WIIW Conference
Panel discussion
26 March 2009

# The impact of the economic crisis on Hungary

## and policy measures taken/suggested

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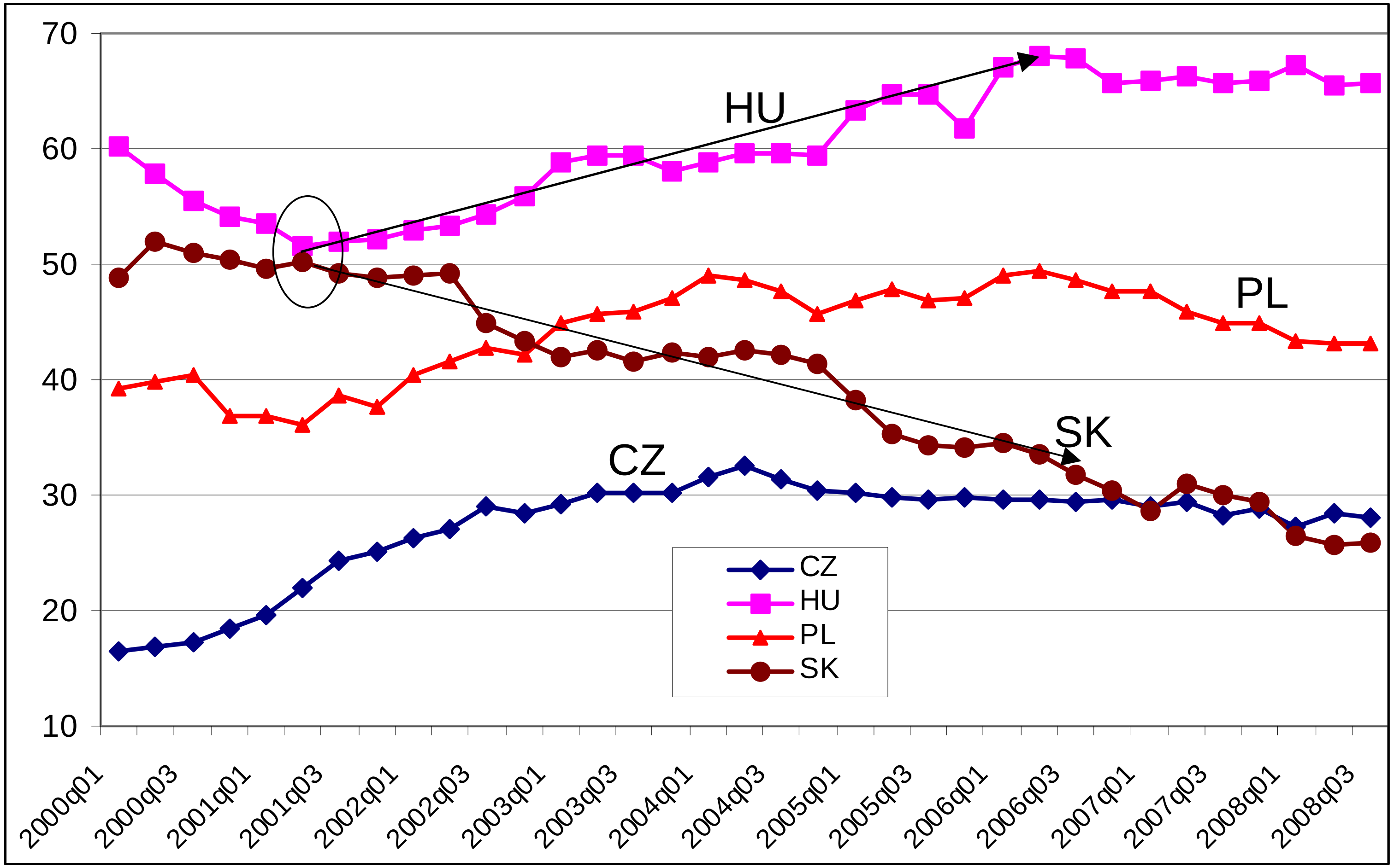
# Outline

- **Focus on financial issues – less on real effects**
- Why Hungary? (Why first hit among NMS of EU)
- Domestic measures taken: fiscal and mon. policy
- Further measures: domestic (controversial), external
- „Accelerated” ERM / EMU-accession?

# Why Hungary?

- Background: fiscal irresponsibility 2001-2006
- In spite of serious attempts to consolidate public finances since mid-2006,
- HU’s macro-vulnerabilities did not diminish sufficiently →
- Increasing vulnerability originating in the private sector (+ reinterpretation of risks)

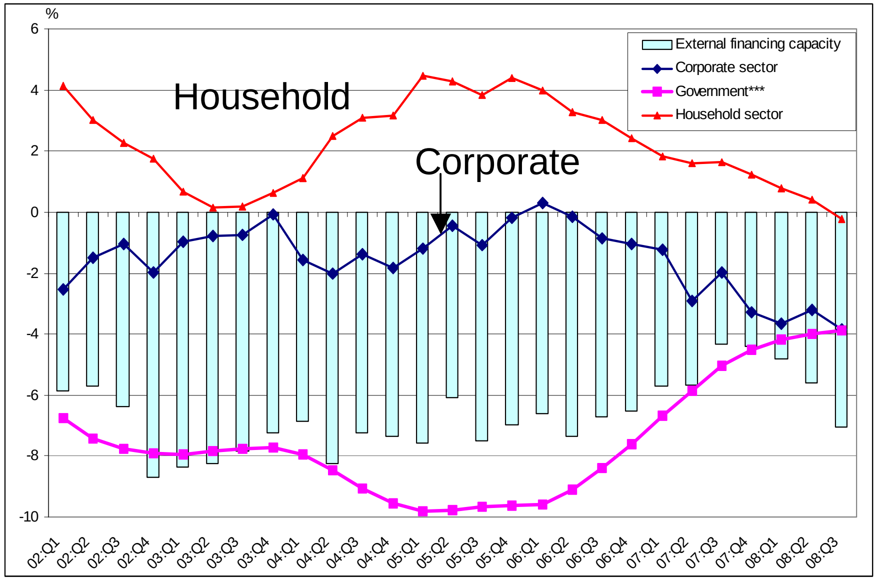
# Public debt/GDP (%)

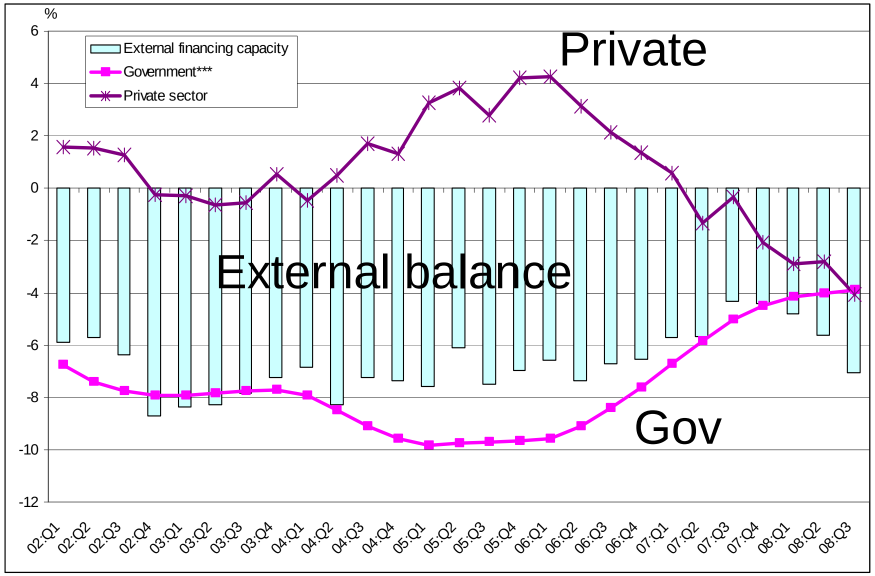



Source: EUROSTAT

# Hungary: net lending in % of GDP

## Public, private sector and total economy




Rational („Ricardian”) response to fiscal policy or „irresponsible” behaviour of the private sector?

-„Real-time” interpretation: rational („consumption-smoothing”)

- Hindsight: serious mistakes, irresponsibility

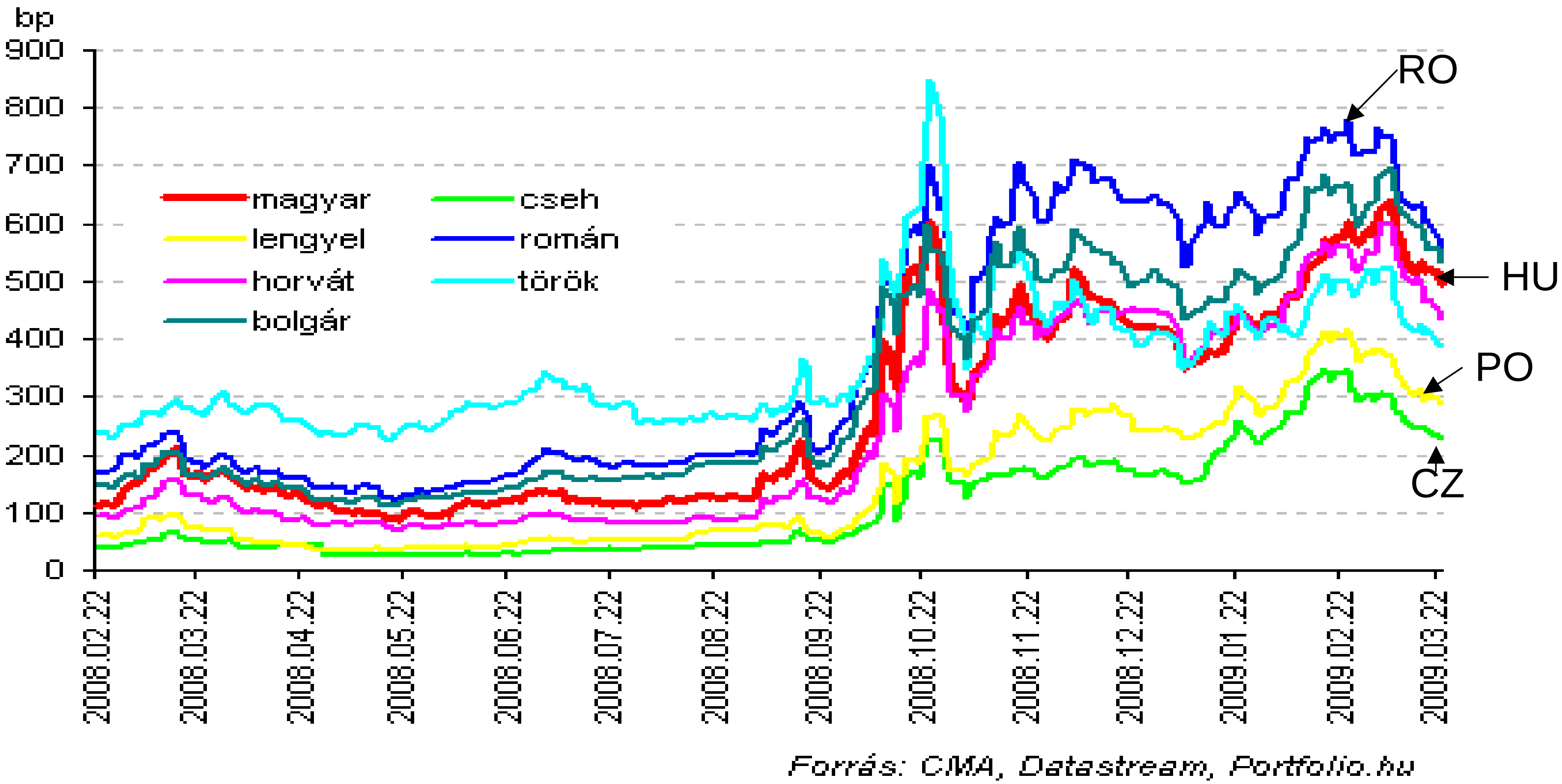
# International background

- Drain of international liquidity
- Reinterpretation of vulnerability

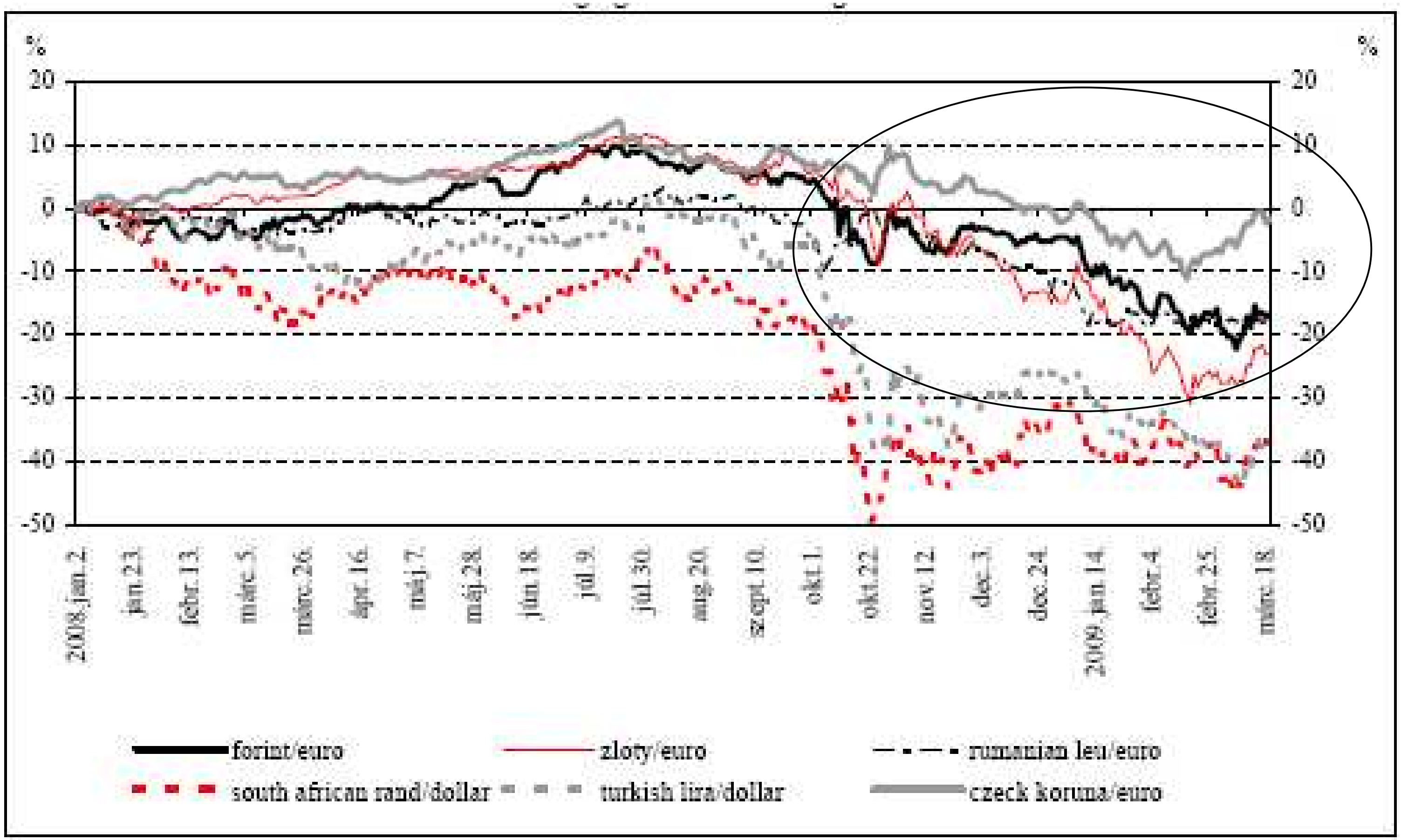
# The international environment

## Liquidity vanished after the fall of LB

# 5 year sovereign CDS spreads



# Exchange rates



# Effects on individual countries – two questions

- How strongly hit by the evaporation of international liquidity?
  - Depends on **both** the openness (financial integration) **and** perceived vulnerability of countries
  - [Unintended effects of solutions for handling problems of other countries (regions)]
- What comes to the surface after liquidity dries up??
  - Hungary’s special feature: large size of both public and private debt
  - Formerly essentially public debt considered as a problem, but:
  - Recently private debt came into the focus
    - Roll-over problems of commercial banks?
    - Currency-composition of household domestic debt
    - (In the background of corporate foreign debt: FDI-exports)

# Why pick on Hungary? – an expert view from the market

(Drawbacks of being financially integrated at the wrong time)

Felix W. Zulauf in Barron's, MONDAY, JANUARY 19, 2009

**Zulauf**: **Last year I recommended shorting both sterling and the Swiss franc against the U.S. dollar. These trades worked well. *Now short the Hungarian forint against the euro (…)***

*Q: Why pick on Hungary?*

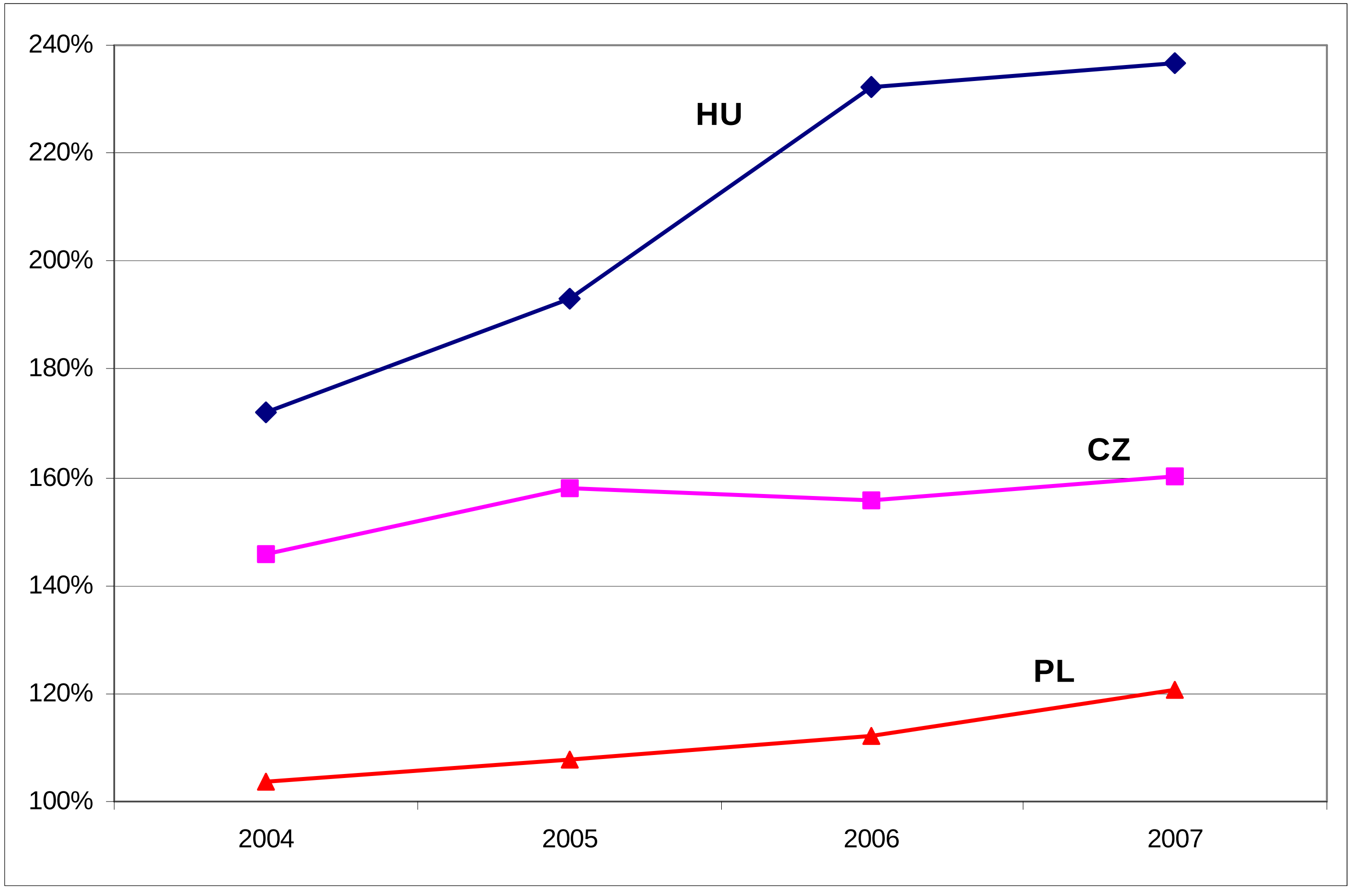
**Zulauf**: **Among European countries, it has the largest percentage of public and private credit -- 57% -- denominated in foreign currencies, largely Swiss francs.** That's public and private credit. Probably 70% of mortgages in Hungary are Swiss-franc denominated because of the interest-rate advantage. The Hungarian central bank is trying to defend the currency and doesn't want to devalue it, which would create more pain. They raised interest rates from 8% to 12% in the fall in the midst of the worst economic recession in modern times; rates are now down to 10%. When the pain eventually becomes too great, they will cut rates and the currency will decline.

***The forint isn't in the worst shape, but it is the most liquid among Eastern European currencies.*** **The currencies of the Baltic states and Romania are much worse fundamentally, but more difficult to trade.**

http://online.barrons.com/article/SB123215888715192693.html?page=1

# Indeed: HU's financial integration has advanced much beyond (i.e.) CZ and PL

(FA+FL)/GDP



# Vulnerability indices from The Economist:
## private, ratter than public indicators seem to matter…

**If one green bottle should accidentally fall...**

| Country | Current-account as % of GDP* | Short-term debt as % of reserves* | Banks' loan/ deposit ratio | Overall risk ranking† |
|---|---|---|---|---|
| South Africa | -10.4 | 81 | 1.09 | 17 |
| Hungary | -4.3 | 79 | 1.30 | 16 |
| Poland | -8.0 | 38 | 1.03 | 14= |
| South Korea | 1.3 | 102 | 1.30 | 14= |
| Mexico | -2.5 | 39 | 0.93 | 12= |
| Pakistan | -7.8 | 27 | 0.99 | 12= |
| Brazil | -1.5 | 22 | 1.36 | 10= |
| Turkey | -2.3 | 70 | 0.83 | 10= |
| Russia | 1.5 | 28 | 1.51 | 9 |
| Argentina | 0.2 | 63 | 0.74 | 8 |
| Venezuela | 0.8 | 58 | 0.75 | 7 |
| Indonesia | 1.2 | 88 | 0.62 | 6 |
| Thailand | 0.3 | 17 | 0.88 | 5 |
| India | -2.4 | 9 | 0.74 | 4 |
| Taiwan | 7.9 | 26 | 0.87 | 3 |
| Malaysia | 11.3 | 15 | 0.72 | 2 |
| China | 5.2 | 7 | 0.68 | 1 |

Sources: HSBC; Economist Intelligence Unit  *2009 forecast  †Higher score implies higher risk

…in the past, economists used to pay most attention to the solvency of governments, and hence their debt-to-GDP ratios. But **today, the biggest risk in the emerging world comes not from sovereign borrowing, but from the debts of firms and banks**. As foreign capital dries up, they will find it harder to refinance maturing debts or to raise new loans. The Economist: Economics focus **Domino theory**, Feb 26th 2009

# Leverage indicators:

## combination of public and private

| | Poland | Czech Rep | Romania | Hungary | Bulgaria | Lithuania | Latvia | Estonia | Ukraine | Russia |
|---|---|---|---|---|---|---|---|---|---|---|
| Credit to GDP (%) | 43 | 51.2 | 41.1 | 63.4 | 75.5 | 62.7 | 95.9 | 98.4 | 75 | 42.7 |
| Credit to GDP increase in past 2 years (pp) | 11.8 | 9.5 | 14.2 | 9.4 | 28.4 | 12.1 | 9.5 | 13.8 | 30 | 10.1 |
| Share of domestic FX loans (%) | 34 | 9.5 | 56.2 | 65.5 | 54.7 | 65.6 | 87.8 | 85.7 | 59 | 29.9 |
| Maximum mortgage loan to value ratios (LTVs, %) | 100 | 70-100 | na | 100 | 75-90 | 100 | 100 | 90 | 100 | 85 |
| Loan to deposit ratios % | 104.5 | 77.9 | 137.7 | 139.3 | 111.5 | 199.7 | 288 | 173 | 213 | 186 |
| Banks' capital adequacy ratio | 10.9 | 12.4 | 12.8 | 12.6 | 14.5 | 10.9 | 11.8 | 18.3 | Na | |
| External bank debt (% of GDP) | 8.9 | 11.2 | 17.4 | 33.3 | 25 | 34.6 | 83.7 | 64.2 | 19.7 | 12.2 |
| Total external debt (% of GDP) | 50.3 | 39.9 | 40.9 | 107.6 | 106 | 72.4 | 126.5 | 117 | 51.6 | 32.3 |
| Total public debt (% of GDP) | 45.5 | 27.9 | 15.2 | 71.9 | 13.8 | 17.1 | 16 | 4.3 | 14.5 | 5.3 |
| Projected growth in 2009 | 0.9 | -1 | -1.5 | -2.9 | 0.8 | -4.1 | -9.1 | -5.6 | -6 | -2.3 |

*Source: Barclays Capital*

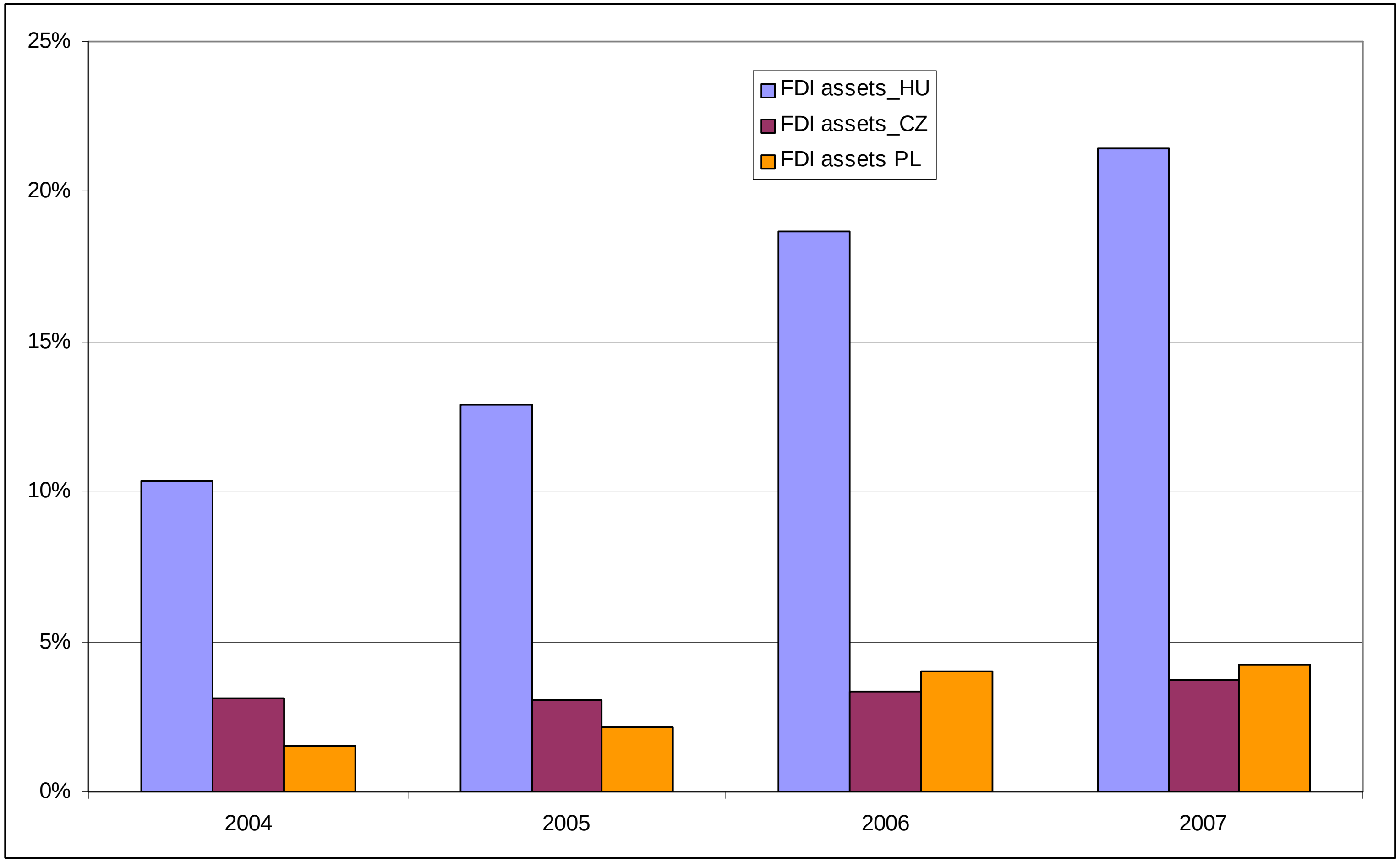
HU more similar to B-3 than to V-2, regarding overall indicators
Specific feature: combination of high public and private debt in HU

# What „went wrong” in the private sector

- High share of domestic FX-credits: source of financial-sector vulnerability: exposure to *depreciation of exchange rate*
  - Conflict between effect on net exports vs. financial stability (+negative effect on income)
- Large FDI exports – backed by accumulation of private foreign debt

# FDI assets in % of GDP:

## HU, CZ, PL



# NBH-measures

**Facilities and measures taken by MNB**

| Description of the measure | Date of introduction | Frequency | Aim of the facility | Notes |
|---|---|---|---|---|
| | | FACILITIES ENHANCING FORINT LIQUIDITY | | |
| Announcement of MNB's auctions for the purchase of government securities | 17 October 2008 | weekly | Supporting domestic credit institutions' forint liquidity management | Primary dealers of the Debt Management Agency, who fulfil their obligations undertaken in the agreement concluded with the MNB |
| Six-month, variable-rate collateralised loan tenders | 21 October 2008 | weekly | Supporting domestic credit institutions' forint liquidity management | Till 2 February 2009: Primary dealers of the Debt Management Agency<br>From 2 February 2009: All resident credit institutions subject to reserve requirements |
| Narrowing the interest rate corridor around the key policy rate to ±50 basis points from ±100 basis points | 22 October 2008 | – | Supporting domestic credit institutions' forint liquidity management | |
| Two-week, collateralised loan tenders with a fixed interest rate | 21 October 2008 | weekly | Supporting domestic credit institutions' forint liquidity management | |
| Widening the range of eligible assets | in a series of steps, from 28 October 2008 | – | Supporting domestic credit institutions' forint liquidity management | 28 October 2008: the provision on close link does not apply to covered bank bonds.<br>18 November 2008: minimum criteria for eligible assets have modified to "BBB-" from "A".<br>20 February 2009: bonds issued by Hungarian local authorities denominated in HUF, EUR or CHF. |
| Reducing the reserve ratio from 5% to 2% | 24 November 2008 | – | Supporting domestic credit institutions' forint liquidity management | |

# NBH-measures (cont.)

| FACILITIES ENHANCING FOREIGN CURRENCY LIQUIDITY | | | | |
|---|---|---|---|---|
| Two-way O/N FX swap tenders (providing euro and forint liquidity) under a competitive bidding scheme | 13 October 2008 | daily | Increasing FX-swap market liquidity decreased due to lowered partner limits | |
| O/N FX swap standing facility providing euro | 16 October 2008 | daily | Increasing euro liquidity in the domestic FX-swap market | |
| Swiss franc liquidity-providing one-week, fixed price FX swap tenders | 2 February 2009 | daily | Increasing Swiss franc liquidity in the domestic FX-swap market | |
| Euro liquidity-providing six-month EUR/HUF FX swap tenders | 2 March 2009 | daily | Increasing long-term euro liquidity of the domestic credit institutions | Domestic credit institutions undertaking to keep at least constant at its 31 December 2008 value or increase their outstanding domestic corporate lending, after adjusting for exchange rate effects, on a quarterly basis from the second quarter of 2009 until the end of 2009, while the 2009 average of their net foreign liabilities, after adjusting for exchange rate effects, does not fall below the amount outstanding on 31 December 2008. Institutions also undertake to draw new foreign liabilities and/or reduce their foreign obligations, after adjusting for exchange rate effects, at least up to the amount of the swap-line in 2009. |

# Fiscal measures taken/ to be taken

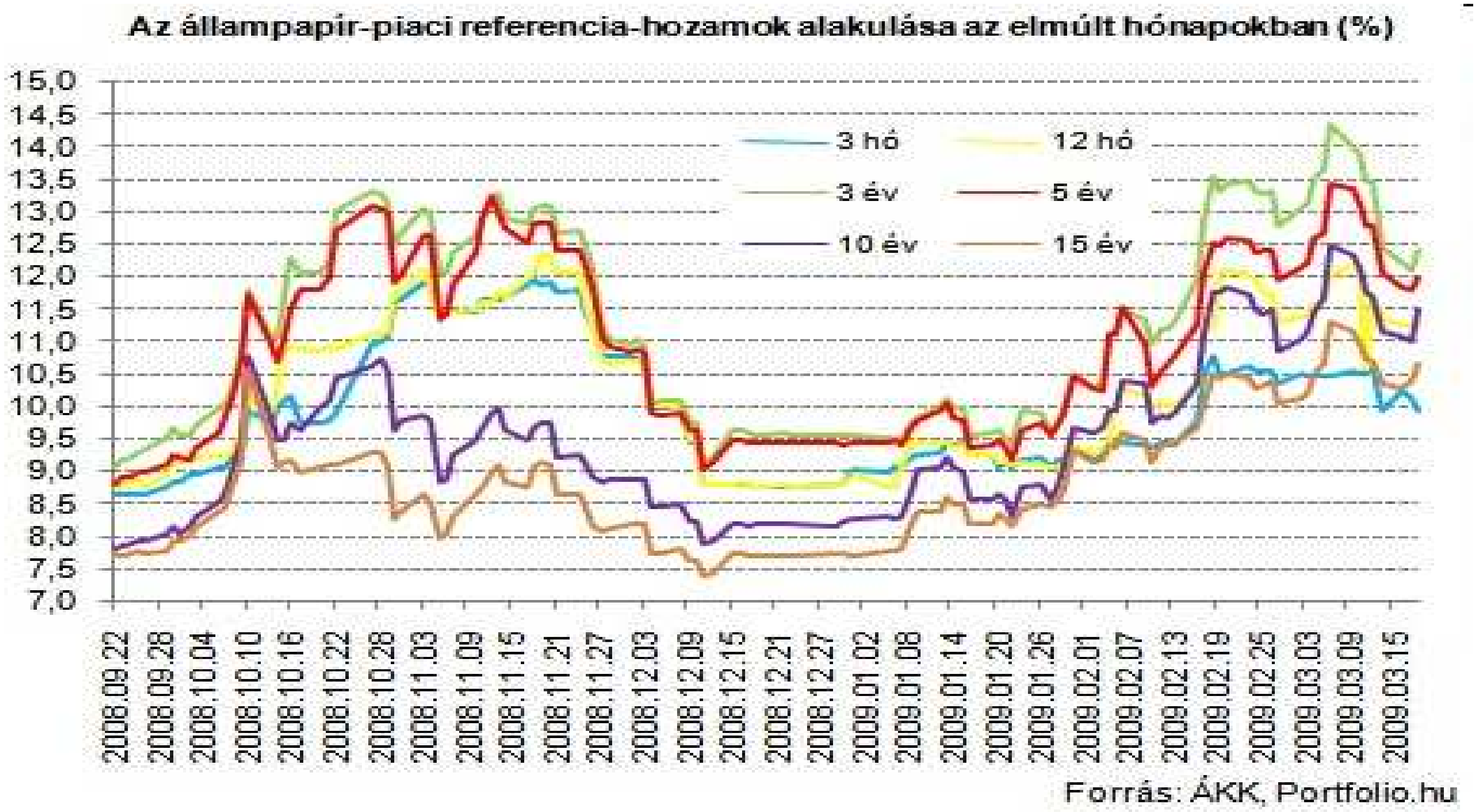
- Keeping public deficit below 3% (in spite of sharp contraction in output)
- Some steps to channel EU-funds for enhancing economic activity
- Controversy over further measures
  - Further expenditure cuts + tax cuts in recession?
  - Potential non-Keynesian (i.e. risk premium) or Keynesian effects?

# Some thoughts on the rush to ERM and EMU

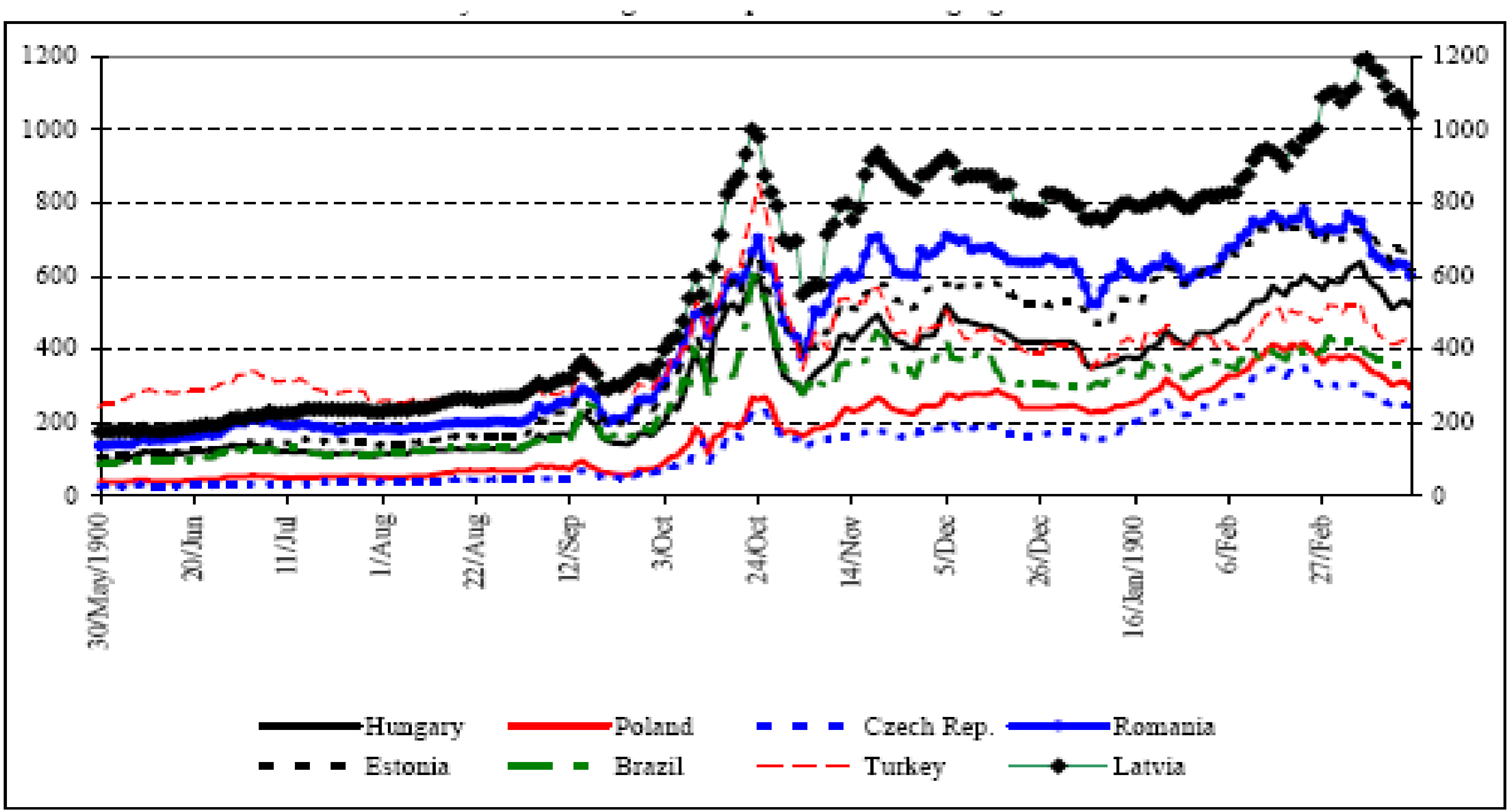
- Appears to be a solution of a major problem: XR volatility, sharp depreciation
- However: do „we" (or does the „market") have any idea of the „proper" exchange rate ***nowadays***?
- If not – consequences of an inappropriate fix
- Sharply different effects on
  - producers/exporters (real economy)
  - debtors in FX
- Rather than „speeding up", very important to reinforce: the rules of entry have not changed as a result of the global crisis

# Background information

# Government bond yields

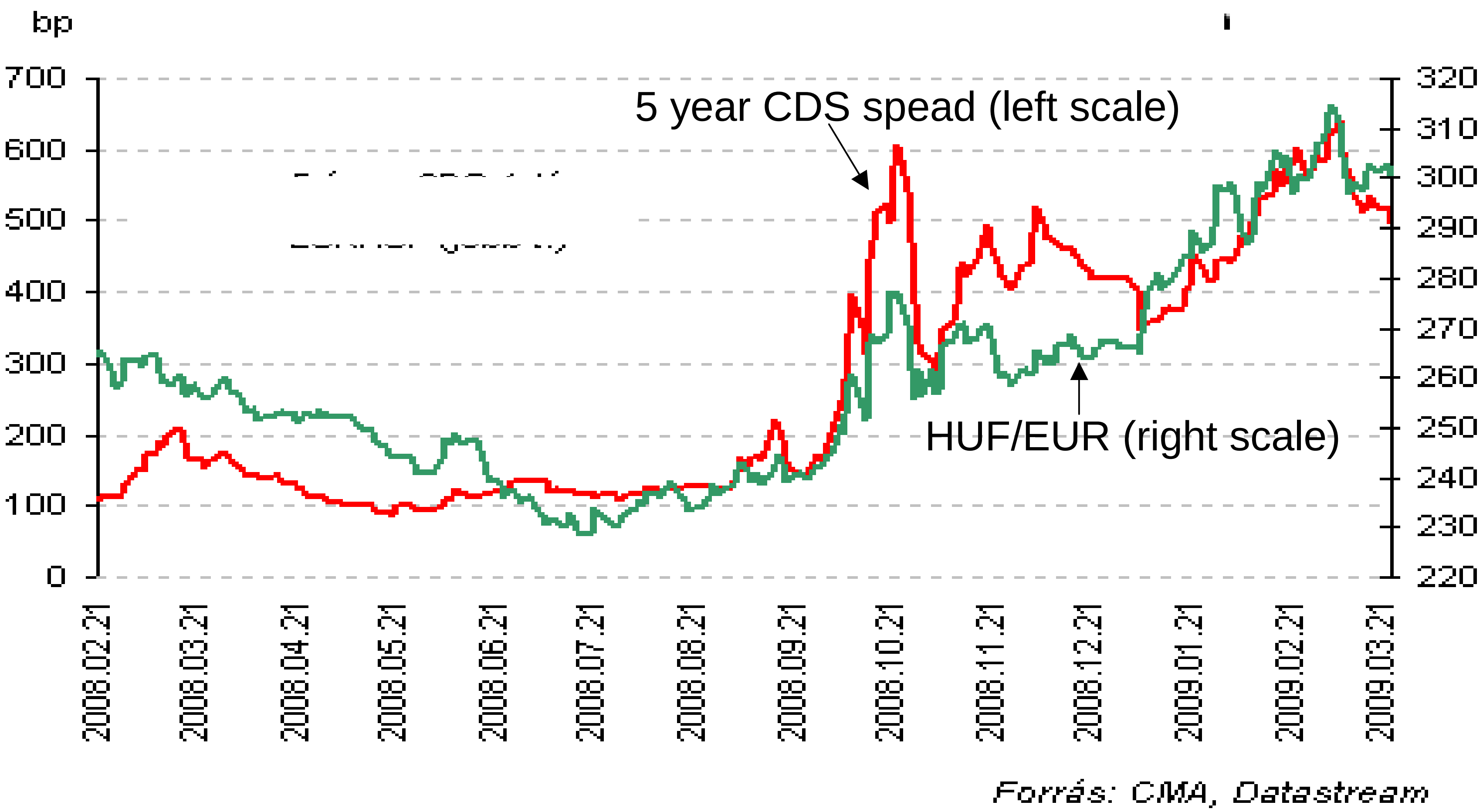


# 5 year sovreign CDS spreads

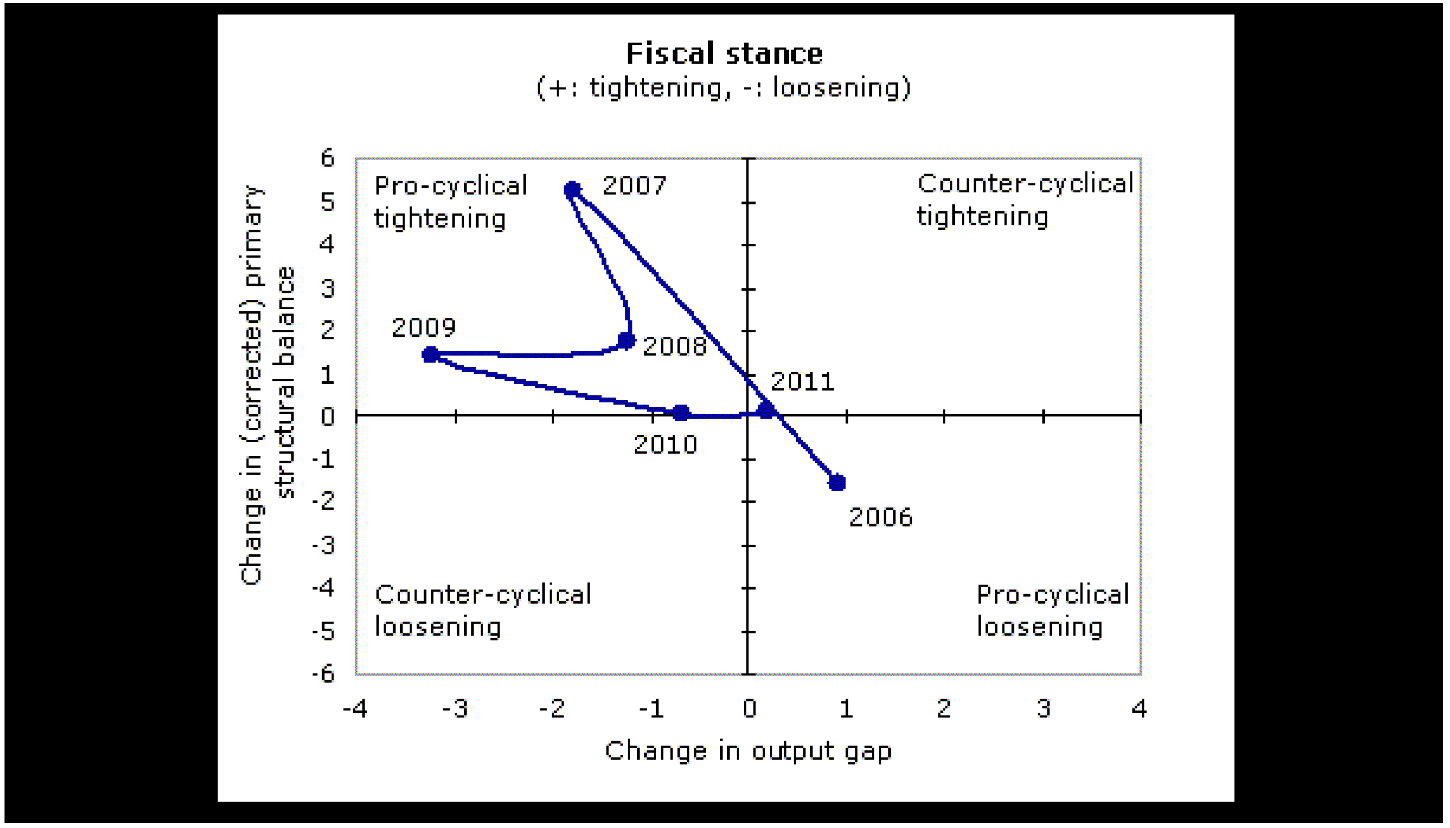



ource: Thomson Reuters

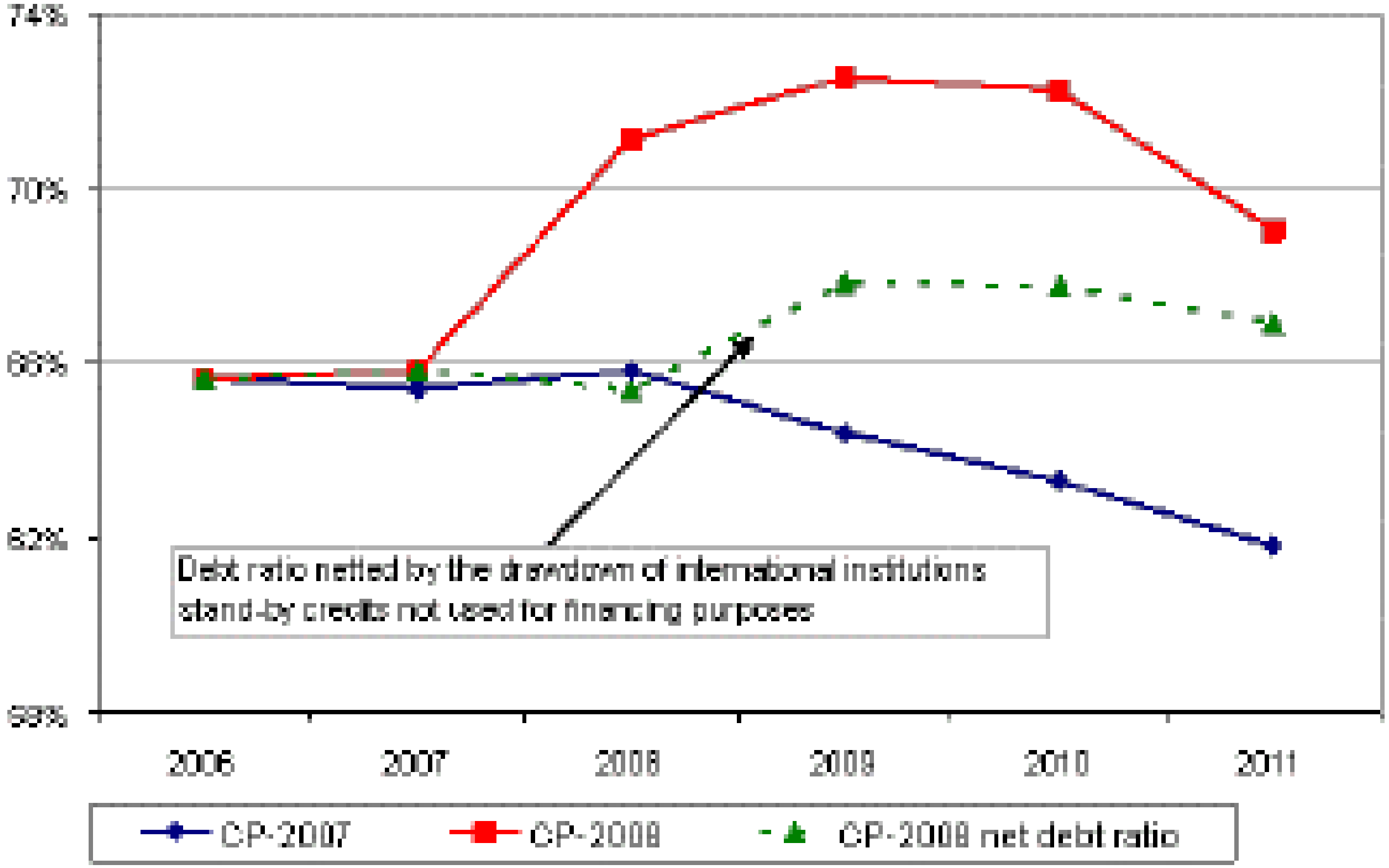
# CDS spread and HUF/EUR



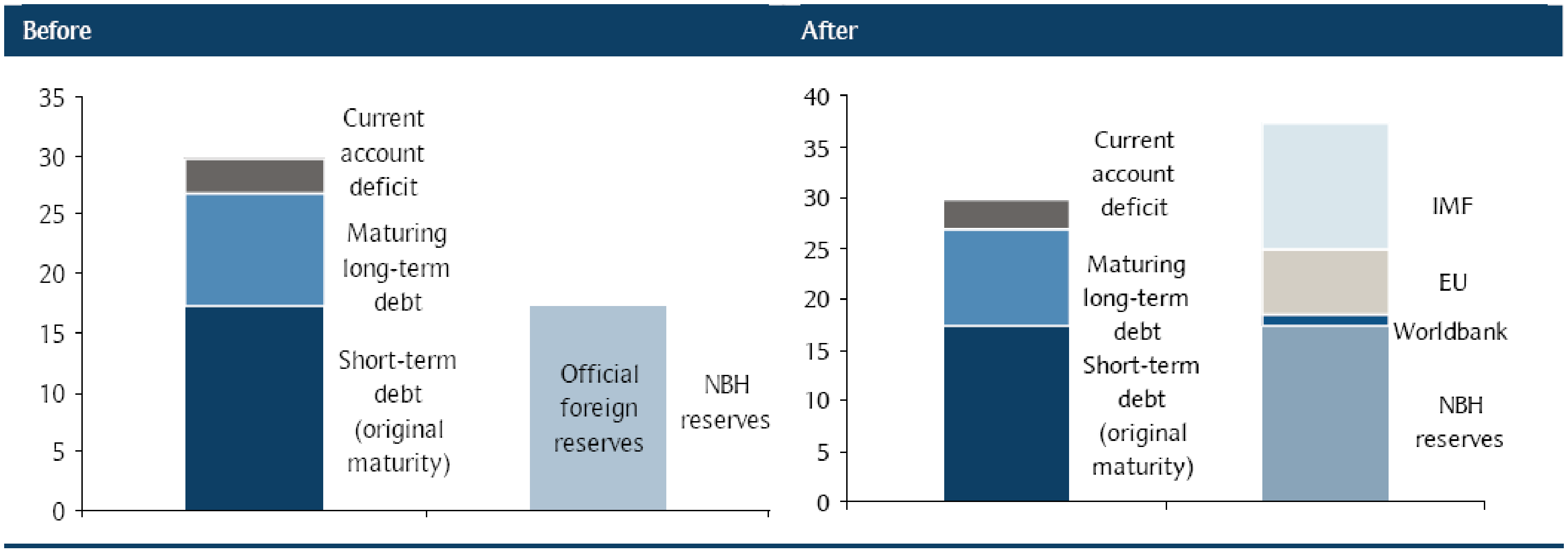
# Fiscal stance



# The official and adjusted („netted”) public debt/GDP ratio

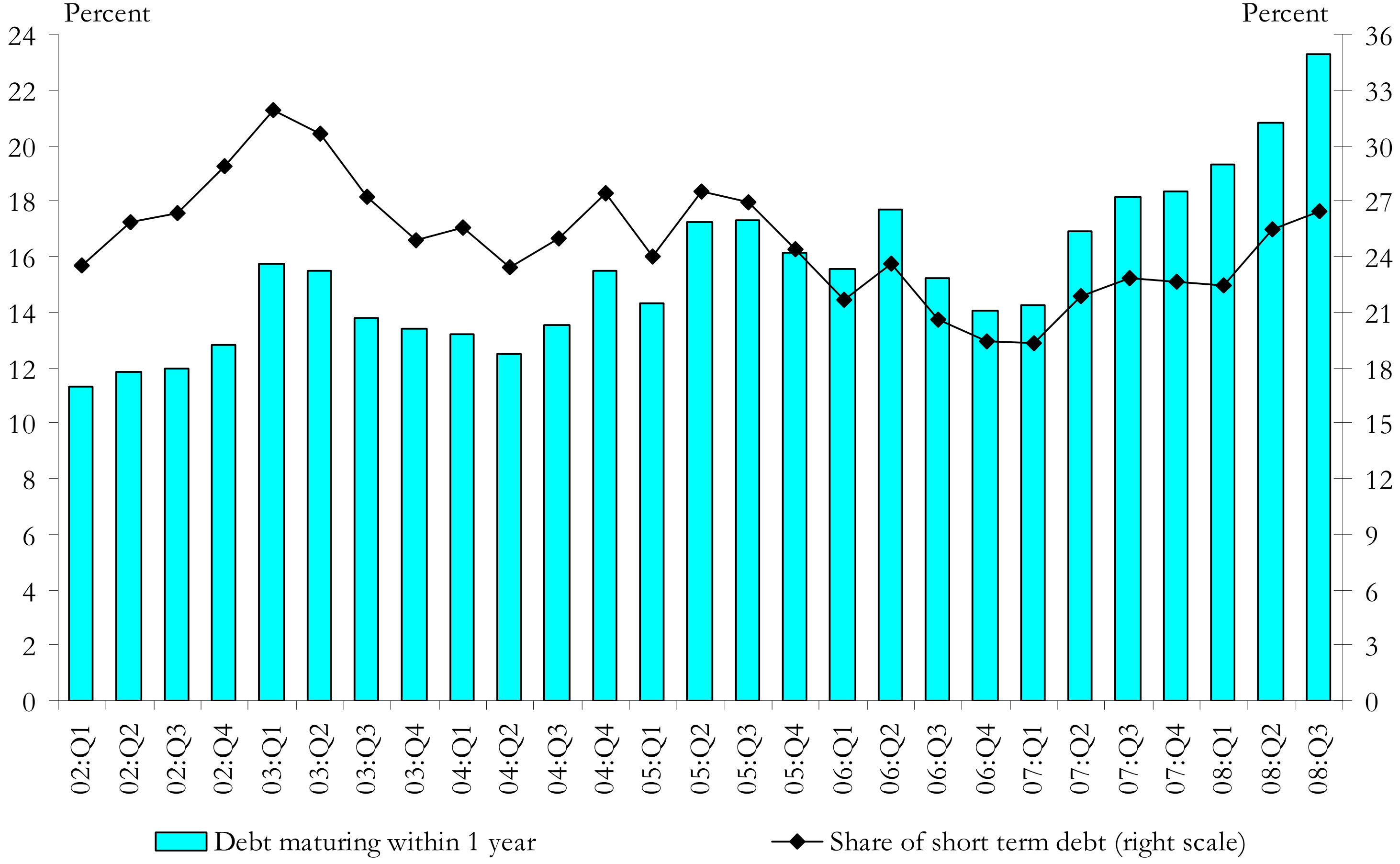


# External financing needs for 2009 vs. official reserves – before and after the IMF-package (EUR Bn)

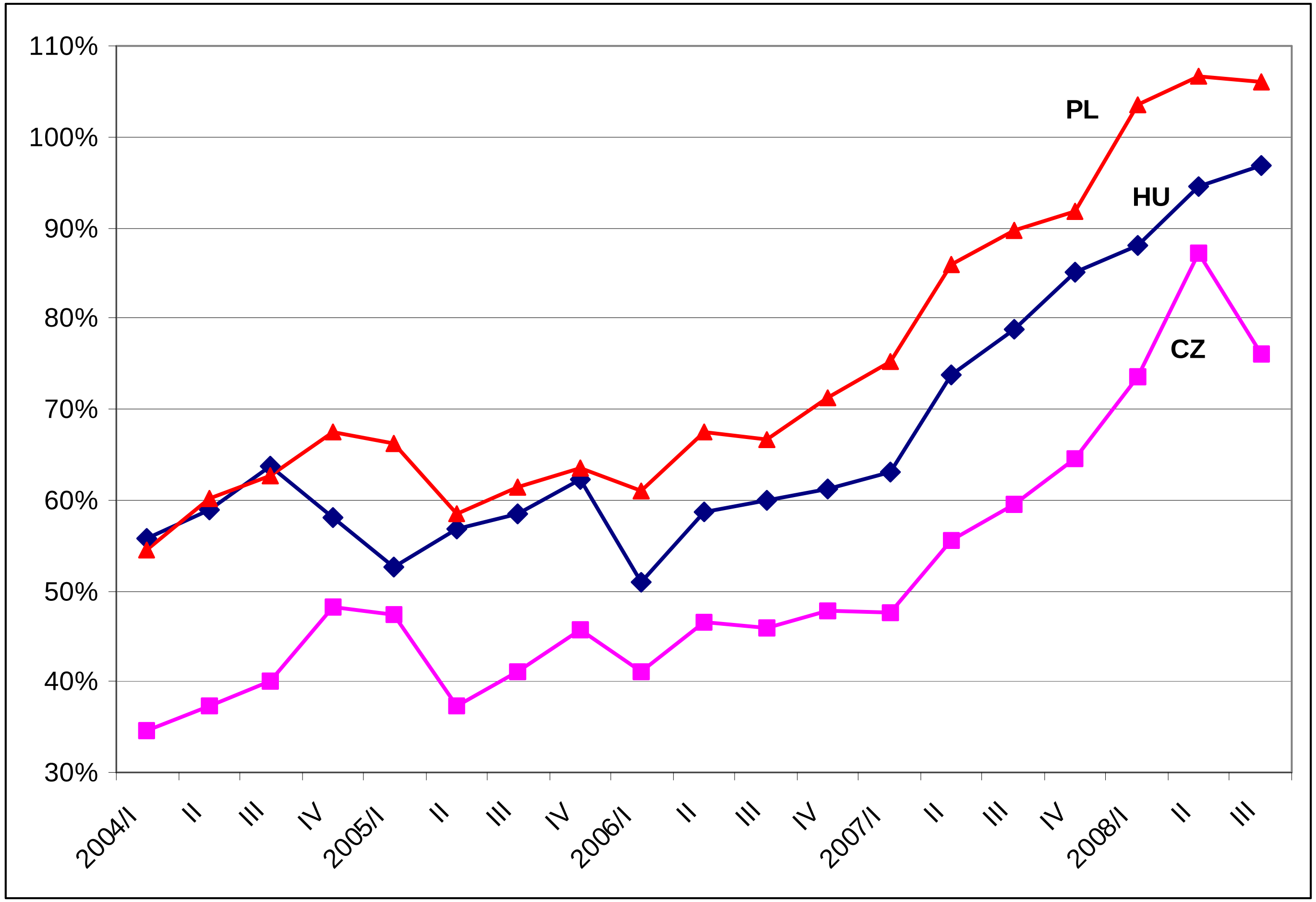



*Source: Haver Analytics, NBH, Barclays Capital*

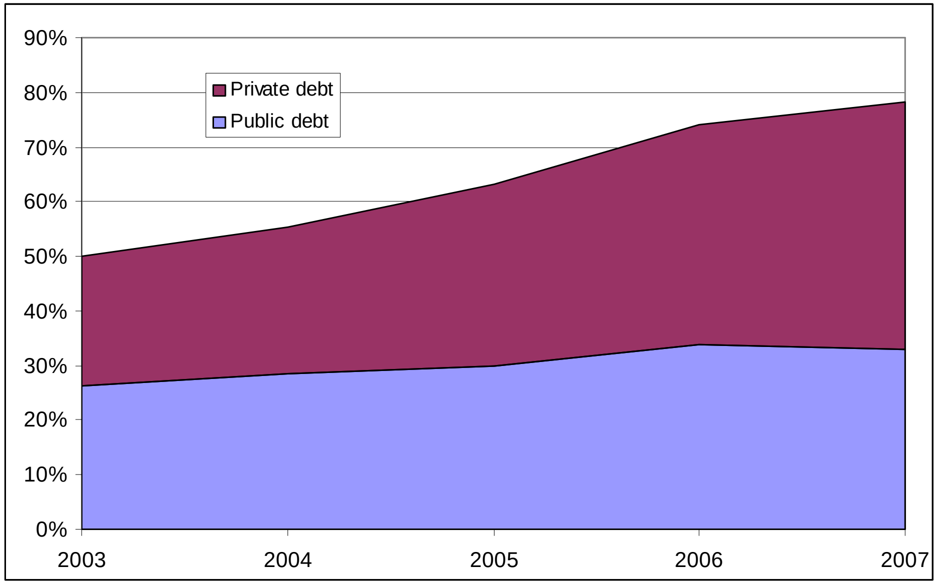
# Hungary's gross short term debt
## (at remaining maturity, per cent of GDP)

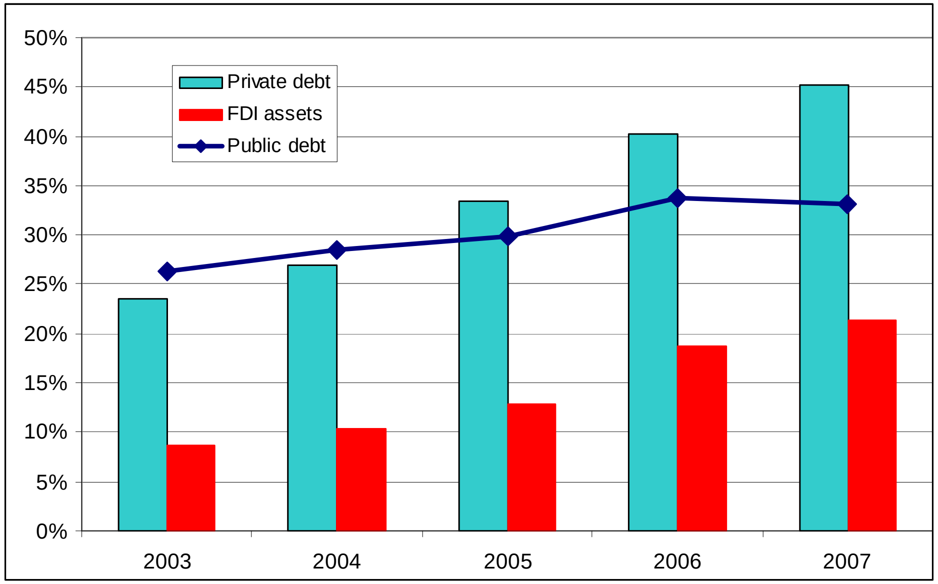


# Short-term debt in % of international reserves – CZ, HU, PL



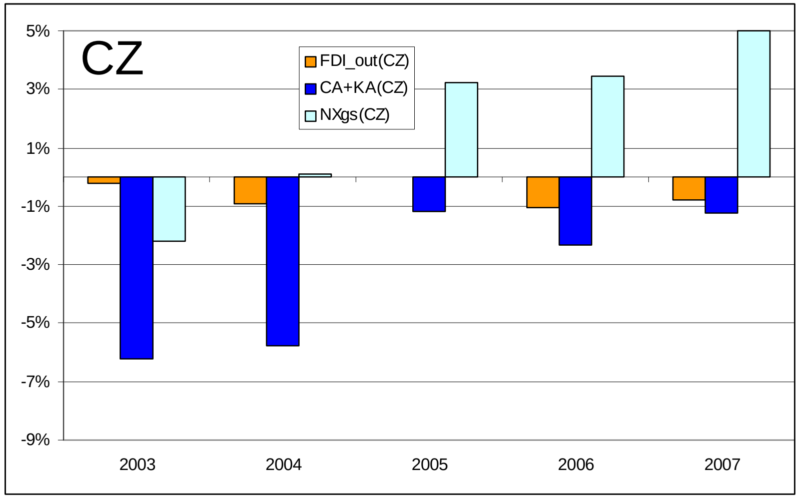
# Hungary's foreign public and private external debt and FDI-exports
## (in % of GDP)

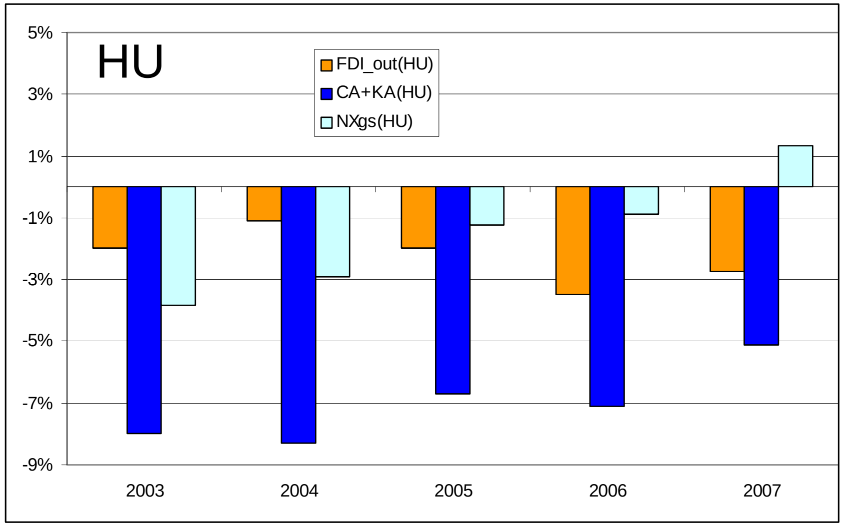


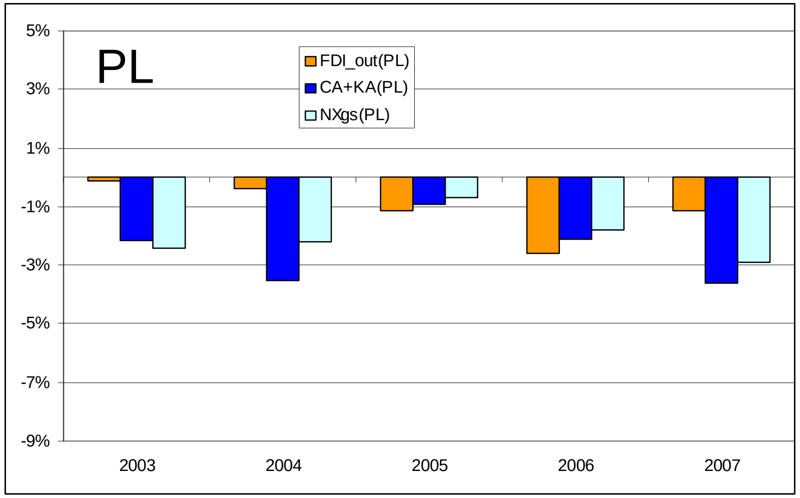




Since 2006, stabilisation of public debt, while
- continued growth of private debt and
- FDI-exports (source: growing private debt)

# FDI-exports, current financing requirement and net exports (in % of GDP)




HU's FDI-exports were relatively large, both compared to
- net exports
- current financing needs →
- financed by debt →„premature" capital exports

## What could the ECB do?

ECB could assist CEE countries at a relatively low cost:

- *By enhancing the list of the eligible collaterals* by including highly rated local currency denominated bonds of the non-EMU member countries for Eurosystem monetary operations.
- *By enhancing the list of the eligible counterparties* by foreign exchange swap arrangements between the central banks of the non-EMU countries and the ECB. (The Federal Reserve has similar arrangements with Brazil, Mexico, South Korea and Singapore.)