

2009-027
 September 30, 2009

Hungary (the Republic of)

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

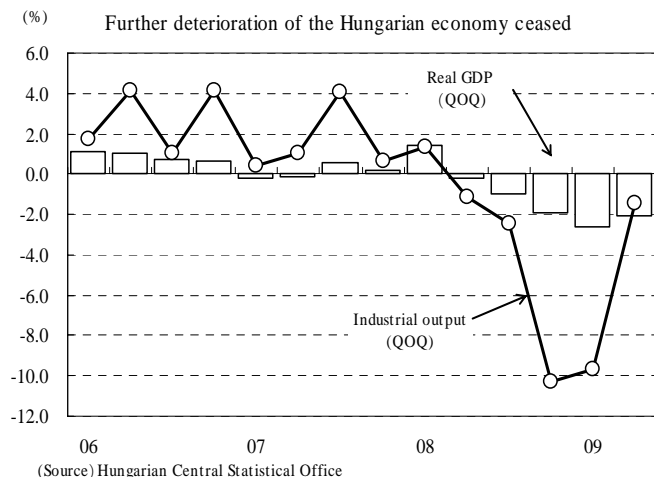
<Rating Perspective>

Positive Factors

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

Negative Factors

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



<Updated: from June to September, 2009>

Positive Factors

- On September 25, the IMF agreed to extend its Stand-By Arrangement (SBA) by six months to October 2010
- On July 17, the government successfully issued a EUR1 billion five-year Eurobond in the international financial market for the first time since June 2008
- Real GDP in the April-June quarter of 2009 shrank by 2.1% (SA: seasonally adjusted terms) quarter-on-quarter (QOQ), a modest improvement from the 2.6% contraction in the previous quarter
- Industrial output (SA) in the April-June quarter of 2009 fell 1.4% QOQ for a major improvement from the 9.7% contraction in the previous quarter
- The central government fiscal deficit in the first eight months of 2009 narrowed slightly to Ft758 billion or 2.0% of GDP from a year earlier
- The National Bank of Hungary (NBH, the central bank) cut its policy interest rate by a total 200bps on July 28, on August 25 and on September 28 to 7.5%
- Trade surplus in the first half of 2009 increased more than fivefold from a year earlier to EUR2,205 million or 2.3% of GDP

Negative Factors

- Foreign debt at the end of March 2009 grew a further 5% to EUR125.3 billion (133% of GDP) from the end of 2008 due mainly to increased borrowing by banks and companies
- The ratio of nonperforming loans at Hungary's largest OTP Bank rose to 7.4% in June 2009 from 5.7% in March
- Unemployment rate at the end of July 2009 rose 2.5 percentage points to 10.3% from a year earlier

<Outlook and Points to Watch>

Government's fiscal and economic outlook to be met

(1) Economy in sync with government projection for 2009

The Hungarian economy plunged into a serious recession in the April-June quarter of 2008 due mainly to the economic downturn in its major European trading partners and the country's intensified liquidity problems. Since then, the real GDP contracted for five consecutive quarters (QOQ) to the April-June quarter of 2009. The real GDP growth rate in 2008 narrowly stayed positive at 0.6%, but the economy contracted 2.6% and 2.0% QOQ in the January-March and April-June quarters of 2009, respectively, due mainly to falls in consumer spending and investment. By contrast, the industrial production showed signs of improvement as the output in the April-June quarter of 2009 fell by 1.4% QOQ, a significant improvement from the 9.7% contraction in the previous quarter. The current economic development is broadly in sync with the new government's revised economic projection for 2009 which downgraded the annual contraction to 6.7% from 5.5-6.0% estimated in May. As for the economy in 2010, JCR expects that expanding infrastructure investment backed by EU subsidies and improved export competitiveness brought by the Hungarian forint's steep depreciation help recover. However, with additional spending cuts expected to be carried out by the new government, an economic recovery may prove only modest. Meanwhile, the consumer price inflation in July jumped to 5.1% year-on-year from 3.7%

in the previous month reflecting increases in VAT and the excise tax. The inflation rate is likely to pick up moderately on the revised tax system and the forint's steep depreciation, but is likely to stay around 4% each in 2009 and 2010 due mainly to weak domestic demand. The NBH lowered its policy rate twice by a total 200bps on July 28, on August 25 and on September 28 to 7.5%. The unemployment rate began rising at the beginning of 2009, exceeding 10% in April for the first time since the middle of the 1990s. The rate stood at 10.3% at the end of July 2009, up 2.5 percentage points from a year earlier.

(2) Fiscal deficit target for 2009 likely to be achieved on spending cuts

Since Mr. Gordon Bajnai assumed the premiership in April with the backing of the Hungarian Socialists Party (MSZP) and the SZDSZ-Hungarian Liberal Party (SZDSZ), Hungary's macroeconomic and fiscal policies have been well on track with its commitments made to the IMF. Except for the central government debt of which target was not met due to technical reasons, the targets for the central government's primary balance, inflation rate and foreign exchange reserves as well as those related to government lending to banks were all met by the end of June. With the backing of the SZDSZ which calls for harsher spending cuts, the new government began implementing a program to slash expenditures by Ft1.3 trillion (equivalent to 4.8% of GDP) through the end of 2010. The package includes a pension cut, lower salaries for public employees and reduced subsidies for housing loans. On the revenue side, the administration cut VAT and the excise tax in July and plans to reduce the payroll and personal income tax while raising the fixed property tax to keep the budget deficit in check. These measures proved effective, as the central government fiscal deficit in the first eight months of 2009 narrowed slightly to Ft758 billion or 2.0% of GDP from a year earlier. Barring further economic deterioration, the government's target to bring the fiscal deficit for 2009 to 3.9% of GDP looks highly likely to be achieved.

(3) Government recovers access to international financial market

The massive loan 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 foreign debt and disbursement of the package will further expand the government debt. The government has so far withdrawn around EUR 13 billion from the IMF and EU following the progress it made on the conditions attached to the loan package. This helped to boost the country's foreign exchange reserves to EUR26.7 billion at the end of August, or 1.35 times as much as its short-term foreign debt at the end of March 2009. Bolstered by the improved external liquidity position and moderating global financial turmoil, the government succeeded in issuing a EUR1 billion five-year Eurobond in the international financial market in July. JCR considers that the government will be able to secure the necessary external financing for 2009 barring drastic capital flight from Hungary.

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

Major Hungarian banks, except OTP Bank, are the subsidiaries of big European banks. The parent banks have so far kept their exposure in Hungary. But there remains the possibility 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 in turn could adversely affect the country's financial system. In fact, the ratio of nonperforming loans at OTP Bank rose to 7.4% in June 2009 from 5.7% in March. As precautionary measures against systemic risks, the government has set up a Capital Base Enhancement Fund and a Refinancing Guarantee Fund. Drawing on the IMF loan, the government has put a sum totaling Ft600 billion (2.2% of GDP) into the two funds.

Main Economic Indicators: The Republic of Hungary

		2004	2005	2006	2007	2008	2009 (f)	2010 (f)
(Convergence criteria)	Criteria							
1.CPI (annual average)	3.8%(note)	6.8	3.5	4.0	7.9	6.2	4.0	3.5
2.10 year government bond yield	5.0%(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	-2.8	-3.2
Trade balance/ GDP	(%)	-3.0	-1.6	-2.3	0.3	0.1	3.2	2.7
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	26,725	27,500	27,000
Forex reserves / monthly Imports (G&S)	(months)	2.4	3.0	2.7	2.4	3.8	4.7	4.3
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	128.2	130.2
External debt/ exports (G&S)	(%)	103.0	110.2	118.0	121.6	138.7	158.5	159.8
Public external debt/ exports (G&S)	(%)	43.7	43.8	44.0	41.3	44.6	54.2	54.1
Debt service ratio	(%)	31.4	30.9	29.5	26.0	23.3	33.9	31.8

(Note) Figures for criteria 1 and 2 are average between August 2008 and July 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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