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Hungary: back to sustainable growth?

Despite restrictive monetary conditions, a revaluation of the national currency, cuts in government spending and a decline in household consumption, Hungary's economic performance has been improving spectacularly since late 2003. It seems that the modest recovery in the main Hungarian export markets has more than offset any obstacles to more rapid economic expansion and so helped place the country back on track again to export- and investment-driven growth.

The last quarter of 2003 already hinted at an acceleration of economic growth, but the 2004 first quarter GDP growth rate of 4.2% was much higher than expected. Even if this is partly a statistical effect due to the weak performance in the respective period of the previous year, the recovery is none the less spectacular: the best quarterly growth rate performance in the last three years. The shift in the components of growth bears even greater promise; gross fixed investment increased by close to 20% in the first quarter, within that figure investment in manufacturing rose by 31.2%. Exports increased by 19%, imports by only 16% (both in real terms) in the first three months. The trade deficit amounted to 7.6% of exports, whereas in the respective period of the previous year it had stood at 10.2% (customs statistics at current prices). Gross value-added of commodity output increased by 7.2%, while that of services by only 3.2%.

Industry data reflect the same tendency. Gross output increased by 10.8% in the first quarter of 2004 and exports sales expanded by 21%, while domestic sales declined. As in 1997-2001, the engine of growth has been foreign-owned companies in such branches as computer manufacturing, telecommunications, consumer electronics, electronic components and the automobile industry. According to surveys conducted by the Budapest-based research institute KOPINT, capacity utilization in the manufacturing sector amounted to close on 82% in the first quarter (compared to the 78% a year earlier).

The growth rate of household consumption dropped to less than half the rate a year earlier (3.8%) reflecting the marginal growth in real wages (1% compared to 14% in the first quarter of the previous year).

In May, Hungary published its 2004 Convergence Report with a new target date for the introduction of the euro: January 2010. The earlier target date 2008 announced in June 2003 had proved unsustainable in the wake of the exchange rate volatility and the loss of credibility in terms of economic and monetary policy since the second half of 2003. In early 2004 Hungary missed all but one of the four Maastricht criteria; even the one criterion it fulfilled, less than 60% public debt relative to GDP, was just marginally below the limit. Hungary has the weakest record among the new EU members. The intention to revise the

2008 target date was declared as early as January, but the government's new strategy concerning the introduction of the euro was only put forward in the Convergence Report. The new target date implies that Hungary intends to meet the four Maastricht criteria by the end of 2007, prior to spending two years thereafter (2008-2009) in the ERM II. The most important difference between the old and new strategy is the difference in timing the reduction of the budget deficit to 3% of the GDP. In order to preserve the growth momentum of the economy, the budget deficit relative to the GDP will be decreased by only 0.5 percentage points annually – and not by 1 percentage point as originally planned. This means postponing the reduction of the deficit to the mandatory level of 3% by two years, from 2005 to 2007. The new schedule makes for a more growth-friendly mode of cuts in government spending and also provides for a tax reform that leaves more income in the business sector. The projected lowering of indirect taxes is also intended to help reduce inflation to the requisite level in the critical two years prior to introducing the euro.

The new medium-term economic strategy envisages accelerating GDP growth (from 3.3-3.5% this year to 4.5-5.5% by 2008) and household consumption lagging by 1 to 1.5 percentage points behind the GDP growth rate in each of the four years. This is a pronounced shift compared to the economic policy of 2001-2003 when, on average, the annual growth rate of household consumption was about 5 percentage points higher than that of the GDP. Unlike the hasty proclamation last summer of 2008 as the target date for introducing the euro, this time round the government has consulted with the social partners and the research community before taking a decision. Negotiations with social partners are also scheduled for this autumn focusing on a medium-term price/wage agreement that would appear to be an essential prerequisite for the successful implementation of the new strategy.

Consumer price inflation amounted to 6.9% in April (year-on-year): equivalent to 4.7% inflation after adjusting for the one-time effect of the rise in excise taxes related to entry into the EU. With inflation being less than expected, the central bank had to revise its (year-end) inflation forecast for 2004 downwards to 6% (from 6.9%). Following a period of high volatility and an exchange rate fluctuating between 260 and 270 HUF/EUR in the first seven weeks of this year, the forint appreciated; it stabilized at around HUF/EUR 252 by the end of May, well within the informal exchange rate target band HUF/EUR 250 to 260 that had been targeted by the central bank prior to the exchange rate turbulence in 2003. Given the stronger forint and the improved macroeconomic data, the Monetary Council of the central bank reduced, in three discrete steps, the key rate from 12.5% to 11.5%. The danger of the forint undergoing a substantial devaluation on account of unsustainable external disequilibrium diminished, leading to lower risk premia on forint-denominated government securities.

Economic performance in 2004 will still be determined in part by the effects of the disappearance of consumption-driven growth and in part by those of the re-emergence of export- and investment-driven growth. GDP may thus increase within the broad range of 3.7 to 4.3%. The current account deficit1 will be more or less as high as in the previous year; non-debt creating financing will compensate for a greater share of the deficit than in 2003, but it will not suffice to cover it fully. The current account deficit thus remains a matter of concern. The general government deficit in January to April followed more or less the path projected, whereas with economic growth being stronger than originally assumed fulfilment of the annual target (4.6% relative to the GDP) becomes feasible – probably without any additional cuts in public expenditure.

[1] Due to methodological changes to comply with international standards, namely the inclusion of foreign-owned companies' profits re-invested in Hungary (as outflow on the current account and simultaneously as inflow on the capital account), the reported current account deficits are substantially higher than before the methodological change. These changes are of no economic significance.

Table HU

Hungary: Selected Economic Indicators

	1999	2000	2001	2002	2003 [1]	2003	2004	2004	2005
						1st quarter		forecast	
Population, th pers., end of period	10222	10200	10175	10142	10117	10131	10108	10085	10065
Gross domestic product, HUF bn, nom.	11393.5	13150.8	14849.8	16740.4	18574.0	4271.2	4670.2	20500	22300
annual change in % (real)	4.2	5.2	3.8	3.5	2.9	2.7	4.2	4	4.3
GDP/capita (EUR at exchange rate)	4402	4953	5679	6782	7233	.	.	.	.
GDP/capita (EUR at PPP - wiiw)	10200	11030	12020	12840	13680	.	.	.	.
Gross industrial production									
annual change in % (real)	10.4	18.1	3.6	2.7	6.4	4.1	10.8	13	15
Construction industry									
annual change in % (real)	9.0	7.9	7.7	17.5	0.7	-17.3	19.5	.	.
Consumption of households, HUF bn, nom.	5826.6	6689.2	7680.4	8767.2	9989.4	2367.4	2626.3	.	.
annual change in % (real)	5.4	4.4	5.7	10.3	7.6	8.5	3.8	2	2.5
Gross fixed capital form., HUF bn, nom.	2724.5	3179.8	3493.0	3916.9	4086.1	582.4	723.3	.	.
annual change in % (real)	5.9	7.7	5.0	8.0	3.0	-1.6	18.9	10	13
LFS - employed persons, th, avg. [2]	3811.5	3849.1	3859.5	3870.6	3921.9	3859.6	3891.5	.	.
annual change in % [2]	3.1	1.0	0.3	0.1	1.3	0.5	0.8	.	.
Reg. employees in industry, th pers., avg. [3]	834.0	844.8	833.9	817.9	801.7	807.2	789.2	.	.
annual change in %	0.8	1.3	-1.3	-1.9	-2.0	-2.7	-2.2	.	.
LFS - unemployed persons, th, average	284.7	262.5	232.9	238.8	244.5	264.7	252.2	.	.
LFS - unemployment rate in %, average	7.0	6.4	5.7	5.8	5.9	6.4	6.1	5.9	5.9
Reg. unemployment rate in %, end of period [4]	9.4	8.6	8.0	8.0	8.4	8.9	9.2	8	8
Average gross monthly wages, HUF [4]	77187	87645	103553	122482	137187	128636	140728	.	.
annual change in % (real, net)	2.5	1.5	6.4	13.6	9.2	13.9	1.1	.	.
Consumer prices, % p.a.	10.0	9.8	9.2	5.3	4.7	4.6	6.8	6.5	4.8
Producer prices in industry, % p.a.	5.1	11.6	5.2	-1.8	2.4	0.7	4.3	.	.
General governm.budget, EU-def., % GDP [5]									
Revenues	.	.	45.5	45.0	44.5	.	.	.	.
Expenditures	.	.	49.9	54.3	50.4	.	.	.	.
Deficit (-) / surplus (+)	.	-3.0	-4.4	-9.3	-5.9	.	.	-4.9	-4.3
Public debt, EU-def., in % of GDP [5]	61.2	55.4	53.5	57.1	59.1	.	.	58.7	58
Refinancing rate, % p.a., end of period	14.5	11.0	9.8	8.5	12.5	6.5	12.3	.	.
Current account, EUR mn	-3531	-4380	-3613	-4900	-6488	-1488	-1756	-6500	-6300
Current account in % of GDP	-7.8	-8.7	-6.2	-7.1	-8.9	-8.5	-9.8	-8.0	-7.1
Reserves total, excl. gold, EUR mn	10845	12038	12164	9887	10108	12499	10067	.	.
Gross external debt, EUR mn	29230.9	32571.5	37387.0	38424.9	44093.4	40384	.	.	.
FDI inflow, EUR mn	3106	2998	4391	3026	2182	403	562	.	.
FDI outflow, EUR mn	235	664	399	292	1408	472	252	.	.
Exports of goods, BOP, EUR mn	24059	31278	34697	36821	38161	8947	10213	43500	48700
annual growth rate in %	14.3	30.0	10.9	6.1	3.6	-0.5	14.1	14	12
Imports of goods, BOP, EUR mn	26102	34457	37193	39024	41132	9547	10719	46100	51000
annual growth rate in %	14.8	32.0	7.9	4.9	5.4	1.0	12.3	12	11
Exports of services, BOP, EUR mn	4910	6114	7435	7269	7036	1541	1530	.	.
annual growth rate in %	2.1	24.5	21.6	-2.2	-3.2	-0.6	-0.7	.	.
Imports of services, BOP, EUR mn	4094	4907	5809	6677	7207	1674	1912	.	.
annual growth rate in %	9.6	19.9	18.4	14.9	7.9	5.7	14.2	.	.
Average exchange rate HUF/USD	237.31	282.27	286.54	258.00	224.44	226.95	208.09	.	.
Average exchange rate HUF/EUR (ECU)	252.80	260.04	256.68	242.97	253.51	243.63	260.31	253	251
Purchasing power parity HUF/USD, wiiw	99.85	108.60	111.76	118.63	124.25	.	.	.	.
Purchasing power parity HUF/EUR, wiiw	109.11	116.74	121.28	128.33	134.09	.	.	.	.

Notes: 1) Preliminary. - 2) From 2002 according to census 2001 and excluding conscripts. - 3) Enterprises with more than 5 employees. - 4) From 2001 wiiw estimate. - 5) According to ESA 95, excessive deficit procedure.

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