COUNTRY REPORT: HUNGARY

YEARS: 2004-2009

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Introduction:

Slightly smaller in area than the state of Indiana, the landlocked, central European country of Hungary currently boasts a per capita income two thirds that of the European Union average. Hungary has successfully developed into a market economy, with the private sector accounting for over 80% of GDP. This has not always been the case. In 1968, Hungary began liberalizing its economy, introducing so-called "Goulash Communism." Hungary held its first multiparty elections in 1990 and initiated a free market economy. It joined NATO in 1999 and became a member of the EU in 2004. In 2011, Hungary adopted the 'six-month rotating presidency' of the EU for the first time (Hungary Factbook).

Currently, foreign ownership of Hungarian firms is prevalent, with the top industries consisting of: mining, metallurgy, construction materials, processed foods, textiles, chemicals (especially pharmaceuticals), and motor vehicles. The top export category is machinery and equipment, accounting for 61.1% of all exports, followed by other manufactures (28.7%), food products (6.5%), raw materials (2%), and fuels and electricity. Germany remains Hungary's largest export partner at 25.5%. Italy, the UK, and Romania follow. In addition to being Hungary's top export, machinery and equipment constitutes 50% of imports, followed by fuels and electricity, food products, and raw materials. The top sources of imports are Germany, Russia, China, Austria, and the Netherlands. While Hungary became a member of the European Union in 2004, it is not yet a member of the Eurozone. The Euro is set to replace the Hungarian Forint in the year 2020, provided the country meets strict guidelines (Hungary Factbook). As a member of the World Trade Organization, Hungary has come a long way from its history of communism, which ended in 1990.

Data:

The data used in this report is organized on a monthly, quarterly, and yearly basis that spans from January 2004 to December 2009, with some data reaching into 2010. Monthly data for Hungary's current account balance and GDP is unavailable, so yearly data is used here instead. Data for the key policy rate and financial capital accounts are also unavailable in monthly form, and therefore are substituted with quarterly data. We were able to retain all of this data through the Hungarian's central bank's website. The central bank is also known as the Magyar Nemzeti Bank (Statistical).

2006 witnessed the beginning of economic problems for the country, with its budget deficit growing. 2008 was yet another troubling year, with Hungary feeling a major ripple effect of the collapse of Lehman Brothers in the United States. The global financial crisis of 2008 wreaked havoc on the Hungarian economy, especially due to the country's high dependence on foreign capital. High government spending and insufficient privatization also earned Hungary much criticism in the wake of the crisis. Due to the significance of these two time periods (2006 and 2008), this report will analyze the effects of Hungary's economic data with a central focus on the year 2008. 2008 brought dramatic economic instability, evidenced by the abrupt changes in the statistical data.

Notes: Labeled data graphs can be found at the end of this report,

In-text citations are in parentheses.

GDP and Unemployment:

A country's GDP or Gross Domestic Product refers to the market value of all final goods and services produced within a country in a given period. For this report our group has decided to look at the GDP of Hungary during the time period of 2004 to 2008. To do this, we will examine the GDP on an annual basis during a very important economic time period in Hungary.

In 2004, Hungary had a total GDP of $102.076 billion dollars. This is the same year they were invited to join the European Union. A key requirement in joining the EU is stated as "The country must have a functioning market economy and must be capable of withstanding the pressure of competition and market forces in the European Union" (Requirements). Hungary had a strong and stable economy, and this was represented by the success of the country. As you can see in Figure A, the following two years, Hungary's GDP climbed up to $110.195 billion in 2005 and $112.791 billion in 2006. Although still an increase, it is very clear that the growth rate of GDP has started to decline. In 2006, Hungary was met with financial instability, and due to a major budget deficit of nearly 10% of GDP, it was clear the economy was showing signs of a recession. To offset the problem, the government decided to decrease government spending, which in turn decreased consumption, which again led to a decrease in GDP growth (U.S).

In 2007, Hungary seemed to be on the right track towards correcting the economic problems it faced in 2006. If you refer to Figure A, you will see that Hungary managed to increase GDP to $137.897 billion in 2007, and saw their largest growth rates in several years. Looming on the horizon however, was the world financial crisis. Still in the midst of recovering from problems in 2006, Hungary's economy took a very big hit. With a lack of investor confidence and in order to "ensure liquidity in domestic financial markets, Hungary concluded a

$25 billion financial stabilization package with the IMF, EU, and World Bank in November 2008" (Economy). When analyzing the GDP during 2008, we see a massive increase to $155.444 billion. This marks the highest ever GDP in the country's history, but can be accredited to the $25 billion dollar bailout package Hungary received in order to stimulate the economy. Despite this boost, Hungary was continuing to see real wages decrease, as well as a massive reduction in consumption, both of which continued to raise concern for the economic situation (Economy).

In addition to the above issues, Hungary also dealt with major unemployment issues. As shown in Figure B, Hungary had an unemployment rate of 5.9% in 2004. As Hungary began to encounter economic trouble, this number increased significantly to 7.4% in 2006. This was mainly due to the fact that the government limited its spending, and consumer consumption saw a large decrease. With such a decrease in consumption and government spending, fewer jobs were created, which caused the increase in unemployment. After receiving the stimulus package in 2008, unemployment still managed to increase by 0.5% to 7.8%. Conditions in the economy were continuing to get worse, as unemployment climbed all the way to 10% in 2009 (Statistical).

Money Supply, Interest Rate, Exchange Rate, and CPI

Through research and analysis of Hungary's money supply, key policy rate or interest rate, exchange rate, and consumer price level, our group was again able to determine the steps taken by economic leaders in Hungary. For the money supply, monthly data was gathered. Instead of the typical interest rate, we chose to use the key policy rate that the Hungarian

Central Bank determined, and that was given quarterly. For the exchange rates and the consumer price levels, the group again gathered monthly data.

According to the graph regarding the money supply, one can tell Hungary's money supply remained constant and was gradually increasing overtime. By referring to Figure C, it is clear that from 2006 to 2008 the money supply had been increasing, and in 2008 there was a huge spike in the money supply. As previously mentioned, Hungary's economy had a $25 billion increase in the money supply from the bailout package. The key reason for the bailout package, which led to the drastic increase in Hungary's money supply, was primarily due to the global financial crisis. In 2006, the Prime Minister instilled a program of fiscal consolidation. This policy increased taxes, mainly on labor which resulted in Hungary decreasing their deficits to 3.4% of the GDP. Greater fiscal discipline, such as decreasing subsidies, significantly decreased government spending, as well as reduced domestic consumption (Economy).

In order to defend its plunging currency, Hungary's central bank hiked its key lending rate by 3% to 11.5% (as seen in Figure D), as an emergency measure. The Hungarian National Bank's monetary policy kept the key lending rate high because foreign liquidity could only be made available by keeping the lending rate for foreign deposits. If they were to cut the lending rate, they would run the risk of a huge capital outflow, and thus rapidly depreciate the currency. This action was also intended to stabilize the exchange rate after the initial drop.

During the 2008 crisis, Hungary's lack of investment in the country did not help its case, instead leading it to high external debt levels as well as budget deficits, which Hungary had been already incurring. All of these factors caused investor risk aversion, and in order to

increase investor confidence and ensure the domestic financial markets, Hungary agreed to the $25 billion stimulus from the IMF in 2008 (U.S.).

Due to this drastic increase in the money supply in 2008, other economic factors have been changed. According to the key policy rate graph, in Figure D, there was a decrease in the lending rate at the end of 2008, and all of 2009. Figure E shows that the exchange rate graph increased from the end of 2008 into 2009. When there is an increase in the money supply this leads to a decrease in interest rates and an increase in the exchange rate. From an increase in the money supply, the key policy rate fell in 2009. From the fall of the interest rate, the exchange rate increased as well which is consistent with the analysis.

A look at Figure F will show that Hungary's consumer price index has been very consistent over the years from 2004 to 2009. In 2008, when the Hungarian economy received the $25 billion stimulus, the CPI did not jump up with the money supply because it was an anticipated temporary move by the Hungarian Central Bank. An anticipated temporary increase in the money supply affects the money supply, price level, interest rate and the exchange rate. The money supply increases at first, and then comes back to where it was before. The price levels slowly increase to adjust and then return to where they used to be. The lending rate jumps up and returns as well. Finally, the exchange rate shows the same characteristic movements – shifts, and then returns.

Balance of Payments:

Current Account:

Looking at Figure G, one can see that the current accounts pre-crisis were consistently in the negative and persistently getting worse. In 2007 and 2008 when Hungary's economy hit its trough, the current account was over 11.5 billion in the red, meaning debt at the pre-crisis time was 7.5% of their GDP. Now in their recovery phase of their recession Hungary has managed to get its current account in balance, with exports exceeding imports.

Pre-financial crisis Hungary, like many other countries, aggressively imported - running up a trade deficit. This of course led to the steady decline of the current accounts. Like the United States, Hungarians were importing on credit and incurring huge deficits. Their total debt to GDP is 79% which is the highest among eastern European countries. To put that into perspective, in order to gain access to the EU one must have a maximum of 60% of total debt to GDP. This means that since joining the EU in 2004 their total debt has increased over 20%.

With the financial crisis that ensued in 2008 and 2009, many in Hungary as well as the rest of the world began to panic. This has led to a fiscal change and cultural change in Hungary. Hungry is currently doing what our "super committee" is attempting to do in the U.S. which is to decrease public debt levels. Hungarians have realized that there can be serious repercussions when dealing with a national debt, which is why since the second quarter of 2009 Hungary has had a trade surplus. Leaders are taking austerity to a level that many rating agencies would like to see in Greece. As part of decreasing public debt, Hungary has cut many private pensions and other socialized organizations. In other positive news, Fitch has raised its outlook on Hungary's sovereign credit rating from negative to stable.

What does all of this information mean for current accounts? Evidenced in the graphs, there is now a surplus of exports compared to imports. The real reason for this is the austerity measures that have been taken which have significantly decreased the demand for imports. Retail sales have been falling since 2006 due in part to the credit squeeze. These changes, accompanied by a falling population (as seen in Figure H), have dug into import demands.

In sum, from 2004 through early 2009 Hungary has been in a large trade deficit, due to running up credit and national debts. Issues such as these became common around the time of the global crisis. Since the second quarter of 2009 the government has taken a drastic and unorthodox approach to the public debt issue. They have significantly decreased their current accounts deficit by importing less and exporting an amount equal to what they were doing pre-crisis. With this approach Hungary is strongly attempting to erase debt, however future growth looks bleak.

Financial and Capital Accounts

In theory we assume that a country's payments balance, meaning that any discrepancies in the current account are negated by the financial and capital accounts. Therefore the balance of payments should look like figure I for Hungary. When Hungary is engaging in a trade deficit they are forced to borrow funds internationally through the financial account, this is the ideal balance for a country. However, figure J shows what is really going on in Hungary with the current account and financial and capital accounts. Figure K shows the diffrence between CA and FKA, making it evident that Hungary's accounts don't balance. In no single quarter is the balalnce of payments equal to zero. The main reason for their lack of balance is the huge negative financial account on hand. Analyzing the balance sheet of Hungary, one will find that

financial derivatives during 2007 and 2008 was their larget liabity when it came to financial and capital accounts, thus explaining why the blalnce of payments doesn't exist and why there is so much soverign debt in Hungary.

International Reserves:

International reserves are assets held by the Magyar Nemzeti Bank, or Hungarian Central Bank. These assets are mainly made up of foreign currencies and less than 3% of their assets are made up of gold. Hungary doesn't hold many international reserves because 70% of their imports and 78% of their exports are done within the EU where many share a common currency. Hungary joined the EU in 2003; this is the reason why data is available post-2004, as shown in Figure L.

Since 2007 Hungary has been increasing currency reserves while decreasing their position in the IMF reserves. Again, this is due mainly to the large $25.1 billion bailout funded mainly by the IMF. Since the bailout, Hungary has been attempting to build up international reserves for precautionary measures.

Recent and Future Updates:

In June of 2011, the International Monetary Fund released a report which evaluated the Hungarian economy post-2008 Stand-By Arrangement. The report details how investors avoided government securities during the 2008 crisis, financing a package offered by the IMF and EU that successfully stabilized confidence within the market. Bank supervision and resolution were also increased. Following the initial turmoil which began in the US, there was a selloff of government securities by foreigners. This selloff, coupled with a significant drop in the

exchange rate, lead to liquidity pressures from banks. Foreign ownership of banks left the country susceptible to external shocks, and ever-growing debt made it more difficult to absorb any shocks to the economy. The program put in place was designed to strengthen the Hungarian economy and return it to normal market conditions. The IMF report explains that the bailout money was justified by Hungary's large balance of payment needs through the year 2009. The package also successfully enabled the country to meet its pressures from foreign holdings of Forint-denominated securities (Ex Post Evaluation).

Other 2011 IMF reports indicate that the Hungarian economy is slowly rebounding from the global economic crisis. After contracting nearly 7 percent in 2009, real GDP rose 1.2 percent in 2010, mainly due to strong growth in exports. Domestic demand has remained low, during this time of questionable recovery, in credit, wages, and employment. In this context, the external change has managed to continue, as the current account balance reached a surplus of more than 2 percent in 2010. This is increase is a significant improvement for Hungary, contrasting the days of substantial deficits recorded during a significant portion of the past ten year (IMF Executive Board).

A much anticipated 2011 Post-Program Monitoring meeting led by Mr. Christopher Rosenberg of the IMF showed that exports and industrial production are growing, yet domestic demand remains low due to high unemployment. Output is expected to grow at a rate of 2.5% for both 2011 and 2012. Rosenberg cautions that "the 2012 outlook, however, depends crucially on the eventual size and composition of the planned structural reform package which may initially weigh on aggregate demand, before boosting economic growth in the medium-

term." It is clear that Hungary remains dependent on foreign capital. Inflationary pressures stemming from increases in global energy and food prices appear relatively under control and inflation is projected to fall to the central bank's target by the end of the policy time period. IMF directors agree that a further increase in reserve coverage would provide additional insurance in the period ahead, due to recent uncertainty in European markets. Banks are continuing to rely heavily on direct external funding, and the foreign exchange swap market poses additional risks for Hungary (Press Release). Although there are some challenges, the measures which have been put in place, combined with increased monitoring, will certainly help to better maintain stability and avoid future crises.

FIGURE A

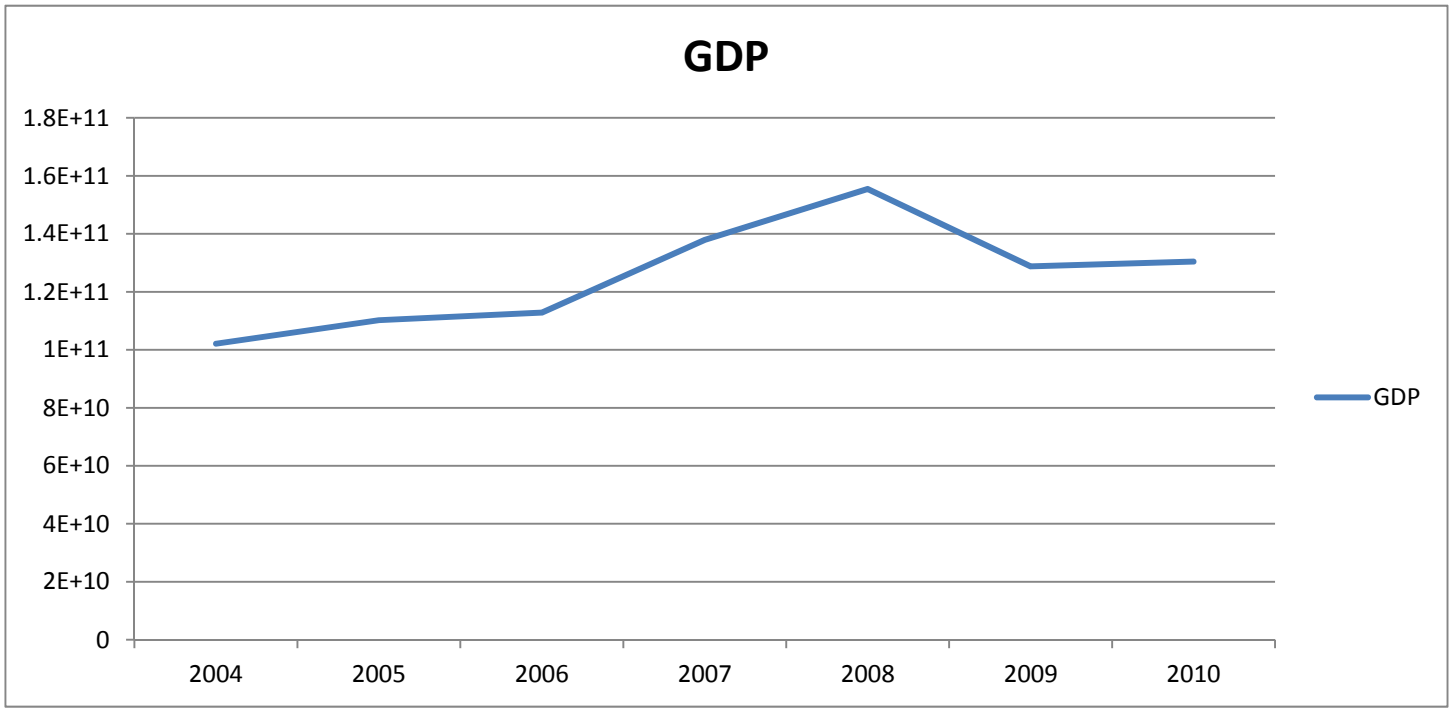


FIGURE B

FIGURE C

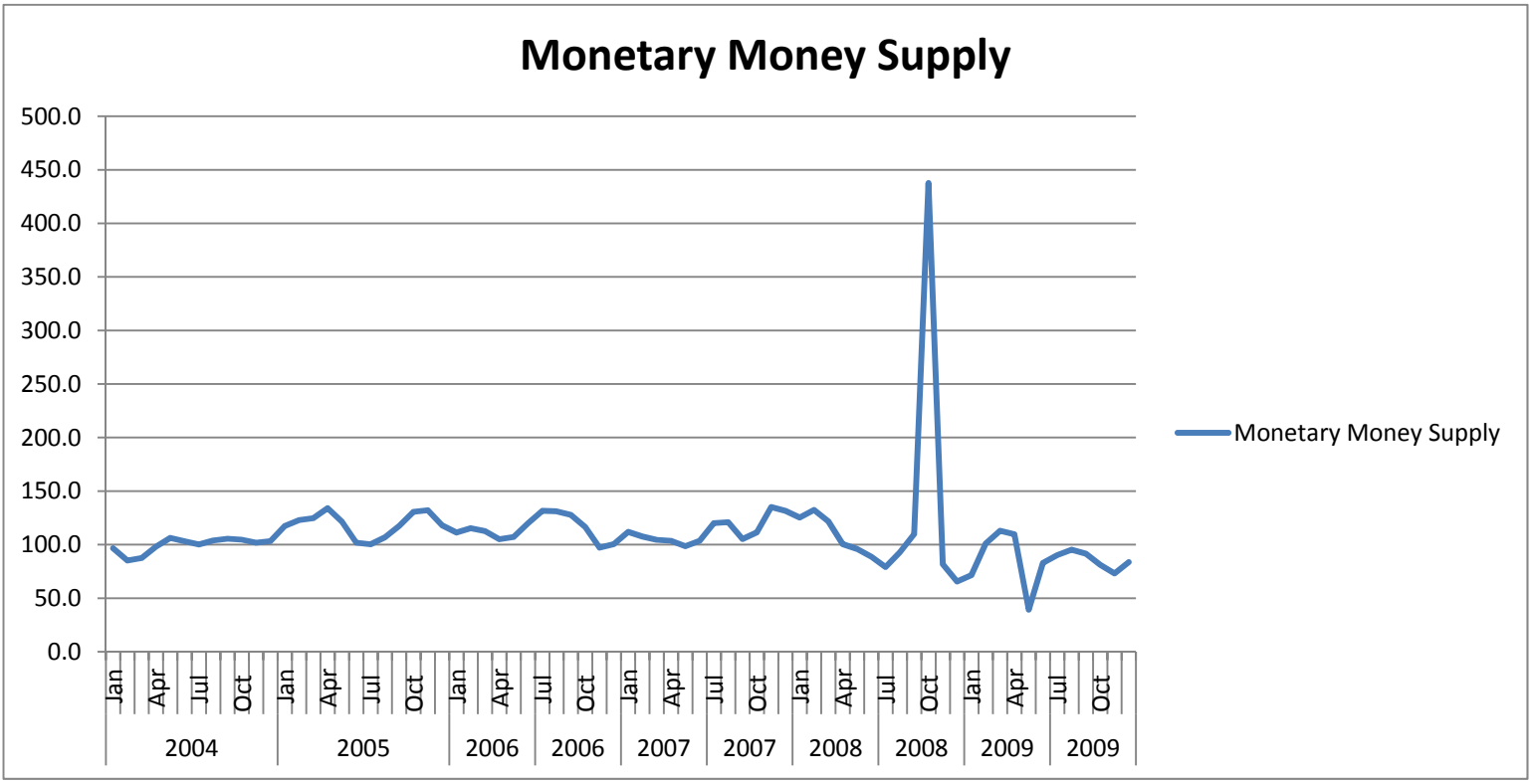


FIGURE D

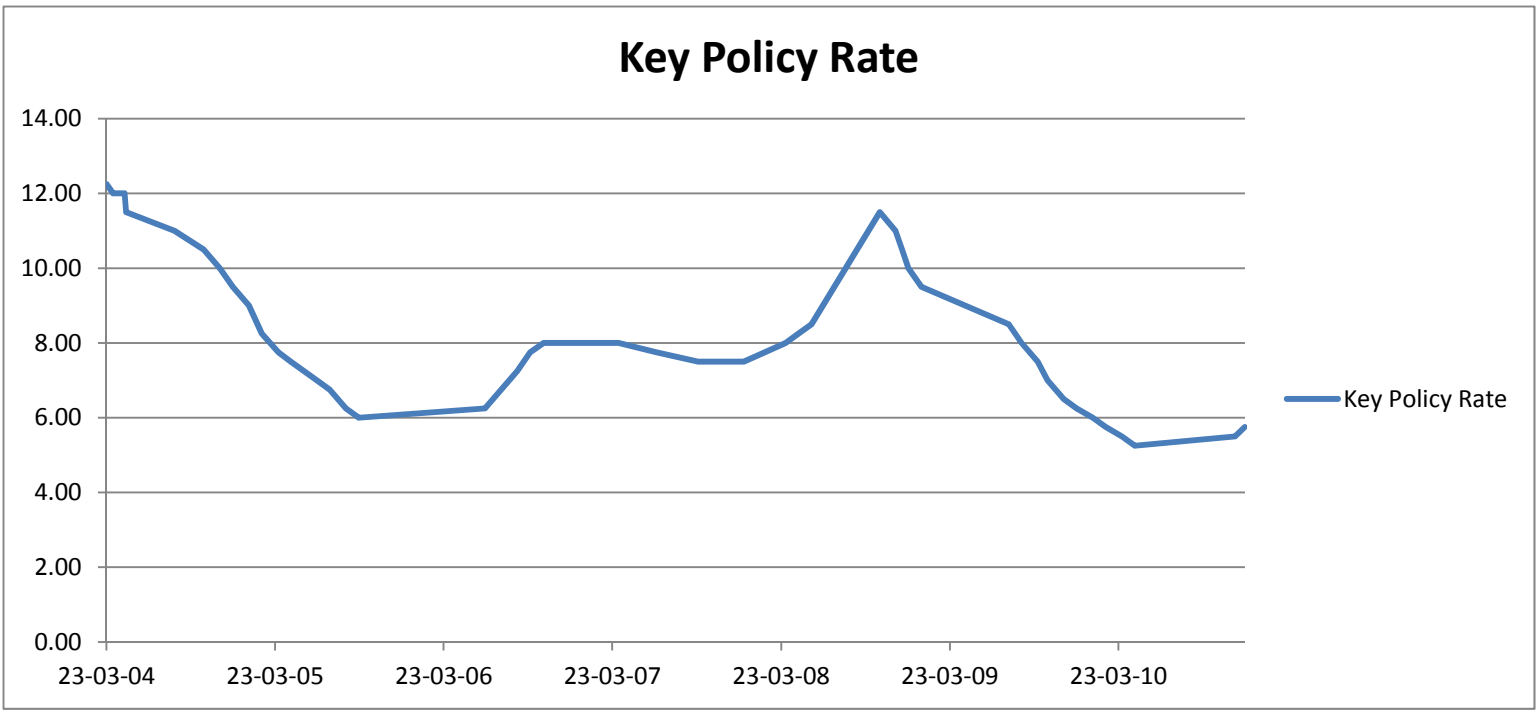


FIGURE E

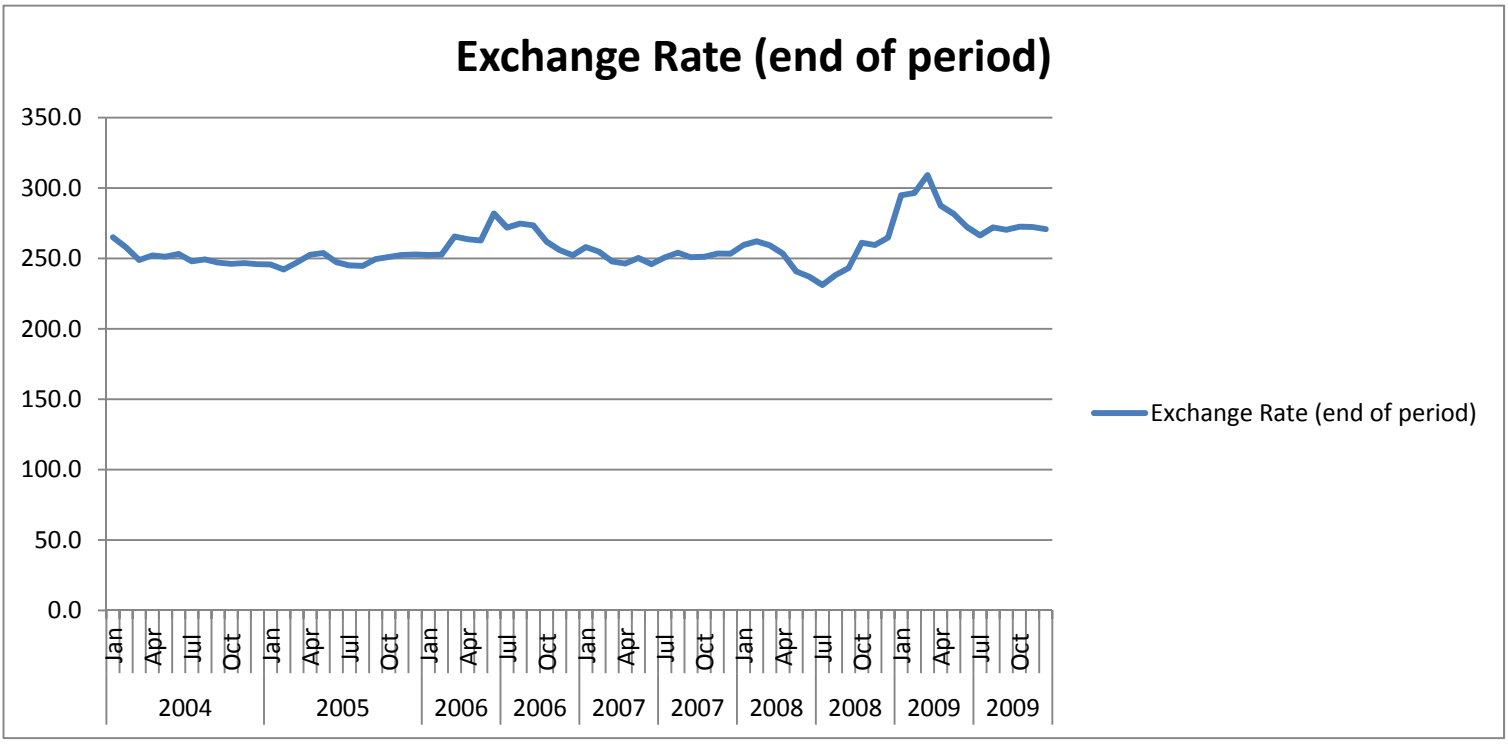


FIGURE F

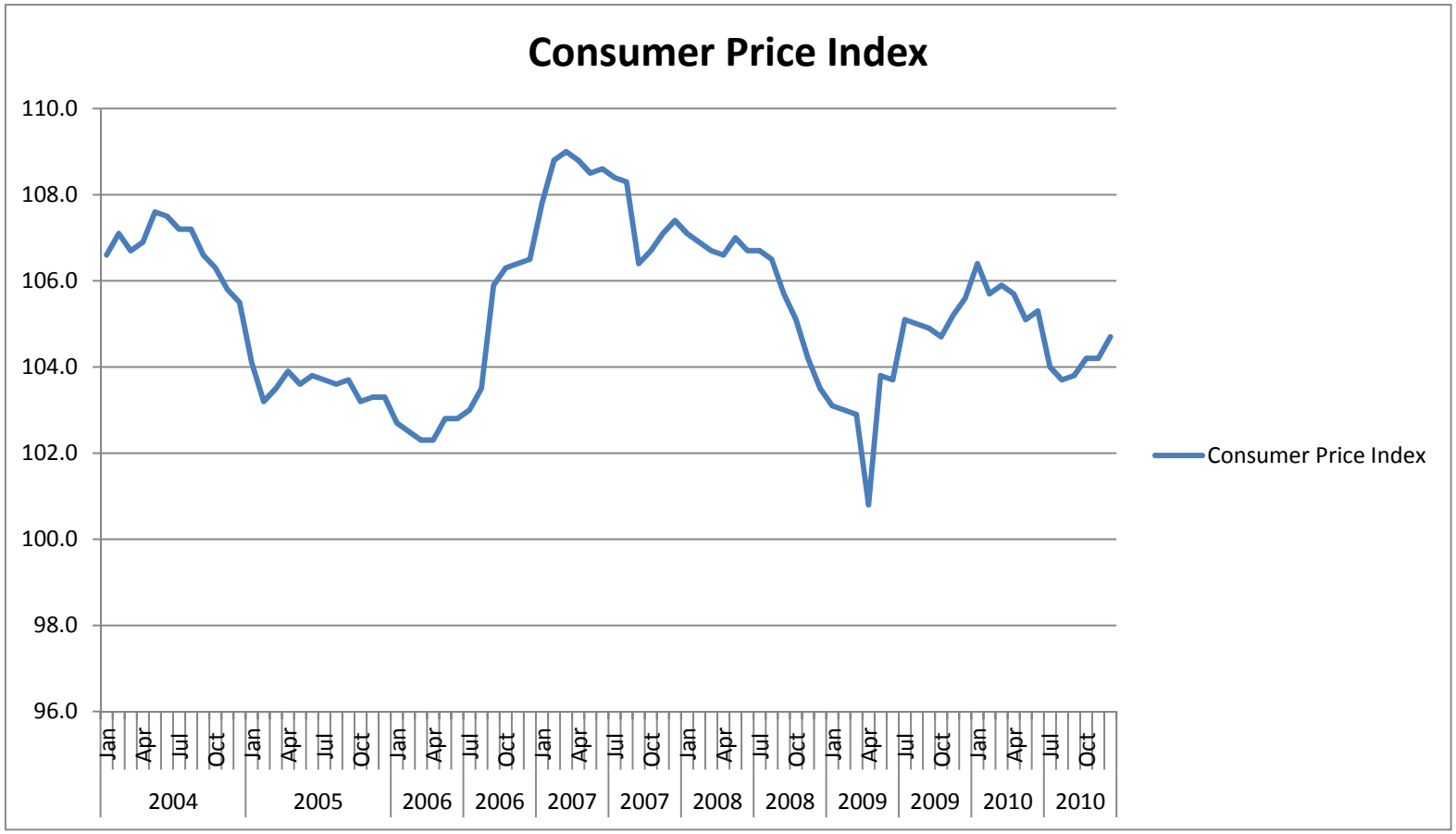


FIGURE G

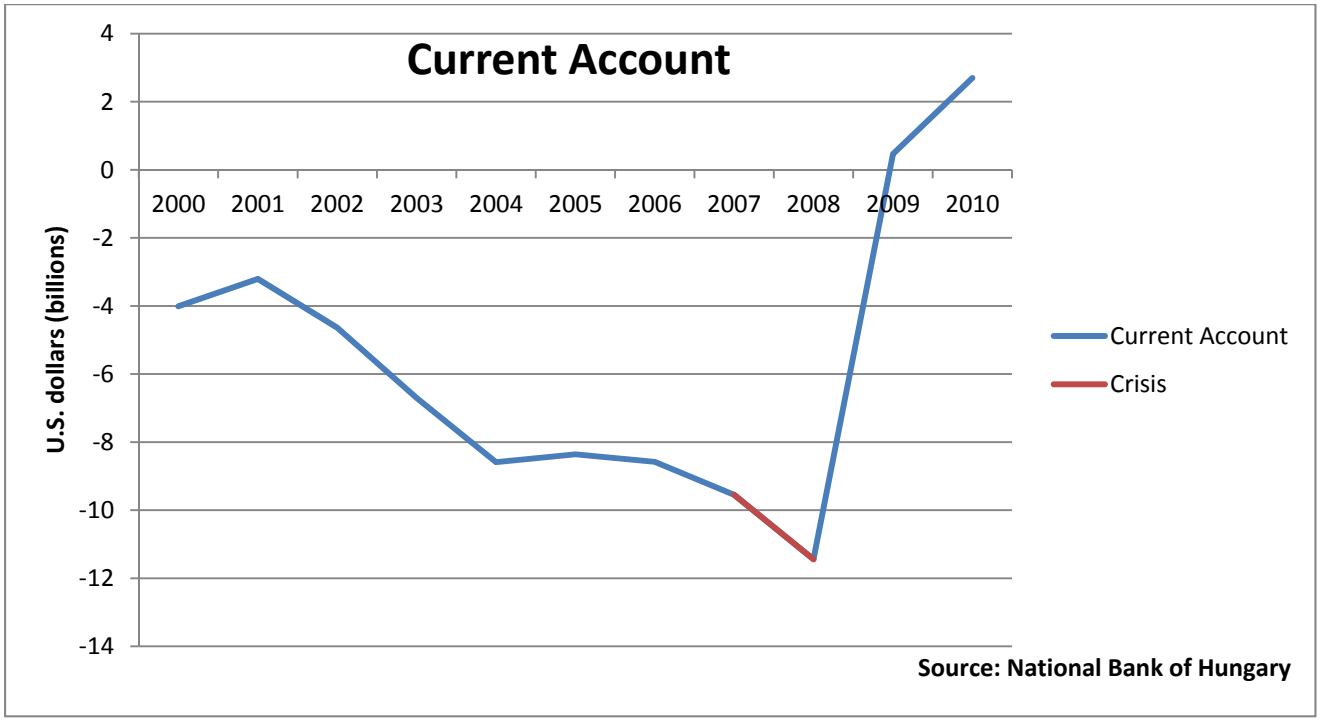


FIGURE H

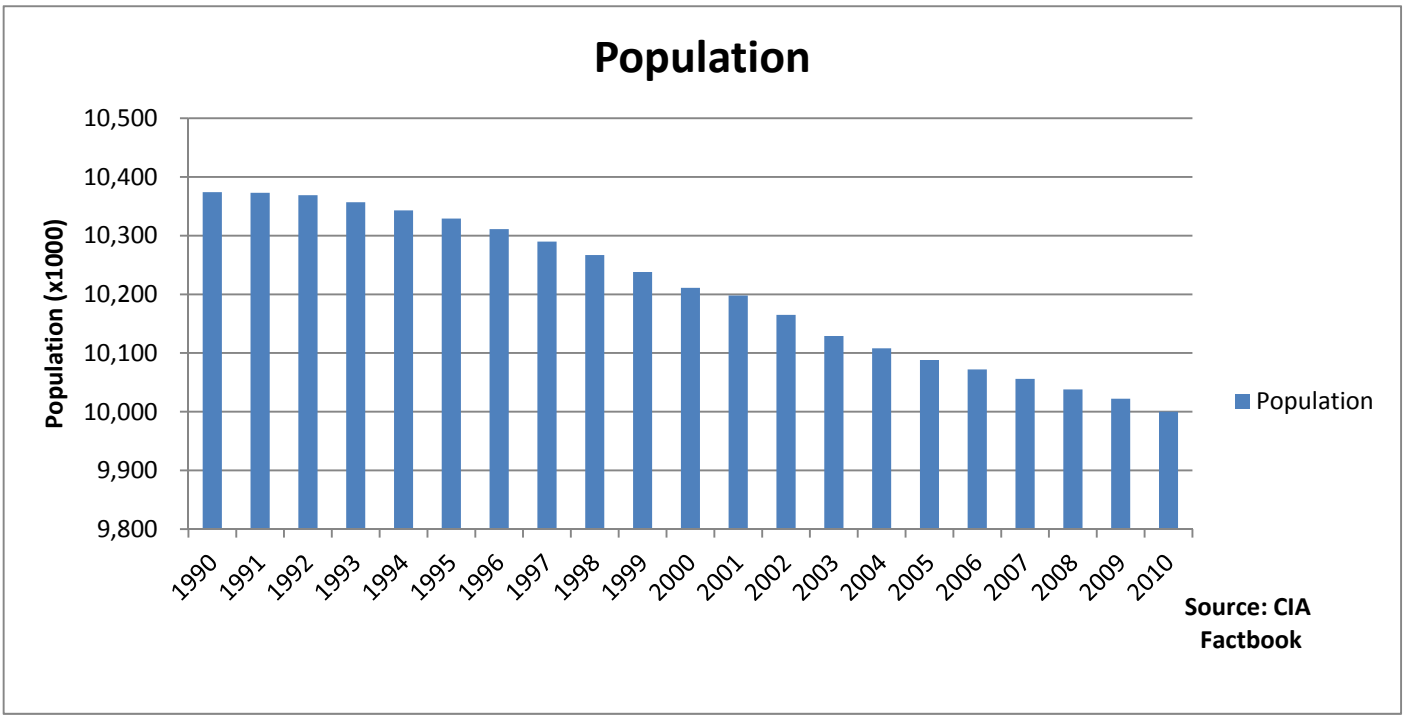


FIGURE I

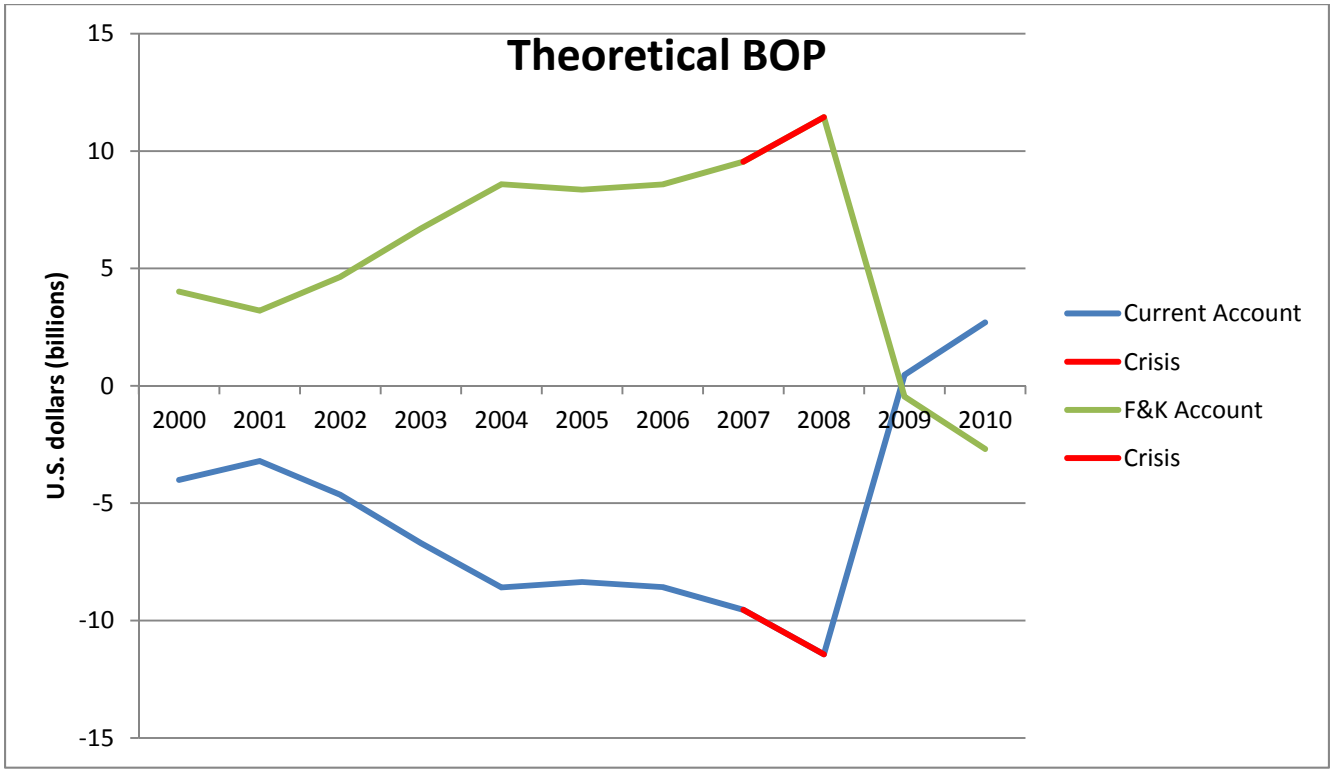


Figure J

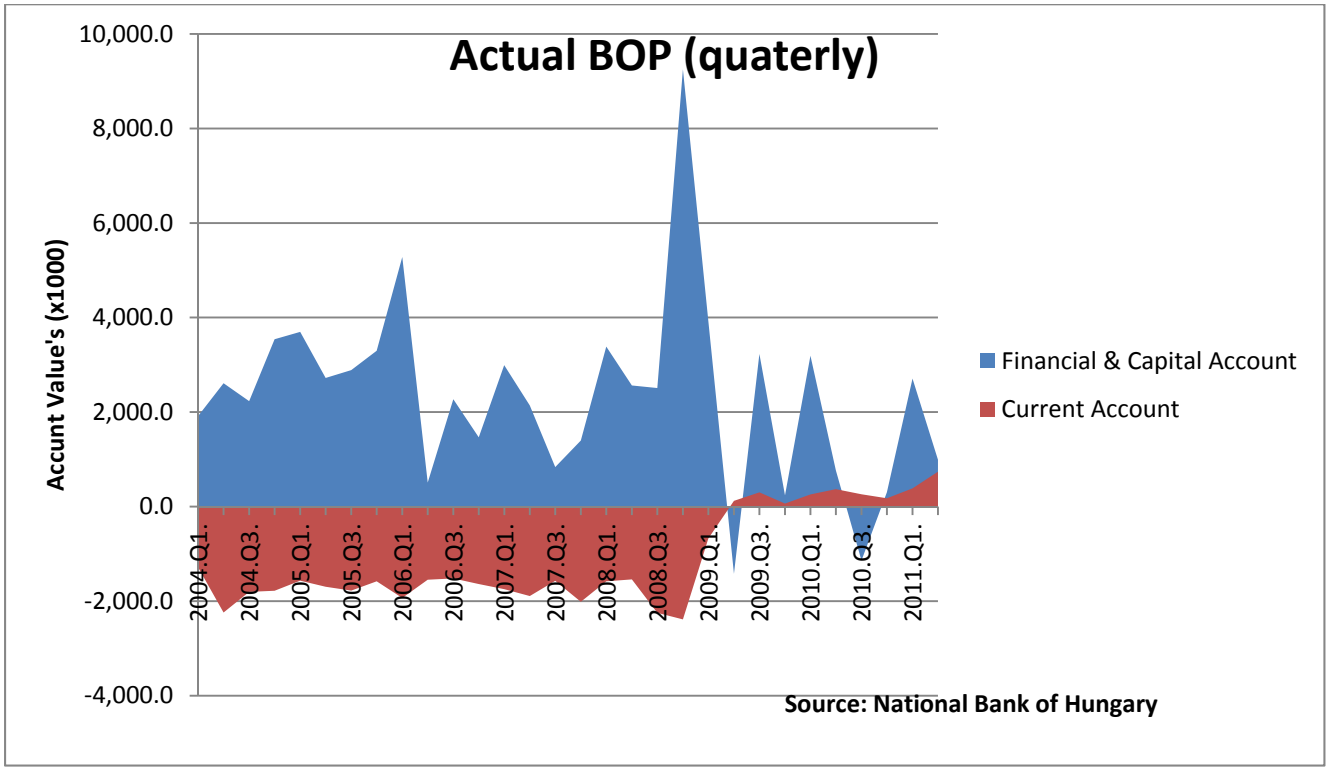


Figure K

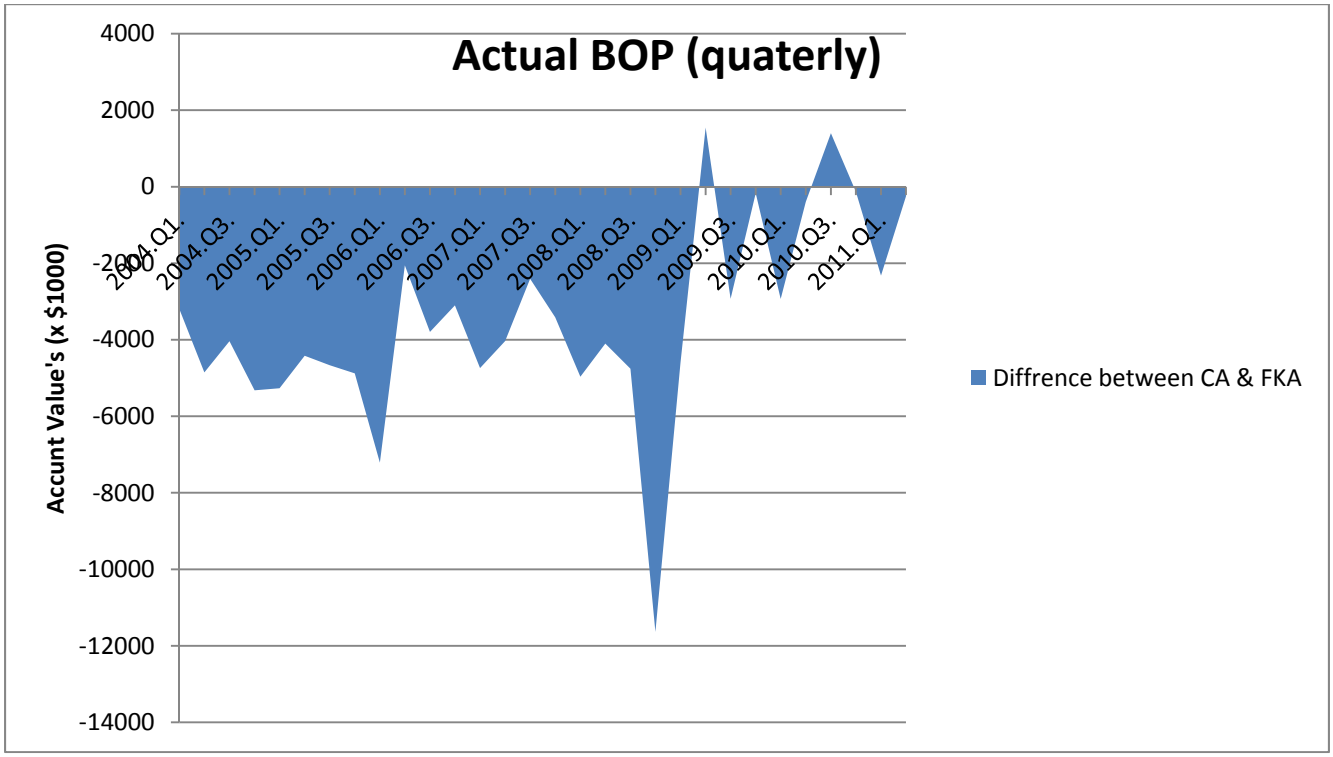
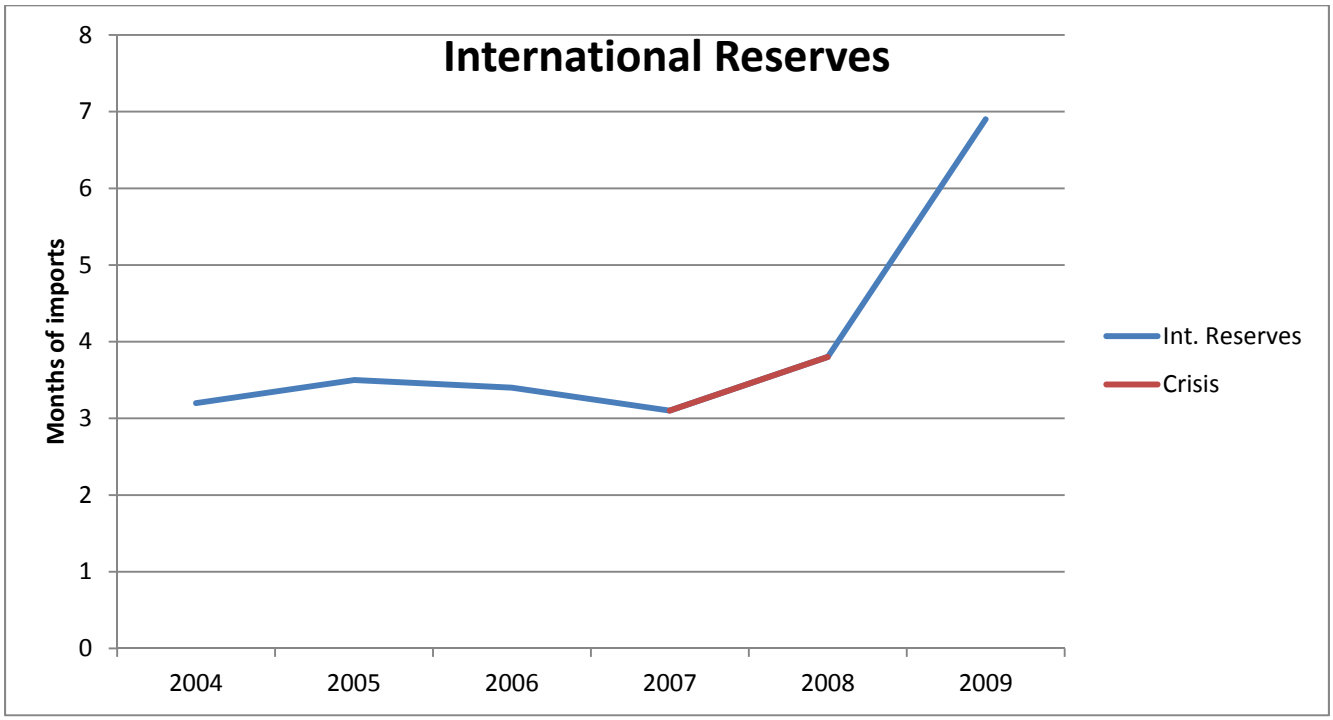


Figure L



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