HUNGARY

FULL-FLEDGED GROWTH

Hungary is benefiting fully from a high international trade exposure, which is now driving its growth. Supply-side pressures are increasing, with high capacity utilisation rates and rising scarcity of labour. These local issues come on top of global industrial shortages. This has resulted in a significant acceleration in inflation, to which the Central Bank has responded with its first policy rate increase in 10 years. Nevertheless, monetary policy remains relatively accommodative, as the Central Bank has acquired the equivalent of nearly 5 points of GDP of government debt in 2021. This support is important in a context where access to European funding (including the resilience and recovery plan) remains subject to sticking points (notably the rule of law clause). None of this undermines the two other driving factors behind Hungary's growth: a credit cycle financing a recovery in investment in construction (relatively sustainable, given the limited indebtedness of the private sector) and the attractiveness of the industrial base to foreign investment.

A FAVOURABLE ENVIRONMENT

Hungary is experiencing strong growth and significant inflationary pressure. On both indicators Hungary is near the head of the list of Central European countries.

The recovery in growth comes from a sharp rise in exports, driven by strong foreign demand, particularly in the automotive sector. The rebound in domestic demand has been limited by repeated severe waves of Covid, particularly in the spring of 2021. Household consumption is the only demand driver that has not yet returned to its pre-Covid level; this has been reflected in a higher savings rate (15% in 2020, from 12% in 2019).

This said, the economic situation has some similarities with pre-pandemic patterns, with high capacity utilisation rates and labour scarcities (unemployment rate of 4.8% in August 2021). These supply-side issues are exacerbated by the size of the manufacturing sector against a background of global shortages (particularly for semiconductors). Business confidence surveys show that these shortages are getting worse. Indeed, since the 3rd quarter they have become the main factor inhibiting production of intermediate and capital goods. The construction sector has experienced the same bottlenecks as a result of shortages of labour and materials.

Meanwhile, domestic demand should accelerate. The normalisation of the pandemic situation (with high vaccine participation) will lead households to raise their spending intentions, notably in the area of home improvements.

TIMELY MONETARY CONSOLIDATION

Thus, everything seems to suggest an acceleration in inflation, which reached 4.9% y/y in August. This is already higher than its pre-Covid level. This issue is even more acute for companies, with producer prices up 14.4%.

This led the Central Bank to begin tightening monetary policy in June 2021, for the first time since 2011. Such rarity of monetary tightening actions results from the room to manoeuvre available to the Central Bank, which can tolerate inflation above its target of 3% if inflation can still converge at this level over the medium term. For example, in 2018-19 inflation exceeded 3% in 14 of the 24 months without any intervention by the Central Bank.

The Central Bank made three increases of 30bp, before scaling back the size of the steps with an increase of just 15bp in September (taking the policy rate to 1.65%). This suggests that the Central Bank considered that the bulk of the rate increase had been achieved and that it was now more likely that inflation would return towards 3% over the medium term (end-2022).

However, core inflation has risen over recent months, reaching 4% in September. Against this background, the slowing of the pace of rate rises in September had a direct impact on the forint, which had been relatively stable until this decision, but which lost nearly 3% over the days that followed.

FORECASTS

	2019	2020	2021e	2022e
Real GDP growth (%)	5.1	4.9	-5.8	5.5
Inflation (CPI, year average, %)	2.8	3.0	3.5	3.3
Gen. Gov. balance / GDP (%)	-2.1	-2.0	-6.0	-4.0
Gen. Gov. debt / GDP (%)	70.2	66.3	74.0	73.4
Current account balance / GDP (%)	0.0	-0.8	-2.0	-1.3
External debt / GDP (%)	77.0	78.0	82.0	76.8
Forex reserves (EUR bn)	27.4	28.4	30.0	31.0
Forex reserves, in months of imports	3.1	3.0	3.7	3.4

e: ESTIMATES & FORECASTS

TABLE 1 SOURCE: BNP PARIBAS GROUP ECONOMIC RESEARCH

EXPORTS OF GOODS (12-MONTHS SUM, HUF BN)

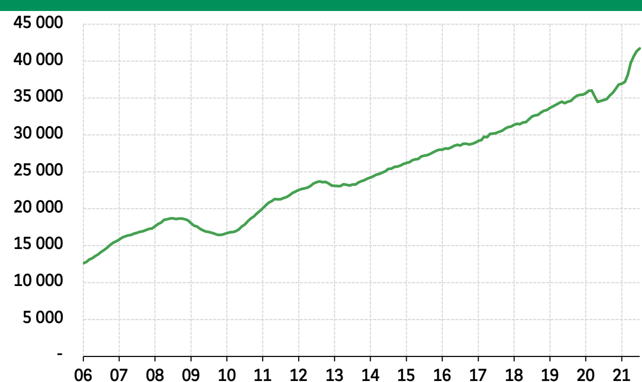

CHART 1 SOURCE: CEIC

UNCERTAINTIES ON FISCAL CONSOLIDATION PATH

Hungary should also be able to consolidate its public finances after the substantial fiscal support provided in 2020 (9.2 points of GDP in direct measures and 4.3 points of GDP in loan guarantees). As a result, the increase in government debt was amongst the biggest in Central Europe (up 15 points of GDP). The Central Bank made a growing contribution to financing this effort, by purchasing government debt in significant quantities: 2.4% of GDP in 2020 and an estimated 5% of GDP for the whole year of 2021.

However, many of the fiscal measures related to the pandemic are likely to be lifted as the situation returns to normal. Alongside this, the Central Bank has started to reduce its weekly purchases (HUF 40 billion from end-September 2021) and is likely to continue in this direction.

The strength of growth is likely to favour fiscal consolidation, even if the government plans to continue to provide considerable support to the economy in 2022 (expected deficit of 5% GDP). Meanwhile, long-term rates have tended to increase more than in other Central European countries, with a 10-year rate of 3.5% on 5 October, an increase of 150 basis points since the end of 2019.

The risk of delays to European funding disbursement under the resilience and recovery plan has increased, including the grants involved. If these are not paid in full, the debt issuance needed to make up the difference could increase Hungary's government debt by nearly 3 points of GDP. This would imply a stabilisation of government debt in 2022 at close to 80% of GDP.

CREDIT RISK UNDER CONTROL

Hungary is still enjoying the benefits of its banking sector consolidation that took place throughout the previous decade. Debt in the non-financial private sector is thus relatively low, and the share of foreign currency debt is contained. However, Hungary entered a credit cycle in 2018, with most notably an increase in residential real estate investment.

The debt repayment moratorium introduced in March 2020 saw much higher participation than elsewhere in Central Europe: 30% of loans to households by value were covered, compared to 20% of the value of loans to companies. This moratorium helped limit credit risk during the pandemic and the banks' non-performing loan rate fell to just 0.9% in the first quarter of 2021. This rate is now likely to rise, as the moratorium has come to an end for the bulk of the loans covered. Central Bank stress tests suggest that it could reach 4% in a negative scenario. The banks have a satisfactory level of capital (CET1 ratio of 17%) and were able to maintain their margins despite the moratorium (ROA of 1.4%). They should thus be able to cope with the potential increase in non-performing loans.

As the economy has reopened, credit growth has resumed, supporting household investment in construction. This growth does not so far appear to have been affected by the beginning of monetary tightening, with households' borrowing capacity remaining high (low indebtedness, strong income growth). Strong demand for real estate could result in an acceleration in price rises (14% y/y in the first quarter of 2021), against a background of shortages in construction materials.

FDI STOCK (HUF BN)

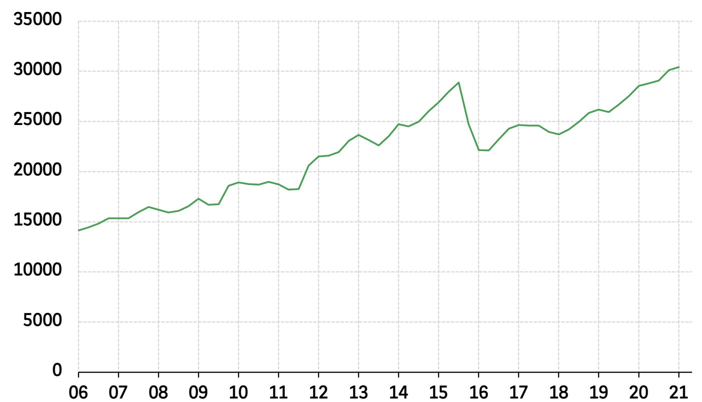

CHART 2

SOURCE: CEIC

ATTRACTIVENESS FOR FOREIGN INVESTORS REMAINS

Hungary is heavily involved in global supply chains. This is true in upstream areas, with the highest rate of Chinese inputs in the European Union. It can also be seen downstream, with the weight of exports in GDP.

The increase in transport costs (notably prices for container transport) and the transformation of supply (increasing use of electronics in the automotive sector) could change the landscape. The prospect of tax harmonisation on an international level could also limit incentives to invest in Hungary (preferential corporate tax rate).

Repeated labour shortages are also a factor limiting potential growth, despite strong and lasting productivity gains (3% per year on average over the last 4 years). In parallel, foreign direct investment continued to remain strong during the pandemic. A more negative factor could arise in case delays or incomplete disbursement of European financing, which has made a significant contribution to the country's development so far.

Completed on 6 October 2021

Stéphane COLLIAC
stephane.colliac@bnpparibas.com