

PRESS RELEASE

Budapest, 13 August 2010

Deficit target for 2010 seems attainable, expected to be 3.5 per cent next year

Erste Bank Hungary analysis of Hungary's longer term economic outlooks

Budapest, 13 August 2010 – After the deterioration of the risk assessment of Hungary, Erste Bank analyst Zoltán Árokszallási now forecasts no change in the base rate for this year, believing it will remain at current 5.25 per cent. On the back of the measures approved and announced by the government, the 3.8-percent deficit gap seems achievable. For 2011, however, the 2.8-percent target set in the convergence program of Hungary cannot be achieved with the measures accepted so far. The Erste analyst projects the deficit in 2011 at 3.5 per cent, with risks to the upside.

After the 6.3 per cent plunge in real GDP last year, the Hungarian economy has started a slow recovery process. In the first quarter of 2010, real economy experienced a 0.1-percent y/y growth, which was a positive surprise. Based on the most recent data from the second quarter, annual growth continued and reached one per cent, but the data released by the KSH [Hungarian Statistical Office], adjusted for seasonal and calendar effects, reflected stagnation. On the back of an increasing demand for Hungarian export products compared to the previous year, export-related industries are expected to be the main driver for recovery

“In the first half of the year, industrial output saw a 9-percent increase compared to the previous year, according to preliminary KSH data, but due to the uncertainties around the global growth outlook and the fading away of the base effect in the second half of the year, we expect FY10 industrial production growth to be at 6 per cent”, Zoltán Árokszallási underlined. On the back of an improving performance of export related industry, export volumes have increased significantly on a yearly basis, whereas import dynamics have fallen short of the pace of exports. Imports are now mainly driven by the demand for inputs for export-related industries, but import volumes still lag behind those of exports. This translates into a considerable trade surplus, significantly supporting the economy; this is expected to positively contribute to GDP growth in 2010, as well. Domestic demand, however, continues to be a drag on the economy because of scarce lending and a high level of unemployment. Households' final consumption is projected to drop 1.5 per cent this year. According to data available at present, construction industry continues to perform poorly, and agriculture is also a powerful downward force.

“Real GDP overall should grow by 0.9 per cent in annual terms in 2010 and expand by 3.1 per cent in 2011, although our forecast is plagued by uncertainty and contains reasonable downward risks. While we project a slight increase of household consumption next year (+1.8 per cent), this is not expected at the moment to be the major contributor to GDP growth. Economic recovery is most likely driven by exports in 2011 as well,” the analyst stated.

However, uncertainties around the global economic growth outlook pose downward risks to our growth forecast, whereas the recently announced banking tax could also slow down the recovery process, due to a potential negative effect on future lending from the financial sector.

In 2009, amid the economic crisis, the Hungarian economy showed a remarkable improvement in its external balance situation. Trade balance improved by more than 4 per cent of GDP, while net income outflow also decreased (mainly on the back of plummeting profits of companies owned by foreigners).

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"In 2010, Hungary's trade surplus may even rise above 5 per cent of GDP, whereas net income outflow is also expected to increase slightly in comparison to 2009, translating into a current account surplus of 0.8 per cent of GDP. In 2011, trade surplus is most likely to narrow, but still remains above 4 per cent of GDP. Current account is forecasted to show a small deficit of around 0.1 per cent of GDP. Taking into account the funds stemming from the European Union, the net financing position is expected to remain positive in 2010 and 2011", the analyst said.

At the beginning of 2010, inflation figures increased above 6 per cent on a yearly basis, while in the following months in the first half of the year the disinflation process was milder than expected in terms of the headline figure. Following higher-than-expected inflation in January, household energy prices and fuel prices started to create upside pressure on the CPI figure, while food prices also pulled the headline figure upwards. In the meantime, however, core inflation continuously decreased from the 5.1 per cent y/y January level and reached 3.5 per cent in June. A moderate boom in the price of services and a muted increase of wages in the first half of this year also indicated that core inflation developments were under control in Hungary. July data indicate core inflation decelerated further to 1.3 per cent, while headline CPI dropped to 4 per cent. The annual index decreased on the back of tax impacts from 2009 having disappeared from the basis. The Erste analyst forecasts CPI to be 3.8 per cent at the end of the year, and this year's average inflation could be 4.7 per cent with continuing upward risk from energy prices and food prices.

Unemployment rate began increasing spectacularly in 2008. Due to unfavourable impact of the current global economic downturn on the domestic economy, the unemployment rate increased to 10.5 per cent by the end of last year, growing higher in Q1 2010 to 11.8 per cent. It has decreased since, mainly due to seasonal effects, but some increase in employment can be tied to a livelier economic activity.

"For FY10, we expect the unemployment figure to be at 11.1 per cent on average. Overall, despite some slight encouraging signs on the labour market in the last few months, we have yet to see a real turn of the trend in the labour market," the analyst added.

Hungary posted a budget surplus of HUF 36.1 billion this July (on a cash flow basis, excluding local governments). The January-July balance shows a HUF 997.5 billion deficit, which is 114.6 per cent of the full-year target already. In the previous year, this number was 88.1 per cent for the same period. Overall, details are highly uncertain behind the root cause of this excess deficit, but a comparison with 1H09 developments shows a difference somewhat below HUF 200 billion compared to 2009. Even if the gap is assumed to keep widening in the second half of the year, the projected HUF 187 billion additional income from the banking tax this year and the planned HUF 120 billion spending freezes in the central government should be enough to contain the deficit at 3.8 per cent of GDP this year (as planned). For 2011, the previous government announced a 2.8 per cent budget deficit target, which, considering current developments, seems to be a very optimistic undertaking.

"Our assumption indicates that this target cannot be met despite the HUF 200 billion banking tax and no reduction in personal income tax (plans of which have already been mentioned by the new PM, which would negatively affect current plans in 2011 from a budget revenue point of view). The accepted tax regime change for corporate taxation, which means a lower tax burden for companies in 2011, has also been incorporated in this forecast. All told, we believe that the deficit should arrive at 3.5 per cent of GDP next year, with risks to the upside. Assuming a nominal GDP growth of 4.5 to 5.0 per cent for 2011, the 3.5-percent headline deficit may be enough to deliver a debt-to-GDP ratio in 2011 that does not exceed the 2010 debt-to-GDP figure," Zoltán Árokszállási stated. "Nevertheless, lack of sustainable measures will surely resurface after 2011-12, and structural reforms will have to be implemented in order to maintain a balanced deficit and healthy, sustainable growth for Hungary," he added.

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Between the summer of 2009 and April this year, the National Bank of Hungary delivered rate cuts totalling 425 basis points. Increased risk premia on Hungarian assets, however, prevented the Monetary Policy Council from continuing with further easing. Hungary's five-year CDS spreads have stabilized over 300 basis points since early June, and the breakdown of negotiations with the IMF also hurt the country's risk assessment. The MPC emphasized after its most recent base rate decision that an increase in the policy rate should be expected if risk premia remain elevated for a longer period of time. Zoltán Árokszallási believes that interest rates will not be lowered further in 2010, but he expects no any rate hikes, either.

The forint is highly dependent on international investor sentiment. Since this May, global investor sentiment has turned gloomier, even though we saw some appreciation of regional FX rates in recent. The European debt woes seem to have calmed down somewhat since May, but debt sustainability is still a major issue that is highly scrutinized by investors. Meanwhile, global sentiment remains fragile. We must also highlight Hungary's still high FX indebtedness of the country (of which a significant proportion is denominated in CHF) as a structural weakness that makes the country more exposed to swings in global risk appetite. In lack of the IMF "safety net", the forint could react more sensitively to any deterioration in global sentiment.

We must also mention, however, that Hungary's debt redemption profile, central bank FX reserves, government FX deposits in the CB and the budget deficit situation mitigate the above factors. All in all, these negative aspects still pose upward risks for the forint. Consequently, the Hungarian currency could be staying at current HUF 280 levels against the euro in the weeks to come. If, however, global risks anticipated now fail to materialise, Hungary's debt redemption continues not to trigger serious concerns, and the government comes up with clearer concepts about the budget for 2011 and a subsequent fiscal path, then the forint might start firming to conclude the year around HUF 270 versus the euro.

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