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)

\[ y = -0.0219x + 0.2276 \]

\[ R^2 = 0.689 \]

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 $\rightarrow$ 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*

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<thead>
<tr>
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<th>HU</th>
<th>PL</th>
<th>SK</th>
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<tbody>
<tr>
<td>Net EU transfers 2010-14 (Bn EUR)</td>
<td>21</td>
<td>57,4</td>
<td>6,4</td>
</tr>
<tr>
<td>dGNI 2010-14 (Bn EUR)</td>
<td>11,6</td>
<td>92,2</td>
<td>10,4</td>
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<tr>
<td>Cum EU transfers/dGNI</td>
<td>181%</td>
<td>62%</td>
<td>62%</td>
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<tr>
<td>Average transfer/average GNI</td>
<td>4,4%</td>
<td>3,1%</td>
<td>1,8%</td>
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*/ 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
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)
Net lending from the domestic side (S-I balance corrected for net capital transfers)

That is the problem
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 $\rightarrow$ consequence
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.
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