

## Hungary (the Republic of)

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

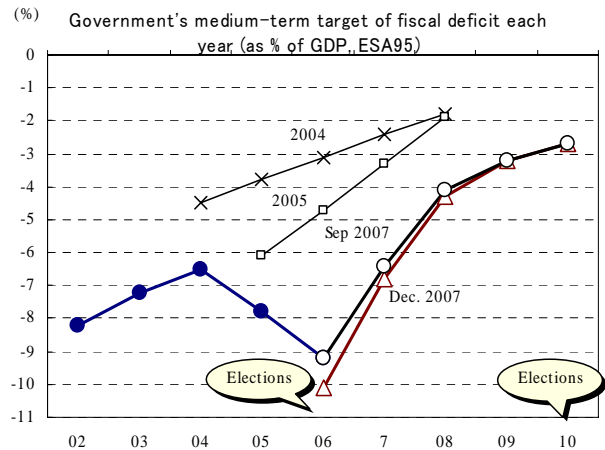
### <Rating Perspective>

#### 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 August 2007 to October 2007>

#### Positive Factors

- The general government fiscal deficit in the first ten months of 2007 improved to 4.8% of GDP from 6.4% in the same period of 2006.
- The government revised its projection of the general government fiscal deficit (ESA95) from initial 6.8% of GDP to 6.6% in April and 6.4% in September.
- The 2008 budget draft plans the general government fiscal deficit to 4.1% of GDP from 6.4% in 2007 (underlying assumption of real GDP growth rate: 2.8% and inflation: 4.5%).
- Consumer price inflation declined to 6.7% year-on-year in October after accelerating to 9.0% in March on increased tax rates and administrated prices.
- The National Bank of Hungary lowered its policy rate twice in June and September by 25 basis points to 7.00%.
- Current account deficit in the first half of 2007 narrowed to 2.9% of GDP from 3.6% the year before.

#### Negative Factors

- Real GDP growth rate in the April-June quarter of 2007 decelerated further to 1.2% year-on-year from 2.7% in the previous quarter on the weakening domestic demand, in particular consumer spending.
- Net foreign direct investment (FDI) inflow in the first half of 2007 was a net outflow equivalent to 1.4% of GDP.

## <Outlook and Points to Watch>

### Narrowing 2007 fiscal deficit

#### (1) JCR has assigned an A- rating to the 5th Samurai bonds

On October 18, JCR has assigned a A- rating to the 5th Samurai bonds. The ongoing progress on fiscal deficit reduction measures is working to narrow the fiscal deficit in 2007 faster than the projection under the budget plan for the year, although the initiatives are having negative impacts on consumer spending to slow down the whole economic growth. Consumer price inflation has apparently peaked out amid stabilized currency fluctuations, allowing the central bank to cut its policy rate twice since the beginning of the year. The government plans to push ahead with expenditure reforms to ensure further reduction of the fiscal deficit. JCR will carefully monitor the implementation of the measures, while retaining its current ratings.

The rating is mainly supported by the fact that the country has deepened its ties with European countries since the early stage of its economic transformation by pushing economic reforms and that FDI mainly from European countries has been contributing to expanding the country's production capacity and enhancing its industrial structure through

increased production of higher value-added products. On the other hand, the rating continues to be constrained by a high-level fiscal deficit, a persistent current account deficit and a relatively large foreign debt owed primarily by the private sector. The surging foreign debt owed mainly by banks may stabilize as the economy slows down.

## (2) Progress on fiscal deficit reduction measures helps narrow the deficit in 2007

The ongoing progress on the fiscal deficit reduction measures is working to cut the fiscal deficit in 2007 faster than what has been projected under the budget plan for the year. Revenues are growing substantially thanks to the 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 and cuts in various subsidies, are contributing to reining the spending. The fiscal improvement prompted the government to revise downward its projection of the 2007 fiscal deficit to 6.4% of GDP(ESA95) in September from the initially estimated 6.8%. Moreover, the estimated ratio of the general government fiscal debt to GDP at the end of 2007 was also lowered 66.2% from an initial 70.1% due mainly to the appreciation of the forint and the narrowing deficit. The government is required to report to the European Commission twice a year on implementation of its fiscal reduction measures. Commenting on a report the government submitted in April, the EC made generally high remarks of its fiscal consolidation efforts, while pointing out that the introduction of additional wide-ranging reforms will be needed to attain the required fiscal consolidation by 2009. The government has pledged to carry out further spending cuts to bring the deficit-GDP ratio down from 6.4% in 2007 to 4.1% in 2008, 3.2% in 2009 and 2.7% in 2010.

## (3) Slower inflation prospects prompted the central bank lower its policy rate amid economic deceleration

Hungary's real GDP growth rate in the first half of 2007 decelerated to 1.9% year-on-year from 3.9% in 2006. While domestic demand centering on consumer spending continued to weaken due to the implementation of the fiscal deficit reduction measures, strong exports underpinned the whole economy amid continuing growth of the European economy. Consumer price inflation declined modestly after accelerating to 9.0% in March 2007 following the hikes of the tax rates and administrated prices. The slower inflation prospects encouraged the central bank to lower its policy rate by a total 50 basis points in June and September. Meanwhile, the current account deficit in the first half of 2007 narrowed to estimated 2.9% of GDP from 3.6% the year before due mainly to a turnaround of the trade balance into surplus. The deficit was mainly financed by increased banking sector liabilities and inflows portfolio investment which more than offset a net outflow FDI. The swelling foreign debt owned by banks looks likely to stabilize as the economy slows down. Credit squeeze in industrialized countries remains limited effects on the economy.

### Main Economic Indicators: The Republic of Hungary

		2002	2003	2004	2005	2006	2007(f)	2008(f)
<b>(Convergence criteria)</b>	<b>Criteria</b>							
1.CPI (annual average)	2.4%(note)	5.3	4.7	6.8	3.6	4.0	8.0	6.0
2.10 year government bond yield	5.5%(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-tem 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 October 2006 and September 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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