HUNGARY

THE IMPORTANCE OF BEING EARNEST

The Hungarian economy was hit particularly hard by the effects of the Covid-19 pandemic in the 2nd quarter of 2020, due to the weight of exports in its GDP. The shock seems to have been absorbed relatively well, with the government and central bank focusing on supporting the labour market and introducing the necessary moratoriums on interest payments and loan repayments. The stimulus measures introduced have been constrained in particular by the need to avoid an excessive depreciation of the forint. The reduction in government debt, interrupted this year, is likely to get back on track quickly, within the framework of an unchanged strategy: maintaining a moderate corporate tax in order to continue to attract foreign investment in the manufacturing sector.

A BRUTAL SHOCK, RELATIVELY WELL ABSORBED

As a country focused on exports, Hungary suffered a bigger than average hit from the Covid-19 pandemic (compared to Emerging Markets' peers), with a GDP drop by 14.5% q/q in Q2 2020.

The economy has bounced back in recent months, but short-term indicators have confirmed that exports lag domestic demand, notably consumer spending which made a substantial contribution to the recovery after the end of lockdown. By contrast, exports in June and July merely returned to pre-crisis levels.

This asymmetry in demand (coupled with a fall in investment) can be seen in trends in manufacturing production, which remains below its pre-crisis level, held back primarily by export sectors, particularly automotive production, down by 15%, and metals (-20%). The lag in manufacturing exports and the fall in tourism receipts are likely to result in a widening of the current account deficit, but not beyond 2% of GDP, a level which remains easily sustainable.

The comeback of private consumption explains the speed with which inflationary pressures have reappeared, after a period when lockdown and lower oil prices had driven them down. Excluding energy prices, inflation was even higher in July (about 4%) than it was at the beginning of the year. Meanwhile, it would seem that the situation in the labour market is relatively little changed. Granted, unemployment increased from 3.5% of the active population at the end of February to 4.7% in July. However, wage growth continued over the first half, a sign of continued market tension: wages were up 6.3% year-on-year in real terms.

The renewed inflation pressures have created a constraint on monetary policy, the easing of which, at the end of the lockdown, has again been interrupted. The gap between Hungarian inflation and the European average limits the Central Bank's leeway to ease. Given that capital is allowed to move freely within the European Union, stabilising the exchange rate assumes that monetary policy will be constrained (as a result of the 'impossible trinity'): higher inflation than in the euro zone implies a higher interest rate.

In April, this constraint led the bank to raise the upper end policy rate of its interest rate corridor to 1.85%, giving it the de facto ability to limit liquidity when the forint comes under excessive pressure, as the bank believes that too low interest rates can weaken the forint. Under these conditions the forint should be stable over the next few months at around the current rate of 360 forints per euro, and this stability will be supported by increasing foreign currency reserves.

Overall, the conclusion that the economic fundamentals have not been lastingly changed by the Covid shock continues to hold sway. Although GDP is not expected to return to pre-crisis levels until Q1 2022, the convergence of Hungary's average per capita income towards the European average looks set to continue.

FORECASTS

	2018	2019	2020e	2021e
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
Exchange rate EURHUF (year end)	321.0	330.0	360.0	365.0

TABLE 1

e: ESTIMATES AND FORECAST
SOURCE: BNP PARIBAS GROUP ECONOMIC RESEARCH

MANUFACTURING PRODUCTION (LEVEL)

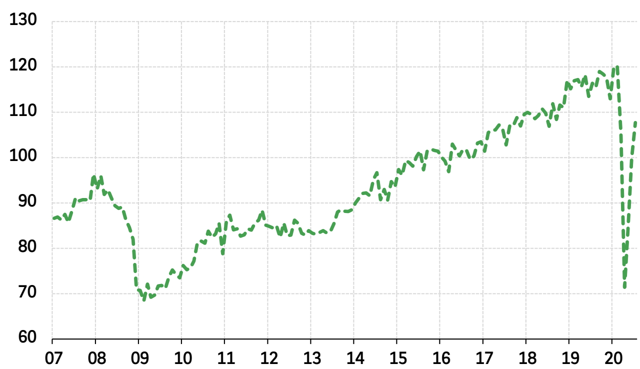

CHART 1

SOURCE: CEIC, BNP PARIBAS

POLICY MIX: SUPPORTIVE, BUT CONSTRAINED

In front of the Covid-19 crisis, the Hungarian government has adopted an interventionist policy, most notably through the granting of greater powers to the Prime Minister. However, this has not resulted in any significant disruption to economic policy.

Constrained in the use of its policy rates, the central bank has focused on supporting liquidity in the economy through a moratorium on debt payments for households and companies who met the criteria and wanted to take up this option. The modest level of household indebtedness, 32% of income, was not a challenge.

However, domestic credit to non-financial corporates required closer attention, particularly as 42% of it is denominated in foreign currencies. Business lending increased as a result of the issue of government-guaranteed loans, together with a programme of lending to SMEs at subsidised rates, but remained modest at around 20% of GDP in 2020, from 30% in 2010.

Meanwhile, the Central Bank began to purchase government debt, albeit fairly late in the day (since May): pressure on Hungarian long-term rates has remained under control (as has the risk premium against the German Bund), benefiting from recent years' reductions in debt ratios. Ten-year rates are therefore likely to stay close to their current level of 2.4% through to the year-end, which is below the implicit average interest rate of 3.5% on Hungary's sovereign debt. The sensitivity of the sovereign risk premium to capital flows has fallen in line with the share of government debt held by foreign investors (from 60% a few years ago to around 30% now).

The support to the economy from fiscal policy has been significant and has come mainly in the form of tax and social security payments holidays and wage subsidies, including for new hires. These latter measures help explain the limited damage to the labour market and the noticeable recovery in consumption. The government has also provided additional funding to priority sectors (including tourism, healthcare, transport and logistics) as well as subsidised and/or guaranteed loans to companies and for the financing of exports. Ultimately, the government deficit is likely to climb to 6% of GDP in 2020, a relatively good performance compared to neighbouring countries.

The adherence to a fiscal rule since 2016 (which will remain in force until government debt is below 50% of GDP) has been a key factor in reducing government debt to GDP ratio. The government is already planning a fiscal consolidation in 2021, bringing the deficit down to 2.9% of GDP, and thus taking it back below the 3% threshold. Although this looks like an optimistic outcome, the scenario of a fiscal consolidation from 2021 is plausible.

The priority is to maintain fiscal targets that are consistent with a relatively low-tax approach, particularly for businesses, in order to continue to benefit from strong levels of foreign direct investment. This investment is a significant source of stability for a country whose currency reserves are stable at a relatively low level, as it creates sustainable financing of the current account deficit that re-emerged from 2019.

ATTRACTIVENESS RELATIVELY UNCHANGED

The automotive value chain has a substantial weight in the Hungarian economy, involving both carmakers and car suppliers (notably metals companies and component makers). The impact on this sector from falling demand throughout Europe in the 2nd quarter of 2020 represented an additional drag on its recovery, coming on top of the effects of local lockdowns that resulted in factories being shut down.

As a result, miscellaneous evidence showed announcements of a limited postponement of investment in the sector and the total volume of gross foreign direct investment fell by 14% in the first half of 2020

FOREIGN DIRECT INVESTMENT (EUR BN), BY SEMESTER

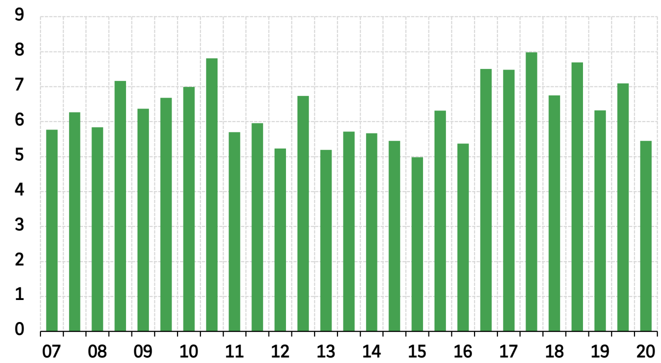

CHART 2 SOURCE: CEIC, BNP PARIBAS

relative to the same period in 2019. That said, investment is still likely to represent nearly 9.5% of GDP in 2020 and will remain important for the future of the country's industry: the value added locally represented only 45% of Hungary's automotive exports value in 2017, one of the lowest share in Central Europe.

The flexibilization of the labour market that has taken place over the last decade, coupled with the lowest corporate tax rate in Europe (9%), have been significant factors in the development of export-led businesses. Against this background, cost competitiveness remains essential and has been maintained despite shortages of workers in the labour market. The gradual depreciation of the forint has even allowed a slight fall in real effective terms over the last decade.

Over the medium term, further progress will be needed in terms of labour productivity, the incorporation of digital solutions and the automation of industry in order to maintain Hungary's lead over its competitors. A ranking of the complexity of exports puts the country 2nd in Central Europe, behind the Czech Republic, in terms of market positioning, but its lead over other countries has narrowed, particularly when it comes to those, such as Romania and Poland, where labour costs remain lower.

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