



## Forecast of GKI for 2019 (27 March 2019)

Hungary's GDP expanded by 5.1 per cent in the second half of 2018 year-on-year and by 4.9 per cent in 2018. This high growth rate has been unprecedented for 15 years. Due to the higher than formerly expected GDP growth rate and the stimulation measures of the government such as the family protection action plan, GKI raised its forecast for 2019 to 3.5 per cent in spite of deteriorating global projections. GDP growth has been driven by domestic demand for three consecutive years whereas the contribution of EU transfers to the acceleration of economic growth has moderated significantly. Inflation is picking up, and the pro-cyclical nature of Hungary's economic policy is easing rather than disappearing. The corrections of economic policy do not touch the substance of the Hungarian model.

**World economy.** The cyclical recovery peaked in 2018. In 2019, the slowdown is likely to be sharper than expected with **intensifying uncertainties**. Global risks include the US president's unpredictable policy, the spread of protectionism, the escalation of trade wars and in part as a consequence of these factors, the stronger than expected slowdown of China's GDP growth. Unpredictability will be neutralized to some extent by the fact that Democrats won majority last November in the interim elections to the House of Representatives of the US. The Fed does not envisage rate rises this year. Financial tensions may arise with a possible crisis in Italy, and the spillovers of the Turkish, Argentine and Venezuelan financial turbulence may lead to problems in the most indebted emerging and developing countries. Geopolitical tensions around Iran, Ukraine, North Korea, etc. must not be neglected either from among the global risk factors. As far as **the EU** is concerned, with the elections to the European Parliament approaching, political uncertainty is intensifying, reiterated by strengthening anti-EU populist forces. The economic policy of the Italian government is particularly dangerous since it could lead to serious difficulties of the banking system and trigger a government debt crisis. There is still great uncertainty about the exit of the United Kingdom from the EU. European 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 common budget, or the acceptance of a common stance on global economic issues. Political risks add to economic ones and they intensify each other.

**Economic expectations.** In February, the EU's economic sentiment index dropped to a **three-year low level**. Hungarian expectations are much more upbeat. Following its historic peak last year, **GKI's economic sentiment index** has been **declining** continuously, albeit gradually **in the first three months of 2019**. Regarding business expectations, only the trade confidence index increased somewhat. Following the deterioration in January and the corrections in February and March, consumer expectations reached their level recorded in last October.

**Economic policy.** Rapid GDP growth in 2018 was attributed to the impact of pre-paid EU transfers despite the inherent limits of the Hungarian model. Nevertheless, the dynamizing role of EU funds is likely to weaken markedly this year. Similarly to the whole world economy, the Hungarian economy, too, is in a more stable financial situation than before the global crisis in 2008, although risks are on the rise. Almost everybody expects deceleration in the world economy, and a recession cannot be completely excluded either. Hungarian economic policy decision makers have prepared for the global slowdown only in words, **fiscal and monetary policy has remained pro-cyclical**. In terms of the general government, the family protection action plan is considered a package stimulating consumption with an adverse impact on external and internal disequilibria. In monetary policy, high inflation would require tightening, but the

cautious behaviour of the Fed and the European Central Bank is a further justification for the National Bank of Hungary to postpone it. If the state-centred Hungarian model that constrains competition is left untouched or further extended, the **competitiveness program** of the government and the National Bank of Hungary may produce only limited results. The further deterioration of **relations with the EU** due to domestic policy considerations would lead to Hungary's ominous **isolation**.

**Consumption. Real earnings** have been on the rise since 2013, the growth rate that was accelerating until 2017 with a **peak** of 10 per cent still remained high, but slowed down to about 8 per cent in **2018**, set to decelerate to 5.5-6 per cent in 2019. The 8 per cent increase of minimum wages in 2019 and the labour shortage will push up wages, but the pressure to improve competitiveness will pose a strong limit to further wage lifts in many companies. The expansion of consumption that has been under way for years must have reached its zenith in 2018, its growth rate is likely to total about 4 per cent this year. In addition to sharp wage growth, the rise in consumption is boosted by the extension of loans, the high level of consumer sentiment and the family protection program of the government.

**Investments.** Gross fixed capital formation in volume terms went up by 18.2 per cent in 2017 and by 16.5 per cent in 2018 and it is likely to increase by 7 per cent in 2019. The **investment rate** was 19.6 per cent of GDP, it rose to 22.2 per cent in 2018 exceeding the pre-crisis level. In 2019 the rate is expected to be equal to 26.3 per cent, representing most probably the peak. The high rate is attributed mainly to the investment projects of the public hand, funded to a large extent by the EU. Investments of the business sector grew at a much slower rate. Last year 17.7 thousand **apartments** were completed, this figure may mount to 23-25 thousand in 2019.

**Real economic trends.** In the past half century Hungary's GDP grew **only once**, 15 years ago more dynamically than last year. Of the EU member states only Malta's, Poland's and Latvia's growth rates were higher than the Hungarian one in 2018. Hungary's growth rate was by almost 3 percentage points higher than the EU average in 2018 and by 3.5 percentage points in the second half of 2018. GDP growth was driven by the 7 per cent increase of **domestic demand**. The **foreign trade surplus** contracted, **extracting** 1.5 percentage point from GDP growth. Although in 2019 the growth rate of domestic demand is anticipated to slow down sharply basically due to less vigorous investment activity, it is still predicted to exceed that of GDP by 1 percentage point. In sectoral breakdown, the production of GDP will be most dynamic in construction (8 per cent), telecommunications (7 per cent), professional and scientific activity (5 per cent) and trade. The growth rates of other sectors will be below the GDP average. The core growth rate (GDP excluding agriculture and public services) will likely equal 4 per cent.

**Industrial GDP** was up by 3.4 per cent in 2017 and 3.2 per cent in 2018. In 2019, further deceleration is forecast mainly due to the weakening of global recovery. The rate of increase of gross industrial production is predicted to slow down from 3.6 per cent in 2018 to 3-3.5 per cent this year. The growth model based on suppliers to foreign companies and assembly of imported inputs in foreign firms with footings in Hungary is showing the signs of exhaustion; dynamic increase of domestic demand such as that for building materials can substitute this model only temporarily. GDP in **construction** surged by 30 per cent in 2017 and 22 per cent in 2018. The business sentiment is still very good, the stock of contracts in the industry was appropriate at the start of 2019. With the upswing in construction of apartments and the absorption of EU funds, the growth rate may reach double-digit figures in the industry.

**Agricultural GDP** ascended by 5 per cent in 2018, at a slower rate than the 8 per cent fall was in 2017. Poor rainfall does not favour crop production currently. **GDP in the service sector** is anticipated to be up by 3.2 per cent, a slower rate than in the preceding year. Increase is projected in business services; public services are likely to be up by about 1 per cent.

**Retail trade turnover** grew by 6 per cent in 2018 with gradually slowdown in the quarterly figures (7.2 per cent, 6.7 per cent, 5.8 per cent and 4.8 per cent, respectively). With the fall of real incomes retail trade turnover is expected to go up more modestly, by 4 per cent in 2019. Demand for non-food items is driven by deferred purchases whose reasons include in the past shortage of purchasing power, burdens

associated with the amortisation of loans and fear of unemployment as well as by the second-round effects of the construction boom raising demand for furniture and household equipment. According to the survey of GKI Digital Ltd, the online retail trade market accounted for about 4.5 per cent of the total, by the end of 2019 5 per cent is expected.

With the **recovery of domestic demand**, the growth rate of imports of goods and services in GDP terms was by 2.4 per cent higher rate than that of exports. Within the total, exports increased more rapidly in services than in goods. With the deceleration of domestic demand, the difference between the growth rate of exports and imports will most probably smaller in 2019 totalling 1-1.5 per cent, also due to the deterioration of the foreign trade balance.

**Employment.** The number of employees increased by 1.1 per cent in 2018. **In 2019 stagnation** or slight growth is likely. The labour shortage will still be substantial. The increase of employment comes to a halt since the number of people in working age is sinking, and the number of potentially employable people that can be integrated relatively easily in the labour market is rather limited due to the inadequate educational and training structure, employment abroad and the inappropriate working culture of certain strata. The **unemployment rate** will diminish from **3.7 per cent** in 2018 to **3.5 per cent**, the number of those involved in **public workfare schemes will further go back**. Due to the lack of perspectives in the inactive population, the actual employment situation is much worse than that pointed out by statistics.

**Financial sector.** At the end of 2018, the corporate loan portfolio was by almost 14 per cent, the retail loan portfolio by 7 per cent higher than one year earlier; and the increase is set to continue in 2019 as well. The interest rate margin is still very high, but it is contracting. The share of on-performing loans of banks is descending further; according to the data of BISZ Credit Information Plc., the principal of loans was up by nearly 5 per cent last year. Due to the guarantees provided in government programs, interest rates paid by the government instead of households and rising interest rates, **profits** of the domestic banking system are expected to reach **outstanding** heights in 2019. The major risk factors include the **insufficient separation of ownership and lending** at some Hungarian-owned banks, whereas the capital strength of the owners is limited.

**General government.** In 2018, the accrual-based general government deficit corresponded to 2.2 per cent of GDP, the same as that of the previous year. The government debt relative to GDP (with the inclusion of the government-owned bank named Exim) was 70.9 per cent, representing a 2.4 percentage point decrease compared to 2017. Hungary's general government deficit the highest in the EU; its gross government debt is one of the highest in the Central and Eastern European region. The cash flow deficit totalled HUF1,445 billion, with the massive inflow of EU transfers in December it exceeded the planned figure by only 6 per cent. According to GKI, in 2019 the accrual-based deficit relative to GDP will be 2 per cent rather than 1.8 per cent due to the more modest rate of GDP growth. The cash-flow balance may reach HUF1,000 billion as envisaged by the government. The government debt relative to GDP is forecast to be some 69 per cent. The budgetary forecast of the government prepared in December as well as the approval of the original draft budgetary law by parliament in summer are of **no use** since they imply the repetition of basic plans independently from the actual general government trends of the previous year and the probably changing ones in 2019. Because of the opacity in the state of affairs, political decisions will play a key role in in general government trends of 2019 in terms of both disbursements and revenues.

**Inflation, interest rates and exchange rates.** After the drop in the price level recorded in 2014 and 2015, the inflation rate was 2.3 per cent in 2017 and 2.8 per cent in 2018, and **2.8 per cent** is expected **in 2019**. The acceleration in 2019 will be the consequence of several factors including wage rises, the surge of household demand generated by increasing earnings, in some cases the cost-raising effects of demand growth as well as the increase of taxes on luxury goods. The **tightening of monetary conditions** will be unavoidable in 2019 implying primarily the phasing out of non-conventional tools, but the **reference rate** of the National Bank of Hungary, too, could be lifted to 1-1.15 per cent. With monetary tightening lagging

behind market expectations, the exchange rate of the forint to the euro is likely to weaken in the course of the year. GKI predicts an annual average exchange rate of HUF320 in 2019.

**External disequilibria. The current account surplus** contracted from EUR7 billion in 2016 to EUR3.5 billion in 2017 due to the fall in the foreign trade surplus and to EUR0.6 billion in 2018. The current account surplus is assumed to disappear in 2019. The **external financing capacity** is projected to drop from EUR7 billion in 2016 to EUR4.9 billion in 2017 and to EUR3 billion in 2018 in spite of the inflow of EU transfers (corresponding to 2.3 per cent of GDP) and as the combined effect of increasing EU transfers and deteriorating current account balance to EUR4.5 billion (3.2 per cent of GDP) in 2019. The net inflow of **foreign direct investments** constituted EUR2.3 billion in 2016, EUR1.9 billion in 2017 and EUR3.7 billion in 2018. The expected magnitude in 2019 will be similar to that of 2018. The rationality of the **government strategy stimulating Hungarian direct investments abroad** is questionable in an economy characterised by the scarcity of capital.

**Risks.** Regarding GDP growth, relative to the base scenario, the sharper deterioration of the global business cycle may result in lower growth rates, the more dynamic increase of domestic incomes in higher ones, with a simultaneous deterioration in the foreign trade balance. Regarding the inflation rate, the more rapid rise of international energy prices and the more robust increase of domestic incomes may constitute factors accelerating inflation. The continuation of the current monetary policy stance may drive inflation, whereas a marked tightening of monetary conditions may suppress it. Hungary's isolation in the EU as well as the continuation of the deterioration in the current account may have grievous consequences in the medium-term.

#### The forecast of GKI for 2019

	2016	2017	2018	2019		
	actual			September	December	March
GDP	102,3	104,1	104,9	103,2	103,2	103,5
Agriculture (1)	113,2	91,9	105,3	100	100	100
Industry (2)	101,0	103,4	103,2	103,5	103	103
Construction (3)	89,7	117,0	122,9	105	105	108
Trade (4)	100,8	108,1	107,9	104	104	106
Transport and storage (5)	105,0	103,4	104,6	103	103	103
Information, communications (6)	105,8	111,0	107,0	105	105	105
Financial services (7)	104,0	104,1	102,4	102	102	102
Real estate services (8)	103,2	102,7	104,3	102,5	103	103
Professional, scientific, technical activities (9)	106,5	110,9	106,5	104	104	105
Public administration, education, healthcare (10)	101,5	98,6	100,2	101	101	101
Arts, entertainment (11)	102,7	103,3	105,5	102	102	102
• Core growth (2)+(3)+(4)+(5)+(6)+(7)+(8)+(9)	102,0	106,2	106,0	103,7	103,5	104
GDP domestic demand	101,0	106,8	107,0	104	104	104,5
• Private consumption	103,4	104,1	104,6	103,5	103,5	104
• Gross fixed capital formation (investments)	89,4	116,8	116,5	105	105	107
Foreign trade in goods						
• Exports	105,1	104,7	104,7	105	105	105
• Imports	103,9	107,7	107,1	106	106	106,3
Consumer price index (preceding year = 100)	100,4	102,4	102,8	103,5	103,5	103,2
Balance of current and capital account						
• EUR billion	7,0	4,9	3	6,5	6,5	4,5
• In per cent of GDP	6,1	4,0	2,3	5	4,8	3,2
Unemployment rate (annual average)	5,1	4,2	3,7	3,5	3,6	3,5
General government balance in per cent of GDP (ESA)	-1,6	-2,2	-2,2	-2	-2	-2

\* Source: HCSO, GKI