Rabobank

Country report

HUNGARY

Summary

Hungary struggled through the financial and economic crisis in 2009. The economy shrunk by 7% and there was little room for fiscal stimulus as Hungary had to adhere to the conditions of the IMF attached to the aid package. For 2010, the economy is expected to stop shrinking, but the recovery is weak. If the export markets, mainly Germany, grow strongly again, this could push growth beyond the current expectations. The latest polls show that the parliamentary elections in April are likely to be won by the opposition party Fidesz. Although Fidesz is promising to reform taxes and increase spending to stimulate the economy and create jobs, the party seems to realize that this could jeopardize international support and investor confidence. Fiscal austerity will remain important to boost confidence in Hungary, even after the IMF agreement ends in October 2010, as the external vulnerability of Hungary is significant. About two thirds of the all private sector loans are in foreign currency and the foreign debt level remains above 100% of GDP. The development of the forint is therefore an important factor. The relatively limited level of short-term debt and adequate foreign exchange reserve mitigate part of the risk.

Things to watch:

- Parliamentary elections in April
- Medium term plans of the new ruling party
- Social security, tax, health care and pension reforms (in combination with IMF conditions)
- Development of the forint

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Hungary

National facts	
Type of government	Parliamentary democracy
Capital	Budapest
Surface area (thousand sq km)	93
Population (millions)	10.0
Main languages	Hungarian (93.6%)
	other (6.4%)
Main religions	Roman Catholic (51.9%)
	Calvinist (15.9%)
	unaffiliated (14.5%)
Head of State (president)	Laszlo Solyom
Head of Government (prime-minister)	Gordon Bajnai
Monetary unit	forint (HUF)

Economy (2009)		
Economic size	*bn USD*	*% world total*
Nominal GDP	155	0.22
Nominal GDP at PPP	186	0.27
Export value of goods and services	94	0.61
IMF quotum (in mln SDR, 2008)	1038	0.48
Economic structure	*2009*	*5-year av.*
Real GDP growth	-6.7	2.9
Agriculture (% of GDP)	3	3
Industry (% of GDP)	34	37
Services (% of GDP)	62	61
Standards of living	*USD*	*% world av.*
Nominal GDP per head	12878	141
Nominal GDP per head at PPP	18800	170
Real GDP per head	10980	142

Social and governance indicators	rank / total
Human Development Index (rank)	43 / 182
Ease of doing business (rank)	47 / 183
Economic freedom index (rank)	44 / 179
Corruption perceptions index (rank)	46 / 180
Press freedom index (rank)	25 / 175
Gini index (income distribution)	26.9
Population below $1 per day (PPP)	<2%

Foreign trade (2008)			
Main export partners (%)		*Main import partners (%)*	
Germany	27	Germany	26
Italy	5	Russia	9
Romania	5	China	8
Austria	5	Austria	6

Main export products (%)	
Machinery & equipment	61
Manufactures	27
Food, beverages & tobacco	7
Raw materials	2
Main import products (%)	
Machinery & equipment	49
Manufactures	32
Fuels & energy	13
Food, beverages & tobacco	5
Openness of the economy (2009)	
Export value of G&S (% of GDP)	74
Import value of G&S (% of GDP)	70
Inward FDI (% of GDP)	1.1

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

Economic structure and growth

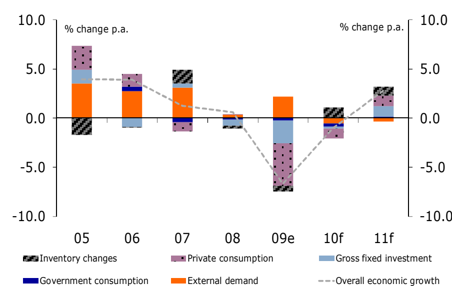
The global crisis pushed economic growth deep into red figures during 2009. Growth plunged from a meager 0.8% in 2008 to -7% in 2009. Export demand, which strongly relies on the German market, dropped. The positive contribution to growth from external demand solely stems from the fact that import demand fell even harder. This was due to the drop in private consumption, which also affected economic growth itself. In the years running up to 2009, foreign borrowing had boosted domestic consumption, pushing up growth (and unfortunately also the number of foreign currency loans). With the foreign credit market in a tight spot, borrowing to Hungarian customers was also curtailed. Due to the IMF agreement there was no room for fiscal stimulus to soften the impact of the financial crisis (see also section on Economic Policy).

In 2010, economic growth is expected to be close to zero. This is still a very weak result, especially since it is largely due to base effects. Fiscal austerity, a modest recovery of export demand, limited investment and weak household consumption are behind this expectation. As production capacity is currently underutilized and FDI inflows are limited, fixed investment is expected to remain slow. Higher unemployment and limited (foreign) borrowing will depress consumer demand, albeit not as much as in 2009. Growth could surprise to the upside if export demand from Western Europe is stronger than expected or if the government reverses the spending cuts.

Despite the gloomy outlook in 2010, the fundamentals of Hungary are still considered good. Hungary has enjoyed a significant inflows of FDI in the past decade, creating a solid base. The workforce is highly skilled, the economy diversified and Hungary has good relations within the EU.

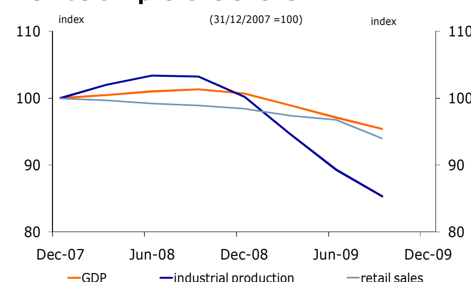
Moreover, the regulatory framework is considered good, although bureaucracy remains a hindrance for the business environment.
Already before the strong recession, Hungary's catching up with the EU average income seemed to have ground to a halt. In 2008, the GDP per capita of Hungary stood at 64% of the EU-27 average, only 1% up from the previous two years. By comparison, in 2008 Slovenia stood at 91% of the EU-27 average, the Czech Republic at 80%, Slovakia at 72%, Estonia at 67% and Poland at 56%. With economic recovery expected to be faster in neighboring countries (except the Baltics, Romania and Bulgaria), Hungary is likely to linger behind. In fact, to catch up with the EU average Hungary must generate economic growth that is two percentage points above the average economic growth in the EU.

Chart 1: Recession hit the economy…



Source: EIU

Chart 2: … and industrial production fell well below pre-crisis level.



Source: EIU

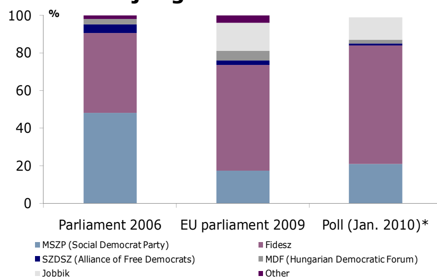
The banking sector in Hungary is dominated by foreign banks, mostly from Western Europe. With a loan book to customer deposit ratio well above 100% (in 2008 slightly more than 140% and in H12009 just below 120%), Hungarian banks are reliant on external sources. The intra-company loans with foreign parents are the main source of funding. As many foreign parents still have limited capital available or require their Hungarian subsidiaries to reduce the loan to deposit ratio, the Hungarian banking sector in effect reduces its lending. Loan growth average around 20-25% per year up to 2008 (thereby being a major stimulus of economic growth), but dropped into negative territory in the first half of 2009. It started to recover in the second half of 2009, but is expected to remain subdued in 2010. Since end 2008, the banking sector is facing a trend of rising non-performing loans (NPLs). Most losses occur in the SME sector, especially associated with transport and export-related industries. The number of bad loans in the mortgage portfolio is slowly increasing due to rising unemployment. Currency mismatches is another major issue in the Hungarian banking sector. About two thirds of all private sector loans are in foreign currency, which is among the highest in Eastern Europe. The depreciation of the forint in early 2009 put significant pressure of the repayment capacity of borrowers. If the forint would depreciate again, this could have a major impact on the NPLs. The combination of sensitivity to exchange rate fluctuations and already rising NPLs makes the financial sector a significant potential liability for Hungary.

Political and social situation

The political scene is dominated by the ruling Hungarian Socialist Party (MSZP) and the main opposition party, the right-wing Fidesz. The liberal Alliance of Free Democrats (SZDSZ) is a small party, but as a de facto coalition party of the MSZP also plays a large role. The MSZP governs with a minority in parliament but generally receives support from SZDSZ (although the SZDSZ officially left the coalition in April 2008). The support of the general public for the ruling party has been

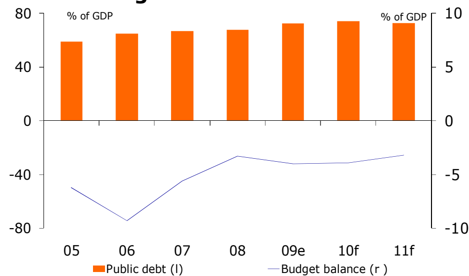
waning ever since the MSZP has admitted using misleading campaign slogans during the elections in 2006. The unpopular fiscal measures and general dismal state of the Hungarian economy during the financial crisis further added to the woes of the MSZP. In April 2009, prime minister Gyrurcsany stepped down to further the reforms and regain some support. This led to a reshuffle in the government, which put Gordon Bajnai, an independent who is backed by the MSZP, at the helm of the cabinet. His caretaker cabinet has been able to push through some reforms in the bloated social expenditures, but much still has to be done. The popularity of the MSZP has only improved slightly after the reshuffle.
Parliamentary elections will be held on 11 April 2010. Opposition party Fidesz is expected to become the largest party, based on recent polls and the results of the European Parliamentary elections in June 2009. The party might even gain a two third majority in parliament. The right-winged Fidesz bases its support on the strong anti-government sentiment with the population and promises to stimulate the economy and create jobs. Limited details are known about their plans on how to achieve this, but suggestions are made about additional government spending, reforming the tax system (which suffers from tax evasion), expansion of the domestic market, increasing exports and reducing red tape (i.e. cutting in the government apparatus). Considering the current state of Hungary and the cautious recovery of the export markets, this strategy seems a bit too shallow, although there is plenty of red tape around to cut spending. Despite these promises, several statements indicate that Fidesz does realize that reversing the recent reforms will jeopardize Hungary's position with the IMF and international investors - and Hungary is certainly in need of both. However, the fact that Fidesz shares little details on its plans increases the uncertainty surrounding the plans of Fidesz, which in turn heightens the political risk in Hungary to some extent. A wait-and-see approach is the current stance by many international investors and international institutions.
In the upcoming elections, Jobbik is also expected to gain ground. The far-right party made its debut at the elections for the European parliament and received almost 15% of the votes. The party leader is openly anti-Semitic and anti-Roma. Although Jobbik is unlikely to become the main party, it seems to push the tone in parliament towards harsher and nationalistic rhetoric. Fidesz has indicated that it will not govern with Jobbik.
Hungary has good relations with the EU and EU members, although it occasionally has a diplomatic spat with neighboring countries. Especially the relationship between Hungary and Slovakia is cool. Hungary and its neighbors struggle with the balance between accepting each other's (rather large) minorities and promoting nationalistic unity. The balance tends to swing towards nationalistic feelings.

Chart 3: Polls parliamentary elections indicate major gain Fidesz



Source: Global Insight, EU and Szonda Ipsos. * Of the decided voters. 40% of voters was undecided or won't vote according to this poll.

Chart 4: Fiscal policy has improved, but remains fragile



Source: EIU

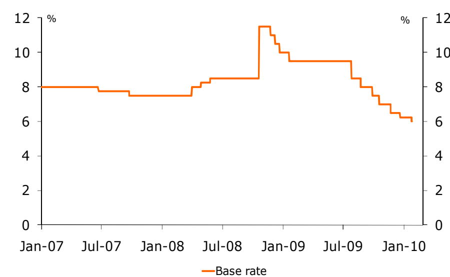
Economic policy

In November 2008, Hungary received USD 20bn in international support from the IMF, EU and World Bank. A maximum budget deficit of 3.8% of GDP in 2009 and 2010 are important conditions for the IMF loan. The government of Bajnai has been able to implement several changes, leading to positive quarterly reviews by the IMF up to now. The government decided not to draw (fully) on the disbursement available after the September and December review, a sign of improved access to other funding sources. The next review is expected in March 2010. The IMF program has recently been extended to October 2010, but the size has not expanded. It is unclear whether a new agreement should be expected. Fidesz has mentioned that it would like to renegotiate the IMF program as the current conditions are too strict.

The IMF program is forcing Hungary to refocus on the issue of bloated budget deficits. During the years with strong economic growth, the fiscal deficit was often very high – up to almost 10% of GDP in 2006. The largest public sector in Eastern Europe (relative to GDP), additional spending before elections and generous social services are main causes. In 2006, a start was made with the consolidation of the fiscal deficit which resulted in a significant reduction. However, the polarized political scene of Hungary have slowed the reforms. To achieve a structural reduction of the fiscal deficit, the government will need to further reform the social security, tax, health and pension systems and reduce the size of the public sector. Public debt has increased to 72% of GDP in 2009 due to the sustained fiscal deficits. For the coming years, a rather high public debt level of around 70-75% of GDP is expected. In the medium term, fiscal austerity and reduction of public debt are necessary if Hungary wants to adopt the euro. The current prime minister Bajnai wants the euro as soon as possible, which seems sensible considering the high prevalence of foreign currency loans. However, considering the fiscal situation, adoption is not likely in the near term.

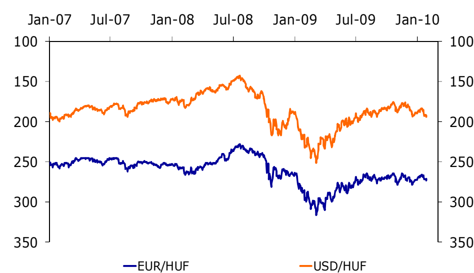
In 2009, the budget deficit is forecast to be 3.5-3.7% of GDP, slightly worse than in 2008, but better than the IMF demanded. Cyclical additional expenditures and lower taxes pushed the deficit up, although the government managed to compensate it partly by stiff budget cuts (of around 5% of GDP) in the second half of 2009 and an increase in VAT. The 2010 government budget aims for 3.8% of GDP. This is a rather ambitious target and also strongly depends on the plans of Fidesz if they win the elections.

Chart 5: Policy rate on downward trend



Source: Ecowin

Chart 6: Exchange rate on upward trend



Source: Ecowin

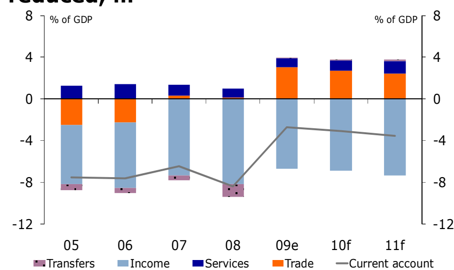
After the central bank hiked its policy interest rate by 300bp to 11.5% in October 2008 to stem the pressure on the exchange rate, the policy rate has gradually been lowered again to 6% in January 2010. The increased stability of the Hungarian forint has aided this loosening of the monetary policy. The inflation target of the central bank is set at 3%. During 2009, downward inflationary pressure came from low commodity prices and weak demand, albeit somewhat offset by the sharp drop in the forint end 2008. As a result, inflation was 4.8% last year. For 2010, a slow recovery of the economy is expected, although the output gap will remain significant in the first half of 2010.

Commodity prices are expected to increase again, thereby limiting the scope to cut rates further. The inflation is expected to be around 4.2% in 2010. An uncertainty in the inflation expectations is the development of the forint. The path of the forint strongly depends on the confidence of foreign investors in Hungary. The IMF reviews, outcome of the elections and economic recovery are important factors determining confidence.

Balance of Payments

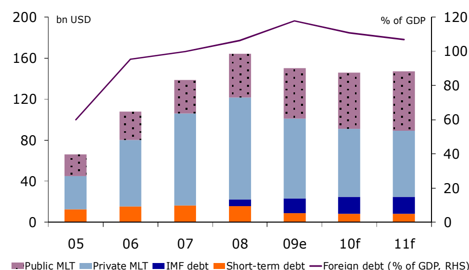
Hungary had been running significant current account deficits (around 7% of GDP) in the years before the financial crisis. The deficit on the income balance, a result of the strong inflow of investment in previous years, was the main reason behind the current account deficit. During 2009, the income of companies owned by foreign investors decreased in line with the general economic downturn. Moreover, the surplus on the trade balance grew to 3.3% of GDP during 2009, as the plunging imports outpaced the falling exports. Overall, the current account deficit improved from 8.4% of GDP in 2008 to 2.7% of GDP in 2009. For 2010, the current account deficit is expected to slightly fall back again to around 3% of GDP. As consumption is slowly expected to recover, import demand will likely follow suit. The revival in export demand is expected to be slower than in import demand, thereby lowering the trade surplus this year. The deficit on the income balance is expected to grow again, as the cautious economic recovery aids profits.

Chart 7: Current account deficit reduced, ...



Source: EIU

Chart 8: ... lowering foreign debt level.



Source: EIU

External position

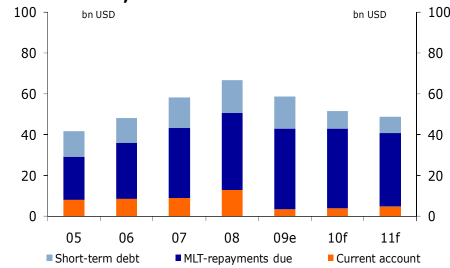
Hungary strongly relies on external financing sources to cover the current account deficit and debt repayments. This makes the country sensitive to changes in investor sentiment, as was clearly demonstrated by the financial crisis end-2008. Commercial bank loans (from foreign parents) are an important source of external financing (see also section 'economic structure and growth'). During 2009, the inflow of commercial bank loans halved (USD 35bn in 2008, USD 16bn in 2009). Other sources of foreign lending also scaled back (e.g. short term debt also halved). Foreign direct investment was also hit by the financial crisis, while portfolio investment benefitted from the appreciation of the forint in the second half of 2009 and higher interest rates (with the risk of carry trade reversing in the future). Although the external financing requirement also dropped due to the lower current account deficit, the IMF loan and officially guaranteed loans were needed to cover the gap.

With the current account deficit expected to be only slightly higher than in 2009, the financing requirements for 2010 will not grow much compared to 2009. As a further improvement of access to international capital markets is expected, this should not lead to problems. Hungary has indeed indicated that it attempts not to draw under the IMF facilities. It must be noted that the inflow of

commercial bank loans will remain subdued as long as (parent) banks in Western Europe remain cautious.

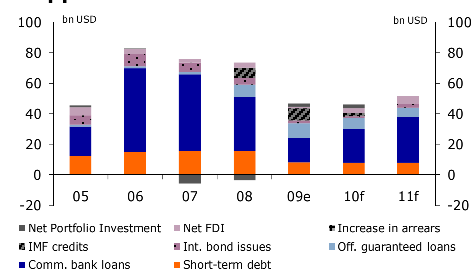
Financing its requirements with foreign lending has pushed the foreign debt level of Hungary well above 100% of GDP. This high level has added to the vulnerable external position of Hungary. After peaking at 118% of GDP in 2008, the foreign debt ratio is expected to decrease to around 105% in 2010. The low prevalence of short term debt (5% of total debt) mitigates part of the risk associated with a high debt level. Moreover, the fact that many loans are intracompany loans aid the debt roll-over rate. Foreign exchange reserves (USD 43.8bn) covered about 30% of the total foreign debt in 2009. Surprisingly, the foreign exchange reserves grew by USD 10bn during 2009 and are expected to continue growing, albeit at a much lower pace. With the falling current account deficit, the import cover boomed from 3 months in 2008 to 6 months in 2009 and is expected to stay at this level in 2010.

Chart 9: Financing requirements decreased, ...



Source: EIU

Chart 10: ... while commercial bank loans dropped.



Source: EIU

Hungary

Selection of economic indicators	2005	2006	2007	2008	2009e	2010f	2011f
Key country risk indicators							
GDP (% real change pa)	4.0	3.9	1.2	0.6	-6.7	-1.0	2.8
Consumer prices (average % change pa)	3.6	3.9	8.0	6.1	4.3	3.8	2.8
Current account balance (% of GDP)	-7.5	-7.6	-6.4	-8.4	-2.7	-3.1	-3.6
Total foreign exchange reserves (mln USD)	18552	21527	23970	33788	43890	44170	46017
Economic growth							
GDP (% real change pa)	4.0	3.9	1.2	0.6	-6.7	-1.0	2.8
Gross fixed investment (% real change)	5.7	-3.6	1.8	-2.6	-10.0	-1.0	5.0
Private consumption (% real change)	3.6	1.9	-1.4	0.1	-6.7	-1.5	1.7
Government consumption (% real change)	-0.1	4.9	-4.5	-1.9	-4.0	-3.0	1.5
Exports of G&S (% real change)	11.5	18.4	16.4	4.8	-14.0	3.4	5.4
Imports of G&S (% real change)	6.9	15.0	13.4	4.7	-16.3	4.2	6.0
Economic policy							
Budget balance (% of GDP)	-6.2	-9.3	-5.6	-3.3	-4.0	-3.9	-3.2
Public debt (% of GDP)	59	65	67	68	72	74	72.8
Money market interest rate (%)	7.1	7.0	7.7	8.9	8.0	7.5	6.5
M2 growth (% change pa)	13	14	10	9	8	3	5.4
Consumer prices (average % change pa)	3.6	3.9	8.0	6.1	4.3	3.8	2.8
Exchange rate LCU to USD (average)	199.6	210.4	183.6	172.1	200.6	197.5	198.9
Recorded unemployment (%)	7.2	7.5	7.3	7.8	10.5	11.2	9.1
Balance of payments (mln USD)							
Current account balance	-8261	-8610	-8922	-12981	-3480	-4070	-4900
Trade balance	-2728	-2573	452	175	3840	3580	3373
Export value of goods and services	61688	73456	93855	106644	79250	87490	97375
Import value of goods and services	64416	76029	93404	106469	75400	83920	94001
Services balance	1409	1592	1435	1376	1120	1250	1627
Income balance	-6245	-7085	-10145	-12613	-8520	-9030	-10120
Transfer balance	-696	-544	-665	-1919	80	140	219
Net direct investment flows	5420	3410	2250	3630	900	3050	5091
Net portfolio investment flows	1525	9	-5764	-3494	2160	2540	-325
Net debt flows	5496	39536	24533	16364	-11560	-6730	2639
Other capital flows (negative is flight)	-1541	-31357	-9635	6303	22050	5490	-655
Change in international reserves	2638	2987	2462	9822	10070	270	1850
External position (mln USD)							
Total foreign debt	66119	107677	138387	164301	150090	145730	147106
Short-term debt	12394	14979	15877	15829	8390	8130	8012
Total debt service due, incl. short-term debt	35839	43222	54479	60488	59820	50820	48058
Total foreign exchange reserves	18552	21527	23970	33788	43890	44170	46017
International investment position	-95000	-118705	-131965	-150254	n.a.	n.a.	n.a.
Total assets	48660	111612	203491	254723	n.a.	n.a.	n.a.
Total liabilities	143659	230317	335456	404977	n.a.	n.a.	n.a.
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	-2.5	-2.3	0.3	0.1	3.0	2.7	2.4
Current account balance (% of GDP)	-7.5	-7.6	-6.4	-8.4	-2.7	-3.1	-3.6
Inward FDI (% of GDP)	6.9	6.5	4.2	2.8	1.1	2.2	3.5
Foreign debt (% of GDP)	60	95	100	106	118	111	107
Foreign debt (% of XGSIT)	82	110	108	116	143	125	113
International investment position (% of GDP)	-86.2	-105.0	-95.1	-97.1	n.a.	n.a.	n.a.
Debt service ratio (% of XGSIT)	44	44	42	43	57	44	37
Interest service ratio incl. arrears (% of XGSIT)	3	4	4	5	4	3	3
FX-reserves import cover (months)	2.9	2.9	2.6	3.2	5.9	5.4	5.1
FX-reserves debt service cover (%)	52	50	44	56	73	87	96
Liquidity ratio	87	90	91	94	103	108	110

Source: EIU

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