Financial resilience and recovery from inflation shock Report about a Ludovika University Conference

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The Faculty of Public Governance and International Relations at Ludovika University has been hosting several conferences attempting to reply for the economics challenges and threats emerged in the recent years. The period 2020-2023 will create a complex situation for financial institutions and businesses worldwide, characterized by increased economic uncertainty and the lagging effects of pandemic COVID-19 and high inflation. In this context, financial resilience refers to the resilience of businesses and economies. Inflation in 2022-2023 has posed significant challenges for both banking and corporate finance.

On 17th October 2024, the Conference on *'Financial Resilience and recovery from inflation shock' took place in the Ludovika University in the organization* of Department of Economics and International Economics in cooperation with the Public Finance Section and the Finance Section of Hungarian Economic Association (MKT). The event was supported and co-financed by the Konrad-Adenauer-Stiftung which organization is devoted to the socio-economic solutions just like the Ludovika University.

The conference articulated the factors blocking economic growth and deteriorating competitiveness that spill over from the high inflation period into the later years. Central banks around the world have raised interest rates to fight inflation, leading to higher borrowing costs for banks and businesses. This can reduce lending activity, squeeze profit margins and increase the risk of credit defaults. In addition, inflation may have reduced the value of bank assets, especially long-term fixed-rate bonds and loans. This could lead to capital losses and weaken banks' financial position.

From a corporate finance perspective, the relevance of the conference was reasonable since companies were facing rising cost of raw material, labor and

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transportation that are compounded by inflation. Higher interest rates can increase the cost of servicing existing debt, which could lead to cash flow problems. All this could force companies to adopt new pricing strategies and/or cost-cutting measures, including possible layoffs, in order to maintain profit margins. This in turn could undermine long-term business plans.

Uncertainty about inflation affected very likely the business investment decisions. Firms may postponed or cut back capital expenditure because of the unpredictability of future costs and revenues. This could stifle innovation and growth and limits long-term competitiveness. Meanwhile, companies may still were forced to invest because of inflation, as rising costs and limited availability of materials can cause delays and inefficiencies that companies would have had to adapt to by diversifying suppliers or adjusting their supply chain strategies.

The challenges of inflation are having a significant impact on both banking and corporate finance, testing the resilience of financial institutions and businesses. In addition to the risks, the potential for efficiency pressures in an inflationary environment is also worth considering. Banks need to improve risk management practices and maintain strong capital buffers, which will improve prudence. Finally, firms will be forced to increase financial flexibility, namely they will be forced to innovate production processes in terms of cost efficiency.

The conference featured keynote speeches and panel discussions by renowned experts from academia and industry.

- László Vastag, executive director from National Bank of Hungary (MNB), responsible for Prudential and Consumer Supervision of Financial Market Institutions, and who talked about the response of bank sectoring against inflation shock.
- Peter Tóth from National Bank of Slovakia and University of Economics in Bratislava, who demonstrated the households' resilience.
- Svatopluk Kapounek, dean of Faculty of Business and Economics in Mendel University, Brno. He presented the cyclical impacts.
- Dorina Clichici, the researcher of Institute for World Economy of the Romanian Academy of Science. She enlightened the linkage between economic policy and resilience against inflation shock.
- Gábor Regős, analyst of Gránit Asset Management, who taught us the lessons of recent anti-inflationary monetary policy.
- And last but not least Vivien Czeczeli from Ludovika University. She uncovered the risks of Eurodollar markets.

The banking resilience

The executive director, Mr. Vastag made the keynote speech about Financial Resilience in Banking After the Inflation Shock and Anti-Inflation Policies. He stated that the Hungarian banking sector has shown strong resilience in the face of multiple shocks over the past few years, including the COVID-19 pandemic, interest rate hikes, and

geopolitical tensions. The main message was demonstrated by the robustness of the consolidated capital adequacy ratio (CAR) of the banking system, which was 19.6% at the end of Q1 2024, a slight decrease from the previous quarter but still indicative of strong capital buffers. The sector's excess capital was nearly HUF 2,000 billion in early 2024, reflecting significant capitalization efforts and the ability to meet increasing capital requirements. Concerning the trends in liquidity, the reserves remained adequate with a high Liquidity Coverage Ratio (LCR), consistently above the MNB's recommended 140%. The retail deposits exhibited an increasing trend since Q4 2023 after a five-quarter decline, influenced by rising nominal incomes and personal saving rates. The banking sector maintained a strong liquidity position into 2024. The bank lending, however, does not represents a strong recovery path, since it still lags behind deposit collection. Mr. Vastag understood it as an indication of cautious lending behavior amid the ongoing economic uncertainties and regulatory expectations for maintaining robust liquidity and capital buffers. The highest risk is originated from the OTP subsidiaries in Russia and Ukraine, which necessitates close monitoring by the supervisory authority. He reported that the MNB implemented several supervisory measures for financial stability such as intensified monitoring of loan stocks and regular discussions with banks to prevent portfolio deterioration. The MNB recommended the banks to maintain LCR above 140% and preserve liquidity buffers, while it encouraged the adoption of conservative assumptions in their liquidity and capital planning, especially regarding dividend payments and loan portfolio quality. Nevertheless, the MNB has been seeking the strengthening factors of green financing to enhance the financial stability.

The Hungarian banking sector has demonstrated resilience through effective capitalization and liquidity management. The supervisory authority recommends for banks to maintain high LCR levels and liquidity buffers, moreover, a conservative approach in planning next year year. The MNB foresees big opportunities and competition trends in digital and AI solutions to enhance operational efficiency, improve risk management, and offer innovative financial services, and that is why it encourages banks to invest into these technologies.

Households resilience

Péter Tóth, from the National Bank of Slovakia explained the role of Income, Consumption and Wealth concerning the life satisfaction and inequality in Slovakia.[1] The research together with Biswajit Banerjee delved into the intricate relationships between life satisfaction and various economic well-being indicators, emphasizing the simultaneous influence of income, consumption, and wealth, along with the role of self-centered and community-centered inequalities. The primary focus of this speech was to understand how different aspects of economic well-being – namely income, consumption, and wealth – impact subjective well-being (SWB) in Slovakia. The presentation also explored how inequalities influence life satisfaction, both the self-centered (relative to a reference group) and the community-centered (within

broader communities). The literature of life satisfaciton underscores the multifaceted nature of subjective well-being, which is influenced not only by absolute income but also by consumption and wealth. The presentation highlighted the importance of considering consumption and wealth as separate channels affecting well-being. The focus was: "How do absolute levels of income, consumption, and wealth, as well as their relative measures and associated inequalities, affect the subjective well-being of individuals?" The data was included from the Slovakian Household Finance and Consumption Survey (HFCS) and proceeded with Ordinary Least Squares (OLS) regression models. The speaker explained that the absolute income was consistently found to have a positive correlation with SWB, while the relative income effects were mixed as the feelings of relative deprivation or achievement depended on whether the individual's income was below or above the reference group average. Besides, the community-centered income inequality can have both negative (due to aversion to inequality) and positive (signaling future prospects) effects. The consumption is a more direct measure of utility than income, impacting well-being through the goods and services it enables, that is why conspicuous consumption has a stronger positive effect on SWB than basic consumption, and as a robust statement, the relative consumption effects also show a negative impact when reference group consumption is high, suggesting a comparison effect. Finally, the wealth contributes to SWB by providing financial security, smoothing consumption over the life cycle, and serving as a status symbol, consequently, assets have a positive effect on SWB, while liabilities have a negative impact. However, the role of relative wealth is less clear. Mr. Tóth concluded that that subjective well-being in Slovakia (whose society is very similar to the Hungarian) significantly influenced by all three economic well-being indicators and that is why he recommended that policies should aim to reduce disparities, particularly at the lower end of the economic spectrum, to ensure broader, more inclusive growth.

Financial instability and business cycles

Svatopluk Kapounek, dean from Mendel University, acquainted the audience with a Wavelet analysis – which creates heat maps from regression analysis – about financial instability and cycles. His presentation investigated the determinants of financial instability within the EU countries. The focus of the research as a basis of his speech was on that how the credit cycles and real asset prices interact to influence financial instability; what role the macroprudential policies play in mitigating financial instability, finally, how the interaction between macroprudential and monetary policies affects financial stability. He also demonstrated the heterogeneities in financial cycles across different EU countries. In his analysis, the financial cycles were found to be longer than business cycles, with significant heterogeneity across EU countries. In some countries (e.g., Germany, Czech Republic, Hungary, Netherlands), financial cycles closely followed business cycle frequencies. Meanwhile, the data indicated substantial co-movement between credit cycles and real asset

prices, underscoring the interconnectedness of these variables in driving financial instability. Professors Kapounek's empirical analysis showed that macroprudential policies had statistically significant effects on credit activity and house prices. These policies were more effective during the upturns of the credit cycle.

The heat maps in his Wavelet coherence analysis revealed a strong correlation between credit cycles and real asset prices. The phase shift analysis indicated that changes in credit cycles often led changes in real asset prices, suggesting that credit expansion precedes increases in asset prices. Why this analysis was very relevant to the inflationary perspective is that, he managed to verify a trade-off between macroprudential and monetary policies, particularly in the periods of low inflation. This can be interpreted as while macroprudential policies aimed to stabilize the financial sector, monetary policies focused on broader economic stability, leading to potential conflicts. That is why he voiced the necessity for coordination between macroprudential and monetary authorities to effectively manage financial stability. The presenter underscored the importance of robust macroprudential policies in mitigating financial instability. According to his speech, the policymakers should prioritize the implementation and continuous refinement of macroprudential tools to address the evolving dynamics of financial cycles, nevertheless, these policies must be tailored country-specific way considering the heterogeneity in financial cycles across the EU. This is a challenge in the euro zone, for the European Central Bank, how to support heterogeneous national authorities with single policy measures.

The speaker articulated that the continuous monitoring of credit cycles and real asset prices is essential for early detection of financial instability risks. The use of Wavelet analysis provided valuable insights into the temporal dynamics of these variables as an early warning system. Professor Kapounek confirmed the execute director of the banking supervisory authority in the recommendations toward banks about maintaining adequate capital buffers, managing liquidity risks, and ensuring prudent lending practices.

In conclusion, the presentation by Svatopluk Kapounek provided a comprehensive analysis of financial instability determinants using Wavelet analysis. The findings emphasized the critical role of macroprudential policies, the need for coordinated policy efforts, and the importance of tailored, country-specific approaches to managing financial stability. By adopting these recommendations, policymakers can better navigate the challenges posed by financial cycles and enhance the resilience of the financial system.

Monetary experience of Romania

The presentation by Dorina Clichici examined Romania's resilience in monetary and fiscal policies amid significant inflationary shocks.[2] Key areas of focus included the response of monetary policy, fiscal measures to counter inflation, medium-term risks, and steps for future economic stability. As she explained, Romania experienced a sharp rise in inflation, just like many other neighboring countries, and in response,

the National Bank of Romania (NBR) increased its key interest rate 11 times from October 2021 to January 2023, reaching 7%. (The audience could recognize several parallel characteristics with the high Hungarian inflation.) This proactive stance aimed to curb inflation while avoiding abrupt economic impacts.

Economic activity showed mixed results; while GDP growth in many CEE countries turned negative, Romania maintained positive growth in early 2023, thanks to external economic support and internal factors like supply shocks and monetary normalization. However, the banking sector, despite high liquidity, saw low credit activity as households and corporations remained cautious. She reported in her conference speech that the domestic fiscal policy was notably expansionary during the period of high inflation, resulting in increased public deficits and debt. Public debt rose from 35.1% of GDP in 2019 to over 50% by early 2024. Fiscal measures included public sector salary increases and extensive use of the Budget Reserve Fund.

According to Ms. Clichici's summary about the Romanian inflation crisis, the NBR's aggressive interest rate hikes were balanced to prevent severe economic downturns, while fiscal policies focused on public spending and deficit financing. The government also implemented price caps on electricity, gas, and food to ease household burdens. Ms. Clichici established that structural adjustments included adopting the EU's new economic governance framework to support fiscal consolidation. She voiced about the future that Romania must focus on fiscal consolidation, combining expenditure cuts with revenue enhancements to stabilize public finances.

She assumed that leveraging EU support and structural reforms will be vital for fiscal consolidation. Efficient use of European funds will be necessary for sustainable growth and mitigation of adjustment costs. In overall view, Romania's response to inflation involved significant monetary and fiscal actions. While the NBR's rate hikes managed inflation, expansionary fiscal policy increased debt. Future efforts must prioritize fiscal consolidation, policy coordination, and structural reforms to ensure economic stability amidst uncertainties.

The appropriate anti-inflationary policy

Gábor Regős from Gránit Fund Management discussed what could monetary policy do against inflation in the last three years in the context of recent global inflationary trends. His presentation highlighted the significant surge in inflation across various regions, including the US, the Eurozone, and Central and Eastern Europe, driven by factors like supply chain disruptions, energy price increases, and post-pandemic demand pressures. Mr. Regős revealed that while monetary policy has tools to combat inflation, it is not omnipotent. It can influence inflation through interest rates, asset prices, expectations, and risk-taking channels, but it cannot fully counteract supply-side shocks such as the energy crisis or global supply chain disruptions. His assumption is that central banks face dilemmas in balancing the goals of controlling inflation and supporting economic growth. High indebtedness in certain regions,

particularly southern Eurozone countries, complicates the tightening of monetary policy due to the potential increase in debt servicing costs. Mr. Regős voiced that the effectiveness of monetary policy also varies depending on the size and openness of the economy, with different impacts observed in small versus large economies and dependent versus independent monetary policies. Effective communication is essential for managing market expectations according to his expression. Central banks must articulate their policies clearly to influence inflation expectations and maintain credibility. Geopolitical conflicts and transitions, such as the green transition, pose additional challenges for inflation management regarding his opinion. These factors can create persistent price pressures that monetary policy alone cannot address. He suggested in his presentation that the era of zero or negative interest rates is over, and while high inflation may have peaked, inflation rates are likely to remain above the pre-pandemic levels for some time. That is why, he said, there is a need for better coordination between monetary and fiscal policies, in accordance with the policy conclusion made by professor Kapounek. While monetary policy focuses on price stability, fiscal policy can address supply-side constraints and support structural adjustments.

The Eurodollar market instability

Vivien Czeczeli talked about the particular risk and financial instability of emerging markets originated in Eurodollar market as it is impacted by the US monetary policy. She argued that the Eurodollar market, a significant source of dollar-denominated financing for emerging markets, can amplify the effects of US interest rate changes. The presentation was based on a Vector Error Correction Model (VECM), which analyzed the relationship between US interest rates and sovereign bond yields in emerging market (including East European economies, like Hungary). Ms. Czeczeli demonstrated that the emerging markets are more vulnerable to US monetary tightening if their external debt was higher. An increase in US interest rates can lead to capital flight from emerging markets, currency depreciation, and higher borrowing costs. The main message of her presentation was that emerging markets should diversify their funding sources, strengthen their financial systems, and implement prudent macroeconomic policies to mitigate the risks associated with the Eurodollar market. Additionally, international cooperation is crucial to address global financial imbalances and promote stability in the global financial system.

The overall conclusion of the conference is the following: For the macroprudential stability and resilience, the big picture still contains potential risk factors, even though the inflationary challenges seem to be over. That is why the supervisory authorities should encourage the financial institutions for cautious and conservative financial planning with high capital adequacy and buffers. Nevertheless, the economic policymakers should institutionalize a sophisticated coordination mechanism between the monetary and fiscal policy. Finally, monitoring the financial cycles and the asset prices is essential since their strong co-movement.

The Ludovika University has had organized several conferences related to finances, which can be followed in these websites: https://gvk.uni-nke.hu/, https://rice.uni-nke.hu/.

Endnotes

1 Biswajit Banerjee and Peter Tóth (2014): Life Satisfaction and Inequality in Slovakia: The Role of Income, Consumption and Wealth. NBS Working Paper 1/2024. https://nbs.sk/en/publications/research-papers-working-and-occasional-papers-wp-op/

2 Dorina Clichici, Andreea – Emanuela Drăgoi, Angela Timuş (2024): Monetary Support and State Aid under the Pandemic Challenges in Romania: A Comparative Approach ROMANIAN JOURNAL OF EUROPEAN AFFAIRS 24(1):67-85