Rabobank

Country report **HUNGARY**

Summary

Hungary's economic situation leaves much to be desired. After contracting by nearly 7% in 2009, the economy grew by less than 2% in the subsequent years, only to fall back into recession at the start of 2012. Explaining this recession is Hungary's exposure to the European debt crisis, the indebtedness of its own private sector, as well as the government's poor handling of the crisis, resulting in a steep fall in investor confidence and a deteriorating business climate. As a result, the three largest rating agencies downgraded Hungary's sovereign debt to junk status, thereby raising borrowing costs. Whether the government will be able to refinance its debt and stabilize the banking crisis will in part depend on the ongoing negotiations with the IMF over a stand-by agreement and thereby on the government's willingness to accept the IMF's conditions.

Things to watch:

- Negotiations with the IMF over a stand-by agreement
- Credit crunch as a result of the mortgage crisis
- Government's efforts (or lack thereof) to restore investor confidence

Author: **Anouk Ruhaak**
Country Risk Research
Economic Research Department
Rabobank Nederland

Contact details: P.O.Box 17100, 3500 HG Utrecht, The Netherlands
+31-(0)30-21-64860
A.N.Ruhaak@rn.rabobank.nl

Hungary

National facts		
Type of government	Parliamentary democracy	
Capital	Budapest	
Surface area (thousand sq km)	93	
Population (millions)	9.9	
Main languages	Hungarian (93.6%)	
	Other (6.4%)	
Main religions	Roman Catholic (51.9%)	
	Calvinist (15.9%)	
	Unaffiliated (14.5%)	
Head of State (president)	Paul Schmitt	
Head of Government (prime-minister)	Viktor Orban	
Monetary unit	Forint (HUF)	
Economy	2011	
Economic size	*bn USD*	*% world total*
Nominal GDP	140	0.20
Nominal GDP at PPP	195	0.25
Export value of goods and services	129	0.58
IMF quotum (in mln SDR)	1038	0.48
Economic structure	*2011*	*5-year av.*
Real GDP growth	1.6	-0.1
Agriculture (% of GDP)	4	4
Industry (% of GDP)	29	27
Services (% of GDP)	67	69
Standards of living	*USD*	*% world av.*
Nominal GDP per head	13986	129
Nominal GDP per head at PPP	19567	157
Real GDP per head	11125	137

Social and governance indicators	rank / total
Human Development Index (rank)	36 / 169
Ease of doing business (rank)	46 / 183
Economic freedom index (rank)	51 / 179
Corruption perceptions index (rank)	50 / 178
Press freedom index (rank)	23 / 178
Gini index (income distribution)	30.04
Population below $1.25 a day	2%

Foreign trade			2011
Main export partners (%)		*Main import partners (%)*	
Germany	25	Germany	26
Italy	6	China	10
France	5	Russia	8
UK	5	Austria	6

Main export products (%)	
Machinery & equipment	60
Manufactures	27
Food, beverages and tabacco	7
Raw materials	2
Main import products (%)	
Machinery & equipment	50
Manufactures	32
Fuels and energy	11
Food, beverages and tabacco	5
Openness of the economy	
Export value of G&S (% of GDP)	92
Import value of G&S (% of GDP)	85
Inward FDI (% of GDP)	2.8

Source: EIU, CIA World Factbook, UN, Heritage Foundation, Transparency International, Reporters Without Borders, World Bank.

Economic structure and growth

Once one of the top performers in the Central and Eastern European region, Hungary's current economic situation leaves much to be desired. After contracting by nearly 7% in 2009, the economy grew by less than 2% in the subsequent years, only to fall back into recession at the start of 2012. The deterioration of Hungary's economic situation was triggered by the eurozone debt crisis. For one, a fall in eurozone demand has impacted Hungary's export growth. More damaging still is the deleveraging by eurozone banks. This will have pronounced effects, as roughly 88% of all Hungarian bank assets are held by foreign banks. Moreover, foreign bank subsidiaries in Hungary still rely heavily on funds provided by their eurozone parents. Finally, the crisis has induced investors to pull out of the more risky emerging markets in search of perceived safe(r) havens.

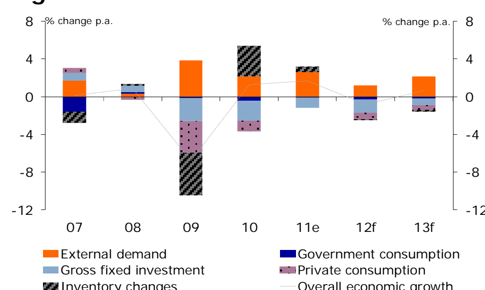
However, even though external pressures have had a severe impact, Hungary's economic problems are mostly of the country's own making. Hungary entered the crisis in 2008/9 with large deficits on both the current and fiscal account and an overleveraged private sector. The latter is the result of the credit boom in the years leading up to the crisis, when households massively acquired mortgages in foreign currencies. The idea at the time was that, since Hungary was on the road to become a eurozone member, exchange rate risks were low. Unfortunately, once the crisis broke out this assumption proved to be false and subsequent depreciation of the forint quickly raised household's repayment costs. The steep repayment costs, combined with rising unemployment are depressing domestic demand. In 2009, private consumption fell by over 6%. And, as households continue to deleverage, we expect consumption to fall further in the coming two years.

The mortgage crisis has had a significant impact on the financial sector as well. With some households unable to repay their debt, non-performing loans in the household sector have shot up to just below 15% in 2011. In addition, the government's handling of the mortgage crisis added to the pain. A mortgage repayment scheme, adopted in 2011, forces banks to assume part of the repayment costs, as households are allowed to repay their mortgage against the more favorable 2008 exchange rate. To make matters worse, households can only participate in the scheme if they pay off their debt at once (and before 2013). Consequently, the scheme has little value to households that are struggling to meet their monthly payments, implying that banks still hold most of the low quality debt on their balance sheets. In addition, banks have also felt the impact of a newly created bank tax, which further cuts into their revenue. It is therefore not surprising that the sector made an after-tax loss of roughly EUR 300m in 2011. Unsurprisingly, banks are forced to deleverage and reduce their exposure to Hungarian risk, resulting in a severe credit crunch. It should be noted however that although banks are cleaning up their balance sheets, high exit costs have so far forced them to maintain their presence in Hungary.

Unfortunately, banks are not the only ones pulling their funds: foreign investors are running for the exits. The government, in an attempt to boost its revenue, while also maintaining its popularity among the electorate, imposed a crisis tax that specifically targets foreign businesses. This combined with a large number of other poorly timed crisis measures (including the mortgage repayment scheme) has created wide uncertainty and forced rating agencies to downgrade the country to junk status. Already in 2010, capital flight amounted to roughly USD 10bn and in 2011 another USD 4bn left the country.

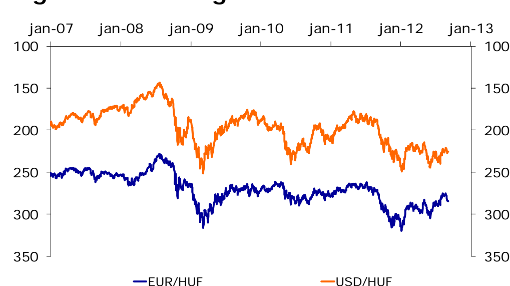
The only sector that has been relatively shielded from this turmoil is Hungary's industrial sector. Since the outbreak of the global crisis, manufacturers in Western Europe have relocated their factories to low-wage countries, including Hungary. This trend is particularly pronounced in the automotive sector. The Hungarian government has further supported the sector by granting special tax cuts and other benefits. This explains why, despite the recession in the eurozone, Hungary's exports have remained relatively stable (even though export growth did come to a halt). However, aside from the industrial sector, businesses in other sectors have been hurt by the combination of a credit crunch and crisis taxes. In addition, a minimum wage hike further cuts into their profits.

Figure 1: Income level



Source: EIU

Figure 2: Exchange rate



Source: EIU

The fall in private and public demand, combined with an expected 8% drop in fixed investments is expected to cause the Hungarian economy to contract by 1% in 2012. Thereafter, Hungary's economic performance will come to depend on whether the government will be able to strike a deal with the IMF (see economic policy section), as well its ability to restore confidence in the economy.

A new agreement with the banking sector, which divides the burden more evenly and helps remove the bad loans from their balance sheets, would be a good first step.

Political and social situation

Hungary's political scene is dominated by the right-wing Fidesz party, which gained power in 2010. The party, led by Prime Minister Victor Orban, holds a two third majority in parliament, implying that it can pass any law without having to include other parties. Unfortunately, this power has been employed to pass a large number of laws and constitutional reforms that threaten the democratic future of Hungary. These include laws that undermine the independence of both the central bank and the constitutional court. For instance, by increasing the number of members of the central bank committee and appointing new members loyal to the Fidesz party, it has gained the ability to strongly influence monetary policy. In a similar fashion, it also increased its control over the constitutional court. Moreover, the constitutional court's responsibilities have been reduced, with an earlier created fiscal committee assuming some of these responsibilities. The fiscal committee itself is entirely made up of members loyal to the Fidesz government. More worrying still, is that it holds the right to veto budget proposals and to force out any government that is unable to pass a budget proposal before March 31st each year. This effectively gives the Fidesz party the power to rule beyond the proverbial grave. Furthermore, under the new constitutional laws, the state no longer recognizes various religions, including Islam. The laws also attack the main opposition party, the socialist MSzP, which can now be held responsible for crimes under the communist regime. Finally, the government also passed a law that curtails media freedom.

Unsurprisingly, many, including the European Commission (EC) and Hungary's own intellectual elite, have spoken out against these measures, as they threaten to undo twenty years of democracy building. Nonetheless, the EC has so far proven unsuccessful in forcing the Hungarian government to reverse the laws. In fact, the EC has only been successful in getting the Hungarian government to partly retract the law undermining the Central Bank's independence, which was a precondition for starting negotiations on an emergency loan. The main reason for the lack of success in other areas is the fact that the Fidesz party has (loosely) based the laws on examples of similar laws in other European countries. However, despite Hungary's reluctance to abide by EU standards, we believe that fears of Hungary leaving Europe are premature. For one, Europe forms Hungary's prime export market. And, secondly, the country heavily relies on funds from Europe.

For the remainder of 2012, we expect ongoing negotiations with the IMF over a much-needed standby agreement (SBA) will force the government to adopt a more moderate tone of voice. In addition, the upcoming parliamentary elections in early 2014 will have a similar effect. Nonetheless, we should not expect any miracles. Although the Fidesz party would have to win back some of the votes it has lost in the past two years, the opposition remains weak. This means the Fidesz party is still very likely to be re-elected.

Economic policy

Over the last two years, the government has implemented a number of reactive, short-sighted and damaging economic policies. It started its term in office by ending the loan programme with the IMF, as it refused to adhere to IMF conditions. Following that, and in an attempt to finance its budget, the government introduced a banking tax, as well as a crisis tax, which mainly hit sectors dominated by foreign investors. In addition, in 2011, it nationalized the second pillar of the pension fund, which gave it direct control over the fund's assets. Finally, the government introduced a flat income tax. As such a tax disproportionally harms the poorer segments of the population, it also

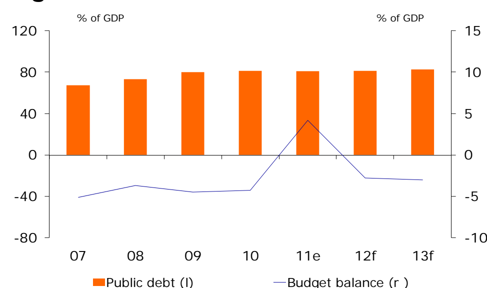
increased minimum wages by 19%. These measures, combined with the previously mentioned mortgage repayment scheme, have created great uncertainty among investors and business owners. In a time were investors are easily spooked, this is a dangerous development.

To make matters worse, the deteriorating business environment combined with the state of Hungary's public finances forced three main rating agencies to downgrade Hungary's sovereign rating to junk status. This has limited the government's access to international capital markets, while raising the costs of borrowing. As Hungary heavily depends on foreign lenders to finance its debt, it is doubtful that it will be able to refinance the public debt that is due this year. In order to prevent a default, the government called on the IMF for a USD 21bn credit line in November 2011 and started official negotiations with the IMF and EU in July 2012. However, reaching an agreement will prove difficult, as the parties involved still disagree over the type of credit facility to be extended, as well as the conditions attached to such a facility. Whereas the government is eager to avoid strict fiscal targets, the IMF is likely to demand such targets, as well as a tax reform. In general, the speed of the negotiations will depend on economic conditions. As long as the government has access to international capital markets it will use this to leverage its position vis-à-vis the IMF. Nonetheless, the failure to reach an agreement will likely result in a further deterioration of Hungary's economic outlook, thereby eventually forcing the government to surrender. Unfortunately, an IMF package will not solve all problems overnight. With a public debt of 81% of GDP, the government will have to implement further austerity measures and reforms to ensure the long-term sustainability of the public debt.

Monetary policy focuses on keeping inflation below the 3% benchmark. However, despite the fact that the Fidesz party did not gain full control over the central bank, it did appoint three new members to the central bank commission. As a result, monetary policy has become more focussed on spurring growth. The central bank's recent lowering of the policy rate (by 25bp) is regarded an example of this shift in focus. Especially given the fact that rising food prices and the various taxes mentioned above are expected to push inflation above the 3% benchmark. For 2012, we expect inflation to come in at 5%, from 3.9% in 2011.

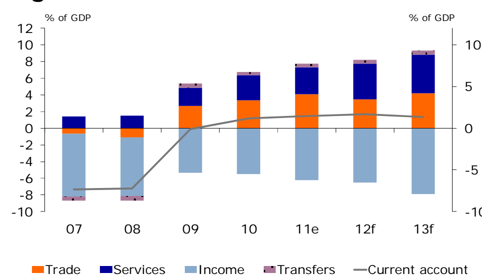
Over the past year the Hungarian forint strongly depreciated vis-à-vis other currencies. Although the central bank has intervened from time to time, in an attempt to strengthen the currency, these attempts have proven largely unsuccessful. For the coming year we expect the value of the forint to remain tied to the shifts in investor sentiment. Obtaining an IMF loan would certainly help boost confidence and thereby strengthen the forint.

Figure 3: Public finances



Source: EIU

Figure 4: Current account balance



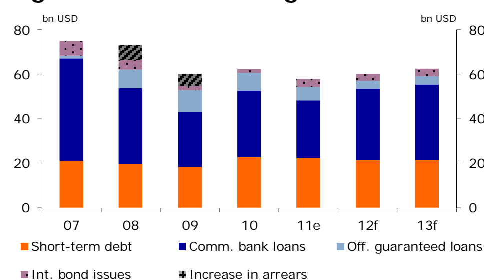
Source: EcoWin

Balance of Payments

Hungary entered the crisis with a large deficit on the current account. However, in recent years, low domestic demand combined with a relatively stable performance of the export sector turned this deficit into a surplus. Especially the trade balance improved notably. Despite the recession in the eurozone, Hungary's growing automotive industry has kept total exports largely constant. In addition, the low value of the forint vis-à-vis the euro has further boosted exports. As a result, Hungary reported a trade surplus of 3.5% of GDP in 2011. The favorable exchange rate also spurred Hungary's services exports, which mainly include transport services and, to a lesser extent, tourism. The deficit on the income balance widened considerably, as the cost of borrowing (i.e. interest payments) shot up. As interest costs are not expected to come down in the short term, the widening of the income deficit is expected to continue in 2013 as well. Finally, the transfer balance reports a small surplus. The resulting current account surplus came in at 1.5% of GDP in 2011 and is expected to increase slightly in 2012, as domestic demand remains low.

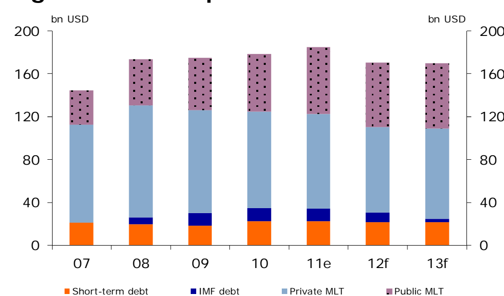
Nonetheless, despite this current account surplus, FX reserves are expected to fall in 2012 (by roughly USD 3.5bn). The main reason for this fall is an expected drop in foreign direct investments, capital flight and the central bank's efforts to strengthen the forint. As a result, we expect import coverage to drop from 4.9 months of imports in 2011, to 4.6 months of imports in 2012. However, large downside risks remain, such as the failure to reach an agreement with the IMF, which could motivate further capital flight and further reduce foreign investments.

Figure 5: Debt financing



Source: EIU

Figure 6: Decomposition external debt



Source: EIU

External position

Both the government and the private sector are heavily indebted to foreign lenders. As a result, external debt is high at 141% of GDP. Hungary is therefore very vulnerable to shifts in investor sentiment, which became very clear in the last two years. Roughly USD 37bn (26% of GDP) of external debt is coming due this year, much of which is held by the banking sector. Although some of this debt will be refinanced through inter-company funding, the remainder will have to be financed through bond issues. The above-mentioned downgrades and reduced investor confidence mean that both the government and private entities are finding it difficult to refinance their debt. This problem is largest for the government, which already endured several partially failed bond issuances this year. In addition, reduced investor confidence resulted in a weaker forint, which has raised the repayment costs.

Assuming that the government is able to reach an agreement with the IMF, we expect external debt to decrease from the expected 141% of GDP in 2012, to 124% of GDP in 2013, with roughly 12% held as short-term debt. However, a failure to reach an agreement could cause both (part of) the private sector and the government to default on their external debt holdings.

Rabobank

Hungary

Selection of economic indicators	2007	2008	2009	2010	2011e	2012f	2013f
Key country risk indicators							
GDP (% real change pa)	0.1	0.9	-6.8	1.3	1.6	-0.8	0.6
Consumer prices (average % change pa)	8.0	6.0	4.2	4.9	3.9	5.5	4.3
Current account balance (% of GDP)	-7.3	-7.2	-0.1	1.2	1.5	1.7	1.3
Total foreign exchange reserves (mln USD)	23970	33788	44074	44849	48681	45400	42540
Economic growth							
GDP (% real change pa)	0.1	0.9	-6.8	1.3	1.6	-0.8	0.6
Gross fixed investment (real % change pa)	3.8	2.9	-11.0	-9.7	-5.5	-7.9	-4.0
Private consumption (real % change pa)	1.1	-0.7	-6.2	-2.2	0.0	-1.3	-1.0
Government consumption (real % change pa)	-7.2	1.1	-0.7	-2.1	-0.6	-1.5	-0.8
Exports of G&S (real % change pa)	15.0	5.7	-10.2	14.3	8.4	0.2	3.0
Imports of G&S (real % change pa)	12.8	5.5	-14.8	12.8	6.3	-1.1	1.1
Economic policy							
Budget balance (% of GDP)	-5.1	-3.7	-4.5	-4.3	4.2	-2.8	-3.0
Public debt (% of GDP)	67	73	80	81	81	81	83
Money market interest rate (%)	7.7	8.9	8.6	5.5	6.2	6.5	5.8
M2 growth (% change pa)	9	9	2	0	7	-5	6
Consumer prices (average % change pa)	8.0	6.0	4.2	4.9	3.9	5.5	4.3
Exchange rate LCU to USD (average)	183.6	172.1	202.3	207.9	201.0	228.6	211.5
Recorded unemployment (%)	7.3	7.8	10.0	11.2	10.9	11.2	10.7
Balance of payments (mln USD)							
Current account balance	-9963	-11122	-108	1514	2055	2010	1830
Trade balance	-962	-1754	3335	4273	5634	4190	5660
Export value of goods	93057	106278	80116	91446	107127	105950	110310
Import value of goods	94019	108032	76781	87173	101493	101760	104660
Services balance	1838	2267	2796	3869	4516	5160	6370
Income balance	-10156	-10792	-6815	-7132	-8735	-7890	-10820
Transfer balance	-683	-843	576	504	640	560	630
Net direct investment flows	370	3790	170	970	-140	380	580
Net portfolio investment flows	-5764	-3837	-2958	981	7587	2060	1870
Net debt flows	30769	19519	4622	7559	-1577	-4320	1860
Other capital flows (negative is flight)	-12950	1472	8584	-10219	-4078	-3520	-8990
Change in international reserves	2462	9822	10309	805	3847	-3390	-2860
External position (mln USD)							
Total foreign debt	144755	173793	175229	178758	185034	170700	170110
Short-term debt	21214	19874	18409	22749	22400	21590	21540
Total debt service due, incl. short-term debt	49426	60888	60471	59105	64386	68620	64560
Total foreign exchange reserves	23970	33788	44074	44849	48681	45400	42540
International investment position	-132561	-148902	n.a.	n.a.	n.a.	n.a.	n.a.
Total assets	210450	264591	n.a.	n.a.	n.a.	n.a.	n.a.
Total liabilities	343011	413493	n.a.	n.a.	n.a.	n.a.	n.a.
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	-0.7	-1.1	2.6	3.3	4.0	3.5	4.1
Current account balance (% of GDP)	-7.3	-7.2	-0.1	1.2	1.5	1.7	1.3
Inward FDI (% of GDP)	3.0	3.8	1.8	1.9	2.8	1.8	2.1
Foreign debt (% of GDP)	106	113	138	139	132	141	124
Foreign debt (% of XGSIT)	114	119	146	136	125	115	111
International investment position (% of GDP)	-97.4	-96.5	n.a.	n.a.	n.a.	n.a.	n.a.
Debt service ratio (% of XGSIT)	39	42	51	45	44	46	42
Interest service ratio incl. arrears (% of XGSIT)	4	5	4	3	3	3	3
FX-reserves import cover (months)	2.6	3.2	5.7	5.2	4.9	4.6	4.1
FX-reserves debt service cover (%)	48	55	73	76	76	66	66
Liquidity ratio	93	95	105	105	103	99	100

Source: EIU

Disclaimer
This document is issued by Coöperatieve Centrale Raiffeisen-Boerenleenbank B.A. incorporated in the Netherlands, trading as Rabobank Nederland, and regulated by the FSA. The information and opinions contained herein have been compiled or arrived at from sources believed to be reliable, but no representation or warranty, express or implied, is made as to their accuracy or completeness. It is for information purposes only and should not be construed as an offer for sale or subscription of, or solicitation of an offer to buy or subscribe for any securities or derivatives. The information contained herein is not to be relied upon as authoritative or taken in substitution for the exercise of judgement by any recipient. All opinions expressed herein are subject to change without notice. Neither Rabobank Nederland, nor other legal entities in the group to which it belongs accept any liability whatsoever for any direct or consequential loss howsoever arising from any use of this document or its contents or otherwise arising in connection therewith, and their directors, officers and/or employees may have had a long or short position and may have traded or acted as principal in the securities described within this report, or related securities. Further it may have or have had a relationship with or may provide or have provided corporate finance or other services to companies whose securities are described in this report, or any related investment. This document is for distribution in or from the Netherlands and the United Kingdom, and is directed only at authorised or exempted persons within the meaning of the Financial Services and Markets Act 2000 or to persons described in Part IV Article 19 of the Financial Services and Markets Act 2000 (Financial Promotions) Order 2001, or to persons categorised as a "market counterparty or intermediate customer" in accordance with COBS 3.2.5. The document is not intended to be distributed, or passed on, directly or indirectly, to those who may not have professional experience in matters relating to investments, nor should it be relied upon by such persons. The distribution of this document in other jurisdictions may be restricted by law and recipients into whose possession this document comes from should inform themselves about, and observe any such restrictions. Neither this document nor any copy of it may be taken or transmitted, or distributed directly or indirectly into the United States, Canada, and Japan or to any US-person. This document may not be reproduced, distributed or published, in whole or in part, for any purpose, except with the prior written consent of Rabobank Nederland. By accepting this document you agree to be bound by the foregoing restrictions.