CREDIT RATING AGENCY

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Hungary

May 2020

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SOVEREIGN RATING	Initial rating	Review
Date of Rating Committee:	21.05.2019	14.05.2020
Date of rating publication:	24.05.2019	15.05.2020
Long-term rating:	BBB+ (ns)	BBB+ (ns)
Outlook:	Stable	Stable
Short-term rating:	A-2 (ns)	A-2 (ns)

● (ns) – not solicited rating

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The report has been prepared and the rating – assigned, based on public information, made available by the Hungarian National Bank (MNB), 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.

BCRA - CREDIT RATING AGENCY AD **affirms** the **unsolicited** long-term and short-term sovereign rating of Hungary and **maintains** the outlook related to them:

Long-term rating: **BBB+(ns)**
Short-term rating: **A-2(ns)**
Outlook: **Stable**

BCRA's officially adopted **Sovereign Rating Methodology has been applied:**
https://www.bcra-bg.com/files/Sovereign_Methodology_2019_en.pdf

Notes:

1) Prior to the present publication the credit rating and the rating outlook were disclosed to the rated entity. Following that disclosure amendments in the credit rating and rating outlook have not been executed;
2) During the last two years, BCRA Credit Rating Agency AD has not provided ancillary services to the rated entity or a related third party;
3) The users of the rating can find information on the meaning of each rating category in the Global Scale (https://www.bcra-bg.com/files/global_scale_en.pdf). The definition of default can be found in the Sovereign rating Methodology (https://www.bcra-bg.com/files/Sovereign_Methodology_2019_en.pdf).

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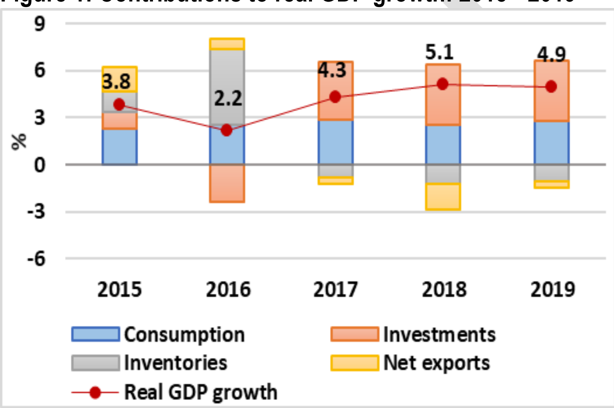
Overview

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 and a comfortable majority in the legislature. The state of emergency due to COVID-19 spreading in Hungary was enforced on the 11th of March 2020. Next, the national assembly seamlessly voted the Prime Minister the right to govern by decree, without parliamentary approval, from the 30th of March 2020 on in a set of extraordinary coronavirus measures. The emergency law has lacked a time frame, which provoked criticism that it would give Orbán unnecessary and unlimited power.

This action of the Hungarian authorities triggered another episode of tension in relationships with Brussels which have been strained in recent years. The European Commission triggered in 2018 the EU's rule of law mechanism (known as the Article 7 disciplinary procedure) against Hungary for allegations on undermining democratic rules including migrant abuse, restrictions on press freedom, corruption, and conflicts of interest. 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. Besides, Hungary may face a large cut in the size of its allocation for the 2021-2027 EU Financial Framework.

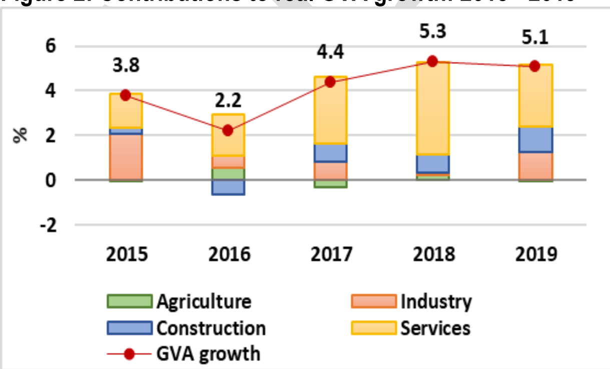
Figure 1: Contributions to real GDP growth: 2015 - 2019



Source: HCSO

The Hungarian **economy** has recorded several year of outstanding expansion, being among the top performers in the EU. Despite the marked slowdown in Eurozone, Hungary posted real GDP growth of 4.9% in 2019, just 0.2 pp below the result in 2018. Consumption and investment were the growth drivers on the expenditure side, while inventories and net exports had negative contribution. Supported by robust income and employment gains, the households' consumption growth accelerated to 5% in 2019. Concurrently, the buyout investment upswing was sustained, although at a somehow slower pace. Fixed investments annually rose by 15.3% in 2019, reaching a record high level of 28.6% of GDP. Both exports and imports accelerated in real terms, however, imports grew at a faster rate (6.9%) than exports (6%), thus, net exports once again dragged down the GDP growth.

Figure 2: Contributions to real GVA growth: 2015 - 2019



Source: HCSO

On the production side, **gross value added** (GVA) annually increased by 5.1% in 2019, mainly backed by services as well as industry and construction. Services expanded by 4.2% in total, whereas trade services had the largest contribution. Industry rebounded as its production rose by 5% in real terms, driven by the automotive sector. Also, construction sector kept its booming performance with annual growth accelerating to 21.4%.

The global **COVID-19** crisis hit the Hungarian economy at the peak of the business cycle, but will inevitably lead to a sharp recession in 2020. Many services are restricted by the introduced sanitary measures, whereas tourism and transport are among the most affected sectors. Concurrently, Hungary's high integration in western European value chains will result in significant output losses for the industry. The major carmakers have temporarily halted their local production. This represents a great shock for the Hungarian economy, which is highly dependent on the automotive industry, as it accounts for more than ¼ of total manufacturing production. Although direct

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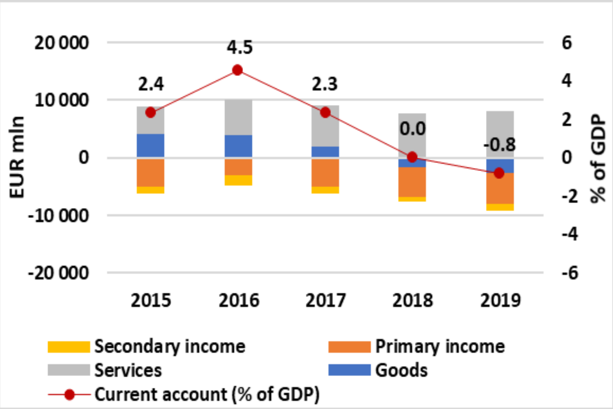
effects vary from sector to sector, practically the vast majority of them would suffer the indirect effects of the decline in both domestic and external demand.

Main growth drivers - private consumption, investment and exports will be severely suppressed. Consumption expenditures will fall, due to social distancing measures, pickup in unemployment and decline in household's disposable income. High uncertainty and shrinking demand will weight on private investment activity, while some public investment projects may be postponed. The growth prospects for Hungary's main trade partners have deteriorated significantly, which means that the external demand will continue to worsen. Also, disruptions in supply chains still persist, while services exports are greatly hampered by travel restrictions. However, the negative contribution of net exports will be partially limited by the expected reduction in imports.

The European Commission projects that the Hungarian economy will contract by a 7% in 2020 and grow by 6% in 2021. However, the recession magnitude and the recovery speed are yet uncertain to predict, as they will be shaped by the pandemic evolution and the timelines of the associated containment in the country, as well as by the dynamics of the recovery in the other Member States.

Figure 3: Current account balance: 2015 – 2019

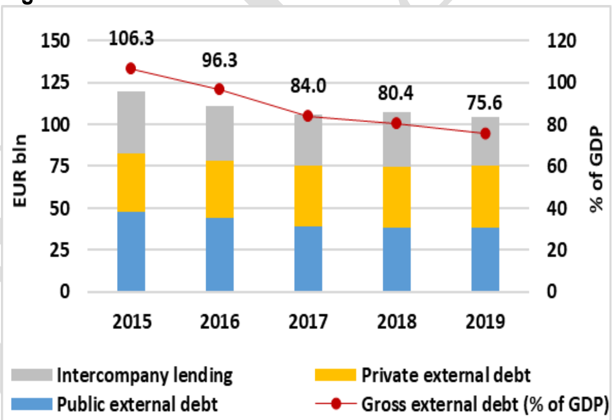


Source: MNB

The **current account** balance has turned negative, deteriorating to 0.8% of GDP in 2019, mostly driven by the trade balance. Weaker external demand combined with a strong rise in domestic demand have caused a further drop in the balance of goods, pushing it into deficit of EUR 2692 mln (1.9% of GDP), compared to a deficit of EUR 1 688 mln (1.3% of GDP) in 2018. Also, the primary income deficit and the secondary income deficit slightly increased, while only the higher surplus on net services trade somehow limited the overall balance reduction.

However, the current account deficit was more than fully financed by stable long-term **capital inflows** in the form of EU structural funds and foreign direct investments. The capital account showed a surplus of EUR 2 620 mln (1.8% of GDP) in 2019, while inward FDI flows declined on an annual basis, but remained high at EUR 4 620 mln (3.2% of GDP).

Figure 4: Gross external debt: 2015 – 2019



Source: MNB

Due to the persistently favourable net lending position, country's external vulnerabilities have been strongly reduced over the past years. Hungary's **gross external debt** (excluding SPEs) declined from EUR 107 567 mln (80.4% of GDP) in 2018 to EUR 104 665 mln (72.8% of GDP) at the end of 2019, whereas intercompany lending accounted for 27.9% of total liabilities. The maturity profile is also favourable, with 87.7% of total debt being long-term. In parallel, the adequacy of **international reserves** has improved, as their coverage of short-term debt reached 219.9%.

In line with both the expansion in external assets and the decrease in debt liabilities, **net external debt** fell to 6.8% of GDP at the end of 2019, while country's negative net international investment position improved to 52.2% of GDP.

The real sector expansion in recent years has transmitted into economic activity gains - both record low **unemployment** and high employment resulted in an activity rate of 63.0% in 2019 (by

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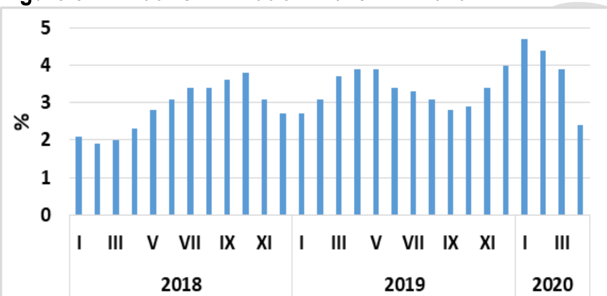
0.5pp. higher than in 2018). The unemployment rate in Hungary shrank to barely 3.4% as of 2019 (3.7% a year earlier), however, 38% of the total comes from the group up to 15-29 years.

Labour incomes continued to grow robustly over 2019 - by 11.4% in nominal terms (11.3% for 2018). The steeper hikes have been visible since the adoption of the six-year wage agreement complemented by the overall tightening of the market and well-performing economy. The national income measured by **GDP per capita** reached EUR 14 720 or 46.1% of the EU average in 2019, according to Eurostat data.

In 2020, unemployment is going to hike despite the measures for employment protection in combating pandemic effects on the economy. The government has launched schemes for net wage subsidies, reductions in social security contributions, and a series of tax and administrative reliefs pursuant to the sector of economic activity and levels of income.

Figure 5: Annual CPI inflation: 2018 – IV 2020

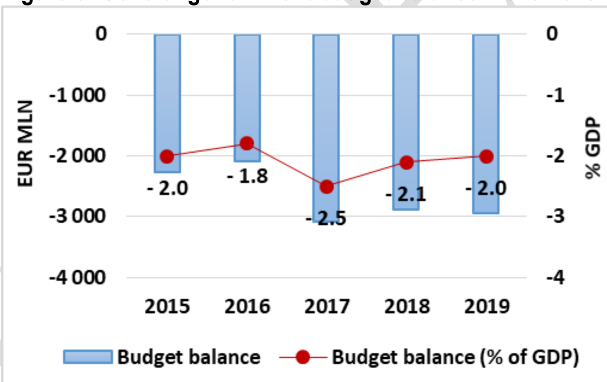


Source: HCSO

Annual CPI inflation accelerated to 3.4% in 2019, mainly driven by food and services price dynamics, as well as increases in excises on alcohol and tobacco. Inflationary pressures remained elevated in the first months of the current year, but the plunge in fuel prices and the coronavirus crisis would have a moderating effect on the overall rate of price increases in 2020. In contrast, food prices and HUF weakening may support the CPI growth, so we see inflation hovering around the central bank's target at 3%.

The solid economic growth has underpinned the **fiscal performance** which provided room for relaxation. The government has decided to implement several tax cuts and spending increases, instead of building buffers. However, their budget impact was largely offset by the expansion in the tax base derived from the dynamic rise of earnings and consumption growth. In parallel, lower interest payments and social expenditures provided additional deficit-moderating effect. Annual revenues' growth accelerated to 6.1% in 2019, but was surpassed by the 6.2% rise of expenditures, so the general government budget recorded a negative balance of 2% of GDP. This result exceeded the 1.8% deficit target, but also represented a slight decline compared to 2018.

Figure 6: General government budget balance: 2015-2019



Source: Ministry of Finance

The government aimed to achieve balanced budget by 2023, but the coronavirus pandemic has postponed this plan. According to the updated Convergence Programme submitted to the European Commission, this year's budget deficit is expected to deteriorate to 3.8% of GDP, from 2.7% envisaged earlier, while the original deficit target was planned at 1% of GDP. In order to mitigate the economic fallout from the coronavirus pandemic, the government announced a package of measures valued at around 20% of GDP consisting of direct fiscal support (around 3% of GDP), MNB support and guarantees. Key measures announced so far included:

- Creation of 2 new domestic funds – the Disease Control Fund and the Economy Protection Fund;
- Wage subsidy scheme to maintain jobs;
- Tax holiday on employers' social security contributions for the most affected sectors and tax holiday for small businesses under the simplified, small business oriented tax regimes;
- Retention of the 2 pp. cut to employers' social contributions from July 2020;
- Research and Development Subsidy;

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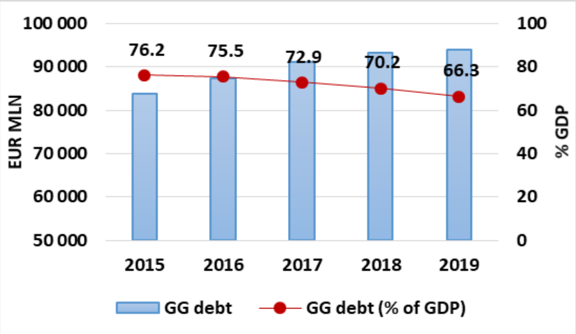
- Additional health care spending (about 0.6% of GDP);
- Introduction of new export support schemes through the state-owned Eximbank;
- Introduction of package of financial support instruments for companies by State-owned development bank;
- Launch of MNB' asset purchase programs with the Government Security Purchase Programme and the Mortgage Bond Purchase Programme;
- Introduction of a new and enlarged loans scheme (Funding for Growth Scheme Go) by the central bank, helping SMEs to overcome the economic effects of the coronavirus;
- Introduction of payment moratorium for debtors of households and company credit, loan and financial lease contracts until 31 December 2020.

Financing sources for the direct fiscal measures are provided largely from budgetary relocations and reserves absorption, as well as from new taxes on banks and retail companies. Also, a third fund will be set up containing the disease prevention resources that will be provided by the EU.

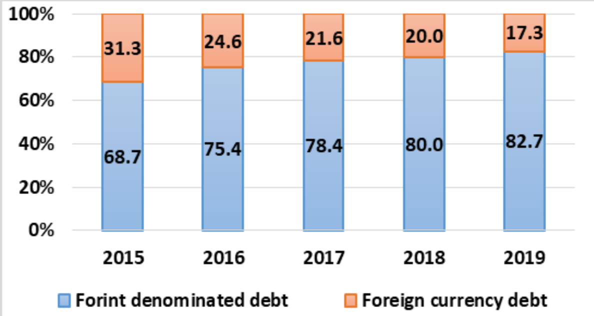
Figure 7: General government gross debt: 2015 – 2019



Source: Eurostat

At the end of 2019, the **general government gross debt** stood at EUR 93 911 mln, accounting for 68.2% of GDP. Compared to the end of 2018, debt level increased by EUR 564 mln in nominal terms, while its proportion in country's GDP decreased by 3.9 pp., thanks to the surpassing rate of GDP growth. Although on a sustained downward trajectory since, the government debt-to-GDP ratio still represents a source of vulnerability, as it exceeds the 60% threshold, set by the Maastricht Treaty, and is substantially higher than the values observed in regional peers.

Figure 8: Currency structure of CG debt: 2015-2019



Source: Government Debt Management Agency

Nevertheless, market risks are partly mitigated by the continued improvement in the debt profile. In line with the negative net FX issuance, the share of foreign currency debt in central government debt further decreased from 20% in 2018 to 17.3% in December 2019. Hungary also enjoys a comfort share of debt with a fixed coupon.

Public debt will increase temporary, due to the fiscal measures in respond to the coronavirus crisis. According to the Convergence Programme, debt-to-GDP ratio is expected to reach 72.6% in 2020 and to decrease to 69.3% of GDP in 2021. Debt management has heavily relied on the domestic retail sector recently, but new financing needs are likely to be met via increased FX debt issuance. The original EUR 1 bln foreign currency bond issuance target for 2020 was increased to EUR 4 bln. In April, the government successfully issued a 6-year EUR 1 bln Eurobond with interest rate of 1.125% and a 12-year EUR 1 bln Eurobond with an annual rate of 1.625%, thus, tapping international markets for the first time since 2018.

After some troublesome periods, the Hungarian **banking system** got back on track in the period 2016-2018, and the trends have been generally preserved over 2019. The volatilities in size of assets and profitability were reduced along with an increase in attracted deposits and accelerated credit growth. The banking sector has been still consolidating, with banking groups of domestic control increasing in importance.

Dynamic increment in granted loans to the non-financial sector is continued at double-digit rates, boosted by the low interest rates, large investment projects as well as government-supported special credit schemes. The prenatal baby support loans have been the newest significant driver since July 2019. Regarding trends in lending, MNB stated that

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overheating could not be detected given that the credit penetration remained among the lowest in the EU at 32% of GDP (taking into account household and enterprise credit). The NPL ratio has been on a steady downward path with a continuous decrease in non-performing amounts. From the previously high proportion of credit, the NPLs bottomed out to 4.0% at end-2019 (5.4% in 2018).

Banks remained profitable on average in 2019, and the main prudential indicators concerning solvency (CAR of 16.9%) and liquidity (LCR of 163.9%) of the system have been broadly satisfactory. The latest stress tests conducted based on H1 2019 data showed that all the institutions would be able to meet the regulatory requirements of solvency, while the majority of banks would comply with those of liquidity, and several institutions would become loss-making following the profitability test.

Banks' profitability will be limited by the further rising loan loss provisions and the elevated credit risk. Also, government anti-crisis measures such as the nationwide loan repayments moratorium (for all companies and private borrowers until the end of 2020) and the additional tax on banks will be a drag on this year's financial result. Concurrently, the MNB has initiated a series of steps to provide liquidity to banks and to promote lending activity including a reduction of capital buffer rates for domestic systemically important credit institutions to 0% from the 1st of July 2020.

Outlook:

The **stable outlook** of the Sovereign Rating of Hungary reflects the BCRA's opinion that risks are broadly balanced. After several years of outstanding performance, Hungarian economy will contract sharply this year due to the pandemic shock. However, we consider that the fundamentals are sound, while the strong fiscal and monetary policy coordination will safeguard the economy against a more pronounced contraction. The outlook also reflects our view that the current counter-cyclical fiscal stance will be temporal by nature and will not jeopardize the public finance sustainability.

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

- Strong and quick economic recovery in the period ahead;
- Stronger than expected fiscal results,
- Sustained external debt reduction;
- Faster income convergence with EU-average;

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

- Escalating conflicts with the EU institutions;
- Sustained fiscal loosening, leading to a material increase of public debt level;
- Strong capital outflows related to sudden shift in investors' sentiments.

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Regulatory announcements

Rating initiative:

This rating is unsolicited

Unsolicited sovereign rating	
With Rated Entity or Related Third Party Participation	NO
With Access to Internal Documents	NO
With Access to Management	NO

The complete version of BCRA's policy on unsolicited credit/sovereign ratings can be downloaded through the following link: https://www.bcra-bg.com/files/policy_unsolicited_rating_en.pdf

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 May 2020.

Summary of the minutes of the Rating Committee:

On the 14th of May 2020, Rating Committee of BCRA – CREDIT RATING AGECY (BCRA) had a session, on which the **Report regarding the affirmation of an unsolicited initial sovereign rating of Hungary** was discussed. The session was headed by Dr Kiril Grigorov - chairmen of the Rating Committee.

The members of the Rating Committee discussed the grades of numerous credit rating factors included in the **Rating Model** and analysed in the **Credit Rating Report** according to the **Sovereign Rating Methodology**.

The members of the Committee reviewed the qualitative and quantitative risk factors, taking in account the expected impact of the global coronavirus pandemic. Key points discussed included: 1) macroeconomic fundamentals and growth outlook; 2) external vulnerabilities; 3) fiscal and monetary measures in respond to the economic crisis; 4) public debt sustainability and 5) financial sector developments.

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					
	2019	2018	2017	2016	2015
Gross domestic product (EUR mln)	143 804	133 791	125 595	115 252	112 247
Final consumption	97 349	91 513	87 744	80 601	77 126
Gross capital formation	41 169	36 425	28 697	24 569	26 155
Net exports of goods and services	5 286	5 852	9 154	10 082	8 966
Exports of goods and services	119 829	113 640	109 447	100 444	98 754
Imports of goods and services	114 544	107 788	100 293	90 362	89 788
Real GDP growth (% change)	4.9	5.1	4.3	2.2	3.8
GDP per capita[1] (EUR)	14 720	13 690	12 830	11 740	11 400
Unemployment rate[2], (%)	3.4	3.7	4.2	5.1	6.8
Average net monthly earnings	752	688	639	562	524
CPI - annual average (% change)	3.4	2.8	2.4	0.4	-0.1
HUF/EUR, annual average	325.4	318.9	309.2	311.5	309.9
HUF/USD, annual average	290.7	270.3	274.3	281.4	279.5
EXTERNAL SECTOR[3]					
EUR mln	2019	2018	2017	2016	2015
Current account	-1 215	-21	2 937	5 209	2 648
Goods	-2 692	-1 688	1 909	3 958	4 052
Services	7 995	7 687	7 244	6 126	4 907
Primary income	-5 301	-5 195	-5 066	-3 131	-5 131
Secondary income	-1 218	-826	-1 151	-1 744	-1 180
Capital account	2 620	2 996	1 075	-21	5 160
Gross external debt	104 665	107 567	105 478	110 940	119 339
Net external debt	9 808	12 068	16 309	26 886	22 002
International reserves	28 386	27 403	23 368	24 384	30 322
International investment position	-75 042	-74 521	-76 948	-79 411	-74 980
% of GDP					
Current account	-0.8	0.0	2.3	4.5	2.4
Goods	-1.9	-1.3	1.5	3.4	3.6
Services	5.6	5.7	5.8	5.3	4.4
Primary income	-3.7	-3.9	-4.0	-2.7	-4.6
Secondary income	-0.8	-0.6	-0.9	-1.5	-1.1
Capital account	1.8	2.2	0.9	0.0	4.6
Gross external debt	72.8	80.4	84.0	96.3	106.3
Net external debt	6.8	9.0	13.0	23.3	19.6
International reserves	19.7	20.5	18.6	21.2	27.0
International investment position	-52.2	-55.7	-61.3	-68.9	-66.8

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PUBLIC FINANCE					
EUR mln	**2019**	**2018**	**2017**	**2016**	**2015**
General government revenues	63 278	59 565	55 911	52 312	54 581
General government expenditures	66 223	62 440	58 996	54 401	56 842
Interest expenditures	3 290	3 200	3 364	3 589	3 882
Budget balance	-2 945	-2 875	-3 085	-2 089	-2 261
Primary budget balance	346	325	279	1 501	1 621
General government gross debt	83 834	79 576	78 882	77 531	72 882
% of GDP					
General government revenues	44.0	44.5	44.5	45.4	48.6
General government expenditures	44.0	44.5	44.5	45.4	48.6
Interest expenditures	2.3	2.4	2.7	3.1	3.5
Budget balance	-2.0	-2.1	-2.5	-1.8	-2.0
Primary budget balance	0.2	0.2	0.2	1.3	1.4
General government gross debt	76.2	76.8	77.4	78.6	80.8

BANKING SYSTEM[4]					
EUR mln	**2019**	**2018**	**2017**	**2016**	**2015**
Total assets	150 610	130 988	125 529	114 923	108 819
Deposits (total economy)	120 630	104 954	100 973	92 359	86 999
Loans (total economy)	94 124	79 154	74 670	71 095	70 184
%					
Non-performing loans ratio	4.0	5.4	7.5	10.7	14.6
Capital adequacy ratio	16.9	19.1	19.2	19.3	18.2
Liquidity coverage ratio (LCR)	163.9	186.8	192.2	216.6	223.4
Return on assets (ROA)	1.4	1.5	1.5	1.2	0.0
Return on equity (ROE)	13.1	13.4	13.2	10.6	0.9

1) Data from Eurostat;
2) Labour Force Survey data for population aged 15-74;
3) MNB data, excluding SPEs;
4) Data from MNB - Prudential data of credit institutions.

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