remain in surplus over the forecast horizon as weak domestic demand will keep import growth subdued. In addition, the capital account will receive a boost from swelling EU transfers as the current financial period comes to an end. Inflation will again increase in 2012, contrary to earlier expectations of a decreasing inflationary path, and thanks in large part to the VAT increase tabled in the budget.



Risks to GDP growth in 2012, currently projected at ½%, remain on the downside. The economy is projected to grow by just below 1.5% again in 2013, aided by the assumption of an improving external environment and the dissipation of associated uncertainties, with cautiously recovering domestic demand.

Turnaround from structural fiscal deterioration in 2011 to consolidation in 2012

Following a deficit of 4.2% of GDP in 2010, the general government balance is expected to turn to surplus thanks to one-off revenues linked to the elimination of the obligatory private pension

scheme. The official estimate for this year's surplus has been revised up from 2% of GDP (contained in the April 2011 Convergence Programme update (CP)) to 3.9% of GDP in the autumn notification. The larger surplus is mainly due to: (i) higher one-off revenue stemming from the elimination of the obligatory private pension scheme (now amounting to 9¾% of GDP, i.e. ½% of GDP higher than previously assumed); (ii) an intention not to assume the debt of the public transport companies (1.4% of GDP) and not to buy out selected PPP projects (0.7% of GDP), contrary to earlier plans; and (iii) additional measures of 0.4% of GDP adopted in September 2011.⁽⁶⁵⁾ These factors are only partly counterbalanced by one-off expenditure of around 0.9% of GDP triggered by a decision of the European Court of Justice against Hungary on the rules of carrying forward excess VAT for enterprises. The forecast shows a somewhat lower surplus projection (3.6% of GDP), notably since it assumes a partial assumption of the debt of public transport companies (0.2% of GDP) based on recent information.

Regarding 2012, the draft budget submitted to Parliament on 30 September targets a deficit of 2.5% of GDP as set in the latest CP. In order to achieve this, the budget proposal contains several measures altogether amounting to a gross effect of more than 4% of GDP to reduce the underlying deficit of around 6% of GDP in 2011 and to compensate the earlier enacted personal income tax (PIT) cut of close to 1% of GDP. First, in compliance with the CP and the announcement of the Széll Kálmán Plan in March 2011, the draft budget reflects structural measures in several areas (such as labour market, pharmaceutical subsidies and retirement schemes). However, the expected gross saving of around 1½% of GDP is 0.3% of GDP lower than the original plans. Second, additional measures already announced in the CP of around 1¼% of GDP are also included, such as the nominal wage freeze and the limited increase of purchase of goods and services in the public sector as well as the cut of the employment tax credit. Third, the budget contains additional revenue increasing measures of around 2% of GDP (including a hike in indirect tax rates, the increase of the social security contribution rate and the full elimination of the employment tax credit) and

⁽⁶⁵⁾ The permanent wide-ranging cuts in budgetary appropriations with a gross deficit-improving impact of more than ¾% of GDP to counterbalance budgetary slippages was already incorporated in the latest CP.

further saving measures of ½% of GDP. Fourth, the deficit-decreasing measures are partly counterbalanced by deficit-increasing decisions of around 1% of GDP, such as the expansion of the public works programme, the tightening of the tax base of the PIT as well as the supplementary wage both in the public and the private sector. Finally, in order to counterbalance the negative budgetary effect of unforeseen adverse developments, the government, based on the revenue-increasing steps, created a substantial reserve of 0.7% of GDP.

In contrast to the deficit target set by the government, the Commission projects the 2012 general government deficit to reach 2.8% of GDP. Compared to the draft budget this higher deficit forecast reflects on the revenue side: (i) lower economic growth by 1 pp. as well as a more cautious assessment of revenue developments resulting in a higher deficit of around ½% of GDP; and on the expenditure side: (ii) higher outlays of ¼% of GDP related to state-owned transport enterprises⁽⁶⁶⁾ and maintenance of roads; as well as (iii) higher interest expenditure and higher contribution to the EU budget (altogether ¼% of GDP) due to exchange rate and yield assumptions. At the same time, these revenue shortfalls and expenditure slippages amounting altogether to 1% of GDP are assumed to be largely counterbalanced by the extraordinary reserves of 0.7% of GDP taking into account a recent proposal to amend the budget bill so that a cautious use of this reserve is ensured.⁽⁶⁷⁾

Compared to the spring forecast of a deficit of 3.3% of GDP in 2012, the improvement of the budgetary forecast is explained by the recently announced consolidation measures, which more than offset the worse macroeconomic forecast.

In 2013, the budget deficit is forecast to deteriorate again, since the phasing out of the extraordinary levies on selected sectors (including the financial one) is not expected to be counterbalanced by the structural reform programme reaching its peak.

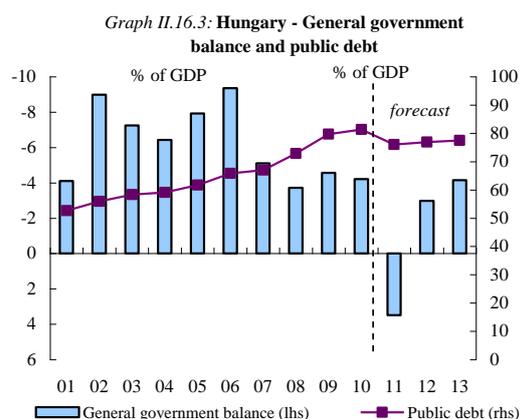
⁽⁶⁶⁾ At the calculation of the additional financing need of the public transport companies, the partial assumption of the debt of these companies has already been taken into account.

⁽⁶⁷⁾ According to an amending proposal submitted to the Budget Bill by the Audit and Budget Committee of Parliament, the extraordinary reserves cannot be used before September 20, 2012 and stipulates that the government may decide on the use only if in the Autumn 2012 Notification the expected EDP-deficit for 2012 does not exceed 2.5% of GDP.

This is based on the usual no-policy-change assumption and does not take into account potential measures that the government may take to achieve its deficit target of 2.2% of GDP. In particular, the decisions aiming at savings in local government and the public transport sector, as outlined in the CP, are not appropriately specified and planned revenue from the introduction of the electronic road toll is not backed by measures.

There are positive and negative risks around the scenario presented here. On the one hand, expenditure of the line ministries may be higher than budgeted if some of the detailed measures underpinning the savings are not fully implemented. Moreover, a further deterioration of the macroeconomic environment compared to what is already projected may result in additional revenue shortfalls. On the other hand, mainly in 2013, the full implementation of structural reform plans as set out in the CP could generate significant savings compared to the current forecast.

Following a structural deterioration of 1½% in 2010 and 1¼% in 2011, the structural balance is expected to improve by 2½% in 2012, in large part due to the measures described above. In 2013, a structural deterioration of ½% of GDP is expected.



Given both the forecast deficit numbers and the exchange rate assumptions, gross public debt is expected to increase again to nearly 77% of GDP following a temporary drop in 2011 due to the takeover of the private pension assets.

Table II.16.1:

Main features of country forecast - HUNGARY

	2010			92-07	Annual percentage change					
	bn HUF	Curr. prices	% GDP		2008	2009	2010	2011	2012	2013
GDP	26747.7		100.0	2.6	0.9	-6.8	1.3	1.4	0.5	1.4
Private consumption	14246.6		53.3	-	-0.7	-6.2	-2.2	0.2	-0.8	0.3
Public consumption	5839.7		21.8	0.4	1.1	-0.6	-2.1	-0.9	-0.7	0.9
Gross fixed capital formation	4806.3		18.0	4.2	2.9	-11.0	-9.7	-4.9	-1.0	1.8
of which: equipment	1810.3		6.8	-	1.6	-16.7	-4.2	0.0	1.0	4.5
Exports (goods and services)	23148.8		86.5	12.7	5.7	-10.2	14.3	9.1	7.2	7.9
Imports (goods and services)	21409.8		80.0	12.7	5.5	-14.8	12.8	7.1	6.4	7.9
GNI (GDP deflator)	25446.1		95.1	-	1.5	-4.8	0.8	0.1	0.1	1.5
Contribution to GDP growth:										
Domestic demand				2.4	0.5	-5.9	-3.7	-1.0	-0.8	0.6
Inventories				0.2	0.2	-4.5	3.1	0.2	0.0	0.0
Net exports				0.0	0.2	3.6	1.8	2.2	1.3	0.8
Employment				-	-1.3	-2.8	0.2	0.5	1.1	0.0
Unemployment rate (a)				-	7.8	10.0	11.2	11.2	11.0	11.3
Compensation of employees/f.t.e.				-	6.6	-1.3	-2.2	3.6	3.2	3.8
Unit labour costs whole economy				-	4.3	2.9	-3.2	2.7	3.9	2.4
Real unit labour costs				-	-0.9	-0.6	-6.1	0.4	-0.2	-1.0
Saving rate of households (b)				-	8.0	9.9	8.1	-	-	-
GDP deflator				12.5	5.3	3.6	3.1	2.3	4.1	3.4
Harmonised index of consumer prices				-	6.0	4.0	4.7	4.0	4.5	4.1
Terms of trade of goods				-	-1.1	1.1	-0.2	-0.5	0.4	0.1
Merchandise trade balance (c)				-4.3	-1.2	2.5	3.2	4.6	6.2	6.7
Current-account balance (c)				-	-6.9	-0.2	1.0	1.7	3.2	3.8
Net lending(+) or borrowing(-) vis-à-vis ROW (c)				-	-5.9	1.0	2.8	3.6	6.5	7.1
General government balance (c)				-	-3.7	-4.6	-4.2	3.6	-2.8	-3.7
Cyclically-adjusted budget balance (c)				-	-4.9	-2.3	-2.4	4.8	-1.8	-3.2
Structural budget balance (c)				-	-4.5	-2.3	-3.8	-5.0	-2.6	-3.2
General government gross debt (c)				-	72.9	79.7	81.3	75.9	76.5	76.7

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