Macroeconomic and financial environment in 2017

MACROECONOMIC AND FINANCIAL DEVELOPMENTS IN HUNGARY

In 2017 macroeconomic processes were favourable in the developed world. Economic growth in the USA and in the eurozone topped expectations. Fears surrounding China's slowing economy have not come true, and Brexit negotiations have not caused difficulties. Commodity prices picked up, with the Brent crude oil crawling above 60 USD/barrel, even though oil exporter countries' output freeze agreement is precarious. Seeing the positive growth prospects, the major central banks of the world are set to gradually tighten their loose monetary policies.

Over the past quarters, the US economy fared well. Even though markets had expected America's growth to decelerate, even the forecasts of 2.6% year/year (2018) and to 2.2% year/year (2019) have shifted higher by now. In the first estimate, America's economy may have expanded by 2.3% (year/year) in full-year 2017. It took one year for Donald Trump to deliver on one of his key election promises, and pass the tax reform, which clearly benefits high-income earners. Meanwhile the Fed raised interest rates by 25 basis points (to 1.25–1.5) three times in 2017, continuing similar moves in December 2015 and December 2016. The minutes of the December FOMC meeting reveal that the Fed's decision-makers plan two to four hikes in 2018, while the market expects two to three increases.

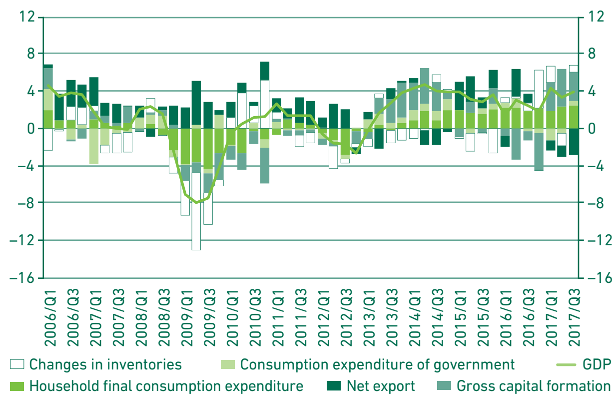
In 2017 was clearly back on the map of growth, with recovery gaining momentum as a result of previously launched reforms, the end of fiscal tightening, but predominantly because of the improving labour market. In 2017 the eurozone's GDP grew by 2.5%, based on the preliminary data, topping by a large margin analysts' forecasts, which had estimated only 1.3–1.5% a year ago. With employment hitting all-time peak, consumer confidence and business sentiment went to its highest on record or ten-year highs, domestic demand picked up, helping Europe's economy leave the early stage of recovery and enter the phase of matured, broad-based growth, which can pave the way for lasting robust growth if external conditions remain favourable. In the years ahead, monetary policy will support economic growth, because despite the good prospects, the ECB is likely to be rather cautious about normalizing monetary conditions. The ECB extended its quantitative easing programme by additional nine months, until September 2018, reducing its purchases from EUR 60 billion to EUR 30 billion a month, and is not expected to lift interest rates before 2019.

Hungary's full-year 2017 GDP growth surpassed all expectations, including our forecast. The 4% reading signifies the second strongest growth since 2005 (it was 4.2% in 2014). But this is not outstanding in regional comparison: Romania sky-rocketed 6.9%, Poland surged 4.6%, and the Czech Republic expanded by 4.5%. The key driver of this robust growth remained private consumption, which was coupled with a marked rise in private investment in 2017. The latter can be attributed to the rapid improvement in the real estate sector, as well as the technology developments

necessitated by the capacity constraints in commercial and industrial real estates. Starting from the second half of 2017, agreements linked to EU-funded projects resumed, giving a big boost to investment activity (in addition to the low base in 2016): its value added last year may have jumped by more than 20%, while the final consumption of households may have increased by about 4.5%. Nevertheless, economic actors have become more cautious about manufacturing investments. Therefore, the stronger external demand caused by the more-robust-than-earlier-though upswing in the eurozone (with 2.5% economic growth versus the 1.5% forecast at the beginning of the year) did not lead to an impressive jump in industrial production or in the volume of exports. On balance, the private sector, excluding agriculture, had a very strong year, growing by more than 6% year/year in the second half of 2017.

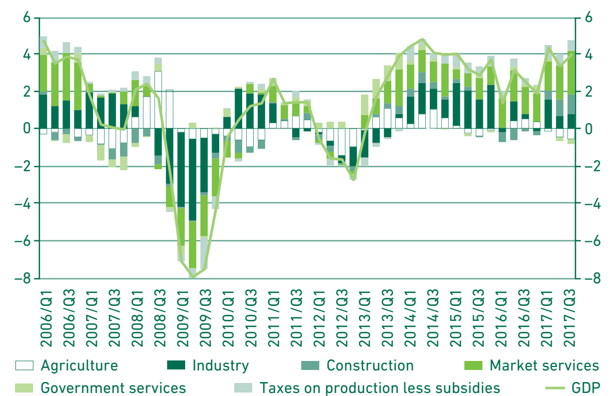
In 2018, the structure of growth is likely to undergo a small change but its rate may be near 4% again. Investment growth may decelerate to about 10%, but most of this slowing will be compensated by the better contribution of net exports to growth due to the drop in import demand. Because of the cut in VAT and employers' social security contributions, inflation is likely to remain below the MNB's 3% target (our forecast for 2017 is 2%) this year again. This, coupled with the strong wage growth stemming from the tight labour market, may accelerate the growth in households' consumption. Lending may be expanding noticeably for the second year in a row. The most important short-term risk is that projects may need to be cancelled because of capacity bottlenecks. In the long run, price-setting should be increasingly monitored, and attention should be paid to the risks of the deterioration in the external balance position, which started simultaneously with a pick-up in domestic demand.

Hungary's GDP growth, expenditure side breakdown (%)



Sources: HCSO, OTP Research

Hungary's GDP growth, production side breakdown (%)



Sources: HCSO, OTP Research

Hungary's Q3 current account surplus amounted to EUR 0.8 billion, which is EUR 1.2 bn less than a year earlier. Thus the surplus remains substantial, even though it has been shrinking since the peak it reached in 2016, owing to the expanding imports, stemming from the resuming consumption and private investments. In the following years, the surplus is likely to contract further, but it is important to highlight that the gross external debt of Hungary's economy has fallen to the average level of other countries in Central and Eastern Europe, from a level that twice exceeded the regional average, which was the main reason for the vulnerability of the Hungarian economy.

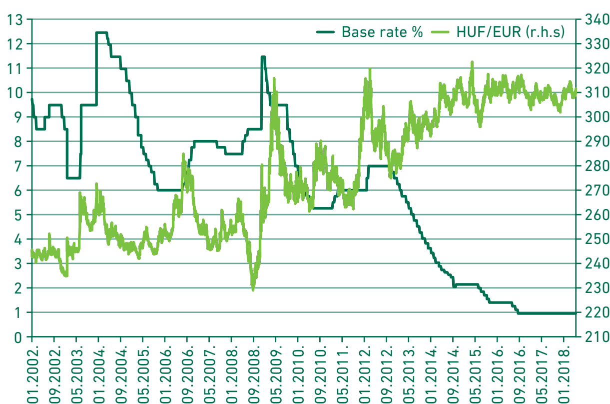
Hungary's labour market strongly improved in 2017. The unemployment rate gradually sank to 4.4%, simultaneously with the decline in the number of public employment programme participants. The growing employment and the drastically falling labour reserve led to more than 12% annual wage growth. Most of this is the result of the statutory increase in minimum wages by 15% and by 25% for skilled workers, as well as the wage

adjustments in selected fields of the public sector and in state-owned companies. Because of the shortage in workforce, some segments of the labour market have reached their capacity constraints.

Hungary's public deficit stood near 2% of GDP in 2017 (ESA concept), the Minister for National Economy informed. The MNB's preliminary financial accounts signified 1.9% financing requirement. Hungary's government debt contracted to 74% of GDP (from 76% in 2016), including Eximbank's debts. Hungary's fiscal position remained stable. The strong economic performance boosted tax revenues, despite tax cuts. The inflow of EU funds tripled in year/year comparison (on accrual basis) in the first three quarters of 2017. What represents upside risk to the deficit and the debt trajectories is that the wage pressure stemming from the tight labour market conditions are also perceptible in the public sphere, capacity bottlenecks add to construction costs, and the existing disputes with the EU make funding from the Structural and Cohesion Fund fragile. Taking into account these risks, Hungary's fiscal policy may remain conservative, while the loose monetary policy helps keeping financing costs at low levels.

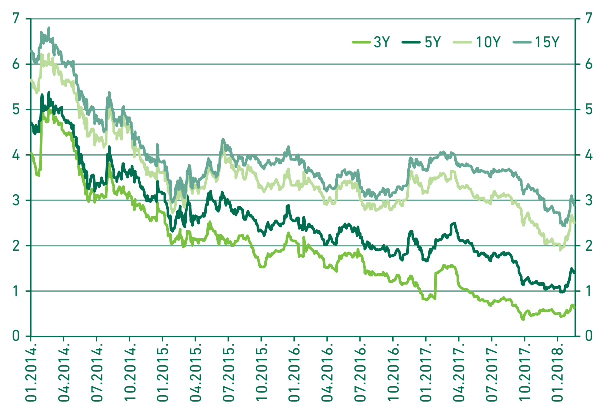
Following two years of deflation, consumer prices picked up by an average of 0.4% in full year 2016, but signs of further acceleration appeared in the last four months of the year, mostly because of the inflation in market services and the stronger-than-expected upswing in fuel prices. This trend continued in 2017, when annual average inflation accelerated to 2.4%, as a result of a fall after reaching near-3% levels at the beginning of the year and topping out in August (chiefly owing to the base effect of fuel prices). The acceleration of the rise in inflation exhausted at the end of the year, due to the lower prices of market services (mostly telecommunications fees), processed food and second-hand cars within the durable goods group. Inflation is likely to remain below the central bank's 3% target in 2018, as agriculture will probably produce better harvest this year, thus slowing the rise in food prices. In addition, the one-off effects (milk, tobacco) that raised core inflation in 2017, dropped out of the consumer price index in 2018. It is also assumed that a substantial reduction in employers' social security contribution in 2017 and 2018, as well as productivity improvement will counterbalance the negative effect of wages' growth on companies' profitability. That said, services' inflation is further fuelled by the increases in minimum wages, and the tightening labour market. We expect 'trend inflation' (inflation without the effect of government measures, but including market services and manufactured goods) to reach 3% by 2019, but other components of the consumer price index may keep the index below the MNB's target.

HUF/EUR and base rate



Sources: Reuters, MNB, OTP Research

Government bond yields (%)



Sources: ÁKK, OTP Research

Unlike the world's leading central banks and those of the CEE region, the MNB further eased its monetary policy in the last third of 2007, after the forint's appreciation pushed the EUR/HUF to 302 in August, and the rise in consumer prices remained below the central bank's target. While keeping the base rate at 0.9%, the MNB capped the amount of 3M deposits accepted from banks at HUF 75 billion, which boosted the excess liquidity of the banking system, reduced short-term yields, and it caused a modest HUF depreciation. In a further measure to ease monetary policy, the 5Y and 10Y interest rate swaps (IRS) were implemented, with an amount of HUF 300 billion for the first quarter of 2018, made available to banks at regular tenders starting from January 2018. Furthermore, the MNB launches a targeted programme to buy mortgage bonds with 3Y or longer maturities. In October, the MNB's Benchmark Quotation Committee decided to expand the obligatory BUBOR quotation to include the 6M instruments, in addition to the 1M and 3M ones, starting from January 2018. The EUR/HUF rate at the end of the year was consistent with achieving the debt target at the end of 2017, annual average inflation stood at 2.4% in 2017, short-term yields dropped to nearly 0%, and long-term yields also fell meaningfully by the end of the year – thus the MNB was no longer forced to act at its December 2017 meeting. Interest rate conditions were left unchanged in January 2018, but the Monetary Council's post-meeting statement caused a small surprise by indicating that Hungarian central bankers would focus on the relative position of domestic long-term yields relative to international yields, when evaluating monetary policy instruments. The market assessed the announcement as the softening of the central bank's stance regarding long-term yields, and that it no longer insists on keeping the long end of the curve at low levels. Still, in the auction on 1 February (in the second interest rates swap auction with the instruments announced in November) interest rates swaps were sold with the same interest rates as in the previous auction, but with different amount, even though long-term yields have materially risen since the previous IRS auction – both at the auction and on the secondary market. We expect the loose monetary conditions and the near-0% short-term yields remain for long, but the long end of the yield curve may follow he major international benchmarks. The MNB's year-end Inflation Report revised its 2017 and 2018 growth forecasts trivially higher (to 3.9%), while keeping its 2018 CPI projection at 2.5%.

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

The economic performance of the countries where OTP Bank's subsidiaries operate was basically favourable in 2017. Central and Eastern Europe maintained robust growth; Serbia was the only one on the Balkans to miss expectations, owing to an unfavourable agricultural season. Commodity exporting countries continued their recovery from the recession caused by the collapse of commodity prices in 2014–2015. Favourably for banks, the growth in private investment and consumption, which started in 2016, went on in Central and Eastern Europe, triggering an expansion in loan volumes. Lending in commodity exporting countries recovered, but a real upswing is yet to come. The intensifying lending activity is barely reflected by banking penetration.

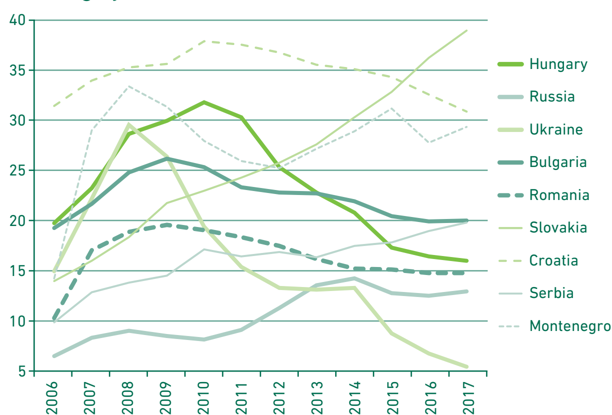
Central and Eastern Europe's economic performance remained outstanding. The available data confirm the view that growth has reached its maturity phase; its structure is balanced across the region. Preliminary figures indicate that Romania surged by nearly 7%, Slovakia soared 3.4%, and Bulgaria expanded by 3.8% last year. Hungary's GDP growth accelerated to 4%, up from a temporary slowing to 2% in in 2016. Across the CEE region, domestic demand (household consumption, and the resuming investment) clearly became the engine of growth, which will be firmly supported by the rising employment, the

robust growth in wages, and the revival of the loan market. No meaningful risks seem to surround sustainability, as the budget deficit is mostly low, government debt is on a declining trajectory, and external debt is steadily shrinking. This paves the way for 3% growth in the CEE region. There are no visible risks to growth in the next few years.

The growth prospects of the Balkans have also improved, but the higher debt ratios indicate bigger vulnerabilities. Ending six consecutive years of recession, Croatia's economy returned to growth in 2015, and it is likely to have expanded by around 3% in 2017. Public debt stopped rising, the budget is balanced, the current account has been running surplus since 2013, and external debt has noticeably reduced over the recent years. Serbia, which overcame the crisis in 2015–2016, is clearly one of the best pupils in the CEE region. Its growth has started, the balance trajectory is sustainable, the government is committed to reforms and accessing the European Union. In 2016, its GDP grew by 2.8%, which temporarily slowed to less than 2% this year, owing to the bad harvest, but starting from 2018, growth may be nearing 3%, as fundamental processes remained favourable. Fiscal and external balances are sustainable, but debt indicators remained high. Montenegro's situation remained ambiguous: its growth has considerably surpassed analysts' expectations, as tourism posted its best season ever, but its budget and external deficits remained high, and its public-debt-to-GDP ratio has increased, owing to the motorway constructions financed from Chinese loan. The fiscal adjustment announced in 2017 did not materialize, and if fiscal conditions are tightened as promised this year, that will add to the country's vulnerability.

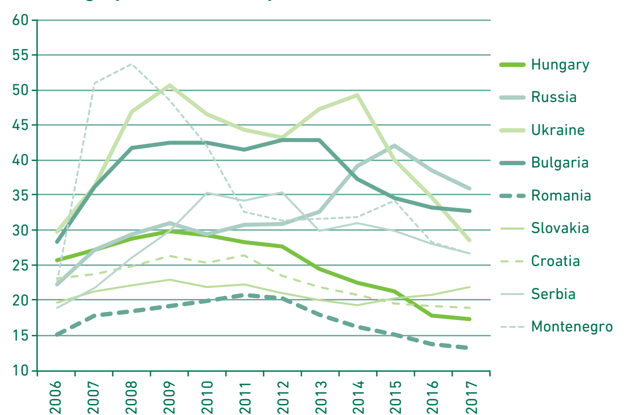
In commodity exporting countries, Russia and Ukraine, recovery started from the second half of 2016, ending two years of recession. GDP growth resumed, consumption is expanding, and real wages are rising. Lending activity has started, but a real upswing would take one or two years. Growth may be impeded by subdued commodity prices, as well as the economic consequences of the geopolitical conflict between Russia and Ukraine.

Banking system retail loans (EOY, % of GDP)



Sources: National banks, OTP Research, 2017 forecast

Banking system NFC corporate loans (EOY, % of GDP)



Sources: National banks, OTP Research, 2017 forecast