Economic Trends in Eastern Europe

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Authors:

Chapter 1: International Environment
Katalin Nagy

Chapter 2: Central and Eastern Europe
Katalin Nagy, Péter Vakhal

Chapter 3: The Hungarian Economy
Zoltán Matheika, Gábor Oblath, Éva Palócz, Péter Vakhal

Edited by Éva Palócz

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info@kopint-tarki.hu

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1. International economy

The second half of 2018 saw a slowdown of **global growth**, and despite the relatively favorable numbers in the first quarter of 2019, the slowdown is likely to continue. The latest OECD forecast predicts the global economy to expand by about 3.2 percent in the next couple of years, a rate below the 2011-2018 average. Growth tends to decelerate in both the developed and the emerging economies, even though the developed economies, especially the US, remained relatively dynamic in the first quarter. Capacity utilization is slipping, another sign of the downward turn in the cycle. After a 2.3 percent growth in 2018, the GDP of developed countries may expand by 1.9 and 1.6 percent, respectively, in 2019 and 2020. Still tight labor markets will help private consumption in most countries, partially compensating for the loss of external demand. Economic growth tended to moderate in the emerging economies as well. Most notably, the Chinese economy has been losing momentum since 2016, due to both the trade conflict with the US and domestic structural factors. But economic expansion decelerates in the Latin American countries and in Russia as well. In a number of countries (e.g. Venezuela, Argentina or Turkey) the crisis symptoms are getting out of hand. The global slowdown is clearly visible in industrial production while services growth is still robust. But the negative multiplier effect is bound to reach the services sector as well sooner or later. The softening demand for investment goods leads to a deceleration in the growth of world trade turnover.

The joint GDP of **developing countries** was up 4.4 percent in 2018, a pace above the global average. An interesting contrast to previous trend, Eastern African countries have constituted the fastest-growing group of countries in the 2010s, especially Ethiopia, but also Tanzania and Kenya. Among the East and South-East Asian countries, primarily the relative latecomers in which still very cheap labor and/or valuable natural resources can be found – Laos, Cambodia, Vietnam, the Philippines and Mongolia – produced outstanding growth rates. The Indian economy has expanded by more than 7 percent in the past years, largely due to the 'new economy' and the growing involvement in the global production networks. In Latin America, by contrast, per capita GDP has stagnated in the last five years, with prolonged recession in several countries. The Venezuelan crisis is the most severe, but Argentina and Brazil have also difficulties in getting out of the recession, the longest they have ever faced.

We revised our **global trade forecast** somewhat, due to the trade war and the global slowdown. Unlike in the past years, the slowdown will have a substantial impact on emerging countries too – the deceleration is truly global. The escalation of the China-US trade war halted after the last G20 meeting where an agreement about the restart of negotiations was reached, but the respite may well be temporary. This trade war is particularly harmful for relatively newly emerging South-Eastern Asian countries like Vietnam and Malaysia: most of the demand for their export comes for US consumers.

Commodity prices decreased by 4-6 percent in the first half of the year on average, primarily due to falling prices of industrial metals that were among the first casualties of the trade war: the drastic raise of tariff rates on steel led producers to decrease production. Still, the steel demand from the Chinese infrastructure projects is still enormous – with these projects the Chinese government tries to keep up economic growth. The trade war caused a 13 percent fall of aluminum prices while – due to Chinese fiscal stimulus – iron prices rose by 27 percent. Food commodity prices continued to fall and palladium a downward correction of the price of palladium took place as well, a

result of the auto industry slowdown. Hence the leap in the iron ore price could not offset the fall in the prices of other industrial commodities.

According to the medium-term forecasts, demand for **crude oil** will decelerate in the coming years, partly due to the Chinese slowdown – even though the Indian growth of oil demand will remain robust. But US shale oil production also plays a role. The IEA predicts an average demand of 100.4 million barrels per day for 2019, a 1.2 percent growth compared to 2018. After months of rise crude oil price surpassed USD 70 per barrel by late April but slipped again in mid-June. In early July, the oil price is hovering slightly above USD 65. We expect an annual average oil price of about USD 65 in 2019 and 2020. The oil market is likely to remain roughly balanced amid relatively stable oil supply and softening growth oil demand.

Due to the worsening growth outlook and more frequent slips in stock market indices, the central banks of the developed countries **halted monetary tightening**. The FED stopped raising the policy rate and the expectations about a rate cut in July are becoming overwhelming. The FED's dilemma is that the US economy still seems strong, hence it prefers the 'wait and see' approach for now. The ECB will keep rates low and will ensure to provide sufficient liquidity to banks. The president of the ECB even maintained the possibility of further monetary easing if the inflation remains below target and if economic outlook does not improve. Euro is still relatively weak: on average, it stood at *1,13 USD/EUR* in the first half of the year. We expect a similar exchange rate for the rest of the year and for 2020 as well. The BOJ will keep up its expansive monetary stance as well: the Japanese central banks struggles to raise inflation while trade tensions and the global slowdown may cause recession in Japan.

In the **US**, the fiscal expansion will moderate in the forecast period, which – along with the worsening external conditions and the trade policy uncertainties – will bring about a deceleration of economic growth. GDP growth is to slightly surpass 2 percent in 2019 while the growth rate may dip below 2 percent in the next year. Due to the still robust labor market and growing wages, private consumption will keep supporting growth.

The **Japanese** economy will continue to grow at a very modest pace, by about 0.7 percent per year, during the forecast period. Overall growth is dampened by the downward trend in the export toward China: after years of deceleration, overall Japanese export is expected to contract by 1.4 percent in 2019. The general shortage of labor and productive capacities pushes wages upwards, which forces firms to modernize their operation: hence investments are still on the rise, even if at a decelerating pace. But new manufacturing orders decreased sharply in the recent months, demonstrating that weakening Chinese demand puts a wrench in the wheels of growth of the export-oriented Japanese economy.

The trade war puts considerable pressure on **China** but this has only limited impact on the publicly available economic indicators – so far. Industrial growth is decelerating but it still around 6 percent while retail sales expand at a steady rate of 8 percent. Still as much as one-fourth of global economic growth can be attributed to China. Behind the overall growth of slightly above 6 percent (we expect 6.2 percent for 2019) significant structural changes are underway, driven by dynamic consumption growth and the expansion of services, especially the e-economy. Strong wage and income growth and the rise of e-commerce ensures the intense growth of consumption, but the dangers connected to the growing indebtedness – of households, firms and certain municipalities – is becoming more and more severs. The decrease in the formerly very substantial

current account surplus poses a threat to the world economy – what is more, a slight current account deficit is expected lately for 2019. The prominent position of China regarding the 'new economy' is indicated by the arsenal of protectionist measures which is hurled at China by the worried hegemon, the US. The unpredictable behavior of the US jeopardizes the global economy as well. China holds about USD 1.1 trillion US treasury bonds and it can dump them on the market if needed. This is not a likely scenario, but the fear of a mass sale may precipitate a panick that would hurt emerging economies the most.

The global slowdown has reached the member states of the **European Union** as well. Decelerating global trade, fears about the trade war and about the possibility of monetary tightening affected economic growth from the second half of 2018. Manufacturing will remain weak during 2019. GDP growth may decelerate to 1.5 percent (from 2 percent in the last year) and no substantial rebound is expected for 2020.

The same goes for the **eurozone**. After the 1.9 percent GDP growth in the last year, we expect only 1.2 percent in 2019 and 1.4 percent in 2020. The slowdown is primarily due to the unfavorable global trade environment and the resulting weakening of manufacturing growth. The latter is spectacular especially in the large EU countries and affects almost every important subsector (auto industry, pharmaceutical, chemical and electronic industries). In particular, extra-eurozone export lost momentum, most notably toward China, the UK and Turkey.

Inflation is still low: the harmonized price index was 1.2 percent in both May and June, the lowest rate since April 2018. The deceleration is primarily due to the prices of energy and services. We expect an annual inflation of 1.5 and 1.4 percent, respectively, in 2019 and 2020 – both are way behind the ECB target. Core inflation minimally rose in June to 1.1 percent, which suggests that at least deflation is not a threat right now. Labor markets are usually robust within the eurozone, unemployment is low – with very few exceptions. The average unemployment rate is about 7 percent in the EU19 and even lower, roughly 6.5 percent, in the EU28. Labor shortage is still a problem everywhere but tends to become less severe in the large member states.

German GDP growth decelerated to 1.5 percent in 2018 (from 2.5 percent in 2017) and it was as low as 0.4 percent in the first quarter of 2019. While GDP may even decrease in the second quarter, a very modest growth of 0.5-0.7 percent can be expected for 2019 as a whole. The German economy is marred by the difficulties the auto industry and the chemical industry faces, and by the general softening of external demand. Business sentiment also suffers from the uncertainties around Brexit, sending sentiment indicators into a tailspin. The export slowdown will probably put a damper on demand for investment goods as well.

The economic prospects in the **United Kingdom** are still profoundly damaged by the Brexit chaos. The growth rate will continue to decelerate in 2019 to about 1.2 percent (from 1.4 percent in the last year), with some further slowdown in 2020. The Brexit-problem has a deepening impact on investment activity. The government tries to mitigate the slowdown and prop up business sentiment with fiscal measures, yet gross fixed capital formation is likely to contract in 2019, after stagnating in the last year, and the export of goods and services will probably be almost flat. No substantial change can be expected in 2020 either. Inflation fluctuates around the target (2 percent), but the BOE leaves the policy rate unchanged (at 0.75 percent since August 2018), due to the gloomy business sentiment and the dim economic outlook.

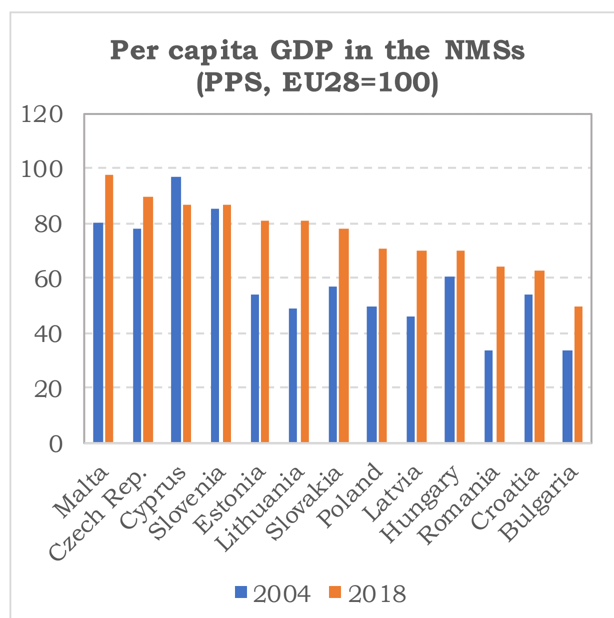
Central Eastern European new member states

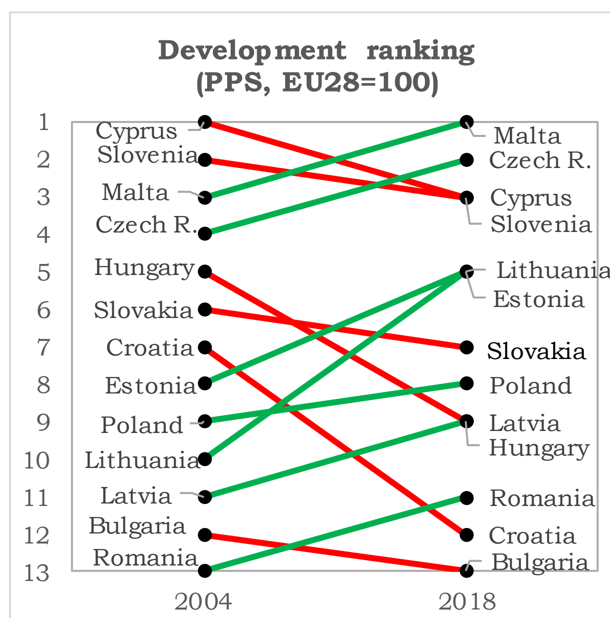
Convergence to the EU

In every year early in the summer, the Eurostat publishes the data about the relative levels of economic development in each EU member states in the previous year. Compared to 2017, only two countries among the new member states improved its position in 2018: Latvia (from 10th to 9th) and Lithuania (from 6th to 5th). At the same time, however, no country slipped back in the ranking, leading to new ties: Lithuania is the fifth together with Estonia in terms of GDP per capita, while Latvia is the ninth along with Hungary.

In terms of GDP per capita denominated in purchasing power parity, Malta is still the most developed economy with 98 percent of the EU-average. The Czech Republic is the second (90%), and – as already mentioned – Cyprus and Slovenia are the third (87%). At the other end of the spectrum are Bulgaria (50%), Croatia (63%) and Romania (64%). In the case of Hungary and Latvia, the respective ratios stand at 70 percent.

Over the past 14 years, Lithuania achieved the most impressive economic development, starting at 49 percent of the EU average at the time of joining the EU and reaching 81 percent by 2018. As a result, its ranking improved from 10th in 2004 to 5th in 2018. Real convergence was almost as impressive in Romania – its level of per capita GDP (in PPS terms) was 30 percentage points higher in 2018 than in 2004. Still, the starting level of Romania was so low that even with this improvement it got ahead only by 2 places in the ranking. Cyprus is the only new member state where real divergence has taken place compared to 2004 (a decrease of 10 percentage points in 2018), due to the steep fall in GDP during the financial crisis, a result of very close links to the Greek economy. Among the other countries Hungary produced the least relative development, with its relative per capita GDP rising only 9 percentage points (from 61% of the EU28 average to 70%). Hungary's relative position within the group of NMSs worsened drastically, from the fifth place to the ninth. In 2004, Hungary was the closest to Slovakia and the Czech Republic in terms of relative development but economic development in the latter two countries far exceeded that in Hungary, resulting in a much steeper growth trajectory. There is a good chance that in 2019 Hungary will slip behind Latvia, landing on the tenth place,





just ahead of Romania. Romania achieved spectacular growth in the past couple of years but at the same time accumulated considerable macroeconomic imbalances that weighs its further growth down.

Dynamic growth, mounting problems

In the first quarter, the GDP of new EU member states grew by an average 4.3 percent, a slight acceleration compared to 2018 as a whole. Atypically, Hungary achieved the highest growth rate (5.3 percent). Still, due to their larger weight, Poland and Romania contributed the most the overall growth of the NMSs, with growth rates of 4.7 and 5 percent, respectively.

Czechia continues to underperform compared to the average. While the Czech economic seems to operate near full capacity, this very fact hinders further grows. With an unemployment rate of 2.2 percent, they virtually achieved full employment, which means that they can only increase output through increasing productivity. To achieve this, new investment would be necessary, but investment projects tend to be delayed due to the gloomy German outlook, and to the Brexit-related uncertainties. High wage growth pushes housing prices upward. Furthermore, developers cannot keep pace with the increased housing demand, which boosts housing prices further. Strong demand was accompanied by a substantial decrease in private savings during the last three years. To keep labor shortage checked, the Czech central bank raised the policy rate by 25 basis points – to 2 percent – in May 2019. In the meanwhile, the government tries reducing the firms' transport costs through long-term infrastructure development projects but in the short run these projects also absorb workforce badly needed elsewhere. The Czech Republic is the first Visegrad country getting into a situation that warrants urgent action to adjust the structure of its economy. While there are no further capacities available for raising the output, consumption growth raises overall demand, probably resulting in the disappearance of the current account surplus in 2019. Raising productivity has become an urgent task. This task, however, makes the comprehensive overhaul of education, health systems and of the society as a whole necessary, which in turn would require an extraordinary political determination.

While Romania managed to maintain its high growth rate so far (5 percent in the first quarter), this comes with a heavy price. The consumption-centered growth model causes severe macroeconomic imbalances, most notably a rise of external financing requirement to 3.1 percent of GDP in 2018, the highest by far in the region. National-level net savings fell to 50 percent of GDP and the current account deficit rose to 5 percent of GDP. The fact that part of investments is financed from the EU cohesion funds provides some breathing space. Romanian fiscal deficit is on the rise, it stood at 3 percent of GDP in 2018 and is likely to deteriorate further. The fiscal deficit and the current account deficit make the country vulnerable even though the fiscal debt is stable for now. Without fiscal adjustment, Romania may be forced to adjust in some other way soon – for example, through an exchange rate crisis – resulting in an about-turn of domestic demand.

In the majority of new member states, private consumption is the main driver of growth in the first quarter. While investment growth is substantial in a number of countries, its growth contribution often remained modest, due to investments' smaller weight within GDP. Hungary and, to a lesser extent, Croatia were the exceptions. Net export contributed markedly to overall growth in Latvia and Bulgaria while its contribution was negative in Romania in the first quarter. Slovakia is a notable case: private consumption only grew by 1.2 percent in the first quarter, a substantial deceleration. Hence Slovakia is the only new member states where private consumption contributed to economic

growth by less than 1 percentage point. Investments were up 6.6 percent, which is much to do with the available EU funds. At the moment, net export still largely offsets the deceleration of consumption but sooner or later the transformation of the automotive sector – and the resulting erratic growth of its output – is likely to cause serious problems for the Slovakian economy.

Central banks bide their time amid rising core inflation

Between January and May the average inflation among the new member states was 2.4 percent, an acceleration compared to the previous years. The average was pulled up considerably by the 4 percent registered in Romania. The higher price indexes were primarily due to food and energy prices: In Hungary and Romania, food prices rose by more than 5 percent while energy prices rose by roughly the same in Latvia and Slovakia. Core inflation was 1.8 percent in the EU13 in January-May, with Hungary and Romania at the top with rates of 2.9 and 2.8 percent, respectively. Beside these two countries, the Baltic states saw a rise of core inflation to slightly above 2 percent. Apparently, these core inflation levels do not yet disturb central banks since none of the Romanian, Polish or Hungarian central banks seem to plan rate hikes. It should be noted that central banks face a conundrum: economic growth is expected to slow down in the second half of the year, which means that a monetary tightening would exert severe pressure on fiscal policy.

Growth trends expected to slightly flatten from the second half

While the first-quarter growth was surprisingly buoyant in the new member states, the mounting uncertainties and the worsening of external economic conditions may well put a dent on their short-term growth prospects. The slowdown of German economy may reduce the growth contribution of net export, already not very high in most countries, while the capacity of consumption growth to offset this negative effect may moderate. EU-financed investments may cushion the slowdown, but the labor shortage puts a brake on the implementation of investment projects. While most new member states converged to the EU average during the past 14 years, a thorough upgrade of the education system would be necessary for further convergence, while at the same time fiscal policy should be put on a more sustainable footing in several countries. The slowdown in the second half of the year will probably remain moderate, thus we expect an annual average GDP growth rate of about 4 percent in 2019 as a whole. The average growth rate is likely to slow down to slightly above 3 percent due to weakening investments and worsening net export.

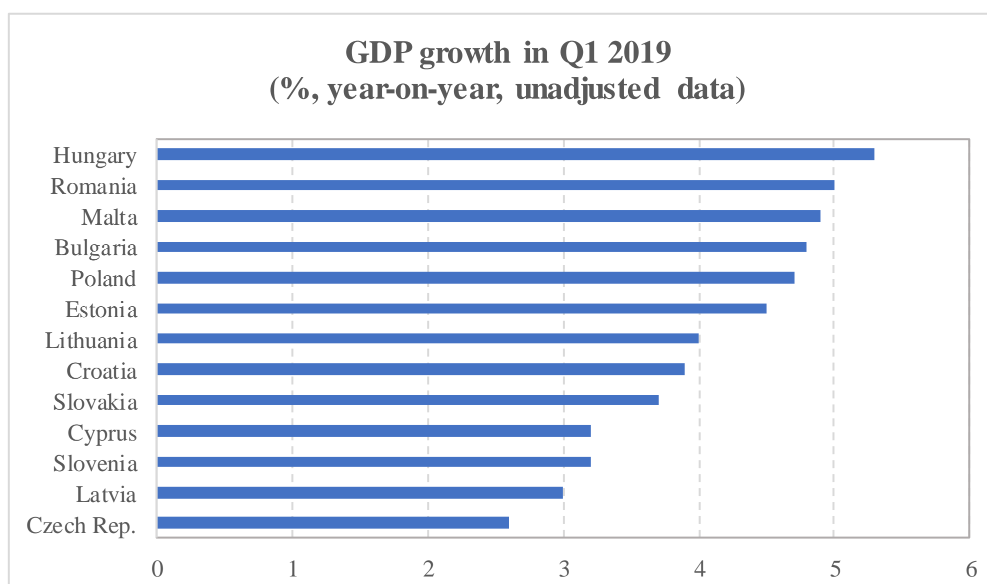


Table 2.1.

Economic Growth in the EU Member States

(Percentage change of real GDP over the previous year)

	Weight	2013	2014	2015	2016	2017	2018	2019*	2020*
Germany	21.4	0.5	2.2	1.7	2.2	2.2	1.4	0.8	1.2
France	14.8	0.6	1.0	1.1	1.2	2.2	1.7	1.3	1.4
Italy	11.1	-1.7	0.1	0.9	1.1	1.6	0.9	0.1	0.5
Netherlands	4.9	-0.2	1.4	2.0	2.2	2.9	2.7	1.8	1.8
Belgium	2.8	0.2	1.3	1.4	1.4	1.7	1.4	1.3	1.4
Luxembourg	0.3	3.7	4.3	3.9	2.4	1.5	2.6	2.6	2.7
Ireland	2.0	1.6	8.3	25.1	5.0	7.2	6.7	3.8	3.1
Greece	1.2	-3.2	0.7	-0.3	-0.2	1.5	1.9	1.3	1.9
Spain	7.6	-1.7	1.4	3.6	3.2	3.0	2.6	2.1	2.0
Portugal	1.3	-1.1	0.9	1.8	1.9	2.8	2.1	1.6	1.5
Austria	2.4	0.0	0.7	1.1	2.0	2.6	2.7	1.5	1.6
Finland	1.4	-0.8	-0.6	0.5	2.8	2.7	2.3	1.6	1.2
Estonia	0.2	1.9	2.9	1.9	3.5	4.9	3.9	4.7	3.5
Slovakia	0.6	1.5	2.8	4.2	3.1	3.2	4.1	3.8	3.4
Slovenia	0.3	-1.1	3.0	2.3	3.1	4.9	4.5	3.5	3.1
Cyprus	0.1	-6.0	-1.3	2.0	4.8	4.5	3.9	3.3	2.7
Malta	0.1	4.6	8.2	9.5	5.2	6.7	6.7	4.6	4.0
Latvia	0.2	2.4	1.9	3.0	2.2	4.6	4.8	3.2	2.8
Lithuania	0.3	3.5	3.5	2.0	2.3	4.1	3.5	3.5	3.2
Euro Area	**72.9**	**-0.3**	**1.4**	**2.1**	**1.9**	**2.4**	**1.9**	**1.2**	**1.4**
United Kingdom	15.1	2.1	2.9	2.3	1.8	1.8	1.4	1.1	1.0
Denmark	1.9	0.9	1.6	1.6	2.0	2.3	1.4	1.7	1.6
Sweden	2.9	1.2	2.6	4.5	2.7	2.1	2.4	2.0	2.0
Hungary	**0.8**	**2.1**	**4.2**	**3.5**	**2.3**	**4.1**	**4.9**	**4.5**	**3.3**
Czech Republic	1.3	-0.5	2.7	5.3	2.5	4.4	2.9	2.7	2.4
Poland	3.1	1.4	3.3	3.8	3.0	4.8	5.1	4.6	3.7
Romania	1.3	3.5	3.4	3.9	4.8	7.0	4.1	4.7	3.9
Bulgaria	0.3	0.9	1.3	3.6	3.9	3.8	3.1	3.5	2.7
Croatia	0.3	-1.1	-0.1	2.4	3.5	2.9	2.6	3.5	3.2
EU-15	**91.1**	**0.1**	**1.3**	**2.3**	**1.9**	**2.3**	**1.8**	**1.2**	**1.3**
New EU-13	**8.9**	**1.3**	**2.7**	**3.8**	**3.2**	**4.8**	**4.3**	**4.1**	**3.3**
EU-28	**100**	**0.3**	**1.8**	**2.3**	**2.0**	**2.5**	**2.0**	**1.5**	**1.5**
BREXIT	**84.9**				**2.1**	**2.6**	**2.1**	**1.5**	**1.6**
Memorandum items									
USA		1.8	2.5	2.9	1.6	2.2	2.9	2.4	1.9
Japan		2.0	0.3	1.1	1.0	1.9	0.8	0.7	0.7
China		7.7	7.3	7.0	6.7	6.9	6.6	6.2	6.1
Russia		1.3	0.7	-2.8	-0.2	1.5	2.3	1.3	1.5
South-Eastern Europe									
Serbia		2.6	-1.8	1.7	3.3	2.1	4.3	3.2	3.8
Turkey		4.2	5.2	6.1	3.2	7.4	2.5	-1.2	3.9

* Kopint-Tárki forecast

EU-15 = Countries that joined the European Union before 2004 (“Old EU Member States”)

New EU-13 = Countries that joined the European Union in 2004, 2007 and 2013 (“New EU Member States”)

Sources: Eurostat, national statistical offices, OECD

Table 2.2.

Inflation in the EU Member States

(Harmonized consumer price indices, percentage change over the previous year)

	Weight	2013	2014	2015	2016	2017	2018	2019*	2020*
Germany	20.1	1.6	0.8	0.1	0.4	1.7	1.9	1.5	1.6
France	14.3	1.0	0.6	0.1	0.3	1.2	2.1	1.4	1.4
Italy	12.4	1.2	0.2	0.1	-0.1	1.3	1.2	0.9	0.8
Netherlands	3.9	2.6	0.3	0.2	0.1	1.3	1.6	2.3	1.7
Belgium	2.6	1.2	0.5	0.6	1.8	2.2	2.3	1.6	1.8
Luxembourg	0.2	1.7	0.7	0.1	0.0	2.1	2.0	2.0	2.1
Ireland	1.1	0.5	0.3	0.0	-0.2	0.3	0.7	1.0	1.2
Greece	1.4	-0.9	-1.4	-1.1	0.0	1.1	0.8	0.9	1.0
Spain	8.0	1.5	-0.2	-0.6	-0.3	2.0	1.7	1.2	1.4
Portugal	1.5	0.4	-0.2	0.5	0.6	1.6	1.5	1.4	1.6
Austria	2.2	2.1	1.5	0.8	1.0	2.2	2.1	1.4	1.3
Finland	1.4	2.2	1.2	-0.2	0.4	0.8	1.2	1.4	1.6
Estonia	0.1	3.2	0.4	0.1	0.8	3.7	3.4	2.9	3.0
Slovakia	0.6	1.5	-0.1	-0.3	-0.5	1.3	2.5	2.5	2.5
Slovenia	0.3	1.9	0.4	-0.8	-0.2	1.6	1.9	2.0	2.1
Cyprus	0.2	0.4	-0.2	-1.6	-1.2	1.0	0.8	1.4	1.4
Malta	0.1	1.0	0.7	1.2	0.9	1.3	1.7	2.7	3.0
Latvia	0.2	0.0	0.7	0.2	0.1	2.9	2.6	2.8	2.9
Lithuania	0.3	1.2	0.3	-0.7	0.7	3.8	2.5	2.7	3.0
Euro Area	**70.9**	**1.3**	**0.4**	**0.0**	**0.2**	**1.5**	**1.8**	**1.5**	**1.4**
United Kingdom	17.8	2.6	1.5	0.0	0.7	2.7	2.5	2.0	2.3
Denmark	1.6	0.5	0.4	0.2	0.0	1.1	0.7	1.6	1.2
Sweden	2.3	0.4	0.2	0.7	1.1	1.9	2.0	2.0	2.2
Hungary	**0.7**	**1.7**	**0.0**	**0.1**	**0.4**	**2.4**	**2.9**	**3.5**	**3.7**
Czech Republic	1.1	1.4	0.5	0.2	0.7	2.3	2.0	2.5	2.6
Poland	3.4	0.8	0.1	-0.7	-0.2	1.6	1.2	2.2	2.8
Romania	1.5	3.2	1.4	-0.4	-1.1	1.0	4.1	4.6	4.4
Bulgaria	0.4	0.4	-1.6	-1.1	-1.3	1.0	2.6	3.0	3.0
Croatia	0.3	2.3	0.3	-0.3	-0.6	1.3	1.6	1.0	1.7
EU-15	**90.8**	**1.5**	**0.6**	**0.1**	**0.4**	**1.7**	**1.9**	**1.6**	**1.6**
New EU-13	**9.2**	**1.4**	**0.3**	**-0.4**	**-0.2**	**1.7**	**2.2**	**2.8**	**3.0**
EU-28	**100.0**	**1.5**	**0.5**	**0.0**	**0.3**	**1.7**	**1.9**	**1.7**	**1.7**
BREXIT	**82.2**				**0.2**	**1.5**	**1.8**	**1.6**	**1.6**
Memorandum items [a]									
USA		2.1	1.5	1.6	0.1	1.3	2.4	1.8	2.2
Japan		0.0	0.4	2.7	0.8	0.5	1.0	0.8	1.7
China		2.6	2.6	2.0	1.4	2.0	2.2	2.3	2.3
Russia [b]		6.8	7.8	15.5	7.0	3.7	2.9	4.9	4.0
South-Eastern Europe									
Serbia		1.5	2.3	1.4	1.1	3.1	2.0	2.5	2.7
Turkey		7.8	8.9	7.8	7.7	11.0	16.7	13.3	9.6

a Non-harmonized comsumer price indices
b December/December
* Kopint-Tárki forecast
EU-15 = Countries that joined the European Union before 2004 (“Old EU Member States”)
New EU-13 = Countries that joined the European Union in 2004, 2007 and 2013 (“New EU Member States”)
Sources: Eurostat, national statistical offices, OECD

Table. 2.3.

Harmonized Unemployment rates in the EU Member States

(Unemployed as a percentage of the labor force aged 15-74, ILO-Eurostat)

	Weight	2013	2014	2015	2016	2017	2018	2019*	2020*
Germany	16.4	5.2	5	4.6	4.1	3.8	3.4	3.2	3.2
France	12.6	10.3	10.3	10.4	10.1	9.4	9.1	8.6	8.5
Italy	11.7	12.1	12.7	11.9	11.7	11.2	10.6	10.4	10.1
Netherlands	3.3	7.3	7.4	6.9	6.0	4.9	3.8	3.4	3.1
Belgium	2.2	8.4	8.5	8.5	7.8	7.1	5.9	5.5	5.3
Luxembourg	0.1	5.9	6.0	6.5	6.3	5.6	5.3	5.0	4.9
Ireland	0.9	13.8	11.9	10	8.4	6.7	5.8	4.5	4.0
Greece	2.1	27.5	26.5	24.9	23.6	21.5	19.3	18.9	17.6
Spain	9.2	26.1	24.5	22.1	19.6	17.2	15.3	13.8	13.6
Portugal	2.0	16.4	14.1	12.6	11.2	9.0	7.0	6.5	6.1
Austria	1.8	5.4	5.6	5.7	6.0	5.5	4.9	4.8	4.6
Finland	1.0	8.2	8.7	9.4	8.8	8.6	7.4	6.8	6.6
Estonia	0.3	8.6	7.4	6.2	6.8	5.8	5.7	5.0	4.9
Slovakia	1.1	14.2	13.2	11.5	9.7	8.1	6.9	5.8	5.8
Slovenia	0.4	10.1	9.7	9	8.0	6.6	5.6	4.4	4.3
Cyprus	0.2	15.9	16.1	15	13	11.1	8.2	7.5	7.3
Malta	0.1	6.4	5.8	5.4	4.7	4.0	3.9	3.5	3.5
Latvia	0.4	11.9	10.8	9.9	9.6	8.7	7.3	6.7	6.5
Lithuania	0.6	11.8	10.7	9.1	7.9	7.1	6.5	6.1	6.0
Euro Area	**66.3**	**12.0**	**11.6**	**10.9**	**10**	**9.1**	**8.2**	**7.7**	**7.5**
United Kingdom	12.6	7.5	6.1	5.3	4.8	4.4	4.0	3.9	3.7
Denmark	1.1	7.0	6.6	6.2	6.2	5.7	5.0	4.9	4.7
Sweden	1.9	8	7.9	7.4	6.9	6.7	6.3	5.7	5.2
Hungary	**2.0**	**10.2**	**7.7**	**6.8**	**5.1**	**4.2**	**3.7**	**3.5**	**3.3**
Czech Republic	2.1	7.0	6.1	5.1	4.0	2.9	2.4	2.1	2.0
Poland	7.8	10.3	9.0	7.5	6.2	4.9	3.3	3.8	3.6
Romania	4.0	7.1	6.8	6.8	5.9	4.9	4.3	4.2	4.1
Bulgaria	1.4	13.0	11.4	9.2	7.6	6.2	6.0	4.9	4.8
Croatia	0.8	17.4	17.2	16.1	13.4	11.1	9.1	7.6	7.4
EU-15	**78.9**	**11.1**	**10.5**	**9.9**	**9.2**	**8.4**	**7.5**	**7.1**	**6.9**
New EU-13	**21.1**	**10.1**	**10.4**	**7.9**	**6.6**	**5.5**	**4.5**	**4.2**	**4.0**
EU-28	**100.0**	**10.9**	**10.2**	**9.4**	**8.6**	**7.6**	**7.0**	**6.5**	**6.3**
BREXIT	**87.4**				**9.2**	**8.3**	**7.4**	**6.9**	**6.7**
Memorandum items [a]									
USA		7.4	6.2	5.3	4.9	4.3	3.9	3.8	3.8
Japan		4.0	3.6	3.4	3.1	2.8	2.4	2.4	2.3
China[b]		4.6	4.7	4.1	4.0	4.0	4.0	4.0	4.0
Russia[c]		5.5	5.1	5.6	5.7	5.4	5.1	5.5	5.8
South-Eastern Europe									
Serbia[d]		22.1	19.2	17.7	15.3	13.5	12.7	11.0	9.0
Turkey		9.0	9.9	10.3	10.9	10.9	11.0	14.0	13.6

a Non-harmonized unemployment rates
b Urban unemployment
c OECD statistics, unemployment rates for the age group 15-64
d National statistics, unemployment rates for the age group 15-64
* Kopint-Tárki forecast
EU-15 = Countries that joined the European Union before 2004 (“Old EU Member States”)
New EU-13 = Countries that joined the European Union in 2004, 2007 and 2013 (“New EU Member States”)
Source: Eurostat, national statistical offices, OECD

Macroeconomic indicators for Hungary and Kopint-Tárki forecast

(year-on-year change, percentage)

	Data				**Forecast**			
			2019		**2019**		**2020**	
	2017	**2018**	**Q1**	**Apr-May.**	**2019 May**	**2019 July**	**2019 May**	**2019 July**
GDP aggregates, real growth								
GDP total	4.1	4.9	*5.3*		4.5	**4.5**	3.2	**3.3**
Domestic Demand	6.8	7.0	*4.3*		5.5	**5.4**	3.7	**3.7**
Private Consumption	4.1	4.6	*4.8*		4.5	**4.5**	3.7	**3.7**
Public Consumption	2.0	-2.1	*2.1*		0.0	**0.5**	0.0	**0.0**
Gross Fixed Capital Formation	18.2	16.5	*23.4*		10.5	**15.0**	5.0	**5.0**
Gross Capital Formation	17.1	17.2	*5.7*		10.5	**9.0**	5.0	**5.0**
Export	4.7	4.7	*7.7*		5.5	**6.0**	5.0	**5.0**
Import	7.7	7.1	*6.7*		6.8	**7.1**	5.7	**5.7**
Industrial production	4.6	3.6	*6.2*	*7.5*	5.4	**5.4**	4.5	**4.5**
Consumer Price Index	2.4	2.8	*3.2*	*3.9*	3.5	**3.5**	3.5	**3.7**
Employment, Earnings								
Number of Employed, p. avg.[b]	1.6	1.1	*1.4*	*0.8* [e]	0.5	**0.9**	0.3	**0.5**
Employment Rate [b]	59.3	60.4	*60.6*	*60.8* [e]	60.7	**60.8**	61.1	**61.1**
Unemployment Rate [b]	4.2	3.7	*3.6*	*3.3* [e]	3.6	**3.4**	3.5	**3.3**
Unit Labor Costs, in EUR[d]	11.4	6.1	*5.8*		5.2	**5.4**	3.2	**4.4**
Gross Nominal Wages	12.9	11.3	*11.0*	*9.0* [d]	8.5	**9.7**	8.0	**8.5**
Net Real Wages	10.3	8.3	*7.6*	*4.9* [d]	5.3	**6.0**	4.7	**4.6**
Savings Rate, % of GDP [e]	5.2	5.9	*5.3*		5.0	**4.9**	4.0	**4.0**
Current Account Balance								
% of GDP	2.8	0.5			-0.2	**-0.1**	-0.4	**-0.8**
Current and Capital Account Balance								
% of GDP	3.9	2.2	*-2.8* [f]		1.5	**1.5**	1.0	**1.0**
General Government								
Balance, ESA-2010, % of GDP	-2.2	-2.2			-2.4	**-1.7**	-2.6	**-1.5**
Gross Government Debt, % of GDP	73.3	69.0	*68.3* [g]		68.0	**68.0**	67.0	**67.0**
Short-term Government Yields (3M), eop	-0.01	0.00	*0.04*	*0.21* [h]	0.3	**0.1**	0.5	**0.3**
Long-term Government Yields (10Y), eop	2.02	3.01	*2.86*	*2.63* [h]	3.5	**3.0**	3.8	**3.5**
External Assumptions								
Internat. Trade in Goods and Services	4.9	4.0			4.0	**3.4**	4.0	**3.9**
Brent Oil Price ($/bbl, p. avg.)	54.2	71.2	*63.1*	*71.3*	67.0	**65.0**	68.0	**64.0**
GDP Real Growth, Eurozone	2.4	1.8	*1.0*		1.3	**1.2**	1.4	**1.4**
GDP Real Growth, New EU Members	4.8	4.3	*4.3*		3.6	**4.1**	3.2	**3.3**
EUR-HUF, period average	309	319	*318*	*323*	319	**322**	319	**322**
EUR-USD, period average	1.13	1.18	*1.14*	*1.12*	1.14	**1.13**	1.14	**1.13**

a ILO methodology, period averages, aged 15-74, public workers are counted as employed

b Manufacturing, based on gross value added and monthly average compensation of employees in euro, cumulated from the beginning of the year

c Net lending of households according to the financial accounts statistics, four-quarter cumulative data, % of GDP

d April

e Q2

f Seasonally adjusted by the NBH

g Kopint-Tárki estimate, based on NBH data

h June

2. The Hungarian Economy

As in the last year, the pace of growth surpassed expectations in the first quarter of 2019. GDP rose by 5.3 percent, the highest unadjusted year-on-year growth rate among the EU member states.

The economic expansion was broad-based: on the expenditure side, almost every component boasted significant growth. *Private consumption* keeps rising at a good pace while *gross fixed capital formation* skyrocketed at a pace well above 20 percent. There was one component, however – the change in inventories – that exerted a harsh downward pull on overall growth. Because of this component, final domestic use expanded by only 4.3 percent, instead of the 7-8 percent that would follow from dynamic consumption and fixed investment growth. In a way, the change in inventories obscures the fact that economic growth is, in essence, still driven by domestic demand.

It is beyond doubt that the stellar growth rate of fixed investments will lose momentum in the coming months. At present, the utilization of EU funds is peaking, which drives, above all, investment growth in the transport, electricity, and water and sewage sectors. The infrastructure and utility development projects in these areas drove the growth rate of building investments well above the growth rate of investments in machinery, even if the latter expands at a good pace as well.

Besides, the strong growth in the investments of *private firms* (most prominently in *manufacturing* and *agriculture*) may also be partly due to the business development support received under the aegis of development programs co-funded by the EU. The push from the spending of EU-funds is likely to weaken during the rest of the year.

Private consumption growth continued at a pace comparable to the last year. Moderating wage growth is a factor that will gradually pull consumption dynamism down. For now, the wage growth slowdown is largely limited to the public sector but the depletion of the capacity to raise wages at many firms – and the slow easing of labor shortage, already visible in certain areas – will eventually manifest itself in less sanguine business sector wage growth as well.

But the impact of all this on consumption growth may be delayed beyond the end of this year: consumption dynamism may be maintained through increased household borrowing. From July, the government introduced various credit and support schemes to give a boost to household spending, including both consumption and investment spending. As a result, we expect private consumption to expand in 2019 at a pace only slightly slower than in the last year.

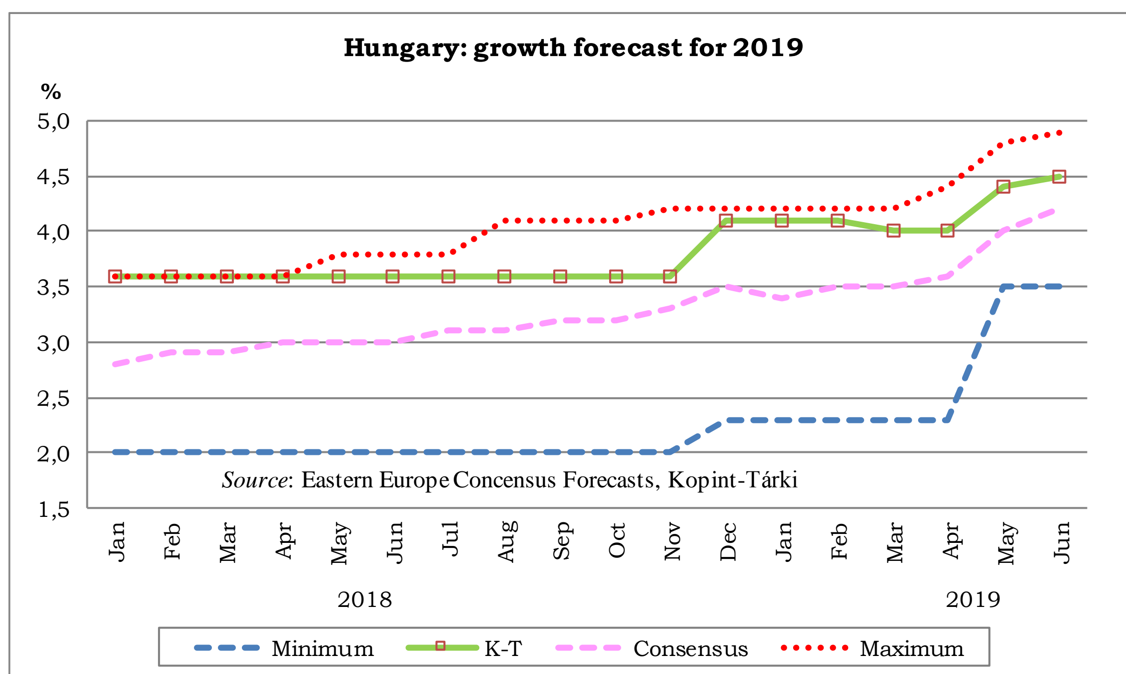
Beside outstanding fixed investment growth, the marked improvement in *net export* was the other striking feature in the first quarter. Technically, this was the factor that helped the growth rate to remain above 5 percent since overall domestic use growth was decimated by the change of inventories.

The turnabout in net export was primarily due to the acceleration in merchandize export and secondarily due to a slowdown o services import. The latter is definitely temporary. The former is harder to assess, but the fact that the export acceleration according to the external trade statistics is much less spectacular than the acceleration according to the GDP statistics, also points to a possible (downward) correction in the coming quarters.

Also, the gloomy European (especially German) economic outlook and the growing threat of escalation of trade war(s) makes it likely that export growth will not keep up the pace

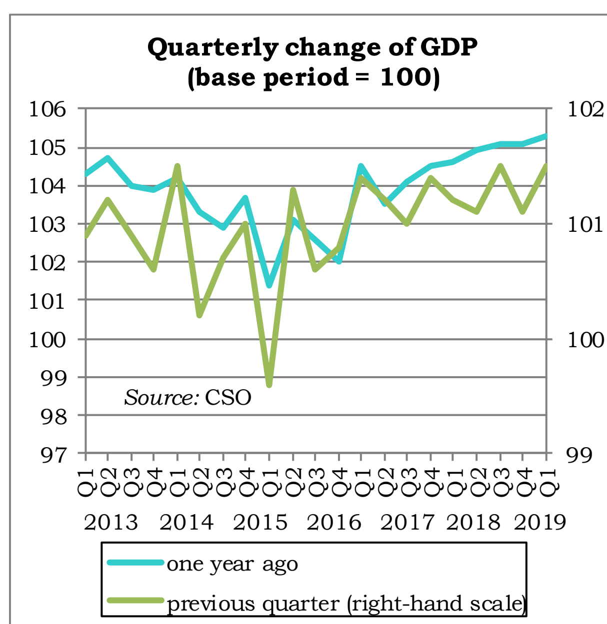
seen in the first quarter. As a result, we expect that annual export growth will fall short of the pace of import growth in 2019 – even if not as drastically than in the last year.

Which means that economic growth will keep being driven by domestic demand, even if – despite the dramatic first quarter – domestic demand itself will moderate compared to the last year, especially due to decelerating fixed investments. On the whole, GDP is expected to expand by **4.5 percent**, a slight deceleration compared to 2018. The next year, on the other hand, will see a more marked turnaround in both investments and consumption, resulting in a subdued economic expansion.



3.1. GDP and its components

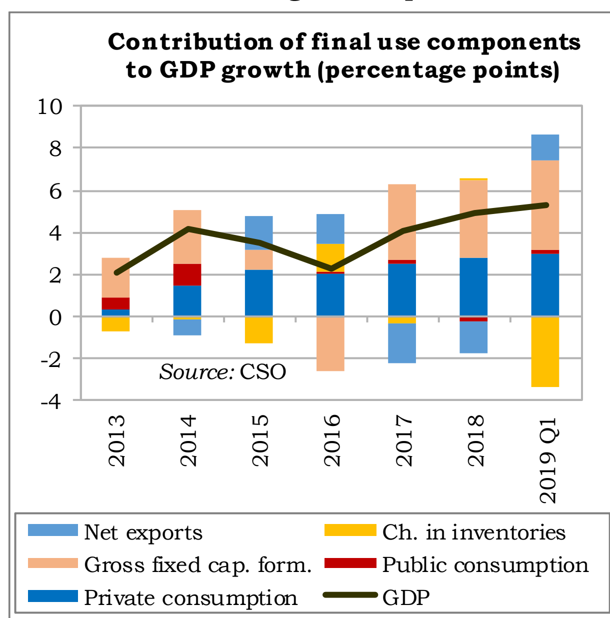
GDP expanded by 5.3 percent in the first quarter, an unexpected acceleration after the 5.1 percent in the second half of 2018. It was also the highest year-on-year growth rate among the EU member states in the first quarter of 2019. The *quarter-on-quarter* growth rate was 1.5 percent.

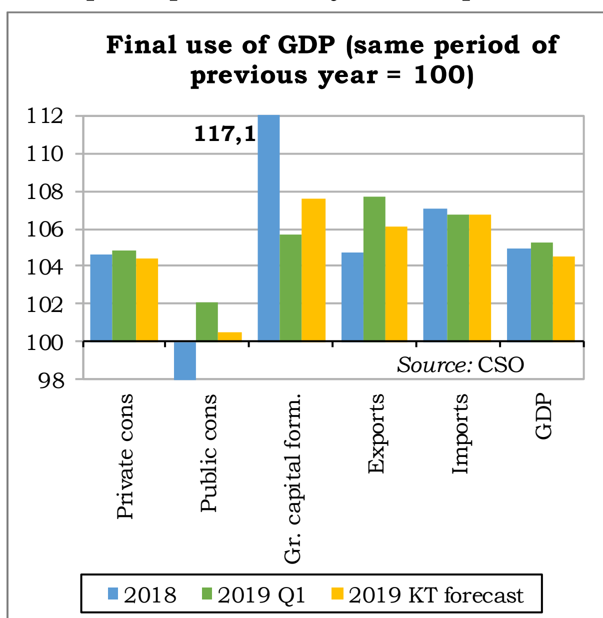


As for the *structure* of growth, the explosion of ***construction*** growth (by a whopping *46.7 percent*) was the most striking element on the **production side**. As a result, the construction sector contributed to the first-quarter growth rate with 1.2 percentage points, an absolute record. This frantic pace was primarily driven by civil engineering projects, largely co-financed by EU funds. Instead of decelerating, the growth in the spending of EU development funds apparently accelerated in the first quarter. Beside construction, ***industrial*** growth gained momentum as well: the higher growth rate (5.9 percent) mostly reflects an improvement in industrial export sales.

On the other hand, the expansion of ***services*** continued to lose steam, even if only symbolically (from 3.9 percent in Q4 2018 to 3.8 percent in the first quarter of this year). The expansion of wholesale and retail trade, transport and information and communication services value added slowed down considerably. At the same time, ***agricultural*** value added declined, due to unfavorable weather conditions, and agricultural output is likely to contract in 2019 as a whole as well.

On the **expenditure side**, a spectacular growth of ***gross fixed capital formation*** (by 23.4 percent) was registered in the first quarter (in line with the galloping construction expansion), but this growth was partly offset by the unfavorable change in inventories. As a result, overall gross capital formation was up 5.7 percent only, which pulled down

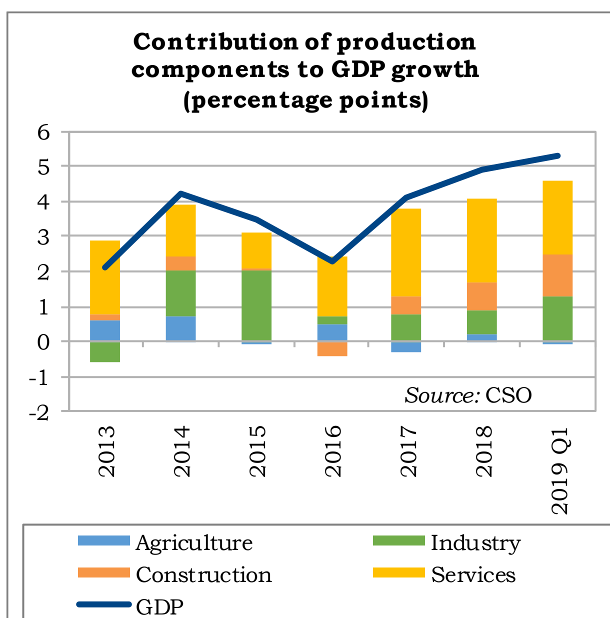


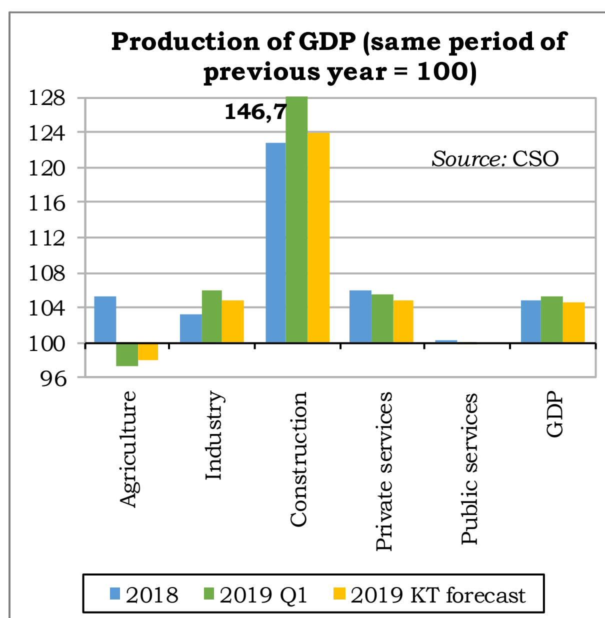


the growth rate of ***final domestic use*** as well to 4.3 percent, the lowest pace since 2016, even though ***private consumption*** continued to expand at a good pace.

While the expansion of domestic demand in itself remained strong – the evolution of inventories does not really reflect domestic demand but other factors, for example, the dwindling stock of finished goods, due to stronger export sales – the dynamism of final domestic use was not strong enough to keep the pace of GDP growth above 5 percent. Conveniently enough, ***net external trade*** came to the rescue: merchandize export grew at a higher pace than merchandize import, as opposed to the past two years, while the net export of services was suddenly very favorable due to a temporary drop in services import growth. As a result, the net export of goods and services contributed to GDP growth by 1.3 percentage points, while its contribution was consistently negative during 2017-2018.

It is highly doubtful whether this positive – or even neutral – growth contribution of net export can be sustained for the coming quarters. We expect that in 2019 as a whole net export will contribute to GDP growth negatively, as in the previous years, even if to a lesser degree. On the other hand, the negative contribution of the change in inventories will markedly ease during the rest of the year, which will permit a faster expansion of final domestic use, even amid a moderation of fixed investment growth. On the whole, **GDP is expected to grow by 4.5 percent in 2019.**





3.1.1. Production of GDP

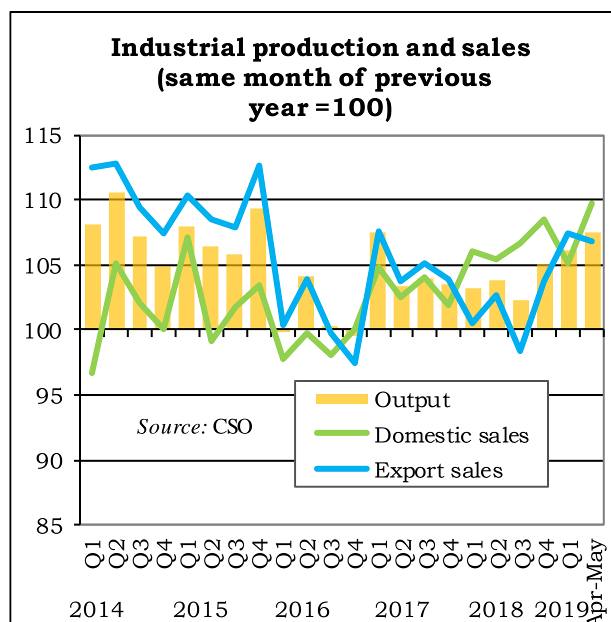
Industry

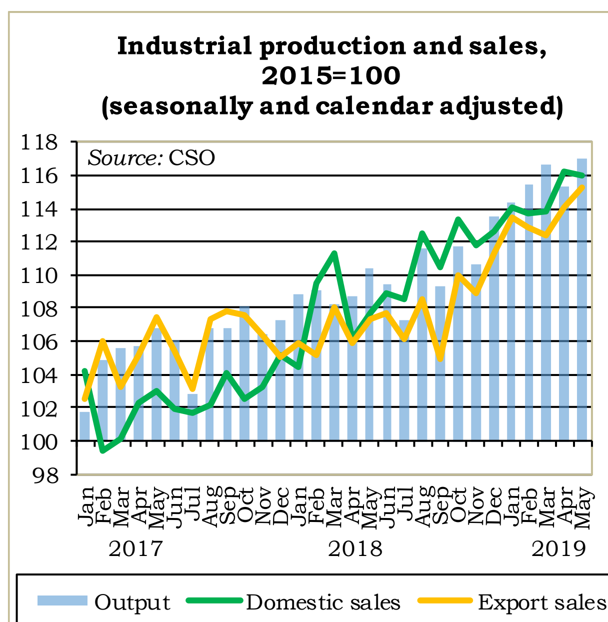
Industrial growth took off after the disappointing pace in 2018: in January-May, industrial output was up 6.7 percent on an annual basis, after 3.6 percent in the last year. The acceleration was due to export sales: while the latter rose by only 1.4 percent in 2018, it jumped by 7.2 percent in the first five months. At the same time, domestic sales were up 6.9 percent, almost identical with the pace seen in the last year.

Still, the upturn in export is not universal: export sales decreased in about one-third of manufacturing branches. Especially notable is the decrease in metal industry and chemical industry, two medium-sized sectors within manufacturing where export sales rose in 2018. In the chemical industry the negative turn is especially severe.

The most important factor behind the renewed export sales expansion is the *automotive* sector, the largest manufacturing branch. Besides, galloping electric industry, strongly rebounding other manufacturing and the tentative revival of machinery and equipment industry should be mentioned. On the other hand, the marked slowdown in rubber industry and the already mentioned fall in chemical industry had a negative impact on overall growth.

At present, we expect annual industrial growth to come close to – or to reach **5.5 percent** in 2019. On the other hand, the prospects for the subsequent years are less encouraging, in the light of the deteriorating outlook in Germany and the turbulences caused by the US-China trade war and the Brexit-chaos.





Construction

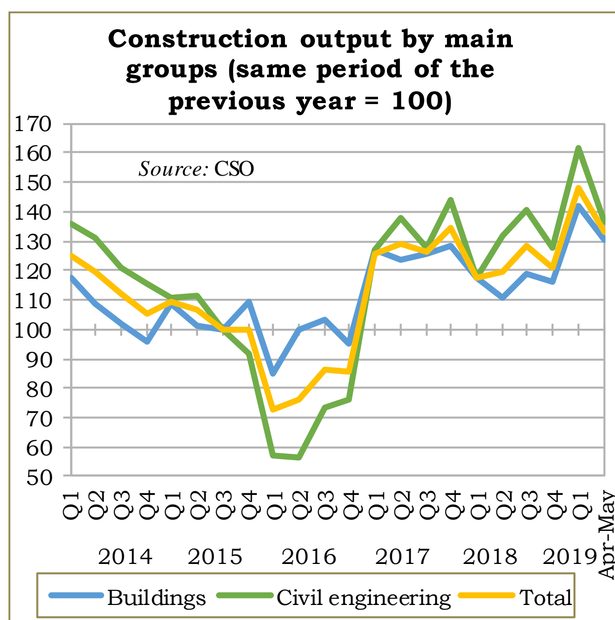
Construction output continues to grow at a dramatic pace: in January-May the output was up 40.4 percent, a record pace. While according to the revised data, the seasonally and working day adjusted output surpassed its previous peak (in the third quarter of 2005) as late as in the last quarter of 2018, in the first quarter the average output was about 16 percent higher than that former peak.

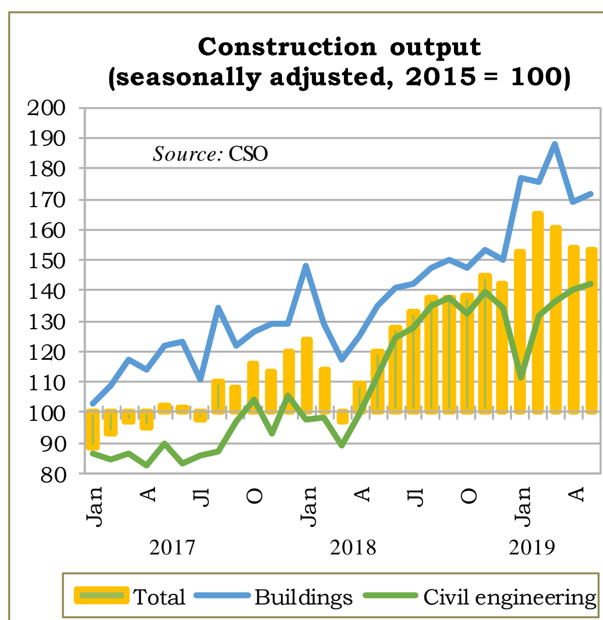
Civil engineering continued to be the primary engine of growth, at least on a year-on-year basis: it rose by about 46 percent in January-May. The output of *construction of buildings* also expanded at a steep pace, by 37 percent.

Civil engineering growth is still driven by road and railroad construction projects, in large part funded by the European Union. But the extreme growth of civil engineering output was partly due to a particularly strong positive seasonal effect in the first four months that apparently came to a halt in May. Civil engineering growth may continue to the rest of the year, but the utilization of EU funds is expected to peak in 2019, signaling a softening or reversion of growth in the next year.

As for the construction of buildings, here the role of EU funds is much more limited, yet the output expanded at a record pace, supported by industrial and storage buildings and – to a lesser extent – by office building and housing construction. In the light of the trends of new orders, the boom in building construction may last longer that the civil engineering boom, even if this probably concerns only the next year.

On the whole, now we expect a much steeper growth in 2019 than previously, **by 25 percent or even more**. In 2020 a slowdown is likely to occur that may become drastic, depending on the evolution of the utilization of EU funds.





Housing construction

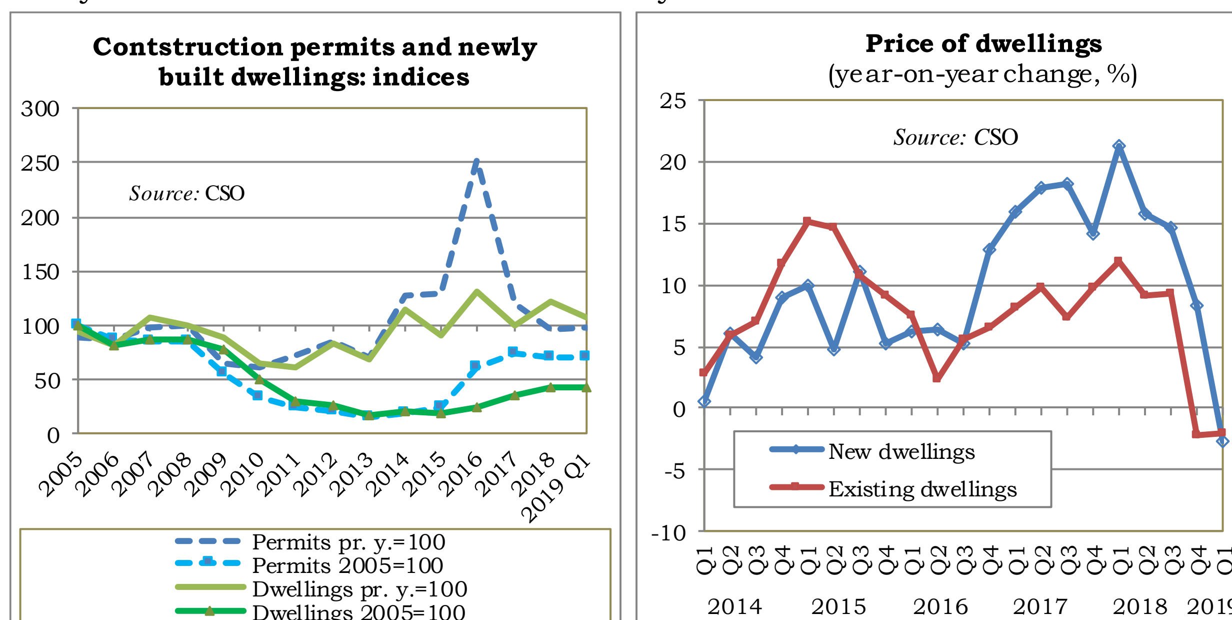
In the first quarter, the *number of dwellings built* was up 7.9 percent, a much more modest pace than in 2018 and especially in 2017. Also, the number of housing building permits and housing building notifications continued to contract at a slow pace in the first quarter, which suggests that the number of newly started building projects is not likely to help keeping up the housing construction boom in the coming years.

It is hard to assess to what degree the extension of the family home allowance scheme (CSOK) and the new very favorable credit scheme offered for young married couples that plan having children, both effective from 1 July, will boost demand for new dwellings and housing construction. For now, we expect that they will not offset the negative effect of the raise of housing construction VAT, effective from January 2020.

But this negative effect will become visible in 2020-2021 and is unlikely to have an impact on this year. There are many dwellings are under construction at present, and their completion is primarily hindered by capacity constraints. The completion of several thousand dwellings is delayed, and the developers are not forced to complete the construction projects by the end of the year now, due to the decision to uphold the preferential VAT rate for projects that were notified before the end of November 2018.

Housing demand remains strong, but a moderation of price increase may indicate a degree of softening of demand growth. According to the CSO, the year-on-year rise in the average price of new dwellings *became negative* in the first quarter of 2019. It should be noted, however, that the price index adjusted for the composition effect, that is, the shift of demand toward cheaper dwellings (the 'pure' price change) remained high in the first quarter. Also, other sources (for example Duna House, a major real estate firm), housing prices keep rising at a fast pace even in 2019.

We expect, despite the soft growth in the first quarter, the number of dwellings built to rise at a two-digit rate in 2019 as a whole. The next year, on the other hand, will see a marked deceleration as the construction projects notified before November 2018 gradually come to an end. Actually, the housing construction activity may contract in 2020. This means that the ebbing of the boom will coincide with the ebbing of the more general construction boom based on the utilization of EU funds, which will accentuate the cyclical fluctuation of construction activity.



3.1.2. Final use of GDP

Household income, consumption and savings

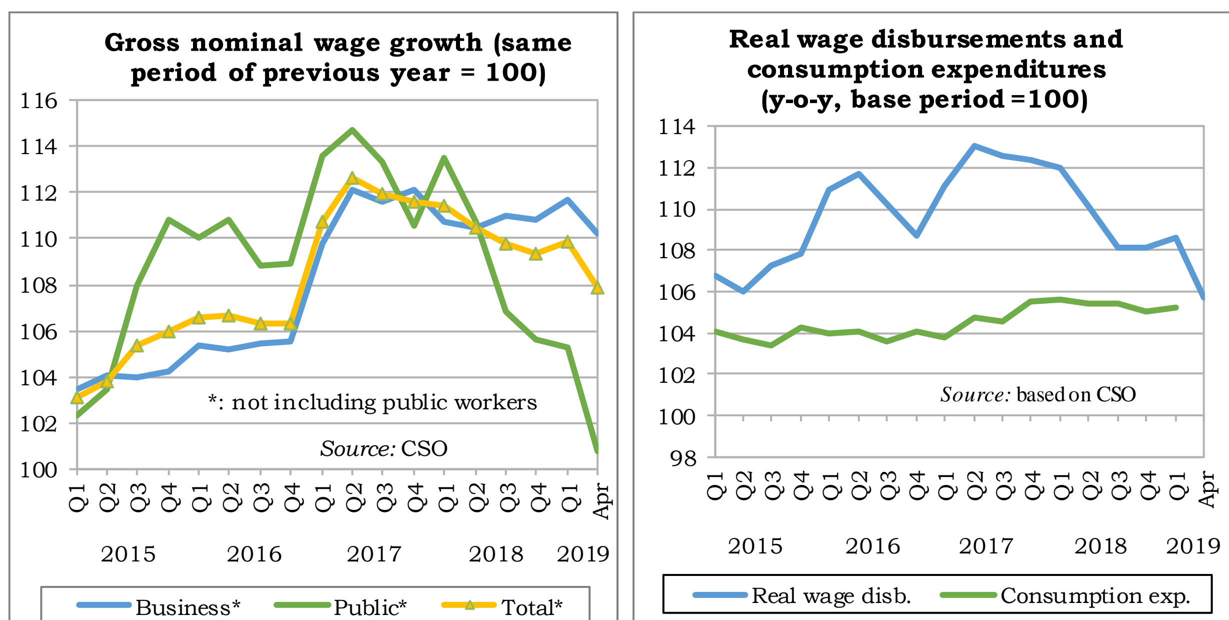
Gross and net wages were up 9.4 percent in January-April (without public workers), a moderate slowdown compared to the yearly average 10.2 percent in 2018 as a whole. *Business sector* wage growth even accelerated somewhat, from 10.8 percent in 2018 to 11.3 percent in the first third of 2019. As it seems, business sector wages keep rising due to the persistent labor shortage. But labor shortage is not the only factor: wage growth was especially strong in manufacturing, despite the fact that labor shortage seems to have already peaked there (see the section on employment and unemployment below). On the other hand, wage growth decelerated, even amid worsening staff shortage. The capacity of firms to raise wages and the string of strikes among auto firms apparently played a role in shaping wage trends as well.

In the *public sector*, by contrast, a profound deceleration of wage growth took place: wages rose by only 4.1 percent in January-April, not counting public workers.

If public workers are taken into account as well, overall wage growth was higher – 10.4 percent – due to the composition effect of the downsizing of the public works program. **Real wage** was up 6.8 percent, ***net real wage disbursements*** grew by 7.8 percent, a deceleration compared to the respective numbers of 2018 (8.3 and 9.6 percent).

Still, it seems that the deceleration of wage growth will be less pronounced in 2019 than previously expected. **Nominal wages are likely to rise at a rate of 9.5-10 percent, resulting in a real wage growth of 5.8-6.3 percent.** The latter implies a slowdown of the growth of real wage disbursements of at least 2 percentage points compared to 2018.

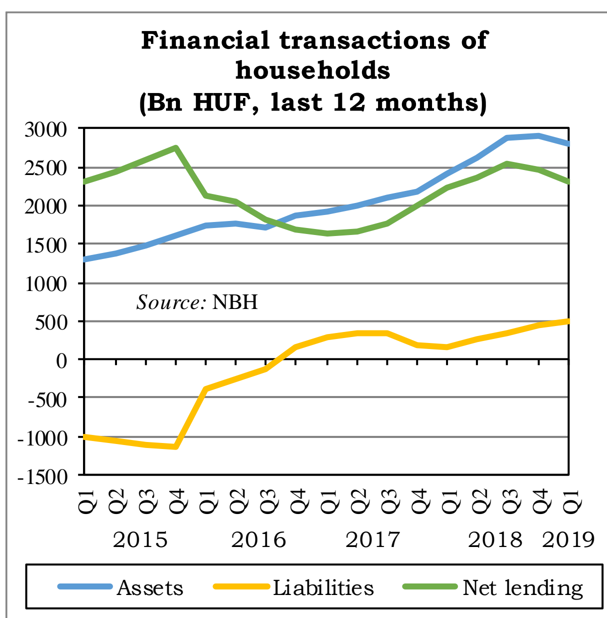
While the growth of real wage disbursements decelerated in the first quarter by more than 3 percentage points compared to the first quarter of the last year, ***household consumption expenditures*** remained strong: the 5.2 percent growth rate fell only short by less than 0.4 percentage point from the rate in Q1 2018. This suggests that consumption is supported, beside real wage growth, by the upturn in household borrowing as well. Private consumption expenditures may grow by around 5 percent in 2019 while the actual consumption of households may be up about 4.5 percent.

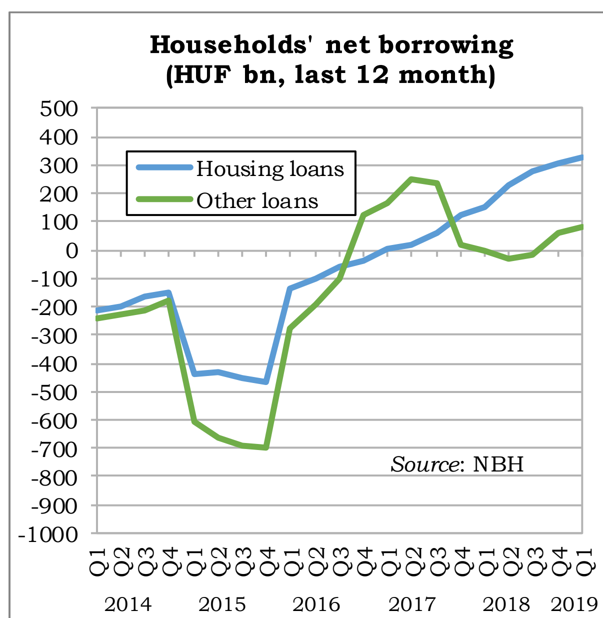


Net financial savings of households showed an upward trend up to the third quarter of 2018, with the four-quarter cumulative saving rate reaching peak level (6.2 percent of GDP) in Q3. The trend, however, turned downward afterwards: at the end of the first quarter of 2019, the cumulative rate stood at 5.3 percent of GDP.

This is due to the ending of the markedly rising trend in gross savings in the fourth quarter, followed by a decline in the first quarter, while at the same time net borrowing continued to rise. Both housing and other loans continued to contribute to this rise. It is worth noting, however, that the *level* of non-housing net borrowing is still relatively low, that is, the value of new borrowings is only moderately exceeding the value of non-housing loan repayments.

Private consumption expenditures are likely to rise at a somewhat higher pace in 2019 than household incomes, and the level of savings as a percentage of GDP will probably continue to slip. But the downward trend may be slowed down if the appearance of a new, high-interest government bond ('MÁK+'), introduced in June, gives a boost to households' propensity to save.





Investments

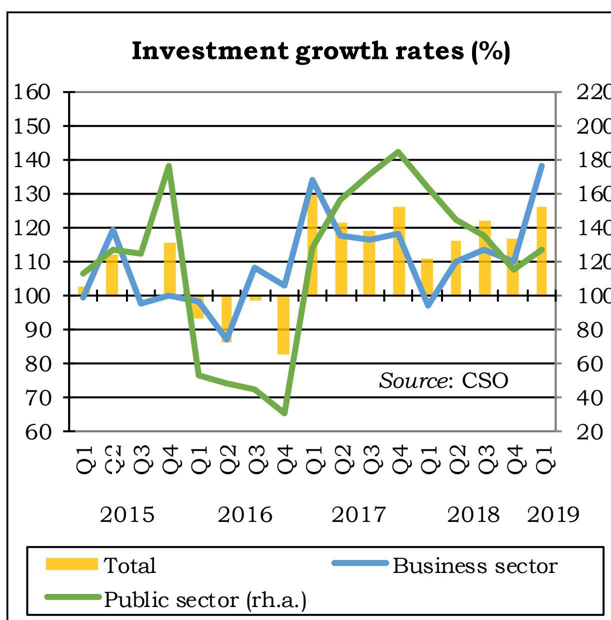
Investments grew at a near-record pace, by 26.4 percent, in the first quarter, defying earlier expectations about the continuation of gradual slowdown. As opposed to the last year, *business investments* expanded at the highest pace, even though public investment growth kept growing by about 27 percent. Business investments were up 38 percent in the first quarter, an absolute record.

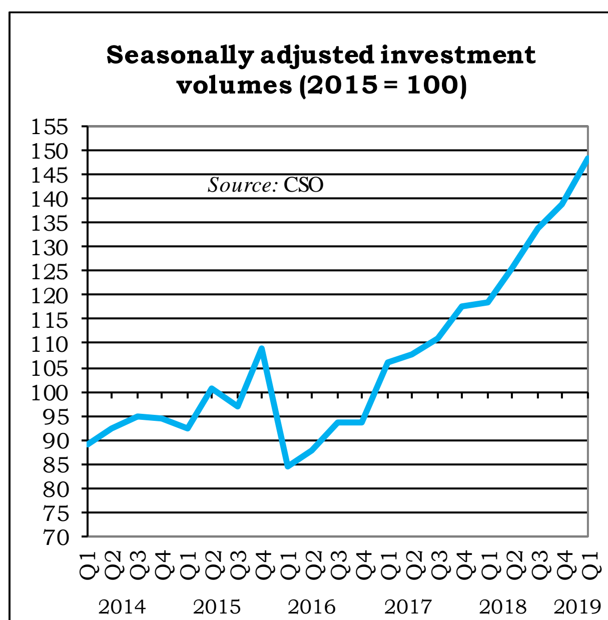
Much of the business investment growth, however, is related to sectors where business entities have close links to the government. These 'quasi-fiscal' investments drove the frantic investment growth in the transport, energy supply, and water and sewage sectors. This growth is largely financed by EU funds and reflects expanding government demand. The growth in the utilization of EU funds is apparently reaching its peak level now, with a likely deceleration in the coming months.

But private business investments also rose fast, most notably in manufacturing (32.6 percent) and agriculture (26.4 percent). Within manufacturing, electric, chemical and food industry investments grew most dynamically, with a less sanguine growth in the automotive sector.

The numbers suggest that the investments of households and the SME sector grew at a more subdued pace, but they may rebound during the rest of the year.

While previously we assumed that the contribution of the spending of EU funds to overall investment growth would be less pronounced in 2019 than in 2018, now this cannot be taken for granted anymore. Still, we expect a slight deceleration of the annual investment growth – from 17 percent in 2018 **to about 15 percent in 2019**. Beside quasi-fiscal investments, private business is likely to grow at an outstanding rate – beside high capacity utilization and the still acute labor shortage, the EU development funds distributed to private businesses may help keep investment growth going.





External trade

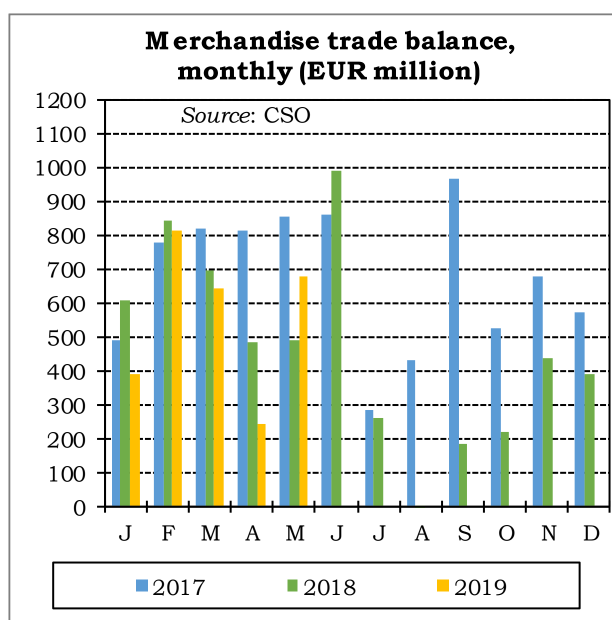
According to the external trade statistics, a degree of improvement in external trade trends can be observed in 2019. While in 2018 euro denominated net export contracted by about 31 percent, the pace of decrease moderated to roughly 11 percent in the first five months of this year. While there is no volume data about May yet, export volume was up 5 percent in January-April, while import volume grew by 6.4 percent. This negative growth gap, however, clearly decreased in May, due to a major slowdown in import growth, although we do not yet have numerical volume data for that month.

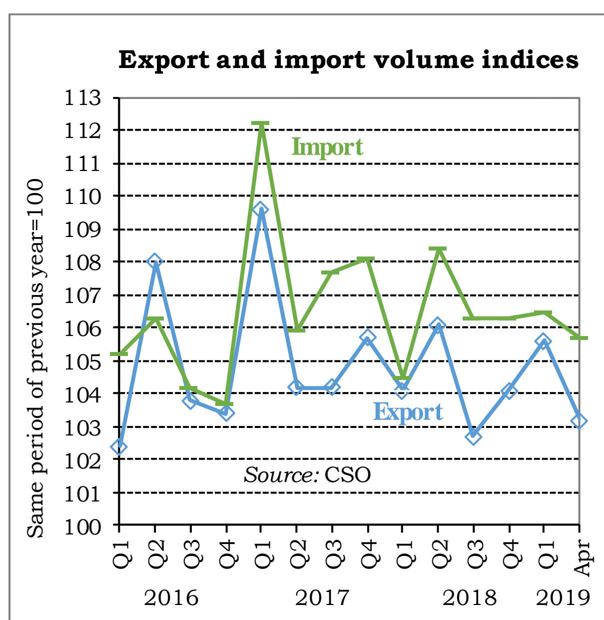
On top of the negative gap between the respective rates of export and import growth, the deteriorating terms of trade also contribute to the decrease in the trade surplus. But the deterioration is slowing down: as opposed to the 1 percent in 2018, the terms of trade only worsened by 0.7 percent in January-April.

In any case, it seems that export growth moderately accelerated in 2019 compared to the last year – the acceleration (0.8 percentage point in January-April) falls far short of what is shown by the first-quarter numbers in the GDP statistics.

The export acceleration was primarily due to the steep rise in food export, a result of the agricultural output growth in 2018, and to a moderate gain in machinery and vehicle export growth – the latter is far less spectacular than what the industrial sales data within industrial statistics suggest. At the same time, a notable softening in the growth of the export of manufactured goods was observed, mostly due to certain chemical goods and manufactured goods classified by material (for example, metals). In the case of import, a jump in fuel import (following a decrease in 2018) and the deceleration in the import of manufactured goods is worth mentioning.

For the rest of the year, we expect the present trend to continue in roughly the same vein: an export growth that moderately surpasses what was seen in 2018 but far from spectacular, and a somewhat faster import growth that comes near to the pace observed in the last year. The annual trade surplus is likely to fall to, or below, EUR 4.5 billion from the EUR 5.6 billion in 2018. If the deteriorating external conditions weighs down export growth, the annual surplus may come close to EUR 4 billion.





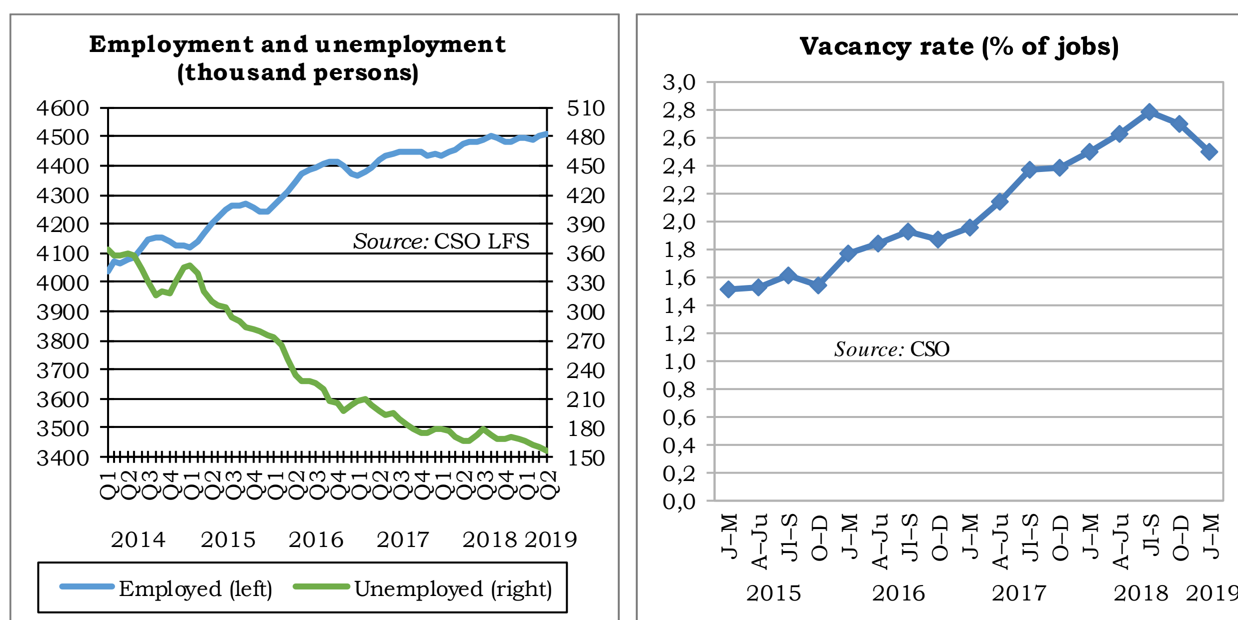
3.2. Employment, unemployment

According to the LFS survey, the growth in the number of employed temporarily regained momentum at the start of 2019: the first-quarter growth rate was 1.4 percent, as opposed to the 0.8 percent in the second half of the last year. The growth, however, slowed down to 0.8 percent again by the second quarter. The number of employed *not including public workers* rose at a higher pace, by 2.2 percent. The bad news is that this growth was in large part due to a renewed rise in the number of employed working abroad and to a rise in the number of part-time workers.

The *unemployment rate* decreased to 3.3 percent by the second quarter (among the active population of 15-74 years), a moderate improvement compared from the 7 percent in 2018. If *public workers are included* into the number of unemployed, however, this broad unemployment rate decreased from 7.2 percent in 2018 to 5.7 percent in the second quarter, a more substantial fall than in the case of official unemployment rate. This suggests that while the official unemployment numbers underestimate the prevalence of unemployment, they may also underestimate the present improvement in the unemployment situation.

In the meanwhile, the vacancy rate decreased in the first quarter (to 2.7 percent from 2.9 percent in Q4 2018). In the business sector, this was the second consecutive quarter of falling vacancy rate, the first of such a series since 2015. Also, the absolute number of vacancies decreased on an annual basis in the first quarter in the business sector, unlike in the public sector.

This can be seen as a hint that the cyclical upturn is at its peak, with a possible downturn on the horizon. On the other hand, it may indicate that the labor-saving investments begin to bear fruit. This may be the case in manufacturing where the decrease in the vacancy rate and the number of vacancies was relatively spectacular.



3.3. Fiscal, monetary and financial developments

3.3.1. Fiscal trends and outlook

Fiscal balance in 2018

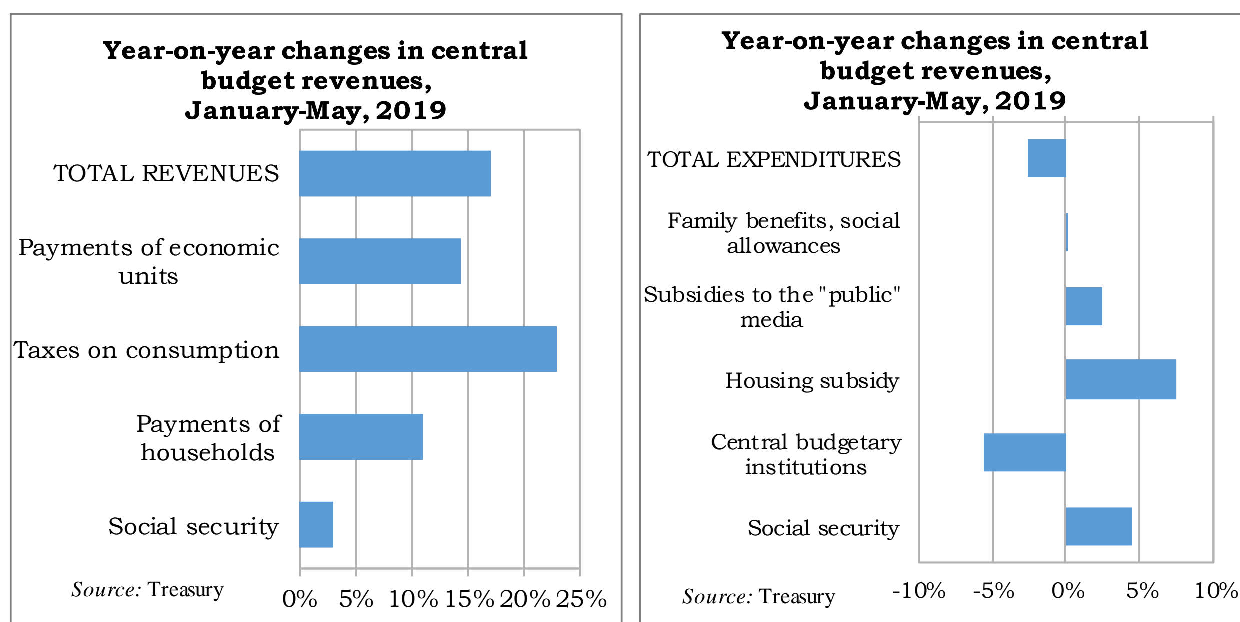
The cash flow deficit of the central subsystem was merely HUF 176 billion in the first five months of 2019. More specifically, the central budget deficit stood at HUF 253.4 billion, partly offset by surpluses of the social security funds and the extra-budgetary funds (HUF 25.5 billion and HUF 50.5 billion, respectively).

The deficit was kept low by the fact that revenues grew by a year-on-year 17 percent in January-May while expenditures actually were down 3 percent.

The steep growth in revenues was primarily due to the rise in the inflow of taxes on consumption and especially of payments by households. VAT revenues rose by 27 percent, excise tax revenues by 12 percent. Consumption growth only partially explains the two-digit rise of VAT revenues – after all, retail sales volume only grew by 5.9 percent in January-May, and even some VAT rate cut was introduced from January (in the case of ESL and UHT milk). Thus, the jump in VAT revenues reflects the success of the measures aiming at whitening the economy. Part of the rise in excise tax revenues is the result of a reclassification of energy tax as an excise tax from January 2019.

As for the payments by households, personal tax revenues rose by 10 percent, fee and duty revenues by 23 percent in January-May.

Revenues from the payments by economic units "only" grew by 14 percent but even this indicates that the annual inflow will surpass the yearly target substantially. Revenues from the simplified business tax (EVA) decreased but at the same time revenues from the itemized tax on minor taxpayers (KATA) and from tax on small corporations (KIVA) rose substantially. This is in line with the governments intentions to abolish EVA and to extend the scope of KATA and KIVA.



On the *expenditure side*, major savings have been made in expenditures on central budgetary institutions and chapter-administered appropriations. These savings, however, are primarily due to the spending related to EU-funded programs that fell by 39 percent in January-May. Apparently, the government strives to reduce the refinancing of these projects compared to the previous years since the inflow of EU funds is much slower than expected. The latter can be attributed to the stricter inspections on the part of the EU and to the fact that certain lines of support were abolished, due to the revelations regarding several irregularities in their allocation and utilization. Even more importantly, the completion of the projects supported by the EU are often delayed – as a result, the invoices are submitted to the EU belatedly as well.

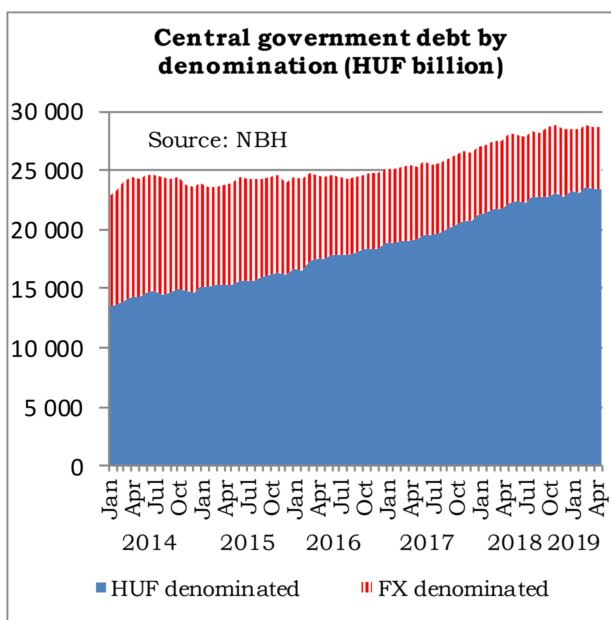
On the whole, overperforming revenues makes possible, in principle, to reduce the annual deficit below the target (1.8 percent of GDP). Since the latest EU recommendations unanimously point to a reduction of expenditures, the government's freedom to spend the surplus revenues to its various sport, church or prestige investment projects is limited. It is to be seen whether the government will actually make efforts to acquiesce to these recommendations, something that may depend on the government's wider strategy regarding its relationship with the EU.

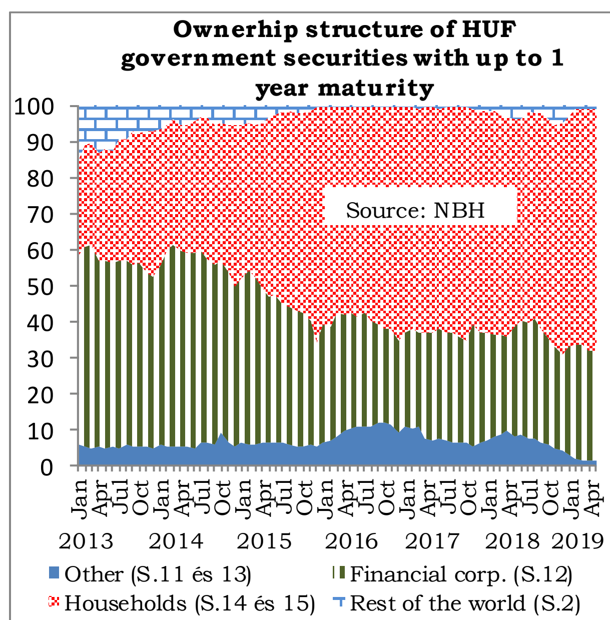
The Health Insurance Fund notably achieved a surplus of nearly HUF 26 billion in January-May, a sum that is probably sufficient to finance the necessary debt consolidation of the hospital sector.

State debt

According to the financial accounts statistics of the NBH, the consolidated gross state debt stood at HUF 29,375 billion, merely HUF 342 billion higher than its level at the end of 2018. This strongly suggests that the target – a debt-to-GDP ratio below 70 percent by the end of 2019 – is within reach.

During the first quarter the ratio of forint-denominated and FX-denominated debt roughly remained the same (81 vs. 19 percent) Within forint-denominated debt with short-term maturity the share of households rose further, above 67 percent.





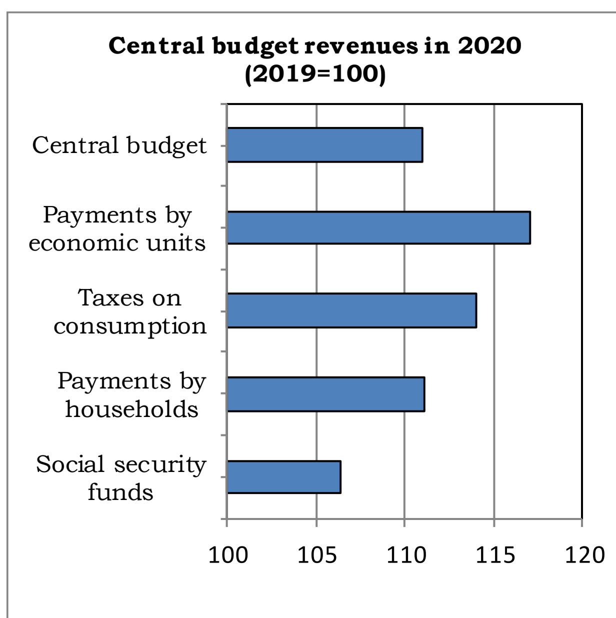
The 2020 budget plan

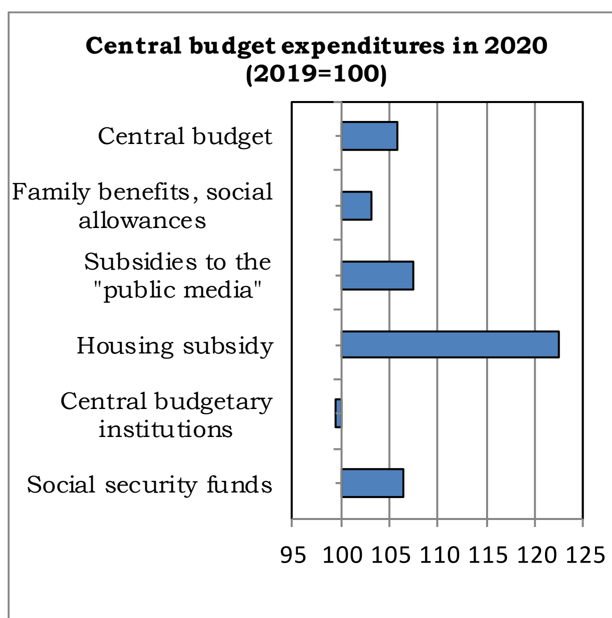
The budget plan for 2020 envisages annual fiscal ESA deficit to decrease to 1 percent of GDP. It assumes that GDP growth by 4 percent and inflation moderates to 2.8 percent. The Kopint-Tárki predicts slower GDP growth and higher inflation rate for 2020, yet our expectation about the overall growth of nominal fiscal deficit (about 7 percent) is not altogether different from the government's projection.

Regarding the most important revenue items, the budget plan seems realistic, especially since an overperformance of consumption tax revenues and household payments is expected in 2019. Whether the *expenditure* targets are realistic is more difficult to assess since the government's discretional spending decisions can divert overall spending levels considerably. However, a substantial sum – HUF 663 billon – buffer is built in the 2020 budget, which may be sufficient to meet the overall fiscal target, even if expenditures in some particular expenditure items go beyond the respective targets.

Besides, the fiscal expectations on the part of the EU limit the government's room for maneuver regarding revving up expenditures. In last June, the Council of the European Union recommended that the *net primary expenditures* (calculated without interest payments and expenditures on EU programs that are fully matched by revenues from EU funds) should not exceed 4.7 percent of GDP – this requirement entails a fiscal structural correction of 0.75 percent of GDP. It cannot yet be established whether the budget plan for 2020 meets this requirement.

In any case, the budget plan does not defuse the tension between the diverging assessments of the government and the EU Parliament regarding the structural fiscal balance. The budget plan claims that the output gap (the gap between actual and potential GDP) is only 0.2 percent, hence the structural deficit is only 1.1 percent of GDP. The EU Commission, on the other hand, says the output gap will be 2.8 percent in 2020, which implies that the structural deficit will be as much as 2.9 percent.





3.3.3. Inflation

In the first six months of 2019 consumer prices rose by an average 3.5 percent, exceeding previous expectations. In June the monthly inflation stood at 3.4 percent.

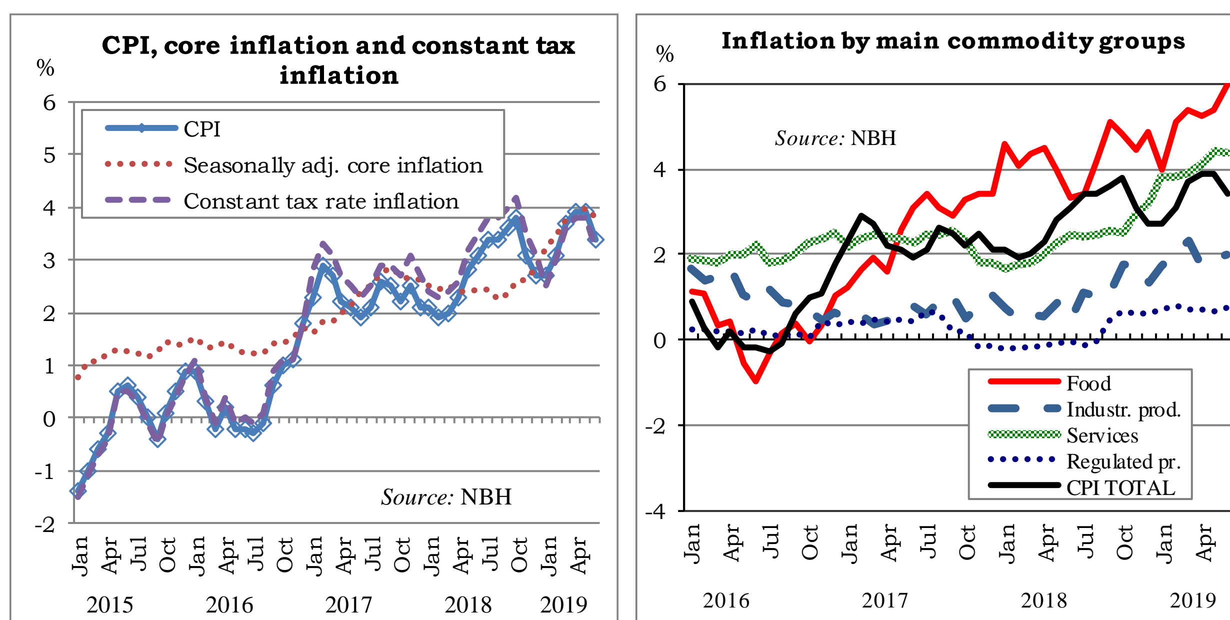
Fuel prices shot up in April and May, following global energy price movements, but in June they decreased year-on-year as oil prices markedly fell. Besides, food prices rise steadily, even if not dramatically. The season of early fresh vegetables pushed food prices upward in May even if not as drastically as in 2018. The prices of market services also keep growing at a pace higher than the average, which is not surprising: services, a labor-intensive sector, are particularly vulnerable to labor shortages that push wage costs upward.

Seasonally adjusted core inflation, after trailing behind headline inflation until late 2018, now tends to be somewhat higher than headline inflation – or approximately the same. The unstable difference means that core inflation does not provide a clear signal about the future price trends at the moment. A stagnation of the inflation rate seems likely for the rest of the year.

On the other hand, some elements of demand may point to an acceleration of inflation. Private consumption has been growing steadily for 2-3 years now, yet the inflationary pressure remained low since market supply could adjust, through imports, to rising demand. But the continuing rise in labor costs will eventually appear in consumer prices, as it can already be seen, in the case of non-tradable services.

Global oil prices began sliding in late May, after months of steady rise. Lower oil prices will permit, at least for a couple of months, a lower inflation rate.

On the whole, we revise our annual inflation forecast upward: now we expect **consumer prices to grow by 3.5 percent** in 2019.



3.3.4. Financial and capital markets

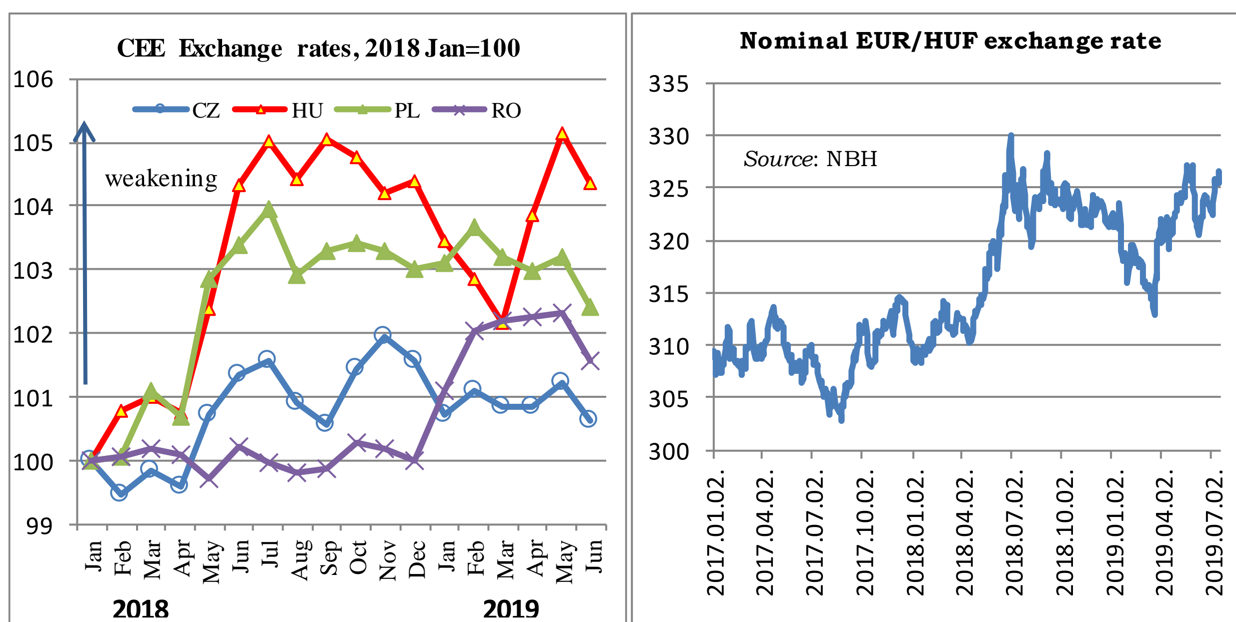
Exchange rate

Since May 2018 the exchange rate of the forint produces hectic fluctuations but also the center of fluctuations shifted. Before May 2018 the EUR/HUF exchange rate usually remained within the 310-315 interval. But afterwards it almost reached 330 EUR/HUF in the summer of 2018 but after a period of strengthening it shortly dipped below 315 again in last March, only to start weakening again. During much of July, the exchange rate has been hovering around 325.

These hectic fluctuations indicate a growing vulnerability of the forint. The specific causes of the specific movements notwithstanding, the main causes are the general volatility of global financial markets, the evolving currency war between the EU and the US and certain local currency crisis.

The volatility of the forint cannot be sufficiently explained by the relative inaction of the NBH monetary council. So far, the NBH only slightly tightened monetary conditions in the face of rising inflation, but this is a reasonable response considering that the ECB just announced its intention to relax monetary conditions in June, and a rate cut is widely expected in the US as well. Although it should be noted that inflation is lower and economic growth is slower in both the eurozone and the US than in Hungary.

Another noteworthy fact is, however, that the other Central Eastern European currencies have not fluctuated as widely since mid-2018 as the forint. The first weakening spell of the Polish zloty was almost as drastic as in the case of the forint, but later the zloty remained relatively stable at a new, weaker, exchange rate level. The Czech koruna is moving within a 1-2 percent range, while the Romanian leu only began weakening in early 2019.



Government yields

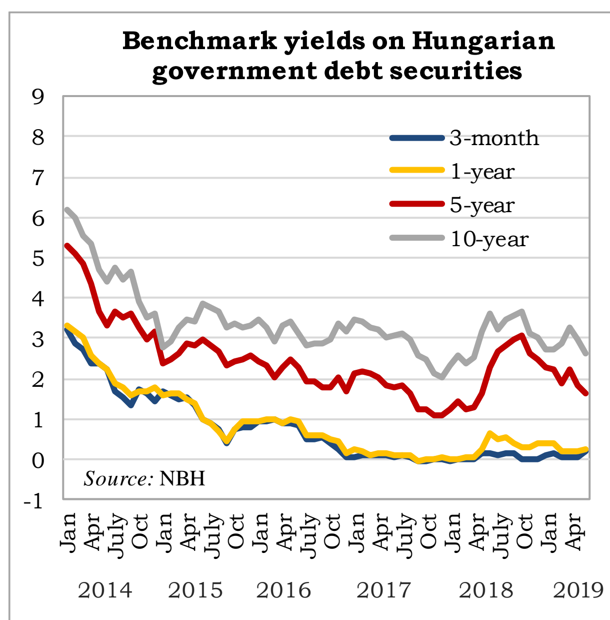
During the past 3-4 years there was no drastic change in the yields of government papers. Long yields have been fluctuating between 2-3.5 percent since mid-2015. Yield movements and changes in demand are generally shaped by developments on the global financial markets and by the occasional upgrading decisions on the part of the rating agencies. But these movements are not significant. Out of the first six months of 2019, the ten-year yield was above 3 percent in one, April (3.27 percent) – it was as low as 2.63 at the end of June.

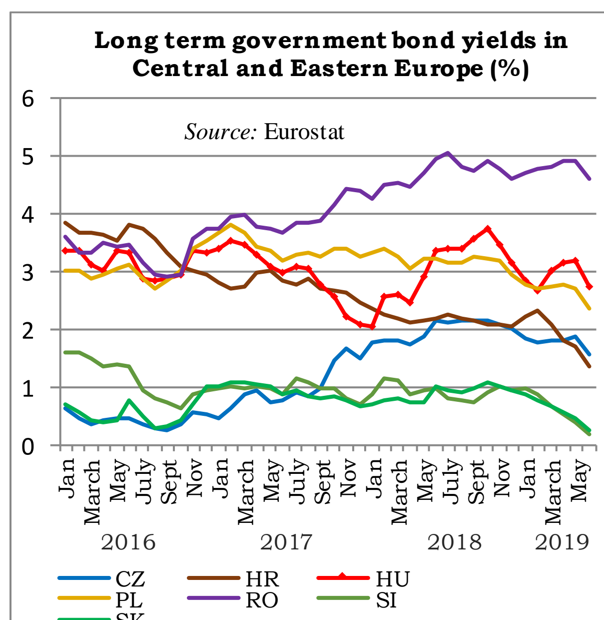
Five-year yields ran a similar trajectory, at a somewhat lower level, fluctuating within the 1.5-3 percent band. The last major fluctuation was in last October when the five-year yield just about surpassed 3 percent but returned into the 1.5-3 percent range afterwards. At the end of June, the yield stood at 1.61 percent.

the yield of one-year government papers peaked earlier, in May 2018. Since then, it has either descended or stagnated, and it remained only marginally above 0.2 percent during the second quarter.

Short (three-month) yields has remained close to 0 percent since early 2017, fluctuating within a relatively narrow interval.

The long yields in the other Central Eastern European countries moved into diverging directions. Since early 2017, Romanian long yields are by far the highest, fluctuating almost continually between 4.5 and 5 since March 2018, which indicates the low confidence of the financial markets toward the overheated Romanian economy. Since the summer of 2018, Polish long yields tend to remain below Hungarian long yields – even if the gap is not large. Czech long yields almost stagnated around 2 percent for about a year but dipped well below 2 percent in June. The EMU member state Slovakia boasts the lower long yields: after stagnating around 1 percent for a while, the Slovak ten-year yield has been descending throughout the first half of 2019; it reached 0.25 percent by the end of June. Beside the solid fiscal and debt position and policies, the record low level of yields reflects the additional confidence-boosting effect of being and eurozone member state.





3.3.5. Corporate and retail lending and interest rates

Corporate lending and saving

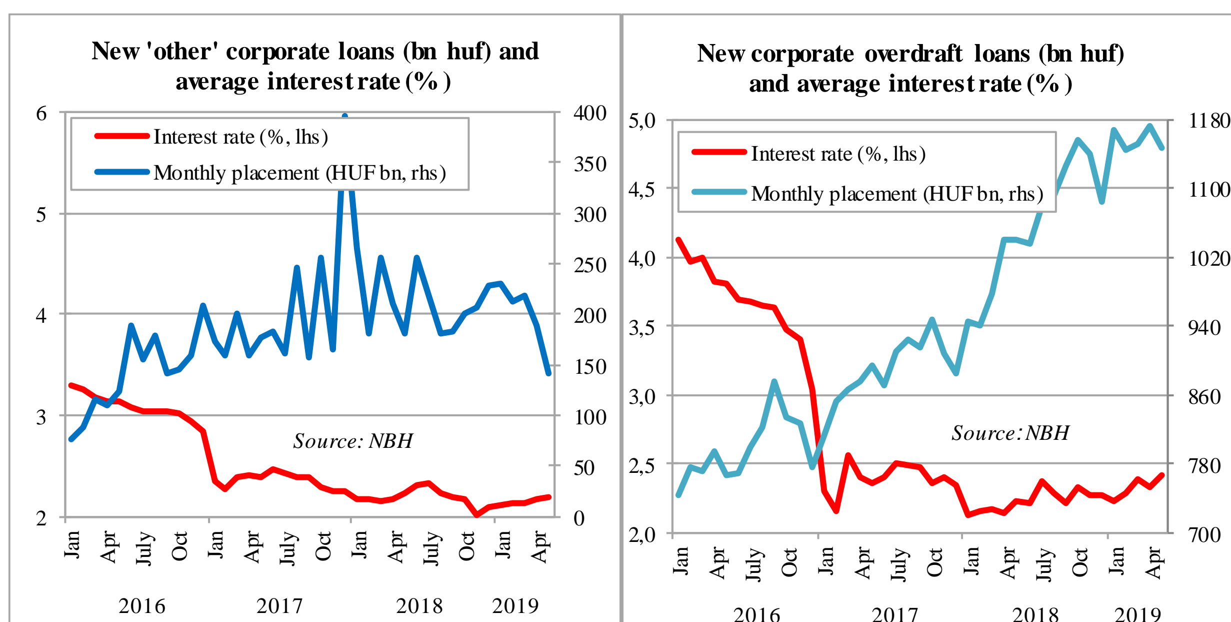
During 2018 the monthly sum of new corporate *overdraft loans* rose also consecutively compared to the previous month, while the rising trend largely flattened in the first six months of 2019, with monthly sums fluctuating between HUF 1,000-1,200 billion.

The rising trend was basically nonexistent, however, in the case of *other loans* (much of which serve as investment loan). What is more, the monthly values of new loans fell well below HUF 200 billion in April-May, although they were usually above that threshold until then.

A new credit support construction, the Credit for Growth Scheme Fix was launched by the NBH in January 2019. Its objective is to increase the share of long-term, fixed-rate loans within the overall corporate loan stock. Under the scheme, the central bank provides zero-interest loans with maturity no less than 3 years but no more than 10 years to banks. The banks can lend these sums to SMEs at an interest rate margin of no more than 2.5 percent. The NBH allocated a total of HUF 1,000 billion to the facility. By the end of April 2019, the firms borrowed almost HUF 100 billion under the aegis of the scheme.

To give a liquidity boost to the domestic corporate bond market, the NBH launched its Bond Funding for Growth Scheme (BGS) that entails purchasing bonds with good ratings issued by non-financial corporations for a facility amount of HUF 300 billion by the central bank.

Interest rates remained low during the recent months. The interest rate of overdraft loans stood at 2.42 percent in May, definitely low, but the highest since the start of 2018. The interest rate of overnight deposits is still virtually 0 percent, while the average interest rate of deposits with an agreed maturity is slightly below 0.3 percent, with a somewhat higher average rate (1.3 percent) on deposits with an agreed maturity beyond 2 years. As for other loans, the annualized average interest has been rising slightly, reaching 2.32 percent. The interest rate of loans with interest rates not fixed or fixed for less than one year was 2.11 percent. For loans with long-term interest rate fixation, interest rates varied between 2 and 3.1 percent in May.



Retail lending

While households' borrowing activity – including overdraft, consumption and housing loans – displayed a very hectic fluctuation in 2018, this fluctuation gave way to steep rise in 2019 in every type of loans.

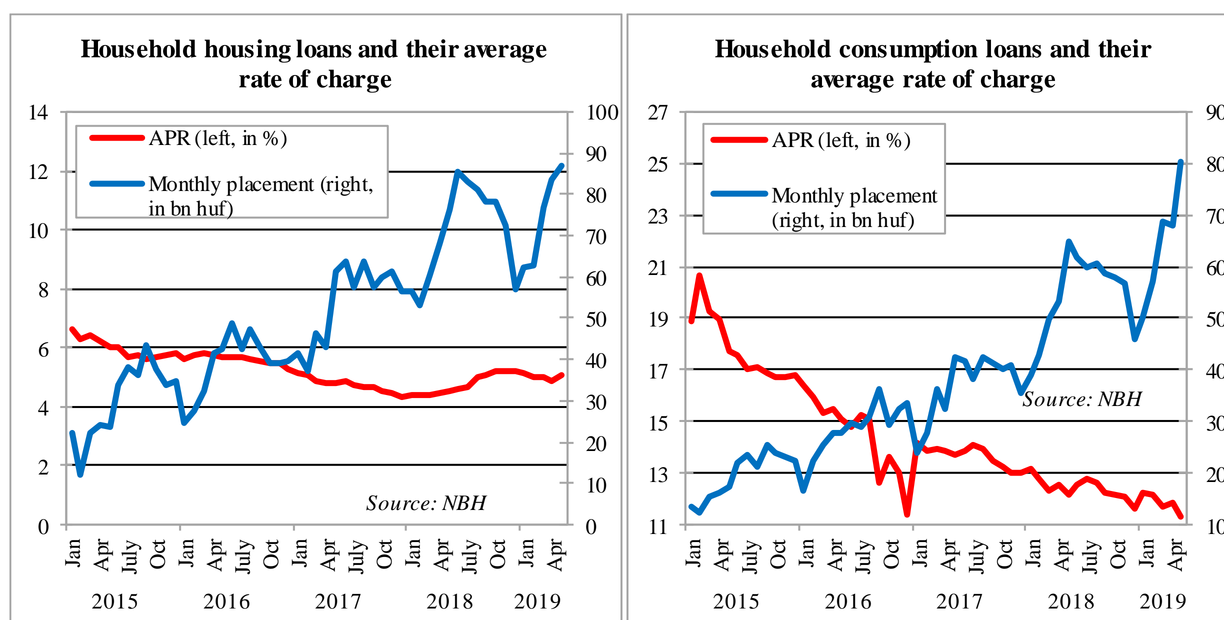
Housing borrowing hit new record in May, HUF 86.7 billion. The share of loans used for buying or building new dwellings is rising slowly within housing loans, it reached almost 21 percent in May. Still, the dominant share of loans is used for the purchase of existing dwellings.

After a steep year-end drop, consumption lending rebounded too: its monthly sum surpassed HUF 80 billion in May. Its structure is relatively stable: personal loans make up more than 60 percent of the total, while loans for purchase of goods amount to more than 20 percent. Both car loans and mortgage loans for consumption purpose amount to roughly 6-7 percent of the total.

As for interest rates, the APR of consumption loans has been on a decreasing trend in the past years, reaching 11.3 percent in May. Consumption loan interest rates are, however, still pretty high. The APR of personal loans stood at 13.3 percent in May, while the APR of car loans and of loans for purchase of goods was 9.5 and 5.7 percent, respectively.

The APR of housing loans – after reaching a historical low at 4.3 percent at the end of 2018 and rebounding afterwards – is basically stagnating around 5 percent. It stood at 5.1 percent in May. The very slow decrease until April and the rebound in May was primarily due to movements in the APR of loans with rate fixation of 1-5 years. The APR of loans for building or purchasing new dwellings with long-term rate fixation bounced above 5 percent in May, while the APR floating-rate or short-term fixation loans rose to 3.4 percent. The slightly higher level of monthly debt payments is a small price compared to the benefit of much lower risk of the loan becoming untenable if interest rates begin to shoot upwards.

A welcome development is the rise of the share of housing loans with a rate fixation for at least one year to 97 percent. The average fixation period is 9.2 years now, as opposed to the 6.9 years one years ago.



Economic Indicators 2011-2018, Forecast 2019 2020

(Percentage change)

	2011	2012	2013	2014	2015	2016	2017	2018	2019*	2020*
GDP AGGREGATES, ANNUAL REAL GROWTH										
GDP total	1.7	-1.6	2.1	4.2	3.5	2.3	4.1	4.9	4.5	3.3
Domestic Demand	-0.3	-3.1	2.2	5.4	2.1	1.0	6.8	7.0	5.4	3.7
Private Consumption	0.7	-2.3	0.5	2.4	3.7	3.4	4.1	4.6	4.5	3.7
Public Consumption	0.0	-0.2	6.6	10.0	0.0	0.9	2.0	-2.1	0.5	0.0
Gross Capital Formation	-3.5	-6.9	5.7	12.4	-1.3	-5.4	17.1	17.2	9.0	5.0
of which: Fixed Capital Formation	-1.3	-3.0	9.8	12.3	4.7	-11.7	18.2	16.5	15.0	5.0
Export	6.5	-1.8	4.2	9.1	7.2	5.1	4.7	4.7	6.0	5.0
Import	4.4	-3.5	4.5	11.0	5.8	3.9	7.7	7.1	7.1	5.7
PRODUCTION INDICES										
Agricultural Production (gross)	11.1	-10.0	12.5	11.4	-2.4	9.3	-5.2	3.6	-3.0	0.0
Industrial Production	5.6	-1.8	1.1	7.7	7.4	0.9	4.6	3.6	5.4	4.5
Retail Trade Volume	0.2	-2.2	1.8	5.2	5.8	4.8	5.6	6.5	6.0	5.1
EMPLOYMENT, EARNINGS										
Number of Employed	0.7	1.8	1.7	5.3	2.7	3.4	1.6	1.1	0.9	0.5
Unemployment Rate	11.0	11.0	10.2	7.7	6.8	5.1	4.2	3.7	3.4	3.3
Gross Nominal Wages	5.2	4.7	3.4	3.0	4.3	6.1	12.9	11.3	9.7	8.5
Net Real Wages[a]	2.4	-3.4	3.1	3.2	4.4	7.4	10.3	8.3	6.0	4.6
PRICES, EXCHANGE RATES										
Consumer Price Index	3.9	5.7	1.7	-0.2	-0.1	0.4	2.4	2.8	3.5	3.7
EUR/HUF Exchange Rate (annual average)	279	289	297	309	310	311	309	319	322	322
EUR/USD Exchange Rate (annual average)	1.39	1.28	1.33	1.33	1.11	1.11	1.13	1.18	1.13	1.13
Short-term Interest Rates (3M), eop	7.55	5.33	2.86	1.43	0.80	0.06	-0.01	0.00	0.10	0.30
Long-term Interest Rates (10Y), eop	9.75	6.11	5.61	3.60	3.33	3.16	2.02	3.01	3.00	3.50
BALANCE OF PAYMENTS										
Current and Capital Accounts, % of GDP	3.1	4.3	7.4	5.2	7.4	6.2	3.9	2.2	1.5	1.0
GOVERNMENT BUDGET										
General Government Balance, ESA-95, % of GDP	-5.4	-2.4	-2.6	-2.6	-1.9	-1.6	-2.2	-2.2	-1.7	-1.5
Gross Government Debt, % of GDP[b]	80.5	78.4	77.1	76.6	76.6	75.9	73.3	69.0	68.0	67.0

a The numbers do not take into account the effect of the family tax benefit.
b General government debt, including the balace sheet of Eximbank
* Kopint-Tárki forecast
Source: CSO, NBH

CONTENTS

1. International economy 1
2. Central Eastern European new member states 4
Macroeconomic indicators for Hungary and Kopint-Tárki forecast 10
3. The Hungarian Economy 11
3.1. GDP and its components 13
3.1.2. Final use of GDP 18
Investments 20
External trade 21
3.2. Employment, unemployment 22
3.3. Fiscal, monetary and financial developments 23
3.3.3. Inflation 26
3.3.4. Financial and capital markets 27
3.3.5. Corporate and retail lending and interest rates 29
Economic Indicators 2011-2018, Forecast 2019 2020 31