MINISTRY
FOR NATIONAL ECONOMY

The worst threat: public debt

Focus

- Public debt has become one of the most important subjects of economic policy discourses since the onset of the economic crisis.

- It is an important indicator, which shows the situation of the economy, because many important economical processes (economical growth, interest rate, budget deficit) simultaneously influence it.

- Growing debt means that we live off the opportunities of the next generation: we put our future in pawn.

- Public debt also shows that whether or not the current economical trends are sustainable in the long term.

- The high amount of public debt carries high servicing costs (mainly in a high return environment), so it limits the government's scope of action. We could spend a part of that 1100 billion HUF, which we are spending now on interest payments, on productive investments or other productive expenditures (health care, public education), and we could substantially reduce tax liabilities while we might keep expenditures unchanged.

    - What is the equivalent of 1100 billion HUF? (calculated with data of 2010)

        - we could spend 7,5-fold more on housing support than in 2010, or

        - we could spend twice as much on family support than in 2010, or

        - we could halve the value-added-tax, or

        - the one-third of the interest expenditure would be enough to abolish the whole corporate tax, or

- we could reduce the revenue from personal income tax by 40%, or
- we could reduce the social insurance contributions of the employer and the employee by more than one-third, thus further narrowing the tax wedge and stimulating the labor market.

- Financial markets consider Hungary risky because of the high public debt. We can see this in the level of the CDS prices and in the HUF exchange rate. Both limit the borrower's scope of action: the loan repayment of households and enterprises depend partly on it.

- The high level of public debt also limits the government's scope of action: via the crisis of 2008 we could comprehend that countries which had managed prudent economic policy could reduce the effects of the crisis by running into debts only temporarily. We could not do the same, because we had "lived up the future" earlier. It is in our common interest that we should be able to respond properly to a similar crisis in the (we hope only far) future.

The story of Hungary's public debt

Public debt from the 70's

- For the period before the regime change we have reliable data on the external convertible debt, which corresponds to the consolidated public debt of Hungary, because the domestic corporate and banking sector was mostly state-run (so their debt is likely to be within the scope of consolidation according to today's standards), and the non-convertible debt, which we owed mostly to CMEA countries, was not significant.

- The budget deficit was financed largely by the central bank in the early 90's, therefore – until the debt swap in 1997 – the debt appeared mostly in the books of the National Bank of Hungary.

- After that, the public debt in Hungary became also accurately measurable and traceable, due primarily to the transperancy criteria which was required by our EU accession and by the demands of investors. Parallel to this tendency, most of the debt has become market-based. By now only a limited number of the central government's maturing debts, the IMF/EU loan package of 2008 and 2009 and the loans of the local governments constitute the non-marketable part of the public debt.

- The USD denominated of Hungary began to rise at the beginning of the 70's. The early rise was caused by -- besides the deceleration of the 1968 reforms -- mostly by global economic factors which were independent from domestic developments. As the economic structure of Hungary was based mainly on the import of raw materials and energy and the export of finished goods already in this period, the first wave of the oil crisis led to a powerful deterioration of the value of swap deals. Unlike in western economies, in the first half of the seventies no efforts were made in Hungary to correct the deterioration of the foreign trade balance by restructuring the product and cost structures. Instead, Hungary was financing the losses from foreign loans.

FIGURE: Convertible debt of Hungary (million USD, 1973-1989)

- There was an attempt in 1978 to stop the worrisome trends, but it could bring no lasting relief to the flaws of Hungary's foreign trade, so the amount of debt continued to grow from the mid-80's. Therefore, because of the further misguided economic policy decisions, foreign creditors of Hungary had to keep funding the recession of the country, too. The pace of debt accumulation slowed somewhat in 1987 and 1988, but this temporary improvement was caused mostly by the fall in domestic demand.

Changes in public debt after the regime change

- Due to the growth of the public debt during the 1980s, by the time the regime change took place the size of public debt had exceeded the 60% of GDP and most of it was denominated in foreign currencies. Out of the countries where a regime change took place, the debts of Hungary, Poland and Bulgaria was more than 20% and it was only Hungary which did not request debt restructuring or debt reduction. This posed a great challenge to the economic policy of the first half of the 1990s and liabilities have been weighing on the Hungarian economy up until now.
- The Antall government was trying to fill the gaps of the budget which were mostly the result of debt servicing requirements by primarily a speedy privatization process. However, public debt relative to GDP was hovering around 80-90% in the first half of the decade.
- By the middle of the 1990s, it had become obvious in Hungary and abroad alike that it was not possible to manage public debt any longer without cutting costs. During the

implementation of the budgetary changes which had been based basically on inflating the forint and cutting social expenditures (the infamous 'Bokros Package') the level of public debt began to decrease after 1995.

- There was a debt swap between the government and the National Bank of Hungary (NBH) during this period – more precisely on 2 january 1997. Before that, it was the responsibility of the NBH to take out credits which amounts were passed on to the state as forint loans. As the NBH could not profit from the difference in the rate of interest and it had been incurring losses because of the constant devaluation of the forint, the government had kept making up for these deficits by booking its liabilities as 'zero-rate debt'. By the debt swap, this amount was transformed into foreign currency loans of appropriate pricing and in this way the overall debt could be booked as debits in the auditing system of the recently established Government Debt Management Centre.

Changes in the public debt from 1998

- Although between 1998 and 2002 the government debt increased nominally by more than 3000bn HUF, due to the robust growth of that period it actually decreased by four percentage points (from 59.9% to 55.6%) calculated relative to the GDP.
- Another tendency of the 1998-2002 period was that the proportion of foreign currency denominated debt fell sharply from 39% to 25% and that made Hungary less vulnerable.
- The year of 2002 was a key turning point as the first Orbán government ended its term by having achieved high economic growth and a declining rate of public debt which was below 60% according to the Maastricht criteria. The Socialist governments that followed, however, could not respond to the challenges of the era by a potent economic policy and during their eight years in power our public debt-to-GDP ratio skyrocketed again.
- Between 2002 and 2010 the nominal debt grew by 12 000bn HUF and the debt ratio by almost 25 percentage points.
- We surpassed the 60% threshold which was set by the Maastricht criteria in 2005 and we have been getting further away fom the level required for the Euro-zone membership ever since.
- Besides having failed to implement structural reforms, another mistake the government made was that it continued to finance non-productive expenditures from the ever-increasing debts and that had an adverse, negative impact on employment as there was nothing to stimulate the return to the labour market.

- The flawed and unaltered economic structure, however, was not only speeding up the growth of nominal debt but it was slowing down the potential growth of the economy, too. To sum it up, the primary reasons for the increase of the public debt-to-GDP ratio were the constantly extremely high budget deficits and lacklustre economic growth, as well as the anomalies in connection with foreign currency denominated loans which were due to the devaluation of the forint.
- In other words, the basically negative tendency was further exacerbated by the fact that loans had been increasingly preferred which were denominated in foreign currencies. The ratio of public debt denominated in a foreign currency and calculated on the basis of the Maastrich criteria rose from 25% in 2002 to almost 47% in 2010.
- As a result of these tendencies, by 2010 the Hungarian 'Maastrich-type' debts added up to 21 790bn HUF which was approximately on par with the 80% of the GDP. On 31 December 2010 the gross public debt of the national budget was 20 041bn HUF. The average maturity of this amount is about 4.5 years, and the implicit rate of due interest is 5.8% (the proportion of foreign currency denominated debt which carries lower interest liabilities is 44%).
- It is not only the high public debt level, however, that Hungary will have to conquer in the near future. Without a doubt, our public debt is one of the highest relative to our competitors, but the level of overall external debt including households and enterprises is also extremely high in Hungary, as the chart below shows. It has been the result of the popularity of foreign currency denominated loans of the last decade and of the external funding of public debt. During the course of the next couple of years we need to break out of this debt trap.

The structure of the Hungarian public debt

It is reasonable to analyze the changes in the structure of public debt from various aspects:

a. **Borrowing bodies**:

- Although the indebtedness of the central government is the most pressing issue, but municipalities have been accumulating debts from the middle of the 2000s too, and their

share of the overall national debt as it is defined by the Maastricht criteria has been also on the rise. Currently they make up the 5% of the amount of overall debt.
- The debts of the social insurance funds peaked in the middle of the 2000s at 3%, but by now this amount has become minimal.

b. Ratio of HUF and foreign currencies

- Up to 2002 the proportion of foreign currency denominated debt had decreased.
- Due to the increasing demand of foreign investors, the National Debt Management Agency (AKK) issued more and more bonds denominated in foreign currencies, and the proportion of foreign currency denominated bonds stands currently almost at 24% of the overall amount of debt.
- After the 2008-2009 utilization of the IMF-EU loan package the entire foreign denominated debt stands nearly at 5000bn HUF, adding up 23% of the overall liabilities.
- Because of this, the ratio of foreign currency denominated debt to the overall amount of public debt has risen substantially.
- The ratio of foreign currency denominated debt calculated by the Maastricht criteria rose from 25% in 2002 to 47% by September 2010.
- Two contradicting arguments must be considered if we want to define the optimal ratios of the debt denominated in the domestic and in foreign currencies:
    1. A higher ratio of foreign currency denominated debt increases the risk exposure of the country to exchange rate fluctuations (which is far too high anyway) and it can reduce the flexibility of economic policy (especially of monetary policy).
    2. A high amount of HUF-denominated Hungarian government securities which are held by foreign investors makes us vulnerable and exposed to risks, as a wave of selling could have grave impacts on the market of government securities and on the exchange rate (as events in the past prove), and there can be no such scenarios with foreign currency denominated debt.

c. Ownership structures

- During the course of transformation to market financing the public debt holdings of the domestic financial sector – and within that especially the NBH – had been replaced by private financial market ownership, most of which was foreign.

- By now, partly because of the international loan package, the 56% of public debt is in foreign hands, and another 40% is owned by financial institutions.
- Only a tiny proportion of domestic households and enterprises hold government securities.

How we got here: the question of responsibility

- Because of the policy of the past eight years which had been based on overspending, high budget deficits and accumulating public debt, the financial crisis which erupted in autumn 2008 pushed the country into such a situation that we could avoid bankruptcy only by the help of international credits.
- The question of why the national debt had ballooned like this can no longer be left unanswered. The decisions of the previous governments led to selling out our future, and if the political and economic responsibility can be defined, justice must be administered by the instruments of democracy.
- Since 2002 the former opposition politicans and experts have pointed out again and again to the liberal leftwing governments which had been knowingly overspending and buying shortlived popularity that their measures were flawed, dangerous and were bloating the national debt. These warnings had fallen on dead ears year after year.

2003

„During the past year the economic indicators of Hungary deteriorated sharply: the national debt increased, the deficit of the national budget and the current account balance rose, unemployment worsened and the confidence of foreign investors in Hungary – parallel to these processes – nosedived spectacularly." (*Péter Szijjártó, imre Takács, Ferenc Ivanics*)[1]

„During the last one-and-a-half years, since the MSZP-SZDSZ government has entered office, the national debt rose by 2000bn HUF which as a whole now surpasses 10 000bn HUF. In 2003 we spent about 800bn HUF on debt service. It is getting hazardous. There are new loans which

[1] http://www.parlament.hu/internet/plsql/ogy_irom_adat?p_ckl=37p_izon=5153

are unrelated to the old ones. This is the result of a grave balance shift in the national budget…I believe this has been the root cause of the country's difficulties nowadays." *Sándor Lámfalussy*[2]

2004

„The level of public debt has reached a critical height. People are not aware that the Socialist-Free Democrat government which is currently in power has been selling out our future. The public debt has risen by 2800bn HUF since May last year. This pace has been two to four times more than it was during the era of the Orbán government. The increase of debts at this speed is bankrupting the citizens of Hungary and the national budget." *Antal Rogán*[3]

2005

„What we must comprehend is that since the government change in 2002 the public debt has risen by about 5000bn HUF. If we calculate this per head, it means that currently in Hungary everybody from a newborn to a senior citizen has debts of 1.3 million forints…These days more than 90% of the overall personal income tax paid by taxpayers for an entire year goes to servicing the debt. This is the amount from which we cannot build schools, pay pension benefits and provide social and healthcare services." *Viktor Orbán*[4]

2006

„We need a new adminisration, because the one in power is not loyal to Hungarians…It has not been loyal partly because it has been drowning them in debts. By the end of the 1980s the country had learned the lesson well that although the central administration takes out a credit, but it is the citizens of the country who keep repaying it. The current Hungarian administration has been living off our future and living off even the future of our children and grandchildren, too. Therefore, after the next elections, they will need to answer just where the money is, because the billions of forints of debt they had taken out has improved nothing in the country." *Viktor Orbán*[5]

2007

[2] http://www.ufi.hu/index.php?site=cikkr+c0id=698
[3] http://www.2.mno.hu/portal/208812
[4] http://nemzetikonzultacio.hu/indexs.php?kat=4+cikk=26
[5] http://2001-2006.orbanviktor.hu/hir.php?aktmenu=2’id=2490

„We need to consider how the state finances could be put in better shape for the long term. Currently debt service is weighing enormously on taxpayers. This year 1112bn HUF have been spent on repaying the interest liabilities of the national debt. Even back in 2006, it was only 830bn HUF…That was 40 000 HUF per head at that time. In other words, we have been paying the price of their credibility deficit, of inflation and of flawed economic policy." *Mihály Varga*[6]

2008

„It has not been productivity issues or high unemployment that has retarded Hungary's economy relative to countries in the region, but uncontrolled borrowing and the mistaken interest policy of the National Bank of Hungary." *Imre Boros*[7]

2009

„In the view of the Fidesz, the government has put Hungary in debt for several decades and the situation is further exacerbated by the loan of 132bn HUF which was taken out fom the European Investment Bank. Hungary had sunk so deep in the debt spiral that this amount of 132bn HUF had to be taken out because Hungary had had no more resources to finance the downpayment of EU support." *István Balsai*[8]

„The Gyurcsány era was the period of political crimes, because the person these years had been named after committed political crimes against Hungary and the Hungarian people. One of the gravest political crime was to put Hungary in debts. A short time ago Hungary was in a state of hopeless apathy and we need to unite all our energies and all the forces of the Hungarian people in order to put the Hungarian economy on the path of recovery…Because of the political crimes of Ferenc Gyurcsány and the Gyurcsány era the servicing of debt swallows more money than what the budget spends on healthcare or eduation or pension benefits." *Péter Szijjártó*[9]

[6] http://www.fidesz.hu/index.php?Cikk=100597
[7] http://mn.mno.hu/portal/563410
[8] http://www.fn.hu/belfold/20090128/fidesz_kormany_evtizedekre_eladositotta/
[9] http://hirszerzo.hu/belfold/166080_gyurcsany_a_gyavasagrol_es_a_kormanyzasrol_csa