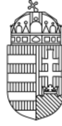

Economic growth and added value in the European Union

In terms of closing the economic gap with the rest of Europe, Hungary has not been among the best performers of the countries which joined the EU after 2004, but since the financial crisis the Hungarian economy has been on a stable growth path, and this – together with the relatively high added value by labour – signals a promising future. A positive consumption trend also points to further improvement in the quality of growth, which means that the share of added value relative to total output produced in Hungary can be further increased. To this end, the Hungarian Government has introduced significant measures, and thus – along with the favourable effect of EU operative programmes – balanced economic growth can be predicted.

Member states which joined the EU in the summer of 2004 have been members of the world's largest economic union for the thirteenth year. In our short study we aim to analyse sectoral divergences within member states and their impact on the direction of their future economic growth.

Just how much member states have managed to profit from the accession to the EU and the subsequent opening of markets shows wide divergence. Data reveal that a group of countries has obviously benefited from integration, while another one has failed to exploit the growth potential offered by membership. To the latter group typically belong countries which had been at a higher level of development prior to the accession and therefore the progress they have made appears less spectacular. Our country study focuses on the following member states:

Accession of 2004: Slovakia (SK), Hungary (HU), Poland (PL), Czech Republic (CZ), Slovenia (SN)

Accession of 2008: Romania (RO), Bulgaria (BG)

Prior to 2004: Austria (AU), Greece (GR)[1]

Benchmarks: EU28, Euro-zone

[1] Austria is selected because of a population size similar to Hungary's, while Greece was selected as the country with an economic structure that had been the least prepared for accession.

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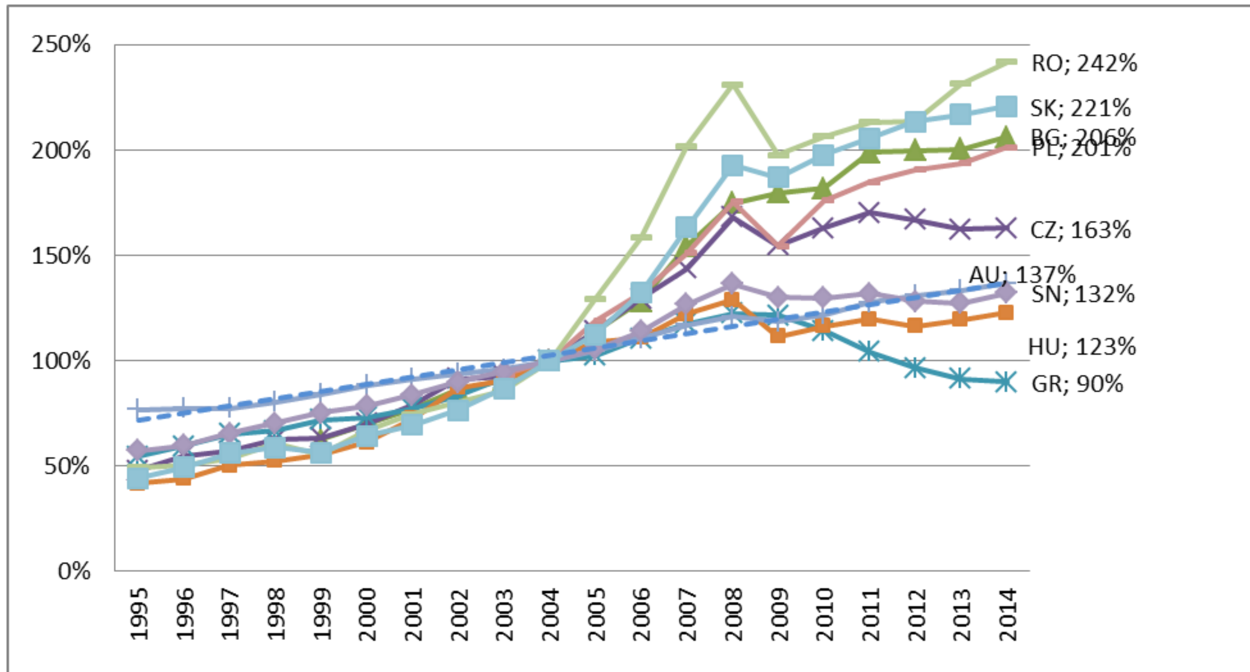
GDP growth at current prices, million EUR, (2015, 2004=100 percent), blue dashed line=EU average



Source: Eurostat

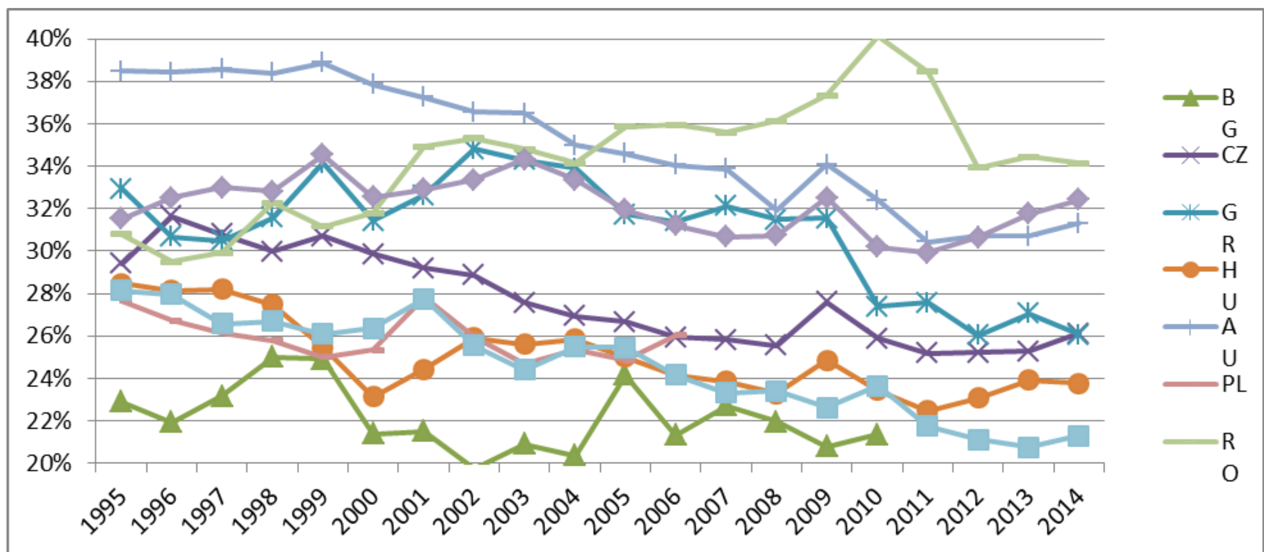
As the above chart shows, Hungary and Slovenia have not been among the best performers, as since the EU accession the economies of these two countries could not post growth rates above the EU average. **Thanks mainly to recently introduced, potent Government measures, Hungary has been put on a growth path that is more modest than before but it shows a steady upward curve. GDP growth data of 2015**, which are not shown above, **also confirm this trend.** However, it has to be noted that recent weaker forint exchange rates caused GDP growth in EUR terms to appear lower.

In order to gain more insight into differences in economic growth trends, we have analysed structural factors. Examining the period 2003-2014, for which sufficient relevant data are available, reveals that economic sectors have undergone a major change in the European Union: the weight of primary sectors and light industries has been (further) reduced, and so has that of the manufacturing sector across the EU. The services sector in general and the business services and property management division in particular as well as the state services sector[2] have gained more importance. This has partly been the result of a natural, long-term process, as parallel to

[2] Public administration, education, welfare services, human healthcare services

economic development the services sector tends to become an economic growth engine, as blue collar sectors typically move to low-wage regions. For the majority of "old" members (EU15), post-2004 member states have qualified as low-wage regions. It would seem logical that – besides low wages – short distances, a favourable, state-subsidized investment environment and incoming industrial production capacities should result in a stronger manufacturing sector, but **this has only been the case in the Czech Republic, Poland and Hungary. The highest manufacturing sector output-to-GDP ratio was registered in the Czech Republic (26.8 percent in 2014) and in Hungary (23.5 percent in 2014).** Taking a look on data from figure 1 shows that **a prominent manufacturing sector does has not necessarily led to low growth rates**, as the weight of this sector in Romania and Slovakia is far larger than the EU average. The significance of the manufacturing sectors of Austria and Slovenia, which show economic growth rates in line with EU averages, is also larger than the EU average. That is why we also examined the added value-to-total output ratios of various countries.

Added value-to-total output ratio, million EUR, at current prices (2015)



Source: Eurostat

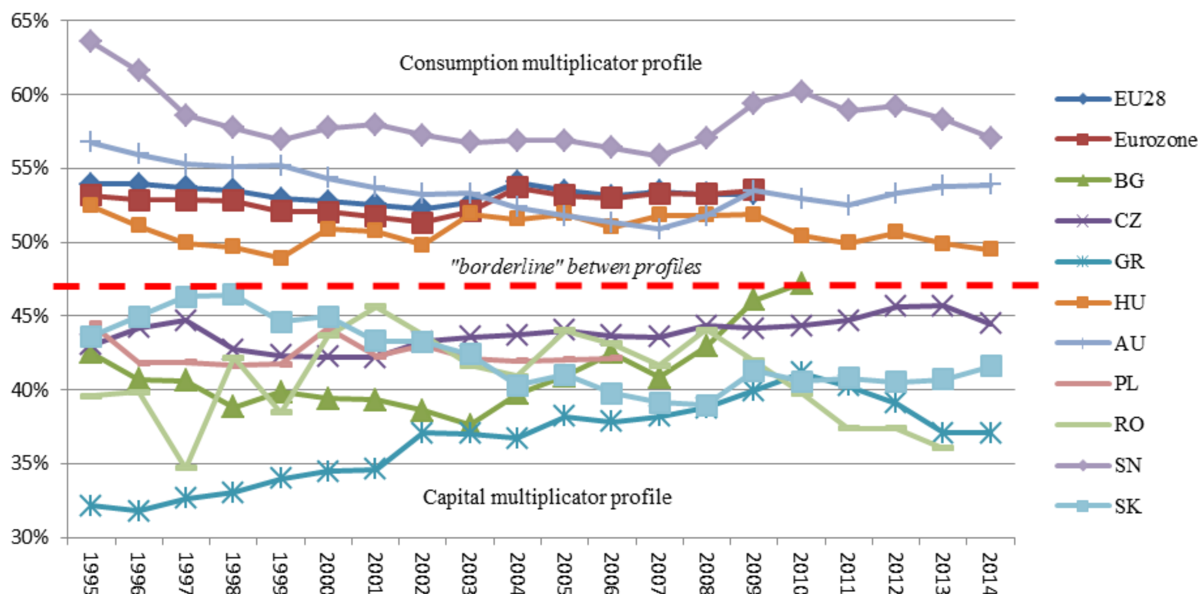
The above chart shows the share of added value within gross output (the sum of gross added value plus final consumption**). While in high-growth Romania this indicator has been rising, in also high-growth Slovakia it has been edging down** (along with Hungary and the Czech Republic). At first it may appear that just as there was no interrelation between the weight of the manufacturing sector and the rate of economic growth, neither is there any direct causality

between the growth rate and gross added value. Total output may rise quantitatively, but unless the quality of output is altered, the share of added value in percentage of GDP will remain unchanged. In the longer term, however, the lack of qualitative improvement in growth components inevitably leads to lower overall quantity as well. Therefore, countries which in the future fail to increase the share of added value in production (e.g.: Slovakia, Bulgaria, Hungary) will **face lower output figures**. In case expansion comes to a halt, the industrial sector's performance weakens and wages stagnate, these factors may curb consumption and cause retrenchment (the likelihood of this, of course, is different in each country). The wage multiplier we have created aims to show this difference. Through this indicator we can analyse the proportion of employee incomes (including wages) relative to added value produced.[3] A lower figure signals better return on invested capital, while a higher one shows that a relatively high share of the generated income is returned to employees.[4] A downward added value trend coupled with a high capital multiplier[5] signals the worst scenario that must in any case be avoided as this causes structural imbalances (as it did, for example, in Greece[6]).

Added value within total output, according to a classic economic formula, the so-called Cobb-Douglas production function, is constituted by labour and capital input, and these together determine the volume of economic output. The technological development level of a given economy determines the proportion of individual elements. Highly educated labour force enables a more highly developed economic structure and production. Labour force which can be engaged in activities of higher technological development can also produce output of higher value, and it also benefits from higher income and gains more weight in economic development and consumption growth.

[3] We call this figure a multiplier, as it magnifies the effect on consumption within the national economy and (in case of a capital multiplier) the return on invested capital.
[4] In other words, households obtain more from total output before taxes and other state transfers. This, *ceteris paribus,* boosts consumption, which – provided the macro-economic cycle runs its course as usual – may result in other knock-on effects.
[5] The capital multiplier is high if the share of employee incomes is low relative to gross added value. The division line shows the average of observed countries and regions (47 percent).
[6] Structural discrepancies in Greece were of course the combined outcome of various interconnected factors, but several analysts have pointed out that these discrepancies had resulted – besides wasteful public finances – from the lack of competitiveness. Data we evaluated also show that in the observed period the added value-to-GDP ratio was on a declining path, and the wage-to-gross added value indicator was also very low.

Wages-to-GDP ratio, sectors combined, million EUR, at current prices (2015)



Source: Eurostat, Ministry for National Economy (NGM)

Countries with typically high capital multipliers, such as Romania, Slovakia and, to a lesser extent, the Czech Republic, may only be successful in the future if quantitative growth is coupled with the employment of more skilled labour. Companies are willing to pay higher wages for better educated, highly skilled workers. On the other hand, for example **Hungary and Slovenia may be capable of further development even when world economic conditions discourage investment, as in these periods special significance is attached to the quality of labour and domestic markets**. In Hungary, data show that employees – compared to our regional peers -- receive a relatively high share of final output value and this is expected to have a positive impact on consumption. **Domestic retail trends confirm this assumption**. The volume of retail sales increased year-on-year by 6.8 percent in May 2016 and by 5.2 percent in the initial five months of the year. **This growth trend, in place for the 35th consecutive month, is seen to continue in the remainder of the year, thanks – among others – to dynamic job and wage growth, low inflation and the reduction of personal income tax rate.** This economic expansion, driven also by domestic consumption and coupled with stable fiscal management, may succeed in elevating Hungary to the group of top performers and turn the country into a

European growth engine. To this end, added value within the manufacturing sector must be increased through economic development and education reform. In order to boost added value at manufacturers, the **Government launched an industrial development programme, the Irinyi Plan, in spring 2016. In this blueprint, the Government has identified seven priority fields regarding which added value can and should be increased**. Positive ripple effects are expected from bolstering SMEs and supplier chains through operative programmes managed by the Ministry for National Economy as well as from the development of economic infrastructure (regional and urban development, vocational education support).