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Country Profile: Hungary

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It has never been more important for you to understand what is occurring in the world beyond your country's borders. Whether you realize it or not, we are now all fellow citizens...Global Citizens.

The Thomas White organization was founded in 1992 with the goal of bringing the benefits of globalization to investors around the world. We believed that once investors understood that globalization was a positive force, they would also see the advantages of adding international equities to their portfolios. It only makes common sense that professional investors would begin searching the globe for the most attractive opportunities. Researching a wider universe of companies should improve long-term performance. Moreover, broad diversification typically lowers return volatility. Multinational corporations have been using this global strategy for years; why shouldn't investors do the same?

Now 15 years later, our firm growth and strong subsequent portfolio performance has confirmed our investment premise. Currently, Thomas White professionals are performing research and managing over one billion dollars in close to 50 countries. We believe one reason for our success is that the nationalities of these analysts are as globally diverse as our portfolios.

A handwritten signature in black ink that reads "John S. White, Jr." The signature is written in a cursive, flowing style.

Hungary: Emerging Economic Power in Central and Eastern Europe



Culturally rich, Hungary boasts of architectural marvels, displaying Gothic, baroque and Transylvanian styles. The 300 year old Festetics Palace in Keszthely, the oldest town in the Balaton region, stands testimony to the country's architectural treasures.

One of the most prosperous countries in Central and Eastern Europe, Hungary enjoys the status of an upper middle-income economy, as classified by the World Bank. The country transitioned from communism to a free-market economy with relative ease in comparison to its peers. Gaining entry into the European Union (EU) in 2004, Hungary was one of the first erstwhile communist countries to apply for membership to the bloc. The country was also a dominant force in hastening the collapse of communism across Eastern Europe in 1989, when it opened its border with Austria, allowing East Germans to escape to the west. A cultural treasure trove, Hungary boasts of a rich tradition of folk and classical music, touting some of the world's greatest composers. Nestled along the Danube River basin, Hungary is a landlocked state, sharing its boundaries with Slovakia, Ukraine, Romania, Serbia, Croatia, Slovenia and [Austria](#).

As the home to Lake Balaton, the largest lake in Central Europe, the country is also a popular tourist destination and Budapest, its capital, regarded as one of the most beautiful urban landscapes in the world.

A turbulent past

Hungary, as we know it today included Dacia and Pannonia, provinces situated on the periphery of the ancient Roman Empire. It was one of the first to be seized by the Germanic tribes in the second century A.D. Subsequently, the region fell to the Huns and after the death of Attila the Hun, a brief German occupation followed. The Avars, an Asian tribe, gained control of the region in the fifth century followed by Moravians, the Slavic people.

Towards the end of the eighth century, Charlemagne, the king of the Franks, expanded the region under the umbrella of his domain. By the end of the ninth century, the Magyars, a Finno-Ugric tribe took control of Pannonia, as well as large parts of Central Europe for over half a century. They were defeated by the Holy Roman Emperor Otto I in 955 A.D., and with this, Christianity and the Western culture began to penetrate Hungary. Thereafter, the Magyars maintained cordial relations with the Holy Roman Empire, and the Hungarian state was founded in 1000 A.D., with Stephen I, a descendent of the Magyars, getting formal recognition as the king.

In 1526, the Ottomans attacked the kingdom of Hungary, which was partitioned between Austria, the Ottomans and a region called Transylvania. By 1699, however, Austria took control of all of Hungary, with the Habsburg dynasty at the helm. Social unrest under the Austrian rule led to an unsuccessful uprising in 1848 and eventually the military defeat of the Austro-Hungarian monarchy in 1918. A treaty in 1920 substantially reduced Hungary's territory and population, with a communist government rising to power in an era of conservative rule until World

| Hungary and the World | |
|------------------------------|---|
| Nominal GDP (\$) | 154.67 billion |
| GDP Rank | 51/186 |
| Per Capita GNI (\$) | 12,810 |
| Per Capita GNI Rank | 66/210 |
| Population Rank | 82/227 |
| Geographical Area Rank | 116/250 |
| Global Competitiveness Rank | 58/133 |
| Economic Freedom Index Rank | 44/179 |
| Human Development Index Rank | 43/182 |
| Major Industries | Automobiles, Information and Communications Technology, Electronics, Renewable Energy, Shared Services, Logistics, Pharmaceuticals & Biotechnology. |

War II.

After a brief German occupation during World War II, Hungary witnessed the strong military presence of Soviet troops, which had routed the Germans in the war. This was followed by a forced Soviet-backed communist government accompanied with political instability. The Hungarian revolution of 1956 against the Soviet-supported communist government was unsuccessful. The communist era finally withered away with major political upheavals happening across the communist states of Central and Eastern Europe in the late 1980s. By 1990, a multiparty political system had been established in Hungary, with an emphasis on a free market economy. The 1990 election was won by the center-right Hungarian Democratic Forum (MDF) and József Antall became the first democratically-elected prime minister of Hungary. The Socialists came back to power in 1994, losing briefly to the center-right Fidesz in 1998, but regaining control of the government beginning in 2002. Irrespective of the ideologies of the political parties, the economic reform process as well as steady movement towards the market mechanism continued.

But the government of Hungarian Prime Minister Ferenc Gyurcsany fell prey to the economic recession that began in the fourth quarter of 2008. Amid public outcry in March 2009, he resigned, over the government's controversial handling of the economic crisis. Gordon Bajnai was appointed by the ruling Socialist Party, until the general elections in April 2010. The election outcome resulted in a major political upheaval, with Hungary's conservative opposition party, Fidesz, ousting the ruling Socialists. Fidesz leader Viktor Orban is set to take over the reins as the next Prime Minister, marking the end of the eight-year reign of the Socialists.



An artisan delicately hand paints a piece of Herend porcelain china, one of Hungary's most sought after decorative arts.

Rich folk tradition blends with an ancient Spa culture

The population of Hungary predominantly consists of Magyars, an ethnic group that inhabited the region from the 11th century onwards. While the Magyars constitute more than 90% of the population, the country is home to minorities such as Gypsies, Germans, and Serbs, among others. While over half

the people are Roman Catholic, there is also a significant Calvinist minority. Hungary is also home to the largest Jewish population in Central and Eastern Europe.

With this, Hungary is a pot-pourri of diverse cultural influences beautifully woven into its rubric. The country has a rich folk art as well as music tradition, ranging from folk and gypsy music to classical rhapsodies. Prominent composers that hail from Hungary include Liszt, Béla Kun, Dohnányi, Bartók, Kodály, and Rózsa.

Decorative arts, including intricate embroidery, decorated pottery and carving are some of Hungary's specialties. But it is Herend Porcelain china that is the most coveted among Hungary's artistic treasures. In the mid-19th century the company supplied the Habsburg Dynasty as well as several aristocratic customers throughout Europe. Many of its classic motifs, such as the iconic Rothchild Bird pattern, are still produced today.

The country also boasts of a rich literary heritage, though the limitation of the Hungarian language has prevented writers and poets from gaining widespread international acclaim. Notable writers include Imre Kertesz, who won the Nobel Prize in Literature in 2002, and Sandor Marai, the first person to write reviews on the work of Franz Kafka, a prominent Czech literary figure. Another illustrious Hungarian is Albert Szent-Györgyi, who discovered the existence of Vitamin C.

Hungarian cuisine is as varied as the ingredients in the world famous *Goulash*, a kind of a stew or *Paprikas*, a delicacy made of diced meat and mushrooms. In fact, paprika flavoring is a Hungarian invention. Some famed desserts include the *Dobos cake* and *strudels*.

Home to about 1500 thermal springs, Hungary has a 2000 year old spa culture, blending Roman, Greek and Turkish influences, reflected in the architectural design of the spas. Budapest is endowed with the richest supply of thermal water among all the world capital cities, and almost 80% of the country's area harbors ample thermal water. Widely renowned to be therapeutic, the lure of the thermal springs has generated a lucrative spa tourism industry in Hungary.

From Communism to a market-oriented economy

Hungary was once predominantly an agrarian economy, but after World War II, the country pursued an aggressive industrialization policy under its communist regime. While the country's strategic position in Europe encouraged a natural proclivity to foreign trade, this rapid phase of industrialization emphasized a more self-sufficient economy. The economy was dominated by state-owned enterprises until 1968 when the 'New Economic Mechanism' was initiated. This

pioneering initiative, a virtual comprehensive overhaul of the economic system, encouraged decentralization and the private sector.

This spurred the dormant private sector firms to make investment decisions, which were better aligned with the global market. Until the mid-1960s, Hungarian trade remained highly restricted geographically as well as in terms of the range of products exported. For instance in 1966, the Soviet Union accounted for



The contribution of the agricultural sector to GDP has steadily declined from over 50% in the immediate post-World War II period to 4% currently. However, half of Hungary's land is arable, and its agricultural sector continues to keep the country self-sufficient in food.

32% of Hungary's exports and 29% of its imports. Primary products constituted a substantial 42.7% of its exports while manufactured products contributed 43.5%. Moreover, Hungarian exports were considered inferior, unable to meet western technological and quality standards.

Though the 'New Economic Mechanism' gave Hungary the status of one of the most economically advanced countries in the Eastern Bloc, investment in both the agricultural as well as the industrial sectors suffered by the 1970s, and Hungary's net foreign debt spiraled from \$1 billion in 1973 to \$15 billion in 1993. Consumer subsidies and inefficient state enterprises exacerbated the deteriorating economic conditions. To improve its fiscal state as well as better integrate with the world economy, Hungary joined the IMF and the World Bank and steadily implemented economic reforms that laid the foundation of its post-communist era market-oriented economy.

With the collapse of the Soviet Union in 1991, most Eastern European economies including Hungary suffered a significant loss of export markets as an economic crisis ensued. The democratically elected government led by József Antall initiated market reforms incorporating price and trade liberation measures, as well as an overhaul of the tax and the financial system. In this painful transition period, industrial output suffered a severe setback, while government overspending caused deficits to spiral over 10% of GDP. Unemployment accelerated as almost one-third of the jobs were destroyed during the period from 1990-95. This was accompanied by double-digit inflation and a steep contraction of the economy as well. Between 1990-92 GDP plunged by about 20% and inflation galloped to over 160%. The rate of unemployment was over

12% by 1992. Worse still, the social welfare programs suffered a severe setback, as spending cuts were undertaken.

Pioneering transition in the Eastern Bloc



Built towards the end of the 19th century, the Central Market Hall is the largest indoor market in Budapest, housing three stories of stalls. Despite the current financial crisis, higher levels of economic well-being, an increased access to credit and an overall robust demand are expected to drive retail sales in Hungary at an annual average of 3.2% between 2009 and 2014.

The turnaround for the economy came in March 1995, when the government under the leadership of Prime Minister Gyula Horn put into action an austerity program to rein in deficits accompanied by aggressive privatization. By the end of 1995, a wave of privatization had swept through Hungary as it embarked upon the last leg of its transition to a market-oriented economy. All retail trade was privatized and more than half of the economy's output originated

from the private sector. As the reforms bore fruit, economic growth recovered to 5% per year in the late 1990s, inflation eased from 30% in 1995 to less than 10% in 2000. The current account deficit declined and the budget deficit was trimmed significantly to 3% of GDP by 2000. The Hungarian economic success story was lauded globally, as other transition economies tried to replicate the model.

Hungary achieved a robust average annual GDP growth of 4% during the period from 2000-07. From a predominantly planned system in which most enterprises were owned by the state, the economy transformed to a market-based system, in which market forces exercised a significant influence on resource allocation, with the private sector playing an important role in production. As an erstwhile communist country, Hungary stands out in the former Eastern Bloc as the most progressive, integrating much faster with the global economy. While most of these Eastern Bloc countries joined the IMF and the World Bank after 1989, Hungary became a part of these global institutions as early as 1982.

Hungary also made notable progress in opening up its economy, which is amply evident in the fact that by 2008, its external trade represented 155% of its GDP, higher than most countries in the EU. Further, foreign direct investment (FDI) accounted for 60% of total value added in manufacturing by this time, indicating international confidence in the country's economic development.

A strategic player in the Central and Eastern European economy

Hungary's favorable geographical position in Europe has led to its emergence as a potential logistics and production hub in Europe. It is well-connected with Western Europe, with four major European transportation corridors running through the country, and has easy access to public utilities as well. Moreover, its strategic position gives the country direct access to the entire emerging market region of Eastern Europe as well as the Balkans. With the EU accession, investors in Hungary became exposed to a market of over 493 million people in this region. This vaulted Hungary to a leading regional position in logistics and distribution, especially in Central and Eastern Europe. Several large reputed global logistics providers are present in Hungary, offering integrated supply chain solutions, which have also helped other critical sectors of the economy.

The industrial and the services sectors are predominant, contributing to 29% and 66% of the economy's output respectively. Some of the key sectors that have contributed significantly to the economy's growth are the automotive, biotech, information technology, electronics, renewable energy industries as well as the shared services sector. The automotive sector is one of Hungary's thriving businesses contributing



Hungary has a flourishing auto sector, which excels in the manufacture of auto components. Coupled with its strategic location with direct access to Central and Eastern Europe, Hungary has emerged as an important hub for global auto majors such as Audi, General Motors, Suzuki, Renault and Porsche.

over 20% of industrial production as well as exports. The country houses over 600 automotive

companies, while the sector employs over 100,000 people. It is a matter of pride for Hungary that its indigenous cars constitute 94% of exports, while domestic engine and component production also accounts for a sizeable 88% of total exports. Importantly, Hungary has proved to be an attractive destination for reputed global car manufacturers, who have set up their production base in the country. Also fueling growth in Hungary's automotive sector is the world-class education and training offered to its engineers. While wages are lower than many of its Western European peers, labor productivity is higher in the country.

The availability of highly productive, skilled labor has also helped the electronics industry in Hungary. This has led to several global multinationals setting up their R&D centers in the country, particularly in the fields of telecommunications, electronics and medical research. The country touts over 200 industrial parks with state-of-the-art infrastructure, and boasts of seven of the top ten global Engineering Manufacturing Services (EMS) firms, providing contract design, manufacturing and related product support worldwide.

The Hungarian Information and Communications Technology (ICT) sector has also displayed the potential for tremendous growth, its market expanding a phenomenal 50% between 2002 and 2007. Hungary is a leader in terms of per capita ICT expenditure and ICT expenditure as a percentage of GDP in the Central and Eastern European region. The global contribution of Hungarian firms to this field has been highlighted time and again. Much of the data damaged during the terrorist attacks on the World Trade Center in 2001 was recovered by a Hungarian firm. The country also originally pioneered the program that enables the blind to use computers. While both hardware as well as software production are expected to grow at a compound annual average growth rate between 6%-8%, the IT services market is also emerging strongly, constituting about 40% of the total IT market.

The renewable energy sector has been earmarked as a priority sector by the government. Indeed, before 2004, renewable energy production amounted to about 0.5% of total electricity production compared to 4.5% by the beginning of 2009. In 2008, the government introduced the Renewable Energy Strategy for 2007-2020, which projects that renewable energy production will reach 15% of total energy production by 2020. This policy would focus on generating new investment in the fields of biomass, wind, solar and geothermal energy. The government is providing various plans to encourage investment in this field, including certain subsidies and funds from the European Union.

Hungary has emerged as an important global Shared Services Center (SSC), capitalizing on the availability of its skilled, educated and productive workforce at a competitive cost. Since 2000, more than half of the total foreign capital invested in Hungary has been in the service sector, a boon to employment in the country. Over a period of time, the country has emerged as a

recognized shared services destination for global multinationals in the fields of financial services, accounting as well as human resources.

While biotechnology is a relatively young field in Hungary, the national pharmaceutical industry is one of the largest and well-developed in Eastern Europe, attracting significant amounts of foreign investment as well. Hungary possesses a wide source of accumulated knowledge in chemistry and biology, which is being harnessed by large international pharmaceutical companies who have invested in local manufacturing as well as R&D.

Financial vulnerabilities exposed as the global economy sputters

While Hungary was one of the most economically advanced countries that joined the EU in 2004, it has always been financially vulnerable. With an extremely open economy, Hungary has harbored high levels of current account deficit, while half of its household and corporate debt has been denominated in foreign currencies. As such, Hungary has been highly leveraged, susceptible to volatilities in the global economy. Levels of current account deficit were as high as 6%-7% in 2005 and 2006, and around 5% in 2008.

Moreover, excessive spending by successive governments since the start of the millennium has caused the country's public debt and fiscal deficit to swell. Reckless subsidy schemes for the housing sector, wage hikes by over 50% in the public sector, and an ambitious road construction project, left Hungary with a spiraling budget deficit by 2005-06. Government debt as a percentage of GDP, which was brought down to about 52% in 2001, galloped to about 73% by 2008, and about 78.3% in 2009, one of the highest in the EU. As well, the fiscal deficit, which was brought down to about 3% of GDP in 2000, ballooned to over 9% by 2006 before being brought down through spending cuts to 3.9% of GDP in 2009.

Sadly, the global economic slowdown and plummeting demand from its major export markets took a severe toll on the country's economy. With the global financial crisis shaking the global investor community, investors became increasingly skeptical about the ability of the highly leveraged Hungarian economy to service its huge foreign debt. This resulted in jittery investors hastily exiting the economy, causing the country's currency, the forint, to come under a speculative attack in October 2008. In order to defend its plunging currency, Hungary's central bank hiked its key lending rate by 3% to 11.5%, as an emergency measure. The emerging economy was the hardest hit by the global financial crisis in the Eastern European region, becoming the first country in the EU to secure a \$25 billion lifeline from the IMF, World Bank and the EU, in November 2008.

Entering recession in the fourth quarter of 2008, Hungary is currently facing its worst recession since 1991. While GDP growth tumbled to 0.6% in 2008, economic activity contracted about 6.3% in 2009. It is expected to slump by 0.2% in 2010, before returning to growth in 2011. Rising unemployment has become a key cause for concern for the recession-torn Hungarian economy. The unemployment rate already crossed 11% in early 2010, even as the government cut employer social-security contributions, hoping to bolster the country's employment. The retirement age is also being gradually raised to 65 years.

Poised to emerge stronger from the slump



Contributing to more than half of GDP, private consumption forms the backbone of Hungary's economy, clearly evident on Vaci Street, one of the main shopping streets in Budapest. Still, the severe economic slump has caused private consumption to shrink 7.5% in 2009.

While the IMF led rescue package brought the economy back from the brink of bankruptcy, it came with conditions. Hungary had to continue to trim its high budget deficit, and correct other macroeconomic imbalances. In fact, the government began austerity measures to narrow the deficit beginning in 2006, which were continued as terms of the IMF bailout package. This turned out to be a blessing in disguise for the distressed economy, which managed to rein in its budget deficit to 3.9% of GDP in 2009. In this regard, Hungary has performed much better than many of other EU member countries, which are seeing their budget deficits soar as a result of huge stimulus spending.

However, in the dire recession times, austerity measures including tax hikes, and salary and pension cuts were not well received by the average Hungarian, resulting in widespread disenchantment and protests. Public ire was reflected in the parliamentary election outcome, where the ruling socialists were convincingly trounced. As Fidesz, Hungary's conservative, center-right opposition party, assumes power, it remains to be seen whether the fiscal deficit

will be restrained to 3.8% of GDP in 2010. Fidesz leader, Viktor Orban has promised to cut taxes in a bid to fuel growth and create jobs in the recession-torn economy. To restore economic growth, the incoming government's agenda includes curbing tax evasion, and reviewing the corporate tax, some local taxes as well as social security contributions.

While these austerity measures have taken a toll on economic output in the country, Hungary is poised to emerge from the severe recession as a global fiscal leader. So while the country is expected to be in sound fiscal health by 2011, other economies will still be coping with accumulated fiscal deficits. Hungary will also be in a better position to adopt the euro and become a member-country of the now 16-member Euro-zone. Despite receding exports, a deceleration in domestic demand and imports has played an instrumental role in the drastic decline of the country's current account deficit to 0.5% of GDP in 2009. The highly leveraged Hungarian economy had a precariously high current account deficit before the economic crisis struck.

Hungary's central bank has also been consistently following the path of monetary easing, after its initial reaction of raising interest rates in order to stem the forint's decline. By April 2010, the bank had reduced its key rate to 5.25%, the lowest since communism ended 20 years ago. Receding inflation on the back of weak demand has provided the central bank leeway for monetary easing, to spur economic activity.

Clearly, while the recession will be remembered as a tumultuous era that impeded Hungary's growth, the financial crisis also marks a turning point for the country. The economy is now benefitting from correcting its macroeconomic imbalances, and adhering to prudent economic policies and fiscal discipline. Needless to say, Hungary is eager to reassert its strategic standing in Central and Eastern Europe, and reemerge as a force to reckon with in the EU. 🌐

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