

Ferenc Karvalits: The impact of financial turmoil on the Hungarian economy

Speech by Mr Ferenc Karvalits, Deputy Governor of Magyar Nemzeti Bank (Hungary's central bank), at the Reuters Central European Investment Summit, Vienna, 21 October 2008.

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Ladies and Gentlemen,

A few months ago, I was asked by the organisers of the Reuters Summit to talk about some current issues in Hungarian monetary policy. Unfortunately, over the course of the recent weeks the turmoil in international money and capital markets have escalated to such a degree that it inevitably calls for an analysis of the current situation engendered by the global financial crisis.

While at this stage it is probably too early to tell how and how much we will be affected by the crisis, I will take this opportunity to discuss the major challenges and issues the Hungarian economy currently faces, and how they will affect monetary policy-makers' room for manoeuvre and their mandate to meet the inflation target and ensure financial stability.

Without going into details of the drivers that have led to the turmoil in financial markets, I would like to briefly summarise the channels through which this financial crisis is causing difficulties in the conduct of our monetary policy.

The global environment is now characterized by (1) increased risk aversion as investors are trying to de-leverage their balance sheets, and (2) a shortage of liquidity as mutual trust within the financial sector has not yet recovered.

At the moment, Hungary is negatively affected by both these global phenomena. First, being an emerging economy, Hungarian assets are subject to the process of de-leveraging. Demand for these assets has decreased, and their prices have fallen. Second, as it is natural for an economy that is in the phase of catching up with its more developed peers, Hungary has been running a current account deficit, and is highly dependent on external financing. Concerns have emerged recently about how Hungary will be able to finance this deficit. Indeed, the global liquidity shortage and the resulting reversion of cross-border capital flows may make this financing more difficult.

We anticipate that the fall in global risk appetite and the slowdown in the world's major economic regions will have repercussions for the Hungarian economy. In the more vulnerable emerging regions, where external debt levels are high and/or the economy has shown signs of overheating through credit expansion, risk premia have risen sharply and capital outflows have been substantial.

Hungary's vulnerability indicators improved as a result of the fiscal adjustment measures. However, markets responded to the changes in external financing conditions with an increase in the expected return on Hungarian assets, instead of appreciating the results of fiscal consolidation by reducing risk premia. We were not surprised at this move for two reasons. First, although the general government deficit fell significantly, contributing to an improvement in external balance, the continued growth in household debt had an offsetting effect. Second, the pattern of external financing deteriorated, leading to an increase in the ratio of debt liabilities to the total.

The domestic financial sector is heavily integrated into the European system and, therefore, problems in Europe may spill over to Hungary. Domestic banks have significant levels of capital reserves and high profitability. Unfortunately, some of the measures that were taken by the European authorities to ease the liquidity problems of financial institutions within the

euro-zone have some unintended, but dramatic and detrimental consequences for the systems of financial intermediation within the member states outside the euro-zone, like Hungary.

First, the ECB's steps to alleviate the tensions on the different segments of the inter-bank market for liquidity resulted in a situation where the ECB's instruments increasingly take over the allocative role of inter-bank markets. These facilities provide riskless and convenient means to manage liquidity across a range of currencies for the institutions that operate within the euro-zone. Under the current, turbulent circumstances these institutions are not motivated to return to the market. However, financial intermediaries outside the euro-zone are hit two-fold at the same time: not only they have no access to the ECB facilities, but they also have to manage their liquidity needs on increasingly thin inter-bank markets, as their traditional euro-zone counterparties opt to resort to the central bank instruments instead.

The lack of motivation is further exacerbated by the guarantee schemes for bank liabilities. As a consequence of these safety nets, the non-euro area institutions, who do not fall under their coverage, has become excluded from certain trades due to a shift in perceived riskiness relative to those who are covered by these schemes. These effects are not exclusive to unrelated entities: they even hinder trading relations between parent banks and their subsidiaries outside the EMU.

All in all, the liquidity-inducing measures by the ECB and the European authorities, which help to reduce the burden of the banks within the euro-zone, create a greatly uneven playing field and additional liquidity pressures for these banks "extra muros".

Second, the broadening of the range of eligible collateral for ECB operations have a similar, back-lashing impact on the Member States' financial markets outside the euro area. Financial institutions across Europe that rely increasingly on collateralised ECB operations, need eligible collateral more than ever. The unintended by-product is that markets, rather than considering risk and return when valuing assets, has begun to differentiate between securities to a greater extent on the basis of ECB eligibility, creating excess demand for the eligible instruments, and reducing the holdings of those assets that are not in the acceptable collateral pool. As securities denominated in the currencies of the Member States outside the EMU, including government bonds, are not part of the eligible set, markets for these securities now suffer from illiquidity and excess supply.

The consequences are unusually high yields, a general lack of demand, and severe frictions on both the primary and the secondary markets for government paper issued in local currency. Again, the measures attempting to alleviate the problems within the Euro area leads to deteriorating market conditions outside the eurozone.

All these factors, market-driven and regulatory alike, led to a rise in Hungary's external financing cost and in the expected return on forint-denominated assets. The financial sector has been adjusting to the increasing financing costs of forint and foreign currency assets by tightening credit standards, which, in turn, has led to a deterioration in the prospects for the real economy. As a result, credit quality may decline, but the ratio of non-performing loans to the total portfolio remains low. Difficulties with raising funds may enforce a degree of adjustment which may ultimately lead to tighter domestic credit supply.

Having listed all these problems, I still believe that the current risk perception of the markets regarding Hungary is overplayed. First of all, I believe that by now the commitment of policymakers both in Europe and the US is very clear: they are willing to do everything to unfreeze the credit markets and solve the liquidity shortage. I think that it is only a question of time before these efforts will bear fruit and the global liquidity situation will ease. That would mean that the single most important factor factor that makes our position difficult at the moment will disappear, or at least become less pronounced.

This does not mean that Hungary on its own should sit and wait until the problems are solved by the authorities elsewhere. My impression is that the Hungarian government has realised

the importance of a prompt action. It seems to be committed to bring further improvements in the budget deficit, potentially to introduce spending caps and to increase the size of emergency reserves. These measures come on top of the fiscal consolidation process that has been going on for two years now quite successfully, as the fiscal targets have been met and usually overperformed. Chances are that Hungary will meet the Maastricht fiscal criterion as early as this year. This means that the Excessive Deficit Procedure against Hungary will be terminated earlier than previously envisaged in the Convergence Programme. The bottom line is that reducing the budget deficit will decrease the external financing needs and will help to keep the economy on a sustainable path in the face of the recent increase in financing costs for emerging economies.

In the first half of 2008, Hungary's external financing requirement stabilized between 4 to 4.5 per cent of GDP. The economic slowdown in Europe and the increasing financing costs have already had some influence on the balance of payments, as the improvement in the trade balance has stopped, and the income payments on debt slightly increased. In spite of these developments we still believe that the external vulnerability of the country will gradually diminish as the net external financing requirement is expected to decline further.

Why? First, the probable decrease in the foreign currency lending is likely to diminish the households' consumption, and improve the trade balance. In other words, we expect a sharp rise in household savings as the credit to the sector will be cut back. Second, the ongoing fiscal measures will have also improve the external balance. Finally, according to our projections, the significantly increasing EU-transfers induce lower external financing needs. As a consequence, Hungary's external financing requirement is likely to decrease to close to 3 per cent of the GDP in 2009.

As to the measures implemented by the central bank, we have introduced new instruments aimed at kick-starting the government securities market and the FX swap market. We try to use every tool at our disposal to increase liquidity on these markets. It is important to see that the domestic currency interbank market does not show signs of a liquidity problem. It is the allocation of foreign currency liquidity where we have experienced frictions. The situation in this respect is very similar to the money markets in the euro-zone, where one of the most acute problems were also related to foreign currency liquidity, mainly US dollar and Swiss franc. It is important to note that in our effort to ease the liquidity squeeze in the domestic FX-swap market, we are backed by the ECB, based on a bilateral agreement that we jointly announced last Thursday.

The MNB constantly monitors the functioning of financial markets and the banking sector. The domestic financial sector continues to be stable. Nevertheless, the MNB is prepared to take further measures if necessary to maintain the stability of the domestic financial infrastructure, consistent with its mandate.

While at the moment financial markets and the banking sector are in focus, the ultimate goal of monetary policy is the achievement and maintenance of price stability. The Monetary Council of the Magyar Nemzeti Bank must consider the constant changes in the external environment, which influence the outlook for both economic growth and inflation. The current situation is aggravated by the fact that, albeit growth continues to be low, and domestic demand remains subdued, our external equilibrium have not yet improved to the extent that we could leave behind our vulnerability that we have built up in the past.

According to the forecast published in our August Inflation Report, the 3 per cent inflation target will be met by 2010. This baseline forecast is a conditional one. Needless to say, the conditions changed significantly since August; most notably the price of crude oil, which was above 130 US dollar per barrel, and the forint's exchange rate, which was more than 10% stronger back then.

This sizeable drop in the oil price is of course good news to the inflation outlook. In addition, the latest incoming data, and the dramatic downward revisions of the macro-economic

projections for Europe highlighted the downside risks of a domestic economic growth lower than the baseline. This should also help us to bring down the rate of inflation.

On the flipside of the coin is the sharp increase in the risk premia, and the forint's subsequent depreciation. Due to the quick pass-through from the exchange rate to import prices, this is of course bad news for the inflation outlook.

We are facing significant uncertainty, and both downside and upside risks are recognised. We will assess the balance and come up with a baseline forecast in our November inflation report. As usual, risk scenarios will also be presented in our Inflation Report. In the current situation of heightened uncertainty, these may receive more attention than usual.

I am convinced that we will have the best chance to steer the economy through the challenging times ahead, if we act consistently and stick to our fundamental principles that we laid down at the time of developing our inflation-targeting regime:

- achieving price stability shall be in the focus of monetary policy,
- our decisions shall be based on a balanced assessment of fundamental developments, and
- we shall adopt a medium-term, forward-looking approach to developing our monetary policy.

We are convinced that monetary policy can best contribute to long-term balanced growth by ensuring price stability, as this is how we can best preserve investor confidence and allocate resources available for the economy most efficiently. However, the smooth functioning of the system of financial intermediation is a necessary condition for efficient resource allocation. The central bank, therefore, will make every effort to detect and prevent the disturbances to the banking sector as early as possible.