CASE Network E-briefs

1/2009 January 2009

2008 Hungarian Financial Crisis

By Julius Horvath

By 2004 Hungary had become a member of the European Union (EU), successfully transformed itself from a centrally planned to a market economy, and similarly to other new EU member states embarked on a path towards convergence with the old EU member states. Despite its encouraging growth performance, irresponsible domestic economic policy together with global financial turmoil brought Hungary to financial crisis in the fall of 2008. A rescue package from the International Monetary Fund (IMF) and the European Union eased the situation, but the perspectives on future Hungarian stability and growth are still quite bleak in view of deferred reforms and political instability.

Hungarian Vulnerabilities

The Hungarian financial crisis of 2008 is not the result of irrational panics. The unfolding of the global financial crisis brought financial markets to re-evaluate their risk tolerance. As mounting financial difficulties led to a decline in global liquidity and to an increase in risk aversion, investors started to differentiate between emerging markets and began to appraise Hungarian assets as more risky. This higher perceived risk reflected some vulnerabilities specific to the Hungarian economy:

-1-

A likelihood of recession in the euro-zone had amplified the risk given to Hungary's high external debt, wide current account deficit, large external financing requirement, still-excessive fiscal deficit, and maturity and currency mismatches in the financial system, both within the individual household as well as corporate sector.

-2-

Even if Hungarian banks were not exposed directly to the sub-prime crisis, Hungary was too sensitive to movements in international capital markets since a considerable proportion of financing depends on flows to Hungarian daughter-banks from their western European parents.

-3-

In addition, foreign currency denominated loans account for a large portion of household and private sector credit as high domestic interest rates led them to take up credits in low interest currencies. As a result, both the household and the corporate sectors' net foreign currency liabilities increased, raising indirect risk to the banking system. However, there was no sign of an asset bubble within the Hungarian real estate market.

-4-

Hungarian policy makers struggle with huge credibility problems. The Hungarian government consolidated its fiscal position somewhat from 2006, as taxes increased and some tax widening happened. Nevertheless, government debt and net external liability positions in Hungary are still the largest among the new EU member states. Gross external financing needs for this and the next year are high, however short-term debt is roughly covered by net international reserves.

-5-

Hungary already had a large government debt under the communist regime. The ratio of debt to GDP was reduced from its peak of around 90% to around 50% in 2001. Irresponsible policies from 2002 onwards led to a 15% increase from 2001 levels which rose to around 65% of GDP, while the debts of the Czech Republic and Slovakia were under 30% and 50% for Poland.

-6-

In 2007 Hungarian performance in all basic macroeconomic statistics was worse than the typical point of reference, the V-3 (Poland, the Czech Republic, and Slovakia) countries. GDP growth in Hungary was significantly below un-weighted V-3 average (below 2% compared to 7%); inflation above 7% in Hungary, under 3% in V-3; current account deficit was under 7% in Hungary while in the V-3 countries it was under 4%.

Financial Crisis in October-November 2008

As markets began to re-assess perceived risk, the forint started to weaken, the stock market had fallen to a two-year low, interest rates had increased, the inter-bank market as well as the Hungarian government securities market experienced serious stress, and financial institutions suffered shortages of liquidity.

One of the economy's vulnerabilities was that Hungary's government debt was to a large extent foreign-owned. As the crisis evolved, foreigners wanted to sell Hungarian bonds, and with buyers very slow to buy, the government bond market began to dry up. Auctions to issue new government bonds were also not successful. Hungary's central bank used a quasi interest rate defense of the forint as it raised its benchmark interest rate by 300 basis points to 11.5 percent. This step was aimed at supporting the forint, which had then been losing its value, dropping 14 percent against the euro over the previous three weeks. In addition, the shares of OTP, the leading Hungarian bank, fell drastically. Rating agencies exacerbated an already bad situation, particularly when Fitch Ratings and others instigated to downgrade Hungary.

Hungarian authorities were not really clear in what way to respond. They monitored more closely the market and increased deposit guarantees in line with the EU-wide policy. Because the Hungarian government was not able to rescue the financial system and provide stability to the public, it turned to the IMF and the EU as a last resort.

IMF and EU Rescue Package

A full-fledged currency and financial crisis was avoided with policy action from the IMF and the EU. The IMF support arrived just at the right time, *i.e.*, when the first signs of a full-blown crisis had started to emerge, and by tyring to restore confidence, it probably help prevent contagion from spreading to other new EU member states as had been the case in the 1997 Asian crisis.

The IMF has approved a $15.7 billion loan for Hungary as part of a program designed to ease financial market stress. The 17-month Stand-By Agreement is a component of a larger financing package to which the European Union has committed $8.4 billion and the World Bank $1.3 billion respectively. The IMF immediately made available more than $6 billion, with the remainder to be released in five installments subject to quarterly reviews. The Stand-By Arrangement was approved under the fast-track Emergency Financing Mechanism of the IMF. The rescue package primarily concentrates on securing government finances and stabilizing the banking sector.

The IMF-supported economic program aims to implement a fiscal adjustment package to ensure that the government's debt-financing needs decline. Fiscal adjustment will be achieved in part through reductions in the overall government wage and pension bill. In addition, nominal wage adjustments and pension bonuses are to be postponed. This program is positioned to help maintain adequate liquidity and capital in the banking system. Measures include a preemptive recapitalization of eligible banks and a strengthening of the supervisory and crisis management abilities of the Hungarian Supervisory Agency. Prior to this rescue package's approval, the European Central Bank had given out €5 billion to help support liquidity in the local interbank market.

Need for IMF Help and Some Early Consequences

Given Hungary's large public debt, substantial fiscal adjustment is required to provide confidence that the government's financing needs can be met in the short and possibly medium term. This large external financing assistance was needed to minimize the risk of a run on Hungary's debt and currency.

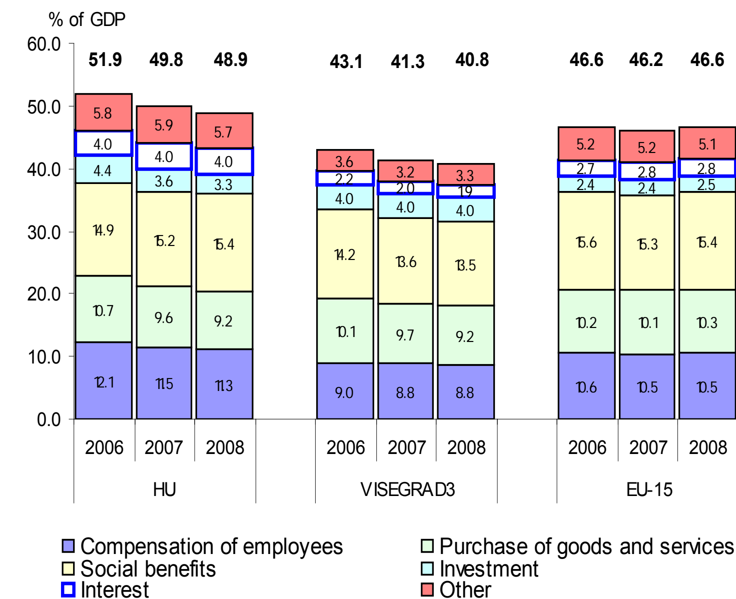
It is difficult to foresee whether the rescue package will facilitate the introduction of changes in Hungarian economic policy, however, it is clear that external pressures triggered the need for adjustment. During the first initial steps of implementation, one could see efforts to buy political support through short-term promises which ultimately might erode the commitment to fix old imbalances. Evidently, moral hazard prevails in the current environment. Specifically, policy makers might feel they can afford any policy since the international community is here to save them. The stigma of IMF assistance may in fact evaporate in a relatively short time especially since the conditionality requirements surrounding the bail-out do not seem to be too excessive.

It is also hard to estimate the extent to which Hungary gained credibility through the IMF agreement. After the rescue package was introduced the forint had gained strength compared with its weakest level. Without the agreement the forint would likely have fallen further, consumers with foreign currency debts would have suffered, and the government would not have been able to issue new debt securities. A failure to achieve credible budget goals could also have led to a government financing crisis resulting in severe consequences. One point in particular would be the impact of the government's inability to offer Hungary's rather generous social benefits and how that would have affected citizens' ability to weather the social effects of the crisis. Initial strikes by government employees have already been witnessed and more are expected in the near future.

On Sources of Hungarian Fiscal Deficit

Hungary's 2002 election campaign heightened competition among its political parties and propelled populism to such an extent that the subject of political litigation resulted in large monetary contributions from the state budget to various citizen groups. Examples include arranging for pensioners to receive a 13th monthly payment or increasing the salary of public employees by 50% all in the hopes of securing votes. Simultaneously, strong lobbying groups and political clients pushed for state subsidies and favors. Checks and balances in budget negotiation were rather weak while statesmanship looked inexistent. Inefficient state monopolies and fragmented and costly municipal systems just raised the social costs of the crisis.

Total Government Expenditures



Source: Barbara Kauffman, "How to Ensure the Durability of Fiscal Adjustment" (European Commission, 2008).

Thus, Hungary's government debt expansion was not a result of mass demonstrations but rather of political inter-elite conflicts. Changing the situation seems very difficult as those who receive transfers feel that they are entitled to them. In addition, tax evasion in Hungary is widespread and morally acceptable. Relatively to the Czech Republic, Slovakia, the Baltic States and other new EU member states, Hungarian taxes are very high and were even raised two years ago under the populist slogan of 'taxing the rich'. The previous Figure illustrates total government expenditures between Hungary, V-3 and EU-15 countries.

This figure indicates that in Hungary compensation of government employees – even if relatively decreasing – is still quite considerable, as well as the provision of social benefits. Relative compensation of employees is higher not only as compared with V-3 countries but also within the EU-15. Similarly the interest payment on debt is also superior to that of the V-3 and EU-15. In the end, Hungarian policy makers opted for a welfare model which they cannot afford.

Hungarian Banking and Financial System

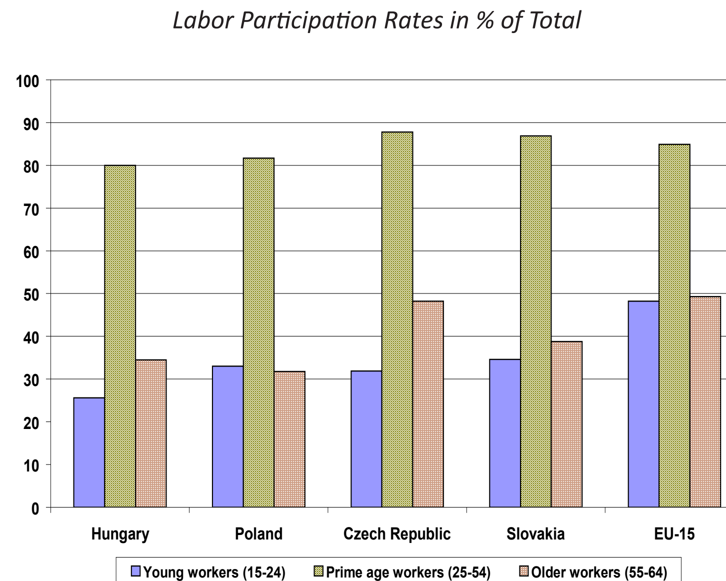
When it comes to its banking and financial system, Hungarian banks have no direct exposure to the U.S. sub-prime market. The banking system appears well-capitalized and profitable. Lower interest margins reflect buoyant competition and Hungary's nonperforming loan ratio has been stable in part because banks have sold overdue loans to workout companies, firms that buy debt at favorable prices and then help borrowers reduce or restructure either their debt or payment obligations. Rapid credit growth has been driven in part by the easing of lending standards for both individual consumers and households.

In Hungary, most of the banking system is foreign-owned. For a time there was a risk – it seems now unsubstantiated - that foreign banks would reduce their exposure to their Hungarian daughters if domestic pressures at mother banks were seen as more important. But so far, the Hungarian subsidiaries of such foreign banks have been profitable.

What Should Be Done to Prevent Future Crisis

There is a definite need to decrease labor costs and increase labor participation, which the government objects. The graph below shows that labor participation for most of the age groups is lower in Hungary in contrast with V-3 and EU-15 countries.

Labor Participation Rates in % of Total



Source: Elena Flores, "How to Raise Potential Growth in Hungary" (European Commission, 2008).

There also seems to be a need to shift the tax burden away from labor towards consumption and property taxes. These steps might improve work incentives and boost employment, and decrease the level of tax avoidance. This could be accompanied by a reduction of exemptions, which would broaden the tax base.

Hungary also needs a comprehensive structural reform in its public finances that includes far-reaching cuts in spending and tax rates. This is the way to move the potential rate of growth upward and to avoid the risks of a similar crisis in the immediate future as the government struggles with a constant credibility problem. In a tense political environment, changes that might weaken the government's popularity are however highly unlikely.

Short-Run Forecast

The IMF estimates that growth in Hungary will contract by one percent in 2009. Already weaker private consumption and investment will be negatively affected by a reduction in new bank lending and the depreciation of the exchange rate. Inflation is projected to continue a downward trend to 4 percent by the end of 2009. The economy is expected to recover, however, only gradually as the slowdown occurs not only in Hungary, but throughout the region and among its main trading partners.

Julius Horvath is Professor and Head of the Department of Economics at the Central European University in Budapest as well as a CASE associate. A Slovak national, he obtained his BA at The University of Economics in Bratislava, Slovak Republic, a Ph.D. at Southern Illinois University-Carbondale in Illinois, USA, and Dr. Habil. at The University of Debrecen, Hungary. He is the author of several academic and policy papers.

The opinions expressed in this publication are solely the author's; they do not necessarily reflect the views of CASE - Center for Social and Economic Research, nor any of its partner organizations in the CASE Network. CASE E-BRIEF EDITOR: EWA BŁASZCZYNSKA