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Weekly Briefing

Hungary Economy briefing:
Hungarian economy’s ratings

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The 10th of November 2017, the Fitch has revised and upgraded its outlook on the Hungarian economy's ratings (long-term foreign and local currency issuer default) from stable to positive and the Fitch affirmed the ratings at BBB-. This move means an upgrading in 12 months unless negative economic trends emerge in the Hungarian economy. The Fitch argued, upgrading the outlook can be explained by the following factors: a combination of high current account surpluses accompanied by substantial EU-transfers, and by the deleveraging process taking place in the public and private sector of the Hungarian economy. The deleveraging process improved the net external debt position of the country which was only 9 percent in 2017, while 54 percent in 2014 in percent of GDP. In the forecast, the Fitch expects:

- surpluses on the current account balance will be lower but still positive next year;
- the government debt will slowly decrease to 72 percent (in percent of the GDP) to end 2017, from 74 percent in the last year;
- the government deficit will be still moderate (2.1 percent in 2017), despite the slight increase in contrast to 2016 (1.8 percent);
- the GDP growth will be 3.7 percent in 2017, and 3.5 percent in 2018;

The Fitch also stressed the importance of improved labor market conditions contributing to strong domestic demand that was one of the main drivers of stronger than expected growth in the Hungarian economy.

Former revisions of the outlook on the Hungarian economy and upgradings clearly triggered political discussions over the last years, however, this last one was not questioned and discussed by opposition parties and media. The silence can be explained by in the following factors. Surpluses on the current account balance are not now phenomena, since 2009, the Hungarian economy has had substantial surpluses, however these surpluses back then originated from increasing net exports and more importantly falling domestic demands after

2009. Between 2006 and 2010 the private consumption shrank each year; only after 2010 private consumption began expanding. Since 2010, surpluses on currents account could be kept despite the growing private consumption, since the consumption could expand by 4.6 percent in the first three quarters of 2017. In 2017, increase in private consumption was not fueled by new credits, but growing wages and strong demand in the labor market. Thus, the nature of current account surpluses is entirely different from earlier periods, when shrinking domestic demand was the underlying reason.

Another driving force behind the expanding GDP was rebounding investment, mainly public investment utilizing the inflow of EU-transfers in the new multiannual framework of the European Union. Gross fixed capital formation grew by around 25 percent in the first half year (2017), the increase in public investment reached 59 percent during the same period, while manufacturing (16.9 percent) trade, motor vehicle repairs (15.9 percent) grew at a much slower pace than the average. (According to media coverages, none of the 3 leaked scenarios on the EU-budget between 2020 and 2016 project decreases in the general amount of the budget, thus it is more likely, that EU-transfers will help the Hungarian economic development after 2020 as well.)

The difference between exports and imports have been growing over the last decade. The driving force behind this expansion have been manufacturing multinational enterprises from Western European countries. That is one of the main reasons why the Irínyi-plan defining the main goals of the Hungarian policy, included a plan of the re-industrialization of the Hungarian economy as a medium- long-term goal. In this plan, manufacturing sector was given a key role, however, that approach goes against mainstream economics that stresses the importance of the added value. The Hungarian economic managers clearly are aware of the theoretical background (endogen growth theories), however, they emphasize the relevance of job creation. The question remains how long it will take the robotization will cut into manufacturing jobs, eliminating the main value producing sectors of the Hungarian economy for the time being. Special

attention must be given to the Hungarian car-making industry that generated round 5 percent of the GDP, and it is most likely be affected by ongoing and future technological improvements (electric cars).

Despite the clear and looming changes in the labor market, changes in unemployment and employment rates are still very positive. Labor market conditions have continuously improved over the last period, and according to several estimates, the unemployment rate will drop to 4.0 percent until end 2017. Scarcity of labor is evident in capital city where there are plenty of vacant jobs and in the western regions of the country, where pull forces of the Austrian and German labor market are tangible. Structural problems of the Hungarian labor market will affect the growth potential of the Hungarian economy soon, dragging on the GDP growth, scarcity of labor is very clear in manufacturing and construction.

Public debt in percent of the GDP shrank over the last years; end of 2017, the debt ratio will be 72 percent in contrast to the 74 percent in the last year, however, the dispute between the Eurostat and the Hungarian Statistical Bureau (KSH) is not settled yet. The debate evolves around the question whether the liabilities of the state-owned Eximbank (an agency responsible for export credit financing of Hungarian firms) are part of the Hungarian public debt or not. According to the latest news (17-11-2017), the Hungarian Statistical Bureau (KSH) agreed on including the liabilities of the Eximbank in Hungary's public debt that would lead to an increase in the public debt by 2 percentage points.

The Eurostat questions certain transactions of the Central Bank of Hungary as well. According to the Eurostat and the European Central Bank (ECB), the Central Bank of Hungary (MNB) has programmes which traditionally are carried out by the state. If the Eurostat does not accept the Hungarian arguments, the debt ratio will substantially increase affecting the outlook on the Hungarian economy.

Regardless of how the dispute will be solved, positive trends regarding public debt and government deficits and surpluses are clear, it must be added

that the composition of the Hungarian debt has changed favorably this year, since the percentage of the Hungarian bond owners has substantially increased, creating a more stable financial environment, less exposed to the world economy shocks.

A positive sign in the aspect is that yields on the ten-years bonds of the Hungarian state were lower than those on US bonds last week. Government bond yields issued by the Central Bank of Hungary in November 2017 were 2.26 percent while the American bond yields were 2.34 percent. According to the textbook explanations, these data show that Hungary is being considered by investors as a very secure place to invest. However, the underlying reason for the favorable financing conditions can be found in the extremely low interest rates throughout the world, and the changes in American interest rates policy might only herald a new era when interest rates will return to their normal levels, when there will be more room for maneuvering in the Hungarian economy policy. The Central Bank of Hungary (MNB) still intends to keep interest rates low for the next couple years. The question is when the shrinking margin between Hungarian and American or German interest rates will reach a point when investors will turn away from Hungarian bonds choosing a more secure investment. If the Central Bank of Hungary (MNB) will be able to channel Hungarian savings into state bonds, future external shocks won't profoundly affect public debt financing of the country. It is most likely that the policies of the Central Bank of Hungary will be successful in maintaining this favorable economic environment the next years.

However, there are downside factors which must be considered by the macroeconomic managers of the country. Slowly accelerating inflation rates can force the Central Bank of Hungary (MNB) to alter its course and raise interest rates end 2018. The MNB might be forced to take this step, since scarcity of workers, high growth rates, robust consumption and rebounding investment already indicate a feverish phase in the Hungarian economy, although this economic growth rate can be kept for a while, most likely until the 2018

elections, thereafter a slight cooling period must follow, since real unit labor costs have already been on the rise over the last one and a half year (2016: 3.4 percent, 2017: 2.0 percent) indicating a slowly deteriorating competitiveness of the Hungarian economy.

To sum it up, after the Fitch revised its outlook on the Hungarian long-term foreign and local currency issuer default ratings and changed it to positive, the rating agency joined the Standard & Poor's which also revised and improved the rating of the Hungarian economy this August, when the country was given investment-grade. The Moody's took the same step last November (2016), then it argued that the positive changes in the debt composition explain the upgrading. The Moody's announced its new statement November 17, 2017, the announcement doesn't contain a credit rating action, at the risk factors tightening labor market and strong dependency are emphasized.

Generally, it can be states that improvements in the grading of the Hungarian public debt are to be expected end 2018, if inflation and interest rates can be kept at low levels, and planned tax relief won't affect tax revenues substantially, thus increasing public budget deficit.