Monitoring Hungary: Full-year growth outlook downgraded

In our latest update, we reassess our Hungarian economic and market forecasts, as we turn gloomier on the full-year growth prospects. The marked collapse in domestic demand supports both external balances and disinflation. We also add some more hawkishness to our monetary policy call

Hungary: at a glance

- Following weaker-than-expected activity data in the second quarter, we now see a recession in 2023 as we lower our full-year GDP growth forecast to -0.5%.
- The collapse in domestic demand is reflected in industry and retail sales data, while the value added share of both sectors remained weak in the second quarter.
- Real wage growth has been negative for 10 months, and even after a turnaround, we expect only a limited impact on consumption in the fourth quarter.
- The slowdown in economic activity is drastically reducing import demand, and we now expect both the trade and current account balances to end the year in surplus.
- Disinflation will continue amid constrained repricing power, with the headline and core measures falling below 8% and 10%, respectively by the end of the year.
- After the September rates conversion, monetary authorities will likely switch off

the autopilot mode and move to a second phase of policy normalisation, so we make a slight hawkish change to our interest rate forecast.

- We see a 2% of GDP slippage in this year's budget, which is likely to be addressed by a combination of consolidation and an upward shift of the target after the expected September revision.
- We remain positive on the forint, as the relative carry opportunity has improved in light of the latest guidance from the central bank.
- In the rates space, a possible upside surprise to inflation might be convincing enough for investors to adhere to the hawkish tone of the central bank, shifting short-end rates higher.

Quarterly forecasts

	2Q23	3Q23F	4Q23F	1Q24F	2Q24F	3Q24F	4Q24F	1Q25F
Real GDP (%YoY)	-2.4	-0.2	1.7	2.8	4.2	3.5	3.0	3.2
CPI (eop, %YoY)	20.1	12.3	7.4	4.9	5.7	4.7	4.3	3.6
Central bank key rate (eop, %)	13.00	13.00	12.00	9.00	8.00	7.25	6.50	5.75
3m interest rate (eop, %)	15.17	13.00	12.00	8.25	6.80	6.00	5.25	5.15
10yr yield (eop, %)	6.99	7.25	7.00	6.80	6.85	6.75	6.50	6.65
EUR/HUF exchange rate (eop)	373.1	378.0	370.0	368.0	365.0	365.0	370.0	370.0
USD/HUF exchange rate (eop)	342.0	337.5	327.4	317.2	312.0	309.3	316.2	321.7

Source: National sources, ING estimates

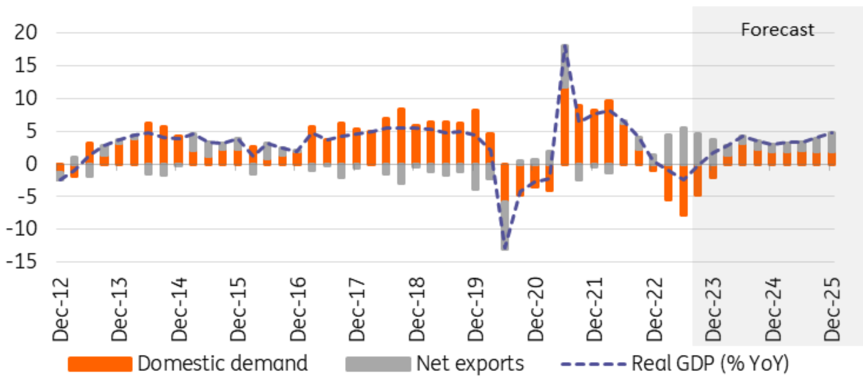
First-half data prompts downgrade to our 2023 growth outlook

Hungary has been in a technical recession for a year now, with economic activity contracting in all sectors except agriculture in the first half of 2023. The positive contribution from agriculture was not enough to pull the economy out of technical recession, as the collapse in domestic demand weighed on all sectors.

Going forward, although real wages are likely to rise from September, this should have a limited impact on consumption. With double-digit interest rates for the rest of the year and with scarce fiscal room, investment activity will be severely constrained. On the export side, a looming global manufacturing recession is likely to weaken export prospects.

Taking these factors into account, we have decided to revise our full-year growth forecast from 0.2% to -0.5% year-on-year, thus we now see a recession in 2023.

Real GDP (% YoY) and contributions (ppt)



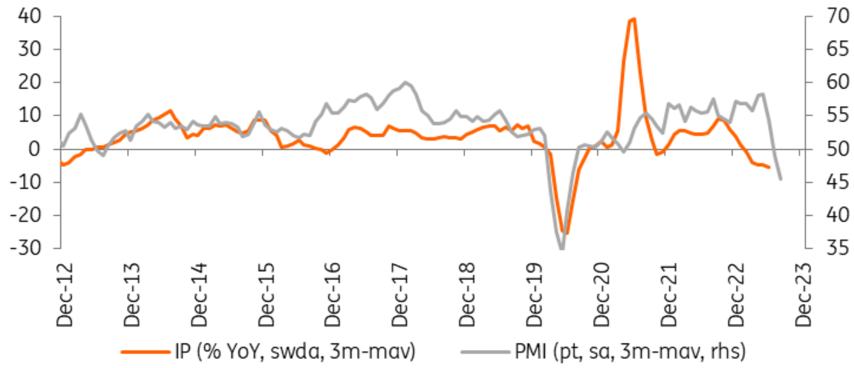
Source: HCSO, ING

Industry continues to struggle as domestic demand remains weak

Industrial production continued to disappoint in June, as production volumes fell by 0.9% month-on-month, contributing to a 6.1% year-on-year decline in output, adjusted for seasonal and calendar effects. At a sectoral level, the picture remains unchanged from recent months, with volumes expanding only in the electrical and transport equipment sub-sectors.

Essentially, these sub-sectors are largely producing for export sales, while others are clearly struggling with domestic sales. We see no major improvement in domestic demand going into year-end. Plus, as forward-looking indicators suggest that recessionary forces are building globally, this could weaken export prospects. Therefore, although the next month or two may bring some minor improvement, the longer-term outlook is still not favourable.

Industrial production (IP) and Purchasing Manager Index (PMI)



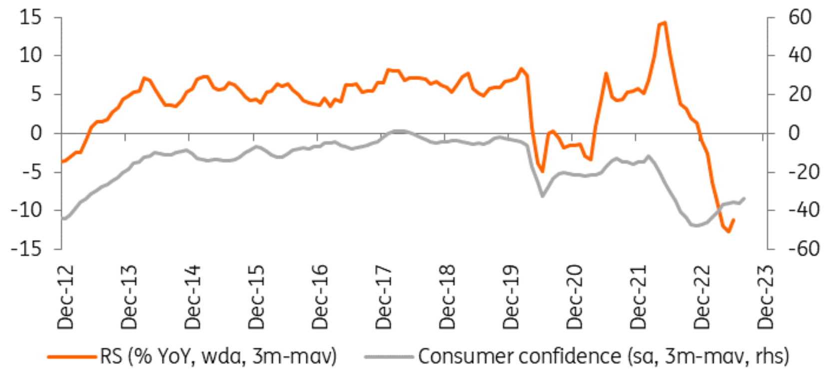
Source: HALPIM, HCSO, ING

Retail sales surprised in June, but the picture remains unchanged

June's retail sales release surprised to the upside as the annualised index improved to -8.3% YoY after a 0.7% monthly increase in sales volume. At the component level, both food and non-food retailing grew, with the latter posting an exceptionally strong 2.5% MoM performance. As for fuel sales, volumes fell on a monthly basis in line with higher fuel prices.

The tourist season (and the World Athletics Championships) might boost retail sales in the short run, but in general, constrained household purchasing power remains a major drag on retail performance. And although we expect a turnaround in real wage growth as early as September, we believe this will have a limited impact on retail sales this year, given the depleted savings and rising household overdraft debt.

Retail sales (RS) and consumer confidence



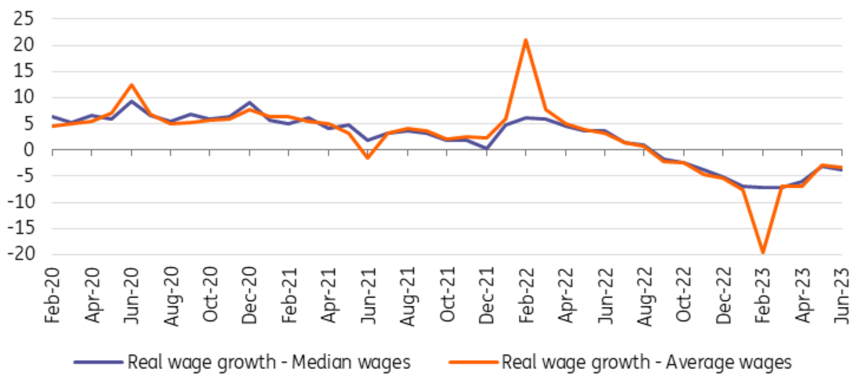
Source: Eurostat, HCSO, ING

We see limited growth impact from the turnaround in real wages

Average wage growth remained strong in June, rising by 16% YoY, although this was a bit slower compared to May. However, after adjusting for inflation, real wages fell by 3.4% YoY, extending the streak of negative real wage growth to 10 months. In our view, even after the turnaround in real wage growth in September, we do not expect a rapid recovery in consumption due to depleted savings and depressed consumer confidence.

The three-month unemployment rate rose slightly to 4.0% in the May-July period, which is remarkably low given the one-year technical recession. We believe that even if positive seasonal effects fade, the peak could remain close to 4% as companies face structural labour shortages. Nevertheless, this puts upward pressure on wage growth and thus represents an upside risk to the inflation outlook.

Growth of real wages in Hungary (% YoY)



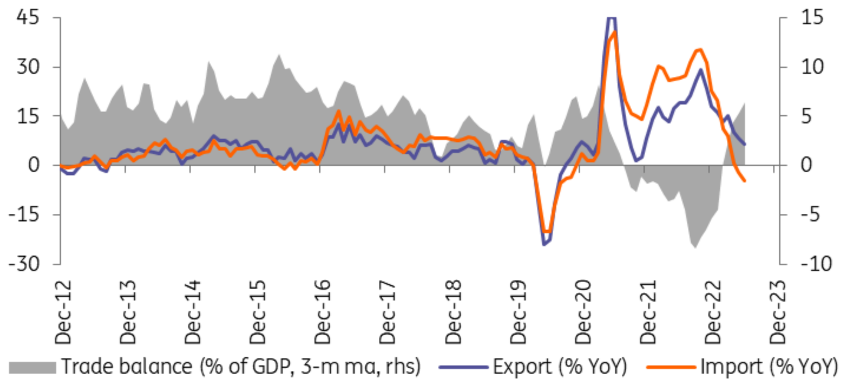
Source: HCSO, ING

We expect the current account to be in surplus in 2023

As economic activity has been weakening, the collapse in domestic demand is rapidly 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 is still supported by new EV battery plants, while carmakers are still dealing with some backlogs.

Taking all these factors into account, it is hardly surprising that the trade balance has been in surplus for five months, while the current account also posted a surplus in the second quarter, according to preliminary data. Against this backdrop, we lift our forecast and now see the current account balance reaching a surplus of 0.3% of GDP in 2023. However, a further slowdown in the global economy could weaken export prospects, limiting the upside to this forecast.

Trade balance (three-month moving average)



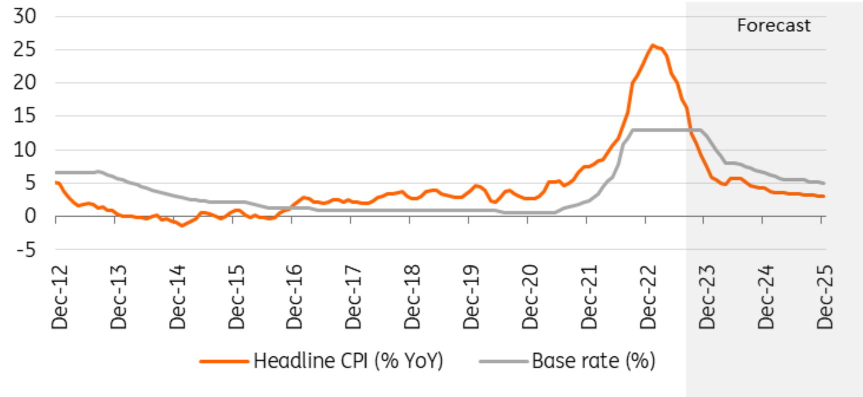
Source: HCSO, ING

Inflation will fall below 8% by December, but 2024 brings challenges

Headline inflation sank to 17.6 % YoY in July, mainly on base effects, while prices rose by 0.3% compared to June. At the component level, food inflation continued to moderate, while the slump in domestic demand was reflected in both durable and non-durable goods prices. 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.

We expect headline inflation to fall below 8% by December, but next year brings a number of upside inflationary pressures, such as the increase in excise duty on fuel prices and a possible 10% minimum wage increase. In addition, this year's budget revision, due in September, will include some tax increases, which we believe will pose further second-round inflationary risks.

Inflation and policy rate



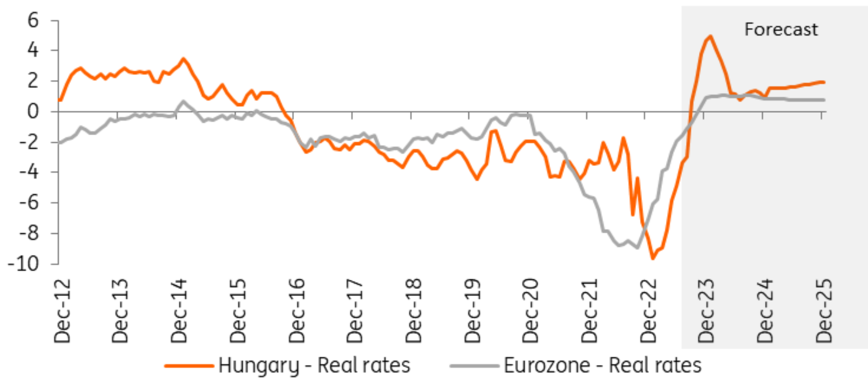
Source: NBH, ING

Our interest rate forecast has changed due to recent hawkish message

At the August meeting, policy normalisation continued as the National Bank of Hungary (NBH) cut the effective interest rate by a further 100bp to 14%. The main takeaway from the meeting was that the autopilot will be switched off after the September rates conversion, a clear hawkish pushback against "excessive rate cut expectations". With a data-dependent approach, the NBH will focus on both the inflation outlook and maintaining market stability, so nothing is set in stone.

Moreover, the plan to manage the highest positive real interest rate in the region will shape the NBH's decision-making function, which will both strengthen disinflation and make HUF assets more attractive. In our view, the second phase of monetary policy normalisation will bring a first rate cut in December, with a 100bp step. As for October and November, we currently expect a pause, as the NBH will continuously assess the risk environment, paying special attention to the uncertainty surrounding the EU funds and pro-inflationary risks going into 2024.

Real rates (%)



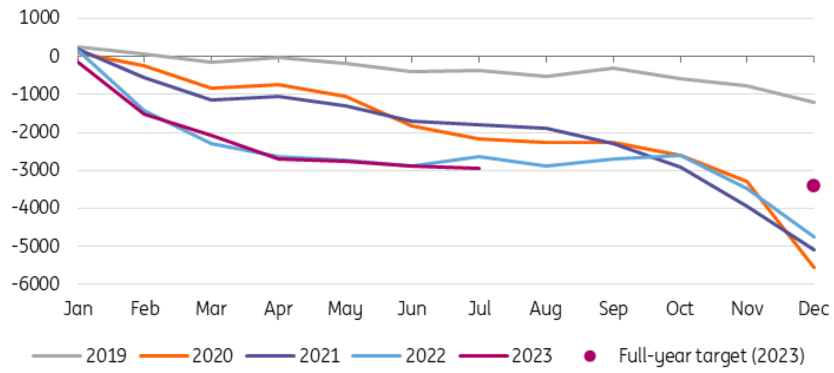
Source: ECB, NBH, ING

The 2% of GDP slippage in the budget will be addressed in September

The Hungarian budget posted a deficit of HUF 44.3bn in July, bringing the year-to-date cash flow deficit to 86% of the full-year target. The decline in domestic demand is weighing heavily on tax revenues. In this respect, VAT receipts in the first seven months of 2023 were only 1.5% higher than a year ago, compared to an average inflation of 23.2% in this period.

We see a 2% of GDP slippage in this year's budget, which is likely to be addressed by a combination of consolidation and an upward revision of the target after the expected September revision. We see the EDP deficit target being raised by 0.5ppt to 4.4%, while a number of austerity measures are likely to be announced. From a financing perspective, the financing needs are likely to be met through FX debt issuance in the form of another market-sized Eurobond issuance.

Budget performance (year-to-date, HUFbn)



Source: Ministry of Finance, ING

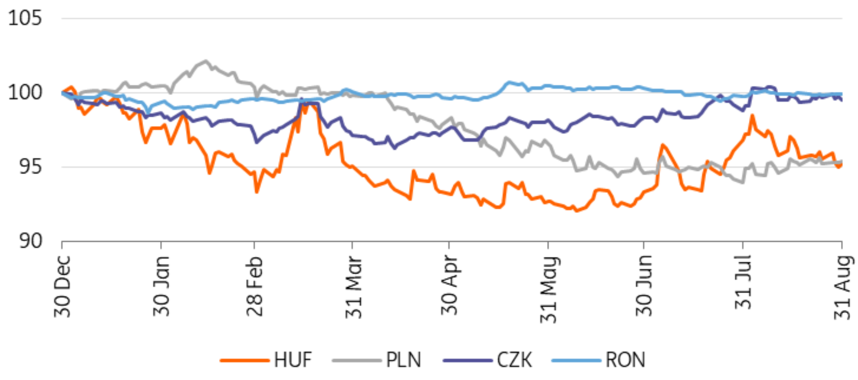
We believe the forint will benefit from the retuned hawkish message

Since the beginning of August, the Hungarian forint has strengthened versus the euro from levels above 390 to below 380. This has happened despite the fact that the "higher for longer" narrative has gained momentum in the US, which has kept the dollar firmly bid. Not to mention the uncertainty surrounding the Australian LNG strikes, which caused volatility in gas prices. However, the forint seemed to shrug off these headwinds and closed the month with a gain of around 2.5% against the euro.

Going forward, we remain constructive on the overall outlook for the HUF. As the central bank has reined in excessive rate cut expectations, the relative carry opportunity has definitely improved. In this respect, the forint can maintain its very attractive carry, the highest in the Central and Eastern European region and leads the emerging markets space despite 400bp of cuts so far.

The NBH will carry out the second phase of monetary policy normalisation in such a way that HUF assets will be supported by the highest real interest rates in CEE. In addition, the country's external balances have improved significantly due to the slump in domestic demand, and we now expect the current account to post a full-year surplus. Taking these factors into account, we still believe that the forint can strengthen back to the 370 level against the euro by the end of this year. But the road there will be bumpy, with many red flags waving, from the fate of EU funds to the outcome of this year's budget review to the decisions of credit rating agencies.

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



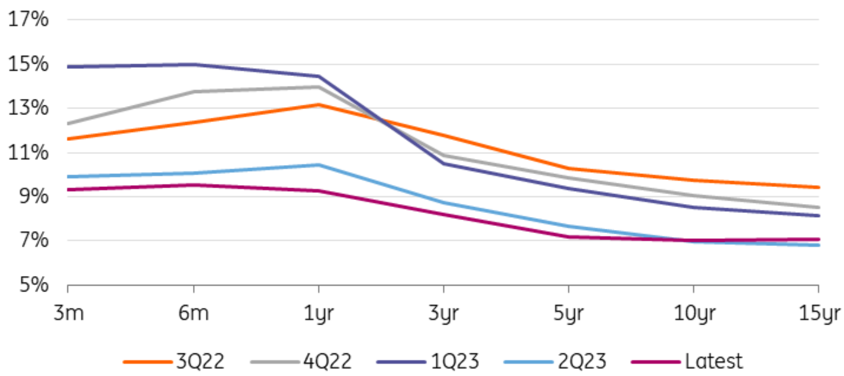
Source: NBH, ING

We see an increased chance for a stark repricing

On rates, the 6x9 month FRA rose 8bp in the immediate aftermath of the August meeting, although we acknowledged that this is still relatively modest, so we saw some room for further correction. However, the market has ignored the hawkish message and continues to price in a more dovish monetary policy with the three-month implied rate at 10.1% at the end of the year.

In our view, investors need evidence of hawkishness, and, like the central bank, the market is becoming data-dependent, just like the National Bank of Hungary. The next test will be the incoming August inflation print on 8 September. If we see a higher-than-consensus inflation reading - and we see a fair chance of upside risk here, mainly on food, services and fuel - then it could really reverse the market's pricing of an aggressive easing cycle.

Hungarian sovereign yield curve



Source: GDMA, ING

The Hungarian government bond (HGB) market went through a bull steepening in August as a result of the ongoing rate cut cycle, the strengthening disinflation and some risk reversal which was also visible in HUF gains. As the summer lull comes to an end and the market deepens, we may see more interest in forint bonds. The only limitation here could be the expected budget review.

However, the retail bond market is doing well and we see the Government Debt Management Agency filling the gap with FX debt issuance, so we believe that HGBs will remain attractive. The fastest disinflation in the region should also be supportive. A big red flag here is the possibility of another negative sovereign credit rating outcome. Tactically, investors need to be quick because of the volatility, while strategic market players need to have nerves of steel.

Forecast summary

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Central bank key rate (eop, %)	13.00	13.00	12.00	9.00	8.00	12.00	6.50	5.00
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10yr yield (%)*	6.99	7.25	7.00	6.80	6.85	7.76	6.78	6.22
EUR/HUF exchange rate*	373.1	378.0	370.0	368.0	365.0	380.5	367.6	370.0
USD/HUF exchange rate*	342.0	337.5	327.4	317.2	312.0	346.5	316.4	320.6

Source: National sources, ING estimates

*Quarterly data is eop, annual is avg.

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