The detailed forecast of GKI Economic Research Co. for 2018 and 2019

The Hungarian economy grew faster than expected, by 4.9 per cent in the third quarter of 2018, and such quarterly rate has been unprecedented for thirteen years. The Hungarian GDP growth rate according to the EU methodology was more than double the EU average in the first three quarters of 2018, one of the fastest in the CEE region. This is certainly 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 last quarter of 2018 and especially in 2019. In addition, a deterioration is expected in external demand as well. Based on data reviewed by the Hungarian Central Statistical Office (HCSO) and the better than expected figures of the third quarter, GKI raised its GDP forecast for 2018 from 4.2 per cent to 4.6 per cent, its investment forecast from 12 per cent to 15 per cent and its consumption forecast from 4.5 per cent to 5 per cent. The 2019 forecast remains unchanged: GKI expects a marked slowdown, a GDP growth rate of only about 3.2 per cent. The growth rate of domestic demand will exceed that of GDP in both years, and the growth rates of almost all sectors are expected to decline in 2019. Construction, info-communications and trade are expected to expand fastest. Inflation is accelerating in 2018, and external and internal equilibria are deteriorating. In this regard, no change can be expected in 2019 either. Fiscal and monetary policy is tightening only slowly. Corrections of economic policy will hardly affect the substance of the one-centred Hungarian political model.

World economy. Global economic growth peaked in 2018. There will be a slight but greater than expected deceleration in 2019, and uncertainty can be expected to increase. Global risks include the unpredictable policy of the US president, the resulting spread of **protectionism** and escalation of a trade war. However, the latter eased somewhat in December. Unpredictability in 2019 may be somewhat counterbalanced by the Democratic majority in the US House of Representatives. **Financial problems**, especially in indebted emerging countries may emerge as a result of the rippling effects of further interest rate hikes envisaged by the **Fed**; correction of overvalued stock markets; the possibility of the Italian financial situation turning into a crisis; or the contagious impacts of the Turkish, Argentine and Venezuelan financial crises. **Geopolitical tensions** still exist (Iran, Ukraine, North Korea, etc.). As the European Parliament elections approach, political struggle is intensifying **in the EU**, boosted by strengthening anti-EU populist forces. Merkel's gradual departure and Macron's weakening increase uncertainty. The **Italian** government's economic policy is especially **dangerous** as it may cause the eventual collapse of the banking system and government debt crisis. There is still great uncertainty about the exit of the United Kingdom from the EU. Integration is hindered by a wide variety of **divisions** such as those related to North-South, West-East, deeper cooperation, EU scepticism or even migration. Uncertainty surrounding the constructive cooperation of the 27 EU member states remains after Brexit regarding the approval of the new budget, or the acceptance of a common stance on global economic issues. Political risks add to economic difficulties.

Economic expectations. The **slow erosion of the EU's economic sentiment index** continued in November, and it reached its lowest point in the past one and a half years. The German business confidence index declined further in November, it was so low last time a year and a half ago. **GKI's economic sentiment index remained essentially unchanged in November.** The business confidence index is at around its 2018 average now. Although the consumer confidence index is close to its lowest point this year, it continues to reflect optimism. **According to the OTP-GKI 2018 autumn agricultural survey**, agricultural businesses are cautiously optimistic regarding the next six months. **GKI**'s Budapest and national **real estate market indices** rose to another **historic peak** in October.

Economic policy. As the global economy as a whole, the Hungarian economy is also in a more stable financial position than before the 2008 global economic crisis. However, risks are rising. After a nearly decade-long recovery, the possibility of a sharp downturn or recession is increasing. However, the Hungarian economic policy is **prepared** for this **only ostensibly** because **both fiscal and monetary policy are procyclical**. This year's rapid growth took place in spite of the "Hungarian model", primarily as a result of EU transfers (and their budgetary advance payment). The accelerating effects of these factors will be significantly reduced in 2019. The government rightly sees the way out in improving **competitiveness**. However, it can only make little difference if the anti-competitive, **state-centred, loyalty-based Hungarian model is left untouched**. In addition, in 2018 **government control became extremely intense** in jurisdiction, science, higher education and the media. **Hungary became politically isolated** in the EU. The rigid, **confrontational** Hungarian position is quite **risky**. Although in the 2019 elections to the European Parliament the **populist forces are expected to gain ground, the winners will certainly be the centrist parties**, and taking into account that the adoption of a common European budget is equally in the interest of Hungary and the Western European countries, the Hungarian opposition does not bode well (for example, regarding the enforcement of the rule of law). It cannot be expected from the populist parties of net contributor countries to support the expansion of cohesion funds.

Consumption. Real earnings are expected to grow by about 8.5 per cent in 2018, which is still very high, though less than the two-digit increase of last year. They will **decelerate to around 5.5 per cent in 2019**. A minimum wage increase similar to this year will also exert pressure on earnings in 2019. Although the wage increasing effects of labour shortages are also significant, requirements of competitiveness have already restrained wage increases in many companies. Wage rises in the public sector are slowing down to the level registered in the competitive sphere. **Consumption has been expanding** for the sixth consecutive year and it is expected to **reach its peak in 2018** by 5 per cent. It will grow by around 3.5 per cent in 2019. The net financing capacity of households will rise slightly.

Investments. Gross fixed capital formation exceeded pre-crisis levels in 2017. Following last year's 18.2 per cent increase in volume terms, a 15 per cent growth can be expected in 2018, and "only" 5 per cent is likely in 2019. The **investment rate** was 19.6 per cent of GDP in 2016, and it increased to 22.2 per cent in 2017. It will rise close to 24.5 per cent in 2018, exceeding its pre-crisis level. 25 per cent can be expected in 2019. This will be mainly due to investment projects in the **public sector**, largely based on EU transfers, whereas **business investments are well below the average**.

Real economic trends. The rate of Hungary's GDP growth according to the EU methodology was **5.2 per cent** in the third quarter of 2018, **higher than ever before**. Of the EU member states only Malta's, Poland's and Latvia's growth rates were higher than the Hungarian one. According to forecasts, this ranking probably remains unchanged during the year. However, Hungary's GDP growth rate of 3-3.5 per cent in 2019 will be **among the weakest in the CEE region**. GDP increased by 4.8 per cent in the first three quarters of 2018, whereas **domestic consumption** expanded significantly faster, by 6 per cent. GKI expects a similar difference throughout the year, thus imports will continue to increase by about 1.5 percentage points faster than exports. However, this is only half of the difference measured a year ago. Domestic consumption in 2019 will be only 0.5-1 percentage points higher than the growth rate of GDP, and the gap between imports and exports will be narrower by 0.5 percentage points due to slower growth in domestic consumption. Accordingly, the **foreign trade surplus** will decrease in both years; however, it still **remains high**. The **core growth** rate, i.e., the growth rate of GDP excluding agricultural and public services, will be higher in both years (by 1 and 0.5 percentage points) than that of total GDP as the public sector is expected to stagnate in 2018 and it will grow only slightly next year. In addition, the growth rate of agriculture will be below the average.

Industrial growth will slow down in 2018 and 2019, mainly due to the weakening of the automobile industry in Europe, including Germany. Presently, the main **driving force** of Hungarian industrial growth is **domestic sales** rather than exports. Industrial expectations are slightly worse now than in the first half of 2018. Industrial production is expected to increase by 3.5 per cent in 2018 and by around 3 per cent in 2019. **Construction** continues to **soar** in 2018 as well. Although the sector's contract portfolio is high, there are some unfavourable signs in structural engineering. The expectations of construction companies rose to a historic peak. **Construc-**

tion output may grow by at least 22 per cent in 2018 and by 5 per cent in 2019. Agriculture was less successful at the beginning of 2018 due to **two droughty periods**. The underdevelopment of the irrigation system causes problems not only in the general absence of rainfall but also in the event of rainfall in unsuitable periods. GDP in agriculture will **grow by about 2 per cent** in 2018. It is expected to stagnate in 2019, though significant variations upwards or downwards may occur depending on the weather. The growth rate of real income **in 2018** will slightly decrease compared to the previous year. However, consumers **"smooth out"** their purchases, thus the growth rate of **retail sales** will rise from 5.3 per cent in 2017 to **around 6.5 per cent** in 2018. The growth rate of real income will continue to decline **in 2019**, causing retail sales to increase slower as well, by 4 per cent. After 2017, the **surplus of foreign trade turnover** will also **decrease** in 2018 and 2019 (from EUR8.1bn in 2017 to EUR6.5bn 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 0.7 per cent in the first three quarters of 2018. The terms of trade are expected to decline by about 0.5 per cent during the year, and they will be basically unchanged in 2019.

Employment. The number of employees will increase by 1 per cent in 2018 and by no more than 0.5 per cent in 2019, with a significant shortage of labour. The decline in the **unemployment** rate stopped in summer compared to previous months. However, it is still declining on an annual basis, to 3.7 per cent in 2018 and to 3.6 per cent in 2019. The slow decline in the number of those involved in **public workfare schemes** started in 2017 will continue. **Productivity** measured by output per employees and GDP per employee rose by 3.5 per cent in 2018 and by 2.7 per cent in 2019, representing an **improvement** over previous years.

Financial sector. The corporate **loan portfolio** has been **increasing** since 2016 and the retail loan portfolio since 2017. The latter jumped unprecedentedly in the third quarter of 2018 compared to the previous one. Although their growth is expected to reach its peak in 2018, it will also continue in 2019. After a three-year decline, the **interest rate margin** applied by banks 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**.

Internal and external equilibria. The accrual-based 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; it is moving away from the medium-term goal; and the structural deficit is above 3 per cent. Although the accrual-based general government deficit was only 0.4 per cent of GDP in the first three quarters of 2018 and tax revenues are very favourable, the annual **cash-flow deficit** may be HUF500bn higher than expected (around HUF1,900bn). This is primarily the consequence of the **domestic prepayments of EU transfers**, which limits the possible reduction of the debt-to-GDP ratio. In 2018, due to, among others, the EU's call for deficit reduction, the general government deficit will be slightly below the planned 2.3 per cent of GDP, **around 2.2 per cent.** However, in 2019, due to a marked slowdown in the economy, the deficit relative to GDP is expected to slightly exceed the planned 1.7 per cent, reaching **around 2 per cent**. The **government debt ratio**, even with the application of some "creative" methods, will decrease only minimally, to 73 per cent after last year's 73.3 per cent. However, in 2019 the rate may reach 71 per cent, mainly due to the significantly lower cash-flow deficit. The huge surplus of the **current account** has been declining steadily and spectacularly since 2016 as a result of the rapid increase in domestic consumption, by about 4.5 percentage points of GDP till 2019. **External financing capacity** reached its peak of EUR8.3bn in 2015 and it decreased to EUR5.1bn in 2017. It remains stagnant in 2018, around 4 per cent of GDP, and as a result of rising EU transfers it will slightly rise in 2019, to 4.5-5 per cent. The improvement in Hungary's **credit rating** did not continue in 2018.

Inflation, interest rates, exchange rates. Inflation has **accelerated** for more than two years since September 2016. It was 2.4 per cent in 2017 y-o-y, and after an average of 2.8 per cent in the first ten months of 2018 it rose to 3.8 per cent in October. In November, however, the increase of the price index was only 3.1 per cent due to the fall in oil prices. The factors contributing to inflation include increasing demand, rising wage costs, growing oil prices on the world market and the weakening of the forint. **Inflation will be 2.9 per cent in 2018**

and 3.5 per cent in 2019. The interest rate corridor of the National Bank of Hungary is expected to be moved upwards at the end of 2018 or at the beginning of 2019, and the **base rate** is expected to be raised in the summer of 2019, **following the ECB's interest rate hike**. **The base rate may be around 1-1.5 per cent at the end of 2019. The exchange rate of the forint to the euro is expected to be HUF320 in 2018 and HUF325-HUF330 in 2019.**

Risks of the forecasts. GKI **raised** its GDP growth forecast for 2018 from 4.2 per cent to 4.6 per cent, and a slightly **higher growth rate is more likely** than a lower one. This is the case with investments as well. The 3.2 per cent growth rate projected for 2019 remains unchanged. The growth rate may be lower due to the higher than previously assumed statistical base and the weakening driving forces of economic growth. However, the carry-over effects and the forcing of economic growth may outweigh this. The **inflation forecast** has not changed and the exact figure is expected to be 2.9 per cent in 2018. GKI projects 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, with a resulting significant weakening of the forint. From the point of view of Hungary's growth trajectory, **the future of its relations to the EU poses the biggest risk**. The deceleration of global recovery and **insisting on the Hungarian model** may also undermine the possibility of medium-term growth.

The forecast of GKI for 2018 and 2019

	2014	2015	2016	2017	2018	2019	
	fact				estimate	September	December
GDP	104.2	103.5	102.3	104.1	**104.6**	103.2	**103.2**
Agriculture (1)	117.4	96.7	113.2	91.9	**102**	100	**100**
Industry (2)	105.8	109.0	101.0	103.4	**103**	103.5	**103**
Construction (3)	110.7	102.5	89.7	117.0	**122**	105	**105**
Trade (4)	103.9	104.8	100.8	108.1	**108**	104	**104**
Transport and storage (5)	102.0	101.1	105.0	103.4	**105**	103	**103**
Information, communications (6)	104.4	101.7	105.8	111.0	**107**	105	**105**
Financial services (7)	96.2	99.7	104.0	104.1	**102.5**	102	**102**
Real estate services (8)	101.9	100.1	103.2	102.7	**104**	102.5	**103**
Professional, scientific, technical activities (9)	105.7	104.0	106.5	110.9	**106**	104	**104**
Public administration, education, healthcare (10)	101.1	100.7	101.5	98.6	**100**	101	**101**
Arts, entertainment (11)	106.0	100.2	102.7	103.3	**107**	102	**102**
• Core growth (2)+(3)+(4)+(5)+(6)+(7)+(8)+(9)	104.4	104.7	102.0	106.2	**105.8**	103.7	**103.5**
GDP domestic demand	105.4	102.1	101.0	106.8	**106**	104	**104**
• Private consumption	102.4	103.7	103.4	104.1	**105**	103.5	**103.5**
• Gross fixed capital formation (investments)	112.3	101.9	89.4	116.8	**115**	105	**105**
Foreign trade in goods							
• Exports	109.1	107.2	105.1	104.7	**104**	105	**105**
• Imports	111.0	105.8	103.9	107.7	**105.5**	106	**106**
Consumer price index (preceding year = 100)	99.8	99.9	100.4	102.4	**102.9**	103.5	**103.5**
Balance of current and capital account							
• EUR billion	5.5	8.3	7.0	5.1	**5**	6.5	**6.5**
• In per cent of GDP	5.2	7.6	6.1	4.1	**3.8**	5	**4.8**
Unemployment rate (annual average)	7.7	6.8	5.1	4.2	**3.7**	3.5	**3.6**
General government balance in per cent of GDP (ESA)	-2.6	-1.9	-1.6	-2.2	**-2.2**	-2	**-2**

Source: HCSO, **GKI**