2 December 2002

Assessment of financial stability

At its meeting on 2 December 2002, the Monetary Council discussed and approved for publication the *Report on Financial Stability*. In addition to focusing on the analyses of macroeconomic environment and financial system stability, the *Report* addresses two issues in detail – the sustainability of current account deficits, and the expected future developments in the Hungarian housing market and house finance. The major findings of the *Report* are summarised below.

Uncertain external environment, slow growth and high risk premia characterise international capital markets. Fast improvement cannot be expected.

Since publication of the May *Report*, the conviction has strengthened that a global economic recovery can only be expected in 2003. Member states of Economic and Monetary Union (EMU), Hungary's most important trading partners, are also anticipating slow growth in the months ahead. This *sets limits to the growth prospects of the domestic economy*. Investors' appetite for risk is low and *risk premia are high* in global financial markets, due to the current economic slowdown, the risks carried by some emerging countries and loss of investor confidence in exchange-traded companies. As a result of the developments observed in the real economy and financial markets, risk perception of developed-country *financial sectors*, particularly of those of *European countries*, has deteriorated somewhat.

Hungary's risk perception has been shaped by a combination of rising domestic imbalances and expectations related to European convergence.

Amid these unfavourable external events, risk perception of the Hungarian economy has recently been influenced by *contrasting* developments. The pick-up in domestic demand, fuelled by rapid wage growth and fiscal loosening, is a source of risk to macroeconomic stability and slows down disinflation. Standard and Poor's downgrading Hungary's domestic sovereign debt was also an evidence of the shift in risk perception. However, events which increased the likelihood of a *near-term accession to the European Union* and *fast convergence* required to obtain early EMU membership have been ameliorating the effects of adverse developments since mid-summer. These positive developments include the announcement of the Government's Medium-term Economic Policy Programme as well as decisions taken on the accession timetable and the conditions of joining the EU. Moody's improving Hungary's foreign currency-denominated sovereign debt rating has boosted confidence. Investors have attached greater importance to the positive factors, which is reflected in the decline in risk premium and appreciation of the exchange rate.

The current account deficit is sustainable over the medium term.

Households' falling propensity to save and the increasing public sector borrowing requirement have resulted in a rise in the current account deficit. With the pick-up in economic activity, the corporate sector's borrowing requirement is likely to increase as well. If the public sector borrowing requirement is reduced, consistent with the Medium-term Economic Policy Programme, the current account deficit may stabilise around the current 5% in the coming years. With GDP growing by 4% on average, a current account deficit of around 5%–6% is seen as sustainable over the medium term. Moreover, the European convergence process raises the sustainable level of current account deficit, as it allows faster growth and reduces the amount of interest to be paid on existing debt.

The most important preconditions for preserving a stable economic environment are implementation of the nominal convergence programme...

Currently, a potential turnaround in expectations related to Hungary's joining EMU is considered as the most important risk factor. Exuberant optimism of participants playing on convergence may result in a rising wedge between low interest rates, sustained appreciation of the currency and economic fundamentals. Euphoria easily turning into scepticism may lead to significant exchange rate and interest rate corrections, thereby forcing both domestic agents and the authorities responsible for the conduct of economic policy to make costly adjustments.

Given that the current favourable risk assessments are shaped primarily by expectations of accession to EMU, it is particularly important to meet the inflation and fiscal policy criteria of accession at the envisaged pace.

...and wage growth consistent with performance.

The slow adjustment of private sector wage growth fuels real appreciation of the forint, exposing corporate sector financial stability to risk. Corporate sector profitability can only be prevented from deteriorating further by negotiating a wage deal that is consistent with the disinflation path and gains in productivity.

Position of the banking sector continues to be stable.

Stable performance and profitability continued to characterise the performance of the Hungarian banking sector in 2002 H1. In the circumstances of a slowdown in economic activity, growth in bank lending to the corporate sector remained modest relative to the pre-2001 period. By contrast, outstanding household debt continued to grow robustly, owing to a shift in banks' attention toward the household sector, extension of the subsidised house purchase scheme and spectacular improvement in households' income position.

Corporate sector indebtedness does not carry major risks,…

The income position of the corporate sector changed little in H1; however, the decline in commercial property prices reduced the value of its assets. Despite the fast increase in leverage in recent years, the level of corporate sector indebtedness is still not a cause for concern, given the high role of equity within financing. Although companies' demand for credit fell, banks stepped up lending in excess of the increase in balance sheet total by rearranging their balance sheet structures. This indicates their strong commitment toward the sector. Lending to medium-sized companies and micro firms grew well above the average.

…but the slowdown in economic activity may add to credit risks.

In the future, the protracted economic slowdown and the massive cyclical deterioration in manufacturing sector profitability, coupled with strong speculative pressures evident in the property sector and diminishing natural cover, may be an increasing source of risk.

Households' income and indebtedness both increased,…

Real income of the household sector rose robustly in 2002 H1. Growth in consumption was vigorous. Investment spending rose as a result of the extension of the system of subsidised housing, with the consequence that the savings rate fell. Non-bank financial savings continued to gain ground as well. The sector's indebtedness and the interest burden increased, although remained below the values characteristic for developed countries.

…and borrowing with high risk spreads continued.

Increasingly dynamic growth in household lending, seen over the past few years, continued in 2002 H1. The banking sector's outstanding loans to households rose by 25 per cent in six months, due mainly to the strong momentum of mortgage loans. The current still unsaturated market enables banks to use fairly high risk spreads, which, except in the case of subsidised house loans, represents considerable excess costs for households. However, the lending expansion was not associated with an increase in property prices, which is seen as a positive sign in the context of the threat of prospective property price bubbles.

Extraordinary increase in house loans

The state housing subsidy scheme, introduced in 2001, helped interest rates on property loans to fall to the level of euro interest rates. The low rates, in turn, were instrumental in lending increasing rapidly. As a medium-term consequence, an upsurge in house prices should not be expected as an effect of falling interest rates at the time of Hungary adopting the euro. It may expose stability to risks in the short term, if (i) households' income expectations prove unfounded and they overestimate their ability to service debt due to the lack of adequate experience and (ii) lending grows more rapidly than banks develop their risk management systems, which may result in a substantial increase in credit risk. Should the current high growth rate of long-term loans remain, it may also expose the banking sector to risks over the long term. Liquidity risk can only be reduced gradually, simultaneously with the increase in long-term funding as a result of headway by institutional investors and a reduction in market rates.

Banks' credit portfolio quality deteriorated.

Banks' credit portfolio quality deteriorated in the period under review. Presumably because of profitability considerations, their practice of rating and provisioning was not adjusted to the current international and domestic economic outlook, and it failed to take account of the robust increase in the proportion of more risky segments within total lending. In view of this, banks' current practices seem to be overly optimistic, particularly in respect of the corporate segment; however, this does not expose the financial intermediary system to risks.

Banks are not facing

Exposures to both forint and foreign currency interest rate risks rose in 2002 H1. The increase in volatility of forint rates may justify a

significant market risks, and are seen as having adequate liquidity.

narrowing of open interest positions.

Exchange rate volatility was lower and banks' propensity to take on risks higher in the review period relative to the previous year. But, in the aftermath of currency depreciation in the summer, banks' behaviour became more risk averse.

The rapid build-up of short-term loans to households and the more modest rise in customer deposits led to tighter bank liquidity; however, liquidity indicators have not yet shown evidence of excessive risks.

Banking sector profitability remains strong.

Although somewhat weaker relative to the all-time highs recorded a year earlier, the banking sector's profitability ratios indicate outstanding performance in 2002 H1. Significant one-off effects also contributed to the robust increase in banks' profits in the comparable period of 2001. This explains most of the slight deterioration in profitability in the review period. As a favourable development, though, the combined market share of loss-making banks fell considerably. In addition to a modest increase in interest income, there was a robust rise in commission and fee income, which resulted in a shift towards non-interest income within banks' income structure.

Lending by financial enterprises carries increasing risks

A very strong increase in activities carrying credit risks characterised financial enterprises' leasing and lending activities. The vast bulk of this was accounted for by bank-owned firms encouraged by the change to regulations. The Council considers it problematic that the possibility of an increase in risks at the consolidated level preceded the introduction of consolidated data reporting.

Stress tests show a reassuring picture of stability

The stress tests conducted to analyse the banking sector's exposure to market and credit risks show the sector's good ability to tolerate stress. Potential unexpected high lending losses, i.e. lending shocks, may result in much higher losses for the sector than market shocks. However, potential losses caused by lending shocks also fell in the review period relative to the previous year.