Forecast for 2016-2017

Hungary's GDP growth has been low in 2016 compared to other countries in the CEE region or to its growth rate in the previous year. However, some acceleration of the growth rate can be expected in the second half of the year. GKI maintains its GDP growth forecast of 2 per cent for 2016. Internal and external equilibria are very favourable, and inflation almost ceased. However, in the second half of 2016 the general government deficit might be slightly higher (partly in connection with the recovery of the economy) and the external surplus might be lower (due to declining improvement in the terms of trade) than in the first half of the year. In the meantime, price increases may start slowly. The significant decline in investments in 2016 will be followed by a noticeable growth in 2017 mainly due to the restart of EU transfers, while consumption, which is increasing very rapidly this year, will barely slow down. Taking into account Hungary's upgrade by rating agencies, GKI raised its 2017 forecast of GDP growth to 2.7 per cent. Internal and external equilibria, even if they are deteriorating, will remain favourable, and inflation will continue to rise slightly. Faster economic development typical of the region is impeded by the shortage of skilled labour and capital to invest, the business environment causing these problems and the exceptionally high dependence on EU transfers.

The increased economic, political and institutional uncertainties in the **world economy** in the wake of the British referendum subside only slowly. Their negative economic impacts will be felt primarily in Britain, whereas the political ones in the EU. The world's most important central banks (the Fed, the ECB and the Bank of Japan) provide **adequate monetary conditions** for global growth, although **raising the benchmark interest rate of the Fed** is on the agenda. There are **serious political and economic risks** including the inflow of asylum seekers, terrorism, the Islamic State, trouble spots in the Middle East, North Africa and the Ukraine, the precarious situation in Turkey, the US presidential election, the economic slowdown and debt crisis in China, the deflationary pressure, the Zika virus in Latin America, and the future of the EU. That is more than enough.

The **EU's economic sentiment index** fell both in July and August, reaching its **lowest point in the past 20 months**. After its significant rise in July, the GKI economic sentiment index decreased significantly in August, thereby returning to its lowest point this year. Domestic business expectations deteriorated significantly, whereas consumer ones slightly. A **minimum correction was registered in September** as business expectations improved slightly and consumer ones remained unchanged. **Although the GKI economic sentiment index has been fluctuating for about two years at fairly high levels, its current level is relatively low.**

Although Hungarian **economic policy** makers may think that Brexit justifies their own EU-sceptic stance, the case of the UK rather calls attention to the risks that a country may face outside the EU. **Silent deterioration of equilibria** started in the economic policy in the spring due to slow growth and the approaching 2018 parliamentary elections. **The reorganisation of ownership relations and markets by active government involvement continues.** However, **GDP growth based on cheap labour and the new capitalist stratum loyal to the government is sputtering.** Recognizing these changes has just begun, and facing the truth **can again be postponed** for a few years thanks to the continuation of the availability of EU transfers.

Real earnings will increase by about 7 per cent **in 2016** due to the 6 per cent growth of gross earnings, the 1 percentage point reduction in the personal income tax rate and the around 0.5 per cent inflation rate. Taking into account increased employment, declining loan burdens and the increasing propensity to purchase, **consumption is likely to go up by 4.5 per cent**. There are labour shortages in many professions due to work abroad and the obsolescence of the educational system resulting in a strong pressure for wage increases. Wages frozen for several years in the public sector are likely to increase due to the approaching parliamentary elections. However, the compulsory lift of the minimum wage causes great problems in many undertakings. Although current trends are expected to continue **in 2017**, real earnings may increase by less than 5 per cent if inflation goes up. **Consumption** will expand **by around 4 per cent**. In the case of real estate loans, borrowings exceed loan repayments in 2016; however, **in the case of retail loans growth can be expected only in 2017**.

Gross fixed capital formation grew by 11 per cent in 2014 and by 2 per cent in 2015. Following its more than 15 per cent fall in the first half of the year, **GKI** anticipates a **10 per cent decrease in 2016**. As a result of the crowding out effects of EU funds as well as the Funding for Growth Scheme(s) of the National Bank of Hungary, the average investment cost of credits decreased slightly, but it is still rather high (particularly in light of the low producer price index). **However, the overwhelming part of undertakings does not want to borrow.** Although SMEs capable of development have relatively inexpensive access to funds, some of these companies are afraid of rapid growth as they do not wish to become another victim of state-organized market realignments. The **investment ratio** is declining both in 2015 and 2016, and it is expected to be below 19 per cent of GDP in 2016, which is a very low ratio. **In 2017 a 5 per cent volume growth and an investment ratio of over 19 per cent can be expected due to the resumption of the EU investment cycle.**

GDP increased by 2.6 per cent in the second quarter of 2016, or by 1.4 per cent if adjusted for seasonal and calendar effects. The Hungarian Central Statistical Office (HCSO) revised upwards its estimates for the first quarter (to 1.1 per cent and 0.9 per cent, respectively). Thus, the Hungarian economy grew by 1.9 per cent **in the first half of the year** (without adjustments) and by 1.4 per cent after adjustments. This latter figure is **lower than the EU average of 1.8 per cent** and **it is well below** the corresponding rates in Poland and the Czech Republic (2.8 per cent), in Slovakia (3.7 per cent) and especially in Romania (5 per cent). Although **the first statistical data of domestic GDP growth for July are unfavourable** (industrial production and exports fell, the decline in construction was more pronounced than in the previous month, retail sales growth slowed down and business expectations were declining), **an acceleration is likely in the second half of the year**. **GKI** maintains its forecast for 2016, that is, it continues to expect a GDP growth rate of about 2 per cent. **Consumption is definitely the main driving force of the economy in 2016. GKI** raises its forecast from 4 per cent to 4.5 per cent, and it **expects a decline of about 10 per cent in investments instead of 8 per cent** previously thought. **GDP growth may accelerate faster in 2017 than previously assumed to 2.7 per cent** due to the recovery of **investments financed by EU transfers**, a slight increase in business investments and **consumption that is expected to remain brisk**. Domestic demand is likely to expand slower than GDP in 2016 (by 1.6 per cent), and much faster in 2017 (by 3.2 per cent).

The increase in gross **industrial** production will hardly exceed 2 per cent in 2016; however, it is expected to grow by around 3.5 per cent in 2017. 2016 will inevitably be a bad year for **construction** due to the fall in EU transfers. Although housing construction has started to recover, it is not a decisive element in the total performance as its share is only around 5 per cent. The main problem is that in the first half of 2016 the investments of the public sector halved. **GKI** expects a reduction of about 20 per cent in production in 2016. Payments from EU transfers will expand significantly in 2017, thus even a growth of up to 8-10 per cent can be achieved. Weather was favourable for **agriculture** in 2016. Agricultural GDP rose by 10.8 per cent in the first half of 2016, and a similar rate can be expected for the whole year. In 2017 (after an increase of 2016 compensating for a decline in 2015) stagnation can be expected; and the direction of any slight difference will be determined by the weather. GDP in **services** will expand much faster than the average rate in 2016, by almost 3.5 per cent, and close to the average in 2017. Business services will expand more rapidly in both years.

GKI forecasts that **Hungary's exports will expand similarly to imports in 2016**, by 6-7 per cent, but slower than in 2015 (8.6 per cent). **In 2017 the 7 per cent growth rate of exports will be 1 percentage point lower** than that of imports. **Services** will continue to increase **faster than average**. **The terms of trade are improving by around 2 per cent in 2016**, which makes it possible that the foreign trade surplus will be favourable, despite a strong increase in consumption. In 2017 the terms of trade are expected to be the same, or slightly decline (mainly depending on world market energy prices).

The **number of employees will increase by 3 per cent in 2016**, in spite of the **labour shortage** that can be experienced in many areas, thanks to, among others, the further dynamic expansion of employment abroad, the relatively good demand in certain sectors, the positive effects of rising wages on inactive people and on some of those involved in public workfare schemes, some whitening effects in the economy and the further expansion of public workfare. **In 2017**, which is the year before the parliamentary elections, the government is expected to promote the **further increase of employment by about 2 per cent**, which will be supported by some acceleration in economic growth as well. The **unemployment rate declined to around 5 per cent** from mid-2016 on, and it will be similar in 2017, too. In statistical terms, this is the fifth lowest in the EU. However, **the actual situation is far worse**, as the number of those participating in public workfare schemes equals the number of unemployed (around 230 thousand people in the second quarter of 2016). In addition, hundreds of thousands of people are working abroad, similarly to other countries in the CEE region, and they are considered to be "employed".

The **labour-attracting** effects of the EU, causing trouble throughout the CEE region, were experienced **later** in Hungary than in other countries of the region; however, it was **an explosion during the years of general stagnation**. Since more than half a million Hungarians work abroad, the **shortage of skilled labour** also limits domestic growth perspectives. Keeping the skilled segment of labour force remaining at home, too, **compels substantial wage increases** in both the public sector and the competitive sphere, whereas only a tiny fraction of those involved in public workfare schemes can be employed in the business sphere. Public workfare schemes prevent people from taking occasional and seasonal jobs. **A significant number of those participating in public workfare schemes are stuck in the system**, which is increasingly constrain the exploitation of market-based job opportunities. The increase of real earnings by around 7 per cent on average in 2016, which rate is much faster than that of GDP, **erodes the competitiveness of companies involved** (though it is tolerable in the short term for most of them) and **raises budget expenditure requirements**. The lack of reforms makes the reductions in public expenditure only transient as the inevitable wage increases will once again lift public spending. Although wage increases may stimulate consumer demand, this will mainly boost imports due to the **weak adaptation ability** of domestic production.

The quality of the banks' portfolios and the profitability of the banking sector are **improving**, but these factors can contribute to the production of GDP only next year. **The contraction of the corporate loan portfolio ends in 2016; however, concerning retail loans this can be expected only in the case of real estate loans. Total household debt will start to increase no sooner than 2017.** The transfer of the major part of the sector into Hungarian ownership, the not transparently changing roles assumed by the government and the bank supervising authority as well as the occasionally illegal operation of the National Bank of Hungary constitute **risk factors**.

The **general government** deficit in cash flow terms has been extremely favourable until now due to the increase in tax revenues and the decline in expenditures related to EU transfers compared to the previous year. In the spring of 2016 economic policy **set to change implicitly aiming at the deterioration of disequilibria**. The amendment to the budget, the existence of spending constraints and the promise of introducing a demand stimulus package during the autumn will ease the 2016 budget; whereas the proposed 0.7 percentage point increase of the 2017 general government deficit and the carry-over effects of the above demand stimulus package will loosen up the budget in 2017. As a result, **GKI** predicts that the **general government deficit might be 2.3 per cent of GDP in 2016**, higher than the planned 2 per cent. Thus **in 2017**, i.e., in the year before the elections the deficit relative to GDP is expected to total **at least 2.5 per cent**, higher than the planned 2.4 per cent (but almost certainly lower than 3 per cent). The **government debt** to GDP ratio **will decline**, and the rate of decline is expected to reach 0.8 percentage points as required by EU rules both in 2016 and 2017. At the end of 2015 it was 75.3 per cent, and it is expected to drop to about 74.5 per cent in 2016 and around 73.7 per cent in 2017.

In the autumn months of 2016 prices are expected to start to increase slowly. At the end of 2016 the rate of inflation is predicted to reach 1 per cent (averaging around 0.5 per cent in 2016) and it is likely to rise to 1.5 per cent in 2017. The current **base rate of the National Bank of Hungary amounting to 0.9 per cent** can be maintained up to the end of 2017. **GKI expects the annual average exchange rate of the forint to the euro to total HUF312 in 2016 (stronger than the previously assumed HUF315), and around HUF315 in 2017.** The strengthening forint (partly resulting from Hungary's upgrade by rating agencies), however, puts the National Bank of Hungary in a difficult position because it contradicts its "profit orientation". Further easing can be achieved by some "unorthodox" means.

Hungary's **combined current and capital account** has produced surpluses in almost every year since 2009; the surplus reached EUR8.7 billion in 2015. Despite the improvement in the foreign trade balance, this will decrease to EUR7.7bn in 2016 due to the contraction of the inflow of EU transfers. It is expected to exceed EUR8bn again in 2017, as a result of the restart of EU transfers, despite a slight decline in the foreign trade surplus. Excluding the enforced recapitalisation of the banking sector, Hungary's capital stock as a combined result of international capital movements did not change.

The forecast of GKI for 2016 and 2017

	2013	2014	2015	2016	2017
	fact			forecast	
GDP	101.9	103.7	102.9	**102**	**102.7**
• Agriculture (1)	115.3	113.9	87.1	**110**	**100**
• Industry (2)	97.5	106.7	106.3	**102**	**103**
• Construction (3)	105.8	112.3	102.9	**80**	**108**
• Trade (4)	106.3	104.3	105.7	**108**	**105**
• Transport and storage (5)	101.0	102.4	101.7	**103**	**103**
• Information, communications (6)	103.9	101.4	102.9	**104**	**103**
• Financial services (7)	95.2	97.1	99.8	**100**	**102**
• Real estate services (8)	100.3	99.6	101.1	**102**	**102**
• Professional, scientific, technical activities (9)	103.6	105.8	105.6	**105**	**103**
• Public administration, education, healthcare (10)	106.7	97.8	100.6	**101**	**101**
• Arts, entertainment (11)	100.0	104.8	106.0	**102**	**102**
• Core growth (2)+(3)+(4)+(5)+(6)+(7)+(8)+(9)	101.0	104.5	104.4	**102**	**103.5**
GDP domestic demand	101.2	104.2	101.5	**101.5**	**103.2**
• Private consumption	100.6	101.5	102.6	**104.5**	**104**
• Gross fixed capital formation (investments)	107.3	111.2	101.9	**90**	**105**
Foreign trade in goods					
• Exports	104.8	107	108.4	**106**	**107**
• Imports	105.0	108.5	107.8	**107**	**109**
Consumer price index (preceding year = 100)	101.7	99.8	99.9	**100.5**	**101.5**
Balance of current and capital account					
• EUR billion	7.5	6.1	8.7	**7.7**	**8.2**
• In per cent of GDP	7.4	5.9	8.0	**7.0**	**7.2**
Unemployment rate (annual average)	10.2	7.7	6.8	**5.2**	**5.1**
General government balance in per cent of GDP (ESA)	-2.4	-2.5	-2.0	**-2.3**	**-2.5**

Source: HCSO, **GKI**