MINISTRY
FOR NATIONAL ECONOMY

European Commission report underlines Hungary's balanced albeit modest growth path

The Commission's Country Report on Hungary draws mainly upbeat conclusions on macro-economic developments in the country. The institution highlights several positive changes observed in the country, placing special emphasis on the overall improvement of the economy. The Hungarian economy has been on a stable growth path; household consumption has grown, the labour market has recovered, the government budget deficit has declined and the amount of general government debt has also been edging down, while the country's net external position has improved. The report of the European Commission also notes that Hungary has made progress in the implementation of country-specific recommendations issued in 2015.

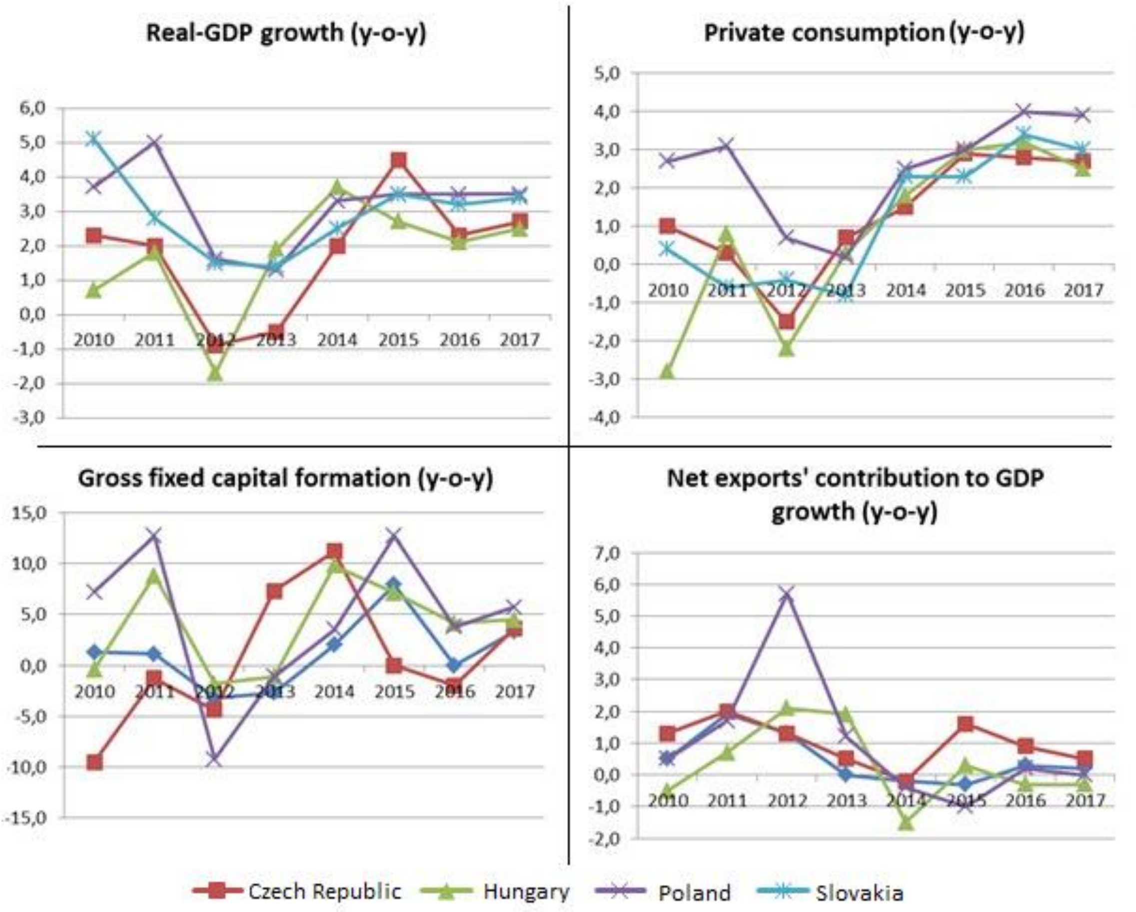
According to Eurostat estimates, although GDP growth in Hungary was slightly lower in 2015 than it was in 2016 (3.7 percent), **the economy has managed to post growth of 2.9 percent**. The largest growth impetus was received through the economic upturn observed in Europe and the launching of new EU-funded projects. Household consumption and net export growth were also among major positive factors. Thanks to measures that eased mortgage financing pressures, low inflation and the rise in nominal wages, households' disposable income has increased, which has subsequently fuelled household spending.

Household consumption is expected to continue to significantly contribute to Hungary's economic growth, partly as a result of the reduction of personal income tax rate, from 16 percent to 15 percent. Minister of National Economy Mihály Varga has once remarked that the 1 percentage point cut "leaves HUF 120bn more in the pockets" of 4.3 million people. Despite steady export growth, net exports will be a less decisive growth factor, due to the increase in domestic demand. Some prognoses predict GDP growth to remain stable in 2016 and 2017, albeit below the figure of 2015. This stems from the deceleration of the transfers of EU funds, due to the shift from one programming period to the next. However, once the implementation of EU-funded projects gathers steam again by 2017, GDP growth is to rise to around 3 percent. In order to compensate for the transitory slack resulting from the downturn in EU-financed projects, the Government aims to boost consumption through the reduction of personal income tax and other tax incentives, and thus facilitate economic growth in 2016.

The new Housing Programme is also expected to bring some positive changes. Through promoting the expansion of the construction sector this scheme is seen to add as much as 0.3 percent of GDP to overall growth. Although Hungary still has a small gap to close with regional competitors, robust economic performance over the past three years has led to a gradual improvement of the country's future growth potential (the European Commission predicts GDP growth of 2.2 percent in 2017, while it has forecast only 2 percent for 2015).

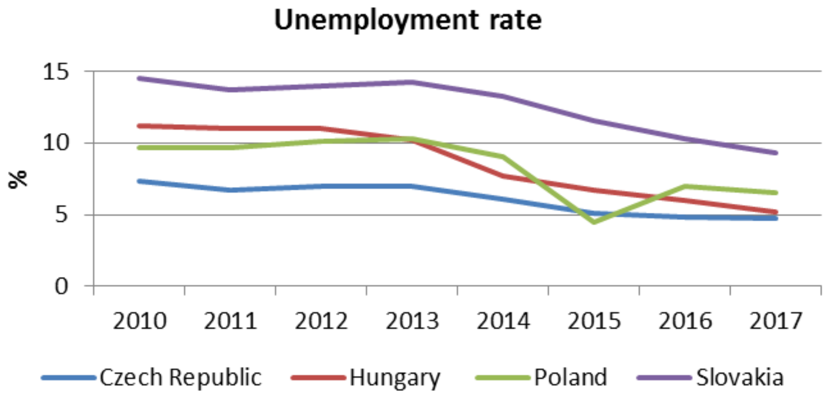
Backed by stable economic growth and recent Government measures, the improvement of labour market indicators has continued. The unemployment rate fell from 11 percent to 6.75 percent between 2010 and 2012, which is already lower than the pre-crisis level. Concurrently, the economic activity rate grew from the former 63 percent to 69 percent in 2015, among the age group of 20-64 years, a major statistical category of the EU2020. Labour market policy has caused labour force to increase on the supply side, as a consequence of restrictions on early retirement and a higher retirement age.

In comparison to our regional peers, Hungary has the lowest unemployment rate, but the country's activity rate – in spite of the impressive improvement in recent years – is still lagging behind that of our neighbours.



Source: Eurostat

The public work scheme channels economically inactive and jobless people to the labour market. On the other hand, for the time being it rather operates as a welfare employment programme than a stepping stone to private sector jobs, but several complementary stimulus programmes are being prepared to help more people make it to a private sector position. The share of public work employees who have managed to find a job was 12.6 percent in 2015 and 13.1 percent in the first half of 2015. In that period, 60.5 percent of people who had left the scheme returned to it within 180 working days. In order to ease the transition, in addition to former measures the Government has recently introduced financial incentives for public work employees who landed a private sector job. Preliminary estimates predict that the unemployment rate is set to fall to 5 percent by 2017. The success of creating steady jobs hinges on the adaptability of programme participants to private sector demand.



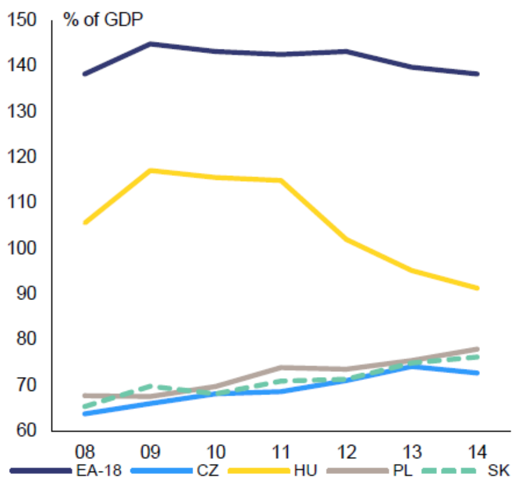
Source: Eurostat

In the Commission's estimate, the deficit of central government budget fell from 2.5 percent in 2014 to 2.1 percent is 2015, and it is set to edge down to 1.9 percent of GDP by 2017, thanks rather to improving economic conditions than structural measures. Fiscal savings stemming from the pension reform and lower interest expenditures may be spent on the housing programme and major tax cuts. The general government debt-to-GDP ratio could also be reduced and the downward trend is expected to continue. According to Minister Varga, preliminary data show that the general government debt-to-GDP ratio fell to 75.5 percent by the end of 2015 from 76.2 percent at the end of 2014. The drop of this ratio is believed to be the result of improving economic performance, but it also reflects large-scale, off-balance capital transactions and more optimal financing conditions due to a lower share of forex debt. In addition to these, the delayed transfer of EU funds had a significant negative impact on state debt without an actual rise in the deficit, as this is calculated according to accrual method. Relatively high GDP growth and a lower deficit are expected to further reduce the debt ratio to as much as 72.5 percent in 2017. However, in comparison to regional competitors, this indicator still remains high.

Positive news also from the financial sector: factors such as the improvement of the stock of household debt and forex exposure have also been instrumental in household consumption growth. The forint conversion of households' forex loans, which involved the equivalent of 15 percent of GDP, has entirely eliminated the former, huge forex exposure of households. These changes and the labour market upturn have re-ignited household lending, especially in terms of mortgages. The new state-funded Housing Programme is also expected to help boost household lending.

Corporate lending, on the other hand, has hitherto failed to revive, due to certain impediments on both the supply and demand sides. The National Bank of Hungary (MNB) has launched several SME lending promotion schemes and it also aims to facilitate schemes to raise funds on the stock market. Until recently, only the existing stock of SME loans could be stabilized. Banks's cautious attitude has played a major role in the lacklustre corporate lending trend. Although their capital adequacy and liquidity ratios are satisfactory, they are very careful with lending and hope to keep the stock of non-performing loans at a minimum. On the other hand, this prudence has mitigated the vulnerability of the financial system in the past year.

Net external debt (% GDP)

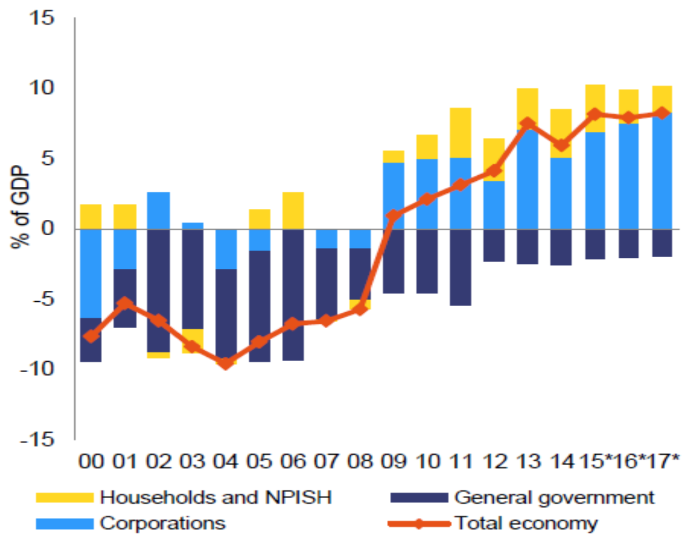


Source: European Commission, Eurostat

After the crisis, Hungary's net external position has improved remarkably. While the high level of external debt and net external liabilities had made Hungary especially vulnerable to external shocks during the crisis, in the pro-crisis era the country has seen a major turnaround in this respect. The adjustment was especially remarkable within the private sector: while the amount of gross savings was rising, the investment rate kept falling and remained at a pre-crisis level despite the massive flow of EU funds. As a result of these developments, the net external debt-to-GDP ratio fell from 116 percent in 2009 to 73 percent in 2014, and the Commission prognosticates that it dropped further in 2015. Economic balance could be restored through permanently high current and capital account surpluses, which were also the result of the diminishing stock debt of private sector debt and the sizable inflow of EU funds.

The country's strong net lending position has remained stable despite the recent pick-up of domestic demand. This is attributed to the fact that robust car industry expansion and massive improvement in cost-competitiveness have helped regain formerly-lost market share. Despite the transitory drop in the flow of incoming EU funds, the country's net lending position is set to stay sound in 2016 and 2017 (6.5 percent and 7.8 percent of GDP, respectively), as domestic demand will continue to be subdued, especially compared to the pre-crisis level.

Net lending/borrowing by sector



Source: European Commission
NPISH: Non-profit institutions serving households