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Macroeconomic Management With Open Capital Accounts

György Szapáry

Central Bank of Hungary

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Introduction

Financial liberalization has important benefits:

- Lowers the cost of capital and improves its allocation, thereby promoting growth
- Promotes trade flows
- Promotes the development of sound institutions (e.g. better information and legal systems, better financial supervision)

However, it can lead to financial instability and crises if not managed properly

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„The issue is not whether financial globalization is inherently good or bad, but whether it can be done right”,

Frederic S. Mishkin, („Financial Stability and Globalization: Getting It Right”, paper presented at the Bank of Spain Conference, Central Banks in the 21st Century, June 8-9, 2006, Madrid)

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Main Themes

- The presentation evolves around three main themes:
- Managing expectations
- The exchange rate and monetary regimes adopted matter
- Risks of credit booms

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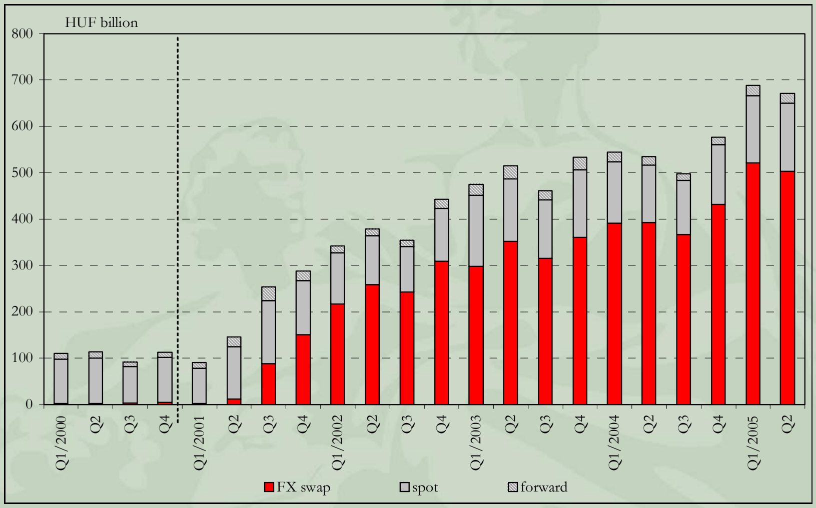
Chart 1 – Hungary - Daily turnover of the various segments of the foreign exchange market



Capital account liberalization has a direct effect on the investment strategy of market participants

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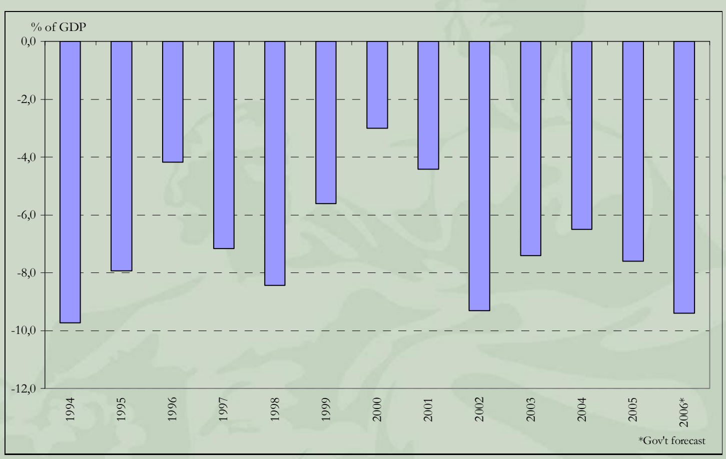
Chart 2 – Hungary - Budget Deficits, 1994-2006



Sharp increase in the fiscal deficit in Hungary

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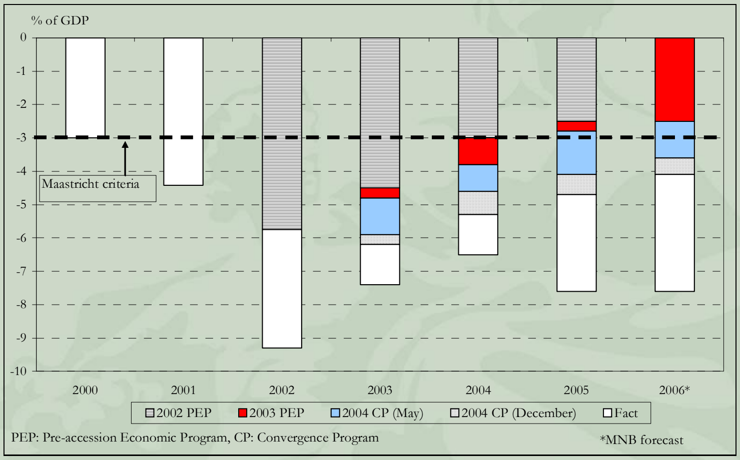
Chart 3 – Hungary - Budget Deficits: Plans and Outcomes, 2002-2006



Weak fiscal credibility in Hungary

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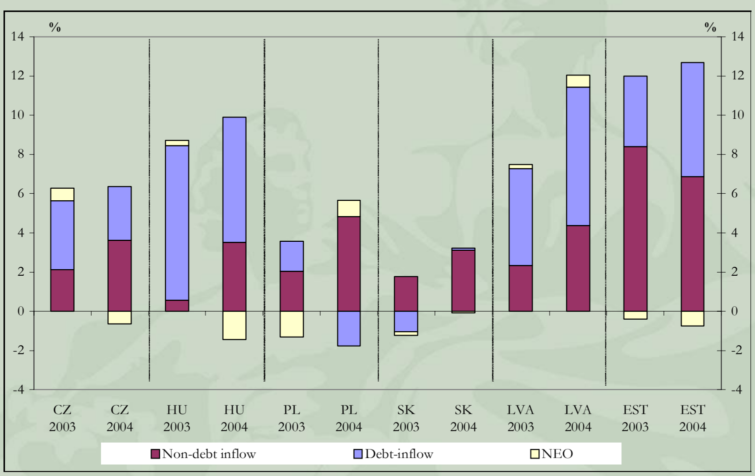
Chart 4 – External financing requirements of CEE4* and two Baltic countries (2003-2004)



High budget deficit is associated with large debt financed external deficit in Hungary

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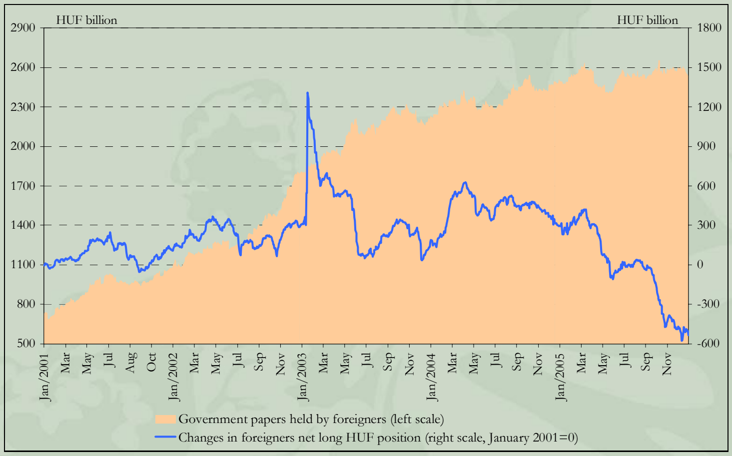
Chart 5 – Hungary – Changes in foreign investors' net position against HUF and stock of government securities held by non-resident, 2001-2005



Liberalization makes countries vulnerable to speculation

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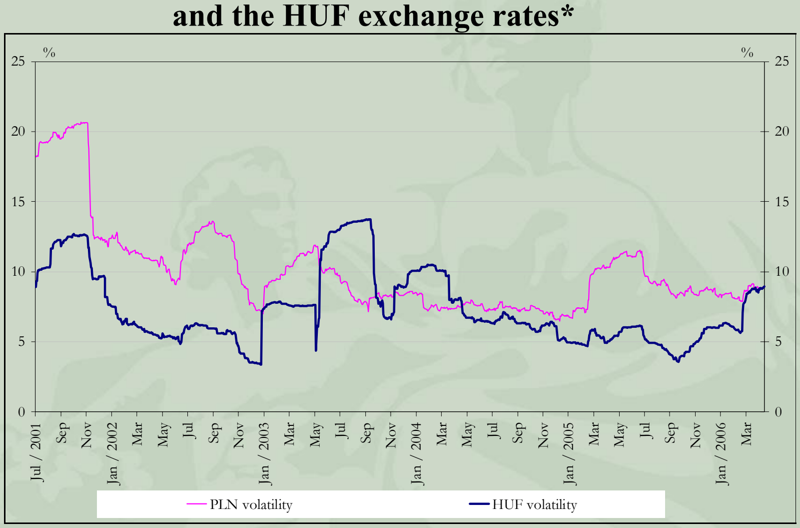
Chart 6 – Historical volatility of the Polish zloty (PLN) and the HUF exchange rates*



The exchange rate regime matters

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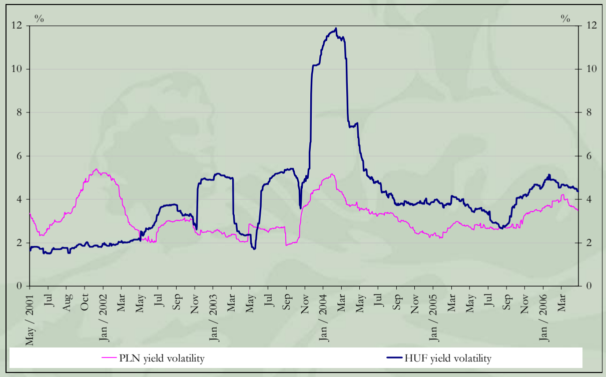
Chart 7 – Historical yield volatility of the PLN and the HUF (standard deviation of yields during a moving 90-day period, yields are based on CEBI bond indexes*)



**CEBI, the DrKW's Central European Bond Index, incorporates the CEE4 local currency denominated government bonds of various maturities*

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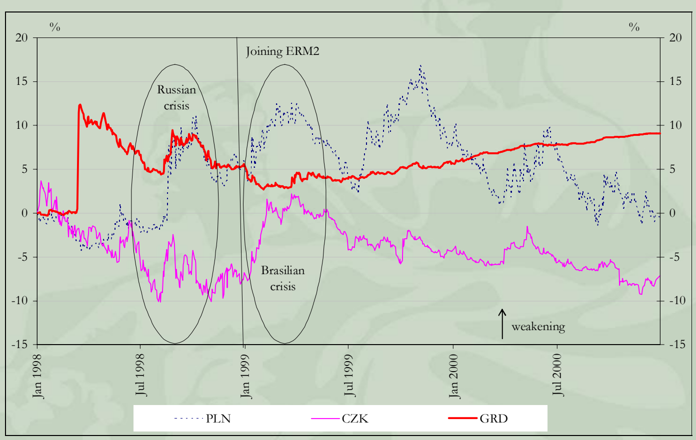
More focus on exchange rate stability can lead to more volatile interest rate

Chart 8 – Exchange rate movements of the Czech, Polish and Greek currencies, 1998-2000



A framework of commitment to stability helps

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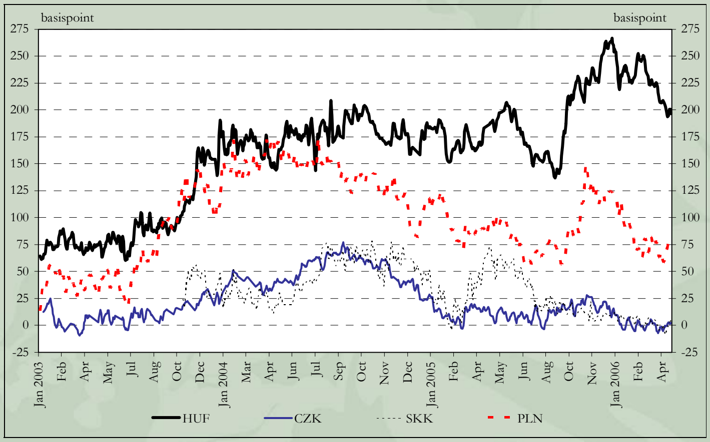
Chart 9 – Polish, Czech, Slovak and Hungarian implied forward rate differentials vis-à-vis euro rates in 5 years time (for 5-year maturity bonds)



Credibility and fundamentals are essential

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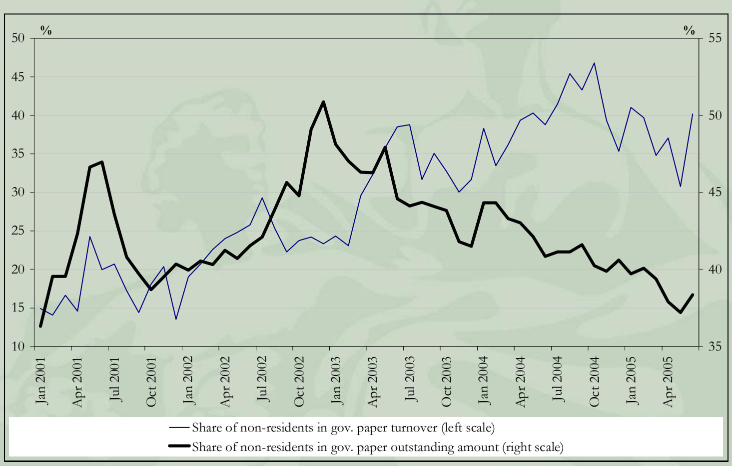
Chart 10 – Hungary - Non-residents' share in the outstanding amount and in the secondary market turnover of government bond



When expectations worsen, short-term speculative investments become important

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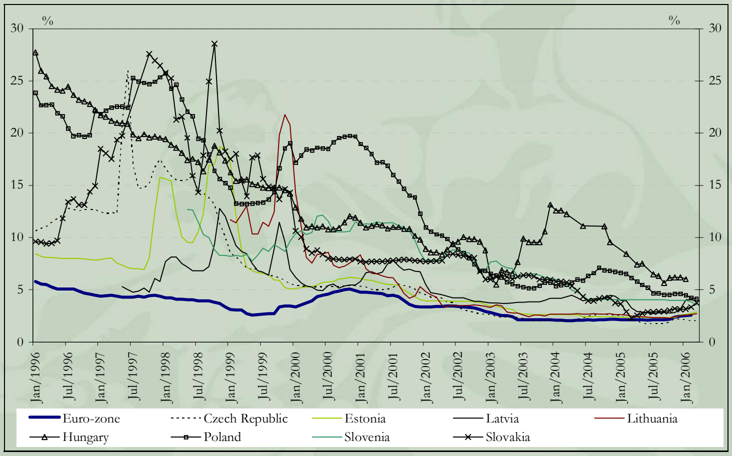
Chart 11 – 3-month interest rates in the Eurozone and the new EU member states (1996-2005)



Strong yield convergence in the new EU members

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Table 1 – Long term average yields and standard deviation, and overall performance of CEE bonds*

	Index	Average yield (1) 1999-2005	Standard deviation of average yield (2) 1999-2005	Performance indicator (3) (1) / (2) 1999-2005
Annual yield in euro (A)	Czech	11,6%	6,8%	**1,70**
	Slovak	10,0%	6,0%	**1,66**
	Hungarian	10,8%	9,0%	**1,19**
	Polish	12,8%	11,2%	**1,15**
Reference indices	*CEBI Composite*	*11,9%*	*7,9%*	***1,50***
	iBoxx (euro)	*5,3%*	*3,1%*	***1,71***
Annual yield in local currency (B)	Czech	8,4%		
	Slovak	6,7%		
	Hungarian	10,6%		
	Polish	11,3%		
Appreciation of the exchange rate (A)-(B)	Czech	3,1%		
	Slovak	3,3%		
	Hungarian	0,2%		
	Polish	1,6%		

**CEBI, the Central European Bond Index (CEBI) of Dresdner Kleinwort Wasserstein (DrKW), incorporates the Czech, Polish, Hungarian and Slovak local currency denominated government bonds. The iBoxx is the euro-region sovereign euro denominated bond index of the International Index Company.*

Different performance

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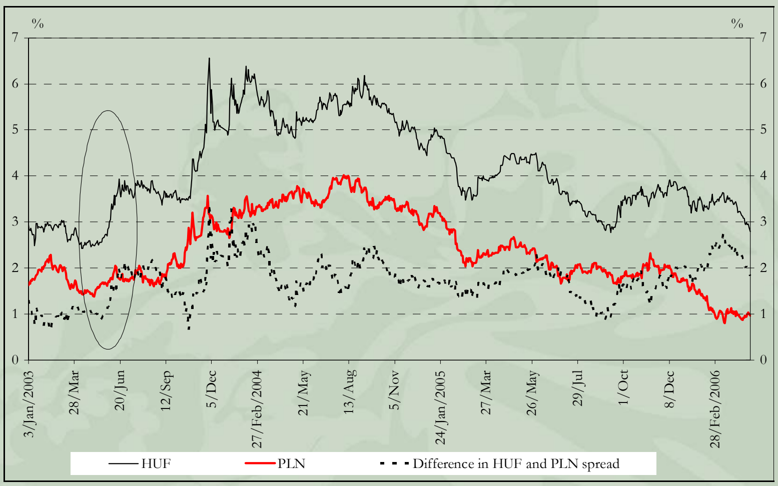
Chart 12 – HUF and PLN Spreads over 5 year euro spot zero coupon interest rate



Unexpected policy moves have long-term impact

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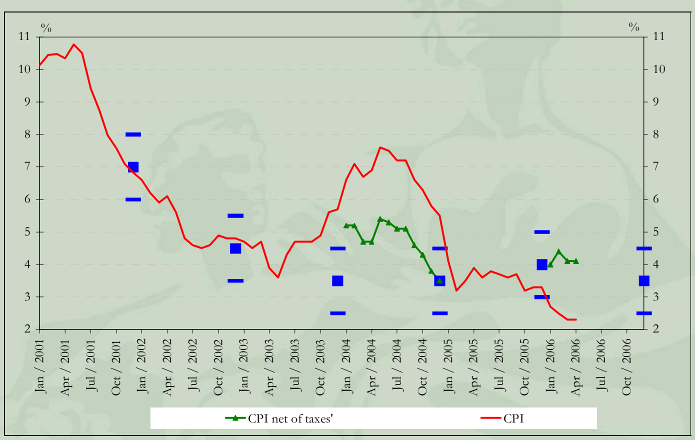
Chart 13 – Inflation targeting in Hungary, 2001-2006



Anchoring expectations is important

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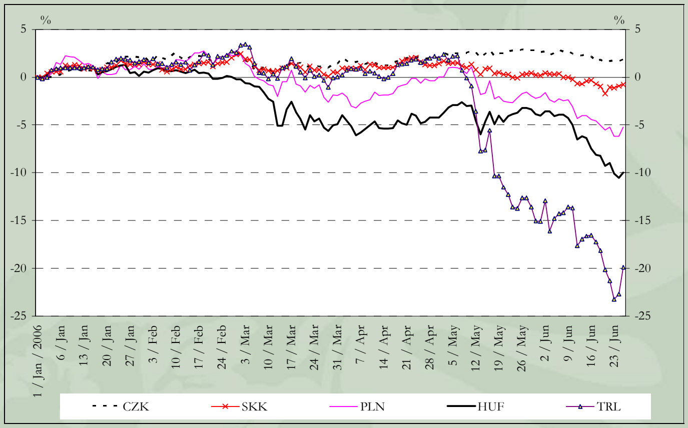
Chart 14 - Exchange rate movements of the Czech, Slovak, Polish and Hungarian currencies against the euro, and the Turkish currency against the dollar (2006. jan.1 = 0)



Vulnerability increases when the fundamentals and credibility are weak

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Table 2: Selected macroeconomic indicators in Emerging European countries

	Czech Republic			Slovakia			Poland			Hungary			Turkey		
	2004	2005	2006	2004	2005	2006	2004	2005	2006	2004	2005	2006	2004	2005	2006
Fiscal balance*	-2.9	-2.6	-3.2	-3.0	-2.9	2.7	-3.9	-2.5	-3.0	-6.5	-7.6	-9.4	-8.1	-5.8	-5.1
C/A deficit*	-6.0	-2.3	-2.6	-3.4	-8.5	-5.7	-4.2	-1.5	-2.0	-8.4	-7.4	-8.3	-5.2	-6.3	-6.5
Inflation	2.6	1.6	2.5	7.5	2.8	4.4	3.6	2.2	1.0	6.7	3.5		8.6	8.2	

*percent of GDP

Source: Eurostat and European Commission, 2006 Spring Forecast

Turkey and Hungary have the worst fundamentals

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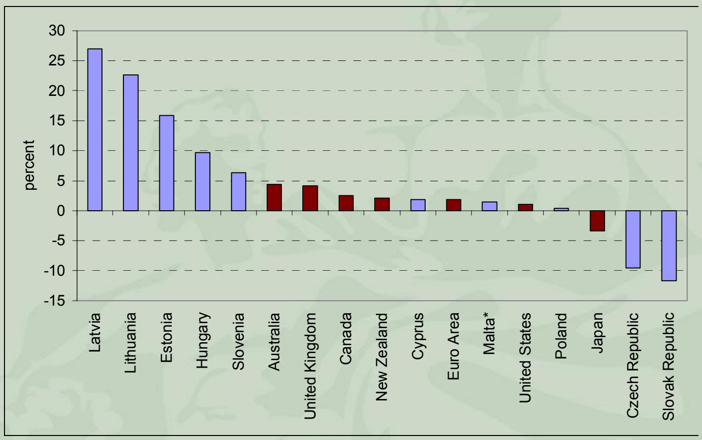
Chart 15 - Average Growth Rate of Domestic Credit to the Private Sector, 2003-2004



Dangers of credit booms

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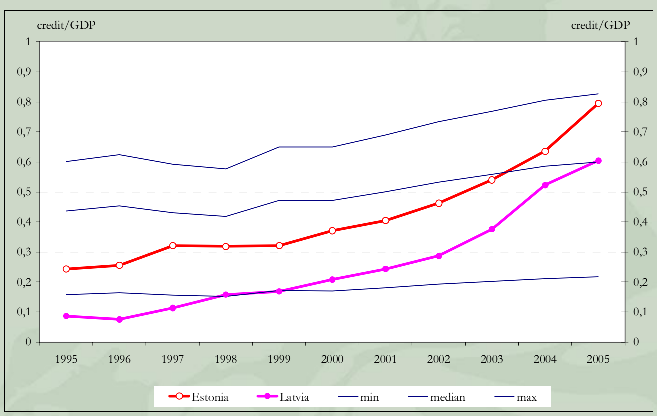
Chart 16 – Credit growth in Estonia and Latvia



Note: min, max and median values correspond to the estimated equilibrium credit/GDP range

Dangers of credit booms

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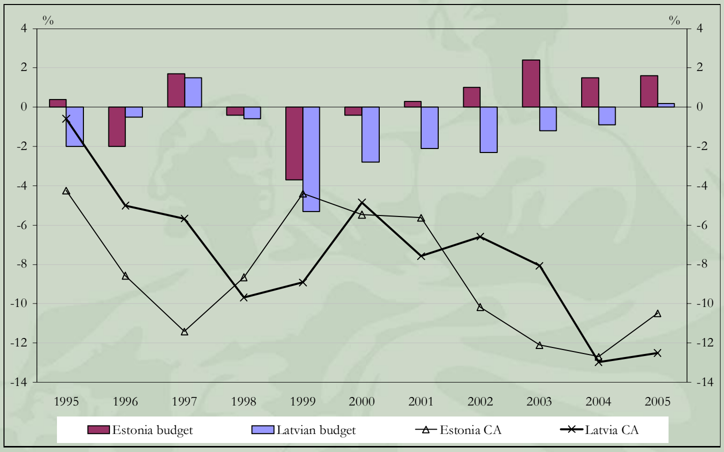
Chart 17 – Budget deficit and current account balance of Estonia and Latvia, 1995-2005



The fast credit growth has lead to high current account deficits in Estonia and Latvia despite strong budged positions.

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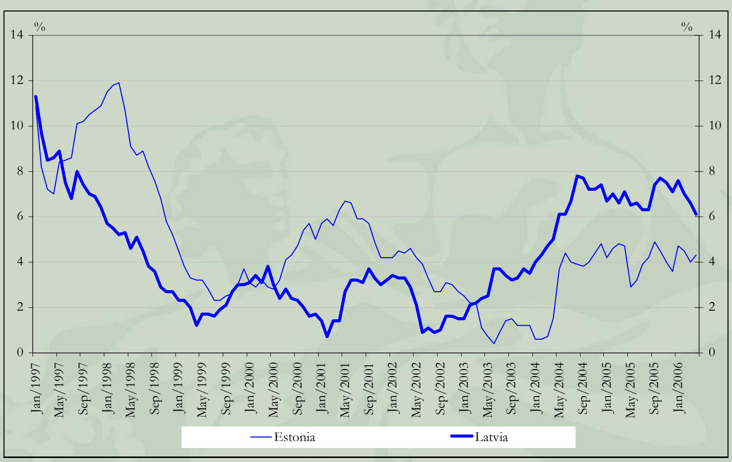
Chart 18 – Inflation in Estonia and Latvia, 1997-2006



An additional sign of overheating in Estonia and Latvia is the acceleration of inflation.

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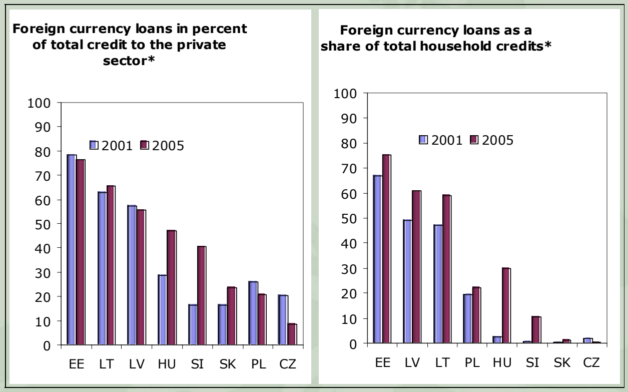
Chart 19 - Share of foreign currency loans



Sources: National authorities, IMF staff estimates
*calculated at constant 2000 exchange rates
Borrowed from Christoph B. Rosenberg, IMF

Dangers of currency mismatch

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Conclusions

Capital account liberalization has important benefits, but also carries dangers:

– Makes countries vulnerable to speculation

– Can fuel credit booms

– Can lead to currency mismatch

all of which can destabilize the banking system and the economy if not managed properly

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Conclusions *(cont.)*

- With open capital accounts, managing expectations is key to success, sound macroeconomic management is a must because markets will penalize misbehavior:
  - Follow sound fiscal policy, enforce transparent accounting
  - Anchor inflation expectations by transparent monetary policy (e.g. inflation targeting), ensure central bank independence
  - Strengthen financial supervision, give sufficient independence to supervisory agencies so that they can withstand political pressure
  - Strengthen information and legal systems

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