EDC

Hungary

EDC Economics

Economic

Credit Agencies

Moody's: A2

S&P: BBB+

Fitch: BBB+

Nominal GDP (2006)

USD112.9bn

Population (2006):

10 million

Exports % GDP:

65.1%

Currency:

Hungarian forint (HUF)

Exchange regime:

Pegged exchange rate within horizontal bands

Merchandise imports from Canada (2006):

CAD131m

Main sources of Foreign Exchange (excl. FDI):

Machinery and equipment exports

Largest Merchandise Trading Partner:

Germany (30%)

Italy & Austria (6% & 6%)

Main imports:

Various Machinery and equipment (52%)

Risks to the Outlook

Further fiscal consolidation and reform.

Unconstrained government spending.

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Market Spotlight: ♦ Hungary's trade deficit narrowed to Ft46.3bn (US$275.5m) in August, from Ft97bn a year earlier ♦ The year-on-year inflation rate fell to a ten-month low of 6.4% in September ♦ Retailers continue to suffer from the government's austerity measures as retail sales in August fell 3.6% y/y ♦ The National Bank of Hungary cut interest rates for the second time since June, to 7.5% in September

Macroeconomic Outlook: Hungary's economic growth slowed to a decade low rate in the second quarter of 2007, with almost flat growth quarter to quarter and up only 1.2% from a year ago. This continued a trend that saw growth of 2.8% (y/y) in the first quarter of 2007, down from 3.6% y/y in the fourth quarter of 2006. Consumer spending has seen a sharp slowdown as households continued to struggle with last year's tax increases and another round of regulated utility-price increases. These measures are all part of the government's plan to reduce the fiscal deficit, which reached 9.2% of GDP in 2006. Reductions in government spending are likely to remain a drag on GDP growth for the rest of the year. Somewhat more encouraging on the domestic side of the economy was a pickup in capital spending. Although investment is falling in annual terms, this is mainly due to a halting of public infrastructure spending by the government. In contrast, manufacturing output showed a more impressive performance, up 13.2%. Although export growth was strong, this was matched by imports, owing to the high import content of domestic production. Looking forward, real GDP growth is expected to be somewhat lower than we had previously thought, most likely to average around 2% in 2007—much slower than the 3.9% growth posted in 2006. In 2008, GDP growth is forecast pick up to around 3%.

Monetary Policy: The Monetary Council of the National Bank of Hungary recently decided to leave their policy interest rate at 7.5%, after having lowered rates twice this year by a total of 50 basis points. The year-on-year inflation rate fell to a ten-month low of 6.4% in September, while core inflation—which excludes the cost of commodities and unprocessed foods as well as regulated prices—eased to 4.3%. The central bank expects that the 3% medium-term inflation target will be achieved in 2009. The bank also noted that there may be scope to reduce interest rates further; it refrained from doing so at the last scheduled announcement because of upside risks to inflation and uncertainty in global financial markets

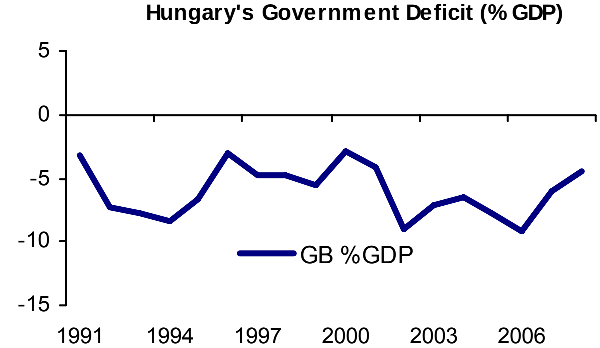
Exchange Rate: Bolstered by high global liquidity and risk appetite, the forint traded at around Ft245-255:€1 between January and early August. However, recent financial market turbulence drove the forint to Ft261:€1 around mid-August, but since then has partially recovered and is trading in the range of Ft250-255:€1. The forint is likely to remain volatile over the coming months, owing to market turbulence and continued uncertainty regarding progress on fiscal reform. If the government strays far from its targets over the forecast period, the country's currency (forint) runs a greater risk of depreciating more sharply.

External sector: The government's austerity measures are set to drive an improvement in the trade balance in 2007. However, the trade gap will begin to increase again in 2008 as consumer and business confidence begins to recover. Consequently, the current-account deficit will fall as a percentage of GDP in 2007 (4.8%) but then rise again in 2008 (5.1%).

Economic Indicators

	01-05 avg.	2006	2007	2008
GDP (% growth, real)	4.3	3.9	2.1	3.0
Inflation (%, year-end)	6.0	4.1	7.8	4.3
Fiscal Balance (% of GDP)	-5.7	-9.0	-6.0	-4.5
Exports (USD bn)	16.7	18.1	16.6	12.8
Imports (USD bn)	15.1	15.6	16.2	13.1
Current Account (% of GDP)	-7.2	-5.5	-4.8	-5.1
Reserves (month of imports)	2.6	2.6	2.5	2.5
External Debt (% of GDP)	57.5	65.4	57.3	56.5
Debt Service ratio	30.0	30.3	31.0	31.1
Currency (per USD, year-end)	221.2	191.6	181.3	185.2

Hungary's Government Deficit (% GDP)



General Political Environment: Hungary is a stable, multi-party democracy; radical policy change is not expected. Emerging from communism, Hungary embraced gradual reform during the 1980s and was able to pursue democracy and market liberalisation in the early 1990s. On the left, the Hungarian Socialist Party rapidly adopted the free-market system and as a result, has largely deprived the right-wing parties of a platform.

Hungary acceded to the European Union (EU) on May 1st 2004. Over the last few years, the focus of the Hungarian government has been on reforms and policy changes related to accession. Hungary's commitment to further integration into EU structures is certain and cuts across the major parties. Euro adoption is currently planned for 2014, however this is still not guaranteed given some of the challenges Hungary faces with its budget deficit. Economic management has become the government's key focus in the wake of the 2006 election.

The Socialist-led government of PM Ferenc Gyurcsány was returned to power in the 2006 parliamentary election along with its coalition partner, the centre-right Alliance of Free Democrats (SZDSZ). The Socialists re-election represented the first time since the collapse of communism that a ruling party was returned to power in Hungary. However, Gyurcsány's success proved to be short-lived following his admission that the public was deliberately misled about the state of the Hungarian economy prior to the election. This admission led to riots in Budapest demanding the PM's resignation and provoked the ire of the conservative-nationalist opposition *Fidesz* party – already in strong position following the 2006 election.

Fidesz is currently working to undermine the government. It has received concessions from the government that include a referendum in the first half of 2008 on the government's deficit-cutting, social welfare and healthcare reform package. This austerity package was introduced following the elections and is part of the government's ongoing process of EU convergence. Although the government would not be defeated as a result of a negative vote in the referendum such a result could foster greater tensions within the governing coalition. It is generally expected by most observers that regardless of what happens, it is unlikely that Gyurcsány will survive as prime minister even though he currently has the support of his Socialist colleagues. There continue to be sporadic protests against the government and the PM. However, the government has maintained stability and little negative reaction has come from outside Hungary. It is likely that Gyurcsány could be forced to resign at a more appropriate and politically-expedient time, possibly after some of the tougher economic and social reforms are implemented.

Investment Environment: Successive Hungarian governments have demonstrated a serious commitment to creating favourable conditions for foreign investors. The government is committed to a free-market economy and the current privatisation programme will be pursued. Although some groups are more nationalist and suspicious of foreign investment, it is unlikely that the overall favourable trend will be reversed. The opposition *Fidesz* party has been lukewarm to foreign investment in the past and on occasion has threatened re-nationalisation.

On the whole, the legal system provides effective protection for foreign investors and regulatory bodies are functioning well and are effective. There is legal protection against expropriation and nationalization. The legal system has been substantially reformed and legislation is now fully harmonized with EU norms. International arbitration is permitted and recognized.

Foreign investors may freely repatriate all profits, dividends, fees and income from the sale of an investment. Full foreign ownership is permitted in almost all but a very few sectors designated as strategic. The Foreign Investment Act gives foreign investors equal treatment.

The still large and unwieldy bureaucracy has been targeted by the government as part of a programme of public administration reform that, if implemented, will result in fewer ministries and agencies and a rationalization of local government.

There are some instances of low-level corruption although this is not a serious problem.

Political Violence: Apart from recent protests against PM Gyurcsány's admissions following the 2006 election political violence is not an issue in Hungary.

Political

Political Structure
Parliamentary Republic

President
Laszlo Solyom

Prime Minister
Ferenc Gyurcsány (MSZP)

Legislative Bodies
National Assembly (*Országgyülés*) (unicameral with 386 seats)

Major Parties
- Hungarian Socialist Party (MSZP) 186 seats
- *Fidesz*-Hungarian Civic Party (F-MPP) 164 seats
- Alliance of Free Democrats (SZDSZ) 18 seats
- Hungarian Democratic Forum (MDF) 11 seats

Last Elections
- Presidential: 2005
- Legislative: April 2006

Next Elections
- Presidential: 2010
- Legislative: May 2010

Press Freedom Survey:
- 2007 Score: 21 Free

(0: Free; 100: Not Free)
freedomhouse.org

Control of Corruption Index:
- 2006 Score: +0.51

(-2.5: Worst; +2.5: Best)
worldbank.org

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Political Outlook

Expect Hungarian politics to continue to revolve around improving the economy and social welfare reform. With such a stable democracy, economic issues will dominate the agenda over the coming years. Gyurcsány and his counterparts will be judged on their ability to implement economic reform and other reforms in public administration. It is unlikely that Gyurcsány will see out his term as PM with his Socialist Party almost certain to seek a new leader in the run-up to the 2010 elections.