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Hungary

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SOVEREIGN RATING	Initial rating
Date of Rating Committee:	21.05.2019
Date of rating publication:	24.05. 2019
Long-term rating:	BBB+ (ns)
Outlook:	Stable
Short-term rating:	A-2 (ns)

● (ns) – not solicited rating

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"BCRA - CREDIT RATING AGENCY" AD rates Hungary with unsolicited sovereign long-term rating BBB+ (ns) and short-term rating A-2 (ns) with stable outlook.

BCRA's officially adopted Sovereign Rating Methodology has been applied (http://www.bcra-bg.com/files/file_330.pdf).

The report has been prepared and the rating – assigned, based on public information, made available by the Hungarian National Bank, the Hungarian Central Statistical Office, the Ministry of Finance, the Government Debt Management Agency, the World Bank, the International Monetary Fund, the European Commission, BCRA's database etc. BCRA uses sources of information, which it considers reliable, however it cannot guarantee the accuracy, adequacy and completeness of the information used.

Research report
(for public disclosure)

National-conservative party Fidesz (Hungarian Civic Union), led by Viktor Orbán, has dominated Hungarian politics since 2010. Fidesz has the support of the small KDNP (Christian Democratic People's Party) as a coalition partner. In the beginning of 2019, Orbán serves as a Prime minister for the fourth (and third in a row) time for the 2018-2022 mandate.

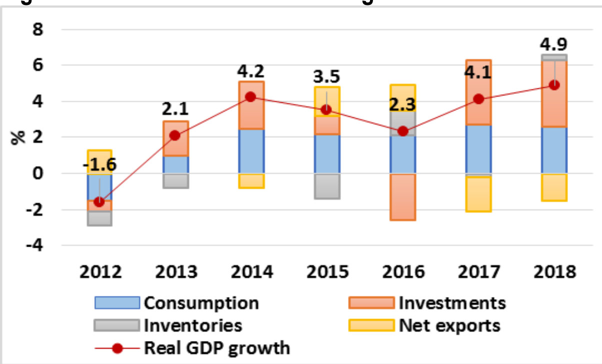
The ruling party used its strong parliamentary majority to rewrite Hungary's constitution in 2011. Broad economic and fiscal reforms also have taken place, with favouring interventionist policies on economic issues.

In relation to Hungarian restrictive migrant policy, Prime Minister Viktor Orbán has led eastern European opposition to EU quotas that aim to distribute asylum seekers around the bloc since 2015. Hungary constructed a barbed-wire fence along its border with Serbia to stanch the wave of migrants and refugees seeking to enter the country and initiated a referendum on the right to reject the EU migrant quota.

Relationships between Hungarian Prime Minister and Brussels remain strained. The European institutions have been observing Orbán's massive push to fundamentally transform Hungary's constitutional, economic, political and social system since 2010. A number of so-called infringements of contract proceedings has been launched in an effort to correct some Hungarian laws that violate EU law. In September 2018, The European Parliament voted to trigger Article 7 disciplinary procedures against Hungary for undermining democratic rules. However, the suspension of Hungary's voting rights requires a unanimous vote from the European Council — a move that is likely to be blocked by Poland.

With all the dynamic changes observed in Hungary during the last decade it would take time to track the long-term economic outcome and single effects. Assuredly these influenced on the international relations of the country and also on the institutional and social environment locally. Current economic developments, however, indicate that some turbulences of the previous years have been overcome and the Hungarian economy has strengthened.

Figure 1: Contribution to real GDP growth: 2012-2018



Source: HCSO

The Hungarian economy has been expanding robustly since 2013, recording an average growth rate of 3.8% over the last five years (2014–2018), above the EU-average and broadly in line with its Visegrad peers.

Driven by strong domestic demand, real **GDP growth** picked up from 2.3% in 2016 to 4.1% in 2017 and accelerated further to 4.9% in 2018. Household consumption expenditure rose by 5.3% in 2018, which constitutes the largest boom since 2003. Following the sharp fall in 2016, investment activity staged a strong recovery in the last two years, favoured by the higher absorption of EU funds and low interest environment. Gross fixed capital formation picked up by 16.5% in 2018 which translated into a 3.7 pp contribution to the annual GDP growth rate.

Hungarian economic performance is fundamentally export-driven, however, the contribution of net exports to GDP growth turned negative in the last two years (2017-2018) as imports grew at a faster rate than exports. In 2018, Hungarian exports increased by 4.7% in real terms, while imports, fuelled by the expansion of domestic demand, picked up by 7.1%.

With a combined value of exports and imports equal to 168.3% of GDP in 2018, trade openness of the country is one of the highest within the European Union, thus, **external trade** plays a key role for the Hungarian economy. Traditionally Hungary trades most actively with the other EU member states. In 2018, the relative share of goods exports to EU picked up by 1.2 p.p. to 80.8% of total exports, while the share of imports from EU dropped by 1.1 p.p. to 75.6% of total imports. The structure of international trade in goods is strongly dominated by the industrial goods. The commodity

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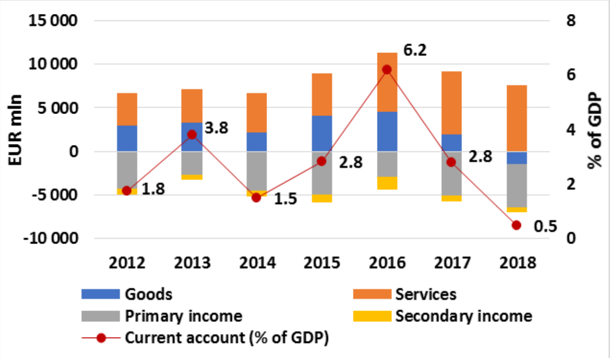
group with the largest weight within external trade turnover was that of machinery and transport equipment, accounting for 55.7% of total exports and 47.7% of total imports in 2018. The weight of the automotive industry within the trade structure, however, represents a risk in case of escalation of international trade disputes and rapid technology changes.

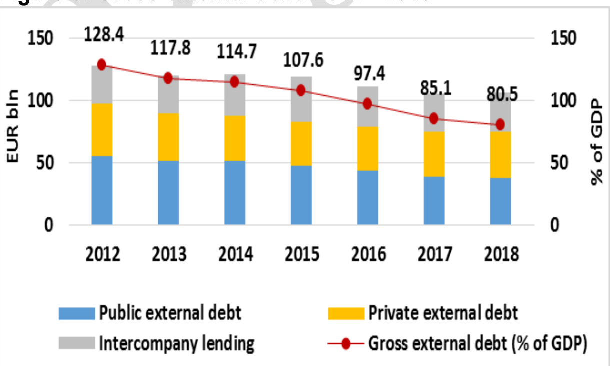
Figure 2: Current account balance: 2012-2018



Source: MNB

Country's external vulnerability has been strongly reduced by sustained **current account** surpluses since 2010. The historically high surplus of 6.2% of GDP in 2016 narrowed over the last two years, as the pickup in the domestic demand contributed to a rapid growth of goods imports, which outpaced that of exports. Current account balance in 2018 amounted to EUR 640 mln (0.5% of GDP), down from EUR 3 451 mln (2.8% of GDP) in 2017. The trade in goods balance dropped into negative territory of EUR 1 400 mln (-1.1% of GDP) in 2018, thus showing a deficit for the first time since 2008. On the other hand, the higher surplus on net services trade and, to a lesser extent, the lower deficit on income accounts limited the overall contraction in positive current account balance.

Figure 3: Gross external debt: 2012 - 2018



Source: MNB

External debt indicators of the Hungarian economy improved substantially over the past decade. Country's gross external debt (excluding SPEs) declined to 80.5% of GDP by the end of 2018 from its peak of 142.2% of GDP in 2010, mainly on account of banking sector deleveraging and lower public debt. The majority of the external debt (34.4% at the end of 2018) is still related to the general government, however, with the repayment of bonds and loans, the value thereof has annually decreased since 2012. Intercompany lending accounted for almost one third (29.9%) of total external debt in 2018. Favourable developments were also observed in the maturity structure, whereas the relative share of short-term debt at remaining maturity equalled to 11.9% of total external debt at the end of 2018. In parallel, **international reserves** adequacy improved, as their coverage of short-term debt increased from 195.4% in 2017 to 217.3% in 2018.

In line with both the expansion in external assets and the decrease in debt liabilities, **net external debt** to GDP ratio fell to a historical low of 8.9% at the end of 2018. In comparative perspective, Hungary saw the largest net external debt reduction among the V4 countries. As a result, the Hungarian indicator is now significantly lower than the corresponding Polish and Slovakian values, but it is still higher than the net external debt of Czechia, which records negative value.

Following the hit of the crisis (2009–2013), **unemployment** in Hungary naturally reached its peak values falling into the 10-11.2% interval of the active population. Since then the unemployment rate has been steadily decreasing across all the age groups, and as of 2018 it shrunk to barely 3.7% (4.2% in 2017). Along with the increasing employment, this led to a progressive growth in the activity rate of the population - to 62.5% in 2018. The labour market seriously tightened, accordingly, and thus, raising the question about its future potential to supply the surging economy with respective human capital.

Labour incomes generally have been increasing with annual growth rate reaching 11.1% in gross terms for 2018. Steeper hikes have been visible since the adoption of the six-year wage agreement[1]

[1] In November 2016, a six-year national economic plan was agreed on the standing consultation forum of the private sector and the Government. The plan envisages significant wage and

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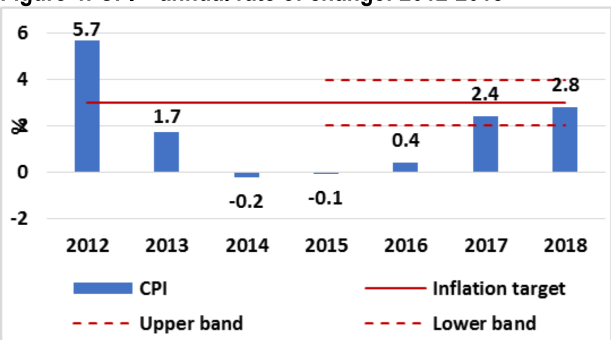
complemented by overall tightening of the market and well-performing economy. Analogously, national income measured by **GDP per capita** have demonstrated positive dynamics except for 2009 and 2012. According to Eurostat data, Hungarian GDP per capita in euro (current prices) reached EUR 13 500 or 43.7% of the EU average in 2018 estimates.

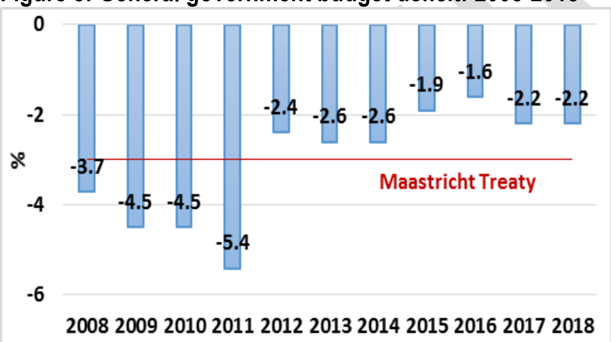
Figure 4: CPI – annual rate of change: 2012-2018



Source: HCSO

Inflation in Hungary re-emerged in 2017 in line with the reversal in global crude oil price trends. Inflation level picked up to 2.4% in 2017 and accelerated further to 2.8% in 2018, boosted also by stronger services and food price dynamics.

Figure 5: General government budget deficit: 2008-2018



Source: HCSO

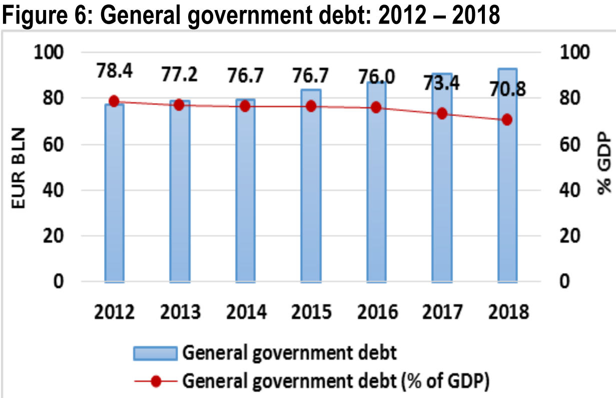
Excessive **budget deficits** were a constant problem in Hungary during the 2000s even before the outbreak of the financial crisis. General government deficit peaked at 9.3% of GDP in 2006. Two years later, in 2008, Hungary became the first EU country forced to seek financial assistance in order to meet its debt obligations.

Fiscal consolidation measures in the following years were geared both at the revenue and expenditure sides, since spending cuts alone were insufficient enough to stabilise the public finances. Hungarian tax system has been transformed, focusing on indirect taxes. Changes to existing taxes were complemented by a fiscal expansion in the form of multiple new sector-specific taxes.

In 2012, the budget deficit finally fell below EU threshold level, which allowed for the long-awaited exit from the Excessive Deficit Procedure[2], to which the country had been subject since its accession in 2004.

Rising budget revenues, driven by solid economic performance, underpinned the stability of public finances which provided room for a fiscal relaxation. After dropping to a historic low of 1.6% of GDP in 2016, the budget deficit increased to 2.2 % of GDP in 2018. Several tax cuts were implemented in the last two years, but their fiscal impact was largely offset by the increase in tax base derived from the dynamic rise of earnings and the expansion of consumption. Regarding the spending programs, key elements in 2017-2018 were the implementation of large-scale investment projects, the career path models in the public sector, as well as the additional budgetary costs of the new housing support scheme introduced in 2016. At the same time, lower interest and social expenditures provided a substantial deficit-moderating effect.

Figure 6: General government debt: 2012 – 2018



Source: Eurostat

Although the **government debt**-to-GDP ratio has declined gradually from 80.5% in 2011 to 70.8% at

tax modifications during the six-year period from 2017 on and it also complied with an EC recommendation for Hungary to reduce the taxes on labour as a pro-growth measure.

2 Hungary exited the EU's Excessive Deficit Procedure in June 2013.

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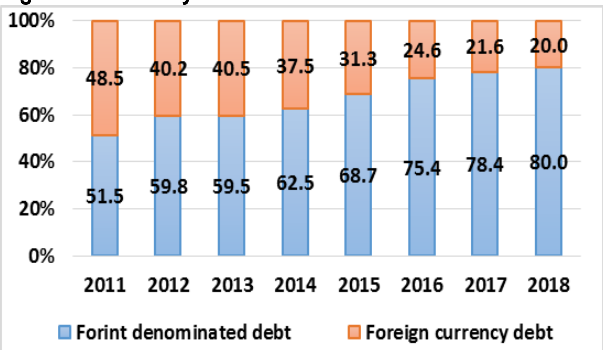
the end of 2018, it still represent an important source of vulnerability. Hungary's public debt ratio exceeds the 60% threshold set by the Maastricht and is substantially higher than the values observed in regional peers.

Figure 7: Currency structure of CG debt: 2012 - 2018



Source: Government Debt Management Agency

There has been noteworthy improvement in the **public debt structure**, as both the government and the central bank have identified the reduction of external exposure as a strategic objective. In line with the negative net FX issuance, supported by the MNB's Self-financing Programme, the proportion of foreign currency debt in the central budget declined rapidly from 48.5% in 2011 to 20% at the end of 2018. Beside the reduction of foreign currency debt, public debt structure was positively influenced by the reduction of non-resident holders.

Yields on the government securities market, which rose sharply at the start of the financial crisis, have now dropped below the pre-crisis levels. Owing to the improving macroeconomic fundaments and loose monetary conditions, the 10-year Hungarian government bond yield declined from round 10% at the end of 2011 to a historical low of 2.06% in January 2018. Similarly, the primary market and auction yields largely followed the secondary market trends.

After some troublesome periods Hungarian **banking system** get back on track (2016-2018). The settlement of the forced conversion of foreign-currency mortgage loans to HUF incurred losses for credit institutions in 2014–2015, overcome by owners' capital injections. This also resulted in shrinking the share of FX housing loans to marginal proportions. Structure of ownership also has altered in a targeted manner to reach a balance between foreign (previously dominating) and domestic capital as of 2018. The subsequent volatilities in the dynamics of assets and profitability, however, are currently reduced along with an increase in attracted deposits and accelerating credit growth in the last three years (2016-2018).

On the one hand, improved domestic macro environment has favoured credit rebound, and on the other, government supported lending by special schemes to boost its growth in both major segments – corporates and households.

At the backdrop of increasing loans and decreasing non-performing amounts, the NPL ratio is on a steady downward path. From previously high proportion of credit, the NPLs shrank two-fold for the last three years reaching to 5.4% in 2018. The process was also attributable to a continuous cleaning (in the forms of write-offs or sales of non-performing debts) of banks' balance sheets, which has become a considerable factor in improving the asset quality of Hungarian banks in 2015.

The other prudential indicators concerning average solvency, profitability and liquidity of the system have been broadly adequate over the last three years.

Since mid-2018, the CPI inflation has been continuously fluctuating around the MNB target (3% ±1 p.p. tolerance band), therefore, the central bank made it clear that it is ready for the cautious and gradual normalisation of its accommodative **monetary policy**. The MNB phased out the monetary policy interest rate swap facility and the mortgage bond purchasing programme but revealed new stimulus measures (Funding for Growth Scheme Fix and Bond Funding for Growth Scheme). The key policy rate is still kept at its record low of 0.9% (since May 2016), while the overnight deposit rate was raised by 10 bp. to -0.05% at the end of March 2019. The timing and intensity of monetary policy normalisation in the coming quarters will depend on the evolution of the outlook for underlying inflation.

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Outlook:

The **stable** outlook of the Sovereign Rating of Hungary reflects the BCRA's opinion that risks are broadly balanced. Hungary's credit rating is supported by its robust economic growth and strong reduction in external vulnerabilities. Despite the sustained fiscal consolidation, public debt remains elevated and represents a key credit rating constraint.

Positive pressures on the Sovereign Rating and/or the Outlook would be considered:

- Stronger fiscal results, lowering the public debt burden at a faster pace;
- Sustained external debt reduction;
- Faster income convergence with EU averages;

Negative pressures on the Sovereign Rating and/or the Outlook may arise in case of:

- Fiscal consolidation reversal;
- Escalating political conflicts with the EU;
- Strong capital outflows related to sudden shift in investors' sentiments;

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Regulatory announcements

Rating initiative

This is an unsolicited sovereign rating. Neither the rated entity, nor a related third party has participated in the credit rating process. BCRA did not have access to the accounts, management and other relevant internal documents for the rated entity or a related third party.

Please, visit www.bcra-bg.com to review BCRA's full policy on unsolicited credit/sovereign ratings.

Clarifying Notes:

There may be some differences in the stated values and changes in the analysed indicators due to the conversion of those values in another currency (namely in EUR). The used exchange rate is the publically announced by the Hungarian National Bank as the average value for the corresponding period (i.e. yearly, quarterly and monthly). There may also be some differences stemming from using average values for the period rather than end-period values. The cited growth rates in the current report are based on changes in national currency, with the exception of data recorded in EUR (i.e. Balance of payments, External debt, Net international investment position). The data on which the current report is based includes the public data available until the end of April 2019.

Summary of the minutes of the Rating Committee:

On the 21st of May 2019 Rating Committee of BCRA – CREDIT RATING AGECY (BCRA) had a session, on which the **Report regarding the issuing of an unsolicited initial sovereign rating of Hungary** was discussed.

The members of the Rating Committee discussed the grades of numerous credit rating factors included in the **Model for grading** and analysed in the **Credit Rating Report** in accordance with the **Sovereign Rating Methodology**.

The members of the Committee discussed the main challenges of institutional and political environment in Hungary. Robust economic growth and record low unemployment were noted. Positive trends in the long-term investor interest in the country, the reduction of external indebtedness, as well as the stabilization of the banking sector were viewed. Fiscal performance and public debt sustainability were discussed in detail, whereas the marked improvement in debt structure was positively assessed.

The sovereign rating and the related outlook have been determined based on the above discussion.

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Tables:

Country	Development classification
Hungary	Emerging and Developing Europe (IMF classification)

MAIN MACROECONOMIC INDICATORS							
	2018	2017	2016	2015	2014	2013	2012
Gross domestic product (EUR mln)	131 943	124 042	113 896	110 934	105 564	101 873	99 444
Final consumption	89 928	86 500	79 714	76 913	74 244	73 354	73 449
Gross capital formation	35 708	28 159	22 784	25 037	24 584	21 420	19 347
Net exports of goods and services	6 307	9 383	11 398	8 985	6 736	7 099	6 648
Exports of goods and services	114 169	109 467	102 195	98 697	92 553	87 263	85 925
Imports of goods and services	107 862	100 084	90 797	89 712	85 817	80 164	79 277
Real GDP growth (% change)	4.9	4.1	2.3	3.5	4.2	2.1	-1.6
GDP per capita (EUR)[1]	13 500	12 700	11 600	11 300	10 700	10 300	10 000
Unemployment rate[2], (%)	3.7	4.2	5.1	6.8	7.7	10.2	11.0
Average net monthly earnings (EUR)	688	639	562	524	504	509	498
CPI - annual average rate of change (%)	2.8	2.4	0.4	-0.1	-0.2	1.7	5.7
HUF/EUR, annual average	318.9	309.2	311.5	309.9	308.7	296.9	289.4
HUF/USD, annual average	270.3	274.3	281.4	279.5	232.5	223.7	225.4
EXTERNAL SECTOR[3]							
EUR mln	2018	2017	2016	2015	2014	2013	2012
Current account	640	3 451	7 035	3 127	1 587	3 892	1 752
Goods	-1 400	1 909	4 593	4 052	2 125	3 331	2 933
Services	7 640	7 327	6 776	4 927	4 607	3 760	3 797
Primary income	-5 060	-5 075	-2 865	-4 939	-4 458	-2 685	-4 226
Secondary income	-540	-710	-1 469	-913	-687	-514	-752
Capital account	2 321	1 403	-18	5 126	3 932	3 625	2 523
Gross external debt	106 220	105 615	110 900	119 339	121 129	119 963	127 667
Net external debt	11 789	16 020	26 823	22 002	47 324	48 390	58 241
International reserves	27 403	23 368	24 384	30 322	34 578	33 782	33 881
International investment position	-69 707	-73 937	-77 476	-73 635	-83 491	-93 129	-100 228
% of GDP							
Current account	0.5	2.8	6.2	2.8	1.5	3.8	1.8
Goods	-1.1	1.5	4.0	3.7	2.0	3.3	2.9
Services	5.8	5.9	5.9	4.4	4.4	3.7	3.8
Primary income	-3.8	-4.1	-2.5	-4.5	-4.2	-2.6	-4.2
Secondary income	-0.4	-0.6	-1.3	-0.8	-0.7	-0.5	-0.8
Capital account	1.8	1.1	0.0	4.6	3.7	3.6	2.5
Gross external debt	80.5	85.1	97.4	107.6	114.7	117.8	128.4
Net external debt	8.9	12.9	23.6	19.8	44.8	47.5	58.6
International reserves	20.8	18.8	21.4	27.3	32.8	33.2	34.1
International investment position	-70.1	-72.6	-73.4	-66.4	-73.3	-75.1	-76.0

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PUBLIC FINANCE[4]							
EUR mln	2018	2017	2016	2015	2014	2013	2012
General government revenues	58 384	55 481	51 416	53 452	49 458	47 623	45 877
General government expenditures	61 314	58 213	53 292	55 562	52 209	50 285	48 263
Interest expenditures	3 344	3 449	3 673	3 929	4 245	4 608	4 542
Budget balance	-2 930	-2 731	-1 876	-2 110	-2 751	-2 663	-2 386
Primary budget balance	413	717	1 797	1 819	1 494	1 945	2 155
General government gross debt	92 861	90 736	87 039	83 443	79 195	78 593	77 170
% of GDP							
General government revenues	44.2	44.7	45.1	48.2	46.9	46.7	46.1
General government expenditures	46.5	46.9	46.8	50.1	49.5	49.4	48.5
Interest expenditures	2.5	2.8	3.2	3.5	4.0	4.5	4.6
Budget balance	-2.2	-2.2	-1.6	-1.9	-2.6	-2.6	-2.4
Primary budget balance	0.3	0.6	1.6	1.6	1.4	1.9	2.2
General government gross debt	70.8	73.4	76.0	76.7	76.7	77.2	78.4
BANKING SYSTEM							
EUR mln	2018	2017	2016	2015	2014	2013	2012
Total assets	122 484	117 161	109 839	104 974	103 984	104 975	107 906
Asset-to-GDP ratio (%)	93.6	94.7	96.3	95.6	100.5	103.0	109.2
Deposits	68 048	63 946	58 057	57 154	53 971	53 558	53 694
Gross loans (excl. credit institutions)	57 322	53 799	50 769	47 154	51 842	55 725	60 387
After-tax profit	1 665	2 010	1 424	-93	-1 718	105	-596
Capital adequacy ratio (%)	19.7	23.2	21.1	19.9	19.3	17.8	16.4
Non-performing loans ratio (%)	5.4	7.5	10.7	14.6	-	-	-

1) Eurostat data;
2) Labour Force Survey data for population aged 15- 74;
3) MNB data, excluding SPEs;
4) Data based on ESA methodology;

Sources: Hungarian National Bank, Hungarian Central Statistical Office, Ministry of Finance, Government Debt Management Agency, World Bank, Eurostat, International Monetary Fund