SPECIAL REPORT

Hungary: Chasing growth

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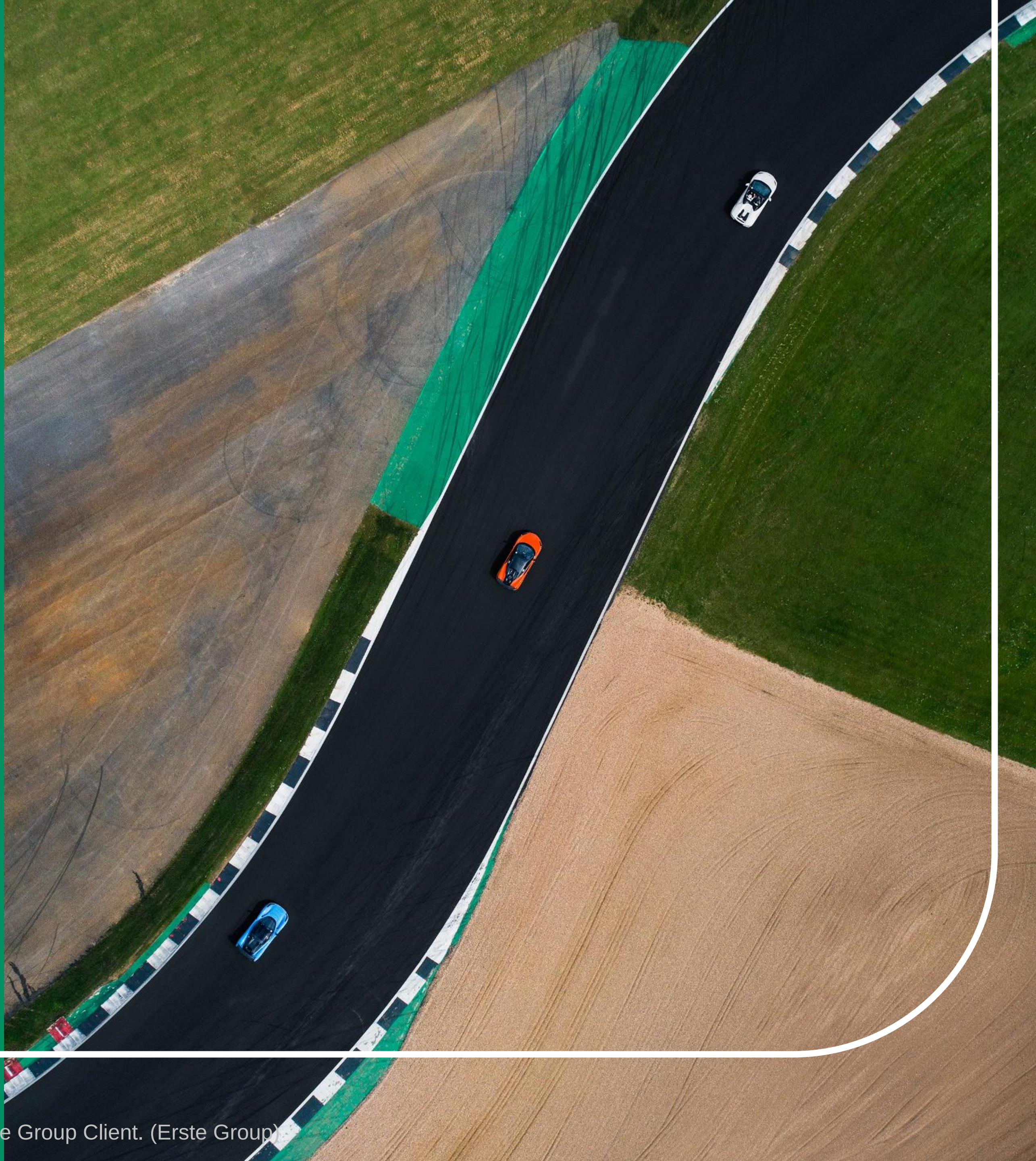
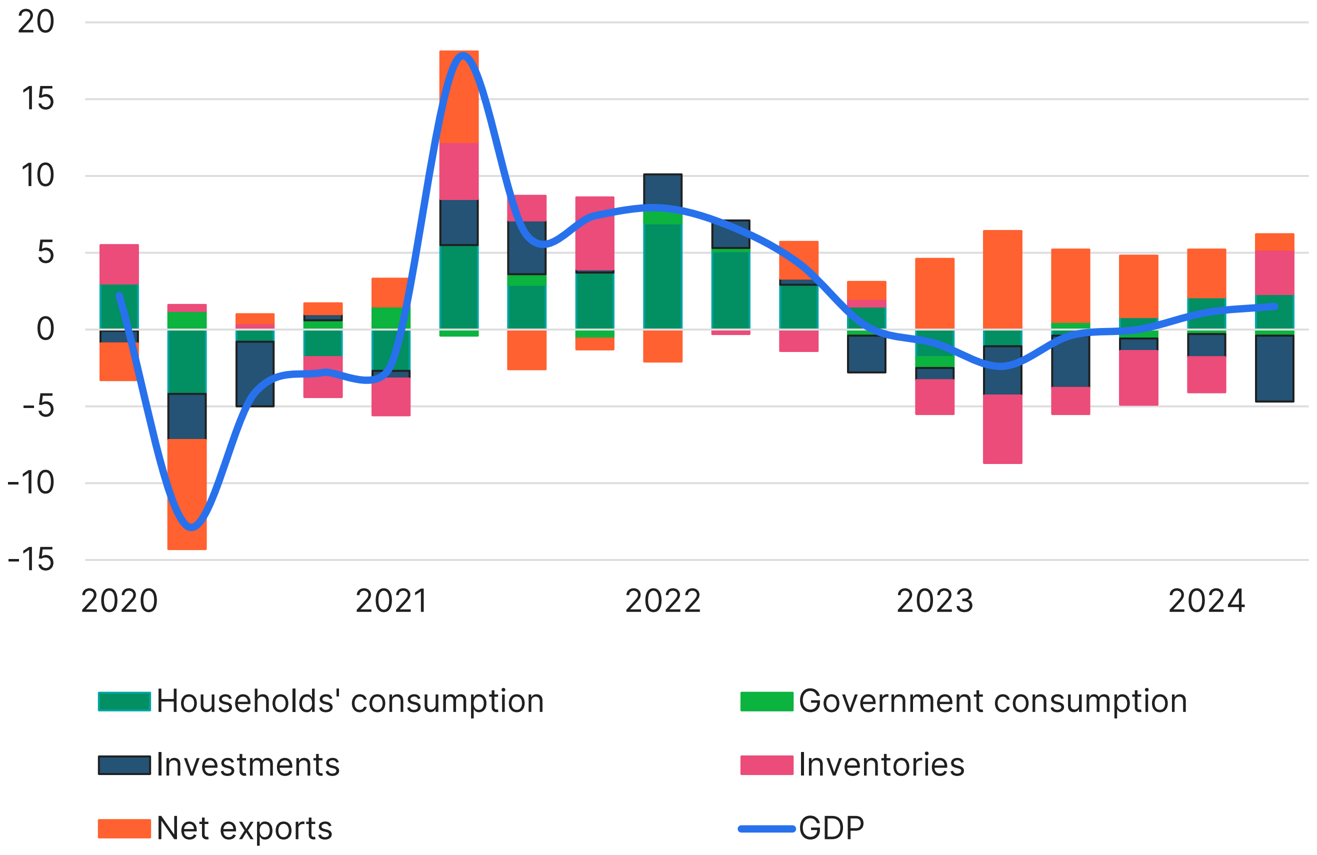


Preface

- Domestic demand is a crucial part of the GDP growth: households' consumption and investments account for 85 percent of GDP in Hungary. Increasing wealth of households has supported the growth. Further, strong investment activity means the expansion of those capacities that maintain the positive contribution of industrial exports to GDP.
- In 2022, the outbreak of the Russian-Ukrainian war and the energy crisis turned into an inflationary and an exchange rate crisis in Hungary, eroding consumer and business sentiment. The key rates must have been raised to 18 percent and kept at this level for more than a half year. Low sentiment, high inflation and rates pulled relevantly back the performance of the real economy in 2023. Hungary was in a mild recession that year (sadly as the only country in the region) that was primarily driven by the plummeting domestic demand.
- Households have recovered only partially from the 2022 energy and inflation shock as private consumption growth ticked up. Worryingly, investment activity remains subdued dragging the growth and the recovery. Actually, Hungary is the only country where investment growth declined since the pandemic making us curious about possible reasons of such development.

Domestic demand has been a decisive growth contributor

Contributions to GDP growth (expenditure side, percentage points)



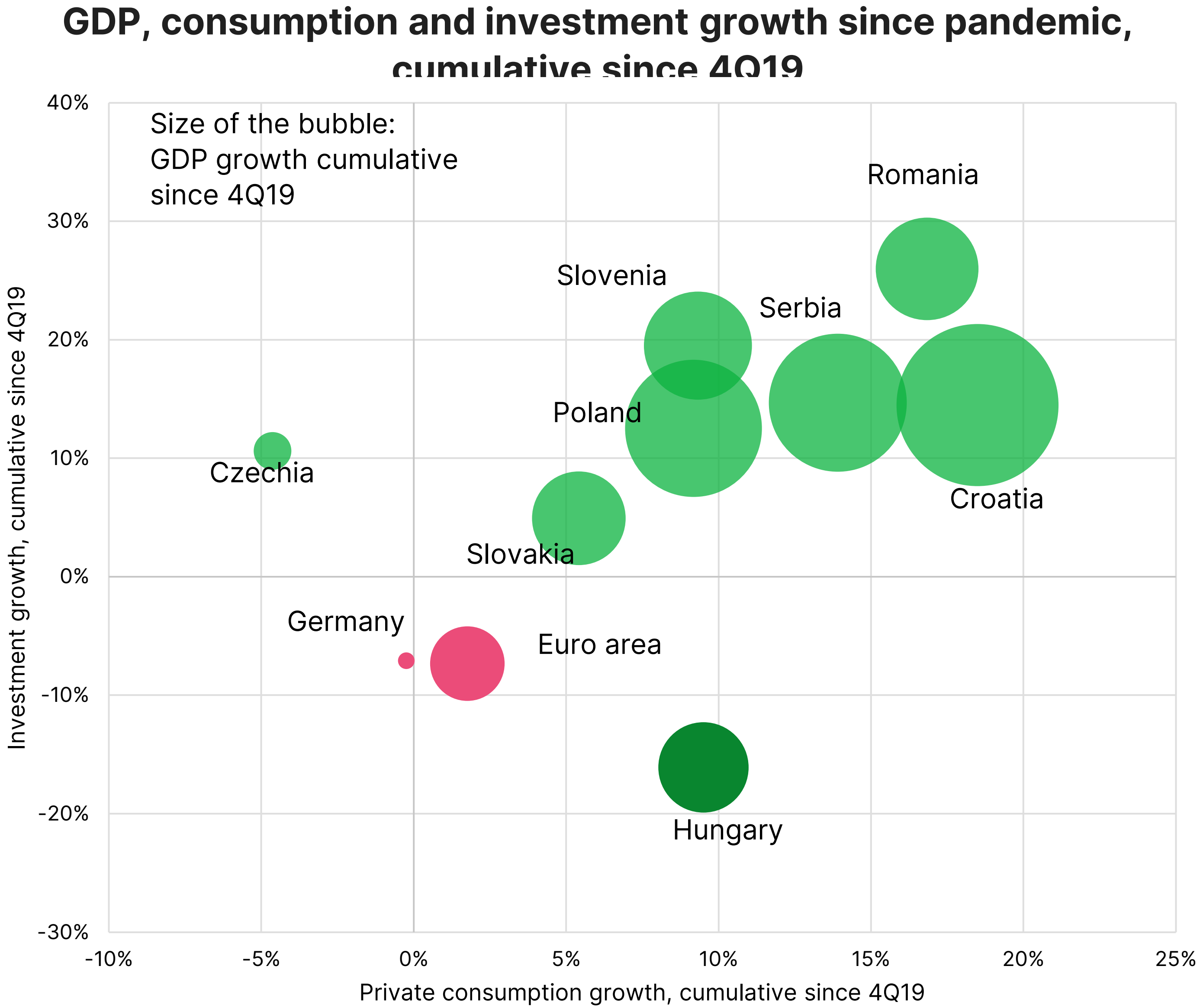
Vivid domestic demand has been a relevant growth factor in Hungary. Due to the favorable performance, the pace of GDP growth usually exceeded 4 percent before the pandemic.

After the fast revival following the pandemic crisis, the recession of the 2022-23 period eroded the power of the domestic segments, however.

In 2024, consumption is on the way to slowly turn back to the positive territory, on the back of positive real wages.

On the other hand, in case of investments, there are less reasons for optimism, as the performance reached a new bottom in Q2 2024.

Source: HCSO, Erste Research



Balanced structure of post-pandemic recovery, apart from Czechia and Hungary

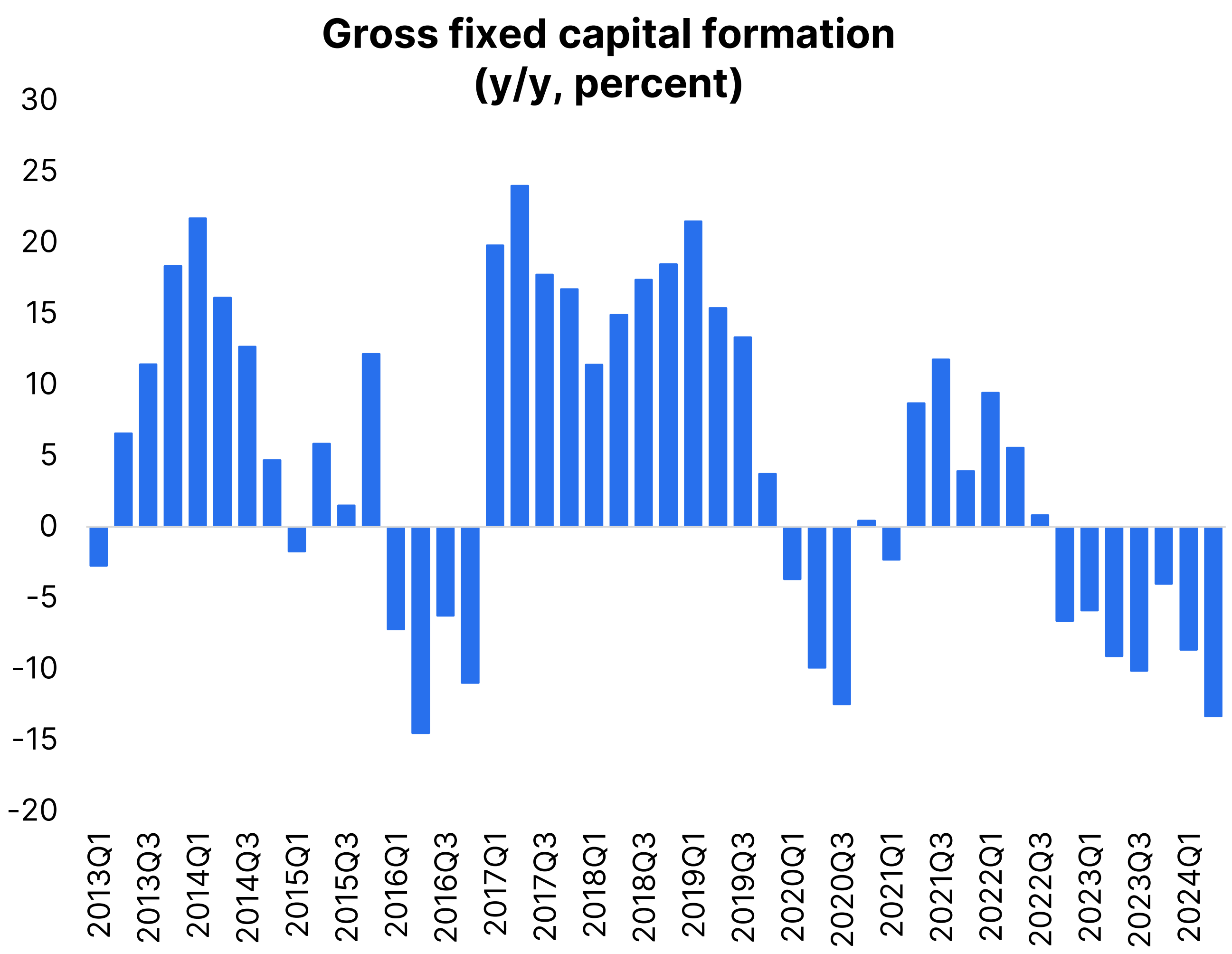
In most of the CEE countries, the post-pandemic recovery has been balanced, i.e. both consumption and investment grew compared to 4Q19.

Czechia and Hungary are the two exceptions, however. Our focus to Hungary today, where investment growth lagged behind, roughly 15% lower compared to 4Q19. It made us curious about possible reasons of such development.

Source: Eurostat, Erste Group Research

Why investment growth has been so weak in Hungary

Freefall of investments restrained growth since end-2022,



In the past 10-15 years, the economic policy encouraged investments through tax reductions, state subsidies and pursuing rather accommodative monetary policy. On average, EU fund inflow amounted to 2.5 percent of GDP per year between 2012 and 2022, supporting the growth via the investment channel, as well. Meanwhile, low-interest rate environment helped the exploitation of the positive impacts.

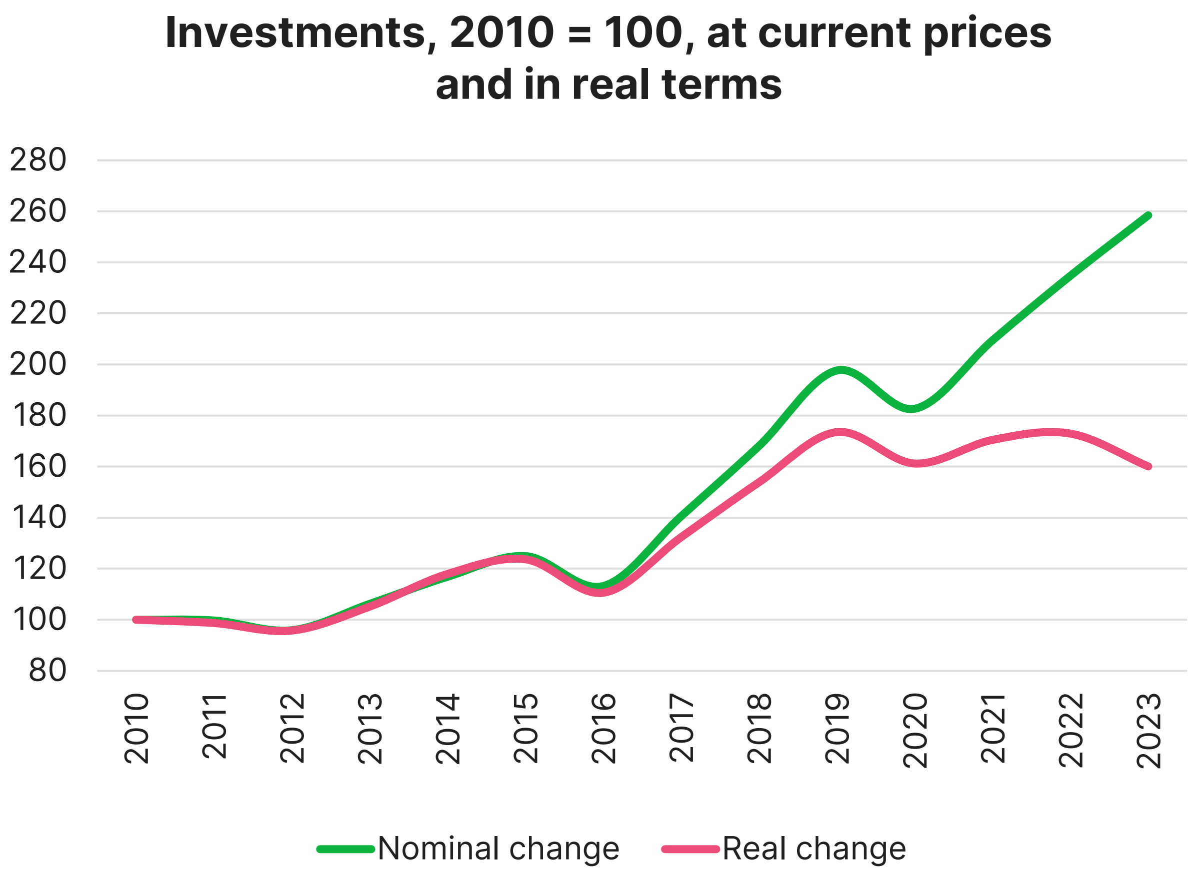
This led to numerous projects and capacity expansions in manufacturing, pushing the investment-to-GDP ratio well above 20 percent.

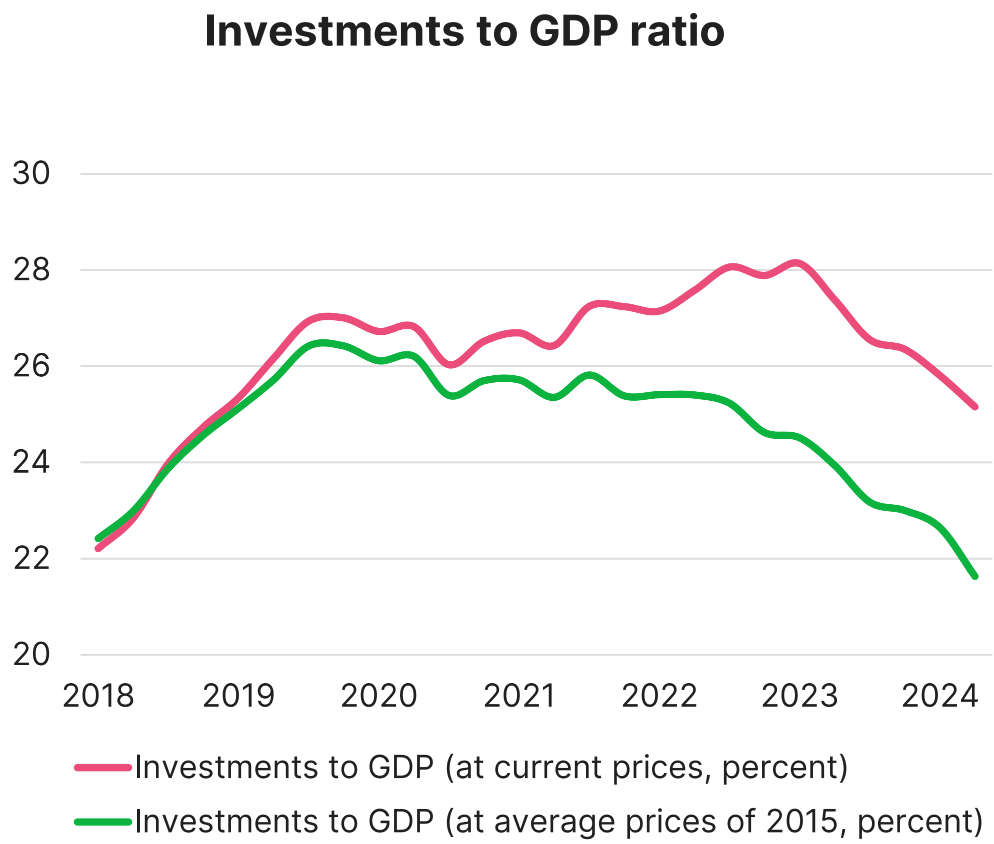
Although there was a rebound after the pandemic crisis - partly driven pre-election spending - it quite quickly faded.

Strict monetary policy, weak external demand, energy crisis, much lower amount of EU funds, increased uncertainties caused partly by the Russian-Ukrainian war all have led to delays of investment and FDI projects.

Source: HCSO, Erste Research

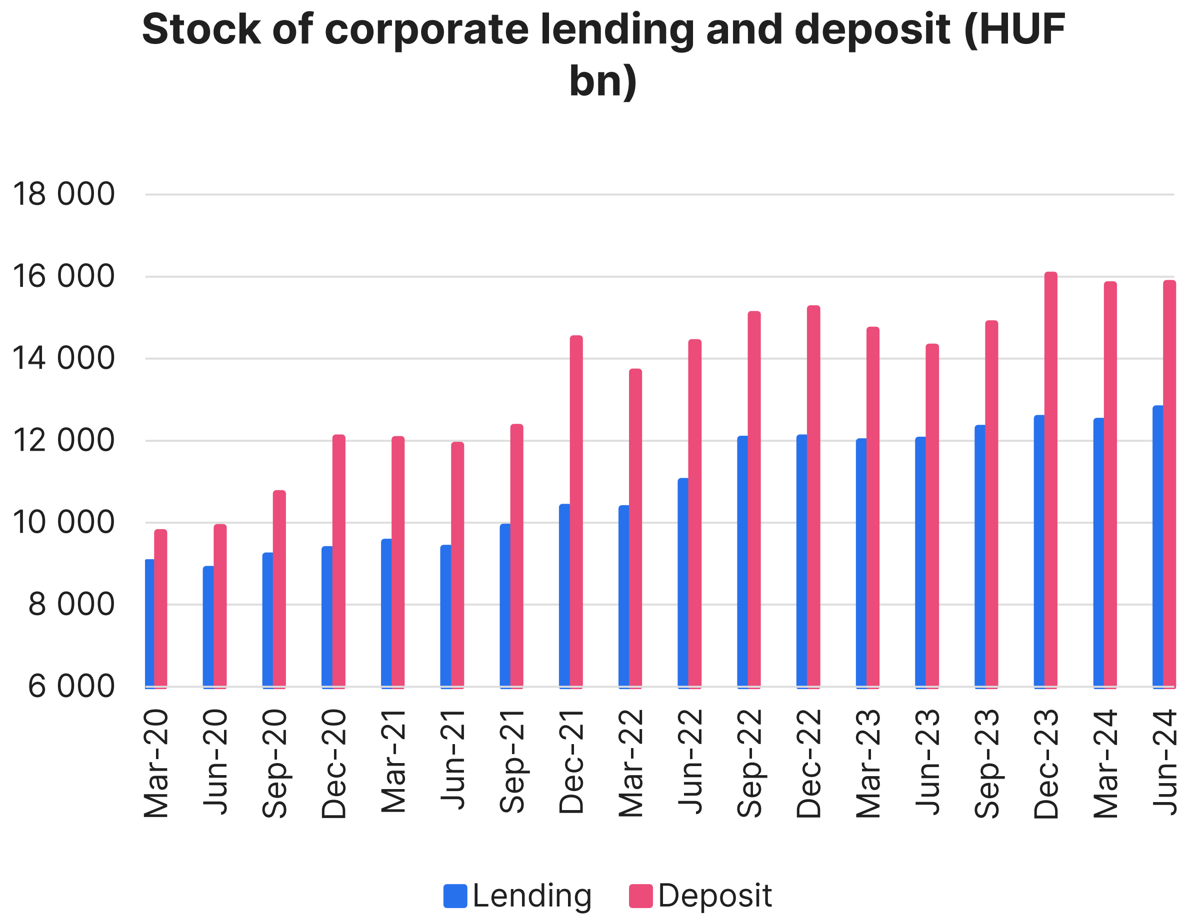
Difficulties appeared even before the pandemic, as rising project costs caused investments to slow down in real terms already from 2019





Source: HCSO, Erste Research

Moderate willingness of firms to invest observable in the deposit and lending figures of the corporate sector



Owing to high interest rates, sluggish economy and uncertain outlook, companies have got accustomed to parking their liquidity in deposits. Meanwhile, corporate lending practically stagnated, as investments were postponed.

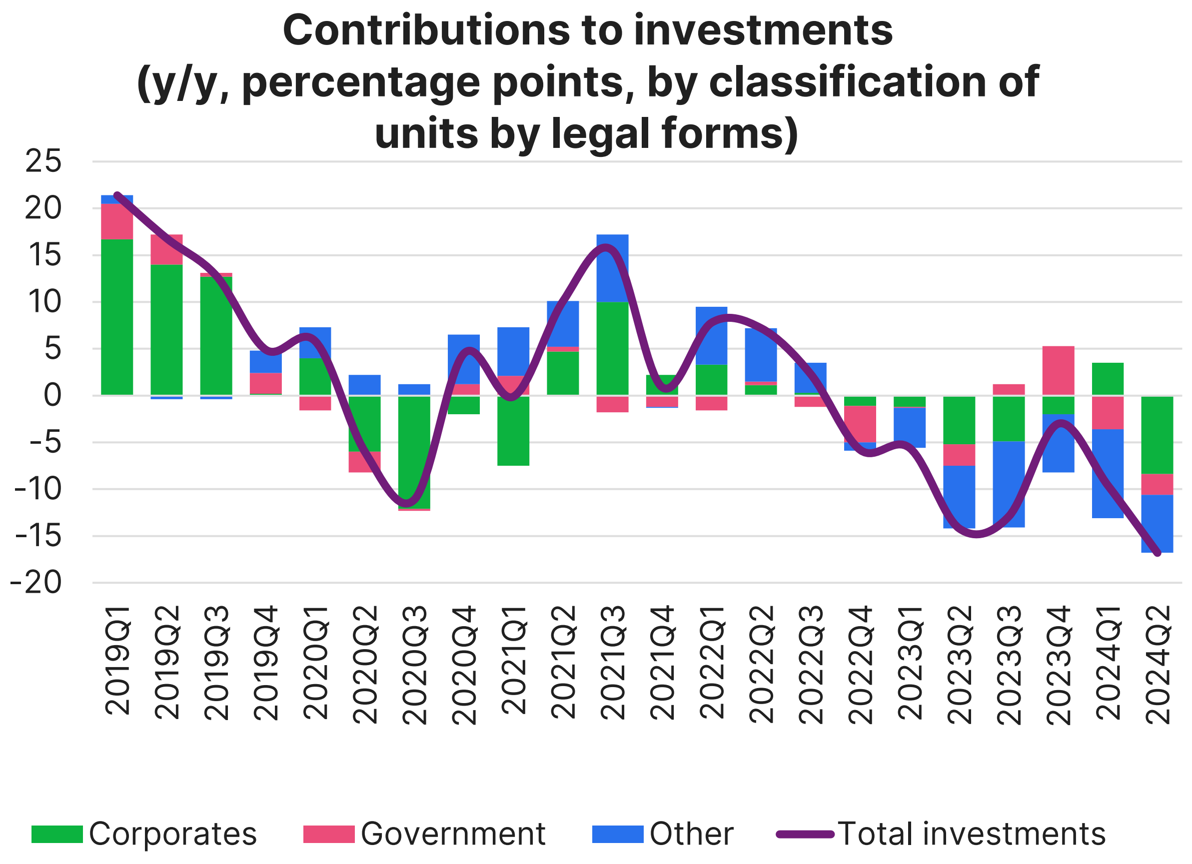
So far, this attitude has practically remained unchanged that had been reflected in 1H 2024 investment figures.

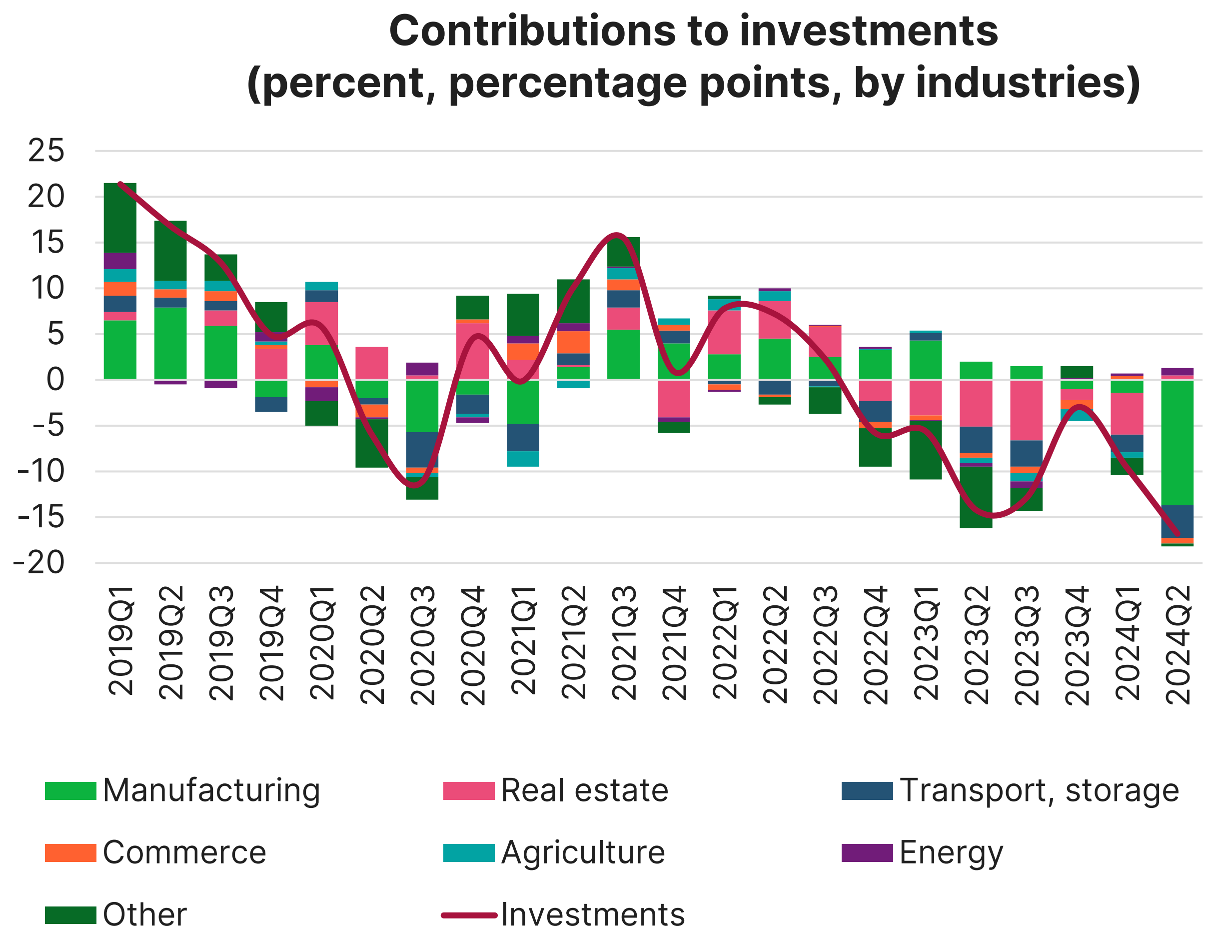
The future looks quite uncertain and unpredictable, causing firms to refrain from borrowing and instead, maintain their wait-and-see approach.

Over the past two years, several government-supported loan programs were introduced. According to recent government communication, new subsidized (especially for SMEs) loans are in the pipeline that might further encourage companies to continue waiting, worsening the short-term, but improving the 2025 outlook.

Source: MNB, Erste Research

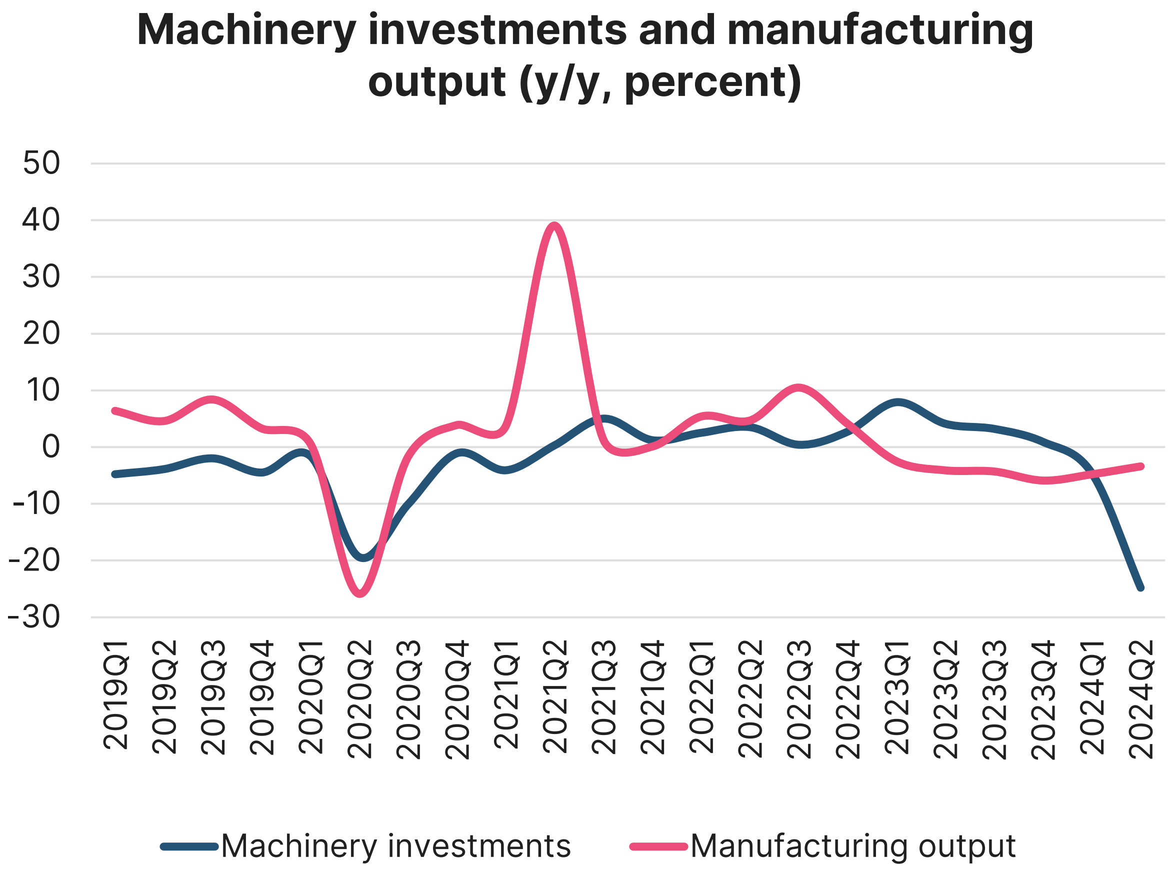
Manufacturing companies' negative contribution to investment was the most relevant in 2Q24

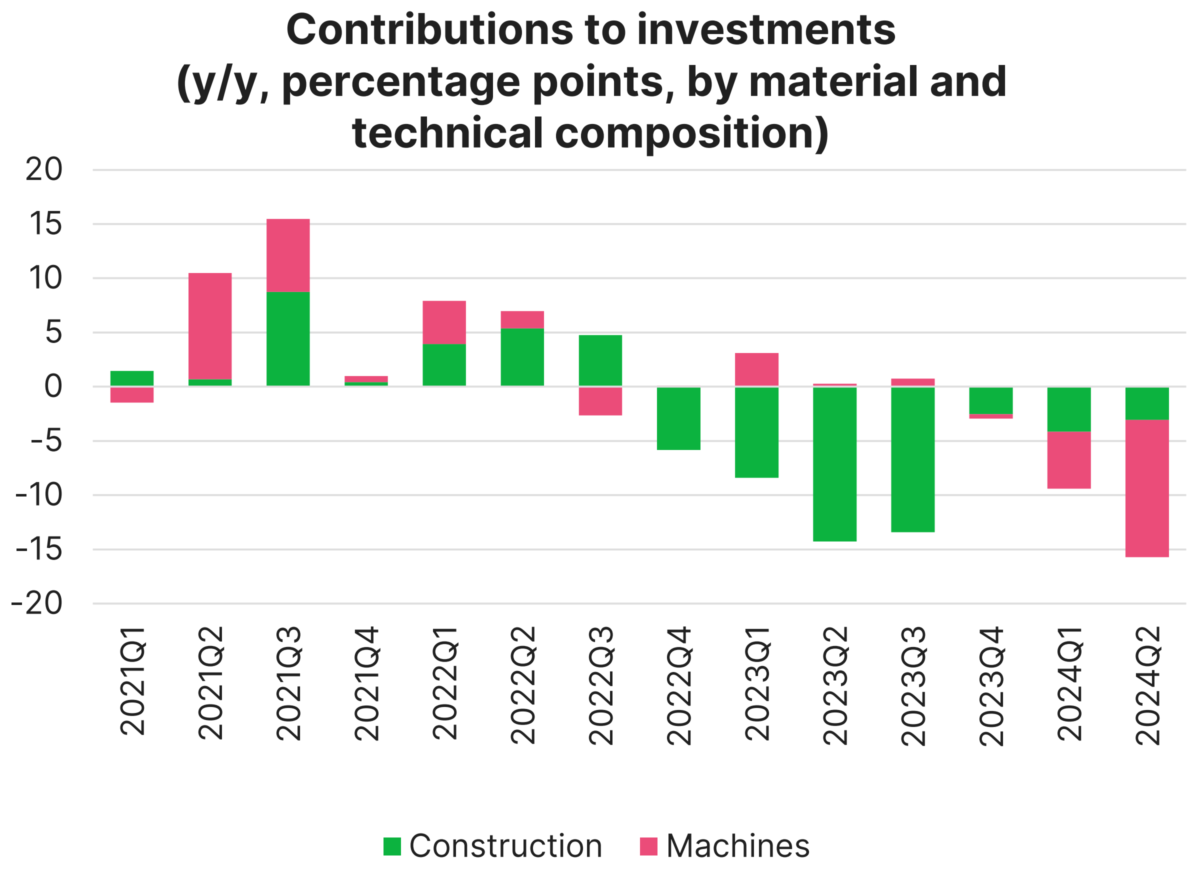




Source: HCSO, Erste Research

That suggests continued sluggish performance of industry in the short-term





Source: HCSO, Erste Research

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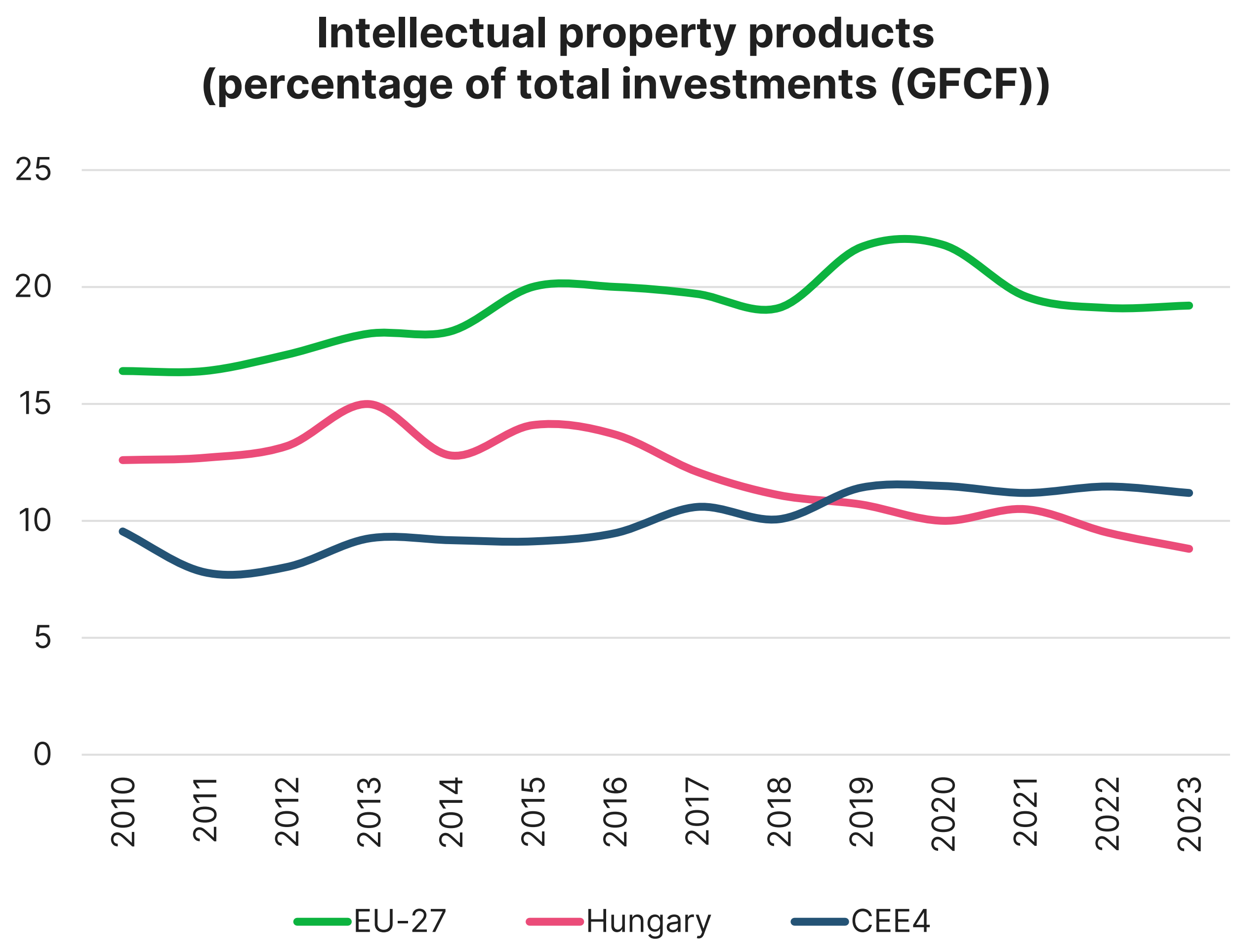
It's unfortunate to witness the reduction in investments for intangible assets, essential in the 21st century



Another structural breakdown shows a key point: as digitalization grew, the need for immaterial products soared, necessitating investments in intangible goods. Around 2010, Hungary excelled in this area.

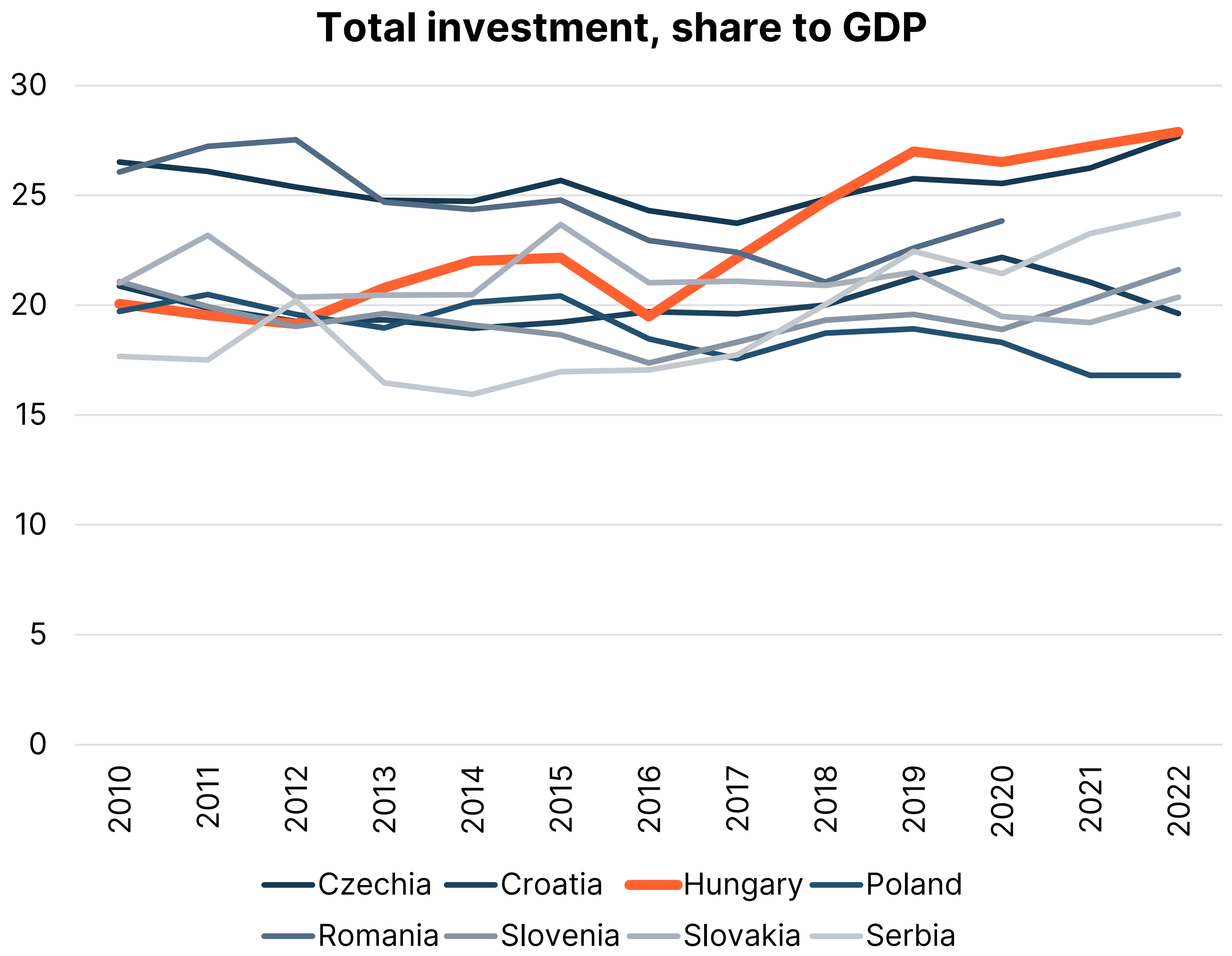
However, the reindustrialization process and subsequent machinery investments displaced some immaterial ones, making Hungary having got farther from the EU average and got behind the regional peers. (Czechia is a positive outlier and quite close to the level of EU-27).

Looking ahead, the proportion of intellectual property products could be a decisive aspect for competitiveness and productivity areas in which Hungary must improve its position.

*CEE4 = Czechia, Poland, Romania, Slovakia

Source: MNB, Erste Research

Hungary has one of the highest investment ratio, however



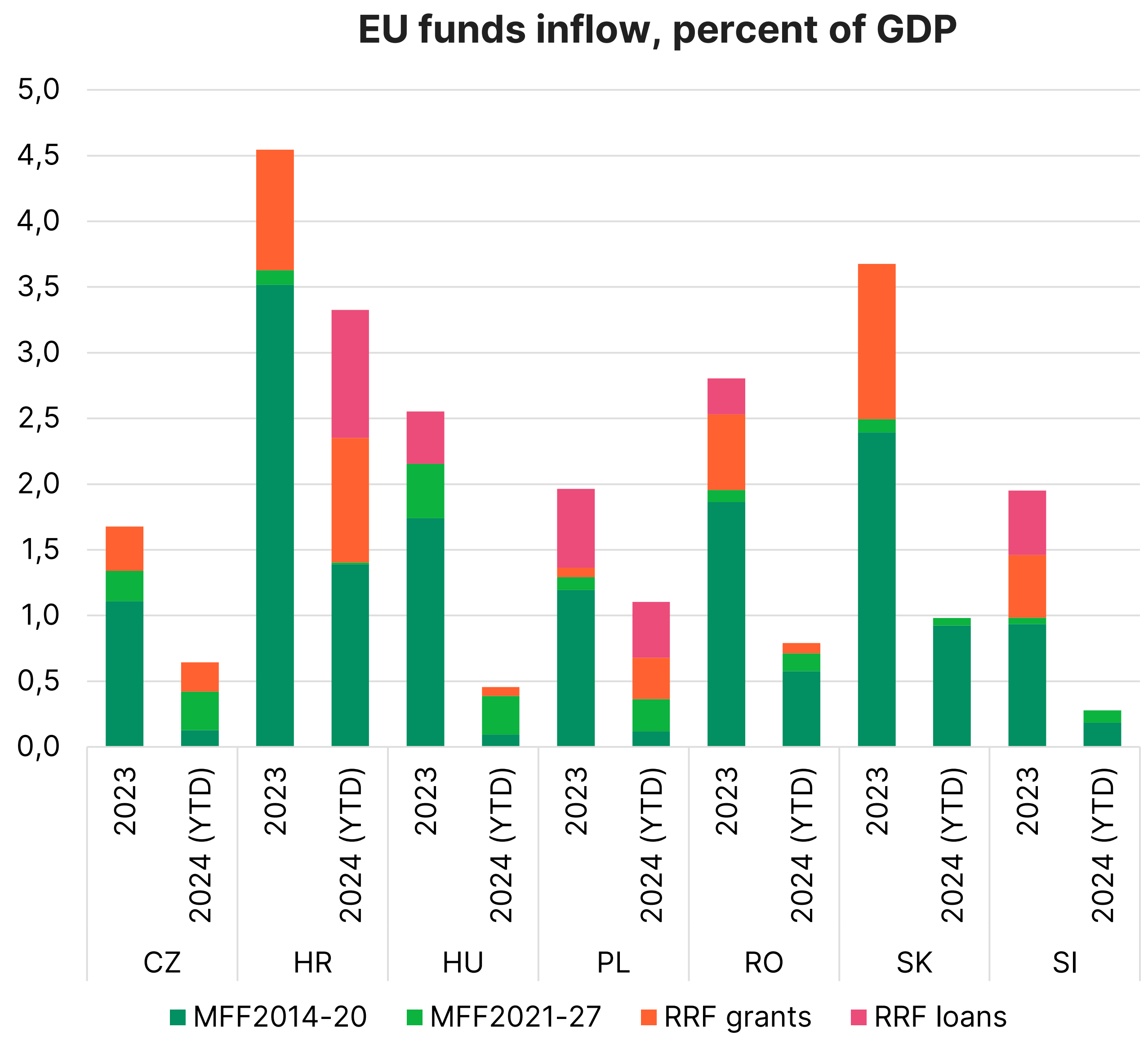
Hungary next to Czechia had the biggest investment share to GDP in 2022. It went up visibly between 2016 and 2018.

At that time, strong investment activity was supported by deeply negative interest rates, various unconventional monetary policy tools, generous state investment projects and fast EU funds inflow. Meanwhile, the ruling high-pressure economy concept also fueled investments that was the focus of the government economic policy.

From 2019 on, however, investment ratio at current prices and investment ratio on fixed prices started to diverge and the divergence has been accelerating since the pandemic crisis (see page 7).

This shows that between 2019 and 2022, the faster inflation of investments kept the investment ratio at a relatively high level compared to regional peers.

Source: Eurostat, Erste Research



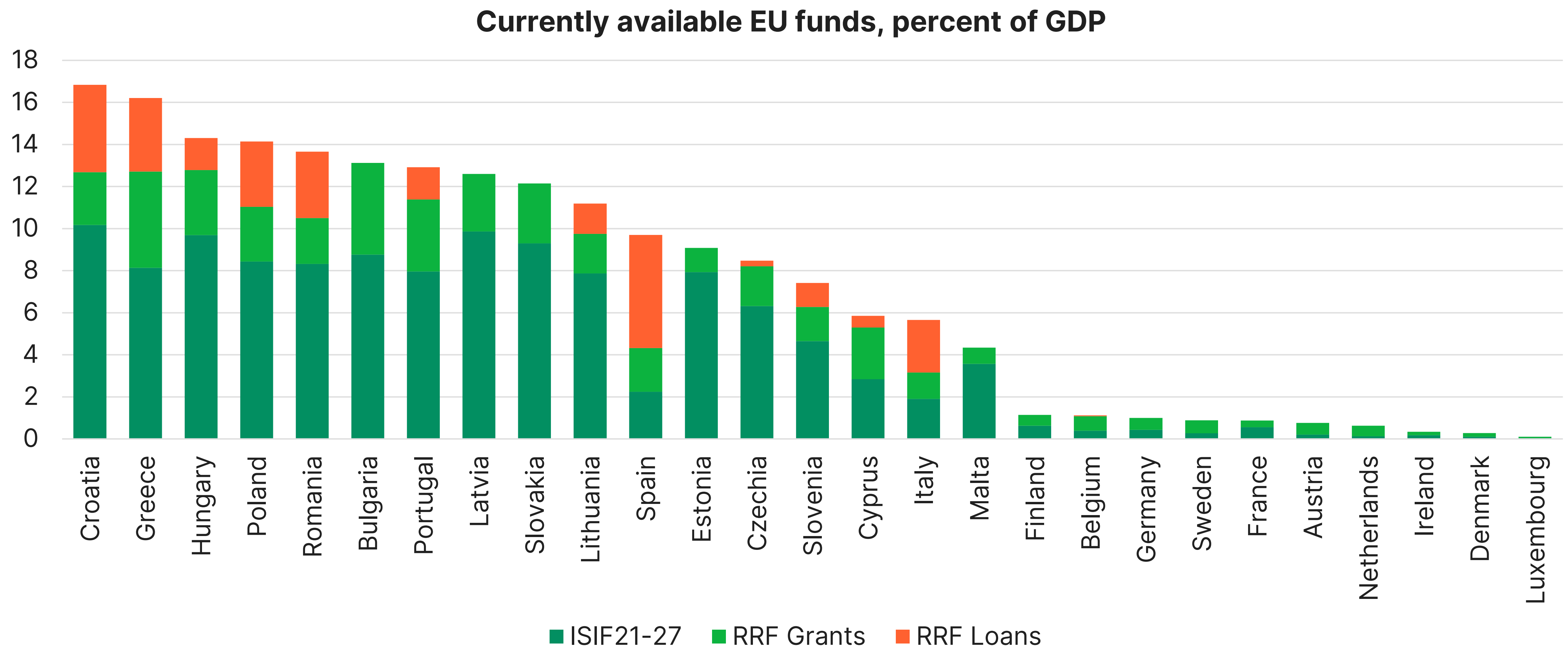
Slowdown in EU funds flow in 2024

The flow of EU funds slowed in line with expectations. Last year, all of the countries aimed to utilize what is left from MFF 2014-20 (T+3 rule for payments for regular EU funds). 2024 is the first year for utilizing the funds from MFF 21-27. Poland has been drawing heavily on RRF grants and loans. Slovenia and Hungary faced the lowest flow of EU Funds (as percent of GDP) so far.

The first year following the T+3 year is usually the bottom in terms of EU fund flows. We thus expect an increase of flows in the years to come.

Source: Eurostat, Erste Group Research

Hungary has one of the largest pot of available funds



Source: Eurostat, Erste Group Research

Huge projects are in the pipeline for 2025, however the utilization highly depends on the stance of external environment

Wage growth supports higher spendings, but precautionary motive has been strong

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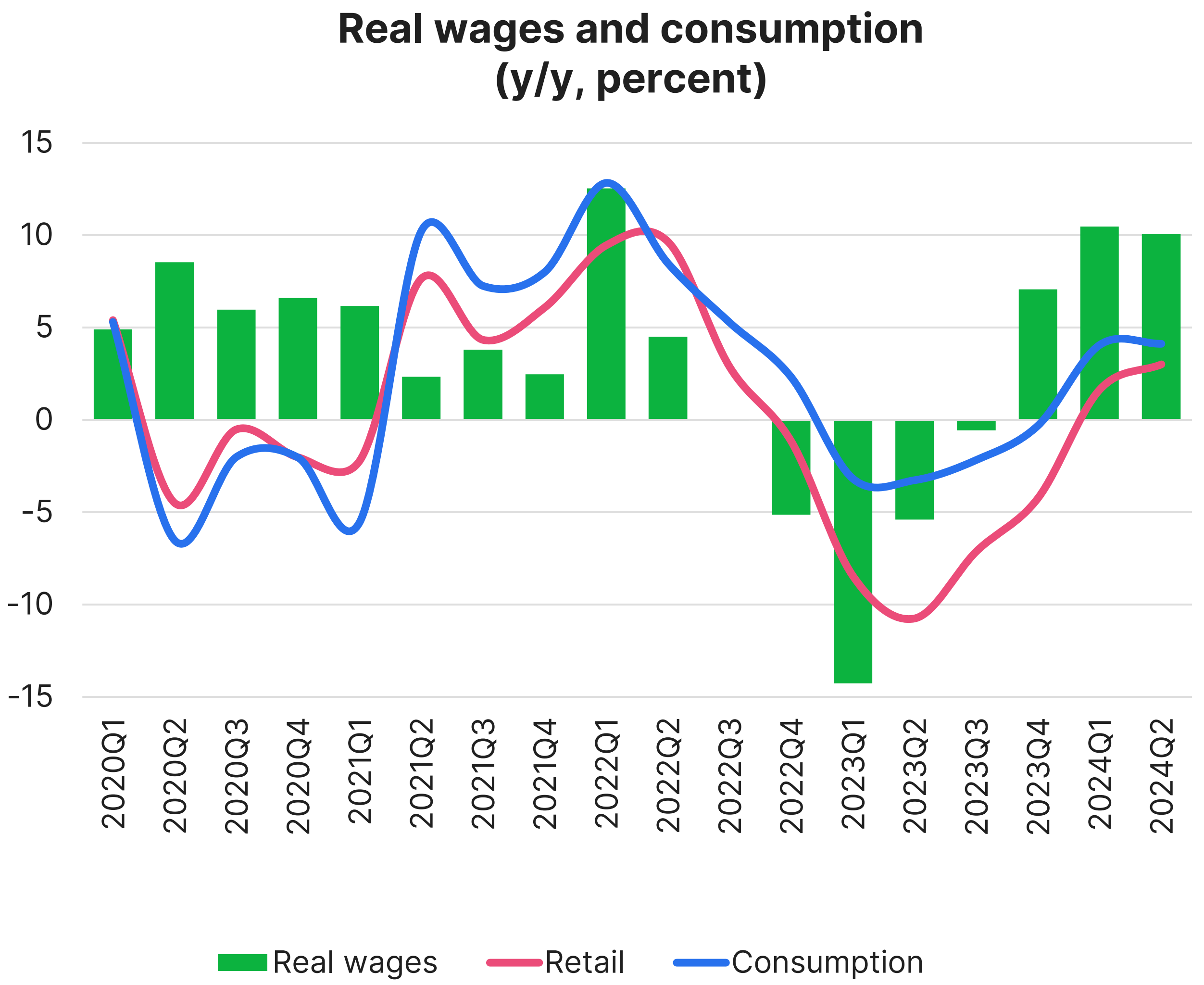
10 percent increase in real wages should imply higher spending figures



Due to skyrocketing inflation and the recession, Hungarian consumers faced massive welfare losses incorporating in negative real wages.

However, mainly due to the resilience and tightness of the labor market, the increase in real wages reached 10 percent in 1H 2024, as the price dynamics normalized.

The relevant increase in real wages should have implied faster revival of consumption, however retail sales performance has remained relatively subdued, affecting negatively the revenue side of the budget balance, as well.

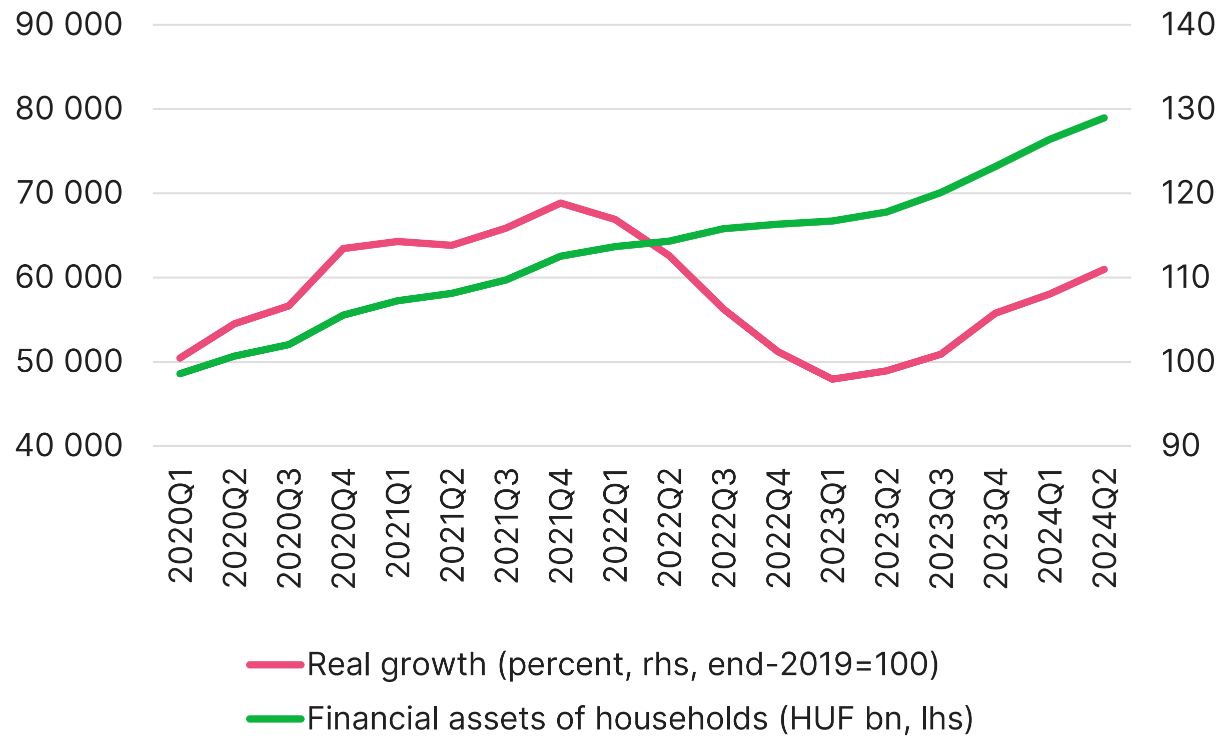
On one hand, high propensity of households to save and revival of real-estate buying mitigate households' consumption.

On the other hand, intensifying 'shopping tourism' in the neighboring countries as well as online shopping support the GDP on consumption's side, however, mitigate the growth via increasing imports at the same time.

Source: HCSO, Erste Research

Precautionary motive of households remained strong

Nominal level and real change of households' financial assets



Households' savings have been steadily growing even during the crisis times, and as a result, by end-2Q 2024 financial assets of households increased by 65 percent in nominal terms compared to end-2019.

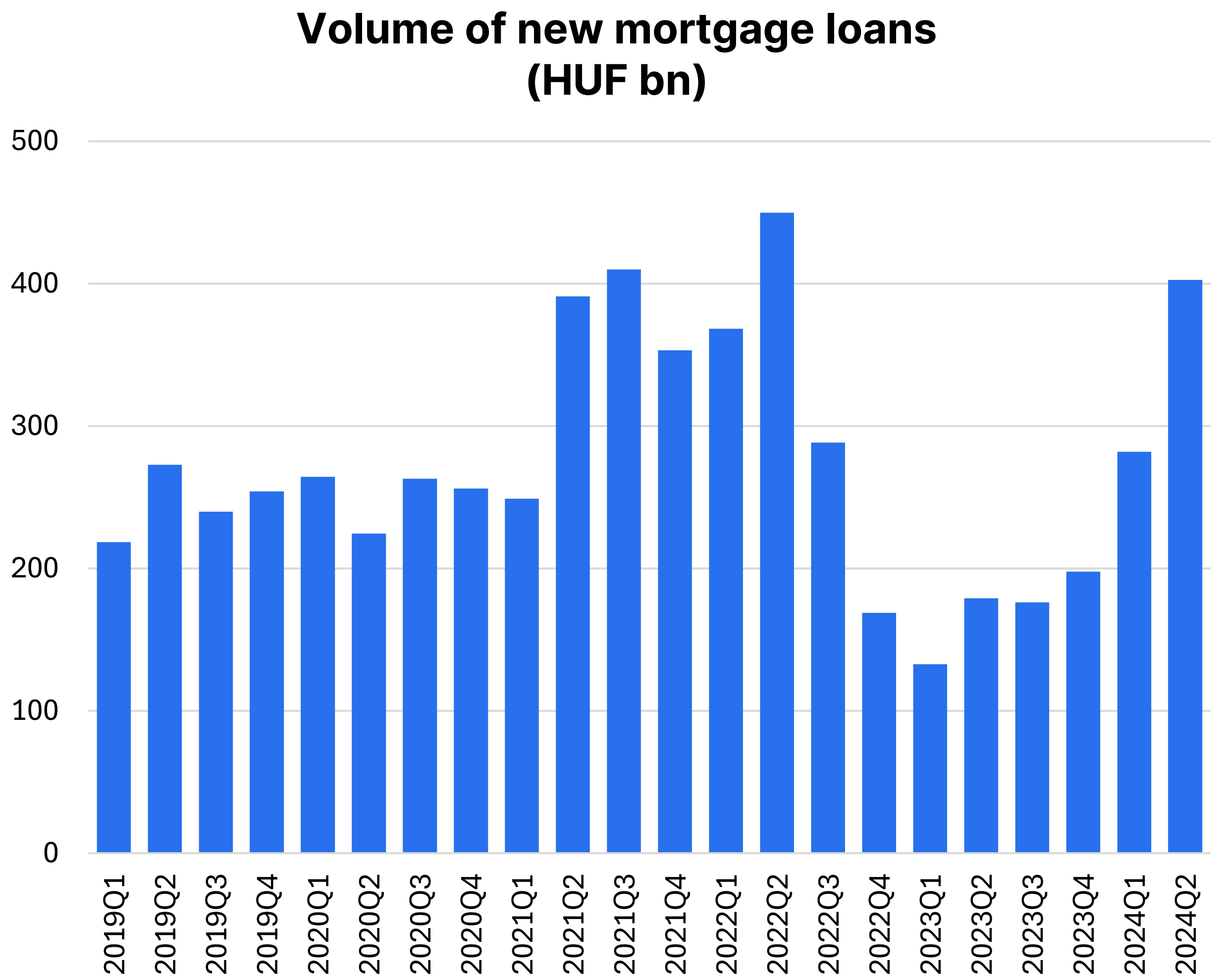
Inflation-adjusted figures show however that high inflation bit into households' savings, as well.

Following huge inflation shocks, strong precautionary motivation of households is understandable; the sector continued to rebuild their savings in 2023 and so far in 2024.

As a result of high inflation, however, the real volume of financial assets is only slowly approaching the end-2021 level, suggesting only slowly dissolving cautiousness of the sector in the near period.

Source: MNB, Erste Research

Mortgage lending improved this year



The housing market stalled last year, due recession fears, high inflation and high interest rates, resulting in subdued mortgage lending figures.

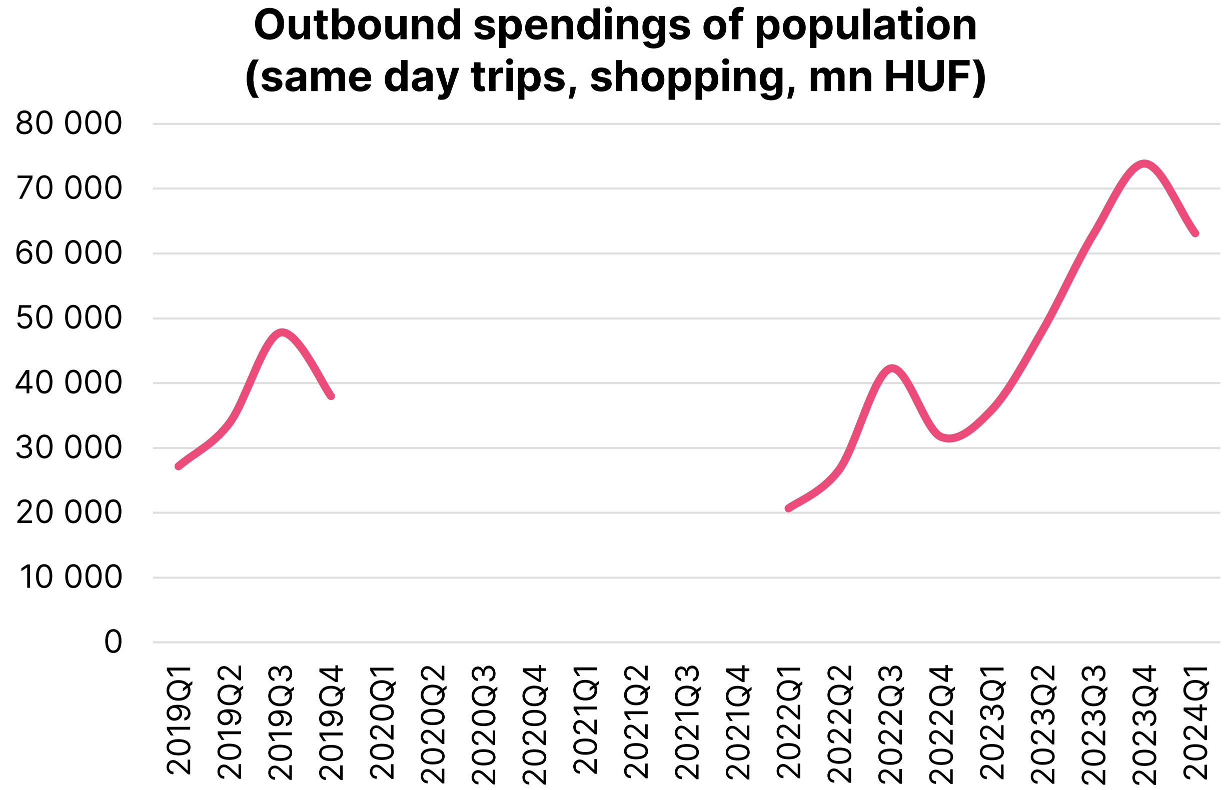
This year however, the rise in household disposable and continued normalization of interest rate environment income have led to a revival in the real estate market.

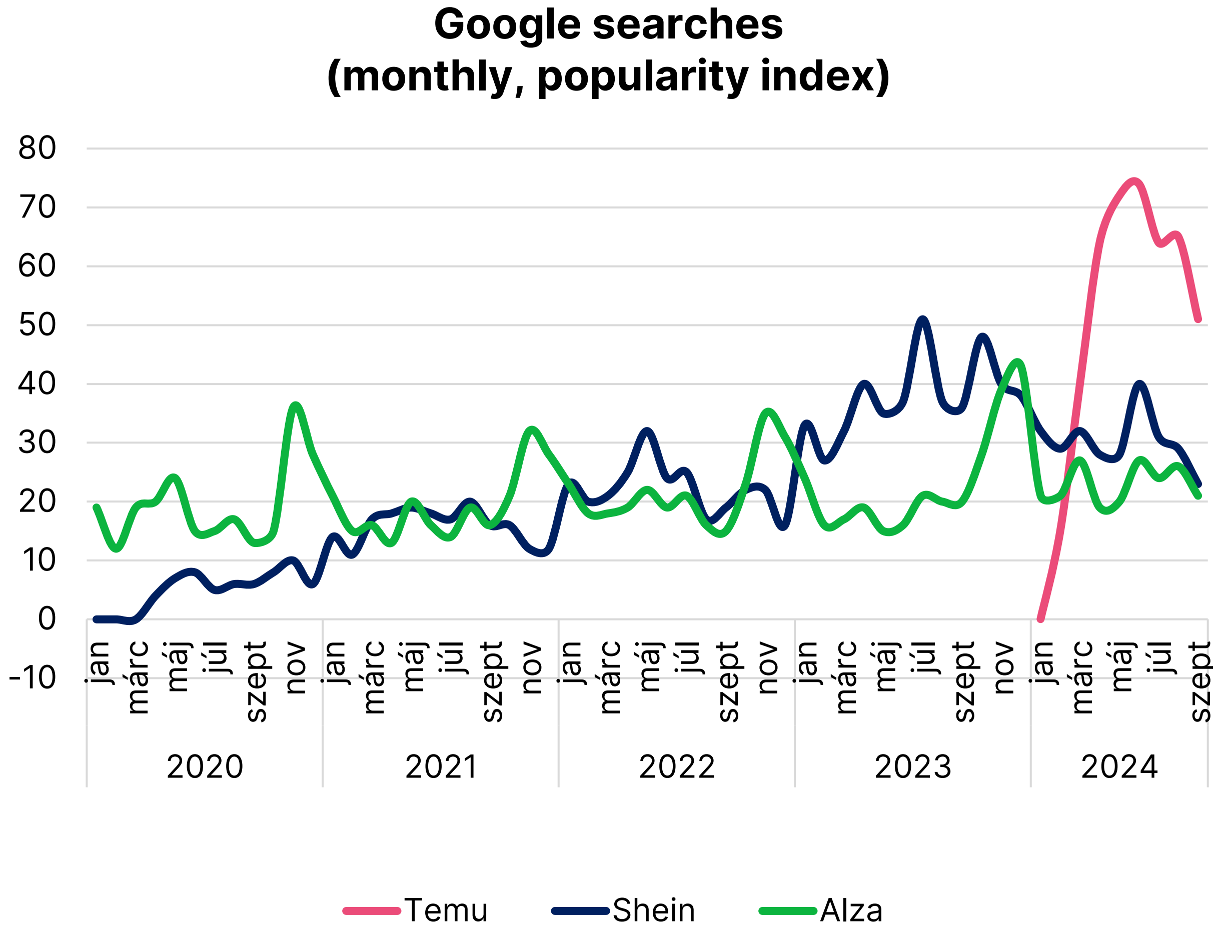
In 2Q 2024, the volume of new mortgage loans approached the levels seen during the post-pandemic rebound.

Meanwhile, driven by the ongoing fiscal adjustments, the relevance of state-subsidized loans slightly declined on the market.

Source: MNB, Erste Research

Outbound spendings almost doubled since 2023, while interest on online shopping considerably intensified





Note1: Data surveys on tourism were paused during the pandemic
Note2: Temu appeared in Hungary in September 2023

Source: HCSO, Google Trends, Erste Research

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Summary and outlook for 2025

- **Following the sluggish economic performance in 2023, expectations for an improvement in 2024 were rather strong. The 2Q GDP figures however brought disappointment and earlier optimism disappeared. High-frequency data indicates slower growth for 3Q as well, thus we reduced our annual GDP growth forecast to 1.4 percent for FY24. As we outlined in the report, the main reason for the poor consumption and investments is the lack confidence.**
- **There are some hopes for 2025, however. It is encouraging that the labor market preserved its resilience, while real wages are to remain in the positive territory next year, as well. Rebuilding of savings seems to remain an important priority for households, however, sooner or later they should feel more confidence to spend more again.**
- **In the lack of impulse from external demand, we see more risks on investments' side, however. Still, further normalization of interest rate environment and planned targeted and subsidized programs (especially for SMEs) could improve business confidence and propensity of companies to invest more. It might be encouraging that Hungary has one of the largest pot of available EU funds. In addition, there are several projects (see the map of page 15) planned for next year that should boost the activity in 2H 2025.**
- **We expect the GDP growth to accelerate to around 3 percent in 2025.**

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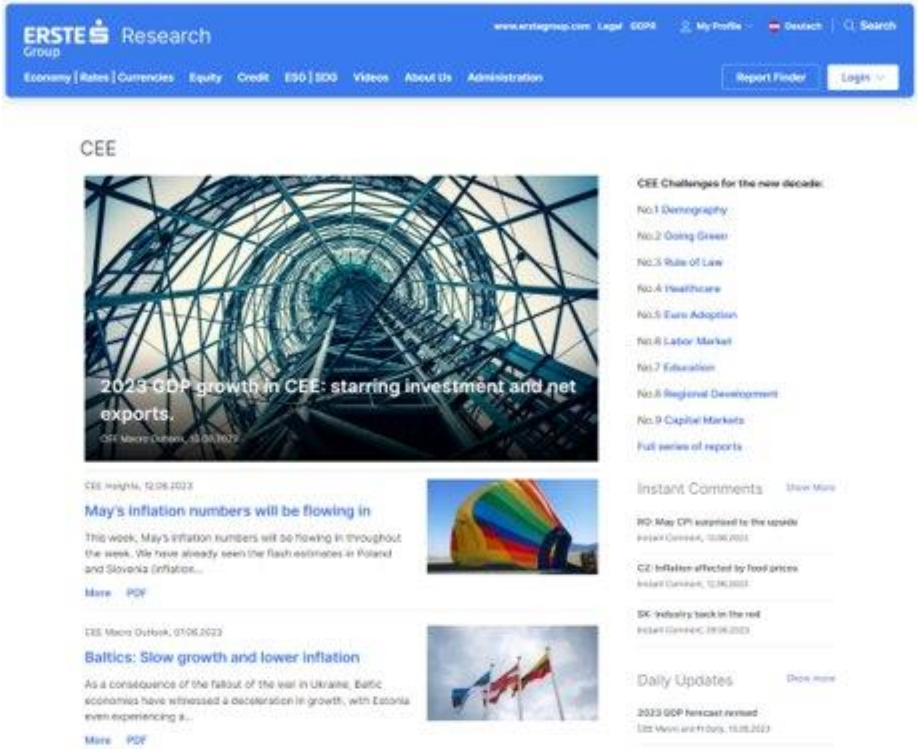

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