Hungary Hits the Wall

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Summary of a speech given by Dr. Surányi at the annual meeting of the Financial Research Institute in Visegrád, Hungary on the 28th of October, 2011

I. European economy

The decision taken at the late October EU summit won't be a lasting solution despite the first positive reactions of the markets. The reason for this is that no cardinal issue has been solved: the Greek situation, the stability of the European banking system or the expansion of the EFSF.

The treatment of the first wave of the crisis (originated in the United States) has dried up the fiscal resources available for further crisis management. In theory, monetary instruments may alleviate the problem, but the existing European institutional framework does not allow the ECB to intervene.

There is no room for more fiscal manoeuvring either since sovereign debt level is already unprecedented high due to economic stimuli and/or bank bailouts in many countries.

I am not a Eurosceptic, but I consider the existing system of the European Monetary Union (EMU) faulty since its conception: its rules are inconsistent and cannot withstand the test of scientific analysis. The benefits of regulating the interest rate, the inflation, the debt-to-GDP ratio and the budget deficit are not supported by economic evidence. The original intention was noble: the creation of transparent and simple rules but the monetary union is now resting on an unrealistic basis. As a result, almost every member of the EMU has been in breach of the targets for years.

A monetary union works well if the participants are close to each other in real convergence and/or there is a common fiscal policy and a flexible labour market. The size of the European Union's budget is, however, negligible, just slightly above one percent of GDP. Beyond the common budget a currency union would need a flexible European job market as well, one that could see nominal wages move in either direction, in order to even out the asymmetries of the real economies. This has remained elusive so far due to mainly cultural and linguistic differences.

The Union has either to create these balancing mechanisms artificially or – lacking these – a certain degree of economic development must be included among the entry criteria. This is, while necessary, still not a satisfactory condition. Because it has been predicted even by Marxists, that over time divergence is a possibility even among developed economies.

The ECB is talking about the adherence to fiscal discipline day and night while the most important element of economic stability is a sustainable external account. On the surface Spain and Ireland conducted exemplary fiscal policies before the crisis (with 35% and 12% debt-to-GDP ratio, respectively) but the world's second largest current account deficit also occurred in Spain (second only to the United States). The situation was similar in Greece. On top of this, Greece and Portugal also held high net external debt.

Had the investors taken into account the current account deficit when lending to Greece, the outcome could have been different. The current account balance is the economic indicator hardest to manipulate. As Martin Wolf (Financial Times) or Charles Goodhart have pointed out, fiscal tightening is not sufficient to treat this crisis and the rigid and one-sided target system failed to take into account indicators like real convergence and the lack of a common labour market.

The EMU is based on three pillars that are mutually exclusive:

1. No sovereign default
2. No sovereign bail-out
3. ECB is no lender of last resort.

The three conditions are contradictory and cannot function simultaneously – the current recession is bound to point this out.

There is no reason why a Euro-zone member couldn't default.

It is also **naïve to believe that constitutional caps on deficit and public debt may yield any results**, even though it has been a growing trend lately.

The no bailout closure is another faulty assumption – and not because of solidarity, but for practical reasons: bailout can be less expensive for the Community than a contagion, or passively looking at the situation deteriorating. Three years ago 100 billion euros would have solved the Greek situation. Today, what is at risk, including the impact of the contagion, is well over a trillion.

The lack of a real central bank in the EMU is a risk, too. There is no entity in the European financial system able to supply unlimited liquidity without the ECB functioning as a lender of last resort. This has made sovereign default a possibility – even, paradoxically, for Germany.

Monetary systems based on fiat money (with no inherent value) cannot function without a lender of last resort. A country cannot stay solvent for long when the markets become suspicious. The ECB is only reluctantly creating extra liquidity at the moment – just enough to keep the system from collapsing. According to its mandate the ECB cannot intervene even on the secondary debt markets. Lacking effective transmission mechanisms the ECB thus cannot function as a genuine central bank. The current system is thus unsustainable – the adherence to all three criteria exposes everyone to default.

The EU is now divided by serious political differences and nationalism is growing. The subject of the federalist Europe vs. the Europe of nation states has returned to the agenda.

The United States and the United Kingdom seem less exposed than the Euro-zone despite their poor economic indicators because of political and fiscal integrity and central banks with a mandate to expand liquidity if necessary. No country defaults in its own currency.

But the Euro is the national currency of no one – or an alien currency for each member state. The sovereign debtors cannot print money but the ECB is also constrained in creating liquidity in an unlimited scale.

Unfortunately, decision makers don't tackle these contradictions. Summits and discussions have been ongoing for the last three years and the pace is accelerating rapidly – but to no avail. In order to change the decision-making mechanisms, national constitutions should be changed. This is, however, impossible during a crisis. Disagreement among the member states prevails due to national interests and, in some cases, incompetence.

II. The Role of Southern Europe in the German Trade Surplus

Ever since the Second World War German public opinion and politicians have tended to place the European interest before the German national interest (see Adenauer, Schmidt, Kohl). We can, however, experience a shift in attitude between the generations. It has already started under Chancellor Schröder. As a consequence, Germany has started to act as any other big European country. The process has culminated under Chancellor Merkel.

Germany has not become more selfish than others – it has merely become less selfless. It is pursuing its real or perceived self-interests – just like any other country. Germans do not wish to partake in a 'Transferunion'. But the situation is more complex than just that.

Germany is the single biggest beneficiary of the monetary union.

This benefit, however, presents itself in everyday transactions – it is thus not that obvious for the German voters. Germany exports billions of euros worth of goods to the South – translating into millions of jobs in Germany. The German trade surplus thus comes with a proportionate trade deficit elsewhere in the Union.

If Germany takes the requirement of a reduced budget deficit or a trade surplus on the constitutional level, it makes it impossible for Southern Europe to reduce deficits. This is a zero-sum game – without German domestic demand Southern states cannot start exporting either.

III. The Hungarian Economy

The Hungarian economic policy has limited room for manoeuvring due to the deteriorating international environment. The economic policy of the Hungarian government has systematically eroded Hungary's credibility – among both foreign and domestic investors and businesses.

The positive current account during the last three years has contributed to the decrease of gross external debt – but it has happened for very depressing reasons: the decline of domestic consumption and lack of investment. (The investments of Audi and Mercedes in Hungary have blunted the effect.)

According to these indicators only, the exchange rate should see upward pressure and the CDS premium and bond yields should be on a downward trajectory. But the opposite is happening due to the unpredictability of the macroeconomic policies and concerns regarding the rule of law.

IV. The Tax System

The new tax system is not capable to deliver as expected: it does not stimulate domestic demand; neither does it decrease the size of the black economy. It hasn't even improved competitiveness.

The new, flat income tax benefits the top 20% of the population – while half of wage earners see a decrease in their monthly pay check. The regime can thus undermine the cohesion of society.

According to the best-case scenario the lower income groups merely consume less. This puts a pressure on domestic demand while we are seeing an increase in savings from the top income brackets. This can even be beneficial in an environment that is friendly to private investments.

This domestic environment, however, does not stimulate domestic investment. The resulting flight of these savings affects the current account negatively.

The second target of the new tax regime was the whitening of the black economy. It is unachievable by these means, too, because the tax wedge did not decrease for 80% of taxpayers. A tax system that benefits the better-off does hardly help legalising the incomes created by the black economy.

The flat tax can only marginally improve competitiveness in the short run for the top 15-20% of earners where the tax wedge had actually decreased, because employers rarely cut nominal wages – leaving labour cost unaffected.

The HUF 500-600 billion budget revenue shortfall caused by the flat tax should be covered in 2012.

V. Austerity 2012

Domestic demand is forecast to decline further in 2012 due to austerity – removing even more jobs. The tax cut for corporations over the first 2 million euro profit does not help SMEs, which are under the required size in turnover, while it is mere "pocket money" for corporations. This tax credit therefore does not affect their investment decisions. It still costs the budget HUF 150 billion in lost revenues.

Flat tax and corporate tax cut together caused HUF 700-750 billion missing from the 2012 budget and it has to be adjusted. In 2011 the growth effect of the tax measures is near zero because the fiscal expansion did not create extra domestic demand. The extra income for top earners and tax cut for corporations have either became domestic saving or left the country. Against official figures the public debt has increased in relation to GDP in 2011.

VI. The Private Pension Savings and the Public Debt

The elimination of the private pension funds is not per definition evil[1] – with a few conditions. These conditions have, however, not been met.

The first such condition was the voluntary nature of entering and leaving the system – neither of which had happened. Those who stayed in the private pillar should not have been negatively discriminated. The most important condition, however, was that the entire sum should have been allocated to reduce public debt as opposed to current expenditures where it was partly used for in this case.

Introducing the private pension system has served to reduce future commitments of the state whilst increasing the deficit of the present. If the money raised by the elimination of these savings is not spent towards reducing the public debt, both the gross (present) and implicit (future) public debt is going to increase.

The structural deficit in 2011 is 6-7% of GDP (without non-recurring items). If the government adheres to the 3% deficit plan in 2012, a further 3-4% austerity will be needed because no source like the pension savings will be available next year. That creates an austerity

[1] During the Q&A session Dr Surányi has given a few reasons why he takes this opinion.

First, we should not delude ourselves believing that pension funds would not fail in case of a sovereign default. One cannot separate the performance of pension funds from the underlying economy. Capital markets will not outperform the economy that is shrinking under declining population and growing welfare expenditures. It is hard to argue that 25-30% of the capital in these funds should be exported abroad. It is necessary to diversify the risk of portfolios or to get better returns but do we really mean to export capital?

All these happen at a time when bond yields are soaring while savings on the macro level are unchanged. The growing savings of the population concentrated in the obligatory private pension pillar only covers the growing deficit of the budget if the entire sum is spent on Hungarian bonds as opposed to foreign stock and bonds. If not, then it is shifting the yield curve upwards.

And again, it will not solve the underlying demographic challenge. The dwindling number of future entries in the system will devalue asset prices.

The second question is how one can create a mandatory private pension system where 90% of the population is financially illiterate? This is what happened in 1998 where most age groups were legally obliged to choose a private fund. This was just as unacceptable as the current step in the opposite direction. Mandatory savings are no voluntary self-reliance.

One must also not forget that it was Gordon Bajnai who opened the door for retuning from the pension system to the ”pay as you go” pillar. True, it was voluntary.

When talking about the dynamics of explicit present and implicit future obligations and debt one must not forget that markets perceive the situation asymmetrically: they punish countries that have introduced private pension schemes at the beginning (about 20 years) when the large explicit debt is amassed due to the fiscal strain of the transition – even though benefits and disadvantages are meant to be balanced in the longer run (in 50 years). Countries running large deficits due to transition are deemed riskier by markets because of large explicit public debt – while countries without a private pension system are not deemed riskier by today’s market due to their large implicit (future) obligations.

need of HUF 800-900 billion. (If recent investments of Mercedes and Audi can start in 2012, their combined contribution could add 1-1.2% to the GDP.)

The government may solve the shortfall by eliminating the anomalies of the new tax system but it is unwilling for political reasons. It may instead reduce domestic demand even more drastically causing a vicious circle of reduced investment and employment, lower tax receipts and further austerity.

VII. Foreign Currency Loans and the Bank Levy

Credit availability has been declining in Hungary for three years now – contrary to regional trends. The bank levy has fatally hurt the lending capacity of banks because they haven't been profitable to start with. The government has thus essentially confiscated their capital – deteriorating their balance sheets. It has rendered any further lending impossible due to legally required loan-to-capital ratio.

One of the reasons for the less than expected growth in 2011 is the vicious circle of bank lending: interest rates rose due to the bank levy and it sent demand for these loans declining. It has in turn reduced output and employment. The early repayment scheme has arrived in this environment.

The problem with the early repayment scheme is not that it makes the banks take a share of losses. But making them taking the losses exclusively will undermine economic stability.

Commercial banks have made a mistake when they contributed to the unprecedented and baseless growth in foreign currency (mainly Swiss franc) lending.

There is, however, another culprit: the fiscal policy since 2001. The sustained and ever growing budget deficit has siphoned off long-term forint resources from the economy – leaving the population and enterprises without available forint loans for property and investment (crowding out). The Central Bank, in the meantime, has acted as if they weren't associated with macro prudential issues like the lending boom.

Investments in Hungary could thus only be financed at reasonable rates by foreign currency loans. The domestic loan-to-deposit ratio has reached the unprecedented 150% - the excess being financed through foreign sources. The external balance was negative with a current account deficit of 7-8% during this period – also financed mainly by increased external indebtedness.

INFLATION VS EXCHANGE RATE TARGETING?

THE ROLE OF THE CENTRAL BANK

The National Bank of Hungary has merely concentrated on its short-term inflation target and pursued an interest rate policy that attracted foreign inflows. While focusing on the exchange rate and its effect on inflation, it effectively sent the message that it wouldn't let the forint depreciate under a certain level. In its effort it has over-strengthened the currency. From 270 to a Euro in 2001 the forint strengthened up to 228. The Hungarian currency has sharply appreciated in both real and nominal terms.

Underlying was a false assumption that the Central Bank is the sole factor in shaping inflation. The inflation is indeed affected by the exchange rate but the international economic environment has an impact on it as well. In a country where 35% of the inflation basket is made up of food products, for instance, – even international food commodity markets (and thus even the weather) affect inflation enormously. (Contrary to the United States, for instance, where food prices have much lower weight in consumers' basket.)

Despite the inflation target, the Central Bank has effectively been pursuing an exchange rate target during this period – and through it, aimed at price stability.

The forint-Euro exchange rate is a nominal anchor for inflation and inflation expectations because imports (mainly in Euros) account for three quarters of the Hungarian GDP. An extremely weak forint (say, 500 to a Euro) would present a 50-60% rise in inflation with a 6-12 months delay. In this case, the nominal interest rate would rise and so would wages in the long run. The wage earners would suffer a cut in real wages but not necessarily as much as the depreciation of the currency.

In the case of the Swiss franc, however**, the exchange rate has no direct impact on the Hungarian real economy**. Devaluation against the Swiss Franc would hit foreign currency debtors exclusively, causing instant insolvency en masse. This is another reason why commercial banks should not have lent in foreign currencies other than the Euro.

Another field where banks have had a responsibility was the pricing of mortgages and loans. It is true that the rise in country risk premiums has sent banks' financing costs soaring but that is no reason to unilaterally increase margins. It is the responsibility of financial institutions to plan for contingencies and hedge against possible future losses. Adding an extra margin to mortgage rates where the monthly payments have already increased by 40-50% due to exchange rate fluctuations is a suicidal policy. This will only tip banks' clients into the financial abyss. (Hungarian banks have raised their mortgage interests by an average of 2.5%.)

Some of the blame still goes to the borrowers since they were aware of the exchange rate risk – and for their own over-indebtedness. Tens of thousands of households have seen their monthly payment soaring. The average monthly payment went up by about 50%, from HUF 53 thousand to 75 thousand. The average household earning would have been able to handle this but many have taken out multiple loans (for consumer goods on top of their mortgage). Many, on the other hand, have been affected by the unforeseen recession through unemployment.

The solution should involve shared losses between all interested parties: the government, the central bank and the banking system. Presently, however, the government pushes all losses on the commercial banks.

The final payment scheme causes massive damage with only minor benefits. It is bad for the borrowers, because only about the top 500000 (including family members) borrowers can take advantage of it. Further 1.5-2 million borrowers who cannot afford to repay their loans in one lump sum will see their situation deteriorating due to forint depreciation in the wake of banks' deleveraging their Swiss franc positions.

Even the Hungarian government will be worse off because 49% of the public debt is denominated in foreign currencies. The interest rate service alone is expected to grow by HUF 60-80 billion due to this impact only.

The short-term effective losses absorbed by the banking system would be HUF 200-300 billion based on 20-25% of borrowers subscribing to the scheme. It would also make the banks lose their best clients – leaving the rest of the portfolio in even worse a shape. As a consequence, the Hungarian banking system will be even less able to lend.

-Visegrád, 28 October 2011