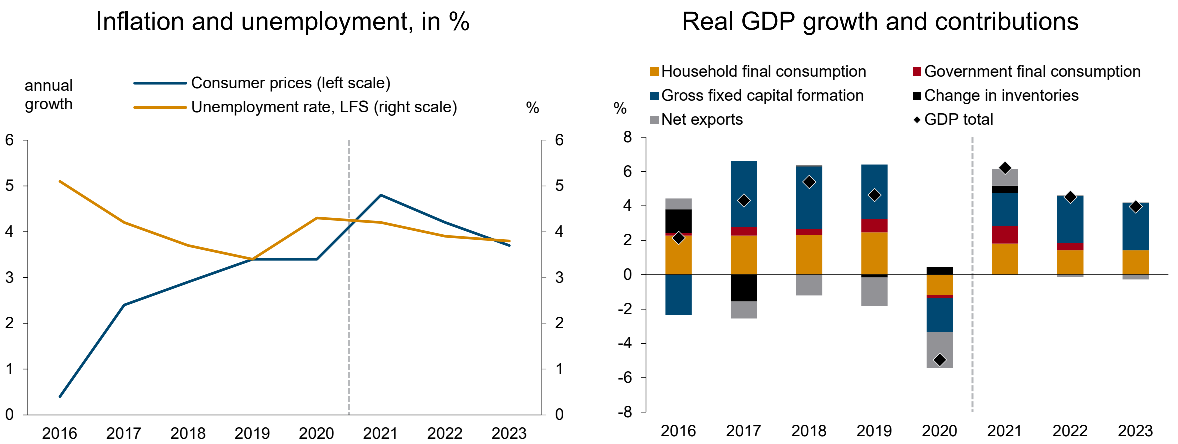
HUNGARY: Tipping from recession to overheating

SÁNDOR RICHTER

By summer 2021, Hungary's economy had regained its pre-pandemic level. Recovery was helped by dynamic growth in industry and a remarkable contribution by net exports. The economy is overheating, however, and inflation has climbed to around 5%. While the central bank has begun tightening monetary policy, the government has stepped up its expansionary fiscal policy, with an eye to the elections early next year. After the elections, the overheating will have to be tackled. The current dynamic growth cannot be maintained for the duration of the forecast.

Figure 4.8 / Hungary: Main macroeconomic indicators



Source: wiiw Annual Database incorporating national and Eurostat statistics, own calculation. Forecasts by wiiw.

Overall, by summer 2021, the Hungarian economy's performance had reached its pre-pandemic level. In Q1 2021, economic performance was 7.6% higher than in the same period of the previous year (when GDP declined by 6%). And in Q2 this year, the level of GDP was even 2.2% above the (pre-pandemic) level of Q2 2019. The recovery has been driven primarily by industry (and to a smaller extent, by construction), while the largest sector – services – has not been able to completely recoup the losses suffered during the crisis. On the distribution side, private and public consumption and fixed capital formation increased by less than GDP; thus, the most important driver of the growth has been foreign trade.

In parallel with the revival of the economy, inflation has become a major issue. In the months April-September, year-on-year monthly consumer price inflation ranged from 4.6% to 5.5% – well above the central bank's inflation target of 3%. Producer prices increased by 9% in the first half year. Nevertheless, inflationary pressure has been present for some time now: an increasing shortage of labour meant that net real wages rose by close to 24% in 2018-2020, while GDP grew by only 4.7% and private consumption by 7.5%. Monetary policy was ultra-relaxed in that period, with policy rates of from 0.6% to 0.9%. Meanwhile, average inflation in those three years amounted to 3.2%, which contributed considerably to the strong negative real interest rates. This and the generous preferential credit schemes offered by the central bank led to a huge expansion in the volume of loans. In this period, there was an ample inflow of EU funds as well, and the value of the Hungarian forint declined steadily. From early 2020, the relaxed monetary policy helped to cushion the crisis. The central bank also started to purchase government securities, in order to support the expansionary fiscal policy in the wake of the crisis triggered by the lockdowns. By spring 2021, however, the situation had changed: instead of the deflationary international environment characteristic of the pre-crisis years, signs of rising inflation were appearing in the global economy. With the Hungarian economy returning to normality in spring 2021, the pre-existing levers of inflation started to exert greater pressure. Exchange rate volatility and the rising monthly inflation figures alarmed the central bank.

The shift in monetary policy has had an impact that goes far beyond its economic significance. The governor of the central bank, Mr Matolcsy – for two decades, Prime Minister Orbán's designated 'right hand' on economic matters – has started to criticise the government (and thereby indirectly Orbán), warning that the recovery is strong, and – given the changed conditions – inflation is too high, the fiscal policy should become less expansive. The central bank embarked on a cycle of tightening by raising interest rates. The policy rate was increased in small steps, from 0.6% in June to 1.65% by the end of September. The central bank also started to withdraw from its government securities purchase programme. It believes that the high fiscal deficit – equivalent to 8.1% of GDP last year – was justified, but that the planned budget deficit of 7.5% this year and 5.9% in 2022 represents a pro-cyclical economic policy that endangers monetary stability.

The government clearly has priorities other than to curb inflation: April 2022, the date of the general election is getting closer. According to opinion polls, there is a chance that the united list of the opposition parties could defeat Fidesz. That explains why economic policy is now clearly subordinate to the election campaign, which has already got under way. The government has announced that, thanks to the strong economic growth, the personal income tax paid in 2021 by families with children will be refunded in early 2022. The 13th monthly pension (which was abolished in the wake of the retrenchment following the 2008/2009 economic crisis) will be restored. And the minimum wage will be raised by 20%. All these measures will come into force just a few months before the elections and will make it hard to carry through the planned reduction in next year's fiscal deficit. The second half of 2022 will be critical for the future of inflation. That said serious efforts to consolidate the budget may render the current high inflation transitory over the forecast horizon.

Meanwhile the conflicts with the European Union have become more acute. The funds earmarked for Hungary from the Recovery and Resilience Facility (RRF) scheme have not yet been released, and those from the traditional EU budget may also be delayed (or even suspended). The government is trying to downplay the significance of this and has renounced the credit element of the RRF (EUR 9.4bn). To compensate for the grants withheld from the RRF (EUR 7.6bn), Hungary raised EUR 4.5bn in credit on the markets (amounting to 3% of GDP) within just two days (two USD bonds with a maturity of 10 and 30 years, plus a euro bond with a 7-year maturity, all on favourable terms). The stated aim of the move is to enable the immediate start of project financing from the national budget, well before genuine financing from the RRF becomes available.

Whether or not Orbán remains in power after the elections, the number one economic priority will be to tackle the overheating in the economy. That will require monetary and fiscal policy steps to reduce aggregate demand and lead to a slowdown in economic growth. If Orbán remains in power, a downside risk to the current growth forecast would be continued conflict with the EU, potentially resulting in a significant delay of transfers. Conversely, if Orbán is voted out of office, another downside risk would be the possible economic consequences of what are very likely to be the intense political conflicts between any new government and a handful of key state institutions that are headed by persons close to Orbán whose mandate will extend for years beyond the current legislative period. A critical issue of these conflicts may well be the dismantling of the Orbán loyalists' economic empire, as part of an anticorruption programme – the flagship project of the current opposition.

Table 4.8 / Hungary: Selected economic indicators

	2018	2019	2020 1)	2020	2021	2021	2022	2023
				January-June			Forecast	
Population, th pers., average	9,776	9,771	9,750	.	.	9,680	9,620	9,600
Gross domestic product, HUF bn, nom.	43,350	47,524	47,743	21,884	24,971	54,000	59,300	64,100
annual change in % (real)	5.4	4.6	-5.0	-6.0	7.6	6.2	4.5	4.0
GDP/capita (EUR at PPP)	21,580	22,810	22,100	.	.	.	.	.
Consumption of households, HUF bn, nom.	20,522	22,542	22,681	11,050	11,854	.	.	.
annual change in % (real)	4.8	5.2	-2.5	-1.6	2.6	3.8	3.0	3.0
Gross fixed capital form., HUF bn, nom.	10,740	12,890	13,054	5,550	6,406	.	.	.
annual change in % (real)	16.4	12.8	-7.3	-8.2	4.8	7.0	10.0	10.0
Gross industrial production								
annual change in % (real)	3.5	5.6	-6.0	-12.6	18.4	11.0	6.0	5.0
Gross agricultural production								
annual change in % (real)	2.7	0.4	-2.2	.	.	.	.	.
Construction industry								
annual change in % (real)	21.2	20.7	-9.8	-7.8	7.1	.	.	.
Employed persons, LFS, th, average 2)	4,470	4,512	4,461	4,437	4,593	4,650	4,700	4,700
annual change in %	1.1	1.0	-1.1	-1.5	0.3	1.0	1.0	0.0
Unemployed persons, LFS, th, average 2)	172	160	198	194	206	200	190	190
Unemployment rate, LFS, in %, average 2)	3.7	3.4	4.3	4.2	4.3	4.2	3.9	3.8
Reg. unemployment rate, in %, eop 3)	5.2	5.1	6.2	8.1	5.7	.	.	.
Average monthly gross wages, HUF 4)	329,943	367,833	403,616	395,605	428,191	439,500	469,400	496,500
annual change in % (real, gross)	8.3	7.7	6.2	6.4	3.9	3.9	2.5	2.0
Average monthly net wages, HUF 4)	219,412	244,609	268,405	263,078	284,747	292,300	312,200	330,200
annual change in % (real, net)	8.3	7.7	6.2	6.4	3.9	3.9	2.5	2.0
Consumer prices (HICP), % p.a.	2.9	3.4	3.4	3.4	4.3	4.8	4.2	3.7
Producer prices in industry, % p.a.	5.6	2.1	4.3	3.5	9.4	9.0	6.0	4.0
General governm.budget, EU-def., % of GDP								
Revenues	43.8	43.6	43.5	.	.	45.0	45.0	45.0
Expenditures	45.9	45.7	51.6	.	.	53.0	50.5	48.5
Net lending (+) / net borrowing (-)	-2.1	-2.1	-8.1	.	.	-8.0	-5.5	-3.5
General gov.gross debt, EU def., % of GDP	69.1	65.5	80.4	.	.	81.0	81.0	79.9
Stock of loans of non-fin.private sector, % p.a.	10.5	13.2	13.4	13.7	10.3	.	.	.
Non-performing loans (NPL), in %, eop 5)	5.4	4.1	3.6	4.0	3.4	.	.	.
Central bank policy rate, % p.a., eop 6)	0.90	0.90	0.60	0.75	0.90	1.90	2.30	2.50
Current account, EUR m 7)	216	-1,017	-2,167	-1,876	-598	900	1,100	1,700
Current account, % of GDP 7)	0.2	-0.7	-1.6	-3.0	-0.9	0.6	0.7	0.9
Exports of goods, BOP, EUR m 7)	88,544	92,525	89,227	41,647	51,211	99,900	106,900	112,800
annual change in %	3.8	4.5	-3.6	-10.8	23.0	12.0	7.0	5.5
Imports of goods, BOP, EUR m 7)	90,824	96,212	90,626	42,871	50,552	99,700	107,200	113,100
annual change in %	8.7	5.9	-5.8	-10.0	17.9	10.0	7.5	5.5
Exports of services, BOP, EUR m 7)	25,396	26,917	19,409	9,568	9,206	19,200	22,100	24,300
annual change in %	6.6	6.0	-27.9	-24.7	-3.8	-1.0	15.0	10.0
Imports of services, BOP, EUR m 7)	17,316	19,828	15,668	7,856	7,193	15,400	17,700	19,500
annual change in %	2.6	14.5	-21.0	-14.7	-8.4	-2.0	15.0	10.0
FDI liabilities, EUR m 7)	6,671	2,698	2,873	1,242	2,678	3,000	.	.
FDI assets, EUR m 7)	4,059	1,926	684	-599	2,796	3,000	.	.
Gross reserves of CB excl. gold, EUR m	26,273	27,010	32,115	28,593	26,314	.	.	.
Gross external debt, EUR m 7)	107,696	105,799	109,356	108,569	119,474	123,000	125,000	127,000
Gross external debt, % of GDP 7)	79.2	72.4	80.5	79.9	78.1	80.4	74.8	70.3
Average exchange rate HUF/EUR	318.89	325.30	351.25	345.40	357.85	353	355	355

1) Preliminary. - 2) From 2021 the new LFS methodology is applied in line with the Integrated European Social Statistics Regulation (IESS). - 3) Unemployed in % of LFS labour force. - 4) Enterprises with 5 and more employees. From 2019 based on tax administration data, survey data before. - 5) Loans more than 90 days overdue and those unlikely to be paid. - 6) Base rate (two-week CB bill). - 7) Excluding SPE.

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