

Risks and challenges to international and Hungarian economy in the middle of the decade

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In 2015, economic growth in Hungary despite of some slowdown remained still dynamic, whilst global growth continued to be slow with new short- and medium term downside risks. The study gives an overview of the international economic and market trends having influence on economic development in Hungary with a special focus on events and problems in the euro area and in the Central-East-European region. It also addresses the macroeconomic and financial processes in Hungary in the course of the last year.

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Economic situation.
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Relatively slow world economic growth with a number of downside risks is expected in the near future. Adjustments in commodity markets, political challenges like the Brexit or other geopolitical tensions, increasing protectionism may create new global conditions leading to different trends as compared to the baseline scenario.

If there will be no major economic shock in the world economy, the Hungarian economy may increase by 2-3% in the near future, under the current economic policy conditions. Compared to the downturn between 2007 and 2012, it is a remarkable pace, but not enough to compensate for the previous backlog and to keep up with regional competitors.

1. Developments in the world economy

Subdued growth will characterize the world economy in the coming two years. Although some acceleration is expected for next year taken as a whole, overall growth will remain relatively slow, and monetary and fiscal stimuli are not sufficient to compensate for structural problems, geopolitical tensions, political uncertainties or signs of strengthening protectionism.

1.1. Slow global growth with new downside risks – substantial regional diversities

According to the recent Interim Economic Outlook of the *OECD* [2016a], weak trade and financial distortions threaten global growth prospects. Recent OECD statistics show that global growth in 2015 reached 3.1%, more or less remaining at the level of recent years; for 2016 some deceleration is expected; and recent forecasts assume only a modest pickup for 2017. Taken as a whole, global growth remains weak, the world economy remains in a low-growth trap: this becomes manifest in an extremely poor performance of world trade, as well as in sluggish investment activity. As compared to the previous years, there was a slowdown of economic growth in most advanced countries, and the less negative performance of major commodity producers was not enough to counterbalance this. Downside risks like still low, even if slightly rising commodity prices, risks related to historically low interest rates bearing the threat of bubble-building, geopolitical tensions, uncertainties about the

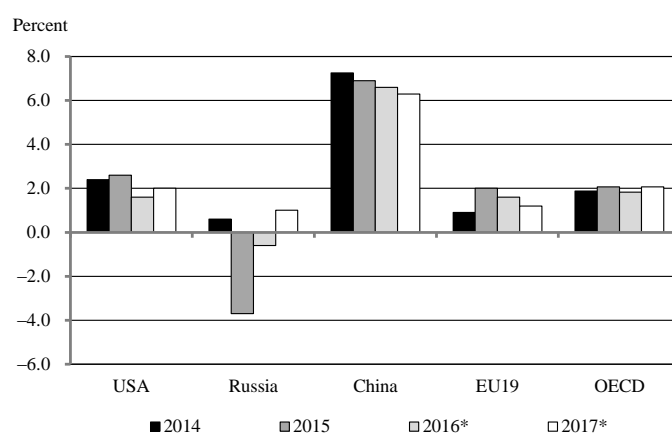
British referendum and the related Brexit, the outcome of the American presidential election, uncertainties related to the policy stance of the elected new US president or problems associated with migration are all factors hindering the stabilization of growth and the recovery of confidence.

According to the *OECD* [2016b], GDP growth in OECD countries reached 2.1% in 2015, and is expected to slow down to 1.8% this year, promising only a slight acceleration in 2017. US growth seems to fall short of expectations, despite of solid consumption growth and improvement in the job market, especially due to slackening private investment activity reflecting adverse developments in the energy sector and a prolonged inventory correction. Thus, the FED (Federal Reserve System) keeps its expansive monetary stance, despite the fact that the state of the American economy would already permit higher interest rates; it will not come to any monetary adjustment before the end of 2016; most likely the FED will be very careful in raising the base rate unless all necessary preconditions (solid growth, consumer price inflation reaching the 2% target rate and satisfactory labour market development) are met. Stagnation in Japan holds on despite of expansive monetary and fiscal stance of the government, the performance of the euro area turned out also less dynamic than anticipated before, and the effects of the exit of Britain bear substantial downside risks. As to emerging countries, commodity exporters are still suffering from low commodity prices, but signs of stabilisation can also be seen. The most important question is what will happen in China, where overall growth seems to stabilize around 6%, and recent PMIs (purchasing managers' index) and consumption data do not indicate any further substantial drop in growth. The structural adjustment is still going on, and the Chinese government launched different infrastructural and social projects in order to boost the economy. The recession in Russia is smoothing down, the drop of the GDP ratio will slow down substantially this year, and in the hope of some rise in oil prices, economic forecasts turned out to be more optimistic, and as a consequence, the dramatic depreciation of the rouble came to a halt. (See Figure 1.)

Under these circumstances, world trade performance showed a negative record this year: in 2016 an expansion rate of 1.9% is expected which will be the lowest rate since the global crisis. Weak trade growth in 2015 and 2016 and modest improvement in the coming years raise concerns how robust global growth really is: in this year's performance, restrained investment activity, low import demand of emerging and of commodity exporter countries, signs of strengthening protectionism and the diminishing confidence of investors in advanced countries are all reflected. The moderate acceleration of growth of world trade expected for 2017 (approximately 3% as compared to 2016) will be well beyond the long-term average. Trade intensity usually falls after downturns, however, the slowdown experienced after the 2008–2009 crisis is much more pronounced than it was in the case of previous downturns (*Ollivaud–Schwellnus* [2015]). This can partly be explained by the extraordinary

demand weakness in the euro area (especially in respect of intra-EU trade), which is one of the most trade intensive regions. As in the coming two years the acceleration of global growth and GDP growth rates in advanced countries will remain rather moderate, there is no hope for a dynamic increase of world trade either (*Gern et al.* [2016]).

Figure 1. Weak growth all over the world, 2014–2017
(percentage change as compared to the same period of the previous year)



Source: OECD Economic Outlook 99 database; * Kopint-Tárki forecast.

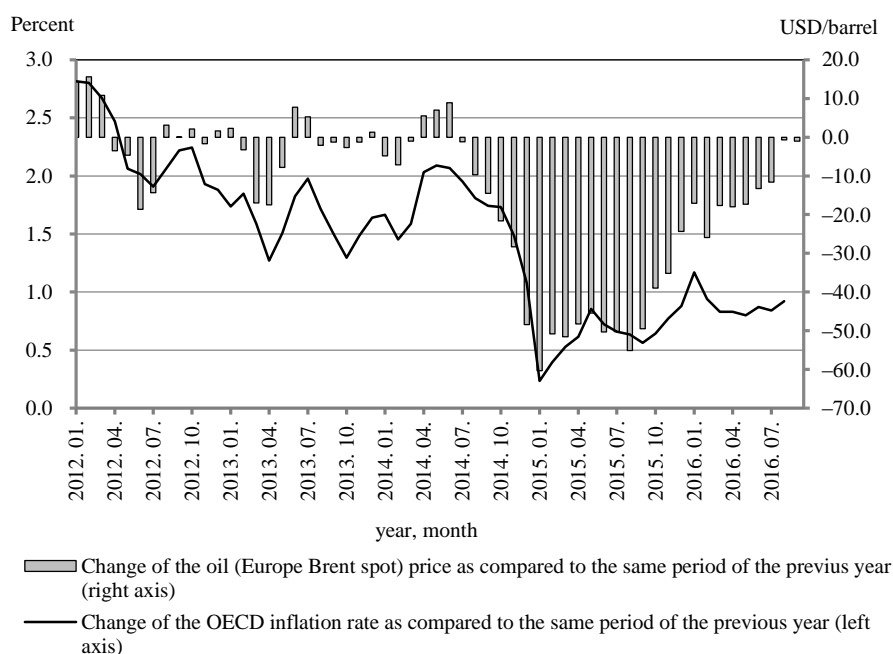
The low level of oil prices has been one of the most important factors determining global trends in the last years. In January 2016, the barrel price of the Brent oil was by almost 70% lower than in January 2014. Since January this year, there has been some upward correction, but the average oil price of \$46.6 per barrel in September 2016 was by about \$62 lower than in January 2014.

This low level is due to a stubborn oversupply in the oil market which – according to the estimates of the IEA (International Energy Agency) – totalled in the first half of 2016 1.6 million barrel per day and will hold on next year as well. This oversupply was due to several reasons: partly a sluggish demand on behalf of major oil importing countries (especially of China) and partly the fact that the OPEC (Organization of the Petroleum Exporting Countries) countries – in the first line due to the pressure on behalf of Saudi Arabia – refused to cut production quotas until the autumn of 2016.¹ In September 2016, however, OPEC countries came to an agreement with the aim to cut the production target ranging between 32.5 and 33.0 million barrel/day, in order to support the drawdown of the stock overhang and contribute to the

¹ The strategy of Saudi Arabia was to keep oil prices at a low level in order to make the use of the American shale oil less attractive and thus hinder the American concurrence.

rebalancing of the market situation.² Due to the long-lasting low level of oil prices, investments into oil production and processing ceased to be rentable, the revenues of oil-exporting countries and oil-companies have fallen dramatically, and the market volatility also increased as with the cut of oil-producing capacities, future market demand may be threatened as well. Although the OPEC agreement temporarily pushed oil prices upward (depending also on how long this agreement will be durable), oil prices will remain subdued in the coming year, as due to the low growth in the major oil-consuming countries, the demand for oil will not so easily recover, and the hangover in stocks is still relatively high.

Figure 2. Impacts of oil prices on inflation rate, 2012–2016



Source: OECD (<http://data.oecd.org/price/inflation-cpi.htm>) and American Energy Administration data (<http://www.eia.gov/dnav/pet/hist/LeafHandler.ashx?n=PET&s=RBRT&f=M>).

The impacts of low oil prices on economic growth remained limited: due to an overall sluggish demand and low growth, the advantage of an ample supply of cheap oil could not be used; in the case of the most oil-importing countries, the intensity of oil production decreased in the course of adjustments to expensive oil prices of the last decades, thus low oil or other raw material prices have less impacts on the de-

² http://www.opec.org/opec_web/en/press_room/3706.htm

mand or on the pick-up of business cycles. At the same time, low oil and other energy prices contributed to the fall of consumer inflation rates and boosted consumer demand. However, as mentioned before, in the case of emerging oil exporting countries (like Russia), the diminishing revenues have had serious negative effects on the business cycle.

The low level of commodity prices and their moderate growth have contributed to a slowdown of inflation since 2014 all over the world, but especially in advanced countries. Inflation rates showed a varying picture from country to country forcing central banks to different reactions. In advanced countries central banks have responded to low inflation rates with expansionary monetary policies, using also a wide range of non-conventional methods. However, with economic growth slowly picking up and the expected slight increase of commodity prices in 2017, it may come to the beginning of normalisation of inflation rates in the coming years, which should also lead to some change in the monetary stance. In emerging countries the picture is more differentiated: in some cases, the low level of energy prices did not become manifest in decreasing inflation rates as national governments took the advantage of centrally administered prices, and used the room provided by lower energy prices for cutting price subsidies; in other cases, the depreciation of the national currency neutralized the impacts of low energy import prices, thus the slowdown of inflation could not be felt at all. In Russia – where the loss of revenues due to low oil prices pushed the country into recession, and as a consequence of the embargo even food prices remained high, and market shortages occurred –, the dramatic depreciation of the rouble led to double digit inflation rates in 2015. In 2016, the situation improved somewhat, but a slow recovery will only start in 2017, bringing about a substantial moderation of inflation.

Under these circumstances in 2015–2016, monetary policy in advanced countries followed an expansive monetary stance, and it is most likely that in the coming years it will hold on or it will come only to careful adjustments. As already indicated, the FED will continue to keep its accommodative stance, but in the course of next year, it may come to some normalisation of interest rates, as already within the FOMC (Federal Open Market Committee) there is a disagreement for and against raising the target range for the federal funds rate. At the latest meeting in September 2016, some of the members would have preferred to raise it to 1/2–3/4% (*FED* [2016]). The Japanese central bank responding to economic stagnation and deflationary expectations introduced negative interest rates and extended asset purchase programmes. The European Central Bank is also forced to keep the interest rates on the main refinancing operations and on the marginal lending facility at a historically low level; it plans to keep this for an extended time and sticks to the asset purchase programme which is planned to be carried on until March 2017 or beyond if necessary, until inflation reaches the target rate of 2%, and economic recovery turns to be more solid. The

Bank of England was actually expected to be one of the first European banks to return to a normalisation and raise the base rate this year as the economy was in a good shape and the business cycle was showing a solid recovery after the crisis. However, the outcome of the British referendum and uncertainties related to the Brexit led to a substantial depreciation of the pound sterling and to gloomy market expectations concerning the coming years. This forced the Bank of England in August 2016 to cut the bank rate by 25 points, and extend its programme of quantitative easing.³

The vote of the UK to leave the European Union on 23 June 2016 led to an increased volatility of financial markets. While markets have stabilised since the referendum, the pound sterling has depreciated by more than 10% in trade-weighted terms. The depreciation of the euro, which started in 2014, continued to hold on in 2015 but came to a halt in 2016. As compared to the peak in early May 2014, the euro depreciated against the dollar by 22% by the end of December 2015. By mid-2016, when expectations faded that a renewed interest rate adjustment on behalf of the FED was on a near agenda, the euro started to strengthen slightly, however, its volatility remained. At the same time, following the British referendum when the strong depreciation of the pound sterling began, the euro appreciated by 14% against the pound. However, the start of the Brexit process or the launching of a serial of interest rate adjustments in the US may bring a new downward pressure on the euro.

In the past two years, fiscal policy in advanced countries became less restrictive, and as at present, most likely in the coming couple of years that it will follow rather a neutral stance. In a number of countries, general government gross debts as compared to the GDP will remain high but showing a slight improvement. At the same time, general government deficit is decreasing as low interest rates give room to savings at the expenditure side. Due to the exceptionally low long-term interest rates, more than 35% of OECD sovereign debt is traded at negative yields. In the coming years, fiscal policy may even get to some extent expansive in some countries of Europe in order to boost economic growth and counterbalance uncertainties of external demand. However, at the same time, the global indebtedness of the world accounts to 225% of the world GDP (*IMF* [2016]), which is at a historically high level. Since the global crisis, government financial injections have contributed to the recovery of growth in most countries with Japan, Greece, Italy, US and Spain reaching the highest level of general government debt. Under historically low level of interest rates, the financing of these debts proved to be manageable; however, the situation might easily change if the FED starts with the monetary restrictions. A rising level of interest rates may bring a number of emerging countries into or at the

³ Quantitative easing is when a central bank creates money and uses it to buy financial assets – mostly government bonds – from businesses like pension funds. The aim of this monetary policy is to encourage spending, boost overall economic activity and keep inflation on track to meet the inflation target by pumping new money into the economy.

edge of national bankruptcy, but it will have dramatic effects also on some advanced countries as well. Under these preconditions, the room for manoeuvre for fiscal policy will remain limited. A sound recovery all over will depend on the performance of the private sector which again in several countries is just over the deleveraging and not ready to undertake new financial burdens under the conditions of rising interest rates.

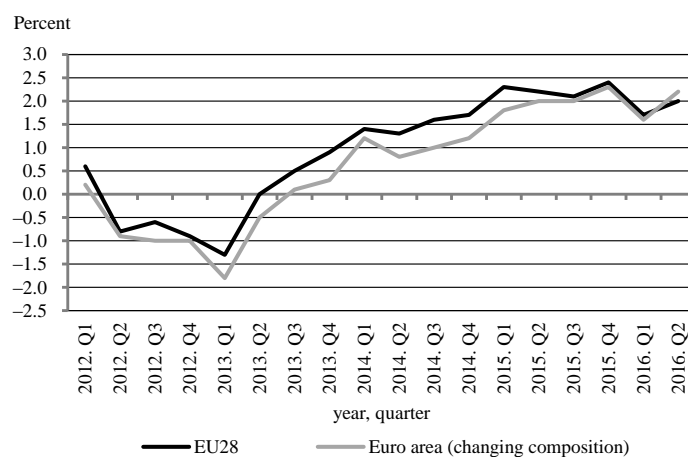
1.2. Slow recovery in the euro area – the Brexit may bring downside risks

Economic recovery has started in the euro area, however, the overall growth seems to remain moderate. Especially gross fixed investments fall short of expectations and concerning uncertainties related to the Brexit, risk aversion of investors may hold on in the period ahead. At present, nobody knows what kind of impacts the planned exit of the United Kingdom from the European Union will have, how the whole process will look like. It is generally assumed that consequences will be negative both for the UK and for the EU, especially for countries with intensive trade relations with the UK (like Germany, the Netherlands, France, or Italy). Besides political uncertainties, the spill-over effects of the Brexit may be felt through different channels: trade, the negative attitude and losing confidence of investors, rising risk premiums, the flow of foreign direct investments, impacts on financial markets and the banking sector, migration flows, regulation adjustments. Taken as a whole, a wide range of spill-over effects may occur. Most experts agree that the impacts retaining growth will be felt in the first line next year. At present – after the first wave of shock – sentiment indicators recovered, and short-term expectations seem to be relatively optimistic as well. However, this might change soon, as the British government announced that it plans to launch the exit procedure and activate Article 50 of the Lisbon Treaty in the first quarter next year. This may lead to postponing investment decisions and to a slower rise of exports next year. According to the first estimates, for example the GDP growth rate for Germany, where the UK is the third largest export partner with a share of 7.4% as compared to total exports, would be by 0.5% higher next year without a Brexit (*Boysen-Hogrefe et al.* [2016]).

In the first half of 2016, the economic performance slowed down as compared to the second half of 2015. (See Figure 3.) Especially investment activities fall short of expectations. As regards the demand side of the GDP in the euro area, especially the contribution of gross fixed investments and exports of goods and services will lose momentum as compared to the baseline scenario. In its recent forecast *Kopint-Tárki* [2016] reckons with an average growth of 1.7% for the euro

area for 2016 and 1.3% for 2017, calculating already with the adverse impacts of the Brexit.

Figure 3. Percentage change of GDP in the euro area as compared to the same period in the previous year, 2012–2016



Source: <http://ec.europa.eu/eurostat/tgm/refreshTableAction.do?tab=table&plugin=1&pcode=teina011&language=en>

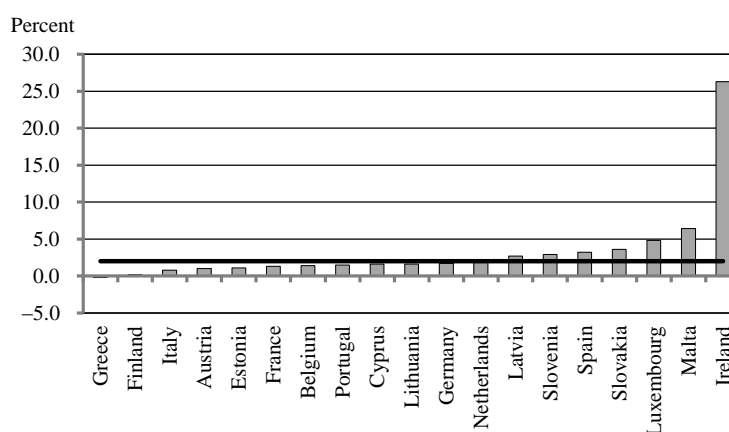
The differences between member states remained relatively high. (See Figure 4.) From the large countries of the euro area, the growth in Italy turned out to be very poor last year, and due to structural problems, Finland has not yet recovered from the consequences of the crisis. In Italy, the problems of the banking sector, the large share of bad, failing loans imply a downward risk, not only hindering the credit business but also threatening the whole banking system of the euro area. Related uncertainties of market players become also manifest in the picking up of Italian long-term government bond yields.

In France, the rate of economic growth will remain moderate in the coming years as well, and, as a consequence of the Brexit, the GDP growth in Germany will slow down. In Spain, where the GDP rates were relatively high, the slowdown can be explained by the increase of corporate taxes in order to avoid deficit procedure because of too high general government deficit. The extremely high GDP growth in Ireland last year had technical reasons⁴, thus in the coming years substantially lower

⁴ The Irish economy grew by 26.3% in 2015, compared with the expected rate of 7.8%, after foreign companies that switched their base to Ireland were included in the value of its corporate sector, pushing up the value of the state's balance sheet. The process of switching tax domicile after a merger or acquisition, called as „inversion”, has increased in recent years, and Ireland has become a popular end destination in these corporate manoeuvres because of its low corporate tax system.

rates are to be expected. The Greek economy despite of a large amount of capital injection is in a very poor shape, and a new support on behalf of the ESM (European Stability Mechanism)⁵ could not be avoided.

Figure 4. Diverging economic growth in the euro area, 2015
(percentage change as compared to 2014)



Source: <http://appsso.eurostat.ec.europa.eu/nui/submitViewTableAction>

Differences in performance between the countries in the euro area can be explained by their different structural preconditions. Besides a number of similarities, individual countries were affected by the crisis in a different way, thus national governments had different policy responses leading to diverging results.

2. New member states in the European Union

New member states⁶ grew by 3.4% in the second quarter of 2016 compared to the same period of the previous year. Principally three member states can be heightened: Slovakia (3.7%), the Czech Republic (3.6%), and Romania (6%). The overall contribution of these three countries to the regional growth is 1.6 percentage points. As Poland's contribution is 1.1 percentage points, nine member states share the remaining 0.7 percentage points. The most disappointing was the Hungarian 2.6% growth

⁵ It is a crisis resolution mechanism for countries of the euro area. The ESM and the European Financial Stability Facility together have so far disbursed € 170.7 billion to Greece, making the rescue funds by far the largest creditor to Greece.

⁶ Member states that acceded to the EU in and after 2004.

because member states and competitors with similar weights grew much faster. The discouraging Estonian 0.8% growth is mainly due to the declining output in the mining and energy sectors as shale gas production was significantly lower in the reference period.

The Romanian economy is led by private consumption (it grew by 7.7%, however, the import also increased by 7.3%) thanks to the tax cuts. The winners of these measures are the trade and IT sectors that give almost half of the total value added. As these industries rely on domestic demand, significant slowdown is expected as the effect of real-wage increase disappears from the system. The growth of construction and manufacturing was only around 1-2% in the second quarter of 2016, and the whole Romanian economy is expected to slow in 2017.

2.1. Last months in deflation

Until August 2016, the regional consumer price index was -0.5% . Out of thirteen member states only eight have deflation while in five it is over. The aggregated price index was “pulled down” by Romania as a result of the VAT cut. Almost half of the deflation was due to this country, without them the regional price index would have been -0.3% . This time the Polish deflation is rather moderating the regional deflation (it is “only” 0.4%).

Tax cuts in Romania are reflected mainly in domestic food prices (their average index in the first eight months was -2.5%). This contributed to the regional food price index by -0.5 percentage points, thus the regional average was 0.1% (without Romania it would have been 0.6%). Negative food price index was measured only in Slovakia (-2.1%) and Cyprus (-0.4%).

Energy prices have been decreasing, and there is no sign of change in this trend. Even more, the further deflation of energy prices is expected in 2017. The regional average in the investigated period is -5.7% to which Poland contributed by -2 percentage points. If oil prices increase in the near future in a significant amount, energy prices will go up as well, but long-lasting price increase will be needed for that on the oil world market. At most, stagnation is awaited in regional energy prices with downward risks – inflation is not expected.

Core inflation of the region is 0.5 , and it is negative only in Bulgaria and Cyprus (-0.9 in both cases). The index has been on a decreasing path since the beginning of the year. Last data show 0.3% core inflation in the new member states. Nonetheless deflation in core price index is not expected in the next year, although there can be member states (especially Romania and Bulgaria) where it may happen for a while.

In 2016, we expect -0.5% deflation and 1.5% in 2017 only if there will be no significant change on the world energy market.

2.2. More or less stable exchange rates and yields

Non-euro-zone member states' foreign exchange rates remain stable this year. The Czech koruna has been the most stable against the euro – practically there was no change in its exchange rate in the first nine months. Both the Hungarian forint's and the Romanian lei's relative volatility was around 1%. There were some very short periods with extreme values, but none of them was longer than a few days, so their effect in the average is not significant. At the same time, the development of Polish zloty exchange rate against the euro was somewhat different from the rest of the region. It is not more volatile than other regional exchange rates, but the relative standard deviation is 1.5% – this measure is only a few base points in other countries. Another significant difference is that while the Hungarian and the Romanian currencies were on the stronger side at the beginning of the year, the Polish zloty was weakening. The main cause behind that is the domestic political affairs; the external assessment of the Polish politics has worsened a lot since the beginning of 2016, and thanks to that, the zloty has fallen out of the regional trend. No doubt that the macroeconomic indicators of the country are good, but it is not enough to convince investors.

The latter can be seen on the field of long term government bond yields. Interest rates of the Polish ten-year maturity bonds were above 3% in the larger part of 2016. Even more, there were months when the Polish yields exceeded the Hungarian that is usually higher. After the summer, regional interest rates became lower.

2.3. Five-year CDS prices improved a lot

Risk assessment of the region was improved a lot between July and September 2016. The five-year CDS (credit default swap) prices – that indirectly measure sovereign risks – decreased the most in Latvia (from 73 points to 52 points), Hungary (from 160 points to 117 points) and Poland (from 99 to 73). Risk ranking did not change, but compared to the same period of 2015, CDS prices decreased by 20% on average. For example, in the case of Latvia, it was declined by 50%. No doubt that this improvement of the region is due to the far better macroeconomic outlook compared to the old member states. CDS prices are expected to further decrease, at the same time ranking is not awaited to be changed. The largest improvement can be in the riskiest states like Croatia, but most probably it will not exceed 100 points.

2.4. Slightly lower but still good growth rates are expected in 2017

Regional growth shall be 3.1% in 2016, which is a bit a lower than in 2015 – as expected. This forecast contains rather upward risks because the Romanian domestic

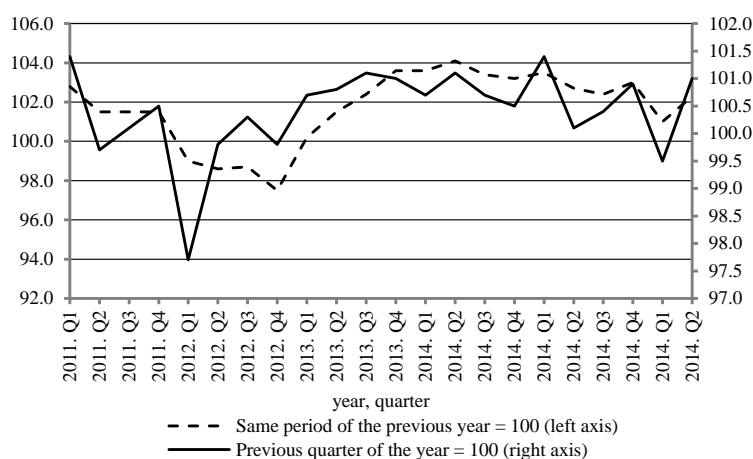
demand may have a serious growth in the last quarter of the year. Thus, the regional growth in 2016 can be higher by 0.1-0.2 percentage points. Next year a moderate slowdown is expected, but the regional average can be still around 3% (the forecast is 2.9%). Deflation will be over, and price indices may increase if the upward trends on the world oil market do not break. At the same time, high inflation rates are not expected in the new member states. The region is not affected directly by the geopolitical and world political turbulences (like the US presidential election). Thus, it may preserve its relative stability in the short-term future.

3. The Hungarian economy in 2015

In the first half of the decade, between 2010 and 2015, the Hungarian economy grew by an annual average of 1.9%. Within this, in the first two years of this period, the overall average growth was zero, but the next three years it amounted, on average, to 3.1% per year. In 2014, the rate of growth exceeded 4%, which has been unprecedented in Hungary in the last nine years.

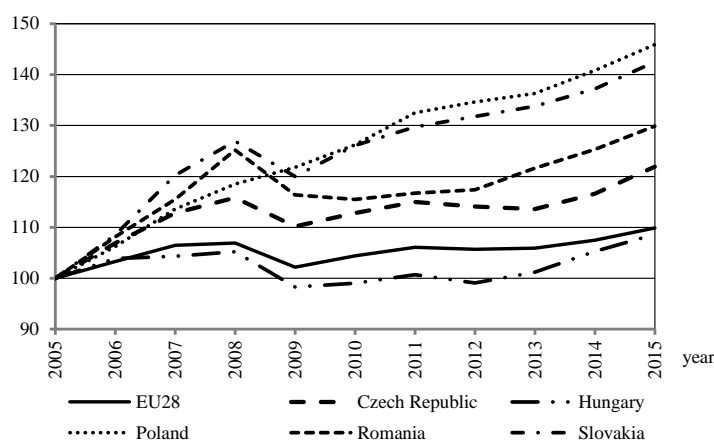
However, the relatively dynamic growth, started in the second half of 2013, was far from sufficient to compensate for the substantial backlog of the Hungarian economy between 2007 and 2012, as compared to the Visegrád region.

Figure 5. Quarterly growth of the Hungarian GDP, 2011–2014



Source: Hungarian Central Statistical Office.

Figure 6. Volume of GDP in the V4 group and Romania, 2005–2015
(2005=100)



Source: Eurostat.

In 2015, Hungary's GDP growth exceeded 3% (3.1%), which can be assessed as decent growth. However, since the annual growth rate of the competitors in the region reached 3.6–4.5% in that year, the Hungarian economy has been still lagging behind compared to them. According to the general consensus of forecasters, the growth of Hungarian GDP in 2016 is expected to be in the range of 2–2.5%, what is the lowest among the V4 countries and Romania.

3.1. Turn in the structure of growth in 2015

Between 2007 and 2012, if there was a slight growth in the Hungarian economy, it was only created by net exports. The domestic consumption component of GDP and both of its main components (private consumption and investments) also fell, stagnated or, at best, grew by some tenths percent. At the same time, the contribution of net exports to growth became dominant, which was also supported by sluggish domestic demand. Both the consumer and investment demand remained very depressed, meanwhile, export capacities increased, especially as a result of the growing production of foreign-owned manufacturing industry (mainly in automobile production) established in Hungary. Net exports could contribute positively to economic growth even in those years in which overall economic growth was actually negative (in 2009 and 2012).

From the second half of 2013, the situation changed. The contribution of net exports to growth declined significantly (in fact, became negative in 2014), while that

of domestic components increased. After several years of shrinking domestic components of GDP, they increased on average by 2.4% per year between 2013 and 2015. Nevertheless, the trade balance surplus remained significant and, in fact, it has further increased (in 2014 to 6.2, in 2015 to € 8.6 billion), largely due to the favourable terms of trade change as a result of substantial decline in international oil prices.

Among the components of domestic demand, the growth in private consumption can be considered to have a clear trend, meanwhile the growth in investments has showed considerable fluctuations, mainly depending on the use of EU funds.

Considering the weight in national economy, private consumption represents the largest component; its share in GDP has been about two thirds in recent years.

After nine years of drop in private consumption of households, a turnaround happened in 2014 (1.5-percent increase). The turning point was followed in 2015 and in the first half of 2016 by a further acceleration (2.6- and 4.3-percent growth). In particular, households' consumption expenditure was the driving force, which grew in 2015 and in the first half of 2016 by 3.1 and 5%, respectively. Despite the rapid growth of private consumption in Hungary in 2015, it was still below the 2007 peak, which can be achieved by 2016 at most if private consumption would grow by 6.5%. However, it would be an excessive expectation (although an increase of about 5% can't be excluded), so the 2007 peak might be reached in the first half of 2017 again: this time the volume of private consumption will be the same, as it was ten years ago.

The revival of private consumption was supported by the relatively fast increase in real incomes of households on the one hand and by the strengthening of household consumption propensity on the other. The significant increase in real wages in 2014 was primarily due to the unexpected negative consumer price index: at the end of 2013, the market consensus still expected an inflation rate of around 2%, and employers were likely to adjust their wage increases to this forecast. However, the actual consumer price index was minus 0.2%. The same occurred in 2015 when the increase of nominal wages in the private sector amounted to 3.9% what is not an outstanding rate, but compared to the negative consumer price index it resulted in a real wage increase of 4.1%. In 2016, the company executives might have been largely accustomed to the stagnating of the negative consumer price index, however, the labour shortage which became acute recently has led to a certain wage competition between firms and consequently, to significant wage increases. Due to the termination of unemployment in the western counties and to virtually full employment and the serious shortage of applicable labour force in the eastern counties, companies can only obtain labour or keep the existing one if they promise higher wages than competing companies.

The spiralling wage increase will continue in 2016, possibly even thrive well, and while the rate of employment is also rising, these two factors together will significantly increase the purchasing power of the population. The growth of the consump-

tion expenditure of households by 3.1 and 5% in 2015 and in the first half of 2016 can be considered still modest if it is compared to the real income increase, suggesting that it is still haunted by the high debt burden on foreign currency loans, and households try to get rid of foreign currency loans by prepayment. In addition, the population is still cautious due to previous losses on foreign currency loans. However, these effects less and less prevail.

While the upward trend in private consumption seems to be fairly clear, in terms of investments we experienced huge fluctuations over the past two years. In 2014 the statistics registered 14% growth of investments, and the increase of gross fixed capital formation in terms of GDP statistics was 11.7% higher than in the previous year. However, in 2015, the rate of growth of investments has shrunk significantly over the previous year, and in the first half of 2016 investments fell dramatically.

This phenomenon has been due to strong fluctuations in government development projects supported by the European Union. This fluctuation can be observed not only from year to year, but within a year, too. In the last quarter of 2015, when the state development projects had to be closed down because the 2007–2013 EU development cycle (7 + 2 years) ended, the volume of public investments was by 76% (!) higher than in the same period of the previous year. However, this high rate was followed by shrinkage of 48 and 53.3% in the first two quarters of 2016.

This significant fluctuation of investment growth was also fuelled by the fact that while in 2014 private sector investments grew very dynamically (by almost 10% year on year), since 2015 a continuous decline has been experienced. Since the beginning of 2015, private sector investments have decreased in every quarter – with the exception of the second quarter of 2015 –, so they could not smooth the fluctuations of public investments.

The decrease of private investments by 18.3% in the second quarter of 2016 is of particular concern. Although investments in overall manufacturing grew somewhat in this quarter, investments in water and waste management fell by 70%, in transport, warehousing and industry by 65%. The decline in these sectors might also be linked to the decrease of European transfers to Hungary. The dynamics of investments in automobile manufacturing and related engineering projects significantly increased in the past year, and significant investments were made in the chemical industry, too.

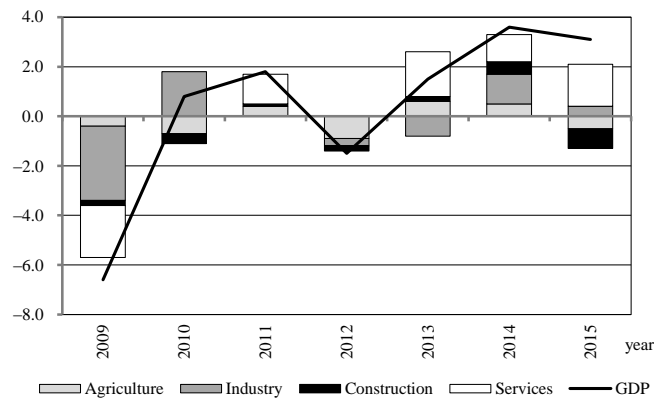
In housing investments, the government had big hopes due to the stimulus by the CSOK (Family Allowance for Housing) introduced in 2015, providing significant support for young families with at least three children. However, the actual impact of this measure on investments in housing and on construction industry lagged far behind the expectations. Although the building of new homes apparently reached its lowest point in 2013 (only 7,300 new homes were occupied), after a temporary and mild increase, the number of new dwellings fell again in 2015. Based on the first half-year data, in 2016 no more than a small increase is expected despite the fact that

the number of building permits issued rose significantly, especially in the second quarter of the year. However, these might have a positive effect on housing investments only in 2017. At the same time, the prices of used homes increased significantly, which can also trigger the revival of housing construction.

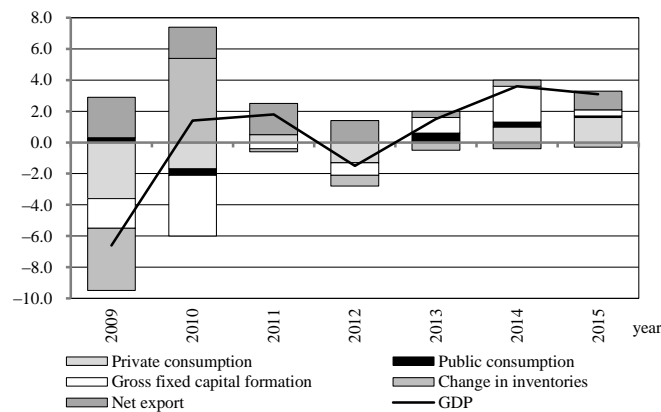
In conclusion, the structure of the expenditure side of GDP has significantly changed since 2014 what can be characterized by a robust increase in private consumption and a volatile up- and downturn in investments. In 2015, private consumption contributed the most (1.6 percentage points) to GDP growth, while investments increased slightly (0.1 percentage points). The contribution of net exports to GDP growth was 1.2 percentage points.

Figure 7. Contribution to GDP growth, 2009–2015
(percentage points)

a) by production components



b) by final use components



Source: Hungarian Central Statistical Office.

Rearrangements of the production side of GDP are much more uncertain. The dynamic growth in the service industries seems to be a long-term trend; in 2015 the added value of services grew by 2.8%, in the first half of 2016 by 3.2%. However, within this, the situation is very different for each sector. Dynamics was especially rapid in the past two years in trade, catering services and information and communication technology, while financial services have been steadily declining since the outbreak of the global financial crisis.

It should be added that the dynamic growth of services even accelerated in 2016. Services value added rose by an impressive 3.3% in the second quarter, surpassing the 3% posted in the first quarter. Apart from finance and insurance, every subsector within the services sector grew, led by wholesale and retail trade and tourism-related services. Besides, info-communication services and professional, scientific and administrative activities expanded at a good pace as well. The dynamic growth in services is crucial in 2016 to cushion the impact of the deceleration (or decline) of other economic branches, which justifies that the services sectors are equally important.

The added value of construction industry has developed in parallel to the fluctuating performance of investments. In 2014, the construction industry has expanded significantly (by 11.2%), which in 2015 has been followed by a more modest expansion (only 2.9%) and in the first half of 2016 by a dramatic fall (25%). These significant fluctuations are detrimental from the point of view of balanced capacity usage of construction industry.

Substantial fluctuations continued also in the performance of agriculture. In 2013 and 2014, the value added in agriculture grew by 15.3 and 13.9%, respectively, which was followed in 2015 by a 12.9% decrease. In 2016, a good harvest is expected again, suggesting an increase of over 10% of the agriculture production. The sharp fluctuations in agriculture point out that the sector is still heavily dependent on the weather conditions and on the amount of rainfall because of the low proportion of irrigated fields and intensive production techniques.

The industry remains the driving force of the economy but in declining extent. In 2015, its added value has increased by 6.3%, but in the first half of 2016, a significant slowdown was witnessed. The fluctuations are only partially caused by the strong dependence of the Hungarian manufacturing industry on the automotive manufacturing sector, which means that if a vehicle manufacturing company temporarily shuts down, the entire manufacturing performance brakes. In 2015, 27.8% of the total manufacturing value added was produced by the automotive industry and an additional 11% by the mechanical and electrical equipment. Apart from a few subsectors – such as computer manufacturing –, the majority of manufacturing subsectors showed volatile performance both in 2015 and in 2016. However, in the directions of industrial sales, a definite change can be determined. From 2014, not only export sales but also domestic sales have expanded. This suggests that the supplier

relationships of manufacturing enterprises and their involvement in global value chains strengthened.

Overall, we can say that in 2014 the agriculture and construction industry contributed to GDP growth by 0.5-0.5 points, the industry and the service sectors by 1.2 and 1.1 points, respectively.

3.2. Labour market developments

At the beginning of 2014, the number of employed people reached 4 million, which rose to 4.22 million at the end of 2015. In 2015, 120 thousand more people were employed than in the previous year. According to LFS (Labour Force Survey) data, 54 thousand fostered workers and 6 thousand people working abroad contributed to this increment, while the rest 60 thousand people found work in Hungary.

To the assessment of the number of workers abroad, it must be added that LFS registered 232 thousand Hungarian citizens working abroad at the end of 2015, meanwhile other sources estimated this number as significantly higher (400-500 thousand).

According to the statistics based on institutional data surveys, between 2014 and 2015, the number of employees increased more modestly, only by hardly more than 70 thousand at companies having more than five employees. The difference between the two statistics can partly be explained by the new jobs at companies with less than five employees and partly by the casual or non-registered employment, since the Labour Force Survey records the respondents having performed at least 1 hour (any) gainful activity in the week preceding the survey.

The increase in the number of employed people was accompanied by the fall of unemployment. In the 15–64 age group, the registered unemployment rate decreased to 6.2% by the end of 2015 from the previous year's 7.1%, and to 5% in July 2016. The employment rate in this age group grew from 61.1 to 67.1%. This is still below the EU average, but is definitely closer to it.

The number of employees increased in almost all sectors in 2015, with the exception of the depressed sectors in which investments decreased. The number of manufacturing employees increased by 3%, in the production of motor vehicles by 7.4%, in the chemical industry by 5.1% and in the rubber and metal processing industry by 6.6%, thus, in those sectors in which relatively large investments were made. Altogether, in the private sector, 60 thousand new jobs were created in 2015.

At the end of 2015, the number of fostered workers rose to 232 thousand, and their monthly gross earnings were close to 80 thousand forints, which is approximately 30% of average earnings. Fuelled partly by economic growth in the past two years and partly by the increasing number of people working abroad, the domestic

demand for labour force has grown significantly. The severe labour shortage in many occupations would justify the reconsideration of the system of public fostered employment programs in order to make the system more flexible, which would support the reorientation of fostered workers into the employment in the competitive sector.

3.3. Financial market developments

Among financial indicators, the evolution of the consumer price index not seen for several decades deserves attention mostly: after a relatively high inflation rate of 5-6% in the previous years, consumer prices have tended to decline or stagnate since 2014.

2015 was the second year when the consumer price index forecasts were definitely refuted. Consensus forecasts expected an inflation rate of 1.8% for 2014 and 1.5% for 2015, while the actual data were minus 0.2 and minus 0.1%, respectively. The same situation was repeated in 2016. The significantly lower-than-expected inflation (or even deflation) over the past years was mainly due to the fall of international oil prices that was previously almost unimaginable. In 2015, the decrease in the consumer price index was primarily affected by the decline of fuels and household energy price.

The fall in world oil prices has beneficial effects on growth in oil-consuming countries in the short term, but a number of factors tinged images. The positive key effect is on private consumption; household savings on lower energy and fuel prices can be spent on more products/services.

The decline in energy prices means lower costs of production companies, too. However, at the same time, the world market producer prices have also decreased or stagnated. Consequently, savings on decreasing energy purchase prices do not necessarily appear in the companies' profits. Companies operating on the competitive market have very modest additional gains, while firms having oligopolistic or monopolistic market position may have significant advantages.

The exchange rate of the Hungarian currency fluctuated partly due to international financial developments, partly as a reflection to domestic economic policy actions and political statements. The Hungarian currency started the year 2015 with an exchange rate of 311 EUR/HUF, and closed with 313. In the meantime, however, it was even under 300 EUR/HUF during the year.

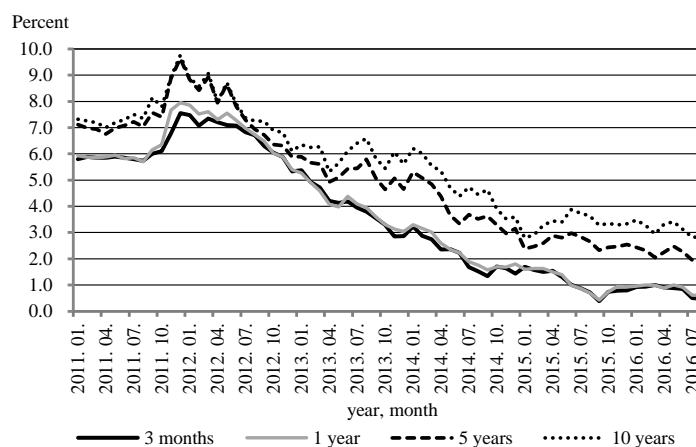
Exchange rate fluctuations are not considered to be significant, only 4-5% in 2015, which does not represent a significant turbulence for exporters. However, the year-end exchange rate was of great importance for the government budget from the point of view of the fulfilment of European Union debt rules. The level of public debt to GDP ratio is calculated by the year-end rate of exchange, and about one-third

of the Hungarian government debt was denominated in foreign currency. In this respect, the year-end exchange rate was not favourable for the budget. However, since the level of nominal GDP also exceeded the expectations, statistics registered a decreasing ratio of the public debt to GDP (to 75.3%).

The higher-than-expected nominal GDP had a favourable impact on the general government deficit, too. The actual deficit amounted in 2015 to only 1.9% of GDP compared to the 2.4% deficit target determined by the Budget Act. The nominal amount of the accrual balance was also lower than planned, but the greater nominal GDP contributed to the rate of decline, too. On cash basis, the deficit was much higher, but the reason for this was that a significant portion of funding for projects financed by the European Union support funds slipped through 2016.

In July 2014, the Hungarian National Bank declared the base rate reduction cycle, commenced in December 2011, at 2.1%. In March 2015, however, the base rate cut was restarted; the central bank implemented a 15-basis-point interest rate cut every month of the year until July 2015, when the second easing cycle was finished at 1.35%. It is worth noting that in March 2016 the third cycle of interest rate cuts started, under which the central bank cut on the base rate to 0.9%.

Figure 8. Hungarian government securities market reference yields of different maturities, 2011–2016

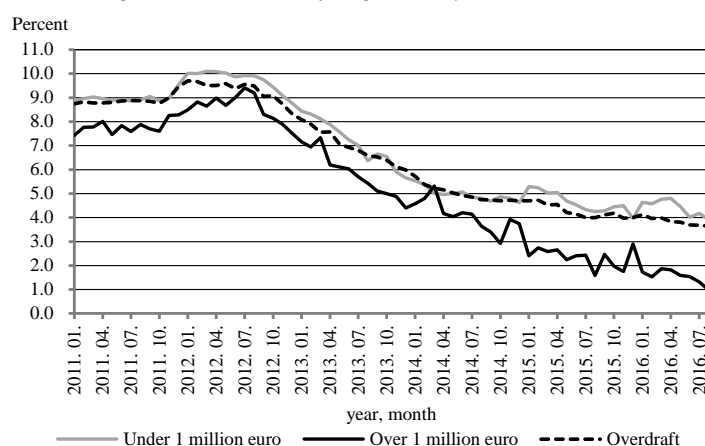


Source: Hungarian National Bank.

In 2015, the decline of the yield on government securities (that started in late 2011) continued. The yield on three-month government bonds dropped to 0.8% at the end of the year (in August 2016, it further decreased to 0.5%). The yield on longer-term bonds also declined to only 3.3% for the ten-year government bonds. Such low yields have been unprecedented since the existence of the Hungarian government securities market. Falling yields are partly explained by the improving confidence in

the Hungarian financial balance sustainability and partly by the low international interest rate environment. The latter is proved by the fact that in the majority of Central and Eastern European countries, the ten-year government bond yields were even lower than in Hungary. Only the Romanian and Croatian long-term yields exceeded the yields of Hungarian bonds. The Czech, Slovak and Polish long-term yields were about 2 percentage points lower. In the first half of 2016, the Hungarian yield reduction continued; in August 2016, the ten-year yield was below 3%. Two rating agencies, the Fitch (in May 2016) and the S&P (in October 2016) upgraded the Hungarian bonds to the investment grade category, which strengthens the possibility of further yield reduction.

Figure 9. Interest rate on foreign currency loans, 2011–2016



Source: Hungarian National Bank.

The low yields significantly reduce the budget debt interest burden, which has been exceptionally high. The budget burden for interest expenditures was in 2015 lower by HUF 140 billion than one year earlier, and by 2016 is expected to fall by another 150 billion.

The global decline in yields showed moderation in corporate interest rates as well. The interest rates on overdraft and on forint loans up to EUR 1 million went down to less than 5%, on forint loans over EUR 1 million to under 3.5%. Such low interest rates would no longer be an obstacle to borrowing if the companies would plan to invest in growing number. Nevertheless, the demand for loans remained weak; the results of the National Credit Program announced by the National Bank have been below expectations. Corporate borrowing propensity is limited by the uncertainties in the economic environment and the unpredictability of economic policy measures.

3.4. Risks and chances in the future

If the rapid growth in the last 2.5–3 years is interpreted as a kind of “recovery” after a period of almost a decade of lagging behind, we can conclude that there is still ample room for growth, as growth for many years would be needed to achieve featuring the middle of the last decade levels. And we have not even mentioned the compensation of lost growth in the last decade.

There are basically three kinds of challenges in front of the Hungarian economy which represent both chances and risks.

The first danger to the Hungarian economy is its extremely strong dependence on the European economic and social support programs. According to our estimation, projects financed by the European Union contributed to overall economic growth in 2010–2015 by 4 percentage points. The strong dependence implies the danger that if these transfers will be reduced, an important driver of economic growth will be eliminated. In addition, the weakness of private investments also draws attention that the impact of projects supported by the European Union on economic growth is not robust. Since these spill-over effects can be manifested only in longer turn, the real impacts will then become apparent in the second half of the decade. However, the Hungarian economic policy should be prepared for the sharp decline of plenty of financial resources after 2020.

The second is the deteriorating relative competitiveness of the Hungarian economy in different international scorings. The weak competitiveness of the bulk of the Hungarian enterprise sector is a long known fact. In the World Economic Forum surveys and in other international rankings, Hungary has been losing ground for years. For example, in the latest survey of the World Economic Forum, Hungary slipped six places. This is primarily due to the ineffective state bureaucracy, the bad state of the infrastructure and the low quality of public services (education, health care). To improve the conditions for economic growth, adequate policy responses to these problems are needed. First of all, measures to reduce bureaucratic red tape and to make the state institutions more efficient, measures to purge the governmental tendering system from political influence and corruption, and measures to ensure a level playing field are essential.

Thirdly, the growing labour scarcity is becoming an effective impediment to economic growth. Besides the large-scale outflow of young and middle-aged labour force and the overexpansion of the public works program, this scarcity is also due to the rising demand for labour (a result of the economic expansion) and to the generally low productivity of the Hungarian economy. The low level of automatization and the limited access to advanced technology, primarily among the domestic-owned enterprises, make the Hungarian economy relatively labour-intensive. This implies that – in addition to the overhaul of the education and training system, and to the

“freeing up” of a segment of the job-seekers from the public works programs – raising productivity and replacing labour with technology will also be an integral part of the solution of the labour scarcity problem. The overhaul of education includes not just the widely discussed issue of vocational training but also a thorough improvement of primary education. The necessity of the latter is highlighted by the complaints of the vocational institutions and firms regarding the extremely low skill levels of the pupils, who, upon leaving primary education, enter the vocational schools, which forces the vocational schools to spend time and resources to teaching basic skills (i.e. reading and writing). The revamping of basic education, with special emphasis to the work with disadvantaged pupils, should be an essential element of the efforts to achieve an increase in the (employable) labour force in the medium term.

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