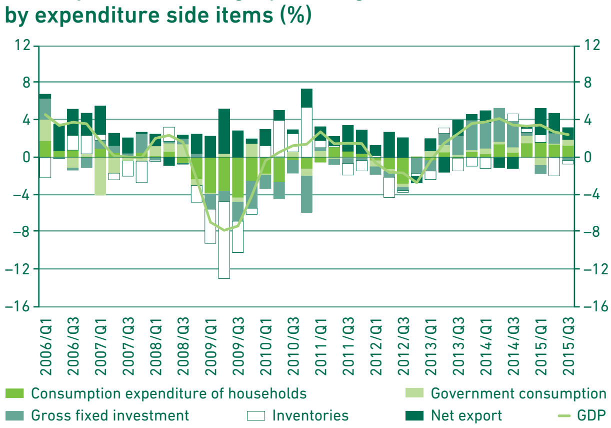
Macroeconomic and financial environment in 2015

MACROECONOMIC AND FINANCIAL DEVELOPMENTS IN HUNGARY

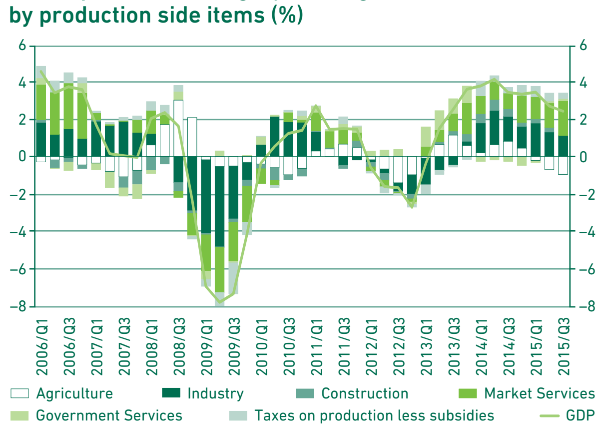
In 2015 Hungary's macroeconomy was mostly shaped by the different monetary policies expected from the Fed and the ECB, and by the continued slump in commodity prices, which started in 2014. In December 2015, the Fed embarked on interest rate hikes (0.25–0.5%), for the first time in seven years, owing to the accelerating growth and the favourable labour market developments in the USA. Meanwhile the ECB decided to extend its asset purchase programme and cut the interest rate on overnight deposits further (to –0.3%). For the first time since the crisis began, the eurozone posted meaningful growth (1.5%), but with significant discrepancies among the European Union's regions. Preliminary GDP data for Q4 suggest that Central and South Eastern Europe remained the strongest region.
The several-month-long negotiations with Greece, which ultimately resulted in a temporary solution to the country's debt crisis, failed to cast a cloud on the supportive sentiment on global markets.
Commodity prices slumped deeper, owing to the shrinking demand caused by the structural changes in China's economy. Despite the sliding oil prices, the December meeting of OPEC members decided to boost output. As a result, prices hit lows last seen during the crisis in 2008.
The persistently low oil prices shifted inflation forecasts lower, providing room for the monetary policy and helping the continued easing of monetary conditions.
In line with our forecasts, Hungary's economy grew by 2.9% in 2015, after expanding by 3.6% in 2014. After the election year, the volume of investments fell, but net exports' contribution returned to positive territory from the slump in the previous year. Nonetheless, the engine of growth was clearly the further accelerating consumption of households.

Decomposition of Hungary's GDP growth by expenditure side items (%)



Sources: HCSO, OTP Research

Decomposition of Hungary's GDP growth by production side items (%)



Sources: HCSO, OTP Research

The increase in the value added by market services has largely contributed to the economy's expansion. Even though the deceleration of Germany's manufacturing may pose risks to the demand for Hungary's export products, it seems that these fears did not get in the way of production. Moreover, mostly owing to the improved terms of trade, Hungary's trade surplus also hit an all-time high, at EUR 8.1 billion (or 8% of GDP) in 2015.

A weaker-than-2014 year pushed agriculture's contribution to GDP into negative territory. Non-farm private sector GDP was as strong as elsewhere in the CEE region; it may have grown by more than 4%.

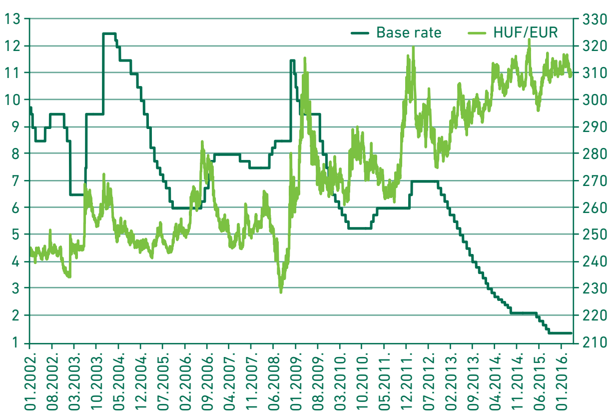
Consumer prices dropped by 0.1% on average in 2015, thanks to the fall in commodity prices; demand-sensitive inflation accelerated until the end of summer, but somewhat slowed towards the end of the year.
The further drop in inflation justified the continuation of the easing cycle; the latest cut, in July, brought the base rate to 1.35%.

The MNB's Self-Financing Programme introduced a two-pronged plan to boost lending for SMEs, then the MNB decided to do away with the two-week deposit bills, to boost commercial banks' appetite for government securities.
At the end of 2015, the MNB announced plans to introduce unconventional monetary policy tools because inflation was likely to remain below its target throughout the forecast horizon.

The further decrease in inflation made a case for the continuation of the easing cycle; therefore the base rate was reduced in July to 1.35%. As a part of the self-financing plan, the MNB introduced a Scheme which aims to boost SME lending, later the MNB decided to phase out the two-week deposit in order to boost the demand of banks towards government bonds.

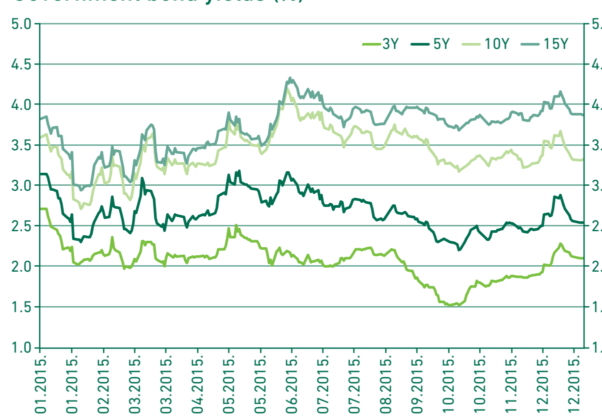
Due to the fact that inflation will remain below the inflation target over the forecast horizon, at the end of the year the MNB announced they plan to introduce new, mainly unconventional monetary policy tools in the future.

The HUF/EUR and the base rate



Sources: Reuters, MNB, OTP Research

Government bond yields (%)



Sources: ÁKK, OTP Research

Short-term yields dropped towards the end of the year, while long-term yields barely moved. The HUF/EUR oscillated in the 296.6–318.5 range. Following a forint appreciation in early 2015, the pair spent most of the second half of the year around 310 levels, largely owing to the measures taken by the central bank.

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

The countries where OTP Bank has foreign subsidiary banks posted mixed economic performance in 2015. In this respect, the eight countries can be classified into three groups: the clearly promising Central and Eastern Europe, the improving Balkans region, and commodity producers who are under pressure but out of recession.

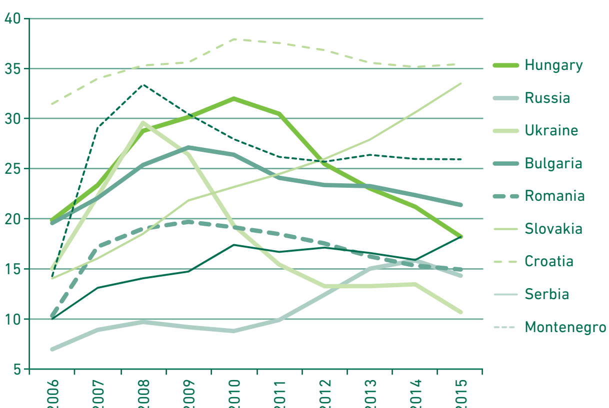
In the first group, the countries of Central and Eastern Europe further enhanced their favourable 2014 performance. The low budget deficit and the shrinking government debt left room for loosening fiscal policies, and these countries used this opportunity more than once. The good fiscal achievements owe a lot to the low commodity prices and to the surge in EU co-financing. External debts have decreased, and external balance positions have improved. Preliminary data rank Slovakia (+4%) and Romania (+3.8%) among the most dynamically expanding economies of the European Union. The high savings ratio was accompanied by consumption growth, which suggests to us that this component's contribution to GDP will remain strong. Domestic demand is becoming increasingly pronounced within economic growth, which makes these economies resilient to external tensions. Hungary, Romania and Bulgaria saw their property markets recover, which bodes well for a rise in lending in one or two years.

Slovakia's balanced economic performance enabled it to better resist external shocks. Nonetheless, the biggest risk in the future is the decline in external demand, mainly that from Germany. The most important engines of economic performance are exports and domestic demand. Romania's economy is diversified, its public and private sector indebtedness is low, and the considerable

fiscal room may give further impetus to growth. Yet the double-digit wage growth and the aggressive fiscal loosening may pose downward risks to short-term growth prospects. Bulgaria's growth pace (at 2.8% YoY in full-year 2015) has also become more robust than in 2014. What may cloud its outlook is the low diversification of Bulgaria's economy and the lack of industries with high value added. In the Balkans region, the most important good news is that economic growth returned to each country. Montenegro is expanding at the fastest speed; its GDP grew by 4.2% in Q3, greatly benefiting from the increasing number of infrastructural investments by the government and from the robust increase in tourism revenues; unfortunately, the government finances the former from debts. Serbia continues to face considerable challenges, mostly owing to the weak economic performance, and the large fiscal and external imbalances. Its banking system is stable, but the ratio of non-performing loans needs to be further reduced. In our view, Croatia exited the six-year-long period of recession in 2015, owing much to the dynamically increasing exports as well as to the increased consumption caused by the fall in commodity prices and administrative changes. Regrettably, significant fiscal and external balance problems still persist in these three countries, therefore their growth seem less sustainable in the medium term than elsewhere in Central and Eastern Europe. If the external environment deteriorates, the market pressure may mount particularly in Croatia.

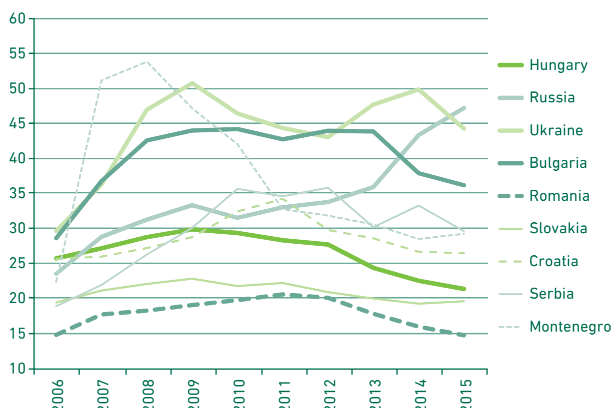
The situation in Ukraine and Russia differs markedly from the above country groups. In addition to the low commodity prices (steel, oil), the geopolitical conflict between these countries further deepens the recession. Ukraine's economy contracted by 10% and that of Russia shrank 3.7%; both fell more than we had expected at the beginning of 2015. It is noteworthy that Ukraine's Q4 gross domestic product (–1.2%) has beaten expectations in year/year comparison. The USD/UAH increased from 15.62 in early 2015 to 24 by the end of the year. Inflation was above 43% in December. What poses risks for its future outlook is the uncertainty surrounding the IMF agreement and the political situation. In Russia, oil prices' slump to record lows weighed heavily on the budget and the steadily depreciating ruble pushed the USD/RUB above 70 by end-December, up from 54 in January 2015. The weak ruble accelerated inflation, thus reducing real wages and consumption as well as lending. Oil prices, which we expect to remain low, will justify further fiscal austerity measures.

The banking system's retail loan penetration (year-end, % of GDP)



Sources: National banks, OTP Research, 2015 forecast

The banking system's non-financial corporate loan penetration (year-end, % of GDP)



Sources: National banks, OTP Research, 2015 forecast