

Hungary (the Republic of)

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

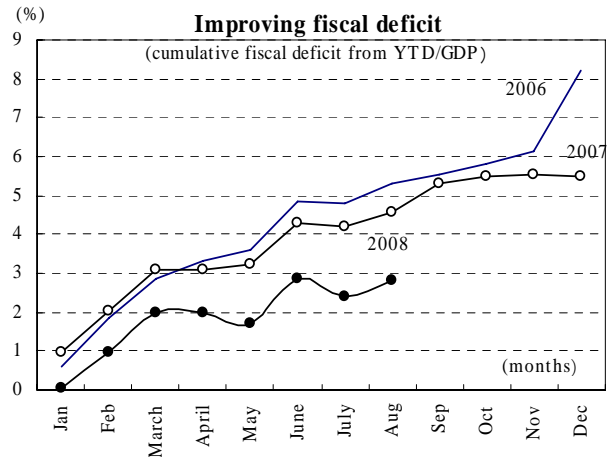
<Rating Perspective>

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

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



<Updated: from June to August, 2008>

Positive Factors

- The government revised its 2008 fiscal deficit target from 4.0% of GDP to 3.8% on September 17
- The central government fiscal deficit in the first eight months of 2008 was Ft 772 billion or 2.8% of GDP, substantially reduced by 34% from the year earlier
- The trade balance in the first seven months of 2008 remained a surplus amounting to EUR 306 million or 1.1% of GDP
- Consumer price inflation (HICP) declined to 6.4% year-on-year in August, stemming from a fall in energy and food prices
- Following the adoption of a floating exchange rate regime in February, Hungarian forint exchange rate against the euro appreciated sharply to Ft 229.45 on July 22, up by 14% from the lowest point in 2008. Stronger forint would help dampen inflationary pressure
- 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

- Hungarian Liberal Party (SZDSZ), departed from the coalition government in April, has refused to support the tax cut reduction package disclosed by the Prime Minister Ferenc Gyurcsany, stating that it did not contain sufficient spending cuts. The proposed package totals around Ft 1 trillion or 3.6% of GDP over a three-to-four year.
- Following the national referendum in March, Parliament has voted overwhelmingly to scrap the controversial Health Insurance Act on June 2.
- Foreign debt as of end of March 2008 increased by 22% to EUR107.2 billion from the year earlier, mainly driven by bank loans and inter-company loans

<Outlook and Points to Watch>

The government lowered its fiscal deficit target

(1) Domestic demand remained weak with a fall in inflation

Hungary's real GDP growth rate in the April-June quarter of 2008 was 2.0% year-on-year (2.2 % quarter-on-quarter in annual term), up from 1.6% in the previous quarter. Domestic demand increased for the first time in two years to 1.6% year-on-year, but underlying domestic demand remained weak as the domestic demand excluding inventories decreased by 2.5% year-on-year. Net exports, which underpinned the whole economy until recently, moderated due mainly to the declining exports. The contribution of net exports to the whole economic growth rate declined to 0.5 pp from 4.7 pp in the previous quarter. While consumer spending increased for the first time in six quarter to 1.5% year-on-year, gross capital formation fell sharply to 16.4% year-on-year.

Consumer price inflation improves to 6.4% year-on-year in August, stemming from the fall in energy and food prices and narrower impact of the increased tax rates and administrated prices. In this macro-economic environment, the National Bank of Hungary (the central bank) keeps its policy rate at 8.5% since May. 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 14%, helped in part by the interest rate hikes and the announcement of new investment by Daimler.

In 2008, the economy will grow around 2% 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 further 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) The government lowered fiscal deficit in 2008 to 3.8% of GDP

The fiscal deficit reduction measures continued to trim the fiscal deficit. The central government fiscal deficit in the first eight months of 2008 was Ft 772 billion or 2.8% of GDP, substantially reduced by 34% from the year earlier. 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. On September 17, the government cut fiscal deficit in 2008 to 3.8% of GDP from 4.0%. 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. The government has also built up its reserves, adding to its resilience to contingency. Meanwhile, the fiscal debt at the end of March 2008 narrowed to 58% of GDP from 61.3% at the end of 2007.

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. Following the collapse of the coalition, the fate of fiscal deficit reduction measures after 2009 has become uncertain. While Prime Minister Gyurcsany expressed his intention to push ahead with fiscal reduction measures from 2009 onward, he recently unveiled his plans to reduce the tax burden including personal income tax and social security by totaling Ft 1 trillion or 3.6% of GDP in view of drawing possible SZDSZ support from outside the cabinet. The reduction of tax burden has been the top priority pledged by SZDSZ. However, SZDSZ has refused to support the plan, stating that it did not contain sufficient spending cuts. 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, which is currently under discussion in Parliament.

(3) Improving C/A deficit and growing foreign debt owed mainly by the private banks

The current account deficit continued to improve due mainly to a turnaround of the trade balance into surplus. The current account deficit in the first three months of 2008 unchanged to 4.9% of GDP from the year earlier, but the deficit excluding the temporal deficit of transfer balance (1.1% of GDP) is estimated below 4%. The deficit was covered by a net inflow of foreign direct investment around 40%. Other financing sources of the deficit are increased borrowings by banks and portfolio investment. Hungary's foreign debt, mainly owed by banks, swelled to surpass 100% of GDP at the end of March 2008, is a source of concern. Although financial system remained sound despite of rising risk involved in larger foreign currency exposure, 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.

Main Economic Indicators: The Republic of Hungary

		2003	2004	2005	2006	2007	2008 (f)	2009 (f)
(Convergence criteria)	Criteria							
1.CPI (annual average)	3.9%(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	8.0	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	2.0	3.0
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	2.0	1.2
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	104.5	107.0
External debt/ exports (G&S)	(%)	104.4	106.6	112.5	119.6	123.2	129.2	131.3
Public external debt/ exports (G&S)	(%)	42.7	43.7	43.8	43.6	41.3	40.6	37.9
Debt service ratio	(%)	14.2	15.3	16.0	13.0	12.9	13.3	11.8

(Note) Figures for criteria 1 and 2 are average between September 2007 and August 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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