

RATING DEFINITIONS

The Republic of Hungary

Fiscal deficit in 2008 to narrow on the progress of the austerity measures

JCR has affirmed its A-/stable ratings on the foreign currency long-term senior debts and A/stable ratings on the local currency long-term senior debts of Hungary (Exhibit 1). The ratings mainly stems from the fact that the fiscal deficit reduction measures, in particular revenue reforms, which were launched in the latter half of 2006 have proved highly effective in trimming the fiscal deficit in 2007, although they have adversely affected consumer spending to slow down the whole economy. The government is set to implement cuts in subsidies and wages for public employees and other expenditure reforms to ensure a further reduction of the fiscal deficit in 2008. JCR holds that improvement on the fiscal deficit will continue in 2008 amid moderate economic recovery from the latter half of the year. This report focuses on main factors reflecting the rating and its future prospects.

1. Progress on fiscal deficit reduction measures to help narrower the deficit in 2008

A persistently huge fiscal deficit before and after the elections has given rise to concern over the credibility of the government's fiscal policies. The coalition government led by the Hungarian Socialist Party re-elected in the April 2006 general election unveiled a medium-term deficit reduction package under its "New Equilibrium Fiscal Plan" in June and a "Convergence program" a roadmap to euro adoption, in September 2006 at the request of the European Commission. The program envisages reducing the fiscal deficit to 3.2% of GDP in 2009 through expenditure and revenue reforms. The fiscal deficit reduction measures helped to trim the fiscal deficit (ESA95, unless otherwise indicated) in 2007 to 5.7% of

GDP (on a preliminary basis) from 9.2% the year before (Exhibit 2). The improvement was prominent even as compared with the 6.8% deficit target envisaged in the initial budget plan. Much of the improvement came from strong revenues brought by the reform initiatives, such as the hike of the VAT and corporate tax rates and increased social security contributions by employees as well as intensified tax collections through the gray economy. At the same time, the growth of expenditures was kept modest through redundancy of public employees, cuts in various subsidies and reduced interest payments. Meanwhile, reflecting the improvement of the fiscal deficit, the general government debt at the end of 2007 came to 65.9% of GDP (preliminary), just a shade down from 65.6% the year before.

2. Further improvement of fiscal deficit is likely in 2008, but there remain concerns over the fiscal policy in 2009 ahead of the election

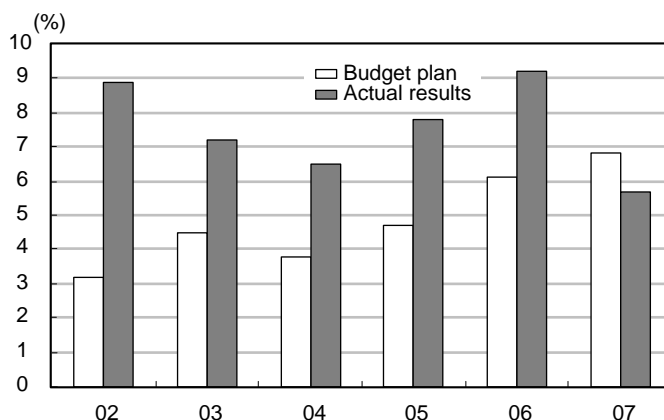
The government has pledged to slash the annual general government fiscal deficit to 2.2% of GDP by 2011 under its updated Convergence Program in November 2007 (Exhibit 3). It aims to cut the deficit in 2008 to 4.0% of GDP, 0.3 percent point lower than that of the previous program. In terms of revenue and expenditure as percent of GDP (Exhibit 4), much of the improvement in 2007 was driven by both increased revenues and reduced expenditure. However, the improvement of fiscal deficit in 2008 was largely dependent on the cuts in expenditures. The government is set to implement its expenditure reforms including the pledged cuts in subsidies, wages for public employees and spending on motorway construction projects. JCR considers that the tar-

Exhibit 1. JCR's ratings for the Central and Eastern European Countries

	Foreign Currency	Local Currency
AA	Slovenia/s	Slovenia/s
AA-		
A+		Czech Rep./p and Slovakia/s
A	Czech Rep./p and Slovakia/p	Hungary/s and Poland/s
A-	Hungary/s and Poland/s	Bulgaria/s
BBB+	Bulgaria/s	Romania/s
BBB	Romania/s	
BBB-		Macedonia/s
BB+	Macedonia/s	

p: positive, s: stable and n: negative

Exhibit 2. General government fiscal deficit (as % of GDP, ESA95)



Source: Ministry of Finance

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get is highly likely to be met because the government has already legislated most of expenditure reforms. The government has built up its reserves to a level equivalent to 0.9% of GDP, adding to its resilience to contingency.

From 2009 onward, through the additional expenditure reforms, the government will reduce the deficit by 0.5 percent point every year. Further details of expenditure reforms, including reduction of social security contribution and cuts in social securities benefit, will be discussed in the coming months. JCR will carefully watch the future development of deficit reduction measures as the current fiscal policies might be shifted ahead of the general elections scheduled for 2010.

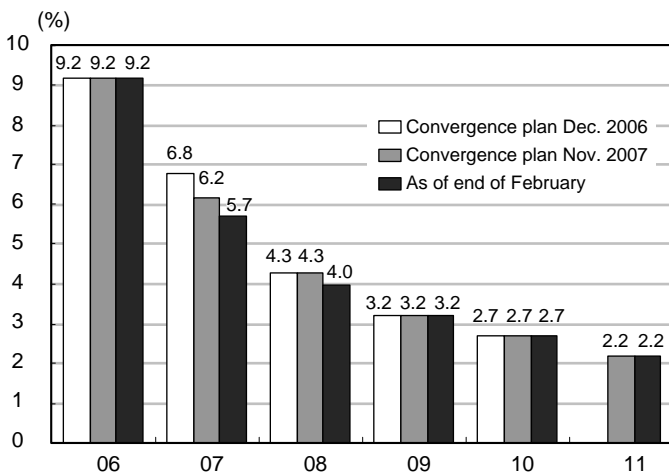
Meanwhile, an opposition-proposed referendum on the payment of medical bills and tuition fee is scheduled for March 9. In the present situation, the opposition looks likely to win the referendum. However, such result may have only

a limited policy impact as the coalition government is committed to implementing its expenditure reforms.

3. After temporary slowdown, the economy may turn to moderate recovery in 2008 amid lower inflation

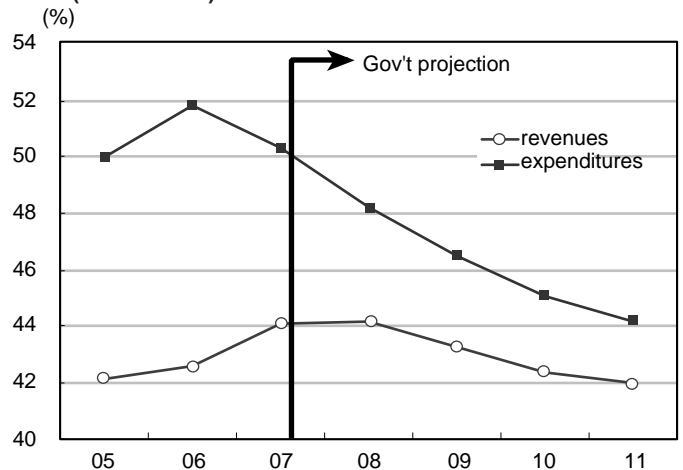
Hungary's real GDP growth rate further decelerated to 0.9% year-on-year in the July-September quarter of 2007 from 1.9% in the first half of the year (Exhibit 5). While domestic demand centering on consumer spending continued to slacken due to the implementation of the fiscal deficit reduction measures, strong net exports underpinned the whole economy. Consumer price inflation declined modestly to 6.4% year-on-year in September 2007 as the effect of the increased tax rates and administrated prices wore away but rose to 7.4% in December on higher energy and food prices (Exhibit 6). National Bank of Hungary (NBH; the central bank of Hungary) cut its policy rate by a total 50 basis points

Exhibit 3. Government projection of fiscal deficit (as % of GDP)



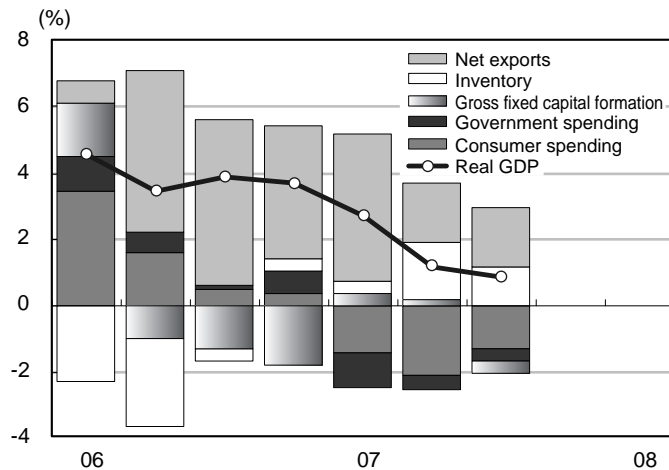
Source: 'Convergence Program' Ministry of Finance

Exhibit 4. Expenditure/Revenue projection made by the government (as % of GDP)



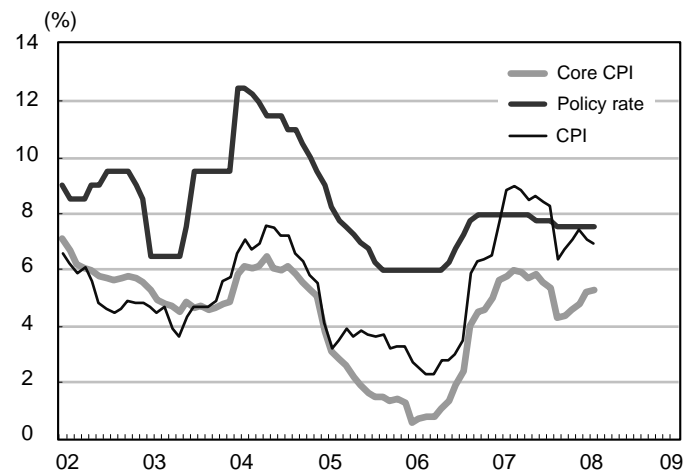
Source: 'Convergence Program' Ministry of Finance

Exhibit 5. Real GDP growth rate (YOY)



Source: Hungarian Central Statistical Office

Exhibit 6. Policy rate and CPI (YOY)



Source: National Bank of Hungary

in June and September 2007 but has since kept it at 7.5%. On February 26, the NBH abandoned the flexible peg of the forint to the euro with a fluctuation band and adopt a floating exchange rate regime (Exhibit 7). JCR appreciates that a floating exchange rate regime contributes to more effective monetary policy to achieve its inflation target.

The current account deficit in the first nine months of 2007 narrowed to 4.0% of GDP (estimated) from 5.1% the year before due mainly to a turnaround of the trade balance into surplus (Exhibit 8). The deficit was mainly financed by increased borrowings by banks and a net inflow of portfolio investment which more than offset a net FDI outflow. Hungary's foreign debt burden is relatively heavy, with the foreign debt mainly owed by banks exceeding 90% of GDP at the end of September 2007. Foreign liquidity is rather insufficient, with the ratio of foreign exchange reserves to monthly imports staying lower than three times. The unstable financing structure has sent the value of the currency and bond and stock prices lower amid the current global credit turmoil. However, this has had only a limited impact on the economy as the financial system itself remains stable.

In 2008, the economy will grow nearly 3% on recovery of consumer spending brought by a gain in real wages, stronger infrastructure investment spurred by massive inflows of EU subsidies (Exhibit 9) and continued expansion of corporate investment led by spending on machinery. Inflation is likely to decelerate below 5% on the moderate wage settlement in 2008, although future developments of energy and food prices remain uncertain.

4. Hungary will be ready for the euro adoption before or after 2014 at the latest

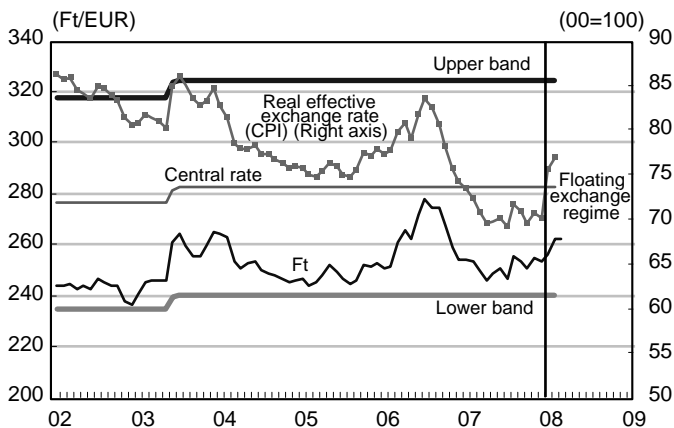
Hungary's adoption of the euro will inevitably be delayed from the initially planned 2010, as the government has put off specifying a target date. The 10 EU members including Hungary which joined the EU in May 2004 initially planned to introduce the euro between 2007 and 2010. Currently,

however, progress on preparations varies from county to country. Slovenia, Malta and Cypress have already introduced the euro by January 2008 as initially planned. In contrast, Poland, Hungary and the Czech Republic, which have larger economies than the other seven, have yet to introduce the ERM2 and are cautious about specifying target dates for euro adoption due to reasons primarily attributable to their large fiscal deficit (Exhibit 10).

JCR considers that euro adoption provides some positive factors for its ratings as it brings a country benefits far bigger than the costs involved. The costs involved include that the country's economic policy is inevitably limited to fiscal measures, as it is required to transfer its monetary policy to the European Central Bank (ECB). Moreover, the country is required to keep its labor market more flexible since it becomes harder to adjust international competitiveness through exchanges rates. On the other hand, benefits include, in the first place, that euro adoption allows the country to reduce various costs related to currency exchange. Secondly, it makes currency exchange almost unlimited. Thirdly, the highly credible ECB rather than the country's central bank becomes the last resort of financial liquidity. These will reduce possible currency risks and spur new FDI inflows. Euro adoption, which is conditional on compliance with the EU's Convergence criteria, may have a favorable impact on the economy as it will help stabilize the inflation rate and long-term interest rates.

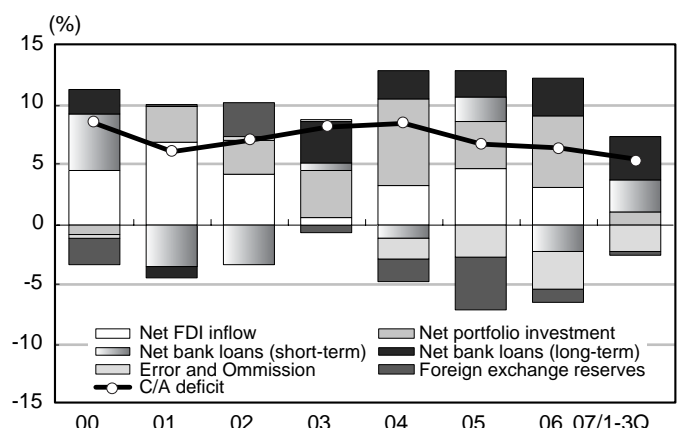
Under its updated 2007 Convergence Program, Hungary aims to fulfill all Convergence criteria in 2009. Hungary is currently under the excessive deficit procedure set by the EC and required to cut the deficit to below 3% of GDP by the end of 2009. The new Convergence Program envisages reducing the deficit to 3.2% (inclusive of pension reform costs) of GDP or 2.9% (excluding pension reform costs). Hungary is asked to submit the progress report to the EC biannually. In response to the latest program, the EC evaluates the progress positively so far, while seeking further progress on the

Exhibit 7. Exchange rate



Source: National Bank of Hungary

Exhibit 8. Financing of the current account deficit (as % of GDP)



Source: National Bank of Hungary. Figure for 07/1-3Q is annualized number

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reform. However, in view of the elections in 2010, there is a concern if the government continues to make some progress on the reforms. Furthermore, inflation remained high and inflation pressure is likely to rise due to tightening labor market condition. Once the economy returns to the potential economic growth rate, inflation is highly likely to rise. Following the change in exchange rate regime, monetary policy became more effective because the NBH can focus more on containing inflation pressure rather than maintaining stability of the currency. However, fulfilling the inflation criteria is difficult task for Hungary, in considering current economic environment. All these grounds suggest that the introduction of the euro will be before or after 2014. **JCR**

Exhibit 9. Total amount of EU subsidy from 2007 to 2013

	EU subsidy (EUR mn)	Nominal GDP 06 (EUR mn)	As % of Nominal GDP
Bulgaria	6,853	25,100	27%
Czech	26,692	113,068	24%
Hungary	25,307	89,894	28%
Poland	67,284	271,610	25%
Romania	19,668	97,008	20%
Slovenia	4,205	29,448	14%
Slovakia	11,588	43,197	27%

Source: the European Commission

Exhibit 10. Fulfillment of Convergence Criteria for new EU member countries

(Criteria)	Fiscal figures		Inflation *	Long-term Interest Rate †	Exchange Rate ‡	Target date for the euro adoption
	Fiscal balance as % of GDP	Fiscal debts as % of GDP				
	Below 3%	Below 60%	2.8%	6.4%	2 years	
	(2006)	(2006)	(2007)	(2007)		
Slovenia	-1.2	27.1	3.8	4.5	Jun. 2004	Jan. 2007
Cyprus	-1.2	65.2	2.2	4.5	May 2005	Jan. 2008
Malta	-2.5	64.7	0.7	4.7	May 2005	Jan. 2008
Slovakia	-3.7	30.4	1.9	4.5	Nov. 2005	Jan. 2009
Estonia	3.6	4.0	6.7	n.a.	Jun. 2004	not specified
Latvia	-0.3	10.6	10.1	5.3	May 2005	not specified
Lithuania	-0.6	18.2	5.8	4.5	Jun. 2004	not specified
Czech	-2.9	30.1	3.0	4.3	No	not specified
Poland	-3.8	47.6	2.6	5.5	No	not specified
Hungary	-9.2	65.9	8.0	6.7	No	not specified
Bulgaria	3.2	22.8	7.6	4.5	No	ASAP
Romania	-1.9	12.4	4.9	7.1	No	2014

Source: The European Commission

The figures in shadow indicate fulfillment of the Convergence criteria.

* The inflation rate not to exceed the average of three best performing Member States by more than 1.5%.

† Long-term interest rate not to exceed the average of three best performing Member State by more than 2%.

‡ The exchange rate to be kept within the normal margin of fluctuations as stipulated by the Exchange Rate Mechanism II.

Exhibit 11. Republic of Hungary: Major economic indicator

	Unit	2004	2005	2006	2007 (f)	2008 (f)	2009 (f)
Real GDP growth rate	(%)	4.9	4.2	3.9	1.8	2.8	4.0
GDP per capita in PPP	(EU25=100)	63.4	64.3	65.0	64.1	63.8	64.0
Consumer price inflation (YOY)	(%)	6.8	3.6	4.0	8.0	5.0	3.8
Unemployment rate	(%)	6.1	7.2	7.5	7.2	7.5	7.3
The central government fiscal balance / GDP	(%)	-6.5	-7.8	-9.2	-5.7	-4.3	-3.2
The central government fiscal debts / GDP	(%)	59.4	61.7	65.6	65.9	66.8	67.0
Current account balance / GDP	(%)	-8.4	-6.8	-6.5	-5.2	-5.5	-6.3
Trade balance / GDP	(%)	-3.0	-1.6	-1.0	1.0	0.0	-1.2
Net foreign direct investment / GDP	(%)	3.3	4.7	3.1	-0.1	0.5	1.6
Net foreign direct investment / Current account balance	(%)	39.6	68.9	47.6	-1.9	8.2	25.7
External debts / GDP	(%)	69.4	76.5	94.2	98.9	102.8	104.9
Net external debts / GDP	(%)	55.7	59.1	76.6	83.1	87.9	90.2
Public external debts / exports G&S	(%)	43.7	43.8	43.6	41.0	39.5	36.0
External debts / exports G&S	(%)	106.6	112.5	121.7	120.8	122.9	120.2
Foreign exchange reserves / monthly imports G&S	(months)	2.4	3.0	2.7	2.4	2.2	2.0
Foreign exchange reserves / short-term external debts	(times)	1.5	1.5	1.5	1.2	1.2	1.2
DSR	(%)	15.3	16.0	13.0	14.5	15.0	16.0

Sources: Central bank, Eurostat and Ministry of Finance. figures for fiscal balance are based on ESA 95, figures for 2007 and 2009 are JCR's projections