Hungary
Rating Report

SCOPE BBB+ STABLE OUTLOOK

Credit strengths

- Robust growth performance supported by high investment
- Increased resilience against external shocks

Credit challenges

- High public debt
- Long-term risks to competitiveness
- Polarized political environment and headwinds with the EU

Rating rationale:

Robust growth dynamics: The economy has a strong record of robust growth and high investment – driven by inflows of foreign direct investment and projects co-financed with EU funds – creating high value-added jobs and supporting growth potential.

Increasing resilience to external shocks: Hungary benefits a small share of foreign-currency-denominated debt, balanced external accounts, a low net external debt ratio and improvements in the net international investment position.

Rating challenges include: i) high public debt and growing budgetary pressures, with discretionary measures implemented during the pandemic weighing on the fiscal position; ii) long-term risks to competitiveness, due to adverse demographic trends, structural employment gaps and labour shortages; and iii) institutional challenges related to rule of law issues, reflected by recent deteriorations captured in governance metrics including the rule of law, political polarisation and political headwinds with the EU.

Risk pillars		Quantitative scorecard		Reserve currency adjustment (notches)	Qualitative scorecard	Final rating
		Weight	Indicative rating		Notches	
Domestic Economic Risk		35%	aa-		0	BBB+
Public Finance Risk		25%	bb+		0	
External Economic Risk		10%	bb		0	
Financial Stability Risk		10%	aaa		0	
ESG Risk	Environmental Risk	5%	aaa		0	
	Social Risk	5%	bbb		-1/3	
	Governance Risk	10%	bb		-1/3	
Overall outcome		a-		0	-1	

Note: The sum of the qualitative adjustments, capped at 1 notch per rating pillar, is weighted equally and rounded to the nearest integer. The reserve currency adjustment applies to currencies in the IMF's SDR basket. For details, please see Scope's 'Sovereign Ratings' methodology. Source: Scope Ratings GmbH

Outlook and rating triggers

The Stable Outlook reflects Scope's view that risks to the ratings are balanced over the next 12 to 18 months.

Positive rating-change drivers

- Increase in medium-term growth potential supported by EU funds
- Significant public debt reduction due to improvement in public finances
- Material reduction of external debt burden

Negative rating-change drivers

- Protracted fiscal deterioration or a fading commitment to fiscal consolidation weakens debt sustainability
- Strong decline in foreign investment and/or significant delay of EU funds availability, lowering growth potential

Ratings and Outlook

Local and foreign currency

Long-term issuer rating	BBB+/Stable
Senior unsecured debt	BBB+/Stable
Short-term issuer rating	S-2+/Stable

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Bloomberg: RESP SCOP

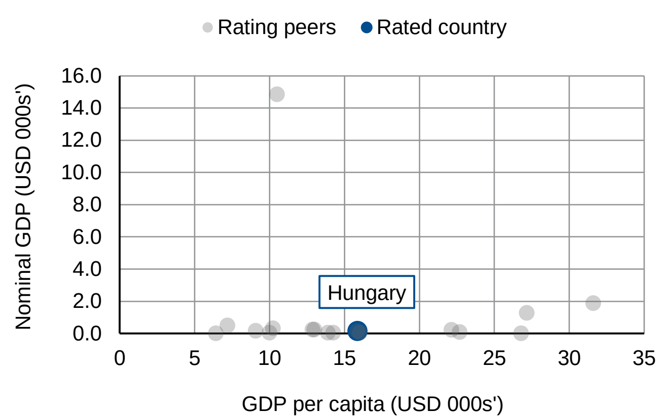
Domestic Economic Risks

- **Growth outlook:** Following a pandemic-related substantial decline in output of 4.7% in 2020, Hungary's economy has rebounded strongly on the back of ongoing fiscal stimulus via tax relief, increased transfers and social spending programmes, with GDP recovering to the pre-pandemic level in the second quarter of 2021. Scope forecasts annual GDP to grow by 7.5% in 2021 and 5.4% in 2022, supported by government support measures, income gains and increases in exports. Going forward, Scope expects growth to slow to a solid 4.0% in 2023 as output returns closer to its potential and policy support is gradually withdrawn.
- **Inflation and monetary policy:** HCIP inflation is set to further increase to 6.7% in Q4 2021. This reflects higher transportation costs and global commodity prices, as well as the pass-through of earlier currency depreciation. According to the Hungarian Central Bank, consumer prices are set to rise by around 5% in 2021 and then gradually stabilise around the 3% target from 2022 H2 on, when the effects of monetary policy tightening become more effective.
- The Hungarian central bank raised its base rate by 30bp to 0.9% in June, becoming the first central bank in the EU to launch a cycle of rate hikes due to growing prices. During the last meeting in November, the Monetary Council decided to further tighten monetary conditions: the Central Bank base rate was raised to 2.10% from 1.80% decided in October. Regarding the government securities purchase programme, the MNB decided in September to proceed at a weekly pace of HUF 40bn, lower than the HUF 50bn weekly pace previously.
- **Labour market:** Employment reached its pre-pandemic level in the summer of 2021 and job creation is set to continue, with an unemployment rate below 4% in Q3 2021.While the general labour market situation has been improving in Hungary in recent years, Hungary's long-term competitiveness is eroding due to adverse demographic trends and structural employment gaps. These remain wide in EU comparison, including employment gaps between skills groups, with the unemployment rate of the low-skilled at 9.5% against 1.3% among graduates in 2019.

Overview of Scope's qualitative assessments for Hungary's *Domestic Economic Risks*

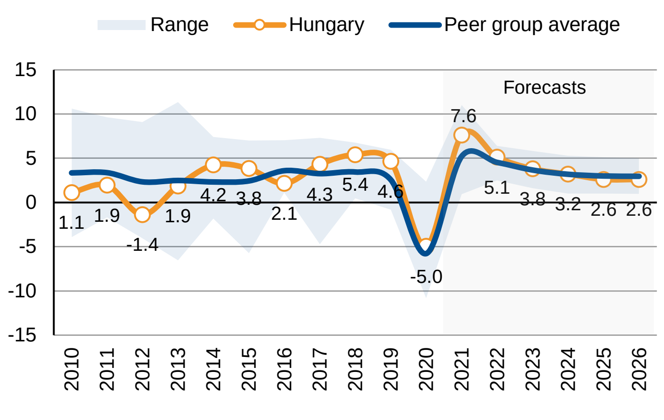
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aa-	Growth potential of the economy	Neutral	0	Robust growth dynamics; labour shortages and low savings
	Monetary policy framework	Neutral	0	Credible central bank; thin local currency bond market limits effectiveness of monetary policy
	Macro-economic stability and sustainability	Neutral	0	Competitive export base; reliance on external markets

Nominal GDP and GDP per capita, USD thousands



Source: IMF, Scope Ratings GmbH

Real GDP growth, %



Source: IMF, Scope Ratings GmbH

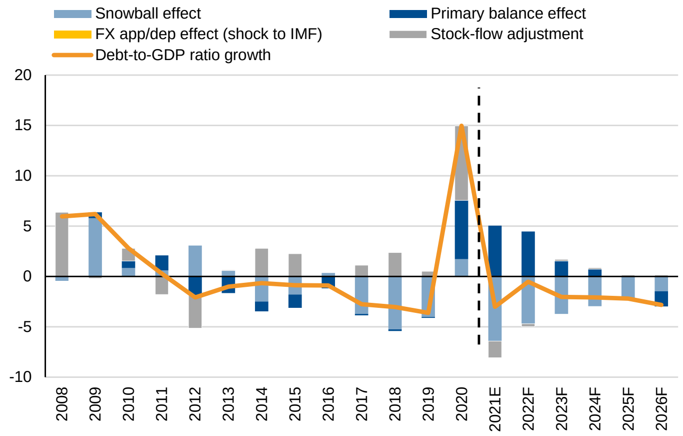
Public Finance Risks

- **Fiscal outlook:** Hungary's budgetary discretionary measures implemented during the pandemic materially weigh on the government's fiscal position. Despite a strong economic rebound in 2021, we forecast the general government deficit to remain high at 7.1% of GDP. Expenditure is set to remain high with implementation of social programmes, support for home ownership and renovation and a subsidised loan programme for SMEs. For 2022, we expect a deficit of 5.3% of GDP supported by strong revenue growth, a gradual reduction in discretionary spending and phasing out of pandemic-related measures including a temporary reduction in the local business tax.
- **Debt trajectory**: Compared to that of middle-income country peers, Hungary's public debt is high, at an estimated 77% of GDP in 2021. We expect the debt-to-GDP ratio will gradually decline to 76% in 2022 and 74% in 2023 and remain on a downward trajectory in the medium-term, supported by a low interest-payment burden benefitting from refinancing of previously issued securities at cheaper rates. However, the delay in the receipt of EU funds, an issue on which a final agreement has not been reached yet, can slow-down this declining trend.
- **Market access:** Hungary benefits from good access to foreign and domestic financing including a sizeable domestic retail programme. Its foreign-currency-denominated government debt significantly declined throughout time, from 31.3% end of 2015 to 19.9% end of 2020. It temporarily increased in 2021 to 21% given the new long-term issuance in foreign currency, but it is expected to decline again towards the end of the year, remaining in the 10-20% range set by the Government Debt Management Agency (AKK).

Overview of Scope's qualitative assessments for Hungary's *Public Finance Risks*

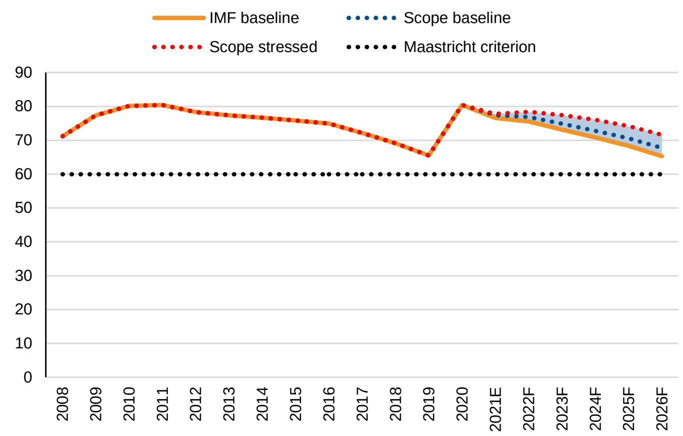
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bb+	Fiscal policy framework	Neutral	0	Adequately supportive fiscal policy during the pandemic crisis, but limited fiscal space
	Debt sustainability	Neutral	0	Elevated debt burden; long-term debt trajectory supported by declining cost of debt service
	Debt profile and market access	Neutral	0	Improving debt profile and investor base

Contributions to changes in debt levels, pps of GDP



Source: Scope Ratings GmbH

Debt-to-GDP forecasts, % of GDP



Source: Scope Ratings GmbH

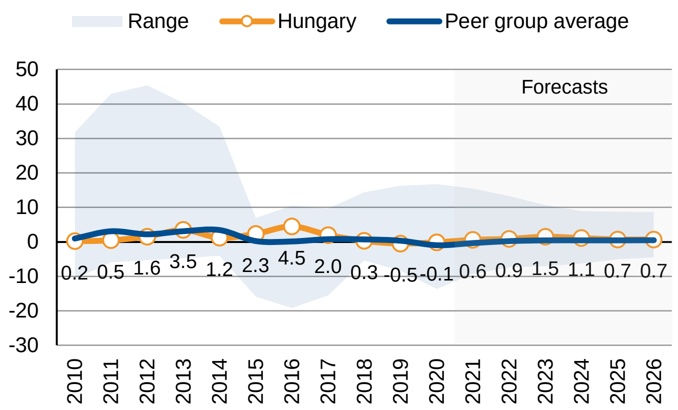
External Economic Risks

- **Current account:** Hungarian exports fell by 5.9% in 2020 due to a sharply drop in tourism flows, supply chain disruptions and lower global activity, counterbalanced by lower imports by 3.5%. We expect the current account to slightly deteriorate further in 2022 on the back of higher imports, before improving again in 2023.
- **External position:** Non-residents' holdings of central government debt have declined to about 20% from almost 50% few years ago. The country has adopted the strategy of increasing the proportion of domestically held retail securities, consequently raising the banking sector's exposure to the government to around 20% of its total assets.
- **Resilience to shocks:** The level of international reserves is adequate. Reserves started to increase in Q3 2020 due to large government's issuance of foreign bonds and EU funds inflow and reached a level of about EUR 37bn in November 2021, remaining above the IMF's reserve adequacy metric. Reserve coverage of short-term debt further improved and provides a comfortable cushion. The Hungarian economy is strongly integrated into global value chains, making exports sensitive to supply disruptions.

Overview of Scope's qualitative assessments for Hungary's *External Economic Risks*

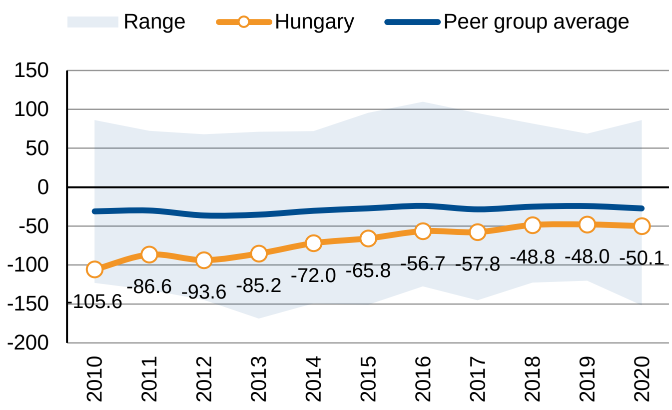
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bb	Current account resilience	Neutral	0	Stable current account surplus receipts with a manufacturing sector highly integrated in global supply chains
	External debt structure	Strong	+1/3	External liabilities mostly consist of direct investment and equity rather than debt-creating flows
	Resilience to short-term shocks	Weak	-1/3	High refinancing needs; reliance on external demand and foreign direct investment

Current account balance, % of GDP



Source: IMF, Scope Ratings GmbH

NIIP, % of GDP



Source: IMF, Scope Ratings GmbH

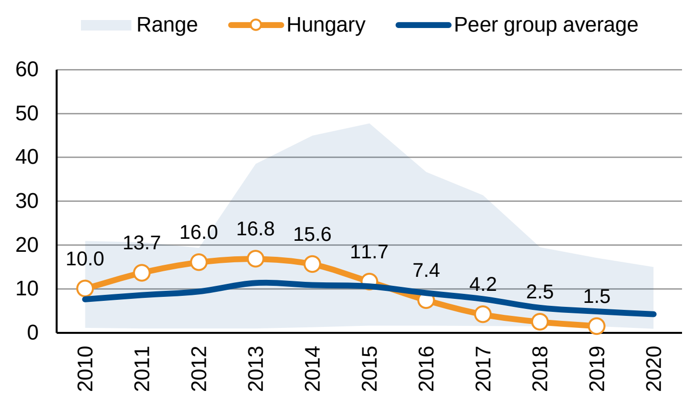
Financial Stability Risks

- **Banking sector:** The banking sector is well-capitalised with relatively strong asset quality. Macroprudential measures and recovering real estate prices over the past few years supported a decrease in NPLs, which fell below 5% of total loans in 2019, from a 2013 peak of 16%. Given the partial phase-out of the general payment moratorium programme end of September 2021, the NPL ratio and number of bankruptcies are likely to increase in the next months.
- **Private debt:** Households' indebtedness is low overall, with 60% of borrowers having an outstanding loan in amount below their annual income. On the other hand, savings remain low. The percentage of highly indebted households, with outstanding loans four times higher than annual income, was 10% end of 2020 and a relevant part of them participated to the payment moratorium.
- **Financial imbalances:** House prices continued to increase despite the pandemic, appreciating both in 2020 and 2021, although at lower growth rate than pre-crisis levels. Starting from 2016 government subsidies to households increased significantly and led to higher housing affordability. This uprising trend could heat the demand, but no signs of excessive lending have been observed on the market: the ratio of home purchases from loans was 47% in 2020 Q4, still a moderate level.

Overview of Scope's qualitative assessments for Hungary's *Financial Stability Risks*

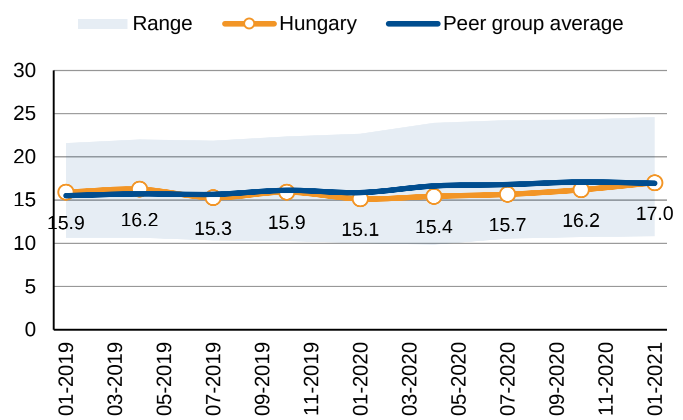
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aaa	Banking sector performance	Neutral	0	High capitalisation levels; declining profitability from a worsening operating environment
	Banking sector oversight	Neutral	0	Effective supervisory control; timely and comprehensive regulatory measures
	Financial imbalances	Neutral	0	Macroprudential measures underpin financial stability

NPLs, % of total loans



Source: IMF, Scope Ratings GmbH

Tier 1 ratio, % of risk-weighted assets



Source: IMF, Scope Ratings GmbH

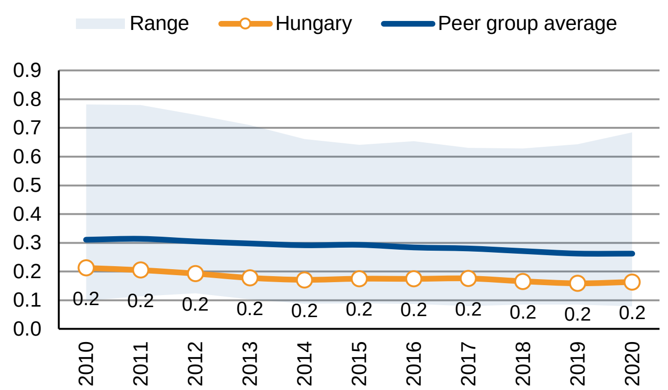
ESG Risks

- **Environment:** Hungary's economy is energy-intensive, with energy consumption levels well-above the EU average. This is largely due to the high household energy consumption per capita, which remains 12% higher than the EU average despite considerably lower income levels. The transformation of the coal region, which produces up to 15% of electric power, and the energy-intensive industries represent transition risks in Hungary. Hungary is among the lowest emitters of greenhouse gases per person in the EU and in pre-pandemic years the economy was able to grow reducing GHG emissions.
- **Social:** While the general labour market situation has been improving in Hungary in recent years, we note persistent employment gaps, which remain wide in EU comparison, including: i) employment gaps between skills groups, with the unemployment rate of the low-skilled at 9.5% in 2019, compared with 3.0% among the medium-skilled and 1.3% among the tertiary graduates; ii) a gender employment gap, reflected by the fact that Hungary has not made progress towards the Sustainable Development Goal 5 (gender equality) in the past nine years, along with limited childcare provision; and iii) rising regional inequalities, with poverty and social exclusion showing strong territorial concentration.
- **Governance:** Relations between Hungary the EU will likely remain tense, testified by the formal notice sent in June for failing to comply with EU court ruling over the treatment of asylum seekers, the legal action started in July over a new law considered discriminating against LGBTIQ rights and fundamental disagreements over the rule of law issues. General elections are scheduled for spring 2022 and current polls show the United Opposition voting intentions close to the ones of Orban's party Fidesz, respectively at 45% and 50%. The polarised political environment in Hungary and political headwinds with the EU limit long-term policy predictability, which could weigh on future foreign investment inflows and on macroeconomic sustainability given Hungary's high reliance on foreign funding and external demand.

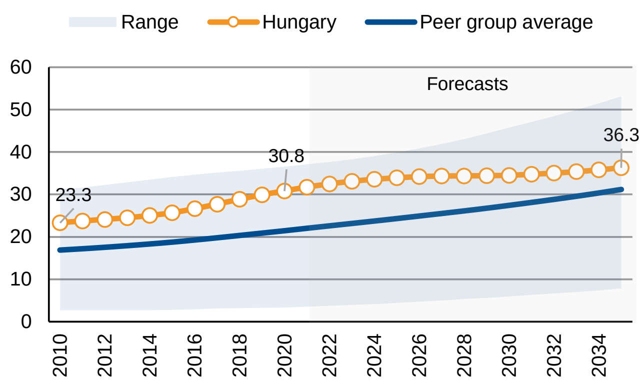
Overview of Scope's qualitative assessments for Hungary's *ESG Risks*

CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bbb	Environmental risks	Neutral	0	Low vulnerability to transition risks and natural disaster risk; poor in natural resources
	Social risks	Weak	-1/3	Substantial employment gaps; high regional inequalities; below average performance on education
	Institutional and political risks	Weak	-1/3	Ongoing institutional challenges and tensions with the EU; polarised political environment

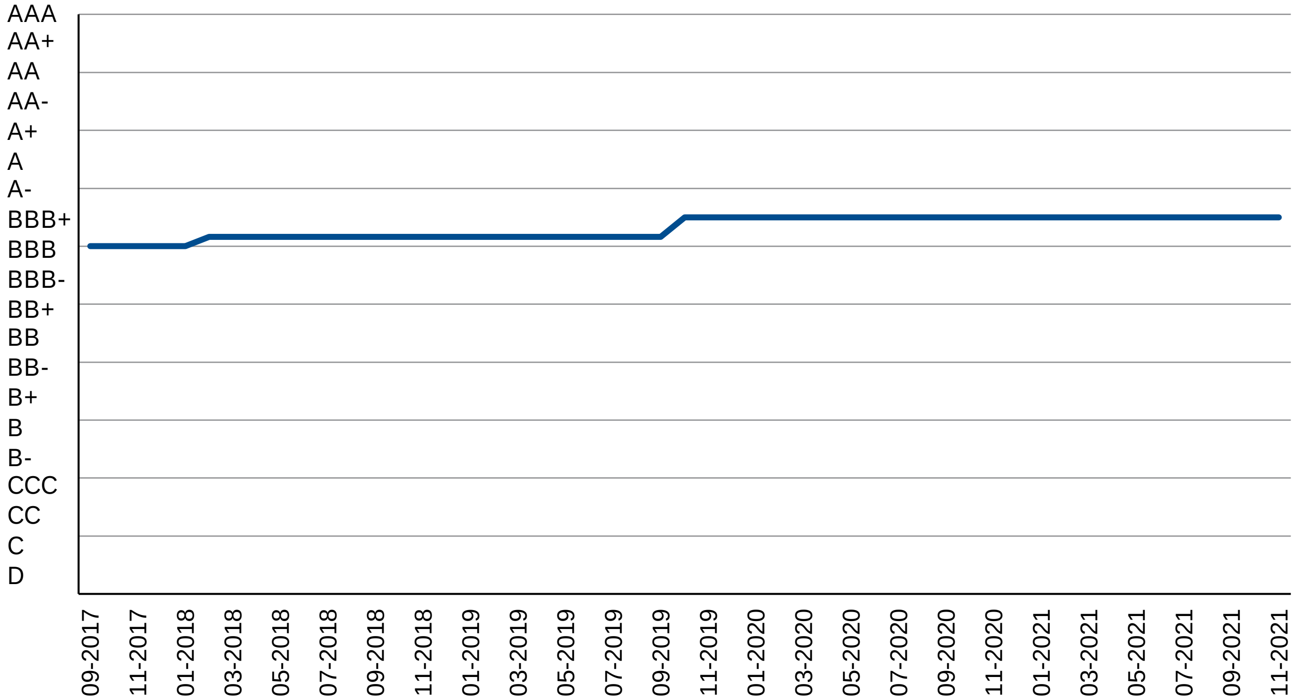
CO2 emissions per GDP, mtCO2e



Old age dependency ratio, %



Appendix I. Rating history



Appendix II. Rating peers

Rating peers are related to sovereigns with an indicative rating in the same rating category or in adjacent categories per Scope's Core Variable Scorecard.

Peer group
Bulgaria
China
Croatia
Cyprus
Hungary
Italy
Portugal
Romania
Spain

Publicly rated sovereigns only; the full sample may be larger.

Appendix III. Statistical table for selected CVS indicators[1]

	2016	2017	2018	2019	2020	2021F	2022F
Domestic Economic Risk							
GDP per capita, USD 000s'	13.1	14.6	16.4	16.7	15.9	18.5	20.4
Nominal GDP, USD bn	128.5	143.0	160.4	163.5	155.0	181.0	199.0
Real growth, %[1]	2.1	4.3	5.4	4.6	-4.7	7.5	5.4
CPI inflation, %	0.4	2.4	2.8	3.4	3.3	4.5	3.6
Unemployment rate, %[1]	5.0	4.0	3.6	3.3	4.1	4.1	3.8
Public Finance Risk							
Public debt, % of GDP[1]	74.9	72.2	69.1	65.5	80.4	77.0	76.0
Interest payment, % of government revenue	6.7	5.9	5.2	5.0	5.2	4.8	4.7
Primary balance, % of GDP[1]	1.2	0.2	0.2	0.1	-5.8	-5.1	-4.5
External Economic Risk							
Current account balance, % of GDP	4.5	2.0	0.3	-0.5	-0.1	0.6	0.9
Total reserves, months of imports	2.6	2.5	2.6	2.5	3.6	-	-
NIIP, % of GDP	-56.7	-57.8	-48.8	-48.0	-50.1	-	-
Financial Stability Risk							
NPL ratio, % of total loans	7.4	4.2	2.5	1.5	0.9	-	-
Tier 1 ratio, % of risk weighted assets	15.9	16.2	16.7	15.9	16.2	17.1	-
Credit to private sector, % of GDP	33.5	32.5	32.4	33.5	38.5	-	-
ESG Risk							
CO^2 per EUR 1,000 of GDP, $mtCO^2e$	174.3	175.8	165.8	158.6	163.4	-	-
Income quintile share ratio (S80/S20), x	4.8	4.9	4.6	-	-	-	-
Labour force participation rate, %	70.0	71.1	71.9	72.6	-	-	-
Old age dependency ratio, %	26.6	27.7	28.8	29.9	30.8	31.7	32.5
Composite governance indicator[2]	0.5	0.5	0.5	0.5	1.1	-	-

* Average of the six World Bank Governance Indicators
Source: European Commission, IMF, World Bank, UN, Scope Ratings GmbH

Appendix IV. Economic development and default indicators

IMF Development Classification	Emerging and Developing Europe
5y USD CDS spread (bps) as of 9 December 2021	54

[1] This table presents a selection of the indicators (24 out of 29) used in Scope's quantitative model, the Core Variable Scorecard.

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