

There is Life in Junk too

Zoltán Török

Chief Economist,
Raiffeisen Bank Hungary,
torok.zoltan@raiffeisen.hu

The development of Hungary's risk profile

Amidst the recent euro-zone sovereign-debt problems, attention has clearly shifted to countries with extensive vulnerabilities not only inside, but also outside the euro-area. Hungary qualifies among the first where investors' attention is focused in such a scenario. This is partly due to the inherited problems (those developed in the past one or even more decades) as well as to the current economic policies of the administration.

Probably the two words "unconventional" and "unpredictable" are the best to describe the economic policies of the Orbán government. As far as its fiscal policies are concerned, one should add the word "nontransparent" as well.

Hungary Public debt (in GDP%)



Figure 1.

The public debt in Hungary (in GDP%)

Source: own compilation

Orthodox and non-orthodox fiscal measures are mixed together with suddenly changing emphasis-shifts between the two. For example, the government stepped out from the IMF program in 2010 summer, however it has launched negotiations with the IMF in November 2011 once again. The government set penalizing banking tax and crises tax on certain industries (retail; energy; telecom sectors) for three-years time period, in the same time it has cut the both the corporate income tax and the personal income tax. Nevertheless corporate income tax cut plans were largely abandoned. Structural reforms have put on the agenda in late 2010, and several major items will be implemented – though several needed ones will be not. There is a shift in taxation: income tax has lessened while consumption and wealth tax increased. Altogether, the 2012 and 2013 budget plans signify a shift from erratic unconventional and loose fiscal policy to a orthodox and restrictive one.

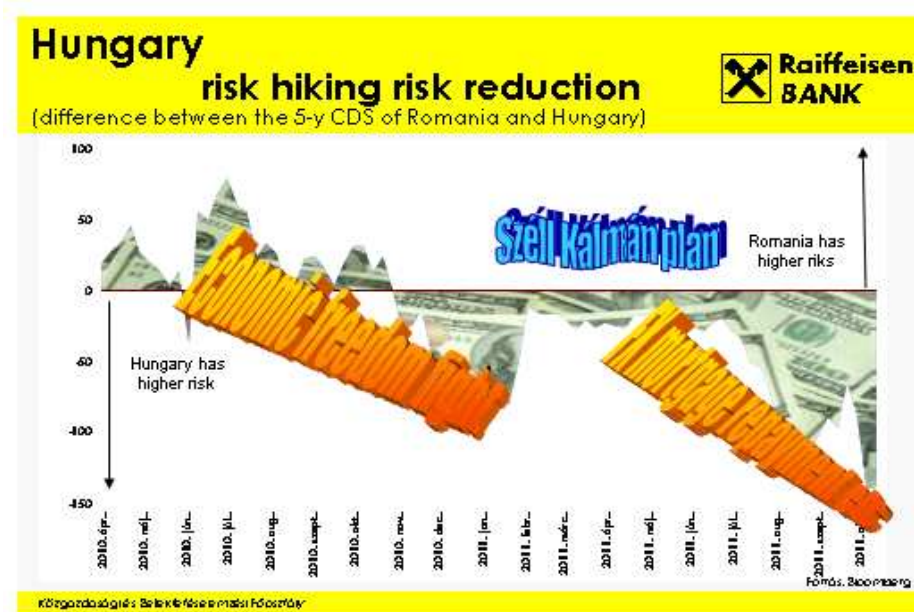


Figure 2.

Risk hiking risk reduction in Hungary

Source: own compilation

In 2011 Hungary has a genuinely loose fiscal policy stance. Without the pension fund assets returning to the state (one-off revenue equalling around 10% of GDP), and without all the other one-off items (both on the expenditure and on the revenue side), the budget deficit would run at around 6.5% of GDP. Nevertheless, in ESA methodology, due to the pension fund assets (almost 10% of GDP revenue) the budget will be balanced.

The zero budget deficit year is an exceptional one and clearly unsustainable one. Therefore there is no alternative for the Orbán government but massive savings for 2012 and beyond. Certainly there is the political power and apparently, there is the willingness from the side of the government to make the necessary and painful measures. However, communication-wise the government's performance was rather dubious. It has developed several programs and ad-hoc measures that aims to tackle the deficit issues – nevertheless it has not bundled them together. Moreover, as far as the structural expenditure cuts are concerned – the communication was very low-key so far. Clearly, in 2012, the government will spend less money on several items (social

transfers; pensions; higher education etc.) All those who will be worse off, will certainly become rather unhappy about it, and will raise their voice. It has already happened in early summer with regards to police and the fire department (street demonstration). Others will follow suit.

These measures can be categorized into four subgroups. 1.) structural reforms on the expenditure side (also known as the “Széll Kálmán” plan); 2.) the “Convergence” program; 3.) 2012 extra expenditure cuts; 4.) 2012 extra revenue hikes. According to our estimates the savings on the different items will come as follows:

1.) Széll Kálmán plan HUF 400-425bn

A. Labor market measures (HUF 140-160bn in 2012 vs. HUF 195bn original plan)

1. stricter conditions for job search allowance (duration: 270-> 90 days; upper limit 120% of the lowest mandatory wage -> 100%)
2. termination of job search benefit
3. public work scheme (no details yet)
4. transformation of the wage substitute benefit (to employment substitute benefit; only those can receive who are unable to get temporary job in a public work scheme)
5. maximization of social and family support transfers available under several titles (90% of the public employment wage level)
6. financing of active labor market policies and vocational trainings from EU funds
7. transformation of the sick pay benefit system (upper limit 4times the minimum wage -> 2 times of the minimum wage) + passive sick pay benefit ceased to exist (2011 July)
8. fixing the nominal level of family allowance

B. Pension reform (HUF 20-25bn vs HUF 93bn plan)

1. review of disabled pension benefits and early pension schemes

C. Public transport (HUF 15bn vs 45bn plan)

1. cutting subsidies

D. Higher education (HUF 6bn vs. HUF 12bn plan in 2012)

1. cutting the number of those who can study for free
2. merger of universities

E. Drug subsidies (HUF 83bn plan is realistic in 2012)

1. revenue side items (all kind of extra burden on pharmaceutical companies)
2. generic program
3. all other measures

F. Central government and municipalities (HUF 44bn vs. 32bn plan)

1. reorganization of functions with regards to the economy of scale (education, healthcare etc.)
2. central govt. efficiency enhancement measures

G. Revenue side item (HUF 90bn)

1. banking tax unchanged

Altogether HUF 400-425bn vs. HUF 550bn plan

2.) *Convergence program HUF 300bn*

- A. public wage freeze
- B. stability reserve measures

3.) *Extra measures on the expenditure side (HUF 150bn)*

- A. cutting administration costs
- B. cutting money allocated to road reconstruction fund
- C. eliminating public functions
- D. reorganizing social subsidy schemes

4.) *Extra measures on the revenue side (HUF 450-475bn)*

- A. VAT hike (25% -> 27%)
- B. excise duty hike

- C. social security contribution increase by 1%
- D. all sorts of small taxes (extension and increase of the unhealthy food tax; introduction of the accident tax; company car tax hike; gambling tax hike; etc.)

Nevertheless, several of the above mentioned measures overlap. Moreover, for example the convergence plan itself does not mean nominal savings, it is rather a tool that enables expenditures to stay (i.e. no increase).

According to my calculations, roughly HUF 1100bn savings is needed in order to reach the budget target (2.5% deficit in 2012). As the above measures may not be fully implemented and because of the overlaps, we forecast 3.5% budget deficit. Nevertheless, with additional measures or even with a full commitment in the implementation of the above measures, the budget deficit may be reduced below 3% of GDP.

During the financial crisis in October 2008 the Monetary Council decided to take a drastic 300bp rate increase before the Council started lowering rates again in a slowly improving macroeconomic environment. For Hungary a comparable crisis situation seems to have re-appeared again starting in August 2011 when the forint began a weakening streak against the euro and yield levels started to rise significantly. This time, however, the crisis was not a global one but rather a European made one. The inability of European politics to resolve the debt issues in a credible manner as well as home made topics in Hungary led to the renewed meltdown in Hungarian assets. On top of all the unsolved external and internal troubles the rating agencies put pressure on Hungary and threaten with rating downgrades below investment grade.

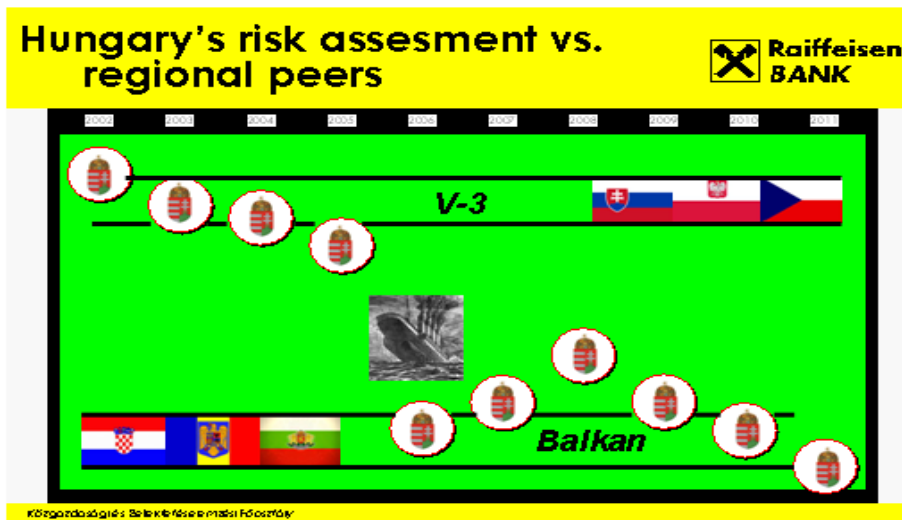


Figure 3.

Hungary's risk assesment vs. regional peers

Source: own compilation

Clearly this environment proves to be difficult for the Monetary Council and there is rising pressure to react to the situation. We are of the opinion that the council will raise interest rates in order to support the forint and try to buffer the negative shocks from the current market environment. We currently expect the council to increase interest rates by 25bp at each scheduled meeting in order to give some support, but we do not expect a one time massive increase as seen during the financial crisis. But all this depends on the continuation and extend of the current debt crisis. If we see continued extreme pressure and ongoing forint depreciation against the euro the Monetary Council could decide to react in a massive step to try and calm markets. While this is not the base case assumption we would not rule it out. Another important role in the interest rate outlook will also be the development of foreign exchange loans. The strong increase in FX loan payments due to a weaker forint was one of the reasons why the Central Bank had to support the forint via a massive interest rate increase. Should there be a convergence of the FX loans into HUF loans the Council would have considerably less pressure to stabilize the forint via stronger interest rate increases.

The situation for the forint turned uglier and uglier since it started to depreciate against the euro in August 2011. The debt situation in the Eurozone brought along rising risk aversion and the domestic political practice did its part to the worsening of the situation. In November the forint reached the highs seen during the peak of the financial crisis in March 2009.

Clearly the Monetary Council will try to give some support to the forint via interest rate hikes, but the overall weak development of the Hungarian economy compared to its CE peers together with the sometimes unclear political communication and decision making will continue to keep EUR/HUF on the weaker side in the coming months. Nevertheless, the very recent news of the Hungarian government's intention to set up an IMF agreement should limit further HUF weakening and stabilize the currency.

Our expectations are that EUR/HUF will remain slightly above 300 during the course of the European recession that we expect for the fourth quarter 2011 until the second half of 2012. Only with an improvement of the economic outlook in the second half 2012 do we expect first moderate improvements in EUR/HUF and a strengthening below 300. Apart from the economic situation a lot will also depend on Hungarian politics.

While in summer 2010 the Orbán government stepped out of the IMF program and proclaimed an economic freedom fight (involving several "unconventional" policy measures those would not have been passed within the IMF program, such as the nationalization of the pension fund assets and the penalizing bank tax and other crises taxes). In the autumn of 2011 amidst the growing concerns on Hungary's debt sustainability, the necessity of the security belt of an IMF agreement has become evident even for the policy makers. While for many observers such a move appeared to be rather difficult given the previous anti-IMF rhetoric, one should not underestimate the flexible nature of Mr. Orbán's profile proven in the past 2 decades.

All in all the forint will be hostage to the economic downturn in Europe in until H2 2012 and the possibility for Hungarian institutions to support the forint will be scarce. Afterwards the influence of Hungarian decision making by the political parties will increase and it will depend on their ability to learn from the recent past to make the right decisions with improved communication to regain market trust. This in return will pave the way for future EUR/HUF development.