

# Hungary Watch: Strong start – but be prepared for a poor finish

Despite the strong start of the year, the Hungarian economy is facing multiple challenges pointing towards a fast and drastic deceleration of economic growth in the rest of the year. The negative factors include the deterioration of the terms of trade, the hefty fiscal consolidation need, the ongoing global supply chain problems, the freezing of EU funds and even a potential energy crisis. We keep our GDP forecast for 2022 unchanged at 2.5% as a baseline scenario.

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Preliminary Q1 GDP came at 8% yoy and (working day and seasonally adjusted) and 2.1% qoq. This is above market consensus and our estimate (7.4% and 7% respectively). According to the statistical office, growth was registered everywhere in the economy, but especially industry and market services could contribute to growth. The strong start of the year was not unexpected as the growth momentum was particularly strong in the previous quarters. Moreover, in the pre-election months, the government provided generous income transfers to households (13<sup>th</sup> month pension, minimum wage increase, tax rebate for families etc.). It is also worthwhile to mention that in Q1 2021 covid lockdowns were still effective, providing a low base to compare. Nevertheless, going forward, the robust growth performance of the Hungarian economy is challenged from various directions.

1. So far, the headwind coming from **deterioration of the terms of trade** (i.e. import prices – most notably energy prices – increasing much faster than export prices) was not much visible yet in the GDP data, but in our view, this would change in the rest of the year, damaging growth performance.
2. Another problem of the economy is the durable nature of **post-covid supply chain disruptions** – as the Hungary's extensive export-oriented manufacturing industry is deeply integrated in global trade. The outlook is not promising as the global supply-demand frictions are unlikely to get resolved in the next 1-2 year and may get worse before becoming better.
3. **Hungary-EU relations** are strained, and no quick compromise expected. The European Commission started the Rule of Law Mechanism in April. This is going to be a lengthy procedure which may end in Q4. For the time being we assume that eventually there will be a political compromise achieved. However, the likelihood of such a scenario is not increased by recent political tensions (i.e. Hungary's veto on the EU's sixth sanction package against Russia including a ban on oil import from Russia). The bottom-line is that as long as the Rule of Law mechanism goes on, **the EU keeps blocking EU funds to Hungary**. Over the past years, Hungary's net financial position with the EU was around EUR 5bn (3-4% of GDP). Apparently, the bulk of this money is going to be missing from the Hungarian economy in 2022.

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4. **Fiscal consolidation in the magnitude of 2-3% of GDP** in order to reach the 4.9% budget deficit target in 2022. This is the cost of higher interest rates (and therefore more costly debt-refinancing) and the fixed household energy price regime (effective since 2013) amidst the circumstances of drastic energy price increase. It is generally assumed that fiscal consolidation will be carried out by 1) cutting public sector infrastructure development projects and 2) introduce or increase sectoral taxes (similar to the 2010-2013 fiscal consolidation episode). The targets are likely the same as previously: financial, telecom, energy, retail trade sectors. In its unorthodox measures, the government is typically fairly creative though, meaning that one can not rule out any twist in the fiscal consolidation. Anyhow, fiscal consolidation is painful for those who bear the burden and therefore it is growth-negative.
5. **Energy shipments:** Hungary is the major proponent of leaving out Russian energy import from EU sanctions. We do not know whether to what extent these efforts will bring the hoped results. But in case the war is not ending any time soon (which seems to be the case) the **chances are growing that not all the needed Russian energy import gets realized**. The capability of Hungary to substitute potentially missing Russian oil and gas shipments is limited (much more limited compared to most other EU members due to geographical location and existing infrastructure). That is why we need to cautiously prepare to negative scenario that involves rationing energy (at least temporary and to a limited group of users).

Having sketched up the above challenges the Hungarian economy is facing in the rest of the year, we believe that growth will swiftly decelerate. We expect quarterly growth rates to come already in the negative territory from Q2 on (therefore we forecast technical recession) and calculate with a negative yoy GDP reading for Q4. Despite the marginally better than expected Q1 GDP data, **we keep our 2.5% growth forecast for 2022 and 2% for 2023**. This is our baseline scenario, and we admit that in case the biggest danger (i.e. energy crisis) can be avoided, the Hungarian economy may deliver around 4% GDP growth this year.

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