The forecast of GKI Economic Research Co. for 2012-2013

Hungary is lagging behind the EU in economic terms and is becoming isolated from the EU as far as its economic policy is concerned. In the first half of 2012 the Hungarian economy got into recession. It further deepened in the second half of this year due to the drought. Consumption, investments and lending are all plummeting. The financial position of the majority of companies is deteriorating. Hungarian financial market indicators improved following the easing of the European debt crisis and the start of the IMF negotiations. However, inflation is accelerating strongly. Owing to the risk of the continuation of the excessive deficit procedure, significant adjustments of the 2013 budget are unavoidable. The successful conclusion of the negotiations with the IMF and the EU remains questionable. The government does not seek agreement, and it even makes these international organizations appear as if they would pose a threat to the sovereignty of Hungary. Only the sharp deterioration in financing conditions may force a quick agreement. Thus, even if an agreement is reached, no substantial improvement in economic trends can be expected in 2013 compared with this year.

Hungary's **recession** in the first half of 2012 was the deepest in the CEE region. In addition, most of the surrounding countries could grow. This suggests that only a small part of the weak performance in Hungary can be explained by weakening external demand; the main factor is the tightening of the domestic market, triggered by **wrong domestic economic policy**. In the second half of the year recession can be expected to deepen in Hungary. External demand is not improving, and the expanding activities of the Mercedes plant in Kecskemét can only lift industrial exports slightly. Domestic demand is going to slow further, and owing to an uncertain future, even economic actors well-endowed with production factors are waiting. However, the main reason of the further deterioration is falling agricultural produce due to drought. **GDP is expected to drop by 1.5 per cent** in 2012. (GKI has forecasted a 1.5 per cent drop of GDP since the end of 2011. At present we think that industry will stagnate rather than grow, and agriculture and investments will decrease more, whereas services and consumption will decline less than we estimated previously.) GDP adjusted for terms of trade will drop by about 3 per cent in 2012 reducing domestic resources by this amount compared with 2011.

Employment expands only statistically, due to growing public works. Real wages (including public employees) will **decrease** by 3.5 per cent, real incomes by 2.5 per cent and **consumption by 2 per cent**. Social differences are increasing. **Inflation will increase by 5.7 per cent** in 2012, and almost 40 per cent of it is due to tax increases. At the beginning of 2012 the situation in **money markets** was threatening. Although there has been **substantial improvement** in this field, Hungarian risk premium remains high, and it is very sensitive to national and international news. The fact that the reduction of the central bank reference rate was approved by the votes of external Council members, despite the opinion of the whole leadership of the Bank, further **erodes the credibility of the Central Bank of Hungary**. **Further interest rate cuts could not stimulate the economy without substantive changes in economic policies and the long-term decrease of the risk premium**, in fact, the weakening of the forint could even curb it. The 2012 budget foresaw **significant restrictions**, as it aims to keep the deficit below 3 per cent of GDP (officially 2.5 per cent) without having last year's pension fund sources. GKI forecasts a deficit **reaching 2.9 per cent of GDP** (in line with the methodology used by the EU). The **government debt** can be expected to be around 78-79 per cent of GDP at the end of 2012 after 80.8 per cent at the end of 2011 and 81.4 per cent at the end of 2010. Though the **external balance** is favourable, it is no longer improving. The outflow of **foreign direct investments** is surpassing the inflow.

The combined **GDP** of the **EU** is expected to stagnate in 2012 compared with its 1.5 per cent increase in 2011, that of the **eurozone** will decrease by 0.3 per cent in 2012 after a 1.5 per cent growth last year, and it will

increase by 1 per cent in 2013. GDP in Germany (which gives more than a quarter of the eurozone's GDP) will increase by 0.9 per cent in 2012 after 3 per cent in 2011. The rate is expected to be 1 per cent in 2013. The main reason for this modest growth is the slowdown of external demand. **Differences** between the growth rates of individual EU member states **are increasing** (-4.7 per cent in Greece and +2.7 per cent in Poland are the two extremes). The idea of strengthening joint institutions and **progressing towards federalism** (banking, fiscal and political union, and a more democratic union) gains force in the EU, while many governments are against it. As a result, a **two-speed** EU is emerging. After the decision of the German Constitutional Court, the European Stability Mechanism (ESM) can be established. In addition, the ECB has expressed its willingness to intervene without any limits in the secondary market for government securities in order **to mitigate the problems in the government securities market and to increase the effectiveness of monetary transmission**. These interventions affect government securities with maturities between one and three years. The program is only open to countries that already applied for outside financial assistance (EFSF/ESM) and **meet the terms of the rescue package**. According to the proposal of the European Commission on **banking union**, the ECB would assume a significant proportion of the banking supervisory authority functions of the eurozone and the member states joining voluntarily, relying on the national supervisory authorities as agencies. The banking union **could mitigate the interpenetration between banks and states**. The deposit insurance system could prevent capital flight from indebted countries and ease the burden on the financial resources of the European Stability Mechanism. The recapitalization of commercial banks using European Union funds would not increase the government debt of the given country. **All of these together, if really introduced, for the first time provide a realistic chance of recovery from the European debt crisis.**

Because of the sovereign debt crisis and the presidential elections in the USA, **monetary policy will remain loose**. The **exchange rate of the euro to the US dollar** is likely to average USD1.25 in 2012 against USD1.39 in 2011, and then it is expected to increase to USD1.3 in 2013, with significant short-term volatility. In the wake of the global slowdown demand for **oil** will decline in 2012. Following the improvement in international economic activity in 2013 demand will slightly rise again; however, the annual average oil price will hardly change. **Food prices will increase** due to the global drought.

Following its almost continuous and significant decrease last year, the **GKI-Erste economic index stagnated** in the first nine months of 2012, **reflecting great pessimism**. During the last few months business expectations declined slightly, whereas consumer expectations increased somewhat.

Although the **government** restructures and transforms almost everything, it is **unable to reform**. The reasons for this are manifold. The government is bound by its former anti-reform rhetoric and policy, as well as by its etatist world view. Measures that have been taken until now in healthcare, education and the local government system can be considered mainly as nationalization, **confiscation**, and the creation of a **new system of personal dependence**. The scope of services is narrowing. Conditions necessary for more efficient and better services are missing. By the end of the summer the state of financial markets improved slightly, and **the propensity of the government to spend without appropriate revenues has intensified again**. Negotiations with the IMF and the EU started in November 2011, that is, more than ten months ago, resemble a **"peacock dance"**. The government has **no real intention to conclude an agreement** with the IMF, more precisely, it will make small concessions to maintain (an appearance of) negotiations that are **indispensable for gaining the minimum confidence of market participants**.

By mid-September, however, a **new situation** has developed to a certain extent. Owing to, on the one hand, the almost unlimited money creation of the ECB and the Fed and, on the other hand, the markets' pricing of the IMF agreement, a much more favourable financial situation (which **currently looks manageable in the long term**) has emerged. However, there seems to be an **additional deficit reaching 2 per cent of GDP affecting the 2013 budget**, which threatens by the **continuation of the excessive deficit procedure** and related **sanctions**. For this reason, **the government is forced to introduce austerity measures, putting the blame on the IMF for them**. The government needs the IMF to be able to draw financing from the EU cohesion funds. First the government rejected the (non-existent) proposals of this international organization so

that it could be able later, in part accepting, and in part standing up against them, to **introduce the constraints** necessary for the adjustment of the 2013 budget. Real **stability can only based on the IMF agreement**, though its conclusion could only be en**forced by funding difficulties**. For example, **problems may arise** from a sudden deterioration of the assessment of the Hungarian fiscal and monetary policy if the government, in cooperation with the new leadership of the central bank after the spring of 2013, would **allow the level of foreign reserves too low**. Taking into account the liquidity reserves of the government (its deposits at the central bank, the remainder of marketable pension fund assets and the state-owned MOL shares) **the government, under favourable circumstances, could be able to meet its repayment obligations until the next elections** even without concluding an IMF agreement by relying on the **continuous** issuance of HUF government securities (and using the central bank's special conversion rate). (New FX bond issues before the IMF agreement would probably entail a boomerang effect.) However, it might also be that the IMF, experiencing the uncompromising Hungarian economic policy, will suspend the negotiations, which could significantly degrade Hungary's financing conditions.

In principle, the Parliament has already adopted the basic figures of the 2013 budget; however, the **budget would be significantly modified**. If this does not take place, a **general government deficit exceeding 4 per cent of GDP** could be expected (compared with the planned 2.2 per cent figure), resulting in the continuation of the EU's excessive deficit procedure and effective sanctions. GKI forecasts that **the government will amend the budget to the extent that the EU would consider it containing a deficit below 3 per cent** to avoid any sanctions. It is also conceivable that, as the elections are approaching towards the end of next year, the deficit would be allowed to exceed 3 per cent slightly to finance measures improving public sentiment. (The report for 2013 in line with the EU methodology will be prepared after the elections.) As a result, GKI assumes the introduction of **at least HUF400bn measures to improve the balance** compared with the summer draft of the 2013 budget. Debt levels are expected to decline, but much less than it would heave contracted if the total nationalized pension assets had been used for debt relief.

The **external balance** will be positive in 2013 as well; however, the **trend is worsening**. The increase in exports will slightly exceed imports (5 and 4.5 per cent, respectively), and the trade balance will grow to EUR7.7bn, from 7 per cent of GDP to 7.3 per cent of GDP. Due to increasing revenue outflow, the current account surplus will switch to EUR0.5bn deficit, and the **external financing capacity**, in spite of the slightly increasing EU transfers, will **decrease** from EUR3bn to EUR2.5bn, that is, **2.4 per cent of GDP**. The **inflow of FDI to Hungary**, reflecting the deceleration of investments in the automotive industry, **will not exceed the outflow of FDI, even under favourable circumstances**, due to the poor domestic investment climate.

Employees' **income**, including the minimum wage, will rise **by the rate of inflation** at most in 2013. Super grossing-up will be eliminated completely, and the tax rate for all income categories will be 16 per cent. (For example, the increase in the monthly net salaries of those earning gross HUF300 000 and HUF400 000 will be HUF4200 and HUF8600, respectively.) **Real incomes** will stagnate at best. The share of grey incomes expands further. The use the exchange rate barrier increases the disposable income of households slightly, whereas **consumption** remains unchanged. The amortisation of households' debts continues to exceed their borrowings in 2013, too. Considering the unstable economic situation people may favour to place their savings abroad.

Investments will only **stagnate** in 2013, even if trends are favourable. The investment rate is close to 16 per cent, lagging far behind the rate of developed countries (around 20 per cent), and it is unprecedented since the transition to the market economy. Payments from EU sources are slow, although some acceleration is expected in 2012 compared with the average of 2011. It is becoming more and more unlikely that Hungary will be able to reasonably utilize the available EU funds in full.

Gross **industrial** output will increase by 2.5 per cent in 2013. Next year will be the eighth successive one in which the output of **construction** has been declining, and the seventh one when services have been dropping, too. The **financial sector frozen by the government's economic policy** holds back the

development of the whole economy. **GDP will increase by 0.8 per cent** in 2013 but this will be almost exclusively due to agriculture (low basis in 2012), that is, in fact, the economy will **stagnate**. (**GDP can be expected to grow by 0.7 per cent during three years**, between 2011 and 2013.) **Employment** will rise only as a result of public works. The unemployment rate in 2013 will be around 11.2 per cent, similarly to 2012. Some improvement may be expected from the end of 2013, when the government prepares for the elections more intensively. The majority of the government's decisions are directly or indirectly accelerating **inflation**. Utility and energy price rises can be curbed only for a short time. **If the economic policy remains unchanged, inflation will be around 4-5 per cent for a longer period of time in Hungary (around 4.7 per cent in 2013).** The internal financial situation is determined by developments in international financial markets and negotiations with the EU and the IMF, and the uncertainty is very substantial. From the spring of 2013 on all members of the Monetary Council will be appointed by the current government. This is likely to strengthen the loyalty of the **central bank** to the government and the bank's **interest rate reduction ambitions**. However, this will be **limited** by Hungary's dependence on international financial markets. By the end of next year, the central bank reference rate may drop to 6 per cent (or, under very good international circumstances, to 5.5 per cent). The average annual exchange rate will fluctuate at around 285 HUF/EUR.

The government's confrontational, anti-market economic policies scaring away capital and skilled labour greatly hinder new investments and modernization. **Without a genuine turn in economic policy Hungary will follow a hardly more than stagnant path without perspectives, hoping only to avoid getting bogged down.**

GKI forecast for 2012-2013

	2008	2009	2010	2011	**2012**	**2013**
		(fact)			**forecast**	
Gross Domestic Product	100.9	93.2	101.3	101.6	**98.5**	**100.8**
• Agriculture (1)	151.6	85.1	83.7	127.2	**85**	**110**
• Industry (2)	96.3	85.1	113.4	105.7	**100**	**101**
• Construction (3)	91.2	96.3	91.1	92.2	**93**	**98**
• Retail and wholesale trade (4)	100.2	83.2	98.4	99.6	**98.5**	**100.5**
• Transport and storage (5)	93.7	90.3	100.5	100.7	**99**	**101**
• Information and communication (6)	103.0	113.1	104.8	102.2	**103**	**102**
• Financial services (7)	97.7	100.5	95.7	93.3	**98**	**99**
• Real estate activities (8)	99.9	102.5	100.2	98.4	**97**	**98**
• Professional, scientific, technical and administrative activities (9)	102.4	96.1	96.9	98.1	**99**	**99**
• Public administration, education, healthcare (10)	100.3	100.2	97.2	99.9	**100**	**99**
• Arts, entertainment (11)	100.6	93.4	103.4	103.0	**99**	**99**
Core growth (2)+(3)+(4)+(5)+(6)+(7)+(8)+(9)	98.0	91.8	103.4	100.9	**99**	**100**
GDP domestic demand	100.7	89.5	99.5	99.4	**96**	**100**
• Private consumption	99.8	94.3	97.3	100.2	**98**	**100**
• Gross fixed capital formation (investments)	102.9	89.0	90.3	94.5	**94.5**	**100**
Foreign trade in goods						
• Exports	104.2	87.3	116.8	110.2	**103**	**105**
• Imports	104.3	82.9	115.0	106.9	**101**	**104.5**
Consumer price index (preceding year = 100)	106.1	104.2	104.9	103.9	**105.7**	**104.7**
Current and capital account balance						
• EUR billion	-6.8	1.0	2.9	3.6	**3.0**	**2.5**
• In per cent of GDP	-6.4	1.1	3.0	3.7	**3.0**	**2.4**
Unemployment rate (annual average)	7.8	10	11.2	11	**11.2**	**11.2**
General government balance in per cent of GDP (ESA)	-3.8	-4.4	-4.2	+4.2	**-2.9**	**-3**

Source: CSO, **GKI**