17. HUNGARY

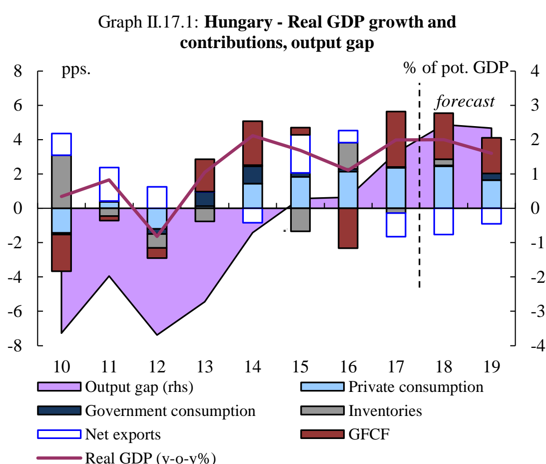
Rapid growth is facing increasing capacity constraints

Growth remains strong in 2018 but is set to slow in 2019 as construction experiences capacity constraints and the impact of minimum wage increases on consumption fades. The tight labour market will gradually feed into costs and prices while strong demand should contribute to a narrowing current account surplus. Growth is also being supported by fiscal expansion that should see the deficit peaking at 2.4% of GDP in 2018.

Economic growth rebounded in 2017

GDP growth rose to 4.0% in 2017, driven by strong domestic demand. Gross fixed capital formation grew by 16.8% thanks to rebound in public investment and the cyclical recovery of the housing market. Private consumption was supported by significant administrative wage increases and rising employment. Final demand was increasingly met by imports; the falling trade balance contributed to the narrowing of the current account surplus, by 3.1 pps. to 2.9% of GDP.

Graph II.17.1: **Hungary - Real GDP growth and contributions, output gap**



Domestic demand continues to drive growth

Short-term business indicators and surveys point to sustained growth momentum in early 2018. GDP growth is expected to remain close to 4% this year, but is forecast to slow down in 2019 as the level of investment reaches a plateau and the tailwinds supporting consumption moderate.

Corporate investment is forecast to grow vigorously, supported by high capacity utilisation, FDI inflows, and the rising absorption of EU funds. The investment-to-GDP ratio may rise to 25% by 2019, close to its historic peak. At the same time, capacity constraints in the construction sector may limit the further expansion of residential investment. Household income and consumption growth are likely to remain strong in 2018 but are expected to slow down in 2019 as the impact of past, large administrative wage increases fades. Rising household borrowing is decreasing the saving rate. This will be matched by an increase in households' investment ratio. Despite a moderation of external demand growth, export growth is expected to remain stable. However, imports will continue to outpace exports due to the rapid growth of investment and durables' consumption. The trade balance and the current account surplus are expected to narrow, although the rising absorption of EU funds will keep net lending stable.

Tight labour market and strong demand put pressure on costs and prices

Employment growth is expected to moderate as available labour reserves become exhausted. The unemployment rate is projected to decrease further to below 4%. In addition to administrative wage hikes over 2017 and 2018, labour shortages are also contributing to wage growth, although their impact on labour costs is being mitigated by significant cuts in social contributions. Nonetheless, rising production costs are already becoming apparent in the prices of more labour-intensive services and in construction costs. House prices have risen rapidly as demand continued to outpace supply. HICP inflation is set to remain at 2.3% in 2018 thanks to moderating food price dynamics and selective VAT cuts. After these temporary factors fade, inflation is expected to rise to 3.0% in 2019.

Risks to the forecast are broadly balanced. Labour shortages could accelerate wage growth and consumption, but they may also raise inflation and contribute to a more pronounced deterioration of the external balance. On the other hand, capacity constraints in construction could lead to the postponement of investment projects, reducing GDP growth over the forecast horizon.

Fiscal expansion continues in 2018

In 2017, the general government deficit reached 2.0% of GDP, increasing from 1.7% in the previous year but remaining below the official target of 2.4%. The tax-to-GDP ratio declined notably as a result of tax and social contribution cuts, although fast wage growth generated considerable extra revenues. While interest outlays decreased nominally, primary expenditure grew strongly, particularly capital spending from national sources. However, public expenditure without EU funds increased more slowly than nominal GDP, partly compensating for the budgetary impact of tax cuts.

The headline deficit is set to remain on an increasing path in 2018, rising to 2.4% of GDP. This reflects further tax cuts, including an additional 2.5 pps. reduction in the employers' social contribution rate. In addition, a significant deficit-increasing effect stems from the phase-out of temporary receipts from land sales and an extra item in corporate tax payments, which benefited the budget in 2016 and 2017. The impact of these developments on the deficit is expected to be moderated by the slowdown in expenditure growth, apart from the spending on EU co-financed projects. In 2019, based on a no-policy change assumption, the deficit is projected to decline to 2.1%.

The key budgetary risks are linked to plans for a sizeable increase in public investment expenditure. The Commission forecast projects lower-than-budgeted capital spending in 2018, expecting some delays in projects partly due to capacity constraints in construction. However, implementation risks could affect the deficit in both directions compared to the forecast figure. At the same time, the tightly set operating budget for healthcare providers remains a source of a negative fiscal risk.

The structural balance is calculated to have deteriorated in 2017 from around -1¾% of GDP to below -3%. The fiscal stance is estimated to loosen further in 2018 with the structural balance reaching -3½%, while some reversal is projected in 2019. The public debt-to-GDP ratio decreased from 76.0% in 2016 to 73.6% in 2017. The reduction of debt is expected to slow down in 2018 due to adverse stock-flow adjustment effects, with the debt ratio decreasing to 73.3%. Thereafter, the debt ratio is projected to decline at a faster rate, falling to 71% by the end of 2019 due to the high rate of nominal GDP growth forecast.

Table II.17.1

Main features of country forecast - HUNGARY

		2016		Annual percentage change						
	bn HUF	Curr. prices	% GDP	98-13	2014	2015	2016	2017	2018	2019
GDP		35420.3	100.0	2.1	4.2	3.4	2.2	**4.0**	**4.0**	**3.2**
Private Consumption		17669.6	49.9	1.9	2.8	3.6	4.3	**4.7**	**4.9**	**3.3**
Public Consumption		7174.8	20.3	1.5	5.1	1.1	0.8	**0.3**	**0.2**	**1.8**
Gross fixed capital formation		6811.7	19.2	2.4	12.3	1.9	-10.6	**16.8**	**12.5**	**8.8**
of which: equipment		3102.9	8.8	4.0	21.5	0.8	1.1	**10.0**	**12.6**	**12.3**
Exports (goods and services)		31714.2	89.5	9.4	9.1	8.5	3.4	**7.1**	**7.0**	**6.5**
Imports (goods and services)		28143.5	79.5	8.6	11.0	6.4	2.9	**9.7**	**9.5**	**8.0**
GNI (GDP deflator)		34545.5	97.5	2.3	2.6	3.1	4.3	**2.0**	**4.6**	**4.0**
Contribution to GDP growth:	Domestic demand			2.0	5.0	2.5	0.0	**5.6**	**5.2**	**4.1**
	Inventories			-0.3	0.1	-1.3	1.5	**-0.3**	**0.4**	**0.0**
	Net exports			0.5	-0.8	2.2	0.7	**-1.4**	**-1.5**	**-0.9**
Employment				0.0	4.8	2.4	2.6	**2.0**	**0.9**	**0.5**
Unemployment rate (a)				8.0	7.7	6.8	5.1	**4.2**	**3.7**	**3.6**
Compensation of employees / head				7.3	0.8	-1.5	4.0	**7.9**	**7.4**	**5.6**
Unit labour costs whole economy				5.1	1.4	-2.4	4.4	**5.8**	**4.2**	**2.8**
Real unit labour cost				-0.6	-1.9	-4.2	3.4	**2.1**	**1.4**	**-0.3**
Saving rate of households (b)				9.8	10.9	9.6	8.4	**10.2**	**9.7**	**8.6**
GDP deflator				5.8	3.4	1.9	1.0	**3.7**	**2.8**	**3.0**
Harmonised index of consumer prices				6.3	0.0	0.1	0.4	**2.4**	**2.3**	**3.0**
Terms of trade goods				-0.6	1.1	1.0	1.4	**-0.4**	**-0.6**	**-0.1**
Trade balance (goods) (c)				-2.3	2.0	4.0	4.1	**1.9**	**0.3**	**-0.5**
Current-account balance (c)				-4.8	1.5	3.4	6.1	**2.9**	**1.2**	**0.9**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)				-3.8	5.2	8.0	6.0	**4.2**	**4.1**	**3.8**
General government balance (c)				-5.5	-2.6	-1.9	-1.7	**-2.0**	**-2.4**	**-2.1**
Cyclically-adjusted budget balance (d)				-5.3	-2.2	-2.0	-1.8	**-2.8**	**-3.6**	**-3.3**
Structural budget balance (d)				-	-2.1	-2.0	-1.8	**-3.1**	**-3.6**	**-3.3**
General government gross debt (c)				65.9	76.6	76.7	76.0	**73.6**	**73.3**	**71.0**

(a) as % of total labour force. (b) gross saving divided by adjusted gross disposable income. (c) as a % of GDP. (d) as a % of potential GDP.