A 0.5 percent decline and 19 percent inflation expected in 2023

(Summary of the March 2023 forecast of GKI Economic Research Co.)

Hungary entered a technical recession in 2022, facing serious imbalances, and it became very isolated internationally. The Russian-Ukrainian war, the related energy crisis (security of supply and prices) and the impact of the international banking crisis in 2023 on financial and real processes cause major global political and economic uncertainties. The extent and timing of Hungary's actual access to EU transfers is questionable. GKI's forecast differs from the current majority view, in particular in its assumption of a downturn this year and a slower decline in inflation, as well as in the extent of the likely delay in access to EU transfers. The background to these considerations is the assumption that the political and economic policy thinking of the government changes only at the tactical rather than at the strategic level.

- **Global economic developments—new and emerging risks**

GKI assumes that the Russia-Ukraine war will become a **frozen conflict** this year at best, with no winner and no peace, with a possible ceasefire maintaining a fluctuating level of tension. **Energy supply** will not be in deep crisis, but prices are expected to rise, even temporarily to a very significant extent, compared to the beginning of 2023. **Protectionism** is on the rise. For the time being, **tight monetary and fiscal policy** may not be pushed into the background, which will result in slower economic growth. The second largest bank failure in US history, the resulting stock market fall and risk aversion are worsening Hungary's global economic environment, but the majority view is that **this will not turn** into a wider financial crisis.

- **Economic policy—reluctant adjustment, brake pedal and accelerator pressed at the same time**

The government is expected to **give in to economic and political pressures in a reluctant and contradictory manner**, as has been the case so far. As a result, a significant proportion of EU transfers may be available in the long term, but with losses and significant delays, amidst ongoing debate. The concessions made by the government **will not qualitatively transform** the single-centre, loyalty-based and non-competitive Hungarian model. Hungarian economic policy tends to approach the European market economy only at the level of appearances, but the external deficit and the need for financing force changes. The **struggle between improving the balance and stimulating the economy** remains, which manifests itself in the continuous **eating up the future** (in the neglect of health care, education, innovation), in the **relatively high level of inflation**, which largely relieves the tensions caused by disequilibrium.

- **Economic expectations—past the trough**

Both business and consumer expectations improved significantly in March, with **GKI's economic sentiment index rising for the fifth month in a row**. Within the business sector, the most pessimistic are construction and trade, which are strongly linked to investments and consumption. Companies' efforts to raise prices declined substantially and their willingness to employ increased, as confirmed by consumer sentiment. The assessment of Hungary's economic situation was also much more favourable than in February.

- **Household consumption—up and down**

While **real earnings** increased by nearly 12 per cent in the first quarter of 2022, they decreased by 4.1 per cent in the fourth quarter, increasing by 2.6 per cent year-on-year. In 2023, with a rise in gross earnings of around 15 per cent and a 19 per cent rise in prices, **real incomes are expected to fall by 3.5 per cent**, and consumption could fall by around 3 per cent, after last year's 6 per cent increase.

- **Investments—despite the downturn, high investment rate with structural question marks**

After expanding by 2.2 per cent in 2022, fixed capital formation is expected to fall by 4 per cent in 2023, but the investment rate will remain one of the highest in the EU at 27-28 per cent, down from 28.5 per cent. There are many **question marks** about the feasibility and rationality of the government's development ideas for **energy and battery production**. Public investments are hindered by a lack of resources, including the uncertainty of receiving EU transfers, while **business investments** are hampered by the proximity of war, the unpredictability of Hungarian economic policy, the reduction of funds available for development, deteriorating borrowing conditions, the limited fiscal capacity and uncertain domestic and foreign demand due to restrictive market conditions. Preferential government programmes typically focus on a narrow group of businesses loyal to government.

- **Real economic trends—export-oriented path, domestic demand typically falling**

In 2022, the Hungarian economy was driven by the electoral stimulus, which led to a drastic deterioration in external and internal balances. In 2023, the Hungarian economy is on a forced **export-led** path, with domestic consumption, including consumption and fixed capital formation, falling. On the **production** side, agriculture could be the **most dynamic** sector after four years of dramatic deterioration, followed by export-oriented industry. The largest **decline** is expected in construction, the real estate sector and trade. The weak but improving European economic activity in 2023 provides the basis for an increase in exports of goods of about 2 per cent in volume and a slight decrease in imports, taking into account the contraction in domestic demand. The terms of trade are uncertain, the low gas price at the beginning of 2023 could be followed by a significant spike in the second half of the year, so technically GKI expects an **exchange rate improvement** of 2 per cent in 2023 after a 6.5 per cent deterioration in 2022. As a result, **the foreign trade deficit in goods could fall from EUR8.6bn in 2022 to around EUR3bn in 2023**. However, the **external trade in services** could continue to grow, to EUR10bn.

- **Employment, unemployment—deterioration that seems tolerable**

Since September 2022, **the number of employees has been falling steadily: by 0.8 per cent until January**. The **unemployment rate** has been rising since June 2022, **from 3.4 per cent in June to 4.0 per cent in February**. In 2023, average annual employment will fall by around 0.3 per cent year-on-year, after a 1.3 per cent increase last year, whereas unemployment will rise to around 4.2 per cent from 3.6 per cent last year. In the last 12 years, the number of employees increased by about 0.9 million, which is around the one million target set by the government. At the same time, the strategy announced this year, according to which employment should be increased **by 0.5 million** in one or two years, seems completely **unrealistic**. Not only because of the short duration, but also because of the lack of conditions for an increase on the labour demand and supply side.

- **General government developments—falling deficit and government debt relative to GDP will be driven by inflation**

The **general government cash-flow deficit for 2022** is **one and a half times higher** than planned, and the deficit-to-GDP ratio is **6.1 per cent instead of 4.9 per cent**. The latter is probably the third highest in the EU. **The 2023 budget contains a number of tensions.** Meeting the forecast of revenue implies a faster-than-planned inflation, which could lead to a disastrous intensification of the problems already "foreseen" on the expenditure side and to unavoidable additional payments when they are addressed.

The extent and timing of the receipt of EU transfers is questionable. Therefore, GKI forecasts a deficit of **around 4.7 per cent, higher than the planned 3.9 per cent**. The problem with the government's increased deficit target is not that it is not **more realistic than before**, but that it signals a lowering of the **deficit reduction ambition**. **Inflation will continue to help reduce the debt-to-GDP ratio in 2023**, with a rate of around 70 per cent expected this year, down from 72.9 per cent last year.

- **Inflation, interest rates, exchange rates—19 per cent average annual inflation, HUF400 to euro exchange rate and convergence of the benchmark and base rates at the end of the year**

Inflation, expected to **rise to 19 per cent** from 14.5 per cent last year, is well above the government's forecast of 15 per cent, and single-digit price rises are unlikely by the end of the year. GKI expects the **euro to weaken** by around 2 per cent to **an annual average of HUF400 in 2023 from HUF392 last year**, with continued high volatility. In particular, further delays in reaching an agreement with the EU could lead to a weakening. A further weakening of the exchange rate could be caused if the MNB, breaking with its declared caution, were to cut policy rates too soon or too much, either on its own or in response to the strong political pressure it is already experiencing. Our current forecast does not take this into account. GKI considers it realistic to start cutting the policy rate in **early summer**. The effective **benchmark rate** (the overnight deposit rate) has been 18 per cent since its introduction in mid-October, and could fall **to the base rate of 13 per cent** in 2023 if the money market situation remains stable. A decision must then be taken on whether to keep or abolish it. In a favourable case, the base rate can again take the lead, which can be reduced to up to 11 per cent in the case of an agreement with the EU involving actual cash inflows. However, this seems to be an optimistic scenario.

- **External balance—declining but high deficit, key issue is the future of EU transfers**

The **current account** deficit could fall to around EUR9bn this year, from EUR13.1bn last year, and **the financing needs could fall from EUR9.1bn to EUR6bn**. Covering this requires additional funding during the year, which calls for an effective agreement with the EU. **Credit rating agencies** have slowly but surely begun to downgrade Hungary's outlook, and their patience seems to last until the end of the year at the latest.

The forecasts of GKI for 2023

	2019	2020	2021	2022	2022		2023
	(fact)				September	December	March
GDP	104.6	95.0	107.1	104.6	96.5	98.7	**99.5**
• Agriculture	98.1	92.2	98.1	68.8	100	120	**120**
• Industry	103.0	92.3	106.2	105.4	98	99	**102**
• Construction	113.1	91.4	109.2	103.0	88	95	**95**
• Trade	105.9	101.7	107.0	104.6	97	97.5	**97**
• Commercial lodgings and catering	104.8	55.5	143.2	127.5	92	100	**101**
• Transport and storage	106.2	90.2	103.6	114.3	95	103	**101**
• Information and communication	110.4	106.5	121.7	107.5	102	102	**102**
• Financial services	113.6	104.4	110.4	105.9	95	95	**98**
• Real estate activities	102.8	100.3	104.0	105.7	99	99	**95**
• Professional, scientific, technical activities	106.3	96.5	115.6	109.9	90	95	**99**
• Public administration, education, healthcare	100.5	95.7	102.1	103.7	98	99	**97**
• Arts, entertainment	108.9	88.4	112.7	109.6	90	93	**101**
• Core growth	105.7	93.6	111.5	107.6	93.7	90	**96.7**
GDP domestic demand	107.1	97.4	104.2	103.9	94.7	97	**97**
• Private consumption	104.5	98.1	104.3	106	96.3	97	**97**
• Gross fixed capital formation	112.8	92.9	105.2	102.2	88	95	**96**
Exports (goods and services)	105.4	93.9	110.3	110.3	99	101	**102**
Imports (goods and services)	108.2	96.1	109.1	109.5	97	99	**99**
Consumer price index (preceding year = 100)	103.4	103.3	105.1	114.5	116	118	**119**
Unemployment rate (annual average)	3.4	4.1	4.1	3.6	4.3	4.2	**4.2**
General government balance in per cent of GDP (ESA)	-2.1	-7.8	-6.8	-6.1	-5	-4.7	**-4.7**
Balance of the current and capital accounts							
• EUR billion	1.5	1.2	-2.5	-9.1	-7	-4	**-6**
• In per cent of GDP	1.1	0.9	-1.6	-5.4	-3.7	-2	**-3**

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