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September 18, 2008

The Acting Chair's Summing Up
Hungary—2008 Article IV Consultation
Executive Board Meeting 08/81
September 17, 2008

Executive Directors agreed with the thrust of the staff appraisal. They commended Hungary's substantial fiscal consolidation since mid-2006 and the associated narrowing of the current account deficit. Monetary policy has been appropriately tightened, and the elimination of the exchange rate band has removed a potential conflict between monetary policy objectives. Directors also welcomed the authorities' publication of guidelines on banks' risk management and consumer protection related to foreign currency loans.

Directors noted that risks to external stability would remain high in the period ahead. In particular, they raised concerns about the high level of government debt, the large net external liability position, and financial system risks, especially in light of unsettled global financial market conditions. Pressures on the current account deficit could intensify from 2009 if economic growth picks up as expected because of strengthening domestic demand, and if real exchange rate appreciation continues. Directors noted the assessment that the real effective exchange rate is somewhat above the value implied by fundamentals, while pointing to the uncertainties surrounding this assessment and observing that Hungary does not appear to have suffered a loss of external competitiveness. They believed that the strength of the currency may reflect in part appropriately tight monetary policy. Directors noted that Hungary's gross external financing needs in 2008-09 are high, though short-term debt is roughly covered by net international reserves.

Directors considered that the key policy priority for the authorities is to continue to reduce vulnerabilities. This will involve sustained further efforts to put the government debt-to-GDP ratio firmly on a downward path, preserve domestic stability and confidence in the currency, and strengthen the resilience of the financial sector. Continued improvements in the business environment will help to preserve Hungary's external competitiveness and attractiveness for foreign direct investment.

Directors welcomed the fiscal tightening under way in 2008 and urged further fiscal consolidation in 2009 in line with the Convergence Program. They observed that expenditure restraint and buoyant revenue made the fiscal deficit target for 2008 attainable, and supported the authorities' intention to use any revenue overperformance for public debt reduction. To achieve further consolidation in 2009, continued strict spending restraint is needed. Tax cuts should be avoided unless they are offset by specific spending cuts. Given the uncertainties in the economic outlook, it would be helpful for the 2009 budget to include sizable contingency reserves. Directors supported the planned introduction of a rules-based fiscal framework; if underpinned by credible policies, this would signal the authorities' commitment to fiscal discipline and help deliver the needed consolidation. Directors suggested reducing the size of government, and the corresponding tax burden, through further reform of pension, health, and education expenditures. They also favored improving work incentives and increasing employment by shifting the tax burden away from labor and toward consumption and by broadening the tax base.

Directors recommended that monetary policy aim to reduce inflation to the 3 percent target over two years. They noted that, in the new floating exchange rate regime, monetary policy is able to focus exclusively on the inflation target. Given the rise in inflationary pressures in the first half of 2008, Directors considered that the tightening of monetary policy had been appropriate. Looking forward, they observed that the policy interest rate would need to respond to the effects of exchange rate developments and the evolution of underlying inflationary pressures. They underscored that the central bank should be prepared to react quickly and forcefully to inflationary shocks.

Directors noted that while the banking system remains profitable and well-capitalized, financial soundness indicators have deteriorated recently. They urged further policy action to improve banks' risk management. Regarding credit risks, the priorities are to establish a credit registry for households and to strengthen stress testing, including of households' foreign currency exposures. It will also be important to ensure that banks remain adequately capitalized. Regarding liquidity risks, the priorities are to expedite the review of banks' liquidity management practices, develop liquidity management guidelines, and ensure that banks have effective contingency arrangements in place. In addition, Directors recommended that the review of financial safety nets be accelerated. They also called for enhanced collaboration with foreign supervisory authorities given Hungarian banks' close links with financial institutions abroad.

The next Article IV consultation with Hungary is expected to be held on the standard 12-month cycle.