Forecast for 2017

(Summary, 28 June 2017)

The Hungarian economy grew by 4.2 per cent in the first quarter of 2017, by a rate not foreseen by anybody. A growth rate higher than this one has been recorded only once since 2007. This high rate was due in part to the low base. The Hungarian growth rate was much higher than the EU average; however, it was not outstanding in the CEE region. The growth rate in Romania and Slovenia was more than 1 percentage point higher than in Hungary, and the economic growth of Poland and the three Baltic countries was also more dynamic. Data indicate a deterioration in Hungary in April, and the fall in the performance of agriculture will be significant in 2017. The growth rate of consumption is expected to accelerate in 2017, whereas a sharp slowdown in investments can be anticipated. Therefore, GKI raised its growth forecast for 2017 from 3.2 per cent to only 3.5 per cent, although it is possible that the rate will be slightly higher. Although external and internal equilibria will deteriorate slightly, and inflation will accelerate, these trends are acceptable in the short term. It is important for the medium-term course of the Hungarian economy that after the German elections the deepening of the integration of countries willing to work in close cooperation will be on the agenda in the EU. This can push Hungary to the periphery of the EU. At the same time, Hungary will less likely be able to rely on EU transfers of crucial importance.

World economy. The growth rate of the global economy will **accelerate** considerably in 2017 compared to its weak performance in 2016. Both advanced and emerging economies are developing dynamically. As far as emerging countries are concerned, mainly countries producing raw materials and fuel will grow. However, the world economic order established after the Second World War and the globalization process are facing great challenges. The realisation of the isolationist and protectionist ideas of Donald Trump and his unpredictable politics **may rearrange the relations of the power centres of the world** and may dampen the previously expected acceleration in the expansion of world trade. The future of the EU is significantly affected by the timing and method of Brexit, elections to be held in some important member states, as well as the Greek and Italian financial and economic situation. The present trends in the world economy that are favourable for Hungary, such as very low interest rates and energy prices, are **slowly coming to an end**.

Changes in the EU. Developments in recent months have not justified the fears that after the British referendum on leaving the EU and then the American presidential elections a breakthrough of populist and Eurosceptic political forces can be expected. The strengthening of the **Franco-German tandem** improves the possibilities of concerted EU actions against the protectionist trade policies of the US. However, it narrows the scope of action for EU member states expecting the further inflow of EU transfers but refusing solidarity with the European Union. In addition, the move towards any form of fiscal union makes it probable that the remaining EU member states will be drifting towards the periphery of the EU.

Economic expectations are favourable. Although the EU's economic sentiment index declined slightly in May compared to April, it was higher than at the end of 2016. In Hungary, **GKI's economic sentiment index was as high as now**, in June, **only once, namely in the summer of 1998, and the business confidence index has never been as high as now so far during its more than twenty years of history**. Consumers are also very optimistic. However, this outstanding Hungarian optimism hardly exceeds the upper limit of the relatively narrow band characteristic of the last three years.

Economic policy. The government realised that attracting capital by cheap labour was sputtering, economic competitiveness was deteriorating, and Hungary became excessively dependent on EU transfers. These factors undermine sustainable growth. The forced increase of the minimum wage and the many kinds of reorganizations, however, are insufficient in themselves. In addition, they become the source of new tensions. Causes of the **lack** of effective measures include that, on the one hand, these measures would question the "Hungarian model", and on the other hand, they can **seemingly be postponed** by the resumption of the inflow of EU transfers that may **partly veil the problems**. **GKI** believes that there is **no need for further fiscal stimulus** in a period of increasing EU transfers; however, the government should aim at the **reform of institutions**.

Incomes and consumption. In 2016, the growth rate of gross earnings was about 2 percentage points higher than in 2015 (6.2 per cent and 4.2 per cent, respectively). This was partly due to wage increases in the public sector, and partly to the increasing labour shortage, though the price level barely increased and the personal income tax dropped. **In 2017**, a further rise of gross earnings by more than 4 percentage points **to over 10 per cent** will be caused mainly by the **forced increase of the minimum wage and the guaranteed minimum wage**. In 2016, after its fall in 2012, the acceleration of consumption growth by around 0.8-1 percentage points per year had lasted for the fourth year. In 2017 the repetition of last year's rate (about 4 per cent) can be expected. The growth rate of real wages will accelerate slightly, and that of real pension and real income will be the same as in 2016.

Investments. Gross fixed capital formation increased by 10 per cent in 2014, only by 2 per cent in 2015, and it fell by more than 15 per cent in 2016 due to a decline in EU transfers. **In 2017, as a result of the resumption of the EU investment cycle 12 per cent growth is expected.** The **investment rate** was 17.8 per cent in 2016, which is a low rate for a moderately developed country like Hungary In 2017 a slight increase can be expected, a rate of 19 per cent. Although the government advertised the calls for tenders of the new EU budget period started in 2014, the announcement of the results typically requires 6-9 or more months instead of the promised one month. Project targets of new calls for tenders are fragmented and unclear; **the main objective is to spend money fast** (before the parliamentary elections). This can be seen from the fact that the government wishes to announce all calls for tenders until 2017. However, there is no substantial acceleration compared to the previous period. Of the HUF5,020bn **available** for applicants in the 2014–2020 cycle only HUF2,122bn have been **spent** until now. In addition, as major projects were handled first in order to gain **as much and as fast as possible**, a significant portion of disbursements are **advance payments**, thus no substantive activities have started in these areas yet (they are often only financial allocations for projects set up later by local governments). **The actual investment process will be postponed to the next few years.**

Real economic trends. In 2017, the **GDP production of all sectors will grow with the exception of agriculture**, and no slowdown can be expected (except in trade). After two favourable years with 7-8 per cent increases, the growth rate of **industrial** production did not reach 1 per cent in 2016. Its performance in 2017 is primarily dependent on the automotive industry. However, the importance of the electronics industry is increasing again. A **5.5 per cent increase in production can be expected in 2017**, in part due to the start of production of the Apollo tire factory. The **construction industry**'s performance rocketed in the first four months of 2017: the volume of production grew by 24 per cent. The construction confidence index also reflects marked optimism; problems may only be caused by labour and capacity shortage. **Production** is expected to **grow by about 20 per cent** in 2017. This year's weather is worse than last year's, thus the output of **agriculture** will be about **10 per cent lower** in 2017 than in 2016 due to a decline in crop production and stagnation in animal husbandry. GDP in **services** will grow by **nearly 3 per cent** in 2017, at a rate similar to the previous year, but slightly below the national average. Growth can be expected mainly in business services, primarily in the telecommunications sector, less in the transport and real estate sectors, and least in the financial sector.

Paradox in retail sales. If the **3 per cent growth of retail sales** in the first four months of 2017 is compared to the more than 9 per cent growth of real earnings and the about 2.5 per cent rise in employment, this rate is **inexplicably low**. The main reason might be that the actual purchasing power increased much slower than real earnings. Retail sales are expected to grow by around 4 per cent in 2017. The government is making attempts to limit large international chains, which, despite the government's current retreat, is **detrimental to the business environment of trade**.

Foreign trade. Exports of goods and services measured in GDP rose by almost the same rate as imports in 2016 (though the growth rate of exports of goods was 1 percentage point lower than that of imports, whereas exports of services exceeded imports by 4 percentage points). Owing to the rise in domestic demand, the growth rate of **imports will exceed exports by 1 percentage point** in 2017; however, the faster expansion of exports will continue in services. The foreign trade surplus amounted to EUR9.9bn in 2016 by EUR1.3bn more than in 2015. The surplus is expected to be **"only" EUR9bn in 2017**, partly due to the deterioration in the terms of trade and partly to the acceleration of imports. The surplus is still very high (7.6 per cent of GDP), though slightly decreasing. In foreign trade of services, the surplus will increase from HUF2,200bn in 2016 to HUF2,400bn in 2017, to 6 per cent of GDP. **After their 1.5 per cent improvement last year, the terms of trade will deteriorate by at least 1 per cent in 2017.**

Employment. The number of employees will increase by **about 2.5 per cent** in 2017, slower than its 3.4 per cent rate in 2016. The **shortage of skilled labour** is a growing problem. The ideas aiming at drastic reduction of employees in state administration decelerate in practice only the growth rate of employment in the public sector. The first steps will be taken to **reduce public employment** in public workfare schemes. Foreign employment is still popular, especially among younger generations. **The unemployment rate will fall to about 4 per cent statistically in 2017, though the actual rate will be around 7 per cent.**

Financial sector. Lending to companies and the general public will also increase in 2017, and the **portfolio quality of banks will improve** as a result of the expanding factoring market. Consumer friendly housing loans are expected to be available from the third quarter of 2017. In addition to the interests of banks, the expansion of the housing loan market will be largely influenced by the US rate rise cycle, as the **possible rise in domestic market interest rates in 2018 and 2019 following the rate rise in the US** will likely affect the retail loan portfolio adversely. On the basis of the subscribed capital, the **weight of foreign banks is again greater** than that of the Hungarian banks. The change of ownership of **MKB Bank** raised serious **concerns** as regards its financing links and the ability to raise capital.

General government. Although the Hungarian general government deficit increased slightly in 2016 (from 1.6 per cent of GDP to 1.8 per cent), and an additional 0.5-1 percentage point increase can be expected in 2017, it will be **below 3 per cent of GDP** in 2017 **for the sixth consecutive year**, with the **government debt on a declining path**. The **drawback** of all this includes an anti-growth tax structure, the degradation of large distribution systems, lack of the transparency of fiscal policy and consuming the resources of the future. The **expenditure-replacing and revenue-generating effects of EU transfers** and the various creative budgeting solutions played a major role in the improvement of the balance. Similarly to the handling of the reduction of households' overheads, the government again puts the burden of financing its economic policy influenced by the forthcoming elections on the corporate sector through the tax burden of forced wage increases, at the expense of their competitiveness. By using these methods, although further rise in spending, and thus in the deficit, can be expected in many areas before the elections, the deficit will remain below 3 per cent, the government debt relative to GDP will decline by about 0.5 percentage points, to around 73.5 per cent. However, the increase in the general government deficit relative to GDP is unfavourable in times of accelerating economic growth as the structural balance deteriorates endangering the permanent decrease of the government debt.

Inflation, interest rates, exchange rates. Inflation was virtually eliminated between 2014 and 2016. Mainly as a result of rising fuel prices inflation started to increase in the last months of 2016, reaching its peak of 2.9 per cent in February 2017. In the decrease of the average rate of inflation (prices grew by only 2.1 per cent in May) fuel prices played an important role, too. However, the rise in wages will have price increasing effects both on the cost and the demand side. The inflation rate is expected to average **around 2.5 per cent** in 2017. Monetary policy will continue to be **loose**, the **base rate will not change**, and its market-orienting role will be taken over by the inter-bank interest rates. The exchange rate of the forint to the euro is projected to average **HUF313** in 2017.

External equilibria. Hungary's combined current and capital account was in surpluse in almost every year between 2009 and 2015, and it reached its peak of EUR8.7 billion in 2015. Despite the outstanding improvement in the foreign trade balance in 2016, it decreased to EUR6.1bn due to the contraction of the inflow of EU transfers. In 2017, however, despite some decline in the foreign trade surplus, the **external financing capacity may increase to EUR7.5bn** as a result of the restart of EU transfers, amounting to 6.3 per cent of GDP. Net inflows of FDI received a boost in 2016, and this trend may continue, though at lower rates, in 2017, too.

Risks of the forecasts. The **higher figures** in GKI's growth and inflation forecasts for 2017 have a **somewhat higher probability** than the lower ones. The two major factors of uncertainty in GDP growth include investments and agricultural production (although rapid wage increases, in principle, may lead to a growth in consumption higher than expected now). The main factors influencing inflation are changes in purchasing power and global energy prices.

The forecast of GKI for 2017

	2014	**2015**	**2016**	**2017 forecast**			
	fact			Sept	Dec	March	**June**
GDP	104.0	103.1	102	102.7	103	103.2	**103.5**
• Agriculture (1)	117.0	94.9	116.8	100	100	95	**90**
• Industry (2)	105.9	108.2	100.8	103	103	103	**104.5**
• Construction (3)	110.5	101.5	82.1	108	108	112	**120**
• Trade (4)	104.1	104.6	106	105	107	107	**105**
• Transport and storage (5)	101.8	101.4	102.5	103	103	103	**103**
• Information, communications (6)	104.0	101.6	103.7	103	103	104	**104**
• Financial services (7)	97.0	100.2	98.9	102	102	102	**101**
• Real estate services (8)	100.0	102.0	101.2	102	102	103	**102**
• Professional, scientific, technical activities (9)	105.4	102.9	106.3	103	103	104	**104**
• Public administration, education, healthcare (10)	100.6	99.9	101.3	101	101	101	**101**
• Arts, entertainment (11)	107.0	98.9	101.4	102	102	102	**102**
• Core growth (2)+(3)+(4)+(5)+(6)+(7)+(8)+(9)	104.2	104.5	101.5	103.5	103.7	104.2	**104.5**
GDP domestic demand	104.6	101.4	101.5	103.2	104.2	104.2	**104**
• Private consumption	102.1	103.1	104.2	104	105	105	**103.5**
• Gross fixed capital formation (investments)	109.9	101.9	84.5	105	105	108	**112**
Foreign trade in goods							
• Exports	106.9	107.8	105.8	107	107	106	**106.5**
• Imports	108.8	106.3	105.7	109	109	107.5	**107.5**
Consumer price index (preceding year = 100)	99.8	99.9	100.4	101.5	102	102.5	**102.5**
Balance of current and capital account							
• EUR billion	6.1	8.7	7.5*	8.2	8.5	8	**7.5**
• In per cent of GDP	5.8	7.9	6.7*	7.2	7.3	6.7	**6.3**
Unemployment rate (annual average)	7.7	6.8	5.1	5.1	5.1	4.2	**4**
General gov. balance in per cent of GDP (ESA)	-2.1	-1.6	-1.9	-2.5	-2.5	-2.5	**-2.5**

* GKI estimate
Source: HCSO, GKI