Hungary

Embracing policy contradictions

Hungary's macroeconomic situation provides a good illustration of how Central Europe is flourishing economically, but has jettisoned some of the principles of liberal democracy, which is the crucible of the European Union. Hungary's real GDP growth is estimated at an average of 4.5% in 2018, the highest level since 2004 and higher than its long-term potential. Endogenous and exogenous factors announce a downturn in the economic cycle in the quarters ahead. Yet there is nothing alarming about the expected deterioration in macroeconomic fundamentals in the short to medium term.

Between interventionism and market-friendly policies

The weakening of European institutions since the eurozone crisis has fostered the rise of national populism, notably in Hungary. In power since 2010 and strengthened by the Fidesz's landslide victory in the April 2018 legislative elections, Prime Minister Victor Orban can boast of a favourable macroeconomic situation. He intends to lead a eurosceptic, sovereigntist and anti-immigration revolt during European elections next May, and to weigh on the general orientation of the EU in the years ahead, at a time marked by the weakening of the French-German couple, the traditional motor of EU construction.

From an economic perspective, the Orban model is more pragmatic than dogmatic, striking a fragile balance between interventionism and pro-business measures. It consists of several contradictions. Despite the strong rejection of European institutions, Hungary is fond of EU structural funds. For Central and Eastern European countries, these funds are likely to decline as of 2021, independently of any measures currently being discussed in Brussels to introduce conditionality criteria that would tie the amount and attribution of these funds to upholding the rule of law. Economic patriotism prevails in strategic sectors (energy, telecommunications, finance), but the authorities are pushing to open up labour intensive industrial sectors to non-resident investors. A small, open economy whose exports of goods and services account for 87% of GDP, the Hungarian economy is highly integrated in European and global supply chains. All the German carmakers operate in Hungary and the sector accounts for ¼ of exports with the second lowest labour costs (EUR 8/hr) in the EU behind Romania. In this quest for attractiveness and competitiveness, the corporate tax was lowered from 19% to 9% in 2017, making it the lowest in the UE. Employer social welfare contributions were also lowered by 2.5 percentage points in 2018. In December, a law raising the ceiling on overtime work (from 250 to 400 hours a year, with the possibility of deferring payment for up to three years) triggered popular backlash, which must be monitored.

Cyclical peak

Economic growth continued to accelerate in 2018 thanks to a cocktail of expansionist economic policies, European structural funds and an upturn in domestic lending since year-end 2016. Banks have cleaned up their balance sheets and are now showing satisfactory levels of capitalisation, liquidity and profitability. This has enabled them to pursue a more aggressive lending policy with support from the central bank (low interest rates, SME financing programme). Although barely 30% of European structural funds have been paid out so far (out of a total of EUR 21.9 bn in 2014-2020), the government has already pre-financed quite a few eligible projects (according to the co-financing principle).

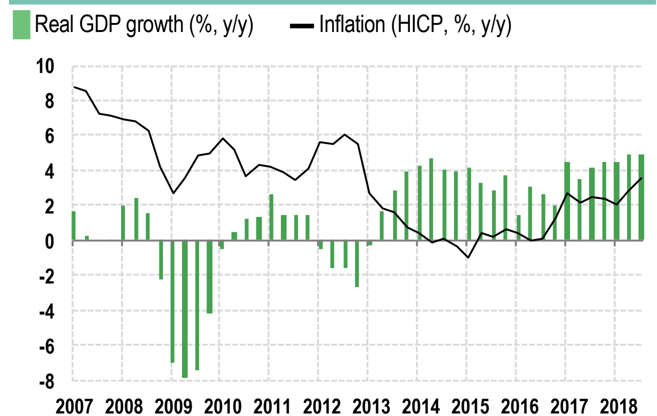
In 2018, real GDP rose 4.8% in the first 9 months compared to the previous year (year-on-year, y/y). Hungary has reported ten consecutive quarters of growth. Household consumption is the main growth engine (+5.5% y/y in the first three quarters of 2018), and retail sales rose 6.3% in the first 11 months of the year. Household spending continues to be supported by strong nominal wage growth,

1- Forecasts

	2017	2018e	2019e	2020e
Real GDP growth (%)	4.1	4.5	3.2	2.8
Inflation (HICP, year average, %)	2.4	2.9	3.3	3.0
Gen. Gov. balance / GDP (%)	-2.2	-2.4	-2.0	-1.8
Gen. Gov. debt / GDP (%)	74.8	74.2	71.7	69.8
Current account balance / GDP (%)	3.2	1.9	0.7	1.1
External debt / GDP (%)	84.6	76.9	70.3	62.2
Forex reserves (USD bn)	23	27	28	28
Forex reserves, in months of imports	2.8	3.1	2.9	2.8
Exchange rate EURHUF (year end)	309	319	330	330

e: BNP Paribas Group Economic Research estimates and forecasts

2- Economic growth and inflation



Source: Eurostat, Hungarian Central Statistical Office (KSH)

up 10% for the year, driven up by labour market tensions in an economy operating at quasi-full employment, with an unemployment rate of 3.8%.

Investment surged by 17.4% y/y in the first three quarters of 2018, driven by the construction sector, whose value added has increased 23.8% y/y in the first three quarters. Fiscal incentives for new home purchases that expire in January 2020 continue to boost residential investment. Investment in the industrial sector (machinery and equipment) continued to benefit from favourable financing conditions as well as foreign direct investment (EUR 4.5 bn in the year to Q3 2018, compared to an average of EUR 2 bn a year since 2010, or barely 2% of GDP).

Manufacturing output let up slightly in Q3 (+2.5% y/y), notably due to the slowdown in the automobile sector (sharp decline in car registrations in Germany) owing to new European anti-pollution standards. Yet monthly indicators show a rebound in automobiles and electronics in October. Thanks to very robust domestic demand, net foreign trade has made a negative contribution to GDP over the past two years, with import growth surpassing export growth (+6.8% and +5.4%, respectively, y/y in volume in the first three quarters of 2018).

Economic activity is expected to slow in 2019-2020. Consumption and investment should grow at a more subdued pace. Bottlenecks have triggered an upsurge in construction costs, and consumer prices have accelerated (2.7% y/y in December, vs 2.1% in the year-earlier period), which is expected to weigh on household purchasing power. Despite the expansion of production capacity, a less buoyant international environment is likely to undermine industrial exports (notably in the automotive sector).

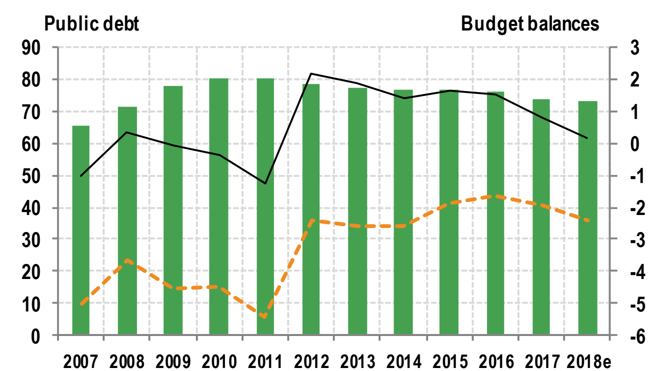
Nothing alarming about the deterioration in macroeconomic fundamentals

Several factors are expected to strain Hungary's external accounts including the economic slowdown forecast for the EU, the risks associated with trade tensions and Brexit, and the "normalisation" of US and eurozone monetary policies. Despite the downward revision of oil prices, the substantial trade and current account surpluses reported in 2015-2017 are bound to narrow in 2019-2020. At the same time, FDI inflows are also likely to slow given the deterioration in the business climate.

This outlook does not endanger the country's external position in the short and medium term. The external debt, though still substantial, has been reduced sharply since 2010 (from 145% of GDP to below 80% in 2018) thanks to deleveraging by the state and the private sector (although the foreign currency liability of banks increased in 2018). The country's net external position (foreign assets minus foreign liabilities) has improved (-47% of GDP in mid-2018 compared to -105% in 2010). The reduction in government borrowing in foreign currencies has drained foreign reserves in recent years. Yet this trend was reversed by foreign currency inflows in late 2018, thanks to Eurobond issues and European transfers. Although foreign exchange reserves are at the threshold of 3 months of imports, they are not a real source of concern for a

3- Public finances (general government, % GDP)

Public debt — Primary balance — Overall balance



Source: European Commission

country that is not a commodity exporter and that posts a current account surplus.

The forint (HUF) has been relatively stable for the past three years but it could experience renewed volatility due to greater political risk (European legislative elections in May) and the end of quantitative easing in the eurozone, more so than from the tightening of US monetary policy. In a very agitated year for emerging market currencies, the forint depreciated by only 4% against the euro and 10% against the dollar, which shows that investors are still confident in Hungary and the other Central European economies. The Hungarian central bank (MNB) announced that it intends to maintain its key policy rate unchanged at 0.90% (an historically low rate in place since May 2016) through 2020, even though core inflation (excluding energy, food and regulated prices) is expected to accelerate above the central target of 3%, to an average of 3.5% in 2019 and 3.3% in 2020. Yet the MNB might be forced to raise its key rate during the course of 2019.

As to public finances, the estimates of the Hungarian authorities and international institutions (European Commission, IMF, OECD) converge on a general government deficit of 2.3-2.4% of GDP in 2018. The deficit is expected to widen again due in part to the loss of certain exceptional revenues and fiscal measures, while the strong performance in terms of fiscal revenues was largely eroded by additional spending (wages and investment). The pro-cyclical nature of fiscal policy is illustrated by the high structural deficit (3.8% of GDP in 2018 according to the European Commission). The apparent deficit is expected to narrow slightly, to about 2% of GDP in 2019-2020, based on the introduction of new fiscal incentives, but also on the assumption that wages and social transfers will rise at a slower pace than nominal GDP growth, and that structural funds will be paid out for projects partially pre-financed by the government. Public debt is nonetheless expected to drop below 70% of GDP in 2020.

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