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Hungary

The government of Hungary (hereinafter, Hungary, or the country) has been assigned the following ratings under the international scale:

- **Long-term** foreign currency credit rating at **BBB** and local currency credit rating at **BBB**;
- **Short-term** foreign currency credit rating at **S2** and local currency credit rating at **S2**.

The outlook on the long-term foreign currency credit rating is **Stable** and local currency credit rating is **Stable**.

Credit rating rationale

Positive rating assessment factors	• High GDP growth and low growth volatility. • Low inflation. • Expected decrease in budget deficits and government debt. • Steady FDI Flows. • Sound banking sector with sufficient capital and liquidity.
Negative rating assessment factors	• Limited growth potential caused by poor demographics. • Low competitiveness due to high unit labor costs. • Low flexibility in budget expenses. • High refinancing needs and low average debt maturity. • Substantial external exposure and moderate international reserves coverage.
Stable outlook	• The Stable outlook assumes that the rating will most likely stay unchanged within the 12 to 18-month horizon.
Potential rating upgrade factors	• Further decrease in public debt. • Lower annual gross financing needs. • Efficient stimulation of the natural population growth. • Further progress in external deleveraging.
Potential rating downgrade factors	• A reversal in public debt trends. • Increased external exposure. • Risk of contingent liabilities materializing.

Sovereign model results

Block	Indicative block rating	Modifier	Score	Modification of an indicative rating of a block	Final block rating
Macroeconomic position	AA-	Potential economic growth	-1	-1	A+
		Sustainability of economic growth	-1		
		Efficacy of structural, economic and monetary policies	0		
Public finance	BB+	Contingent liabilities and risk of them materializing on the sovereign's balance sheet	-1	-2	BB-
		Fiscal policy framework and fiscal flexibility	-2		
		Market access and sources of funding	0		
		Debt sustainability	-1		
External position	A	Balance of payments vulnerabilities	-1	-1	A-
		External debt sustainability	-1		
		Stability of currency regime	0		
Institutional framework	A-	Willingness to pay	0	0	A-
		History of defaults	0		
		Political instability and recent political decisions	0		
		Involvement in geopolitical conflicts, exposure to geopolitical risks	0		

Assigned credit rating

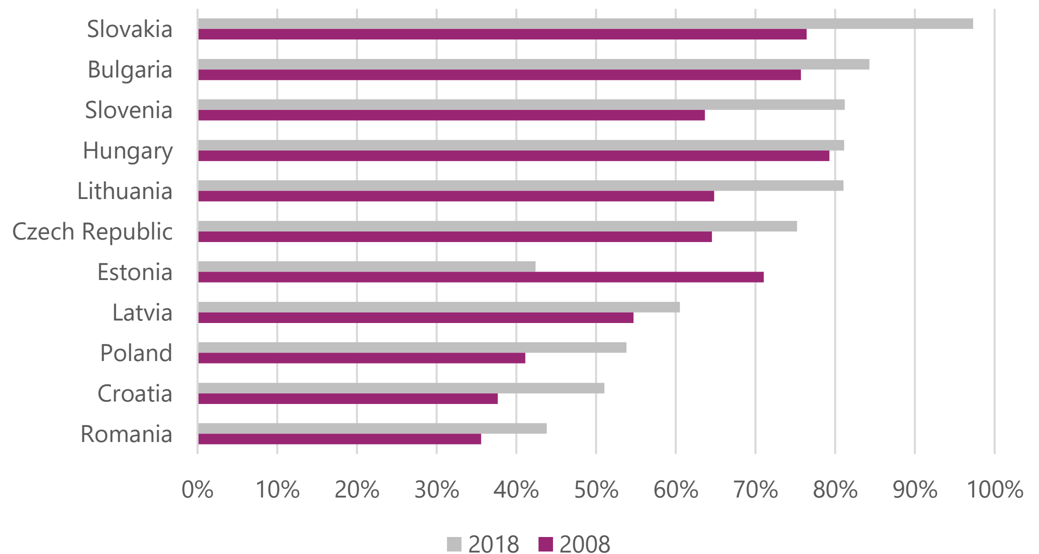
Indicative credit rating	A-
Modifier corrections to the indicative credit rating	-2
Final credit rating	BBB
Assigned credit rating	**BBB**

MACROECONOMIC SITUATION AND ECONOMIC POTENTIAL

The small size and openness of Hungary's economy causes volatility in its growth rate.

Hungary's economy is small and open. With GDP at USD 155.7 bln in 2018, Hungary's economy makes up 0.2% of the world's GDP (by purchasing power parity, PPP) and is the 4rd largest in the Central Eastern Europe (CEE) region, which consists of Bulgaria, the Czech Republic, Slovakia, Hungary, Croatia, Slovenia, Poland, Romania, Estonia, Latvia, Lithuania. In 2018, the country's economy ranked 5th in the CEE region by GDP per capita (by PPP) at 31,903 international dollars. Hungary's economy is one of the most open among CEE countries, as measured by the average of exports and imports of goods and services relative to GDP, which stood at 81.1% in 2018 (*Fig. 1*).

Figure 1. Openness of Hungary's economy, % of GDP

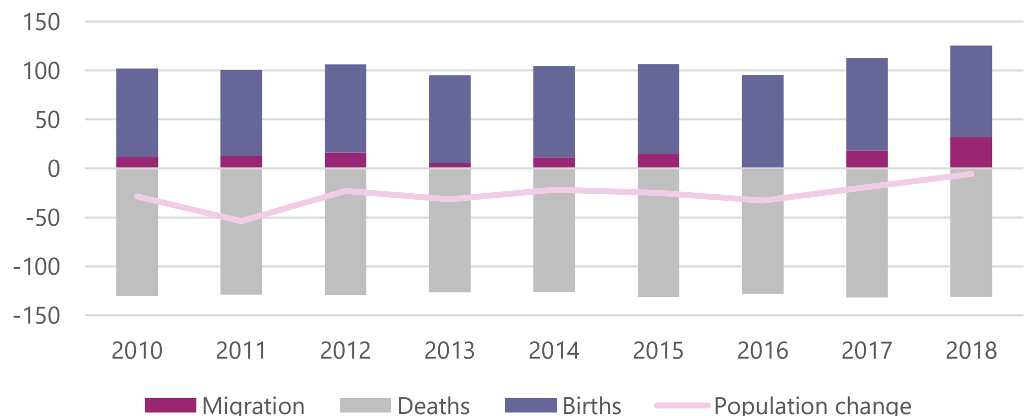


Sources: IMF, ACRA

Hungary's population is declining.

The country's population has seen a strong downward trend in recent years (*Fig. 2*). Hungary's population has decreased by 0.4 mln since 2000, standing at 9.8 mln in 2019. According to the European Commission, it is expected to drop below 9.0 mln by 2066. Hungary's weak population dynamics are driven by low birth rates, despite numerous measures implemented by officials for family support, and high deaths rates, some of the highest in the EU. Migration has not compensated for the negative natural growth rate of population. A diminishing labor force has tightened the labor market and pushed up the cost of labor.

Figure 2. Population change, thousands of people

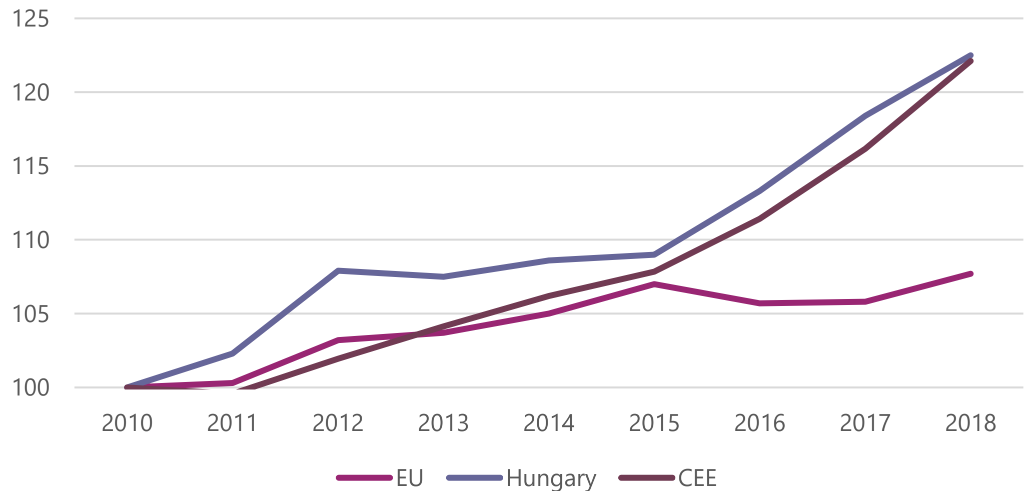


Source: Hungarian Central Statistical Office

Employment has remained at record highs.

Tight employment conditions are pushing up labor costs. The country's employment rate is at record high and is supported by rapid economic growth and various government stimulus programs. Unemployment rates are near their lowest levels (3.4% for 2019, below the EU average of 6.2%). Hungary's tight labor market has pushed up costs on labor growth. From 2015 to 2018, the labor cost dramatically increased by 12.4%, surpassing not only its CEE peers (9.7%), but the average for EU countries as well (0.7%) (*Fig. 3*). Labor productivity increased gradually as well during this period, but only by 1.7%.

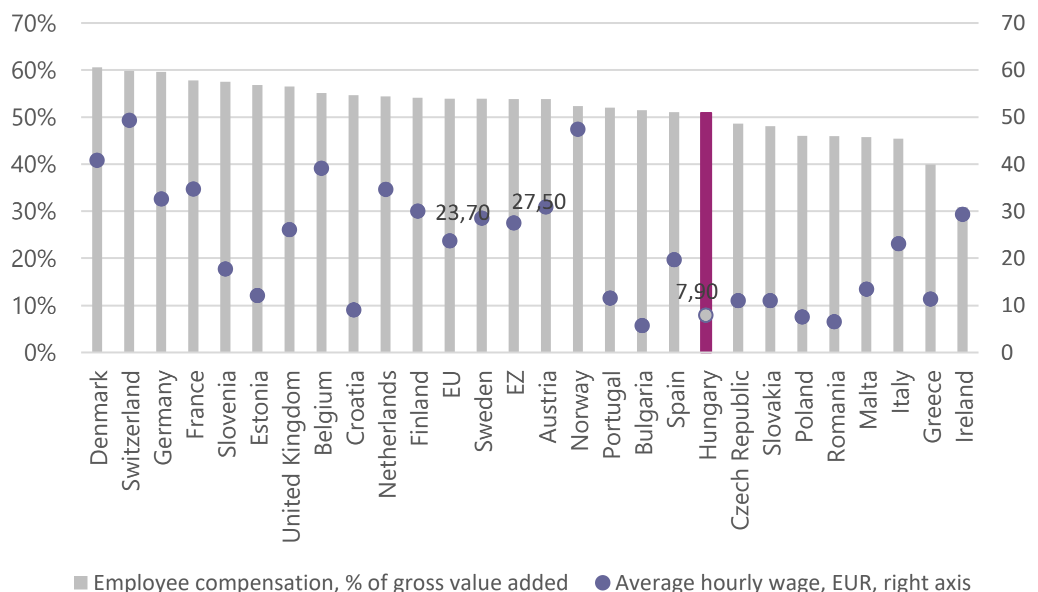
Figure 3. Nominal unit labor costs, index



Source: Eurostat

The share of labor costs in gross value added is approaching the EU average, signaling that Hungary's competitive advantage in terms of labor cost is decreasing (*Fig. 4*). At the same time, the average hourly wage, like in other CEE countries, is well below that of core Europe countries and the EU average. In 2018, this figure stood at EUR 7.9 compared to the EU average of EUR 23.7. This underlines the fact that even though total compensation as a share of gross value added is approaching the EU average, labor is still poorly compensated. Hungary still remains attractive for foreign investors due to the low average cost of labor. ACRA believes the government needs to take steps toward increased labor productivity and provide stimulus for higher value added jobs.

Figure 4. Employee compensation and average hourly wage



Sources: AMECO, Eurostat

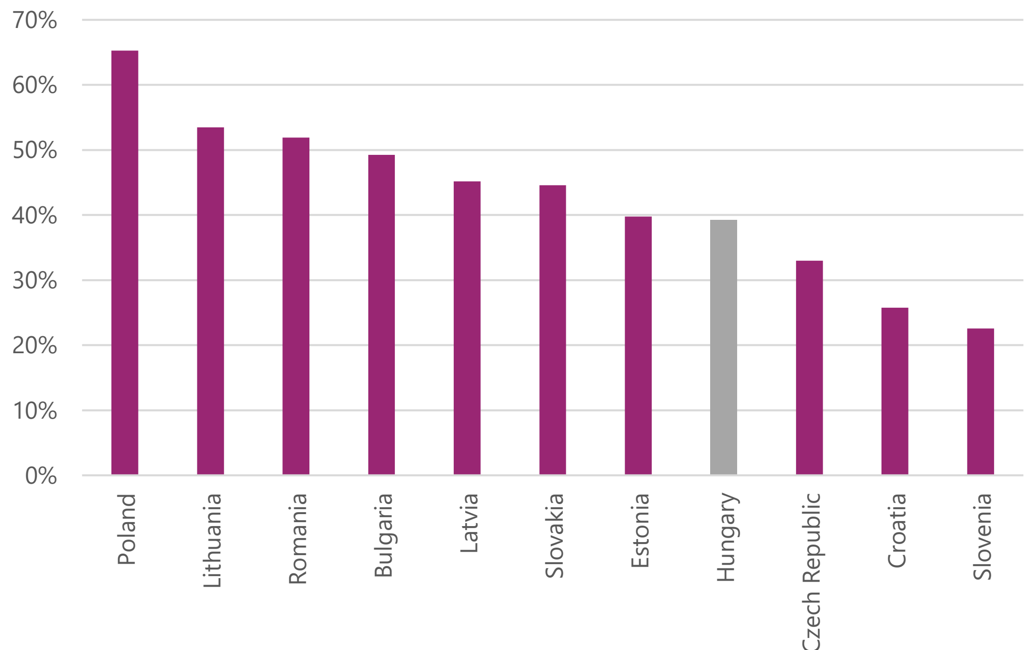
Hungary is geared toward a knowledge based economy.

Hungary's transition to a knowledge-based economy is one of its main economic challenges. In 2018, the country increased its spending on research and development to 1.5% of GDP, up from 1.3% in 2017 with a target 1.8%. These figures are still below the EU average (2.1%) and the Czech Republic (1.9%), but above Poland (1.2%) and Slovakia (0.8%). However, this figure has slightly decreased since 2013, indicating that the country does not promote these expenses. The number of people involved in R&D also remains below the EU average. At the end of 2018, 2.9 thousand per one million were involved in the advanced technological sector of the economy compared to 3.7 thousand in the Czech Republic. However, Hungarian students recorded slightly better PISA scores in 2018 than in 2015, when they were historically low. Therefore, one of the country's main challenge is to transform its low-cost, outsource-based economy into one based on knowledge and technology, making it a full-fledged member of the fourth industrial revolution.

Hungary suffered considerably as a result of the 2008 crisis. Hungary's economy contracted during the 2008 crisis and later in 2012 due to its open economy, significant dependence on external funds, and large fiscal deficits. In 2008, the IMF agreed to provide a USD 15.7 bln rescue loan to protect the country's economy from external shocks and help meet large external financing needs. Hungary suffered more than its CEE peers in the region. Decreases in household consumption and investments by 3.5% and 5.9%, respectively, resulted in GDP dropping by 6.6% in 2009. Subsequent recovery was also one of the weakest among CEE peers. Poor economic performance resulted in a weaker dynamic of GDP per capita (PPP) compared to Hungary's CEE peers (*Fig. 5*). Recent economic growth has not been enough for a significant increase in Hungary's rank. Hungary's GDP per capita (PPP) is above 70.0% of the average GDP per capita (PPP) for all EU countries, compared to 62.5% in 2008.

Hungary's GDP per capita figures lag behind those of its CEE peers.

Figure 5. GDP per capita (PPP), international dollars, 10-year change



Source: IMF

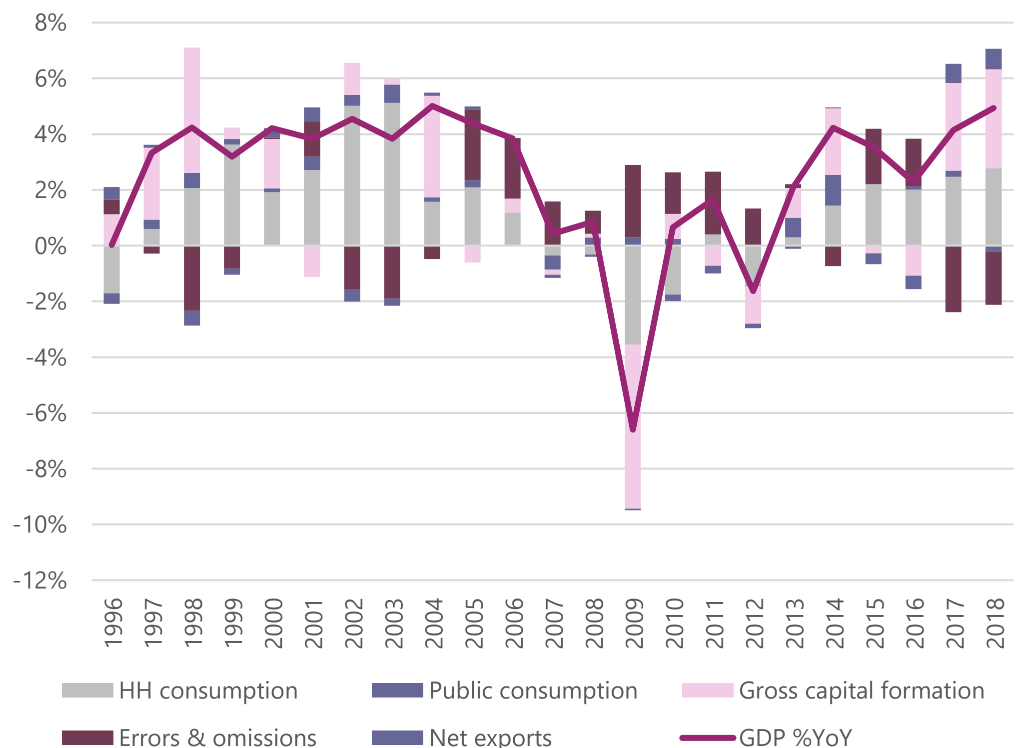
Reforms have positively contributed to economic growth. Since 2010, when the new government took office to mitigate the consequences of the global financial crisis and repay the IMF emergency loan, Hungary raised taxes that discouraged foreign capital, increased its presence in various industries, and nationalized the assets of private pension funds in the amount of USD 12 bln (8.3% of GDP). The government aimed to reduce the country's dependence on foreign ownership, as well as to build up its domestic capital market and increase its importance. Over the last six years, this has resulted in strong economic growth driven by household consumption, EU funds, a low interest rate

environment in Europe supported by private sector inflows, and measures to stimulate economic sustainability. Among these measures are tax reforms that have shifted taxation from labor to consumption, reduced subsidies, led to various social programs aimed at increasing birth rates, and stimulated entrepreneurship.

Hungary's economy has shown a strong upward trend, but there is a risk of overheating.

Since 2017, GDP growth has increased above 4% and is driven equally by investments and consumption. Net exports have contributed to this increase as well (*Fig. 6*). Historically, consumption has been the main contributor to growth and supported by public expenditures and accumulated household savings. However, since 2017, investments have increased significantly – by 24.1% in 2017 and 17% in 2018. In 2019, the growth rate of investments is expected to stay at these levels (the annual growth rate was 14.8% in Q3 2019). A soft monetary policy along with government incentives to support private sector investment are the key reasons behind this dynamic. Among these incentives are low taxes, loan and investment subsidies, as well as more favorable corporate taxation. New investments support new technologies and gradually shift the economy more towards R&D. Therefore, these initiatives help Hungary face its challenges.

Figure 6. GDP growth, % Y-o-Y

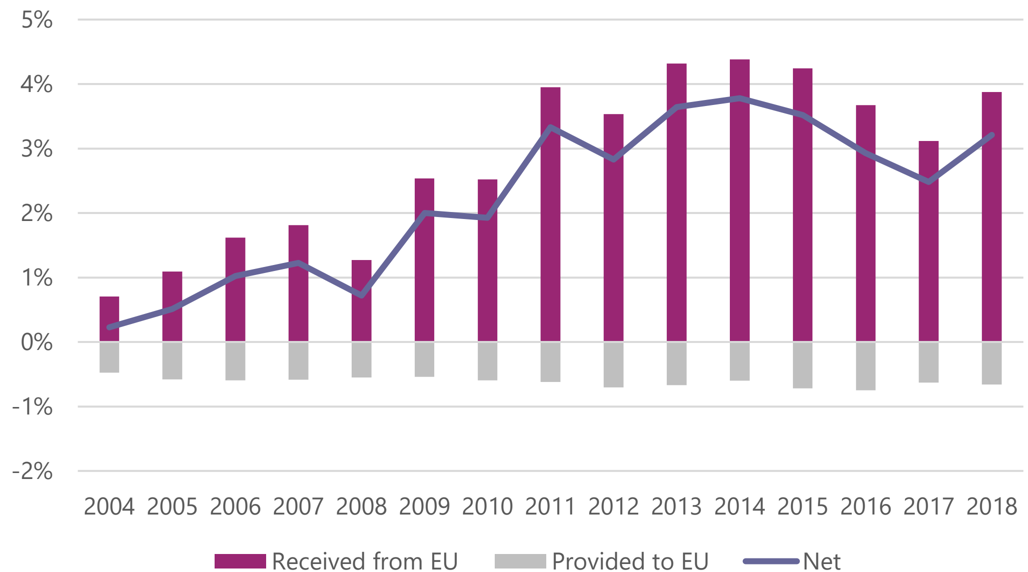


Source: Hungarian Central Statistical Office

EU funds play a key role in public investments and the expected reduction of these funds could hurt economic growth. The main objective of the current EU budget (2013-2020 Multi-Annual Financial Framework, MFF) is cohesive policy – to support the "overall harmonious development" of EU member states by reducing disparities in the level of development between regions. Because CEE countries are comparatively less developed, they are the final beneficiaries of these funds. Among them, Hungary is the largest beneficiary. Compared to its CEE peers, the country has received the most funds as a percentage of its economy. EU funds represent about 90% of Hungary's public investments. Since 2015, net annual receipts have made up more than 3% of GDP (*Fig. 7*). It is expected that the new MFF for 2021-2027 to decrease funding for CEE countries and Hungary could suffer the most. Under these circumstances, the government's role in supporting private investments would increase. Receiving fewer EU funds could negatively affect GDP figures starting in 2023, as the "T+2" rule makes funds accessible for 2 years after being approved.

EU funds are one of Hungary's main investment drivers.

Figure 7. Flow of EU funds, % of GDP

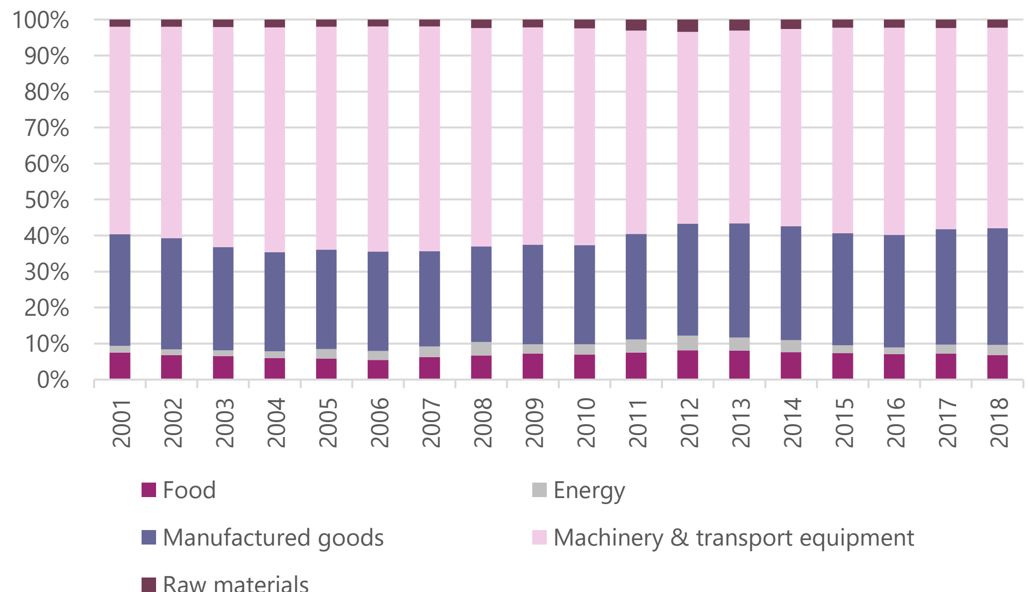


Source: European Commission

Hungary exports value added production, but diversification is limited. In 2017-2018, net exports contributed positively to the economic growth. The majority of Hungary's exports is highly value added, with machinery and manufactured goods accounting for 88.1% of total exports (*Fig. 8*). At the same time, domestic value added in gross exports is very low, second only to Slovakia among CEE peers. In 2016, the latest available data, this figure stood at 55.9%. In addition, exports are concentrated both geographically and in terms of products. Figures show that machinery and transport equipment (electrical, mechanical, car parts) account for 55% of total exports. Hungary's key trading partner is the EU, accounting for 80% of all exports and 75% of all imports. Within the EU, the country relies primarily on Germany, which accounts for 27% of Hungary's exports and 26% of imports. In recent years, Hungary has become more interconnected with Germany as its involvement in automotive production chains has increased. Germany's slowdown in business sentiment and purchasing managers index (PMI) in manufacturing, partly caused by US protectionist policies, might pose excessive risks to Hungary's economy.

Exports are concentrated by products and geographically.

Figure 8. Export diversification, % of total exports

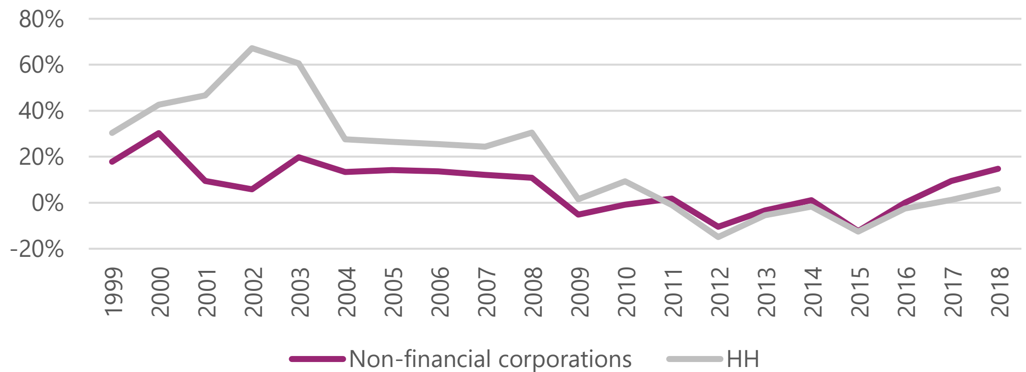


Source: Magyar Nemezeti Bank

Hungary's strong banking sector continues to provide the economy with credit.

Post-crisis economic growth is not fueled by lending. Despite the growth in credit to the non-financial sector and households reaching pre-crisis levels (*Fig. 9*), these growth rates are healthier. Banks focus on providing long-term credit in local currency, thereby limiting foreign exposure. Housing loans accounted for more than half of all consumer loans provided in 2018. The share of mortgage loans with a loan to value ratio higher than 70% decreased to 40% of the total compared to 70% in 2008. Distribution of the payment to income ratio (PTI) has remained stable in recent years. Loans with a PTI of 15-30% account for almost half of all housing loans. Hungary's credit to GDP gap is close to zero, making economic growth more sustainable. At the same time, banks are in good shape with solid capital and liquidity and low amounts of non-performing loans (NPLs). Therefore, their potential to support economic growth is high.

Figure 9. Credit growth, % Y-o-Y

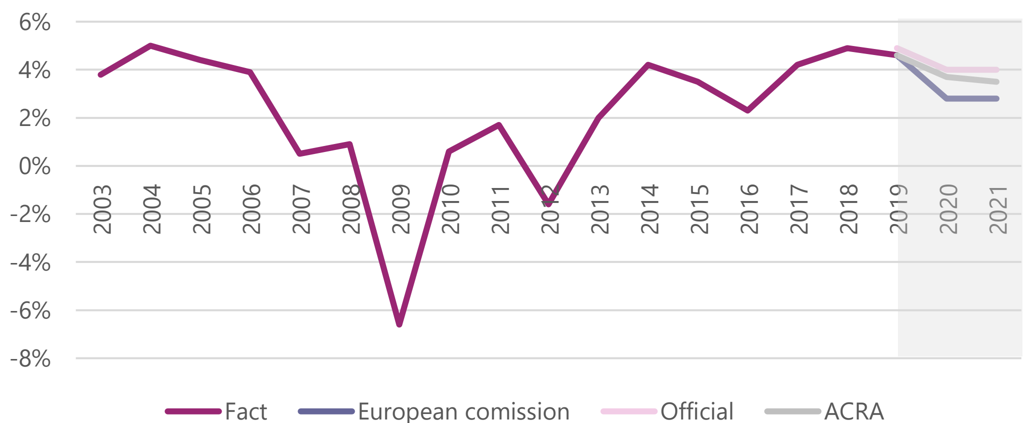


Source: Hungarian Central Statistical Office

Hungary's economic potential is at risk and its sustainability is limited.

Hungary's economic potential is likely to be constrained. ACRA expects Hungary's growth to moderate in coming years, given its economic expansion running above potential. The Country's GDP is expected to grow by 3.7% in 2020 and 3.5% in 2021 (*Fig. 10*). Hungary's growth rate is likely to reverse to its potential economic growth, which was outpaced due to expansionary monetary and fiscal policies. Both of these policies are likely run out of steam. ACRA expects lower growth rates due to poor demographics, cooling economic activity in Europe (Hungary's key external market), reduced inflows of EU funds, and lower net exports (consumption stimulus will likely cause higher imports). In ACRA's view, current wage growth dynamics are unsustainable without a significant improvement in productivity. ACRA expects significant moderation in real wage growth in the medium term and reduced contribution to economic growth from consumption as a result. ACRA believes that to sustain higher wage growth in the longer term, the economy has to boost its innovative potential.

Figure 10. Projected GDP growth, % Y-o-Y



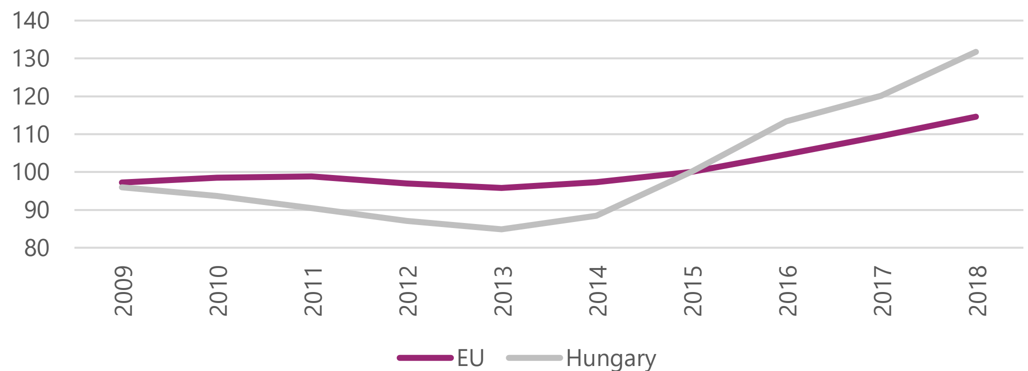
Sources: Hungarian Central Statistical Office, European Commission, ACRA

A recent spike in housing prices does not pose systemic risks. Since 2013, housing prices in Hungary have outpaced those in the EU (*Fig. 11*). In 2018, prices in Hungary grew by 16.6% (24.4% in Budapest), which could be a sign of overheating in the housing market. However, ACRA believes the following factors mitigate this risk:

1. The increase in housing prices was not credit-driven. Since 2015, the average annual growth in mortgages was around 3.6%, compared to a 9.7% increase in housing prices.
2. The proportion of risky mortgages (loan to value ratios below 70%) is below pre-crisis levels.
3. Households have substantial savings, with deposits exceeding loans by 1.4x.
4. The potential misallocation of resources caused by housing price dynamics is likely to be limited by the macro prudential policies of the Magyar Nemezeti Bank - Hungary's central bank (Central Bank), in particular debt cap rules and capital requirements. Overall, housing credit to GDP has remained at 8%, far below the EU average of 40%, showing long-term capacity to support economic growth.

Housing prices are rising, but are not supported by credit growth.

Figure 11. Housing prices, index

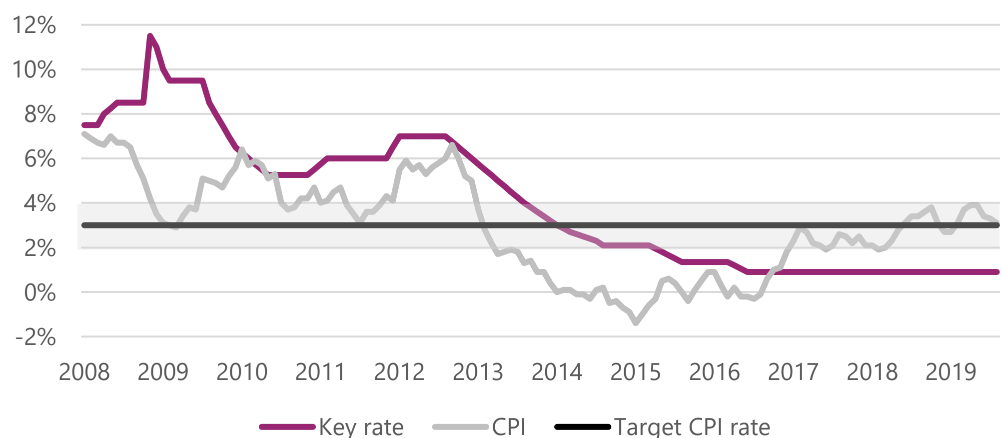


Source: Eurostat

The expansionary policy of the Magyar Nemezeti Bank is likely to run out of steam. Monetary policies aimed at stimulating economic growth after contraction in 2012, coupled with the overall revival of emerging markets, have brought inflation to below the target level of 3% (*Fig. 12*). Since then, inflation has not exceeded the upper limit of the target corridor. However, this figure is trending upward due to loose monetary policies and a fiscal policy aimed at stimulation.

Inflation has remained inside the target bands, but could exceed the upper limit.

Figure 12. Inflation and key rate dynamics



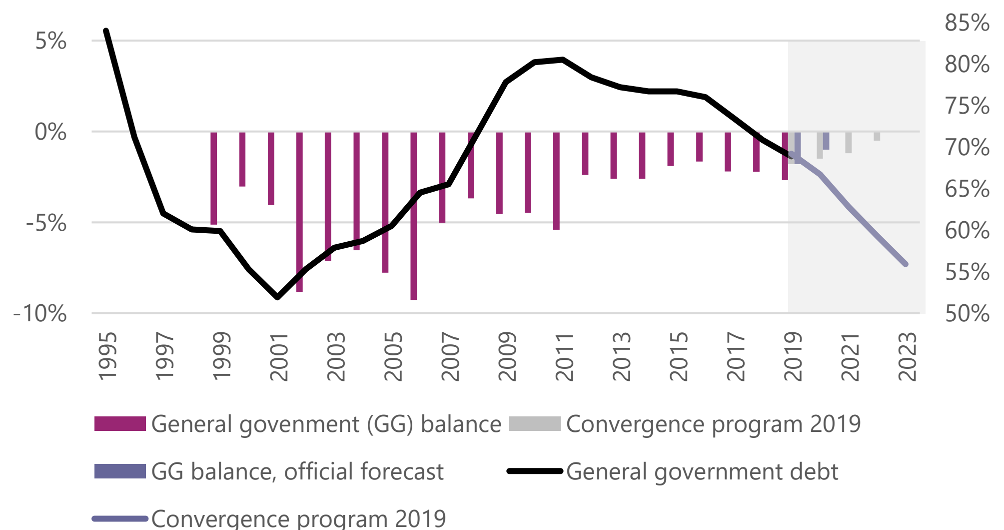
Sources: Hungarian Central Statistical Office, Magyar Nemezeti Bank

To stimulate the economy Magyar Nemezeti Bank has implemented a loose monetary policy using traditional instruments like key rate (that stays at the lowest level since 2016), reserve requirement ratios, and overnight market operations. In addition to these instruments, the Central Bank uses unconventional instruments to provide liquidity and lower bond yields like swap lines and bond buying programs. Looking ahead, wages and social expenditures are likely to continue growing. Therefore, inflation risks are like to increase if the Central Bank continues to implement a soft monetary policy.

Public finance

Narrowing deficits have helped reduce high levels of public debt. Persistent general government deficits have resulted in debt building up to elevated levels — 80.5% of GDP in 2012 which was one of the highest in the EU (*Fig. 13*). Hungary is subject to the significant deviation procedure and debt reduction benchmarks set by the European Council because of its high deficits and substantial debt. These procedures are enforced by the Stability and Growth Pact (SGP), a set of rules for EU countries to pursue sound public finances and better coordinate their finances. Under the SGP, the European Council set medium-term budgetary objectives (MTOs) for Hungary to stabilize its budget. However, in recent years Hungary failed to follow these recommendations and ran deficits above the recommended levels. Even though Hungary has three fiscal rules (the constitutional debt rule that stipulates debt reduction to 50% of GDP, the nominal budget balance rule that limits the nominal deficit to 3% of GDP, and the structural balance rule that prescribes compliance with the MTOs), the country's commitment to following them is weak. As debt has been gradually decreasing (in 2019 it was estimated at 69% of GDP), the nominal deficit has been moving closer to the threshold (it is estimated to decline to 2.7% of GDP in 2019 compared to 2.3% of GDP in 2018). Structural deficit was below the target in 2016–2018 and is expected to breach the limit in 2019, too.

Figure 13. Government debt and deficit, % of GDP



Source: Hungarian Central Statistical Office

The government is targeting a balanced budget in 2022, but poor fiscal discipline puts this plan at risk.

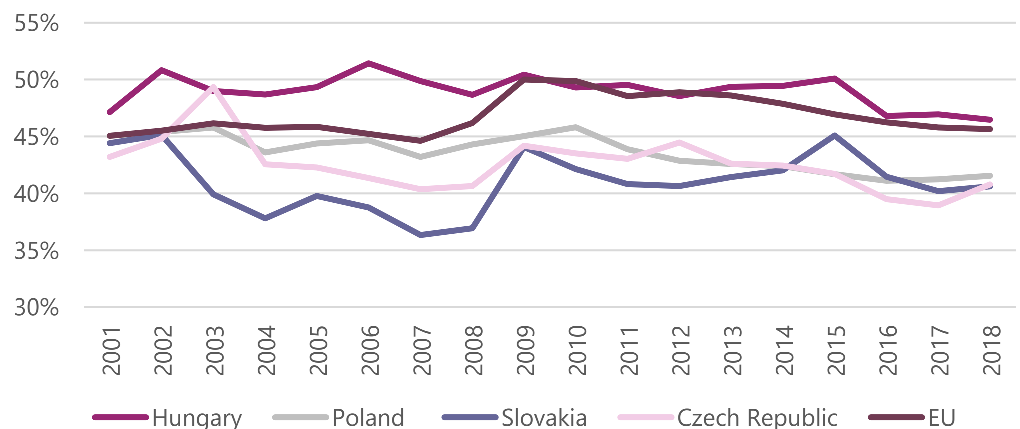
In terms of budget expenditure, the deficit was under pressure from "demographics program" spending, which included increasing wages and pensions, including subsidies for home building and financial incentives for families to support the country's deteriorating demographic situation. Additional revenues were not used to decrease the debt, and instead spent in the form of current and capital transfers. From the revenue side, the most significant effect was created by the expanding tax base. Strong growth and measures to improve tax compliance supported tax collection and the government received higher revenues than it had planned. This allowed Hungary to implement a number of tax cuts, including reducing the contribution rate to the social security fund, VAT reductions on certain goods and newly built houses, and various investment subsidies.

Increased budget revenues helped the government to narrow the deficit to below 3.0% of GDP (2.7% of GDP is estimated in 2019), which led to the debt-to-GDP ratio decreasing to 69% of GDP by the end of 2019. At the same time, Hungary still runs the second largest structural deficit in the EU (after Romania), which nullifies the impact of temporary and one-off revenue and expenditures. In 2018 it reached 3.8% of GDP, having worsened by 1.7 percentage points since 2016. Hungary is the only country in the CEE region where the structural deficit has increased since 2010, indicating the challenge the government faces in balancing its expenditures and revenues. Besides GDP growth, there were several other factors that contributed to the reduction of the budget deficit. The first was the decelerating trend in yield on government bonds. The second was the disbursement of EU funds. The average cash fiscal deficit was 2.9% of GDP from 2014 to 2018 thanks to EU funds. Without these funds it would have been 0.5% lower and amounted to 3.4% of GDP.

In 2019, the cash flow-based deficit stood at 1.2 bln forints (around 2.7% of GDP) and was 122% larger than planned. In November the deficit only amounted to 76.7% of the target, therefore a significant amount of expenditures were made in December and, as stated by officials, involved infrastructure projects and business investment incentives. A widened budget deficit in recent years is a sign of a pro-cyclical fiscal policy, i.e. high dependence of economic growth on fiscal decisions and a limited fiscal capacity when the economy starts to cool.

The budget will likely continue to be the main instrument for supporting the economy. In the coming years, the Hungarian government plans to continue to stimulate the economy by relying on the strong economic growth. The government has projected GDP growth at 4.0% in 2020 and 2021, while ACRA expects economic growth to start to decline — to 3.5% — in 2020. The European Commission expects the country's economy to grow by 2.8% this year and the next, while the IMF sees growth at 3.3% in 2020 and 3.9% in 2021. Hungary plans to retain its family support initiatives, tax cuts, and investment support measures. The payroll tax rate has been lowered from 19.5% to 17.5%, advertising tax has been annulled until 2022, the tax rate for small businesses in 2020 is 12% (down one percentage point compared to 2019), and VAT refunds of up to 5 mln forints are available for home construction. Due to the above-mentioned expected strong growth, the government expects the deficit to narrow to 1% of GDP in 2020 and assumes that it will achieve a balanced budget in 2020 or 2023. At the same time, the European Commission expects that the structural deficit will gradually reduce to 1.5% of GDP in 2021. There is a risk of budget deficits exceeding forecasts given Hungary's weak budget discipline and the possibility of lower-than-expected growth. In addition, the high share of government expenditures in the economy compared to peers (*Fig. 14*) limits the government's ability to stimulate the economy using fiscal instruments in the event of arising headwinds in the future.

Figure 14. General government expenditure, % of GDP



Source: Ameco

Government expenditures remain high compared to GDP.

Public debt is likely to fall in the near future. ACRA expects a further decrease in public debt, which is expected to be 68.0% of GDP in 2019 and around 65.0% in 2020 (*Fig. 12*). The key condition for this trend is persistent economic growth and a contained budget deficit, which has been possible thanks to the budget revenue growth rate outpacing that of expenditure. The government intends to continue its growth-friendly tax policies, which has been an important factor in boosting tax revenue. However, going forward the moderation of economic growth of the country's main trade partners could become a countervailing factor for such an export dependent economy as Hungary and have a negative impact on tax collection. Moreover, a significant share of rigid budget expenditures could limit the government's ability to keep the budget deficit contained.

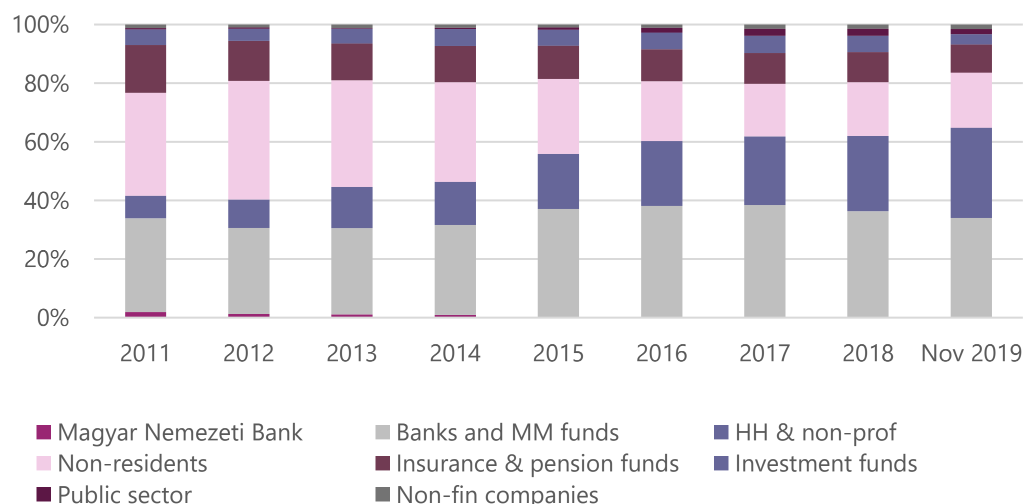
Public debt has been falling, but only marginally.

The government debt structure has become less dependent on external sources. The Hungarian government has improved its public debt structure since 2011. As of the end of 2018, general government debt denominated in local currency constituted the lion's share - 77.2% of total public general government debt, three percentage points higher than the year before. Central government debt denominated in local currency at the end of 2019 amounted to 82.1% compared to 49.4% at the end of 2011. In January 2020, the government bought back its USD 1 bln Eurobond issue in order to further decrease its external exposure. The non-marketable portion of debt has decreased to 7% from 25% since 2011. The share of general government debt held by non-residents at the end of 2018 was 36.5%, one percentage point lower than the year before. Non-resident ownership of domestic government securities decreased from 16.3% in 2011 to 9.6% in November 2019. The investor base has shifted to local participants, thereby lowering external vulnerability and dependence on foreign inflows.

The government debt structure has improved.

As for the composition of the investor base, domestic banks' share increased to 33.8% of total debt in domestic government securities in November 2019 from 32.0% at the end of 2011. Households have become the second largest group of investors in government securities (*Fig. 15*). Their share was 30.8% at the end of November 2019 and increased by 23.1 percentage points from the end of 2011. The government introduced a new retail bond program (MAP+, which has step-up coupon rates, starting from 3.5% and reaching 6% by maturity) in order to maintain households' interest in government securities. Taking into account the fact that the simple average of the coupons over five years is 4.95% and the current yield on market five-year bonds is 1.5%, the final costs of this program will lead to an increased debt burden in the future. On the one hand, this high reliance on retail investors demonstrates the government's will to diversify its investor base, but on the other hand it shows that the domestic debt market has limited capacity and may encounter political issues should the government have any issues with servicing this debt.

Figure 15. Structure of domestic debt holdings

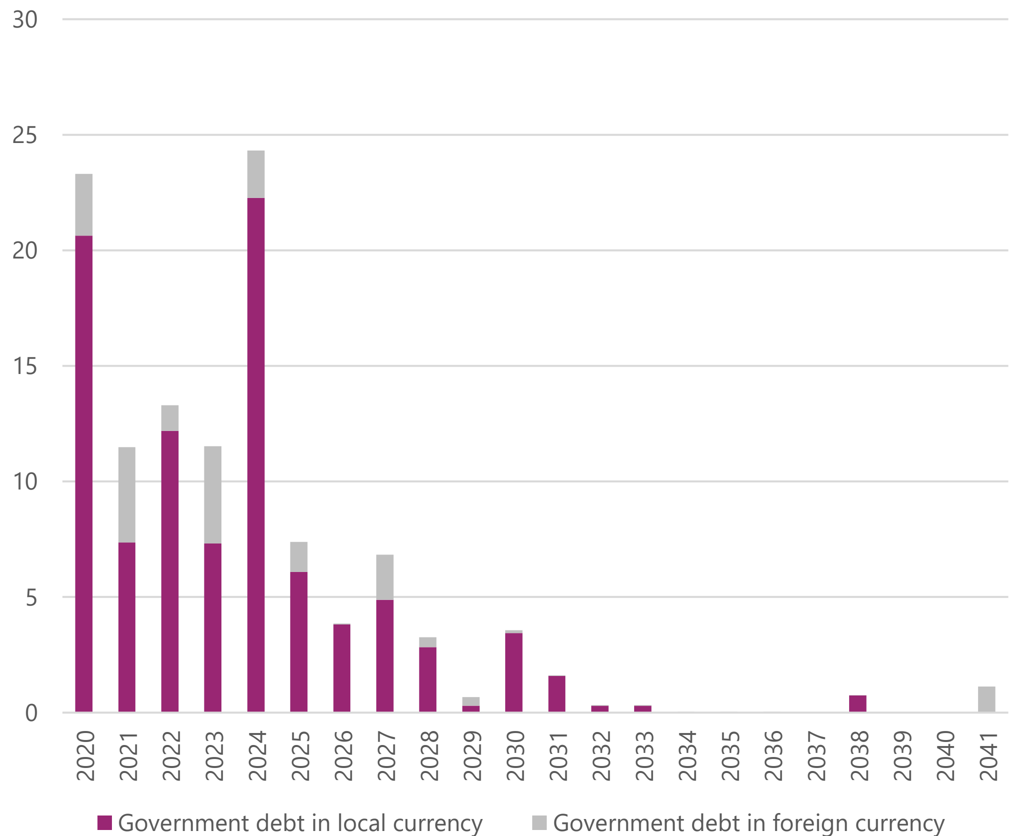


Source: Hungarian Ministry of Finance

Short-term debt increases the risk of refinancing. The average maturity of general government debt in Hungary is the lowest among its peers in the region — at the end of 2019 it stood at 4 years (a 0.4 year increase vs. a year ago), compared to 4.8 years in Poland, 6.1 years in the Czech Republic, and 5.8 years in Romania. As a result, the bulk of redemptions is concentrated in the next 5 years (*Fig. 16*) with the peaks in payments (20.5% and 21.3% of outstanding debt) scheduled for next year and 2024. As the debt structure is predominately tilted towards short-to-medium-term debt, the gross financing needs are estimated at 15.9% of GDP in 2020, significantly lower than the 2019 figure of 24.3%. This is due to a lower planned deficit this year and less redemptions. At the same time, the government tries to improve the redemption profile by issuing more medium-term notes. Compared to the beginning of the year, the share of bonds that mature in 2024 increased from 6.8% to 21.3% at the end of 2019.

Gross borrowing needs are high, but the local market is the main source of borrowing.

Figure 16. Redemption schedule, HUF bln

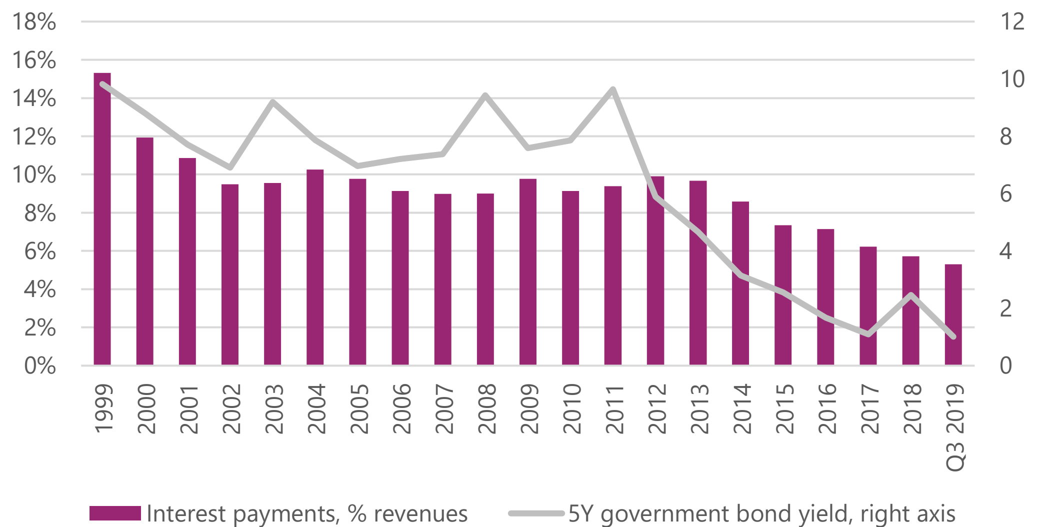


Source: Hungarian Ministry of Finance

The low interest rate environment has improved the affordability of public debt, but the growing share of debt with floating interest rates poses a risk. Government yields in Hungary have been following the downward trend witnessed by Central European countries, which was heavily influenced by the ECB's easing policy. At the end of 2018, interest payments stood at 5.7% of revenues compared to almost 10% at the end of 2012, thereby indicating an improvement in the affordability of debt. However, the share of public market debt with floating interest rates increased to 16.7% at the end of 2019 compared to 7.3% at the end of 2011. A higher share of debt with floating interest rates increases the government's exposure to interest rate risk. Materialization of this risk could put additional pressure on the budget balance (*Fig. 17*). During 2019, the yield curve shifted downward and flattened out. Five-year yield decreased the most (115 bp) and reached 1.26%, while one-year and ten-year yields moved by 37.0 and 73.5 bp and reached 0.07% and 2.13%, respectively. These levels are close to historical lows for Hungary, thus providing a favorable environment to lower debt levels and increase maturity.

Exposure to interest rate shock is high.

Figure 17. Interest payments

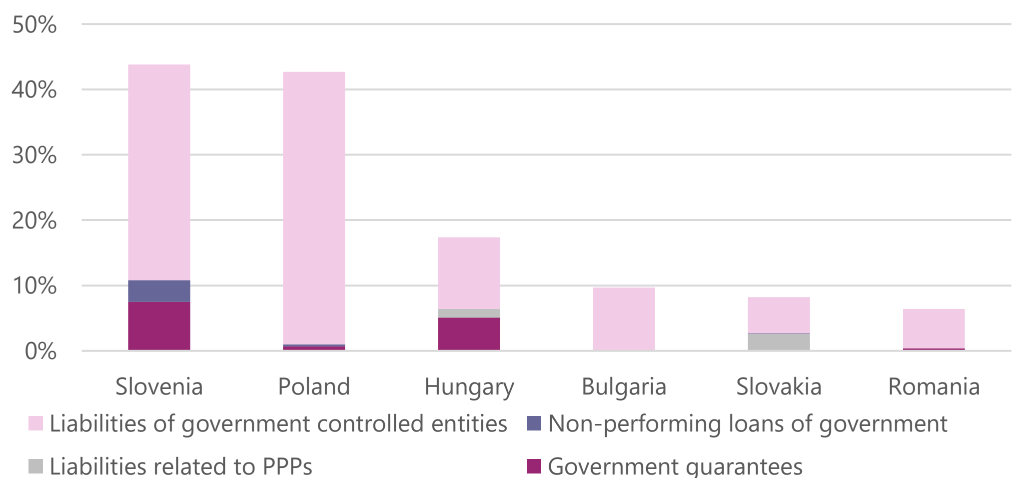


Source: Hungarian Ministry of Finance

Contingent liabilities are contained. Compared to its peers, Hungary has limited exposure to contingent liabilities. The share of contingent liabilities falls between Slovakia and Romania (both at 8.2% of GDP) and Slovenia and Poland (43.8% and 43.3% of GDP) (*Fig. 18*). The elevated levels in the latter two countries are due to state ownership of banks. Contingent liabilities peaked in 2015, reaching 28.5% of GDP. Yet by 2018 they had decreased to 17.5% of GDP. However, the materialization of contingent liabilities could be more damaging for the country in view of its elevated debt level. According to Eurostat data, Hungary's contingent liabilities are mostly represented by government controlled entities, and this mirrors the trend of increased state presence in the economy since the incumbent government took office in 2010.

Contingent liabilities are limited.

Figure 18. Contingent liabilities, % of GDP, as of 2018



Source: Eurostat

The contingent liability risk from the financial sector is muted. After the severe consequences of global financial crisis, Magyar Nemezeti Bank, in line with European banking regulations, presented and implemented a broad macroprudential framework aimed at mitigating excessive systemic risks in the financial sector. Macroprudential policy tools include instruments to contain the risks of excessive credit growth, address liquidity risks, limit excessive exposure concentration, etc. As a result, Hungarian banks became well capitalized and now meet liquidity requirements. At the end of 2018, the non-performing loan ratio had fallen to 5.5% from 23.0% in 2015 and liquidity coverage was well above the regulatory requirement — 167.0% vs. 100.0%. Banks' foreign exposure has decreased and

The standing of the financial sector has improved since the crisis.

assets in foreign currency exceed liabilities, and therefore the sector is a net external creditor. The measures taken by the government after the crisis resulted in its share in the banking system reaching around 20% of total banking assets. Since then the Government has significantly decreased its exposure by selling almost all of the stakes it acquired back to investors. As a result, potential contingent liabilities of the government that may arise from banks' liabilities are limited.

Non-financial sectors are also in better shape, but risks related to government ownership persist

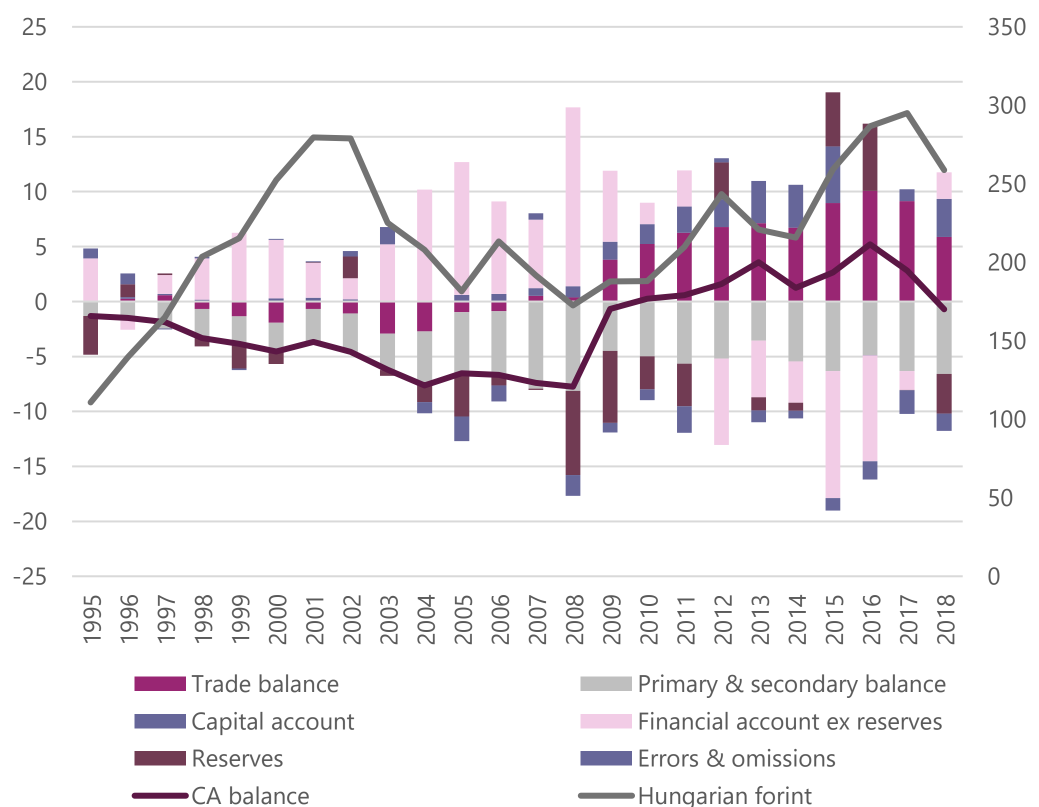
Although the non-financial sector has deleveraged, government ownership in the sector has increased. Liabilities of the non-financial sector in securities and loans have decreased to 52.2% of GDP from almost 80.0% in 2009. External exposure has also decreased from more than USD 30 bln in 2008 to USD 22 bln in 2019. The debt service ratio of the private non-financial sector has improved significantly from above 18% in 2009 to 7.1% in Q2 2019, similar to that of Poland (6.9%), and better than that of the Czech Republic (7.8%). At the same time, the government increased its ownership in various sectors such as electricity, natural gas, and the media. Therefore, contingent liabilities that could arise as the result of poor management of these companies could turn into an additional burden on the state.

External position

Hungary's external position is weak, but has been improving.

The current account is at risk of weakening further. After eight years (2010–2017) in surplus, Hungary's current account (CA) slid into a deficit in the last four quarters, ending September 2019 at 0.8% of GDP. The reversal of the current account trend was driven by a strong increase in imports due to high consumption, which was somewhat mitigated by the record high numbers of tourists, who helped boost exports of services. The CA is likely to decrease further in the near future. This decline is likely to be driven by weakening exports caused by a cooling of the country's key trade partners' economies and higher imports driven by strong consumption. The deficit of the primary income account, a typical feature of countries that are FDI recipients, is unlikely to be mitigated by remittances (around 3% of GDP) and EU funds.

Figure 19. Current account, USD bln



Source: Magyar Nemezeti Bank

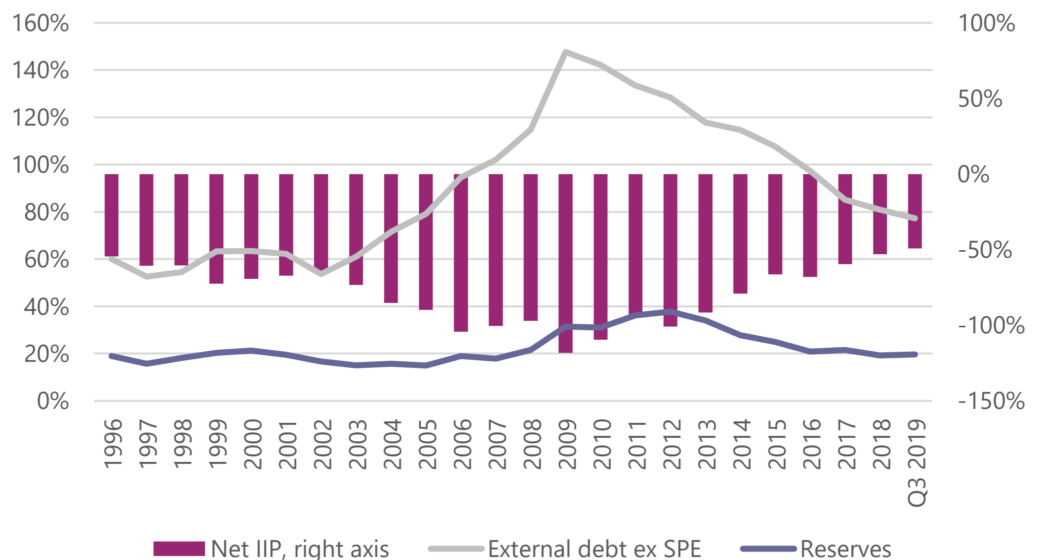
External vulnerability has fallen, but external debt coverage is a cause for concern. After 10 years of deleveraging, by Q3 2019 the external debt excluding special purpose entities (SPEs) had decreased to 77.2% of GDP (EUR 108.9 bln) from its peak of 147.7% in 2009. Taking into account SPEs, external debt stood at 96.9% of GDP. Similarly, by Q3 2019 the net international investment position (NIIP), excluding SPEs, had improved to almost (-)49.2% of GDP compared to (-)113.4 % of GDP in 2009 (*Fig. 20*). The deleveraging was driven by the government-induced policy of rebalancing from external borrowing in foreign currency to domestic borrowing in local currency. In particular, in 2012 and 2015 international reserves were used as one of the instruments to decrease external exposure related to households' FX mortgages. The significant improvement in external indicators is a sign of the country's reduced external vulnerability.

Reserves are well below external debt and cover the minimum needed amount of imports.

At the same time, by the end of Q3 2019, international reserves covered only 25.57% of the country's external debt and 37% of external debt in foreign currency. Also, as of Q3 2019, foreign currency reserves covered external debt due in one year by 146.2%, thus in the short-term the economy is protected from external vulnerabilities. Reserves covered 3.6 months of imports in 2018. This value meets IMF criteria of 3 months, but is low compared to Poland and the Czech Republic, where the coverage is 5.3 and 9.3 months, respectively. ACRA expects a marginal improvement of the external debt coverage because external debt is likely to continue falling gradually and reserves will remain around their current level.

On more positive note, the external debt structure improved due to the decreased share of short-term debt, which had decreased to 17.5% in Q3 2019 from 27.2% in 2011. The government remains the main external borrower, accounting more than a third of external debt issuance.

Figure 20. External exposure and reserves, % of GDP



Source: Magyar Nemezeti Bank

Institutional framework

Hungary's deteriorating institutional framework puts additional pressure on its credit rating. Almost all the institutional indicators show that the quality of Hungarian institutions is worsening (*Fig. 21*). ACRA calculates institutional factors using the World Bank's World Governance Indicators (WGIs). Combined with the government's increased presence in the economy, worsening institutions may point to lower efficiency of the distribution of wealth among economic agents. The European Commission is considering linking government performance to the future distribution of European funds. Hungary has already suffered from this issue — in 2012 the European Commission suspended the

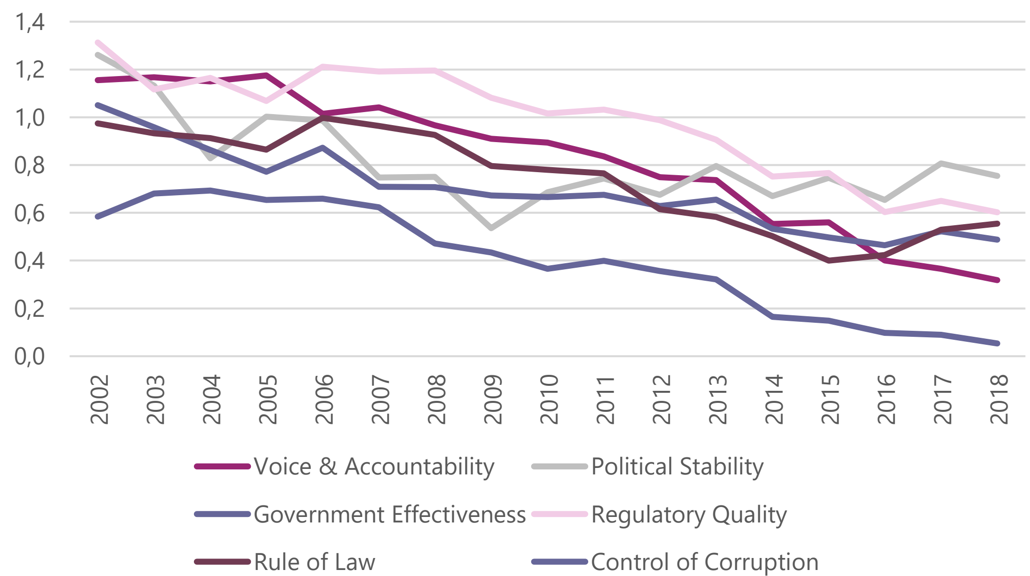
transfer of EU funds to the country due to a lack of efficient measures to stabilize the budget. There were a number of similar cases in 2013, 2015, and 2016.

The EU has already triggered the so-called Article 7 process to question the government for breaching EU values, i.e. removing judges, targeting non-government organizations, and encroaching on freedom of the press and the fundamental rights of migrants, asylum seekers and refugees.

Hungary's institutional quality is under pressure.

The Human Capital Index also limits Hungary's credit rating. The negative HCI dynamic is primarily caused by the decreasing education sub-index (average years of total schooling, age 15+). Hungary also lags behind its peers in the Doing Business Index and Global Competitiveness Index. The poorest pillars (ranked below 130 out of 140) in the Global Competitiveness Index are: efficiency of legal framework in challenging regulations, ease of finding skilled employees, internal labor mobility, attitudes toward entrepreneurial risk, and diversity of workforce that mirrors tight labor markets.

Figure 21. World Governance Indicators, estimate



Source: World Bank

Appendix 1. Comparative analysis of Hungary and the sample group

Comparison of macroeconomic and institutional indicators for 2018

		Hungary	Romania	Czech Republic	Slovakia	Poland	Bulgaria
Macroeconomics	GDP PPP per capita (international dollars)	31,914	26,448	37,340	35,137	32,005	23,169
	Real GDP growth (%)	4.9	4.1	3.0	4.1	5.1	3.1
	CPI (% y-o-y, av / av)	2.8	4.6	2.2	2.5	1.6	2.6
	Openness of economy (% of GDP)	81.1	43.8	75.2	97.3	53.8	84.3
	Unemployment (ILO assessment)	3.7	4.2	2.2	6.6	3.8	5.3
Public finance	General government debt (% of GDP)	70.8	36.7	32.6	48.9	48.9	20.4
	External general government debt (% of GDP)	25.8	17.2	13.2	30.7	22.2	10.1
	General government budget balance (% of GDP)	-2.2	-2.9	1.9	-0.7	-0.5	0.1
External position	Current account (% of GDP)	-0.5	-4.5	0.3	-2.5	-0.6	4.6
	Primary income balance (% of GDP)	-4.0	-2.5	-5.3	-2.0	-3.7	-1.0
	Short-term external debt to total external debt (%)	16.1	13.9	49.2	41.6	14.0	24.0
	External debt position (% of GDP)	81.0	49.1	81.9	113.0	61.4	60.4
	Export diversification index *	0.41	0.45	0.43	0.48	0.40	0.45
Institutional framework **	Political stability and absence of violence	0.8	0.1	1.0	0.8	0.5	0.4
	Government effectiveness	0.5	-0.3	0.9	0.7	0.7	0.3
	Rule of law	0.6	0.3	1.0	0.5	0.4	0.0

* Indicates the extent of differences between the country's trade structure and the average world indicator and ranges from 0 (weak differences) to 1 (strong differences).

** Assessment of effectiveness ranges from -2.5 (weak) to 2.5 (strong).

Sources: IMF, World Bank, United Nations Conference on Trade and Development, International Labor Organization, National Ministries of Finance

Appendix 2. Key indicators

Balance of payments, EUR bln

	2013	2014	2015	2016	2017	2018
Balance of trade	**3.3**	**2.1**	**4.1**	**4.0**	**1.9**	**-1.7**
Exports	70.2	73.8	78.5	78.6	85.6	88.6
Imports	66.9	71.7	74.4	74.6	83.6	90.3
Balance of services	**3.8**	**4.5**	**4.9**	**6.1**	**7.2**	**7.5**
Exports	17.0	18.7	20.3	21.9	23.9	25.0
Imports	13.2	14.2	15.4	15.8	16.6	17.6
Balance of Primary income	**-2.9**	**-4.6**	**-5.1**	**-3.1**	**-5.1**	**-5.3**
Balance of Secondary income	**-0.6**	**-0.8**	**-1.1**	**-1.7**	**-1.2**	**-1.3**
Current account	**3.6**	**1.3**	**2.6**	**5.2**	**2.8**	**-0.7**
Current account (% of GDP)	3.5%	1.2%	2.4%	4.6%	2.3%	-0.5%
International reserves at the end of the period	**33.8**	**34.6**	**30.3**	**24.4**	**23.4**	**27.4**

Source: Magyar Nemezeti Bank

External position (assets and liabilities), EUR bln

	2013	2014	2015	2016	2017	2018
External debt, excluding SPE	**112.0**	**121.1**	**119.3**	**110.9**	**105.6**	**106.8**
long-term (including intra-corporate loans)	76%	82%	82%	83%	84%	84%
short-term (residual maturityup to 1 year)	24%	18%	18%	17%	16%	16%
External debt, including SPE	*147. 3*	*152.8*	*145.3*	*138.7*	*128.5*	*133.4*
External liabilities, excluding SPE	**201.3**	**200.6**	**214.7**	**199.1**	**199.8**	**207.9**
Direct investments	101.2	103.0	120.3	105.8	107.7	116.4
Portfolio investments	49.7	49.9	49.3	49.20	48.6	46.6
Other investments	50.4	47.7	45.1	44.1	43.5	44.8
including deposits	*10.1*	*9.7*	*9.7*	*10.7*	*12.2*	*11.6*
External assets, excluding SPE	**114.8**	**116.7**	**139.7**	**119.7**	**123.1**	**133.8**
Direct investments	53.9	53.8	73.9	51.3	54.7	60.1
Portfolio investments	7.0	7.8	8.3	9.6	11.8	10.9
Other investments	18.2	20.6	27.2	34.3	33.1	35.4
Net external debt, excluding SPE	**48.9**	**47.0**	**22.0**	**26.9**	**16.4**	**11.8**
Net external debt, excluding SPE and FDI	36.8	34.4	27.3	21.9	17.2	11.8
International investment position, net (% of GDP)	**-91**	**-79**	**-66**	**-68**	**-60**	**-53**
External debt (% of GDP)	**118**	**115**	**108**	**97**	**85**	**81**

Source: Magyar Nemezeti Bank

Budget indicators, % of GDP

General government	2013	2014	2015	2016	2017	2018
Income	**46.7**	**46.9**	**48.2**	**45.1**	**44.7**	**44.2**
Expenses	**49.4**	**49.5**	**50.1**	**46.8**	**46.9**	**46.5**
including debt servicing expenses	4.5	4.0	3.5	3.2	2.8	2.5
Primary budget balance	1.9	1.4	1.6	1.6	0.6	0.3
Overall budget balance	**-2.6**	**-2.6**	**-1.9**	**-1.6**	**-2.2**	**-2.2**
General government debt	**77.2**	**76.7**	**76.7**	**76.0**	**73.4**	**70.8**
% of income	*165.1*	*163.7*	*159.2*	*168.4*	*164.1*	*160.1*
Central government						
Income	**31.7**	**32.2**	**32.8**	**31.0**	**31.8**	**31.0**
Expenses	**37.3**	**36.3**	**34.9**	**32.8**	**34.0**	**33.3**
including debt servicing expenses	4.2	3.7	3.3	3.0	2.6	2.3
Primary budget balance	-1.4	-0.4	1.2	1.1	0.4	0.0
Overall budget balance	**-5.6**	**-4.1**	**-2.1**	**-1.9**	**-2.2**	**-2.3**
Central government debt	**72.7**	**73.3**	**71.8**	**71.7**	**69.7**	**68.2**
% of income	*229.4*	*227.9*	*218.9*	*231.6*	*219.1*	*220.2*
Note: nominal GDP, EUR bln	101.8	105.6	110.9	113.9	124.0	132.0

Sources: Government Debt Management Office, Hungarian Central Statistical Office

Rating history

None.

Regulatory disclosure

The sovereign credit ratings have been assigned to Hungary under the international scale based on the Methodology for Credit Rating Assignment to Sovereign Entities under the International Scale and the Key Concepts Used by the Analytical Credit Rating Agency Within the Scope of Its Rating Activities.

Sovereign credit ratings have been assigned to Hungary for the first time. The sovereign credit ratings and their outlook are expected to be revised within 182 days following the publication date of the press release on the sovereign credit rating assignment as per the Calendar of planned sovereign credit rating revisions and publications.

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ACRA provided no additional services to the Hungarian government. No conflicts of interest were discovered in the course of the sovereign credit rating assignment.

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