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# Recession, accelerating inflation, worsening external balance

The forecast of GKI Economic Research Co. for 2022-2023 (closed: Sept. 23, 2022)

**GKI's current forecast was made in a context of even greater uncertainty than usual, and understanding trends was complicated by the sharp change in economic developments in the middle of the year. GKI raised its growth forecast for 2022 from 3.7 per cent to 4.5 per cent, while for 2023 it no longer forecasts a growth of 2.7 per cent, but a decline of around 3.5 per cent. The revision is justified by faster-than-expected growth in the second quarter of 2022, a spectacular deterioration in the equilibrium, the increasingly dangerous global political and economic situation, and the austerity measures taken and expected during the year, which will have an impact in 2023. In addition, GKI assumes the continuation of the current external environment, with slow but at least partial access to EU transfers. While consumption may increase by 7.5 per cent this year, it is expected to fall by 3.5-4 per cent next year, and investments may fall by double-digit figures after this year's stagnation. After falling to 3.5 per cent this year, unemployment will be slightly higher next year than in 2021, at around 4.3 per cent. GKI raised its inflation forecast significantly to 14.5 per cent this year and to around 16 per cent next year; however, it expects inflation to fall rapidly to around 10 per cent in the second half of 2023. The general government deficit relative to GDP will be higher than currently planned, at around 6.5 per cent this year and around 5 per cent next year, and the financing needs relative to GDP will be alarmingly high, at 5 per cent and 3.5-4 per cent, respectively, even if EU transfers start to flow in. This will necessarily cause a threatening rise in foreign debt. The government interprets the EU's rule of law requirements and forced austerity as a technical issue, a task to be implemented within the framework of the state-centred Hungarian model, so no substantive changes can be expected in competitiveness or social policy for the time being.**

The rapid growth in the last five quarters has clearly been driven by the low base due to the Covid crisis and the **recovery**. But it was also the result of the **excessively stimulating electoral economic policy**, which specifically aimed to maximise especially consumption and investments before the April elections. All this led to a predictable dangerous **deterioration** of the **equilibrium**, such as accelerating **inflation**, a **weakening forint**, and a surge in internal and external **deficits**. This economic policy, which is unsupportable in the long term, was made **completely unsustainable** by the gas prices that soared in the summer as a result of the Russian-Ukrainian war. As a result, the government announced **measures to improve the balance**, increase the tax revenues of the budget and reduce expenditure, **austerity** measures with an **inflationary effect**, and was forced to **make concessions** in the negotiations **with the EU**.

The first painful but mostly necessary macroeconomic consequences of austerity and the **first signs of a contraction in domestic demand** are already visible. **Food trade** turnover already fell in June and July, by more than 3 per cent in the latter month. **Household borrowing** was 10 per cent higher in the first half of the year than in the same period last year, but 25 per cent lower in July. **Construction** output rose by 11.5 per cent in the first five months of the year, but fell by 8 per cent in June. Although production increased again by 3 per cent in July, the stock of contracts projects a decline. At the end of July, this lower than a year earlier and new contracts in June and July were on average 20 per cent lower than a year ago. **Unemployment** was low but rose slightly in July and August (from 3.3 per cent to 3.5 per cent and then to 3.6 per cent). Hungarian **inflation**, one of the lowest in the CEE region (11 EU countries) for many years, was already the fourth highest in August. **Economic expectations** are deteriorating. At the same time, **external equilibria** continues to deteriorate, mainly due to the deterioration in the terms of trade caused by the rise in energy prices. After EUR6bn in the first seven months, the current account deficit for the year could reach EUR13bn, or around 7.5 per cent of GDP.

The rate of GDP growth is slowing compared to the previous quarter, with 2.1 per cent in the first quarter of this year followed by 1.1 per cent in the second quarter. Stagnation is expected in the third quarter and **recession** from the fourth quarter **until mid-2023**. In the case of consumption, this year's very significant nominal income growth is increasingly **eroded** by inflation, which in part is due to this income growth. While in the first quarter **net earnings** rose by 21 per cent due to one-off payments and inflation increased by 8.5 per cent, resulting in real earnings rising by almost 12 per cent. They **could fall by 3.5 per cent in the fourth quarter due to inflation of around 20 per cent**. Household consumption growth is gradually slowing from 11.5 per cent in the first quarter to around 2 per cent by the end of the year; however, it would still represent a very dynamic **7.5 per cent** growth for the year as a whole. The **2023 budget** adopted this summer projected an increase in average earnings of around 10 per cent (with a 5.2 per cent rise in prices). The latter is clearly **unrealistic**, but to avoid the inevitable constraint on domestic demand and a **wage-price spiral**, national average earnings cannot follow expected inflation. GKI forecasts a minimum wage increase of around 10 per cent, perhaps 1-2 percentage points higher. Gross earnings are expected to rise by around 13 per cent, while annual inflation averages around 16 per cent, and by the end of 2023 it could be around 10 per cent. This implies a **3.5 per cent decline in real earnings**, and a larger **decline** in real incomes due to the high base of payments in early 2022, the non-payment of the pension premium, the depreciation of the family allowance and the decline in entrepreneurial earnings. **Consumption** is expected to **decrease by 3.5-4 per cent**, taking into account the increase in borrowing and repayments, with a very high degree of **differentiation** among sections of the population.

The government wants to reduce the share of public investments, which is very high by EU standards, while **hoping to increase entrepreneurial investments**. However, the **question** is how much this can be expected given the uncertain domestic and foreign demand due to the proximity of war, the unpredictability of Hungarian economic policy, the reduction in the amount of money available for development, the deteriorating borrowing conditions, the limited fiscal capacity (a significant part of business development is supported by government and EU funds) and the brutal energy price hikes and restrictive market conditions. Overall, **investments could fall by up to 12 per cent** in 2023.

On the **output side**, all sectors except agriculture, which recorded a dramatic drop in output, are increasing their GDP output this year, with the best growth coming from sectors that were still underperforming a year earlier due to Covid. However, in 2023, growth may only be expected in the telecoms sector.

In the second half of this year, **export volumes** will grow faster than imports as domestic demand, and hence import demand, tightens, but in value terms the reverse will be true as energy prices rise (with the **terms of trade** deteriorating by up to 10 per cent), while income outflows may also increase. In the end, with a rather high degree of uncertainty, the **current account deficit in 2022** could reach EUR13bn, or 7.5 per cent of GDP. A similar situation can be expected **in 2023**, with a slight decline in the foreign trade deficit; however, income outflows may increase, for example, due to increasing interest charges. Last year, the **external financing capacity** was already in the negative range (-EUR0.9bn), due to a widening current account deficit and the non-availability of part of EU transfers. This year, already in the first seven months, a deficit of EUR2.9bn was accumulated, and since only the remaining amounts from the previous EU budgetary cycle are expected to be received by the end of the year, **the annual deficit could be around EUR9bn**, which is very high. **This could fall to a deficit of EUR4-5bn in 2023**, due to the slow start of transfers as a result of an agreement with the EU expected by the end of the year. This also means that a significant amount of foreign currency borrowing will still be needed this year and next year. This is because Hungary's **foreign exchange reserves** are declining despite increasing financing needs. The EUR38.4bn at the end of 2021 decreased to EUR36.5bn by August 2022.

Hungary's **general government deficit** relative to GDP (ESA) has been the second to third largest of the 11 countries in the CEE region for several years. **This year and next year**, the general government deficit relative to GDP is expected to be higher than planned (4.9 per cent and 3.5 per cent), at **around 6.5 per cent and 5 per cent**, respectively, as the high spending in the first half of this year, gas purchases, and crisis response expenditure, caused by, among other things, the increase in energy prices, are **not expected to be sufficiently offset** by additional inflationary revenues, tax increases and investment expenditure cuts. The government has already announced a **redesign** of the 2023 budget.

**Price rises** are likely to continue in early 2023, spill-over from, for example, soaring energy prices, and will depend heavily on wage increases. Even if the wage-price spiral is avoided, average price increases **in 2023** are likely to be **higher than this year's 14.5 per cent, at around 16 per cent**; however, this would mean a sharp slowdown in the second half of the year, to around 10 per cent by the end of the year. Inflation **could be significantly lower** if global energy prices normalised and monetary policy (including the interest rate freeze and investor confidence measures imposed by government decisions) were tighter and more supportive of the forint, but there is little chance of this.

The impact of imported inflation in Hungary is amplified by the **almost continuous weakening of the forint** against almost all European currencies. Distrust in economic policy (giveaways before the elections, the re-introduction of special taxes, the delay in EU negotiations) and loose monetary policy also play a role in this. The forint depreciated by almost 10 per cent against the euro by the end of August this year, while the zloty, for example, depreciated by only around 6.5 per cent. This year the euro exchange rate is expected to be around HUF400, since the compromise agreement with the EU, which foresees further disputes, is stabilizing overall, whereas the deteriorating external balance and debt can have a negative impact on the Hungarian currency. **The average exchange rate of the forint to the euro is expected to be HUF385 this year and HUF410 next year.**

The **base rate of the central bank and the benchmark interest rate** is 11.75 per cent from the end of August. This is quite low compared to August's inflation rate of 15.6 per cent, but the **negative real interest rate** of around 3.3 per cent is slightly better than the -4 per cent of the past period. **GKI expects a base rate of around 15 per cent by the end of 2022 and around 10 per cent by the end of 2023.**

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## GKI forecast for 2022-2023

| | 2018 | 2019 | 2020 | 2021 | 2022 | 2023 |
|---|---|---|---|---|---|---|
| | (fact) | | | | forecast | |
| GDP | 105.4 | 104.6 | 95.0 | 107.1 | **104.5** | **96.5** |
| • Agriculture | 105.2 | 98.0 | 91.3 | 97.8 | **70** | **100** |
| • Industry | 102.6 | 103.0 | 93.0 | 109.8 | **104** | **98** |
| • Construction | 115.2 | 113.1 | 89.1 | 115.8 | **100** | **88** |
| • Trade | 110.6 | 105.8 | 100.9 | 106.8 | **105** | **97** |
| • Commercial lodgings and catering | 107.5 | 104.8 | 57.5 | 114.1 | **150** | **92** |
| • Transport and storage | 107.0 | 105.2 | 89.5 | 109.5 | **115** | **95** |
| • Information and communication | 110.5 | 110.3 | 105.0 | 113.9 | **112** | **102** |
| • Financial services | 105.2 | 113.7 | 104.1 | 104.9 | **103** | **95** |
| • Real estate activities | 104.5 | 102.9 | 100.9 | 102.6 | **105** | **99** |
| • Professional, scientific, technical activities | 109.1 | 106.3 | 95.1 | 107.2 | **110** | **90** |
| • Public administration, education, healthcare | 100.9 | 100.6 | 96.7 | 103.9 | **103** | **98** |
| • Arts, entertainment | 107.3 | 108.8 | 86.0 | 106.3 | **105** | **90** |
| • Core growth | 107.1 | 106.8 | 97.3 | 108.6 | **106.7** | **93.7** |
| GDP domestic demand | 107.1 | 106.6 | 97.3 | 105.6 | **104.5** | **94.7** |
| • Private consumption | 104.2 | 104.5 | 98.0 | 104.3 | **107.5** | **96.3** |
| • Gross fixed capital formation | 116.3 | 112.8 | 93.1 | 106 | **101** | **88** |
| Exports (goods and services) | 105.0 | 105.4 | 94.1 | 110.1 | **105** | **99** |
| Imports (goods and services) | 107.0 | 108.2 | 96.5 | 108.2 | **105** | **97** |
| Consumer price index (preceding year = 100) | 102.8 | 103.4 | 103.3 | 105.1 | **114.5** | **116** |
| Unemployment rate (annual average) | 3.7 | 3.4 | 4.1 | 4.1 | **3.5** | **4.3** |
| General government balance in per cent of GDP (ESA) | -2.1 | -2.1 | -8.0 | -7.3 | **-6.5** | **-5** |
| Balance of the current and capital accounts | | | | | | |
| • EUR billion | 3.4 | 1.7 | 0.6 | -0.9 | **-9** | **-7** |
| • In per cent of GDP | 2.5 | 1.2 | 0.4 | -0.6 | **-5** | **-3.7** |

Source: HCSO, MNB, MoF, **GKI**


*For more information:*

*András Vértes (vertes.andras@gki.hu);*

*Gábor Karsai (karsai.gabor@gki.hu)*