György Kovács

Financial stability and the banking system, or the imbalance of the intermediary system

This survey intends to address a special segment in the fiscal imbalance problems of the Hungarian economy, namely the peculiar "balance disturbance" of the banking sector, playing a prominent role in financial intermediation, whose capital structure has been increasingly at the beck and call of foreign funding potential. While alarms have for years been sounding on the back of declining foreign direct investments and an increasing extent of capital income extraction by international owners, public attention has been directed to exchange rate risks related to an increasing bulk of retail debts and also to an increasing role of foreign investors in financing government securities, but it seems that an equally important issue has been addressed at a lesser extent. Namely, the Hungarian banking sector has been increasingly dependant on foreign funding, which has become a factor of growing significance in providing external funds for a capital-hungry Hungarian economy. This becomes a particularly interesting issue because the capital intermediary role of the Hungarian banking sector in the economy is relatively low in comparison to Western European countries, at the same time the number of players on the banking market is comparatively high and they boast exceptionally high profitability.

NET CAPITAL INTERMEDIARY ROLE OF THE BANKING SECTOR; DEVELOPMENT OF NET POSITIONS

One of the main indicators of the importance the Hungarian banking sector is playing in the country's national economy by capital intermediation is the ratio of the combined total assets of the banking sector in terms of GDP. For reasons of economic policy, banking sectors and equity markets in various territories of the Western civilisation have developed to play roles of different significance in equity intermediation, and therefore the banking sector has a much more prominent role in the Old Continent than in the United States of America (Marján, 2003, page 801). Of course, due to decades (if not centuries) of lag in the development of the institutional system of the financial and equity market in the transitional economies of Central and Eastern Europe, the equity intermediary function of both the banking sector and the equity market is less advanced, but the dominance of the banking sector is even more prominent in this limited function in these countries, which – taking the level of economic development into consideration – is something of an inevitability. (Pálosi – Németh, 2004).*(See Table 1)*

Table 1

EXTENT OF EQUITY INTERMEDIARY FUNCTION OF BANKING SECTORS AND EQUITY MARKETS, 2000

(%)

Indicator	United States of America	Euro zone	Hungary
Total assets of banking sector /GDP	100	181	63
Securities issued /GDP	149	90	2
Equity market capitalisation /GDP	149	84	25

Source: author's own chart based on Marján (2003, page 801) and PSZÁF [Hungarian Financial Supervisory Authority] (2008d)

Following the turn of the millennium the *function of the banking sector in equity intermediation has increased significantly,* but it is still far from the Western European level, although still regarded the number one player on equity intermediation (The notion of banking sector here includes, beyond the legislative definition, specialised credit institutions and savings cooperatives as well). *(See Table 2)*

Before starting to analyse the banking sector's function of intermediating equity between the four segments of the economy, the way the funding capability and demand of the corporate sector, households, public finance, and international relations have developed since the beginning of the new millennium should be scrutinised first.

As *Chart 1* shows, following the peculiar situation in the first half of 2003 – when the net borrowing demand of the corporate scope and the net financing positions of households both reached an all-time low – the gap between the savings ability of households going through a stabilisation phase until the middle of 2005 and an increasing financing demand on the part of the corporate scope made a more substantial foreign funding necessary in 2004. Since the end of 2005, the net savings capability of households has again declined, again starting to converge to zero in the middle of 2008. As for public finance, in 2002 and also in the period from the middle of 2005 to the end of 2006, a considerable increase in the funding need is evident with shrinking corporate finance and a considerable increase in the need for foreign funds in the first period mentioned, and a high level of foreign funding in public finance and a decrease in corporate funding demands in the second period. The decline in the current financing need of Hungary's public finance beginning in 2007 has not resulted in a considerable or permanent decline in the financing function of international funding sources, because at the same time a smaller growth in the financing demand of the corporate scope and a radical downturn in the funding capability of households had to be faced.

In light of changes in the financing capabilities of individual segments of the national economy and the increasing role of the banking system in terms of GDP, it should be scruti-

Table 2

EXTENT OF EQUITY INTERMEDIARY FUNCTION OF THE BANKING SECTOR, 2001–2007

(%)

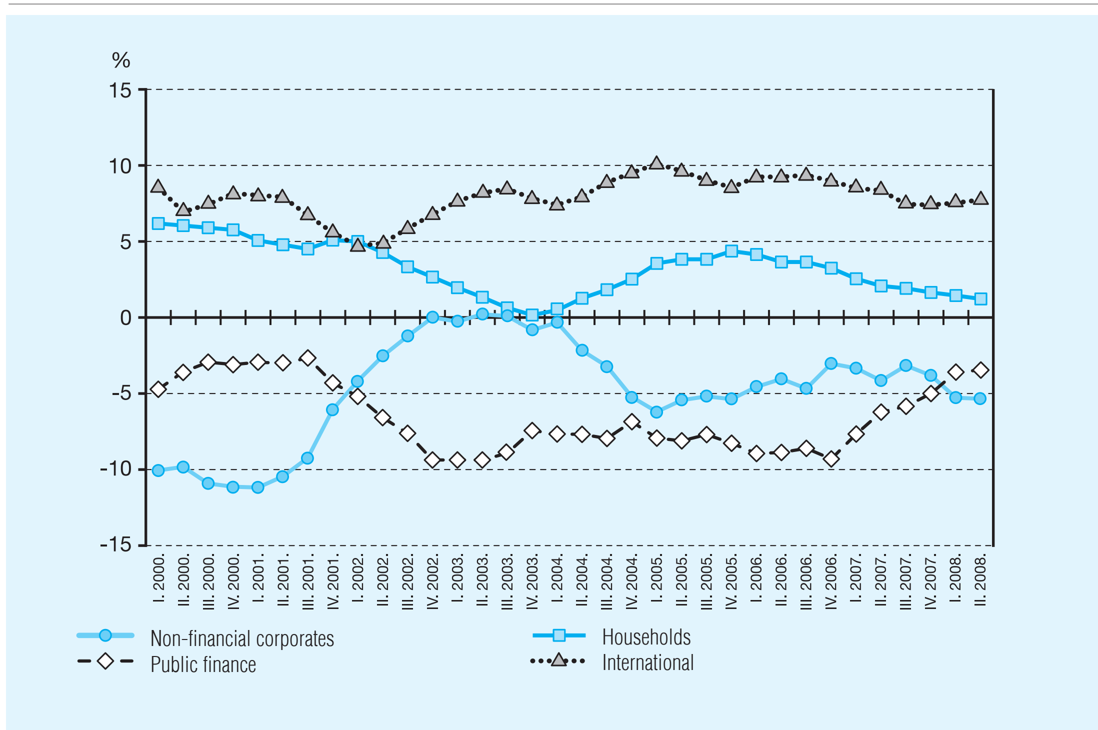
Year	2001	2002	2003	2004	2005	2006	2007
Total assets/GDP	66	68	76	81	90	99	107

Source: author's own chart based in PSZÁF (2008a), page 21

Chart 1

NET FINANCING CAPABILITY OF MAJOR SECTORS IN TERMS OF GDP

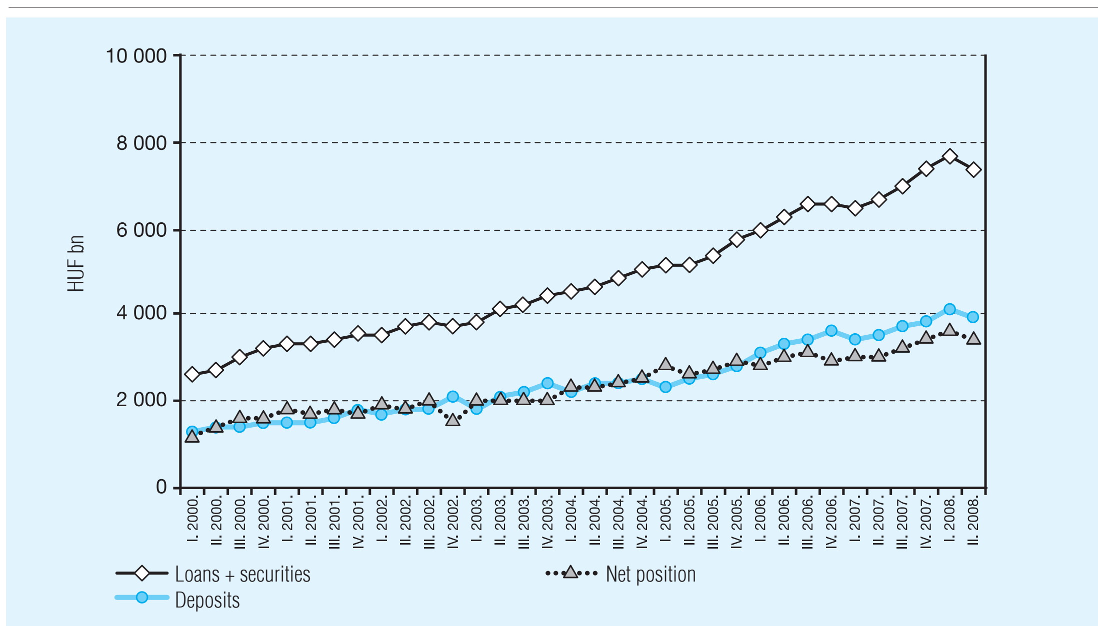
(balance of last four quarters / GDP in last four quarters)



Source: MNB [National Bank of Hungary] (2008a), page 1

Chart 2

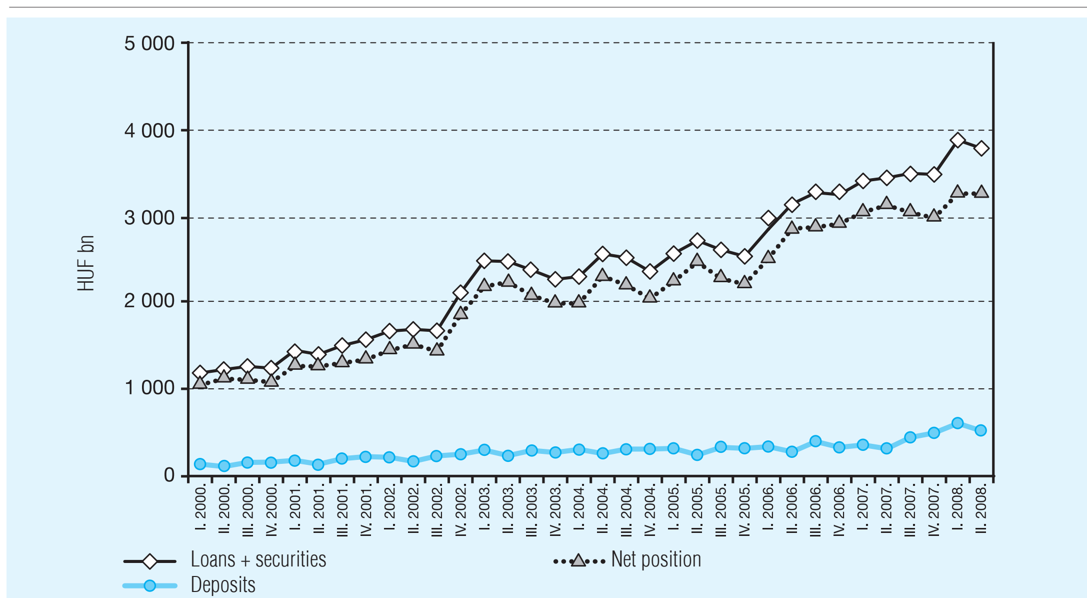
NET POSITION OF CORPORATE SECTOR, 2000–2008



Source: author's own chart based on NBH (2008b)

Chart 3

NET POSITION OF CORPORATE SECTOR, 2000–2008



Source: author's own chart based on NBH (2008b)

nised how the equity intermediary role of the banking system – or, in the accurate statistical terminology, the scope of other monetary institutions including savings cooperatives and specialised credit institutions – has changed in recent years in relation of various macroeconomic players (NBH, 2008b) *(See Chart 2)*.

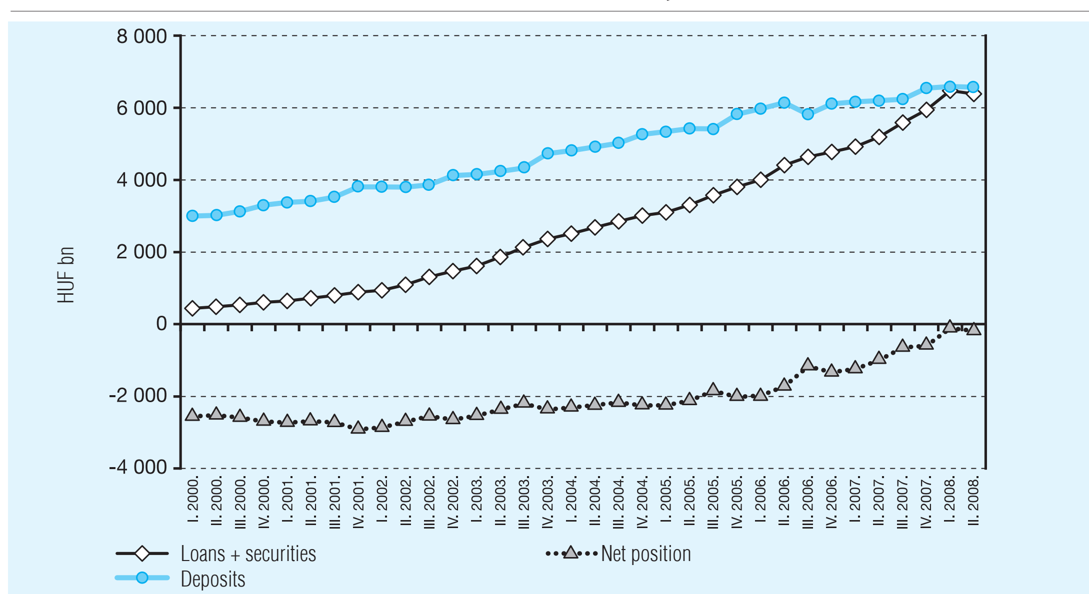
Looking at the corporate loans disbursed by the banking sector and the portfolio of corporate savings, an increase in the financing need is evident with a constant growth in the deposit and loan portfolios alike. This is to be regarded as a more or less balanced growth, which has been in alignment with the increasing functions of the banking sector, with small downturns at the turn of 2002 and 2003, and also in the middle of 2005.

With the stagnation of government deposits or its slow growth marred with downturns, the net debt of public finance with the Hungarian banking sector has clearly been defined by the increase of gross public debt, the bulk of government securities in the portfolio of the banking sector *(See Chart 3)*. Similarly to the dramatic increase that occurred at the turn of 2002 and 2003, there was a considerable bump in 2006 and also in 2008. In the latter two cases – contrary to the change that occurred in 2002/2003 as indicated by Chart 1 – a smaller increase took place in the financing need of the Hungarian public finance, indicating that in these periods the *Hungarian banking sector played an increasing role in financing the Hungarian public finance by bonds* due to diminishing willingness on the part of other players (including foreign and domestic institutional investors) to finance the Hungarian state.

Beginning in 2002, the loan portfolio of households has increased at a greater pace than their deposits, resulting in a net position for households – and NGOs helping them –, as the "classic" financing segment of the banking sector, which was decreasing in terms of absolute value as well *(see Chart 4)*. This was close to zero in 2008, which means the debt ratio of households reached a level where the financing capability of the sector died away. All this resulted in searching for new ways of supple-

Chart 4

NET POSITION OF HOUSEHOLDS, 2000–2008



Source: author's own chart based on NBH (2008b)

mentary funding, which in turn resulted in an increasing level of foreign funding.

As *Chart 5* indicates, Hungary's net position against foreign investors has actually been impacted by the development of the debt portfolio in recent years, and a particularly large bulk of debts were raised in 2007 and in the first two quarters of 2008. *Hungary's foreign debt grew by more than HUF 1,500 billion in 2007 and by nearly HUF 1,000 billion in the first half of 2008, increasing the country's net debt by nearly HUF 1,000 billion and more than HUF 600 billion, respectively.*

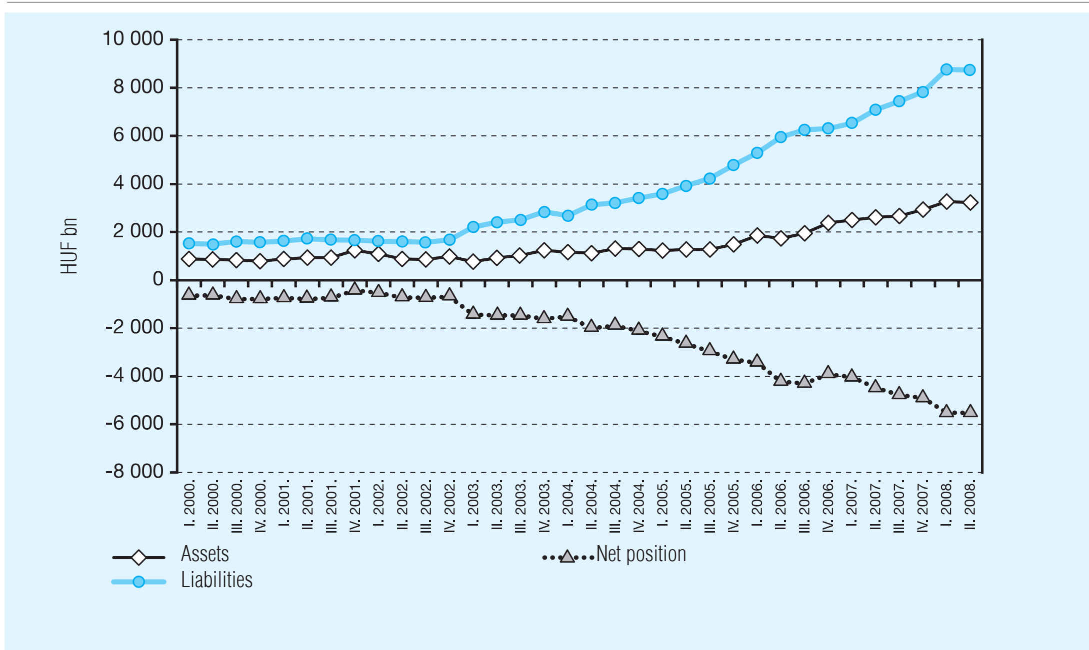
Based on these factors, there have been two apparent trends regarding the Hungarian banking sector's capital intermediary role of more than eight years: on the side of net borrowers, a 'race' between the corporate sector and public finance with clashes in 2002/2003, on the side of net lenders the almost perfect switch-over from households to foreign investors to secure funding (and also using foreign funding to finance the increase in the net loan portfolios of the two sectors mentioned above) *(see Chart 6).*

FOREIGN FUNDING BETWEEN 2000 AND 2008

Particular consideration should be given to the structure of foreign funding in capital-hungry economies, especially at the time of an economic transition. It's equally important for the long-term development of the economy and sustainable financial balance that funding should be done by foreign direct investments at as decisive a rate as possible. This type of funding does not trigger any continuous outflow of income (interests), unlike in the case of debt-based financing, and no extraction of capital invested should be expected in the short term, either (at least in the case of ownership stake, since it's not necessarily true in the case of a loan provided by the owner). At the same time investments naturally prompt income outflows in the medium and long term, and the question here is the extent of the reinvestment of these income and the acquisition of additional stakes compared to this outflow of earnings. Besides, on the back of economic transition in Central

Chart 5

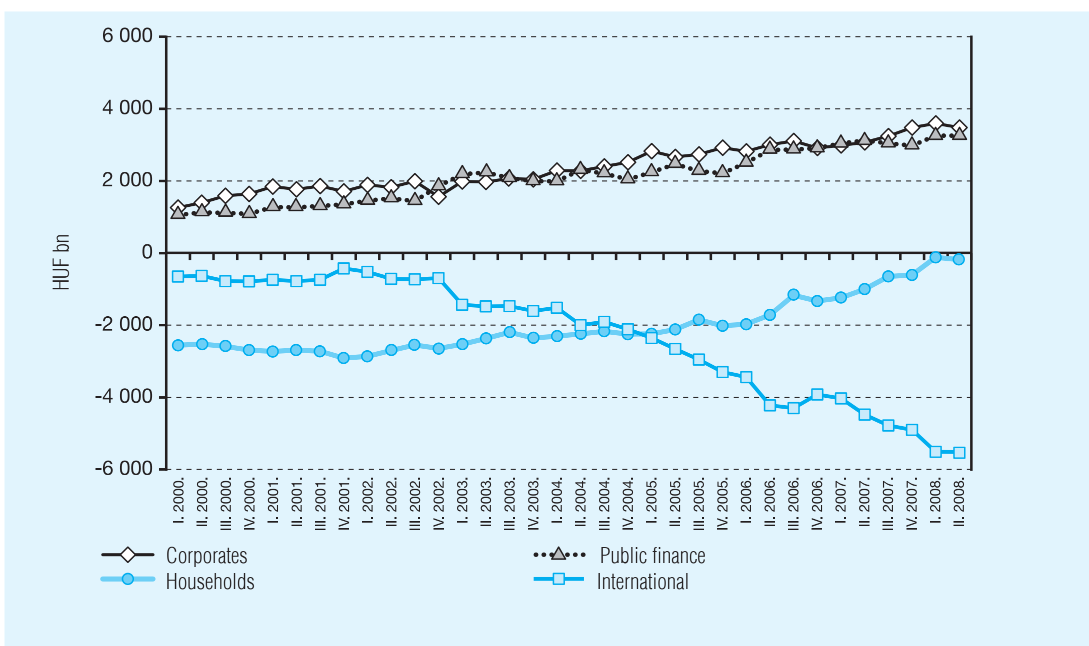
NET FOREIGN POSITION, 2000–2008



Source: author's own chart based on NBH (2008b)

Chart 6

NET POSITION, 2000–2008



Source: author's own chart based on NBH (2008b)

and Eastern European countries, including Hungary, a flow of capital investments in the opposite direction has been evident after the beginning of the new millennium, indicating intensifying capital exports from Hungary and representing another factor to reckon with regarding the decrease of capital available domestically. Of course, the income flow to be recorded later should also be taken into consideration. Accordingly, the development of the capital and income balance of foreign direct investments – both imported and exported – in the new millennium is surveyed here, filtering out capital flow represented by loans provided by owners and focusing on classic equity flow (NBH, 2006a; NBH, 2006b; NBH, 2007a; NBH, 2008c; NBH, 2008d).

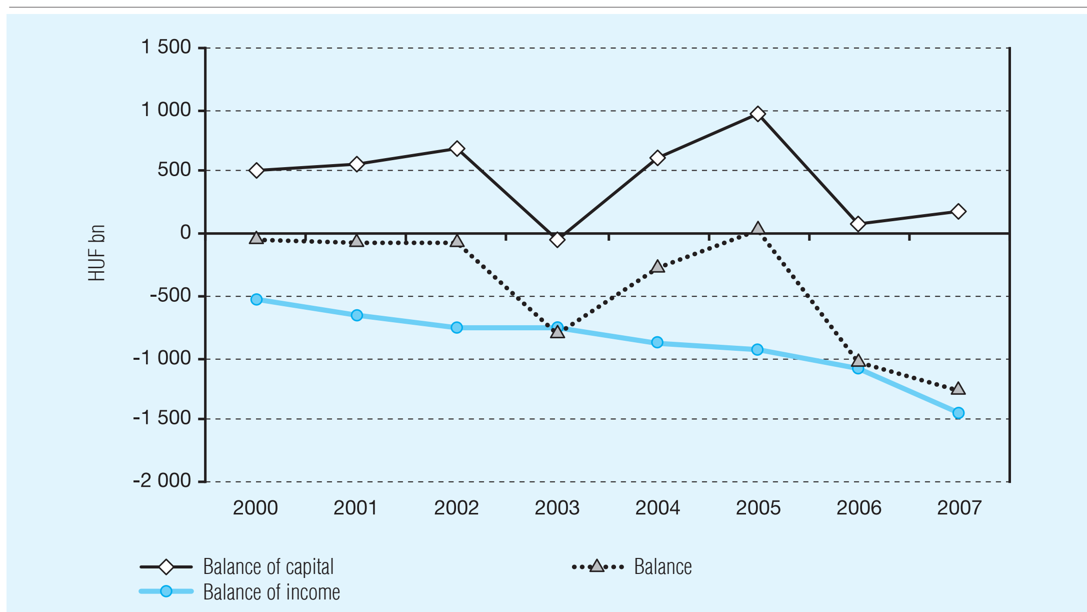
Chart 7 shows that *the balance of income has resulted in a constantly growing deficit in the balance of payments* since the beginning of the millennium, growing to HUF 1,450 billion by 2007 from HUF 540 billion in 2000. However, a slow increase in the surplus of the capital balance could not offset it all the while. A dramatic deficit in the capital balance that occurred in 2003 is explained by FDI plunging to 40 per cent in comparison to the previous year and a 700-percent increase in capital exports. The aggregate value of the capital and income balance ventured into the positive territory for the first time in 2005 due to one-off privatisation income, and at a marginal extent at that, but a dramatic decline occurred in capital inflow in 2006 and 2007. Due to all these factors the aggregate balance of the capital and income flow has recorded all-time high deficits in the past two years at HUF 1,026 billion and HUF 1,257 billion, respectively.

Capital and income flows related to foreign direct investments have failed to provide a solution since the dawn of the new millennium to manage problems of imbalance stemming from foreign trade deficit, and *have even intensified problems of imbalance originating from the balance of payments.* Consequently, the Hungarian economy has of course settled in to use foreign capital at an increasing extent. Thus, loans provided by owners (including loan amounts and commercial credit) in connection with foreign direct investments, capital funds originating from securities issues and managed as portfolio investments, loans and deposits received from foreign banks, as well as commercial credits represented the opportunity to effect supplementary funding. In the following section, the role of the aforementioned forms of supplementary funding in the capital supply of the Hungarian economy will be scrutinised in line with the classification used in the statistical records of the balance of payments, in fact broken down into other sectors and other monetary institutions – actually the corporate sector and the system of credit institutions. Considering that the capital flow in the above forms has apparently been working in the opposite direction, too – as capital exports – scrutinising net capital flows will provide an answer for what capital types contribute to finance the Hungarian economy and at what extent. In respect of funding types, the data show foreign assets *(K)*, foreign liabilities *(T)* and the net positions calculated as their balance *(N=T–K), indicating year-end figures for* the period between 2000 and 2005, and end-of-quarter figures starting from 2006 until the middle of 2008.

Regarding the portfolio of loans provided by owners, there was a slower increase between 2000 and 2005, which started accelerating in 2006 with an interim stagnation, offsetting a considerable outflow of equity. At the same time, the dangers inherent in this capital reallocation should be realised: On the one hand, the possibility of capital extraction is much quicker than in the case of classic owner's equity, and on the other hand interest payment means a constant outflow of pre-tax income. To make matters worse, an increase in the liabilities of Hungarian corporations with their foreign par-

Chart 7

FOREIGN DIRECT INVESTMENTS, 2000–2007



Source: author's own chart based on NBH (2006a), NBH (2006b), NBH (2007a), NBH (2008c), NBH (2008d)

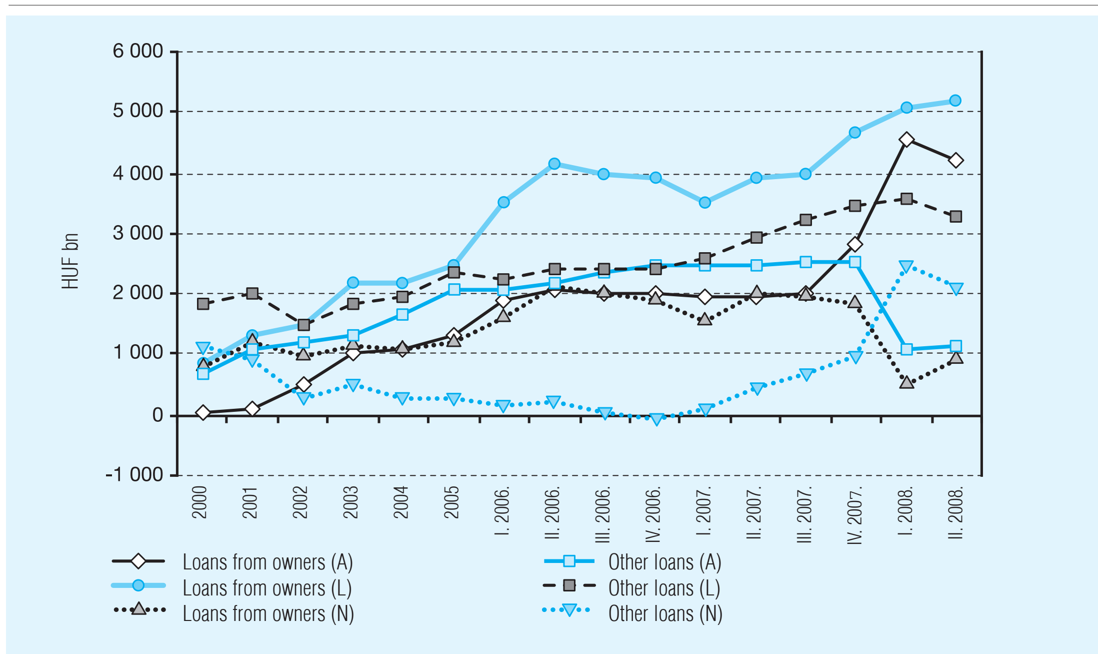
ents and subsidiaries has been apparent in this funding class since the middle of 2006, as a result of which stagnation in the net debt portfolio has been evident in the past two years.

Regarding the other loan sources of the corporate sector, *Chart 8* shows that the net financing potential has been of less and less significance in recent years as foreign funding started to increasing slowly then stagnating with a considerable expansion in liabilities. A steady increase in assets and, as a result, a repeated expansion of net debt became evident in 2007, but as a result of these processes, the total of net debt at the end of 2007 reflected roughly the same value recorded in 2000. (Other loans include assets and liabilities stemming from loans and deposits with foreign banking sectors, and also assets and liabilities originating from commercial credits). Those considerable changes in portfolios that occurred in 2008 – an increase in liabilities classified as originating from the owner, and also other types of liabilities – did not represent actual changes in the portfolio but a reshuffle as the combined value of these two items remained unchanged.

The scope of portfolio investment is dominated by stake-type investments, while other investments (bonds, money market instruments, and financial derivatives) play a marginal role, and at times are even registered as a disbursement surplus *(see Chart 9)*. In the case of stake-type investments, the value of the net capital portfolio is in fact defined by the development of the debt portfolio, the increase in the liabilities portfolio starting in 2006 was not actual transactions, but revaluation impacts in foreign exchange rates and market valuations. The upswing in the debt portfolio between 2000 and 2006 was explained at an equal rate by capital inflow evidenced in actual transactions and by revaluation. Processes in 2007, however, could be explained by actual transactions at a considerable extent, because the Hungarian capital market had to suffer a HUF 900 billion actual capital outflow in that year. What should

Chart 8

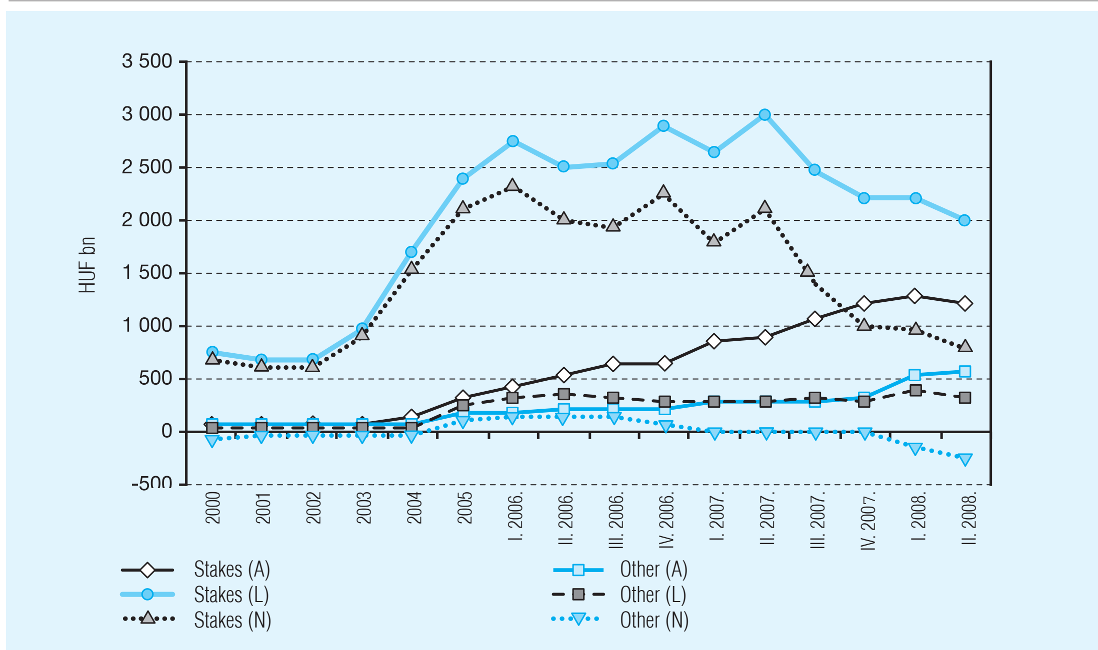
LOANS OF OTHER SECTOR, 2000–2008



Forrás: MNB, 2006a; MNB, 2006b; MNB, 2007a; MNB, 2008c; MNB, 2008d alapján saját szerkesztés

Chart 9

PORTFOLIO INVESTMENTS OF OTHER SECTOR, 2000–2008



Source: author's own chart based on NBH (2006a), NBH (2006b), NBH (2007a), NBH (2008c), NBH (2008d)

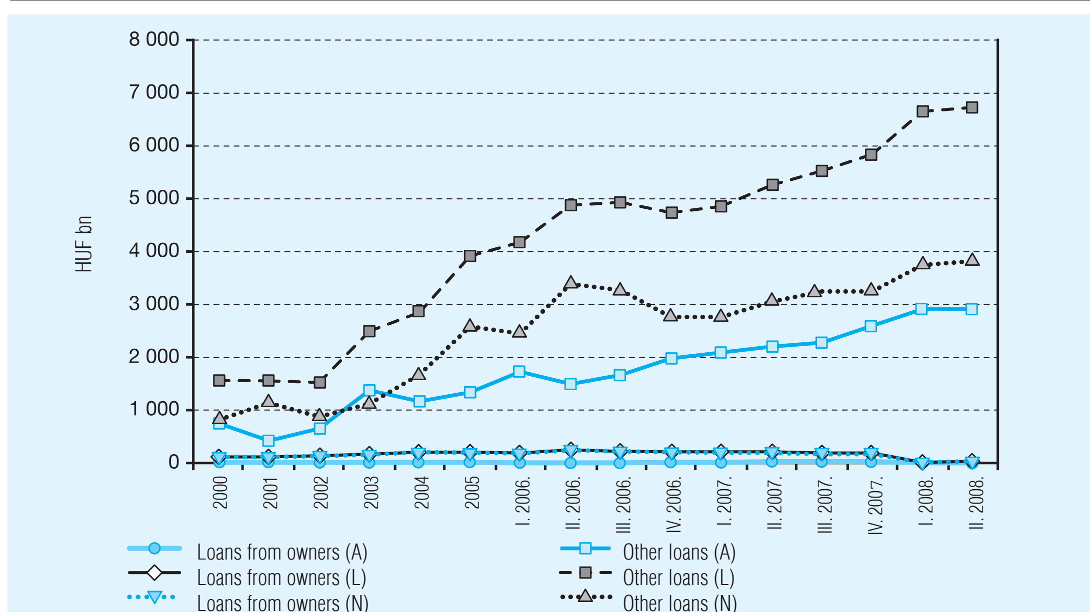
also be underlined is that a rapid capital extraction could happen any time in the scope of stake-type portfolio investments by way of selling on the stock market, a likely scenario in case the financial balance of the economy should slump dramatically. And, as data of recent quarters indicate, high volatility can also be detected. In light of the aforementioned trends of the corporate sector's net funding capabilities based on its loans and securities options, the funding capabilities of other monetary institutions – the banking sector, in fact – should be scrutinised.

Loans provided by owners have just a marginal significance from the aspect of foreign funding in the Hungarian system of credit institutions, unlike in the corporate scope. However, assets – loans and deposits – *received from foreign banking sectors are decisive* in the scope of credit institutions, starting a dramatic growth in 2003 and subsequently rising to HUF 6,732 billion by the middle of 2008 from HUF 1,528 billion at the end of 2002 *(see Chart 10)*. However, since the middle of 2006 the *net debt portfolio* of the Hungarian banking sector has increased to HUF 3,824 billion in the past two years with minor troughs from HUF 3,388 billion. Within this scope, an *expansion of nearly HUF 600 billion was recorded in 2008.*

In respect of the capital flow of the Hungarian banking sector registered as portfolio investments in the past 8 years, a considerable net funding position is evident *(see Chart 11)*. The role of stake-type securities is not decisive, there was just a marginal bulk of transactions in the portfolio surge of 2008 (by HUF 75 billion and HUF 51 billion in the first two quarters of the year, respectively). On the other hand, the increase in the debts related to *non-shareholding-type portfolio investments* has been decisive since 2003. In the *past 18 months* there has been a particularly considerable surge *both in the gross and the net debt position as they increased by HUF 1,000 billion and HUF 900 billion,* respectively, but the decrease registered in the last quarter was also caused by transactions (in addition to a substantial revaluation effect).

Chart 10

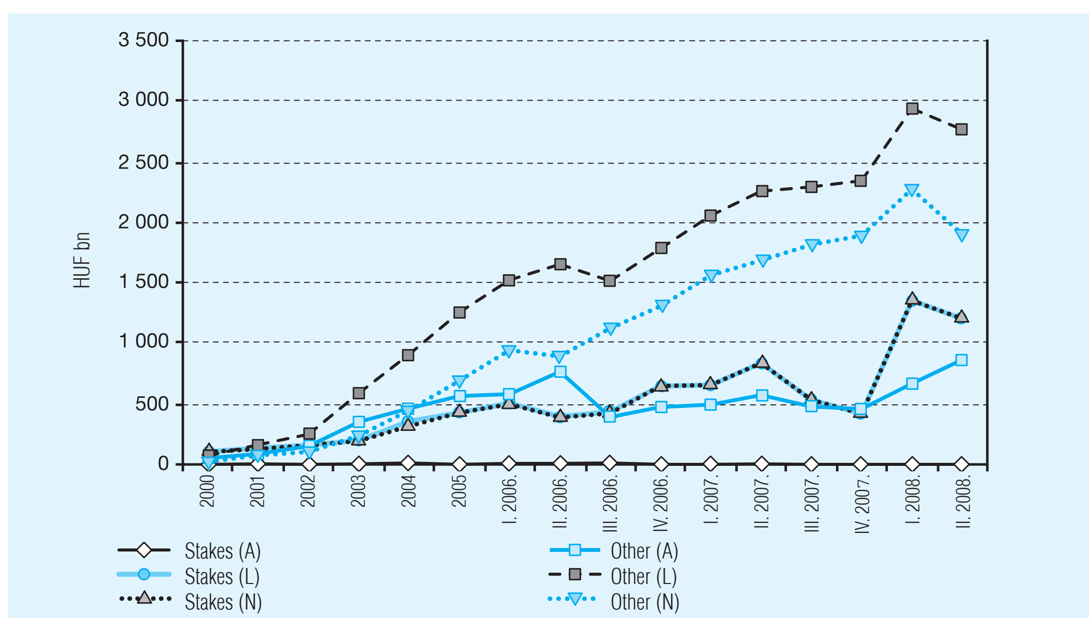
LOANS OF OTHER MONETARY INSTITUTIONS, 2000–2008



Source: author's own chart based on NBH (2006a), NBH (2006b), NBH (2007a), NBH (2008c), NBH (2008d)

Chart 11

PORTFOLIO INVESTMENTS OF OTHER INSTITUTIONS, 2000–2008



Source: author's own chart based on NBH (2006a), NBH (2006b), NBH (2007a), NBH (2008c), NBH (2008d)

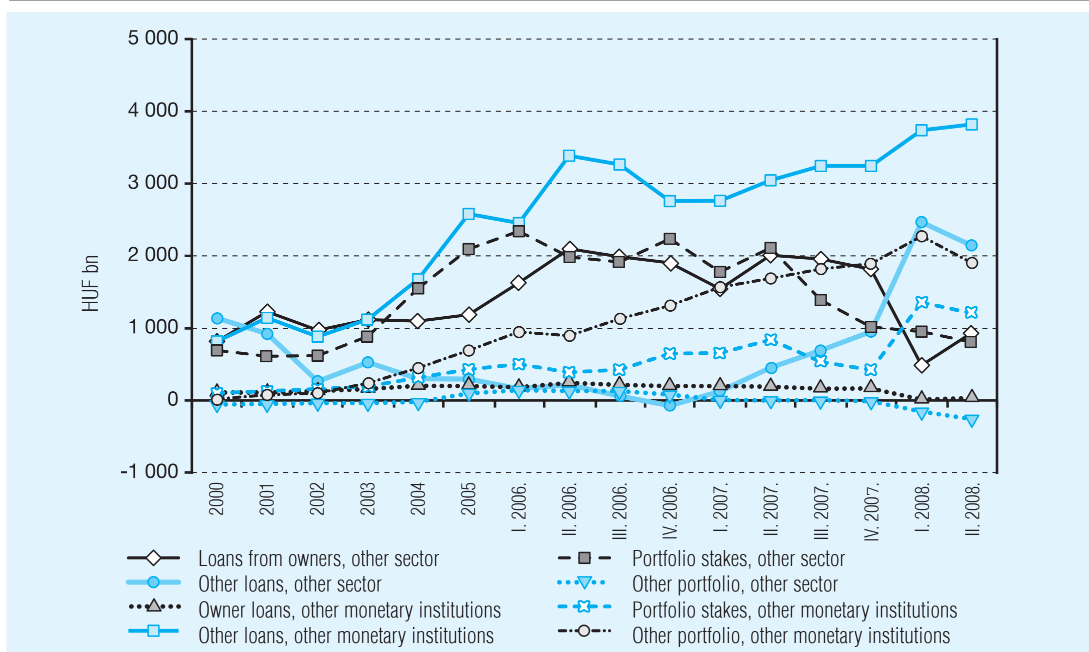
Looking into the net positions of considerable capital funds it is evident that *supplementary funding in the Hungarian sector of credit institutions* has played an prominent role in recent years *(see Chart 12)*. In light of what has been established above, the growth of non-stake-type portfolio investments as well as loans and deposits received from foreign banks has been increasingly decisive in *determining the financial balance of the Hungarian economy,* an economy dependent on foreign capital. At the same time the trends of recent years should also be underlined, as there has been a shift in the role foreign banking sectors has played in financing the Hungarian banking sector. On the one hand, a decline in the ratio of debts and an increase in deposits within the portfolio of loans and deposits, representing a higher liquidity risk for the Hungarian banking sector. On the other hand, an important role is played by foreign disbursement of securities issued by banks, indicating higher risk aversion on the part of lenders (maintaining the option to sell at secondary markets as opposed to banking loans). While 55.5 per cent of the foreign funds of Hungarian credit institutions were deposits, 41.8 per cent were loans, and 2.7 per cent were securities in 2003, the corresponding rates were 51.2 per cent, 27.2 per cent, and 21.6 per cent, respectively, in the middle of 2008 (PSZÁF, 2008b; page 28).

Regarding the capital flows outlined here, the trend that increasing funding prompts a growing amount of income outflow should also be acknowledged, as shown in *Chart 13.*

(Of course, the net balance of income outflows and inflows is considered here, as this defines the income positions of the national economy). Consequently, the *net income outflow related to all portfolio and other investments increased fivefold* between 2000 and 2007, to HUF 407 billion from HUF 73 billion. (In the first half of 2008, the total of income outflow already recorded HUF 272 million, representing 105 per cent of the amount registered in the comparative period of 2007).

Chart 12

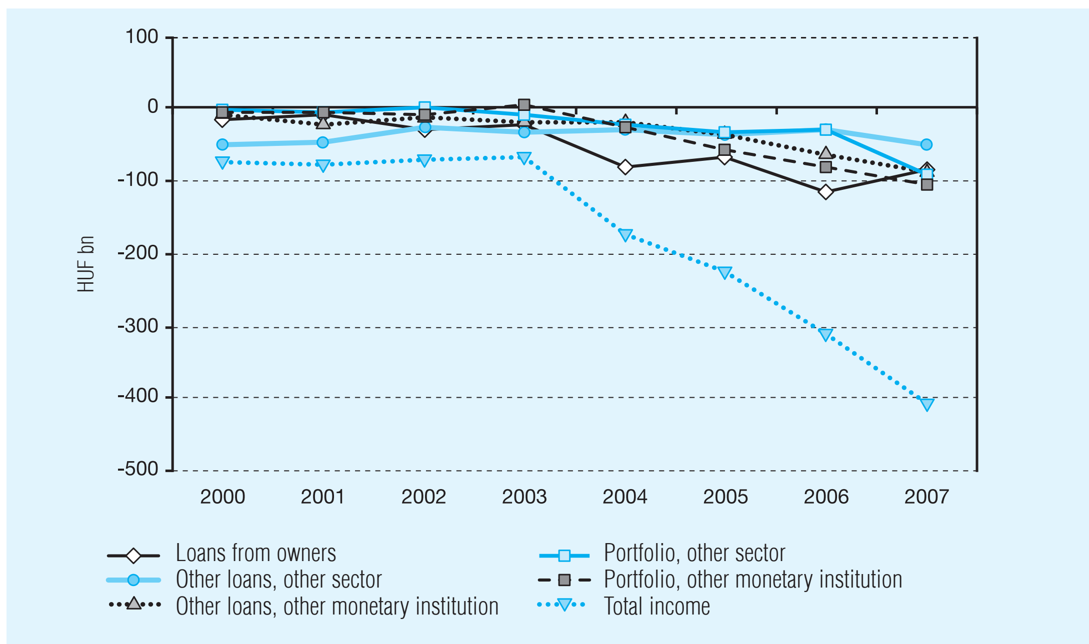
NET POSITIONS, 2000–2008



Source: author's own chart based on NBH (2006a), NBH (2006b), NBH (2007a), NBH (2008c), NBH (2008d)

Chart 13

INCOME BALANCE OF PORTFOLIO AND OTHE INVESTMENTS, 2000–2007



Source: author's own chart based on NBH (2006a), NBH (2006b), NBH (2007a), NBH (2008c), NBH (2008d)

When the aggregate net positions of foreign direct investments and income flows (Chart 7) and the net income position regarding portfolio and other investments (Chart 13) are scrutinised together, their combined total indicate a HUF 1,664 billion capital outflow from the Hungarian economy in 2007. All this means that other supplementary funding has had to secure financing for capital and income expenditures related to earlier usage of capital at an increasing rate *(see Chart 14)*.

PROFITABILITY OF THE BANKING SECTOR; BALANCE PROBLEMS

Chart 15 shows how the profitability of the banking sector (in terms of return on equity and return on assets) developed in 2004 in select countries of the European Union.

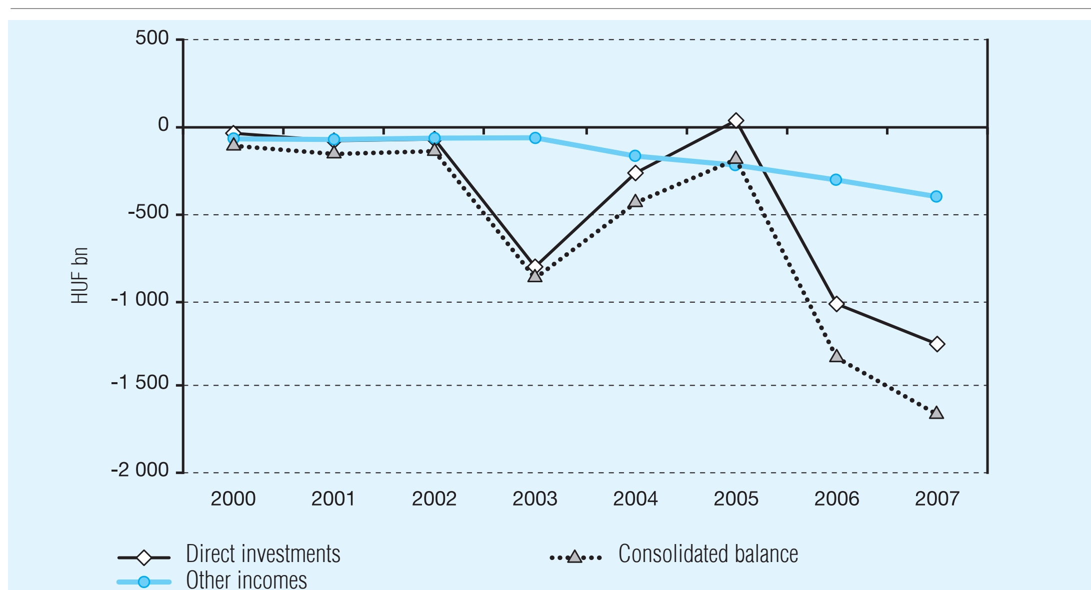
Table 3 shows the development of the *profitability of the Hungarian banking sector in terms of return on equity and return on assets* since the beginning of the new millennium, giving a clear indication that profitability in the Hungarian banking sector stabilised at a very high level between 2004 and 2006, *considerably outperforming not only old EU members but also newly accessed countries in Central and Eastern Europe.*

In addition to this high profitability and the relatively low capital intermediary function described in Section 1, the Hungarian banking sector is characterised by another factor, namely it is regarded *well-developed, or even overdeveloped, in terms of the number of market players.* It is a fitting description even if the number of banks operating in Hungary (including specialised credit institutions) decreased to 36 from 42 between 2000 and 2008 (PSZÁF, 2008c). The relative overdevelopment is best defined and compared by the capital intermediary function per bank, calculated as the average total assets of banks per GDP *(see Chart16)*.

One would think this would force banks operating in Hungary to compete more intensively, leading to minimisation of costs and more efficient allocation of funds, like in other

Chart 14

BALANCE OF CAPITAL AND INCOME, 2000–2007



Source: author's own chart based on NBH (2006a), NBH (2006b), NBH (2007a), NBH (2008c), NBH (2008d)

sectors. However, the approach is getting accepted that the traditional theory of competition does not apply to the banking market, suggesting that an intensifying competition does not lead the market to prices expected to develop in a perfect competition. The existence of fixed fees for switching banks may be one of the reasons, for at even a very low fixed fee the balance is set as it were a monopolistic market, because competing banks apply identical prices initially, thus any one of them could raise the price by a little without running the risk of losing customers. Another explanation suggests asymmetric information is the key to the issue, since declining profitability due to strong competition in an asymmetric-information situation may prompt banks to take excessive risks, which could undermine the stability of not only the banking sector but the entire economy. If banks could apply higher lending rates, it could cover the gathering of customer information, the constant monitoring and assessment of the customer base, but they cannot cover these costs when their profits are decreasing due to an intensifying competition, thus they become less and less interested in reducing their losses by gathering information (Várhegyi, 2004). Some opinions say the current outstanding profitability of banks in Hungary is not to be regarded as excessive, for foreign investors are cashing in their profits after taking losses in previous years (Csillik, 2006). In my opinion, the key to this high profitability is related to their intensifying business activities and their role as capital intermediaries as described above on the back of holding government securities that ensured relatively high yields, a dynamically expanding portfolio of retail loans, a significant increase in foreign deposits, loans, and securities, which represented low funding costs and considerable liquidity risk but playing a prominent role among funding sources; in other words, due to the *Hungarian banking sector's increasing role in the flow of foreign capital.*

Also, Hungary is in a particular situation that high profitability has come with a considerable increase in the propensity to take risks, also indicated by two factors: Easing of lending standards and conditions, and the deterioration of banks' portfolios. The lending practice of Hungarian banks was first surveyed in 2003, and that of banks accounting for 75 to 85 per cent of the lending market has been mapped biannually since. In light of the experience gained from these surveys, credit rating standards and lending conditions (collateral requirements, maximum loan value) in the sector of small and medium enterprises and the retail scope had been easing at most banks by the second half of 2007, and it was not until the first half of 2008 that a slow shift toward stringency started (NBH, 2008e). As for the portfolio with rating requirement, a deterioration in quality was evident: While 91.5 per cent of the portfolio was problem free at the end of 2000, this rate decreased to 88.4 per cent by the end of 2005. Although there has been no additional deterioration in the composition of the portfolio, the net value loss and provisions of banks

Table 3

PROFITABILITY OF BANKING SECTOR IN TERMS OF ROE AND ROA, 2001–2007

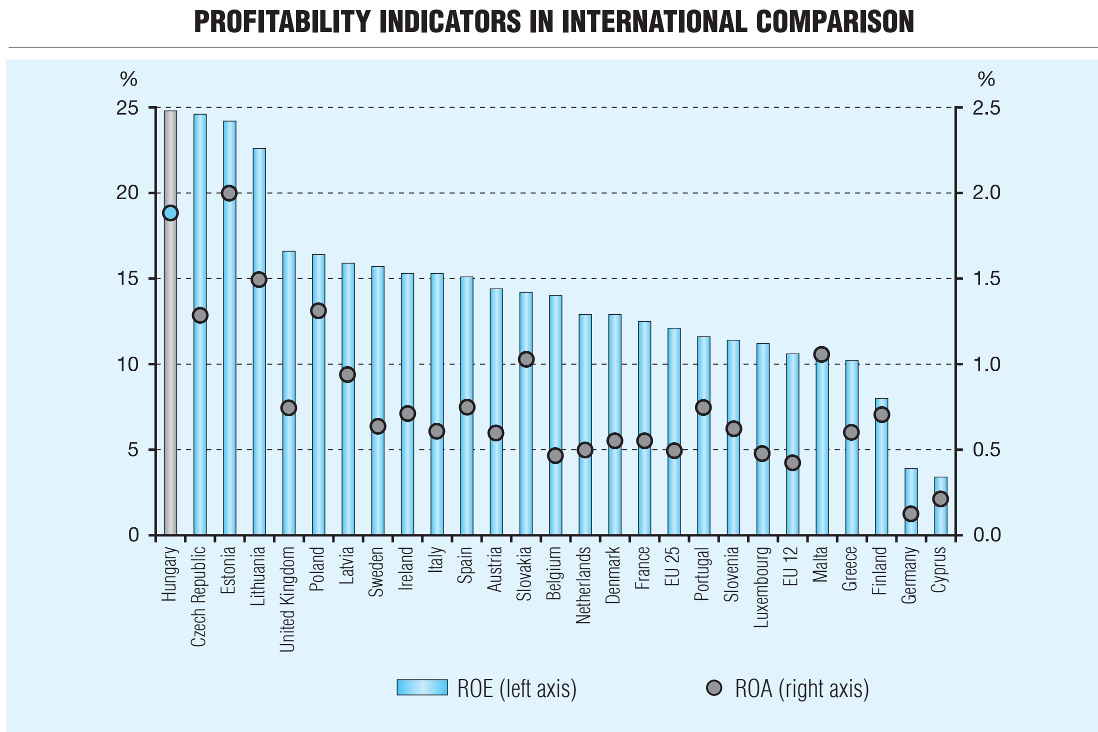
(%)

Year	2001	2002	2003	2004	2005	2006	2007
ROE	14.9	15.0	17.1	23.4	22.3	23.0	17.5
ROA	1.26	1.31	1.50	1.95	1.96	1.86	1.49

Source: Author's own chart based on PSZÁF (2008a), pp 25, 40

Chart 15

PROFITABILITY INDICATORS IN INTERNATIONAL COMPARISON

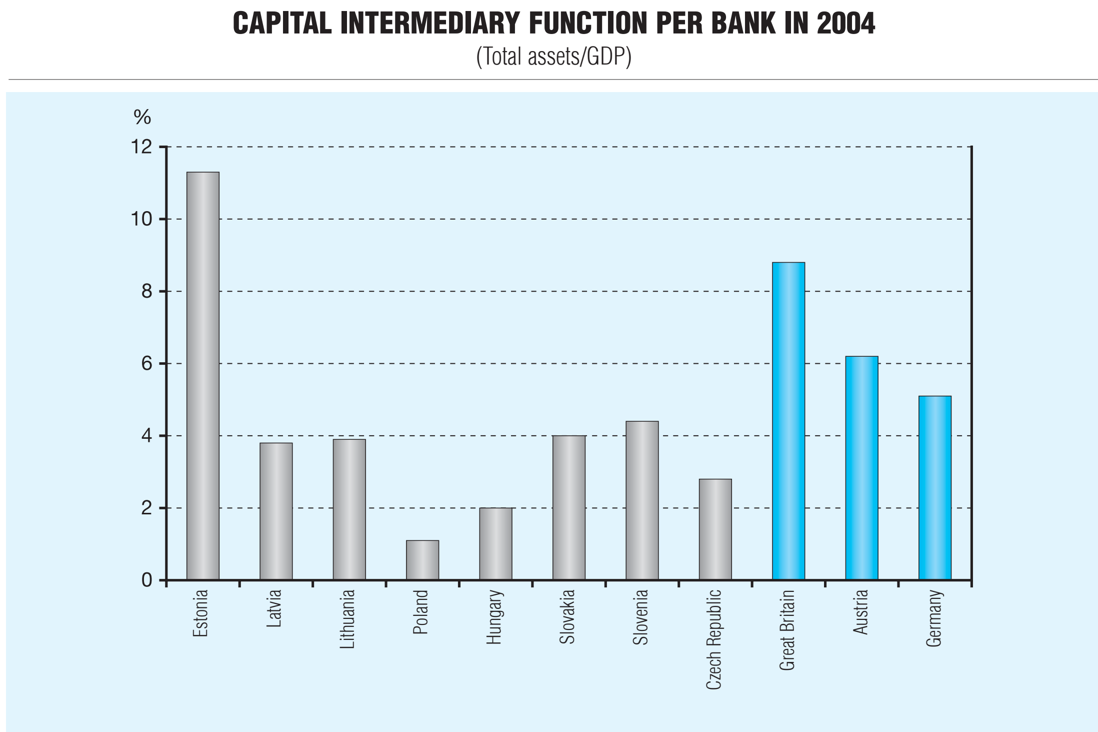


Source: NBH (2006c), page 49

Chart 16

CAPITAL INTERMEDIARY FUNCTION PER BANK IN 2004

(Total assets/GDP)



Source: Kiss (2006), page 175

increased to HUF 150 billion from HUF 77.5 billion registered in the previous year (PSZÁF, 2008d), and has been high since, which may partially account for the decrease in the extent of profitability.

Banks' substantial lending activity – as outlined by Section 1 and Section 2 – has relied on foreign funding at an increasing rate, and loans have been denominated in foreign currencies at a growing extent. However, forex dominance has developed much faster on the assets side than on the liabilities side, as a result of which more than 39 per cent of the total portfolio of liabilities and nearly 49 per cent of assets were denominated in foreign currencies at the end of June 2008, representing a net long position of 9.6 per cent in terms of total assets (PSZÁF, 2008b, pp. 40–41). *This considerable open position will be at risk when the forint is easing or firming.* When the forint is firming, the amount of exchange rate losses on the asset side exceeds that of exchange rate gains, which could be offset by off-balance positions but they come with transaction costs (which also explains the decrease in profitability that has been apparent lately). When the forint is easing, foreign exchange risks are transferred into lending risks because of increasing debt repayment obligations of small business and retail customers, which traditionally have no appropriate forex income. Also, an increase in forint-denominated total assets requires and improvement in meeting regulatory capital criteria while the value of forint-based Tier 1 capital remains unchanged, reducing banks' capital adequacy. This is one of the reasons the fast pace of the expansion of forex lending represents a risks, as the dynamic growth of over-year forex loans and a shift toward short-term deposits triggers an increase in liquidity risks in respect of forex-denominated items.

Also, *the unfavourable effects of a peculiar piece of regulation* is to be reckoned with. In July 2006, the EU directives defining capital adequacy requirements for banks were finalised, and they could be enforced in the member states beginning on 1 January 2007 but their implementation was obligatory as of 1 January 2008. In the case of Hungarian banks, an increase in capital requirements may be triggered by deteriorating loan portfolios in the retail and corporate scope, also causing a slump in lending activities. In the case of foreign banks financing the Hungarian banking sector, unfavourable developments are to be expected in the scope of interbank disbursements, because risk weighting is done in two ways basically in this scope. The standard method links the rating of interbank disbursements either with the rating of sovereign debt – and this does not necessarily call for optimism, considering the state of Hungary's public finance – or with ratings of the individual banks by independent credit rating agencies, but in this case the increasing exposure of Hungarian banks to liquidity and exchange rate issues may have negative implications. The weighting regime based on foreign banks' internal compliance system – either in the basic or the advanced method – could also cause worse and worse ratings for Hungarian banks. Hence, *increasing capital adequacy requirements have had to be expected in the scope of disbursement directed to banks operating in Hungary* since the regulations were implemented. This could lead to rising funding costs and abatement in the lending propensity of foreign banking sectors. All these factors may cause a slump in the funding of the Hungarian banking system, *and narrowing funding opportunities for the Hungarian economy,* because the banking sector has in recent years been more and more active in involving foreign funds.

Ensuring outstandingly high profitability for banks, lending activities in Hungary, financed by foreign funds, have included substantial risks for years, because loss of confidence in the

Hungarian economy could not only trigger higher risk premiums when shorter-term funds have to be refinanced when they mature but may even lead to these funds drying out. It may occur especially when liquidity is getting tighter in international financial markets, which seem to be the case as indicated by what has been happening on global market recently. Also, the fiscal policy consequences of a growing forex debt portfolio in the retail customer scope should not be overlooked, either. On the one hand, as a result of the prompt exchange of substantial forex funding into the forint, a considerable forint firming occurred, and the increasing foreign funding and retail lending in the Hungarian banking system could be regarded as some kind of a thrust-forward, because as long as this expansion was sustainable a *strong forint protected banks from lending losses to be suffered from an easing forint* in the scope of small businesses and retail customers. (This situation could be best described as the 'balance of imbalance'). On the other hand, a considerable forint outflow due to this mechanism caused a pressure to purge and has kept short-term interest rates high. Also, a peculiar situation is evident in this context, because it is precisely high interest rates that have rendered forint loans uncompetitive against forex loans, thus they are as much the trigger as the solution of the problem. In my view the problem of these short-term interest rates are independent of *high interest rates of government securities* in the medium and long term, since this latter is an *evidence of lack of confidence in a permanent consolidation of Hungary's public finance.* The most these two problems are linked is that a forex inflow stemming from foreign investors purchasing Hungarian government securities has triggered a similar process than banks' forex funding has. A high level of short- and long-term interest rates can be explained by the assumption that continuous austerity measures reduce the country's current account deficit almost to no avail, because without structural reforms – that would improve the operating conditions of real economy – these measures would at best have a neutral impact in the long run, but more likely to have damaging effects. This is why the feverish struggle of the Hungarian government to secure the IMF loan, since the conditions bundled with the loan could lead to austerity measures similar to the ones referred to above but never to significant changes in the budget structure, according to international experience gained over decades in various countries. When the inflow of interbank forex funds stopped due to liquidity shortage in global interbank financial markets and commercial banks implemented limitations in forex lending for retail customers on the back of the financial crisis cascading to Hungary – and, in my view, of the surfacing imbalance that had been present in the system for decades – the forint started easing naturally, because said pressure had lifted. But it is precisely the mechanism described above that makes the 300-basis-point *prime rate hike* incomprehensible, because this step could act in favour of *maintaining an erroneous system, the 'balance of imbalance'*, which may cause an even deeper crisis.

Finally, as a researcher specialised in economic history and Protestant economic ethics, I would like to quote *Martin Luther,* whose ideas that he wrote down nearly 480 years ago could be useful even in assessing the situation in Hungary today.

"There is great need of a general law and decree of the German nation against the extravagance and excess in dress, by which so many nobles and rich men are impoverished. God has given to us, as to other lands, enough wool, hair, flax and everything else which properly serves for the seemly and honorable dress of every rank, so that we do not need to spend and waste such enormous sums for silk and velvet and golden ornaments and other foreign wares. […]

In like manner it is also necessary to restrict the spice-traffic which is another of the great ships in which money is carried out of German lands. There grows among us, by God's grace, more to eat and drink than in any other land, and just as choice and good. But the greatest misfortune of the German nation is certainly the traffic in annuities. If that did not exist many a man would have to leave unbought his silk, velvets, golden ornaments, spices and ornaments of every sort. It has not existed much over a hundred years, and has already brought almost all princes, cities, endowed institutions, nobles and their heirs to poverty, misery and ruin; if it shall continue for another hundred years Germany cannot possibly have a pfennig left and we shall certainly have to devour one another." (Luther, 2004, pp. 146–147)

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