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Proactivity and Innovation as a Means of Central Bank Renewal

Thoughts on the National Bank of Hungary's Book Entitled *The Hungarian Way - Targeted Central Bank Policy*

SUMMARY
The 2008-2009 global crisis created major challenges for fiscal policy, monetary policy and the financial regulatory authority at the same time. To respond to these challenges, proactive and innovative solutions were needed. This paper presents the niche volume of the Magyar Nemzeti Bank (National Bank of Hungary), which describes the measures that resulted in the turnaround of the Hungarian fiscal and monetary policy.

Journal of Economic Literature (JEL) codes: E42, E44, E52, E58
Keywords: central bank, global crisis, monetary policy, regulatory policy

The US subprime mortgage crisis of 2007 and other factors like significant international trade imbalances, high debt levels in several major economies, real estate bubbles, and lax regulation of non-depository financial institutions has caused the most serious financial crisis since the Great Depression. This crisis had a huge global impact as well. In 2009 the annual per capita real GDP of the world declined by almost 3%, resulting a global recession. This crisis was so significant that it has earned its own name, entering the economic history books as the Great Recession.

Because of the severe and global impact of the crisis, governments and cen-

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tral banks had to take complex measures to fight the negative consequences, like the high unemployment rates, low or negative GDP growth, and struggling financial systems. Although the crisis was having a global impact, some countries were facing more significant and complex challenges. One of these countries were Hungary.

Multiple factors caused the complex problems of the Hungarian economy. The country had a high government debt ratio (71.6% in 2008), mostly because of the huge budget deficits of the previous years (the negative balance was between 6% and 10% of the GDP in the years 2002-2006, much higher than the 3% Maastricht criteria). As one of the consequences, the level of the public debt was expanding rapidly. External financing requirement was also high, and the country was dependent on foreign financing in times when international capital flows to emerging markets have dried out significantly. The employment rate was one of the lowest in Europe (around 50% before the crisis). The composition of the household debt was also a significant problem, since majority of this debt (in 2008 around 70%) was denominated in foreign currencies, mainly Swiss francs. Thus, as the Hungarian forint weakened because of the capital outflows triggered by crisis, the debt burden of the population increased materially. Because of these problems, Hungarian policymakers were facing a more complex and challenging situation, than their European, American or Japanese colleagues. Both fiscal and monetary policy was in a desperate need of a sharp turnaround.

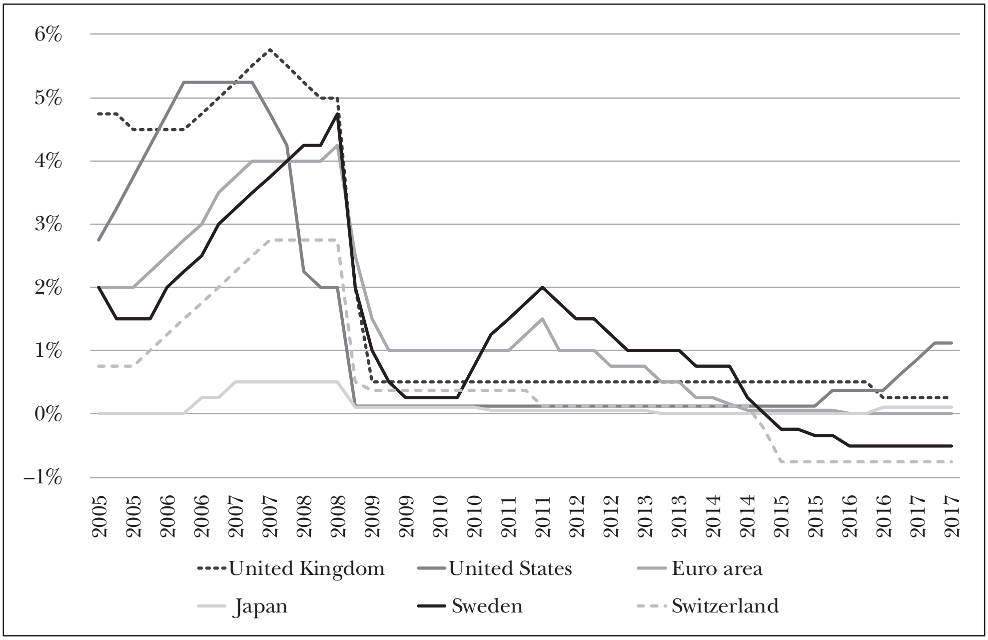
This review is organised in three parts in line with the three main chapters of the book. The first part is introducing the effects of the crisis on foreign central banks. The second part is focusing on the Hungarian monetary policy turnaround. The third part is introducing the challenges and reforms in the Hungarian regulatory policy.

The effects of the global crisis on central bank policy

The decades before the 2008-2009 crisis gave a false sense of stability to many economists.[1] Stable growth, falling inflation and interest rates diverted the attention from widening imbalances. Among these imbalances, balances of payments problems were prominent. Current account imbalances were on the research agenda well before the 2008-2009 crisis. Although many theories have been worked out to explain this phenomenon (i.e. Bretton Woods II, dark matter, excessive global savings, demand for secure investments) (Krugman, 2007), only few authors believed that this could not be sustained in the long run. A common assumption was that current accounts must be balanced in an adjustment that would mostly affect countries with the largest surpluses and shortages. Events following the crisis surprised both optimists and skeptics of sustainable imbalances. Although imbalances moderated, the dynamics of the processes was not in line with the expectations of the skeptics either. The main losers of the crisis were not necessarily those countries, which had high surpluses or deficits. The euro area for example had a more or less balanced current account. On the other hand, the deficit and surplus positions of the regions were maintained.

The depth and the global spillovers of the crisis required novel and complex measures both in monetary policy and regulation. The main objectives of the monetary policy had to be reconsidered. It became clear that price stability alone was not enough to ensure the stability of the financial system (Kolozsi and Hoffmann, 2016). The role of macroprudential policy has appreciated (Ábel et al., 2014). Real-economy targets such as the reduction of unemployment and the promotion of economic growth have become more pronounced. Short-term interest rates, which were formerly the main tools of monetary policy, hit the zero lower bound. In countries like Switzerland, Sweden, or Japan, central banks experimented with negative interest rates but were cautious about the uncertain consequences of negative rates on financial and macroeconomic developments (see Figure 1). This also meant that central banks had essentially lost their number one and best known instrument in conducting monetary policy.

Figure 1: Key interest rates



Source: BIS

Asset purchases that bloated central bank balance sheets became the key tool of central bank policy. Monetary easing was achieved in many cases through open market operations. Both the Fed and the ECB had launched liquidity-providing, targeted lending, and large-scale asset purchase programmes,[2] which actions significantly boosted their balance sheets.[3] With respect to balance sheet totals, the most drastic measures were applied by the Japanese central bank, which increased the central bank assets to GDP ratio from 30% to over 90% in a few years.

In the case of the ECB the same ratio has increased to almost 40% from the pre-crisis 17%, while the Fed went from 7% to over 22%.

At the same time, the role of central bank communication became more pronounced (Csortos and Lehmann, 2014) as medium and long-term yields (which are of paramount importance for the economic actors) were determined by the subsequent short yields of the full maturity, hence monetary easing can not only be achieved by lowering the short-term yields, but also by lowering market expectations regarding future short-term yields.[4]

The severity of the global downturn posed serious challenges to monetary policy makers. Interest rates at zero level did not enhanced growth, or solved inflation and unemployment problems, so additional tools were needed to address the crisis. These new, previously untested tools, combined with the once in a lifetime economic downturn created serious uncertainty among economic actors. Besides, monetary transmission became less efficient and more difficult to forecast. In addition, many central banks faced unique, specific problems.[5]

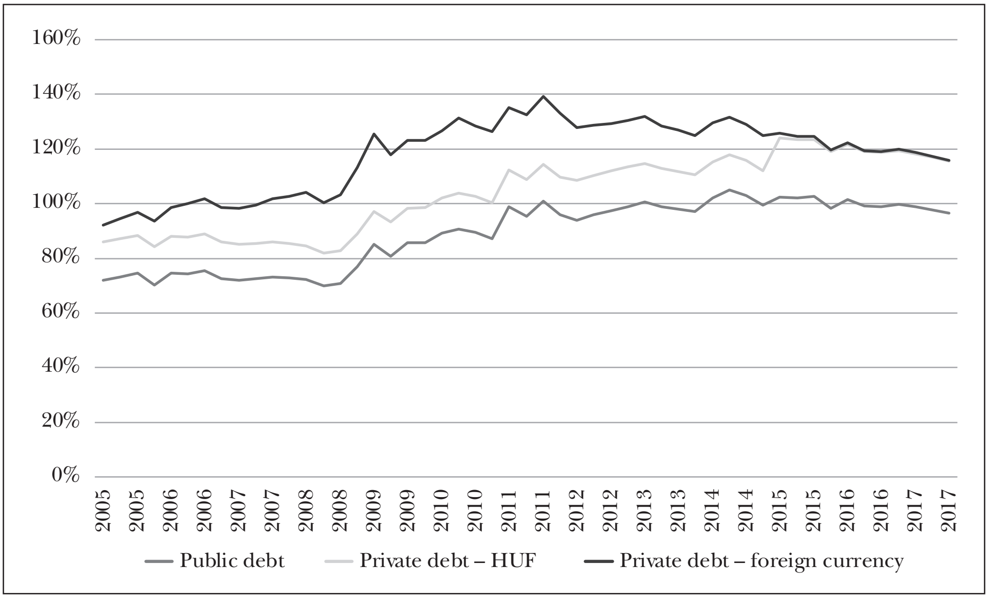
The first main chapter of the volume guides us through the international consequences of the crisis. Starting with the build-up of global imbalances, introducing the pre-crisis explanations, guiding us through the unfolding of the crisis, and depicting the situation of the global economy after the crisis (decreasing flow but remaining stock imbalances, balance sheet recession, protracted recovery), the changing framework of the monetary policy (transmission mechanisms, the relationship between fiscal and monetary policy, changing objectives, reform of the instruments) and the responses of the major central banks to the crisis (crisis management, unconventional monetary policy instruments and changing framework and communication of the Fed, the ECB). In the last part of the first main chapter, we receive an overview of the protracted struggles of the BoJ against sub-target inflation.

Complex economic and monetary policy related challenges in Hungary

The crisis hit Hungary in a particularly vulnerable state. The economic growth before 2006 was unsustainable, the high budget deficit (Orbán and Szapáry, 2006) (the country was subject to the excessive deficit procedure since 2004) has significantly increased the total debt of the country. Both the public and the private sector has increased its indebtedness materially. The external financing requirement was high, which was boosted not only by the public overspending, but by the high volume foreign currency retail lending as well (Matolcsy and Palotai, 2016, see Figure 2). The country was also running on a high current account deficit. And, though the reforms of 2006 were able to bring the very high public deficit to lower levels, current account deficit remained high, so external imbalances remained, and the cuts in public spending significantly dampened both the potential and the actual GDP growth rate of the country. These negative tendencies were also amplified by the procyclical banking sector.

Hence the effects of the global crisis were multiplied by some serious country-specific problems, coming together to

Figure 2: Total debt to GDP in Hungary



Source: National Bank of Hungary

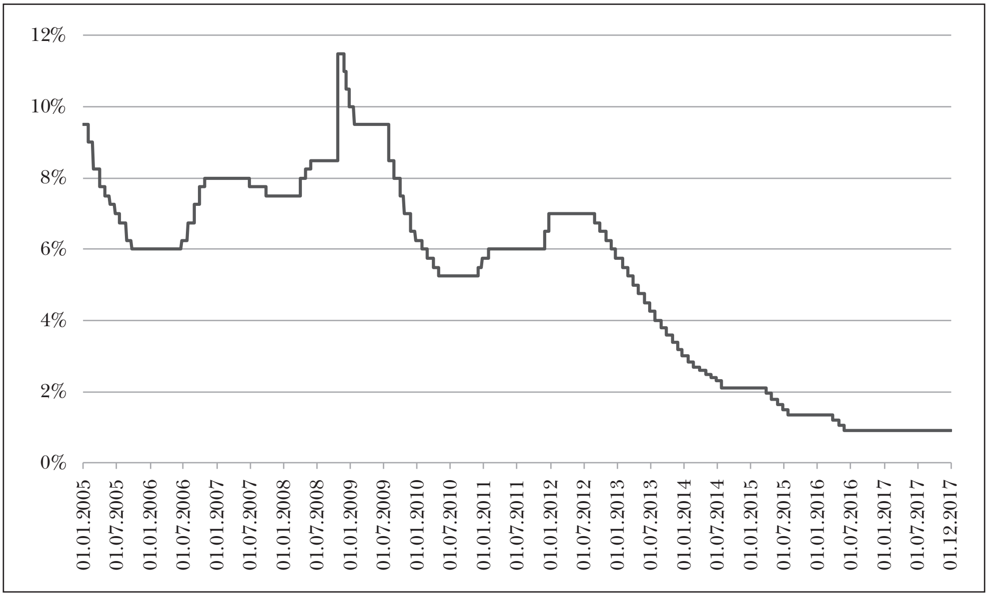
cause a severe recession. These negative processes had a significant and unfavourable impact on the domestic financial sector as well, which has propagated the adverse impacts pro-cyclically. Like the Baltic States, Hungary suffered the longest and largest decline in corporate lending in the region (Balog et al., 2014).

Hungary had faced problems regarding both growth and stability even before the eruption of the crisis (Matolcsy, 2016). In 2010 the newly elected government has implemented a deep fiscal turnaround, which has, in multiple steps, significantly improved the balance of the budget (Matolcsy and Palotai, 2014) by reducing work-related taxes, simplifying the system of taxes and contributions on labour, focusing on consumption and sales based, as well as sector-specific taxes, and introducing online cash registers.[6] As a result of the fiscal turnaround, Hungary was released from the excessive deficit procedure in 2013 (Matolcsy, 2016).

Although the fiscal turnaround was very successful in reversing the tendencies and was able to stop fiscal dominance, the financial system still faced some serious challenges. To address these challenges, the new management of the National Bank of Hungary launched a complex monetary policy turnaround in 2013.

The monetary policy turnaround had multiple steps. The base rate was materially reduced in three easing cycles, from 7% to 0.9%, by 610 basis points in total (see Figure 3). This has significantly reduced the interest burdens of both the public and the private sector. The National Bank of Hungary introduced its targeted lending incentive instruments, the Funding for Growth Scheme (FGS), and the Market-Based Lending Scheme, which actions helped to kick-start the SME lending in the country (Baksay and Palotai, 2017), which has been in decline since 2009 (Banai, 2016). The National Bank of Hungary has developed and launched its Self-Financing Programme, a mix of actions with the objective of decreasing the external financing requirements of the country. This measure helped to cut the ratio of foreign currency debt to public debt from 50% in 2011 to 25% in 2016 (Baksay and Palotai, 2017). The Central Bank was also a key player in the conversion of the substantial foreign currency denominated household debt to Hungarian forints. In the absence of this action, many people would have lost their homes and the country would have faced irreparable and significant social losses on 15 January 2015, when the Swiss National Bank unpegged the CHF from the EUR. As majority of Hungarian private mortgages were denominated in Swiss francs, the massive strengthening of the Swiss currency would have materially increased the debt burden of the domestic debtors.

Figure 3: Key interest rates in Hungary



Source: National Bank of Hungary

The second main chapter of the volume introduces the challenges and answers in Hungarian monetary policy. First we get familiar with the macroeconomic conditions in the first decade of the 2000s, the path of the GDP growth rate from balanced to unsustainable to negative, the very high public deficit, tax wedge and social benefits, the increasing public and private indebtedness and the external debt ratios. Then we can learn about the interactions between the fiscal turnaround and monetary policy, how the rearrangement of the tax regime, the review of social expenditures, and the contracting budget deficit has helped and gave room to the monetary policy. The next chapter introduces the way of Hungary from unsustainable indebtedness and a pro-cyclical banking system. After this we get familiar with the three easing cycles, which have resulted in a significant easing of the monetary conditions. The next chapter deals with the theoretical background of maintaining the level of the base rate for an extended period of time. After this chapter, we get an introduction into a more flexible framework of inflation targeting. Then we get to know the targeted lending instruments FGS and GSP (Growth Support Programme), which actions were helping not only domestic lending, but also growth in Hungary. The next chapter introduces the monetary policy considerations for the conversion of foreign currency loans. After this, we learn about the self-financing programme of the National Bank of Hungary. The next chapter deals with the development of BUBOR and the domestic interbank market. Then we get introduced to the logic behind the capping of the 3-month deposit as unconventional easing. The next three chapters are guiding us through the instruments to improve the functioning of the monetary transmission mechanism (a more efficient banking system, development and modernization of payments and financial infrastructures, and the relationships between monetary policy and the stock exchange).

Changes in the Hungarian regulatory policy

In addition to monetary policy, Hungarian regulatory policy had also significantly changed and improved. The crisis has shown that monetary policy alone cannot ensure the long-term balance of an economy. The role of macroprudential policy has been appreciated both internationally and domestically. The occasionally fatal impacts of the crisis on the banking sector and on some individual banks has led to the emergence of the resolution function. In addition, micro-prudential supervision, market surveillance and consumer protection have been renewed.

The third main chapter of the volume introduces these advancements. First we get introduced to the theoretical basis of macro-prudential policy, learning about the ultimate objective, the types of systemic risks and the market problems causing them, the instruments of macro-prudential policy, and the institutional framework of macro-prudential policy. The next chapter is a detailed account of the targeted Hungarian macro-prudential policy instruments which were introduced and used after the crisis like the debt cap rules payment-to-income ratio and the loan-to-value ratio, the countercyclical capital buffer, the liquidity coverage requirement, the foreign exchange funding adequacy ratio, the foreign exchange coverage ratio, or the mortgage funding adequacy ratio. After this we get introduced to the new resolution function of the National Bank of Hungary, where we learn about the goals, the setup of the new function, resolution planning, the conditions for ordering resolution, tools and international activities, and we get guided through the resolution of MKB Bank, one of the largest banks in Hungary. The next chapter offers an insight into the central bank supervisory functions,[7] where we can learn about the aim and the instruments of supervision, like the capital requirement directive, the bank resolution and recovery directive, the market abuse directive, the markets in financial instruments directive, licensing and enforcement activities, the concept of continuous supervision, types of inspections, and the market surveillance procedures. Next we get an overview of the improvements in the Hungarian micro-prudential supervision, like stronger supervisory regulation, the forward-looking approach, the basic monitoring system and the early warning system, the business model analysis, targeted and periodical inspections, stronger sanctioning, the internal capital adequacy assessment process, the internal liquidity adequacy assessment process, the liquidity coverage ratio, stress testing, the admission of capital market products and the gatekeeper role of the central bank, the supervision of insurance companies and funds. After this, we are offered an in depth look into the market surveillance and consumer protection procedures, where we get acquainted with the means of evidence, the inspection instruments, prevention, the priority of market surveillance, the paradigm shift in consumer protection, and the right to prepare action in the public interest. The last chapter deals with the new approaches and challenges of regulation in the 21st century, like cloud-based technologies, e-administration, the emergence of new players, the alternative banking system, technological challenges, the impact of digitalization, and the development of the efficiency of IT supervision and data analysis.

The monograph is an equally useful source for both domestic and international experts, academics and students, as well as for those of the general public, who are interested in the complex challenges ignited by the 2008-2009 global crisis as well as the countermeasures of the domestic monetary and regulatory decision-makers. The reader will not only get a professionally outstandingly precise and versatile introduction of the events, but also a colorful, readable account of the proactive and innovative measures of the National Bank of Hungary, with 46 tables, 216 figures, numerous framed stories and small case studies. This work is a worthy continuation of the book series launched by the National Bank of Hungary in 2015, with the first two volumes *Balance and Growth* (2015) and *Competitiveness and Growth* (2016).

The editors of the monograph are Kristóf Lehmann, Head of the Monetary Strategy Department of the National Bank of Hungary and the MNB Department at Corvinus University of Budapest, Dániel Palotai, Executive Director and Chief Economist of the National Bank of Hungary, and Barnabás Virág, Executive Director of the National Bank of Hungary responsible for Monetary Policy and Credit Promotion.

(Lehmann, Kristóf; Palotai, Dániel and Virág, Barnabás (eds.) (2017): A magyar út – célzott jegybanki politika [The Hungarian way – targeted central banking policy]. Magyar Nemzeti Bank, Budapest, 955 pages.)

Notes

1 The years between the mid-1980s and the late-2000s were labelled as the Great Moderation. Many believed that because of central bank independence, improved modelling, better monetary policy frameworks and tools, and an improved economic structure, the world economy has entered into a more predictable and less volatile state.

2 The Fed introduced the terms auction facility, securities lending facility, primary dealer credit

facility, the asset-backed commercial paper money market mutual fund liquidity facility, the commercial paper funding facility, the term asset-backed securities loan facility, the large-scale asset purchase programmes, and the maturity extension programme. The ECB has started its main refinancing operations, long-term refinancing operations, targeted longer-term refinancing operations, FS swap tenders, the covered bond purchase programmes, the securities market programme, the public sector purchase programme and the corporate sector purchase programme.

[3] These actions also significantly increased money supply, measured by M0.

[4] Two important practical examples are the forward guidance, a tool extensively used by many central banks after the crisis, and the famous "whatever it takes" speech by ECB president Mario Draghi on the 26th of July 2012, which was able to calm down the markets, and contributed to a sharp turnaround in the evolution of the government bond yields of the PIGS countries.

[5] Greece and Japan was dealing with high levels of government debt and high public deficit, Russia was impacted by the falling oil prices, Switzerland saw a flood of capital inflow and hence a quickly appreciating currency, the US, Ireland and Spain saw their real estate prices collapsing, Latvia, Croatia and Hungary was suffering because the foreign currency loans of the private sector.

[6] The budget deficit, which moved between 4% and 10% before 2010 has decreased significantly, mildly fluctuating around 2% since 2012.

[7] The National Bank of Hungary has assumed the tasks related to the supervision of financial institutions and financial consumer protection from the Hungarian Financial Supervisory Authority (PSZÁF) on the 1th of October 2013.

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