

CHAPTER 18 – Long Term Financing

EMU predictions boost Hungarian bond

By Jules Evans (Euromoney)
January 30 2003

Hungary has launched its first sovereign bond since 2001, with a EUR 1 billion issue lead managed by Dresdner Kleinwort Wasserstein and SSSB. The country may issue three big bond deals this year. Laszlo Buzas, the head of Hungary's public debt agency, says that further sources of issuance are emerging for the country, including local mortgage banks and the Hungarian student loan company, which may come to market with a securitization issue in the autumn.

At 27 basis points over mid-swaps, the spread on the latest transaction underlines the extent to which investors are willing to consider Hungary to be comparable to eurozone countries. For deals of a similar size and maturity, Greece can usually expect to issue at around 20 basis points over the same benchmark.

Hungary hopes to join the EMU by 2007. But any investors who are betting on that by buying these bonds should be wary of the country's problems with currency instability and inflation.

In the middle of January, market speculators started betting millions of dollars that the government would be forced to revalue, because the forint (HUF) would breach the upper limit of its euro trading band (i.e., 234.69 HUF/EUR). Sure enough, it did, and the central bank responded by cutting interest by 100 basis points, and by intervening in the FX market. CSFB analysts believe the bank may have bought EUR 6 billion in euros.

That rate cut happened just hours after the central bank governor, Zsigmond Jarai, said inflationary pressures ruled out any more rate cuts. This, combined with the continued strength of the forint, made markets think a revaluation was imminent, and even heavier bets were made that the government would revalue the forint.

Instead the central bank, acting in concert with the ministry of finance, cut interest rates by another 100 basis points, down to 6.5%, and intervened in the FX markets again. There is still market talk of further euro purchases by the central bank. These renewed signs of determination to defend the trading band were enough to see off the speculators, and the forint settled at 250.9 HUF/EUR, leaving those betting on a revaluation with losses of an estimated EUR 600 million.

Analysts are predicting that Hungary has done enough to protect the trading band for the time being, but the defensive maneuvers have now caused another problem - the threat of rising inflation.

Gyorgy Sandor, managing director at the central bank, said on the recent new issue road show: "We will meet the inflation targets of 2004, which will make it possible to join the EMU at the earliest possible time." However, a number of analysts think the rate cuts, combined with the amount of new cash injected into the economy, will lead to higher inflation. CSFB's emerging markets research team thinks inflation will hit 5.2% at the end of the year, considerably above the government's 4.5% target. Both CSFB and other market analysts

think continued rising inflation this year and in 2004 will force the central bank to raise interest rates, and EMU entry may be delayed beyond 2007. If this happens, foreign investors may reject Hungarian debt. "This could put downward pressure on the currency as well as upward pressure on spreads," says Peter Worthington of CSFB's emerging markets team. "If investors think such a development is likely, they might anticipate it, which would become a self fulfilling prophecy."

Worthington thinks the best option is to let the forint float until the Hungarian economy is closer to the eurozone's. The central bank is also thought to be privately open to revaluation. However, the government is reportedly very opposed to revaluation because it could harm exports and weaken the Socialist Party's support from the industrial sector.

All of this uncertainty about what the government will do has translated into volatility in Hungary's domestic debt, which is what many emerging market investors are investing in, to pick up yields of around 250 basis points over Bunds. Buzas of the Hungarian debt agency says investors can find relative stability in the longer end of the curve, but he admits there is little his agency can do to prevent FX volatility. Many investors will be prepared to stomach this volatility in the solid expectation of ultimate entry to the eurozone. But it is not absolutely certain that entry will be at the soonest possible date.

Questions

- 1.** Name all the factors that were probably considered by Dresdner Kleinwort Wasserstein and SSSB to set the YTM of the issue. Explain how these factors affected the YTM.
- 2.** Explain how country risk affected the YTM of the Hungarian bond issue. According to the YTM is Hungary a high risk?
- 3.** Why is Hungary borrowing in EUR?
- 4.** Why is the YTM different for EUR denominated Hungarian bonds and HUF denominated Hungarian bonds?
- 5.** As Hungary becomes closer to joining the EMU, what do you think is going to happen to the YTM of HUF denominated bonds?
- 6.** Provide a rationale for Hungary's absence from the sovereign bond market since 2001.