HUNGARY

GEARING TOWARDS BUDGET CONSOLIDATION

Economic growth remained very dynamic until the first quarter of this year. Strong wages growth and significant government measures to back up purchasing power over this period have supported consumer spending. Inflation rose sharply in recent months but remained lower compared to other Central European countries, due to a price cap on certain food and energy related goods. Economic growth is expected to slow down significantly in 2023, owing to the deterioration in the international environment, monetary and fiscal tightening from H2 2022. The temporary suspension of European funds presents a serious challenge given that budget and current account deficits have increased and external liquidity has eroded.

DOMESTIC DEMAND IS HOLDING UP WELL

The macroeconomic consequences of the war in Ukraine are not yet reflected in growth figures in Q1 2022. Economic activity continued to grow, by 2.1% q/q after 2.2% and 1.1% respectively in the previous quarters. It was primarily driven by strong domestic demand, currently at 7% above its pre-Covid level. The strong performance in terms of consumption (retail sales up by 9.2% compared to January 2020) can be explained by new supportive measures implemented by the government, ahead of the legislative elections last April. These included bonuses, income tax cuts, or the payment of an additional month's pension. Other government measures aimed at supporting households' purchasing power included a temporary freeze on 1) prices of energy and certain food items and 2) mortgage rates. Similarly, the moratorium on loan repayments has been extended until December 2022. Furthermore, the average salary increase over the past few months has been higher than inflation, thus has contributed to support the purchasing power of household incomes against a background of rising inflation (10.8% year-on-year in May). Contrary to expectations, investment remained strong in the first quarter with an increase of 4.4% in Q1 2022 following 0.2% q/q and 2.1% q/q respectively in Q4 2021 and Q3 2021. Net exports, on the other hand, were a drag on activity.

Economic indicators suggest a slowdown in activity over the next few quarters. Retail sales excluding vehicles appear to have peaked in March. Industrial production has also weakened since March, probably due to supply disruptions and rising costs for intermediate goods and raw materials. In May, the drop in new orders and the increase of delivery times, reflected by the underlying manufacturing PMI indices, suggest that the decline in industrial activity could continue over the short term. As a result, investment could suffer in coming quarters. The uncertainties related to the war in Ukraine are weighing on business confidence and will undoubtedly lead to the postponement of projects. Similarly, the recent introduction of a tax on windfall corporate profits in certain sectors could have a negative impact on investment decisions.

In terms of foreign trade, exports have increased at a slower pace in recent months while imports have remained high. Hungary's direct exposure to Russia in terms of exports is very low, at 2.1% of GDP, but the indirect effect through trade relationship with EU is significant. In contrast, Hungary is heavily dependent on Russia for its energy supply (50% of energy imports). At the present time, the EU embargo on Russian oil imports does not apply to Hungary, Slovakia and the Czech Republic.

The expected slowdown in activity over the next few months will nonetheless have a limited impact on growth in 2022 due to the significant carry-over effects in the first quarter, currently at 5%. Real GDP growth is likely to remain very strong at 6% this year. In contrast, it is expected to slow significantly to 2.9% in 2023 due to inflation remaining at high levels and slowing activity in the advanced countries.

FORECASTS

	2019	2020	2021	2022e	2023e
Real GDP growth, %	4.6	-4.7	7.1	6.0	2.9
Inflation, CPI, year average, %	3.3	3.3	5.2	11.0	10.0
Gen. Gov. balance / GDP (%)	-2.1	-8.0	-6.7	-5.4	-3.7
Gen. Gov. debt / GDP (%)	63.9	77.6	74.4	72.2	69.9
Current account balance / GDP, %	-0.7	-1.0	-2.9	-3.9	-3.0
External debt / GDP, %	84.4	89.0	82.3	75.8	68.0
Forex reserves, EUR bn	28.4	33.7	38.4	37.1	35.8
Forex reserves, in months of imports	3.0	3.8	3.7	3.2	3.0

TABLE 1

e: ESTIMATE & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

HUNGARY: INDUSTRIAL PRODUCTION AND RETAIL SALES

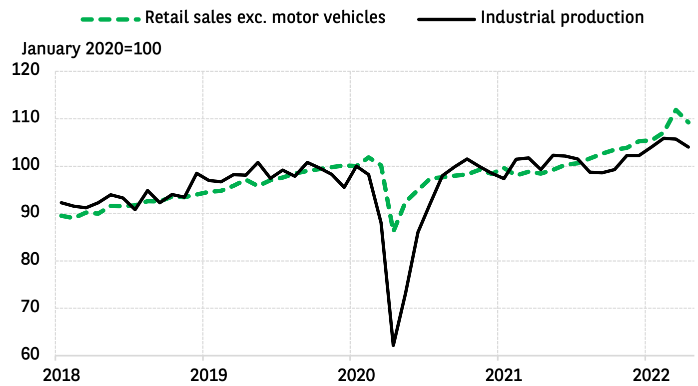

CHART 1

SOURCE: HUNGARIAN CENTRAL STATISTICAL OFFICE, BNP PARIBAS

MONETARY TIGHTENING TO COMBAT INFLATION

Central European countries (CECs) have been experiencing a sharp rise in consumer prices since end 2021, exacerbated by the war in Ukraine. The rate of inflation is higher than European Union's average and other emerging countries in Asia and Latin America. In Hungary, it has been at its highest since 2001 (+10.7% year-on-year in May) and well above the Central Bank's target of 3%. However, inflation is relatively lower than other CECs owing to a temporary freeze on commodity and energy prices, initially until June and then extended until 1st October.

Food and transport were the main contributors to inflation at 4.3 points and 1.9 points respectively in May. But core inflation (+9.1% year-on-year in May) also picked up significantly, reflecting all production costs, including wages. Inflation could reach an average of 11% in 2022 and remain at high levels in 2023 due to high wage pressures.

Monetary tightening that began in June 2021 was gradual at first. The pace then has gained momentum since the beginning of this year, bringing the benchmark rate to 7.75% end of June, a cumulative of 715 bps since this cycle began. This tightening is all the more justified as the forint has depreciated by 8.6% against the euro since the end of 2021 and foreign exchange reserves have fallen significantly. The import coverage ratio was low at 3.7 months at the end of 2021, even if the floating exchange rate regime and EU membership limit the liquidity risks. Monetary tightening is likely to continue in the coming months. It is however worth noting that monetary policy is not really restrictive, as the real interest rate calculated in relation to the policy rate or the 5 or 10-year bond rate still remains negative.

TEMPORARY SUSPENSION OF EUROPEAN FUNDS

Hungary has been temporarily suspended from obtaining European funds under the Recovery and Resilience Plan, worth EUR 7.2 billion in subsidies over the period 2021-2023. EU's decision to block these funds prevents the country from having access to an important source of financing for balancing the budget and the current account.

Budget deficit is likely to exceed the official target of 4.9% this year. Over the first five months of the year, the deficit has already reached HUF 2879 billion, or 4.6% of GDP. Besides, funding costs have increased significantly due to monetary tightening and markets' overreaction in the context of the current geopolitical situation. The average yield on 5-year bonds has reached 5.62% in June, an increase of 212 bps compared to January 2022. Against this backdrop, the recent measures announced by the government should contribute to contain the deterioration in the public accounts. Expenditure (including public investment) is expected to be reduced in the second half of 2022. In addition, a tax on companies' windfall profits may be applied temporarily in order to support government revenues. The government debt-to-GDP ratio is expected to decline on high nominal growth but this ratio should remain above 70% in 2022.

The current account balance was structurally in surplus until 2019. It turned into deficit in 2020-2021. In 2021, the widening of the current account deficit was mainly attributed to the pronounced slump in the trade balance. The income balance, structurally in deficit, also worsened last year. Furthermore, the balance of services, in surplus, has not yet returned to its pre-Covid level. The fall in income from tourism partly explains this situation. Travel component in the balance of services was at HUF 803 billion at the end of 2021 compared to 1,324 billion at the end of 2019, or only 61% of its pre-Covid level.

HUNGARY : CONTRIBUTION OF PRINCIPAL COMPONENTS TO INFLATION

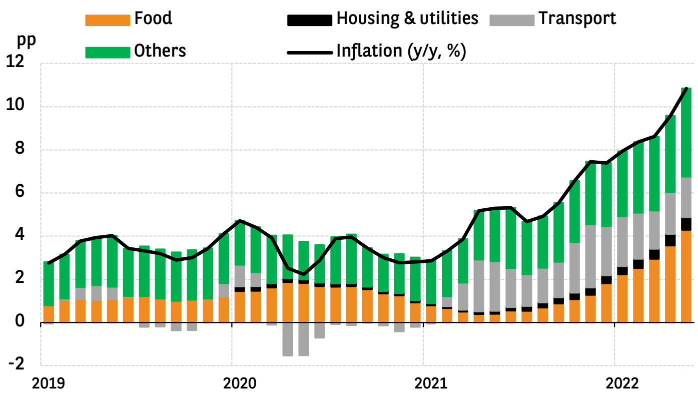

CHART 2 SOURCE: EUROSTAT, BNP PARIBAS

This year, the current account deficit will widen due to higher energy bills and weaker exports. The trade balance stands at EUR -1,544 million cumulatively over the first 4 months of the year compared with a trade surplus of EUR 2,920 million over the same period last year. Next year, we still expect a current account deficit due to a more marked economic slowdown in Hungary's main trading partners alongside with energy prices remaining at high levels.

Article completed on 30 June 2022

Cynthia KALASOPATAN ANTOINE
cynthia.kalasopatanantoine@bnpparibas.com