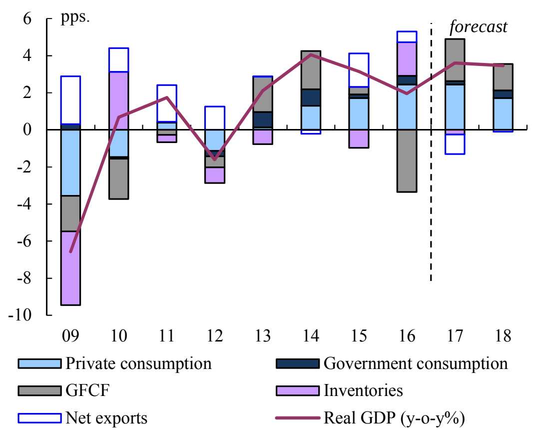
17. HUNGARY
High private consumption and rebounding investment

Economic growth slowed in 2016 but is forecast to pick up again, driven by private consumption and rebounding investment. The labour market is becoming increasingly tight and price pressures are expected to increase over the forecast horizon. The fiscal stance is expected to loosen.

Investment drop slowed GDP growth in 2016

In 2016, real GDP growth slowed to 2.0%, from 3.1% in 2015. The decline was due to the lower absorption of EU funds at the end of the 2007-2013 Multiannual Financial Framework. As a result, investment contracted by 15.5% in 2016. Consequently, the contribution of domestic demand to GDP growth was negative, despite remarkably strong private consumption. The latter increased by 5.0% on the back of high wage and employment growth. The trade surplus increased to over 10% of GDP in 2016 from 8.9% in 2015. At the same time, the combined current and capital account surplus is estimated to have declined to 6.0% of GDP in 2016, reflecting the fall in EU transfers. Accumulation of inventories played a significant role in real GDP growth in 2016.

Graph II.17.1: **Hungary - Real GDP growth and contributions**



Investment and consumption are set to drive economic growth in 2017 and 2018

Real GDP growth is projected to rise to 3.6% in 2017 and 3.5% in 2018. Investment is expected to pick up sharply as EU-funded and public investment in infrastructure increase. In addition, the manufacturing sector is expected to benefit from capacity upgrades. Household consumption is forecast to grow at a fast pace, driven by dynamic wage growth, an upturn in bank lending to households and the continuation of positive labour market developments. As a result, domestic demand is set to become the main contributor to economic growth. From 2017, it is expected to be supported by a government-initiated package comprising a multi-annual cut in social security contributions, a minimum wage increase and corporate income tax cuts.

The large trade surplus is forecast to decrease as higher domestic demand boosts imports and higher wage costs are expected to moderate export dynamics. Nevertheless, export growth is forecast to remain strong, supported by planned improvements in manufacturing capacities, mainly in the automotive sector. A decrease in external financing capacity is expected to moderate as the inflow of EU transfers rebounds from 2017 onwards.

Domestic risks to the forecast are broadly balanced. On the upside, the adjustment of firms to higher wages and of workers to increased skill requirements may be smoother than expected in the baseline. On the downside, the pass-through of wage increases to domestic prices may be higher and faster, which could trigger a monetary policy reaction.

Employment growth is set to slow while inflation rises rapidly

The unemployment rate fell to 5.1% in 2016. The employment rate has increased significantly since the recovery started in 2013, while activity rates have been steadily increasing since 2008. Employment reached a historically high level in 2016, supported partly by the public work scheme. Private sector job creation has also been strong. However, national employment growth is set to slow over the forecast horizon as the labour market tightens and skill mismatches increase.

High domestic demand is projected to push inflation up to 2.9% in 2017. In 2018, inflation is expected to overshoot the 3% target of the central bank.

The general government deficit rebounds

In 2016, the general government deficit reached 1.8% of GDP, increasing somewhat compared to the 1.6% deficit in the previous year. The fiscal balance benefited particularly from the strong growth of wage-related tax receipts, temporary revenues and declining interest outlays. Expenditure on both EU-funded and domestic investment shrank significantly. However, these deficit-reducing effects were offset by spending increases, most notably on the public wage bill and capital transfers.

The headline deficit is forecast to rise to 2.3% of GDP in 2017. This reflects the impact of considerable tax cuts and expenditure increasing measures. While public investment is forecast to fall below the budgeted amount, the unspent appropriations are expected to be partly reallocated for current spending. Based on a no-policy-change assumption, the deficit is projected to increase slightly to 2.4 % of GDP in 2018. The forecast takes into account further cuts in social security contributions and counterbalancing further decreases in social payments and interest spending.

Overall, the risks to the 2017 forecast are to the upside, pointing towards a lower deficit. Spending on investment may turn out lower than projected due to delays in implementation and the related savings may not be fully spent. At the same time, the accumulating carry-overs of expenditure commitments are likely to pose a negative risk for the 2018 deficit outcome and further years.

Hungary's structural balance is estimated to have worsened only slightly in 2016 from -1½% to around -2% of GDP. Thereafter it is expected to deteriorate sharply reaching about -3¾% by 2018, due to a widening positive output gap. The debt-to-GDP ratio decreased from 74.7% to 74.1% by the end of 2016. Afterwards, it is projected to decline at a faster rate, approaching 71% by 2018 thanks to the forecast acceleration in nominal GDP growth.

Table II.17.1:

Main features of country forecast - HUNGARY

	2015		Annual percentage change						
	bn HUF Curr. prices	**% GDP**	**97-12**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**
GDP	33999.0	100.0	2.2	2.1	4.0	3.1	**2.0**	**3.6**	**3.5**
Private Consumption	16775.0	49.3	2.0	0.3	2.5	3.4	**5.0**	**4.8**	**3.3**
Public Consumption	6811.7	20.0	1.1	4.1	4.5	1.0	**0.1**	**0.9**	**2.0**
Gross fixed capital formation	7366.9	21.7	2.4	9.8	9.9	1.9	**-15.5**	**12.8**	**7.2**
of which: equipment	3077.7	9.1	4.7	2.6	20.5	2.2	**-7.8**	**4.0**	**7.0**
Exports (goods and services)	30846.2	90.7	10.5	4.2	9.8	7.7	**5.8**	**5.0**	**5.8**
Imports (goods and services)	27816.7	81.8	9.8	4.5	10.9	6.1	**5.7**	**6.8**	**6.5**
GNI (GDP deflator)	32404.2	95.3	2.2	3.6	2.4	2.6	**3.4**	**4.5**	**2.8**
Contribution to GDP growth: Domestic demand			2.0	2.9	4.3	2.3	**-0.4**	**4.9**	**3.5**
Inventories			-0.2	-0.8	0.0	-1.0	**1.8**	**-0.3**	**0.0**
Net exports			0.5	0.0	-0.2	1.8	**0.6**	**-1.0**	**-0.1**
Employment			-0.1	1.1	4.8	2.3	**2.2**	**0.6**	**0.3**
Unemployment rate (a)			8.0	10.2	7.7	6.8	**5.1**	**4.1**	**3.9**
Compensation of employees / head			8.4	1.6	1.3	1.5	**5.3**	**7.1**	**6.3**
Unit labour costs whole economy			6.0	0.6	2.1	0.6	**5.5**	**4.0**	**3.1**
Real unit labour cost			-0.7	-2.3	-1.2	-1.1	**4.5**	**1.1**	**-0.2**
Saving rate of households (b)			10.2	9.8	10.9	9.6	**9.7**	**9.2**	**7.0**
GDP deflator			6.8	2.9	3.4	1.7	**1.0**	**2.9**	**3.3**
Harmonised index of consumer prices			7.3	1.7	0.0	0.1	**0.4**	**2.9**	**3.2**
Terms of trade goods			-0.6	0.8	1.0	0.8	**1.8**	**-1.0**	**-0.4**
Trade balance (goods) (c)			-2.9	3.3	2.3	4.0	**4.7**	**2.8**	**2.0**
Current-account balance (c)			-5.3	3.8	2.0	3.1	**5.0**	**3.5**	**2.8**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)			-4.5	7.4	5.8	7.8	**6.0**	**5.9**	**5.4**
General government balance (c)			-5.6	-2.6	-2.1	-1.6	**-1.8**	**-2.3**	**-2.4**
Cyclically-adjusted budget balance (d)			-5.6	-1.1	-1.6	-1.6	**-2.0**	**-3.0**	**-3.7**
Structural budget balance (d)			-	-1.2	-1.9	-1.6	**-1.9**	**-3.4**	**-3.7**
General government gross debt (c)			64.9	76.6	75.7	74.7	**74.1**	**72.6**	**71.2**

(a) as % of total labour force. (b) gross saving divided by adjusted gross disposable income. (c) as a % of GDP. (d) as a % of potential GDP.