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Genuine change is needed in economic policy

The projection of GKI for 2012

In its forecast released in September GKI has already indicated that external demand would slow down and domestic economic policy exerted a strongly adverse effect on domestic demand and financial trends. Based on these considerations GKI projected 1.5 per cent GDP growth in 2011 and – as the first institution among those involved in forecasting - a 1 per cent recession in 2012. It also stressed that a new agreement with the EU and the IMF could be necessary as well. Trends of the past months have justified this prognosis. According to the evaluation of GKI the Hungarian economy reached a dead end and genuine turn is needed in economic policy. There is no alternative to the IMF agreement. In the possible absence of an agreement the reactions of international financial markets could raise the danger of direct government insolvency. Even for the successful launch of negotiations with the IMF changes, including the recovery of credibility and trust as well as the return to the principles of the market economy are unavoidable. Nevertheless, all this will be enough only for avoiding a recession in 2012 deeper than the projected 1.5 per cent. The recovery of the confidence of financial markets and foreign direct investors may bring results in the real economy only in 2013 the earliest.

In mid-November 2011 the Hungarian government had to face a grave **risk of financing** the government debt. It was not possible to sell government securities at all or if it was, only at sharply increasing yields. The country risk premium reached 600 base points, the exchange rate of the forint to the euro HUF317. The government had to request the financial help of the IMF, an institution that it reprimanded even in the preceding days. Nevertheless, the way it did so suggested the continuity of its economic policy. Therefore, Moody's downgraded Hungarian government securities to junk status. Talks aiming at the preparation of negotiations with the IMF and the EU were broken off. Following in part growing market interest rates, the Monetary Council of the National Bank of Hungary (NBH) lifted its reference rate by 50 bps at the end of November. It anticipated further similar steps. At the end of the year the reference rate is likely to mount to 7 per cent, the exchange rate of the forint to the euro to reach HUF280 in the average of 2011 against HUF275 in 2010 and it will exceed most probably HUF300 at year-end.

Hungary's GDP is projected to grow by **1.5 per cent** in 2011, at a somewhat slower rate than the EU average of **1.6 per cent**. Nevertheless, this rate can be attributed to the **extraordinary good agricultural harvest** due to favourable weather conditions. **The core rate of GDP growth** excluding agriculture and public services will total **only 0.5 per cent**. **The consumption of households is expected to stagnate, investments to contract by 5 per cent.** The reason for this is mainly inadequate economic policy including the negative effects of tax changes and the erosion of the rule of law.

The economic policy of the present government is dominated by considerations related to political power, ideology and public relations; negotiations with professional organisations and social groups on the reconciliation of interests are missing completely. In this **confrontational approach** economic problems are explained exclusively by **external factors** in general and the crisis of the euro as well as

Hungary's external dependence in particular. **It is recognised only rather slowly that an agreement with the IMF should imply a compromise with commercial banks, the National Bank of Hungary and domestic and foreign capital as well as the return to the division of power in the rule of law and to the model of the market economy.** If the government wants to reach only a technical agreement with the IMF, **the recovery of confidence will be only temporary**.

Almost none of the economic policy objectives have been achieved so far:

1. **Economic growth** that had been originally absolute priority was pushed into the background; the rate of GDP growth is not accelerating, and **in 2012 GDP is expected to contract by 1.5 per cent.** Hungary will be lagging behind the central and eastern European region. In the general government loose fiscal policy (in terms of growing incomes) was pursued in 2011 that corresponded to at least 3 per cent of GDP. In spite of this GDP is likely to increase only by 1.5 per cent.
2. **Employment** did not go up, **unemployment** did not drop. In 2012 concepts seem to be restricted to part-time public employment drafts that promise improvement basically only on paper.
3. The new priority set in the spring of 2011 was the reduction of **government debt**. Government debt fell only as a result of the one-off nationalisation of private pension funds. Nevertheless, the weakening of the exchange rate of the forint to the euro eroded this decrease of government debt relative to GDP. The preconditions of the sustainable reduction of government debt were not created.
4. The **structural reforms** envisaged in the so called Széll Kálmán Plan remained to a large extent on paper. Because of the taboos such as the tuition fees and the fees of medical examination, the quality of services deteriorated and the systems concerned became socially more and more unequal; meanwhile in some cases fees were imposed. The real objectives and the advantages beyond the slogan of nationalisation are completely opaque.
5. With the special taxes that were levied on a wide range of industries and the lack of transparency, **foreign direct investments** are leaving Hungary rather than flowing in.
6. The slogan of the **significant reduction and simplification of taxes** voiced from 2010 to 2012 was distorted in reality to a substantial restructuring of taxes. At present the rise of taxes is the dominant trend. The government is overstretching, it promises more than it can perform. (It occurs frequently that the government does not fulfil its promises.)
7. The **competitiveness and the evaluation of Hungary** are not improving but they are definitely deteriorating; a heavy loss of credibility is perceived.

In the past few months **uncertainty** concerning the sustainable financing of government debts has **increased extraordinarily in the world economy**. In addition, business confidence deteriorated in both the EU and globally that has an adverse impact on investments and consumption in Hungary. Fiscal restrictions dampen domestic demand, and the deterioration of world economic conditions limits the growth of exports. According to its own forecast, the EU's GDP is likely to mount by 2.1 per cent in 2011 and by 0.6 per cent in 2012, by 0.2 percentage points and 1.2 percentage points slower than according to the spring forecast. **A slight recession cannot be excluded either.** The EU started to move from monetary union towards a **genuine fiscal and political union** and **in turn for decreasing national sovereignty it offers stability and development**. The measures taken and envisaged for the future to manage the sovereign debt crisis will be hopefully efficient and uncertainly concerning the financial crisis will ease by mid-2012. **Monetary policy** will remain loose.

Following its peak recorded in February 2011, the **GKI-Erste business confidence index** has been **deteriorating significantly almost continuously** since the announcement of Széll Kálmán Plan. Business expectations have stagnated since October; the value of the index is equal to the rather low level of late 2009 and early 2010. The consumer confidence index has been falling for a year almost permanently, households perceive their financial situation and savings possibilities negatively, and fear from unemployment and inflationary expectations intensified as well.

The general government of 2012 indicates a turn in fiscal policy referring to strong tightening. Nevertheless, only one third of the improvement in the general government balance will be attributed to measures related to structural reforms. The major tool of tightening is the raise of taxes, but the reduction of expenditures, too, plays an important role. **Tensions valued at HUF200bn – HUF250bn are likely in both the revenue and the expenditure side**. **Half of the probable increase in the deficit will be covered by reserves.** Thus, the actual deficit may exceed the planned one by about HUF250bn without further measures. The total deficit may total 3.5 per cent of GDP. The budgetary law envisages an ESA deficit of 2.5 per cent of GDP in 2012. This or a somewhat higher figure may form the basis of the IMF agreement. According to **GKI** **the general government deficit is expected to reach about 2.9 per cent of GDP** with measures under preparation and those to be implemented according to the IMF agreement. Nevertheless, with the fall of GDP this **will not be sufficient to reduce the government debt**. The **government debt** is likely to amount to about 84 per cent of GDP, higher than in 2010 and in 2011.

With the drop of domestic demand and the launch of exports of the Mercedes plant, **the external balance** will be favourable in 2012, too. The foreign trade surplus may reach EUR10 billion in 2012 against EUR7.5 billion in 2011. Nevertheless, with the increase of interest payments and the repatriation of profits due to the unfavourable investment climate, the current account surplus is likely to increase from EUER2.5 billion only to EUR3 billion, **the external financing capacity** from EUR4.7 billion to EUR5.5 billion, corresponding to **5.5 per cent of GDP**. Within the former item the EU funds used are likely to go up slightly from EUR2.2 billion to EUR2.5 billion due to Hungary's weak capital absorption capacity. The outflow of foreign direct investments may exceed the inflow.

In 2012 the government sets to **continue the reform of personal income taxes**, the possibility of automatic **tax reclaim** under set conditions will be abolished completely, and the rate of healthcare contributions will be raised by 1 percentage point to 8.5 per cent. Assuming unchanged gross wages, these effects will **reduce net wages by nearly 11 per cent**. The government made a "recommendation" to the competitive sphere to raise wages by 5 per cent. This may imply the significant, often unbearable increase of **company burdens** even in the case of the envisaged tax allowance. The rules of the provision of extra wage allowances are going to become tougher**.** This may stimulate a lot of companies to counterweight the wage increases by the reduction of these allowances. In the public sector the government intends to maintain the compensation system so that monthly net wages would not drop in 2012. Due to the further need to reduce expenditures, the implementation of this is questionable. Because of the great number of uncertainty factors, **GKI** forecasts that **gross earnings are likely to increase by 3-3.5 per cent in 2012**. In other words, a considerable part of firms will not be able to meet the guideline of the government or they will avoid the lift of minimum wages by various means such as by employing people formally only for 6 hours. This may imply the growth of net earnings by 1-1.5 per cent and **the drop of real ones by about 3.5 per cent**. **Real incomes** are forecasted to fall by about 3 per cent, at a lower rate than real wages. Although social transfers will loose much from their value and entrepreneurial incomes, too, will contract, but the real value of pensions will remain unchanged, and grey incomes are assumed to grow. Trends in **savings** are very uncertain. The agreement between the government and the Banking Association may reduce the burdens of households indebted in foreign exchange by nearly HUF200 billion in 2012, a smaller amount than in 2011. At the same time households' propensity to save is very strong, cautious consumer behaviour will prevail in 2012. **The consumption of households is expected to decrease by about 2.5 per cent, less than real incomes**.

With the exception of some projects launched in the automotive sector, business investments will be impeded by the shortage of both financial sources and sales markets in 2012. The institutional system of the general government and local authorities is in complete motion, it is impossible to know who will be responsible for the individual institutions, who will assume commitments related to EU funds (such as co-financing). Therefore, investments in the public sector are expected to slow down in 2012. As a consequence of the factors analysed **investments are likely to contract again, by about 4 per cent**.

In **industry**, the business cycle is expected to improve only in the second half of 2012. Industrial production is projected to increase by 5.5 per cent in 2012. Hungary's car industry is decoupled from international trends to a certain extent. Several investment projects are under implementation, one part of them will be activated next year. Therefore, Hungary's industrial production may accelerate in the second half of 2012. This may be supported by the launch of production of some suppliers in the car industry. On the other hand, domestic sales of industry are expected to continue to contract. Following 6 years of decline, c**onstruction** is projected to fall by another 5 per cent in 2012. The number of homes completed plummets from 14 thousand in 2011 to 11-12 thousand in 2012. Following the above the average harvest in 2011, the performance of **agriculture** is predicted to decrease mainly due to different weather conditions. With the exception of transport and telecommunications, the performance of services is expected to drop in 2012 again. **Retail trade turnover** is going to decrease by 2.5 per cent. Following the modest increase of this year, **core growth** will turn negative. With the expected restructuring in the public sector, the deterioration of the propensity to employ in the business sphere, the loss of market shares of companies and increasing wage costs, **employment** will be down by 1 per cent in 2012. The rate of **unemployment** is likely to **stagnate at 11 per cent** as recorded in 2011, but this will be the result of the extension of public work schemes based on part-time work substituting unemployment benefits. The scheme will not contribute to GDP and generate genuine incomes.

Bank lending is predicted to contract in terms of both demand and supply. Banks are not willing and are not able to lend. The agreement concluded with the government may restrain this trend. Households avoid borrowing, companies postpone their investments, thereby their credit demand. It is questionable whether the mother banks will be **willing to raise capital** in their local affiliates producing losses in an uncertain regulatory environment or they achieve the required proportions by building down borrowing.

As a consequence of tax and price rises and in spite of contracting purchasing power, **the rate of inflation** is predicted to total **5 per cent in the average of 2012 and 4.5 per cent at year-end**. The **exchange rate of the forint** to the euro and the **reference rate** of the National Bank of Hungary depend to a large extent on the progress of negotiations with the IMF, in this context also on the specific features of the agreement with the banks, the final amortisation of foreign exchange loans in 2012 as well as on decisions over the budget. The exchange rate of the forint to the euro is expected to average HUF290 in 2012 amidst huge fluctuations. The reference rate of the NBH is likely to be lifted to 7-7.5 per cent in early 2012. In the second quarter of 2012 the exchange rate may fall to nearly HUF 280, by the end of 2012 in a favourable case the reference rate of the NBH may equal to 7 per cent.

In the lack of significant institutional changes that improve legal certainty and accountability the economic situation may be much worse, even a crisis may emerge.

The forecast of GKI for 2012

	2008.	2009.	2010.	2011	2012	
		(Fact)		Estimate	September	**December**
Gross Domestic Product	100.9	93.2	101.3	101.5	99	**98.5**
– Agriculture (1)	154.5	85.1	83.7	125	95	**90**
– Industry (2)	99.9	85.1	113.4	106	104.5	**105.5**
– Construction (3)	89.8	96.3	91.1	90	97	**95**
– Retail and wholesale trade (4)	97.8	83.5	98.5	99.5	98	**98**
– Transport and telecommunications (5)	96.3	101.8	102.6	101	101.5	**101**
– Financial services (6)	101.8	97.3	100.4	96	90	**90**
– Public administration, education, healthcare (7)	99.7	100.2	97.2	99.5	99	**99**
– Other services (8)	94.7	93.8	103.4	101	100	**100**
Core growth (2) + (3) + (4) + (5) + (6)	99.1	91.0	104.1	100.5	98.4	**98.9**
GDP domestic demand	100.7	89.5	99.5	99	97.5	**96**
– Private consumption	99.8	94.3	97.3	100	97	**97.5**
– Gross fixed capital formation (investments)	102.9	89.0	90.3	95	100	**96**
Foreign trade in goods						
– Exports	105.7	89.8	114.3	109	108	**108**
– Imports	105.5	85.2	112.8	107	107	**106**
Consumer price index (preceding year = 100)	106.1	104.2	104.9	104	104.8	**105**
Current and capital account balance						
– EUR billion	-6.8	1.4	3.8	4.7	4.0	**5.5**
– In per cent of GDP	-6.4	1.5	3.9	4.7	4.1	**5.5**
Unemployment rate (annual average)	7.8	10.0	11.2	11	10.8	**11**
General government balance in per cent of GDP (ESA)	-3.7	-4.6	-4.2	+3	-2.9	**-2.9**

Source: Hungarian Central Statistical Office, **GKI**