GKI Economic Research Co.
We analyse and you take the decision.

The forecast of GKI Economic Research Co. for 2011

Some key indicators of the Hungarian economy are improving simultaneously with the easing of the global economic crisis; however, the real situation is not better than it was at the time of the change of government. In 2011 external demand has been somewhat better than expected. The decline in domestic demand has been over. The government was forced to announce restrictions it wanted to avoid during the past year and before, when the parties supporting it were in opposition. These announcements have inspired cautious confidence among foreign investors and high anxiety among those concerned. External disequilibria continue to improve. The general government deficit (excluding the nationalized pension fund assets) has changed as envisaged. The exchange rate and debt risk premiums are again at levels they were before the change of government. As a result of last year's unconventional economic policy Hungary's ability to attract capital and to generate economic growth weakened. The question of how to restore it is still waiting for an answer. The general government structural deficit is significantly increasing. The financial reserves of small businesses and the middle classes are increasingly exhausted. Social tensions are intensifying.

The **world**'s aggregate GDP growth rate slows down from 4.9 per cent in 2010 to 4 per cent in 2011, owing to decelerating growth rates especially in Asian and Latin American emerging countries. The engines of growth are still the emerging Asian economies. The **EU** continues to experience a modest recovery: GDP will increase by 1.8 per cent in 2011, which was the same in 2010; however, in Germany its rate of growth will decrease from 3.7 per cent in 2010 to 2.6 per cent in 2011. Employment in the EU will rise slowly, the growth rate of wages will be low, and inflation will increase faster (to 3 per cent) due to global energy and food price increases. In the last period the EU has considerably enhanced **common economic governance**. At the same time, in the wake of the crisis, political, economic and social tensions within the EU are intensifying. The new, **real decision-making centre** will be the Eurogroup and the acceding countries. **Hungary, due to its short-sighted decision, has stayed away from it**. General government deficits, which increased due to the economic crisis, have started to decrease. The EU's consolidated general government deficit relative to GDP will drop from 6.5 per cent in 2010 to 4.7 per cent in 2011. The federal funds **rate** is between 0 and 0.25 per cent; the reference rate of the European Central Bank is 1 per cent, while long-term bond yields are much higher than these levels. The difference between the short term interest rates of EMU and the USA increased in the first quarter of 2011, and this trend will continue. The **euro is strong**; the average exchange rate of the US dollar to the euro is expected to be around USD1.4 with significant fluctuations. In 2011 the average price of **crude oil** (Brent) is projected to be USD110 per barrel. Higher oil price levels would have negative effects on the global economy. The world market price of **commodities** will increase by 25 per cent in 2011 (similarly to last year).

In 2011 GKI-Erste confidence index reached its lowest point in May. Following a continuous improvement of nearly two years, **industrial expectations** deteriorated to a surprising extent. **Construction** is still the **most pessimistic industry**. The deterioration of expectations continued in May. **Expectations** of **commercial** and **service companies** have been fluctuating. They worsened in the last months (albeit minimally improved in May). Since the announcement of the Szell Kalman Plan, the assessment of the Hungarian economy's prospects slumped spectacularly. The intentions of employment and raising prices are subdued. Following its peak in October 2010, **GKI's consumer confidence index** had slowly but steadily declined; it plummeted in March, and the downturn continued in May. People consider their own and the country's financial and general economic situations to be much worse than previously. Experiencing financial troubles and deteriorating prospects, they feel the real effects of a policy of double talk more and more.

Last year's economic measures taken by the government, which have their effects in 2011, do not help economic growth, while they threaten serious imbalances in the medium term. By announcing the

Szell Kalman Plan and later the convergence programme in the spring of 2011, the government changed from a so-called growth-oriented policy threatening by default to a policy focusing on debt reduction, which sounded more acceptable to financial markets and investors. Though these changes contain important steps into the right direction, there has been no declaration of an economic policy change. The ideas that have become known excessively focus on curbing social transfers and on traditional budgetary restrictions instead of institutional and operational reforms. Some of the restrictions are unreasonable; impact studies and the conciliation of interests have been ignored.

Therefore, the implementation risk is high. When the **incentives to work** are discussed, only the reduction of social transfers is stressed, without mentioning the development of a comprehensive employment, education and social policy program. Paradoxically, with reducing the resources devoted to public employment, the number of people in need is increasing. The government seems to be satisfied if the purpose of job creation is achieved only statistically – for example, by obliging the recipients of aids to accept formal public work. Forcing hundreds of thousands of mostly low-skilled and inactive people to the labour market characterized by oversupply **threatens by imminent failure**. However, the extent of the improvement of disequilibria the government envisaged by its various programs (a combined effect of the real **structural changes** and classical **austerity measures**) will be probably higher than required. Therefore, the government deficit target for 2012 will likely be met, though mainly not as a result of reforms making the functioning of the state more effective and development projects supporting growth, but as a result of **unilaterally compelling** hard state measures – even at the cost of general degradation. In addition, an **inward-looking** national economic policy prevails. **Taking into account the circumstances of a legal security losing important guarantees since last year, a struggling economic policy avoiding the financial crisis but incapable of boosting economic growth can be anticipated with rising social tensions. The burden on small businesses increases, credit supply is tightening, and the crisis levies restrict the activity of large firms.**

The general government deficit reltive to GDP calculated by the ESA methodology will **differ** from the 2.94 per cent deficit target included in the 2011 budget act, because the assets of private pension funds should be entirely recorded as a one-off capital income in 2011. Missing tax incomes (mainly corporate income and value added taxes) are expected to be about HUF150bn. Freezing in general government expenditures is planned to balance this deficit. The HUF528bn transferred from the private pension funds and the HUF350bn EU funding increment will allow that, in spite of the tax cuts, **expenditures rise much more than tax incomes**. Such expenditures include the planned HUF400bn debt consolidation of Hungarian State Railway Company (MÁV) and Budapest Transport Company (BKV), as well as the buyout of PPP facilities. As a result, GKI predicts a general government **surplus of around 2 per cent of GDP in 2011**. **This means that without the nationalization of the private pension fund assets the general government deficit would be approximately 7 per cent.** During the European Economic Semester mainly the structural deficit will be assessed excluding one-off revenues and expenditures. (The European Commission estimates that this will increase to 5.2 per cent in 2011, while it was 3.1 per cent in 2010 and 2 per cent in 2009.) The forecast of the European Commission in spring 2011 expects a 3.3 per cent ESA deficit in 2012 in Hungary, due to the **implementation risks** of the convergence programme and the additional expenditures. As a result, **the excessive deficit procedure will continue against Hungary**.

The **government debt** may decrease **below 75 per cent of GDP** in 2011, due to the nationalization of the private pension fund assets. Without this, it would rise a little further. The nationalization of companies and the assumptions of corporate debts will **lift the government debt** in the long term, contrary to the stated main objective. The government debt has been financed from money and capital markets since the summer of 2009. (However, the purchase of MOL shares will consume more than half of the fiscal reserves allocated from IMF and EU loans. This will raise the borrowing needs for the next years, while the nationalization of private pension funds has reduced it.)

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); 4-4.5 per cent MoM at the end of the year, lower than the 4.7 peak in April. There are **no signs of any changes** in the Monetary Council's policy. In the first months of 2011 the interest rate spread decreased, due to the favourable investment climate and the positive expectations concerning Hungarian equilibria; however, it is still the highest in our region. Following the downgradings in the second half of 2010, an upgrading can be expected in 2011 (from negative to stable outlook). The exchange rate and yield fluctuations in 2011 will probably be milder than last year. The **exchange rate of the forint to the euro** will be stronger than last year's average, slightly weaker than at the end of May, **around HUF272** (between HUF260 and HUF280), while the **central bank rate is expected to stagnate at 6 per cent**.

Gross earnings will increase by 4 per cent (by 4.5 per cent in the competitive sector, which is somewhat higher than expected before, and by 2.5 per cent in the public sphere), resulting in an average **increase of 2.5 per cent in real earnings**. The competitive sector is expected to grow by 3.5 per cent, while the public sphere will probably stagnate. Real wages are likely to drop by some 3 per cent for people receiving the minimum wage. **Income differences will increase.** Following the rise in inflation, pensions will increase, while family allowances will not grow even in nominal terms, the support of unemployed will shrink, and entrepreneurial incomes will probably mount by 1-2 per cent. Therefore, real income will go up by 1 per cent, which will be raised by an additional 1 percentage point by the disbursement of the real yields of private pension funds. The elimination of the so called expected wage category, the increase in the costs of low wage employees and the nationalization of the assets of private pension funds bolster the **expansion of the grey economy**. As the combined consequence of these factors, the **real income of households will increase by about 2 per cent**. Final household consumption will grow only by 1.5 per cent. This is because burdens associated with the amortization of bank loans are very high and the uncertain future encourages self-sufficiency and the formation of reserves, too. On the other hand, surplus income will mostly be generated at people with higher incomes, who prefer to save rather than lift their consumption. Borrowing intentions and options are also limited. The number of credit cards and mobile subscriptions will fall. The net savings rate may reach last year's level (4.6 per cent).

Although the number of **employees** will **increase by 0.5-1 per cent** in 2011, the **unemployment rate** will **remain at last year's level of 11.2 per cent** at best. Labour demand will rise only modestly. A marked expansion can be expected only in a few manufacturing branches. **Investments**, after a decline lasting for two years, will **grow by** a mere **1 per cent**. The single dynamic sector will be manufacturing, especially the automotive industry relying on foreign capital. Lending rates are high in the business sector, due to the strict risk limits, and it is very difficult to gain access to any, even expensive, loans for firms producing only for the domestic market. Central and local government investments rely almost exclusively on EU transfers. The utilization of these funds is not a smooth process, thus a decline can be expected in this sphere. The modest increase in **domestic demand** will only be **due to EU funds** as well. Sluggish domestic demand will cause **selling and financing repercussions** in the Hungarian economy, especially in the **SME sector** and among companies having survived the crisis until now.

Agricultural production is **growing**, as following last year's 15 per cent decline an increase can be expected, despite the drought. The global recovery period after the crisis in industry comes to an end slowly, the stocks are replenished, in many sectors and regions capacity utilization is close to or even in excess to the 80 per cent threshold value. In Hungary production has not yet reached pre-crisis levels, since domestic sales are still declining. The main engine of growth remains **industrial exports** (despite their slowdown), and production will increase by 9 per cent. **Construction** has declined for six years and this will continue in 2011 as well (by about 5 per cent). **Services** are developing only very modestly. The fastest growth can be expected in partly export-oriented transport and tourism sectors. The revenue of the telecommunications sector will decrease by 4 per cent. Following four years' decline, with the increase of purchasing power **retail trade** turnover will be up by about 1.3 per cent, while car sales will increase by more than that. As a result of previous investment decisions, new business premises will also be completed this year. However, in the market of offices and warehouses investment projects have almost completely stopped. The market of used **homes** is stagnating,

and the number of homes built will decline to 16 thousand units from 20 thousand ones in 2010. Details of the system for helping **those having taken mortgage loans** are not yet known. Although it will not burden the budget, it will provide relief for only a few debtors. It is likely that the real target is not much more than just make it easier to **terminate the much debated eviction moratorium** and cover up the fact that waiting for a miracle in the past year has been in vain and **no substantive changes** have been achieved in solving this problem.

The **current and capital account surplus** will also be high in 2011, around **3.5 per cent of GDP**. The foreign trade surplus is likely to increase to EUR5.7bn in 2011 from EUR5.5bn in 2010, while the terms of trade will deteriorate by 1 per cent. **Since the summer of 2009 Hungary has not required new external financing**, only the renewal of a large part of its maturing loans. **Net external debt has been decreasing.** The debt can be financed from the money and capital markets, but at higher interest rates than the IMF credits. The purchase of the Russian-owned part of MOL will reduce Hungary's foreign exchange reserves (EUR33bn) by 5-6 per cent.

In 2011 **GDP will grow at a rate of around 2.5 per cent**, but in recent months **downside risks have intensified**. The source of acceleration is in part agriculture (weather was not so terrible as last year). The core growth rate of GDP calculated without agriculture and public services will be roughly the same as last year. **The main problem is that although the government will produce the 7 per cent general government deficit coveted last year (masked by the assets of private pension funds), in spite of this extraordinary deficit economic growth will not substantially accelerate, investments will not increase, and structural and institutional reforms will hardly start. The public debt will decrease due to one-off reasons, and no long-term improvement in disequilibria can be expected.** A **lack of perspective** can be derived from the fact that although Hungary may be forced to meet the Maastricht criteria from 2013 on, it **remains permanently outside the eurozone**. As a result, Hungary excludes itself from the EU's most important decision-making mechanism.

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	2007	2008	2009	2010	Outlook for 2011			
	(fact)				September	December	March	**June**
Gross Domestic Product	100.8	100.8	93.3	101.2	102.5	102.7	102.5	**102.5**
– Agriculture (1)	78.3	154.5	84.8	84.6	110	115	115	**107**
– Industry (2)	106.0	99.9	86.9	108.9	105.5	107	107	**107**
– Construction (3)	93.4	89.8	93.7	91.7	104	104	97	**95**
– Retail and wholesale trade (4)	104.6	97.8	89.2	99.0	101	101.5	101.5	**101.5**
– Transport and telecommunications (5)	105.5	96.3	94.6	102.7	102.5	103	102.5	**102.5**
– Financial services (6)	99.1	101.8	97.9	100.1	99.5	99	99	**99**
– Public administration, education, healthcare (7)	96.1	99.7	97.7	99.0	100.5	100	100	**100**
– Other services (8)	103.3	94.7	98.5	102.5	101	101	101	**101**
Core growth (2)+ (3)+ (4)+ (5)+ (6)	102.8	99.1	92.0	102.7	102.5	103	102.9	**102.7**
GDP domestic demand	98.3	100.6	93.2	98.9	101.8	103	102	**101.8**
– Private consumption	98.4	99.4	93.3	97.8	100.5	101.5	101.2	**101.2**
– Gross fixed capital formation (investments)	101.7	102.9	92.0	94.4	104	104	101	**101**
Foreign trade in goods								
– Exports	115.8	104.2	87.3	116.8	110	112	111	**113**
– Imports	112.0	104.3	82.9	115.0	111	113	111	**113**
Consumer price index (Preceding year = 100)	108.0	106.1	104.2	104.9	103.5	103.8	104.2	**104.2**
Current and capital account balance								
– EUR billion	-6.3	-6.8	1.4	3.8	2.6	3.0	4.5	**3.7**
– In per cent of GDP	-6.3	-6.4	1.5	3.9	2.4	2.9	4.3	**3.5**
Unemployment rate (Annual average)	7.4	7.8	10	11.2	11	11	11.2	**11.2**
General government balance in per cent of GDP (ESA)	-5.0	-3.8	-4.4	-4.2	-3.0	-2.9	+2.5	**+2.0**

Source: CSO, GKI