Macroeconomic and financial environment in 2016

MACROECONOMIC AND FINANCIAL DEVELOPMENTS IN HUNGARY

In 2016 macroeconomic developments were shaped by a still fragile global growth, intensifying fears surrounding China's slowing economy, concerns about the Brexit referendum, and the political uncertainty caused by the US presidential election, as well as the associated persistence of ultra-loose monetary policies. Another important factor was the continued slump in commodity prices that started in 2014 – even though they started to pick up in spring 2016, global crude prices could not go beyond USD 50, thus some OPEC and non-OPEC oil exporter countries struck a deal in December to freeze output at fixed levels.

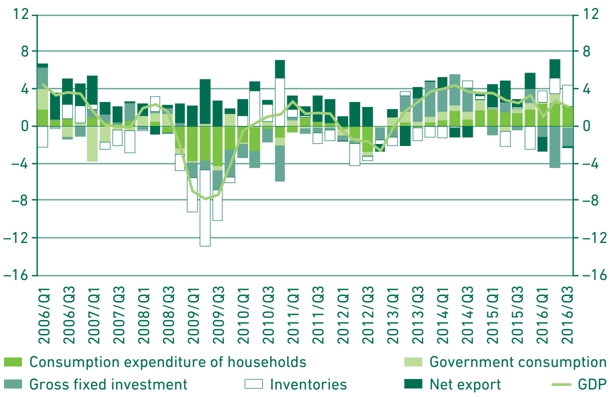
The USA's economic performance was fairly good in comparison with other developed economies, even though the increase in its GDP and productivity in recent years missed expectations. The first half-year of 2016 did not start well: growth was subdued, and the Fed did not touch interest rates for a whole year after the rate hike in December 2015, because of China's deceleration and the slow rise in wage inflation. But unemployment shrank further and long-term yields rose meaningfully. In response, the Fed raised interest rates in December again by 25 basis points, to 0.5–0.75%. Despite the expected two-to-four increases per year, the nominal level of short-term interest rates may for years lag behind inflation, which is likely to exceed 2% and accelerate further from the beginning of 2017. The infrastructure investments and the tax cuts outlined in the new president's economic programme may further accelerate growth, wage dynamics, and inflation.

Even though some core countries performed somewhat better than expected, the whole eurozone's growth (1.7% year/year) was sluggish. In a number of countries, chiefly in the periphery, massive government debt and the fragile banking system continue to pose problems. Because of the high unemployment, the strong price competition caused by the unused capacities in the real economy, and the low commodity prices, inflation was short of the ECB's target. As a result, the ECB further eased its monetary conditions in spring 2016, and it extended its asset purchase programme at its December meeting until end-2017, although its size will shrink from EUR 80 bn to 60 bn from April 2017.

Matching our expectations, Hungary's economic growth temporarily slowed to 2% in 2016 owing to a fall in EU funding, and a lacklustre industrial production. The amount of EU-fund-related budgetary payments shrank by 2% of GDP in 2016, to 2,100 billion, down from HUF 2,800 billion a year earlier. (The reason for this temporary drop is that from 2016 on, funds from the former 2007–2013 budgetary cycle were no longer available, only from the 2014–2020 budget). Moreover, the government paid nearly half of this amount in December, therefore its economy-boosting effect will be felt in 2017 only. On the whole, the lower governmental payment lowered last year's growth by nearly two percentage points, and the excellent agricultural performance could offset only half of that.

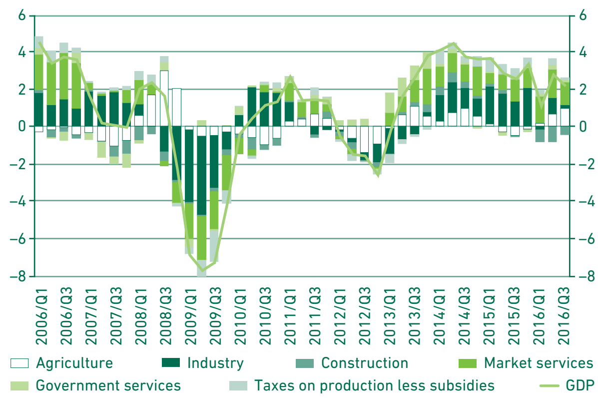
Growth without one-off items remained robust. The Hungarian economy, which had entered the mature phase of growth, saw its consumption vigorously growing (by almost 5%), thus becoming the engine of growth instead of exports and EU-co-financed investments. The sustainable and persistent growth in consumption was supported by the rise in real wages, the decreasing unemployment rate, the substantial growth in savings during the crisis years, as well as the substantially falling debt volumes.

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



Sources: HCSO, OTP Research

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



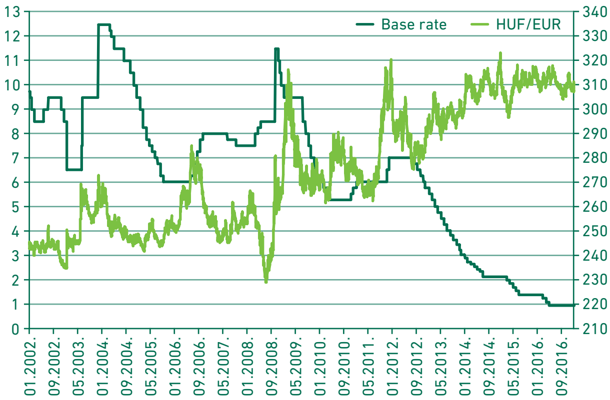
Sources: HCSO, OTP Research

Although investments contracted by 10%, this is because of EU-co-funded public or government-related investments, which masks the fact that industries that are based on domestic demand – mainly market services and real property sector – show some signs of pick-up. The anticipated turnaround on the real estate market has happened. Because of the rising prices and the government's measures to boost the housing market – through VAT cut and housing subsidy for families ('CSOK') –, the number of building permit claims grew sharply, implying that as many as 20,000 homes may be built in 2017; now the narrow construction capacities may be the bottlenecks. In this context, both companies and households have borrowed more than they have repaid, for the first time since the financial crisis.

There was a strong improvement on the labour market last year. Unemployment steadily fell, thanks to the rise in the private sector's demand for labour, to an increase in the number of public work participants, and expatriation. Wages grew strongly (by around 4%), slightly accelerating at the end of the year. It seems that some segments of the labour market may face capacity limits.

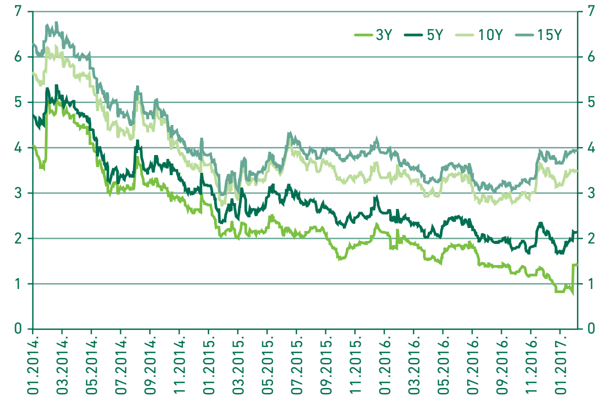
Consumer prices grew by an average of 0.4% in 2016. In the last four months of the year, inflation exceeded our expectations, due to the accelerating inflation of market services and the steeper-than-estimated rise in fuel prices (excise duty grew in Q4, as did crude oil prices on global markets, and the forint weakened against the US dollar). Meanwhile, the excise duty hike in September did not filter into tobacco prices until the end of 2016, posing some upside risks to the future of CPI. At the beginning of 2017 inflation may grow faster than had been thought. The disinflationary effect of food prices will also decrease. Services inflation, which has been accelerating, will be further spurred by the increase in minimum wages and guaranteed minimum wages for skilled workers, as well as the narrowing of the labour market.

HUF/EUR and the MNB's base rate



Sources: Reuters, MNB, OTP Research

Government bond yields (%)



Sources: ÁKK, OTP Research

While keeping the base rate at 0.9%, the MNB steadily decreased the cap on 3M central bank deposits. As a result, the banking system's excess liquidity has grown, short-term yields have come down, and the HUF slightly depreciated. So far, the MNB's measures have achieved their goals, because the 3M BUBOR interest rate and the 3M government bond yield has fallen meaningfully since the cap's introduction. In early December the forint's depreciation took the EUR/HUF to 315, but it opened on a stronger note in January. Continuing the December increase, the 10Y government bond yield rose slightly at the beginning of January.

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

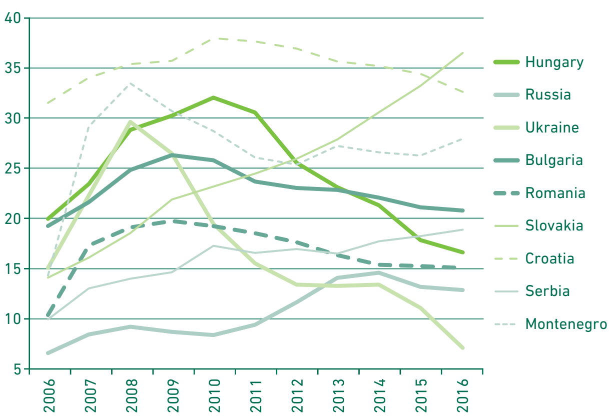
The economic performance of most countries where OTP has subsidiaries has improved since 2015. Central and Eastern Europe maintained its robust growth; in the Balkans countries, except Montenegro, growth increased and fiscal position stabilized; while commodity exporting countries seem to be recovering from the recession caused by the collapse of commodity prices in 2014–2015: the contraction of the Russian economy slowed to 0.2%, and Ukraine's economy even expanded. In a favourable development for banks, household consumption growth has accelerated in all countries but Bulgaria (in Russia from –9.8% to –5%), and investment activity was on the rise in most countries. However, only part of that has been reflected in banking penetration so far.

Central and Eastern Europe kept up its excellent performance. Economic growth may have been near 5% in Romania, 3.7% in Slovakia, and 3.4% in Bulgaria. Hungary's GDP growth slowed to 2%, but that was fundamentally due to a temporary fall in EU funds. In the CEE region, households' consumption remained the engine of upturn, which will remain a robust and stable source of growth in the future, as unemployment is decreasing, wages are rising, and savings rates are high. There is no problem with sustainability, not even in Romania, which has the least robust balanced position and where budget deficit is climbing towards 4% of GDP based on the measures announced so far; both sovereign and external debts are declining. On the basis of the above, the region's growth is expected to remain at 3% in the coming years.

The background in most countries of the Balkans also improved. Recovering from six consecutive years of recession, Croatia's economic growth speeded up to nearly 3% and it is forecast to expand by 2–3% annually in the years to come. Its balance indicators have become favourable, the country posted current account surplus, while its budget deficit dropped to near 2% of GDP, its public debt is on a slightly declining path, and the country's financing conditions have improved a lot. A major engine in its sturdy growth in 2016 was the record strong tourism season; it will be difficult to repeat this degree of improvement, but the tax cuts in 2017 and the accelerating EU fund absorption may give an impetus to domestic demand. Serbia's balance indicators have also improved, and its growth speeded up. Only Montenegro's environment is unclear: its economic expansion slowed, while the budget deficit and external imbalance remained high, and so are its debt indicators.

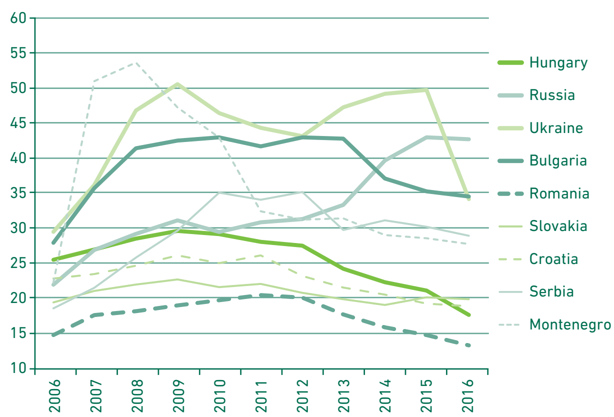
In commodity producing countries, Ukraine grew by nearly 1% in 2016, recovering from almost 10% recession in 2015; its 2016 Q4 growth exceeded 4%. Despite the uncertainty caused by the war situation and the implementation risk of the IMF programme, domestic demand could expand, while balance indicators did not deteriorate. Russia is also likely to have ended economic contraction, and as the effect of rouble weakening is coming to an end, inflation fell below 5% by early 2017. Yet the central bank remains cautious in cutting interest rates; this points towards rouble firming and goes slightly against growth. The rebound in crude prices is clearly positive for the whole of the economy; the country's budget may return towards equilibrium in two or three years.

The banking system's retail loans (EOY, % of GDP)



Sources: National banks, OTP Research, 2016 forecast

The banking system's NFC loans (EOY, % of GDP)



Sources: National banks, OTP Research, 2016 forecast