Prospects

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The point of view

Xi Jinping visits Hungary, an economy in remission

After visiting France and Serbia, the Chinese president was in Hungary from 8 to 10 May. His visit was an opportunity for the two countries to strengthen political and economic ties: way back in 2004, before Viktor Orbán et Xi Jinping were leaders of their respective countries, Hungary and China entered into a "friendly cooperative partnership". However, it was only when Orbán came to power in 2010 that Hungary began to see China as a key partner in its economic development.

In 2017, the two countries came together in a "comprehensive strategic partnership". Hungary was also one of the first countries to participate in Chinese initiatives in Central and Eastern Europe such as the Belt and Road Initiative (BRI) and the "16 + 1" cooperation forum[1]. The country very quickly derived tangible benefits from this strategic choice, notably in the form of infrastructure construction loans. China and Hungary have also entered into agreements to strengthen their trade ties. However, while Hungarian exports to China were growing, most of the commercial benefits were going to China. Over its first few years, the effect of this partnership on Hungary's economy was thus far from what one might call decisive.

Timely foreign direct investment from China

And yet, despite global geopolitical tensions, Hungary's prime minister has maintained course: during this first visit by Xi Jinping, the relationship between the two countries was elevated to an "all-weather comprehensive strategic partnership for the new era". And for good reason: in the post-Covid era, the bilateral relationship has kicked up a gear in a way that is very valuable to Budapest, with private Chinese foreign direct investment (FDI) into Hungary taking off. The success of China's electric vehicle sector, combined with fears of tariff tensions between the European Union and China, presents Hungary with an opportunity that's hard to turn down after so many years of investing in such a partnership. According to the government, €16 billion-worth of Chinese FDI has already flowed into Hungary, mainly in the electric vehicle and battery sector.

This investment is all the more important given the economic shock suffered by Budapest by way of its external balances: Hungary has been one of the European countries hit hardest by the inflation crisis, notably because of its reliance on Russian gas, though rising food prices and the weak forint have also played a part. **Now, in the first half of 2024, disinflation is underway but the process remains slow**: after averaging 17.6% in 2023, inflation finally fell back below 4% in the first quarter of 2024. This allowed the central bank to cut interest rates as early as October 2023. However, persistent political and geopolitical tensions have weighed on the forint. Services are now the main driver of inflation overtaking energy and food. This all means the process of monetary easing will have to be a slow one.

The upturn in growth thus remains fragile (with growth expected to come in at 2.3% in 2024 and 3.4% in 2025, compared with -0.9% in 2023),making Chinese investment all the more significant. Rising real wages are supporting domestic demand, while the recovery in European demand and the opening in 2025 of

[1] The "16 + 1" forum consists of China and 16 countries in Central and Eastern Europe: Estonia, Latvia, Lithuania, Poland, Czech Republic, Slovakia, Hungary, Romania, Bulgaria, Slovenia, Croatia, Serbia, Bosnia-Herzegovina, Montenegro, Albania and Macedonia.

production facilities financed by Chinese FDI should support exports. When it comes to investment, divergent factors are at play: slow fiscal consolidation has led to the postponement of some public investment in 2024 (worth 0.8% of GDP) and interest rate hikes in 2023 have filtered through to construction, hampering real estate investment; on the other hand, European funds (worth 7% of GDP) will enable public investment to bounce back, while FDI, notably from China, will support private investment.

Since 2020, public finances have suffered due to slowly falling expenses: while the public deficit has fallen, it is still high and, to add to the uncertainty, the government is struggling to map its future trajectory. Above all, the government is doing little to boost revenue, which has been falling as a proportion of GDP since 2015 (down 5.8 points), and has done nothing to offset rising expenditure. At the same time, Hungary's reliance on Russian energy and tensions with the EU have made Hungarian debt more expensive.

Turning to its external accounts, Hungary had a large external deficit in 2022 as a result of the energy crisis (-8.3% of GDP) but posted a current account surplus in 2023 (0.2% of GDP) as inflation and the weak forint suppressed domestic demand.

Chinese investment has come at just the right time to stabilise Hungary's external balances and revive growth. The country hopes to harness the influx of FDI to develop a strong new manufacturing sector focused on exports and move up the value chain towards activities with a larger R&D component. Alongside these foreign direct investments, Hungary continues to secure funding from Beijing for infrastructure that will help Chinese products access the European market: a planned Budapest rail bypass linking the east of the country, where new Chinese production facilities are located, with Western Europe was announced during the Chinese president's visit. Meanwhile, a rail link between Belgrade and Budapest, financed by a $2.1 billion loan as part of the BRI, is still under construction[2]. Lastly, as the Hungarian government puts the finishing touches to the renationalisation of Budapest airport, the big three Chinese airlines (Air China, China Southern Airlines and China Eastern Airlines) have reportedly shown an interest: they would like to use it to develop direct links with China for their air freight operations. **Hungary has thus opted to act as a bridgehead for Chinese industry within the EU…**

Reliance on both the European Union and Russia

Yet Hungary remains primarily reliant on the European Union, both for its public investment programmes – notably to finance its energy transition – and in terms of trade. But recent years have brought increasing tensions with the EU. These relate not only to Hungary's institutions (respect for the rule of law, judicial independence, freedom of the press, corruption) but also to geopolitics (NATO expansion, support for Ukraine and its accession to the EU, sanctions against Russia). As a result of these disagreements, the EU has made the release of a portion of European funding for Hungary (worth 18% of GDP) subject to conditions[3]. The stance adopted by the Orbán government, which oscillates between working to undermine European institutions and pursuing a bargaining strategy, thus poses significant risks. While rating agencies appear relatively optimistic that European funding will eventually be forthcoming, there are two main factors that could encourage Orbán to adopt a tougher stance: (i) domestic politics in Hungary and (ii) new European allies who could exercise their influence following the European elections in June. **While Hungary's relationship with China is not currently central to its quarrels with the EU, a number of factors (US elections, Chinese trade practices, the relationship between China and Russia) could lead to a hardening of EU-China relations.**

On top of this, Hungary is also reliant on Russia. The government says its official stance towards Russia, in light of its energy interests, is neutral. Yet, despite some efforts to do without Russian gas, Hungary's decision to press ahead with a Russian-built nuclear power station to help it navigate the energy transition creates major vulnerabilities that will play out throughout the construction process and beyond.

[2] Serbia is the second pillar underpinning China's presence in Europe. This rail corridor could one day extend as far as the Port of Piraeus in Athens, also under Chinese control.

[3] Out of a total allocation of €50 billion over the period 2021-2027 (equivalent to 24% of 2023 GDP), a portion equating to 18% of GDP has been made contingent on Hungary respecting the rule of law. Following negotiations between the European Commission and the Hungarian government culminating in concessions from Hungary, funding equivalent to 7% of GDP was released in late 2023/early 2024.

☑ **Our opinion –** *Hungary's multi-alignment with Europe, China and Russia means it runs the risk of being multiply dependent. Yet the European Union is still the Hungarian economy's most vital partner in all areas (fiscal and commercial, in the short, medium and long term). Its relationship with China is thus a development choice that carries risks. Should a scenario of geopolitical hardening come to pass, these risks would quickly crystallise. For example, Hungary's European and US allies could attempt to impose a forced realignment. Meanwhile, the possibility of Donald Trump – a staunch ally of Viktor Orbán – winning a second term as US president in November 2024 is a much more uncomfortable proposition for the Hungarian government than might currently appear to be the case.*

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