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Atradius Country Report

Hungary – March 2012

Overview

General information

Capital: Budapest
Government type: Parliamentary democracy
Currency: Forint (HUF)
Population: 9.9 million
Status: Upper middle income country (GDP/capita: US$ 13,112 in 2011)

Most important sectors (% of GDP, 2011)

Services: 60 %
Industry/mining: 37 %
Agriculture: 3 %

Main import sources (2010, % of total)

Germany: 26.1 %
Russia: 7.7 %
China: 6.8 %
Austria: 5.9 %
The Netherlands: 4.4 %

Main export markets (2010, % of total)

Germany: 25.5 %
Italy: 5.5 %
UK: 5.4 %
Romania: 5.3 %
Slovakia: 5.1 %

Main expenses of foreign exchange

Machinery and equipment (52 %), other manufactured products (32 %), fuel/energy (11 %)

Main sources of foreign exchange

Machinery and equipment (62 %), other manufactured products (29 %), food products (7 %), tourism

Key indicators

	2009	2010	2011*	2012**	2013**
Real GDP growth (y-on-y, % change)	-6.7	1.2	1.5	-0.8	0.7
Consumer price inflation (y-on-y, % change)	4.2	4.9	4.1	4.6	3.7
Real private consumption (y-on-y, % change)	-5.7	-2.7	0.1	-2.7	1.2
Retail sales (y-on-y, % change)	-7.6	-2.1	1.5	-2.3	1.4
Industrial production (y-on-y, % change)	-17.6	10.5	5.3	2.5	4.4
Unemployment rate (%)	10.0	11.2	10.9	11.0	11.0
Gross fixed capital investments (y-on-y, % change)	-11.0	-9.7	-7.3	-5.9	1.9
Real net exports (EUR billion)	6.0	8.4	10.1	10.7	11.0
Fiscal balance (% of GDP)	-4.5	-4.3	4.8	-4.2	-3.2

*estimate **forecast Source: IHS Global Insight

Political situation: Government with a two-thirds majority

Head of state: President Pal Schmitt (since August 2010)
Head of government: Prime Minister Viktor Orban (since May 2010)
Form of government: Centre-right Fidesz party governs with an absolute majority in parliament

In the April 2010 parliamentary elections the centre-right Fidesz party gained a landslide victory over the ruling Socialists, achieving a two-thirds majority in parliament (262 of the 386 seats): the strongest mandate a party has yet gained in post-communist Hungary. This large majority enables the government to amend the constitution without the support of the opposition. However, Orban´s popularity has decreased sharply since the last general election.

Economic situation: A second IMF bailout package is needed

Only a weak recovery after the deep 2009 recession

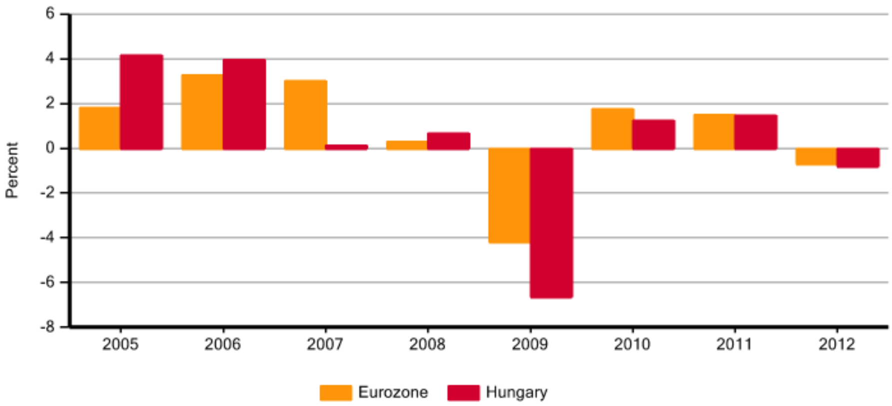
After years of private and public sector overspending, resulting in high GDP growth but also in high twin deficits, the economy fell into a deep recession in 2009. GDP contracted 6.3 %, as domestic demand-oriented sectors were hit by budgetary tightening while industrial exports suffered as a result of the economic meltdown in the Eurozone, as Hungary is heavily dependent on its exports to other EU countries.

In 2008/2009, the forint plunged in the face of increasingly adverse global market sentiment against the Hungarian currency. A massive multilateral bailout package by the IMF and the EU (worth US$ 25.8 billion) was introduced to shore up the forint and deeply eroded international reserves. IMF-monitored fiscal consolidation led to a reduction in the budget deficit - from its record 9.3 % of GDP in 2006 to 4.3 % of GDP in 2010 - as the government introduced further austerity measures, curbing public sector spending even more and raising taxes: especially VAT.

Growth has returned since 2010 but so far remains weak (1.2 % in 2010 and 1.5 % in 2011).

Real GDP growth

(Annual percentage change in real GDP; forecast for 2011 and 2012)

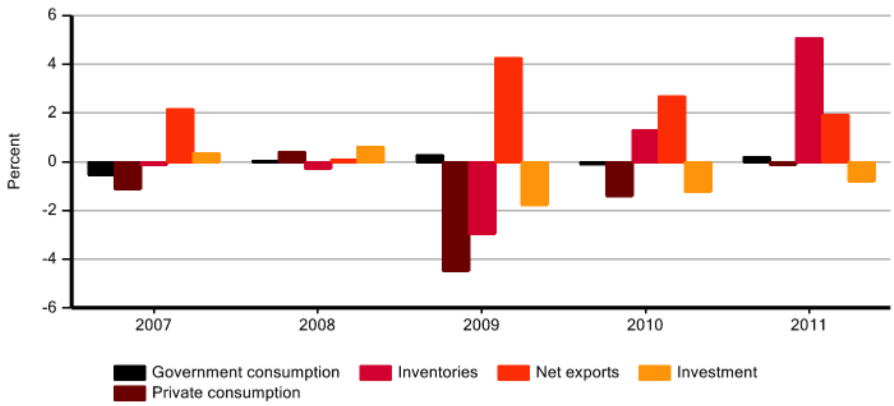


Source: IHS Global Insight.

The main contributions to growth were from inventories and industrial exports, while domestic demand remained subdued, as households and businesses alike continued to rein in spending. The reasons for this have been a shortage of new funding, high private sector debt obligations denominated in foreign currency (mainly in EUR or Swiss francs), budgetary tightening, lower real incomes and the high unemployment rate which, by December 2011, stood at 10.7 %.

Contribution to GDP Growth: Hungary

(Chain-weighted basis; forecast data edge 2010)



Source: IHS Global Insight

However, in 2012 a 0.8 % contraction is expected, as a result of the economic slowdown in the eurozone and on-going domestic financing problems.

Economic policy: populist and market-adverse measures have caused concern

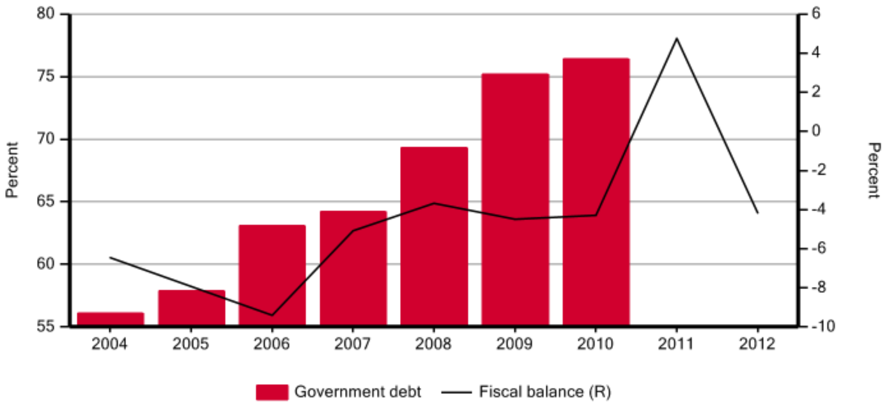
The new government, under Prime Minister Orban, has until recently resisted IMF demands to impose more long-lasting cuts in state spending, and has refused to negotiate a new stand-by agreement with the IMF (the stand-by loan agreement having expired in October 2010).

Instead, the Orban administration has tried to narrow the budget gap with temporary measures, moving away from a solid fiscal policy: for instance, a windfall tax on the financial sector was introduced in mid-2010, intended to improve the fiscal balance by bringing in an additional EUR 700 million within three years. Those mainly affected by this tax are foreign-owned financial institutions. In November 2010, the government also decided to transfer private pension funds worth US$ 14.6 billion to the public sector, thereby reversing one of the major privatisation measures of the late 1990s. The government planned to use the pension fund to pay current state pensions and to cut debt, as it sought to reduce the budget deficit below 3 % of GDP in 2011. In September 2011 the parliament passed a bill that forced banks to accept early repayment of foreign currency mortgages at exchange rates below the market rate.

The budget deficit is projected to have been 6 % of GDP in 2011 - excluding the one-off measures - and will not drop below 3 % in GDP in 2012 (see chart below) as the economy has begun to slow down. The IMF and EU have repeatedly criticised the one-off measures as artificial and short-lived, as the structural fiscal position remains unchanged and long-term risks increase.

Public debt and budget balance: Hungary

(Government debt and budget balance in percent of GDP)



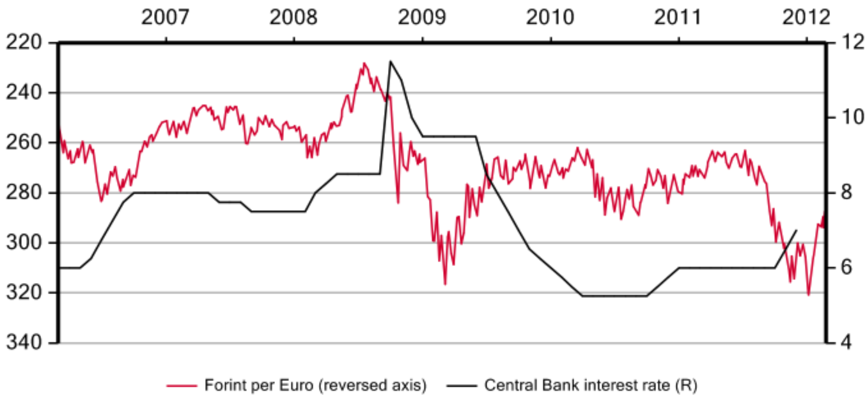
Source: IHS Global Insight.

Conflict with the EU and the IMF escalated in late 2011

With increasing worries over Hungary's fiscal policies, international investors began to pull their capital out of Hungary. As a result, the exchange rate of the forint against the euro came under pressure, losing more than 15 % in the second half of 2011 (see chart below).

Exchange rate Forint per Euro

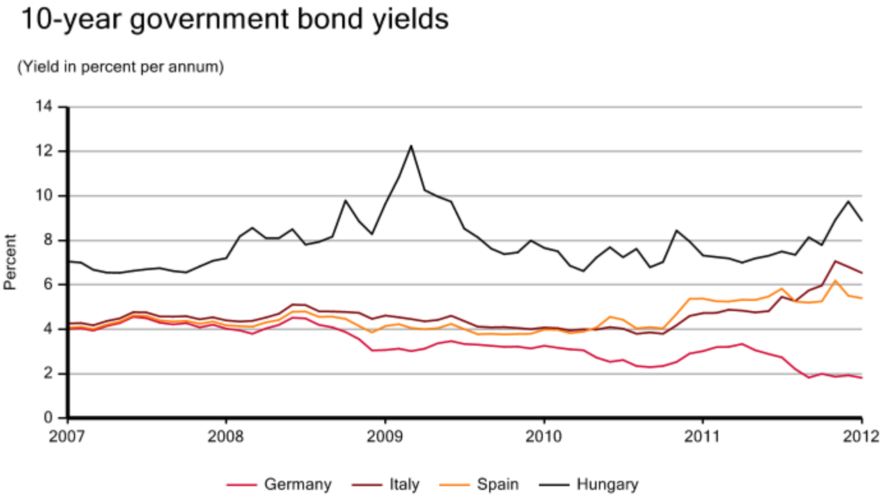
(Daily spot market rate, Central Bank discount rate end of period)



Source: IHS Global Insight

A lower forint exchange rate is undesirable, as a large part of the domestic loans are denominated in foreign currency, and a forint depreciation makes these loans more expensive in the local currency, thereby massively hurting domestic borrowers.

At the same time, the interest rate on 10-year government bonds increased markedly at the end of 2011, making it too expensive for Hungary to refinance its debt on the market (see chart below).



Source: IHS Global Insight.

Despite mounting economic troubles caused by adverse market sentiment, Hungary left negotiations over a second financial package from the EU and the IMF in December 2011, as it was unwilling to agree to the conditions attached to the loan. The EU Commission put increasingly pressure on the Hungarian government, even threatening legal actions. The reason for the Commission's concern was new legislation aimed at curtailing the independence of the Central Bank, the data ombudsman and the judiciary, which the Commission perceived as incompatible with EU laws, and which it therefore demanded that the Hungarian government reverse. In the recent past there have been repeated tensions between the government and the Central Bank over fiscal and monetary policy and, since the beginning of 2011, the government has taken steps to increase its influence on the Monetary Policy Council of the Central Bank, thus raising concerns about the independence of the bank and its monetary policy.

Adverse market sentiment has forced the government to compromise

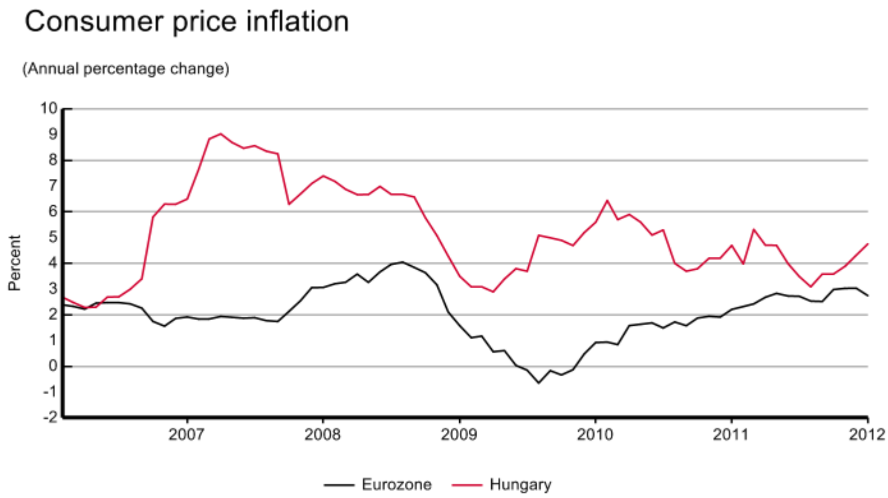
At the end of 2011/beginning of 2012, Hungary was faced with the fact that it needed external financing to fund its budget deficit, while funding from the market became too expensive. At the same time the forint depreciation threatened to massively hurt private sector borrowers.

This forced Budapest to resume negotiations with the EU and the IMF on financial aid. However, both the EU and IMF made clear that they will not agree to new financial aid unless Hungary compromises on its controversial new legislation. In mid January 2012, the EU Commission went as far as beginning legal proceedings against Hungary over the new laws. Under this pressure, Prime Minister Orban finally pledged to make the demanded legislative changes in order to satisfy EU demands. A new bailout agreement with the EU and the IMF is now expected to be reached by the end of Q2 of 2012, once the promised legislative changes have been made.

Inflation increases above the Eurozone average

Consumer prices have been increasing faster than the Eurozone average for many years (see chart below). Inflation rose again in the second half of 2011, partly as a result of a VAT increase and higher fuel prices due to the weaker forint exchange rate. Increases in the interest rate imposed by the Central Bank are expected to put downward pressure on inflation.

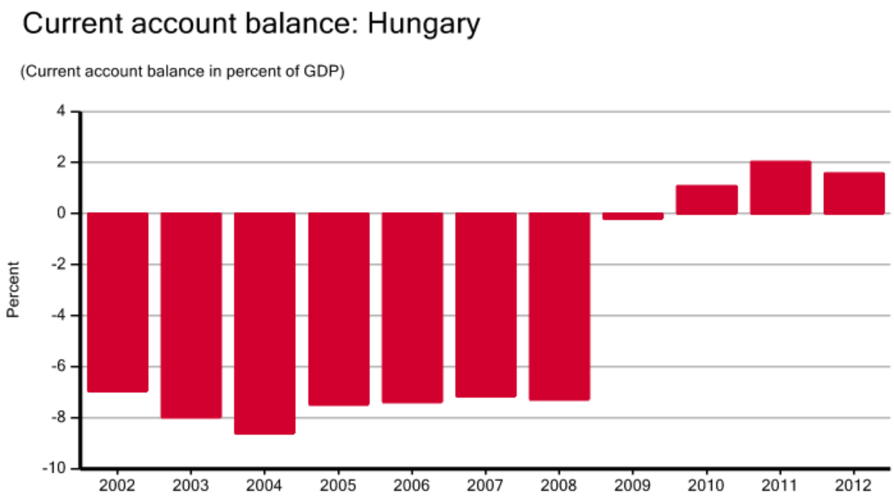
Efforts by the Central Bank to stem the foreign direct investment (FDI) outflow have resulted in an interest rate increase to 7 %: the highest rate in the EU. However, this may burden the real economy as borrowing becomes more expensive. According to the Central Bank, the interest rate should be kept unchanged until a bailout agreement with the IMF and the EU has been reached.



Source: IHS Global Insight.

Improvement to the current account

The current account balance improved significantly in 2009 due to a drop in imports and a rapid recovery of exports. The depreciation in the forint against the euro in 2009 and in the second half of 2011 improved Hungary's international competitiveness. The balance is likely to stay positive in 2012, but at a more moderate rate (see chart below).



Source: IHS Global Insight

Industry performance: construction remains under pressure

According to the Hungarian Statistics Office, construction output decreased by 7.8 % year-on-year in 2011, continuing its negative trend of the past six years. The volume of new orders decreased by 16.7 % and building construction output declined by 11.3 %, while the civil engineering sector registered a lower decrease: of 3.8 %. The main problems are:

- a continuous decrease in demand and performance, with public orders recording the steepest decrease;
- capacity surplus and sharp competition;
- the highest level yet of liquidation procedures; and
- several Hungarian commercial banks deciding to pull out or reduce their financing of the sector, especially through project credit lines.

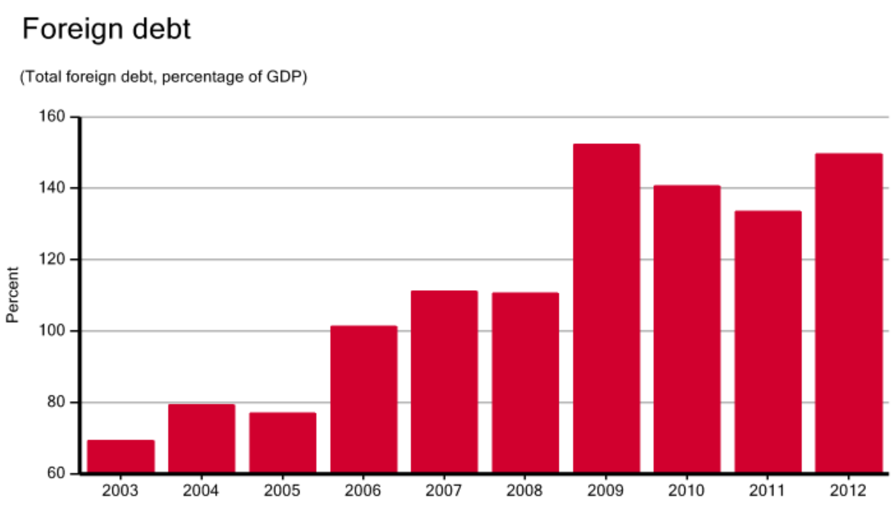
The downturn in the construction sector has affected related industries, such as the metals sector.

Many information and communication technology (ICT) businesses that import parts and products have been severely affected by the sharp currency depreciation in the second half of 2011, as those companies mainly buy in EUR and sell in forint. Credit lines too are usually denominated in foreign currency.

Payment delays are still prevalent in all sectors, including public buyers such as municipalities and ministries. Construction and transport in particular are notorious for their very late payment record. The number of business insolvencies increased by 16.5 % - to more than 20,000 cases - in 2011, with construction the main victim. In 2012, we expect a further increasing trend, with construction, food, consumer durables, IT, and retail sales suffering most.

Prospects: Looming uncertainty

In 2012, growth is forecast to decrease by 0.8 % due to subdued domestic demand and a poorer export performance. In 2013, a slight recovery is expected. Foreign debt has increased over the past few years and will rise to 150 % of GDP in 2012 (see chart below).



Sources: IHS Global Insight; National Bank of Hungary.

The Central Bank has recently announced liquidity measures aimed at reducing the ongoing credit squeeze. Since 2009, lending to companies has contracted and households have also faced stricter loan conditions, as many of the foreign-owned banks have reduced their exposures. The Central Bank's two-year lending facility is intended to push banks into providing more credit again. However, due to the deteriorating economic and business environment, it is far from certain to what extent banks are willing to do so.

It remains to be seen when the new IMF/EU agreement will be reached and what it will contain in terms of financial aid and conditions. End of February 2012 the EU Commission proposed to suspend EUR 495 million of Cohesion Fund commitments (representing 0.5 % of GDP) for 2013 as it concluded that Hungary has not taken effective action to bring its deficit to below the target of 3 % of GDP by 2011 in a sustainable and credible manner and that in 2012 and 2013 the budget will swing into deficit again.

In any case, Hungary's economic problems need a structural approach and, even with the recent signs of compromise on the government's part, doubts will remain. While Prime Minister Orban's parliamentary majority would enable him to take the drastic measures needed to tackle Hungary's structural economic problems, his economic policy has so far failed to satisfy the financial markets, rating agencies or the IMF. His populist economic measures have damaged Hungary's reputation on the international markets, weakening its reliability as a debtor and its long-term budgetary sturdiness.