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Hungary:
Sliding into recession

Given the decline in both consumption and investments and in view of the budget consolidation measures already introduced or still in the pipeline, recession looms large in Hungary. Positive contribution of net exports has not been enough to sustain economic growth. The question as to when (if at all) the government will conclude an agreement on the financial assistance package with the IMF and the EU that the economy so badly needs is still open, as is the question whether the government will be prepared to adjust its (economic and other) policies to comply with the international community's expectations.

In economic terms, everything points to an upcoming recession. In the first quarter of 2012, Hungary's GDP declined by 0.7%; however, once adjusted for seasonal and calendar effects, actual contraction was twice as great. The value added by the traditional driver of economic growth, the vibrant export-oriented industry, stagnated in the first quarter. Of Hungary's two major industrial sectors, the manufacture of transport equipment and the production of electronic equipment, the first sector performed well, while low external demand for computers, electronic and optical devices led to an appreciable drop in the volume of exports in this sector. In the construction sector, value-added has come close to free fall. Agricultural performance also recorded a decline, partly owing to the fact that the sector's performance in the previous year provided a strong basis for comparison. Value-added in the services sector stagnated. In terms of GDP distribution, consumption declined, mainly because the government's consolidation measures started to 'bite'. The high cost of borrowing, deleveraging in the banking sector and flat domestic demand are reflected in the unrelenting contraction of investment activities. The only positive contribution to the shift in GDP came from net exports (+2.2 percentage points). Although the growth rate of both exports and imports diminished substantially compared to the period 2010-2011, the large gap of more than 2 percentage points in favour of the export growth rate saved Hungary from lurching into a much deeper slump.

Throughout the spring season, Hungary fought three battles on various sectors of one and the same front. The first engagement involved an attempt to get out from under the EU excessive debt procedure: a battle into which the country had been locked for the past eight consecutive years and where defeat bore the threat of the 2013 Cohesion Fund transfers being suspended - to the tune of EUR 500 million. The second skirmish was related to the launching of negotiations with the IMF-EU tandem on a precautionary financial support package. The third struggle was a foray to secure acknowledgement of the legitimacy of a whole clutch of new Hungarian laws that were suspected of contravening EU laws. All three issues are closely interrelated. Furthermore, in all three cases the European Union has been the main counterpart, although, where the latter two issues are concerned, the implications extend beyond the European context. By early summer 2012, however, Hungary had scored partial success in all the three sectors.

On the first front, the European Commission (EC) acknowledged that in terms of its economic policy, the government had indeed moved towards consolidating the country's fiscal balances for both 2012 and 2013. The EC deemed the measures announced in the "Széll Kálmán Plan 2.0" package and the up-dated convergence programme sufficient to nudge the general government deficit below the 3% Maastricht threshold in both 2012 and 2013. On 30 May 2012, the EC thus recommended that the Economic and Financial Affairs Council lift the sanctions that suspended part of the Cohesion Fund transfers to Hungary. This recommendation was approved on 22. June. That notwithstanding, despite the progress being acknowledged, it is still not enough to permit a decision to release Hungary from the excessive deficit procedure. That decision may follow early next year, as it will be conditional upon the Hungarian economic policy being positively evaluated in terms of sustainability.

On the second front, negotiations with the IMF and EU have come closer to getting started than they have ever been since the government announced its intention to embark on such an undertaking in late 2011. Nevertheless, the controversial law pertaining to the central bank remains an open issue. Furthermore, uncertainty rules given the government's bombastic statements, alternating between outright hostility and plain indulgence, on the content of the negotiations, the IMF and EU against a backdrop of the government's propaganda machine urging a 'fight for freedom' against all foreign influences of any kind. Amidst all the international turbulences related to Greece, the vulnerable Hungarian economy is in dire need of a protective umbrella that an agreement with the IMF/EU would afford; however, neither a quick start nor a successful conclusion can be guaranteed. Meanwhile an exchange rate close to 300 HUF/€ and yields on long term government bonds over 8%, both closely related to the uncertainties concerning the IMF/EU financial package, cause painful losses for the budget, on one hand, and for households tackling with the high debt service after their foreign currency loans, on the other hand.

On the third front, the conflict over the controversial Hungarian laws is also far from being resolved, despite the government having scored a minor victory inasmuch as the EU gave a conditional go-ahead for the start of negotiations with the IMF-EU tandem on the financial assistance package. Once negotiations begin with the tandem, economic policy issues may well be topped by the emergence of other issues of paramount importance, viz. the independence of the Central Bank, curtailment of the rights of the Constitutional Court and the licence granted to the Fiscal Council.

Fiscal policy has been, and will remain, the focal point in both the international and domestic policy context. Successive Hungarian governments have done battle with the grave consequences of the lax fiscal policies pursued in the period between mid-2001 - mid-2006 as well as the lack of reforms in public spending that have long been outstanding. In 2010, the newly elected Orbán government toyed with the idea of a return to stimulating the economy by deficit spending. However, given the unfavourable external circumstances and for want of the growth effects that it had hoped for, the government was compelled in less than a year thereafter to revert to the disagreeable practice of fiscal consolidation, even though Orbán's flagship project, the 16% 'flat' income tax, which alone led to a gap in budget revenue equivalent to 1.8% of GDP, was introduced. The Orbán government's fiscal consolidation has been 'unorthodox' in the sense that instead of restrictive measures hitting the population head on, the financial sector (in the form of a bank levy) and primarily multinational enterprises in the energy, wholesale, telecom sectors (in the form of sectoral levies) bore the brunt of consolidation. Moreover, the second, mandatory private pillar of the pension scheme was nationalized, the aim being twofold: reduction of both the fiscal deficit and public debt. All those steps, coupled with a propaganda campaign against multinational companies and the financial markets, was successfully sold to large segments of the population in Hungary. That notwithstanding, though designed to step up budget revenues from unconventional sources, the measures proved inadequate to the task; they failed to reduce the fiscal deficit to below the 3% threshold. Furthermore, as they were mostly of a temporary nature, they left the issue of medium-term sustainability unresolved. Only the increasing confrontation with the EC (see above) compelled the government to launch a second wave of economic-policy measures designed to diminish the budget deficit to well below 3% of the GDP. More importantly, they should be able to replace the temporary sector-specific taxes and reduce the bank levy by half, with promises of everything being phased out next year.

Although uncertainties abound in terms of the details, the main features of the forthcoming wave of fiscal consolidation will be: new taxes on financial transactions and telecom services; electronic road pricing; a modified tax on the energy sector and insurance companies; reduced subsidies for pharmaceutical products; reverse VAT charges in the agriculture sector; reduced government spending on research and innovation; and further cuts in expenditure in central government. The government aim is to reduce the fiscal deficit to 2.5% of GDP in 2012 - and 2.2% in 2013.

As for Hungary's poor track record in terms of fiscal balances, high public debt and the external pressure for fiscal consolidation, it is out of the question that economic growth over the next few years can be stimulated by way of deficit spending. Other means of fostering growth should be sought. One such growth resource would be an increase in inflow of FDI. Currently, FDI-inflows are focused on a limited number of major projects in the automotive cluster. The government encourages 'productive' FDI projects (in selected manufacturing branches), yet discourages them in communal services and agriculture. Even more important, trust in the rule of law has been seriously undermined by the manner in which sectoral levies, the nationalization of pension funds and the scheme for the early repayment of foreign currency mortgage loans were introduced, not to speak of the often hostile government rhetoric about the presence and influence of foreigners in Hungary. All this has effectively put the brakes on new projects and proven a disincentive for the local reinvestment of profits generated.

One alternative growth strategy would be to improve and broaden financial intermediation. Most countries are intent on keeping the central bank policy rate low in order to offset the negative impact of fiscal restrictions on growth. This is no simple task in Hungary, which boasts one of the highest policy rates (7%) in the EU-27 and has but limited manoeuvring space for introducing substantial cuts in the immediate future. The stock of business sector credits has dropped unabated in real terms since 2009. This is one explanation for the decline in investment activity, especially in the typically domestic-owned medium and small enterprises, which, unlike foreign-owned companies, do not enjoy access to intra-firm credits from a parent company abroad. Moreover, stagnating domestic markets and the high costs of borrowing diminish the readiness of firms to raise credits. Loans to households have also been contracting.

Banks are certainly key players where the future of financial intermediation is concerned. Whereas banks were highly profitable ventures in Hungary over the past decade, the Orbán government 'discovered' them first as a source of an inordinate bank levy, then as the main donors to the reduction of the costs associated with the early repayment of foreign currency mortgage loans at preferential rates. The government also announced that the banks were to bear the costs of the financial transaction tax that it was about to introduce. 2011 was a year of severe losses for Hungarian banks. Amidst the pressure for deleveraging the banks are finding themselves compelled to pursue a conservative or even restrictive lending policy.

The Orbán government's original plan to foster growth via domestic consumption has not taken off. A series of improvised economic policy measures over the past twelve months appear to have finally managed to consolidate the budget for this year and the next year - or at least to keep the budget deficit below or close to the 3% threshold. Nevertheless no coherent medium run economic policy is in sight. The politically motivated centralization introduced in undue haste in every possible segment of the economy and society excludes any reasonable reconciliation of interests. In fact, it even distorts any appropriate government initiatives.

The wiiw expects a 1% decline in GDP this year, contrary to the marginal growth forecast by the government. The wiiw reckons with fiscal consolidation having a greater negative impact on both consumption and investments. The positive net-exports position at a later juncture will prove incapable of offsetting that impact. Given the probable release of Hungary from the excessive debt procedure and the agreement with the IMF-EU tandem being concluded by the end of the year at the latest, the external pressure on Hungary may ease up in 2013, thus leading to cheaper financing of external debt. A modest upturn in investment, a check in decline in consumption and a positive net-exports position at a later juncture will make for a 1.5% expansion of the economy in 2013. Despite flat domestic demand, inflation will remain a matter of concern over the next two years. The current account will show a considerable surplus, albeit diminishing as of next year, when imports take off - coupled with a modest recovery of economic growth. While this is the baseline scenario for Hungary, the downward risks are considerable. In view of the country's high external debt and the vulnerability so induced, Prime Minister Orbán's confrontational course poses a serious risk. However, there is no reason to expect any change at the present juncture.

Table HU

Hungary: Selected Economic Indicators

	2008	2009	2010	2011 1)	2011	2012	2012	2013	2014
					1st quarter			Forecast	
Population, th pers., average	10038	10023	10000	9960	9973	9953	9940	9920	9900
Gross domestic product, HUF bn, nom.	26546	25623	26748	28080	6228	6498	29000	30300	32000
annual change in % (real)	0.9	-6.8	1.3	1.7	2.5	-0.7	-1	1.5	2.5
GDP/capita (EUR at exchange rate)	10500	9100	9700	10100	.	.	.	.	.
GDP/capita (EUR at PPP)	16000	15200	15800	16300	.	.	.	.	.
Consumption of households, HUF bn, nom.	13985	13568	13854	14471	3398	3585	.	.	.
annual change in % (real)	-0.5	-6.4	-2.1	0.0	-0.6	-0.2	-1.5	0	1.8
Gross fixed capital form., HUF bn, nom.	5760	5295	4806	4710	851	820	.	.	.
annual change in % (real)	2.9	-11.0	-9.7	-5.5	-1.5	-6.6	-1	2	3
Gross industrial production									
annual change in % (real)	-0.2	-17.6	10.5	5.4	12.6	-0.1	3	4	8
Gross agricultural production (EAA)									
annual change in % (real)	27.7	-10.3	-11.5	10.1	.	.	.	.	.
Construction industry									
annual change in % (real)	-5.2	-4.4	-10.4	-7.7	-6.6	-11.3	-6	3	8
Employed persons - LFS, th, average	3879.4	3781.8	3781.2	3811.9	3732.5	3791.3	3810	3830	3850
annual change in %	-1.2	-2.5	0.0	0.8	0.4	1.6	0	0.5	0.5
Unemployed persons - LFS, th, average	329.1	420.7	474.8	467.9	489.8	504.1	.	.	.
Unemployment rate - LFS, in %, average	7.8	10.0	11.2	10.9	11.6	11.7	11.5	10.5	10
Reg. unemployment rate, in %, end of period	10.9	13.6	13.3	12.5	14.7	13.3	.	.	.
Average gross monthly wages, HUF 2)	198741	199837	202525	213054	209908	219212	.	.	.
annual change in % (real, net)	0.8	-2.3	1.8	2.4	-1.0	-3.9	.	.	.
Consumer prices (HICP), % p.a.	6.0	4.0	4.7	3.9	4.3	5.6	5.5	4	3.7
Producer prices in industry, % p.a.	4.6	4.5	6.3	2.5	5.2	6.4	.	.	.
General governm.budget, EU-def., % GDP									
Revenues	45.5	46.9	45.2	52.9	.	.	.	.	.
Expenditures	49.2	51.4	49.5	48.7	.	.	.	.	.
Net lending (+) / net borrowing (-) 3)	-3.7	-4.5	-4.3	4.2	.	.	-3	-3	-3
Public debt, EU-def., in % of GDP	73.0	79.8	81.4	80.6	.	.	79	78	77
Central bank policy rate, % p.a., end of period 4)	10.00	6.25	5.75	7.00	6.00	7.00	.	.	.
Current account, EUR mn	-7728	-112	1185	1442	338	.	1800	1700	1100
Current account in % of GDP	-7.3	-0.1	1.2	1.4	1.5	.	1.8	1.6	1.0
Exports of goods, BOP, EUR mn	72043	57397	68964	76979	19308	.	83100	92200	102300
annual growth rate in %	6.2	-20.3	20.2	11.6	23.6	.	8	11	11
Imports of goods, BOP, EUR mn	73233	55028	65749	72931	17973	.	78300	86500	95800
annual growth rate in %	6.9	-24.9	19.5	10.9	21.7	.	7.4	10.5	10.8
Exports of services, BOP, EUR mn	13804	13305	14634	15578	3447	.	16500	18200	20000
annual growth rate in %	9.8	-3.6	10.0	6.5	3.8	.	6	10	10
Imports of services, BOP, EUR mn	12287	11319	11704	12355	2991	.	12800	13800	14900
annual growth rate in %	9.4	-7.9	3.4	5.6	11.7	.	4	8	8
FDI inflow, EUR mn	4225	1518	1708	3033	-100	.	.	.	.
FDI outflow, EUR mn	1503	1440	998	3097	97	.	.	.	.
Gross reserves of NB, excl. gold, EUR mn	23807	30648	33667	37242	35601	34697	.	.	.
Gross external debt, EUR mn	123454	137125	138222	131511	139985	.	.	.	.
Gross external debt in % of GDP	117.0	150.0	142.4	130.8	139.3	.	.	.	.
Average exchange rate HUF/EUR	251.51	280.33	275.48	279.37	272.46	296.76	295	290	290
Purchasing power parity HUF/EUR	165.55	168.29	169.20	172.63	.	.	.	.	.

Note: Gross industrial production, construction output and producer prices refer to NACE Rev. 2. Gross agricultural production refers to Economic Accounts for Agriculture (EAA).

1) Preliminary. - 2) Enterprises with 5 and more employees. - 3) In 2011 including one-off effects. Without those effects general government budget balance is estimated to have attained -4.6% of GDP (Source: Porfolio.hu). - 4) Base rate (two-week NB bill).

Source: wiiw Database incorporating Eurostat and national statistics. Forecasts by wiiw.