

## Hungary (the Republic of)

Foreign LT: **A-/Stable**, Local LT: **A /Stable** (revised on October 4, 2006)

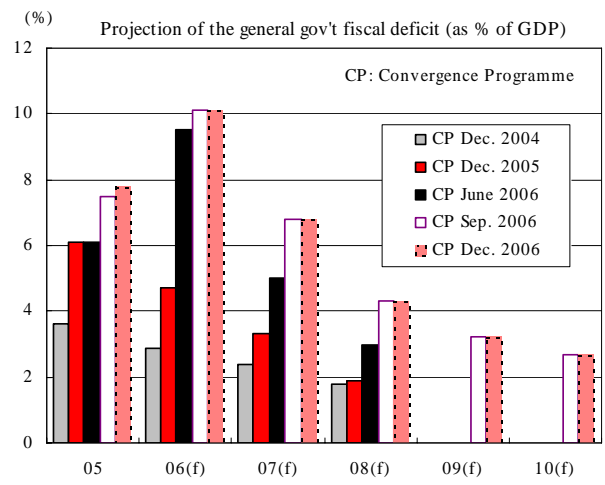
### <Rating perspective>

#### Positive Factors

- The expectation that Hungary will bring itself into harmony with the euro-zone economy through implementation of economic and fiscal reforms geared for euro adoption in the medium-term
- Rising exports resulting from the expansion of production capacity and transformation into a more value-added industrial structure through inflows of FDI

#### Negative Factors

- The continuing large fiscal deficit will boost the government debt.
- Growing external debt and fragile external financing structure



### <Updated: from November 2006 to January 2007>

#### Positive Factors

- The government announced that the general government fiscal deficit (ESA95, accrual-based accounting) in 2006 will be narrower than the 10.1% of GDP envisaged under the revised fiscal plan.
- The general government fiscal deficit (GFS, cash-based accounting) in 2006 was 8.7% of GDP, marginally lower than the 8.8% projected under the revised fiscal plan.
- The fiscal plan for 2007, which projects the general government deficit in 2007 at 6.8% of GDP (ESA95), was approved by parliament.
- The European Commission endorsed the new Convergence Program submitted by Hungary at the beginning of December 2006.
- Current account deficit in the first nine months of 2006 was reduced by 12% year-on-year to Ft 4,060 million or 4.7% of GDP.

#### Negative Factors

- Real GDP growth rate in the July-September quarter of 2006 went on decelerating to 3.8% year-on-year.
- Consumer price inflation in December 2006 accelerated to 6.5% year-on-year on increased tax rates.

### <Outlook and Points to Watch>

#### *Further fiscal deterioration halted*

##### (1) **Fiscal deficit in 2006 is set to narrow slightly as compared with the one estimated in the revised fiscal plan**

Fiscal deficit in 2006 is set to narrow slightly as compared with the one estimated in the revised fiscal plan. The government had initially projected the general government fiscal deficit (ESA95, accrual-based accounting and excluding pension reform costs) to rise to 6.1% of GDP in 2006. However, it had to revise the deficit upward to 10.1% of GDP due mainly to increased spending on election measures and some changes in the accounting methodology related to military and motorway construction spending. The cash-based general government fiscal deficit (excluding local government), which has already been released, came to 8.7% of GDP in 2006, marginally lower than the 8.8% estimated in the revised fiscal plan. The hike of value-added tax rates, increases of personal and corporate tax rates and social security contributions as well as a 20% reduction in the number of public employees under the fiscal deficit reduction measures contributed favorably to both expenditures and revenues. Both actual expenditures and revenues were in line with those set in the revised fiscal plan. Accrual-based general government deficit in 2006 has not been released yet, but the government has already announced that it will be narrower than the 10.1% of GDP envisaged in the revised fiscal plan.

##### (2) **Hungary in for a crucial stage of fiscal deficit reduction**

Although a further fiscal deterioration was halted, no optimism is warranted about future prospects given the

impact of a full-fledged implementation of spending cuts, a possible economic slowdown and rising inflation. As a follow-up to its Convergence Program unveiled in September 2006, the government submitted a new Convergence Program outlining its structural reform initiatives to the European Commission in December 2006. The new program was generally in line with the September program. It envisaged slashing the fiscal deficit to 2.7% of GDP in 2010 from 10% in 2006 primarily through spending cuts. In the new programme, the government again avoided specifying a target date for euro adoption as in the previous program. While the European Commission endorsed the new program, it urged the government to rigorously implement its 2007 budget and curb expenditures including those on public administration and healthcare. A full implementation of the new program would make the steering of fiscal and monetary policies harder as tax increases and expenditure cuts would slow economic growth and a cutback on subsidies would push up the inflation rate. However, full implementation of the programs would prove effective in stemming a further expansion of the fiscal deficit and bringing a reduction of the current account deficit.

### (3) Economy continued to decelerate amid rising inflation

Real GDP growth rate in the July-September quarter of 2006 decelerated to 3.8% year-on-year on weak domestic demand amid rising inflation. Slow investment and government consumption were mainly to blame. Consumer price inflation in December 2006 accelerated to 6.5% year-on-year on increased tax rates, staying above the 3.0% medium-term inflation target set by the National Bank of Hungary (NBH). The NBH has kept its policy rate at 8.00% since October 2006 after raising it by a total of 200 basis points in 2006. Current account deficit remained large, but reduced by 12% year-on-year to Ft 4,060 million or 4.7% of GDP in the first nine months of 2006 due mainly to reduced trade balance. More than 70 % of the current account deficit was covered by FDI inflows in the first nine months of 2006. The value of the forint against the euro plunged to a historic low of over 280 at the end of June 2006 amid rising concern over the twin deficits. However, the forint has since begun recovering moderately thanks in part to the fiscal deficit reduction measures.

### (4) Economy will decelerate further as the implementation of the fiscal deficit reduction package

The Hungarian economy is likely to continue decelerating as the fiscal deficit reduction package is fully put into force. Following the tax increases in September 2006, more are expected in 2007. Retrenchment and a wage freeze for public employees will also be carried out. These measures will have negative impacts on household disposal income in the coming months. Inflation is set to rise further on a series of adjustment on administered prices and tax increases. JCR will closely watch how the government will push ahead with the fiscal deficit reduction package amid the decelerating economy and rising inflation.

The ruling coalition's political base been dented following its setback in the recent local elections and a wave of protest rallies triggered by the prime minister's admission that he had connived at a false report on past economic policies. Therefore, there remains a possibility of a lukewarm implementation of the package. If this could happen, a further rise in interest rates, a weakening of the currency and a flight of invested capital could be triggered.

## Main Economic Indicators: The Republic of Hungary

		2002	2003	2004	2005	2006 (f)	2007(f)	2008(f)
<b>(Convergence criteria)</b>	<b>Criteria</b>							
1.CPI (annual average)	2.8%(note)	5.3	4.7	6.8	3.6	3.9	7.0	5.0
2.10 year government bond yield	5.2%(note)	7.1	7.0	8.1	6.6	7.1	6.8	6.5
3.General gov't fiscal balance/GDP(ESA95)	Below -3%	-8.9	-7.2	-6.5	-7.8	-10.0	-7.0	-5.5
4.General gov't debt/GDP(ESA95)	Below 60%	55.6	58.0	59.4	61.7	67.5	70.0	71.5
Real GDP growth rate	(%)	3.8	3.4	4.9	4.2	4.1	2.2	2.5
Unemployment rate (year-end)	(%)	5.9	5.9	6.1	7.2	7.6	7.8	8.0
Current account balance	(EUR mln)	-4,929	-5,933	-6,916	-6,002	-4,926	-3,595	-3,162
Current account balance/ GDP	(%)	-7.1	-8.1	-8.5	-6.8	-5.7	-4.0	-3.3
Trade balance/ GDP	(%)	-3.2	-3.9	-3.0	-1.6	-1.4	0.5	1.9
Net Foreign Direct Investment/ GDP	(%)	4.2	0.6	3.4	4.7	4.1	3.0	1.9
Forex reserves (excl. gold)	(EUR mln)	9,279	9,527	11,224	15,432	15,200	14,500	14,000
Forex reserves / monthly Imports (G&S)	(months)	2.4	2.3	2.4	3.0	2.7	2.3	2.1
Forex reserves/ short-term external debt	(times)	2.0	1.4	1.5	1.5	1.3	1.2	1.1
External debt/ GDP	(%)	56.8	65.3	70.3	78.1	90.7	95.5	99.1
External debt/ exports (G&S)	(%)	88.5	104.4	106.5	114.8	114.6	113.5	113.5
Public external debt/ exports (G&S)	(%)	40.6	42.7	43.9	45.5	40.5	36.8	33.7
Debt service ratio	(%)	13.7	14.2	15.3	15.8	16.2	17.7	18.3

(Note) Figures for criteria 1 and 2 are average between Dec. 2005 and Nov. 2006. Figures for 2006 and 2008 are based on JCR projection

(Source) The European commission, The National Bank of Hungary, and Ministry of Finance.

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