

Post-Crisis Global Economy and the Convergence Process

András Simor

Magyar Nemzeti Bank

Brussels Economic Forum: „Strategies for a Post Crisis World: Enhancing European Growth”,

Section: „Coping with the crisis – how the world has changed”

25-26 May 2010, Brussels

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

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.

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.

Features of Hungary’s convergence pattern before the crisis

During the period before the crisis, the CEE countries, 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.

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.

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.

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

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.

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.

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.

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.

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.