Hungarian debt downgraded to junk status

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The downgrading of Hungary's creditworthiness to junk status means the debt crisis has now fully hit eastern Europe. Rating agency Moody's justified the downgrade last Friday by pointing to Hungary's strong dependence on foreign creditors, the poor economic outlook and the country's level of debt at 82 percent of economic output. The government of Viktor Orban confronts a debacle.

Since the conservative Civic Union (Fidesz) took power in May 2010 with a two-thirds majority, Orban has sought to balance the budget through a combination of cuts in social services and financial tricks. In addition to layoffs and salary cuts in the public service, his administration has undermined the employment protection act and introduced compulsory labour service for the unemployed.

Late last year, the government nationalised the private pension funds and stuck more than €10 billion that Hungarians had set aside for their retirement into the treasury. As a result, the Hungarian budget has a surplus this year. Next year, the budget deficit should lie below 3 percent because special taxes on the telecoms and energy sectors will bring further millions into the state coffers. From 2013, the deficit will then rise again, according to calculations by the European Union.

To dampen the discontent with his austerity measures, Orban is playing the nationalist card and behaves as though he were the enemy of the foreign banks. In September, he issued an order requiring the banks to convert foreign currency loans at a fixed price in Hungarian forints. The banks must bear any difference with the current exchange rate, meaning they must effectively take a debt "haircut."

Above all, this move has significantly dampened the confidence of the international financial markets in the Orban government and contributed to the increased pressure on Hungarian government bonds and the forint. Last week, the government was forced to ask the International Monetary Fund (IMF) for assistance, which amounted to a public humiliation. A few days earlier in parliament, Economics Minister Gyorgy Matolcsy had categorically ruled out asking for help from the IMF and Prime Minister Orban has consistently insulted the IMF.

Fidesz could largely credit its 2010 victory to the fact that the previous social democratic government of Ferenc Gyurcsany turned to the IMF in 2008 to avert national bankruptcy and imposed massive cuts in salaries and benefits in return for IMF loans.

The Orban government turned to the IMF, hoping to avoid a downgrading of the country's credit rating, which has now proved a fruitless effort. Since that action, Hungary has come under immense pressure. Following the credit downgrading, the yield on 10-year government bonds reached nearly 10 percent at times—far more than the 7 percent mark above which escaping the debt trap is virtually impossible.

The Hungarian currency is rapidly losing its value against the euro. Since the beginning of the year, the exchange rate has fallen 13 percent. The Hungarian stock market went into a tailspin last Friday, losing about 5 percent. On Monday, the Hungarian central bank raised its key rate from 6 to 6.5 percent to slow the decline of the currency. But this has also increased the danger of a recession.

The rapid devaluation of the forint threatens the economic survival of many Hungarian citizens, businesses and communities that had taken out loans and mortgages in euros or Swiss francs because of low interest rates. The total amount of such foreign currency loans amounts to 4.8 billion forints (€16 billion), or about 17 percent of Hungary's gross domestic product.

The downgrade by Moody's also weakens the Hungarian government's negotiating position with the

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IMF. “The Orban government’s room for manoeuvre is smaller. Without the downgrading they could have been more flexible in negotiations with the EU and IMF. Budapest now urgently needs a deal”, Sandor Richter of the Vienna Institute for Eastern Europe (WIIW) told the Austrian newspaper *Der Standard.*

Western European banks are also affected by the crisis in Hungary. Austrian banks in particular, which have been heavily involved in eastern Europe and the Balkans since the 1990s, are in danger. The three biggest Viennese banks—Bank Austria, Raiffeisen and Erste Bank—are the biggest lenders in the region. According to the Austrian National Bank (ÖNB), at the end of 2009, the latter had outstanding loans and debts of about €35 billion in Bulgaria, Romania and Serbia alone.

According to Citigroup, Austria’s Erste Bank is threatened by the Hungarian crisis with a loss of up to €1 billion, which would be the case if Budapest ordered all foreign currency loans to be denominated in forints at the expense of the banks. Also, MKB, a subsidiary of Bayerische Landesbank, and several large Italian banks would be seriously impacted.

Many finance houses now plan to dispose of subsidiaries in eastern Europe and cut their lending dramatically. According to a survey by the Polish central bank in November, finance houses have already tightened up their money-lending criteria. Especially in Hungary and the Baltic countries, lending has long been declining. Since the eastern Europe market is dominated by banks from the euro zone, a continuation of this trend would trigger a serious credit crunch and recession.

Many eastern European countries are already in major difficulty. For example, the Czech koruna is at its lowest level in 18 months and the Polish zloty at its lowest point in two-and-a-half years. On Tuesday, Latvia called off a 10-year government bond auction due to lack of demand. The Latvian government cited the nervousness of investors and the bad mood on the European markets.

Even before the negotiations with the IMF, the Hungarian government had intensified its attacks on the general population. Although the rise in prices of essential goods (basic foodstuffs, housing, energy) is already well above the official inflation rate, parliament decided on Monday to raise the VAT (sales tax) from 25 to 27 percent, as well as to make numerous other charges. Liability insurers must pay 30 percent of premiums over to the state. Increases were also made in the vehicle tax and the registration fee for cars. The basic tax rate will rise from 30 to 37 percent of profits, burdening many small businesses enormously.

The opportunity to retire early is being severely restricted despite high unemployment. Early retirees who were previously paid from the pension fund will be forced to rely on welfare and must put themselves back on the job market. Disability retirees are now required to undergo a meticulous medical review by state doctors. About 350,000 early retirees will in future have to pay 16 percent tax on their pensions.

Support for the Orban government is now plummeting. Fidesz entered government taking over all state positions and virtually abolishing freedom of the press to secure its rule for years to come; now, support for the party has dropped to 32 percent, down from 52 percent in the April 2010 elections. According to a survey by the pro-Fidesz Nezopont Institute, only around 1.2 to 1.5 million voters would now cast their votes for Orban’s party, which received 3 million votes in the last election. Turnout today would be only 40 percent of eligible voters, compared to 65 percent at the last election.

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