Hungary
Rating Report

SCOPE **BBB** STABLE OUTLOOK

Credit strengths

- Strong record of robust growth performance, supported by high investment
- Resilient external position and public debt profile against external shocks

Credit challenges

- High public debt
- Polarised political environment and headwinds with the EU

Rating rationale:

Strong record of robust growth dynamics: The Hungarian 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 fossil fuel imports amplified by an economic structure dominated by energy-intensive businesses with complex value chains. Prolonged supply chain disruptions, further inflationary pressures amid weakened policy predictability 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; 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: Weight	Quantitative: Indicative rating	Reserve currency: Notches	Qualitative*: Notches	Final rating
Domestic economic risk		35%	bbb+	HUF [+0]	-1/3	BBB
Public finance risk		20%	a		0	
External economic risk		10%	ccc		0	
Financial stability risk		10%	aa+		0	
ESG Risk	Environmental factors	5%	aa		0	
	Social factors	7.5%	bb+		-1/3	
	Governance factors	12.5%	bb		-1/3	
Indicative outcome		**bbb+**			**-1**	
Additional considerations					**0**	

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 Stable Outlook reflects our view that risks to the ratings are balanced.

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 and/or external metrics weaken more-than-expected
- Protracted fiscal deterioration weakens debt sustainability

Ratings and Outlook

Foreign currency

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

Local 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

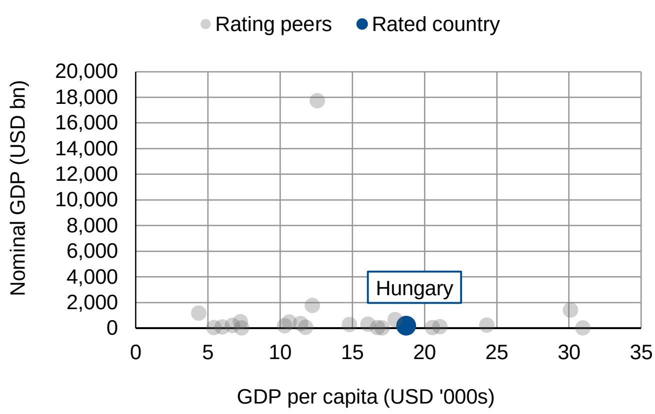
Domestic economic risk

- **Growth outlook:** After experiencing a strong post pandemic rebound in 2021 (+7.1%), real GDP growth remained robust in the beginning of 2022, in a context of expansionary fiscal policy. It decelerated markedly over the course of the year, however, from the impact of the Ukraine war and gradual fiscal policy tightening. The Hungarian economy entered a technical recession in H2 2022, in a context of slowing investment dynamics and depressed agricultural output, resulting from a severe drought. We expect the economic momentum to remain subdued over the coming months, as elevated price pressures weigh on real incomes, while tightening funding conditions and high uncertainty are impacting investment decisions. We expect real GDP growth to slow to 0.5% in 2023, from an estimated 4.6% in 2022, before gradually edging towards its medium-term potential, estimated at about 2.5-3.0%.
- **Inflation and monetary policy:** Inflation (HICP) has soared over the course of the past year, up to 25.7% (YoY) in January 2023 – the highest level among EU countries. This rise was primarily driven by high food and energy prices, amplified by a weak forint. Core inflation has risen markedly as well, at 25.4%, reflecting the feed-through of high energy costs and tax increases, the acceleration of wage dynamics and the context of strong domestic demand, fuelled by large fiscal stimulus. The Hungarian central bank has sharply tightened its policy stance as a response, raising its base rate to 13% by September 2022 (up from 0.6% in June 2021) and implementing several measures aimed at draining liquidity. Nevertheless, the transmission of monetary policy is hindered by a set of interest rate and price caps implemented by the government. We anticipate price pressures will remain strong in 2023 and only gradually decelerate over the coming months.
- **Labour markets:** The Hungarian labour market remains tight, with the employment and activity rates standing at historical highs (respectively at 74.6% and 77.5% of population aged 15 to 64 as of Q3 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 and medium-term growth potential.

Overview of Scope's qualitative assessments for Hungary's *domestic economic risk*

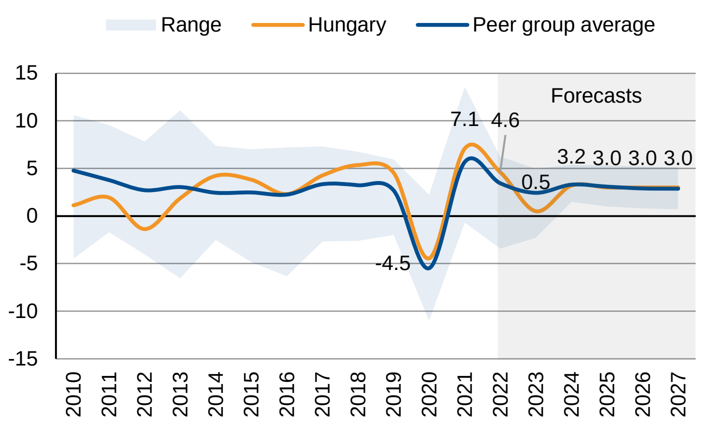
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bbb+	Growth potential of the economy	Neutral	0	Robust growth dynamics supported by high investments; low savings
	Monetary policy framework	Neutral	0	Credible central bank; thin local currency bond market and discrepancies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

Nominal GDP and GDP per capita, USD



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

Real GDP growth, %



Source: IMF WEO, Scope Ratings forecasts

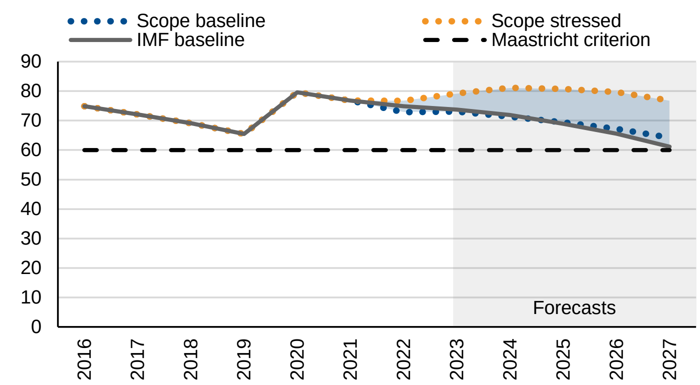
Public finances risk

- **Fiscal outlook:** The Hungarian government fiscal policy stance remained accommodative through H1 2022, ahead of elections in the spring, with sizable spending measures including direct transfers to households and a 20% increase in the minimum wage. Authorities subsequently introduced policies aimed at tightening the fiscal deficit in the second half of the year, including the postponement of public investment projects and windfall taxes on the energy and banking sector, though pressures stemming from the energy shock continued to weigh on spending. The headline government deficit stood at an estimated 6.1% of GDP in 2022, only moderately down from the previous year (-1.0 pp). We expect it to recede further in 2023, to 4.1% of GDP, amid continued fiscal consolidation efforts and continued revenue growth.
- **Debt trajectory:** Hungary's public debt is elevated, at 72.9% of GDP in 2022, up 7.6pp from 2019. We expect the government debt-to-GDP ratio to remain broadly stable in 2023 and decrease to around 71.0% in 2024, before gradually declining to about 64.0% by 2027. This trajectory is driven by expectations of robust nominal growth offsetting the impact of growing interest payments and persistent primary deficits. The uncertainty around the release of EU funds adds significant downside risk to the debt outlook, however, through increased financing costs and weakened growth prospects.
- **Debt profile and market access:** Hungary benefits from good access to foreign and domestic financing, including through a sizeable domestic retail programme. The debt profile is favourable, with adequate average maturity (6.2 years at end-2022) and moderate share of foreign currency denominated central government debt (around 25% of total). After rising markedly over the course of 2022, funding costs have moderated somewhat in recent weeks.

Overview of Scope's qualitative assessments for Hungary's *public finances risk*

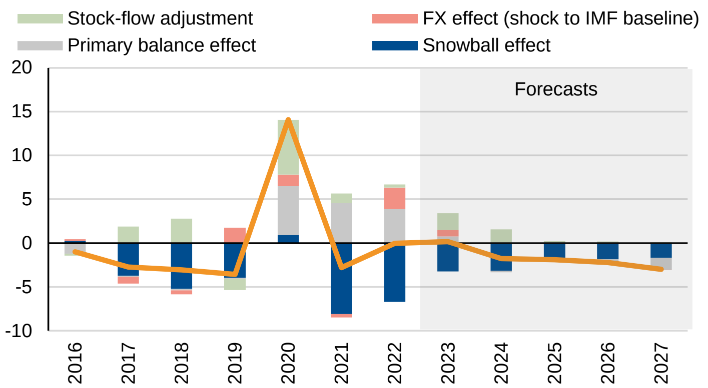
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
a	Fiscal policy framework	Neutral	0	Good record of prudent primary surpluses; limited fiscal space
	Debt sustainability	Neutral	0	Elevated debt burden and growing interest payments; long-term debt trajectory supported by robust nominal growth prospects
	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

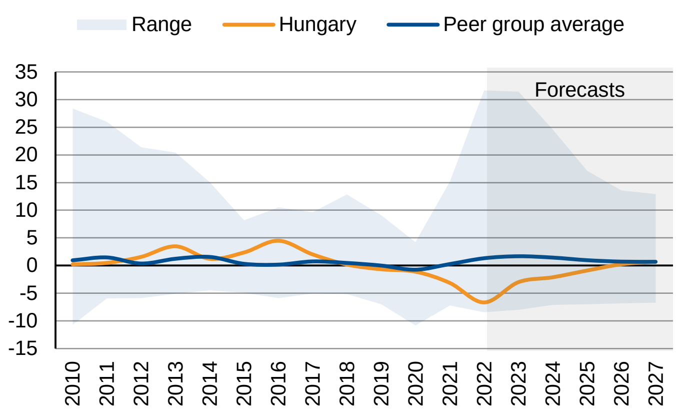
External economic risk

- **Current account:** After a period of robust current account surpluses, averaging at 1.8% of GDP over 2010-18, Hungary's current account balance turned negative in 2019, on the back of a widening deficit in the trade of goods. The country's external balance deteriorated sharply in 2022, in a context of soaring global commodity prices and government-fuelled domestic demand. The current account deficit reached 7.3% of GDP in the year to Q3 2022. We expect external imbalances to moderate over the medium-term, thanks to declining prices in energy imports, though the deceleration of the growth outlook in Europe will weigh on the recovery of the trade balance.
- **External position:** Gross external debt is comparatively elevated, at about 85% of GDP, though associated risks are partially offset by a favourable composition. External liabilities mostly consist of direct investment and equity rather than debt-creating flows, while the shares of short-term liabilities and banking sector external debt are low. The NIIP is negative but moderate in size, having improved from around -90% of GDP in 2013 to -37% in Q3 2022.
- **Resilience to shocks:** International reserves (excluding gold) amounted to USD 37.8bn in January 2023, remaining comfortably above the IMF's reserve adequacy metric with a 140% coverage of short-term external liabilities, thus providing a comfortable cushion against shocks. Nevertheless, further uncertainty around EU funds inflows amid heightened borrowing needs could create pressure on the country's external financing. Additionally, the Hungarian economy remains exposed to developments in the Ukraine war, as a result of its high level of integration in regional value chains and elevated reliance on Russian fossil fuel imports.

Overview of Scope's qualitative assessments for Hungary's *external economic risk*

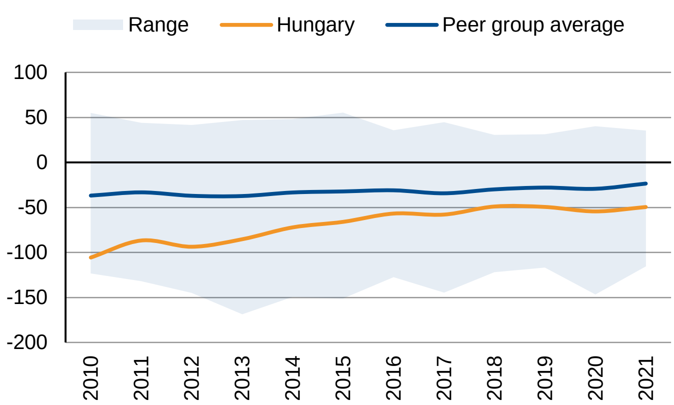
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
ccc	Current account resilience	Neutral	0	Pre-pandemic track record of stable current account receipts with a manufacturing sector highly integrated in global supply chains
	External debt structure	Strong	+1/3	External liabilities mostly consist of direct investment and equity rather than debt-creating flows
	Resilience to short-term external shocks	Weak	-1/3	High refinancing 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

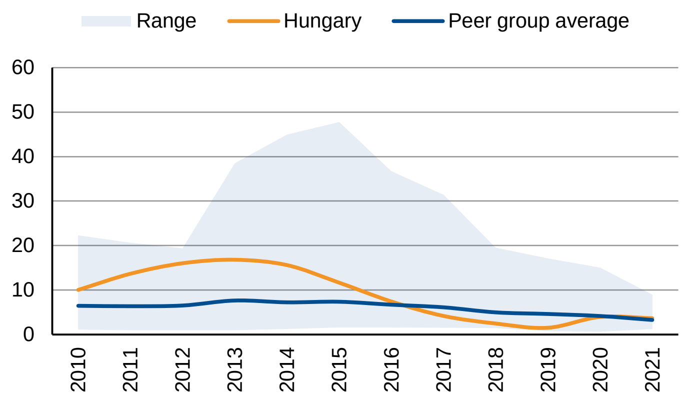
Financial stability risk

- **Banking sector:** The Hungarian banking sector's resilience is underpinned by stable, robust capital and liquidity positions, as reflected in aggregate CET-1 capital and loan-to-deposit ratios of 16.3% and 83.4%, respectively, as of Q3 2022. The non-performing loans ratio is moderate, at 3.7% of aggregate loans, despite a slight uptick following the phase out of the general repayment moratorium. Profitability is robust, as reflected in an aggregate return-on-equity of 9.9%, supported by robust interest margins amid higher lending rates, although the implementation of windfall taxes will weigh on returns over the near term. The new interest rate environment and slowing economic activity could create pressure on asset quality over the near-term, but the sector's buffers are adequate to absorb a temporary increase in credit risk.
- **Private debt:** Hungarian non-financial corporate benefit from moderate debt levels, at about 82% of GDP as of Q2 2022, and comfortable reserves of liquid financial assets (34% of GDP). Household balance sheets are resilient, with low indebtedness (amounting to about 20% of GDP) and a marginal share of variable rate mortgage loans (2% of GDP). After growing robustly over the pandemic period, in part owing to state-sponsored lending schemes, we expect private sector borrowing to decelerate over the medium-term amid higher interest rates, tightening lending standards and weaker economic momentum.
- **Financial imbalances:** Following a protracted period of very strong dynamism, residential real estate activity decelerated markedly over the course of 2022, in turn leading to a slow down in price growth towards the end of the year. As of 2022 Q2, housing market overvaluation remained elevated, at about 21.5% according to MNB estimates. In February 2022, the European Systemic Risk Board issued a warning to Hungary, deeming macroprudential policies in this area to be only partially sufficient to address associated risks. In June 2022, the MNB announced it would raise the countercyclical capital buffer from 0.0% to 0.5% to increase the banking sector's resilience to a potential downward adjustment in the housing market.

Overview of Scope's qualitative assessments for Hungary's *financial stability risks*

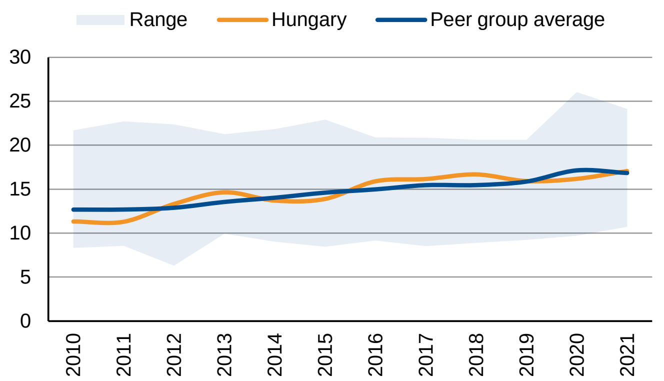
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aa+	Banking sector performance	Neutral	0	High capitalisation and liquidity levels; resilient profitability
	Banking sector oversight	Neutral	0	Effective supervisory control; timely and comprehensive regulatory measures
	Financial imbalances	Neutral	0	Macroprudential measures underpin financial stability

Non-performing loans, % of total loans



Source: IMF, Scope Ratings

Tier 1 ratio, % of risk-weighted assets



Source: IMF, Scope Ratings

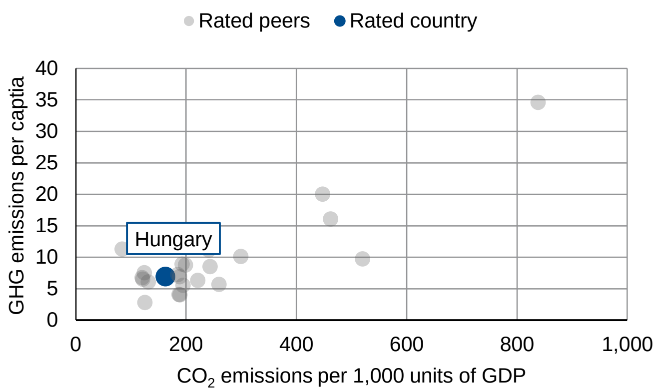
ESG risk

- **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. 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. The country's persistent reliance on Russian fossil fuel imports, which cover around 40% of its energy needs, create a significant degree of exposure to adverse developments in the Ukraine war.
- **Social:** Despite structural improvements in the labour market over recent years, persistent employment gaps remain, which remain wide in an EU comparison. Income inequality is comparatively elevated 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 – limit 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*

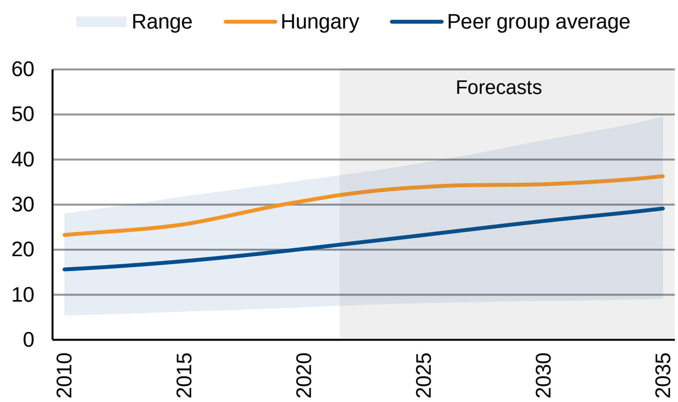
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bbb-	Environmental factors	Neutral	0	Low vulnerability to transition risks and natural disasters risk; elevated reliance on fossil fuel imports
	Social factors	Weak	-1/3	Substantial employment gaps; high regional inequalities;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

Emissions per GDP and per capita, $mtCO_2e$



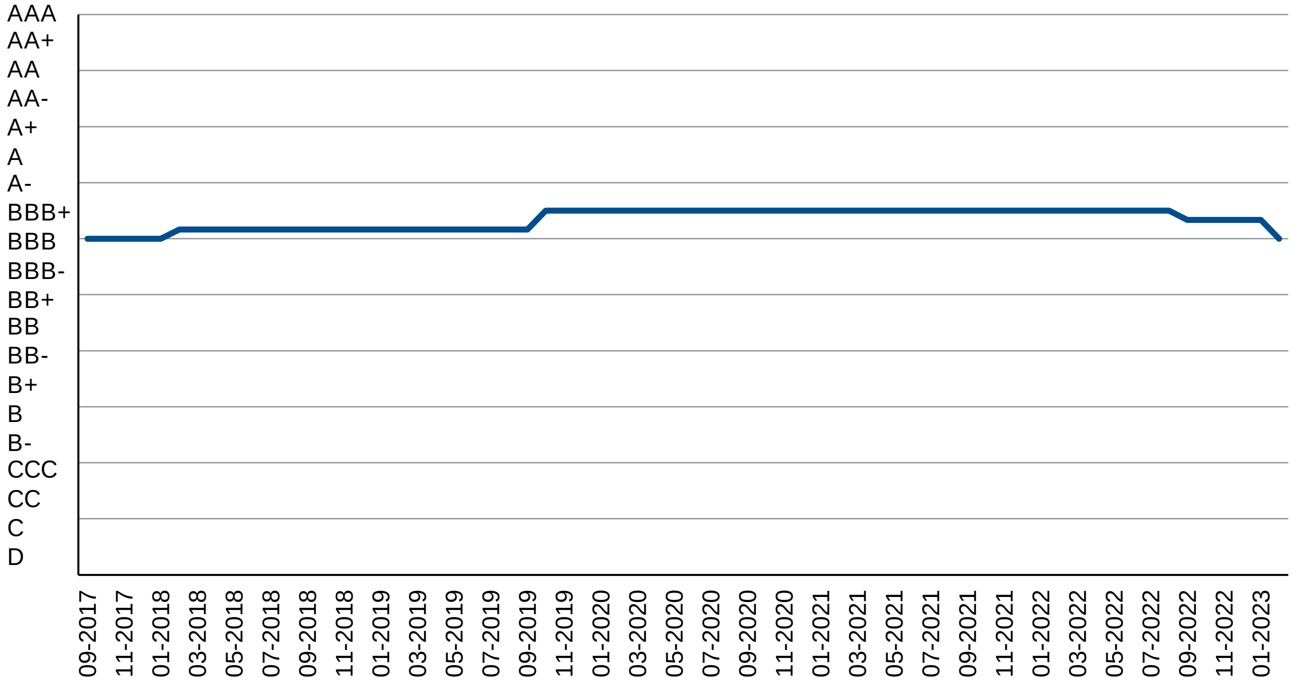
Source: European Commission, Scope Ratings

Old age dependency ratio, %



Source: United Nations, Scope Ratings

Appendix I. Rating history (foreign-currency long-term debt)



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, including a methodological reserve currency adjustment.

Peer group*
Bulgaria
China
Cyprus
Latvia
Poland
Portugal
Romania
Slovakia
Spain

*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 30 – with the governance indicator reflecting a composite of six indicators) used in Scope's quantitative model, the core variable scorecard, in line with Scope's Sovereign Rating Methodology. The metrics and sources for the data presented here ensure comparability across global peers and may therefore differ from national and other selective international statistics.

Pillar	Core variable	Source	2017	2018	2019	2020	2021	2022
Domestic economic	**GDP per capita, USD '000s**	IMF	14.6	16.4	16.7	16.0	18.7	19.0
	Nominal GDP, USD bn	IMF	143.1	160.6	163.5	156.7	182.3	184.7
	Real growth, %	IMF	4.3	5.4	4.6	-4.5	7.1	5.7
	CPI inflation, %	IMF	2.4	2.8	3.4	3.3	5.1	13.9
	Unemployment rate, %	WB	4.2	3.7	3.4	4.3	4.1	-
Public finances	**Public debt, % of GDP**	IMF	72.1	69.1	65.5	79.6	76.8	74.8
	Interest payment, % of revenue	IMF	5.8	5.1	4.9	5.1	5.4	5.1
	Primary balance, % of GDP	IMF	0.1	0.2	0.1	-5.6	-4.6	-2.7
External economic	**Current account balance, % of GDP**	IMF	2.0	0.2	-0.7	-1.1	-3.2	-6.7
	Total reserves, months of imports	IMF	2.5	2.5	2.5	3.6	3.0	-
	NIIP, % of GDP	IMF	-57.7	-48.7	-49.2	-54.2	-49.2	-
Financial stability	**NPL ratio, % of total loans**	IMF	4.2	2.5	1.5	4.0	3.7	-
	Tier 1 ratio, % of risk-weighted assets	IMF	15.8	15.8	15.9	15.1	17.0	16.1
	Credit to private sector, % of GDP	WB	32.4	32.4	33.4	37.9	-	-
ESG	**CO_2 per EUR 1,000 of GDP, $mtCO_2e$**	EC	175.8	166.9	160.1	162.6	155.8	-
	Income share of bottom 50%, %	WID	23.0	22.0	22.0	22.0	22.0	-
	Labour-force participation rate, %	WB	71.1	71.9	72.6	-	-	-
	Old-age dependency ratio, %	UN	28.2	28.9	29.8	30.8	31.4	30.5
	Composite governance indicators*	WB	0.5	0.5	0.5	0.5	0.5	-

* Average of the six World Bank Worldwide Governance Indicators.

Appendix IV. Economic development and default indicators

IMF Development Classification	Emerging market economy
5y USD CDS spread (bp) as of 23.02.2023	194

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