

2005-24
August 24, 2005

Hungary (the Republic of)

Foreign LT: **A/Stable**, Local LT: **A+/Stable** (Affirmed on June 16, 2005)

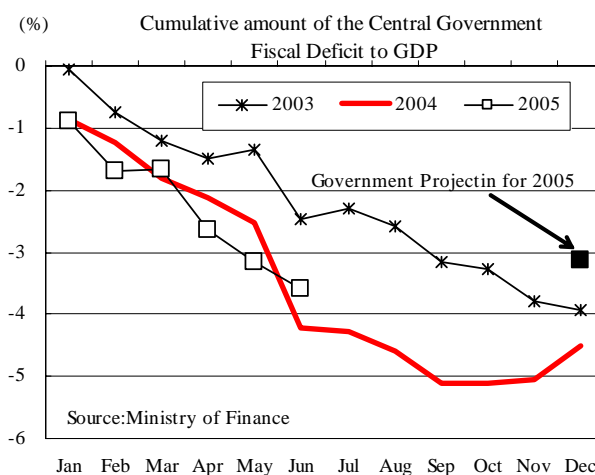
Main Factors for the Ratings

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 fiscal and external imbalances
- Growing external debts and fragile external financing structure



Updated: from May 2005 to July 2005

Positive Factors

- While consumer price inflation accelerated moderately to 3.8% year-on-year in June due to rising food and fuel prices, that of the core CPI excluding foods and fuels slowed down to 1.9% year-on-year.
- As a result of interest rate cuts by the central bank in May, June and July, the policy rate lowered to 6.75%. (Interest rate cuts in the phase of monetary relaxation since March 2004 totaled 5.75%)
- The government suggested implementing its new economic and fiscal reforms, the so-called "100 Programs," in April. It revealed a number of programs.
- Industrial production in April grew 9.0% year-on-year, up from a 1.3% rise in the first three month of 2005.

Negative Factors

- The central government's fiscal deficit in the first half of 2005 widened to 3.6% of GDP, rising above its annual target of 3.1%.
- The current account deficit in the first three months of 2005 increased by 14% to EUR1.5 billion or 7.6% of GDP.

<Prospects and Noticeable Points>

Foreign and local currency ratings were affirmed

(1) Following its affirmation of the ratings on foreign and local currency debts on June 17, JCR assigned the ratings to the Second and Third Samurai bonds on June 28

The affirmation of the ratings has been primarily supported by the followings: (1) there is the expectation that Hungary will make further progress on economic and fiscal reforms in preparation for the adoption of the euro in 2010 and (2) foreign direct investment (FDI) mainly from European countries has contributed to expanding the country's production capacity and enhancing its industrial structure through increased production of higher valued-added products.

On the other hand, the ratings are constrained by the fact that the country's fiscal and current account deficits are still large and that its external financing structure remains fragile due to relatively large external debts mainly in the private sector.

(2) Back to balanced economic growth led by investment and exports

Real GDP growth rate in the January-March quarter of 2005 slowed down to 2.9% year-on-year from 4.1% in the previous quarter. While domestic demand centering on consumer spending and gross fixed capital formation recovered, exports decelerated. According to the Central Statistical Office, the real GDP growth rate in the January-March quarter after adjustment for the leap-year effect in 2004 was 3.5%, which meant that the deceleration was smaller than it looked. The economy has been recovering of late, as indicated by a 9.0% rise in industrial production in April (up 1.3% in the first three month of 2005) and an upturn of exports in April

and May amid a moderate depreciation of currency. JCR projects that the economy will resume expanding in the latter half of 2005 bolstered by the growth of exports and gross fixed capital formation, with real GDP growth rate reaching 3.5% in 2005 and 4.0% in 2006. Consumer price inflation was slightly up in June to 3.8% year-on-year, but that of the core CPI further decelerated to 1.9%. Encouraged by the favorable economic and inflation trends, the central bank cut its policy rate in May, June and July to 6.75%.

(3) While reduction of fiscal deficit will come to a temporary halt ahead of May 2006 general election, there will be only modest improvement on current account deficit

The government intends to cut the fiscal deficit to 4.7% of GDP (ESA95 including pension reform expenses) after allowing for reserves equivalent to 0.8% of GDP under its budget plan for 2005. However, the central government deficit in the first half of 2005 has already exceeded its annual target, due primary to extra expenditures such as the payment of a one-month additional salary to the public servants based on legislative amendments. The government suggested implementing its new economic and fiscal reforms, the so-called "100 Programs." It bared 64 of the 100 programs by the beginning of June. These included a stricter collection of tax and social security contributions, tax reductions and reforms on social security systems. The programs seem to reek of election politics by the Socialist-led coalition government, which needs to improve its dwindling popularity. The government has already announced tax cuts measures including the reduction of the VAT rate from 25% to 20% and the highest personal income tax rate from 38% to 36%. The fiscal deficit in 2005 as a whole is very likely to go above 5% of GDP if that tax cuts are implemented without some expenditure reforms.

The current account deficit in the first three months of 2005 widened 14% year-on-year to EUR1.5 billion or 7.6% of GDP. Though the trade deficit narrowed, both the income and transfer accounts ended up with bigger deficits. Much of the income balance deficit stemmed from reinvestment earnings by foreign enterprises operating in Hungary and transfer of returns on portfolio investments. The transfer balance deficit was caused by the payment of increased contributions to the EU budget after the country's entry into the EU. JCR believes that the current account deficit will moderately narrow on a diminishing trade deficit, although the income balance deficit will remain large due to structural factors. External financing remains fragile as the current account deficit continues to be financed mainly by portfolio investment.

(4) Adoption of the euro in 2010 hinges on policies of post-election government

The government plans to adopt the euro in 2010. It intends to comply with the Convergence criteria, the prerequisite to the adoption of the euro, by 2008. In order to realize this, it is crucial for Hungary to contain its fiscal deficit. The government plans to bring the deficit down to 3.0% of GDP by 2007. Given the fact that the adoption of the euro is supported by both the ruling and opposition parties, the basic policy to pursue fiscal and economic reforms looks irreversible. For the time being, however, the fiscal reforms will make only little progress because of the upcoming election. JCR is of the view that some structural spending-cut measures are indispensable in order to fulfill the fiscal target. Meanwhile, as recent opinion polls indicate, the main opposition party, Fidesz-Hungarian Civic Union which is more proactive to economic and fiscal reforms, stands a better chance of winning the next election.

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	6.6	7.0
3.General gov't budget deficit/GDP(ESA95)	Below -3%	-3.0	-3.7	-8.5	-6.2	-4.5	-5.0	-5.0
4.General gov't debt/GDP(ESA95)	Below60%	61.9	61.2	55.4	52.2	55.5	57.0	57.5
Real GDP growth rate	(%)	5.2	3.8	3.5	3.0	4.0	3.5	4.0
Unemployment rate (year-end)	(%)	6.4	5.7	5.8	5.9	6.1	6.2	6.1
Current account balance	(EURbn)	-4.3	-3.6	-4.9	-6.3	-7.1	-7.4	-7.5
Current account balance/ GDP	(%)	-8.6	-6.2	-7.2	-8.7	-8.9	-8.0	-7.4
Trade balance/ GDP	(%)	-6.3	-4.3	-3.2	-4.0	-3.0	-2.5	-2.3
Net Foreign Direct Investment/ GDP	(%)	4.6	6.9	4.2	0.6	3.7	2.4	1.6
Forex reserves (excl. gold)	(EURbn)	11.7	11.6	9.3	9.5	11.2	12.5	13.6
Forex reserves / monthly Imports (G&S)	(months)	3.6	3.2	2.4	2.3	2.4	2.5	2.5
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	110.8	113.0
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	13.6	13.7

(Note) figures for 2005 and 2006 are based on JCR forecast.

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

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