Hungary: Technical recession will be shallow

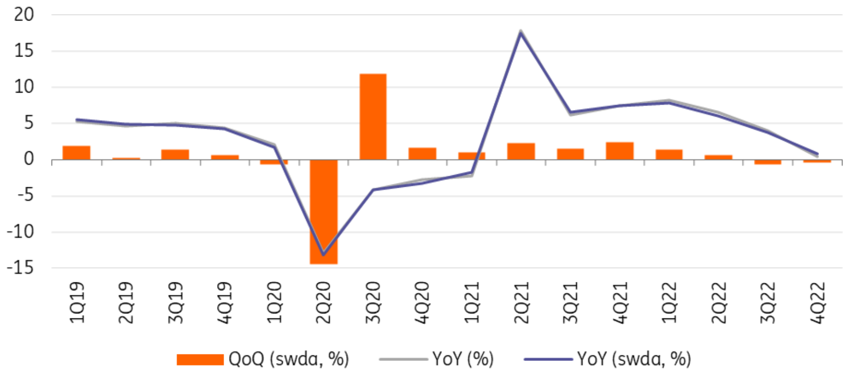
In our latest update, we briefly reassess our Hungarian economic and market forecasts, as we believe a sequential contraction of the economy in the first quarter of 2023 is in the making. Nevertheless, a short-lived technical recession is the likeliest scenario as economic activity will gently rebound in the second quarter this year

Source: Shutterstock

Second leg down confirms technical recession

In line with expectations, the Hungarian Central Statistical Office (HCSO) did not change either the fourth-quarter or the full-year 2022 GDP figures. On a year-on-year (YoY) basis, the volume of gross domestic product increased by 4.6% last year, while in the fourth quarter, the economy registered an increase of 0.4%. As far as the quarterly growth rate is concerned, the volume of GDP shrank by 0.4% in the last quarter of 2022. Hungary has thus officially entered a period of a technical recession. Detailed GDP data delivered some surprises to the structure of quarterly growth; however, it is important to note that these releases are subject to significant revisions due to increased uncertainty around seasonal adjustments.

Hungary's real GDP growth



Source: HCSO, ING

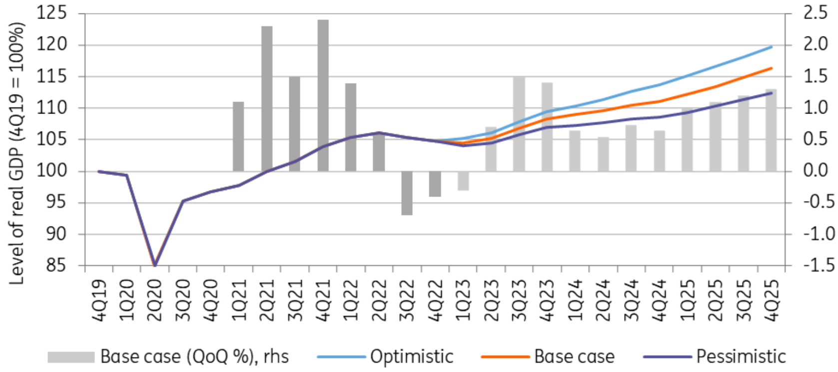
The YoY growth profile is much clearer and more straightforward. The performance of agriculture is down by a third compared to the previous year, while the growth rates of industry, and the construction and services sectors have all slowed down. Within the latter, wholesale and retail trade has already contracted on an annual basis, reflecting the impact of high inflation. On the expenditure side, year-on-year dynamics show that domestic demand has fallen, driven by a sharp fall in investment and a marked slowdown in consumption (which is still expanding on a yearly basis). Finally, the 0.5pp contribution of net exports to overall GDP growth was able to keep the annual figure (0.4% YoY) above water.

The detailed data thus confirmed our view that the internal processes that induced a drop in the volume of GDP in the third quarter continued in the fourth quarter and officially prompted a technical recession. At the same time, the economy has not yet been really hit by the declining purchasing power of households in spite of the high interest rate environment and tighter fiscal policy, which has crushed investment activity.

Decisive growth will only start in the second half of 2023

According to our current estimates, Hungarian GDP will expand by 0.7% in 2023, with a two-sided growth profile. The economy will likely contract in the first quarter of this year, as high inflation suffocates economic activity on various fronts: from private consumption to investments. As the disinflationary process slowly unfolds from February and strengthens from the middle of the year, we expect a very shallow quarter-on-quarter (QoQ) rebound in GDP growth. Thus, the economy in the first half of 2023 will likely stagnate, with GDP growth in the second quarter offsetting the drop in the first. As domestic demand slowly recovers in the third and fourth quarters this year on the back of positive real wage growth, the economic recovery can finally take place. Besides domestic demand, we expect that net exports will be the powerhouse of growth in the second half of 2023, bringing the full-year GDP growth to 0.7%. At the moment, we see more upside than downside risks to our growth forecast, the main one being the global economic outlook. As for 2024, we expect the Hungarian economy to expand dynamically, fuelled by easing monetary conditions and the real economic impact coming from the inflow of EU funds.

The volume of GDP and our forecast scenarios



Source: HCSO, ING

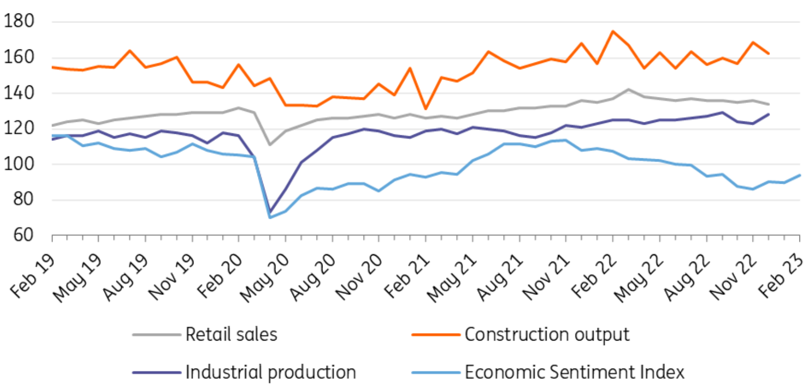
The short-term outlook of different sectors is quite a mixed bag

Although this year's first batch of hard data is yet to be released, based on a range of surveys and anecdotal evidence we believe that:

The volume of **retail sales** is likely to drop further at least until March as the purchasing power of households deteriorates. We expect both food and non-food retailing to show a trend-like retreat in the coming few months as households try to keep up with record inflation. In the absence of the fuel price cap, we believe that fuel retailing is also set to drop further as consumers adjust to market fuel prices. As an umbrella effect, the recent indications of upcoming layoffs also pose a downside risk to the retail sector outlook.

In our opinion, Hungarian **industry** will be in a relatively comfortable position in the short run due to both global and local factors. Growth expectations are improving globally, thus external demand could be more resilient than previously thought. On the local side, the latest (December) data indicates that the stock of orders was up by almost 8% YoY, coupled with improving capacity utilisation (standing at 79% in the fourth quarter of 2022) which shows that industry still has some reserves to tap into.

Volume indices of the main sectors (2015=100) and economic sentiment (balance)

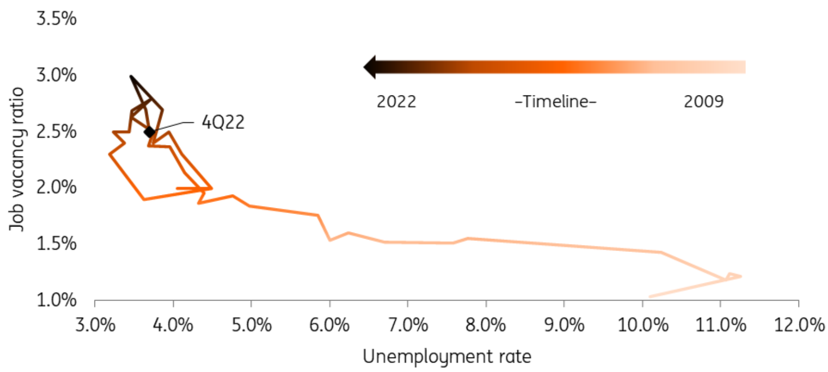


Source: HCSO, ING

The **construction** sector lost some ground during 2022 due to cost-side pressures and weakening demand. The latter is not just coming from the housing sector. As the government needed to cut public spending, it delayed more than HUF 2tn worth of infrastructure projects. With the ongoing fiscal and monetary tightening and still missing the massive inflow of EU funds, the construction sector has slowed. The short-term outlook is deteriorating as well considering the volume of contracts falling by 1.2% year-on-year at the end of 2022.

After the summer 2022 peak in the **labour market**, there has been a steady deterioration in labour statistics. Companies have started to adapt to rising costs and more and more leaders are seeing downsizing as an adequate reply to the recent challenges. In addition, more people may decide to actively look for work in order to cope with the drop in purchasing power. In the short run, we see these trends continuing. Against this backdrop, we see the unemployment rate peaking around 4.5% in mid-2023. An improving economic outlook and rising demand for labour in the second half of the year may put pressure on wages again. Thus, we expect 15% average wage growth this year with upside risks. This could lead to positive real wage growth from late 2023, which may stimulate domestic inflation pressure in the Hungarian economy further, keeping monetary policy on alert.

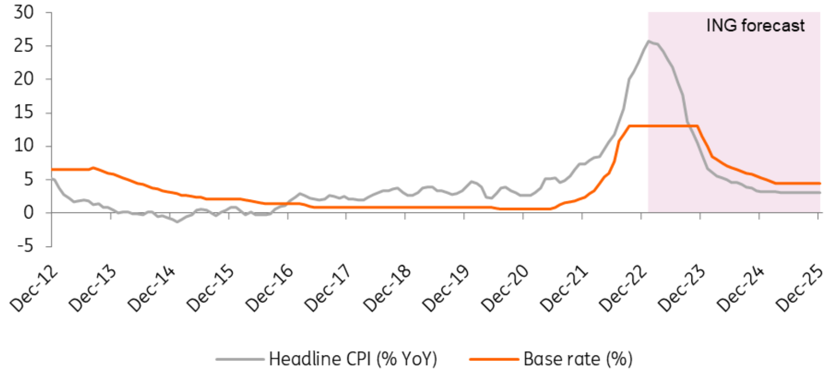
Tightness of the Hungarian labour market (the Beveridge curve)



Source: HCSO, ING

Inflation accelerated to new highs at the start of 2023, but it is very likely that the January 25.7% YoY print marked the peak. Fuel prices have started to decline based on pump prices. Food and consumer durables prices should follow suit as the forint's recent strength should help to tame imported inflation. Household energy could also prove to be a drag on inflation. The caveat, however, comes from market services. We expect further price increases in the services sector, so despite the above-mentioned drags, this could be a significant counterforce. In all, the year-on-year inflation rate will most likely show small drops (or go sideways at worst) in the coming months. A more serious deceleration is likely to take place from April onwards as base effects should also help the index to fall substantially. For this year, we expect average inflation of 19%, with year-end figures dipping into high single-digit territory. However, the real challenge comes in 2024 when it comes to further deceleration.

Inflation and policy rate



Source: NBH, ING

The **National Bank of Hungary (NBH)** is aware of the shifting structure of inflation, and in our view, they will patiently wait until May-June before announcing the start of the easing cycle. The increased and recently tiered reserve ratio requirement further highlights the NBH's strong commitment to curb forint liquidity and hints at no pivot in the near term. The updated forward guidance echoes this as well as the central bank is focusing on the "persistence of the recent improvement in risk perceptions" and in our interpretation, this persistence means multiple months. Even if easing starts during the late second quarter, the process will be gradual and slow. We see the central bank starting regular rate cuts only in late-2023, taking strict care that the real interest rate remains positive.

As far as **fiscal policy** is concerned, in our opinion, the Hungarian government is committed to the full-year 3.9% deficit-to-GDP target and fiscal consolidation will happen in 2023. This is necessary and non-negotiable in order to avoid further downgrades by credit rating agencies, in our view. Furthermore, strict fiscal control is a must to keep the trade balance and current account balance improving, which has just started. Tight fiscal and monetary policy will put enough of a drag on domestic demand – complementing the relatively low energy prices – to help the current account deficit to be around 4.5% in 2023 after a close to 8% deficit in 2022.

Quarterly forecasts

	4Q22	1Q23F	2Q23F	3Q23F	4Q23F	1Q24F	2Q24F	3Q24F
Real GDP (%YoY)	0.4	-0.6	-0.9	1.3	2.9	3.9	4.2	3.4
CPI (eop, %YoY)	24.5	25.2	21.9	13.6	8.8	5.5	4.6	3.8
Central bank key rate (eop, %)	13.00	13.00	13.00	13.00	11.50	8.00	6.75	6.00
3m interest rate (eop, %)	16.18	16.50	16.00	14.00	11.25	7.75	6.50	5.75
10yr yield (eop, %)	9.05	8.50	7.75	7.25	7.05	7.05	7.00	6.80
EUR/HUF exchange rate (eop)	400.3	375.0	370.0	383.0	375.0	370.0	365.0	365.0
USD/HUF exchange rate (eop)	375.7	350.5	336.4	342.0	326.1	321.7	317.4	317.4

Source: National sources, ING estimates

Forint rally may run out of steam in the short term

The Hungarian forint has performed admirably since the beginning of the year and, in our view, still has the potential to strengthen further in the medium term. In the short term for the coming weeks, however, we expect it to take a break or at least slow down its current pace of appreciation.

After all, the problems from last year are still on the table, led by EU money, which the rating agencies' actions regularly remind us of. Moreover, heavy long positioning plays against further appreciation while making the forint vulnerable to a turn in global sentiment. On the other hand, we believe that a more significant sell-off would serve as a good entry point for new investors attracted by the highest carry in the CEE region.

Hungarian bonds will find new buyers

The global sell-off has hit the Hungarian market hard over the last two weeks, and the high CPI number and hawkish NBH pushed the whole interest rate swaps (IRS) and Hungarian bonds (HGBs) curve up, disrupting the normalisation process. The NBH appears to be serious about its hawkish tone, and in our view, it will be a challenge for the market to start pricing in central bank rate normalisation again. On the other hand, in the interim, core rates should ease their pressure on the long end of the curve. The question mark is whether we will see a steeper or flatter curve first. At the moment, we are leaning more toward the latter. In either case, however, the direction of the curve's movement should be downward. In bonds, Government Debt Management Agency AKK has issued about 18% of planned HGBs for this year, a bit behind CEE peers. On the other hand, issuance is strong on the retail and FX bond side, so overall we see AKK in a comfortable position. With a 10y yield within reach of 9%, we believe HGBs will be able to find new buyers betting on a reboot of the normalisation story.

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