Speech of András Simor, Governor (MNB)

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It is a great pleasure and honour to welcome deputy governors and high level officials from 10 Central and Eastern European EU member countries on the occasion of the Central Bank Roundtable on Financial Stability. I am delighted that you all have accepted our invitation.

Maintaining financial stability at times of financial market turbulence is like navigating a ship in a storm: we have to be ready to prevent or handle distress situations. The main goal of this meeting is to share experience in dealing with financial stability challenges. Besides information sharing, I would also like to highlight the importance of strengthened co-operation between the authorities responsible for financial stability.

Although our countries have had differences in their transition paths and the levels of economic convergence are also different, there are a great number of common features across the banking sectors of the region: the presence of strong foreign ownership, fast credit growth with significant dominance of FX lending in most countries, and external imbalances, just to name a few.

The global financial and banking landscape has changed dramatically over the past twelve months. Financial market turbulence generated by the US sub-prime crisis made a strong impact on some of the world's largest and most developed countries; however, the CEE region was also affected – albeit indirectly. Recent events in the developed world, that is, the liquidity squeeze and solvency problems facing the financial system, as well as the fear of both recession and inflation, have increased the importance of the exchange of views and co-operation on financial stability issues. These are all the more important as financial sectors in individual countries have become more and more interconnected, opening potential channels of cross-border contagion.

1. Common challenges in the CEE region

First, it is worth looking at some common features of our region. Most of our countries show external vulnerability, accentuated but not caused by the recent market turbulence. Financial deepening, and especially fast credit expansion are general phenomena. Rapidly increasing household indebtedness and the dominant role of FX lending in some countries warn us of the increasing risks that we, the authorities responsible for financial stability, have to manage. FX based lending plays a dominant role where interest rate spreads (between the domestic currency and the euro or Swiss franc) are high, or the exchange rate is fixed (for example, in a currency board regime) or quasi-fixed. Some countries show signs of overheating: strong economic growth, signs of a credit boom and asset price bubble, double-digit inflation and fast wage growth. In addition, a high current account deficit and continuous real exchange rate appreciation are symptoms of imbalances that pose potential financial stability risks if a rapid adjustment were to occur.

2. Effects of financial market turbulence on the CEE region and some policy conclusions

Due to strong trade linkages and deep financial integration, the CEE countries have not been able to avoid the effects of the present financial turbulence. Here I would like to briefly discuss contagion through financial integration, which has two channels: the risk premium and intra-group linkages.

- The current market turbulence has highlighted the importance of the risk premium channel. The volatility of asset prices shows a general change in investors' risk profile: CDS spreads reflecting default risk of government debt in the region have increased, with some downward adjustment since March. Some countries experienced volatile exchange rate movements and depreciation, while yields on government securities also rose considerably in some other countries. On the other hand, market liquidity fell and some asset markets behaved in a disorderly fashion. The extent of market reaction depended mainly on the vulnerability of the respective countries. Investors seem to have punished countries with higher current account deficits.
- The second main channel, the intra-group channel of contagion, is very important due to the dominance of foreign ownership in the banking sectors of the CEE region. The 'search for yield' by banking groups from Western Europe, the US and other regions expanded into the CEE region. This expansion has strengthened the interdependence of parent banks and subsidiaries, and opened potential channels of contagion through higher risk taking in the region, as well as through foreign funding by parent banks. Due to the rapid growth of credit and the lack of adequate domestic savings, financial sectors of certain countries have been relying to a great degree on foreign funding. Consequently, these countries are not isolated from unfavourable global liquidity trends.
  - Funding liquidity risk could increase due to higher funding costs and the shortening of funding maturity, which in turn enhances the risk of renewing liabilities. However, countries without any foreign funding need and low interest rates may also be affected through the intra-group liquidity allocation mechanism. Banking groups with regional presence may finance their activity from countries where funding is more easily available.
  - Deteriorating liquidity conditions at parent banks could result in rising loan rates and the tightening credit standards, ultimately causing a reduction in the availability of loans in economies of the region.

After highlighting the potential channels of contagion and the likely regional effects of the sub-prime crisis, we can draw some policy conclusions.

  - The intra-group contagion channel and the cross-border crisis potential call for the strengthening of crisis prevention and crisis management capabilities of central banks. Prevention capability should be enhanced through appropriate monitoring and a risk assessment framework. In addition, the crisis management toolkit should be extended not only to handling individual but also to system-wide liquidity problems. But every coin has two sides: banks should also ensure that their own crisis management practices are in place and adequate, including regular updates of contingency funding plans and conducting stress tests at both individual bank as well as group level.
  - Last but not least, authorities in home and host countries should strengthen information sharing and co-operation in order to detect early signs of potential cross-border contagion. To ensure that central banks react in a timely and efficient manner, the procedure of systemic assessment should be harmonised, and coordination procedures should be developed in order to shorten the time necessary to share national assessment results. Most difficult and problematic questions are the burden sharing in solvency crisis and coordination of ELA type activities in the case of a liquidity problem within a banking group.

3. Some financial stability issues in Hungary

Finally, after reviewing the effects of market turbulence on CEE countries, let me give you a brief update on some financial stability issues in Hungary.

The Hungarian financial sector seems to be resilient to the shocks experienced during the recent period; however, three main risk factors, discussed in detail in our most recent Report on Financial Stability, are worth mentioning.

Firstly, asset side and funding side liquidity has tightened during the last ten months. On the one hand, tighter conditions in international financial markets, coupled with some idiosyncratic events in the Hungarian market, caused turbulences in the government securities market in early March. On the other hand, tightening funding liquidity (more expensive funding with shortening maturities) may squeeze the profits of the financial sector and increase maturity mismatches.

Secondly, a possible deceleration of economic growth due to international and domestic factors may lead to deterioration in credit quality in the medium term.

Thirdly, intensifying risk-based competition among financial institutions, in addition to increasing household indebtedness, may also generate additional risks. The development of new innovative products, (for example, FX lending, yen-based credits to households), easing credit conditions (higher LTVs and instalment to income ratios, longer maturities) and the increasing use of credit agents are typical forms of risk-based competition.

4. Concluding remarks

In conclusion, let me stress the need to learn from the present financial turbulence and draw important conclusions regarding the financial stability functions of central banks. Vigilance and stronger co-operation between authorities, developed internal crisis prevention and management toolkit can help to cope with possible disturbances.

Accordingly, I hope that the discussions in the sessions of the Central Bank Roundtable on Financial Stability will be lively and will show the differences and commonalities in your challenges and problem-solving. I also hope that such meetings among countries in the region will become more and more common. I wish you a fruitful and effective meeting, and a pleasant stay in Budapest.