ICEG EUROPEAN CENTER

Quarterly Forecast on Hungary

Winter

Hungary: Economic Forecast – Winter 2006

Overview

Fiscal stabilization measures begin to exert their effects on the economy: domestic demand growth is considerably moderating and consumer prices are on the rise. Backed by strong external demand there is, however, clear improvement in the current account.

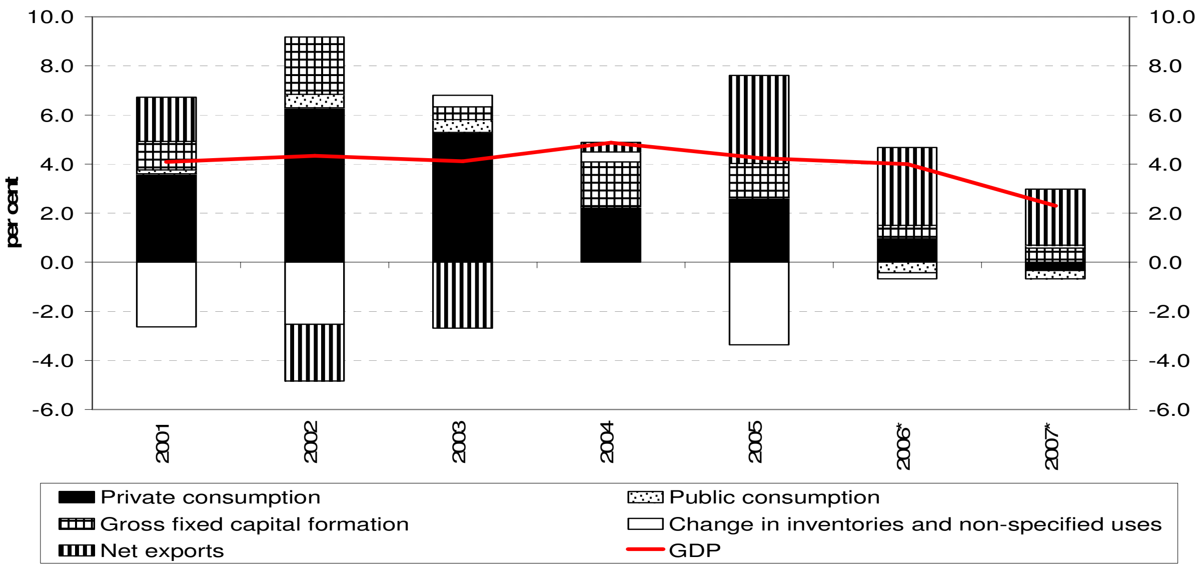
Economic Growth

In the third quarter of 2006 the year-on-year growth rate of real GDP was 3.8 per cent[1]. As was expected, private consumption growth embarked on a downward path, since fiscal stabilization measures will lead to reduced disposable income as well as lay-offs in 2007. Gross fixed capital formation is still a surprise element in this slowdown: while many analysts anticipated some deceleration, few would expect a sharp decline (resulting in a 4 per cent reduction in the third quarter year-on-year). It was especially construction-related investments that suffered a blow, but investment into machines and equipment also produced dismal growth rates. Favourable external developments (lower oil prices and continued strong growth performance in the eurozone), however, resulted in further improvement in net exports.

In the fourth quarter of 2006 private consumption might have slowed even further, as is confirmed by retail trade data. Based on the Central Statistical Office's practice from the past, a revision of gross fixed capital formation data can not be excluded at the end of the year, but even in that case, average annual growth will not exceed 2 per cent. In 2007 fiscal stabilization measures will be fully felt in domestic demand. Private consumption growth, for the first time after 1996, will be in negative territory, and gross fixed capital formation will not resume its former, strong dynamics. The improving trend in net trade, however, will continue, leading to significantly positive contributions to economic growth on the forecast horizon. Taken together, we estimate that real GDP might have expanded at a rate of 4 per cent in 2006, while for 2007 we project a 2.3 per cent annual average growth rate. Judged by contributions the engine of economic growth will almost solely be net export in this year, domestic demand will have a negligible effect.

[1] Due to methodological changes some items in the national accounts were considerably revised

Chart 1. GDP growth and its composition: 2001-2007



Monetary indicators

Consumer prices remained on an upward path in the fourth quarter of 2006. While the jump in September could be mostly attributed to elements of the fiscal austerity package, there is also an unexplained part especially in services prices. This might reflect that inflationary expectations also changed upwards. In the fourth quarter of 2006 the most significant increases were seen in foods and clothing prices due to changes in the VAT rate, in energy prices due to changes in administered prices and even in durable goods prices due to the weaker exchange rate of the forint. At the end of the year 12-month CPI-inflation stood at 6.5 per cent (3.9 per cent average annual rate), somewhat higher, than we expected a quarter before.

Due to developments primarily in energy prices, the reduction of subsidies on medicines and public transport and also the secondary effects of the 2006 tax changes, inflation will further shoot up in early 2007. Contrary to what we expected in our Ocotber report, it might have a peak as early as March or April, when 12-month CPI-indices could exhibit an increase over 9 per cent. In the remaining part of the year inflation will gradually decrease and there will also be offsetting effects, like moderating wage growth and decreasing public consumption and investments. By December, the 12-month change in consumer prices could fall back to around 5 per cent, but average annual inflation will be as high as 7.5 per cent in 2007.

The base rate – set by the Monetary Council of the central bank – was raised only once in the fourth quarter (back in October) from 7.75 to 8 per cent. Since the fiscal stabilization package might have already induced secondary effects through influencing inflation expectations, we wouldn't claim that there will be no more interest rate hikes. While with the easing of pressures at the end of 2007, we maintain that the base rate could fall back to 7 per cent by the end of this year, the possibility of interest rate rises especially until the end of March remains a real option in our view.

The exchange rate of the forint has become stronger recently, but is still rather volatile. Its flotation centre is assumed to be at around the 260-265 band vis-à-vis the euro, as long as there are no radical changes in market sentiment and economic fundamentals..

Fiscal Balance and Public Debt

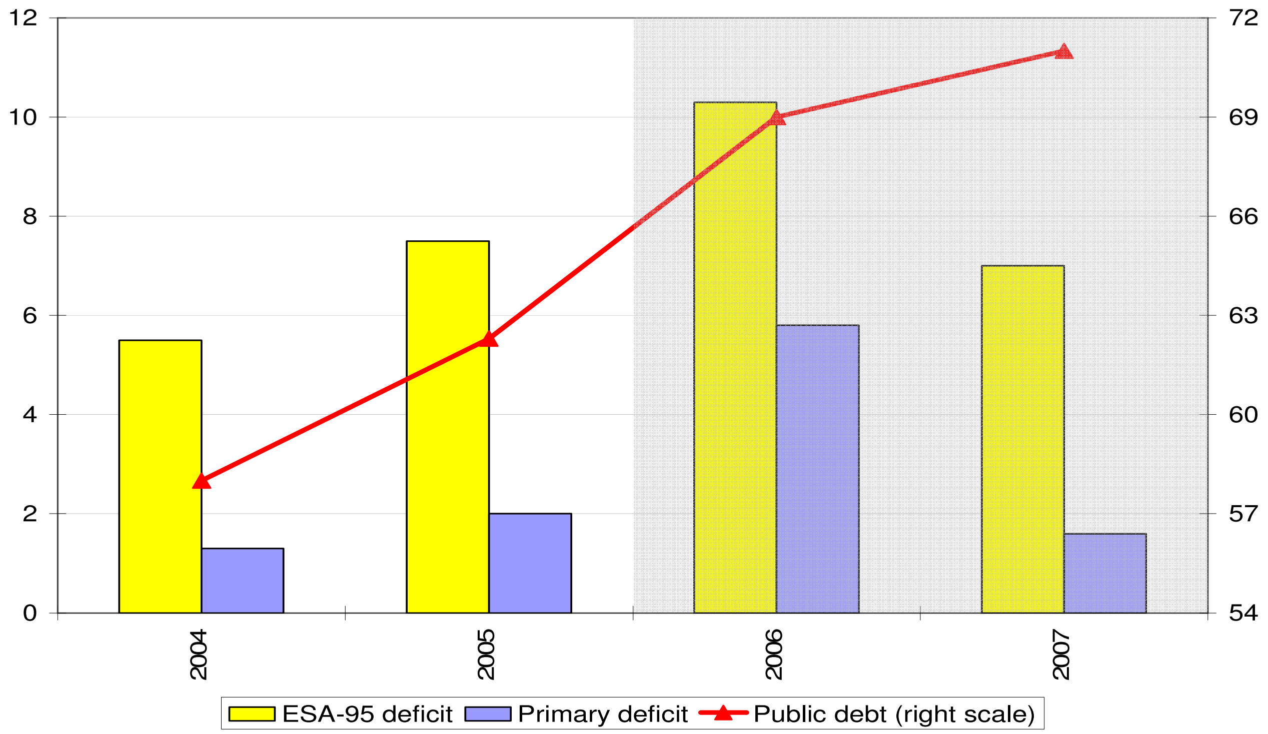
Excluding the balance of the local governments, the 2006 budget deficit reached 8.7 per cent of GDP on cash basis. In nominal terms it amounted to HUF 2033 billion, more than twice of the previous year's figure. The more relevant accruals based (ESA-95) budget deficit could be as high as 10.1 per cent of GDP according to our estimates (this is without the usual corrections for pensions).

The deficit could even be higher, but the fiscal measures, introduced on the course of the third and fourth quarters of last year, already exerted a downward effect on the budget deficit. One percentage point of the improvement is associated with revenue growth (through increased VAT and social contributions), while approximately half percentage point comes from reduced spending (freezing the amounts in the case of some expenditure items). Thus, the fiscal stabilization measures *per se* resulted in a 1.5 percentage point (relative to the GDP) reduction of the budget deficit in 2006. The still high deficit primarily reflects well over planned spending in the case of pensions and subsidies on medicines, exogene effects (e.g. higher interest payments) and one-off items.

As the stabilization measures continue to exert their effect this year, we expect a further improvement in the budget deficit. It could finally fall to 7 per cent of GDP, based only on the already announced measures. The composition of this improvement will be more even between expenditure reductions and revenue increases. The primary balance could exhibit an even larger improvement, but payments on outstanding government debt will still increase in 2007.

Assuming that the local governments balance will not significantly modify the estimated budget deficit for 2006, at the end of the year public debt could be around 69 per cent of GDP. As it was mentioned above, the budget deficit will moderate somewhat in 2007, nevertheless it will still remain quite high. Coupled with slower GDP growth this will result in further increase of the public debt, to approximately 71 per cent of GDP by the end of this year..

Chart 2. Fiscal deficit and public debt in per cent of GDP: 2004-2007



Balance of payments

In the third quarter of 2006 the current account exhibited a deficit of EUR 1.1 billion thereby raising the cumulated deficit to slightly over EUR 4 billion in the first three quarters. The merchandise trade balance again showed a relatively small deficit (less than EUR 300 million), but taken together with services, their balance was positive again for the second consecutive quarter. Because of the high errors and omissions balance, however, there is continued suspicion that imports are underreported.

The income balance still has a deteriorating trend. While net income payments on debt instruments seem to have stabilized, net income payments on non-debt (direct investments and portfolio equity investments) are rising. Of the EUR 4 billion C/A-deficit this latter item alone explains EUR 3.2 billion. Current transfers showed slightly positive balance in the third quarter, and are on the rise, especially compared to 2005 figures. This is probably due to increased use of the cohesion funds from EU.

Even if imports are underreported, the improving trend of the trade balance will clearly continue in 2007. While the current account deficit in 2006 could eventually be 6.3 per cent of GDP, in 2007 it will fall below 5 per cent as the goods and services balance will be well in positive territory.

The stock of gross external debt at the end of September reached 86.8 per cent of GDP, while that of net external debt stood at 40.4 per cent of GDP. As the forint considerably appreciated in December last year, these ratios might have increased only marginally by the end of 2006. Even assuming a favourable financing structure for the 2007 C/A-deficit, gross foreign debt could increase to 89 per cent of GDP by the end of this year.

Unemployment and wage dynamics

Job creation, mostly in construction and services, was still relatively strong in 2006, but manufacturing employment continued decreasing. The announced lay-offs from the public sector have also started.

The slowing economy in 2007 will create considerably less jobs than it will destroy. Lay-offs will concentrate in construction and the public sector. From its end-2006 value of 7.5 per cent, the unemployment ratio could rise to close to 7.8 per cent by the end of 2007.

High real wage growth (we estimate an increase of 3.7 per cent) in 2006 kept disposable incomes high, but rising consumer prices will erode the increase of nominal wages in 2007. Since the majority of enterprises will not compensate its employees for the tax increases and rising social contributions, real earnings – assuming that our inflation projection materializes – can decrease by almost 3 per cent in this year.

Table 1. Main macroeconomic indicators for Hungary: 2005-2007

	2005	2006*	2007*
GDP growth (%)	**4.2**	**4.0**	**2.3**
Private consumption (%)	**3.8**	**1.5**	**-0.5**
Public consumption (%)	**0.2**	**-4.7**	**-4.0**
Investments (GFCF, %)	**5.6**	**1.9**	**2.4**
Export (%)	**11.6**	**15.6**	**10.3**
Import (%)	**6.8**	**11.8**	**8.1**
Consumer price index (average,%)	**3.6**	**3.9**	**7.5**
Unemployment ratio (%)	**7.3**	**7.5**	**7.8**
Real wages	**6.0**	**3.7**	**-2.8**
General government balance (%)	**-7.5**	**-10.1**	**-7.0**
Public debt/GDP (%)	**62.3**	**69.0**	**71.0**
Current account /GDP (%)	**-6.8**	**-6.3**	**-4.6**
Trade balance /GDP (%)	**-0.8**	**-0.1**	**1.4**
Gross foreign debt /GDP (%)	**77.0**	**86.9**	**89.0**
Base rate (%)	**6.00**	**8.00**	**7.00**

** Forecasts by ICEG staff.*