2006-38
November 22, 2006

Hungary (the Republic of)

Foreign LT: **A→A-/Stable**, Local LT: **A /Stable** (revised on October 4, 2006)

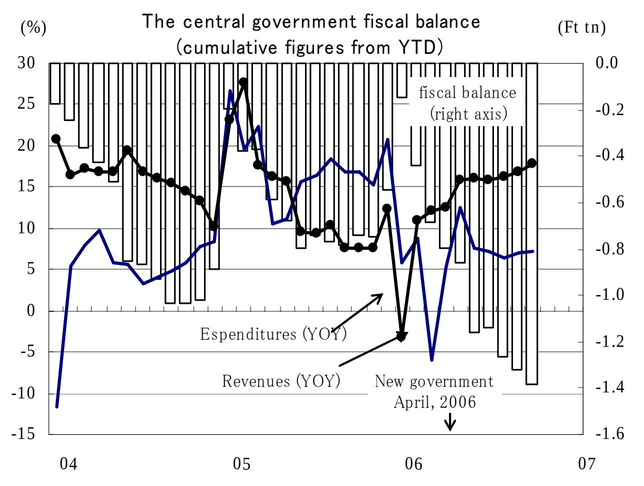
Main Factors for the Ratings

Positive Factors

- The expectation that Hungry will bring itself into harmony with the euro-zone economy through implementation of economic and fiscal reforms geared for euro adoption in the medium-term.
- 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 continued large fiscal deficit will boost the government debt.
- Growing external debts and fragile external financing structure



Updated: from August 2006 to October 2006

Positive Factors

- The government presented a new Convergence Program, which plans a large scale fiscal deficit reduction measure, to the European Commission (EC) on September 26.
- The EC cautiously approved Hungary's Convergence Program.
- On October 24, the National Bank of Hungary (NBH) decided the fifth hike in policy rate to 8.00% since June 2006.

Negative Factors

- The central government fiscal deficit (GFS) in the first ten months of 2006 amounted to Ft 1,385 billion or equivalent to 5.9% of GDP, accounting for 91.4% of the government-set target for the year.
- The protest against the Prime Minister continues calling for his resignation since mid September.
- The ruling coalition lost heavily in local election on October 3.
- Consumer price inflation in September 2006 accelerated to 5.9% year-on-year on higher foods prices and rises in administrative prices.

<Outlook and Points to Watch>

Large scale fiscal deficit reduction measures

(1) JCR downgraded a rating reflecting concern over widening fiscal deficit

On October 4, 2006, JCR has downgraded the rating on foreign currency long-term senior debts of the Republic of Hungary. The rating on local currency long-term senior debt was affirmed this time following the downgrade to A from A+ on February 23, 2006.

The revision of the ratings reflects the 2006 fiscal deficit swelling faster than JCR's projection which makes a further expansion of the government debt unavoidable in the medium term and an uncertain prospect of the fiscal deficit reduction measures in the government's new Convergence Program being implemented in full. The rating outlooks are stable.

(2) Drastic deficit cut eyed in new Convergence Program

Since revising the rating on the local currency long-term senior debts in February 2006 based on the prospect that the country's persistently large fiscal deficit is unlikely to narrow in the immediate future, JCR has focused on a new program, which the government was required to submit to the EC by September. In its published program, the government gave up specifying a target date for euro adoption which had earlier been set for 2010. The fiscal deficit estimate for 2006 was revised to 10.1% of GDP from 6.1% as projected in the initial budget plan. The deficit would be slashed to 3.2% of GDP in 2009 through new fiscal adjustment measures. More than 70% of the reduction would come from spending cuts on mainly personnel expenses of public employee, goods and services purchases and infrastructure investment. The remainder would be attained through increased revenues such as tax hikes. The government debt, estimated at 68.5% of GDP (ESA95 without the pension reform correction item, unless otherwise indicated) at the end of 2006, would increase to 72.3% at the end of 2008 before falling to 70.4% at the end of 2009, according to the program.

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The program contained the largest deficit reduction measures ever to be unveiled since 1995. A full implementation of the package would make the steering of fiscal and monetary policies harder as tax increases and reduced expenditures would slow economic growth and a cutback on subsidies and tax increases would push up the inflation rate. However, such measures would prove effective in stemming a further expansion of the fiscal deficit and a reduction of the current account deficit.

(1) Full implementation of the fiscal deficit reduction measures remains uncertain due to weakening political base

Re-elected in April 2006, the Socialist-led coalition government announced a fiscal reform package called a "New Equilibrium Fiscal Plan." Some of the tax reform proposals and spending cut measures contained in the plan were approved in parliament and have been put into force in stages since September. These have been making modest contribution toward reducing the fiscal deficit.

However, a full implementation of the fiscal deficit reduction measures incorporated in the new Convergence Program remains uncertain. The momentum for economic and fiscal reforms may lose steam now that the government has given up specifying a target date for euro adoption. The credibility of the government's fiscal policies has been eroded as annual fiscal deficits have stood well above the initial government estimates for five years running. The fiscal deficit in the first ten months of 2006 amounted to 5.9% of GDP (GFS), accounting for 91.4% of the government-set target for the year. The government has revised its general government fiscal deficit estimate for 2006 from 6.1% of GDP (ESA95 without the pension reform correction item, unless otherwise indicated) as envisaged in the initial budget plan to 10.1%. Judging from the current revenues and expenditures developments, the deficit in the year looks certain to exceed 10% of GDP. Furthermore, a heavy lost in the recent local elections and a wave of protest rallies triggered by the prime minister's admission that he had connived at a false report on past economic policies, have been shaking the political base of his administration.

(2) Economy may decelerate amid rising inflation caused by implementation of the fiscal deficit reduction package

The Hungarian economy continued to grow on strong investment and exports amid a modest rise of inflation. Currently, the pace of expansion remained stable although real GDP growth rate in the April-June quarter of 2006 decelerated to 3.8% year-on-year (4.1% after calendar adjustment) from 4.6% the previous quarter. Consumer price inflation in August 2006 rose to 3.5% year-on-year on higher food prices, staying above the 3.0% medium-term inflation target set by the National Bank of Hungary (NBH). To counter the inflation pressure brought by a weaker forint exchange rate and higher food prices, the NBH has raised its policy rate by a total 200 basis points to 8.00% since June.

Current account deficit remained large, with the deficit in the first six months of 2006 reaching 3.4% of a projected GDP on an increased income balance deficit. Much of the income balance deficit stemmed from profit remittances by foreign businesses operating in Hungary and increased debt-servicing burdens. While nearly 70 % of the current account deficit in the first six months of 2006 was covered by FDI inflows, the value of the forint against the euro plunged to a historic low of over 280 at the end of June amid concern over twin deficits despite the interest hikes by the NBH. Amid prospects of an economic slowdown and rising inflation that may result from the implementation of the deficit reduction measures, the twin deficits are expected to stay large for some time to come. Accordingly, it is crucial for the government to maintain investor confidence by enforcing appropriate fiscal and monetary

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 fiscal balance/GDP(ESA95)	Below -3%	-3.5	-8.5	-6.5	-5.4	-6.1	-11.0	-7.5
4.General gov't debt/GDP(ESA95)	Below60%	52.2	55.5	57.4	57.4	58.4	68.0	72.0
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	-5,933	-6,916	-6,002	-6,094	-3,874
Current account balance/ GDP	(%)	-6.1	-7.1	-8.5	-8.5	-6.8	-7.1	-6.9
Trade balance/ GDP	(%)	-4.3	-3.2	-3.9	-3.0	-1.7	-1.9	0.8
Net Foreign Direct Investment/ GDP	(%)	6.8	4.2	0.6	3.4	4.7	3.8	2.2
Forex reserves (excl. gold)	(EUR mln)	11,670	9,279	9,527	11,224	15,432	15,200	13,500
Forex reserves / monthly Imports (G&S)	(months)	3.2	2.4	2.3	2.4	3.0	2.7	2.3
Forex reserves/ short-tem external debt	(times)	2.0	2.0	1.4	1.5	1.5	1.4	1.2
External debt/ GDP	(%)	64.2	56.8	65.3	70.3	79.0	86.4	89.9
External debt/ exports (G&S)	(%)	88.1	88.5	104.4	106.5	114.8	108.2	104.6
Public external debt/ exports (G&S)	(%)	38.6	40.6	42.6	43.9	45.5	43.3	41.5
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.

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

policies.

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