

RATING PERSPECTIVE

Republic of Hungary – At a crucial stage to fully implement its fiscal deficit reduction package

JCR downgraded its rating on the foreign currency long-term senior debts from A to A- on October 4, 2006, following its rating revision on the local currency long-term senior debts from A+ to A in February that year. The downward revisions were prompted by the fact that the country's 2006 fiscal deficit swelling faster than JCR's projection will make a further expansion of the government debt unavoidable in the medium term and that the country's fragile political situation will make a full implementation of its fiscal deficit reduction package more difficult. This report focuses on the progress made so far on the package and its future prospects.

1. New government unveiled a comprehensive fiscal reduction package amid eroding credibility of its fiscal policies

A persistently huge fiscal deficit has given rise to concern over the credibility of the government's fiscal policies, with annual deficits standing well above the initial government estimates for five years running (Exhibit 2). Returned to office in the April 2006 general election, the coalition government led by the Hungarian Socialist Party 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.

In the Convergence Program, the government revised its fiscal deficit estimate for 2006 to 10.1% of GDP (ESA95 without the pension reform correction item unless otherwise indicated) from 6.1% as projected in the initial budget plan. The deficit would be slashed to 3.2% of GDP in 2009 through implementation of the new fiscal adjustment package. More than 70% of the reduction would come from spending cuts mainly on personnel expenses for public employees, goods and services purchases and infrastructure investment. The remainder would be attained through increased revenues such as tax hikes. The growing government debt should be curbed to 70.4% of GDP at the end of 2009. Under the

Exhibit 1. Ratings to the Central and East European Countries

	Foreign Currency	Local Currency
AA	Slovenia	Slovenia
AA-		
A+		Czech Rep. and Slovakia
A	Czech Rep. and Slovakia	Hungary and Poland
A-	Hungary and Poland	
BBB+		Bulgaria
BBB	Bulgaria	Romania
BBB-	Romania	

program, the government gave up specifying a target date for euro adoption which had earlier been set for 2010.

A full implementation of the package looks difficult due mainly to erosion of the coalition government's political base amid a wave of protest rallies triggered by Prime Minister Ferenc Gyurcsany's admission that he had connived at a false report on past economic policies and the devastating setback the ruling parties suffered in the local elections.

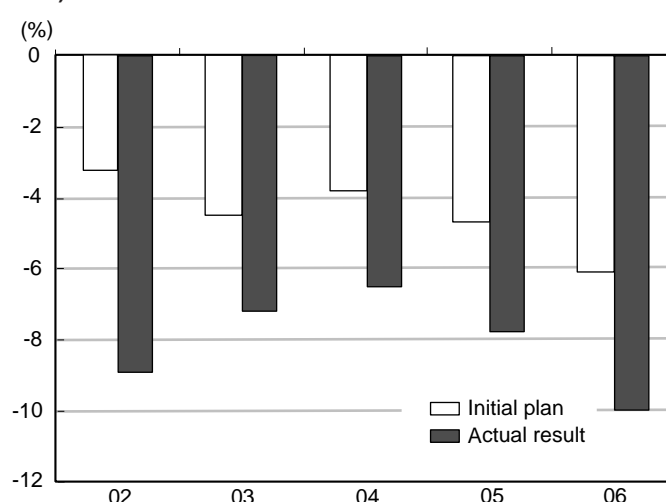
* According to the European Treaty, EU member countries, which have yet to adopt the euro, are required to submit a "Convergence Program" annually to the European Commission. Hungary has been in the process of excessive deficit procedures since July 2004.

2. Fiscal deficit expected to remain large, though any further deterioration may be avoided through implementation of the deficit reduction package

The deficit reduction measures carried out so far have been primarily aimed at increasing revenues (Exhibit 3) through higher VAT and corporate tax rates and larger employee contributions to social security. On the other hand, while there has been phased redundancy of public employees, most of the expenditure reforms, in particular those involving the healthcare and pension systems, are set to be implemented in 2007 and 2008.

The cash-based general government fiscal deficit (excluding local governments) for 2006 came to 8.6% of GDP, marginally lower than the 8.8% as estimated in the revised budget. Both expenditures and revenues were in line with

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



Source: Ministry of Finance

those set in the revised budget, an indication of some effects brought by the deficit reduction package. Accrual-based (ESA95) general government deficit in 2006 has not been

released yet, but the government has announced that it will prove narrower than the 10.1% of GDP as envisaged in the revised budget.

Exhibit 3. Outline of the fiscal reduction packages

<Major structural reform program and its progress>	Adopted
<i>Public administration reforms</i>	
1 20% reduction of public employees in the central government A reduction of the ministries to 11 from 14	Yes
2 Consolidation and regional reorganization of the central administration and its regional bodies	No
<i>Local government reforms</i>	
1 Promotion of services performed base	Yes
2 Introduction of value-based real estate taxation	No
<i>Healthcare reforms</i>	
1 Increase in individual health insurance contribution	Yes
2 Introduction of prescription fee	Yes
3 Gradual liberalization of the opening of pharmacies	Yes
4 Charge for basic care	No
5 Creation of health service supervision	No
6 Potential opening of the health insurance market to private insurers	No
<i>Pension reforms</i>	
1 Lower age of eligibility for early retirement	No
2 Stricter qualification of early retirement	No
<Revenue enhancing measures implemented>	
● <i>Changes effective from September 2006</i>	
1 VAT rate to 20% from 15%	
2 Excise duty on cigarettes increased by 5.7% and on alcohol increased by 7%	
3 Tax on income from interest and stock exchange deals to 20%	
4 Rate of simplified business tax increased from 15% to 25%	
5 Individual health insurance contribution increased from 4% to 6%	
6 Pensioners who are in employment have to pay a 4% health insurance contribution	
7 Duty payable on the purchase of cars increased by 20%	
● <i>Changes effective from November 2006</i>	
1 The first income bracket of personal income taxation in the progressive rate structure will increase from HUF1.55 million to HUF1.7million	
2 Individual health insurance contribution increased from 6% to 7%	
3 Abolition of tax relief system of repayment of housing loans, education and purchasing computer	
4 Minimum base for contributions of Social security will increase from HUF125,000 to HUF 131,000 per month	
● <i>Changes effective from January 2007</i>	
1 People working while in retirement are required to pay 8.5% pension contribution	
2 Dependent people supported by close relatives will be required to pay health service contribution	

Source: Convergence Programme

3. Inflation rising amid economy deceleration

Hungary's real GDP growth rate decelerated to 3.9% year-on-year in 2006 from 4.2% in 2005. While domestic demand centering on consumer spending and investment continued to weaken due to the gradual implementation of the deficit reduction measures, strong exports bolstered the whole economy amid an expansion of the European economy (Exhibit 4). Consumer price inflation surged to 8.8% year-on-year in February 2007, due primarily to one-off factors, such as indirect tax increases and subsidy cuts as well as the depreciation of the currency in the middle of 2006. The inflation rate has been staying above the 3.0% medium-term target set by the National Bank of Hungary (NBH) since August 2006. The NBH has kept its policy rate at 8.00% since raising it by a total of 200 basis points between June 2006 and October 2006 on the assumption that inflation will slow down as one-off factors diminish (Exhibit 5).

The current account deficit in 2006 was remained large at 5.8% of GDP. More than 50% of the deficit was covered by FDI inflows. There is little concern over the external finance as foreign exchange reserves are enough to cover nearly three months of imports. The current account deficit is likely to narrow in 2007 as imports will fall due to an economic slowdown. The country's financial system remains sound, but the growing balance of bank loans led by those denominated in foreign currencies is fraught with possible exchange risks.

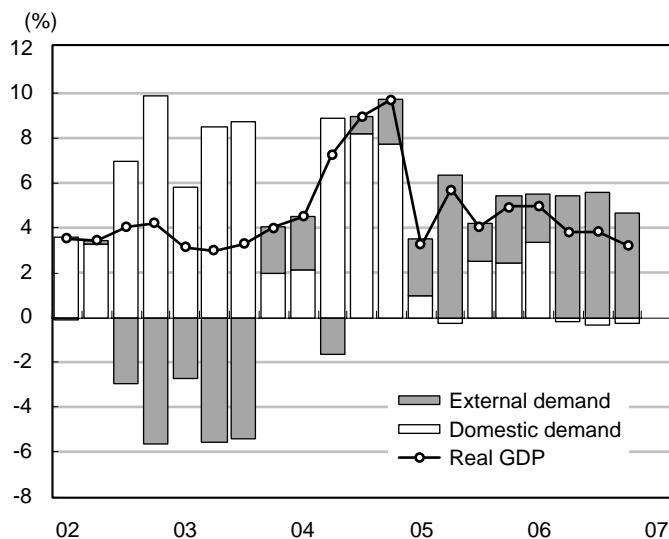
The value of the forint against the euro, though down to a historical low of over 280 in the middle of 2006 amid concern over the twin deficits, has been stabilized as a result of the implementation of the deficit reduction package.

4. Hungary in for a full implementation of the fiscal deficit reduction package

As an economic slowdown and rising inflation deepen in 2007, Hungary is entering a crucial stage where it needs to fully implement its fiscal deficit reduction package. The economic growth is likely to continue decelerating to around 2% in 2007 and 2008, nearly half the country's potential economic growth rate estimated at around 4%, as additional tax hikes and full-fledged expenditure reforms are put into force. The inflation rate will rise further at least until the temporary factors wear out this summer. For the whole of 2007, the inflation rate may go above 7% from 3.9% in 2006. A murky political situation has somewhat improved as the protest rallies against Prime Minister Gyurcsany have calmed down. However, political situation remains fragile as the main opposition Fidesz-Hungarian Civic Union is strongly opposed to the deficit reduction package and proclaims populist policies. Moreover, the approval rating of Prime Minister Gyurcsany remains weak.

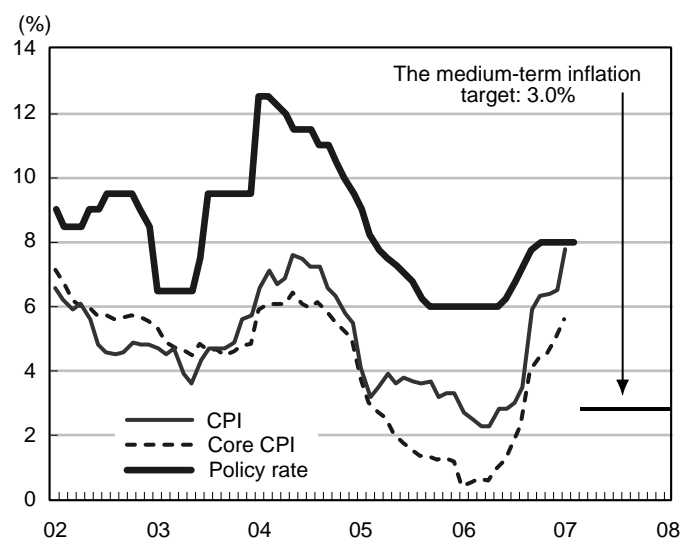
In December 2006, the government unveiled a "New Convergence Program" aimed at slashing the fiscal deficit to 2.7% of GDP in 2010 mainly through expenditure reforms. Its major reform programs will involve the central and local administration systems, education system and healthcare and pension systems. According to the program, the ratio of expenditures to GDP would drop significantly in 2007 and 2008 as compared with the ratio of revenues to GDP (Exhibit 6). This is because large-scale expenditure cuts will be implemented during the period covered by the new program whereas there will be some improvement on revenues due to the tax hikes that have already been carried out. If these

Exhibit 4. Real GDP growth rate (YOY)



Source: The Central Statistical Office

Exhibit 5. Consumer price inflation (YOY)



Source: National Bank of Hungary

measures are enforced according to the program, the fiscal deficit should narrow to 6.8% of GDP in 2007 and 4.3% in 2008.

In endorsing the new program, the EC urged the Hungarian government to rigorously implement its 2007 budget and curb expenditures, including those on public administration and healthcare. The government is expected to make some progress on its deficit reduction package as it has been required to report to the EC twice a year on its implementation. However, it will have to face an uphill battle, given the prospect of an economic deceleration and fragile political situation. JCR will continue to carefully monitor how the package will be carried out.

5. Hungary to adopt the euro in 2012 at the latest

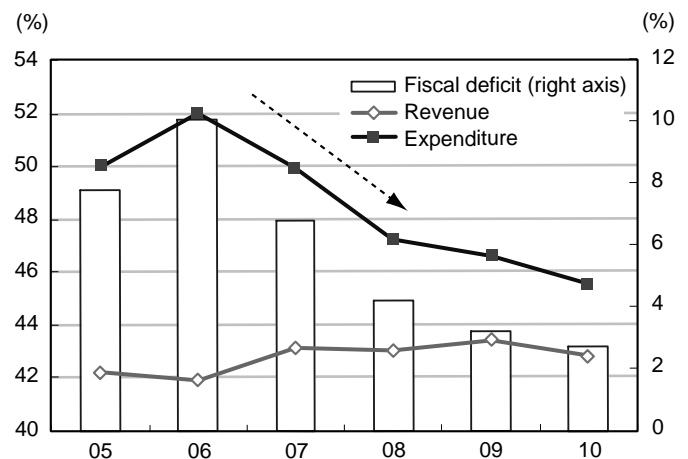
Hungary's adoption of the euro will inevitably be delayed from the initially planned 2010, as the government has put off specifying a target date. The 10 EU members including Hungary, which joined the EU in May 2004 initially, planned to introduce the euro between 2007 and 2010. Currently, however, progress on preparations varies from county to country. Slovenia has already decided to introduce the euro in January 2007 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.

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 exchange 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 2006 Convergence Program, Hungary did not fulfill any of the Convergence criteria, the prerequisite to euro adoption (Exhibits 7 & 8). The new Convergence Program envisages attaining compliance with all criteria in 2010. However, this timetable is highly dependent on whether the Hungarian government can fully implement its deficit reduction package. (JCR)

Exhibit 6. Projection of the general government fiscal balance (as % of GDP)



Source: Convergence Program

Exhibit 7. Overview of the New Convergence Program

	05	06	07	08	09	10
Real GDP	4.2	4.0	2.2	2.6	4.2	4.3
CPI	3.6	3.9	6.2	3.3	3.0	2.8
Unemployment rate	7.2	7.4	7.5	7.4	7.3	7.2
General gov't fiscal deficit/GDP	7.8	10.1	6.8	4.3	3.2	2.7
General gov't debt/GDP	61.7	67.5	70.1	71.3	69.3	67.5
Current account balance/GDP	6.8	6.9	5.0	3.3	2.3	1.5
Long-term interest rates	6.6	7.2	7.2	6.6	5.9	5.5

Source: Convergence Program

RATING PERSPECTIVE

Exhibit 8. Achievement of convergence criteria for the euro adoption

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				
	within -3%	below 60%	2.9%	5.4%	2 years	
	2005	2005	2006	2006	Entry	
Estonia	2.3	4.5	4.4	n.a.	June 2004	2008
Cyprus	-2.3	69.2	2.2	4.1	May 2005	2008
Latvia	0.1	12.1	6.6	4.1	May 2005	2008
Lithuania	-0.5	18.7	3.8	4.1	June 2004	unspecified (initially 2007)
Malta	-3.2	74.2	2.6	4.3	May 2005	2008
Slovenia	-1.4	28.0	2.5	3.9	June 2004	2007
Slovakia	-3.1	34.5	4.3	4.4	Nov 2005	2009
Czech Rep.	-3.6	30.4	1.9	3.5	No	unspecified (initially 2010)
Hungary	-6.5	61.7	3.9	7.1	No	unspecified (initially 2010)
Poland	-2.5	42.0	1.3	5.2	No	unspecified (initially 2009)

* 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.

Highlighted area indicates fulfillments of criteria

Source: The European Commission, Convergence program of each country

Exhibit 9. Economic indicators of the Slovak republic

	unit	2004	2005	2006 (f)	2007 (f)	2008 (f)
Real GDP	(%)	4.9	4.2	3.9	2.2	2.5
Per Capita GDP	(EU25=100)	61.3	62.5	63.0	63.5	64.0
Consumer price inflation	(%)	6.8	3.6	3.9	7.0	5.0
Unemployment rate	(%)	6.1	7.2	7.6	7.8	8.0
General government fiscal balance/GDP (ESA95)	(%)	-6.5	-7.8	-9.5	-7.0	-5.5
General government fiscal debt/GDP (ESA95)	(%)	59.4	61.7	67.5	70.0	71.5
Current account balance/GDP	(%)	-8.5	-6.8	-5.8	-2.8	-2.1
Trade balance/GDP	(%)	-3.0	-1.6	-0.5	1.4	2.9
Net Foreign direct investment	(%)	3.4	4.7	2.8	3.0	1.9
Net FDI/CA deficit	(%)	39.6	68.9	48.3	75.1	56.9
Foreign debt/GDP	(%)	70.3	76.9	97.9	95.6	99.8
Net foreign debt/GDP	(%)	56.5	59.5	79.4	79.5	85.3
Foreign debt/Exports	(%)	106.5	113.0	121.4	111.5	112.1
Public foreign debt/Exports	(%)	43.7	43.8	43.7	36.2	33.1
FOREX/Monthly imports	(months)	2.4	3.0	2.8	2.3	2.0
FOREX/Short-term foreign debt	(%)	1.5	1.6	1.5	1.2	1.0
Debt services	(%)	15.3	15.8	15.9	17.1	18.0

Source: The Central Statistical Office, National Bank of Hungary, Ministry of Finance and Eurostat. Figures for 2006 and 2008 are based on forecasts of JCR