# Hungary
## Rating Report

SCOPE BBB+ STABLE OUTLOOK

### Credit strengths

- Robust growth performance supported by high investment
- Increased resilience against external shocks

### Credit challenges

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

## Rating rationale:

**Robust growth dynamics:** The economy has a strong record of robust growth and high investment – driven by inflows of foreign direct investment and projects co-financed with EU funds – creating high value-added jobs and supporting growth potential.

**Increasing resilience to external shocks:** Hungary benefits from a moderate net external debt ratio and improvements in the net international investment position. Hungary's economy is vulnerable to supply chain shocks as it has a high degree of international fragmentation of its production processes.

**Rating challenges include**: i) high public debt and growing budgetary pressures, with discretionary measures implemented during the pandemic weighing on the fiscal position; ii) long-term risks to competitiveness, due to adverse demographic trends, structural employment gaps and labour shortages; and iii) institutional challenges related to rule of law issues, reflected by recent deteriorations captured in governance metrics including the rule of law, political polarisation and political headwinds with the EU.

**Hungary's sovereign rating drivers**

| Risk pillars | | Quantitative scorecard | | Reserve currency adjustment (notches) | Qualitative scorecard | Final rating |
|---|---|---|---|---|---|---|
| | | Weight | Indicative rating | | Notches | |
| Domestic Economic Risk | | 35% | aa- | | 0 | |
| Public Finance Risk | | 25% | bb+ | | 0 | |
| External Economic Risk | | 10% | bb | | 0 | |
| Financial Stability Risk | | 10% | aaa | | 0 | BBB+ |
| ESG Risk | Environmental Risk | 5% | aaa | | 0 | |
| | Social Risk | 5% | bbb | | -1/3 | |
| | Governance Risk | 10% | bb | | -1/3 | |
| **Overall outcome** | | **a-** | | **0** | **-1** | |

Note: The sum of the qualitative adjustments, capped at 1 notch per rating pillar, is weighted equally and 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 GmbH

## Outlook and rating triggers

The Stable Outlook reflects Scope's view that risks to the ratings are balanced over the next 12 to 18 months.

### Positive rating-change drivers

- Increase in medium-term growth potential supported by EU funds
- Significant public debt reduction due to improvement in public finances
- Material reduction of external debt burden

### Negative rating-change drivers

- Protracted fiscal deterioration or a fading commitment to fiscal consolidation weakens debt sustainability
- Strong decline in foreign investment and/or significant delay of EU funds availability, lowering growth potential
- Prolonged supply chain disruptions and further inflationary pressures fuelled by imported energy prices and/or currency weakness, materially weighing on macroeconomic stability

### Ratings and Outlook

**Foreign and 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

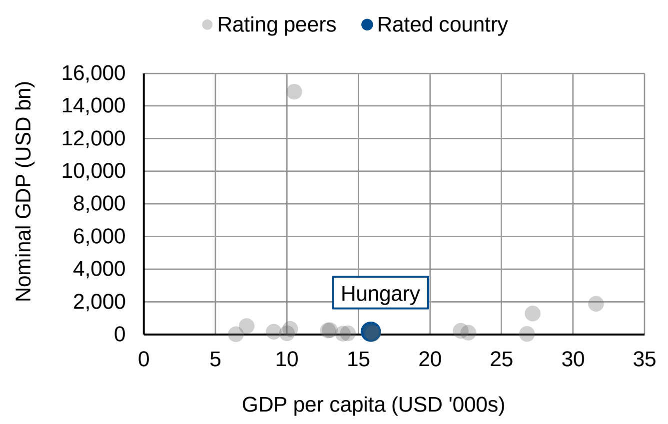
## Domestic Economic Risks

- **Growth outlook:** Following a pandemic-related substantial decline in output of 4.7% in 2020, Hungary's economy has rebounded strongly on the back of robust fiscal stimulus via tax relief, increased transfers and social spending programmes. Growth accelerated in 2021 Q4, driven by strong private consumption, investment and the recovery in net exports. Provisional data puts annual GDP growth at 7.1% in 2021, which would bring 2021 GDP more than 2% above its pre-crisis level. The Russia-Ukraine war that broke out at the end of February fundamentally changed the global economic outlook. The war is causing additional inflationary effects through rises in commodity and energy prices, which have been aggravated by a repeated increase in supply disruptions. We expect Hungary's growth to slow to 3.5% in 2022, before picking up to 4% in 2023 and gradually returning to potential in the following years.
- **Inflation and monetary policy:** HICP Inflation increased to 5.2% on average in 2021, the highest rate in the European Union. Both headline and core HICP inflation accelerated in recent months, reaching 8.4% and 6.7% in February 2022, respectively, despite government-imposed price caps over a number of goods (fuels, basic foods). This reflects widespread inflationary pressures which should be further fueled by heightened energy and commodity prices resulting from the Ukraine crisis. The Hungarian Central Bank (MNB) one of the first central banks in the EU to initiate monetary policy tightening, phasing out its quantitative easing programme in December 2021 and hiking its benchmark interest rate by a cumulated 380 bps between June 2021 and March 2022 to 4.40%. Additional rate hikes are expected this year.
- **Labour market:** After declining moderately during the crisis, employment returned above pre-pandemic level in the summer of 2021. Unemployment stood at 3.8% in February 2022, one of the lowest levels among peers, and is expected to decline further in line with the economic recovery. While the general labour market situation has been improving in Hungary in recent years, adverse demographic trends and persisting structural employment gaps represent significant headwinds to Hungary's long-term competitiveness.

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

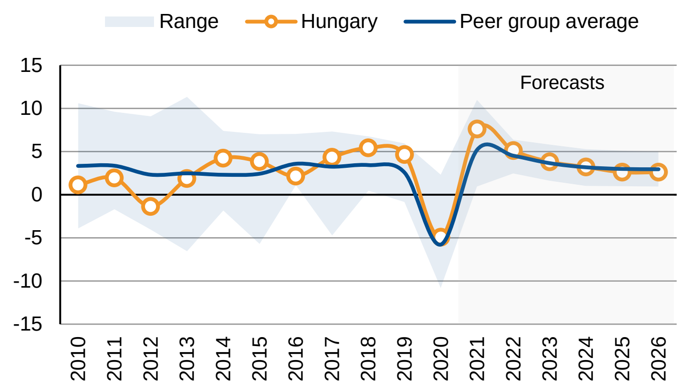
| CVS indicative rating | Analytical component | Assessment | Notch adjustment | Rationale |
|---|---|---|---|---|
| aa- | Growth potential of the economy | Neutral | 0 | Robust growth dynamics; shortages on labour market and low savings |
| | Monetary policy framework | Neutral | 0 | Credible central bank; thin local currency bond market limits effectiveness of monetary policy |
| | Macro-economic stability and sustainability | Neutral | 0 | Competitive export base; reliance on external markets |

**Nominal GDP and GDP per capita,** USD '000s




Source: IMF, Scope Ratings GmbH

**Real GDP growth**, %




Source: IMF, Scope Ratings GmbH

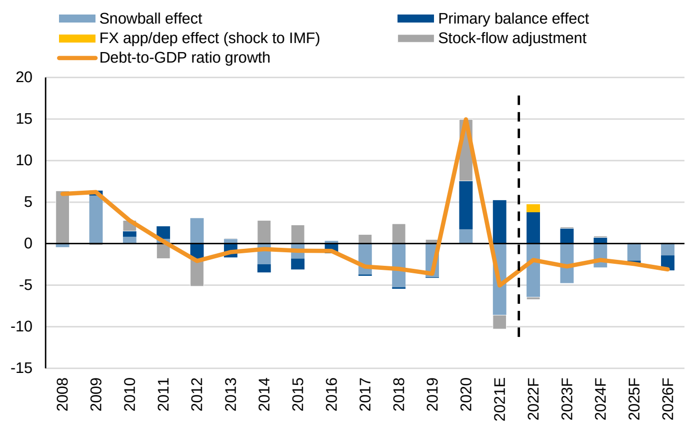
## Public Finance Risks

- **Fiscal outlook:** Hungary's budgetary discretionary measures implemented during the pandemic materially weigh on the government's fiscal position. Despite a strong economic rebound in 2021 and the gradual phase out of Covid-19 related expenditures, we estimate that the general government deficit only decreased moderately in 2021 to about 6.8% of GDP, down from 7.8% in 2020. Public expenditures are set to remain high in the first half of 2022 following the roll-out of spending measures including personal income tax refunds, pensioner and public sector bonuses. The sharp rise in oil and gas prices that followed Russia's invasion of Ukraine is set to exert further pressure on public spending. The state-imposed cap on retail fuel prices could create large losses to state-owned energy group MVM, which could warrant further capital injections from the government. Additional public spending should also result from the inflow of refugees from Ukraine. Hungary's finance minister has already signaled his intention to revise the 2022 budget following the April elections so as to take into account the worsened economic environment. Under the current budget bill, we expect the budgetary deficit to reach 5.8% of GDP in 2022.
- **Debt trajectory:** Compared to that of similarly rated country peers, Hungary's public debt is high, at an estimated 76.8% of GDP in 2021. We expect the debt-to-GDP ratio will gradually decline to 75% in 2022 and remain on a downward trajectory in the medium-term, supported by a low interest-payment burden benefitting from refinancing of previously issued securities at cheaper rates. However, the delay in the receipt of EU funds, an issue on which a final agreement has not been reached yet, can slow-down this declining trend. Further depreciation of the forint could also inflate the weight of foreign-denominated public debt.
- **Market access:** Hungary benefits from good access to foreign and domestic financing, including through a sizeable domestic retail programme. Average debt maturity increased to 6.1 years at end-2021. The share of foreign-currency-denominated central government debt significantly declined in recent years, from 31.3% end of 2015 to 20.6% at end-2021.

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

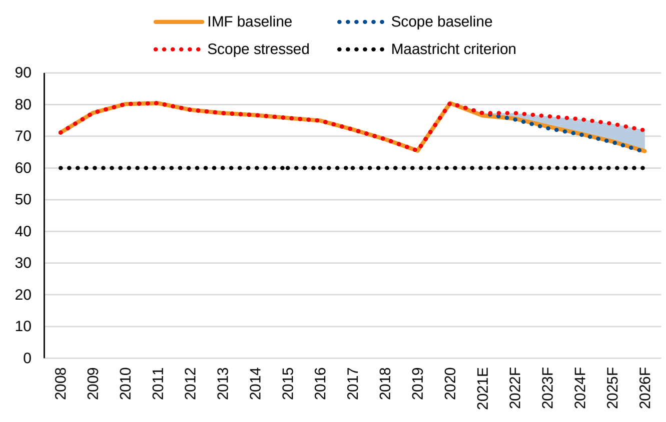
| CVS indicative rating | Analytical component | Assessment | Notch adjustment | Rationale |
|---|---|---|---|---|
| bb+ | Fiscal policy framework | Neutral | 0 | Adequately supportive fiscal policy during the pandemic, but limited fiscal space |
| | Debt sustainability | Neutral | 0 | Elevated debt burden; long-term debt trajectory supported by declining cost of debt service |
| | Debt profile and market access | Neutral | 0 | Improving debt profile and investor base |

**Contributions to changes in debt levels**, pps of GDP




Source: Scope Ratings GmbH

**Debt-to-GDP forecasts**, % of GDP




Source: Scope Ratings GmbH

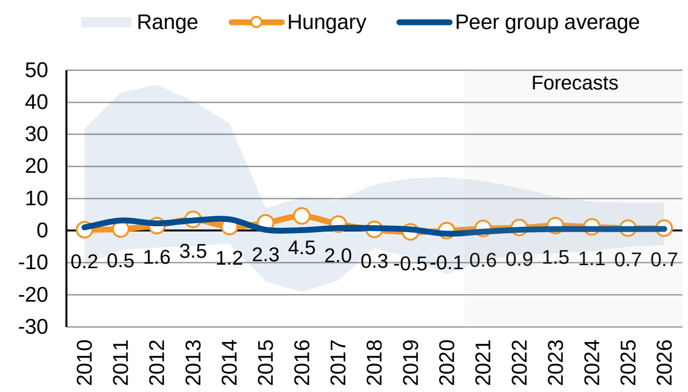
## External Economic Risks

- **Current account:** Hungary registered a current account deficit of 3.1% of GDP in 2021, due in large part to poor goods exports performances in a context of global semiconductor shortages which caused large scale production slow-downs in the automotive industry, while rising energy prices and dynamic domestic demand boosted imports. The Russia-Ukraine crisis should weigh on Hungary's current account balance in the medium-term, due to the two countries' position as suppliers of some key inputs to Hungary's automotive manufacturers. We expect Hungary's current account balance to recover only gradually in coming years and to remain hampered in the medium term by supply chain disruptions, high energy prices and weaker external demand.
- **External position:** The gross external debt increased moderately compared to the pre-crisis, reaching 62% of GDP in September 2021, largely due to general government external borrowing. Its composition remains favorable, with a moderate share of short-term liabilities and declining banking sector external liabilities. The NIIP is negative but moderate in size at less than 45% of GDP as of 2021 Q4, and benefits from a stable composition with a large share of foreign direct investment.
- **Resilience to shocks:** The level of international reserves is adequate. Reserves reached a level of about EUR 36.2 bn in February 2022, remaining above the IMF's reserve adequacy metric. Reserve coverage of short-term debt further improved and provides a comfortable cushion against shocks. The Hungarian economy's high level of integration in regional value chains makes it vulnerable to supply chain disruptions, however, and exposes it the fallout from the Russia-Ukraine crisis.

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

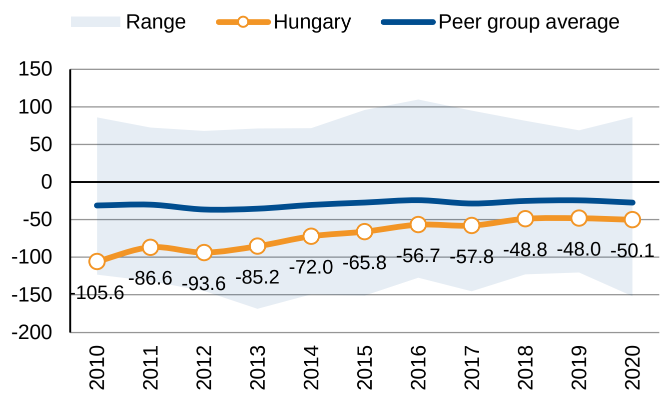
| CVS indicative rating | Analytical component | Assessment | Notch adjustment | Rationale |
|---|---|---|---|---|
| bb | Current account resilience | Neutral | 0 | Stable current account receipts with a manufacturing sector highly integrated in global supply chains |
| | External debt structure | Strong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

**Current account balance,** % of GDP




Source: IMF, Scope Ratings GmbH

**NIIP**, % of GDP




Source: IMF, Scope Ratings GmbH

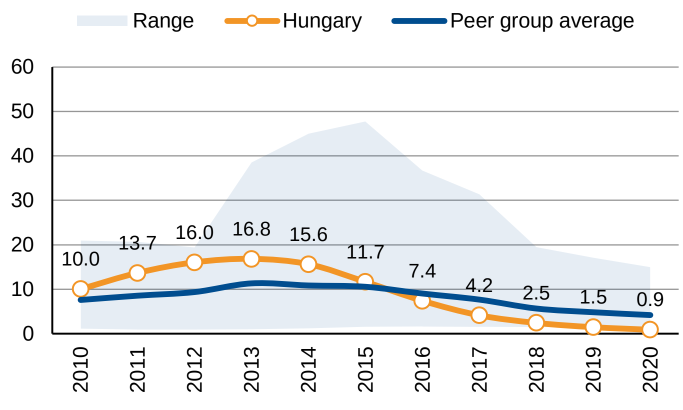
## Financial Stability Risks

- **Banking sector:** The banking sector is well-capitalised, highly liquid with improving asset quality. Macroprudential measures and recovering real estate prices over the past few years supported a decrease in the non-performing loans (NPL) ratio, which fell below 5% of total loans in 2019, from a 2013 peak of 16%. After increasing moderately during the crisis, the NPL ratio declined to 3.0 in 2021 Q3, though they are likely to increase again in the medium term following the partial phase-out of the general payment moratorium programme at the end of September 2021. OTP Bank, the country's largest lender, has material, albeit manageable exposure to Ukraine and Russia where it generates 15.8% of consolidated net profits. The implementation of the EU's sanctions against the Russian banking sector led the MNB to order the closure of Sberbank Hungary, causing, in turn, its liquidation and the disbursement of compensations from the National Deposit Insurance Fund to customers.
- **Private debt:** Credit growth is strong, with loans to non-financial corporations (NFC) and to households growing by 10.7% and 15% in 2021, respectively. The increase was largely driven by housing loans in a context of rising housing prices as well as by state subsidized programmes. Households' indebtedness remains moderate overall, with one of the lowest household debt-to-GDP ratios in the EU (17% as of 2021 Q2), and exposure to interest rate risk has declined in recent years. The increase in NFC debt was largely driven by loans to SMEs, within subsidized schemes.
- **Financial imbalances:** Residential real estate prices continued to increase despite the pandemic, appreciating both in 2020 and 2021, although at lower growth rate than pre-crisis levels. Starting from 2016, government subsidies to households increased significantly and largely increased housing affordability. This uprising trend has underpinned the recent sharp rise in household loans, though the dynamic should moderate in the medium term as subsidized schemes are progressively phased out and as lending rates increase.

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

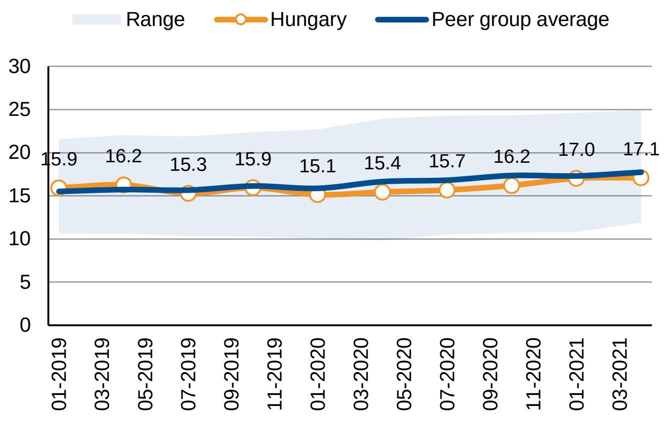
| CVS indicative rating | Analytical component | Assessment | Notch adjustment | Rationale |
|---|---|---|---|---|
| aaa | Banking sector performance | Neutral | 0 | High capitalisation levels; declining profitability from a worsening operating environment |
| | Banking sector oversight | Neutral | 0 | Effective supervisory control; timely and comprehensive regulatory measures |
| | Financial imbalances | Neutral | 0 | Macroprudential measures underpin financial stability |

**NPLs,** % of total loans




Source: IMF, Scope Ratings GmbH

**Tier 1 ratio**, % of risk-weighted assets




Source: IMF, Scope Ratings GmbH

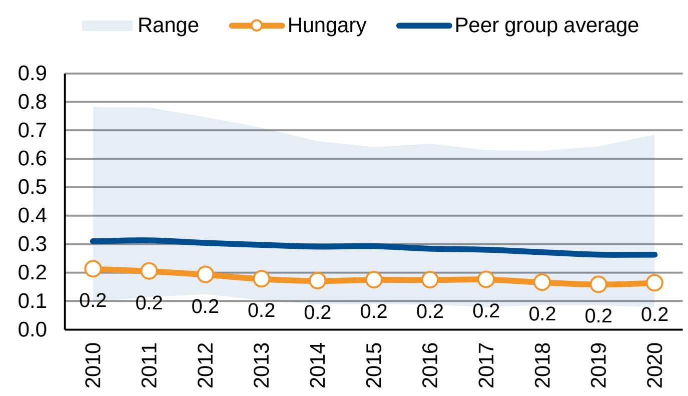
## ESG Risks

- **Environment:** Hungary's economy is energy-intensive, with energy consumption levels well-above the EU average. This is largely due to the high household energy consumption per capita, which remains 12% higher than the EU average, despite considerably lower income levels. The transformation of the coal region, which produces up to 15% of electric power, and the energy-intensive industries represent transition risks in Hungary. Hungary is among the lowest emitters of greenhouse gases per person in the EU and in pre-pandemic years the economy was able to grow reducing GHG emissions. Hungary remains reliant on imported oil and gas for about two-thirds of its energy consumption, however, which exposes it to movements in global energy prices.
- **Social:** While the general labour market situation has been improving in Hungary in recent years, we note persistent employment gaps, which remain wide in EU comparison, including: i) employment gaps between skills groups, with the unemployment rate of the low-skilled at 9.5% in 2019, compared with 3.0% among the medium-skilled and 1.3% among the tertiary graduates; ii) a gender employment gap, reflected by the fact that Hungary has not made progress towards the Sustainable Development Goal 5 (gender equality) in the past nine years, along with limited childcare provision; and iii) rising regional inequalities, with poverty and social exclusion showing strong territorial concentration.
- **Governance:** Relations between Hungary and the EU are likely to remain tense after a period of protracted legal disputes over failure to comply with EU court rulings over the treatment of asylum seekers and on the erosion of the rule of law in the country. The polarised political environment in Hungary and political headwinds with the EU limit long-term policy predictability, which could weigh on future foreign investment inflows and on macroeconomic sustainability given Hungary's high reliance on foreign funding and external demand.

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

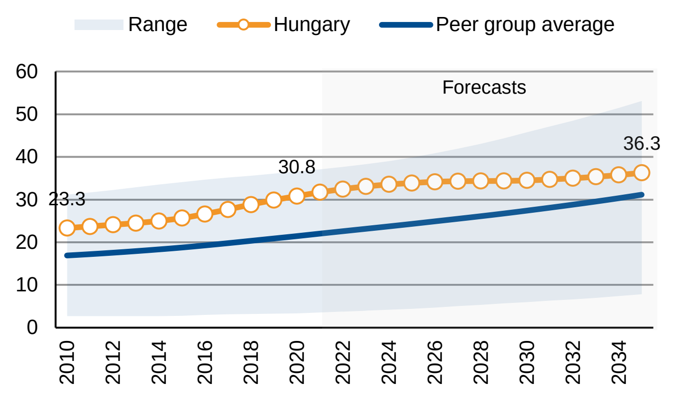
| CVS indicative rating | Analytical component | Assessment | Notch adjustment | Rationale |
|---|---|---|---|---|
| bbb | Environmental risks | Neutral | 0 | Low vulnerability to transition risks and natural disasters risk; poor in natural resources |
| | Social risks | Weak | -1/3 | Substantial employment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

**CO2 emissions per GDP,** mtCO2e



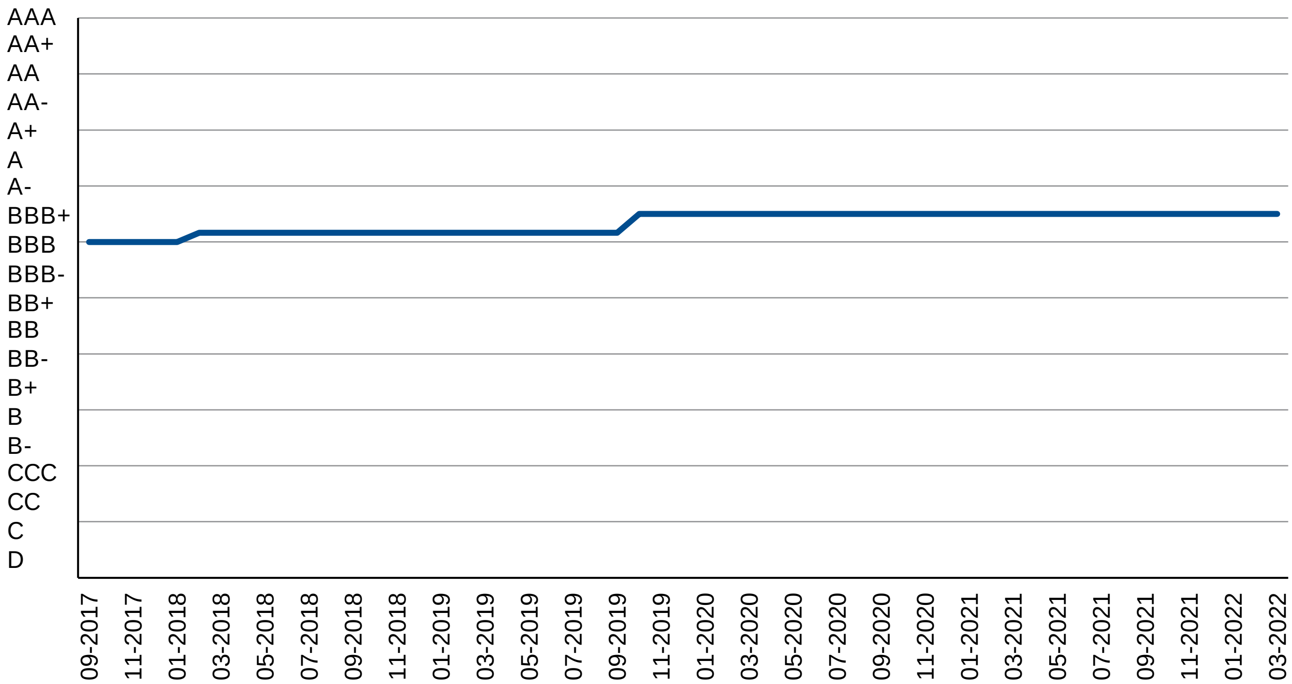

Source: European Commission, Scope Ratings GmbH

**Old age dependency ratio**, %




Source: United Nations, Scope Ratings GmbH

## Appendix I. Rating history




## 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.

| Peer group |
|---|
| Bulgaria |
| China |
| Croatia |
| Cyprus |
| Italy |
| Portugal |
| Romania |
| 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 29) used in Scope's quantitative model, the Core Variable Scorecard.

| | 2016 | 2017 | 2018 | 2019 | 2020 | 2021E | 2022F | 2023F |
|---|---|---|---|---|---|---|---|---|
| **Domestic Economic Risk** | | | | | | | | |
| **GDP per capita, USD 000s'** | 13.1 | 14.6 | 16.4 | 16.7 | 15.9 | 18.5 | 20.4 | 22.2 |
| **Nominal GDP, USD bn** | 128.5 | 143.0 | 160.4 | 163.5 | 155.0 | 181.0 | 199.0 | 216.4 |
| **Real growth, %[1]** | 2.2 | 4.3 | 5.4 | 4.6 | -4.7 | 7.1 | 3.5 | 4.0 |
| **CPI inflation, %** | 0.4 | 2.4 | 2.8 | 3.4 | 3.3 | 4.5 | 3.6 | 3.3 |
| **Unemployment rate, %[1]** | 5.0 | 4.0 | 3.6 | 3.3 | 4.1 | 4.1 | 3.9 | 3.7 |
| **Public Finance Risk** | | | | | | | | |
| **Public debt, % of GDP[1]** | 74.8 | 72.1 | 69.1 | 65.5 | 79.6 | 76.8 | 75.3 | 72.6 |
| **Interest payment, % of government revenue** | 6.7 | 5.9 | 5.2 | 5.0 | 5.2 | 4.8 | 4.7 | 4.0 |
| **Primary balance, % of GDP[1]** | 1.2 | 0.2 | 0.2 | 0.1 | -5.8 | -5.1 | -3.8 | -1.8 |
| **External Economic Risk** | | | | | | | | |
| **Current account balance, % of GDP** | 4.5 | 2.0 | 0.3 | -0.7 | -1.1 | -3.1 | 0.9 | 1.5 |
| **Total reserves, months of imports** | 2.6 | 2.5 | 2.5 | 2.5 | 3.5 | - | - | - |
| **NIIP, % of GDP** | -56.7 | -57.8 | -48.8 | -48.0 | -50.1 | - | - | - |
| **Financial Stability Risk** | | | | | | | | |
| **NPL ratio, % of total loans** | 7.4 | 4.2 | 2.5 | 1.5 | 0.9 | - | - | - |
| **Tier 1 ratio, % of risk weighted assets** | 15.9 | 16.2 | 16.7 | 15.9 | 16.2 | 16.6 | - | - |
| **Credit to private sector, % of GDP** | 33.4 | 32.4 | 32.4 | 33.5 | 38.3 | - | - | - |
| **ESG Risk** | | | | | | | | |
| **$CO^2$ per EUR 1,000 of GDP, $mtCO^2e$** | 174.3 | 175.8 | 165.8 | 158.6 | 163.4 | - | - | - |
| **Income quintile share ratio (S80/S20), x** | 4.8 | 4.9 | 4.6 | - | - | - | - | - |
| **Labour force participation rate, %** | 70.0 | 71.1 | 71.9 | 72.6 | - | - | - | - |
| **Old age dependency ratio, %** | 26.6 | 27.7 | 28.8 | 29.9 | 30.8 | 31.7 | 32.5 | 33.1 |
| **Composite governance indicator[2]** | 0.5 | 0.5 | 0.5 | 0.5 | 0.5 | - | - | - |

[1] Forecasted values are produced by Scope and may differ from those presented in the charts of the previous sections
[2] Average of the six World Bank Governance Indicators
Source: European Commission, IMF, World Bank, Scope Ratings GmbH

## Appendix IV. Economic development and default indicators

| | |
|---|---|
| IMF Development Classification | Emerging market and middle income economy |
| 5y USD CDS spread (bps) as of 25 March 2022 | 22 |

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