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HELPING YOU PLAN FOR A CHANGING GLOBAL ECONOMY.

We aim to deliver state-of-the-art macroeconomic research to improve the performance of businesses.

Hungary

Business cycle update: prices and exchange rate

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Country Monitoring, July 2018

MONETARY POLICY AND FORINT OUTLOOK

The MPC statement from the July meeting did not signal any change in the monetary stance and reinforced the message of the last few months highlighting that the sole target of the Council is price stability.

Inflation is currently at the central bank's target and is likely to remain there under current conditions, but in our view the risk is biased towards a higher inflation rate next year.

Hungary is the only EU country we monitor that shows no signs of economic slowdown yet. Although it is not immune to external conditions, domestic demand is likely to stay strong even with exports moderating going forward and thus the acute shortage of labour will remain in place in coming years in our view. With strong domestic demand and strong tourism usually comes a growing inflationary pressure on food inflation, which is an important driver of overall inflation. Crude prices globally may end up rising abruptly further as the world economy is decelerating, but not rapidly, while capacity is tight.

We expect the central bank to very slowly unwind its various policy tools supporting growth and to raise the policy rate by 100bp in the second half of next year (possibly earlier depending on global conditions). Even with such increase in the policy rate (from 0.90% to 1.90% and in equal amount to the deposit rate), real borrowing costs would remain very low in Hungary and thus must likely will face further upward pressure going into 2020.

The forint has recently stabilised around 325 to the euro. In our view the recent recovery is partially due to some improvement in financial markets' confidence and expectations of a tighter monetary stance going forward. In our view, there is an emerging trend of accelerating capital outflows due to bigger earning repatriation and external debt repayments to foreign companies. This trend in our view is set to continue in the coming year and thus poses a risk in favour of greater depreciation. Our central scenario is for forint on average at 330 to the euro in 2018/19, but with a growing risk of gravitating towards 340-350 to the euro in the coming two years.

INFLATION OUTLOOK.

Headline inflation has been trending between 1.9% yoy and 2.1% yoy in the first quarter of the year, accelerating to 2.8% yoy in May and rising again to 3.1% yoy in June. The recent key inflation pressure is due to fuel costs and transport prices generally, adding 0.8p.p. to the yearly change in inflation, while food inflation is brisk but steady and other items show a steady contribution of 1.2p.p to CPI.

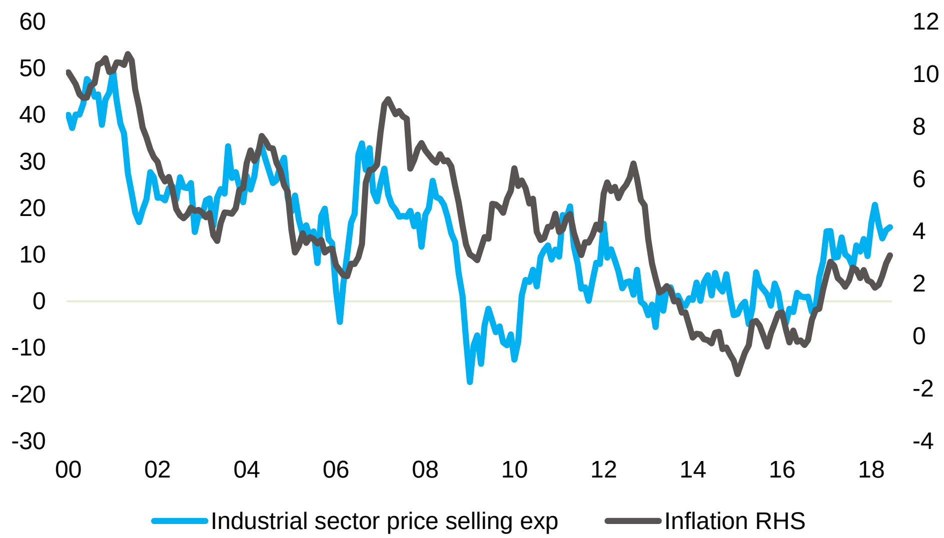
Our model has overestimated actual inflation on average by 0.5p.p., except in June when the inflation reading jumped by more than expected. Surveys on inflation expectations show that price expectations are rising among businesses and households, but in historical content both are still below what seen in the previous before 2012, especially for households.

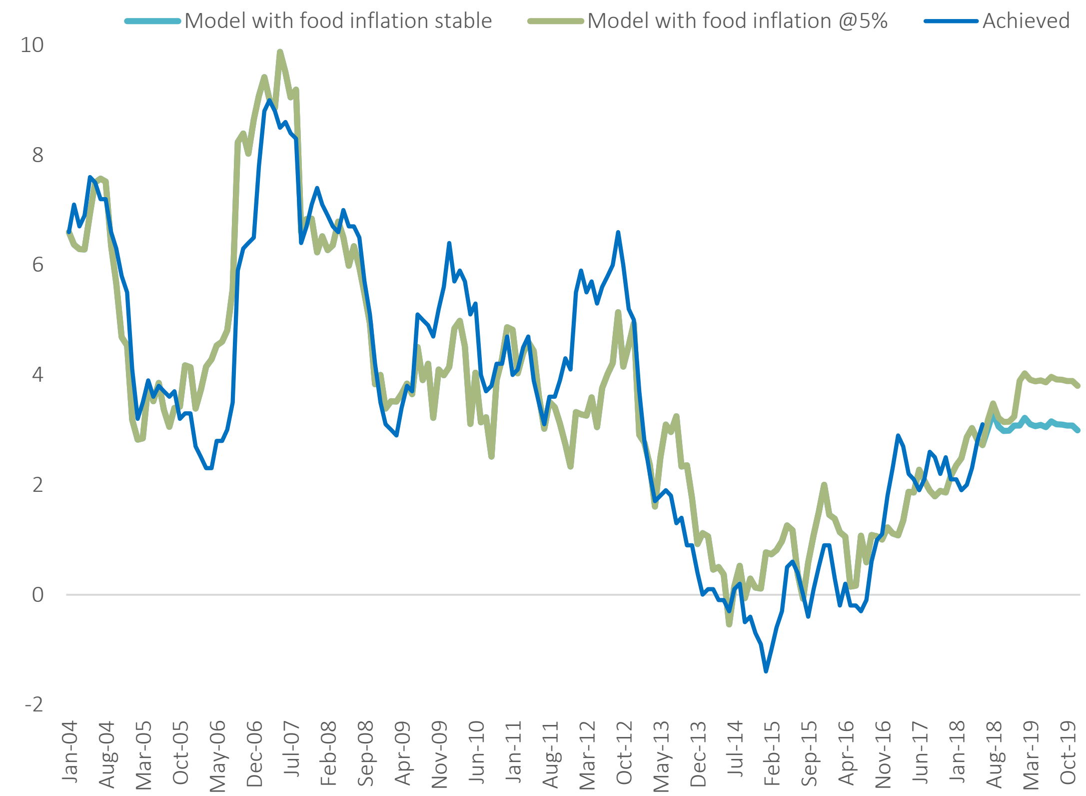
Going forward, our model suggests that under the assumption of a stable currency of 330 forints to the euro, wage growth of 13% and food and fuel inflation at 3.5-4% then inflation is projected to stabilise close to 3% going forward until the end of 2019.

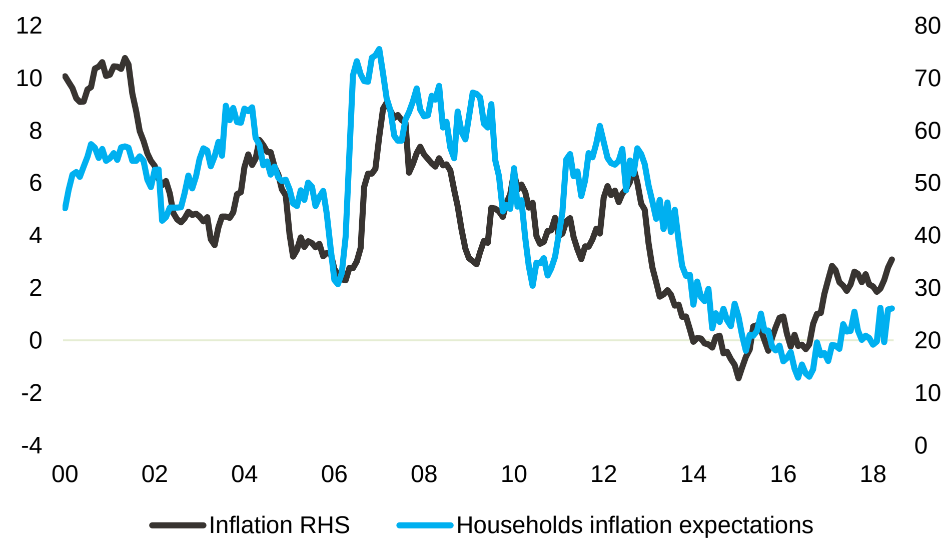
We do underscore that although Hungary price dynamics have probably benefited from intensifying domestic competition in recent years and lower inflation expectations, as economic activity remains strong and the shortage of labour is very high, there is a medium-high risk that inflation will exceed our projection projections and accelerate to 4% next year. Inflation at 4% on average next year would appear plausible for example if food inflation rises to 5% next year from 3.5% yoy currently, consistent with continuing strong domestic and tourism activity.

Parliament has recently approved the 2019 Budget draft, which plans a consolidation of the budget deficit to 1.8% of GDP, from 2.4% of GDP this year. The government will reduce further social security contributions by 2p.p., which will partially offset the high wage pressures. Our forecasts do not yet fully reflect the details of the upcoming budget, but at this stage we don’t anticipate a material impact on our inflation forecasts.

INFLATION OUTLOOK: USEFUL CHARTS.







The charts to the left show the trend in the indices representing households and industrial companies inflation expectations 12 months ahead.

The chart above shows achieved inflation and our model projections under the two scenarios described in page 2.

Sources: CEIC, Macrobond, ADA ECONOMICS LTD

MONETARY POLICY COUNCIL STRUCTURE AND RECENT COMMENTS.

Monetary Policy Committee consists of 9 members. The Committee is chaired by the Governor, 3 Deputy Governors and 5 other members. The Prime Minister makes a proposal for the Governor and Deputy Governors for a term of six years to the President of the Republic. The other five members are elected by the Parliament for a term of six years.

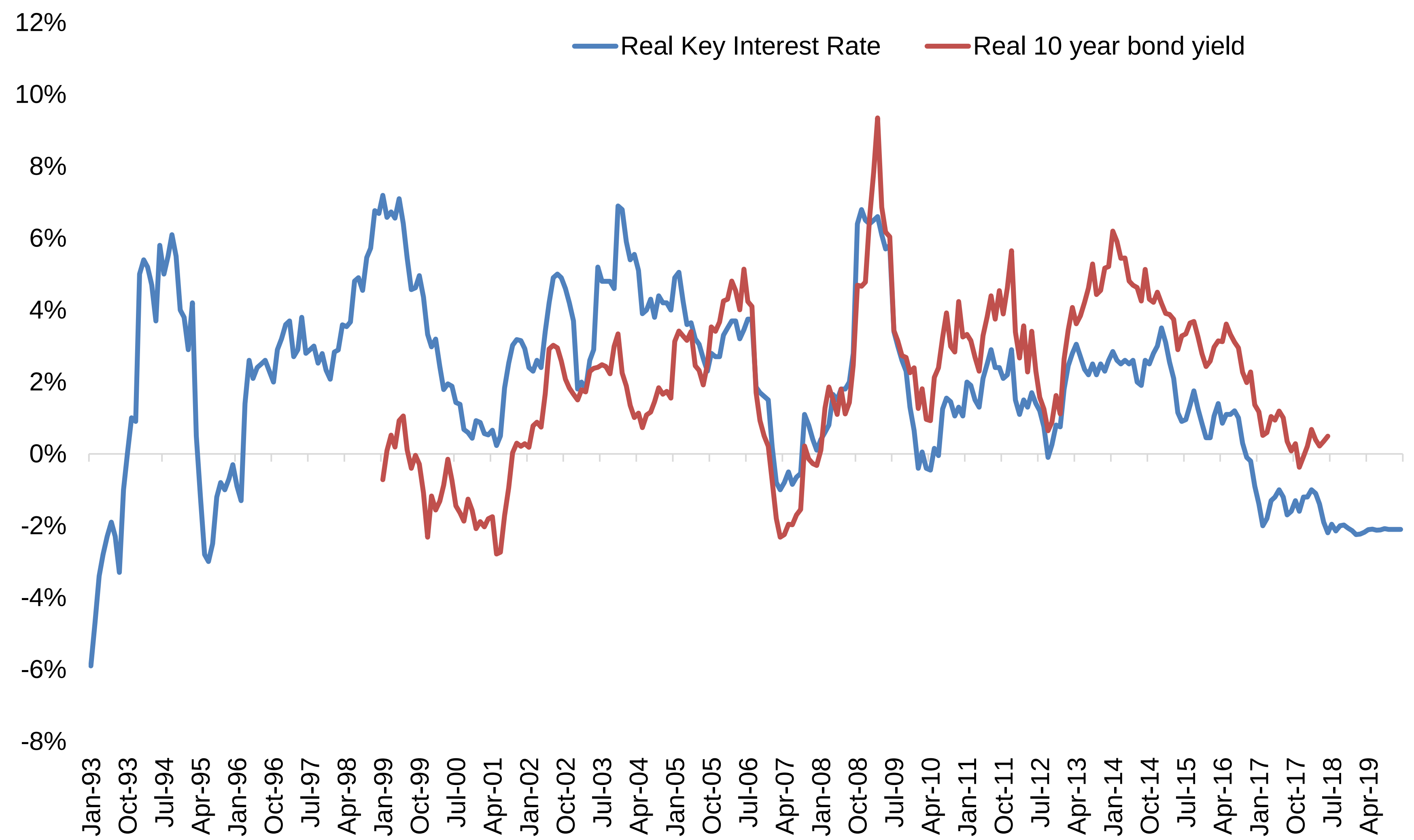
The central bank is independent[1] and the primary object of MNB is to achieve and maintain price stability[2] around its target of 3% (with ±1% tolerance band).

According to the July MPC statement, the council is of the view that economic output is close to its potential level and the robust growth is likely to continue. Growth would pick-up further in 2018 before slowing down in 2019. Inflation will remain temporarily above 3% in the coming months due to increase in oil prices, but as inflation expectations are anchored at low levels, oil prices are unlikely to have a second-round effect. The fundaments of the Hungarian economy continue to be stable and as the inflation boosting effect of oil price fades away, the inflation target is expected to achieved sustainably from mid-2019

Members	Term starts	Term ends
György Matolcsy (Governor)	4th March, 2013	March, 2019
Ferenc Gerhardt (Deputy Governor)	22nd April, 2013	April, 2019
László Windisch (Deputy Governor)	2nd October, 2013	October, 2019
Márton Nagy (Deputy Governor)	1st September, 2015	September, 2021
Gusztáv Báger (Member of MPC)	6th July, 2015	July, 2021
Kardkovács Kolos (Member of MPC)	12th September, 2016	September, 2022
György Kocziszky (Member of MPC)	6th April, 2017	April, 2023
Dr. Bianka Parragh (Member of MPC)	23rd March, 2017	March, 2023
Gyula Pleschinger (Member of MPC)	5th March, 2013	March, 2019

1 under Article (2) of the Act CXXXIX of 2013 on MNB
2 under Article 3 (1) of the Act CXXXIX of 2013 on MNB

REAL BORROWING COSTS



The chart above shows the main policy rate (0.9%) minus current inflation and projected forward assuming no change in the policy rate and assuming the central scenario for inflation. That means that at best, the real policy rate will stay as low as it was in 1995 and at worse (that is if our higher-food inflation scenario materialises) it will drop further!

We don't expect the central bank to shift its stance this year, but we highlight that eventually a cumulative 200-400bp of monetary tightening would appear appropriate over a 3 year horizon.

Sources: CEIC, ADA ECONOMICS LTD

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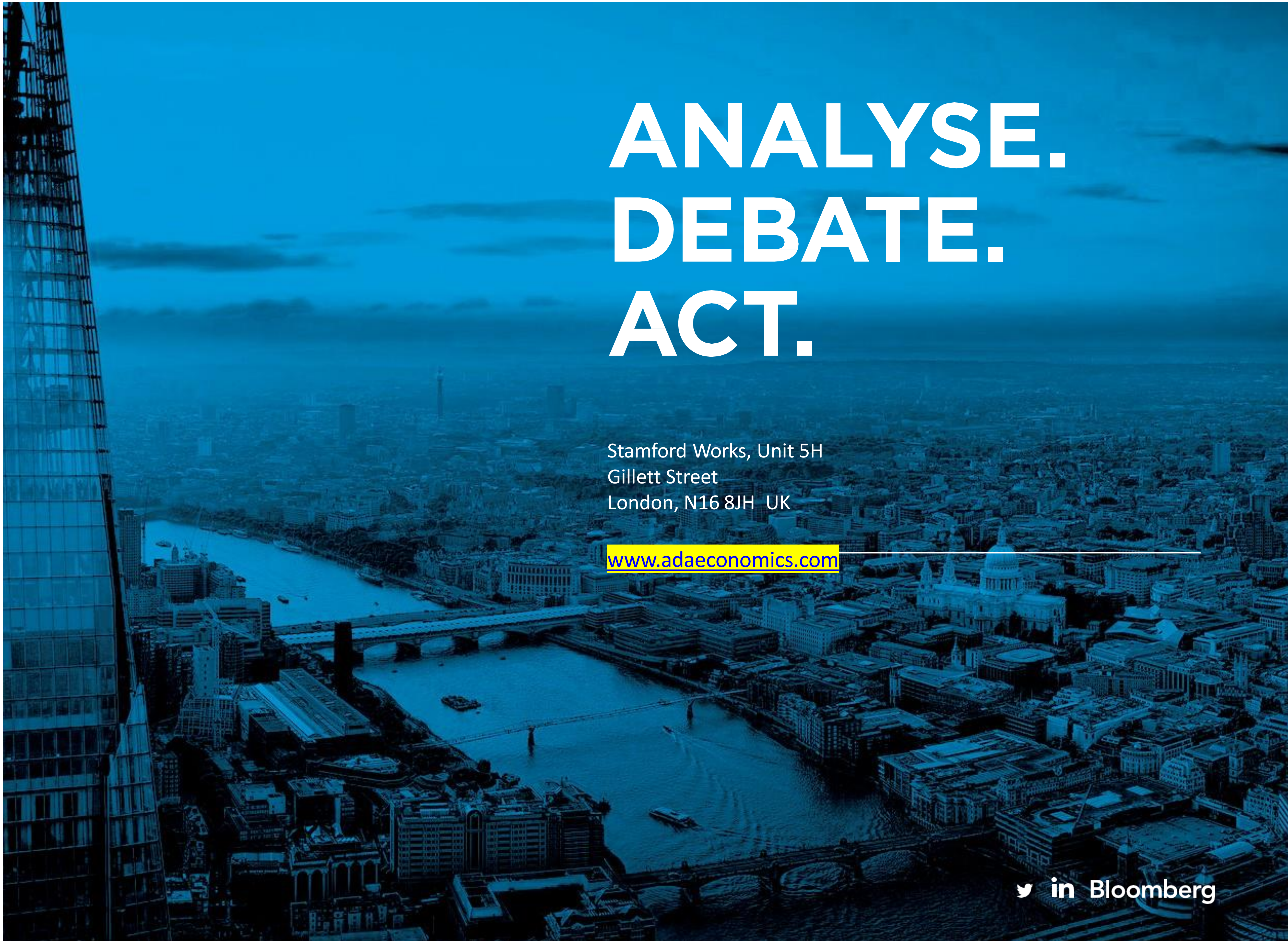
25th July, 2018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