Forecast for 2019-2020

(Summary of the detailed September 2019 forecast)

The Hungarian economy grew by 4.9 per cent in the second quarter of 2019, faster than expected. This was the highest growth rate in the EU. However, the slowdown, if only to a very small extent, has begun (the growth rate was still 5.3 per cent in the first quarter). According to the data of the first half of 2019, growth of the Hungarian economy is driven by investments and consumer demand. Domestic demand grew by 5.5 per cent, faster than GDP (by 5.1 per cent). The foreign trade surplus continued to go up in the second quarter, and the slightly increasing surplus of services could not offset the significantly deteriorating merchandise trade balance. GKI's current forecast of the annual GDP growth rate of about 4.3 per cent in 2019 is in line with the recent expectations of the government and the National Bank of Hungary. The deterioration of the external economic environment, the decelerating investment stimulating effects of EU transfers, and the worsening trends in domestic business expectations all will play a role in the anticipated slowdown in the second half of the year (to around 3.5 per cent). As a result of these factors, and above all the phasing out of EU transfers and the deteriorating economic situation in Europe, GDP growth is expected to be below 3 per cent in 2020, at around 2.7 per cent. The general government deficit relative to GDP may fall to the planned 1.8 per cent in 2019, and to 1.3 per cent in 2020 (decreasing by less than the projected 1 per cent) if the envisaged "economy protection" policy will not include recovery measures. The rate of inflation will fall compared to its peak in spring 2019 (3.5 per cent on average this year; 3.3 per cent next year, which is still very high in Europe). However, the forint will continue to weaken: the average exchange rate of the forint to the euro of HUF320 in 2018 will rise to HUF325 in 2019 (to around HUF330 at the end of the year), and to HUF335 in 2020. The external balance is deteriorating noticeably and the current account balance may be in deficit already in 2019.

World economy. The cyclical recovery peaked in 2018. In 2019, the slowdown is likely to be sharper than expected, mainly affecting manufacturing and world trade. The escalation of the US-China economic war and the greater-than-expected slowdown of the Chinese economy represent a significant downward **risk**. The stalemate in the re-election of institutions in the EU will continue until the end of the year. There is still uncertainty surrounding **Brexit** and the approval of a new common budget in the EU. The resolution of the government crisis in Italy is likely to reduce the negative risks related to the country for the time being. The spillovers of the Turkish, Argentine and Venezuelan financial turbulence may lead to problems in indebted emerging and developing countries. **Geopolitical** tensions around Iran, Ukraine, North Korea, etc. remain significant. **Political risks**, including Trump's unpredictability, add to economic ones and they intensify each other. The EU's summer 2019 GDP forecast for 2020 expects a modest recovery (from 1.4 per cent to 1.6 per cent). Monetary and fiscal policies may support this (ECB loosened slightly in September and proposed fiscal stimuli). At the same time, recent international data, above all those indicating the danger of a German recession, the EU's three-year low in business confidence, and the decline in China's imports from the EU, suggest that stabilization is more likely than recovery.

Economic expectations. The **trends** of economic expectations are **worsening** both in the EU and in Hungary. The EU's economic sentiment index declined further in August within the statistical margin of error, reaching its three-year low. **Hungarian business expectations fell in September; however, customer ones were bursting with optimism.** As a result, the GKI economic sentiment index fell to its two-and-a-half-year low, within which business expectations plummeted to their lowest level in the past three years. However, consumer expectations improved slightly, they were more favourable than this last time in summer 2002. The fall of the business confidence index in September was significant (albeit compared to its temporarily increased August level). Such a high deterioration in a single month has not been seen for over ten years.

Economic policy. The main features of the Hungarian model, such as above all the **suppression of real market competition**, 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 by the Hungarian government if the set minimal conditions are met have remained unchanged for many years. At the same time Hungary's government is trying to become as independent from the EU as possible. The Hungarian government became extremely **isolated in the EU**. Although Hungary has some **"potential for blackmail"**, its isolation will severely limit its ability to enforce its interests during, for example, the negotiations of the European budget for 2021-2027. However, it is an important success for the government that after a long investigation the EU **did not identify any systemic problems** in the payment of EU transfers in Hungary. There is a **debate** in the government that the main goal of the so-called economy protection programme be the **improvement of disequilibria or the stimulation of economic growth**. However, the current pro-cyclical economic policy makes the application of the latter option quite risky.

Incomes, consumption and savings of households. Real earnings have been rising since 2013. The year-on-year growth rates accelerated until 2017, with a peak of over 10 per cent. The growth rate was 8.2 per cent in 2018, it will **slow down** to 6.5 per cent in 2019 and to around 4.5 per cent in 2020. Since real wages are expected to rise at a rate of above 6 per cent in 2019, according to the wage agreement, the social contribution tax **should be reduced by 2 percentage points in 2020** as well. 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 **limit** to further wage lifts for many companies (especially for the smaller ones). The seven-year increase in consumption is likely to have peaked (after 4.6 per cent last year, a similar increase of 4.5% is expected this year). This will probably decline to 3.5 per cent in 2020. In addition to sharp wage growth, the **further rise** in consumption is boosted by the extension of loans, the high level of consumer sentiment and the family protection programme of the government. At the same time, expansion is hindered by the high level of housing costs (construction, renovation, renting) and the higher yields in the government securities market available from June.

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 13 per cent in 2019. The **investment rate** was 19.6 per cent of GDP in 2016, it rose to 22.2 per cent in 2017 and to 25.5 per cent in 2018, exceeding the pre-crisis level. The peak is expected to be around 27.5 per cent in 2019, and a slight decline in investments is expected in 2020, as a result of investment volumes growing at a slower rate (by about 2 per cent) than GDP.

Real economic trends. Since the slowdown of the Hungarian economy in 2016, when the GDP growth rate was one of the smallest in the region due to the phasing out of EU transfers, it has gradually emerged into the **forefront**, largely due to accelerated use and advance payments of EU transfers, and it was already **at the top of the list** in 2019. This is also true for growth rates compared to the previous quarter. Hungary's GDP growth rate according to the EU methodology (based on seasonally and calendar adjusted data) has been at least 5 per cent compared to the same period of the previous year for four quarters. According to the latest data for the second quarter, Hungary's 5.2 per cent growth rate is well above the EU average of 1.4 per cent, as well as the figure of runner-up Romania (4.6 per cent) and that of second runner-up Poland (4.2 per cent). In the second quarter of 2019, industrial and construction GDP growth slowed down (which may have been due to fewer working days), whereas services, including trade, transport and the financial sector picked up. **In the second half of the year, GKI expects a slowdown in virtually every sector, which will continue in 2020** (especially in construction that was soaring in the last three years). Within this, the slowing down of core growth (expansion of GDP without agriculture and public services) will be above average. The growth rate of domestic consumption—due partly to the slowdown in Hungarian export demand and partly to the continued rapid expansion of consumption—will continue to exceed that of GDP, even to a larger extent than in 2019. This will result in the **deterioration of external disequilibria**.

Employment. The growth rate in the number of employees will slow down in 2019, and its maximum growth rate will be 1 per cent in 2019, and only a modest, not more than 0.5 per cent rise can be expected in 2020. The number of employees will continue to be reduced in the public sphere. The decline in the number of people of working age and the low activity of certain social groups (e.g., women, the low-skilled) mitigate the expansion of the workforce. **Labour shortages** persist, and in some areas where demand is high, wage levels are low or labour outflows abroad are strong, may become even more pronounced; on the other hand, they may ease in areas where demand is low. Considerable structural tensions between labour demand and supply will remain. The **unemployment rate** will fall to around 3.5 per cent on an annual average in 2019 and it will drop slightly below this in 2020, which is one of the lowest figure in the EU. The role of **public workfare schemes** will be significantly reduced, and the unemployment rate will be lower than the EU average even when counting those involved in public workfare schemes as well.

Financial sector. Although corporate and retail loans are growing dynamically, they are not expected to accelerate further. The share of **non-performing loans** overdue for more than 90 days has been decreasing for years. At the end of the second quarter of 2019, 2.7 per cent of corporate loans and 6.3 per cent of household loans belonged to this category. This is about half of the corresponding figures at the end of 2016. However, in the case of households, bank portfolio cleaning played the biggest role, thus non-performing loans were transferred to the balance sheets of **debt management companies**. The decline in non-performing loans was significantly **facilitated by the exceptionally high increase in wages and the housing market boom**, which made it possible to sell homes at higher prices in the capital and big cities and eliminate debts. Banks achieved record-high after-tax profits of almost HUF650bn in 2018, significantly higher than the already high profits in 2017 containing many one-off items. After a long time, interest incomes increased again, thus operating incomes could grow as well. This trend continued **in the first half of 2019**, and compared to the first half of last year, interest incomes, operating incomes and even profits increased somewhat, and this is expected to continue **in 2019 and 2020**. The major risk factors include the **insufficient separation of ownership and lending** at some Hungarian-owned banks (including the planned conglomerate uniting the Takarék group, MKB and Budapest Bank), whereas the capital strength of the owners is limited.

General government. In the first seven months of 2019, general government revenues were achieved at a much more favourable ratio than in the previous year (62 per cent compared to 52 per cent last year). However, expenditures were only slightly higher (61 per cent compared to 58 per cent last year). Although general government revenues will be negatively affected by a 2 percentage point cut in social contribution tax in the second half of 2019 and expenditures will be lifted by the family protection programme, **the deficit target of 1.8 per cent of GDP and a government debt ratio of around 69 per cent this year might be attained in 2019**. The **cash-flow deficit** may be smaller due to the inflow of EU transfers. The government's macroeconomic projection for 2020 is very **optimistic**. However, the differences at factors relevant for tax revenues are smaller, and the excess revenues in 2019 (serving as a base), high inflation and the government's ability to intervene during the year make the 1 per cent deficit target **achievable**. The cost of this will include the severe problems in financing expenditures caused by higher inflation, GKI expects a larger but declining **deficit of around 1.3 per cent of GDP**. **Government debt may fall to 67 per cent by 2020.** Although the general government deficit is **one of the highest in the EU** in 2019 and the decline in government debt is slow, the main problem is the **poor revenue and expenditure structure**, which impedes market competition, worsens social disparities and generate **major malfunctions** in large public systems. Within revenues, for example, flat personal income taxation and the multitude of sectoral taxes are unfavourable. On the expenditure side, the **government is strong where it should not be** (for example, the operation of the market, as well as municipal and institutional autonomy are hindered by the hierarchical and expanding organizational structure of the state), and it is **weak** (health care, education, etc.) where it should be strong.

Inflation, interest rates and exchange rates. After being 2.9 per cent in 2018, inflation averaged 3.4 per cent in the first eight months of 2019. Price increases in the spring months, reaching almost 4 per cent, decelerated to 3.1 per cent in August. As a result, together with the fact that foreign central banks are now easing instead of tightening, **the pressure on the National Bank of Hungary to raise interest rates weakened**. The cost of this is the weakening of the **forint to its historical low**. After a **3.5 per cent inflation rate this year**, GKI expects a slightly declining rate **next year**, **3.3 per cent**, which remains extremely high in the EU. According to the intentions of the National Bank of Hungary, the base rate will hardly change until the end of 2020 (though its feasibility is questionable). However, the weakening of the forint will continue: the average euro exchange rate of HUF325 in 2019 may rise to an average of HUF335 in 2020, assuming a close to, or rather higher than HUF330 exchange rate at the end of 2019.

External disequilibria. The **current account** surplus decreased from a record EUR7.1bn in 2016 to EUR0.6bn in 2018 as a result of a fall in the foreign trade surplus. The **deficit** is expected to be around EUR1bn in 2019 and around EUR2bn in 2020. **External financing capacity** fell from EUR7bn in 2016 to EUR3bn in 2018. Despite increasing EU transfers, **it will fall** to EUR2bn in 2019 and EUR1.5bn in 2020. Net inflow of **FDI** was EUR3.7bn in 2018 and EUR1.5bn in the first quarter of 2019. This year and the next one the amount is expected to be slightly lower than last year.

Risks. The rate of economic **growth may be faster** than projected in 2019 and 2020, as a result of better-than-expected trends in the world economy, an improvement in European economic activity and a resulting faster rise in Hungarian exports, and a greater willingness of Hungarian firms to invest. Although the present forecast precludes its possibility, in the case of a European recession or a greater fall in growth rates, economic growth might be significantly slower. If the inflationary impact of continued rapid wage increases and the weakening of the forint can be offset by fiscal tightening and the narrowing room for price increases due to slower growth in Europe and Hungary, the rate of **inflation** may be **slightly lower** than currently projected in 2019 and 2020. At the same time, if **oil price** surges in September become permanent, it would lead to faster price increases. As a result, **GKI** considers a slightly **faster growth rate and lower inflation rate than projected more likely** than the reverse case.

The forecast of GKI for 2019-2020

	2016	**2017**	**2018**	**2019**	**2020**
	fact			forecast	
GDP	102.3	104.1	104.9	**104.3**	**102.7**
• Agriculture (1)	113.2	91.9	105.3	**100**	**100**
• Industry (2)	101.0	103.4	103.2	**103.5**	**103**
• Construction (3)	89.7	117.0	122.9	**120**	**102**
• Trade (4)	100.8	108.1	107.9	**106**	**104**
• Transport and storage (5)	105.0	103.4	104.6	**103**	**103**
• Information, communications (6)	105.8	111.0	107.0	**107**	**105**
• Financial services (7)	104.0	104.1	102.4	**103**	**103**
• Real estate services (8)	103.2	102.7	104.3	**104**	**104**
• Professional, scientific, technical activities (9)	106.5	110.9	106.5	**106**	**104**
• Public administration, education, healthcare (10)	101.5	98.6	100.2	**100**	**100**
• Arts, entertainment (11)	102.7	103.3	105.5	**102**	**102**
• Core growth (2)+(3)+(4)+(5)+(6)+(7)+(8)+(9)	102.0	106.2	106.0	**105.5**	**103.5**
GDP domestic demand	101.0	106.8	107.0	**105.3**	**104**
• Private consumption	103.4	104.1	104.6	**104.5**	**103.5**
• Gross fixed capital formation	89.4	116.8	116.5	**113**	**102**
Foreign trade in goods					
• Exports	105.1	104.7	104.7	**103**	**102**
• Imports	103.9	107.7	107.1	**104.5**	**103.5**
Consumer price index (preceding year = 100)	100.4	102.4	102.8	**103.5**	**103.3**
Balance of current and capital account					
• EUR billion	7.0	4.9	3	**2**	**1.5**
• In per cent of GDP	6.1	4.0	2.3	**1.5**	**1**
Unemployment rate (annual average)	5.1	4.2	3.7	**3.5**	**3.4**
General government balance in per cent of GDP (ESA)	-1.6	-2.2	-2.2	**-1.8**	**-1.3**

* Source: HCSO, **GKI**