

2004-37  
November 24, 2004

## Hungary (the Republic of)

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

### Main Factors for the Ratings

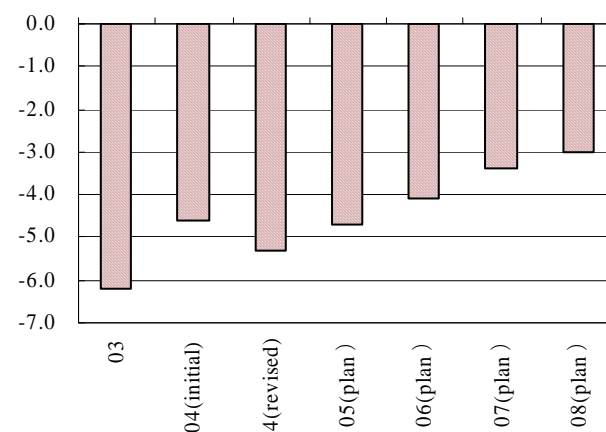
#### Positive Factors

- With adoption of the euro in sight, a 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

The government's projection of fiscal deficits (ESA95)  
(as a % of GDP)



### Updated: from August 2004 to October 2004

#### Positive Factors

- Following resignation of Prime Minister Peter Medgyessy, former Sports Minister Ferenc Gyurcsany became new prime minister on September 30 after approval of a confidence vote in parliament.
- Real GDP in the April-June quarter of 2004 grew by 4.0% year-on-year, spurred by expansion of consumer spending and investment (September 19).
- September inflation rate slowed down to 6.6% from a recent peak of 7.6% in May.
- The government submitted a budget plan for 2005 to parliament, envisaging a fiscal deficit equivalent to 4.7% of GDP (October 4).

#### Negative Factors

- The government revised its fiscal deficit estimate for 2004 upward from 4.6% of GDP to 5.3%, due mainly to slower tax revenues.
- The European Central Bank indicated in its Convergence Report that Hungary needs to push fiscal reforms and lower inflation. It also pointed to what it sees as inadequacy of the country's central bank law (October 20).
- The current account deficit for the first six months of 2004 totaled EUR3, 830 million, up 13 % year-on-year.

### <Prospects and Noticeable Points>

#### Concern over possible delay in adoption of euro in 2010

##### Generally improving economic performances

Hungary's real GDP in the April-June quarter of 2004 grew 4.0% year-on-year, slightly down from 4.2% in the previous quarter. While consumer spending gained 4.7% year-on-year, the main driving force shifted to gross fixed capital formation which grew a strong 10%. External demand turned a negative contributor as imports surged 18.5% to outpace exports which gained 16.9%. Meanwhile, the inflation rate rose to 7.6% in May on a surge of food and energy prices and a tax rate hike but eased to 6.6% in September as the impact of the tax rate hike receded. This led the central bank to cut its policy rate by 50bp each in August and October to 10.5%.

##### No significant improvement on twin deficits

The current account deficit, which widened to 8.9% of GDP in 2003, has shown no improvement so far this year. The deficit for the first six months of 2004 rose by 13% from the same period of last year. While the trade deficit during the period improved from the year earlier (following deterioration in April-June quarter), transfer balance surplus continued to shrink and both income and

service balance deficits widened considerably. The income balance deficit -- twice bigger than the trade deficit -- was largely caused by increased transfers of earnings and investment returns by foreign enterprises operating in Hungary. A larger service balance deficit was primarily attributable to reduced tourist income. As the large current account deficit was covered mainly by portfolio investment centering on bonds, it is inevitable for Hungary to maintain confidence of investors.

The fiscal deficit, though improving modestly as compared with the previous year, remained bigger than the government estimate. In September, the government revised its fiscal deficit estimate for 2004 upward from 4.6% of GDP to 5.3%. Despite a surplus in October, the accumulative deficit for the first ten months of the year totaled Ft1,328 billion, coming close to the revised projection. The biggest factor was slower revenues that fell short of the government estimate due mainly to reduced VAT receipts (expenditure growth was in line with the government projection).

#### **New government looks less enthusiastic about fiscal reforms**

Prime Minister Peter Medgyessy resigned after his Cabinet reshuffle proposal aimed to stem the government's declining popularity failed to win support within his coalition camp. Former Sports Minister Ferenc Gyurcsany, a member of the ruling Socialist Party, was appointed new prime minister. The policy platform unveiled by the new prime minister indicates that he has taken over the priority policies pursued by his predecessor, such as the adoption of the euro in 2010 and maintenance of balanced economic growth. However, there is no denying that his administration is less eager to tighten budget spending. Gyurcsany has made clear his intention to put priority on improving the living standards of the distressed and weaker people (reallocation of income to low-income earners).

There are some points that should be positively evaluated about the 2005 budget plan he has sent to parliament. It seeks to keep a year-on-year expansion of both revenues and expenditures within the nominal GDP growth estimate and reduce the fiscal deficit to 4.7% of GDP. However, it contains measures to cut income tax rates for lower-income earners and raise tax rates for the banking industry. The proposed tax reforms would reduce tax receipts by an estimated Ft80billion in net terms or 0.7% of the planned total revenues.

#### **JCR may consider revising rating outlooks should fiscal deficit estimate be revised upward**

In order to adopt the euro in 2010, it is critical for Hungary to contain its fiscal deficit. The coalition government led by the Socialist Party has time and again made upward revisions of fiscal deficit estimates. There is the possibility of another upward revision being made, considering the political priorities of the Gyurcsany administration. His government has taken over its predecessor's target to contain the fiscal deficit below 3% of GDP by 2008. But it will be extremely difficult to adopt the euro in 2010 should the government be forced to revise the target upward. The sole bright spot is that the economy has begun growing steadily. However, given the widening current account deficit, there will be a limit to what the high interest policy can do to defend the value of the forint. Therefore, the most appropriate policy that can be taken under the present situation will be to cut budget spending. With the next general election expected in 2006, there remains the possibility that expenditure pressure will gather momentum. JCR will closely watch the new government's fiscal management. It may consider revising its rating outlook should the government make an upward revision of its fiscal deficit estimate.

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

		2000	2001	2002	2003	2004(f)	2005(f)
<b>(Convergence criteria) (note 1)</b>							
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 deficit/GDP(ESA95)	(%)	-3.0	-4.4	-9.2	-6.2	-5.5	-5.0
4.General gov't debt/GDP	(%)	55.4	53.5	57.2	59.1	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	-7.0
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
Forex reserves/ short-term external debt	(times)	2.3	2.0	2.0	1.4	1.3	1.2
External debt/ GDP	(%)	65.0	64.8	57.3	65.6	73.9	77.8
External debt/ exports (G&S)	(%)	88.0	89.0	89.6	106.4	121.4	126.9
Public external debt/exports (G&S)	(%)	47.9	43.3	45.8	40.8	38.4	36.5
Debt service ratio	(%)	15.4	14.6	13.9	14.5	14.0	13.5

(Note 1) The Convergence criteria are inflation rate: inflation rate does not exceed 1.5 % of the average of three best performing Member States, long-term interest rate: long-term interest rate does not exceed 2 % of the average of three best performing Member State, government budgetary position: the ratio of planned or actual general government deficit to GDP does not exceed 3%, government debt: the ratio of general government debt to GDP does not exceed 60%, unless the ratio is sufficiently diminishing, and exchange rate: currency has been within the normal fluctuation margins stipulated by the Exchange Rate Mechanism II for at least two years.

(Note 2) figures for 2004 and 2005 are based on JCR forecast.

(Sources) The European commission, Central bank, and Ministry of Finance.

(Toshihiko Naito, Senior Analyst)