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Hungary: the election year is over, repair of damages may begin

Despite the relatively good growth performance compared to the EU 15 or the CEECs, Hungarian economy in 2002 was further departing from the successful growth path of the period 1997-2000 and was heading towards uncertain waters. Runaway wage increases, huge fiscal imbalance, deteriorating competitiveness and a growing current account deficit call for urgent corrections in 2003.

The hysterical political atmosphere related to the general elections in April and the municipal elections in October last year determined the developments in 2002. The irresponsible 'who promises more' contest run by both big parties (the conservative FIDESZ and the socialist MSZP) led to a chain of events that began with the raising of the minimum wages in 2001 and 2002, altogether by nearly to the double by the Orban government. That was topped by the 50% wage raises for public servants by the new Medgyessy administration. Business sector wages increased about 10% in real terms, pushed partly by the distortion in the wage structure due to the disproportionately high new minimum wages, lower than originally expected inflation and partly by the demonstration effect of public sector wage increases. Government transfers to households rose by about 13% in real terms. All that resulted in 8-8.5% growth of household consumption, which is two and a half times the growth rate of the GDP.

GDP growth in 2002 may have attained 3.3%, while growth of domestic use amounted to about 5%. Nevertheless growth was not completely consumption-driven. Gross fixed investment increased by about 6%. That expansion derives from rocketing housing investment of households pushed by state-supported preferential credits and government-initiated infrastructure projects. A warning sign, manufacturing investments declined by about 15% in 2002.

On the production side of the GDP, the performance of industry was weak with 2.6% output growth. Industry's export sales increased by about 4%, while domestic sales, despite the household consumption bonanza, stagnated. Agricultural output dropped. Due to booming infrastructure investments construction recorded a double-digit growth rate.

In the wake of the appreciating forint and the rapid increase in household consumption the current account deteriorated significantly as compared to the preceding year. An increasing deficit in commodity trade and shrinking surplus in tourism were the two main components of the deterioration, with comparatively equal weight. The current account deficit amounted to an estimated EUR 3.6 billion or more in 2002, that is over EUR 2 billion worse than in 2001, exceeding 5% of GDP. Non debt creating financing was much below the 2001 level;

not even 20% of the current account deficit was counterbalanced by respective inflows in November. Compared to the huge expansion of household consumption the deficit on the current account is relatively moderate. That can be explained by the compensating effect of the decline in manufacturing investment and its impact on imports of investment goods. Commodity exports (BoP) may have increased by about 9%, a remarkable performance considering the declining import demand on Hungary's main export markets and the strong appreciation of the national currency. The growth rate of imports was about 2 percentage points higher than that of exports.

There was an explosive increase in the general government deficit, which amounted to 9.6% of the GDP. Part of this was, however, not having any effect on demand. Certain items that were booked in 2002 had actually been spent in 2000 and 2001 already (highway construction, Hungarian Development Bank, a subsidized credit line for students, etc.) but were treated by the previous government as off-budgetary outlays. Also, some expenditures creating demand only this year were booked in the last days of December 2002 (such as the consolidation of the Budapest public transport company). Without these items, the general government deficit would have amounted to about 5.5-6% of GDP. According to the central bank's estimation, the contribution of government spending to the increase of aggregate demand in 2002 corresponded to 4.3% of GDP.

A spectacular achievement of the year 2002 was the reduction of consumer price inflation from a level of 9-10% (annual average) in the previous three years to 5.3% in 2002. The drop in December-to-December inflation was smaller, from 6.8% to 4.8%. That means that the National Bank of Hungary (NBH) attained its year-end inflation target for 2002 (4.5% ±1%). Part of that success is explained by the repeated postponement of long due price rises of certain important commodities and services (household gas, public transport and medicaments).

The NBH, headed by Mr. Járai, minister of finance in the former government before switching over to the central bank, has been deeply concerned about the wage rises and rapidly growing public finance deficit, especially since the inauguration of the new government in summer last year. Referring to the maximum 4.5% CPI inflation to be attained in December 2003 the central bank kept the interest rates high. By the end of 2002 real interest rates were twice, the interest premium three times as high as in May 2001 when the intervention bend was broadened to ±15% from ±2.25%.

The prospect of high yields on government securities coupled with the declining risk perceived due to the progress achieved in the process of accession to the EU, made Hungary a target for foreign financial investors. The increasing inflow of capital pushed the exchange rate to the strong edge of the intervention band. Reaching that edge at 234.69 HUF/EUR in January 2003, the forint became 13.8% more expensive in euro terms than before the broadening of the intervention band. That implies about 20% real appreciation of the national currency in one and a half years.

In November and December 2002 the monetary policy got into the crossfire of criticism of experts and business circles. The policy of high interest rates was criticized because of its devastating effect on the competitive position of exporters and import-competing firms. It was argued that the inflation target could be achieved with lower interest rates as well. But the central bank stuck to its principle that due to the huge budget deficit and excessive wage raises there was no way to decrease the prime rate because that would endanger the observation of the inflation target. Nevertheless, the central bank cut the prime rate by 0.5 percentage points in November, and to the same extent in December.

In mid-January 2003 a speculative attack was launched against the intervention band of the forint by foreign investors who expected that the central bank and the government could be forced to move the intervention band upwards, allowing for a further appreciation of the forint. The central bank intervened, and allegedly EUR 5 billion or more was bought up in the course of the intervention. To stop further speculative actions the central bank decreased the prime rate within two days, and in two steps, from 8.5% to 6.5%; further the overnight interest rate corridor around the two-week central bank deposit rate was widened the to ±3 percentage points and a quantity limit was set on the availability on two-week deposits. With these steps the effective key policy rate dropped to 3.5%. After the intervention the forint/euro exchange rate declined to 243.72.

That speculative attack showed the limits of using the interest rate policy solely for keeping inflation in the targeted range. The central bank was forced to defend the exchange rate, and while the credibility of the inflation targeting monetary policy may have weakened with the interest rate cuts, the positive side effects of that step are obvious, as a weaker forint is badly needed by the business sector and the new volatility of the interest rates and exchange rate diminishes the chances of speculative attacks in the future.

As the consumption- and non-productive investment-driven economic growth came to its limits by the beginning of 2003 it would be important to stabilize the exchange rate at its new, lower level to support a switch back to an export-based expansion of the economy. That would make even the attainment of the high edge of the targeted inflation range by December 2003 very difficult if not impossible. The market has been reckoning with higher than targeted inflation since November last year. The question is now whether the central bank will try to move the exchange rate closer to the strong edge of the intervention band again in order to force inflation down or whether it accepts the new situation and sets a new inflationary target. A recent interview with central bank governor Járai hints at the realization of the latter option.

In 2003 two issues, the budget and the wages, will play a crucial role. The 2003 budget is restrictive compared to the previous year. The government's target is to reduce the general government deficit to 4.5% of the GDP. Public spending on wages will still grow dynamically, due to pervading effects from the previous year, and the main post for savings will be public investment. The wage rise in the business sector proposed by the tripartite council amounts to 4.5%, in real terms. That means that the rise of incomes and consumption will again be higher than the growth of GDP.

In its optimistic scenario for 2003, the WIIW assumes that Hungary will be returning to the growth path of the earlier years, helped by increasing import demand from its main export markets. That process will certainly not be completed within one year. At an average exchange rate of around 245 HUF/EUR exports will pick up. Productive investment will also start to grow, resulting in higher imports and a deteriorating current account. The fiscal deficit will decrease but will be 0.5 to 1 percentage points higher than targeted. Inflation will remain at the previous year's level, slightly above 5% (annual average). GDP growth will be higher than in 2002 but remains below 4%, falling short of the governments target of 4-4.5%. The pessimistic scenario for 2003 assumes that the central bank returns to its policy mix of a strong forint and a high interest rate, putting inflation reduction above any other target. That would provoke a permanent conflict between the central bank and the government, and would lower the GDP growth rate but not necessarily inflation.

Table HU

Hungary: Selected economic indicators

	1996	1997	1998	1999	2000	2001	2002 [1]	2003	2004
								forecast	
Population, th pers., end of period [2]	10301.0	10280.0	10253.0	10222.0	10200.0	10175.0	10155 Nov	.	.
Gross domestic product, HUF bn, nom.	6893.9	8540.7	10087.4	11393.5	13150.8	14823.9	16200	17600	19200
annual change in % (real)	1.3	4.6	4.9	4.2	5.2	3.7	3.3	3.8	4
GDP/capita (USD at exchange rate)	4382	4444	4582	4690	4563	5078	6180	.	.
GDP/capita (USD at PPP - wiiw)	9220	9850	10620	11310	12200	13430	13720	.	.
Gross industrial production									
annual change in % (real)	3.4	11.1	12.5	10.4	18.1	3.6	2.6	7	9
Gross agricultural production									
annual change in % (real)	6.3	-3.3	0.7	0.4	-6.5	15.8	-4	2	.
Goods transport, mn t-kms	24874	24789	27144	26339	26399	26240	18931 I-IX	.	.
annual change in %	5.1	-0.3	9.5	-3.0	0.2	-0.6	-0.5	.	.
Gross fixed capital form., HUF bn, nom.	1475.5	1898.9	2384.6	2724.5	3179.8	3484.7	.	.	.
annual change in % (real)	6.7	9.2	13.3	5.9	7.7	3.1	6	7.5	8
Construction industry									
annual change in % (real)	2.7	8.1	15.3	9.0	7.9	7.7	20.1 I-XI	10	.
Dwellings completed, units	28257	28130	20323	19287	21583	28054	15742 I-IX	.	.
annual change in %	14.3	-0.4	-27.8	-5.1	11.9	30.0	15.1	.	.
Employment total, th pers., average [3][4]	3648.1	3646.3	3697.7	3811.5	3849.1	3859.5	3861.5 I-XI	.	.
annual change in % [3][4]	-0.8	0.0	0.7	3.1	1.0	0.3	0	0	0
Employees in industry, th pers., average [5]	789.0	783.5	795.9	834.0	844.8	833.9	819.9 I-XI	.	.
annual change in %	-5.3	-0.7	1.6	0.8	1.3	-1.3	-2.0	.	.
Reg. unemployed, th pers, end of period	477.5	464.0	404.1	404.5	372.4	342.8	.		
Reg. unemployment rate in %, end of period	11.4	11.0	9.6	9.6	8.7	8.0	8.2		
LFS - unemployment rate in %, average	9.9	8.7	7.8	7.0	6.4	5.7	5.8 I-XI	5.8	5.8
Average gross monthly wages, HUF [5]	46837	57270	67764	77187	87645	103553	118643 I-XI	.	.
annual change in % (real, net)	-5.0	4.9	3.6	2.5	1.5	6.4	13.1	4	.
Retail trade turnover, HUF bn	2594.5	2949.1	3682.8	4329.7	4822.0	5394.0	5434.8 I-XI	.	.
annual change in % (real)	-4.9	-1.6	12.3	7.9	2.0	5.4	11.0	.	.
Consumer prices, % p.a.	23.6	18.3	14.3	10.0	9.8	9.2	5.3	5.3	5
Producer prices in industry, % p.a.	21.8	20.4	11.3	5.1	11.6	5.2	-1.8	.	.
Central government budget, HUF bn [6]									
Revenues	2079.3	2364.6	2624.4	3227.6	3681.0	4068.0	4365.8	.	.
Expenditures	2209.1	2703.1	3176.6	3565.8	4049.7	4470.9	5840.5	.	.
Deficit (-) / surplus (+)	-129.8	-338.5	-552.2	-338.1	-368.7	-402.9	-1474.7	.	.
Deficit (-) / surplus (+), % GDP	-1.9	-4.0	-5.5	-3.0	-2.8	-2.7	-9.1	.	.
Money supply, HUF bn, end of period									
M1, Money	1237.2	1528.4	1791.1	2135.6	2378.3	2775.9	3306.1	.	.
Broad money	3352.8	4036.3	4635.8	5399.5	6052.0	7089.8	8409.8	.	.
Refinancing rate, % p.a., end of period	23.0	20.5	17.0	14.5	11.0	9.8	8.5	.	.
Current account, USD mn	-1678	-981	-2298	-2081	-1328	-1105	-3400	-3900	-3700
Current account in % of GDP	-3.7	-2.1	-4.9	-4.3	-2.9	-2.1	-5.4	-5.1	-4.6
Reserves total, excl. gold, USD mn	9714	8400	9312	10824	11202	10738	9706 Nov	.	.
Gross external debt, USD mn	27956	24395	27280	29336	30742	33386	38222 Nov	.	.
Exports total, fob, EUR mn [7]	10471.6	16910.1	20476.8	23491.0	30544.5	34082.0	36100	39000	42900
annual growth rate in %	5.0	35.1	21.1	14.7	30.0	11.6	6	8	10
Imports total, cif, EUR mn [7]	12911.6	18779.5	22871.2	26287.8	34856.3	37654.1	39700	42900	46800
annual growth rate in %	8.5	29.9	21.8	14.9	32.6	8.0	5.5	8	9
Average exchange rate HUF/USD	152.57	186.75	214.45	237.31	282.27	286.54	258.00	.	.
Average exchange rate HUF/EUR (ECU)	191.15	210.93	240.98	252.80	260.04	256.68	242.97	244	240
Purchasing power parity HUF/USD, wiiw	72.55	84.30	92.53	98.38	105.53	108.34	116.16	.	.
Purchasing power parity HUF/EUR, wiiw	78.67	90.73	100.85	107.17	114.51	121.79	126.33	.	.

Notes: 1) Preliminary. - 2) Revised data according to census Feb 2001. - 3) Based on Labour Force Survey. - 4) From 1998 new sample. - 5) Enterprises with more than 10, from 1999 more than 5 employees. - 6) Excluding privatization revenues. - 7) Converted from the national currency to EUR at the official exchange rate. From 1997 including trade of firms with customs free legal status.

Source: **wiiw** Database incorporating national statistics; **wiiw** forecasts.