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Benedek Magyar: Fiscal Recklessness in Hungary

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Background

The need for economic policy-making usually emerges as a result of frictions between the actual state of an economy and the some desired outcome. In the context of the current financial crisis in Hungary such frictions represent no overstatement. Recently, the Economist Intelligence Unit revalued Hungary's risk status to negative in terms of debt, currency and banking risk. International consultancy firm Goldman Sachs recently called Hungary *"the most vulnerable of emerging market economies in the region."* Internationally renowned economist Nouriel Roubini of Roubini Global Economics referred to Hungary as *"an accident waiting to happen"*, whilst the Economist stated with regards to Hungary that *"No amount of monetary rectitude can save a country from fiscal recklessness."*

Such fiscal recklessness by Mr. Gyurcsány and his Hungarian Socialist Party (MSZP) should come as no surprise, as Hungary has been subject to the European Union's (EU) excessive budget procedure since 2004. This forms part of the Stability and Growth Pact[1] which has two arms: a *preventative* arm that strengthens the surveillance of member states budget positions and a *corrective* arm aimed at speeding up and clarifying the implementation of the excessive budget procedure.

In May 2004, Hungary submitted its first convergence programme and by July 2004, the Council delivered an opinion that Hungary was in excessive budget and issued under Article 104(7) for its correction by 2008. This was again reiterated by the Council in March of 2005. By November 2005, the Council's patience had begun to run thin and they deemed the corrective measures by Mr. Gyurcsány's government as inadequate and that far from correcting the existing budget deficit, they had in fact deviated further from the adjustment path. Then in December 2005, the Hungarian authorities presented an updated convergence programme. Again, the Council remained unconvinced indicating that this programme was *"not backed by concrete measures."* In September 2006, the Hungarian authorities submitted an adjusted convergence programme, and as a result of the above mentioned *irregularities*, the Hungarian government is now required to report twice a year on the implementation of its programme.

Macroeconomic Outlook

The recent World Bank EU8[2] Quarterly Economic Report of September 2006 reported that Hungary remained the most vulnerable among the EU8 countries to external shocks[3]. Much of this stems from the fact that Hungary's Gross Domestic Product (GDP) (at current prices) US$ 103.79 billion, and GDP per capita (at current prices) US$ 10,813.98[4] has been placed under an enormous strain.

At present, Hungary runs an unsustainable twin fiscal and current account deficit.[5] This implies a forecasted figure for the current account that amounts to 8.4% of GDP or approximately US$ 8.72 billion (at current prices), alongside a budget deficit that amounts to 10.1% of GDP or US$ 10.48 billion (at current prices) which has almost doubled since 2001. What is of critical concern is, that the increase in the current account was not driven by real investment growth yet Hungary continually saw an increase in borrowings from the international banking system from 49.9% of GDP in 2001 to 62.9% of GDP in 2005. This implies that on current prices foreign borrowing by Hungary increased in 2001 from approximately US$ 51.79 billion to US$ 65.28 billion.

The gross public debt in 2006 stands at 68.5% of GDP or US$ 71.1 billion and is projected to rise to 71.3% of GDP in 2007 and 72.3% of GDP in 2008. What has not been considered in this equation thus far are the interest payments that still must be made to service this astronomical debt. Given that interest payments typically run at between 5% and 10% of government expenditures this implies, on a worse case scenario, annual interest payments of approximately, US$ 5.13 billion per annum (at current prices).

[1] The Stability and Growth Pact aims to ensure sound government finances as a means of strengthening price stability for sustainable growth and employment creation.
[2] I.e. The eight Central European Countries that joined the EU in 2004.
[3] External shocks imply for instance increases in oil prices, commodity prices, and energy prices.
[4] Sourced from the International Monetary Fund World Economic Outlook, September 2006.
[5] The current account of the balance of payments shows current transactions between Hungary and the rest of the world such as traded goods and services, interest payments etc.

The New Equilibrium Package and its Implications

The Hungarian government's response to this disaster has been to introduce a set of reforms what it calls the *New Equilibrium* package. The package aims to generate savings of around US$ 6.5 billion between 2006 to 2008. The process will begin by eliminating the middle bracket of value added tax of 15% and introducing a standard 20% tax along with a rise in corporate tax from 16% to 20%. Additional taxes will include tax on capital gains, interest income and a bank tax. It further intends to cut energy subsidies to households via a hike in gas prices by an average of 30% and electricity prices from between 10-14%. Further cutbacks are planned via the closure of underutilized schools, hospitals, plus co-payments for healthcare, tightening eligibility for early retirement along with tuition fees for higher education. There is further speculation that the government will privatise the motorways in order to remove this debt from its books. In addition, there are further plans to layoff 7000 central government workers (10% of the total).

The real danger with this package is that the fiscal measures will stifle economic growth via the reduction in disposable income. The emphasis on raising taxes and revenues rather than controlling expenditures will mean negative supply side effects on labour and capital by hitting the most productive sectors of the economy. The increase in corporate taxes is accompanied by an increase in labour costs reducing the number of workers that can be profitably employed. This further reduces the ability of the Hungarian economy to meet its financial commitments.

This appears to be the general consensus of the global markets and economists that the package comes too little too late, lacks credibility, is misguided in its selection of policy instruments and underestimates the economic realities. The present direction and magnitude of changes in the Hungarian economy, accompanied by a lack of faith by the global markets is likely to make present and future investors risk averse, shrinking their appetite for Hungarian assets. This is already evident in with the Hungarian stock market falling 20% in 2006. Since the current account deficit has up until now been financed by foreign direct investment this will no doubt exacerbate the economic strain. The pending rise in inflation due to high oil and commodity prices and depreciation of the forint, which has fallen 8% against the euro in 2006 alone (1.00 HUF = € 0.003769), will squeeze individual households even further. There exists a real risk that Hungary will fall into a scenario of a large primary deficit[6] with low growth, where the real rate of interest exceeds the rate in growth. This would mean a highly volatile and fragile economic outcome.

The size of the current account deficit, a high budget deficit accompanied by a high level of debt, are clear signs that the Hungarian government has been systematically living beyond its means. The consequences of such irresponsible financial management are likely to be severe. High levels of spending, dissaving, now accompanied by higher taxes indicate a serious decline in future living standards. The continual increase in debt to foreign banks will impede Hungary's ability to borrow from abroad without a high risk premium attached. The loss of confidence by global markets in Hungary is already evident, which will again see a critical fall in the value of the forint. Such depreciation in the local currency could lead to stresses on the current account, which could spawn internal inflation and lead to a depreciation inflation cycle. Given this worse case scenario the present aims of the Hungarian opposition to introduce a *technocratic* or *business government* are absurd to say the least. What global financial markets need to see is a stable government that has the incentives to carry out the corrective measures, and not a *mixed-bag* of individuals that would include members of the present government who have already been tainted by post-contractual opportunism.[7]

[6] The primary deficit is a better measure of the current government budget policies as it removes government interest spending on public debt as this is beyond its control. Thus it is government spending (G) minus government revenue via taxes (T) i.e. *Primary Budget Deficit = G - T*

[7] The author acknowledges the use of multiple sources in the preparation of this article.

