HUNGARY

SOFT DOMESTIC DEMAND

Economic activity has weakened significantly in the last three quarters. In Q1 2023, GDP contraction was largely attributed to the drop in domestic demand. For 2023, the scenario of a weak recession seems to be emerging, due to a strong negative carry-over effect. Moreover, prospects for a recovery are weak in the short term, as inflation remains very high and the real estate market is showing signs of weakness. In 2022, budget and current account deficits increased due to the energy shock. However, debt ratios (public and external) worsened slightly. In 2023, external accounts are expected to improve thanks to the easing of commodity and energy prices.

RECESSION CONTINUES

The Hungarian economy posted a negative growth in the last three quarters. Real GDP fell by 0.3% q/q in Q1, after -0.6% in Q4 2022 and -0.8% in Q3. Domestic demand is losing momentum and is mainly responsible for this. Household consumption and destocking contributed negatively to GDP growth. By contrast, net exports improved in Q1 but were not sufficient to offset weakening domestic demand.

This year, Hungary may underperform compared to its neighbours in Central and Eastern Europe. Several factors support this scenario. Firstly, the country has a negative carry-over effect of -1% for 2023 in Q1. Inflation, which is much higher in the region, will still impact negatively on growth, as wages have been rising more slowly than consumer prices since August 2022. Furthermore, the level of interest rates is not favourable to demand for new loans. Besides, fiscal policy will provide a relatively weak support to the economy given consolidation efforts introduced since summer 2022. The authorities' target is to reduce their budget deficit to 3.9% of GDP in 2023 and then to 2.9% in 2024, although, at first glance, this seems optimistic, particularly for 2023.

As a result, prospects for an improvement in economic activity are weak in the short term. High frequency indicators, such as industrial production, retail sales and households' major purchase intentions for the current and future period, have deteriorated in recent months. Production fell by 3.6% y/y in April, after reaching -2.9% and -1% in previous months. The drop in retail sales was more pronounced (-12.0% y/y in April; -12.7% in March; -8.4% in February). Importantly, industrial production and retail sales fell below their pre-Covid-19 level in April.

Investment has contracted in recent quarters (Q1:-6.7% y/y; Q4 2022: -6.9%; Q3: -0.9%), and is barely expected to improve in the coming months. In fact, public investment planned for this year will undoubtedly be postponed due to budgetary savings and the absence of European funds, suspended by the European Union since 2022. Private investment will be held back by the slowdown in industry. The deterioration of confidence in the manufacturing sector, reflected by the PMIs and European Commission indexes, do not bode well for a significant recovery in the industrial sector in the short term. Similarly, the increase in the funding cost of companies in the shape of bank loans or bond issues can only hinder new investment projects. External demand is likely to weaken in the coming quarters. The German economy has already entered recession in Q1, which will impact Hungarian exports, with Germany alone accounting for 25.2% of Hungarian exports in 2022. Furthermore, Hungary's export price competitiveness could deteriorate if the upward trajectory of its currency observed since January 2023 were to continue. The Hungarian forint appreciated against the euro and the dollar by 7.1% and 9.7% respectively in H1, after a year (2022) marked by strong downward pressure. For the time being, the nominal effective exchange rate is not overvalued as it is 10% below the trend over the past 10 years.

FORECASTS

	2020	2021	2022	2023e	2024e
Real GDP growth, %	-4.7	7.2	4.6	-0.2	3.1
Inflation, CPI, year average, %	3.4	5.2	15.3	18.7	7.6
Gen. Gov. balance / GDP (%)	-7.5	-7.1	-6.2	-4.3	-3.3
Gen. Gov. debt / GDP (%)	77.3	74.4	71.0	66.6	64.7
Current account balance / GDP, %	-1.1	-3.9	-8.2	-3.0	-2.6
External debt / GDP, %	81.0	84.7	88.3	85.0	80.9
Forex reserves, EUR bn	33.7	38.4	38.7	39.0	39.5
Forex reserves, in months of imports	4.0	3.8	3.0	3.9	4.1

TABLE 1

e: ESTIMATES & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

HUNGARY: INDUSTRIAL PRODUCTION AND RETAIL SALES

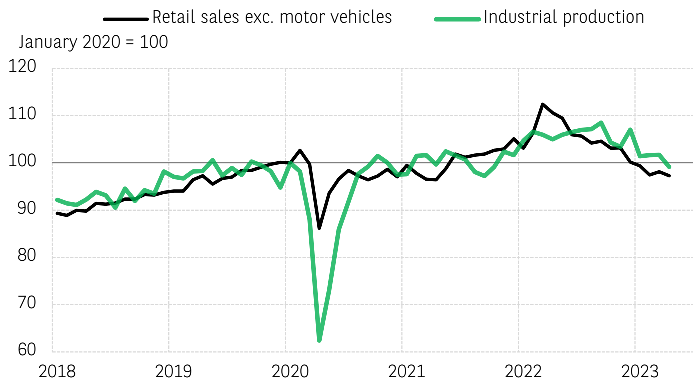

CHART 1

SOURCE: CENTRAL STATISTICAL OFFICE, BNP PARIBAS

In 2024 and 2025, economic activity should recover owing to the expected recovery in global demand and the drop in inflation. Similarly, the economy could benefit from the postponement of investment projects initially planned for 2023.

SLOW DISINFLATION

Hungary has by far the highest inflation rate among countries in the European Union. In May, it stood at 21.5% y/y compared with an average of 10-15% in the region. This gap with other Central European countries can be explained by the lifting of the price freeze on fuel last December. In addition, upward pressure on food prices is comparatively higher than in neighbouring countries. The reason for this lies in the price ceilings on certain food goods, which initially resulted in shortages. At the same time, the rise in uncapped prices has been reflected in other food products. Food price inflation was still 34.1% y/y in May, the historic high having been reached last December (47.9%).

Inflation reached a peak in January 2023. However, disinflation will be slow due to relatively strong wage pressure. Hungary will very probably continue to post the highest rate of inflation in the region in 2024. New tax measures (hikes in tax on fuel, alcohol and tobacco in 2024, tax on interest, etc.) announced by the government to consolidate public accounts should have an impact of around +0.7 to 1.0 point on inflation in 2024 according to central bank estimates.

Hence, monetary authorities will probably keep their key rate unchanged at 13% (after the strong increase of 1,010 bp in Q1-Q3 2022) for a certain period of time. The benchmark interest rate cut is not expected before 2024. Nevertheless, it should be noted that the Central Bank has lowered the overnight lending rate by 650 basis points cumulatively since April 2023 to 18.5%. But this rate represents the cap on the central bank's interest rate corridor ceiling, i.e., the highest refinancing rate for banks.

THE PROPERTY MARKET IS RUNNING OUT OF STEAM

The interest rate environment is not without its consequences on the real estate market. In all Central European countries, a reversal of the property market has been observed since April/May 2022. In response to the increase in the cost of mortgage loans, new home loans fell sharply (73.2% y/y in April 2023). Similarly, in Q1 2023, real estate transactions fell by 43% y/y, according to the latest report on the real estate sector by the Central Bank of Hungary. The drop in building permits for housing reflects, has translated into the loss of confidence amongst builders and developers who are currently facing a drop in demand for housing. At the same time, construction costs increased due to rising building material prices and wage pressure. For the time being, residential prices (in nominal terms) are still rising, but their increase has slowed very sharply, after several years of sustained rise. A decline in house prices seems inevitable in the short term, given the scale of the decline in property transactions.

It should be noted that, as seen in the Czech Republic and Slovakia, mortgage loans in Hungary are mainly taken out at a fixed rate. As a result, the increase in the cost of borrowing primarily affected new loans. So, in order to support households, the Hungarian authorities capped interest rates linked to new mortgage loans since the beginning of 2022.

CENTRAL EUROPE: HOUSE PRICE INDEX

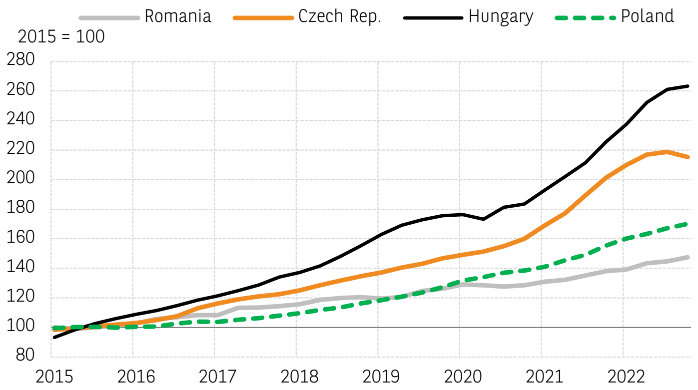

CHART 2 SOURCE: OECD, BNP PARIBAS

SMALLER DEFICITS IN 2023

The year 2022 was characterised by significant macroeconomic imbalances while the country was facing a suspension of European funds.

In 2022, the budget deficit reached 6.2% of GDP, well above the official target of 4.9%, due to supportive measures for households and businesses put in place following the energy price shock. Similarly, interest payments were up sharply, reaching 8.3% of tax revenue in Q4 in 2022. However, the deficit would have been more pronounced without the fiscal consolidation measures introduced in H2 2022.

The increase in energy prices also widened the current account deficit to -8.2% of GDP in 2022 after reaching -3.9% in 2021 and -1.1% in 2020. External debt increased 3.6 points to 88.3% of GDP. However, the Hungarian economy still benefited from significant capital flows despite uncertainties associated with the war in Ukraine. Portfolio and direct foreign investment flows contributed to the coverage of the current account deficit by 60%.

In 2023, the outlook is brighter for fiscal and external accounts. With inflation, the government's debt-to-GDP ratio should continue to fall even if growth slows. And the ratio is expected to improve over the next three years even if deficit reduction targets are not fully met. The current account balance should benefit from the easing of commodity prices on international markets. And the trade balance posted a surplus in Q1. The current account deficit stood at EUR -0.8 billion in Q1 2023 compared to EUR -2.1 billion in Q1 2022. Net capital flows remained positive in Q1 2023.

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