

BUSINESS REPORT

25 January 2017

Drawing breath before turning toward 4% YoY GDP growth

- Overview: monthly indicators suggest that growth could be as weak as 1.7% YoY in Q4, and 2.1% in 2016 as a whole. Given the faint GDP figures and the decelerating growth pattern (2014: 4%, 2015: 3.1%, 2016: 2.1%), our 3.9% forecast for 2017 may be surprising. This report lays out the key arguments that support our forecast: (1) Underlying growth dynamics – excluding the impact of EU funds – show a more robust pattern, driven by a tight labour market and rising consumption; fiscal easing and the minimum wage increase should boost consumption further; (2) business and residential investment has already showed signs of revival and may become important drivers in 2017; (3) EU fund absorption is due to recover in 2017. In our view, these factors will ensure that growth accelerates substantially in 2017. Nonetheless, there are downside risks to our forecast, related to the external environment (growth in the EU) and the performance of agriculture after an exceptionally strong 2016.*
- 2016 was the year of sudden stop in EU transfers. After the end-2015 surge of investment activity in line with the expiration of the EU fiscal cycle, the dearth of EU funds [brought collapse to capital formation](#), shaving off ~1.5 pp from GDP growth in 2016. This was most visible in the nearly 30% downward level shift of construction production in 2016Q1. In addition, after spring 2016 private sector activity also lost steam: industrial production growth stalled, while external trade indicators also suggest deceleration (see page 3). Our short-term forecast for 2016Q4 GDP suggests mere 1.7% YoY growth, while non-farm private GDP may have decelerated to 1.4% from 1.5% a quarter ago (see the chart on next page).
- However, we assess this slowdown as temporary and think business activity will soar in 2017. Accordingly, most of the forward-looking indicators promise meaningfully improving economic performance in 2017. Business sentiment in Germany as well as in Hungary has improved recently. New export orders of manufacturing are heading upward again. The stars are aligning for a recovery in manufacturing and export growth.
- The [tightening labour market](#), coupled with policy measures such as the 10% minimum wage hike and 25% raise of skilled workers' minimum wage, may result in 8-9% gross wage growth in 2017 (about 2.0-2.5 pps higher than our earlier medium-term forecast released in September 2016). Given that CPI may stay below the MNB's 3% target, real income growth could remain as robust as in 2016, above 5% YoY. Higher real income will support household consumption; so will the reduction of VAT on some basic foodstuffs (poultry, egg and unprocessed milk) and on internet providing services. (VAT cuts for restaurants may not pass through to consumers; firms may keep savings to themselves as a compensation for large, mandated wage hikes). Furthermore, as the budget still contains large room for manoeuvre, we suppose that ahead of the 2018 parliamentary elections the government will find further ways to support households. Finally, consumption will also be backed by higher propensity to consume, hence a lower savings ratio: notably, household loans flow returned to above-zero territory after seven years of contraction.
- After a soft 2016, private investment is expected to recover in 2017. Since the middle of 2016 we have seen signs of climbing private investment activity, while government investment also nudged higher in 2016Q3. The [overall FDI picture seems more encouraging](#) than before, and big-ticket capital projects by Mercedes-Benz and Samsung (for a combined EUR 1.3 bn) are also in the pipeline for 2017. Furthermore, the elevated level of building permits should transform into construction output soon, while the further drop in office vacancy rates supports private investment as well.
- Finally, the level of EU funds absorption has bottomed out. According to the 2016Q3 balance of payments, the net inflow of EU transfers is gaining momentum (up to HUF 226 bn in Q3, compared to HUF 9.8 bn in 2016H1). The [2016 year-end government spending spree](#) will bear fruits: the rising EU-related expenditures were mostly advance payments for future investment spending.
- All in all, we think that after a moderate 2.1% expansion in 2016, the stage is set for about 4% GDP growth this year. The year-end government spending spree and weaker-than-expected economic performance in 2016H2 may even pose risks to the upside. On the other hand, downside risks are related to the external environment (rising inflation may pose headwinds for eurozone growth, while the heavy political calendar could weigh on

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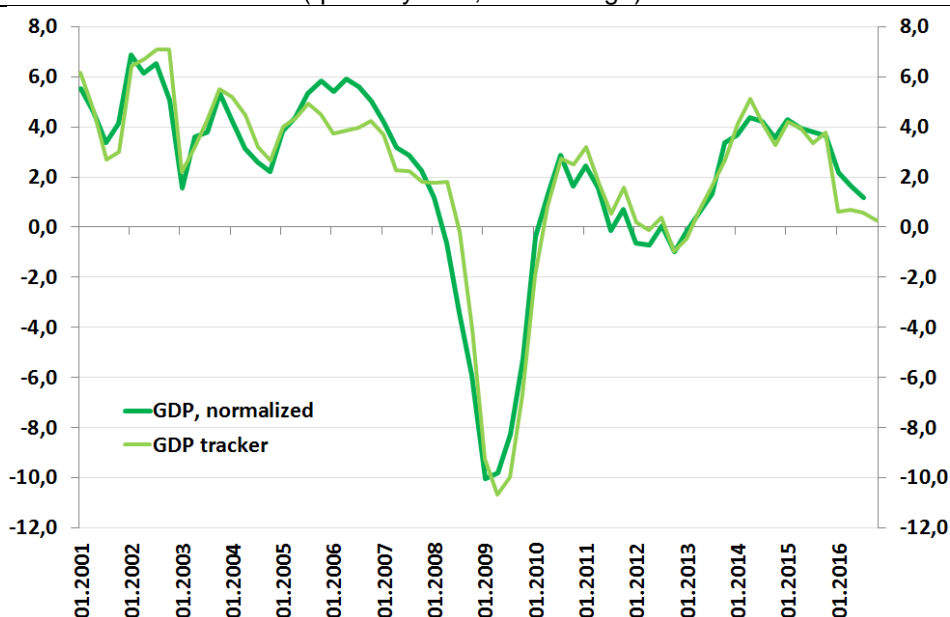
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business sentiment), and the performance of agriculture after a stellar 2016 (wheat crops reached an eight-year high while corn output was the fourth highest ever).

- Although the investment cycle has been quite volatile lately, we think the rising weight of private investment and robust household consumption will provide solid ground for 2018 growth as well. As expanding domestic demand will require more and more imports, the current account surplus will erode, while the tight labour market and accelerating wage growth will certainly fuel inflation. The main question at the current stage of the recovery is whether companies can (or are willing to) accumulate enough fixed capital and boost productivity sufficiently to overcome the constraint of enormous and pervasive labour shortage. If yes, the favourable macro setup could last for years. If not, stronger-than-optimal wage growth and the lack of labour reserve may bring the cycle to its limit sooner or later.

Business cycle forecasting indicator for non-farm private GDP*
(quarterly data, YoY change)



Sources: HCSO, OTP Research

Summary table of main macroeconomic indicators

Key economic indicators	2012				2013			2014			2015			2016F			OTP			Focus Economics			2017.01.			EC Autumn 2016			
	2012	2013	2014	2015	2016F	2017F	2018F	2016F	2017F	2018F	2016F	2017F	2018F	2016F	2017F	2018F	2016F	2017F	2018F	2016F	2017F	2018F	2016F	2017F	2018F	2016F	2017F	2018F	
Nominal GDP (at current prices, bn HUF)	28 628	30 065	32 180	33 712	34 869	37 104	39 200							35 005	36 777	38 714													
Real GDP change	-1,7%	2,1%	4,0%	3,1%	2,1%	3,9%	3,1%	2,0%	2,9%	2,9%	2,0%	2,9%	2,9%	2,1%	2,6%	2,8%													
Household final consumption	-2,3%	0,6%	2,5%	3,4%	4,3%	4,2%	4,1%	4,5%	4,0%	3,4%	4,9%	4,0%	3,4%	4,9%	4,0%	3,6%													
Household consumption expenditure	-2,3%	0,2%	2,1%	3,1%	4,9%	4,9%	4,8%																						
Collective consumption	-0,3%	3,0%	9,2%	0,6%	0,7%	0,5%	1,0%																						
Gross fixed capital formation	-4,4%	7,3%	9,9%	1,9%	-9,1%	13,7%	2,8%	-8,8%	5,4%	4,9%				-8,2%	5,9%	3,0%													
Exports	-1,8%	6,4%	9,8%	7,7%	6,6%	4,6%	7,5%	6,7%	5,1%	6,4%				6,2%	6,6%	7,2%													
Imports	-3,5%	6,3%	10,9%	6,1%	5,6%	6,0%	7,2%	6,2%	6,6%	7,2%																			
General government balance (ESA'10 based, HUF bn)	-662	-770	-673	-534	-368	-433	-784																						
in percent of GDP	-2,3%	-2,6%	-2,1%	-1,6%	-1,6%	-1,2%	-2,0%	-1,8%	-2,5%	-2,5%	-1,5%	-2,3%	-2,3%	-1,5%	-2,3%	-2,3%													
General government debt (in percent of GDP)	78,3%	76,8%	76,2%	75,3%	74,4%	73,6%	71,7%	74,3%	73,3%	72,1%	73,4%	72,5%	71,8%	73,4%	72,5%	71,8%													
Current account (EUR bn)*	1,7	3,9	2,2	3,7	5,7	4,2	2,5	5,5	5,0	4,4				4,1%	3,1%	4,1%													
in percent of GDP	1,8%	3,8%	2,1%	3,4%	5,0%	3,5%	2,0%	4,9%	4,2%	3,6%	4,1%	3,1%	4,1%																
Gross nominal wages**	5,7%	4,1%	3,6%	4,4%	5,7%	6,4%	6,8%																						
Gross real wages	0,0%	2,3%	3,8%	4,5%	5,4%	3,8%	3,9%																						
Gross disposable income***	2,0%	3,1%	4,0%	4,8%	4,4%	5,5%	5,9%																						
Gross real disposable income	-3,5%	1,3%	4,2%	4,9%	4,1%	3,0%	3,0%																						
Employment (annual change)	1,8%	1,7%	5,3%	2,7%	2,9%	1,3%	0,8%							2,7%	0,6%	0,8%													
Employment domestic concept w/o public workers	-0,2%	0,5%	3,3%	1,5%	2,3%	1,8%	0,9%							5,1%	4,7%	4,1%													
Unemployment rate (annual average)	11,0%	10,2%	7,7%	6,8%	5,1%	4,5%	4,1%	5,4%	5,1%	4,9%	5,1%	4,7%	4,1%	5,1%	4,7%	4,1%													
Inflation (annual average)	5,7%	1,7%	-0,2%	-0,1%	0,3%	2,4%	2,8%	0,4%	2,0%	2,5%	0,4%	2,3%	2,7%	0,4%	2,3%	2,7%													
Base rate (end of year)	5,75%	3,00%	2,10%	1,35%	0,90%	0,90%	1,35%	0,90%	0,92%	1,34%																			
1Y Treasury Bill (average)	7,0%	4,11%	2,28%	1,17%	0,77%	0,43%	0,97%																						
Real interest rate (average, ex post)	1,3%	2,3%	2,5%	1,2%	0,4%	-1,9%	-1,8%																						
EUR/HUF exchange rate (average)	289,3	297,0	308,6	309,9	308,8	311,8	313,3	311,0	310,0	310,0				310,0	310,0	310,0													
EUR/HUF exchange rate (end of year)	291,3	296,9	314,9	313,1	311,0	312,6	314,1	309,0	311,0	310,0				309,0	311,0	310,0													

*: Official data of balance of payments (excluding net errors and omissions)

** : Total wages including accrual based salaries in governmental sector. In the case of private sector wages we calculated with whitening effect filtered wages and we adjusted the changeable seasonality of the bonus payments.

***: Calculation based on financial accounts data

Assessing the short-term evolution of the business cycle

- Turning to high-frequency indicators, the picture is a bit discouraging. Manufacturing production has not really grown since mid-2015; in 2016H2 we could even see a slight decline (after 2016 April, when a supposedly one-off boost from the Esztergom Suzuki plant delivered an all-time high output volume). Looking at the details, a new divergence could be observed between the two main product groups: while the production of vehicles (responsible for about 28% of total manufacturing production in nominal terms) heads upward and has reached its previous high, the output of electronic, computer and optical products (accounting for about 11% of total manufacturing production) turned south in mid-2016. The latter can be put down to trend-like declines of production of computers and parts as well as consumer electronics. We saw similar divergence between 2010 and 2014 when insufficient demand, coupled with the gradual shutdown of the Nokia plant in Esztergom, led to 48% cumulated drop in the output of the sector. This time, our suspect is Jabil, which is reported to have laid off 600 workers (14% of its workforce) after relocating part of its production to Ukraine, seeking lower labour costs.
- Simultaneously with industrial production figures, the export volume of goods went down recently, which naturally led to some drop in import volumes. As the terms of trade were favourable over 2016, the trade balance surplus remained near its historical highs and may have been almost 10% of GDP in 2016 as a whole.
- After the collapse in 2016Q1, construction activity showed certain but limited improvement, thanks to supporting factors (vanishing free capacity on office market, introduction of government housing subsidy scheme, the so-called CSOK, VAT cut for new housing). However, the rise of building permits stopped in 2016H2, and the climb of construction production and orders stalled. Indicators of existing home sales and prices show that the revival of the housing market cycle may have arrived at a short break, at least.
- Finally, income and spending indicators of households tell that the acceleration has ended and the rate of expansion is stabilizing. Nominal income figures have steadied around 7-8% YoY, still a spectacular space, while the YoY changes of retail sales volume w/o fuels have been around 5% for a while. The growth of domestic nights spent in accommodation and soaring new passenger vehicle registrations also suggest robust household demand. Besides, household consumption has room for further increase: the gross saving rate of households has not started to decline yet (although the net saving rate has, owing to a recovery in borrowing).

Indicators of external demand

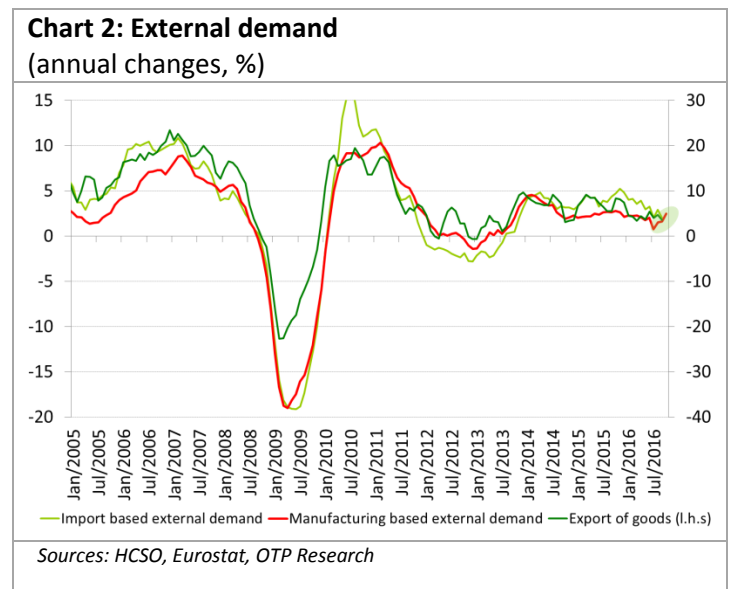
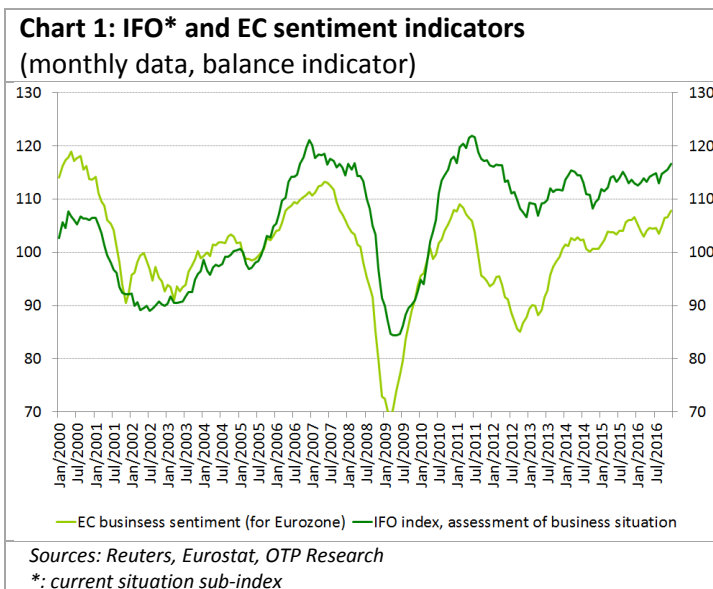
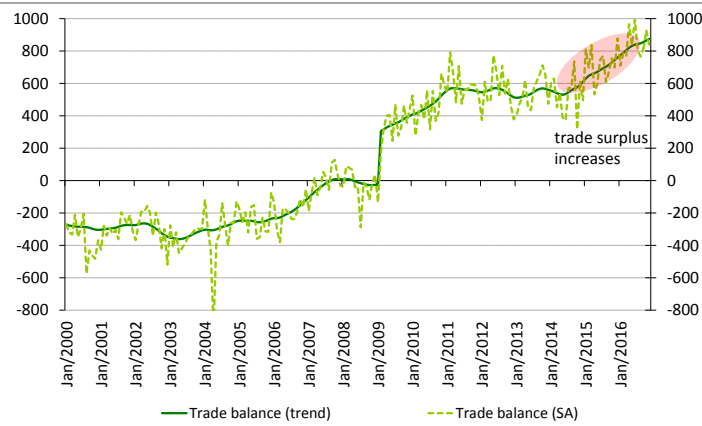
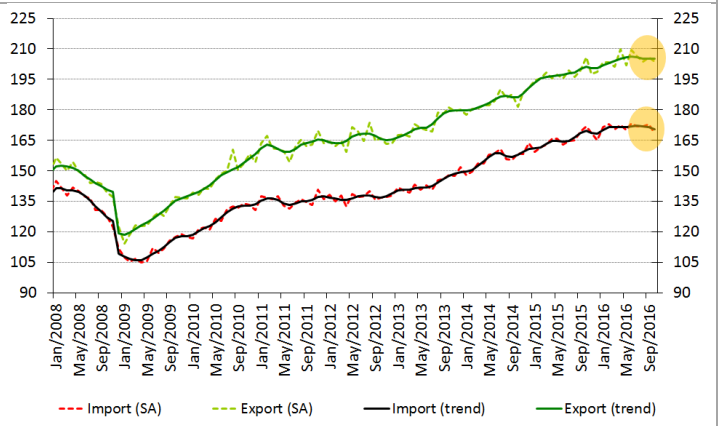


Chart 3: Trade balance
(monthly data, SWDA, EUR mln)



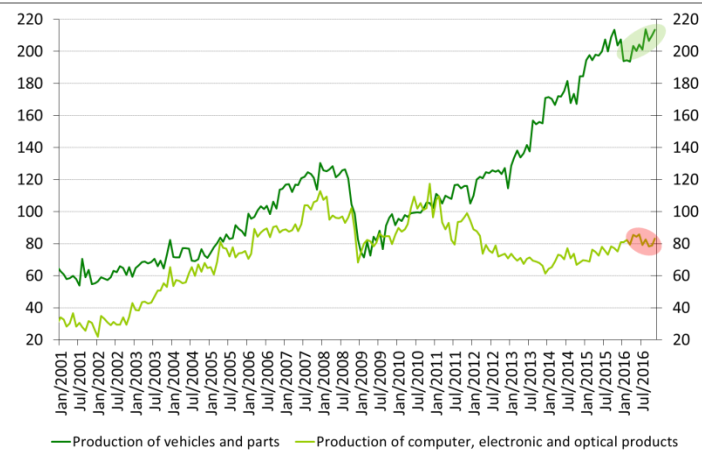
Sources: HCSO, OTP Research

Chart 4: Export and import of goods
(SA, 2010 = 100)



Sources: HCSO, OTP Research

Chart 5: Production of vehicles as well as computer, electronic and optical products (SA, 2010 = 100)



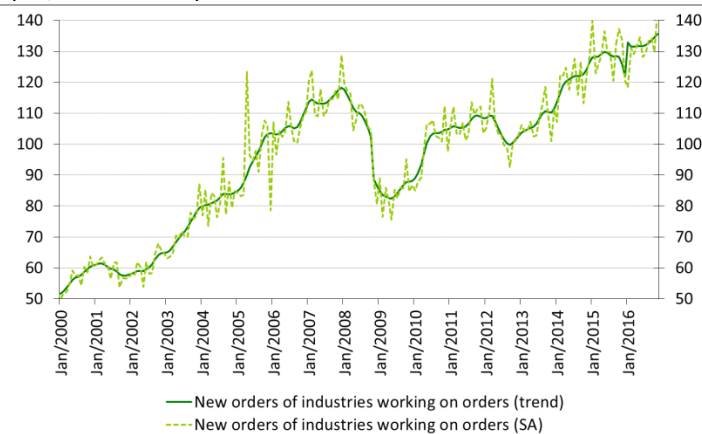
Sources: HCSO, OTP Research

Chart 6: Production of computers and peripheries as well as consumer electronic products (production value w/o VAT, monthly, HUF bn)



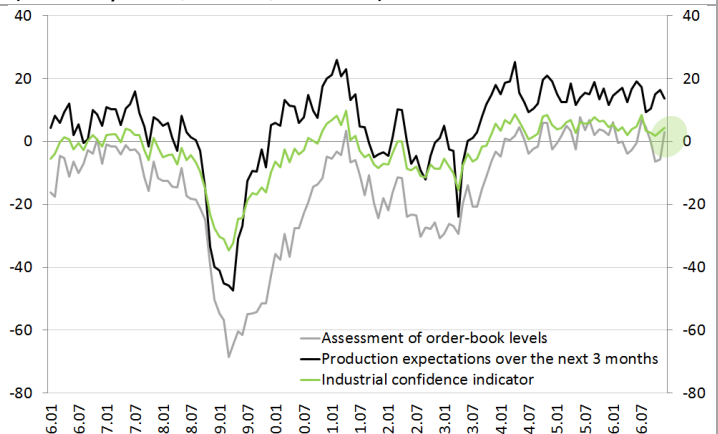
Sources: HCSO, OTP Research

Chart 7: New export orders
(SA, 2010 = 100)



Sources: HCSO, OTP Research

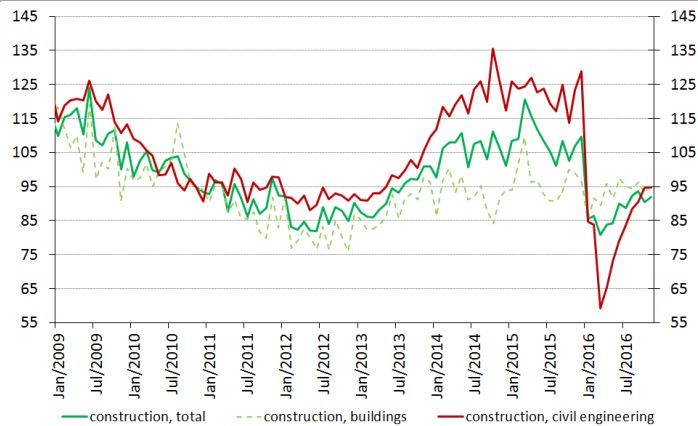
Chart 8: Business confidence in industry
(monthly data, SWDA, balance)



Sources: Eurostat, OTP Research

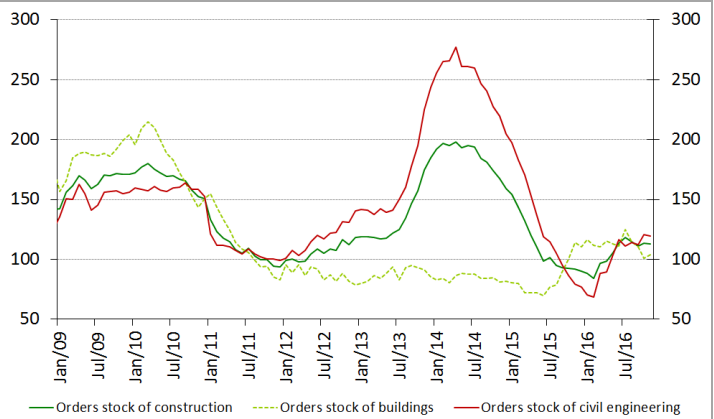
Indicators of domestic demand – Investments

Chart 1: Construction production
(SA, 2010 = 100)



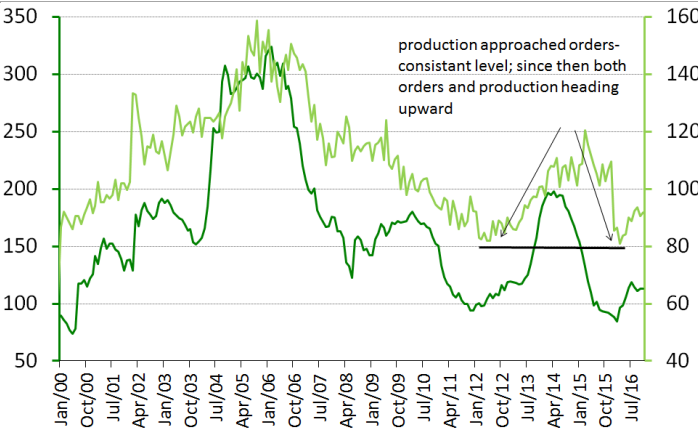
Sources: HCSO, OTP Research

Chart 2: Orders stock of construction
(SA, 2000 = 100)



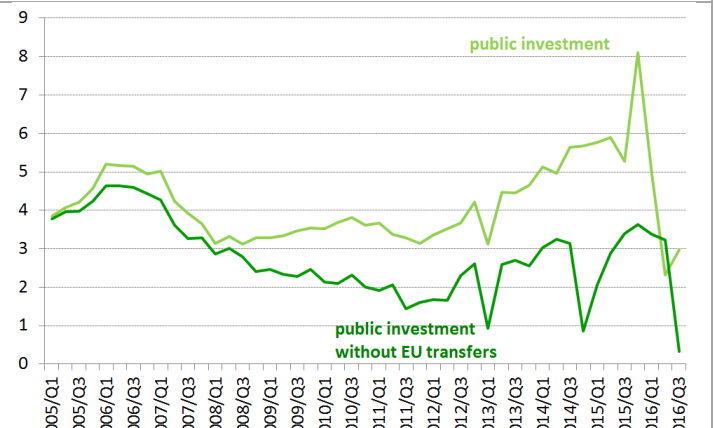
Sources: HCSO, OTP Research

Chart 3: Orders stock and production of construction
(SA, 2000 = 100, 2010 = 100)



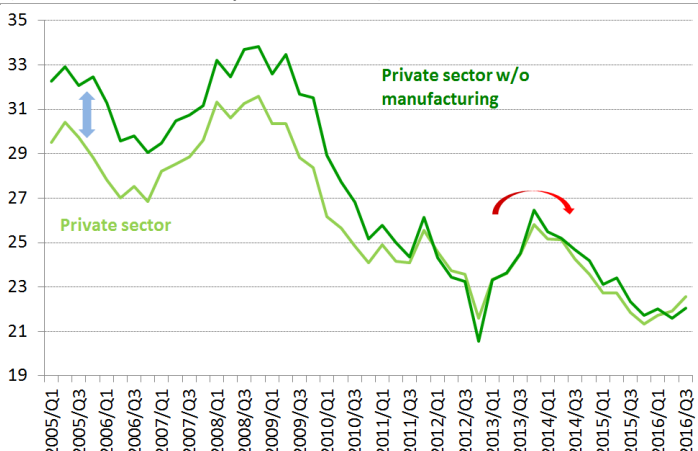
Sources: HCSO, OTP Research

Chart 4: Investment rate in the public sector
(SWDA, as % of total GDP)



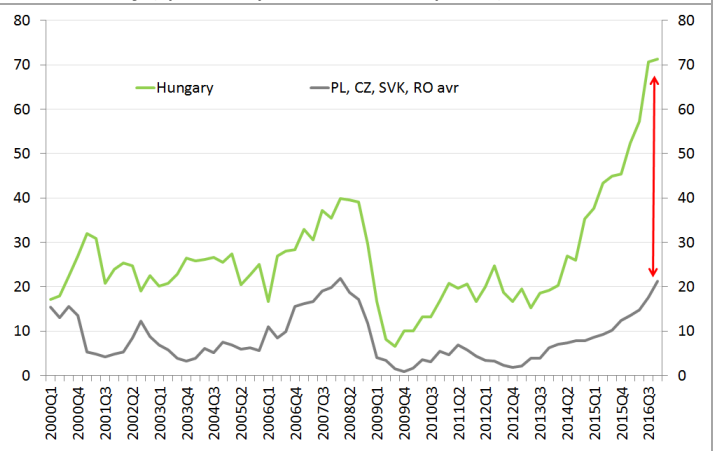
Sources: HCSO, OTP Research

Chart 5: Investment rate in the private sector
(SWDA, as % of respective GDP)



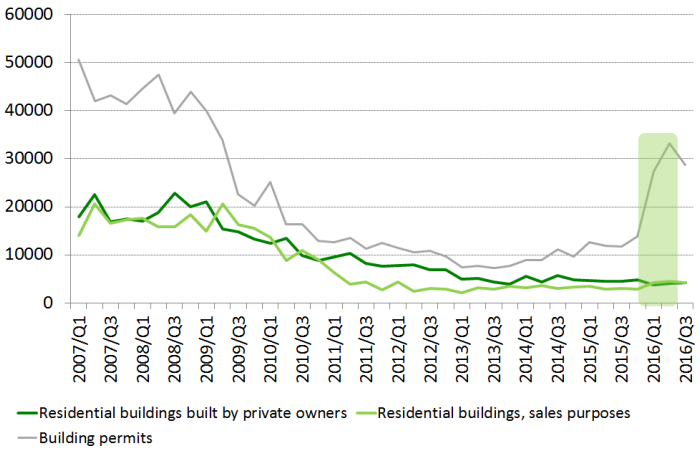
Sources: HCSO, OTP Research

Chart 6: Labour shortage as the constrain of production in industry (quarterly, balance, SA, point)



Sources: Eurostat, OTP Research
avr refers to numerical average

Chart 7: Building permits and completed dwellings
(ann quarterly data, SA)



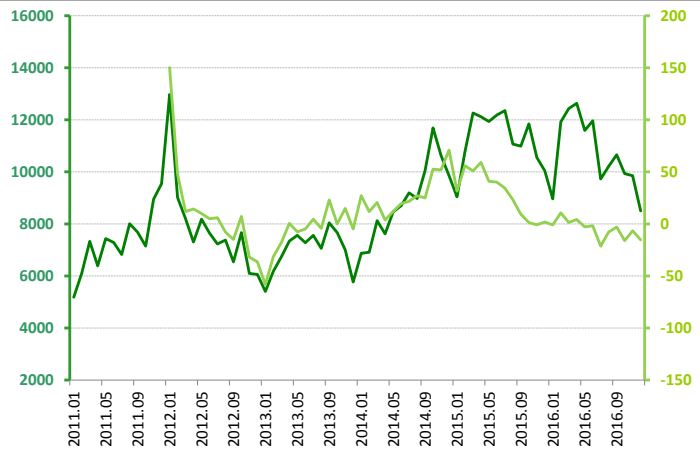
Sources: HCSO, OTP Research

Chart 8: Non-residential building permits
(monthly, floor space mn square meters, SA, 6M MA)



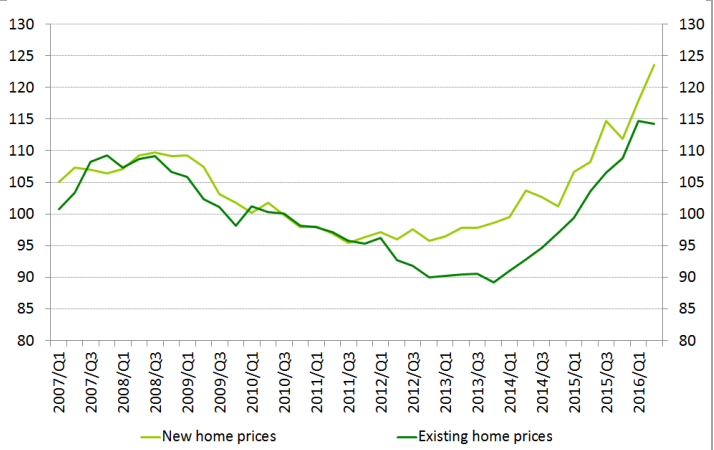
Source: HCSO, OTP Research

Chart 9: Number and YoY index of transaction of dwellings
(monthly, NSA)



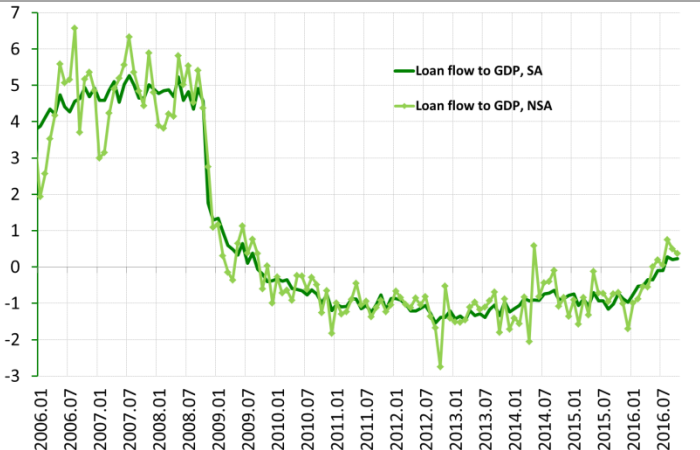
Sources: Duna House, OTP Research

Chart 10: Home prices
(previous year = 100, NSA)



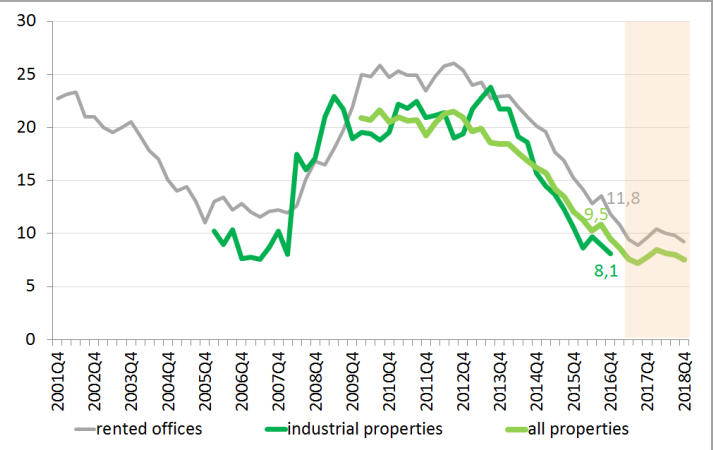
Source: HCSO, OTP Research

Chart 11: Housing loan flow
(monthly, HUF bn, SA)



Sources: MNB, OTP Research

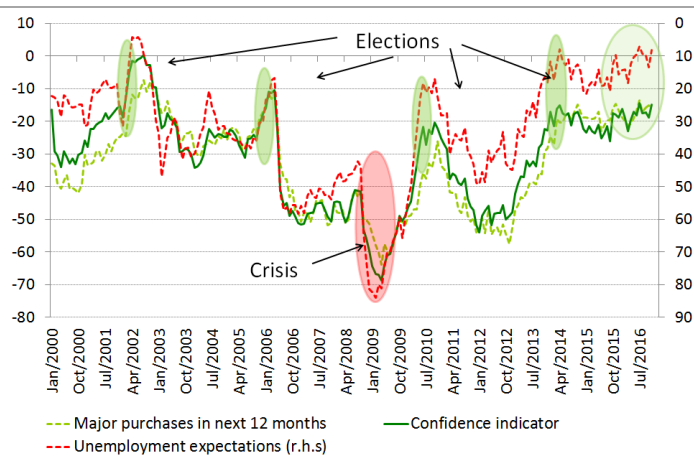
Chart 12: Vacancy rates
(quarterly, NSA)



Source: OTP Research

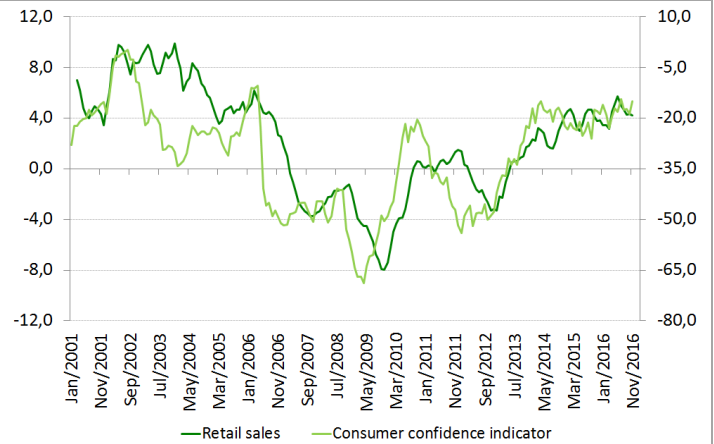
Indicators of domestic demand – Consumption

Chart 1: Consumer confidence
(monthly data, balance index)



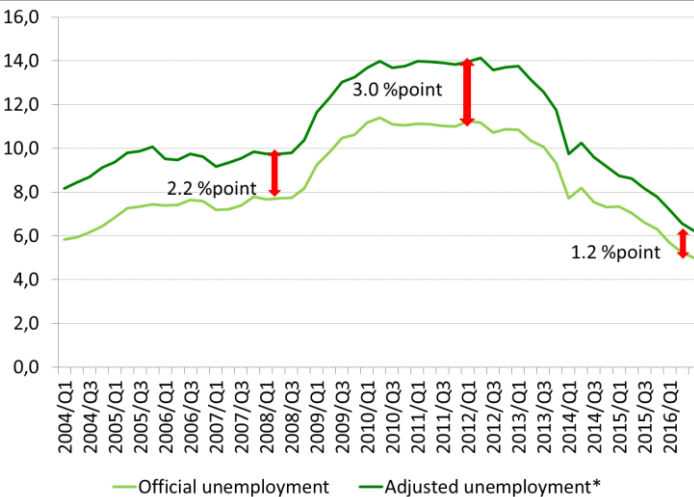
Sources: Eurostat, OTP Research

Chart 2: Consumer confidence and retail trade
(monthly data, SA, 3M MA of annual changes, % and balance indicator)



Sources: Eurostat, HCSO, OTP Research

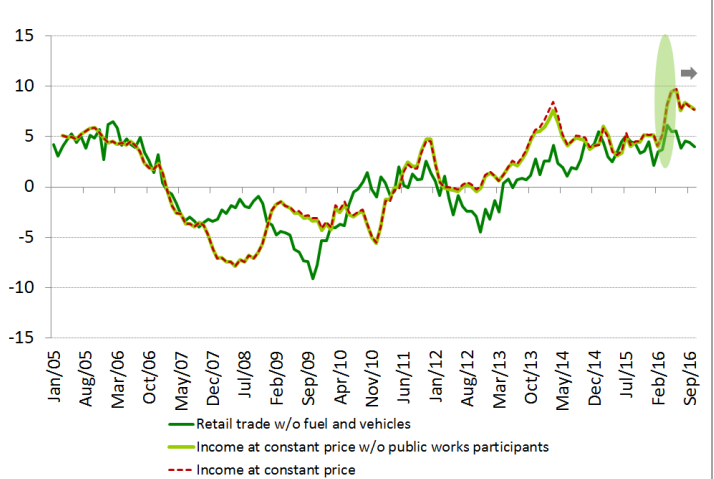
Chart 3: Measures of free labour force
(quarterly data, SA, %)



Sources: HCSO, OTP Research

*: unemployed people + people who are willing to work but think no work is available

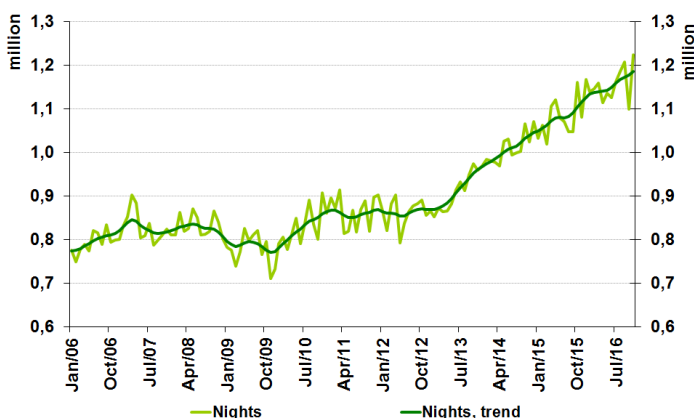
Chart 4: Income in real terms*
(monthly data, SA, annual changes, %)



Sources: HCSO, MoF, OTP Research

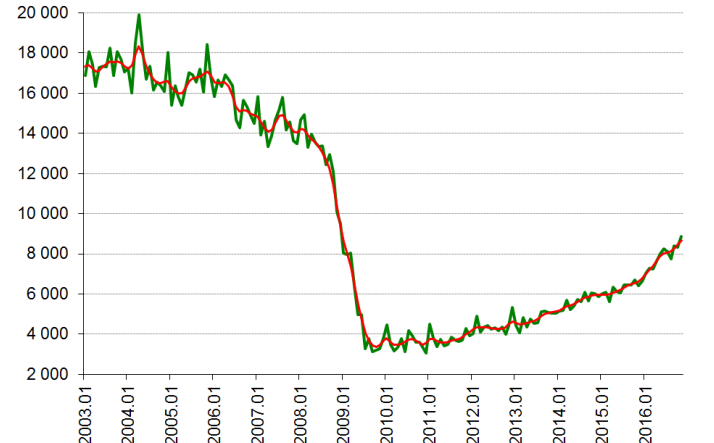
*: compensation of employees plus social transfers in cash

Chart 5: Tourist overnight stays w/o foreigners
(monthly, SA)



Sources: HCSO, OTP Research

Chart 6: New passenger vehicle registrations
(monthly, SA)



Sources: ACEA, OTP Research

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