

# The forecast of GKI Economic Research Co. for 2011

(As of 30 March 2011)

The history of the new government's first year is mainly that of fighting for a larger room of manoeuvring for economic policy, mostly in vain, rather than initiating real changes. The confidence of international and domestic investors has been eroded by the government's attempts to eliminate the separation of powers of the constitutional state, the attacks on independent institutions, and the confrontation with international organizations in general, and with the EU in particular, as well as with foreign companies investing in Hungary. The economic policy decisions of the new government affected financial conditions more than real economic trends in 2010. Typically, last year the forint weakened, the risk premium and the interest rate increased, and credit rating agencies downgraded Hungary's government debt to the bottom of the investment grade. Therefore, the country's ability to attract capital and to generate economic growth weakened. Those fields were hit (SMEs, employment, protection of debtors in foreign exchange) that had been considered very important by the government. **The government was finally forced to do what it wanted to avoid, and in early March it presented Szell Kalman Plan, a promising program envisaging some structural changes as well. It took 10 months for the Hungarian economic policy to formulate those questions for which the answers should have been given in summer of 2010.**

**Hungary's GDP grew by 1.2 per cent in 2010, slower than the EU average (1.8%),** and particularly slower than that of Germany (3.5 per cent), Poland and Slovakia (3.8-4 per cent, respectively). (If agricultural production had not fallen due to the disastrous weather, Hungary's GDP would have increased by about 1.8 per cent.) Growth of the Hungarian economy in 2010 was attributed solely to net exports. Nevertheless, in the second half of the year Hungary's GDP growth rate already reached the EU average (2.2 per cent). In fact, services also set to grow slowly as domestic demand started to rise slightly following a decline in the first half of 2010. Due to the increases in public employment, in 2010 both the number of employees and the employment rate were stabilized at levels of 2009. In spite of this, the annual average rate of unemployment rose to 11.2 per cent in 2010 from 10.1 per cent in 2009. The real value of wages grew by 1.9 per cent over the previous year, whereas total real income probably stagnated. In 2010 consumer prices increased by 4.9 per cent. Prices of household energy, consumer goods and fuels went up more than the average.

Propensity (or compulsion) to save by households increased significantly in 2010. The stock of borrowings in foreign currency mounted in spite of the fact that the value of new loans fell far short of those repaid. This is a consequence of the revaluation of the forint. At the end of 2010 the forint was 22 per cent weaker against the Swiss franc and 3 per cent weaker against the euro compared with the previous year. The net financial savings of households amounted to 4.5 per cent of GDP (against 3.5 per cent in 2009). **Final household consumption expenditure fell by 2.1 per cent** as a result of the combined effects of the stagnation of real incomes, the increasing burden of borrowings and the uncertainties of the future. Reviewing and suspending some EU subsidies, partly in connection with the change of the government, and the drop in housing construction played a major role in the **5.6 per cent fall of investments**.

The foreign trade balance was in surplus in two consecutive years; in 2010 its surplus totalled EUR5.5bn. GKI estimates show that, as a result of this, the current account surplus was around EUR2bn. The external financing capacity, including the current account plus net EU transfers valued at about EUR1.7bn, amounted to EUR3.7bn, corresponding to 3.8% of GDP. After not finding the envisaged skeletons in the budget of the previous government and taking measures during the year, the **general government deficit in cash flow basis (excluding local governments) was in line with planned figures**. However, the **government deficit relative to GDP (ESA deficit) was around 4.2 per cent**, due to mainly the high deficit in the **municipal sphere**. By the end of 2010 the government debt relative to GDP increased to approximately 80 per cent of GDP from 78.3 per cent at the end of 2009, mainly due to the weakening of the forint.

**In the EU a deep transformation process is taking place with increasing political integration and more effective economic governance.** Governance aims at the genuine harmonization of the economic and fiscal policies of EU member states, the adoption of more prudence in the Stability and Growth Pact, and the more efficient use of international instruments for financial stability and competitiveness. The EU is likely to be **divided into a eurozone interested in the deepening of integration and the rest. If Hungary is not going to belong to the first group (Eurogroup), it will be excluded from the club where important decisions are taken.** This is why Hungary should negotiate about joining the Competitiveness Pact.

Similarly to the previous year, in 2011 the combined GDP of the EU and the EMU is expected to grow by 1.8 and 1.6 per cent, respectively, whereas in Germany it is likely to slow somewhat (2.4 per cent). The consolidated general government deficit relative to GDP of the EU member states is expected to decrease to 5.1 per cent in 2011 from 6.8 per cent in 2010. Though inflation in the developed countries is low, it is accelerating. The market expects the **ECB to raise its reference rate** from mid-2011 at the earliest; however, recent statements suggest that the lifting of the rate may already start in April. In 2011 the price of crude oil (Brent) per barrel is projected to be around USD110; higher price levels would have negative effects on the global economy.

The **GKI-Erste confidence index** reached its local peak in February; business expectations, especially in view of the Hungarian economy's prospects, **fell sharply in March, whereas the consumer confidence index declined.**

**At the beginning of 2011 the government faced three major economic problems.** First, it became clear that the steps taken in 2010 were **not going to yield a spectacular acceleration of economic development.** The slight increase in domestic consumption and investment demand, which is quite natural in a recovery period after a crisis, is a positive development; however, **the economy is picking up only very modestly. The burden on businesses has increased** as the lowering corporate tax rates affected only a small number of companies, and the flat personal income tax made some wage increases necessary to keep the level of net earnings unchanged for more than half of the employees. The credit supply has tightened (due to the special levy imposed on banks, nonperforming mortgage loans, and the increase in forint interest rates). The **main beneficiaries** of tax changes, in most part **those with higher incomes**, would rather opt for raising their savings. The **crisis levies restrict** the activity of the firms concerned. The slow start of the new Széchenyi Plan, as well as the decision to freeze the payment and the distribution of EU funds, which limits the investment demand, have also adverse effects on the economy. The **lack of predictability**, the further **deterioration of transparency**, and **anti-foreign bias** inhibit new foreign capital investments.

The **second** problem is that the **structural deficit of the general government will increase** in 2011 (instead of its assumed reduction), **threatening by the suspension of EU funds aiming at investments.** Although the government originally hoped that the EU accepts the deterioration of the structural deficit this year, it is highly doubtful. This is the **reason behind the HUF250bn freezing** in the budget. However, it might become necessary to spend HUF50bn to cover the extra expenditures of local governments and HUF100bn to offset the lost budget revenues, thus only HUF100bn would remain for meaningful improvement in the balance. It is questionable whether the EU would be satisfied with the structural deficit that can be achieved this way (essentially of the same magnitude as last year). If not, **further corrective actions** may also be considered in **this year's budget.**

The **third** problem is the **most serious one:** the dominance of the transitional arrangements will cause **huge holes in the budget already in 2012, but especially in 2013** (HUF450bn and HUF700bn, respectively). Since the **EU directs its attention on sustainability** in the framework of the European Economic Semester introduced this year, this problem will come into focus in spring 2011. Additional **risks** are posed by the Constitutional Court proceedings on the nationalization of the private pension fund assets and the EU infringement proceedings because of the extra tax levied on the telecommunications sector. Aimed at creating a sustainable balance, the **Szell Kalman Plan seeks solutions to these three problems. The English**

**version of its text contains important steps into the right direction; however, its implementation is uncertain owing to the lack of detailed programs, its dubious social acceptance, and the continued double talk.**

The deficit calculated by the ESA methodology will differ from the 2.94 per cent deficit target included in the **budget act**, because the assets of the private pension funds should be entirely recorded as capital income in 2011. However, the planned HUF400bn debt consolidation of the state railway company (MÁV) and the Budapest Transport Company (BKV) will worsen the balance. Taking into account additional one-off expenditures (for example, local governments) as well, GKI forecasts a general government **surplus of 2-3 per cent** of GDP for 2011. The effects of one-off spending at the expense of private pension fund assets are well demonstrated by the fact that the general government **deficit would be 6.5 per cent** of GDP without it. During the excessive deficit procedure and the European Economic Semester in spring mainly the structural deficit will be assessed excluding one-off revenues.

The **government debt** may decrease **below 75 per cent of the GDP** in 2011, due to the nationalization of the crucial part of the private pension fund assets. There are signs that the government will only be able to present detailed adjustment measures that may induce a positive change in investor sentiment only in mid-summer or early autumn. Thus, the Hungarian economy remains highly exposed to changes in the international atmosphere. No big changes can be expected in monetary policy after the replacement of the **Monetary Council's** four members whose terms expired, as the **room of manoeuvring is relatively narrow, irrespective of the Council's composition**. In the context of rising international interest rates, increased central bank credibility is required even to maintain constant central bank reference rates (and credibility depends mainly on the government). Similarly to last year, significant exchange rate and yield fluctuations are possible in 2011. The **exchange rate of the forint to the euro** will be similar to last year's average, slightly weaker than at the beginning of March, **around HUF275, while the central bank rate is expected to stagnate at 6 per cent**.

**Inflation** can only be expected to decline slightly by the end of the year. **In 2011 the annual average rate of inflation is expected to total 4.2 per cent** (energy, fuel and food price indexes will go up by 6-7 per cent); 4 per cent MoM at the end of the year. Gross earnings will increase by 3.5 per cent. Unit labour costs continue to decline. **Real wages will increase by around 2 per cent** (by 2.5 per cent in the private sector and about 1 per cent in the public sphere). The expansion of the grey economy is bolstered by the elimination of the so called expected wage category, the increase in the costs of low wage employees and the nationalization of assets of private pension funds. As the combined consequence of these factors, the **real income of households** (after the disbursement of the real yields of private pension funds to their members) **will increase by about 2 per cent. Income differentiation will be more intense. The increase in final household consumption** will be lower, representing some **1.5 per cent**. This is because burdens associated with the amortization of bank loans are very high and the uncertain future encourages the formation of reserves, too. **Borrowing intentions and options are also limited**. The net savings rate (4.5 per cent), with a slow start in the recovery of borrowings, may reach last year's level – mainly because of the continuous repayments of existing loans.

Although the number of **employees** will increase by 0.5 per cent in 2011, **the unemployment rate will remain at last year's level of 11.2 per cent at best**. Despite the reduction of working hours to 4, the significant cuts in the money earmarked for public work, the average number of participants will inevitably drop (from 60 thousand to about 45 thousand people per month), and this would lift unemployment. The growth promoting impact of EU funds will also be weak this year, thus, **investments will increase only slightly** (by about 1 per cent). Apart from some big ongoing automotive manufacturing projects, a downturn will be typical.

**Although the base of economic growth will be somewhat broader, its driving force remains industrial exports. Recession in domestic demand will come to an end; however, no substantial recovery can be expected in 2011.** Reaching the sixth consecutive years of decline, construction may slightly recover in the

second half of 2011. Services are developing only very modestly. Low deposit interest rates indicate that there is no need for new resources (and in a way they compensate for the effects of crisis levies). The number of homes built will decline further to 16-18 thousand units from 20.8 thousand ones in 2010. A slight expansion of retail trade is likely, mainly in the fields of sale of vehicles and consumer durables.

The **foreign trade balance** surplus is likely to increase to EUR6bn in 2011 from EUR5.5bn in 2010. The **current and capital account** will show a considerable **surplus** in 2011 reaching EUR4.5bn (4.3 per cent of GDP) compared with EUR3.7bn in 2010. **In a regional comparison only Hungary will not need net external financing. This fact contributed significantly to the success of the recent bond issuance denominated in US dollars.**

**GDP will grow at a rate of about 2.5 per cent in 2011. The acceleration over the last year, however, will be almost entirely generated by agriculture (weather factors), and the 2.9 per cent core growth rate is almost the same as it was in 2010.** The main problem is that there are no signs of the mobilization of factors necessary for a more dynamic development of the economy. Moreover, there are signs that economic disequilibria improved in part as a result of restrictions rather than reforms, whereas confidence necessary for the improvement of Hungary's competitiveness and attractiveness for foreign capital will not be strengthened properly. A **lack of perspective** can be derived from the fact that true intention of joining the eurozone is missing. Although **Hungary may be forced to meet the Maastricht criteria for equilibrium from 2013 on** and the government debt may drop below the magic 60 per cent figure of GDP by 2016, **Hungary remains outside the eurozone, without enjoying the confidence as well as the financial and decision-making benefits associated with membership.**

### The forecast of GKI for 2011

	2007	2008	2009	2010	Forecast for 2011		
	(fact)				September	December	March
Gross Domestic Product	100.8	100.8	93.3	101.2	102.5	102.7	<b>102.5</b>
– Agriculture (1)	78.3	154.5	84.8	84.6	110	115	<b>115</b>
– Industry (2)	106.0	99.9	86.9	108.9	105.5	107	<b>107</b>
– Construction (3)	93.4	89.8	93.7	91.7	104	104	<b>97</b>
– Retail and wholesale trade (4)	104.6	97.8	89.2	99.0	101	101.5	<b>101.5</b>
– Transport and telecommunications (5)	105.5	96.3	94.6	102.7	102.5	103	<b>102.5</b>
– Financial services (6)	99.1	101.8	97.9	100.1	99.5	99	<b>99</b>
– Public administration, education, health care (7)	96.1	99.7	97.7	99.0	100.5	100	<b>100</b>
– Other services (8)	103.3	94.7	98.5	102.5	101	101	<b>101</b>
Core growth (2)+ (3)+ (4)+ (5)+ (6)	102.8	99.1	92.0	102.7	102.5	103	<b>102.9</b>
GDP domestic demand	98.3	100.6	93.2	98.9	101.8	103	<b>102</b>
– Private consumption	98.4	99.4	93.3	97.8	100.5	101.5	<b>101.2</b>
– Gross fixed capital formation (investment)	101.7	102.9	92.0	94.4	104	104	<b>101</b>
Foreign trade in goods							
– Export	116.2	105.7	90.4	114.1	110	112	<b>111</b>
– Import	113.3	105.8	85.4	112.0	111	113	<b>111</b>
Consumer price index (preceding year = 100)	108.0	106.1	104.2	104.9	103.5	103.8	<b>104.2</b>
Current and capital account balance							
– EUR billion	-6.3	-6.8	0.8	3.7*	2.6	3.0	<b>4.5</b>
– in per cent of GDP	-6.3	-6.4	0.9	3.8 *	2.4	2.9	<b>4.3</b>
Unemployment rate (annual average)	7.4	7.8	10	11.2	11	11	<b>11.2</b>
General government balance in per cent of GDP (ESA)	-5.0	-3.8	-4.4	-4.2*	-3.0	-2.9	<b>+2.5</b>

\* GKI estimate

Source: HCSO, GKI

**General government balances in 2011**  
(%-points of the GDP)

<b>Budget law balance</b>	<b>-2.9</b>
Pension funds capital transfer incorporated into the budget law	-1.9
<b>Core balance int he budget law (without pension funds capital transfer)</b>	<b>-4.8</b>
Consolidation expenditures on transport companies	-1.4
Other consolidation expenditures	-0.3
<b>Balance without pension funds capital transfer</b>	<b>-6.5</b>
Pension funds capital transfer	9
<b>ESA balance</b>	<b>2.5</b>

Source: **GKI calculations based on the budget law and GKI forecasts**