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Hungary's Inauspicious Swiss Connection

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The Swiss franc's spike in late July and early August once again increased Hungary's risk premium relative to its regional peers, due to the country's large stock of unhedged franc-denominated residential mortgages. A further widening between the currencies could be destabilizing for Hungary, but the government's temporary relief scheme should cap some of the tail risk.

In just two weeks ending on August 10, the Swiss franc (CHF) appreciated aggressively against most currencies, including more than 15% against the Hungarian forint (HUF). This has created significant volatility in Hungarian asset prices—above and beyond that experienced by the country's regional peers—even though Hungary has only negligible real economic exposure to Switzerland through external trade links. Hungary's inauspicious connection to the Alpine confederation has been through the large exposure of households (and some municipalities) to unhedged CHF-denominated loans.

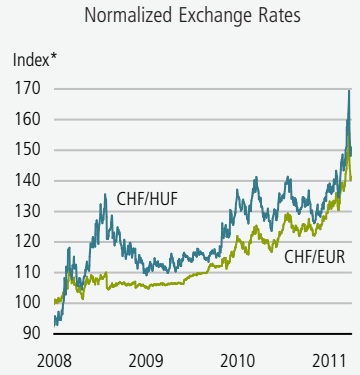
These loans—predominantly residential mortgages—were contracted during the credit boom of 2006–2008, when Hungarian banks and borrowers took advantage of the large, double-digit interest-rate differentials between CHF-denominated mortgages and those denominated in forints. They also extrapolated the pre-2008-crisis strengthening of the HUF against both the euro and the CHF. But the tables have turned dramatically since then.

Painful CHF/HUF Appreciation…

The CHF's appreciation against the HUF at the beginning of August was especially painful since it came on top of a 66% appreciation since the collapse of Lehman Brothers in 2008—including nearly 20% since March of this year **(Display 1)**. All of this has resulted in more than a 50% increase in the cost of monthly payments on CHF-denominated debts. And since Hungarian borrowers have not benefited from the simultaneous compression of Swiss yields, they are now bearing the full brunt of these currency realignments.

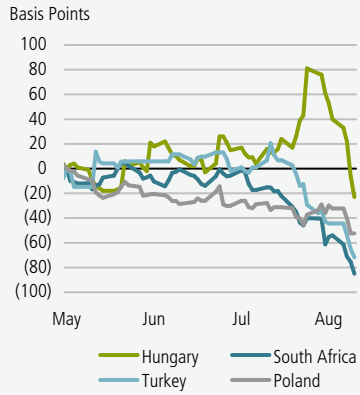
The increased risk premiums on Hungarian assets that have accompanied the recent HUF/CHF move have been a clear reminder of Hungary's lingering external vulnerabilities: Hungarian bond yields rose sharply in

Display 1
The Swiss Franc's Relentless Ascent…



* Average of 2006 - August 2008 = 100
As of August 18, 2011
Source: Bloomberg

Display 2
…Caused a Countermovement in Hungarian Bond Yields



As of August 18, 2011
Source: Bloomberg

the first week of August even as growth concerns led to a decline in bond yields elsewhere in the world—including in Hungary's regional peers such as South Africa, Poland and Turkey **(Display 2, previous page)**. This initial counter-movement in Hungary reflected market concerns that the central bank might actually have to raise interest rates in order to anchor the exchange rate and preserve financial stability.

The outstanding stock of CHF-denominated residential mortgages in Hungary currently stands at about 16% of gross domestic product (GDP), and most of these loans were taken out at the HUF/CHF exchange rate of 150–170—significantly more favorable terms than the current market rate of 240. Last October, National Bank of Hungary (NBH) Governor András Simor indicated that the HUF could weaken 30% against the CHF without posing a risk to Hungary's financial system. At the time, this implied a critical level of 270 HUF to CHF…which was indeed reached on August 9.

Meanwhile, Hungary's high exposure to global growth (especially European) has added insult to injury, as that growth has been heavily questioned in the past few weeks. Hungary is highly vulnerable to negative shocks to core European growth because of its large export sector, which focuses primarily on Germany. At the same time, domestic demand in Hungary won't be able to provide a cushion due to its weakness (unlike, for instance, in Poland), and the country has little room for stimulative fiscal and monetary policies. Weaker growth would, in turn, undermine the ambitious fiscal consolidation process that has anchored the perception of Hungarian risk during much of 2011.

…Underscores Lingering Vulnerabilities

Much of the recent sharp CHF appreciation has been reversed through massive monetary easing by Switzerland's central bank. But the episode has put Hungary back up on the list of some of the region's most vulnerable economies vis-à-vis external shocks, undoing the positive impact of the government's ambitious reform package announced in March.

The key area of concern is the banking sector. Although that sector is currently well capitalized and well provisioned, a further significant weakening of the HUF against the CHF might substantially increase the nonperforming loan ratio on Swiss franc loans (7% in the first quarter of 2011) and require the recapitalization of some mortgage lenders. This would have a cost in terms of a widening public debt to GDP ratio, as well as the growth outlook.

Another cause for concern is the actual debt-service burden of households. This has risen from less than 12% of household disposable income before the global credit crunch to nearly 15% today, and stands at an equivalent of approximately 5.5% of GDP. If there is a further increase in debt-servicing costs due to weaker HUF exchange rates, this will undermine already weak consumer spending. Since mortgages constitute about 50% of total loans to households, an additional 10% weakness in the HUF to the CHF could potentially lead to a reduction in the expected GDP growth rate of approximately 0.2%. And again, any such reduction would make the government's fiscal consolidation and debt reduction plan more challenging.

Temporary Government Relief

On a positive note, a government program announced several months ago should provide some temporary respite for Hungary's indebted households: Until January 2012, any household that took out a foreign-exchange mortgage and is current on its debt service will have an option of recalculating its monthly payments at a more favorable fixed exchange rate of 180 HUF per CHF. Households could retain that lower rate until the end of 2014. The difference between debt-servicing costs based on this fixed rate and the market rate will accrue in a separate HUF credit account on which the borrowers will pay interest. The government will guarantee this de facto new loan until the end of 2014. The households who opt into the government scheme will enjoy a 25% reduction in debt payments (relative to those based on the current market exchange rate), which could potentially boost consumption and add up to 0.7% to GDP growth.

Yet there seems to be some uncertainty as to how soon the government's relief scheme will actually be rolled out and what percent of households will end up participating. The central bank has actually been speaking out against the scheme, seeing it as unnecessary market interference. But given the compression in real incomes this year (due to higher-than-expected inflation), indebted households may have a difficult time refusing—even if it's just temporary relief.

Importantly, the unhedged CHF exposure of households is a stock problem: While no new foreign-exchange-linked mortgages are effectively being extended in Hungary any more, the current stock of these has an average maturity of just over 10 years. So they will continue to be the country's key vulnerability for some years to come.

Central Bank to Remain on Hold

There has been a reversal of the initial spike in Hungarian bond yields. This was due to the reversal of the recent CHF move and, arguably, a full realization that the government's relief scheme will provide some cushion to households. But we think it's unlikely that Hungarian bonds will now follow their peers into pricing actual rate cuts on the back of a weaker global and domestic growth outlook.

We believe that the central bank will likely resist any temptation to ease monetary policy, even if the global growth backdrop deteriorates from here. This is due to Hungary's still-elevated risk premiums (the five-year credit default swap is now 150

basis points higher than in early June), which could even rise further if growth prospects in the euro area falter. Also, the NBH will likely consider the offsetting impact of the government's relief scheme on private consumption and growth.

At the same time, we don't expect a rate hike in the foreseeable future either: Higher interest rates in Hungary are no cure for the country's main vulnerability, which is the HUF/CHF exchange rate sensitivity. As for the HUF's exchange rate relative to the euro (which is the appropriate exchange to look at for an indication of Hungary's fundamentals), it has been relatively well behaved so far this year—even during the market turbulence of recent weeks. This is quite different from 2008, when the HUF was exceptionally pummeled. The most likely reason for the greater exchange rate stability today is that Hungary is running a current account surplus of close to 3% of GDP, as opposed to a deficit of more than 8% of GDP in the third quarter of 2008. And we expect Hungary's current account to remain in surplus for at least the next year. ■