Ferenc Karvalits: Current challenges and responsibility of economic policy in Hungary

Speech by Mr Ferenc Karvalits, Deputy Governor of Magyar Nemzeti Bank (the central bank of Hungary), at the Reuters Summit, Vienna, 13 October 2010.

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It is a pleasure to be here today. Two years had passed since the fall of Lehman Brothers, and while the most acute phase of the crisis is already behind us, it can have lasting effects on the working of our economies. Let me have a look at how our economy fared in this turbulent period, and what challenges lie ahead.

Before going into the details, I would like to set the stage by describing the macroeconomic situation in Hungary just before the financial crisis unleashed its full power on us. Looking back into the pre-crisis years, it might even seem to be a peaceful, relatively prosperous period. It is true, that loose fiscal policy in the previous period created external imbalances; however until early 2008 all segments of our financial markets enjoyed ample liquidity, while GDP growth was driven by dynamic exports. At that time, few people thought that these can be the symptoms of a bubble just about to burst. Thus, despite the ongoing fiscal tightening that decreased their disposable income, households were rather optimistic about the future, and they kept up their level of consumption by borrowing mainly in foreign currencies. However, it is important to emphasize that the Hungarian economy started facing difficulties earlier than the autumn of 2008, and that the tension had been building up below the surface for a while, as illustrated by the continuous increase of external and government debt ratios, and the increasing currency mismatches on household- and to some extent on corporate balance sheets. I have to admit, it was mainly fiscal. The twin deficit made Hungary fundamentally weakest country among non-member states.

The financial crisis had gravely impacted the Hungarian economy at nearly all levels. The sustainability of the debt path became uncertain, external financing suddenly dried up, the risk premium on Hungarian assets dramatically increased, and we had to face a free fall in external demand – all this happening at the same time. With the benefit of hindsight this is not surprising: Hungary was among the most vulnerable countries at the autumn of 2008.

These vulnerabilities also accounted for the fact that Hungary was not in a position to engage in countercyclical policy measures. The high level and uncertain sustainability of government debt made it all but impossible to implement fiscal stimulus measures. On the contrary, in order to secure long term sustainability, a significant fiscal adjustment took place, which was necessarily pro-cyclical in the short run. The fiscal adjustment also contributed to the dramatic adjustment that took place within the private sector. Households increased their net savings, while firms cut down on their investments, which resulted in a strong trade balance surplus, and a net financing capacity towards the rest of the world. The financial gap was closed. In less than 18 month the external finance position improved by more than 8%.

It must be stressed, that when the crisis hit, countries relying heavily on external funding to finance their growth suffered a more severe recession in 2009, in contrast to those where growth was financed by domestic savings to a greater degree. As it appears unlikely that investors' risk appetite will return to pre-crisis levels for quite some time, over the medium term, the process of real-convergence cannot proceed at the expense of a significant deterioration in external balance. We need a new growth model. We have to rely mostly on domestic savings.

Neither monetary policy was in a position to act strongly against the sharp downturn, due to the high expected risk premium and the currency mismatch problem. However, from the outset the central bank introduced liquidity support measures, and after risk appetite seemed to be stabilizing, we begun to lower or policy rates gradually, keeping in mind that we must not let sudden movements in risk appetite to translate into potentially destabilising balance sheet effects.

How can we address these vulnerabilities, that are a threat in themselves but also constrain the effectiveness of economic policies so much? There are no quick fixes here. While the pre-crisis level of indebtedness of households was not particularly high by international standards, its currency composition became very risky.

The debt burden increased significantly due to the weakening of the forint-euro exchange rate and the strengthening of the Swiss franc. The currency mismatch on private sector balance sheets took years to build up and cannot be undone easily. There is no simple way of converting foreign currency debt to domestic currency debt. If government takes over, it would only mean a transfer of risks, but not elimination. If the conversion would take place directly and *en masse* on the foreign exchange market, this would almost certainly imply large exchange rate depreciation and possibly other unintended consequences. Moreover it is hard to imagine indebted households that are eager to realize their losses on their foreign exchange liabilities while switching to the more expensive domestic currency financing, which is also subject to interest rate risks. It seems that the only safe way forward is a slow process of private sector balance sheet adjustment. Policy can support this process by doing everything in its power to reduce the country specific risk premium and enhance financial stability. This includes ensuring sustainability of public finances, anchoring inflation expectations, preventing the recurrence of irresponsible foreign exchange lending through prudential regulation, and last but not least creating a growth friendly environment through structural reforms.

The other key vulnerability, the high level of public debt has already been addressed to some extent through a significant fiscal adjustment process that took place in the last couple of years; this year Hungary will register a cyclically adjusted primary balance of around +1.4 per cent of GDP. However to ensure robust and continuous debt reduction, tight and credible fiscal consolidation needed with focus on lasting structural reforms on the expenditure side.

It is important to point out, that fiscal adjustment in and of itself will not necessarily do the trick. While one key aspect of fiscal sustainability is the size of the (cyclically adjusted primary) deficit, at the end of the day it is the long term growth potential of the economy that matters. Thus it is imperative, that while keeping a low average level of primary deficit through the economic cycle, the structural weaknesses of the Hungarian economy are also taken care of. By this I mean – *inter alia* – increasing labour force participation, enhancing competition in certain sectors, strengthening the rule of law, creating a growth friendly system of taxes and social transfers. In order to realize the “growth dividend” from this measures a well capitalised and competing banking sector, which is able and willing to lend to the private sector is essential. The above measures make a permanent reduction in government debt more likely to happen.

Decreasing the above mentioned vulnerabilities by appropriate policy actions has the additional benefit of a lower, country specific risk premium. A permanently lower risk premium has a beneficial feedback effect on both debt sustainability and the balance sheet vulnerabilities. A lower level of risk premium decreases the refinancing cost of the existing debt stock thus enhances fiscal sustainability while it decreases the cost of capital which has a beneficial effect on potential output through higher investments. Lower risk premium can lead to exchange rate appreciation and in a competing banking system decreases lending rates. Both of these have the potential to facilitate the ongoing balance sheet adjustment in the private sector. It is important to point out, that these feedback effects are also there when the risk premium increases – but with the opposite sign. These are the reasons why policymakers in countries where high debt burdens are coupled with currency mismatches must not be complacent.

Let me now turn to monetary policy related issues. Currently we see a huge slack in our economy, which affects the behaviour of all economic actors. While there are clear signs of recovery in the export sector due to strong external demand, domestic demand is still very weak. The latter is reflected by the price setting behaviour of the private sector. While the evidence is still not fully conclusive, based on the latest data it seems likely that the pass-through of exchange rate fluctuations into consumer prices has slowed down. Labour market data may point to the direction of a stronger than expected slowdown in nominal wage growth. Inflation expectations at one year horizon are on the decline. Although headline inflation is still a bit high, due to the above-mentioned factors, it seems more and more likely that our medium term target can be attained with the current monetary conditions.

However, we are fully aware of possible upside risks to inflation stemming from imperfectly anchored long term inflation expectations and larger than expected increases in food and commodity prices, and will not hesitate to act if they materialize. Of course, in this case we would face a trade off between inflation and output gap stabilisation, but given our price stability mandate and taking into account the inflation track record of the country anchoring inflation expectations should be the priority.

Another issue we faced was the recent appreciation of the Swiss franc against the euro and the forint. Since in Hungary the majority of foreign currency loans are denominated in Swiss francs, this put a particularly heavy burden on indebted households. Beyond the adverse effect on their disposable income and thus domestic demand, borrowers' declining ability to repay their debt can lead to deterioration in credit quality, which, in turn, may prompt banks to reduce the supply of credit. Moreover, since the share of Switzerland in Hungarian exports is negligible, there is no short term competitiveness effect stemming from the weaker forint-Swiss franc exchange rate. Thus the strengthening of the Swiss franc against the euro has only adverse effects on the Hungarian economy. While this pressure eased somewhat lately, we should keep in mind that the Swiss franc – euro exchange rate can react sharply to sudden movements in global risk appetite. Although we have to take all these factors into account when deciding about policy rate, I want to underline, I'm certain that households and banks can (have to and will) solve the loan problem on their own. I do not see financial stability risks which would put constrain on monetary policy.

Turning to the state of the banking sector, let me stress one important thing. When we raise the issues that I will talk about in a second, we do not speak on behalf of the banking sector. What we are concerned about is the lending capacity of the financial system, which is essential for the economic recovery, let alone long term growth. We at the central bank do our job for the public good, and not for the comfort of any particular sector of the economy.

That is why we are a bit concerned, when we see corporate and household lending lagging behind the economic recovery. In the corporate sector the weak domestic absorption from demand side and the tight lending condition from supply side lead to a long-lasting credit contraction. In the household sector the over-indebtedness, the high debt burden as well as unemployment cause depressed credit demand. From supply side the ban on foreign currency mortgage-lending introduced by the government is a strong negative contributing factor.

Banks' willingness to lend is still low due to the unfavourable economic and financial market environment. While the liquidity position of the Hungarian banking system is currently strong, deteriorating loan portfolio quality weakens banks' capital position. The income generating capacity of banks is lower not only because of the portfolio deterioration but also the massive amount of the recently introduced bank levy.

The bank levy has several unintended consequences. This special and rather arbitrary bank tax may impair the ability of the banking sector to attract foreign capital and funding compared to other countries in the region. Since the profitability-outlook and therefore the competitiveness of the Hungarian banking system are deteriorating parent banks may reallocate their financial sources and rather channel to another country. This may negatively affect Hungarian banks' capacity to lend, which in turn may result in a slower recovery, and if remains permanent can hamper long term growth.

Main messages

- The post crisis world permanently requires less resilience on external financing. Hungary needs a new growth model, which rely on domestic savings.
- Robust and continuous government debt reduction has to be in the focus of macroeconomic strategy.
- To preserve real convergence in the post crisis world we need tight and credible fiscal policy. Fiscal consolidation has to rely on long lasting structural measures on the expenditure side.
- To enhance long term growth potential structural weaknesses has to be addressed as well:
  - tax and social transfer reform, which support increasing labor force participation,
  - improvement of the quality of primary and secondary education to strength employability,
  - strengthening technological transfer among multinational and small/medium size businesses, to eliminate the dual structure of our economy.
- Stability of the regulatory environment, strengthening the rule of law, respect of contracts and market based coordination.
- Anchored inflation expectations.
- Keep financial intermediation active and motivated to provide appropriate level of financing future business activities.