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Weekly Briefing

Hungary Economy briefing:

Potential Output in the Focus-or How to deal with good news

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This briefing aims to survey the evaluations and assessments of the Hungarian economy's performance based on reports and analyses of several international organizations and rating agencies. In the briefing, we attempt to contrast these assessments to our evaluation of the Hungarian economy's recent performance. The paper looks in particular at reports and analyses of the EBRD, IMF, and the European Commission.

1. Downside risks: protectionism in the world economy – the evaluation of the EBRD

The European Bank for Reconstruction and Development (EBRD) issued its latest analysis "Regional Economic Prospects in the EBRD Regions" in November 2018. In the analysis, the Bank underlined the strengths of the Hungarian economy such as:

- robust growth,
- strong domestic demand, and
- significant investments.

The analysis stressed that after eight years of contraction, credit volume growth started to pick up in the Hungarian economy, whereas the bulk of credit growth came from the corporate side (around 10 percent on year on year basis), and the rise in household borrowing only slightly increased – by around 1 percent on year on year basis. The report put an emphasis on the so-called growth potential.

According to the EBRD, GDP growth is expected to reach an annual 4.3 percent in 2018, while the growth potential is around 4.0 percent in the Hungarian economy. In other words, they argue that given the present GDP growth rate of the Hungarian economy, the output gap has not only been closed during the recent period, but growth is above the potential. The optimal growth rate equals to the growth potential that is being reached when we fully utilize capital stock, and labor force in the economy, however, if the growth rate were above the potential, it would lead to overstretching capacities, and growing inflation. And the report states that these conditions can be found in the Hungarian economy.

On the downside, growth constraining effects of labor scarcity were emphasized in the report as well. The EBRD underlined that the potential trade war between the US and China might have detrimental effects on the open Hungarian economy where 3 percent of the finished goods (in term of added domestic value) are being exported to the US and China. The same negative effect could be forecasted if the United Kingdom would fall out of the EU without a Brexit deal. Despite the downside risks, the EBRD raised its GDP forecast from 3.8 to 4.3 in 2018 and from 3.0 to 3.3 in 2019.

2. Growing need for structural reforms – according to the IMF

In August 2018, similar positive growth estimates were issued by the International Monetary Fund (IMF). According to the IMF, the GDP growth in the Hungarian economy is expected to be around 4 percent in 2018. Both the IMF (3.0 percent) and EBRD (3.3 percent) estimate a slower GDP growth rate for 2019, however, the IMF highlighted decreasing EU funds and increasing inflation as risks threatening future growth. In contrast to the EBRD, the IMF drafted recommendations to Hungarian policy-makers: the report underlined the importance of structural reforms while welcoming the establishment of the Competitiveness Council. The IMF urged the Hungarian government to address challenges in the following areas:

- obtaining construction permits and electricity connection,
- an easing of paying taxes,
- fighting against perceived corruption;
- improving education and vocational training,

— reducing the number of participants in public work schemes

— leveling the playing field for all investors

- by reducing red tape and
- by simplifying the regulatory environment.

By and large, the IMF's assessment is positive about the future, and it doesn't formulate any serious threats as for the future of the Hungarian economy, however, the structural reforms the paper refers to, are already underway. Some of the proposed elements of the structural reform are already parts of the governmental reforms that have been launched this year, such as improving education and vocational training or reducing the number of participants in public work schemes.

3. EU transfers in focus – the evaluation of the European Commission

While the latest analysis of the European Commission similar to the EBRD's and IMF's assessment doesn't specify any serious economic challenge regarding the Hungarian economy, there is still an ongoing dispute between Hungary and the European Commission about EU-funded projects, that might not be settled until the end of 2018 despite former news in the media. As we emphasized in our earlier briefings, the delay in transferring EU-funds to Hungary has already increased the budget deficit well above the targeted annual deficit. By the end of August budget spending related to EU projects were around nine times higher than the actual reimbursements. (1.388 trillion HUF versus 183 trillion HUF). However, it must be underlined, the cash-flow budget deficit might increase significantly, it doesn't have any impact on the deficit calculated basing on EU standards. As a result of that, the Hungarian budget deficit will be still around 2.4 percent of the GDP, which is below the EU's 3 percent ceiling.

4. Going for stronger competitiveness – the analysis of the Standard and Poor's

The Standard and Poor's (S&P) reaffirmed its earlier assessment of the Hungarian economy's performance in August 2018. (BBB– and A–3 for the long and short-term foreign and local currency sovereign credit ratings). The outlook remained stable and positive. The S&P underlined Hungary has a strong external profile, i.e. a "resilient export-driven economy, low private sector debt levels, and the flexible exchange rate regime". All these elements support the stability of the economy. In contrast to former analyses, the S&P also investigated the efficiency of the political system. Though this approach can be justified in long-term analyses, however, one can raise doubts on how this approach can be applied in rather studies focusing on short-term issues. The analysis refers to "Relatively weak checks and balances between government branches, moderate wealth levels" as problems. As for the future, the S&P also underlines that there are signs of an overheated economy in the Hungarian economy, where labor shortages and fast wage growth could lead to weaker competitiveness unless policy measures are implemented by the government to boost productivity.

5. Low potential growth – the Fitch Ratings' assessment

The Fitch also affirmed Hungary's rating in August 2018. (Long-Term Foreign- and Local-Currency Issuer Default Ratings at BBB– with a Positive Outlook.) The communication of the Fitch underlined that sustained current account surpluses (around 2.3 of GDP in 2018) have fundamentally improved the stability of the economy. Net FDI inflows and EU transfers also contribute to this stability. The 2.3 percent current account surplus is outstanding if compared with countries with similar ranking. The average of the peers is –1.9 percent of the GDP.

The analysis underlines that the structure of public debt has improved and it is favorable: only 20 percent of public debt is nominated in foreign currencies, the non-resident holding of government debt is declining; and only 5 percent of the current debt is short-term external debt.

The Fitch estimates that the GDP is to grow by 4.0 percent in 2018, in line with others it also forecasts a slower GDP growth rate for the next year (2019). The growth is still driven by public and private investment and EU transfers, they argue. The Fitch believes that the growth potential is around 2 percent, which is not only lower than that of countries with similar ranking (BBB–) but it is much lower than the estimate of the EBRD (4.0 percent.)

6. The summary

Based on the above-mentioned evaluations of the Hungarian economy, we can conclude easily that the Hungarian economy must have reached the potential growth rate and it can go above it if everything remains the same. The discussion is about whether the present growth rate has just reached the potential growth or it is already above it, is insignificant since the potential growth rate of an economy is not a given number, it can be influenced, moreover, it can be increased by proper economic policy measures. Obviously, the new economic policy elements – adopted after the third victory of the Fidesz-KDNP in the Hungarian elections – center more and more on changes with the potential to boost productivity, attract more foreign direct capital investment and increase the pool of potential labor in the economy. One of the plans is to lay off workers in the public labor market and guide them into the private labor market. According to present plans of the government jobs will be cut by 10 percent in the ministries, and by 8 percent in the institutions of governmental bodies. These ratios are already below the earlier announced number – varying between 15 and 20 percent.

Slowly rising inflation and labor market bottlenecks also indicate that the growth rate will be sustainable even if EU transfers would decline in the medium term. At the same time, as we pointed out earlier, in coming months the reform of public services and cutting the number of public workers will contribute to the rise of potential growth, since new workers will be available to the private labor market and the new inflow of worker into the private labor market can ease the labor-scarcity, however it is clear that further steps are required to change the potential growth of the Hungarian economy.