



The forecast of GKI Economic Research Co. for 2014

In 2013 the improvement in the economy was relative, temporary and apparent. Although GDP grew by 1.1 per cent, it did not reach its 2011 level. The improvement was mainly due to agriculture (more specifically the weather) and the construction industry (public investments accelerated in order to absorb EU funds). These are only temporary factors. Following stagnation in the first half of 2013, GDP grew by around 2 per cent in the second half of the year. The following factors played a role in this: the low statistical base, industrial exports boosted by the recovery of the European economy, public investments and economic policy influenced by the oncoming elections, including increased household purchasing power as a result of dictated overhead reductions. The conditions for substantial acceleration of growth are missing due to the weak propensity to invest of the business sector. The effects of the acceleration factors in the second half of 2013 will still be at work this year, whereas decline can be expected in agriculture in case of average weather conditions. Thus, in 2014 GDP is expected to grow by 1.5 per cent, which is slightly faster than last year, but slower than in the second half of 2013. Without change in economic policy, GDP growth cannot be expected to exceed 1.5 per cent and the sham improvement detected statistically in employment, inflation and other areas can easily be followed by deterioration.

The Hungarian economy **performed well** in 2013 compared to the stagnant EU and the still declining eurozone (-0.4 per cent) and it grew by 1.1 per cent. The **agricultural sector** contributed to this growth by **0.9 percentage points**, and consequently the **core growth** (GDP excluding agriculture and the public sector) was **only 0.1 per cent**. **Industrial production** rose by 1.4 per cent in 2013; however, it did not reach its 2011 level. Value added generated by industry did not grow at all. **Industrial exports** increased by almost 5 per cent in an accelerated way during the year. Although **domestic sales** decreased by 1.8 per cent, they already expanded during certain autumn months. After seven years of decline strong recovery started in the **construction industry** in 2013, mainly due to the fast utilisation of EU transfers. Following 6 years of decline, **retail trade increased by only 0.9 per cent**, despite the 2.5 per cent rise in real incomes. In the last quarter, however, retail trade grew by 3 per cent, and by almost 4 per cent in January 2014 year-on-year. In 2013 GDP of the **financial** sector had dropped for four consecutive years, though its rate was "only" 1.5 per cent in 2013. The **deterioration of corporate and retail loan portfolios** continued. Corporate forint loans rose significantly in the third quarter of 2013 due to the **Funding for Growth Scheme of the National Bank**; however, they fell sharply in the fourth quarter. Without changing the whole economic environment, **schemes like this are insufficient to stimulate the Hungarian economy effectively**. The **quality of the loan portfolio** in the corporate sector improved slightly as nearly 30 thousand companies were **deleted** from the register of companies in accordance with the regulations of the tax authority (NAV), most of which belonged to the non-paying category and their loans **had to be written off**. The share of non-performing loans having matured in more than 90 days **grew** significantly in the case of **households**. As a consequence of increasing tax burdens, the cost of financial services increased by 55 per cent in 2013, whereas deposit interest rates decreased more than lending rates.

Real employment stagnated in 2013, although it set to increase in the autumn. **The real unemployment rate was rising**. **Real earnings and real pensions grew by 3.1 per cent and 3.4 per cent, respectively**, primarily due to the artificially depressed inflation, whereas **real incomes increased by around 2.5 per cent**. However, households **did not increase their consumption**. **Gross fixed capital formation expanded by 5.9 per cent**, mainly due to the rapid absorption of EU transfers. Investments in manufacturing increased sporadically.

In 2013 the average annual rate of **inflation dropped to 1.7 per cent** from 5.7 per cent, in part as a result of mandatory overhead reductions. **The core inflation rate** fell to 3.3 per cent in December 2013, indicating that this decrease, if not to this extent, would have occurred on the basis of market processes; and this process is unsustainable. Currently, the inflation rate in Hungary is the same as in the EU, but it is unsustainable. The

aim of the Monetary Council is the **continuous reduction of the base rate**. However, the Hungarian **interest rate spread** is even higher than the Romanian and Bulgarian ones, and the Hungarian **CDS spreads** are the third highest in the CEE region, only lower than those in Slovenia and Croatia. In 2013 reductions in the base were **not followed by drops in the yields of long-term government securities** (they stagnated or increased), whereas the forint depreciated far more than the inflation rate (by 7 per cent in March 2014), amidst large fluctuations. The intention of the continued reduction of the base rate is a more and more risky element of **political window-dressing**. GKI forecasts a **deficit of 2.5 per cent** of GDP in **ESA** terms (or 2.9 per cent in the event of adverse developments in Hungary's statistical settlement method dispute with Eurostat). Gross government debt relative to GDP seemingly decreased to 79.2 per cent by the end of 2013 from 79.8 per cent at the end of 2012. In fact, as far as the essence of the process is concerned, it increased. It is indicative of the end-of-year "**tuning in**" of the government debt that in January 2014 the government debt in HUF terms rose by 1.3 per cent of GDP. The external financing capacity increased from 3.6 per cent of GDP to 5.6 per cent. The **capital outflow**, however, continued.

From the second half of 2013 the **global economy** has shown signs of recovery. Curbing of quantitative easing of the Federal Reserve continues, and the resulting increase in yields and investor risk aversion may lead to withdrawal of capital from emerging countries. The Ukrainian crisis, even if it could be handled, will have a negative impact on the financial assessment of the Central and Eastern European region, and through the deterioration of relations with Russia, on the EU as a whole. Institutional reforms in the EU will be stopped until September because of the elections to the European Parliament and the Commission's re-election. The combined GDP of the EU is expected to **grow by 1.6 per cent in 2014**, and that of **Germany** will **accelerate** from 0.4 per cent to 1.8 per cent. **Differences between the growth rates** of individual EU member states **will likely be abating**. **Monetary policy will be less loose**.

In the spring of 2013 the excessive deficit procedure was **terminated** against Hungary. Its **cost** included **crippling the business sector** and a **dramatic deterioration** in many areas of public services and social care (physician shortage, the increasing number of dependants) as a result of general cuts affecting households and the avoidance of real reforms, lack of legal certainty, the introduction of crisis taxes and a drop in market demand. Meanwhile, the government continued to **further extend the scope of influence of the state**. The methods of favouring some economic actors through public orders, aggressively reviewing acquired rights, using various forms of strong-arm tactics and nationalization have become typical. The government restructures the market for the benefit of its clientele. Converting the ownership structure takes precedence over the health of the economy.

Sentiment surveys showed that **optimism not observed for more than a decade reigned in Hungary** at the end of 2013 and at the beginning of 2014. In addition to the improvement of European expectations, this is certainly in connection with the economic policy influenced by the oncoming elections. In the first quarter of 2014, however, the almost continuous nine-month rise of the GKI-Erste confidence index slowed down. As a result of the relatively favourable European business cycle and domestic expectations, the around 2 per cent of GDP growth rate in Hungary in the second half of 2013 may continue **in the first half of 2014**. GKI raised its GDP growth forecast from 1.3 per cent to 1.5 per cent due to EU supported investments expanding faster than previously thought. However, compared to the higher base, **only 1 per cent growth can be expected in the second half of the year**.

A **deficit of 0.2 per cent of GDP** can be projected in **government revenues**, even after the use of the Country Defence Fund. As far as **expenditures** are concerned, uncertainties include the budgetary impact of EU-funded programmes, liabilities carried forward from last year, the **increased use of reserves** before the elections and the **weak forint**. GKI forecasts that the **general government deficit (ESA methodology) will be 2.9 per cent of GDP in 2014**, as planned; however, to achieve this, **mid-year measures to improve the balance** will be required. The **debt ratio**, assuming unchanged exchange rate and fiscal reserves, would remain the same. However, at the moment none of these assumptions are likely. In addition, according to the new second EU rule on excessive deficit, not yet valid for Hungary, instead of minimal improvement; one percentage point annual decline in the debt ratio should be achieved in average during three years. We will be still very far from this next year. Consequently, **essential improvement in the general government balance will be required from 2015 onwards**. A major transformation in the **revenue structure**, and cutting crisis

taxes down to European standards and levels are also inevitable for a turn in economic growth trends. The **external balance** will be **favourable** in 2014 as well; however, **its improvement will stop**. In spite of growing EU transfers, the external financing capability remains around 5.5 per cent of GDP. No significant changes in the **flow of capital** can be expected, even if Hungarian economic policy becomes more predictable, **the outflow of capital will stop at best**. **Investments** will increase by 4 per cent in 2014, less than in 2013 (but slightly faster than previously assumed by **GKI**). In particular, **EU supported public and/or infrastructural investments** will grow. As far as we know, in the business sector **no major investment projects are planned**, and GKI surveys show that in addition to investments mainly in car manufacturing, many companies plan the **long-delayed replacement** of worn-out equipment and smaller capacity expansions. In the case of creditworthy companies, this is supported by the new Funding for Growth Scheme of the National Bank.

In 2014 **real employment** is expected to **stagnate** or **rise marginally**. The annual average unemployment rate will decrease to 9.2 per cent from 10.2 per cent, but **at the end of the year** it will be **higher** than it was last year and at the beginning of 2014. **Minimum wage** was raised by 3.6 per cent in 2014. **GKI** forecasts that gross earnings will increase by 3.5 per cent. They will increase in the public sector significantly faster, by 6.5 per cent, whereas in the business sector only by 2.5 per cent. **Real earnings** will rise by **2.3 per cent**. The **extension of the availability of family tax benefits** at the expense of contributions will raise total earnings by a further **0.7 percentage points**. **Incomes** earned abroad and **remitted home** may also mount. As a result, **real incomes can be expected to increase by around 1.8 per cent**. In 2014 **consumption** will grow at a **lower rate** (by 1.5 per cent) than real incomes. Households are cautious about spending due to the weak forint, the rising burden of foreign currency loans, and the high level of uncertainty. **Uncertainty** concerns jobs, the sustainability of dictated price cuts, the deterioration of health care and the amount of future pensions. For families with FX-loans the income-draining effect of the weak forint is greater than the savings resulting from overhead reductions.

Core growth (GDP without agriculture and administrative activities) is expected to **accelerate to 1.8 per cent from last year's stagnation**. If weather conditions remain more or less unchanged, GDP may increase as a result of the acceleration of exports and the termination of the decline, or slight increase, in service industries. Regarding the use of GDP, consumption picks up (as always in election years), investments increase more slowly than in 2013, and the trade surplus declines slightly. In case of average weather conditions, **agriculture** is expected to stagnate. **Industrial** production will slightly accelerate, from 1.4 per cent in last year to 3 per cent in 2014. Although the main driving force will be **exports**, the negative effects of the **domestic market** experienced since 2008 will diminish or stop. Projects financed by **EU funds** may raise demand for the **construction industry**. The noticeably higher dynamics of retail sales and the high level of the trade confidence index foretell the acceleration of **retail sales to 1.5 per cent**. The performance of the **transport** sector will accelerate to at least 2 per cent as a result of economic growth and accelerating foreign trade. As a consequence of the increase in purchasing power, GDP growth in the info-communications industry may reach 2 per cent. The decline in the **financial** sector might terminate. Some banks outsource their bad portfolios, and, if necessary, continue to raise capital. All this prepares the **sale** of subsidiaries in Hungary. The government also encourages the withdrawal of foreign banks by its programme of **“creating a banking system half of which is owned by Hungarians”** and the forced nationalization of savings cooperatives. The **potential negative consequences** of a domestic banking system are well illustrated by the consolidation requirements of the Slovenian banking system, which play an important role in the country's long-term recession.

Foreign trade continues to expand. **Exports of goods** grow slightly **faster** due to the improvement of the European business cycle and the exportable grain surplus. Last year's acceleration of the exports of services continues partly by the electronic toll system and partly by the expansion of some business services (e.g., call centres). The terms of trade are expected to remain unchanged. The growth rate of imports exceed that of exports by 1 percentage point. At the same time this means that domestic consumption will grow by 2 per cent, faster than GDP. As the source of this GDP growth is not investment-oriented, it means that the process is unsustainable as well. **The dynamic role of EU funds will end in 2015 at the latest.**

Election-induced overhead reductions resulted in a zero per cent annual **price index** in the first two months of 2014, and for the same reason inflation will be less than 1 per cent in the first half of the year. In the second half of the year, especially after the municipal elections, **inflation is expected to accelerate**, which will continue in 2015. This can be explained by market effects such as the increase of purchasing power and the weakening of the forint, as well as the unsustainability of overhead reductions. **The inflation rate is expected to average 1.3 per cent in 2014 year-on-year and about 3 per cent in December month-on-month.** It is quite possible that the Monetary Council, unless the exchange rate of the forint to the euro weakens above HUF320, will **reduce the base rate further**, although in the present international environment this seems to be a very **risky**, moreover, counterproductive step. It seems that the **main goal of the National Bank of Hungary is its own balance sheet consolidation and the avoidance of losses.** The need to renew maturing government debt, as well as the damage caused by the devaluation of the forint to FX-debtors is likely to **start a period of rising interest rates after the elections.** The reason given by the government will probably be the otherwise real risk of the acceleration of price increases. Actually, it will be caused by the **voluntarist monetary policy** of the government. The later it occurs, the greater the shock it causes. After a lowest point of around 2.5 per cent, GKI forecasts that the **base rate will be around 3.5 per cent** by the end of 2014, and the exchange rate of the **forint to the euro is projected to average HUF305-310** (amid significant volatility).

Extreme measures to eliminate FX loans or some radical actions against banks or the budget may seriously impair the assessment of the Hungarian economy by financial markets. In fact, this would be a scenario **much worse** than anything predicted by GKI until now. Without a turnaround in economic policy, economic growth will not accelerate in 2015, and the process of **regional marginalization** cannot be stopped. The Hungarian economy wobbles on a lagging behind trajectory, providing no significant improvement to society.

GKI forecast for 2014

	2012	2013	Forecast for 2014		
	fact		September	December	March
Gross Domestic Product	98.3	101.1	101.3	101.3	101.5
- Agriculture (1)	81.1	122.0	100	100	95
- Industry (2)	98.7	99.8	102.5	102.5	102.5
- Construction (3)	93.7	107.4	105	105	106
- Retail and wholesale trade (4)	98.3	99.7	102	102	102
- Transport and storage (5)	98.5	101.8	101	101	102
- Information and communication (6)	103.3	100.4	102	102	102
- Financial services (7)	96.4	98.5	98	100	100
- Real estate activities (8)	98.1	96.8	101	100	100
- Professional, scientific, technical and administrative services (9)	99.9	100.9	100	100	100
- Public administration, education, healthcare (10)	101.6	101.4	100	100.5	102
- Arts, entertainment (11)	95.3	103.5	100	100	100
Core growth (2)+(3)+(4)+(5)+(6)+(7)+(8)+(9)	98.6	100.1	101.7	101.8	101.8
GDP domestic demand	96.5	100.8	102	101.9	102
- Private consumption	98.3	99.9	101.5	101.5	101.5
- Gross fixed capital formation (investments)	96.3	105.9	102	102	104
Foreign trade in goods					
- Exports	101.7	104.8	105	106	106
- Imports	99.9	105.0	106	107	107
Consumer price index (preceding year = 100)	105.7	101.7	102.5	102.1	101.3
Current and capital account balance					
- EUR billion	3.5	5.5*	4.7	4.7	5.5
- In per cent of GDP	3.6	5.6*	4.6	4.6	5.5
Unemployment rate (annual average)	10.9	10.2	10.8	10.6	9.2
General government balance in per cent of GDP (ESA)	-1.9	-2.5	-2.9	-2.9	-2.9

*GKI estimates

Source: HCSO, **GKI**