Ferenc Karvalits: Current issues of the monetary policy in Hungary

Speech by Mr Ferenc Karvalits, Deputy Governor of Magyar Nemzeti Bank (the central bank of Hungary), at the Reuters Summit, Vienna, 29 September 2009.

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It is a pleasure to be here today. Just a bit more than a year after the global financial crisis intensified dramatically in September 2008, it is appropriate to look back at what the Hungarian policy makers have done in the last twelve months. In this stock taking I will focus on the measures of the Magyar Nemzeti Bank, presenting the various policy instruments in a consistent framework.

Before going into the details, I would just like to set the stage by describing the macroeconomic situation of Hungary in mid-2008. Looking back into the pre-crisis years, it might even seem to be a peaceful, relatively prosperous period. Until early 2008 all segments of the financial markets enjoyed ample liquidity, GDP growth was driven by dynamic exports. Despite the ongoing fiscal tightening, households were rather optimistic about the future, consumption growth hardly decelerated from its peak values. However, it is important to emphasize that the Hungarian economy started facing difficulties earlier than last autumn and that the tension had been building up below the surface for a while, as illustrated by the gradual increase of external and government debt ratios. The crisis last September had gravely impacted the Hungarian economy at nearly all levels. The sustainability of the debt path became uncertain, external financing resources dried up, the risk premium expected from Hungarian instruments dramatically increased, and we had to face a free fall in external demand in the real economy – all this happening at the same time. One can summarize with the benefit of hindsight that Hungary had large vulnerabilities by 2008, even though the fiscal consolidation since 2006 helped to bring the economy closer to a sustainable path. Neither the public sector, nor the financial system, nor the wider private sector had sufficient cushions for the once-in-a-century-crisis that was ahead of us.

Therefore it is no surprise that in the first months of the crisis the central bank focused on "fire fighting" measures: combating the consequences of the liquidity crisis and strengthening the confidence in Hungarian assets. As the most straightforward way to demonstrate strong commitment to longer term sustainability, to rebuild confidence, the Monetary Council increased interest rates by 300 bps on October 22. To ease the liquidity situation, the Magyar Nemzeti Bank implemented various measures, providing liquidity in different markets, lowering the required reserve regulations and also introducing euro and Swiss francs swap facilities with various maturities for domestic banks.

Notwithstanding the importance of the monetary policy measures probably the most important development in this period was the deal reached with the IMF and the EU on the financial support package. On the one hand the package gave us the necessary "ammunition" to avoid a full-blown current account crisis, a sudden stop in capital flows. On the other hand, by designing a medium term path towards sustainable fiscal and external position, helped significantly to increase the credibility of the fiscal tightening measures announced by the government. In short, we needed two things, funding and credibility and the international institutions could help us with both. With the help of the package we could manage the roll-over risk of the Hungarian economy, and at the aggregate level there was no capital outflow from the banking sector, foreign investors only withdraw capital from the government securities market.

In the subsequent months the focus of policy makers shifted towards the real economy. This was mainly justified by the global collapse of trade that worsened short term economic outlook to a previously unimaginable extent. Hungary as a small, open economy was hit particularly hard by fall in external demand. On top of this adverse external impact, the

sizeable fiscal consolidation further deteriorated short term GDP outlook. Our inflation forecasts indicated that, despite inflation persistence stemming from the high inflation history of Hungary, the fall in demand will bring CPI below the target over the monetary policy relevant horizon. The text book response of monetary policy in this situation is to ease monetary conditions, trying to smooth the downturn of the economic cycle, without endangering the primary objective of price stability. Our situation, however, was complicated by the sustainability concerns, justifying higher interest rates to compensate investors for the higher risk premium. Monetary policy had to balance between these two forces and following the rate increase in October, we ultimately decided to cut the interest rate 4 times between November and February, tolerating a gradual, controlled weakening of the forint. But investor sentiment worsened abruptly and dramatically towards the Central and Eastern European region at the beginning of the year.

We faced the second wave of the crisis during the spring of 2009, as the entire Central and Eastern European region did. The exchange rate depreciated to historic lows, risk premiums and yields jumped up, region-wide concerns of banking failures intensified significantly. We witnessed a clear over-shooting in risk perception.

Two forces were at play in the region. First, all countries in the region depend heavily on external demand, especially on German demand. As you know, Germany was hit particularly hard by the collapse of international trade. Second, financial sector tensions grew by the worsening macroeconomic outlook until spring 2009. In Hungary, as in many new EU members, it was not only the well-known pro-cyclicality of banking sector at play, but also the effects of FX lending started to surface. At the first sight, banks had no FX exposure: FX loans were matched by FX funding. However, the funding had a much shorter maturity, as indicated by the FX liquidity shortage, and ultimately the balance sheet problems of unhedged borrowers could turn into significant bank losses, at times when collateral values were also falling. It is thus no surprise that banking sector risks in Hungary are closely correlated with the exchange rate.

Our foremost objective was, in this period, to contain financial stability risks, to ensure the adequate capitalization of commercial banks. To this end, we could use the assigned portion of the IMF package and encouraged mother institutions to maintain capital adequacy ratios above the required levels in their Hungarian subsidiaries. I can summarize that our objective in this period was to avoid worst case scenarios, a meltdown of the financial sector and uncontrolled weakening of the exchange rate. And we succeeded.

At this point, let me take a sidestep, and share with you some thoughts on FX lending. With the benefit of hindsight it is very tempting to identify the rapidly growing FX lending as one of the major causes of problem in the region. This is indeed the case for a large part of the financial stability risks. Let me mention, though, two additional considerations. As a central banker, I am aware of the impact FX lending can have on monetary transmission. When significant stocks of FX loans have already built up the depreciation of the domestic currency can exert pressure on the balance sheet of unhedged borrowers. This, in turn, can have an impact on the transmission mechanism: lower interest rates, and thus weaker exchange rate in a UIP framework, will not necessarily mean a substantial monetary easing. The increased burden of the FX loans can act against the effect of the lower domestic interest rates. Therefore in economies with high levels of FX loans monetary policy has less room to behave counter-cyclically. Because of that we, central bankers are interested in limiting currency mismatches in the balance sheet of domestic market participants.

One can also look at FX borrowing of the unhedged domestic agents as the mirror image of the well-known convergence play, when foreigners invest in assets denominated in local currency. The only constraint of this convergence play is the risk absorption capacity of the borrowers. Magyar Nemzeti Bank supports responsible lending and borrowing behavior that targets to increase the risk absorption capacity of borrowers.

I am sure we still have to discuss the role of FX loans in more detail in the future. However, I am convinced that an overly simplified view, emphasizing only type of risks, would not lead us towards a consensus view and would help little in guiding future policy measures.

Finally let me say a few words about the events of the most recent months and touch briefly on future challenges we are facing.

Summer brought favourable developments in various dimensions. Global risk aversion eased significantly, thanks mainly to the well coordinated fiscal and monetary measures of developed countries. This was obviously a very welcome phenomenon for Hungary. It helped the currency to appreciate by more than 10% compared to the levels in spring, and also contributed to the significant drop of domestic bond yields, even at longer maturity. I consider the functioning of the government securities market to be a key indicator of market perception on fiscal sustainability. In this regard, it was particularly favorable that, following a long pause, the government was also able to issue long maturity bonds in forints. While the IMF/EU package provides reliable source of financing, the ultimate goal is obviously to return to market financing, preferably in forints. Therefore we not only have to present sound and credible fiscal consolidation measures to the international institutions for approval, we also have to make sure that market participants find the fiscal path credible. Last, but not least, the return of market confidence gave the Magyar Nemzeti Bank the room to start reducing the key interest rates.

Further positive news was coming from price developments. Ex ante there were well-grounded concerns about the inflation impact of the large VAT hike, a crucial part of the fiscal tightening measures. Central banks never welcome any administrative increase in the price level, there is always the risk that a part of the one-off increase will lead to more permanent inflation pressure. This was especially a pronounced concern in Hungary given our less than satisfying track record of meeting the inflation targets. While it is obviously too early to say the final judgments, July and August CPI data indicate that VAT increase is reflected in the prices to a smaller degree than previously expected, and, probably more importantly, there is no sign that underlying inflation trend would have accelerated due to the tax increase.

I find it important to emphasize in this context that monetary easing in Hungary is also conditional on the evolution of global risk appetite. We have learned during the crisis that risk premia can be extremely volatile. It is therefore essential to have a robust strategy, to be prepared to cope with potential unfavorable shifts in risk perception. To this end the Monetary Council has decided to follow a gradual approach in reducing the interest rate.

Despite of the dominance of good news of the last few months becoming complacent at the current juncture would be a great mistake. We are perfectly aware that still a lot has to be done in Hungary to finally reach a sound, sustainable fiscal and external position, characterized by dynamic growth and low inflation and well functioning financial sector. Monetary policy of the Magyar Nemzeti Bank has a clear objective: price stability. This does not mean that we are narrowly looking only at inflation forecasts, but rather, in a broader context, we want to contribute to longer term predictability in the Hungarian economy. I am convinced that price stability cannot be attained and maintained without longer term predictability. To this end we will be focusing on managing risks to stability and sustainability, risks that we expect to be with us for a protracted period of time.

Thank you for your attention!