Assessment and recommendations

Economic growth has slowed less than in other small OECD countries…

Growth in Hungary has averaged 4½ per cent since 1997, and was well maintained in 2001 at close to 4 per cent. The economy was hit by the international slowdown, with exports and private investment decelerating sharply. But this was largely offset by an aggressive fiscal loosening of nearly 2½ per cent of GDP and strong real wage growth of 8 per cent, which together stimulated public infrastructure building, housing and private consumption. Unemployment fell below 6 per cent, and the labour force remains fully employed in western Hungary and the Budapest area. Upward pressure on domestic prices has been strong, as reflected in inflation in non-tradables slightly above 10 per cent. But an appreciating currency has kept downward pressure on import prices and, helped by favourable food and energy price developments, led to a decline in headline inflation to below 7 per cent by the end of the year. The current account continued to improve, reflecting a significant increase in tourism revenues. The current account deficit – 2.1 per cent of GDP on a cash basis and 5.9 per cent on a transactions basis according to OECD estimations – was to a large extent financed by FDI inflows and reinvested earnings of foreign firms. The ratio of total gross external debt to GDP nonetheless remains at the relatively high level of 65 per cent.

… but labour market bottlenecks could increasingly constrain future growth possibilities

Beyond the decrease in the registered unemployment rate, there are signs of additional tensions in labour markets. In the past a skilled labour force available at internationally-competitive wages has been a major factor attracting foreign investment to Hungary, and an important incentive for domestic investment as well. Now the skills and profiles most demanded by businesses have fallen in short supply with the risk that potential growth will be constrained in the coming

years. Meanwhile, very low activity rates persist among the low-skilled segments of the working-age population. Within this group, older individuals in particular appear increasingly unable to re-enter the labour market at prevailing labour costs (which include regressive labour taxes). They are thereby withdrawing from the labour force, leaving Hungary with the lowest activity rate among OECD countries for low-skilled individuals. These developments create a divide between those who are actually employed and whose productivity increases rapidly, and the inactive. In the face of the resulting dual labour-market problem, upskilling efforts need to be intensified and policies should aim more resolutely at increasing demand for low-skilled workers, in particular by reducing the high burden of social security contributions.

Economic results should improve through 2002 and beyond

Looking forward, economic developments will reflect a re-balancing between the stimulus of international recovery and less dynamic domestic demand, leading to a broader-based growth. According to Secretariat projections, private investment and exports will remain weak in the first half of 2002 but will then respond to a recovery in foreign demand in the second half. At the same time, public infrastructure and government-sponsored housing investments may grow faster, as some funding earmarked for 2001 has been carried forward. However, with an increase in precautionary savings and less exuberant household borrowing following more cautious consumer sentiment, consumption should grow at a lower pace than in 2001. Overall, growth in 2002 may slow slightly to 3.5 per cent. Thereafter, scheduled general government deficit reductions indicate a welcome fading of the fiscal impulse. The emerging slack in the economy may be partly re-absorbed in 2003 in the course of an export driven recovery, with growth rising above 4 per cent somewhat higher than its estimated potential.

The main risk is that excessive wage growth in combination with a strong forint may endanger competitiveness

The main risk for future growth is likely to come from a possible overshooting in wage growth and an ensuing deterioration in competitiveness. Real wage growth in the competitive sector had reached 6½ per cent in 2001, following a 57 per cent increase in minimum wages, strong wage growth in the public sector, and high inflationary expectations in the first half of the year which led to high wage settlements.

Rapid wage growth may persist in 2002 because of a further increase in the minimum wage, and an expected 19 per cent increase in public sector wages. The latter is driven by the government's aim to achieve earnings parity between public and private-sector workers with comparable educational backgrounds within the short time span remaining in the current electoral cycle. Private-sector wage increases may be less rapid than in 2001 but overall wage growth, combined with exchange rate appreciation, may well raise previously unknown competitiveness challenges. In 2001, the net outcome of large wage increases, nominal exchange-rate appreciation and the somewhat-offsetting reduction of social-security contribution rates was an appreciation of the real exchange rate based on unit labour costs of close to 9 per cent. Even if this should be seen in relation to the earlier much larger real depreciation (of more than 50 per cent between 1994 and 2000), Hungarian producers might face rising competitive pressures on both their domestic and export markets. The resulting risks to both exports and business investment may affect GDP growth negatively.

Monetary policy is on track towards a credible inflation targeting regime...

A new monetary regime has been in place since mid-2001. The crawling peg was abandoned and the forint now fluctuates in a wider band, permitting monetary policy to tighten according to ambitious disinflation objectives. The regime change is part of a declared policy of participating in the European Monetary Union as early as possible after EU accession. The early disinflation record of the new regime has been encouraging, as the target for headline inflation of 7±1 per cent by the end of the year 2001 was reached with ease. The currency promptly appreciated and fluctuated between 7 and 11 per cent above its central parity in the second half of 2001, reinforcing the passthrough of international price deceleration. However, domestic price pressures remained strong, and inflation in non-tradables stayed at a yearly average of 11 per cent. The Central Bank has been successful in developing its communication strategy and began to make progress in altering markets' inflationary expectations in line with its objectives. Future inflation targets are ambitious – a band of ±1 per cent around 4.5 per cent at end-2002 and 3.5 per cent at end-2003. Latent wage pressures, price effects related to the productivity catch-up

(the Balassa-Samuelson effect, calculated at 1-2 per cent over EU trade partners' inflation) and expected inflationary effects of the international recovery may require monetary tightening in 2002 and beyond.

… requiring a strict implementation of budgetary consolidation targets

For such tightening to remain as moderate as possible and avoid a too strong exchange rate appreciation, which would hamper growth, a prudent fiscal policy will be required. In the circumstances of the international slowdown and of the electoral cycle (with general elections in April and country-wide municipal elections in autumn 2002), budget stimulus reached 2½ per cent of GDP in 2001, raising the SNA-compatible budget deficit estimated by the OECD to above 5 per cent of GDP; an additional loosening equivalent to 0.7 per cent of GDP is expected in 2002. It will be important not to allow any further loosening during the execution of this budget. The fiscal stance should then tighten in 2003 along the lines indicated in the medium-term economic programme submitted to the European Commission. Sticking strictly to the announced budgetary objectives of the pre-accession programme would avoid a costly tension between fiscal and monetary policies. Achieving fiscal consolidation should be helped by the broad stabilisation of public debt (at below 60 per cent of GDP) and the associated implications for debt servicing, but it will also require a reduction of primary expenditures, projected to decrease from 44.2 per cent of GDP in 2001 to 41.5 per cent in 2004. It is important that these consolidation plans are met.

Public expenditure and taxes need to be trimmed back

The fulfilment of the scheduled short and medium-term fiscal objectives, as well as longer-term tax and expenditure reduction policies, requires a thorough reform of public spending. Longer-term spending reduction is important, as the high tax pressure at 39 per cent of GDP (2001) may hamper potential growth while similarly high labour taxes need to be reduced further to increase labour market participation and employment. However, such a reduction will present a real challenge: substantial new spending on infrastructure, public health, education and environment protection is implied by national priorities and EU accession rules, so that the room for such items has to be provided by curtailing spending more forcefully in other parts of the budget.

The required public expenditure reform will necessitate more explicit medium-term spending priorities, better and internationally-comparable indicators of the fiscal stance, the containment of off-budget spending by quasi-fiscal institutions, and improved efficiency in the supply of public services.

Effective multi-year expenditure ceilings should be imposed

The competing and growing claims on public resources, notably from the emerging spending areas reflecting the new priorities outlined above, complicate the implementation of fiscal restraint. Following the experience of other OECD countries, firm multi-year expenditure ceilings based on cautious growth and inflation projections should provide useful hard-budget constraints to deal with this risky budget situation. Medium-term fiscal priorities declared at the beginning of each legislature and delineating multi-year spending frameworks should be set and followed through so as to give the necessary credibility to such expenditure ceilings. Their sustainability will depend crucially on effective reforms of individual spending programmes to improve efficiency.

The fiscal stance should be monitored according to international standards

Important progress has been achieved in the modernisation of fiscal management but the accounting basis for the monitoring of general government accounts should be improved. Ongoing efforts to develop accruals based accounting in line with ESA95 norms should be accelerated and completed, and these standards should be used not only in co-operating with EU and international partners, but also in the domestic – notably parliamentary – monitoring of the fiscal stance. Furthermore, spending by off-budget institutions should be more accurately reflected in government accounts, reflecting common understandings with and guidance by international bodies (EUROSTAT re-emphasised recently the need to include road building expenditures in the general government budget). Debts and loan guarantees of off-budget institutions should be monitored closely, and the ongoing efforts for a better measurement of public debt should be completed by including off-budget liabilities in the government accounts.

Off-budget spending should be contained

Quasi-fiscal institutions, whose borrowing and spending are very imperfectly reflected in the general government accounts, play a growing role in public finances. The Hungarian

Development Bank (MFB) has been in charge of road construction financing and some other schemes of the national economic plan ("Szechenyi Plan"), while the National Privatisation and State Holding Corporation (APV) owns and exerts shareholder rights in 162 government-controlled companies. There are also smaller but numerous municipal holding companies, which play quasi-fiscal roles at the local level. The remaining state-owned corporations with policy-driven rather than profit-making objectives should also be considered as quasi-fiscal institutions. Taken together, these bodies represent a large share of public resources, total yearly expenditures of MFB, APV and MAV (the Hungarian State Railway Company) amounting currently to more than one-third of central government expenditures. The policy-driven activities of these institutions need to be delineated clearly and consolidated with general government accounts. Institutions carrying out off-budget activities, including their subsidiaries, should be subjected to rigorous financial control and their procurement programmes should be opened to competitive bidding. At the same time, in recognition of the long-term character of their investments, they should enjoy the necessary long-term planning and funding horizons in the context of explicit national priorities and related multi-yearly budgetary frameworks.

The efficiency of service supply should be enhanced by intergovernmental reform

The structure of public service supply, which is a major consumer of budgetary resources, should also be improved. At present public services, including technically demanding health and education services, are provided in highly fragmented ways by a large number of local governments. The separation of central funding and local execution of services reflects efforts to promote local democracy. Funding mechanisms are based on objective criteria and are transparent, but the service supply system is hampered by organisational inertia. Over-staffing and low technical efficiency in the supply of these services are the main problems and it is desirable to reassess the suitability of the existing degree of fragmentation in their provision. The responsibility for some of these services can be consolidated at an intermediate level between central and local governments, with comparative benchmarks gauging the efficiency of services, and – when

possible – competition introduced between supply units. Central government funding should be provided on the basis of more demanding reviews of the efficiency of services and the State Audit Office should be better equipped to cater to this need.

Speeding up convergence makes continued structural reforms necessary

Hungary has narrowed the living standards gap separating it from more advanced economies, moving from 47 to 52 per cent of the OECD average per capita GDP from 1996 to 2001. To sustain and indeed speed up this convergence process, it will be necessary to pursue structural reforms in a number of areas. To consolidate progress in establishing a competitive market-based economy, the authorities ought to divest the remaining state holdings of productive assets more resolutely than in recent years. In this context there is no justification for listing 93 entities as strategic. The government should legislate measures to reduce this list and should in any case act to sell off the portfolio of strategic stakes in diverse firms to the minimum levels stipulated by the law as soon as possible.

Having established a strong FDI sector, the focus should now be on improving the employment potential of SMEs

Hungary attracted considerable inflows of foreign direct investment over the last decade, resulting in the creation of a competitive and dynamic economy. To broaden the growth-enhancing effects of foreign investment, the authorities started to implement a programme providing considerable assistance to the medium-sized and small enterprises (SMEs) in the framework of the Szechenyi Plan. While this policy improved the access of domestically-controlled businesses to credit and know-how, the same businesses were hit hard by the doubling of the minimum wage mentioned above. The authorities responded by cutting social-security contribution rates and developing a special scheme to allocate wage subsidies to businesses whose wage costs were increased most by the higher statutory wage minima. At the same time, however, the flat-rate health charge was increased, inflating the cost of unskilled labour. Specific initiatives for SMEs are unlikely to yield good results if the framework conditions for this development are adverse. The authorities ought to set the employers' costs of minimum wages such that they do not have significant adverse effects on the demand for low-skilled

labour. Abolishing the flat-rate health charge would be a timely first step – this measure could be financed by cutting other subsidy programmes.

Increasing labour force participation is the main task for further labour market reforms

Ten years ago, Hungary's labour force participation was comparable to that of the United States, exceeding the OECD average. Subsequently, the authorities responded to rising unemployment associated with market-based restructuring by creating a comprehensive system of early retirement, light-disability and welfare benefits that reduced the labour force participation rate to well below the OECD average by the mid-1990s. Despite a considerable tightening of access to welfare benefits in recent years, the marginal improvement in the participation rate observed in the late 1990s appears to have stopped in 2001. Given the still considerable number of early retirees and disability benefit recipients, the authorities ought to review these benefits and rationalise access, removing actuarial distortions which favour early retirement and emphasising rehabilitation rather than passive treatment of disabilities. The abolition of the tax clawback reducing the take-home pay of working retirees is a welcome development that has increased the incentives to remain in the labour force. A more general strategy of reducing taxes on labour would improve employment-increasing incentives.

Challenges related to the Roma minority are rooted in low employability and activity rates

A specific and rather difficult policy challenge is posed by the objective to improve living conditions of the country's historically disadvantaged Roma population. Despite ongoing government efforts, this group continues to be characterised by substandard educational, health and labour-market achievements. Policies promoting the advance of this ethnic minority may need to be better co-ordinated and target the employability and activity rate of working-age individuals. Measures stressing human capital formation and facilitating workers' access to growing local labour markets (including via measures improving housing and transportation opportunities and costs) may be useful. In this difficult area, all policies should be regularly re-evaluated and public resources should be concentrated on the most effective programmes.

Recent moves may endanger the long-term sustainability of the pension system

Hungary reformed its pension system in 1998, introducing a system combining a PAYG pillar and a fully-funded mandatory second pillar consisting of privately-operated pension funds. Last year the government modified key parameters of this reform, abolishing the mandatory nature of the second pillar, withdrawing the state guarantee of a minimum annuity generated on individual retirement accounts and refusing to increase the contribution rates to such accounts according to the original reform plan. At the same time, the government has announced that it intends to modernise the existing PAYG system, making it more attractive to all workers. These measures trade off a short-run cash flow gain against long-term liabilities. Given the importance attached to the long-run sustainability of the public pension system, these moves ought to be reconsidered by the authorities.

Network industries have been liberalised and should be further opened to effective competition,…

The government pushed forward liberalisation of network industries, adopting new legislation governing the telecom, gas and electricity sectors. The progress in the telecom sector is impressive and international best-practice standards are already being implemented – although impacts on tariffs are not yet fully visible. However, the opening of the energy sectors will be more gradual. The electricity and gas sectors will experience partial liberalisation following EU Directives, starting in 2003. The situation in the gas sector is worrisome with the government proposing to purchase the gas production and transportation network from the dominant privately-owned energy group and let the current artificially low household prices approach the market level over a number of years. This contradicts the previous achievements of the privatisation process and regulatory reform. The authorities are encouraged to reconsider such regressive moves and resume the liberalisation agenda.

… which has to be supervised by competent regulators

For liberalisation of network industries to be effective, there is an urgent need for regulators who are both competent and independent. In the telecommunication sector, the authorities established aregulatory framework and equipped the supervisors with the tools needed to do the job adequately in the context of relatively rapid liberalisation.

In the not yet liberalised energy sector, the situation is more complicated. Although recent legislation improves the status of the Hungarian Energy Office, the final price-setting authority remains with the government. The authorities are encouraged to transfer politically-sensitive pricing decisions to the independent regulators.

To sum up

Hungarian structural reforms have permitted an impressive catching up with living standards in more advanced OECD member countries. Sustaining the convergence process will require both further structural reforms, including in particular addressing the low labour force participation rate, and appropriate macroeconomic policies. The economy outperformed most of the other countries during the recent slowdown largely due to a strong fiscal impulse and rapidly growing private consumption expenditure. Looking forward, it will be crucial for fiscal policy to return to the announced consolidation path. This aims at reducing primary expenditures by almost 3 percentage points of GDP by 2004. Achieving this target is necessary to avoid a costly confrontation with monetary policy, which aims for a relatively rapid disinflation over the same period in order to ensure an early entry into EMU. The intended fiscal consolidation is unlikely to be realised without a deepening public expenditure reform entailing a medium term budgeting framework with credible expenditure ceilings. It should also promote increased use of performance budgeting, benchmarking and other quality control mechanisms. Reforming public service provision, especially in the case of education and health care, can be expected to improve human capital with positive consequences for long-term growth. The reform agenda should notably aim to reverse the recent expansion of off-budget activities. The decision to widen the PAYG pillar of the pension system has changed key parameters of the pension reform and should be reconsidered in order to maintain the long-term sustainability of the public pension system. The high growth rates necessary for a rapid catch-up to average EU income levels will require both high trend productivity growth and increased labour force participation. This will only be possible if structural reform and liberalisation pick up again. Privatisation of the remaining state enterprises should be completed and the liberalisation of

the energy sector should be accelerated. Labour market policies need to focus on increasing the low participation rate which threatens to impose a speed limit on growth and aggravate economic and social inequality. Progress along these lines will significantly contribute to achieving the ambitious goals set by the authorities for the Hungarian economy.