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The transformation of the Hungarian financial system

3.1 Introduction

The accession to the European Union (EU) of eight Eastern European countries[1] on May 1st 2004 constitutes a major milestone after the fall of the Berlin Wall. Several commentators observed that this date marked the end of transition for these economies and the beginning of convergence to EU standards. Between 1995 and 2004 average annual growth rates in the region have been around 4.3%, against 2.2% for the EU (15 countries), providing an indication of economic convergence. The integration of Eastern European countries with the EU will be completed with their accession to the Euro zone. Estonia, Lithuania and Slovenia started the procedures for Euro membership on June 1st 2004, the remaining countries (Hungary among them) delayed entry as they needed more time to improve government accounts.

Hungary represents one of the most successful Eastern European transition economies. The fact that it enjoyed partial economic liberalisation under the planned system gave the Hungarian economy an edge at the beginning of transition, allowing it to face a lower initial cost of economic reforms compared to other formerly centrally planned economies. The choices made in terms of strategy and sequencing of reforms also proved to be successful. In contrast to the Czech Republic and Poland, that opted for the so called shock therapy, Hungary choose a gradual approach to economic reform. The results have been extremely positive: since 1993 GDP has risen steadily, unemployment has fallen continuously, labour productivity has grown more than in other Eastern European economies, and international competitiveness has improved.

This chapter reviews the key aspects of the Hungarian transition process in order to provide the institutional and macroeconomic background for the empirical microeconomic analysis conducted in the subsequent chapters.

[1] Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovak Republic and Slovenia.

3.2 Macroeconomic background

Looking at a wide range of macroeconomic indicators, such as output growth, unemployment, credit to the private sector, almost all transitional economies display a remarkably similar pattern. These economies implemented in the same period a similar set of reforms starting from almost identical conditions. However, as it will be shown, there are striking differences in terms of the outcome of the transformation process. In general, considering the last 15 years, we can divide the transition process into three main phases.

Phase 1 is the shock period. It coincides with the first 2-3 years of transition, during which the dominating factor is the transition shock: prices and trade are liberalised and the economy starts to behave like a market economy, being freed by the constraints of the planned system. This is the phase where inefficiencies arise and the costs of transition become evident: inflation rises, output collapses, the credit system crunches, inefficient firms shut down and unemployment increases. Phase 2 covers the implementation of the reforms. After the initial painful phase reforms become effective: firms are privatised, the banking system is recapitalised and reformed, institutional reforms are implemented. Phase 3 is the post-reform period. The performance of the economy during this period is an indicator of whether reforms implemented were effective or not. In the majority of the cases reforms were indeed effective to the point that several Eastern European countries started the procedures for EU accession that led to the enlargement on May 1st 2004.

Output growth

Since the beginning of reforms, the evolution of GDP in transition economies followed a similar U–shaped pattern: after an initial severe contraction that lasted two to four years, GDP stabilised and then started to grow, as illustrated in Fig. 3.1, displaying real GDP dynamics against the number of years since the beginning of reforms.[2] The figure shows that, compared with the Czech Republic, Poland, and the Slovak Republic, the initial output contraction in Hungary was more gradual. However, it also lasted longer than in the other countries. For instance, in the Czech Republic the growth rate turned positive already after two years since the start of transition; in Hungary, instead, it took four years to achieve positive GDP growth.

The initial output contraction was a necessary phase in the transition process: during the communist period output growth was due almost exclusively to massive accumulation of fixed capital while almost no contribution was given by TFP growth. After a positive period during the fifties and the sixties, the diminishing returns on accumulated capital became more and more

[2] Year 0 is defined as the year before the start of reforms, with real GDP normalised to 100. The figure assumes that reforms started in 1990 for Poland and Hungary, and in 1991 for the other countries.