Post-Crisis Global Economy and the Convergence Process

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Outline

1. How will the post-crisis world be different from a growth perspective for CEE countries?
2. Features of Hungary's convergence pattern before the crisis
3. What are the likely consequences of the crisis for our convergence pattern?
4. Implications for our Euro adoption strategy

1. How will the post-crisis world be different from a growth perspective for CEE countries?

Slow recovery is expected due to increased risk aversion…... The bankruptcy of Lehman Brothers in September 2008 triggered a generalised collapse of confidence, and all indebted or leveraged regions, countries, sectors and asset markets suddenly turned out to be too risky in the eyes of investors. Liquidity preference increased dramatically and investors were seeking safety. Massive and coordinated intervention by major central banks and governments was necessary to avoid the fire-sale-induced collapse of the financial sector. It became clear that the pattern of growth based on increasingly unsustainable imbalances which prevailed during the last few years of the “Great Moderation” cannot be maintained.

….. and sluggish demand. As a consequence of the crisis financing costs will be higher both internationally and domestically - at least in the foreseeable future - due to reduced appetite for risk. As a result, capital accumulation will be slower, albeit hopefully more sustainable. Productivity growth will also slow down, as even more successful companies will find it harder to obtain credit. As global aggregate demand is likely not only to grow more slowly, but also to be distributed more evenly across countries and regions, the composition of output should change too. This will render existing capital stocks to some extent obsolete, and result in higher equilibrium unemployment for several years. Finally, growth in aggregate demand is expected to be sluggish due also to the inevitable restructuring of balance sheets in sectors, countries and regions who previously built up significant imbalances.

2. Features of Hungary's convergence pattern before the crisis

Convergence optimism. During the period before the crisis, the CEE countires, including Hungary, enjoyed a very favourable international environment. They were seen as converging countries with a clear roadmap to the EU and EMU. Strong integration was achieved through increased trade and heavy FDI inflows in nearly all sectors, while financial integration was achieved through strong capital flows and a massive presence of West-European banks in the region. This level of integration is comparable only to that of the old member states themselves. Coupled with a clear and natural "exit option" from independent monetary policy, risks out of foreign exchange liabilities and other financial risks were underestimated or plainly ignored. Disciplined macroeconomic policies were supposed to be guaranteed by adopting EU regulations, institutions and common macroeconomic surveillance procedures.

Cautionary signs. With the benefit of hindsight, it is easy to see that part of this optimism was unwarranted. The size of current account deficits, the rate of credit flows and the level of indebtedness (largely denominated in foreign currency) in many cases proved to be unsustainable under the new, harsher global conditions, even though part of them could have been justified by the anticipation of a steady catch-up in income levels. In some countries, real exchange rate appreciation was not underpinned by productivity differentials, and thus resulted in deterioration in competitiveness.

Vulnerabilities of Hungarian economy. During the last few years before the crisis, Hungarian growth relied increasingly on external sources of financing. The crisis hit the Hungarian economy with high levels of public debt and external liability denominated mostly in foreign currency. Even more disturbing was the fact that despite rising government and household sector debt, growth was sluggish already before the crisis. Given the combination of high external debt and expectations of weak growth, Hungary was among the first countries to be hit by the confidence shock in the fall of 2008.

3. What are the likely consequences of the crisis for our convergence pattern?

Post-crisis convergence prospects. Growth with an external account closer to balance seems unavoidable for Hungary. Accordingly, growth should be led by exports and investments. Household savings should increase, and credit growth should be slower compared with pre-crisis dynamics. That would result in more moderate consumption growth, due hopefully to productivity-driven real wage growth and more prudent banking behaviour. This would stabilise and, over time, reduce household indebtedness which is necessary for a balanced growth path.

Households had begun the adjustment process. Actually, to a large extent this adjustment by households has already taken place as a result of the crisis. Savings increased sharply and consumption slowed down. This is also reflected in our much improved trade balance, due largely to a decline in imports. Not only did the rate of credit growth to households decrease, but the denomination of the newly extended credits has also shifted away from foreign currencies towards Hungarian forints. Furthermore, credit quality has improved as lending conditions have tightened, due to more prudent selection of debtors and higher collateral requirements by banks. Thus, in the household sector, to a large extent, the adjustment has already taken place and this sector now adds stability to the economy. It is important that these achievements are consolidated, but we do not see that further adjustment would be necessary.

As well as the fiscal policy. The crisis has been a strong catalyst for the fiscal consolidation process as well, which actually already began a couple of years before the outbreak of the crisis. The government implemented an ambitious austerity programme, along with financial assistance provided by the EU, the IMF and the World Bank. Some excesses of the various welfare programs have been rolled back and changes in pension entitlements helped to improve pension system sustainability. In addition, the tax wedge has been reduced.

But further measures are necessary: while in some areas serious under-spending emerged (health care or public investments), in others overspending is still present (general government spending). In other words, the problem to be tackled is not only the still large size of the government sector, but also the quality of public finances. Accordingly, government spending and the tax system should be made more growth friendly: helpful for upgrading skills, promoting closer integration among international companies and local suppliers, eliminating economic duality and distorting incentives as much as possible.

Risks still remain. Even in an optimistic scenario, where adjustment by the household sector is consolidated and further fiscal adjustment is implemented, risks would still remain in the new environment in financing the large foreign currency denominated stock of debt accumulated over many years. Overall, a more prudent macroeconomic policy, which is prepared to absorb shocks and ready to adjust unsustainable developments is needed to prevent the economy from going off its convergence trajectory. The expected new environment will not be as forgiving of unsustainable developments and policy mistakes as it was before the crisis.

Nonetheless, a more balanced path is possible for Hungary. Actually, such a sustainable path, which could lead to lasting convergence, is already beginning to take shape. An element of uncertainty that remains is the extent to which these recent adjustments are just cyclical developments.

4. Implications for our Euro adoption strategy

Hungary has come close to fulfilling some convergence criteria, particularly the inflation criterion, but much remains to be done. As a side effect of this crisis, Hungary has come closer to the fulfilment of the convergence criteria, especially the inflation criterion. In addition, fiscal adjustment has been reinforced, but not yet completed.

Favourable signs in trend inflation. Despite the many disadvantages of the crisis, one positive aspect is that inertia in inflation expectations has been broken. It is expected that inflation will sink below the 3% target in 2011. This would not only stem from the imported elements of inflation, but also from domestic developments, such as weak demand and moderate wage dynamics.

In this respect, the biggest risk is that inflation expectations will become unanchored when the recovery gathers momentum. It is uncertain how much of the improvement in the inflation outlook is only cyclical. It should serve as a warning sign that markets do not yet price quick euro area accession into long-term yields.

Euro adoption: is it better inside or outside? Our view towards euro adoption did not change, or if it did, it has only been reinforced by the crisis. One important lesson of the crisis is that the level of financial integration is an equally important OCA criterion on two counts. One is that an own currency itself could be a source of shocks, not only a well behaving adjustment tool under the control of the domestic authorities. A second, but related, aspect is that a large share of foreign currency denominated lending, seriously constrains the lender of last resort capacity of the central bank.

Resisting temptations inside EMU: Alas, the advantages of participating in EMU are not without disadvantages. Elimination of one important source of risk, namely, the exchange rate risk, may induce investors to underestimate the remaining ones; the credit risks associated with the indebtedness of both the public and private sectors. Such a perception, if dominant, could lead to the build-up of financial imbalances and the development of bubbles in countries with weak fundamentals. In such cases, independent monetary policy would not be available to help adjustment after the bubble bursts.

Entering ERM2 is best when the Hungarian economy is surely on a stable, sustainable path. This has been our earlier view, and it has not changed in the wake of the crisis. Macroeconomic adjustment forced by the crisis brought formal fulfilment of the convergence criteria closer, but we are still uncertain about how long it will last. Tensions within EMU have shown that divergences could lead to serious macroeconomic difficulties, thus it is best to join when convergence is secured on a sustainable basis.

Uncertainty over the long-term growth potential and the equilibrium real exchange rate makes it harder to find a sustainable path for the economy. Some time may be needed to find the right exchange rate which would be appropriate as an ERM2 central parity. Although there may be a chance of realignment before finally joining monetary union, it is not optimal to count on a last time redefinition of the irrevocable exchange rate.

Recent developments within EMU are not encouraging for fast euro adoption. Last, but not least, recent developments within EMU are not very encouraging for our European partners to embrace countries with weak fundamentals and poor policy records.

Conclusion. To sum up, we believe that Hungary needs a stability-oriented economic policy following the first stage of crisis management. Steps taken towards restoring equilibrium and creating a sustainable macroeconomic path also facilitate meeting the convergence criteria required for the adoption of the euro. In terms of timing, we think that a credible target date for euro adoption may be set based on stable fundamentals, especially after clear results are attained in the fields of price stability and fiscal discipline. Determining the concrete schedule, including the date of ERM II accession, will be possible based on this credible target date.