Research Report: The impact of crisis management solutions on SME development on the example of the ten Central Eastern European countries

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Central and Eastern Europe was badly hit by the world economic crisis, most countries suffer of recession and disequilibria. Most vulnerable to the crisis were countries that integrated at a greater level to the world economy, where export played an important role in generating national income, as well as countries with small domestic markets where demand could not compensate for losses related to the decrease in export. Crisis could be even deepened through the strong domestic need for external financial resources (e.g. Hungary, Baltic states). Countries with qualities described above have been hardest hit by the world economic recession and the financial crisis as of 2008. Central banks reacted quickly to the shortage and price increase of resources, they have started to decrease interest rates and enlarge money supply. This was complemented by bank saving and rescue packages of national governments, focusing on specific sectors as well as tax decrease.

Due to the shortage in resources the dynamics of investments and consumption broke and it has been felt in the negative impacts of the decreasing level of employment and lower savings. A classic model of overproduction took place where equilibrium could be restored only through lower level of output and demand. However, it has an important issue for governments, how quickly would households and companies be able to restore their previous capacity and stabilize their situation. States have developed domestic rescue and stimulus packages in order to advance stabilization of the enterprise sector and households after the recession, furthermore, to limit the social consequences of the crisis. Further to the financial character of the crisis, an additional burden on SMEs turned to be the difficulties of access to external financing resources.

Financial deepening in periods of stable economic growth and increasing real incomes is generally a natural phenomenon and it is normally indicative of strengthening confidence in improving economic prospects.[1] Loans are essential instruments in financing investment or consumption and their balanced and non-overheated growth is an important factor behind economic growth. Beside positive expectations for the future, the price of lending may also influence the growth of private indebtedness at an even greater extent. Cheap loans are a very important driving force behind increasing private demand for loan financing.

Interest rates had already been very low before the economic crisis in a number of EU countries; real interest rates in the Eurozone countries were sometimes even negative given the low ECB key rate and the relatively high inflation rate in some countries. In the “new” member states interest rates varied considerably, but in Hungary it was one of the highest in comparison in the whole Central European region. This cost factor is the key reason behind the specific structure of the private indebtedness that unfolded in a number of Central European countries. The high cost of domestic loans explains the shift towards inexpensive foreign currency denominated (FX) loans in Hungary. High domestic (forint) interest rates pushed private demand to turn towards foreign currency denominated loans. These FX loans started to become the major drivers behind the rapid

[1] Várhegyi (2003)

credit expansion of households and the corporate sector alike from around 2004 and they soon became the most important instruments in financing investment and household consumption. The subsequent risks associated with the exchange rate movements became apparent as early as the outbreak of the financial crisis and the Hungarian forint – given its vulnerability due to the external financing needs that affected public and private debt too – started to devaluate rapidly. The now much weakened exchange rate became permanent making financing private debt increasingly difficult. Foreign currency denominated loans started to play a pivotal role in shaping Hungarian household and corporate indebtedness as a unique feature in comparison with several countries in the region. As a result of the changing domestic and external economic environment, FX lending became one of the core reasons behind Hungary's macro-financial vulnerability, which manifested itself in the rising volume of nonperforming loans once the crisis unfolded and prolonged its negative impact on economic growth and the income position of households and the corporate sector.

From a macroeconomic perspective, the loans drawn directly from abroad by the private sector (in most cases by large firms which more likely hedged their exchange rate risks) are also important as they may also be affected by exchange rate changes. While the external indebtedness of the corporate sector obviously bears certain risks from a macroeconomic perspective, this is not the most problematic factor when it comes to indebtedness in Hungary, particularly since large firms had more or less managed to ward off the negative effects of the falling exchange rate. The greatest problems are associated with the indebtedness of households and small and medium sized firms that typically took HUF or FX denominated loans from the domestic banking sector. Due to both supply and demand side factors, these loans moved into focus after the unfavourable economic implications of the economic crisis caused increasingly worsening loan portfolios for the banks.

Loans to households and the nonfinancial corporate sectors and the trends of their indebtedness and repayment ability are very important in assessing the financial stability of a country and have significant consequences on economic growth and development. During the nineties, the conditions for household and corporate lending were unfavourable in Hungary and in most of the countries of the region. There was very little difference in this respect between the countries concerned. Unemployment was on the rise, inflation and interest rates were high and the banking system faced difficulties because of the large volume of non-performing loans – a result of the collapse of the domestic economy and the spiralling trend of bankruptcies in the corporate sector. After the consolidation of the banking system and the privatisation of the major banks, rapid changes begin to take place. When measured by bank lending as a share of GDP, the financial deepening witnessed significant changes at the end of the nineties. Before this period, the ratio of household and corporate debt to GDP was very small. The macroeconomic stabilisation which was coupled with decreasing inflation, together with the recapitalisation of the banking system and the changes in government regulations had contributed to the increasing loan activity especially in the household sector.[2]

[2] The most important issues to be regulated after international financial turmoil are analysed here: Bánfi–Kürthy–Bánfi (2011).

After the millennium indebtedness on all sides became typical in Hungary. The state, commercial banks, households and local governments were all severely indebted.[3] Due to the simultaneous emergence of several types of indebtedness, risks did not simply add up but multiplied. According to several analyses, the "balance sheet recession could be even more severe in an emerging economy that is greatly dependent on external financing because if foreign capital is withdrawn as a result of risk appetite, this increases deleveraging in the private sector and also narrows the opportunities for state borrowing."[4] In Hungary, the indebtedness of all sectors was the most important characteristic making the country's prospects widely different from other countries in the region prior to the economic crisis of 2008.

Macroeconomic changes and challenges

Since 1997-98 the strengthening institutional and legal conditions had set the scene for the normal operation of a credit and mortgage market. In addition to this, the supply side also experienced favourable stabilisation after privatisation of most of the financial institutions and the emergence of well-capitalised foreign owned affiliates. Increasing credit demand was also associated with improving economic environment and better income position of the population, which significantly contributed to the increasing need to satisfy their pent up demands. This was also an important factor in increasing demand for household loans.

All these factors however were insufficient to boost mortgage backed financing. A real breakthrough in the household sector came in 2001 with the introduction of a very generous state-subsidised housing loan scheme. In fact, these state-subsidised loans had almost entirely crowded out market based housing loans by 2003. In that year – due to the unsustainability of the system[5] – the terms and conditions of lending had been tightened and because of the high domestic interest rates (the key interest rate of the Central Bank of Hungary (MNB) was raised to 12.5% at the end of 2003), forint loans became very expensive again. This was the moment that gave rise to FX based loans. The surge of demand was not only driven by housing loans but it started to spread over all loan products in the household and corporate sector alike. Because of the extremely large price difference between FX and domestic currency denominated loans the demand dramatically shifted in favour of FX based loans.

As a result, a credit boom started, which also intensified the inherent risks in the system soon after the millennium, but the process speeded up dramatically after 2003-2004 when FX loans started to become increasingly popular. Cyclical credit booms are often followed by busts which negatively influence the developments in the real economy too. Credit booms are also oftentimes coupled with increased lending to a more risky set of clientele because of the fierce competition between the financial institutions. The precautionary measures displayed not only by the government and the players of the private sector but also by the central bank proved to be insufficient and ineffective. In addition to the factors that motivated the expansion of lending, the

[3] Giday (2013): p. 288. From a wider perspective see Landesmann–Gligorov (2010) and from another aspect Celasun–Harms (2011)

[4] Giday (2013): p. 287.

[5] The central budget subsidised the interest rate of these loans. Because the subsidised interest rates were much lower than the market rates, demand for these loans increased exponentially.

very low savings rate of the private sector must also be mentioned together with deposits, which had failed to expand at the rate of loans. By September 2008, total FX loans to households soared from HUF 380 billion in late 2004 to an incredible HUF 5500 billion, amounting to a surge in ratio from 10 to 60 percent.

The boom in FX loans can also be explained by the problems in economic and monetary policy. The rapid rise in the budget deficit increased the forint's risk premium, creating a growing gap between the interest rates of the forint and those of the euro and the Swiss franc.[6] Secondly, the policy of the central bank combining inflation with exchange-rate targeting also exacerbated the exceptionally high forint interest rate. The ratio of FX loans only surged in countries where the risk premium – raised by equilibrium problems – had significantly separated the interest rate of the national currency from the interest rates of currencies in the developed world.[7] Falling far behind the growth rate of loans, the low level of willingness to save affected the asset-liability structure of the banking sector and contributed further to the vulnerability of the Hungarian economy. As early as 2008 the banking sector had one and a half forints in loans for every single forint in deposits, which left Hungarian banks needing more and more resources from foreign money markets. As the crisis of confidence intensified, the renewal of loans necessary to fund state debts became uncertain and likewise, financing the bank sector became difficult.

It must be pointed out, however, that the Hungarian credit expansion was far slower than in several other countries of the region, and the problem was primarily put down to the low savings rate, which triggered the increasing reliance of the banking sector on foreign funds, and secondarily to the high interest rates, which prompted financial institutions, households and the corporate sector to turn towards FX denominated loans.[8] In 2006, due to the unsustainability of the budget position, austerity measures were introduced which in turn slowed immediately down the credit growth. The macroeconomic implications, which were felt almost immediately and included slower GDP growth and smaller real wage increase in the presence of higher inflation, impacted on the quality of the loan portfolio too albeit to a small extent. The slowing down of the loan expansion however was not in line with the worsening economic and income perspectives. The retail and the corporate sector thought the problems temporary thus they continued to finance their consumptions from loans.

The overspending of prior years/decades led to high public or private debt and fears concerning their repayment mounted gradually after 2008. The level of household indebtedness had played an important role in the investment activity in the years prior to the crisis. Mortgage loans which were available at low interest rates resulted in a rapid growth in housing investment. The tightening of credit conditions, the deterioration in the income position resulted in a substantial drop in the output of the construction industry and investment shrank to a fraction of its former levels. Although no real estate market bubble developed in Hungary, a rapid increase in mortgage-backed household indebtedness mostly denominated in foreign currency was typically evident. Faster adjustment needs were observed in the countries where the debt-to-GDP ratio was higher (such as in Hungary) and thus the decline in investment was more significant. The magnitude of indebtedness presented a less significant problem in the corporate sector: compared to the

[6] On the context of budget deficit and the bank lending see more details in: Moinescu (2013)
[7] Brown–Kirschenmann–Ongena (2010b)
[8] Varhegyi (2009)

household sector, the balance sheet adjustment requirement was lower in connection with the reduction of debts. The lending capacity of banks and other credit institutions weakened as the losses suffered on their loan portfolios and the negative revaluation of the remaining portfolio significantly worsened the balance sheets of banks. The contraction of funding sources and banks' falling risk tolerance still represented severe constraints to private sector entities, which had, in turn, cut back on their investment.

In principal two major instruments are available for managing or preventing over indebtedness of the private sector. First the ex-ante instruments aimed at preventing the building up of unbearable risks into the system must be mentioned while the second set of instruments are the ex-post ones, which are aimed at easing the burdens of the indebted households and SMEs in order to maintain their ability to repay earlier loans. The best system tries to strike a balance between the two groups of instruments in order to prevent much deeper problems. In addition the proper control and supervision of the financial institutions may function as an additional safety measure within the system.

Only one year before the crisis, the indebtedness indicators of the private sector started to deteriorate, debt service in relation to disposable income increased while the GDP virtually stagnated causing profit prospects for firms to worsen. The flagging income position was coupled with a high demand for loans because of the high competition on the supply side and the adamant belief that the implications of the austerity measures will only be temporary.[9] This had led to rapidly falling savings and increasing debts to finance consumption. Adding to this, banks had eased credit conditions to tap the segment of the population that had previously proved uncreditworthy. These changes and the altered conditions triggered an increased demand for borrowing by the less wealthy exposing the banking system to increased dependence on hopes of positive changes in economic processes. In the meantime in 2007-2008, about 75-80% of the new loans were denominated in FX, mainly in Swiss franc.

When the crisis in the fall of 2008 broke out, the loan portfolio suddenly started to deteriorate because of higher instalments that needed to be made due to a devaluating domestic currency, which exacerbated the already vulnerable credit portfolio. The population became more cautious in the second half of 2008 but it was then too late; the perfect combination of much deeper problems with the debt in the coming years with weaker domestic currency, falling or stagnating GDP and increasing unemployment was already in place.

Since 2008 two very important trends have been observed regarding the behaviour of the private sector in the loans market. The first one was related to demand, which kept declining throughout the entire period from the onset of the economic crisis and led to the development of a unique situation in Hungary in Central European comparison. The negative implications of the economic processes in Hungary and the second wave of the recession in 2011 resulted in very weak lending activities to the corporate sector.[10] This was quite different from other countries in the region,

[9] Budget consolidation was thought to be the most important precondition for rapid recovery of economic activity during the first years of the crisis. Based on evidence, in recent years this approach is increasingly viewed as a factor that contributed significantly to the postponement of the crisis in several countries. See for example Gros (2012)
[10] Problems of the Hungarian economy that are peculiar in the new member states are dealt with in several recent papers, see for example: Magas (2012)

where corporate lending started to pick up in 2010-2011 despite the unfavourable growth implications of the renewed recession. This negative trend, similarly to the household sector, was caused by events and changes on the demand and supply sides alike. In addition, in 2011-2012 the still quite high interest rates also curbed the demand for loans.

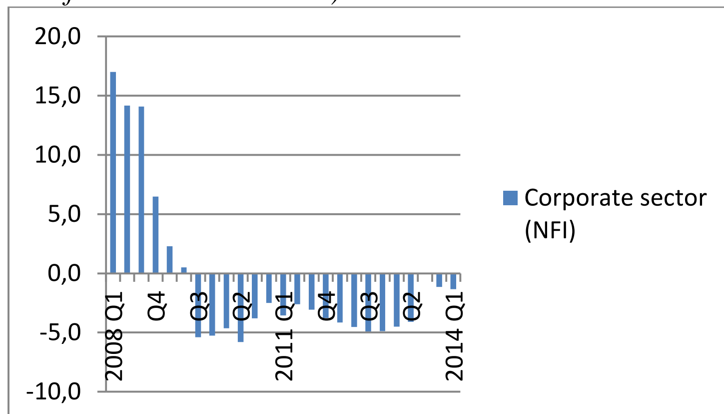
On the supply side, the banking sector was hard hit by different corporate taxes the government introduced in order to implement its structural change objective in taxation with the aim of decreasing the share of labour related burdens and increasing the share of consumption and corporate taxation.[11] Banks reacted to the crisis by weakening financial activity which is not unprecedented in Central Europe given the deteriorating business environment, but in Hungary this was further burdened by the taxes.[12]

In 2013 the Central Bank launched its cheap loan program for the corporate sector, which was mostly used for swapping FX loans in order to eliminate the exchange rate risk but later it started to finance investment too. Low interest rates and the Central Banks program is expected to support the domestic corporate credit demand although the improving growth figures may play a more important role. On the other hand it must be noted that because of the less favourable business environment, corporate investments can only produce slow growth figures. Probably the most important long-term problem is related to the discouraging performance of business investments (household investments also weak in Central European comparison).[13] The issue of business investments is increasingly important, which was pointed out, for example, by Tibor Erdos already a decade ago.[14] Unfavourable trends in business investments imply long-term growth problems, which are underlined by negative FDI trends. (Although after 2010 there were periods when favourable FDI inflow was evidenced – at least on the level of statistics – still a large share of that was related to the recapitalization of subsidiaries of foreign financial institutions instead of the creation of additional jobs or new production facilities.) As a result, the volume of gross fixed capital formation barely amounted to 81% of the 2005 level in 2013 – a very poor performance relative to any of the other Visegrad countries.

[11] The government introduced quite heavy sectoral taxes on different services sectors including the financial institutions. Later the so called transaction tax was levied on banks. The financial institutions could only partially transfer these burdens on the consumers thus their profitability worsened, which required large additional capital transfers from the foreign parent banks.
[12] More on that: De Haas, R. –Van Lelyveld, I. (2011)

[13] Martonosi (2013)
[14] Erdős (2004)

Graph 1
Annual growth rate of lending to the corporate and SME sectors (% - non-financial institutions)



Source: based on data of the Central Bank of Hungary

What is particularly interesting and clearly different in Hungary compared to other countries is that the corporate lending in Hungary has been declining (net lending remained negative since the third quarter of 2009) while in the vast majority of other countries in the region, corporate loans have started to pick up in recent years.[15] This implies that economic growth in Hungary was either very sluggish or the growth of 2013 was not based on credit growth (discussed later) that fuelled investments but on several different factors.[16] In Central European comparison the data confirms that in Hungary the new corporate loan placements are still sluggish with only Romania delivering poorer results.

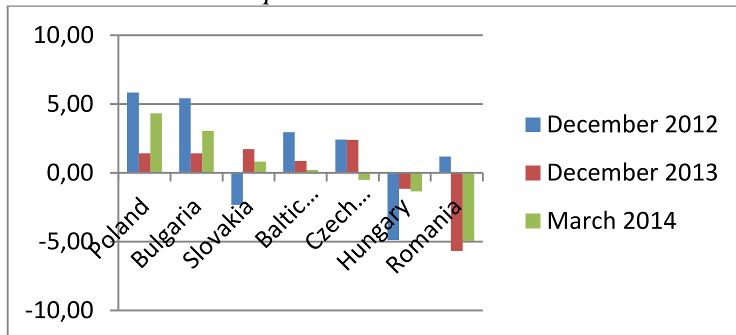
In 2013 the Central Bank introduced a new instrument to improve lending to the corporate sector in addition to steadily cutting the key interest rate. As a result the key interest rate fell to a record low in Hungarian economic history. A significantly lower interest rate was supposed to be the most important tool for improving the financing environment for both the corporate and the household sectors. The new instrument – aimed at improving the conditions for financing the corporate sector – was the launch of the "funding for growth" scheme with the clear aim of supporting small and medium-sized enterprises in accessing forint-denominated loans and to strengthen financial stability. The accessibility of credit to companies operating in Hungary has significantly tightened since the onset of the financial and economic crisis; particularly hard-hit were small and medium-sized enterprises which also face greater difficulties in finding alternative sources of financing. Following the announcement of the scheme (which in principal was based on the similar British model) enterprises showed considerable interest in loans provided within the new framework. The volume of the program reached HUF 750 billion (EUR 2.5 billion). The MNB provided refinancing loans with 0 per cent interest to the participating credit institutions, which were to offer these loans to SMEs with an interest margin capped at 2.5 per cent; these loans were designed to be used exclusively for investment, working capital financing, pre-financing EU funds, or for the redemptions of existing forint loans. SME customers could also use loans received under the scheme for the redemption of foreign currency loans. On the one hand, even this program

[15] Fábián–Hudecz–Szigel (2010)
[16] GDP growth in Hungary has recently been fuelled by state related investments financed mostly from EU transfers while private demand including household consumption and corporate investments played a negligible role.

proved unable to stop the further contraction of the corporate credit stock, but it was instrumental in easing the exchange rate exposure of SMEs as significant part of the very cheap resources was used for replacing FX loans with domestic currency denominated loans. On the other hand, however, the unceasingly declining stock is very much associated with the still difficult situation of commercial project credits which are mostly responsible for the large non-performing loans in the corporate sector. A further problem is caused by the inactivity of large banks due to the lack of profitability and the still sluggish domestic market demand.[17]

Graph 2

Annual transaction-based growth rate of corporate loans in international comparison

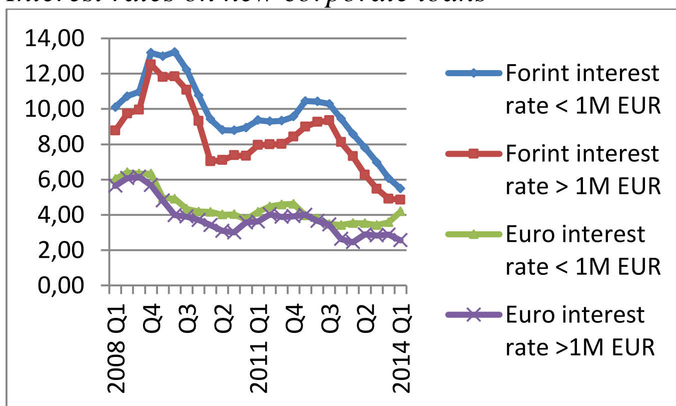


Source: based on data of the Central Bank of Hungary

With the stabilization of the external economic environment and the decreasing international financial risk, which has recently been coupled with steps by the Central Bank, interest rates on forint loans for the corporate sector have decreased significantly. By today the interest rate difference between EUR and HUF loans is insignificant. As far as interest rates are concerned, the conditions of taking out corporate loans have improved significantly and the low deposit and loan interest rates should – in theory – result in increasing demand for corporate loans.

Graph 3

Interest rates on new corporate loans



Source: based on data of the Central Bank of Hungary

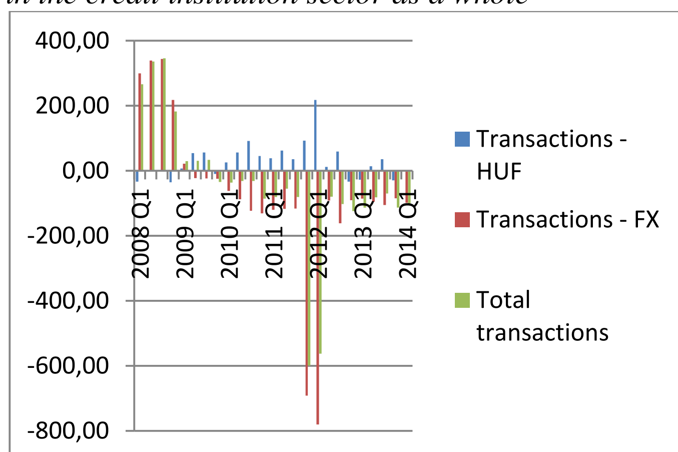
[17] Details of the program can be found at MNB 2013/May, p. 13., on the first result at MNB 2013/November p. 39, and about the prospects and dilemmas in MNB 2014/May, p. 34

These instruments create a favourable environment for financing, but less favourable conditions for saving money in financial institutions. Given the current conditions and income position of the society however, it is doubtful that they can contribute to a dynamically rising overall demand. What is more, it cannot be ruled out that a kind of liquidity trap develops: despite the very low interest rates, cheap loans would not have significant impact on investments (because of the unfavourable business environment), but would rather motivate domestic savings to be put into investment funds. These investment funds most probably invest in foreign securities and instruments because of the weakness and low yield of the domestic capital market. The same crowding out effect may be associated with the debt financing strategy of the state. It aims to replace foreign financing with domestic savings in order to reduce the external vulnerability caused by exposure to exchange rate volatility. As a result, government securities offer favourable alternatives and higher yields compared to investment. In addition, the need for new loan placements may increase the volume of bad quality loans especially if state owned or influenced financial institutions gain more importance in the banking system – an objective which was declared earlier by government officials.

As regards household loans, several trends can be identified that are similar to those of corporate loans. On the whole the household sector has been repaying more debts than drawing new loans since the fourth quarter of 2010. Not surprisingly, as the FX loans became unavailable[18] they have been on the decrease since the second quarter of 2009. HUF loans have also been shrinking almost continuously and some minor increases in net terms were only experienced in a few random quarters. These hikes were partly explained by credit swaps related to the changing regulations of FX loans or the temporarily improving economic environment.

Graph 4

Net quarterly change in outstanding household loans in the credit institution sector as a whole



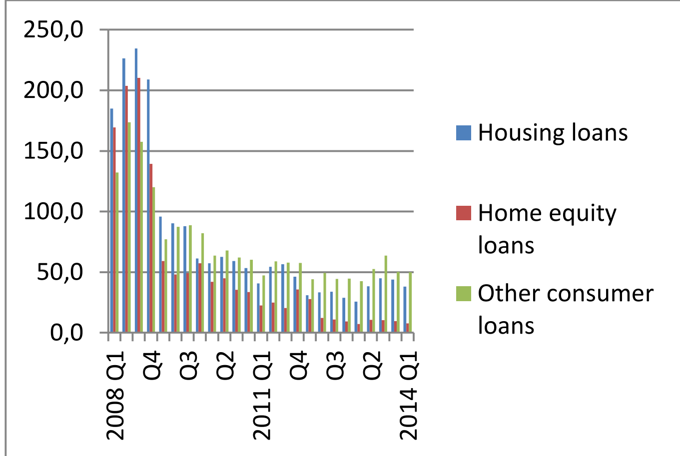
Source: based on data of the Central Bank of Hungary

[18] The government banned the placement of new FX loans in 2010. Later the complete ban was replaced by a regulation that made excessively difficult for customers to apply for these products.

The volume of new household loans is still only a fraction of the volumes prior to or around the economic crisis. The overall low level has been coupled with unclear trends in recent years as temporary improvement is followed by worsening periods. All these demonstrate the instability of future prospects even tough interest rates have fallen considerable. On the other hand it is increasingly probable that – unless an economic depression occurs – the very low interest rates will sooner or later trigger increasing household demand for loans as yields on bank deposits are bottoming out. In addition, the government is very decided on resolving the problems associated with household FX loans and this will happen during the second half of 2014. This would create better conditions for household demand. Although its impact on the demand side would probably be feeble, even this small improvement is expected to stabilise the demand side when coupled with many other minor improvements in the near future.

Graph 5

New household loans in the overall credit institution sector (HUF billion)

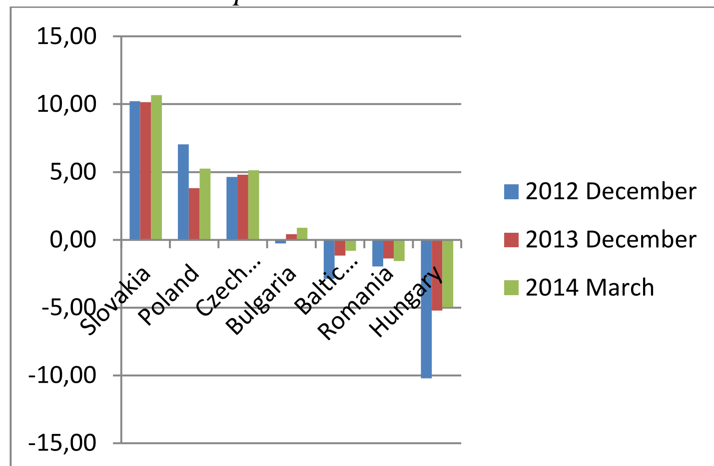


Source: based on data of the Central Bank of Hungary

The problems with loan demand of the household sector are even more obvious than in the case of the corporate sector. In Central European comparison household loan demand has been the most sluggish in Hungary. While the other countries in the region have been experiencing significant loan increases, Hungary is still delivering a declining trend. It is certainly related to the large share of the non-performing loans that excludes several people from the demand side and, at the same time, impairs the supply side as banks are apparently still reluctant to offer loans. The much poorer Hungarian data in regional comparison are the result of the several negative factors referred to earlier (new taxes, FX loans, generally unfavourable business environment).

Graph 6

Annual transaction-based growth rate of household loans in international comparison



Source: based on data of the Central Bank of Hungary

As a result of the continuous decline of net placements, by today the shrinking of the amount of credit has become really significant. In 2013 corporate credits fell to the 2004 level when expressed in the ratio of the GDP, while in the household sector the rate did not surpass the level of 2006. We may say that in the short-term the decline of lending is expected to continue even if the financing conditions improve further and the demand for credit both in the household and corporate sector increases due to the large stock of non-performing loans. If that happens and the business environment improves considerably, then the better loan conditions may lead to increased lending activities but it will be a very slow process.

Structural changes in lending

In the same period, two significant trends could be observed. The first change relates to the decreasing share of FX denominated household loans in total loans. The reasons behind this are manifold. First of all, continuous repayment – in theory – decreases the volume of FX loans, but its positive impact has been largely eliminated by the weakening domestic currency. The government enforced programs of prepayment with favourable conditions made possible for several debtors to pay off their FX debt completely.[19] Large parts of these prepayments were financed from forint denominated housing loans. The significant rise of this type of loan within total household debt is partly explained by this phenomenon and partly by banning of new FX

[19] It became clear that the FX loans were becoming increasingly difficult to be financed and they became one of the crucial brakes on economic growth and catalysts to financial vulnerability. The government started to introduce instruments in order to decrease these risks by either making the repayment of these loans easier or provided exchange rate protection for groups of debtors. The government regulated that for a limited period household FX loans could be paid back at a 180Ft/CHF rate (exchange rate at that time was about 250 HUF/CHF) and the losses were to be borne by the banking sector. A lot of debtors tried to get forint loans in order to refinance their FX loans or tried to get resources from their relatives and friends in order to utilise this short-term opportunity to get rid of the exchange rate risk.

loans from the system. At the same time, FX personal loans almost disappeared largely because they had much shorter maturity than housing loans and the loan volume was much smaller. Similar shrinking, although at a slower pace, was observed in the case of FX car loans but the problem here is manifests in the very high level of non-performing loans, which makes it very difficult to clean out the portfolio. The slow decrease of FX loan shares was coupled with slowly increasing forint denominated loans particularly in 2012-2013 when in spite of the very weak credit demand, the significant cuts in the key interest rate made domestic loans more attractive and this started to support household credit growth – albeit at a very low pace.

Table 1
Structure of household loans after the onset of the economic crisis (% of total stock of loans)

	2009.12.	2010.12.	2011.12.	2012.12.	2013.12.
Total household loans	100	100	100	100	100
FX housing loans	33.23	34.63	32.79	28.04	27.30
FX mortgage loans without specific purpose	27.65	28.51	28.55	26.20	25.18
State supported housing loans	16.84	14.07	12.80	13.67	13.33
Overdraft	5.38	5.47	4.80	5.94	6.21
FX car loans	3.56	3.12	3.40	2.87	2.99
FX personal loans	2.97	2.24	1.72	1.21	0.68
Forint personal loans	3.52	3.29	3.53	3.82	3.92
Market based forint loans	1.71	3.06	5.54	8.74	9.76
Consumer loans	1.13	0.83	0.57	0.53	0.50
Forint (non-housing) mortgage loans	0.39	1.82	3.36	5.90	6.51
Forint car loans	0.31	0.44	0.69	0.99	1.50

Source: based on data of the Central Bank of Hungary

Table 2
Stock of different loan types compared to the end 2008 data (%)

	2009.12.	2010.12.	2011.12.	2012.12.	2013.12.
Total household loans	91.79	100.87	99.65	83.75	79.48
FX housing loans	89.87	102.92	96.28	69.20	63.95
FX mortgage loans without specific purpose	88.48	100.24	99.17	76.51	69.78
State supported housing loans	97.31	89.35	80.26	72.08	66.70
Overdraft	109.78	122.68	106.18	110.48	109.70
FX car loans	78.13	75.29	81.10	57.38	56.74
FX personal loans	69.59	57.68	43.62	25.90	13.82
Forint personal loans	109.44	112.43	119.18	108.47	105.57
Market based forint loans	109.09	215.24	384.85	509.96	540.54
Consumer loans	129.33	104.48	70.59	55.13	49.71
Forint (non-housing) mortgage loans	159.81	828.51	1515.06	2235.35	2339.57
Forint car loans	135.18	208.92	322.35	391.04	563.21

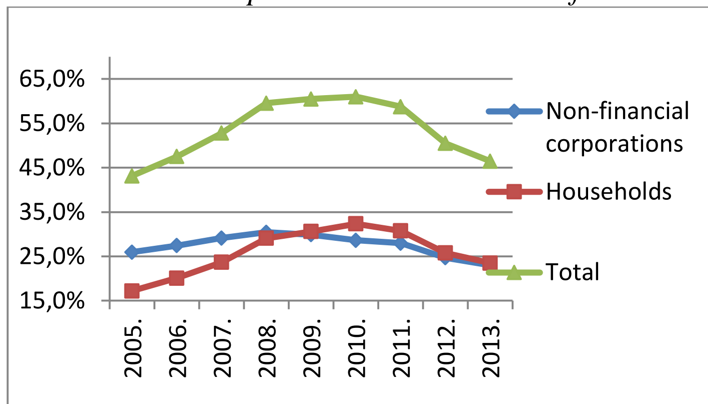
Source: based on data of the Central Bank of Hungary

Similar patterns can be observed as regards the loan structure and individual loan types. Altogether lending activity remained sluggish and the volume of household loans was around 80% of the end 2008 levels, which clearly indicates the difficulties households are facing. The volume of FX loans declined significantly while forint loans generally increased with the exception of consumer loans. The volume of consumer loans declined because new placements were rare due to the worsening income position of the retail sector. When evaluating the size of FX loans, the impacts of exchange rate changes have to be taken into account too. The significant jump of FX loans in 2012 was strongly linked to the drastically weakening forint at the time.

As a result, loan to GDP ratio fell significantly, but larger movement and changes have been experienced in the case of the household sector which – for obvious reasons – faced much greater volatility than the corporate sector.

Graph 7

Household and corporate loans as a share of the GDP

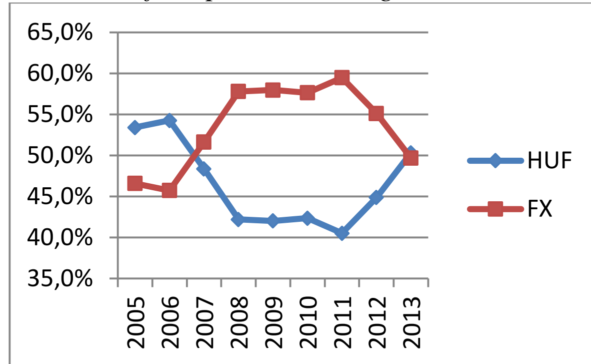


Source: based on data of the Central Bank of Hungary

Because of the strong need to overcome the burden and risks associated with FX loans, there has been a continuous restructuring in the ratio of FX and HUF loans. This has certainly eased somehow the risks inherent in the FX loans exposure to exchange rate volatility but the overall problem remained unchanged, especially because of the substantial depreciation of the domestic currency that continues to maintain indebtedness level despite the repayment of a large share of FX loans in recent years. Although the share of FX loans declined, the affected participants – households and corporations – are still facing big difficulties.

Graph 8

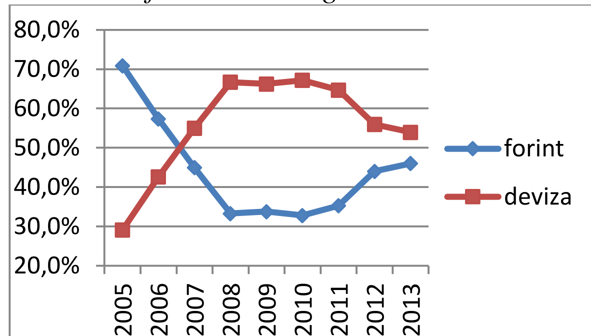
Structure of corporate lending



Source: based on data of the Central Bank of Hungary

Graph 9

Structure of retail lending



Source: based on data of the Central Bank of Hungary

In the meantime, the quality of household loans worsened significantly and the share of non-performing loans – in arrears over 90 days – has been increasing in spite of the different programs introduced in recent years to help household FX loan repayments. It clearly indicates that an increasing share of households in arrears is unable (or unwilling)[20] to meet their obligations. It also demonstrates that the problems associated with household loans increasingly slow down household consumption and thus make the conditions for economic growth even worse. It has to be noted however that apparently not only FX loans show big arrears but so do HUF loan debtors, who are also facing great difficulties, which is indicative of a deeper and more general problem undermining the economy.

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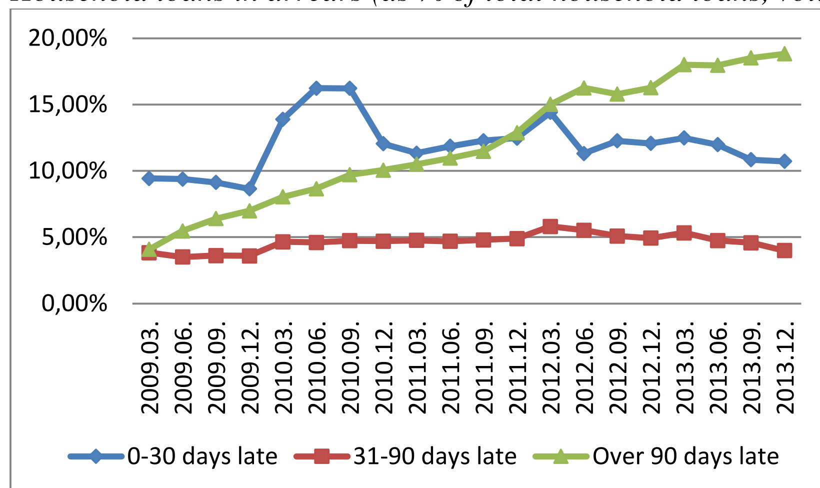
[20] The unwillingness is partly related to the continuous expectation of the FX loan debtors for comprehensive government programs aimed at eliminating all FX-loans. –

Graph 10

Household loans in arrears (as % of total household loans, volume)



Source: based on data of the Central Bank of Hungary

In the new environment unfolding in recent years, banks have been paying greater attention to rebalancing their loan-to-deposits ratio and putting more focus on domestic funding sources. The unbalanced funding position of several CEE countries coupled with the generalized tightening of liquidity conditions contributed to the rising fears that capital needs and funding pressures, faced by Western European banks may heighten pressure to deleverage in the CEE region.[21] As a result of increasing demand for domestic funding and the weak domestic credit demand, the loan to deposit ratio has improved significantly in the Hungarian bank sector.

Given the negative trends regarding loan placement in Hungary compared to most of the Central European economies, the question of financing growth is becoming increasingly important. As confirmed by literature, creditless recoveries are not that rare at all. According to the findings of a recent ECB paper, based on a sample of low and middle income countries, economic recovery may take place and growth may accelerate even without significant expansion of credit activity. Evidence also suggests that creditless recoveries are typically preceded by large declines in economic activity and financial stress, in particular when private sector indebtedness is high and the country is reliant on foreign capital inflows.[22] In the Hungarian economy creditless growth is also supported by the very dynamic inflow of EU funds, which finance large segments of investments in the economy and have been able to substitute, at least partially, the weak loan demand of the private sector. [23]

[21] See more on that in detail: Vienna Initiative (2014)

[22] Bijsterbosch–Dahlhaus (2011).

[23] It is important to note that in 2013-2014 the inflow of EU transfers has been exceptionally strong (5-6% of the GDP) partly owing to the fact that this money was badly needed and partly because the 2007-2013 financial perspective is now winding down. At the beginning of the new financial perspective of the European Union (2014-2020), the inflow is reasonably expected to fall since the new programs need some time to take shape. We can be certain however that in order to maintain the growth impetus related to EU resources, strong efforts will be made to immediately channel as much money into the Hungarian economy as possible. This will be very important in counterbalancing the continued poor activity of private investments (these investments in net terms – after deducting amortization – are close to 0% of the GDP).

If we compare the data with eurozone information, we can also arrive at an interesting conclusion. Due to the government's actions and the falling demand, household loans per GDP today amount to only half of the Eurozone average while at the same time the debt repayment obligation per income ratio fell to 10 percent, which is again not very significant. On the other hand, there are significant differences between the households. Within the group of households with credits in the lowest income groups, the problems are continuing to be significant. In this group the average debt obligation is about 30% of income, while for about 14 percent this burden is over 50% of the household's income, which is definitely over the critical level. For many in this group the situation is dramatic. [24]

Conclusions

Prior to the financial and economic crisis, Hungary was a country where each sector was highly indebted, which was not true for any of the other Central European countries. In addition, the role of foreign financing was significant, which made the country excessively vulnerable to the liquidity of the international financial markets and the exchange rate movements. In comparison with the Eurozone countries, none of the debts of the sectors (government, household, corporate) was high as a percentage of the GDP, but the problem was with the structure of the debt. In addition to relatively high public debts, the structure of private indebtedness, in particular, the very large share of FX denominated loans created serious risks for the macroeconomic balance. These risks created a trap for the macroeconomic policy: strict budgetary policy was required because of the high public debt, which curbed domestic demand and worsened the profit prospects for the enterprise sector. At the same time, the weakening domestic currency led to increasing arrears in the repayment of household FX loans. FX loans, which offered much more favourable conditions compared to the high interest rate forint loans, became dominant both in the retail and the corporate sectors. Because of the large financial vulnerability and the subsequent devaluation of the domestic currency, the implications went far further than simple financial stability issues, but the domestic demand and the growth perspectives were also hit hard along with the banks' ability and willingness to place new loans. [25] Besides cyclical developments and the economic policy measures, FX indebtedness of the private sector limited the possibility of new loan placements.

In recent years one of the main objectives of the economic policy has been to manage and keep the FX loan problems under control. This need triggered several waves of programs but they all proved unable to solve the problems. Parallel to this, lending to the private sector (both households and non-financial corporations) decreased continuously reflecting problems on both the demand and the supply sides. This is a characteristic that is completely different from the experiences of other central European countries at least in terms of the length and perseverance of this trend. The recent significant monetary easing of the Hungarian Central Bank, i.e. the cuts in the key interest rate along with the favourable loan programs have improved the conditions of getting loans for the enterprise sector. The continuously decreasing interest rate and the subsidised credit programmes all contributed to the replacement of former riskier and more expensive loans.

[24] Balás (2013)
[25] Gém (2011)

To sum up, the structure of the increasing private debt and the growing importance of FX loans deepened the problems of private indebtedness, but not affected the absolute level of debt. As a result of all the above and the other problems with the economic environment in Hungary, we forecast to see creditless growth and the very slow and balanced increase of private and corporate indebtedness in the future.[26] In the longer run this would lead to a more secure and solid financial system and a more cautious and balanced financial deepening, if the economic policy will not be overly tempted by artificial demand promotion by soft loan programs targeting .

[26] The new government program on eliminating household FX loans by converting them into forint may somehow change the situation, but the final results remain to be seen after the execution of the program at the end of 2014.

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