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Title:

Analyse the debt of Hungary in the 1990's. Use economic theory to explain the relationship of debt with the macroeconomic aims and indicators

In this assignment I would like to state first what government debt is and how does it affect the economy. We would like to analyse the debt of Hungary in the 1990's from 1990 to 1997, with the help of data collected by the Központi Statisztikai Hivatal (Central Statistical Office), and the reports provided by the Hungarian Ministry of Finance[1]. At the end we would also like show what implication debt had on macroeconomic aims and indicators of Hungary.

Just before starting we would like to define what macroeconomic aims and indicators are. The main macroeconomic indicators of a country are the GDP, the current balance of payment, the inflation rate, the rate of unemployment, the amount of debt etc. The macroeconomic aims, goals of a country are high and stable economic growth (steady growth in real GDP), low unemployment, low inflation, and the avoidance of balance of payment deficits and excessive exchange rate. According to John Sloman's Economics[2] the economic growth means that there will be more goods and services for the people to consume, the rate of inflation means "the percentage increase in prices over a twelve-month period. The balance of payment shows the country's transactions with the rest of the world, and the exchange rate is the rate at which one national currency changes too another. And at last the unemployment rate is the number of unemployed expressed as a percentage of the labour force." Why are these goals of economies? We will see it through the effect of debt.

Debt

We should state here that we are talking about government debt not the debt generated by one individual to a bank for example. According to Michael Parkin's Macroeconomics government debt is: "the total amount of borrowing the government has undertaken and the total amount it owes to households, firms and foreigners."[3] We should also make a distinction

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[1] Report 2338/4/1998 Ministry of Finance: Information On The 1997 Position Of The Economy, Budapest, April 1998

[2] 'Economics' John Sloman, Prentice Hall Europe, 1997 3rd edition, pp399-413

[3] 'Macroeconomics' Parkin, Michael Addison-Wesley Publishing Company, Inc. 1990, Appendix

between external and internal debt. The external debt is owed by a nation to foreigners, and the internal debt is owed by a nation to its own citizens.

The debt of Hungary is made up of mainly the central budget debt, the debt guaranteed by the government, the credits taken up by the state to finance special projects etc.

In case of budget deficit (deficit = revenues less expenditures if the expenditures exceed revenues, profit/sufficit/ = revenues less expenditures if revenues exceed expenditures) the government has three solutions to finance it. First by debt, (lending from inland or foreign savers) or by lending from the central bank that is by creating money. The first solution means real debt service, but the second one does not as the Central Bank represents no real income owner, to which the debt should be paid back. If the money created is spent then it can cause acceleration in the economic growth or acceleration in inflation as prices go up. But if the money is spent on imports then the balance of payments will worsen and the external debt will be bigger.[4] Until 1996 there was a third solution as well, which meant financing the deficit by selling out part of the state-owned property that is by privatisation.(The amount of property which remained to privatise is very small.) The nominal value of deficit can be then defined as following: the increase of bonds sold to the central bank and the private sphere, and the decrease of the state property.

The balance of payments depends mainly on how the revenues and expenditures change within a given time period. How these change depends on the economic policy, because the stimulating economic policy is likely to bring deficit and the restrictive one profit (sufficit) or little deficit. But the economic policy is only one factor that affects the process of changing in the revenues and expenditures. It has proved that when looking at the business cycle of one country, mostly in times of recession there is a deficit and in times of prosperity there is a sufficit or very little deficit. This is an effect of economic stabilisers, because the reduction in

GDP causes in the meantime the reduction of tax revenues. The growth in unemployment has just the same effect. The increase of inflation causes a growth of the interest rate, which means that the interest costs of the state debt will be risen as well.

We should define here now what primary deficit and what total deficit mean. The primary deficit is the difference between the revenues and the expenditures. If interest payment on debt is added to it we will get total deficit. If in a given time period there is primary deficit in the economy, the total deficit will rise as interest should be paid on debt, which interest has grown as the interest rate has risen due to the deficit. This way a cycle can be born, which causes that the deficit makes the debt to rise, the bigger debt causes that bigger interest should be paid on debt, which again makes the deficit grow. And the bigger deficit makes the debt grow again and so on, and so forth. This problem can only be solved in a way that primary deficit should be ceased, and this will make the debt to decrease. So the expenditures should be decreased in such a way that they should equal revenues or even revenues should exceed a little expenditures. This can be of course very painful to the economy and can even cause a fallback in economic growth. [5]Which is again a contradiction to one of the macroeconomic aims of an economy that is high and stable economic growth . Having known all these we can look at how the deficit and debt formed in the period 1990-1997.

The analysis of debt in the 1990's

For analysing the debt in Hungary in the 1990's we would like to use Tables 1, and 2 in the Appendix.[6] . In Table 1 we can see the percentage change from year to year of GDP, which reflects the economic growth of the country, it also shows the unemployment rate, the current account balance, the amount of foreign debt. Table 2 shows the current account balance and

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[4] 'Ki fizet a végén ? '(Who pays at the end?) ed.Erdős Tibor Institute of Economics , Hungarian Academy of Sciences , Budapest , 1991 pp.66-68

external debt as a percentage of GDP. These all will be needed for the analysis and to draw conclusion how debt has affected the macroeconomic aims and indicators. We would also like to use Diagrams 1-4,6.

Two main periods can be distinguished in all 4 diagrams. The first period between 1990-1994, and the second period between 1995-1997. From 1991, we can see a rapid economic growth (there was a need to change the whole economic system), and this economic growth had commenced alongside decline of inflation, resulted in a dramatic increase of imports and a rapid increase of indebtedness of the state and the country. In 1995 a change come to all this, because the new government introduced tough stabilisation measures, and began to apply a fundamentally new economic policy. This policy is equally characterised by efforts made at stabilisation and improvement of competitiveness. Therefore, while in 1994-1997 the indicators of equilibrium and indebtedness improved radically. The growth of GDP slowed down only for an interim period. (See Diagram 3) There was also a growth in exports. The inflation process that accelerated again in 1995 as an unwelcome consequence of the adjustment was brought under control already in 1996 and in 1997 the rate of price increase continued to substantially decelerate. (Diagram 7.) This process was also followed by a decline of interest rates.[7]

Let us look at the cause one by one. The state debt has grown very rapidly in the first period. This was mainly due to the increase of budget deficit (which has grown ever since 1990 until 1994), and on the other hand because the privatisation began, so it decreased the property of the state. In most of the cases privatisation would reduce the debt, but in Hungary the revenues from privatisation were spent, which caused excessive expenditures. In 1995 a law

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[5] 'Bevezetés a gazdaságplitikába' (An introduction to economic policy) ed. Veress József, Aula Kiadó , Budapest 1996

[6] The tables are taken from the web site **www.meh.hu/ministry** of finance/sumeco.htm

[7] Report 2338/4/1998 Ministry of Finance: Information On The 1997 Position Of The Economy, Budapest, April 1998

was passed in, which stated that the revenues from privatisation should be spent on debt service, that is to reduce the debt of the country.. This brought its effect, as the debt has decreased from 1995, with special regard to foreign debt. The decline of debt, mainly the decline of external debt was due to the big inflow of foreign capital, the firm and bank sector took up foreign credits; (the interest in foreign countries was smaller, and less risky), and most of the privatisation revenues came from abroad. The first two of the mentioned have a real macroeconomic effect, they increase the net internal debt, by decreasing the net external debt Privatisation revenues increase only the internal debt if they make the government to spend more. The internal debt has increased again because from 1990 the developed countries and foreign organisations no longer financed the budget deficit. The state debt could have also grown because of another fact. The currency of Hungary was not convertible until 1996. We know from above that the current devaluation of the Forint made the interest rate on debt grow, that is why there was extra debt generated. Since 1995 the budget deficit is declining, which is also a cause of the decreasing debt. The decreasing deficit is mainly due to the cut in the expenditures, (which caused the slow down of economic growth in 1995-1996). The reduction of expenditures was extremely radical and was not limited to the financial restrictions applied of necessity. "Reform type initiatives were taken in areas hardly affected earlier (education, social policy) and effective selection was carried out in the institution system, the separated state funds, in the principles of funding. A fundamental and comprehensive reform took place in 1997 in the pension scheme, albeit the transformation of the whole of the social security system is still to be undertaken."[8](Tables 1,2,and Diagrams 1-4, 6)

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[8] Report 2338/4/1998 Ministry of Finance: Information On The 1997 Position Of The Economy, Budapest, April 1998

The changing of the external debt brought a positive image for Hungary. It became an attractive and reliable place for investment. The attraction of foreign currency to the country is very essential, cause it may help to speed up economic growth of the country, may reduce unemployment by providing new places of work for the citizens of the country, and although not directly but it may reduce inflation. (More people can work, more people can pay taxes, increase in government revenues, no or less price increase). But the too big amount o foreign investment in the long run will not be good either, as it causes an increase in the internal debt.

We have not yet examined yet how the exchange rate changed in the above mentioned two periods. Let us look at Diagram 8..There we can see that there is stable growth in the Forint dollar exchange rate without any fluctuations. We can state that as the Forint approached to became convertible, the exchange rate went higher and higher, and there were not two periods here, which may mean that there was ever growing interest towards Hungary.

Conclusion

Altogether we can summarise that from the four macroeconomic aims, goods steps were made towards achieving most of them. Economic growth is not to fast, but the aim here would be to achieve economic growth without any shock, (the increase of inflation and so on). There were good steps toward reducing unemployment, but the unemployment rate is still too big and something should be done about the black labour force market as well as there are many people working unregistered, that is they have incomes without paying taxes. It is very good that the exchange rate between the dollar and Hungarian Forint is not fluctuating, that is it is stable. The deficit of the budget is still too big. It would be essential to reduce this to the extent so that no primary deficit would be achieved so as to stop the increase of internal debt. If the internal debt is too big there will be inflation again which is not good for the economic development of the country.

To the extent of economic policy definitely retains the requirement of improving competitiveness and the of preserving equilibrium for the following years. It will be possible for the economic development of Hungary and her economic policy to get over the decades' old dilemmas of "balance or growth" and "stimulation or restriction" and a balance keeping economic growth based on the improvement of competitiveness may gradually accelerate. This would be very essential to achieve as Hungary wishes to be part of the European Union soon, which may also arise new economic problems, and in the meantime better solutions for the country.

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