The forecast of GKI Economic Research Co. for 2013

The Hungarian economy essentially follows trends predicted by GKI. Although Hungary has been let out of the excessive deficit procedure, election-related spending would require further austerity measures. The latest Varga package mainly makes more room for manoeuvring by using old tools. The recession is over; however, only "positive" stagnation can be expected for 2013. Investments continue to decline and consumption remains practically unchanged in spite of increasing real incomes. The further temporary suppression of already declining inflation by market distorting measures has been more radical than previously thought. Taking advantage of this and the favourable international atmosphere in money markets until May, the reduction of the base rate is also faster than expected. Looking ahead, risks are accumulating in Hungarian financial markets. The growth-hindering aspects of the government are becoming stronger and the Hungarian economy lacks perspectives.

In Hungary **recession has come to an end** in statistical terms. However, there are **no genuine changes**, as investments and consumption continued to decline compared with the previous quarter, and only exports (and, to a larger extent, imports) increased. Data showing unfavourable performance of industry, foreign trade and retail trade in the first quarter of 2013 improved slightly in April. The banking system is in **survival** mode. In the first four months **employment** at companies employing more than five persons and in the public sector **declined by 0.7 per cent**. However, CSO surveys show that the proportion of those doing some kind of work **increased by 1 per cent**. The **difference** might be explained by the expansion of **foreign and grey employment**. The rate of unemployment was 11 per cent in February-April 2013, 0.5 percentage points lower than a year ago. The number of those working abroad in a year most probably increased more than this. Although in the first four months of 2013 **real earnings rose by 2 per cent**, it was **not enough for recovery in consumption**. The **government debt** jumped to 82.2 per cent of GDP at the end of the first quarter of 2013 after having reached 79.2 per cent at the end of 2012. This was caused by the especially weak forint at the end of March (the exchange rate of the euro was HUF304.30). After taking into account the depletion of the assets of private pension funds, **the government debt actually increased by about 6 percentage points**. **Inflation fell to 1.8 per cent** in May 2013 from 5 per cent in December 2012. It would have dropped significantly for statistical and market reasons as well (phasing out the effects of the VAT increase, fall in oil prices and the still modest increase of purchasing power), reaching about 3 per cent. Enforced overhead reductions made this drop more marked. The Monetary Council continued its **interest rate reduction** policy, decreasing the base rate to 4.5 per cent in May from 7 per cent in the end of summer 2012. International financial glut was favourable for the Hungarian monetary policy. However, the weakening of the forint at the beginning of June, despite the termination of the excessive deficit procedure, is indicative of the **vulnerability** of financial processes in Hungary.

The importance of **lifting the excessive deficit procedure** is somewhat **obscured** by the fact that the EU **severely criticized** virtually every essential elements of Hungarian economic policy. The philosophy of the recently announced **Varga package** is essentially the same as that of the previous Matolcsy packages. **New taxes introduced by surprise** will further deter investors, and making banking more expensive will enhance the use of cash and the grey economy. Almost **none of the main objectives of the government is fully met**; and the unilateral subordination of the economic policy to power-political aims is being more and more widespread. This process is only curbed by the risk of the quick restart of the excessive deficit procedure and the reaction of money markets.

Financial markets in Europe have stabilized since the summer of 2012, the risk of the break-up of the Economic and Monetary Union (EMU) has decreased, and European crisis management institutions have gained in strength. However, these changes have not yet had an impact on the real economy. The number of question marks is increasing in the USA and China. The **Fed will start scaling down monetary easing stimulus measures (date still unknown)**, leading to an increase in long-term yields, and thereby to the increasing unwillingness of investors to take risks. **Financial markets are becoming volatile.**

The **new central bank leadership** from March 2013 is obviously loyal to the government. The reduction of the base rate has continued and **the wider use of unconventional measures has started**. One of the aims of integrating the National Bank of Hungary (NBH) and the Hungarian Financial Supervisory Authority (PSZÁF) is to **increase the pressure on the banking system**. Increasing the magnitude of zero-interest loans to commercial banks will not threaten financial equlibrium. However, **it will hardly be able to stimulate growth**, as the unpredictable business environment remains unchanged. These cheap sources will probably be used mainly to replace more expensive loans and to support the financial investments of the best companies. It is possible that the unconventional methods of the NBH (for example, buying HDB bonds) will get a further boost as they would allow to bolster demand through selected companies in the short run without jeopardizing the balance of the budget.

The government apparently intends to continue its **plundering (nationalizing and market-redistributing) economic policy, further increasing the influence of the state**. The new stages of overhead reductions may serve not only as giveaways before the elections, but they may facilitate the purchase of some **energy service companies in a difficult position** by public companies or firms close to the government. The programme of creating a banking system half of which is owned by Hungarians also points in this direction; however, at present its conditions are missing. The reorganization of the **tobacco trade** and the ever-changing **agricultural policy** restructure the market for the benefit of the clientele of the government, partly at the expense of domestic small businesses, by raising costs and degrading services. However, **credit rating agencies and the markets** will **assess the suspicious fees associated with debts of local governments** and the further increase of sectoral taxes **negatively**. These criticisms and assessments do not seem to affect the government. Now the government is only paying attention to the **forthcoming elections**. On the one hand, **popular** measures are taken, whose burdens can mostly be passed on to the business sector, similarly to the overhead reduction schemes. On the other hand, **income generating** measures can also be expected to employees in **healthcare** and **teachers**, perhaps to **those ready to bear children**, and to **pensioners** as a one-off payment. Although this may keep the deficit in 2013 and 2014 at a level that can still be tolerated by the EU, it would further deteriorate the possibility of an even modest economic growth.

Despite earlier promises, **sectoral levies** have not been eliminated; their share in the budget revenues is extremely high by international standards, 2-2.5 per cent of GDP in 2013, and their trend is growing. Following its increase in 2012, the **tax centralisation rate** relative to GDP remains unchanged, around 39 per cent. Although current spending stagnates in real terms, in some areas (for example, in higher education) cuts are becoming unrealistic. Investment spending increased considerably as a result of EU programmes. **Financing the government debt** is cheaper than before due to the global financial glut; however, it **continues to be expensive** compared to other countries in the region. Taking into account the traditional redistribution of incomes before the forthcoming elections, the **general government deficit** is expected to be **around 3 per cent of GDP** (somewhere between 2.7 and 3.4 per cent), that is, slightly above the official deficit target of 2.7 per cent. The **government debt** to GDP ratio will be around 79-80 per cent at the end of 2013. The **nature of its annual change** will depend on the year-end exchange rate of the forint and the size of fiscal reserves. **The economic preconditions of a sustainable reduction of government debt have not been created yet.**

The **external balance** will be positive in 2013 as well. The foreign trade surplus continues to rise (to EUR7.5bn from EUR6.8bn in 2012). However, due to increasing revenue outflow, the current account surplus will grow only by EUR0.4bn, from EUR1.6bn to EUR2bn. Owing to this and the increasing EU transfers (from EUR2.6bn to EUR3bn), the external financing capacity will increase from EUR4.2bn to EUR5bn, corresponding to 4.3 per cent and 5.1 per cent of GDP, respectively. The **net inflow of FDI to Hungary**, which was very modest last year, **will cease** in 2013, reflecting the deceleration of investments in the automotive industry, the lack of interest of investors due to the constantly deteriorating domestic investment climate and, last but not least, capital flight. **Foreign exchange reserves** of the central bank are expected to fall slightly. However, if they would decrease to less than EUR31bn or EUR32bn, Hungary's financial reputation could be **highly endangered**.

Super grossing-up and the cap on social security contribution for those whose gross earnings per month exceed HUF660 thousand were completely eliminated in 2013. As a result of these two effects the average annual net earnings will grow by nearly 0.5 percentage points faster than gross wages. The changes do not affect those earning less than gross HUF200 thousand per month. They are favourable for those earning between gross HUF200 and HUF1 million, and those earning above this level (main winners of the flat income tax to date) will be worse off than before. GKI forecasts about **3 per cent gross** and slightly higher than 3 per cent net **salary increases** for 2013. **The real value of wages will grow by 1.3 per cent (assuming 2.2 per cent inflation).** The real value of **pensions will go up by almost 3 per cent** as pensions were nominally raised by 5.2 per cent in accordance with the government's original forecast of inflation. The **real income of households** can be expected to **increase by around 1.5 per cent**. Households indebted for various reasons, typically wary of loans, feeling uncertain about their work, the future value of their pensions, or the future in general, **would hardly lift their consumption**. In 2012 consumption decreased less than real income; however, in 2013 the slight increase in real income will likely be accompanied by the stagnation of consumption. **In 2013 investments will contract further by 2 per cent.** The investment rate will drop below 17 per cent in 2013 (the EU average was 19.6 per cent in 2012). **It is more and more unlikely that Hungary will be able to absorb the available EU funds completely and rationally.**

In **industry**, exports can be expected to grow due to partly a modest expansion of demand in Europe, and partly the expanding production of new car factories starting their operation last year. The production of electronic goods will decrease less than in 2012. Domestic sales continue to decline this year, and the gross output grows **by 1 per cent** in 2013. Crop prospects are very favourable in **agriculture**, and **approximately 20 per cent GDP growth is expected** in this sector (compensating the drop in 2012). The uncertainties around the land law, however, hinder investments and long-term lending seriously. After seven years of fall, the **construction industry** started to recover, and it is expected to increase by 2 per cent in 2013. The GDP and employment generation capacity of **business services** will decrease as well. Self-sufficiency and the grey economy are gaining in importance at the expense of purchased goods and services. The sources of **collective services** are reduced, and the quality and availability of public services continue to deteriorate. In **healthcare** the role of the private sector is increasing, whereas in **higher education** learning abroad is becoming more widespread, further increasing **social differentiation** and freezing mobility.

Domestic economic expectations are at their two-year peak, marking the end of a recession and making a modest growth in the second half of the year probable. After a 1.7 per cent decline in 2012, Hungary will follow a **hardly more than stagnant path in 2013**. **However, GKI has raised its growth forecast slightly, to 0.3 per cent from 0 per cent, mainly due to the fact that expected agricultural output is likely to be more promising than previously thought.** In addition, a **modest growth** can be expected in the **construction industry** as well. This small correction, however, **does not change the bottom line**: **between 2011 and 2013 GDP will basically not grow at all.** Investments are 10 per cent lower, and the consumption of households is 1.5 per cent less than in 2010. **Even to achieve this, the economy depletes its reserves: people's private pension assets are lost, foreign exchange reserves are decreasing, and companies are depleting their reserves (due to, for example, overhead reductions) and using up their retained profits. Capital and skilled labour are leaving Hungary.**

The **rate of unemployment** will be around **11 per cent** corresponding to the average recorded in 2012. Employment will rise only as a result of the significant increase in the number of part-time fostered workers. The number of "real" jobs in Hungary in the business and public sectors is more likely to decline. **Inflation** in the rest of 2013 will fluctuate around at 2 per cent, its **annual average will be 2.2 per cent**. Price reductions financed by cutting budgetary expenditures and exhausting the capital of service companies may generate temporary real income growth; however, they will induce a **new wave of inflation** within one and a half year. **Inflation**, if it is **too low**, will hinder recovery of the economy by **slowing down growth and increasing unemployment**.

Possible **interest rate changes** are mainly **determined by external factors**. Risk appetite caused by ample liquidity seems to be running out by the middle of 2013. The Fed has announced the reduction of the rate of expansion of liquidity. Investors are beginning to reassess the risks. This can be seen from the fact that the previously declining long-term **government bond yields began to rise** again, especially in countries designated as risky (e.g., Hungary). In such an environment **monetary policy can find itself in a difficult situation**. Neither inflation projected for the next 12-18 months, nor the deteriorating risk appetite would justify further interest rate cuts. Low interest rates beyond a certain point will no longer be enough to attract the strongest foreign and domestic government bond buying groups of the past period. If they change their investment decisions nearly concurrently, the costs of financing the government may rise. However, the Monetary Council is expected to **continue the rate cuts**. If the external environment will deteriorate only slowly, it will entail an euro exchange rate of between HUF295 and HUF300, that is, a slightly lower rate than in the first half of the year. However, a number of political and economic events may cause sudden exchange rate depreciation. If the forint weakens and the euro exchange rate reaches HUF310-HUF320, the interest rate cutting cycle will stop, and the central bank will do everything to strengthen the forint before the elections. **As a result, it cannot be ruled out that the official rate may even rise.**

The forecast of GKI for 2013

	2010	2011	2012	Forecast for 2013			
	fact			September	December	March	**June**
Gross Domestic Product	101.3	101.6	98.3	100.8	100	100	**100.3**
• Agriculture (1)	83.7	127.2	78.8	110	110	115	**120**
• Industry (2)	113.4	105.7	98.9	101	101	100.5	**100.5**
• Construction (3)	91.1	92.2	93.6	98	98	100	**102**
• Retail and wholesale trade (4)	98.4	99.6	98.8	100.5	99	100	**100**
• Transport and storage (5)	100.5	100.7	97.5	101	101	100	**100**
• Information and communication (6)	104.8	102.2	103.4	102	101	101	**101**
• Financial services (7)	95.7	93.3	97.0	99	97	97	**97**
• Real estate activities (8)	100.2	98.4	98.8	98	98	98	**98**
• Professional, scientific, technical and administrative services (9)	96.9	98.1	99.9	99	99	99	**99**
• Public administration, education, healthcare (10)	97.2	99.9	100.0	99	99	99	**99**
• Arts, entertainment (11)	103.4	103.0	99.3	99	99	99	**99**
Core growth (2)+(3)+(4)+(5)+(6)+(7)+(8)+(9)	103.4	100.9	98.8	100	100	100	**100**
GDP domestic demand	99.5	99.4	96.3	100	99	99	**99.5**
• Private consumption	97.3	100.2	98.1	100	99	100	**100**
• Gross fixed capital formation (investments)	90.3	94.5	96.2	100	98	98	**98**
Foreign trade in goods							
• Exports	116.8	110.2	100.9	105	105	105	**103**
• Imports	115.0	106.9	100.0	104.5	104.5	104.5	**102.5**
Consumer price index (preceding year = 100)	104.9	103.9	105.7	104.7	105	103	**102.2**
Current and capital account balance							
• EUR billion	2.9	3.6	4.2	2.5	2.5	4.2	**5.0**
• In per cent of GDP	3.0	3.7	4.3	2.4	2.4	4.3	**5.1**
Unemployment rate (annual average)	11.2	10.9	10.9	11.2	11	10.9	**10.9**
General government balance in per cent of GDP (ESA)	-4.2	+4.2	-1.9	-3	-3	-3.5	**-3**

Source: CSO, GKI

GKI ECONOMIC RESEARCH CO.

1092 Budapest, Ráday u. 42-44.
Phone: +36 1 318 1284
E-mail: gki@gki.hu
For more information: Andras Vertes, Laszlo Akar, Laszlo Molnar, Gabor Karsai