MINISTRY
FOR NATIONAL ECONOMY

Analysts predict subdued inflation and GDP growth of above 3 percent for 2015

According to the quarterly inflation report of the National Bank of Hungary published on 24 September 2015, Hungary's economy has continued to expand. The main driver of economic growth was the recovery in domestic demand. Inflation remained subdued in Summer months, and the inflation rate is expected to be below the medium-term target of 3 percent both this year and next. Base effects were in line with the forecast of June, while the slight discrepancy within the overall consumer price index is attributable to lower-than-expected fuel prices. The global cost environment as a whole is highly favourable for Hungary, thanks partly to the substantial drop of raw material prices over the past months. Private sector employment growth continued in the second quarter, while wage dynamics remained moderate. This favourable cost environment is expected to persist over the outlook horizon.

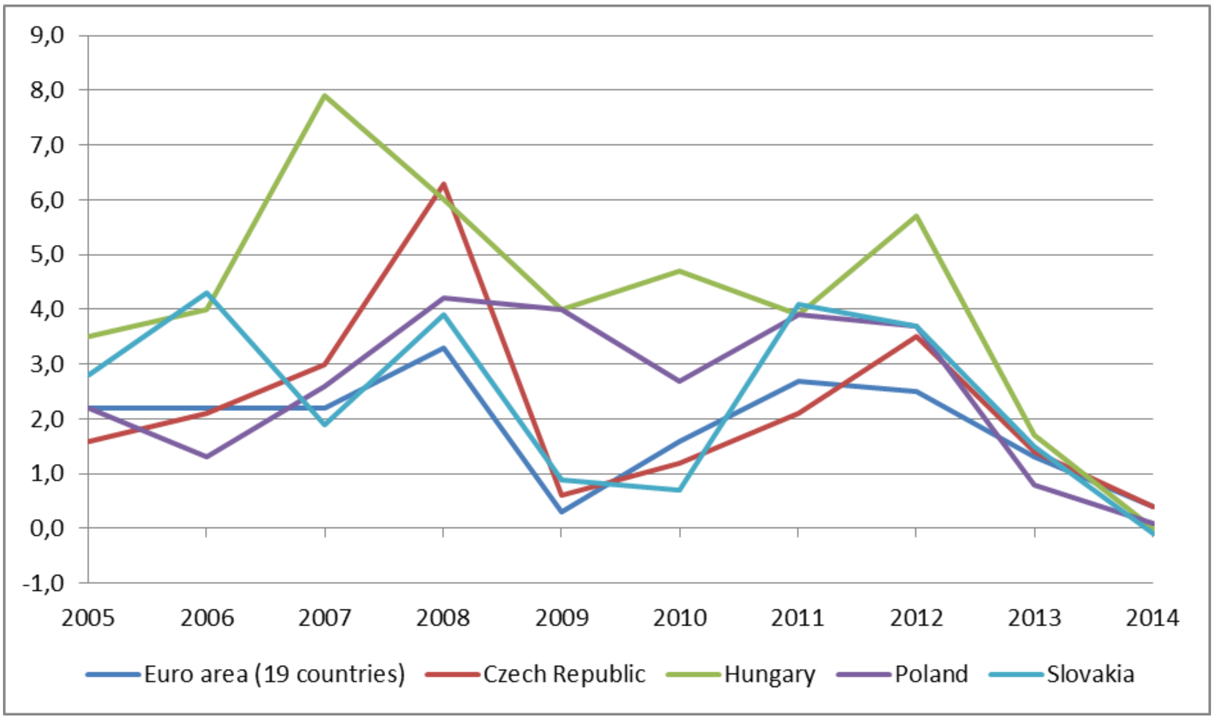
The balanced expansion of the Hungarian economy is anticipated to continue in the coming years. **Analysts are prognosticating robust economic growth for this year, exceeding 3 percent of GDP.** In the current, benign global inflationary environment inflation is forecast to remain subdued also in the coming quarters, partly as a result of slumping oil prices in recent months. The MNB's short-term report estimates that **the year-on-year growth of consumer prices will remain around zero percent in coming months.** At the end of the year, prices will certainly be in positive territory, while price growth is prognosticated to average 1.9 percent next year. Parallel to the modest increase of costs and the acceleration of household consumption and wage growth, core inflation – the primary driver of inflation trends – is also seen to gradually pick up. Contrary to the assumption of the former forecast, the inflationary target is currently expected to be reached half a year later, in the second half of 2017.

Growth may slow in early 2016, due to base effects and as funds originating from EU cohesion funds and the Funding for Growth Scheme run out. However, strengthening lending activity, the accelerating withdrawal of EU funds and increasing external demand may all contribute to improving economic performance as of the second half of 2016.

Subdued cost-side processes will substantially determine the inflationary path; however, **costs are expected to slowly rise**. The asset purchasing programme of the European Central Bank may lift Hungary's inflation rate through our major trading partner, the Euro-zone. **Due to declining oil prices, the Euro-zone consumer price index remained subdued**, showing year-on-year inflation of 0.1 percent in August. Although inflation rates in core countries show a downward path, **trends display more diversity in peripheral countries**: at the beginning of the year, inflation had risen in Italy, Portugal and Spain, but it has stagnated over the past months. In Greece, the consumer price index has ranged between -2.2 percent and -2.1 percent since February. In the past months, the inflation rate of the United Kingdom has remained low but was still in positive territory. From a historic perspective, **imported inflation is expected to remain subdued also in the medium term.**

It is also worth comparing Hungarian inflation with the consumer price growth of the Euro-zone countries and the Visegrad Four (V4 countries). The below chart shows changes in the Harmonized Index of Consumer Prices, on a year-on-year basis, between 2005 and 2014.

Change of all-items HICP in the Euro-zone and V4 countries, 2005-2014 (y/y)



Source: Eurostat

Note: Annual average rate of change

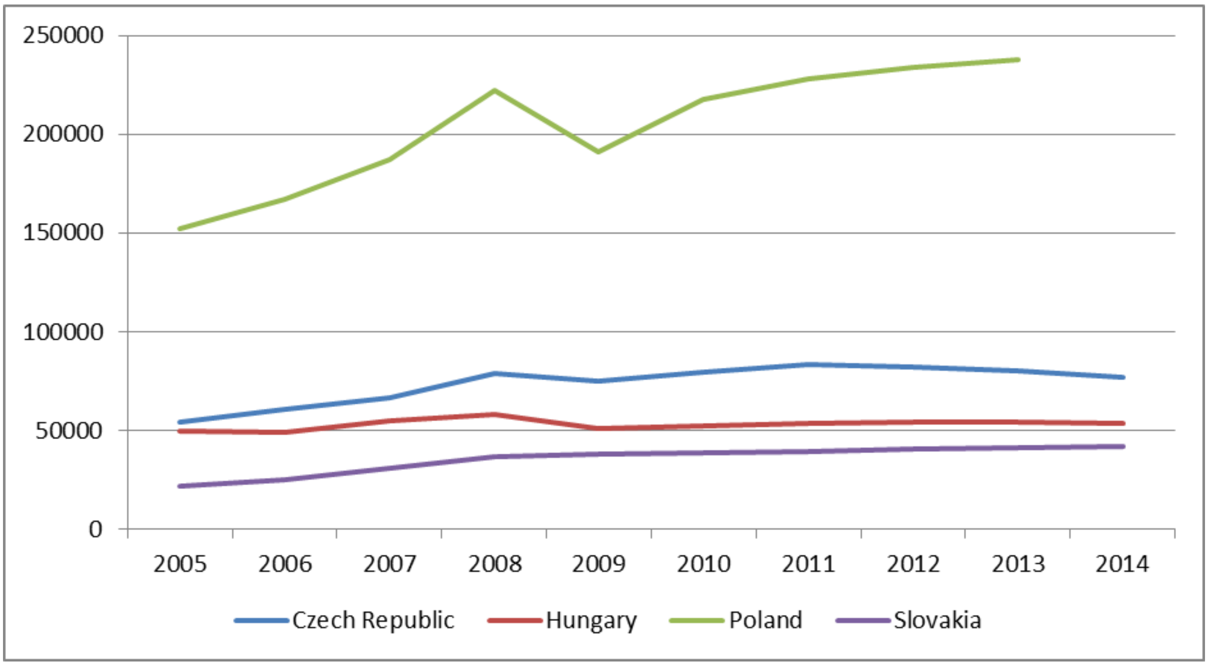
Within Central and Eastern Europe, the Visegrad Four are characterized by inflation rates that are uniformly below the diverse inflation targets of note banks. In the observed period, average inflation rates were in negative territory. In Poland, inflation had edged slightly up in the second quarter, but due to low raw material prices and modest wage growth there was no sizable cost pressure on the economy, therefore the annualized consumer price index remained in negative territory. In the second quarter, inflation of the Czech Republic had risen somewhat compared to the first quarter, while it fell to 0.3 percent in August, well below the 2 percent inflation target.

Major determinants of Hungary's economic growth

Hungary's economic expansion has been mainly driven by domestic demand growth, but the gradual revival of external demand has also been a key factor, as export market growth has been fuelling export volumes. Improving labour market processes, low inflation and a lower personal income tax rate introduced as of next year are set to increase the purchasing power of household incomes and thus boost domestic demand. Over the past years, **the volume of household debt has gradually declined** and this trend has also contributed to consumption growth. In addition to these factors, the conversion of forex loans had substantially reduced the sensitivity of households to forint exchange rate fluctuations which in turn has led to a decline in precautionary considerations and an easing of balance sheet adjustment pressure. Accordingly, the Hungarian central bank predicts that a gradually decreasing savings rate from the current high level coupled with rising incomes will contribute to a pick-up of household consumption over the forecast horizon. In coming years, the investment rate-to-GDP ratio will remain firmly around 20 percent, but its composition is set to change fundamentally.

Analysing one of the key factors of domestic demand growth, the final consumption expenditure of households, it can be concluded -- as the below chart also demonstrates -- that **household spending on consumer goods has been growing slowly but steadily**. Within this category, spending on non-durable items had the largest share, accounting for 40 percent, followed by spending on services. In 2013, the share of disposable incomes spent on non-durable goods and services was 45.2 percent and 42.5 percent, respectively, while spending on durable and semidurable items accounted for 5.8 percent and 6.4 percent, respectively, totalling at current prices HUF 16 054 715 million.

Final consumption expenditure of households in V4 countries, at current prices, million Euro, 2005-2014



Source: Eurostat

When compared to the spending trends of the Visegrad Four, **Hungarian households are most similar to Slovakian ones**, and the growth curve of spending was almost alike in the two countries. Although household spending in Poland grew the most dynamically in the period 2005-2014, but the country also saw the largest slump as a consequence of the 2008 credit crisis. Since 2002, final consumption expenditure has been declining in the Czech Republic.