2007-53
February 29, 2008

Hungary (the Republic of)

Foreign LT: **A-/Stable**, Local LT: **A /Stable**

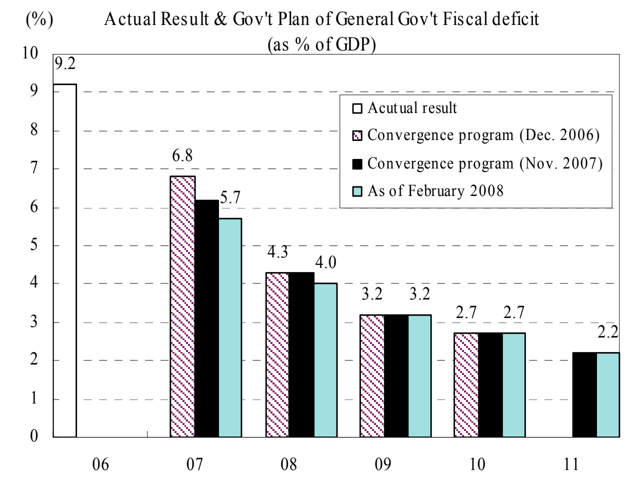
<Rating Perspective>

Positive Factors

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

Negative Factors

- persistent large fiscal deficit and high level of government debt
- Large foreign debt owed primarily by the private sector



<Updated: from November 2007 to January 2008>

Positive Factors

- The fiscal deficit (ESA95) in 2007 improved to 5.7% of GDP (on a preliminary basis) from 9.2% the year before
- The government has pledged to slash the annual general government fiscal deficit to 2.2% of GDP by 2011 under its updated Convergence Program published in November 2007. It is aiming to cut the deficit in 2008 to 4.0% of GDP
- On February 26, the NBH abandoned the flexible peg of the forint to the euro with a fluctuation band and adopt a floating exchange rate regime
- The current account deficit in the first nine months of 2007 narrowed to 4.0% of GDP (estimated) from 5.1% the year before

Negative Factors

- An opposition-proposed referendum on possible increases in medical bills and tuition is scheduled for March 9
- Real GDP growth rate further decelerated to 0.9% year-on-year in the July-September quarter of 2007 from 2.0% in the first half of the year
- Consumer price inflation, although declined to 6.4% year-on-year in September 2007, rose to 7.4% in December on higher energy and food prices
- Net foreign direct investment (FDI) inflow in the nine months of 2007 was a net outflow equivalent to 0.04% of GDP
- The financing of the current account deficit in the nine months of 2007 was mainly covered by long and short-term lending

<Outlook and Points to Watch>

Continued narrower fiscal deficit in 2008

(1) Progress on fiscal deficit reduction measures to help narrower the deficit in 2008

The fiscal deficit reduction measures helped to trim the fiscal deficit (ESA95, unless otherwise indicated) in 2007 to 5.7% of GDP (on a preliminary basis) from 9.2% the year before. The improvement was prominent even as compared with the 6.8% deficit target envisaged in the initial budget plan. Much of the improvement came from strong revenues brought by the reform initiatives, such as the hike of the VAT and corporate tax rates and increased social security contributions by employees as well as intensified tax collections through the gray economy. At the same time, the growth of expenditures was kept modest through redundancy of public employees, cuts in various subsidies and reduced interest payments. The general government debt at the end of 2007 remained high as it came to 65.4% of GDP (preliminary), just a shade down from 65.6% the year before.

The government has pledged to slash the annual general government fiscal deficit to 2.2% of GDP by 2011 under its updated Convergence Program. It is aiming to cut the deficit in 2008 to 4.0% of GDP. JCR considers that the target is highly likely to be met because the government is set to implement its expenditure reforms including the pledged cuts

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in subsidies, wages for public employees and spending on motorway construction projects. The government has built up its reserves, adding to its resilience to contingency. From 2009 onward, additional expenditure reforms will be needed to ensure a further deficit reduction. Such measures are to be discussed in the coming months. JCR will carefully watch the future development of deficit reduction measures as the current fiscal policies might be shifted ahead of the general elections scheduled for 2010.

Meanwhile, an opposition-proposed referendum on possible increases in medical bills and tuition is scheduled for March 9. In the present situation, the opposition looks likely to win the referendum. However, such result may have only a limited policy impact as the coalition government is committed to implementing its expenditure reforms.

(2) After temporary slowdown, the economy may turn to moderate recovery in 2008 amid lower inflation

Real GDP growth rate further decelerated to 0.9% year-on-year in the July-September quarter of 2007 from 2.0% in the first half of the year. While domestic demand centering on consumer spending continued to slacken due to the implementation of the fiscal deficit reduction measures, strong net exports underpinned the whole economy. Consumer price inflation declined modestly to 6.4% year-on-year in September 2007 as the effect of the increased tax rates and administrated prices wore away but rose to 7.4% in December on higher energy and food prices. NBH cut its policy rate by a total 50 basis points in June and September but has since kept it at 7.5%. On February 26, the NBH abandoned the flexible peg of the forint to the euro with a fluctuation band and adopt a floating exchange rate regime. JCR appreciates that a floating exchange rate regime contributes to more effective monetary policy to achieve its inflation target.

In 2008, the economy will grow nearly 3% on recovery of consumer spending brought by a gain in real wages, stronger infrastructure investment spurred by massive inflows of EU subsidies and continued expansion of corporate investment led by spending on machinery. Inflation is likely to decelerate below 5% on the moderate wage settlement in 2008, although future developments of energy and food prices remain uncertain.

(3) Weak financial structure of C/A deficit and growing foreign debt led by the private sector

The current account deficit in the first nine months of 2007 narrowed to 4.0% of GDP (estimated) from 5.1% the year before due mainly to a turnaround of the trade balance into surplus. The deficit was mainly financed by increased borrowings by banks and a net inflow of portfolio investment which more than offset a net FDI outflow. Hungary's foreign debt burden is relatively heavy, with the foreign debt mainly owed by banks exceeding 90% of GDP at the end of September 2007. Foreign liquidity is rather insufficient, with the ratio of foreign exchange reserves to monthly imports staying lower than three times. The instable financing structure has sent the value of the currency and bond and stock prices lower amid the current global credit turmoil. However, this has had only a limited impact on the economy as the financial system itself remains stable.

Main Economic Indicators: The Republic of Hungary

		2003	2004	2005	2006	2007 (f)	2008 (f)	2009 (f)
(Convergence criteria)	**Criteria**							
1.CPI (annual average)	2.8%(note)	4.7	6.8	3.6	4.0	8.0	4.8	3.6
2.10 year government bond yield	5.7%(note)	7.0	8.1	6.6	7.1	6.7	6.2	6.0
3.General gov't fiscal balance/GDP(ESA95)	Below -3%	▲7.2	▲6.5	▲7.8	▲9.2	▲5.7	▲4.0	▲3.8
4.General gov't debt/GDP(ESA95)	Below 60%	58.0	59.4	61.7	66.0	66.5	66.8	67.0
Real GDP growth rate	(%)	3.4	4.9	4.2	3.9	1.8	2.8	4.0
Unemployment rate (year-end)	(%)	5.9	6.1	7.2	7.5	7.2	7.5	7.3
Current account balance/ GDP	(%)	▲8.1	▲8.4	▲6.8	▲6.5	▲5.2	▲4.1	▲4.8
Trade balance/ GDP	(%)	▲3.9	▲3.0	▲1.6	▲1.0	1.0	1.4	0.3
Net Foreign Direct Investment/ GDP	(%)	0.6	3.3	4.7	3.1	-0.1	0.5	1.6
Forex reserves (excl. gold)	(EUR mln)	9,527	11,225	15,451	15,841	15,804	16,500	18,000
Forex reserves / monthly Imports (G&S)	(months)	2.3	2.4	3.0	2.7	2.4	2.2	2.1
Forex reserves/ short-tem external debt	(times)	1.4	1.5	1.5	1.5	1.2	1.2	1.2
External debt/ GDP	(%)	65.3	69.4	76.5	94.2	98.9	102.8	104.9
External debt/ exports (G&S)	(%)	104.4	106.6	112.5	121.7	120.8	122.9	120.2
Public external debt/ exports (G&S)	(%)	42.7	43.7	43.8	43.6	41.0	39.5	36.0
Debt service ratio	(%)	14.2	15.3	16.0	13.0	14.5	15.0	16.0

(Note) Figures for criteria 1 and 2 are as of end 2007. Figures for 2007, 2008 and 2009 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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