DOI: 10.1007/s10272-008-0249-8

The Hungarian Puzzle

One of the poorest performers in the current European economic scene seems to have suffered the least from the international financial turbulence of 2007/2008. While the subprime crisis has uncovered the regulatory weaknesses as well as the inadequacy of the sophisticated econometric models to forecast difficulties and to manage risk, especially in a pre-emptive manner, Hungarian banks have performed well in 2007 and also in 2008. This is all the more surprising since studies from the early 2000s have shown high operating costs, low servicing levels and some skeletons in the cupboard. Since then the transnationalisation of the Hungarian financial system has by and large been completed, with over 80% of assets being in foreign hands.

This exposure to global markets could have triggered a major crisis, given the usual overreaction of peripheral markets to the tremors in financial centres. Surprisingly enough this has not been the case. First, banks have adopted a rather cautious approach, which has often triggered public criticism. The collateral requirement in most cases is about 100%, and even in the case of mortgage loans the value of the object is taken only at 50 to 60% of market value. High real rates of interest could also have deterred home-building. Still, the construction of new homes boomed until the summer of 2007. The explanation for this somewhat paradoxical situation is rather straightforward: an ever-growing part of financing is transacted in foreign currency – Swiss francs, euro and yen – thus avoiding skyrocketing domestic costs.

One of the major differences to a number of other countries, notably the Baltics, Romania and Bulgaria, has been the fact that income policy and monetary policy have remained rather strict, not allowing the consumption spree which has driven the overheating of those economies. Furthermore, the exchange-rate instrument has never been fully abandoned. On the contrary, with the decision of 14 March 2008 even the broad ERM-2 band was abolished, allowing for much more volatility in exchange-rate developments. This choice has created a new situation by putting the risk on the shoulders of those taking out loans in foreign currency.

What should we think about these developments? On the one hand, as reflected in several warnings issued by the State Supervisory Agency for Financial Institutions, running a debt in forex while exchange-rate volatility is on the increase is risky. This applies a fortiori to exotic currencies, the value of which might, and indeed does, fluctuate substantially against the euro and the forint. Second, there is a fundamental difference between short-term and long-term perspectives. In the short run, of course, anything goes, especially with capital account convertibility. On the other hand, since the Hungarian money market is dominated by large foreign players, bets and counter-bets tend to hedge. This may explain why the exchange rate of the Hungarian currency has remained surprisingly stable despite the continuous political turmoil since early 2006, which might be termed an uninterrupted election campaign.

In the longer run the approximation of productivity levels, the ongoing catching up process and the ensuing appreciation of the local currency – which is at the time of writing at the levels of summer 2005 despite recurring fiscal derailments – together make it unlikely that, say, a mortgage-type long-run loan could become nonperforming. Meanwhile it is also true that many households act under limited information and limited financial culture. For this reason the major – often the only – criterion for taking out loans is consumption-smoothing and the size of monthly repayment relative to current income. In the latter case many debtors – in some estimates hundreds of thousands – have taken out loans with conditions that may turn extremely strained, should the recovery, already expected for mid-2007, not be forthcoming. However, even in the latter case systemic risk along the lines of the subprime crisis – or the 1992 savings and loans cooperatives crisis in the

USA – is unlikely to evolve. *Inter alia* this is due to the predominant foreign ownership of Hungarian banking. The latter implies that – measured against the capital strength of such owners as Kredietbank of Belgium or Bayerische Landesbank – the total value of the entire Hungarian portfolio is a fraction, of which the housing loan section is also just a limited share.

However, underscoring the lack of systemic risk should by no means lead to complacency. Many households were taking out loans for consumption-smoothing, putting their faith in the governmental adjustment package and the convergence programme of August 2006. This policy document has adopted a rather conventional adjustment trajectory, first applying the brake, then relying on market adjustment, allowing for a gradual but sizable recovery. If the actual processes had followed this scenario, accumulating short and medium debt would have followed the Fridmanian maxims. However, reality has been different.

Owing to the structural nature of the slowdown of the Hungarian economy, coupled with the poorly conceived fiscal adjustment measures, recovery is still to come and is going to be slower than originally forecast. In short, the fiscal adjustment measures that were needed to remedy a general government deficit of 9.2% by the end of 2006 were predominant, and supply-side measures were generally neglected. Despite a hot reform rhetoric Hungary is one of the few postsocialist countries which has not experimented with the flat rate tax, nor even with major tax and expenditure cuts since 2002. Also unique among the new EU members is the Hungarian governments' lasting inability to remedy chronic fiscal overspending in the good years. While in the 2001-2006 period growth was on average 4%, fiscal deficits ballooned. Not only did growth rates reach 8.9% in the election year of 2002, but 7.2% in 2003, 6.5% in 2004, 7.8% in 2005 and 9.2% in 2006. It should be remembered that the respective eurozone figures declined from 3.1 to 1.6%.

In 2007 and 2008 an improvement in the deficit situation can be observed. For 2007 preliminary figures indicate a deficit of 5.5% and for 2008 most analysts see the governmental forecast of 4% to be on target. However, hardly anybody takes for granted the planned improvement to 3.4% by 2009. Meanwhile, economic growth has turned into a near-stagnation, with a mere 1.3% in 2007 and a growth of around or below 2% in 2008. For 2009 even official numbers hardly go beyond 3%, which is not really a fast catch-up scenario. Meanwhile inflation remained at 5.8% in 2001-2005, 4% in 2006, 8% in 2007 and 6.3-6.5% in 2008. The recent inflation forecast of the central bank states that the mid-term inflation target of 3% will not be attained before 2010.

This short overview may have indicated that the macro situation is evolving on a rather different trajectory than forecast by the convergence programme of 2006-2009. This has little to do with the inability to institute relevant structural reforms, which results in a sustaining and recurring fiscal deficit with its obvious crowding out effects. In turn, there is no reason to expect the return of the 4-5% growth scenario in a quasi-automatic fashion. Higher inflation and low activity levels may be stuck, and the ensuing eroding real wages may make the life of households even tougher. Fighting the irregular economy and expanding the tax base might be a virtue from the fiscal perspective, but might also contribute to substantially less disposable income, especially for higher and middle income families. Regulation by the state, as well as by the banking community itself, is well advised for reasons of circumspection, as competition has already triggered a series of irresponsible steps and the sale of junk financial instruments to a notoriously underinformed clientele. This might backfire and the ensuing difficulties cannot be blamed on global markets, since they are home-made.

László Csaba

Professor of economics, Central European University, University of Debrecen and Budapest Corvinus University