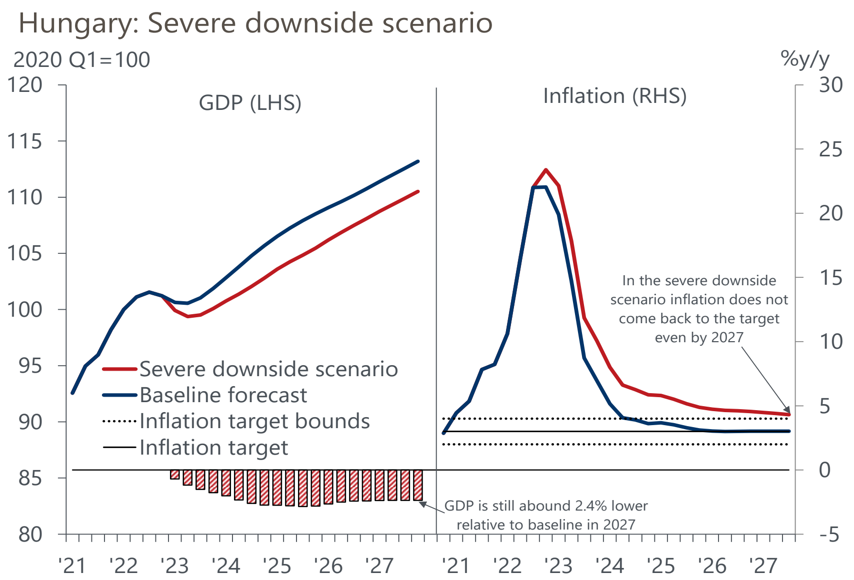
Research Briefing | Hungary

EU funding cuts could trigger an economic crisis

- **The Hungarian economy is being hit by a perfect storm of shocks, particularly surging inflation and a weakening currency. Our baseline forecast already anticipates a recession over the winter and inflation staying elevated for some time. But risks of a more severe scenario are rising.**
- **If a number of catalysts – especially the cut-off of some EU funding – crystallise, Hungary could enter a period of macroeconomic instability not seen since 2008. In this scenario, we think the economy would shrink 1.3% next year, and GDP would stay 3% below baseline into 2025. At the same time, policymakers fail to bring inflation back to target until as far away as 2027.**
- **The biggest risks in a severe downturn scenario stem from inflation getting out of hand. In September, headline inflation breached the 20% y/y threshold – the first out of the larger CEE countries. Worryingly, it shows little signs of abating. But a slower-than-expected decline in inflation, not least due to the weaker forint, would lead to inflation expectations fully de-anchoring. This, in turn, would weigh on asset valuations and amplify economic instability.**
- **Other threats are no less serious. The standoff with the EU could curtail Hungary's access to a vital source of investment financing. This could drag public investment down by around 25% relative to the baseline, weighing on potential output. Hungary's swelling external imbalance – the current account deficit is wide (currently over 6% of GDP) – makes the economy especially vulnerable to this kind of shock. And Hungary's external debt denominated in US dollars and euros is higher than in its peers, meaning that currency depreciation hits it disproportionately.**
- **Striking a deal with the EU and getting the macroeconomic policy mix right in the coming months will be critical to the economy's short-to-medium-term outlook. Recent actions by the Hungarian National Bank, as well as Prime Minister Viktor Orban's push to appease the conflict with the EU offer a glimmer of hope. But much more will need to be done especially on the fiscal side to avoid permanent damage to the economy.**

Chart 1: Realisation of a number of key risks would exacerbate Hungary's stagflationary predicament



Source: Oxford Economics/Haver Analytics

Mateusz Urban - Senior Economist - murban@oxfordeconomics.com

Every take-off is optional. Every landing is mandatory.

—pilots' common saying

Despite the robust performance of the Hungarian economy since the onset of the post-pandemic rebound (see here and here), dark clouds have been steadily gathering over the outlook. To gauge the extent to which realisation of a number of key downside risks would affect the path of the economy, we have modelled an adverse crisis scenario using our Global Economic Model (GEM).

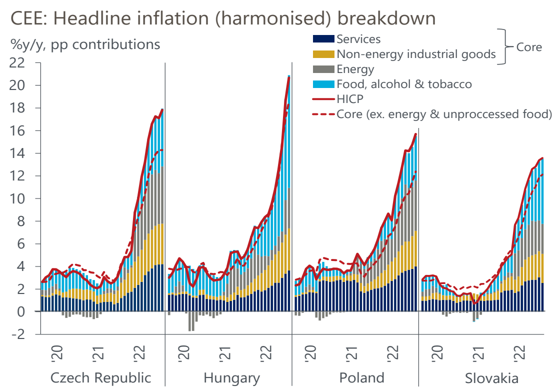
But as a number of distinct – though often related – factors are currently weighing on the outlook, it's worthwhile first to set out the risks, before examining the results of the quantitative analysis.

Inflation is still the key risk

Inflation tops the list of near- and medium-term risks. This should not come as a surprise, given how large the current surge in inflation in both advanced and some emerging economies has been. However, a number of factors render the inflationary risks in Hungary much more pronounced compared to some of its peers (e.g. Czechia or Slovakia), not to mention the more advanced eurozone economies.

Firstly, inflation momentum shows little signs of abating, with the CPI index growing 4.5% m/m (20.1% y/y, Chart 2) in August – an eye-watering print indicating that prices grew more strongly over the month than they should over the year under an annual inflation target of 3%.

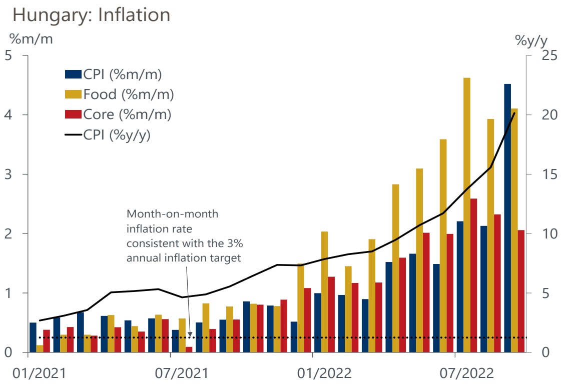
Chart 2: Hungarian inflation is growing at an alarming rate



Source: Oxford Economics/Haver Analytics

Granted, most of the monthly pick-up in September is attributable to the modification of governmental caps on retail energy prices (with energy, excluding motor fuels, prices jumping 59% m/m) and the rapid rise in food prices (4% m/m and 35% y/y). But, worryingly, a solid momentum in core inflation (consistently posting above 2% m/m since May) indicates that strong underlying price pressures are still very much present despite the policy tightening (Chart 3).

Chart 3: Core inflation momentum remains historically high

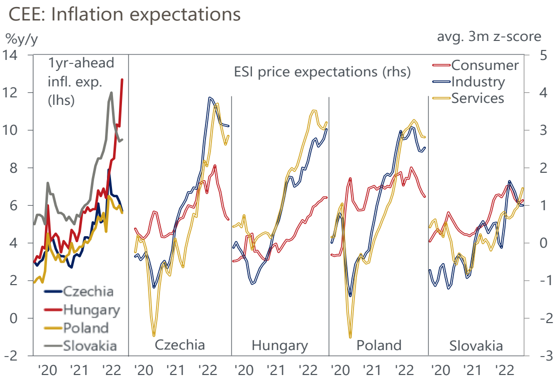


Source: Oxford Economics/Haver Analytics

Second, excessive domestic demand is playing a vital role in the surge in inflation, alongside global factors. This resembles the characteristics of inflation drivers in Poland (see here), but is slightly at odds with Czechia and Slovakia, and even more so the eurozone. Demand drivers in Hungary remain unchanged, at least since the start of the year, including primarily: tight labour markets keeping nominal wage growth pressures strong (16.6% y/y in August); and the use of excess savings (which were boosted by pre-electoral bonuses and government caps on energy prices) to cushion the inflationary hit to disposable incomes. Indeed, our recent analysis pointed out that although the risk of a fully-fledged wage-price spirals overall remains contained in Central and Eastern Europe, we cautioned that the situation in Hungary will likely lead to a prolonged period of high nominal compensation growth. Data received since indicates this scenario is indeed materialising.

Third, near-term consumer and business inflation expectations show signs of de-anchoring in Hungary, in contrast to other CEE countries, where recently we saw some easing (Chart 4). The issues associated with measuring inflation expectations notwithstanding, this serves as a warning sign that Hungarian inflation might have become self-propelling. This, *in extremum*, could result in decoupling from any nominal anchor, rendering a return to target long and very costly.

Chart 4: Inflation expectations continue to creep up in Hungary, in contrast to the rest of CEE

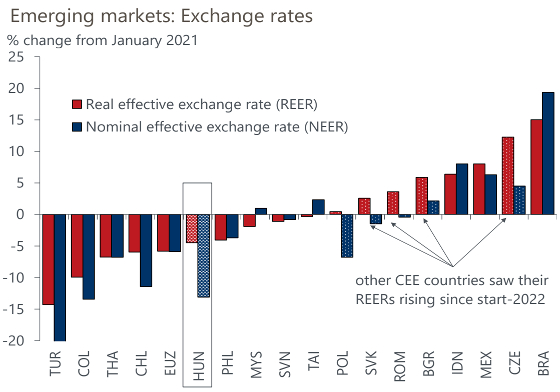


Source: Oxford Economics/Haver Analytics

Current account deficit and foreign debt weigh on the forint

We recently observed that, in stark contrast to previous crises, EMs have proved much more resilient in the energy crisis – at least so far. But while this is true on the aggregate, net commodity importers in Europe, of which Hungary is a prime example, have been hit disproportionally hard, with depreciating exchange rates being a direct consequence of the deteriorating economic outlook. But even a cursory look at the data shows that weakness of the Hungarian forint, which has lost around 13% of its value since the start of the year in broad terms, is remarkable.

Chart 5: Hungarian forint fell 4.5% since January in inflation-adjusted terms

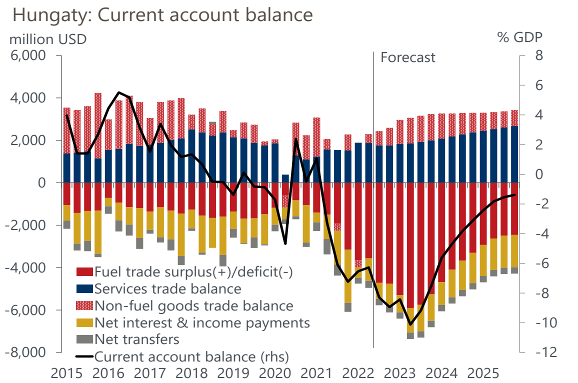


Source: Oxford Economics/Haver Analytics

This is especially true if we compare real (i.e., inflation-adjusted) exchange rates; it turns out that the HUF has suffered more than the inflation differential would suggest, being the only major CEE economy where real effective exchange rate (REER) fell since January (Chart 5). This suggests we need to look past inflation to determine root causes of the realised depreciation in the forint.

The growing external imbalance is an obvious candidate. The excess demand at home, in conjunction with a spike in prices of imported fuels – a monthly bill that has ballooned from around €850m in January 2020 to €2.3bn in August 2022 (which is exacerbated by the fact that the price for Russian gas is directly linked to the market price) – has led to a marked deterioration in the Hungarian current account. The deficit grew to around 6.2% of GDP in August and is expected to deteriorate further, likely surpassing 8% of GDP in 2023, substantially above its CEE peers (Poland 4.3%, Czech 6.8% of GDP), then narrowing only gradually (Chart 6).

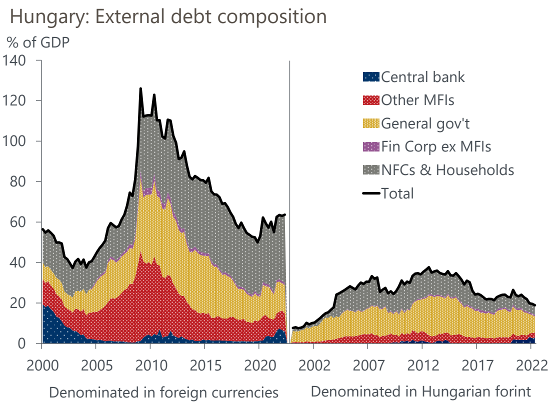
Chart 6: Hungary's current account deficit widened markedly as import fuel costs shot up



Source: Oxford Economics/Haver Analytics

In addition, despite the secular fall since the early 2010s, Hungary is still burdened by elevated external debt. In Q2 2022, debt was equal to 82% of GDP, notably above Czechia (around 30%), Poland (51%) and Romania (46%). But it's not just the amount of the external debt that is a cause for worry, it's the composition. Around three-fourths (62% of GDP) of external debt is denominated in hard currencies, primarily the dollar and euro, with around half of it constituting liabilities of households and non-financial corporations (Chart 7). The weaker the forint gets, the bigger pressure non-HUF-denominated debts put on the balance sheets of domestic actors, weighing on growth and investment outlays.

Chart 7: Hungarian external debt burden is amplified through forint weakness

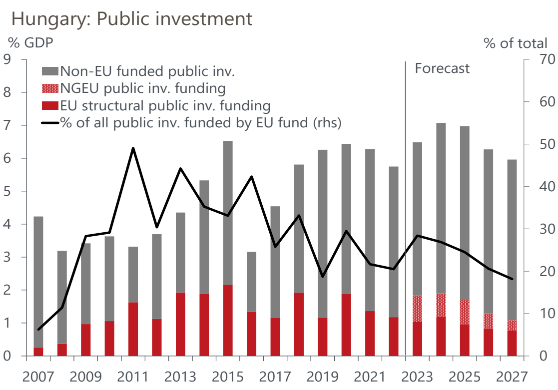


Source: Oxford Economics/Haver Analytics

Cuts to EU funding would exacerbate Hungary's stagflationary predicament

Political factors are also at play. Hungary has been one of the biggest recipients of EU funding per capita, with net annual inflows averaging around 1.7% of GDP since 2007. Crucially, the bulk of these inflows have been financing investment – private and, especially, public, as EU money financed around a third of all public investment outlays since the accession (Chart 8).

Chart 8: Transfers from the EU have funded around a third of all public investments



Source: Oxford Economics/Haver Analytics

The ongoing standoff with the EU puts future flows in doubt, and not just the NGEU grants (€7.2bn/4.4% of GDP). The more important so-called "structural" funds (€22.3bn allocated in the 2021-2027 perspective) are also at risk. A detailed review of the current stand-off is beyond the scope of this note (for a concise summary, see here), but the bottom line is that the risk of a substantial cut to EU funding is material. The NGEU grants remain frozen, given the rejection of the National Recovery Plan, which Hungary has until end of year to get accepted otherwise 70% of these funds will be lost. But even if the NRP is accepted, which might happen as soon as next week, Hungary will still need to pass the prescribed milestones to receive the money. On the structural funds, the European Commission recently threatened to cut them by €7.5bn (4.6% of GDP), should Hungary fail to agree to the EU's demands on the rule of law and corruption prevention.

We think that failure to secure the funding would exacerbate Hungary's current predicament, and would affect the trajectory of the economy now and in the long-term. To quantify the impact, we used our GEM to model a severe downside scenario. This assumes that the NGEU money remains locked and that the conditionality mechanism is triggered, curbing the amount of structural funding. On top, a worsening of the near-term outlook weighs on the forint, and inflation expectations pick up further (for the full set of assumptions see **Box** below).

In this scenario, Hungary falls into recession next year (-1.3% y/y, down 1.4ppts from the baseline). as investments slump 8%, largely due to lower public outlays (down by around 20% relative to the baseline forecast) and a further hit to sentiment. This hampers the productive capacity of the economy, which is one of the reasons why GDP remains 2.8% below the baseline forecast in Q4 2025 (Chart 1). Despite demand destruction cooling inflation, the deteriorating exchange rate and higher inflation expectations reverse this effect and keep inflation higher. As the forint weakens further by around 5% against EUR, with only a limited rebound over 2023-2024, inflation remains very high (at 18.5% next year and 7.7% in 2024) and does not come back to target even by the end of the scenario horizon in 2027. Hungary's central bank is forced to prop up its policy rate by another 300bps, deepening the squeeze on financial conditions, and reflected in 10-year bond yields, which stay around 200bps higher relative to the baseline forecast.

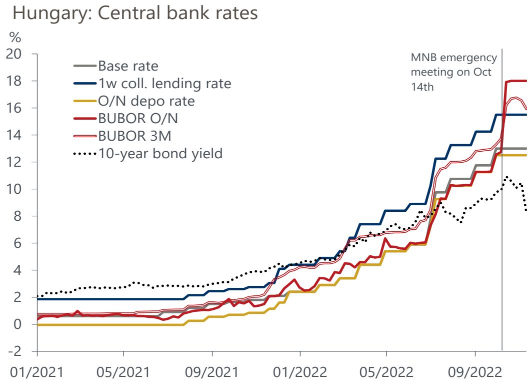
Getting the policy mix right is key to escape the stagflationary trap

Securing EU money would be instrumental in limiting the chances of a severe downturn scenario materialising, as it would bolster the exchange rate and support capacity-enhancing investments. But even if the recent talks and signals of concessions coming from government officials warrant cautious optimism, this alone will not negate a (very) hard landing scenario completely.

What else would have to happen? Lower world commodity prices would certainly help, but getting the domestic policy mix right seems even more important. And while the National Bank of Hungary has hiked its policy rate to 13% (Chart 9) and is actively defending the forint using other interest rates (such as the one-day deposit tenders, with the interest rate at 18%), it remains to be seen if the amount of tightening implemented will prove sufficient to sustainably counter the pressure on the forint, especially if inflation continues to surprise to the upside. But arguably, given the outsized squeeze on financial conditions to date, it might be preferable to use alternative policy levers to correct imbalances.

This is why, apart from securing EU funds, fiscal policy also needs to get in line. It seems to be well understood as a principle by the government, but its actions to date have proved insufficient to materially alter the path for fiscal deficits. Despite a push to cut some expenditures (mostly on the investment side), the fiscal deficit is likely to surpass 5% of GDP this year, with little improvement seen in 2023, not least due to high import gas prices locked-in in the latest bilateral deal with Gazprom. The situation is being worsened by the fact that the Hungarian government has excessively subsidised retail energy. And while withdrawing all remaining support at once is likely politically unfeasible due to the high social cost, at the very least Orban's government needs to provide a clear path for fiscal tightening, and then follow through on it. To escape its predicament without suffering permanent economic damage, Hungary will need to harness all available tools.

Chart 9: The MNB has tightened policy to fight inflation and support the forint



Source: Oxford Economics/Haver Analytics

Box 1: Severe downside scenario assumptions and transmission mechanisms

Table 1: Severe downside scenario assumptions and transmission mechanisms

Scenario lever	Assumptions	Transmission
European funds	European Commission does not accept Hungarian NGEU; structural funds for the 2021-2027 MFF are cut by 7.5bn	Public investments take a proportional hit to the funds cut; the hit to private investments is in line with the assumed proportion of EU funding channelled to private firms
Confidence	The decision to cut European funds inflow hits business and consumer confidence	Investments and consumer spending fall in line with the shock to confidence, which is calibrated to be around a quarter of the magnitude of the 2008 shock
Inflation expectations	Expectations of a weaker forint causes inflation expectations to de-anchor from the inflation target	Inflation expectations increase to over 10% y/y in 2023 and decay only gradually thereafter
Financial markets' reaction	Financial markets react to the worsening growth outlook by demanding a larger risk premium on Hungarian assets; MNB tightens monetary policy	Forint weakens by a further 5% against EUR; risk premium on government bond yields increases by around 200bps relative to the baseline; MNB increases the policy rate by 300bps

Source: Oxford Economics