

Hungary: Walking the Tightrope

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Despite an urgent need for an official external financing backstop and policy anchor, Hungary's government has been unwilling to make the necessary concessions to secure an IMF program. We think a compromise will eventually be reached, but expect Hungarian assets to endure more pain at the hands of capital markets in the meantime.

A sell-off in Hungarian assets and the decline of the forint accelerated over the past week, as the market's hopes for a prompt agreement between Hungary and official external lenders on a potential new line of credit dimmed. Preparatory talks among Hungary, the International Monetary Fund (IMF) and the European Commission (EC) on financing broke down in mid-December.

After the IMF and EC delegations left Hungary, S&P promptly lowered the country's credit rating by one notch to BB+ (with negative outlook), which is below investment grade, and Fitch followed suite this Friday. Hungarian negotiators are expected in Washington, DC, on January 11, presumably to restart discussions with the IMF, but an agreement will be difficult to achieve without fundamental compromises from Hungary.

New Laws Stir Controversy

The relationship between Hungary and

both the EU and IMF has been thorny ever since the Fidesz government came to power in April 2010. The source of the most recent contention has been Hungary's refusal to abandon two controversial pieces of legislation.

The first piece is a new Central Bank Act that's expected to restrict the bank's independence. The measure would open the door for a merger of the central bank with the financial-markets regulator under a new, government-appointed governor. The Act also provides for an expansion of the bank's Monetary Policy Council by adding two new government appointees and a new deputy governor—all of this potentially increasing government influence over monetary policy.

The second controversial piece of legislation that was being considered by Hungarian officials was a new Financial Stability Act that would enshrine in the country's new constitution a low, flat

personal income tax. While this legislative change would potentially be positive for the medium-term growth outlook (which is what the government had intended by this law), it would substantially reduce the fiscal flexibility of all future governments that fail to command at least a two-thirds majority in Parliament. This would be suboptimal for a country that still has one of the highest public debt-to-gross domestic product (GDP) ratios among the emerging markets.

Hungarian Government Remains Stubborn

Instead of making a U-turn after the suspension of talks and subsequent credit-rating downgrade, Hungary's government pushed the controversial laws through Parliament with only minor modifications. The Parliament also approved a new constitution that contains a host of other controversial articles. Opposition parties and most observers see many flaws in these new laws, including their inconsistency with EU legislation, restrictions on media freedom and changes to election rules that would favor the current ruling party.

The adoption of the new constitution has already triggered street protests in Budapest, although the Fidesz ruling party still enjoys very strong popular support. The constitution also elicited fairly negative reactions from both the US and EU. US

Secretary of State Hillary Clinton fired off a letter expressing the administration's "concerns over democratic freedoms in Hungary." This communication has probably made US investors even more bearish toward Hungary by helping paint a somewhat unjustified picture of a new up-and-coming European banana republic.

The Need for a Financing Backstop Requires Compromise

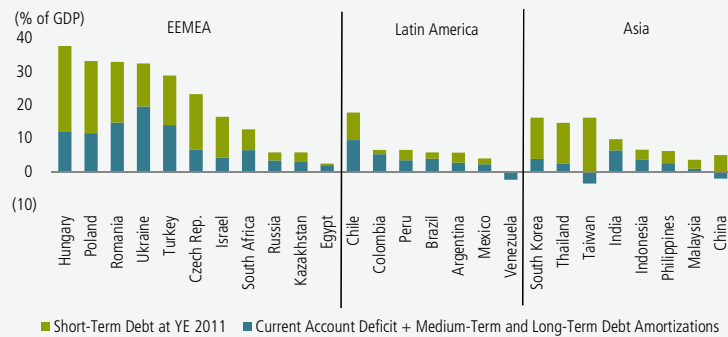
Hungary needs a joint IMF/EC credit facility (with strong policy conditionality attached) not only to restore market confidence but also to plug the hole in the country's balance of payments, which has been created by large repayments due to the IMF/EU later in 2012.

Critically, Hungary's external and government financing needs this year are the largest among the major emerging markets relative to GDP (**Displays 1 and 2**). The country's estimated external financing requirement in 2012, excluding short-term debt, is about €14 billion; of this, €4.6 billion is accounted for by the government's external debt repayments.

For an IMF/EC program to materialize, Hungary's government would first have to openly accept that any negotiated deal would be a (precautionary) stand-by arrangement, i.e., a credit facility with full-blown policy conditionality. Incidentally, Hungary stated its acceptance of such an arrangement yesterday, facing mounting pressure from markets, which had pushed the forint below its historic lows against the euro.

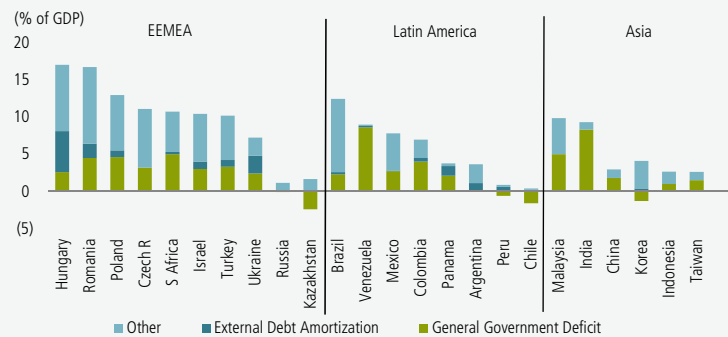
Hungary would also have to amend the controversial laws it just passed, and make a commitment to rethink its blanket schemes aimed at alleviating its foreign exchange-linked mortgage problem. Further, we think Hungary would have to pledge to phase out sector taxes that create economic distortions—including the bank levy—by year-end. The IMF would probably tolerate a budget deficit above 3% this year, given Hungary's weak

Display 1
A Challenging Year Ahead: External Financing Needs for 2012



As of December 7, 2011
Source: Credit Suisse

Display 2
A Challenging Year Ahead: General Government Financing Needs for 2012



As of December 7, 2011
Source: Credit Suisse

economy, but the EC is likely to insist that Hungary stick to its fiscal targets. This means that some additional (although not major) budget measures may be needed to secure joint IMF/EC support.

From economic and social perspectives, these concessions would be relatively modest. But Prime Minister Viktor Orbán might not accept an about-face just yet on the freshly inked legislative changes at the behest of the IMF—an institution he brazenly defied not long ago, scoring major political points. Namely, we're not convinced that the pain Hungary is enduring in capital markets has reached a

high enough threshold to make this a viable option for Orbán. The fact that the government has about €4 billion in fiscal reserves is probably the main reason for its stubborn attitude and insistence on negotiating a credit facility on its own terms.

Assuming that Hungary can roll over all of its maturing Treasury bills, it should be able to get by without turning to capital markets—at least through this May. At the same time, it's hard to see either the IMF or EC budging, especially on the issue of central bank independence.

Markets Will Force a Deal—Eventually

Ultimately, we believe that the Hungarians will compromise, but we expect that more market pressure on Hungarian assets will be needed before the government is ready to make the concessions necessary to secure an IMF/EC deal on a credit facility. We believe that more failed domestic bond auctions could be a part of this

convergence process: a three-year government bond auction failed just last week.

Meanwhile, it's possible that continued pressure on the Hungarian currency could trigger a more aggressive response from the National Bank of Hungary, perhaps akin to the three-percentage-point rate hike of October 2008. However, we

suspect that the bank may stick to its gradual 50-basis-point monthly hikes that began last November, perhaps to keep pressure on the government to compromise. We doubt the central bank would want to waste its foreign exchange reserves on fighting a losing battle against markets. ■

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