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Veröffentlichungsversion / Published Version

Zeitschriftenartikel / journal article

#### Empfohlene Zitierung / Suggested Citation:

Lentner, C. (2010). A few historic and international aspects of the Hungarian economic crisis and crisis management. *Public Finance Quarterly*, LV(3), 581-606. <https://nbn-resolving.org/urn:nbn:de:0168-ssoar-214183>

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Csaba Lentner

## *A few historic and international aspects of the Hungarian economic crisis and crisis management*

**B**ecause of the significant international embeddedness of the Hungarian economy formulated over a period of two decades, the causes of the economic crisis inflicted upon the country and the potential methods of crisis management can exclusively be assessed after an itemised examination of the historical and international processes of integration in market economy. The study places a key emphasis on the regulation of money markets and accounting, which represents a formative influence on capital investments, lending processes in banks and on consumer behaviour. Due to the fact that the Hungarian economy and the system of market mechanisms are considerably oriented towards foreign markets, the potential solutions to crisis management can only be successful if adapted from the major international trends.

The study mostly relies on the author's research results, with special respect to his study tour taken to Great Britain between 2007 and 2009 examining the subject of the crisis in the secondary mortgage market.

### THE ULTIMATE CAUSE OF THE HUNGARIAN CRISIS LIES IN THE CONTRADICTIONS OF TRANSITION TO A MARKET ECONOMY

The crisis generated by the British-American secondary mortgage markets found the Hungarian

economy devoid of efficient means of protection and in a weakened condition, although the permanent integration in market economy going on since 1987 was considered as exemplary, signs of financial tension were observed at the turn of the millennium. One reason for weakening is a lack of sufficient internal capital accumulation and high foreign capital dependence that temporarily compensates for it, which at times of crisis entail a decline in production at the level of the national economy and emergence of budgetary, corporate and bank liquidity problems. The other is that the reform measures in the general government and the related services sector have not been realised. The corrective convergence programme of 2006 adopted in order to eliminate the significant 'sticky' general government deficit above 10 per cent set the right course; however, in the fields of correction, healthcare, higher education and public administration reforms were aborted due to the resistance of the Hungarian society. By the time the economic crisis set in in 2008, which grew international out of the British-American secondary mortgage markets, the conditions of efficient anti-crisis measures had not been created in Hungary.

Knowing the current contradictory situation of the Hungarian economic policy, it is crucial to define and model the specific link of inte-

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gration that has evolved between Hungary and the developed market economies in the past 20 years. Being one of the most successful Eastern European states pursuing a planned economy, Hungary definitively lost the potential of further development by the late 1980s. After the internal resources of the socialist system of planned economy depleted, the foreign loans borrowed in order to facilitate restructuring were utilised unfavourably, and the standard of living was artificially kept up, funded from other than internal income generated, the Hungarian economic policy – giving in to social expectations – kept on seeking the possibilities of economic growth and, on those grounds, of raising the standard of living. It is obvious for an economic policy that also seeks to meet social expectations to prefer a social medium that represents the least possible resistance, and to strive for implementing the objectives set as broadly and as fast as possible. At the end of the 1980s, in the period of depletion and then failure of the social and economic system of socialism, fast and spectacular results were achievable through the investment of capital arriving from the developed market economies in search of good investment possibilities, in a volume sufficient to dynamise the conditions of the Hungarian economy – with a view to avoiding full economic and social escalation. The social aspect of this – particularly, job creation and a chance of a more developed industrial culture – was also anticipated to be spectacular. Favourable to the need for fast dynamisation of the Hungarian economy in the late 1980s was the enforcement of an economic political environment seen across the global economy, which facilitated more liberal and easier capital investments, known as the Washington Consensus.

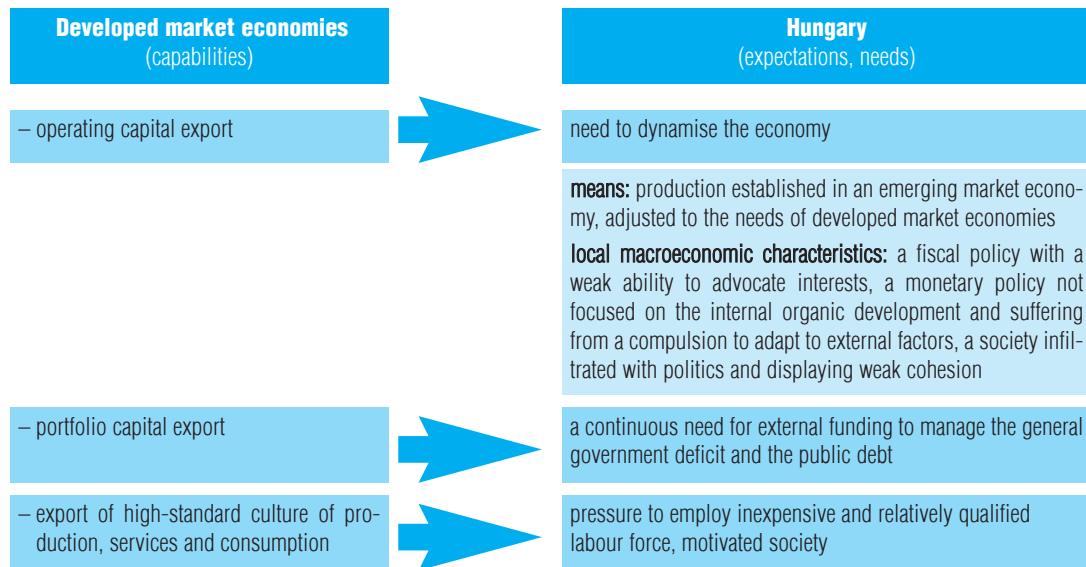
As of the late 1980s, the masses of working capital investments flowing into Hungary, then the portfolio capital investments aimed at financing the general government were

favourably affected by the Hungarian regulatory tax, finance and accounting environment, sector-neutral handling of capital, which created favourable conditions also in terms of convertibility of capital and bilateral movements (investments, profit repatriation) on both the social and the investor side. A peculiar set of relations developed among the Hungarian economic policy, which was short of capital but emphasised dynamic development objectives, the Hungarian households, which preferred a consumption level characteristic of the West, and expected a consumers' paradise, as well as the developed market economies or transnational corporations, which – compared to the Hungarian dimensions – were capable of unlimited capital investment. On the one hand, a continually growing level of needs, a pile of expectations grew permanent on the recipient side of the bilateral relationship of the Central Eastern European system of post-planned economy, which was seeking convergence with the developed market economies (which shows characteristics of economic and social semi-periphery in a number of aspects) and the Western European and North American investors, while on the side of developed economies, the constant abilities that facilitated transferring unlimited capital and developed technologies were available. (See Chart 1) This flow of capital, technology and consumption transfer evolved 20 years ago. It dynamised the Hungarian economy for a certain period and to a certain extent, and increased social welfare. After 20 years, however, it is a problem that the Hungarian economy still formulates a similarly structured range of needs and similar types of expectations, *i.e. the success of the Hungarian economy continues to depend on keeping up foreign capital investments*. Its development without operating problems will last as long as the level of capital investments does not decrease considerably. Hungary has gradually become a market economy driven by external resources

Chart 1

## A LINK OF INTEGRATION BETWEEN THE CENTRE AND THE CONVERGING SEMI-PERIPHERY IN CENTRAL EASTERN EUROPE

(during the growth period, capabilities and expectations mutually boost each other, in crisis, dysfunctionality)



Source: A model developed by Lentner, Cs. (2009)

over a period of two decades; the internal processes of accumulation, however, did not manage to steer the society's level of consumption needs and the course of the budget permanently towards a good and autonomous development course. The volume of capital invested and the accumulated production experience did not become "internally self-boosting" production factors, did not permanently stabilise the budgetary situation, and did not broadly improve the comfort of society. Another criterion is that budgetary deficit became a system-specific phenomenon in Hungary as early as in the period of dynamic growth in the portfolio of working capital; and even increasing rates and figures of budgetary deficit became a specific characteristic of the system before the corrective convergence programme of 2006 autumn.

In the life of a country that is shifting economic and political arrangements and is seek-

ing a new development alternative, the model selected and then integrated must be adapted to the economic and historical past of the country, to the development level of the existing economic and social resources and to the potential performance capacity of the existing economic resources. Elimination of the socialist large-scale industry and agriculture in Hungary was practically completed by the mid-1990s. Obsolete and discontinued production capacities were replaced by fresh and efficient foreign capital. The majority of domestic strategic sectors, vertical integration of production, new technology branches, and services sectors were transferred to or were developed through a circle of transnational corporations capable of implementing more advanced technology and more secure output, partly by way of privatisation and partly by way of green-field investors. The inventory of the financial policy included fiscal means of the government aimed at

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increasing the role of small and medium enterprises of domestic ownership in the national economy, as well as direct means of monetary policy until the mid-1990s;<sup>1</sup> however, the various government cycles, and sometimes even measures taken during a cycle made supports to the small entrepreneurial sector uneven and their operation weak in terms of efficiency. A kind of “zigzag”,<sup>2</sup> a lack of careful consideration was seen in the supports to domestic enterprises, which prevented the internal circle of owners from gaining strength, and, consequently, the evolution of a societal-scale middle class (“middle-class status”) through the evolution of a domestic stratum of owners and entrepreneurs.

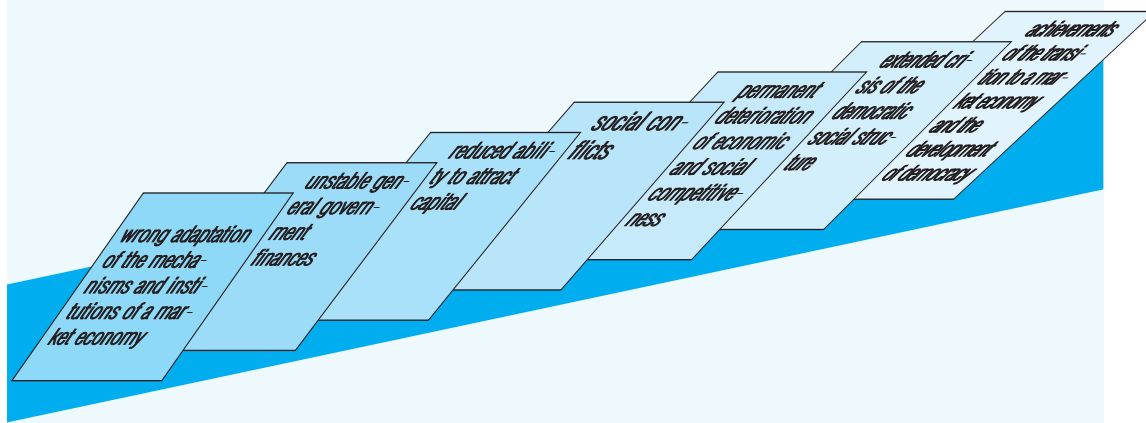
*The key problem of the Hungarian transition to a market economy is that in the period when continuously growing and massive working capital was flowing in, the budget and the balance of payments were constantly imbalanced – to a growing extent at times –, while in terms of households, a growing gap opened up between the income expected from the new type of production method and the actually achieved level. The reform measures displaying a vision of a permanent growth path (corrections in 1995, 2006, and 2008–2009), on the other hand, shocked the public climate of the population deeply influenced by politics; as a result, a significant portion of the society became an antagonistic opponent to reforms and ultimately to resolving macroeconomic imbalance. After 20 years, the results lend themselves to the conclusion that the early economic successes and the measures taken at the time of the regime change in order to facilitate social welfare have evaporated in the current decade that has nearly passed by. A combination of weaker market and profitability positions of and funding opportunities to small and medium enterprises of domestic ownership in comparison to those of transnational corporations, as well as the crisis-related decisions with a preference for nar-*

*rowed reproduction passed by the transnational corporations that provide the majority of Hungarian economic output have reduced the total output of the national economy and, consequently, the solvent demand of households generated from labour income. The excessive and unilateral dependence on foreign capital, which evolved during the transition to Hungarian market economy, coupled with the unstable general government finances that evolved as early as in the period of dynamic capital influx after a while collectively result in a reduced ability to attract capital, and, ultimately, a reduced propensity of the resources exclusively dynamising the Hungarian economy to invest. Similarly to the decades of the planned economy, the Hungarian society socialised into an economic performance and dynamism of wages perceive decelerated growth already as a conflict situation. In the current circumstances in Hungary, the majority population traditionally infiltrated with politics and rejecting the reforms offered so far when expressing their political opinion and when voting, combined with the economic sector displaying weaker performances along with the set of economic conditions surrounding it result in a deteriorated economic and social competitiveness of Hungary.<sup>3, 4</sup> This process, or rather its final result – similarly to a chain reaction – may lead to an extended crisis of the democratic social arrangement, or to the twilight of the transition to a market economy and the processes of democratisation seen so far. (See Chart 2) The economic policy applied by Hungary on the inception of the regime change was considered as exemplary among the countries in transition from a planned economy to a market economy, but also on a global economic scale.<sup>5</sup> It can be justified subsequently that the consequences of an economic and social model adopted without deliberating each detail of it are capable of wavering the achievements of a Central Eastern European country that has*

Chart 2

### A CHAIN REACTION OF WRONG CONVERGENCE TO MARKET ECONOMY

(through the example of Hungary)



Source: A model developed by Lentner, Cs. (2009)

run a fast but not fully organic development course, like a chain reaction, accelerating after a point. Adoption and application of a wrong market economy model may generate permanently chaotic conditions, in terms of both the functioning of economic resources and the social factor.

#### THE ROLE OF TRANSNATIONAL CORPORATIONS IN THE DEVELOPMENT OF THE HUNGARIAN ECONOMY

Transnational companies globally may number 77 thousand, holding 800 thousand foreign interests in total, as opposed to the 45 thousand and 280 thousand as at 1995. It is characteristic of their size and influence that they generate half of the total global export. At the turn of the millennium, their share was 30 per cent. They employ nearly 70 million people, hardly one per cent of the global population. The share of transnational corporations in the Hungarian export is a globally outstanding figure – 65 per cent –, while in the Czech Republic at a similar level of development is as low as 15 per cent.

In the past two decades of the transition to a market economy, the Hungarian economic policy has expressed a key preference for investors of foreign working capital; consequently, their role and economic influence have been reinforced. It is crucial, however, to refer to the business policies of transnational corporations, which maintain autonomy in organising the combinations of input resources of production and commercial services. The transnational companies seek to minimise payments made to the national budget, and even require tax allowances, or, as seen in the recent years, direct state subsidies for their operations, and, increasingly frequently, to their settlement. Through their subsidiaries and global expansion, they are capable of internationally optimising capital factors, i.e. they invest where the historical input costs and taxes are the lowest, while profit, available economic benefits and influence on interests are the highest. After a while, a conflict of interest between the recipient country and the settled corporations emerge, however, *they are capable of using their economic potential to restrict the governments' possibilities of market supervision and regulation, as well as their intention of interest enforcement.*

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On the road out of the transformation crisis of the regime change as defined by *Kornai, János*,<sup>6</sup> it appeared to be a simpler and more spectacular solution to promote foreign investors to gain ground in the privatisation of former state-owned companies, and to motivate transnational corporations to invest through green-field investments than to improve and even out the “zigzag” of the domestic entrepreneurial sector by way of rational and lasting developments. Today, though, problems have emerged on a massive scale in both transnational companies and enterprises of domestic ownership, which influences the efficiency and latitude of the government's economic political measures. In this way, the government is faced with a sector that has been weakened or rather failed to gain strength in the first place – in terms of the domestic SME sector –, and with a sector producing a restrained output, in terms of international companies.

Transnational companies feature high profit repatriation, high costs of job creation and a low propensity to pay public dues in comparison to their financial muscle and the subsidies received. In the event of deteriorated or uncertain input conditions (such as the current crisis is), they are capable of withdrawing their production equipment from the country in question, due to their high mobility, or to shift to narrowed reproduction processes. In such cases, state tax revenues are diminished, and problems are faced in the field of employment and the balance of payments. The domestic enterprises, however, cannot replace transnational corporations due to their weak financial muscle, and cannot fill the economic gap left by such transferring transnational companies.

*Transnational corporations may induce dynamisation in the economic life and social relations of the receiving country, but they are also capable of generating decline through their departure.* Their role in the period of economic

convergence in Hungary has had a positive balance so far; nevertheless, we are not prepared for a world without transnational companies. It is undoubted that they have brought in a higher-standard production culture, creating hundreds of thousands of jobs, and boosted the national economy to a certain extent, but in the event their economic activity permanently decreases, plummeting economic output, emerging social conflicts and wavering achievements of the transition to a market economy and democratisation are anticipated. *The Hungarian governments were not careful enough when focusing their development and fiscal policies mostly on transnational corporations.* Transnational corporations are far from playing such a crucial role in the economic lives of Slovenia, Slovakia, the Czech Republic and a number of surrounding countries as they do in Hungary. The domestic entrepreneurial sector, and even the well-managed state-owned companies have had a crucial role in Central Eastern European countries other than Hungary, and even in certain Western European countries. In this way, the corporate business policy in place in the countries of origin of transnational corporations operating in Hungary is actually fully mapped, and even has a formative effect on the Hungarian social relations, too. It is material, though, that the consequences of transnational corporations' restricted production are more severe in Hungary, which is strongly driven by external fundamentals (i.e. is highly dependent on foreign capital) and is in a weak budgetary position anyway, compared to Western European countries or some of the neighbouring countries that feature better fiscal positions than Hungary does. Governments in a more favourable situation than Hungary are able to provide more resources in order to keep up the production level of transnational corporations, consequently, economic and social shocks are also smaller.

*A considerable part of the processing industry that represents the main body of the Hungarian*



*economy successfully stands the test of global competition, too.* It is well characterised by an outstanding share – 21 per cent – of the export of high technology products, which has improved since the second half of the 1990s, which is comparable to the figures of the United States of America and the United Kingdom at 27 per cent each, Japan at 20 per cent, Finland at 19 per cent, and easily exceeds the corresponding figures of the Central Eastern European countries. The high technology export, however, means assembly performed for foreign companies, mostly from imported parts, to a significant extent. *The import content of the entire Hungarian export is 60 percent, by far the highest among the OECD countries.*<sup>7</sup> It is explained by the fact that the export companies in developed countries retain the most valuable phases of the value chain, the ones that produce the highest added value, i.e. the knowledge-intensive phases. In this way, the knowledge deficit and the development gap characteristic of the developed countries can only be closed at a slow pace in Hungary.

The philosophy of the Hungarian economic policy that relied on transnational corporations has ultimately generated an internal market with a high propensity to consume, as a result of growing production followed by an expanded offer of products and services.

The output of the corporations producing in Hungary and the increasing product export practically provides the same product and service offer as in developed market economies. Further continuation of these is doubted, nevertheless, and at the time of the credit crunch, even bank financing of consumption faces increasing problems. *The Hungarian consumer paradise built in a period of hardly 10 years on the ruins of the planned economy is in ruins again after another 10 years.* The increasing income of households decelerated as a result of the crisis, the social transfers from the state kept ebbing away, and the commercial banks achieving a 20-

per cent annual growth in loan disbursements by subsequently crediting dynamically growing consumption have faced a liquidity crisis since the autumn of 2008. Both the production output boosted by the transnational corporations and the Hungarian consumers' paradise entered a crisis, because the impetus of the Hungarian economic policy relying on external resources seen so far has broken. The propensity of working capital and portfolio investors to invest grew more difficult as a result of the economic crisis and because of the rising market risks, and it keeps generating the crisis.

## INTERNATIONAL TRENDS IN CONSUMPTION

The economic vulnerability of the United States of America was (also) caused by consumption that permanently exceeded internal production after a point. In 2007, *Botos, Katalin*<sup>8</sup> in her study on the permanently passive trade balance of the United States established that the winning party was the one that held the import surplus on real terms, provided that funding it was not a serious obstacle. Until the summer of 2007, practically until the end of a “peacetime”, excessive consumption and funding the deficit of the trade balances and the balances of payment did not cause a serious problem.

*A banking system that provided funding for credits and a lending practice were also associated with the consumption of an abundant choice of products. Between 2003 and 2008, the deficit of the USA's trade balance increased by 55.2 per cent (see the analysis of Table 1<sup>9</sup>), which represented a serious problem in the United States. In Great Britain, the negative trade balance doubled between 2003 and 2008, while in France, a deficit of nearly USD 74 billion was generated by 2008, following a positive balance of USD 5.7*



Table 1

**CHANGES IN THE TRADE BALANCE FIGURES IN A FEW COUNTRIES, 2003–2009**

(Data in billion USD)

Countries	2003	2004	2005	2006	2007	2008	2009
USA	-549.5	-634	-767.8	-842.2	-806.4	-853.1	-517.0
EMU	+84.3	+100.1	+47.3	-24.1	+51.7	-40.4	+33.1
UK	-74.4	-103.2	-115.5	-149.4	-165.8	-182.6	-128.1
France	+5.7	-5.2	-28.9	-36.3	-47.4	-82.7	-59.1
China	na.	na.	na.	na.	+259.8	+278.8	+173.0
Japan	+100.6	+135.8	+98.2	+76.7	+107.6	+64.8	+43.5
Germany	+142.7	+189.1	+202.9	+194.6	+263.1	+283.3	+191.2
Russia	na.	na.	na.	na.	+124.0	+194.6	+112.1
Saudi Arabia	na.	na.	na.	na.	+146.6	+150.8	212.0

Source: data gathered by the author, from The Economist

billions in 2003 through a dynamic rise. It is to be noted that the countries of the eurozone had positive trade balances in the years 2003 to 2005 and in 2007, and again in 2009, while between 2008 and the first half of 2009 they were negative. Underlying the favourable figures of the eurozone compared to those of the United States – referring to Botos, Katalin – was a slow strengthening of the euro's economic role and its role as an international currency, i.e. “Europe could not afford the luxury of shortage”. Saudi Arabia and Russia owed their permanently positive balances to the export of hydrocarbon derivatives, while Germany, Japan and China to competitive export that flooded the American and Western European markets. As a result, basically two country groups were formulated in global economy: 1. countries that featured permanently negative trade balances, i.e. a society with a high propensity to consume, a financial system that transfers imported goods to consumers using less inflexible financing techniques, and 2. countries that are capable of a lasting export offensive due to their competitive, marketable (partly strategic) products.

The crisis of the global economy developed in the countries with a high consumption culture, and basically, these are afflicted by it,

although the traditionally “emitting” net exporter countries are also affected through the well-established “bilateral” trade relationships, as the demand for their export decreases, which curbs their performance and their growth set to high rev. At the same time, the figures in the balance of payments and the trade balance are continuously improving in the United States since the year-end of 2008, which suggests a more economical consumption practice of the American society moving towards restriction, efficiency of the relevant government measures, in parallel with a decrease in the income available for consumption, while an effect of the sectoral packages aimed at rescuing banks and the automotive industry weakening the budget is also markedly present. The processes are worth watching.

*The deficit in the American balance of payments was USD 697.9 billion in December 2008 –4.5 per cent of the GDP –, while the deficit of the trade balance was USD 851.3 billion.<sup>10</sup> At the end of June 2009, the deficit of the USA's balance of payments in the latest 12 months was 3 per cent compared to the GDP, which represented a USD 628.3 billion negative balance, while the deficit of the trade balance amounted to USD 674.4 billion.<sup>11</sup> At the end of 2009, the deficit of the bal-*

*ance of payments kept on decreasing, and reached USD 465.3 billion, which represents 3 per cent of the GDP, while the trade balance was at USD 517 billion. At the same time, the budget deficit equalled 9.9 per cent of the GDP (currently, as at the end of March 2010 it is already 11.1 per cent).*

The United States and a number of other market economies that struggle with a negative balance of payments conveyed their internal production and permanent import surplus that had been growing for decades to the end-consumers through various banking credit products. This financing method – and the “lenient” financial regulatory system facilitating it – was also adopted in the Hungarian practice. The consumer credit portfolio of the households in Hungary and in similar transitional market economies underwent a dynamic expansion, which generalised after a point, and a permanent excess demand developed in the credit market. The expansion of the credit portfolio far beyond realistic properties acts as a self-motivating process affecting both production and consumption. The low-interest credits were used by bank clients to refinance their mortgage loans, to purchase new real estate and to buy consumer goods. A spectacular development was seen in the construction industry, which resulted in an over USD 300 thousand excess supply of real estate in the American market in early 2008, for example.<sup>12</sup> The apartments built from credit could not be sold after a while, and due to the potential buyers losing solvency and a growing number of people struggling with repayment problems, the credits borrowed by the construction companies were not repaid either, and then the liquidity of mortgage banks wavered. The chain of construction – selling – credit repayment, which functioned for decades, was broken.

Similarly, the construction industry became a chief propulsive industry for GDP in Hungary; however, residential real properties lost 20-25

per cent from their market values due to the dynamic and then drastic rise in the number of newly built flats that could not be sold after a time. In the past years, investments in the futures markets of raw materials and energy jumped due to the low interest rates. The increasingly liberal regulation of financial institutions and the activity of hedge funds basically free of any regulation provided an opportunity for multiplying huge amounts. With the capital gearing ratios rising, the supply in the money market has been continuously growing, and the prices of products and services are exposed to significant speculation effects (see oil, biofuels). Through the households on the demand side of the money market and the consumption generated by them, the growth path of the corporate sector has also seen an explosive rise. Maintenance of the growing consumption backed by bank loans, with natural coverage increasingly provided by other countries, has become unsustainable by now.

*The phenomenon of sub-prime<sup>13</sup> developed in Hungary, too, which produced a huge credit expansion through lenient lending rules, fundamentally on the basis of the deregulatory and free market principles called into existence by the Washington Consensus. Liberalisation came to be the cornerstone of the Hungarian economic policy and economic regulation that were rapidly moving towards a raw system of a market economy from an inflexible system of a planned economy. A similar production base – controlled from developed countries –, an unreasonable propensity to consume and a practice facilitating unlimited credit multiplication to finance it along with the necessary regulation has evolved in Hungary, too, similarly to the developed countries that had been developing their systems of market economies for centuries, applying the principles of deregulation to this base a good two decades ago. Cutover to neoliberal market relations, to developing and supporting behaviours that pre-*

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fer consumers' paradise took place without the due transition, and without thoroughly testing the domestic relations and potential social responses; it can be stated that it was generated as a result of other than organic development. In addition to importing the production capital crucial to developing its market system, Hungary also "imported" the habits of the western consumer society, and the regulations applicable to accounting and credit institutions needed to ensure the set of economic conditions of accommodating a productive capital and unlimited consumption.

*The working capital and the culture of consumption imported from the west, as well as the import of portfolio capital aimed at bridging the central budgetary imbalance may lead to operating dysfunctions in the recipient country, once the region capable of capital export loses some of its financial muscle and impetus. In this situation, western reception of the product export flowing out of Hungary is also faced with obstacles, the manufactured products cannot be sold; consequently, the companies that have moved in restrict their output. In the first four months of 2009, the production of processing industry sectors typically in foreign ownership dropped by 25.4 percent<sup>14</sup> in Hungary, and continued to be caused chiefly by limited orders of the sectors producing for export and their domestic suppliers. The most considerable plummets – 41 per cent each – were seen in vehicle manufacturing, metallurgy and production of fabricated metal products. Continuity of economic setback is justified by the fact that in months 1 to 9 2009, industrial production was 19.1 per cent behind that of the corresponding period in the previous year.<sup>15</sup>*

Amidst the uncertainty of Hungarian state subsidies and the difficulties of the market, they do not take risks, and do not maintain the level of production previously established in Hungary, as a result of which the labour

income and then the purchasing power of the Hungarian households get weaker. The difficulties of lending for financial institutions, the ebbing primary sources of household and corporate consumption do not allow retention of the current dynamism of the Hungarian consumption and internal utilisation. Further alleviation of the borrowing facilities, i.e. expansion of the sub-prime circle cannot be continued any further for reasonable reasons. All these result in reduced consumption and further recession in the production that caters for consumption.

*The last general government reform before the crisis is dated as of the autumn of 2006. Reduction of the budgetary deficit permanently stuck at 10 per cent became a primary duty. For the period of correction announced to last until 2010, as a combined effect of funds withdrawn from the owners of income, and taxes raised would have generated a total HUF 2500 billion<sup>16</sup> in retained state transfers and allocation of surplus tax revenues. The processes of international financial crisis emerging since 2007 kept up the alteration of the convergence path set a year previously, and even a firmer retention of the fiscal results achieved up to that point prevailed with reference to the crisis. Consequently, the elimination of excessive consumer preferences<sup>17</sup> commenced as early as before the events spiralling in the autumn of 2008. During the crisis, the Hungarian economy, being driven by external capital, has had its balance positions in deficit, its internal production system and banking system have struggled with a liquidity crisis, and it is able to provide the consumers with decreasing supply in the long run; nevertheless, the related financing limits for loans have also shown a decreasing tendency. As opposed to the American and British governments, which rescue vehicle factories and production plants by providing state funds and support schemes, it is unable to increase demand using governmental means. In*

this way, the Hungarian society experiences a crisis that is more severe than the decline of the western consumer society. With the production and supply diminished, consumption will sooner or later drop permanently.

The fast integration of Hungarian society's propensity to consume with the western consumer society was not a unique phenomenon in the former countries of the CMEA,<sup>18</sup> which, as research by Csaba, László<sup>19</sup> shows, is represented by high deficits in the balance of payments. In the post-millennial years in the Baltic states, deficits of the balance of payments exceeding 12–13 per cent of the GDP were seen, while in Bulgaria and Romania, the deficit ran ever higher.<sup>20</sup> The lending practice of “western” financial institutions obtaining a monopoly of commercial lending through privatisation of the former state-owned banks had a crucial role in the formulation of the Central Eastern European imbalance. The transnational corporations considered Central Eastern Europe as a new market. The parent banks being deregulated and their subsidiaries in the region did not hinder conveyance of the multinational corporations' dumping-priced products and services to the societies of planned economies expecting a consumers' paradise. Not even despite the fact that consumers proved to be decreasingly creditworthy clients in the absence of primary income. The system of banking supervision was only slightly able to prevent lending to clients with weak creditworthiness. As described by Csaba, László: the central banks considerably lost their power over the monetary base.

*Based on audited data published by the HFSA,<sup>21</sup> the bank loans to households in Hungary amounted to HUF 9144 billion as at the end of 2008, which, compared to the figures of 2004, represents a 143.8-per cent rise. Concentrating the scope of analysis to a short time interval – the period of austerity measures launched as of*

*September 2006 –, the intensifying activity of the Hungarian households in the credit market can be demonstrated even more expressively. In the period of reducing the budget deficit (2006–2008), the loans to households rose from HUF 5713 billion to the foresaid HUF 9144 billion, which is 60-per cent dynamics.*

## PROBLEMS OF MONEY MARKET SUPERVISIONS

After outlining the nature of the Hungarian crisis, it is important to analyse the financial, supervisory and accounting regulatory environment that facilitated an insufficiently prudent transition to a market economy and unlimited lending, as well as to assess the integration thereof initiated in the international region, in addition to unilateral dependence on foreign capital and the formulation of a consumption-centred value system.

*The economic policy of the Washington Consensus announced as of the late 1980s basically considered liberalisation of money and capital markets as its goal, in the hope that the markets were capable of self-regulation.* In this system, regulation and supervision of money markets gained completely new contents, still, the crisis that developed after 30 years in the American secondary mortgage market and that spread across the entire banking sector and has also reached industrial companies today has inflicted serious damage on the authority and influence of the American stock exchange supervision. This is because continuous and significant confinement of the responsibility of the state and of supervisory control, in parallel with the increasing independence of money and capital markets, topped with the employment of business consulting companies to perform supervision under the Washington Consensus subsequently turned out to be an insufficiently deliberated action. The Hungarian

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regulation of money markets originally featured a kind of conservative, continental view that has in the past 20 years changed to approach the British-American model, which increasingly prevails in the global economy, and a “mellowed supervision” and a more “lenient” regulatory attitude conveyed by it also affected the Hungarian conditions.

Among those evaluating the negative effects of the economic policy laid down in the Washington Consensus, *John Williamson*<sup>22</sup> and *Lányi, Kamilla*<sup>23</sup> in Hungary were the first to call attention to the dangers of excessive liberalisation. Their key thesis is that economic policies are centred on growth, and they fail to address distribution of income and social policy in their right positions; moreover, the authors even referred to inconsistency of the reforms.

*Lányi, Kamilla*<sup>24</sup> explains that the international financial system is only able to integrate companies that operate along the same principles in deregulated environments controlled identically, which, not negligibly, prefer the American type of corporate control and supervision that has the weakest audit practice. In this financial structure, opportunities are available to develop financial products that yield extra profit but entail high risk.

Becoming integral parts of globalising money markets, the new financial innovations are not only out of state regulation but also out of sight of financial control and of those that intend to review financial processes globally. Problems are aggravated by the fact that the financial regulation of the United States of America generated the processes leading up to the current crisis not only by failing to ensure enforcement of a thorough regulatory system, but also directly.

Ten years after the Washington scheme was adopted, a proposal on regulating the increas-

ingly expanding and non-transparent derivative products was submitted to the Congress of the USA, at the suggestion of the Commodity Futures Trading Commission. However, the Congress rejected it, and opted for further deregulation, thus facilitating further growth of products transferring credit risk (Collateralised Debt Obligation), credit derivatives and work-out companies.

*In the Hungarian practice, supervisory regulation is laid on legal bases*, and the Ministry of Finance, the National Bank of Hungary and the Hungarian Financial Supervisory Authority even signed a stability agreement in 2004 to promote harmony between the tasks and the scopes of responsibility.<sup>25</sup> The effectiveness of the stability agreement and the supervisory activities of the participating institutions – in the light of the unfolding crisis – can be termed as weak, similarly to that of the American supervision and credit rating agencies. In the past 5 years in Hungary, credit disbursements of the banking sector rose by 20 per cent annually. Exceeding its labour income and social benefits, society spent considerably more on consumption. What is more, bank credit applications were topped by withdrawals performed under the reform of the general government, which did not restrict the households' propensity to consume, and they even had a chance of abundantly replacing lost income from the banking market in the alleviated regulatory environment; although HFSA called the attention of the relevant decision makers to its unsustainability.<sup>26</sup>

Increasing the disbursement of funds without sufficient funding – in the form of consumer credits and housing loans – was also a fundamental interest of the government, which displayed weakening financial and political efficiency, in order to avoid worsening of the social climate. *HFSA*, which acted as a government agency, *although perceived the emerging problem, could hardly take any action in the course of*



*excessive lending, in the absence of specific authority to intervene and to restrict the dynamics of lending.* The Hungarian supervisory system – seeing the ultimate effect – was just as much incapable of materially reducing risks intrinsic to excessive lending, as the American system failed to live up to the expectations, although the operation of the Hungarian supervisory system contains no contradictions between the scopes of responsibility and the financing model. The dynamics of the credit overflow in past 2–3 years, as well as the lack of consequences of the HFSA reports criticising it represents an underlying conflict of contradicting government interests. The Hungarian government urged stabilisation through withdrawals from the households and improvement of the financial discipline, still it did not restrict abundant credits disbursed to insolvent debtors for social and political reasons.<sup>27</sup>

It can be established concerning both the Hungarian and the American lending system that the internal invasion of production and imports generated by consumption led to an unlimited credit disbursement practice that was increasingly less secured after a while.

The supervisory curbs built into the system did not function. As a result, the credit portfolio and its derivative transactions overflowed, and became largely unsecured.

*It grew to be a general banking practice that the bank disbursed multiple times the amount of loans generated by it through the involvement of structured investment vehicles (SIV<sup>28</sup>) to other actors in the financial sector, thus distributing risk across the system. After a point, this model results in barely transparent forms of investment that are difficult to regulate, which also pushed the British Northern Rock bank towards a crisis in September 2007, because the value of the portfolio previously securitised by it decreased, and the bank was unable to securitise its new loans. Serious liquidity problems emerged within a*

*short time,<sup>29</sup> after the liabilities underlying the assets represented in the balance sheet disappeared. It is observable in liquidity crises of this type that the lack of funding in the SIV would be replaced from the funding credit line provided by the bank, which further deepens the liquidity crisis of the bank. In addition, as the crisis spreads, financial institutions acting as net lenders restrict their activities; consequently, losses, the resulting write-off and need for consolidation drastically rise,<sup>30</sup> and the state or an external investment group interested in acquisitions have entered as guarantors – in the absence of the bank's own funding. Crumbling of the most frequent method of crisis management prior to this crisis, M&A (merger and acquisition) activity, was a direct consequence of ebbing liquidity in the global money and capital markets, caused by deteriorated repayment abilities of subprime American mortgage debtors. Investment banks – not only Americans – incorporated these liabilities in investment products with various weightings to be offered on the global money market with a view to distributing risks; however, in the wake of the severe waver of the American residential real estate market, investor demand for these product practically ebbed away with the deepening of the crisis. Moreover, banks have also been in a tight situation in the wholesale liquidity market, as they were unaware of the various actors' involvement in the market of securitised subprime liabilities, and consequently were reluctant to provide short-term financing even to one another in the interbank money market.*

In the period 2007–2008, the supervisions did not have sufficient information on banks' exposure on the mortgage market and the portfolio of infected securities, which hindered crisis management. The Basel-based calculation method of capital requirements did not prove efficient in this non-transparent situation, and the practice of risk management could not live up to the expectations. On riskier changes to the



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classic model of banking, the institution of securitisation was assigned an increasing role in parallel with the mortgage-based financing to households expanding, whereby the credit risk was partly or fully transferred to capital market investors.<sup>31</sup> The supervisory methods, however, were unsuited to manage risks and enforce rules. The first capital regulation laid down in Basel in 1988 already addressed riskier banking activities, derivatives. The Committee adopted the notion of credit equivalent amounts and intended to secure off-balance sheet exposures with capital. In 1996, the new set of guidelines laid down by the Committee permitted banks to apply their own most efficient risk management practices. Adoption of Basel II in 2006 did not contain innovations from this aspect, either, and recognition and comprehensive regulation of special risks were missing again.

*The regulation and supervision in Hungary function in line with the norms of the European Union*, and reflect the quality of supervision in developed market economies also in terms of efficiency. The domestic banking system has almost fully integrated with that of the developed market economies, and the Hungarian banks are mostly owned by foreign (parent) banks. As a joint consequence of all these, the domestic lending processes and supervisory modifications follow the trends evolving in the developed market economies, even if they leave much to be desired. In the summer of 2008, the HFSA justifiably called the attention of the domestic financial sector and their clients to the increasing risk exposures,<sup>32</sup> and, consequently, to the increasing costs of money-market and bond-market funding, the deteriorating situations and decreasing support of parent banks, as well as the worsening profit prospects, in particular. It is expedient for the supervision to pay special attention in the future to the valuation processes and methods, particularly the adequacy of VaR measurements<sup>33</sup> and management of liquidity risks.

More efficient regulation of leveraged financial products and the financial institutions dealing with them, as well as implementation of control over them are high-priority supervisory tasks.

The status of the Hungarian supervisory authority is settled, its stability forecasts are reliable; to what extent the government utilises the information received is a different issue. According to the concept of the previous (Bajnai) government,<sup>34</sup> the Hungarian Financial Supervisory Authority would become the consumer protection authority in the financial sector, i.e. the consumer protection act will become applicable in terms of financial service providers and products. This measure can be considered as a kind of sequel to the act adopted in September 2008 on the prohibition of unfair trade practices. Introduction of the legal institution of a financial ombudsman, however, is currently a mere plan, although establishment of a new role would provide a facility to raise general problems on the basis of individual declarations, and present them to the competent bodies and the public opinion. Although, the real solution to the situation would be filling the existing legal institutions with true and effective contents, instead of introducing a new one.

*At numerous points around the world, for example in the United States, too, reconsideration combined with a discussion of the supervisory roles is going on.<sup>35</sup> By establishing a Consumer Financial Protection Agency (CFPA), the consumer protection duties currently assigned to a number of authorities would be assigned to a new organisation. CFPA would monitor compliance with mortgage and bank card contracts. The American stances are unified in their opinion that the supervisory procedure insufficiently covers agents selling real estate loans and large financial corporations, and consequently, financial institutions may gain dominance of power over*

consumers. It is still debated, however, whether to assign the licences to the federal reserve banks (FED) or to a new supervisory authority. In Great Britain, a Financial Ombudsman Service has been in place since 2001, which works in cooperation with but independently from the local financial supervision (Financial Services Authority). The ombudsman is competent in all products, and offers their services free of charge; however, confidence towards them has been shaken since the crisis of the banking system.

## ACCOUNTING REGULATION AND THE FINANCIAL CRISIS

During the crisis, not only governments but also enterprises faced serious difficulties. On restoring market confidence, the auditors and consequently the professionally audited annual reports have received more attention, particularly securitisation processes that proved to be an efficient behaviour of loss control in the past two decades.<sup>36</sup> The issuer companies are required to provide information that highlights potential risk and the detailed properties of the instrument. The auditors are required to issue an opinion on the issuance brochures attracting greater and more critical market attention compared to the previous years.

*The International Auditing and Assurance Standards Board (IAASB) published a practice alert concerning the auditing challenges to estimations based on fair value. The facts that affect the principle of going concern emerge exponentially, as the measures taken to restore the economy can be measured through them. The liquidity risks markedly raise the principle of going concern, to see how it is represented, or, on the contrary, how endangered it is. In their audit reports, the auditors need to highlight an evaluation of the company management's work and decisions. Should the auditor's opinion not agree with the*

*management's opinion, it is to be indicated in order to provide correct information to the market actors. The greatest loser in the crisis so far has been the financial sector and the financial instruments; consequently, the accounting profession currently primarily focuses on settling and valuing these. It is an international crisis management measure concerning the accounting profession that IASB set up a group consisting of financial and accounting experts in 2008 (Expert Advisory Panel), with the primary task of developing practical guidelines applicable to situations of determining fair value when no active market price is available.*

As a result of amended international standards, the Hungarian accounting requirements have also changed, particularly in the field of reclassifying financial instruments. The amendment to the Hungarian accounting act effective as of the end of 2008 facilitates reclassification of financial instruments for trading in the event of using valuation at fair value, due to the extraordinary circumstances. The areas to be highlighted on auditing are assessments of the company's crisis management, representations and the business environment, disclosure of the fair values, management of the risk of fraud, as well as the principle of going concern. The new challenges and effects arise in various areas with varying severity within companies. It is mostly companies with interests in foreign markets, suppliers of the automotive industry and construction companies that have been in the epicentre of the crisis. On evaluation of the annual reports for 2008 performed by auditors, the procedures of establishing fair value, hedge accounting and provisioning were paid special attention. In order to assess going concern, the auditor needs to devote special attention to evaluating the dynamics of orders, changes in the customer base, breaches of the agreements between the bank and the customers, restriction of bank financing and the circumstances of

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extending loan terms. On planning the audit work, risk assessment, materiality, assessment of the risk of errors and consideration of documentations are given more emphasis.

By virtue of the Hungarian economy's strong dependence on external capital and regulation, the anti-crisis measures of accounting and regulation of financial institutions are only conceivable under the umbrella of international regulation, i.e. stabilisation of the regulatory environment of the Hungarian economy may depend on the effectiveness of international regulation or its efficient adoption.

The G-20 summit convened in order to manage the crisis considered improvement in the accounting of financial instruments to be a priority task, with the definition of the fair value and the impairment loss of credits within it. The G-20 summit confirmed the measures of the Financial Stability Forum taken to enhance accounting standards. In the light of this, it is desirable to decrease complexity in the accounting rules of financial instruments, to consider broader credit information on accounting credit impairment, to improve the accounting standards applicable to provisions, off-balance sheet items and valuation uncertainties, to harmonise the activities of supervisors in order to apply the valuation standards. Not least, participation of regulatory organisations and emerging markets in the independent system of setting up accounting standards needs improvement with the help of the IASB.

### HOW TO PROCEED?

Two fundamental techniques exist for managing the crisis that reached the real economy by the autumn of 2008. The central banks and governments are regularly faced with the conflict that if they act against the economic recession – pumping extra state funds into the economy –, they risk a repeatedly increasing deficit

and accelerated inflation. If, however, they prefer to act against inflation and to retain the budgetary balance, they are to expect a recession in the economy.

The United States of America and a number of European countries seek to rescue dying industries by way of state subsidies, and, where it is viable, they reduce the tax burdens on enterprises, in the hope of revving up production, and then, consumption. Subsidies are funded from budgetary expenses, while tax cuts reduce budget revenues, and, in combination, increase the budgetary deficit.

Hungary cannot repeatedly commit the mistake of adapting any of the practices without due caution, although in the period close to a national bankruptcy, there was not even a realistic possibility of these crisis management actions. Crisis management and even utilisation of external assistance are hindered by the fact that *since 2001 Hungary has had no marked strategy of organic convergence to the technical and technological level represented by the developed world*<sup>37</sup>. The Hungarian economic crisis is not only a result of fiscal and central bank decisions of poor efficiency spanning across governments, but also a concomitant of the compulsion to comply with the excessive expectations of the population, which anticipates the shortage economy to turn into a consumers' paradise immediately and permanently. The Hungarian banking system has also created the credit volume technically needed to meet consumer needs, which was implemented as a more lenient regulatory system for lending and funds multiplication.

The new path of convergence started as of the autumn of 2006 in combination with the aborted healthcare and higher education reform measures as at the spring of 2008 brought about a difficult situation in Hungary by the autumn of 2008. On the one hand, *the preferred profit targets of the convergence programme in the narrow sense were justified, even*

*if temporarily, whereas the social support to the austerity measures grew disastrous.* Nevertheless, the consolidated cash deficit of the general government deficit in the first ten months of 2008 – until the crisis set in – amounted to HUF 454 billion less compared to the corresponding period of the 2007. The improved balance is basically attributable to the reduced central budgetary deficit, which, at HUF 828 billion, is HUF 565 billion below that of 2007. The social security funds had a positive balance even at the end of 2008. With decelerated macroeconomic growth combined with improving balances, the positions of households had unfavourable tendencies. In the first nine months of 2008, the gross financial assets of households amounted to HUF 25 trillion (HUF 25.7 trillion at year end), which is 6 per cent more than the nine-month figure twelve month earlier. The liabilities of households in the same period, however, grew by 20 percent. Within this, the foreign currency credits stated on the side of foreign currency liabilities increased by 40 per cent during a year.<sup>38</sup> Unfavourable tendency of the household debts and net financial assets, i.e. indebtedness kept growing in the crisis-stricken year of 2008. The surplus government revenues generated as a result of the budget adjustment were used up by the end of 2008, consequently, the government funds that could be used to help the household sector practically ran out.

Moreover, a combination of continuously growing indebtedness of the households, the measures of transnational companies that restricted production and induced unemployment, as well as the freezing of the primary bank loan market generated a situation close to bankruptcy. In the autumn of 2008, the foreign investors in government securities withdrew government bonds close to the HUF equivalent of 1100 billion from the government securities market, which created a disastrous situation. It was the standby credit of

EUR 20 billion provided by the World Bank and the ECB for a term of 18 months that has saved Hungary from bankruptcy, which also further reinforces the fact that the Hungarian economy depends on external portfolio capital – as outlined earlier in this paper. It is an interesting point in the crisis management as at the end of October 2008 that foreign investors did not return to the Hungarian government securities market despite a classic rise in the central bank base rate (by 300 basis points), although by February 2010, activity in the government securities market was gradually gaining speed, and today, foreign investments of the HUF equivalent of 2400 billion are present in the government securities market, along with an all-time low central bank base rate of 5.75.

The Hungarian economic policy may only apply the crisis management techniques of developed market economies only after careful adaptation, due to its weakened positions in all fields. From the non-existent budget reserves, the Hungarian government is unable to support foreign automotive factories operating in Hungary, currently short of market orders. Neither can it expect a material impact that would affect the whole of the national economy from potential supports to the small and medium enterprises of domestic ownership that have been suffering from a market loss for 20 year on end. The measures taken by Hungary against bankruptcy cannot accommodate considerable cuts on taxes imposed on either production or consumption. *Today, the classic means of fiscal policy deployable against the Hungarian crisis are restricted.*

The use of classic central bank crisis management measures (such as raising the base rate) has been to no effect so far. Due to a weak assessment of the government's fiscal policy, a higher central bank base rate and, through it, improved yields in the government securities market failed to win back the investments of

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foreign investors to the market, which represents restricted applicability of Hungarian central bank measures at the time of crisis. The funds needed to keep up an ever-diminishing general government system are expected to be provided from the standby credit for a long period, consequently, the recession of the Hungarian economy in terms of production and consumption is foreseen as longer than in the case of developed and capital-strong market economies.

In the British-American countries and in Western Europe, it is a general supposition that the budgetary funds spent on the crisis are not aimed at helping banks and companies but at avoiding the crash of national economies.

*By the early 21st century, the economic policy advocating stimulation of demand by the government, associated with John Maynard Keynes is living its second renaissance in the economic political practice of countries external to Europe.*

The European countries are prepared to increase the ownership share of the state – even if temporarily only –, which may as well generate new internal social and economic political relations – even if temporarily. In Hungary, however, using a growing ownership share of the state as a means of crisis management is yet to be awaited even at a conceptual level. In the practice of the European countries and the United States, budget reserves significantly higher than that of Hungary, and even state transfers provided to the debit of increasing the deficit, and at times, decreased enterprise taxes may establish an adequate basis for repeated application of the Keynesian elements of economic policy,<sup>39</sup> which, however, may result in additional problems. The deficit of the United States' federal budget in the first 10 months of the financial year ended in September 2009 was USD 1300 billion, which is USD 880 billion more in comparison with the first 10 months of the previous financial year. The deficit increment results from pro-

grammes launched to rescue banks and from the economy-boosting programme announced in the spring of 2009 at a value of nearly HUF 800 billion, as well as from a decrease of federal revenues due to the economic recession. The cost of life buoys provided by the state and the inflation effect of the resulting government debt combined with the burden of financing will hinder emergence from the crisis, and may generate new tensions also in the credit markets. The American budget deficit in proportion to the GDP may move in the range of 9 to 13 percent, which may be the highest since the years following World War II.

The unfavourable processes taking place in the Hungarian fiscal and monetary policy and the nature of the crisis management provided so far suggest restricted latitude for the new government to be formulating in the summer of 2010. No doubt, the Hungarian banking system is stable, with capital adequacy above the requirement; however, any increase in the currently 4-per cent budget deficit may be received badly by IMF. According to the promise made to the International Monetary Fund on signing the credit agreement,<sup>40</sup> reduced financing requirement of the state and improved long-term maintenance of the budget balance are items that the next government cannot ignore either. Intensified credibility and economical management of the fiscal policy, production boosted concurrently with tax cuts and the related concurrent improvement of the domestic demand side using government measures, as well as intensified demand of international markets may be factors to decrease the country's dependence on the standby credit. What is more, expansive external lending provided to finance productive investments through an authentic new economic policy may also be seen as a realistic alternative. Diversification of external markets, finding new segments and aiding the domestic solvent demand through state measures – concurrently



with boosting supply – using a similar technique as at the time of implementing Széchenyi National Development Plan are of material importance. At the same time, domestic authors – Báger – Pulay<sup>41</sup> – state that *the role of the state needed for emerging from the crisis is more complex than in the countries capable of spending huge amounts to alleviate the effects of the crisis, or, let us add, even in Hungary 12 years previously.*

It follows from the Hungarian economy's dependence on external fundamentals and regulation that the crisis may be controlled and the national regulation reinforced through correct and prudent adaptation of crisis management procedures launched from the international field, which may yield results also in a socio-economic environment displaying a new approach.

The Hungarian money markets have a specific legislative background to regulation and a system of mechanisms; however, with the financial and economic political approach of the Washington Consensus adopted, the Hungarian governments did not have an opportunity to practice supervision of money markets with due efficiency and, chiefly, due results. As a consequence, market based financing and credit risk of the general government and the banking system are faced with a number of difficulties. Due to funding from fiscal resources and the limited effectiveness of the means of central bank intervention, effectiveness of the Hungarian crisis management is only possible in the short run through renewed accounting regulation that facilitates presentation of the relations of money market supervision and correct business. *In its current situation, Hungary may do the most for regaining the confidence of market actors – either in the short or in the medium term – by effectively adopting anti-crisis measures and rules of international financial organisations and bodies formulating accounting standards.*

*The decision-making bodies of the European Union have presented multiple recommendations in the field of supervision and regulation. The most specific of these is adoption of prompt corrective actions,<sup>42</sup> which is in theory suitable to indicate problems to the authorities holding special rights prior to the crisis, in order to facilitate them to carry out the least expensive solutions. This method of the United States has been adopted by multiple countries (Canada, Japan), but it is in place only in Switzerland and Norway in Europe, although they show only slight similarities. A generally used feature of this system is normativeness that requires mandatory actions to be taken when predefined conditions are met. Such may be interventions affecting ownership rights (replacement of the management even in the event of the owners' resistance) or the institutions of accelerated wind-up, liquidation of banks or forced nationalisation. The toolkit of the advanced PCA method contains an institution of bridge banks, where the government accommodates a financial institution in crisis, and where the necessary measures of reorganisation are carried out over a period of 1-3 years. The final objective of the procedure is to restore the bank to the market as an independent entity, or maybe to sell it, but once it is unsuccessful, the bank is wound up or actually nationalised. A difficulty of using the PCA method is that it is insensitive to managing confidence problems and the resulting liquidity problems. A PCA method further developed and more limited in function, however, may be a crucial element of future supervisory systems.*

*The work of supervisions primarily consists of crisis prevention activities. Crisis management is rarely performed, in unique cases only, and normally entails no more than assigning a supervisory commissioner, or reviewing an already issued licence. On winding up a multinational financial group, however, even national controversies may ensue, as based on the principle of home banking, the foreign supervision – associated with the*



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parent bank – and the domestic authorities start blaming each other. Although an EU directive is in place concerning the wind-up and reorganisation of credit institutions, but these primarily regulate the way the depositors are to be notified in such situations. In addition to this, a requirement of an asset maintenance ratio also exists in Hungary, with a view to keeping the assets held in Hungary by a credit institution branch originating from a country external to the EU always above the value of funds raised.

On 1 October 2008, the European Commission published a draft amendment to the capital requirements directives (CRD<sup>43</sup>) applicable to credit institutions and investment enterprises, which was submitted for decision-making to the European Council and the European Parliament. According to the Commission's plans, the amendment proposals are accepted by the Council and the Parliament, and then, they need to be adopted by the member states until 31 January 2010, and applied by credit institutions and investment enterprises as of 31 March 2010. The amendment proposals of the Commission are particularly focused on modifying the frameworks of supervisory cooperation, and, accordingly, strengthening the home supervisory jurisdictions in the field of requiring added capital and data supply, and recognition of hybrid instruments as tier 1 capital elements, as well as reinforcement of the capital and risk management rules for securitisation positions.

Probably one of the key areas of anti-crisis action in the European regulator work is regulation of the operations of credit rating institutions. Credit rating institutions are private companies that pursue insufficiently regulated operation; they act upon a code of conduct only. The rating agencies, however, play an important role in market stability, and this is why it is important to have them under authority control. In October 2008, the finance ministers of the EU formulated a joint position concerning the crisis, in which, among others, they made a proposal to assess the role of credit rating institutions and to manage all discrepancies arisen in connection with the crisis. At its meetings held on 20 June and 16 October 2008, the European Council addressed restoration of the market confidence and proper operation of the financial sector as a key issue, and, accordingly, tightening the rules applicable to credit rating agencies. A priority objective of the new rules is to support establishment of credit rating institutions that do not reflect conflicts of interest characteristic of the rating business. In the light of this, credit rating institutions are not allowed to carry out business consultancy, and they must provide information on the models, methods and basic assumptions used for producing their ratings, they must publish a transparency report on an annual basis, as well as establishing an internal review department in order to control the completed ratings.

## NOTES

<sup>1</sup> Until the mid-1990s, the central bank opened a refinancing credit line to support small and medium enterprises and agricultural producers. The most widely known are: E-hitel (E-loan), Start-hitel (Start loan), a credit line for bill rediscounting, agricultural bill rediscounting, green credit for spring farm work, loans to replenish long-term revolving funds. The central bank's refinancing policy supporting the production sector was discontinued with the central banks' stronger efforts at independence, i.e. with the technical conditions of monetary integration gaining

ground. Separating the central bank positions from the fiscal policy is a reasonable decision, however, in the author's opinion, it happened too early – being aware of the shortage of capital in the Hungarian economy and in the circle of domestic owners at the time. For more information on this subject, see Lentner, Cs. (2003)

<sup>2</sup> For more information on the “zigzag” in the fiscal policy and its social consequences, see Lentner, Cs. (2002, 2005)

- <sup>3</sup> For more information on a scientific taxonomy of competitiveness, see Török, Á. (2008a). For more information on the (partial) forces affecting the economy, healthcare, higher education and the society within the competitiveness of the national economy and their models, see Lentner, Cs. (2007 a, b, c)
- <sup>4</sup> A more detailed discussion of the correspondences of competitiveness is provided in Kovács, Árpád (2005, 2007). According to his stance, growth and development both assume and implicate that a country or even a social model is competitive. "Measurement" of competitiveness, similarly, entails a peculiar social aspect: "Competitiveness is also primarily construed in terms of a nation's performance and development".
- <sup>5</sup> For more details on deteriorating performance and competitiveness of the Hungarian market economy, see a paper by the former Minister of Economy in the first Orbán cabinet, Matolcsy, György (2008), in his book entitled "Éllovasból sereghajtó" ("From front-runner to straggler").
- <sup>6</sup> Definition of the transformation crisis is associated with the name of Kornai, János (1993). In the interim phase between the planned economy and the market economy (when the old structure did not function anymore, and the new one did not start functioning yet – in a "free approximation" by Lentner, Cs.) the GDP underwent a 30-per cent decrease, which completely rearranged the current structure and system of the economy and the society.
- <sup>7</sup> The import contents of Japanese export are approximately 10 percent, but the Finnish indicator does not reach 35 per cent either. In more detail: Versenyképességi évkönyv (Competitiveness Yearbook), 2008
- <sup>8</sup> Botos, K. (2007), the study presents a detailed analysis of the difficulties concerning the balance of payments and the currency of global economic centres.
- <sup>9</sup> The figures in the table: issues of the British economic periodical, *The Economist*, December 20th, 2003, December 18th 2004, December 24th 2005, December 16th 2006, December 22nd 2007, December 20th 2008, July 25th 2009, February 25th 2010. Consequently, I present the USA's trade balances as at the end of calendar years, i.e. those of the 12 months preceding the month of December (the latest 12 months). In the USA, the fiscal year and the calendar year are not identical.
- <sup>10</sup> *The Economist* December 20th, 2008
- <sup>11</sup> *The Economist*, July 25th 2009, Febr 25th 2010
- <sup>12</sup> Losoncz, M. (2008) identifies falling real estate prices and the associated decline in housing constructions as one of the three interrelated factors underlying the crisis.
- <sup>13</sup> Massive appearance of second-rate (i.e. often not creditworthy) debtors on the credit market and credits provided to them for mostly consumption purposes, i.e. for unproductive lending purposes, generally by "money lenders" or so-called non-traditional banks [for example, Provident Magyarország Rt. (a subsidiary of the British Provident), KP Hitel in Hungary]. The absence of an income certificate or of an official employer represented no obstacle to credit disbursement.
- <sup>14</sup> Source of data: KSH jelenti 2009/4 (reported by the Central Statistical Office (KSH) in 04.2009). KSH Ecostat, Budapest. A dramatic and accelerating plummet in the Hungarian industrial production is justified by the data published in *The Economist*: the setback in October 2008 was 7.2 per cent, whereas in May 2009, 22.1 per cent. The flagship of the domestic vehicle industry, being also one of the largest Hungarian production company, Győr-based Audi Hungaria Motor Kft. published its figures on manufacture on 31 July 2009 for the first half of the year. The series of data reveal that until the end of June 2009, 661 847 engines were manufactured in Győr. It represents a nearly 35-per cent decline compared to the 1 023 228 units of the corresponding period in the previous year. ([www.origo.hu/uzletinegyed](http://www.origo.hu/uzletinegyed))
- <sup>15</sup> Export sales decreased by 20.5 per cent, domestic sales by 12.6 per cent in comparison with the corresponding figures one year previously. Decrease in vehicle manufacturing amounted to 33 per cent. KSH 2009/11.
- <sup>16</sup> Lentner Cs.(2007/a). The paper quantifies the joint value of withdrawals and extra burdens of HUF 2500 billion planned for 4 years, with a starting point of reducing the deficit in relation to the GDP.
- <sup>17</sup> Dynamic integration of latent needs with the effective needs is not visible in all fields of the standard of living; at the same time, purchase of vehicles, mobile phones, real estate and foreign holiday without a self-financed portion became symbols of a new feeling of life. A "lenient" lending practice in

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the last decade helped goods not necessarily needed for living become “everyday reality”. Child mortality, data of increasing numbers of addictive patients (and statistics referring to a number of other life circumstances), however, do not reflect the fact that people would live in more advanced circumstances in terms of quality of life.

- <sup>18</sup> Analysts Backé – Égert – Walko (2007) show that growth in small sized open countries cannot become independent of the position of the external balance of payments, even in the medium term. Analysts of the imbalance seen in the Baltic states and in Romania [Darvas – Szapáry (2008a, 2008b)] explain the formulation of the deficit by the peculiarities of the system of a planned economy as of earlier times (state investments, military industry), and then by the boom driven by personal consumption in the circumstances of a market economy. It must be added, however, that Hungary is unique also in this respect (it struggles with general comprehensive problems), because of the fact that it is driven by external fundamentals, which represent exclusiveness in its national economy, its set of exchange rates is unstable (as opposed to that of Bulgaria, Romania and certain Baltic states), its general government finances are unstable, and its “definition of the identity of its economic policy” (Veress, J., 2007) is yet to be awaited, while Bulgaria, for instance, has significantly reduced its public debt, uses a set of exchange rates fixed to the euro, and, consequently, the national currency has no fluctuations. Cf. fluctuations of the Hungarian forint: HUF 317 (as in March 2009) and HUF 266.61 (as at 4 March 2010).
- <sup>19</sup> Csaba, L. (2009 a, b). The author explains that Hungary has lost its advantages gained at the time of the regime change; consequently, it is considerably out of line with the countries in a similar situation that acceded to the EU concurrently with it.
- <sup>20</sup> The deficit in Bulgaria reached 17.8 per cent of the GDP in 2006, 21.5 per cent in 2007, and is expected to be at 14.5 per cent by 2008, and at 11 per cent by 2009. The corresponding expected deficit figures in Romania for the same years are 10.4, 13.9, 14.2 per cent, respectively, and 13.5 per cent by 2009. [Figures by Csaba, László (2009 a)]
- <sup>21</sup> Source of credit dynamics data: a report entitled “Risk outlook” published by HFSA in May 2009
- <sup>22</sup> Being a reviewer of the Washington Consensus, Williamson, John (2003) establishes a unilateral

growth-centredness and omission of secondary reforms.

- <sup>23</sup> Lányi, Kamilla (1997) presents the correspondences of the North American and Western European economic processes.
- <sup>24</sup> Lányi, Kamilla (2000) refers to a probability of certain crisis processes as early as in the period of unlimited ground gained by the processes of globalisation.
- <sup>25</sup> In more detail about the Hungarian stability agreement, see Lentner, Cs. (2006), and about an assessment thereof, see Boros, A. – Lentner, Cs. (2008)
- <sup>26</sup> The activity of fast money lenders in the secondary credit market was of unchanged intensity also in 2009, although it is now a stipulation in their advertisements that they are capable of providing still the fastest credit available, although not at the lowest rates.
- <sup>27</sup> Correction of the fiscal path and elimination of the deficit that was sticky until 2006 yielded considerable results by the end of 2008, as the deficit in a percentage of the GDP hardly reached 3 percent. It was chiefly due to rationalisation and deprivation adopted in the public administration and in the social area, as a result of which the disposable income of households decreased, and on top of that, the solvency and creditworthiness of households and enterprises adopted a critical aspect as a result of general weakening of the real sector's possibilities in the foreign and domestic markets. Deterioration of the income situation of households endangers repayment of outstanding loans, and, ultimately, prudent operation of the banking sector, which the SAO and the HFSA regularly referred to in their reports in the past years. In the absence of sufficient primary and secondary income ensured, increase in the retail loan portfolio “favoured” the government, as the declining standard of living was not so striking in the short term.
- <sup>28</sup> Structured Investment Vehicle (SIV), i.e. a special purpose business organisation specifically founded to restructure and transfer asset-backed bank loans. During such transactions, securitised credits are financed by short-term asset-backed commercial papers (ABCP). A proven practice was that the bank that sold its assets to a SIV in order to avoid liquidity problems provided the company with a credit line.
- <sup>29</sup> In the autumn of 2007, long queues of depositors were lining up in front of Northern Rock bank in

order to rescue their savings from the bank in crisis. Coming from Central Eastern Europe, it was astonishing for me to see worried people in front of a bank with a national branch network in a developed market economy in 2007, i.e. 12 years after similar events involving the Hungarian Postabank. The activities of the British government and supervision have been harshly criticised since, and neglected control of the lending processes is a permanent issue in the Parliament. The British government resolved the crisis management of Northern Rock in an exemplary fashion, by temporarily – and relatively rapidly – drawing it into state ownership, and appointed a new management that reduced further loss of confidence.

<sup>30</sup> According to data by Bloomberg, the ratios of banks and insurance companies in total write-offs are 80 and 20 percent, respectively. 70 per cent of write-offs took place in the United States, 25 per cent in Europe and hardly 5 per cent in Asia.

<sup>31</sup> Erdős, M. – Mérő, K. (2008): The subprime crisis and supervision of financial organisations, *Hitelintézet* Szemle, Vol. VII. No. 5, pp. 491-519

<sup>32</sup> Publication of HFSA entitled “Risk Outlook”, 2008

<sup>33</sup> The theoretical bases needed to calculate VaR were laid down by Harry Markowitz (1952, 1987). He used a periodical standard deviation of return as the unit of measurement for VaR, and built his recommendation on portfolio selection around it. Consideration of the standard deviation in addition to the expected return or the expected portfolio value was seen again in the 1980s, when the American Securities and Exchange Commission (SEC) required a version of VaR to establish capital adequacy of brokerage firms. Use and wide spreading of VaR started in the early 1990s – at the time of financial bankruptcies. In 1994, investment bank JP Morgan launched its service called RiskMetrics, which could constitute the basis of any VaR model. In 1995, the Basel Committee accepted the requirement concerning banks' capital adequacy, which also necessitated an approximate calculation of VaR. On testing the systems of VaR, however, it was proved that it can fail just when the information obtainable from it is needed most, for example, in the event of financial crises. At the time of the Russian state bankruptcy in 1998, the hedge fund considered as the largest at the time lost solvency within a week despite a sophisticated VaR system of Long Term Capital Management. The bankruptcy of LTCM also pointed out that the extremely disadvantageous

change in the correlations may be accompanied by full draining of the secondary market of instruments previously considered to have acceptable liquidity. The approach of VaR, nevertheless, proved useful, because it helps bringing the risks assumed by the financial institution to a common platform.

<sup>34</sup> The government approved its decree No. 153/2009. (VII. 23.) on increasing the efficiency of consumer protection in the financial sector in June 2009, which assigns broader licences to HFSA.

<sup>35</sup> Finance Minister Timothy Geithner and FED President Ben Bernanke agree on the establishment of a new federal authority (Consumer Financial Protection Agency, CFPA), but the debate concerning its organisation is animated. The question is whether it is to function as a new independent authority or as a part of the FED. The concept of CFPA also matches the broader reorganisation concept of president B. Obama aimed at financial supervision. B. Bernanke regards FED as the most suitable to control the new supervision, considering that the monitoring of financial risks and consumer protection are closely related, and accordingly, combined management of the two duties may yield further benefits. Nevertheless, Republicans and Democrats were equally reluctant to assign further authorities to FED. According to their position, the federal reserve system has already failed on supervising banks and high-risk mortgages.

<sup>36</sup> The current tasks of auditing are addressed as a priority in the studies by Lukács, János (2009), Fekete, Imréné (2009), Boros, Judit – Rakó, Ágnes (2009), Ladó, Judit (2009) in the professional journal of the chamber entitled *Számvitel – Adó – Könyvvizsgálat* (Accounting – Taxation – Audit).

<sup>37</sup> Veress, József (2007) addresses the global and European losses of the Hungarian economic policy, annulations of economic theories and the lack of a marked definition of identity in depth. In the light of these, Veress states that the European Union did not know as early as before the crisis which Hungarian strategy to face.

<sup>38</sup> Source of data: KSH jelenti, No. 2008/9-10, Budapest

<sup>39</sup> J. M. Keynes's textbook (1965) is a collection of theses on various economic policies with political overtones. At the time of general weakening of the system of planned economy in 1985, the then single party organised a theoretical conference in

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- Kaposvár. The fundamental ideology adopted the tenets of American economist Robert Heilbroner on the general crisis of the capitalist production method and on the business civilisation about to crumble. In contrast to the crisis of the capitalism, the system of planned economy formulated along the state regulation was preferred. Presentations held by my former professors, Kozma, Ferenc and Kiss, Arthur referenced the possibilities of renewal of the socialist planned economy, i.e. decreasing the totalitarian nature of state intervention and more liberal representation of market elements. For more details on the subject, see Horváth, J. (1985), R. Heilbroner (1994). Gáspár, T. – Varsádi, Zs. (2009)
- <sup>40</sup> According to a letter written by leaders of the MNB (National Bank of Hungary) and the PM (Finance Ministry) to IMF CEO Strauss-Kahn on 4 November 2008, the government applies a strict restrictive policy, where the primary objective is financing capability of the country and reduced deficit.
- <sup>41</sup> Báger, Gusztáv and Pulay, Gyula (2010) present the peculiar transition of the Hungarian economy to a market economy, with the adequate and relevant finding stating that integration has taken place but convergence of Hungary has been basically omitted.
- <sup>42</sup> Prompt Corrective Actions (PCA) – The system of early intervention by supervisions was adopted in the USA in the early 1990s, when a vast number of banks went bankrupt. Adoption of the system in America seemed to have achieved the desired effect, after the number of bankruptcies of banks had fell to one tenth, although the result was not exclusively owed to PCA, as the American business cycle and M&A activities were surging in this period, which added to the stability of the financial system.
- <sup>43</sup> Capital Requirements Directives – CRD: A collective term for directives 2006/48/EC and 2006/49/EC that transferred the Basel II regulation in the *acquis communautaire*.

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