

# RATING PERSPECTIVE

## The Republic of Hungary

### Massive Financial Package has helped to stabilize external position

JCR has affirmed its BBB+ rating on the foreign currency long-term senior debts and A- rating on the local currency long-term senior debts of Hungary. The outlook of the ratings remained Negative (Exhibit 1). The massive financing package committed by the IMF, EU and World Bank has helped to stabilize the country's external liquidity position. Nonetheless, the country's debt burden remains heavy with a large foreign debt and withdrawals from the aid package are further expanding the government debt. To make up for revenue shortfalls stemming from a sharp economic downturn, the government plans to hold down the fiscal deficit primarily through spending cuts. However, Prime Minister Ferenc Gyurcsany's announcement of his intention to resign in March 2009 could affect progress on the spending cut programs. This report will review those factors related to the ratings and their future outlook.

#### 1. The government secures external financing for 2009 barring drastic capital flight

In the midst of the deepening global financial crisis, the Hungarian government won the loan commitment from the IMF in November 2008 (a 17-month loan equivalent to EUR 12.5 billion). Together with the aid pledges made by the EU and World Bank, the country has been assured of the total financial aid equivalent to EUR20 billion or over 18% of GDP in 2008. The government has already withdrawn EUR 4.9 billion that has been made available immediately and another EUR 2 billion from the EU. The withdrawn financial aid is kept in the account of the foreign exchange reserves

until disbursement. As of end March 2009, foreign exchange reserves increased to EUR 27.9 billion from EUR 17.0 billion as of end October 2008 (Exhibit 2).

The aid package is conditional on the reduction of the government's financing requirements, further fiscal consolidation in the long-term, adequate capitalization of domestic bank and stability of external financing. To date, the government has tried to rein further fiscal deficit by adopting spending cut measures and adopted the Fiscal Responsibility Act for ensuring stringent spending rules. The government also set up a Capital Base Enhancement Fund and a Refinancing Guarantee Fund in December 2008. A portion of the IMF loan totaling Ft 600 billion (2.2% of GDP) was used for the two funds. Following the progress made so far by the government, another EUR 2.3 billion can be withdrawn from IMF in coming weeks. As a consequence, the foreign exchange reserves will be boosted further and will secure government external finance for 2009 barring drastic capital flight from Hungary.

#### 2. The worst economic recession since the country's economic transition

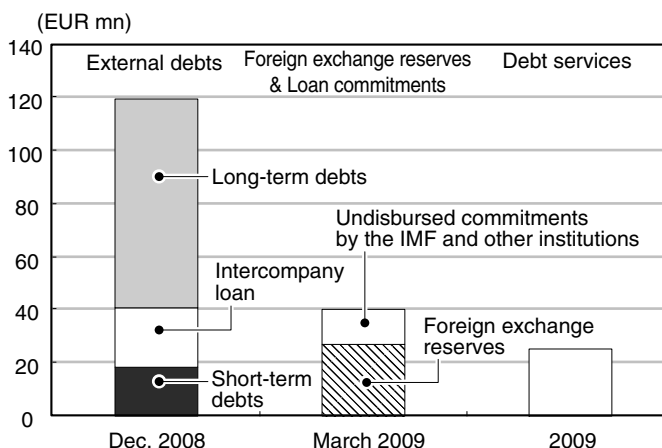
The Hungarian economy plunged into a serious recession from the latter half of 2008 reflecting a steep slowdown of exports derived from economic downturn in its major European trading partners and a sharp fall in domestic demand. The real GDP growth rate in the October-December quarter of 2008 contracted sharply more than 4% quarter-on-quarter (Exhibit 3). Throughout the year, the economy narrowly

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

	Foreign Currency	Local Currency
<b>AA</b>	Slovenia/s	Slovenia/s
<b>AA-</b>		
<b>A+</b>	Slovakia/s	Slovakia/s Czech Rep/s
<b>A</b>	Czech Rep/s	Poland/s
<b>A-</b>	Poland/s	Hungary/n
<b>BBB+</b>	Hungary/s	Bulgaria/n
<b>BBB</b>	Bulgaria/s	Romania/n
<b>BBB-</b>	Romania/s	

p: positive, s: stable and n: negative

**Exhibit 2. External Liquidity Position of Hungary**



Source: National Bank of Hungary

stayed positive at 0.5%, but the economy is highly likely to contract around 3% in 2009 for the worst recession since its economic transition. In 2010, expanding infrastructure investment backed by EU subsidies (Exhibit 4) and improved export competitiveness brought by the Hungarian forint's steep depreciation may sustain the economy to some extent. However, with spending cuts expected to continue, an economic recovery seen to begin in 2010 will be only moderate. Reflecting fall in prices of foods and energy and easing supply-demand, consumer price inflation in February 2009 decelerated further to 2.9% year-on-year, reaching below 3% of the inflation target set by the central bank.

**3. The government to meet revenue shortfalls with spending cuts**

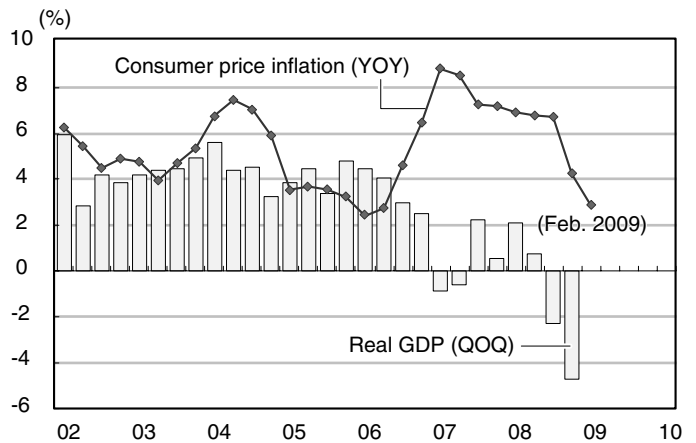
The austerity fiscal policy initiated by the government in 2006 helped to reduce the general government fiscal deficit to an estimated 3.4% of GDP in 2008 from 5.0% the previous year (Exhibit 5). At the end of 2008, the government had aimed to reduce the fiscal deficit in 2009 to 2.6% of GDP, based on the assumption that the economy would fall by 0.9%. In the midst of deepening economic downturn, the government was forced to revise the deficit upwardly to 2.9% reflecting the revised economic outlook to a 3.3% contraction. To make up for revenue shortfalls estimated at more than 1% of GDP, the government implemented a program to trim expenditures totaling 0.7% of GDP, including cuts in wages of public employees and pensions, as well as subsidies to households. With the aim of ensuring future economic growth, the government also carried out a tax revision, including reductions of the payroll tax and personal income tax and increases in the value added tax and excise tax. These changes are neutral to the budget. The government has earmarked a sum equivalent to 0.3% of GDP as a reserve fund to provide against contingencies. It has pledged that should the economy worsen further, it would seek to hold the deficit below 3% of GDP through additional expenditure cuts. However, the fiscal deficit in 2009 is highly likely to exceed the government projection.

JCR holds that a further deterioration of the fiscal deficit from 2010 can be stemmed as the government will have to restrain easy spending increases in accordance with the stringent rules set under the Fiscal Responsibility Act adopted in 2008. Nonetheless, there is concern over the future fiscal policy in view of the general election scheduled in 2010 and the prime minister's recent resignation statement. Meanwhile, the general government debt, which had increased to 65.8% of GDP at the end of 2007, grew further to exceed 70% of GDP at the end of 2008 following withdrawals from the IMF and EU loan commitments.

**4. Heavy external debt burdens led by the continued current account deficit**

The current account deficit was estimated to grow more than 8% (preliminary) of GDP in 2008 from 6.5% the previous year

**Exhibit 3. Deteriorating Economic Condition Amid Stable Inflation**



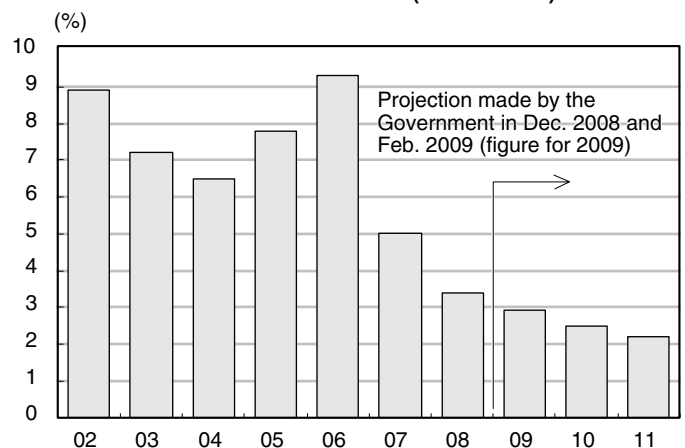
Sources: Hungarian Central Statistical Office, Eurostat

**Exhibit 4. Total Financial Transfer from EU in 2007-2013**

	EU subsidy (EUR mn)	Nominal GDP in 2006 (EUR mn)	As % of Nominal GDP
Bulgaria	6,853	25,100	27%
Czech Republic	26,692	113,068	24%
<b>Hungary</b>	<b>25,307</b>	<b>89,894</b>	<b>28%</b>
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: Eurostat

**Exhibit 5. General Government Deficit (as % of GDP)**



Sources: Ministry of Finance, Eurostat

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(Exhibit 6). However, the deficit in 2009 is likely to narrow as a larger trade surplus will more than offset a continuing income balance deficit. The current account deficit has been mainly financed with debt-creating funds centering on bank loans and portfolio investment. As a consequence, Hungary's foreign debt burden is heavier, with the gross foreign debt, mainly owed by banks, estimated at more than 110% of GDP at the end of 2008. Foreign debt to private sector increased to more than 70% of its total.

In the midst of global de-leveraging process, international investors became more risk averse and withdrew significant capital from the highly leveraged countries including Hungary. As a consequence, the currency and bond and share prices of those countries fell sharply. Among them, countries in weak external liquidity position were forced to turn to financial aid from the IMF (Exhibit 7). Bolstered by the loan provided by the IMF and EU, Hungary's foreign exchange reserves at the end of March 2009 increased to EUR 27.9 billion. The reserves strengthened its external liquidity position as the ratio of the foreign exchange reserves to the short-term debt at the end of 2008 improved to 1.5 (Exhibit 8). Monthly import cover ratio was also strengthened to almost 4 times.

### 5. The stability of the financial system needs to be watched

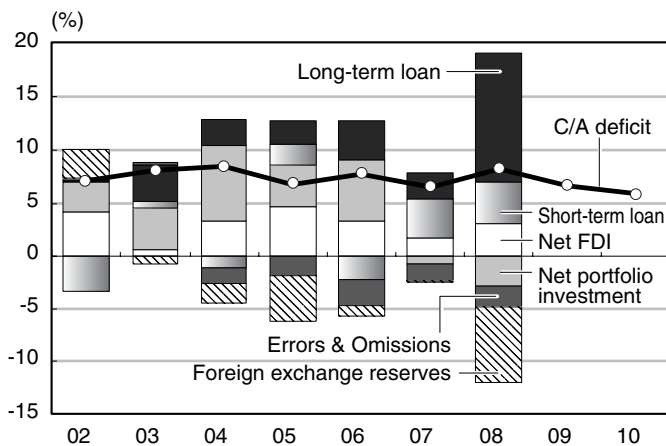
The country's financial market came under severe pressure in October 2008. But it is restoring stability thanks to the measures taken by the government and the central bank to replenish liquidity and the commitments of financial aid from the IMF and EU. The central bank raised its policy rate by 300bps to 11.5% in October 2008, but eased its policy rate

for three times from November 2008 by cutting a total 200 bps to 9.50%. Major Hungarian banks except OTP are the subsidiaries of big European banks. The parent banks have kept their exposure in Hungary so far. But there remains the possibility that they may reduce their exposure should they slip into a harder situation. Hungarian banks have so far remained profitable and kept their capital at adequate levels. But they are rather cautious about taking further risks as their profits are eroded by increased loan-loss provisions. A prolonged recession and a continuation of a weaker forint could add to the burdens of foreign currency-denominated liabilities owed by both households and companies, which already account for more than 50% of the total loan balance. Any increase in nonperforming loans could adversely affect the country's financial system. To prevent this, the government injected capital to OTP bank in April 2009 through the Capital Base Enhancement Fund.

### 6. Hungary will be ready for the euro adoption after 2014 at the latest

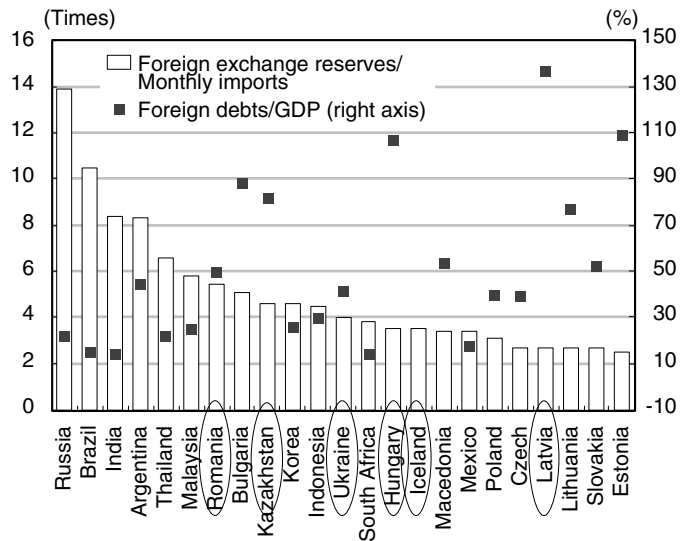
The coalition government formed by the leftist Socialist party and the SZDSZ-Hungarian Liberal Party (SZDSZ) in 2006 withdrew the target date for Hungary's adoption of the euro in 2011 and has put off specifying a target date. The 10 EU members including Hungary which joined the EU in May 2004 initially planned to introduce the euro between 2007 and 2010. Currently, however, progress on preparations varies from county to county. To date, Slovenia, Malta, Cyprus and Slovakia have already introduced the euro by January 2009 as initially planned. In contrast, Poland, Hungary and the Czech Republic, which have larger

Exhibit 6. Finance of the Current Account Deficit (as % of GDP)



Source: National Bank of Hungary

Exhibit 7. Foreign exchange reserves and foreign debts



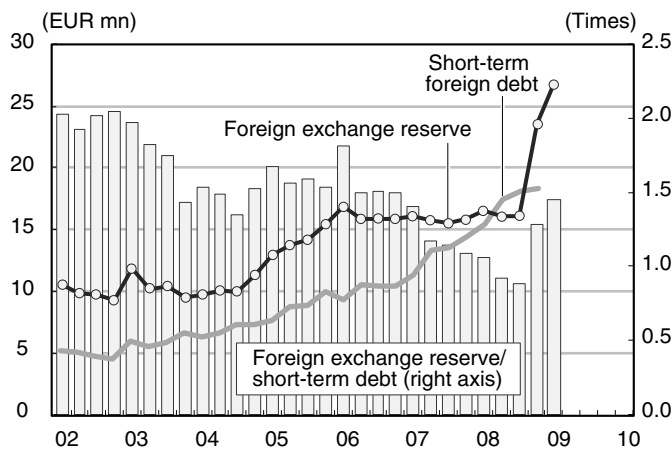
Sources: EIU, Central bank of each country. Countries in circle indicate those countries received IMF financial aid. Iceland (Foreign debt/GDP: 542%)

economies than the others, have yet to introduce the Exchange Rate Mechanism 2 (ERM2) and had been cautious about specifying target dates for euro adoption due to reasons primarily attributable to their chronic fiscal deficit.

Even though the government failed into minority status following the departure of SZDSZ from the coalition, Prime Minister indicated to introduce the euro between 2012 and 2014 in February 2009. Finance Minister also hinted to enter the ERM2 in 2009 for the future euro adoption. As Slovakia, which adopted the euro in January 2009, showed some resilience to the global financial crisis unlike other Central and East European countries, the euro adoption greatly contributes to stability of currency. While a country is required to transfer its monetary policy to the European Central Bank (ECB), highly credible ECB becomes the last resort of financial liquidity.

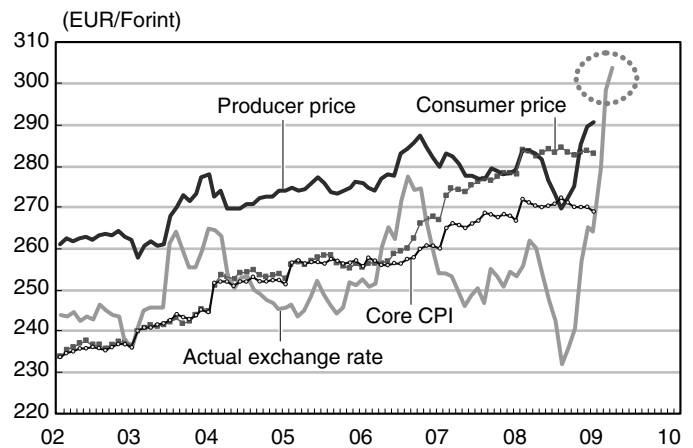
Hungarian Forint strengthened after the introduction of a float exchange rate regime from the flexible peg to the euro with fluctuation band (plus and minus 15%) in February 2008. However, forint fell sharply more than 30% from the end of 2008 as the global financial crisis deepened. According to the estimation made by JCR about equilibrium exchange rate against the euro (purchasing power parity), current exchange rate seems to be undervalued (Exhibit 9). Under these circumstances, it is still premature to fix an appropriate exchange rate. Regarding Hungary's other convergence criteria, the country only complied with inflation criteria. Under its updated Convergence Program in December 2008, Hungary aims to fulfill all criteria in 2010. However, JCR holds that Hungary will be able to join the euro in 2014 at the latest, as the country needs more time to prepare for the adoption. JCR

**Exhibit 8. Foreign exchange reserve and short-term foreign debt**



Source: National Bank of Hungary

**Exhibit 9. EUR/Forint exchange rate in terms of purchasing power parity**



Source: National Bank of Hungary. Compiled by JCR from Eurostat. Standard year was selected in 2001

**Republic of Hungary: Major economic indicator**

	Unit	2006	2007	2008	2009 (f)	2010 (f)
Real GDP growth rate	(%)	4.1	1.1	0.3	-4.0	-1.0
Consumer price inflation (YOY)	(%)	4.0	7.9	6.2	4.0	3.5
Unemployment rate	(%)	7.5	7.4	7.9	8.2	8.5
General government fiscal balance/GDP	(%)	-9.3	-5.0	-3.4	-3.5	-2.8
General government fiscal debts/GDP	(%)	65.6	65.8	72.0	76.0	81.2
Current account balance/GDP	(%)	-7.7	-6.5	-8.3	-6.4	-5.7
Trade balance/GDP	(%)	-2.3	0.3	0.1	-0.7	0.0
Net foreign direct investment/GDP	(%)	3.2	1.7	3.0	0.5	1.0
External debts/GDP	(%)	90.4	97.1	110.6	117.4	124.0
Public external debts/Exports G&S	(%)	44.0	41.3	44.6	47.4	46.1
External debts/Exports G&S	(%)	118.0	121.6	138.7	133.0	136.3
Foreign exchange reserves/Monthly imports G&S	(months)	2.7	2.4	3.8	3.9	3.6
Foreign exchange reserves/Short-term external debts	(times)	1.5	1.1	1.5	1.3	1.1
Debt Service Ratio	(%)	29.5	26.0	23.3	29.3	27.8

Sources: Ministry of Finance, Central bank, Eurostat. Figure for fiscal balance is based on ESA 95. Figures for 2009 and 2010 are projections by JCR.