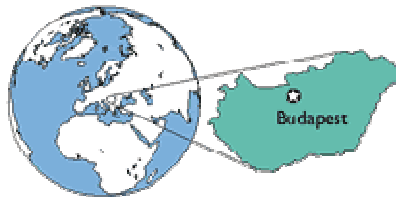


COUNTRY REVIEW

Hungary



21 August 2009

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EULER HERMES COUNTRY RISK GRADE: C

Country Risk Grades are on a scale of AA, A, BB, B, C, D
where AA is the lowest and D the highest risk.

Strengths

- Broadly stable political system
- EU membership
- Fairly strong business environment

Weaknesses

- High exchange rate volatility
- Severe economic slowdown since mid-2006; deep recession in 2009
- Weak fiscal position
- High and rising external debt burden (forecast at 145% of GDP at end-2009)
- High external financing requirements in relation to foreign exchange reserves
- Hungarian companies and consumers are highly indebted in foreign currencies and thus exposed to exchange rate risk which raises overall credit risks
- Amid the intensification of the global financial crisis since September 2008, the banking system was faced with foreign exchange illiquidity which resulted in a domestic banking/financial crisis

KEY RISKS

- **Exchange rate risk (with respect to external debt repayments due as well as foreign trade credits)**
- **External liquidity risk (difficulties to refinance maturing private-sector external debt, potentially resulting in insolvencies or debt restructurings of companies and banks)**
- **Recession-driven sharp rise in bankruptcies**
- **Banking sector illiquidity**

Country Risk Assessment

Ratings	Hungary		Median Grade C	Peers		
	Latest	Previous		Bulgaria	Romania	Russia
Systemic Political Risk:	P2+	P1	P3+	P2+	P2-	P3+
Systemic Economic Risk:	E5	E5	E5	E5	E5	E5
ME rating:	ME5	ME5	ME5	ME5	ME5	ME5
<i>Structure</i>	1.6	1.6	5.9	3.3	3.3	4.0
<i>Policy</i>	5.8	4.8	5.2	5.2	5.6	6.0
<i>Solvency</i>	4.6	4.6	2.8	3.8	4.8	2.6
<i>External Liquidity</i>	6.0	6.0	4.3	6.0	6.0	4.8
SBE rating:	SBE2	SBE2	SBE4	SBE3	SBE3	SBE5
COUNTRY GRADE:	C	C		C	C	C

Nomenclature:

Political Risk Ratings are on a scale of P1 (lowest risk), P2+, P2-, P3+, P3-, P4 (highest risk).

Economic Risk Ratings are on a scale of E1 (lowest risk), E2, E3, E4, E5, E6 (highest risk).

ME (Macro-Economic) ratings are on a scale of ME1 (lowest risk), ME2, ME3, ME4, ME5, ME6 (highest risk).

The constituent parts of the ME rating are on a scale of 1.0 (best) to 6.0 (worst).

SBE (Structural Business Environment) ratings are on a scale of SBE1 (best), SBE2, SBE3, SBE4, SBE5, SBE6 (worst).

Country Grades are on a scale of AA, A, BB, B, C, D where AA is the lowest and D the highest country risk.

Source: Euler Hermes Country Risk Unit

ECONOMIC STRUCTURE

Country Profile

Capital city:	Budapest
Population:	10.012 mn (2008)
GDP:	USD 153796 mn (2008)
Currency:	Hungarian forint (HUF)
Form of state:	Parliamentary democracy
Head of government:	Prime Minister Gordon BAJNAL (since April 2009)
Next elections:	Legislative and Presidential: 2010

Major Industries (% of GDP at market prices, 2006)		Global Assumptions		2008	2009
Services	69.9%	Real GDP grth (% yr/yr) *	1.0		-0.6
Real estate, renting & business activities	19.5%	Inflation (% , av) *	3.4		1.5
Industry	26.4%	Dated Brent (USD/b)	98		55
Construction	4.0%	* Major economies			
Agriculture & forestry	3.7%				

Main Exports (% of total, 2007)		Main Imports (% of total, 2007)	
Machinery and transport equipment	62.3%	Machinery and transport equipment	52.2%
Manufactured goods	26.7%	Manufactured goods	32.3%
Food, beverages, tobacco	6.2%	Fuels, electric energy	9.6%
Fuels, electric energy	2.9%	Food, beverages, tobacco	4.2%
Crude materials	1.9%	Crude materials	1.7%
Lead Export Markets (% of total exports, 2007)		Lead Import Markets (% of total imports, 2007)	
EU	78.8%	EU	69.6%
Germany	28.3%	Germany	26.8%
Italy	5.5%	Austria	6.0%
France	4.7%	Russia	6.9%

Basic indicators

Selected economic indicators	2006	2007	2008	2009f	2010f
Nominal GDP (USD mn)	113,101	138,353	153,797	118,807	115,961
Population (mn)	10.05	10.03	10.01	9.99	9.97
GDP per capita (USD)	11,249	13,791	15,361	11,890	11,628
Real GDP growth (% yr/yr)	4.0	1.1	0.6	-6.2	-0.5
Inflation (% , eop)	6.5	7.4	3.5	5.0	2.9
Fiscal balance (ESA 95, % of GDP)	-9.2	-4.9	-3.4	-3.9	-4.5
Current account balance (% of GDP)	-7.6	-6.4	-8.4	-3.6	-3.5
External debt/GDP (%)	94.8	104.5	109.4	145.4	157.8
External debt/Exports of goods & services (%)	123.5	130.4	132.7	174.4	179.4
Debt-service ratio (%)	13.2	13.1	14.2	20.9	22.8
Foreign exchange reserves (EUR mn)	15,841	15,804	23,560	25,000	22,000
Import cover (months)	2.7	2.4	3.3	4.2	3.5
Exchange rate assumption, HUF:USD (av)	210.4	183.6	172.1	218.0	230.8
Exchange rate assumption, HUF:EUR (av)	264.3	251.4	251.5	290.0	300.0
f: CRU central forecast					

Sources: National sources, ECB, Eurostat, IMF, World Bank, Euler Hermes Country Risk Unit

Political Stability

Hungary is a well-established democracy and a member of NATO, OECD and the EU. A centre-left coalition government of the Hungarian Socialist Party (MSZP) and the Alliance of Free Democrats (now renamed as SZDSZ-Hungarian Liberal Party) took office in May 2002 and was comfortably re-elected in April 2006. The 2006 win was largely a personal victory for Ferenc Gyurcsany, who took over as PM in September 2004 and revived the government's popularity through his charisma, populist policies and some pre-election benefits. However, that popularity weakened significantly after the re-election, owing to the introduction of intense fiscal austerity measures and the leaking in September 2006 of a tape in which the PM admitted that the government had lied to the electorate about public finances in order to win re-election. In a binding referendum in March 2008, 80% of voters rejected the introduction of modest fees for health care and higher education. The emphatic referendum result was a major setback for PM Gyurcsany who, in turn, decided to dismiss the health minister—a member of the SZDSZ—responsible for the health care programme. That decision led to the collapse of the ruling coalition in April 2008 and reduced the government to minority status with 190 out of 386 members in parliament. Nonetheless, the SZDSZ has served as a loyal opposition and continued to back the government on key bills.

The intensification of the global financial crisis forced Hungary into an IMF-led multinational economic stabilisation programme in October 2008, which required even stricter fiscal austerity measures. This led to mounting public opposition, and in March 2009 PM Gyurcsany offered his resignation in order to maintain the MSZP's hold on power. In April 2009, Gordon Bajnai replaced Gyurcsany in a constructive vote of no confidence and formed a largely technocrat government of crisis management, which has continued the socially painful, but necessary, fiscal consolidation policy, supported by the SZDSZ. The government is likely to remain in power until the next parliamentary election, scheduled for April 2010. According to current polls, the opposition Fidesz party is expected to win the 2010 election, probably with a sufficiently large majority to govern alone. This creates some uncertainty regarding policy as leading members of the populist Fidesz, including party head Victor Orban, have suggested repealing reform measures.

Overall, the political environment should remain broadly stable, while the familiar weaknesses in policymaking will continue. Occasional political upheavals have so far had limited impact on the conduct of businesses, though they may disturb investor confidence. International relations are generally good and Hungary has been able to secure timely foreign and multilateral help if needed, as the domestic financial crisis in Q4 2008 has revealed.

Economic Stability

Considerable macroeconomic imbalances combined with lax, inappropriate economic policies have posed considerable country risk in Hungary for a long time. Although the government made significant progress in addressing the economic imbalances in recent years, the still large fiscal and current account deficits left the economy vulnerable to a sudden loss of investor confidence. Since continued large current account deficits have been largely financed by new external borrowing, the country's external debt levels surged and annual external financing requirements were substantial in relation to modest foreign exchange (FX) reserves. Moreover, Hungarian companies and consumers were highly indebted in foreign currencies (mainly euro and Swiss franc) and thus exposed to exchange rate risk which raises overall credit risks.

Against this backdrop, the intensification of the global financial crisis in September 2008 hit Hungary particularly hard. The tightening of global credit markets curtailed the country's access to international financing dramatically. As a result, the country's stock and government bond markets as well as the local currency, the forint (HUF), came under severe strain as concerns over a foreign exchange shortage heightened considerably. This development further increased exchange rate, credit, banking system and transfer risk as Hungary's already modest foreign exchange reserves were on a declining trend.

By 21 October 2008, the HUF had depreciated 21% against the euro from its recent high in mid-July and FX reserves had fallen by almost 20% from the recent high of USD27bn in June 2008, largely owing to intensified capital flight and, possibly, heavy speculative pressure. On 22 October, the Hungarian National Bank (MNB, the central bank) raised its base interest rate by 300 bps to 11.5% in an emergency move. Nonetheless, the exchange rate remained highly volatile and continued to slide in the following days. In this situation, the IMF, EU and World Bank moved quickly and decisively, granting an exceptionally large rescue package of about EUR20bn by the end of October.

The IMF has completed two reviews under the Stand-By Arrangement and a large part of the funding package has already been disbursed. While the assistance plan initially succeeded in stabilising Hungary's markets, exchange rate weakness and volatility returned in the first quarter of 2009 in the wake of the then further darkening global outlook, a reminder that the economy remains one of the most vulnerable to external shocks. The government must continue to meet strict IMF conditionality, in particular socially painful fiscal austerity measures, in order to restore and maintain investor confidence.

The economic situation and outlook for Hungary is as follows:

- Several interest rate hikes and the implementation of fiscal austerity measures in 2006 had already sharply reduced real GDP growth to just 1.1% in 2007. Growth fell further to 0.6% in 2008. The tightening of monetary and fiscal policy combined with sharply reduced external demand caused yr/yr GDP declines of 2.5% in Q4 2008, 6.7% in Q1 2009 and 7.6% in Q2. We expect a deep prolonged recession, with output contracting by more than 6% in 2009 and about 0.5% in 2010.
- Inflation has generally been on a gradual downward trend since the beginning of 2008, reaching 3.5% at end-year and 2.9% yr/yr in March 2009. Rising food prices and increases in VAT and excise taxes pushed inflation back to 5.1% yr/yr in July, a rate that we expect to be broadly retained through year-end, before prices moderate again in 2010.
- Exchange rate weakness and volatility will remain a serious cause of concern. After recovering from a low of 284 HUF/EUR on 23 October 2008 to 260 HUF/EUR at end-November, the currency weakened again and reached a new low of 316 HUF/EUR on 6 March 2009. Since then it has recovered and stood at about 274 HUF/EUR in mid-August 2009. Still weak macroeconomic fundamentals, doubts over successful fiscal consolidation and protracted uncertainty on global financial markets potentially will continue to put occasional downward pressure on the HUF. Any domestic or global bad news could lead to another relatively sharp drop, such that continued close monitoring is required.
- In order to support the faltering economy, the MNB has begun to ease monetary policy since October 2008, but with a close eye on exchange rate movements. Up to January 2009, it lowered its base interest rate by a total of 200 bps, as inflation fell and the HUF recovered. Owing to considerable currency depreciation in February-March, the MNB kept interest rates on hold until 27 July 2009 when it cut the base rate by another 100 bps. The MNB will continue to prioritise maintaining financial stability, which translates into stabilising the HUF.
- The fiscal deficit was reduced from 9.2% of GDP in 2006 to 4.9% in 2007 and 3.4% in 2008, mainly the result of the fiscal austerity measures outlined above and stronger than expected revenue collection. Despite further fiscal tightening as required by the IMF programme, we expect the deficit to rise to about 3.9% of GDP in 2009 (target agreed with the IMF) and 4.5% in 2010 as the shrinking economy will sharply reduce government revenues. Public debt is also rising rapidly. Relative to GDP, it was 73% in 2008 and is set to increase to about 80% in 2010.
- The current account deficit widened from 6.4% of GDP in 2007 to 8.4% in 2008, but is projected to narrow to an average 3.5% in 2009-2010, as imports are expected to contract by more than exports, while the faltering economy will decrease the income deficit as the repatriation of company profits and dividends (the counterpart of earlier FDI) will decline.
- The external debt burden is high and will continue to rise, as a result of the multinational funding package. Gross external debt stood at 109% in relation to GDP and 133% in relation to export earnings in 2008 and these ratios are projected to rise to about 145% and 175% respectively at end-2009. However, short-term external debt accounts for a relatively low share of 15% of gross debt. Moreover, thanks to the boost to FX reserves through the multinational funding, current reserves are now sufficient to cover roughly all short-term debt plus principal repayments due in 2009. In October 2008, the latter exceeded reserves by around 60%, which was a cause of serious concern then. However, while risks related to external debt payments falling due have declined in the short term, they are not yet out of the way. Hungary may need an extension of the international support package in spring 2010, when the current arrangement expires, if the global financial environment is still weak. Positively, Hungary was able to raise EUR1bn on five-year eurobonds in July 2009.
- Official FX reserves have recovered from less than EUR16bn in October 2008 to EUR25.7bn in June 2009, which is sufficient to cover about four months of expected imports in 2009.

Structural Business Environment

The structural business environment is fairly strong, though just short of our highest category. Generally speaking, Hungary has a market-oriented economy that is very open to foreign investors, and the legal system and regulatory regime already come very close to EU-15 standards, although the overburdened and therefore slow court system remains a weakness.

The financial system appeared fairly strong and well regulated until mid-2008, with an open banking sector that has been largely restructured and privatised. Nonetheless, continuously increasing foreign exchange exposure had been highlighted as a particular risk for some time (meanwhile most of private sector credit is denominated in foreign currencies and household exposure is typically unhedged, raising credit risks). Against this backdrop, the intensification of the global financial crisis in September 2008 resulted in severe banking system illiquidity that eventually caused the banking/financial crisis in Hungary in October. The IMF-led rescue package has so far helped to stabilise the sector, but the economic downturn will continue to undermine credit quality. The share of non-performing loans in total loans increased from 2.5% at end-2007 to 3.5% in Q1 2009. The government had to extend foreign exchange loans to three domestic banks (OTP, FHB, MFB) in April so that they could meet their external funding needs, but as foreign banks control over 80% of the market in Hungary by assets, and therefore most of the foreign funding is inter-group lending, makes it less likely that funding to the country will be completely choked off. Importantly, in May 2009, the major parent banks confirmed their commitments to support their subsidiaries in Hungary. Still, there remains a second-order risk if one or more of the parent banks were to face serious problems of their own in the wake of the global financial crisis.

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Charts

