



**Press Release: Rating Action**

**JCR affirms the BBB+/A-(FC/LC) ratings on Hungary and NBH and revises outlook to Negative from Stable**

**Issuer: The Republic of Hungary**

<i>Issues</i>	<i>Rating</i>	<i>Outlook</i>
FC (Foreign Currency Long-Term Senior Debts)	BBB+	To Negative from Stable
LC (Local Currency Long-Term Senior Debts)	A-	To Negative from Stable

<i>Issues</i>	<i>Amount (bn)</i>	<i>Issue Date</i>	<i>Due Date</i>	<i>Coupon</i>	<i>Rating</i>
No.3 Yen bonds	JPY 45	July 12, 2005	July 12, 2012	0.96% p.a.	BBB+
No.4 Yen bonds	JPY 50	March 17, 2006	March 18, 2013	1.67% p.a.	BBB+
No.5 Yen bonds	JPY 25	Oct. 26, 2007	Oct. 26, 2017	2.11% p.a.	BBB+

**Issuer: National Bank of Hungary (NBH)**

<i>Issues</i>	<i>Rating</i>	<i>Outlook</i>
FC (Foreign Currency Long-Term Senior Debts)	BBB+	To Negative from Stable
LC (Local Currency Long-Term Senior Debts)	A-	To Negative from Stable

<i>Issues</i>	<i>Amount (bn)</i>	<i>Issue Date</i>	<i>Due Date</i>	<i>Coupon</i>	<i>Rating</i>
No.25 Yen bonds	JPY 10	Oct. 19, 1995	Oct. 19, 2015	6.00% p.a.	BBB+

JCR has affirmed its BBB+ ratings on the foreign currency long-term senior debts and A- ratings on the local currency long-term senior debts of Hungary and the National Bank of Hungary (NBH). The outlook of the ratings has been revised to negative from stable. JCR has also affirmed its BBB+ ratings on the listed Japanese yen bonds issued by Hungary and NBH.

The ratings on Hungary are primarily supported by its diversified economic structure, strong economic ties with European countries since the early stage of its economic transformation by pushing economic reforms, the growing production capacity rendered by massive foreign direct investment in the manufacturing sector and EU subsidies. On the other hand, the ratings remain constrained by a structural fiscal deficit, and large foreign and general government debts.

The ratings on NBH are considered virtually identical to those on Hungary as it is the country's central bank and its shares are entirely held by the Republic of Hungary.



The outlook of the ratings has been revised to negative from stable. JCR acknowledges the government has set forth in March 2011 a major structural reform program focused on medium-term spending cuts as a step towards fiscal consolidation. However, there remains a question if the government could steer its way to a serious fiscal consolidation from its pro-growth past and fully implement the program. Furthermore, the country's external financing, with already heavy debts, is vulnerable to international financial condition.

**(1) Sustained by improving investment and consumer spending, the economy may grow in 2011 nearly as fast as its potential growth rate**

Hungarian economy continues a gradual recovery stemming from improved domestic demand stimulated by the robust exports, after experiencing the worst contraction in 2009 since its economic transition. The economy is highly exposed to international trade with the ratio of export to GDP in real terms exceeding 130%. For the present, it continues benefiting from the favourable economic trend in Germany, its biggest export market. While the economy grew only by 1.2% in 2010 according to preliminary data, JCR forecasts it will expand around 3% each in 2011 and 2012, a level close to its potential growth rate. The increased investments associated with numerous automotive manufacturing projects and massive EU subsidies, and the recovery of consumer spending to be brought by the income tax cut are likely to push up the domestic demand. Meanwhile, the consumer price inflation is on the rise due to higher food and energy prices, but JCR considers that it is likely to stay below 4% in 2011 and 2012, given contained wage pressure and moderate economic recovery. The country's financial system has been keeping its stability. The quality of foreign currency-denominated mortgage loan may further deteriorate if the domestic currency weakens. However, the country's banks have been keeping their profitability and capitalization adequate enough to absorb the increasing credit cost.

**(2) Spending cuts after 2012 are crucial to curbing the structural fiscal deficit**

The Fidesz-led centre-right government that took office in May, 2011, has strong political base with a two-thirds majority in the parliament, which enables it to pass legislation without compromise with other political parties. It gives top priority to the enhancement of economic growth, an improvement in the country's competitiveness and a rise in the country's longstanding low employment rate, aside from its commitment to the EU to cut the fiscal deficit below 3% of GDP by 2011. The fiscal measures implemented so far focus on tax reductions for households and SMEs, an introduction of bank tax and special levies on retail, telecommunication and energy sectors, and pension reform, as well as moderate expenditure cuts. Preliminary data made available suggests that the fiscal deficit (ESA95) for 2010 seems slightly narrowed to 4.2% of GDP (3.8% under the government plan) from 4.4% a year earlier. The 2.94% fiscal deficit target for 2011 is likely to be attained by the continued special taxes and sufficient stability reserves. The pension reforms are expected to provide the government with one-time revenues around 9% of GDP, allowing it to reduce the government debt to around 70% of GDP at the end of 2011 from an estimated 80.1% a year before. With regard to the pension reform, Hungary made bold measures such as introduction of the mandatory private pension fund in 1998 and was reducing long-term government fiscal burdens ahead of the more developed European countries. However, given the country's negative demographic trend, the latest transfer of the mandatory private pension fund to a public coffer may lead to increasing the government's long-term fiscal burdens unless it is properly managed. Furthermore, the fiscal deficit



may deteriorate again after a bunch of one-time tax measures run out in 2012, unless fiscal reforms focused on spending cuts are implemented. Faced with the situation, the government announced in March 2011 a structural reform program focused on spending cuts. This is an indication of a step towards the fiscal consolidation. The program includes curtailment of social and pension benefits, reorganization of the public transportation systems, reduction of prescription drug subsidies, rationalization of local governments, a delay in corporate tax cut, and an extension of bank tax, which together should increase the annual fiscal savings to an estimated Ft 902 billion (or around 3.0% of GDP estimated by JCR) in 2013 and 2014 from 550 billion in 2012. Despite solid political base, there remains a question how successfully the government will steer its way to a serious fiscal consolidation and a full implementation of the program. The proposition to set the constitutional limit on the fiscal debt is under a parliamentary contemplation, which will support the ratings if it makes a law.

**(3) External financing risk remains stemming from its heavy external debt burden without the IMF financial assistance**

The financial assistance from the IMF, attainment of a current account surplus and a sharp increase in the foreign exchange reserves have helped improve the country's external liquidity position. The government has so far withdrawn around EUR 14.2 billion from the IMF and the EU, stopping short of resorting to the remainder of their credit facilities in consideration of the availability of funds on the domestic financial market and ample foreign currency deposits. The government decided not to renew the IMF loan arrangement upon its expiration in October 2010. Helped by the one-time revenue gains from the pension system reform and the recent successful USD bond issuances, the government will have no debt financing problems at least in 2011. Amid a turnaround to a current account surplus, the foreign exchange reserves swelled to a record EUR32.3 billion at the end of 2010, or 1.3 fold as much as the short-term foreign debt at the end of September 2010 and around five fold as much as the average monthly imports (goods and services) in the first nine months of 2010. However, the country's external debts owed by the government, banks and private businesses remain heavy, standing at EUR129.5 billion at the end of September 2010 or equivalent to around 140% of GDP, which is one of the highest among BBB sovereigns assigned by JCR. With the high level external financing requirements including the redemption of the IMF-EU loans, the country's external financing of private and public sectors remains vulnerable to international financial condition.

*Toshihiko Naito, Chief Analyst  
Makoto Ikushima, Analyst*

The primary rating methods applied to the ratings are posted on JCR's website (<http://www.jcr.co.jp>) "Sovereign, International Public Finance and Multilateral Development Bank Rating Methodology." The rating methods are subject to change or addition. However, the changes and additions including those that have been made in the past are posted in chronological order. Please refer to the rating methods above after checking by comparing the date of press release about the ratings with the release date of the rating methods (effective date of each of such rating methods).