Forecasts of GKI for 2015-2016

By the end of summer 2015 statistical data also revealed that the Hungarian economy has been on a slowing trajectory. It is no surprise as the rapid growth in 2014 (that also continued in the first quarter of 2015) was basically due to temporary factors, such as the peak of the inflow of EU transfers, the revitalization of consumption in connection with the election year, the excellent harvest and former automotive investments. Economic prospects are further dimmed by a slowdown in the Chinese economy and the expected deterioration in European business activity, due to rising political risks (e.g., migration crisis). In addition, the consequences of past years' flawed economic policies can be felt more and more in Hungary: capital and labour are leaving the country, supply is deteriorating due to restrictions on competition and tensions are increasing in public services (from the pension system to education and healthcare), caused by the depletion of reserves and the eating up of the future. Risks are increased by the disorganization of the EU, including the increasing political isolation of Hungary. Implementing the government's gigantic ideas, like the Paks Nuclear Power Plant and the Budapest Olympics, involving huge budgetary expenditures, may entail increasing risks.

Global economic growth will be **slower** than expected due to the probably long-lasting slowdown in **China**'s economic growth. This will not be offset by the growth-enhancing effects of low raw material and fuel prices, loose monetary conditions and neutral fiscal policies. Global economic growth will be negatively affected by the rise of the **Fed**'s benchmark interest rate, which was delayed as a precaution, but **it will surely begin within six months**. As a result, the strengthening of the dollar can be expected, the depreciation of the yuan will continue, a devaluation race will start and deflationary pressures will be stronger. The Greek financial package has a stabilizing effect on the EU in the short term. The EU has been unable to find a proper answer to the problem of the huge inflow of asylum seekers. (The Hungarian stance and practice, however, disrupts integration, serves domestic political purposes and it is inhuman.) A decision to consciously stay away from the inner circle of those planning close cooperation within the EU would be a historic sin. According to the Eastern Europe Consensus survey, economic growth will **slow down only in Hungary and Slovenia in 2015-2016** compared to 2014.

In the first eight months of 2015, economic **expectations** were essentially **stagnant** in the EU, including Hungary, reflecting an **optimistic** mood. In Hungary **business expectations reached their peak this year in September, whereas consumer ones deteriorated to their lowest level in the past two years** (concerns related to the problem of the inflow of asylum seekers may play a role in this). In the coming period, **economic expectations are likely to deteriorate significantly in Europe**.

Hungarian **economic policies have failed** for one and a half decades, and **Hungary belongs to the worst performers in the CEE region**. Hungary tried to finance its growth initially by **capital inflow** and **debt**, and in recent years by **EU transfers**. The inflow of FDI helped to modernize the economy, indebtedness caused financing problems, and the absorption of EU funds was not effective enough. **In either case, the use of external resources was not associated with successful domestic reforms.** Since the 2010 change of power, the present government continues the completion of the model bypassing market economy and the system of power-sharing institutions in order to restructure incomes in favour of their own social and business beneficiaries. Consuming the resources of the future, **legal uncertainty and economic unpredictability**, economic governance based on loyalty make the trajectory of the Hungarian economy and society hopeless, and force part of the capital and workforce to leave the country.

Promoting growth by low interest rates and weak forint has failed. This failure has a lot to do with the policy against banks that has undermined confidence in legal certainty, and, as a result, decreased the propensity to invest. The **National Bank of Hungary has a more confrontational attitude towards banks** than the Ministry for National Economy that wishes to come to terms with banks, albeit inconsistently. The National Bank of Hungary also seeks to **extend the scope of its activities**, in a way that is quite unusual and unaccepted in Europe. Thus, the bank took over the **supervision of the financial sector**, it owns the giro system, and wishes to acquire the stock market infrastructure as well. The bank participates extremely ambitiously (and biased in a professionally unacceptable way) in the organization of **economic education and research**. In addition, there was a temporary sharp increase in profits from the depreciation of the forint (induced also by the bank itself), and the bank invested it into various **foundations**, thus indirectly contributing to the financing of the general government, and into prestige purchases. **These profits might have been paid into the budget in order to reduce the government debt, or they might have been allocated as reserves for difficult times.** (For example, the Funding for Growth Program of the National Bank of Hungary is already causing a loss of HUF30-35bn per year to the bank, which will increase substantially after the Fed starts its cycle of interest rate increases.) This is an **unusual behaviour of a central bank**.

Wages will increase in 2015 by around 3 per cent, similarly to 2014. However, the growth rate of real wages and real income will slightly decrease as inflation will rise minimally compared to the price level decrease in 2014. As a result of the increase in real incomes that has been under way for three years and the fall of credit burdens due to the settlement of FX loans by banks, **consumption** is predicted to go up by **about 2.5 per cent** in 2015 from 1.5 per cent in 2014. **In 2016**, real wages will rise only by 1.3 per cent, the real value of pensions will not change, and thus **real incomes and consumption will grow at a slowing rate** (1 per cent and 1.5 per cent, respectively).

Following its 4.2 per cent decline in 2012, **gross fixed capital formation** increased by 5.2 per cent in 2013 and by 11.7 per cent in 2014. **In 2015 stagnation** is most probable. The main reason is the termination of projects funded by EU transfers as well as that of investments in the automotive industry. EU transfers will drop in **2016**, thus a **5 per cent decline** can be expected in investments. With the Credit for Growth Program(s) of the National Bank of Hungary (NHB), the average cost of loans dropped somewhat, but it is still rather high, and the **major part of businesses does not want to borrow from the banks**. However, SMEs with good perspectives are able to obtain relatively cheap funding. The **investment rate** was 19.9 per cent in 2013 and 21.3 per cent in 2014. It may decrease to 20.8 per cent in 2015 and 19.3 per cent 2016, which is low.

Hungary's GDP grew by 3.6 per cent in the first quarter of 2015 and by 2.7 per cent in the second one. **The slowdown has begun.** A **further deceleration is likely** in the second half of 2015 and in 2016, primarily as a result of the temporary decline of EU transfers and a drop in domestic consumption. In addition, the deterioration in export opportunities will also play a part in this. The latter is due to the scarcity of new industrial capacities, the decline in exportable agricultural commodity and the uncertainty of the trends in European business activity. **Domestic consumption grew by 3.7 per cent in 2014, it will increase by 1 per cent in 2015 and its expansion will not reach even 0.5 per cent in 2016.** This will mainly reflect the fall of investments. GDP growth will be **export-oriented** in both years. **Economic growth is expected to be 2.7 per cent in 2015 and 2 per cent in 2016.**

Industrial growth will slow down somewhat in the second half of 2015 and the annual rate is expected to be around 7 per cent. In the absence of significant new capacity, deceleration continues in 2016, and industrial growth will between 5 and 6 per cent. **Construction** market demand created by EU transfers and budgetary sources will certainly decrease in 2015 and 2016. This negative effect can only be partially offset by market orders. Thus, the growth of the construction industry will fall to 3-5 per cent in 2015 from 14 per cent in 2014. It will be around 2 per cent in 2016. In **agriculture**, crop production will be less than in 2014, and the same can be expected in 2016, providing average weather conditions. Animal husbandry has responded remarkably well to the changes caused by the land law.

GDP of **services** in 2015 will grow by nearly 2 per cent, just short of previous year's rate and in 2016 it will decline to 1.3 per cent. These rates will be below the national average in any year. Business services will expand more rapidly in both years.

Hungary's **exports of goods and services** will expand faster than imports in 2015 and 2016, the **surplus will rise significantly**, and the average terms of trade will improve slightly during these two years. The eastern and southern external economic opening has not led to the restructuring of the geographic structure of Hungarian foreign trade. The main market for Hungarian exports continues to be the **European Union**. The foreign and domestic policies of Hungary sometimes **insult the country's main political and economic partners** exerting **negative impact** on economic cooperation.

The **number of employees** will grow by around 2 per cent in **2015** in all sectors of the national economy. In **2016**, however, it will increase by only 1 per cent. The statistical **rate of unemployment** is expected to **decline** to about 7.2 per cent in 2015 from 7.7 per cent in 2014 and to around 7 per cent in 2016. **The real unemployment rate is around 10 per cent.** Labour markets of the European Union often attract Hungarian labour force that would be greatly needed in Hungary as well. Unfortunately, domestic wages and working conditions are not competitive. **Public workfare schemes** are now an **obstacle** rather than a facilitator in the creation of real jobs.

The financial sector became a victim of the crisis all around the world. This is even more the case in Hungary: the share of the sector in GDP was only 3.6-3.7 per cent between 2014 and 2016, which is approximately a 1 percentage point decline compared to the peak. The **contraction** is partly the natural consequence of the previous unsustainable indebtedness. However, its **prolongation** is closely related to the anti-bank and anti-business economic policy of the government and the lack of creditworthy projects. The **elimination of FX loans** (their conversion into HUF loans) has been **successful**. However, **households bore the largest part of the burden** through the exchange rate losses (about HUF3,000bn), and the **banking system also assumed a huge amount** through interest repayments and extra taxes (HUF2,000bn-HUF2,500bn). **The state bore only one tenth of the expenditure of whole operation** (approximately HUF500bn). The government is trying to expand the sources of economic growth through reaching a **partial compromise with the banks** (reduction of bank levies for 2016). However, this has **failed** until now. In 2015 the volumes of corporate and retail **loans continue to decline**. In 2016 a modest increase may start, especially in corporate lending. However, the **quality of loan portfolios** may deteriorate again after this year's improvement.

GKI believes that the **realization of the planned general government deficit** (2.4 per cent of GDP in 2015 and 2 per cent in 2016) **is uncertain** and the actual deficit will likely to be **some tenth of a per cent higher** in both years. The actual **rate** largely depends on the level of the **reduction of government debt relative to GDP;** the government considers necessary to **avoid the excessive deficit procedure** (that is, what is still tolerated by the EU). A government deficit that does not involve structural changes but only one-time tools and manoeuvres, the survival of an anti-growth tax regime and the deterioration of the quality of large general government systems impose huge burdens on subsequent generations.

In 2014 and in the first half of 2015 **the rise of the price level came to a halt** temporarily, the reference rate of the National Bank of Hungary fell to all time low. From the second quarter of 2015 on, the effects of the dictated reduction of overheads and the plummet of oil prices are gradually fading away, therefore a **slight increase of the price level resumes**. Inflation is expected to be zero per cent or a few tenths of a per cent higher in **2015**, and 2.5 per cent in 2016. The **reference rate** of the National Bank of Hungary is likely to stay at 1.35 per cent. Following the rate increases by the Fed, it may amount to 1.8 per cent at the end of 2016. However, the Monetary Council is likely to postpone the decision on interest rate increases as long as possible. Thus, the **exchange rate of the forint to the euro is expected to weaken further**; the annual average exchange rate is projected to total HUF310 in 2015 and HUF320 in 2016.

Since 2009 Hungary's **combined current and capital account** has been **increasingly in surplus** year by year. The surplus is expected to reach EUR9bn in 2015, and as a result of declining EU transfers it will drop to EUR7.5bn in 2016. In the past seven years **Hungary's FDI stock did not change**. This can be considered a **hard critic of the domestic investment environment**. In 2014 the net outflow of FDI amounted to EUR1bn (EUR1.2bn in the first six months of 2015). According to the data of the national tax authority (NAV) the share of foreign ownership decreased by more than 4 percentage points between 2011 and 2013. The capital shortage did not cause much harm because the outflow FDI was replaced by the inflow of EU transfers. Nevertheless, the other countries of the CEE region **did not substitute but complemented** FDI by EU funds.

In spite of the improvement of the end of 2014 and the first quarter of 2015, **the three big international credit rating institutions left Hungary in the junk category** representing non-investment grade. Nevertheless, they set to signal positive perspectives. **The upgrading to investment category may take place only in 2016.**

The forecast of GKI for 2015-2016

	2012	2013	2014	**2015**	**2016**
		fact		**forecast**	
GDP	98.5	101.5	103.6	**102.7**	**102**
• Agriculture (1)	77.4	115.1	112.6	**90**	**100**
• Industry (2)	98.8	96.5	105.3	**105.5**	**104**
• Construction (3)	94.2	106.6	113.6	**103**	**102**
• Trade (4)	99.9	106	103.7	**105**	**101**
• Transport and storage (5)	98.4	102.5	103.7	**102**	**101.5**
• Information, communications (6)	103.9	101.0	102.9	**103**	**102**
• Financial services (7)	97.2	97.4	99.3	**99**	**100**
• Real estate services (8)	98.2	100.6	99.5	**101**	**102**
• Professional, scientific, technical and administrative activities (9)	100.7	104.3	105.4	**103**	**103**
• Public administration, education, healthcare (10)	101.8	105.3	99.9	**100**	**100**
• Arts, entertainment (11)	96.2	102.7	103.1	**102**	**102**
• Core growth (2)+(3)+(4)+(5)+(6)+(7)+(8)+(9)	99.1	100.6	104.2	**103.7**	**102.5**
GDP domestic demand	97.0	101.2	103.7	**101**	**100.3**
• Private consumption	98.0	100.2	101.6	**102.5**	**101.5**
• Gross fixed capital formation (investments)	95.8	105.2	111.7	**100**	**95**
Foreign trade in goods					
• Exports	100.9	104.8	107	**108**	**105.5**
• Imports	100.0	105.0	108.5	**106.5**	**104**
Consumer price index (preceding year = 100)	105.7	101.7	99.8	**100**	**102.5**
Balance of current and capital account					
• EUR billion	4.3	7.7	8.1	**9**	**7.5**
• In per cent of GDP	4.4	7.7	7.8	**8.3**	**6.8**
Unemployment rate (annual average)	11	10.2	7.7	**7.2**	**7**
General government balance in per cent of GDP (ESA)	-2.3	-2.4	-2.6	**-2.6**	**-2.3**

Source: HCSO, GKI