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

Although Hungary came out of recession this year, its economy did not follow into a trajectory ensuring sustained fast and healthy growth. This year's recovery is based almost only on temporary sources: a favourable base as a result of last year's decline, great agricultural harvest due to weather factors much better than in 2012, public investments accelerated in order to absorb EU funds, consumption revitalized by unsustainable overhead reductions. This situation may survive until the elections; however, the unchanged adverse business, legal and investment environment, causing an increasing lag compared to neighbouring countries, will again restrain the Hungarian economy from the second half of 2014. Appearances are improving, whereas the real situation remains unchanged.

In Hungary GDP grew by 1.8 per cent in the third quarter of 2013, and by 0.6 per cent in the first three quarters of the year. **The increase was expected; however, its magnitude was surprising.** GKI has increased its Hungarian GDP projection of 2013 to 1 per cent from 0.3 per cent. **However, GDP in 2013 will still be below its 2011 level.** The increase will be almost exclusively due to **agriculture** (weather factor). GDP calculated without agriculture and the public sector will not grow at all. Assessment of banks has become infected with politics and the **banking system** cannot effectively perform its main functions under these conditions. Following a long period of decline, the **loan portfolio of the corporate sector almost reached its level of 2012** mainly as a result of the first phase of the new Funding for Growth Scheme of the National Bank. However, the credit portfolio of households continues to decline.

The four-year decline in investments has stopped. The driving force was mainly the acceleration of infrastructure development financed by EU funds. **Investment activity in the private sector remains weak.** Developments in the manufacturing sector were rather sluggish (despite the surge in the third quarter). In 2013 investments will rise by about 4 per cent. In the first three quarters of 2013 the combined **number of people** working in companies employing more than five persons and in publicly financed institutions grew by 0.1 per cent; however, it **declined** by 0.4 per cent if those involved in public employment schemes are not taken into account, and by 0.5 per cent in the competitive sphere. The number of those involved in **workfare programs** during the winter will continue to rise artificially (instead of the usual decrease), until the elections, **statistically improving** employment figures. The average **unemployment rate** in 2013 will be 10.6 per cent, and it will be below 10 per cent at the end of the year. Much of the improvement is only **appearance**. **Real incomes** grow by about 2.2 per cent, partly as a result of the artificially depressed inflation. However, households will **hardly increase their consumption**. **Bank deposits are falling** due to low deposit interest rates, **cash holdings are rising dramatically**, and the role of government securities and shares is increasing.

On the one hand, the Hungarian government **"nationalized" the decline in global energy prices by mandatory overhead reductions; on the other hand, it went further**: **inflation** dropped to 0.9 per cent in October, and to 1.9 per cent in average in the first ten months, by a rate larger than previously expected. Inflation will be **1.8 per cent in 2013**, and its level will be below 1 per cent at the end of the year, as a result of the second package of overhead reductions. Referring to the inflation artificially depressed by the government, the Monetary Council **stands by its policy of interest rate reductions**. Thus, the reference rate being 3.2 per cent at the end of November may be lowered to 3 per cent by the end of the year. Meanwhile, despite the favourable international financial investor sentiment, the exchange rate of the euro increased to over HUF300 since the end of November, the yield curve continued to become steeper, reflecting the **increasing risks of interest rate cuts**. Hungarian **CDS spreads** are significantly lower than last year; however they did not yet reach their level prior to the change of government, and considering the CEE region they are only lower than those in Slovenia and Croatia. **Internal risks** in connection with the financial assessment of Hungary have **decreased** as measures to save FX-debtors were very reasonable compared to those announced previously. However, **the uncertainty caused by politicians remained unchanged**.

Fiscal trends in 2013 are slightly more favourable than previously expected. As a result **GKI changes its forecast for government deficit relative to GDP (ESA deficit) to 2.8 per cent from 3 per cent**, considering it the mean value of a band ranging from 2.5 per cent to 3.2 per cent. As a result of repeated mid-year adjustments, the **deficit will also be kept below 3 per cent** in 2013, just like in 2012; however, the **deficit will rise by nearly one percentage point this year**. 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 by the state of fiscal reserves. **GKI** expects the **debt ratio between 79 and 80 per cent** by the end of 2013. **Debt reduction resulting from economic processes has not been achieved either in 2011, or in 2012, or in 2013.** The **external disequilibria** of the Hungarian economy (foreign trade, current account, external financing capacity) reflect a **forced surplus** since 2009. Thus, the net foreign debt (excluding inter-company loans) decreased from 50 per cent of GDP to 40 per cent by the beginning of 2013. The external balance of Hungary improves further in 2013, the current account surplus and EU transfers rise, and the **external financing need** relative to GDP increases to 4.5 per cent from 3.6 per cent.

Global economic growth will accelerate in 2014, and a 1.4 per cent growth can be expected in the EU after this year's stagnation. In the **EU**, Germany will grow by 1.7 per cent. The **main risk** to the global economy is the uncertainty concerning the US budget and the Fed's monetary policy. Economic expectations have typically improved in the EU. The trend of the **GKI-Erste economic sentiment index** has been rising since the end of 2012, and it was as high as now last time almost three years ago. **In the business sphere optimism strengthened in all sectors.** In November, the proportion of industrial companies expecting improvement exceeded slightly that of those expecting deterioration. **Consumer expectations** increased spectacularly as a result of measures in connection with the election cycle aimed at improving the general mood of the population.

The government apparently has won the "war of independence". They avoided the conclusion of an IMF agreement, the excessive deficit procedure was terminated, and as far as this point of view is concerned, and taking into account the expected economic growth of around 1 per cent in 2013, Hungary belongs to the leading one third of EU member states. Inflation fell to the average level of the EU by October, and unemployment was even lower than that. In addition, the government advanced the positions of its own staunch supporters at the expense of competing foreign and domestic capital. **However, behind these achievements essentially temporary, costly and unsustainable processes can be found.** Systematic deviation from the norms of market economy, as well as the anti-capital and anti-competitive business environment turned off the long-term drivers of growth. Without a turnaround in economic policy Hungary will remain on a trajectory preserving its diversion from the developed world.

Hungarian economic policy influenced by the elections does not involve a traditional election budget. In accordance with its previous practice, the government passes the burdens of the redistribution of incomes primarily on the business sphere (taxes, overhead reduction). The government **definitely wants to avoid the resumption of the excessive deficit procedure**. This is also indicated by the November forecast of the EU for Hungary, which contains exactly the tolerated deficit level of 3 per cent of GDP and assumes that **there will be no new packages to save FX debtors requiring serious fiscal commitment of the government** (obviously according to the government's assertions in this regard). Since the passing of the burdens on banks, without the financial involvement of the government, is also unacceptable, as European institutions already called attention to this in context of the early repayment of FX loans, **drastic government actions to rescue FX debtors can hardly be expected**. This is also supported by the actions that involve the courts in trying to solve this set of problems; not to mention that these are also suitable for procrastination.

Passing the burdens of an economic policy influenced by the forthcoming elections on banks and companies is **only possible in the short term**, since the **stakeholders will eventually increase the burdens of households and the business sphere** in different ways, such as by passing on their costs, by impairing the quality of their products or by deferring improvements. The government continues to **integrate the theoretically independent institutions** and dismantle the institutional system of democracy and market economy. Meanwhile, they do not deal with the fundamental problem that **capital and skilled labour are both leaving** Hungary. **Hungary is attractive to financial investors due to high yields, but repels investors due to the lack of legal certainty.** Although zero-interest loans provided to commercial banks by the National Bank of Hungary up to now did not threaten the financial balance, they can **hardly stimulate growth** either, as they do not affect the main problem of the Hungarian economy, the **general lack of confidence**. The **second** HUF2,000bn **zero-interest loan package is unrealistically high**, one and a half times that of the total investments of the SME sector in 2011, thus there is little chance of realization. Due to rising long-term yields, **there is a strong risk of arbitrage**.

GKI forecasts that the **general government deficit (ESA methodology) will be about 2.9 per cent of GDP in 2014**; however, to achieve this, **mid-year measures to improve the balance** will likely be required next summer. The **debt ratio** will slightly **decrease**. According to the **new second EU rule on excessive deficit, not yet valid for Hungary**, instead of minimal improvement; **one percentage point yearly decline** in the debt ratio should be achieved in average during three years. We will be still very far from this next year. **The external balance will be favourable in 2014 as well; however, its improvement will almost stop.** In spite of growing EU transfers, the external financing capability remains around 4.7 per cent of GDP. 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. **Investments** will also increase in 2014, mainly due to EU supported investments; however, only by 2 per cent, more moderately than in 2013. Investment activity in the **private sector** remains **weak**. Although real **employment** will **stagnate** in 2014, figures based on labour force surveys may show a 1.5 per cent increase due to the further expansion of public work schemes and working abroad. The annual average unemployment rate remains at around 10.5 per cent.

Owing to the slight growth of non-agricultural sectors and the easing government wage policy (election year), **4–4.5 per cent gross and net wage increase can be expected**, slightly faster than in 2013, making an **increase of 2–2.3 per cent of real earnings** possible. Wages may rise by 6-7 per cent in the public sector. In the private sector low inflation restrains the increase of wages, and 3-3.5 per cent growth can be expected (the minimum wage will rise by 3.6 per cent). The extension of the family tax benefit will raise net wages by a further 0.7 percentage points. The 2.4 per cent increase of pensions will only result in minimal real growth. **As a result, the real income of households can be expected to increase by around 2 per cent.** After the decline and stagnation of previous years, the **consumption** of households will go up by **around 1.5 per cent**, reaching its starting level.

As a result of the improvement of the European business cycle started this year and the temporary, artificial and unsustainable boosting of domestic demand, the GDP growth rate in Hungary at the end of 2013 **may continue in the first half of 2014**. However, **handling the tensions arising from disequilibria** due to an economic policy influenced by the forthcoming elections **seems to be essential** after the elections, whereas **making economic growth sustainable is unthinkable without restoring predictability, the proper functioning of the banking system, and dynamic growth in business investments**. Thus, in the second half of 2014 GDP growth **may decelerate to around 1 per cent**, and an **annual average of 1.3 per cent can be expected**. In **agriculture**, **GKI** forecasts stagnation in 2014. **Industrial** growth continues to be driven by exports, with a boosting effect on domestic suppliers of exporters. Improving European, and especially German, prospects may result in an industrial growth of **around 3 per cent**. As no new larger production capacities have been established in recent years, except in the motor industry, and companies' investment plans aim mainly replacement and modernization, exceeding this rate noticeably is hardly probable. In **construction** the main projects remain those financed by EU funds until the end of 2014. In the corporate sector construction demand is not expected to expand noticeably. The **number of homes completed** plummets further from 6-8 thousand in 2013 to 4-6 thousand in 2014. The volume of construction output will **grow by around 5 per cent**. Following the increase of purchasing power with some delay, **retail sales** will increase by 2 per cent. The increase of real wages will be eliminated by rising inflation at the end of the year thus its **slowdown** can be expected in contrast with mid-year acceleration. The contribution of transport and communication industry to GDP will slightly mount in 2014, compared to stagnation in 2013, and the **decline in the financial sector might terminate**. Public services are still growing, though at a slower pace, due to the extension of public work schemes. **Exports will accelerate slightly** due to in part the improving European economic activity and in part the increasing amount of exportable grains. The terms of trade is expected to remain unchanged. As domestic supply can meet increasing domestic demand only partially, the **gap between imports and exports** 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. As the source of this growth is not investment-oriented, it is quite **unfavourable** and reflects that the process is **unsustainable** as well.

Overhead reductions and the international inflation environment will still keep the rate of inflation under 2 per cent, **around 1 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, and the unsustainability of mandatory overhead reductions will **gradually intensify market pressure to push up inflation**. The 3.4 per cent core inflation in 2013 also indicates that price reductions using market distorting methods are unsustainable in the long-term, thus the 1 per cent inflation in the first few months of 2014 may increase **to around 3.5 per cent by the end of the year** (because of the extremely low base). **In 2014 inflation is likely to be 2.1 per cent.** In 2013 **monetary policy** in part took advantage of the opportunities presented by a favourable international environment, and the base rate was dramatically reduced. (However, taking into account **terms of 12-18 months**, there has been no room for interest rate cuts for months.) However, **if the exchange rate of euro** is markedly and for a long time **exceeds HUF300, interest rate cuts are likely to stop, and even a raise of interest rates is also possible**. The expected tightening of US monetary policy, though its date is uncertain, may also lead to the weakening of the forint and, depending on the assessment of Hungary, may result in raising interest rates as well. In the second half of 2014, rising inflation will also justify the lift of the **reference rate**, and by the end of the year it **will likely be around 3.5-4 per cent**. Owing to low interest rates, **the protection against exchange rate fluctuations became cheaper for investors, and they may speculate against the forint**. Therefore, the exchange rate fluctuations of the forint may increase.

GKI forecast for 2013-2014

	2012 fact	2013 (est.)	Forecast for 2014	
			September	**December**
Gross Domestic Product	98.3	101	101.3	**101.3**
- Agriculture (1)	81.1	122	100	**100**
- Industry (2)	98.7	100	102.5	**102.5**
- Construction (3)	93.7	106	105	**105**
- Retail and wholesale trade (4)	98.3	99.5	102	**102**
- Transport and storage (5)	98.5	101	101	**101**
- Information and communication (6)	103.3	100	102	**102**
- Financial services (7)	96.4	98	98	**100**
- Real estate activities (8)	98.1	97	101	**100**
- Professional, scientific, technical and administrative services (9)	99.9	100	100	**100**
- Public administration, education, healthcare (10)	101.6	101.5	100	**100.5**
- Arts, entertainment (11)	95.3	100	100	**100**
Core growth (2)+(3)+(4)+(5)+(6)+(7)+(8)+(9)	98.6	99.8	101.7	**101.8**
GDP domestic demand	96.5	101.2	102	**101.9**
- Private consumption	98.3	100	101.5	**101.5**
- Gross fixed capital formation (investments)	96.3	104	102	**102**
Foreign trade in goods				
- Exports	101.7	105	105	**106**
- Imports	99.9	105.5	106	**107**
Consumer price index (preceding year = 100)	105.7	101.8	102.5	**102.1**
Current and capital account balance				
- EUR billion	3.5	4.5	4.7	**4.7**
- In per cent of GDP	3.6	4.6	4.6	**4.6**
Unemployment rate (annual average)	10.9	10.6	10.8	**10.6**
General government balance in per cent of GDP (ESA)	-1.9	-2.8	-2.9	**-2.9**

Source: HCSO, GKI