



Poland - Hungary

In the same boat

Poland's and Hungary's economies have outperformed the average rate of growth for the European Union, despite having zero inflation. What's more, unemployment has declined steadily. The banking sectors are in a different position and will be a drag on growth going forward. Politically, Poland has fallen into line with Hungary, where the conservative right took power in 2010. Like in Hungary, its first measures were aimed at consolidating the positions of the new majority. As events in Hungary have shown, the threat of a monitoring procedure by the Council of Europe should curb these excesses, which are considered as attacks on democracy, without the need for sanctions to be taken.

■ Growth: excellent year in prospect

2015 was a good year for these central European economies. Poland recorded a growth rate of 3.6% (year-on-year average over the first three quarters of 2015), followed by Hungary (2.6% y/y over the same period). These rates are well above the EU average of 1.9% over the same period. Industry was in fine fettle in both countries and seems little affected by the Volkswagen scandal. Hungarian industrial output increased by 7.6% y/y in the first 10 months of 2015. Polish industry has not enjoyed such spectacular success, with its growth averaging 4.5% y/y over the same period, but it still outperformed the European average of 1.7% y/y according to Eurostat.

The main driver of growth was again the consumer spending, which increased by 3.3% y/y in Poland and by 2.8% y/y in Hungary over the first three quarters of 2015. Investment slowed in both countries after an exceptional rise in 2014. After increasing by 9.8% y/y in 2014, investment in Poland rose by 6.6% y/y on average over the first three quarters of 2015. Hungary has seen larger swings, with investment contracting in 2015 (down 0.4%) after double-digit growth in 2014 (11.5%).

Both economies are creating new jobs (Figure 2). Since 2013, both countries' unemployment rates have slipped below the EU average. It stood at 7.2% in Poland in November 2015 and an even more impressive 6.4% in Hungary in October 2015 (Eurostat data seasonally adjusted), while the active population has remained stable in Poland and continues to grow in Hungary.

Poland has maintained its lead on the growth front and continues to display lower volatility. Leading indicators confirm these trends, with Poland's manufacturing PMI index holding stable at slightly above 52 in the final three months of 2015 and Hungary's PMI index dropping below the 50 mark in December 2015 (49.1), after three months above 55 (close to its all-time high).

■ Inflation: still waters

Inflation has tracked the general trends seen right across the European Union, with both countries recording modest price decreases. The HICP index averaged -0.75% y/y in Poland and -0.03% in Hungary over the first 11 months of 2015 (this level mirrors the EU average over the period). The producer price index remained in negative territory, too, for the second year in a row in Hungary (with the average for the first eight months of 2015 at -0.8% y/y) and for the third year in a row in Poland (the average for the first 11 months of 2015 stood at -1.8% y/y). Current inflation rates remain well below the Central Banks' targets (i.e. 3% +/-1% in Hungary and 2.5% +/-1% in Poland).

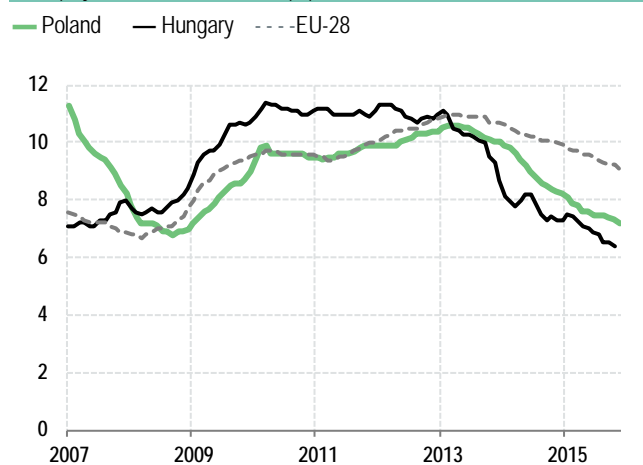
1- Summary of forecasts – Poland

	2014	2015f	2016f	2017f
Real GDP growth (%)	3.4	3.5	3.1	3.1
Inflation (CPI, year average, %)	-0.0	-0.8	1.6	1.9
Gen. Gov. balance / GDP (%)	-3.0	-2.5	-2.9	-3.0
Gen. Gov. debt / GDP (%)	50.2	50.5	50.5	50.9
Current account balance / GDP (%)	-1.3	-0.6	-1.2	-1.1
External debt / GDP (%)	68.6	73.0	76.3	75.8
Forex reserves (USD bn)	96	98	104	111
Forex reserves, in months of imports	5.3	6.2	6.7	6.6
Exchange rate EUR:PLN (year end)	4.30	4.15	4.10	4.30

f: BNP Paribas Economic Research forecasts

2- Job-creating growth

Unemployment rate, as % of active population



Source: Eurostat

Poland's monetary policy committee left its benchmark rate unchanged at its lowest ever level of 1.5% in December. Benchmark rates are also at an all-time low of 1.35% in Hungary following a series of rate cuts in the first half of 2015. Though both countries are outside the euro zone and have set benchmark rates at record low levels, they have little scope to combat imported deflation.



■ Banks to play a key role going forward

Granted, both countries have enjoyed spectacular economic success, but their main engine is set to slow over the next few years. In fact, after a period of strong growth in European financing (transfers net of contributions rose from 1% of GDP in 2008 to over 3% in 2015 in Poland and topped 5% of GDP in Hungary). Granted, the countries are set to maintain their positions throughout 2014-2020, but relative to GDP, the size of transfers is set to stabilise or even dip slightly (in Hungary's case). As a result, they will have to look elsewhere for factors boosting their growth.

Since the end of the excessive deficit procedures (in May 2013 for Hungary and in May 2015 for Poland), their national budgets will regain in capacity of supporting growth. This will be the case in Poland where the government is getting ready to launch several sector and regional development projects. But given the levels public debt has already reached (50% of GDP in Poland and 77% of GDP in Hungary), the fiscal policies' leeway will remain limited by the national fiscal rules and by the Maastricht criteria. This constraint will be harder in Hungary.

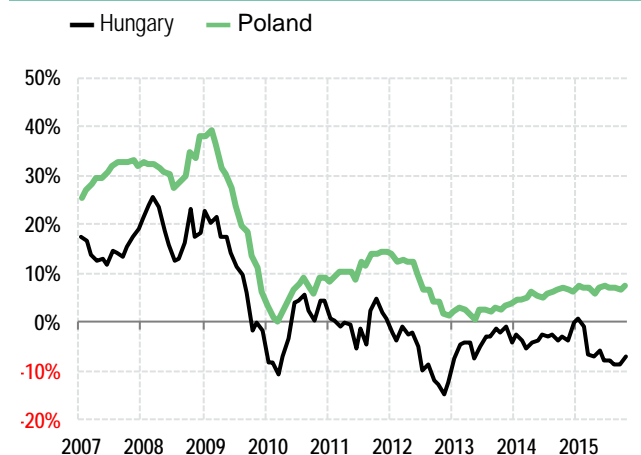
Acceleration in bank lending represents the third source of potential support for growth. This is where trends in the two countries diverge. Credit growth rates in Poland remain in positive territory – total bank lending to the private sector grew by 7% y/y in nominal terms in October 2015, thus providing the necessary funds to finance growth. This momentum is likely to be maintained by the directed credit programmes announced by the new government. Conversely, Hungary has been struggling to get credit flowing again since 2009. Despite the directed lending policies (known as Funding for Growth Scheme), bank lending to the private sector has declined by 37% from the March 2009 peak and fell another 7% year-on-year in October 2015. Paradoxically, the Hungarian government has made things more complicated. In a bid to reduce its external debt, it has found in domestic banks an alternative source of financing¹, crowding-out the private sector.

Another factor accounting for the divergence in credit trends between both countries is the quality of their loan portfolio. In Q3 2015, non-performing loans accounted for 16% on the loans to households and 13% on loans to businesses. The average ratio in Poland was just 8%². Saddled with non-performing loans, Hungarian banks find themselves in a less favourable position to pursue active expansion of their lending portfolio.

Even so, the weak performance of Hungarian banks relative to their Polish counterparts was a result of their external debt paydown drive over several years. Hungarian banks' external debt, which peaked at 40% of GDP in 2009, now stands at just 13% of GDP. This level is very close to that for Polish banks, which had a stable level of external debt over the period, leading us to believe that the

3- Trends in lending to the private sector

Credit to the private sector, y-o-y % change



Sources: IMF IFS, BNP Paribas

debt reduction drive in Hungary is coming to an end and is no longer likely to curb lending growth.

Lastly, to inject fresh impetus into lending, Hungary is set to reduce the tax on bank assets introduced in 2010 from 0.53% to 0.24%, thereby easing the burden on banks. Conversely, Poland is getting ready to introduce the same type of tax (at a rate of 0.39% in 2016). While it may boost budget revenues by 0.3% of GDP, it could take a toll on the necessary growth in lending.

■ Political situation: European Commission watching closely

Politically, Poland joined Hungary in 2015, which has been led by the conservative, eurosceptic right since 2010. Since the October 2015 elections, the Prawo i Sprawiedliwość (PiS) party has held a majority in the Sejm and the Senate, as well as the country's presidency (since May 2015). It thus possesses a very strong grip on political power, even though, unlike Fidesz in Hungary, it did not secure a constitutional majority.

Mirroring events in Hungary five years ago, the first measures taken by the new majority in Poland to secure its power base targeted the Constitutional Court and the media. These changes to the system of democratic checks and balances upset the Brussels authorities. Just as happened in Hungary in 2013, the threat of a monitoring procedure by the Council of Europe should facilitate a compromise, curbing these excesses considered as attacks on democracy without the need for sanctions to be taken.

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¹ In October, banks' total lending to the government increased by 23% y/y, with this line item now accounting for 20% of GDP and 19% of bank assets (vs. 8%, 14% and 14% respectively in Poland)

² This difference in credit quality no doubt influenced the Hungarian authorities' decision a year ago to oblige banks to convert their Swiss franc real estate loans. Just prior to conversion, the non-performing loan ratio on Swiss franc loans stood at 24%, while it stands at just 3.4% in Poland, where the issue is currently being debated.