2 September 2022

Sovereign and Public Sector

Hungary
Rating Report

SCOPE BBB+ NEGATIVE OUTLOOK

Credit strengths

- Robust growth performance supported by high investment
- Resilient external position and public debt profile against external shocks

Credit challenges

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

Rating rationale:

Robust growth dynamics: The economy has a strong record of robust growth supported by large foreign investments and significant EU funding – creating high value-added jobs and supporting economic development.

Resilient debt profile amid elevated risks: Hungary benefits from a low share of foreign-currency-denominated debt, a low net external debt ratio and good reserve adequacy. The country's external liabilities mostly consist of direct investment and equity rather than debt-creating flows, supporting Hungary's external position and resilience to external shocks.

Weakening growth outlook due to external risks: Hungary counts among the most exposed countries to the fallout from the Ukraine conflict, in view of its high reliance on Russian energy amplified by an economic structure dominated by energy-intensive businesses with complex value chains. Prolonged supply chain disruptions, further inflationary pressures and currency weakness are weighing on the country's growth prospects.

Rating challenges include: i) high public debt and growing budgetary pressures, with discretionary measures weighing on the fiscal position; ii) long-term risks to competitiveness, due to labour shortages compounded by adverse demographic trends and structural employment gaps; and iii) institutional challenges related to rule of law issues, reflected by recent deteriorations captured in governance metrics and political headwinds with the EU, which have led to delays to the disbursement of EU funds from the Recovery and Resilience Facility.

Hungary's sovereign rating drivers

Risk pillars		Quantitative scorecard		Reserve currency adjustment (notches)	Qualitative scorecard	Final rating
		Weight	Indicative rating		Notches	
Domestic Economic Risk		35%	a+		-1/3	
Public Finance Risk		25%	bbb-		0	
External Economic Risk		10%	bb		0	
Financial Stability Risk		10%	aa+		0	BBB+
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 qualitative scorecard adjustments, capped at one notch per rating pillar, are weighted equally with an aggregate adjustment 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.

Outlook and rating triggers

The Negative Outlook represents Scope's view that risks to the ratings over the next 12 to 18 months are tilted to the downside.

Positive rating-change drivers

- Improvement of medium-term growth prospects supported by improving external metrics
- Significant public debt reduction due to improvement in public finances

Negative rating-change drivers

- Growth prospects weaken more-than-expected
- Worsening external debt structure weakens resilience to external shocks
- Protracted fiscal deterioration weakens debt sustainability

Ratings and Outlook

Foreign currency

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

Local currency

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

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Bloomberg: RESP SCOP

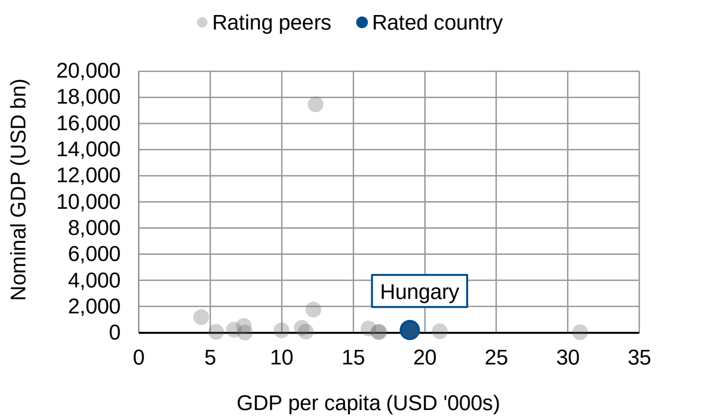
Domestic Economic Risks

- **Growth outlook:** Following a 4.5% dip in GDP in 2020, the Hungarian rebounded strongly in 2021, registering real growth of 7.1%. The positive momentum continued into Q1 2022 (+8.2% YoY) thanks to a strong policy stimulus to respond to the crisis. We expect economic activity to slow down markedly in H2 2022, reflecting the impact of the Ukraine war. Accelerating price pressures and rising interest rates will weigh on household consumption. Renewed supply chain disruptions continue to weigh on industrial activity. The weakening of the growth outlook in neighboring countries will dampen external demand. We expect growth to remain strong at 4.9% in 2022, thanks to a quick rebound following the pandemic, high carry-over effect and the expected disbursement of currently delayed EU funds allocated under the Recovery and Resilience Facility, before slowing to around 1.5% in 2023.
- **Inflation and monetary policy:** Inflation has risen markedly in recent months, with headline (HICP) and core inflation reaching 14.7% and 16.7% in July 2022, respectively, among the highest rates in the EU. This acceleration has been fuelled by the spike in global food and energy prices in the wake of the Ukraine conflict. The significant weakening of the forint and a tight labour market add further pressures to price dynamics. The National Bank of Hungary has rapidly tightened monetary policy, hiking its benchmark interest rate to 11.75% in August 2022.
- **Labour market:** The Hungarian labour market remains tight, with the employment rate standing at historical highs (74.3% as of Q2 2022). The number of vacancies has risen sharply in parallel, with some sectors (manufacturing, healthcare) reporting acute labour shortages, reflecting growing risks to the country's competitiveness.

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

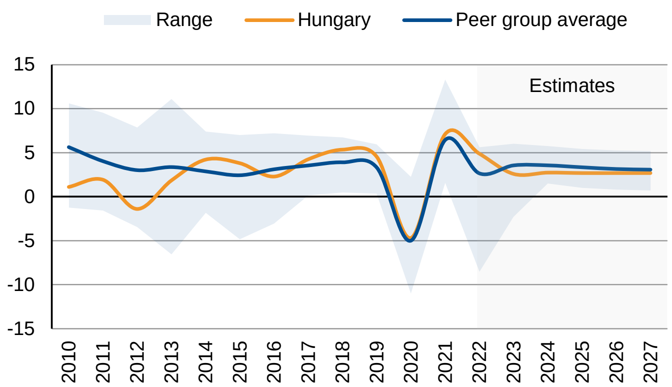
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
a+	Growth potential of the economy	Neutral	0	Robust growth dynamics; shortages on labour market, low savings
	Monetary policy framework	Neutral	0	Credible central bank; thin local currency bond market limits effectiveness of monetary policy
	Macro-economic stability and sustainability	Weak	-1/3	Competitive export base; high reliance on external markets and on Russian energy amplified by an economic structure dominated by energy-intensive businesses with complex value chains

Nominal GDP and GDP per capita, USD '000s



Source: IMF World Economic Outlook (WEO), Scope Ratings

Real GDP growth, %



Source: IMF WEO, Scope Ratings forecasts

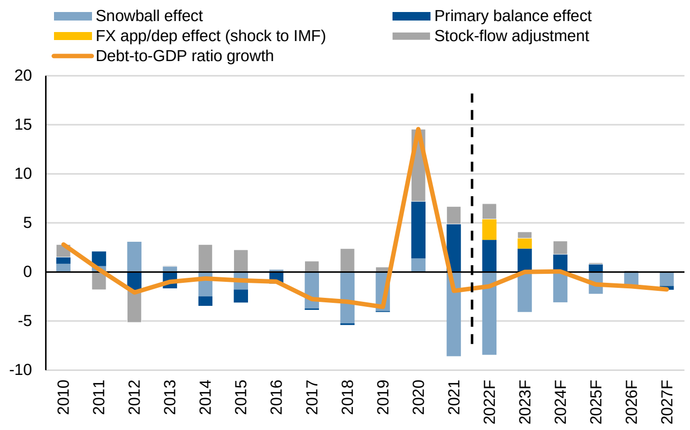
Public Finance Risks

- **Fiscal outlook:** Hungary's budget balance improved somewhat in 2021, with a 1pp reduction in the headline budget deficit to 6.8% of GDP, on the back of strong economic recovery and despite still elevated Covid-19 related expenditures. Public expenditures remained high in the first half of 2022, due to several spending measures including a personal income tax refund, as well as to support measures to alleviating the impact of rising inflation on the private sector. In June 2022, the government rolled out a fiscal consolidation package, including windfall taxes on specific sectors, expected to yield additional resources of about 1.4% of GDP over 2022-23, as well as spending cuts (mostly public investment) amounting to around 2.3% of GDP. We expect the headline budget deficit to decline and Hungary to meet its budgetary target in 2022 (4.9% of GDP), thanks to high nominal GDP growth and the government's modified fiscal policy stance.
- **Debt trajectory:** Compared to peers, Hungary's public debt is high, at 76.7% of GDP in 2021, up 11pp from 2019. We expect the debt-to-GDP ratio will gradually decline to 76.6% in 2022 and remain on a downward trajectory in the medium-term, supported by a moderate interest-payment burden benefitting from refinancing of previously issued securities at cheaper rates. However, further substantial delays in the receipt of EU funds could slow-down the declining trend of the debt-to-GDP ratio.
- **Market access and debt profile:** Hungary benefits from good access to foreign and domestic financing, including through a sizeable domestic retail programme. The debt profile is resilient to shocks. Average debt maturity increased to 6.1 years at end-2021. The share of foreign-currency-denominated central government debt significantly declined in recent years, from 31.3% end of 2015 to 20.6% at end-2021. Similarly to peers, funding costs have increased markedly in recent months, with the 10-year benchmark yield rising to 8.5% on average in July 2022, up from 2.8% a year before.

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

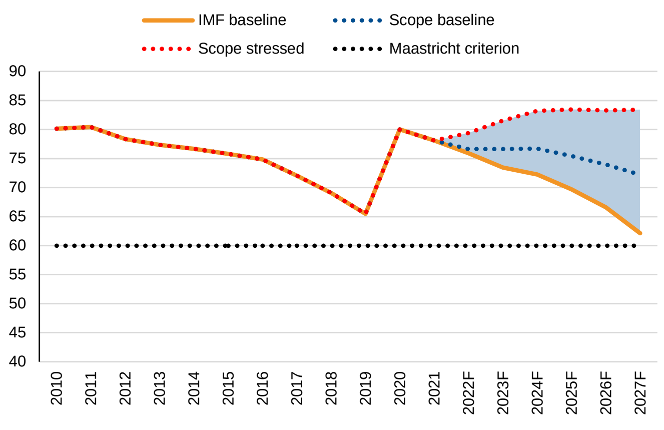
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bbb-	Fiscal policy framework	Neutral	0	Good record of prudent fiscal policies; limited fiscal space
	Debt sustainability	Neutral	0	Elevated debt burden;long-term debt trajectory supported by high nominal GDP growth and low interest-payment burden
	Debt profile and market access	Neutral	0	Resilient debt profile and investor base

Contributions to changes in debt levels, pps of GDP



Source: IMF WEO, Scope Ratings forecasts

Debt-to-GDP forecasts, % of GDP



Source: IMF WEO, Scope Ratings forecasts

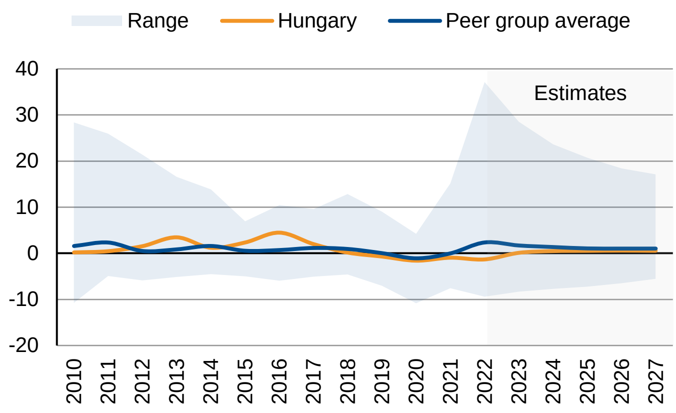
External Economic Risks

- **Current account:** Following a period of steady surpluses, averaging at 1.8% of GDP over 2010-18, Hungary's current account balance turned negative in 2019 (-0.7%), on the back of a widening deficit in the trade of goods. The deficit widened further in recent months in a context of rising global fuel prices pushing up the energy bill and global supply chain disruptions dampening the export performance of some key export industries. While direct trade exposure to Russia is moderate, representing around 1.5% of exports, the weakening of the growth outlook in Europe will materially weigh on external demand in the medium term.
- **External position:** The gross external debt stood at 61% of GDP as of Q1 2022. Its composition remains favorable, with a moderate share of short-term liabilities and declining banking sector external liabilities. The NIIP is negative but moderate in size at less than 45% of GDP as of 2021 Q4. The country's external liabilities mostly consist of direct investment and equity rather than debt-creating flows, supporting Hungary's external position.
- **Resilience to shocks:** International reserves stood at USD 36.6bn in June 2022, remaining comfortably above the IMF's reserve adequacy metric with a 129% coverage of short-term external liabilities, thus providing a comfortable cushion against shocks. The Hungarian economy's high level of integration in regional value chains makes it vulnerable to supply chain disruptions, however, and exposes it to the fallout from the Russia-Ukraine crisis.

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

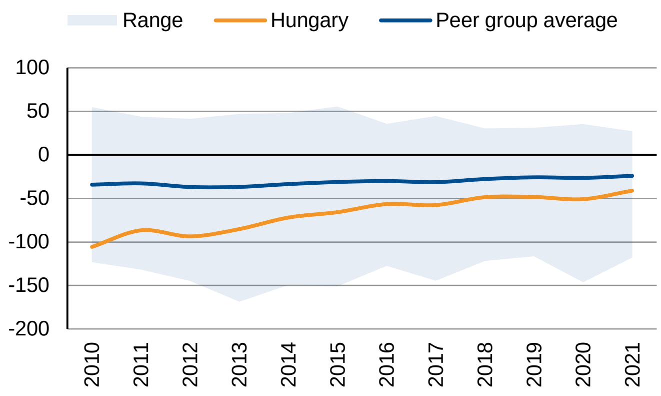
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bb	Current account resilience	Neutral	0	Stable current account receipts with a manufacturing sector highly integrated in global supply chains
	External debt structure	Strong	+1/3	External liabilities mostly consist of direct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

Current account balance, % of GDP



Source: IMF WEO, Scope Ratings

Net international investment position (NIIP), % of GDP



Source: IMF, Scope Ratings

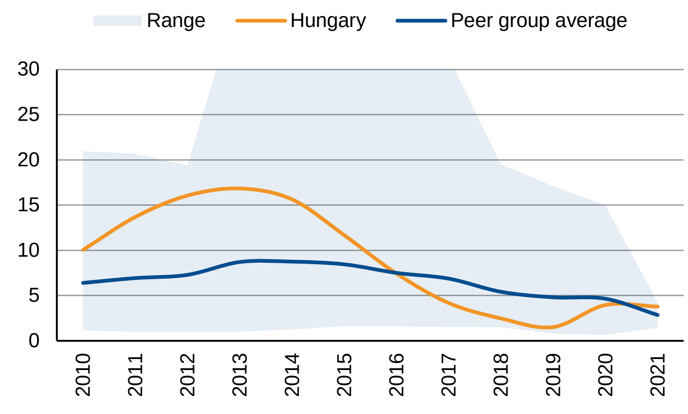
Financial Stability Risks

- **Banking sector:** The banking sector has an adequate capital position with a consolidated capital adequacy ratio of 18.6% and a favourable financing situation with a loan-to-deposit ratio at 79.6% at the end of 2021. The sector achieved overall good results in 2021, with ample liquidity reserves providing robust protection against potential liquidity shocks in view of the increase in geopolitical risks.
- **Portfolio quality:** Following the partial phasing out of the general payment moratorium in October last year, the ratio of non-performing loans picked up slightly from its historical low, reaching 3.5% in 2022 Q2, up from 3.2% at end-2021, respectively. The level of Russian and Ukrainian exposures of banks in Hungary is manageable, therefore representing a low risk at system level.
- **Financial imbalances:** Residential real estate prices continued to increase throughout the pandemic, with an annual nominal growth rate of 20.1% in Q1 2022, after more than doubling over 2013-20. Increases in house prices accelerated mainly outside of the capital, which has fueled an acceleration of credit growth last year. These dynamics cause concerns of overvaluation in the housing markets. In February 2022, the European Systemic Risk Board issued a warning to Hungary, deeming macro prudential policies in this area to be only partially sufficient to address these risks. We expect a structural decline in the demand because of recently sharply rising housing loan interest rates.

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

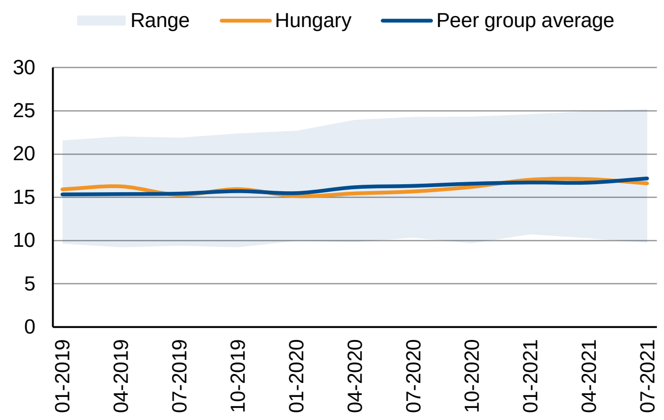
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aa+	Banking sector performance	Neutral	0	High capitalisation levels
	Banking sector oversight	Neutral	0	Effective supervisory control; timely and comprehensive regulatory measures
	Financial imbalances	Neutral	0	Concerns of overvaluation in the housing markets, compounded by external risks

Non-performing loans (NPLs), % of total loans



Source: World Bank, Scope Ratings

Tier 1 ratio, % of risk-weighted assets



Source: IMF, Scope Ratings

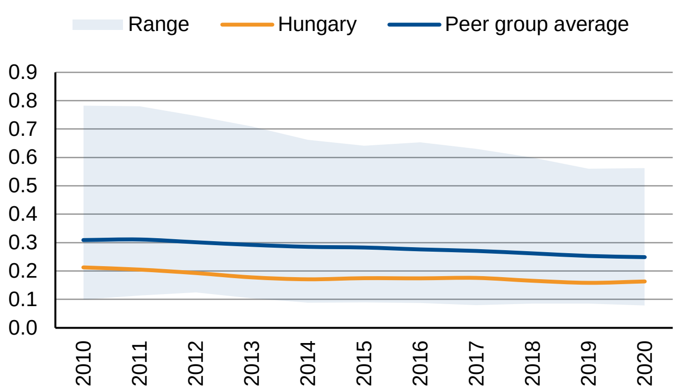
ESG Risks

- **Environment**: Energy consumption in Hungary is above the EU average, largely due to high per-capita consumption, which remains 12% higher than the EU average despite considerably lower incomes among Hungarians. The transformation of the country's coal region, which produced 8.6% of electricity in 2021, and Hungary's energy-intensive industries represent transition risks. Electricity consumption is expected to increase over the next decade, in parallel with the electrification of the economy. In the EU, Hungary is among the lowest emitters of greenhouse gases per person. Hungary faces several environmental challenges, including weak water quality and air pollution, reflected by persistent breaches of water and air quality standards and weak energy efficiency in the residential sector.
- **Social:** While the general labour market situation has been improving in Hungary in recent years, we note persistent employment gaps, which remain wide in an EU comparison. Income inequality has increased over the past decade and inequalities in access to public services remain high. Housing also remains inadequate for much of the population. The shortage of affordable rental housing hinders social mobility. Educational outcomes are below the EU average with large differences in certain areas. By the age of 15, basic skills are well below both EU and regional averages and have decreased over the last decade.
- **Governance:** Worsening governance metrics are compounded by increasing risks to the country's competitiveness including the public sector's growing market predominance in various economic sectors. In our view, the government's frequent application of regulatory and budgetary changes – along with tense relations with the EU due to fundamental disagreements in relation to the rule of law - are limiting Hungary's policy predictability and budgetary flexibility. The triggering of the EU's conditionality mechanism, a budgetary tool established at the beginning of 2021 to protect the EU budget against breaches related to the rule of law, could also weigh on Hungary's debt sustainability and growth prospects given its high reliance on foreign funding and external demand. The way in which the EU applies its conditionality mechanism to Hungary will define their relations over the coming years.

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

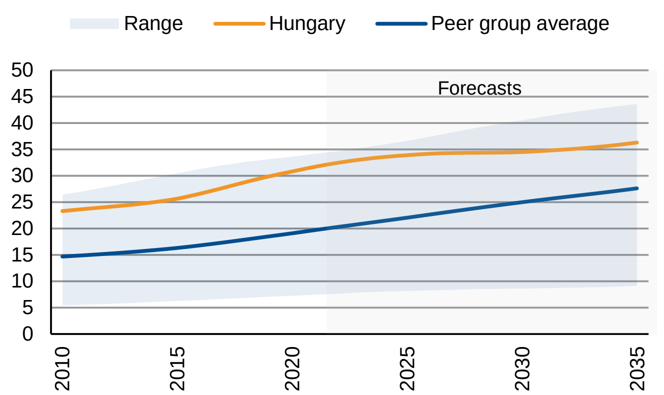
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bbb	Environmental risks	Neutral	0	Low vulnerability to transition risks and natural disasters risk; poor in natural resources
	Social risks	Weak	-1/3	Substantial employment gaps; high regional inequalities; below-average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

CO_2 emissions per GDP, $mtCO_2e$



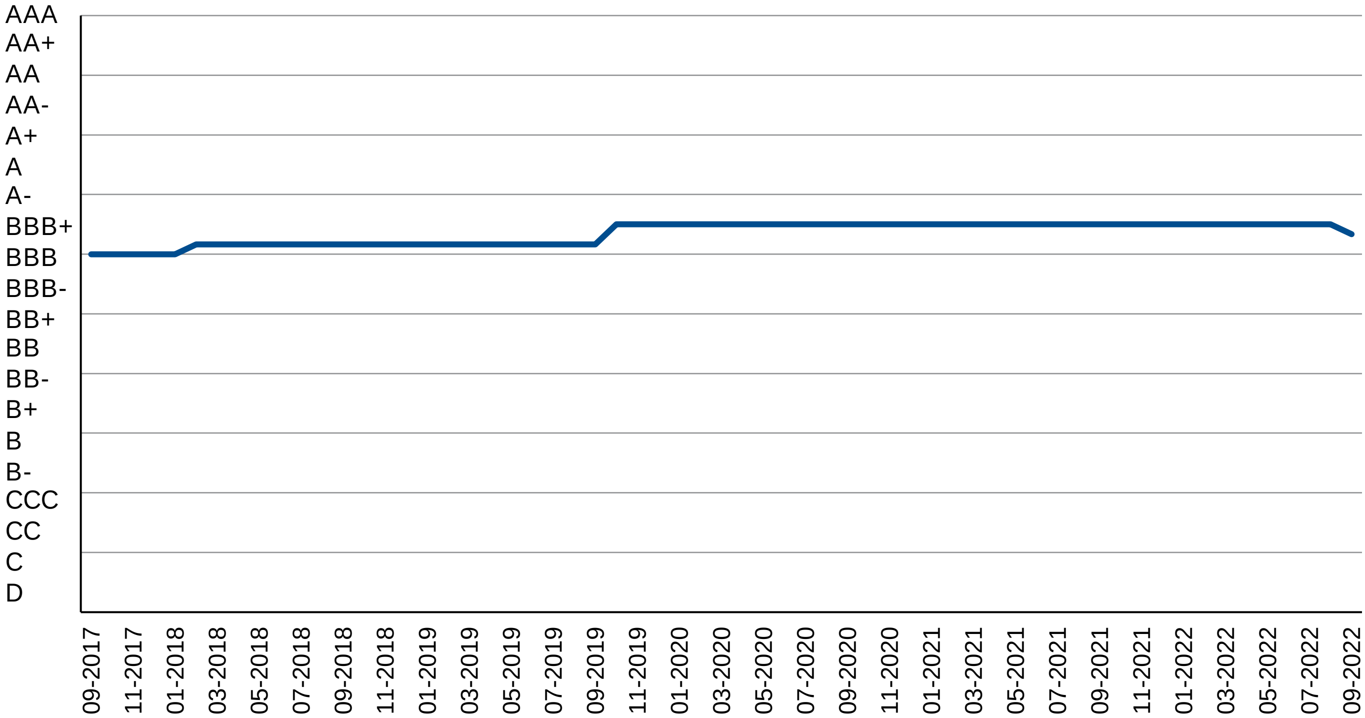
Source: European Commission, Scope Ratings GmbH

Old age dependency ratio, %



Source: United Nations, Scope Ratings GmbH

Appendix I. Rating history



NB. Positive/Negative Outlooks are treated with a +/-0.33-notch adjustment. Credit Watch positive/negative with a +/-0.67-notch adjustment.

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 embedding a methodological reserve-currency adjustment.

Peer group*
Bulgaria
Croatia
Cyprus
Slovakia

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

Appendix III. Statistical table for selected CVS indicators

This table presents a selection of the indicators (24 out of 29 – with the governance indicator reflecting a composite of six indicators) used in Scope's quantitative model, the Core Variable Scorecard.

	2016	2017	2018	2019	2020	2021E	2022F	2023F
Domestic Economic Risk								
GDP per capita, USD '000s	13.1	14.6	16.4	16.7	16.1	19.0	20.3	22.6
Nominal GDP, USD bn	128.7	143.2	160.6	163.5	156.8	184.6	197.8	219.5
Real growth, %[1]	2.3	4.3	5.4	4.6	-4.5	7.1	4.9	1.5
CPI inflation, %	0.4	2.4	2.8	3.4	3.3	5.1	10.3	6.4
Unemployment rate, %[1]	5.0	4.0	3.6	3.3	4.1	4.1	3.8	4.0
Public Finance Risk								
Public debt, % of GDP[1]	74.8	72.1	69.1	65.5	79.6	76.7	76.6	76.7
Interest payment, % of government revenue	6.7	5.9	5.2	5.0	5.2	4.7	3.8	3.7
Primary balance, % of GDP[1]	1.2	0.2	0.2	0.1	-5.8	-4.9	-3.3	-2.4
External Economic Risk								
Current account balance, % of GDP	4.5	2.0	0.2	-0.7	-1.1	-0.9	-1.3	0.1
Total reserves, months of imports	2.6	2.5	2.5	2.5	3.5	3.1	-	-
NIIP, % of GDP	-56.6	-57.7	-48.7	-48.4	-51.0	-41.6	-	-
Financial Stability Risk								
NPL ratio, % of total loans	10.7	7.5	5.4	4.1	3.5	3.2	-	-
Tier 1 ratio, % of risk-weighted assets	17.4	17.3	17.3	16.4	17.4	18.1	-	-
Credit to private sector, % of GDP	33.4	32.4	32.4	33.5	38.0	-	-	-
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	4.7	-	-	-	-
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	33.1
Composite governance indicator[2]	0.5	0.5	0.5	0.5	0.5	-	-	-

[1] Forecasted values are produced by Scope
[2] Average of the six World Bank Worldwide Governance Indicators
Source: European Commission, IMF WEO, World Bank, CSO, Scope Ratings

Appendix IV. Economic development and default indicators

IMF Development Classification	Emerging market and middle income economy
5y USD CDS spread (bps) as of 25 August 2022	204

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