2008-40
December 26, 2008

Hungary (the Republic of)

Foreign LT: BBB+/**Negative**, Local LT: **A- /Negative**

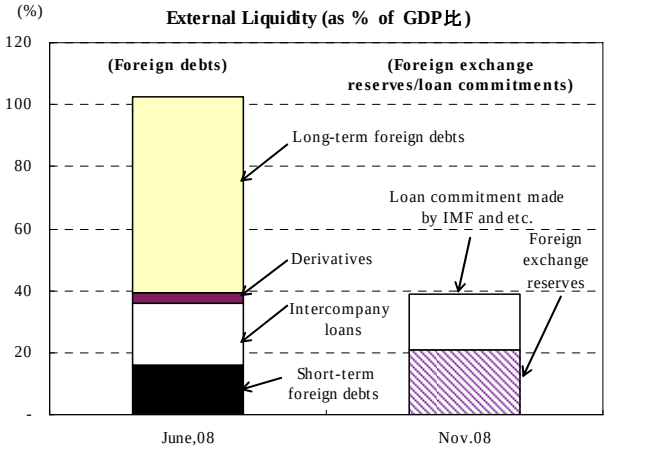
<Rating Perspective>

Positive Factors

- Diversified export and economic structures on the back of early stage of its economic reform in the process of economic transition
- Expanding production capacity rendered by massive FDI inflows and EU subsidy
- Improved external liquidity supported by the IMF financial assistance

Negative Factors

- Continued fiscal deficit and growing government debt led by loans provided by the IMF
- Weakening resilience to external liquidity amid the deepening global financial crisis due mainly to large foreign debt



<Updated: from September to December, 2008>

Positive Factors

- On November 6, the IMF approved a 17-month loan equivalent to EUR 12.5 billion for Hungary. Together with the loans from the EU and World Bank, this has brought the total amount of the financing package for the country to EUR20 billion or over 18% of GDP
- The government reduced the general government fiscal deficit in 2008 and 2009 to 3.4% and 2.5% of GDP
- The central bank cut its policy rate three times by totaling 150 bps to 10.0% in November and December
- The foreign exchange reserves as of end November 2008 increased by EUR 5.1 billion to EUR 22.9 billion from previous month
- The parliament approved a bill to create a Capital Base Enhancement Fund and a Refinancing Guarantee Fund on December 15. A part of the IMF loan totaling Ft600 billion (around 2% of GDP) is to be set aside for the two funds
- The central government fiscal deficit in the first nine months of 2008 improved to 3.0% of GDP (Ft 824 billion) from 5.0% from the year earlier
- Consumer price inflation (HICP) declined to 4.1% yoy in November, stemming from a fall in energy and food prices

Negative Factors

- Foreign debt as of end of June 2008 increased by 18% to EUR111.8 billion (109% of GDP) from the year earlier, mainly driven by bank loans and inter-company loans

<Outlook and Points to Watch>

IMF led commitment bolstered the external liquidity

(1) The foreign and local currency ratings was downgraded

On December 18 2008, JCR has downgraded the ratings on the foreign currency long-term senior debts and yen-denominated bonds to BBB+ from #A-/negative (# stands rating under credit monitor) and the rating on the currency long-term senior debts to A- from #A/negative. The outlook of the ratings is negative. The downgrade mainly reflects the country's growing government debt and weakening resilience to external financing amid the deepening global financial crisis, as well as poor economic prospects in the short-term. The massive financing package committed by the IMF, EU and World Bank helps stabilize the country's liquidity position. Nonetheless, the financing package will add to further increase in the government debt. On the other hand, the ratings continued to be supported primarily by the country's diversified export and economic structures and its expanding production capacity backed by massive inflows of foreign direct investment (FDI) and EU subsidy, as well as the country's untarnished debt repayment records.

(2) IMF led commitments bolstered the country's external liquidity

On November 6, the IMF approved a 17-month loan equivalent to EUR 12.5 billion for Hungary. Together with the loans from the EU and World Bank, this has brought the total amount of the financing package for the country to EUR20 billion or over 18% of GDP. The Hungarian government has already withdrawn EUR4.9 billion (currently

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deposited in the central bank) that has been made available immediately. The package is conditional on the country's further fiscal consolidation and additional measures to strengthen its banking system. The government has made progress on implementing those measures as planned. The government has revised its economic outlook and fiscal plan for both 2008 and 2009. The general government fiscal deficit in 2008 and 2009 was narrowed to 3.4% and 2.5% of GDP, through postponement of tax cuts and introduction of additional measures to trim expenditures (The earmarked reserves and special reserves altogether equivalent to 0.5% of GDP in the 2009 budget allow funds in case of emergency). The fiscal plan for 2009 was approved in the parliament on December 15. The targets are highly likely to be met barring significant revision of the economic outlook. However, the general government debt, which had increased to 66% of GDP at the end 2007, will grow further to exceed 70% upon actual utilization of IMF loans. With the aim of stabilizing the banking system, the parliament approved a bill to create a Capital Base Enhancement Fund and a Refinancing Guarantee Fund on December 15. A part of the IMF loan totaling Ft 600 billion (around 2% of GDP) is to be set aside for the two funds.

(3) The country's financial market showed its stability

The country's financial market came under severe pressure in October due to the upsurge of inter-bank lending rates, a freeze on the government bond market and the plunge of the currency and share prices. But it is restoring stability thanks to the measures the government and the central bank have taken in concert with the ECB. In a bid to defend the value of its currency, the central bank raised its policy rate by 300bps in October. But it eased its policy by cutting the rate three times by totaling 150 bps to 10.0% in November and December. Major Hungarian banks except OTP are the subsidiaries of big European banks. The parent banks have kept their exposure in Hungary so far, but there remains a risk that they reduce their expose, should the liquidity problem intensify.

(4) Fiscal deficit to improve on the spending cut measures despite a fall in economic recession in 2009

The Hungarian economy has been rapidly deteriorating amid the economic recession in its major European trading partners. The real GDP growth rate is likely to remain positive in 2008. But the economy is projected to contract around 1% in 2009 amid slower inflation.

The current account deficit continued improving moderately to reach 3.2% (estimated GDP for 2008) in the first half of 2008, down from 3.4% the year before. The deficit has been mainly financed with debt-creating financial inflows centering on bank loans and portfolio investment. As a consequence, Hungary's foreign debt burden is heavier, with the foreign debt, mainly owed by banks, projected to reach around 100% of GDP at the end of 2008. In this process, foreign currency-denominated liabilities owed by both households and companies expanded to more than 50% of its total. Any increase in nonperforming loans could adversely affect the country's financial system. The foreign exchange reserves at the end of November 2008 increased by EUR 5.1 billion to EUR 22.9 billion from previous month. However, the amount remains 1.3 times of the short-term foreign debt at the end of June and was only enough to cover around 3 months of imports. Thus, Hungary will have to depend more on assistance from the IMF for stabilizing external financing as the global financial crisis deepen.

Main Economic Indicators: The Republic of Hungary

		2003	2004	2005	2006	2007	2008 (f)	2009 (f)
(Convergence criteria)	**Criteria**							
1.CPI (annual average)	4.0%(note)	4.7	6.8	3.5	4.0	7.9	6.7	4.0
2.10 year government bond yield	5.6%(note)	7.0	8.1	6.6	7.1	6.7	n.a.	n.a.
3.General gov't fiscal balance/GDP(ESA95)	Below -3%	-7.2	-6.5	-7.8	-9.2	-5.0	-3.4	-2.6
4.General gov't debt/GDP(ESA95)	Below 60%	58.0	59.4	61.7	65.6	65.8	72.0	80.0
Real GDP growth rate	(%)	3.4	4.9	4.2	3.9	1.4	0.8	-1.5
Unemployment rate (year-end)	(%)	5.9	6.1	7.2	7.5	7.4	7.8	8.2
Current account balance/ GDP	(%)	-8.1	-8.4	-6.8	-7.7	-6.4	-4.2	-3.1
Trade balance/ GDP	(%)	-3.9	-3.0	-1.6	-2.3	0.3	2.5	1.9
Net Foreign Direct Investment/ GDP	(%)	0.6	3.3	4.7	3.2	1.6	2.5	0.5
Forex reserves (excl. gold)	(EUR mln)	9,527	11,225	15,451	15,841	15,804	22,580	17,800
Forex reserves / monthly Imports (G&S)	(months)	2.3	2.4	3.0	2.7	2.4	3.2	2.8
Forex reserves/ short-tem external debt	(times)	1.4	1.5	1.5	1.5	1.1	1.3	1.1
External debt/ GDP	(%)	65.3	69.4	76.6	92.4	99.4	106.2	112.5
External debt/ exports (G&S)	(%)	104.4	106.6	112.5	120.6	124.3	130.0	134.9
Public external debt/ exports (G&S)	(%)	42.7	43.7	43.8	44.0	41.3	43.2	50.8
Debt service ratio	(%)	29.4	31.4	30.9	29.5	26.0	24.7	30.6

(Note) Figures for criteria 1 and 2 are average between November 2007 and October 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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