otp Research

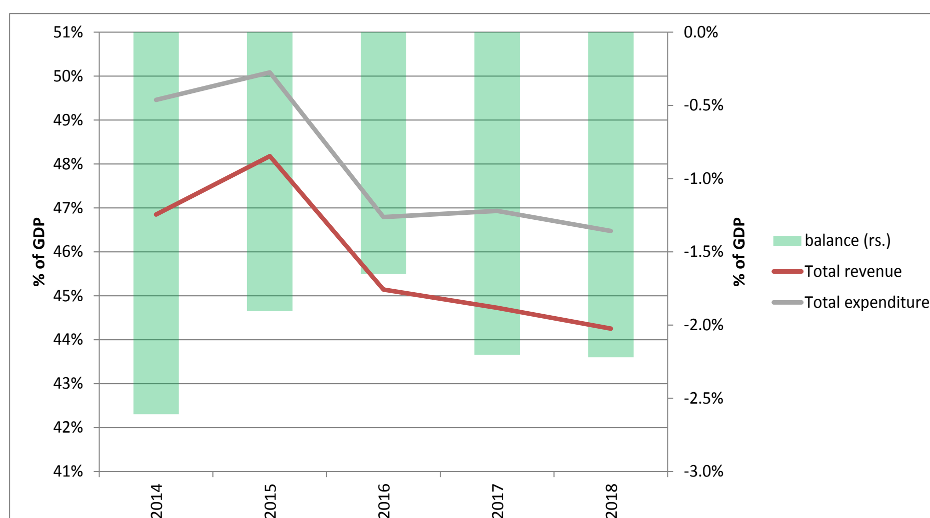
FLASH REPORT

2 April 2019

Robust revenues and lower-than-expected expenditures helped Hungary undershoot its 2018 deficit target. The deficit could remain below 2% in the coming years

- Hungary's ESA-based fiscal balance stood at -2.2% of GDP in 2018 overall, the KSH statistical office reported on Monday. This indicates an unchanged position compared to the previous year, but it is 0.2 ppts below the original target. This outcome was driven by similar declines in revenues and expenditures to GDP, compared to 2017 (Figure 1). The deficit was 0.2 ppts higher than our in-house forecast and 0.1 ppt above the market consensus.
- Nonetheless, the Q1-Q3 data were subject to significant revision, which deteriorated the deficit by 0.5 ppts of GDP, so in this sense the Q4 data were actually somewhat better than the forecasts. While revenues' growth accelerated to 8.5% YoY from 7.1% in 2017, expenditures posted practically unchanged growth (8.6% in 2018 vs 8.4% in 2017) as opposed to the assumption of 0.8 ppts extra expenditure growth compared to revenues in the Convergence Programme. This suggests that both the robust revenues growth and the contained increase in expenditure contributed to the outcome.
- In terms of expenditures, all major items declined compared to GDP, while investment surged substantially. In terms of intra-year pattern, Q4 brought an end-of-the-year pick-up in expenditures again, albeit by a slightly smaller magnitude than in previous years (Figure 2).
- On the revenue side, indirect taxes and other revenues (related to EU transfers) grew stronger than GDP did, while social security contributions and income taxes showed lower growth. However, once we filter out temporary factors, these latter categories also marked robust growth.
- Looking ahead, we expect the budget deficit to decline to 1.5% of GDP by 2020, assuming a robust real economy, savings on financial transfers and interest expenditure, as well as increasing EU transfers in 2019-2020. Nonetheless, things could start to turn around from 2021, once (i) EU-related revenues decline, and the government's own-funded investment increases (ii), the economy slows further (iii), the costs of the demographic programme will take their toll (iv) and the health care wage programme could lead to further significant wage growth. However, we still see the deficit slightly below 2% by 2021.

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



**KSH and OTP Research calculations*

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Fixed Income Desk

András Sovány
+36 1 288 7561
SovanyA@otpbank.hu

Benedek Károly Szűts
+36 1 288 7560
SzutsB@otpbank.hu

FX Desk

András Marton
+36 1 288 7523
MartonA@otpbank.hu

József Horváth
+36 1 288 7514
Horvath.Jozsef@otpbank.hu

Money Market Desk

Gábor Fazekas
+36 1 288 7536
FazekasGa@otpbank.hu

Gábor Heidrich
+36 1 288 7534
HeidrichG@otpbank.hu

Judit Szombath
+36 1 288 7533
SzombathJ@otpbank.hu

FX Option Desk

Gábor Réthy
+36 1 288 7524
RethyG@otpbank.hu

Máté Kelemen
+36 1 288 7525
KelemenMat@otpbank.hu

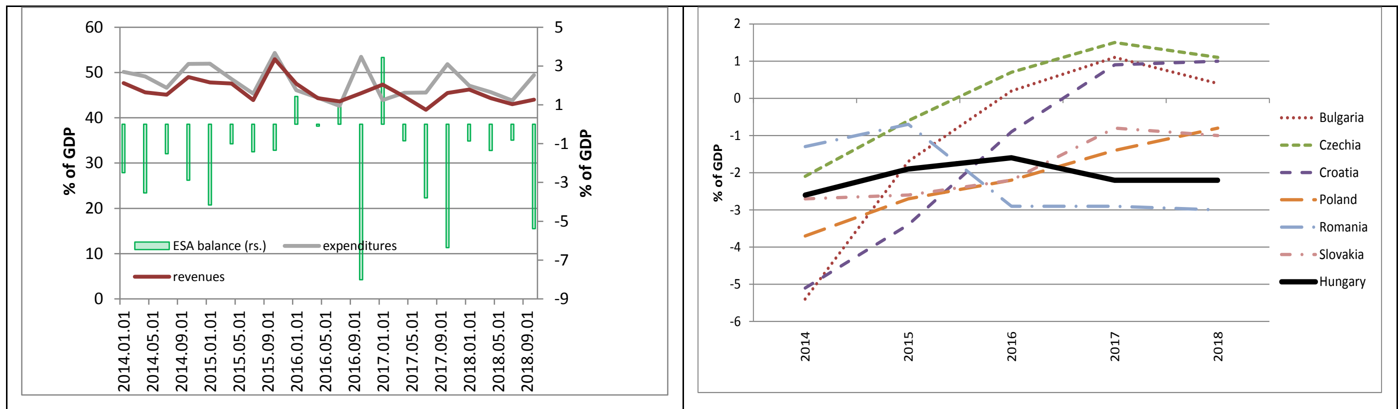
Chief Economist

Gergely Tardos
+36 1 473 7273
TardosG@otpbank.hu

Analysts

Mihály Kovács
+36 1 374 7274
Mihaly.Andras.Kovacs@otpbank.hu

Figure 2 – Quarterly ESA data (left panel) and Hungarian budget data in international comparison (right panel)

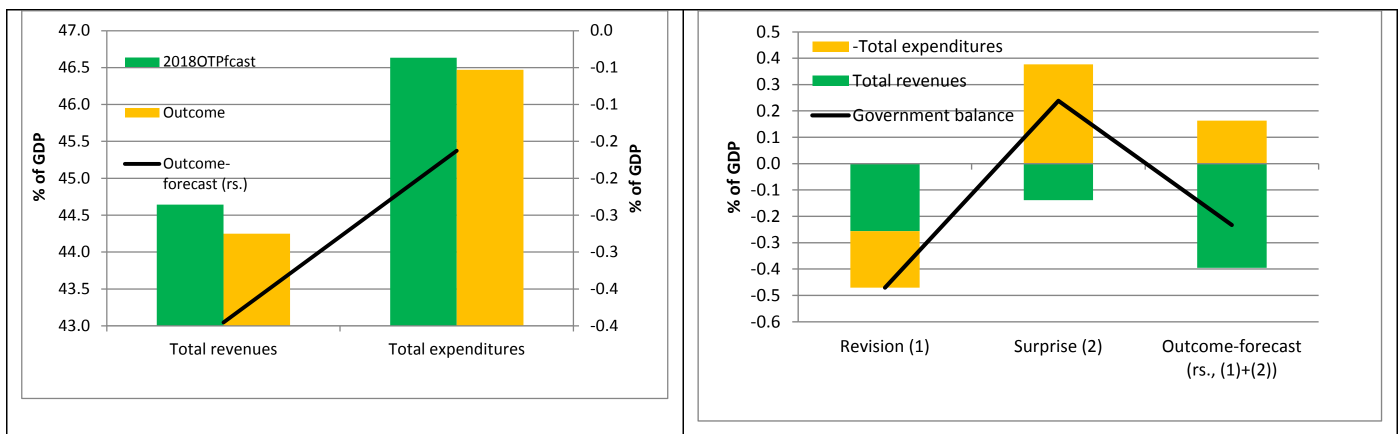


**KSH, Eurostat and OTP Research calculations*

The data was subject to significant deficit-increasing revisions, while Q4 data pointed to better-than-expected outcome

The incoming data suggest that revenues were 0.4% ppts of GDP lower than our expectations, while expenditures missed them by roughly 0.2 ppts. Nevertheless, as the Q1-Q3 data were subject to significant revisions, altogether amounting to -0.5 ppts of GDP, the actual surprise in the data was deficit-improving (Figure 3, right panel). Most of the revision is related to capital and current transfer revenues (0.3 ppts of GDP). We think that the revisions were mainly related to the new estimates of EU transfer inflows. As the underlying tax revenues and expenditures developed broadly in line with our expectations, we do not think that the data changes our underlying forecast story.

Figure 3 – Data revisions and surprise elements*



**OTP Research calculations*

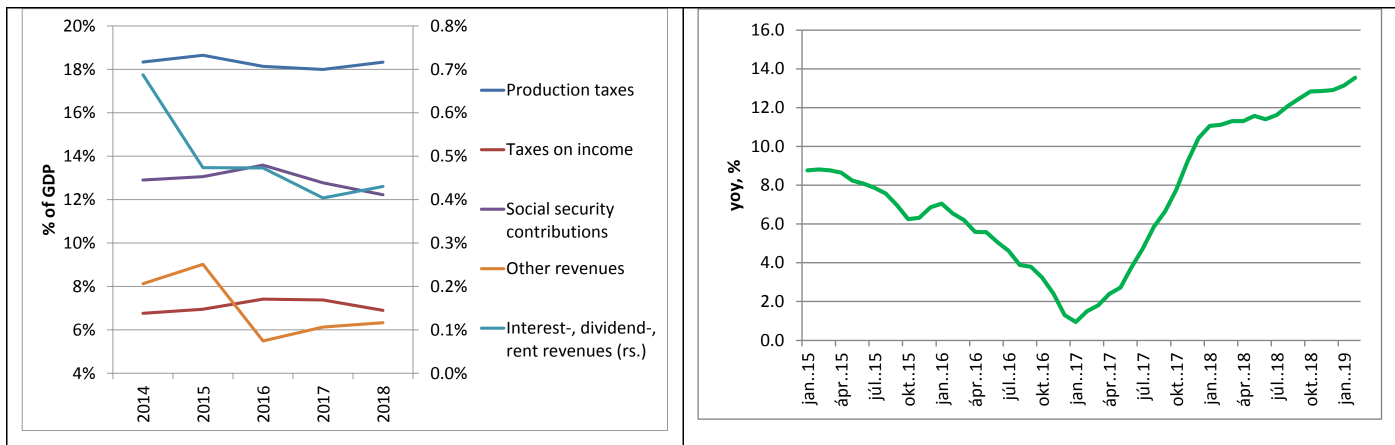
Revenues continued their robust rise

Total revenues grew by 8.5%, below nominal GDP. As regards major revenue items, VAT and other revenues increased compared to GDP, while all the remaining larger items declined. The robust VAT growth of 13.9% YoY was driven by strong consumption and investment expenditure, as well as improvements in tax collections. In terms of the latter, we estimate that around HUF 170 bn (0.4% of GDP) extra revenues were collected, compared to the increase in tax bases. In terms of other revenues, the pick-up compared to the previous year reflects higher EU transfers.[1] Social security contributions declined, reflecting the cuts made in January, while the income taxes' poor performance could be explained by the high base in

[1] Based on BoP statistics, EU transfers to the government increased by HUF 397 bn (1% of GDP). However, it is important to note that there is no one-to-one correspondence between BoP and ESA actual capital transfer data.

CIT.[2] However, once we filter out the effect of SSC rate changes and other temporary factors, income tax growth was also robust, at 13.2% (up from 8.5% in 2017), while underlying SSC somewhat slowed to 10.9% (down from 12.9%), but still remained solid.

Figure 4 – Annual ESA-based budget revenues (left panel) and 12-month VAT cash revenues (right panel)*

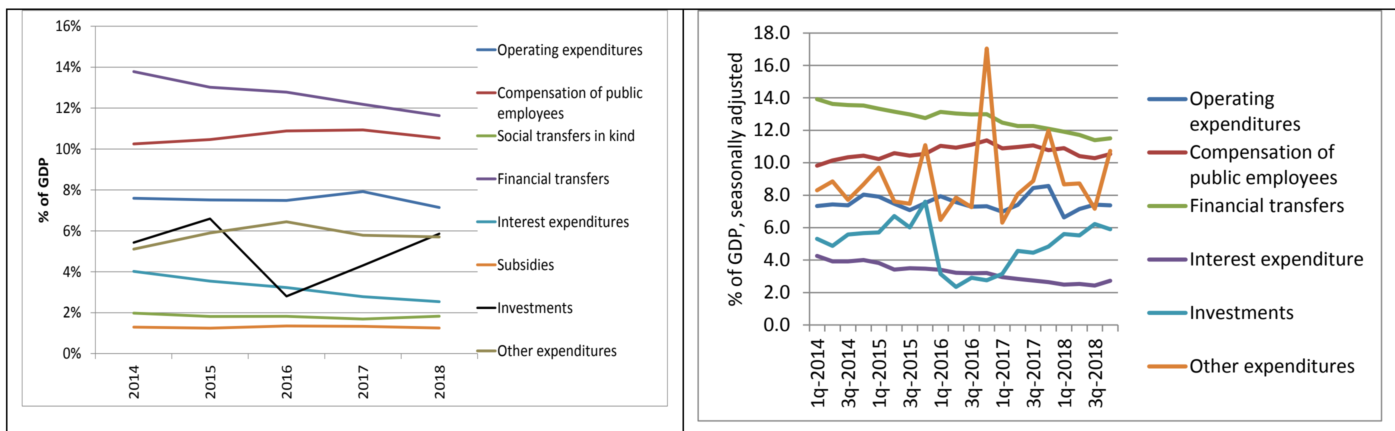


**KSH, MoF and OTP Research calculations*

In terms of expenditures, investment continued to rise, while all major other items remained contained

Total expenditure grew by 8.6% YoY, by less than nominal GDP did. The 0.5 ppts of GDP decline compared to 2017 was driven by all major expenditure items, with the exception of investment. This latter category posted a 49.3% YoY growth, showing 1.6 ppts increase if compared to GDP. Still, one could observe a pick-up in end-of-the-year spending in other expenditures, a seasonal pattern existing since 2015.[3]

Figure 5 – Annual (left panel) and quarterly (right panel) ESA-based 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 higher-than-expected outturn, we forecast below-2% deficit for the coming years

Looking ahead, the budget deficit could decline until 2020, driven by (i) further decline in financial transfers to GDP (ii) savings on interest expenditure (iii) contained government wage bill (also helped by SSC cuts). Although investment will rise further, EU-related revenues will peak in 2019-2020, meaning that higher investment spending will not lead to deterioration in the balance. While revenues could be eroded slightly on account of a further SSC cut in July this year, as well as a slowing economy, this latter effect falls short of

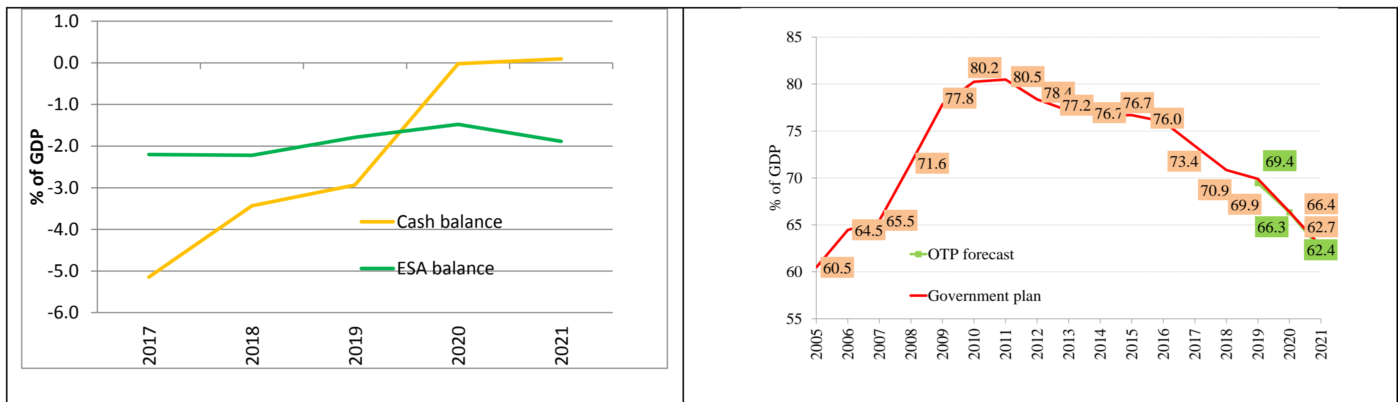
[2] Related to extra tax payments from merger activities of one large multinational company in the magnitude of HUF 267 in 2017 within the Tax Credit for Growth scheme.

[3] Given that we perform seasonal adjustment on a longer horizon, seasonal adjustment techniques could not yet correct for this new tendency.

savings on the expenditure side. This means that this year's 1.8% deficit target seems achievable, and the 2020 deficit declines further to around 1.5% of GDP. Nonetheless, we foresee the deficit to increase toward 2% of GDP from 2021 as (i) as EU-related revenues decline, and the government's own-funded investment increases (ii) the economy slows further (iii) costs of the demographic programme will take their toll (iv) the health care wage programme could lead to further significant wage growth.

Monthly data until February suggests that the revenue growth remained solid in 2019, while EU-related cash balance posted a small surplus of around 0.2% of GDP, much higher than in 2018H1. We expect the EU-related cash deficit to be below 2% this year and project surplus afterwards, thus the government will be in a safe position for debt reduction. Hence we foresee the debt the government's reduction plan as safely attainable and forecast debt to decline slightly below 70% by the end of this year, and to around 62.4% of GDP by 2021. This scenario already contains safe assumptions for the single treasury account of over HUF 1,500 bn.

Figure 6 – ESA and Cash deficit (left panel) and the gross government debt projections



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