Hungary: EC to block some Cohesion funds

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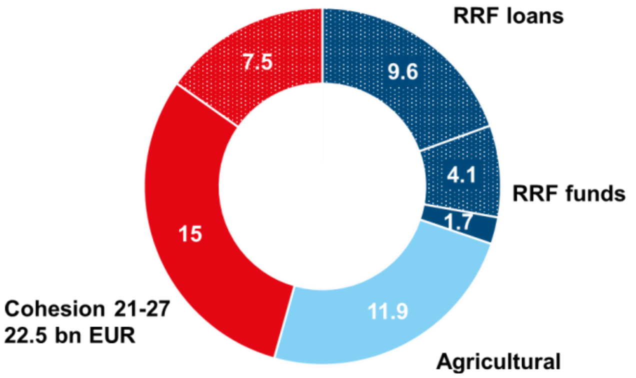
EC recommends freezing some Cohesion funds

In the dispute between Hungary and the European Commission, it should be made clear at the start that there are two parallel processes underway. The first is about cohesion funds, which are subject to being frozen. Cohesion funds are part of regular EU funds within the 2021-2027 budgeting period and have been assigned to every country. Secondly, there is a Recovery and Resilience Facility (RRF funds) that comes on top of regular EU funds within the budgeting period and are granted independently of regular EU funds. RRF funds are divided into grants and loans. Both Hungary and Poland have had the Cohesion funds allocated. Furthermore, Poland has had its Recovery Plan accepted, but needs to meet milestones to receive payments. Hungary is still waiting for its Recovery Plan to be accepted in order to have access to RRF. If it is not approved by the end of this year, 70% of RRF allocations would disappear forever for Hungary.

Part of the Cohesion funds can be frozen until the situation is solved. This dispute could go far beyond the year-end, but if progress is reached, the funds can be unfrozen later. In the dispute over having the Cohesion funds frozen, EUR 7.5bn is at risk. It should be kept in mind that not all funds will be blocked. This EUR 7.5bn is approx. 30% of the EUR 22.5bn in Cohesion funds granted to HU in the 2021-2027 budgeting period.

Hungary should be able to access the remaining EUR 14-15bn part of the Cohesion funds. The Commission has to approve the so-called Partnership Agreement at first, but in principle, it would not be blocked by the Commission and Council's suspension decision. In addition, a significant amount of agricultural funds were approved by the EC in November. Therefore, more than half of the available funds (graph below) are secured for the country. Furthermore, at this point, Hungary is still smoothly receiving payments from the previous 2014-2020 budget. Hungary is still waiting for approx. EUR 5bn altogether from the previous budgeting period, of which EUR 3.5bn is expected for 2023.



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Timeline

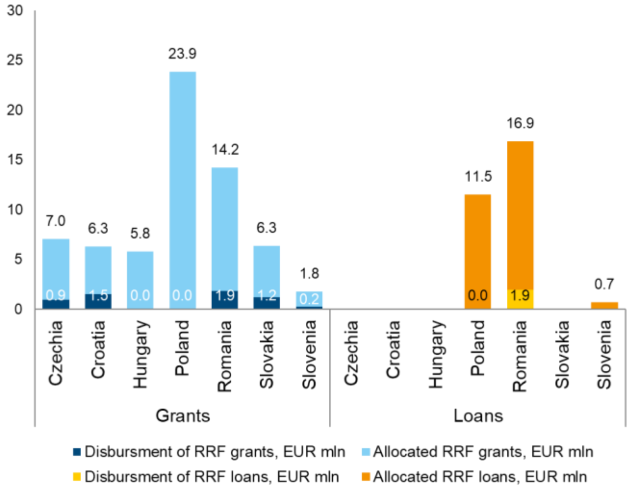
- 24 November: The European Parliament voted (416 to 124) to oppose any release of EU funds to Hungary.
- 30 November: The European Commission made a recommendation on the Hungarian rule of law and RRF funds. It is essentially a decision-making body, so this recommendation is typically approved later. The Commissioners cannot act based on national policy considerations; they must look only at the interest of the EU. The media reported that the responsible bodies in the European Commission have concluded that Hungary has not sufficiently fulfilled its promises of reform in the fight against corruption. The European Commission will therefore recommend that Member States freeze EUR 7.5bn from three Cohesion programs. The European Commission should accept Hungary's Recovery Plan with a very strong conditionality, opening the way to the EUR 5.8bn RRF funds.
- 6 December: European finance ministers make the final decision on the rule of law procedure and RRF funds. A qualified majority is required for approval.
- 19 December: Final deadline for approval. As the last finance ministers' summit is scheduled for 6 December, an extraordinary meeting would have to be called if no vote is taken.
- Actual funding from RRF could come next year, while Cohesion funds discussion could continue far beyond the year-end. If progress is reached, the Cohesion funds can be unfrozen (payments until 2030 due to T+3 rule).

Implications for FX and bond market

The effective rate has been raised from 13% to 18% to curb the vulnerability of the currency from mid-October onwards, which, along with the direct FX liquidity provided to energy importers, was enough to mitigate the pressure on the HUF. The extraordinary monetary policy steps by the MNB led to another wave of yield increases. However, we have seen some easing of the tension on the bond market recently. In the short run, we do not see room for substantial drop of yields, mainly given the risks to inflation, which still point to the upside.

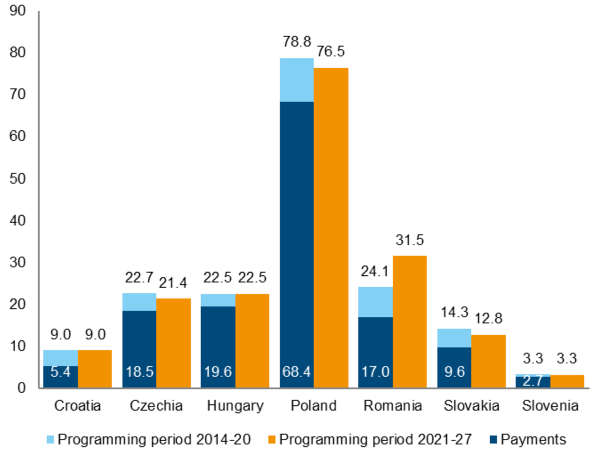
If there is no agreement by the year-end, the Hungarian currency would come under pressure, as EU funds used to be a significant driver of growth in Hungary and source of FX. Hungary has changed the structure of its public debt over the last decade and reduced the proportion of FX debt considerably, so even strong depreciation of the HUF would be unlikely to trigger speculation of a default. If there are any problems with FX liquidity, Hungary can go to the international bond market to renew the maturities. For an example, in mid-November, Hungary successfully issued Green EUR bonds in the amount of EUR 1bn. In a final case, the IMF could be approached for a credit line. All in all, the current level of interest rates is high enough to prevent the currency from stronger depreciation; substantial weakening would come only if Hungary's future in the EU was in real threat, which is not the case.

Disbursement of RRF funds
Billion EUR



Source: EC, Erste Group Research

Cohesion funds
Billion EUR



Source: EC, Erste Group Research

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