Slowing economic growth, accelerating inflation, eastern closing

(Forecast of GKI Economic Research Co., March 29, 2022)

The **war launched by Russia against Ukraine** and the resulting widespread international economic sanctions are forcing the global economy, including the Hungarian economy, onto a new economic path, which **can only be forecast with great uncertainty in both the short and medium term**. **In the short term, the most striking are the sharp spike in inflation, the general stock market fall, the general depreciation of the dollar, and the instability of global supply chains (from energy to food, raw materials and components).** The latter confront governments with the need to rapidly develop **a new system of world economic relations, especially in the medium term**, while taking into account environmental considerations.

Moreover, these problems are not without precedent. After all, these problems were already present last year, partly as a result of the Covid crisis and the subsequent recovery, aided by loose and only slowly (sometimes too slowly) tightening fiscal and monetary policy. The anti-inflationary tightening of economic policy around the world, planned at the beginning of this year, has been called into question, at least in terms of scale, due to the war. In addition, the **relatively stable political environment to date has changed radically**, as a result of military and foreign policy as well as security of supply considerations. In recent years, the **EU** has ignored the fact that, in parallel with the inward turn of the **United States** and its loss of ground in world politics, **China** is growing economically and militarily, and **Russia** is gaining strength in the latter area in particular. While the **Euro-Atlantic alliance, and the EU within it, has become more united** since the Russian attack, short-term interests of individual EU member states (e.g., their different dependence on Russian energy supplies, fear of Russian expansion) **may continue to make it difficult to act in unison**.

For Hungary, this means that its policy, which can be characterised by opening up to the East and being anti-Brussels, has reached a dead end, and its room for manoeuvre and potential for blackmail have been greatly reduced. The one-sided Russian orientation of Hungarian energy policy has become untenable (the construction of Paks II has become virtually impossible, the operation of Paks I and the supply of natural gas have become more uncertain). Access to the resources of the EU's reconstruction fund was clearly linked to the **rule of law requirements** even before the outbreak of the war. This forces a review of Hungarian policy and, to some extent, of the model. Paradoxically, however, it is also possible that, **in order to demonstrate unified European action**, the EU will, in practice, at least for the time being, be **generous** in tackling the real problems of the rule of law in Hungary. However, the Hungarian Prime Minister's request for the European Commission to approve without delay the Restoration and Resilience Plans, Partnership Agreements and operational programmes of the member states protecting the eastern borders of the European Union, and for the Commission to allow the rapid, targeted and flexible use of EU budget resources by removing the pre-financing, co-financing and transferability barriers, **does not seem realistic**. This would be an **open violation of the recovery fund's objectives and instruments**.

It is also not impossible that a political compromise will be reached quickly with Poland, which is clearly anti-Russian and significantly larger, stronger and more influential than Hungary, and Hungary will be left completely on its own. If the proceedings were initiated only against Hungary, it would be—in addition to its real basis—a gesture made to the European Parliament, a response to Hungarian policy, which is still sympathetic to Russia in its rhetoric, especially domestically. While **Hungarian-Polish** relations deteriorate due to the different perceptions of the war, and Slovenia is now also oriented in a different direction, **Hungarian-German** relations receive a new element due to similar dependence on Russian gas. Based on leaks and expert advice in March, **it is most likely that the rule of law procedure will remain pending for both Hungary and Poland, and that plans for the use of the recovery fund will be approved if appropriate concessions are made.**

Hungary's exposure to EU transfers is very high due to the Hungarian economic policy. In the spring of 2022, the economic policy of **forced growth**—officially called demand stimulus, then crisis management and revival, but in reality client-builder and increasingly electoral—that has been in place since 2017 **is still in place**, although it is fading due to imbalances. **This policy is very ill-equipped to face this new crisis.** It is sufficient to think of the huge general government deficit or the overall failure of inflationary restraint attempts, which, despite government interventions, even cause supply disruptions. During the period of energy price explosion, the inherently erroneous method of reducing utility charges becomes **untenable**. In order to tackle all these problems, EU transfers are necessary, and for this, **reconciliation with the EU** is necessary. A **sharp tightening** of fiscal and monetary policy, to be implemented already in the course of the year, is inevitable. There is a need to enforce the **principles of the European market economy**, which is what the EU expects behind the need to combat corruption. **A change of strategy is therefore needed, which requires substantial concessions if the current government remains in power, and reforms in line with its values if the current opposition wins the elections.**

The current GKI forecast **does not foresee an escalation of the war**, although it cannot be ruled out. According to various authoritative analyses, severe disruptions to supply chains and a fall in demand due to the war and sanctions could **reduce EU growth by 1.5-2 percentage points compared to what was previously thought, which would mean a GDP growth of around 2-2.5 per cent**. Some think that a **recession this year cannot be ruled out**. GKI expected a 4.5-5 per cent **growth in Hungary** in December by 2022, which is now **significantly reduced to 2.5-3 per cent**, which still suggests faster growth than the EU average. The larger-than-average forecast deterioration is explained by the proximity to Ukraine, the uncertainty and likely delay in the arrival of EU transfers, the over-dependence on Russia and the struggling car industry, and the impact of very high inflation in holding back consumption growth.

The euro area **investor sentiment index** fell in March to its lowest level since November 2020. **GKI's economic sentiment index fell** in March to its late spring 2021 level, mainly as a result of a deterioration in the consumer confidence index. **Business expectations worsened only in industry and services**, but not in construction and trade. Across all sectors, the **perception of the Hungarian economy** became dramatically more pessimistic, as it was when the **Covid pandemic broke out**, but **companies barely perceive this in their own situation**. The propensity to hire has hardly fallen, but the **drive to raise prices** has continued to gather momentum, with the exception of services. Consumers' **inflationary expectations** have also risen significantly.

Last year, the Hungarian economy essentially **overcame the crisis caused by the pandemic** (although it may yet gain momentum), but the **consequences of the Russian-Ukrainian war** are still unclear. In its December forecast, GKI had already expected a slowdown in 2022 compared to the recovery-induced growth in 2021, but the war could lead to a much sharper slowdown, with **growth expected to be only around 2.5-3 per cent, with a high degree of uncertainty**.

Household income will rise very significantly in 2022 as a result of the government's electoral economic policies. And although this is partly eroded by the resulting surge in inflation, **real earnings could still rise by 4.5 per cent, real pensions by around 5 per cent and real incomes by around 5.5 per cent, even with inflation at around 9 per cent**. In the case of pensions, an extra three weeks of pension were paid compared to last year, but the slowdown in economic growth is unlikely to allow for the payment of a pension premium. A correction will be needed in the autumn due to much higher-than-planned inflation this year. In the case of real incomes, the effects of the one-off personal income tax refund and the tax exemption for those under 25 are partly offset by stagnant or minimal increases in social spending and entrepreneurial income. Consumption growth will be held back by the **tightening** of the **repayment moratorium** from October 2021 and its expected end from mid-2022 (although further limited assistance to borrowers is possible). Growth in household consumption will be rapid at around 4 per cent, but slightly lower than last year and previously thought. The **net financing capacity** of households continues to rise.

After a 6.9 per cent decline in 2020, **fixed capital formation** increased by 6 per cent in 2021, i.e., it has not yet reached its pre-crisis level. The Hungarian **investment rate** is still almost 27 per cent, the second highest in the EU. This year, the **investment level is expected to stagnate** due to the uncertain and late arrival of EU transfers, the reduced fiscal capacity, rising interest rates and, most recently, the uncertain investment environment resulting from the Russian-Ukrainian war and the failure of the opening-up to the East. For the time being, the **government seemingly remains firmly committed** to major **Russian and Chinese** investments, such as the Paks nuclear power plant, the V0 and the Budapest-Belgrade railway line. However, in the changed global political situation, it is **unlikely** that these investments will be realised as planned, **given the political, economic and financial constraints**.

The war plays an important, but not exclusive, role in the sharp slowdown in Hungarian economic growth in 2022. The fall in exports to Russia and Ukraine is **causing a loss of industrial production** not only directly, but also as a result of a worldwide fall in exports, for example in the automotive sector. Moreover, production is likely to be seriously affected by **disruptions in global supply chains**, partly due to the loss of supplies of raw materials and parts from Ukraine and Russia, partly due to disruptions in supply routes, and more recently due to the closures caused by the Covid pandemic in China. The slowdown in growth is also holding back demand for **transport**. After the previously expected increase, **only stagnation can be expected in investments and thus in construction** as well. This is due to the uncertain arrival of EU transfers, the reduced fiscal capacity, rising interest rates and, last but not least, the uncertain investment environment resulting from the Russian-Ukrainian war. The war inevitably brings a decline in international tourism. **The lower-than-expected growth rates of consumption and hence retail sales are being driven above all by the dramatic rise in inflation, which is expected to decline only very slowly.** This has implications for borrowing and the ability to repay loans, and thus for the GDP-producing capacity of the **financial sector**. However, in the context of war and the wave of refugees, **public consumption will rise**.

In terms of **unemployment**, Hungary, with its 3.8 per cent unemployment rate in January 2022, was apparently in 5th place among the 27 EU countries. However, if we take into account public employees, who are in the category of social employment in other member states, the unemployment rate would be 5.4 per cent, which would give us the 14th place, **in the middle rank**. **GKI forecasts employment to stagnate or increase by 0.5 per cent at most in 2022, while the unemployment rate is expected to fall minimally from 4.1 per cent to 4 per cent on average over the year.**

Both the **retail and corporate loan and deposit portfolios** of Hungarian banks grew at double-digit rates in 2021 compared to the previous year. The growth was driven by **housing loans**, which were almost one and a half times higher than in 2019. The constantly rising and accelerating interest rate environment, the end of government and central bank subsidies, and the uncertainty caused by the Russian-Ukrainian war may cause **at least a slowdown, but it may also cause a decline** in the credit market.

Despite the **election overspending**, the Finance Ministry's forecast at the end of last year did not even add HUF100bn to the HUF3,309bn cash-flow deficit in 2022. In addition, the government forecast **reduced** the EU methodology deficit from 5.9 per cent of GDP **to 4.9 per cent**. In the first two months of 2022, **around 40 per cent of the full-year deficit target** was already met. There is a serious chance that the deficit will be higher than planned, **close to the original deficit of around 6 per cent**. This represents a **cash deficit of around HUF4,000bn**, which in addition may be accompanied by **increasing tensions** on the expenditure side.

As a result of the loose monetary and fiscal policy, the Hungarian **inflation** was **one of the highest** in the region even before the Covid crisis, as was the almost continuous **weakening of the forint**. These developments have **accelerated** in recent months, while the key interest rate has also started to rise sharply. In February 2022, the price increase was 8.3 per cent compared to the previous year, the value of the euro in HUF reached 400 temporarily, and the key interest rate (announced in the one-week deposit tender) was 5.85 per cent from 17 March. A year earlier, in February 2021, inflation was only 3.1 per cent, the exchange rate of the euro was around HUF358, and the key interest rate was 1.85 per cent. Although global inflation has risen significantly and monetary policy has tightened since then, these figures indicate a dramatic change. **GKI** expects further deterioration in the coming months, followed by stabilisation by the end of the year. **Tightening monetary policy (with the key interest rate rising to around 8 per cent by the end of the year, equal to the base rate) could result in an annual average price increase of around 9 per cent and an euro exchange rate of HUF375, with a price index of around 10 per cent in some months, with a very high degree of uncertainty and fluctuations.**

In recent years, the Hungarian economy has seen a recurrence of **twin deficits**, i.e., a simultaneous and interrelated deterioration in the general government and current account deficits linked to demand stimulus policies. The **current account deficit** is expected to rise further to around **EUR7bn** (nearly 4.5 per cent of GDP) this year. Last year, the **external financing capacity** also turned negative due to a significant lack of EU transfers. In 2022, if an agreement is reached with the EU, transfers could increase dynamically from the third or the fourth quarter, with the amount received reaching EUR5bn. Even in this case, however, the external financing capacity would still be **negative**, at around -2 billion euros.

The forecast of GKI for 2022

	2018	2019	2020	2021	2022		
	(fact)				September	December	March
GDP	105.4	104.6	95.0	107.1	105	104.7	**102.7**
• Agriculture	105.2	98.0	91.3	97.8	100	100	**100**
• Industry	102.6	103.0	93.0	109.8	107	107	**102.5**
• Construction	115.2	113.1	89.1	115.8	106	104	**100**
• Trade	110.6	105.8	100.9	106.8	105	107	**105**
• Commercial lodgings and catering	107.5	104.8	57.5	114.1	115	115	**108**
• Transport and storage	107.0	105.2	89.5	109.5	104	104	**102**
• Information and communication	110.5	110.3	105.0	113.9	106	106	**106**
• Financial services	105.2	113.7	104.1	104.9	103	103	**101**
• Real estate activities	104.5	102.9	100.9	102.6	102	102	**102**
• Professional, scientific, technical activities	109.1	106.3	95.1	107.2	102	102	**102**
• Public administration, education, healthcare	100.9	100.6	96.7	103.9	103	103	**103**
• Arts, entertainment	107.3	108.8	86.0	106.3	105	105	**105**
• Core growth	107.1	106.8	97.3	108.6	105	104	**102.7**
GDP domestic demand	107.1	106.6	97.3	105.6	103.5	104	**102.2**
• Private consumption	104.2	104.5	98.0	104.3	104.5	104.5	**104**
• Gross fixed capital formation	116.3	112.8	93.1	106	105	104	**100**
Exports (goods and services)	105.0	105.4	94.1	110.1	110	110	**106**
Imports (goods and services)	107.0	108.2	96.5	108.2	109	109	**105.5**
Consumer price index (preceding year = 100)	102.8	103.4	103.3	105.1	104	105	**109**
Unemployment rate (annual average)	3.7	3.4	4.1	4.1	4	3.9	**4**
General government balance in per cent of GDP (ESA)	-2.1	-2.1	-8.0	-7.3	-6	-6	**-6**
Balance of the current and capital accounts							
• EUR billion	3.4	1.7	0.6	-0.9	3	0.5	**-2**
• In per cent of GDP	2.5	1.2	0.4	-0.6	1.8	0.3	**-1.3**

Source: HCSO, MNB, MoF, **GKI**

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