17. HUNGARY

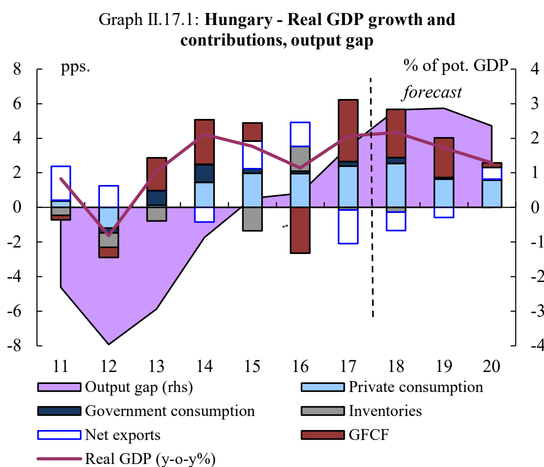
The maturing of the cycle brings slower growth and rising inflation

Economic growth is set to slow down after a strong 2018 as the domestic business cycle matures, fiscal stimulus gradually moderates, and headwinds from the global economy strengthen. Fuel and food prices have driven inflation up, but underlying inflation is also gathering momentum. After peaking at 2.4% of GDP in 2018, the budget deficit is set to fall below 2% in 2019.

Economic growth accelerates further in 2018…

Hungary's broad-based, cyclical upswing is continuing, supported by pro-cyclical fiscal and monetary policy. GDP growth accelerated to 4.9% (y-o-y) in the second quarter of 2018, but survey indicators suggest slower growth ahead as the short-term boost from public spending earlier in the year fades while the manufacturing sector remains in the doldrums.

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



…but is forecast to slow in 2019 and 2020.

GDP growth is set to moderate from 4.3% in 2018 to 3.4% in 2019 and to 2.6% in 2020. The key factor behind the slowdown is the moderation in investment growth, expected as a result of capacity constraints in the construction sector. These bottlenecks are already manifesting themselves in building costs: the construction price index rose by 9.8% (y-o-y) in August 2018. After increasing by almost 2 pps. between 2017 and 2019, the public investment ratio will stabilise in 2020 at a historic high level. Residential investment is also set to peak in 2019, before the preferential VAT rate on new housing expires in January 2020. Corporate investment continues to benefit from strong demand and accessible financing. The central bank extended favourable credit conditions by renewing its lending programme for small enterprises. In addition, several major FDI-related projects are in progress in the manufacturing sector.

Household consumption is set to decelerate in 2019 as employment growth moderates and the impact of past administrative wage increases fades. The recovery of the housing market has reignited mortgage lending, which will gradually reduce households' net financial savings.

Exports will be partly shielded from the slowdown of trade partners as large new export capacities gradually enter into production. However, import demand is set to outpace exports in 2019, and Hungary's terms of trade will worsen as imported energy prices rise. Consequently, the current account surplus is set to diminish.

Commodity prices hasten the rise of inflation

Employment growth is projected to slow as unemployment has already fallen to historically low levels. Additional labour demand will be partially met by the mobilisation of existing reserves, including the reallocation of workers from the public sector, and the continuing rise of the participation rate. Real wage growth is forecast to remain high owing to the tight labour market.

Inflation has risen rapidly since the spring due to rising fuel and unprocessed food prices, as well as the depreciation of the forint. HICP inflation climbed to 3.7% in September, exceeding the central value of the (3% ±1 pp.) tolerance band of the Hungarian National Bank. Average annual inflation is set to increase from 3.0% in 2018 to 3.3% in 2019 on the back of higher commodity prices and tobacco duty increases. While cost-side factors should fade in 2020, strong wage and consumption growth will continue to build the underlying inflation momentum. As a result, HICP inflation is forecast to remain at 3.0% in 2020.

Risks to the forecast are balanced. The tight labour market may sustain rapid real wage growth, leading to faster consumption growth and higher inflation. Downside risks are related to the

evolution of international trade due to the strong integration of Hungary into global value chains.

The fiscal stance is set to tighten after 2018

The general government deficit is forecast to peak at 2.4% of GDP in 2018, affected by the loss of previous one-off and temporary receipts. Revenues have also been reduced by tax measures, including a 2.5 pps. decrease in the employer social contribution rate. However, the effect of tax cuts remains largely dampened due to the fast growth of major tax bases. While the revenue outlook improved significantly since the spring, it is set to be matched by extra spending, mainly on public wages and investments. Nonetheless, the growth of government expenditure, excluding increased spending from EU transfers, is forecast to slow down notably compared to 2017.

In 2019, the headline deficit is expected to decrease to 1.9% of GDP. The forecast incorporates an additional 2 pps. cut in social contributions as of next July. The remaining elements of the 2019 tax package are estimated to be revenue neutral overall. While investment expenses are forecast to continue expanding, current expenditure, particularly the public wage bill and social transfers, are set to increase moderately relative to GDP growth, driving the deficit-reduction. In 2020, under a no-policy-change assumption, the nominal deficit is projected to decrease further, to 1.8% of GDP.

The main budgetary risks stem from the rapid growth of public investments planned over 2018-2019. Capacity constraints may slow the execution of projects, but also lead to cost inflation, leaving the overall impact on the deficit uncertain.

The structural balance is estimated to deteriorate further in 2018 by about ½ percentage points to around -3¾% of GDP. After 2018, the impact of past fiscal expansion is expected to be gradually reversed and the structural balance should improve to about -3¼% of GDP in 2019 and -3% in 2020. The debt-to-GDP ratio is set to decrease only modestly in 2018, to 72.9% from 73.3%. This reflects sizeable below-the-line effects mainly due to the pre-financing needs of EU-funded projects and the weakening of the exchange rate. Thereafter, the debt ratio is projected to decline at accelerated speed, falling below 69% by the end of 2020 thanks to the improving budgetary position and the high rate of nominal GDP growth.

Table II.17.1:

Main features of country forecast - HUNGARY

		2017		Annual percentage change						
	bn HUF	Curr. prices	% GDP	99-14	2015	2016	2017	2018	2019	2020
GDP		38355.1	100.0	2.1	3.5	2.3	4.1	**4.3**	**3.4**	**2.6**
Private Consumption		18981.4	49.5	1.8	3.9	4.0	4.8	**5.2**	**3.3**	**3.2**
Public Consumption		7765.3	20.2	1.8	1.3	0.7	1.3	**1.7**	**0.4**	**0.3**
Gross fixed capital formation		8528.1	22.2	2.5	4.7	-11.7	18.2	**12.5**	**9.4**	**1.0**
of which: equipment		3597.0	9.4	4.1	1.5	2.5	13.8	**8.5**	**5.6**	**5.0**
Exports (goods and services)		33848.2	88.2	9.0	7.2	5.1	4.7	**7.1**	**6.0**	**5.6**
Imports (goods and services)		30946.9	80.7	8.0	5.8	3.9	7.7	**9.0**	**7.1**	**5.1**
GNI (GDP deflator)		36823.6	96.0	2.2	3.3	4.4	2.5	**3.9**	**3.2**	**2.4**
Contribution to GDP growth:	Domestic demand			2.0	3.3	-0.5	6.2	**5.7**	**4.0**	**1.9**
	Inventories			-0.5	-1.3	1.4	-0.2	**-0.3**	**0.0**	**0.0**
	Net exports			0.6	1.6	1.4	-1.9	**-1.1**	**-0.6**	**0.7**
Employment				0.2	2.4	3.1	2.0	**0.9**	**0.5**	**0.1**
Unemployment rate (a)				8.0	6.8	5.1	4.2	**3.6**	**3.3**	**3.2**
Compensation of employees / head				6.4	-1.5	4.4	6.2	**8.1**	**6.6**	**6.2**
Unit labour costs whole economy				4.4	-2.6	5.2	4.1	**4.5**	**3.5**	**3.6**
Real unit labour cost				-0.6	-4.4	4.3	0.2	**0.8**	**0.2**	**0.6**
Saving rate of households (b)				11.4	11.2	12.8	12.1	**10.4**	**10.2**	**10.0**
GDP deflator				5.1	1.9	0.9	3.8	**3.7**	**3.3**	**3.0**
Harmonised index of consumer prices				5.4	0.1	0.4	2.4	**3.0**	**3.3**	**3.0**
Terms of trade goods				-0.6	0.8	1.5	0.0	**-0.8**	**-0.7**	**0.0**
Trade balance (goods) (c)				-1.7	3.7	4.1	1.5	**0.3**	**-0.7**	**-0.3**
Current-account balance (c)				-4.3	2.7	6.2	3.0	**1.2**	**0.0**	**0.3**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)				-3.1	7.4	6.2	4.3	**3.2**	**2.4**	**2.3**
General government balance (c)				-5.2	-1.9	-1.6	-2.2	**-2.4**	**-1.9**	**-1.8**
Cyclically-adjusted budget balance (d)				-4.9	-2.0	-1.8	-3.1	**-3.8**	**-3.3**	**-3.0**
Structural budget balance (d)				-	-2.0	-1.8	-3.4	**-3.8**	**-3.3**	**-3.0**
General government gross debt (c)				67.0	76.6	75.9	73.3	**72.9**	**70.3**	**68.6**

(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.