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Corruption by design – the economic and financial impact of the Government’s Golden Visa bonds in Hungary

The role of residency state bonds in financing the Hungarian government 2013-2017

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I. Executive summary

The government raised revenues of approximately 1.666 billion euros in total from the residency bonds issued between 2013 and 2017, with a total par value of 1,844 billion euros. At the time of issuing the residency bonds, the government had no need for financing the deficit, for the roll-over of expiring debt, whether denominated in foreign currency or in forint, for raising the level of foreign exchange reserves, for maintaining or smoothing the liquidity of the Treasury Single Account, or for the recruitment of investors who have difficulty in taking flight even at the times of crisis.

Residency bonds proved to be an expressly expensive source of founding; furthermore, they played no substantive role in financing the government. Relative to the comparable (5-year) Hungarian foreign exchange bonds traded on the secondary market, residency bonds were more favourable in the first two years of the residency bond program, but in the entire program period they generated relative net losses of 66.5 million euros or, at current exchange rates, more than 21 billion forints.

Another perspective is added to the assessment of the relative cost and the residency bond program as a whole by the fact that simultaneously with the expansion of the residency bond portfolio, the stock of borrowings from the European Investment Bank (EIB) declined. Consequently, it is reasonable to compare the cost of residency bonds as sources of funding not only to the required yield of 5-year Hungarian forex bonds but also to the interest rate of EIB loans. EIB loans had played a significant and, until 2013, growing part in financing government projects. The interest rates of individual EIB loans are treated as business secrets; therefore, we are unable to perform accurate calculations. It is generally acknowledged, though, that EIB loans are among the cheapest funds available on the market; that is, they are one of the most favourable solutions in terms of interest rates - even though they can be used exclusively for specified investment purposes. As revealed in the final accounts, in the 2010-2017 period the average interests rate of the entire stock of EIB loans was continuously at least two percentage points lower than the yield of the foreign exchange bonds. Even though this benefit could not remain at the same level when the required yield of newly issued forex government bonds fell below 2 percent, then below 1 percent, we can certainly assume that the EIB loans would have been more competitive than residency bonds. This assumption is definitely valid for the 2013-2014 period, when the issuance of foreign exchange bonds was less advantageous than the issuance of residency bonds. Taking this into consideration, the relative loss from the issuance of residency bonds is close to 30 billion forints, which is a conservative estimate.

We have reason to believe that the primary reason for the government to issue residency bonds was to recruit investors, replacing EIB, who raise no demands regarding the use of funds. From the perspective of the government, this is an indisputable benefit of the residency bonds. However, Hungary lost 30 billion forints while the government obtained funds that could be used to benefit entities of their choice and spent without resorting to public procurement procedures.

II. Background

Hungary intentionally extended the possibility to lawfully reside in its territory and in the European Union's Schengen Zone to third country nationals who purchased the country's residency bonds. Though a ferocious opponent of migration, Mr. Orbán's administration has thus relocated 19,855 migrants, or High Net Worth Individuals, in the country, who paid 300,000 euros to the Hungarian

government. Though it may seem reasonable at first glance, in reality the Hungarian Golden Visa Program, operational between 2013 and 2017, opened a gateway for the corrupt, who used this intentionally created loophole to launder their ill-gotten assets and to transfer them into the European Union without boosting investments in Hungary's economy.

There was a twist in the tale, though: non-EEA citizens wanting to obtain a Hungarian permanent residency permit were expected to pay the 300,000 euro par value¹ of a package of Hungarian residency bonds to one of eight intermediary organisations licensed by the Parliament Economic Committee instead of transferring the purchase price directly to Hungarian state coffers. Intermediary organisations, all but one of which were registered in secrecy jurisdictions², accumulated profits in the range of 192 million euros, at the expense of Hungarian taxpayers. Intermediary organisations, whose beneficial owners remain unidentified, were granted a monopoly to trade the residency bonds in certain jurisdictions specified in their licences.

Table 1: intermediary organisations' place of incorporation and geographical scope of operation

Intermediary Organisation's Name	Place of Intermediary Organisation's Incorporation	Geographical Area of Intermediary Organisation's Operation
Hungary State Special Debt Fund	Cayman Islands	China, Vietnam
Discus Holding Limited (licence revoked)	Malta	South Africa, Kenya, Nigeria, Indonesia
Innozone Holding Limited	Cyprus	Cyprus, India
Arton Capital Hungary Pénzügyi Tanácsadó Kft.	Hungary	UAE, Indonesia, Singapore, Nigeria
VolDan Investments Limited	Liechtenstein	Russia & Post-Soviet
S&Z Program Limited (licence revoked)	Liechtenstein	Maghreb & Middle-East
Euro-Asia Investment Management Pte. Limited (licence revoked)	Singapore	Singapore
Migrat Immigration Asia Limited	Cyprus	Malaysia, South Korea, Mongolia

Source: HSDMC³

The involvement of intermediary organisations was not just a clear endeavour on the Hungarian government's behalf to facilitate the hiding of lucrative profits generated through the residency bond business, but it also clearly violated a provision in Hungary's Fundamental Law, which bans the transfer of public assets to organisations with an unclear proprietary background.

¹ The par value of residency bonds was 250,000 euros between January 1, 2013 and December 31, 2014, and 300,000 euros from January 1, 2015.

² Intermediary organisations are incorporated in Liechtenstein, Cyprus, the Cayman Islands, Singapore, and Malta. The Parliament Economic Committee, without disclosing the reasons, has revoked the licences of three of the intermediary organisations.

³ The list of the licensed intermediary organisations, as well as the ones whose license has been revoked, is available here: <http://akk.hu/en/page/government-securities-issuance-and-trading#types-of-government-securities> and here: <http://www.akk.hu/en/page/government-securities-issuance-and-trading>



In the estimation of Transparency International Hungary, the country's shady golden visa program was set up to enable the enrichment of selected influential Hungarian individuals at the expense of public funds, a reason why the Hungarian residency state bond program can be regarded as an indication of high level corruption in Hungary, with a corrosive effect on the country's government.

Until June 30, 2017, 6,621⁴ residency bonds were subscribed, making it possible for a total of 19,855 non-EEA citizens, including bond investors' relatives, to reside in Hungary and offering them free entry into the Schengen zone of the European Union. The government of Hungary, following the residency bond program's suspension on 31 March, 2017⁵, terminated the program at the end of July 2018⁶.

III. Overview of economic and financial impacts

Residency bonds were issued by the Hungarian State Debt Management Company (hereinafter referred to as: HSDMC) between 2013 and 2017. The stock in circulation at the end of 2017 was 1,844 billion euros. Residency bonds are so-called zero coupon bonds, i.e. they do not pay any interest during the time to maturity and even on the expiry date they only pay the face value. As a consequence, the price of residency bonds at issuance has to be lower than the face value by an amount that corresponds to the advertised yield. The cumulated revenue over 4 years was 1,666 billion euros or 519 billion Hungarian forints, half of which was received in the period between Q2 2016, and Q3 2017, i.e. in the final year and a half.

Residency bonds did not play a significant role in the stock of government debt, in annual fundraising or in stabilizing the Treasury Single Account.

Even at face value the stock of residency bonds at the end of 2017 amounted only to 2 percent of the central government's total debt. Its weight in the foreign-exchange denominated debt was 10 percent, but this was mainly the consequence of the rapid and deliberate reduction of the foreign-exchange denominated debt (apart from the residency bonds).

The annual gross financing need of the government was approximately 4 to 6 thousand billion Hungarian forints in the years investigated. Residency bonds barely covered 2 percent of this amount. Their weight in raising foreign exchange funds was 50 percent, but only due to the 85 percent reduction in the amount of other foreign exchange funds raised.

In the years 2012-2017 the average quarterly closing stock of the Treasury Single Account (TSA) held at the Central Bank of Hungary was 1,438 billion Hungarian forints, but the fluctuation of this stock from quarter to quarter was more than 400 billion Hungarian forints, compared to which the quarterly amount of 30 billion Hungarian forints of the residency bonds was practically negligible.

Not only did residency bonds play no significant role in the total debt, but they were not necessary to maintain either liquidity or the stock of foreign exchange reserves, or the share of foreign exchange denominated debt in the stock of total debt.

⁴ In fact, 6,621 is the number of permanent residency permits requested from the Immigration Office. As the purchase of a residency bond is a prerequisite of applications for a permanent residency permit, one can conclude with reason that at least 6,621 packages of residency bonds have been subscribed. However, there may be an unknown number of residency bond holders who did not request the issuance of a permanent residency permit. For the sake of simplicity, we will calculate with 6,621 residency bonds.

⁵ Government Decree 45 of 2017.

⁶ Section 35(2) of Act XL of 2018, in force as of 26 July 2018.

Annual reports of the HSDMC in the years 2013-2016 show a positive liquidity position. Even in the more critical period between 2013 and 2015 the HSDMC spent several times the amount of residency bond revenues on the buy-back of bonds expiring in later years. If the HSDMC had been concerned about liquidity problems, it would not have started such large buy-back programs.

According to international standards, investors treat a country as high risk if the foreign exchange reserves of the country's central bank do not cover the short term liabilities of the country (not just those of the government). Foreign exchange reserves in the years 2012-2017 would have covered the short term liabilities of Hungary even if no revenue whatsoever had been raised via residency bonds.

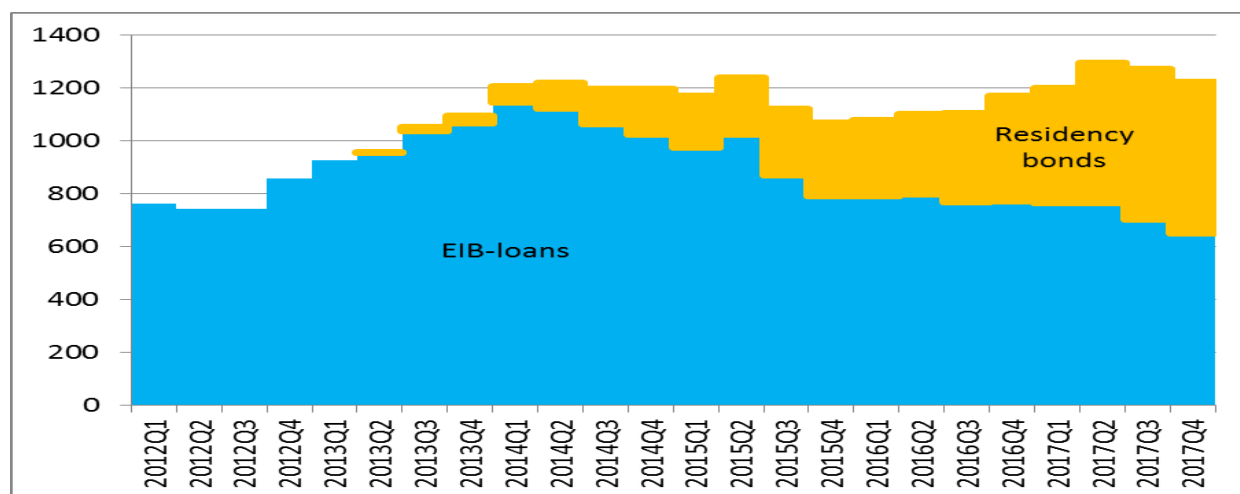
Eventually residency bonds could have been used to smooth out the maturity profile of the foreign exchange denominated debt, but it seems that even avoiding the expiry of the bonds hindering the artificial minimisation of the year-end stock of gross debt was a more important goal, an explicit proof that the funds raised from residency bonds were not necessary for financing.

Theoretically, increasing the share of instruments that investors cannot entirely dispose of even in crises periods could have been a valid motivation, but there are more reasonable ways to prevent capital flight, namely if governments get indebted in long term credits instead of in securities.

In contrast, not only did the Hungarian government prepay before expiry the credit taken from the International Monetary Fund and the European Union at the end of 2008, but even the stock of extremely cheap credits taken from the European Investment Bank (EIB) diminished significantly; the amount of credit lines contracted per year was practically cut in half. This is understandable from the government's perspective, but not from the country's. The Hungarian government's intention must have been to find creditors willing to offer financing without any (economic policy, public procurement, cost-benefit analysis, etc.) preconditions whatsoever, or, in other words, to raise unrestricted funds.

This also implies that the adequate comparator for the cost of residency bonds as financing instruments is actually not the required yield of the 5-year Hungarian foreign exchange denominated government bonds but the interest rate of the loans of the European Investment Bank.

Chart 1: End-of-period combined stock of EIB loans and residency bonds (bn HUF)



Source: FRIB estimate based on data of the HSDMC

IV. Issuance and value of residency bonds

Residency bonds were issued by the HSDMC between 2013 and 2017.

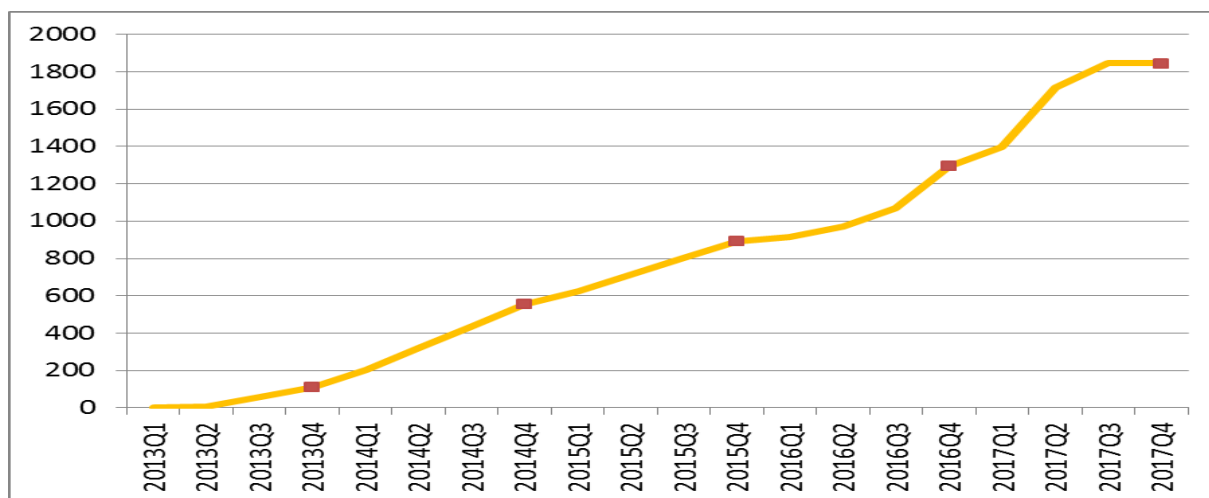
Table 2: Official data of the residency bonds

Name / Code	Original currency	Date of issuance	Date of maturity	Notional maturity (year)	Type of interest	Yield	Stock at the end of the year (mEUR)				
							2013	2014	2015	2016	2017
2018/T	EUR	2013.06.19	2018.12.20	5	Zero kupon	2,53%	107,5	107,5	107,5	107,5	107,5
2019/T	EUR	2014.01.15	2019.12.20	5	Zero kupon	2,24%		445,8	445,5	445,5	445,5
2020/T	EUR	2015.01.14	2020.12.20	5	Zero kupon	2,00%			336,6	336,6	336,1
2021/T	EUR	2016.01.13	2021.12.20	5	Zero kupon	2,00%				9,0	9,0
2021/T1	EUR	2016.03.09	2021.03.27	5	Zero kupon	2,00%				17,4	17,4
2021/T2	EUR	2016.04.06	2021.06.27	5	Zero kupon	2,00%				60,3	60,3
2021/T3	EUR	2016.07.13	2021.09.27	5	Zero kupon	2,00%				98,4	98,4
2021/T4	EUR	2016.10.05	2021.12.27	5	Zero kupon	2,00%				218,1	218,1
2022/T1	EUR	2017.01.11	2022.03.27	5	Zero kupon	2,00%					116,7
2022/T2	EUR	2017.04.12	2022.06.27	5	Zero kupon	2,00%					349,2
2022/T3	EUR	2017.07.12	2022.09.27	5	Zero kupon	2,00%					85,8
Total							107,5	553,3	889,6	1292,8	1844,0

Source: HSDMC

In the beginning the HSDMC opened new series every year, but in 2016-2017 new series were started every quarter. Only the newest series was on sale at any time, hence the issuance period of previous series closed upon the appearance of the new series. As the maturity of all the bonds was above 5 years and there was no buy-back option, the current outstanding stock of each bond is equal to the stock sold before the opening of the next series. The amount at face value issued each quarter can be estimated relatively well based on the official data shown above if we assume that issuance was uniformly distributed over the whole issuance period.

Chart 2: Estimated face value of the outstanding stock of residency bonds at the end of the period (mEUR)

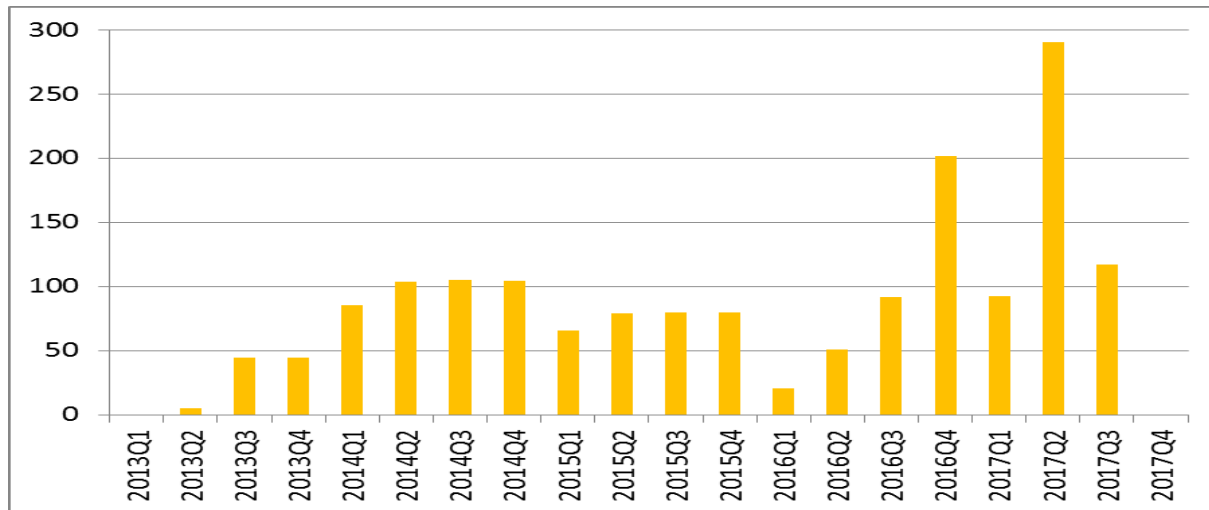


Source: FRIB estimate based on data disclosed by the HSDMC

The stock in circulation at the end of 2017 was EUR 1,844 bn. As residency bonds are so-called zero coupon bonds, i.e. they do not pay any interest during the time to maturity and on the expiry

date they only pay the face value, the price at issuance has to be lower than the face value by an amount that corresponds to the advertised yield. 5-year maturity and 2 percent yield imply an approximately 90% net issuance price. Assuming uniform distribution of issuances, the following chart shows the revenues stemming from residency bonds.

Chart 3: Revenue raised from the issuance of residency bonds (mEUR)



Source: FRIB estimate based on data disclosed by the HSDMC

The cumulated revenue over 4 years was 1,666 billion euros or 514 billion Hungarian forints, half of which was received in the period between Q2 2016 and Q3 2017, i.e. in the closing year and a half.

Table 3: relative loss due to issuance of residency bonds compared to “standard” foreign exchange denominated bonds (mEUR)

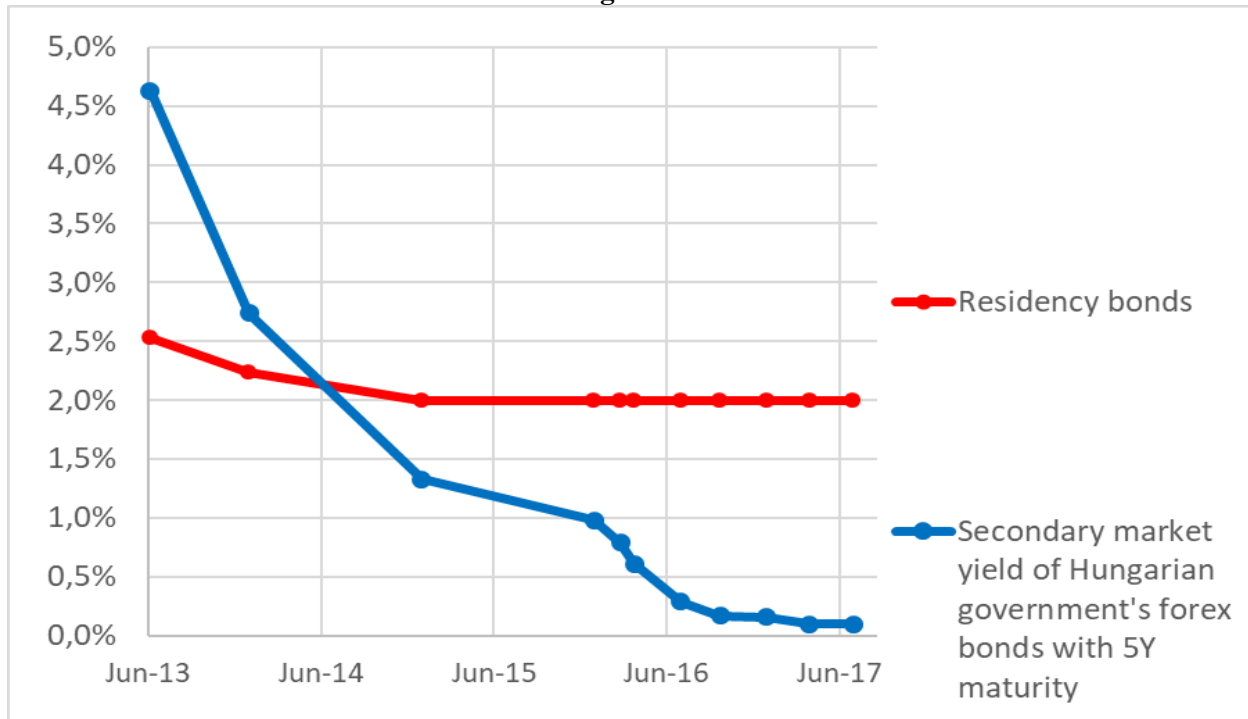
First day of issuance	Residency bond		5Y secondary market bond yield	Estimated loss
	Face value	Yield		
2013-06-19	107,5	2,53%	4,63%	-11,7
2014-01-15	445,5	2,24%	2,74%	-11,9
2015-01-14	336,1	2,00%	1,33%	10,3
2016-01-13	9,0	2,00%	0,98%	0,4
2016-03-09	17,4	2,00%	0,79%	1,0
2016-04-06	60,3	2,00%	0,61%	3,9
2016-07-13	98,4	2,00%	0,29%	7,8
2016-10-05	218,1	2,00%	0,17%	18,5
2017-01-11	116,7	2,00%	0,16%	9,9
2017-04-12	349,2	2,00%	0,10%	30,7
2017-07-12	85,8	2,00%	0,10%	7,5
Total	1 844			66,4

Source: HSDMC, Bloomberg Finance

Though in 2013-2014 residency bonds were cheaper as a financing source than “standard” foreign exchange denominated bonds, following 2014 this relation was reversed and as a result of the

issuance of residency bonds rather than standard foreign exchange bonds, taxpayers incurred a net relative loss of more than 66 million euros (approx. 21 billion forints) over the total program period.

Chart 4: Yield of residency bonds and secondary market yields of “standard” foreign exchange denominated government bonds



Source: HSDMC, Bloomberg Finance

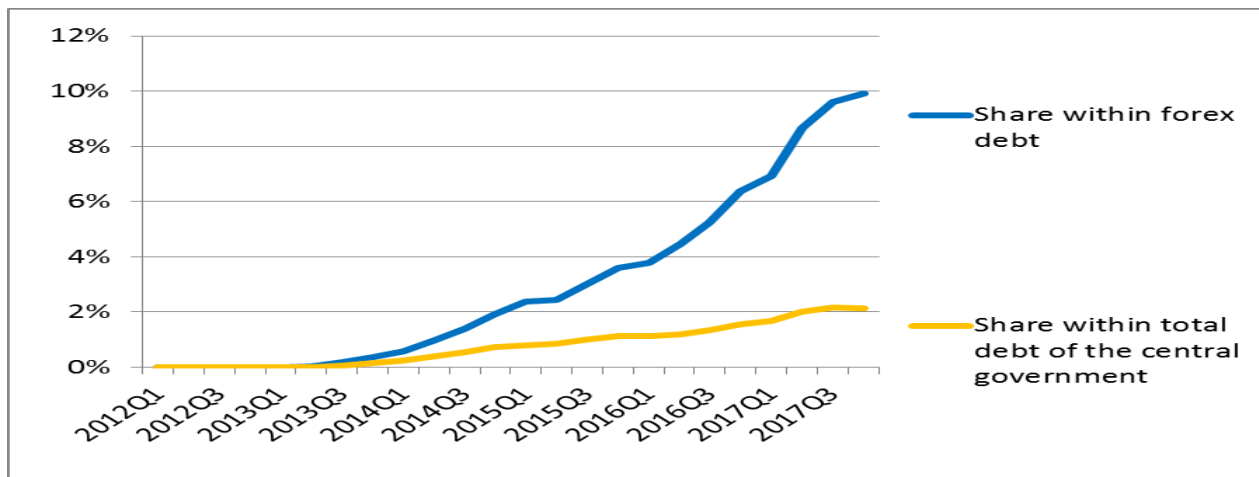
Chart 4 compares the yield of residency bonds with that of “standard” foreign exchange denominated government bonds. After 2014 the government clearly incurred a relative loss by opting for the residency bonds as an instrument to finance the government debt.

V. *The significance of residency bonds in financing the government*

IV.1. *Proportion of residency bonds to total foreign exchange denominated debt*

Even at face value the stock of residency bonds at the end of 2017 amounted only to 2 percent of the central government’s total debt.

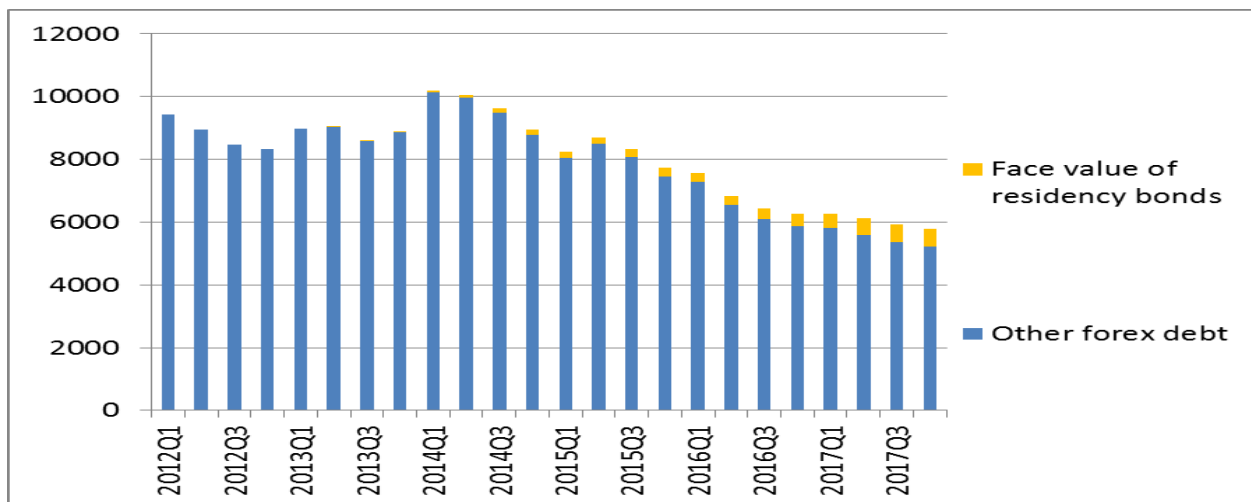
Chart 5: Share of residency bonds within the debt



Source: FRIB estimate based on data disclosed by the HSDMC

The weight of residency bonds in the foreign exchange denominated debt reached 10 percent, but this was mainly the consequence of the rapid and deliberate reduction of the latter (apart from the residency bonds themselves).

Chart 6: Share of residency bonds within the foreign exchange denominated debt



Source: FRIB estimate based on data disclosed by the HSDMC

Residency bonds would have had any significance only if they had helped to maintain the foreign exchange denominated part of the debt in a period when the government had difficulties in raising foreign exchange funds via other channels. As we will show below, initially the HSDMC deliberately aimed to reduce the foreign exchange denominated debt. If the HSDMC had intended to raise foreign exchange funds, it could have been able to achieve this via other channels at a lower price.

V.2. Proportion of residency bonds within annual issuance (total and in foreign exchange)

The annual gross financing need of the government was approximately 4 to 6 thousand billion Hungarian forints in the years investigated. There was no single year when revenues from residency bonds exceeded 150 billion Hungarian forints, covering approximately 2 percent of the government’s gross financing need.

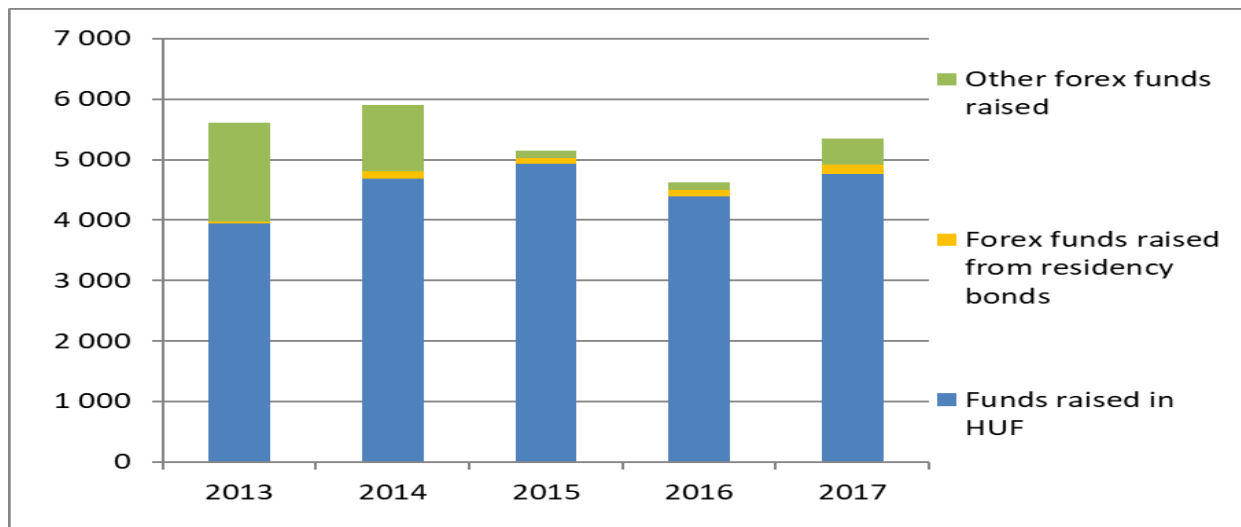
Table 4: Share of residency bonds in financing the deficit and refinancing maturing old debt

	2013	2014	2015	2016	2017	2013-2017
Budget deficit	937,3	825,7	1218,6	848,3	1973,5	5803,4
Prefinancing EU-funds	296,6	40,7	-185,3	272,1	66,8	490,9
Prepayment of debt instruments maturing	4096,6	4711,3	3800,2	3817,8	3563,8	19989,7
Total	5330,5	5577,7	4833,5	4938,2	5604,1	26284,0
Revenue from residency bonds	28,2	122,5	94,7	114,0	154,9	514,3
Share of residency bonds	0,5%	2,2%	2,0%	2,3%	2,8%	2,0%

Source: HSDMC

Their weight in foreign exchange funds reached 50 percent, but only due to the fall of other foreign exchange funds from 1,600 billion Hungarian forints in 2012 to 200 billion Hungarian forints in 2015.

Chart 7: Annual fund raising (bn HUF)



Source: Ministry of Finance (annual final accounts)

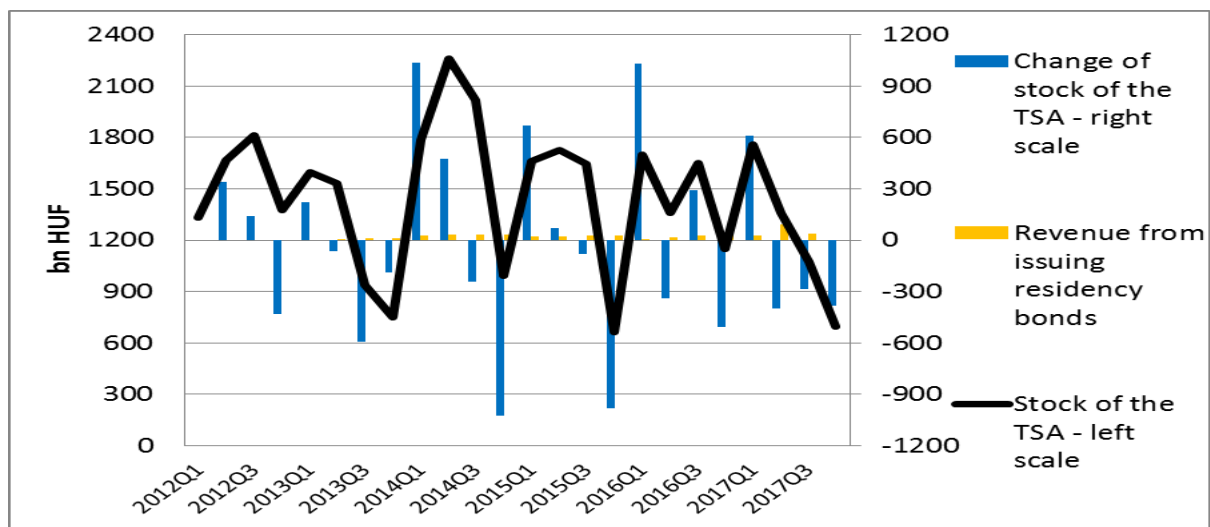
VI. Was the Hungarian government in need of the extra funds collected from residency bonds?

VI.1. Funds in Hungarian forints

VI.1.1. The level of the Treasury Single Account

In the years 2012-2017 the average quarterly closing stock of the Treasury Single Account held at the Central Bank of Hungary was 1,438 billion Hungarian forints, but the fluctuation of this stock from quarter to quarter exceeded 400 billion Hungarian forints. The 30 bn HUF quarterly revenue from residency bonds was practically negligible compared to this fluctuation.

Chart 8: Revenue from the issuance of residency bonds compared to the volatility of the TSA

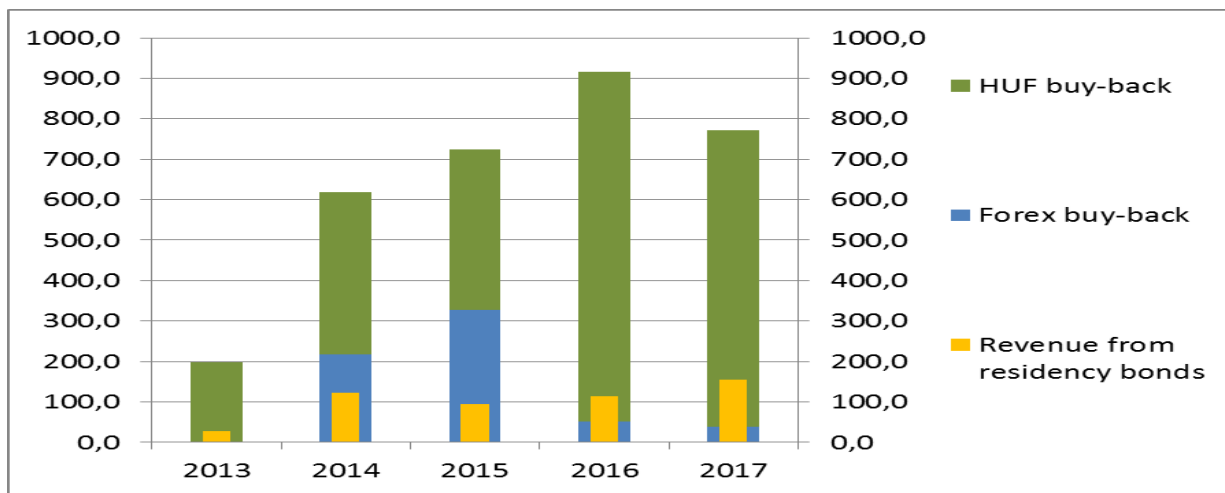


Source: Hungarian Central Bank, HSDMC and FRIB estimate

VI.1.2. Buyback of bonds expiring in later years

Had the funds from residency bonds been really necessary for financing the government, the HSDMC would certainly have used all other, simpler and cheaper sources before resorting to such bonds. In contrast, all of the annual reports published by the HSDMC between 2013 and 2017, show a positive liquidity situation and bond buybacks well above planned amounts. Bonds expiring after the year of the buy-back program were also bought back.

Chart 9: Revenue from residency bonds and the amount used to buy back bonds expiring in later years (bn HUF)



Source: data disclosed by the HSDMC

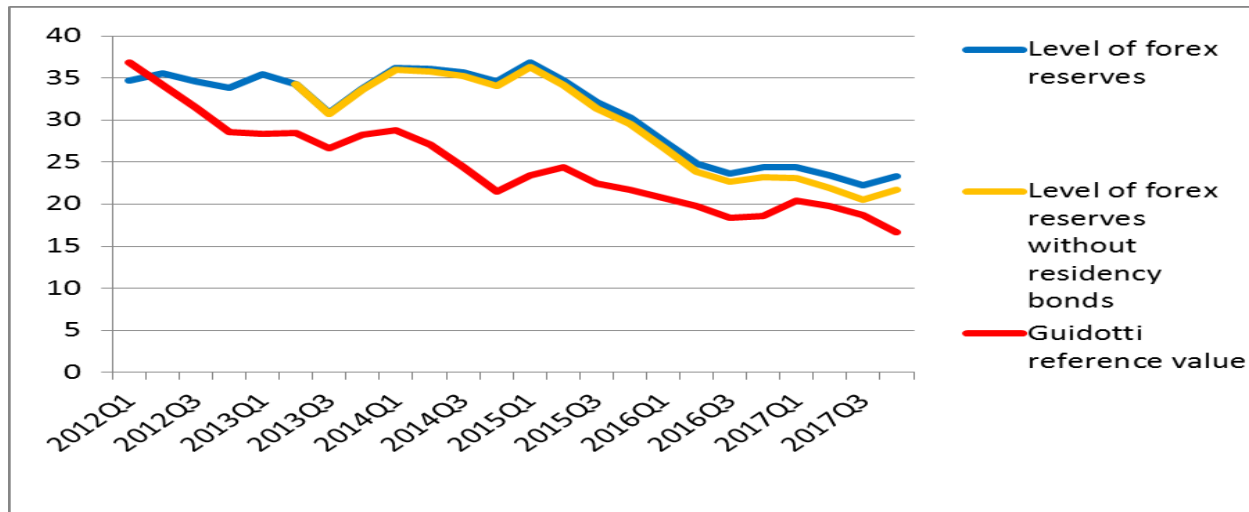
Even in the more critical period between 2013 and 2015 the HSDMC spent several times the amount of residency bond revenues on the buyback of bonds expiring in later years; consequently, their prepayment clearly increased the financing need in the respective years. If the HSDMC had been concerned about liquidity problems, it certainly would not have started such large buyback programs.

VI.2. Funds in foreign currency

VI.2.1. The Guidotti rule to determine the minimum required level of foreign exchange reserves

Investors, in line with international standards, treat a country as high risk if the foreign exchange reserves of the central bank do not cover the short-term liabilities of the country (not just those of the government). Hungary's central bank monitors the so called Guidotti rule and publishes the related data in its reports on the balance of payment.

Chart 10: Foreign exchange reserves measured against the Guidotti rule (bn EUR)



Source: Hungarian Central Bank, HSDMC and FRIB estimate

As the chart shows, in the period 2012-2017 foreign exchange reserves would have covered the short-term liabilities of the country even if no revenue had been collected from residency bonds.

VI.2.2. The currency composition of the total government debt

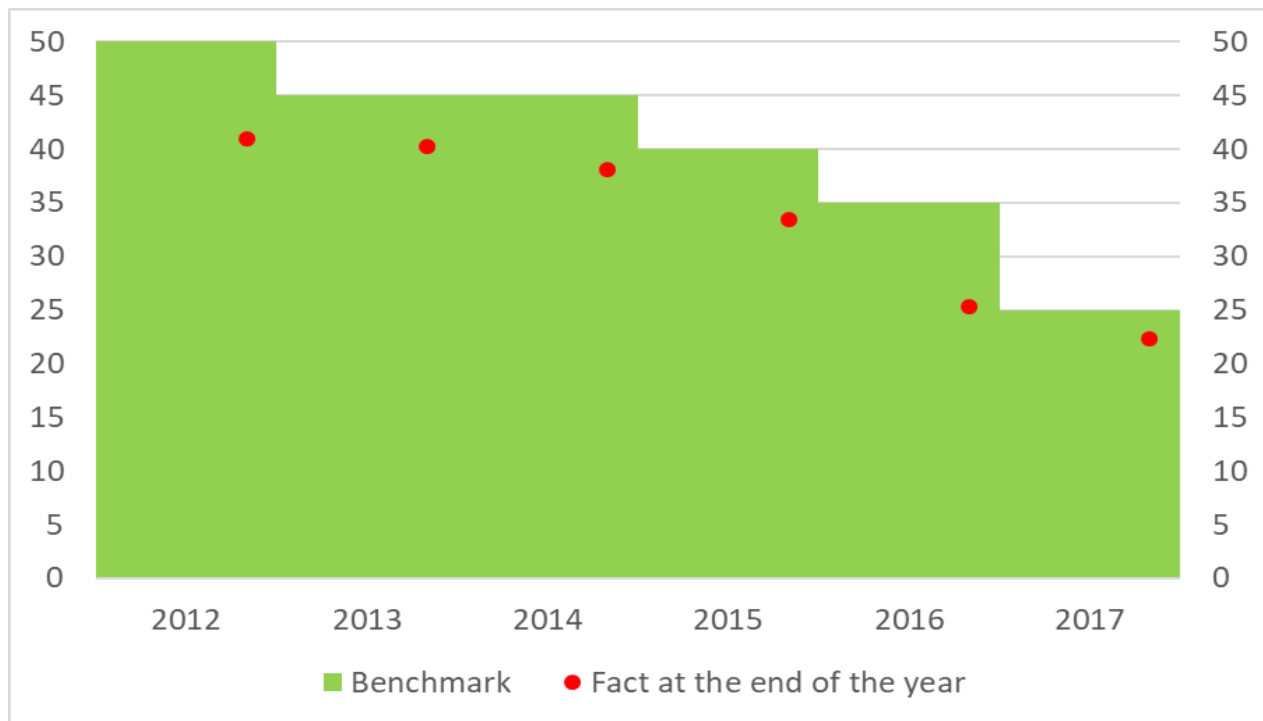
The Hungarian language edition of the HSDMC's annual reports of 2013-2017⁷ state: „According to the benchmark set for 2013, the foreign exchange denominated part of the debt had to be below 45%, that is, lower than the 50% set for 2012. Furthermore, it is an important goal for debt management to reduce the share of foreign exchange denominated debt to approach the value prevailing before 2008. To this end, the HSDMC decided to refinance expiring foreign exchange denominated debt in foreign currency, and both maturing HUF debt and the budget deficit (net financing need) by HUF issuance. If demand in the domestic market allows more issuance in HUF, then a part of the expiring foreign exchange denominated debt can also be financed from the domestic market in order to accelerate the reduction of the proportion of foreign exchange debt. In 2013 the share of foreign exchange denominated debt diminished from 41 % to 40,3 %, in line with the benchmark.”

Subsequently, in the HSDMC's 2014 report the text of the 2013 report highlighted above is repeated with the difference that while the benchmark remained 45 %, the actual value of foreign exchange denominated debt decreased to 38,1 % from the 40,3 % value at the end of the previous year.

In 2015, the benchmark was cut from 45 % to 40 %, but the actual value decreased to 33,5 % from previous year's 38,1 %. The benchmark for 2016 was reduced from 40 % to 35 %, but the actual value decreased to 25,3 % from the 33,5 % of the previous year. In 2017 the benchmark was cut from 35 % to 25 %, while the actual value decreased to 22,3 %.

⁷ The HSDMC's annual reports are available here: <http://akk.hu/hu/oldal/kiadvanyok#eves-jelentesek>. Relevant page numbers: page 9 of the 2013 report, and page 13 of reports published in the years 2014-2017. Translation courtesy of the author.

Chart 11: Share of forex denominated debt within the total government debt (%)



Source: HSDMC

Chart 11 and the text of the annual reports cited above both show that the HSDMC intended to reduce the foreign exchange ratio with maximum urgency, without any sign of the need to raise foreign currency funds via the residency bonds. From this aspect there was no need for the foreign exchange funds raised through the residency bonds. In addition, residency bonds worked against the goals of the HSDMC’s debt management objectives.

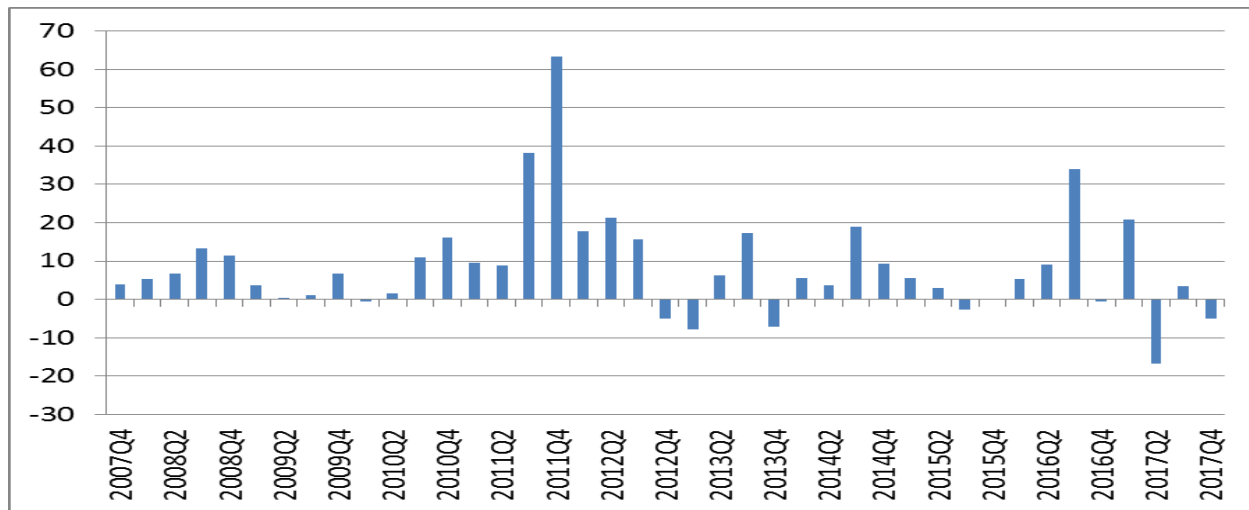
VI.2.3. The seasonal fluctuation of the Treasury Single Account

Finally, the HSDMC could have made use of the residency bonds to smooth out fluctuations in the Treasury Single Account. In March there are generally plenty of funds on the TSA, while in October the balance tends to be significantly lower. In recent years, the balance was lowest in December by far, but this was an artificial reduction due to the HSDMC’s intention to present the lowest possible gross debt to GDP ratio at the end of the year. The HSDMC could have timed the maturity of residency bonds to March, for instance, to smooth out the fluctuations of the TSA; however, in 2018, 2019 and 2020 the expiry date is 20 December, which proves that the HSDMC’s main concern was the artificial reduction of the presented debt-to-GDP ratio rather than the sufficient level of liquidity of the TSA.

VI.3. The government’s suspected determination to find a special group of investors

One of the lessons learnt in the period of 2011-2012 was that in times when market trust diminishes, even Hungarian investors might seek refuge for their money abroad.

Chart 12: Change of the stock of foreign currency denominated household deposits abroad due to transactions (bn HUF)



Source: Hungarian Central Bank

One of the potential advantages of the residency bonds from the HSDMC’s perspective could be that these securities do not have a secondary market, hence investors can neither get them redeemed by the government (this could only happen if the HSDMC organised reverse auctions), nor can they put the success of another primary auction to risk by dumping their securities on the secondary market at a low price.

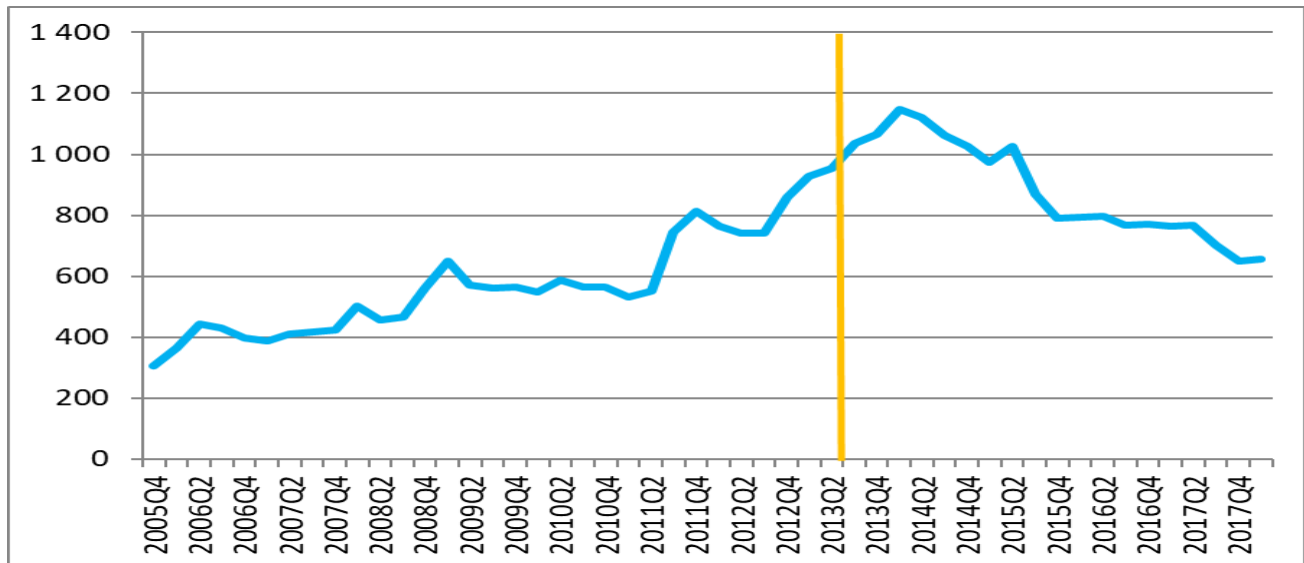
However, it would be more sensible for the government to protect itself from capital flight by getting indebted in long term credits instead of securities.

VII. Conclusion

None of the factors enumerated and analysed above, either on their own or in combination, can reasonably explain the introduction of residency bonds and especially the fast growth in their stock following 2015. There is, however, another potential explanation that may make the decision look reasonable, even if only from the perspective of the government and not from that of the nation as a whole. We presume that the Hungarian government was looking for creditors willing and ready to provide funding without any precondition whatsoever. International and European organizations, such as the International Monetary Fund, the European Union or the European Investment Bank usually attach some strings to the loans and credits allocated to Hungary. Some of the preconditions set by the aforementioned institutions are of an economic policy nature, while on other occasions the only requirement is related to the allocation procedure of the sum concerned. Such requirements regularly entail public procurement or the conduct of a cost-benefit analysis. In the case of the residency bonds neither the individuals seeking a residency permit nor the intermediary agencies that traded the bonds could impose such demands.

It had a significant coverage in the media when the government repaid its debt first to the IMF, then to the EU. However there was no news about the fundamental changes occurring in the long-standing and well-functioning relationship with the European Investment Bank (EIB).

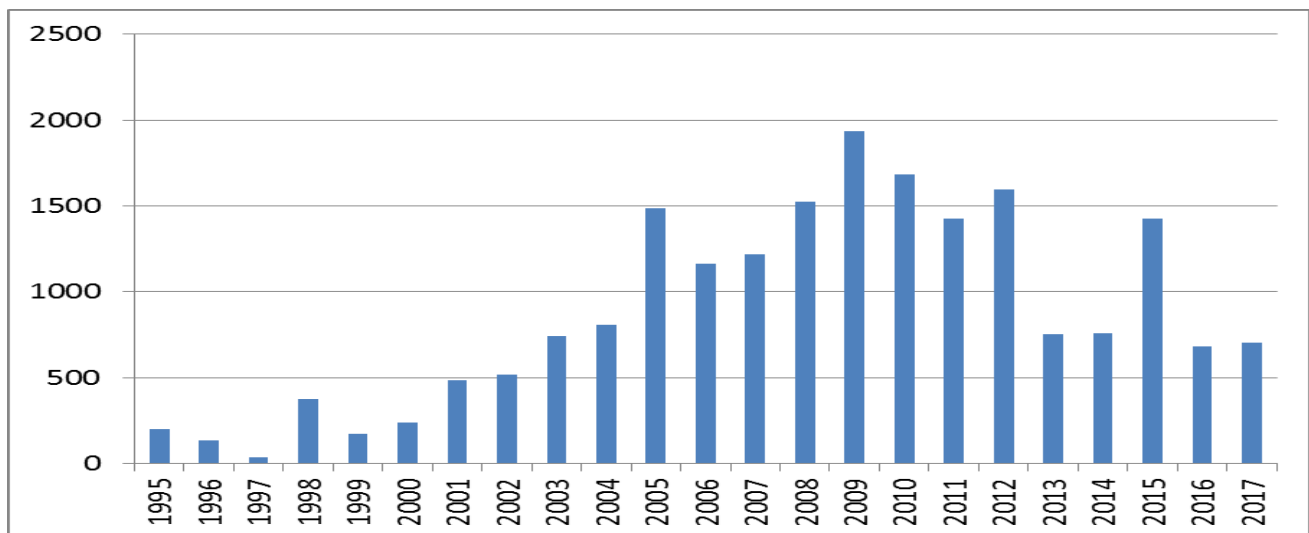
Chart 13: Stock of loans from the EIB (bn HUF)



Source: HSDMC

Shortly after the introduction of residency bonds to the market, a significant decrease started in the stock of loans from the EIB. While the average value of new, cheap project credit lines contracted between the Hungarian government and the EIB was 1,5 billion euros between 2008 and 2012, this amount was cut in half from mid-2013 onwards.

Chart 14: Credit line agreements signed with the EIB (mEUR)

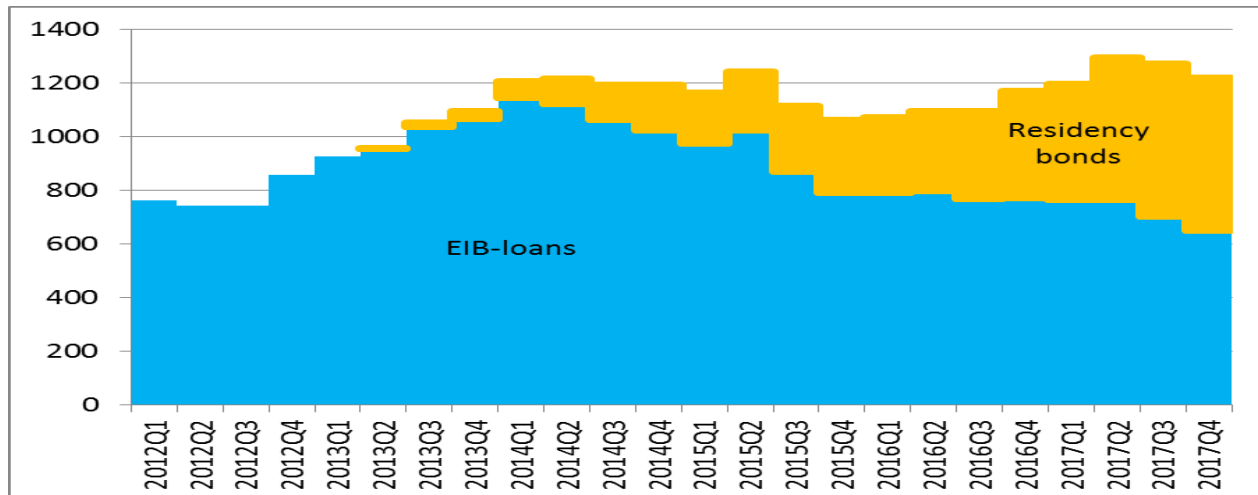


Source: EIB⁸

⁸ <http://www.eib.org/en/projects/loan/list/?region=1&country=HU>

This trend becomes even more obvious if we consider the combined value of these two financing sources.

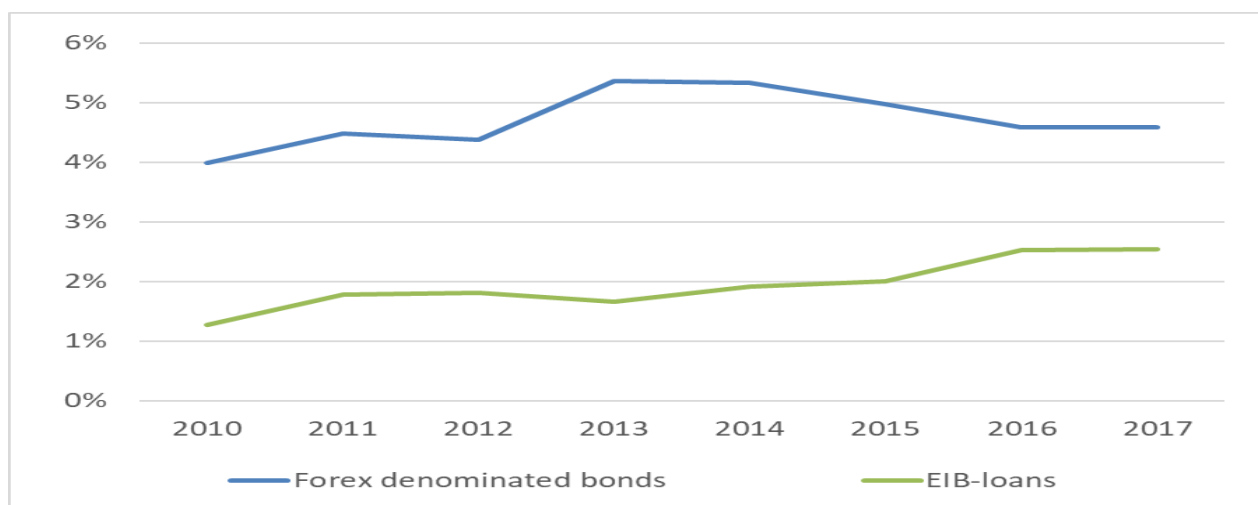
Chart 15: End-of-period combined stock of EIB loans and residency bonds (bn HUF)



Source: HSDMC & FRIB estimate

The HSDMC repeatedly announced its intent to refinance maturing foreign exchange funds in foreign currency, and HUF funds and the budget deficit in Hungarian forints. These announcements need to be reconsidered in light of the data shown in Chart 15 above. Foreign currency denominated EIB funds were refinanced by foreign exchange funds, but not from EIB loans; instead, revenues from residency bonds were used for this purpose. This also implies that the adequate comparator for the cost of residency bonds as financing instruments is not only the required yield of the 5-year Hungarian foreign exchange denominated government bonds but also the interest rate of EIB loans.

Chart 16: Average interest on the stock of foreign exchange bonds issued after 1999 and of EIB loans at the end of the previous year, on a cash basis



Source: HSDMC & final accounts of the budget



Though the interest rates of individual EIB loans are treated as business secrets, the annual average interest paid (not accrued) on the total stock of foreign exchange denominated EIB loans has always been lower than the interest paid on foreign exchange denominated government bonds by at least 2 percentage points.

Table 3 and Chart 4 above clearly show that in the period of 2013-2014 residency bonds were cheaper as a financing source than “standard” foreign exchange denominated bonds, but this relation was reversed from 2015 onwards. In the post-2015 period, by the issuance of residency bonds instead of standard foreign exchange bonds, taxpayers incurred a net relative loss of more than 66 million euros (approx. 21 billion forints). In addition, if we compare the residency bonds to EIB-loans instead of “standard” foreign exchange denominated bonds, the relative profit earned in the years 2013-2014 disappears entirely, and the relative loss incurred over the whole period of the residency bond program increases by 22.5 million euros, from 66.5 million euros to almost 90 million euros (approx. 30 billion forints).

The Hungarian government, in an endeavour to reach out to financiers, who, on one hand, do not raise concerns either about the way their funds are spent or about the goals on which money is spent, while, on the other hand, cannot flee their investment by selling their bonds in times of economic crises, introduced residency state bonds. Transparency International Hungary and Fiscal Responsibility Institute Budapest hold that the residency bond program is the product of Hungary’s unorthodox economic policy, and are of the opinion that these Golden Visa bonds obviously aimed at obtaining unrestricted funds that can be allocated without an open call for tenders. To go along this path, the Hungarian government was ready to pay a higher price, as the revenues collected from residency bonds were 90 million euros (approx. 30 billion forints) more expensive than EIB loans.

VIII. Key findings

At the time of issuing the residency bonds, the government had no need for financing the deficit, for the roll-over of expiring debt, whether denominated in foreign currency or in forint, for raising the level of foreign exchange reserves, for maintaining or smoothing the liquidity of the Treasury Single Account, or for the recruitment of investors who have difficulty in taking flight even at the times of crisis. The residency bond program played no substantive part in the financing of the public debt or the stabilisation of the budget; indeed, it had the contrary effect.

- i.** The stock of residency bonds in circulation at the end of 2017 amounted to 1,844 billion euros at par value, while the government obtained revenues of only 1,666 billion euros. This is because residency bonds are so-called zero coupon bonds, which do not pay any interest during the time to maturity and even on the expiry date they only pay the face value; consequently, the price at issuance has to be lower than the face value by an amount that corresponds to the advertised yield.
- ii.** Residency bonds had no significant role in the stock of government debt, in the annual fundraising or in stabilizing the Treasury Single Account.
- iii.** Compared to the required yield of Hungarian foreign exchange bonds in circulation on the secondary market during the period concerned, the relative loss is more than 21 billion forints, suffered by taxpayers because the government issued residency bonds rather than the “standard” foreign exchange bonds.



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- iv.** Even at face value the stock of residency bonds issued in four years barely came to 2 percent of the central government's total debt. Even though the weight of residency bonds in the foreign exchange denominated debt reached 10 percent by the end of 2017, this was mainly the consequence of the rapid and deliberate reduction of the forex debt (without residency bonds).
- v.** The annual gross financing need of the government was approximately 4-6 thousand billion forints in the years investigated. Residency bonds, which generated revenues of 100-150 billion forints a year, covered barely 2 percent of this amount. The weight of residency bonds in raising foreign exchange funds was 50 percent, but only due to the 85 percent reduction in the amount of other foreign exchange funds raised.
- vi.** In the years 2012-2017 the average quarterly closing stock of the TSA was 1,438 billion forints, but this stock fluctuated from quarter to quarter by more than 400 billion forints; relative to this, the quarterly 30 billion forints of the residency bonds was practically negligible.
- vii.** Not only did residency bonds play no significant role in the total debt, but they were not necessary to maintain either liquidity or the stock of foreign exchange reserves, or the share of foreign exchange denominated debt in the stock of total debt.
- viii.** Annual reports of the HSDMC in the years 2013-2016 show an extremely favourable liquidity position. Even in the somewhat more critical period between 2013 and 2015 the HSDMC spent several times the amount of residency bond revenues on the buy-back of bonds expiring in later years. If the HSDMC had been concerned about liquidity problems, it would not have started such large buyback programs.
- ix.** Investors, in line with international standards, treat a country as high-risk if the foreign exchange reserves of the central bank do not cover the short-term liabilities of the country (not just those of the government). In the period 2012-2017 foreign exchange reserves would have covered the short-term liabilities of the country even if no revenue had been collected from residency bonds.
- x.** According to the annual reports of the HSDMC, it was an explicit goal of debt management to reduce the foreign exchange ratio with maximum urgency, while the sale of residency bonds had an effect that went against this declared objective pursued by the HSDMC because it resulted in raising foreign exchange funds.
- xi.** Increasing the weight of instruments that investors cannot get rid of even in times of crisis could have been an argument in favour of residency bonds; however, there are more rational ways of protection against capital flight: for instance, if the government is indebted in long-term credits rather than securities.
- xii.** In contrast, not only did the Hungarian government prepay before expiry, at the end of 2008, the credits taken from the International Monetary Fund and the European Union but the stock of expressly cheap credits taken from the European Investment Bank (EIB) also diminished significantly; the amount of credit lines contracted per year was practically cut in half.



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- xiii.** After 2014 the interest rate of residency bonds was higher than those of foreign exchange bonds; consequently, the government and taxpayers suffered a relative loss of at least 21 billion forints on the residency bond program as a whole. As an average for the stocks rather than on the individual transaction level, the interest rate of foreign exchange bonds was at least 2 percentage points above those of EIB loans. Consequently, residency bonds resulted in an even greater relative loss, at close to 30 billion forints, for Hungary when compared to EIB loans.⁹
- xiv.** This replacement of EIB loans with residency bonds can be considered a rational step from the side of the government if the goal was to find creditors willing to finance the government without any (economic policy, public procurement, cost-benefit analysis, etc.) preconditions. However, the country as a whole is left out of pocket by the credit freedom fight of the government because the relative loss resulting from the residency bonds, taking into consideration the interest rate of EIB loans, came close to 30 billion forints.

⁹The detailed calculations regarding the comparison of EIB loans and residency bonds can be found in the Appendix to the paper.