Euler Hermes Economic Research

Country Report

Hungary

The recovery has gained momentum

General Information

GDP	USD133.42 bn (World ranking 59, World Bank 2013)
Population	10 mn (World ranking 88, World Bank 2013)
Form of state	Parliamentary Republic
Head of government	Viktor ORBAN (Fidesz Party)
Next elections	2017, presidential

Strengths

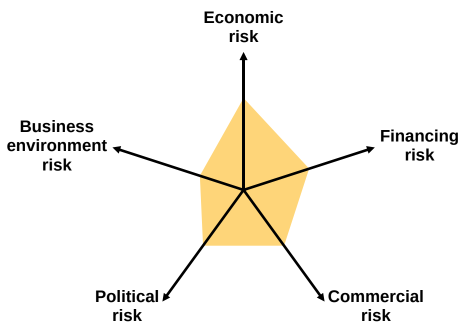
- Generally stable parliamentary democracy
- Strong specialization in automobile industry
- Current account surpluses since 2010
- Low inflation

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

Country Rating

B2



Source: Euler Hermes

Trade Structure

By destination/origin (% of total)

Exports		Rank		Imports
Germany	24%	1	23%	Germany
Romania	6%	2	9%	Russia
Slovakia	5%	3	7%	China
Austria	4%	4	6%	Slovakia
Italy	4%	5	5%	Poland

By product (% of total)

Exports		Rank		Imports
Engines	10%	1	7%	Telecommunications Equipment
Electrical Apparatus	9%	2	7%	Electrical Apparatus
Telecommunications Equipment	7%	3	6%	Engines
Cars And Cycles	6%	4	5%	Miscellaneous Hardware
Pharmaceuticals	5%	5	4%	Crude Oil

Source: Chelem (2013)

Economic Overview

Return to robust growth

Real GDP growth accelerated to +3.6% in 2014 from +1.5% in 2013. Fixed investment was the key growth driver as one-off factors (subsidized loans to SMEs and accelerated absorption of EU funds) led to an increase of +12% in 2014. Private consumption growth improved slightly but remained modest at +1.6% while government consumption expanded by +3.4%. Import growth (+10%) outpaced exports (+8.7%), so that net exports had a small negative effect on 2014 growth.

In Q1 2015, real GDP grew by +0.8% q/q, seasonally adjusted, and +3.5% y/y. Private consumption growth picked up to +2.6% y/y, supported by lower energy prices and declining unemployment. Government consumption declined by -5.4% y/y, and fixed investment went down by -6.7% y/y, though base effects played a strong role as it grew by +2.7% q/q. Exports (+10.3% y/y) expanded faster than imports (+7.8% y/y) so that net exports became the key growth driver in Q1. Euler Hermes expects the recovery to continue in the coming years but GDP growth should become more balanced and moderate to around +3% in 2015 and +2.5% in 2016 as the investment boom from 2014 will abate.

Monetary easing cycle likely to end in 2015 as deflation pressures wane

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. Over the past three years, the MNB has pursued a steady path of monetary easing, initially in order to support economic growth and later to fight deflation pressures. Since August 2012 − although inflation was still elevated at that time − it has reduced its key policy interest rate in 27 steps from 7% to 1.65% in May 2015, a total of 535bps. As the economic recovery appears to be sustainable now and inflation has just moved back to positive territory (+0.5% y/y in May 2015) after eight consecutive months of deflation and should continue to pick up gradually, Euler Hermes expects one or two more interest rate cuts before the monetary easing cycle ends.

Exchange rate to remain somewhat volatile

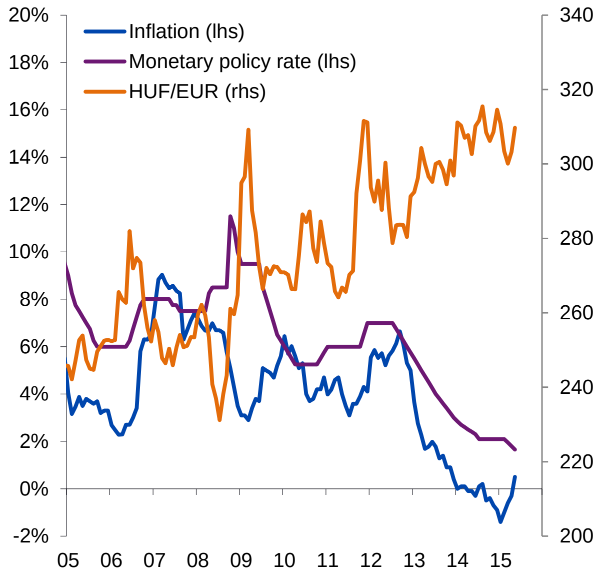
Over the past decade, the HUF/EUR exchange rate has shown significant volatility, reflecting the economy's high vulnerability to domestic and external shocks, coming from a long period of large macroeconomic imbalances and low growth. Recently, imbalances have improved and vulnerability has declined as the government's decision in late 2014 to convert foreign exchange-denominated mortgage loans into HUF (at the then market rate) has drastically reduced the overall FX exposure from 67% of GDP in April 2014 to just 1.4% a year later. As this scheme was decided shortly before the removal of the CHF:EUR cap by the Swiss National Bank which triggered a sharp CHF appreciation, Hungarian consumers benefited substantially from the conversion of their CHF debt (accounting for the majority of their debt) before the CHF rise. Fortunately, Hungarian banks had adjusted their balance sheets already before with regard to the conversion of households' EUR and CHF mortgages so that they were not hurt particularly by the CHF appreciation from this angle. Going forward, Euler Hermes expects the HUF/EUR exchange rate to remain somewhat volatile but the considerable

Key economic forecasts

	2013	2014	2015f	2016f
GDP growth (% change)	1.5	3.6	3.0	2.5
Inflation (%, end-year)	0.4	-0.9	1.5	2.0
Fiscal balance (% of GDP)	-2.5	-2.6	-2.6	-2.5
Public debt (% of GDP)	77.3	76.9	76.0	75.0
Current account (% of GDP)	4.0	4.2	3.5	3.5
External debt (% of GDP)	118.9	117.0	116.0	115.0

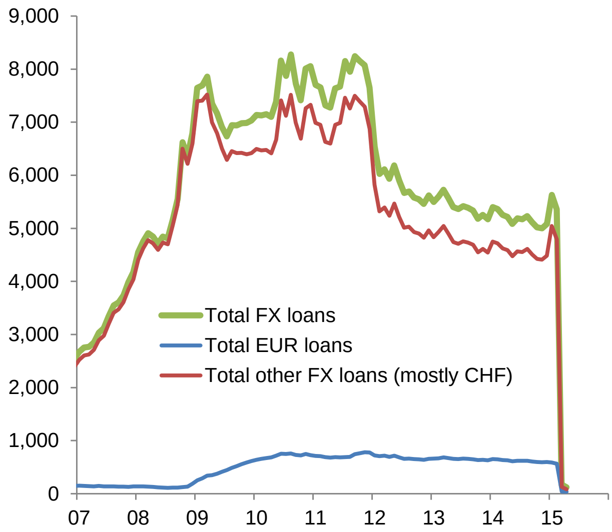
Sources: National sources, IHS, Euler Hermes

Monetary policy interest rate, inflation and exchange rate



Sources: IHS, national sources, Euler Hermes

Foreign exchange-denominated loans of private sector (corporates, individual and mortgages; HUF bn)



Sources: National Sources, Euler Hermes

downward momentum from 2010 to 2014 should become softer in the medium term.

Fiscal balance has improved

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. Since, the fiscal deficit has improved, down to -2.6% of GDP in 2014 from -5.2% in 2011. However, Euler Hermes expects the annual shortfall to remain at around -2.6% in 2015-2016. Public debt is gradually improving but will still remain above 70% of GDP for some time still.

Current account remains in surplus

Following 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 4.2% of GDP in 2014 but is expected to narrow slightly to around 3.5% of GDP in 2015-2016.

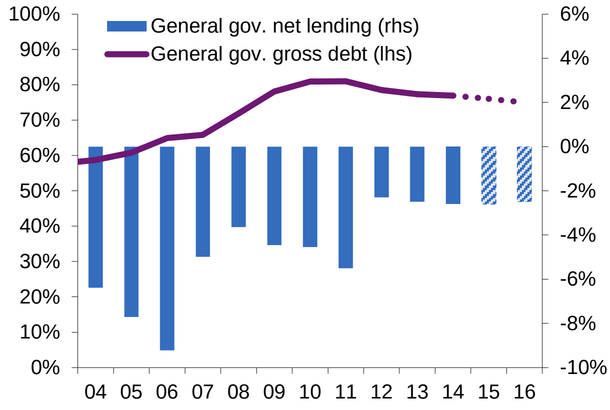
External debt burden declines gradually but remains high

Hungary's total external debt has fallen from 130% of GDP in 2012 to around 117% in 2014 but remains among the highest in the region. The estimated annual external debt service in 2015 will amount to about 27% of exports earnings.

International reserves need monitoring

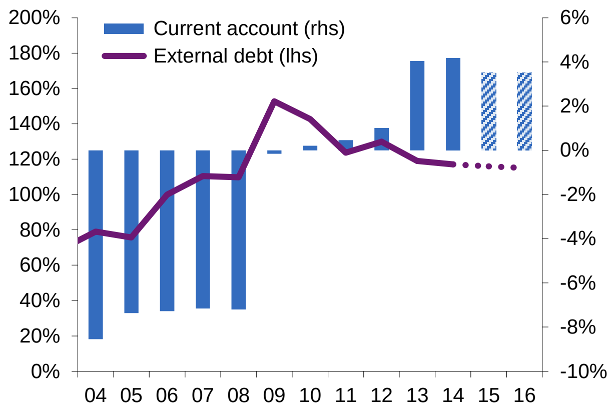
After an upwards trend to a peak of EUR38 bn in September 2011, FX reserves declined in Q4 2011 and H1 2012, owing to a sharp drop in investor sentiment and several sovereign debt downgrades. Since mid-2012, reserves have broadly moved sideways and stood at EUR37 bn in May 2015. The current level of reserves is comfortable with regard to import cover (five months). However, they cover just about 90% of the estimated external debt payments falling due in the next 12 months, which is below an adequate level of at least 100%.

Public finances (% of GDP)



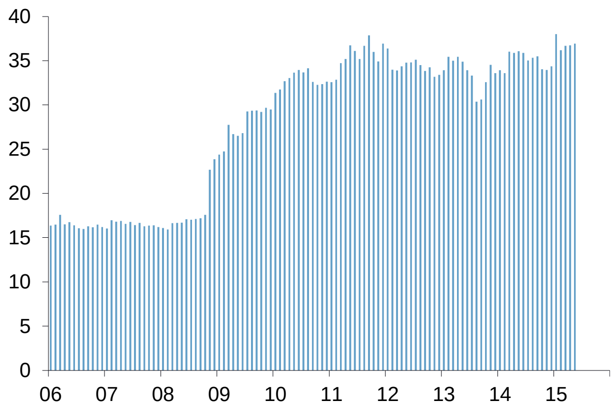
Sources: IMF, national sources, Euler Hermes

Current account and external debt (% of GDP)



Sources: IHS, national sources, Euler Hermes

Foreign exchange reserves (EUR bn)



Sources: National Sources, Euler Hermes

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