

Hungary's Slippery Slope

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Hungary has made significant progress over the past few years in stabilizing its public debt dynamics. But serious vulnerabilities remain, and the growing pains of a new government bristling at the demands for further economic austerity could seriously harm market sentiment.

The center-right Fidesz government won an important parliamentary election in April on promises of cutting taxes and stimulating growth. The previous Socialist government fell out of favor, due to the belt-tightening measures it enacted—including reforms under the auspices of a \$25 billion International Monetary Fund (IMF) bailout program that began in October 2008.

Public Debt Dynamics Under Control...

The Socialists had managed to cut the general government budget deficit from over 9% of gross domestic product (GDP) in 2006 to an estimated 4% in 2010 (**Display 1**), the lowest fiscal gap in the EEMEA region, and lower than the major industrialized economies.

Even more dramatic was the decline in the structural budget deficit, which adjusts for the fiscal impact of the 6.2% economic contraction during last year. It plunged from 10.9% of GDP to only 2.2%. In comparison, Poland's fiscal balance

deteriorated significantly in 2009. Although Poland started from a much more favorable debt-to-GDP level, its deficit swelled to 7.1% of GDP from 3.6% in 2006 even though its economy expanded last year by close to 2%.

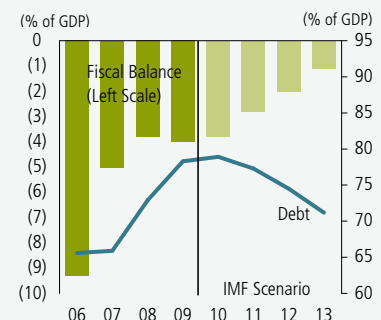
Our analysis shows that if Hungary were to maintain its fiscal stance at the 2009 level, it might be able to stabilize its public debt-to-GDP ratio at approximately 80% over the coming decade. In contrast, most peripheral and core euro-area countries will probably struggle to contain explosive debt dynamics.

...but More Austerity Needed to Quell External Financing Risks

But some serious vulnerabilities remain. Hungary has one of the largest external financing needs among all major emerging markets (EM). At 38% of GDP, its external debt repayments combined with the estimated current account deficit for 2010 are second only to Bulgaria and Latvia (**Display 2**). That makes Hungary's exchange rate highly vulnerable to the

Display 1
Debt Dynamics Stabilized, but Only Just

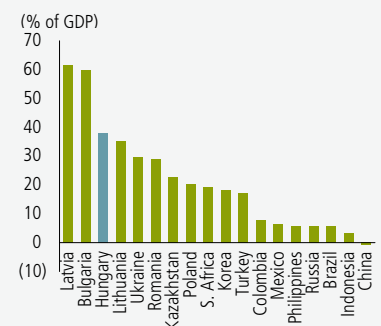
General Government Budget Balance and Debt



Source Eurostat and AllianceBernstein
As of July 31, 2010

Display 2
Hefty External Financing Needs

2010 Gross External Financing Needs*



Source: Fitch and AllianceBernstein
*Current account deficit, medium- and long-term debt amortizations, and short-term debt at end of previous period
As of March 31, 2010

market's sentiment and outlook for the country's macro stability.

This vulnerability matters more in Hungary than almost any other EM economy because of the large open foreign-exchange position of Hungary's private sector. Nearly two-thirds of all bank loans in Hungary are denominated in foreign currencies—euros (EUR) for corporations and Swiss francs (CHF) for households. For households in particular, there's almost no offsetting assets or income except in local currency.

No Room for Further Weakening of the Exchange Rate

Household loans, primarily mortgages, represent the equivalent of 20%–25% of GDP. While these loans currently have a nonperformance rate of about 10%, the central bank's stress tests show this could accelerate alarmingly if the Hungarian forint's (HUF) exchange rate were to weaken beyond 225 per CHF (or, equivalently, above 295 per EUR).

The forint currently stands less than 3.5% away from this critical exchange-rate level. A significant, permanent move beyond this level could potentially present a sizable liability for the public sector, which would need to aid insolvent households and recapitalize lenders. Unfortunately, the government has little or no room for large-scale rescue operations, because Hungary's public debt-to-GDP ratio—albeit now stabilized and comparing favorably with that of most developed economies, including Germany—stands out as one of the highest in emerging markets.

Fidesz's Rebuff of IMF Puts Public Finances on a Slippery Slope

With fiscal health now being the foremost medium-term concern across Europe, we feel very uncomfortable with the new Fidesz government's decision to turn its back on the IMF. The IMF program has provided a crucial policy anchor over the

past two years. It stabilized market sentiment and plugged the external financing hole in the initial stages when foreign capital flows all but froze amid the onset of the global credit crisis. Although the IMF's financial stopgap role has now receded, its policy anchor role remains as important as ever.

We feel additional concern because Hungary's new government has an unproven policy track record and, even this late in the year, its fiscal plan for 2011 remains unclear. To refuse the option of official IMF funding and, instead, rely completely on capital markets may prove troublesome, given the uncertain global growth outlook that's likely to produce large swings in global risk appetite. If Hungary could maintain a stable exchange rate and continue gradual growth recovery, then a 4% budget deficit would still lead to public debt-to-GDP stability. But a deficit of less than 3%, as demanded by the IMF and the EU's Maastricht criteria, would be more prudent and consistent with a declining debt-to-GDP path—something that's critical if Hungary wants to adopt the common euro-area currency later in the decade.

At Issue: Reform Fatigue and Preelection Promises

But the new Fidesz government's perspective is clouded by the upcoming October municipal elections and its earlier promises to cut taxes and stimulate growth. So it's understandable that the government is unwilling to commit to the IMF's required additional fiscal belt-tightening on the order of 1.25% of GDP—and that it rebuffed the IMF last month. With the Socialists in disarray, Fidesz's main political competition comes from the far-right Jobbik party, which is probably why the government has adopted rather harsh rhetoric against the “dictatorship” of the IMF—making it even more difficult to return to the negotiating table.

Uncertain Prospects If Fidesz Flies Solo

Could the Fidesz government “go it alone” without the IMF? If the government can access capital markets (especially to roll over domestic short-term debt), it can use its sizable deposits with the central bank to cover its domestic and external bond maturities through February of next year (equivalent to about €5.5 billion).

But the government would still have to agree with the EU on an acceptable fiscal target for next year if it wants to preserve market confidence, prevent a further weakening of the exchange rate and restrain excessive increases in funding costs. Here we doubt that the EU will grant any flexibility on the GDP target of less than 3% for 2011. Hungary holds the dubious distinction as the most serious deficit offender under the Union's “excessive deficit procedure” rule. And the current government has made far too many revisions to the 2011 fiscal target already. If the EU were to allow such a relaxation, it would send a negative incentive to other European countries, including (most critically) Greece.

The government will also have to return to the international capital markets to start repaying the 2008 IMF/EU rescue. Including previously issued Eurobonds maturing over the next three years, Hungary faces €4 billion coming due in the second half of 2011, €4.5 billion in 2012 and €5 billion in 2013. Depending on market sentiment at the time, refinancing these obligations may prove complicated unless a credible policy anchor is in place.

What Lies Ahead?

From a public debt sustainability perspective, we believe it wouldn't be a disaster if there were no IMF agreement this year and the 2011 fiscal deficit exceeded the IMF's target by only about 1%. But the government courts serious risk that market

sentiment may suffer due to uncertainty about the medium-term fiscal outlook. Worse, if this scenario coincides with an episode of global risk aversion, the forint could weaken significantly and make it difficult for the government to roll over short-term debt. Such market stress would then force the government back to the negotiating table with the IMF.

Hungary's central bank already adopted a more hawkish stance at its most recent monetary policy meeting—reflecting its discomfort with the fiscal outlook and the possibility of further increases in the country's risk premiums. In case of market stress, the central bank would first

intervene in the foreign exchange market. If that proved unsuccessful, the bank would have to hike interest rates, which is contrary to its goal of lower domestic borrowing costs in order to wean the private sector from borrowing in foreign currencies.

Several key events will clarify the situation over the next two months. When the EU's Economic and Financial Affairs Council (Ecofin) meets at the end of September, it will assess Hungary's fiscal prospects for 2011. Ecofin may also opine on whether there's any room to relax the rules on reporting the cost of pension reforms, which could help Hungary make its fiscal

target more achievable. More important, the local elections in early October may help free the government's hands to propose and pass a market-friendly budget for 2011, which is due in mid-October. But until then, there's the possibility that continued policy uncertainty could trigger ratings downgrades. Unless the government voluntarily reengages the IMF and signs a new program—a very small probability, in our view—we would expect Moody's to finally follow the lead of the other agencies and downgrade the country's sovereign credit rating by at least one notch. ■

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