

2006-22
August 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

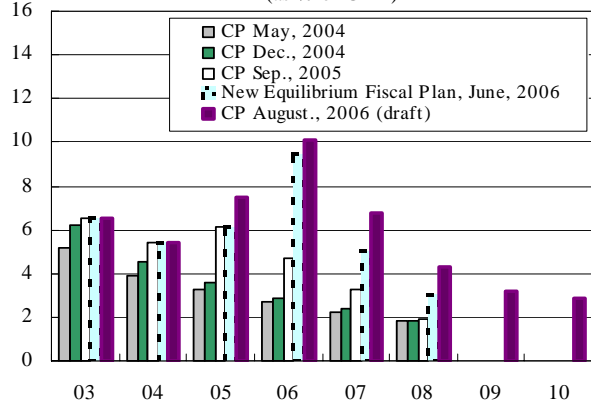
Positive Factors

- The expectation that Hungary will bring itself into harmony with the euro-zone economy 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

- The large fiscal and external imbalances.
- Growing external debts and fragile external financing structure

(%) The government projection of the fiscal deficit (as % of GDP)



Updated: from May 2006 to July 2006

Positive Factors

- On June 2, a new coalition government took office with a comfortable parliamentary majority.
- On June 10, Prime Minister Ferenc Gyurcsany unveiled a fiscal reform package called “New Equilibrium Fiscal Plan for 2006-2008” aimed at a drastic reduction of the fiscal deficit.
- A tax reform program proposed in the “New Equilibrium Fiscal Plan” was approved in parliament on July 24.
- The government revealed a draft Convergence Program showing a roadmap to euro adoption on August 22.
- The National Bank of Hungary (NBH) raised its policy rate twice, by 0.25 percentage points on June 19 and by 0.5 points on July 24, bringing it to 6.75%, the first hike since September 2005.
- Foreign direct investment (FDI) inflows into Hungary in the first quarter of 2006 doubled from a year before to EUR2 billion.

Negative Factors

- The central government fiscal deficit (GFS) in the first six months of 2006 amounted to Ft1,158 billion or equivalent to 5.0% of GDP, accounting for 74.4% of the government-set target for the year.
- The value of the forint against the euro fell to a historic low of 285.00 at the end of June.
- Consumer price inflation in July 2006 accelerated to 3.0% year-on-year on higher foods prices.

<Outlook and Points to Watch>

Major initial step toward reducing fiscal deficit

(1) **New coalition government formed with a comfortable majority**

The Hungarian Socialist Party (MSZP) and the Hungarian Liberal Party (SZDSZ) together won a parliamentary majority in the two general elections held on April 9 and 23, gaining a mandate to serve two consecutive terms for the first time since the fall of Communism in the country. The MSZP garnered 190 seats, just four short of a majority in the 386-seat National Assembly, expanding its strength from 178 seats it won in the 2002 election. As its coalition partner, it again chose the liberal SZDSZ, which had won 20 seats. With 210 seats out of 386, the new coalition government has a more stable majority than the outgoing government. A new Cabinet was formed on June 2, in which four ministers were newly appointed and eight others including the finance minister were retained.

(2) **A fiscal deficit reduction package unveiled**

Soon after its inauguration, the new government acknowledged that the 2006 budget deficit target of 4.7% of GDP was unrealistic and revised it upward to 9.5% (based on ESA95 and including pension reform costs). This revision reflecting the country’s deteriorating fiscal position was much beyond JCR’s projection. In fact, the central government fiscal deficit in the first half of 2006 amounted to Ft1,158 billion or equivalent to 5.0% of GDP, which already accounted for 74.4% of the initial government target for the year. The fiscal deterioration was primarily caused by increased expenditures centering on current expenses reeking of election politics and lower tax revenues.

On June 10, Prime Minister Gyurcsany unveiled a fiscal reform package called “New Equilibrium Fiscal Plan for 2006-2008” aimed at a massive reduction of the chronic fiscal deficit. The plan is specifically intended to slash the annual fiscal deficit to 5% of GDP in 2007 and to 3.5% in 2008 with an aim of retaining a 2010 target date for euro adoption. The scheme is highly dependent on

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revenue increases. Two thirds of the planned deficit cut will come from increased revenues and a third from reduced expenditures. On the revenue side, the plan calls for increasing the median VAT rate (from 15% to 20%), the corporate income tax rate (from 16% to 20%), tobacco and alcohol taxes, healthcare and employment insurance premiums and administrated prices of energy. On the expenditure side, specifics have yet to be revealed. On July 10, the tax reform proposals in the "New Equilibrium Fiscal Plan" were approved in parliament to be put into force in stages from September. The implementation of the programs will contribute to a modest improvement on the deficit. However, the credibility of fiscal policies has been marred by the fact that annual fiscal deficits have stood well above the government estimates for five years running. Therefore, specific spending-cut measures and their steady enforcement will be extremely important. On August 22, the government revealed a draft Convergence Program. Details of the program were not made known immediately. But it put greater emphasis on spending cuts in seeking to reduce the deficit. The program called for revising the 2006 deficit estimate further upward to 11.6% of GDP before slashing it to 2.9% by 2010. The government gave up specifying a target date for euro adoption.

(3) Economic growth led by investment and exports

The Hungarian economy continued to grow on expansion of both investment and exports amid the rising consumer price inflation. Real GDP growth rate in the January-March quarter of 2006 accelerated modestly to 4.6% from 4.5% the previous quarter, growing more than 4% for the fourth consecutive quarter. Consumer price inflation in July 2006 stood at 3.0% year-on-year on higher food prices, staying well below the NBH's inflation target (3.5%±1%) for the year. Significant rises of food prices nullified the drops in the prices of regulated goods and services and industrial goods. Reflecting the current inflation development and inflationary pressure brought by higher indirect taxes and energy prices, the NBH raised its policy rate for the first time since September 2005, by 0.25 percentage points on June 19 and by 0.5 points on July 24 to 6.75%. The current account deficit remained large, with the deficit in the first quarter of 2006 reaching 1.6% of GDP on an increased income balance deficit. The income balance deficit stemmed from profit remittances by foreign companies operating in Hungary and increased debt servicing burdens. While much of the deficit in the January-March quarter was sufficiently covered by FDI inflows, the value of the forint against the euro plunged to a historic low of 285.00 at the end of June amid concern over twin deficits despite the interest hikes by the NBH. With the current account deficit expected to stay large, it is crucial for Hungary to maintain its investor confidence.

The economy is expected to grow modestly in 2006, but how it will fare in 2007 will largely depend on implementation of fiscal reduction measures. The growth in the first half of 2006 was paced by strong consumer spending that followed the pre-election tax cuts and increased government spending. However, consumer spending will begin to decelerate toward the end of the year as the fiscal reduction measures will erode household disposal income. Investment will stay solid supported by FDI inflows and by increased use of EU structural funds for public investment projects. A full implementation of the draft Convergence Program would result in a sharp slowdown of economic growth in 2007, with the inflation rate accelerating on higher household gas prices, tax increases and a weaker forint.

(4) Without decisive actions to reduce fiscal deficit in the Convergence Program, 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 developments, a delay of two to three years in euro adoption will be more realistic.

JCR sees the "New Equilibrium Fiscal Plan" as an important initial step toward reducing the fiscal deficit. From now on, much will depend on what specific measures the government will figure out and how soon it will carry them out. From this viewpoint, JCR will begin reviewing its current ratings after looking into details of the Convergence Program to be submitted by the government to the EU at the beginning of September and examining their feasibility.

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	6.8	3.6	3.2	3.5
2.10 year government bond yield	5.4%	8.0	7.1	7.0	8.1	6.6	7.3	7.6
3.General gov't budget deficit/GDP(ESA95)	Below -3%	-3.5	-8.5	-6.5	-5.4	-6.1	-9.5	-6.5
4.General gov't debt/GDP(ESA95)	Below60%	52.2	55.5	57.4	57.4	58.4	70.5	74.5
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	-6,370	-6,789	-6,482
Current account balance/ GDP	(%)	-6.1	-7.1	-8.7	-8.6	-7.2	-8.0	-6.9
Trade balance/ GDP	(%)	-4.3	-3.2	-3.9	-3.0	-1.8	-2.1	-1.2
Net Foreign Direct Investment/ GDP	(%)	6.8	4.2	0.6	3.5	4.9	3.8	2.6
Forex reserves (excl. gold)	(EUR mln)	11,670	9,279	9,527	11,224	15,432	19,500	22,000
Forex reserves / monthly Imports (G&S)	(months)	3.2	2.4	2.3	2.4	3.0	3.4	3.5
Forex reserves/ short-tem external debt	(times)	2.0	2.0	1.4	1.6	1.5	1.9	1.9
External debt/ GDP	(%)	64.2	56.8	65.3	70.3	79.0	89.4	87.7
External debt/ exports (G&S)	(%)	88.1	88.5	104.4	106.1	116.2	113.2	107.8
Public external debt/ exports (G&S)	(%)	38.6	40.6	42.6	43.7	46.0	45.3	42.6
Debt service ratio	(%)	14.5	13.7	14.2	12.7	13.2	14.0	16.5

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

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

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