23 February 2018 Public Finance

Hungary Rating Report

Credit strengths

- Robust economic performance
- High absorption of EU funds
- Fiscal consolidation
- Improving debt structure

Credit weaknesses

- High government debt
- Low non-price competitiveness
- Labour shortages
- Weakening institutional credibility

Rating rationale and Outlook:

Scope's affirmation of Hungary's BBB rating and the change in the outlook to positive reflects: i) the sovereign's robust economic outlook, along with an on-going pick-up in the absorption of European Union structural funds; ii) the significant progress achieved in reducing external imbalances, driven by sustained current-account surpluses and the deleveraging in the private sector; iii) the consolidation of public finances accompanied by a marked improvement in public debt structure and funding sources; and iv) the stabilising and strengthening financial sector. The Positive Outlook indicates Scope's assessment that upside potential from better-than-expected economic and fiscal outcomes outweighs the risks from the still-high public-debt burden, low non-price competitiveness and labour shortages as well as weakening institutional credibility.

Figure 1: Sovereign scorecard results

Scope's sovereign risk categories	Hungary	Peer comparison		
		Average	Romania	Bulgaria
Domestic economic risk				
Public finance risk				
External economic risk				
Financial risk				
Political and institutional risk				
Qualitative adjustment (notches)	-		-	-
Final rating	BBB		BBB	BBB

AAA AA A BBB BB B CCC CC C

Positive rating-change drivers

- Sustained debt reduction
- Continued FDI inflows, improvements in non-price competitiveness, supporting high growth potential
- Institutional credibility ensuring adequate economic policy

Negative rating-change drivers

- Reversal of fiscal consolidation
- Lower-than-expected absorption of EU funds and reversal of FDI inflows
- Rise in external vulnerabilities
- Incoherent economic policies

Ratings and Outlook

Foreign currency

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

Local currency

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

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Bloomberg: SCOP

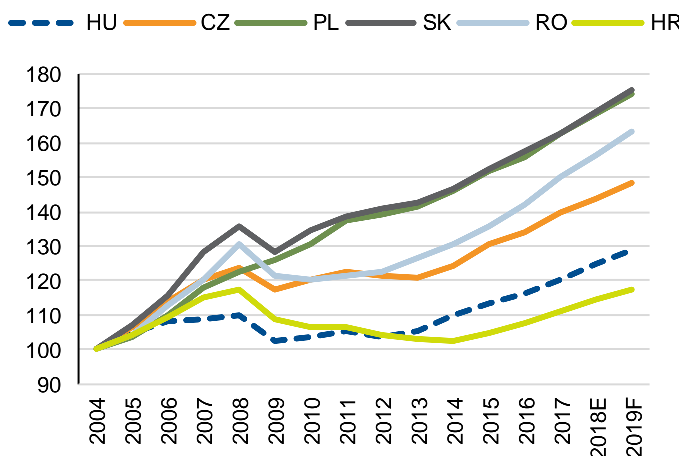
Domestic economic risk

Growth potential of the economy

Robust growth prospects but still catching up with peers

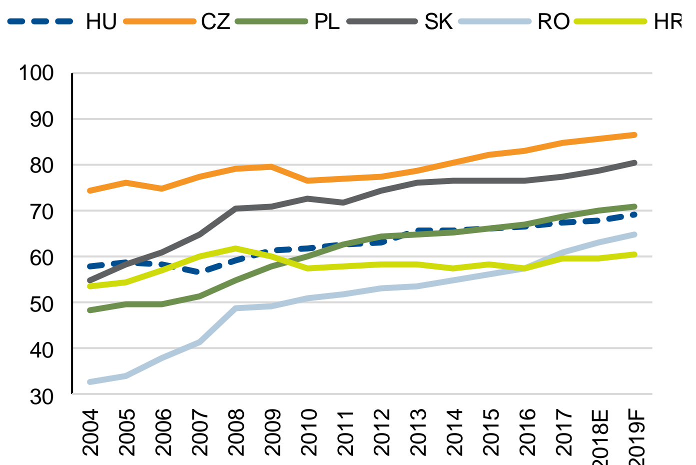
After a successful exit from the EU's Balance of Payments programme in November 2010[1], Hungary's economy grew robustly for 19 consecutive quarters, averaging around 3.1% of real growth since 2013. This was driven mainly by: i) private consumption as labour markets improved (the number of persons employed increased by around 730,000 between 2010 and 2017 while unemployment is expected to fall to 4.0% in 2018, down from 11.2% in 2010); coupled with ii) continued investments, particularly financed by EU structural funds; and iii) a favourable external environment, enabling Hungary to generate strong current-account surpluses and thus reduce external imbalances. However, compared to its Visegrád[2] peers, real GDP growth has been subdued since Hungary's EU accession in 2004, while GDP per capita, on a purchasing power standard (PPS) basis, remains relatively low, at around 70% of the EU28 average.

Figure 2: Real GDP growth (2004=100)



Source: European Commission, Calculations Scope Ratings GmbH

Figure 3: GDP per capita (PPS, % of EU28 average)



Source: European Commission, Calculations Scope Ratings GmbH

Growth driven by private consumption and investment, especially EU structural funds

Going forward, Scope expects private consumption to remain strong, notably because of the robust labour market and rising minimum wage (up by 18% in 2017) which will increase income for around one million workers or 25% of all those employed[3]. However, higher incomes are also likely to lift demand for imports, reducing the overall positive contribution to the economy from net exports, which is expected to continue given strong demand in Hungary's main export market, the EU. In fact, the second and third quarters of 2017 recorded strong growth in imports of goods, more than offsetting the growth in exports and thus resulting in a negative contribution from net exports.

Contributions from the public sector are also expected to be positive over the coming years. Public consumption is likely to intensify leading up to the 2018 parliamentary elections. Public investment slowed down in 2016-17 (as was the case for other Visegrád members) driven by the lower absorption of EU structural funds related to the transition to the new 2014-2020 EU multiannual framework.

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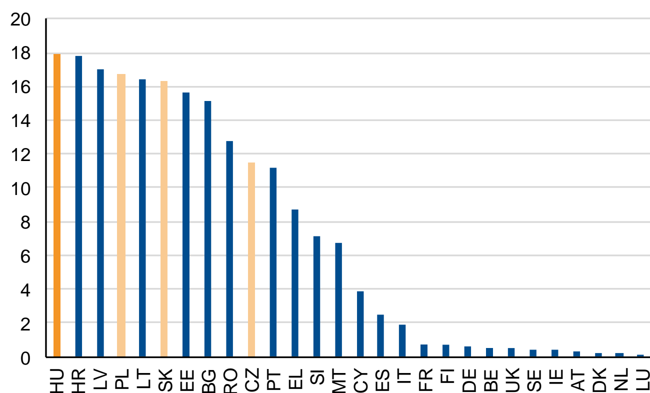
[1] Hungary received EUR 14.2bn, of which EUR 8.7bn came from the IMF and EUR 5.5bn from the EU. The final repayment was completed by April 2016.
[2] The Visegrád Group was formed in February 1991 by the heads of state of Hungary, Poland and the then Czechoslovakia (today both countries, the Czech Republic and Slovakia, are part of the group) to further their EU integration process and cooperate on military, economic and energy-sector affairs.
[3] Hungarian Central Statistical Office, Statistical Reflections, Minimum of subsistence, 2013, 13 June 2014.

It is, however, now set to rebound as the disbursement of structural funds, and associated co-financing from the Hungarian authorities, accelerates. Scope notes that over the 2014-2020 time period, Hungary is expected to receive EUR 22bn in EU structural and cohesion funds, making it the sixth-largest recipient of EU funds in absolute terms and the first in terms of percentage of 2017 GDP.

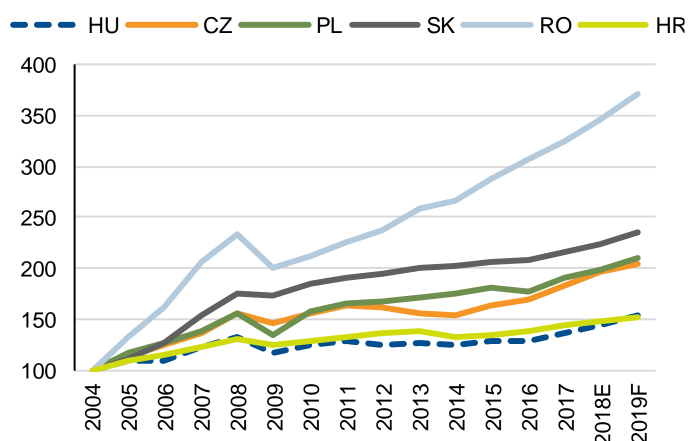
In addition, strong Purchasing Manager Indices (around 60) and new manufacturing orders point to the continued strength in private-sector investment. According to the Hungarian Investment Promotion Agency, large-scale developments in the automotive sector and shared service centres were recently announced by large corporations, including Mercedes-Benz, Samsung and Procter & Gamble, amounting to almost HUF 1,200bn (around 1% of GDP). In 2017 alone, 96 positive investment decisions amounting to EUR 3.5bn were made[4]. However, according to the IMF (2016), the state is expanding its role in the economy, particularly in the banking and energy sectors, which may have an adverse effect on some investment prospects.

Figure 4: EU structural funds allocations 2014-20 (% GDP)



Source: European Commission

Figure 5: Productivity growth (in output per person employed, 2004=100)



Source: European Commission

While the short-to-medium-term growth outlook is robust, Hungary's long-term economic growth prospects face considerable challenges. While Hungary's real unit labour costs remain in line with EU28 and Visegrád member averages, non-price competitiveness indicators point to several shortcomings. Productivity, measured as output per employed person, has lagged that of peers since 2004. Hungary's potential growth also depends on the country's ability to embrace the turning point in the automotive industry where e-mobility and digitalization are becoming the driving factors. As the Hungarian central bank (Magyar Nemzeti Bank or MNB) notes, education and infrastructure as well as an increase in the importance of creative industries and services, are key for the shift towards the production of higher value added[5].

In addition, The European Commission[6] noted that Hungary remains among those EU member states with the highest skills mismatches, based on differential employment and unemployment rates for high, medium and low-skilled workers. Finally, demographic trends are poor, with a decline in the working-age population every year since 1997 leading to a cumulative loss of around 450,000 persons, despite positive net migration.

[4] https://hipa.hu/quality-is-the-new-quantity-in-fdi
[5] MNB, Growth Report 2017
[6] European Commission, Country Report Hungary 2016, February 2016

The setting up of the new National Competitiveness Council, a consultative board for governmental interventions, reflects the government's ambition of addressing these structural issues and improving the business climate.[7]

Economic policy framework

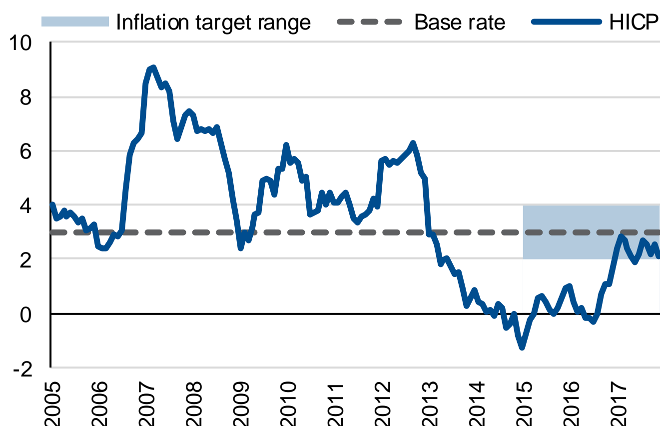
Accommodative monetary policy stance

Economic growth has also benefited from an effective economic policy framework overall, in particular, the accommodative monetary policy pursued by the Hungarian central bank and its implementation of non-standard monetary policy measures. These include: i) mobilising excess liquidity into government securities and money markets, as well as into the private sector by lowering the base rate (now at an all-time low of 0.9%); ii) narrowing the interest-rate corridor; iii) reducing the liquidity of the underlying instruments for the key policy rate; iv) extending maturities; v) reducing the frequency of its auctions; and vi) capping tendered amounts[8]. These efforts have pushed inflation into the MNB's target range of 3% (+/- 1%) and, since the beginning of 2017, have also improved private credit flows.

Going forward, Scope expects that inflationary pressures – resulting from relatively high employment participation (around 68%) and increased wage levels (approx. 22% higher than 2015), real estate value increases (+17% since January 2015[9]) as well as the value of the Hungarian stock market index more than doubling over the past two years – could lead to a gradual reversal of the accommodative monetary policy stance.

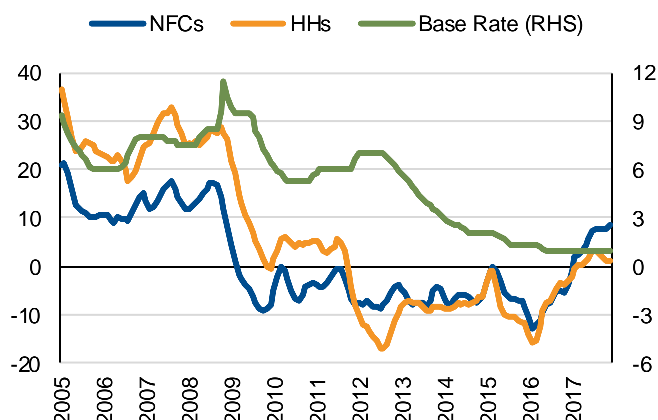
At the same time, while the accommodative monetary policy appears adequate overall, Scope is mindful that the independence of the Hungarian National Bank has been curtailed by the current government, as emphasized by the ECB on several occasions. The concerns relate to the potential conflict with the monetary financing prohibition, as well as the independence of the composition of the MNB's decision making bodies. These developments could affect the adequacy of the MNB's monetary policy stance going forward, particularly in light of the growing need for a prudent macro-economic policy stance as inflation keeps rising[10].

Figure 6: HICP & target inflation rate (%)



Source: Eurostat, Hungarian National Bank

Figure 7: Base rate (%), loans to NFCs & households (YoY growth, %, 3mma)



Source: European Central Bank

[7] The National Competitiveness Council has already proposed measures to facilitate the licensing of investments and the simplification of company formation, including the automation of registering for local tax.
[8] IMF, Article IV Consultation, Country Report No. 17/123, May 2017
[9] New houses only. Central statistical office.
[10] https://www.ecb.europa.eu/pub/pdf/annrep/ar2016en.pdf, https://www.ecb.europa.eu/ecb/legal/pdf/en_con_2012_26_f_sign.pdf

Hungary's fiscal policy framework is robust and adequate. The country successfully exited the EU's Excessive Deficit Procedure in June 2013, having recorded fiscal deficits below the Maastricht threshold of 3% of GDP since 2012, with deficits somewhat higher than those of the Czech Republic but lower than those of Poland. Scope expects Hungary to continue to adhere to its Fundamental Law, which stipulates that as long as the debt-to-GDP ratio remains higher than 50%, budgets can only be approved if they also lead to a reduction in the debt ratio. The government's Convergence Programme of April 2017 underscores its continuing commitment to fiscal prudence and the cutting of debt levels to around 60% of GDP by 2021.

Adequate fiscal framework

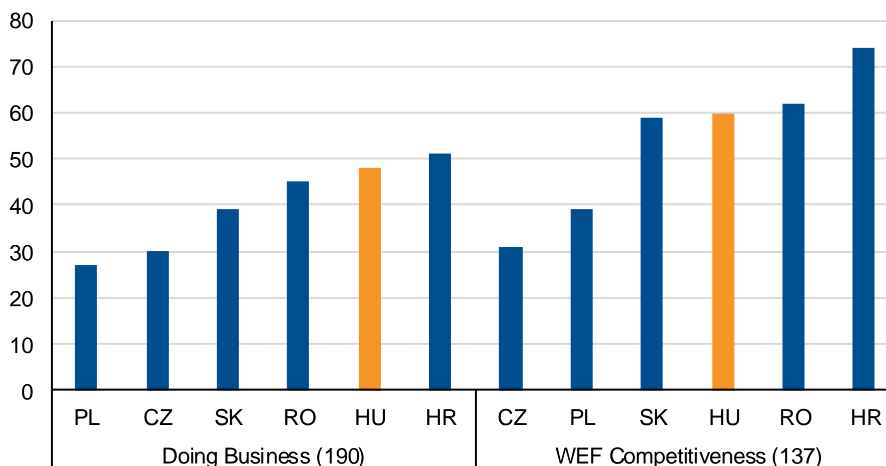
Overall, the country's track record of reduced budget deficits is in line with that of Hungary's Visegrád peers, and confirms the country's commitment to fiscal consolidation and adherence to European fiscal rules.

Deteriorating business environment

However, Scope notes that the economic policy framework is constrained by the weak business environment. The World Bank's 2017 Doing Business report ranked Hungary 41st out of 190 countries (22nd place among the EU28), with the country scoring particularly poorly on the availability of electricity (121st), payment of taxes (77th) and starting a business (75th). The World Economic Forum's competitiveness indicator ranks Hungary 60th out of 137 countries (24th place among the EU28, ahead of only Cyprus, Romania, Croatia, and Greece), highlighting institutional shortcomings, especially the efficiency of the legal framework in challenging regulations, favouritism and a lack of transparency in government policymaking, the country's ability to attract and retain talent, as well as the quality of education.

Figure 8: Competitiveness rankings

World Bank index and WEF Competitiveness Report



Source: World Bank, World Economic Forum

Macroeconomic stability and imbalances

Scope has a positive view of Hungary's exit from the EU's Balance of Payments programme in November 2010 and the EU's Excessive Deficit Procedure in June 2013, having recorded fiscal deficits below the Maastricht threshold of 3% of GDP since 2012. Macro-economic imbalances have not resurged since. In addition, the economy is relatively balanced, between a large manufacturing sector with automotive but also shared-service centres.

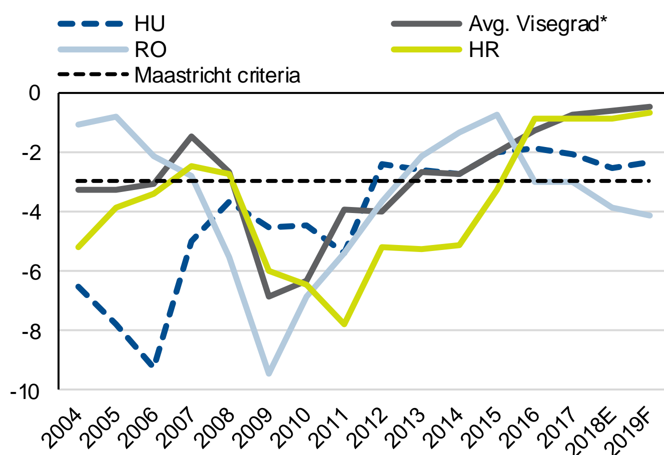
Public finance risk

Fiscal performance

Ongoing fiscal consolidation but debt levels still high

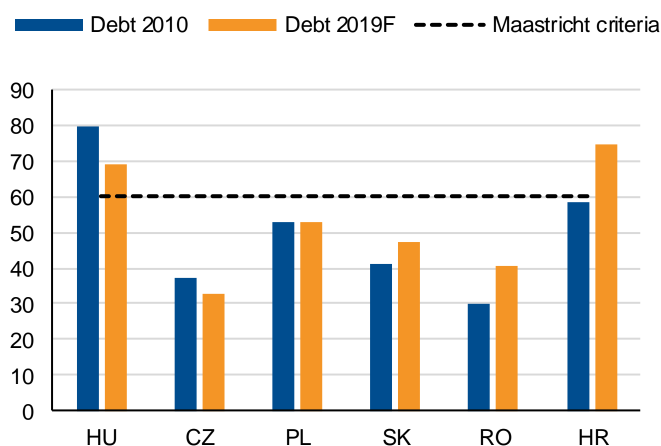
While the Hungarian authorities have consolidated public finances over the past few years, recording deficits below the 3% Maastricht criterion since 2012, Hungary's relatively high debt levels represent a key weakness in its sovereign credit profile. This is particularly the case given the country's comparatively low GDP per capita income. While the debt-to-GDP ratio has fallen every year (down to 73% in 2017 since peaking at 80% in 2011), it remains well above the 60% threshold set by the Maastricht criteria, with Hungary representing the only Visegrád country to exceed that threshold.

Figure 9: Fiscal balances, % of GDP



Source: European Commission; *Average for CZ, PL and SK.

Figure 10: Debt levels, % of GDP



Source: European Commission

Fiscal balances below Maastricht threshold

Going forward, Scope expects the government to adhere to the Maastricht 3% deficit criteria, despite higher expenditures and lower tax rates. The direct budgetary effect of the recently adopted six-year wage agreement (which included raising the minimum wage by 15% and the guaranteed wage minimum by 25%, reducing employers' social contributions from 27% to 20% and lowering the corporate income tax from 19% to 9% – the lowest rate in the EU[11]) amounts to about 1.4% of GDP in 2017 and 1.6% in 2018[12]. In addition, ahead of the elections, the government announced a reduction of the VAT on the sale of new apartments from 27% to 5%, tax reimbursements for families building a home, and the introduction of the Family Housing Subsidy Scheme with subsidised interest-rate loans. Expenditures on capital projects are also likely to continue to rise with the resumption of EU structural funds. While these measures are set to enlarge the deficit somewhat over the coming two years, higher economic growth and positive wage dynamics should help offset direct budgetary outlays.

Scope notes that the government's Convergence Programme of April 2017 underscores its continuing commitment to fiscal prudence and the cutting of debt levels to around 60% of GDP by 2021. Scope expects Hungary to continue on its course of fiscal consolidation, also due to the current government's ambition of reducing the EU's spheres of competence, including on tax and social policies, as laid out in Prime Minister Orbán's state of the union speech in February 2017, and again at the Visegrád Group conference on "The Future of Europe" in January 2018[13]. In this context, any breach of the Maastricht

[11] According to the Ministry of Finance, this policy reduces Hungary's tax wedge from 48% to 41%.
[12] Hungary's Convergence Programme, 2017-2021, April 2017
[13] http://www.kormany.hu/en/the-prime-minister/the-prime-minister-s-speeches/viktor-orban-s-speech-at-the-visegrad-group-conference-the-future-of-europe

deficit criteria, which would (re)open an intrusive excessive deficit procedure, would be costly from a fiscal, and especially political, point of view.

High government guarantees offset by manageable ageing-related expenditures

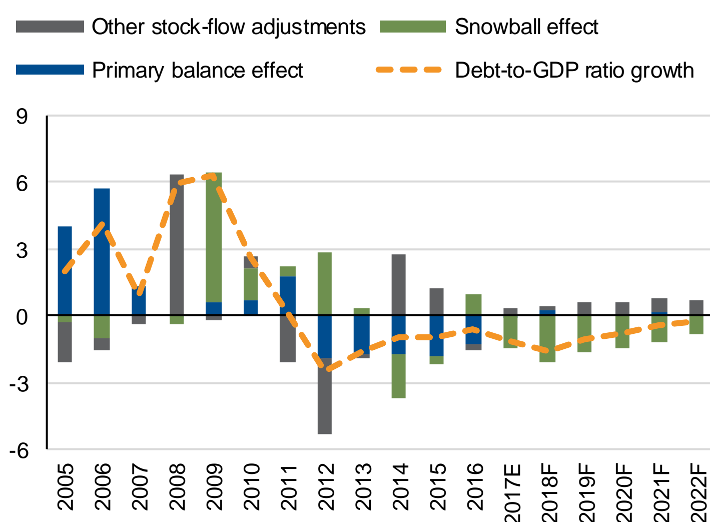
Scope considers Hungary's contingent liabilities to be mixed, with relatively high guarantees due to the large role of the state in the economy, tempered by expenditures resulting from an ageing population. These expenditures are, however, expected to be manageable. According to the IMF[14], at the end of 2015 the government had issued guarantees of up to 9% of GDP, levels which were significantly higher than those of its peers (with Poland at 6% and both the Czech Republic and Slovakia below 1% of GDP). On the other hand, according to the European Commission's 2015 Ageing Report, long-term-health and pension-related expenditures amounted to around 16% of GDP in 2013, in line with peers and below the EU28 average. The EC's projections to 2060 envisage the stable development of pensions with only a minimal increase in healthcare-related spending, reducing the risk of significant additional ageing-related expenditures. Similarly, the IMF highlights the fact that the net present value of pension- and health-care related liabilities from 2015-2050 amounts to 6.9%, significantly below Hungary's peers Slovakia (29.3%), the Czech Republic (29.4%), Poland (32.4%) and Romania (40.4%)[15].

Debt sustainability

Adequate debt dynamics, even in stressed scenario

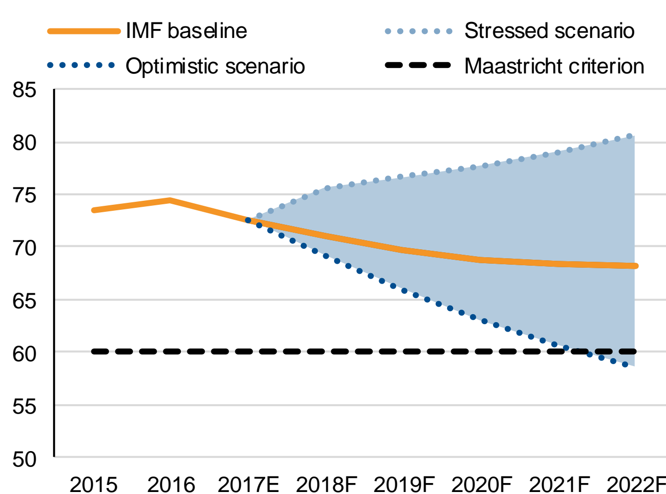
Scope's public debt sustainability analysis, based on IMF forecasts and a combination of growth, interest-rate, primary-balance and foreign-currency shocks, confirms that slower growth remains the key risk to Hungary's debt sustainability. The results reflect Hungary's high debt level, expected narrow fiscal deficits going forward, as well as a more moderate exchange rate sensitivity given the reduction in foreign-currency-denominated debt. Scope's baseline scenario is for the debt-to-GDP ratio to fall slightly below 70% by 2022, while a more adverse scenario, assuming a combined one percentage point shock for each year over the forecast horizon to real GDP growth (lower), interest payments (higher), the primary balance (lower) and a 10% depreciation in the forint, would lead to a debt-to-GDP level of around 80% by 2022. This would still be below the peak of 2011 and in line with some of Scope's other BBB rated sovereigns.

Figure 11: Contribution to gov. debt changes, % of GDP



Source: IMF, Calculations Scope Ratings GmbH. NB Other includes exchange rate effects and stock-flow adjustments.

Figure 12: Government debt, % of GDP



Source: Calculations Scope Ratings GmbH

[14] IMF, Article IV Consultation, Country Report No. 17/123, May 2017
[15] IMF's October 2017 Fiscal Monitor.

Scenario	Time period	Real GDP growth (%)	Primary bal. (% of GDP)	Real eff. int. rate (%)	Debt end period (% of GDP)
History	2013-2017	2.9	1.3	2.3	72.9
IMF baseline	2018-2022	2.7	-0.1	0.7	68.7
Optimistic scenario		3.2	0.9	0.5	58.9
Stressed scenario		1.7	-1.1	1.7	80.9

Source: IMF, Ministry of Finance, Calculations Scope Ratings GmbH

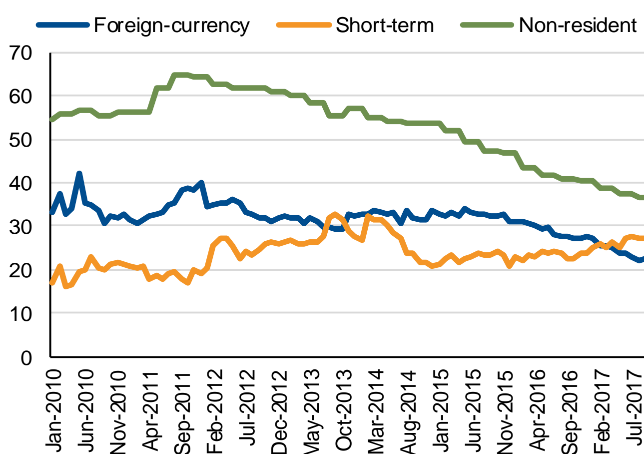
Market access and funding sources

Significantly improved debt structure and funding strategy

Despite Hungary's relatively high debt levels, the country's debt structure has improved significantly over the past few years, reflecting the debt management office's prudent debt funding strategy[16] aimed at developing the domestic investor base, keeping foreign-currency debt within a 15-25% share of total debt, and mitigating cross-currency exchange rate risks by using euro swaps for all foreign-currency obligations. Thanks to this successful strategy, the share of foreign-currency-denominated debt has decreased by more than 10 percentage points of total debt since 2010. This reduction was also supported by the MNB's self-financing programme[17]. According to the government's debt management agency, the AKK, total gross issuance in 2018 is planned at HUF 8.8bn, 95% of which will be in domestic currency and only 5% in foreign currencies.

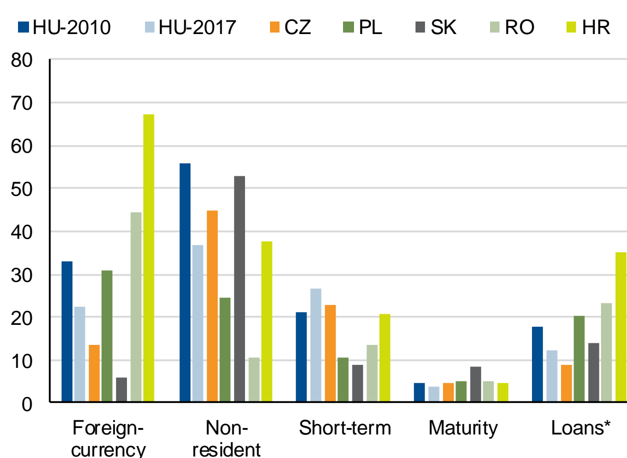
Hungary's share of short-term debt hovers around 25%, with an average four-year maturity for issued securities, in line with its peers. Debt held by non-residents has decreased markedly from a share of above 60% in 2011 to below 40% in 2017, which in turn was absorbed mostly by banks (driven by the self-financing programme) and households (via the government retail programme), in line with the debt management office's strategy of developing the domestic investor base. It is Scope's opinion that these structural changes in the composition of Hungary's debt, combined with a solid cash buffer of approx. 5% of GDP and continued investor demand significantly reduce the sovereign's refinancing risk.

Figure 13: Evolution of Hungarian government debt structure, % of total public debt stock



Source: European Central Bank

Figure 14: Government debt structure comparison with peers, % of total debt securities, Q4 2017



Source: European Central Bank, Eurostat, National central banks. *Loans for HU-2010 refer to 2013 data, earliest available. Non-resident data refer to Q3 2017. Maturity refers to years.

[16] AKK, Debt Management Outlook 2018, December 2017. http://www.akk.hu/uploads/Y79ggRw0.pdf
[17] Under the programme, the MNB transformed the liquidity profile of central bank instruments, prompting banks to shift their funds towards liquid securities, specifically the government securities market. The Hungarian government refinanced maturing foreign-currency debt in forint (IMF, 2017).

External economic risk

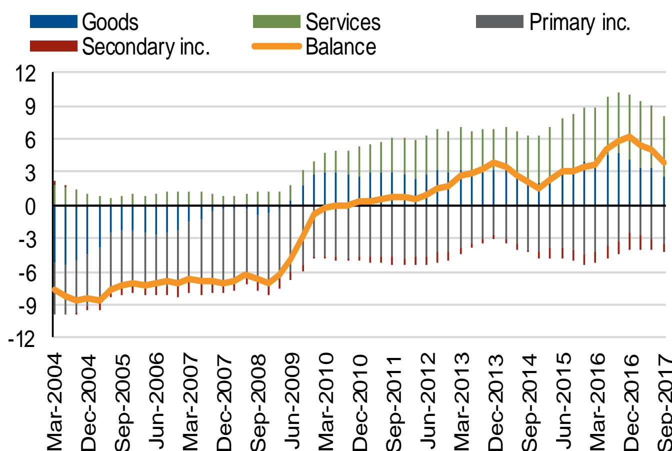
Current-account vulnerabilities

Reduced external imbalances

Hungary's external vulnerabilities have been reduced by sustained current-account surpluses since 2010, deleveraging in the banking sector, the redemption of loans granted under Balance of Payments assistance, as well as the government substituting government external debt for domestic issues, supported by the MNB's self-financing programme.

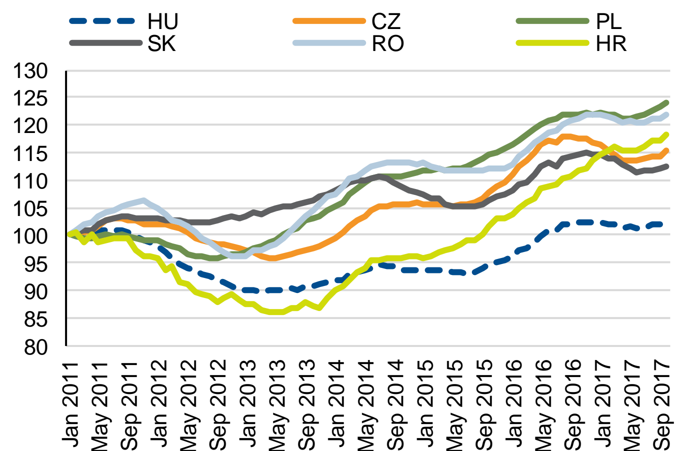
The turnaround of the current account was driven by sustained net exports of goods and services, particularly in transportation, tourism and business services. Scope expects Hungarian exports to continue to grow, driven by the favourable external environment (supported by increasing world trade, improving net new manufacturing orders and strong confidence indicators) and Hungary's heightened export capacity (the result of significant foreign direct investment). However, despite the expected increase in exports, and in contrast to Visegrád peers, Hungary's share of world exports has only recently exceeded 2010 levels and is still behind its peers. According to OECD 2017 data[18], the stock of inward foreign direct investment in Hungary has fallen over recent years, potentially weighing on future export performance. In addition, stronger domestic demand, driven by higher wages and investments, is increasing import demand, reducing the positive contribution to growth from the external sector.

Figure 15: Current account breakdown, % of GDP



Source: Statistical Office of the European Communities

Figure 16: Share of world exports, 2011=100



Source: IMF

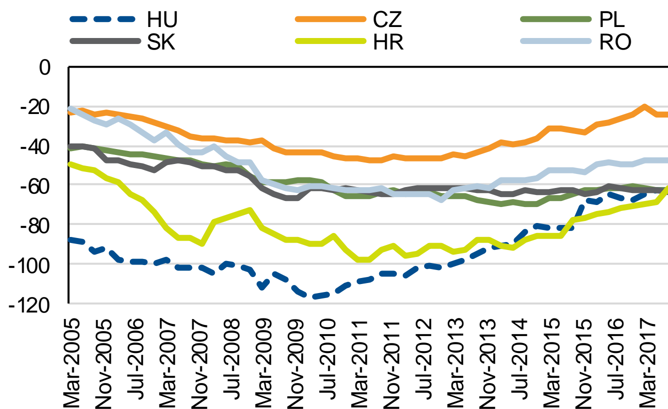
External debt sustainability

Adequate reserve coverage

Over the past few years, these positive developments have led to a marked decline in Hungary's external debt and an improvement in the country's net international investment position, which now conforms to that of other Visegrád members at around -60% of GDP. Based on MNB data, gross external debt declined to 89% of GDP in Q3 2017 from 156% of GDP in Q2 2010 and, accordingly, external public debt dropped to around 32% of GDP. As of Q3 2017, 53% of gross foreign liabilities are related to direct investments, reducing the potential impact of any possible reversal of capital inflows resulting from a normalisation of US and euro-area monetary policies. In addition, the maturity profile of external liabilities has also improved, with the share of short-term external liabilities falling to around 12% in Q3 2017 from 17% back in 2010, in line with Poland (12.8%) and Croatia (10%) and significantly below the Czech Republic (57%) and Slovakia (42%).

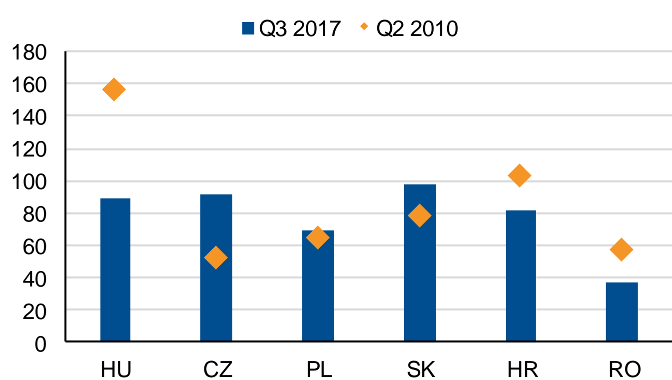
[18] http://www.oecd.org/daf/inv/investment-policy/FDI-in-Figures-July-2017.xlsx

Figure 17: Net international investment position, % of GDP



Source: National central banks and statistical offices, Eurostat

Figure 18: External debt, % of GDP



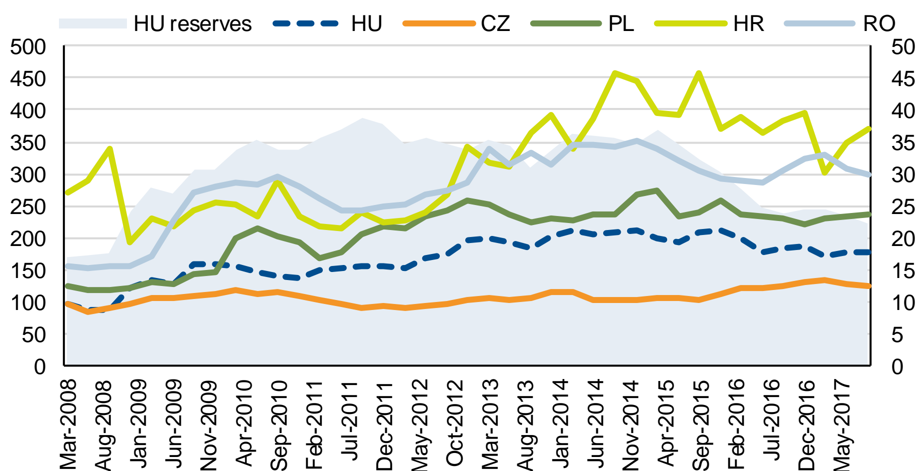
Source: National central banks, Eurostat

Vulnerability to short-term shocks

Foreign-currency reserves have halved over the past five years, down to around EUR 24bn in Q4 2017, reflecting the conversion of foreign-currency loans by the banking sector (for which the MNB provided around EUR 9bn) and the repayment of government foreign-currency debt via the self-financing programme. However, the reserves-to-short-term-external-debt ratio remains elevated at around 170%, in line with Visegrád peers. Going forward, Scope expects reserves to stabilise or even increase as the foreign-currency conversion programme is phased out and EU structural funds pick up.

In addition, Scope is mindful that Hungary's exchange rate has been relatively stable since 2014 at around 310 forint/euro. However, Scope notes that while pressure on the exchange rate is likely to support economic growth via expenditure switching, as foreign goods become more expensive and exports cheaper (trade channel), the depreciation would adversely affect borrowers' balance sheets by raising the value of foreign-currency debt. It is this financial channel which exposes Hungary to short-term shocks: a sharp currency depreciation, possibly caused by heightened domestic political risks or a change in global market sentiment, could adversely affect economic growth in Hungary.

Figure 19: Reserves and short-term debt coverage (%), reserves EUR bn (RHS)



Source: National central banks

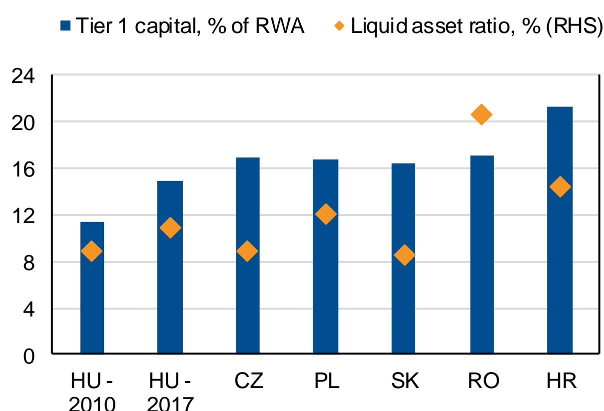
Financial stability risk

Financial sector performance

Better-capitalised banking sector has returned to profitability

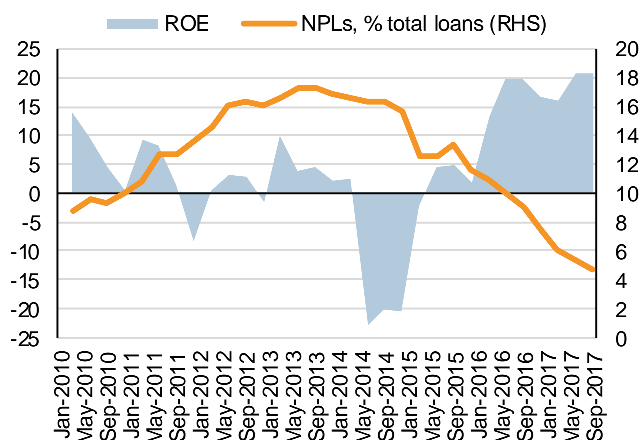
After years of deleveraging, the banking sector is well capitalised, with a common equity tier 1 ratio of 15%, and liquid, posting a liquid asset ratio of around 28%, similar to that of other Visegrád members. After heavy losses in 2014, the banking sector returned to profitability, mostly due to lower provisions, as well as a reduced sectoral tax, posting a return on equity of around 21% in Q3 2017. However, in its November 2017 financial stability report, the MNB calculated that the banking sector's after-tax return on equity of around 14% in Q2 2017, after adjusting for one-offs, would still be around 5-7%. Asset quality has also improved, with non-performing loans declining markedly to around 5% of gross loans, down from over 17% in 2013, supported by the MNB's asset management company (MARK) for commercial real estate[19].

Figure 20: Banking sector capitalisation and liquidity, %



Source: IMF

Figure 21: Banking sector asset quality and profitability, %



Source: IMF

Financial sector oversight and governance

Governance has changed from foreign to government ownership

Over the past few years, the banking sector has experienced a notable structural governance shift, away from foreign and towards government ownership, in line with Prime Minister Orbán's objective of gaining domestic ownership over at least half of the banking sector. Following the government purchase of several foreign banks, including MKB in 2014, Budapest Bank in 2015, and a part of Erste Bank in 2016, the proportion of foreign banks declined from about 70% of total assets to around 50%. At the same time, state participation in the financial sector now stands at around 60%, although it is still below 50% in commercial banking[20]. This shift may also have been induced by the introduction of the bank levy, the financial transaction tax and losses resulting from forced rescue schemes in support of foreign-currency mortgage holders.

Regulatory oversight may be weakening

The sector has also undergone an important change from a regulatory perspective. In 2013, the central bank absorbed the Hungarian Financial Supervisory Authority, the then financial sector regulator. According to a Hungarian State Audit Office report in April 2015[21], this regulatory consolidation undermined the system's ability to provide effective enforcement.

[19] MARK was set up with a EUR 1bn loan from the central bank in autumn 2014. It became operational in March 2016, following an agreement with the European Commission in February 2016 to avoid state-aid issues.
[20] https://www.state.gov/e/eb/rls/othr/ics/investmentclimatestatements/index.htm#wrapper
[21] https://www.asz.hu/storage/files/files/Angol_portal/reports_on_the_sao_annual_activity/2015_sao_activity_report.pdf?ctid=520

In March 2015, insolvency, lax regulations and alleged embezzlement resulted in the failure of three brokerage firms, leading to a total loss of about 1% of GDP[22]. On the other hand, as of 1 January 2017, the MNB imposed a systemic risk buffer for commercial real estate loans, while for mortgages regulation on payment-to-income and caps on loan-to-value ratios were introduced in January 2015. Furthermore, from 1 January 2016, 100% coverage of foreign-exchange funding was introduced while limits on the currency mismatches between the banks' foreign-currency assets and liabilities were set to a maximum of 15% of the balance sheet total. In addition, the government lowered the levy on larger banks, from 0.53% to 0.24% of assets. The government also reached a Memorandum of Understanding with the European Bank for Reconstruction and Development in early 2015 to sell public stakes in large banks within three years, which should further improve the functioning of the banking sector[23]. Based on this analysis, Scope believes that the banking sector does not pose immediate, direct risks to the sovereign.

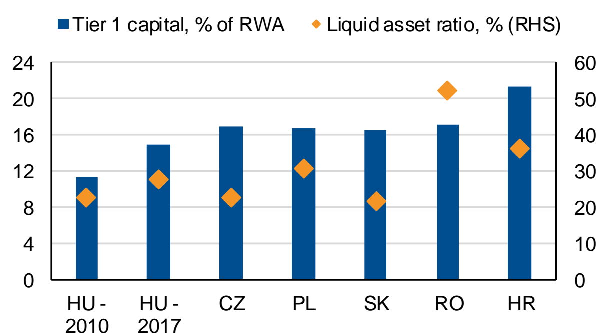
Macro-financial vulnerabilities and fragility

Rise in house prices still in line with fundamentals

The MNB's Market-Based Lending Scheme, which offers incentives to banks that commit to increasing their lending to SMEs, has increased bank-based financing to the private sector. Credit flows to non-financial corporations and households were positive in 2017, pointing to an end to the deleveraging cycle during which the private sector (non-financial corporations and households) reduced its outstanding debt by about 50 percentage points of GDP since 2010. In Scope's view, given the deleveraging process over the past few years, private-sector debt levels do not constitute a significant source of risk to the sovereign, and are in line with other BBB rated peers.

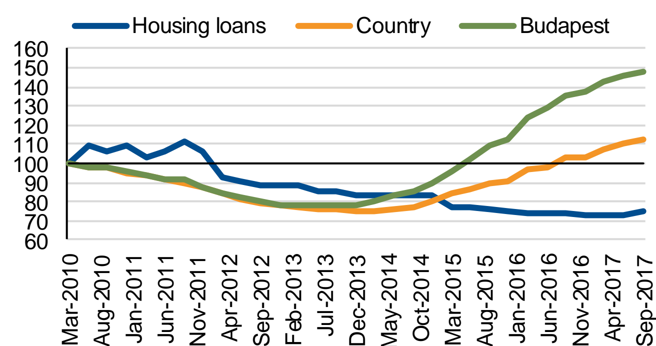
The rise in housing prices, particularly in Budapest, needs to be assessed within this context. Since 2015, prices have increased by around 50% in the capital city. However, this post-crisis recovery was mostly driven by rising real incomes, the low interest rate environment and pent-up demand from postponed home purchases from previous years[24], rather than by an increase in housing credit, which is curbed by the MNB's debt cap rules, in place since 2015. According to the MNB's financial stability report[25], the price levels in the housing market are still below the equilibrium level justified by macroeconomic fundamentals, and, in fact, the property market boom has had a positive impact on the recovery of foreclosure procedures.

Figure 22: Private-sector debt, % of GDP



Source: European Central Bank

Figure 23: Housing prices and loans, 2010=100



Source: Hungary Central Statistical Office

[22] https://www.state.gov/e/eb/rls/othr/ics/2016/eur/254371.htm
[23] https://www.oecd.org/eco/surveys/hungary-2016-OECD-economic-survey-overview.pdf
[24] Hungary's Convergence Programme 2017-2021, April 2017
[25] https://www.mnb.hu/letoltes/stabilitasi-jelentes-2017-november-eng.PDF

Finally, Scope is mindful that the largest part of the outstanding retail housing loans are still variable rate loans or loans with interest fixed for less than one year, increasing financial stability vulnerabilities. However, the measures of the MNB, announced in November 2017 – the interest rate swap facilities and the mortgage bond purchase programme – should facilitate growth in the ratio of loans with interest fixed for longer than one year, abating these concerns going forward[26].

Institutional and political risk

Perceived willingness to pay

Hungary joined the European Union in 2004 and has fully adopted the EU's regulatory framework, providing an anchor for institutional stability and predictability. In Scope's view, Hungary is as likely as any EU peer to honour debt obligations in full and on time.

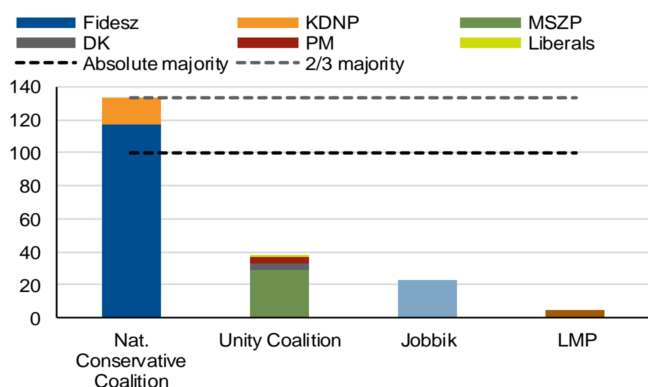
Recent events and policy decisions

Hungary has been ruled since 2010 by a Fidesz-KDNP (Hungarian Civic Union and Christian Democratic People's Party) coalition led by Prime Minister Viktor Orbán. Following a by-election in February 2015, the government lost the two-thirds majority needed to amend the constitution, but still governs with an absolute majority. Elections are scheduled for 8 April 2018 and, based on current polls, Fidesz is expected to continue governing, cementing its ruling position, ensuring policy continuity. The withdrawal of the prime ministerial candidate of the Socialist Party (MSZP) in October 2017 confirms this.

Political stability at the expense of independent institutions affecting business environment

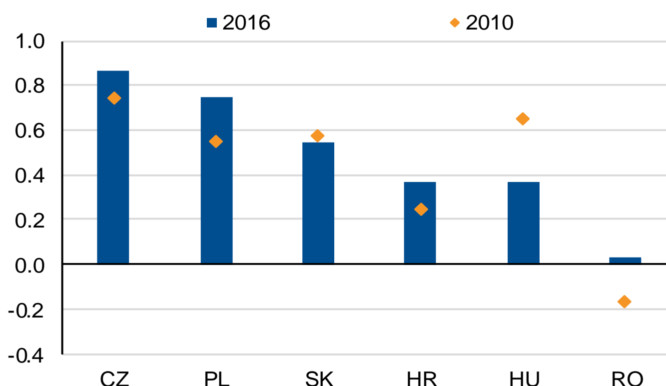
However, the current government's consolidation of political power has come at the expense of independent institutions, especially affecting the central bank and judiciary, fair democratic processes and a free media. Despite its EU membership, the current government has been in legal conflict with European Union institutions over shortcomings in the government's respect for human rights, democracy and the rule of law. In addition, the government openly declared that Hungarians should own at least half of the banking, media, energy and retail sectors. Many foreign companies have noted the relative unpredictability of Hungary's regulatory system, with the implementation of legal and tax changes without proper consultation with the businesses affected. In fact, in 2010-2012, the banking, energy, telecommunications and retails sectors were targeted with specific taxes which penalised foreign businesses whilst favouring Hungarian companies.

Figure 24: Distribution of seats in parliament



Source: EIU, Hungarian Parliament

Figure 25: 3Y-Average World Bank scores



Source: World Bank Worldwide Governance Indicators (government effectiveness, rule of law, control of corruption)

[26] MNB, Inflation Report December 2017

These developments affect Hungary's creditworthiness insofar as they influence perceptions of institutional credibility, as well as the ability to conduct business in a free, transparent and predictable environment. The World Bank's governance indicators point to consistent weaknesses and a deterioration in the country's rule of law, government effectiveness and control of corruption, also compared to peers. This is even more important for the economy as foreign firms control about 90% of the telecommunications, 66% of the manufacturing, 50% of the banking and 35% of the energy sector[27].

Some of the institutional aspects affecting the business climate are likely to be addressed by the National Competitiveness Council. Moreover, Scope expects the government to cooperate with EU institutions and European member states to the extent necessary to ensure the full and timely disbursement of agreed EU structural fund allocations. In this context, the EU budgetary implications of the UK's decision to leave the EU are of crucial importance to Hungary's economic growth model.

Geopolitical risk

Hungary has been a member of NATO since 1997, supporting the country's Western allegiances as well as increasing its geostrategic importance to its Western partners. While Hungary's dependence on Russia for gas increases the sovereign's vulnerability to strained EU-Russia relations, Scope considers Hungary's exposure to potential geopolitical risk to be equal to that of its CEE and Visegrád peers.

Methodology

The methodology applicable for this rating and/or rating outlook, Public Finance Sovereign Ratings, is available at www.scoperatings.com.

Historical default rates from Scope Ratings can be viewed in Scope's rating performance report at https://www.scoperatings.com/#governance-and-policies/regulatory-ESMA. Please also refer to the central platform (CEREP) of the European Securities and Markets Authority (ESMA) at http://cerep.esma.europa.eu/cerep-web/statistics/defaults.xhtml. A comprehensive clarification of Scope's definition of default and definitions of rating notations can be found in Scope's public credit rating methodologies at www.scoperatings.com.

The rating outlook indicates the most likely direction of the rating if the rating were to change within the next 12 to 18 months. A rating change is not automatically ensured, however.

[27] https://www.state.gov/e/eb/rls/othr/ics/2016/eur/254371.htm

I. Appendix: CVS and QS results

Sovereign rating scorecards

Scope's Core Variable Scorecard (CVS), which is based on the relative rankings of key sovereign credit fundamentals, provides an indicative "BBB" ("bbb") rating range for Hungary. This indicative rating range can be adjusted by up to three notches on the Qualitative Scorecard (QS) depending on the size of relative credit strengths or weaknesses versus peers based on analysts' qualitative findings.

For Hungary, the following relative credit strength has been identified: i) public-debt sustainability. On the other hand: i) vulnerability to short-term shocks and ii) recent events and policy decisions constitute relative credit weaknesses. The combined relative credit strengths and weaknesses generate no adjustment and indicate a sovereign rating of BBB for Hungary. A rating committee has discussed and confirmed these results.

Rating overview	
CVS category rating range	bbb
QS adjustment	BBB
Final rating	BBB

To calculate the rating score within the CVS, Scope uses a minimum-maximum algorithm to determine a rating score for each of the 22 indicators. Scope calculates the minimum and maximum of each rating indicator and places each sovereign within this range. Sovereigns with the strongest results for each rating indicator receive the highest rating score; sovereigns with the weakest results receive the lowest rating score. The score result translates to an indicative rating range that is always presented in lower-case.

Within the QS assessment, analysts conduct a comprehensive review of the qualitative factors. This includes but is not limited to an economic scenario analysis, a review of debt sustainability, fiscal and financial performance and policy implementation assessments.

There are three assessments per category for a total of 15. For each assessment, the analyst examines the relative position of a given sovereign within its peer group. For this purpose, additional comparative analysis beyond the variables included in the CVS is conducted. These assessments are then aggregated using the same weighting system as in the CVS.

The result is the implied QS notch adjustment, which is the basis for the analysts' recommendation to the rating committee.

Foreign- versus local-currency ratings

Hungary has reduced its share of foreign-currency-denominated public debt over the past few years. In addition, throughout its recent balance of payment crisis, Hungary treated its foreign- and local-currency commitments equally. Consequently, Scope sees no reason to believe that Hungary would differentiate between any of its contractual debt obligations based on currency denomination. Furthermore, the recent history of sovereign defaults does not provide a strong justification for a rating bias in favour of either local-currency or foreign-currency debt.

II. Appendix: CVS and QS results

CVS

Rating indicator	Category weight
Domestic economic risk	35%
Economic growth	
Real GDP growth	
Real GDP volatility	
GDP per capita	
Inflation rate	
Labour & population	
Unemployment rate	
Population growth	
Public finance risk	30%
Fiscal balance	
GG public balance	
GG primary balance	
GG gross financing needs	
Public debt	
GG net debt	
Interest payments	
External economic risk	15%
International position	
International investment position	
Importance of currency	
Current-account financing	
Current-account balance	
T-W effective exchange rate	
Total external debt	
Institutional and political risk	10%
Control of corruption	
Voice & accountability	
Rule of law	
Financial risk	10%
Non-performing loans	
Liquid assets	
Credit-to-GDP gap	
Indicative rating range	**bbb**
QS adjustment	**BBB**
Final rating	**BBB**

QS

Maximum adjustment = 3 notches

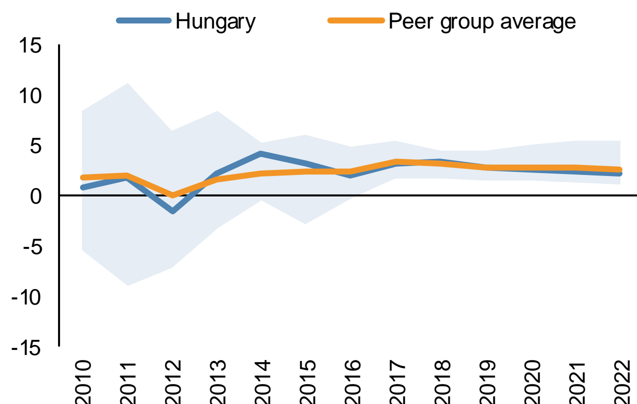
	+2 notch	+1 notch	0 notch	-1 notch	-2 notch
Growth potential of the economy	○ Excellent outlook, strong growth potential	○ Strong outlook, good growth potential	◉ Neutral	○ Weak outlook, growth potential under trend	○ Very weak outlook, growth potential well under trend or negative
Economic policy framework	○ Excellent	○ Good	◉ Neutral	○ Poor	○ Inadequate
Macroeconomic stability and imbalances	○ Excellent	○ Good	◉ Neutral	○ Poor	○ Inadequate
Fiscal performance	○ Exceptionally strong performance	○ Strong performance	◉ Neutral	○ Weak performance	○ Problematic performance
Debt sustainability	○ Exceptionally strong sustainability	◉ Strong sustainability	○ Neutral	○ Weak sustainability	○ Not sustainable
Market access and funding sources	○ Excellent access	○ Very good access	◉ Neutral	○ Poor access	○ Very weak access
Current-account vulnerabilities	○ Excellent	○ Good	◉ Neutral	○ Poor	○ Inadequate
External debt sustainability	○ Excellent	○ Good	◉ Neutral	○ Poor	○ Inadequate
Vulnerability to short-term shocks	○ Excellent resilience	○ Good resilience	○ Neutral	◉ Vulnerable to shock	○ Strongly vulnerable to shocks
Perceived willingness to pay	○ Excellent	○ Good	◉ Neutral	○ Poor	○ Inadequate
Recent events and policy decisions	○ Excellent	○ Good	○ Neutral	◉ Poor	○ Inadequate
Geo-political risk	○ Excellent	○ Good	◉ Neutral	○ Poor	○ Inadequate
Financial sector performance	○ Excellent	○ Good	◉ Neutral	○ Poor	○ Inadequate
Financial sector oversight and governance	○ Excellent	○ Good	◉ Neutral	○ Poor	○ Inadequate
Macro-financial vulnerabilities and fragility	○ Excellent	○ Good	◉ Neutral	○ Poor	○ Inadequate

*** Implied QS notch adjustment = (QS notch adjustment for domestic economic risk)*0.35 + (QS notch adjustment for public finance risk)*0.30 + (QS notch adjustment for external economic risk)*0.15 + (QS notch adjustment for institutional and political risk)*0.10 + (QS notch adjustment for financial stability risk)*0.10**

Source: Scope Ratings GmbH

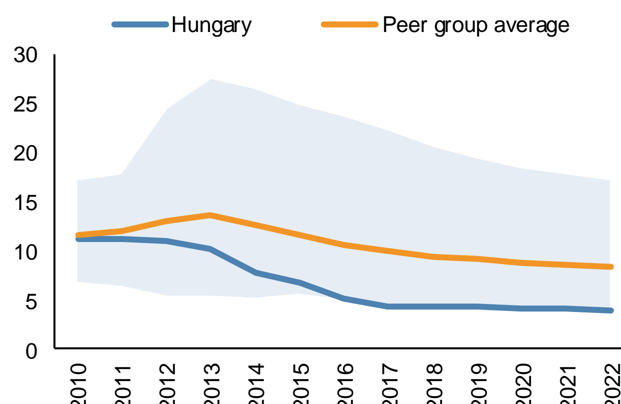
III. Appendix: Peer comparison

Figure 26: Real GDP growth



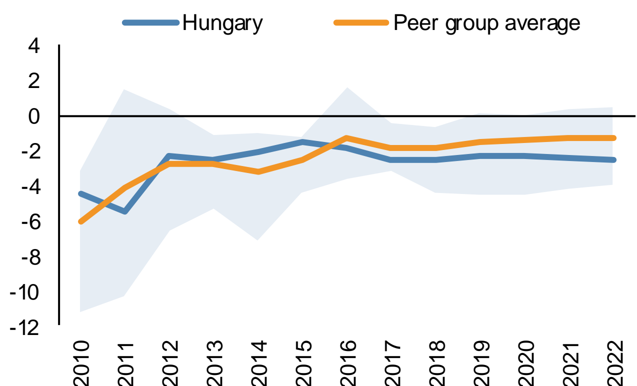
Source: IMF, Calculations Scope Ratings GmbH

Figure 27: Unemployment rate, % of total labour force



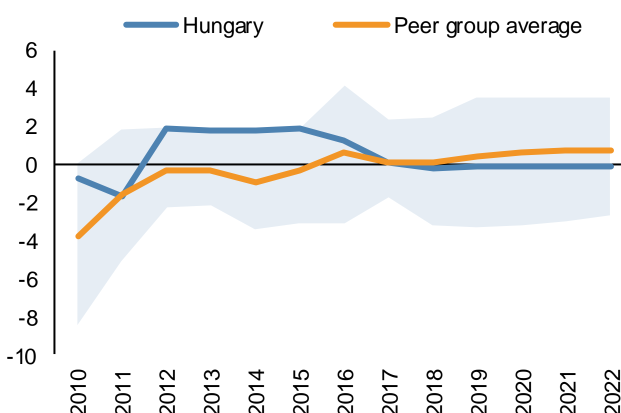
Source: IMF, Calculations Scope Ratings GmbH

Figure 28: General government balance, % of GDP



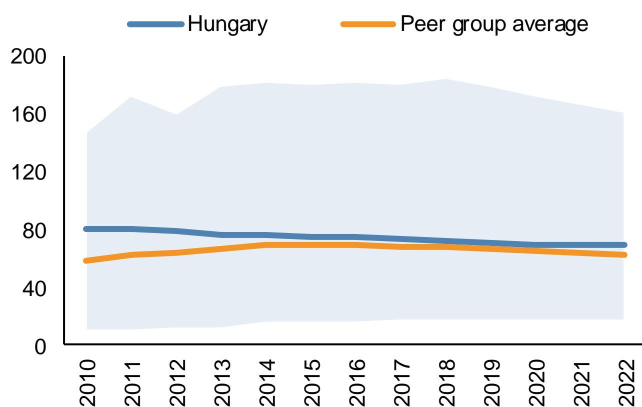
Source: IMF, Calculations Scope Ratings GmbH

Figure 29: General government primary balance, % of GDP



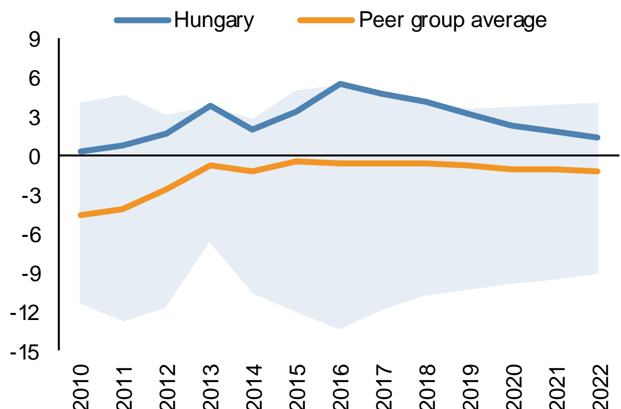
Source: IMF, Calculations Scope Ratings GmbH

Figure 30: General government gross debt, % of GDP



Source: IMF, Calculations Scope Ratings GmbH

Figure 31: Current account balance, % of GDP



Source: IMF, Calculations Scope Ratings GmbH

IV. Appendix: Statistical tables

	2013	2014	2015	2016	2017E	2018E	2019F
Economic performance							
Nominal GDP (HUF bn)	30,127.4	32,400.2	33,999.0	35,005.4	36,920.4	39,168.2	41,311.8
Population ('000s)	9,909.0	9,877.0	9,856.0	9,830.0	9,810.0	9,789.0	9,768.0
GDP-per-capita PPP (USD)	24,463.2	25,645.0	26,689.0	26,996.8	-	-	-
GDP per capita (HUF)	3,040,402.6	3,280,363.3	3,449,575.1	3,560,906.6	3,763,704.7	4,001,361.6	4,229,340.3
Real GDP growth, % change	2.1	4.0	3.1	2.0	3.2	3.4	2.8
GDP growth volatility (10-year rolling SD)	3.4	3.3	3.1	3.0	3.1	3.2	1.6
CPI, % change	1.6	-0.2	-0.1	0.4	2.5	3.2	3.0
Unemployment rate (%)	10.2	7.8	6.8	5.1	4.4	4.3	4.3
Investment (% of GDP)	21.1	22.9	21.7	19.1	19.6	20.3	20.9
Gross national savings (% of GDP)	24.9	24.9	25.1	24.5	24.4	24.5	24.1
Public finances							
Net lending/borrowing (% of GDP)	-2.6	-2.1	-1.6	-1.8	-2.6	-2.6	-2.3
Primary net lending/borrowing (% of GDP)	1.7	1.7	1.9	1.3	0.1	-0.2	-0.1
Revenue (% of GDP)	46.8	46.9	48.5	45.6	48.8	48.5	47.2
Expenditure (% of GDP)	49.3	49.0	50.0	47.5	51.4	51.1	49.5
Net Interest payments (% of GDP)	4.3	3.8	3.4	3.1	2.7	2.4	2.2
Net Interest payments (% of revenue)	9.2	8.1	7.0	6.9	5.4	4.8	4.7
Gross debt (% of GDP)	76.6	75.7	74.7	74.1	72.9	71.3	70.2
Net debt (% of GDP)	71.1	70.5	70.8	70.2	69.3	67.9	67.0
Gross debt (% of revenue)	163.7	161.2	154.1	162.3	149.4	146.9	148.7
External vulnerability							
Gross external debt (% of GDP)	144.7	144.6	129.3	121.3	-	-	-
Net external debt (% of GDP)	59.6	57.6	24.0	9.5	-	-	-
Current-account balance (% of GDP)	3.8	2.1	3.4	5.5	4.8	4.2	3.2
Trade balance [FOB] (% of GDP)	3.3	2.0	4.0	4.1	2.7	2.3	2.6
Net direct investment (% of GDP)	0.0	-2.7	-2.2	-1.9	-	-	-
Official forex reserves (EOP, mil EUR)	33,778.9	30,778.7	29,488.3	22,946.9	24,016.1	-	-
REER, % change	-1.5	-3.6	-2.1	0.7	1.5	-	-
Nominal exchange rate (EOP, HUF/EUR)	297.0	315.5	316.0	309.8	310.3	-	-
Financial stability							
Non-performing loans (% of total loans)	14.0	14.3	11.0	8.1	-	-	-
Tier 1 Ratio (%)	14.7	13.8	13.9	15.9	-	-	-
Consolidated private debt (% of GDP)	95.1	91.2	84.3	77.0	-	-	-
Domestic credit-to-GDP gap (%)	-27.1	-28.9	-35.9	-37.4	-	-	-

Source: IMF, European Commission, European Central Bank, National Bank of Hungary, World Bank, Haver Analytics, Scope Ratings

V. Regulatory disclosures

This credit rating and/or rating outlook is issued by Scope Ratings GmbH.

Rating prepared by Rudolf Alvise Lennkh, Lead Analyst

Person responsible for approval of the rating: Dr Giacomo Barisone, Managing Director

The ratings/outlook were first assigned by Scope as subscription rating in January 2003. The subscription ratings/outlooks were last updated on 01.09.2017.

The senior unsecured debt ratings as well as the short term issuer ratings were last assigned by Scope on 01.09.2017.

The main points discussed by the rating committee were: i) Hungary's growth potential, ii) macroeconomic stability and imbalances; iii) current-account vulnerabilities; iv) vulnerability to shocks; v) coherence and credibility of monetary policy; vi) fiscal performance; vii) public debt sustainability; viii) external debt sustainability; ix) recent events and policy decisions; and x) peers.

Solicitation, key sources and quality of information

The rating was initiated by Scope and was not requested by the rated entity or its agents. The rated entity and/or its agents did not participate in the ratings process. Scope had no access to accounts, management and/or other relevant internal documents for the rated entity or related third party.

The following material sources of information were used to prepare the credit rating: public domain and third parties. Key sources of information for the rating include: the Ministry of Finance of Hungary, the Hungarian National Bank, the BIS, the European Commission, the European Central Bank (ECB), the Statistical Office of the European Communities (Eurostat), the IMF, the OECD, and Haver Analytics.

Scope considers the quality of information available to Scope on the rated entity or instrument to be satisfactory. The information and data supporting Scope's ratings originate from sources Scope considers to be reliable and accurate. Scope does not, however, independently verify the reliability and accuracy of the information and data.

Prior to publication, the rated entity was given the opportunity to review the rating and/or outlook and the principal grounds upon which the credit rating and/or outlook is based. Following that review, the rating was not amended before being issued.

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