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ACRA assigns long-term credit ratings of BBB to Hungary under the international scale, outlook Stable

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**.

The **Stable outlook** assumes that the rating will most likely stay unchanged within the 12 to 18-month horizon.

Credit rating rationale

Hungary's BBB sovereign credit rating is supported by strong GDP growth, which is likely to slowdown in the short-term, significant reduction of foreign currency exposure, and balanced banking sector fundamentals. The rating is constrained by the country's weak fiscal position, elevated level of general government (GG) debt, constrained economic potential, weak current account balance, limited export diversification, and relatively weak institutional factors.

In 2018 Hungarian GDP growth rate achieved 4.9%. It's economy is likely to slow down following a period of strong economic expansion in last six years. ACRA expects GDP to grow at 4.5% in 2019 and 3.5% in 2020. Hungary is likely to reverse to its potential economic growth, which was outpaced due to expansionary monetary and fiscal policies. Both of these policies could soon run out of steam. The current economic environment might push inflation outside the target corridor, whereas public debt is already one of the highest among the Central and Eastern European (CEE) countries. Moreover, a weaker external environment, which has negatively affected Hungary's main trade partners, will be another factor limiting the country's GDP growth. ACRA believes that in the long-term, Hungary's economic potential will be constrained by poor demographics, the expected phasing out of EU funds, and a lower share of research & development expenditure in GDP than the EU average.

After chronic deficits that pushed the general government debt to an elevated level of 80.5% of GDP in 2012, the country's public debt decreased to 70.8% of GDP by the end of 2018. The decrease was driven by narrower budget deficits starting in 2012 as well as buoyant economic growth. ACRA expects a further decrease in public debt, which is expected to be at 68.0% of GDP in 2019 and around 65.0% in 2020. These decreases should be driven by economic growth, which is likely to outpace budget deficits. Achieving these targets will be challenging given Hungary's historically high general government expenses, which account for almost half of GDP and are the highest in Central Europe. ACRA also notes that the increasing rigidity of the budget expenditures could limit the government's ability to effectively manage its expenses.

Hungary's public debt structure poses concern. Unlike its peers, Hungary's debt has low average maturity with gross financing needs at 25% of GDP. Moreover, the government has increased the issuance of floating rate bonds. This is justifiable in a low interest rate environment but may carry interest risks if the rates start to increase, causing significant deterioration in the country's fiscal position. In ACRA's view, contingent liability risks associated with the banking sector are balanced.

The financial sector is in better shape compared to the pre-crisis period. Hungary has implemented a macroprudential framework aimed at mitigating excessive systemic risks in financial sector. As a result, Hungarian banks are well capitalized, having low

levels of non-performing loans and meeting liquidity requirements. Banks' foreign exposure decreased, assets in foreign currency have exceed liabilities, and as a result, the banking sector is a net creditor. In recent years, housing prices dynamic in Hungary have been stronger than in the EU. However, they do not pose systemic risk because, in ACRA's opinion, they are not credit driven and household assets are high. However, contingent liabilities associated with the non-financial sector are not negligible. In ACRA's view, they are driven by an increased share of state in the economy.

Hungary's external debt significantly decreased from 150% of GDP in 2009 to 80% of GDP in 2018 due to the policy measures aimed at decreasing external exposure and limiting associated risks. However, external debt coverage remains weak. By the end of 2018, international reserves covered only 19.4% of the country's external debt and 25.3% of external debt in currency, which is one of the lowest ratios in the region. At the same time, as of Q2 2019, foreign currency reserves cover external debt due in one year by 157%. Therefore, Hungary's economy is protected from external vulnerabilities in the short-term. The import cover at 3.1 months in 2018 was also below that of the country's peers. The significant decrease in Hungary's external debt has positively affected the country's net international investment position, which decreased from its pre-crisis level of almost 120% of GDP in 2010 to around 40% in 2018. However, it is still lower compared to the country's CEE peers.

After eight years in surplus, Hungary's current account dropped to -0.5% of GDP in 2018. It is likely to decrease further in the short-term due to weakening exports and higher imports driven by strong consumption and the deficit of the primary income account. Machinery and transport equipment make up 55% of Hungary's total exports, with the EU being the main export destination (80% of total exports). The country's largest single trade partner is Germany, which makes up 27% of total exports. Germany and the automobile industry are exposed to industry-specific risks and risks associated with global trade tensions. Therefore, Hungary's exposure causes some concern regarding the country's export outlook.

Hungary's institutional factors are relatively weak according to World Bank governance indicators. Almost all indicators show that quality of Hungary's institutions is worsening. Decreasing institutional quality may also negatively affect public investments as the European Commission considers the quality of institutions in the allocation of EU Funds.

Sovereign model application results

Hungary has been assigned an A- Indicative credit rating in accordance with the core part of ACRA's sovereign model. A number of modifiers in the modifiers part of the model decrease the Indicative credit rating. These include the following, which are determined by the Methodology for Credit Rating Assignment to Sovereign Entities under the International Scale:

- Potential economic growth;
- Sustainability of economic growth;
- Contingent liabilities;
- Fiscal policy framework and fiscal flexibility;
- Debt sustainability;
- Balance of payments vulnerabilities;
- External debt sustainability.

Modifiers that could serve as grounds to increase the Indicative credit rating have not been identified.

In view of the abovementioned modifiers, Hungary's credit rating has been decreased by two notches. Therefore a Final credit rating of BBB has been assigned. There are no

extraordinary factors that could result in an adjustment of the Final rating. In connection with this, the Assigned credit rating remains at BBB.

Potential rating downgrade factors

Slower decrease in government deficit and debt than expected, increased external exposure, further increase in state presence in the economy that could trigger contingent liabilities.

Potential rating upgrade factors

Faster decrease in general Government Debt than planned, lower annual gross financing needs, efficient stimulation of the natural population growth.

Issue ratings

No outstanding issues have been rated.

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.

The 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 this press release as per the Calendar of planned sovereign credit rating revisions and publications.

The sovereign credit ratings are based on information from publicly available sources, as well as ACRA's own databases. The sovereign credit ratings are unsolicited. The Hungarian government did not participate in the credit rating assignment.

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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