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Hungary is returning to talks with the International Monetary Fund

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On 21 November, Hungary submitted a request for financial assistance to the International Monetary Fund and the European Commission. This decision marks a shift in the policies of Viktor Orban's centre-right government. In mid-2010 he stopped working with the Fund, and made his opposition to international financial institutions the main element of his strategy of independent economic policy. The change in his government's attitude to cooperation with the IMF is the result of the increasingly difficult economic situation in Hungary: lower than expected economic growth, the depreciation of the forint, and the real risk that the major rating agencies will lower their estimate of the value of Hungarian bonds to junk status. However, the current budgetary situation is not so dramatic that the Hungarian government was forced to conclude this new credit agreement so quickly. If it is signed, it should not lead to any radical change in economic policy in Hungary. Since the beginning of this year, Hungary has increasingly focused on reducing budget expenditure and implementing structural reforms, moves which are consistent with the demands of the international financial institutions.

The Hungarian 'sovereign economic policy'

In connection with the global financial crisis, in late 2008 Hungary received a stand-by loan (forcing them to implement a package of reforms) to the tune of €20 billion, under a special agreement with the IMF, the European Union and the World Bank. This agreement concluded by the then left-wing government predicted a need for a significant reduction in the budget deficit, as well as structural reforms (such as raising the retirement age and the abolition of bonus-month payments for retirees). The content of the agreement was very strongly criticised by the opposition Fidesz party, which after taking power in April 2010 halted cooperation with international financial institutions; they refused to sign a new agreement, and decided not to use the funds awarded under the previous line of credit. Prime Minister Orban presented this move as a desire for a 'sovereign economic policy', and as opposition to the dictates of foreign financial institutions.

The absence of formal commitments to international financial institutions has allowed the Orban government to implement a number of unconventional economic measures. Special taxes have been introduced on the financial sector, telecommunications, large retail chains and the energy sector, while income tax and corporate income tax rates for small and medium enterprises have been reduced. In February 2011, the government took over the

assets of open pension funds, thus *de facto* dismantling the public-private pension system. In September this year, the parliament adopted a law allowing citizens to pay off their one-time and total foreign currency loans at preferential fixed rate.. These actions were criticised by international financial institutions and foreign companies in Hungary as being bad for business and impeding sustained economic growth. However, the Hungarian government argued that these solutions would revive the Hungarian economy, and also help to boost public finances.

The results of the economic policy so far

The government's actions have not led to faster economic growth, although its fiscal position has significantly improved. Hungary, which is dependent on exports, is among the slowest growing countries in Central Europe, and has the lowest forecast for future growth. It has failed to stimulate domestic demand, and the government's actions have been received very negatively by most investors. Hungary's unfavourable image and its very high level of public debt (see Appendix) is reflected in the exceptionally high rate of Hungarian bonds, and the difficulty in selling them. The yield on 10-year bonds denominated in the Hungarian currency is currently 8.4% (compared to 5.7% for Poland, 4.3% for Slovakia, 3.1% for the Czech Republic, and 2.0% for Germany [data from the end of October]). The risky economic policy and uncertainty on the global markets have also affected the forint's record low value (since the beginning of July, it has lost 15.5% against the euro). The main reason for the Hungarian currency's depreciation over recent months was the announcement of negative economic forecasts, and the adoption in September of a mechanism for the early repayment of foreign currency loans; this will hit the profitability of the banking sector, and has already caused a significant increase in demand for foreign currency.
However, the government has succeeded in improving the state's financial situation. Hungary is the only EU country which will record a surplus in 2011. But this will be possible thanks to the nationalisation of the funds from the second pension pillar, which have been counted as budget income. The relatively favourable fiscal situation is likely to be maintained thanks to structural reforms, which will begin to be implemented in 2012. The government foresees significant budgetary spending cuts, including in the social security system, subsidies for medicines and transportation, as well as education funding (saving a total of 3% of GDP in the budget for the year 2012). These steps should allow the budget deficit to be held below 3% of GDP in the next few years.

Prospects

The resumption of the Hungarian government's cooperation with the IMF has been welcomed by the market, and has had a positive effect on the stability of the financial system. But it is not clear when, how large, or under what possible conditions the loan will be made. At present, there is only some speculation that a €4 billion grant will be made under a precautionary credit line (PCL) at the beginning of 2012. But we should not expect the rapid signature of loan agreements with the IMF and the European Commission. This is primarily due to the relatively low financial needs in the short term, which result from the

high levels of government deposits with the central bank (about €8 billion), and from the funds remaining from the acquisition of the pension funds. An important factor complicating the agreement with the IMF is the politicisation of this issue by the Hungarian government; it is trying to stress the difference between the newly negotiated agreement with the IMF and the stand-by loan agreement from 2008 which it so ostentatiously questioned. Budapest will primarily be interested in obtaining a precautionary credit line, which will not impose significant restrictions on the state in shaping its economic policy. The IMF will put pressure on Hungary to adopt a broader package of commitments (including the abolition of bank tax), which will not help prospects for a quick agreement.

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Appendix



Source: European Commission