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Hungary: Pre-Crisis Macro Vulnerabilities, Policy Responses and Current Outlook

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The pre-crisis period in Hungary

- Institutional flaws
  - Fiscal policy: weak fiscal institutions → unsustainable debt dynamics
  - Monetary policy constrained by the ER band → unable to sufficiently counterbalance fiscal expansion
  - Overly optimistic expectations of convergence → low savings contribute to large CA deficits

- All this made possible by abundant global liquidity (cheap financing) → lack of disciplining power of financial markets

- Fiscal adjustment
  - started too late (in H2 2006) and in wrong composition (public investment ↓, labour and capital taxes ↑)
  - harmed long-term growth potential, which was already low, probably due to „premature welfare state" supressing both labour supply (overly generous social transfers) and demand (high tax wedge)
  - was not enough to reduce vulnerability substantially before the crisis hit

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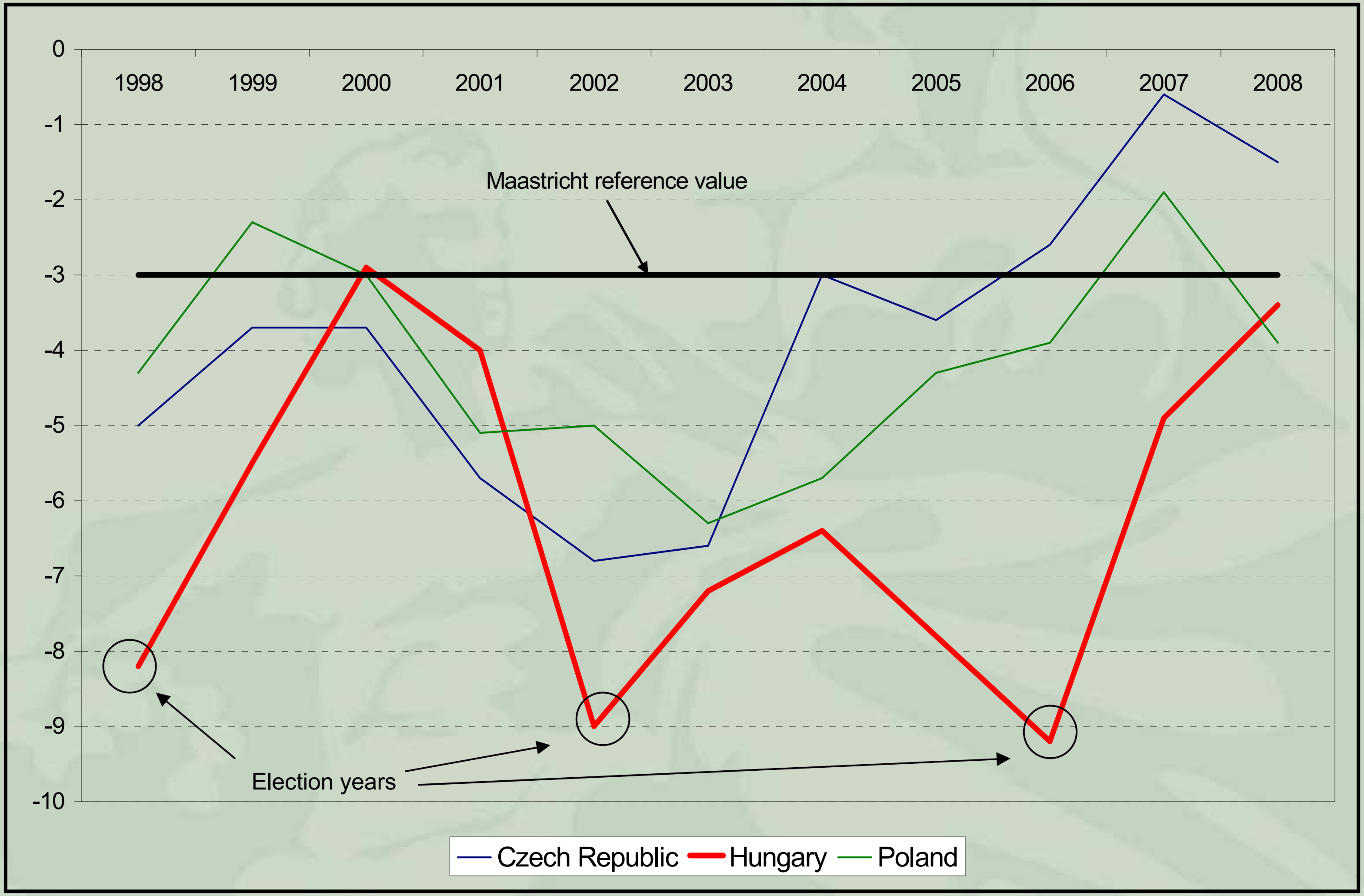
Chronically large budget deficits, „political business cycle”

budget balance, % of GDP



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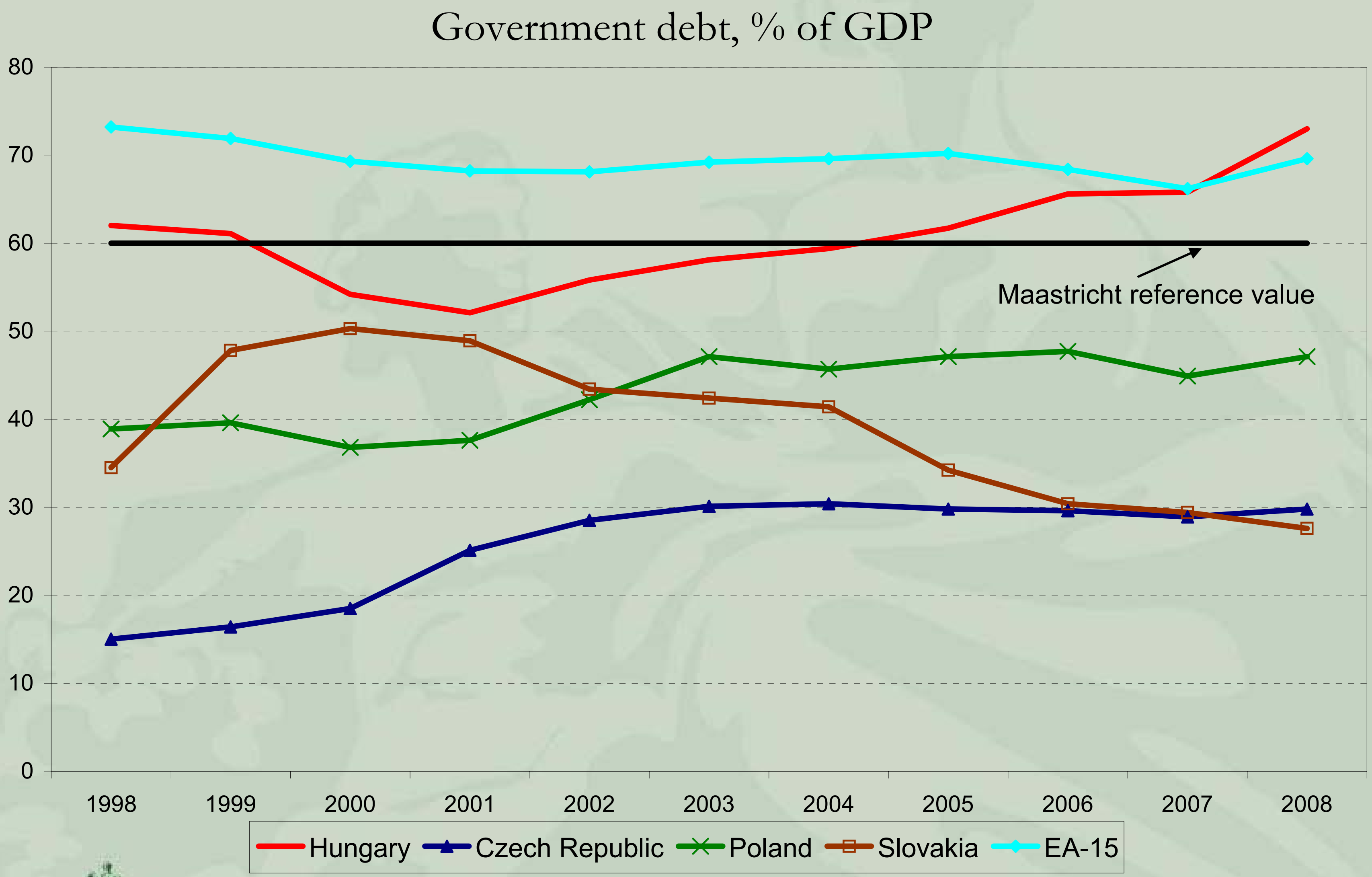
Unsustainable debt dynamics, tolerated by the market during the „global savings glut”, but punished after Lehman



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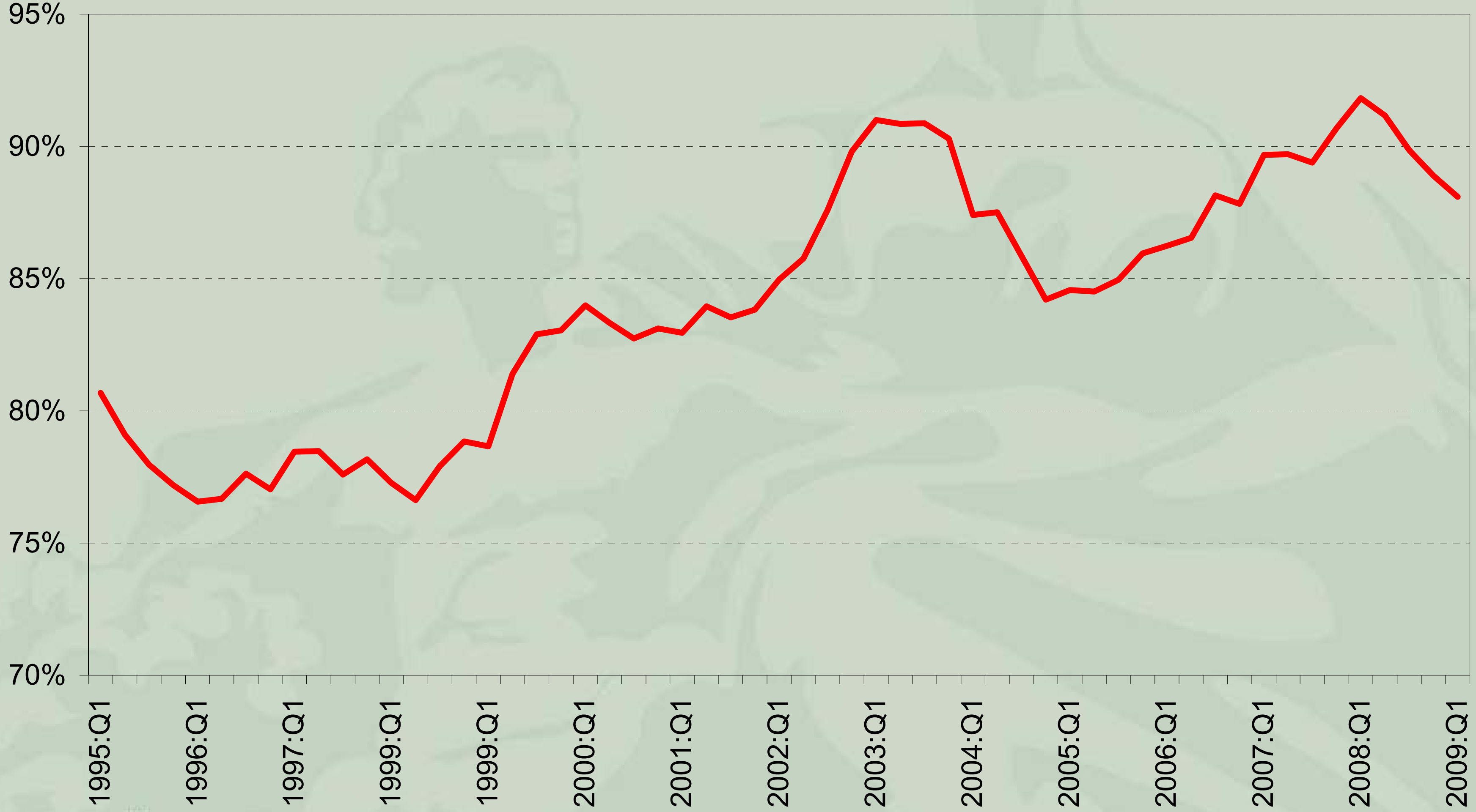
Overly optimistic convergence expectations

Households' consumption ratio
(as a percentage of disposable income)



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Unhedged FX debt: an unpleasant heritage from the pre-crisis period

- High internal and external indebtness → high long risk premium

- ER band →Constraint on monetary policy → HUF disinflation process not fast enough → high long-term interest rates

- Low perceived risks of FX borrowing by the private sector due to
  1. Low FX volatility due to the existence of ER band
  2. „Fear of floating” behaviour of the central bank: large interest rate reaction to negative premium shocks
  3. Expectation of swift euro adoption

- Due to above factors, FX loans more attractive, especially for longer horizons (e.g. mortgages)

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Policy Response to the Crisis I
Firefighting: sorting out the liquidity crisis

- The immediate response in October 2008: FX liquidity provision after the FX swap market dried out
- The challenge: LOLR capacity in FX is limited
- Started with short horizons: overnight FX swaps
- Horizon gradually lengthened after various forms of backing from international community was secured:
  - ECB credit facility
  - Loan agreement with the IMF, European Union and the World Bank
  - EUR/CHF swap line with the Swiss National Bank
- Domestic currency liquidity provision
  - 2-week and 6-month credit tender facilities
  - Lower required reserve ratio
  - Extension of eligible collateral range (mortgage securities, municipal bonds)

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Policy Response to the Crisis II
Procyclical fiscal adjustment and cautious monetary easing

- Because of the unsustainable level of public debt anticyclical fiscal easing is out of question in Hungary
- A sizeable and largely structural fiscal adjustment is being implemented, this time with the proper structure:
  - social transfers↓,
  - tax reshuffling: VAT and real estate tax↑ - taxes on labour↓
- In the midst of the crisis this is pro-cyclical and painful…
- …but inevitable and hopefully will increase long-term growth potential
- Monetary policy constrained by financial stability concerns (unhedged FX debt)
- Initially had to tighten substantially to prevent a full-blown currency crisis…
- …but has since embarked on a cautious easing cycle as global risk appetite started to recover

Consolidation in financial markets

- The April G20 summit had a positive impact on global investor sentiment
- The HUF, along with other CEE currencies has started to regain previous levels
- Foreign investors are reopening their HUF positions
- Domestic government bond market regains stability, substantial drop in the yield curve
- Government bond issuance restarted, supported by increasing demand
- During the summer the government launched a successful Euro bond issue
- Foreign currency liquidity normalized, banks are no longer dependent on the central bank's FX swap instruments

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Policy Response to the Crisis III
Addressing the root causes of vulnerability

Fixing long-standing institutional weaknesses:

- ER band has been abolished already in early 2008
- Public finance mechanisms have been strengthened
  - introduction of fiscal rules
  - enhancing expenditure control mechanisms
  - setting up an independent Fiscal Council to increase transparency
- The disciplining power of financial markets has increased after the crisis
- After such a deep recession, the illusion of early convergence is unlikely to return soon
- As a consequence of increased risks, both banks' and households' willingness to supply/ take on FX debt has substantially fallen, however may pick up again in an upturn necessitating regulatory action
- MNB initiated a regulatory proposal on 'responsible lending' to prevent a rebound of excessive unhedged FX lending: risk differential between domestic and foreign currency loans should be adequately reflected in lending terms (maximum payment-to-income and loan-to-value ratios)

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Economic outlook

- Domestic economic growth will resume in the middle of 2010
  - Larger drop in domestic demand and stronger adjustment in external balance than previously projected
  - In 2010–2011 Hungary's external financing requirement is expected to fall slightly further

- According to our latest projection, inflation may fall below target on the horizon relevant for monetary policy
  - After the temporary rise in 2009 due to increase in indirect taxes inflation will gradually fall
  - General macroeconomic environment will be strongly disinflationary

- Significant quantity adjustment in the labour market, although wage moderation less pronounced than expected

- Budget deficit target for 2009 could be achieved if stability reserves in the budget are not fully spent
  - Tight expenditure control plans are required for 2010
  - The risks are on the upside from 2010 onwards

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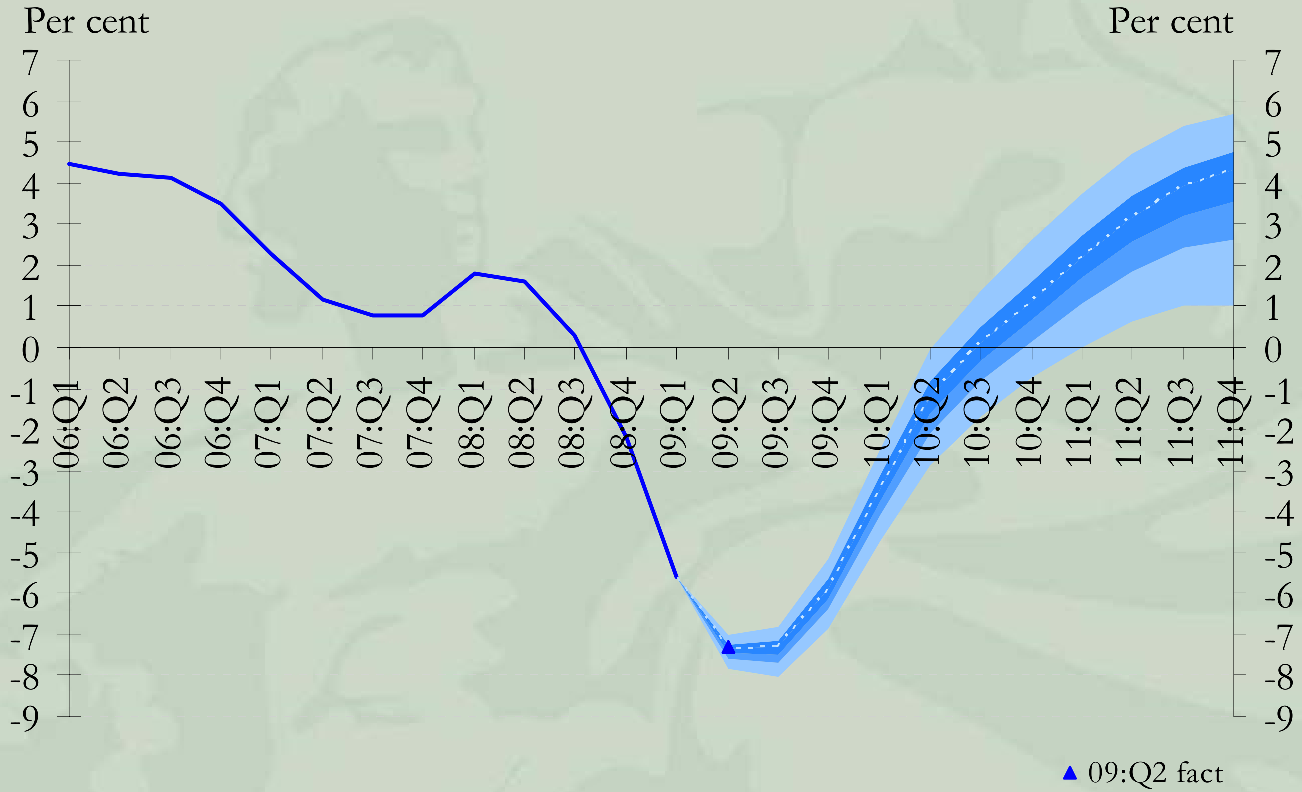
Growth expected to resume only in the second half of 2010

Fan chart of the GDP growth forecast



Source: MNB's Quarterly Report on Inflation, August, 2009

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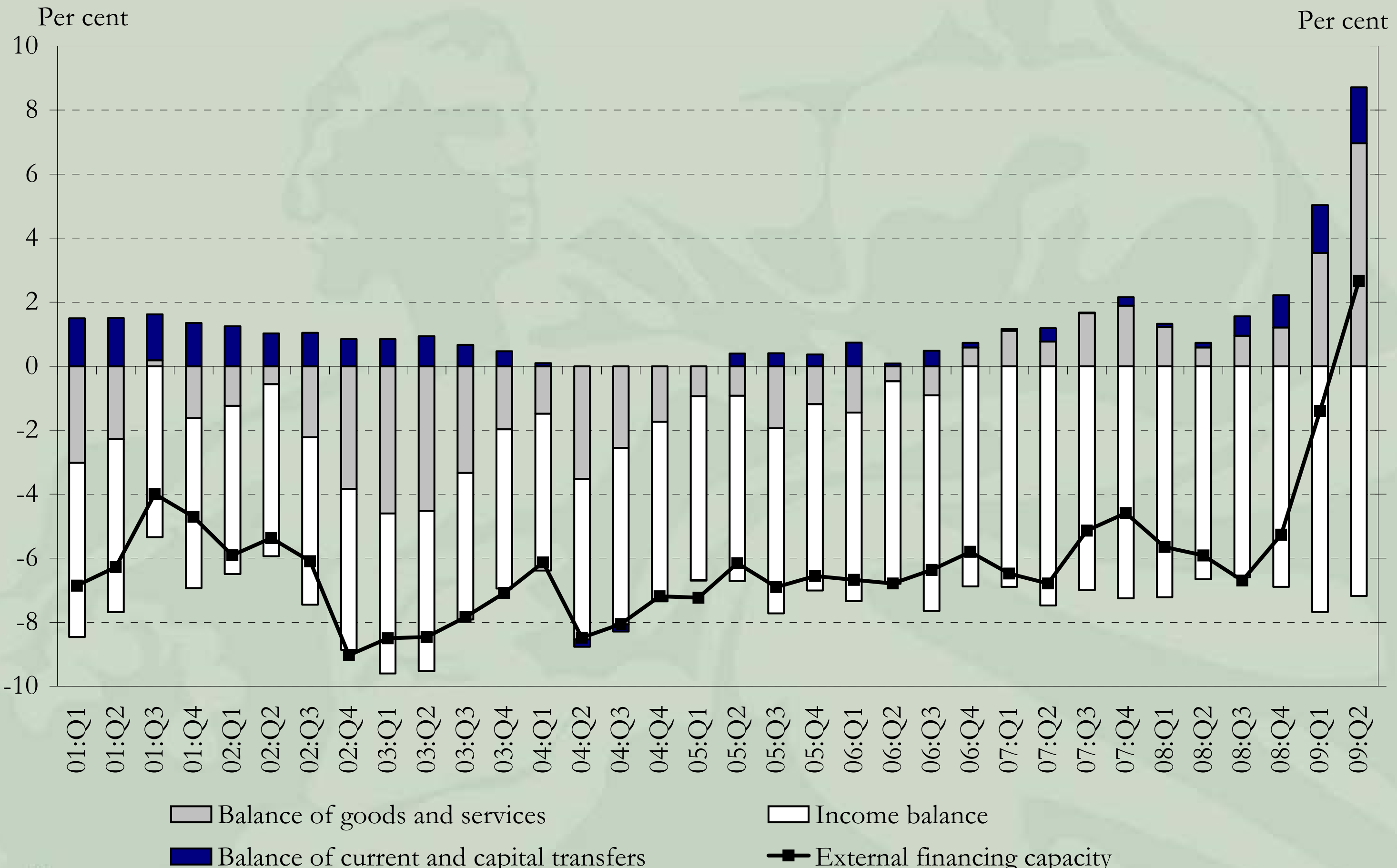
Adjustment in external balance is stronger than expected

Components of the external financing requirement (seasonally adjusted data, per cent of GDP)



Source: MNB

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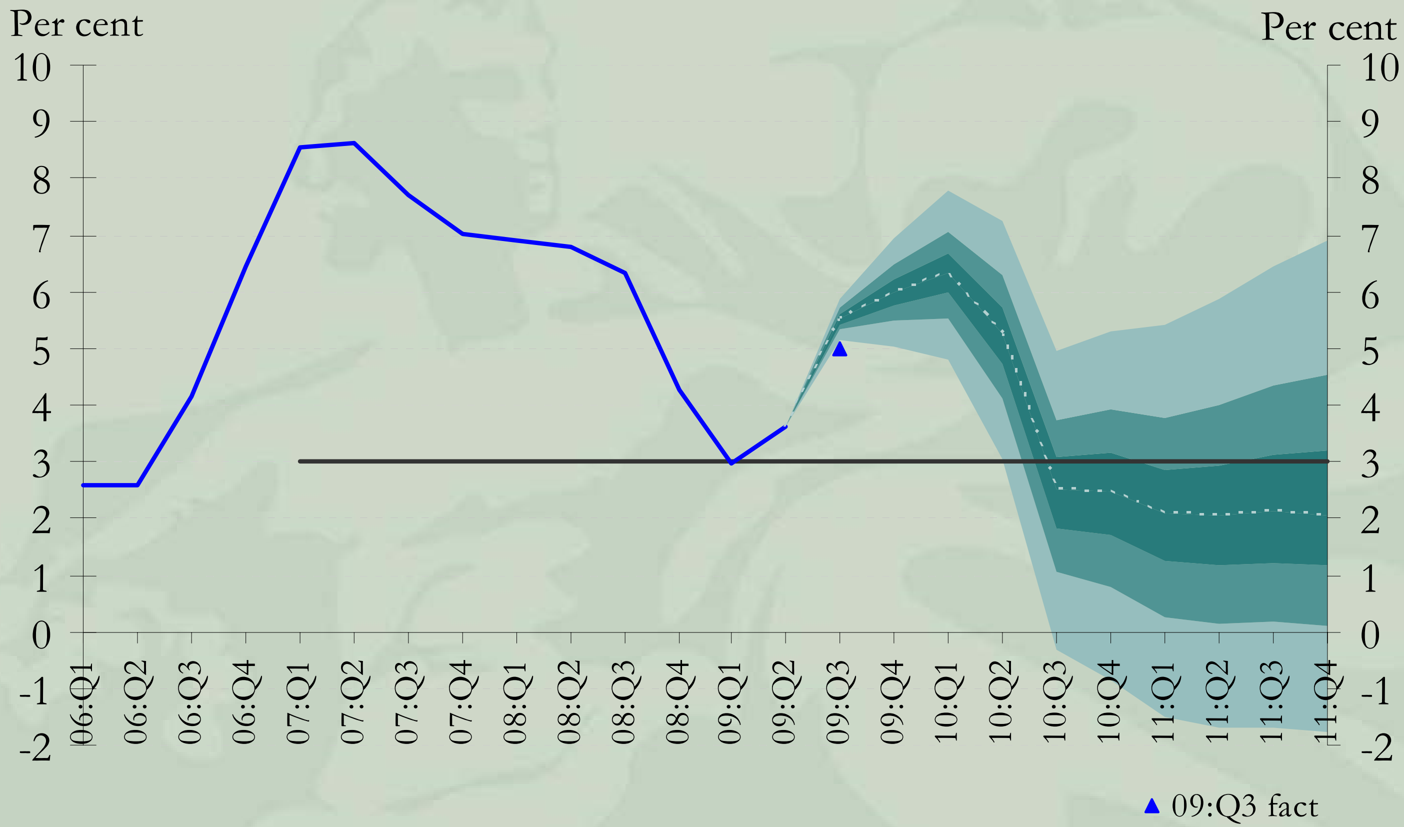
Inflation forecasts are below target on the policy horizon (after a temporary rise due to a 2009 VAT hike)

Fan chart of the inflation forecast



Source: MNB's Quarterly Report on Inflation, August, 2009

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Financial sector developments: strengths and weaknesses

- Substantial adjustment in the banking sector leading to lower financing vulnerabilities
  - lower loan to deposit ratios (lower external financing requirement)
  - lower FX swap requirements
  - longer financing maturities in the swap markets
    - lower lending activity due to lower corporate and household demand and increased credit risk expectations of banks
    - more deposits from corporates and households due to lower private sector financing requirement

- Portfolio deterioration is in line with our expectations
  - peak expected in 2010 with LLP around 3-3,6% from 1% in 2008

- Still high profitability partly due to one-off factors
  - After-tax ROE 15,3 %, ROA 1,2% in 2009 H1 (EU banking sector -3,02% and -0,11% in 2008)
  - Profitability gap remains high between Hungarian and home market banking systems

- Strong capital buffers
  - Tier1 ratio 10,3%, CAR 12,3% in 2009 H1 (EU banking sector 8,3% and 11,7% in 2008)

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