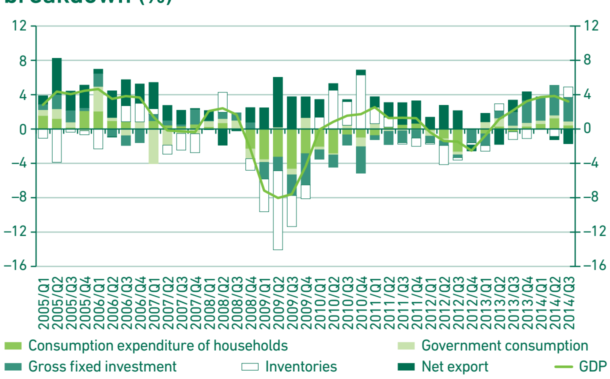
Macroeconomic and financial environment in 2014

MACROECONOMIC AND FINANCIAL TRENDS IN HUNGARY

In 2014 economic trends were the product of sluggish external demand, a supportive international money-market environment and strengthening domestic demand. In the eurozone, the economy picked up in the second half of the year, and several of the peripheral countries were also able to put the recessionary period behind them. The money-market environment was supportive; while the Fed began to phase out its quantitative easing program, the Bank of Japan and the European Central Bank both implemented further monetary easing measures. The strengthening of the dollar, falling commodity prices and the Russian conflict negatively impacted emerging markets, although the central and eastern European region, which is less dependent on raw materials, was affected only to a smaller degree.

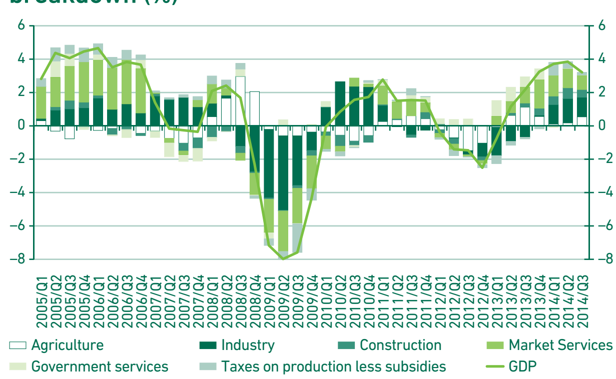
In 2014 the Hungarian economy expanded by 3.5%, following 1.5% growth in 2013. The trend of previous years, in which growth was essentially driven by net exports, came to an end last year. Instead of this, in 2014 the growth in capital investments was the main driver, while the contribution of net exports to growth turned negative following a long period of positive input. Besides capital investments, a degree of recovery was also seen in consumption; following the stagnation of 2013, household consumption expanded by around 1.5% in 2014.
As a combined effect of an election year and the end of the seven-year EU budget cycle, state investments grew at an extremely rapid pace, but in the private sector as well, fixed-asset accumulation began to expand. In terms of the latter, the main driver was car manufacturing, and the capacity expansions that were implemented in the supplier networks associated with it.

Hungary's GDP growth, in an expenditure-side breakdown (%)



Source: HCSO, OTP Research

Hungary's GDP growth, in a production-side breakdown (%)



Source: HCSO, OTP Research

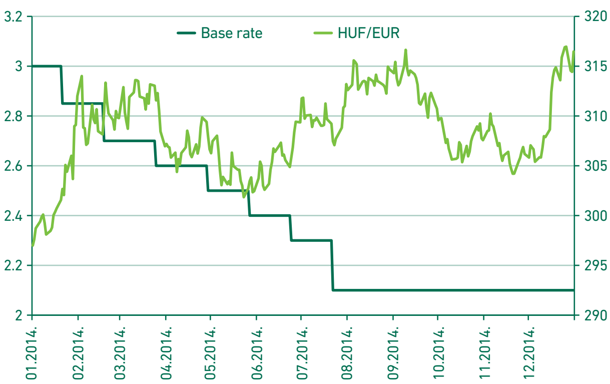
Following the stagnation of 2013, household consumption also increased in 2014. The rate of such consumption growth, however, was significantly lower than the rate of growth in real incomes, and thus household savings increased at a rapid pace. On the labour market there was significant improvement, mainly in the first half of the year; by the end of the year the growth in employment had come to a halt. The low interest rate environment and increasing real incomes also brought about a change in household investments, and thus household lending and home investments also began to rise.

Inflation, from what had been a record low of 1.7% in 2013, continued to fall, with consumer prices decreasing by 0.2% over the year as a whole. Besides various government measures, the drop in inflation was also due to falling agricultural prices and, in the last third of the year, to plummeting oil prices too.

The further fall in inflation prompted a continuation in the first half of the year of the rate-cutting cycle, which closed with a 20 bps cut in July, at 2.1%.

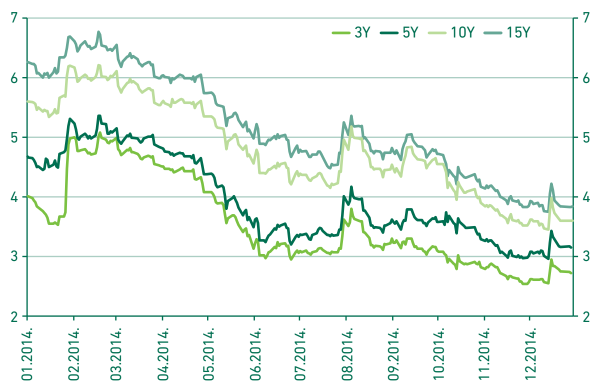
As a result of the supportive international environment (liquidity abundance), yields continued to drop in the government securities market.

HUF/EUR rate and base interest rate



Source: Reuters, MNB (National Bank of Hungary), OTP Research

Change in government bond yields (%)



Source: ÁKK (Hungarian Debt Management Agency), OTP Research

From February on, the forint remained mainly in the 305–315 HUF/EUR band, with the Hungarian currency depreciating some 5% over the year as a whole.

MACROECONOMIC AND FINANCIAL TRENDS IN THE COUNTRIES OF OTP BANK'S FOREIGN SUBSIDIARIES

The economic performance of the countries of OTP's foreign subsidiaries was mixed. Most of these countries suffered from the weak growth of the eurozone, which acted as a break on exports. Despite this, economic growth, at 2.5–3.5%, was highest in the economies that are the most tightly integrated with the European Union – Hungary, Slovakia and Romania. Besides the increase in EU funds that accompanied the end of the seven-year budget cycle, this was also due to the fact that in these latter countries, the macroeconomic balance had been restored by 2013; there was no need for any further austerity measures, and domestic demand was free to rise, thus reducing the reliance on exports. The countries of the Balkan region, however, are still struggling with budgetary or with external balance problems, which in most of these countries served to limit domestic demand.

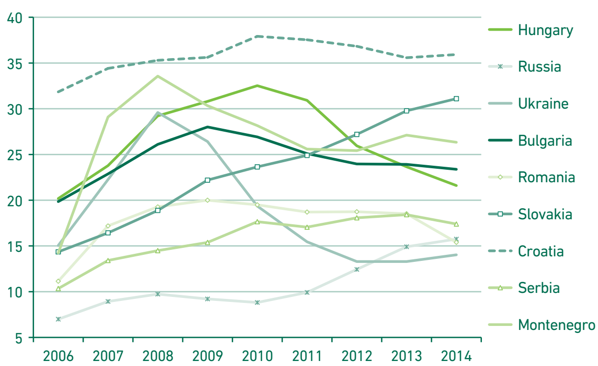
Due to this, in Croatia the recession continued, while Serbia found itself back in recession following a year of growth. Bulgaria, in terms of its location and economic structure, is most closely associated with this second group of countries: here, growth accelerated slightly, but remained below two percent, despite the fact that it supported the economy through a marked increase in its budget deficit.
In the third group, the macroeconomic outlook deteriorated significantly in commodity-exporting Russia and in Ukraine last year. In Russia, due to the sanctions resulting from the deepening conflict with Ukraine and to the dramatic fall in the price of oil, GDP growth slowed considerably, to 0.5%, while the rouble weakened against the dollar from 37 in early September to 58 at the end of December. Although the 76% y-o-y depreciation effectively offsets the impact of a

fall in the price of oil on rouble-denominated budgetary and export revenues, it raises the spectre of a serious recession on a number of fronts. For one, the Russian central bank, in order to guard against market turbulence, raised the benchmark rate by 10.5 ppts to 17% during the year, and this, together with increased payments on corporate foreign-currency loans, is restricting investment activity. While foreign-currency exposure is notably low in the Russian economy, and thus in the medium term the country stands to gain from the depreciation of its currency in terms of greater competitiveness, the weaker exchange rate comes with a cost: annual inflation rose to 11.4% by December. This is leading to a drop in real wages not seen for a long time, thus reining in consumption. The balance-of-payments position remains stable, but the USD 131 billion net capital outflow from the country last year is a call to caution. The central bank's reserves stood at USD 389 billion at the end of December, which is nearly four times the required level.

In Ukraine there was a revolution at the start of 2014, which brought an end to the presidency of Viktor Yanukovych. In response, Russia carved off and effectively annexed the Crimean peninsula, and lent its support to eastern Ukrainian separatists, as a result of which matters soon deteriorated into a situation of armed conflict in Donetsk and Lugansk. Due to the flight of capital from the country, and despite a loan package from the IMF, the hryvnia depreciated by 92% over the year. The Ukrainian central bank raised its benchmark rate by 7.5 ppts to 14% over the course of the year. Industrial output dropped by 10.7% over the year, and GDP fell by 7.5%. By December, inflation had increased to 24.9% y-o-y, partly because household gas prices had risen from April. National debt doubled (to 66%) between the end of 2013 and the end of 2014.

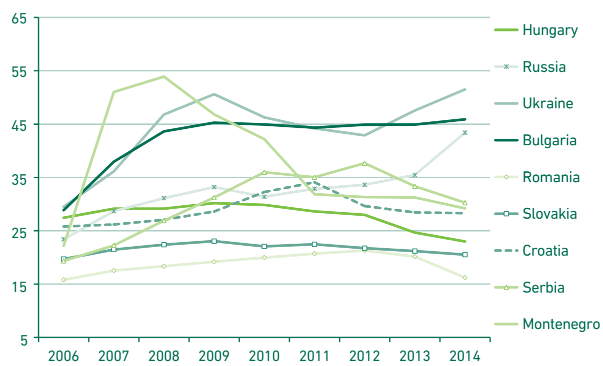
In terms of the banking markets, there continues to be considerable variation between the countries of the region. In Ukraine, Romania and Croatia, net lending, in both the retail and the corporate sectors, was negative. By contrast, in Russia and Slovakia, the volume of both retail and corporate loans grew. In the other countries, net lending to households was generally positive, while the corporate sector repaid more credit than it took up.

Retail loans of the bank sector (as a percentage of GDP)



Source: National banks, OTP Research

Corporate loans of the bank sector to non-financial companies (as a percentage of GDP)



Source: National banks, OTP Research