Hungary's economic policy goals and the room of manoeuvring for the economy after the elections

Detailed forecast of GKI Economic Research Co. for 2018 (27 June 2018)

The Hungarian economy grew by 4.4 per cent in both the last quarter of 2017 and the first quarter of 2018. A growth rate faster than this was registered only once in the past decade. This is the fourth or fifth highest rate in the CEE region, and Hungary is likely to be at the peak of its current business cycle. The rate of increase in investments financed by 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, external demand is expected to deteriorate rather than grow further. However, based on the better than expected figures of the first quarter, GKI raised its GDP forecast for 2018 to 4 per cent from 3.8 per cent and its consumption forecast to 4.5 per cent from 4 per cent. GKI raised its inflation projection to 3 per cent due to the rise in world oil prices and lowered the expected general government deficit to 2.2 per cent of GDP as a result of a shift in the government's economic policy. Although the announcement of an equilibrium-oriented economic policy rather than a stimulating one was justified by a possible global economic crisis, the shift may have also been due to the EU's marked criticism regarding Hungary's problems achieving its medium-term general government objective.

World economy. The era of trends in the world economy particularly **favourable** for Hungary with low energy prices and interest rates **is being over**, and the European recovery that started six years ago is likely to be over its zenith. **Geopolitical tensions** are exacerbated by conflicts around Iran; however, the Korean situation seems to be improving. The **Turkish** situation, the rising **oil prices** and the devaluation of the currencies of emerging countries are especially troubling for money markets. Apart from the unpredictability of the American president, a significant risk is the effect of a very predictable raise of interest rates by the **Fed**. It is questionable what kind of corrections and for how long a period can be expected in the otherwise overvalued **stock exchanges**. Although the danger of a **trade war** between the United States and China has fallen sharply, US-EU relations are noticeably deteriorating. In addition to the actual implementation of **Brexit**, from the point of view of the **future of the EU** further uncertainties arise from the facts that the new German coalition government is more divided than before and **seems to be less committed** to deepening integration. It is worrisome that **populist and Euro-sceptical** forces have strengthened in several countries, and that they could form a government in Italy. As a result of the many divisions that make the functioning of the EU difficult (such as North vs. South, West vs. East, those interested in deeper cooperation vs. EU-sceptical populists), the **unity of the EU is weakened**, including the **Visegrád country group** as well (for example, regarding their relationship with Russia).

Economic expectations. Although there was a slight deterioration in May compared to both the beginning of the year and April, economic expectations are very favourable in Europe, including Hungary. The GKI economic sentiment index fell somewhat in May; however, it was **only slightly below its historic peak reached in February**.

Economic policy. Being at the helm for eight years, Fidesz-KDNP won a two-thirds majority again at the parliamentary elections in April and this entails the possibility of **a stronger establishment of the one-centred Hungarian political model than before**. The new government does not show any substantive change despite a variety of organizational and personal changes that were made without any real professional or political justification. The highly centralized but incoherent government administration appreciating loyalty and the ability to control instead of professionalism remained essentially unchanged. The conversion of the illiberal system to an **"old-fashioned Christian democracy"** is only a rhetorical gesture. The first measures of the government indicate the persistence of a **confrontational policy with the EU**. GKI believes that **the government is not aiming to leave the EU** as it would cause enormous losses and would not be popular among the population according to surveys. The government pursues as far as possible the maintenance of its sovereignty, or, in fact, the representation of the short-term, especially domestic political interests of a narrow political-economic elite. It also seeks to present **its ability to prevent** the intensification of cooperation in the EU as a value for countries such as Russia, China and the United States that are not interested in a strong EU.

The deterioration of global economic trends, the deepening conflicts with the EU, a significant drop by 20 per cent to 30 per cent of net EU transfers after 2020, the need for the reduction of the general government deficit required by the EU as well, and the persistently weak competitiveness **pose great challenges to the sustainability of this policy.** The idea of drastically stimulating corporate and retail borrowing instead of strengthening competitive market conditions seems to be a new problem rather than a solution. The proposal is obviously a voluntarist response to the **sustained 4 per cent growth** demanded by the head of government **and the decreasing EU transfers**. The change in the system of economic policy objectives in June, that is, focusing on equilibrium instead of forced growth, can be considered to be a partial response to these challenges, not affecting the essence of the Hungarian model or its growth potential. GKI believes that **focusing on equilibrium is a correct and necessary step**. However, as it is justified only by external, world economic reasons, **it can hardly affect the essence of the Hungarian model, which is far from satisfactory for sustainable growth**. However, GDP growth rate may be 4 per cent in 2018.

Incomes, consumption and savings of households. The growth rate of gross earnings will slow down from 13 per cent in 2017 to 10 per cent in 2018, entailing a very fast **growth rate of real earnings by about 7 per cent** (less than its two-digit increase last year). Although the minimum wage will go up "only" by 8 per cent in 2018 after 15 per cent last year, exerting a smaller impact on earnings in 2018, labour shortages and the election year will still have significant effects on them. Consumption has been expanding for the sixth consecutive year and it is expected to reach its peak this year by 4.5 per cent, and **final household consumption** will grow even faster, by 5.5 per cent.

Investments. As a result of its almost 17 per cent increase last year, the level of investments exceeded the pre-crisis value in absolute terms. The last decade was characterized by a high degree of fluctuations, depending partly on the inflow of EU transfers. The volume of **investments** is expected to **increase by at least 9 per cent** in 2018. The **investment rate** was 19.2 per cent in 2016, 21.5 per cent in 2017, and it may rise to 22.5 per cent in 2018, reaching its pre-crisis levels. This will be mainly due to development projects in the public sector, largely based on EU transfers, whereas business investments are more restrained. For example, in the spring of 2018, German companies considered the Hungarian investment environment **least attractive** among the four Visegrad countries. Although the government announced the calls for tenders of the new EU budget period started in 2014, project targets are fragmented and unclear; the main objective is **to spend EU money fast**. By the end of May 2018, 84.3 thousand proposals submitted to calls for tenders were approved and the total sum awarded was HUF8,345bn (nearly 95 per cent of all EU transfers for the 2014-2020 EU development cycle). However, only 56 per cent of this sum was disbursed until now valued at about HUF4,685bn. A significant portion of disbursements are **advance payments**, as major projects were handled first in order to gain as much and as fast as possible, and in most cases no actual activities have started at all. Due to the "overload" in construction, it was already necessary to raise the accepted prices of earlier tenders automatically (by 20 per cent) so that the implementation of these projects would not become impossible.

Real economic trends. As far as production is concerned, the commercial, real estate and agricultural sectors (due to favourable weather conditions) are expected to grow slightly faster than previously thought, whereas industry is likely to perform modestly. In 2018, construction, agriculture, info-communications and trade are expected to expand fastest, though the increase in construction will be lower than last year due to its high statistical base. Although **industrial** expectations are favourable, changes in the automotive industry that is the driving force of the Hungarian industry, exacerbated by the risk of a customs war between the EU and the US, may cause serious concerns. Although labour shortages, high capacity utilization and the emergence of new technologies would require substantial improvements, industrial investments and development intentions are currently stagnating. Thus, in 2018 Hungarian industry will grow slower than last year's 5 per cent, by 4 per cent. Expectations in **construction** are favourable, the stock of contracts is high; however, the volume of newly concluded contracts is only stagnating. Although the recovery in construction continues, the growth rate of output is expected to drop from 30 per cent in 2017 to around 10 per cent in 2018. The growth rate of **agricultural**

GDP is expected to be a double-digit figure in 2018 as well. As a result of favourable precipitation in May, the expansion rate of agriculture will be around 10 per cent in 2018, and it is likely to reach its 2016 level in absolute terms. GDP in **services** will grow by about 3.6 per cent in 2018, slightly faster than in the previous year, but below the national average. Growth can be expected in market-based services. Retail sales are expected to grow by around 6 per cent in 2018. Participants of the **real estate market** are optimistic, and 20 thousand new homes are expected to be built in 2018. However, the number of housing construction permits increased hardly, as the government has not yet commented on the possible extension of the reduced rate of VAT on new housing being in force until the end of 2019. As the growth rate of domestic consumption exceeds that of GDP in 2018 to a lesser extent than in the previous year, the 2.5 percentage points **import-export gap** in 2017 **will drop to about 1.5 percentage points** in 2018. After 2017, the **surplus of foreign trade turnover will also decrease** in 2018 (from EUR9.7bn in 2016 to EUR8.1bn and EUR7bn), whereas that of services will continue to rise. The **terms of trade** deteriorated by 0.4 per cent in 2017, they improved by 0.1 per cent in the first quarter of 2018, and they will deteriorate during the rest of the year.

Employment. The number of employees will increase by **about 1 per cent** in 2018, slower than its 1.6 per cent rate in 2017. The **shortage of skilled labour** is a growing problem; however, the supply of unskilled labour with good work culture is also unsatisfactory. The number of **those involved in public workfare schemes** is decreasing continuously. Foreign employment is still popular, especially among younger generations. In 2018, the **unemployment rate** (in statistical terms) may drop to 3.7 per cent, which is one of the most favourable figure in the EU. If those involved in public workfare schemes were included, the rate would still be about twice as high, somewhat higher than the EU average.

Financial sector. The provision of new loans has been growing for several years. However, the corporate **loan portfolio started to increase** in 2016 and the retail loan portfolio in 2017 as well. A further expansion of corporate and retail loans can be expected in 2018. The loan portfolio, profitability and capital adequacy ratio of banks are **favourable**. However, the interdependence of the government and the 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. The **new lending concept** announced by the National Bank of Hungary, according to which by 2030 the corporate loan portfolio should be increased by 10-15 per cent per year and the retail one by 15 per cent per annum, is obviously a **voluntarist response** to the sustained 4 per cent growth demanded by the head of government and the decreasing EU transfers, whose actuality is called into question by the new demand of tight fiscal policy as well.

General government. The general government deficit will be below 3 per cent of GDP in 2018 for the sixth consecutive year, with the government debt on a declining path. However, in the sixth year of economic boom, in a period of very low interest rates, **this is not enough**. The Hungarian deficit is one of the highest in the EU and it is moving away from its medium-term objective. Therefore, the EU called on the Hungarian (and the Romanian) governments to **reduce the deficit**. Although this does not entail direct sanctions, its importance is great. As a result of the widespread budgetary advance payment of EU transfers and certain budgetary programs justified by election considerations, the cash flow deficit of the central government in the first five months of 2018 reached 87 per cent of the target amount for the whole year. Taking into account the EU's warning, there will be no major spending in December 2018, although this will be countered by the 2019 EU parliamentary and local municipal elections, GKI predicts a slightly smaller than planned (but above its 2017 level) **accrual-based deficit of around 2.2 per cent of GDP**. At the same time, the **cash flow deficit will likely be much higher than planned**, above HUF1,500bn. As a result, the government debt relative to GDP is expected to decrease by only 0.5 percentage points, to 73 per cent. As the budget for 2019 is based on overoptimistic assumptions, during the year some modifications and a somewhat higher than projected general government deficit can be expected.

Inflation, interest rates, exchange rates. The Hungarian price level has been rising steadily since 2016, albeit modestly. The inflation rate was 2.4 per cent in 2017, and it will be **close to 3 per cent in 2018**. This is supported by the fact that inflation accelerated in May over April both in the euro area (from 1.2 per cent to 1.9 per cent) and in Hungary (from 2.3 per cent to 2.8 per cent). Although the forecast takes into account the surge in world energy prices and the weakening of the forint, it does not reckon with the stronger inflationary impacts of domestic wage growth on the cost and demand sides. **The rise of the 0.9**

per cent base rate of the National Bak of Hungary can only be expected next year. The **weakening of the forint in 2018 was expected** as the Fed's interest rate increases were not followed by the National Bank of Hungary. However, the **speed and magnitude of weakening** in May **were unexpected** and it was primarily caused by the turmoil in the Turkish financial system and also by the Italian situation. The average annual exchange rate of the forint to the euro is projected to be **around HUF317** in 2018. However, the weakening of the forint does not prompt the central bank to tighten its monetary policy as it considers **profitability** as one of its main objectives. Earlier measures of the central bank had a dampening effect on the yields on government securities in general, and short-term ones in particular. In **May**, yields on short-term government securities rose by 5-10 basis points, and those of long-term ones by 50-70 basis points. This encourages the government to **raise the proportion of short-term financing**, which, in turn, **increases the refinancing needs** and concomitant risks. The forint depreciated by nearly 5 per cent compared to the beginning of 2018 by mid-June.

External equilibria. After its huge surplus of EUR7bn in 2016, the **current account** surplus dropped to EUR3.6bn in 2017 due to a fall in the foreign trade surplus, and it will shrink further to EUR2.5bn in 2018. Although the **external financing capacity** was down from EUR6bn in 2016 to EUR5.1bn in 2017, it is expected to rise to EUR7bn in 2018 as a result of the resumption of EU transfers (increasing from 4.1 per cent of GDP to 5.4 per cent). The Hungarian 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 EUR 1.9bn in both 2016 and 2017. No major expansion can be expected in 2018 either. Net FDI dropped from 50 per cent of GDP before the crisis to around 43 per cent in 2017.

Risks of the forecasts. From the point of view of the path of the Hungarian economy, the **future of EU relations** poses the biggest risk. Overcoming the **world economic boom** and **insisting on the Hungarian model** may also undermine the possibility of medium-term growth.

The forecasts of GKI for 2018

	2014	2015	2016	2017	2018			
	fact				September	December	March	June
GDP	104.2	103.4	102.2	104.0	103.8	103.8	103.8	**104**
• Agriculture (1)	117.4	95.9	109.9	91.0	105	105	105	**110**
• Industry (2)	105.8	108.1	101.0	103.9	105	105	104	**103**
• Construction (3)	110.7	102.5	89.5	131.6	112	110	110	**110**
• Trade (4)	103.8	104.2	101.2	106.2	105	105	105	**106**
• Transport and storage (5)	102.7	101.3	105.5	104.5	103	103	104	**103**
• Information, communications (6)	104.4	101.3	105.7	106.1	104	106	106	**107**
• Financial services (7)	96.7	101.5	100.4	100.7	102	102	102	**102**
• Real estate services (8)	101.8	100.0	103.1	102.3	102	102.5	102.5	**104**
• Professional, scientific, technical activities (9)	105.5	102.8	107.5	107.2	104	104	106	**106**
• Public administration, education, healthcare (10)	101.0	100.2	101.7	98.7	101	100	100	**100**
• Arts, entertainment (11)	106.0	100.8	102.9	105.0	102	102	104	**105**
• Core growth (2)+(3)+(4)+(5)+(6)+(7)+(8)+(9)	104.4	104.6	102.1	105.9	104.5	104.7	104.7	**104.5**
GDP domestic demand	105.5	101.2	101.6	106.0	104.5	105.5	105	**105.3**
• Private consumption	102.4	103.4	103.8	104.1	103	103.5	104	**104.5**
• Gross fixed capital formation (investments)	112.3	101.9	89.4	116.8	109	109	109	**109**
Foreign trade								
• Exports	109.1	108.5	103.4	107.1	106	106	106	**104**
• Imports	111.0	106.4	102.9	109.7	107	108	107.5	**105.5**
Consumer price index (preceding year = 100)	99.8	99.9	100.4	102.4	103	103	102.7	**103**
Balance of current and capital account								
• EUR billion	5.5	9.0	6.8	5.1	8.3	7.5	8	**7**
• In per cent of GDP	5.2	8.2	6.0	4.1	6.4	5.7	6.2	**5.4**
Unemployment rate (annual average)	7.7	6.8	5.1	4.2	4	4	3.7	**3.7**
General government balance in per cent of GDP (ESA)	-2.8	-2.0	-1.9	-1.9	-2.9	-2.8	-2.5	**-2.2**

Source: HCSO, GKI