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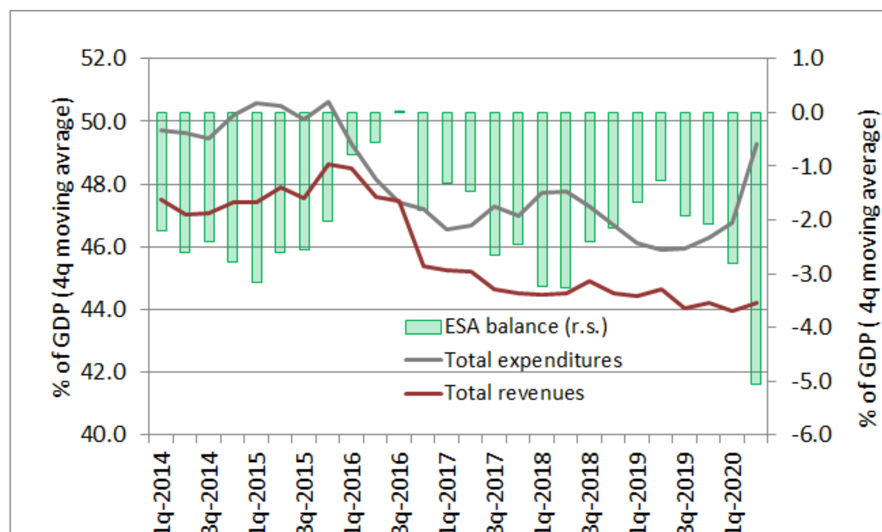
FLASH REPORT

2 October 2020

Q2 2020 ESA budget data are in line with expectations; The no-policy change deficit is around 7% of GDP for 2020, but it will end up higher as further spending is in the pipeline

- Hungary's ESA-based fiscal deficit widened to -5.1% of GDP in Q2 2020 on a four-quarter rolling (henceforth 4Q) basis, the KSH statistical office said. This indicates 2.2 ppts deterioration compared to Q1 2020. The outcome is solely driven by an increase in expenditure to GDP (+2.5 ppts), which was just counterbalanced by a slight rise in the revenue to GDP ratio (+0.3 ppt., Figure 1). The figure was largely expected, as the 4Q data turned out at -4.7% for Q2 in the previously published financial accounts data.
- The seasonally adjusted Q2 deficit-to-GDP ratio stood at 9.3% in our assessment (KSH's figure is 9.1%), an increase of 7.1 ppts from Q1, again solely reflects the growth in expenditure-to-GDP ratio (+8.8 pp), which was partly counterbalanced by a rise in revenue to GDP (+1.6 pp).
- The growth in revenue to GDP should not come as a surprise, as monthly cash data indicated that major nominal revenues declined by 0.5%, while nominal GDP contracted by 1.5% in H1. In fact, some items, like PIT have even increased. Furthermore, VAT and excise duties also made gains in YoY terms by August.
- At the same time, the increase in expenditure is not driven by a single factor – it was prevalent in most components, particularly in financial transfers, the compensation of public employees, investment, and in other expenditures.
- Our current baseline projects an annual deficit of 7%, revised significantly upwards from our previous forecast, on account of worse macro, and spending overruns. This is at the lower edge of the government's consistent communication on a 7-9% deficit for this year. However, from now on, every new discretionary spending from the two open-ended funds set up at the start of the pandemic add to the deficit, and based on official communication, further measures are likely. However, it is an open question to what extent the new rounds of stimulus will support this year's data; they might affect the 2021 macro figures to a larger extent. Overall, if we need to pick one figure, we think the deficit could be around 8% of GDP, but probably not higher.
- As regards next year, with ongoing economic recovery and as some one-off items drop out, we see the deficit around 5.5% of GDP. This already contains further increases in public investment to GDP ratio, to support the recovery. Consequently, we do not expect the government to get closer to a 3% deficit before 2022.
- Our budget deficit forecast implies a government debt figure peaking around 78% of GDP this year, but the decline will be very slow afterwards – we think the debt-to-GDP ratio could remain above 70% for the next two or three years.

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



KSH and OTP Research calculations

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Revenues to GDP have increased, but the ratio masks falling revenues

Despite the gloomy economic situation, total revenues fell less than nominal GDP did: the 4Q[1] revenue/GDP ratio increased by 0.2 ppts, to 44.2%, compared to Q1. In seasonally adjusted terms it increased from 45% to 46.6% of GDP. The simple YoY revenue growth was -5.5%, while nominal GDP fell by 8% in Q2.

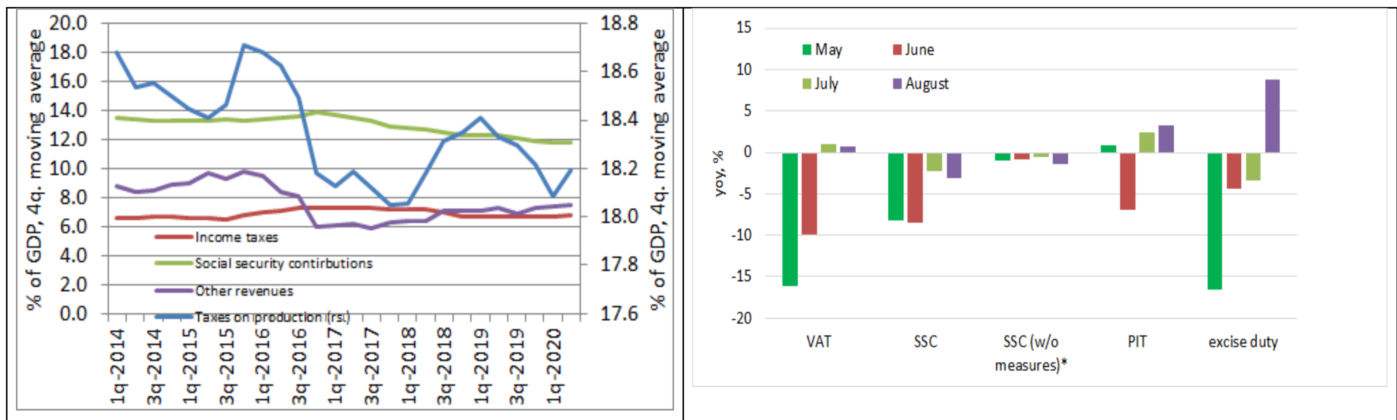
VAT growth fell to 4% for Q2, from 7.4% YoY in Q1 (both 4Q), Q2 simple YoY figure was -5.8%, down from 2.7% in Q1. There has been a slowing trend from Q1 2019 as the effect of anti-shadow-economy measures was fading, and the slowdown in investment growth also mitigated VAT growth, but the pandemic brought a sharper adjustment. Total indirect taxes slowed similarly, to 3.2% from 6.8% in 2020Q1 (both 4Q); but simple YoY figures indicated a sharper decline (from 2.5% to -5.5%), also owing to allowances related to the simplified tax measure and other smaller taxes.

Social security contributions (SSC) stagnated YoY on a 4Q basis, down from 4.1% growth in Q1; simple YoY data indicate a -7.3% figure for Q2 after -0.5% in Q1. SSC revenues were heavily affected by allowances to the tune of HUF 60bn.

Income taxes slowed to 4.4% YoY (4Q) in Q2, from 8.5% in Q1, the simple YoY gauges were -3.6% and 1.4%.

Cash data up to August show that major revenue items are in positive territory (Figure 2) with the exception of SSC, where employers' contribution for August was cut by 2 ppts. YTD revenues in January-August also remained in positive territory for all major revenue items.

Figure 2 – Budget revenues*: ESA-based data (left panel) and monthly cash data in May-August (right panel)



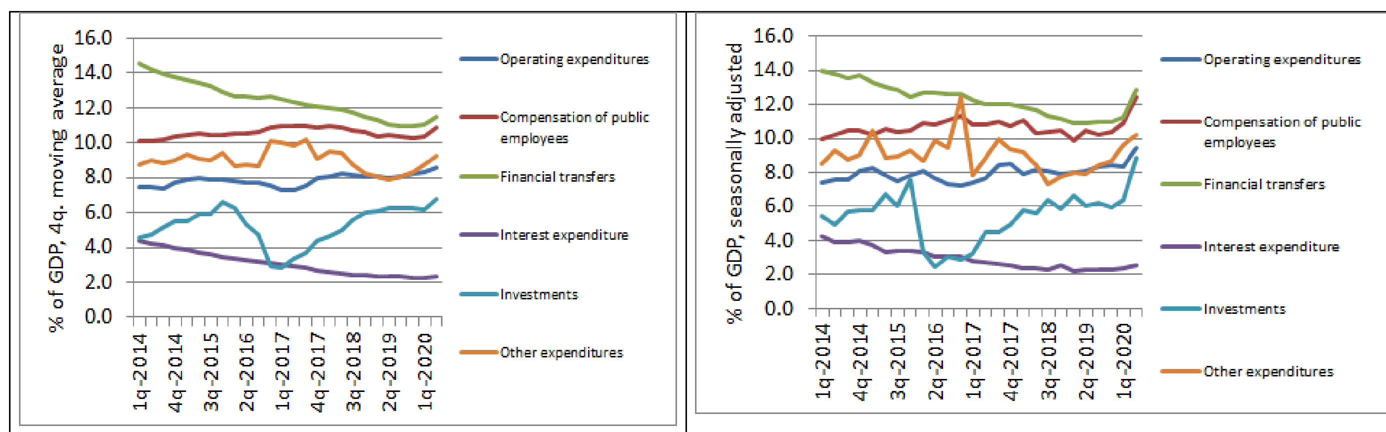
KSH, MoF and OTP Research calculations, SSC (w/o measures): corrects for the effect of the 2 pp. cut last July and the SCC allowances in the Economy Protection Action Plan.

Expenditures picked up in absolute terms, even more if compared to GDP

Total expenditure grew by 11.7% YoY (4Q), up from 10.3% in the previous quarter, the simple YoY growth rate increased to 14% in Q2, from 11.1% in Q1. The 2.5 ppts of GDP increase in the expenditure-to-GDP ratio (4Q) compared to Q1 was driven by all major items: financial transfers grew on account of higher unemployment benefit payments as well as the lengthened family support measures due to the pandemic. Operating expenditures on account of higher health care spending, while investment on account of new ventilator purchases. The bonus for health care workers in June significantly affected the compensation of employees. Finally, other expenditures increased primarily due to investment grants.

[1] Four-quarter moving average

Figure 3 – Budget expenditure*



**KSH and OTP Research calculations*

Our no-policy-change budget deficit forecast is around 7% of GDP, but the continuous overrun of major funds will likely result in higher deficit for the full year

Having seen the financial accounts figures, the Q2 data came as no surprise but the second half of the year is increasingly uncertain. On the one hand, a macroeconomic analyst should deal with the uncertainty of GDP outlook and its effects on revenues. However, in the current case we find the expenditure side even more difficult to forecast. As we indicated in our previous report after the pandemic broke out, the government created two open-ended fund in the 2020 budget: The 'Járványvédelmi Alap' (JVA, Health and Epidemic Defence Fund) and the 'Gazdaságvédelmi Alap' (GVA, Economy Protection Fund). By then, starting from a closed to balance budgetary position (as the significant budget reserves were not spent), the government allowed the automatic stabilizers to work and implemented new loosening measures to support the economy by roughly equal amount (2-2 pp. of GDP). In our case, this resulted in a -4.2% budget balance forecast, slightly below the updated target of the government at that time (-3.8%). Since spring, two major factors forced us to change our view: (i) the macro picture deteriorated considerable: (ii) the government overran the initial target level of funds. In the former case, based on incoming revenue data up to August and our revised GDP projection, we could add 1 ppt to our previous deficit forecast. The extent of expenditure overrun is trickier, as we cannot rely on models, but need to follow the day-to-day decisions of the government. Up to mid-September, we found based on official communication and media sources, that the two funds have been overrun by 1.6 pp of GDP (GVA) and 0.3 pp of GDP (JVA). Then a simple calculation adds up to a 7% of GDP deficit forecast. However, very likely the story does not end here, as from now on every forint spent from these funds raises the deficit, as there is no extra funding. Not surprisingly, the government has been communicating since August that the budget deficit could reach 7-9% of GDP this year. Based on our calculation, we are already at the lower edge of this range. Nevertheless, it remains to be seen (i) how quickly the government can spend 1-2% of GDP in the remaining part of the year (ii) whether this will be in the form of a specialized new stimulus package for housing or economy protection, or will rather involve extra discretionary spending.

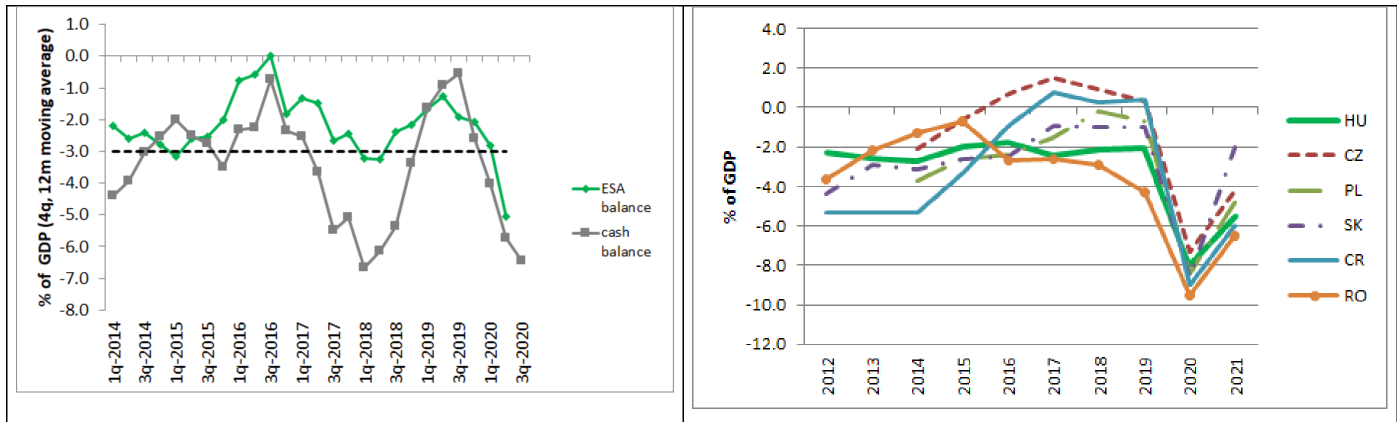
Table 1: Deviation of our current budgetary forecast from the previous projection

Our previous (May) budgetary projection	**-4.2**
(2) Overrun of GVA (-)	*-1.6*
(3) Overrun of JVA (-)	*-0.3*
(5) Macro effect	*-1.0*
Current no-policy-change forecast	**-7.0**

The type of end-of-the-year spending also has severe consequences for the 2021 budget: the more permanent the new spending measures will be this year, the more difficult it will be to decrease the deficit for next year. On the one hand, next year the pace of deficit reduction will be constrained by Hungary's Fiscal Stability Law, which stipulates that unless there is recession, the debt-to-GDP ratio should decline by at least 0.1 ppt of GDP. A second constraint is how the EU framework will tackle next year's budgetary policy. Although this latter is very

uncertain, given that Hungary's budgetary situation is not at all an outlier in EU comparison, probably other member states will face similar problems. Hence, the first constraint seems more binding at this stage. Based on our calculation, and our current best deficit forecast of 8% for 2020 and 5.5% for next year[2], Hungary's debt-to-GDP ratio could decline from 78% to 76.6% of GDP by 2021. However, should next year's recovery fail to materialize dynamically, a 5.5% deficit could easily become incompatible with the requirement of declining debt-to-GDP ratio. In that case, the government might be forced to tighten the budget within the year, as the debt reduction requirement should be valid even ex-post, unless there is recession. Nonetheless, we have learned in the past that the economic policy has also other means to manoeuvre, for example in the form of changing the level of end-year cash reserves.

Figure 4 – ESA and Cash deficit* (left panel) and the ESA deficits in the CEE region (right panel)**



** Cash balance data for Q3 is up to August, OTP Research calculations*
***KSH and OTP Research calculations, Focus Economics,*

[2] This does not include the recently the announced plan to double physicians' wages from 2021 in two steps. This could cost around 0.3% of GDP in 2021 and 0.1% in 2022 in net terms.

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This document was prepared on 02 October 2020.