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Hungary Macro Monitoring

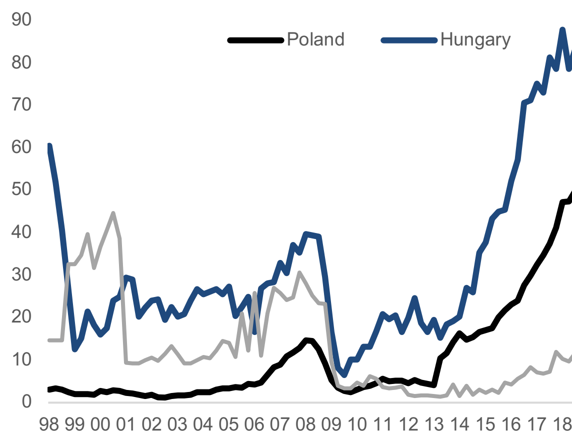
Hungary: Not as dormant as it may appear

The MNB has kept its monetary policy stance "cautious, but loose", unchanged since the spring. The MPC's communication appears puzzling to many, given the very tight labour market and gradually rising inflation.

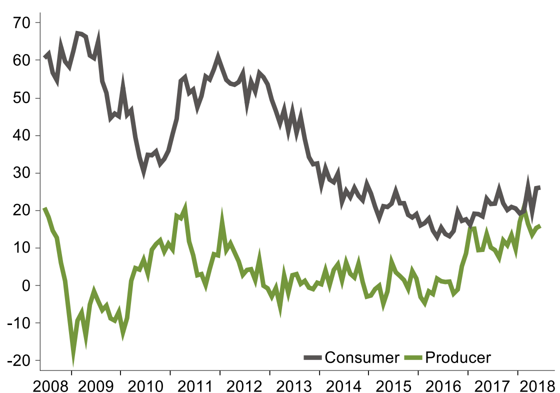
In the last week, however, significant government measures have been announced that should support the Council's neutral stance. The government is planning to fire 15-20% of the public administration, and introduce the flexibility and incentives needed to bring back workers from retirement. This, in our calculations, could unlock 250k workers, and potentially more, which would significantly alleviate the labour shortage in the near term. The MNB also released its "180 steps" plan to boost competitiveness, in line with the Cabinet's priority to increase competitiveness. We believe this document should be taken seriously by investors, as the Orban administration has a track record of announcing and implementing its goals.

The Monetary Policy Council kept interest rates unchanged this week, and the tone of the press statement was not particularly different to previous ones. The Council reiterates that its sole goal is inflation and that it takes into consideration all factors to assess whether inflation will be sustainable at 3% in five to eight quarters. It noted that inflation rose recently, but expects the inflationary effect of world crude prices to subside in the near term, and noted that wage pressures and inflation expectations remain modest.

Industrial companies' perception of the bottlenecks for production: labour shortage



Index of price expectations 12m ahead



Source: Macrobond, ADA Economics

In the last week, the government has announced critical measures, in our view, that will have an impact on both monetary policy and the growth potential of the economy, in the long run. Three broad sets of measures were announced that should have an impact fairly quickly: we guess in under 12 months:

- The number of jobs in the public administration will be reduced by 15-20%, which implies around 86k of redundancies.

- Individuals that have reached retirement age will be allowed to return to work if they wish and, should they do so, there will be a fiscal incentive for both employers and employees. It is difficult to say how many workers could return to work, as a recent survey by GKI showed that half of retirees would like to go back to work, but it will depend on whether they are sufficiently fit to do so. We assume that around 150k workers return to the labour force.

- The government will deploy HUF 16bn to boost the productivity of construction companies, which have been particularly badly hit by the labour shortage.

Together, these measures should, in our view, unlock at least 250,000 workers within two years, who could be redeployed elsewhere in the private sector. Given that the current number of unemployed is 165,000, with an unemployment rate of 3.5%, we believe that such an increase in available labour should significantly reduce the pace of wage growth in the next two years, from our current expectation of 12-15% through to the end of the decade, to perhaps c.7-8%, on average, going forward.

Of course, these measures do not immediately address the relatively low productivity of some segments of the labour market - the workers that will become available may not have the appropriate skills for the manufacturing and services sectors – but at least it should temporarily reduce the problem.

For the long term, one of the key priorities announced for Orban’s third term is to boost productivity, especially within the SME sector. The MNB recently released a “180 steps” plan to support that goal, and to accelerate the convergence process in the next 15 years. The programme includes the following key aims:

- Boosting the quality of education and healthcare services, and supporting a family friendly environment overall. It is critical to note that the MNB suggests widespread support for education in a second language. Over time, this would reduce one of Hungary’s biggest production bottlenecks: there are simply not that many people that speak Hungarian, while the economy is cruising at a pace of growth of 3-4%.

- Productivity growth of around 4% a year.

- Boosting the investment rate to 23-25%, from 20-21% currently.

- Tax reductions of a further 5ppt on the labour tax wedge and extending the MAT plan (a scheme that provides a tax discount to companies that hire less-qualified workers), with the aim of increasing the employment rate further, and facilitating the return of Hungarian workers living abroad (which may bring home at least 100,000 workers).

- Improving the efficiency of the public administration, including: a boost in the number of digital public services available (currently, Hungary appears well below the average in the EU); a reduction in the number of hours spent on “red tape”; and attempting to further “whiten” the economy.

- Favouring import substitution, to keep the current account in surplus and develop local production capacities, while continuing to support export capacity.

- In order to boost the productivity of SMEs, the government plans to encourage the process of gaining scale via: supporting production clusters; fiscal support for investment; and creating support centres to boost management knowledge at the SME level.

- Boosting the quality of infrastructure, particularly railways and upgrading the electrical network (and significantly increasing energy efficiency).

We believe that the “180 steps” plan is an important document, even though it does not contain the “funding plan” for these measures. The Orban administration has proven time and time again that it can deliver its objectives, and has the political and skills abilities to do it, so we do not believe that this time will be different. However, this is more ambitious, and should be interpreted as a plan to unfold over a decade. Equally important, the content of the measures signals a change in the growth strategy, in our view, and a focus on increasing the quality of life of families should be a critical competitive edge in the current world, especially while Hungary still benefits from below-EU average wages.

These measures will probably lead to a lower wage growth path than we had priced into our inflation models, and thus pose some downside risk to our call for 100bp of tightening next year. While we do not believe this plan takes away the case for rate hikes completely, we do flag the risk of a delay to 2020E. Ultimately, all these measures imply that potential growth in Hungary could increase from around 3% to around 4%, which would place Hungary at the top of the growth potential league in the region: above Poland, Romania and Turkey, probably. In addition, this strategy, in our view, should facilitate a less-severe economic downturn compared with Hungary’s historical experience when the bottom of the business cycle is hit.

Our view on the currency does not change as a result of these announcements. The balance of payments in the coming 18 months will be largely dictated by the narrowing of the trade surplus (as global growth moderates, while domestic demand stays strong) and a growing risk of capital outflows via the “other” investment segment, which reflects a reallocation of capital by multinationals abroad. We thus reiterate the view of average HUF 330/EUR rate in 2018E and 2019E.

ADA Team, 22nd August 2018

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