

16. HUNGARY

Forceful adjustments help reduce economic vulnerabilities

Fragile situation at the onset of 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 stimulus 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.⁽⁸⁷⁾ However, these corrective fiscal measures mainly focused on achieving higher revenues and not sufficiently on expenditure cuts based on structural reforms, which contributed to lower GDP growth compared with most neighbouring countries and even old Member States in both 2007 and 2008.

Initial effects of 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, a joint financial assistance of up to EUR 20 billion was provided to Hungary

by the EU, the IMF and the World Bank linked to policy conditions. In order to counteract the decreasing revenues caused by declining output, the government also implemented a mix of structural and temporary expenditure saving measures.

Second round effects in the downturn

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 during the first eight months of 2009, also in line with a limited demand for credit. Nevertheless, financial market conditions are expected to slowly but continuously improve over the forecast horizon as uncertainty about the recovery subsides and investor confidence picks up.

Based on diminishing real wages and increased uncertainty regarding employment, consumption expenditure by households is foreseen to decline by more than 10% between 2008 and 2010. At the same time, fixed capital formation is also expected to decrease substantially due to financing difficulties and low capacity utilisation with the possible exception of infrastructure investments linked to EU funds. The depletion of inventories was extremely strong in the fourth quarter of 2008 and the first quarter of 2009, when their contribution to the decline in GDP is estimated to have been around 4½ percentage points. However, net exports are projected to make a large positive contribution to growth as imports fall even faster than exports. GDP is forecast to decrease by 6½% in 2009, and to decline further in 2010 before returning to positive territory (at around 3%) in 2011.

The sharp decline in production has induced a pronounced flow from full-time employment to part-time and non-employment and has also capped wage expectations for those who remained active in the labour market. The drop in full-time-equivalent employment in the private sector could be roughly 5% in 2009 and, due to a lagged response of the labour market, a further decline is expected in 2010. At the same time, the government launched its 'Pathway to Work' programme, which provided short-term employment in public services for a large number

⁽⁸⁷⁾ In the context of second notification, the ESA95 general government deficit increased by 0.4 of a percentage point to 3.8% of GDP compared to the first notification in spring 2009.

of non-employed. Moreover, in an attempt to boost employment in a budget-neutral way, the authorities shifted a part of the tax burden from labour to consumption and wealth. All in all, these measures, together with growing unemployment and deleveraging in the financial markets, took a heavy toll on the purchasing power of households in the short run.

The rapid adjustment in consumption and thus imports also induced a remarkable decline in the current account deficit, which improved from 7.2% of GDP in 2008 to 2.7% in the first quarter of 2009 and turned into a 2.1% of GDP surplus by the second quarter of this year. It appears that the adjustment in the current account is heavily frontloaded: no further improvement is therefore foreseen in 2010. In the medium term, a smaller export–import gap is expected, with the external deficit stabilising at a more sustainable level.

Labour market challenges in a medium-term perspective

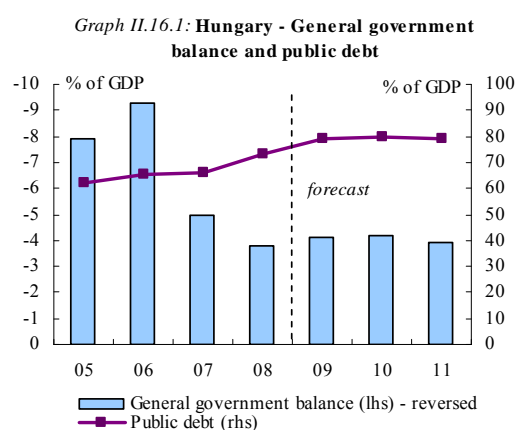
Starting from 2011, the recovery is set to be largely supported by an improved external environment with both higher demand for Hungarian exports and better market sentiment in global finances. Moderate wage growth, low inflation and decreasing income taxes may enhance consumption and previously subdued investments may also accelerate. As a result, cost competitiveness should improve and attract additional direct investment. However, the structural problems of the labour market are likely to deepen during the crisis as high and persistent unemployment depletes acquired skills. This phenomenon, in combination with a permanently lower risk appetite, could set the stage for jobless and credit-less growth in the medium run. While growth could nonetheless become more balanced with a lower contribution from public and private consumption than previously, which would also suggest more sustainable external balances, the challenge of escaping a 'low-growth' trap will remain.

Focus on consolidation of public finances

General government revenues are forecast to decrease by about 6% in real terms in 2009 and by 4% in 2010, reflecting mainly the deterioration of tax bases and to a smaller extent the reduction of the tax wedge on wages. In 2009 and 2010, this revenue shortfall is expected to be broadly

counterbalanced by reforms in the pension system and in social transfers, and numerous saving measures, e.g. freezing the wage bill in the public sector.

As a baseline scenario, taking into account adopted measures and the draft 2010 budget and applying the no-policy-change assumption, the general government deficit is forecast to come out at around 4% of GDP in the period 2009-2011.



In 2009, despite the unfavourable economic environment, the deficit should not increase significantly from the level reached in 2008 reflecting the projected structural effort of some 2¼ pp. However, the deficit is foreseen to slightly exceed the government's target set at 3.9% of GDP, mainly due to the decreasing tax revenues related to diminishing corporate profits.

In 2010, despite the already-adopted and additional budgeted measures, as well as the increased level of reserves, the deficit target of 3.8% of GDP is expected to be exceeded for several reasons. First, a larger local government deficit than foreseen in the draft budget (1.0% vs. 0.7% of GDP) is expected as the reduction of central support to local governments could be replaced by a depletion of their large liquid assets. Second, for the time being, the intended reduction of the subsidy (of 0.4% of GDP) for the state-owned railway company cannot be taken into account due to the lack of detailed measures. Third, expenditure is forecast 0.3% of GDP higher than planned in the draft 2010 budget, notably in the area of health care financing, partly linked to

policy announcements. These expenditure overruns could not be counteracted even if most of the 0.7% of GDP reserves were to be frozen⁽⁸⁸⁾.

In 2011, the forecast recovery should trigger the increase of the budget revenues, but this cyclical increase in revenues is not likely to be fully realised due to the decision to increase the ceiling of the lower personal income tax bracket from 5 to 15 million forints. This measure, which is expected to lower the budget revenue by 0.6% of GDP, was already adopted by Parliament in June 2009 and will be effective as of 2011. Moreover, the expected losses (of about 0.4% of GDP) of the central bank in 2010 will also have to be compensated in 2011. Thus, under the no-policy-change assumption, the deficit is expected to remain above the 3% of GDP threshold.

This deficit forecast is subject to risks. In 2009, it mainly refers to further expenditure overruns, notably in the health care system. In 2010 and 2011, the risk is higher and is mainly related to two factors. First, some measures that have recently supported the deficit reduction do not look sustainable (notably a freeze in public sector wages and expenditure by institutions, lower

spending on education, health care and the local government system without structural reform, and an increase in the carryover balance). Second, there is a risk of lower-than-budgeted revenues arising from insufficient companies' profits also in 2010.

The general government debt as a ratio of GDP is expected to increase significantly in 2009 and to reach its peak in 2010 at almost 80% of GDP, the highest among the central and eastern European countries. The drivers of this increase are the lower nominal GDP and the exchange rate depreciation in 2009 compared to 2008. A fall in the debt ratio is foreseen from the end of 2010, mainly in view of the expected use of the accumulated assets although the advance financing obligations of EU funds might partly counteract this trend.

⁽⁸⁸⁾ It is assumed that all the stability and the interest rate risk reserve (0.5% of GDP) and half of the general reserve (0.1% of GDP) can be saved.

Table II.16.1:

Main features of country forecast - HUNGARY

	2008			Annual percentage change						
	bn HUF	Curr. prices	% GDP	92-05	2006	2007	2008	2009	2010	2011
GDP	26543.3	100.0	3.0	4.0	1.0	0.6	-6.5	-0.5	3.1	
Private consumption	14331.8	54.0	-	1.7	0.4	-0.5	-7.4	-2.5	3.0	
Public consumption	5743.1	21.6	1.2	3.8	-7.4	-0.8	-1.1	-1.6	1.8	
Gross fixed capital formation	5559.1	20.9	5.7	-3.6	1.6	0.4	-6.0	1.0	4.3	
of which : equipment	2231.2	8.4	-	-	-	-	-9.0	2.7	3.9	
Exports (goods and services)	21804.9	82.1	12.5	18.6	16.2	5.6	-13.1	3.6	6.0	
Imports (goods and services)	21545.5	81.2	12.9	14.8	13.3	5.7	-16.2	2.5	6.2	
GNI (GDP deflator)	24615.6	92.7	-	3.6	-0.4	1.1	-5.2	-0.8	3.7	
Contribution to GDP growth :										
Domestic demand			3.1	0.9	-1.1	-0.4	-5.5	-1.4	2.9	
Stockbuilding			0.2	0.8	0.0	1.0	-3.4	0.0	0.0	
Foreign balance			-0.3	2.3	2.2	0.0	2.4	1.0	0.2	
Employment			-	0.9	-0.1	-1.2	-3.0	-0.8	0.9	
Unemployment rate (a)			8.1	7.5	7.4	7.8	10.5	11.3	10.5	
Compensation of employees/f.t.e.			-	4.5	6.8	6.6	-1.4	0.0	3.9	
Unit labour costs whole economy			-	1.4	5.6	4.6	2.3	-0.3	1.7	
Real unit labour costs			-	-2.4	-0.3	0.8	-1.5	-2.8	-0.1	
Savings rate of households (b)			-	-	-	-	-	-	-	
GDP deflator			13.2	3.9	5.9	3.8	3.8	2.6	1.8	
Harmonised index of consumer prices			-	4.0	7.9	6.0	4.3	4.0	2.5	
Terms of trade of goods			-	-1.4	-0.1	-1.4	0.9	-0.6	-1.1	
Trade balance (c)			-4.5	-2.3	0.2	-0.1	2.7	3.0	2.3	
Current account balance (c)			-	-7.5	-6.5	-6.6	-1.3	-1.7	-1.8	
Net lending(+) or borrowing(-) vis-à-vis ROW (c)			-	-6.9	-5.5	-5.6	0.5	0.3	0.4	
General government balance (c)			-	-9.3	-5.0	-3.8	-4.1	-4.2	-3.9	
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	-4.8	-2.1	-2.1	-3.0	
General government gross debt (c)			-	65.6	65.9	72.9	79.1	79.8	79.1	

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