Euler Hermes
Economic
Research

Country Report

Hungary

Growing again, but vulnerabilities remain

General Information

GDP	USD125.5 billion (World ranking 58, World Bank 2012)
Population	9.94 million (World ranking 87, World Bank 2012)
Form of state	Parliamentary Republic
Head of government	Viktor ORBAN (Fidesz Party)
Next elections	2017, presidential

Strengths

- Generally stable parliamentary democracy
- Strong specialization in automobile industry
- Current account surpluses since 2010
- Low inflation

Weaknesses

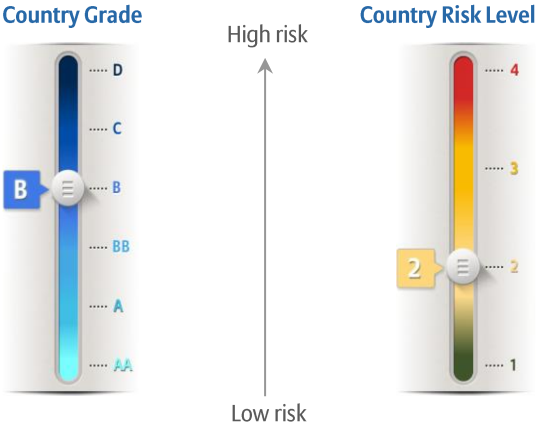
- Deteriorating investment climate, as a consequence of unconventional economic policy measures since 2010
- Difficult relations with the IMF and the EU
- High public debt and large total external debt burden
- Exchange rate volatility (reflecting high vulnerability to domestic and external shocks)
- Banking sector remains vulnerable (significant corporate and consumer debt in FX poses credit risks)

Country Rating

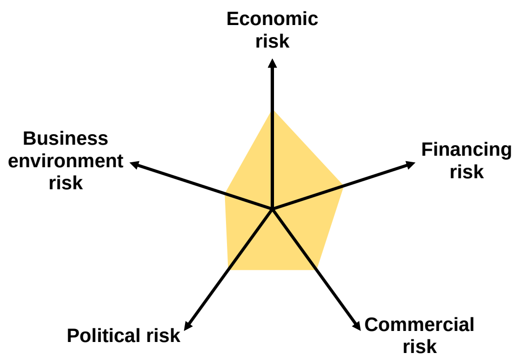
B2

Country Grade

Country Risk Level

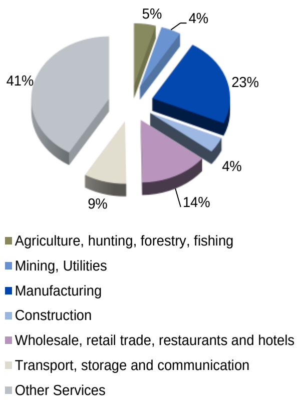


Risk Dimensions



Economic Structure

GDP breakdown (% of total, 2011)



Sources: UnctadStat, IHS Global Insight, Euler Hermes

Trade structure (% of total, 2011)

By destination/origin

Exports		Rank		Imports
Germany	25%	1	23%	Germany
Romania	6%	2	7%	China
Austria	6%	3	7%	Russian Federation
Italy	5%	4	6%	Austria
Slovakia	5%	5	6%	Slovakia

By product

Exports		Rank		Imports
Telecommunication and sound recording apparatus	18%	1	14%	Electrical machinery, apparatus and appliances
Electrical machinery, apparatus and appliances	11%	2	11%	Telecommunication and sound recording apparatus
Road vehicles	9%	3	8%	Petroleum, petroleum products and related materials
Power generating machinery and equipment	9%	4	6%	Road vehicles

Economic Forecast

	2010	2011	2012	2013	2014f	2015f
GDP growth (% change)	1.0	1.6	-1.7	1.1	2.6	2.5
Inflation (%, end-year)	4.7	4.1	5.0	0.4	2.5	3.0
Fiscal balance (% of GDP)	-4.4	4.2	-2.0	-2.2	-2.8	-3.0
Public debt (% of GDP)	82.1	82.1	79.8	79.2	79.8	80.0
Current account (% of GDP)	0.2	0.5	1.0	3.0	2.2	1.8
External debt (% of GDP)	144.9	124.2	132.7	119.0	118.0	120.0

Sources: IHS Global Insight, national sources, Euler Hermes

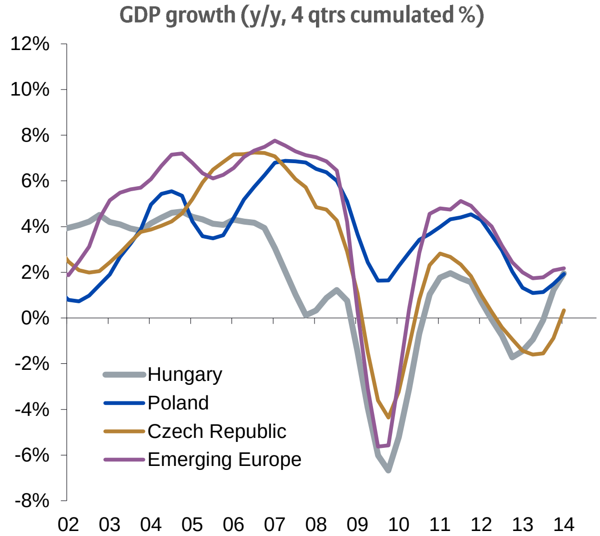
Economic Growth

Gradual recovery from recession continues

Since Q2 2013, Hungary has gradually recovered from the recession in 2012, thanks to fiscal stimulus and a rebound in investment. Real GDP grew by +1.1% in full-year 2013. Private consumption remained weak, declining by -0.1%, while government consumption increased by +4.3% and fixed investment by +5.9%. Exports and imports expanded at the same rate, by +5.3% each. Since the volume of exports was larger than imports, net exports contributed +0.4pps to full-year 2013 growth.

In Q1 2014, the recovery gained further momentum thanks to strengthening domestic demand. Real GDP grew by +3.5% y/y and +1.1% in q/q seasonally adjusted terms. Private consumption growth improved to +1.6% y/y, government consumption expanded by +3.5% and fixed investment surged by +13.3%. Exports increased by +7.5% y/y and imports by +7.6%, so that net exports made again a small positive contribution to Q1 growth. EH expects the recovery to continue in the next few quarters, though the growth rates should moderate somewhat due to base effects, resulting in full year growth of about +2.6% in 2014 and +2.5% in 2015.

GDP growth (y/y, 4 qtrs cumulated %)



Sources: IHS Global Insight, national sources, Euler Hermes

Monetary policy lacks credibility

Monetary policy of the Hungarian National Bank (MNB) is officially based on consumer price inflation targeting. Since 2007, a medium-term inflation target of 3% has been in place, with a ± 1pp ex post deviation defined as acceptable. It has to be noted that the target has been missed recurrently, for several reasons – (i) earlier on due to excessive credit growth; (ii) ongoing high exchange rate volatility, often feeding through to domestic prices; (iii) at times financial market turbulences; (iv) pressures to support the faltering economy – which have frequently distracted monetary policy from its key objective. Generally, EH expects the need for ad hoc monetary policy measures to recur every now and then.

Over the past two years however, the MNB has pursued a steady path of monetary easing in order to support economic growth. Since August 2012 – although inflation was still elevated at that time – it has reduced its key policy interest rate in 22 monthly steps by a cumulative 460bps from 7% to 2.4% in May 2014. As GDP growth has indeed gained momentum, the monetary easing cycle is likely to end soon.

Lower interest rates have also helped private sector credit to improve from a record decline of -15.4% y/y in October 2012, though it has remained in contraction territory to date (-3.2% y/y in February 2014).

Inflation is currently low, set to rise modestly

Despite the recent monetary easing cycle, headline inflation has fallen rapidly from 5% at end-2012 to 0.4% at end-2013 and an average 0% y/y in the first four months of 2014, partly on the back of a one off (10%) adjustment in regulated energy prices for households in 2013. As this effect is waning, EH projects inflation to rise again modestly to an average 1.2% in 2014 and 2.8% in 2015.

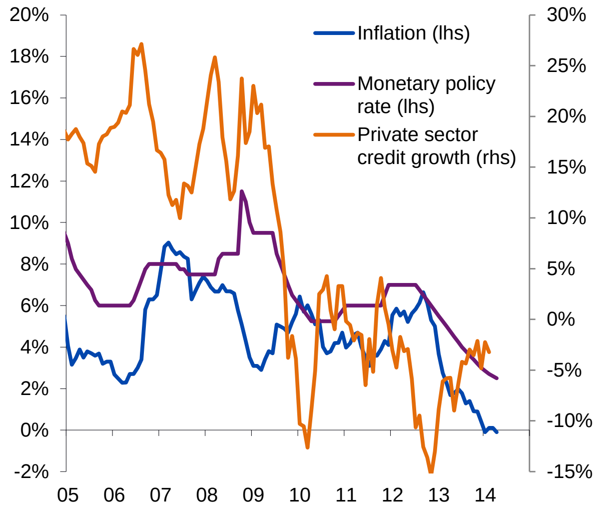
Exchange rate remains vulnerable

Over the past decade, the HUF/EUR exchange rate has shown excessive volatility, reflecting the economy's high vulnerability to domestic and external shocks, which was a result from a long period of large macroeconomic imbalances and low growth. Meanwhile the imbalances have improved, but the adjustment process is not complete yet, and especially large foreign exchange-denominated public and private debt continues to cause a high vulnerability to a global asset re-pricing. More recently, the HUF/EUR exchange rate weakened by 1.9% in the course of 2013 and fell further by about 3% in 2014 year-to-date.

The fiscal position remains difficult

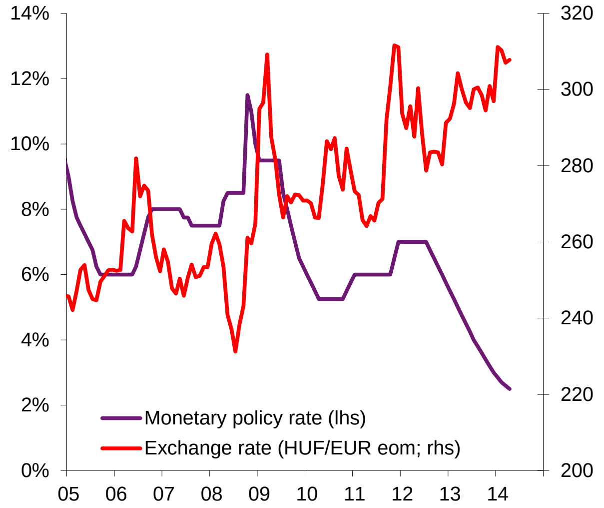
After nine years under the excessive deficit procedure and to avoid the suspension of cohesion funds, the government has embarked on a sizable consolidation since 2010. The adjustment between 2011 and 2013 reflects higher revenue collections, mainly higher taxes (such as the VAT rate increase to 27%, the highest rate in the EU). Spending restraint and the implementation of structural reforms also resulted in savings, while public investment from national resources considerably decreased, notably in the local government sector. Combined with a number of one-off measures, a fiscal surplus of +4.3% of GDP was reached in 2011. However, the fiscal balance shifted back to deficits of 2% of GDP in 2012 and 2.2% in 2013. EH expects the shortfall to deteriorate further to around 3% in 2014-2015. This will be mainly due to the phasing-out of temporary revenues, the revenue-reducing stimulus measures, i.e. introduction of a fully flat personal income tax system and targeted cuts of social security contributions. Public debt will remain high at around 80% of GDP.

Monetary policy interest rate (%), inflation rate (y/y; %) and private sector credit growth (y/y; %)



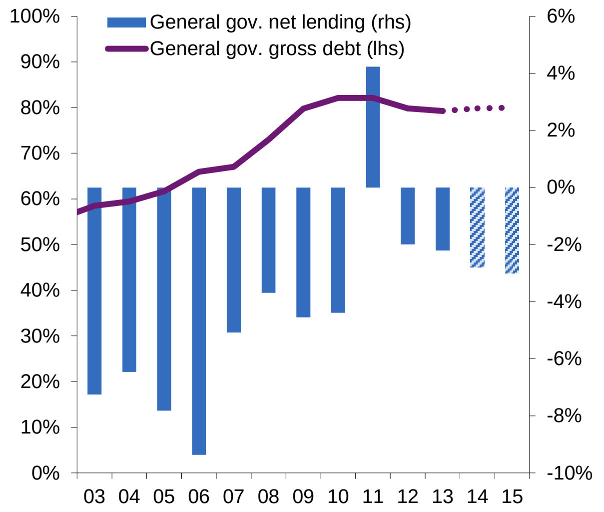
Sources: IHS Global Insight, national sources, IMF, Euler Hermes

Exchange rate (HUF/EUR) and policy interest rate (%)



Sources: National sources, Euler Hermes

Public finances (% of GDP)



Sources: IMF, national sources, Euler Hermes

External Sector

Current account remains in surplus

After heavy external imbalances during the 2000's, the current account balance has been positive since 2010, as export growth outpaced import growth, in a context of internal demand and import compression. The current account surplus reached 3% of GDP in 2013 but is expected to narrow slightly to around 2% of GDP in 2014-2015 as imports will gain traction amid the gradual economic recovery.

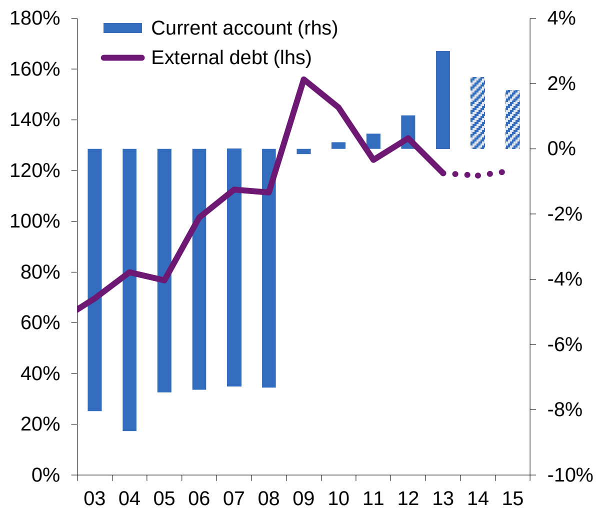
External debt burden is heavy

Hungary's total external debt has fallen from 133% of GDP in 2012 to around 120% in 2013 but remains among the highest in the region. The estimated annual external debt service in 2014 will amount to almost 30% of exports earnings. The FX exposure of the economy as a whole has declined to some extent, reflecting the ongoing balance sheet adjustment in the economy as well as currency swaps in 2012, but corporate and consumer indebtedness in foreign currencies is still significant and continues to pose credit risks.

International reserves need monitoring

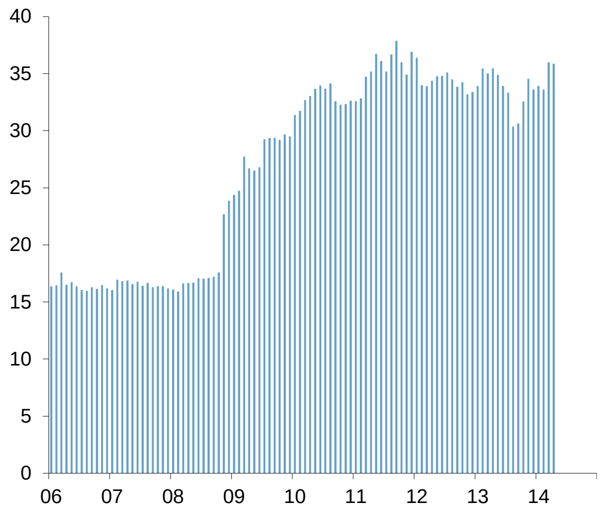
After an upwards trend to a peak of EUR38bn in September 2011, FX reserves declined in Q4 2011 and H1 2012, owing to sharply deteriorated investor sentiment and several sovereign debt downgrades. Since mid-2012, reserves have broadly moved sidewards and stood at EUR36bn in April 2014. The current level of reserves is comfortable with regard to import cover (almost five months). In other terms, however, they cover just about 90% of the estimated external debt payments falling due in 2014, which is below an adequate level of at least 100%.

Current account and external debt (% of GDP)



Sources: IHS Global Insight, national sources, Euler Hermes

Foreign exchange reserves (EUR billion)



Sources: National sources, Euler Hermes

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