

Hungary... leaving investors undernourished

December 2010, Daniel Wood, Fund Manager

Hungary has found itself front and centre stage in recent weeks with asset volatility unusually high. The forint fell over 13% against the dollar in the last two weeks of November and nearly 5% against the euro for the month. In addition the 10 year borrowing rate increased almost 1.6% in the two months to the end of November.

Hungary does seem to be suffering a little schizophrenia at the moment. In 2009, Hungary appeared the favourite to be the next Eastern European country to adopt the euro. However, things turned sour when incoming Prime Minister, Victor Orban, compared the country to Greece and recent policy is beginning to look a lot more Argentinean. So just how concerned should investors be going forward? Is Hungary an isolated case or the beginning of a more general trend towards reform reversal within emerging markets?

It was all going so well

Hungary's structural debt levels are excessive. At circa 80% of gross domestic product (GDP), government debt levels are higher than those of Ireland, Portugal and Spain. More worryingly, over half of this debt has been borrowed in either dollars or euros, increasing the probability of default or restructuring. When combined with private debt, the net external debt load increases to 140% of GDP. This was largely a function of a trend for households, attracted by low financing rates, to take on mortgages in Swiss franc or euros.

Less well known is the fact that unlike much of the developed world today, the collapse of Lehman was not the catalyst for Hungary to begin addressing its excessive deficits. In September 2006, the government of then ruling Prime Minister, Ferenc Gyurcsany, was caught on tape admitting he had lied about the state of the Hungarian economy to secure an election victory. Once rumbled, a defiant Gyurcsany began an austerity crusade, repealing tax cuts and reducing public expenditure, including those in the politically sensitive healthcare and education sectors.

That Hungary which recognised the need to take measures to reduce the debt burden ahead of the crisis is commendable and both Gyurcsany and his fellow Socialist party predecessor, Gordon Bajnag, can be applauded for halving the fiscal deficit from 10% of GDP. Market sentiment to Hungary improved further when they became the first country to apply successfully for an IMF facility to shore up its ailing balance sheet. At this point Hungary was touted by many experts as the poster child for austerity and tipped to become the next Eastern European country to reach the "promised land" of euro adoption. Hungarian dollar debt spreads fell to just 49 basis points over treasuries and the 10 year borrowing rate was just a touch over 6.5%.

Then came the elections

There is a problem with democratically elected governments in times of economic crises. Short term solutions are generally employed to ensure the greatest probability of re-election. If this mantra is ignored and more structural solutions to a debt crisis such as cutting jobs, benefits and services are employed, they have a tendency to make you very unpopular. And so it was at the 2010 elections as the incumbent Socialist Party lost by an



Hungarian flag likely to be flying half mast in international capital markets.

Source: newshopper.sulekha.com

overwhelming margin to the centre right Fidesz. Worryingly for investors, populism appears to be the new governments chosen path, a journey that can only end badly given the considerable financing requirements of the country. In 2010 there is a sense that Hungary has got away with its policy error as credit markets have remained liquid and yield hungry.

Funding pressures continue to mount



Despite appearances to the contrary, PM Orbán is unlikely to apply for further international aid soon.

Source: noinvite.com

Into 2011 Hungary needs to raise approximately 30 billion euro (circa 25% of GDP). The IMF crutch has been withdrawn - the household sector continues to de-leverage, growth is likely to be anaemic and tax receipts constrained. In a more benign global environment the solution would be for the market to devalue the currency allowing the export sector to regenerate the economy. However, there is a problem. As such a high proportion of both private and public sector debt is denominated in foreign currency, these loans are vulnerable to a sharp drop in the value of the forint and non-performing loans will continue to rise sharply, further pressuring both bank and household balance sheets.

The central bank is caught very firmly between a rock and a hard place. Raise rates and risk sending the sputtering economy back into a deep recession, or cut them further and watch the value of the forint tumble as neighbouring central banks begin tightening monetary policy.

The government has made it very clear where they stand on this dilemma with very public accusations. They firmly believe that the central bank is responsible for the economic crises through overly high interest rates. The situation descended further into farce as the government cut the central bank governor's salary by 75% citing poor performance. In recent weeks they have followed up by insisting that they will elect four of the seven voting MPC members next April and increase the inflation target – moves that will destroy the bank's credibility and independence.

The fiscal side is equally concerning. Hungary has more potential than most to enact structural policy aimed at reducing the debt load. Benefits in Hungary are generally not means tested. The participation rate in the welfare system is at least 30% higher than the average emerging economy. However, the government has opted to take short cuts to reduce the deficit. One of the more controversial measures is raising taxes on corporations operating in key sectors of the economy. This is a dangerous tactic. Many of the companies are foreign owned, operating on tight margins and can quite easily take their business elsewhere.



Governor Simor hears news of 75% pay cut?

Source: bodylanguages.com

There has also been a reversal of the pension reform - private pension fund holders have a gun to their heads to ensure that assets are transferred back to the public sector to fund pending liabilities. These policies have not gone un-noticed by the rating agencies with Moody cutting Hungary's rating by two notches with a negative outlook. All three of the major agencies now have Hungary hovering just above non-investment grade. There is a large investor base that relies heavily on ratings to steer them clear of the perceived danger that junk bonds hold and borrowing costs will ultimately rise as demand for government paper falls.

It's never ALL bad news

The outlook does look bleak for Hungarian asset prices, although there are a number of positives that investors need to be conscious of. As the economy has been in such disarray, imports have not surprisingly fallen off dramatically. As core Europe shows signs of recovery, Hungarian exports are climbing and the current account balance is now in surplus, reducing pressures on external financing. Hungary also enjoys a small primary surplus, but needs to retain this surplus just to prevent debt levels escalating. However, this is likely to come under pressure if the government continues along its current path.

Having secured a majority victory in both the 2010 general and local election and unlike many other Eastern European countries, the current government enjoy the autonomy to pass reform legislature. This is, however, a double edged sword. Fidesz do not have a great track record at implementing market friendly reform. The cost of borrowing could become so burdensome that the government have little option but to reverse existing policy and return cap in hand to the IMF.

Should emerging market investors extrapolate Hungary's policy mistakes?

In a world where establishing the difference between developed and developing nations is becoming increasingly problematic, it's rather nostalgic for an active emerging market fund manager that at least one country is treading a policy path more closely associated with emerging markets of old.

However, Hungary's problems are very specific and their "solutions" to these problems are unique. Nowadays the emerging market universe is more closely defined by considered and well communicated market friendly policy. Strong consumption and investment growth, positive balance sheets and a decade spent fine tuning monetary and fiscal control have afforded them this luxury.

As currency appreciation pressures mount there will be bumps in the path as temporary capital controls are utilised to retain export competitiveness and prevent economies from over-heating. It is an inevitable consequence however that emerging currencies will strengthen against the G7 as emerging markets become wealthier and converge towards the developed world. In my opinion, Hungary is more likely to act as the ghost of Christmas future in the US, UK, Japan and Europe as hardship becomes increasingly widespread.

As an active emerging market debt manager we have maintained both an underweight and short duration exposure to Hungary throughout the year. There have been painful months such as September when the forint rallied strongly, but we remain dedicated to our fundamentally driven debt sustainability analysis and have been rewarded handsomely both over the course of the year and more recently in November. Unless we see a dramatic u-turn in government policy over the coming months, there is every chance that we will look for an opportunity to take Hungary to a zero weight in our strategy.