

2005-07
May 26, 2005

Hungary (the Republic of)

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

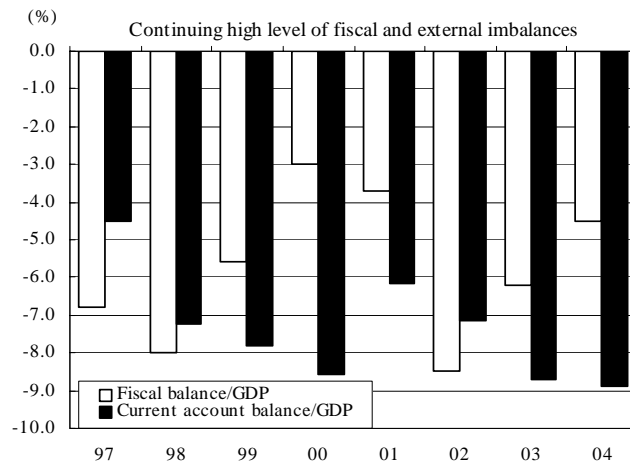
Main Factors for the Ratings

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

- High level of fiscal and external imbalances
- Growing external debts and fragile external financing structure



Updated: from February 2005 to April 2005

Positive Factors

- Foreign direct investment in 2004 grew by 76.3% year-on-year to EUR3.37billion or 4.2% of GDP.
- Consumer price inflation slowed down to 3.5% year-on-year in March, due to falling food and fuel prices and the currency's appreciation.
- The central bank lowered its policy rate to 7.5% in a series of cuts carried out on February 22, March 29 and April 26.

Negative Factors

- Prime Minister Ferenc Gyurcsany dismissed Finance Minister Tibor Draskovics for his failure to fix the country's fiscal imbalance and appointed Mr. Janos Veres, his chief of staff, to replace him. (April 25).
- The general government fiscal deficit in 2004 widened to 4.5% of GDP from 3.8% as initially estimated by the government. The deficit in the first four months of 2005 already topped 3% of GDP.
- The European Commission urged Hungary to adopt additional measures to reduce the fiscal deficit to less than 3% of GDP (the level set in the EU Stability and Growth Pact) by 2008 (February 16)
- Real GDP growth in the October-December quarter of 2004 remained moderate at 3.8% year-on-year as strong external demand was nullified by weak domestic demand.
- The current account deficit in 2004 totaled EUR7,123million or 8.9% of GDP, up slightly from 8.7% in 2003.

<Prospects and Noticeable Points>

Hungary at a crucial stage to fulfill the euro in 2010

The economy is expected to slow down in the short term

Paced by a balanced expansion of domestic and external demand, the Hungarian economy in 2004 grew by 4.0% year-on-year, a rate commensurate with the country's growth potential. With a possible overheating of consumer spending subdued, trade deficit narrowed on a slowdown of imports. Real GDP in the October-December quarter of 2004 grew by a moderate 3.8% year-on-year after a 3.7% growth in the previous quarter. Domestic demand slowed down to post a meager 0.7% year-on-year expansion after a 3.5% rise in the previous quarter, although external demand continued to gain ground. Consumer spending declined further due mainly to the falling real wages. Government spending remained slow reflecting the country's fiscal constraints. Gross fixed capital formation, which had been gaining strength, slowed down temporarily. Amid a weakening domestic demand, growth of industrial production in the January-March quarter decelerated noticeably to 1.7% year-on-year from 8.3% in 2004 as a whole. In 2005, the

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economy is expected to slow down further in the first half due to a weak domestic demand but will improve in the latter half, bolstered by the growth of exports and gross fixed capital formation. Consumer price inflation, which rose to 7.6% in May 2004, eased to 3.5% in March this year on falling food and fuel prices and the currency's appreciation. The exchange rate of the forint against the euro went up throughout 2004, but has been easing off since the beginning of 2005 amid the growing expectation of interest rate reduction. Encouraged by the declining inflation rate, the central bank lowered its policy rate to 7.5% in a series of cuts on February 22, March 29 and April 26.

Current account deficit deteriorated slightly despite improved fiscal deficit

The general government fiscal deficit in 2004 narrowed to 4.5% of GDP from 6.2% the previous year. However, this was well above the initial government estimate of 3.8%. The government overshoot its initial target for three years running. Against this background, the European Commission cautioned Hungary to adopt additional measures to reduce the fiscal deficit to below 3% of GDP by 2008. The fiscal deficit in the first four months of 2005 already exceeded the deficit in the same period of last year, topping 3% of GDP. In April, Prime Minister Gyurcsany dismissed Finance Minister Draskovics for his failure to fix the fiscal problem and unveiled a "100 steps program" for fiscal reconstruction with particular emphasis on social welfare and local government finance. The new program was to be discussed by the cabinet in May and it is unclear how much it would contribute toward containing the fiscal deficit.

The current account deficit in 2004 widened to 8.9% of GDP from 8.7% in 2003. While the trade and service balance deficits narrowed from the year earlier, both income and service balance deficits widened substantially. The income balance deficit in 2004, over twice as much as the trade deficit, largely stemmed from increased income through reinvestment by foreign enterprises operating in Hungary and transfer of returns on portfolio investment. JCR believes that any reduction of the current account deficit will be limited to the extent of an improved trade deficit since the income balance deficit is structurally widening. The large current account deficit in 2004 was covered mainly by portfolio investment centering on government bonds as was the case in the previous year. With a large current account deficit expected for continue at least in the short term, it is imperative for the government to maintain investor confidence in Hungary.

With general election expected in 2006, Hungary faces a crucial moment over Convergence criteria

The Hungarian government remains committed to its policy to adopt the euro in 2010. In order to realize this, Hungary must comply with the Convergence criteria by 2008. The government intends to bring the fiscal deficit below 3.0% of GDP by 2008 in order to clear all Convergence criteria. JCR believes that adoption of additional spending-cut measures is indispensable to trim the fiscal deficit. With a general election expected in 2006, JCR will closely watch the government's fiscal management in 2005 and the fate of Prime Minister Gyurcsany's new fiscal reconstruction program.

Main Economic Indicators: The Republic of Hungary

		2000	2001	2002	2003	2004	2005 (f)	2006 (f)
(Convergence criteria)	Criteria (2004)							
1.CPI (annual average)	2.6%	9.8	9.2	5.3	4.7	6.8	3.3	3.5
2.10 year government bond yield	5.6%	8.5	8.0	7.1	7.0	8.2	7.4	7.6
3.General gov't budget deficit/GDP(ESA95)	Below -3%	-3.0	-3.7	-8.5	-6.2	-4.5	-4.5	-5.0
4.General gov't debt/GDP(ESA95)	Below60%	61.9	61.2	55.4	52.2	55.5	56.5	57.0
Real GDP growth rate	(%)	5.2	3.8	3.5	3.0	4.0	3.6	3.8
Unemployment rate (year-end)	(%)	6.4	5.7	5.8	5.9	6.1	6.0	6.0
Current account balance	(EURmn)	-4,352	-3,577	-4,929	-6,364	-7,123	-7,386	-7,483
Current account balance/ GDP	(%)	-8.6	-6.2	-7.2	-9.0	-8.7	-8.9	-8.0
Trade balance/ GDP	(%)	-6.3	-4.3	-3.2	-4.0	-3.0	-3.1	-3.7
Net Foreign Direct Investment/ GDP	(%)	4.6	6.9	4.2	0.6	3.7	2.3	1.6
Forex reserves (excl. gold)	(EURmn)	11,730	11,670	9,279	9,527	11,224	12,500	13,600
Forex reserves / monthly Imports (G&S)	(months)	3.6	3.2	2.4	2.3	2.4	2.4	2.4
Forex reserves/ short-tem external debt	(times)	2.3	2.0	2.0	1.4	1.6	1.5	1.4
External debt/ GDP	(%)	65.0	64.8	57.3	65.6	70.8	74.5	75.9
External debt/ exports (G&S)	(%)	87.3	88.1	88.5	104.4	108.0	109.1	110.4
Public external debt/ exports (G&S)	(%)	47.9	43.9	45.8	40.8	41.3	41.3	40.2
Debt service ratio	(%)	15.3	14.5	13.7	14.2	12.9	13.4	13.5

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

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

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