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May 2016

# PANORAMA

# OVERVIEW OF HUNGARY

## Corporates: on the starting block for sustainable growth?

COFACE ECONOMIC PUBLICATIONS


**by Grzegorz Sielewicz,**
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Hungary is performing well, considering the context of struggling economies globally. Admittedly, since enjoying the podium position for growth among the CEE nations in 2014, Hungary has registered a slowdown, but with 2.9% in 2015 and 2.2% for this year (forecast by Coface), it is still benefitting from a moderately growing economy. Support from the EU budget will not boost Hungarian growth as much as it did in the previous two years – but with the acceleration of uptake of new EU funds, the positive effects will return next year. 2016 growth will be close to its potential (estimated at 2.5% by the National Bank of Hungary[1]), driven by private consumption, in turn strengthened by falling unemployment, higher disposable incomes, the public welfare programme and the resolution of problems surrounding foreign-currency mortgage loans. These all create opportunities for higher turnover for the retail sector, which is already benefitting from growing retail sales. The sector risk assessment provided in this Panorama shows that impacts are not only stemming from the country's internal environment and business conditions but also from developments in foreign markets. This is the case for the metals sector, which is suffering from the negative effects of low international commodity prices, in contrast with the transport sector. The automotive sector has benefitted from increasing demand in its core markets.

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DOSSIER

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**"Although Hungary will record a slower pace of growth this year, it is nevertheless forecast to reach a reasonable level, at 2.2%. While private consumption remains robust, economic activity has suffered from the adverse business environment, which is continuing to hamper the private sector's contribution to growth."**

## Has Hungary's corporate sector overcome the worst times - and will it be able to take the lead for growth?

The challenging budgetary situation and costly election promises have led the government to introduce measures aimed at increasing revenues. These measures, including sectorial taxes, have had a negative effect on companies. Although they were mainly designed to target foreign-owned companies, local entreprisese have also suffered. The pace and quantity of taxes and quasi-taxes being introduced has made companies refrain from business expansion, due to perceived uncertainty on the business environment. The entire corporate sector is still deleveraging, although small and medium companies (SMEs) have received support from the Funding for Growth Scheme, with its low interest rate loans and the conversion of FX loans incurred in the past. Business sentiment is on track to improve, with companies more confident about the economic outlook and the introduction of stimulus measures. However, this will still take some time, due to the challenging times that corporates have been through.

Coface's decision to upgrade the country's assessment to A4, in January this year, reflects its satisfactory economic growth and more favorable prospects for Hungarian companies, along with improved payment experiences. Nevertheless, Hungary still lags behind other peers in the Visegrad group, notably the Czech Republic, Poland and Slovakia – all of which enjoy A3 country risk assessments.

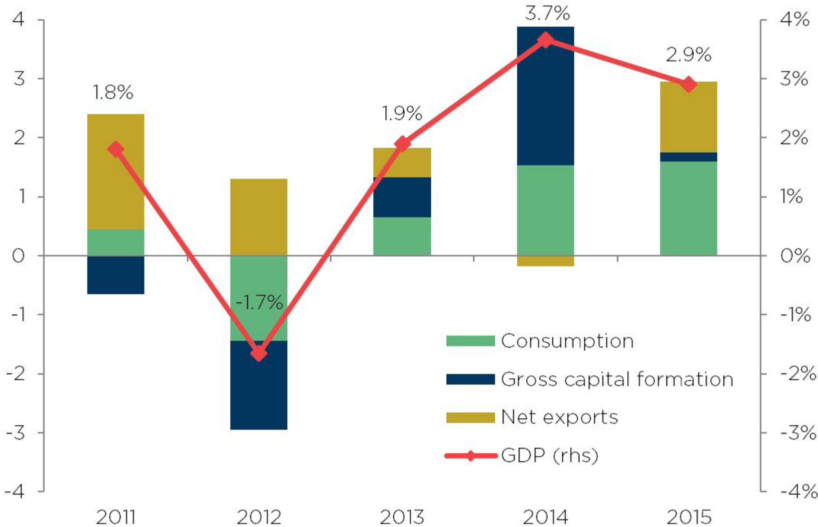
# 1 THE RISE IN POWER OF PRIVATE CONSUMPTION

**The Hungarian economy has entered into a solid growth phase.** By 2014 there was no trace of the recession recorded just two years previously (chart 1) and the growth rate of 3.7% made Hungary the leader in terms of economic activity in the Central and Eastern Europe (CEE) region. This was also one of the highest growth rates in the entire European Union[2]. Hungary's buoyant economic activity was the result of several factors. 2014 was a year of triple elections for Hungary – parliamentary, EU parliament and local. An effect of this has been the completion of a number of new and outstanding investment projects. There was strong support in the form of EU funds, which boosted fixed investments by 12% in 2014. Households benefitted from increased business activity and the more dynamic labour market. The unemployment rate fell from 10.2% in 2013, to 7.7% in 2014 - then down again, to 6.8% in 2015. This was partly due to a substantial enlargement in public workforce programmes and changes in calculations of the labour force residing outside the country. This significant reduction in unemployment was the highest in the whole of the EU last year.

[2] Higher 2014 growth rates were recorded by Ireland (5.2%), Luxembourg (4.1%) and Malta (4.1%).

**Although some drivers were one-off effects, growth remained solid in 2015, reaching 2.9%.** It was once again fueled by private consumption, while net exports also made a positive contribution. The 2015 growth rate was strongly enhanced by EU transfers - which had been high since 2013 but peaked in 2015. Net transfers from the EU amounted to 5.4% of GDP in 2013 and 5.3% in 2014, climbing to 6% in 2015 (the final year for using 'past' EU budget). EU transfers also aided public finances, by helping to keep the general government balance slightly below 2% last year (half of the EU transfers were disbursed to central government and municipalities). The Hungarian government intends to soften the effects of the decline in EU transfers by speeding up the allocation of funds from the current EU budget and implementing economic stimulus measures (in particular, measures from the central bank such as cutting interest rates and increasing supporting loans for SMEs). Nevertheless, a slower pace of growth will be recorded this year, with Coface forecasting 2.2%.

**Chart 1:**
Real GDP growth (%) and its contributions (percentage points)

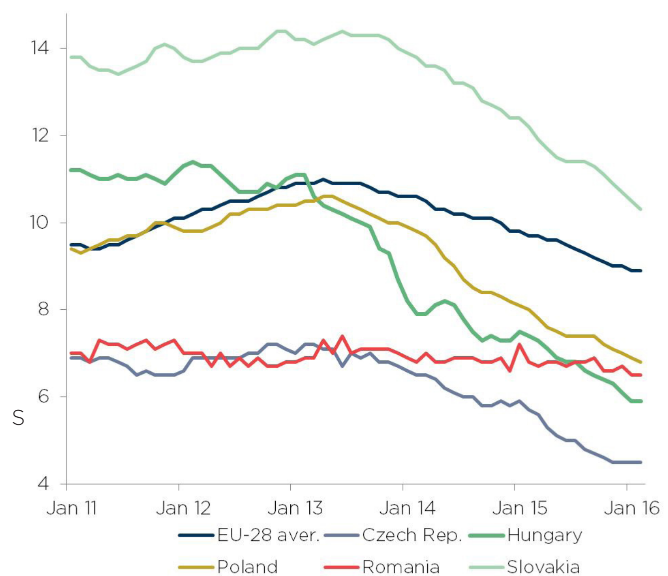



Source: Hungarian Central Statistical Office

**The strong contribution of private consumption to GDP, growth is mainly explained by the continued improvements on the labour market.** By the end of last year, the unemployment rate had dropped to 6.1%, which is considerably lower than the EU average of 9.0% at the time (chart 2). This is mainly due to a rising number of employees in the public and business sectors, as well as calculations concerning Hungarian nationals working abroad. More specifically, the public workfare programme, which was introduced in 2011, obliged the unemployed to join the public work force in order to keep their allowances once they had reached an unemployment period of 6 months. Increased budget expenditures due to the programme were mainly compensated for by the decrease in social allowances. The improved picture of the labour market has also been supported by growth in nominal wages, which increased by 4.3% last year. Low levels of consumer price inflation (HICP +0.1% in 2015 and 0.0% in 2014, following 1.7% in 2013 and 5.7% in 2012) were significantly impacted by low global commodity prices, which also made wages growth more evident in real terms.

Nevertheless, the labour shortage is a growing concern for some Hungarian companies, particularly those in manufacturing, health care, transport, construction and tourism. Low wages in Hungary, particularly in the west of the country, have increased the attractiveness of Austria - being a close destination with higher salaries. This is adding to the difficulties Hungarian companies are experiencing in filling job vacancies. The unemployment rate is expected to decrease further, although not on such a large scale as seen previously. A rising number of job offers, combined with difficulties in finding specialised employees, will keep the dynamics of wage growth solid. In 2016, the contribution from private consumption will remain strong. These growth dynamics will be supported by rising employment and wages, with lower credit burdens for households thanks to transfers from Hungarians working abroad and resolutions of the problems surrounding FX loans.

**Chart 2:**
Unemployment rate (%)

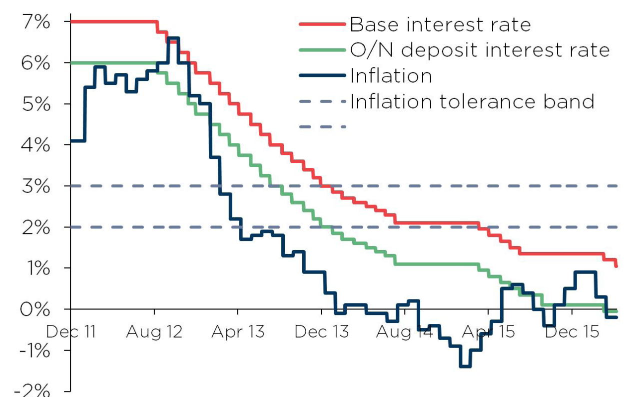



Source: Eurostat

**Government policies have also been supporting consumption via stimulus packages.** These packages have been particularly targeted to larger families, in order to tackle demographic issues, for example by providing support for new housing. A series of measures were implemented between 2010 and 2015 to resolve the problem of foreign currency loans. These measures helped to decrease systemic risks and brought relief for borrowers, thereby helping to boost consumer confidence and spending. As a reminder, FX loans constituted nearly 70% of all household and corporate loans in 2010. They were mainly incurred in Swiss francs for household mortgages, although other loans, including for consumption, were also financed by foreign currencies. The measures introduced between 2010 and 2015 by the Hungarian government and central bank, were successful in eliminating the risks connected to household loans in foreign currencies.

**Households also benefitted from the environment of low interest rates. Benchmark interest rates declined from 7% in 2012, to 1.35% in July 2015.** This trend of cuts has continued, with the main interest rate down to 1.20% in March this year, then to 1.05% in April, bringing the overnight deposit rate into negative territory (-0.05%). A subsequent communication from the central bank's Monetary Council indicated its ambition to achieve an inflation target of 3%, to continue with rate decreases and to conduct the easing cycle (probably over the coming months). This latest decision from the Hungarian central bank was likely hastened by the further monetary easing conducted by the European Central Bank a few days earlier - and the probability of more foreign inflows to Hungary, which would strengthen the forint, thus hurting Hungarian competitiveness. The Hungarian central bank is the first in the CEE region to introduce negative rates. Experience from developed economies has shown that these actions may help to boost exports (by encouraging currency depreciation) and supporting lending and domestic demand (by further easing credit conditions). On the other hand, negative rates could encourage floating rate loans, with risks of repayment problems when interest rates increase. Investors seeking a higher rate of return could suffer from excessive risk taking and banking profitability could be impacted[3]. Although inflation is still subject to externally-driven low commodity prices, the continued easing cycle could trigger an increase in domestic prices through more depreciation of the forint (thus increasing import prices), especially as food and beverages account for 21.3% of the CPI basket and energy for 16%. Headline CPI is expected to record an average of 1% for 2016, while the lower tolerance band of the MNB (National Bank of Hungary)'s inflationary target of 2% should be reached in 2017. While the Monetary Council has stated that it remains ready to use every instrument at its disposal to contain second-round inflationary effects, it should be noted that the effects of interest rate changes are usually seen in the real economy no earlier than 12 months from the rate setters' decision. Although the estimated output gap of around -0.3 percentage points is closing, negative inflation expectations remain stable. Further turbulence in the global economy and the possible rise of risk aversion, with sudden capital outflows, could be followed by actions from the central bank to adjust interest rate levels, or use its international reserves.

**Chart 3:**
Interest rates and inflation




Source: Central Bank of Hungary
Latest available data: April 2016

## 2 COMPANIES: DELEVERAGING, DESPITE STIMULUS MEASURES

Since its recession in 2012, Hungary's economy has rebounded quickly, delivering solid growth levels - particularly at the end of 2014. The country has benefitted from its economic openness (exports are equivalent to over 92% of GDP) and from the recovery of the Eurozone, its main trading partner.

**Fixed investments co-financed by EU funds contributed to activity, and were particularly evident in the foreign-owned automotive cluster.** The Hungarian government has been focusing on attracting foreign investors to its manufacturing sector, especially in the car industry. Direct investment flows for vehicle manufacturing reached a net of EUR 5.5 billion in the 2012-2014 period. The industry has been supported by various measures, such as tax incentives and the subsidisation of manufacturing plants. Hungary is the home to car factories for a number of important brands, inclu-

[3] "Negative interest rates in Europe", Global Economic Prospects, World Bank, June 2015

ding Audi, Mercedes, Suzuki and General Motors. As an example, the Hungarian plant in Győr develops and manufactures engines for Audi and other companies in the Volkswagen Group. Moreover, its output includes full production of Audi A3 Saloon, A3 Cabriolet, TT Coupé and TT Roadster models. Although, due to the VW diesel scandal, the company has reduced its investments at several sites, this has not affected the Hungarian base. A further HUF 32 billion (EUR 106 million) are to be invested in new models and technological developments, at Audi Hungaria Motor Ltd. in Győr, between 2015 and 2018. This will obviously create a larger number of jobs, in addition to the 11,000 people already employed there.

**In contrast, other sectors of the Hungarian economy, particularly those with a strong foreign capital presence, have been subjected to various new sectorial taxes.** The challenging situation faced by public finances, which deteriorated during the years of economic crisis, have made the government introduce financial burdens on banks, energy and telecommunication companies, as well as the biggest retailers. Despite the improvement of the budget situation and stronger growth, new taxes have been implemented - such as health tax, taxes on tobacco companies, food inspection fees, financial transaction taxes, taxes on chemical products and an internet tax (the latter of which was revoked following social unrest). Some of these taxes have been called into question by the EU Commission[4]. At the beginning of this year, the banking tax was lowered from 0.53%, to 0.31% of assets. An inspection fee, which hit the major food retail chains (a quasi-tax, also known as the 'Tesco tax'), was changed to a flat fee of 0.1% of turnover, regardless of company size. This followed concerns raised by the EU Commission that the food inspection fee selectively favoured firms with lower turnover. The pace and number of taxes introduced have increased uncertainty for all businesses, both foreign and domestic.

As previously mentioned, investments have mainly been fueled by foreign-owned automotive companies, while other businesses, including domestically-owned ones, have been relatively reluctant to take investment decisions. The idea of sectorial taxes was also taken up by Poland's new right-wing government, which took office at the end of last year. The new government intends to promote domestic business ownership and to seek financing for its costly election promises. The Polish government has already implemented a banking tax and the final form of a retail tax is being discussed – one which takes into account the European Commission's objections to the Hungarian equivalent.

**In order to encourage more investments, the Hungarian central bank (MNB) has been introducing a number of conventional, and less-conventional, measures.** Between 2012 and 2015, the Monetary Council decreased the benchmark rate by 565 basis points, in several steps (chart 3). It appears that the latest cut in rates, in March and April this year, could be the start of further easing. Besides numerous rate cuts, the Hungarian central bank has implemented unconventional measures to encourage lending and company investments. These measures have been targeted to small and medium enterprises, which constitute the bulk of the Hungarian economy (as is the business structure in most EU countries).

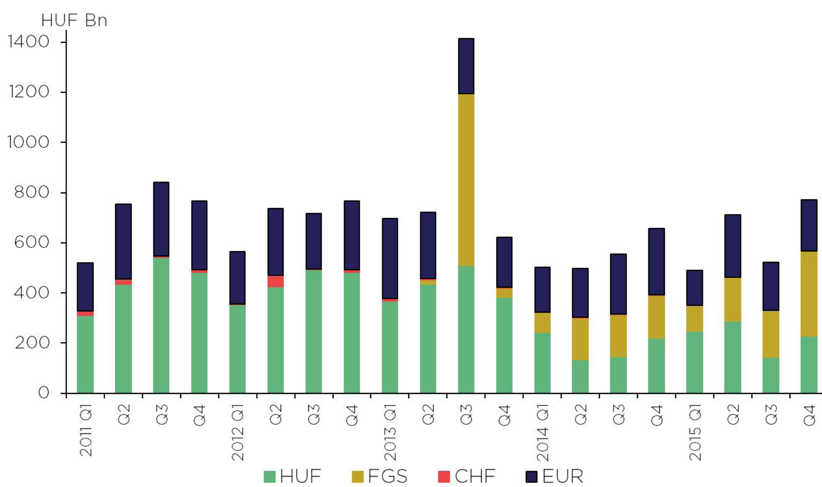
The first phase of **the central bank's Funding for Growth Scheme (FGS) was implemented in** June 2013. Funds were then capped at HUF 750 billion (ca. EUR 2.5 billion). The Scheme's objectives, to reduce barriers to the credit market and to strengthen competition, were supported by two pillars - the first being the allocation of HUF 472 billion to new investment loans (45%), new working capital loans (20%) and refinancing existing loans (35%). The second pillar was the dedication of HUF 229 billion to refinancing existing FX loans. Rates on loans were capped at 2.5%, significantly below the base rate of 4.5% effective in June 2013. The Scheme attracted companies from all sectors, although agriculture, manufacturing and trade accounted for a dominant share. **Due to high demand, at the end of 2013, the MNB decided to extended the FGS with funds capped at HUF 2trn (ca. EUR 6.6 billion).** The Scheme resulted in a significant fall in the interest burdens of enterprises. The average interest of converted loans decreased to 2.5%, from 5.9%, with the implementation of these two pillars. Companies also benefitted from the possibility of refinancing their FX loans and reducing their exchange rate exposure. The extension of the program, named the FGS+, included providing banks with non-interest funds which then were dedicated to low interest rate loans (up to 2.5%) for SMEs. It also applied to higher-risk entities, as the central bank accepted bearing part of the losses due to non-performing loans. The latest report from the central bank indicates that borrowing by SMEs is growing. Overall, new corporate loans reached HUF 771 billion (EUR 2.5 billion) in the fourth quarter of 2015 - a yearly growth dynamic of 17%. New lending was dominated by HUF-denominated loans, amounting to HUF 568 billion, while EUR-loans reached HUF 203 billion. The value of loans contracted under the Funding for Growth Scheme was almost HUF 338 billion (EUR 1.1 billion), 73% of the total volume of forint loans (chart 4).

As the end of 2015 was the deadline for Phase 2 of the FGS, there was particularly high demand in December. The deadline for the disbursement of concluded contracts will be the end of 2016. According to the MNB, up to 31 December 2015, the enterprises participating in Phase 2 of

[4] "Hungary to cut big fee on food retail chains after EU probe", Reuters, http://www.reuters.com/article/hungary-retail-idUSL8N12S4C320151028

the scheme accessed financing totaling HUF 1,402 billion which, together with the contracts concluded under FGS+, amount to HUF 1,425 billion (EUR 4.6 billion). Nearly 31,000 micro, small and medium enterprises participated in the two phases of the scheme, with loans of almost HUF 2,126 billion (EUR 6.8 billion). Approximately one-third of total loans outstanding to the SME sector were extended under the scheme.

**Chart 4:**
New corporate loans in the overall credit institution sector (HUF billion)




Source: MNB

**While new lending increased as indicated above, the level of outstanding loans throughout the entire corporate sector shows further deleveraging.** Besides short incidents of low positive dynamics in late 2014/early 2015, the corporate sector's outstanding loan portfolio has been decreasing (chart 5). Increased costs of companies' business activities, due to various new taxes and regulations, have led to uncertainty regarding future business conditions, causing the postponement of investments and financing by many corporates. The corporate loan portfolio contracted by 6.7% in the fourth quarter of 2015, but the central bank emphasised in its report[5] the fact that the annual growth rate was impacted by several one-off items. In previous periods, these included the debt consolidation of BKK (Centre for Budapest Transport) and the base effect of a large-volume syndicated loan, as well as the portfolio cleaning performed by MKB bank at the end of 2015. After deducting the effects of these factors, the annual rate of portfolio decrease is 2%.
In contrast, the loans extended by the banking system to the SME sector increased by 3.6% y/y. Corporate lending processes thus continue to show a dual trend, based on enterprise size.

**Chart 5:**
Growth rate of loans outstanding in the corporate sector (%)

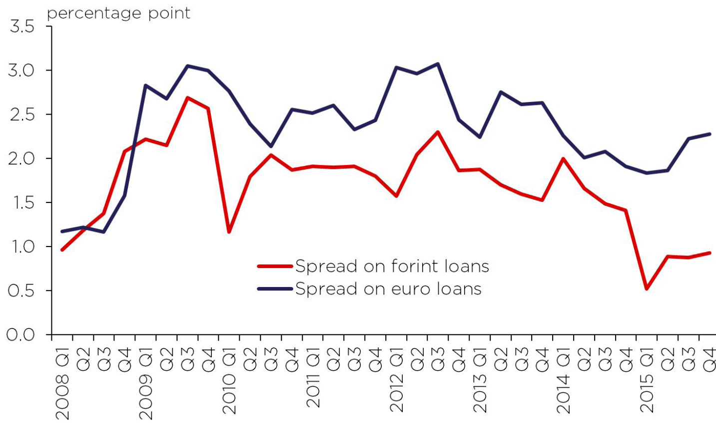
Source: MNB

The banking sector will benefit from improved economic conditions and probably growth in demand for loans. Nevertheless, a key issue will be the burden they are charged, even though at a lower rate than previously.

**Banks are expecting an increase in credit demand for loans, especially long-term ones.** In addition to the third phase of the FGS, support is coming from the Market-based Lending Scheme (MLS), which is the interest rate swap conditional on lending activity (LIRS). This instrument, which supports risk and liquidity management, has been launched to boost economic growth through lending to SMEs. By contracting LIRS transactions, banks make a quantified commitment to increasing their outstanding lending to SMEs. The MLS package of incentives comprised LIRS, complemented by a preferential deposit, incentives affecting banks' capital reserve requirements and access to a corporate credit information system that the central bank is setting up. Five tenders were held between 28 January and 24 March with the allocation of HUF 780 billion. This has resulted in the commitment by institutions to credit growth of HUF 195 billion, a 5% increase in the total SME loan portfolio for 2016. When including the last phase of FGS and bank lending outside LIRS tenders, SME lending could even increase by 10% this year, according to the MNB[6].

[5] "Trends in lending", Magyar Nemzeti Bank, February 2016
[6] http://bbj.hu/economy/mnb-banks-undertake-to-raise-sme-lending-by-huf-195-bln_113550

**Chart 6:**
Interest spreads on new corporate loans (percentage points, loans above EUR 1 million)

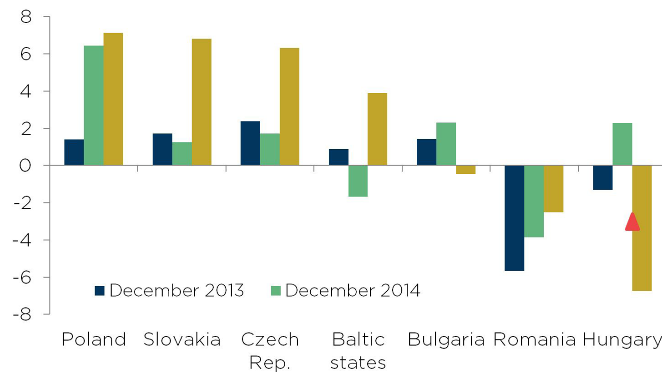



Note: Spread on the 3-month BUBOR and EURIBOR. Loans with floating interest, or with up to 1-year initial rate fixation.
Source: MNB

**The latest lending survey[7] shows that credit conditions for corporates have been loosening.** Whereas in the past (especially in 2013 and 2014), credit conditions for corporate loans that contributed to tightening mostly concerned the economic outlook and industry-specific problems, all factors in the new survey contribute to easing, with the greatest effects due the improved economic situation. At the same time, banks anticipate that the first half of this year will bring substantial demand for corporate loans – in fact, the highest number of banks for several years (except for a temporary peak recorded in 2013) are expecting this. Among the most important factors contributing to stronger demand, banks have indicated customers' investments, their inventory financing needs and accounts receivable financing requirements.

**Nevertheless, banks are facing the lowest interest rates in the history, as well as the newly introduced burden of the banking tax (which is a key issue).** Within this environment, interest rates for new corporate loans have also been been falling. Banks have been trying to compensate for this by slightly increasing spreads on loans, since the beginning of last year (chart 6). Despite this, regional comparisons show that interest rate spreads on corporate loans in domestic currencies remained the lowest in Hungary during the course of last year, closely followed by spreads in the Czech Republic, especially at the end of 2015. Nevertheless, the uncertainties and risks of possible further regulations have made businesses reluctant to invest and increase their financing from banks. Deleveraging was not experienced by most of Hungary's regional peers (chart 7). The highest annual growth rates for corporate loans were recorded by Poland, Slovakia and the Czech Republic, where the dynamics were in excess of 6% at the end of last year. In Hungary this growth was negative, at -6.7%[8].

**Chart 7:**
Annual transaction-based growth rate for corporate loans (%)




Note: The red triangle indicates the annual growth rate of corporate loans in Hungary, in December 2015, excluding the effect of one-off transactions.

Source: MNB

**Hungarian GDP growth is expected to remain solid, despite the unfavourable government measures that have impacted many businesses.** The government's attempts to boost economic growth (faced with a slower pace of EU funds this year) could bring results. However, the measures implemented by the Hungarian central bank will only yield significant results when corporates start to feel more comfortable about investing and expanding their businesses. It appears that companies are becoming more confident about the economic outlook, despite the massive 'inflow' of newly introduced taxes and that business sentiment is pointing to a gradual improvement over the next few months. Although the central bank is able to create conditions to support economic growth, it cannot force companies to incur loans if they remain reluctant to increase their capacities. Past experience of incentives with relatively low uptake have shown that corporates assess a variety of factors when making business decisions. There is therefore a risk that further stimuli will not achieve the desired result of increasing business activity.

[7] Lending survey, Magyar Nemzeti Bank, February 2016
[8] The annual growth rate reached -2.0% in the period, excluding the effect of one-off transactions due to afore-mentioned reasons.

# 3 HUNGARY SECTOR RISK ASSESSMENT

| SECTOR RISK ASSESSMENT | | |
|---|---|---|
| Sectors | Central and Eastern Europe | Hungary |
| Agrofood | Medium risk | Medium risk |
| Automotive | Medium risk | Medium risk |
| Chemical | Low risk ↘ Medium risk | Medium risk |
| Construction | Medium risk | Medium risk |
| Energy | High risk | High risk |
| Metals | High risk | High risk |
| Paper-wood | Medium risk | Medium risk |
| Pharmaceuticals | Medium risk | Medium risk |
| Retail | Medium risk | Low risk |
| Services | Medium risk | Medium risk |
| Textile-clothing | Medium risk | Medium risk |
| Transportation | High risk | High risk |

Source: Coface
* Information and communications technologies

Low risk; Medium risk; High risk; Very high risk
↗ The risk has improved
↘ The risk has deteriorated

## Automotive

**The automotive sector has become a major component of the Hungarian economy, thanks to government incentives offered to foreign car makers.** The industry accounts for almost 4.5% of the country's added value and over 10% of its total output. The sector is highly dependent on foreign demand, as the bulk of production is exported. It currently benefits from dynamic sales, particularly in Western Europe - although demand from Eastern Europe is also supporting export growth. Passenger vehicle registrations in the European Union grew by 9.3%, y/y, last year. Several major foreign manufacturers, such as Audi, Mercedes, Suzuki and General Motors, have production plants in Hungary. Despite the relatively good outlook for the automotive industry, with positive sales dynamics both domestically and on core foreign markets, the sector is concerned by some risks. Only moderate growth in car sales, of around 2%, is expected in the European Union this year. Although some time has passed since the revelation of the Volkswagen scandal over the manipulation of emissions' testing data, it cannot be excluded that VW will experience negative consequences. This would affect Hungary, where 2 million of the total of 11 million engines with the defective device were produced. Audi Hungaria, which is a part of the VW Group, accounted for 7.8% of the country's exports and 1.4% of GDP last year. According to MNB's estimations[9], a 10% fall in the global market share of the Volkswagen Group could lower Hungary's GDP by 0.2%, due the impact on its local unit and suppliers. On the other hand, last year was very successful for the Audi brand. It sold a record number of 1.8 million of vehicles worldwide - a growth of 3.5% y/y. Despite the company reducing its investments in several sites, this has not concerned the Hungarian plant - which will, in fact, be expanding over the coming years, with investments in new projects and developments. In the EU, passenger car registrations grew by over 8% in the first quarter of this year.

## Retail

**Private consumption is the main driving force behind the Hungarian economy.** The sizeable fall in unemployment over recent years has been beneficial for Hungarian households. This trend is expected to continue, thanks to the government's public works scheme and job creation in the private sector. Retail companies are benefitting from robust private consumption. This internal demand is being supported by fiscal measures, including the lowering of VAT and personal tax rates, as well as increases in allowances. The dynamics of retail sales have been solid in recent months, reaching an average of nearly 6% since 2015. This is double the average pace of growth recorded by the EU-28 during the same period. The resolution of the issue of foreign currency mortgage loans, which had a financial impact on borrowers, is continuing to bring support. Nevertheless, competition in the sector remains relatively intense and risks of further quasi-taxes that would impact retailers cannot be excluded.

## Transport

**The transport sector is benefitting from a blend of supportive conditions.** These include continued low oil prices and the improving economic situation of not just Hungary but the Eurozone market – the destination for the majority of Hungarian exports. Last year exports rose by 7.9% y/y, with trade to EU-28 countries reaching 9.5% y/y. Hungarian transport companies are significantly exposed to foreign markets, with international carriage accounting for nearly three-quarters of road haulage. This share is significantly higher than the EU-28 average of 35% but fairly in line with shares recorded by other CEE economies. Thanks to relatively low labour costs, Hungarian (and other CEE) transporters are able to compete for local carriage on the Eurozone markets. Measures recently introduced to protect some markets (such as in Germany, France and Norway) have impacted the profitability of CEE transport companies. Moreover, a further escalation of the migration crisis could hamper the transfer and free movement of goods. Extended transport times and higher costs would have negative effects on the sector and could lead to an increase in bankruptcies among transport companies.

[9] Inflation Report, Magyar Nemzeti Bank, December 2015

# 4 CONCLUSION

The Hungarian economy has been recording solid growth rates since its recession in 2012. EU funding has been an important contributor to growth, but by no means the only factor. The country's high pace of growth has been supported by government policies including monetary easing, more unconventional measures aimed at boosting SME lending and increasing public sector employment. The perspectives for the Hungarian economy and most of the country's main trading partners have been improving. Households have seen a growth in demand for labour from both the public and private sectors. They have also benefitted from the conversion of their foreign currency mortgage loans into domestic currency. Although the growth of 2.2% forecast for this year by Coface will be slower than the 2.9% achieved in 2015, this will mainly be due to the decrease in absorption of EU funds - which should speed up as from next year. Nevertheless, ongoing improvements in the labour market and fiscal measures (such as cuts in personal taxes and VAT rates), are supporting private consumption as the main driving force behind the economy.

The corporate sector has not been very lucky. The country's excessive public budget and debt levels have led the government to introduce measures aimed at increasing revenues. Businesses have been suffering from various taxes and quasi-taxes, which have included additional financial burdens for the country's banks, energy and telecommunication companies and biggest retailers. Despite improvements to the budget situation and stronger growth, further taxes have been implemented, such as a health tax, tax on tobacco companies, food inspection fees, taxes on financial transactions, taxes on chemical products and an internet tax (the latter of which was revoked due to social unrest). The possibility of further changes to the country's regulatory and legislative frameworks have caused uncertainty, making companies reluctant to invest and expand their businesses. The Hungarian central bank has implemented stimulus measures, including the substantial lowering of interest rates and the Funding for Growth Scheme, which provides low interest rates loans to SMEs. Nevertheless, the entire corporate sector has continued deleveraging. Additional measures to support further borrowing by SMEs may contribute to the country's economic activity, while among larger entities, the sentiment is that there could be improvements if no further tax burdens are implemented. Banks will feel some relief, as the banking tax was lowered at the beginning of this year and the government has announced that it will refrain from policy measures with negative impacts on banking sector profitability. However, it is unlikely that banks will bring down their high fees, following the difficult times when they not only endured the banking tax but also the costs related to limiting the share of foreign currency loans and their conversion to forint-denominated loans. Banks have, in fact, transferred most of the burden of the banking tax to their clients. Tariffs include charges on all bank transfers (including remittances between internal accounts), as well as ATM cash withdrawals.

The challenges in the corporate sector were particularly felt by foreign-owned entities. This did not apply, however, to the automotive sector, which benefitted from Hungary's preferential business climate. The automotive sector is a significant contributor to Hungary's economic activity, creating nearly 4.5% of the country's added value and over 10% of total output. The industry's relatively positive outlook is benefitting from the demand for Western Europe – the destination of most of its production - as well as from its continued cost competitiveness in comparison to other Eurozone plants which often suffer from overcapacities. The sector may suffer from the effects of the Volks-wagen scandal, due to a strong presence of the Group's FDI in the country, but it seems that this risk has been mitigated over recent months. The Hungarian sector risk assessment is being supported by the retail sector, which is benefitting from the dynamic labour market and improved consumer sentiment, leading to higher consumer spending. Household consumption will thus continue to be the main driver behind the Hungarian economy over the next few quarters. Nevertheless, high competition and additional tax burdens (although at low rates) are continuing to bring some risks to the sector and its profitability.

Faced with a slower pace of growth this year, Hungary's government and central bank have decided to increase other pillars of growth, besides support through EU funding (a component which significantly contributed to growth during previous periods). Business sentiment will still take some time to recover, following the challenging times that corporates have been experiencing. Nevertheless, companies are becoming more confident about the economic outlook and the central bank is continuing to create measures to discourage corporates from deleveraging and to help to boost the economy. It cannot, however, force companies to incur loans if they remain reluctant to expand their businesses.

**RESERVATION**
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