MINISTRY
FOR NATIONAL ECONOMY

Hungary's sovereign debt continues to be in investment grade category

Two out of the three major international credit rating agencies, Moody's and Standard&Poor's had reviewed the rating of Hungarian long-term forex government securities this year and left it unchanged for at "BBB-", with stable outlook. The announcement of Standard&Poor's came on 24 February 2017, while that of Moody's was on 6 March. Prudent fiscal policy, improving economic performance and Hungary's stable economic balances have all contributed to the fact that Hungary has managed to maintain the rating. On the other hand, the country must improve the external debt position.

Formerly, Hungary's investment grade status had been restored by Fitch Ratings in May, by Standard&Poor's in September and by Moody's in November 2016. The fact that none of the credit rating agencies has in this year revised Hungary's debt rating is fully in line with analysts' expectations. Following the latest upward revision in November, resulting in a "stable outlook" verdict by Moody's, no further change has been expected, especially as it is highly unusual for international credit rating agencies to announce two upgrades at successive revisions. The fact that Hungary's debt rating has been left unchanged and government securities are recommended for investment shows that the Hungarian economy has been growing stronger.

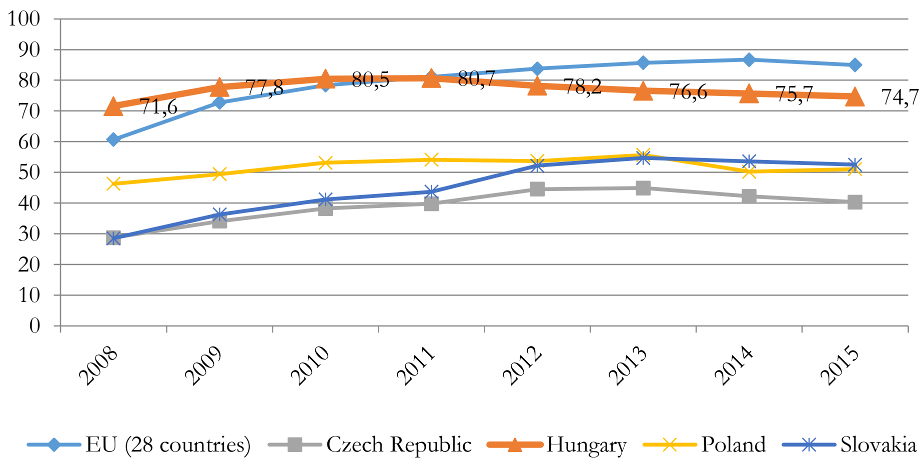
In the rationale accompanying the decision, Standard&Poor's noted that **Hungary's external balance is strong, thanks to a massive current account surplus** and a modest general budget deficit. These two factors have substantially helped the country to remain in the "stable outlook" category in spite of the relatively high external debt ratio. Demand for Hungarian government securities has picked up in recent months, which concurrently reduced yields and cut fiscal expenditures related to interest payments. This trend may further steady the financing of state debt. Hungary has managed to gradually regain the confidence of economic stakeholders in the country since the global financial crisis, which in turn helped boost employment and improve financing conditions.

S&P analysts predict modest economic growth in the long term: around 3 percent of GDP this year and slightly below 2.5 percent annually in the period 2018-2020. They also expect that the current general government debt-to-GDP ratio of 73.9 percent, a figure estimated by their own methodology, is set to decline to 73.0 percent by the end of 2017, to 71.5 percent by the end of 2018, to 69.3 percent by the end of 2019 and 67.4 percent by the end of 2020. The ratio of government budget deficit is prognosticated at 2.5 percent of GDP for this year, 2.3 percent for

2018 and 2.2 percent for 2019. The Government-brokered wage deal concluded at the end of last year and subsequent real wage and consumption growth are seen as major factors behind the almost 3 percent of GDP growth predicted for the end of this year. Other drivers of growth are forecast to be the accelerating EU fund inflows, fiscal easing, the reduction of VAT on certain products, the lowering of the bank tax rate, employment growth, the improving financial position of the private sector and the extension of housing incentives.

Fig.1. shows the general government debt-to-GDP ratios of the Visegrad Four and the European Union. This indicator signals a downward trend in Hungary since 2011: in 2011-2015, Hungary's government debt-to-GDP ratio fell by 6 percentage points. Although the ratio is still above those of the other Visegrad Four members, it is better than that of the EU average. In this respect, the Czech Republic posted the most favourable data: 40.3 percent in 2015.

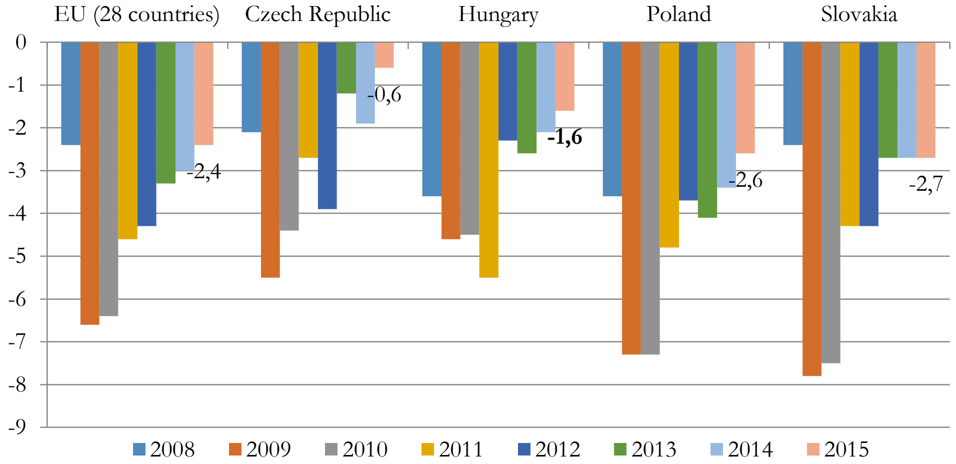
Fig. 1: General government gross debt (% of GDP)



Source: Eurostat

Hungary's general government budget deficit totalled EUR 1 722.3 million in 2015, accounting for 1.6 percent of GDP (Fig.2.). The ratio of fiscal deficit in percentage of GDP has been edging down since 2013. This indicator showed a decline of 3.9 percent of GDP between 2011 and 2015, over the course of four years, and it has been below the EU average since 2012. Among the Visegrad Four, in comparison to Hungary only the Czech Republic had a lower government budget deficit in percentage of GDP in 2015.

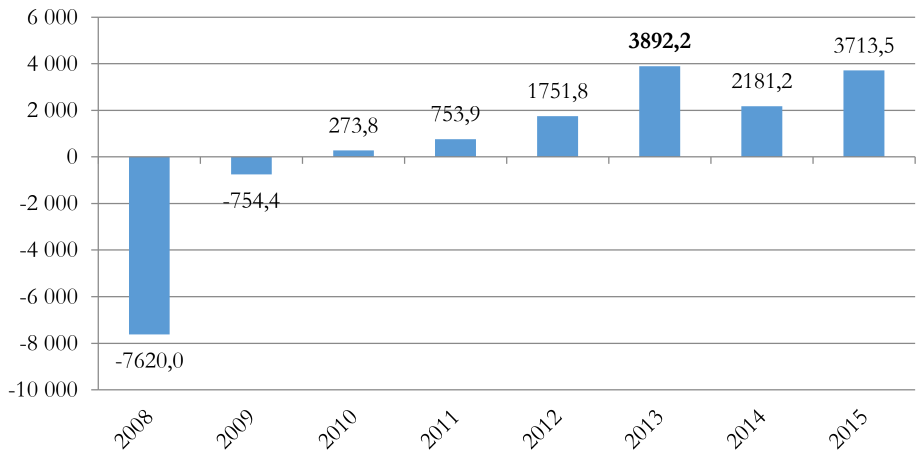
Fig. 2: General government deficit (-) and surplus (+) – annual data (% of GDP)



Source: Eurostat

Data of Fig. 3 demonstrate how stable Hungary's external balance has become: they show Hungary's current account deficits and surpluses each year between the crisis year of 2008 and 2015. The chart reveals that while Hungary had a huge shortfall of EUR 7 620 million in the current account in 2008, a surplus of EUR 273.8 million was registered in 2010. After that, in 2015, the surplus of the current account has soared as high as EUR 3 713.5 million. Since 2009, Hungary has not closed a single year with a deficit.

Fig. 3: Current account balance of Hungary, yearly data (million EUR)

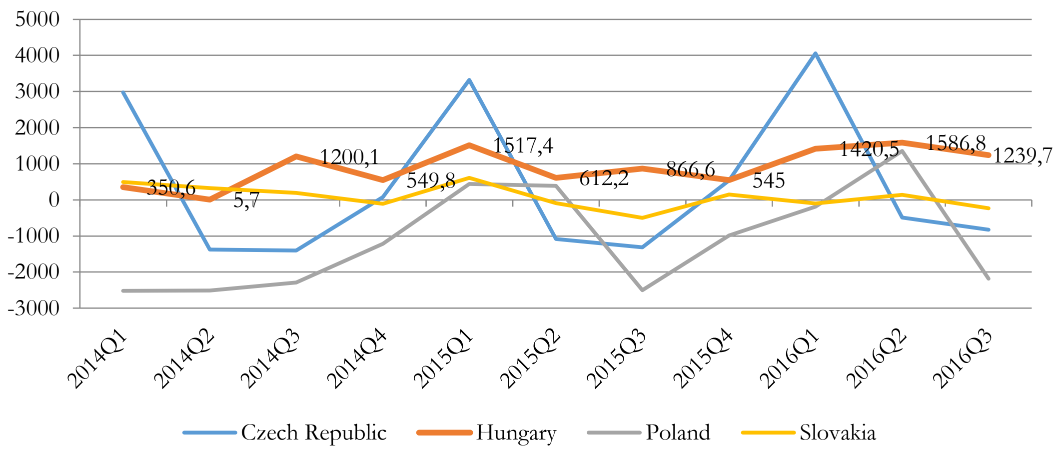


Source: Magyar Nemzeti Bank (MNB)

Fig. 4 shows quarterly current account data of the Visegrad Four. **Between Q1 2014 and Q3 2016, only surpluses were recorded in Hungary**, of which the highest, EUR 1 586.8 million, was registered in Q2 2016. The largest overall surplus was posted by the Czech Republic in Q1

2016, but the country's current account balance tends to display large fluctuations. Poland's current account typically closed the observed quarters with deficits, of which the largest, EUR 2 515.6 million, was registered in Q1 2014.

Fig. 4: Current account of V4 countries, quarterly data (million EUR)



Source: Eurostat

High external debt may be one of the hurdles in the way of the next upgrade. Public finances have changed favourably last year, but fiscal expenditures jumped at the end of the year, and the general government debt-to-GDP ratio has also failed to fall as much as credit rating agencies had expected. As a whole, the Hungarian economy posted meagre growth, which signals structural problems on the one hand and, on the other hand, reflects the fact that Hungary has scored worse on global competitiveness rankings in various categories than our regional peers. Foreign investment continues to be a key determinant for Hungary and Hungarian banks still rely heavily on forex financing. Accordingly, exposure in this aspect should be mitigated and Hungary's banking system requires development and stronger foundations.

Aiming for a more affirmative view by international rating agencies and a better rating in the next round of revisions, Hungary must further improve the economic outlook, for which the prudent fiscal policy pursued in recent years may serve as a potent stepping stone. As next, Fitch Ratings is scheduled to have a review date on 12 May 2017.

As market perceptions continue to presage the decision of credit rating agencies, and these are far more upbeat about the performance of the Hungarian economy, our sovereign debt rating is highly likely to be lifted again. As another factor, the faster-than-expected pace of government debt reduction and relieving frictions in the transmission mechanism of monetary policy may also help in obtaining a more favourable conclusion.