BCRA
CREDIT RATING AGENCY

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Hungary

May 2021

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SOVEREIGN RATING	Initial rating	Review	Review	Review
Date of Rating Committee:	21.05.2019	14.05.2020	12.11.2020	05.05.2021
Date of rating publication:	24.05.2019	15.05.2020	13.11.2020	07.05.2021
Long-term rating:	BBB+ (ns)	BBB+ (ns)	BBB+ (ns)	BBB+ (ns)
Outlook:	Stable	Stable	Stable	Stable
Short-term rating:	A-2 (ns)	A-2 (ns)	A-2 (ns)	A-2 (ns)

● (ns) – not solicited rating

* *The full rating history is available at: https://www.bcra-bg.com/en/ratings/hungary-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:

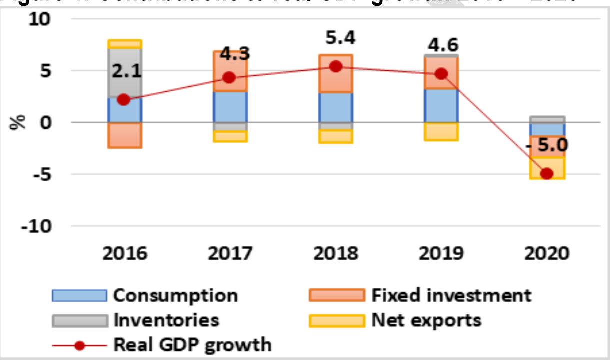
1) Prior to the present publication the credit rating and the rating outlook were disclosed to the rated entity. Following that disclosure amendments in the credit rating and rating outlook have not been executed;
2) During the last two years, BCRA Credit Rating Agency AD has not provided ancillary services 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).

Overview

The containment measures against the COVID-19 spreading were in general lifted in the summer months of 2020, but the government reintroduced the state of emergency in November as the second wave of the pandemic hard hit the country and also did the third wave thereafter. The prime minister - Viktor Orbán defends his position that the extraordinary situation requires the respective measures and the state of special legal order should be maintained until the control over the pandemic is achieved. Concurrently, Hungary targeted a broad-based and prompted policy in immunisation against COVID-19. They contracted some quantities from the Russian and the Chinese first preparations, accordingly, aside from the EU's common vaccine programme. Likewise, the local medicines regulator continued to approve vaccines from third countries at the background of a worsened epidemiological situation in the country.

The emergency legislation, as well as the individual approach to the vaccination process of Hungary, have triggered new episodes of tension in relationships with Brussels which have been strained in recent years. European institutions have recently criticised Hungarian authorities' policies particularly in the fields of non-governmental organisations, media freedom, and asylum policy and rights of migrants[1]. The last led to Frontex's temporary suspension of operations at the country's border at the beginning of 2021.

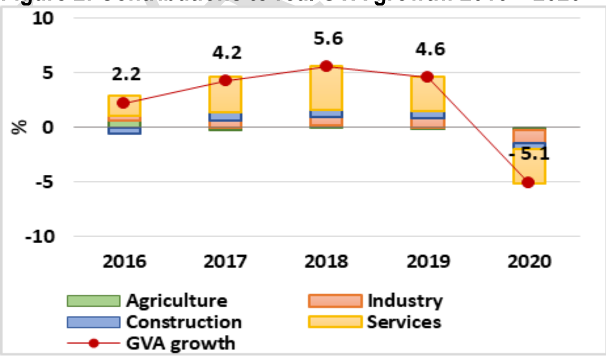
Figure 1: Contributions to real GDP growth: 2016 – 2020



Source: HCSO

The COVID-19 pandemic hit the Hungarian **economy** at the peak of the business cycle. Measures taken to limit its spread caused a sharp slump in economic activity. The real GDP contracted by 5% YoY, driven by the negative contributions of both domestic demand and net exports. Affected by lockdown restrictions, increase in unemployment, and decline in confidence, households' consumption decreased by 2.8% in real terms, which was only partly compensated by the increase in government consumption. Following the rapid upswing in 2017-2019, fixed investment annually fell by 7.3%, as high uncertainty and shrinking demand weighed on private investment decisions. Reflecting the parallel recession in main trading partners, supply chain disruptions and travel restriction, Hungarian exports of goods and services declined by 6.8% in real terms, while imports fell at a milder rate of 4.4%, mostly driven by plummeting trade in services.

Figure 2: Contributions to real GVA growth: 2016 – 2020



Source: HCSO

The spread of COVID-19 took its toll on almost all economic activities, thus, **gross value added** (GVA) declined by 5.1% in 2020. The aggregate services sector shrank by 4.7% in real terms as many activities were put at a standstill during the lockdown. The highest falls within the sector were recorded in transportation and storage, and arts and entertainment services, while only financial services, and information and communication posted growth rates. Industry contracted by 4.9% in real terms with manufacturing being particularly hard hit due to the dominant role of the strongly cyclical automotive industry. After the booming performance in the past years, construction activity fell by 9.4% in 2020.

The growth drivers remained suppressed in the first months of 2021 as the rebound was interrupted by new waves of the pandemic, which led to a reintroduction of strict restrictions from mid-November 2020. Against this background, we

[1] In February 2021, the Commission sent to Hungary the last warning to comply with the EU asylum law before taking the issue to the EU Court of Justice.

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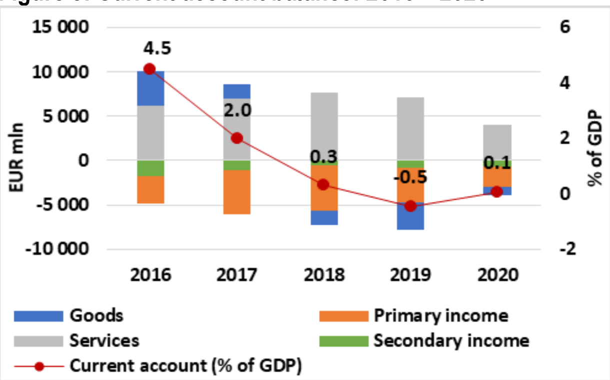
expect a gradual recovery of economic activity starting from mid-2021, but its pace will largely depend on the vaccination progress and the timing of economic reopening. The recovery will receive backing from large public investment and funding from the EU, however, downside risks associated with the pandemic evolution are still present.

The global spread of COVID-19 had a strong negative effect on **international trade** dynamics. In 2020, Hungarian exports of goods decreased by 4.2% in nominal terms, while imports declined at an outpacing annual rate of 5.8%. Machinery and transport equipment, which traditionally account for more than ½ of total exchanged goods had the largest contribution to the decline in exports. Weaker demand and the strong fall in crude oil prices also contributed to the lower export value, but their effect was increasingly felt in the drop in imports.

Figure 3: Current account balance: 2016 – 2020

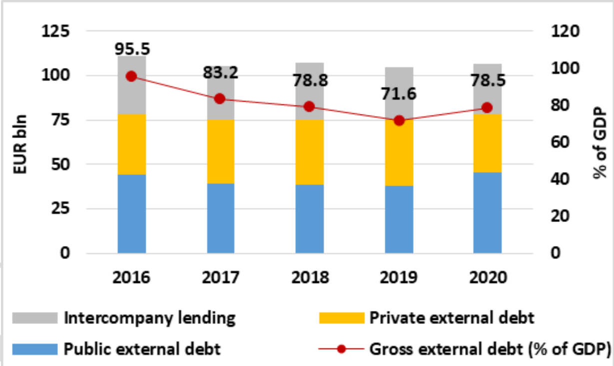


Source: MNB

The **current account** balance shifted to a modest surplus of EUR 99 mln (0.1% of GDP) from EUR 658 mln deficit (-0.5% of GDP) in 2019, mainly driven by a lower deficit on trade in goods as well as improvement in the income account. Reflecting the stronger decline in nominal imports of goods than that in exports, the negative goods balance fell by 71.6% YoY to EUR 866 mln (-0.6% of GDP), but this was more than fully counterbalanced by services surplus, which decreased by 44.7% to EUR 3 966 mln (2.9% of GDP) amid the downturn in tourism and transport services. Concurrently, the crisis led to lower profit of foreign-owned companies and the primary income deficit narrowed by 42.5% to EUR 2 260 mln (1.7% of GDP), while secondary income deficit slightly improved to EUR 742 mln (-0.5% of GDP).

Possible external vulnerabilities continue to be mitigated by stable long-term **capital inflows** in the form of EU funds and foreign direct investments, which expanded further despite the crisis. In 2020, the capital account surplus amounted to EUR 2 747 mln (2% of GDP) and the net inflows of direct investment reached EUR 3 627 mln (2.7% of GDP). The annual absorption of EU funds has been constantly increasing since 2016 and is expected to continue at a faster pace this year.

Figure 4: Gross external debt[2]: 2016 – 2020



Source: MNB

By the end of 2020**, gross external debt** advanced to EUR 106 742 mln (78.5% of GDP), from EUR 104 561 mln (71.6% of GDP) at the end of 2019. The upward dynamic reflected government bond issuances and the funding of central bank's euro liquidity providing swap instrument while private debt and intercompany lending declined. The relative share of short-term debt slightly increased, but the maturity profile remained favourable with 84.5% of total debt being long-term and reserves to short-term ratio stood at 203%.

International **reserves** held by the MNB amounted to EUR 33 677 mln (23.1% of GDP) as of end-2020, annually increasing by 18.6% amid foreign currency inflows from government bonds issuance and EU transfers. In line with the increase in gross external assets, Hungary's negative **net international investment position**[2] improved from 50.1% of GDP in 2019 to 48% of GDP in 2020 with direct investments accounting for more than a half of the liabilities.

Hungarian **labour market** slack has been among the lowest in the EU driven by the real sector expansion in recent years. In 2020, the unemploy-

[2] Excluding SPEs (special purpose entities).

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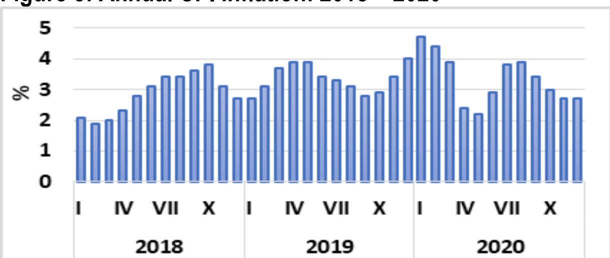
ment rate turned upwards but also remained relatively low at 4.1% (3.4% in 2019) as compared to the EU-27 average of 7.1%. The government has launched a series of schemes for sectoral wage subsidies and tax reliefs aiming at employment protection in combating pandemic effects on the economy. As a result, the employment rate lost only 0.5 pp. (to 62.1% for 15-74 y.o.) YoY as manufacturing, transportation and tourism were the economic sectors that released the largest headcount during the last year. The human health activities employed more people and marked a significant increment in the average remunerations following the targeted government support.

Earnings economy-wide (except for the sector of Mining and quarrying) did not lose momentum and increased by 9.7% in nominal terms (11.5% in 2019). However, the national income measured by **GDP per capita** declined to EUR 13 940 in 2020, which represented 47% of the nominal EU-27 average, according to Eurostat data.

Figure 5: Annual CPI inflation: 2018 – 2020

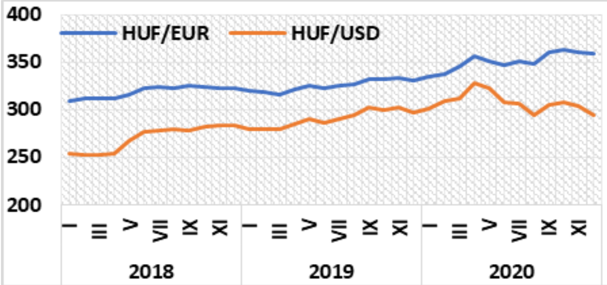


Source: HCSO

Annual **inflation** moderated following the pandemic outbreak amid the plunge in global oil prices and muted domestic demand, while food prices and forint's weakening somehow counterbalanced the disinflationary effects. As a result, the annual CPI inflation in 2020 averaged 3.3%, being successfully kept within the central bank's 2–4% tolerance band. Inflation is expected to accelerate during 2021 driven by increasing fuel prices, indirect tax hikes and recovering domestic demand.

The forint **exchange rate** has been adjusting flexibly. The national currency has witnessed a steady depreciation against the euro in 2019 and the trend gained further momentum following the outbreak of the pandemic amid elevated uncertainty and loose monetary stance. As a result, the annual average forint exchange rate weekend by 7.9% against the euro in 2020.

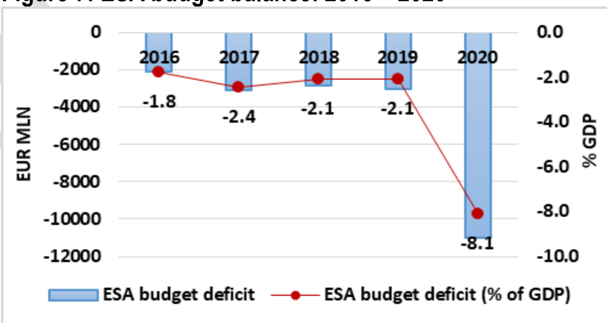
Figure 6: Exchange rates – monthly average: 2018 - 2020



Source: MNB

Last year's **fiscal gap** escalated because of the economic impact of the COVID-19 pandemic as well as policy measures to mitigate it. The Hungarian government adopted an ample support package with a broad list of measures, which included: 1) additional funding for the health sector; 2) wage subsidy scheme; 3) cut to employers' social contributions; 4) tax deferrals and temporary support to specific sectors; 5) large sovereign guarantee schemes to support lending during the crisis and 6) export support measures through the state-owned Eximbank.

Figure 7: ESA budget balance: 2016 – 2020



Source: Ministry of Finance

General government budget developments in 2020 were characterised by both a decrease in revenues and a significant rise in expenditures. Total revenues fell by 7.2%[3] against 2019, mainly driven by the fall in collections from social contributions and indirect taxes, which suffered the contraction of tax bases and tax cuts. Concurrently, public expenditures rose by 5.1%, reflecting the surge in current spending on support measures. As a result, the general government budget posted a negative balance of EUR 11 019 mln (8.1% of GDP) as of end-2020, which represented a major slippage compared to the deficit of EUR 3 036 mln (2.1% of GDP) recorded in 2019.

[3] Growth rates were calculated on values in EUR.

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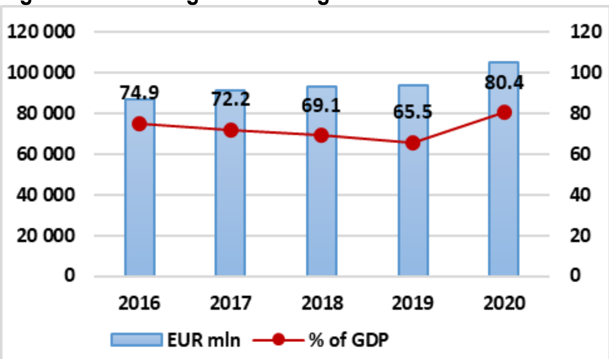
In December 2020, the government set the 2021 ESA budget deficit target to 6.5% of GDP, but it is now expected to reach about 7.5% of GDP as the third wave of the pandemic necessitated greater budgetary support than previously planned. The economic recovery will provide a gradually declining deficit path, however, downside risks persist in case of further recovery setbacks.

Figure 9: General government gross debt: 2016 – 2020



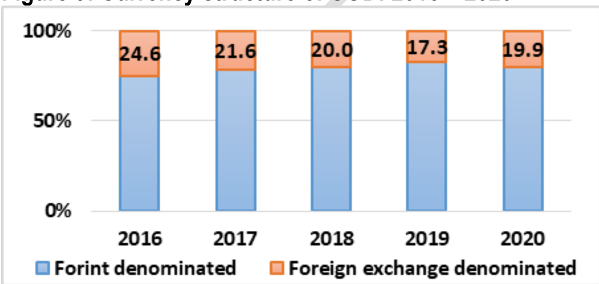
Source: Ministry of Finance

The **general government debt**-to-GDP ratio, which followed a strict downward path over the past decade, rose to 80.4% of GDP as of end-2020 - far above the 60% reference value of the Maastricht Treaty. The debt ratio increased by 15 percentage points against the end of 2019, reflecting the sizeable fiscal gap, pre-financing for 2021 and the contraction in nominal GDP.

As of end-2020, **central government debt** reached EUR 100 469 mln (76.8% of GDP), increasing by EUR 10 665 mln (+11.9%) against the end of 2019, of which EUR 4 548 mln corresponded to the growth of external debt and EUR 6 380 mln to domestic debt. Over the past years, debt management has heavily relied on the expansion of the domestic investor base via the retail market, but the retail program slowed down temporarily during the pandemic. Given the elevated budget financing needs, Hungary successfully tapped the international financial markets in 2020 in order to ensure more favourable borrowing costs. The government issued EUR 2 bln of Eurobonds in April, EUR 1.5 bln green bonds in June, and EUR 500 mln in Samurai bonds in September.

Hungary's debt profile has improved significantly over the past decade. In line with the negative net FX issuance, the share of foreign currency debt in central government debt rapidly fell from 48.5% in 2011 to 17.3% in 2019. Despite the foreign currency borrowing in 2020, its share increased only slightly - to 19.9% and the strategic goal for keeping it under 20% of the total debt remains in place. Also, the central bank's government securities purchase programme has contributed to maintaining the stable liquidity position of the market.

Figure 9: Currency structure of CGD: 2016 – 2020



Source: Government Debt Management Agency

Fiscal measures in response to the pandemic are complemented by a broad array of **monetary tools**. Anti-crisis packages developed by the Hungarian government and central bank include financial support instruments such as subsidised loan products, guarantee instruments and asset purchase programs. The nationwide loan payment moratorium has been extended for the first six months of 2021 as a targeted rather than general one. The overall easing conditions, including also the release of bank capital buffers, base rate cut (to 0.60%), and the moratorium on FGS refinancing loans repaid by banks to the central bank, have led to intensified broad money growth and assured ample liquidity in the financial system.

The Hungarian **banking sector** remained generally sound and successfully channelling funds regarding pandemic-driven economic measures and programmes in the altered financial environment over 2020. The dynamics of the main banking indicators were high and in a positive direction, with a marked increase in attracted deposits and granted credit as of the year's end. The state-subsided products (like FGS Go!; CSOK housing subsidy scheme; prenatal baby support loans) had a major contribution to support lending and ensure financial stability.

Concurrently, the main prudential indicators for solvency (CAR of 18.7%) and liquidity (LCR of 221%) remained high enough, with the required minimum ratios being covered by all the credit

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institutions. From the previously high proportion of credit, the NPLs bottomed out to 3.6% at end-2020 as the absolute value of non-performing loans turned upwards, yet, lagging behind the robust total loan growth.

On the other hand, banks' profitability contracted sharply on an annual basis (with 43.9%), and the ROA and ROE diminished to 0.6% and 6.5%, respectively (1.4% and 13.1% in 2019), with a total of six loss-making banks in 2020 (2 in 2019). The operating income remained on the rise while impairment and provisions were the major drag.

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, the Hungarian economy has suffered the pandemic shock. Economic activity is expected to rebound in the second half of this year, in line with the gradual reopening and vaccination progress. External vulnerabilities are limited by stable long-term capital inflows in the form of foreign direct investments and EU funds, which are expected to continue at a fast pace. Public finance metrics deteriorated strongly, however, the large policy support safeguarded the economy against a more pronounced contraction and continued well-targeted support is needed to support the recovery. The public debt burden is elevated, but the exposure to market volatility is contained by a favourable debt profile. The banking sector remains sound, liquid and well-capitalised, supported by the central bank's accommodative stance.

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

- Swift recovery of economic activity, once the COVID-19 outbreak is contained;
- Stronger than expected fiscal results;
- Sustained external debt reduction.

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

- Escalating conflicts with the EU institutions, jeopardising inflow of EU funds;
- Sustained fiscal loosening, leading to a material increase of public debt level post-pandemic;
- Strong capital outflows related to a 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) as well as the fiscal data. The data on which the current report is based includes the public data available until May 2021.

Summary of the minutes of the Rating Committee:

On the 5th of May 2021, Rating Committee of BCRA – CREDIT RATING AGECY (BCRA) had a session, on which the **Report regarding the affirmation of an unsolicited 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 reviewed numerous qualitative and quantitative risk factors included in the **Sovereign Rating Model** and analysed in the **Credit Rating Report** in accordance with our **Sovereign Rating Methodology**.

Key points discussed included: 1) domestic politics; 2) macroeconomic fundamentals and growth outlook; 3) external metrics; 4) policy measures to support the economic activity; 5) fiscal results 6) public debt sustainability and 7) monetary and banking 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					
	2020	**2019**	**2018**	**2017**	**2016**
Gross domestic product (EUR mln)	135 955	146 070	135 950	126 883	116 122
Final consumption	95 476	101 013	93 781	89 289	81 471
Gross capital formation	37 548	40 953	36 184	28 935	24 569
Net exports of goods and services	2 931	4 104	5 985	8 660	10 082
Exports of goods and services	108 306	120 192	114 043	109 132	100 444
Imports of goods and services	105 375	116 088	108 058	100 472	90 362
Real GDP growth (% change)	-5.0	4.6	5.4	4.3	2.1
GDP per capita[1] (EUR)	13 940	14 950	13 910	12 960	12 960
Unemployment rate[2], (%)	4.1	3.3	3.6	4.0	5.0
Average net monthly earnings	764	752	688	639	562
CPI - annual average (% change)	3.3	3.4	2.8	2.4	0.4
HUF/EUR, annual average	351.2	325.4	318.9	309.2	311.5
HUF/USD, annual average	307.9	290.7	270.3	274.3	281.4
EXTERNAL SECTOR[3]					
EUR million	**2020**	**2019**	**2018**	**2017**	**2016**
Current account	99	-658	408	2 536	5 209
Goods	-866	-3 043	-1 684	1 712	3 958
Services	3 966	7 168	7 687	6 947	6 126
Primary income	-2 260	-3 927	-5 049	-5 021	-3 131
Secondary income	-742	-857	-547	-1 102	-1 744
Capital account	2 747	2 697	3 063	1 075	-21
Gross external debt	106 742	104 561	107 155	105 523	110 940
International reserves	33 677	28 386	27 403	23 368	24 384
International investment position	-65 236	-73 195	-73 277	-76 543	-79 411
% of GDP					
Current account	0.1	-0.5	0.3	2.0	4.5
Goods	-0.6	-2.1	-1.2	1.3	3.4
Services	2.9	4.9	5.7	5.5	5.3
Primary income	-1.7	-2.7	-3.7	-4.0	-2.7
Secondary income	-0.5	-0.6	-0.4	-0.9	-1.5
Capital account	2.0	1.8	2.3	0.8	0.0
Gross external debt	78.5	71.6	78.8	83.2	95.5
International reserves	23.1	20.9	21.6	20.1	21.6
International investment position	-48.0	-50.1	-53.9	-60.3	-68.4

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PUBLIC FINANCE[4]					
EUR million	**2020**	**2019**	**2018**	**2017**	**2016**
General government revenues	59 159	63 737	59 533	55 911	52 312
General government expenditures	70 178	66 774	62 383	58 996	54 401
Interest expenditures	3 212	3 260	3 173	3 364	3 589
Budget balance	-11 019	-3 036	-2 850	-3 085	-2 089
Primary budget balance	-7 807	224	323	279	1 500
General government gross debt	105 190	94 162	93 193	91 288	87 135
% of GDP					
General government revenues	43.5	43.6	43.8	44.1	45.0
General government expenditures	51.6	45.7	45.9	46.5	46.8
Interest expenditures	2.4	2.2	2.3	2.7	3.1
Budget balance	-8.1	-2.1	-2.1	-2.4	-1.8
Primary budget balance	-5.7	0.2	0.2	0.2	1.3
General government gross debt	80.4	65.5	69.1	72.2	74.9

BANKING SYSTEM[5]					
EUR million	**2020**	**2019**	**2018**	**2017**	**2016**
Total assets	165 992	149 683	130 988	125 529	114 923
Deposits (total economy)	135 963	119 831	104 954	100 973	92 359
Loans (total economy)	104 511	94 104	79 154	74 670	71 095
Net profit / loss	1 068	2 100	2 003	1 908	1 432
in %					
Non-performing loans ratio	3.6	4.1	5.4	7.5	10.7
Capital adequacy ratio	18.7	18.4	19.1	19.2	19.3
Liquidity coverage ratio (LCR)	220.8	163.6	186.8	192.2	216.6
Return on assets (ROA)	0.6	1.4	1.5	1.5	1.2
Return on equity (ROE)	6.5	13.1	13.4	13.2	10.6

1) Data from Eurostat;
2) Labour Force Survey data for population aged 15-74;
3) MNB data, excluding SPEs;
4) EDP methodology;
5) MNB data - 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