Some Financial Issues in Transition Economies: The Case of Hungary

György Szapáry

As the last speaker at the end of a two-day conference and having been invited to speak at this conference just a few days ago, I am afraid that I will not be able to add any innovative thoughts to the discussion. I propose to talk briefly about three issues: first, about bank regulation and supervision issues faced by Hungary and, I believe, by all the other transition countries; I propose then to say a few words about the impact of the Asian financial crisis on Hungary; and, finally, I will touch upon some of the issues concerning exchange rate and monetary policies in transition economies, as seen through the experience of Hungary. These topics have been addressed by the previous speakers and I propose to now add some of my own thoughts to these issues.

I Bank Regulation and Supervision

One of the characteristics of the transforming economies has been that, compressed into a few short years, these economies have encountered, since the start of the reforms, all the difficulties and problems of the financial system that other countries have had to deal with at some time during the last five decades. Weak risk assessment practices, insufficient internal controls within the banks, inadequate accounting standards, weak supervision and, last but not least, an unprecedented economic recession have led to the accumulation of large bad loan portfolios by financial institutions, often followed by bankruptcies. At the start of the reforms, when the mono-bank system was abolished and a two-tier banking system was established, with a separate central bank and separate commercial banks, the latter started their lending activities immediately, although supervision and regulation of the banks were not yet fully in place. In Hungary, as in other transition countries, the authorities had to create laws and regulations, and had to develop their supervisory skills while the commercial banks were already operating. One of the main weaknesses of the financial system, in the early years of the reforms, was that most credit institutions were state-owned. Lacking a truly profit-oriented ownership, the banks were ill placed to resist political pressure or to undertake the needed internal reforms.

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With banks accumulating a large amount of bad loans, it had become increasingly evident to the Hungarian authorities that privatisation could not take place without bank consolidation. Therefore, Hungary undertook a bank consolidation programme at the end of 1992 which took about two years to complete. Consolidation basically took the form of providing the banks with market interest rate-bearing government bonds equal to the amount of bad loans. The bad loan portfolio was for the most part left to be worked out by the commercial banks. The total amount of the consolidation reached about 7.5% of GDP at the end of 1994, and the cost to the government budget in the form of interest paid on the consolidation bonds was 1.6% of GDP in 1995. This ratio has been declining since then as inflation and nominal interest rates have fallen and the GDP has grown. Following the consolidation, the capital adequacy ratio of all the consolidated banks was brought up to 8%. Thus, the road toward bank privatisation was paved.

Bank privatisation has brought many benefits: technological upgrading, improved bank management, increased competition, and new, faster services. Hungary, with a population of 10 million, has already over two million credit cards and several banks have opened so-called direct banking services, where all services can be obtained via telephone. It is interesting to note that people in Hungary seem to be very receptive to technological change. This may be due to the fact that the services provided before were very poor. To give an example, previously people often had to take off several hours from their work in order to withdraw money from a bank. Therefore, when automatic teller machines and credit cards came around, people were eager to seize this opportunity of getting faster service.

Undertaking a comprehensive programme of strengthening bank supervision early on in the reform process is a very important issue in transition economies, as there is no time for the sequencing of institutional development. Indeed, one cannot first establish the supervisory agency, then train the supervisors, and only then allow commercial banks to operate. The authorities of the transition countries have had no other choice than doing everything simultaneously. As a result, supervision is still lagging behind the rapid development of the commercial banking activity in these countries. Great efforts need to be made to improve regulation and supervision. In Hungary, we have passed the necessary laws and regulations, but as we gain experience, we realise that further work is needed in this area. Hungary will start accession negotiations with the EU this year and thus will have to adopt all of the EU directives. We have already adopted many of them as we were going along, but there is still more to be done. Training of supervisors is also a very important element in the task ahead.

I would like to single out four of the Basle core principles that, in my

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view, particularly apply to transition economies. First, banks must establish adequate internal procedures and practices for evaluating risks. Risk assessment was not a real issue under the socialist system, because credit was directed and expertise of evaluating credit risks was not developed. Second, it is necessary to establish adequate management information systems within the banks, an area also particularly weak at the start of the transition. Third, strict rules to prevent abuse of connected lending need to be formulated. For instance, there were some Hungarian banks established whose owners clearly did not see banking in the way it should be seen. They considered banking as a way of channelling credit into their own businesses, a practice which naturally resulted in bankruptcies. Fourth, it is essential to secure capital adequacy ratios that are high enough to cope with the uncertainties inherent to the transition. This may mean a higher ratio than the Cook ratio of 8%. Hungary has 36 commercial banks, and for a country of 10 million people, this clearly seems to be too many. One can, therefore, expect that there will be mergers and acquisitions. It is going to be an interesting case to watch, because all but seven of the commercial banks are foreign owned. The bank mergers in Hungary will probably follow the mergers of their mother-banks abroad. One such merger has already taken place.

II The Impact of the Asian Crisis

The effects of the Asian financial crisis on Hungary were limited. We experienced no significant capital flight and, as a result, the exchange rate depreciated very little. Hungary has a pre-announced crawling band system and the exchange rate moved away from the most appreciated edge of the band only for a few weeks – at the most by 1% – but most of the time following the Asian crisis the move away from the strong edge of the band was below 0.5%. There was, however, a temporary fall in the equity prices on the Budapest Stock Exchange. This fall was quite sharp and it was caused mostly by a sell-off by domestic investors. Why did foreign investors stay put and not withdraw from the Hungarian capital markets in the wake of the Asian financial crisis? It could be just luck, but I believe that it certainly helped that Hungary had good economic fundamentals and that the country was seen as going in the right direction. Indeed, there has been a substantial reduction in the fiscal and current account deficits, as well as in the country's net external indebtedness. At the same time growth has accelerated, while inflation has declined. Although there is no guarantee that strong economic fundamentals will protect a country from contagion, they will help the country to better cope with its effects (see below).

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III Exchange Rate and Monetary Policy[1]

In a small, open economy like Hungary's, the exchange rate plays a dual role: it can protect external competitiveness and it can provide a nominal anchor for domestic price stability. In the short run, these two objectives can be conflicting and policymakers must decide on the relative weights to be assigned to each of these objectives. We in Hungary considered that it was important to protect our competitiveness, since the balance of payments remained a binding constraint as Hungary also inherited a high level of foreign indebtedness. It was considered that the higher rate of inflation in Hungary – relative to its main trading partners – was due to the inflation forces inherent to the reforms. These include changes in relative prices and wages, ingrained inflation expectations, and fiscal pressures emanating from systemic reforms (e.g. bank consolidation, pension reforms, closing of unviable firms). Since it takes time for these inflationary forces to fade away, the nominal exchange rate has to be depreciated in order to maintain competitiveness. Given these circumstances, in March 1995 the Hungarian authorities adopted a pre-announced crawling peg system with a band of ± 2.25% on either side of the central rate. The National Bank of Hungary (NBH) has only committed itself to intervene at the upper and lower edges of the intervention band, though it has reserved the right to intervene also within the band. The rate of crawl was originally set at 1.9% per month and was gradually reduced to 0.7% per month starting in October 1998 (-announced in August 1998).

The rate of crawl has been set by the authorities in light of the developments in the balance of payments and inflation, also taking into account the improvement in productivity. Considering that the average level of productivity in Hungary falls well below that of the more advanced countries, the potential for productivity growth is relatively high in Hungary. During the five years ending in June 1997, the productivity of labour in the manufacturing industry rose by an average of 14% per year. Taking into account the faster productivity growth in Hungary, as compared to its trading partners, the rate of crawl has been set somewhat below the anticipated inflation rate, allowing the exchange rate to contribute towards a reduction of inflation while maintaining competitiveness. On a CPI basis, the real effective exchange rate has appreciated by about 9% between March 1995 and June 1998. However, on a unit labour cost basis, the real effective rate has depreciated by approximately 23% during the same period.

Chart 1 shows the movements of the exchange rate within the interven-

1 These remarks have been updated to reflect the impact of the financial crisis currently taking place in Russia.

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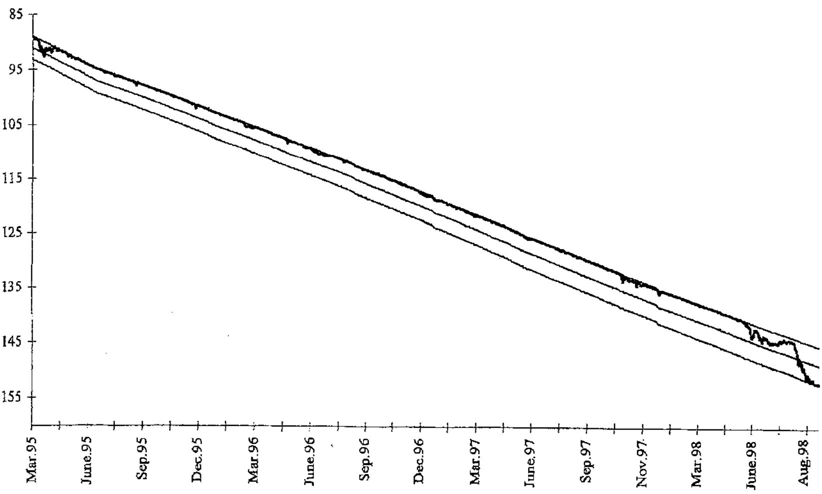
tion band. As can be seen, the exchange rate remained at the upper edge of the band throughout almost the entire period since the introduction of the crawling peg, reflecting the confidence of the markets. Following the outbreak of the financial crisis in Russia, however, the exchange rate depreciated to the lower edge of the band and, in order to prevent the exchange rate to depreciate beyond the band, the NBH had to intervene. The pressure on the forint remained modest though and the amounts of the intervention were limited. The weakening of the forint principally reflected the liquidation of foreign portfolio investments as foreign investors tended to withdraw from the emerging markets in general. No attack on the forint and no domestic capital flight could be observed, which I believe is a reflection of market confidence in the good fundamentals of the Hungarian economy.

Chart 1 Hungary – Position of the Forint within the Intervention Band, 1995-1998
(value of the basket in forints)



The interest rate policy pursued by the NBH since the adoption of the crawling peg has had a double objective: to maintain positive real interest rates high enough to provide adequate incentive for saving in domestic currency, while at the same time limiting the inflow of capital induced by interest rate differential. The pursuit of these admittedly conflicting objectives has required a careful assessment of the sources of inflation, the nature of the capital inflows (there are inflows which are not induced by interest rate differential, such as foreign direct investment or portfolio

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investment in equity), and the cost of sterilisation. The interest rate policy pursued by the authorities led to the maintenance of a premium on domestic interest rates, although that premium has substantially declined over time as the borrowing requirement of the government has shrunk and inflation has fallen.

When the exchange rate is fixed, as it is in fact in the Hungarian preannounced crawling system, and markets have confidence in the sustainability of the crawl, the existence of the premium on domestic interest rates leads to capital inflows which have to be sterilised in order to prevent the emergence of excess liquidity. In fact, Hungary did experience capital inflows which needed to be sterilised. However, the cost of sterilisation was not excessively high, representing an average 0.16% of GDP per year over the three-year period 1995-97. I do not want to minimise that cost, but if I compare it to the benefits of the crawling peg – that is, maintenance of external competitiveness, moderation of inflation and establishment of credibility – I would argue that the benefits have far exceeded the costs. The crawling peg could, of course, not have been successful without the support of other policies. The substantial reduction of the fiscal deficit, coupled with the marked downsizing of the state budget, so that consolidated government primary expenditures as a ratio of GDP shrank from about 55% in 1993 to 39% in 1997, have helped the disinflation process and created room for the private sector to expand. The speeding-up of structural reforms, in particular privatisation, has contributed to the growth of foreign direct investment and productivity. Finally, the reduction in real wages during the first two years of the crawling peg regime also helped to improve productivity and the balance of payments. If there is a lesson to draw from the Hungarian experience, it is that the crawling peg can be a helpful tool of macroeconomic management, as it combines the flexibility and credibility needed during the inherently uncertain period of reforms, provided it is part of a comprehensive policy mix aimed at ensuring macroeconomic balance.[2]

2 A more detailed analysis of the Hungarian experience with the crawling peg is available in György Szapáry and Zoltán M. Jakab, "Exchange Rate Policy in Transition Economies: the Case of Hungary," to be published in the *Journal of Comparative Economics*.

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