MINISTRY
FOR NATIONAL ECONOMY

International recognition of remarkable improvement in Hungary's economic vulnerability

According to the latest analysis of financial services giant Morgan Stanley, the vulnerability of the Hungarian economy to external shocks declined the most since 2008 among the CEEMEA (Central and Eastern Europe, Middle-East and Africa) countries. Analysts of the research unit of Morgan Stanley conclude that this improvement was large not only in relation to the other countries: Hungary's position may make further gains despite deteriorating growth prospects. Authors of the study attribute this improvement to declining deficit figures and healthier current account balance data. The experts also express their conviction that Hungary should be restored to investment grade status this year. In the study, they point out that several underlying factors safeguard the existing good results, such as prudent fiscal policy and the changes in debt financing.

The global economic crisis of 2008 posed new challenges not only for companies and regulators but analysts as well. The fact that only a few economists had been able to predict the events and repercussions of 2008 made investors rethink their strategies: instead of examining solely business cycles and monetary policy messages before coming to a conclusion, they nowadays also tend to seek out advantages stemming from economic structures. Thus, the role of economic policy has gained special importance also in countries previously dominated by market mechanisms. Data, for example, on changes in the stock of state debt, interest payments, regulations on banks' liquidity or in the volume of household debt weigh significantly in the decision of investors. Morgan Stanley analysts had compiled these factors to create a single indicator. The so-called **Vulnerability Scoring Indicator (VSI**) is a figure capable of indicating comparative vulnerability within a group of observed countries; therefore it is not a tool to define vulnerability in absolute terms. The indicator[1] is an especially potent instrument as investors usually scrutinize regions before making a decision: when it comes to attracting foreign capital, Hungary is competing rather with regional EU neighbours and other emerging countries from Asia and Africa than, for example, with Spain.

[1] In their comprehensive analysis published on Monday, Morgan Stanley economists present their new, expanded model with 11 variables of equal weight (source: Portfolio.hu)

The entire CEE region has in recent years become less vulnerable. But Hungary stood out thanks mainly to an annual GDP growth rate that has exceeded the EU average of the past three years (2.3 percent in Hungary). In this period, the **bank loan-to-deposit ratio has improved** and the **share of foreign currency-denominated state debt has fallen** to 25 percent in Hungary. The most striking difference between Hungary and its regional peers lies in the massive, above 4 percent surplus of current account balance which has led to rising demand for forint.

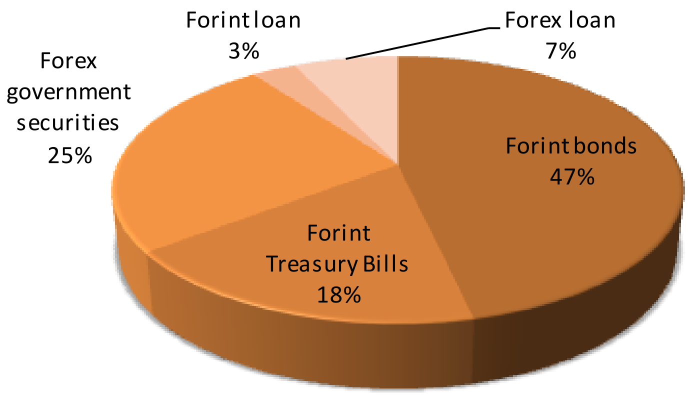
Components of VSI across the CEEMEA

2015Q3	VSI Sign	RU	TR	SA	PL	HU	CZ	RO	UA
Growth									
Real GDP Growth (3Y Average)	-	-0.1	3.3	1.8	2.4	2.3	1.4	3.0	-5.6
Financial									
Loan to Deposit Ratio	+	1.1	1.2	1.1	1.0	1.0	0.8	1.0	1.5
FX loans % of total PS credits	+	28.3	33.7	12.2	28.0	25.4	9.3	50.3	53.7
External									
C/A % of GDP	-	5.1	-5.5	-4.3	-0.5	4.2	1.2	-0.3	-1.8
External debt % of GDP	+	40.6	54.8	40.9	70.6	136.4	69.9	44.5	135.2
St external debt/FX reserves	+	12.3	100.9	65.2	41.6	46.0	69.6	35.1	160.7
External Portfolio Liabilities/Total External Liabilities	+	17.3	25.0	52.3	28.9	24.7	18.2	13.9	17.5
Fiscal									
Budget deficit % GDP	-	-4.3	-1.3	-3.8	-2.8	-0.8	-0.7	-0.9	-0.4
Gov't debt % GDP	+	10.1	30.6	44.0	51.9	78.0	41.4	37.2	83.8
Interest payments/Revenues	+	1.7	12.5	12.1	5.1	7.7	2.8	4.6	13.3
Governance									
Governance Indicator (-2.5=bad & 2.5=best)	-	-0.5	0.2	0.2	0.8	0.5	0.9	0.2	-0.7

Source: Haver Analytics, Morgan Stanley Research

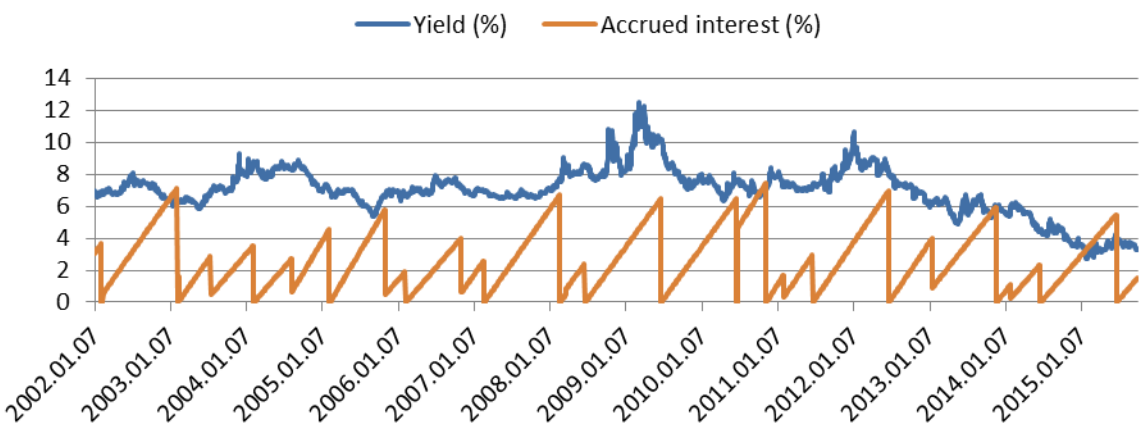
Source: Haver Analytics, Morgan Stanley Research, Portfolio

As far as the debt picture is concerned, other positive economic processes have been accompanied by a shift towards a larger proportion of retail and domestic holdings of state debt. The Hungarian Debt Management Agency (ÁKK) has facilitated this change on the one hand through **attractive yields** for government securities (some retail bonds, for example, yield 2 percentage points above the inflation rate) and on the other hand through **opening new customer centres** throughout the country and offering more and more **user-friendly services** (e.g.: low-cost savings accounts) that



encourage Hungarian households to participate in financing state debt. Yields on government securities currently vary between 2.1 percent and 3.5 percent (on tenors of two years and ten years, respectively). In addition, the ÁKK has also increased the number of available long-term instruments, for example through the so-called **Baby Bond**. Under this scheme, families can open a savings account with the new-born child as beneficiary and purchase long-term bonds that mature in the year of the child's 18th birthday. The beneficiary can obtain the accumulated money after he has turned 18. Favourable interest rates (they currently carry a premium of 3 percent) make this bond highly popular. In October 2012, the ÁKK – in order to add to liquidity options – issued a **Euro-denominated security** and thus offered an inflation-linked bond that carries a premium of 2 percent above the average inflation rate of the Euro-zone. The security can be purchased by a wide range of investors. Momentarily this instrument yields 2.1 percent. A basic prerequisite of lowering state debt is a proper growth path capable of generating coverage for the financing of premia. Ideally, this would be around 3 percent of gross added value growth per year. On the other hand, robust economic growth and declining fiscal deficits already ensure a falling debt rate.

Benchmark yields on 10-year government bonds and historic accrued interest payments (2016)



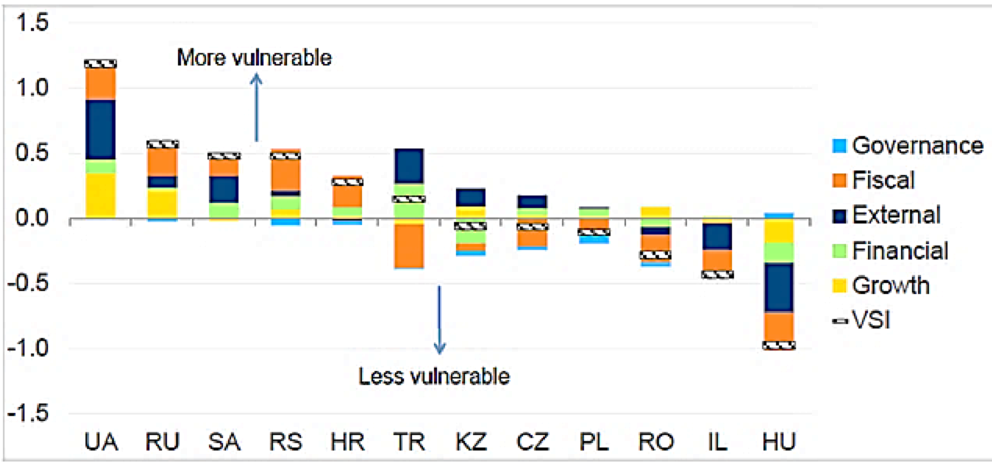
Source: Hungarian Debt Management Agency (AKK), Ministry for National Economy (NGM)

There is a third key component of reducing vulnerability: a new **fiscal guarantee** was added to the constitution in the course of the Amendment of the **Fundamental Law of Hungary** in

2011. This stipulates that **the National Assembly may not adopt an Act on the central budget** as a result of which state debt would exceed half of the Gross Domestic Product (Article 36). As long as state debt exceeds half of gross domestic product, the National Assembly may only adopt an Act on the central budget which provides for state debt reduction in proportion to the Gross Domestic Product. **The calculation of state debt and gross domestic product is defined by a law**. Aiming for optimal calculability, **the Ministry for National Economy is scheduled to submit the budget bill of 2017 as early as the spring of 2016**, just as it did with the budget bill of 2016.

Last year, the deficit of the central government budget was 2 percent of GDP. The Government is aiming to keep reducing this level, in order to cut gross state debt as well. Prudent fiscal management, which is also safeguarded by legal provisions, is a pivotal requirement for reaching this goal. This can only be achieved provided **cash-flow deficit can be lowered in the current low-inflation environment**. Accordingly, EU funding, domestic consumption and investments must act as economic growth engines, instead of budgetary expenditures. Every prerequisite is in place for reaching EU funding projections: every operative programme was approved by the beginning of 2016 and the Government has committed itself to channel until 2018 HUF 2 048bn (EUR 6.6bn) annually to the Hungarian economy through faster and more efficient distribution of EU funding. The acceleration of the disbursement of funds will have a direct impact and give a sudden boost to economic growth, as opposed to the former evened-out payment schedule.

Change in VSI and its key sub components (concerning certain CEE, Middles East and African countries, between Q3 2015 and Q3 2008 Q3 (2016)



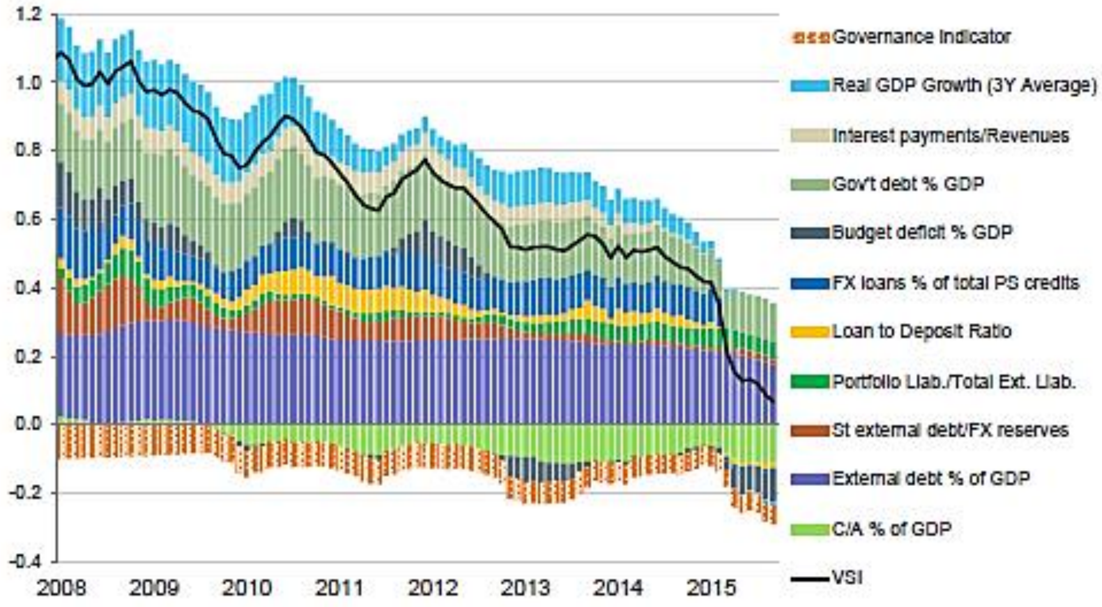
Source: Morgan Stanley Research, Portfolio

The optimization of fiscal management has required the maximization of revenues. The most potent instruments for improving economic transparency and generating extra revenues have been the Electronic Trade and Transport Control System (EKÁER) and on-line cash registers. Sectoral taxes have also played a key role in boosting revenue flow.

As far as the country's economic resilience is concerned, the analysts of Morgan Stanley express recognition of achievements as a whole: their study concludes that **Hungary currently has the best external position in the region.** As a special acknowledgement they note that while former improvement had been the result of oil prices, **the current one stems rather from structural than non-cyclical factors.** To sum it up, it can be concluded that indicators of "momentarily health status", such as current account balance and fiscal deficit, are having ripple effects on long-term indicators, such as state debt and GDP growth. These results are making Morgan Stanley experts more upbeat: favourable flow data have led them to predict that **in the coming quarters the relative position of Hungary within the CEEMEA region is set to improve further,** bucking a global slow-down.[2]

[2] *Quote by Portfolio.hu*

Detailed VSI drivers of Hungary (2016)



Source: Morgan Stanley Research, Portfolio