Monitoring Hungary: Disinflation shifts into a higher gear

In our latest update, we reassess our economic and market forecasts for Hungary, as we expect disinflation to shift into a higher gear due to a marked collapse in domestic demand. In contrast, we see the technical recession ending in the second quarter, while the monetary normalisation will continue unabated if market stability prevails

Budapest, Hungary

Hungary: at a glance

- Economic activity has slowed significantly in all sectors, except one. The positive contribution of agriculture will lift the economy out of the technical recession in the second quarter of 2023.
- However, unsurprisingly, the lack of domestic demand is weighing on both retail sales and industrial output, with the latter currently being supported only by export sales.
- Real wage growth has been negative for nine months, but we expect to see a turnaround as early as September, as the disinflationary process picks up speed.
- Weakening economic activity lowers import demand, which combined with lower energy prices is helping the country's external balances to improve faster than expected.
- The rapid deterioration in the pricing power of businesses has contributed to the

strengthening disinflationary process, which we expect to markedly accelerate, especially in food items.
- The normalisation cycle of monetary policy should continue unabated in 100bp steps until the September merger. Beyond that, we expect a pause and then further 100bp cuts.
- Currently we see a 0.5-1.0% of GDP slippage in this year's budget, but a revision by the Ministry of Finance will only come in September.
- We still believe in a turnaround in forint due to FX carry and support by the improving current account and a better gas price story.
- We see the market underestimating further normalisation in the next year or two, opening the door for more curve steepening.

Quarterly forecasts

	1Q23	2Q23F	3Q23F	4Q23F	1Q24F	2Q24F	3Q24F	4Q24F
Real GDP (%YoY)	-0.9	-1.2	0.6	2.0	3.1	3.3	3.1	3.0
CPI (eop, %YoY)	25.2	20.1	11.8	6.9	4.3	4.9	4.2	3.7
Central bank key rate (eop, %)	13.00	13.00	13.00	11.00	8.00	7.25	6.50	5.75
3m interest rate (eop, %)	16.30	15.17	13.00	10.50	7.75	7.00	6.25	5.50
10yr yield (eop, %)	8.50	6.99	7.05	6.90	7.00	6.85	6.75	6.50
EUR/HUF exchange rate (eop)	381.0	373.1	378.0	370.0	368.0	365.0	365.0	370.0
USD/HUF exchange rate (eop)	349.9	342.0	337.5	321.7	311.9	309.3	317.4	321.7

Source: National sources, ING estimates

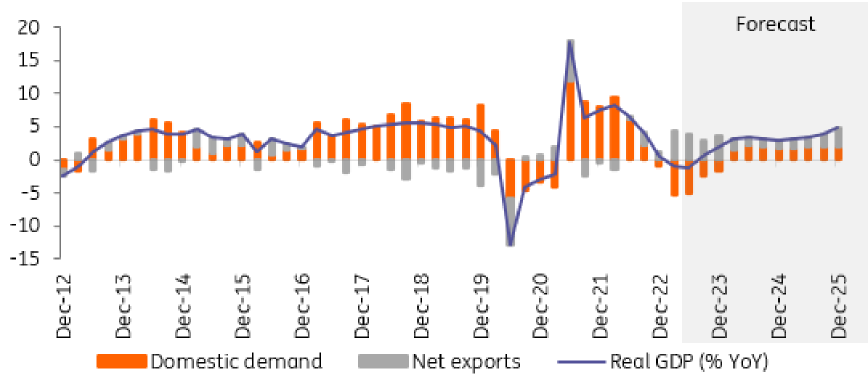
Technical recession will end in the second quarter, but no change to full-year outlook

Hungary has been in a technical recession for three quarters (3Q22-1Q23) as sky-high inflation has stifled economic activity. Consumption has slowed markedly, and investments have come to a standstill due to high interest rates and fiscal savings.

While most sectors continue to struggle with weak domestic demand, agriculture stands out. This is due to a combination of base effects and favourable weather conditions. In our view, these factors will lead to a significant positive contribution from agriculture to overall growth, lifting the economy out of the technical recession in the second quarter.

As we expect domestic demand to remain subdued for the rest of the year, we believe that agriculture could be the only silver lining for growth prospects this year. However, we maintain our full-year GDP growth forecast of 0.2% as we await the official second-quarter data.

Real GDP (% YoY) and contributions (ppt)



Source: HCSO, ING

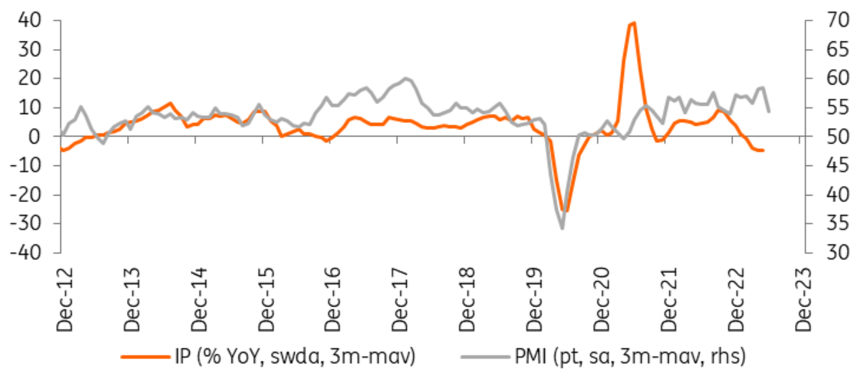
Industrial performance hinges on export activity

Industrial production surprised on the upside in May, as production volumes rose by 1.6% month-on-month but fell by 4.6% year-on-year. At a sectoral level, the picture remains unchanged, with volumes expanding only in the electrical equipment and transport equipment sub-sectors (e.g. electrical vehicle batteries and cars).

We believe this trend underlines our view that only those sub-sectors that are linked to the automotive sector, and thus largely dependent on export sales, are performing well. Nevertheless, the heavy reliance on export sales is understandable in the context of subdued domestic demand. However, with global leading indicators suggesting that recessionary forces are building globally, this could weaken export prospects and thus delay the turnaround in overall output growth in industry until next year.

Hungary's retail sales and industrial output continue to plunge

Industrial production (IP) and Purchasing Managers' Index (PMI)



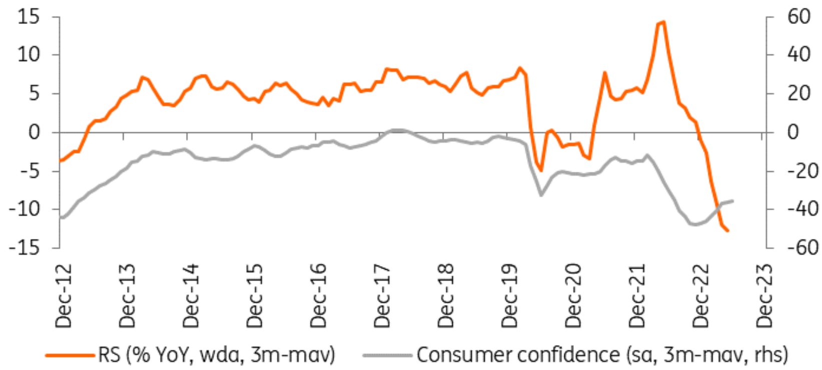
Source: HALPIM, HCSO, ING

Retail sales continue to plunge as real wages deteriorate

The retail sector continues to suffer from the cost-of-living crisis, as the volume of sales in May fell by 12.3% YoY, adjusted for calendar effects. Short-term dynamics further cloud the picture, as retail sales volume fell by 0.8% MoM, with no recovery in sight. At the component level, food retailing was virtually flat, while non-food retailing fell slightly on a monthly basis. However, the lack of domestic demand is most evident in the case of fuel, as the volume of fuel retailing fell despite lowering fuel prices.

In our view, this phenomenon underlines our view that the deterioration in household purchasing power is having a significant negative impact on retail sales. In this respect, we expect this downward trend to continue at least until real wage growth turns positive, which we expect to happen as early as September.

Retail sales (RS) and consumer confidence



Source: Eurostat, HCSO, ING

We expect a turnaround in real wages as early as September

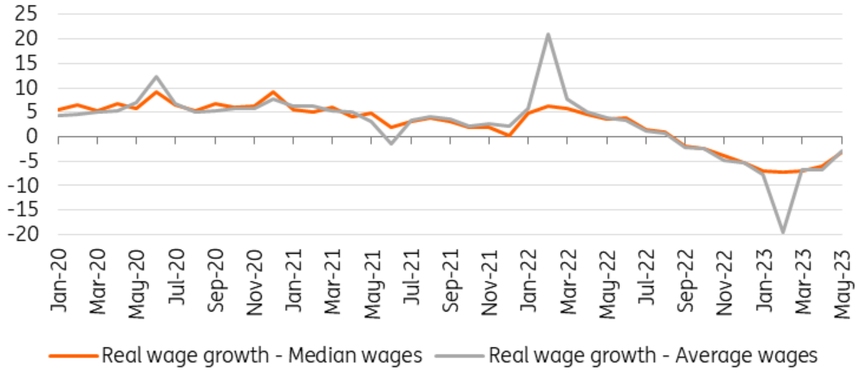
Average wage growth remained strong in May, rising by 17.9% YoY on the back of higher bonus payments. However, after adjusting for inflation, real wages fell by 3% YoY, extending the streak of negative real wage growth to nine months. The good news is that we expect real wage growth to return to positive territory as early as September, in line with the strengthening of the disinflation process.

As for other labour metrics, the three-month unemployment rate remained at 3.9% in the April-June period, showing that the cost-of-living crisis is encouraging people to work. In addition, strong demand for seasonal workers pushed the participation rate to a record high in June. In this regard, even if the seasonal effects fade, we expect the unemployment rate to peak in the vicinity of 4%, as the labour market faces structural shortage problems.

[Hungarian wage growth remains strong]

[Seasonal work pushes labour market participation rate to record high in Hungary]

Growth of real wages in Hungary (% YoY)



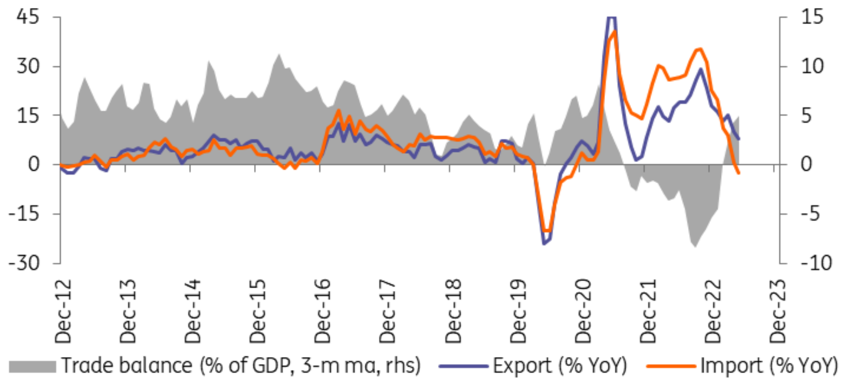
Source: HCSO, ING

Import pressure eased by subdued domestic demand

The combination of high inflation and high interest rates is weighing heavily on domestic demand, reducing the need for imports. In addition, as the energy issue appears to be easing this year, the pressure on the trade balance from the import side is easing significantly. Conversely, the export side has huge growth potential due to new EV battery plants, while carmakers are still dealing with backlogs.

Taking all these factors into account, the staggering €1.1bn trade balance surplus in May hardly comes as a surprise. In our view, high-frequency data point to a balanced current account (CA) at the end of the year. However, a looming recession in the eurozone, coupled with a weaker-than-expected economic rebound in China, could significantly weaken the export outlook, and thus may limit the upside to the CA.

Trade balance (3-month moving average)



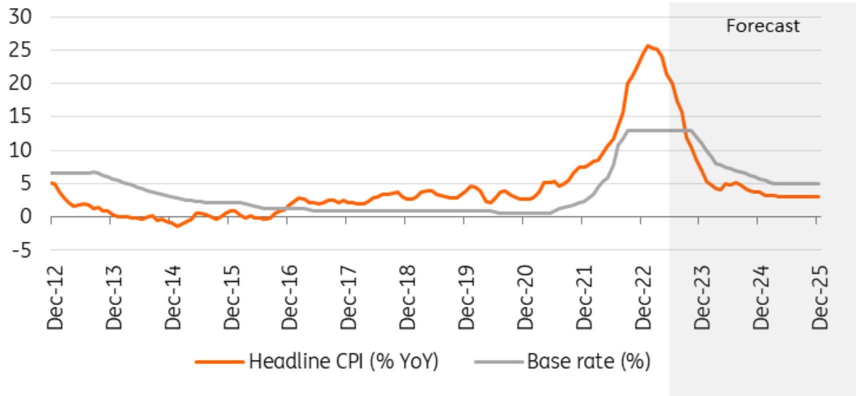
Source: HCSO, ING

The collapse in domestic demand strengthens disinflation

Headline inflation eased to 20.1% YoY in June, mainly driven by the 0.4% MoM decline in food prices. Within this, the fall in processed food prices was the main driver, hence the sharp 2ppt deceleration in core inflation to 20.8% YoY. In our view, the rapid deterioration in firms' pricing power is evident, and will only accelerate going forward as competition among retail outlets for households' overall shrinking disposable income intensifies.

Based on our high-frequency data collection, we expect disinflation to strengthen further going forward, driven mainly by food deflation. In this context, we expect average inflation to fall to single digits in the fourth quarter, while average inflation for the year as a whole is likely to be below, but close to 18%.

Inflation and policy rate



Source: NBH, ING

Rate cuts to continue in 100bp steps if market stability prevails

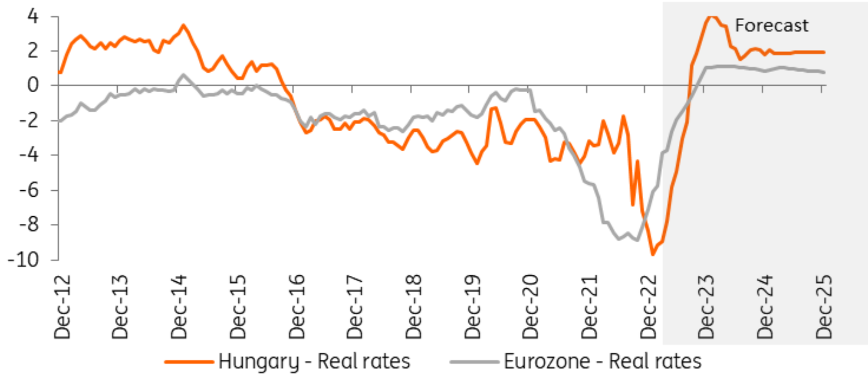
At the July meeting, monetary policy normalisation continued as the National Bank of Hungary (NBH) lowered the effective interest rate by a further 100bp to 15%. The central bank emphasised cautiousness, graduality and predictability, so we expect same-sized cuts into the September merger of base and effective rates.

After September, however, the NBH has several options to alter the interest rate complex. The central bank can either continue the easing cycle unabated in 100bp increments, setting the policy rate at 10% at the end of 2023. However, reducing the pace of cuts to 50bp seems to be another viable option, leaving the key rate at 11.5%.

In our view, the NBH will cut both repo and deposit rates by 100bp in October, leaving room for market rates to adjust lower, but will only cut the base rate by 100bp in November and December. We, therefore, expect the policy rate to end the year at 11%.

[National Bank of Hungary review: Sticking to the script]

Real rates (%)



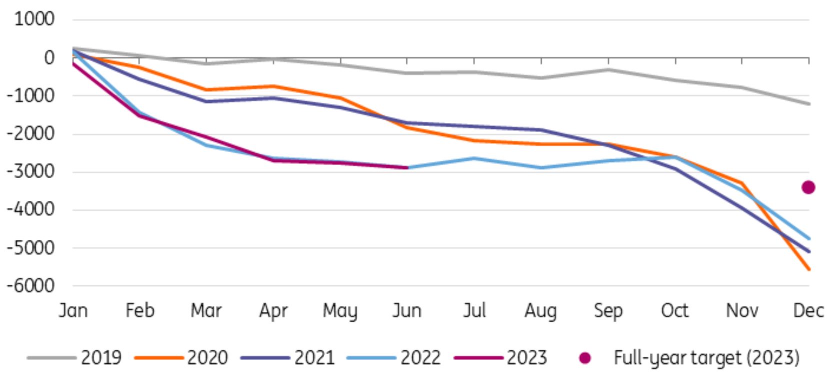
Source: ECB, NBH, ING

VAT receipts hit hard by fall in domestic demand

The Hungarian budget posted a deficit of HUF 132.7bn in June, bringing the year-to-date cash flow-based shortfall to 85% of the full-year target. The decline in domestic demand is weighing heavily on tax revenues. In this respect, VAT receipts in the first half of 2023 were only 2.2% higher than a year ago compared to the 24% average inflation during this period. Despite some ongoing adjustments (e.g. public investment cuts), we still see a slippage of 0.5-1% of GDP in this year's budget.

A recent interview with the Finance Minister revealed that a revision could come as early as September, which in our view could lead to additional adjustments plus a minor increase in the 2023 EDP deficit target. From a cash-flow perspective, the fate of the EU funds remains a key issue, with the clock ticking (90 days) at the European Commission's table, as the government officially submitted the self-review on horizontal enabler (judiciary) reforms on 18 July.

Budget performance (year-to-date, HUFbn)



Source: Ministry of Finance, ING

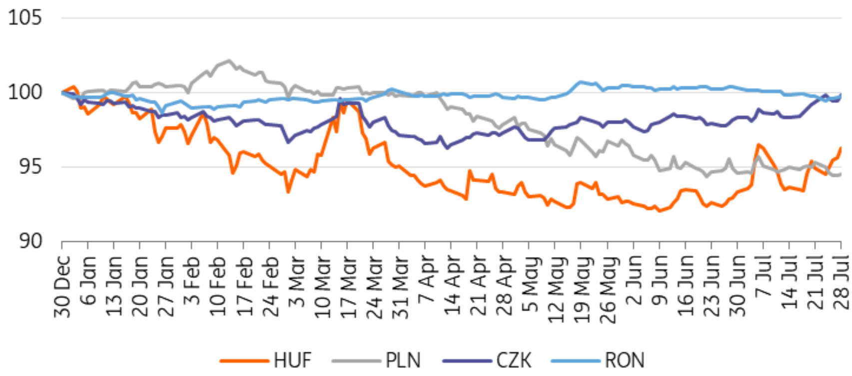
We still believe in a HUF turnaround

Although we heard what we thought we would from the National Bank of Hungary – a cautious cut with a commitment to remain patient – market players were ignorant of the hawkish message. The NBH's assurance that the cutting cycle will not be accelerated did not result in a turnaround in

EUR/HUF as we expected. However, our market view remains unchanged. In case of further forint weakening, we expect the central bank to hit the wire and repeat some hawkish statements, trying to push against HUF underperformance versus Central and Eastern European peers. Moreover, we see some improvement in conditions at the global level, too.

Last but not least, despite the whole EU fund issue being overly politicised, we still believe in a positive outcome before the year-end. Our ultimate argument would be that European politicians don't want to bother with Hungarian issues when European Parliament elections are approaching (June 2024). On a local level, we think FX carry should continue to be the main positive driver for the HUF, supported by an improving current account, a record decline in gas prices, and despite cuts by a cautious central bank, overall pushing EUR/HUF closer to 370.

CEE FX performance vs EUR (30 December 2022 = 100%)



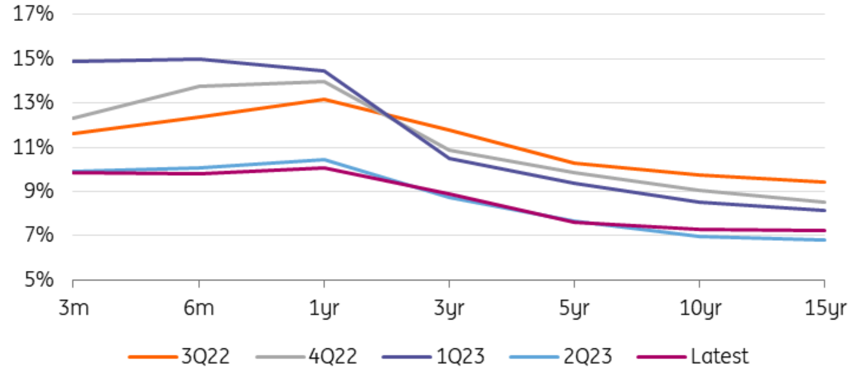
Source: NBH, ING

We continue to see further curve steepening

In the rates space, we found the IRS curve a bit steeper again after the last NBH meeting and a steeper and lower curve remains our main view for the coming months. 2s10s spread has moved roughly 100bp since May, the first rate cut, and we still see room for further normalisation of the IRS curve, which remains by far the most inverted in the CEE universe.

Market expectations for this year are more or less fair given that the September rate merge is a broad market consensus, however, NBH's next steps are unclear to the market, and we see the market underestimating further normalisation in the next year or two, opening the door for more curve steepening. On the other hand, the fall in core rates will slow the normalisation of the curve compared to previous months.

Hungarian sovereign yield curve



Source: GDMA, ING

Hungarian government bonds (HGBs) eased in July and the rest of the region caught up with the swift rally. We therefore see current valuations of HGBs as more justifiable, which could attract new buyers. Despite the fiscal slippage risk, year-to-date issuance has reached 60% by our calculations, which we see as more than sufficient. Moreover, recent government measures supporting HGBs and the fastest disinflation in the region should be enough to sustain demand.

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