

Monitoring Hungary: Technical recession set to end soon

In our latest update, we reassess our Hungarian economic and market forecasts, as high inflation continues to stifle domestic demand. The good news is that the technical recession is set to end soon, with disinflation set to strengthen. These, combined with market stability, should keep monetary policy normalisation on track



Vehicles line up to be fueled at a gas station in Budapest, Hungary

Hungary: At a glance

- Economic activity has slowed significantly in all sectors, but the positive contribution from agriculture could lift it out of technical recession in the second quarter of 2023.
- Lack of domestic demand is weighing on both retail sales and industrial output, with the latter currently being supported mainly by export sales.
- With the pricing power of companies rapidly diminishing, the disinflationary process has shifted into a higher gear. This is reflected in May's negative monthly inflation.
- The normalisation of monetary policy has started - we see further 100bp cuts to the effective rate before it reaches the base rate at the September meeting.
- Weakening economic activity is hitting import demand which, combined with lower energy prices, is helping the country's external balances to improve.

- The marked drop in consumption puts significant pressure on the budget's VAT revenue stream, with key challenges looming.
- Real wage growth has been negative for eight months, but the cost-of-living crisis is encouraging a willingness to work, hence the improvement in labour metrics.
- Hungary's credit rating was kept at 'BBB' by Fitch Ratings, and we do not expect any rating changes from other rating agencies in the near future.
- We expect EUR/HUF to oscillate in the current range of 368–378, depending on the NBH's communication regarding the rate-cutting cycle and on progress with the EU.
- HGBs can benefit the most from monetary policy normalisation, further supported by government measures and debt agency funding control.

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	20.0	12.6	7.6	5.0	5.7	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	15.15	13.20	10.50	7.75	7.00	6.25	5.50
10yr yield (eop, %)	8.50	7.15	7.00	6.75	6.90	6.80	6.65	6.50
EUR/HUF exchange rate (eop)	381.0	372.0	378.0	370.0	368.0	365.0	365.0	370.0
USD/HUF exchange rate (eop)	349.9	344.4	334.5	313.6	306.7	312.0	317.4	321.7

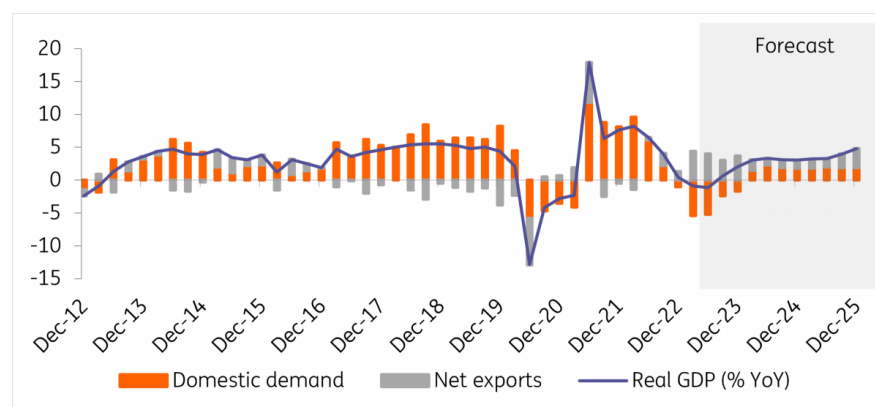
Source: National sources, ING estimates

Technical recession might end in Q2, thanks to agriculture

Hungary has been in a technical recession for three quarters (3Q22-1Q23) as high inflation has stifled economic activity. Consumption has slowed markedly, while investment has virtually come to a standstill due to high interest rates. 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. These factors should lead to a significant positive contribution from agriculture to overall growth, which could move the economy out of the current technical recession in Q2. What's more, we believe that the fate of overall growth in 2023 will depend more on the performance of agriculture. Domestic demand is set to remain weak for the rest of the year, holding back industry, construction and services. We look for 0.2% GDP growth in 2023.

Technical recession continues in Hungary

Real GDP (% YoY) and contributions (ppt)



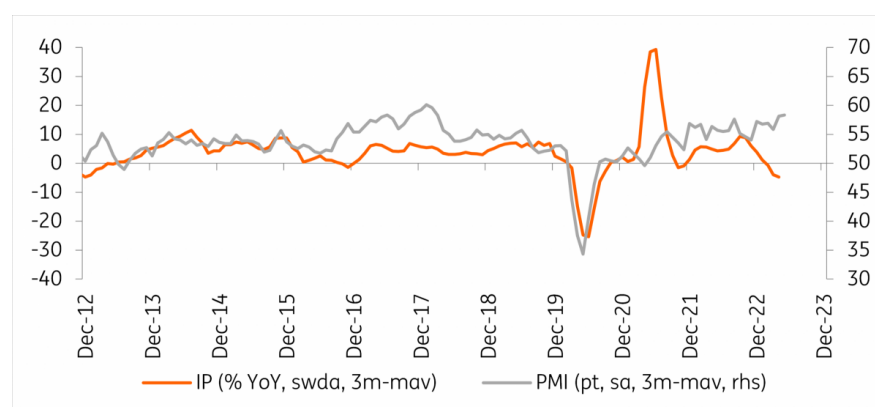
Source: HCSO, ING

Industry dominated by opposing forces

Industrial production continued to disappoint in April, falling by 5.8% year-on-year (YoY) when adjusted for calendar effects. This underperformance was not only due to base effects, as the 2.5% month-on-month (MoM) decline in production suggests. Output grew in only two sub-sectors - transport equipment and electrical equipment (including EV batteries and cars) - implying that those sub-sectors related to the automotive sector, which is largely dependent on export sales, have been performing best. As weakening domestic demand weighs heavily on industrial production, export sales are able to compensate to some extent. However, with global leading indicators suggesting that recessionary forces are building globally, this could weaken export prospects and thus delay the expected turnaround in overall output growth until next year.

[Hungarian industry faces opposing forces](#)

Industrial Production (IP) and Purchasing Manager Indices (PMI)

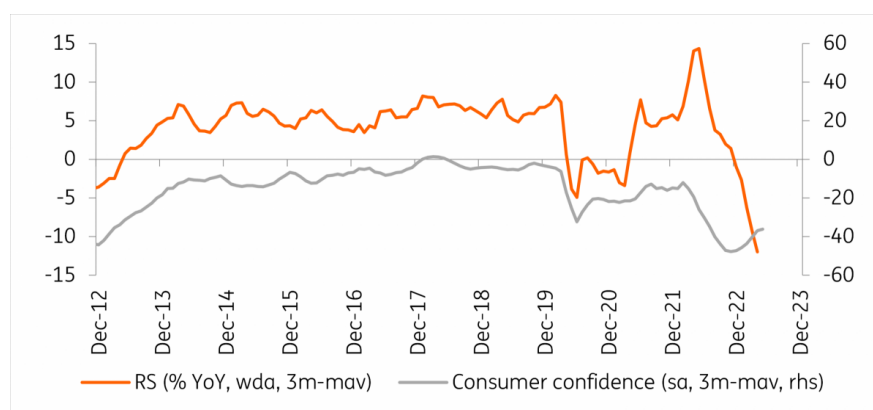


Retail sales suffer amid weakening domestic demand

The retail sector continues to suffer from the cost-of-living crisis. Sales volumes fell by 12.6% YoY in April, adjusted for calendar effects. As in the case of industry, the annual decline is not entirely due to base effects, with sales volumes falling by 0.9% MoM. At the component level, food and fuel retailing grew on a monthly basis, the latter due to lower fuel prices. The 0.6% MoM contraction in non-food retailing suggests that households are prioritizing food purchases over non-food items as the loss of household purchasing power curbs overall consumption. This trend is set to continue at least until real wages turn positive again, which we expect to happen in the fourth quarter of this year. However, with the possibility that the positive income impulse is channeled into savings, retail sales could also suffer for the rest of the year.

[Hungarian retail sales still in decline](#)

Retail sales (RS) and consumer confidence



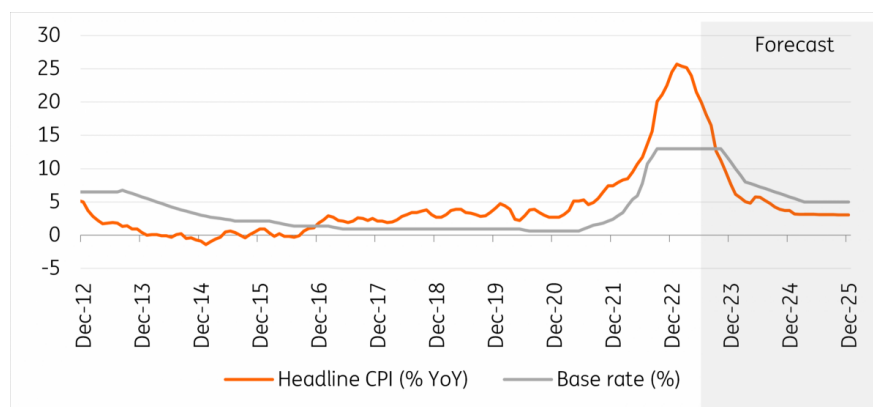
Source: Eurostat, HCSO, ING

The disinflationary process has shifted into a higher gear

Headline inflation retreated to 21.5% YoY in May, the first notable drop in this figure. Base effects certainly helped, but the -0.4% MoM print suggests that businesses' pricing power is rapidly diminishing as consumption is severely curtailed. Motor fuel and household energy prices fell on a monthly basis as global energy prices retreated. Food price pressures also eased. These contributed to the decline in core inflation, suggesting that underlying price pressures have started to ease. Services inflation poses a risk to the disinflationary outlook, but the deterioration in companies' pricing power limits the upside. We expect domestic demand to remain severely constrained- although single-digit inflation might arrive as soon as November, 2023 average inflation is set to be around 18%.

Hungarian inflation drops further than expected

Inflation and policy rate



Source: NBH, ING

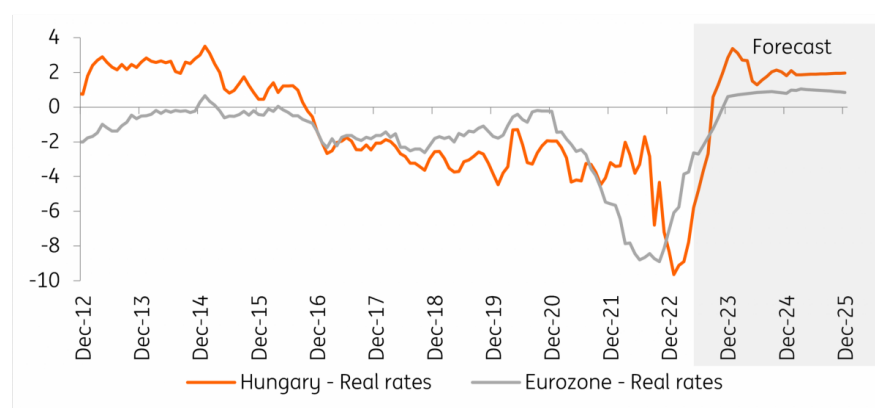
Effective normalisation of monetary policy continues

At its June meeting the National Bank of Hungary (NBH) continued with its normalisation of monetary policy. Mirroring May's move, it cut the effective rate by a further 100bp to 16%. Normalisation remains a function of market stability, which has continued to improve. If market

stability remains intact, we expect the effective rate to merge with the base rate at the September meeting, at 13%. In our view, the incremental change in the wording of the forward guidance and the fact that the NBH sees inflation risk tilted to the downside might signal that the first cut in the base rate could come shortly after this. We expect the year-end base rate to be 11%, roughly in line with market pricing. The renewed hawkishness of central banks around the world poses upside risk to the base rate cut playbook.

National Bank of Hungary Review: Normalisation remains a function of market stability

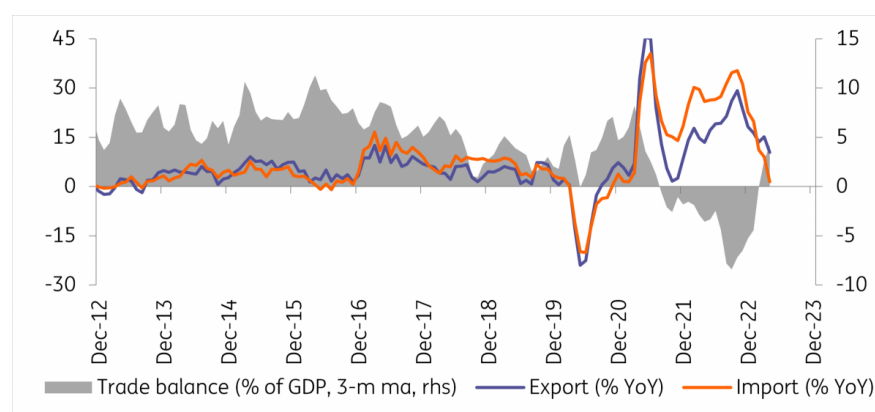
Real rates (%)



The trade balance has been in surplus for the last three months

With the energy issue apparently easing this year, pressure on the trade balance from the import side is softening significantly, as reflected in three consecutive positive readings. In addition, the combination of high inflation and high interest rates has weighed on domestic demand, further reducing import need. Conversely, the export side carries huge growth potential. New export capacities have improved significantly recently with EV battery plants, while car manufacturers are dealing with large backlogs. Combining all these factors, we expect the current account (CA) balance to close this year at only -2.2% of GDP. Clearly any global recession could significantly weaken export prospects and so limit the upside for the CA.

Trade balance (3-month moving average)

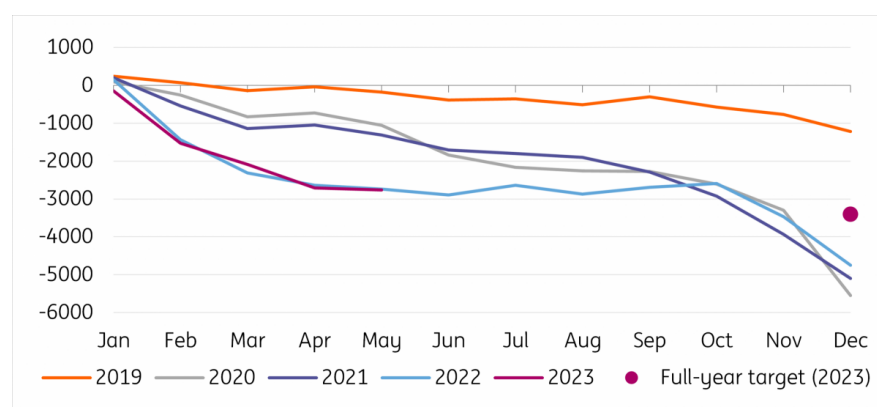


VAT receipts hit hard by falls in domestic demand

The Hungarian budget posted a deficit of HUF53.6bn in May, bringing the year-to-date cash flow-based target to 81% of the full-year target. The decline in domestic demand is weighing heavily on tax revenues, with VAT receipts showing the largest slippages compared to the plan. On the expenditure side, the biggest challenge remains debt servicing. In general, we believe that this year's expenditures are less back-loaded than last year. While we see a roughly 0.6% of GDP gap in the budget on the revenue side, the full-year cash flow-based target is broadly achievable, with that buffer on the expenditure side. Last year's deficit time-line seems to be the closest proxy for this year's trajectory and, if we remove one-off energy-related spending at the end of 2022, the situation looks manageable.

[Hungarian budget posts lowest May deficit in years](#)

Budget performance (year-to-date, HUFbn)



Source: Ministry of Finance, ING

Real wages have dropped for eight months in a row

The labour market strengthened in May as the cost-of-living crisis encouraged people to return to work. The three-month unemployment rate fell to 3.9% in the March-May period. Forward-looking indicators suggest that only a small percentage of firms plan to reduce their workforce in the future. We believe that even if positive seasonal effects fade, the peak in unemployment rate could remain close to 4%. Structural labour shortages could also explain the lack of layoffs, but at the same time this puts upward pressure on wages. Average gross wage growth remains strong at 15.5% YoY in April but, adjusted for inflation, real wages fell by 6.9%. The slowdown in economic activity due to the fall in domestic demand is hardly surprising, as real wages have been shrinking for eight months. We do not expect any turnaround until the fourth quarter of 2023.

[The dilemma of Hungary's strong labour market](#)

Growth of real wages in Hungary (% YoY)

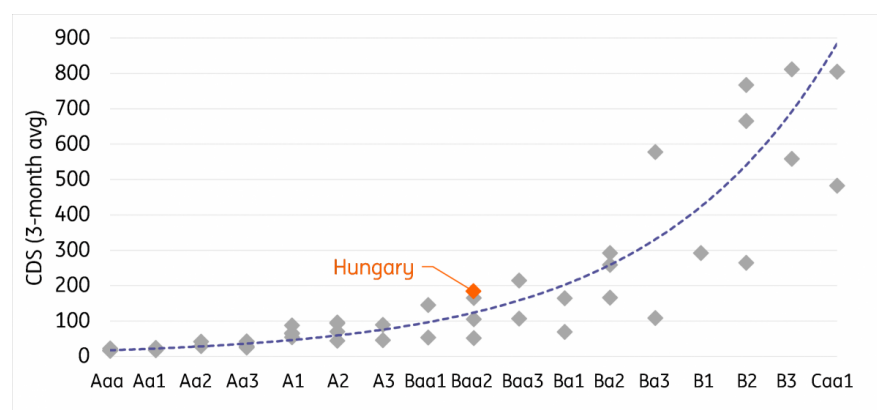


Source: HCSO, ING

EU funds remain the most significant risk to the credit rating

After downgrading its outlook from stable to negative in early 2023, Fitch affirmed Hungary's 'BBB' rating with a negative outlook in June. An outright downgrade was avoided - the country's external balances have improved significantly and the inflation outlook is promising. The unorthodox economic policy mix and the still uncertain disbursement of EU funds stand in the way of an outlook upgrade, although we remain optimistic that these funds can be disbursed before the end of the year. While we do not expect any change in the rating or outlook at S&P's forthcoming decision (7 July), the decision by Moody's (1 September) is more uncertain. This uncertainty stems from the lack of a review for the March rating decision, so we do not know the exact sensitivities. In addition, there is a high probability that Hungary will still not have a definitive agreement with the EU by 1 September.

CDS and sovereign credit rating (Moody's)



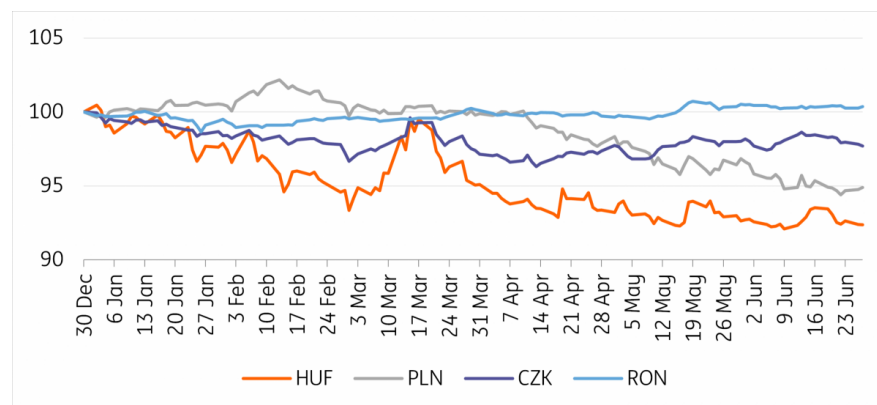
Source: Moody's, ING

We expect forint range trading to continue

After the expected 100bp rate cut in June, we've seen the usual pattern in EUR/HUF. In our [NBH preview](#), we noted that the market could well use weaker forint levels as an opportunity to build new positions and benefit from the highest FX carry within the region. Due to this carry, HUF is still the most popular currency in the EM space. We expect range trading to continue in the coming weeks and months, within a range of 368-378. Until the EU funds issue is resolved, the low-end of

the range will likely provide a strong resistance level. HUF has the potential to weaken if we see stronger-than-expected disinflation, possibly resulting in increased bets on more aggressive NBH easing. We believe that the central bank will stick to gradualism, and pre-meeting HUF weakness (from the top-end of the range) is set to return post-meeting. Another within-the-range risk for HUF would be if the government were to favour GDP growth over fiscal stability, particularly if economic activity was to weaken further.

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

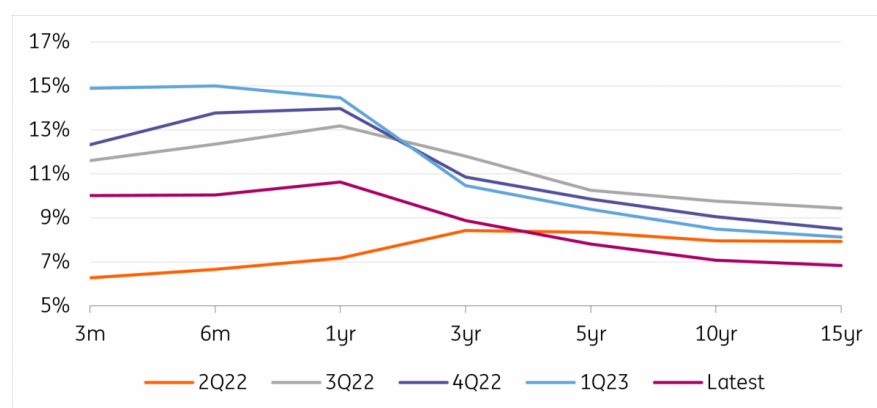


Source: NBH, ING

We continue to like Hungarian Government Bonds

In the rates space, we see the market more or less fairly pricing in the rate cuts this year and the super short end thus being anchored. Looking at the longer 1-3y horizon, we see room for the market to further price in some normalisation of NBH policy. Our long-term view thus remains unchanged - the 2s10s spread should steepen, with the entire curve moving lower and catching up with the market.

Hungarian sovereign yield curve



Source: GDMA, ING

Hungarian Government Bonds (HGBs) have rallied strongly in recent weeks, posting the highest overall returns in the CEE region this year. We continue to like HGBs, which benefit most from the overall outlook in Hungary, further supported by government measures and with funding fully under the control of the debt agency. We could still see strong flows into HGBs. But there are some

limitations here. We could see episodes of profit-taking and upward yield pressure from core rates, with further hawkishness coming from major central banks. We see a non-negligible risk that the government might be overly relaxed about the long-term inflation outlook, favouring growth via fiscal finetuning. On the other hand, it is hard to see a long sell-off after all the structural improvements - we expect the market to continue to like HGBs in general.

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