GKI Economic Research Co.
We analyse and you take the decision.

Forecast until 2013

1. **Hungary's trajectory until 2013.** GDP is expected to reach pre-crisis levels in early 2013, slightly later than other EU countries. The Hungarian growth rate is slightly faster than the EU average, but slower than that of the region. The implications of the **basically flawed, growth-oriented** unconventional economic policy, including the tensions caused by the forced reduction of the structural deficit of the general government (which was raised in 2010 and 2011) and the extensive lack of willingness to invest will **curb the expansion opportunities of the Hungarian economy** as well as the non-export oriented sectors **for years**. **The debt reduction policy announced in the spring of 2011 contains steps in the right direction, but its means and extent are unfounded.**

2. **World economy.** Global economic growth will slow down somewhat compared to 2010, and it remains below the pre-crisis level. In addition, the nature of this growth is primarily labour-saving. The high public debt and deficit in the USA and several EU member states are a major source of tension. Despite the expected improvement, the dollar and the euro remain vulnerable, though later they are **becoming more stable**. In 2011 the average price of crude oil (Brent) remains below USD110 per barrel, thus it will not have negative effects on the global economy.

3. **Hungary's place in the EU.** Fears from an escalation of the Greek debt crisis strengthen European Union legislation aiming at **stricter fiscal policies**. Hungary does not participate in the **Euro-Plus Pact** fostering closer co-operation, the sustainability of public finances and economic growth. This was a short-sighted decision as the new, real decision-making centre will be the Eurogroup and the acceding countries, and Hungary has stayed away from it.

4. **EU transfers.** The change of government caused a 1 to 1.5 year halt in the utilisation of these funds. Net EU transfers between 2011 and 2013 will total EUR9-10bn. The EU just begins developing its new budget period stating from 2014. Hungary, together with other medium-developed central and eastern European EU member states, is mainly interested in securing cohesion policy resources aiming at catching up more developed countries (even at the expense of a decline in agricultural subsidies).

5. **Equilibrium.** The room of manoeuvring for the Hungarian government's economic policy has been strongly limited by equilibrium constraints for five years. In the 2011-2013 period, however, **not the external, but the internal equilibrium will be the bottleneck**. The new government that came into office in spring 2010 tried to **introduce a growth-oriented economic policy and loosen the deficit targets**, but **failed spectacularly**. Finally, the market (the danger of classifying Hungarian government securities in the junk-bond category) and the EU pressed the government to adopt the "inherited" deficit trajectory. Meanwhile, though formally complying with the requirements, the government chose **"creative"** solutions to meet its major **tax cutting** and certain **spending** targets. The point is that the government in 2011, by forcibly nationalising the private pension fund savings, achieved a one-off budget revenue amounting to 9 per cent of GDP, and as a result, a 2 per cent general government surplus (that is, without this the general government deficit would be approximately 7 per cent of GDP). Between 2010 and 2012 revenues will be raised by special **sectoral taxes** planned for three years. Permanent tax cuts are covered by temporary resources, making them **unsustainable from 2012 on**. Therefore, the Szell Kalman Plan contains **structural** changes, and the new convergence programme applies additional **"regular" budget cuts** in order to find a long-term equilibrium trajectory.

6. **Sources of supply.** Hungarian SMEs **suffer from a shortage of financing** sources due to their modest profitability caused by weak domestic demand and the crisis levies (except for some export-oriented sector). The government's anti-foreign capital measures and its loosening the rule of law do not favour the inflow of FDI. The banks' lending activity remains weak, and the use of available EU funds requires great efforts due to the delays.

7. **Features of economic path.** According to the forecast of **GKI** covering the period until 2013 the most likely economic trajectory has the following characteristics:
   - The annual **average rate of GDP growth** will be **nearly 3 per cent**. The main driving force will be industrial exports, as well as the modest growth in investments – mainly due to an accelerating inflow of EU funds. The three-year average rate of growth of investments will be around 5 per cent. The rate of increase in consumption will remain in 1 to 1.5 per cent range per year.
   - **In statistical terms, the unemployment rate will drop** significantly, from 11.2 per cent to 9 per cent, while **employment will rise** to a similar extent. However, this will be mainly a result of restricting benefits and increasing part-time public employment. **The actual increase in employment will be very modest.**
   - **Statistically, the general government deficit will be below 3 per cent** each year.

   However, substantially **different** scenarios are also conceivable:
   - The crisis in some countries of the **eurozone** may affect the zone as a whole, or the USA debt crisis may cause dramatic events on financial markets, leading to **unfavourable** developments in the financing of the Hungarian government debt and on money market conditions (interest rates, exchange rates), having negative effects on inflation and real GDP growth.
   - It is possible that new serious problems emerge in the **global financial system**, or for this or other reasons another sharp stock market drop occurs. This may hold back the activity of the Hungarian banking system even further and lead to slower economic growth in Hungary as well.
   - It is possible that in 2013, in a non-declared way, a **softening** of fiscal policy will start before the coming elections. The **sharpening of social conflicts** arising from the dramatic cuts in social spending and other steps, as well as the political reaction to the loss of social support for the ruling party may strengthen this trend. It might be a possibility that the reforms will be **more successful** than it can be forecast now, enhancing the room of manoeuvring for the budget without softening it (although this might be true for 2014, the year following the forecast period). These factors may have **negative** or **positive** effects on financial market trends and inflation, which would have an impact on economic growth as well.

   These options, however, are **unlikely to occur**, and the differences induced by them are not significant enough to justify the elaboration of more scenarios.

8. **Structural changes.** The government formed in 2010 intervened in the economy in a number of areas. Some of the changes are in the right direction, while others are very harmful. There have been very few **real institutional and operational changes**.
   - In essence, the government eliminates the mandatory **private pension funds** system.
   - A **flat personal income tax rate system** was introduced. This significantly enhanced income differences. Real wages declined for many people. The low propensity to consume of those with rising real wages has also hindered the increase of household consumption.
   - The innovative widening of the system of **sectoral crisis taxes** is especially harmful in terms of investments.
   - The government attempts to dismantle **social transfers** radically, especially the benefits of unemployed under retirement age. However, this will not have a considerable impact on

employment, because economic development will create only very few new jobs, while family crisis situations may develop, particularly in disadvantaged parts of the country.
- The **planned labour and wage measures** will not promote real employment. They will have widespread adverse effects on business competitiveness, pushing businesses **towards the grey and black economy**.
- The incoming reform of the **local government system** is expected to be centralizing in nature, resulting in significant budget savings in the longer term, while causing extra expenses and serious political tensions in the short term.
- The outcome of the transformation of the **health care system** is very uncertain.
- We cannot see today what kind of reforms can be expected concerning state-owned enterprises and in particular the **transport companies** (in addition to consolidating their debts).
- Changes in the **public and higher education system** are likely to result in budgetary savings, but their ability to improve the long-term professional level of domestic labour is quite uncertain.
- The new **Széchenyi Plan** barely differs from the previously developed programmes, and its realization is **very slow**.
- It is not yet apparent whether the reduction in **bureaucracy** will yield any material results.
- The government has **removed the euro-accession preparations from the agenda**, although Hungary will meet the accession criteria from 2013. In addition to the unrealized potential benefits of convergence, this will mean **more expensive financing** for all Hungarian debtors.

Ideas for changes that have been made public are **unnecessarily radical**, and they **take away vested rights**, or **does not leave time to adapt**. Meaningful **professional consultation** with stakeholders and the **reconciliation of interests** have generally **failed to happen**. Owing to the way these changes were made, the social resistance may sweep part of the current decisions away.

9. **The structure of economic growth.** Following an average annual decrease of 1.6 per cent in the 2008-2010 crisis period, GDP will return to the level of the previous three years, and it will even slightly exceed it with its annual 2.9 per rate. **This increase is essentially driven by export sales.** The weakness of domestic demand entails negative changes in the economic structure and a decline in services. Though especially public services will fall, the prospects of business services are also dim, except for transportation and tourism driven by external demand.

10. **Employment.** A slow increase in employment will start, and an overall 2.8 per cent raise in headcount can be expected in three years. However, this will remain below the pre-crisis level, even at the end of the period. The overall employment will increase by 80 thousand people between 2011 and 2013, **due to mainly an increase in the number of people participating in public works**. The unemployment rate will decline by two percentage points to around 9 per cent over three years, though this will be mostly a statistical illusion.

11. **Income, consumption and savings.** During the economic and financial crisis real average annual earnings dropped by 1 per cent, while household consumption fell by 2.5 per cent. Real earnings will grow at a rate of around 2.5 per cent per year in 2011-2013, but with large differentiation. Owing to the **high burdens associated with the amortization of bank loans** and the limited borrowing options, consumption will increase only by 1.2 per cent, not reaching the pre-crisis levels. The net savings rate will slightly decrease compared to 2010, but it will be significantly higher than in the former periods characterized by high borrowing levels.

12. **Investments.** The volume of investments fell by an annual average of 3.7 per cent between 2008 and 2010, and its decrease was greater than that of GDP. Between 2011 and 2013 investments are expected to grow by 4.9 per cent per year, faster than GDP, thus **reaching pre-crisis levels by 2013**.

The growth in investments can be attributed primarily to the manufacturing industry and development projects based on EU sources.

13. **Innovation.** The driving force behind economic growth in the coming years could be the spreading of new technologies. Though the Hungarian R and D sector's performance and prospects are not good, in some cases international cooperation may offer breakthroughs.

14. **The banking system. Even in 2011**, the Hungarian financial sector is characterized by a **slow but persistent decline**. The balance sheet total of banks, the number of insurance contracts and insurers' fee income all go down. Essentially, only **stagnation can be expected** in the coming years. The ability and willingness of banks to lend, the credit-worthiness of the customers will improve, at best, **from 2013**.

15. **Capital markets.** The Hungarian stock exchange is a weak player in the domestic market. Its ability to attract capital is small, and businesses are seeking bank loans when they are looking for new financing sources. The government's measures, such as sectoral levies, government regulations and acquiring ownership can directly affect the prices of individual firms.

16. **External disequilibria.** In recent years the external disequilibria of the Hungarian economy improved markedly due to the recession and the impact of economic adjustments: in contrast to the external financing needs of the previous years (amounting to 6-7 per cent of GDP), there will be a **surplus in current and capital accounts corresponding to 2.2-3.5 per cent of GDP in 2011-2013**. Hungary, in terms of the net position, will not require external financing, only the renewal of a large part of its maturing loans. The external debt **can be financed from the money and capital markets, but at higher interest rates than the IMF loans**. Owing to the **unpredictability** of economic policy and the **taxes** imposed on foreign companies, the **inflow of foreign direct investments will go down** (excluding the automotive sector).

17. **General government.** Controlling the general government balance in Hungary, unlike in most other EU member countries, was a priority during the crisis in 2008-2010. The general government deficit relative to GDP remained around 4 per cent each year. **In statistical terms it will continue to improve in 2011-2013, because the deficit will be below 3 per cent every year.** However, owing to the large-scale tax cuts and certain extraordinary expenses, a significant deterioration of the balance occurs in 2011. **Significant consolidation measures will be required to put Hungarian public finances on a sustainable path by 2013.** The tax centralisation rate relative to GDP will drop by about 2.5 percentage points until 2013, other revenues will decrease by 1.8 percentage points (compared to a one-time high base), and primary expenditures and interest expenses will fall by 5.6 and 0.4 percentage points, respectively. As a result the structural balance will improve by 1,7 percentage points.

18. **Inflation, interest rates, exchange rates.** The 3 per cent inflation target is **not expected to be met** until 2013. The exchange rate of the forint and the interest rate policy is largely **dependent on the financial confidence** in Hungary. The central bank reference rate can hardly be reduced in a rising international interest rate environment until the end of 2012. If the forint is weakening substantially, the official rate may even rise.

19. **Business perspectives.** Businesses have nothing to wait for; they can expect neither extra foreign sources, nor extra domestic government support. It's time to take further development steps. In many cases the only way out can be to join export chains. Consolidation can be expected in some sectors.

20. **In traps.** The Hungarian economy is **in traps**: the tax cuts may improve competitiveness only in the long term, but the steps introduced to cover these cuts immediately hurt small businesses and most of the population. The reforms and EU financed investment projects are not set to start. The banking system is passive due to the unprecedentedly high taxes. Hungary's economic and political Atlantic integration has stopped, and in some cases, has been reversed. Economic policy is not predictable, and legal certainty is weakened further.

Macroeconomic indicators, 2002-2013
(per cent)

	2002-2004	2005-2007	2008-2010	2011-2013
	annual average			
GDP	104.2	102.5	98.4	**102.9**
Household consumption	107.1	101.2	97.2	**101.2**
Investment	106.8	101.3	96.3	**104.9**
External financing need / GDP	-7.9	-6.6	-0.3	**2.7**
Rate of unemployment	5.9	7.4	9.6	**10.2**
General government balance/GDP (ESA)	-7.5	-7.4	-4.1	**-1.1**
Inflation	105.6	105.1	105.1	**103.9**

Source: HCSO, NBH, 2011-13: **GKI**