The forecast of GKI Economic Research Co. for 2023 (2/2023)

(An update of GKI's forecast published in March 2023. Summary. Closed: 23 June 2023)

GKI's latest detailed forecast, in March, differed from the majority view, **in particular in its assumption of a downturn this year and a slower decline in inflation, as well as in the extent of the likely delay in access to EU transfers.** GKI did not change the main findings of its economic forecast in June. It still expects **a decline in GDP of 0.5 per cent** this year, and the danger of an even greater decline can only be averted by a faster-than-foreseen expansion of agriculture. GKI continues to predict an increase in **inflation of around 19 per cent** this year, but it gives a significantly **greater chance** than previously thought **of a single-digit price increase at the end of the year**, and thus an average price increase of slightly below 19 per cent. On EU transfers, there is a growing consensus that this will be minimal at best this year, and that the Hungarian government's **real willingness to reach an agreement is in doubt**.

In Hungary, **the recession continued** in the first quarter of 2023, GDP declined in the third quarter in a row compared to the previous quarter (by 0.2 per cent), and even decreased compared to the same period of the previous year (by 0.9 per cent). In the first four months, industrial production was down by 3.2 per cent, construction by 7.7 per cent, and retail sales by 10.4 per cent compared to a year earlier. **Business expectations** do not point to a rapid recovery. In June, the services confidence index fell to a 5-month low, the industrial one to a 7-month low and the construction and trade ones to a 38-month low. However, after a sharp decline last year, **agricultural** GDP may grow even faster than projected. GKI no longer expects industrial growth this year (and even a slight decline is possible), and raised the expected decline in construction and retail trade to 10 per cent and 4 per cent, respectively. In 2023, 16-17 thousand homes are expected to be built, almost 20 per cent less than last year. However, in many **service** sectors, such as finance, transport, tourism and telecoms, modest growth is likely. Employment is expected to increase marginally this year, with the **unemployment rate** rising only slightly to 3.9 per cent from 3.6 per cent last year.

GKI lowered its forecast for this year's fall in **consumption** from 3 per cent to 2.5 per cent, as the volume of benefits in kind rose by a surprising 4.7 per cent in the first quarter. However, it expects a 3.5 per cent drop in final household consumption. In April, average gross earnings rose by 16.4 per cent in the business sector and by 13.4 per cent in the government sector, which (with a 24 per cent rise in prices) meant a **fall in real earnings** of 6.2 per cent and 8.5 per cent, respectively, averaging **almost 7 per cent in April**. GKI expects an increase in earnings of around 16 per cent throughout the year, but even higher than that is possible if the public sector maintains a minimum level of functionality and the promised wage increases are met, and if workers' demands are met in the prosperous part of the business sector. A 16 per cent increase in earnings would imply (in the case of 19 per cent inflation) an **annual average loss of 2.5 per cent in real earnings** (stagnation in the business sector, but a loss of around 6 per cent in the public sector). However, by the end of 2023, real earnings could already be rising. The real value of **pensions** is guaranteed by law, but in practice there will be some reduction because there is no chance of a pension premium this year. **Real incomes** fall by 3-3.5 per cent, more than real earnings, due to a high base, resulting from, for example, last year's personal income tax refunds.

The freezing and rescheduling of **public investments** started already in the summer of 2022, with a list of hundreds of suspended developments, many of them infrastructure-related, published last autumn. In May this year, the government terminated the contracts for most of these. The obvious explanation is **the lack of**

budgetary resources, including EU funds. The government hopes that the boom in **entrepreneurial investments** will at least partially offset this. However, the proximity of war, the unpredictability of Hungarian economic policy, the reduction of corporate funds available for development, the high cost of borrowing, the limited fiscal capacity and the uncertain domestic and foreign demand make this unlikely. The announcement of the establishment of several new battery factories is insufficient for this. GKI continues to expect **fixed capital formation to fall by around 4 per cent this year**.

The amended 2023 budget was already **out of step with reality** when it was adopted. The general government deficit in cash flow terms was already close to **80 per cent of the annual target** in the first four months of 2023, and **by the end of May it had exceeded it** (81.3 per cent). This can be explained by over-optimistic growth forecasts, such as consumption growth, and by the absence of the envisaged EU transfers. While under-planned inflation is beneficial for budgetary revenues (at least in the short term), it is a source of additional tensions and risks on the expenditure side. The rise in debt servicing is particularly worrying. According to GKI, in the presence of great uncertainty, depending above all on the receipt of EU transfers and the expenditure advanced against them, a deficit excess of up to 1.5 per cent of GDP could also occur without measures to improve the balance. GKI assumes that about **half of this surplus deficit will be treated by the government as an adjustment and the other half as a waiver of the deficit**. This means that it expects a **deficit of around 4.7 per cent of GDP**, compared to the 3.9 per cent deficit target. **Inflation will continue to help to reduce the debt-to-GDP ratio in 2023**, and it is possible to reduce the debt ratio to around 69 per cent.

The rate of inflation is expected to be around 19 per cent in 2023. The high rate is partly the result of pass-through effects, with energy prices pushing up this year's price level until September and fuel prices until December. At the same time, the fading of this base effect implies a **rapid fall in prices** compared to the same period last year. The toughest obstacle to further monthly price increases is the **decrease in purchasing power**. A **single-digit price increase could be achieved** by the end of the year. However, higher core inflation than consumer price increases, the expected rise in energy prices, the difficult fiscal situation, the removal of price caps, the possible acceleration in earnings growth and, last but not least, the possibility of a significant weakening of the forint **could slow down or even prevent** this from being achieved.

GKI expects the **euro to weaken significantly in the second half of the year**, with an annual average **euro exchange rate of around HUF390**, similar to last year's level, compared to HUF383 in the first five months and HUF370 in the penultimate week of June. The exceptionally **high Hungarian policy interest rate** played a decisive role in the strengthening of the forint so far this year, which also attracted speculative money to the country. Although the forint held up well since the start of the rate-cutting period, the ongoing Hungarian rate-cutting cycle could gradually reverse this flow. In addition, the major central banks are considering raising interest rates, which will further reduce the Hungarian interest rate advantage. In addition, the **hope**, which has been a major factor **behind the strengthening of the forint**, that a quick agreement can be reached with the EU on substantial transfers that can be used relatively quickly and effectively, **is also fading**. The high financing needs of the general government have a negative impact, and investor confidence is also dampened by the government's continued anti-market interventions and the Hungarian foreign and economic policy, confrontational with the EU and the US and understanding Russia. All this may weaken the forint even if the credit rating agencies are still waiting. For example, Fitch did not change its rating on Hungary in June, including a negative outlook on a possible downgrade.

GKI expects that if the monthly interest rate cut of 100 points, combined with other forint-weakening effects, would **weaken the exchange rate above HUF400, it will not be sustainable**. It is possible that the current widespread view that the policy rate could fall to 13 per cent as early as September, bringing it back in line with the base rate, is **too optimistic**. However, during autumn or early winter, this **convergence** may indeed occur. In a favourable case, if inflation, and especially the exchange rate, makes this possible, the lowering of the base rate may begin even this year (to about 12 per cent). At the same time, a sharp weakening of the forint, for example, in the event of an excessive pace of interest rate cuts or a breakdown in EU negotiations, could lead to a halt in the rate-cutting process or, in extreme cases, to further tightening.

After a **current account deficit** of EUR13.6bn in 2022, the first four-month deficit this year was only EUR0.5bn. True, the profit repatriation that is common in May, the payment of significant debt service burdens still remains to be made, and the recovery of the economy will also worsen the balance. A deficit of **around EUR6bn, or 3 per cent of GDP**, is expected for 2023. However, it is worrying that the inflow of EU transfers is still minimal (EUR0.5bn in the first four months) and no turnaround can be expected this year. For the year as a whole, the **current and capital account deficit could be around EUR4bn, or 2 per cent of GDP**. At the end of April 2023, the international **reserves** of MNB stood at EUR39.9bn, which is adequate for the time being.

In **economic policy**, despite the crisis that started last year, a **new strategy has not yet been developed**, instead, **the struggle for a balance-improving and an economy-stimulating direction is underway**. This is well illustrated by the 2023 budget, whose amendment, which was adopted this spring, also needs to be substantially revised. Unavoidable crisis management is manifested in **austerity without reforms**: in tax increases and subsidy reductions, in the unpredictable degradation of public services, and in more extensive state interventions in market processes than ever before. In the past two months, the investor climate worsened by the retention of special taxes next year (and in the case of trade, a further increase from the second half of this year), the tax burden on some savings, or the overhaul of the regulation of investment funds, and the continued violent takeovers by close-to-government investors. This lack of strategic thinking is reflected in the continuous **eating up the future** (in the neglect of health care, education, innovation), and it is feared that **inflation**, which largely relieves the tensions of the economic balance, **is stuck relatively high following this year's decline**. The latter is likely because the possibility of raising the central bank's inflation target has already been raised by the government.

By making institutional changes in line with the rule of law requirements, the Hungarian government is trying to **meet EU expectations** not in terms of content, but rather **in terms of form**. Thus, through a system of personal dependencies, it continues to try to ensure the "proper" functioning of supposedly independent organisations. Reluctantly and in a contradictory manner, stalling for time, the government gives in to the economic and political pressures only on the level of appearances, while with its continuous obstruction, veto threats and vetoes it appears as a simple **"troublemaker"** before the EU decision-makers and public opinion. The government is presumably hoping that this **"tedious method"** will allow it to retain the essence of the Hungarian model and gain access to a significant part of EU transfers. So far, this has not been successful, as the government's manifestos now also speak of the dispensability of EU transfers. GKI **does not expect any significant EU transfers this year**. However, it expects that sooner or later some kind of agreement will be reached with the EU, the implementation of which will be the subject of constant debate, but part of the transfers will be paid, even if with suspensions. For Hungary, the interruption of negotiations **would not only result in losses, but also in a serious loss of confidence and thus in financing problems**.