24 September 2020

Hungary and Covid-19: growing risks to public finances in five charts

Hungary's fiscal measures to mitigate the economic impact from the Covid-19 shock have a significant impact on public finances, pushing general public debt toward 80% of GDP this year, the highest such ratio since 2011. Improvements in the public debt structure and the expected timely return of the economy to pre-crisis growth mitigate the increased vulnerability of the country's public finances to future shocks, however. Further extension of government debt maturities would reinforce Hungary's fiscal resilience by reducing high annual gross financing needs (GFNs) but realisation of this depends on the absorption capacity of domestic investors.

Our main conclusions for Hungary (rated BBB+/Stable):

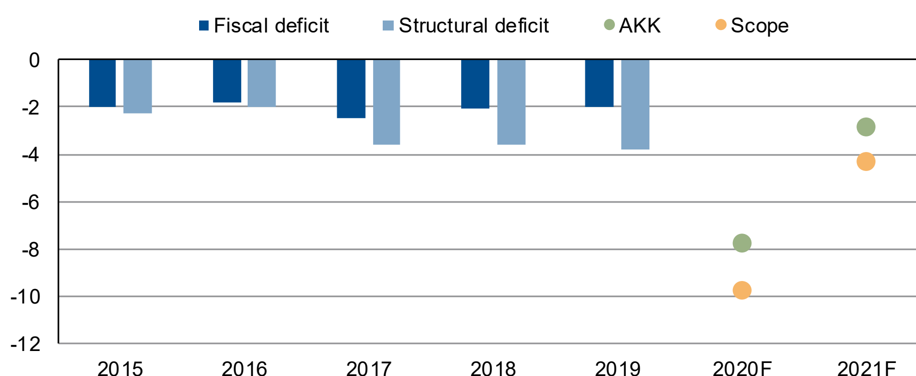
- We revise the fiscal deficit forecast up to 10% of GDP for 2020 after higher spending in response to the pandemic, expected further extension of fiscal support, and a deep recession;
- robust growth in nominal output is expected in the years ahead, which should ensure a gradual decrease of the public debt ratio back toward 75% of GDP by 2024;
- a significant improvement in Hungary's debt profile, including substantially lower shares of foreign-currency denominated (FX) debt, helps to lower external sector risks; however,
- average debt maturity remains comparatively short (4.4 years for HUF-denominated debt), resulting in high yearly gross financing needs relative to other countries in Central and Eastern Europe; further maturity extension can come within the limits of domestic investors' capacity to absorb longer-term government bond issuance;
- stable market conditions, in part due to the expansionary monetary policies by Magyar Nemzeti Bank (MNB), will support Hungary's debt-management agency, ÁKK, to complete funding plans for 2020, including required foreign-currency debt issuance.

Chart #1: Budget deficit sharply up but expected to narrow post-crisis

In response to the Covid-19 shock, the government announced additional direct fiscal spending of around 4.5% of GDP and public guarantees on loans of around 4.7% GDP (source: OECD). According to finance ministry estimates, this overall support package – including non-deficit-relevant spending and loan guarantees – amounts to ~ 22% of GDP.

Given the worse-than-expected economic contraction of 14% in GDP in Q2, authorities have revised an original budget deficit projection of 1% of GDP for 2020 to 7-9% of GDP. For 2021, authorities anticipate the deficit to narrow back to around 3% of GDP.

Figure 1: Fiscal balance, % of GDP



Source: European Commission, ÁKK, Scope Ratings GmbH

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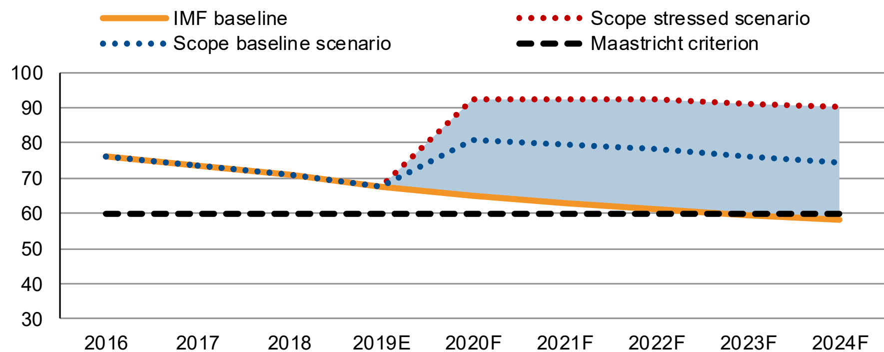
#2: Public debt back to 2011 levels in 2020 but to resume gradual decline in 2021

A buoyant economy between 2011 and 2019 helped the Hungarian government reduce debt by around 15 percentage points from a peak of 81% to 66% of GDP. Hungary's Fundamental Law states that budgets need to be in line with a declining debt trajectory when debt exceeds 50% of GDP. Deviations from this rule are allowed only in a "State of Danger", such as the Covid-19 pandemic.

We expect debt to revert upward to its 2011 levels of around 80% of GDP this year, followed by a gradual return to its pre-crisis downward trajectory from 2021 onward, reaching 75% of GDP by 2024. This debt trajectory assumes real annual growth rates of between 3-4% and medium-term average inflation of around 3%.

Figure 2: Government debt, % of GDP



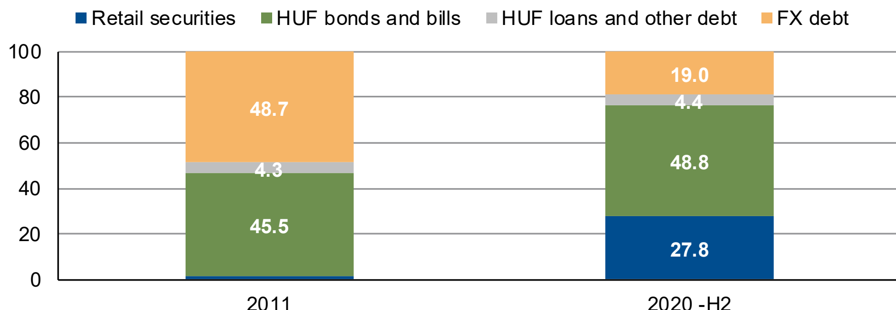
Source: IMF, Scope Ratings GmbH

#3: Debt profile has improved, although domestic investors' absorption capacity may pose a constraint

Hungary's debt profile has improved significantly since 2011, with a pronounced decrease in the share of foreign currency-denominated obligations, from 49% to currently 19% of total outstanding debt. Central to this achievement is the development of the domestic retail market for government bonds, which has helped to lower external sector risks.

Average debt maturity remains low at 4.4 years for domestic debt and around 6 years for foreign currency debt. Hungary, consequently, has fairly high annual government gross financing needs as the government has to roll over a substantial share of its debt. The ÁKK's goals are to extend average debt maturity but the agency is constrained by its focus on domestic debt holders who have comparatively more limited capacity to absorb longer-term government bond issuance compared with the tolerance of international investors.

Figure 3: Debt profile, share of total



Source: ÁKK, Scope Ratings GmbH

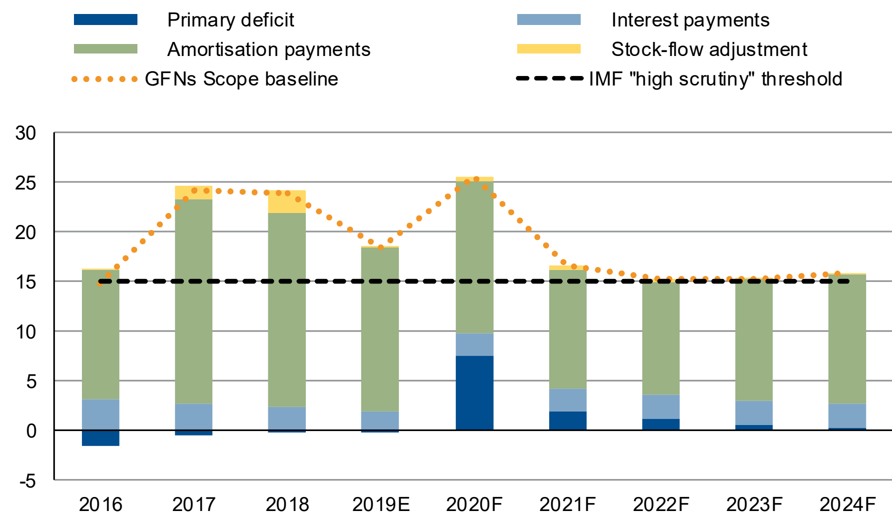
#4: Gross financing needs sharply higher in 2020, and foreseen to remain elevated post-crisis

The government expects gross financing needs equivalent to around 25.3% of GDP in 2020, a forecast subject to upside risks if the economic contraction is steeper or the deficit increases further due to prolongations of fiscal stimulus. The high level of debt redemptions at around 18% of GDP in 2020 (including up to 4.5% of GDP in debt buy-backs) exposes Hungary to significantly higher refinancing risks than the likes of Poland or the Czech Republic, the latter two with redemptions of around 6% and 4% of GDP, respectively. While this year's GFNs for Hungary are particularly high – as referenced, at around 25% after including ÁKK's estimated buybacks of bonds and retail securities as part of its strategy to extend debt maturities – we expect GFNs to remain elevated over the medium term, at close to 15% of GDP, equal to the IMF's "high-scrutiny" threshold for emerging markets.

The government revised its financing plan at the end of August, following updated deficit forecasts, with net issuance expected to increase from HUF 1,890bn to HUF 3,600bn. As the ÁKK does not currently plan to issue additional FX debt compared to the previous plan (EUR 4bn, 100% swapped to euro), the extra financing will be covered in the retail market and by the issuance of forint-denominated bonds targeting institutional investors.

The question is whether the domestic market is sufficiently large enough to accommodate the government's increased borrowing needs. So far, the ÁKK has completed all of its foreign currency debt financing requirements, most recently with a EUR 0.5bn issuance of Samurai bonds, including green debt. The agency secured 72% of planned funding in the retail market by mid-August and 66% of HUF bond issuance in the wholesale sector.

Figure 4: Government gross financing needs, % of GDP



Source: IMF Article IV, Scope Ratings GmbH

#5: Stable financing conditions at a time of elevated funding needs

At the peak of this crisis, we saw volatility in Hungarian government bond markets. The 10-year yield on Hungarian government securities jumped by around 150bps in mid-March. Since then, market conditions have calmed down and have remained relatively stable, with current yields around 70bps above those pre-crisis.

The MNB is also providing support in stabilising Hungary's securities markets, with the introduction of the Government Security Purchase Programme – quantitative easing – in

May together with interest rate cuts in June and July. As of August, the central bank has increased weekly purchases of Hungarian government bonds from HUF 15bn to HUF 40bn, thereby supporting favourable market conditions at a time of increased government funding needs.

Figure 5: 10-year yield on Hungarian government securities and MNB policy rate

Source: Macrobond, ÁKK, MNB, Scope Ratings GmbH

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