MNB forex reserves at an adequate level

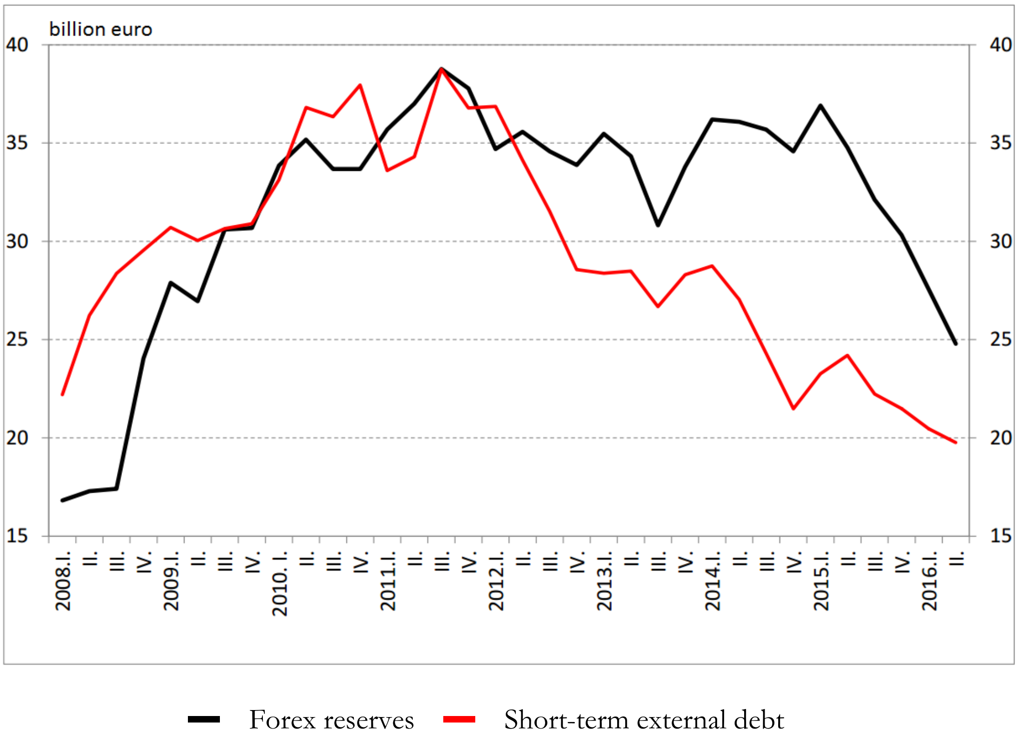
The National Bank of Hungary (MNB) issued a statement on 7 January 2017, pointing out that "foreign currency reserves of the notebank totalled EUR 24.4bn at the end of December 2016, an appropriate amount according to forex reserve adequacy standards, the indicators closely followed by international investors." This fact is being reflected by low yields on government securities, low forint exchange rate volatility and the recent upgrades by all three major credit rating agencies. The European Commission and the International Monetary Fund (IMF) have also found in their latest reports that the amount of forex reserves at the MNB was satisfactory.

Several elements can influence the level forex reserves. Reserves have recently been reduced by the forint conversion of forex loans and the increasingly forint-based financing of government debt. Both factors unfolded over an extended period of time, therefore the current lower amount could be prognosticated in advance. These two programmes were among the factors that helped reduce the vulnerability of the Hungarian economy to external risks.

The MNB report has found that in recent years 75-80 percent of investment banking analyses used the Guidotti-Greenspan rule. This states that a country's reserves should equal short-term external debt (one-year or less maturity). Scientific literature recommends the application of the rule for countries without capital constraints. Hungary is one of these countries, where currency exchange restrictions were lifted already fifteen years ago and the country also complies with the EU principle on the free movement of capital. The latest economic crisis has also proven the adequacy of the Guidotti-Greenspan indicator. At times when external financing comes to a standstill and the payment of maturing external debt can only be financed from forex reserves, countries which comply with this rule have no difficulty in covering liabilities.

The popularity of the Guidotti-Greenspan indicator has reduced the frequency of the use of the second most popular indicator, the so-called import rule, from the former 38 percent to 18 percent in recent years. The import rule prescribes that the forex reserves of a country must cover the cost of imports for a period of at least three months. Hungary's current account balance has been in the green since 2010, so this factor has not been negative in terms of external exposure. The import rule may have lost popularity as in some cases it might prove to be misleading: the volume of imports, for example, may fall in a crisis situation and lead to a lower compulsory forex reserve amount, but the indicator would still fail to raise a red flag despite the fact that the country's vulnerability would in fact be worsening. That is why the MNB has adopted the Guidotti-Greenspan rule as a leading guideline. The analysis of the European Commission found that the level of forex reserves in Hungary has been sufficient and the outlook is also positive. With regard to the MNB's self-financing programme, the report noted that although it has reduced forex reserves, it has also reduced external vulnerability. The IMF's country report published in April 2016 stated that the forex reserves of Hungary were adequate.

Fig. 1: MNB forex reserves and short-term external debt

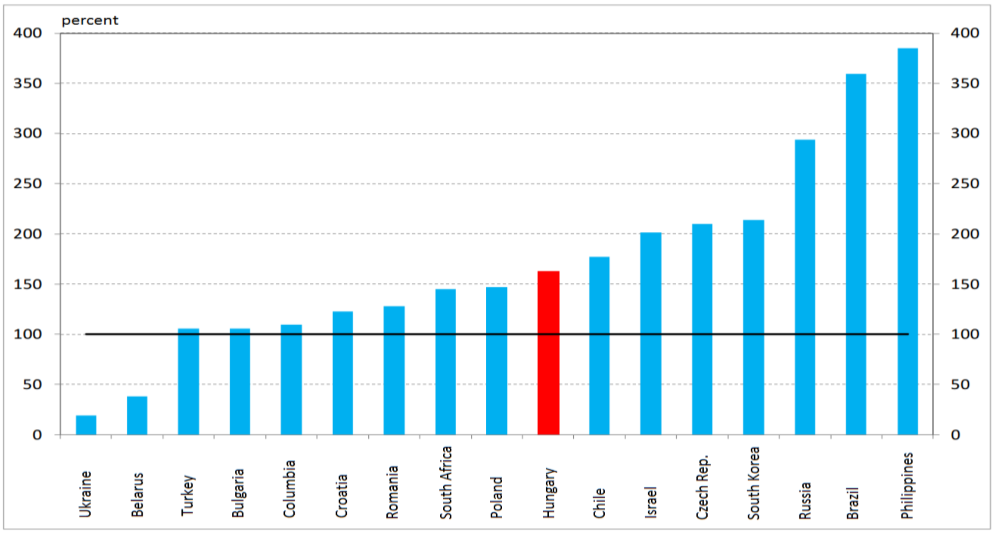


Source: National Bank of Hungary (MNB)

The fact that prior to the announcement of the bankruptcy at Lehman Brothers the indicator moved in close correlation to rising CDS premia for various countries also confirms the adequacy of the Guidotti-Greenspan indicator. The CDS premia for countries concerning which the indicator showed a figure below 100 percent were rising more rapidly than for countries which fulfilled compliance criteria for short-term external debt. Fig. 1 shows that in the run-up to the crisis Hungary was among these endangered countries.

Fig. 2 shows to what extent Hungary and other emerging countries complied with the rule in 2014. Hungary is placed in the middle, having a higher ratio than Romania and Poland, but a lower one compared to the Czech Republic.

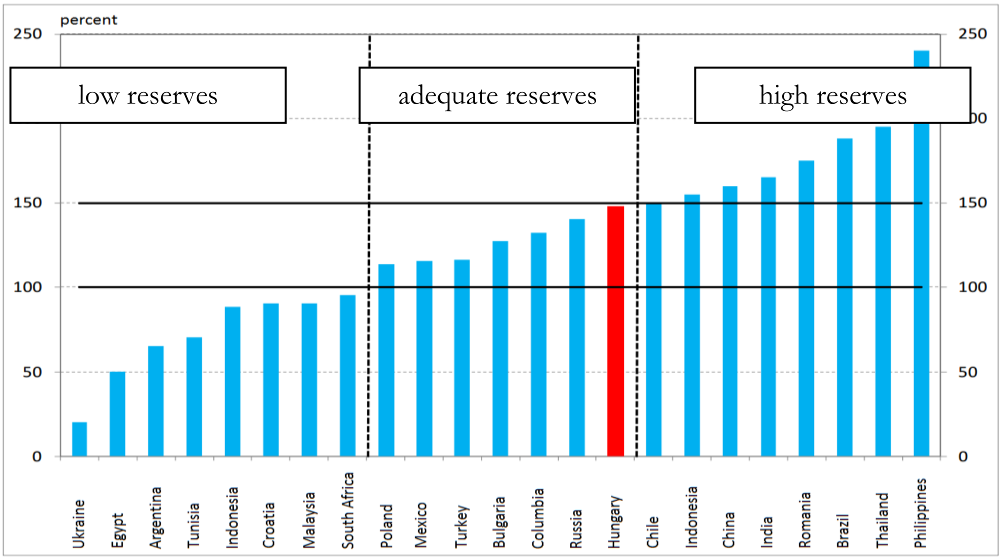
Fig. 2: Forex reserves of emerging countries according to the Guidotti-Greenspan indicator (2014)



Source: National Bank of Hungary (MNB)

Fig. 3 shows how the new, combined IMF indicator categorizes countries. This combined indicator determines the adequate level of forex reserves on the basis of the weighted averages of four indicators, of which the ratio of reserves to short-term external debt has the largest weight of 30 percent. The capability of variables to show forex reserve outflows during former crises has determined the weighting of indicators. The indicator places the forex reserves of countries into three categories: high, adequate or low. The below chart clearly reveals that Hungary had sufficient, almost too high, reserves in the observed period.

Fig. 3: : Forex reserves of emerging countries according to the new combined IMF indicator (2014)



Source: National Bank of Hungary (MNB)