GKI Economic Research Co.
We analyse and forecast. You decide.

Forecast for 2016

(Summary for the press – 30 March 2016)

Despite the numerically similar projections for economic trends in 2016, there are still huge differences in the interpretation of these figures. The government envisions sustainable growth and catching up with Austria in the foreseeable future. GKI, however, can only observe partial successes and continuous lagging behind the CEE region. In recent months the present Hungarian government continued the completion of the model bypassing market economy, legal certainty and transparency. Anti-EU attitudes reached a new, more manifest phase. No turnaround can be expected either in the inflow of capital or the outflow of labour due to the unpredictable investment environment marred by suspected corruption and the lack of perspectives. The deterioration of public services will continue. Despite favourable financial indicators, this restricts the effectiveness of the efforts of the government aiming at the acceleration of economic growth. Hungary ranks only 91st out of 157 countries in the UN's happiness ranking.

The **global economy** is likely to develop at a **more modest rate** than projected earlier. Monetary tightening will slow down or possibly stop in 2016 in the US. The European Central Bank will continue its monetary easing in order to stimulate economic growth and combat deflation. Institutions of the EU and the member states have not yet found an appropriate response to the refugee crisis. Any failure of the Greek financial package and the British referendum on EU membership in June pose further risks for them. The US presidential election, crisis areas in the Middle East and the Russian-Ukrainian conflict, changes in the oil price, the high levels of volatility in financial markets and the threat of China's debt bubble bursting are causing additional **uncertainties**.

Although the **"ambitious" pledges and steps** of the government during the last six years (from protecting pensions, through free or "overhead-reduced" public services, to communal dreams like football and stadium construction) may seem attractive, their main objective is to cover up that resources are utilized mainly on the basis of political power interests. In addition, the government has not only been **using up resources accumulated in the past** and **accumulating in the present**, but **it assumes enormous and probably loss-making obligations at the cost of future generations**. A typical example of using up resources **accumulated in the past** was the quasi-nationalization of the private pension fund assets and the annual contribution payments. A typical example of **using up current resources** can be the intention to **maximize the available EU transfers regardless of the efficiency of their use**. A specific form of **spending at the expense of the future** is the government's vision to absorb all EU transfers by the beginning of 2019. This is quite difficult to achieve, thus stimulating improvisation and wastefulness. In addition, it foreshadows a further slowdown in GDP growth after 2019. **Gigantic and in part secret plans** of the government especially result in **indebtedness at the expense of the future**. They include the expansion of the Paks nuclear power station, the Olympics in Budapest, the Budapest-Belgrade railway line and the incomprehensible projects for transforming the Castle district and the City Park. Although there is no social consensus on these projects, their expensive preparation has already begun.

Economic expectations typically worsened in the EU in the first months of 2016. Compared to its very high January level, the **GKI economic sentiment index** dropped in February by a rate not seen for a year, and the decline continued in March, too.

Growing incomes, decreasing loan burdens and increasing willingness to buy of some part of households, together with incomes earned abroad and remitted home boosts **consumption sharply, at least by 3 per cent in 2016**. There are **labour shortages in many professions** due to work abroad and the obsolescence of the educational system resulting in a **strong pressure for wage increases**. However, the minimum wage increase of 5.7 per cent is causing great concern in other areas. In 2016 the increase in gross wages will slightly accelerate, to 4.5 per cent. **Real earnings** will increase by an **average of 5.2 per cent**, with a high spread, as a result of the approximately 0.8 per cent expected inflation rate and the 1 per cent reduction of the personal income tax rate that will more than offset the effects of inflation. The real value of pensions will again grow slightly. **During a decade**, until the end of 2016 real earnings in the private sector will have increased by about 30 per cent, whereas in the public sector they will have decreased a little bit.

Gross fixed capital formation was up by 11.2 per cent in 2014, and only by 1.9 per cent in 2015. **In 2016 a 5 per cent drop is likely**, mainly due to the decline of EU transfers. With the Funding for Growth Scheme(s) of the National Bank of Hungary (NHB), the average investment cost of credits decreased, but it is still rather high, especially in light of the negative producer price index. (The domestic producer price index of manufacturing was -3.3 per cent in 2015.) SMEs with good perspectives are able to obtain relatively cheap funding, though the overwhelming part of undertakings **does not want to borrow**. The **investment rate** is expected to be below 20 per cent of GDP in 2016, which is a very low rate for a moderately developed country like Hungary. Investments in real terms are **at their level about ten years ago**.

In 2015, the Hungarian GDP growth rate was more than 1 percentage point **faster** than the EU average of 1.8 per cent; however, in the CEE region it **lagged behind** the corresponding Slovak, Polish, Romanian and Czech figures. **At the beginning of 2016 trends and figures in various growth forecasts for the Hungarian economy are very close to each other.** It is generally accepted that after 2015 **the slowdown continues in 2016 as well, then some acceleration can be expected in 2017, primarily as a result of the effects of EU transfers on investments**. **In 2016 GKI expects an expansion of 2.3 per cent.** Industrial, construction, retail and export data, as well as economic expectations also reflect deceleration. The fall in investments will have very negative effects on growth in 2016, whereas the acceleration in consumption positive ones. Exports will contribute to GDP growth slightly less than in the past. Deceleration is likely in all sectors with the exception of agriculture, financial and real estate activities. Economic growth will become **consumption oriented**. It is **incomprehensible** why the Hungarian government was not doing everything **in order to join the so-called Juncker Plan**. The European Strategic Investment Fund (EFSI) could promote the realization of large investments in Hungary.

Hungary's **industrial** growth rate was 7.5 per cent in 2015, almost the same as in the previous year (7.6 per cent). Manufacturing grew faster than average, by more than 8 per cent. Unlike in previous years, energy production did not decrease; it increased. Industrial growth was **driven by the automotive boom**. However, since November 2015 the growth rate of industrial production in volume terms has been decreasing month over month **for three months**. Industrial growth is expected to be **5.5 per cent in 2016**. **Construction output may decrease by 5 per cent** as new sources from EU transfers will still not be materialized as new orders, and the favourable impacts of the new housing policy measures will only be felt in the second half of the year. After the outstanding performance of two years of favourable weather, Hungarian **agriculture** declined in 2015 and its GDP production decreased by 13 per cent. In case of average weather conditions, **around 5 per cent growth** can be expected in 2016.

GDP in services will increase **by about 2 per cent in 2016, slower than the average or in the previous year**. The government has announced an **administrative reorganization** plan for 2016, entailing massive layoffs. Transferring staff of background institutions and independent institutions to the supervisory ministry, however, does not in itself reduces the number of employees. It is likely that in 2016 **only** the otherwise unjustified **increase** in the number of public administration employees **will stop**. As far as **business services** are concerned, trade, tourism, telecommunications and the real estate sector will grow fastest in 2016. However, only the GDP production of the real estate and the financial sectors can be expected to accelerate.

Retail sales are expected to **grow by around 3 per cent** in 2016. Although real incomes are expected to grow faster than in 2015, this will be offset by the fact that the whitening effects will already be included in the statistical base. The **number of stores is decreasing steadily**: by more than 11 thousand units in total over the past four years (by more than six thousand in self-employed businesses). However, **online trading** is increasing much faster than the average. The number of guest nights is expected to mount by 5 per cent in 2016, similarly to 2015, and the **majority of the guests will already be Hungarians**. The proposed reform of the cafeteria system will not affect trends in 2016 yet. The performance of **transport of goods** may increase slightly faster **in 2016** compared to 2015, by 2-3 per cent, primarily due to road transport. In the **telecommunications market** the engine of growth will continue to be **mobile internet**; compared with the nearly 5.4 million subscribers at the end of 2015, even 6 million mobile internet subscriptions can be expected by the end of 2016. The stable growth in the number of smartphones with internet access subscriptions purchased with them ensures further expansion. Although the spectacular development before the crisis cannot be expected to return, **the property market has started to increase by small steps**. The **GKI-MGYOSZ real estate index** reached its nine-year peak in January 2016. Prospects improved in all segments, with the exception of the office space market. In 2015 7.6 thousand new homes were completed, thus housing construction declined by 9 per cent. However, the number of building permits issued increased by 30 per cent in Hungary and by 73 per cent in Budapest. This anticipates a housing upturn, in part as a result of the **home purchase assistance scheme (CSOK)**, albeit starting from a very low level. **GKI** predicts that **10-12 thousand new homes will be built in 2016, and prices are expected to increase considerably**.

In 2016 Hungary's exports of goods and services continue to expand faster than imports, by 6 per cent, but slower than in 2015 (8.4 per cent). The trade surplus in goods and services will rise significantly, and the **terms of trade will improve** by an additional 0.5 per cent after 0.8 per cent in 2015. The **foreign trade surplus** will increase by about EUR1bn, to EUR9bn, whereas the services surplus will rise less (to EUR6bn). Exports of goods were **driven** by the motor industry, and services by tourism and transport.

The number of **employed** increased by 2.7 per cent in 2015, half of the rate in 2014. This is a significant growth, mainly due to the increase in the public sector (in addition to the rise resulting from workfare schemes), agriculture and construction (including partly the effect of whitening in the economy) as well as the dynamic expansion of employment abroad. Employment is expected to grow **by around 1.5 per cent in 2016**, at a slower but still significant rate. Although the level of public employment in workfare schemes will remain high, it will increase only minimally. The annual average of the **unemployment rate** was 6.8 per cent in 2015, almost one percentage point lower than in 2014 (7.7 per cent), and it is expected to decline **slightly further statistically** in 2016, to 6.5 per cent. The real unemployment rate may be around 9 per cent. **Between 2008 and 2016 the number of employees in the public sector grew by 20 per cent, whereas in the competitive sector it still remained slightly at its level of eight years ago.**

Although the loan portfolio of banks decreased in 2015, the quality of their portfolios improved. In spite of the fact that the volume of loans may increase in the small-business sector and housing, **no turn in lending can be expected** in 2016. The main obstacle to lending is insufficient demand. Liquidity and the capital adequacy ratio of the banking system are good, and its profitability is improving. Following the nationalization of MKB Bank and Budapest Bank, the greater part of the Hungarian banking system was in Hungarian ownership. As a result, **foreign exposure dropped, at least on paper**. On the other hand, Hungarian ownership may pose **problems arising from the lack of capital or liquidity**. Nationalization was unable to improve the Hungarian banking system in any way.

The **general government** indicators relative to GDP were **statistically excellent** in 2015: about 2 per cent ESA deficit and a 0.7 percentage points reduction of the government debt over a year, to 75.5 per cent. However, favourable deficit and government debt was achieved by the application of **"repressive"**, one-off, non-transparent instruments and manoeuvres, the **tax system curbs economic growth** and the quality of large general government systems are **deteriorating**. **The attainment of the deficit target of 2 per cent in 2016 relative to GDP is slightly uncertain, GKI expects 2.3 per cent.** Although revenues are realistic in general, as far as expenditures are concerned, mainly the **nominal reduction in the appropriated amounts** of health and education foreshadows severe problems. Extraordinary measures may be required to solve them (due to, e.g., the unpaid bills of HUF17bn of KLIK, the Klebelsberg Institution Maintenance Centre). **GKI** expects that the **government debt** relative to GDP will **decrease** by about 1 percentage point by the end of 2016, **to 74.5 per cent**. This decrease **may be greater** if the major part of EU transfers missed in 2015 is received in 2016, providing that it will not be offset by the amounts **advanced by the Hungarian budget** necessary for the accelerated start of new EU applications. However, if the plans of the government become reality, the latter may exceed the former considerably. The privatization of state banks could significantly reduce the government debt; however, taking new nationalization decision would lead to the opposite effect.

The rate of inflation will accelerate to 0.8 per cent in 2016 from -0.1 per cent in 2015. Outstanding price reductions can be expected in the case of fuels, whereas the greatest increase in the case of consumer goods. As a result of steps taken by the ECB for further easing in March, the **National Bank of Hungary** followed suit and **reduced the reference rate** by 15 basis points **to 1.2 per cent**, promising further base rate cuts, and taking some unorthodox steps as well. GKI expects that the base rate will fall to around 1 per cent, or even slightly below that. As a result, in 2016 a further depreciation of the forint can be expected, with a **HUF315 (or even weaker) average exchange rate of the forint to the euro**.

Since 2009 Hungary's **combined current and capital account** has been in surplus. The surplus probably **reached EUR10bn in 2015**, and as a result of declining EU transfers **it will drop to EUR8bn in 2016**, despite a significant increase of the current account surplus. In the past seven years **Hungary's FDI stock did not change, with the exception of the enforced recapitalization of the banking sector**. This can be considered a **hard critic of the domestic investment environment**. **FDI has been replaced by EU transfers. In 2015, net FDI figures reflected capital withdrawal of around EUR0.7bn, and no turnaround can be expected** in this trend. Other countries of the CEE region did not substitute but complemented FDI by EU funds.

In 2016 **consumption** may increase a bit **faster** than projected by GKI, whereas **investments** and **exports** may grow slightly at a **slower** rate than expected. However, the impacts of a number of **political risks**, such as measures taken to solve the migrant crisis, Brexit, development trends of the EU, could be **much greater** than those of the usual economic factors.

The forecast of GKI for 2016

	2012	2013	2014	2015	**2016 forecast**		
	fact				September	December	**March**
Gross Domestic Product	98.3	101.9	103.7	102.9	102	102.3	**102.3**
• Agriculture (1)	79.0	115.3	113.9	87.1	100	105	**105**
• Industry (2)	97.8	97.5	106.7	106.3	104	104	**104**
• Construction (3)	93.7	105.8	112.3	102.9	102	100	**95**
• Trade (4)	99.4	106.3	104.3	105.7	101	103	**103**
• Transport and storage (5)	101.1	101.0	102.4	101.7	101.5	101.5	**101.5**
• Information, communications (6)	101.0	103.9	101.4	102.9	102	103	**103**
• Financial services (7)	97.2	95.2	97.1	99.8	100	102	**102**
• Real estate services (8)	98.2	100.3	99.6	101.1	102	102	**102**
• Professional, scientific, technical and administrative activities (9)	100.7	103.6	105.8	105.6	103	103	**103**
• Public administration, education, healthcare (10)	101.6	106.7	97.8	100.6	100	100	**100**
• Arts, entertainment (11)	97.3	100.0	104.8	106.0	102	102	**102**
• Core growth (2)+(3)+(4)+(5)+(6)+(7)+(8)+(9)	98.7	101.0	104.5	104.4	102.5	103	**103**
GDP domestic demand	97.0	101.2	104.2	101.5	100.3	101	**101**
• Private consumption	97.7	100.6	101.5	102.6	101.5	102.3	**103**
• Gross fixed capital formation (investments)	95.6	107.3	111.2	101.9	95	95	**95**
Foreign trade in goods							
• Exports	100.9	104.8	107	108.4	105.5	106	**106**
• Imports	100.0	105.0	108.5	107.8	104	105	**105.5**
Consumer price index (preceding year = 100)	105.7	101.7	99.8	99.9	102.5	101.7	**100.8**
Balance of current and capital account							
• EUR billion	4.3	7.7	6.3	10*	7.5	7	**8**
• In per cent of GDP	4.3	7.5	6.0	9.2*	6.8	6.2	**7.2**
Unemployment rate (annual average)	11	10.2	7.7	6.8	7	6.7	**6.5**
General government balance in per cent of GDP (ESA)	-2.3	-2.4	-2.5	-2.0*	-2.3	-2.3	**-2.3**

*Preliminary data
Source: HCSO, GKI
Previous projections of GKI for 2015 are included in Annex 9.