ICEG EUROPEAN CENTER

Quarterly Forecast on Hungary

Autumn

Hungary: Economic Forecast – Autumn 2006

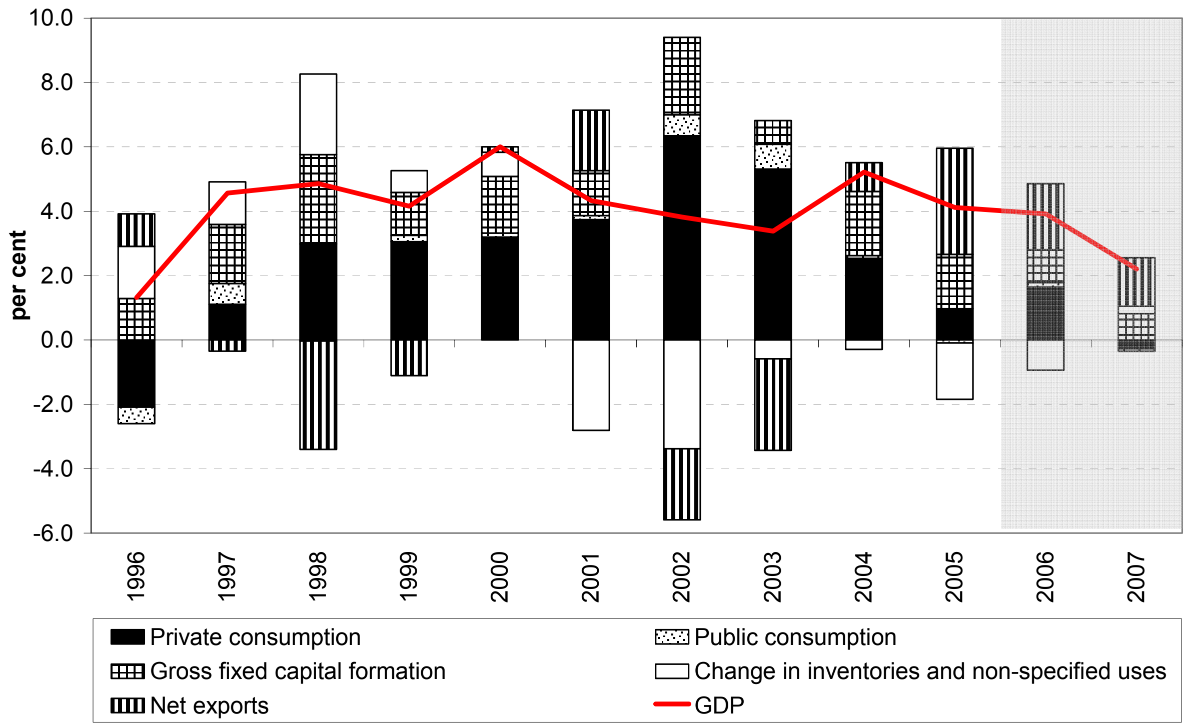
Overview

The two major developments influencing the economy are improving external demand and fiscal stabilization. The former will help to sustain favourable trends in external trade, the latter, however, through its contractionary effect on domestic demand will considerably slow growth.

Economic Growth

The year-on-year growth rate of real GDP fell to below 4 per cent in the second quarter of 2006, despite stronger than expected external demand. A surprise element in this slowdown was the sharp deceleration of investments. Behind this lies a marked reduction in private investments, while public investments also lost momentum as is usual after parliamentary elections. Private consumption growth is also on a downward path, since weaker income expectations and fear of massive lay-offs led to a marginal increase in the savings ratio as well as a deceleration in consumption credit growth. Backed by favourable external developments (significantly lower oil prices, better than expected growth performance in the eurozone), however, exports continued expanding vigorously, which, together with surprisingly slow import growth resulted in considerable improvement in net exports.

Chart 1. GDP growth and its composition: 1996-2007



The rest of 2006 will see private consumption slowing even further. Investments will also follow a downward trend, but a slight upward correction after the unexpectedly low Q2 data can not be excluded. Nevertheless, in 2007 the effect of fiscal stabilization will be fully felt in domestic demand, leading to an explicit fall (the first after 1996) in private consumption and one of the lowest growth in investments for a decade. However, contrary to what we expected three months ago, net trade will have a significant positive contribution to economic growth both in the rest of 2006 and even in 2007, through dynamic export growth. Consequently, we expect that real GDP will expand at a rate of 3.9 per cent in 2006, and a further 2.2 per cent growth is projected for 2007. These forecasts are almost unchanged from the one we presented three months ago, but behind the figures there is considerable difference: the main contribution to growth will come from net exports, while the contribution from domestic demand will be significantly smaller.

Monetary indicators

12-month CPI-inflation hit 5.9 per cent in September. The recent increase of consumer prices began around April, mostly reflecting fuel price developments, increases in import prices, food prices and also special effects. Of these, fuel prices have considerably decreased since then, but a rise in the VAT rate and also in administered prices – as part of the fiscal stabilization package – began to exercise an upward pressure on consumer prices. We assess, that the fiscal stabilization package in itself will generate an additional inflation of close to 2 per cent in 2006, resulting in a nearly 6 per cent 12-month CPI-inflation rate by the end of the year (3.7 per cent average annual rate).

2007 will see further increasing consumer price indices 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. Import prices will also push consumer prices upwards, while the offsetting effect of moderating wage growth and decreasing public consumption will be tiny. Inflation will culminate at around July or August next year at a 12-month rate close to 8 per cent, but will gradually decrease afterwards. In all, average annual inflation can be as high as 7.2 per cent in 2007.

During the third quarter of the year the Magyar Nemzeti Bank (the central bank) increased its base rate in three steps. It now stands at 7.75 per cent compared to its end-June value of 6.25 per cent. Considering that the fiscal stabilization package might induce secondary effects through influencing inflation expectations, and the fact, that foreign money and capital markets became tighter due to interest rate rises in both the eurozone and the USA, we think that the Nemzeti Bank will in one or two steps further increase its base rate, which will thus stand at 8.25 per cent at the end of 2006. With the easing of pressures at the end of 2007, the base rate could fall back to 7 per cent by the end of next year.

The exchange rate of the forint has become rather volatile recently, mostly reflecting the increased risks originating from the unsustainable fiscal deficit. Despite increased volatility we expect, that the forint's flotation centre will be at around the 270-275 band vis-à-vis the euro, which is probably consistent with the present fundamentals.

Fiscal Balance and Public Debt

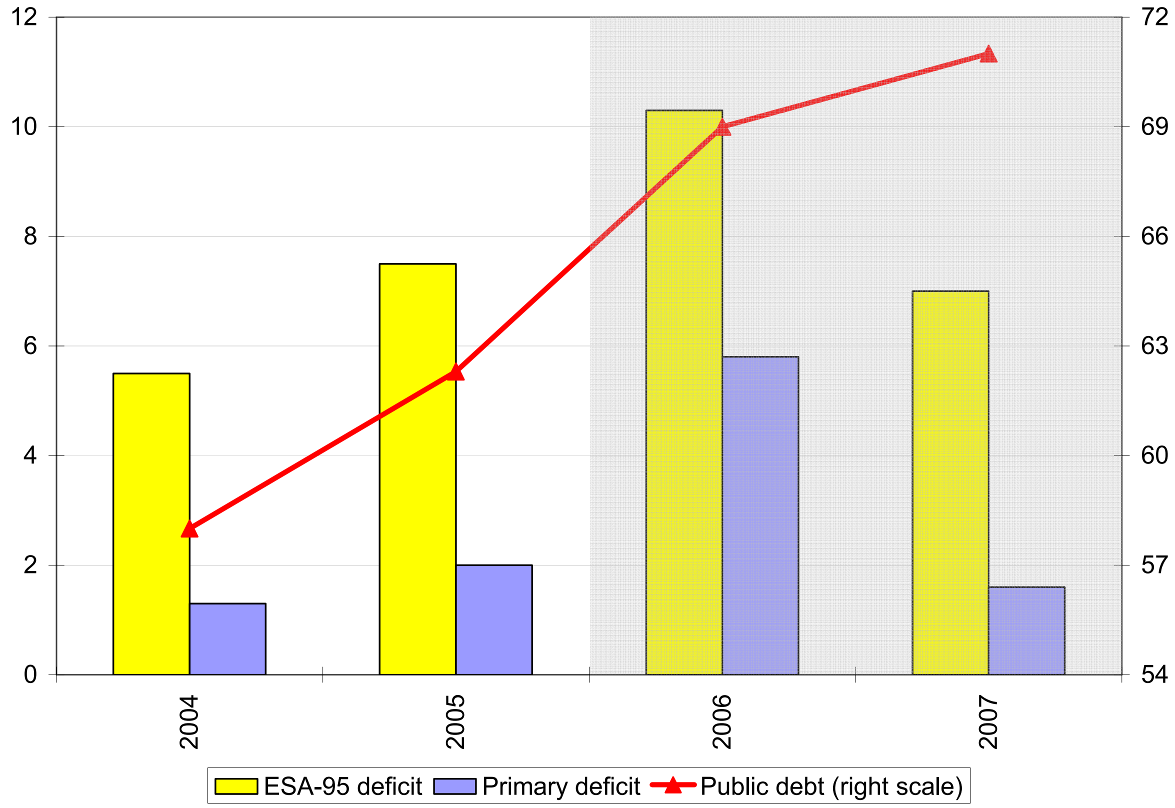
The budget deficit (excluding local governments) reached 6.3 per cent of GDP by the end of September on cash basis. This is 2 percentage points higher than in the same period last year, and by the end of the year it could rise to 8.2 per cent. The more relevant accrual based ESA-95 figure will be even higher at 10.3 per cent of GDP (without adjustment for the pension reform).

It should be stressed, that without the fiscal stabilization measures that were announced in June, the deficit could even reach 11.7 per cent this year, due to markedly higher expenditures. Part of these originate from well above planned outflows on some budget items (e.g. pension, subsidies on medicines), another part comes from the higher price of imported gas and increased interest payments on outstanding government debt. Thus, the fiscal stabilization measures per se lead to a 1.4 percentage point (relative to the GDP) reduction of the budget deficit in 2006 mostly reflecting increased revenues through tax rises, to a lesser extent also a cut in expenditures through freezing outflows on some items.

As the stabilization measures exert their full effect in 2007, we expect a further improvement in the budget balance next year. The ESA-95 budget deficit figure could fall to 7 per cent of GDP (based on already announced measures), and the bulk of improvement will be the result of reduced expenditures rather than increased revenues. The improvement in the primary balance can be even larger, since payments on outstanding government debt will still increase in 2007.

Public debt will stand at 69 per cent of GDP by the end of 2006, which is almost 7 percentage point higher than at the end of 2005. The bigger part of this increase is to be attributed to the high deficit, but the revaluation of the foreign currency denominated stock of debt through the depreciation of the forint also plays a role. Although the budget deficit will moderate somewhat in 2007, interest payments will still be high, thereby further increasing the government debt to approximately 71 per cent of GDP by the end of next year.

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



Balance of payments

The current account exhibited a deficit of EUR 1.5 billion in the second quarter of the year, raising the cumulated deficit to slightly over EUR 3 billion in the first six months. Goods export and import both increased considerably between April and June, with a marked improvement in the trade balance (less than EUR 70 million). There is still an ill feeling about the import figures, because of the high errors and omissions balance, which may be the consequence of underreported imports.

The services balance did not change significantly compared to last year's one, but there was continued worsening in the income balance. Especially net income payments after non-debt generating investments exhibited higher deficit than in last year. Unrequited transfers showed slightly negative balance in the second quarter, though, because of the recording method of payments both to and from the EU, this figure in itself is not indicative about current trends.

Continued improvement in the trade balance (a large part of which can be attributed to decelerating domestic demand in the wake of fiscal stabilization measures) will lead to a minor improvement in the current account relative to the GDP in 2006, and a further, larger improvement in it in 2007. This might result in a current account deficit of 6.6 per cent of GDP in 2006, and 5 per cent of GDP in 2007.

The stock of gross foreign external debt at the end of June stood at 87.3 per cent of GDP, more than 10 percentage points higher, than at the end of 2005. Besides the C/A-deficit, this is also attributed to the depreciation of the forint. We expect no further depreciation of the domestic currency (only higher volatility) until the end of next year, since, however, the C/A-deficit will be financed primarily by debt-generating inflows in the forecast horizon, gross foreign debt could increase to over 90 per cent of GDP later in 2007.

Unemployment and wage dynamics

The relatively good growth performance this year led to considerable job creation, but mostly in construction and services, while employment in manufacturing decreased again. At the end of the year the first stage of a massive lay-off in public employment – as a consequence of fiscal stabilization measures – will be started.

The full effect of the fiscal measures will, however, be felt rather in 2007, when the decelerating economy will be unable to create as many jobs as will be destroyed in public administration and construction. From its end-2006 value of 7.4 per cent, unemployment ratio will rise to close to 8 per cent by the end of 2007.

Despite the acceleration of inflation at the end of 2006, real wage growth could be as high as 3.4 per cent in 2006, mostly because of wage increases in the private sector. The next year, however, will see decreasing real wages due to high inflation, weak demand for labour, the freezing of nominal wages in public administration as well as rises in taxes and social contributions.

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

	2005	2006*	2007*
GDP growth (%)	**4.1**	**3.9**	**2.2**
Private consumption (%)	**1.4**	**2.4**	**-0.4**
Public consumption (%)	**-0.9**	**1.4**	**-0.9**
Investments (GFCF, %)	**6.6**	**3.9**	**3.1**
Export (%)	**10.8**	**13.9**	**9.8**
Import (%)	**6.5**	**11.4**	**8.3**
Consumer price index (average,%)	**3.6**	**3.7**	**7.2**
Unemployment ratio (%)	**7.3**	**7.4**	**7.9**
Real wages	**6.0**	**3.4**	**-2.6**
General government balance (%)	**-7.5**	**-10.3**	**-7.0**
Public debt/GDP (%)	**62.3**	**69.0**	**71.0**
Current account /GDP (%)	**-6.8**	**-6.6**	**-5.0**
Trade balance /GDP (%)	**-1.6**	**-2.0**	**-1.8**
Gross foreign debt /GDP (%)	**77.0**	**89.0**	**90.8**
Base rate (%)	**6.00**	**8.25**	**7.00**

** Forecasts by ICEG staff.*