2003-55
February 25, 2004

Hungary (the Republic of)

Foreign LT: **A/Stable**, Local LT: **A+/Stable** (Latest rating review released on May 16, 2003)

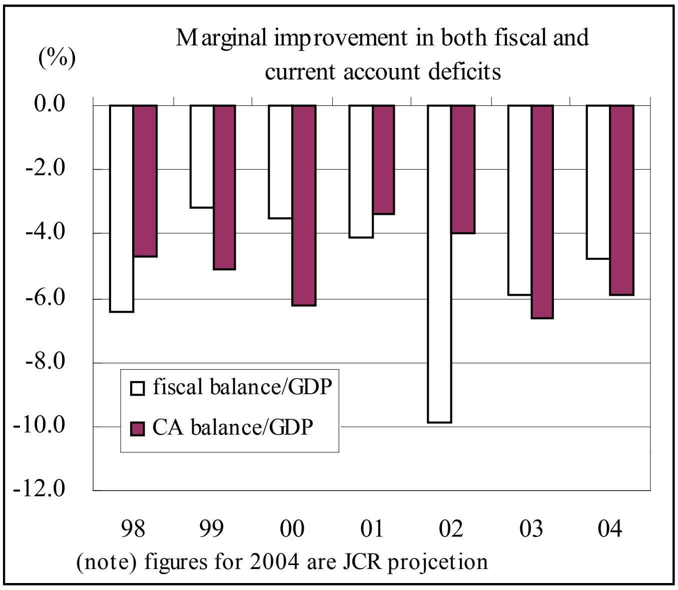
Main Factors for the Ratings

Positive Factors

- Prospective progress in structural reforms prior to the EU accession and possible improvement in economic performance ahead of joining the Economic and Monetary Union (EMU).
- Increasing exports to the EU countries resulting from the expansion of production capacity and heightening its industrial structure through inflows of foreign direct investment.

Negative Factors

- Inflating government debt due to persistent budget deficits.
- A wage increase higher than productivity growth eroding the competitive edge.



Updated: from December 2003 to January 2004

Positive Factors

- A 2004 budget plan envisaging a fiscal deficit equivalent to 3.8 % of GDP was approved in the parliament.
- On November 28, the central bank raised its benchmark interest rate (2 week deposit rate) by 300bp to 12.5%.
- Sign of improvement on trade deficits resulting from increasing exports.

Negative Factors

- The finance minister was forced to resign to assume the responsibility for a larger-than-projected fiscal deficit in 2003 (5.6% of GDP as against 4.5% estimated in the initial plan).
- New Finance Minister, Mr. Tibor Draskovics revised the fiscal deficit estimate for 2004 to 4.6% of GDP from 3.8% in the initial plan and expressed an intention to review the date for the planned adoption of the euro.
- Consumer price index rose 5.7 % in December 2003 from the year earlier, due mainly due to the depreciation of the Hungarian forint against the euro and a surge in food prices.

<Prospects and Noticeable Points>

Unsustainable economic growth led by excessive consumer spending

Hungary's real GDP grew by 2.9% year-on-year in July-September quarter of 2003, up from 2.4% in the previous quarter. However, judging from the performance of each expenditure item, the current economic growth is not sustainable. Domestic demand was driven by a 9.7% growth of consumer spending and a 4.4% gain in fixed capital formation, while a 7.7% growth of exports was more than counterbalanced by a 17.8% surge in imports resulting form strong domestic demand. Inflation increased to 5.7% year-on-year in December 2003, the highest since the beginning of the year, reflecting the depreciation of the forint and a surge in food prices. The central bank raised the interest rate by 300bp on November 28, 2003 following hikes in June 2003 to ease the negative impact of the currency's continuing depreciation on the economy. But on December 3, the value of forint against the euro depreciated to the lowest level of around 272.

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Given the current polices, early correction of economic imbalances is hard to come

Despite signs of improvement on the trade deficit, it is still premature to see the narrowing trade deficit as a set trend. Much of the improvement has been brought by accelerating exports stemming from the depreciation of the domestic currency and economic recovery in Europe. There remains the possibility of the trade deficit again widening due to increased import caused by an expansion of domestic demand.

The fiscal deficit in 2003 is estimated to have declined as compared with 2002. However, it is still unclear whether the fiscal deficit will continue to shrink, as evidenced by that 2004 budget plan, approved in the parliament only last December, has already had to be revised. On January 7, 2004, the government announced that the fiscal deficit in 2003 would widen to 5.6% of GDP from the 4.5% projected in the initial plan. Finance Minister Csaba Laszlo was forced to resign to take the responsibility for the failure to attain the target. Mr. Tibor Draskovics, an adviser to the prime minister, was appointed to succeed Mr. Laszlo as finance minister. Soon after the appointment, the new finance minister revised the 2004 fiscal plan and expressed an intention to reconsider the date for the planned euro adoption. The revised budget plan raised the fiscal deficit estimate to 4.6% of GDP from 3.8% in the initial plan and cut spending by totaling Ft155 billion (equivalence to 0.8% of GDP).

Further spending cut is needed to stem fiscal deterioration

After the entry into the EU scheduled in May 2004, one of decisive factors that will affect the rating on Hungary would be how soon it will adopt the euro. Before a country adopts the euro, it must comply with four economic criteria (see the attached table). The four criteria are the fiscal balance, government debt, interest rate and inflation. However, based on the estimated figures for 2003, none of the four criteria were met, endangering the adoption of the euro in 2008 as envisaged by the government. In order to meet these criteria, Hungary must curb its robust domestic demand through spending cuts since the central bank has already raised its interest rate considerably. JCR considers that the downward revision of the 2004 fiscal deficit estimate made by the new finance minister was reasonable, given the fact that the deficit in January 2004 turned out to be the largest in nine years (Ft 218.6 billion or equivalent to 23.8 % of the total annual deficit in the 2004 budget plan). Focal points are, in the first place, whether the spending cut announced by the new minister would be implemented as planned and secondly, whether the government will be able to carry out additional spending cuts to provide room for expenditures needed for infrastructure investment related to the EU entry. JCR positively evaluates the 2004 budget plan, which contains spending cut measures including reduction of housing subsidy, and the declining rate of wags increases. These two elements together will contribute to toward curbing the domestic demand. JCR has retained its current ratings, but may consider revising its rating outlook should the government fail to carry out spending cuts in 2004. Next general election is scheduled to be held in 2006.

Main Economic Indicators: The Republic of Hungary

		1999	2000	2001	2002	2003(f)	2004(f)
(4 Convergence criteria)							
*CPI (annual average)	(%)	10.0	9.8	9.2	5.3	4.7	6.3
*10 year government bond yield	(%)	8.9	8.0	7.1	6.4	8.0	8.5
*General gov't budget deficit/GDP	(%)	-3.2	-3.5	-4.1	-9.2	-5.6	-5.0
*General gov't debt/GDP	(%)	60.4	54.9	51.9	54.8	60.5	62.0
Real GDP growth rate	(%)	4.2	5.2	3.8	3.3	3.0	3.5
Unemployment rate (year-end)	(%)	7.0	6.4	5.7	5.9	6.0	6.1
Current account balance	(Euro mn)	-2,301	-3,152	-1,967	-2,771	-4,836	-4,485
Current account balance/GDP	(%)	-5.1	-6.2	-3.4	-4.0	-6.0	-6.1
Foreign Direct Investment	(Euro mn)	1,658	1,215	2,518	633	-1,456	500
Foreign Direct Investment/GDP	(%)	3.7	2.4	4.4	0.9	-1.8	0.7
Forex reserves (excl. gold)	(Euro mn)	10,605	11,730	11,670	9,279	9,527	10,000
Imports (G&S) coverage	(months)	4.2	3.5	3.2	2.4	2.3	2.3
External debt/ GDP	(%)	64.2	64.2	64.9	55.2	53.0	58.0
External debt/ exports (G&S)	(%)	98.5	85.9	87.2	85.6	92.1	97.8
Public external debt/exports (G&S)	(%)	45.2	37.6	35.2	38.6	41.7	45.8

Note: figures for 2003 and 2004 are JCR forecast.

Sources: Central bank, Ministry of Finance, IMF and EIU

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