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

The forecast of GKI Economic Research Co. for 2012

The Hungarian economy has been the weakest for years in the region, and it fell short of its own capabilities. Now this is accompanied by a credibility crisis (perceived in the political, economic and business spheres as well). Although the growth was slightly faster than the EU average in 2011, it was lower than the regional one. This was the result of one-off factors such as the outstanding agricultural production due to good weather, and the temporary fiscal expansion (using up the assets of the private pension funds). Last year the real situation of public finances and the financing of Hungary's debts were bad and they were deteriorating. The institutional system of the market economy was also impaired, and the tax burden increased. The withdrawal of capital is going on, investor's sentiment of the country is negative, investments fall, and small businesses are suffering. Only the external balance is favourable. **None of the main purposes of economic policy has been fulfilled. In spite of this, economic policy strives to maintain the appearance of success and continuity. Positive corrections were made only in crisis situations and many times they were no more than a mere rhetorical exercise. Actually, only the measures to reduce fiscal imbalances can be considered as significant (though short of the extent required). However, the government is gradually losing control over the economy.** Together with further fiscal policy measures this could be enough to maintain solvency, but no growth in employment, investments or consumption can be expected as a result. **The lack of legal certainty and predictability cripples the economy. The government's double talk at international level is increasing the tensions with the EU and the majority of member states.**

Financial trends in the EU are extremely unfavourable. The rate of inflation was exceptionally high in Hungary at the beginning of 2012, and Hungary had the highest central bank base rate (even though the rate was still below market expectations). The yields of government securities are higher than in Hungary only in Greece and Portugal (and sometimes in Ireland). Even in February and March 2012 market interest rates were so high that financing the Hungarian government debt in the long run by using these resources would entail very sharp additional restrictions. In order to finance the debt from the market Hungary would need at least 1.5 per cent potential growth rate and 3-4 per cent primary budget surplus, compared to the contraction of GDP and the 1 per cent surplus expected this year. Fluctuations in the exchange rate of the national currency are also the highest in Hungary. The loan portfolios of the banking system in other countries of Central and Eastern Europe are already increasing, except in Hungary.

The rate of growth of the **world gross product** will decelerate from last year's 3.8 per cent to 3.3 per cent in **2012** mainly because of lower growth rates in the advanced European countries and, to a lesser extent, in emerging economies. Similarly to the previous year, in 2012 the GDP of **US** is expected to grow by 1.8 per cent. Owing to the presidential election, an expansionary monetary and fiscal policy can be expected contributing to a relatively high GDP dynamics. By contrast, the combined GDP of the **EU** is expected to **stagnate in 2012** compared with its 1.5 per cent increase in 2011. In the first half of 2012 the entire euro zone may experience recession; however, in the second half of the year a recovery can be expected. **In February and March 2012 the GKI-Erste economic sentiment index substantially increased, following** an almost year-long **steady deterioration** down to its 2009 autumn level. The improvement in the opinions concerning the state of the Hungarian economy is especially spectacular. This suggests that the easing of the crisis atmosphere in early January, as well as the government's promises to conclude an agreement with the IMF (which is constantly postponed nowadays) have played a role in the improvement of economic sentiment. Therefore, probably it is still **too early to consider this as a turn in the expectations** concerning economic trends.

The most important economic and institutional-legal changes (typically proposed by the OECD and the EU as well) are as follows:

- respecting the independence of the **central bank** and the **Monetary Council**,

- returning to the **rule of law standards** by restoring the **Constitutional Court**'s powers and ensuring the full independence of the **judiciary**,
- ensuring the freedom of future **tax policy** by amending the financial stability act,
- creating the professional conditions necessary for the independence of the **Budget Council**,
- bills and reforms should be proposed only after proper **negotiations with the professional and interest representation bodies**,
- cleaning up the messy **tax system**, and eliminating sectoral levies,
- launching the necessary structural changes at state companies, and stopping the escalation of nationalization and special regulations.

In legal terms, the main international procedures in connection with Hungary (IMF negotiations, excessive deficit procedure, three infringement procedures, etc.) **are not directly linked**. However, the IMF, the EU and the ECB rely on each other's opinion. Thus, the successful conclusion of infringement procedures is a **prerequisite** of starting negotiations with the IMF. However, the ECOFIN decision concerning the **excessive deficit procedure** (EDP) **has created new conditions for the market to a certain extent by providing double support**. Taking into account the current high yields, fulfilling the conditions of the EDP may be enough in itself to calm the government bond market. The Hungarian government is trying to regard the negotiations with the IMF and the EDP procedure as mere technical matters. In fact, both procedures require that the budget deficit be safely below 3 per cent of GDP, which would **require serious measures** (including **genuine reforms**). However, meeting the EU’s conditions of the IMF loan goes beyond purely economic issues, involving a continuous monitoring mechanism (which is slower in the case of the excessive deficit procedure). As a result, its confidence strengthening effect would be much stronger. A governmental behaviour may be identified that **urges the start of negotiations with the IMF rhetorically, but by fulfilling the recommendations (preconditions) only partially, it actually postpones the negotiations**. As far as the EDP procedure is concerned, this procrastination **cannot be continued** as specific steps for 2012-2013 should be presented in the new convergence programme by mid-April in order to achieve that the ECOFIN cancel the freezing of the cohesion funds in June. **Therefore, the delaying tactics in fiscal affairs cannot continue.**

The government may think that **the fulfilment of the requirements of the EDP can avert or replace the IMF loan**. In the relatively calm current international situation this may prove to be enough for the government bond market, but **GKI** believes that it would **entail serious risks and uncertainties**. The global risk appetite may deteriorate at any time, and then the IMF loan might be missing very much. Rating agencies would evaluate negatively the lack of agreement with the IMF. Therefore, the crisis of confidence could hardly be alleviated, investments would not be made, and consumption and GDP would not pick up. Meanwhile, essentially the same steps should be taken concerning the budget, but the significantly less expensive IMF sources would not be available for funding. Although the market may accept this situation, exchange rates and interest rates would only improve slightly. As a result, loans would be more expensive for domestic borrowers, and the interest burden of the budget could be up to HUF150bn higher per year, and additional restrictions should be introduced to achieve the desired balance. In addition, it is not at all certain that the EU would be an easier negotiating party than the IMF in budgetary matters. Therefore, **GKI** still believes that the Hungarian government should reach an **agreement with the EU-ECB-IMF trio** in order to alleviate the crisis of confidence and to improve the conditions for economic growth, and the sooner the better. **In fact, the IMF agreement would allow for a smaller budget constraint.**

The general government of 2012 indicates a **turn in fiscal policy** referring to **strong tightening**, and the structural deficit would decrease by around 2 per cent of GDP. Nevertheless, only one third of the improvement in the general government balance will be attributed to measures related to reforms. The **major tool of tightening is the raise of taxes**, but the reduction of expenditures, too, plays an important role. General government **revenues** were originally based on the projection of 1.5 per cent real GDP growth. In contrast to this, a 1.5 per cent drop is likely. (The government predicts stagnation.) A number of revenues are overestimated, whereas much expenditure is underestimated. A HUF500bn deficit can be projected in comparison with the

Budget Act, of which HUF200bn might be covered by the Country Defence Reserve and some favourable developments in certain budgetary items. So maintaining the original balance target (2.5 per cent deficit), which is also expected by the EU's excessive deficit procedure, would require approximately HUF300bn measures. Even if the government (taking into account a worse than expected economic growth) sets a deficit target of 2.9 per cent of GDP (and this is tolerated by international institutions), **measures amounting about HUF200bn (0.7 per cent of GDP)** would also become necessary. According to **GKI** this will be the expected outcome. That alone would not be sufficient to reduce the **government debt** ratio; however, the strengthening of the forint and the sale of the remaining private pension fund assets and their use for debt reduction may decrease the **debt to GDP ratio to near 75 per cent** this year from 80.4 per cent last year.

Owing to the excessive deficit procedure, the prospect of sanctions (withholding part of the cohesion fund as of 2013) and the expected IMF loan, **the preparation of the 2013 budget has great influence on 2012** as well. The deficit should be less than 3 per cent not only in 2012 but in 2013 as well, while the crisis or special taxes should be abolished. (A smaller tax credit may be applicable.) This would require further fiscal **measures amounting to 1 per cent of GDP** in 2013, even if the 2012 deficit could be kept below 3 per cent. The best way to reduce the deficit would be the implementation of properly prepared and sustainable **structural reform measures**, taking into account the aspirations of the Szell Kalman Plan as well. In addition, tax measures are also possible, especially the one-year postponement of the elimination of the second personal income tax rate.

With the drop of domestic demand and the launch of exports of the Mercedes plant, **the external balance will be favourable** in 2012, too, despite the deterioration in external conditions. The foreign trade surplus may reach EUR9bn in 2012 against EUR7bn in 2011. **The external financing capacity** will increase from EUR3.5bn to EUR4bn, corresponding to **4 per cent of GDP**. **The outflow of foreign direct investments may exceed the inflow in 2012 as well, as a consequence of economic and political errors.**

GKI forecasts that gross earnings will increase by around 6.5 per cent in 2012 in the private sector (in companies employing over 5 persons). At the same time it expects that a considerable part of companies cannot meet the guideline of the government or avoid the rise of minimum wages by deploying innovative solutions such as formal six-hour employment, or they will reduce employment. **Real earnings** (with family tax benefits) will decrease by 2.5 per cent altogether (by 1.5 per cent in the private sector and by nearly 5 per cent in the public sphere). **Real incomes** and the **consumption** of households are expected to **decrease by about 2.5 per cent**. **The decline in investments will continue this year, by about 4 per cent.**

In industry recovery can be expected in the second half of 2012, with an annual average rate of 4.5 per cent. Following 6 years of decline, c**onstruction** is projected to **fall** by another 5 per cent in 2012. Following the above the average harvest in 2011, the performance of **agriculture** is predicted to **decrease** mainly due to different weather conditions. The 2.5 per cent **fall in retail sales** only reflects the economic and income trends. However, the **decline** of the financial sector restricts overall economic growth. **GDP will decrease by 1.5 per cent.** The **marked decline in the first quarter** of 2012 may be followed by a **modest recovery** towards the end of the year.

Labour demand will decrease slightly in 2012, at a similar rate it increased in 2011, by around 0.8 per cent. The **unemployment** rate has hardly changed in the last three quarters. It started to increase again early this year, due to seasonal reasons, a winding-up wave, and a rise in the costs of employment. Funds earmarked for **public work** increased significantly in 2012 (more than tripled compared with 2011) and the government will return to the previous 6-8 hours of employment. Thus, budget expenditure is generated reaching at least the amount that was saved by the shortened unemployment benefit period. **Bank lending is predicted to contract in terms of both demand and supply**. Banks are not willing and are not able to lend. Households avoid borrowing, companies postpone their investments, thereby their credit demand. The indebtedness of the local government sector is huge, and the reforms are causing uncertainty, therefore no new credits can be expected from there either. **Loan portfolios are expected to be reduced.**

An annual average of 5.3 per cent inflation rate can be expected with an actual rate below 5 per cent at the end of the year. The Monetary Council did not change the base rate in February either, though one member already voted in favour of a reduction. However, this could be justified only after an agreement with the IMF is concluded, or when at least a fiscal consolidation path is accepted by the EU. The political influence exerted through the new members of the Monetary Council destroys its credibility. As a result, market yields will break away from the base rate to a greater extent than before, monetary policy will become powerless, and Hungary will be more vulnerable. The **average annual exchange rate is projected to be around HUF290** in 2012. It seems that economic policy does not strive for a substantially stronger forint, only for decreasing interest rates, which is quite artificial in such conditions.

No improvement in risk assessment of Hungary can be expected without giving investors lasting reassurance. The successful government bond issues conceal the fact that these resources are very expensive and their long-term financing require a high primary surplus and significant additional restrictions, and, as a result, the public debt continues to increase (assuming other factors unchanged). **After an agreement with the IMF**, a much lower interest rate could be attained. **Procrastination entails huge economic costs** (the EU has estimated that interest expenses might be increased by 0.5 per cent of the GDP by 2013).

Forecasts of GKI for 2012

	2008	2009	2010	2011	**2012**		
	(fact)				September	December	**March**
Gross Domestic Product*	100.9	93.2	101.3	101.7	99	98.5	**98.5**
– Agriculture (1)	151.6	85.1	83.7	126.8	95	90	**90**
– Industry (2)	96.3	85.1	113.4	105.9	104.5	105.5	**104.5**
– Construction (3)	91.2	96.3	91.1	92.0	97	95	**95**
– Retail and wholesale trade (4)	100.2	83.0	98.4	99.7	98	98	**97.5**
– Transport and storage (5)	93.7	90.3	100.5	100.8	101	100.5	**100**
– Information and communication (6)	103.0	113.1	104.8	102.1	102	101.5	**100.5**
– Financial services (7)	97.7	100.5	95.7	93.4	87	87	**93**
– Real estate activities (8)	99.9	102.5	100.2	98.4	91.5	91.5	**97**
– Professional, scientific, technical and administrative activities (9)	102.4	96.1	96.9	99.2	90.5	90.5	**97**
– Public administration, education, healthcare (10)	100.3	100.2	97.2	99.7	99	99	**98**
– Arts, entertainment (11)	100.6	93.4	103.4	102.6	100	100	**99**
Core growth (2)+(3)+(4)+(5)+(6)+(7)+(8)+(9)	98.0	91.8	103.4	101.1	98.4	98.9	**100**
GDP domestic demand	100.7	89.5	99.5	99.5	97.5	95.7	**95.9**
– Private consumption	99.8	94.3	97.3	100.1	97	97.5	**97.5**
– Gross fixed capital formation (investments)	102.9	89.0	90.3	94.6	100	96	**96**
Foreign trade in goods							
– Exports	105.7	89.8	114.3	108.4	108	108	**107**
– Imports	105.5	85.2	112.8	106.3	107	106	**105**
Consumer price index (preceding year = 100)	106.1	104.2	104.9	103.9	104.8	105	**105.3**
Current and capital account balance							
– EUR billion	-6.8	1.4	3.8	3.5**	4.0	5.5	**4**
– In per cent of GDP	-6.4	1.5	3.9	3.5**	4.1	5.5	**4**
Unemployment rate (annual average)	7.8	10	11.2	11	10.8	11	**11**
General government balance in per cent of GDP (ESA)	-3.7	-4.6	-4.2	+4.0	-2.9	-2.9	**-2.9**

*/ Projections are adjusted according to the new classification system
**/ GKI estimates
Source: CSO, GKI