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Hungary—Stand-By Arrangement—Interim Review Under the Emergency Financing Mechanism

In the context of the Stand-By Arrangement for Hungary under the Emergency Financing Mechanism, this paper on the Stand-By Arrangement—Interim Review Under the Emergency Financing Mechanism for Hungary was prepared by a staff team of the International Monetary Fund. It is based on the information available at the time it was completed on December 22, 2008. The views expressed in this document are those of the staff team and do not necessarily reflect the views of the government of Hungary or the Executive Board of the IMF.

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HUNGARY

Stand-By Arrangement—Interim Review Under The Emergency Financing Mechanism

Prepared by the European Department
(In consultation with other departments)

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December 22, 2008

Summary. Financial market stress has moderated since the announcement of the program, though external financing remains difficult and could deteriorate again. Economic indicators confirm that the downturn envisaged in the program is already underway. Policies are being implemented in line with the program, with end-December targets expected to be met. The recently-enacted budget for 2009 should deliver the size of fiscal adjustment envisaged under the program. The new bank support law is important, as it provides Hungarian banks with access to capital enhancement and borrowing guarantee facilities. The gradual reductions in the policy interest rate have been appropriate, given the moderation in financial market stress and the decline in projected inflation. Looking ahead, continued implementation of policies in line with the program is essential to maintain investor confidence and minimize the depth of the economic downturn.

Discussions. During December 9–15, 2008 the staff team met with the Minister of Finance Veres, Minister of National Development and Economy Bajnai, central bank Governor Simor, and other senior officials as well as representatives of the banking and business communities. The mission also met senior representatives of the main opposition party. The team plans to return to Budapest in early February to conduct the first review.

Staff. The staff team comprised Mr. Morsink (head), Messrs. Wiegand and Joshi (EUR); Mr. Frécaut (MCM); Mr. Debrun (FAD); and Ms. Barkbu (SPR). A staff team from the European Commission joined the mission for many of the meetings. The mission also coordinated with a concurrent visit of a World Bank team examining financial sector issues.

I. INTRODUCTION

1. **On November 6, 2008 the Executive Board approved a 17-month Stand-By Arrangement (SBA) for Hungary**, under the Emergency Financing Mechanism (EFM) in the amount of SDR 10.5 billion (€12.5 billion, US$15.7 billion, 1015 percent of Hungary's quota). The first purchase of SDR 4.2 billion was made following the Board meeting. The EFM calls for a review of recent developments and the authorities' policy implementation within two months of the approval of the arrangement. To that end, a mission visited Budapest during December 9–15.

II. RECENT FINANCIAL MARKET AND ECONOMIC DEVELOPMENTS

A. Financial Markets and Banks

2. **The exchange rate has been broadly stable, international reserves have increased, and banks' external funding has increased somewhat** (Figure 1):

- *The stabilization of the exchange rate reflects broadly offsetting actions by residents and non-residents*. In the two months to end-November, non-residents reduced their holdings of government securities by around €4 billion (30 percent) and of equities by about €½ billion, though this selling has eased in recent weeks. This selling was broadly offset by increases in HUF positions by residents, both households and corporates, reflecting the expectation that the exchange rate depreciation in October would be temporary. Households have been switching their deposits from foreign exchange to HUF, and corporates their borrowing from HUF to foreign exchange. With the stabilization of the exchange rate, the foreign exchange swap market has been recovering, with rollover costs falling and maturities lengthening.

- *Major banks' external funding has increased somewhat*. External funding from parent banks rose through mid-November, in response to the financial turmoil, and has since stabilized, consistent with parent banks' commitment to support their Hungarian subsidiaries. Other external funding has remained stable.

- *The gross international reserves of the MNB have increased in line with the disbursements from the Fund and the EU*. The first tranche (€2 billion) of the EU's balance of payment support package was disbursed on December 9.[1]

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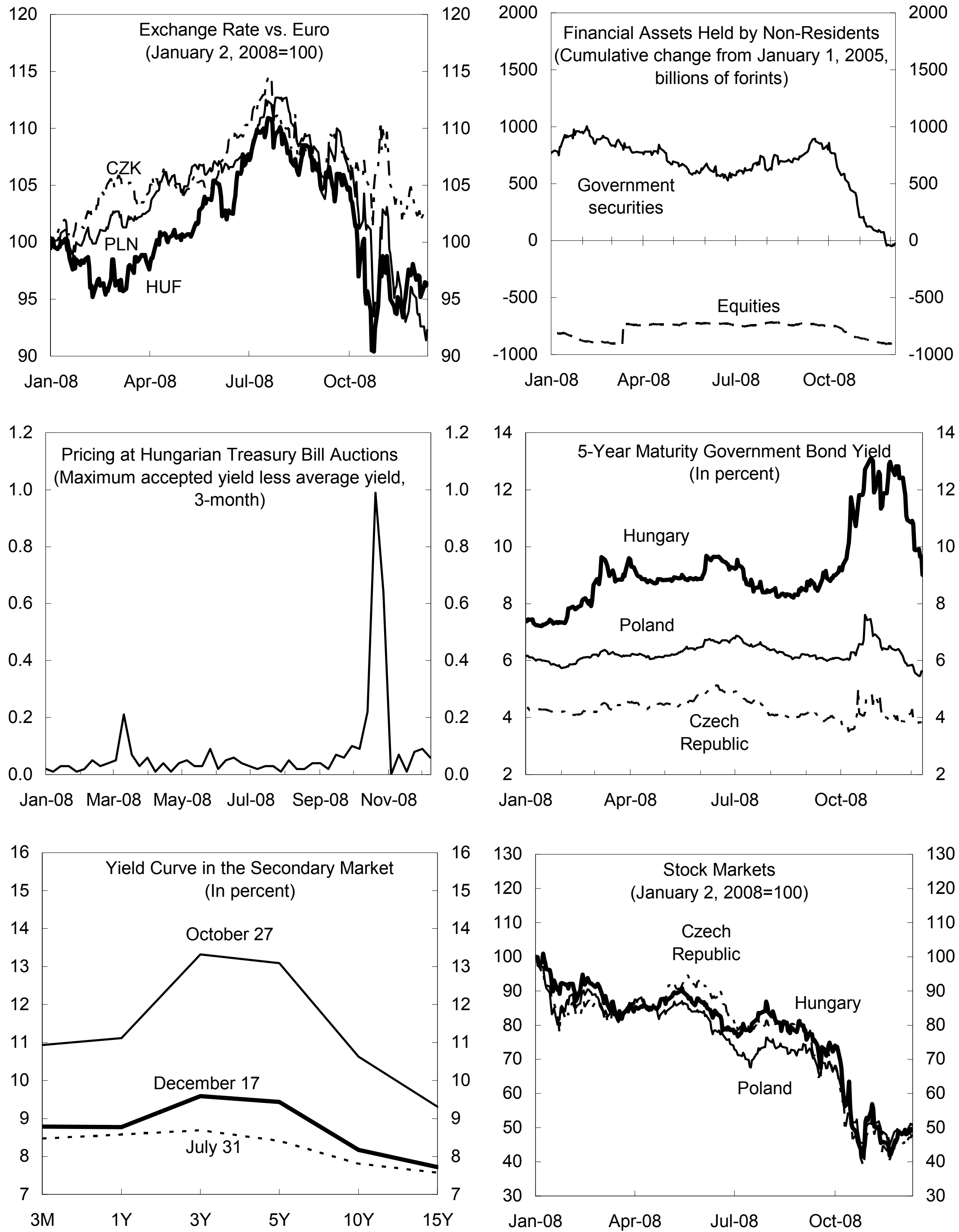
[1] The remaining tranches are tentatively expected to be disbursed in 2009Q1, 2009Q2, and 2009Q4, broadly in line with the assumptions in the staff report for the SBA. The conditionality associated with the EU loan on fiscal policy, the rules-based fiscal framework, and financial sector policies is consistent with that under the SBA. In addition, the EU loan has conditionality on the adoption of active labor market policies, further steps to improve the sustainability of the pension system, and the development of options for further pension reform.

Figure 1. Hungary: Financial Market Developments, 2008



Sources: National authorities; Bloomberg; and AKK.

3. **Conditions in the government securities market have improved, though bond issuance remains suspended.** In recent weeks, the government has relied on issuance of short-term government bills, for which bid-to-cover ratios have been high and bid spreads have come down sharply. However, the recently announced government financing plan for 2009 envisages negative net issuance in the domestic market, with no regular bond auction in 2009Q1 and increased reliance on official external financing. In the secondary market, government bond yields have dropped considerably since October.

4. **Looking forward, bank lending growth is expected to decline**. Demand for credit will be dampened by the economic downturn. As regards credit supply, foreign parent banks remain committed to maintaining their exposures to Hungary, but are reluctant to increase funding further, in view of the deteriorating outlook for the Hungarian economy and the difficult financial environment in the foreign parent banks' home markets. In addition, banks are reducing the foreign currency mismatch in their balance sheets, including by halting lending to households in Swiss francs. Lending growth will likely depend on banks' ability to secure deposits, so banks are raising deposit rates. Most banks plan to focus on lending to households, which is perceived as more profitable and less risky, while becoming more selective in their lending to the corporate sector.

B. Economic Developments

5. **Economic indicators confirm that the slowdown envisaged under the program is already underway** (Figure 2):

- *GDP data for 2008Q3 show year-on-year real growth of only ¾ percent, with a slight contraction relative to the previous quarter*. The slowdown was broad based, with decelerating consumption growth, a drop in investment, and weak net exports. High-frequency indicators point to a sharper slowdown in 2008Q4, with industrial output falling 7¼ percent in October, led by a decline of 12 percent in the car industry.

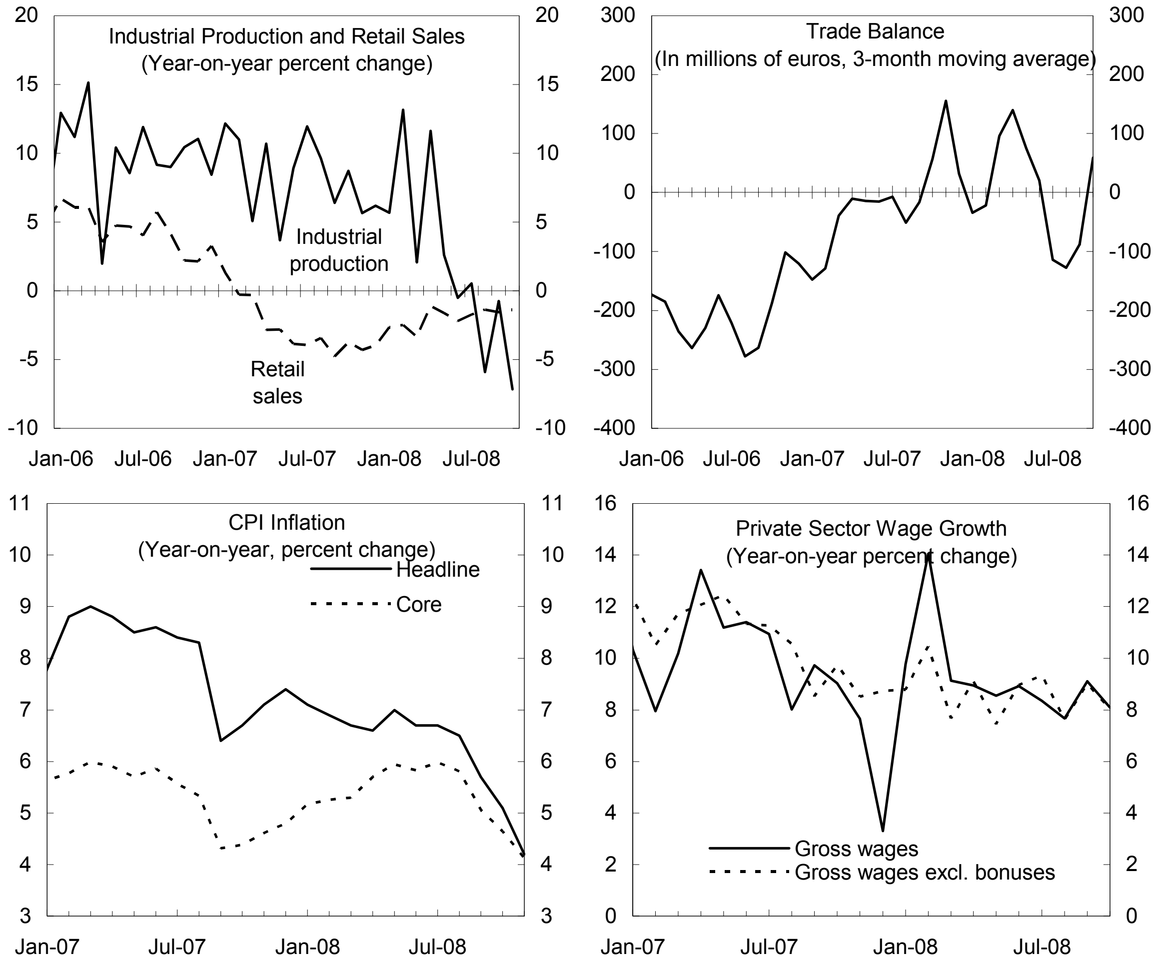
- *Unemployment increased slightly to 7¾ percent for the three months ending in September.* Anecdotal evidence suggests that the pace of layoffs has increased sharply in recent weeks. Private sector wage growth (ex-bonuses) fell to 8 percent in October. The tripartite labor council has recommended private sector wage growth of 3-5 percent in 2009.

- *CPI inflation fell from 5.7 percent in September to 4.2 percent in November, mainly reflecting declines in food and energy prices*. The sharp decline in inflation points to the possibility of breaching the lower inner band (4.1 percent) under the program in December.

- *Preliminary balance of payments data for 2008Q3 indicate a higher current account deficit than expected,* largely due to a worse income balance. In euro terms, export and import growth rates fell sharply from the previous quarter. The large deficit on

net income was due to high reinvested earnings from FDI and high dividend outflows related to non-resident holdings of equities and government bonds.

Figure 2. Hungary. Recent Economic Developments



Sources: Hungarian Statistical Office; and IMF staff calculations.

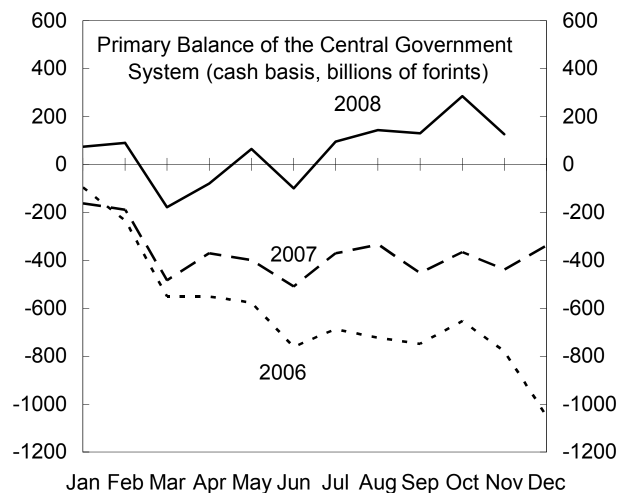
6. **Reflecting recent macroeconomic developments, the central bank (MNB) has updated its projections**. The main changes in assumptions (relative to the program) are a stronger exchange rate and smaller capital outflows, which have broadly offsetting effects on projected real GDP growth, but suggest lower inflation and a larger current account deficit. The macroeconomic framework underlying the program will be revised as needed at the time of the first review.

III. POLICY DEVELOPMENTS

A. Fiscal Policy

7. **Fiscal performance continues to strengthen, in line with the program's main fiscal objective.** The monthly path of the primary balance in 2008 shows substantial improvement with respect to 2007 and 2006 (Figure 3). Although some signs of weakness have emerged in VAT collection, overall revenue has been resilient, reflecting continued progress in tax compliance and the lag in the impact of the economic downturn on the labor market. Expenditure remains under control, in line with the authorities' commitment to freeze contingency reserves, though earmarked reserves have been used to cover operating losses in the rail transportation company. Assuming strict expenditure control, the primary balance at end-December is expected to meet the program target.

Figure 3



8. **The 2009 budget adopted on December 15 is consistent with the size of the fiscal adjustment envisaged under the program, but the recent agreement on public sector wages puts this adjustment at risk.** The overall deficit of the general government is expected to decline from a projected 3.4 percent of GDP in 2008 to 2½ percent of GDP in 2009. On the revenue side, the budget does not envisage any noteworthy tax policy changes except for tax simplification. However, on the expenditure side, the budgeted decline in nominal wage bill is lower than envisaged under the program (¶10, LOI, Country Report No. 08/361), reflecting an ad-hoc allowance that fully offsets the loss of the 13th month salary for about 70 percent of civil servants and provides a partial offset for the remainder. The allowance (amounting to 0.4 percent of GDP) will be financed mainly by reducing reserves and by unidentified cuts in defense and education spending. Staff expressed concern about the negative signal conveyed by this measure regarding the government's commitment to the program, noted that the reduction in reserves significantly raised the risk of not achieving the targeted fiscal adjustment, and suggested the need for compensating measures to protect fiscal reserves and reduce fiscal risk.

9. **The government is implementing a range of EU-funded measures to mitigate the economic downturn.** These actions are aimed at alleviating financing stress for small and medium enterprises (SMEs) through investment subsidies, credit guarantees, and refinancing facilities for commercial bank lending to SMEs for investment purposes. Infrastructure

projects—including railroad and school refurbishment—are designed to boost demand. SMEs that maintain employment or create new jobs will receive wage subsidies. These (mostly previously announced) measures are not expected to have any impact on the authorities' ability to achieve the program targets. The authorities and staff agreed that the authorities' communication strategy should leave no doubt about the consistency between announced policy initiatives and program targets.

10. **The Fiscal Responsibility Law adopted by parliament on November 17 provides a domestic anchor for fiscal policy and is in line with the program.** The law introduces numerical and procedural rules for the preparation of annual budgets, including the obligation to achieve a decline in public debt in real terms, the prohibition of primary deficits, compliance with medium-term expenditure ceilings, and the requirement to offset the impact of legislative initiatives on the budget balance. During a transitory period, which applies to the preparation of budgets for 2010-12, the projected growth of real expenditure cannot exceed half the projected growth of real GDP. The law also establishes a fiscal council, consisting of three wise persons and a secretariat. The council, which should be operational by the end of 2009, will prepare macroeconomic forecasts and projections of budgetary aggregates; it will also assess the budgetary impact of draft legislation (scoring) and make recommendations on corrective actions when needed. Finally, the council will have an advisory role, providing information and assessments to all branches of government upon request. The authorities and staff agreed on the importance of implementing medium-term budget preparation and planning, and of providing the fiscal council and its secretariat with a budget appropriation commensurate to its mandate.

B. Financial Sector Policies

11. **The recently-approved bank support law is in line with the program and other recent initiatives in the EU.** The law, which establishes a Capital Base Enhancement Fund and a Refinancing Guarantee Fund, incorporates the European Commission's guidance while remaining in line with the program. The quantitative criterion for eligibility (own funds above HUF 200 billion) has been removed, so that all banks may apply. Also, refinancing guarantees will be available even for banks that do not apply for a capital increase. At the same time, in the review of the applications, the preservation of the stability of the banking system will be the key factor, as expected under the program. In the capital enhancement component of the law, the triggers that would make it possible for the authorities to take over a beneficiary bank in case of deterioration of its financial position are appropriate.

12. **The size of the guarantee fund will be revisited, based on experience**. In the law, the total size of the support package remains at HUF 600 billion, divided equally between capital enhancement and refinancing guarantees. Any fraction of the HUF 300 billion earmarked for capital enhancement not used by March 2009 will be transferred to the Refinancing Guarantee Fund. The detailed features and practical modalities of the guarantees will be determined soon and will have a large impact on the level of interest from the banks.

Pricing, in line with the European Commission recommendations, will be an important consideration. To start with, the amount available under the law should be sufficient. The authorities and staff agreed that the need for a revision of the size of the guarantee fund could be considered in a few months based on experience.

13. **The authorities are also making progress with separate legislation aimed at strengthening the remedial powers of the financial supervisory agency.** The authorities intend to submit draft legislation, which has benefited from extensive guidance from a World Bank mission, to parliament by the end of 2008, in line with the structural benchmark under the program. However, Fund and Bank staff consider that the draft legislation would still benefit from additional review and outside inputs, including with regard to the range of options for bank resolution. With parliament entering its winter recess, consideration of the legislation will not take place before March 2009. Staff intend to use this delay to further coordinate with the authorities and the World Bank on how to further strengthen the legislation.

14. **The authorities and banks have signed a public agreement on voluntary measures to mitigate households' balance sheet risks associated with foreign currency loans**. The key measures are extension of maturity, temporary easing of repayment, and conversion of loans into domestic currency. However, given the stability of the exchange rate since October, very few borrowers have taken advantage of these measures. Thus, the measures provide a safety net in case household balance sheets deteriorate. The authorities and staff agreed that, if the deterioration is sufficiently large, the existing measures would be insufficient. The mission encouraged the authorities to accelerate consideration of a personal bankruptcy regime.

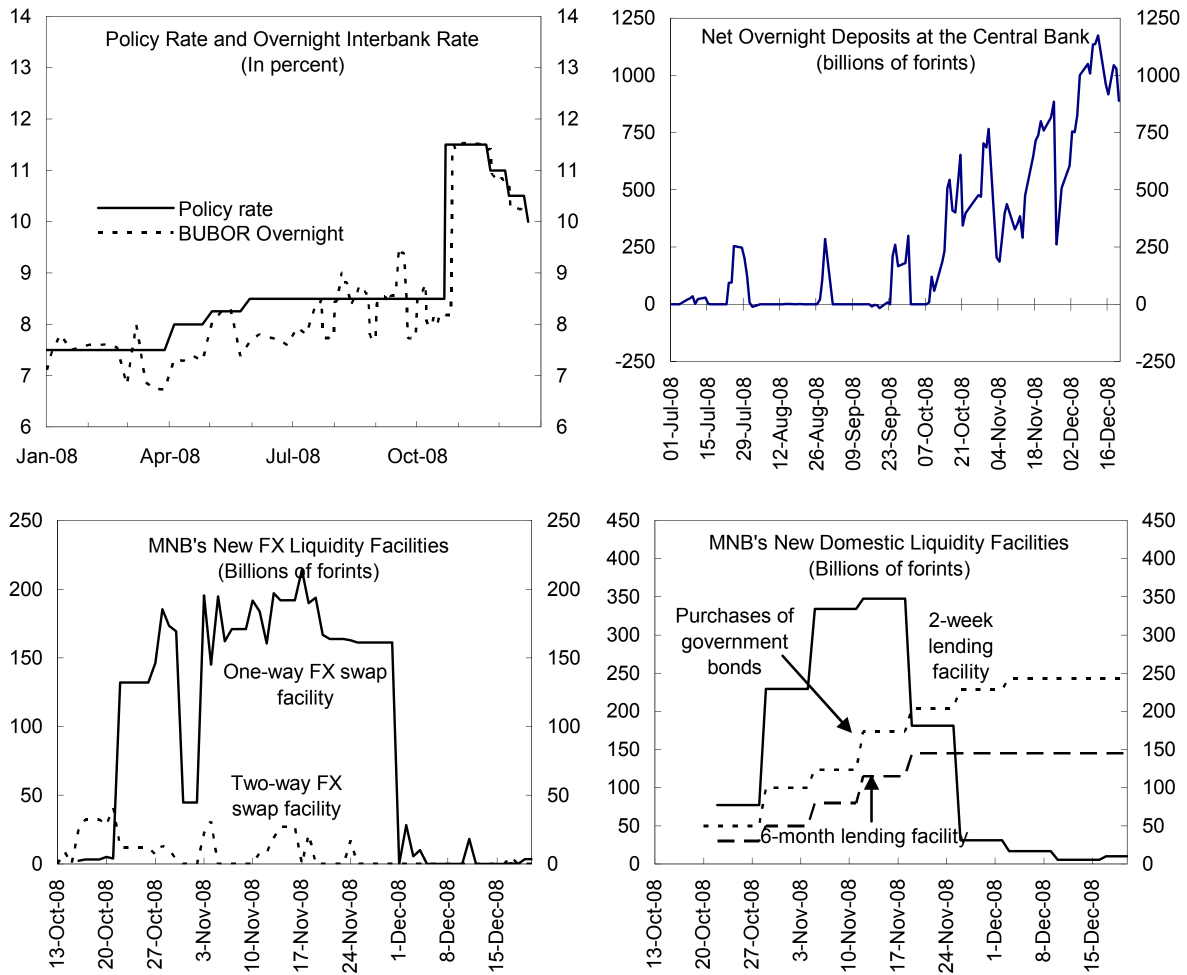
C. Monetary and Exchange Rate Policy

15. **The central bank has gradually reduced the policy interest rate, partly reversing the sharp rate hike in October** (Figure 4). The policy rate was raised by 300 bps on October 22, at a time of intense financial market stress. Since then, the policy rate was cut on November 22, December 8, and December 22, by 50 bps each time, reflecting the moderation in financial market stress, the fall in projected inflation to below target, and policy rate reductions by the major central banks. Financial markets reacted positively to these rate cuts, with the exchange rate appreciating modestly and long-term government bond yields falling somewhat. Financial markets expect further easing in the first half of 2009. The authorities have publicly noted that further rate cuts will depend on the evolution of the markets' risk assessment of Hungary.

16. **Liquidity provision by the central bank has stabilized in recent weeks.** The reduction in the reserve requirement ratio from 5 to 2 percent (in line with the EU norm) has reduced the use of the central bank's 2-week lending facility, though demand for term liquidity supplied through the 6-month facility has remained robust. Overnight deposits at the

central bank have continued to increase, indicating an increase in banks' precautionary balances and the perception of high counterparty risk. The central bank has already broadened eligible collateral, by accepting bonds of mortgage lenders associated with banks, and is prepared to take further steps, if necessary. While demand for the central bank's overnight foreign exchange swap facility has fallen, foreign exchange liquidity generally remains tight, so the authorities and staff agreed that extending the maturity of the facility could be considered.

Figure 4. Hungary: Monetary Policy Indicators, 2007-08



Sources: Bloomberg; Hungarian Statistical Office; Magyar Nemzeti Bank; and IMF staff calculations.

IV. Staff Appraisal

17. **Financial market stress has moderated since the announcement of a program, though external financing remains difficult**. The exchange rate has been broadly stable, government bond yields have declined, foreign parent banks have continued to support their subsidiaries in Hungary, and international reserves have increased. However, with global deleveraging expected to continue in 2009, financial market stress could increase again.

18. **Economic indicators confirm that the downturn envisaged under the program is already underway**. Notwithstanding the moderation of financial market stress, external creditors are reluctant to increase funding, so credit growth in Hungary is likely to slow sharply. Wage restraint is critical to contain employment losses.

19. **Vigilance is needed to minimize the risk of fiscal underperformance vis-à-vis the program targets in 2009**. The fiscal program target for end-December 2008 are likely to be met. The budget for 2009 is consistent with the size of the fiscal adjustment envisaged under the program, though the smaller-than-expected decline in the wage bill (mainly offset by smaller reserves) puts this adjustment at risk. Therefore, it will be important that budget execution delivers the envisaged expenditure restraint. The new Fiscal Responsibility Law is welcome. Given the importance of independent scrutiny of budget preparation and execution, it is essential that the fiscal council's secretariat have adequate staffing and funding.

20. **The recently-enacted bank support law is important, as it provides Hungarian banks with access to capital enhancement and borrowing guarantee facilities that are similar to those available to banks in other EU countries**. Banks currently have strong solvency positions and stable funding. However, going forward, external funding is likely to be tight, given the ongoing global deleveraging, and banks' asset quality will deteriorate in the economic downturn.

21. **The reductions in the policy interest rate have been appropriate**, in light of the fall in projected inflation and the moderation of financial market stress. As inflation is likely to fall below the 3 percent target at the two-year horizon, a prudent easing bias appears appropriate, as long as financial markets remain supportive. Any further rate cuts should be gradual and cautious, and commensurate with improvements in investor confidence. The central bank's readiness to modify or expand its liquidity-providing facilities as needed is welcome.

22. **Continued implementation of economic policies consistent with the program is essential** to maintain investor confidence and minimize the depth of the economic downturn.

Table 1. Hungary: Main Economic Indicators, 2005–09

	2005	2006	2007	2008	2009
				Program	
Real economy (change in percent)					
Real GDP	4.1	3.9	1.1	1.8	-1.0
Private consumption	3.6	1.9	-1.9	0.9	-3.9
Gross fixed investment	5.3	-2.5	0.1	1.0	-0.9
Exports	11.5	19.0	14.2	7.6	2.1
Imports	6.8	14.7	12.0	8.1	0.7
CPI (end year)	3.3	6.5	7.4	5.1	4.2
CPI (average)	3.6	3.9	7.9	6.3	4.5
Unemployment rate (average, in percent)	7.2	7.5	7.4	7.8	8.5
Gross domestic investment (percent of GDP) 1/	23.6	23.1	23.0	22.8	20.0
Gross national saving (percent of GDP, from BOP)	16.1	15.6	16.6	16.5	18.0
General government (percent of GDP), ESA-95 basis 2/					
Overall balance	-7.8	-9.3	-4.9	-3.4	-2.5
Primary balance	-3.7	-5.4	-0.9	0.6	1.9
Debt	61.6	65.5	65.8	67.4	70.1
Money and credit (end-of-period, percent change)					
M3	14.6	13.8	11.0	4.1	1.3
Credit to nongovernment	18.9	17.1	17.3	7.2	-6.2
Interest rates (percent)					
T-bill (90-day, average)	6.8	7.0	7.6	...	...
Government bond yield (5-year, average)	8.0	6.9	7.0	...	...
Balance of payments					
Goods and services trade balance (percent of GDP)	-1.2	-0.9	1.4	1.8	7.5
Current account (percent of GDP)	-7.5	-7.5	-6.4	-6.2	-2.0
Reserves (in billions of euros)	15.7	16.4	16.4	19.5	19.8
Gross external debt (percent of GDP) 3/	75.0	90.4	97.2	106.4	115.8
Exchange rate					
Exchange regime	Floating				
Present rate (December 18, 2008)	Ft 182.6.4 = US$1; Ft. 267.0 = €1				
Nominal effective rate (2000=100)	111.6	105.1	111.8	…	…
Real effective rate, CPI basis (2000=100)	132.6	127.0	142.5	…	…
Quota at the Fund	SDR 1038.4 million				

Sources: Hungarian authorities; IMF, International Financial Statistics; Bloomberg; and IMF staff estimates.

1/ Includes change in inventories.

2/ Consists of the central budget, social security funds, extrabudgetary funds, and local governments, as well as motorway investments previously expected to be recorded off-budget in 2006-07.

3/ Including inter-company loans, and nonresident holdings of forint-denominated assets.