GKI Economic Research Co.
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The forecast of GKI Economic Research Co. for 2012-2013

In 2012 the Hungarian economy is on a recessionary trajectory. In 2013 Hungary will follow a hardly more than stagnant path. In September 2011 GKI, as the first institution among those involved in forecasting, projected a recession in 2012. It also stressed that a new agreement with the EU and the IMF could be necessary as well. From December 2011 GKI has projected a 1.5 per cent recession in 2012, and it indicated already in March 2012 that the government did not want an agreement with the IMF and the EU. In 2012 economic trends have essentially been in line with those anticipated by GKI. GKI now expects stagnation in 2013 (in September it projected a 0.8 per cent growth) due to the government's anti-growth economic policy further eroding investor confidence.

Hungary's GDP drops by 1.5 per cent in 2012, at a significantly larger rate than the EU average of 0.3 per cent. Although 0.7 per cent of this downturn can be attributed to agriculture, Hungary's recession is much higher than the EU average even without this. Investments and consumption will decrease by 4 and 2 per cent, respectively. During one year prior to September 2012 foreign funds worth of HUF2300bn disappeared from the Hungarian banking system, amounting to a 28 per cent loss. Banks compensated this mainly by cutting back lending and partly by deposit collection. Although parent banks are **increasing the capital of their Hungarian subsidiary banks more than it is required by law**, they are **withdrawing their sources** from the Hungarian market where they do not see perspectives. The relatively favourable domestic financial developments in autumn 2012 can be attributed largely to ample international liquidity and the high level of interest rates in the Hungarian market. Therefore, considering the criticism of international institutions and the downgrading of Hungary, the **persistence** of the relatively strong forint and further interest rate cuts is **doubtful**.

There are no signs indicating that the **government would like to introduce changes in its failed economic policy** that hampers economic growth due to legal uncertainty, unpredictability and bad tax policy, and the expected general government deficit can only be achieved by more and more restrictions. Since the spring of 2012 the **single real purpose of the government's economic policy has been to avoid the excessive deficit procedure**, and thus ensuring access to the cohesion funds by keeping the general government deficit below 3 per cent. In addition, the government wishes to achieve this goal without giving up the flat tax system. Unfortunately, the government's economic policy is characterised by its **subordination to power-political goals**, the **expansion of the state** and **improvisation**. (They include, for example, the 10 per cent reduction in energy prices or the unexpected abolishment of quotas set by the government on the number of students admitted in higher education.) Meanwhile, the erosion of the large social systems, such as health and education, is accelerating. In addition to being a major source of **social tension**, this leads to a decline in real incomes and an increase of differentiation. **As a consequence, capital and labour are leaving Hungary.** The government apparently does not want the agreement with the IMF and the European Commission. Although the general government deficit is expected to remain below 3 per cent of GDP in 2012 and 2013, **it is not certain that Hungary can avoid the excessive deficit procedure in 2014** due to the unsustainability of the process. Further uncertainties arise if in the second half of 2013 economic policy is influenced by the forthcoming elections.

Although almost all key figures of the 2013 budget have been changed since its adoption in summer, the measures announced by the government and especially their budgetary implications are still very uncertain. These measures amounted to a total of HUF824bn (only a quarter of them affected expenses, all the other taxes). In reality, the total effect would be around only HUF500bn. In addition, a number of serious adverse differences can be expected compared with the appropriations (in particular, in the fields of financing public education and the introduction of e-tolling. In addition, ECJ judgments may cause a deterioration of the balance by HUF200bn). Therefore, the budget law accepted in December 2012 **will inevitably be modified (several times) in 2013 as well**.

The selective reduction of employer's contributions (social tax) **leaves more money to be available** for smaller businesses; however, it will not substantially affect employment. Its "price", however, will be a **further increase of special taxes**, leading to a reduced activity of banks and the stagnation of the economy.

GKI predicts that in 2013 the general government deficit according to the EU methodology will be slightly below 3 per cent of GDP, or slightly above it in case of increased spending due to the forthcoming elections or any adverse judgments of the EU Court. **The external balance will be positive in 2013 as well; however, the trend is slightly worsening.** The rate of increase in exports will slightly exceed that of imports (5 and 4.5 per cent, respectively), and the **foreign trade surplus will grow to EUR8bn**, from 7 per cent of GDP to 7.6 per cent of GDP. Due to increasing revenue outflow, the **current account surplus** will switch to **EUR0.5bn deficit**, and the **external financing capacity**, in spite of the slightly increasing EU transfers, will **decrease** from EUR3bn to **EUR2.5bn**, to **2.4 per cent of GDP**. The inflow of FDI to Hungary, reflecting the deceleration of investments in the automotive industry, will not exceed the outflow of FDI due to the **poor domestic investment climate**. Hungary's total **net foreign debt** (without other capital recorded within direct investments) is expected to be **EUR44bn** at the end of 2012 and 2013 compared with EUR44.6bn at the end of 2011. Only one third of the net external debt can be attributed to public finances and the National Bank of Hungary.

As planned, super grossing-up will be completely eliminated **from 2013 onwards**, that is, the effective tax rate for all income categories will be uniformly 16 per cent. The cap on social security contribution for those whose gross earnings per month exceed HUF660 thousand will be abolished. Of the two effects the former is somewhat larger. The **minimum wage** will increase by 5.4 per cent, from HUF93 thousand to HUF98 thousand, that is, real wages remain essentially unchanged (assuming 5 per cent inflation). However, wages in general cannot increase by this rate as the general government and companies cannot afford it due to the recession and stagnation. **GKI forecasts gross and net salary increases of about 4.5 per cent.** As a consequence of the expansion of workfare programs **the real value of wages will decrease by 1 per cent if those participating in such schemes are included, or by 0.5 per cent without them**. The **real value of pensions** will remain unchanged. **Real incomes** will decrease by about 1 per cent due to the decline in the real value of earnings (which are responsible for almost half of incomes), the unchanged real value of pensions, the raising of the burdens on cafeteria, the slight increase of corporate incomes, the real-term loss in social spending and a slight deterioration of actual employment. As a result, **consumption is likely to drop by 1 per cent**. The amortisation of households' debts continues to exceed their borrowings, too.

In 2013 **investments** will contract further by 2 per cent, in construction by 3 per cent and in machinery by 1 per cent. In the first decade of the new millennium the **investment rate** was around 20-25 per cent. The present 17 per cent rate is extremely low. **Business investments are expected to decrease**, except for some automotive "islands" due to the lack of investor confidence. Today, Hungary is outside the sphere of interest of large investors, and domestic companies are also waiting on the sidelines. It is more and more unlikely that Hungary will be able to absorb the available EU funds completely (though all funds will be assigned on paper by the end of 2013). Another problem is that an increasing number of applications "require" the use of services that the applicants do not need. The information on accelerated payments of EU funds is true only to the extent that HUF25bn–HUF30bn is paid weekly; however, this is due to down payments, thus in the next period the volume of weekly payments will decrease again. HUF3212bn has been paid until now, and HUF5000bn–HUF5200bn remains to be paid by 2015. In order to absorb all sources HUF34-35bn should be paid weekly; however, in many cases even the calls for tender have not been published yet (for example, large health projects).

In **industry**, only a minimal increase in production (around 1 per cent) can be expected. The utilization of the increased capacity in the motor industry is difficult due to the unfavourable trends in European car demand, the electronics industry is ailing, and domestic sales continue to fall. **Projects financed by EU funds**, in particular road and rail constructions may increase demand for the **construction industry**. In the **corporate sector** substantial changes in construction are unlikely. The **number of homes completed** plummets from 10 thousand expected in 2012 to 6-8 thousand in 2013. 2013 will be the **eighth successive year** in which the output of **construction** has been declining (this time by around 2 per cent). **2013 will be "only" the seventh year when services have been dropping.** In addition to the information and communication sector, a modest growth can be expected in transport as well (primarily in rail and international transport). Retail trade turnover will decrease by around 1 per cent. **The financial sector (considered as a "scapegoat" and deprived of its profits by extra taxes) frozen by the government's economic policy holds back the development of the whole economy.** The performance of public services is also expected to decline, in spite of further expanding workfare programs. Agricultural production in 2013 will be probably less than in 2011. The sowing area of wheat will be 10 per cent less than in 2012; however, in case of average weather conditions higher yields may compensate for the resulting loss. However, a further decline is expected in livestock farming. **GDP will stagnate** in 2013 and this will be almost exclusively due to agriculture (low basis in 2012). **The core growth rate will be –0.3 per cent, that is, the economy will continue to decline in 2013, though at a somewhat slower rate.** (Between 2011 and 2013 GDP will not grow at all, and in 2013 it will be at its 2010 level.)

Employment in 2013 may slightly expand statistically, similarly to the previous year, due to those involved in workfare programs and those working abroad. The annual average unemployment rate remains at around 11 per cent. The government expected that making the employment of some categories of workers cheaper would boost labour demand; however, this will probably remain an illusion due to shrinking markets.

The rate of inflation in 2013 is mainly influenced by government decisions. It is difficult to estimate the extent companies are passing on special taxes to their customers. The telephone tax will definitely be incorporated in consumer prices. Passing on utility taxes is questionable, as they affect market services and municipal and public sector entities as well. The latter may choose loss-making, expecting government bailout in case of bankruptcy. They think that in the pre-election year the government would not tolerate inoperative public services. As a result, price changes of utility companies are totally unpredictable. In fact, "frozen" overhead charges increased by 4-5 per cent in 2012. The announcement that the **retail prices of gas and electricity will be lowered by 10 per cent from January 2013** entailed huge uncertainties. The unpreparedness of the decision is well demonstrated by the fact that only 13 working days are available for elaborating the exact details, with Christmas in between. Technically, the government may reduce these prices, since these prices are regulated; however, the coverage of such a reduction is unknown. The reduction of energy prices is difficult to implement for two reasons. On the one hand, free-market energy prices are rising by more than 10 per cent, thus keeping the prices unchanged causes losses in itself. On the other hand, electricity and gas suppliers are also charged by the new utility taxes, which would require some coverage as well. **It is likely that the reduction of retail prices will be financed by the companies and their loss-making operation will result in a deterioration of the infrastructure.** The most damaging effect of these serious market interventions will be that **inflation expectations and firms' price decisions will be muddled**. There is no predictable operating environment facilitating sound business and consumer decisions. As a result, everyone is more cautious expecting higher inflation in the long term, which becomes a self-fulfilling prophecy. In 2013, the cost of services will increase dramatically. In 2013 a **5 per cent inflation rate** can be expected. However, policy makers can always override it. If the government actually reduces the price of energy and limits the ability of service companies to raise their prices, it is possible to tame inflation.

At the beginning of 2013 the base rate of the National Bank of Hungary may be lowered to **5.5 per cent**. After this the Monetary Council consisting of only members appointed by the current government and the central bank's new management will be likely to continue the reduction of interest rates; however, **there will be not much room for it without risking the exchange rate**. Supposing calm international financial markets and strict fiscal policy ready to adjustments, the annual average **exchange rate of the euro may strengthen to**

HUF285 (with significant fluctuations). In the absence of an IMF-EU agreement, the deterioration of external conditions or the significant increase of distrust towards Hungarian economic policy may lead to the substantial weakening of the forint and then a major increase of the base rate in order to prevent further escalation.

GKI forecast for 2012-2013

	2008	2009	2010	2011	2012	Forecast for 2013	
	(fact)				(est.)	**September**	**December**
Gross Domestic Product	100.9	93.2	101.3	101.6	98.5	**100.8**	**100**
• Agriculture (1)	151.6	85.1	83.7	127.2	82	**110**	**110**
• Industry (2)	96.3	85.1	113.4	105.7	99.5	**101**	**101**
• Construction (3)	91.2	96.3	91.1	92.2	95	**98**	**98**
• Retail and wholesale trade (4)	100.2	83.2	98.4	99.6	98.5	**100.5**	**99**
• Transport and storage (5)	93.7	90.3	100.5	100.7	98.5	**101**	**101**
• Information and communication (6)	103.0	113.1	104.8	102.2	104	**102**	**101**
• Financial services (7)	97.7	100.5	95.7	93.3	97	**99**	**97**
• Real estate activities (8)	99.9	102.5	100.2	98.4	98.5	**98**	**98**
• Professional, scientific, technical and administrative activities (9)	102.4	96.1	96.9	98.1	100	**99**	**99**
• Public administration, education, healthcare (10)	100.3	100.2	97.2	99.9	100	**99**	**99**
• Arts, entertainment (11)	100.6	93.4	103.4	103.0	99	**99**	**99**
Core growth (2)+(3)+(4)+(5)+(6)+(7)+(8)+(9)	98.0	91.8	103.4	100.9	99	**100**	**100**
GDP domestic demand	100.7	89.5	99.5	99.4	96	**100**	**99**
• Private consumption	99.8	94.3	97.3	100.2	98	**100**	**99**
• Gross fixed capital formation (investments)	102.9	89.0	90.3	94.5	96	**100**	**98**
Foreign trade in goods							
• Exports	104.2	87.3	116.8	110.2	102.5	**105**	**105**
• Imports	104.3	82.9	115.0	106.9	100	**104.5**	**104.5**
Consumer price index (preceding year = 100)	106.1	104.2	104.9	103.9	105.7	**104.7**	**105**
Current and capital account balance							
• EUR billion	-6.8	1.0	2.9	3.6	3.0	**2.5**	**2.5**
• In per cent of GDP	-6.4	1.1	3.0	3.7	3.0	**2.4**	**2.4**
Unemployment rate (annual average)	7.8	10	11.2	11	11	**11.2**	**11**
General government balance in per cent of GDP (ESA)	-3.8	-4.4	-4.2	+4.2	-2.7	**-3**	**-3**

Source: CSO, GKI

Three-year average changes in economic indicators, 2009-2014
(per cent)

Year	GDP	Industrial GDP	Investments	Consumption	Inflation
2009-2011	-1.4	-0.6	-8.1	-2.9	4.3
2012-2014	-0.1	1.2	-1.4	-0.7	4.9

Source: HCSO, GKI

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