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Convergence Program versus Divergence Program: The Beginning of Lost Decade in Hungary?

Hungary handed in its obligatory revisited Convergence Program on Friday, 1st of September 2006. The presented new version of the document does not represent surprise data as it was informally leaked few days before the official issue, but means surprise in terms of comparison with previous programs issued before the parliamentary elections in April 2006.

The new numbers are completely different from the last version's data, but show considerably more realistic starting data and convergence path however the given trend and the given measures seam to be questionable to be accepted by European Commission.

The Program misses the punctual expressed date of euro introduction.

Situation

According to the data of current version of Convergence Program, in the year of 2006 Hungary will realize a 10.1% public balance deficit with an almost 70% high public debt. This is a unique record of the last 1 decade that reflects that the fiscal position of the government became extremely unsustainable causing considerable macroeconomic vulnerability.

Table 1. Comparison of Different Convergence Paths in Consecutive Convergence Programs

Indicator	*Convergence Programs*	**2006**	**2007**	**2008**	**2009**
Public Balance	***HNB****	***10.1***	***6.2***	***4.1***	**-**
	September 2006	**10.1**	**6.8**	**4.3**	**3.2**
	December 2005	6.1	4.7	3.4	-
	December 2004	3.1	2.4	1.8	-
	May 2004	2.7	2.2	1.8	-
Gross Public Debt	***HNB****	***68.8-69.3***	***69.5-71.8***	***68.5-73.4***	**-**
	September 2006	**68.5**	**71.3**	**72.3**	**70.4**
	December 2005	63.0	63.2	62.3	-
	December 2004	53.0	50.6	48.3	-
	May 2004	53.0	51.2	48.8	-
Real GDP Growth	***HNB****	***3.9***	***2.4***	***2.5***	**-**
	September 2006	**4.1**	**2.2**	**2.6**	**4.1**
	December 2005	4.3	4.1	4.1	-
	December 2004	4.2	4.3	4.6	-
	May 2004	4.0	4.0-4.5	4.0-4.5	-
Inflation	***HNB****	***3.8***	***7.0***	***7.2***	**-**
	September 2006	**3.5**	**6.2**	**3.3**	**3.0**
	December 2005	2.0	3.0	2.4	-
	December 2004	4.0	3.5	3.0	-
	May 2004	4.0	3.5	3.0	-

Sources: Convergence Program, Hungarian National Bank

The recently reelected government changed its approach on the macroeconomic situation and launched the New Balance program to restate the stability of Hungarian economy via fiscal adjustment (taxes rise, wage freezing, price increase etc.) and public finance reforms (administration, health care, education). By government's expectations this will mean an almost 7 percentage point public balance adjustment finishing in 3.2% deficit in 2009.

The most problematic areas of convergence path are the public debt and the GDP growth, not mentioning the 2007 year 6.2% inflation ratio.

As concerning the gross consolidated public debt as a share of GDP, the peak of more than 72% will be reached in 2008 that is 12 percentage points above the Maastricht criterion. As of real GDP growth, Hungary will likely diverge from other Central European countries growth rates, as in two consecutive years the real GDP growth rate will stay far below the 3%.

Chart 1. Fiscal Adjustment Path according to the Convergence Program

Source: Eurostat, Convergence Program

Officials of Hungarian government think that the current program is able to carry the euro area entry in 2011-2013.

Euro in the Next Decade

In order to achieve the euro area membership in 2011, Hungary has to fulfill the inflation criterion within the period of March 2009 and March 2010, while the fiscal criteria in the 2009 fiscal year. The additional precondition is to join the ERM-II not later than 2009 and to keep relatively stable the national currency against the euro for longer period of time.

The balance and the inflation criteria are likely to be reached. The biggest problem seems to be the public debt of around 70% in 2009 and the extremely volatile exchange rate. Also the growth prospects shown in the growth path can cause serious deformation of convergence criteria because of trade offs observable between them.

However the euro zone entry is not fixed in the communication of officials that is a problem in terms of missing anchor that develops the expectations of markets.

The large shift in – by the leading analysts' predictions – euro introduction, parallel with earlier entry of other NMS countries will probably concentrate speculative pressure on HUF and on monetary policy represented by NBH, not mentioning the structural attributes of Hungary, like openness, foreign currency denominated indebtedness etc.

Adjustment's Effect on Growth

The government predicts 2.2% real GDP growth in 2007 and 2.6% in 2008.

By now, several measures of adjustment and public finance reform steps are unknown. However in first sight, the sort of adjustment is more revenue side, as it contains steps on increase of almost all tax rates (personal income tax, payroll tax, VAT, corporate income tax) and less expenditure side.

The experience of fiscal stabilization history shows, that successful adjustments have had the following features: they were based on fiscal expenditures (primary spending and wages), and not on tax revenues; they were front-loaded that means they were introduced in the beginning of adjustment.

Consequently, fiscal stabilization has not obligatorily negative growth effect, as it is reflected in the convergence program. This statement is also underpinned by adjustment practice of several countries.

The Hungarian National Bank issued its regular inflation report that contains calculation on effects of adjustments on growth. Thus measures affecting prices, like indirect taxes and gas price rise, have considerable finger print on consumption and on growth, -0.7 and -0.6 percentage points in 2007 and 2008, respectively. Measures affecting income and aggregate demand, like PIT and on employees' payroll tax, duties, tax on interest rate etc. will cause 1.4 and 1.6 percentage point slowdown in real GDP growth. These will lead to above 2 percentage point annual loss in real GDP growth in 2007 and 2008.

Nevertheless there are no planned by the government measures to increase economic performance by non-Keynesian elements of growth. This is important as the non-Keynesian effects reflect the situation, when the multiplier shifts in negative and hereby the fiscal adjustment's indirect influence on private consumption and on investment neutralizes the direct action of governmental action.

Consequences of Lack of Credibility

Starting from the year of 2002, governments were not able to keep its official numbers on public finances. Analysts and main grading of the country reflects high level of doubts from the market side.

In case of not carrying the data of convergence program the market is likely to punish through exchange rate by capital outflow causing serious exchange rate crisis. In case of not ambitious and bad structured realization of public finance adjustment and reforms, despite of short term results, the lack of balance is likely to be reproduced, causing under potential growth performance and social tensions.

DOUBTS ABOUT SLOVAKIA'S FAST EURO AREA ACCESSION

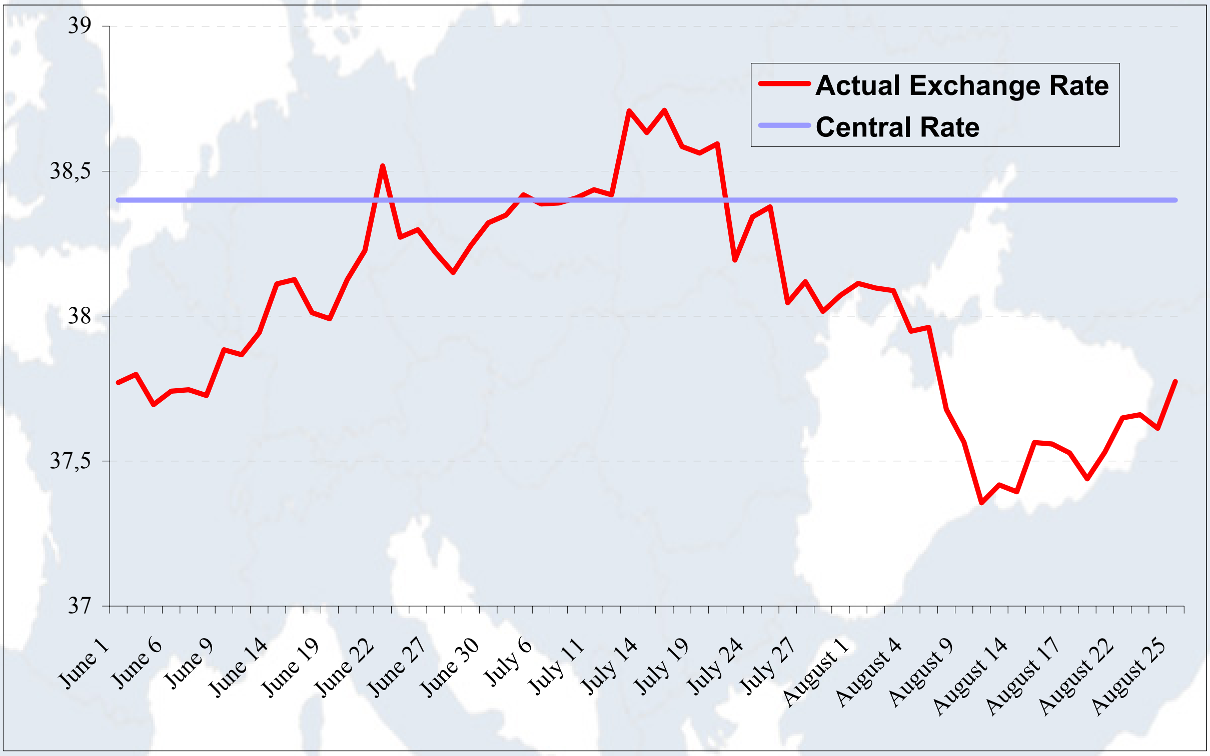
Slovakia joined the ERM II in December 2005 and according to the former government's plan, the country could introduce the euro in 2009. The new government that emerges from the 17th of June 2006 general elections will continue preparations for the introduction, promised the new Prime Minister, Robert Fico.

DEVELOPMENT OF THE EXCHANGE RATE SINCE ERM II MEMBERSHIP

Slovakia has done the first step for the introduction of the euro with joining the ERM II in December 2005. The central rate of the Slovak crown has been set at 38.4554 SKK/EUR. After joining, the Slovak currency was supposed to become less dependent on the development of other currencies in the region. At the end of last year the exchange rate was 37.848 SKK/EUR, while at the end of 2004 it stood at 38.796 SKK/EUR. The exchange rate of the Slovak crown gained 2.44 percent against the reference euro rate last year. (*National Bank of Slovakia - NBS*) The average exchange rate was 38.593 SKK/EUR, up 3.6 percent year-on-year, SITA wrote.

The Slovak crown was gradually stronger between January and May in this year, but because of the parliamentary election the exchange rate temporarily weakened (from May to July). Since June, NBS has intervened in favor of the crown three times. (Earlier this year, NBS already increased key interest rates twice - by 0.5 percentage points each time in February and May due to increasing inflation) It was the first time, when the 38.55 SKK/EUR threshold was breached. The second intervention came at the end of the month when the crown was at the 38.48 SKK/EUR level.

Chart 2. Daily exchange rate SKK/EUR in Slovakia June 2006 - August 2006



Source: National Bank of Slovakia

After days of continued losses on the foreign market, the NBS board decided to raise the key interest rates on 25th of July. The latest increase may be seen as another attempt to defend the Slovak crown against the euro as well as a measure to control inflation. In July, the central bank stepped in to defend the crown when the exchange rate went beyond the 38.70/38.75 SKK/EUR level.

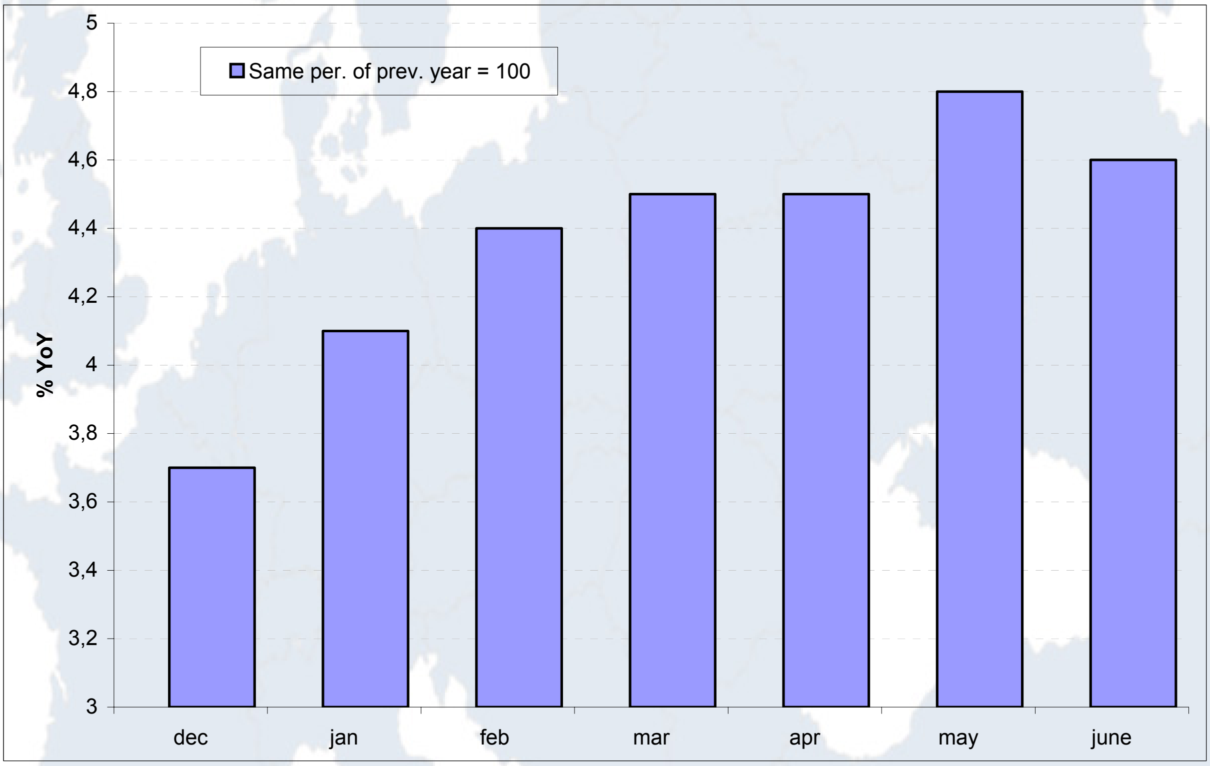
Economic Convergence

In the long run Slovakia likely has not a problem with the sustainability of the central parity of the country's currency against the euro. But analysts said in November last year, Slovakia must take attention on the inflation and on the government deficit criterion. Public finance deficit criterion is fulfilled not at all up to now.

The period from April 2005 to March 2006, the average rate of HICP inflation in Slovakia was 3.1% that is above the current reference value of 2.6%n (in the EU) for the criterion on price stability. The HICP has developed oddly distressingly since the beginning of this year.

Moreover Slovakia's economy has grown strongly since it joined the EU in 2004 (in the third quarter of 2006 the y-o-y change of GDP was 6.3%), thanks to the lion's share of foreign investment into the EU's new Eastern European members. But thanks to the worse economic performance and the uncertain possibility decrease the FDI too. The expenditures because of the election will further worsen the government deficit/GDP ratio.

Chart 3. Y-o-y rate of inflation in Slovakia December 2005 - June 2006



Source: Statistical Office of Slovak Republic

Measures of The New Slovak Government

Between 2002 and 2006, the Dzurinda cabinet undertook a series of structural reforms designed to improve the business environment. NBS Governor Ivan Šramko expects that the new government that emerges from the 17th of June general elections will continue preparations for introducing the euro in 2009 as scheduled, given the wide political consensus over the issue. Analysts fear, however, that if the Smer party may roll back some of the reforms implemented by the precious government. "No problems will occur if the government follows the convergence program and meets the Maastricht criteria. Problems will only arise if there are any divergences," Šramko said.

Although Prime Minister Fico has confirmed his commitment to the euro target date of 2009, he sticks to his election promises of reversing various reforms. "Smer also highlights the importance of the Maastricht criteria. It is important for the surging Slovak economy and the euro introduction that the new government declares continuity in consolidating public finances, reducing the deficit and achieving a balanced budget around the year 2010, the governor said. In particular, the government plans to abandon the flat tax, raise pensions, change the labor code and cancel fees for doctors' visits. But the new Prime Minister also saying "if our welfare state model requires it, we will introduce the euro later". Robert Fico will also drop VAT from 19 to 5 per cent from January, with analysts warning that new debts could endanger Slovakia's planned 2009 entry to the euro area.

While Slovaks living in the country's poorer reasons remain unconvinced of the vigor of the economy, the European Commission continues to have great faith in Slovakia's growth potential. The conversion exchange rate of the Slovak crown and the euro might be known in mid-2008, when outlets might start setting dual prices in both currencies.

Advantages and Disadvantages of Euro Zone Entry

On the strength of the experiences so far the introduction of the euro has many advantages: it eliminates the exchange rate risk; the exchange charges disappear; in the long run euro is more stable than the national currency; prices are comparable; the inner market is more efficient. Since Slovakia is a small, open economy, the euro area membership means expanding trade and economic growth. On the other hand, joining the euro area too fast can be dangerous for a country, in which the government debt/GDP and the current account deficit/GDP ratios are too high or the economic openness is high.

The late introduction has already more disadvantages: lack of a separate monetary policy; effects of the common interest rate policy; asymmetric shocks and possibility of speculative pressure on the currency.

Dangers of the Exchange Rate Volatility

But further exchange rate volatility could happen because of the political and economic uncertainty in Slovakia. The economic stability and the date of introduction to the euro area depend on the new government's commitment to the introduction. After the boom in 2005, the economic performances of Slovakia, a drop is observable: volatile exchange rate, increasing inflation, worsen government deficit/GDP ratio. Medium-term economic outlook deteriorate in Slovakia, thus likely investors turn away from the country.

To the entry the euro area in 2009 first of all, the exchange rate must be stabile, and after that the all of the convergence criteria must fulfill.

Growing Regional Disparity and Social Segregation Enforced by Geographic Factors in Hungary

The one and a half decades that passed since the start of post-socialist transition brought growing regional disparities in Hungarian economy and society. Differences that existed between Hungarian regions became more pronounced. At the same time regions that prospered earlier became laggards. The Western and Central regions of the country became more prosperous, with buoyant economic activity, while the North-Eastern, South-Western, and Eastern regions experienced growing economic and social tensions. In some of their sub-regions poverty and the proportion of gipsy population increased. This tendency was the result of the educated and non-gipsy population moving away to regions with better possibilities, and the higher birth rates among the gipsy population staying in the impoverished areas. Social segregation has been complemented with an increasing geographic segregation.

Economic restructuring and the deterioration of heavy industries in the North Hungary region resulted in the growth of the unemployment rate, reaching 10.6% (the highest in the country) in 2005. Unemployment rate among the 15-24 year old population was also the highest, at 28.4%. At the same time activity rate was only 48.8%, the lowest among the Hungarian regions.

Differences exist between the level of economic activity, living standards, and level of poverty among the areas of the North Hungarian region itself. There are more fortunate larger cities, towns and regional centers with buoyant economic activity. At the same time lack of natural resources and infrastructure, as well as historical circumstances (loss of conventional markets as a result of the creation of new state borders) contributed to the less fortunate position of some sub-regions even before transition started. Economic restructuring worsened their situation more. The loss of work opportunities resulted in high unemployment and low activity rates, a high proportion of the working population forced into early retirement (retired and under 55 years of age). As a result, not only individual villages or towns, but whole sub-regions became affected by poverty. Social segregation took up a geographic dimension.

In November 2005 an integrated program co-financed by the Hungarian government and UNDP was initiated with the aim to improve the situation in the *Cserehát*, a 600 square kilometer area of the North Hungarian NUTS-II region, which is located near the Slovakian border. The program aims to reduce the territorial isolation of and the social exclusion in the area. The program is financed in 90% from national sources, while the remaining 10% of financial backing comes from the UNDP.

The *Cserehát* has more than 90 000 inhabitants, living in 80 settlements. The area is characterized by high rate of unemployment, a settlement structure consisting of small villages, major roads reaching only the edges of the area, and the closest work opportunities on average 30 to 50 kilometers away from the villages. About 20% of the inhabitants are gipsy, but poverty affects the population of the entire area.

It is virtually impossible for the inhabitants to sell their houses and property in the small villages and move closer to work opportunities. At the same time businesses have no incentive to bring workplaces in the sub-region, because of the lack of sufficient infrastructure, and the lack of educated workforce. At the same time even if there is a possibility for subsistence agriculture, not many take the advantages it might offer. The reason for this is that in the impoverished area farm produce is often stolen before harvest. Most of the people here rely on social assistance for a living. Entrepreneurial spirit among the inhabitants is virtually non-existent.

The *Cserehát* program will provide assistance for the area between 2005 and 2007. The program is directed at a geographic area and its whole population, and not a specific social group. The aim of this approach is to avoid positive discrimination. The *Cserehát Development Program* is a complex plan with the following four main goals:

- Enhance social and community participation by social mobilization;
- Build vertical and inter-regional/cross-border partnerships with Slovakia;
- Develop human and financial resources and support equal opportunities;
- Implement integrated social development projects.

An important goal of the program is to improve the ability of the poverty-stricken area in the attainment of development funds. EU Structural Funds will be accessible in Hungary between 2007 and 2013 as part of the second National Development Plan, through the submission of tenders. However, technical expertise in the tendering procedure and sufficient co-financing by the submitters of tenders is crucial to access the funds. The *Cserehát* program aims to prepare the area to these challenges.

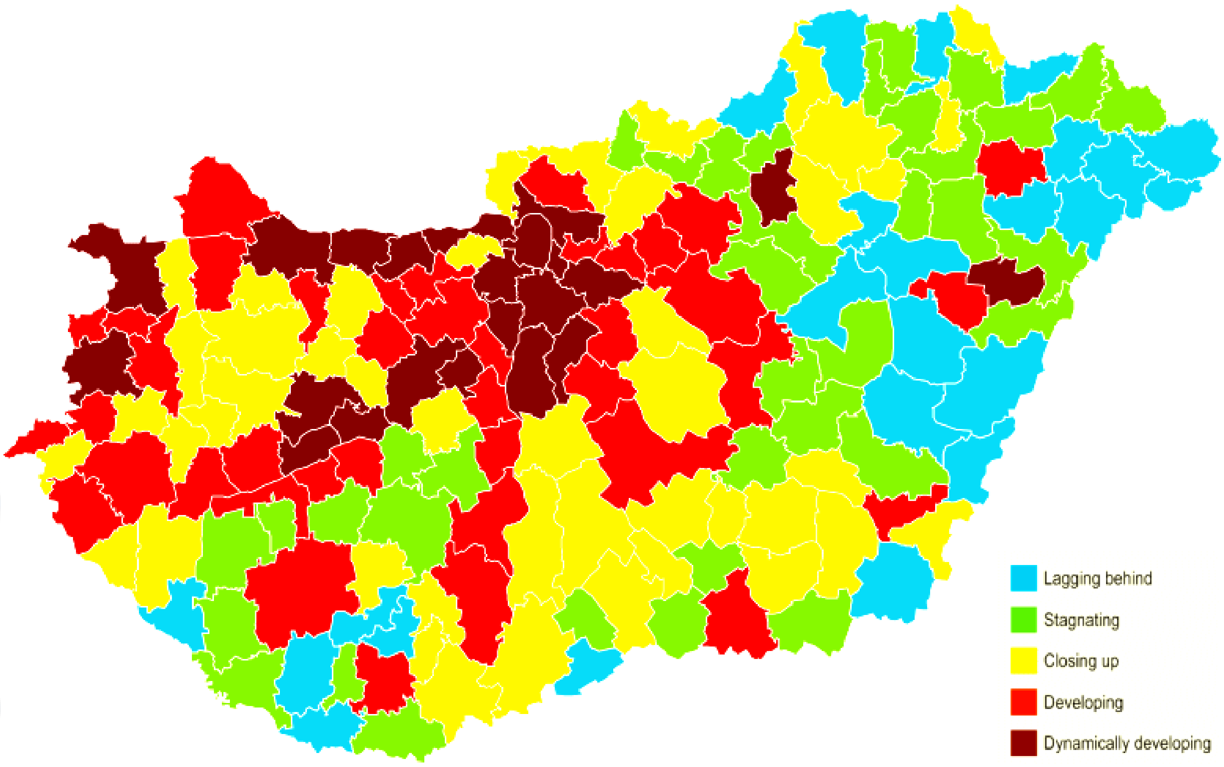
The main breakout points identified by the program's leaders are communal and self-help initiatives in the area, the improvement of skills and human resources in general, as well as the exploration and creation of internal economic opportunities (for example rural tourism based on the natural beauty and cultural heritage). The improvement of public utilities as well as the creation of new channels of communication for obtaining crucial information is also among the goals of the program.

As part of the program a request for proposal has recently been announced in order to establish the *Cserehát Resource Centre for Social Development*. The Centre (with a staff of three members) will enhance local capacity and support local social development activities through technical assistance, and will start working in the second half of 2006.

A characteristic of the *Cserehát Development Program* is that the contractor does not determine in advance the specific projects that will be funded. Communities applying for assistance can apply according to their specific needs. At the same time the maximum amount of money available for each project is quite low (2 million HUF = 9,380 USD). For example the local government of one of the villages applied for assistance to buy a tractor for the community, as none of the 450 inhabitants had one. They also applied for assistance to establish a community centre, which would provide a classroom for teaching illiterate adults (a large proportion of adults in the village) how to read and write. A community centre will also have a computer for public use. The creation of a group for guarding the local traditions is also among the goals to be achieved though financial assistance from the program.

However the *Cserehát Development Program* by itself will not be enough to sufficiently improve the situation in the area (even if it contributes to the ability to absorb the EU Structural Funds). It would be essential to improve accessibility through better connection to major roads, and also through the improvement of the quality and network of roads within the *Cserehát*. A well-functioning public transport system must be established. The quality of schooling needs to be improved through better access to education (both for children and adults). Access to health care and other basic services (post office, pharmacies, and shops) need to be provided. These changes are only possible if sufficient funds are provided by the central government, as well as a strategic vision for the development of the *Cserehát*. The current wage policy of the state – characterized by a high minimum wage, which acts as a strong disincentive for businesses to hire uneducated, unskilled people – should be changed. These changes would not only benefit the *Cserehát*, but other lagging, geographically and socially segregated sub-regions of the country as well.

Map 1. Sub-regional Disparities in Terms of Development



Source: Hungarian Central Statistical Office

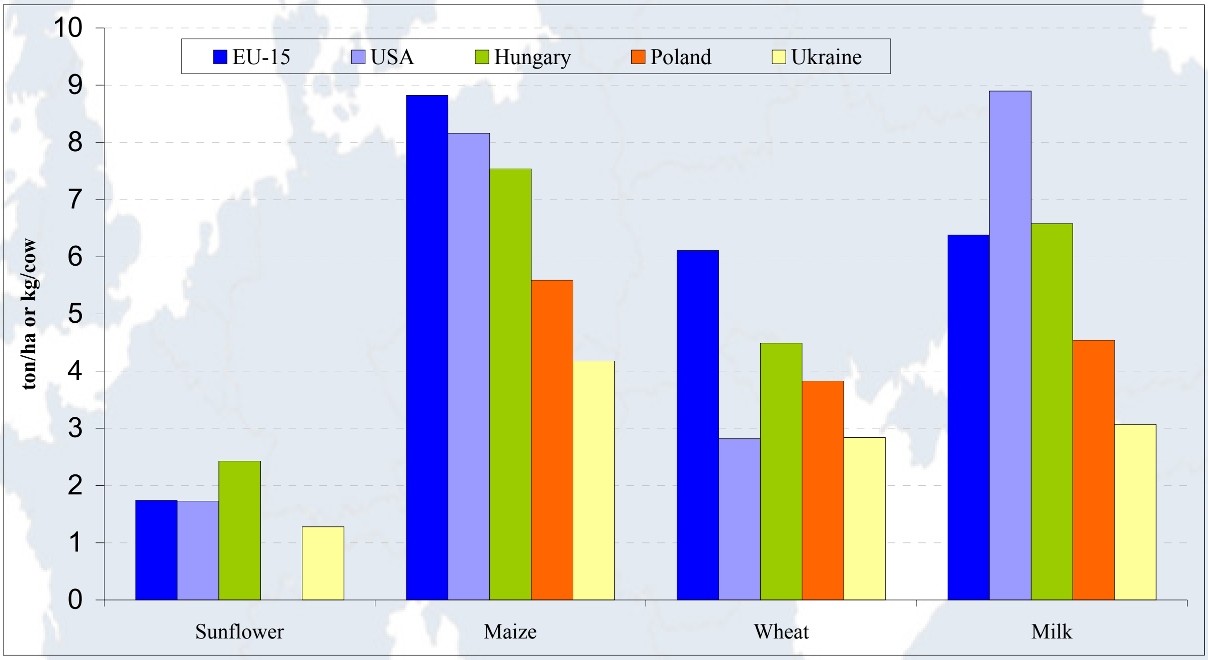
Stagnating Output and Continuing Reform of Agriculture in Ukraine

According to the State Committee of Ukraine for Statistics, Ukrainian farmers harvested 11.75 million tons of barley in the first nine months of 2006, which is 25.6% more compared to the previous year. However, other sectors of agriculture were not that successful, since gross agricultural output decreased by 2.8 percentage points between January and September 2006 compared to the same period of the previous year. Despite positive results in agricultural production and restructuring, Ukraine, having very favorable conditions for agriculture (possessing one third of very fertile black soil of the world, good climate) has to make further efforts in order to overcome the problems of post Soviet republics.

Role of Agriculture in the Economy

After Ukraine gained independency in 1991, following the breakup of the Soviet Union, agricultural production faced a general throw-back. Grain production fell by 50%, while fertilizer use decreased even more, by 85%. Ukrainian farmers lost state subsidies as well, which was one of the main factors of increased feed and production costs in livestock production. Thus profitability of livestock enterprises decreased and prices of meat products increased which resulted in lower consumer demand. This downward spiral caused a throw-back in the livestock sector as well. Due to this recession yields of major commodities are still much lower compared to well-developed countries or other former communist countries.

Chart 4. Yields of Main Commodities in 2005



Source: FAO

However, agriculture remained an important sector of the Ukrainian economy. The country has over 40 million hectares of agricultural land, of which about 80% is arable. After the steep decline in the 1990s these potential started to be utilized. Agriculture makes up a significant proportion of GDP which increased by 3.4 percentage points between 2002 and 2005. It is also an important sector concerning employment. Comparing the share of agriculture in GDP and in employment it can be concluded that there is a surplus of labor force in this sector. The reasons are slow technological development and the remained role of agriculture as a social safety net, absorbing surplus labor into subsistence farming and slowing down migration from rural to urban areas. Agriculture has also the potential for being an export earner as its total share of exports was around 10% in the last years and the country has been a net exporter since 1995. Since 2000 the growth of agriculture was almost continuous and exceeded GDP growth rate several times. The only exception was the year of 2003. Because of the very bad weather, agricultural output decreased by 11%. Besides economic recovery, one of the main driving forces of agricultural development was the division of state and collective farms in 2000. Farm property was divided among farm workers in the form of land shares. Most new shareholders leased their land back to newly formed private agricultural enterprises.

Table 2. Main Agricultural Indicators 1991-2005

	1991	1995	2000	2001	2002	2005
GDP growth (%)	-8.7	-12.2	5.9	9.2	5.2	2.6
Growth of agricultural production (%)	-13.2	-5.6	12.4	10.2	1.2	-0.1
Share of agriculture in GDP (%)	-	14.9	16.3	16.3	15.3	18.7
Share of agriculture in employment	-	22.5	23.2	24.8	25.2	24.0

Source: State Committee of Ukraine for Statistics

Agriculture seems to be attractive for foreign investors. Around 20% of total FDI flowed into the agricultural and food sector. The main investors of agriculture are the United States (25.7 million USD until 2002, Great Britain (7.5 million USD), Cyprus (5.9 million USD) and Germany (4.1 million USD). Leading investors in the food sector are the Netherlands (274 million USD), the United States (86.3 million USD), Switzerland (67.6 million USD), Germany (63.9 million USD) and Great Britain (56.8 million USD). As foreign investors are protected by several laws, further investment is expected, especially in the following priority areas:

- introduction of highly effective technologies in plant and animal industries;
- modernization of processing and preservation of agricultural products;
- creation of capacities for producing containers and packing materials;
- production of mineral fertilizers, chemicals for plant protection and veterinary drugs;
- industrial services for agricultural enterprises.

Major Problems to Solve

There are three major issues which need to be solved in order to utilize the whole potential of the Ukrainian agriculture and make it more competitive. One of the problems is the lack of developed, modern machinery, especially harvesting equipment. In the 1980s Ukrainian winter wheat harvest could be finished in three weeks. Nowadays it takes twice as much time to finish that affects negatively both yield and grain quality. Farmers estimate the loss up to 10-20% due to these delays. Custom harvesting is available for a price of one quarter of the total harvest, thus farmers have still more benefits if they do harvesting for themselves with their own, old machinery.

Another issue is the lack of storage capacities. Farmers are forced to sell their products shortly after harvest, because of the shortage of storage capacities (especially in years with a good harvest). The problem is a result of the Soviet system as it was designed for an immediate post-harvest shipment. Another forcing factor of selling products early is the need to repay short-term debts (of which seed and other equipment was bought in the beginning of the season).

The above mentioned issues are the consequences of credit problems. Farmers are able to receive credits, but interest rates are very high (around 30%). Additionally, since agricultural loans are not guaranteed by the government, banks are not willing to provide long-term loans. The third barrier of bigger loans is the high level of collateral. Banks typically require 200 to 300 percent collateral, depending on the farms credit history and risk level. As under the current legislation land cannot be used as collateral, farmers can only afford short-term, small amount loans, which cannot cover investments in machinery and storage facilities.

EXPECTATIONS

Improvement in land reform and restructuring of agricultural enterprise need to be continued, and ad hoc government interference in agricultural markets should be avoided. The government should provide a good environment for job creation and improve public services. Otherwise, there will be more and more unemployed, who lose their jobs because of the modernization of agriculture and will flee into subsistence farming. Thus rural development strategy will be as important in the future as facilitating the modernization of agriculture. By ensuring a stable macroeconomic development (especially low inflation and interest rates) and growing incomes, agriculture could be boosted in the future as well. In case macroeconomic instability will occur again, agriculture could face the problems (declining demand for agricultural products, high inflation and currency appreciation) of the 1990s again making further reforms more difficult. The question of long-term credits should be solved by the government by providing subsidies, state guarantee of agricultural loans, and allow the use of land as collateral in the future. In case all these reforms will be started/continued agriculture could give a boost to the whole Ukrainian economy and maintain or even improve its position (2^{nd} biggest sunflower seed producer, 5^{th} in sugar beets and barley, 10^{th} in milk, 11^{th} in wheat and 14^{th} in maize production) in the agricultural competition of the world.