

Hungary (the Republic of)

 Foreign LT: **A/Stable**, Local LT: **A+→A /Stable** (revised on February 23, 2006)

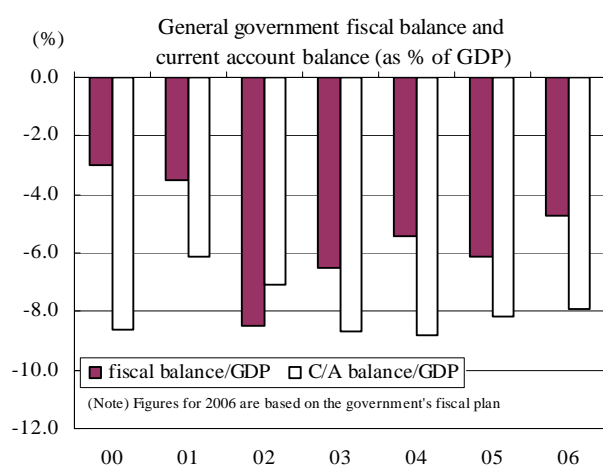
Main Factors for the Ratings

Positive Factors

- Harmonization with the euro-zone economy in the medium term, due mainly to implementation of reforms in view of adopting the euro.
- 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 November 2005 to January 2006

Positive Factors

- Real GDP growth rate in the July-September quarter of 2005 accelerated to 4.5% year-on-year from 3.3% (4.3% if adjusted for calendar effects) in the first half of 2005 due mainly to strong investment and exports.
- BAA, the UK airports group, won the bid for the sale of 75% stake in state-owned Budapest international airport for EUR 1.9 billion.
- The current account deficit in the first nine months of 2005 decreased by 5.4% to EUR5.0 billion or 5.8% of GDP.

Negative Factors

- Both the ruling Hungarian Socialist Party and the main opposition party Fidesz have presented expansionary policy measures for their election campaigns due to be held in April.
- The general government fiscal deficit in 2005 widened to 6.1% of GDP (ESA95 excluding costs of pension reform) from 5.4% in 2004.
- Tax reduction measures including cuts in income tax and VAT amounting to nearly EUR 4 billion or 4.4% of GDP over the next five years were introduced in January 2006.

<Outlook and Points to Watch>

Large fiscal deficits remains even after general elections

(1) JCR revised the rating on the local currency long-term senior debts in annual review

The revision of the rating on local currency long-term senior debts reflects the prospect that the country's persistently large fiscal deficits are unlikely to narrow and that an increase in government debts seems unavoidable in the short run. In the run-up to the general elections in April and local elections in October 2006, the government adopted tax cuts in January. Moreover, both the ruling Hungarian Socialist Party and the main opposition party Fidesz have presented expansionary policy measures for their election campaigns. Whichever wins the general elections, large fiscal deficits will remain unresolved in the short term.

The affirmation of the foreign currency debt ratings is underpinned by the expectation that Hungary will bring itself into harmony with the euro-zone economy in the medium term, due mainly to implementation of fiscal reforms in view of adopting the euro. The ratings are also supported by the fact that foreign direct investment (FDI) mainly from European countries has been contributing to expanding the country's production capacity and enhancing its industrial structure through increased production of higher value-added products and that the country has been promoting its economic ties with European countries since the early stage of its economic transformation by pushing economic reforms including privatization.

The rating outlooks are stable for both local and foreign currency long-term senior debts. Currently, the country is placed under the European Commission's Excessive Deficit Procedure based on the Stability and Growth Pact. It is required to submit a program for reduction of its excessive deficits to the EC by September 2006. In this respect, whether Hungary can come up with an effective measure to slash its excessive deficits holds the key to its future. A lack of effective measures may prompt JCR to review its current credit ratings.

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

The Hungarian economy has shifted back to stable growth led by a balanced expansion of both investment and exports. Real GDP growth rate in the July-September quarter of 2005 accelerated to 4.5% year-on-year from 3.3% (4.3% if adjusted for calendar effects) in the first half of 2005 due mainly to strong investment and exports. Consumer price inflation decelerated to 3.3% year-on-year in December 2005 from 3.7% in the first half of the year as prices of industrial products fell despite the higher energy prices. The favorable economic and inflation trends prompted the central bank to carry out successive cuts of its policy rate to 6.0% in 2005 from the peak 12.5% at the beginning of 2004. The Hungarian economy will expectedly continue to grow more than 4% annually in 2006 and 2007, bolstered by robust exports and investment and improved private consumption resulting from the tax reduction. In contrast, current account deficit in 2005 is estimated to have remained as large as around 8% of GDP due mainly to an increased income balance deficit related to foreign direct investment (FDI) and portfolio investment. Much of the deficit was covered by FDI inflows and portfolio investment centering on government bonds. The country's financial system remains sound, but the outstanding balance of bank loans to the private sector has been growing, centering on those denominated in foreign currencies. With the current account deficit expected to continue to be large, it is crucial for Hungary to maintain its investor confidence.

(3) Large fiscal deficits unlikely to narrow even after general elections

Persistently large government deficits have given rise to concern over the credibility of the government's fiscal policies. Since the Socialist Party came to power in 2002, annual fiscal deficits have stood well above the initial government estimates for four years running. The original deficit target for 2005 was 3.6% of GDP (ESA95 excluding costs of pension reform unless otherwise indicated). Nevertheless, the actual deficit turned out to be 6.1% when highway construction costs were included as pointed out by the EC (the deficit widened to an estimated 7.4% of GDP when pension reform costs were included). The FY 2006 government budget plan approved by parliament sets the deficit target for the year at 4.7% of GDP. However, the government announced in January a set of measures including cuts in income tax and VAT amounting to nearly EUR 4 billion or 4.4% of GDP over the next five years. Moreover, the two main political parties have unveiled expansionary measures as part of their election pledges. Regardless of election results, there will remain the possibility of a further expansion of the fiscal deficit. Any significant improvement on the fiscal deficit seems unlikely in the short run.

(4) Without some drastic tightening measures, Hungary might be forced to review the target date for euro adoption

It is crucial for Hungary to reduce its fiscal deficit to less than 3% of GDP by 2008 in order to meet one of the criteria for its adoption of the euro in 2010. The government released a new Convergence Programme in December last year, which aims to cut the deficit to 3.3% in 2007 and to 1.9% in 2008. Given the ongoing fiscal developments, however, achieving this projection would be a remote possibility unless some drastic tightening measures are implemented after the general elections. Hungary might be forced to review the target date for its euro adoption. JCR expects that the country's large fiscal deficits will be stemmed in the medium term through tightening measures as it seeks to adopt the euro. In this respect, JCR pays its attention to the contents of a deficit-slashing program the country is due to submit to the EC by September 2006.

Main Economic Indicators: The Republic of Hungary

		2001	2002	2003	2004	2005 (f)	2006 (f)	2007(f)
(Convergence criteria)	Criteria (2004)							
1.CPI (annual average)	2.6%	9.2	5.3	4.7	6.8	3.6	2.0	2.8
2.10 year government bond yield	5.6%	8.0	7.1	7.0	8.1	6.6	7.0	7.2
3.General gov't budget deficit/GDP(ESA95)	Below -3%	-3.5	-8.5	-6.5	-5.4	-6.1	-6.5	-6.0
4.General gov't debt/GDP(ESA95)	Below60%	52.2	55.5	57.4	57.4	58.5	60.5	62.0
Real GDP growth rate	(%)	4.3	3.8	3.4	4.6	4.2	4.3	4.3
Unemployment rate (year-end)	(%)	5.7	5.8	5.9	6.1	7.1	7.0	6.8
Current account balance	(EUR mln)	-3,577	-4,929	-6,382	-7,136	-6,828	-7,215	-6,982
Current account balance/ GDP	(%)	-6.1	-7.1	-8.7	-8.8	-7.8	-7.9	-7.3
Trade balance/ GDP	(%)	-4.3	-3.2	-3.9	-3.0	-1.8	-1.9	-1.2
Net Foreign Direct Investment/ GDP	(%)	6.8	4.2	0.6	3.5	5.2	2.2	1.6
Forex reserves (excl. gold)	(EUR mln)	11,670	9,279	9,527	11,224	15,432	16,700	17,500
Forex reserves / monthly Imports (G&S)	(months)	3.2	2.4	2.3	2.4	3.0	2.9	2.7
Forex reserves/ short-tem external debt	(times)	2.0	2.0	1.4	1.6	1.7	1.6	1.5
External debt/ GDP	(%)	64.2	56.8	65.3	70.1	77.2	80.5	83.2
External debt/ exports (G&S)	(%)	88.1	88.5	104.4	106.5	113.9	109.5	105.1
Public external debt/ exports (G&S)	(%)	38.6	40.6	42.6	44.0	46.3	46.3	42.9
Debt service ratio	(%)	14.5	13.7	14.2	12.7	13.3	14.0	14.5

(Note) figures between 2005 and 2007 are based JCR forecasts.

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

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