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

The decline of around 7 per cent this year and deteriorating equilibria will be followed by a relatively slow correction next year

Forecast of GKI Economic Research Co. for 2020-2021 (September 30, 2020)

In mid-March 2020, **GKI** outlined two scenarios with a GDP fall of 3 per cent and 7 per cent, respectively in its forecast for 2020. **At that time, even the first scenario was a very pessimistic prognosis.** In June, **GKI** ruled out the possibility of a 3 per cent recession and set the expected rate of decline in the 5-7 per cent range. Owing to another wave of the pandemic, **GKI** now, in September 2020, considers **only the -7 per cent forecast** to be viable, adding that not only a better but also a worse situation may develop. After a 6.1 per cent decline of GDP in the first half of the year (and a 13.6 per cent in the second quarter), **GKI** expects a contraction of around 8 per cent in the second half of 2020. The rate of GDP decrease may have reached around 7 per cent in the third quarter (when the impact of the pandemic was smaller) and around 9 per cent is projected in the fourth quarter, based on available limited data and the **GKI** economic sentiment index. **GKI** still expects a 4.5 per cent recovery in 2021, with high uncertainties, and assumes that growth will only start in the second quarter compared to the same period last year. The Hungarian economy will **probably reach the GDP level of 2019 only in 2022**. The change in Hungary's GDP is expected to be slightly more favourable than the EU average; however, in a regional comparison it will be only weak-medium.

Although **GKI's** -7 per cent forecast for 2020 is **the same as the EU's forecast**, its 4.5 per cent projection for 2021 is more pessimistic than the EU's 6 per cent forecast. The government announced a 5.1 per cent expected decline for this year, and the National Bank of Hungary, after anticipating growth for this year even in August, forecasts a decline of 6.8-5.1 per cent for 2020 and envisages a growth rate of 4.4-6.8 per cent in 2021. These are only **slightly more optimistic** figures than those projected by **GKI**.

One of the main factors shaping the world economy in 2020 and 2021 will be the coronavirus pandemic and its consequences. The **pandemic causes both a demand and a supply shock**, which affects national economies differently depending on their treatment of the pandemic, their economic structures and other country-specific factors. Political and economic decision-makers focused on health considerations in the spring, whereas **they are giving preference to minimizing the economic damage caused by the pandemic in the current, early autumn phase of the pandemic**. According to the EU and the OECD, GDP may reach its 2019 level in 2022 at best.

Disruptions in global supply chains as well as stagnant or declining production as a result of measures restricting the movement of people played a major role in the economic downturn worldwide in the spring. However, this was **increasingly** complemented by declining **demand** caused by loss-making companies nearing towards bankruptcy, rising unemployment and declining incomes, general business and household uncertainties, and later this became a **determining factor**. Imports, investments and consumer demand also declined. **The size of the pandemic and the government's measures to curb the economic crisis have played and continue to play a significant role in the depth of the crisis.**

The **EU's economic sentiment index** was rising month-on-month since its fall in March, and especially in April, and it eliminated **about 60 per cent** of its fall due to the pandemic by August. Although the European economic outlook is improving, it is still quite **pessimistic**, and it could hardly improve in September when the pandemic worsened. **GKI's** economic sentiment index eliminated only almost half of its April fall by September, and the improvement already stopped in August.

Economic policy responds to the crisis in accordance with the nature of the Hungarian model established a decade ago. While the centralized, state- and non-market-oriented, loyalty-based economic and social governance is being expanded, and the money spent in principle on crisis management is redistributed according to political considerations; very little has been done to prepare health and education for the new situation in order to help the main losers of the crisis. The government **acknowledged the fact of a much more severe recession and imbalance than expected** and decided again to increase foreign indebtedness in order to improve the financing of Hungary's debt. **Relations with the EU are tense.** The National Bank of Hungary (NBH) found itself in a difficult situation due to its unreasonably loose monetary policy. High inflation would require tightening, whereas curbing the downturn would require loosening. **The NBH was compelled to announce more realistic monetary conditions and economic forecasts; however, its credibility eroded sharply.**

This year's official wage increase is overestimated significantly for methodological reasons, the genuine gross wage increase may be much smaller and the actual **real wage increase may be minimal**. Trends are well illustrated by the fact that personal income tax revenues rose by only 5.5 per cent in April after 9.1 per cent in March, by 2.4 per cent in July and 3.2 per cent in August (the first eight-month average was 4.2 per cent). Compared to last year, the real value of pensions is declining due to the lack of pension premiums and the underestimation of inflation (as a result of changes in the consumption structure), social benefits stagnate nominally and entrepreneurial incomes are falling. Thus, **real income will decrease by 1-2 per cent in 2020 and household consumption by 2.5 per cent**. Gross earnings may rise by an average of around 5 per cent **in 2021**, with high differences around the average. Real wages may rise by 1-1.5 per cent, which, taking into account the expansion of employment, would mean an increase in real earnings of around 2-2.5 per cent. As a result of the gradual restoration of the 13th month pension, the real pension will increase by 2 per cent. It is likely that it will also be possible to pay pension premiums, which will result in a further 1 per cent growth in real pensions in 2021 (that is, a total increase of 3 per cent) as they were not included in the 2020 base. As households seek to "smooth out" income fluctuations in consumption, household consumption will go up by around 3 per cent next year (thanks to the resumption of borrowing and the statistical consequence of its decline in the previous year), that is, **it will exceed its 2019 level** (unless the pandemic gets a new impetus next year).

However, due to the pandemic, **investments** will fall faster than GDP (by 10 per cent this year), making a reduction of the investment rate to 27.5 per from last year's 28.6 per cent. In 2021, even in a favourable case, only a 7 per cent increase in the volume of gross fixed capital formation can be expected, that is, the 2019 level will not be reached yet. However, the investment rate will rise. Although significant amounts of cheap resources support the investment projects of firms, **the size and structure of future demand are uncertain**, causing many firms to **postpone** their previously planned investments. **GKI** forecasts that the share of EU transfers in investments will average 11-12 per cent in 2020-2021. **The dynamizing role of EU transfers will end after 2020.**

Of the individual **sectors**, only telecommunications and finances are expected to expand their GDP production (modestly, by around 2 per cent) this year, whereas other sectors will typically shrink by 5-10 per cent. The decline in industry and construction will be above average, at around 10 per cent. Although trade itself may even grow among commercial sectors, catering, tourism and entertainment are going through a serious crisis.

GKI expects an **employment decline of around 2-2.5 per cent on average in 2020 and around 3 per cent at the end of the year and an annual average unemployment rate of at least 4.5 per cent and around 5.5 per cent at the end of the year**, taking into account the intensification of the pandemic in the autumn. The unemployment rate was still 3.3 per cent at the end of 2019. The abolition of domestic wage subsidies on 31 August, which targeted only a narrow circle, also plays a role in these unfavourable trends. Employment is expected to increase by 1 per cent on average in 2021 and unemployment will be around 4.5 per cent, similarly to 2020, though with a continuous improvement during the year. However, structural tensions in employment may increase further. The deteriorating standard of education also plays a role in this. Demographic trends project shrinking labour supply.

In order to mitigate the effects of the crisis, **credit institutions** are tightening lending conditions this year and they expect a sharp decline in credit demand due to significant uncertainties. The moratorium on loan repayments has been a great help to those affected; however, **once the moratorium expires, the rate of non-performing loans**, which is currently low, **could rise drastically**. The liabilities of companies towards suppliers are, of course, not subject to a moratorium, which poses a serious risk. The spill-over effects of this problem may trigger a domino effect in the economy. The Hungarian banking system is expected to be **loss-making** in 2020. However, the liquidity situation of the sector is stable. With the extension of the moratorium, 2021 is not expected to be a good year for banks either. However, with the recovery of funds placed until then and the resumption of repayment following the moratorium, **the banking system is expected to make profits again, despite its deteriorating portfolio**. This is also due to the fact that the additional spending needed to stimulate public demand is largely financed by the banking system, providing a stable and almost risk-free return.

The finance minister announced in August that the general government deficit would be 7-9 per cent of GDP in 2020. The Government Debt Management Agency (ÁKK) amended its annual financing plan accordingly, announcing in August that it already foresees a cash-flow deficit of HUF3,600bn this year. This is almost **ten times** what was envisaged in the budgetary law passed in 2019. Developments in the general government—in the absence of a publicly announced budget, amid constant government improvisations—are in fact **opaque** from the outside. **GKI** considers the 7-9 per cent forecast for the general government deficit relative to GDP by the Ministry of Finance realistic. As the 7 per cent GDP decline expected by **GKI** is deeper than the 5.1 per cent forecast of the Ministry of Finance, a deficit around 9 per cent is more likely. Accordingly, the **government debt** relative to GDP may rise from 66.4 per cent last year to around 78 per cent this year, approaching its level of ten years ago.

Statistically measured Hungary's **inflation rate** fell markedly from 4.7 per cent at the beginning of 2020 until May, but it rose again to 3.9 per cent in August 2020, reaching the top of the target band of NBH. The Hungarian inflation rate is the highest in the EU. The EU average was 0.4 per cent in August, whereas the euro area registered deflation (–0.2 per cent). The outstandingly high Hungarian price index can mainly be explained by the rise in food prices and the weakening of the exchange rate of the forint to the euro, whereas the low level of foreign prices and the slowdown in the growth of domestic purchasing power limit it. Seeing the weakening of the forint in September and the risk of its continuation, the NBH decided to **raise interest rates effectively** at the end of September, by pushing up the interest rate on one-week deposit tenders from 0.6 per cent to 0.75 per cent. **Further tightening of monetary conditions may be needed, at least through unconventional instruments** in 2020 and 2021. The **exchange rate of the forint to the euro weakens systematically**, 1 euro averaged 275.4 forints in 2010 and 325.4 forints in 2019 (18 per cent depreciation). Since the beginning of the year, the forint has weakened by almost 10 percent against the euro. The average exchange rate for the first eight months of 2020 was HUF346.5, though towards the end of September it reached even HUF366. As the NBH does not appear to be changing its loose monetary policy, **an average annual exchange rate of around HUF350** (HUF360 at the end of the year) **is expected in 2020** (a further weakening of 7.5 per cent year-on-year). **The annual average euro exchange rate may be around HUF365 in 2021.**

The deterioration in the **current account balance** was mainly due to the melting of previously huge surpluses in the trade of goods and services. The foreign trade surplus of EUR3bn in the first half of last year dropped to EUR0.5bn this year, with a deficit in the second quarter. The current account deficit may rise to EUR3bn in 2020, and taking into account a similar inflow of EU transfers, the **external financing capacity could be around 0**, or slightly higher. Foreign trade may improve the current account in 2021, and assuming a deficit of EUR2bn and an EU transfer similar to this year, the **external financing capacity may reach around EUR1bn**. In order to finance the general government and to increase Hungary's foreign exchange reserves, the Hungarian government borrowed foreign currency loans, **forcibly giving up the principles of debt policy** pursued in recent years. Therefore, Hungary's net foreign debt increased by EUR2.1bn in the second quarter of the year compared to the previous one. Through borrowing and EU transfers, the central bank reserve increased by EUR4.4bn to EUR30.2bn at the end of June compared with the previous quarter. During the year, if only due to the decline in GDP, the external **debt ratio** will rise, and it may stabilize in 2021.

The forecast of GKI for 2020-2021

	2018	2019	2020	2021
GDP	105.1	104.9	**93**	**104.5**
• Agriculture (1)	104.8	99.7	**100**	**100**
• Industry (2)	100.5	105.0	**90**	**104**
• Construction (3)	118.9	121.4	**90**	**108**
• Trade (4)	113.6	108.0	**95**	**105**
• Transport and storage (5)	103.7	105.3	**85**	**104**
• Information, communications (6)	111.1	106.3	**102**	**105**
• Financial services (7)	104.1	103.9	**102**	**103**
• Real estate services (8)	102.8	104.3	**95**	**105**
• Professional, scientific, technical activities (9)	111.6	106.7	**90**	**107**
• Public administration, education, healthcare (10)	100.4	98.6	**95**	**102**
• Arts, entertainment (11)	103.7	102.5	**85**	**105**
• Core growth (2)+(3)+(4)+(5)+(6)+(7)+(8)+(9)	106.5	107	**92**	**105**
GDP domestic demand	107.3	105.6	**97**	**104.5**
• Private consumption	104.0	104.4	**97.5**	**103**
• Gross fixed capital formation	117.1	115.3	**90**	**107**
Exports (goods and services)	104.3	106.0	**83**	**107.5**
Imports (goods and services)	106.8	106.9	**87**	**107.5**
Consumer price index (preceding year = 100)	102.8	103.4	**103.5**	**103.8**
Unemployment rate (annual average)	3.7	3.5	**4.5**	**4.5**
General government balance in per cent of GDP (ESA)	-2.3	-2.0	**-9**	**-5**
Balance of the current and capital accounts				
• EUR billion	3.0	1.4	**0**	**1**
• In per cent of GDP	2.2	1.0	**0**	**0.7**

Source: HCSO, GKI