Country update **HUNGARY**

Summary

Hungary's economic situation continues to deteriorate with alarming speed. While the ongoing eurozone crisis puts pressure on Hungary's economy, the government continues to spook investors. The most recent, and extremely distressing development, was its decision to implement a number of laws and constitutional reforms that undermine both the central bank's and constitutional court's independence. Investors reacted strongly, sending bond yields and CDS spreads through the roof. With public debt at 76% of GDP, the situation is indeed worrisome. Moreover, a sharp fall of the forint vis-à-vis other currencies will only add to mortgage repayment costs, as many households hold mortgages denominated in foreign currencies. Emergency support will likely be the only way out, but it is not at all certain the government will accept the conditions imposed by the IMF and EU.

Things to watch:

- Market sentiment in light of high public debt and deteriorating business climate
- Negotiations between the government and EU/IMF
- Social and political tensions following the adoption of various constitutional reforms

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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	141	0.20
Nominal GDP at PPP	194	0.25
Export value of goods and services	134	0.61
IMF quotum (in mln SDR)	1038	0.48
Economic structure	*2011*	*5-year av.*
Real GDP growth	1.5	-0.1
Agriculture (% of GDP)	4	4
Industry (% of GDP)	28	27
Services (% of GDP)	68	69
Standards of living	*USD*	*% world av.*
Nominal GDP per head	14101	131
Nominal GDP per head at PPP	19406	157
Real GDP per head	11099	136

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			**1905**
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)			95
Import value of G&S (% of GDP)			88
Inward FDI (% of GDP)			1.7

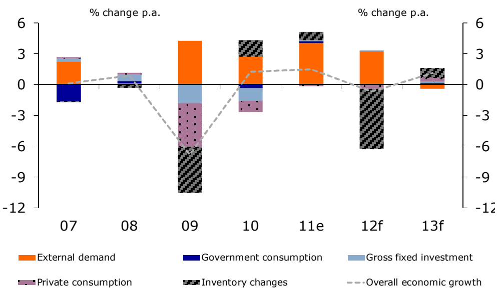
Source: EIU, CIA World Factbook, UN, Heritage Foundation, Transparency International, Reporters Without Borders, World Bank.

Introduction and update

Hungary's economic situation continues to deteriorate. Heavily exposed to the eurozone debt crisis, Hungary suffers from both a fall in eurozone demand and deleveraging by eurozone banks. Especially the latter will have pronounced effects, as roughly 88% of all Hungarian bank assets are held by foreign banks. Finally, the crisis has induced investors to pull out of the more risky emerging markets in search of perceived safe(r) havens.

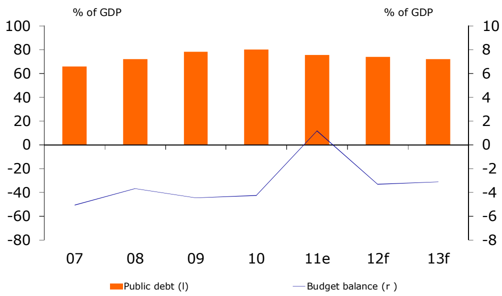
However, even though external pressures have had a severe impact, Hungary's economic problems are mostly of the country's own making. Hungary entered the crisis in 2008/9 with large deficits on both the current and fiscal account, an overleveraged private sector and an uncompetitive labour force. Consequently, already at the end of 2008 it had to turn to the IMF for an emergency loan. Now, three years later, the situation has gone from bad to worse. As a result of the various ill-informed and often extremely damaging economic and social policies,

Figure 1: Growth performance



Source: EIU

Figure 2: Public finances

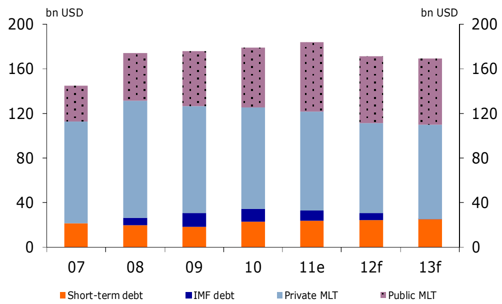


Source: EIU

implemented by the Fidesz government, investor confidence further deteriorated, while economic activity remained low. The policy measures include a crisis tax that especially targets foreigners, the nationalization of the country's pension scheme and a law that allows households to repay their FX-mortgages at a discount (at the expense of mostly foreign banks and the government). In addition, a bundle of new laws, implemented at the start of this year (see below), threatens to undo years of democracy building, while simultaneously jeopardizing the independence of Hungary's central bank.
As a consequence of both these domestic and external factors, we expect GDP growth to slow in the coming year, from 1.5% in 2011 to a meagre 0.6% in 2012. Slow growth will put further pressure on public finances and we expect the government to report a budget deficit of 3.3% of GDP (after reporting a surplus of 1.2% of GDP in 2011, which was largely caused by the nationalization of the pension scheme). However, with inflation at an expected 3.9% in 2011, public debt to GDP is expected to shrink somewhat, to a still elevated 74% of GDP in 2012, from 76% of GDP in 2011. The high level of public debt is especially worrisome in light of reduced investor confidence and the recent downgrade of sovereign bonds to junk status, by all three major rating agencies. Meanwhile, external debt levels remain elevated as well, at a forecasted 121% of GDP in 2012 (from 129% of GDP in 2011).

The road to autocracy...
A bundle of new laws and constitutional reforms adopted by the government at the start of this year brought into question the independence of the central bank and the constitutional court, and sparked fears that the government is becoming even more autocratic. By increasing the number of central bank committee members, the Fidesz party was able to appoint enough members (loyal to the party) to gain the upper hand. In a similar fashion, it also increased its control over the constitutional court. Moreover, the court's responsibilities have been reduced, with an earlier created fiscal committee assuming some of these responsibilities. Most importantly, the fiscal committee,

Figure 3: External debt



Source: EIU

entirely made up of members loyal to the Fidesz government, has the right to veto budget proposals and to dismantle any government that fails to pass a budget proposal before March 31st each year. This gives the Fidesz party the power to force out any new government and thereby the ability to rule beyond its grave.
The new constitutional laws also hold a strong nationalistic component, as they include a law that holds that many religions, including Islam, are no longer recognized by the state. Finally, the country's main opposition party, the socialist MSzP, will be held responsible for crimes under the communist regime. Unsurprisingly, many, including 30,000 protesters and a number of Hungary's most prominent intellectuals, fear that by attacking the country's main democratic institutions, the

new constitution will undo years of democracy building. Still, there also exist many pro-Fidesz sentiments, which have culminated in various pro-Fidesz rallies.

...could also be the road to a default

Hungary's intellectuals and citizens were not the only ones criticizing the recent developments. Almost immediately after the laws were adopted, the European Commission urged the government to retract the law that undermines the central bank's independence, stating that it would not extend emergency support to a country without an independent central bank. Moreover, it has filed charges against Hungary, claiming that the laws governing religions, the central bank and the constitutional courts go against European regulations.

This creates a dangerous situation, as the government is in desperate need of a loan to help (re)finance its debt. Furthermore, it might have to bail-out Hungarian banks that are heavily exposed to the FX mortgages. Roughly USD 37bn (26% of GDP) of external debt will mature this year, much of which is held by the banking sector.

Meanwhile, the political turmoil has sent investors running for the exits. In the first week of January, government bond yields rose to 10%, while CDS spreads jumped to 700bps. Consequently, the market-implied probability of default rose to roughly 50% (assuming a 50% recovery rate). Moreover, the value of the forint vis-à-vis the euro dropped to an all-time low. Given that the government heavily depends on foreign investors to finance its debt (more than 60% of which is held by foreigners), this situation is worrisome. We thus expect that a lifeline from IMF and EU will be the only way out. However, whether the government will accept the conditions imposed by both institutions remains to be seen.

Hungary

Selection of economic indicators	2007	2008	2009	2010	2011e	2012f	2013f
Key country risk indicators							
GDP (% real change pa)	0.8	0.8	-6.7	1.2	1.5	0.6	1.4
Consumer prices (average % change pa)	8.0	6.0	4.2	4.9	3.9	4.9	3.4
Current account balance (% of GDP)	-6.9	-7.2	0.4	2.3	1.5	1.1	0.7
Total foreign exchange reserves (mln USD)	23970	33788	44074	44849	49955	51220	51020
Economic growth							
GDP (% real change pa)	0.8	0.8	-6.7	1.2	1.5	0.6	1.4
Gross fixed investment (real % change pa)	1.7	2.9	-8.0	-5.6	0.5	0.6	1.2
Private consumption (real % change pa)	0.2	0.4	-7.8	-2.0	-0.3	-0.8	0.6
Government consumption (real % change pa)	-7.3	1.1	-0.3	-1.6	0.9	0.1	0.4
Exports of G&S (real % change pa)	16.2	5.7	-9.6	14.1	11.3	6.0	6.5
Imports of G&S (real % change pa)	13.3	5.8	-14.6	12.0	8.0	3.5	8.0
Economic policy							
Budget balance (% of GDP)	-5.1	-3.7	-4.5	-4.2	1.2	-3.3	-3.1
Public debt (% of GDP)	66	72	78	80	76	74	72
Money market interest rate (%)	7.7	8.9	8.6	5.5	6.1	6.2	5.8
M2 growth (% change pa)	9	9	2	0	3	9	7
Consumer prices (average % change pa)	8.0	6.0	4.2	4.9	3.9	4.9	3.4
Exchange rate LCU to USD (average)	183.6	172.1	202.3	207.9	199.6	213.1	213.2
Recorded unemployment (%)	7.3	7.8	10.0	11.2	11.1	10.6	10.2
Balance of payments (mln USD)							
Current account balance	-9580	-11115	472	3049	2113	1520	1110
Trade balance	-175	-792	4782	6212	8402	7920	7290
Export value of goods	93844	107240	81563	93294	116317	124390	132200
Import value of goods	94019	108032	76781	87082	107915	116470	124910
Services balance	1434	1455	1908	3178	1601	1770	1850
Income balance	-10156	-10935	-6728	-6838	-8434	-8710	-8590
Transfer balance	-683	-843	510	497	544	540	570
Net direct investment flows	370	3790	-200	600	593	570	680
Net portfolio investment flows	-5764	-3767	-2599	1524	450	20	630
Net debt flows	30867	19604	4645	7409	-3161	-4160	2090
Other capital flows (negative is flight)	-13431	1310	7992	-11776	5144	3190	-4720
Change in international reserves	2462	9822	10309	805	5139	1140	-200
External position (mln USD)							
Total foreign debt	144847	173942	175409	178855	184086	171120	169470
Short-term debt	21312	20056	18607	22868	23976	24380	25290
Total debt service due, incl. short-term debt	49426	60990	60650	59379	67496	70880	67450
Total foreign exchange reserves	23970	33788	44074	44849	49955	51220	51020
International investment position	-132561	-148902	-163836	-143110	n.a.	n.a.	n.a.
Total assets	210450	264591	275782	233009	n.a.	n.a.	n.a.
Total liabilities	343011	413493	439618	376119	n.a.	n.a.	n.a.
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	-0.1	-0.5	3.7	4.8	5.9	5.6	4.9
Current account balance (% of GDP)	-6.9	-7.2	0.4	2.3	1.5	1.1	0.7
Inward FDI (% of GDP)	2.9	3.7	1.3	1.5	1.7	1.7	2.0
Foreign debt (% of GDP)	105	112	136	137	129	121	114
Foreign debt (% of XGSIT)	113	119	146	136	116	102	96
International investment position (% of GDP)	-96.1	-95.8	-127.2	-109.7	n.a.	n.a.	n.a.
Debt service ratio (% of XGSIT)	39	42	50	45	43	42	38
Interest service ratio incl. arrears (% of XGSIT)	4	5	4	3	3	3	2
FX-reserves import cover (months)	2.6	3.2	5.7	5.2	4.7	4.5	4.2
FX-reserves debt service cover (%)	48	55	73	76	74	72	76
Liquidity ratio	93	95	105	106	103	102	103

Source: EIU