GKI Economic Research Co.

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The forecast of GKI Economic Research Co. for 2013

In 2012 **GDP declined by 1.7 per cent** in Hungary, which was even higher than the 1.5 per cent drop forecasted by GKI a year before. At that time it was considered a **particularly pessimistic** forecast by government officials. Consumption and investments also continued to decline. **GDP adjusted for terms of trade (1.2 per cent) dropped by almost 3 per cent in 2012.** Although the Hungarian economy avoided financial crises between 2010 and 2012, it sank into stagnation, from which it cannot get out with the help of its current economic policy. Hungary is threatened by long-term lagging behind the region and lack of perspectives. Capital and labour are leaving Hungary.

Long-term national interests are completely overlooked. Legal uncertainty, **unpredictability** and **bad tax policy** hamper economic growth, and the expected general government deficit can only be achieved by more and more restrictions. Owing to measures infringing or abusing the law no significant new investors wish to come to Hungary without appropriate international guarantees. **Fiscal experiments** on the Hungarian economy have **caused terrible damage**. Extra taxes on sectors with high potential to modernization have **paralyzed the business world**. Low-wage **employment costs increased extremely** (by more than 25 per cent in 2 years in parallel with 7-8 per cent nominal GDP growth) and the companies affected became uncompetitive or were forced to make their activities "grey". The **perverse redistribution of income** benefiting high-income people has contributed to the further splitting of society. The **excessive involvement of the state** in regulation, ownership and the everyday life of citizens hinders competition and the evolution of independent, responsible citizenship. **Destructive anti-market and anti-foreigners slogans** only serve the financial interests of a **narrow business group**. A similar **experiment with the central bank** could cause an even more serious confusion. At present this is the highest risk and the main reason behind the about 8 per cent weakening of the Hungarian forint against other currencies of the CEEregion in March.

In recent weeks, a number of institutions and the market reacted negatively to Hungarian politics. In addition to sharply criticizing the Hungarian constitutional amendment, the European Commission predicted general government deficits above 3 per cent of GDP in both 2013 and 2014, and, together with the IMF, they recommended growth-friendly adjustments. In response to the risks of personnel and institutional changes in the central bank, as well as the Cyprus crises, the forint weakened against the euro even to over HUF305. **Now the Hungarian economic policy follows only (the otherwise conflicting) goals of the forthcoming elections: avoiding the excessive deficit procedure and redistributing incomes accompanied by populist rhetoric.**

The global economic crisis is far from over. Financial markets have stabilized since the summer of 2012, the risk of the breakup of the Economic and Monetary Union (EMU) has decreased, and European crisis management institutions have gained strength. However, these changes have not yet had an impact on the real economy sector. As a consequence of the **widening social crisis**, it is more and more difficult to make the necessary adjustments and reforms accepted by the public. **Europe has succeeded in making a mountain out of the molehill of financial problems of a tiny island (Cyprus) and shaking the confidence of small depositors in the guarantee scheme.** The European Commission reduced its growth forecast for 2013; however, following a decline in 2012, stagnation can be expected this year. The **general government deficit** relative to GDP of the EU member states decreases; however, government debt relative to GDP will still slightly increase due to stagnating GDP and recent bank consolidation measures. The 0.75 per cent **benchmark rate** of the European Central Bank may decrease to 0.5 per cent in the near future. There is no imminent inflation risk. The euro/dollar exchange rate and the oil price remain basically unchanged.

In March the **GKI-Erste economic sentiment index** reached its quite low peak level of a year ago. **Consumer expectations have continued to rise for almost six months, whereas the business confidence index stagnated in 2013. These different trends indicate the launch of an economic policy influenced by the forthcoming elections.** Although the Hungarian economy is beyond the lowest point of the business cycle, no substantial recovery or growth can be expected.

Almost all key figures of the **2013 budget** have been **changed significantly** since its adoption in summer by three main packages. Their implementation and the realization of their stabilisation effects are very **uncertain**. The employment and growth **effects** of the planned measures, for example, the so-called job protection action plan, are **very modest**. The government tries to rectify this by **open and disguised tax increases** without genuine and permanent structural changes. In addition, revenues can significantly lower than expected due to slow increase of GDP at current prices. Thus, the budget adopted in December 2012 **will be amended** many times.

There will be **significant changes in the payment of public dues**, amounting to 1.5 per cent of GDP in 2013. The so-called job protection action plan requires about HUF300bn, and the phasing out of the super grossing-up system may entail a HUF100bn **loss of revenue**. On the other hand, the **special taxes** will **remain**, effective (bank levies) in spite of the promise to eliminate them, or change form (telephone tax), and with the introduction of a new transaction tax their role is increasing. The government expects to collect additional revenues valued at HUF336bn from the new transaction tax (HUF250bn is more likely) and about HUF100bn from the new utility tax and the raised Robin Hood tax. There are a number of other tax-increasing measures, including the abolishment of the cap on the pension contribution payable by employees. The extra levies on the banking sector amount to almost 1.5 per cent of GDP, leading to a reduced activity of banks and the stagnation of the economy.

The internal structure of **expenditures** changes significantly as well. Major financial sources are to be withdrawn from healthcare, higher education and public education. In spite of the centralization of these systems, the implementation of these cuts is still uncertain due to the defective or unfinished restructuring measures, social and political resistance, and inherently unrealistic goals. **In practice, the built-in reserves can be considered spent.** Based on a February forecast of the EU, measures having an impact of around HUF200bn will be required to avoid the excessive deficit procedure. Announcement of these measures can be expected in April. **The government would like to convince the EU of its commitment to a strict budget, and at the same time to create room of manoeuvring for the spending related to the next parliamentary elections.** However, the EU is aware of this. As a result, it is possible that the excessive deficit procedure for Hungary will only be “conditionally” lifted. In addition to possible **EU sanctions**, the reaction of financial markets, and the **weakening of the forint** may impose limits to fiscal and monetary easing.

GKI predicts that in 2013 the **general government deficit** according to the EU methodology will be **around 3.5 per cent of GDP**. However, the deficit may be markedly higher (by 0.5-1 percentage points) if there would be adverse EU court rulings against Hungary concerning the telecom tax, or the economic policy would be strongly influenced by the forthcoming elections. **The government debt will remain unchanged.** The **external balance** will be favourable in 2013 as well. Owing to the slightly improving current account balance and increasing EU transfers, the external financing capacity will increase from EUR3.5bn to EUR4.2bn, corresponding to 3.6 per cent and 4.3 per cent of GDP, respectively. The **inflow of FDI** to Hungary, reflecting the deceleration of investments in the automotive industry, **will not exceed the outflow** of FDI due to the worsening domestic investment climate. **Foreign exchange reserves** are expected to fall slightly. However, if they would decrease to less than EUR32bn or EUR31bn from their EUR34bn level at the end of last year, Hungary’s financial reputation could be **highly endangered**.

In 2013 GKI forecasts gross and net salary increases of about 4 per cent. The **real value of wages** will grow grew **by 1 per cent** (assuming 3 per cent inflation). The **real value of pensions will go up by almost 2 per cent** as pensions will be raised by 5.2 per cent in accordance with the government’s original forecast of inflation. The real value of the family allowance and other social benefits will decrease, whereas that of the job-seeking benefit remains unchanged. Entrepreneurial incomes will be affected negatively by falling domestic demand; however, the job protection plan’s tax incentives may be favourable for them. Employers are rarely willing to assume the increasing taxes on the Cafeteria system, thus the disposable income of households will decrease. The government is planning to extend family tax relief to individual contributions; however, its introduction is still uncertain. Incomes earned abroad and remitted home may increase. As a result, **real incomes can be expected to grow by 1 or 1.5 per cent** in 2013. Households indebted for various reasons (bank or family loans, outstanding overheads), feeling uncertain about their work, the future value of their pensions, or the future in general, would **hardly lift their consumption**. In 2012 consumption decreased less than the real income; however, in 2013 the slight increase in real income will likely be accompanied by the **stagnation of consumption**.

In 2013 **investments** will continue to **decrease** by 2 per cent, and the **investment rate**, which in the first decade of the new millennium was around 20-25 per cent of GDP, will **drop below 17 per cent in 2013**. This is an extremely low rate, hardly covering the renewal of capital stocks. Following the interest rate cuts of the central bank, the **best companies get access to loans cheaply**, and the banks are courting them. However, weaker companies will not benefit from lower interest rates, they are **unable to acquire loans or only very expensively**. **It is more and more unlikely that Hungary will be able to absorb the available EU funds completely and rationally.** The government is trying to find appropriate objectives for calls for tenders in order to spend the funds rapidly.

After last year's downturn, in 2013 an increase close to 1 per cent can be expected in **industry**, primarily due to the start of production of some automobile industry projects. After last year's draught, **agricultural** GDP will increase by 15 per cent (assuming average wheather conditions), contributing to this year's GDP growth by 0.5 percentage points. Disputes and uncertainties around the draft land law badly hinder investments and long-term lending. Following a decline of seven years, the output of the construction industry is expected to stagnate in 2013, as well as housing construction (10 thousand new homes expected to be built). Retail sales and tourism are also stagnating. The selection of products is reduced, as there is not enough purchasing power for more expensive products. The slight decline continues in the service sector, growth can be expected only in the **info-communications sector** (e.g., mobile Internet). The quality of **public services**, particularly health and education, is **deteriorating quickly** due to resources withdrawn, low wages, and especially imprudent interventions implemented without consulting the stakeholders. In the energy and utilities sector a **deterioration of the security of supply** can be anticipated due to the lack of investments and maintenance.

The Hungarian economy will stagnate in 2013, and GDP in 2013 will be at its 2010 level. Even to achieve this, the economy **depletes its reserves**: people's private pension assets are lost, foreign exchange reserves are decreasing, and capital and skilled labour are leaving Hungary. In 2008 and 2009, in the first 2 years of the financial crisis, GDP and household consumption fell simultaneously. In contrast, since 2010 the gap has widened, and **consumption declined in spite of the stagnation of GDP, as a result of an economic policy "without austerity". No substantial improvement can be expected in the labour market. Employment expands statistically by 1 per cent** due to those involved in workfare programs and those working abroad. **The number of jobs (paying taxes) actually declines in Hungary.** The **unemployment rate** will be 10.8 per cent in 2013, slightly lower than in 2011 and 2012 (10.9 per cent).

The loan portfolios of banks will contract further by 6-7 per cent, due to the repayment of loans. There is hardly any demand for new loans. Government ideas raised in early 2013 like converting residential and small-business FX-loans into forint denominated ones, as well as creating a banking system 50 per cent of which should consist of Hungarian-owned banks, **may put new burdens on the banking sector**. Plans and agreements **developed together** with banks could also be beneficial for the economy; however, **there are concerns** that the series of hasty decisions will continue, causing further serious damage to the sector. A strong weakening of the forint could give a new impetus to **transferring domestic savings abroad**, similarly to the situation experienced at the beginning of 2012.

Although **inflation would slow down anyway**, it may reach historically low levels in 2013 (and early 2014) due to drastic government interventions that seems to be escalating (**reduction of overhead costs**). As a result of measures taken until now, the **annual average inflation rate may drop to around 3 per cent**. However, the **uncertainty of this forecast is quite high** (a 2.5 per cent annual average increase in prices cannot be ruled out either). **Price reductions financed by budgetary expenditures and exhausting the capital of service companies** may generate temporary real income growth; however, **they will induce a new wave of inflation within one and a half year**. The quality of services will decline, which is the worst form of disguised inflation.

Another risk of artificially depressed inflation is that the central bank's inflation target **will be met formally**, and on this ground **interest rates might be forced down to unreasonably low levels**. As the new leadership of the central bank and the Monetary Council are now completely loyal to the government, the interruption of the interest rate reduction period can be expected in the near future only if Hungary's financial stability is threatened (due to an excessive depreciation of the forint). **Interest rate cuts will not boost the economy substantially; however, they will weaken the forint.** This is tolerable temporarily in a favourable international atmosphere. Any negative changes in the international appetite for risk, such as a tithe on deposits in Cyprus, fiscal tightening in the USA, a permanent

Italian political stalemate, or the events of crisis management in Europe, may dramatically worsen financing conditions. **This is a very dangerous gamble!** Owing to the high level of FX-loans, the government and the central bank cannot allow the exchange rate of the forint to the euro to mount above HUF310-HUF320 in the long term. In this case intervention would be inevitable. GKI predicts a **HUF295 annual average exchange rate of the forint to the euro** in 2013 (after last year's HUF290) with large fluctuations.

The forecast of GKI for 2013

	2010	2011	2012	Forecast for 2013		
	fact			September	December	**March**
Gross Domestic Product	101.3	101.6	98.3	100.8	100	**100**
– Agriculture (1)	83.7	127.2	78.7	110	110	**115**
– Industry (2)	113.4	105.7	98.8	101	101	**100.5**
– Construction (3)	91.1	92.2	93.6	98	98	**100**
– Retail and wholesale trade (4)	98.4	99.6	98.9	100.5	99	**100**
– Transport and storage (5)	100.5	100.7	98.4	101	101	**100**
– Information and communication (6)	104.8	102.2	103.5	102	101	**101**
– Financial services (7)	95.7	93.3	97.0	99	97	**97**
– Real estate activities (8)	100.2	98.4	98.9	98	98	**98**
– Professional, scientific, technical and administrative services (9)	96.9	98.1	99.3	99	99	**99**
– Public administration, education, healthcare (10)	97.2	99.9	100.2	99	99	**99**
– Arts, entertainment (11)	103.4	103.0	98.7	99	99	**99**
Core growth (2)+(3)+(4)+(5)+(6)+(7)+(8)+(9)	103.4	100.9	98.8	100	100	**100**
GDP domestic demand	99.5	99.4	96.3	100	99	**99**
– Private consumption	97.3	100.2	98.0	100	99	**100**
– Gross fixed capital formation (investments)	90.3	94.5	96.2	100	98	**98**
Foreign trade in goods						
– Exports	116.8	110.2	100.9	105	105	**105**
– Imports	115.0	106.9	100.0	104.5	104.5	**104.5**
Consumer price index (preceding year = 100)	104.9	103.9	105.7	104.7	105	**103**
Current and capital account balance						
– EUR billion	2.9	3.6	3.5*	2.5	2.5	**4.2**
– In per cent of GDP	3.0	3.7	3.6*	2.4	2.4	**4.3**
Unemployment rate (annual average)	11.2	10.9	10.9	11.2	11	**10.9**
General government balance in per cent of GDP (ESA)	-4.2	+4.2	-2.5*	-3	-3	**-3.5**

* GKI estimate

Source: CSO, GKI

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