MAGYAR NEMZETI BANK

GOVERNOR

Mr László Domokos
President of the State Audit Office
Budapest

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Dear Sir,

On 8 February 2013, I was informed from press reports and materials related to the press conference held by your colleague that the State Audit Office issued a study entitled **'Fiscal risks of monetary policy, particularly with regard to the debt rule'**. I find it unfortunate that in the course of preparing the study, your colleagues did not consider it necessary to consult with my colleagues in advance on certain findings of the study. I believe this would have allowed you to avoid any factual and technical errors and to draw less rigid conclusions in the study. Therefore, in the spirit of minimal cooperation necessary between state institutions, I would like to directly share with you the opinion of the MNB concerning some major statements, and particularly your proposals, contained in the study. My comments are limited in scope for reasons of brevity, but my colleagues would be pleased to carry out further technical consultations with you and to remedy any inaccuracies.

First, I wish to emphasise that I do not wish to comment on the government debt rule, as it does not directly relate to the activity of the MNB, although, as a member of the Fiscal Council, I believe that it would be expedient to even subsequently discuss your proposal in the Council, as the application of the debt rule affects the Fiscal Council more directly than the State Audit Office.

I could not agree more with your statement made at the press conference on Friday, that 'the study does not aim to send a message to the current or future central bank governor, nor should it be interpreted as a proposal', as legislation regulating the State Audit Office (SAO) does not in any way require the SAO to review the basic activity of the central bank, including the review of monetary policy and the management of foreign exchange reserves, or to draft proposals in relation thereto. Should this be the case, the SAO would transgress its authority and breach Article 130 of the Treaty on the Functioning of the European Union and Section 1(2) of the Act on the National Bank of Hungary. Upon hearing the statement, the proposals formulated in the study, directly relating to monetary policy instruments and the level of foreign exchange reserves, seem even more peculiar.

Your study states the following:

1. *'In awareness of the risk of (the central bank) becoming unprofitable, it seems particularly important to consider whether instruments serving the reduction in interest expenditures should be applied in connection with monetary instruments...' '...it is common in the case of other European central banks that they aim at maximising the cost effectiveness of implementing monetary policy objectives. A common instrument in this respect is the quantitative restriction of access to short-term central bank bills.'*

   The two-week bill issued by the central bank and available for purchase by banks is a base rate instrument of the MNB, the premise of monetary policy transmission. It is able to fulfil this role because it offers a marginal investment opportunity to *individual banks*, i.e. when a bank weighs the alternative use of its free forint liquidity, it is able to do so by comparison to the two-week bill, a quasi risk-free investment opportunity. Were the MNB to limit the purchase of the two-week bill, the central bank instrument would lose its function as special marginal investment return specifically in terms of monetary transmission. In this case, banks would invest their surplus liquidity in other forms

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with the central bank. The MNB currently offers one such other instrument, the overnight deposit, which bears a 1 per cent lower interest rate than that the two-week bill, and this would essentially become the base rate.

Thus, the restriction of the purchase of two-week bills by banks would result in a decline in their interest revenues, which is not harmful in itself, but it is important to understand that its effect is equivalent to a base rate cut, i.e. to monetary loosening. Assuming all other conditions remain unchanged, such a step would affect both the forint exchange rate and future inflation. The forint would weaken and inflation would rise. With respect to the above, it is important to note that upon comparing interest rates on a European level, we should take into account levels of inflation in individual countries and the expected future rate of inflation. In this regard, not only the Hungarian interest rate, but also domestic inflation is exceptionally high within the European Union. The *Quarterly Report on Inflation*, issued in December 2012, provides in-depth information on the causes of high inflation, its expected future level and the direction of national interest rate policy, including the view of the Monetary Council of monetary conditions and the desirable level of the base rate.

The question may arise, as raised in your study, as to why it is evident that upon the possible restriction of the purchase of the two-week bill, the same amount would arise in another form at the central bank, such as the overnight deposit? Why couldn't it flow into Treasury bills, for example, or be allocated to lending to the economy? The question is prompted by a frequent, common misconception that the whole of the banking system could reallocate surplus liquidity accumulated by the MNB to alternative investment opportunities, such as government securities or corporate lending. Upon analysing the balance sheet of the central bank, with observance of the accounting principle of correspondence between assets and liabilities, however, it is clear that regardless of the amount by which the banking system increases its portfolio of government securities or loans, for example, the liquidity deposited with the central bank – assuming unchanged stock of cash – will not change unless the value of central bank assets – i.e. foreign exchange reserves – changes.

If, namely, banks would purchase Treasury bills instead of placing two-week deposits, then, as raised in your study, the liquidity of the Hungarian State Treasury would initially increase, which would be reflected in the increased balance on the Single Treasury Account managed by the central bank, resulting in the restored balance of the central bank balance sheet. (I should add that the MNB also remunerates the central bank base rate on the balance on the account of the Treasury, i.e. the earnings of the MNB would not improve.) However, once the Treasury spends liquidity increased in such a manner, increased liquidity would similarly arise within the banking system, and banks would again deposit surplus liquidity with the central bank. An upturn in corporate and household lending would trigger a similar cycle, which I do not wish to elaborate here due to limitations of scope.

There is a way to reduce the interest expenditures of the central bank without negatively affecting the policy rate of the two-week instrument. This is enabled by required reserves. Each bank is required to deposit mandatory reserves with the central bank, in accordance with specific rules. The rate of interest paid on required reserves currently corresponds to the base rate. Central bank financing costs can be reduced by decreasing interest paid on reserves and increasing the rate of reserves. It is necessary to take into account, however, that in economic terms, both of the above measures are deemed to be bank taxes levied on deposit taking, which may encourage banks to increase the margin between deposit and loan interest rates and to curtail lending. Since taxation is not an activity carried out by the central bank, the MNB – in harmony with the practice of the European Central Bank – has not been curtailing bank income through the required reserve ratio since May 2004.

In summary, the limitation of the stock of two-week bills issued by the central bank would result in monetary loosening, which is currently in conflict with the implementation of central bank objectives, and would not in any way contribute to a higher level of financing the budget or the economy.

2. *'In view of the long-term sustainability of fiscal balance, we need to ask whether cost savings criteria on the scale of the national economy should be assigned a higher priority when taking decisions relating to government debt financing, with the current, safe volume of foreign exchange reserves.'*

Foreign exchange reserves can be regarded as a form of insurance, and as all forms of insurance, it has a price. If the level of reserves is low relative to the risks, i.e. the insurance indemnity is low, this increases financing costs for all domestic participants, in the public and private sectors alike. The Monetary Council of the MNB determines the desirable level of foreign exchange reserves by analysis of several indicators. It takes into account the external debt of the country, particularly the amount thereof with short-term maturity, as well as model calculations, which consider the current cost of maintaining foreign exchange reserves and many other factors. The current level of foreign exchange reserves does not exceed the desirable level determined by the Monetary Council. Reserves may be reduced in the future and to the extent permitted by the decline in the country's external debt and exposure. This process is under way, and the level of reserves may be appropriately reduced on a gradual basis. Your study claims that *'In 2011, the rise in foreign exchange reserves was fundamentally financed by the savings of domestic economic agents'*. Admittedly, reserves are financed by the central bank with the reserves of other economic agents, but we should add that such a high level of reserves is necessary specifically because the development of the country in the past twenty-odd years was financed with the savings of non-resident participants, leading to high external debt.

3. *'The significant rise in foreign exchange reserves between 2009 and 2011 in itself increases the risk of the MNB's earnings turning negative, as the higher the level of foreign exchange reserves, the higher the difference could be between interest revenue from the placement of foreign exchange reserves and interest expenditures of funds financing the foreign exchange reserves.'*

When analysing this issue, it is once again necessary to reiterate that the balance sheets of the MNB and the budget are in opposite directions in terms of currency composition. Indeed, the difference between the lower interest rate on foreign exchange reserves and the higher interest rate on forint funds financing the reserves is booked as an interest loss in the balance sheet of the central bank. However, foreign currency necessary for the central bank's foreign exchange reserves is provided through the foreign exchange bond issues of the Government Debt Management Agency (ÁKK), i.e. the budget simultaneously enjoys the lower interest expenditure on foreign exchange debt compared with that of the forint. **Thus, in terms of the budget and the MNB as a consolidated unit within general government, the actual cost of maintaining foreign exchange reserves on the level of general government is not the difference between foreign exchange and forint interest rates, but the difference between interest realised on foreign exchange reserves and interest on foreign exchange debt issued by the Hungarian state. Thus, the cost of maintaining reserves may be reduced most effectively by reducing the risk premium paid by the Hungarian state.**

I assume that the study of the State Audit Office was motivated by the aim of drawing the attention of the government to the costs of financing foreign exchange reserves and to the possible risks inherent to the budget. The study raises a relevant issue, which is assigned a priority by the MNB as well. We, too, are of the view that the fiscal effect of the expected future losses of the Magyar Nemzeti Bank may be substantial in the coming years, and their level is difficult to forecast due to dependence on the exchange rate. It is a particularly important issue, as the results of the central bank may, as the case may be, determine the implementation of fiscal objectives – objectives undertaken toward the EU or the debt rule etc. – that are crucial for the country. It is therefore necessary to address the reduction in the level and volatility of MNB losses, but efforts should also be made to ensure that the monetary policy objectives are not compromised. Generally speaking, credible and predictable economic policy serves as the most effective instrument of reducing central bank losses in the long term, which enables sustainable cuts in the central bank base rate, with the reduced financing costs of the MNB, by reducing the country risk premium and inflation.

I wish to inform you that the MNB regularly prepares analyses and forecasts on the expected results of the central bank. We publish our annual forecasts each quarter on our website, which are thus not only accessible to the government, but to the wider public as well. In addition, we prepare a five-year forecast for the government, which we recently submitted to the competent staff of the Ministry for National Economy on 15 August 2012. **The experts of the central bank and the Ministry have also conducted several consultations on the above issues, which have led, for example, to the amendment of the MNB Act in 2011, enabling the joint management of foreign currency securities and forint exchange rate equalisation reserves, and the mitigation of the possible future risks underlying the budget.**

I wish to emphasise that the MNB assigns a key priority to the issue of central bank operating costs, that they do not burden the budget, or only to the extent necessary. As you may be aware, under my governorship we reduced our operating costs by approximately 40 per cent at real value and our banknote and coin expenditures by over 50 per cent, without posing a risk to the implementation of objectives defined by the Hungarian Parliament for the central bank. Thus, the real value of savings realised in the course of six years since 2006 approximates HUF 50 billion. The parties concerned need to conduct dialogue, think together and cooperate to ensure that beyond the foregoing, we are able to achieve substantial results in reducing the costs of financing the country and of maintaining foreign exchange reserves. **In the spirit of these efforts, the State Audit Office, notwithstanding its choice to issue a study in matters falling within the competence of the central bank, which, in our view, is a transgression of its authority, should at least discuss its findings with the experts of the central bank prior to their publication, thereby reducing the probability of the publication of false information that may mislead public opinion.**

Yours sincerely,

András Simor