

2004-53  
February 28, 2005

## Hungary (the Republic of)

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

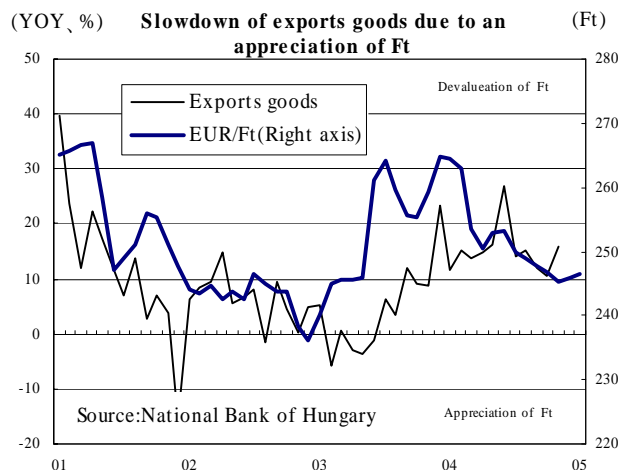
### Main Factors for the Ratings

#### Positive Factors

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

#### Negative Factors

- Growing government debt and persistent budget deficits.
- Rapid rise in wage growth in the past eroded the country's competitive edge.



### Updated: from November 2004 to January 2005

#### Positive Factors

- Parliament approved a budget plan for 2005, envisaging a fiscal deficit equivalent to 4.7% of GDP (November 30).
- The National Bank cut its interest rate by 50bps each on November 23, December 21 and January 25. It cut another 75bps on February 21 to 8.25%.
- Consumer price inflation slowed down to 5.5% in December year-on-year, due to falling food prices and the currency's appreciation,

#### Negative Factors

- The country's updated Convergence Program for 2004 revised the projection of fiscal deficit upward while maintaining the aim of reducing fiscal deficit to less than 3% of GDP by 2008.
- Real GDP growth rate in the July-September quarter of 2004 decelerated to 3.7% year-on-year due to a slowdown of exports, while gross fixed capital formation continued to gain ground.
- The European Commission retained its caution for Hungary to reduce fiscal deficit (December 22). The OECD voiced concern over the credibility of the country's fiscal policy (November 30).
- The current account deficit for the first nine months of 2004 totaled EUR 5,302 million (6.5% of GDP), up 11 %

### <Prospects and Noticeable Points>

## Hungary needs to implement more drastic spending cuts to fulfill Convergence criteria by 2008

### The economy slows down moderately due mainly to declining exports

Hungary's real GDP in the July-September quarter of 2004 grew by 3.7% year-on-year, down from 4.8% in the previous quarter. While gross fixed capital formation continued to grow 12.7% year-on-year, consumer spending and exports declined, respectively, to 3.9% (from 4.8% in the previous quarter) and 9.9% (from 18.7%). Consumer spending is expected to continue weak, due in part to a backlash against the strong demand for automobiles in the previous quarter, but due mainly to the falling real wages (all industry) and rising unemployment rate. A slowdown of exports primarily stemmed from the appreciation of the currency since the beginning of 2004 (real effective exchange rate appreciated by around 10% in the first eleven months of 2004), though the EU economy, Hungary's major trade partner, improved moderately. A slowdown of the Hungarian economy is becoming more definite as the year-on-year growth of industrial production, which grew by more than 10% in the first half of 2004, weakened to 5% in the latter half of 2004. The gradual economic slowdown is expected to continue, but any substantial fall is unlikely in view of the strong gross fixed capital formation. Consumer price inflation, which rose to 7.6% last May, eased to 5.5% last December with the help of falling food prices and the currency's appreciation. Amid the weakening economy and declining inflation, the

central bank cut its policy rate four times between November 2004 and February 2005 to 8.25%.

### **Twin deficits remain high, though improving slightly**

The current account and fiscal deficits improved slightly in 2004 from the previous year but remained at high levels. The current account deficit, which widened to 8.9% of GDP in 2003, is believed to have remained around 8% of GDP in 2004 as the deficit in the first nine months of the year had already totaled 6.5% of GDP. While the trade deficit during the period improved from the year earlier, both income and service balance deficits widened substantially. The income balance deficit in the nine-month period, about 2.5 times bigger than the trade deficit, was largely caused by increased transfers of earnings and investment returns by foreign enterprises operating in Hungary. JCR believes that current account deficit will narrow slightly due to an improved trade deficit, but that it will not shrink substantially because the income balance deficit is structurally widening. As the large current account deficit is covered mainly by portfolio investment centering on bonds, it is inevitable for Hungary to maintain confidence of investors.

The general government fiscal deficit for 2004 presumably narrowed to around 5% of GDP from 6.2% the previous year. This improvement was mainly attributable to spending cuts implemented in the first half of 2004. However, the updated Convergence program released last December revised its projection of annual fiscal deficits between 2005 and 2007 upward, based on an upward revision of the 2004 fiscal deficit by 0.6 point of GDP from the previous projection last May. The Hungarian government sticks to its target of reducing the fiscal deficit to below 3% of GDP by 2008. But it needs to carry out more drastic spending cuts to attain the target. The European Commission retained its caution for Hungary to reduce its fiscal deficit.

### **Fiscal management in 2005 will be a key test to prove whether Hungary can comply with Convergence criteria by 2008**

In order to adopt the euro in 2010, it is prerequisite for Hungary to comply with the Convergence criteria by 2008. At present, Hungary meets the single criterion on fiscal debt. To comply with all the criteria by 2008, the country needs to improve its economic imbalance through a reduction of fiscal deficit. The updated Convergence programs for major new EU member countries including Hungary contained upward revisions of economic prospects as compared with those in the previous programs released last May. But Hungary is the sole country for which the projection of fiscal deficit was revised upward significantly. This implies that Hungary needs to make greater efforts to reduce its fiscal deficit. With the country's next general election expected in 2006, there remains the possibility that expenditure pressure will gather momentum. JCR will closely watch the government's fiscal management in 2005. JCR may consider revising its rating should the government be forced to make an upward revision of its fiscal deficit estimate for 2005.

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

		1999	2000	2001	2002	2003	2004 (f)	2005 (f)
<b>(Convergence criteria)</b>	<b>Criteria</b>							
	<b>(2003)</b>							
1.CPI (annual average)	(%)	10.0	9.8	9.2	5.3	4.7	6.8	4.5
2.10 year government bond yield	(%)	n.a.	8.5	8.0	7.1	7.0	8.2	7.5
3.General gov't budget deficit/GDP(ESA95)	(%)	-3.2.	-3.0	-4.4	-9.2	-6.2	-5.0	-5.0
4.General gov't debt/GDP(ESA95)	(%)	60.4	55.4	53.5	57.2	57.0	58.0	56.5
Real GDP growth rate	(%)	4.2	5.2	3.8	3.3	2.9	4.0	3.8
Unemployment rate (year-end)	(%)	7.0	6.4	5.7	5.8	5.9	6.0	5.8
Current account balance	(EURmn)	-3,531	-4,380	-3,613	-4,900	-6,576	-6,950	-6,600
Current account balance/ GDP	(%)	-7.8	-8.6	-6.2	-7.1	-9.0	-8.6	-7.6
Trade balance/ GDP	(%)	-4.5	-6.3	-4.3	-3.2	-4.0	-2.1	-1.1
Net Foreign Direct Investment/ GDP	(%)	4.0	4.6	6.9	4.0	0.8	3.0	2.3
Forex reserves (excl. gold)	(EURmn)	11,222	11,730	11,670	9,279	9,527	11,224	10,000
Forex reserves / monthly Imports (G&S)	(months)	4.5	3.6	3.3	2.4	2.4	2.6	2.1
Forex reserves/ short-tem external debt	(times)	2.8	2.3	2.0	2.0	1.4	1.4	1.0
External debt/ GDP	(%)	65.2	65.0	64.8	57.3	65.6	73.9	80.1
External debt/ exports (G&S)	(%)	101.5	88.0	89.0	89.6	106.4	119.8	128.0
Public external debt/ exports (G&S)	(%)	51.9	42.2	39.0	41.1	43.4	45.2	46.9
Debt service ratio	(%)	17.9	15.4	14.6	13.9	14.5	13.6	12.9

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

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

(Toshihiko Naito, Senior Analyst)