วารสารวิชาการผลประโยชน์แห่งชาติ
Nationl Interest
ISSN (Online): 2730-2393

Effects of the Global Financial Crisis in Hungary: Housing, Debt Crisis and International Support

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ABSTRACT

Hungary was the worst-hit amongst the Central European EU member-nations by the global financial crisis. Interestingly, its economy was performing quite well initially after the end of the communist rule in 1989. Hungary successfully reduced its debt from 90% of GDP in 1993 to 52% in 2001. But, since 2002, the debt situation in Hungary worsened significantly. In 2008, the global financial crisis led to immediate financial difficulties for Hungary which already had high Government debt and external debt. The lion's share of Hungary's government debt was foreign-owned. The household sector also had nearly two-third of its debt in foreign currency. As a result, there was a huge liquidity pressure on the Hungarian banks. The high debt levels of the economy did not leave enough room to absorb the shocks of the global financial crisis. The paper looks at macro management issues of Hungary before, during and after the global financial crisis with special emphasis on the debt issues of the housing sector. It also looks at the policy measures that helped to avoid a major banking crisis and regional contagion, including the support from the International Monetary Fund and the European Central Bank. This paper connects the economic legacy of the post-communist transition, with special emphasis on the housing finance policy, to the impact of the global financial crisis in Hungary.

KEYWORDS: Hungary, Financial Crisis, Debt, Economic Reform, Macro Management.

Received: 24/12/2024
Revised : 04/01/2025
Accepted: 17/01/2025

Introduction. Hungary was the worst-hit amongst the Central European EU member-nations by the global financial crisis (Darvas, 2008). After some initial hiccups, the economy of Hungary was performing quite well post the end of the communist rule in 1989 (Darvas, 2008). Hungary successfully reduced its debt from 90% of GDP in 1993 to 52% in 2001. But, since 2002, the debt situation in Hungary worsened significantly (Darvas, 2008). There were major structural inefficiencies of the Hungarian economy following its transition to a capitalist economic system (Dapontas, 2011). In 2008, the global financial crisis led to immediate financial difficulties for Hungary which already had high Government and external debt (Carare, 2009). The lion's share of Hungary's government debt was foreign-owned (Darvas, 2008). So, there was a large-scale sell-off of government securities by non-residents (IMF, 2011). The household and private sector also had a large amount of foreign currency denominated loans, because of the high domestic interest rates in Hungary (Horvath, 2009). Before the crisis hit, almost half of company loans and two-third of household debt in Hungary was in foreign currency, particularly in Swiss francs, US dollars and Euros (Gupta, 2023). The Hungarian forint depreciated rapidly against the Euro. There was a speculative run on the forint (Thomas, 2010). These developments, including an increase in the usage of FX swaps, led to huge liquidity pressure on the Hungarian banks (IMF, 2011). There was also the risk of spillovers to the region (IMF, 2011). The high level of financial and trade integration achieved by Hungary left it highly exposed to external shocks (IMF, 2011). On the other hand, the high debt levels of the economy did not leave enough room to absorb these shocks (IMF, 2011). The banking sector of Hungary was largely foreign-owned as well as heavily dependent on international bank flows (IMF, 2011). The troika of the International Monetary Fund, the European Commission and the European Central Bank came together to play an important role in helping Hungary manage the economic crisis (Piroska, 2017). The paper would look at macro management issues of Hungary before, during and after the global financial crisis with special emphasis on the debt financing issues of the housing sector. It would also look at the policy measures that helped to avoid a major banking crisis and regional contagion, including the support from the IMF and the ECB.

Economic Legacy of the Post-Communist Transition in Hungary

Hungary, then officially known as the Hungarian People's Republic, was a communist state with a planned economy from 1949 to 1989. It inherited a large government debt from the Communist era along with a legacy of high rate of unemployment and low competitiveness on the international market. In its initial period, Hungary also suffered from a breakdown of trade with the former Soviet Union which collapsed in 1991. This meant a loss of access to cheap energy and raw materials (Adam, 1995). There was a resultant decline in industrial productivity in Hungary during this period. The GDP of Hungary fell by almost twenty per cent in the first three years after the collapse of the Communist rule (OECD, 1998). Hungary, now officially known as the Republic of Hungary, had to go for extensive economic reforms. Hungary was a front-runner among the former socialist countries of Eastern and Central Europe in bringing about these economic reforms and transitioning towards a market economy from the erstwhile planned economic model (Valentinyi, 2012). The process of reform in 'domestic and economic policy' to bring about the transformation of the socio-economic system of Hungary had actually begun much before the end of the Communist rule in 1989 (OECD, 1998). Through various macroeconomic and liberalisation measures, the authorities were able to gradually bring down the debt to GDP ratio from the peak of 90% in 1993 (Darvas) to around 50% by 2001 (Horvath, 2009). Between 1995 to 2004, Hungary showed relatively rapid growth in terms of its GDP per capita (Valentinyi, 2012). However, towards the turn of the century, Hungary lost this positive momentum. In the early 2000s, early FDI-led growth coupled with privatization of state-owned enterprises and banks opened up the road to debt-based growth (Gagyi, 2023). By 2007, Hungary's macroeconomic performance in key areas like GDP growth, inflation and current account deficit was worse than its peer nations of the V-4 group (namely Poland, the Czech Republic and Slovakia) (Horvath, 2009).

Housing Finance Policy of Hungary in Post-Communist Period

An important dimension of the post-Communist economic reforms was the housing finance policy (Rózsavölgyi & Kovács, 2005). The Government had abolished the Socialist-era housing subsidies, which included heavily subsidised housing loans as well as an up-front subsidy based on the size of the household, after the collapse of the Communist rule in Hungary in 1989 (Rózsavölgyi & Kovács, 2005). During the initial days of the transition, there was no comprehensive housing policy. In the 1990s, there was no preeminent role of loans in housing finance (Rózsavölgyi & Kovács, 2005). From the year 2000 onwards, however, the Hungarian authorities began to devote greater attention towards this. The Government introduced a new housing subsidy scheme, with focus on subsidising interest rates on long-term mortgage loans. This new scheme allowed for interest rate subsidies on loans for purchasing and building new homes, as well as on loans for buying, expanding and modernising existing properties (Rózsavölgyi & Kovács, 2005). There was also a personal income tax benefit attached to the housing loan repayments – for example, around 40% of the loan repayment could be deducted from the tax base in 2002 (Rózsavölgyi & Kovács, 2005). As a result, between 2002 to 2008, there was a dramatic increase in real estate prices in Hungary (Egedy, 2012). However rising prices did not dissuade Hungarian buyers from getting more loans to buy properties. The people, on the other hand, were also able to switch from lower consumption and indebtedness to greater consumption levels (Rózsavölgyi & Kovács, 2005). But the subsidies posed a huge burden on the Hungarian government budget. There was a sharp hike in fixed investment in real estate by the household sector along with a dynamic consumption growth. In 2003, under fiscal constraints as well as concerns about internal and external economic stability, the Hungarian government decided to substantially cut back the housing subsidies. The households were now looking for an alternative source of low-interest rate financing for their housing requirements (Rózsavölgyi & Kovács, 2005). Under these circumstances, several banks in Hungary began to launch a wide range of foreign currency credit products, including new instruments like the foreign-exchange denominated mortgage, which enabled them to target a wide range of potential customers. Many foreign banks also entered the Hungarian market to offer foreign currency loans to the citizens. The citizens preferred to take the loans in foreign currency because of high domestic interest rates (Horvath, 2009) as well as the 'tightening conditions of public interest subsidy system' (Egèdy, 2012). There was also a general expectation about Hungary joining the Eurozone soon. The citizens benefitted from the lower nominal interest rates of the loans denominated in foreign currencies. The foreign currency housing loans saw a dramatic increase by more than 400 per cent as a proportion of GDP, between December 2003 and September 2004 (Rózsavölgyi & Kovács, 2005). By 2008, foreign currency loans consisted of around 60 percent of the total housing loan portfolio of Hungary (Rózsavölgyi & Kovács, 2005). Household debt had increased from mere 5 per cent of GDP in 2000 to a whopping 30 per cent in 2008.

Economic Scenario in Hungary prior to the Global Financial Crisis

In general, economic activity in this period prior to the global financial crisis was sustained using substantial foreign borrowing by both public and private sectors. External debt had increased to 140 per cent of GDP and public debt to 80 per cent of GDP (IMF, 2012). Before the global financial crisis, Hungary had the largest government debt and net external liabilities amongst all the newly joined EU member-nations (IMF, 2008). There was a large fiscal deficit. During the early 2000s, there was an abundance of liquidity in international capital markets which boosted capital inflows into Hungary and helped to keep the current account of the economy in balance (Piroska, 2017). With the advent of the global financial crisis there was no longer the erstwhile easy capital flows into the country. The volume of FDI flows into Hungary fell by around two-thirds of its previous value. The debt pressure coupled with the impact of the global financial crisis destroyed the power and stability of the Hungarian forint, which was somehow safeguarded thus far (Egedy, 2012). It had a 15 per cent depreciation compared to the CHF and 17 per cent depreciation compared to the EUR between the Q4 of 2008 to the Q1 of 2009 (Egedy, 2012). The sharp depreciation of the forint relative to the Swiss franc increased the debt burdens of those Hungarians who had borrowed in foreign currency. The Hungarian central bank raised its interest rate to support the forint.

Impact of the Global Financial Crisis in Hungary

The global financial crisis impacted the labour market causing shrinking employment opportunities and job losses, as well as the economic conditions of households in Hungary – including their income and savings. The gap between rich and poor widened as many slipped to the lowest levels of income. The level of indebtedness of poorer households increased (Egedy, 2012). The decline in aggregate demand in Hungary impacted economic activity within the nation (Egedy, 2012). There was a fall in the real GDP by around 6.7 per cent and in industrial production by around 18 per cent between 2008 and 2009 (Egedy, 2012). This was accompanied by a rise in the inflation and unemployment levels. The unemployment initially increased moderately between October 2008 to January 2009, especially in the industrial centres. But between January 2009 to May 2009, the unemployment rate shot up rapidly across all regions of the country (Egedy, 2012).

Although not directly, but several Hungarian banks like Erste Bank, Raiffeisen Bank, UniCredit Bank, Intesa Sanpaolo, BLB, Volksbank, GE Capial etc, which are subsidiaries of foreign banks, were exposed to the sub-prime crisis through their western European parent banks (Piroska, 2017). The majority of the private sector loans were denominated in foreign currencies, because of the high spread between foreign and domestic lending rates. As the net foreign currency liabilities increased, the risk to the banking system multiplied (Egedy, 2012). In 2008, as the global financial crisis emerged, Hungary suffered from a lack of credibility because of its high fiscal deficit and public debt. Hungary's economy was highly susceptible to the risks of investor flight in the short term (Gupta, 2023). The global financial crisis caused the Hungarian assets to be perceived as riskier (Dapontas, 2011). The major vulnerability of the economy was that government debt was mostly owned by external investors (Dapontas, 2011). As the financial crisis broke out in 2008, the foreign investors began to sell the Hungarian government bonds but there were no buyers and the government bond market dried up. The Hungarian central bank was unable to auction new issues despite efforts to promote foreign currency liquidity and the government bond market (Dapontas, 2011). The global financial crisis brought stress in foreign exchange markets. The banks, especially those without a foreign parent bank, found it difficult to roll over FX swaps due to rollover risks and margin calls on swap contracts (IMF, 2011). All these contributed to a heavy liquidity pressure on the Hungarian banks.

Strategies Undertaken to Deal with the Global Financial Crisis in Hungary

To solve the various adverse issues caused by the global financial crisis in Hungary, there was a need for high policy discipline as well as large external funding (IMF, 2008). The Hungarian government, in its policy responses to the financial crisis, focused on improving fiscal sustainability and financial stability (Carare, 2009). It reduced its spending so as to enable smooth and swift debt repayments. The authorities maintained financial stability by ensuring adequate liquidity and capital in the banking system. They also wanted to safeguard the small and medium enterprises along with helping the households troubled with foreign currency loans. The central bank undertook various measures to energize the forint markets and provide forint and euro liquidity to domestic and external market participants (Gupta, 2023). A scheme of short-term collateralized loan tenders was introduced to provide liquidity to the banking sector (Gupta, 2023). Hungary received major funding support from the troika institutions consisting of the International Monetary Fund, the European Commission and the European Central Bank. Hungary was, indeed, able to avoid a complete financial collapse. Before the assistance program, Hungary only had a two-month cash buffer and therefore needed the support to absorb the shock of the financial crisis (IMF, 2011). The liquidity pressure on the Hungarian banks due to forint depreciation was handled by the Stand-By Agreement with the IMF for Special Drawing Rights of 12.3 billion Euros in November 2008 (IMF, 2008). This was the largest financing package by the IMF at that time after the support to Turkey in 2002 and Korea in 1997 (IMF, 2011). The Stand-By Agreement also helped towards facilitating financial and banking reforms in Hungary, restoring market confidence as well as easing the debt-financing needs of the government (IMF, 2011). It may be noted that, according to Article 143 of the EU treaty, Hungary, being a member of the European Union, had to first seek the approval of the Economic and Financial Committee of the EU regarding its balance of payments before approaching the IMF (Gupta, 2023). There was also the recognition of the underlying risk of a contagion both in the euro area as well as in the broader Central and Eastern Europe region, and therefore the need for immediate assistance to Hungary (IMF, 2011). There was a potential for financial spill-overs to other countries, given that the largest domestic bank of Hungary, OTP, had exposure to the Central and Eastern Europe region and similarly several euro-area banks had exposure to Hungary through their subsidiaries (IMF, 2011). A financial meltdown in Hungary would have led to major losses for the foreign parent banks who had their subsidiaries operating there. The EU agreed to join the negotiations between the Hungarian central bank Magyar Nemzeti Bank and the IMF, in light of the urgency of the economic situation in Hungary. Both European Commission and the European Central Bank were present at the negotiations on behalf of the EU, with their respective perspectives and objectives. This was the first case of an EU/IMF joint program for supporting a nation (IMF, 2011). It set a strong precedent for similar cases in the future (IMF, 2011). The relevance of the troika of IMF, European Commission and ECB increased in the years following the crisis (Piroska, 2017). The MNB entered into a bilateral repurchase agreement of 5 billion Euros with the European Central Bank for addressing the liquidity issues in the domestic foreign exchange swap market (Piroska, 2017). The MNB stated that the swap facility would be made available to all resident credit institutions that came under their reserve requirements (Gupta, 2023). The ECB could provide this repo facility under the provisions of Articles 111 and 23 of the Protocol on the Statute of the European System of Central Banks (Gupta, 2023). The MNB, on the other hand, was acting under the powers bestowed upon it by relevant sections of the Magyar Nemzeti Bank Act (Gupta, 2023). The joint assistance program by the IMF and the EU was successful in stabilizing the financial conditions and reducing financing needs (Gupta, 2023). Hungary was able to issue euro-denominated bonds of € 1 billion in July, 2009 (Carare). The earlier problems regarding the auctions of government bonds also got solved. The IMF-supported economic assistance program to Hungary helped to avoid a contagion like the 1997 Asian financial crisis (Horvath, 2009). This was achieved through the strengthening of financial sector balance sheets through structural reforms, improving the financial market conditions and standing strongly beside the Hungarian Government (Piroska, 2017). The IMF also highlighted to the Hungarian authorities the need to support the 'systemically important' domestic banks in order to boost their credibility (Piroska, 2017). The ECB was focused on its agenda of stabilizing the eurozone. The assistance through the financing package came at the right time, when the financing difficulties for Hungary were most severe. The final program package to Hungary also had some contribution from the World Bank. Mr Andras Simor, the governor of the Hungarian central bank during the global financial crisis, later acknowledged that the "IMF /E.U. umbrella was very important in keeping the confidence of foreign investors" (Thomas, 2010). The investors felt confident that, after the conclusion of the agreement with the IMF, the Hungarian authorities and the banks will be able to fulfil their financial obligations (Piroska, 2017).

Conclusion. Hungary somehow avoided the currency and financial collapse with the help of rescue packages from the troika institutions (Horvath, 2009). The aid of the financial institutions also helped in avoiding a major banking crisis and a regional contagion. The Hungarian economy gradually recovered from the financial crisis. However, there are important lessons to derive from its vulnerable situation on the eve of the global financial crisis, which had structural and long-term causes. Some of these causes came from the post-Communist transition period in Hungary, which saw a transformation of the socio-economic system. Even before the global financial crisis hit, Hungary's macroeconomic performance was not satisfactory. The serious issues relating to indebtedness needed to be solved. In such a situation, balanced and prudent macroeconomic policies and comprehensive structural reforms, keeping in mind fiscal sustainability, are necessary to be adopted by the policymakers.

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