HUNGARY

MONETARY AND FISCAL POLICY RECALIBRATION

Economic activity weakened in the third quarter. The outlook remains gloomy in the short term. Last September, the central bank ended its monetary tightening cycle in the face of downside risks to growth. This policy is currently not very consistent with the trajectory of inflation. Meanwhile, fiscal policy was tightened in the second half of the year due to the marked deterioration in budget deficit. The EU's freezing of funds in 2022, depriving the Hungarian authorities of a source of income, has probably weighed on their decision. While this recalibration limits support for growth, it strengthens the credibility of Hungary's fiscal policy.

In the third quarter, GDP fell by 0.4% compared to the previous quarter after a relatively solid performance in the first half of the year (+1.6% and +0.8% in the first and second quarters respectively). However, unlike neighbouring countries, business confidence has not deteriorated in recent months despite supply constraints and rising commodity prices. Despite higher inflation and a more restrictive monetary policy, consumer and investment growth remained positive. Domestic demand contracted in Q3 mainly due to a strong negative contribution from stocks.

Industrial activity held up quite well, also supported by exports. However, energy-intensive industries are severely affected by higher energy bills. Other sectors, such as the plastics industry and transport, are also losing momentum.

SLOWDOWN IN THE COMING MONTHS

Consumption may weaken in the short term for a number of reasons. Firstly, households saw their purchasing power fall (real wages fell by 7% between April and September). The labour market has become less dynamic with a slightly higher unemployment rate. It stood at 4.1% in November compared to 3.1% in June 2022. Furthermore, the effects of the government's supportive measures to households in the first half of the year will ebb out. Finally, the abolition of the price cap on fuel, firstly for affluent households, then extended to all households last December, will weigh on their budgets. Retail sales are already running out of steam, rising at an annual rate of 2.6% in October-November compared to 4.0% in September.

Other growth drivers are expected to weaken. The expected slowdown of the global economy this year, the energy shock and uncertainties related to the war in Ukraine will likely lead to the postponement of investment projects. Demand from Hungary's main trading partners, including Germany, will likely be weaker. In total, we expect a slightly negative growth in 2023.

LESS RESTRICTIVE MONETARY POLICY

Last year, monetary tightening was pronounced in Hungary. The central bank raised its key rate by 1010 basis points cumulatively in 2022. By way of comparison, the increase was more moderate in other countries in the region, i.e. +450 bp in Poland, +550 bp in Romania and +470 bp in the Czech Republic. Last September, however, the Hungarian monetary authorities ended the cycle of key rate hikes due to downward risks to growth. Other tools, such as deposit rates and lending rates, were favoured for the conduct of monetary policy. Faced with downward pressures on the Hungarian forint last October, the overnight deposit rate was raised to 18%. Similarly, the lending rate was increased to 25%.

The move towards a less restrictive policy could delay the fight against inflation in 2023. Hungary is one of the most affected countries by inflationary pressures in the region. At 23.1% year-on-year in November 2022, inflation will remain high in the short term due to (i) the removal of the ceiling on certain pump prices in December; (ii) the effects of last year's severe forint depreciation; and (iii) significant wage pressures. The dampened rise in energy prices in the last two months (with a 3.1 points contribution to headline inflation in November) could thus accelerate again in the coming months. The same applies to food and alcoholic/non-alcoholic beverage prices, which contributed significantly to inflation (10.9 points in 2022).

FORECASTS

	2020	2021	2022e	2023e	2024e
Real GDP growth, %	-4.7	7.1	5.2	-1.4	2.9
Inflation, CPI, year average, %	3.3	5.2	14.5	20.0	7.2
Gen. Gov. balance / GDP (%)	-7.5	-7.1	-5.6	-4.1	-3.3
Gen. Gov. debt / GDP (%)	77.6	74.4	69.3	62.6	60.0
Current account balance / GDP, %	-1.0	-4.2	-6.8	-2.7	-2.1
External debt / GDP, %	80.9	84.6	78.0	71.7	68.0
Forex reserves, EUR bn	33.7	38.4	38.7	37.2	37.9
Forex reserves, in months of imports	4.0	3.8	3.5	3.6	3.9

TABLE 1
e: ESTIMATE & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

HUNGARY: CURRENT ACCOUNT AND CAPITAL FLOWS

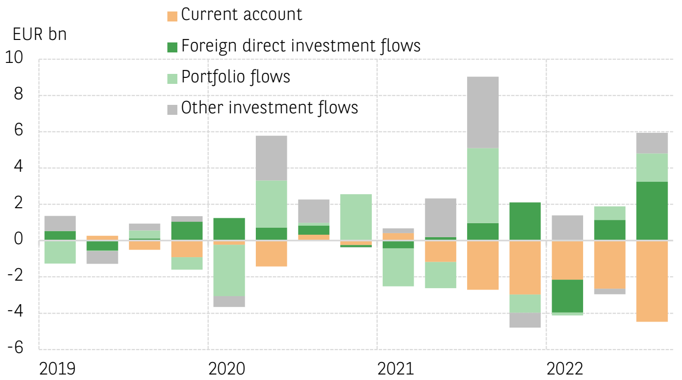

CHART 1
SOURCE: CENTRAL BANK, BNP PARIBAS

LAST-MINUTE AGREEMENT ON EU FUNDS

In 2022, the EU blocked funds related to the recovery plan (EUR 5.8 billion) and cohesion funds under the EU budget over the period 2021-2027 (EUR 21 billion). Finally, a last-minute agreement was reached between the Hungarian authorities and the EU at the end of December. However, the disbursement of funds will not be immediate as it is conditional on the adoption and implementation of many reforms. For example, the EU imposed 27 "super-milestones" regarding legal, audit and anti-corruption reforms before the funds could be paid.

The freezing of EU funds was a serious challenge in the face of the deterioration in public and external accounts. The authorities responded by tightening their fiscal policy. This move strengthens the credibility of budgetary policy, although the scope for supporting growth is limited. As for external accounts, concerns related to the financing the current account deficit. Last year, in the absence of EU funds, the gap was funded in part by debt and foreign direct investment flows.

FISCAL CONSOLIDATION REMAINS IN PLACE

Regarding public finance, last April's generous measures significantly widened the deficit, which reached 4.6% of GDP in June 2022. This was close to the official target of 4.9% for the whole year. In response, the government cut spending, specifically investment, in the second half of 2022, against a backdrop where EU funds were frozen. The introduction of a temporary windfall profit tax has generated additional revenue and the reforms on energy subsidies that came into force on 1st August have led to savings.

Fiscal consolidation efforts are expected to continue in 2023. The government aims to bring the deficit to 3.9% of GDP, although this target seems optimistic.

Financing the deficit is not a major problem, but the cost will be higher as 5-year and 10-year interest rates have risen sharply and EU funds are not yet available. The increase in the cost of debt remains manageable insofar as interest expenses relative to revenue is very low: 5.7% in 2021.

Public debt could hover close to 60% of GDP over the next two years. Its profile has improved in recent years with a sharp drop in the share of foreign currency denominated debt (21% of the total in 2021 compared to the peak of 51% in 2011).

EXTERNAL ACCOUNT DETERIORATION IS MANAGEABLE

The current account slipped back into the red in 2019 after several years of surpluses. This deterioration can be explained by a widening of the trade deficit. In 2022, the energy shock and the rise in food prices increased the estimated current account deficit to -6.8% of GDP in 2022 after -4.2% in 2021.

HUNGARY: INFLATION AND POLICY RATE

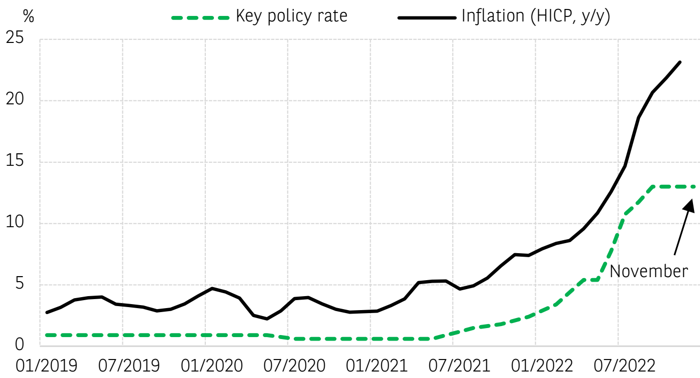

CHART 2 SOURCE: CENTRAL BANK, EUROSTAT, BNP PARIBAS

The deficit was only partially funded by the stable component of capital flows, notably through foreign direct investment (FDI). Over the first nine months, they reached EUR 2.6 billion, thus covering 23% of the expected deficit in 2022. Despite this, foreign exchange reserves continued to improve, reaching EUR 38.7 billion at the end of December. FDI, generally resilient in past crises, is expected to hold up this year. Furthermore, the current account deficit may ease in 2023 due to the relative easing of energy and food prices on global commodity markets. However, the date of payment of EU funds remains a factor of uncertainty.

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Article completed on 13 January 2023