DÉLKELET EURÓPA – SOUTH-EAST EUROPE
INTERNATIONAL RELATIONS QUARTERLY,
Vol. 2. No. 7. (Autumn 2011/3 Ősz)

THE HUNGARIAN INDEBTNESS AND SOME EFFECTS OF THE CRISIS

Working Paper[*]

MIKLÓS, GÁBOR

Summary

In Hungary the 2008/2009 financial and economic crisis exposed many problems of credits denominated in foreign currencies. Opposite the other countries in Central-European region Budapest must face that fact that the Hungary can't use favorable exchange rate policy because of these credits. How did Hungary come into this situation how much is the Hungarian public and private indebtness, why does it mean a very serious problem and what can be the solutions?

Keywords: credits denominated in foreign currency, general and external debt, Hungary, Forint, Swiss Franc, Euro

JEL: E44, E51, F34

A projekt az Európai Unió támogatásával, az Európai Szociális Alap társfinanszírozásával valósul meg.

[*] The study was supported by European Union and the Hungarian Government (project nr. TÁMOP 4.2.1B-09/1KMR-2010-2010-005. It is the result of the research activities in the subproject "Tudásgazdaság" (Knowledge Economy)

The Hungarian indebtness and some effects of the crisis

The 2008/2009 crisis exposed many hidden problems in the world economy and in Hungary which could present some mistakes of the economics which caused serious imbalances and will affect the economic opportunities of the next decade.

This report is engaging in Hungary and in his special situation in the Central-European region. Why is it so dissimilar and why will the Hungarian recovery be difficult?

In our analysis the 2008/2009 financial crisis and the new one, the 2011/2012 debt crisis is separated and the financial crisis is emphasized. The reason is that it could reveal the Hungarian problems and enforced some fast solutions and responses.

There are three statements which featured the crisis and they were true as regard the Hungarian concerns too. We think that they intensified the Hungarian debt crisis and egged the investors not to put money in the Hungarian economy. It was absolutely unnecessary and extremely dangerous.

1. First of all the root of the problem is that the equilibrium which is used by economics as general equilibrium (neoclassical economics and monetarism) or Keynesian equilibrium exists. But our opinion is that the economics is a social science not a natural science where the equilibrium exists indeed. The equilibrium in the economics tries only to approach the real trim but can't attain it. That's why the economic persons can overswing because they don't know it and they cause further damages.
2. The capital doesn't disappear considering the whole global economy but it is in sort of terms. It also means that the lost part of the invested capital is always wanted to regain during shocks. So the investors usually try to find relatively quickly some new goals for their money: for instance new countries, currencies or short term bonds. It can manage if they can find some weak economies because these states alone aren't able to protect the value of their own currencies. It woks absolutely if the given country has got huge state debt or little reserve or twin deficit additionally uses fixed currency mechanism (fortunately Budapest had it in 2008 no longer). That's why the credibility of our country and economy is very important and the political leaders must present and of course prove it with every means.
3. A herd effect can evolve due to an imperfect flowing and having of information. Because of fear and concern a dangerous process can start and strengthen itself with any rational reasons among the economic actors. We have to emphasis the importance of the credibility if we want to avoid a fatal capital escape.

1. That infected the world

Lehman Brothers asked protection according to the Chapter 11. Bankruptcy Code on 15th September 15. The announcement of the protections was the symbol starting point of the crisis despite it is true that the American mortgages crisis had begun a year ago at least.

Of course the Lehman Brothers was only one of many financial companies what participated in the mortgage lending. Lots of American and directly or indirectly European financial companies, banks, hedge funds have had interests so total uncertainty was in the market considered their exposures, assets, obligations. That's why only one month after the Lehman's bankruptcy the global lending was frozen on the interbank market. Forasmuch the most globalized production factor is the capital considering the global level the economic decline appeared suddenly in the whole economy of the USA's partners.

Some countries, such as Latvia, Hungary or Romania couldn't finance themselves longer, so they could have become an insolvent state within a short time without external help. Of course in this case they must have announced state-default and that's why they had to ask the EU-IMF-WB bailout package.

According to our second assumption, the capital is always present in the global economy but the assets which reify the money can change dependently on yields and risks. If we want to say how big loss the global economy suffered, we can assess that summed capital value in the stock exchanges of the world decreased by $ 2700 billion between 4-11. October 2008 (as compared to total Hungarian achievement since the change of regime is HUF 500.000 billion). We think it is understandable that investment banks, hedge funds, risk managements wanted to regain or desired to minimize their losses. Consequently they wanted to realize great profits by bonds and currencies of weak countries in short term because of the lack of reverse.

Such these emerging countries weren't sorted so difficultly, we should focus primarily on the budget of deficit or the passive equilibrium of the current account. Additionally which has already mentioned we have to examine the extent of reverses of National Banks. They can be surely one of the strongest protections at the drought of financial markets.

The following table gives information about it[1]:

2007	Budget deficit	Current account	Reverses	Reverses/ GDP	State debt /GDP	External debt/ GDP*
	In ratio of GDP (%)	In ratio of GDP (%)	Million €	%	%	%
Bulgaria	1,2	-25,2	12.713,5	41,31	17,2	24,3
Czech Republic	-0,7	-3,2	23.697,5	17,97	27,9	50,2
Estonia	2,4	-17,2	2.119,3	13,19	3,7	13,94
Poland	-1,9	-4,7	44.549,9	14,32	45	147,3
Latvia	-0,4	-22,3	4.002	19,03	9	18,9
Lithuania	-1,0	-14,5	5.265	18,32	16,8	27,19
Hungary	-5,1	-6,9	16.360,9	16,45	67	107,3
Romania	-2,9	-13,4	27.205,7	21,81	12,8	42,76

Resource: Eurostat, national statistic offices
* indexmundi, http://www.indexmundi.com/g/g.aspx?c=hu&v=94

Of course the small and opened economies in the Central-European region couldn't avoid the crisis. It was certain because more than 60% of their trade is with EU partner states and in addition the capital market is also dramatically intertwined within the integration.

We can separate them according to their ability to resistance to crisis. The main question is how and why they have been affected by the crisis. Because there have been some countries which didn't suffer only from the decreasing of demand and/or the lack of the capital but they struggled basically with structural problems which were intensified by the crisis since 2008 and they haven't been resolved yet.

The countries in the table are separated into two different groups in accordance with solvency. We have to emphasize that the data are from 2007 and it can present to us that which countries had to face up to dangerous situation because of the drought of capital market.

These data are showing the financial ability of the countries in the table. On the one hand there are the balance of budget and the balance of current account as the short term obligations and on the other hand there are the long term obligations: the state debt and the external debt. This last one means the debt of the public and private debt denominated in foreign currencies. Opposite them there are reserves which can help to ensure the solvency.

[1] These new members in the EU didn't adopt the single currency, the euro before 2010 yet.

These countries which didn't adopt the euro before 2008 are the most uniform according to the extent of reserves in ratio of GDP. So we have to seek the roots of problems on the expenditure side.

That's why we should suspect the budget deficit and the imbalanced current account (so the twin deficit) of endangering the solvency of our countries. So Hungary, Poland and Romania had to fight against twin deficit in the last thriving period before the crisis with regard to the table[2].

Among these three countries the external debt was really high in Hungary and Poland, so it meant a strong external dependence before the starting of the crisis. However there is a big difference between Warsaw and Budapest: it is the ratio of the state debt in the total debt. Though both of them have got debt denominated in own currency and in foreign currency, this ratio shows to us that which country must struggle more for renewal of its own debt. Of course that country has got more concern where the state debt is in higher ratio of total debt – it is independent of which currency is denominated in. Because more money must be orientated to the state budget to save its liquidity.

This value is 30,5% in the Polish case i.e. so the Polish debt is third of the total external debt. The Hungarian case is more difficult than Polish one, the Hungarian number is much higher: 62,44%. This causality meant the direct problem in 2008 autumn. And it means so huge debt that the external financial resources are absolutely necessary to renew it permanently. It is true dramatically if more the 65% of it was denominated in foreign currencies.

What happened? How has this enormous debt been accumulated? And why is it so dangerous? If we want to get responses we must go back to the currency liberalization in 2001 and to the changing of the Forint zone compared to Euro in 2003.

2. Hungarian debt crisis

2.1. Currency liberalization in 2001

As every Central-European country Hungary wanted to adopt the single European currency when it could have been possible. One of the first steps was so called the currency liberalization which came into 15 June 2001. It meant total free conversation of the Forint. So the scope of the Hungarian National Bank's duties was to protect the price stability only. But there were some serious consequences of this decision which came to light just after about 5 years. It is worth to mention here that the other leader Central-European countries such as Czech Republic or Poland initiated similar methods at that time. It was an important steps towards adopting euro.

The problem will begin if the responsible monetary policy didn't associate with restrict fiscal policy what happened in Hungary since 2002.

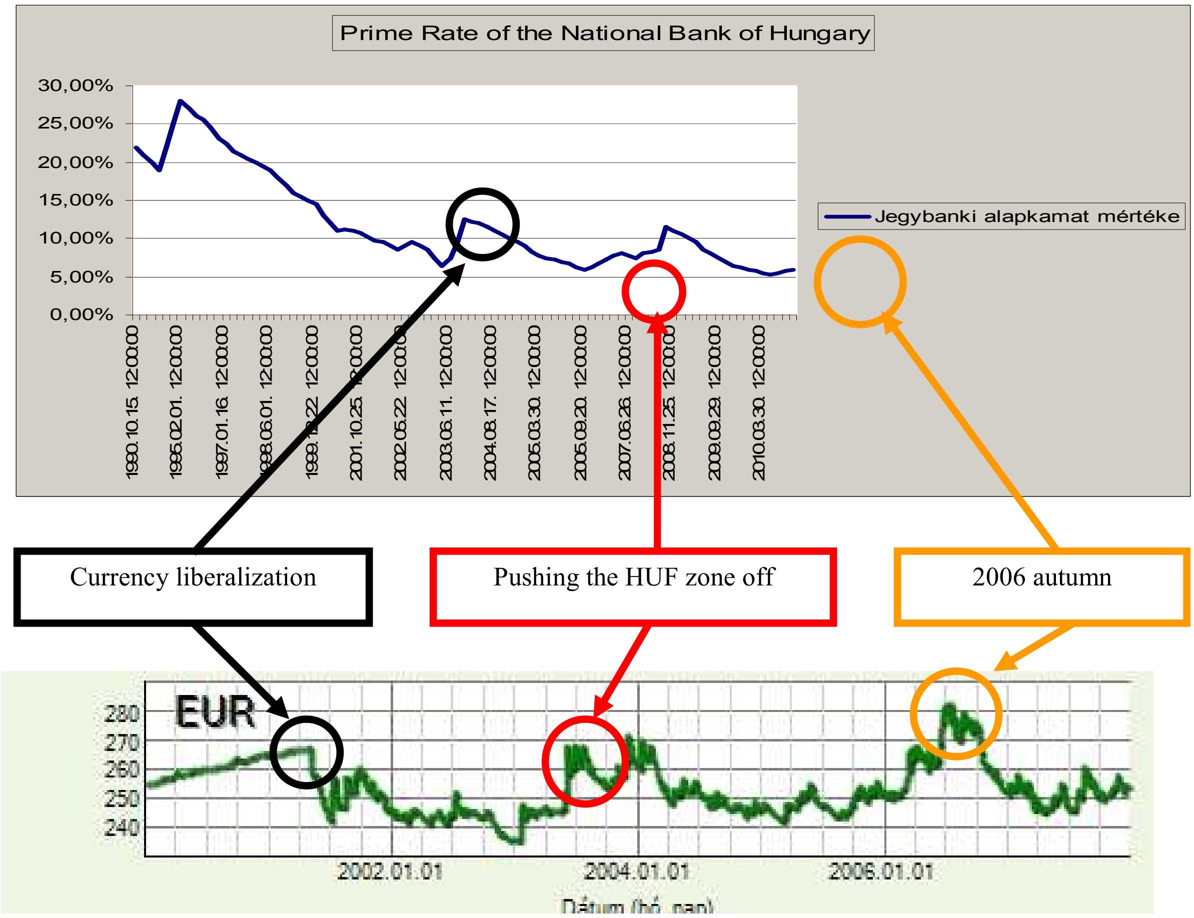
In spring 2002 the socialist - free democratic coalition won the general election by minimal majority. It was wanted to strengthen or to increase by the new government on the self-government election in autumn 2002. That's why the Medgyessy administration went about a unprecedented expansive fiscal policy. It meant HUF 190 billion extra expenditure for the budget (it was the first 100 days program). Of course the political outcome was extraordinary for them. Then the second 100 days program followed the first one. Its value was approximately HUF 65,5 billion.

However these expenditures didn't have funds, it was proved by the 2002 budget deficit, so this amount which streamed out was wanted to get back (of course the government didn't want to suffer political losses). That's why they decided to increase the level of the inflation because the accelerating inflation spread in the economy, everybody must pay it but they can't perceive it consequently the support of governmental parties wouldn't as much as in a normal case (what is more the inflation is only income which isn't voted in the Houses of Parliament).

[2] We don't consider the deficit below 1% of GDP as a budget deficit.

However the National Bank provided for the price stability at that time according to the National Bank Law, so the fiscal policy wasn't able to change the inflation rate. The last alternative of the government was to enlarge the seats of the Council of National Bank and then due to the new delegates the inflation rate was changed indirectly (because of the National Bank Law to accelerate the inflation was prohibited directly). That's why the decision of the new body was push the Forint zone by 2,26% off compared with € on 4th June 2003. The investors didn't understand the process because since 2003 summer the Hungarian economy had been reliable and thriving. They feared their invested money from other extra negative influences so the capital started to escape from Hungary. It could grow the inflation rate thus The National Bank of Hungary had no other choice but to raise the interest rate to avoid the accelerating inflation. It was increased to 12,5% so to finance the general debt became more expensive again. But the main problem was the following: Hungary lost its reliability and credibility.

On the other hand and as we mentioned the other problem was that to finance the debt became more expensive. As the currency liberalization and the free convertibility of Forint has already existed, the banks could give credits much cheaper in foreign currency than in the Hungarian Forint. Of course the private and public sphere of Hungarian economy took full advantage of it. Let's consider the next figure.



Resource: National Bank of Hungary and own calculation

After pushing the Forint zone off the Hungarian fiscal policy overspent and it was unreliable permanently. It must have been clear that the high interest of huge amount of the Hungarian debt couldn't be financed by a country such as Hungary where so little part of the active society has worked and has had to pay so high taxes nevertheless there are so many inactive persons and additionally lost of active and working citizens earn minimal wages officially (in Hungary the minimal wages haven't been levied taxes). After the accession to EU there haven't been any years when the European Commission initiated overdeficit proceedings against Hungary. And finally the coalition of Hungarian Socialist Party – Alliance of Free Democrats couldn't achieve any convergence programs which were submitted in Brussels. But the problems were concealed by the cheap money from abroad and the economic growth due to foreign credits.

2.2. Events in 2006

The peak of these processes was in 2006 when the real statistic data came out. The Hungarian budget deficit jumped up to HUF 2120 billion what is 9,3% of GDP. It was the second highest budget deficit in 2006 after Lebanon (but Lebanon was in war in 2006). The budget deficit could have been more than 10% of GDP if the interest rate of European Central Bank hadn't remained as little as in 2006 so to finance the state was cheaper by HUF 250 billion than expected.

The government had no choice but to have to decrease the expenditures. Initiating of special visit fee at doctors (according to the most optimistic estimate about HUF 50 billion would be paid as visit fee) or of costly higher education would reduce the level of deficit. But the giant and/or spendthrift social systems weren't modernized for insurance the 13th month pension system was approximately HUF 180 billion per year. Of course the government couldn't achieve actual reduction in very short term. However additional drawback was the following: government has been decreasing the investments since 2006.

In the meantime the interests didn't go down. It couldn't because Hungary absolutely lost his total credibility and Budapest had to counteract it for higher yields. But parallel with it the interest rates of Swiss National Bank and of ECB were falling so the credits denominated in foreign currencies became even cheaper. The extra investments were helped by the cheap money more or less. Needless to say there weren't any chances that this process would stop or just moderate. Additionally the monetary authorities didn't have any financial resources or authorization to stop it, they could warn the government and the citizens but it absolutely wasn't enough.

2.3. At the beginning of crisis

The Hungarian economy weakened by September 2008. While the other Central-European members could grow by six-seven percent average (moreover the Baltic countries or Slovakia developed by more than ten percent between 2007 and in the first part of 2008) meanwhile the Hungarian economy stagnated. Of course in this period Hungary couldn't increase the reserves either.

We can prove it with a simple example:

1. The 10 million Hungary had € 16,3 billion reserves in summer 2008 which was only 1,65 times more than in 2001.
2. The 5,4 million Slovakia could increase its reserves by 6,6 times between 2007 and 2001.[3]

And the two processes meet here which was presented at the beginning of paper. While the most Eastern-Central-European states were able to finance themselves and their own expenditures in 2008 and in 2009 due to the their accumulated reserves (because the capital market didn't provide it) in the meantime Hungary didn't have other resources as only the external help of EU-IMF-WB bailout package which was approximately € 20 billion. Without this Budapest should have announced state-default (it is true that it would have been a so called soft state-default i.e. temporary insolvency). Additionally the National Bank of Hungary had to raise the interest rate by 300 basic points (22nd October 2008.) however any Hungarian state bonds couldn't be sold until the beginning of March 2009. There was only advantage that the value of the domestic reverses went up.

[3] The data in 2008 wouldn't be competent because Slovakia had to consign its reserves and gold to the European Central Bank.

2.4. The Crisis became specific

Hungary doesn't have favorable exchange rate in this situation. There is less disadvantageous at the longest. If the Forint is weak compared with euro then it will the surplus of Hungarian trade balance forasmuch the more expensive import can't be sold during recession. In the meantime the weak Forint contributes the accelerating of Hungarian export. It is true even if we know that so called big and multinational companies can realize the surplus of export. The small and medium enterprises have very small part of the income of Hungarian export (Palánkai – Nagy – Miklós, 2011.)

The second version can be the more beneficial for Hungary in my opinion. Budapest should be intent on attaining the strong Forint with the monetary policy altogether. As the country imports the basic energy sources and its price is nominated in € that's why it makes differences that what sort of the level of Forint there is. Just the stronger Forint alone is able to apply the brakes of inflation. It doesn't move into the Hungarian economy throughout the price of energy sources.

On the other hand the appreciated Forint should be better to finance the debts which are denominated in foreign currencies. Due to strong Forint the installments namely will fall down because the strong Forint means lower interest rates not only for the debtors who incurred Forint basic debts but of course it is installments denominated in foreign currencies are also cheaper. Considering the state debts of new members in EU Hungary is the most indebted country and considering the private debts Hungary is one of the most indebted economy too, I think it must be obvious that the stronger Forint should be achieved.

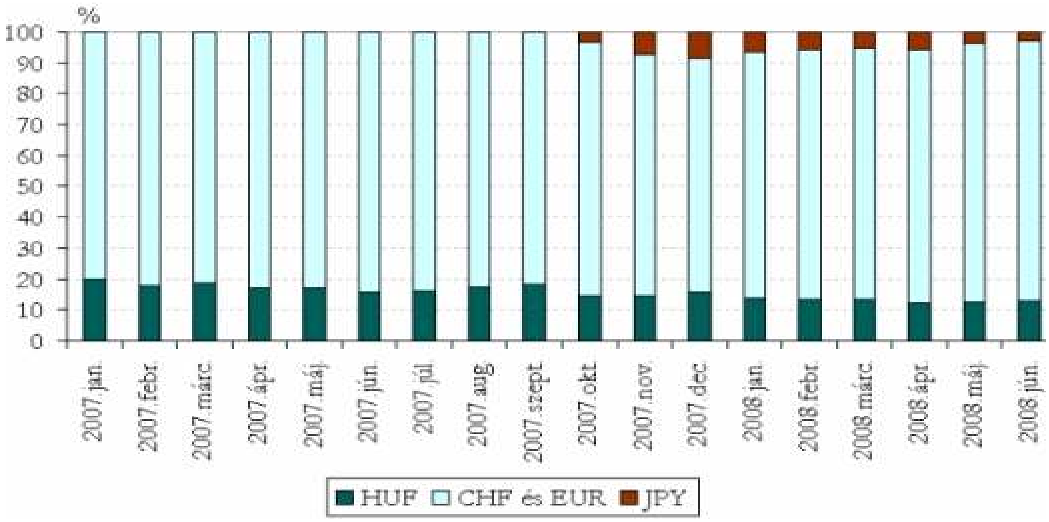
3. The structure of Hungarian debts

I think Hungary should have strong Forint (below 290 HUF/EUR) to finance the debts and to stop the accelerating inflation because of the prices of import energy resources. But how big is this amount? We are going to present it now:

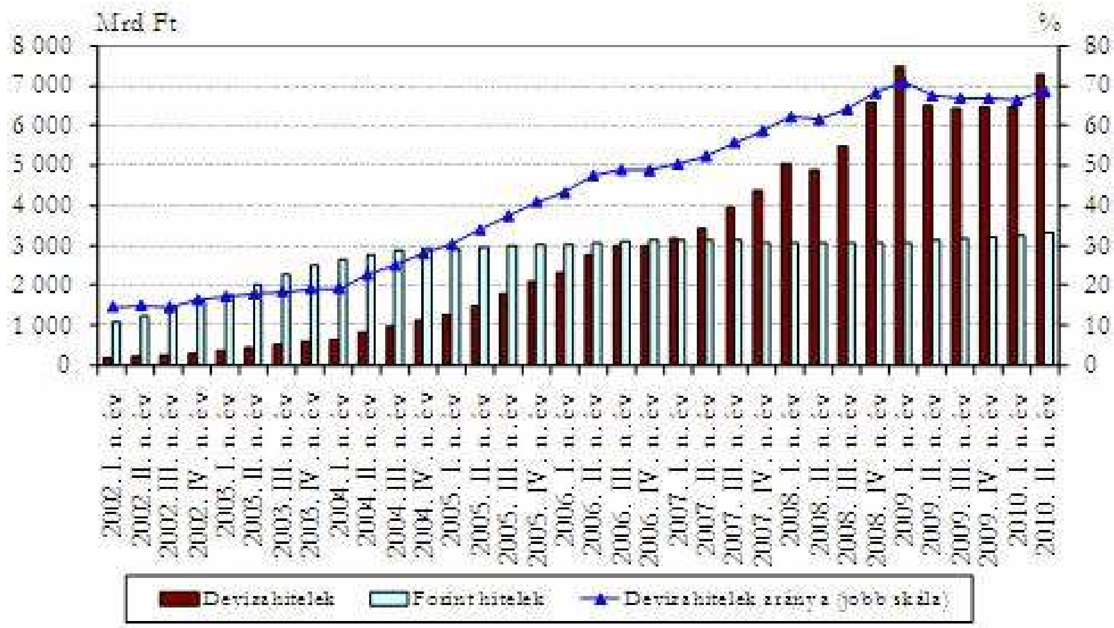
3.1. The indebtness of private sphere

As we mentioned the Forint interest rate didn't move closer to interest rates of Euro and Swiss Franc but it went away further from them due to the pushing Forint zone off on 4th June 2003. Then after a year they convergence again with each others but Forint interest rate left from so high level that the banks offered the relative very cheap credits denominated in foreign currencies to their partners and clients.

As we can see it on the following tables the ratio of debts denominated in foreign currencies has risen dramatically after the end of 2003 considering the total debts or the ratio of GDP. So the total value of private debts was HUF 8.486 billion. Its 34% was denominated in Forint and its 66% is in foreign currency. The debts denominated in foreign currency can be separated into debts in Euro and in Swiss Franc. 54 percent points is in Swiss Franc (which is 82% of the total private debt) and 12 percent points is in Euro (which is 18 percent of the whole private debts in foreign currencies). It is a very huge amount in an extreme wrong structure.



Resources: Hungarian National Bank



Resources: Hungarian National Bank

3.2. The indebtness of public sphere

The Hungarian state debt is in the first position compared with the other countries' value in ratio of GDP. Additionally its bigger part is denominated in foreign currency.

The total Hungarian state debt was HUF 21.426,1 billion on 30th November 2011. Its 48,7% (HUF 10.433,6 billion) was in Forint and 51,3% of it is denominated in foreign currencies (which is HUF 10.641 billion if we convert it into the Hungarian currency)[4].

[4] The foreign currency debt is always converted into Forint according to the Hungarian National Bank's value of HUF/EUR exchange rate. It was HUF/EUR = 311,54 and HUF/CHF = 254,16 on 30th November 2011.

4. The future

The statements which were formulated at the beginning of the paper should be rethought: are there any chances for a country with financial situation such of Hungary to survive a new global economic shock or not. We think Budapest managed to survive it in 2008/2009 and that is our opinion it will succeed in 2012/2013 too so we shouldn't fear from state default.

However a new recession is going to weaken the exchange rate of Forint which will be able to cause a new panic against Hungary. The question is the following what will trigger the Forint weakening: a general European recession or some Hungarian domestic weaknesses. Because we will be able to consider more depreciation of Forint more internal Hungarian problems mean the reasons. That's why we mustn't aggravate the foreign public opinion with some bill such as a new law of National Bank.

On the other hand we have to exploit absolutely but we have to look to two recommendations as regard the economy.

1. Hungary mustn't amass a new deficit of budget but it endeavors to have a zero balance budget. The Hungarian (external and state) debt is so huge with high interest rates and additionally there is at least recession in the old continent so Budapest should take care of the balance of budget. Unfortunately the tax moral is really low compared the Western part of the integration so the income of the state and the recession together can be dangerous to debt spiral though our purpose is to push the budget deficit down below the Maastricht-criteria.

2. The Hungarian should use only such economic and labor policy which motivates the citizens to work and only to work. Nowadays Budapest doesn't have any other possibilities just negative incentives (there aren't any financial resources) so the government should to stop the all aids particularly the unemployment benefits. Without it the country will be in such a situation, even we have to refine, we are in such a situation that many budget resources are paid for people who are on the dole (however they can but don't want to work) that the budget won't bear this burden. In the meantime the qualified employees leave the country and nobody will pay high taxes. Of course the private debt will decrease but the state per capita is going to increase.

We have to mention the redemption in fixed exchange rate. Though neither the Hungarians nor the foreigners have unanimous opinion about it – however the author of this report agrees with it because without decreasing the credits in foreign currencies the Hungarian monetary policy can not be effective on the domestic economy (to set the level of exchange rate isn't the National Bank's work) but the Hungarian government shouldn't make and try to implement some other political recommendations which are on the razor's edge. Because they jeopardize the recent ones, for example the final redemption too.

Resources

Erdős, Tibor (2010) Forintárfolyam, kamatszint és devizaalapú eladósodás – Az árfolyam szerepéről, *Közgazdasági Szemle*, VOL. LVII. 10., Budapest, page 847-867.

Dr. Palánkai, Tibor – Dr. Nagy, Sándor Gyula – Miklós, Gábor (2011) *Internationalization (Transnationalization) of the Enterprise Sector*, Budapest

Hungarian National Bank's database and statistics

Hungarian Government Debt Management Agency's database and statistics

*

www.southeast-europe.org
dke@southeast-europe.org