Fighting against the virus and the rule of law

(GKI's forecast in December 2020)

According to the HCSO, economic developments picked up significantly in the third quarter of 2020 compared to the previous one, faster than expected. However, we already know that the fourth quarter will certainly be significantly worse. This is due to the second wave of the pandemic, the dampening effects of restrictive measures on supply and demand, and the impact of all this in deteriorating economic expectations. Looking at the trends, GKI is not going to change its September "W"-line forecast, expecting a decline again in the fourth quarter after a large downturn in the second one and an improvement in the third one. However, based on favourable third-quarter data, GKI is reducing its forecast of downturn for the fourth quarter from 9 per cent to 7 per cent and the annual decline in GDP from 7 per cent to 6 per cent. This is still close to, but slightly more optimistic than the government's and the EU's 6.4 per cent forecast, though somewhat more pessimistic than the OECD's 5.7 per cent forecast published in recent days. There is also a general consensus that Hungary's GDP will probably reach the level of 2019 only in 2022: GKI expects a 3.5-4 per cent (3.7 per cent) expansion in 2021. The EU's forecast is 4 per cent, and that of the OECD is only 2.6 per cent. These economic trends are accompanied by huge general government deficit, higher unemployment and inflation than before, and a very weak forint and deteriorating current account balance. The blackmailing ability of Hungarian and Polish politics won a modest battle against the EU as far as the rule of law is concerned. However, due to the general resentment in the EU, this may have serious negative consequences.

The growth rate of the **world economy**, after declining by 4.3 per cent in 2020, will be 4.6 per cent in 2021 (primarily due to rapid growth in China) and 3.6 per cent in 2022. The combined GDP of the **EU and the euro area** will fall by 7.4 per cent and 7.8 per cent, respectively in 2020 and then increase by 4.1 per cent and 4.2 per cent in 2021, respectively. **Germany's** GDP will grow by 3.5 per cent in 2021 after a 5.6 per cent decline in 2020. World trade will fall by 10.5 per cent in 2020, and a growth of 6.2 per cent can be expected in 2021 and 4.5 per cent in 2022. **In the UK**, a 10.3 per cent recession in 2020 will be followed by a 3.3 per cent increase in 2021. The current state of negotiations has increased the likelihood of a **secession from the EU without a deal** on 31 December this year, exacerbating the effects and consequences of the pandemic. The situations **in Greece and Italy are the worst** in the EU. In the longer term, reducing the increased government debt will be one of the biggest challenges facing EU member states. The impact of the coronavirus pandemic on global value chains cannot be assessed yet. However, risk-sharing and the pursuit of security will intensify.

After improving for almost six months, the **EU's economic sentiment index** fell sharply in November, falling back to its August level. The confidence indices of industry, trade and services **declined** noticeably, whereas that of construction decreased only within the statistical margin of error. The consumer confidence index fell to its six-month low. After rising for five months, EU employment expectations deteriorated in October and November as well. From a Hungarian point of view, however, it is favourable that the German industrial confidence index stagnated in November, remaining at a 17-month high.

GKI's economic sentiment index fell sharply in November, falling below its level of early summer. This is a consequence of falling business expectations. In the **business sector**, the confidence indices of services and trade fell dramatically, close to their lowest points in April, and the increase in pessimism in industry was also very significant. However, construction companies became more optimistic markedly, although this is far from their pre-pandemic optimism in March. This improvement was presumably due to the new government measures to support housing construction and renovation. The **consumer confidence index** rose minimally in November, although due to its decline in the previous three months, it also fell short of its

June level (within the statistical margin of error). (The fact that households were interviewed in early November and companies in mid-November may play a role in the different trends in November.) In December, however, the consumer confidence index **fell** to its May level.

The **willingness of the business sector to employ** weakened again in November, and the number of companies planning to reduce their staff exceeded again that of those intending to increase it. The deterioration in services was dramatic, its rate was close to that of April. In construction, on the other hand, intentions to employ even strengthened. The fear of unemployment of households weakened slightly after three months of decline. **Intentions to raise prices** decreased in all sectors with the exception of services, whereas the inflationary expectations of consumers strengthened further. The **assessment of the future of the Hungarian economy** in the business sector this year, with the exception of April, has never been as pessimistic as in November, and the deterioration was most significant in services. However, households became a little more optimistic.

The Hungarian government 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. No coherent crisis management programme has been announced, and the apparently outdated budgets for 2020 and 2021 have not been amended. The measures of the government serve partly to maintain and even increase the support of its beneficiary groups, and partly to make the financial positions of opposition parties, local governments and independent non-governmental organizations that endanger the power of the government impossible. By changing the focus of Hungarian economic policy to **revitalization instead of economic protection**, it has become possible to support the investments and acquisitions of **loyal business circles**, while in the absence of government assistance, much more companies and families are in crisis than would be inevitable.

The essence of the debate with the EU on the rule of law is to protect a narrow, powerful **political and economic interest group**. This was also the aim of the Hungarian government's joint veto with the Polish government on the EU's crisis management fund, which was eventually withdrawn. Although Hungarian politics currently has **the ability to blackmail rather than constructively enforce its interests**, the government was able to use this ability maximally. However, due to the general resentment in the EU, this may have serious **negative consequences**.

Hungary's share of the EU's crisis management fund amounts to **almost EUR8bn in grants and EUR10bn in soft loans**. However, a smaller proportion of the long-term EU borrowing to cover the grants is expected to be financed after 2027.

The Hungarian GDP growth figure for the **third quarter** (a decline of 4.6 per cent year-on-year) is not only much more favourable than the 13.6 per cent decline in the second quarter (this was expected anyway) but it is better than the typically expected 5-6 per cent contraction or the 6.9 per cent fall expected by the EU. Hungarian data are **slightly weaker than the EU average (by 0.4 percentage points) and weak or medium in the region**. The declines in Poland, Slovakia, Slovenia and the three Baltic countries are significantly smaller, whereas in Croatia and Romania they are significantly larger, and in the Czech Republic and Bulgaria they are slightly larger than in Hungary. The German downturn, which is particularly important to us, was slightly lower than the EU average.

As far as **real economic trends** are concerned in Hungary, the actual consumption of households fell by 2.2 per cent year-on-year **in the third quarter**, whereas public consumption by 4.8 per cent. Gross fixed capital formation decreased by 13.4 per cent. Industry (-2.4 per cent) and trade (including tourism, -1.8 per cent) roughly recovered, whereas construction plummeted (-18 per cent). The info-communications sector soared (+5.3 per cent) and despite the loan repayment moratorium, the financial sector also performed well (+2.9 per cent). Although tourism, catering and entertainment in particular will suffer from the effects of the restrictions due to the pandemic **in the fourth quarter**, the decline in demand could affect almost all sectors. After the sharp decline in 2020, growth can be expected in all sectors from the second quarter in 2021.

This year's **official wage increase is overestimated significantly for methodological reasons**, the actual **real wage increase may be minimal**. Trends are well illustrated by the fact that after a 9.1 per cent rise in March, **personal income tax revenues** rose by only 2.4 per cent in July (the lowest point until now), and **by only 4.4 per cent on average in the first ten months**. Considering that the officially 3.5 per cent inflation rate was severely underestimated due to a significant change in the structure of the consumer basket used to measure it; the purchasing power of real wages may in fact have stagnated. Pensioner inflation is higher than the average consumer price increase, and the purchasing power of pensioners is reduced by the lack of a pension premium compared to last year, and entrepreneurial incomes are declining, while social benefits are typically nominally unchanged. As a result, it can be rightly assumed that **the real income of households decreased noticeably**. The difference between the official average earnings and the growth rate of total personal income tax indicates an increasing differentiation of society, which is logical due to the deteriorating employment situation anyway. GKI expects a **2.5 per cent decrease in consumption in 2020, and an expansion of around 3 per cent in 2021**, assuming a 4-5 per cent increase in gross earnings, the payment of the first week of the 13-month pension and an improvement in consumer confidence, as well as in view of the forthcoming parliamentary elections.

However, due to the pandemic, **investments will fall** faster than GDP in 2020, **by 10 per cent**, making a **reduction of the rate to 26 per cent (by more than 1 percentage point)** likely. **Investments are expected to grow by 4 per cent in 2021.** Although significant volumes of cheap resources support the investment projects of firms, **many of them postpone their previously planned investments due to the uncertainty of future demand**. The CEE region, including Hungary, **may benefit from the restructuring of global supply chains** in the medium term (especially in the field of batteries and electric motors).

After an 8 per cent decline in 2020, gross industrial production may expand by 4-5 per cent in 2021 and 7-8 per cent in 2022. According to GKI, **construction** output may fall by just over 10 per cent this year. Although **construction is expected to grow by around 5 per cent in 2021**, substantial expansion is more likely only in the second half of the year. The **technological backwardness of Hungarian agriculture** was also highlighted by the shortage of guest workers in the spring. Agricultural GDP is expected to decline by 2 per cent in 2020, and the growth level in 2021 will be largely dependent on the weather. **Retail turnover** will stagnate in 2020 at best, and it is expected to expand by 2-3 per cent in 2021. Although the growth rate of online trade will be far above average, around 30 per cent in 2020, it is likely to slow down next year. **Tourism** is one of the main losers in the pandemic. Although domestic turnover picked up substantially in the summer (even if it was lower than a year earlier), foreign turnover, especially in Budapest, was still very weak. As a result, in the first ten months of 2020, foreign guests spent only a quarter of guest nights in commercial lodgings a year earlier, and domestic guests spent only a third. A further deterioration is expected due to the second wave of the pandemic during the rest of the year, and only a partial recovery can be expected next year. In 2020, both volume and performance of **freight transport** are expected to **decline by around 10 per cent**, with pipeline and road transport sectors suffering the largest declines. With the recovery of the economy, a **moderate expansion is likely in 2021**, within which rail freight transport can expect a slower correction, and road transport a slightly faster one. **Telecommunications are one of the few sectors that was able to grow in 2020 as well.** The sector's GDP production in 2021 could be around 4-5 per cent. Households' expectations for housing construction and purchase picked up slightly, partly as a result of the announced measures. GKI predicts that **17-18 thousand new homes will be built in 2020 and 15-17 thousand new homes in 2021**. In the office space market, the **demand for offices is declining** partly due to the narrowing of tenants' financial opportunities and partly due to the spread of home office. In **foreign trade in goods**, turnover fell sharply in the first half of 2020, and the surplus declined markedly due to a stronger decline in exports. The situation **improved temporarily** in the summer months, and the foreign trade surplus in the first three quarters was already slightly higher than a year earlier, driven by a 2.2 per cent improvement in terms of trade (mainly due to lower world energy prices). At the same time, a slowdown again can be expected in the fourth quarter due to the pandemic. The balance is unlikely to rise, though it will still be higher than in 2019. **The increase in foreign trade surplus in services, which has been characteristic of recent years, was clearly broken in 2020, mainly due to the decline in tourism and international transport.** The **foreign trade balance of goods** will be around EUR4.5-5bn in 2021 after EUR4.5bn in 2020, and the **foreign trade balance of services** may increase from close to EUR5bn in 2020 to close to EUR6bn in 2021 as the pandemic eases. However, it will still be far behind its value of EUR8.8bn in 2019.

The **number of employed** will decline at a much slower rate than that of GDP in 2020, by an annual **drop of 1.5 per cent**. As far as the **official** data of the **number of employees** is concerned, the expected decline in 2020 will be more significant, **around 4 per cent**, and the employment capacity of the business sector will suffer mainly from the crisis (-5 per cent). According to the labour force survey, an average **unemployment rate of 4.5 per cent** is expected in 2020, which will be similar in 2021, too. However, while unemployment was lower at the beginning of the year in 2020, it will be lower at the end of the year in 2021.

The **current account balance** was positive from 2010 to 2018, then turned to a deficit of EUR0.4bn in 2019. Although the **deficit** was EUR0.8bn in the first three quarters of 2020, Hungary's **external financing capacity remained at a high level** (EUR1.6bn) due to the inflow of EU transfers. 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 current account deficit may rise to EUR1.5bn in 2020, and taking into account the around EUR3bn inflow of EU transfers, the external financing capacity could be around EUR1.5bn. Foreign trade may improve the current account in 2021; however, the income deficit may increase, thus in the end an amount similar to 2020 can be expected.

This year's **general government** cash-flow deficit will be about **ten times higher** than envisaged in the budget law, and the **deficit** (accrual-based, ESA) **will be around 9 per cent** of GDP and the **government debt will be around 78 per cent**. The deficit will barely shrink **in 2021**, to about **7 per cent** of GDP. Partly because of the carry-over effects of crisis management, and partly because of the forthcoming 2022 elections, the **deficit reduction ambition** will be missing during the advancement of EU transfers. This will also be made possible by the EU's crisis management fund and the further suspension of the 3 per cent deficit ceiling in Europe. **Government debt** is expected to remain below 80 per cent of GDP in 2020 (around 78 per cent); however, it will substantially exceed 80 per cent in 2021, bringing it above its 2011 peak.

The National Bank of Hungary continued its **loose monetary policy** in 2020 and it is expected to be maintained in 2021 and 2022 as well. The base interest rate of 0.6 per cent is not expected to change, inflation will remain high, its slowdown is unlikely, and the forint will weaken further. At the same time, in practice the NBH **somewhat tightened** its policy in 2020: seeing the weakening of the forint in September and the risk of its continuation, it decided to raise interest rates effectively by pushing up the interest rate on one-week deposit tenders from 0.6 per cent to 0.75 per cent. After 3.4 per cent in 2020, GKI expects a similar price increase in 2021, around 3.5 per cent. The exchange rate of the forint weakens in a trend-like manner, at the end of November 2020 the forint was 9 per cent weaker compared to the beginning of the year. The annual average exchange rate of the forint to the euro is expected to be HUF351 **in 2020** (close to HUF360 at the end of the year), corresponding to **an annual average weakening of 7.5 per cent**. An average annual exchange rate of **HUF360 is likely in 2021** (possibly even weaker).

The forecast of GKI for 2021

	2018	2019	2020	2021	
	(fact)		(est.)	September	December
GDP	105.4	104.6	**94**	104.5	**103.7**
• Agriculture (1)	104.1	100.4	**98**	100	**100**
• Industry (2)	103.3	104.1	**93**	104	**104.5**
• Construction (3)	115.1	113.0	**90**	108	**105**
• Trade (4)	109.9	110.1	**95**	105	**104**
• Transport and storage (5)	106.5	105.2	**85**	104	**104**
• Information, communications (6)	110.4	108.8	**104**	105	**105**
• Financial services (7)	104.9	108.1	**103.5**	103	**102**
• Real estate services (8)	104.5	98.9	**97**	105	**100**
• Professional, scientific, technical activities (9)	109.6	106.5	**90**	107	**107**
• Public administration, education, healthcare (10)	100.9	100.3	**97**	102	**102**
• Arts, entertainment (11)	107.6	106.5	**85**	105	**105**
• Core growth (2)+(3)+(4)+(5)+(6)+(7)+(8)+(9)	106.8	105.9	**94**	105	**104**
GDP domestic demand	107.1	106.0	**95.7**	104.5	**103.3**
• Private consumption	104.5	104.2	**97.5**	103	**103**
• Gross fixed capital formation	116.4	112.2	**90**	107	**104**
Exports (goods and services)	105.0	105.8	**91**	107.5	**107.5**
Imports (goods and services)	107.2	107.2	**93**	107.5	**108**
Consumer price index (preceding year = 100)	102.8	103.4	**103.4**	103.8	**103.5**
Unemployment rate (annual average)	3.7	3.5	**4.5**	4.5	**4.5**
General government balance in per cent of GDP (ESA)	-2.3	-2.0	**-9**	-5	**-7**
Balance of the current and capital accounts					
• EUR billion	3.4	2.1	**1.5**	1	**1.5**
• In per cent of GDP	2.5	1.4	**1.1**	0.7	**1.1**

Source: HCSO, GKI