Macroeconomic and financial environment in 2019

There were many risks in the global economy in 2019, but at the end of the year, it seemed that in a number of cases (Brexit, trade war) the world was moving towards a solution. Therefore, at the end of 2019, until the coronavirus outbreak, it seemed that 2020 could be more favourable than 2019 – at least for European economies. However, with the coronavirus outbreak, 2019 seems to be the last year of peace from the aspect of operation.

In the United States, 2019 saw the onset of the expected slowdown in economic growth, as the positive effects of tax cuts in 2017 are fading away and as the trade war weakens export and investment dynamics. However, the deceleration was slower than expected, owing to robust consumption growth. According to preliminary data, GDP growth rate was 2.3% in full-year 2019.

The labour market remained tight, with an unemployment rate of 3.5%, while employment growth has slowed down compared to 2018, but it was still above the equilibrium level, with wage dynamics around 3%. Therefore, the labour market is unlikely to slow down America's economy.

Inflationary developments have been in line with the Fed's expectations. Due to rising fuel prices, CPI inflation slightly exceeded 2% (2.3% in December 2019), while core inflation

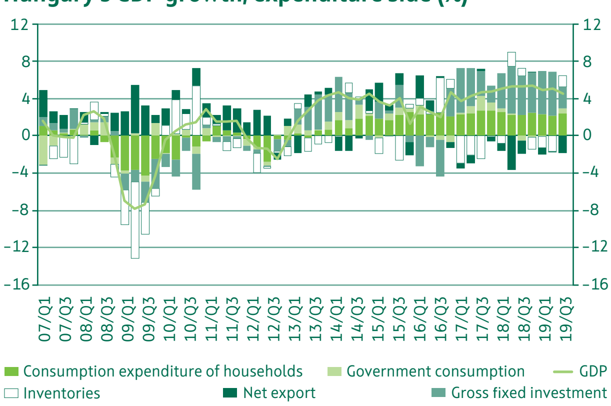
remained stable at 2.3% in the last months of the year. With wage dynamics halting in 2019, the Fed does not have to worry about rising inflation. In recent times, the dollar remained stable against the euro – this means that the exchange rate will not have a significant impact on inflation in 2020.

Owing to the slowdown and rising recession fears over the year, the Fed cut interest rates for the third time in November (by a total of 75 bps in 2019).

In Europe, the slowdown that began in 2018 continued in 2019. The performance of the eurozone's economies increased by only 1.2% in 2019 (down from 1.9% in 2018), and the annualized quarterly growth rate slowed to just 0.4% in the last quarter of the year. Uncertainty around Brexit, and trade war concerns have particularly hit Europe, and left a strong mark on the region's export performance, which was the main reason for the slower economic growth. Thanks to the favourable labour market developments (the unemployment rate dropped to 7.5%, wage dynamics exceeded 2.5%) consumption decelerated at a smaller rate than GDP did, and investment grew faster than GDP. Towards the end of 2019, progress was made both in Brexit negotiations and in the trade war, so at the end of 2019 there was rightful hope that European economies could recover somewhat in 2020. As a result of the worsening economic outlook and continued inflationary pressures, the ECB has restarted its monthly EUR 20 billion asset purchase program.

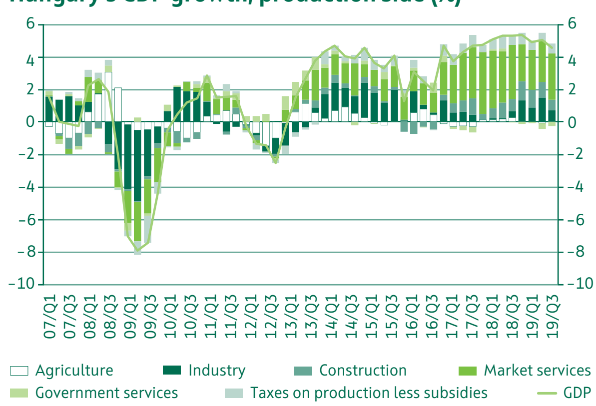
Despite the deteriorating international environment, Hungary's 2019 GDP growth rate, at 4.9%, surpassed expectations and our own forecast. Domestic demand remained the main driver of this robust expansion; household consumption grew by 5% and investment surged 15.3%. In addition to public investment financed by EU funds, the latter has been increasingly supported by private investment to boost capacity. Supportive economic policies also contributed significantly to the rapid economic growth. Monetary conditions (real interest rates, real exchange rates) remained loose, and the government introduced stimulus measures under the Demographic Action Plan.

Hungary's GDP growth, expenditure side (%)



Sources: KSH, OTP Research

Hungary's GDP growth, production side (%)



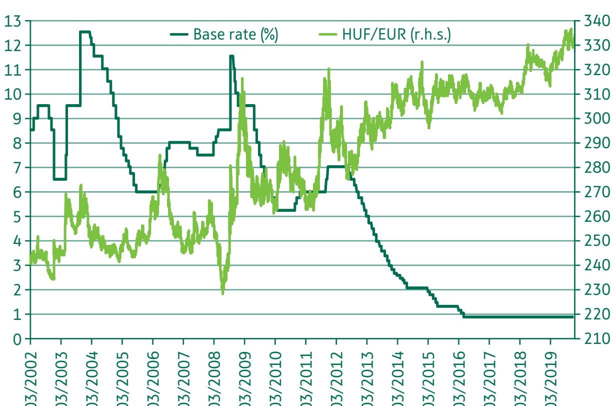
Sources: KSH, OTP Research

The strong domestic demand has led to further recovery in retail and corporate borrowing. The retail loan market was up 16.5% in 2019 (FX-adjusted), benefiting from the introduction of baby loans in the middle of the year. Corporate borrowing surged 14%, on account of the strong investment activity. In the household segment, the subsidized 'baby loans' totalled HUF 560 billion by the end of the year, housing loans hit HUF 910 billion, and personal loans reached HUF 556 billion.

In the housing market, the introduction of the MÁP Plus government bond scheme may have absorbed a significant amount of investment, slightly reducing the number of housing market transactions in 2019. Housing prices continued to rise rapidly in the first half of the year, owing to the strong demand and the announcement of further stimulus measures, but there was growing evidence that home prices have peaked.

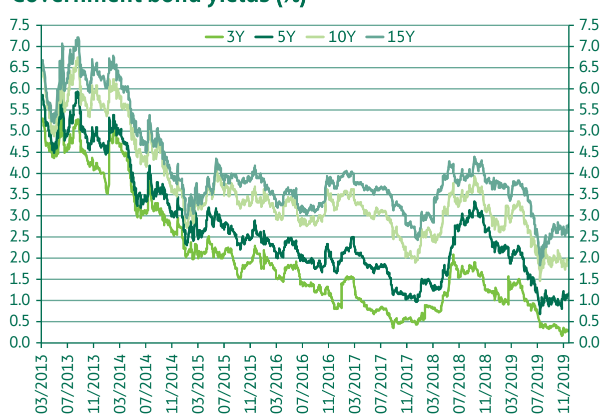
From macroeconomic point of view, the only delicate issue is the evolution of inflation. In Hungary, average annual inflation rose from 2.8% in 2018 to 3.4% in 2019, and accelerated to 4.7% in early 2020, pushing the CPI above upper edge of the central bank's inflation target band. Although inflation fluctuated rather hectically over 2019, the main problem is that the central bank's closely watched inflation indicators have remained steadily above 3%, despite the increasingly weak external inflation environment. As a result, any unfavourable inflationary shock can easily raise inflation close to, or above the central bank's target band. In 2019, many unfavourable shocks hit consumer prices; the most important of them were the African swine fever, and the rapidly rising vegetable & fruit prices. It was also evident that the small increases in agricultural prices passed through into consumer prices faster and stronger than before.

The HUF/EUR and the base rate



Sources: Reuters, MNB, OTP Research

Government bond yields (%)



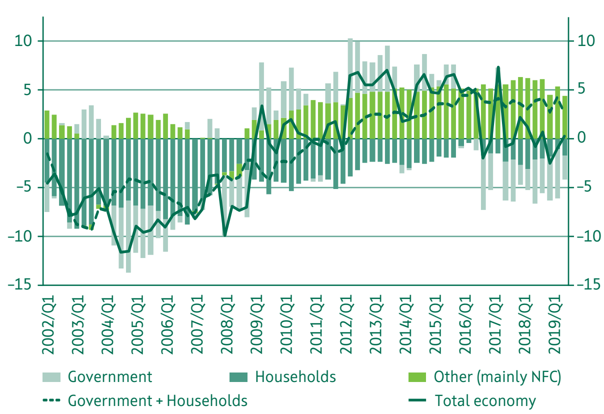
Sources: ÁKK, OTP Research

As it became increasingly apparent that the trade war is slowing advanced economies' growth, the world's leading central banks have turned to monetary easing in the second half of 2019, after tightening in 2018. The Fed lowered its key policy rate three times, by 25 bps in each move (from 225/250 to 150/175 bps), and the ECB reduced its key policy rate from -40 to -50 bps in one fell swoop, and expanded its asset purchase programme. Most central banks in Central and Eastern Europe left their interest rates unchanged – except a single tightening of the Czech Republic, as well as the central banks of Ukraine and Russia, which lowered interest rates in several steps, owing to the rapidly decreasing inflationary pressure.

In this environment – even as underlying indicators have risen –, the MNB did not tighten interest rate conditions substantially; money market yields have fluctuated slightly above zero, basically with minimum volatility. The forint weakened against the euro practically throughout last year: the EUR/HUF gradually climbed from 315-320 at the beginning of the year to 330-335 by end-2019.

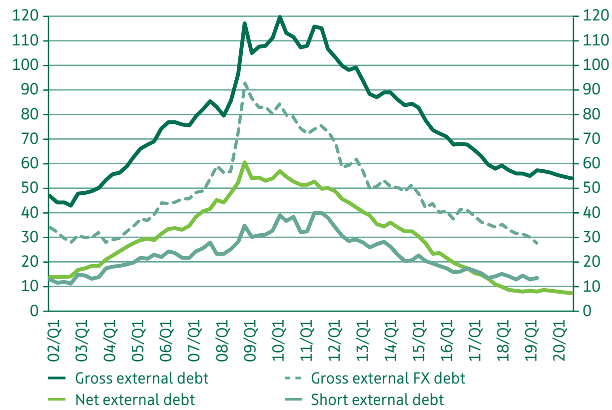
Owing to the strong domestic demand, Hungary's current account deficit worsened slightly, from 0.5% of GDP to 0.6% of GDP, and the previous rapid decline in external debt came to a halt after reaching the average of the CEE region's countries.

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

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

The macroeconomic situation

In 2019, OTP Group's countries were characterized by favourable macroeconomic environment. Despite a slowdown in Europe's economy and a deterioration in the global investor sentiment, growth in the CEE region's countries tended to be slightly slower but remained near historical highs. Among the countries where OTP Group is present, Hungary, Romania, and Serbia grew by around 4%, while the economies of Bulgaria, Ukraine, Croatia, Montenegro, Albania and Moldova expended by 3–4%. Only Russia posted a weaker GDP growth rate of 1.3%, on account of VAT increases and tight economic policy.

With the exception of Russia, the countries where OTP Group is present, were clearly in the mature phase of the economic cycle in 2019, with domestic demand being the main driver of growth, mostly expanding faster pace than GDP. In Hungary, Romania, Bulgaria, and Ukraine, consumption growth was around or above 5%; in other countries (except Russia's 2.4%) it was around 3–4%. In most countries, the rapid growth in consumption is attributable to all-time low unemployment rates, rapid wage growth, and rising lending activity. Although investment dynamics remained strong in many countries (Hungary, Romania, Ukraine, Serbia, Croatia) thanks to continued vigorous private and EU-backed public investment, other countries experienced a significant slowdown, signalling the adverse effects of a deteriorating external environment. External balance continued to deteriorate, albeit at a slower pace because of the strong consumption, but the imbalances remained low (except in Montenegro, Albania, Moldova and Romania); in most countries, the deficit is offset by the capital balance and net FDI inflow, thus there is no sustainability problem with respect to the external debt path. Similarly, the moderate budget deficits – with only Moldova (4%) and Romania (4.5%) having deficits above 3% of GDP–indicate that vulnerabilities are low. Public-debt-to-GDP ratios continued to show a downward trend in most countries, with the exception of Albania, Moldova, and Romania where stagnation is more likely. As a result of the above factors, both corporate and retail credit demand continued to expand at a robust pace, with household dynamics showing an average growth rate of 10% and the corporate segment expanding by 6% in 2019, which is not a significant shift from 2018 levels. Overall, most of these countries were doing fine from the aspect of vulnerability, with favourable equilibrium and declining debt ratios, and generally low levels of foreign currency loans. Therefore, their economic policies may have more room for manoeuvre to offset the negative external shock caused by the coronavirus crisis than they had before the financial crisis in 2008. Although the vulnerabilities are decreasing, the weight of tourism and the high debt ratios of Croatia and Montenegro add to risks. In Ukraine, Moldova and possibly Albania, the above-average external imbalances and the high debt ratios pose risks. In Romania the main risks stems from an overheated economy, twin deficit, and above-target inflation (due to irresponsible fiscal policies in the past) call for fiscal adjustment, while the resulting political stalemate does not make it possible.

The two commodity-exporting countries followed different paths. In 2019, Ukraine successfully left behind the recovery period following the crisis years of 2014–2016; its economy entered a mature phase of the cycle, with consumption and investment expanding. Meanwhile, due to prudent economic policies, vulnerability has gradually declined from previous high levels; debt indicators, inflation and interest rates have dropped. Although the risk of refinancing debt in Ukraine remains very high, this is mitigated by the IMF agreement. In contrast, Russia's economic growth remained low in 2019, and even slowed further from 2.5% to 1.3%, ranking again the lowest among OTP Group's countries. There are two factors behind this. First, its potential growth rate is low, near 2%, due to the economy's structural problems, unfavourable demographics, state interference, and a non-market-friendly environment. In addition, last year, in addition to sanctions, sluggish economic policies and slippage in public investment programs slowed growth. At the same time, economic policy has accumulated considerable room for manoeuvre, in the form of substantial budget surplus and strong external surplus, low debt ratios, extremely low FX exposure, and high reserves, which can be used to ease external recessionary pressures.