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MDBs spy subordinated debt financing breakthrough

By Jon Hay

A new chapter in finance for development banks — both national and supranational — could be opening, with the beginning of subordinated debt issuance. There are plenty of factors that could make this slow to develop, but it offers a chance for these banks to support their ratings and possibly even make their scarce capital go further.

Last week Banque Ouest Africaine de Développement (BOAD), the regional development bank of the West African

Economic and Monetary Union, began talking to investors about a planned \$500m subordinated bond issue.

Junior debt, which would absorb losses before senior debt, is another avenue for development banks to pursue in making their capital structures more efficient, alongside techniques such as securitization and risk sharing.

The African Development Bank attracted widespread notice in 2018 by executing a \$1bn synthetic securitization of about 40 loans, to free up capital



Banque Ouest Africaine de Développement

for new lending.

Earlier, in 2015, the AfDB, Inter-American Development Bank and World Bank each transferred \$4.5bn of sovereign loan risk to the other two, and

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Stressful year could bring obstacles and opportunity for green finance in CEEMEA

By Jon Hay

Sustainable financing has been growing rapidly in central and eastern Europe, the Middle East and Africa as bond issuers have joined in enthusiastically with a trend that until recently had largely bypassed the region.

Despite the ravages of the coronavirus, green, social, sustainable and sustainability-linked bond issuance more than doubled in CEEMEA in 2020, to \$15bn-equivalent, and last year rose by 80%, to \$28bn.

The pace of growth outstripped western Europe in 2020 and matched it in 2021, according to Dealogic data.

Globally, only the markets in south Asia, north Asia and Australasia grew faster last year.

“These regions are likely to become very active,” said Jarek Olszowka, head of sustainable finance at Nomura in London. “There has been a step change. Ministries in central and eastern Europe are organising a lot of events, local banks are hiring chief sustainability officers and dedicated teams. Four or five years ago some of them felt sustainability belonged in the same bucket as charity events — it was a marketing thing. That has gone now, in the vast majority of cases. They see it as of strategic importance. A lot of changes are being driven by the stewardship work of equity investors.”

Poland beat France to issue the first sovereign green bond in 2016, but it has taken a long time for that early leadership to bear fruit in wider issuance.

It is now happening, as a virtuous circle gradually builds of issuers being reassured by seeing peers use the technique — and fearing missing out if they do not do so.

There were 49 deals in 2021, almost four times as many as two years earlier. Hungary

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War bombshell to fall on European countries wounded by Covid-19

By Phil Thornton

The largest and most intense crisis to hit eastern Europe since the collapse of the Soviet Union three decades ago has left economists struggling to estimate how great the impact will be.



War shock: Russia's invasion of Ukraine will be felt far and wide

While the pain will be felt most deeply by the two combatants — Ukraine and Russia — its second round effects will also hit both their immediate neighbours and the European continent as a whole.

For Ukraine itself the numbers are almost beyond comprehension. The International Monetary Fund estimates the war-torn republic's economy will shrink by 35% this year. But the Vienna Institute for International Economic studies (which shortens to its German acronym WIIW), says it may

collapse by as much as 45%.

Ukraine's most war-affected regions, where activity has ground to a halt, normally underpin the country's growth. According to the WIIW, they account for just over half of GDP, 43% of industrial production and 34% of agricultural production. The Black Sea ports, many of which have closed, handle half of all exports.

The Russian economy may shrink 8.5% this year while Oxford Economics forecast a near 11% contraction this year

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War bombshell

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and 3.3% in 2023. This will cut household income that in turn will depress private consumption even further.

But the issues worrying ministers and central bankers at the EBRD's annual meetings this week will be the shock to their economies not just from the war itself but also from its impact on the European Union.

The region has benefitted both from the globalisation of finance and trade that has been underway since China joined the World Trade Organisation in 2001 but also stimulated as a result of the efforts of development banks such as the EBRD and the European Investment Bank.

EBRD countries of operation in central and eastern Europe have enjoyed a boost in supply chains and investment programmes linking them to wealthier countries in the western European Union.

But the war has dealt a blow to a lucklustre economic recovery from the impacts of the Covid-19 pandemic that were still only beginning to pay dividends. The EBRD's annual economic forecasts published on Tuesday are likely to show severe downgrades for the region and individual countries.

The IMF forecasts that GDP growth in 2022 in advanced European economies is now forecast to decline to 3% from the 4% it had pencilled in in January and even further below 2021's 5.6% growth. Several major economies — such as France, Germany, Italy and the United Kingdom — are projected to fall into a technical recession this year.

Growth in emerging European economies excluding Russia and Ukraine will drop from 6.7% to 3.2% between 2021 and 2022. WiiW sees Belarus and Moldova diving into recession and sharp slowdowns in the other 21 economies it covers.

Many smaller countries will be hit by spikes in commodity prices. High metal prices, for example, will hit countries with sectors that are strongly integrated into global value chains such as the Czech and the Slovak republics.

“Already we see that there are supply chain problems in many sectors because of the sanctions,” says Vasily Astrov, senior WiiW economist. “That, together with the withdrawal of many Western companies for example in the car industry, is hammering industrial production.” ●

Subordinated debt option opens up for MDBs

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took on the same amount of their risk, so as to improve the diversity of their loan books, which supports their ratings.

But adoption of such techniques has been slow, partly because of the highly political nature of their governance.

Subordinated debt would be another way to strengthen development banks' balance sheets: by raising risk-bearing capital from private sector investors, to complement the equity they receive from their government shareholders, most of which is not paid in but callable if they should ever need it.

BOAD's bond has some similarities with corporate hybrid capital issues. It will have a 60.75 year, non-call 5.75 year maturity. After that 5.75 year point, its interest rate will reset every five years if it is not called, with a 100bp coupon step-up after 10 years.

JP Morgan (development finance structuring agent) and HSBC are bookrunners on the deal, set to be rated Ba1 by Moody's.

The deal is not the only project of its kind among supnationals, sovereigns and agencies, although very few have surfaced publicly.

A banker at an investment bank away from the BOAD deal said other SSAs, including MDBs, would issue subordinated debt — including issuers that

were less “heavily emerging market” than BOAD.

BLUEPRINT

“Structure-wise, [BOAD] does showcase the blueprint for the future,” he said. Development banks “are starting to do them. It won't be an avalanche but just a new ... asset class slowly developing over time.”

The head of debt capital markets at another firm said he knew one investment bank had been talking to issuers about this at least four years ago.

Sub debt could work when a supnational's rating was held down by weak ratings of some of its shareholders, he said.

The first banker off the deal said “In terms of features... these are more like [financial institution] instruments such as [insurance companies' restricted tier one and banks' additional tier one capital] than corporate hybrids.”

Moody's and Fitch, which rate BOAD Baa1/BBB, are giving significantly more equity credit to this structure than the standard 50% for corporate hybrids.

Moody's said on Monday that it expected to give it 75% equity credit. This could be particularly valuable to BOAD, as Moody's has it on review for downgrade, partly because of fighting in Mali, which has made it difficult for Malian borrowers to repay their loans.

The subordinated bond has not per-

sueded Moody's to lift the review for downgrade, but it will weigh in the rating agency's calculations.

The bond's rating three notches below BOAD's senior debt reflects its long maturity and the fact that it is senior only to equity. BOAD can choose to stop interest payments on it at any time, and must do so if its equity to assets ratio falls below 18%. BOAD would not later make up any skipped interest payments. It also cannot issue preferred shares that would rank junior to the sub debt.

A spokesperson for Moody's told *GlobalMarkets*: “Several supnational entities have subordinated debt facilities in place, including [infrastructure funding organisation] GuarantCo, which has a subordinated facility from... Agence Française de Développement. The Currency Exchange Fund (TCX), which we also rate under the MDB methodology, has subordinated convertible loans from several governments.”

The official said Moody's had developed criteria for assessing hybrid capital issued by MDBs in 2020, because it expected to see more of them being issued. “While we broadly follow the approach that Moody's adopts for corporate hybrids, we pay close attention to who provides the funding, the final maturity and the triggers for coupon and/or repayment suspension.” ●

Green Finance

Continued from page 1

has issued the first sovereign green Samurai bonds, while Egypt issued the first sovereign green bond from the Middle East and north Africa in 2020, raising \$750m, and followed it with a \$3bn green loan last November.

One factor is waning political resistance to green issues. Until a few years ago the ruling parties in countries such as Poland and Hungary were resisting EU policies on climate change, and even voiced climate-sceptic views. But they have dropped that opposition, perhaps judging that they have enough battles with Brussels they have enough battles with Brussels over issues such as the rule of law and independent judiciary.

However, despite widespread willingness, this may not be another year

of strong growth for green finance in the region. “This year we are expecting much lower bond issuance volumes from CEE and Middle East,” said Ajit Punia, a CEEMEA debt capital markets banker at Nomura in London. “The share of ESG issuance should increase, but overall volumes will probably be down.”

THE 'S' IN ESG

Issuers are focused on negotiating the crisis of the Russia-Ukraine war and soaring energy prices — which are good for some issuers, if bad for many others.

This is also stimulating interest, however. “The importance of the ‘S’ in ESG has gone up sharply with the influx

of refugees from Ukraine,” said the head of debt capital markets at a bank in London. “Nothing has happened yet, but if I were a Polish bank or company or development agency that was spending a lot of money supporting refugees, that is a social bond waiting to happen. We are pitching it hard.”

The Council of Europe Development Bank issued a €1bn social inclusion bond in April to help finance spending on the refugee crisis. ●



IFIs dig deeper to provide aid to help ease Ukraine's \$600bn loss

By Phil Thornton

Ukraine's president Volodymyr Zelensky received a much-needed financial boost on the eve of this week's EBRD meetings with a pledge of more than \$6.5bn in humanitarian aid from international donors.

While welcome, the offer from governments and multinational companies will only make a dent in a total bill for the conflict that the Kyiv School of Economics last week estimated will be as much as \$564bn-\$600bn.

Its latest methodical analysis includes the costs of physical destruction of \$92bn of infrastructure including damage to 33,700 homes (\$30.0bn), 23,800km of roads (\$29.8bn), and almost 200 industrial units (\$10.0bn).

But the vast majority of the bill comes from impacts of the collapse in economic activity, the freeze on inward investment, the flight of workers as part of the migration of 5m Ukrainians and additional defence and social support costs.

It is no surprise that Zelensky welcomed the \$6.5bn package with a call for a "modern analogue of the Marshall Plan for Ukraine" — a reference to the US initiative of 1948 to provide foreign aid to Western Europe in the wake of the Second World War.

It is clear that Ukraine will need an

influx of capital both during and after the conflict. According to Oxford Economics, the budget deficit is expected to hit around \$5bn-\$7bn a month during the acute phase of the war.

Governments, charities, agencies and financial institutions have all unveiled packages designed to help those affected by the conflict. The International Monetary Fund provided emergency assistance of \$1.4bn via a rapid financing instrument in March, agreed less than two weeks after the invasion.

Last month the Fund, which estimates Ukraine will need \$5bn a month just to keep the government and economy going, established an "administered account" for Ukraine to provide donors with a secure vehicle to direct financial assistance.

Across 19th Street in Washington DC, the World Bank Group — which estimates Ukrainian economic output will almost halve this year — has committed a \$3bn package of support, of which it has so far mobilised \$925m.

Europe's IFIs have also stepped up. The EBRD is implementing a €2bn "resilience package" to support Ukraine and help countries directly affected in the surrounding region.

Given its mandate to support private sector development, funding is being



Volodymyr Zelensky

made available to support Ukrainian companies through deferred loans, liquidity support, and trade finance. Where possible, businesses will be helped to relocate so their work can continue.

Meanwhile, the European Investment Bank has approved €668m in immediate financial assistance.

Individual EBRD shareholders have also pitched in. The UK has provided £220m in funding including £120m of humanitarian aid, while France has allocated €100m and Canada \$145m. The US Congress has approved \$13.6bn to support Ukraine split roughly equally between support for refugees and military assistance.

But at some point, agencies will have to look beyond the immediate crisis and help fund the reconstruction of Ukraine. The EIB is looking at ways to accelerate the delivery of an additional €1.3bn of investment to cover critical infrastructure in transport, energy, urban development and digital technology. ●

EBRD ups climate risk mitigation efforts in drought-hit Morocco

By Phil Thornton

As North African countries find themselves on the frontline of the battle against climate change, the EBRD is teaming up with the Moroccan central bank and banking sector to support climate and environmental risk management in the country's financial sector and promote green finance.

The EBRD on Monday signed a memorandum of understanding with Morocco's central bank Bank Al-Maghrib and the Association of Banking Professionals (GPBM) to co-operate on the implementation of a central bank directive issued last year.

This directive is designed to encourage Morocco's financial sector to address and manage risks related to climate change and the environment. It also hopes to encourage new commitments from Moroccan banks on sustainable finance.

EBRD president Odile Renaud-Basso believes that the agreement will help Morocco's financial institutions to "take climate action" and will "contribute to the country's green transition" — a transition that is becoming ever more pressing as the country's economy is suffering from the direct impact of more frequent droughts.

The agriculture sector employs more people than any other sector in Morocco, and accounted for 17% of the economy in 2021, but continues to be affected by extreme drought, and wheat and barley harvests are expected to be sharply down this year.

According to the US Department of Agriculture's April update, wheat production in 2022/2023 is expected to be 70% lower than in 2021/2022, while barley will be down 78%. And drought was one of the main drivers — alongside higher energy prices, as Morocco is an oil importer — behind the IMF slashing its 2022 growth forecast for the country from 3.1% to 1.1% in April.

Morocco lost its investment-grade status with Standard & Poor's last year. Upon downgrading the sovereign from BBB- to BB+, the rating agency noted that consecutive years of drought had "cramped Morocco's agricultural sector output".

In its latest Article IV report on the country, the IMF argued in favour of "drought-resistant infrastructure" that could "help shield Morocco from more frequent and intense events generated by climate change". ●

Egypt feeling pressure as food crisis bites

By Oliver West

Economists are growing increasingly worried about pressures on Egypt as the country endures an acute food crisis. Though the IMF managing director Kristalina Georgieva says the government is taking the need for financial stability "very seriously", this may not save external bonds or the Egyptian pound from severe drops, and some analysts fear a debt restructuring may be necessary.

Egypt is the world's largest importer of wheat, as it does not produce anywhere enough grains to meet domestic demand. The outbreak of the Russia-Ukraine conflict was therefore disastrous — not only because of the sudden surge in prices, but also because the two countries at war provided around 85% of Egypt's wheat.

Faced with suddenly growing external imbalances, the government first

devalued the pound by 10%, and then approached the IMF for a potential programme in March.

However, James Swanston at Capital Economics warned on Monday that the "remarkable" stability of the pound since the devaluation suggests that the authorities were "heavily managing" the nominal exchange rate. This could prompt a "fresh build-up of external imbalances and the need for further disorderly falls in the currency down the line".

Patrick Curran, senior economist at Tellimer Research, echoed Capital Economics' point that "continued exchange rate flexibility" will be key. Yet though Curran called the IMF talks an "encouraging development", he highlighted that the "margin for error is small" and believes "there is a risk the IMF may view debt as unsustainable and push for restructuring".

Curran said that his firm's concerns were heightened by perceived "increased concerns by the Fund about debt sustainability risks and emphasis on private sector involvement in debt restructurings".

Secondary market prices suggest that bond investors — having driven a strong rally during March in the wake of Egypt's IMF approach — are losing optimism. Egypt's 2032s dropped to below 75 cents on the dollar on Friday — 15 points below their March 31 peak and the lowest level since IMF talks were revealed in early March. They now yield almost 12%.

However, this is still some way from fully pricing in a restructuring, and Matias Montes at EMFI Securities highlighted that "external liquidity ratios remain under control despite the weaker macro of the past few months". ●

Worsening war in Ukraine slashes hopes for CEE equities boom

By Victoria Thiele

Equity capital markets in central and eastern Europe (CEE) are facing a dire second half of the year as hopes for a swift resolution to the war in Ukraine dwindle.

The Russian invasion has crushed ECM issuance all over the continent, but the CEE region has been hit especially hard.

In eastern Europe including the Baltics and Balkans, 12 ECM deals have raised €1.5bn this year to date, according to Dealogic data. In terms of value, this is an 85% plunge from the same period last year.

In all of Europe, the total deal value dropped by 69% over the same time.

“We had high hopes especially for Poland to have a strong year,” said a senior banker at a bulge bracket bank in London. “But they are just too close to Ukraine. The only sensible thing to do is to wait.”

Poland provides the largest share of equities issuance in the region. For 2022, market participants expected several initial public offerings including billion euro deals from game developer Techland and medical diagnostics

firm Diagnostyka.

But the conflict in Ukraine escalated before any of the candidates came to the market. The few deals that had been completed were mostly accelerated bookbuilds of energy companies that benefitted from surging oil and gas prices.

Polska Grupa Energetyczna sold a primary block of €689m of shares on April 22 at a discount of 7.1% to the last trade before launch of the deal.

One week later, Polish electric power distributor Enea raised €160m in a primary block trade at a discount of 3.7% to the last pre-launch trade.

A re-opening of the broader market in the coming weeks is unlikely as long as the fighting in Ukraine continues. “The situation is even worse than a month ago, when we had hopes for peace talks,” said the banker.

Investors are also nervous about countries getting drawn into the war. “The proximity to Russia makes it much harder to buy Moldovan equities,” said a fund manager at a large investment firm.

While Moldova is trying to stay out of the conflict, the Ukrainian military



Poland's Techland was all set for an IPO until Russia invaded Ukraine

has suggested that Russia could consider it an easy target to take over and attack Ukraine from the west.

The war has also pushed some of the other challenges of the region back in public attention. Populist governments are distancing themselves from the European Union. The European Commission has launched a rule of law infringement procedure against Poland and is threatening to cut EU funding for Hungary.

“I don't think there is a hugely supportive consensus around activity in those regions, which is typically driven by privatisations,” said the fund manager. “But without further economic liberalisation, there is going to be much more state control.” ●

Counting the cost of going cold turkey on Russian oil

By Phil Thornton

Whoever controls oil controls much more than oil, the late US senator John McCain said on the presidential campaign trail in 2008. Fourteen years later, access to hydrocarbons hangs over the economic outlook for countries across the EBRD's sphere of influence.

In one corner of the battlefield sits Russia, the world's third largest oil producer, behind Saudi Arabia and the US, and supplier of 41% of Europe's gas needs. In the other are the European Union and its allies in Washington and London who are determined to impose embargoes on imports to deprive Moscow of much-needed revenues.

In the middle is a host of smaller economies that depend on a stable and sustainable supply of energy to power their industries and ensure their populations do not fall into crisis. But for some, going cold turkey on Russian oil could lead to nasty withdrawal symptoms.

Some of these are in central and eastern Europe, according to the Vienna Institute for International Economics Studies (known by its German acronym WIIW). It warns that soaring gas prices and restrictions on supply will hit countries that are dependent on Russian exports, including the Czech Republic, Germany, Hungary, Italy and the Slovak Republic.

This tension came to a head last week when Hungary, a traditional ally of Russia and sceptic of the EU's interventions, said it would block the EU's proposal to phase out all supplies of Russian crude oil without an exception for countries that import oil through pipelines. Along with Slovakia and the Czech Republic it relies on the Druzhba pipeline for supplies of heavy crude.

The three states are likely to be offered more to wean themselves of Russian supplies — at least two years rather than six months for the rest of the EU — but the row highlights the impact of sanctions on the group taking the measures as much as the target.

WIIW warns that sharply rising energy and food prices will hit the region by squeezing real household incomes and thus reducing private consumption. “If there is an energy embargo against Russia, the inflation rate will be in double digits in almost all countries of central, eastern and southeastern Europe,” says Vasily Astrov, its senior economist.

Janet Yellen, the US treasury secretary, has discouraged Europe from introducing an oil embargo on Russia, as it would lead to higher oil prices, higher inflation and lower growth, not just in Europe, but also in the US and the rest of the world. ●

CEE primary bond markets struggling to cope as investors turn their backs

By George Collard

Emerging market bond investors see little chance of a rebound in central and eastern European (CEE) debt issuance in what has already been a stunted year.

Russia's invasion of Ukraine on February 24 halted CEEMEA primary market dealflow but the impact was felt hardest in CEE and the Commonwealth of Independent States (CIS). Since then issuers from Africa and the Middle East have printed new bonds but there have been just four from CEE and one from the CIS.

So far in 2022, CEE and CIS issuers have raised \$24bn-equivalent in dollars or euros on international bond markets, according to Dealogic. This is a 37% drop from the \$37bn by this time last year, of which nearly a fifth came from Russia.

Issuers in CEE, which face volatile US Treasury rates and rising inflation like other EM borrowers, also have the Ukraine problem. In April, when Russia

cut off gas to Bulgaria and Poland, fears rose other CEE names could face similar punishment. This, several EM bond bankers said, meant some planned CEE deals may have to go on hold.

“I see very little new bond issuance from CEE,” said one EM investor in London. “Investors are avoiding the area, reducing their exposure. Personally I think it's for the wrong reasons — they're being punished for geography, not fundamentals.”

EM bond syndicate bankers had hoped clarity on rate rises from the US Federal Reserve earlier this month would allow CEE issuance to restart. Their CEE pipelines are heavy due to the lack of new deals.

“The short answer is we don't want to buy anything on the primary market anywhere, let alone CEE,” said a second EM fixed income portfolio manager in London. “Bankers do have big CEE pipelines, but there's just no appetite for primary risk.”



KTZ is planning a three year bond

Peace in Ukraine would reignite CEE issuance, he added, but that does not look likely in the near term.

However, two deals from Kazakhstan, one printed and one planned, show issuers in regions affected by Russia and Ukraine can get deals done.

Development Bank of Kazakhstan (DBK) sealed a \$500m bond last week and Kazakhstan Temir Zholy (KTZ), the state owned railway operator, is eyeing a three year dollar deal.

CIS issuers suffer from geographic proximity to Ukraine and Russia and some have close political links to Russia. Russian troops went to Kazakhstan in January to help quell social unrest. ●

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Foreword by Governor of the Magyar Nemzeti Bank, György Matolcsy

LONG-TERM QUID PRO QUO FOR SUSTAINABILITY AND ECONOMIC GROWTH

For all players of the global business community, there is an urgent need for reforming the present key structures of global capitalism

After 2010, the Hungarian government and central bank used unconventional and targeted tools to turn the economic tables. These policies created room for manoeuvre and supported us in delivering the most efficient crisis management within the EU between 2010 and 2012. They also helped drive the country's strong macroeconomic performance between 2013 and 2021.

The fiscal policies that underpin national economies tend to differ from country to country because government policies, and the economies themselves, differ too. All this results in different monetary policies of the larger and smaller central banks. This has always been the case in the past.

However, all members of the economy – including central banks – need to focus on the future and shift their attention towards environmental and



Governor of the Magyar Nemzeti Bank, György Matolcsy

technological changes. For all players of the global business community, there is an urgent need for reforming the present key structures of global capitalism.

Global investment should be directed toward sustainable,

ethical, and inclusive growth projects. All the main elements for such business opportunities are there, due to the new changes in technologies and finance. These will inevitably affect monetary policies in the long run.

All central banks should be given a sustainability mandate and full authority to issue their own digital currencies to create a new financial system. Sadly, most global central banks lack the legal authority to issue central bank digital currency (CBDC).

CBDC could create a healthy mix of lending, fiscal easing, artificial intelligence, big data, blockchain technologies, and even cryptocurrencies in order to help create a new global financial system. CBDC will also let us use targeted means instead of general quantitative easing.

The time has come for governments and central banks to step in. ●

MNB: PURSUING A NEW PATH ON SUSTAINABILITY AND DIGITAL ASSETS

Hungary's central bank has implemented some unconventional policy measures over the years to support the economy's growth, stability and development. In an interview for GlobalMarkets, Deputy Governor, **Mihály Patai**, highlights some of these measures and the approach the central bank is taking on sustainability and digital assets.

GM: Governor Matolesy has talked about using some unconventional and targeted measures to support growth in the economy since 2010. What were some of the key elements to these measures? And how do you evaluate the Funding for Growth Scheme (FGS), the MNB's first lending incentive programme?

Patai: FGS, launched in 2013, played an important role in turning SME lending into an area of dynamic growth after several years of decline following the 2008 global financial crisis. The programme also proved to be one of the most important tools in mitigating the effects of the coronavirus pandemic. Under the FGS, about 75,000 enterprises received funding in the amount of nearly Huf6.4bn. According to MNB's estimates, the programme has contributed by more than 5 percentage points to the economic growth since 2013.

GM: MNB has been given a new mandate from the Hungarian parliament to support environmental sustainability and help accelerate the economy's green transition, the first central bank in Europe to have such a mandate. What is the central bank's view on sustainability and its promotion across the economy?

Patai: In recent years, there has been a worldwide recognition that the financial intermediation system cannot operate independently of climate change and other environmental anomalies. Like several other central banks, MNB has made it a strategic objective to ensure that the domestic financial intermediation system, including financial products and services, strongly support environmental sustainability.

As a milestone, and based on the Hungarian parliament's decision, the promotion of environmental sustainability – without prejudice to the primary objective of price stability – has been included (since August 2021) in the MNB's statutory objectives as one of the bank's core mandates.

GM: In practice, what does the MNB's support of sustainability look like?

Patai: In line with its Green Programme, announced in February 2019, MNB has applied an increasing number of instruments to reduce risks related to climate change and other environmental issues and to enhance the financing of the domestic green economy.

To provide professional support, MNB has, for instance, published a recommendation and measured the performance of the financial sector in its Green Financial Report, and expects financial institution products, services and internal operations to become more climate-friendly. In addition, to increase the popularity of green mortgages for households, the bank launched a Green Capital Requirement Deduction Programme, and subsequently started a similar initiative to stimulate green corporate and local government lending.

Importantly, and to further encourage green mortgage lending and energy-efficient housing, MNB launched its Green Mortgage Bond Purchase Programme and Green Home Programme as well. Under the programme, loans of up to Huf70m and a maximum term of 25 years can be granted for construction or purchases of new, highly energy-efficient residential real estates.

MNB has also prepared its first 30-year pilot climate stress with a focus on the quality of bank loans, has been building its dedicated green bond portfolio since 2019, and places great emphasis on financial education and research in this area. The central bank has, for example, launched green finance courses and workshops at several Hungarian universities.

GM: Similar to most European countries, Hungary has recently introduced an instant payment system. However, it has been introduced in an unconven-



Deputy Governor, Mihály Patai

“ MNB has been given a new mandate from the Hungarian parliament to support environmental sustainability and help accelerate the economy's green transition, the first central bank in Europe to have such a mandate. ”

tional way. What is the main unusual feature of the Hungarian model?

Patai: The instant payments service was launched in Hungary on March 2, 2020, with the coordination of the MNB. The bank followed what it believes is a unique approach: seeing the provision of instant payments as mandatory for payment service providers (PSPs), therefore it is available as a basic service to all consumers. Transactions under Huf10m (about €28,000) must be processed within five



“There are several potential benefits associated with CBDC including promoting financial innovation and competition, supporting financial inclusion or making cross-border transactions more efficient.”

seconds on a 24-hour, seven day a week, 365-day basis. For safe liquidity management, an instant credit facility for PSPs was applied, which is also unique when compared to other countries. In addition, MNB owned GIRO ACH – payment infrastructure – helps the widespread use of instant payments with two additional services: request-to-pay; and secondary account identifiers (currently mobile phone numbers, email addresses and tax IDs), which can be linked to IBAN numbers in a central database.

Since 2020 we have experienced dynamic uptake of the service (36% of domestic credit transfers today are instant), especially outside of the normal operational hours. From September 2020, the MNB made it possible for PSPs to send corporate batch, value date and standing order transactions to the instant payment platform. A mass real-time transport protocol (RTP) functionality was also introduced by GIRO. In the next step, the MNB intends to facilitate the development of instant payment-based solutions i.e. we plan to take

further legislative and standardisation steps. We are also analysing whether it is possible to raise the current transaction value limit.

GM: Many central banks are now involved to some degree in research on Central Bank Digital Currency (CBDC). Does the MNB see any benefits in CBDC?

Patai: There are several potential benefits associated with CBDC including promoting financial innovation and competition, supporting financial inclusion or making cross-border transactions more efficient. Also, the monetary policy features of a CBDC have become an interesting area for exploration.

GM: CBDC would bring change not only for users but also for banks. What role can banks play in a CBDC-based system?

Patai: Commercial banks are an integral part of the financial system. Therefore, the introduction and operation of a CBDC can only be successful if banks are part of

this new platform. Market participants can make a valuable contribution in areas where advances in customer interaction can be exploited.

GM: What steps has the MNB taken in the field of CBDC so far?

Patai: The MNB intends to join the leading central banks in the field of CBDC research. As a first step, a unique, comprehensive study volume was published which covers the conceptual and design considerations, monetary policy, financial stability, technological and infrastructural implementation aspects. The MNB also launched its first retail CBDC pilot project, the Digital Student Safe, with a dual purpose: to gain hands-on experience on a potential operational model of a future CBDC platform; and to support digital financial inclusion of primary school students. In addition, the MNB has joined Project Dunbar, driven by the Monetary Authority of Singapore, as an observer to explore the potential of CBDC in cross-border transactions. ●



Hungary's economic resilience undergoes stress test

For the past decade, Hungary's economy has been one of Europe's best performers. Yet, the impact of the war in Ukraine together with rising inflation at home, are presenting a stern challenge to economic growth and stability.

Viktor Orbán's fourth successive victory in April's parliamentary elections was yet another emphatic sign of the support the Fidesz party has in the country after 12 years in power.

Part of the reason for that is the relative strength of the Hungarian economy over the past decade, thanks in part to some unconventional fiscal and monetary policy measures engineered by the government and the central bank.

Yet, while the Hungarian economy has been a top performer among its central and eastern, and western European peers, it

is now facing some tough challenges to growth, not least from the impact of the war in Ukraine and economic sanctions, limiting the country's exports to Russia.

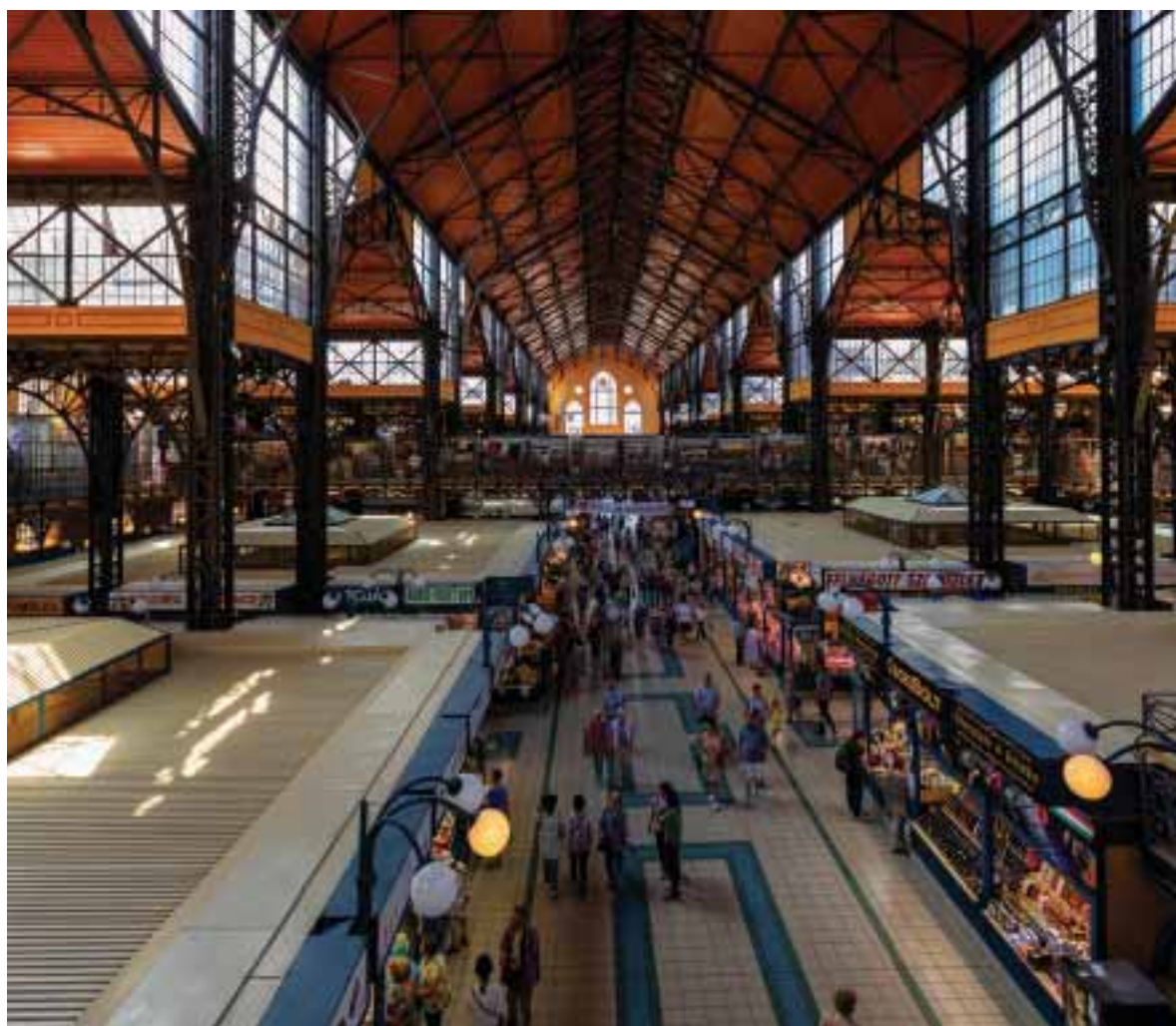
Pre-war, Hungary was on course in 2022 to record another strong year for economic growth. Now, "the longer the war in Ukraine lasts and with more rounds of sanctions, growth prospects are increasingly declining," says Peter Virovacz, a senior economist at ING.

As such, Virovacz cut his 2022 GDP forecast on Hungary in April to 4.5% and warned that that could be cut further given

"risks are clearly tilted to the downside with looming fiscal tightening, rising inflation and continued supply chain disruptions."

While 4.5% growth is still high enough to be the envy of Hungary's western European peers, it is by no means the consensus view. Indeed, analysts at Fitch Ratings are more bearish, forecasting a sharp slowdown in the country's economic growth to 2.3% in 2022 from 7.1% last year.

They similarly cite the impact of high inflation – now at about 8.5%, the highest level since 2007 – on domestic demand as



Budapest's Great Market Hall.

Consumers are feeling the effects of rising inflation.

“Risks are clearly tilted to the downside with looming fiscal tightening, rising inflation and continued supply chain disruptions.”

well as the sharp hit to external demand resulting from the Ukraine conflict.

For its part, the Hungarian central bank raised rates by 100 basis points to 5.4% last month to help curb inflation, the latest hike in a tightening cycle that started in June 2021.

“If necessary, the [NBH] stands ready to intervene using every element in its monetary policy toolkit to ensure financial market stability,” the central bank said. “Mitigating increased fundamental inflation risks and driving expectations appropriately make it necessary to continue the base rate tightening cycle in the coming period,” it added.

Importantly, Fitch says its growth forecast continues to factor in Hungary receiving €7.2bn of pandemic recovery funding from the EU but warns that failure to secure these funds would weaken medium-term growth prospects, “possibly by as much as 1.5 percentage points in 2023.”

The EU is holding back from paying these funds to Hungary, and Poland, due

to democratic

shortcomings in government policy. This is problematic for both countries. Hungary more so.

In early April, the European Commission launched the EU’s new rule-of-law disciplinary procedure for the first time against Hungary. The untested mechanism, designed to prevent EU funds from being misused by countries backsliding on the rule of law, essentially jeopardizes €40bn of EU payments to the country.

A €40BN GAMBLE

Ironically, given Budapest’s defiance of the EU, Hungary is one of its biggest beneficiaries.

Dan Bucsa, UniCredit’s chief CEE economist, estimates that since Orbán took office – for the second time – in 2010, the country has received no less than €46.5bn in EU funds.

He calculates that this is almost 4% of annual GDP and more than any other country, contributing up to 0.5 percentage

points per year to its annual average GDP growth of 2.4% during this past decade.

What’s more, since 2003, when Hungary voted to join the EU, UniCredit estimates that the country has received no less than €94bn in foreign direct investment, predominantly from the rest of the EU, making it a major hub for the auto industry, including in electric vehicles and battery production.

Looking forward, the €7.2bn of EU funding is only one chunk of support Hungary is asking for; the country has, for instance, over €40bn in EU grants due during the next six years (the EU’s 2021-27 budget), which may be at risk due to the gamble Orbán is making with his EU defiant policies.

Erik Nielsen, group chief economics advisor, UniCredit, says it is difficult to judge how this will play out, but suggests the government’s alignment with Russia may be influential.

“In the past, Hungary could count on protection from Germany and Poland. The German auto- and auto-related industries are known to have lobbied Angela Merkel and her government to go easy on Hungary, as the government moved away from the values of European institutions towards ‘illiberal democracy,’ as Orbán calls it.”

He adds: “I’m not sure those calls will be heard to the same extent by the new government coalition in Berlin. Meanwhile, Hungarian relations with Poland have come under severe constraints given the two governments’ diametrically opposite views on Putin and Russia.”

By pushing back on the EU, the government is making it more difficult for itself. And at a time when it could do with the financial support to ease its budget problems, exacerbated by the gift of some €5bn in family tax rebates and pension bonuses ahead of the April 3 election.

BUDGET PROBLEMS

The government’s largesse in the first quarter helped push the deficit to Huf2.31 trillion, which equates to 73% of the full-year cash-flow based deficit target, according to ING’s Virovacz.

Importantly, additional government spending due to the war in Ukraine was also a big contributor, including on areas such as border defence and assisting refugees.

For Virovacz, the big question now is what does the government do?

“We see two different paths in front of

“If the situation worsens, increasing revenues via the recalibration of some sector taxes seems more likely than burdening households with extra taxation.”

“The easiest path would be to let the original deficit target (4.9% of GDP) go and amend the budget to reflect the new situation. The tricky part here is the debt accumulation, although with better-than-expected 2021 debt-to-GDP data at 76.8% there is more room for manoeuvre.”

The other path, says Virovacz, would be to carry out austerity measures that would reflect the budget slippage. “As for now, it is really hard to make a calculation or even an educated guess about the adjustment needed. As a rough estimation, we see it at Huf500bn or roughly 1% of GDP. This could be achievable via cuts in public spending related to investment projects. Should we see a bigger recalibration needed, then the government could levy/increase taxes to boost revenues.”

Orsolya Nyeste, chief macro analyst at Erste Bank in Hungary, shares some of the same analysis, estimating a possible adjustment 0.5-1% of GDP.

“As a first step, the government would reduce spending related to state investment projects,” she says. “If the situation worsens, increasing revenues via the recalibration of some sector taxes seems more likely than burdening households with extra taxation. This year’s ESA deficit target is 4.9% of GDP; however, without decisive government measures, the deficit is likely to exceed 5% of GDP.”

Orbán’s government does not face any easy options here. Indeed, if it lets go of the original deficit target and amends the budget to reflect the new situation, it is challenging to see how markets, and rating agencies in particular, would see that as positive.

Virovacz says that while he doesn’t think that an immediate downgrade is on the cards, with “upwardly revised fiscal targets, we see an increased chance for a negative outlook regarding the Hungarian sovereign credit ratings.”

The country is rated BBB/BBB/Baa2 with a stable outlook by Fitch, Standard &



HUNGARIAN BANKING SECTOR STANDS STRONG

In December last year the central bank published its latest financial stability report in which it declared the Hungarian banking system stable, strong, and resilient to risks.

Some two months later and a key risk – unforeseen by anyone – that all banks have needed to quantify, and remedy, is their exposure to Russia after its invasion of Ukraine.

This issue is particularly acute for OTP Bank, Hungary’s largest bank, which has significant banking operations in the country, including 134 branches.

Such operations have come into focus under economic sanctions on Russia, even leading the Ukrainian government to pressure the bank to sell its Russia business, according to an interview CEO Sándor Csányi gave to private broadcaster InfoRadio in late April.

OTP, which has operations in Ukraine, has said it is winding down corporate lending in Russia in compliance with international

sanctions and may examine a possible withdrawal from the country.

The extent of exposure that other Hungarian banks have to Russia is difficult to quantify. Some foreign banks with significant operations in Hungary, such as Raiffeisen and UniCredit, are among the banks that are most exposed to Russia.

In general, however, the Hungarian banking sector has greater exposure to Ukraine (€2.4bn) than Russia, according to data published by the European Banking Association.

While this exposure may have some negative financial impact on the Hungarian banking sector, the country’s banks are generally in good health with more than sufficient capital to absorb it.

Indeed, according to the central bank’s financial stability report, which analysed the banking sector up to the end of June last year, the sector’s consolidated capital adequacy ratio reached 19.1 per cent in the first half of the year, which is a record high.

The report said the improvement compared to the end of 2020 was “a result of the inclusion of last year’s [2020’s] profits and a portion of this year’s H1 profits into own funds.”

In addition to the banking sector’s capital strength, the report said profit generation was also robust.

In fact, the after-tax profit of the credit institution sector hit Huf342bn in the first half of last year, up from Huf274bn in the same period the year before. On a consolidated basis, which includes the profits of domestic and foreign subsidiaries, the report said profits were even higher at Huf391bn.

According to the central bank, the annual growth in half-yearly profit was mainly attributable to a decline in risk costs and an increase in net interest income. It added that the profitability of domestic credit institutions was outstanding, with return on equity levels often the highest among their EU country peers. ●



The Hungarian central bank is engaged in an interest rate tightening cycle

Poor's and Moody's Investors Service. On affirming the ratings in April, Fitch said this reflected the Hungarian economy's strong structural indicators relative to peers and record of stable growth fuelled by investment.

However, the agency added that these factors are "balanced against high public debt, a record of unorthodox fiscal and monetary policy moves, and a worsening of governance indicators in recent years."

FX AND BOND MARKETS REACT

Given the complexity of Hungary's situation and the challenges it faces, the country's foreign exchange and bond markets have been volatile.

On March 7, for instance, the euro forint exchange rate hit an all-time high of 400, largely driven by foreign investors' concerns over the impact of Russia sanctions being extended to the energy sector.

While Hungary is reliant on Russia for its crude oil and oil products, the EC said in early May that it may exempt the country, and Slovakia, from its plans to implement a Russian oil embargo.

The forint has strengthened – primarily supported by the central bank raising interest rates – since spiking in March to trade in the 370-375 range, but it has overall been underperforming since the election due to Fidesz party's two-thirds majority and the EU's rule-of-law case, says ING's Virovacz.

However, he says there are several factors that could help strengthen the forint. These include fiscal tightening measures, promising developments regarding the rule-of-law mechanism, and the central bank's double pledge to maintain tighter monetary conditions for longer and demonstrate flexibility with its one-week deposit rate decisions, should money market moves warrant it.

"The hope of a de-escalation in Ukraine and our call to have a positive real interest rate environment by the year-end in Hungary could be able to push Eur/Huf back to the 355-360 area during the second half of 2022," Virovacz adds, optimistically.

Such factors would also influence the Hungarian bond market, which has similarly undergone bouts of volatility over the past few months.

Indeed, yields on Hungary's wholesale bonds have risen significantly since Russia invaded Ukraine on February 24, and "exploded" in on news of the European Commission's preparation of disciplinary action against the country, says Erste's Nyeste.

While she believes the high spreads "are hardly justified by fundamentals," geopolitical risks and strengthening conflicts with the EU, are "strongly burdening the bond market, implying yields sticking at higher levels for a longer period of time."

Virovacz is similarly bearish on yields given all the uncertainties around core market monetary policies, scope and magnitude of local fiscal tightening, sources of extra financing needs, inflation, the rule-of-law issue, war and sanction policies.

"Against this backdrop, our two high conviction calls are that: the central bank needs to continue its tightening cycle with the effective and base rates heading toward 8.25%; and the government debt management agency [ÁKK] will prefer FX bond issuance combined with a possible tweak to ramp up retail bond demand to bring some relief on the longer dated government bond yields."

For the ÁKK's part, the agency had, by the end of March, successfully completed 32% of the country's Huf3,153bn 2022 net financing need, including Huf321bn in foreign currency issuance, equivalent to 21% of its Huf1,551bn target for the year.

One of the most important transactions within that was the country's ¥75.3bn four-tranche Samurai bond issue in mid-February, which was larger than planned and tighter on pricing that's it previous Samurai last year despite the sale coming just ahead of Russia's invasion.

Three of the four tranches – the five, seven and 10-year – were issued under Hungary's green bond framework, contributing to the solid investor demand for the issue and its ultimate success, Zoltan Kurali, ÁKK's chief executive, told GlobalCapital at the time of the sale.

It's uncertain to what extent and when Hungary will be issuing on the Eurobond market in the coming months. Yet, in a financing note published by the ÁKK on April 4, it said "there is significant headroom for net FX financing" given that its foreign currency debt ratio at the end of March was comfortably under its ceiling of 25% of total debt.

What is certain is that when the sovereign does come, it will provide a clear test of foreign investor sentiment on Hungary's economic resilience. ●

HUNGARIAN BANKHOLDING – MODERN BANKING FOR A NEW ERA

The combination of three banks into one is set to create a new banking powerhouse in Hungary and potentially the broader central eastern European region. In an interview for GlobalMarkets, Levente Szabó, chief business officer of individuals services, explains the merger and the proposition of the combined banking group



GM: At the end of March, Budapest Bank, MKB Bank and Takarékbank merged to form a new, more powerful banking institution in the Hungarian market. What is the significance of this development for the Hungarian banking sector and economy?

Szabó: The integration is a major step in the historic merger of three leading Hungarian banks. A complex and large-scale integration such as the merger of Budapest Bank, MKB Bank and Takarékbank is unique in the financial sector of Hungary and the region. The banking group is the market leader in several segments, including corporate loans, especially in lending

to the micro, small and medium-sized enterprise sector, which is particularly important for the Hungarian national economy. The holding's agri-food and the leasing businesses are also the number one players in their respective markets.

GM: When thinking about the combined bank's growth and development strategy, what will form core pillars of this strategy?

Szabó: Adopted in March 2021, the five-year business strategy of Hungarian Bankholding identifies a number of synergies, which could allow for the new integrated bank to operate more efficiently in

the future than its member banks individually would have. Our goal is to create the most modern bank in Hungary by 2023 – we are building our solutions on the combined strengths, values and best practices of the member banks of the group. Strong digitalisation is, of course, a key element of the business strategy, because digital transformation supports growth while rationalising costs.

The unified bank will serve the full market spectrum and all customer segments in the future, with a significant emphasis on the provision of a new, modern range of products and services to retail, micro, small and medium-sized enterprises and agribusiness customers.

“ Our goal is to create the most modern bank in Hungary by 2023 – we are building our solutions on the combined strengths, values and best practices of the member banks of the group. ”

Levente Szabó, chief business officer of individuals services



“ We have a key role and responsibility in supporting and financing sustainable and climate-friendly investments and can thus make a significant contribution to the fulfilment of Hungary’s climate goals and the development of a sustainable society. ”

Furthermore, the merger process focuses on creating a flexible organisation and corporate culture that is capable of continuous renewal. We learn from startups in this respect, embrace the approach and solutions of the leading fintech companies.

GM: How does, and will, the new combined bank differentiate itself from other banks? Its lead in digital innovation may be a key differentiator, but what else makes the bank stand out?

Szabó: The banking group is already a market leader in many areas and is currently the second largest market player in Hungary in terms of total assets. It also has the largest branch and ATM network in Hungary. Our goal is to build a Hungarian-owned bank that transforms the traditional image of financial institutions and operates in a digital-first manner, very much like the leading neobanks and fintechs.

Hungarian Bankholding is currently

building a new digital banking platform that will revolutionise both technology and customer experience. We are embarking on a new journey, at the end of which, over a few years, technology-driven changes will deliver clear business results.

The goal of the group is to introduce customer-centric, competitively priced, internationally leading digital solutions, products and services.

GM: All banks have needed to embrace and implement an ESG strategy. How important is ESG to the bank’s strategy and operations and what is it doing to demonstrate this?

Szabó: Identifying one of the main challenges of our time, environmental and operational sustainability, Hungarian Bankholding is committed to become a key player in the creation of sustainable business operations in the domestic financial market. We have a key role and responsibility in supporting and financing sustainable and climate-friendly investments and can thus make a significant contribution to the fulfilment of Hungary’s climate goals and the development of a sustainable society.

For these reasons, the group has set two main strategic objectives. First, to create an infrastructure, product and service offering for both retail and corporate customers that will help them achieve their own sustainability and climate goals. Secondly, the group aims to adopt sustainability principles in its own operations – i.e. by reducing its ecological footprint, by being

a fair and supportive partner to its employees and customers, and by continuously ensuring ethical, transparent, compliant and sustainable operations.

GM: What is your assessment of the Hungarian banking sector’s strength and stability, and what do you expect to be some of the key risks to that this year?

Szabó: The war in Ukraine will worsen domestic growth prospects through a number of – largely indirect – effects, and will substantially override outlooks, the impacts of which cannot yet be estimated. Inflation may also rise further in the coming months due to global shortages of raw materials and components, soaring international transport prices and the global energy crisis. However, there has been no information on a major break in growth since the outbreak of the war. GDP growth in the coming years in Hungary is expected to remain strong, but more subdued than previously forecasted.

The Hungarian Bankholding Group is a stable and strong player in the domestic financial sector, which provides a high level of security for clients. MKB Group closed the financial year 2021 with an after-tax profit adjusted for one-off items of Huf77.7bn, achieving the most outstanding result in the history of the bank. We are building on very solid foundations and with significant capital strength behind us, so we are confident that the triple bank merger will be concluded in 2023 as planned. ●

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