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FLASH REPORT

4 January 2019

Moderating expenditures and robust revenues led to an undershooting of the 2018 deficit target, while significant year-end EU payments contributed to a quick fall of debt. However, the medium-term outlook remains unchanged.

- Hungary's ESA-based fiscal balance stood at -0.7% of GDP in 2018Q3, indicating a 3.2 pp. improvement compared to a year earlier, the KSH statistical office said on Thursday. The 4Q rolling deficit decreased to 1.9% of GDP, down from 2.7% of GDP in 2018Q2.
- The significant improvement was brought about by both moderating expenditures and strong revenues. On the expenditure side, spending slowed to 9% YoY (down from 11.5% in Q2), leading to a 0.6 pp. decline in expenditure, to 46.9% of GDP. Revenue growth stood at 10.4% YoY (up from 8.1% in Q2), which led to a 0.2 pp. increase in the revenue ratio, to 45.0% of GDP (all figures 4Q rolling).
- Although the government has implemented some extra spending in December, this will not be enough to offset the effect of better-than-expected data, hence we estimate the ESA deficit at 2.1-2.2% of GDP for 2018 overall. The recent improvement is driven more by the moderating expenditures than by the higher-than-expected revenues. As expenditures will eventually correct on account of recently announced measures, we still expect the 2019 deficit figure at 1.8% of GDP.
- The last quarter of 2018 brought a significant improvement in the financing position of the government, which received substantial EU fund payments, in the magnitude of HUF 800 bn. This could have brought the cash deficit to 3.7% for 2018 overall, leading to swift debt reduction, to a level well below the official target.

Figure 1 – Government revenues, expenditures and the ESA deficit*

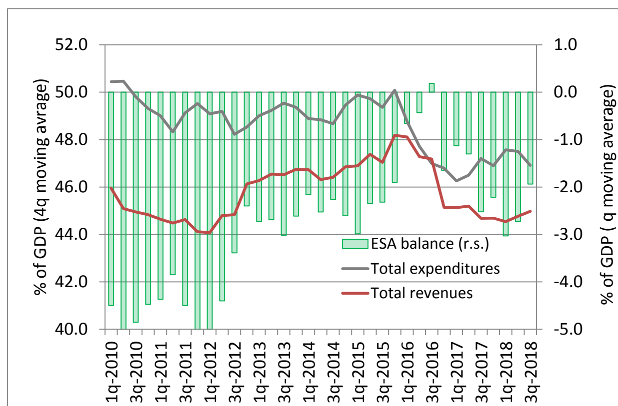
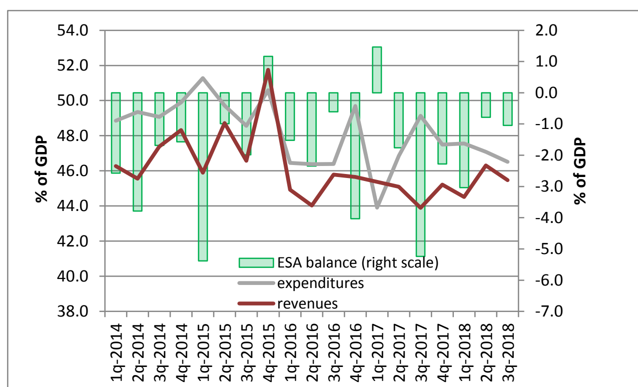


Figure 2 – Seasonally adjusted revenues, expenditures and ESA deficit*



**KSH and OTP Research calculations*

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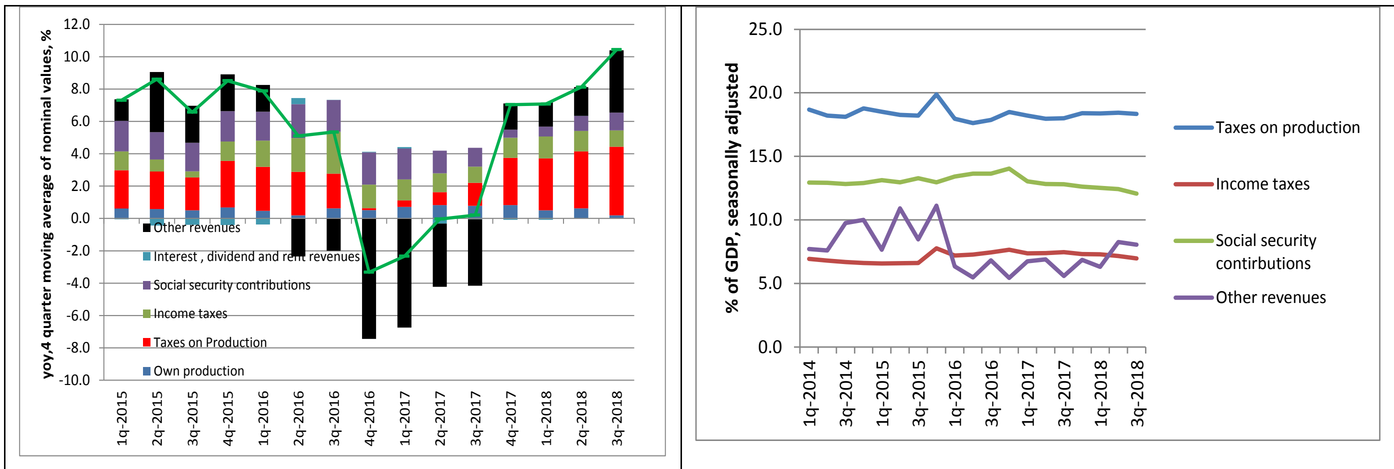
Revenues continued their robust rise, but may have reached a peak

Total revenues grew by 10.4% YoY, up from 8.1% in Q2, slightly higher than nominal GDP, increasing to 45.0% of GDP, from 44.8% in Q2 2018 (all 4Q rolling). The pick-up in revenue growth compared to the previous quarter is primarily explained by higher other (mostly EU transfers) and VAT revenues. In addition to buoyant consumption growth, higher VAT revenues could also be related to the introduction of the real-time VAT reporting. Nevertheless, seasonally adjusted data indicate that taxes on production may have reached their peak compared to GDP, while social security contributions and income taxes are already declining (the former related to the 2018 cut in contributions, Figure 3, right panel). The only exception is 'Other revenues', mostly due to EU fund payment. However, this latter finances expenditure directly, hence cannot be considered as contributing to net improvement of the budget balance. Therefore looking ahead, we do not think the pace of tax revenue growth could be sustained, or that the revenue side could contribute to further deficit reduction. Consequently, the outlook on the budget balance will depend more on what happens to expenditures.

Figure 3 – Budget revenues*

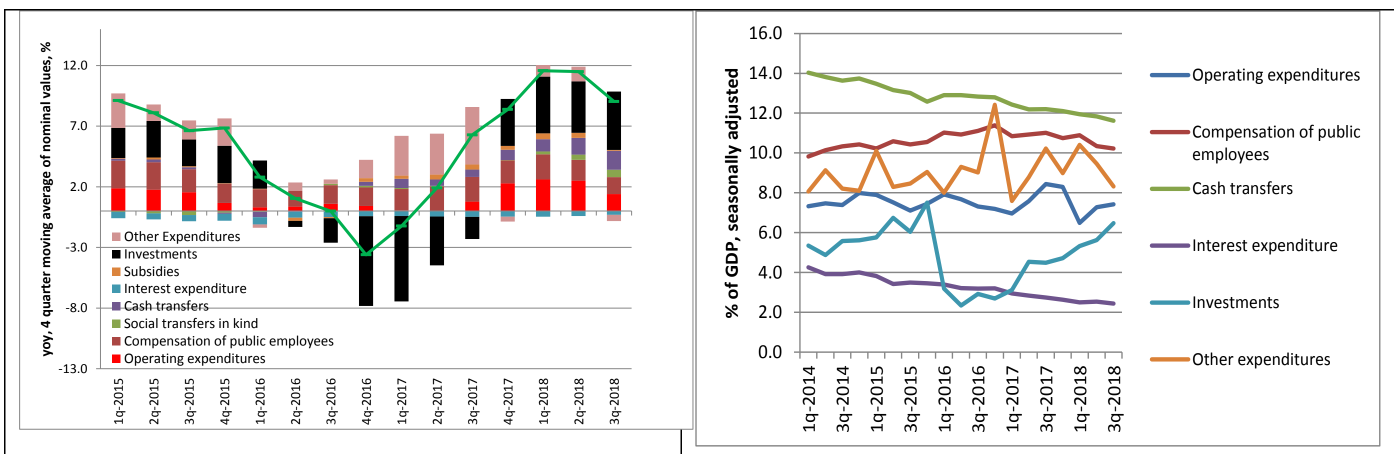


**KSH and OTP Research calculations ('Other revenues' on the right panel is the sum of other revenues on the left panel+own production+interest and dividend revenues.)*

..while expenditure growth slowed down visibly

Total expenditure grew by 9.0% YoY, down from 11.4% in Q2, hence the expenditure to GDP ratio declined to 46.9% of GDP, down from 47.5% in Q2 (all 4Q rolling). In fact all items, apart from investment slowed down, and declined in comparison to GDP. Seasonally adjusted quarterly data reveal similar tendency (Figure 4, right panel). Importantly, the seasonally adjusted quarterly investment to GDP ratio, at 6.5% in Q3, is still well below its historical peak of 7.5% in 2015Q4. However, this is the item where we expect further substantial increase in the following quarters, mostly on account of higher construction prices, as extra capacities are not available in the economy.

Figure 4 – Budget expenditures*



**KSH and OTP Research calculations ('Other expenditures' on the right panel is the sum of other expenditures on the left panel+subsidies+social transfers in kind.)*

Despite the better-than-expected data for 2018, the medium-term outlook points to a deficit stagnating slightly below 2% of GDP

As a consequence of the factors mentioned above, the four-quarter rolling deficit declined by 0.8 pp of GDP (from 2.7% of to 1.9% of GDP). In order to reach the deficit target of 2.4% for 2018 overall, the last-quarter deficit would need to increase to 7.9% of GDP, implying a HUF 150 bn extra spending compared to what comes from 'normal' activity. Given that other sources of information estimate the end-year extra spending half of this magnitude, we think that the 2018 target will be undershot and could be around 2.1-2.2% of GDP.[1]

Notwithstanding the expectation of better outcome for 2018, we still expect the 2019 deficit at 1.8% of GDP: most of the Q3 surprise comes from lower expenditures rather than from higher revenues, and we think that expenditures will gradually correct (see e.g. the announcement in December on the subsidy program for small villages).

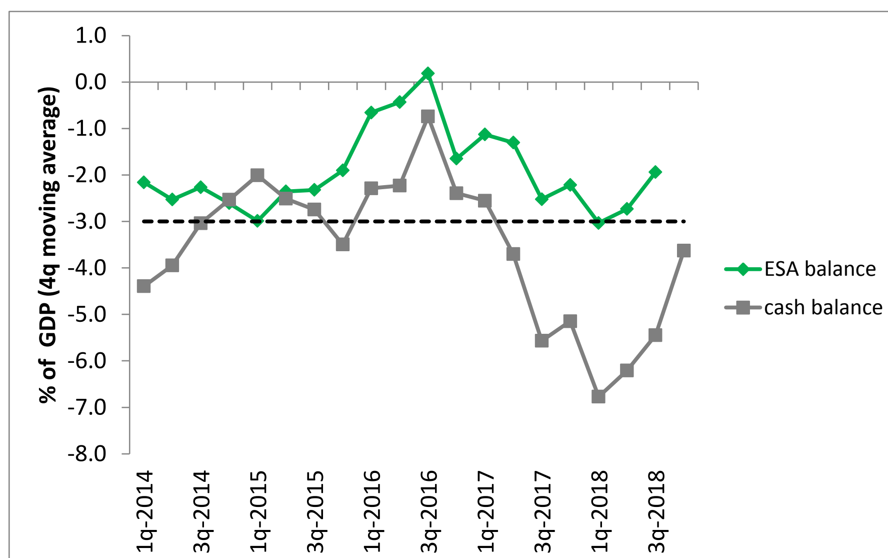
As regards the deficit outlook afterwards, given the slowing economy and ambitious plans for wage increases, we think that the deficit could stick at 1.8%-2.0% of GDP under no policy change, as indicated in our previous analysis.[2] This picture is somewhat more pessimistic than the government's medium-term projection (published in December), which indicated a decline of the budget deficit to 1.2% by 2021.

Substantial year-end EU payments brought the foreseen swift debt decline forward

The 2018 Q4 central government cash balance may have reached a surplus of above HUF 300 bn on account of substantial EU fund payments from the EU commission. Our calculation suggests that payments could have arrived around HUF 500-550 bn, while other sources indicate that a further amount of about HUF 300 bn may have been received still from the previous financing cycle. As a consequence of the improving cash balance, government debt at the end of the year may have declined to around 71.5%-72.0% of GDP, well below the official target of 73.2%.

Despite this short-term improvement, our medium-term picture has not changed as the recent EU payments brought forward the payments expected for later years. Hence we foresee government debt to decline slightly above 70% by the end of this year and to around 63% of GDP by 2021.

Figure 5 – ESA government balance and the central government cash deficit*



**KSH, MoF and OTP Research calculations*

[1] This figure is at the higher range of the government's own forecast of 1.9-2.1%, published in December.

[2] In line with the spirit of the six-year wage agreement, we have pencilled in a 2 pp. social security rate cut in mid-2021 as well.

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