

2009-014  
June 30, 2009

## Hungary (the Republic of)

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

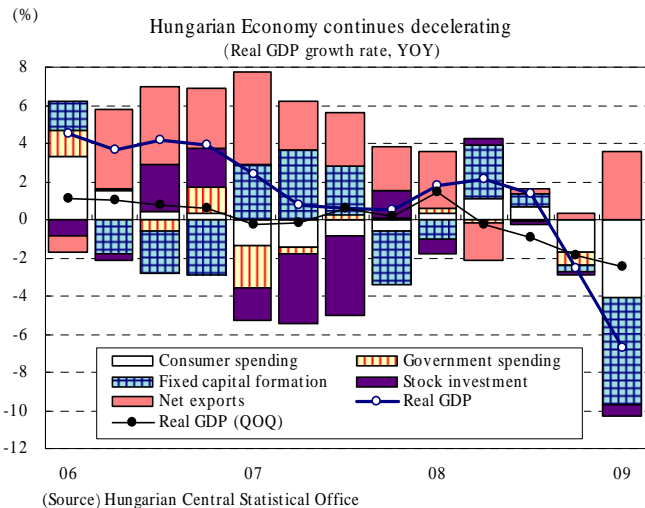
### <Rating Perspective>

#### Positive Factors

- Diversified economic structure bolstered by its deepening economic ties with European countries
- Expanding production capacity rendered by growing investment reflecting massive inflows of FDI and EU subsidies
- Improved external liquidity position supported by the IMF financial package

#### Negative Factors

- Sizable foreign debt owed primarily by the private sector amid the persistent 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 March to June, 2009>

#### Positive Factors

- Following the resignation of Prime Minister Ferenc Gyurcsány, Mr. Gordon Bajnai became new prime minister on April 12 with the backing of the ruling Hungarian Socialists Party (MSZP) and its former coalition partner, the SZDSZ-Hungarian Liberal Party (SZDSZ)
- The IMF and the EU approved the new administration's spending-cut plan for 2009 and 2010 totaling Ft1.3 trillion (4.8% of GDP)
- Trade surplus in the first four months of 2009 increased 2.8 times from the year earlier to EUR1,104 million or 1.1% of GDP
- The foreign exchange reserves at the end of May 2009 increased to EUR24.3 billion, equivalent to 1.45 times of the short-term foreign debt at the end of 2008
- The central government fiscal deficit in the first four months of 2009 narrowed slightly to Ft534 billion or 2.0% of GDP from the year earlier
- Core consumer price inflation rate in May 2009 stayed stable at 3.1% year-on-year

#### Negative Factors

- Real GDP in the January-March quarter of 2009 contracted further by 6.7% year-on-year (contraction of 2.5% quarter-on-quarter) from 2.5% in the previous quarter
- Foreign debt as of the end of 2008 swelled to reach EUR119.3 billion (110.6% of GDP) from the year earlier due mainly to increased borrowing by banks and companies
- The new administration revised in April the general government fiscal deficit estimate for 2009 upward to 3.9% of GDP from 2.9%

## <Outlook and Points to Watch>

### Worst economic recession since 1991

#### (1) New prime minister unveils his fiscal tightening measures

On April 12, Mr. Bajnai became new Prime Minister with the backing of the ruling MSZP and its former coalition partner, the SZDSZ. Mr. Bajnai, who was National Development Minister in the previous administration, has little political tone as he doesn't belong to any political parties. Renewed cooperation with the SZDSZ which has been calling for harsher spending cuts may prompt his administration to promote more stringent fiscal measures despite its minority status in parliament. Mr. Bajnai has already unveiled a severer-than-expected spending-cut program totaling Ft1.3 trillion (equivalent to 4.8% of GDP) through the end of 2010. The package includes a pension cut and a reduction of salaries for public employees as well as reduced subsidies for housing loans. These measures have already been approved by parliament. On the revenue side, the administration plans to cut the payroll and personal income taxes to boost economic growth while raising the consumption and fixed property taxes to keep the budget deficit in check. Following approval of these measures by the IMF, the government announced an upward revision of its fiscal deficit target for 2009 to 3.9% of GDP from 2.9%.

## (2) The economy is likely to contract substantially in 2009

The Hungarian economy plunged into a serious recession in the second quarter of 2008 amid the economic downturn in its major European trading partners and the spending cut carried out by the previous administration since 2007. The real GDP growth rate in 2008 narrowly stayed positive at 0.6%, but the economy contracted 2.5% quarter-on-quarter in the January-March quarter of 2009 due mainly to falls in consumer spending and investment. As the new administration revised its economic projection for 2009 to minus 6.7% from an earlier minus 5.5-6.0% in May, the economy looks headed for the worst recession since 1991. Expanding infrastructure investment backed by EU subsidies and improved export competitiveness brought by the Hungarian forint's steep depreciation may sustain the economy in 2010. However, with additional spending cuts expected to be carried out by the new administration, an economic recovery in the year may prove only modest.

## (3) Heavy debt burden despite improved external position

The massive financing package totaling EUR20 billion or over 18% of GDP committed by the IMF, EU and World Bank has helped to stabilize the country's external position. Nonetheless, its debt burden remains heavy as a huge outstanding foreign debt and disbursement of the package will further expand the government debt. The 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, EUR11.4 billion was initially withdrawn. The government will be allowed to withdraw another EUR 1.5billion from the IMF toward the end of June. Bolstered by the package, the foreign exchange reserves increased to EUR24.3billion at the end of May 2009. The ratio of the foreign exchange reserves to the short-term debt at the end of 2008 improved to 1.45. JCR considers that the government will be able to secure the external financing for 2009 barring drastic capital flight from Hungary.

The trade surplus in the first four months of 2009 grew 2.8 times from the year earlier to EUR1,104 million or 1.1% of GDP. The current account deficit in 2009 is likely to 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 the private sector, standing at an estimated 110.6% of GDP at the end of 2008, up from 97.1% the year before.

## (4) Stability of the financial system needs to be watched

The country's financial market came under severe pressure in late 2008. But it is restoring stability thanks to the measures taken by the government and the central bank to replenish liquidity and the financial commitments made by the IMF and EU. The auction of government bonds resumed in April after a temporary suspension. The central bank eased its monetary policy in November 2008, cutting its key 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 a risk that they may reduce their exposure should they slip into a difficult fiscal position. A rising unemployment rate and the forint's depreciation that added to foreign currency-denominated liabilities owed by households and companies (which account for more than 50% of the total loan balance) may lead to an increase in nonperforming loans, which could adversely affect the country's financial system. To prevent this, the government has set up a Capital Base Enhancement Fund and a Refinancing Guarantee Fund. A portion of the IMF loan totaling Ft600 billion (2.2% of GDP) was put into the two funds. JCR will continue to monitor how the country's banking system will evolve.

### Main Economic Indicators: The Republic of Hungary

		2004	2005	2006	2007	2008	2009 (f)	2010 (f)
<b>(Convergence criteria)</b>	<b>Criteria</b>							
1.CPI (annual average)	2.8%(note)	6.8	3.5	4.0	7.9	6.2	3.7	3.0
2.10 year government bond yield	5.2%(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	-4.0	-3.7
4.General gov't debt/GDP(ESA95)	Below 60%	59.4	61.7	65.6	65.8	72.0	76.5	81.5
Real GDP growth rate	(%)	4.9	4.2	3.9	1.4	0.3	-6.5	-1.5
Unemployment rate (year-end)	(%)	6.1	7.2	7.5	7.4	7.9	10.5	11.0
Current account balance/ GDP	(%)	-8.4	-6.8	-7.7	-6.4	-4.2	-3.4	-1.9
Trade balance/ GDP	(%)	-3.0	-1.6	-2.3	0.3	2.5	2.4	3.1
Net Foreign Direct Investment/ GDP	(%)	3.3	4.7	3.2	1.6	2.5	0.5	1.1
Forex reserves (excl. gold)	(EUR mln)	11,225	15,451	15,841	15,804	26,725	27,500	27,000
Forex reserves / monthly Imports (G&S)	(months)	2.4	3.0	2.7	2.4	3.8	5.1	4.8
Forex reserves/ short-tem external debt	(times)	1.5	1.5	1.5	1.1	1.5	1.3	1.1
External debt/ GDP	(%)	67.0	75.0	90.4	97.1	110.3	121.1	129.4
External debt/ exports (G&S)	(%)	103.0	110.2	118.0	121.6	138.7	167.1	171.4
Public external debt/ exports (G&S)	(%)	43.7	43.8	44.0	41.3	44.6	59.6	57.9
Debt service ratio	(%)	31.4	30.9	29.5	26.0	23.3	36.8	34.9

(Note) Figures for criteria 1 and 2 are average between June 2008 and May 2009. Figures for 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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