Macroeconomic and financial background in 2018

On the basis of global economic growth in 2017, last year started on a bright note but as time has progressed, it became increasingly obvious that the previous year's success story will discontinue. The eurozone lost speed at the beginning of the year, and by the second half of 2018 it became obvious that the modest performance cannot be put down to temporary effects only. The Brexit agreement triggered fierce debates, and the conflicts of interest caused an ever widening rift between the decision-makers of the EU and of the UK Parliament. Italy formed new government, which tried to make good on its populist election promises, putting the country's fiscal sustainability at risk. Turkey sank into a currency crisis, then into a recession. The trade war with the USA has clearly slowed China's economic expansion, particularly in the fourth quarter (to 6.4% year-on-year), adversely affecting most of its trading partners. Moreover, the USA ended the year with a government shutdown, owing to the debate over the funding of the wall planned on the Mexican border.
The key central banks of the world tightened monetary conditions but their guidance became increasingly cautious as the year-end drew closer.
In 2018 the US economy may have grown by around 3% but it is likely to slow in the near future. One of the early signs may be the Q4 GDP figure, which is estimated to undershoot 3%. This is partly because the effect of the tax cut programme, which used to fuel growth, is now fading. The trade war also left its mark on the economy's performance; and its resolution is making no progress, despite the on-going negotiations. Thus the USA's import tariffs on Chinese goods worth USD 100 billion are still in place. Following the mid-term elections, Republicans retained majority in Senate, but Democrats gained the upper hand in the House of Representatives. It did not take long for the two parties to clash, over the funding of the wall planned on the Mexican border. This ultimately led to a more-than-one-month-long government shutdown. Meanwhile the Fed raised the benchmark rate four times in 2018 (to 2.25–2.5), but the post-meeting statements' language became increasingly cautious about the future schedule of tightening. In January 2019, the communication shifted markedly by pointing out that in the light of global economic and financial events, central bankers will be about unwinding the Fed's balance sheet and will be cautious in continuing the tightening cycle – this makes rate hikes in 2019 unlikely, and the balance sheet will be reduced slower than earlier planned.
Following the outstanding performance of 2.5% year-on-year growth rate in 2017, the eurozone's economy slowed to 1.8% in 2018, preliminary data suggest. Moreover, the storm clouds never stop gathering – in the form of intensifying trade war, the politics of Italy's new government, the faltering Brexit talks, the new emission rules in the auto industry, and Turkey's problems. Illustratively, the annualized quarterly growth rates of near 2.5% in 2017 sank to 1.5% in the first half of 2018, and fell below 1% in the last two quarters.
At the beginning of the year, the modest growth figures could be attributed to one-off, country-specific factors (e.g. the several-week-long railway strikes in France), it became clear in the second half of the year that the performance in year 2018 will be nowhere near the previous year's one. Based on the currently available data, the moderate performance owes a lot to the core countries, particularly Germany and Italy. Dancing on thin ice, Italy became less worrisome by the end of the year, but its new government still plans a string of fiscal loosening measures, and the resulting increase in public debt is not in sync with the EU's

requirements; moreover, investors' confidence in financing the country's debt has wobbled. Although the EU's decision-makers approved the Brexit agreement drafted in November, but the House of Commons of the UK Parliament rejected the bill several times, even though EU leaders repeatedly ruled out re-opening talks into the deal. At the end of 2018, the ECB phased out its asset purchase programme, and thus launched the second monetary tightening – but seeing the eurozone's growth data, interest rate hikes, previously supposed to take place in the second half of 2019, seem now unlikely, and the ECB will be cautious about further tightening monetary conditions.

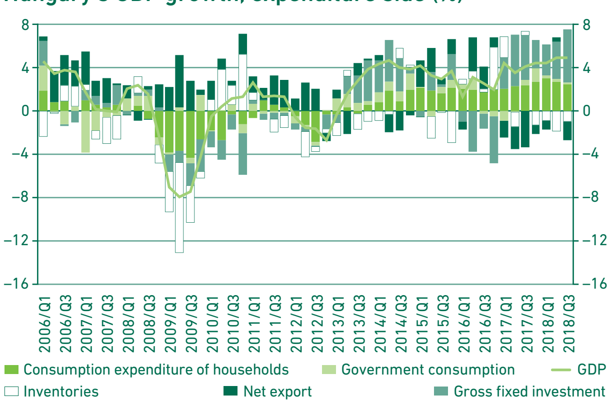
Having lost its credibility, Turkey's monetary policy could not put an end to the lira's depreciation, and the currency crisis ultimately sent inflation above 20%, halted lending, made consumption and investment plunge, causing recession in a country that struggles with massive foreign currency debts. Meanwhile Turkey's intensifying conflict with the USA made it all the more difficult for Turkey's troubled economy to weather the storms. For a while, the Turkish lira's ebbs and flows dragged emerging currencies but then this correlation gradually faded away.

Raw material prices picked up in 2018. Brent crude exceeded 85 USD/barrel, before a drop started in early October owing to increasing inventories and fears that global growth is slowing. Gold futures fell about 15% from the January peak by August, before climbing higher, to end the year trading a touch higher than at the beginning. In sync with the clear deceleration in the Chinese economy's growth pace, copper price nose-dived more than 20% by mid-year, before a small uptick in August. It fell 15% last year.

Despite the fast deterioration in the external environment, Hungary's full-year 2018 GDP growth rate surpassed expectations and our own forecast. Based on preliminary data, the 4.8% growth rate marks the second fastest one both in the history of Hungary (surpassed only in 2004) and in comparison with its regional peers (preceded by Poland only). Just like in 2017, this robust growth was largely driven by domestic demand, consumption expanded by 5%, and investment surged 17%, equally benefiting from EU-co-financed public investment projects and capacity-boosting private investment.

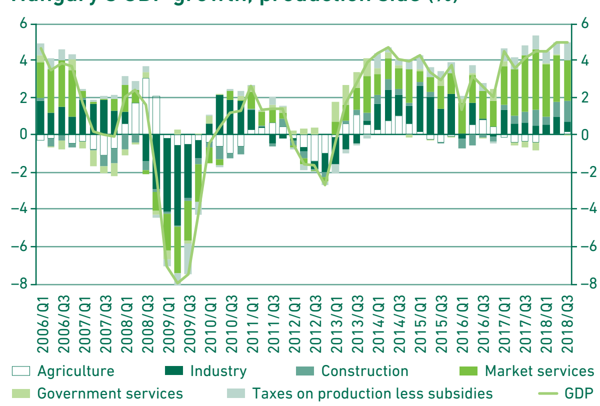
In 2019, this growth rate is likely to slow to less than 4% as domestic demand dynamics moderate. The expansion in consumption may decelerate by 1 ppt. Investment growth rate is likely to sink below the still exceptionally high 10%, mostly because EU-co-financed public investment is likely to post a modest rise in 2019, compared with the rapid growth in 2017–2018, to reach its peak in this EU budgetary period. It is the fast deterioration in the external environment that poses the biggest risk. Should the eurozone's growth significantly miss expectations, Hungary's exports may slow despite the higher export capacities.

Hungary's GDP growth, expenditure side (%)



Sources: KSH, OTP Research

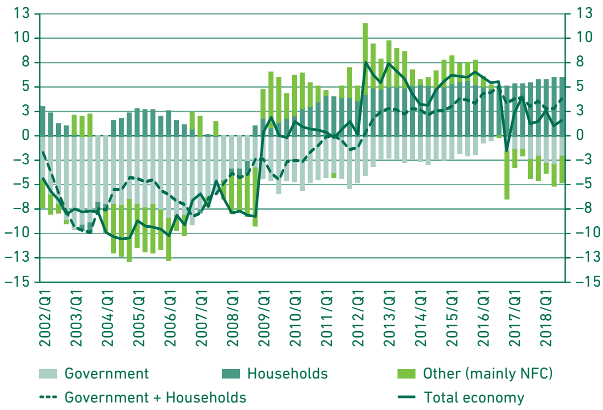
Hungary's GDP growth, production side (%)



Sources: KSH, OTP Research

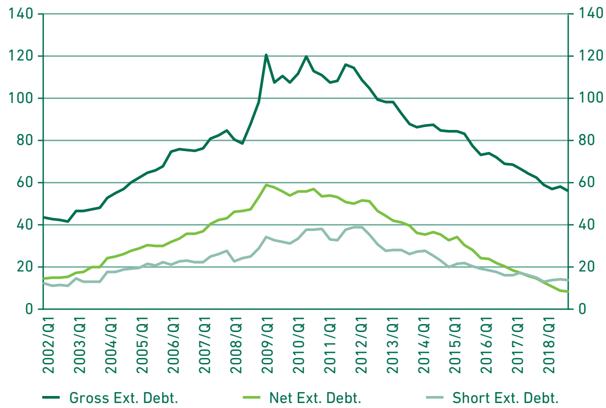
Following the peak in 2016, Hungary's current account surplus shrank further. Based on the latest figures, the surplus may have decreased to 1.3% of GDP, down from 6.3% in 2016 and 3.2% in 2017. Reasons include higher crude prices, the deterioration in Europe's business cycle, the subsiding exports owing to the new WLTP measure, the rising import need of the strong domestic demand, and foreign-owned companies' higher profits also worsen the balance of income. Nevertheless, Hungary's net financing capacity still runs surplus, its net FDI inflow is positive, and net annual debt repayment reaches 3–4% of GDP. External debt is still shrinking, but it is average-sized in regional comparison.

Net financing capacity by sectors (as % of GDP, 4Q rolling)



Sources: MNB, OTP Research

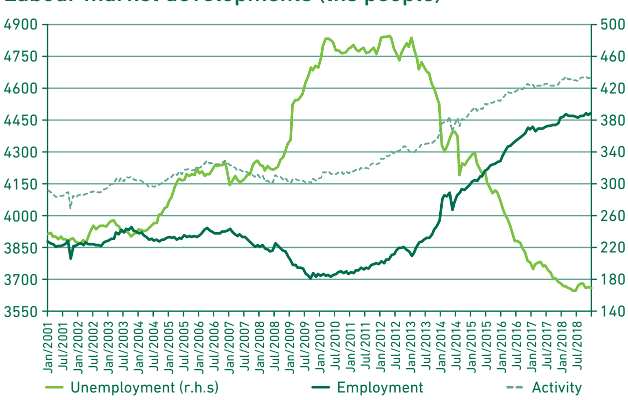
Hungary's external debt (as % of GDP)



Sources: MNB, OTP Research

In the labour market, the trend that began in 2017 continued last year. In 2018, the average number of employees amounted to 4.469 million, topping the previous year's figure by 48,000 while the number of public works scheme participants declined in the second half of the year. The 3.7% rate of unemployment was 0.4 ppts less than in 2017. The labour shortage causes capacity constraints in some segments of the labour market. The annual growth in gross wages was above 10% in the first 11 months of the year, but the accelerating inflation reduced real wages in the second half of the year, which left its mark on retail sales' growth pace as well.

Labour market developments (ths people)



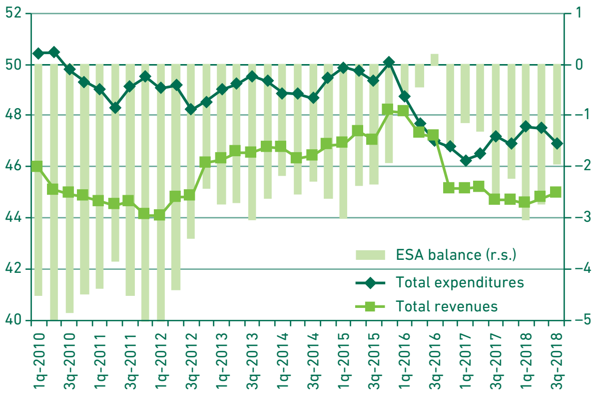
Sources: KSH, OTP Research

Unemployment rate (%)

Sources: KSH, OTP Research

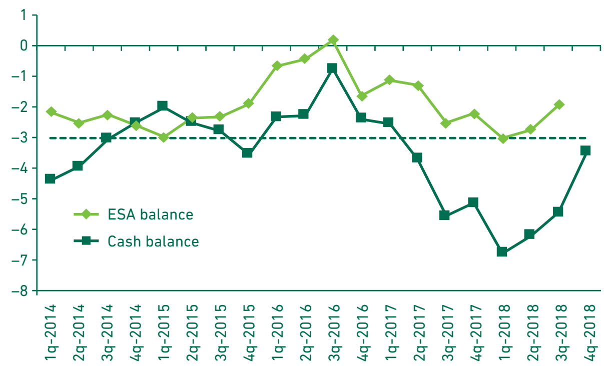
By Q3 2018, Hungary's accrual-based four-quarter government deficit fell to 1.9% of GDP. Taking into account the estimated Q4 trends, Hungary's 2018 deficit may have been at 2.2% of GDP, less than the official target of 2.4%. Nevertheless, the budget's financing position has improved, as the central budget received more than HUF 1,000 billion EU funding in the fourth quarter. Therefore, public debt may have shrunk to 71% of GDP by the end of the year, lagging behind the 73.2% target.

Budget expenditure, revenue and ESA balance (4Q rolling, as % of GDP)



Sources: KSH, NGM, OTP Research

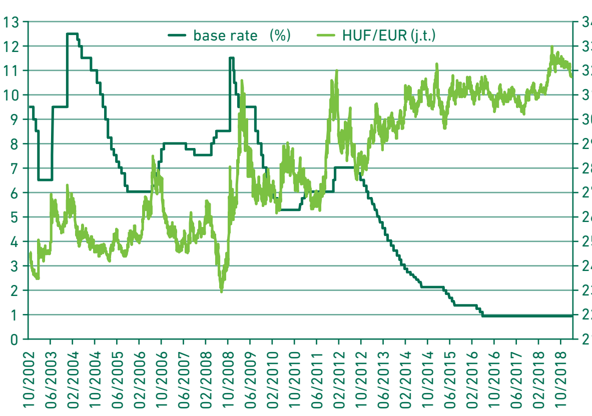
The general government's ESA balance and the central budget's cash-basis balance (4Q rolling, as % of GDP)



Sources: KSH, NGM, OTP Research

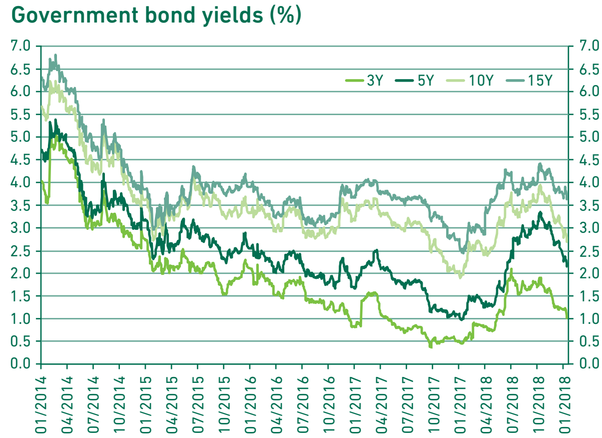
Consumer prices grew by an average of 2.8% in 2018, up from 2.5% a year earlier. Inflation was a result of opposing effects. On the one hand, the combination of robust domestic demand, the wage growth caused by the tight labour market, an increase in seasonal food prices, and a pick-up in oil prices in the second half of the year have temporarily sent the consumer price index above 3%, but then oil prices declined, second-hand-car prices fell owing to the diesel emission scandal, and the base effects in some food products all dragged inflation down.

The HUF/EUR and the base rate



Sources: Reuters, MNB, OTP Research

Government bond yields (%)



Sources: ÁKK, OTP Research

In line with the world's leading central banks, the tightening cycle began in some countries in Central and Eastern Europe (Romania and the Czech Republic). Poland left its interest rate at 1.5%, which is considered rather high in regional comparison. But the picture was quite different in Hungary; in the second half of the year the MNB's communication came with multiple changes that pointed towards tightening the extremely loose monetary conditions, yet no measures followed them. The MNB's September meeting brought some change, when the central bank announced that, by transforming monetary policy tools, the MNB was prepared for the gradual and cautious normalization of monetary policy: it abandoned 3M deposit facility and the required reserve became the benchmark tool, ended the MIRS (monetary policy interest rates swap) and the mortgage bond purchase program, but the FX-swap volume was not fully wound down. As a new tool, the Funding for Growth fixed scheme was introduced, with an aim to increase the share of fixed-interest rate loans within the SME sector. As the global environment is likely to remain volatile, we expect the CEE region's currencies to see-saw, but the depreciation pressure on the forint is likely to ease. This January the MNB gave another strong signal, which points toward the beginning of the tightening, but the unpredictability of the external environment may provide reason for putting off normalization. The MNB's most recent forecast is based on 3.5% economic growth and 2.9% consumer price index for 2019.

MACROECONOMIC AND FINANCIAL DEVELOPMENTS IN OTP BANK'S FOREIGN SUBSIDIARIES' COUNTRIES

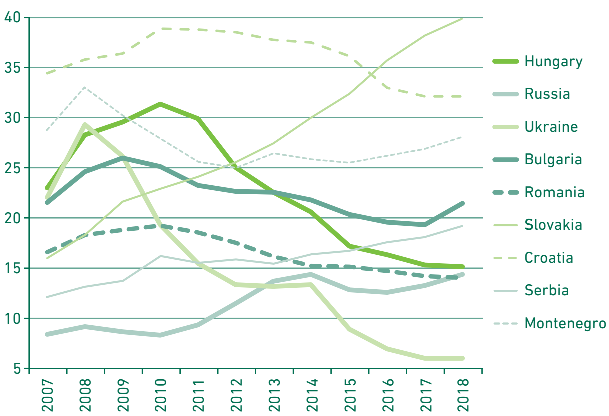
The macroeconomic picture

In 2018, the Group's countries benefited from favourable macroeconomic environment, and despite the deceleration in Europe's economy and the deterioration in global investment sentiment, growth in most of the CEE region's countries remained robust. Among the countries where OTP Group is present, Slovakia, Romania, Serbia, and Montenegro reported at least 4% growth rates, while Bulgaria, Ukraine and Croatia expanded by around 3%. Only Russia's GDP increased less than 2%.

Except for the commodity exporters, Ukraine and Russia, the OTP Group's countries are clearly in the mature phase of the economic cycle, with domestic demand being the main engine of growth. Consumption expanded by 5% in Romania, by 3–4% in Slovakia, Croatia, Serbia, and Montenegro – most of these figures equal or surpass the respective GDP growth rates. In most countries, the fast increase in consumption can be put down to the all-time low unemployment, the fast wage growth, and a pick-up in lending. Investment is also rising fast, by 4–15% in every country except Romania. Beside public investment, private investment plays an increasing role, and provides support, thanks to the capacity bottlenecks in a number of sectors, which drives businesses towards more capital-intensive production, because of tight labour market, and owing to the accelerating real property investment. The CEE region's housing and real estate markets are either in the matured phase – featuring strong demand and rapid price growth –, or in the preceding phase, recovery, which is characterized by intensifying demand, rising number of building permits and a pick-up in prices. External balances started to deteriorate as domestic demand strengthened and oil prices rose for the best part of the year. At this point, the vast majority of countries in Central and South Europe run either current account surpluses, or their deficits are offset by the surplus in the capital account and the net FDI influx, leaving no external debt sustainability issues. Fiscal positions are characterized by below – 3% deficit levels and shrinking debt rates – except for Romania and Montenegro, where the deficit reaches 3% of GDP, forcing these governments to make fiscal adjustments. These factors facilitated a rapid growth in corporate and retail demand for loans. Starting from 2019, GDP growth is expected to slow towards 3%, whereas loan volumes are likely to increase by 10% (retail), and 6% (corporate). In terms of vulnerability, Slovakia and Bulgaria seem resilient, as their favourable balance indicators and declining debt rates are coupled with a low ratio of FX loans, therefore their economic policy has the elbow-room to offset any negative external shock. In Croatia and Serbia, the favourable fiscal position partly diminishes the risks stemming from the high level of public debt and foreign currency loans, but these economies may be more susceptible than the previous group to any negative external shock. Romania's overheated economy and Montenegro's particularly high debt indicators may make these countries particularly exposed to adverse changes in the external environment.

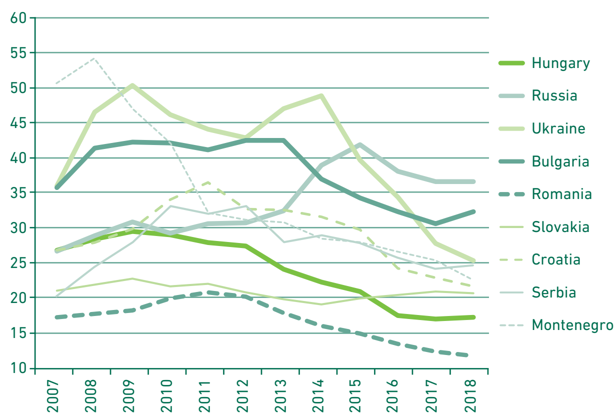
The economies of Russia and Ukraine remained in the recovery phase that followed the crisis years of 2014–2016. Ukraine is a bit further ahead in the cycle – in 2018, for the first time since 2011, its GDP growth rate exceeded 3%, and the attributes of mature growth have appeared: both consumption and investment grew rapidly. Nevertheless, the refinancing risk of maturing debt remained high in Ukraine, particularly in the current global capital market situation when risk appetite is subsiding; that is why continuing the IMF programme remains imperative. Although the average oil price level was higher in 2018 than in 2017, Russia's economic growth was the slowest one in the OTP Group in 2018. The modest rise can be put down to (1) the economic sanctions on Russia, which hinder trade, make financing more expensive, and weigh on willingness to invest, and (2) the existing ultra-tight economic policy, which noticeably decelerates the economy. By not spending the extra revenue from the higher oil prices, the budget runs a surplus now. Meanwhile the central bank keeps real interest rate level high, to reach its inflation target. At the beginning of 2018 inflation hit its low at 2.2%, then it picked up. Later inflation outlook deteriorated further when a VAT rate hike was announced and as the sanctions weakened the rouble. Simultaneously, the previous cautious rate cutting cycle came to an end in the first half of 2018, and the central bank even raised the benchmark rate in two steps, to 7.75% by the end of the year. The tight economic policy reduces the country's vulnerability as well as its economic growth.

The banking system's retail loans (end of the year, as % of GDP)



Sources: National banks, OTP Research, 2018 forecast

The banking system's NFC loans (end of the year, as % of GDP)



Sources: National banks, OTP Research, 2018 forecast