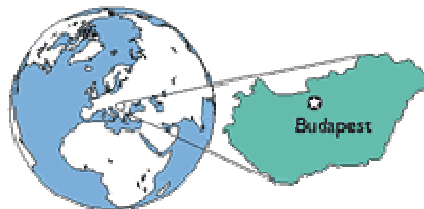


COUNTRY REVIEW

Hungary



20 September 2010

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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

- EU membership
- Moderate to low inflation
- Overall fairly strong business environment

Weaknesses

- Opaque, unorthodox economic policy programme causes uncertainty
- Suspension of IMF Stand-By Arrangement after breakdown of talks with IMF and EU
- Protracted weak domestic demand
- Weak fiscal position
- High exchange rate volatility and vulnerability
- Very high external debt burden (forecast at 150% of GDP at end-2010)
- 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
- Vulnerable banking sector

KEY RISKS

- **Exchange rate risk**
- **Refinancing risk of private-sector companies and banks**

Country Risk Assessment

Ratings	Hungary		Median Grade C	Bulgaria	Peers Romania	Russia
	Latest	Previous				
Systemic Political Risk:	P2-	P2+	P2-	P2+	P2-	P3+
Systemic Economic Risk:	E5	E5	E5	E5	E5	E5
ME rating:	ME5	ME5	ME5	ME5	ME5	ME5
<i>Structure</i>	2.3	1.6	5.9	3.3	3.3	4.0
<i>Policy</i>	5.3	5.8	5.2	5.2	5.2	6.0
<i>Solvency</i>	3.9	4.6	3.0	4.8	4.8	3.9
<i>External Liquidity</i>	6.0	6.0	4.8	6.0	6.0	2.8
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 Economic Studies

ECONOMIC STRUCTURE

Country Profile	
Capital city:	Budapest
Population:	10.011 mn (2009)
GDP:	USD 128965 mn (2009)
Currency:	Hungarian forint (HUF)
Form of state:	Parliamentary democracy
Head of government:	Prime Minister Viktor ORBAN (since May 2010)
Next elections:	Municipal: Oct. 2010; legislative: 2014; presidential: 2015

Major Industries (% of GDP at market prices, 2009)	Global Assumptions	2010	2011	
Services	67.4%	Real GDP grth (% yr/yr)	3.3	2.9
Financial services, real estate activities	23.6%	Inflation (% , av) *	1.2	1.4
Industry	29.6%	Dated Brent (USD/b)	75	70
Construction	4.8%	* Major economies		
Agriculture	3.0%			

Main Exports (% of total, 2010H1)		Main Imports (% of total, 2010H1)	
Machinery and transport equipment	60.6%	Machinery and transport equipment	50.1%
Manufactured goods	27.5%	Manufactured goods	32.2%
Food, beverages, tobacco	6.5%	Fuels, electric energy	10.8%
Fuels, electric energy	3.0%	Food, beverages, tobacco	4.8%
Crude materials	2.3%	Crude materials	2.0%
Lead Export Markets (% of total exports, 2010H1)		Lead Import Markets (% of total imports, 2010H1)	
EU	78.2%	EU	68.6%
Germany	25.8%	Germany	26.4%
Italy	5.6%	Russia	7.9%
Romania	5.1%	China PR	6.4%

Basic indicators

Selected economic indicators	2007	2008	2009	2010f	2011f
Nominal GDP (USD mn)	138,366	154,223	128,965	125,523	115,627
Population (mn)	10.07	10.05	10.01	9.98	9.94
GDP per capita (USD)	13,746	15,353	12,882	12,583	11,630
Real GDP growth (% yr/yr)	1.0	0.6	-6.3	0.2	2.0
Inflation (HICP, %, eop)	7.4	3.4	5.4	3.5	3.0
Fiscal balance (ESA 95, % of GDP)	-5.0	-3.8	-4.0	-4.5	-4.5
Current account balance (% of GDP)	-6.6	-7.0	0.3	-0.4	-2.0
External debt/GDP (%)	105.2	110.9	146.0	149.4	166.1
External debt/Exports of goods & services (%)	131.2	134.1	187.6	168.8	159.3
Debt-service ratio (%)	12.4	17.1	27.0	17.7	17.7
Foreign exchange reserves (EUR mn)	15,804	23,560	28,527	28,000	25,000
Import cover (months)	2.4	3.3	5.2	4.2	3.2
Exchange rate assumption, HUF:USD (av)	183.6	172.1	202.3	218.1	250.0
Exchange rate assumption, HUF:EUR (av)	251.4	251.5	280.3	281.4	300.0
f: CRU central forecast					

Sources: National figures, ECB, Eurostat, European Commission, IMF, Euler Hermes Economic Studies

Political Stability

Hungary is a well-established democracy and a member of NATO, OECD and the EU. In April 2010, the centre-right, populist Fidesz party won parliamentary elections overwhelmingly, benefitting from the unpopularity of the Hungarian Socialist Party (MSZP) which had led the government since 2002. The electorate was particularly disenchanted with the socially painful, though essential, fiscal austerity measures that the MSZP introduced since 2006 and tightened further under the IMF- and EU-led EUR20bn economic stabilisation loan programme adopted in the wake of the global financial crisis in October 2008. Moreover Fidesz secured a two-thirds majority in parliament (262 of 386 seats), enabling it to change fundamental legislation on its own, which it intends to do, though its mandate falls short of pushing through an entirely new constitution. The election (by the new parliament) of Pal Schmitt as president in late June is widely seen as part of a broader effort by Fidesz to attain greater control over state institutions.

There are doubts that Fidesz and its leader, PM Viktor Orban, will be able to keep populist campaign pledges (especially repeal of earlier reform measures) and at the same time continue prudent economic crisis management necessary to retain the confidence of investors and international creditors. Doubts have been fed by a series of events that have shaken market confidence since the Fidesz government took office in May 2010. In June, two senior party officials claimed that the previous government had allegedly falsified fiscal data and that Hungary faced a Greek-style crisis. In July, the IMF and EU support package was suspended after talks with the government broke off unexpectedly because Fidesz wanted to alter substantially the economic policy programme to which the previous government had agreed. The Fund particularly opposed a comparatively high, retroactive bank levy which the Fidesz government nevertheless introduced later that month. Further, Fidesz has repeatedly said that it wants to loosen fiscal policy substantially in order to revive economic growth and has stressed that Hungary can do without IMF funding. Although the government is not under immediate financing pressure, operating without a safety net in the form of a (precautionary) IMF Stand-By Arrangement appears to be a risky strategy as Hungary remains highly vulnerable to external shocks and changes in investors' risk appetite.

Summarising, the clear Fidesz victory in the April 2010 elections provides the potential for increased political stability and more government effectiveness. However, Fidesz' populist stance and unorthodox economic policy plans cast serious doubts that the potential will be used to reduce the current high level of systemic economic risk. Moreover, there is a danger that the previous government's achievements regarding fiscal consolidation and improved investor confidence will be reversed in the medium term.

Economic Stability

Substantial macroeconomic imbalances combined with lax, inappropriate economic policies had posed considerable country risk in Hungary for some time. Against this backdrop, the intensification of the global financial crisis in autumn 2008 hit the economy particularly hard. The tightening of global credit markets curtailed the country's access to international financing dramatically. As a result, domestic markets came under severe strains and the banking system faced a serious foreign exchange (FX) liquidity shortage. The IMF- and EU-led EUR20bn support package helped shore up FX reserves, stabilise markets and reduce the financing risks on external debt. Until Q1 2010, Hungary was in full compliance with the agreed economic stabilisation programme, and it stopped drawing on the facility in Q4 2009 after it regained access to long-term FX bond markets. As noted above, the support package (which officially ends in October 2010) was suspended in July when talks between the new government and the IMF and the EU failed.

Fiscal austerity measures brought only meagre real GDP growth of 1% in 2007 and 0.6% in 2008 before the economy fell into deep recession in 2009 in the wake of the global financial crisis, shrinking by 6.3%. Despite base effects, real GDP returned only to modest growth of 0.5% yr/yr in H1 2010. Private consumption and investment continued to contract, by about 4.3% and 4%, respectively. Government consumption increased by some 4.3% and exports by almost 15%, while imports expanded by 13.5%. In qtr/qtr terms, real GDP grew 0.6% in Q1 but stagnated in Q2. H2 2010 is likely to be even weaker than H1 as base effects gradually fade and external demand eases. We forecast growth of about 0.2% in 2010 overall and 2% in 2011.

The fiscal deficit was reduced from 9.2% of GDP in 2006 to 3.8% in 2008—mainly the result of the fiscal austerity measures mentioned above and stronger than expected revenue collection—and increased only slightly to 4% in 2009, despite the deep recession. The IMF-agreed deficit targets (prior to the suspension of talks) were 3.8% for 2010 and 2.8% for 2011. Fearing market turbulences, the new government has half-heartedly pledged to meet the 2010 target, but it remains reluctant to

adhere to the 2011 target. We forecast annual fiscal deficits of 4-5% of GDP in 2010-2011. The government does not have a short-term financing problem, but the breakdown of talks with the IMF and EU has already raised borrowing costs. The deeper concerns lie beyond 2010. A loss of market confidence or a downgrade by the sovereign rating agencies could make access to long-term FX bond markets very difficult. Further, it could put downward pressure on the forint (HUF) and retard economic recovery. Moreover, Hungary's public debt is relatively high at about 80% of GDP and so too is the debt-service burden for 2011, particularly if there is no roll-over of IMF loans via a new facility. Overall, it cannot be ruled out that markets force Hungary back into the arms of the IMF.

Over the past two years, monetary policy of the Hungarian National Bank (MNB, the central bank) has prioritised maintaining financial stability, which has largely translated into stabilising the HUF. The floating HUF/EUR exchange rate has shown considerable vulnerability and high volatility in the wake of the global financial crisis. From an all-time high of 228 HUF/EUR on 18 July 2008, the currency weakened to a temporary low of 284 HUF/EUR on 23 October 2008 (-24%). Although an emergency policy interest rate hike of the MNB, by 300 bps to 11.5% and the IMF and EU bail-out package calmed markets for some time, the HUF weakened again sharply in Q1 2009, hitting an all-time low of 316 HUF/EUR on 6 March 2009. Thereafter the currency recovered and averaged 272 HUF/EUR in the year to end-April 2010, though it remained volatile. Since the election of the Fidesz government, the HUF has shown renewed weakness and suffered several bouts of volatility (overall the HUF/EUR rate is currently about 7% down from mid-April). Still weak macroeconomic fundamentals, doubts over 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.

Inflation has fallen from an average 4% (on the EU's HICP) in 2009 and 5.4% at end-2009 to 3.6% yr/yr in August 2010. We expect it to remain moderate in 2010-2011. In order to support the faltering economy, the MNB has gradually eased monetary policy after the emergency hike in October 2008, but with a close eye on exchange rate movements. Overall, it has cut its policy interest rate from 11.5% to 5.25% in April 2010. Further significant rate cuts are unlikely in view of continued exchange rate vulnerability.

The current account shifted from a deficit of 7% of GDP in 2008 to small surpluses in 2009 and H1 2010. However, as external demand is expected to ease from H2 and the repatriation of company profits and dividends (the counterpart of earlier foreign direct investment) is set to increase, we forecast the current account to record small deficits in 2010 and 2011 overall. Net foreign direct investment flows have been small in 2009 and negative in Q1 2010.

The external debt burden is very high. Gross external debt increased to 146% in relation to GDP and 188% in relation to export earnings in 2009, and similar ratios are projected for 2010-2011. Short-term external debt accounts for about 17% of gross debt (USD32bn in 2010). The annual debt service on medium- and long-term debt is estimated at about USD20bn in 2010-2011.

In part thanks to the boost to FX reserves through the multinational funding, official reserves have recovered considerably from about EUR16bn in October 2008 to EUR30bn in August 2010. This is sufficient to cover more than four months of expected imports in 2010. However, current reserves cover only about 82% of external debt payments falling due in 2010 and 73% of the debt due in 2011, leaving Hungary vulnerable to market confidence reversals. This underscores once again that a new (precautionary) IMF Stand-By Arrangement would be helpful to retain investor confidence.

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 open to foreign investors, and the legal system and regulatory regime already come very close to EU-15 standards. However, over the past year or so there have been reports of a number of relatively opaque actions by local governments that have dispossessed foreign investors, mainly in sectors servicing the public such as utilities, broadcasting and transport infrastructure.

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 (most of private sector credit is denominated in foreign currencies and household exposure is typically unhedged, causing high credit risk). 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 a month later. The IMF-led rescue package helped to stabilise the banking sector. But the economic downturn has continued to undermine credit quality. The share of non-performing loans in

total loans increased from 2.3% at end-2007 to 6.7% at end-2009. In April 2009, the government had to extend foreign exchange loans to three domestic banks (OTP, FHB, MFB) such 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, it is 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. In this context, however, foreign banks are particularly frustrated by the sizeable retroactive bank levy which the new government introduced in July 2010.

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Charts

