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Economic News

THE FINANCIAL MARKET CRISIS IN HUNGARY

Hungary: teetering on the brink

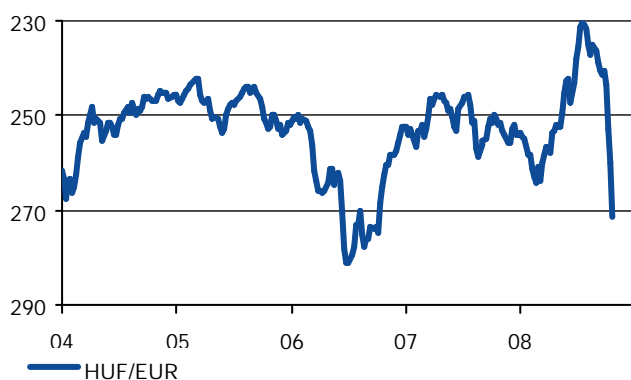
Hungary is also experiencing major dislocations on the capital markets as a result of the financial market turmoil. Although the country has witnessed several financial crises in recent years, it has not been confronted with such a critical situation for a long time. However, as both the IMF and the ECB are in close contact with the Hungarian authorities and have pledged their support, we assume that there will not be a default.

- Hungary is also facing major problems on the capital markets as a result of the financial market turmoil. The Hungarian forint has shed over 10% since early October. Trading on the Hungarian government bond market has virtually come to a standstill at times. The spread between Hungary's 10-year (forint-denominated) government bonds and Bunds is currently more than 600 basis points. International rating agencies S&P and Fitch have also announced that they will review Hungary's ratings and have downgraded its outlook to negative.
- Hungary has been prone to confidence problems for some time due to its unfavourable fundamental data. The current account deficit reached 5% of GDP last year and is also unlikely to contract significantly this year. Although the state deficit has been curtailed substantially thanks to the government's stringent austerity measures, at an estimated 3.8% of GDP this year, it remains clearly above the Maastricht target. Foreign debt has tripled during the last five years to around USD 150bn. Many households have increasing debt in foreign currencies such as in Euros or Swiss Francs due to the lower interest rate level.

Monika Wohlmann
+49 211 826-2221
monika.wohlmann@westlb.de

Hungarian Forint

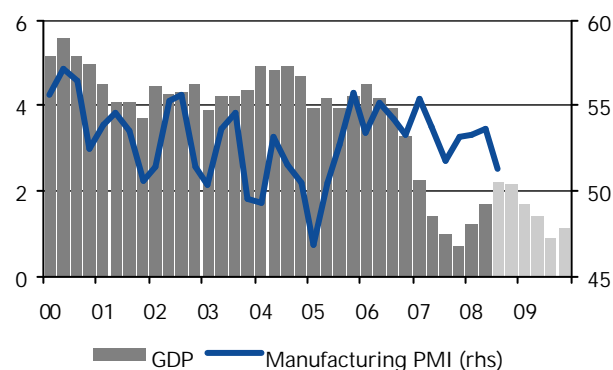
HUF/EUR



Source EcoWin, WestLB Research

Gross domestic product and PMI

% vs. previous year and index points



Source EcoWin, WestLB Research

- Last week, the IMF promised it would step in and provide Hungary with financial backing: "We are in close dialogue with the Hungarian authorities and the EU to discuss further responses to the current challenges, including possible technical and financial support by the IMF. I have informed the authorities that the IMF stands ready to assist their efforts." This aid, as is commonly the case for IMF programmes, will probably be linked to corresponding terms and conditions, e.g., a fiscal austerity package. The ECB is also in close touch with the Hungarian Central Bank and has provided it with a swap line worth up to €5bn, in order to make euro-denominated liquidity available. In addition, the Hungarian Central Bank has taken steps to stabilise the situation on the Hungarian money and capital markets by setting up two new credit facilities in order to be in a better position to provide the banking sector with liquidity. Besides this, agreements have been reached between the Hungarian Central Bank and the "primary dealers" on the Hungarian bond market in order to guarantee the operation of the market. Moreover, the Central Bank will purchase government bonds.
- Hungary has the highest base rate in the region at 8.50%. Although the prospects for the economy have deteriorated significantly, key rate cuts will probably not be on the cards for the time being. High interest rates are necessary to ensure an influx of foreign capital and prevent the currency devaluing any further. A stable Forint is not only required to fight inflation (inflation is falling in Hungary, but still very high at 6.5%). But a devaluation of the Forint would also increase the burden of servicing debt for households with debt in foreign currencies and therefore severely curb private consumption. We therefore only expect to see the first key rate cuts in H2 2009 – if the situation on the financial markets has recovered by then. For the short term, the Forint may well still be highly volatile. On a 6M horizon, we expect it to settle at a level of about HUF/EUR 260.
- Although Hungary has had to combat financial market crises on several occasions in years gone by, the situation has not been as serious for some considerable time. Unlike Iceland or the Ukraine, Hungary can benefit from being an EU member. The close cooperation with the ECB and the potential backing from the IMF, persuade us that it will not ultimately come to a default.
- The financial market crisis will take a heavy toll on the real economy: economic growth in 2007 was restricted by the government's stringent austerity package and the hesitant economic recovery seen this year may well come to an abrupt end. Following on from a growth rate of 1.8% this year, we expect to see a mere 1.3% for next year. This would therefore still be well below Hungary's potential growth.

FORECASTS				
%	current	in 3	in 6	in 12
		months		
Base rate	8.50	8.50	8.50	7.50
3M funds	8.95	8.8	8.6	7.8
10Y bonds	10.25	9.0	8.0	7.5
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% y/y	2007	2008	2009	
GDP	1.3	1.8	1.3	
Inflation	8.0	6.2	3.5	

WestLB AG
Herzogstrasse 15
D-40217 Düsseldorf

WestLB AG
London Branch
Woolgate Exchange
25 Basinghall Street
London EC2V 5HA
United Kingdom

T: +49 (0)211 826 71841
F: +49 (0)211 826 6154

T: +44 (0)20 7020 2000
F: +44 (0)20 7020 4209

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