Forecast of GKI for 2015

In 2014, the performance of the Hungarian economy was much better than anticipated by anyone. Nevertheless, in a forward looking perspective, it did not reach a trajectory that ensures sound caching-up by Central and Eastern European standards. The spectacularly favourable statistical figures of 2014 are attributed to temporary factors and/or unduly heavy sacrifices made in other fields. The extension of the model aiming at the roll back of the market economy and the increase of buy-outs of private companies by the government is continuing. The objective of the government is to strengthen its political power whose scope is increasing and the position of its preferred social and business groups. The government faced sharp conflicts with the EU, the US, several social strata as well as domestic and foreign business groups. As a consequence of these factors, the performance of the Hungarian economy is predicted to weaken significantly in 2015 compared to 2014.

In 2014 Hungary's GDP **grew by 3.6 per cent.** This growth rate was not only much more dynamic than the EU average of 1.3 per cent, but after Ireland it was the second highest in the EU. Hungary was the last country in the CEE region whose GDP reached the pre-crisis level (2007). Investments rose spectacularly sharply, by 11.7 per cent, the 1.6 per cent growth rate of consumption was close to the EU average. The rate of increase in the production of GDP (more than 10 per cent) was particularly high by EU standards in agriculture and construction, and to a lesser extent in industry. The performance of services was below the average, that of finances and real estate decreased further. **Basically with stagnating investments, the growth rate of Hungary's GDP is expected to decelerate to some 2 per cent in 2015.** Industry is likely to grow most dynamically. Some deceleration is expected in finances and after two good years in agriculture, and a pronounced one in construction. **In 2014 GDP growth was driven by investments. In 2015 the main driving force will be consumption, leading to further deceleration in growth.** In 2014 GDP growth was attributed mainly to EU transfers funding public investments. In 2015 temporarily factors promoting consumption will contribute to GDP growth. **In 2016** the contribution of both demand factors is likely to diminish.

In 2015 **global growth** will be somewhat more dynamic than in 2014. The most important driving force of global growth is the low world market price of energy. First of all net oil importing countries, including Hungary will benefit from this. The growth rate of the global economy will be restrained by **increased political risks**, such as the Russian-Ukrainian conflict and the more resolute approach of the West towards Russia, the unpredictable governance of Syriza in Greece as well as the further expansion of the Islamic State in the Middle East. The further acceleration of GDP growth in the European Union is impeded by its slow modernization, the dragging macroeconomic adjustment that has not been finished yet and the slow implementation of structural reforms. **Germany's** GDP growth rate amounting to 1.5 per cent is not expected to decelerate in 2015, in spite of this it will exceed the EU average. The rate of inflation in the EU will drop from 0.6 per cent in 2014 to about 0.2 per cent in 2015. Since the end of 2014 deflation has been prevailing. **The exchange rate of the euro to the US dollar** is likely to fall continuously in the course of 2015. The annual average exchange rate is predicted to drop to **USD1.1** in 2015 from USD1.33 in 2014. The annual average per barrel price of **Brent** will most probable decrease from USD100 in 2014 to USD60 in 2015.

Following substantial improvement in 2013, **economic expectations** in the EU were rather fluctuant. They were more favourable in the first half of the year than in the second one. In 2015 pronounced improvement will be only in consumer sentiment. In Hungary the value of the **GKI-Erste economic**

sentiment index (adjusted for seasonal factors) has been **deteriorating** for six consecutive months, although in small steps. Nevertheless, its level reflects relatively optimistic sentiment.

In 2015 wage increases indexed to the inflation rate were terminated, the growth rate of **real earnings** will fall from 3.2 per cent in 2014 to 2.3 per cent in 2015. As a result of the increase in real incomes that has been under way for three years and the fall of credit burdens due to the settlement of FX loans by banks and household, **consumption** is predicted to grow by 2.5 per cent in 2015.

Investments fell by more than 15 per cent between 2010 and 2012, they picked up modestly in 2013 and sharply in 2014, by 13 per cent. In 2015 **stagnation** is most probable. This can be explained by the high statistical base of last year, by the termination of the investment projects in the motor industry and by the fall of investments funded by EU financial sources. With the Credit for Growth Program of the National Bank of Hungary (NHB), the average cost of loans dropped somewhat, but it is still rather high, and the major part of businesses does not want to borrow from the banks. GKI assumes that EU funds valued at HUF200bn-HUF300bn will be "frozen", i.e. will not be used. The **investment rate** was 19.9 per cent in 2013 and 21.8 per cent in 2014; it is likely to total 21.4 per cent in 2015.

In 2014 gross production of **industry** went up by 7.6 per cent, an increase that has not been seen for three years. This was due to the fact that former investments in the motor industry were put in operation. Production in mining and particularly in the energy industry decreased by 0.7 per cent and 6.3 per cent, respectively. In 2015 capacities in the motor industry will not grow significantly, nevertheless, their utilization will increase. **In 2015 industrial production will mount by about 5 per cent. Construction** rallied in 2014, after a recession lasting for three years and a nearly 10 per cent expansion in 2013 its performance jumped by 14 per cent last year. This high growth rate was due to the absorption of EU funds and with the drop of EU transfers it will decelerate substantially in 2015. This year the rate of growth is anticipated to fall to 3 per cent. After 2013, **agriculture** closed an excellent year in 2014 as well. Under average whether conditions some decrease is expected in this performance. Environmental regulations, too, will have an adverse impact. GDP in **services** grew by 2 per cent in 2014, and it is likely to grow by 1.4 per cent in 2015, i.e. at a slower rate than the average. The value added of public services is essentially stagnating; some increase can be expected in business services. **The expansion of trade was most rapid**. The "whitening" of the turnover played a significant part in it. The modernization of public services is not on the agenda either.

After three years, the rate of growth of **imports** exceeded that of **exports** in 2014. Exports, too, picked up with the recovery in the EU in the first half of the year as well as the start of production of investment s in the motor industry, but imports mounted by about 1.3 percentage points more quickly as a result of the recovery in domestic demand and the rise of energy inventories. With stagnating economic sentiments in the EU and due to weak domestic investment demand, the rate of growth of both exports and imports is likely to decelerate to 5.5 per cent in 2015. Due to the fall of crude oil prices, the **terms of trade** are expected to **improve** by 1-1.5 per cent in 2015 following a 1 per cent increase in 2014.

The **number of employees** grew by 1.7 per cent in 2013 and 5.3 per cent in 2015. **The real improvement is less spectacular.** About half of the increment accounts for the extension of public workfare schemes. The increase of employment in the narrowly defined public sector and abroad, too, played a part in it. **In 2015 employment is expected to increase by maximum 1 per cent**, basically driven by public workfare schemes. The unemployment rate went back from 10.2 per cent in 2013 to 7.7 per cent in 2014. In 2015 further modest decrease (amounting to 0.3 per cent) is expected, also as a result of the expansion of public workfare schemes.

Following the fall by several thousand persons as a consequence of the global financial and economic crisis, between 2008 and 2014 the number of employees grew by 250 thousand, out or which some 150 thousand persons were involved in public workfare schemes and 100 thousand ones had jobs abroad.

In other words, according to the estimations of GKI, **genuine employment reached only the pre-crisis level** (such as GDP). Between 2008 and 2014 employment in the **public sector** (including that of public workfare schemes) grew by 18.3 per cent; at the same time that of **the competitive sphere contracted by 4.4 per cent. This is a very unfavourable structural change.** In the quarter ending at late January 2015 unemployment increased again in the winter season. **The decrease of the unemployment rate** (and the increase in employment) **adjusted for seasonal effects that lasted for two years came to a halt.**

In 2014 the contraction of GDP in the financial sector continued. No change can be expected in this segment in 2015 either. **The loan stock was down, but that of companies was slightly up** (at constant prices it stagnated). **No turn in lending** can be expected on the demand and supply side this year. The record loss the banking sector suffered in 2014 was the consequence of government measures (namely the settlement of FX loans provided to households). The profitability of the sector will deteriorate in 2015 as well. With the partial compromise with the banks, the government makes efforts to enlarge the sources of economic growth in 2016. Nevertheless, **in 2015 only stagnation is likely in borrowing, with a slight increase in the corporate segment**. From the point of view of households, the default of individual brokerage firms and small banks may lead to the upgrade of investment possibilities abroad and stable assets offered by banks, in addition to government securities. At present no sufficient resources are available for the compensation of those concerned by the defaults.

In 2014 the **general government deficit** relative to GDP was 2.2 per cent, less than planned (2.9 per cent) and less than that of the previous year (2.4 per cent). **The government debt ratio**, too, fell from 77.3 per cent in 2013 to 76.9 per cent in 2014, although the fine-tuning of the figures is expected. Nevertheless, the structural balance deteriorated. The budget law does not ensure the achievement of the 2.5 per cent deficit target in 2015. In addition, EU institutions will hardly accept increase in the deficit. According to GKI, **the 2.2 per cent deficit relative to GDP can be attained by measures to be taken in the course of 2015.** They will allow the slight reduction of the government debt ratio provided that the government will not spend much on the acquisition of private companies or compensations of different social groups and others. **In the majority of large redistribution systems unbearable tensions are at work even in the short-term.** The management of these tensions is missing particularly in the light of the planned tax reductions envisaged from 2016. Poverty and social income differences are on the rise.

In 2014 the **price level** decreased by 0.2 per cent in Hungary. This was attributed in part to the low rate of inflation all over the world and in part to the reduction of overheads by the government. **With the plummet of the world market price of energy, the major part of the overhead reduction was (temporarily?) sustainable.** The price level remains unchanged this year. In the course of 2015 the reference rate of the National Bank of Hungary is likely to decrease. **The annual average exchange rate of the forint to the euro** is assumed to total **HUF315.** The major reason for this is that the balance sheet surplus of the NBH can be achieved only this way.

Since 2009 the surplus in Hungary's **current and capital account** has been on the rise, and according to the estimation of GKI it reached EUR8 billion in 2014. In 2015 the surplus falls to EUR7.2 billion since the mounting surplus in the trade of goods and services cannot compensate for the decline in the inflow of net EU transfers for investment purposes by EUR1bn-EUR2bn. Because of the unpredictable economic policy of the government directed against foreign companies and maintaining legal uncertainty, **foreign capital is leaving** Hungary.

Credit rating agencies expect from the government sustainably decreasing government debt trajectory and economic policy that ensures improvement in the investment climate and stability in the banking system. If favourable external and internal equilibria will be accompanied by the enactment of the reduction of the special bank levy in the context of the budget to be approved by

Parliament in June 2015, an upgrade may take place in the second half of the year by referring to improving the perspectives or putting Hungary back to investment grade category. Various developments, such as further acquisitions of private companies by the government, the uncertain situation concerning the Paks2 project, the deteriorating evaluation of the Hungarian capital market as a result of the default of brokerage firms and their financial implications may have an adverse impact on the stance of international rating firms.

The forecast of GKI for 2015

	2012	2013	2014	2015 forecast		
	Fact			September	December	**March**
GDP	98.5	101.5	103.6	102	102	**102**
• Agriculture (1)	77.4	115.1	112.6	100	100	**95**
• Industry (2)	98.8	96.5	105.3	104	104	**104**
• Construction (3)	94.2	106.6	113.6	106	103	**103**
• Trade (4)	99.9	106	103.7	101	101	**104**
• Transport and storage (5)	98.4	102.5	103.7	102	102	**102**
• Information, communications (6)	103.9	101.0	102.9	102	102	**102**
• Financial services (7)	97.2	97.4	99.3	99	99	**99**
• Real estate services (8)	98.2	100.6	99.5	101	101	**101**
• Professional, scientific, technical and administrative activities (9)	100.7	104.3	105.4	102	102	**102**
• Public administration, education, healthcare (10)	101.8	105.3	99.9	100	100	**100**
• Arts, entertainment (11)	96.2	102.7	103.1	100	100	**100**
• Core growth (2)+(3)+(4)+(5)+(6)+(7)+(8)+(9)	99.1	100.6	104.2	102.5	102.5	**102.8**
GDP domestic demand	97.0	101.2	103.7	101.7	101.7	**101.7**
Private consumption	98.0	100.2	101.6	101.2	101.2	**102.5**
Gross fixed capital formation (investments)	95.8	105.2	111.7	100	100	**100**
Foreign trade in goods						
• Exports	100.9	104.8	108.7	105.5	105.5	**105.5**
• Imports	100.0	105.0	110	105.5	105.5	**105.5**
Consumer price index (preceding year = 100)	105.7	101.7	99.8	102.5	102.0	**100**
Balance of current and capital account						
• EUR billion	4.4	7.8	8*	6.5	5.5	**7.2**
• In per cent of GDP	4.5	7.8	7.7*	6.5	5.3	**6.8**
Unemployment rate (annual average)	11	10.2	7.7	8	7.4	**7.4**
General government balance in per cent of GDP (ESA)	-2.3	-2.4	-2.2	-2.5	-2.4	**-2.2**

* GKI forecast
Source: HCSO, GKI