Erzsébet Gém

Development of Internal Demand and Bank Lending

SUMMARY: The study discusses the unique features of the growth of the Hungarian economy, the weakness and lack of internal demand, and the lending activities of banks in that context. Although recovery from the economic crisis has been ongoing for more than a year in Hungary, growth has been almost exclusively driven by the processing industries producing for (predominantly German) exports, and by net exports on the absorption side of the GDP, while domestic demand has failed to pick up to this date. This specific feature of growth reflects the dual structure of the Hungarian economy: the isolated coexistence of the Hungarian subsidiaries of mostly large multinational corporations tied into the fabric of international commodity and services trade, and of the mostly non-exporting micro-, small and medium-sized enterprises; the rudimentary (or completely missing) supply and services relations between them; and the resulting smaller-than-necessary scope of the positive (economic, technological, and welfare) impacts of large multinational corporations operating in Hungary.

KEY WORDS: economic growth, domestic demand, bank lending
JEL CODES: F43, G2, E5, F3

Economic recovery in Hungary started three to six months later than in most European countries, and Hungary, with its 1.2% rate of growth in 2010, ranked in the middle of the European pack. The economic growth in former Eastern Bloc countries accessing the EU as part of the 2004 enlargement was much more accelerated last year than Hungary's. By the end of last year, however, growth had slowed down in every European country, and in the first half of 2011, the growth rates of the countries of the region started to converge. *(See Chart 1)*

At the beginning of recovery from the crisis, growth in most European countries was driven by exports related to dynamically expanding international trade, mostly to developing countries. However, in euro area countries (except in the PIIGS countries hit by the debt crisis, with no growth to date), the components of domestic demand started showing signs of picking up as early as the beginning of 2010: the volume of investment projects grew by 1.9%, whereas consumption rose by 1.2% per annum, domestic demand becoming the main driver of growth this year. By contrast, domestic demand took longer to recover in the V4 countries. Investments only started to pick up this year after last year's stagnation, whereas domestic demand is still increasing only at rates below 1%.

The nature of Hungarian growth is unique in comparison with countries in the region: growth is still solely driven by exports of the processing industry to supply Germany's exports to Asia and China in particular, whereas domestic demand continues to contract. Household consumption is once again on a course of moderate contraction or stagnation after a temporary growth spurt in the third quarter of last year. Household consumption has not factored into economic growth since

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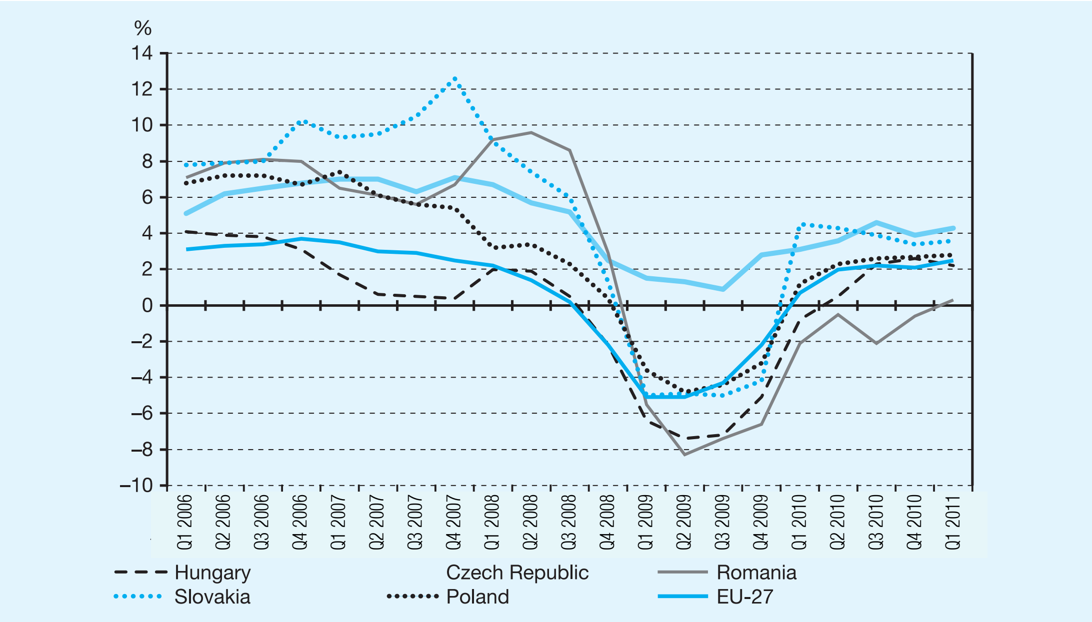
Chart 1

GDP GROWTH* IN THE EUROPEAN UNION AND IN CENTRAL AND EASTERN EUROPE (YEAR/YEAR)



* seasonally adjusted data

Source: Eurostat

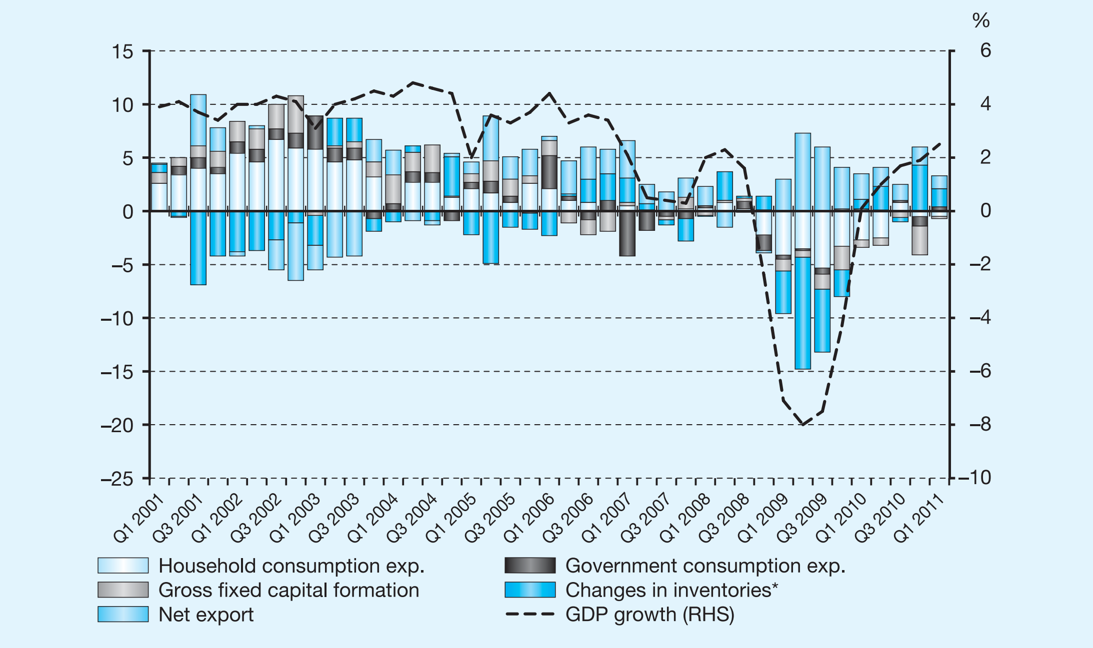
the first quarter of 2006. Investments are not much different: their volume dropped in both 2010 and 2011. As this has been a tendency since 2006 with minor interruptions, investments have now become more of an obstacle to growth. *(See Chart 2)*

The inadequacy of domestic demand is further underscored by the weak growth capabilities of service industries supplying the domestic market: apart from the export-geared processing industry, which quickly rebounded after the crisis, only transport was able to grow on account of its ability to take advantage of an increase in export related transport demand. For the first time since the crisis, trade made a moderate contribution to GDP growth in the first quarter of this year. At the same time, crisis continues in the construction industry, ongoing since 2006 (this April, the rate of contraction was close to 10% year on year), and domestic industrial sales were still considerably lower at the beginning of this year than a year earlier. *(See Chart 3)*

Labour market processes also underscore that growth hinges on a single prong: although the unemployment rate has been on a moderate decline, the number of employed persons in the private sector only increased, until 2010, in the subsectors of the processing industry which supply German exports, and that is also where most of the improvement has been seen this year. This year has already produced slightly improving employment figures in trade, commercial accommodation establishments and financial services; however, this growth is much more constrained than in the processing industry. After a dramatic fall, employment continues to dwindle in the construction industry: in the major domestic production sectors (trade and construction), the number of employed persons is still 90,000 less than at the beginning of 2008. *(See Chart 4)* A half of all new jobs

Chart 2

CONTRIBUTIONS OF THE MAIN COMPONENTS OF THE HUNGARIAN GDP TO GROWTH



* including statistical deviation

Source: MNB, CSO

Chart 3

GROSS ADDED VALUE OF THE MAIN SECTORS

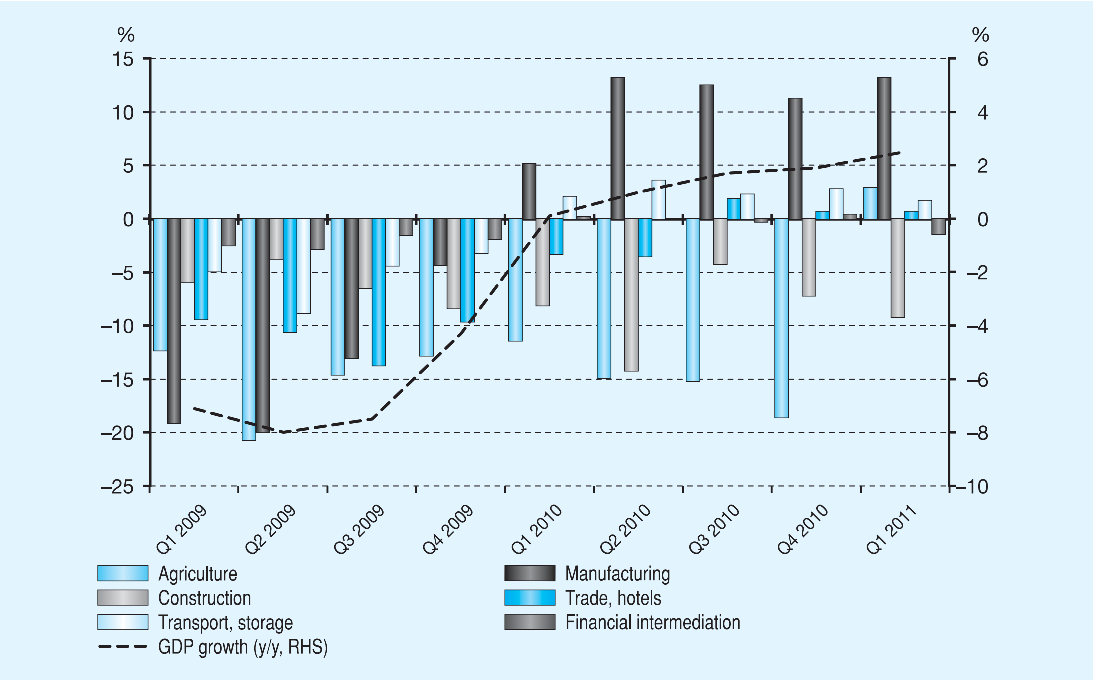
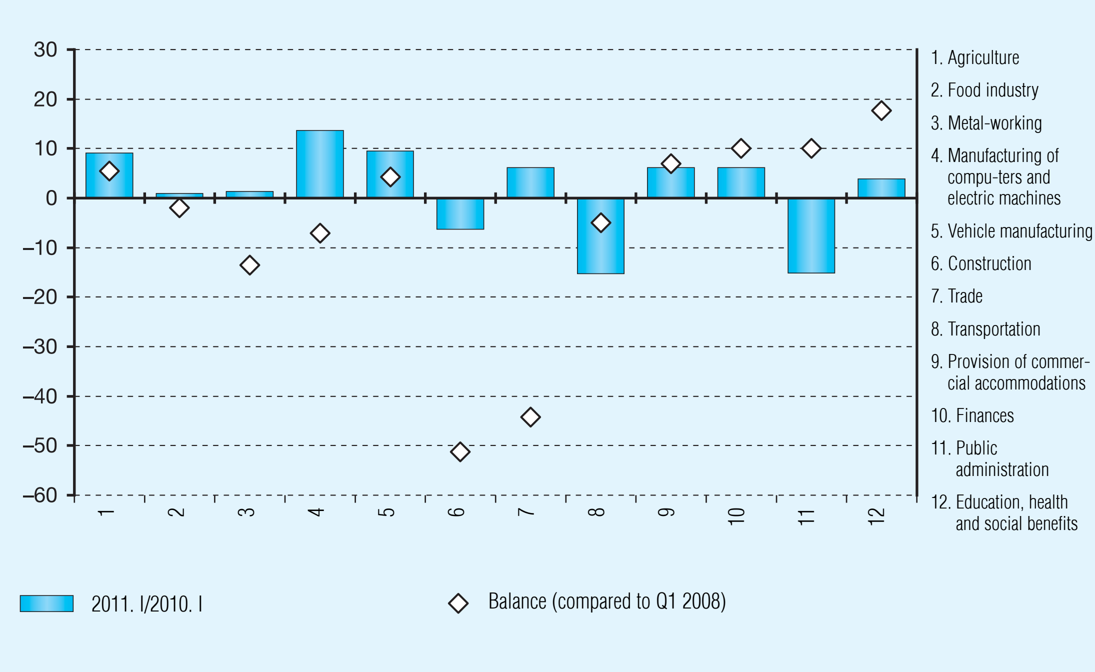


Chart 4

CHANGES IN THE NUMBER OF EMPLOYED BY SECTORS



Source: CSO

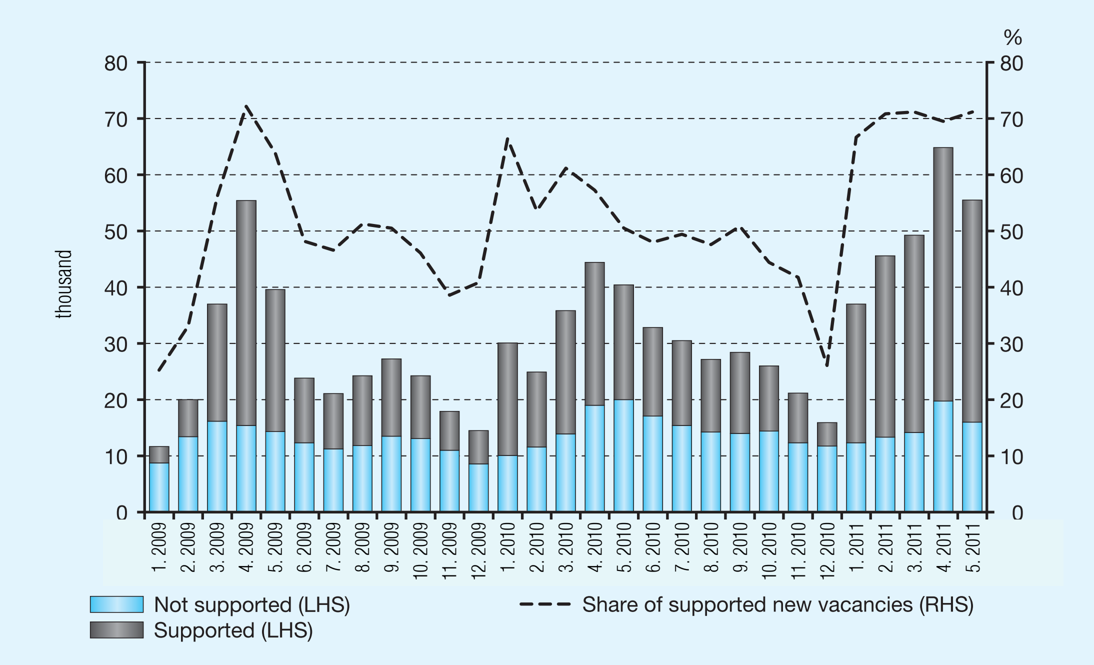
were created as part of subsidised community work programmes. That is to say, at least a half of the growth in employment is the result of government measures and not renewed growth. *(See Chart 5)*

The weakness of domestic demand is also manifested in the delayed recovery of the SME sector: in terms of both employment and investments, micro- and small enterprises, which predominantly supply goods and services to the domestic market[1], have been considerably less active than large corporations. This is reflected in their employment, investment and borrowing plans as well as in employment and SME borrowing data. According to the figures of the Hungarian Central Statistical Office (HCSO), the number of jobs in the business sector was 150,000 less in April 2011 than on 1 January 2008, of which the number of jobs missing in the SME sector represented 110,000.[2] A rapid growth in employment remains unlikely in the coming year as well. According to the corporate survey by MFB, 61% of companies are not planning to hire new workers, and hiring intentions are the weakest in the SME sector. This is mostly related to SMEs' weak export orientation on the one hand, and to their inability to strengthen their domestic market positions in comparison with large corporations on the other hand, which, according to corporate surveys, is an important factor that encourages hiring. Low business and investment activity is also reflected by SME loan portfolios shrinking by nearly 15% over 4 years, continually dropping from HUF 3,850 billion in early 2008 to HUF 3,290 billion in 2011.[3]

Corporate surveys register the relative lag or disadvantage of micro-, small and medium-sized enterprises compared to large corporations in all areas relevant to the recovery of domestic economic growth (such as plans for hiring, invest-

Chart 5

REGISTERED NEW SUBSIDISED AND NOT SUBSIDISED JOBS



Source: National Employment Service

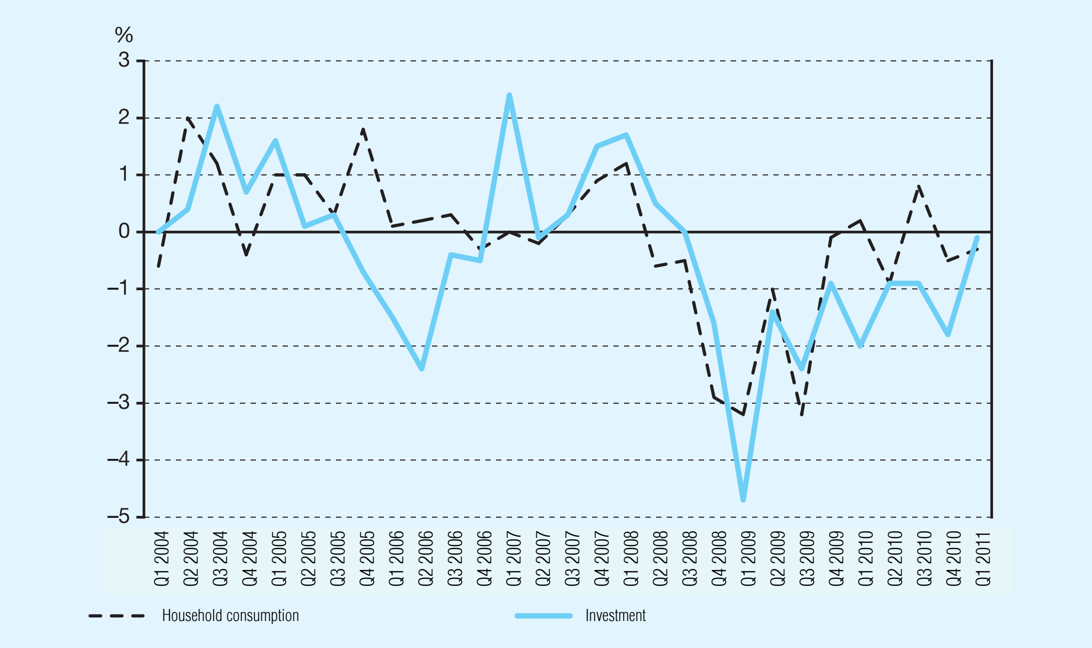
ment projects, borrowing and the expansion of exports; increased profits, market gains, etc.). This signals, in accordance with the relevant macroeconomic data, that growth is limited to the subsidiaries of export-geared multinational corporations, and that due to weak business/economic relations, for lack of orders and of increased demand, the positive effects of growth in that sector have not been transmitted to the SME sector, which mainly produces goods and provides services for the domestic market.

DEVELOPMENT OF THE TWO MAJOR COMPONENTS OF DOMESTIC DEMAND: INVESTMENTS AND PRIVATE CONSUMPTION

The declining investments trend, similarly to that of the construction industry, has been present since 2006. The downward spiral has only been broken in 2007 by a few investment projects by large corporations (e.g. the heavily subsidised Hankook investment). *(See Chart 6)* The continued drop in new housing development since 2008 has set back construction industry investment projects, whereas the budgetary consolidation that started in the summer of 2006 has set back government investment projects. In terms of growing domestic demand, the sectoral breakdown of investments is not very promising either: apart from industry, including the processing industry in particular, investments expanded somewhat in the financial sector, and also in the educational sector as a result of utilising EU funds in one large amount. *(See Chart 7)* Although last year, everyone was expecting investments to increase with some delay following the economy returning to a growth path, investment volumes dropped by 5.5% per annum, and by 8% in the last quarter. In the first quar-

Chart 6

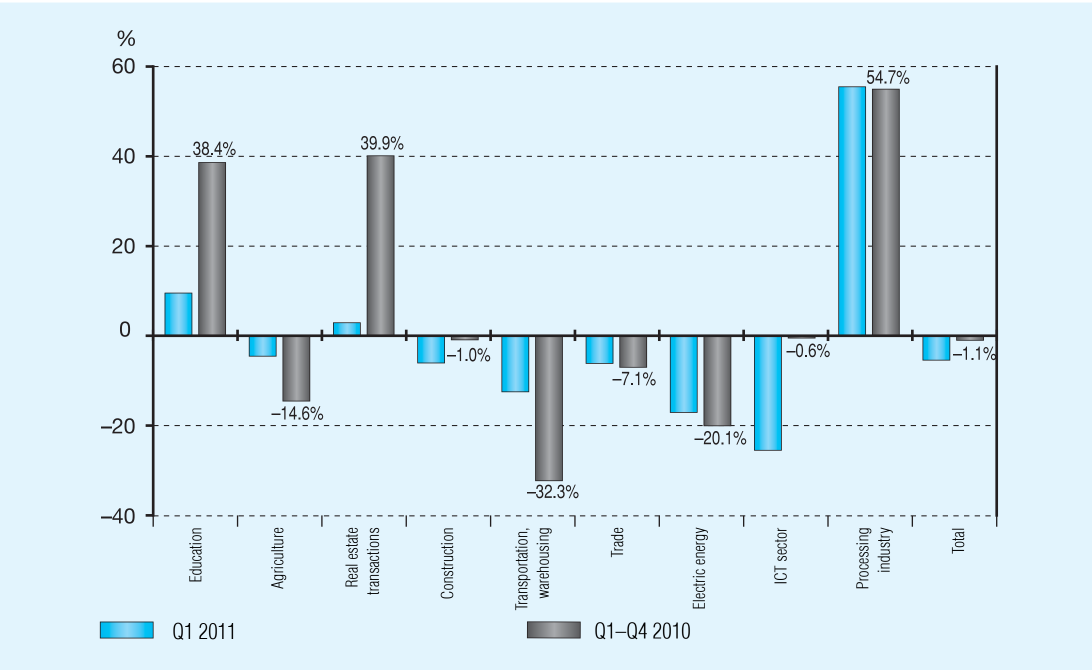
CONSUMPTION AND INVESTMENT IN HUNGARY 2004–2011 (Q/Q–1)



Source: CSO

Chart 7

INVESTMENT IN SELECTED SECTORS OF THE NATIONAL ECONOMY



Source: CSO

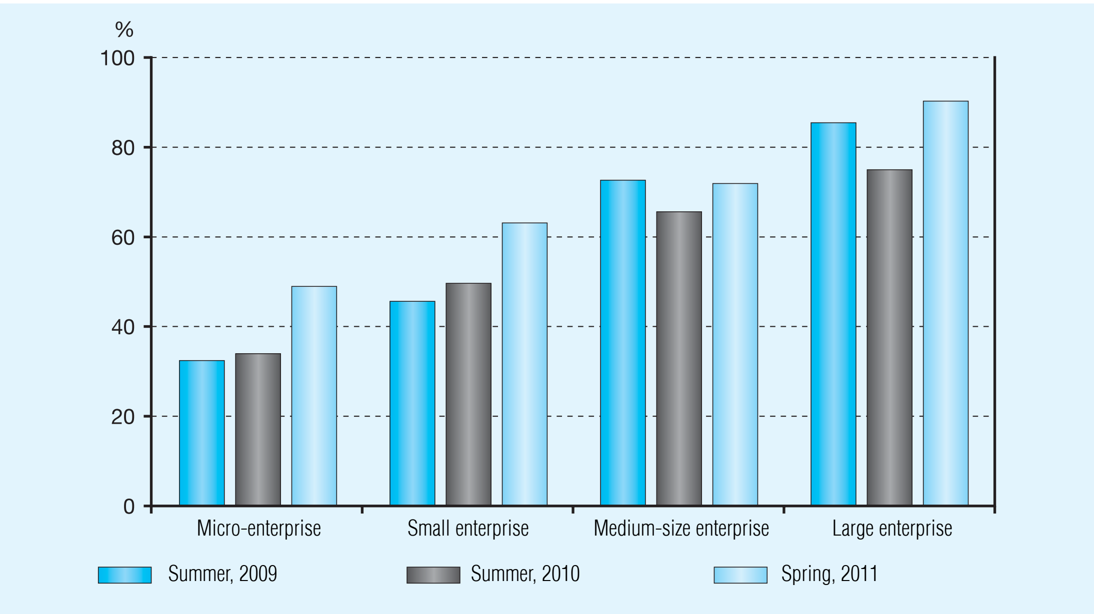
ter of 2011, investments were still down, although almost stagnating at a mere 0.1 drop from the previous quarter, reaching levels 1.6% lower than what was registered in the first quarter of 2010.

There is cause for optimism owing to the fact that according to the corporate survey conducted by MFB for the past two years[4], the investment intentions of companies have been improving since summer 2009, increasing with the size of the company concerned, and were the strongest during the spring of 2011 for each size of enterprise. It is illustrative of the trend, however, that whereas the majority of enterprises of virtually all sizes, with the exception of micro-enterprises (62% of small enterprises, 70% of medium-sized enterprises and 90% of large corporations), have plans this year to carry out an investment project in the coming year, the investment intentions of micro and small enterprises, predominantly supplying the domestic market, have been the weakest. *(See Chart 8)* As there are still considerable under-utilised capacities in the production sectors, in the midst of difficult borrowing, a slow increase in demand and the uncertainty of the regulatory environment, investments are not likely to grow this year either. It is, however, noteworthy that while in 2009 business owners cited insufficient demand as the main obstacle to investment, in 2010 and 2011, lack of funds and the difficulty and high costs involved in getting access to loans were cited as the major reasons. *(See Chart 9)*

Retail consumption trends, similarly to investment volumes, have been on a downward spiral since the first quarter of 2006, interrupted by a few shorter periods of growth. One of the most important indicators of household consumption, retail turnover was still down in 2011 compared to both the previous month and April 2010. *(See Chart*

Chart 8

COMPANIES IN HUNGARY PLANNING TO INVEST IN THE NEXT 12 MONTHS

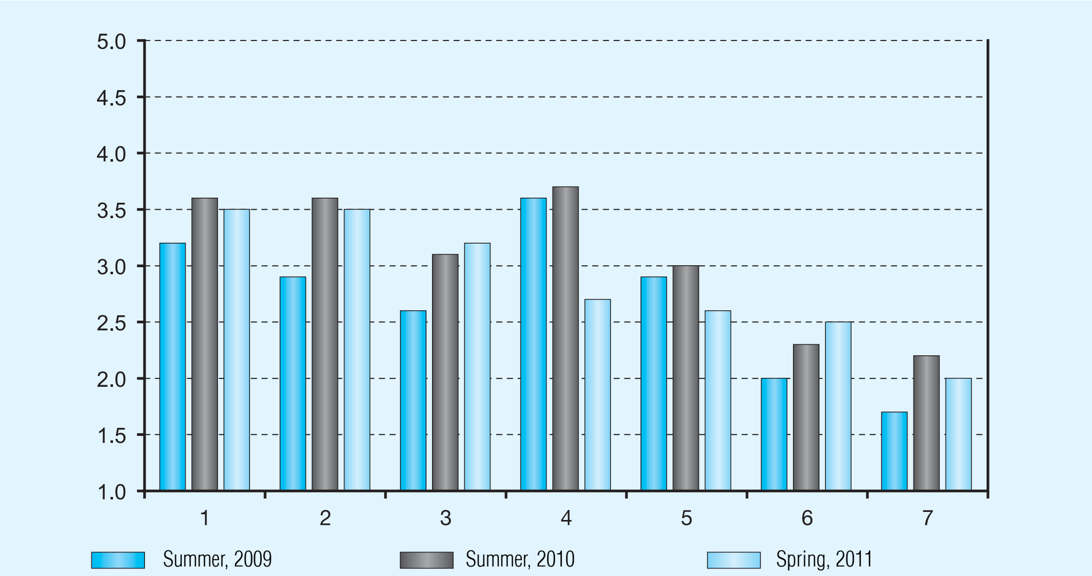


Source: MFB-INDIKÁTOR corporate survey

Chart 9

FACTORS THAT HINDER CORPORATE INVESTMENT

(1 – the least important factor, 5 – the most important factor)

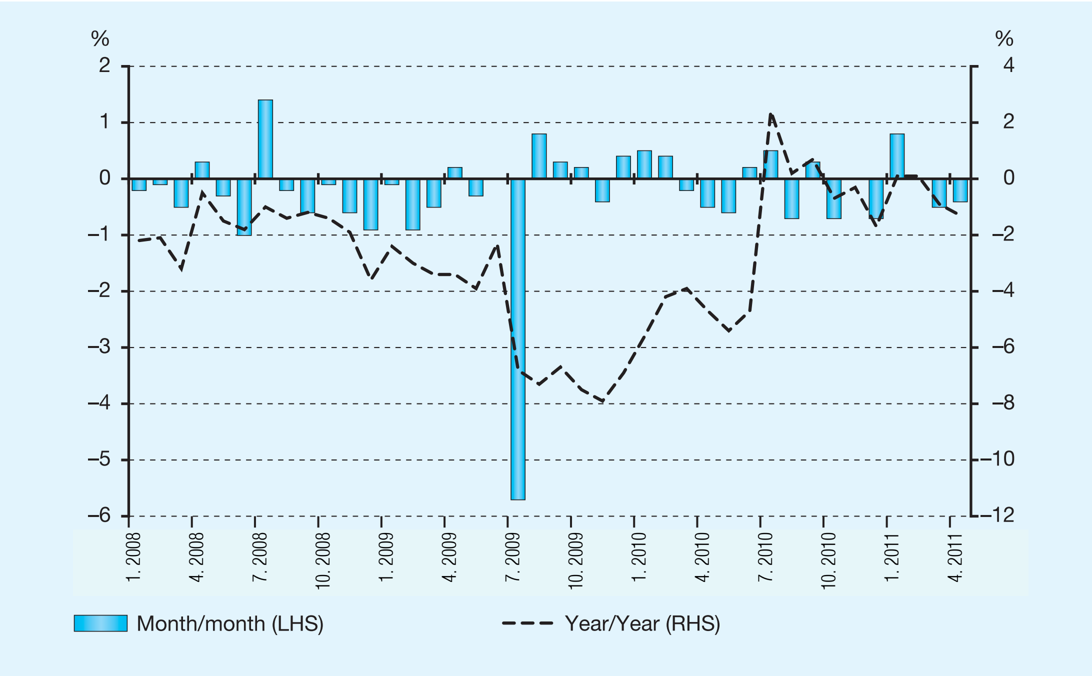


1 – high borrowing rate, 2 – lack of own funds, 3 – scarce credit supply, 4 – low market demand, 5 – insufficient demand for the products of the company following corporate development, 6 – a previous development was completed not long ago, 7 – will be on the agenda in a year at the earliest

Source: MFB-INDIKÁTOR corporate survey

Chart 10

RETAIL TRADE VOLUME IN HUNGARY



Source: CSO

10) The protracted recovery of consumption is rooted in the weak income position of the population, complicated by unemployment, higher loan repayment burdens, and an increasing willingness to save in the face of an uncertain economic environment.

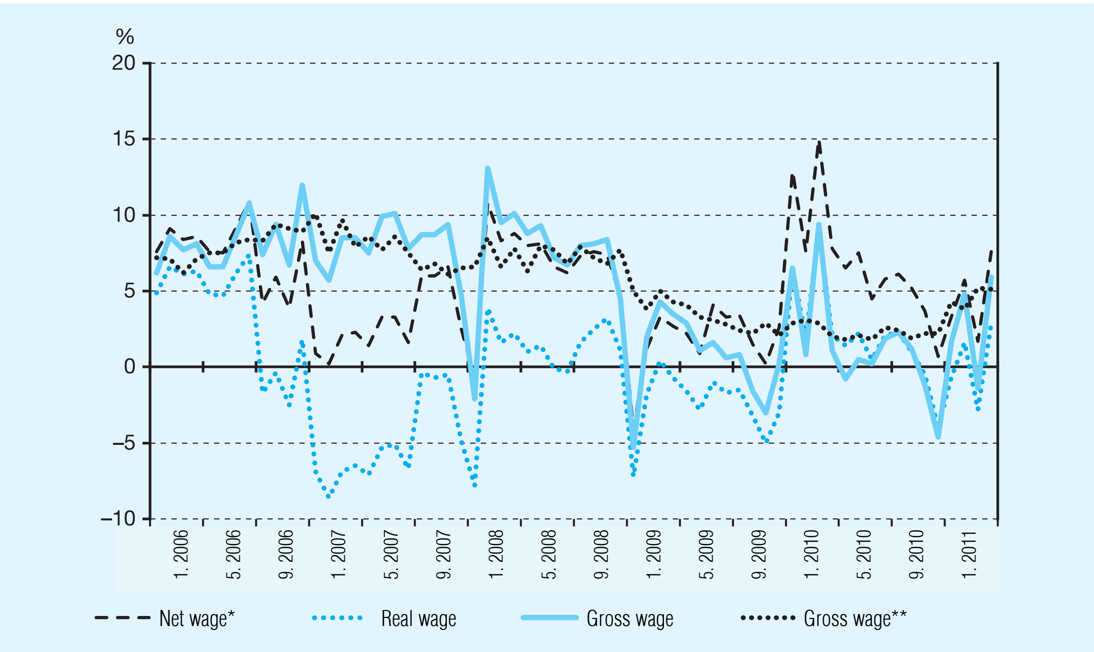
FACTORS THAT DETERMINE DOMESTIC DEMAND: INCOME AND BANK LENDING

Development of Incomes in Households and the Corporate Sector

The revival of consumption and investments hinges on two key factors: the development of household and corporate income and the development of borrowing opportunities. Looking at the development of incomes, they are somewhat different for corporations and households: the growth of the first is yet to take place, but income data suggest that household incomes have been on the rise. *(See Chart 11)* Since the eruption of the crisis, the growth rate of gross and net wages has slowed down to around 2%, leading to a decrease in real wages. In 2010, as a result of personal income tax changes, net wages grew at a more accelerated rate, which continued through the beginning of 2011 after a brief drop, and is expected to be permanent. As a result of this year's tax cut, the government budgeted HUF 400 billion less in PIT revenues in 2011 than a year earlier. Based on the fact that PIT has been collected as planned, the government's estimation of the effects of the changes on budget revenues appear to be accurate. Increasing net incomes have been supplemented by a moderate improvement in monetary transfers, which has been reducing available incomes since the middle of 2009. The income of the

Chart 11

WAGES (YEAR/YEAR) IN THE HUNGARIAN ECONOMY



* excl. family allowances
** gross wages less bonuses, rewards and additional month's allowance

Source: KSH, MFB

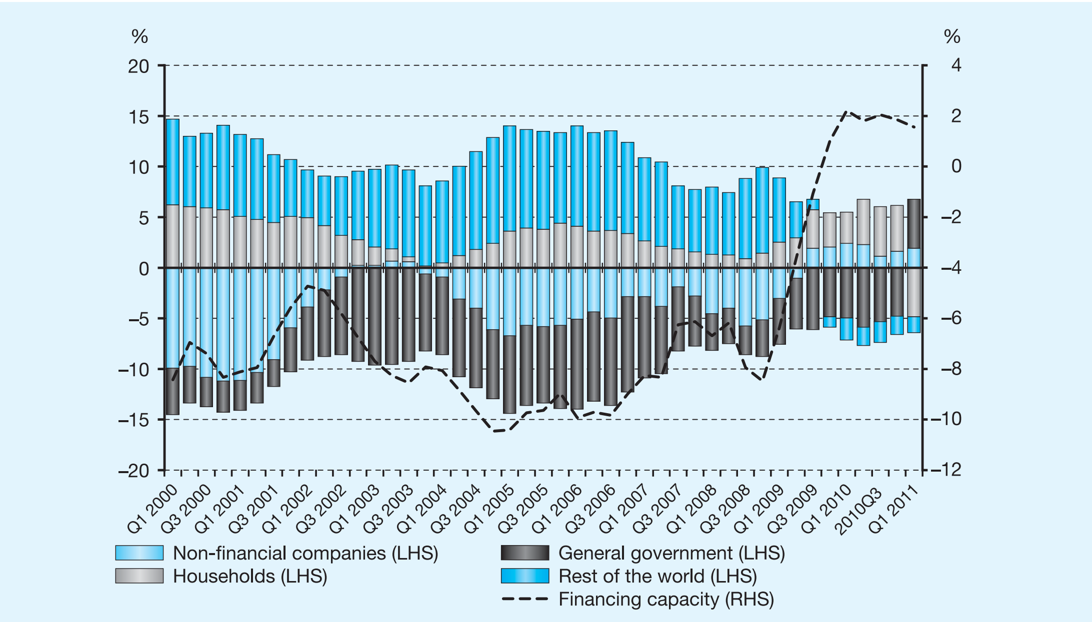
population is expected to be increased by the slow improvement already taking place in the labour market, as well as the realisation of private pension fund yields.

Consumption data, however, do not reflect the increase in the income of households: as we have seen earlier, consumption and retail turnover were still stagnating or slightly dropping in the spring of 2011. The main reason is that the behaviour of the population and corporations has changed since the eruption of the crisis. The fast track to indebtedness and decreasing willingness to save that characterised the 2000s have been replaced by increased caution in terms of people's willingness to spend their income. Since the middle of 2009, the private sector has been a net saver, one reason being significant loan repayments (in 2010, loan repayments by the corporate sector and households amounted to 1.1% and 3.6% of the GDP, respectively), the other reason being a slowdown in borrowing. As a result, the net savings of households (their financing capacity) represented 4.8% of the GDP in the first quarter of 2011 (without the money flows of the private pension funds), whereas the net savings of companies accounted for 2.2% of the GDP. (In 2010, 4.8% and 1.9%, respectively.) At the same time, the financial assets of the two sectors have also grown: those of corporations accounted for 1.6% of the GDP, whereas those of households[5] represented 3.3% of the GDP in 2010). Although this tendency is a positive turn of events in terms of the financial equilibrium of the Hungarian economy and the reduction of the country's dependence on foreign countries, it sets back the growth in domestic demand considerably. *(See Chart 12)* The spending of disposable income was further thwarted by consumer confidence, again on the decline as of the beginning

Chart 12

THE FINANCING CAPACITY OF THE MAIN SECTORS

(in % of GDP)



* balance of last 4 quarters/GDP of last 4 quarters

Source: MNB

of the year as reflected in decreasing consumer confidence indices, as well as by high inflation.

As a result of the delayed and weaker-than-expected recovery, corporate incomes take longer to recover, which is also seen in actual corporation tax revenues falling short of those budgeted for 2011.[6] According to the corporate survey by the MFB, some improvement is expected in the field of corporate incomes, because an increasing percentage of companies report increasing profits: 40% of the sample in spring 2011, with 43% expecting their pre-tax profits to increase over the next 12 months. *(See Chart 13)* Company size clearly has a positive effect on profitability: in our sample, 35% of large corporations increased their profits by over 5% in the past year, while the same ratio was 25% with medium-sized enterprises, 15% with micro-enterprises, and 17% with small enterprises. *(See Chart 14)*

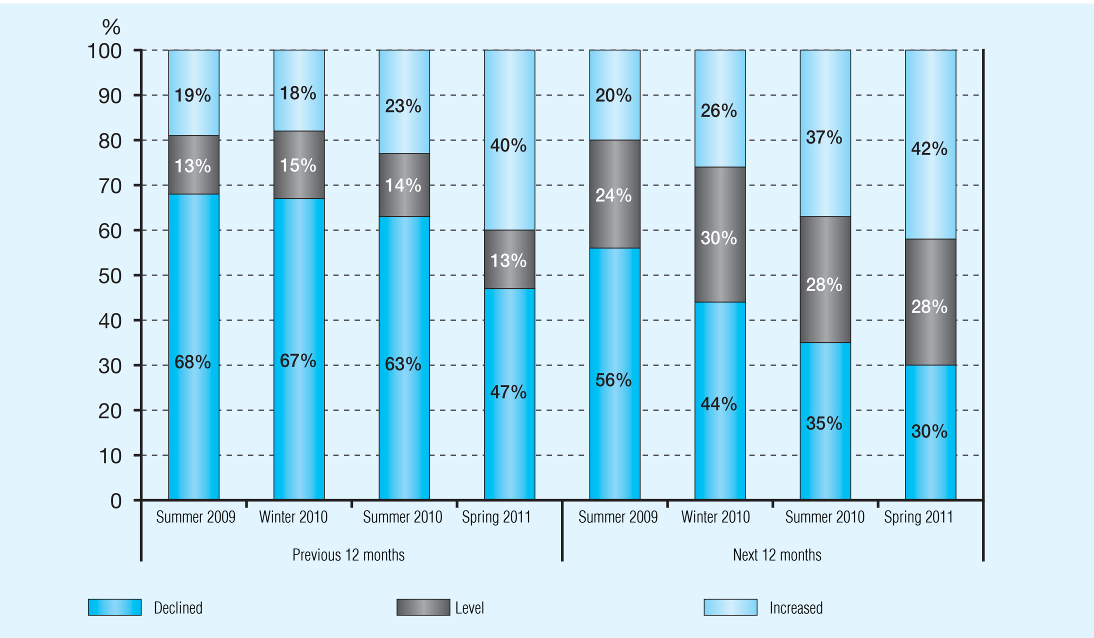
THE DEVELOPMENT OF BANK LENDING

The start of economic growth was not followed by improvement in bank lending: In 2010, corporate (–3%) as well as retail loan portfolios continued to drop, and with the exception of April 2011, the reduction in corporate loans continued in the first five months of 2011 as well. *(See Chart 15)* Contraction was primarily seen in the foreign currency loan portfolios, and two thirds of that affected long-term loans, which is a clear indication of the lack of investments. At the same time, the drop in long-term loans shows the limited nature of loan demand. Though at a much more modest rate, short-term loans also decreased, which, given that working capital loans are one of the continuous channels of financing production, also indicate the scarcity of credit supply[7]. Both MNB's lending survey and MFB's corporate survey give cause for optimism as they show the strength-

Chart 13

CHANGES IN (PRE-TAX) CORPORATE PROFIT

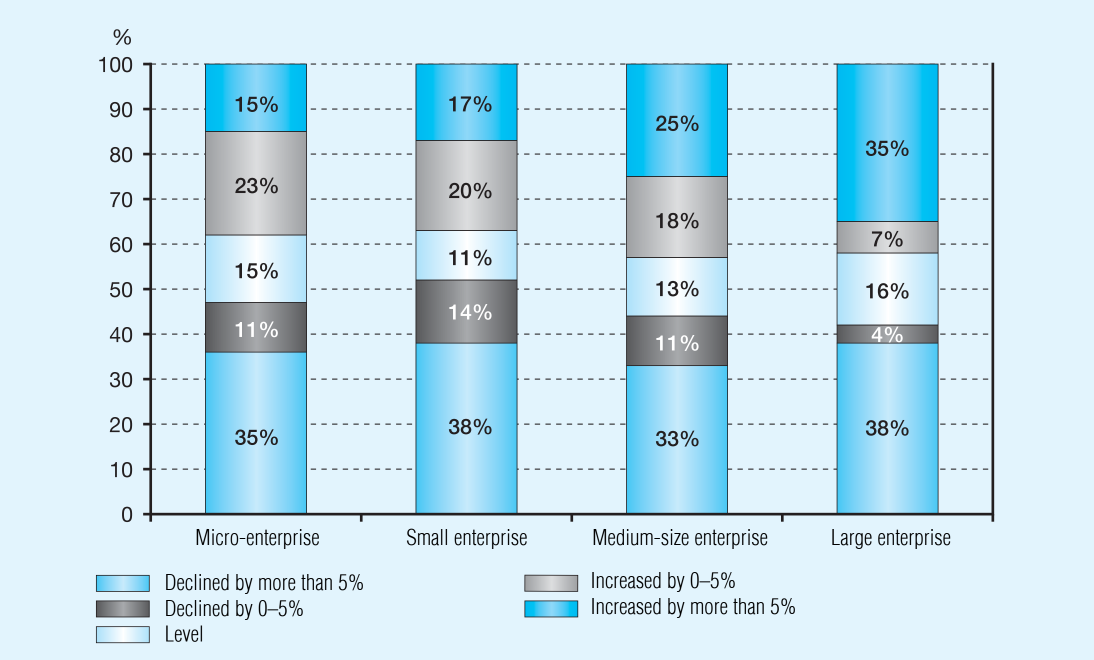
(2009–2011)



Source: MFB

Chart 14

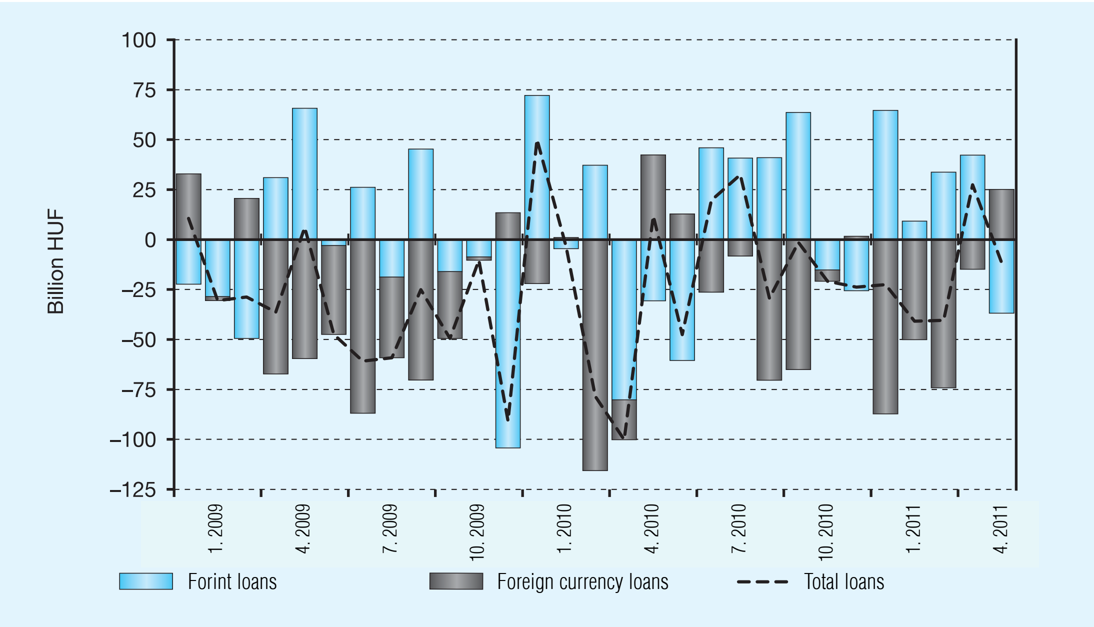
CHANGES IN PROFIT IN 2010



Source: MFB

Chart 15

MONTHLY CHANGES IN CORPORATE LOANS OUTSTANDING DUE TO TRANSACTIONS
(January 2009 to May 2011)



Source: MNB

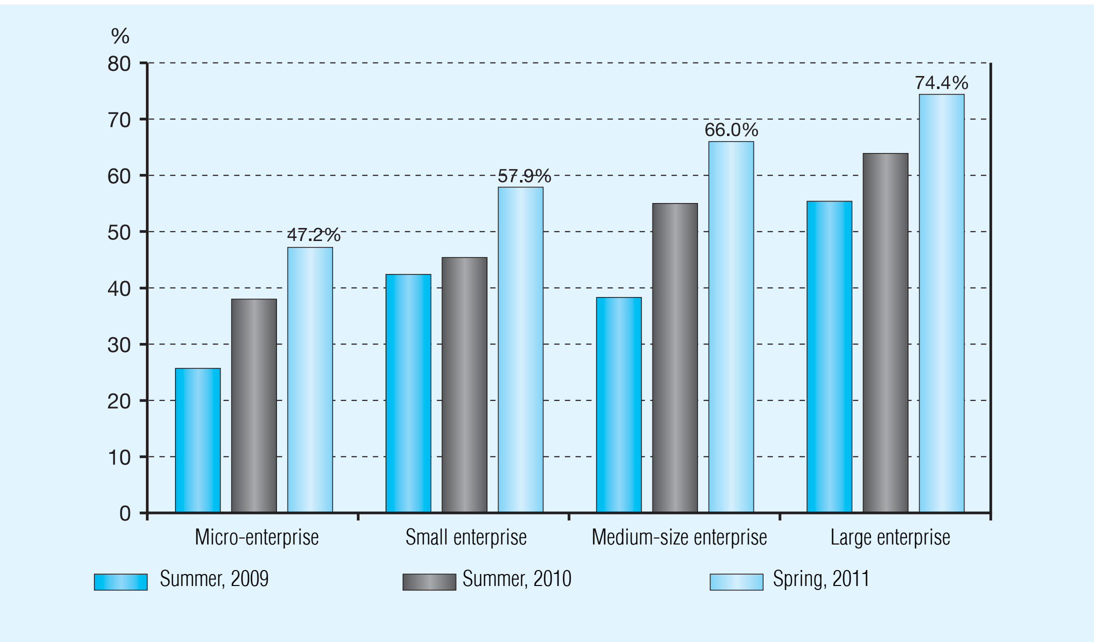
ening borrowing intentions of enterprises. Today, a much greater percentage of enterprises are planning to borrow than in 2009. However, corporate size is again relevant here: less than a half of micro-enterprises, but close to three quarters of large corporations are planning to take out loans. *(See Chart 16)* Yet, according to the spring 2011 lending survey by MNB, banks, citing bad profit outlooks, deteriorating portfolios and weakening capital positions, continued to tighten lending conditions even at the beginning of 2011, and are, indeed, willing to lend to enterprises only following rigorous screening. In the future, this could prove to be a serious obstacle to economic growth and might even make it uncertain and vulnerable.[8]

The retail loan portfolio (with the exchange rate effect removed) continues to decrease (by 3.3% in 2010), but again as a result of the decline in foreign currency loans, while HUF loans have increased even on a net basis. *(See Chart 17)* Underlying the decrease in household loans, we find barriers to lending on both the demand and the supply sides: apart from consumption becoming increasingly cautious with such a slow improvement in incomes, retail loan demand is restrained by active debt repayment and banks' ever tightening lending conditions. On the banks' side, lending is also restrained by regulatory restrictions introduced in 2010.

This year's growth and employment outlooks are largely influenced by whether domestic demand (retail and government consumption, investments) will be able to increase so that it affects the widest possible range of households and enterprises. As we have seen, bank lending has not been supporting this process and, apparently, will provide substantial support this year either. In developed countries, governments played a major role in facilitating recovery from the crisis. However, for a number of other countries, this proved to be a

Chart 16

PROPORTION OF COMPANIES PLANNING TO BORROW IN THE NEXT 12 MONTHS, BY CORPORATE SIZE

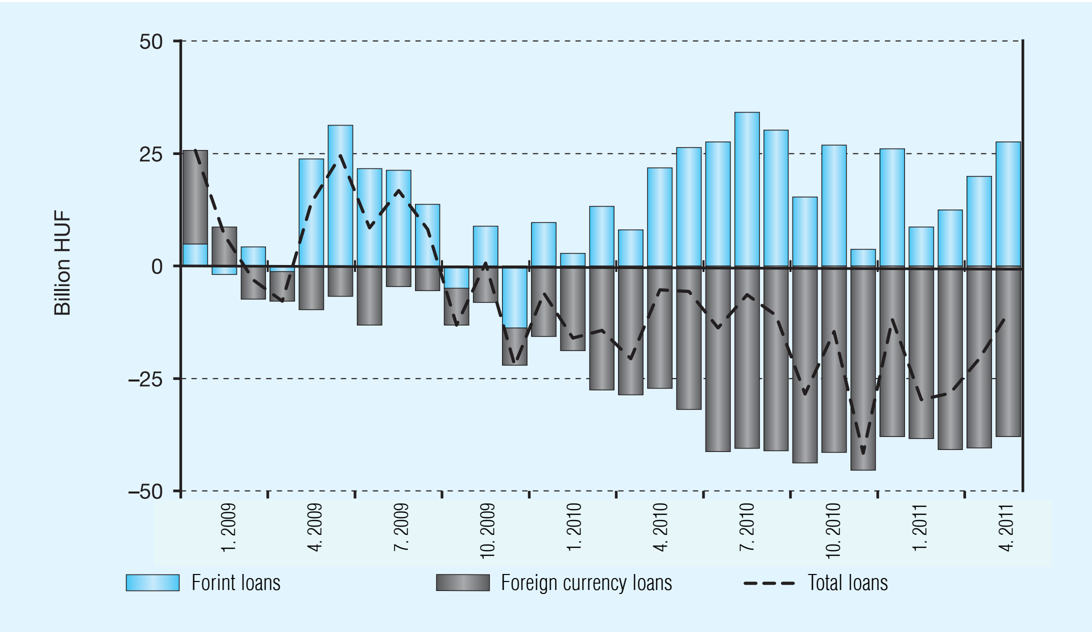


Source: MFB-INDIKÁTOR corporate survey

Chart 17

MONTHLY CHANGES IN HOUSEHOLD LOANS OUTSTANDING DUE TO TRANSACTIONS

(January 2009 to May 2011)



Source: MNB

task beyond the abilities of their governments. The crisis reached Hungary in a state of having an unsustainably high general government deficit and public debt. Hungary was forced to start removal of those burdens at a time when other countries were attempting to mitigate the consequences of the crisis through anti-cyclical economic policy. In order to adhere to the Maastricht path of sustainable deficit and to decrease public debt, a continued disciplined public finance policy and improvement in the efficiency and operability of the major distribution systems will be required; however, these will significantly limit the resources available to the government for the stimulation of demand. Nevertheless, the government measures already taken could facilitate the increase in domestic demand: the easing of taxation will increase retail consumption and saving as well as the disposable income of companies (particularly SMEs), while accelerated disbursement of EU grants will improve access to external resources by domestic companies. At the same time, the government measures planned as part of the Széll Kálmán Plan, which is supposed to create the sustainable equilibrium of the general government for the long term, are expected to decrease public consumption and government investments, while cutbacks in household transfers, public-sector wages and employment will most likely also decrease the disposable income of households, which in turn will reduce domestic demand. Even if in the short run this does hold back the acceleration of growth, in the interest of long-term, sustainable growth it is vital to strive for a permanent external and internal economic equilibrium, and that external and public debt are reduced. Navigating between the *Scylla* and *Charybdis* of growth and equilibrium/debt reduction is one of the greatest challenges facing current Hungarian economic policy.

Notes

1 In the 2000s, Hungarian micro- and small enterprises employing between 0 and 50 employees accounted for 21–22% of overall exports, whereas medium-sized enterprises employing between 50 and 249 persons represented 14–15% of the same. Source: Small and medium-sized enterprises in 2008, Ministry of National Development and Economy (A kis- és középvállalkozások helyzete 2008, Nemzeti Fejlesztési és Gazdasági Minisztérium)

2 Source of the data: HCSO employment statistics, The number of full-time employees at enterprises employing more than 4 persons

3 Source: Hungarian Financial Supervisory Authority

4 The MFB-INDIKÁTOR corporate survey, started in 2009, was conducted for the fourth time between 31 January and 18 February 2011. 794 companies returned the 16-page questionnaire (willingness to respond was 18.6%). The analysis, following data cleaning, was based on responses by 673 enterprises. The range companies included in the survey corresponded to the proportions of the national economy in terms of sectoral breakdown, geographical location and size.

5 The changes in the private pension fund system upset the data on the financial assets of the population: according to financial account data reported for the first quarter of 2011, the transfer of the private pension fund savings from the population to the general government during the quarter deteriorated the net financing capacity of households to 37.2% of the GDP for the quarter (HUF –2,348 billion). At the same time, the financing capacity of the general government was improved to 35.7% of the GDP (HUF 2,252 billion). (Without the private pension fund transfers, the latter would have represented a –6.7% net funding requirement of HUF 398 billion.) Source: Financial accounts of the National Bank of Hungary (MNB) Q1 2011

6 In the first five months of 2011, 35% of budgeted corporation taxes were paid (HUF 131 billion). Source: Report by the Ministry of National Economy on the central subsystem of public finances in May 2011. 21 June 2011

7 While banks' low lending activity is explained by commercial banks' increasingly limited resources, weakening capital supply and low profitability, it is worth pointing out that in neighbouring countries, where subsidiaries of the same parent banks operate, expansion in lending began a year ago, and expansion rates vary between 5% and 10% across countries.

8 See growth barriers arising in case of a potential '*creditless recovery*' (for more details see: MNB Stability Report, April 2011).