The transformation and the ownership structure in Hungary

Katalin Botos[1]

Was there a transition at all in Hungary? Did the system changed at all in 1990? The answer of the author is yes. Not in the sense that from the society's top became bottom- as during the transformation after 1945- but in the sense that private property became again to be the basic feature of the economic system. We can follow the evolution of the economy in the mirror of the financial accounts. The players of the market, households, state and financial and non financial enterprises have changed their financial account positions during the period 1990-2006 markedly. The study based on HNB data follows carefully the changes in the asset and liability structures of households, state and enterprises and the financing capacity of each sector. The state's asset position has diminished, the households' has grown. But the great winner is the foreign owner's sector. It has an influence on the per capita GDP and GNI creating a marked difference between them. It is very important to have internal financing capacity because state budget has a deficit since decades. We don't have enough in the household sector therefore the country needs external financing. The study examines the roots of the international indebtedness of the country, the role of the economic policy and the banking sector's strategy (selling foreign-financed mortgage loans to the households). Today the state is in a much worse situation than before transition: State debt (and foreign debt of the country) is even higher than in 1990 and state's ownership (covering the national debt) is now on a minimum level.

Keywords: *asset and liability structure of firms, state and households, financing capacity, economic policy, foreign financing, international indebtedness*

1. Introduction

"Did political transformation took place in Hungary at all?"- sounds the passionate question one often hears everyday talks. .

If we look at the changes of the ownership structure in the country we may say that very basic transformation happened., actually twice. The first after the II. World War, the second after 1990.

[1] Dr. Katalin Botos, University of Szeged Hungary, Faculty of Economics and Business Administration (Szeged)

As a result of nationalisation the private ownership had been abolished by the communist forces in 1949, but regained its previous economic function by the privatisation after 1990. Legal experts claim that amendments to the Hungarian constitution in 1989 solidified the function and significance of private property to the highest degree. More, than in any country.

The newly emerged socio-economic system in Hungary could be presented in several ways. I chose to describe these changes on the basis of financial accounts data. (I rely on a recent publication of the Hungarian National Bank: Financial Accounts of Hungary. Data, analysis, methodology. National Bank of Hungary. 2008.) The sources of statistical figures in this article are referred to by page numbers of the quoted issue.

The present study has historical perspective and does not aim to analyse the effects of the financial-economic crisis of 2008 but the long term trends since 1990.

2. The citizen as proprietor

The economic model of the "existing socialism" after 1956 households were able to save some money. Their savings were generally disposed at mutual saving associations or branches of the National Savings Bank. People had holiday houses around the cities. The housing , too, became more and more financed by private credits from the Savings Bank (OTP).

In the years preceding the fall of communism, when the IMF surveyed public expenditure and did not allow money creation for financing the budget deficits, money was raised by issuing so called "dwelling fund bonds". Indebtedness was growing and so did subsidies from the state budget for housing. As a consequence of the political transformation in 1990, *the composition of household monetary assets has changed quite a lot*

In order to cut budgetary expenditures the new government of 1990 offered to abolish the other half of credits if debtors paid back their credits before the deadline. A number of advance repayments occurred, a lot of people, who could afford, took. Massive repayments happened. The savings of the population diminished .Later it started growing again. Between 1993 and 1998 financing capacity of the households stabilised around 10 % of the GDP but again gradually decreased in the late 90ies. In 2003 it amounted only to half a percent. (p. 75) The reduction was partly the result of a housing boom due to increased state subsidisation of housing. Private investments in housing inevitably used up household savings and as a result these savings could no longer cover budget deficits. Without household savings there is a heavy pressure for external financing of budget deficits, which became a cardinal problem by now in Hungary.

Originally most of the savings was in form of bank deposits or cash. By the beginning of the 1990's the rate of cash or deposits within household's monetary assets decreased by half. Stock ratios and business shares added up to 25%, non-

stock based securities and insurance reached only 7 %. By 2007 only 36% of household monetary assets were found in cash and bank deposits, business share ratios stayed at 25-26% (p. 46). Business share assets were about fourfold higher than stock share assets. These assets arose in the early years of political transformation and were due mainly to privatisation. On the other hand a great proportion of citizens were forced to launch their own enterprises in order to escape from collapsing workplaces. So they became owners of business shares. Although little profit could be expected from these enterprises they offered self-employment at least.

Following a wave of privatisation in 1995, investment in stock exchange shares increased to 5% but fell back to 1,5 % after the Russian crisis. In the portfolio composition of the households we find investment coupons, public securities and mortgage bonds, too. The most spectacular growth can be seen in insurance and pension insurance savings. The rate of pension insurance savings rose from 4% to 18%. It must be admitted though that the above transition did not begin spontaneously. It involved a certain legal compulsion since entrant employees were obliged to enter pension insurance funds in 1998.

As a consequence of amendments to taxation laws in 2006, investment yields became exempt from the 20% interest rate tax. Additionally, the taxation of the gain on the exchange was abolished. This measure drove remarkable amounts into unit trusts. Nevertheless, significant capital market boom should not be expected from that, since unit trusts put the money in bank deposits. This means that *people keep their money in banks indirectly rather than directly.*

Financing capacity *of the private sector* is greatly influenced by its liabilities. Let us take a look at the credit portfolio of the population. Prior to the fall of communism the population was given significant credits connected to housing. In addition to housing loans, collateral loans, car purchase loans, free credits on mortgage and student loans were introduced later on. According to data from 1990 the ratio of personal credits to the GDP had scarcely exceeded 10%, whereas this ratio trebled by 2007 reaching 29% (p. 47). A sudden increase in currency credits can be seen after 2002. By 2007 and 2008 60% of the total personal credit portfolio was credit in foreign exchange- mainly in Swiss francs. Interest rates of those currency credits were lower; therefore they were more easily financed, unless exchange rates tottered. In the case of devaluation of the forint currency credits become very expensive for Hungarians

Our credit portfolio is still behind the average of the European Union, it amounts to 29% of the GDP (in 2007), while in the European Union this figure is 65% (p. 48). Even in two decades we did not manage to catch up with European countries whose citizens were more successful in achieving middle-class status. No wonder, since Hungarian salaries are one-fifth of the average European salaries.

To sum up financial situation of the households: Notions have different meanings in Hungary: shares in investment mean (indirect) bank deposits rather than

real investments in securities, and business shares are rather for self-employment than for real competitive ventures, so how could we possibly reach a strong, wealthy middle class? *If GDP per capita is one half of the European average but salaries reach only one-fifth of the European level, relative numbers will hardly resemble that of the European Union.* In other words, Hungary has only quasi middle-class with quasi property structure. Not to mention the dispersion of incomes, the analysis of which, however, is not within the scope of this study based on financial accounts.

3. The state as (the) proprietor (of monetary assets)

The question of state property is of primary importance when one intends to assess the economic processes of the past twenty years. *As real balance sheets were not available at the time of transformation and are not at our disposal even to this day*, I rely in this respect on the information available in the publications of the National Bank of Hungary. From the publication of the HNB the *financial ratios* can be used for the evolution of the gross and net capital of the state. The majority of corporations were public corporations before the fall of communism. *The value of public finance assets, that is the value of gross capital, was one and a half times as great as the contemporary GDP. By 2007 this value decreased to 20 percent of the GDP.* What concerns liabilities: At the end of 1989 the nominal value of the public debt of Hungary mounted to 1264 billion forints which equalled to 73% of the GDP.

A substantial portion of public debt derived from foreign currency credits, yet the state paid these debts to the National Bank of Hungary in Hungarian forints until 1997 when the so called " debt exchange schemes" were introduced.

Preceding the democratic transformation the National Bank of Hungary was considered by foreign creditors as the debtor. Naturally, it was seen as souverain debt. A number of analyses in the field of Hungarian history of recent past (Ignác Romsics, András Vígvári, János Honvári, Csaba Nagy, Katalin Botos) pointed out that facilities for the repayment of currency credits were not available. These credits did not result in exportable national production which would have yielded convertible foreign exchange. After 1979 public foreign debt increased remarkably because of a dramatic increase in international interest rates and the devaluation of the dollar. To make things worse the Hungarian forint was revaluated, although the deterioration of the balance of payments would have demanded the opposite. The reason for such a measure was to avoid inflation yet, suppressed inflation caused an even greater deficit in the balance of payments.

In 1982 Hungary had joined the IMF The foreign exchange policy of the 1970's, based on voluntarism could not be continued. As the balance of payments deteriorated, the forint was devaluated. This process continued for after the fall of communism, though the forint in the first half of the decade was still over -valuated. Under the era of György Surányi, President of the NBH a sliding devaluation of the forint was introduced.

The index for debt and GDP ratio rose above 90% by 1994, the end of the first democratic governmental period, since gross domestic product had decreased but debts had to be met at the same time. The balance of foreign trade closed with a deficit in the first two years of the second democratic government (1994-98), which meant that the deterioration of the balance of payments was due to the debt of the public sector. The public debt and GDP ratio was gradually decreasing from 1996 until 2001. Several factors, such as budget constrains, the introduction of the Bokros-package, and an increase in GDP during the second half of the 1990's – especially in the third governmental period – played a role in the decrease of the above ratio. Public debts were partly refinanced, partly repaid through selling national assets.

Unfortunately, budget deficit was continuously produced; by 2002 the public debt/GDP ratio stopped decreasing, and at the end of 2007 public debt amounted to 67% of the GDP. (Even this proportion has been substantially exceeded by 2009 November).

We have seen that household – sector was not able to finance budget deficit, which means a straight way to external indebtedness. The over-valuated forint contributed to it, too.

Taking into consideration the fact that current balance of payments was continuously showing a deficit one inevitably ponders over the phenomena of continues revaluation of the forint. Two processes took place that both influenced exchange rates. On the one hand an intense inflow of foreign currency began as a result of privatisation; massive privatisation process could be observed during the second governmental era (1994-1998). On the other hand a special foreign exchange policy introduced band based fixing of exchange rates. This policy opened the way to speculative attacks which, making use of higher interest rate levels, pushed exchange rates upwards. We might arrive at a strange conclusion from the above: *prior to the fall of communism it was the economic policy based on voluntarism which revaluated foreign currency, after the fall of communism currency was revaluated by the market, although real economic situation would not demand for that just the contrary.* Does it seem that we get the same results no matter what political system we have?

In *the first years of the democratic transformation monetary assets of the Hungarian state amounted to 250% of its liabilities, it decreased to 30% by 2007.* This fact clearly reveals that our present economic position is much more unfavourable than it used to be at the fall of communism since the *property coverage of our public debt decreased* in the highest degree.

4. Public finance deficit

This fact is rather shocking No one reckoned with the fact that the majority of the Parliament would not dare and *would not even want to protest* against governmental proposals creating deficit 15-20 years after the transformation.. The concern of MP-s was that whichever governmental party secured a place for them in the Parliament that party should stay in power. This dependence oriented them to accept the yearly budgets with huge deficits.

Debts had to be paid, so selling national assets became the a way of the financing the repayment of the country's debts. By selling state property for cash the ownership portfolio of the state was exchanged for funds; the most of which was used for debt reimbursement and a smaller portion covered current budget deficits. If a portion of those funds had been used for creating economic development funds, a faster growth of the GDP might have been facilitated, even though net public debt wouldn't have diminished. Debt service in that case would have remained a considerable item of the expenditure- side of the state budget. But if there is considerable economic growth, the relative value of debt might have even decreased! It is true, the operation of economic development funds requires civil servants of impeccable character. It must be admitted that temptation was (and still is) rather great for those in power to use governmental means for political purposes, although this is a rather sad reason for rejecting a rational alternative of economic policy.

Budget deficit and public debt are significant markers of economic policy. Low budget deficit (3 %to GDP) and lower than 60% public debt to GDP are preconditions for joining the euro zone, as well as diminishing the rate of inflation.[2]

If we take a look at financial data of member states from 2007 (based on a press release of the European Union, October 2008) it appears that most member states (15 members) closed the financial year of 2007 with a deficit. Only Greece (3, 5%) and Hungary (5%) closed with a deficit greater than 3%. The above data again represent the unique failure of recent Hungarian economic policy. If we take a close look at the dynamics of the Hungarian deficit index, we see that it slummed in 2002 and stayed at a low level, 8-9% of the GDP in 2006.

Let us not console ourselves with the fact that the leading economy of the European Union, that is Germany, also struggles with budget deficit — the shouldering of the German Democratic Republic by the German Federal Republic meant a serious burden on the German budget. Let us compare ourselves to Finland

[2] It is worth mentioning that the Maastricht concept of debt differs from the one used in financial accounting, and Hungarian authorities are to create a special notion for it deducted from the financial account data. The concept of debt accepted in Maastricht does not include portions of property, only cash, deposits, securities (without derivatives), and credits. It is a gross concept; claims are not deducted from debts. Particular debt items are calculated at face value rather than at marketable value.

who realised 5, 3% budget surplus, and we must wait the coming 20th anniversary of the democratic transformation of Hungary with discontent.

5. Finances of the corporate sector

To use a precise technical term in international statistics, we look at the financial accounts of non-financial corporations.[3]

It is a technicality of financial corporations that their assets and commitments change in the same rate, thus the amount of their net monetary assets, their balance is almost zero. Net monetary assets of non-financial corporations are, however, usually negative, since these corporations do not invest their financial resources into assets. (Exceptions to this are those *special purpose enterprises* whose function is to intermediate money between their foreign partners instead of financing production. For this reason they are not included in corporate account statistics.)

Finance requirements of corporations reached their peak during the second half of the 1990's, due to a boom of investments. The year of 2002 was a confine – enterprises became savers. Most obviously, this is an unfavourable phenomenon since it indicates that in the economy has less realisable income than in the financial sector, that is it is better to save income then reinvest… Where does the financial sector transfer the savings of the enterprises? The market shows that, because of the high yields on state securities, financial intermediaries concentrated on financing the state. This means that the corporate sector provided credit for the state occasionally...For instance in 2002, when the population's financing capacity decreased almost to zero, corporations became net financier. The corporate sector became net borrower again in the early years of the 2000.

In the resource structure of the corporate sector owners' shares and credits dominate: the owners' shares constitute about fifty percent. (The EU average is 55%, that is, somewhat higher.) Credits reach one-third of resources. (This rate is 29% in the European Union). Interestingly, credit ratio is much lower in Poland or Slovakia: it is around 20%. Commercial credits are more significant in these countries. *Foreign currency debts* of the corporate sector amount to more than 40% of the GDP (p. 61). Non-stock based securities are not common in former socialist countries such as Hungary, and they are rarely seen in the European Union either. Large-scale presence of such securities can be detected only in the USA, where credit ratio is very low, only 9% (p. 62).

[3] Financial corporations are too, enterprises as all the others, even if they operate with specifically greater external financial resources. For exactly this reason they form a different category. Undeniably, if we emphasise the entrepreneurial nature of banks their public service function is underplayed

Corporate resources are to provide for operation costs and the corporation's assets. The importance of monetary assets out of all assets is ascending, which is due to ownership and credit relations of corporations. Out of all assets cash, deposits, credits and ownership claims have a significant ratio. The greatest proportion is formed by other active debts, which amount to one third and include outstanding liabilities. Regrettably enough, the enforcement of lending through delayed settlements of outstanding liabilities has become fashionable recently. This process is not among the positive parameters of market relations; a process which we cannot be proud of in relation to democratic transition in Hungary.

As regards the *proprietary structure* of the corporate sector, we can establish that state ownership –as we have seen studying the state's asset structure- was characteristic of Hungary in 1989 as most corporations were owned by the state. In the past 18 years the ratio of state-ownership has lowered from 85% to 7 %. Private ownership rate reached 20% by 2007, while the percentage of foreign ownership has increased even more spectacularly. *Foreign* ownership rate reached 25% by the middle of 1990's and doubled by 2007. Property value of foreign investments increased from 39 billion forints (in 1989) to 15.200 billion forints. *Nowadays, foreign investors own fifty percent of Hungarian enterprises.*

The ratio of capital inflow and outflow is what counts. If national investors have at least as much invested capital abroad as the inflow of foreign capital –no problem should arise. At least, if their yields transferred back and forth are – by and large –balanced. In this case only the advantages of the division of labour are experienced and all parties make a profit. When the flow of capital is one-sided and economic development is based on external resources, a fundamental difference between the GDP and the GNI should be expected.

In an OECD report (OECD 2004) one can find significant and relevant data concerning the issues above. There is no significant difference between GDP and GNI in most of the OECD countries , there were no major differences between the development of the two indexes*, except in the cases of two or three countries – including Hungary.*

In Hungary the outflow of incomes was far higher than inflow; thus *GNI remained much lower than GDP*. This indicates indirectly that the ratio of foreign-owned corporations, the profit of which is mostly repatriated, is significantly high.

The welfare of a country's population depends on the income remaining inside the country. National consumption is (or might be) increased in the long run, if national income is spent or invested at home. Incomes transferred abroad work the same way – only in a foreign country. IF an FDI, it creates in the other country incomes in form of wages. Besides these issues, the dynamics of GDP and GNI are also strongly influenced by the *terms of trade*. Unfavourable terms of trade mean

that through the exchange of home made goods for imported goods income is drawn out of the country. According to certain calculations (see Botos J., 2009), the decrease in the terms of trade in the last ten years were almost as much as the GDP of a base year. Because of the price formations of external trade, that amount, one base year's GDP, flowed out of the country in 7 years. This could happen since one or two years of improvement was counterweighted by the deterioration of these terms in the remaining years. Analysts may come to think that the explanation lies in foreign-owned corporations. These corporations may influence the income remaining in the country by means of import, which in many cases comes from their subsidiaries... The formulation of transfer prices can be especially interesting from the point of view of taxation – besides, it can also influence GNI indexes. Keeping the setting of prices under control is a complicated task, the importance of which, in our view, has so far been overlooked by Hungarian economic leaders.

6. Summary

After the fall of communism financial accounts of market participants changed profoundly. On the one hand, the ratio of business share assets increased in the housholds' portfolio; on the other hand, it has decreased to the minimum in the state portfolio. The winners of all this are foreign investors– who became the owner of a significant proportion of Hungarian national wealth. Both the 'inherited' and the continuously 'produced' public finance deficit - financed from external resources- played a part in the above process. We had to sell out our wealth for foreign owner to finance our debts.

Economic policy after the fall of communism was mainly based on export-led development. We can conclude that such an economic policy, which was guided by external markets, is a cause and an effect at the same time – and did not serve social welfare in Hungary properly in the past decades. It is an effect of the significant outstanding total debt inherited from the socialist controlled economy, which made the economy become export-directed for the sake of foreign currency acquisition. It is also a cause because it invited too much foreign capital into Hungary as FDI-s. These foreign investments took the majority of their profit out of the country, blocking the way in certain sense for both present and future welfare development. It seems that Hungarian standards of living have little chance of reaching the Western European level in the near future.

We seem to have manoeuvred ourselves into an economic policy that proves to be dead end-if the final aim of any economic policy is to increase welfare in the society.

References

Antalóczi, K. – Botos, K. 1990: Lesz-e konvertibilis a magyar forint? A klíringtől a konvertibilitásig. Közgazdasági és Jogi Kiadó, Budapest.

Botos, J. 2009: Mi a teendő? Georgikon konferencia előadás, Keszthely.

Botos, K. 1987: Világméretű pénzügyi egyensúlyhiány. Közgazdasági és Jogi Kiadó, Budapest.

Botos, J. – Botos, K. 2005: *What can we expect from joining the EU?* In: Essays in Economics and Economic History. Heller Farkas Füzetek 1, Budapest.

Boriani, R - Johanson, A- d'Ercole, M. M. 2006: *Alternativ measures of well–being*. OECD, Social employment and working papers, 33.

Honvári, J. 2006: XX. századi magyar gazdaságtörténet. AULA, Budapest.

Magyarország pénzügyi számlái 2008. Magyar Nemzeti Bank, Budapest.

Nagy, Cs. 2007: Az IMF-csatlakozás elvetélt kísérletei. Heller Farkas Füzetek, Budapest.

Romsics, I. 2005: Magyarország története a XX. században, Osiris, Budapest.

Vígvári, A. 1990: *On the History of Indebtedness in Hungary*. Paper to the third International Karl Polanyi Conference 1990. November.