mBank – CASE Seminar
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Economic policy and macroeconomic developments in Hungary

The recent past and factors affecting medium-term prospects

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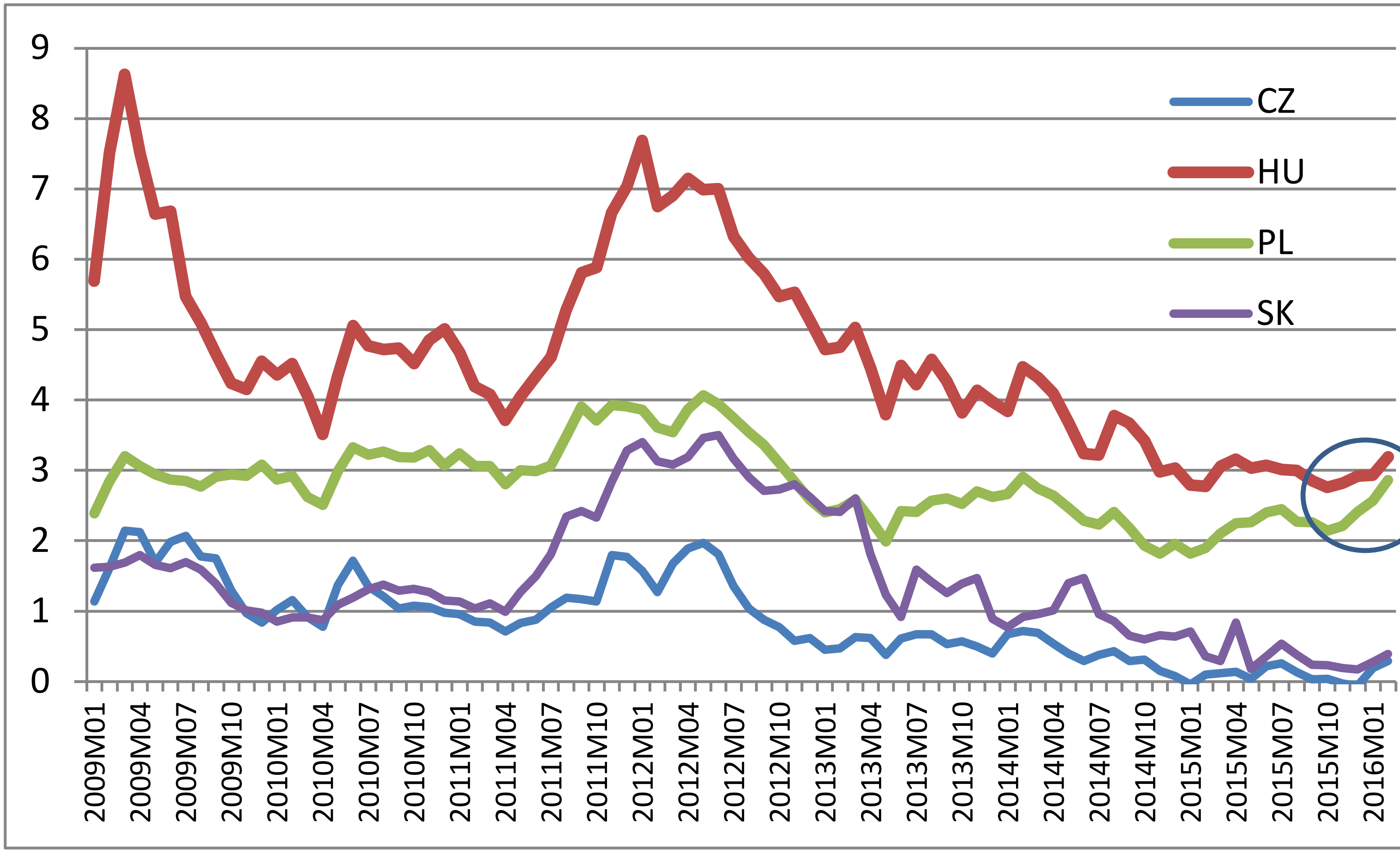
Outline

- Points of departure – the scope of the presentation and its background: a short and longer-term comparison between HU and PL
- A checklist regarding Hungary’s recent macroeconomic performance and effects of exogenous factors and government policy
- Some key issues: GDP-growth, employment, household income, EU-transfers, macroeconomic balance, investments and institutional decay
- Medium-term prospects
- Summing up (the key role of institutions)

I. Points of departure

- Main purpose: try to present an objective review (both positive and negative aspects)
- Scope: selective overview of macroeconomic developments and ***economic*** policy since 2010
  - No discussion of ***politics***
  - No discussion of social conditions, education and health – though very important
  - Focus on facts/statistics (sources: Eurostat, EU Commission, HSO, NBH, international surveys)
- Begin with
  - A short-term issue: yields on long-term government bonds
  - A longer term issue: economic convergence

10-year government bond yields above Germany's in the V4: a „riskiness" indicator



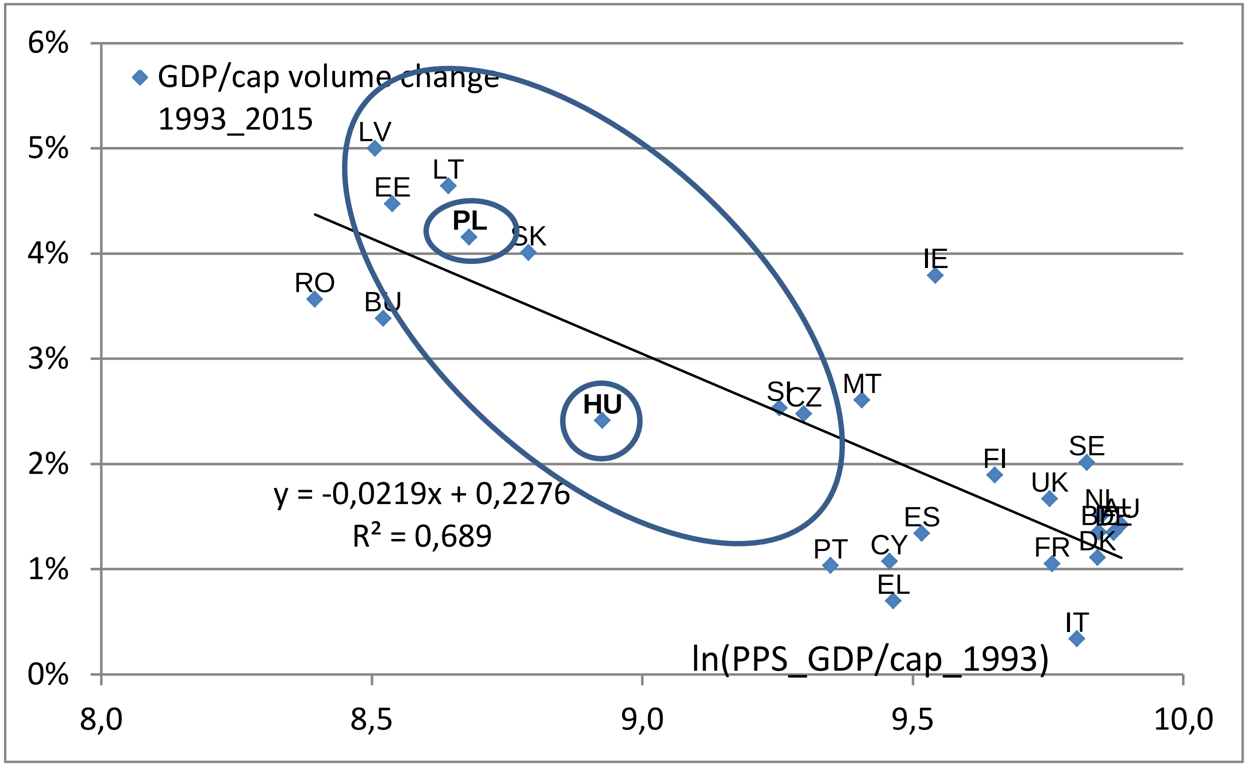
HU: large improvement since 2012, but still 3pp above CZ and SK

HU: little change since 2015
PL: large increase since 2015 autumn
PL-HU difference: 1pp in 2015; 0,3 in 2016M2

Longer-term real convergence to the EU15

- GDP/capita growth 1993-2015 in EU26 comparison
- Comparison between HU and PL (1991-2015)
  - At current PPP
  - (At constant PPP -> Appendix)

HU's and PL's per capita real GDP growth as a function of „initial" income in the EU26 context: 1993-2015 (22 years)

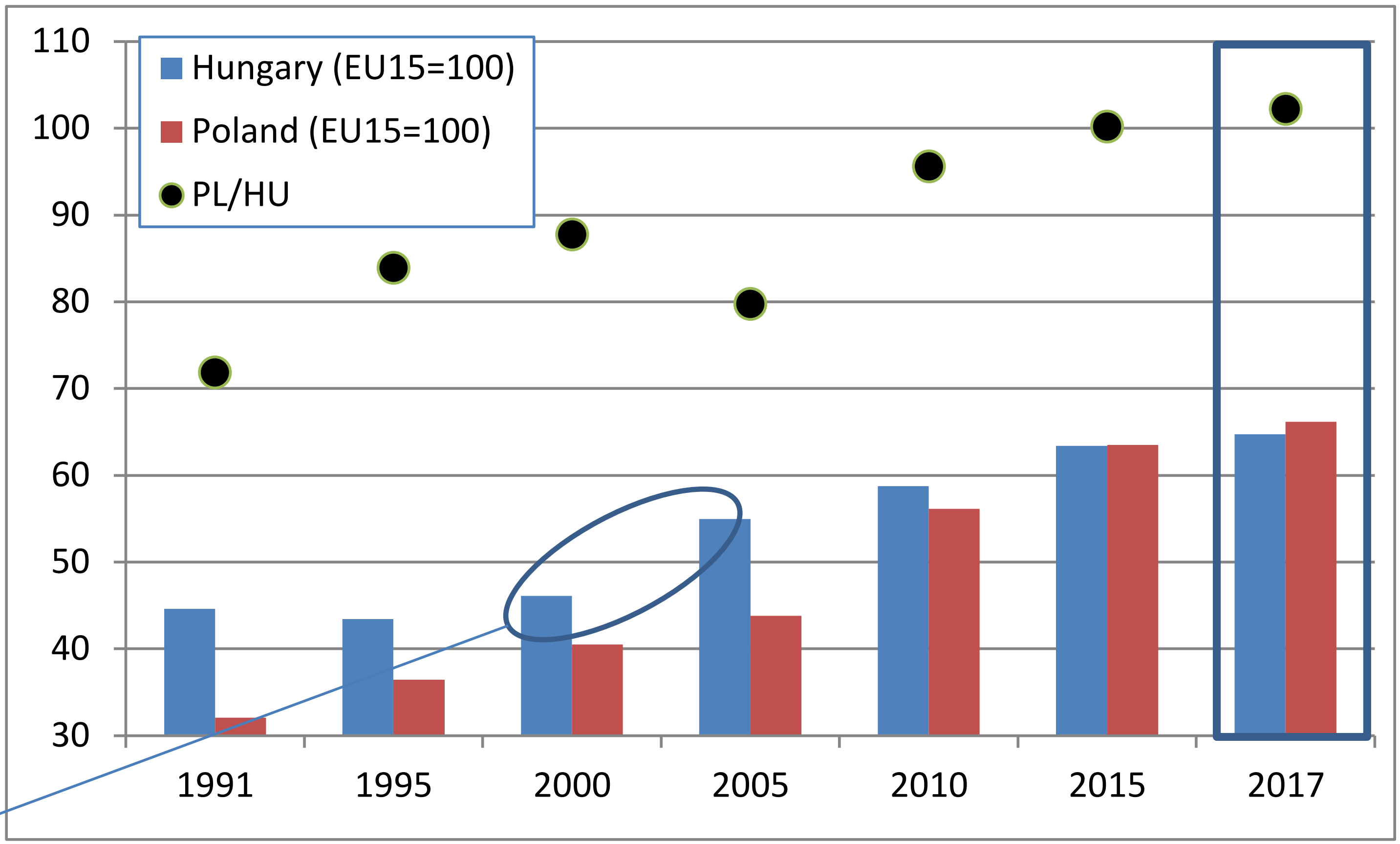


Observations:

- Clear sign of beta convergence in the EU (negative relationship between „initial" income
- and growth)
- HU clearly underperformed
- PL over performed

GDP/capita: Hungary's and Poland's convergence at **current** PPPs to the EU15 (cross section comparisons)

In 1991: PL 70%; in 2015 100% of HU's level



Between 2000 and 2005: HU's rapid convergence
But unsustainable increase in public and private debt

2017: EU Commission forecast

II. Characteristics and drivers of HU’s economic performance since 2010 (and 2014) – not exhaustive

- A checklist: the bright and the gloomy side
- Drivers (from the point of view of economic policy pursued since 2010)
  - Exogenous
  - Endogenous
  - Mixed
- Briefly on Hungary’s „non-orthodox” economic policy

Some features of Hungary’s recent economic performance

Bright side

- GDP and employment growth (2014 -
- Fiscal balance, fall in debt/GDP ratio
- External surplus, fall in net foreign liabilities

- Increase in real household income and consumption
- Investment growth
- Low inflation and interest rates

Reverse side

- EU-funds, public works, low productivity
- Special taxes; nationalization of private pensions
- High saving/low investment of corporations

- 2 years; increasing inequality
- Mainly public investment
- Mainly external factors (+PU)

Exogenous (non-policy related)

- Negative
  - Inherited private and public debt → deleveraging (balance sheet adjustment)
- Positive
  - By 2010 the bulk of stabilization was over
  - EU-transfers: a radical increase - to the highest in CEEU
  - Inherited agreements on FDI
  - International capital markets: favorable environment (low interest rates, liquidity)
  - Significant terms-of trade gains (2014-15)

Endogenous (policy related) (I)

- Positive:
  - Decreasing public deficit, but: procyclical policy in 2012 (difference in 2014-15)
  - Converting FX-denominated household debt to forints (negative for banks, mainly positive for households)
  - Cutting interest rates, when possible
  - NBH: Credit for growth – though limited effect

Endogenous (policy related) (II)

- Negative:
  - Flat tax, removal of tax credits for low wage earners
  - Special taxes on the financial sector and other services („sectoral taxes”)
  - Deterioration in the institutional environment, examples:
    - undermining property rights;
    - retroactive legislation,
    - policy instability and uncertainty,
    - significant increase in perceived corruption
  - „Freedom-fight” against the IMF + Bruxelles; „Eastern-opening”

Mixed/dubious

- Public works
- Absorption of private pension funds
- „Self-financing” → promoting larger holding of government-bonds by commercial banks
- Exchange rate policy (continuous depreciation of the forint, in spite of huge/increasing external surplus)

On Hungary’s „unorthodox” economic policy and the underlying ideology

- ***Communication***: Hungary is a European success story, due to its unorthodox economic policy → posters:
- ***Actual policy***: rather orthodox (flat tax, the smallest possible fiscal deficit, the strictest regulation of unemployment benefits in the EU etc.)
- ***Ideology (1)***: services are unproductive (see Karl Marx)->
  – Sectoral taxes on services
- ***Activity***:
    - Nationalization
    - Redistribution of properties and markets → corruption
- ***Ideology (2)***:
  – What is perceived as corruption by the public, serves a majestic goal (A. Lánczi, head of the think-tank of the government) →
  – Increase the capital stock under national ownership →
  – (establish a new elite, devoted to the present government)

→

Government „information”
Text: Hungary performs better

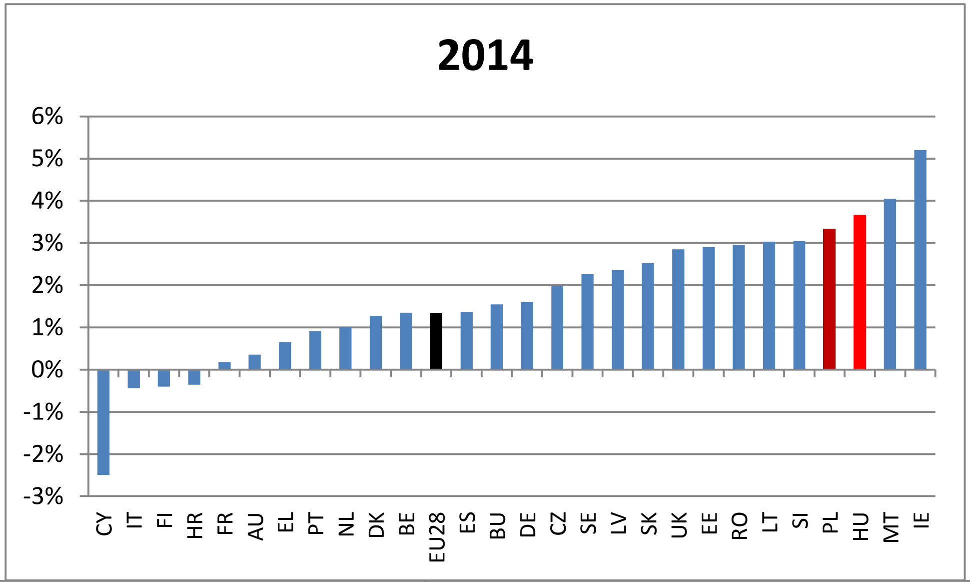
Price of public utilities : -20%   Debt to the IMF= 0   Earnings: +4,6%

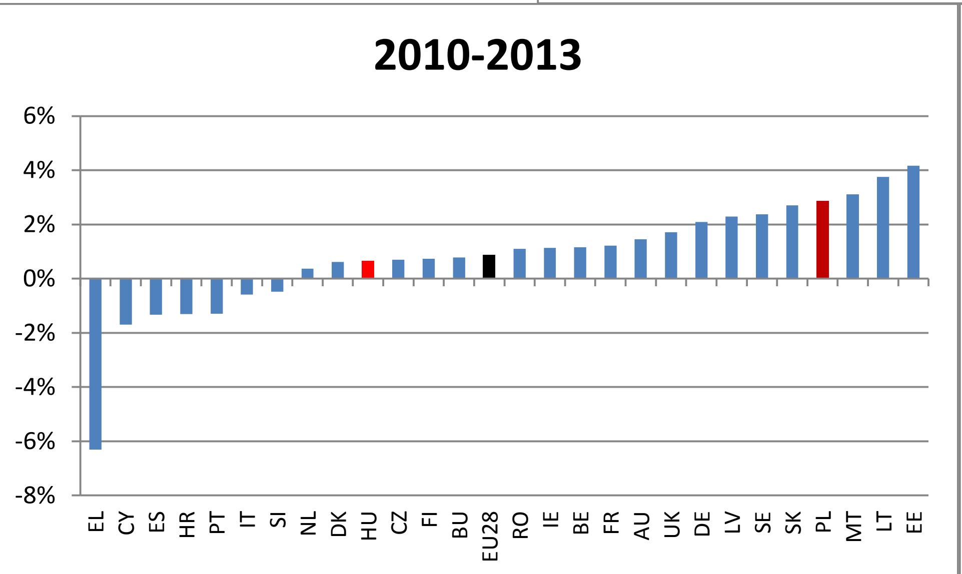
An other „information” by the government: Hungary’s reforms WORK!

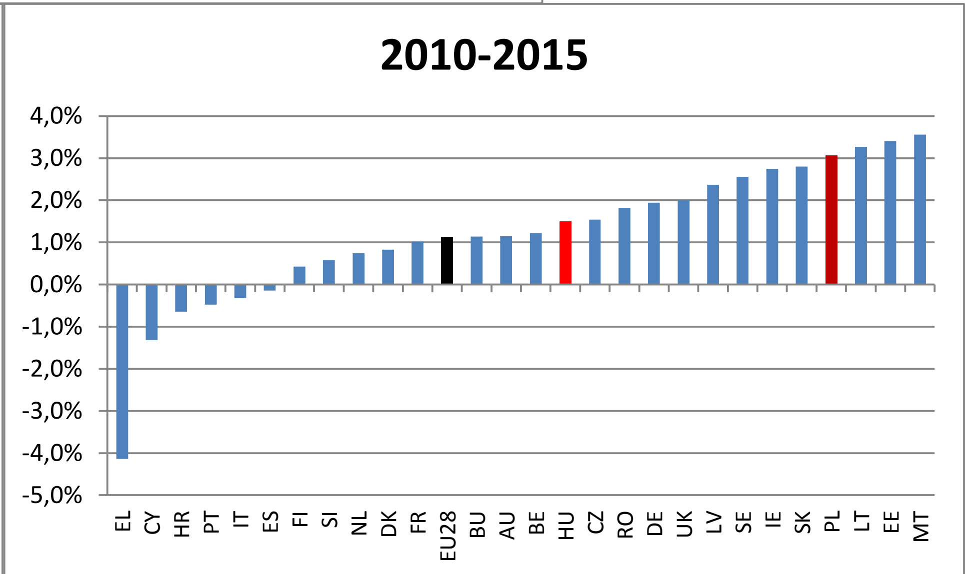
Our economy’s growth is higher than the EU’s!

Hungary’s reforms **WORK!**

The slogan is based on the performance of a ***single*** year: 2014 (GDP volume growth in the EU-countries)





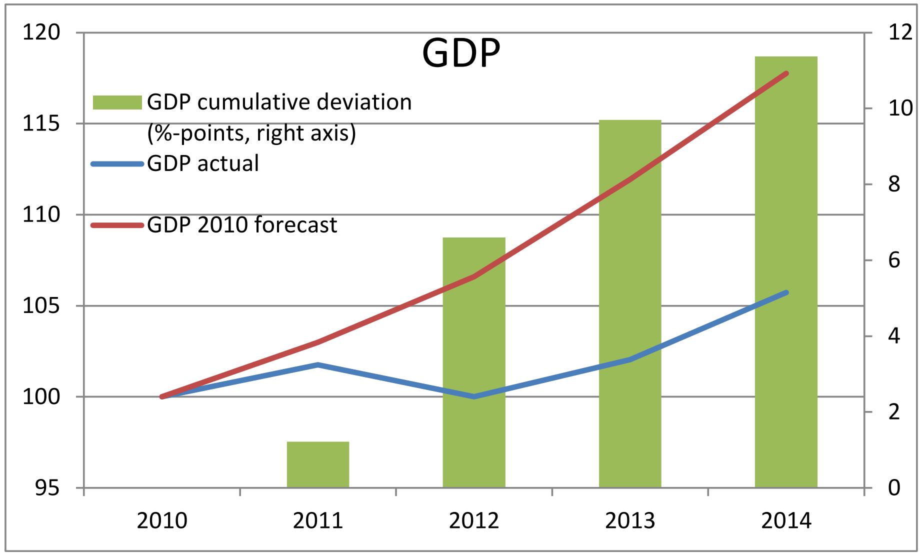


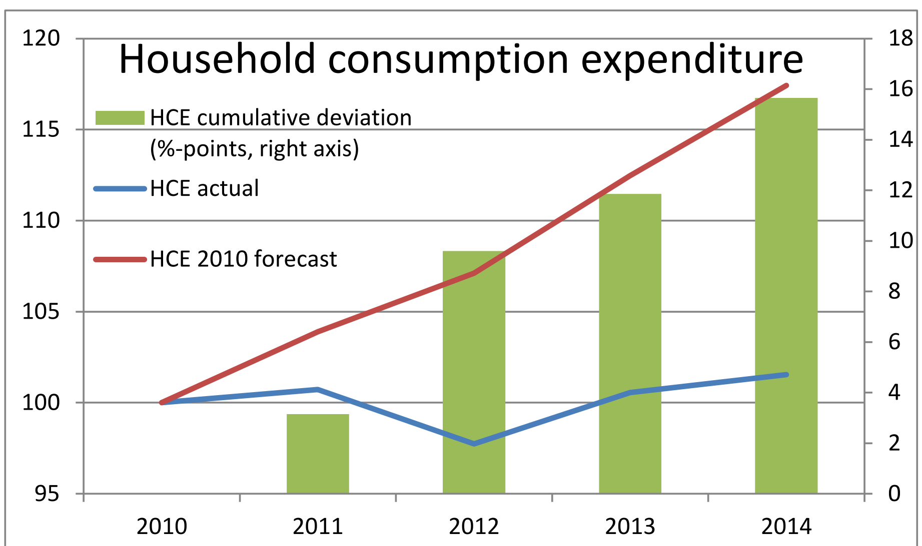
III. Some key issues/aspects of Hungary's recent macroeconomic performance

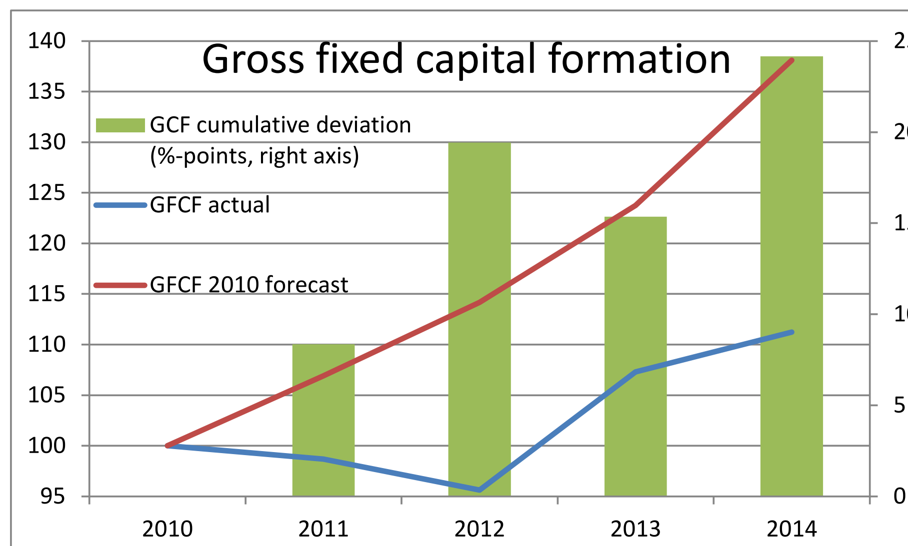
- Expectations/forecasts of the FIDESZ-government in 2010 vs. realizations
- GDP-growth in international comparison
- EU-transfers in international comparison
- Employment
- Household income
- Growth of GDP vs. domestic uses of GDP
- Investments
- Macroeconomic balance (briefly; details in the Appendix)
  - Fiscal
  - External
- Institutions in international comparison

III/1. Government expectations in 2010 and realizations by 2014

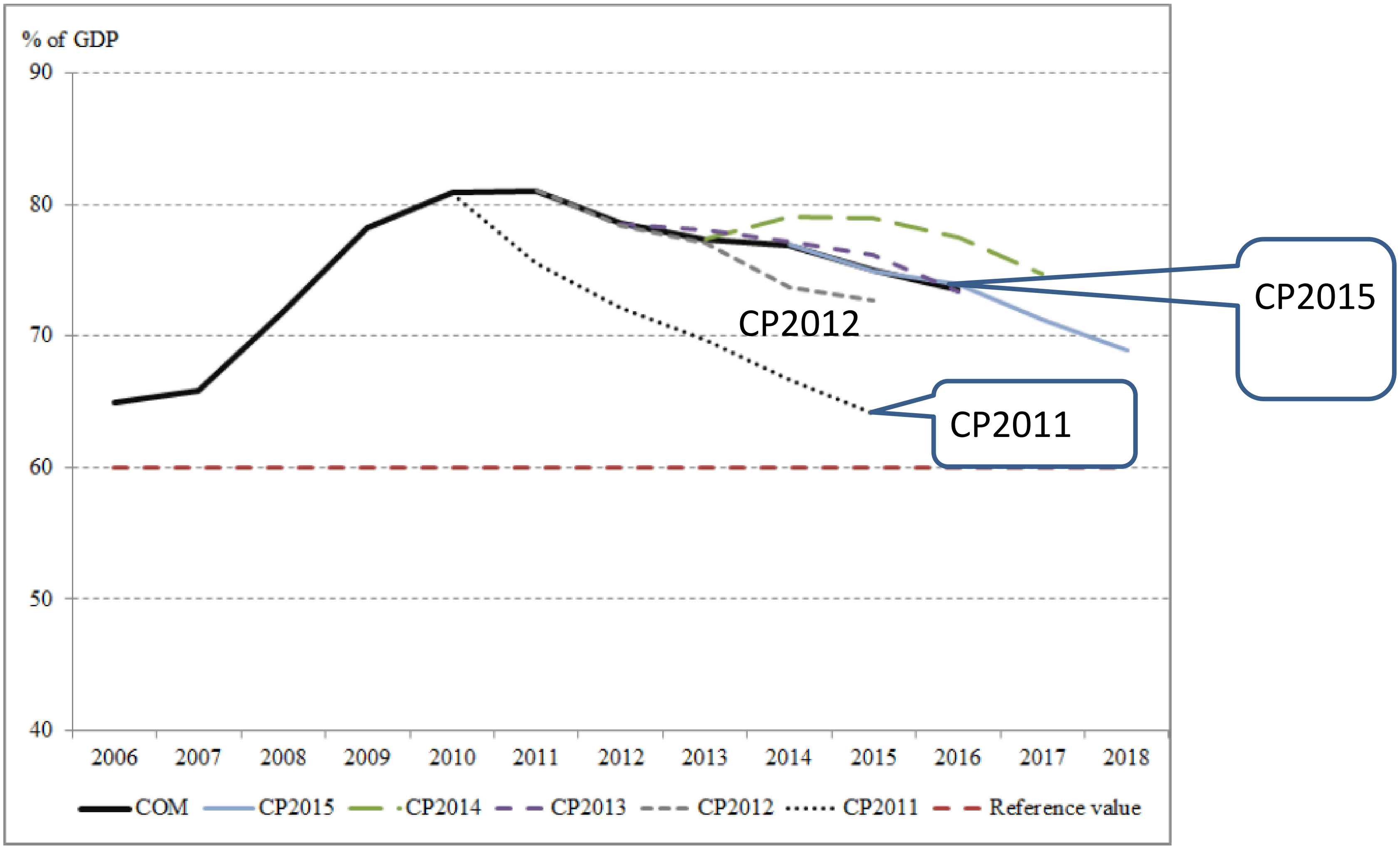
The medium-term forecast of the budget for 2011 (expected effects of the flat tax + other elements of non-orthodox policy and realizations 2010=100, left axis; deviations in %-points, right axis)





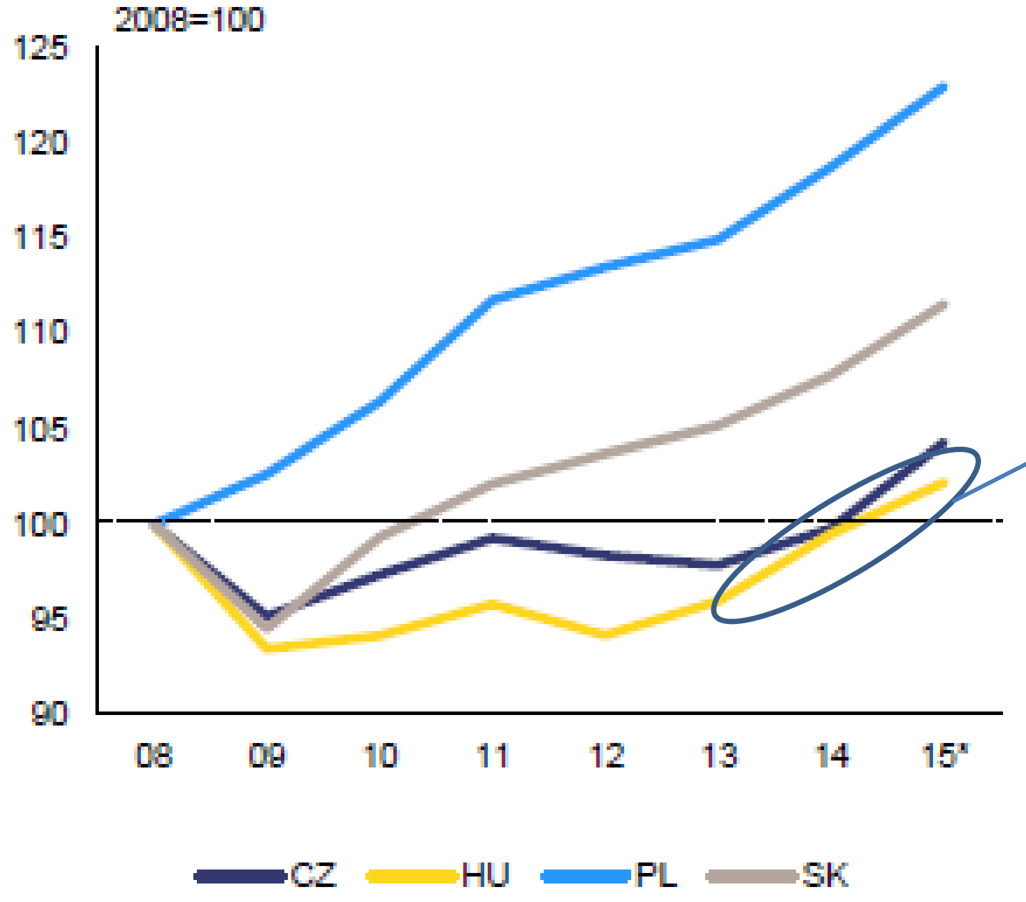


Public debt projections in successive convergence programs (CPs; % of GDP)



Source: Commission 2015 spring forecast; Convergence Programmes

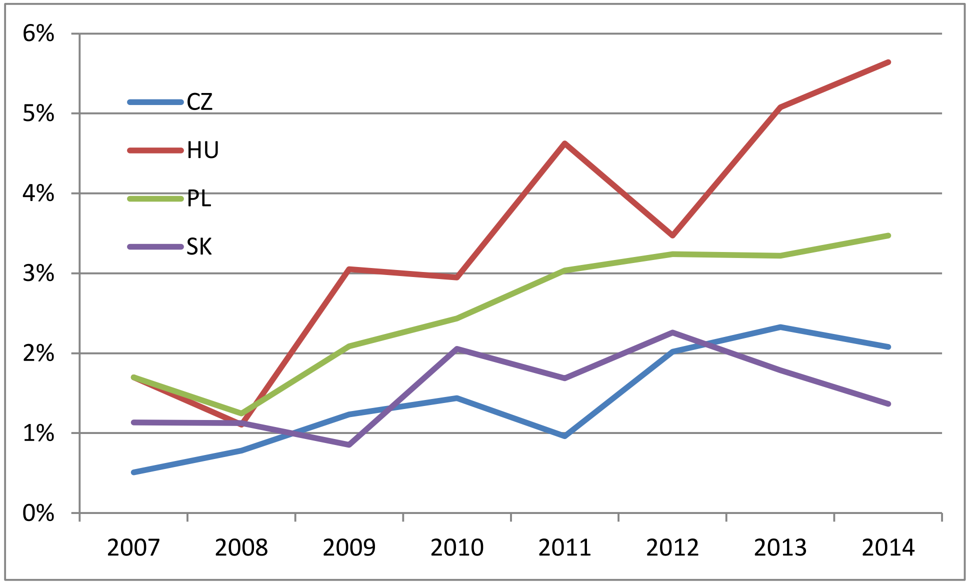
III/2 GDP growth in the V4-countries (2008=100)

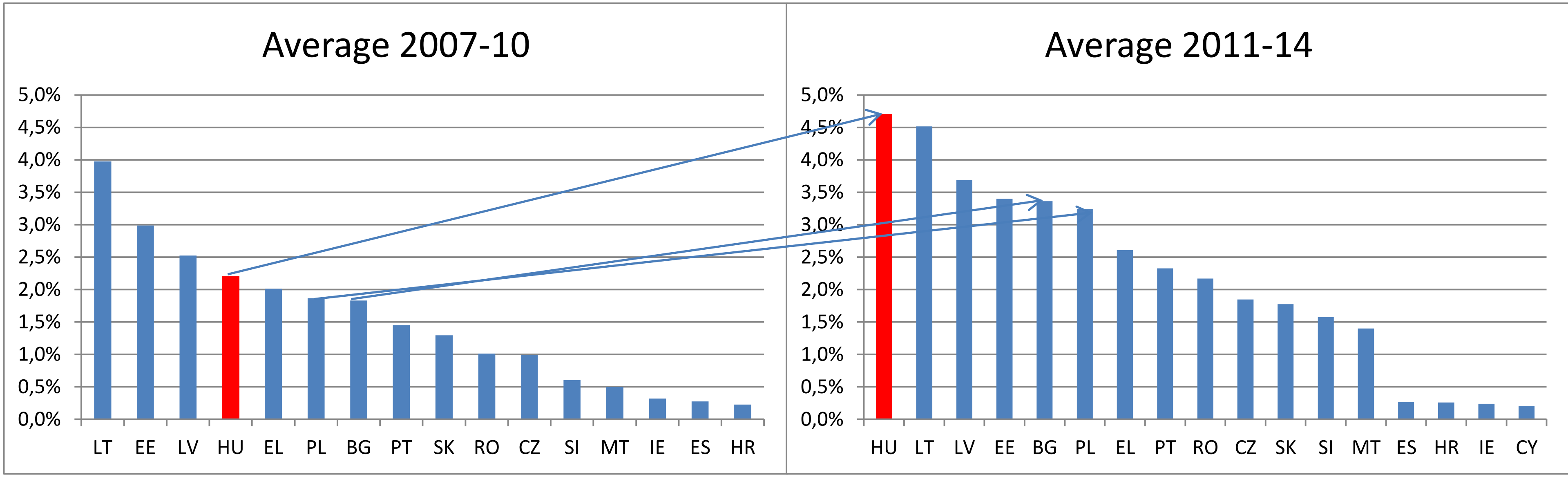


Factors behind the recent acceleration:
- EU-transfers
- Close in the output gap

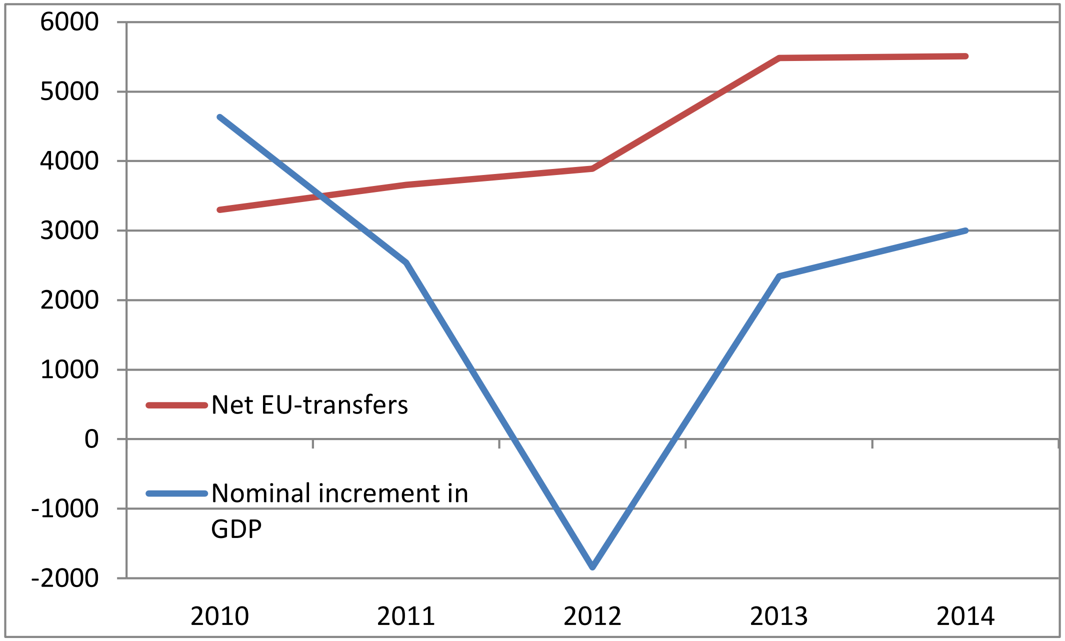
The chart is taken from the recent (2016 February) country report of the EU Commission

III/3. Net EU-transfers in % of GNI





Hungary: net EU-transfers and the nominal change in GDP 2010-2014 (in million Eur)



Between 2010 and 2015 (QI-III)

Cumulative **gross** EU-transfers: 32,5 bn EUR

Cumulative **net** EU-transfers: 26,6 bn EUR

Nominal increment in GDP: 15,2 bn EUR

Increment in GDP in % of cumulative net EU transfers: 57%

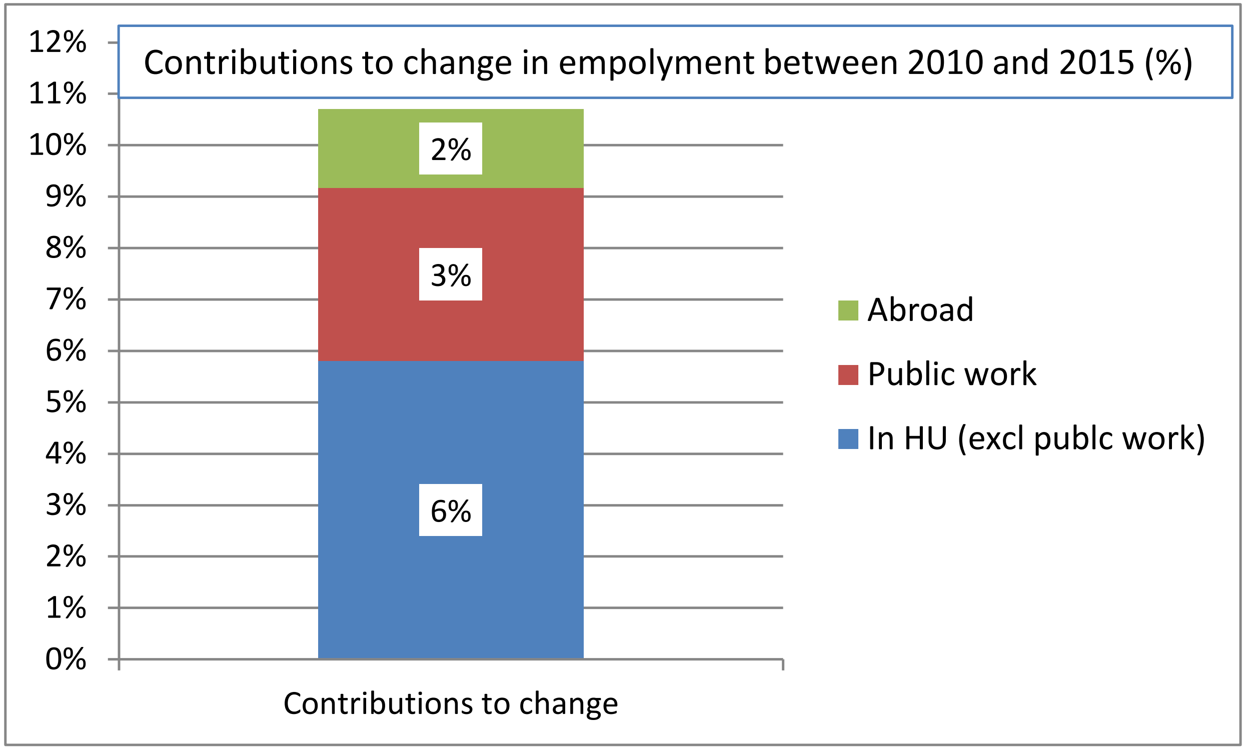
Cumulative EU transfers and cumulative change in GNI: comparisons between HU, PL and SK 2010-2014*/

	HU	PL	SK
Net EU transfers 2010-14 (Bn EUR)	21	57,4	6,4
dGNI 2010-14 (Bn EUR)	11,6	92,2	10,4
Cum EU transfers/dGNI	181%	62%	62%
Average transfer/average GNI	4,4%	3,1%	1,8%

*/ Source: EU expenditure and revenue 2000-2014
http://ec.europa.eu/budget/figures/interactive/index_en.cfm

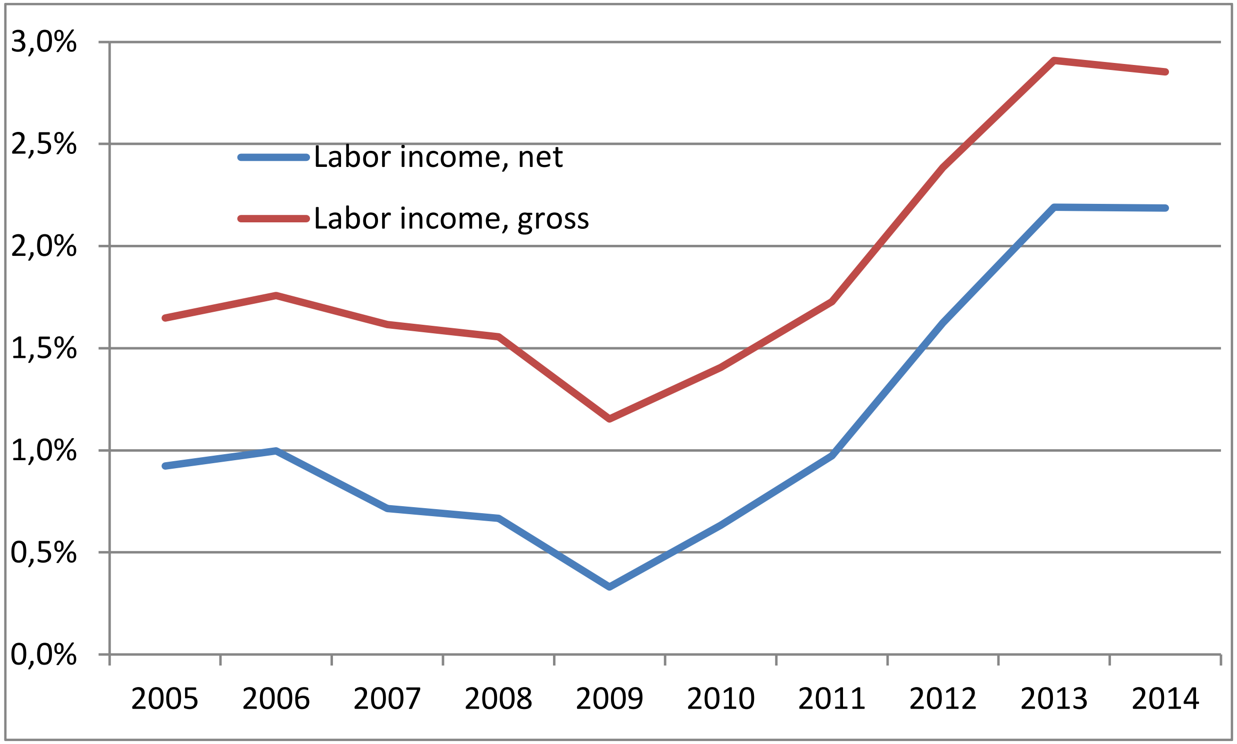
III/4. Employment (LFS)

Increase from 3,7 to 4,1 (+0,4 million, 11%) between 2010 and 2015
Almost half of the increase: persons working abroad + public work schemes

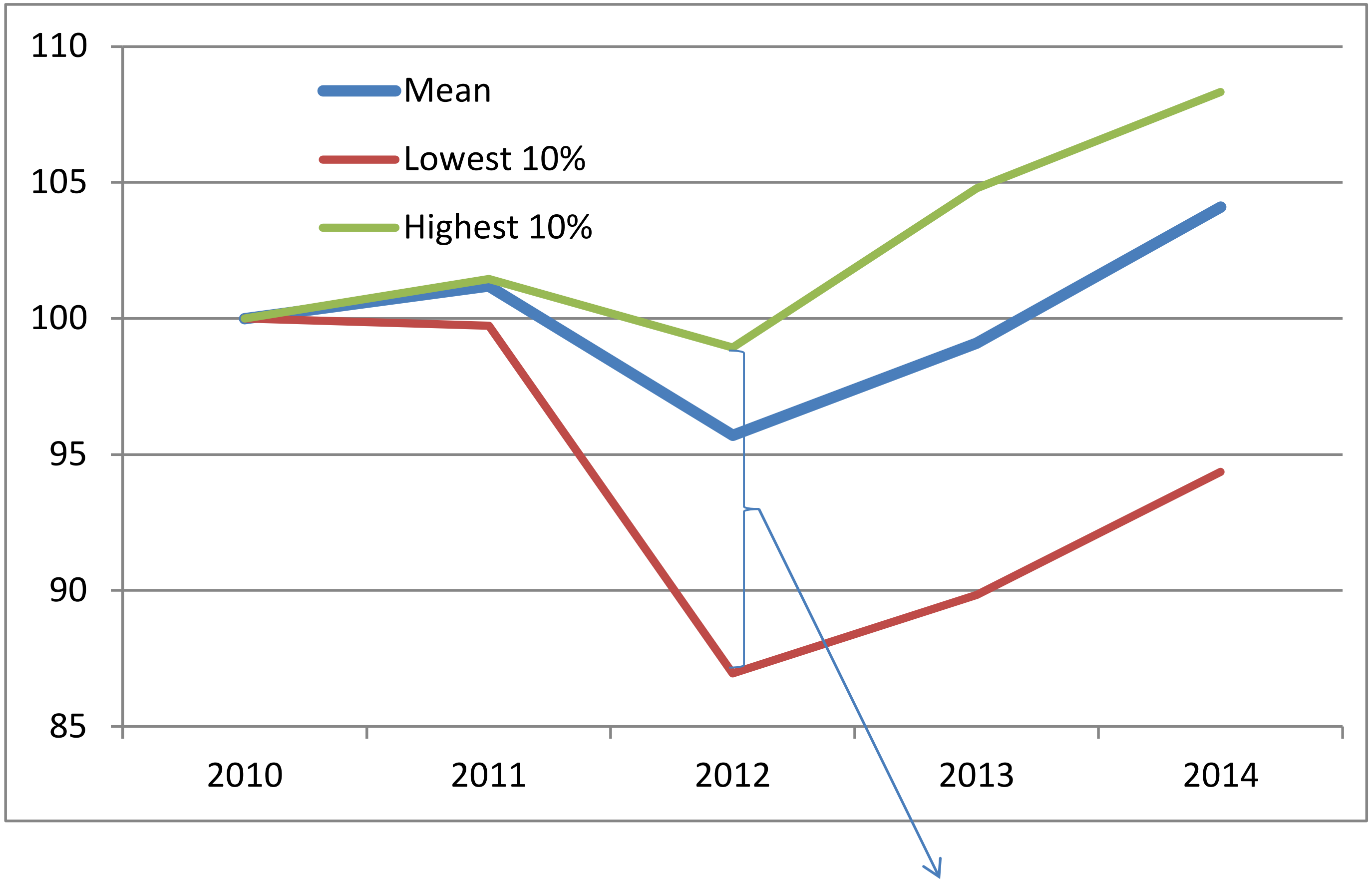


The problem with public works - lower wages than the minimum wage; - very low exit to the actual labor market	***The problem with increasing employment abroad:*** the most talented and motivated part of the labor force is involved

Balance of payments statistics: Labor income – gross and net transfers from abroad (% of GDP)



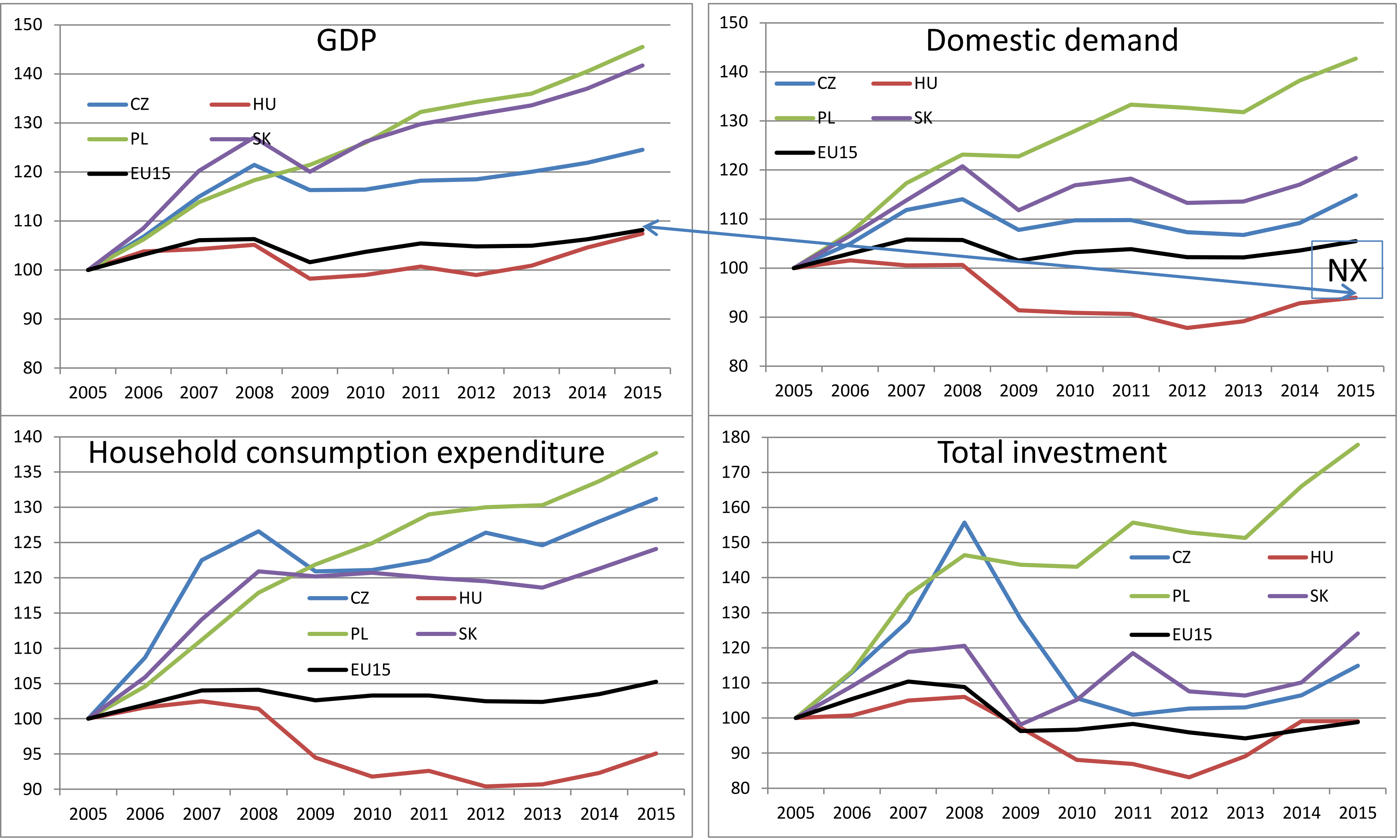
III/5. Household real income growth: mean, lowest and highest decile: divergence



Flat tax + removal of tax credit for low wages

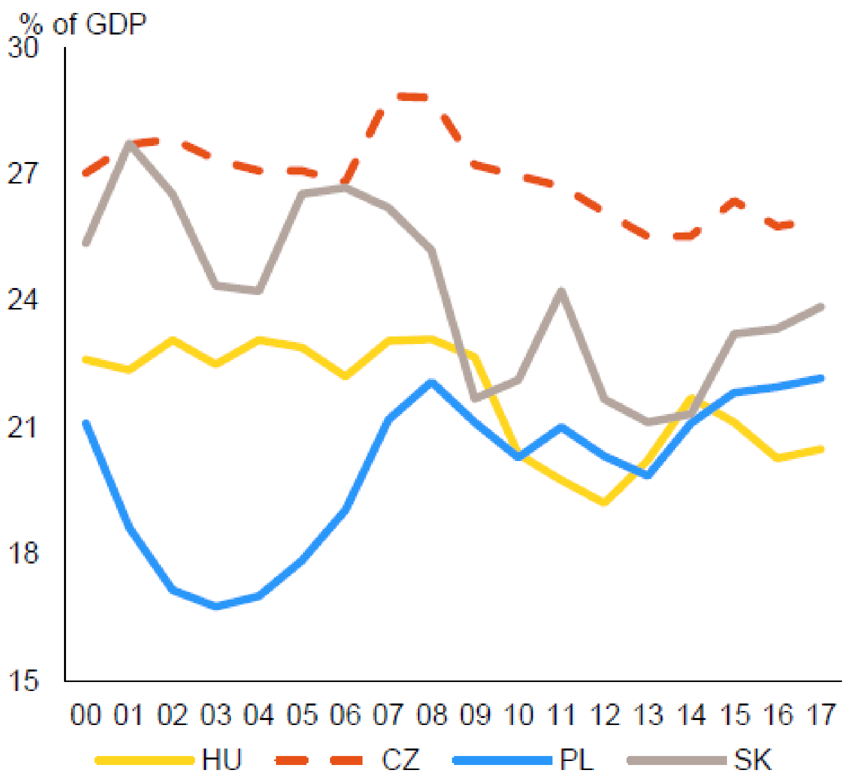
III/6. GDP vs. domestic demand (volume change)

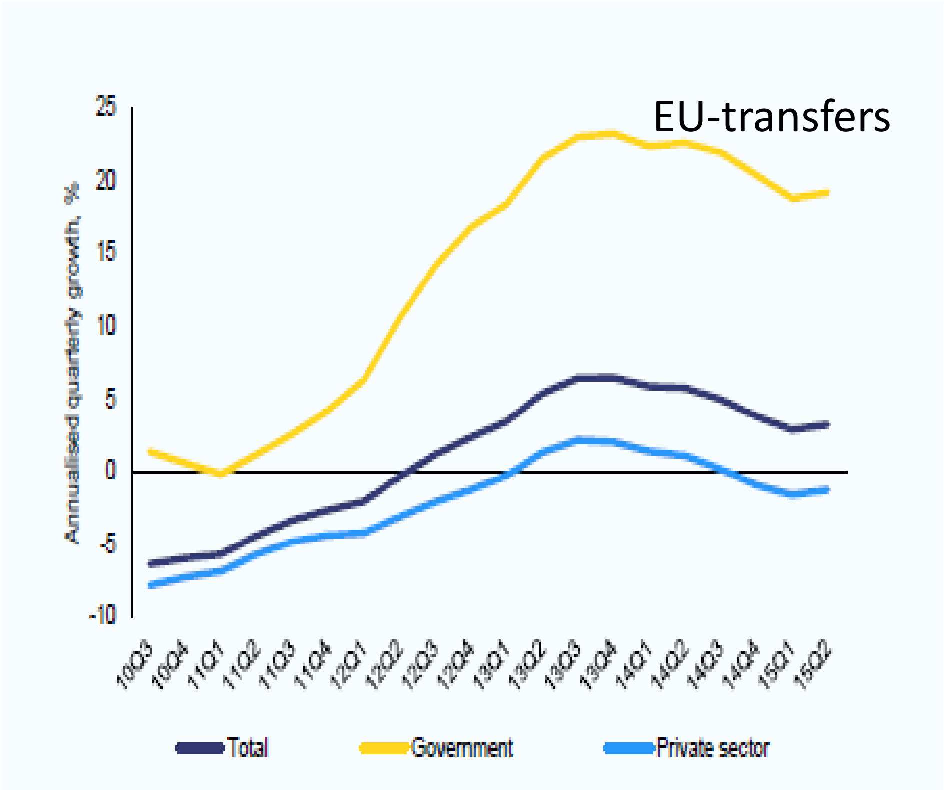
The V4 and the EU15 average (2005=100)



III/7. Investments

Investment rate (lhs) and growth in public vs. private investments (rhs)

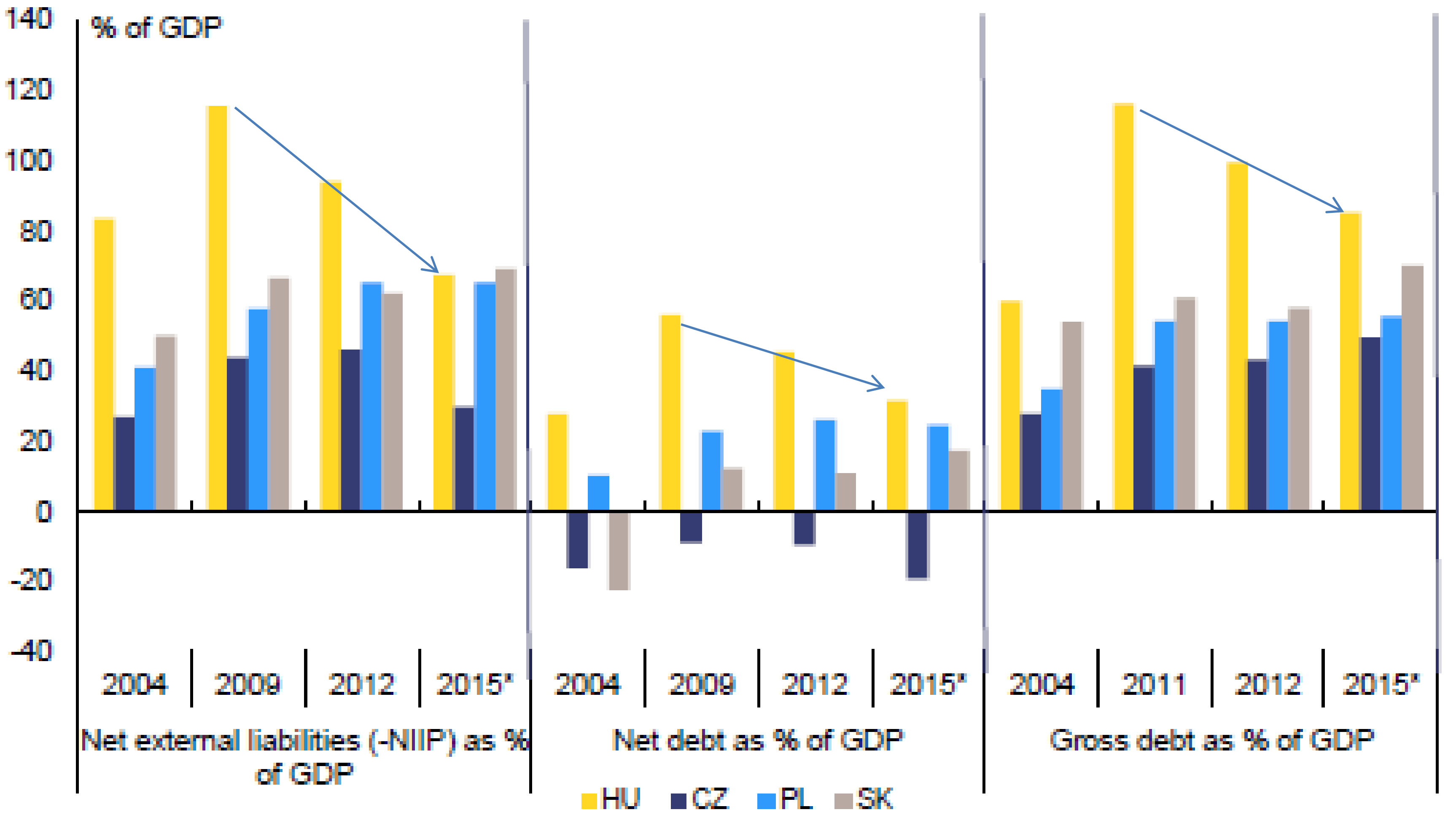




III/8. Macroeconomic balance: strong external adjustment; slow decline in public debt

- External
  - Stocks
  - Flows
- Fiscal
  - Stocks
  - Flows

III/8.1. Stocks: net foreign liabilities, net foreign debt, gross foreign debt in the V4 countries in 2004, 2009, 2012 and 2015 HU: significant adjustment (deleveraging)

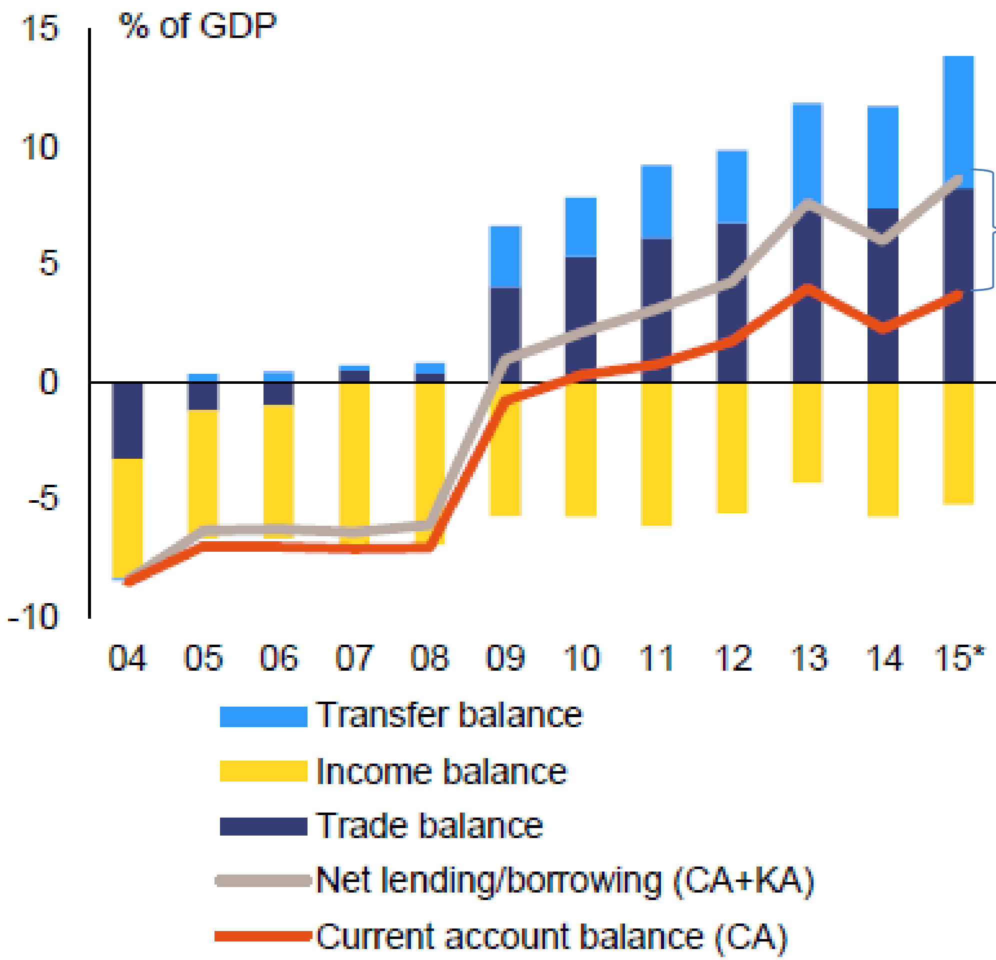


* The value for 2015 is the latest available quarterly data (Q2 2015)

III/8.2 Components of the external position: flows

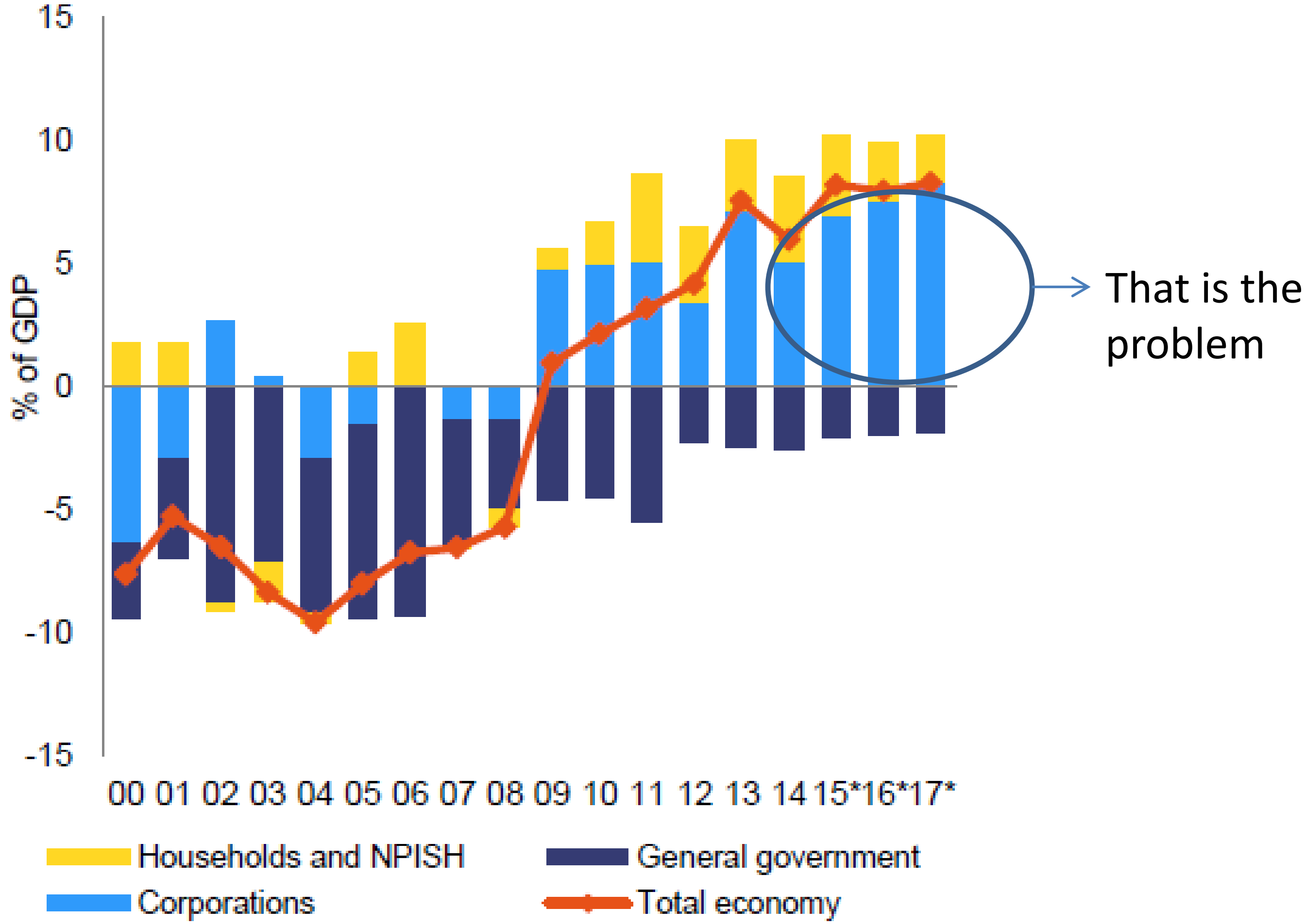
Current account and net lending in % of GDP

(The difference: EU capital transfers)



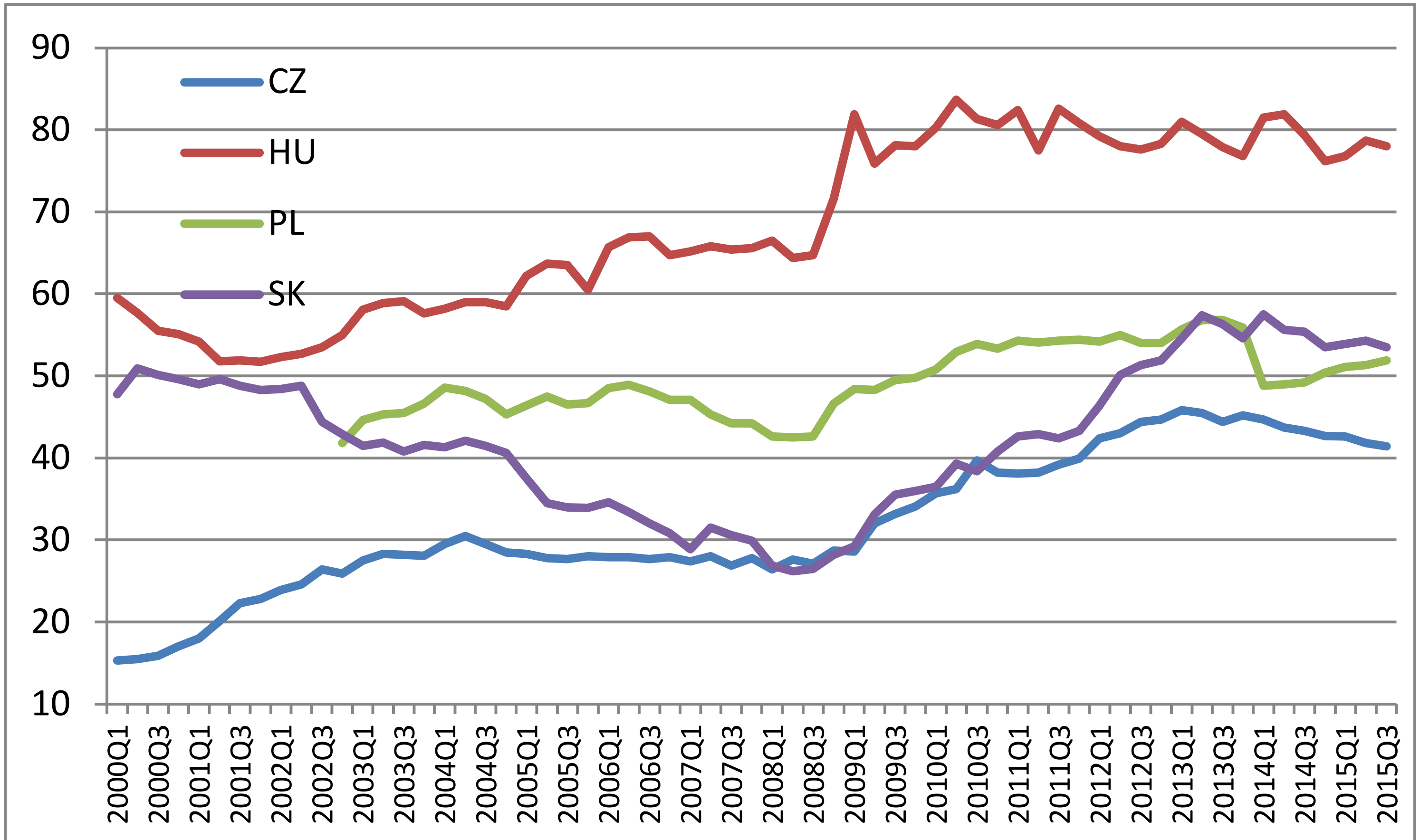
Gap between CA and net Lending (CA+KA): capital transfers from EU-funds 5,5%

Net lending from the domestic side
(S-I balance corrected for net capital transfers)

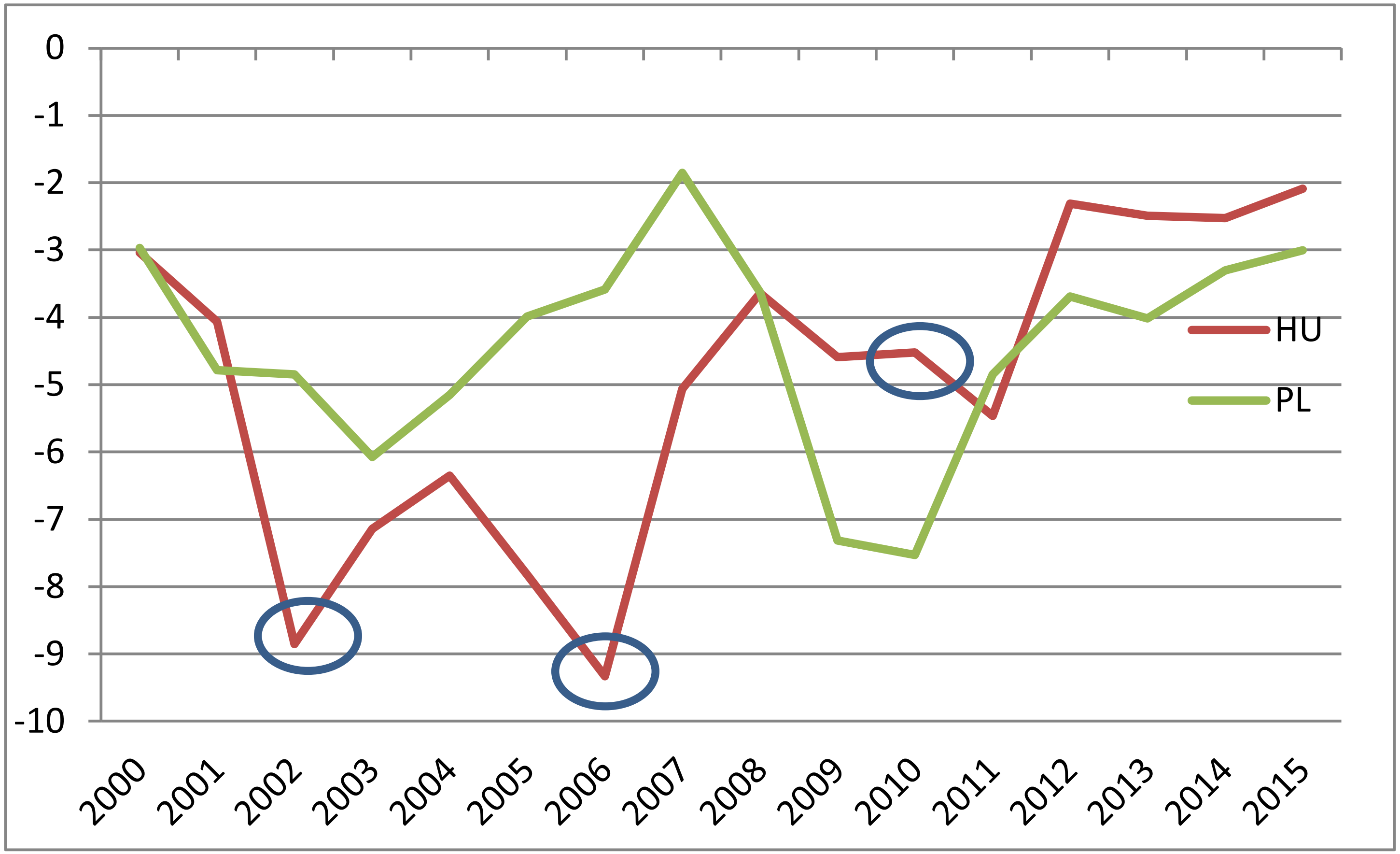


(1) NPISH: Non-profit institutions serving households

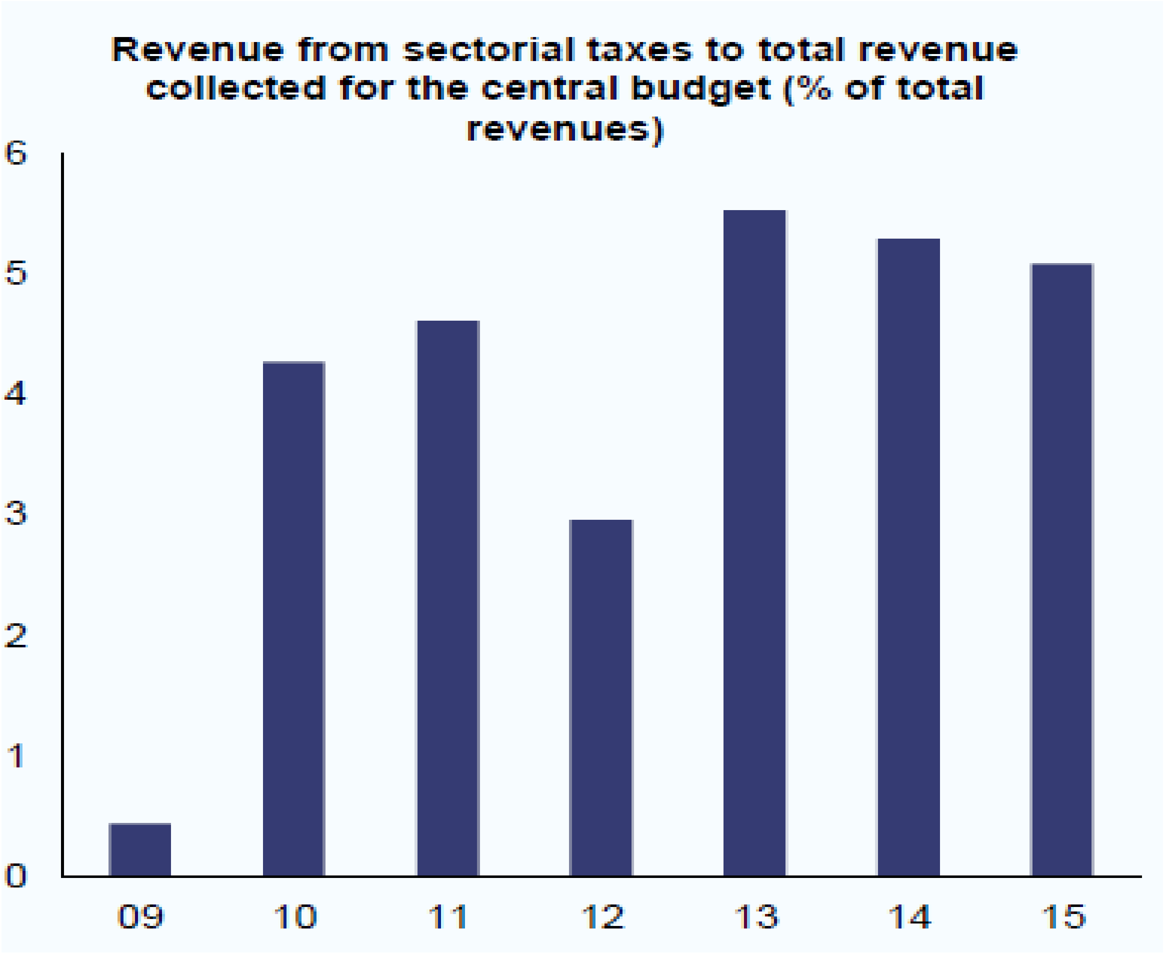
III/8.3. Public debt: slow decline (in spite of the seizure of private pension savings)



III/8.4. Internal (fiscal) balance: government net lending



The dependence of the budget on special/sectoral (= „unorthodox”) taxes



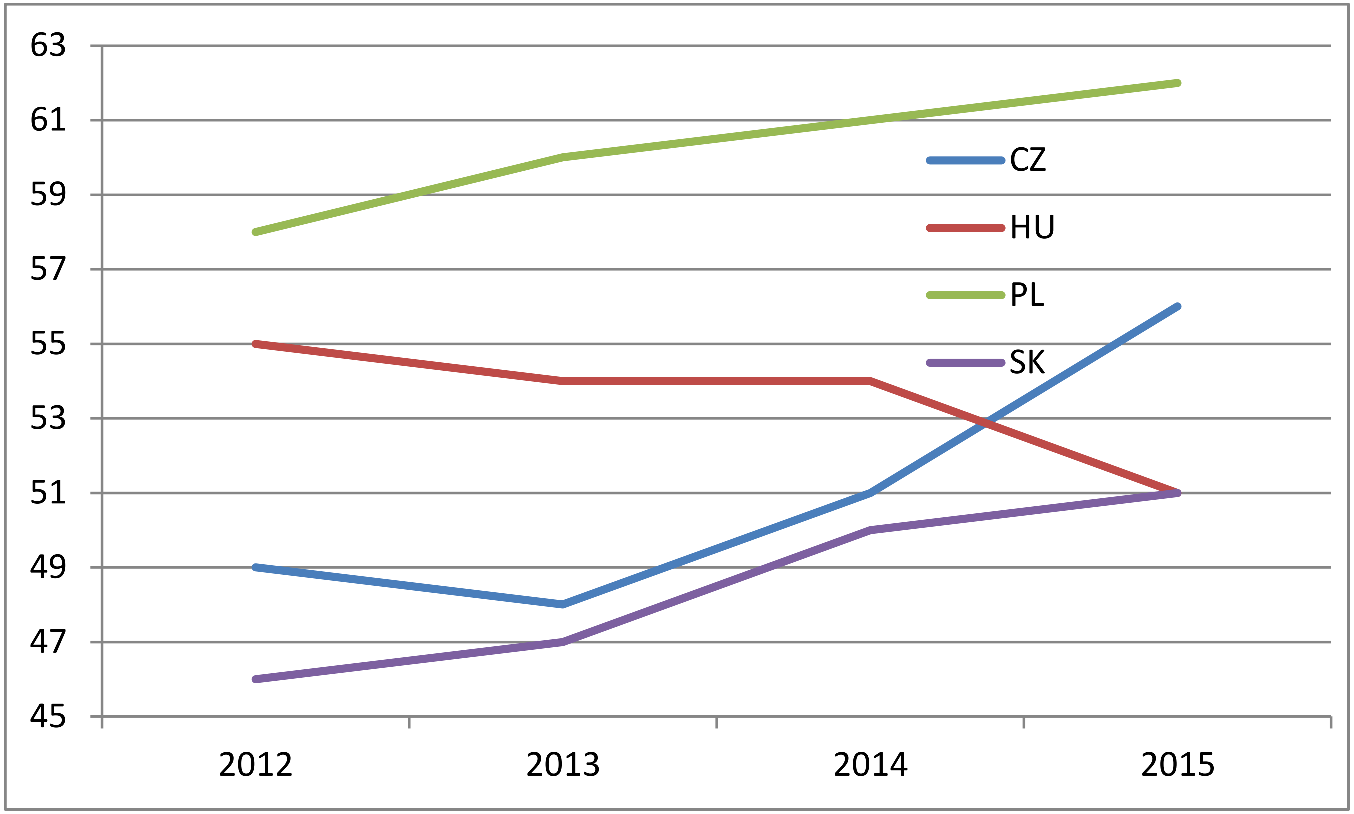
III/9. Institutions

- The „original sin”: the new Constitution („Fundamental Law” – 2010) states: the Constitutional Court cannot judge economic issues unless the debt/GDP ratio reaches 50% → never in my lifetime
- Quality of institutions: examples/illustrations

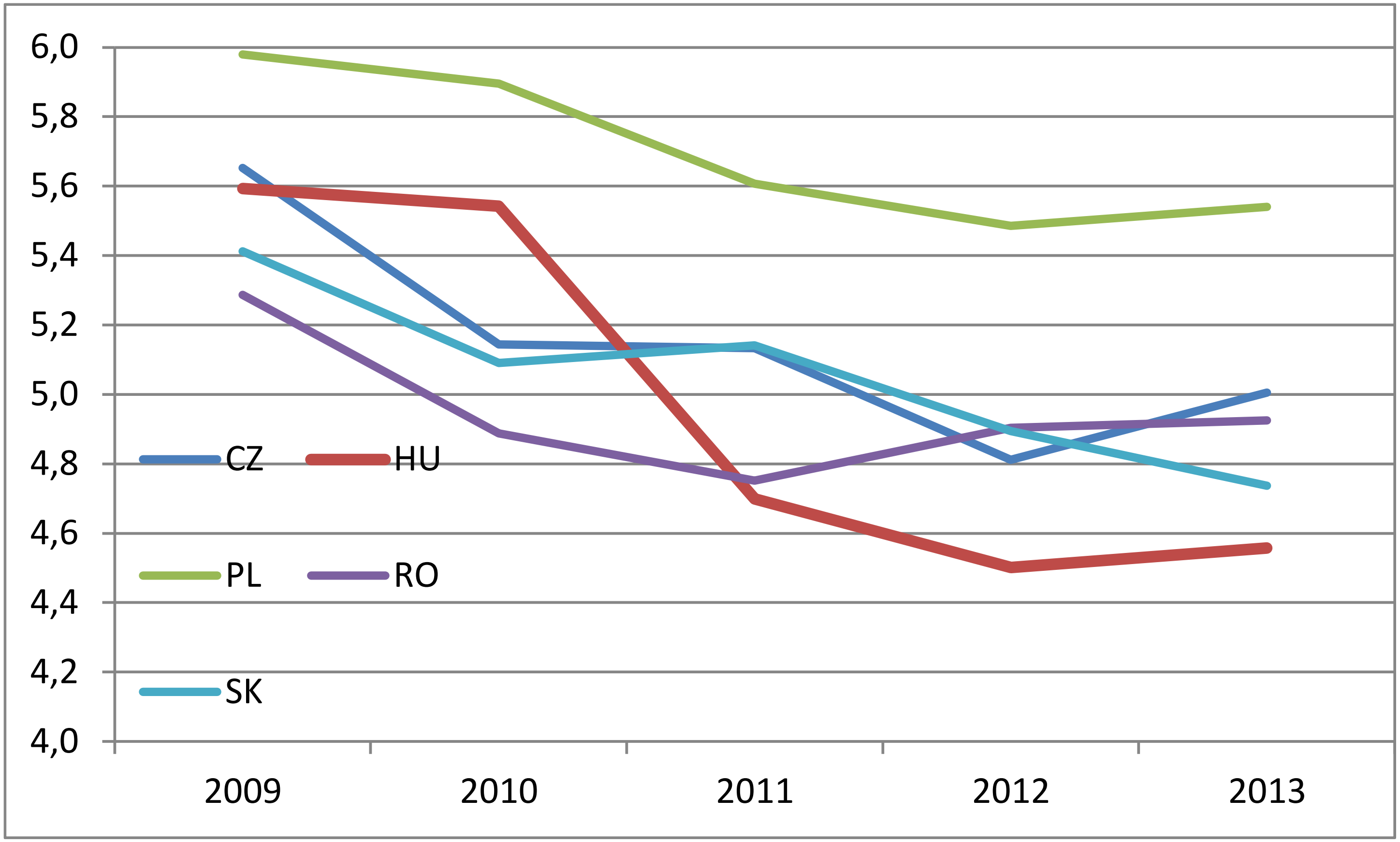
Quality of institutions: examples/illustrations

- Transparency International: corruption perception index: ***score*** (2012-2015)
- Economic freedom index: protection of property rights: ***score*** (2009-2013)
- World Economic Forum: Global Competitiveness Index ; institutions and some of its subcomponents: ***rank*** (2010 vs. 2015)

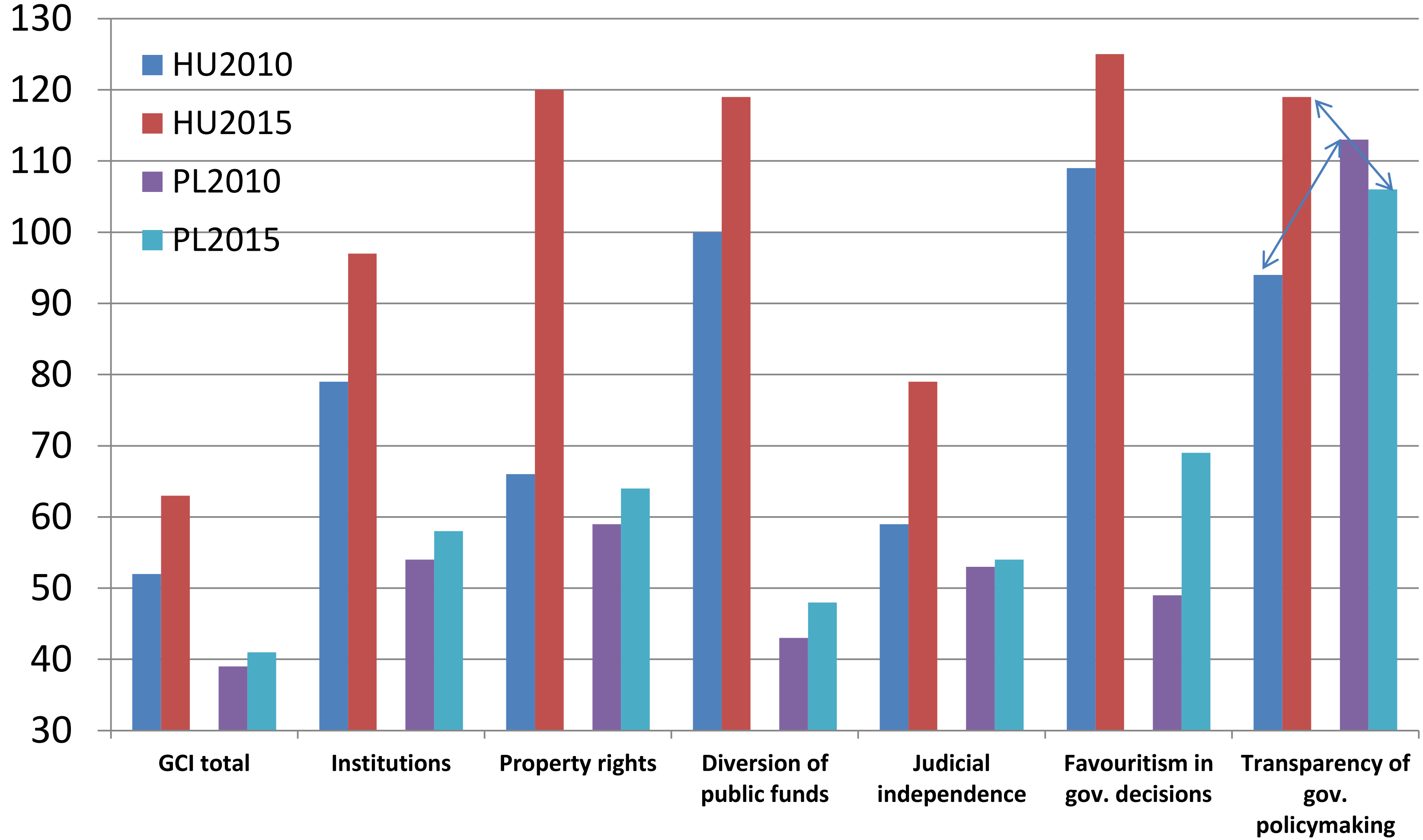
Transparency international: score of corruption perception index (the higher, the better)



Protection of property rights (2009-2013)
(Economic freedom index: the higher, the better)



WEF-GCI: overall **rank**, the rank in institutions and some important components: Hungary and Poland in 2010 (among 139) and in 2015 (among 140 countries) (The lower, the better)

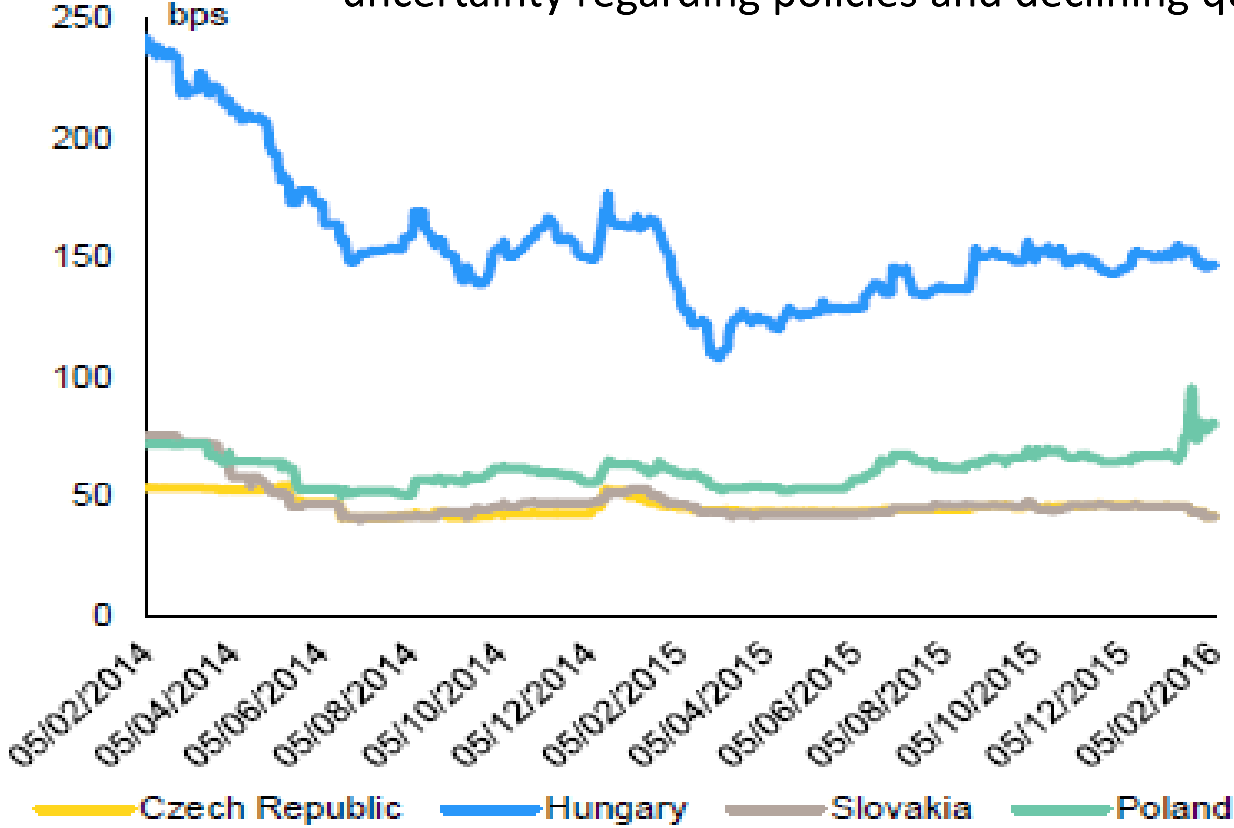


Regarding institutional quality: Hungary does ***not*** „perform better"

In this respect: Hungary's „reforms" do ***not*** work → consequence

5 year credit default swap (CDS) in Hungary and regional peers (between mid 2014 and early 2016 – in basis points)

In spite of declining public deficit and debt-ratio, HU's government bonds are considered significantly riskier than those of the V3. The reason: uncertainty regarding policies and declining quality of institutions.

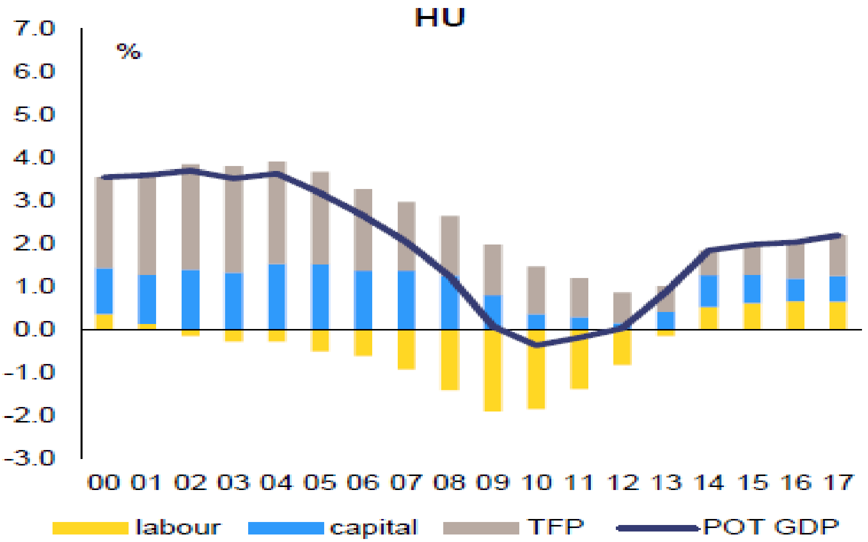


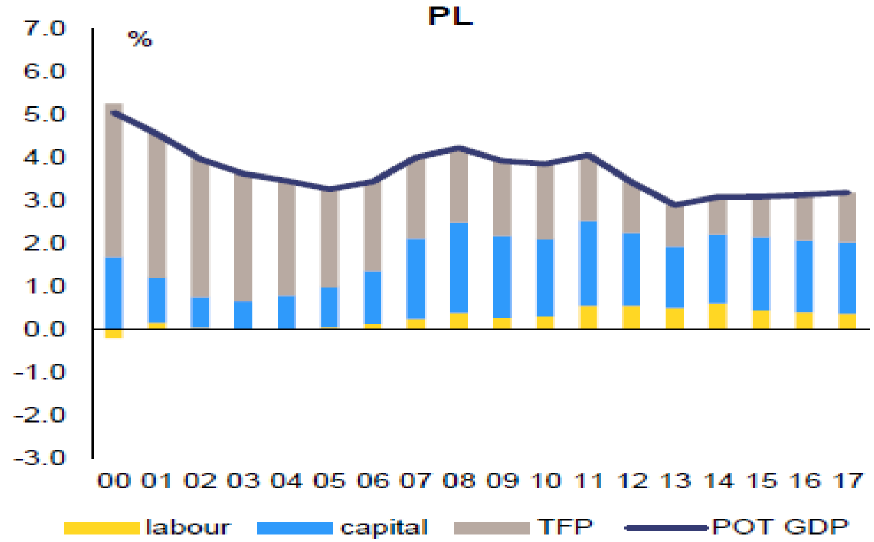
Source: Thomson Reuters

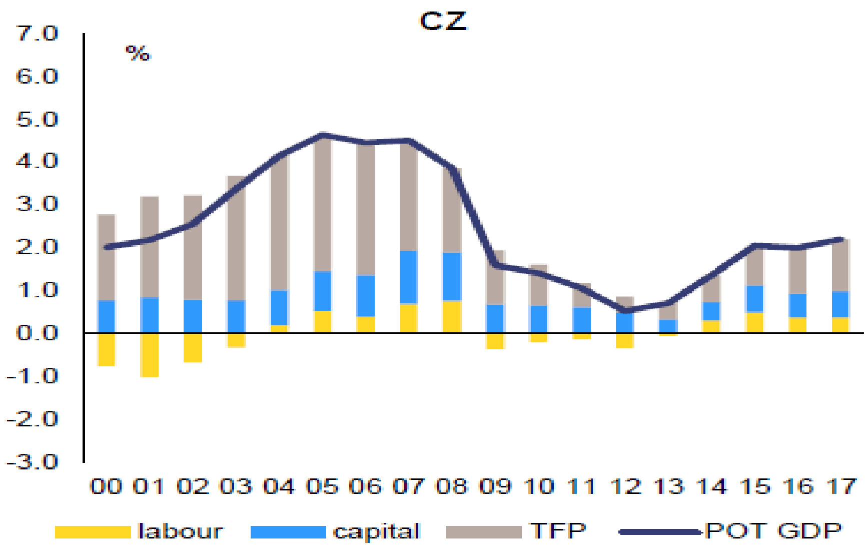
IV. Prospects

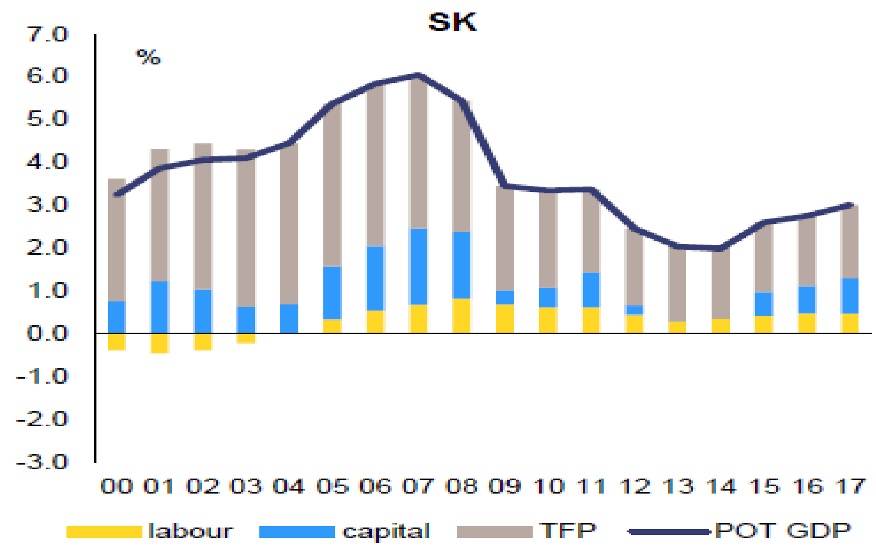
- EU Commission forecast
  - TFP-growth - small
  - Employment- small
  - Capital - small
- Potential growth: comparison with PL
- No policy change: very slow convergence to the EU15 average

Potential growth – the EU Commission's view









V. Summing up and conclusions (I)

- Following a prolonged period of economic decline and stagnation, Hungary's GDP-growth accelerated to 3.7% in 2014 and was close to 3% in 2015.
- The reasons for the country's economic performance over the last six years are only partly related to economic policies pursued since 2010.
- Deleveraging (the decrease in excessive debt both at the macroeconomic and microeconomic level) had a strong negative impact on Hungary's growth performance.
  - But strongly negative: flat tax, special taxes, etc.

Summing up and conclusions (II)

- However, the acceleration in 2014 is also mainly due to "exogenous" factors, in particular
  - the closing of the output gap (Appendix)
  - the exceptionally large transfers from EU-funds (additions to aggregate demand)

  which have nothing to do with the government's so called "unorthodox" economic policy.
- The deteriorating institutional environment of the economy, in turn, is a direct consequence of this policy →
  - Low investment rate
  - Outflow of labor and capital
  - Low TFP-growth

Summing up and conclusions (III)

- Without fundamental improvements in the
  - institutional environment and
  - the stability/predictability of economic policy,
  - (and other aspects: in particular, education)
- the country’s growth potential is expected to be rather low
- accompanied with continuing net outflow of labor and capital
- implying very slow convergence to the more affluent nations of the European Union

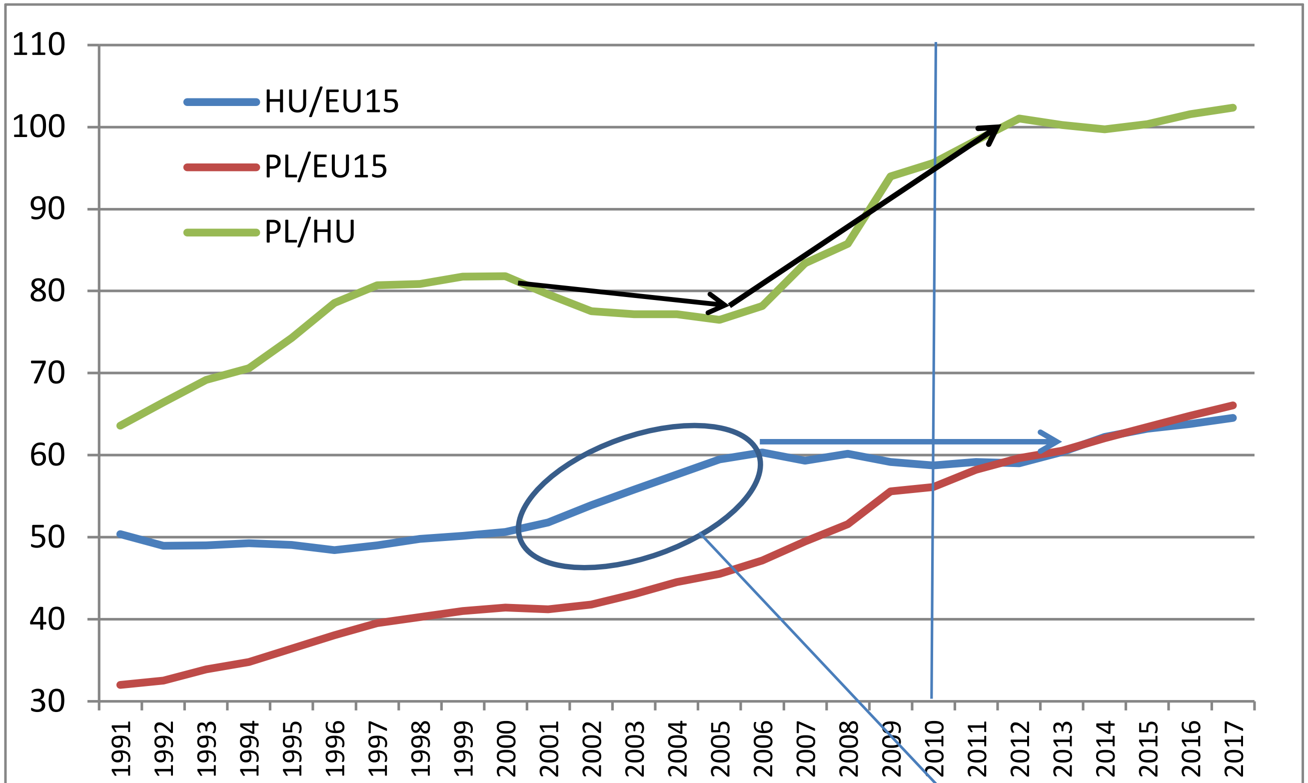
Thank you for your attention!

Appendix: complementary issues

- Comparison of HU’s and PL’s convergence dynamics (at constant PPPs)
- Output gap in HU (EU Commission estimates)
- FDI: reinvested earnings and FDI flows vs. stock-changes
- No. of employees in the business sector
- The dependence of the budget on sectoral taxes in % of GDP
- The contribution of gross exports to GDP growth
- Decline in net foreign debt (two interpretations)

Comparison over time: GDP/capita convergence to the EU15

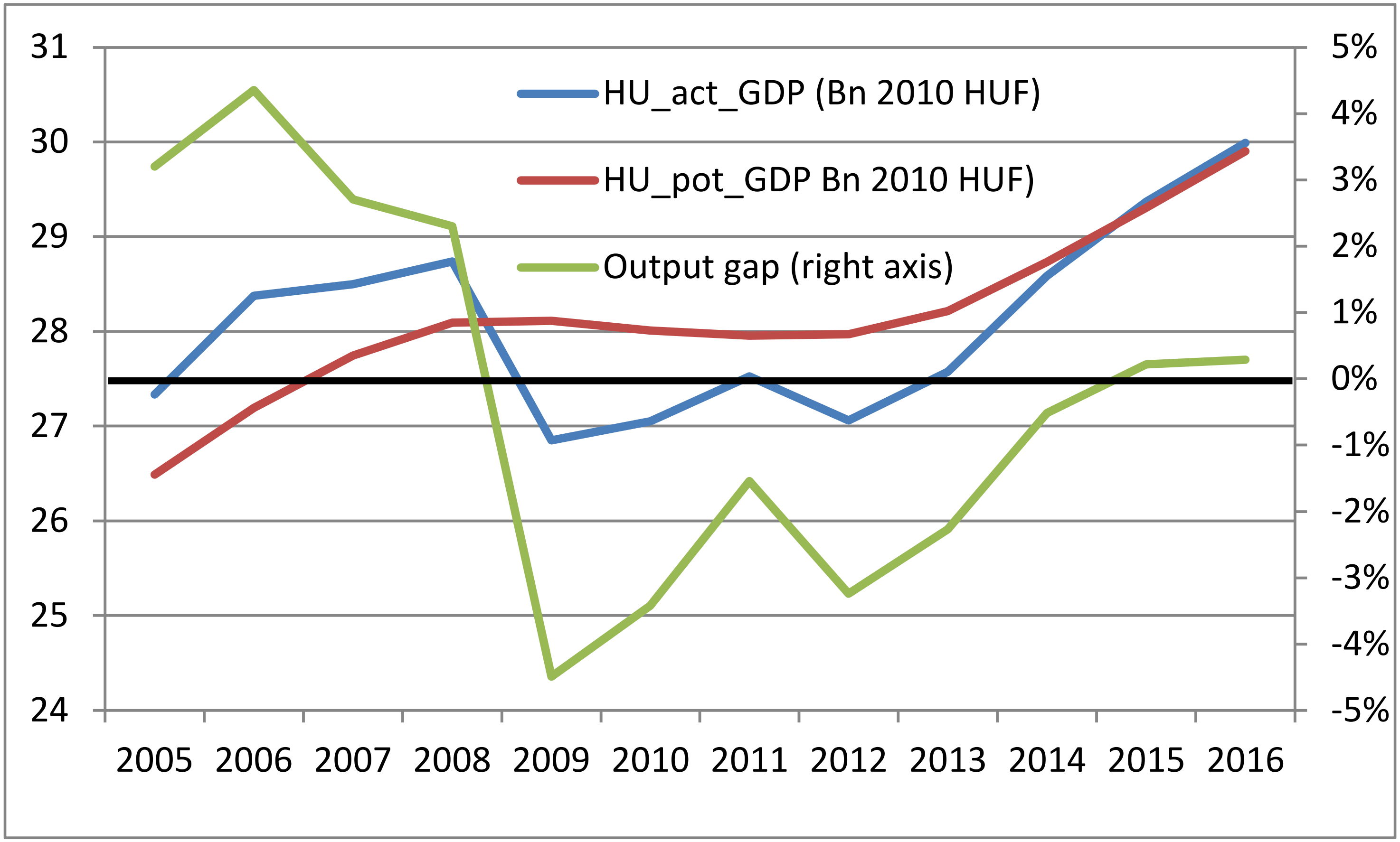
At constant PPPs and prices of 2010 (PL/HU: 60% change)



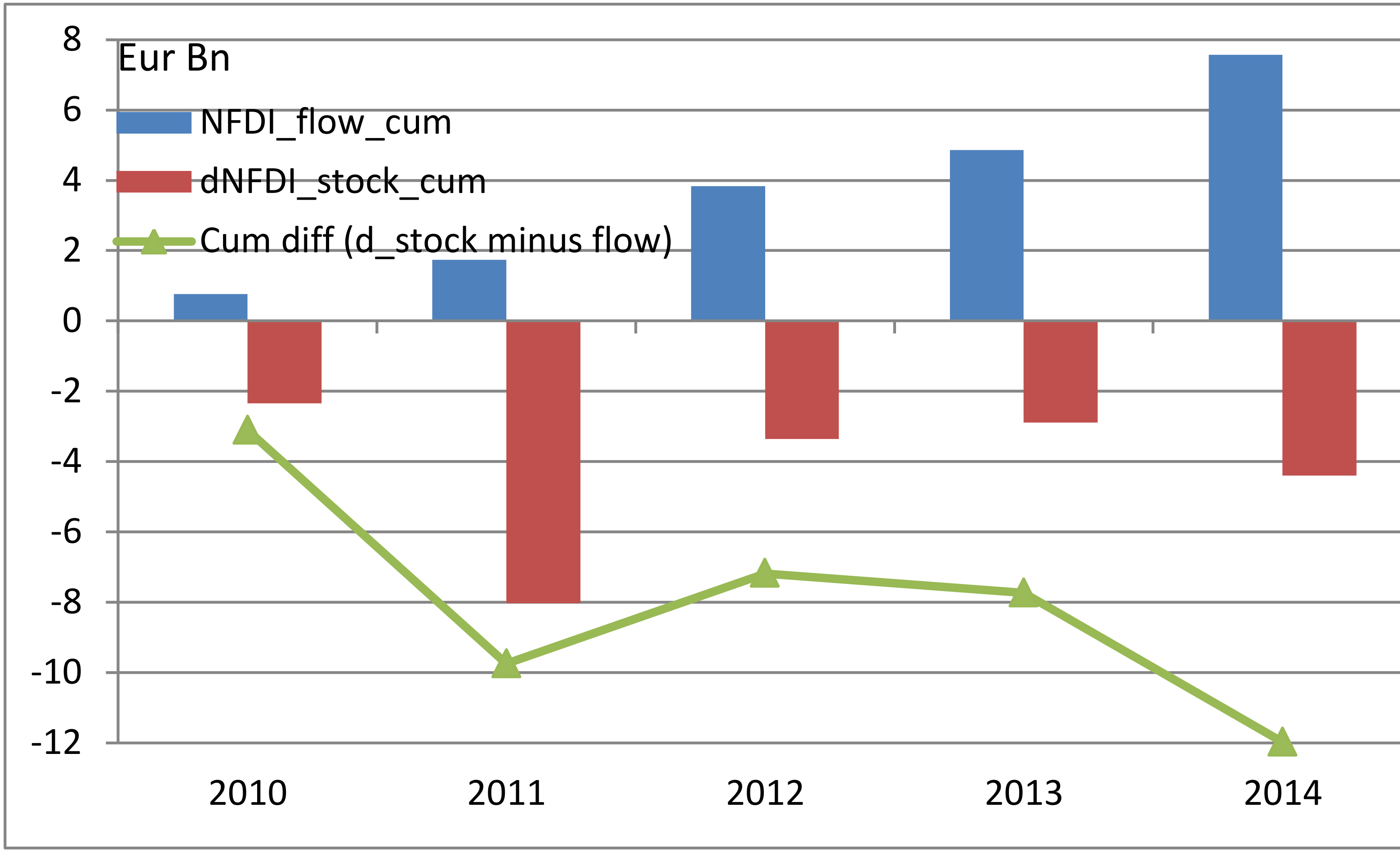
Between 2005 and 2013: HU vs. PL

Huge increase in public and private indebtedness

Actual and potential GDP (Bn 2010 HUF) and the output gap (actual in % of potential, left axis)

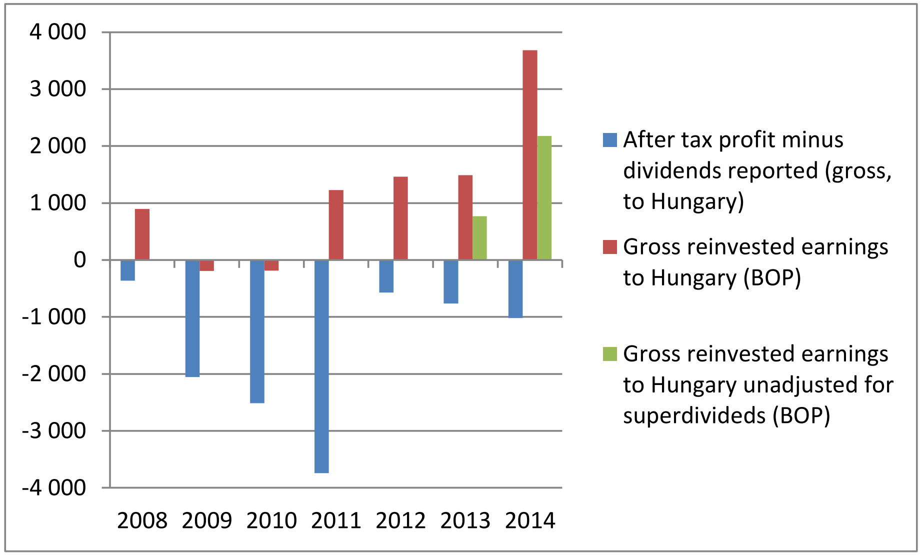


Net FDI: flows and changes in stocks
a large inflow accompanied by a cumulative decline in net stocks
(Eur BN)

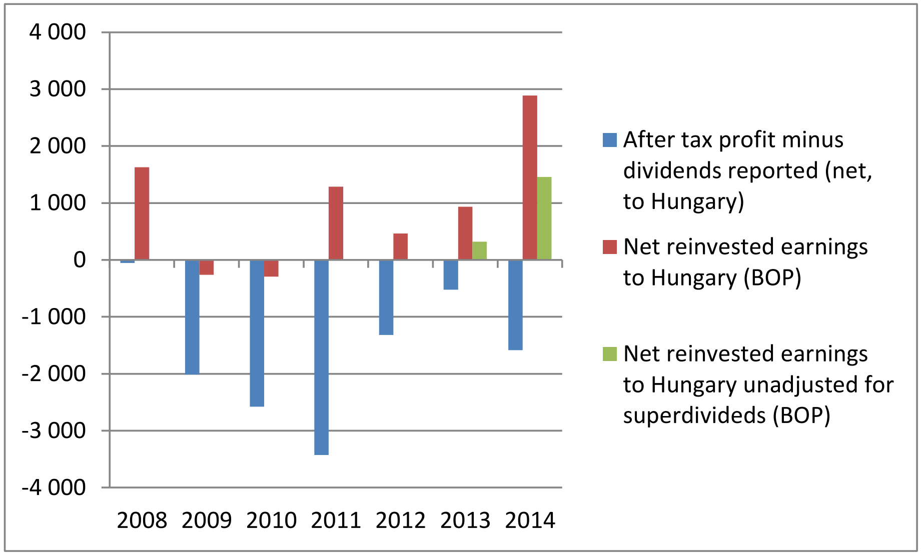


After tax profits minus dividends vs. reinvested earnings in BOP-statistics: gross and net (The fundamental effect of statistical corrections)

Gross (in HU) million EUR



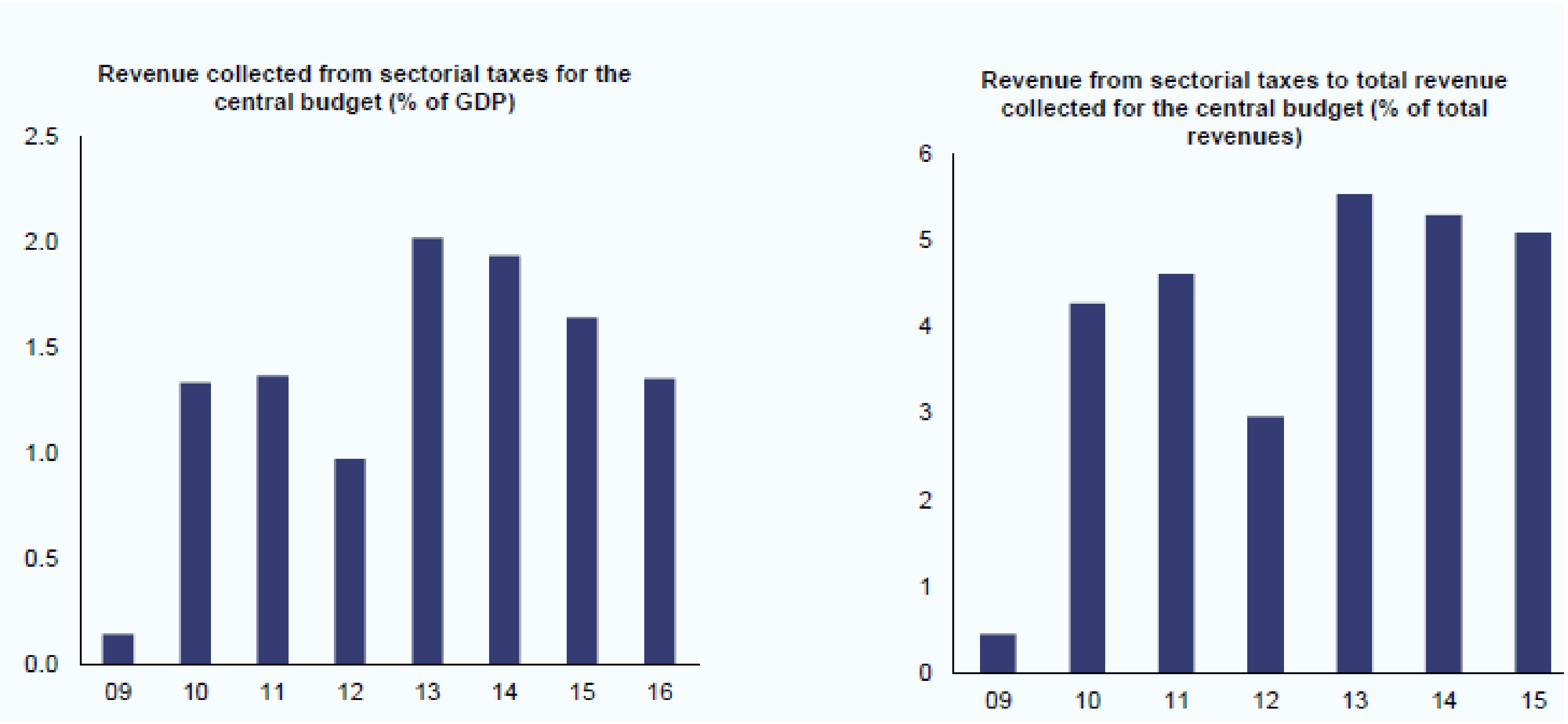
Net (in HU minus abroad), million EUR



No. of employees in the business sector:

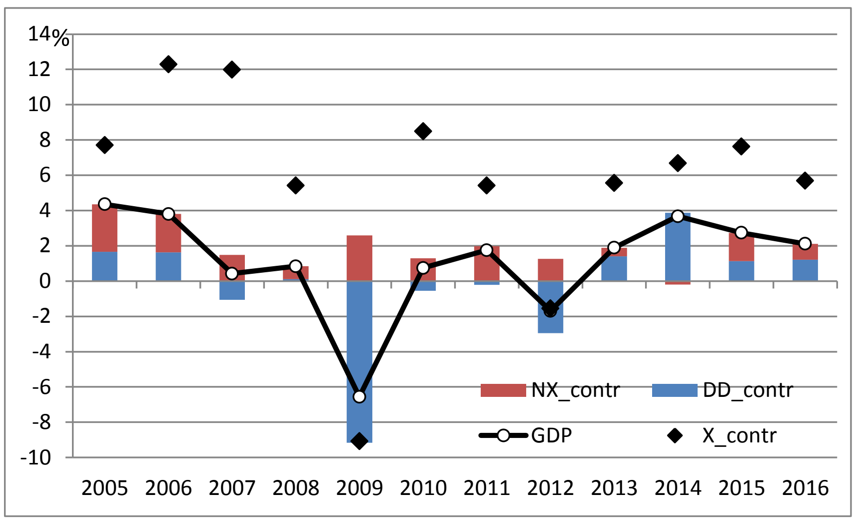
rapid growth in 2014 and 2015, but still below the level of 2008

The dependence of the budget on special/sectoral (= „unorthodox”) taxes

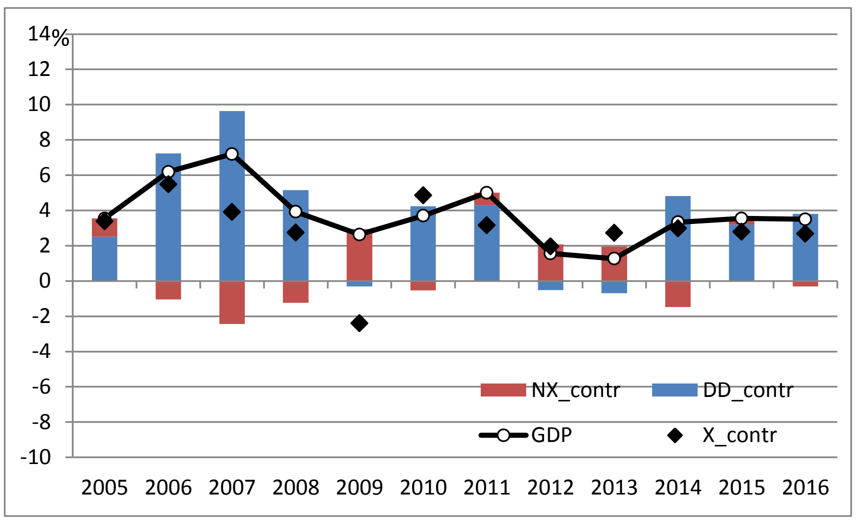


Annual contributions to GDP-growth: domestic demand (DD), net exports (NX) and the partial effect of gross export-growth

Hungary



Poland



Net foreign debt in % of GDP
Two interpretations for HU