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CRISIS AND RECOVERY

In memoriam Werner Riecke

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I first came across Werner's name in a paper he wrote on exchange rates applying a model by *Trzeciakowski* (*Ábel*–Riecke, 1980). We first met in person at the Rajk' College for Advanced Studies where he delivered a lecture on the pitfalls of time series estimations of production functions. Later, we became colleagues and friends at the Secretariat of the Economic Policy Cabinet of the Government, which I joined in 1988, and Werner in 1989.

1 A PIVOTAL PERIOD

In the period following the unfinished reform of the new economic mechanism in 1968, planning decisions had priority in economic policy, both fiscal and credit policy had to serve them. The lack of an explicit monetary policy did not prevent the economy from operating as if it had responded to a very expansive credit growth. Because of extra demand, depending on the strictness of import rules, either inflation or imports increased uncontrollably. The endgame closing that period, which first produced fast growth and then stagnation and a debt crisis, was introduced by the stimulation announced at the 1985 Party congress. It became evident in less than a year and a half that a Party congress could not become a growth engine. 1987 became the year of disillusionment; changes in the economic policy, on senior positions and, finally, in politics laid down the foundations for the transition.

A two-tier banking system was reintroduced by outsourcing financing production and development from the National Bank. Independent monetary policy, taking responsibility for certain economic policy decisions, was needed. To make the balance of payments sustainable, domestic use of the GDP had to be reduced, so the primary task was to ensure that the growth of money supply should lag behind the GDP. Since it came into being amid a financial crisis, the top priority of Hungarian monetary policy was (and remained for another decade) to preserve

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the solvency of the country, while the objective of achieving price stability was temporarily shelved.

As the two-tier banking system was restored, new commercial banks appeared taking their share in enterprise promotion and selection, in funding development projects and on the capital market, however, their impact remained limited because of the lack of equity investment institutions and investors. Hungarian banks were closed to foreign and retail funds. They were cut off from the former by a system of controlled currency management (inherited from 1931 and, although restrictions were getting more and more lenient over time, it was finally eliminated in 2001 only); and from the latter by the decades-long dominance, transformed into a market leadership by now, of the National Savings Bank (OTP). Thus, monetary policy started to operate through the National Bank refinancing.

Werner always treated the monetary system as a model, using the monetary approach to the balance of payments, and he was aware of the mechanism and the limits of the approach as well. It was limited not only in the general sense, in a small and open economy, where the central bank is able to control money supply only partially, particularly when the exchange rate is fixed.[2] Monetary transmission was also restricted by temporary and lasting wedges and leaks. The period starting at the end of 1987 was the story of a central bank trying to strictly control credit supply; and of an economy evading it wherever possible.

Queueing, trade credit enforced by dominant market positions, was temporary. Because of its narrow monetary function, it remained limited, and the transformational crisis and the wave of bankruptcies caused by the fall of the GDP swept it out of the system. On the other hand, the positive balance with COMECON countries was a decade-long significant leak eating away any BOP impact of the tightening monetary and fiscal policy. The surplus was induced by the failure to increase imports, rather than by structural changes. Only when COMECON disintegrated did that leak close, including the forced lending to other member states; liquidation of the accumulated debts took a decade in itself.

As the two-tier banking system was introduced, the commercial banks took over existing loan portfolios that quickly deteriorated along the transformational crisis, revealed as market transparency started to improve. The concentration and deterioration of the loan portfolios of the banks limited customer selection, and even enforced further lending to loss-making companies. Non-performing loans were toxic for the banking system and jeopardised its functioning, so it indirectly

2 As regards the impossibility of enforcing the stability of exchange rates, monetary independence and integration into the international capital markets at the same time (trilemma), cf. (in Hungarian): Magas, 2018.

hindered monetary policy too. Only when the central government intervened, starting from 1992 until 1995, with direct purchase of non-performing loans through consolidation schemes, did commercial banks and monetary policy start to operate efficiently.

It became apparent as early as in 1988 that a hardening monetary policy could be offset by softening budgetary constraints, as commercial banks turned to the budget lobbying on behalf of their large debtors, even when the resolution of defaulting companies by the state appeared to be legally successful. Fiscal policy offset monetary policy by substituting credit with direct government aid. As of 1989, the refinancing policy of the National Bank regarded offsetting this substitution as its main objective in terms of managing money supply.[3]

2 THE YEARS OF TRANSFORMATION

During the years of transformation, Werner directed the monetary policy of the National Bank of Hungary, operating and also from time to time adjusting the instruments of monetary policy adapting it to shifting objectives and circumstances. Given the free fall of production, the collapse of the COMECON markets and the loss of balance caused by the crisis of transformation, household savings increased despite the shrinking employment. In the shadow of the wave of bankruptcies hitting the country, the productivity of companies, production, and sales structure also improved significantly. However, the loss of solvency was a constant threat. On the other hand, forced improvement of the double deficit would have driven adaptation to a halt and "the economy would be reduced to the consolidated balance sheet of the budget and the National Bank".[4] A series of inflationary fiscal measures (known later as the infamous *Bokros package)* was supported by new exchange rate policy measures and privatisation was boosted. As a result, economic consolidation slowly commenced in 1995. (Its speed was well characterised by Lajos Bokros, Minister of Finance at the time: "A warship will take time to turn but it can sink rapidly.")

Foreign exchange reserves started to grow as the deficit of the current account balance was reduced, the so-called non-debt-generating financing (FDI) gained momentum and additional privatisation revenues were accumulated. Thus, maintaining solvency was no longer the overarching priority of monetary policy

3 The above paragraphs were written using *Werner's* chapter on monetary policy (Antal et al., 1990:27–35) supplementing his ideas and sometimes wording with later events.

4 Werner expressed his worries at a private talk - alas, I cannot ask for his approval to quote his sentence.

and achieving price stability became the key objective. A modern state security market was established where state debt could be effectively managed. Forint, the national currency drew near to ERM-II due to the one-off devaluations, the crawling peg and floating the exchange rate in a narrow band (disregarding the unfortunate episode of the so termed re-alignment of the band). Step by step, the convertibility of HUF was established. The evolutionary changes and the growing impact of interest parity (a shift in the centre of gravity of the trilemma) enforced gradual amendments of the means of monetary policy as well. Limiting the growth of foreign exchange reserves (at a satisfactory level) provided a cap on interest rates regulating credit demand.

Establishing the modern institutions of a market economy contributed to clarity and, through it, to business trust among the economic actors, a factor that, in addition to its other beneficiary effects, promoted monetary transmission. Using privatisation revenues to reduce public debt did not only mitigate budgetary crowding-out" but also improved transparency, as the so-called "zerocoupon stock" (state debt automatically generated to finance accumulated loss on the open FX positions of the central bank) was eliminated and the interest earned on government debt was solely determined by the demand of the financial market. That was the end of the process of debiting transformation losses to the state that started with loan consolidation.

Werner had been a witness of the birth of modern Hungarian monetary policy, responsible for economic political goals; and he was an active participant of its first two decades. Monetary policy would have been different without him. He left his mark on Hungarian monetary policy instruments and contributed to its success. It is a pity he did not live long enough to see its climax: the retirement of the forint.

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