GKI Economic Research Co.
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The forecast of GKI Economic Research Co. for 2011-2012

The **deteriorating growth prospects** of the Hungarian economy are in part a consequence of the worsening global economic environment, the lower than expected level of indicators in the second quarter and, especially, in the summer, and the uncertainties concerning the solvency of some countries. However, domestic **economic policy** played a decisive role. According to data of the second quarter in 2011, it prevented an increase in domestic demand more than previously envisaged and lifted risk premiums. The increase in real wages experienced only by high-income people has not raised consumption, whereas the crisis taxes have curbed the current and investment demand of companies as well as their borrowing options. Deluding those with mortgage loans and putting the problems off until later seemed only to preserve them. Later, the idea of paying back FX-loans at below market exchange rates caused a crisis of confidence concerning the Hungarian economy, similarly to the crisis in summer 2010. The legal uncertainty and the lack of predictability also played a part in the fact that in the first quarter of the year the **outflow of foreign direct investments surpassed the inflow**. The **investment activity** of the business sector is **modest and declining**, except a few projects, typically launched several years ago, of some large automotive companies.

The state of the Hungarian economy in 2011 is in many respects worse than last year, and where it seems to be better, it is only imaginary (except the improvement of the external balance). Economic growth is accelerating only due to the favourable agricultural harvest caused by good weather (by 1.5 per cent from 1.2 per cent last year). There is no substantial improvement in the labour market. The real general government deficit is much larger now than last year. (A structural deficit,excluding one-off revenues, will rise to 5 per cent this year from 2 per cent in 2009.) The government debt will only decrease due to the nationalization of private pension funds and the reduction of foreign exchange reserves. Companies suitable for economic development and investments are overtaxed and their willingness and opportunities to invest are worsening. The government used up a part of the previously accumulated reserves, and income reserves of small businesses and individuals are also being depleted. The assessment of Hungary by money markets set to deteriorate again in the summer of 2011, and the idea of the preferential repayment of FX-loans weakened the exchange rate of the forint to the euro to around HUF290. The annual average of the exchange rate of the euro to the forint is around HUF275, however, in the next few months it is expected vary between HUF280 and HUF290. The National Bank of Hungary may be forced to raise the base rate to 6.5 per cent by the end of the year.

Global economic prospects are worse than before. The combined GDP of the **EU** increased by 1.8 per cent last year, whereas it will be up by 1.7 per cent in 2011, and by 1.6 per cent in 2012. In **Germany** the rate of GDP growth would drop from 3.6 per cent in 2010 to 2.3 per cent in 2011, and to 1.8 per cent in 2012. The probability of a **managed Greek bankruptcy** is quite high. The **exchange rate of the euro** to the dollar would increase from an annual average of USD1.32 in 2010 to USD1.42 in 2011 and USD1.45 in 2012, due to, among others, the higher European interest rate level, with significant short-term volatility. The Swiss franc, which is considered to be a refuge currency, extensively strengthened against major currencies. However, in September the Swiss National Bank decided not to allow its currency strengthening below the EUR1 = CHF1.20 exchange rate. **Inflation** in the EU may reach 3 per cent this year (after 2.1 per cent last year). However, in 2012 it will be again around 2.5 per cent, as a result of the weakening domestic demand and a drop in oil and commodity prices.

The GKI-Erste confidence index has deteriorated for half a year, since the announcement of Szell Kalman Plan. The intentions to employ and to increase prices were moderate in all sectors. In September the value of the GKI consumer confidence index was close to the very low level of autumn 2006. People consider their own and the country's financial and general economic situations to be much worse than previously.

The government's economic policy is determined by power, ideological and PR considerations, whereas professional and social discussions are almost completely absent. This confrontational, "freedom fighter" (national populist) approach finds the causes of economic problems almost exclusively in external factors, especially in the euro crisis and in Hungary's international dependence. They are not aware of the fact that collective action and solidarity are on the rise in the EU as a result of the unavoidable crisis management, and Hungary may again need help from international organizations if it faces a new financial crisis. **Economic policy has reached a dead end.** Instead of the expected stabilizing effect, the two-thirds majority of the governing parties in Parliament resulted in unpredictable economic decision-making without proper social and professional control. **GKI believes that the government should reconsider its so-called tax-cutting fiscal policy, which is, in fact, a tax restructuring policy.** The tax reduction part of this policy (lowering the corporate tax rate and the personal income tax burden of high-income people) has not generated an increase in either consumption or investments, whereas the gradual phasing out of tax compensation for low-income employees, as well as the various crises and other taxes in the business sector have led to a decline in demand, employment and investments. Continuing this policy in 2012, as can be expected based on already known ideas, will be a textbook example of this: a flat income tax, which is actually not flat, which does not improve employment but makes it worse, and which is not simple but complicated, which does not bleach the economy but makes it even greyer. The main purpose of **Szell Kalman Plan** was to combat the government debt. Until now this has been no more than mere **rhetorical practice** in economic policy. The ideas that have become known excessively focus on curbing social transfers and on increasing the burdens on companies instead of institutional and operational reforms, whose implementation is delayed. This is why it became necessary to announce further tax increases.

Economic policy measures detrimental to the institutional system of the market economy and legal certainty are especially harmful as they are choking the engine of economic growth: the investment willingness of Hungarian and foreign companies. The **crowning** of this process was the announcement of the preferential repayment option of FX-loans in September. The government decided to overwrite the private contracts of the borrowers and the banks, causing huge losses for the banks. This would be **unthinkable in a constitutional state**. The Hungarian state will be sued, and it will be required to pay serious **compensation**. **As a consequence**, the wealthy and/or creditworthy families, those who are actually able to pay their debts and therefore do not pose a risk to the banking system, would be able to **get rid of their FX-loans cheaply**. However, the situation of other families will become **more difficult**. This means that the government sharply violates legal certainty and **after a few years it will pay the compensation from the taxes of Hungarian citizens** (amounting 1-2 per cent of GDP). In the meantime the banks will **lose a part of their capital**, the quality of their loan portfolios will deteriorate and the **financial system will become more risky**. **Investors will turn away from the country**, risk premiums will be rising, the forint will weaken, financing will become more expensive, **foreign exchange reserves will be reduced** and the probability of a speculative attack against the forint will increase. **The whole society will bear the burdens, and only a narrow circle will enjoy the advantages.**

In 2012 GDP will be expected to grow by 2-2.5 per cent in nominal terms. Revenues from taxes and contributions may rise by approximately 7 per cent due to the various tax increases and the growth in gross wages, which will be more dynamic than the growth of GDP, enforced by the continuation of the income tax reform. On the whole, **tax burden will increase by about 1.5 percentage points** next year, **returning to the 2010 level**. It is very unfavourable that mainly owing to economic policy failures a **recession** started in the economy and **consumption dropped**, restricting the automatic generation of additional revenues. Various tax increasing and expenditure cutting measures may improve the balance by around HUF650-750 billion next year. HUF528bn would be required to replace the missing private pension fund takeover revenues, and some HUF100bn to replace the revenues from this year's one-off measures (for example, outstanding VAT collection, purchase stop). As a consequence, there is no guarantee that the nearly HUF100bn necessary to meet the 2.5 per cent general government deficit target will be available. In addition, the risks associated with the planned tax revenue and spending cut targets are also very high. **Consequently, GKI now forecasts a**

government deficit of 2.9 per cent by 2012. Tax burdens will increase next year, whereas income redistribution will be reduced drastically (in spite of the growth in GDP, spending will fall in nominal terms). **The structural deficit will improve by more than 1 percentage point**, and it will be below 4 per cent. This means a **very restrictive budget**.

The **government debt** will further increase in 2012 for unavoidable budgetary reasons. However, the sale of state assets acquired from pension fund assets (and an unexpected improvement of the forint exchange rate at the end of the year) may have opposite effects. Therefore, GKI expects a debt ratio of 74 per cent in 2012, similarly to this year.

The **external balance** will also be favourable in 2012 due to the decreasing domestic demand and the start of exports by the plant of Mercedes. However, the external financing capacity will decrease from EUR4.2bn in 2011 to EUR4bn in 2012, as the outflow of income will rise, whereas EU transfers will only increase slightly due to Hungary's low absorption capacity. **The outflow of FDI may be more than the inflow.** This can be assumed based on the lack of new investments, the decrease in loans, as well as Hungarian investors turning toward foreign investment opportunities.

The government plans to **continue the personal income tax reform** in 2012. In order to maintain the net worth of the current minimum wage level (HUF78 thousand), it should be raised to more than HUF92 thousand (by almost 20%). This would mean a dramatic increase in the burden on business. In order to maintain the net income of people, irrespective of the tax changes, an average gross wage increase of nearly 7 per cent would be needed, while keeping its real level, about 11 per cent. It is obvious that **the majority of companies cannot and will not implement this increase** (or if seemingly implement, they will reduce employment and/or make their activities "gray"). Taking into account the great number of uncertainty factors, GKI forecasts **an average of 1.5 per cent decrease in real earnings** in 2012, while gross earnings will rise by 5 per cent. People having gross earnings around HUF140-HUF150 thousand will suffer a decline in net or real wages because a 7–19 per cent increase in gross wage, depending on their current wage levels, is very unlikely. The real value of pensions will remain unchanged in accordance with legal requirements. Rules pertaining to family subsidies are expected to tighten. **The real income is expected to decrease by 2.5 per cent.** Owing to the new preferential option to repay FX-loans, the evolution of savings is very uncertain, however, the continuation of a prudent consumer approach and the utilization of liquid capital are quite certain. A **3 per cent drop in consumption** is likely.

Investments are unlikely to increase in 2012, even after three years of fall (due to the huge losses planned to pass on the banks and the lack of predictability). In **industry** some improvement can be expected from the second half of 2012. Hungarian industrial production may accelerate greatly in the second half of the year due to automotive investments starting their production gradually. However, industry's domestic sales will continue to fall. **Construction** has declined for six years and this will continue in 2012 as well (3 per cent). Following this year's above average weather, a slight decline is likely in **agriculture** in 2012. The output of the **service sector** will also decline in 2012. The financial and real estate sector will experience a substantial contraction due to the losses of banks. However, in transportation a slight increase can be expected, in connection with exports and investments. **Employment** will stagnate in 2012, whereas unemployment may be reduced, especially statistically, due to part-time, public work replacing unemployment benefits. However, this will contribute neither to GDP growth, nor to the improvement of capabiltiy to work of those concerned, nor to the improvement of the fiscal balance. As a result, **GDP will decrease by 1 per cent**, due to the decline in domestic demand in general and in consumption in particular.

The preferential repayment of FX-loans will cause **huge losses to the whole Hungarian banking system**, **eliminating its liquidity**, and **sometimes causing shortage of capital**. The unstable operating environment may force banks to minimize their local activities. **This will affect especially the domestic SME sector. After depleting their reserves during several years, the majority of companies are in a very difficult situation due to the narrow market and the lack of capital.** Companies still capable of growing and ready to invest are affected by various sectoral taxes, which, together with the general and growing legal uncertainty, hinder them and direct their activities abroad.

Inflation will accelerate in 2012, due to the raise of the VAT rate to 27 per cent, the weakening of the forint, and the pressure from overhead expenditures frozen in 2011. On the other hand, declining household incomes and sluggish consumer demand would limit the price increases of goods and services. As a result, an average rate of inflation of 4.8 per cent can be expected in 2012, 1 percentage point higher than in 2011. The **exchange rate** of the forint and the **base rate** are highly dependent on the government's decisions concerning foreign currency loans and the budget, as well as on the behaviour of the households. The **exchange rate of the forint to the euro may average HUF285** in 2012 amid **great fluctuations**, especially in the first half of the year. It is likely that **at the beginning of 2012 the base rate will be raised to 7 per cent**. A higher increase cannot be ruled out if more severe financial stresses arise, for example, the country is downgraded.

If the preferential repayment of FX-loans becomes extensive and the huge losses force banks to reduce their activities, and if the assessment of the country risk is dramatically worsening, **Hungary may be drifted to an economic trajectory more unfavourable than projected**. Financing the government debt from the market would be more difficult, leading to budget freezes already at the beginning of the year. Concluding a **new arrangement with the IMF** may also become necessary.

GKI forecast for 2011-2012

	2007	2008	2009	2010	**2011**	**2012**
	(fact)				**forecast**	
Gross Domestic Product	100.8	100.8	93.3	101.2	**101.5**	**99**
– Agriculture (1)	78.3	154.5	84.8	84.6	**120**	**95**
– Industry (2)	106.0	99.9	86.9	108.9	**104.5**	**104.5**
– Construction (3)	93.4	89.8	93.7	91.7	**92**	**97**
– Retail and wholesale trade (4)	104.6	97.8	89.2	99.0	**100.5**	**98**
– Transport and telecommunications (5)	105.5	96.3	94.6	102.7	**102**	**101.5**
– Financial services (6)	99.1	101.8	97.9	100.1	**96**	**90**
– Public administration, education, healthcare (7)	96.1	99.7	97.7	99.0	**100.3**	**99**
– Other services (8)	103.3	94.7	98.5	102.5	**101**	**100**
Core growth (2) + (3) + (4) + (5) + (6)	102.8	99.1	92.0	102.7	**100.2**	**98.4**
GDP domestic demand	98.3	100.6	93.2	98.9	**100.2**	**97.5**
– Private consumption	98.4	99.4	93.3	97.8	**100**	**97**
– Gross fixed capital formation (investments)	101.7	102.9	92.0	94.4	**98**	**100**
Foreign trade in goods						
– Exports	115.8	104.2	87.3	116.8	**107**	**108**
– Imports	112.0	104.3	82.9	115.0	**106**	**107**
Consumer price index (preceding year = 100)	108.0	106.1	104.2	104.9	**103.8**	**104.8**
Current and capital account balance						
– EUR billion	-6.3	-6.8	1.4	3.8	**4.2**	**4.0**
– In per cent of GDP	-6.3	-6.4	1.5	3.9	**4.1**	**4.1**
Unemployment rate (annual average)	7.4	7.8	10	11.2	**11**	**10.8**
General government balance in per cent of GDP (ESA)	-5.0	-3.8	-4.4	-4.2	**+1.0**	**-2.9**

Source: CSO, **GKI**