Forecast for 2017-2018

(Summary for the press, 29 September 2017)

Following the continuous spectacular expansion in investments in the second quarter of 2017, GKI raised its GDP forecast for 2017 from 3.5 per cent to 3.8 per cent, and it expects a similar growth rate for 2018 as well. This is a significant acceleration compared to the 2 per cent rate in 2016, driven by the renewed inflow of EU transfers and the pre-election demand boost. At the same time, although the Hungarian growth rate is far above the EU average, it is only very modest in the CEE region. The close to 4 per cent GDP growth, the around 3.5 per cent consumption and the 20 per cent and 9 per cent growth rates of investments in 2017 and 2018 are very favourable indicators in themselves; however, they are unsustainable in the Hungarian model without EU transfers. The government will soon have to decide on the revision of its European policy, including its accession to the euro area, providing that it does not want to end up on the EU's periphery, on a disadvantageous economic trajectory leaving to relative decline.

World economy. Although global **economic growth is expected to continue both in 2017 and 2018**, it will be slower than before the crisis. The economic growth rate will be slower than expected formerly in the US in 2017, and somewhat faster in Japan and the euro area as well as in China. Although **risks** associated with geopolitical trouble spots, terrorism and the unpredictable foreign policy of the US president have negative impacts, **they seem to have no tangible influence** on economic trends. The **future of the EU** is mainly shaped by its own modernization, the timing and method of Brexit, as well as the Greek and Italian financial and economic situation. **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 extension of the euro area.** The present trends in the world economy, such as very low interest rates and energy prices, are ending very slowly.

Economic policy. The **main features of the Hungarian model**, such as the loyalty-based central control of institutions and market actors that are theoretically independent of the government and the perceived right to receive EU transfers that are considered entitlements if the set conditions are met have **remained unchanged** for many years. At the same time Hungary's government is trying to become independent from the EU. During the period of 2017-2018, **election considerations** such as wage increases and fiscal easing will influence the shaping of economic policy. The source of this is largely the inflow of EU transfers, and the price to be paid is lagging behind the CEE region. The **decline** of Hungary's **competitiveness** in international rankings continued in 2017. This is illustrated by GKI's calculations according to which the magnitude of **specific government-funded investment subsidies** and the amount of subsidies relative to investments and the number of new jobs envisaged by the beneficiaries have **increased considerably** in recent years. 2017 will hardly be the "Year of Rebellion" in Europe. On the contrary, the deepening of European integration and the extension of the euro area will be on the agenda. In the coming years, these changing external conditions will **challenge the sustainability of the Hungarian model based on EU transfers** and the government cannot avoid important decisions, even in the short term. The adaptation to the changing EU is a **strategic issue for the whole Hungarian political elite** in the coming years, which can mean adopting solutions in line with the rule of law and market economy, or, unfortunately, the opposite of this as well.

Economic expectations. Economic expectations are **very favourable both in the EU and Hungary**. The EU's economic sentiment index reached its 10-year peak in July 2017 and it remained essentially unchanged in August. **After reaching historic peaks in July, GKI's economic sentiment index and**

its business confidence index continued to rise in September. Although consumer expectations deteriorated slightly in September, they still show strong optimism.

Incomes and consumption. In 2017, the 13 per cent increase in gross earnings and the **10-11 per cent increase in real earnings** were primarily caused by the forced minimum wage increase, the pre-election salary increase of employees of the public sector and the labour shortage. **Actual purchasing power**, however, will rise at a slower rate due to the whitening of the economy and the **much slower** growth rate (or stagnation) of other incomes. For the time being, the increase in purchased consumption of households is lagging behind the nearly 5 per cent rate in last year and the final consumption of households is lagging behind even more. The **3.5 per cent increase in consumption** will be lower than last year's 4.2 per cent. The growth rate of gross earnings will slow down to 7 per cent **in 2018**; and as a result of the acceleration of inflation, **real earnings will increase by only 4 per cent**. However, the growth rate of **consumption** will decrease to a lesser extent due to the "smoothing effect", to around **3 per cent**. If the cut in contributions and the raise of the minimum wage were higher than envisaged in the wage agreement, the consumption of households would further increase slightly.

Investments. After the four-year downturn in the wake of the 2008 crisis, gross fixed capital formation grew by nearly 10 per cent per annum in 2013 and 2014 due to the inflow of EU transfers, followed by a sharp slowdown in 2015 and a 15.5 per cent drop in 2016 due to a fall in the inflow of EU funds. **As a result of the resumption of the EU investment cycle in 2017**, a 20 per cent increase in the volume of investments can be expected in 2017 after its 25 per cent increase in the first half of the year. Investments are likely to ascend by 9 per cent in 2018. The **investment rate** was 17.8 per cent in 2016. It may rise to **20.5 per cent** in 2017 and 21.5 per cent in 2018, **still low** compared to Hungary's economic development level.

Real economic trends. The Hungarian economy grew by 4.2 per cent in the first quarter of 2017 and by 3.2 per cent in the second one. In fact, the number of working days of each quarter was different from that of last year. Taking this and other seasonal effects into account, the slowdown was much lower, from 3.8 per cent to 3.6 per cent. Although the 3.7 per cent increase in the first half of the year is **considerably faster than the EU average of 2.3 per cent, it is only better than the rates in Slovakia, Croatia and Bulgaria out of the eleven countries of the CEE regions**. The growth rates of the other countries were around 4 per cent, or even above 5 per cent, as in Slovenia and especially in Romania.

The contribution of **construction to GDP grew extremely fast** in the first half of 2017, and some **slowdown** is likely later due to statistical base effects. (In July, the rate of growth of output was 5 percentage points lower than in the first half of the year.) Public procurement and corporate markets as well as housing are also growing. Construction output is expected to go up by 23 per cent in 2017 and by around 12 per cent next year. Of the major sectors, **industry and trade expanded by 4-5 per cent**. In these latter sectors, **some acceleration** can be expected in the coming months. Industrial growth is supported by favourable world market trends; however, the **technological transformation in the vehicle industry restrains** the activity of the Hungarian members of the global value chain. **The electronics industry has become the engine of economic growth.** The gross production of industry will be around 5.5 per cent both in 2017 and 2018. **Retail trade** sales are expected to increase by 4.5 per cent in 2017 and by 3.5 per cent next year. The **output of agriculture** fell **by 10 per cent** in the first half of 2017 the decline may be even deeper in the second half of the year. Investing in agriculture (for example, irrigation) is still scarce, and the arable crops still dominate the sector. There is no indication of the incentive effects expected from VAT cuts in livestock farming. As a result, agricultural performance will be determined by weather conditions in 2018 as well. The **performance of freight transport** will increase by 4 per cent in 2017 and by 2-3 per cent in 2018, in which the rise in rail transport will play a significant part as the share of road freight will contract due to intensifying competition and stricter foreign regulations. With the spread of online services, the slowdown in the **voice call market** that started three years ago will continue in 2017 as well. **Internet services** will continue to expand dynamically both in 2017 and 2018. Participants of the **real estate market** have been **optimistic** for a long time. Prospects already r**eached their peak** as the GKI **real estate market index declined somewhat in July compared to April**, though it is true that it went up slightly on an annual basis. The performance of the real estate sector is expected to grow by 2 per cent both in 2017 and 2018. Following the construction of 10 thousand new flats in 2016, the building of **15 thousand units can be expected in 2017, and nearly 20 thousand units in 2018**. Exports of **goods and services** increased by almost the same rate as imports in 2016. The growth rate of **imports will exceed that of exports by 1.5 percentage points in 2017** due to the recovery of domestic demand and lower service surplus, and **by 1 percentage point in 2018 due to the slowdown in domestic consumption**. The **terms of trade** will fall by 1 per cent in 2017 and by 0.5 per cent next year. The foreign trade balance will decrease by approximately EUR1bn to EUR7.7bn by 2018, from 8.8 per cent of GDP to 6 per cent, whereas the services balance will remain unchanged or will go slightly down. The core growth (GDP growth without agriculture and public administration) will be 5.5 per cent in 2017 and 4.5 per cent next year.

Employment. The number of employees is expected to increase in most sectors of the national economy in 2017 by a rate similar to that rrecorded in the first half of the year (2 per cent), which is slower than the 2.5 per cent rate in the previous year. Although improving economic activity is favourable for employment, its positive effects are counterweighted by the **gradual reduction of public workfare schemes** and the shortage of labour. Only about 1-1.5 per cent growth can be expected in 2018. The **unemployment rate** will fall to 4 per cent in 2017, and it will be similar in 2018. The real unemployment rate is around 7-8 per cent, and it is only slightly lower than the EU average.

Financial sector. In 2017, not only banks' **corporate loans** but their retail loans started to **increase** as well. The **quality** of the loan portfolio **improved**, primarily as a result of the growing **factoring market**. The profit rate of banks rose to a spectacularly high level, mainly due to the release of previous reserves.

General government, government debt. Although the 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**. **This will likely to be the case in 2018.** This is a significant government success, which is needed, as this is an indispensable condition for safe access to EU transfers. The **drawback** of all this includes an anti-growth tax structure (sectoral and individual taxes, flat personal income taxation), the dangerous degradation of educational and health systems that are vital for the future, and the lack of the transparency of fiscal policy. Consuming the resources of the future (e.g., in terms of expensive prestige investments) continues. The expenditure-replacing and revenue-generating effects of EU transfers and the various creative budgeting solutions (such as converting former private pension fund contributions to steady general government revenue and, more recently, introducing growth tax credits) played a major role in the improvement of the balance. Similarly to the handling of the reduction of households' overheads, **the government 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. As a result of these methods, although a further rise in spending, and thus in the deficit can be expected in many areas before the elections, the accrual-based (ESA) **deficit may remain below 3 per cent of GDP (2.5 per cent in 2017 and around 2.8 per cent in 2018), the government debt relative to GDP will decline by 0.5–1 percentage points per annum, from 74.1 per cent in 2016 to around 73 per cent in 2017**. However, the increase in the general government deficit relative to GDP is unfavourable in times of accelerating economic growth since it leads to the **deterioration of the structural balance** that endanger the permanent decrease of the government debt. The widespread domestic advancement of EU transfers in the event of any hiccups in the inflow of EU transfers could **jeopardize** the reduction of public debt, due to an increase in the cash-flow deficit. If, according to Eurostat's decision, the Hungarian Central Statistical Office is forced to include **Eximbank** in the general government, the government debt relative to GDP would increase by 1.5 to 2 percentage points in all years concerned; however it would not substantially change the trend of the decrease.

Inflation, interest rates, exchange rates. Price levels were practically unchanged from 2014 to 2016. They started to rise in September 2016, and the **inflation rate is expected to be 2.5 per cent in 2017 and around 3 per cent in 2018**. The main risk factor is the cost and demand increasing effect of global energy prices and the rapid rise in wages--so far barely visible in statistical figures. The **base interest rate of the National Bank of Hungary** is expected to remain at the current 0.9 per cent until the end of 2018. The forint is likely to strengthen in 2017 and it will remain unchanged next year (the EUR/HUF exchange rate will be HUF308). The **real interest rate** on savings is typically negative.

External equilibria. Hungary's **combined current and capital account** was **in surplus** in almost every year between 2009 and 2015, and it reached its peak of EUR8.9 billion in 2015. Despite the outstanding improvement in the foreign trade balance in 2016, it decreased to EUR7bn due to the contraction of the inflow of EU transfers. In spite of some decline in the foreign trade surplus, the **external financing capacity may increase to EUR7.5bn in 2017 and EUR8.3bn in 2018** as a result of the restart of EU transfers, amounting to 6.2 per cent and 6.4 per cent of GDP, respectively. Net inflows of **FDI received a boost in 2016** (EUR1.9bn according to the figures of the National Bank of Hungary), and this will hardly be achievable in 2017 and 2018. The foreign direct investment stock in Hungary has risen by **only EUR1.5bn since the beginning of 2008**.

The forecast of GKI for 2017-2018

	2014	2015	2016	2017	2018
		fact		forecast	
GDP	104.0	103.1	102	**103.8**	**103.8**
• Agriculture (1)	117.0	94.9	116.8	**90**	**105**
• Industry (2)	105.9	108.2	100.8	**105**	**105**
• Construction (3)	110.5	101.5	82.1	**123**	**112**
• Trade (4)	104.1	104.6	106	**106**	**105**
• Transport and storage (5)	101.8	101.4	102.5	**103**	**103**
• Information, communications (6)	104.0	101.6	103.7	**104**	**104**
• Financial services (7)	97.0	100.2	98.9	**101**	**102**
• Real estate services (8)	100.0	102.0	101.2	**102**	**102**
• Professional, scientific, technical activities (9)	105.4	102.9	106.3	**106**	**104**
• Public administration, education, healthcare (10)	100.6	99.9	101.3	**100.5**	**101**
• Arts, entertainment (11)	107.0	98.9	101.4	**102**	**102**
• Core growth (2)+(3)+(4)+(5)+(6)+(7)+(8)+(9)	104.2	104.5	101.5	**105.5**	**104.5**
GDP domestic demand	104.6	101.4	101.5	**105**	**104.5**
• Private consumption	102.1	103.1	104.2	**103.5**	**103**
• Gross fixed capital formation (investments)	109.9	101.9	84.5	**120**	**109**
Foreign trade in goods					
• Exports	106.9	107.8	104.4	**106.5**	**106**
• Imports	108.8	106.3	104.9	**108**	**107**
Consumer price index (preceding year = 100)	99.8	99.9	100.4	**102.5**	**103**
Balance of current and capital account					
• EUR billion	5.5	8.9	7.0	**7.5**	**8.3**
• In per cent of GDP	5.2	8.1	6.2	**6.2**	**6.4**
Unemployment rate (annual average)	7.7	6.8	5.1	**4.2**	**4**
General government balance in per cent of GDP (ESA)	-2.1	-1.6	-1.9	**-2.5**	**-2.9**

Source: HCSO, **GKI**

The projections of **GKI** for 2017 are included in Annex 9.