Forecasts for 2018-2019

(25 September 2018)

The Hungarian economy grew by 4.8 per cent in the second quarter of 2018, and such quarterly rate has been unprecedented since 2005. The Hungarian GDP growth rate according to the EU methodology is double the EU average, one of the fastest in the CEE region. This is the zenith; the growth rate will slow down. The rate of increase in investments financed by pre-payments of EU transfers and in household consumption, boosted by the elections as well, is expected to slow down during the rest of the year. In addition, a slight deterioration is expected in external demand as well. Based on the better than expected figures of the second quarter, GKI raised its GDP forecast for 2018 to 4.2 per cent from 4 per cent and its investment forecast to 12 per cent from 9 per cent. However, it expects a marked slowdown in 2019, a growth rate of around 3.2 per cent. External equilibrium is likely to remain very favourable in 2019, inflation is expected to accelerate, and fiscal and monetary policy tighten only slowly. Possible corrections of economic policy will hardly affect the substance of the one-centred Hungarian political model.

World economy. The growth rate of the world economy will **somewhat accelerate** in 2018 and 2019 compared to 2017, albeit with slightly increasing geographical differentiation and increasing risks. The **slight slowdown in industrialized countries** will be offset by the acceleration of emerging and developing countries. One of the major global risks is the unpredictable policy of the American president, the spread of protectionism resulting in the escalation of a **trade war**. Financially, the rippling effects of further **interest rate hikes** promised by the Fed; correction of overvalued stock markets; the contagious impacts of the Turkish and Argentine financial crises and the potential deterioration of the Italian banking system can cause significant problems. **Geopolitical tensions** still exist (Iran, Ukraine, North Korea, etc.).

The situation in the EU. The shape of the eventual Brexit is still unclear in the EU. Sources of significant uncertainty include the presence of anti-EU populist forces and the **many divisions** hindering integration, such as those related to North-South, West-East, deeper cooperation, EU scepticism, populism or migration. **Conflicts may sharpen** significantly in the European parliamentary elections regarding the new leaders of the EU institutions. The constructive cooperation of the 27 EU member states remaining after Brexit seems to be difficult on the approval of the **new budget**, or the acceptance of a **common stance on global economic or political issues**. Political tensions make it even more difficult to create a compromise between the interests that are already very different, for example, between net contributors and net beneficiaries, or those who wish to preserve the EU's unity and values and those emphasizing the paramount importance of national interests. This weakens the unity of the EU and may adversely affect business confidence.

Hungary in the EU. As a result of the European Parliament's approval of the Sargentini report on the state of affairs concerning the rule of law in Hungary by more than two-thirds majority, the European Council has to discuss the launch of the rule of law process. **Hungary has become politically isolated.** The possibility of a combined discussion of the Polish and the Hungarian cases has also been raised. The majority of the members of the European Commission think that after 2021 disbursements from the cohesion funds should be made dependent on the situation of the rule of law in the countries concerned, and that the necessary voting majority can be created to accept it. According to some member states, the status of the rule of law should be reviewed regularly by an independent institute for all countries. In this situation the **rational** behaviour of the Hungarian government would be the **adjustment** to the most important expectations. Rigid denial could have serious economic and political consequences such as risking the inflow of EU transfers, eroding relations with EU leaders, and deteriorating the country's general assessment by other countries further.

Economic expectations. The **EU's economic sentiment index** reached its peak of more than a decade at the beginning of 2018. Since then it has been mildly but almost constantly deteriorating. This **deterioration stopped in August**. After reaching its **historic peak** in July, in August the **GKI** **economic sentiment index** fell to its **lowest point** this year and continued to decline in September. Although business expectations deteriorated further, consumer ones improved. Overall, **GKI**'s economic sentiment index remains **optimistic**.

Economic policy. In addition to the emphasis on economic policy **successes**, such as a significant increase in consumption and employment, **several new elements** have recently been added to the government's economic policy rhetoric. The new convergence programme, published in April after the 2018 parliamentary elections, still envisaged **forced** economic growth of at least 4 per cent per annum (higher than previously thought) up to 2022. However, since the debate on the 2019 budget in June, by referring to a possible global economic crisis, the necessity of a **"massive and earthquake-proof" budget** has been emphasized. The only problem with this is that **the main figures of the budget continue to be consistent with the growth-oriented appropriations of the convergence programme**. In practice, therefore, the necessary changes will be made by **low-profile fiscal adjustments** in order to keep the government deficit near the promised one even at the expense of growth, which is certainly a **new element** in comparison to recent years. For the time being, the **180 points reform proposal of the National Bank of Hungary does not constitute a real turning point** since only a part of the facts were taken into account, and the examination of the reasons leading to the present situation, which would be essential to determine therapy, and the analysis of the real functioning of the Hungarian model were missing.

Household consumption. The **growth rate of real earnings** is expected to be very fast in 2018, though less than its two-digit increase last year: **around 8 per cent**. It will drop to less than half of the rate this year **in 2019** mainly due to the slowdown in the growth rate of the minimum wage. Although the minimum wage exerts a smaller impact on earnings, labour shortages still have significant effects on them. Consumption has been expanding for the sixth consecutive year and it is expected to reach its peak in 2018 by 4.5 per cent (final household consumption by 5.5 per cent). It will decrease by about 1 percentage point in 2019.

Investments. Gross fixed capital formation exceeded pre-crisis levels in 2017. Investments of the **private sector** grew by only 7 per cent in the first half of 2018 in spite of the fact that in the current EU financial framework Hungary allocates more than half of the EU transfers to the private sector. Meanwhile, investments in the **public sector** went up spectacularly and the volume of investment projects increased by 50 per cent. Owing to the high statistical base a sharp slowdown can be expected in the second half of the year. A **12 per cent** volume growth is likely in 2018 following last year's 17 per cent. The slowdown continues in 2019, and a **5 per cent** increase can be projected. For a significant part of large EU-funded projects the actual realization is quite slow, thus real spending will hardly reach the planned 100 per cent by 2020. The investment rate will rise to 23 per cent in 2018 after 21.5 per cent in 2017, reaching its pre-crisis levels. 23.5 per cent can be expected in 2019. This will be mainly due to investment projects in the public sector, largely based on EU transfers.

Real economic trends. From 4.9 per cent in the fourth quarter of 2017, Hungary's GDP growth rate decreased slightly to 4.7 per cent in the first quarter of 2018 and to 4.6 per cent in the second one. **Only the Polish and probably the Slovenian** growth rates were faster than this **in the CEE region**. According to market forecasts this ranking probably remains unchanged during the year. However, the Hungarian GDP growth rate of around 3.2 per cent in 2019 will be **among the weakest** in the CEE region. **Domestic consumption** will exceed GDP growth in both years, and with the exception of industry, growth rates of all sectors are expected to decline in 2019. Construction is expected to expand the fastest, followed by trade and info-communications. Following demand trends in Europe, **industrial** growth will slow down. Gross production grew by 4.8 per cent in 2017, and is expected to increase only by 3.5 per cent in 2018, and by 3.5-4 per cent in 2019. Domestic sales will grow faster in 2018 than exports, as a consequence of structural problems in the European automotive industry and the expansion of demand due to the rise in domestic construction investments. The latter's sustainability is questionable. **Construction** continued to increase dynamically in the first seven months of 2018, growing by 22 per cent on an annual basis after a rate of nearly 30 per cent in 2017. The sector's contract portfolio is high, and the expectations of construction companies reflect strong optimism. The rate of growth is expected to reach 17 per cent in 2018 and 5 per cent in 2019. Agricultural

GDP is predicted to be about 5 per cent higher in 2018 than last year. GDP in **services** will grow by about 4 per cent in 2018 and by 2.8 per cent in 2019, below the national average in both years. Growth can only be expected in **market services**. **Retail sales** will increase by around 6.5 per cent in 2018 and by about 4 per cent next year. In **tourism**, the number of overnight stays will increase by about 6 per cent in both years, and after a long time, in 2018 the number of domestic guest nights will again be higher than that of foreign guest nights. In the fast-growing **telecommunications** market, structural changes between companies can be expected in 2019. Freight transport performance will decline by 5 per cent in 2018 due to the contraction in international freight transport, whereas in 2019 substantial reduction can only be expected in road transport. Optimism is still very high on the **real estate market**, and **GKI**'s Budapest and national real estate market indices grew slightly on a quarterly basis in July, and both indicators reached their **historic peaks**. As the growth rate of **domestic consumption** exceeds that of GDP in 2018 and 2019 to a lesser extent than in 2017, the **import-export gap will drop to about 1 percentage point**. Within this, the gap in foreign trade of goods will be wider. After 2017, the surplus of foreign trade turnover will also decrease in 2018 and 2019 (from EUR9.7bn in 2016 to EUR8.1bn in 2017, EUR7bn in 2018 and EUR6bn in 2019), whereas that of services will continue to rise. The **terms of trade** deteriorated by 0.4 per cent in 2017 and by 0.2 per cent in the first half of 2018. The terms of trade are expected to decline similarly during the year, and they will be basically unchanged in 2019.

Employment. The growth rate of the number of employees will slow down both in 2018 and 2019, reaching 1 per cent in 2018 and 0.5 per cent in 2019. The number of employees will be reduced in the public sphere. Although economic activity is favourable for employment, its positive effects are counterweighted by the gradual reduction of **public workfare schemes** and the permanent shortage of labour. There are still considerable **structural tensions** between labour demand and supply. The annual average **unemployment rate** will fall close to 3.5 per cent in 2018, and it will be similar in 2019 as well. The real rate of unemployment (if those participating in public workfare schemes are included) is around the EU average.

Financial sector. The corporate **loan portfolio** has been **increasing** since 2016 and the retail loan portfolio since 2017. The expansion will continue in 2018 and 2019, and it is likely to reach its peak this year. The **interest rate margin** applied by banks was at its ten-year high in 2015, since then it has declined consistently. However, it started to widen over the past few months partly due to the rise in fixed interest rate housing loans. The **loan portfolio, profitability and capital adequacy ratio of banks are favourable**. However, the **interdependence** of government and 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. The general government deficit will be **below 3 per cent of GDP in 2018 for the sixth consecutive year**. However, the Hungarian **deficit** is **one of the highest** in the EU and the structural deficit is above 3 per cent. As a result of widespread budgetary advance payments of EU transfers and certain budgetary programs justified by election considerations, the **cash-flow deficit** exceeded the target amount by about 70 per cent last year, and in the first seven months of 2018 it surpassed the target amount for the whole year by 10 per cent. Taking into account the EU's warning as well, there will be no major spending in December 2018, and **GKI** predicts a slightly smaller than the planned 2.4 per cent ESA deficit relative to GDP, **around 2.2 per cent** (which is somewhat above its 2017 level). At the same time, due to the huge cash-flow deficit and the weakness of the forint, the government debt will decrease only **slightly** more than expected by the EU (about 0.7 percentage points), reaching about 73.5 per cent of GDP. As **the 2019 budget** is based on overoptimistic assumptions, **further adjustments** are likely during the year. **The general government deficit can be expected to total some 2 per cent of GDP (exceeding the planned 1.8 per cent).** The government predicts a 3.6 percentage point decline in government debt by 2019. This might be supported by the expected shrinking deficit, and hindered by the probably lower than expected GDP and the weak forint. **GKI**, similarly to the EU, forecasts a 2-2.5 percentage point decrease in 2019, that is, a rate of around 71-71.5 per cent.

Inflation, interest rates, exchange rates. Inflation will **accelerate** in 2018 and 2019, and it is expected to be around 3.5 per cent at the end of 2018, resulting in an **average annual rate of 3 per cent**. Although the average price increase will reach 3.5 per cent in 2019, no significant acceleration can be anticipated during the year. However, the rise in the price level **may be higher** if oil prices in the world market continue to go up, wage inflation intensifies, and the tightening of monetary policy is delayed. The National Bank of Hungary will presumably be forced to **move the interest rate corridor upwards** for the first time at the turn of 2018 and 2019, and later **raise its reference rate** during 2019. The reference rate remains unchanged at 0.9 per cent at the end of 2018, and it might mount to 1.5 per cent at the end of 2019, whereas the exchange rate will continue to **weaken**, with an annual average of HUF320 following a rate of HUF309 last year. The exchange rate of the euro to the forint may reach HUF325–HUF330 in 2019.

External equilibria. After its huge surplus of EUR6.9bn in 2016, the **current account** surplus dropped to EUR3.9bn in 2017 due to a fall in the foreign trade surplus. It is expected to shrink further to EUR2.5bn in 2018 and to EUR2bn in 2019. Although the **external financing capacity** was down from EUR6.8bn in 2016 to EUR5.1bn in 2017, it is expected to rise to EUR6bn in 2018 and to EUR6.5bn in 2019 **as a result of the resumption of EU transfers** (4.7 per cent and 4.9 per cent of GDP). Hungary's net financing capacity remains significantly above the EU average and it is one of the highest in the CEE region. **Net inflows of FDI** were EUR2.4bn in 2016 and EUR1.7bn in 2017. Similar amounts can be expected in 2018 and 2019. Net FDI dropped from 50 per cent of GDP before the crisis to around 43 per cent in 2017. This is expected to stagnate.

Risks of the forecasts. GKI raised its GDP growth forecast **for 2018** from 4 per cent to 4.2 per cent, and a **slightly higher growth rate is more likely** than a lower one. However, a **lower** than 3.2 per cent rate predicted for **2019** is more likely than a higher one. The **inflation** prognosis remained unchanged. Although earlier a rate lower than 3 per cent appeared more likely, now the chances of two-way deviations became **more or less identical** due to, among others, the weakening of the forint. GKI expects 3.5 per cent inflation rate in 2019 that may be even **higher** if **oil prices** in the world market continue to rise, **wage inflation** intensifies, and central bank tightening is **delayed**.

The forecast of GKI for 2018 and 2019

	2014	2015	2016	2017	2018	2019
	fact				forecast	
GDP	104.2	103.4	102.2	104.0	**104.2**	**103.2**
• Agriculture (1)	117.4	95.9	109.9	91.0	**105**	**100**
• Industry (2)	105.8	108.1	101.0	103.9	**103**	**103.5**
• Construction (3)	110.7	102.5	89.5	131.6	**115**	**105**
• Trade (4)	103.8	104.2	101.2	106.2	**107**	**104**
• Transport and storage (5)	102.7	101.3	105.5	104.5	**104**	**103**
• Information, communications (6)	104.4	101.3	105.7	106.1	**107**	**105**
• Financial services (7)	96.7	101.5	100.4	100.7	**102**	**102**
• Real estate services (8)	101.8	100.0	103.1	102.3	**104**	**102.5**
• Professional, scientific, technical activities (9)	105.5	102.8	107.5	107.2	**106**	**104**
• Public administration, education, healthcare (10)	101.0	100.2	101.7	98.7	**100**	**101**
• Arts, entertainment (11)	106.0	100.8	102.9	105.0	**105**	**102**
• Core growth (2)+(3)+(4)+(5)+(6)+(7)+(8)+(9)	104.4	104.6	102.1	105.9	**105**	**103.7**
GDP domestic demand	105.5	101.2	101.6	106.0	**105**	**104**
• Private consumption	102.4	103.4	103.8	104.1	**104.5**	**103.5**
• Gross fixed capital formation	112.3	101.9	89.4	116.8	**112**	**105**
Foreign trade in goods						
• Exports	109.1	108.5	103.4	107.1	**105**	**105**
• Imports	111.0	106.4	102.9	109.7	**106**	**106**
Consumer price index (preceding year = 100)	99.8	99.9	100.4	102.4	**103**	**103.5**
Balance of current and capital account						
• EUR billion	5.5	9.0	6.8	5.1	**6**	**6.5**
• In per cent of GDP	5.2	8.2	6.0	4.1	**4.7**	**5**
Unemployment rate (annual average)	7.7	6.8	5.1	4.2	**3.5**	**3.5**
General government balance in per cent of GDP (ESA)	-2.6	-1.9	-1.7	-2.0	**-2.2**	**-2**

Source: HCSO, GKI