MAGYAR NEMZETI BANK

26 May 2003

Assessment of financial stability

At its meeting on 26 May 2003, the Monetary Council discussed and approved for publication the *Report on Financial Stability.* The major findings of the *Report* are summarised below.

In January, speculators mounted an attack to force a shift of the intervention band. The MNB's presence in the foreign exchange market contributed to stabilising the situation.

From the perspective of stability, the most important events of the past six months have been related to the speculative inflow of capital in January. The attempt, aimed at putting pressure on the authorities to make a shift in the upper limit of the intervention band, was unjustified, causing losses to speculators. After the inflow of speculative capital, the MNB's presence in the foreign exchange market helped normalise market processes and stabilise the exchange rate. As soon as the vast majority of the capital flowing in during the speculative attack had left Hungary, the Bank ended its operations in the foreign exchange market and returned to the normal course of business, which was to influence exchange rate movements mainly through changes to official interest rates. As during the period preceding the January speculative attack, in the future the Bank will only conduct interventions in cases of market disturbances.

Lower interest rates do not pose a threat to stability.

The Bank has lowered its major policy rate by 300 basis points in the past six months, in order to stabilise the position of the exchange rate within the intervention band. Current interest rates, lower in comparison with those of previous years, do not add to risks to stability in the current phase of the business cycle. Over the longer term, domestic real interest rates may speed up the recovery of investment demand and contribute to a price bubble developing in either the real property or the share market, provided the outlook for growth improves.

Growth in domestic demand is unsustainable.

The cyclical position of export markets determines the growth opportunities of the Hungarian economy. An increase in demand, outpacing export growth, has helped the Hungarian economy to gather momentum in the past two years. But this path is unsustainable, as it leads to higher macroeconomic imbalance. The slow adjustment of wages and, as a result, the deterioration in corporate profitability may lead to a rise in unemployment.

The increasing borrowing requirement of corporate fixed investment requires fiscal adjustment.

If economic performance and firms' investment demand pick up, the external financing requirement may rise. This can be counterbalanced mainly by reducing fiscal policy's borrowing requirement, as the pattern of wealth developing in the household sector may result in a permanently low saving rate. Therefore, the sustainability of Hungary's external equilibrium makes it necessary for general government to curb its borrowing requirement in the coming years. If the net borrowing requirement of general government remains high, the public sector debt-to-GDP ratio may rise above 60%, the allowable maximum in the Maastricht convergence criterion.

Debt-creating inflows finance the current account deficit.

The financing structure of the current account has undergone a transformation, due to changes in the financial position of sectors. Simultaneously with firms' investment activity, the inflow of direct investment capital and foreign borrowing by the sector have slowed down. Parallel with this, the percentage share of portfolio investments, and purchases by non-residents of long-term government securities in particular, have risen within financing.

The banking sector is stable and profitable.

The Hungarian banking sector featured stable and profitable operation in 2002. Measured by the balance sheet total-to-GDP ratio, the depth of financial intermediation continues to lag behind that in the European Union, similar to other Central East European countries. Favourably, financial intermediation, measured by the loans-to-GDP ratio, has deepened as a result of a strong expansion of lending.

Corporate sector debts do not carry risks.

Non-financial corporations reduced their fixed investment activity in 2002 and they continued to run down their stocks as well. From 2002 Q2, firms have been in a net lending position. Capital leverage decreased somewhat, after rising in the previous two years. In the Council's view, the sector's indebtedness does not carry risks.

Lending to SMEs is robust.

There was an upsurge in outstanding loans to small and medium-sized companies in 2002. The sector's rising demand, improvements in its profitability and credit rating as well as the Government's subsidy system are behind this development, in addition to the saturation of the market of large companies.

Household real income grew and the saving rate fell in 2002.

Real net income rose at a robust rate in 2002. In addition to steady growth in consumption, accumulation expenses increased, due to the extension of the housing subsidy system. Income growth, serving as a source of savings, only partly offset the rise in outstanding borrowing, which led to a fall in the saving rate. Indebtedness and the interest rate burden of households increased. However, the increase in the relative interest burden is lagging behind the expansion of outstanding loans. This is due mainly to the increasing share of subsidised housing loans.

House loans are rising dynamically.

Bank lending to households has been rising at an increasingly dynamic rate, with a 70% surge in 2002. The very strong, 165% rise in housing mortgages in the review year was the result of the expansion of Government subsidies towards used home purchases. This extremely robust increase did not cause a wholesale rise in real property prices, as the house market picked up simultaneously. Taking into account the higher coverage ratio of loans and the acceptable rate of price increase, the risk carried by this price bubble is not seen as excessively high, despite the expansion of lending.

Loans to the corporate sector are deteriorating

Due to the slowdown in domestic and international economic activity as well as the shift towards small and medium-sized companies, the risks in lending to the corporate sector have

slightly; those to households are improving.

increased in the past 1–2 years. As expected, the percentage share of non-performing loans has risen. On balance, however, there has only been a slight deterioration in portfolio quality. Perception of risks in lending to households has improved, due to the sector's favourable income position and the Government's housing subsidy scheme. This is reflected in household loan portfolio quality as well.

The banking sector's market and financial liquidity does not threaten financial stability.

The re-pricing period of the banking sector lengthened on the assets side, due to higher volatility of interest rates. This may cause wider fluctuations in interest income over the short term, but, assuming the long-term downward trend of interest rates continues, it may affect profitability positively. Faced with increased exchange rate volatility around mid-year, banks reduced their exposure to exchange rate risk. This, however, remains insignificant. Maturity transformation intensified initially, but stopped increasing in the second half, due to rising issuance of mortgage bonds. On balance, banking sector liquidity continues to be adequate.

Financial standing is stable and profitability is high.

The sector's capital position continues to be stable, with a high capital adequacy ratio. Profitability has been improving for several years. The number of loss-making banks and their market share both fell. One source of profitability, realised on consumer credit, is interest margin, which is high even by international standards. However, in addition to a modest increase in interest income, the strong rise in banks' commission and fee income reflected shifts in the profile of incomes.

Savings cooperatives are facing unchanged risks.

Savings cooperatives have been growing at a higher rate than banks for several years. In 2002, their portfolio quality was much worse than that of the banking sector. Equity growth was slower than growth in the balance sheet total, as seen in most of the previous few years. The capital adequacy ratio fell. Most of the risks facing the sector arise from more lenient regulations relative to the banking sector, small individual size of business and lack of close integration.

Institutional investors continue to gain ground.

Institutional investors, including money market funds, pension funds and insurers, continued to increase their share in re-channelling household and corporate sector savings. The substantial risks facing pension funds were mitigated significantly by the consolidation process of the past few years.

Car purchase finance by financial enterprises jumped in 2002.

Financial enterprises specialised in lending, leasing and factoring can build up equally risky portfolios on the assets side as can banks. However, the statutory rules relating to measuring and managing risk by enterprises are much less stringent. Alleviating these risks, most of them are owned by banks, so rating, product development, loan assessment and provisioning are based on more or less the same principles as those of the parent banks.

Robustly rising settlement transactions were executed smoothly in the review year.

The payment and settlement systems operated smoothly in 2002. Operational reliability of the systems improved. The payment and settlement systems were able to transact turnover efficiently, despite less ample liquidity compared with earlier years. Development projects were implemented to maintain stability and improve efficiency. With the instalment of VIBER's hot back-up system, the MNB contributed to strengthening operational reliability.

Group regulation serves financial stability.

The proposed law amendments, affecting the regulation of financial conglomerates on a consolidated basis, are of prime importance for financial stability, as they allow assessing and controlling financial conglomerates as one entity. The amendments are aimed at increasing the transparency and controllability of financial conglomerates' relationships and risk-taking.