17. HUNGARY

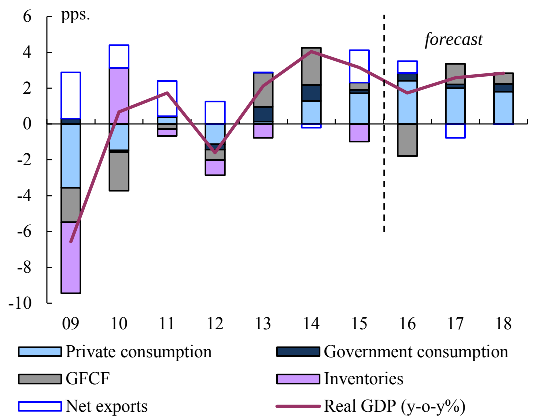
High private consumption and rebounding investment

Hungary's real GDP growth declined in 2016 but is forecast to strengthen again in 2017 and 2018. Unemployment is set to continue falling and inflation is forecast to rise towards the central bank's target. The country's fiscal stance is projected to loosen.

Domestic demand depends on household consumption

Real GDP growth temporarily declined in 2016 to an estimated 1.9%. This was, mainly due to a 12.7% drop in investment in the first three quarters of the year which was associated with the changeover to a new planning period for EU investment funding. Despite this contraction, domestic demand growth remained positive, as private consumption grew by a robust 4.8%on the back of accelerating wage growth and growing employment. Trade flows remained strong, with imports and exports rising by 7.4% and 6.7% respectively in the first three quarters of 2016.

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



In November 2016, the government and social partners agreed to substantially increase the minimum wage and to decrease employers' social security contributions in both 2017 and 2018. The corporate income tax rate was cut from 19% for large companies and 10% for SMEs to a single rate of 9% for all companies. This is expected to have a positive effect on growth as higher wages boost consumption and lower taxes boost investment. At the same time, the rise in the minimum wage may also drive firms to substitute labour with capital.

GDP growth is expected to reach 3.5% in 2017 and 3.2% in 2018. Investment is also expected to pick up as investment funds from the EU are put to use. Household consumption is forecast to continue growing, driven by improved consumer confidence, an upturn in bank lending to households and continuing positive labour market trends. As a result, private consumption remains the main contributor to economic growth. Consumer confidence is at a post-crisis high, and further positive developments are expected in lending to households and from the second-round effects of an improved housing market scheme; factors which support household investment from 2017 onwards.

Net exports contributed positively to growth until 2016 but are forecast to turn negative in 2017, when the pick-up in domestic demand stimulates imports. Hungary's relative trade performance is set to weaken slowly in line with increasing unit labour costs, which should start putting pressure on price competitiveness.

Unemployment continues to fall while inflation picks up gradually

The unemployment rate is estimated to have fallen to 5.2% in 2016, and is projected to decrease further by an additional 1 pp. over the forecast horizon. This is because the labour market is already tight, with increasing skill mismatches. Consequently, there is significant pressure on wage growth, adding to the wage pressure stemming from the minimum wage increase. This leads to a sizeable expansion in real incomes. However, as higher minimum wages will encourage firms to replace workers with capital, the tightening of the labour market will be mitigated. Nominal gross wages are forecast to grow by around 8% per year over the forecast horizon. As the further expansion of labour shortages has already started to limit production, mainly in industry, construction and services, wage pressures are expected to become more prominent.

HICP inflation was slightly positive at 0.4% in 2016. In 2017, domestic demand is projected to push inflation up significantly, to 2.4%. In 2018, inflation is expected to reach and even overshoot the 3% target of the central bank.

The general government deficit is set to increase

The 2016 general government deficit is expected to turn out at 1.8% of GDP, helped by strong tax dynamics and temporary revenues, even though planned one-off receipts from land sales were partly shifted to 2017. At the same time, expenditure on goods and services and on investment declined, considerably below budgeted levels. However, transfer payments to the private sector are forecast to have risen significantly, reflecting the reallocation of unspent appropriations towards the end of the year.

The headline deficit is forecast to rise to 2.4% of GDP in 2017. This reflects the effect of rising domestic co-financing for EU-funded projects, expenditure increasing measures and sizeable tax cuts, including a 5 pps. reduction in employer social security contributions. The deficit increasing measures are expected to be partly offset by declining social transfer payments and interest outlays, as well as by one-off revenues. Based on a no-policy-change assumption, the deficit is projected to increase further to 2.5 % of GDP in 2018. The forecast incorporates further cuts in social security contributions, while it is assumed that the stability reserves will not be spent.

The 2016 deficit outcome depends on the fiscal performance of local governments, about which there is still some uncertainty. Looking ahead, the forecast assumes that the planned increase in investment will not be fully implemented, but this assumption may not hold and is a negative risk for the deficit forecast this year and next. The fiscal effects of a new housing scheme and measures to improve tax collection efficiency are also sources of uncertainty.

The structural balance is estimated to deteriorate significantly, by about half a percentage point to -2¼% of GDP in 2016 and is expected to hit about -3½% in 2017. This reflects a widening positive output gap. The debt-to-GDP ratio is projected to decline steadily, by some 1 pp. in 2016 to around 73.5% and close to 71% by the end of 2018. The fall in debt is helped by the higher nominal GDP growth rate forecast, although lags in the cash payment of EU funds are expected to result in an adverse cash-flow adjustment effect.

Table II.17.1:

Main features of country forecast - HUNGARY

	2015		Annual percentage change						
bn HUF	Curr. prices	% GDP	97-12	2013	2014	2015	2016	2017	2018
GDP	33999.0	100.0	2.2	2.1	4.0	3.1	**1.9**	**3.5**	**3.2**
Private Consumption	16775.0	49.3	2.0	0.3	2.5	3.4	**5.0**	**4.8**	**3.9**
Public Consumption	6811.7	20.0	1.1	4.1	4.5	1.0	**2.0**	**1.0**	**2.0**
Gross fixed capital formation	7366.9	21.7	2.4	9.8	9.9	1.9	**-9.6**	**10.0**	**5.0**
of which: equipment	3077.7	9.1	4.7	2.6	20.5	2.2	**-7.8**	**8.0**	**4.0**
Exports (goods and services)	30846.2	90.7	10.5	4.2	9.8	7.7	**6.7**	**5.0**	**5.9**
Imports (goods and services)	27816.7	81.8	9.8	4.5	10.9	6.1	**6.4**	**6.8**	**6.7**
GNI (GDP deflator)	32404.2	95.3	2.2	3.6	2.4	2.6	**3.9**	**2.5**	**2.8**
Contribution to GDP growth: Domestic demand			2.0	2.9	4.3	2.3	**0.8**	**4.5**	**3.3**
Inventories			-0.2	-0.8	0.0	-1.0	**0.2**	**0.0**	**0.0**
Net exports			0.5	0.0	-0.2	1.8	**0.9**	**-1.0**	**-0.1**
Employment			-0.1	1.1	4.8	2.2	**1.9**	**0.5**	**0.3**
Unemployment rate (a)			8.0	10.2	7.7	6.8	**5.2**	**4.8**	**4.5**
Compensation of employees / head			8.4	1.6	1.3	1.6	**5.0**	**6.1**	**5.6**
Unit labour costs whole economy			6.0	0.6	2.1	0.7	**5.1**	**3.0**	**2.6**
Real unit labour cost			-0.7	-2.3	-1.2	-1.1	**2.7**	**0.2**	**-0.5**
Saving rate of households (b)			10.2	9.8	10.9	9.6	**14.2**	**8.2**	**5.5**
GDP deflator			6.8	2.9	3.4	1.7	**2.3**	**2.8**	**3.2**
Harmonised index of consumer prices			7.3	1.7	0.0	0.1	**0.4**	**2.2**	**3.1**
Terms of trade goods			-0.6	0.8	1.0	0.8	**1.7**	**0.1**	**0.2**
Trade balance (goods) (c)			-2.9	3.3	2.3	4.0	**5.5**	**4.3**	**3.9**
Current-account balance (c)			-5.3	3.8	2.0	3.1	**5.4**	**3.7**	**3.2**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)			-4.5	7.4	5.8	7.8	**7.0**	**6.5**	**6.6**
General government balance (c)			-5.6	-2.6	-2.1	-1.6	**-1.8**	**-2.4**	**-2.5**
Cyclically-adjusted budget balance (d)			-5.6	-1.2	-1.7	-1.7	**-1.9**	**-3.0**	**-3.6**
Structural budget balance (d)			-	-1.3	-2.0	-1.7	**-2.2**	**-3.4**	**-3.6**
General government gross debt (c)			64.9	76.6	75.7	74.7	**73.5**	**72.3**	**71.2**

(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.