The forecast of GKI Economic Research Co. for 2013-2014

In Hungary (as in Europe) recession has come to an end. However, the significant decline of GDP in 2012 and the slight one in the first half of 2013 will be followed only by a small increase of about 0.8 per cent in the second half of 2013. In addition, the fact that GDP will increase in 2013 at all will be almost exclusively due to agriculture thanks to this year's relatively favourable weather conditions following very unfavourable ones last year. Although Hungary has been let out of the excessive deficit procedure, the measures applied for achieving this goal have frozen the economy. The Hungarian economy wobbles on a recessionary trajectory. Only 1.3 per cent economic growth can be expected in 2014, after a rate of 0.3 per cent in 2013, and the lagging behind of the Hungarian economy in the region continues. The annual average rate of of GDP growth will be only 0.4 per cent between 2011 and 2014, and only Slovenia will perform worse. This suggests that only a small part of the sluggish performance in Hungary can be explained by weakening EU demand; the main factor is the permanent contraction of the domestic market, triggered by wrong domestic economic policy. The forthcoming elections have increasingly stronger influence on economic policy (forced reduction of households' overheads, elimination of FX loans) worsening investor sentiment on the Hungarian economy. In addition, the rate of expansion of international liquidity is also slowing down. All these factors may cause a negative turn in the financing conditions of the Hungarian economy that started to improve last year.

Economic policy, influenced by the elections, has **singled out the banking system as its main victim**. Banking services are made more expensive (the price index of financial services was 28.7 per cent as opposed to the average inflation rate of 1.3 per cent in August) and banks are declared guilty for their past and current activities. The banking system **cannot effectively perform its functions** under these conditions. Taking into account all the costs, **deposits do not provide real returns to investors**, and **lending rates without preferences are very high for investors**. It is **paradoxical** that while the liquidity and capital position of the Hungarian banking system are good and improving, this is achieved by measures extremely unfavourable for the real economy, **the loan portfolio is drastically reduced** and the losses caused by excessive taxation are offset by **capital increase provided by parent banks**. In particular, German and Austrian owned banks are reducing their lending, and they transfer their withdrawn financial resources mainly to other countries in the CEE region. This makes it clear that **this is not a regional problem but a special Hungarian one**.

No signs of promising long-term changes can be detected either in the financial system or production or demand. In the second half of the year slowdown can be expected both in agriculture and construction. In agriculture this is caused mainly by the droughty weather unfavourable for maize and the continuing decline in livestock production, whereas in the latter case it will be the result of an increased statistical base due to the slight revival started in the second half of 2012. GDP of business services stagnates. Real earnings are increasing in the second half of the year, and this may result in slightly rising retail sales in 2013. In industry, after a decline in the first half of the year, exports are expected to grow, and gross output will increase by 1 per cent in 2013. The quality and availability of public services continue to deteriorate. **The number of "real" jobs in Hungary will decline in 2013.** However, employment will increase **statistically** as a result of the pubic work scheme (the government plans to **increase the number of those participating in public work schemes to 200 thousand people** due to the forthcoming elections) and working abroad. **Real earning and real income will increase by 2 per cent.** Indebted households with uncertain future would hardly lift their consumption. **GDP in 2013 will be at its 2010 level. Investments are 10 per cent lower, and the consumption of households is 1.5 per cent less than in 2010.**

Inflation fell to 1.3 per cent in August 2013 from 5 per cent in December 2012, in part due to the **enforced overhead reductions**. **GKI expects 1.9 per cent inflation in 2013.** The rate of inflation is reduced by overhead

reductions, whereas it is lifted by **new taxes and official measures** like the telephone tax, utility tax, e-tolling, transaction tax, the increased sales margin on tobacco and fixed high taxi fees. The aim of the Monetary Council is to reduce the base rate. Although international financial trends have been favourable for the Hungarian monetary policy since the summer of 2012, the forint is vulnerable to destabilizing financial news, such as the plan to eliminate FX loans. Accordingly, the **depreciation of the forint** in the summer **detached from regional trends again**. The **weak credibility of the Hungarian economic and monetary policy** is indicated by the fact that rate cuts in the summer only affected the yield of short- term government securities. The yield curve became very steep, and the **yields of long-term Hungarian government securities were markedly greater than those in the other countries of the CEE region**. The **general government deficit** (ESA) is expected to be **some 3 per cent of GDP (somewhere between 2.7 and 3.4 per cent)**. The main **risk factor** is an **election spending** with delayed effects. The final change in **government debt** at the end of year will be determined by the **year-end exchange rate** of the forint and in particular the state of **fiscal reserves** (the timing of new borrowings). The **debt ratio** can be expected **between 79 and 80 per cent** by the end of 2013. In recent years the Hungarian government debt has declined only because of the nationalization of private pension funds; in fact, **it would have increased by about 6 per cent without it**. The **external disequilibria** of the Hungarian economy have been **favourable** since 2009, resulting in a steady **external financing surplus of between 2 and 5 per cent of GDP**.

The **global economy** expands in 2013 at a rate similar to that of last year, and it is expected to accelerate in 2014. The main risk is the uncertainty concerning the Fed's monetary policy. Although the institutional system of the **European crisis management** has become stronger, these changes have not yet had an impact on the real economy. Reform measures may accelerate at the end of 2013 after the German elections. **Economic expectations** have improved in the EU. In Hungary expectations were stagnant during the summer, and they got a new momentum in September.

The **government apparently won its "economic war of independence"** as the excessive deficit procedure was terminated for Hungary (from this viewpoint, Hungary belongs to the leading one third of EU member states), avoided an IMF agreement, and advanced the positions of its **own staunch supporters** at the expense of competing foreign and domestic capital. However, **the Hungarian economy and society is going to pay a high price for this**: GDP, investments, consumption and real domestic employment have declined or remained unchanged for three years, and the interest paid to foreign financiers has always been significantly higher than what the Bulgarians or Romanians paid. All international institutions (European Commission, OECD, IMF, rating agencies, etc.) sharply criticized this economic policy. **Hungary is losing its former positions in various competitiveness rankings. The government has won the battle at the expense of the whole country.**

The **new central bank leadership** from March 2013 **is obviously loyal** to the government. The reduction of the base rate has continued and the **wider use of unconventional measures** has started. Integrating the National Bank of Hungary (NBH) and the Hungarian Financial Supervisory Authority (PSZÁF), which could be a right measure, may increase the pressure on the banking system. Although zero-interest loans extended to commercial banks up to now did not threaten the financial balance, they **did not stimulate growth either**, as they did not affect the general lack of confidence. However, the further offer of HUF2,000bn zero-interest loans involves **special risks**. By itself, it will cause at least **HUF120bn loss annually** to the central bank and, indirectly, to the budget. The amount is **too high**, one and a half times that of the total investments of the SME sector in 2011.

Until the 2014 parliamentary elections the government will continue its **current policy unchanged**, further strengthening the influence of the state. Although the timing and scope of overhead reductions and "saving" of FX-debtors are still uncertain, these programmes continue spectacularly. The government wishes to pass on the financial burdens of these programmes to banks and companies. However, **GKI** believes that the crux of the problem is **not the provision of FX loans but the weakened repayment capacity of people** indebted either in forint or foreign currencies.

In 2014 economic growth in Hungary **may temporarily accelerate to 1.3 per cent, close to the EU average**, as a result of increasing demand in Europe and the short-term, enforced and unsustainable boosting of domestic demand. Handling the tensions arising from the disequilibrium due to an economic policy influenced by the forthcoming elections (such as general government deficit or artificially depressed inflation and interest rates) seems to be essential after the elections, whereas making economic growth sustainable is unthinkable without restoring business confidence, predictability and proper functioning of the banking system. **GKI projects a deficit of 2.9 per cent for 2014**; however, it is quite possible that **new interim restrictions** should be introduced before next summer to achieve this goal. The **government debt to GDP ratio** will decline by 0.5 percentage points in 2014 solely due to the 2.9 per cent annual deficit. **Hungary's foreign exchange reserves continue to decline: they were EUR30.6bn at the end of August 2013. This figure is the lowest since October 2009.** This is probably acceptable as far as foreign currency reserve requirements are concerned. **However, a decline of EUR7bn during 20 months strongly increases risks.** In a favourable global economic and financial environment the Hungarian government debt can be financed from the international financial and capital markets, although with significant risks. For example, **if foreign currency reserves fall below EUR30bn for a longer period, it would seriously impair the financial reputation of Hungary**. The government wishes to raise the foreign exchange reserves by issuing FX bonds. The large-scale use of FX reserves to ease the burdens of FX-debtors may deplete the reserves to dangerously low levels.

The external balance will be favourable in 2014 as well; however, its improvement will stop. In spite of growing EU support, the external financing capability remains unchanged, around 4.7 per cent of GDP. In the wake of an improving European economy, **exports will grow by about 5 per cent**, whereas **imports will increase by a larger extent** due to rising domestic demand. The **terms of trade** remains unchanged. No significant changes in the **flow of capital** can be expected, even if the Hungarian economic policy becomes more predictable, the outflow of capital will stop **at best**. **In spite of the increasing inflow of EU transfers, investments will increase only by 2 per cent in 2014.** It is more and more unlikely that Hungary will be able to absorb the available EU funds completely. Currently, valid support contracts amount to HUF7,500bn, and **more than HUF1,000bn is waiting to be awarded this year**. **Half of this amount will probably not be authorized.**

Real jobs can only be created by customers and demand. Though **in reality** employment and the unemployment rate **stagnate**, they **improve statistically** due to the growth of public work schemes. **GKI** forecasts that **gross earnings** will increase by 3.5 per cent in 2013 and by 4.5 per cent in 2014. This acceleration will mainly be the result of probable wage increases (about 6 per cent) in the public sector in the context of elections, whereas this rate in the private sector will be around 4 per cent. Real wages will increase by 2 per cent in 2014, similarly to 2013, if inflation will be 2.5 per cent. The **extension of the availability of family tax benefits** will increase total earnings by a further 0.7 percentage point. **Real income is expected to grow by 2 per cent and consumption by 1.5 per cent.**

The **production structure** of GDP has been changing in a negative direction since the crisis. In Hungary, unlike the international trends, the contribution of the productive sectors to GDP is increasing, whereas that of **services is decreasing**. The change will be 0.5 percentage points in 2013 and 1 percentage point in 2014. In agriculture, after a relatively good harvest in 2013, we can expect stagnation in 2014. **Industrial** production will grow by 3 per cent. **The shrinking of construction, which began in 2005, ends in 2013**, and in 2014 the output of construction will grow slightly faster (4 per cent and 5 per cent, respectively). **Retail trade turnover** will increase by about 2 per cent due to the fact that real incomes are increasing for the second year. Other services will stagnate or slightly grow. However, **the financial sector remains in hibernation**, its contribution to GDP is further reduced. Public services will largely stagnate despite the expansion of public work schemes. As a result, **GDP may grow by 1.3 per cent** due to the expansion of external demand and the stimulation of domestic demand, partly achieved by temporary means. As domestic supply can meet demand only partially, the gap between exports and imports will widen from 0.5 percentage points to 1 percentage point. At the same time this means that **domestic consumption** will grow by 2 per cent, faster than GDP.

Until the elections **inflation** trends will mainly be determined, to an extent unusual in market economies, by certain **government decisions** like those in recent months. As a result of enforced overhead reductions and the interfering with market processes as well as the unavoidable passing on of various official burdens to customers will keep the rate of overall price increases **under 2 per cent** in the coming months. However, the modest growth in purchasing power, the slowly but steadily weakening forint, the pressure to passing on of cost increases to customers will gradually intensify market pressure to increase inflation. Therefore, a **new wave of price increases** is expected in the second half of the year after the local elections. Inflation will be around 3 per cent in the second half of 2013 and about 2.5 per cent in 2014.

The central bank reference rate was reduced to 3.8 per cent at the end of August. From an economic point of view, **there is not much room** to reduce it further. In a long-term negative international financial market situation the **reference rate could be increased already this year**. In the second half of 2014, rising inflation will also justify raising the reference rate. The **exchange rate of the forint** will continue to fluctuate strongly; the average exchange rate of the forint to the euro will be around **HUF295**. Before the elections an even weaker forint can be expected, around HUF300 and above. Later, in the second half of 2014 this **may be followed by some strengthening of the forint** due to the expected improvement of the predictability of economic policy.

In extreme cases, if measures to eliminate FX loans or some radical actions against banks or the budget **may seriously impair the assessment of the Hungarian economy by financial markets**, the **reference rate may be raised significantly** at the end of 2013 or the beginning of 2013 in order to prevent the collapse of the forint or the outflow of financial capital. In fact, this would be **a scenario much worse than anything predicted by GKI until now**.

GKI forecast for 2013-2014

	2010	2011	2012	**2013**	**2014**
	fact			**forecast**	
Gross Domestic Product	101.3	101.6	98.3	**100.3**	**101.3**
• Agriculture (1)	83.7	127.2	78.8	**118**	**100**
• Industry (2)	113.4	105.7	98.9	**100.5**	**102.5**
• Construction (3)	91.1	92.2	93.6	**104**	**105**
• Retail and wholesale trade (4)	98.4	99.6	98.8	**100**	**102**
• Transport and storage (5)	100.5	100.7	97.5	**102**	**101**
• Information and communication (6)	104.8	102.2	103.4	**101**	**102**
• Financial services (7)	95.7	93.3	97.0	**97**	**98**
• Real estate activities (8)	100.2	98.4	98.8	**100**	**101**
• Professional, scientific, technical and administrative services (9)	96.9	98.1	99.9	**99**	**100**
• Public administration, education, healthcare (10)	97.2	99.9	100.0	**99**	**100**
• Arts, entertainment (11)	103.4	103.0	99.3	**99**	**100**
Core growth (2)+(3)+(4)+(5)+(6)+(7)+(8)+(9)	103.4	100.9	98.8	**100.3**	**101.7**
GDP domestic demand	99.5	99.4	96.3	**100.5**	**102**
• Private consumption	97.3	100.2	98.1	**100.5**	**101.5**
• Gross fixed capital formation (investments)	90.3	94.5	96.2	**100**	**102**
Foreign trade in goods					
• Exports	116.8	110.2	100.9	**103**	**105**
• Imports	115.0	106.9	100.0	**103.5**	**106**
Consumer price index (preceding year = 100)	104.9	103.9	105.7	**101.9**	**102.5**
Current and capital account balance					
• EUR billion	2.9	3.6	4.2	**4.5**	**4.7**
• In per cent of GDP	3.0	3.7	4.3	**4.7**	**4.6**
Unemployment rate (annual average)	11.2	10.9	10.9	**10.8**	**10.8**
General government balance in per cent of GDP (ESA)	-4.2	+4.2	-1.9	**-3.0**	**-2.9**

Source: HCSO, GKI