GKI Economic Research Co.
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The Hungarian economy before elections

The detailed forecast of GKI Economic Research Co. for 2018, 21st March 2018

Hungarian GDP exceeded its level reached before the global financial crisis in 2014, whereas investments and consumption did the same in 2017. Industry exceeded pre-crisis levels in 2015, retail sales in 2016, construction in 2017. However, the financial sector is still far from this.

Although Hungary's GDP expanded slightly faster than expected in 2017, by 4 per cent and considerably faster than the EU average, its growth rate was moderate in the CEE region. GKI do not change its GDP forecast of 3.8 per cent and investments forecast of 9 per cent for 2018. However, it raises the projected increase in consumption from 3.5 per cent to 4 per cent. Although last year's soar of construction slows down in 2018 due to the high statistical base, this sector continues to grow fastest. Similarly to last year, industry will grow by 5 per cent in 2018. The decline in agriculture in 2017 is expected to be followed by some increase this year. Public administration will stagnate, whereas some acceleration can be expected in the financial sector. Compared to its previous projections, GKI cut its inflation rate forecast from 3 per cent to 2.7 per cent, and its unemployment forecast from 4 per cent to 3.7 per cent.

World economy. Global economic growth continues to be faster than previously anticipated. However, its rate will be slower than before the crisis. **Global recovery** affects more and more emerging and developing countries alongside the expanding number of developed countries. In addition to geopolitical trouble spots and terrorism, **new threats** have also emerged. It is still uncertain whether the **fall and correction of the global stock markets in February** was only a temporary fluctuation or the beginning of a sustained downturn. Global trade can be severely affected by the **US tariff war**. The formation of the **German** government is favourable for the **future of the EU**. However, governing **Italy** that needs reforms will be quite difficult after the strengthening of populist and Eurosceptic forces. The strengthening of the **German-French axis** is pointing towards multi-speed European integration (becoming more and more independent of the US), and towards the **strengthening and extension of the euro area**. The way of Brexit is still unclear. The period of low global interest rates and energy prices is slowly coming to an end.

Economic expectations. Economic expectations are very favourable in Europe, including Hungary. The EU's economic sentiment index rose to its more than a decade long peak in January, and it declined only minimally in February. However, industrial expectations deteriorated. The **German business** confidence index, which is particularly important for Hungary, dropped to its lowest point in the past five months, though it is still quite favourable. **However, GKI's economic sentiment index rose to a new historic peak in February.**

Economic policy. The otherwise boosted Hungarian economic growth is only moderate in the CEE region, and it is largely due to EU transfers and the effects of the approaching elections. Several international institutions (OECD, IMF, EU) call the attention of the Hungarian government to **establish the foundations of sustainable economic growth during these relatively favourable years**. They call the attention of Hungary to the necessity of loosening its too strong **dependence** on EU transfers, reducing the **general government deficit**, restructuring the **institutional system** by applying a market economy approach and improving its **competitiveness**. They emphasize that growth driven by domestic demand will **worsen** Hungary's currently outstanding external surplus as well. The **three main problems** of Hungarian economic policy are **the elimination of competition, the erosion of human capital and international isolation**. After the elections, it will be necessary to reconsider Hungary's European policy, including the introduction of the euro, which will inevitably affect the Hungarian model as well. (GKI's present forecast does not deal with the outcome of the elections. It points to what it is expedient to do, whoever wins.)

Economic growth. In 2017, the Hungarian economy grew faster than expected by GKI and most other forecasting institutions, such as the National Bank of Hungary, the EU or the IMF, but slightly slower than anticipated by the government, by 4 per cent. The GDP growth rate was 4.2 per cent according to the EU methodology, which is **considerably faster than the EU average of 2.4 per cent, whereas it was only moderate in the CEE region**. In the CEE region six countries grew faster than Hungary and four countries slower. (The exceptionally fast growth rate of 4.9 per cent in the fourth quarter was enough only for the fifth place in the CEE region.) GKI expects a GDP growth rate of 3.8 per cent in 2018. With the exception of the government (4.3 per cent) practically all other forecasts project a somewhat less than 4 per cent increase. Although it would again substantially exceed the 2.3 per cent average of the EU, it is likely to be moderate again by CEE standards. Domestic consumption is expanding faster than GDP both in 2017 and 2018 (6 per cent and 5 per cent, respectively). However, the gap is decreasing.

Incomes and consumption. In 2018 consumption is expanding for the sixth consecutive year. The growth rate of **real earnings** will slow down to around 4.5 per cent from last year's 10 per cent, however, that of **consumption** will remain substantially unchanged (4 per cent), as households are trying to smooth out their purchases, their expectations are favourable and their willingness to borrow is improving.

Investments. As a result of the **investment cycle** that restarted in 2017, investments grew by 17 per cent in 2017 and their volume is expected to increase by 9 per cent in 2018. The **investment rate** was 19.2 per cent in 2016, 21.5 per cent in 2017, and it may rise to 22.5 per cent in 2018, reaching its pre-crisis levels. Investments are expected to increase in all sectors in 2018, partly as a result of EU transfers. In the current EU financial framework, Hungary allocates more than half of the EU transfers to the private sector. By mid-March 2018, 81 thousand proposals submitted to calls for tenders were approved and the total sum awarded was HUF8,150bn (nearly 92 per cent of all EU transfers for the 2014-2020 EU development cycle). However, only half of this sum was disbursed until now, about HUF4,300bn. A significant portion of disbursements are advance payments, as major projects were handled first in order to gain **as much and as fast as possible**. However, no substantive activities have started in these areas yet.

Major sectors. After almost stagnating in 2016, **industrial** output rose substantially in 2017, although it showed a significant slowdown in the last quarter. The driving force of the automotive industry has ceased for almost three years, and the hindering effects of automotive technological transformation will be manifest in 2018 as well. Gross output will grow by **around 5 per cent** in 2018, similarly to last year. After its big downturn in 2016, **construction** soared in 2017, and its production increased by almost 30 per cent. The substantial contract portfolio and the construction confidence index at its historic peak are predicting a continuation of brisk construction activity in the public procurement, retail and corporate markets. Production is expected to rise **by 10 per cent** in 2018. GDP of **agriculture** decreased by 9 per cent in 2017, and its gross output volume by 5 per cent. The downturn was mainly due to bad weather and the inappropriate production structure. These big fluctuations, however, are also caused by the **lack of a real land market** and the risks of investing in land. No change can be expected in 2018 either. The excessive preference of small individual farms to economic organizations leads to distortions in the structure of agricultural production and technical backwardness. In case of average weather conditions, **agricultural GDP is expected to grow by around 5 per cent** in 2018. GDP in **services** expanded by 3.3 per cent in 2017, below the national average. However, its rate was almost the same as in 2016 and the one that can be expected this year. Growth can only be expected in **business** services in 2018, whereas public services are likely to stagnate after their 1.3 per cent fall in 2017. Retail sales increased by 4.9 per cent in 2017, and they are expected to grow by about 4.5 per cent in 2018.

Foreign trade. Exports of goods and services grew faster than imports in 2015 and 2016. As a result of the recovery in domestic demand, this trend reversed in 2017. **In terms of contribution to GDP, exports increased by 7.1 per cent and imports by 9.7 per cent in 2017, and the corresponding figures are expected to be 6 per cent and 7.5 per cent in 2018.** After 2017, the **surplus of foreign trade turnover** will also **decrease** in 2018 (from EUR9.7bn in 2016 to EUR8.1bn and EUR7bn), whereas that of **services**

will continue to **rise**. The terms of trade will deteriorate by 0.5 per cent in 2018, similarly to last year's drop of 0.4 per cent.

Employment, unemployment. The unemployment rate has **significantly decreased** since 2013 and **labour shortage** has been increasing since 2016. The statistical improvement was initially the result of the explosive expansion of public workfare schemes and employment abroad; however, real domestic employment also mounted significantly. However, **employment** growth slowed down **from about 1.6 per cent in 2017 to about 1 per cent**, as the number of working-age people dropped due to demographic reasons and the number of available workers is limited, due to the poor training structure, foreign employment, and the low level of work culture in certain strata. One of the major obstacles to growth is **labour shortage**. This problem could be alleviated by automation and increased productivity. The annual average **unemployment rate** was 4.2 per cent in 2017 and it is expected to decrease to 3.7 per cent or below, whereas the number of those participating in public workfare schemes will further decline. **If those involved in public workfare schemes (or at least most of them) were considered unemployed, Hungary's unemployment rate would be essentially the same as the EU average of around 7.5 per cent.** The actual situation is worse than showed by statistical figures due to the **lack of perspectives of the great number of people considered inactive**.

Financial sector. The provision of new loans has begun to grow for several years. However, **the corporate loan portfolio started to increase in 2016 and the retail loan portfolio in 2017 as well**. A further expansion of corporate and retail loans can be expected in 2018. The loan portfolios, profitability and capital adequacy ratios of banks are **favourable**. The **interdependence** of the government and the banks resulting from the self-financing programme of the National Bank of Hungary and the **insufficient separation of ownership and lending** at some Hungarian-owned banks are posing a source of **risks**.

General government, government debt. The general government deficit will be below 3 per cent of GDP in 2018 for the sixth consecutive year, with the government debt on a declining path. The general government deficit was 1.9 per cent of GDP in 2017, lower than the projected 2.4 per cent. At the same time, due to the widespread budgetary **advance payment** of EU transfers, the cash-flow deficit of the central government was almost 70 per cent higher than anticipated. **In the first two months of 2018, it approached 40 per cent of the target amount for the year.** Despite the significantly different trends, **there has not been any review of the 2018 budget approved last spring**. No wonder that Hungary is **the last in the EU** as far as the transparency of fiscal policy is concerned. Thus, in connection with the elections, a sharp rise of the general government deficit to GDP is currently projected in 2018, by 0.6 percentage points, to 2.5 per cent. According to EU projections, only the Romanian and French general government deficit ratios will be higher in the EU. The government debt relative to GDP decreased in 2017, by 1.8 percentage points, at a somewhat smaller rate than projected. With the inclusion of Eximbank, the debt ratio was 74 per cent. **GKI expects that the general government deficit will be around 2.5 per cent of GDP in 2018, and the government debt ratio will decrease to 72-73 per cent.**

Inflation, interest rates, exchange rates. Following their fall in 2016, agricultural producer prices and domestic sales prices of the processing industry started to rise in 2017 and the rise in construction prices accelerated. Consumer prices went up by 0.4 per cent in 2016 and by 2.4 per cent in 2017. The inflation rate was 2.1 per cent in January 2018 and 1.9 per cent in February, whereas core inflation slightly rose. As a result, GKI **reduced its annual inflation forecast** from 3 per cent **to 2.7 per cent**. GKI expects that the reference rate of the National Bank of Hungary will remain unchanged (0.9 per cent), and annual average **exchange rate of the forint to the euro will be HUF312**. The goals of the central bank include the maintenance of **loose monetary conditions**, the stimulation of lending expected from low interest rates, the **cheaper funding** of the Hungarian general government and the further maintenance of the **profitability of the central bank**. The latter goal is disputable.

External equilibria. After its huge surplus of EUR7bn in 2016, the **current account balance** dropped to EUR4.5bn in 2017 due to a fall in the foreign trade surplus, and **it will shrink further to EUR3.5bn in**

2018. As a result of the resumption of EU transfers, the **external financing capacity** could rise from EUR7bn in 2016 to EUR7.7bn in 2017, and it is expected to amount to EUR8bn in 2018 (6.2 per cent of GDP). **Net inflows of FDI** received a boost in 2016 (EUR1.9bn). In the first three quarters of 2017 this amount was only EUR0.4bn, and no major expansion can be expected in 2018 either. FDI in Hungary has increased by only EUR3bn since the beginning of 2008. Net FDI **dropped** from 50 per cent of GDP before the crisis to around 45 per cent in 2016, and no increase can be expected in 2018 either.

Risks of the forecasts. GKI do not change its 3.8 per cent **GDP growth** forecast in 2018; however, a **higher rate** is more probable than a lower one. The sources of faster growth may include a more favourable performance of agriculture and a more dynamic increase in domestic consumption. The price of this latter would be an **external equilibria deteriorating** more than projected. GKI decreased its **inflation** projection to 2.7 per cent from 3 per cent, and in this case smaller or larger figures have **similar** probabilities. The lower rate would be mainly due to a more modest rise in **world energy prices**. The higher rate could be the result of the strong inflationary effects of **increasing domestic wages**, both from cost and demand side. However, regarding the medium-term outlook of the Hungarian economy, **the most significant risk is the immutability of the government's European policy**, with all its domestic implications, as **Hungary may be pushed to a position of marginal importance in the European Union**.

Forecast of GKI for 2018

	2014	2015	2016	2017	2018		
	fact				September	December	March
GDP	104.2	103.4	102.2	104.0	103.8	103.8	**103.8**
• Agriculture (1)	117.4	95.9	109.9	91.0	105	105	**105**
• Industry (2)	105.8	108.1	101.0	103.9	105	105	**104**
• Construction (3)	110.7	102.5	89.5	131.6	112	110	**110**
• Trade (4)	103.8	104.2	101.2	106.2	105	105	**105**
• Transport and storage (5)	102.7	101.3	105.5	104.5	103	103	**104**
• Information, communications (6)	104.4	101.3	105.7	106.1	104	106	**106**
• Financial services (7)	96.7	101.5	100.4	100.7	102	102	**102**
• Real estate services (8)	101.8	100.0	103.1	102.3	102	102.5	**102.5**
• Professional, scientific, technical activities (9)	105.5	102.8	107.5	107.2	104	104	**106**
• Public administration, education, healthcare (10)	101.0	100.2	101.7	98.7	101	100	**100**
• Arts, entertainment (11)	106.0	100.8	102.9	105.0	102	102	**104**
• Core growth (2)+(3)+(4)+(5)+(6)+(7)+(8)+(9)	104.4	104.6	102.1	105.9	104.5	104.7	**104.7**
GDP domestic demand	105.5	101.2	101.6	106.0	104.5	105.5	**105**
• Private consumption	102.4	103.4	103.8	104.1	103	103.5	**104**
• Gross fixed capital formation (investments)	112.3	101.9	89.4	116.8	109	109	**109**
Foreign trade							
• Exports	109.1	108.5	103.4	107.1	106	106	**106**
• Imports	111.0	106.4	102.9	109.7	107	108	**107.5**
Consumer price index (preceding year = 100)	99.8	99.9	100.4	102.4	103	103	**102.7**
Balance of current and capital account							
• EUR billion	5.5	8.9	7.0	7.7*	8.3	7.5	**8**
• In per cent of GDP	5.2	8.1	6.2	6.3*	6.4	5.7	**6.2**
Unemployment rate (annual average)	7.7	6.8	5.1	4.2	4	4	**3.7**
General government balance in per cent of GDP (ESA)	-2.8	-2.0	-1.9	-1.9	-2.9	-2.8	**-2.5**

*GKI estimates
Source: HCSO, **GKI**