2008-15
June 30, 2008

Hungary (the Republic of)

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

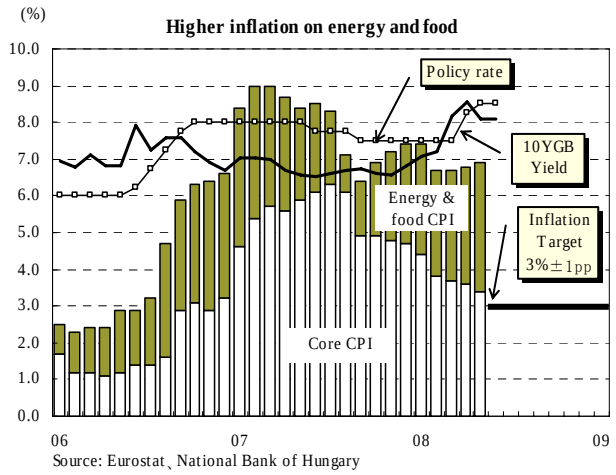
<Rating Perspective>

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 government debt
- Large foreign debt owed primarily by the private sector



Source: Eurostat、National Bank of Hungary

<Updated: from March to May, 2008>

Positive Factors

- The fiscal deficit (ESA95) in 2007 improved to 5.5% of GDP from 9.2% the year before.
- Real GDP growth rate improved to 1.6% year-on-year in the January-March quarter of 2008 from 0.8% in the latter half of 2007.
- The current account deficit in 2007 narrowed to 5.0% of GDP from 6.5% the year before as the trade balance turned into surplus.
- German automaker Daimler bared a EUR800 million plan to construct a new car assembly plant in Hungary, which will produce 100,000 units annually. (The plant is to go into operation in 2011.)

Negative Factors

- Introduction of doctor's fees and higher education tuition was rejected by more than 80% of the voters in the opposition-proposed referendum on March 9. (The government estimates a revenue shortfall resulting from the rejection at Ft50 billion or 0.2% of GDP.)
- Prime Minister Ferenc Gyurcsany (Socialist Party) dismissed his health minister from the junior coalition partner SZDSZ-Hungarian Liberal Party, holding her responsible for the referendum defeat. Following her dismissal, SZDSZ pulled out of the coalition in April, sending the government into minority status (commanding 190 out of a total 386 parliamentary seats).
- Prime Minister Gyurcsany unveiled plans to cut personal income tax and social security burdens by Ft920 billion or 3.6% of GDP.
- Foreign debt as of end of 2007 increased to EUR99.6 billion or 98.6% of GDP driven by bank loans and inter-company loans
- Consumer price inflation stayed persistently high at 6.9% year-on-year in May on higher energy and food prices.

<Outlook and Points to Watch>

Slower progress on the fiscal austerity measure

(1) The economy improved somewhat on strong foreign demand amid persistently high inflation

Hungary's real GDP growth rate improved to 1.6% year-on-year in the January-March quarter of 2008 from 0.8% in the latter half of 2007. Strong net exports underpinned the whole economy as domestic demand centering on consumer spending continued to slacken due to the impact of the tax increase and spending cuts carried out under the fiscal deficit reduction measures at the end of 2006. Consumer price inflation stayed persistently high at 6.9% year-on-year in May on higher energy and food prices although the impact of the increased tax rates and administrated prices was fading out. In this macro-economic environment, the National Bank of Hungary (the central bank) raised its policy rate by a total 100 basis points in April and May to 8.5% as it found that the inflation rate had significantly deviated from its target (3% plus or minus 1pp). NBH abandoned the flexible peg of the forint to the euro within a fluctuation band and adopt a floating exchange rate regime in February. Following the shift, the forint exchange rate against the euro has appreciated nearly 10%, helped in part by the interest rate hikes.

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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 slightly to 6.2% in 2008 and 4.2% in 2009 on currency appreciation and departure of the effect of increased tax rates and administrated prices, although higher energy and food prices will remain a source of inflationary pressure.

(2) Emerging risk of slower progress on fiscal deficit reduction in 2009 budget

The fiscal deficit reduction measures helped to trim the fiscal deficit (ESA95, unless otherwise indicated) in 2007 to 5.5% of GDP from 9.2% the year before. 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 from 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 at 66.0% of GDP, just a shade up 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 published in November 2007. The defeat in the referendum in March and the subsequent collapse of the coalition has given rise to risks that the government may delay implementation of additional deficit reduction measures. The government is aiming to cut the deficit in 2008 to 4.0% of GDP. JCR considers that the target is highly likely to be met as the government is set to implement its expenditure reforms including the pledged cuts in subsidies, wages for public employees and spending on motorway construction projects. In fact, the central government fiscal deficit in the first five months of 2008 narrowed to 1.7% of GDP from 3.2% the year before on strong revenues and reduced expenditures. The government has built up its reserves, adding to its resilience to contingency. However, the fate of fiscal deficit reduction measures after 2009 has become uncertain. While Prime Minister Gyurcsany expressed his resolve to push ahead with fiscal reduction measures from 2009 onward even after the futile referendum result, he bared his plans to cut personal income tax and social security burdens by Ft920 billion or 3.6% of GDP. It will be too hasty to see the proposed tax cut as departure from a fiscal austerity policy. Rather it should be viewed as a step intended to draw possible SZDSZ support from outside the cabinet. Heavy social security burdens and the higher tax rate have been the pending issues for Hungary. Their reduction has been the top policy pledged by former coalition partner SZDSZ. With the country's next general election scheduled for 2010, JCR will carefully watch if the government will be able to carry out additional deficit-cutting measures under its 2009 budget.

(3) Weak financing of C/A deficit and growing foreign debt owed mainly by the private sector

The current account deficit in 2007 narrowed to 5.0% of GDP from 6.5% the year before due mainly to a turnaround of the trade balance into surplus. The deficit was financed in part by a net inflow of foreign direct investment but mainly by increased borrowings by banks. Hungary's foreign debt, mainly owed by banks, swelled to reach almost 100% of GDP at the end of 2007. Foreign liquidity remains rather insufficient, with the ratio of foreign exchange reserves to monthly imports staying lower than three times. This financing structure is susceptible to conditions on the international financial market. In fact, the yield on 10-year government bonds surged above 9% in March reflecting the referendum result and resurgence of a global credit squeeze. JCR will consider revision of the ratings depending on future progress in the government's fiscal deficit reduction measures.

Main Economic Indicators: The Republic of Hungary

		2003	2004	2005	2006	2007	2008 (f)	2009 (f)
(Convergence criteria)	**Criteria**							
1.CPI (annual average)	3.7%(note)	4.7	6.8	3.5	4.0	7.9	6.2	4.2
2.10 year government bond yield	5.7%(note)	7.0	8.1	6.6	7.1	6.7	7.8	7.0
3.General gov't fiscal balance/GDP(ESA95)	Below -3%	-7.2	-6.5	-7.8	-9.2	-5.5	-4.3	-3.2
4.General gov't debt/GDP(ESA95)	Below 60%	58.0	59.4	61.6	65.9	66.0	66.8	67.0
Real GDP growth rate	(%)	3.4	4.9	4.2	3.9	1.4	2.8	4.0
Unemployment rate (year-end)	(%)	5.9	6.1	7.2	7.5	7.4	7.5	7.3
Current account balance/ GDP	(%)	-8.1	-8.4	-6.8	-6.5	-5.0	-4.7	-5.3
Trade balance/ GDP	(%)	-3.9	-3.0	-1.6	-1.0	1.4	1.4	0.8
Net Foreign Direct Investment/ GDP	(%)	0.6	3.3	4.7	2.8	1.0	1.4	1.6
Forex reserves (excl. gold)	(EUR mln)	9,527	11,225	15,451	15,841	15,804	16,600	17,800
Forex reserves / monthly Imports (G&S)	(months)	2.3	2.4	3.0	2.7	2.4	2.3	2.2
Forex reserves/ short-tem external debt	(times)	1.4	1.5	1.5	1.5	1.1	1.0	1.0
External debt/ GDP	(%)	65.3	69.4	76.6	92.5	98.6	99.4	100.1
External debt/ exports (G&S)	(%)	104.4	106.6	112.5	119.6	123.2	125.8	123.9
Public external debt/ exports (G&S)	(%)	42.7	43.7	43.8	43.6	41.3	40.9	38.2
Debt service ratio	(%)	14.2	15.3	16.0	13.0	12.9	13.4	11.9

(Note) Figures for criteria 1 and 2 are average between June 2007 and May 2008. Figures for 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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