



**Zoltán Farkas**

## Hungarian bubbles

Despite the horror–stories circulating in the world press, Hungary's budget deficit at 3 per cent of GDP and its public debt at just above 70 per cent do not fare too badly in a global comparison. "So what's our problem?", asks Zoltán Farkas.

In early March, during a visit by Prime Minister Gordon Brown, President Barack Obama made an unguarded remark about "emerging markets like Hungary or the Ukraine", and how to make sure their problems do not "wash back onto our shores".<sup>1</sup> Well, it is hardly we who present a danger to America. Hungary, on the other hand, faces a real threat after 2010 thanks to the massive indebtedness of large nation states — and this goes for the whole of central and eastern Europe, too.

How did we enter the picture? Mark Hutchinson, the editor of the New York Times, scared his readers in February by saying that "the [US] federal government's ratio of debt to gross domestic product [...] may equal Hungary's current ratio." As a result of bank bailouts and fiscal stimulus, the US ratio of debt to GDP will reach 70 per cent in the next three years, the level which has made the financing of Hungary so difficult in the past six months,<sup>2</sup> he added.

The latest European Commission forecast suggests the British figures are no less worrying: its public debt is seen jumping from 44 per cent in 2007 to 71 per cent by 2010. Even the combined budget deficit of the euro zone — the world's most disciplined region regulated by the Stability and Growth Pact — is expected to more than double this year, and the public debt of 15 member states will swell to 73 per cent of their GDP in 2009 and to 76 per cent next year.<sup>3</sup>

Hungary does not stick out like a sore thumb, but government bonds underpinning its public debt must compete with bonds denominated in euros and dollars, as well as with British or American government securities. It is hard even for Irish, Greek or Spanish bonds to keep pace with such competition. The European Central Bank takes their bonds as collateral in exchange for credit. No such luck for EU members outside the euro zone. No wonder both former Prime Minister Ferenc Gyurcsány and the opposition's likely candidate for prime minister Viktor Orbán raised a cry urging a level playing field. This would not go amiss: Hungarian bonds were nigh on impossible to sell for many months since October last year. (It was only in April that Hungary finally braved the market with a sale of medium–term government bonds.) Without its 20 billion euro credit line from the International Monetary Fund and the European Commission available until March 2010, Hungary would have had to shut up shop.

Has Hungary been blackballed by the global financial community? Almost. It is a fact that ever since Iceland's spectacular collapse the forint and Hungary's situation has been steady fodder for the world's press. And this is a problem whether they worry or promise help. Obama did both. It is just that some of his remarks got less coverage than others. In both cases, the forint stands to fall. Neither Hungary's budget deficit at 3 per cent of GDP nor its public debt at just above 70 per cent — high, but not excruciatingly so — fare too badly in a global comparison. So what's our problem?

Hungary's road to hell was paved with nothing but good intentions, along with a handsome measure of irresponsibility. The government blew up the largest bubble in the public finances between 2002 and 2006 by misleading people with wage rises well in excess of economic performance — nearly double its growth rate — and making them believe that this would last for ever. Households planned their future based on the promise of higher income, and this is what boosted retail turnover; this gave the hope for young and old alike to borrow. The bubble popped in 2006 and its echoes still reverberate. In the three years since, the government has pared the budget deficit by 7 per cent of GDP, carrying with it a drastic decline in wages and income. As a consequence of austerity measures, economic growth slowed from 4 per cent to 1 per cent. This is when the crisis hit.

Hungary has inflated other bubbles, large and small, within its public finances. The first one is the state pension fund, whose deficit has climbed to 2–3 per cent of GDP, including 13th-month bonus payments and corrections based on the Swiss indexing method, which adjust pension rises to inflation and wage rises in equal measure. Money to finance this had to be re-channelled from tax revenues, which were also used to top up the state health-care coffers. The health-fund deficit was reined in by a drastic law on streamlining hospitals and cutting drug spending in 2006, but this is not likely to produce dividends for long. There is still no harmony between social security contributions and health-care services. No limits have been placed on the use of services, and contributions deducted from pay at source give no incentive to anyone — except for the health-conscious few — to stay in good health via prevention such as screenings. In other words, instead of being used sparingly, health care is still characterised by souped-up demand. The government has created a social bubble, too: the value of various types of support, come rain or shine, follows the rate of inflation regardless of economic output. This bubble has also burst: the government can't be profuse enough in retracting earlier promises made to pensioners and takes an axe to welfare spending wherever it can (or where it has the courage to do so).

In short, over the past six years the state has redistributed enormous amounts of income between the economically active and inactive population in favour of the latter group. Now it is forced to do the opposite. But what it now takes back from social security funds and welfare spending will scale back consumer demand. And this will deepen the recession. It has no other choice, however.

Hungary's own crisis was not caused by the liberal state — there was no such thing. It was caused by the welfare state, the vastest among the region's new democracies and one which has put a ruthless burden on the economy. No wonder, that it has been hit so seriously by the international credit crunch and the recession.

Another bubble emerged on the housing market. Government interest subsidies and other types of state support enabled the barely creditworthy to buy homes.

Banks competed with each other to waive proof-of-income as well as combining two types of state subsidy based on interest and assets. And by this subsidy they lowered mortgage rates to a third of market rates. This was as good as pouring money on the credit market by the bucket load. Just like in America. The middle classes took the most advantage, and when the Socialist-Liberal government realised that this was unjust, it introduced slight cuts in benefits to the more well-to-do, providing more support for poorer families. This however led to serious abuses of the system: some lined their pockets while taking everything away from uneducated indebted families — in some places with the willing assistance of the local housing authority and banks.<sup>4</sup>

Hungary's mortgage bubble would only burst if house prices fell below the value of mortgages. In this case, banks would either need extra collateral or to foreclose on defaulters. To a limited extent, this is the situation today. But if the situation gets out of hand financial institutions will save themselves or their clients — in either case this would be one and the same: the state would have to step in either on their behalf or on behalf of debtors. Provided it has the means. And the bubble, which in itself would have been trouble enough, is part and parcel of the dizzying spiral of consumer debt. In 2002, fiscal and monetary policy started falling out of sync. The state went on a spending binge and the central bank tightened the monetary belt. Speculators leaped at the contradiction and two attacks on the forint followed in 2003. After this period the central bank kept base rates at a high level. There was not much else it could do, as foreign investors were only willing to purchase any Hungarian government instruments at a considerable interest premium. Forint-denominated loans were expensive, so commercial banks switched to euro loans, then to Swiss Frank-denominated ones with even lower interest rates, and they encouraged their retail and business customers to become indebted in these currencies. It was easy for them to do: their parent banks provided all the foreign currency they needed. The banks bought forints in return for euros and Swiss francs, and, in the end, it is in forints that they granted the loan which was originally calculated in the foreign currency. Their purchases and constant demand also contributed to the forint's strengthening. This created a fictitious foreign-currency debt bubble as far as households were concerned. On money markets, however, the bubble was very real. The generosity of parent banks suddenly evaporated last October as they seemed to concentrate instead on their own balance sheets. Recovery from this sea change has not been achieved since.

That being said and done, the Hungarian economy in Spring 2009 was no stronger or weaker than in the months preceding the eruption of the crisis in October. Only, at that time, foreign direct capital was still flowing in, banks were still basing their lending on foreign currencies and foreign investors were still showing interest in Hungarian shares and government bonds. Since October 2008, stock market investors have been leaving in droves, the government bond market has dried up, bank lending has come to a halt and foreign direct investments have run aground. There hasn't been any demand for forints or forint-denominated instruments — either stocks or bonds — for months. Some signs of a thaw were seen in the first few days of May coinciding with some glimmers of global improvement.

When the financial crisis erupted, foreign investors and banks turned their backs on Hungary (and several other states in the region). This was a real problem, because the gross foreign currency debts of the Hungarian state and the private sector combined was almost equivalent to gross domestic product

in forint terms in October 2008. This data has done the rounds of the world's press. The amount of foreign currency debt rather than the budget deficit, whose downward trajectory had been securely established, most likely drove speculators preying on the forint. In 2008, the deficit had shrunk to 3.6 per cent of GDP, which put Hungary in the midfield in the EU. Still, the past two years of disciplined budgetary policy has not been sufficient to restore Hungary's credibility.

The central bank and government saw the danger early on and they swiftly turned to the International Monetary Fund and the European Commission, creating a model for other countries seeking global bailouts. (After Ukraine and Latvia turned to the IMF promptly in the first days of the bloodshed, Romania and Poland followed suit.) But this was of little use in fighting the recession, which is bundled up with the financial crisis; it even embroiled stronger new EU countries than Hungary. States who had pegged their national currency to the euro are spared the speculative attacks against their currency, but, at the same time, they import all the pain and anguish of their export markets: every euro of loss has an immediate and decisive impact on the incomes of businesses and consumers. In the last quarter of 2008, production in Latvia and Estonia fell by a tenth compared to the same period a year earlier, and the Lithuanian economy has stagnated for a year. Members of the euro zone — Slovenia and Slovakia — lose out not only as a result of their atrophied export markets but also due to dwindling competitiveness compared to their regional rivals courtesy of the firming euro. What Slovaks now feel as a blessing — they can shop cheaply in Hungary — may in time become a curse in terms of price competition between the "Visegrád" countries (Hungary, Slovakia, Czech Republic, Poland). The devaluation of the zloty, the Czech crown and the forint, despite its extreme dangers, can act to some extent as an automatic stabiliser: the same amount of income in euros was worth 30 per cent more in forints in January 2009 than six months before. Increased export revenues can somewhat compensate for fallen business income suffered from the loss of some markets.

However, no cure is available for the complete loss of a market. Hungary's industrial output in the first months of the year was down by a fifth from a year before.

Moreover, the rate the forint was fetching in early March was already doing more harm than good. Hungary's GDP was worth roughly 1109 billion at a forint/euro rate of 250, but only 88 billion at a rate of 310 to the euro. This is not a fictional loss. As the forint weakens, the debts of borrowers in foreign currencies jumps. And by recalculating loans, banks also add risks related to foreign-currency loans to their balance sheets. Imports and foreign travel become dearer, and large swings in the exchange rate make Hungarian export income unpredictable. The devaluation of the local currency evidently increases public debt calculated in forint terms: its level in proportion to GDP was 66 per cent in 2007 and 73 per cent in 2008. Under such circumstances, neither the central bank nor the government can be choosy about its methods: everything must serve the aim of retaining the state's solvency and protecting the forint — whatever the cost — even if high interest rates and timetabled public spending cuts make economic recession even worse. Elsewhere governments try to pump supplementary demand into the economy; in Hungary, the government sucks money out month by month and from day to day.

This is where the government's greatest dilemma lies: how to secure solvency and still boost the economy. As prime minister, Ferenc Gyurcsány, battered and brutally attacked by the opposition, settled for the former: he more or less calculated that public spending must be reduced by exactly the amount by which revenues were shrinking so that pledges to the European Union could be kept (the budget deficit should not exceed 3 per cent of GDP). The 2009 budget approved by a majority in parliament last December had estimated a contraction of 1 per cent, but in March, the finance ministry already forecast a contraction of 3–3.5 per cent. In line with these developments, the government had proposed spending cuts of the same measure, curtailing, among other things, health-care spending and agricultural subsidies. This turned out to be inadequate: it was clear from December and January data that the recession would be even deeper, possibly contracting to 6 per cent.

There was no time for a complete makeover of the budget, and the Socialist prime minister appeared to lack the stomach for it. He resigned instead, making way for a semi-technocratic government. Mr Gyurcsány was replaced by his former Economy Minister Gordon Bajnai, who gathered around him a fairly homogeneous team to tackle the crisis. His finance minister, Péter Oszkó, a first-rate tax expert, was András Simor's deputy at Deloitte's Hungarian unit until the summer of 2006 when Simor went over to head the National Bank of Hungary. Oszkó then took over from Simor at Deloitte and it is from there that he moved to the ministry in April. Bajnai himself had worked with Simor at CA Securities in the 1990s and they still have a sound understanding. The new prime minister had received the backing of two parliamentary parties — a majority — while still a candidate for the job, and presented a strongly pro-cyclical economic policy.

While half of Europe is relaxing, Hungary is eager to keep fiscal rigour in the hope that this policy will sooner or later bear fruit.

With the aim of bringing public finances closer to balance, Bajnai has taken a radical hand to welfare spending. He has scrapped the 13th-month pension, introduced by the Medgyessy government in 2002 without corresponding revenue from pension contributions. Similarly, he has eliminated the 13th-month bonus for public-sector workers and frozen wages in the public sector for two years. Family benefits will also roughly stay level, while the period of child-care benefits will be shortened and the retirement age raised from 62 to 65. The government topped the clear-cut austerity measures by reconfiguring the tax system: tax and contributions on labour will be gradually reduced; value-added tax and excise duties are to be raised; and a graduated real-estate tax will be introduced from 2010. The former is expected to ease the cost of employment and improve Hungary's economic competitiveness; and the latter can be seen as measures through force of necessity. Without raising taxes on consumption, other cuts in taxes and contributions could not be made. Keeping in mind that the deficit target is sacrosanct.

The Bajnai package was well received by analysts at home and abroad, so the forint could benefit from an easing (temporary or long-term, who knows?) of the global money market: early in May one euro fetched for just under 280 forints, whereas in February–March the rate was 300–310 forints. "An improvement in the international environment undeniably plays a role in the forint's strengthening. I did not expect such improvement in confidence in the short term, and there could certainly still be volatility, as markets are very uncertain. If we are consistent in doing what we must, the forint can stabilise in about six months, while foreign-currency loans and jobs can also stabilise. But

this requires many months of work and several tough decisions, as the initial decisions have only brought us conditional confidence," the prime minister said in a radio programme.<sup>5</sup> Let's add: confidence will return only if the bubble in default-prone Hungary, blown up partly by the international financial world, is burst once and for all.

## Hungary and the IMF

Hungary will have little choice other than to extend its loan with the International Monetary Fund. At the spring financial summit in Washington, 25–26 of April, a correspondent for business weekly HVG heard the organisation's leaders say that the Fund would not leave the vulnerable region of eastern Europe in the lurch.

Here the real catastrophe is only just beginning. Anyone who got a glance at the meeting of the IMF and World Bank last weekend was not left in any doubt about that. This year, the recession will surpass 10 per cent of gross domestic product in the three Baltic States. Because their local currencies are pegged to the euro, wages will slide by a similar ratio. The IMF predicts that the Czech Republic and Slovakia — both more competitive than Hungary — will get through the year with economic slumps of 3.5 per cent and 2 per cent respectively (both countries' leaders had hoped to escape a recession only a few months ago). The IMF in its latest World Economic Outlook cheerfully forecasts a 3.3 per cent contraction of Hungary's economy in 2009. But appearances are deceptive. No one in IMF circles in Washington feigned ignorance of the source of this weird optimism: during the March review of Hungary's bailout programme, the Finance Ministry balked at forecasting a bigger contraction lest the country's budget deficit target for this year of 3 per cent of GDP should be put at risk. (A deeper recession, of course, means less budget revenue and an automatically higher deficit.) The Bajnai government, which came into office in April, plans to reconfigure the public finances accordingly. At the meeting, Finance Minister Péter Oszkó and Central Bank Governor András Simor personally briefed IMF and World Bank leaders of the latest corrections, which include welfare and pension changes as well as modifications to tax policy.

It was a little over a month ago that the IMF's delegation reviewed the government's November programme and approved the second tranche of the loan, worth \$2.4 billion, after disbursing the first tranche of \$4.9 billion. Three parts of \$1.5 billion each are still available for refinancing foreign-currency debts and strengthening the banking sector until the programme's expiry in March 2010. The latter guarantees the Hungarian state the ability to get through this period without a penny of new financing. The question is what will happen later. An increasing number of experts think that if the financial crisis fails to ease, the loan's deadline should be extended or a new pact agreed with the IMF, since it would be too early to allow the market alone to shape Hungary's state financing. This is something that the IMF leadership probably anticipates as well, knowing that the crisis has hit the eastern European region especially hard. To make matters worse, the world's largest countries are only now beginning to pile up their own enormous public debts, arising from a combination of dwindling revenues, bank bailouts and economy-boosting spending. These require financing too. So the states of eastern Europe too are likely to face a disturbing lack of financing after 2010. "The global economy will begin to recover in 2010 and the credit squeeze will ease, provided that governments' economic stimulus programmes work," Jörg Decressin, Chief of the IMF's World Economic Studies Division, told HVG. So far the IMF has

granted some \$78 billion worth of loans to this troubled region, almost the same amount as they granted to all needy countries combined during the 1998 Asian crisis.

Lately, the IMF has become more and more lenient with its debtors. During the review in March of Hungary's programme, its experts were not insistent about it sticking to the 3 per cent budget deficit goal at all costs. But the government did not want to risk any slackening, keen as it is to avoid European Union procedures for excess deficits and to concentrate in earnest on adopting the euro. "The costs of a higher-than-anticipated recession must be weighed against the risks of stimulus," IMF chief executive Dominique Strauss-Kahn told HVG on the press conference. "It was a very challenging moment (when Hungary turned to the IMF), but in a difficult time, you may be aware that we recently had our first review of that arrangement, and were able to move forward with some additional funding for the Hungarian economy. We're hopeful in a difficult time that we can provide adequate support", IMF's first deputy CEO John Lipsky added. And indeed, some weeks later, at the second review of the Hungarian programme in May, both the IMF and the European Commission accepted some fiscal easing: the new deficit target for 2009 is 3.9 per cent of GDP and 3.8 per cent for 2010, not to freeze the economy completely.

The IMF, which in 2008 had been suffering from budget and staff cuts, managed to renew its entire arsenal in six months so that it could engage new sources and loan constructions. Based on a decision made at the G20 summit in London, the IMF will grant \$250 billion worth of Special Drawing Rights (SDR), its own "currency". Of this, Hungary will receive some \$1.2 billion worth of funds which can be drawn on unconditionally and can be used towards boosting foreign currency reserves. A further 221 million SDR (\$332 million at current rates) is also available if member states finally approve a policy mooted many years ago to grant members reserve currency who had never received SDR, among them Hungary, which joined the Fund in 1982. On top of this, the IMF may draw in new sources of up to \$500 billion, although it is not very clear at this point who might donate this sum. "We'll manage it by the end of the year," Strauss-Kahn said with confidence, who described the new policy, using IT terminology, as IMF 2.0.

Among its latest innovations proudly cited, IMF has already launched its so-called flexible credit line, more of a kind of insurance than a loan and can only be granted to states that run a rigorous fiscal policy. But they can get it fast and almost without conditions in order to contain troubles due to market disturbances beyond their control. First Mexico, then Poland appealed for these funds, though Polish Deputy Finance Minister Ludwik Kotecki hastened to state that it is not likely that the money would actually be used. Hungary is not yet eligible for the loan the Poles have earned, and is receiving a "traditional" standby credit line instead. In response to HVG's question whether this could be converted into a flexible credit line if needed beyond the expiry date of March next year, European Director at IMF Marek Belka said "the latter requires demonstrating outstanding fiscal progress". In other words no — or at least not as things stand today.

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<sup>1</sup> "One of the things that Prime Minister Brown and I talked about is, how can we coordinate so that all the G-20 countries, all the major countries around the world, in a coordinated fashion, are stimulating their economies? How can we make sure that there are a common set of principles, in terms how we're approaching banking, so that problems that exist in emerging markets like Hungary or the Ukraine don't have these enormous ripple effects that

wash back onto our shores? And we're providing them with some help in a coordinated international fashion, as well." (Jeff Zeleny–David E. Sanger, "Obama and Brown Pledge Cooperation". The New York Times, March 4, 2009)

- <sup>2</sup> "Based on the costs of fiscal stimulus and the bank bailout, the federal government's ratio of debt to gross domestic product is heading much higher. By 2011, it may equal Hungary's current ratio — which skyrocketed due to profligate spending and remnants of centrally planned waste. While other factors are important, that suggests the credit quality of currently top-rated Treasury debt may trend down more toward the quality of Hungary's government debt, which is nearer the bottom of the investment grade pecking order. That's not a complete disaster, but it means Treasuries won't really be a safe investment, either. Assuming deficit projections by the Congressional Budget Office for the 2009 and 2010 fiscal years are right, and adding the cost of the stimulus plan, the bank rescue plan and borrowing costs, public debt would rise from 41 per cent of G.D.P. in September 2008 to about 70 per cent of G.D.P. three years later. That is roughly in line with Hungary's December 2008 ratio. After 2011, America's debt-to-G.D.P. ratio is expected to decline again. The budget office projects deficits of less than 2 per cent of G.D.P. after 2012, and the capital injected into the banking system under the government's bailout plans should start to produce some returns for taxpayers around that time. There are considerable downside risks. The budget office's projections are based on optimistic assumptions: that growth averages 4 per cent annually from 2011 through 2014, that the Bush tax cuts and alternative minimum tax relief all expire in December 2010, and that discretionary spending increases only in line with inflation after 2010. The falling debt projection also assumes that none of the costs under the stimulus plan migrate into annual spending after 2010. Should the recession deepen, or persist beyond 2010, higher budget deficits could become entrenched. Finally, the projection assumes interest rates in the United States remain low. With Treasury bond maturities now averaging only 48 months, higher interest rates would rapidly feed into higher borrowing costs and budget deficits. 'No European government has done anything as boneheaded as we have,' Ferenc Gyurcsany, Hungary's prime minister, said of his country's fiscal policy in May 2006. By 2012, United States policy makers may be echoing his words." ("U. S. Debt Gains on Hungary's". The New York Times. February 19, 2009.)
- <sup>3</sup> European Commission, Interim Forecast, January 2009. The projection was based on economic stimulus measures announced thus far.
- <sup>4</sup> For a period of time, a certain type of subsidy called the "semi-social support" could be used as collateral for a mortgage when buying resale homes and there were no criteria as to the comfort level of the home purchased. See Sággy, Erna, "Árnyékvilág" [Shadowland]. In: HVG, June 28, 2008.
- <sup>5</sup> Info Radio, May 7, 2009.

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