

2007-21
August 29, 2007

Hungary (the Republic of)

Foreign LT: **A-/Stable**, Local LT: **A /Stable** (affirmed on April 4, 2007)

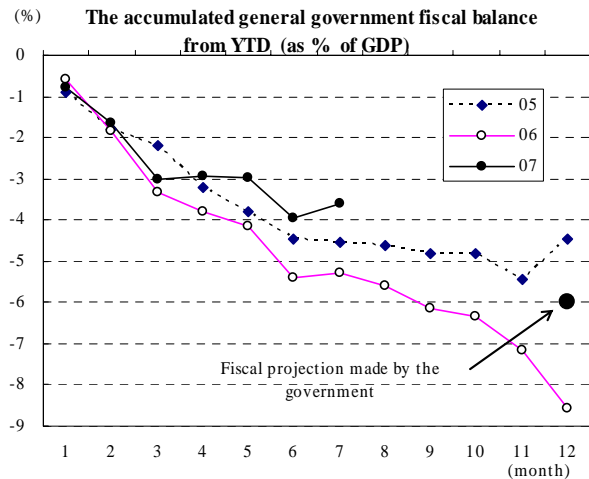
<Rating Perspective>

Positive Factors

- Deepening economic ties with European countries since early stage of its economic transformation triggered by reform initiatives
- Growing exports and progress on enhancement of industrial structure amid expanding production capacity rendered by massive FDI inflows

Negative Factors

- Growing government debt resulting from persistent large fiscal deficit
- Massive foreign debt owed primarily by the private sector



<Updated: from May 2007 to August 2007>

Positive Factors

- On June 19, the Ministry of Finance lowered its projection of the general government fiscal deficit (on cash base, excluding local governments) in the first half of 2007 to 3.8% of GDP from 4.1%. At the same time, the fiscal deficit for 2007 as a whole was revised downward to 6.0% of GDP from 6.6%.
- The general government fiscal deficit in the first seven months of 2007 improved to 3.6% of GDP from 5.3% in the same period of 2006.
- The European Commission commended the fiscal consolidation efforts made by the government on June 14.
- Current account deficit in the first three months of 2007 narrowed to 4.8% of GDP from 7.2% the year before.
- Consumer price inflation declined modestly to 8.6% year-on-year in June after accelerating to 9.0% in March on increased tax rates and administrated prices.
- The abated inflation rate prompted the central bank to lowered its policy rate to 7.75% from 8.00% on June 25.

Negative Factors

- Amid continuing sluggish domestic demand, real GDP growth rate in the January-March quarter of 2007 further decelerated to 2.7% year-on-year from 3.3% the previous quarter.

<Outlook and Points to Watch>

Progress on fiscal deficit-reduction package

(1) **The package helps narrow the deficit in 2007**

The fiscal deficit continued to improve thanks to the implementation of a deficit-reduction package, with the general government fiscal deficit (on cash base, excluding local governments) narrowing to 3.6% of GDP in the first seven months of 2007 from 5.3% in the same period of 2006. Revenues during the period grew 7.5% from the year before on reform initiatives, such as the hike of the VAT and corporate tax rates and an increase in social security contributions by employees. Expenditure reforms, notably redundancy of public employees, contributed to reining the spending growth in the period to 3.9% year-on-year. The fiscal improvement prompted the government to revise downward its projection of the 2007 deficit twice – to 6.6% of GDP in May and to 6.0% in June from the initially projected 6.8%. In June, the European Commission passed a generally high remark of the fiscal consolidation efforts made by the government, while pointing out that further implementation of wide-ranging reforms will be needed to achieve the required fiscal consolidation by 2009.

(2) **The central bank lowers policy rate on reduced inflation amid economic slowdown**

Amid a continuing slump of domestic demand, the country's real GDP growth rate in the January-March quarter of 2007 further decelerated to 2.7% year-on-year from 3.3% the previous quarter. While domestic demand centering on consumer spending

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and investment continued to weaken due to the implementation of the deficit-reduction package, strong exports underpinned the whole economy amid continuing expansion of the European economy. Consumer price inflation declined modestly to 8.6% year-on-year in July after accelerating to 9.0% in March on increased tax rates and administrated prices. The slower inflation rate encouraged the central bank to lower its policy rate to 7.75% from 8.00% on June 25. Meanwhile, the current account deficit in the first three months of 2007 narrowed to 4.8% of GDP from 7.2% the year before due mainly to strong exports. The deficit was mainly financed by a net inflow of portfolio investment centering on bonds which more than offset a net outflow FDI. The foreign exchange reserves posted a modest increase, remaining at a level enough to cover almost three months of imports. The forint (Ft/ EUR) weakened to upper Ft 280 in the summer of 2006 amid concern over fiscal deterioration and repeated protest rallies targeted at the prime minister. But it has since recovered due mainly to the implementation of the fiscal reduction package. Currently, the forint is being traded at the Ft 250 level.

(3) Implementation of the fiscal deficit reduction package at a crucial stage

The fiscal deficit has been improving thanks to the implementation of the measures prescribed in the package. The economy has so far managed to avert a serious deceleration, bolstered by strong exports. The inflation rate has apparently peaked out and started to stabilize, allowing the central bank to cut its policy rate.

Under its Convergence Program released in December 2006, the government pledged to slash the fiscal deficit (ESA95 excluding costs of pension reform unless otherwise indicated) to 6.8% in 2007, 4.3% in 2008, 3.2% in 2009 and 2.7% in 2010 through implementation of expenditure and revenue reforms. Fiscal development so far this year seems to be in line with the government projection. Moreover, the government has revised downward its 2007 deficit estimate to 6% of GDP. The new estimate is highly likely to be met. The improvement made so far was largely attributable to the tax hikes and wage cuts for public employees, which were relatively easier to carry out. However, a further reduction of the deficit from 2008 onward will have to depend on much tougher expenditure reforms. Currently, the government is in the process of working out wide-ranging reform measures involving education, local governments and healthcare/pension systems. JCR will keep a close watch on whether Prime Minister Ferenc Gyurcsany, now facing a bleak approval rating, can push ahead with effective expenditure reforms. With the main opposition Fidesz-Hungarian Civic Union strongly critical of the deficit-reduction package and advocating populist policies, the future course of spending reforms appears to remain in the balance.

The Hungarian economy is expected to post a moderate growth rate of around 2% in 2007 as robust exports make up for weak domestic demand. However, the economy may begin gradually picking up in the latter half of 2008 on completion of initial expenditure/revenue reforms and the effect of the interest rate cut. JCR holds that the inflation rate will continue to improve as wage increases are kept lower mainly for public employees.

(4) No revision of the ratings and outlook

JCR takes a positive view of the improved fiscal and macroeconomic performances brought by the deficit-cutting package. However, it has to remain cautious about future prospects since much will depend on the implementation of additional expenditure reforms. For this reason, JCR has kept its ratings and outlook unchanged. If significant progress is made in implementing effective spending reforms, it will consider a revision of the ratings and outlook.

Main Economic Indicators: The Republic of Hungary

		2002	2003	2004	2005	2006	2007(f)	2008(f)
(Convergence criteria)	Criteria							
1.CPI (annual average)	3.0%(note)	5.3	4.7	6.8	3.6	4.0	8.0	6.0
2.10 year government bond yield	5.4%(note)	7.1	7.0	8.1	6.6	7.1	6.6	6.3
3.General gov't fiscal balance/GDP(ESA95)	Below -3%	-8.2	-7.2	-6.5	-7.8	-9.2	-6.0	-4.6
4.General gov't debt/GDP(ESA95)	Below 60%	54.0	58.0	59.4	61.7	66.0	68.3	69.5
Real GDP growth rate	(%)	3.8	3.4	4.9	4.2	3.9	2.5	3.0
Unemployment rate (year-end)	(%)	5.9	5.9	6.1	7.2	7.5	7.8	8.0
Current account balance/ GDP	(%)	-7.1	-8.1	-8.5	-6.8	-5.6	-3.4	-4.4
Trade balance/ GDP	(%)	-3.2	-3.9	-3.0	-1.6	-0.5	1.2	0.3
Net Foreign Direct Investment/ GDP	(%)	4.1	0.6	3.4	4.7	2.7	2.2	1.6
Forex reserves (excl. gold)	(EUR mln)	9,279	9,527	11,224	15,451	15,841	15,500	14,500
Forex reserves / monthly Imports (G&S)	(months)	2.4	2.3	2.4	3.0	2.8	2.4	2.0
Forex reserves/ short-term external debt	(times)	2.0	1.4	1.5	1.6	1.5	1.2	1.1
External debt/ GDP	(%)	56.7	65.3	70.3	76.9	93.3	92.3	88.8
External debt/ exports (G&S)	(%)	88.5	104.4	106.6	113.0	121.4	117.3	114.8
Public external debt/ exports (G&S)	(%)	40.6	42.7	43.7	43.8	43.7	40.0	38.3
Debt service ratio	(%)	13.7	14.2	15.3	15.8	15.9	16.2	17.2

(Note) Figures for criteria 1 and 2 are average between May 2006 and April 2007. Figures for 2007 and 2008 are based on the projection made by JCR

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

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