

2006-06
May 31, 2006

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

- The expectation that Hungary will bring itself into harmony with the euro-zone economy in the medium term through implementation of fiscal reforms geared for euro adoption.
- Rising exports resulting from the expansion of production capacity and transformation to a more value-added industrial structure through inflows of FDI.

Negative Factors

- Short-term continuation of high-level fiscal and external imbalances.
- Growing external debts and fragile external financing structure

<Election Results> (no. of seat)	1st (%) (April 9)	2nd (%) (April 23)	Total (%)
(Ruling parties)			
MSZP	109 51	77 36	186 48
SZDSZ	4 2	14 7	18 5
Alliance of MSZP/SZDSZ	0 0	6 3	6 2
Sub-total	113 53	97 45	210 54
(Oppositions)			
Fidesz	97 45	67 31	164 42
MDF	0 0	11 5	11 3
Independent	0 0	1 0	1 0
Sub-total	97 45	79 37	176 46
Total	214 100	172 100	386 100

Updated: from February 2006 to April 2006

Positive Factors

- The governing coalition of the Hungarian Socialist Party (MSZP) and the Liberal Alliance of Free Democrats (SZDSZ) won parliamentary majority in the two general elections held on April 9 and 23 to serve two consecutive terms for the first time since the fall of Communism.
- Immediately after the second election, Prime Minister Ferenc Gyurcsany pledged to introduce measures to reduce the fiscal deficit (April 24).
- Industrial production in the January-March quarter of 2006 grew a robust 12.9% year-on-year.
- Consumer price inflation in April 2006 remained unchanged at 2.3% year-on-year for the second consecutive month.
- Current account deficit in 2005 decreased to 7.2% of GDP from 8.6% in 2004 on improved trade deficit.

Negative Factors

- The European Commission cautioned Hungary to take urgent steps to cut its substantial deficit.
- Both the ruling MSZP and the main opposition party Fidesz had advocated expansionary fiscal policy measures before the April election.
- General government fiscal deficit in 2005 widened to 6.1% of GDP (ESA95 excluding pension reform costs) from 5.4% in 2004. The central government fiscal deficit (GFS) in the first four months of 2006 amounted to Ft794.2 billion or 3.5% of GDP, equivalent to 51.9% of the government-set target for the year.

<Outlook and Points to Watch>

Decisive actions needed to reduce fiscal deficit

(1) **The ruling parties won parliamentary majority in the elections**

The governing MSZP and SZDSZ won parliamentary majority in the two general elections held on April 9 and 23, gaining mandate to serve two consecutive terms for the first time since the fall of Communism in the country. The two parties won in both the first and second voting to secure 210 out of 386 parliamentary seats, or 12 more than before the elections. In the absence of any major obstacles, the two parties are set to form a cabinet soon.

(2) **Economic growth led by investment and exports**

The Hungarian economy continued to grow on expansion of both investment and exports amid further deceleration of consumer price inflation. Real GDP growth rate slightly slowed down to 4.1% in 2005 from 4.6% in 2004, but recovered to 4.5% (preliminary) year-on-year in the January-March quarter of 2006. Industrial production grew a robust 12.9% year-on-year in the January-March quarter of 2006, mainly on a rise in production of transport equipment. Japanese automaker Suzuki Motor boosted its production in Hungary by 54% year-on-year in the January-March quarter of 2006. The company plans to increase its annual production to 170,000 units this year and invest another EUR180 million this year after spending EUR230 million in 2005. Consumer price inflation in April 2006 remained unchanged at 2.3% year-on-year for the second consecutive month, staying well below the inflation target (3.5%±1%) set by the central bank. Despite significant rises in food and no-alcoholic beverage prices, CPI

remained steady as the upward pressure was offset by lower prices of regulated goods and services and industrial goods. Despite the declining inflation, the central bank has been keeping its policy rate unchanged at 6.0% since last September. The forint weakened to around Ft260 per euro (monthly average) in March from Ft248.06 per euro (annual average) in 2005. Higher interest rates had kept the forint rather strong, but concern over the country's twin deficits and narrower interest rate differentials with industrialized countries are putting downward pressure on the forint.

Barring a substantial devaluation of the currency, the Hungarian economy is projected to continue growing more than 4% annually in 2006 and 2007, bolstered by robust exports and investment and improved private consumption. Inflation rate will remain stable at around 2% year-on-year in 2006, supported by a rise in long-term real interest rate, moderate real wage growth and cuts in VAT rates.

(3) Current account deficit improved slightly, but twin deficits remain large

The current account deficit in 2005 narrowed to 7.3% of GDP from 8.8% in 2004 on an improved trade deficit. Nonetheless, the income balance deficit widened to 6.3% of GDP from 6.0% in 2005, owing to profit remittances by foreign companies operating in Hungary and increased debt servicing burdens. Much of the deficit was covered by FDI as well as other forms of capital inflows such as bank loans and securities investments. The country's financial system looks sound, but the outstanding balance of bank loans to the private sector has been growing, centering on those denominated in foreign currencies.

The general government fiscal deficit in 2005 widened to 6.1% of GDP (ESA95 excluding costs of pension reform) from 5.4% in 2004. The central government fiscal deficit (GFS) in the first four months of 2006 amounted to Ft794.2 billion or 3.5% of GDP, equivalent to 51.9% of the government target for the year, due mainly to lower tax revenues and higher expenditures. The government set the general government fiscal deficit target for 2006 at 4.7% (ESA95) of GDP. However, the government put into force in January 2006 a package of income tax and VAT rate cuts amounting to nearly EUR4 billion or 4.4% of GDP over the next five years. Moreover, the two ruling parties pledged to pursue expansionary fiscal measures during their election campaign. Without significant spending cut measures, a bigger fiscal deficit seems unavoidable in 2006. In its latest projection, the European Commission estimated Hungary's fiscal deficit/GDP ratios in 2006 and 2007 at 6.7% and 7%, respectively. At the same time, the commission cautioned Hungary to promptly carry out effective deficit-cutting measures.

(4) Without decisive actions to reduce fiscal deficit, JCR will consider revision of the ratings

Hungary has so far met only one (government debt has to be below 60% of GDP) of the Convergence criteria, the prerequisite for euro adoption. It has the largest fiscal deficit among the EU-25 member countries. For Hungary to adopt the euro in 2010, it must bring its deficit to below 3% of GDP by 2008. However, given the current fiscal situation, a delay of two to three years in euro adoption might be highly likely. The liberal coalition government led by MSZP needs to implement decisive actions to reduce the fiscal deficit during its four-year tenure of office.

Immediately after the general elections, Prime Minister Gyurcsany pledged to introduce measures to cut the deficit. Reports said that his government is planning to slash up to Ft350 billion (1.5% of GDP) from this year's budget through fiscal reforms centering on a large cut in the number of public employees. This measure, when implemented, should be positively evaluated as an important initial step forward toward reducing the fiscal deficit. JCR expects that as long as Hungary holds fast to its euro adoption policy, it can stem its large deficit in the medium term through tighter fiscal measures. In this respect, JCR will closely watch the contents of a deficit-cutting program the country is required to submit to the EC by September 2006.

Main Economic Indicators: The Republic of Hungary

		2001	2002	2003	2004	2005	2006 (f)	2007(f)
(Convergence criteria)	Criteria (2005)							
1.CPI (annual average)	3.0%	9.2	5.3	4.7	6.7	3.6	2.0	2.8
2.10 year government bond yield	5.4%	8.0	7.1	7.0	8.1	6.6	7.3	7.3
3.General gov't budget deficit/GDP(ESA95)	Below -3%	-3.5	-8.4	-6.4	-5.4	-6.1	-6.5	-5.5
4.General gov't debt/GDP(ESA95)	Below60%	52.2	55.0	56.7	57.1	58.4	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	7.2	6.8
Current account balance	(EUR mln)	-3,577	-4,929	-6,382	-6,976	-6,283	-6,684	-6,364
Current account balance/ GDP	(%)	-6.1	-7.1	-8.7	-8.6	-7.2	-7.4	-6.8
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	4.9	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-term external debt	(times)	2.0	2.0	1.4	1.5	1.5	1.6	1.5
External debt/ GDP	(%)	64.2	56.8	65.3	70.3	78.6	81.3	85.1
External debt/ exports (G&S)	(%)	88.1	88.5	104.4	106.1	115.6	108.9	104.6
Public external debt/ exports (G&S)	(%)	38.6	40.6	42.6	43.7	46.0	46.1	42.6
Debt service ratio	(%)	14.5	13.7	14.2	12.7	13.2	14.0	16.5

(Note) figures between 2006 and 2007 are based JCR forecasts.

(Sources) The European commission, National Bank of Hungary, and Ministry of Finance.

(Toshihiko Naito, Senior Analyst)