

2004-24
August 16, 2004

Hungary (the Republic of)

Foreign LT: A/Stable, Local LT: A+/Stable (Affirmed on March 22, 2004)

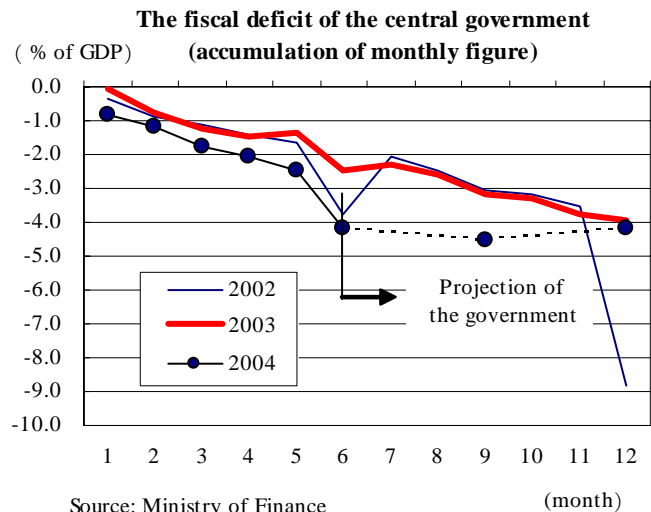
Main Factors for the Ratings

Positive Factors

- With the adoption of the euro in sight, more stable economic structure will be established.
- Stronger economic ties with EU since the early stage of economic transformation.
- Rising exports resulting from the expansion of production capacity and transformation to more value-added industrial structure through inflows of FDI.

Negative Factors

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



Updated: from May 2004 to July 2004

Positive Factors

- Spurred by an expansion of investments and exports, the real GDP grew 4.2% year-on-year in the January-March quarter of 2004, up from 3.6% in the previous quarter.
- The central bank cut its policy rate by 50bps to 11.5% on May 3, following two successive cuts by 25bps each on March 23 and April 6.

Negative Factors

- The current account deficit for the first four months of 2004 was EUR2, 780 million, an increase of more than 20 % from the same period of last year.
- In the European parliamentary election held on June 13, the opposition parties Fidesz-MPSD garnered more votes than the ruling Socialist Party.
- Consumer price index rose by 7.5 % (6.1% in terms of core inflation rate) in June from the year earlier, due mainly to a surge in food and energy prices.
- IMF raised concerns over Hungary's large current account and fiscal deficits as well as inflation pressure.

<Prospects and Noticeable Points>

Focal point is fiscal policy in the latter half of 2004, which will affect future developments

Returning to sustainable economic expansion

Hungary's real GDP grew 4.2% year-on-year in the January-March quarter of 2004, up from 3.6% in the previous quarter. The economy had expanded at an unsustainable pace led mainly by overheating consumer spending until the July-September quarter of 2003. However, the economy showed signs of returning to sustainable growth in the October-December quarter. While both gross fixed capital formation and exports gained strength, consumer spending slowed down. This economic trend became firmer in the January-March quarter of 2004 than in the previous quarter. Meanwhile, the consumer price index in June rose 7.5% from the year earlier (core inflation rate was 6.1%), reflecting a surge in food and energy prices and a tax rate hike. It is likely that inflation will continue to accelerate, mirroring the additional upward pressure to be brought by the planned hikes in the exercise tax rate and utility rates, although additional inflation pressure related to the country's EU entry may remain minimal. The central bank cut its policy rate by a total of 100bps from 12.5% between January and May of 2004. Since then, the bank has kept the rate unchanged, concerned over the ongoing inflation pressure.

No significant improvement in both current account and fiscal deficits; close watch is needed of developments in latter half of 2004

The current account deficit, which widened to 8.9% of GDP in 2003, showed no improvement as far as the figures for the first four months of 2004 were concerned. Rather the deficit increased by more than 20% year-on-year during the period. While the trade deficit tended to improve gradually, barring a one-off surge in imports ahead of EU entry, both income and service balance deficits deteriorated considerably. The income balance deficit —1.3 times bigger than the trade deficit — was largely caused by transfer of earnings by foreign enterprises. The service balance had remained in surplus until 2002 but turned adverse in 2003 due to reduced tourist income. It is likely that the current account deficit will gradually shrink, underpinned by continued growth of exports and reduced imports resulting from a slowdown of consumer spending. However, developments of the income balance need to be watched carefully.

The fiscal deficit, another cause for concern along with the current account deficit, turned out to be within the government estimate for the first half of 2004. The government projection envisages a major improvement of the deficit in the latter half of 2004, assuming an increase in tax revenues following the country's EU entry and the effect of a spending cut program (totaling Ft155 billion or 0.8% of GDP) approved in parliament at the beginning of the year. Whether that estimate can be achieved highly depends on the government's fiscal policy in the latter half of 2004. The government estimates the general government deficit to narrow to 4.6% of GDP in 2004.

Further spending cut is needed to ensure fiscal improvement

JCR believes that the fiscal deficit will continue to shrink gradually over the medium term, but maintains the view that the government will have to step up spending cuts to provide more room for expenditures needed for infrastructure investment. With the next general election expected in 2006, there remains the possibility that expenditure pressure will gather momentum, given the declining popularity of the ruling Socialist Party. If such concern becomes real, the government plan to cut the fiscal deficit to 3% of GDP in 2008 could be endangered. In this respect, JCR will closely watch developments, in particular the fiscal policy in the latter half of 2004 and the budget plan for 2005, which is under consideration within the government. JCR has retained its current ratings but may consider revising its rating outlook should the government fail to carry out its planned spending cuts in 2004.

Main Economic Indicators: The Republic of Hungary

		2000	2001	2002	2003	2004(f)	2005(f)
(Convergence criteria)							
1.CPI (annual average)	(%)	9.8	9.2	5.3	4.7	7.0	5.0
2.10 year government bond yield	(%)	8.0	7.1	6.4	8.0	8.3	7.5
3.General gov't budget	(%)	-3.0	-4.4	-9.3	-5.9	-6.3	-5.5
4.General gov't debt/GDP(ESA95)	(%)	55.4	53.5	57.1	59.0	59.9	61.4
Real GDP growth rate	(%)	5.2	3.8	3.3	2.9	3.5	3.8
Unemployment rate (year-end)	(%)	6.4	5.7	5.8	5.9	5.6	5.3
Current account balance	(Euro mn)	-4,380	-3,613	-4,900	-6,488	-6,408	-5,950
Current account balance/GDP	(%)	-8.6	-6.2	-7.1	-8.9	-8.1	-7.5
Net foreign Direct Investment	(Euro mn)	1,199	2,513	824	-1,228	500	500
Net foreign Direct Investment/GDP	(%)	2.4	4.3	1.2	-1.7	0.6	0.6
Forex reserves (excl. gold)	(Euro mn)	11,730	11,670	9,279	9,527	10,000	10,000
Imports (G&S) coverage	(months)	3.6	3.3	2.4	2.4	2.3	2.2
External debt/ GDP	(%)	64.9	65.6	56.6	62.4	65.8	68.3
External debt/ exports (G&S)	(%)	87.9	90.0	88.5	101.1	108.1	111.5
Public external debt/exports (G&S)	(%)	48.0	43.3	46.4	43.0	46.6	46.3
Debt service ratio	(%)	15.4	14.6	13.9	14.5	14.0	13.5

Note: figures for 2004 and 2005 are based on JCR forecast.

Sources: European commission, Central bank, and Ministry of Finance.

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