

**Hungary (the Republic of)**

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

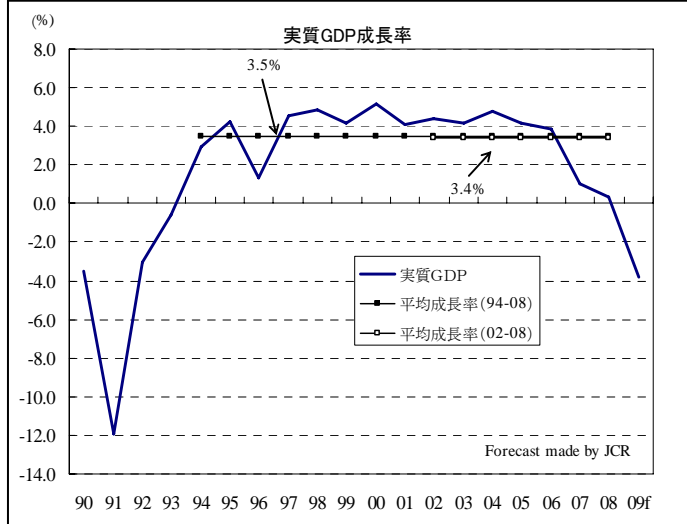
**<Rating Perspective>**

**Positive Factors**

- Diversified economic structure bolstered by its deepening economic ties with European countries
- Expanding production capacity rendered by a heavy FDI inflow and growing investment backed by a massive inflow of EU subsidy
- Improved external liquidity supported by the IMF financial assistance

**Negative Factors**

- Sizable foreign debt owed primarily by the private sector driven by the continued current account deficit
- Large general government debt stemming from the chronic fiscal deficit
- The worst economic recession since the country's economic transition.



**<Updated: from January to March, 2009>**

**Positive Factors**

- IMF concluded its first review and evaluated positively on the progress on the policies for fiscal deficit reduction measures and strengthening banking system. After official approval, the country will be able to draw EUR 2.4 billion in the coming weeks (March 25).
- The general government deficit in 2008 was estimated at 3.4% of GDP, down from 5.0% in previous year.
- The central bank cut its policy rate again to 9.5% in January 20, the fourth rate cut totaling 200 bps.
- The foreign exchange reserves as of end February 2009 kept same level from previous month at EUR 23.7 billion.

**Negative Factors**

- Prime Minister Ferenc Gyurcsany's announced his resignation on March 21.
- Industrial output in January contracted 22.3% year-on-year, four consecutive contractions from October 2008.
- Exports in January fell sharply by 30.9% year-on-year, driven mainly by machinery and transportation equipment.
- Foreign debt as of end of September 2008 increased by 22% to EUR117.2 billion (109% of GDP) from the year earlier, mainly driven by bank loans and inter-company loans.

**<Outlook and Points to Watch>**

**Worst recession since economic transition**

**(1) The economy will contract more than 3% in 2009**

The Hungarian economy plunged into a serious recession in the latter half of 2008 amid the economic downturn in its major European trading partners and the continued spending cuts carried out by the government. The real GDP growth rate in 2008 narrowly stayed positive at 0.3%, but the economy is highly likely to contract around 3% in 2009 for the worst recession since its economic transition. Expanding infrastructure investment backed by EU subsidies and improved export competitiveness brought by the Hungarian forint's steep depreciation may sustain the economy to some extent. However, with spending cuts expected to continue at least until 2011, an economic recovery seen to begin in 2010 will be only moderate.

**(2) The government can secure external financing for 2009 barring drastic capital flight**

In the midst of the deepening global financial crisis, the Hungarian government won the loan commitment from the IMF in November 2008. Together with the aid pledges made by the EU and World Bank, the country has been assured of the total financial aid totaling EUR20 billion or over 18% of GDP. The government has already withdrawn EUR4.9 billion that has been made available immediately. The aid package is conditional on the country's further fiscal consolidation and measures to strengthen its banking system. Following the progress made so far by the government, another EUR2.5 billion can be drawn from IMF in coming weeks. JCR considers that the government will be able to secure the external financing for 2009 barring drastic capital flight from

Hungary.

**(3) The government to meet revenue shortfalls with spending cuts**

The general government fiscal deficit reduced to an estimated 3.4% of GDP in 2008 from 5.0% the previous year. In February, the government lowered its 2009 economic outlook to a 3.3% contraction in a revised budget and is estimated the fiscal deficit at 2.9% of GDP. The government has earmarked a sum equivalent to 0.3% of GDP as a reserve fund to provide against contingencies. It has pledged that should the economy worsen further, it would seek to hold the deficit below 3% of GDP through additional expenditure cuts. There is concern over the fiscal policy in view of the general election scheduled in 2010 and the prime minister's recent resignation. However, JCR holds that a further deterioration of the fiscal deficit can be stemmed as the government will have to restrain easy spending increases in accordance with the stringent rules set under the Fiscal Responsibility Act. Meanwhile, the general government debt, which had increased to 65.8% of GDP at the end 2007, grew further to exceed 70% of GDP at the end of 2008 following withdrawals from the IMF and EU loan commitments.

The current account deficit was estimated to have narrowed to around 4% of GDP in 2008 from 6.4% the previous year. The deficit in 2009 is likely to further narrow to less than 4% of GDP as a larger trade surplus will more than offset a continuing income balance deficit. The current account deficit has been mainly financed with debt-creating funds 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, estimated at more than 100% of GDP at the end of 2008. The foreign exchange reserves at the end of February 2009 increased to EUR23.7 billion, bolstered by the loan provided by the IMF. The amount was strengthen its external liquidity position as the ratio of the foreign exchange reserves to the short-term debt at the end of September 2008 improved to 1.3 (Monthly import cover ratio was also improved to 3 times).

**(4) The stability of the financial system needs to be watched**

The country's financial market came under severe pressure in October 2008. But it is restoring stability thanks to the measures taken by the government and the central bank to replenish liquidity and the commitments of financial aid made by the IMF and EU. The central bank eased its policy in November 2008 by cutting the rate three times by a total 200 bps to 9.50%. 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 the possibility that they may reduce their exposure should they slip into a harder situation. A prolonged recession and a continuation of a weaker forint could add to the burdens of foreign currency-denominated liabilities owed by both households and companies, which already account for more than 50% of the total loan balance. Any increase in nonperforming loans could adversely affect the country's financial system. To prevent this, the government set up a Capital Base Enhancement Fund and a Refinancing Guarantee Fund in December 2008. A portion of the IMF loan totaling Ft600 billion (2.2% of GDP) was set aside for the two funds. JCR believes that the two funds will greatly contribute to stabilizing the country's banking system.

**(5) The country is not yet ready to adopt euro in 2012**

The massive financing package committed by the IMF, EU and World Bank has helped to stabilize the country's external liquidity position. Nonetheless, the country's debt burden remains heavy with a large foreign debt and withdrawals from the aid package are further expanding the government debt. To make up for revenue shortfalls stemming from an economic downturn, the government plans to hold down the fiscal deficit primarily through spending cuts. However, Prime Minister Ferenc Gyurcsany's announcement of his resignation on March 21 could affect progress on his government's spending cut programs.

**Main Economic Indicators: The Republic of Hungary**

		2004	2005	2006	2007	2008 (e)	2009 (f)	2010 (f)
<b>(Convergence criteria)</b>	<b>Criteria</b>							
1.CPI (annual average)	4.0%(note)	6.8	3.5	4.0	7.9	6.2	4.0	3.5
2.10 year government bond yield	5.9%(note)	8.1	6.6	7.1	6.7	8.3.	n.a.	n.a.
3.General gov't fiscal balance/GDP(ESA95)	Below -3%	-6.5	-7.8	-9.2	-5.0	-3.4	-3.2	-2.2
4.General gov't debt/GDP(ESA95)	Below 60%	59.4	61.7	65.6	65.8	72.0	76.0	81.2
Real GDP growth rate	(%)	4.9	4.2	3.9	1.4	0.3	-3.8	-1.0
Unemployment rate (year-end)	(%)	6.1	7.2	7.5	7.4	7.9	8.2	8.5
Current account balance/ GDP	(%)	-8.4	-6.8	-7.7	-6.4	-4.2	-3.7	-2.9
Trade balance/ GDP	(%)	-3.0	-1.6	-2.3	0.3	2.5	2.1	2.9
Net Foreign Direct Investment/ GDP	(%)	3.3	4.7	3.2	1.6	2.5	0.5	1.0
Forex reserves (excl. gold)	(EUR mln)	11,225	15,451	15,841	15,804	22,580	24,500	25,000
Forex reserves / monthly Imports (G&S)	(months)	2.4	3.0	2.7	2.4	3.2	3.4	3.3
Forex reserves/ short-tem external debt	(times)	1.5	1.5	1.5	1.1	1.2	1.2	1.0
External debt/ GDP	(%)	69.4	76.6	92.4	99.3	111.1	130.0	137.8
External debt/ exports (G&S)	(%)	106.6	112.5	120.6	124.3	134.3	137.1	141.2
Public external debt/ exports (G&S)	(%)	43.7	43.8	44.0	41.3	39.8	50.1	52.0
Debt service ratio	(%)	31.4	30.9	29.5	26.0	22.4	28.2	26.8

(Note) Figures for criteria 1 and 2 are average between March 2008 and February 2009. Figures for 2008, 2009 and 2010 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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