AEGON Asset Management

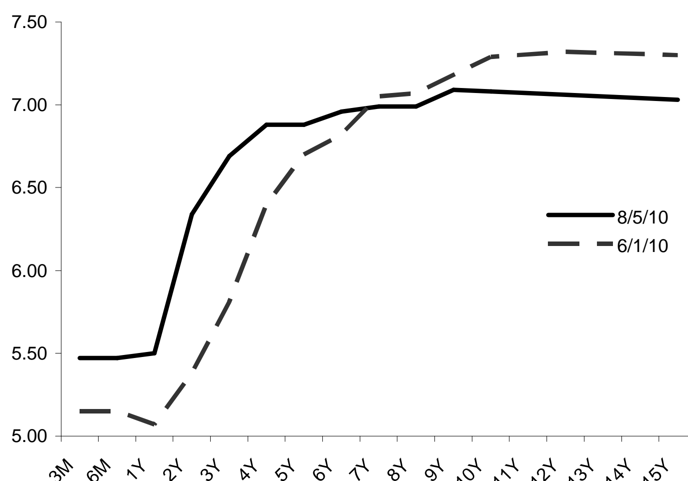
Monthly analysis – August

How can we repay the IMF loans? [1]

A review of the Hungarian IMF programme at the beginning of July revealed that the government was not a constructive negotiating partner, prompting the international body's representatives to pack their bags. With the IMF's departure, the opportunity has evaporated (at least for the time being) for us to draw the remaining IMF/EU funds or conclude a fresh agreement in the event of a negative market environment. The overwhelming majority of analysts and commentators have interpreted the development negatively. In reality, the dependence on foreign financing of the Hungarian economy – and within it the Hungarian state – is a given as our external debt is considerable. Although this state of dependence cannot be altered in the short term, we can change whom we are dependent on. But with the IMF's departure, our dependence on the international market has only increased, and the latter is more unpredictable …

It is no wonder if the initial reactions have been negative, with our markets underperforming in recent months. Most articles and analyses point out that some sizeable amounts will mature in the years 2013-2014, which might have been spread out in the event of a fresh IMF programme. This aspect seems to have come to the forefront in terms of pricing: securities with short or mid-term maturities (due in 2011-2014) have grossly underperformed in the past two months. Naturally contributing to the rise in yields on shorter-term securities is the constantly present risk that a major interest rate hike may be needed in defence of the forint – as indicated by the interest hike already priced in this year in the case of derivatives (swaps, FRAs).

The yield curve has adopted a humped shape in the past two months



Source: Bloomberg

The real question, however, is not about "how the Hungarian state will now be financed." Not one of the analysts of my acquaintance basically expects a drawing of new funds or a fresh IMF programme.

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[1] My thanks go to Judit Antal (MNB) and Gergely Tardos (OTP) for their constructive criticism of the original version.

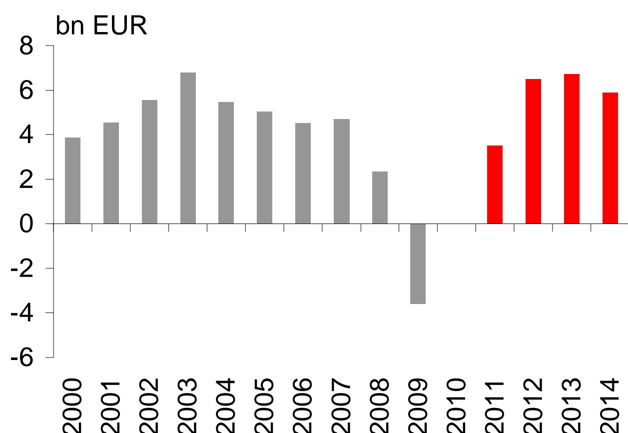
The exclusion of such opportunities is of course not a positive thing as it means that we have to stay on the present fiscal and financing path. The real question, therefore, is how uninviting and sombre this path will be. I make the assumption that the government will pursue a strict fiscal policy to hold the deficit below 3% of GDP, from which it follows that I "expect" a significant surplus in the second half of this year. In addition, in historical comparisons I "equalize" past figures using the nominal GDP for 2009 in order to gain comparable numbers (with all data expressed here as a percentage of GDP).

First of all let's take a look at net bond issues in historical comparison. What strikes one immediately is the similarity between the net market financing need/or: net borrowing requirement after 2010 and prior to 2007, which is hardly surprising if we recall the massively swollen budget deficits at that time.

In the more recent past, in 2009, net bond issues were negative as the state was unable to sell bonds on the market and even had to repurchase a significant amount. This year the balance is more or less zero as maturing bonds and the budget deficit alike are largely financed from IMF/EU loans. The year 2011 promises to be relatively "normal" (even if what appears normal in this country actually constitutes a quite significant market financing demand) because the amount of drawn but unused EU/IMF credit remaining at the government's disposal is approximately sufficient for it to be able to repay the EU loans due in 2011. From 2012 onwards, besides the budget deficit, maturing loans from international institutions will also need to be refinanced from net market bond issues, and the market will thus need to be burdened to a similar or slightly greater degree than before 2007.

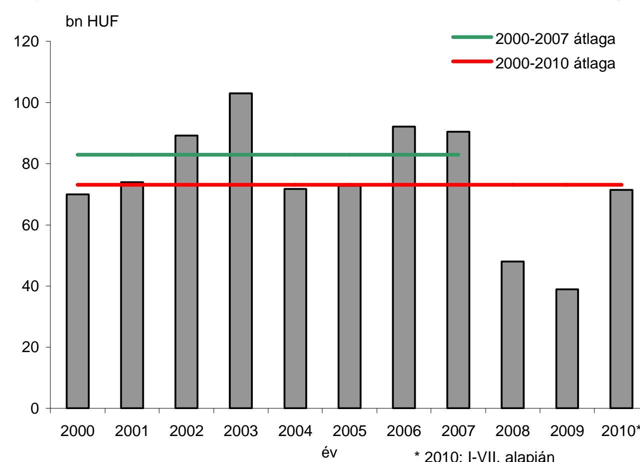
What issuing structure may be employed? Let's suppose that the present system of bond issues by auction could be successfully continued on the forint bond market. Is this even realistic? In the diagram below it can be seen that the average issue at auction in 2010 so far is HUF 71 billion, which more or less corresponds to the average of the past ten years, so that maintaining the present issue volumes would not be unrealistic at the initial stage. What burden would then be placed at this time on foreign currency bond issues? The volume of foreign currency bond issues thus remaining would be close to EUR 4 billion in 2012 and 2014, and would reach as much as EUR 5.5 billion in 2013.

Net market financing need (forint and foreign currency, on 2009 GDP basis)



Sources: MNB, KSH, AEGON Alapkezelő

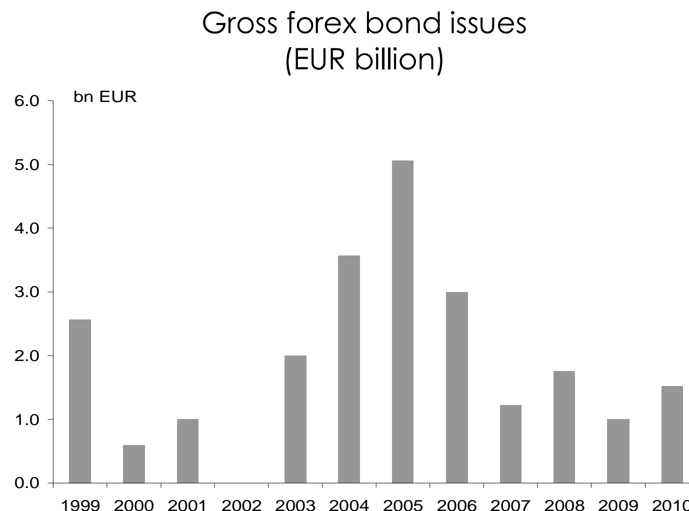
Gross forint bond issues (equalized to fortnightly auction volumes, on 2009 GDP basis)



Sources: ÁKK, KSH, AEGON Alapkezelő

The problem is that the present auction quantities can probably not be maintained over several years without purchases by foreigners, just as in the past the contribution of foreign accounts was needed in order to issue the auction lots at that time. Next year and in 2012, a net issue of EUR 3 billion will

arise from the fortnightly auction lots of over HUF 70 billion. Along with the bonds reaching maturity at the time, an advertised quantity on this scale would probably not meet sufficient domestic demand, or at least only if domestic savings were to show an exceptionally high growth. Again adjusted for nominal GDP, domestic demand was able to purchase an average of HUF 534 billion in bonds between 2000 and 2007. If, instead of the current auction volumes, we assume net forint bond issues of "only" HUF 550 billion next year, then foreign currency bond issues of on average EUR 5.5 billion would be needed over three years. This would be unprecedented: over the past decade or so, the issued volume has been EUR 2 billion on average, and only in 2005 was a larger amount of over EUR 5 billion successfully issued.



Source: Bloomberg

The situation is made all the more serious in that the above comparisons take the period before 2008 as their basis, when the national/public debt was considerably smaller and the international market mood exceptionally favourable.

Overall, then, the following conclusions can be drawn:

- Well-timed swap auctions must be used to spread out the maturities of the following years, principally those falling in 2013 – leading to a steepening of the yield curve.
- Demand on the part of foreign investors on the scale typical of 2007 and the years before it will be needed either on the forint or foreign currency bond markets, but preferably on both.
- The budget deficit cannot rise above our assumption of 3% of GDP, even technically (no one will pay for it), nor from the point of view of the trust that is absolutely essential for the renewal of other maturing debts.

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