

# CONFERENCE REPORT

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## **BUDAPEST ECONOMIC FORUM ABOUT THE HUNGARIAN MONETARY POLICY**

When the financial crisis drama started, Hungary was exceptionally vulnerable to it due to its pre-crisis policy mistakes, high debt, and the lack of international reserves. Thus anti-cyclical policy measures could not be implemented. Therefore, particularly painful, pro-cyclical austerity policies had to be taken. These measures, in turn, opened the door for populist policies. After the 2010 election, the new government formed by the Fidesz party relied on its supermajority to adopt sweeping constitutional changes and unorthodox economic policies. Since then, a growing financial nationalism distinguishes Hungary from its European partners. Through confrontations with the Fidesz government, the Hungarian Central Bank (MNB) had retained its independence, but after the appointment of a new Governor in 2013, a U-turn followed in monetary policy. Major changes occurred both in organisational and in political terms. Ten measures of a “well-functioning Hungarian banking system” (Fábián – Vonnák 2014) have been implemented, but the inflation targeting as monetary policy regime remained.

When the previous central banker management’s mandate expired in 2013, they preferred not to talk in front of the public, and refrained from criticising the monetary policy of the ensuing era’s steps and decisions. This gentleman’s credo changed at a very interesting panel discussion of the Budapest Economic Forum held on October 2, 2014, in Budapest. The title of the discussion was “*Cen-*

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*tral bank governors among themselves: Manoeuvring room of the Hungarian economy in the world*". This report summarises this debate and illustrates it with figures and time series of the Hungarian monetary policy (inflation, base rate, FX rate, reserves, and loans).

### **The participants**

More than 200 experts participated at the Budapest Economic Forum 2014 conference, which had a monetary policy section, whose moderator was István Madár, Senior Analyst of the economic and financial on-line news website *Portfolio*. The members of the section were the former MNB governors: Péter Ákos Bod (1991–1994), György Surányi (1990–1991 and 1995–2001), Zsigmond Járαι (2001–2007), Vice-governors Ferenc Karvalits (2007–2013) and Ádám Balog (since 2013). The previous and the present governors, András Simor (2007–2013) and György Matolcsy (since 2013), were absent from this event.

### **The debate**

The first theme of the conversation was that having an enlarged role and using more instruments is normal for the central banks when there is a financial melt-down. Bod mentioned that there would a general global consensus that day when the responsibility for system stability defines key objectives and tasks for central banks (see, for example, Benati – Goodhart 2008).

According to Ádám Balog, the MNB supports and strengthens financial stability with the resources at its disposal, especially after it merged with the Hungarian Financial Supervisory Authority in 2013 in order to ensure harmony between micro-prudential regulatory supervision of the individual risks of institutions operating in the financial intermediation system on the one hand, and macro-prudential regulatory supervision, which monitors systemic risks posing a threat to the entire financial system, on the other.

According to Bod, it is difficult to find the responsible person or institution in times of crisis. Nevertheless, politicians around the world were quick to put all the blame on the commercial banks. But in reality, the authorities were responsible, too. They should have regulated long before the collapse of Lehman Brothers. Járαι mentioned that the current management of MNB did completely different things than the previous one. Járαι's contention was questioned by Karvalits who said that when Járαι was the governor, he acted in exactly the opposite way

as J rai had just said – according to Karvalits, J rai used to argue in favour of a strong HUF for the weak economy.<sup>1</sup>

J rai replied that different instruments were needed in different times. Karvalits argued in favour of a more flexible inflation targeting monetary regime. Sur nyi noted that there was nothing new among the measures of the ECB and of the FED, and that central banks had been using these instruments for a hundred years, for example open-market transactions and quantitative easing. According to him, the FED acted much better than the ECB. Sur nyi contended that the Inflation Targeting (IT) regime had failed, and today the world was facing the threats of a deflation; he continued by noting that there was no longer a “Spanish Curtain” between monetary and fiscal policies. According to him, for many years prior to the crisis, the MNB believed in the self-regulating nature of the financial markets and in their efficiency. It assigned itself the role of a “night watchman”, and rejected out of hand any approaches that ran contrary to this.

Balog resented that the novelty and originality of the recent measures of the MNB were not acknowledged by the participants. According to the present vice-governor, they are trying, and succeeding, in finding less orthodox solutions to problems through the concerted application of monetary policy.

### **Inflation and exchange rate data**

Balog said that even though Hungary had adopted the IT regime in June 2001, it could not have worked until the recent times. The reason was that by maintaining a range until the spring of 2008, there was an interventional zone, then the crisis set in, and therefore the MNB could not really focus on IT. However, after that period, the circumstances allowed it. Sur nyi mentioned that before 2013, the core inflation had been lower than the headline inflation, but despite that, the central bank modified the base rate in connection with the headline inflation level. The tendency today seems to be the opposite: the core inflation is higher than the headline inflation (see *Figure 1*). Balog was working with incorrect data: the core inflation and the constant tax rate index is 1.5%, therefore the inflation target has been reached (see *Figure 2*). After this personal insult, Sur nyi remarked that it was regrettable that Balog did not understand the basic connections of the theory. Like a teacher, Sur nyi explained in front of the audience that the inflation target was  $3 \pm 1\%$ , so if inflation was 1.5%, it would not not satisfy the criterion.

<sup>1</sup> According to the author of this report, if we examine *Table 1* we can see that Karvalits was right: J rai never voted to decrease the prime rate between 2005 and 2007, while Karvalits voted the most (46 times) to maintain the rate between 2007 and 2013.

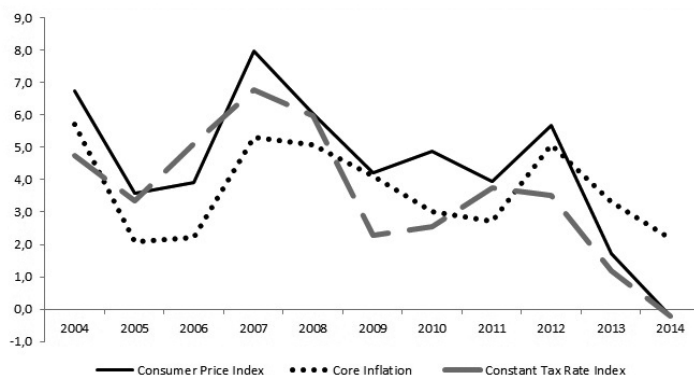


Figure 1. Core inflation – year-on-year changes

Source: MNB.

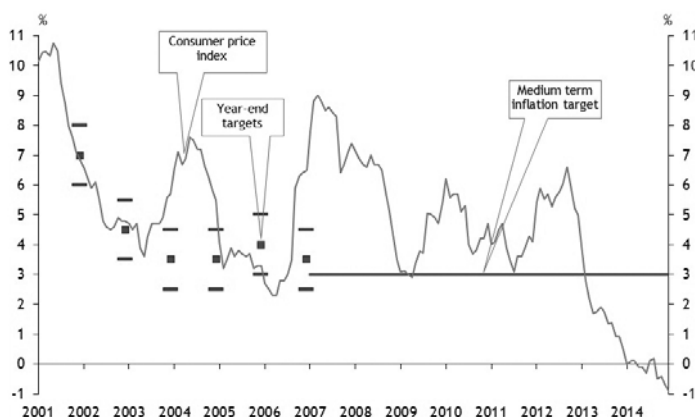


Figure 2. Inflation and targets, 2011–2014

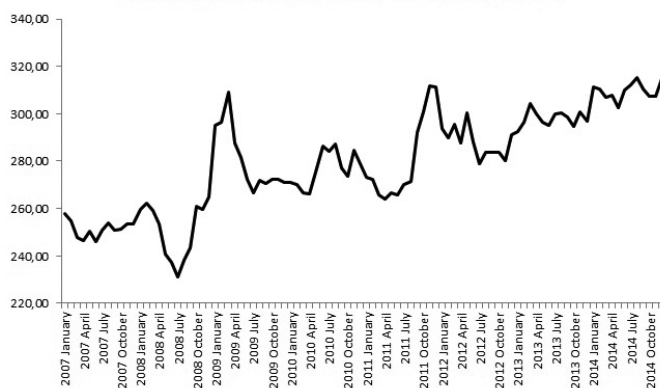
Source: MNB.

If we look outside Hungary, the effectiveness of IT regimes is subject to heated debates even in big, closed, developed economies, while in the small, open economies of Central and Eastern Europe, the track record of IT regimes is very poor. A long series of empirical studies have already proven that the interest rate channel in these countries is much weaker than the FX-rate channel. One may or may not believe in IT regimes, but it cannot be disputed that the only effective tool of the central bank is the FX rate – in a small, open economy. Hence, a central bank operating under an IT regime should, in practice, target the FX rate and adjust its

interest rate level to the “implicit” FX target that is consistent with the inflation goal (Surányi 2009, 2010).

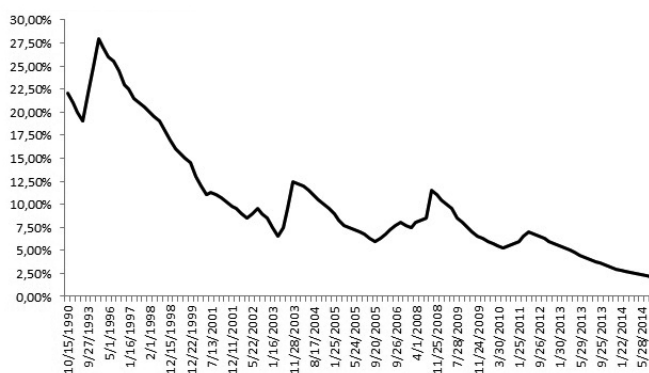
According to the author of this report, the major risk of the IT regime in an open, export oriented small economy like Hungary is that the central bank cannot intervene in the currency market. *Figure 3* demonstrates the changes of the HUF exchange rates between 2007 and 2014.

The monetary council decreased the prime rate in long term (*Figure 4*). During the Lehman crisis, the council raised the reference rate by 300 basis points.



*Figure 3.* EUR exchange rate at the end of the month, HUF, 2007–2014

*Source:* MNB.



*Figure 4.* The Hungarian Central Bank's prime rate, 1990–2014

*Source:* MNB.

The interest rates remained unjustifiably high for many years, which contributed to stimulating domestic demand for foreign currency loans. According to Karvalits, their decisions should be judged on the basis of the information that was available at the time of the decision making. Even an *ex ante* risky decision might become an *ex post* good decision, and vice versa, an *ex ante* responsible decision might become an *ex post* bad decision.

Table 1

Interest rate decisions of selected members of the Monetary Council, 2005–2014

Members	Voted to increase	Voted to reduce	Voted to maintain	Meetings attended
Ádám Balog	0	16	2	18
Zsigmond Járαι	8	0	9	17
Ferenc Karvalits	10	15	46	71
György Matolcsy	0	15	2	17
András Simor	12	15	44	71

*Note:* Non-attributed voting records of the Monetary Council were published until September 2005, and individual voting records have been published in the minutes since then. On October 22, 2008, there was an unscheduled interest rate decision; the minutes of that meeting have not been published.

*Source:* MNB.

If we analyse the rate decisions of the Monetary Council (MC),<sup>2</sup> we can state that under Governor Simor, there were 74 rate decisions altogether: 42 times there was neither base rate raising nor base rate decreasing, 23 times there was base rate decreasing, and only 9 times did the MC decide to raise the base rate. During the next period, under Governor Matolcsy, there were altogether 19 rate decisions: 2 times there was neither base rate raising nor base rate decreasing and 17 times there was base rate decreasing. Keeping the prime rate (*Figure 4*) at a record level low is a good thing.

According to Surányi, the first and foremost mistake was the inadequate level of foreign exchange reserves that made Hungary among the first to request outside assistance, in the form of international credit, in autumn 2008, following the outbreak of the global financial crisis. At that time, Hungary was not able

<sup>2</sup> Members of the MC: The Governor, as chairman of the MC, the deputy governors and other members, elected by Parliament for six years. Hungarian citizens with outstanding theoretical knowledge and practical professional expertise in issues related to monetary, financial or credit institution activities may be appointed or elected members of the MC (See Act CXXXIX of 2013 on the MNB).

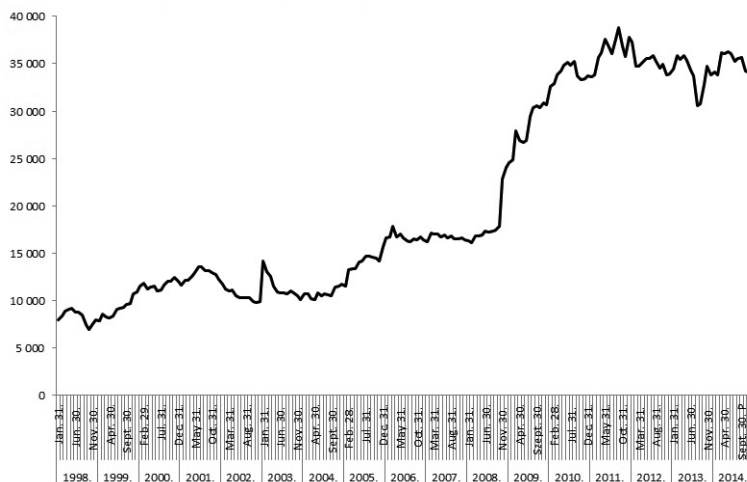


Figure 5. Total reserve assets, million EUR, 1998–2014

Source: MNB.

to accumulate reserves to counterbalance the external shocks – there was a lack of reserves that would have enabled fiscal policy to operate anti-cyclically. The explanation for this is basically that the central banks of the other countries in the region had sufficient international reserves – enough to bridge a few months. In stark contrast to this, the MNB’s foreign exchange reserves were low, not only relative to the country’s foreign debt, but also in comparison with imports. In this respect, Hungary really was the most vulnerable economy in the Central European region in autumn 2008. The central bank’s foreign exchange reserves totalled 16.3 billion euros (*Figure 5*). The external debt of the Czech Republic, which is similar in size and has a similarly open economy, was half the size of Hungary’s, but it had reserves of 27 billion euros when the crisis broke out. In proportionate terms, this level of reserves was three times of Hungary’s. The MNB’s explanation, officially downplayed, that the international reserve requirement analysed using the Guidotti model only pointed to a significant shortage of reserves two or three months before the crisis emerged, is not a convincing argument. If the decision-makers had simply taken a look at the countries surrounding Hungary, and/or applied the best-known rule of thumb – based on the estimation of forex reserves measured in terms of import value – then the severe shortage of reserves would have been obvious. Measured in terms of import value, the central bank’s currency reserve level fell to 2.4 months’ worth of imports, and this obviously was not due to an increase in the volume of imports from one day to the next. A year later, the country’s foreign exchange reserve exceeded 30 billion euros

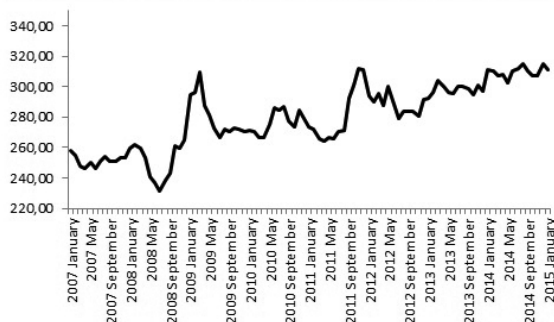


Figure 6. Exchange rate, million EUR, 2007–2014

Source: MNB.

(which corresponds to roughly five months' worth of imports). The low international reserves, however, prevented the central bank from performing one of its basic functions. Even over a short, 3–6-month horizon, the central bank was incapable of guaranteeing the liquidity of the Hungarian financial system without any major hitches; in other words it was only partially able to fulfil its role as the “lender of last resort” (Surányi 2010).

### The MNB's role in providing credit

The negative effects of the tax on banks' capacity to lend, and therefore on the supply of credit, were considerably larger than those on credit demand. The tax paid by commercial banks was much higher (as a share of GDP) than from bank taxes proposed in Austria, Germany, France, and the UK. Unlike in Hungary, each of those governments had to provide capital injections or otherwise intervene in failed institutions since the onset of the global financial crisis in 2008. If we examine the loans, we can see a decrease (*Table 2*). Without loans, there is no growth in the economy. Surányi mentioned that the central bank, playing a part in the weakening of the banking system will negatively impact on the Hungarian economy in the medium term. Thus, in violation of the Hippocratic Oath, it did harm to the national economy *via* the punishment of the commercial banks.



Table 2

Total loan portfolio to households, million HUF, 2009–2014

	2009	2010	2011	2012	2013	2014
March	8 069 490	7 449 655	7 597 592	7 183 924	6 892 163	6 477 475
June	7 349 858	8 193 274	7 860 934	7 002 555	6 597 189	6 426 389
September	7 378 210	7 905 602	8 254 176	6 797 243	6 570 518	6 416 277
December	7 407 011	8 139 637	8 041 633	6 758 215	6 414 266	

Source: MNB.

## CONCLUSION

Although the foundations of the Hungarian economy became more solid and sound by the autumn of 2014, the country is still unable to retain its ability to attract capital. The dilemma was that due to the permanent process of cutting the interest rate, the exchange rate of the forint was weakening in spite of a positive current account balance. The households' and the state's forint denominated debt increased and its deleveraging imposed a huge burden on the entire economy, in which actors could not increase their consumption and therefore the growth lagged behind and there were no investments.

I prefer not to conclude the paper with the assumption that irresponsible economic policies will be pursued in Hungary over the medium term. But in that case, the country had better become a member of the Euro zone as soon as possible, where the monetary policy is driven by the European Central Bank. If Hungary still prefers not to become a member of the Euro zone, more public debates like the one organised by *Portfolio* should be held. Let me close this report by voicing my pessimism about the forthcoming events regarding the international and Hungarian monetary policy.

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