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HUNGARY

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Prior to the EU accession most people agreed that it was a privilege to be a member state of the European Union, and that this would result in fast convergence to the 'West'. Being the most open country in the CESEE region, expectations of Hungarians were even higher. EU accession was considered as the first step towards joining the economic and monetary union (EMU), i.e. the Eurozone. Several analysts expected it to happen within 2-3 years after the accession. Most studies that investigated the potential effect of EMU accession on potential growth, the business cycle and long term development unanimously came to a positive assessment. The past 15 years have not fully justified these positive expectations: accession to the EMU has been postponed several times, and the positive effect of EU membership has been partially vaporized by the Global Financial Crisis. Euphoria and disappointment characterizing these years will be analyzed in three areas: changes in monetary policy, evolution of the banking sector, and problems of crisis management.

Due to harmonization with the EU legal system, the last elements of capital control should have been abolished in the CESEE countries at accession. This happened in Hungary already in 2001, i.e. three years prior to accession. During the years of strict capital controls, exchange rate management was the dominant

monetary policy framework in most of the CESEE countries. In Hungary, in particular, it was the rather successful crawling peg system, which had been introduced in 1995 and helped to stabilize the country at the expense of moderately high (10-15 percent) inflation. After the abolition of capital controls, monetary authorities had to choose between a free float with an independent monetary policy or a pegged exchange rate regime without an independent monetary policy. The Czech Republic, Slovak Republic, Poland, Romania and Slovenia (as well as the late comers Serbia and Croatia) chose the first option, and introduced the step by step inflation targeting system. Other countries gave up the independent monetary policy, the three Baltic states and Bulgaria chose a currency board system (or a variation of it), while later, Bosnia and Montenegro introduced unilateral euroization.

Hungary chose a mixed solution: inflation targeting with a wide FX band, which let the HUF oscillate +/- 15 percent around the middle of the band. The immediate consequence of this distorted system was dirty floating of the exchange rate with all its negative consequences. As the exchange rate channel was the most effective channel of monetary transmission, due to the band, the efficiency of the monetary policy had been significantly reduced. This was not the only reason for the tragically unsuccessful episode of Hungarian inflation targeting. Such a framework requires well disciplined fiscal policy. Hungary on the other hand could have been characterized by fiscal alcoholism, that is, operating at much above the 3 percent limit of government deficit. Due to dirty floating and government overspending, the central bank managed to bring down inflation to 4-5 percent, but could never keep it steadily on the target of 3 percent. Euphoria and disappointment.

The third reason for unsuccessful inflation targeting was the FX-denominated lending boom, which contributed to the over-indebtedness and overspending of households. The Hungarian banking sector – like in most of the CESEE countries – had been privatized to foreign banks during the 1990s. In the first half of the 2000s the national champion, the OTP bank, dominated both retail and corporate markets, but the subsidiaries of big Austrian, Italian, German and Belgian banks firmly kept their 8-10 percent share on the corporate market, and attempted to challenge the OTP on the retail market. In 2003/2004 after long hesitation and unnecessary delay the government put an end to the over-generous housing–subsidy system, and the mortgage interest rates immediately jumped by 400-500 basis points. The abolition of all capital control measures gave a unique opportunity to the foreign owned subsidiaries to challenge the OTP. They had easy access to the cheap FX funds of the parent bank, and could provide cheap FX denominated mortgage loans for households,

almost as cheap as the subsidized mortgages used to be. FX lending greatly accelerated, showing similar features to those of the US subprime boom: irresponsible banks advanced huge FX-denominated loans to subprime, non-creditworthy households, who had bought the dreams of their lives with this loan. Though the MNB, the Central Bank of Hungary, had sent, from time to time, serious warnings about the threat of over indebtedness of households and the potential risks of FX lending, this verbal intervention proved to be ineffective, since it lacked the necessary supervisory and regulatory measures. As, in the new Capital Requirement Directive (the European adaptation of Basel II) there was nothing about FX lending, so the regulator had no right to increase the capital requirement. Other authorities were as inactive as their counterparts in the US. In 2008 just on the eve of the Lehman-crisis the total share of FX denominated loans was more than 70 percent in the retail sector. Both the lenders and the borrowers were convinced that within a few years Hungary would be a member of the Eurozone, and the problem of FX lending would be solved. At that time nobody cared that 90 % of FX loans were denominated in CHF, in a non-EU currency. During the crisis the accumulated CHF loans became an unbearable burden for households, tens of thousands lost their homes. Financial, economic and social tragedy was the consequence of the FX lending bubble. Euphoria and disappointment.

Just on the eve of the Global Financial Crisis, central banks of the European Union signed a Memorandum of Understanding about the joint efforts to be taken during a possible crisis. It seemed that it didn't matter whether it was an "Eastern" or "Western" country, since everybody was a member of one big family, during a possible crisis as well. We were all equal. Euphoria.

On 9th of October 2008 the post-Lehman global liquidity crisis hit Hungary heavily. All the Hungarian financial markets – that of government papers, FX swaps as well as the stock exchange - all of a sudden dried up entirely. It was really the sinister sudden stop, when funding just disappeared from the system. On 10th October, the MNB applied to the European Central Bank for a EUR-HUF swap line, but was refused. Instead, the ECB offered a repo line, which meant that the MNB had access to euro liquidity at the expense of its international reserves. It was never clear why the ECB refused formal FX swap lines to CESEE countries in the first place. In private conversations, ECB officials mentioned operational risk as a key hurdle, which was in fact a politically correct way of saying that they were uncomfortable with accepting forint or zloty on their balance sheets, while Danish and Swedish korona were accepted. We are all equal, but some are more equal than others. Disappointment.

Hungary had to turn to the International Monetary Fund (IMF) and apply for a stand-by loan. The country's negotiated policy package was supported by what was a truly large – "oversized" - combined IMF stand-by and EU balance of payments loan of Euro 20 billion. This helped calm the markets, restore confidence and avert a deep overall crisis. Euphoria!

However, the October 2008 liquidity crisis did not mean the end of the crisis. The stability of the banking sector was fragile, and a sudden stop and credit crunch were real threats. First the credit flow slowed down and then practically stopped. The consequences illustrated the old textbook thesis: "When the banks stop – the economy dies". The economies of the former Eastern bloc contracted by 5-15 percent. The lack of international collaboration had a particularly negative effect on the CEE region as well as on the Balkans. Governments of EU member states which bailed out their banks often asked them informally (but sometimes even publicly) to focus more on domestic lending, instead of funding their Central European subsidiaries. Uncertainty arose as to whether multinational banks would keep funding East European customers through their local subsidiaries. This increased the threat of an uncoordinated rush on banks in the region. Irrespective of whether or not a CEE country happened to be a member of the EU (or in some cases of the Eurozone), global sentiment did not distinguish between them. The countries were uniformly considered as belonging to a crisis-hit region, which was left out from the umbrella of the Union. Several politicians (then European Commission President José Manuel Barroso among them) opposed setting up a crisis management fund for the CEE region. Deep disappointment.

And then the EBRD reacted. Together with the EIB, the International Finance Corporation (IFC) and the World Bank it drew up a plan to first mobilise the official sector – home and host country authorities, international financial institutions, particularly the IMF – to establish the "rules of engagement" (who does what in crisis management) and in the second phase engage the parent banks as well. It was the Austrian Ministry of Finance that convened the first meeting of the future Vienna Initiative in Vienna on 23rd of January 2009. The Vienna Initiative had a positive effect not only on the stability of the banking system, but on the assessment of the participating countries, among them of Hungary, and the region as a whole. The message was unanimous: none of the countries of the region would be left without protection, and international cooperation would extend to all the crisis-hit countries. The East European panic slowly faded away. A little euphoria in the middle of deep disappointment.