Forecast for 2016

(Summary for the press, 28 June 2016)

Due to the decrease of EU transfers and hence public investments, the deceleration of GDP growth in the first quarter of 2016 could have been foreseen. Nevertheless, in the light of the investment restraining effects of the Hungarian model that had been at work for six years the slowdown proved to be unexpectedly spectacular. In addition, in some segments of industry sales problems appeared in the first quarter. Because of the figure that was much worse than expected, GKI downgraded its GDP growth forecast for this year from 2.3 per cent to 2 per cent, but even a lower growth rate is feasible. The fall of investments may be deeper than predicted earlier, it may reach about 8 per cent. Nevertheless, as a result of rapid increase in earnings, the growth rate of consumption may be by one percentage point higher than forecast earlier and may total 4 per cent. The growth rate of exports will hardly exceed that of imports. More favourable economic development is impeded mainly the shortage of skilled labour and capital to invest.

In 2016, the **world economy** is likely to grow more slowly than projected earlier. With the leave of the EU by the United Kingdom, **political uncertainty** is going to pick up. **Brexit is economic catastrophe for the United Kingdom, and a political catastrophe for the EU.** Compared to direct economic losses, a more serious problem for the EU is that **national endeavours may intensify** that may lead even to the breakup of the integration. Nevertheless, the option cannot be excluded either that this danger compels those committed to integration for more successful actions. The refugee problem and the Ukrainian crisis remain still on the agenda. **The increase of economic risks** is related mainly to the more moderate GDP growth rate in China, the US and the EU, to the recession in Latin America, and to the gradual fading away of the favourable growth effects of low crude oil prices. **In the US,** the pace of monetary tightening is expected to be slower. In order to **promote GDP growth and combat deflation**, countries in the rest of the world are characterized furthermore by loose monetary policy. **EU** institutions and member states have not found efficient response to the refugee crisis yet.

The **business sentiment index** of the EU increased slightly not only in April, but in May as well, nonetheless, it did not reach the level of early 2016. As far as Hungary is concerned, in January the **GKI** business sentiment index started the year from a high level not seen since the parliamentary elections in 2014. The index deteriorated somewhat until April, and stagnated basically in May and June. **Since the beginning of the year, expectations of businesses have deteriorated almost continuously, but those of consumers have recovered slightly since the nadir of April,** but they were still lower in June than at the beginning of the year.

In the past months, **economic policy** has set to change implicitly aiming at the deterioration of disequilibria. The **loosening** envisaged in the 2017 budget, too, will have an impact on decisions to be taken in the rest of 2016. **The reorganisation of ownership relations and markets by active government involvement** continues. Fresh examples include the tightening of the position of voluntary pension and health funds due to the reorganization of the cafeteria system, the nationalization of the account management of local, governments, the promotion and later the blocking of the expansion of the FHB bank group involved in the integration of savings cooperatives by legal rules, the involvement in the latter the theoretically independent banking supervisory authority. **Important objective of monetary policy** is the weakening of the exchange rate of the forint to the euro, thereby the realization of profits by the National Bank of Hungary. The price of this monetary policy is the devaluation of the Hungarian economy as a whole. **The National Bank of Hungary exceeds by far** the frames allowed by the law on the central bank, its decisions destroy public confidence. In May, Fitch Ratings **upgraded** Hungary. Because of the unpredictable economic policy**, S&P does not intend to do so**, and the intensions of Moody's are uncertain.

The growth strategy based on cheap Hungarian labour seems to be failed. Since more than half a million Hungarians work abroad, the shortage of skilled labour limits domestic growth perspectives significantly. Keeping the skilled segment of labour force remaining at home, too**, compels substantial wage increases in both the**

public sector and the competitive sphere, whereas a tiny fraction of those involved in public workfare schemes can be employed in the business sphere. The compulsory raise of the minimum wage by 5.7 per cent, too, causes great problems in many undertakings. In 2016, growth earnings are likely to grow by 6 per cent. As a combined result of the 0.8 per cent inflation rate and the reduction of the personal income tax rate by 1 percentage point, **real earnings** are predicted to **mount by 6.5-7 per cent** amidst enormous differentiation. The real value of pensions will rise slightly. Due to sharply increasing incomes of a specific part of households, decreasing credit burdens and intensifying propensity to purchase, **consumption is set to recover, leading to a 4 per cent increase in 2016.**

Following the huge contraction recorded between 2009 and 2012**, gross fixed capital formation** is likely to expand by 6-7 per cent annually in the average of 2013-2015. Nevertheless, within this time frame, the gross rate of investments was a mere 0.6 per cent in 2015. With **the decline of EU transfers and the lack of confidence of the business sphere**, investments are expected to **contract by 8 per cent**. **Efforts aiming at the acceleration of GDP growth have proved to be unsuccessful until recently.** From the EU funds allocated for the 2014-2020 budgetary period, only HUF100 billion were disbursed until early June; this corresponds to less than 5 per cent of the total of HUF2,140 billion planned by the government for 2016. The **investment rate** was about 21-22 per cent of GDP in 2014-2015, it will drop below 20 per cent in 2016, to a very low ratio in a country with medium level of economic development.

In the first quarter of 2016, the rate of GDP growth **accelerated** from 0.3 per cent to 0.5 per cent quarter-on-quarter **in the EU**. In contrast to this, with a **0.8 per cent decline Hungary's figure** was the **worst** in the EU. The rate of Hungary's GDP growth year-on-year according to EU methodology was only 0.4 per cent. With the exception of two Baltic states, GDP growth rates of Hungary's competitors in the CEE region were at least 2 per cent, with 3 per cent in the Czech Republic, 3.7 per cent in Slovakia and 4.2 per cent in Romania. Because of the figure that was much worse than expected, **GKI downgraded its GDP growth forecast for this year from 2.3 per cent to 2 per cent, but even a lower growth rate is feasible.** Nevertheless, **GKI reckons with a spectacular improvement in GDP growth compared to the first quarter.** In 2016, **contraction** is likely only in construction, but the growth rate of industrial production and foreign trade, too, is **slowing down**, whereas that of services is slightly **accelerating**. As the combined result of the decline in 2015 and the favourable weather conditions in the first half of 2016, **the rate of GDP growth in agriculture** may reach 10 per cent.

In March, **industrial production** had decreased for five consecutive months. Production in the **motor industry** accounting for nearly one third of total industrial output dropped by 1.6 per cent in the first quarter of 2016. The problems hit first of all Audi. The **general trend of slowdown** is indicated by the fact that in this time period the performance of 7 branches out of 13 decreased in manufacturing. Nevertheless, **in April** industrial production **was up** by 5.4 per cent compared to March. **Gross industrial production is expected to increase by 3.5 per cent** in the average of 2016 compared to the 1.5 per cent growth recorded in the first four months of the year. The performance of **construction** is highly dependent on demand generated by the inflow of EU funds, the increase of funding triggered the spectacular growth of the past years and its sudden stop the fall of this year. The slight increase of the disbursements at the expense of the 2014-2020 budgetary period of the EU and the recovery of home building as a result of government promotion measures will be sufficient to **brake the contraction** of this year, in 2016 **production is likely to plummet by 15 per cent**.

In 2016, **GDP in services** is projected to grow by about 3 per cent representing **slight acceleration** compared to the 2.8 per cent increase in 2015. GDP in **public services** is likely to go up by about 1 per cent, the increase of the whole branch will be nurtured by growth in **business services**. In **public administration**, the communicated huge staff reduction based on the winding up of a great number of background institutions has died away (in the lack of appropriate conceptual foundations), in part it took the form of incorporating institutions in the administration. **Red tape is the inherent accompanying part of the state-centred Hungarian model. Business services** are likely to grow more rapidly than the whole service sector. This is promoted by the rise of **consumer** demand (retail turnover is expected to increase by about 5 per cent, and domestic tourism, too, is flourishing), whereas the contraction of investments **narrows** demand for services associated with investment projects. In 2016, the performance of **freight transport** will increase by 2-3 per cent, mainly due to the expansion of road transport. In the telecommunications market, the driving force of growth is mobile internet. In the **real estate market**, recovery that started last year is picking up. **Exports of services** will increase further, particularly in transport, in the service centres outsourced to Hungary and in tourism.

In 2016, **the number of employees** will grow by **1.5 per cent**, at a slower rate than in the previous years. Labour force shortage and unemployment (that is higher than that pointed out by statistics) are present simultaneously. Sums allocated for **public workfare schemes** were raised further. The ideas aiming at drastic reduction of employees in state administration **decelerate in practice only the growth rate of employment in the public sector**. **Employment abroad** is spreading further. In 2016, the **unemployment rate** is likely to drop to 5.8 per cent. In Hungary's most developed regions **employment is only of frictional nature** (in the western part of the country this is mitigated by commuting across the border). In certain parts of underdeveloped regions, such as in Heves and Tolna counties, the unemployment rate decreased significantly to about 5 per cent. This indicates that **market based employment creation** relying on economic recovery is much more successful than that based on artificial government measures. **Productivity** measured by GDP per employee is improving by a mere 0.5 per cent.

At the end of the first quarter of 2016, the **loan stock** of undertakings and households was **smaller** than one year earlier, that of households smaller than as of the end of 2015. **The portfolio quality of banks improved,** and as a result of the reduction of the tax rate imposed on banks, the **profitability** of the sector increased as well. The shortage of demand is still the major limiting factor of lending, nevertheless, this year **some increase** may be feasible in the **corporate segment**. Although the **liquidity and the capital adequacy ratio** of the banking system is **outstandingly good**, the transfer of the major part of the sector into Hungarian ownership, the **not transparently changing roles assumed by the government and the bank supervising authority constitute risk and uncertainty factors.**

In the first five months of 2016, trends in **general government** revenues and equilibria were excellent. Nevertheless, by the modification of the 2016 budget, the government has already tied the additional sum exceeding the planned one by HUF500 billion. Therefore, achieving the planned deficit amounting to 1.9 per cent of GDP is uncertain since, in part due to various pressures and the preparations for the parliamentary elections in 2017, the government is likely to **raise its expenditures** in the second half of 2016. **GKI reckons with a deficit of 2.3 per cent of GDP.** The convergence program envisaged the reduction of **government debt relative to GDP from** 75.3 per cent to 74.5 per cent by the end of 2016. **GKI reckons with a symbolic reduction** of government debt with a ratio of about 75 per cent since due to the increase of expenditures and the **advance payments** needed to accelerate the absorption of EU funds by the budget, the financing needs of the general government will be very high and its level relative to GDP lower than that expected by the government.

The rate of inflation is likely to accelerate slightly, totalling **0.8 per cent** in the average of 2016 and 1.5 per cent at the end of the year, year on year. The **0.9 per cent reference rate** of the National Bank of Hungary will hardly change in the course of 2016, the exchange rate of the forint to the euro is projected to average HUF315. With Brexit, money market volatility is on the rise.

Hungary's combined current and capital account has produced surpluses in almost every year since 2009; the surplus reached EUR9.5 billion in 2015. **In 2016, this surplus will drop to EUR8 billion due to the reduction of EU funds** in spite of **sharply growing current account surplus**. In the past seven years, **Hungary's capital stock** (apart from the enforced recapitalisation of the banking sector) did not change as the net result of international capital movements. This is a sharp critic of the domestic international investment environment. FDI has been replaced by EU transfers. In 2015, **net FDI figures reflected capital withdrawal of around EUR0.2 billion**, and **no turnaround can be expected in this trend**. Other countries of the CEE region did not substitute but complemented FDI by EU funds.

The financing surplus that is outstandingly high by even international standards makes incomprehensible the policy of the NBH aiming at the continuous weakening of the exchange rate of the forint to the euro. In fact, a slight and **cautious appreciation would be justified**. This may help the gradual catching up of wages to the EU average and keeping the skilled labour force in Hungary. It is true, however, that it would not bring hundreds of billions of euros to the central bank that it could invest in a non-transparent way.

Compared to the projection of **GKI**, **slower rates are most probable than higher ones regarding GDP growth and inflation**, However, the **effects** of the management of **several political risks**, such as the refugee crisis and the direction of the future development of the EU may be **much more significant than those of other usual economic risk factors**.

The forecast of GKI for 2016

	2012	2013	2014	2015	2016 forecast			
	fact				September	December	March	**June**
Production of GDP	98.3	101.9	103.7	102.9	102	102.3	102.3	**102**
• Agriculture (1)	79.0	115.3	113.9	87.1	100	105	105	**110**
• Industry (2)	97.8	97.5	106.7	106.3	104	104	104	**102**
• Construction (3)	93.7	105.8	112.3	102.9	102	100	95	**85**
• Trade (4)	99.4	106.3	104.3	105.7	101	103	103	**106**
• Transport and storage (5)	101.1	101.0	102.4	101.7	101.5	101.5	101.5	**102**
• Information, communications (6)	101.0	103.9	101.4	102.9	102	103	103	**103**
• Financial services (7)	97.2	95.2	97.1	99.8	100	102	102	**101.5**
• Real estate services (8)	98.2	100.3	99.6	101.1	102	102	102	**102**
• Professional, scient., techn. and adm. activities (9)	100.7	103.6	105.8	105.6	103	103	103	**105**
• Public administration, education, healthcare (10)	101.6	106.7	97.8	100.6	100	100	100	**101**
• Arts, entertainment (11)	97.3	100.0	104.8	106.0	102	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	**102**
GDP domestic demand	97.0	101.2	104.2	101.5	100.3	101	101	**101.5**
• Private consumption	97.7	100.6	101.5	102.6	101.5	102.3	103	**104**
• Gross fixed capital formation (investments)	95.6	107.3	111.2	101.9	95	95	95	**92**
Foreign trade in goods								
• Exports	100.9	104.8	107	108.4	105.5	106	106	**106**
• Imports	100.0	105.0	108.5	107.8	104	105	105.5	**106**
Consumer price index (preceding year = 100)	105.7	101.7	99.8	99.9	102.5	101.7	100.8	**100.8**
Balance of current and capital account								
• EUR billion	4.3	7.7	6.3	9.5	7.5	7	8	**8**
• In per cent of GDP	4.3	7.5	6.0	8.7	6.8	6.2	7.2	**7.2**
Unemployment rate (annual average)	11	10.2	7.7	6.8	7	6.7	6.5	**5.8**
General government balance in per cent of GDP (ESA)	-2.3	-2.4	-2.5	-2.0	-2.3	-2.3	-2.3	**-2.3**

Source: HCSO, **GKI**