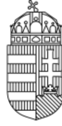


MINISTRY
FOR NATIONAL ECONOMY

Prudent fiscal policy and declining state and external debt levels prevail in Hungary

The general government budget accumulated a surplus of HUF 15bn in the initial two months of the year, despite the fact that it closed the month of February with a deficit of HUF 77.4bn. In February, revenues of the central budget were up by 7.2 percent compared to February last year. This figure has been mainly attributable to the massive growth of corporate tax revenues in February and the lower-than-anticipated amount of expenditures due to a drop in EU funding.

Hungarian fiscal data in this period typically show large deficits; however, the budget has this time posted a surplus of HUF 15bn. Economic growth in recent years has been accompanied by a steady improvement of balance indicators. The stabilization of the budget has also resulted in Hungary's exit from the excessive deficit procedure and the recent drop in the ratio of gross general government debt.

Background of real economic process

Favourable real economic processes are also helpful for maintaining low fiscal deficits. Economic expansion has contributed to the increase of tax revenues. This has been based on multiple pillars: on the one hand, economic growth is raising the level of employment, as the labour demand of enterprises has grown. Improving economic performance is pushing up wages, which in turn boosts fiscal revenues stemming from personal income tax payments and contributions. In addition, rising employment and wages are fuelling consumption which leads to VAT revenue growth. On the other hand, the pick-up of corporate activity increases receipts from corporate taxes.

In this regard it must be noted that the Hungarian Central Statistical Office last week revealed that the number of people in employment grew by 110 thousand last year, and in the month of January 2016 wages in real terms were up year-on-year by 6.4 percent.

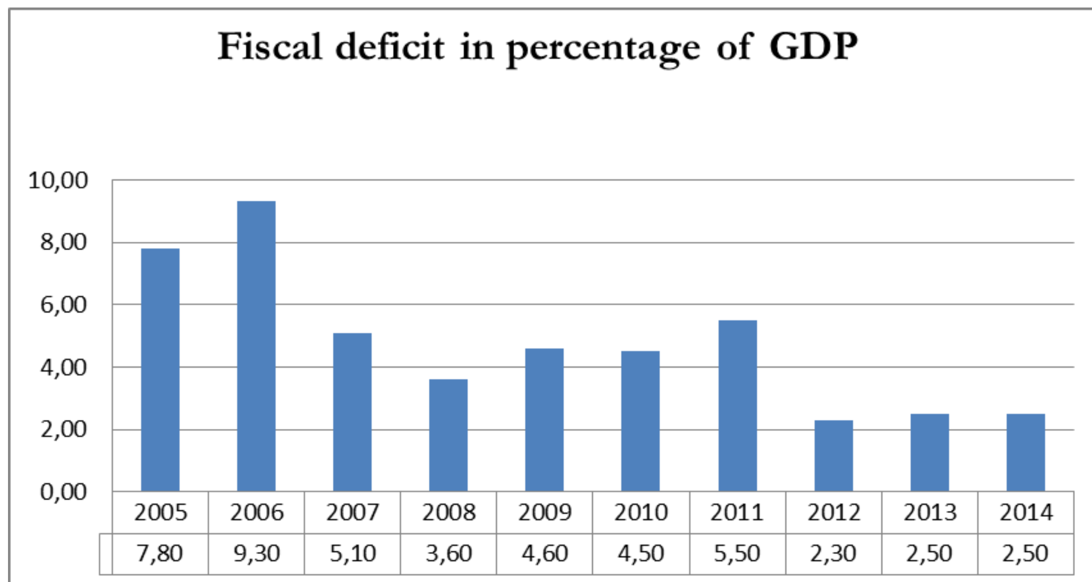
In the period November 2015-January 2016, the number of those in employment averaged 4 million 240 thousand, up by 113 thousand year-on-year. Employment rate in the age bracket of 15-64 years edged up to 64.5 percent; within that, the employment indicator of men showed the largest improvement.

In January 2016, average gross wages gained 5.8 percent compared to the corresponding period of the previous year. Wage increases have been underpinned by the 5.7 percent growth of the minimum wage and the guaranteed minimum wage, the wage hike of armed forces as well as the supplementary compensation paid for welfare sector employees. Thanks to the 1 percentage point cut of the personal income tax, net wage growth has exceeded that of gross wages, reaching 7.4 percent.

Changes in fiscal deficit over the past years in Hungary

After the crisis, Hungary's economic policy was confronted with the challenge of restoring the macro-economic balance and re-igniting the process of real-economic convergence. The unsustainable growth model of the prior era had resulted in the accumulation of massive debts which, coupled with balance-adjustment processes during the period of recovery, have significantly dampened economic performance.

In the past couple of years, however, Hungary has fulfilled the Maastricht criterion on fiscal deficit which stipulates that the deficit of the central government budget must not exceed 3 percent of a country's GDP. It has to be noted that between 2004 -- when Hungary joined the EU -- and 2010, the country could not once meet this goal. The below graph shows the changes of fiscal deficits. It aptly demonstrates that in 2014 a formerly usual phenomenon was ended: prior to that year, fiscal deficit used to soar in years of general elections. This phenomenon -- and its adverse effects -- is well known all over the world. It increases general government debt while the timing of higher state spending disregards the demands of economic cycles. Fiscal policies that do not adjust themselves to periods of boom and bust lead to growth risks, as they fail to generate extra demand when that would be necessary. In periods when an economy expands in line with its normal growth potential, demand-boosting fiscal policy generates inflation and the subsequent accumulation of state debt prevents it from deploying pro-growth instruments in a recession era that could stimulate capacity utilization.



2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
7,80	9,30	5,10	3,60	4,60	4,50	5,50	2,30	2,50	2,50

Source: Eurostat

Permanently low fiscal deficits naturally help reduce general government debt. As a result, falling interest payments generate extra revenues in the budget. Lower state debt levels lead to more favourable country risk indicators which in turn further improve financing conditions for the budget. Interest expenditures are this year expected to remain below 3 percent of GDP; this indicator used to be as high as 5 percent when the base rate of the MNB was 7 percent and a haphazard fiscal policy was pursued.

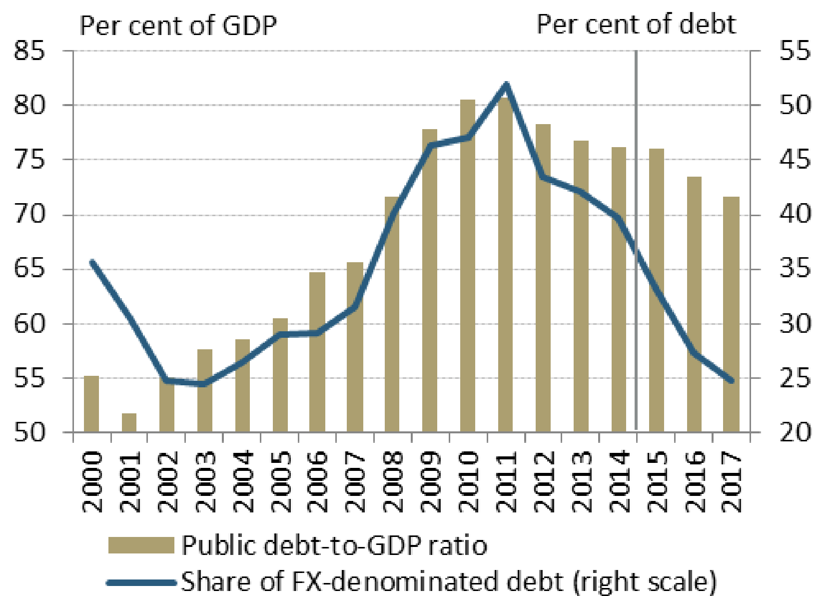
Prognoses on fiscal deficits and the state debt

Predictions on Hungary's fiscal deficit all agree that it will stay below 3 percent of GDP. According to the inflation report of the National Bank of Hungary for the month of December 2015, the ESA deficit of the central government will likely be 2.0 percent and 1.7 percent of GDP in 2016 and 2017, respectively. The improvement of the primary balance and the persistent decline of the net interest payments-to-GDP ratio resulting from the substantial decline of yields on government securities over the past three years have both contributed to the 0.5 percentage point drop of this year's deficit figure compared to last year. The MNB points out that the improvement of the balance of the central government sector has been the consequence of the combined effect of a massive decline of fiscal expenditures in percentage of GDP and a slight fall of revenues.

The European Commission's report published in December 2015 also predicts a fiscal deficit of 2 percent for this year 1.9 percent for next year.

The prognoses of both the MNB and the European Commission forecast that in 2016 and 2017 the fiscal deficit may drop to levels unseen since the regime change in 1989.

Similarly to fiscal deficit figures, expectations of both the MNB and the European Commission are upbeat on state debt indicators. In the opinion of the MNB, debt levels are likely to fall further when calculated with a EUR/HUF exchange rate from the end of 2014. Their prognosis predicts that the general government debt-to-GDP ratio is set to fall significantly in 2016 and 2017, to 72 percent by the end of the forecast horizon. In addition to more favourable inflows of EU funds, the reduction of debt will also be underpinned in the long term by a primary fiscal balance seen to post steady surpluses, gradually falling interest payments and economic growth. The European Commission also expects substantially lower debt ratios for this year and next: 74.3 percent and 72.4 percent of GDP, respectively.



Source: National Bank of Hungary (MNB)

Fiscal deficit and the vulnerability of the Hungarian economy

Morgan Stanley and Capital Economics have recently published reports of countries' economic vulnerabilities. The Morgan Stanley study concludes that in the observed period Hungary's

position has improved to the largest extent in the region. The favourable change in fiscal deficit levels has been instrumental for this improvement, which helps reduce state debt. In addition, the composition of state debt also shows improvement: the share of forex debt has been falling and that also helps mitigate vulnerability. The debt status of the private sector has also been improving and net external debt has fallen significantly. Among European countries with robust economic growth, Hungary was the country with the largest drop in the net external debt level. Thus, a more and more dynamic economic expansion has been coupled with the steady reduction of the country's vulnerability.

Analysts of Morgan Stanley have contrived the VSI (Vulnerability Scoring Indicator), which fuses several key indicators observed by investors, such as the external debt-to-GDP ratio, fiscal deficit, state debt and the lending-to-deposit ratio.

According to the analysts of Capital Economics, Hungary was given 2.3 points (out of 10) with regard to CERI (Capital Economics Risk Indicator) with makes us one of the top performers in the CEE region. The country received 1 point, the lowest score, in the categories trade balance, private sector lending and forint real exchange rate fluctuations. It was given 2 points in the external debt sub index and four points for share price changes in real terms.

The 2008 crisis has demonstrated that countries must place a larger emphasis on reducing economic vulnerabilities. In this aspect, Hungary has managed to achieve huge improvement between 2008 and 2015. Forecasts are predicting further progress in this direction. Analysts are prognosticating that these favourable processes will lead to an upgrade of Hungary's credit rating.

Accordingly, Hungary has been on a sustainable economic growth path. In order to maintain the pace of convergence, there must be further gains in competitiveness.