András Simor: Anchor 2013

Speech by Mr András Simor, Governor of Magyar Nemzeti Bank (the central bank of Hungary), at the Anchor 2013 Conference, Budapest, 7 December 2012.

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Ladies and Gentlemen,

Two statements, three proposals: these will be the main points of my speech today. Let me begin with the first statement.

First statement: Predictability and stability are required for growth

Let us try to imagine that Hungary is a successful country once again. Admittedly, this is no easy feat as we enter the fifth year of the crisis. Still, let us toy with the idea. What does success mean in economic terms? It means at least three things. If you want to work, you can find a job. Your income increases. And last but not least, you need not worry about inflation, or your savings losing their value. In other words, success also requires price stability. Every country that we can consider as a model has price stability. Even where inflation is not on target at present, monetary policy has managed to create a persistently low inflationary environment, which ensures that the expectations of economic agents are well anchored.

Price stability is not the luxury of rich countries, it is a prerequisite for growth. Price stability is an indispensable component of a predictable economic environment where it is worth investing and creating jobs. When prices are stable, the highest rate of economic growth can be reached over the longer term, not only in developed countries but also in emerging ones.

However, in addition to price stability, growth also requires predictability in terms of laws, regulations, taxes, that is, the predictability and stability of the entire regulatory environment for businesses.

Second statement: Hungary has a severe growth problem, which cannot be remedied by fiscal and monetary stimulus. What is more, the recovery from the debt trap is hindered not only by the adverse international environment, but also by a complex crisis of confidence.

Hungary's potential growth already slowed down before the crisis, and the process of catching-up with the euro area halted close to a decade ago. Before the crisis, analysts mostly blamed the problem on the long-term unsustainability of the budget and the disincentives prevalent in the labour market. The tax wedge, which was excessively high compared with other countries of the region, the welfare benefits system, which was too generous for our level of development, and tax evasion due to the high tax rates all contributed to undermining Hungary's growth potential.

We have made significant progress towards a sustainable growth path since the outbreak of the crisis. The previous government already started to remedy the country's structural problems. The government currently in office also has as its priority removing the obstacles to improved economic performance, focusing on improving labour market incentives. We have made considerable achievements. The fiscal deficit has fallen to around 3% despite the crisis; banks have stopped lending in foreign currency; the country's current account has been in surplus for years. And external debt has also been declining gradually, albeit slowly.

Although the adjustment has required huge sacrifices, we have not reached the end of the road. We have not been able to place the economy on a balanced growth path, we have not become an attractive target for investments, we have been declining in the international competitiveness ranks, our credit rating is worse than it has been ever since the political transition and we have remained at the bottom of the regional league in terms of growth.

It is difficult to escape from this situation, because the unpredictability of future economic developments renders rational calculation nearly impossible. If we consider the future to be uncertain, we postpone major decisions with long-term effects until the fog lifts. This response, which is rational for the individual, leads to subdued consumption, postponed investments and jobs not created at the macroeconomic level. Without growth, debt reduction becomes an uphill struggle.

Today, the international and domestic uncertainties reinforce each other; we are living through a highly complex crisis of confidence.

In respect of the global economy, there is no proven recipe for stimulating the recovery of developed countries as they run out of ammunition for fiscal and monetary stabilisation and struggle with high debt.

In the past, the recovery of countries hit by debt crises typically occurred along an export-driven growth path, which was supported by a favourable international economic climate. In the current crisis, we have not been given such a forward escape route, due to the adverse external environment. Consequently, the time required for debt reduction is even more uncertain, along with the growth rate that the Hungarian economy can produce during that time.

Our future therefore is highly dependent on factors beyond our control. But we have to realise that small, open economies do not have any other option. At the same time, external market conditions are regularly turning out to be worse than expected, and this continuously increases the extent of adjustment expected from us. It is hardly surprising that weariness with this struggle creates an intense demand for, let us say, novel economic policy proposals which promise to painlessly set the economy on a growth path. However, ideas that do not pass the test of economic rationality are of no help. Indeed, they may actually make things worse by adding to the confusion. I am convinced that the only way to overcome the crisis is to do our utmost to reduce uncertainty, at least in the areas under our control and to create a predictable institutional environment. In the words of James Madison, 4th President of the United States: “It will be of little avail to the people, that the laws are made by men of their own choice, if the laws be so voluminous that they cannot be read, or so incoherent that they cannot be understood; if they be repealed or revised before they are promulgated, or undergo such incessant changes that no man, who knows what the law is to-day, can guess what it will be to-morrow.”

What are the potential building blocks of confidence and predictability?

- Fiscal consolidation must be made credible, and public debt must be set on a sustainably declining path. At the same time, the predictability of the legal and regulatory environment must be ensured.
- The operation of the financial intermediation system, which ensures the smooth operation of the economy, must be restored.
- Price stability must be achieved.

There is no chronological or preference order in the implementation of these three tasks. If we are to create a predictable economic environment, they need to be performed simultaneously and in combination with each other, rather than at one another’s expense.

First task: Stabilisation of the fiscal outlook

The crisis put an end to the excessive fiscal spending that characterised Hungarian economic policy in the first half of the 2000s. The narrowing of cheap funding opportunities necessitated the stabilisation of long-term fiscal prospects.

As a result of the adjustment measures adopted since 2006, the deficit has been reduced substantially, and several sub-systems of general government have undergone major structural changes. The systems for education, health care, welfare benefits and local governments have all been changed. These changes have led to an improvement in the balance in the short term, but their effects on fiscal sustainability will only be manifested in the longer term.

Since the onset of the crisis, fiscal tightening has faced strong headwinds. The fiscal room for manoeuvre of Hungarian governments has been continuously diminishing, and easy-to-play cards have become scarce. After the initial programmes based on expenditure cuts with significant immediate debt-reducing effects, revenue-increasing measures came to the fore. So, overall, tax centralisation has not been reduced, what happens is that some are paying less tax and others are paying more.

Furthermore, the improvement in the budget balance was not accompanied by greater long-term sustainability and the stabilisation of the economic policy outlook. As a result of the pressure from short-term deficit targets and excessive government optimism relating to the future, a number of temporary measures severely distorting economic activity have been implemented, postponing the reinforcement of a sustainable fiscal structure to a later date.

Another equally important problem is that the frequent changes in the regulatory environment and the windfall taxes have rendered all commercial calculations concerning the future uncertain, leading to a predictability chaos. It is hardly surprising that the fiscal easing financed from the nationalisation of pension funds did not yield the results hoped for. The deterioration in business prospects and, consequently, the postponement of investment plans was aggravated particularly by the measures affecting the banking system, which severely undermined the competitiveness of Hungarian financial institutions and the chances of banks in competing with their regional peers for the funds of their parent institutions. In turn, postponed investment plans and an unemployment rate stuck at a persistently high level have impaired the growth potential of the economy, and debt servicing has become an ever greater burden in a weak economy.

Thus today, despite the numerous painful measures and the few structural reforms which were actually implemented, we cannot claim to have anchored expectations relating to long-term fiscal developments. This is also supported by the fact that so far we have only managed to reduce our debt-to-GDP ratio by nationalising private pension fund assets, rather than by improving our economic performance.

Fiscal consolidation cannot be successful unless it creates a predictable environment and thereby promotes long-term growth. Instead of improvised temporary measures, government decisions should focus on gradual consolidation to set out a longer-term path. Improving the potential for growth hinges on the abolishment of the tax regime distorting investment and saving decisions, as well as on the creation of a regulatory environment which strengthens competition, creates a level playing field for competitors, restores legal certainty and assures legal guarantees.

Second task: Stop the decline in lending

The smooth operation of the financial intermediary system is indispensable for economic growth. Through the efficient allocation of savings and lending, the banking system maintains the circulatory system of the economy in good health. Currently, the Hungarian banking system fulfils this role only with severe limitations. Lending has been contracting continuously since the start of the crisis, and we are in the rear guard in the region in this respect as well.

In addition to the obvious decline in demand for credit, there are signs indicating that banks are also reluctant to lend or will only do so at a higher price and only to premium clients. Primarily, this is not due to tight liquidity or insufficient capital levels. The problem is that the ability of borrowers to repay their debts has worsened dramatically due to the deteriorating economic outlook. The marketability and value of collateral behind the defaulted portfolio is uncertain; the series of regulations and taxes introduced unexpectedly and without consultation undermines the best of business plans, and the government unpredictably but systematically takes away part of the income earned by the banks through the bank levy, the financial transaction tax or other means.

Unfortunately, given the impossibility of business planning and the highly uncertain profitability, it is a natural reaction if foreign shareholders decide to gradually downsize their operations in Hungary.

The retreat of parent banks may last for years. Make no mistake: owners may implement substantial capital increases where necessary, but they are not doing this to enhance the lending capacity of their subsidiaries. In this period, withdrawals of deposits by parent banks are several times higher than the amount of capital injections, which indicates that owners do not consider operations in Hungary to be a profitable business. In other words, the additional capital is needed only to maintain the stability of the system so that the downscaling or potential winding-down of operations can be conducted in an organised manner, without any major disturbances.

Furthermore, the reduced credit supply deepens the recession, which in turn increases the probability of corporate bankruptcies. The recession also erodes public revenues, and therefore the government seeks new revenue sources and finds some of them in the banking system which is already hit by its deteriorating loan portfolio. Thus, the government's policy exacerbates the recession by causing an even deeper decline in lending and investment. However, the price of this economic policy is eventually paid by us all, through unrealised job opportunities and falling income levels.

The behaviour and expectations of the government, banks, businesses and households all have an influence on one another. Still, there is only one participant that is sufficiently large and has the coordination potential to break the negative spiral: the government itself. Individual banks by themselves are unable to do this; even if any of them started lending, it would have no noticeable effect at the macroeconomic level. The government, on the other hand, might be able to provide incentives to the banking sector to boost lending by reducing and stabilising the burdens on the banking system and making the regulatory environment more predictable, which could eventually place the system onto an equilibrium path. Consequently, a "compromise" is called for between the government and banks, or else we cannot expect lasting growth to emerge. And the first move must be made by the stronger player by restoring the climate of trust.

And finally, the third task: the central bank must achieve price stability

Similarly to other public entities, pro-growth monetary policy also needs to play its part in creating a predictable environment with the lowest possible risk level for economic agents. The central bank can contribute to this most efficiently by achieving price stability. This is also a precondition for reducing long-term interest rates and avoiding excessive exchange rate volatility.

What does a central bank need to do to create price stability? Over the past two decades, price stability has been achieved in almost all developed countries and a number of less developed ones. The experience of these countries shows that the most important element of success is the transparent and systematic operation of the central bank. Inflation expectations become anchored, that is, lasting price stability and monetary policy itself become credible, if the central bank clearly states its inflation target, and economic agents see that the central bank will act to curb any developments threatening to result in a persistent deviation from that target.

This conduct is greatly facilitated by a supportive fiscal policy. Expectations of exchange rate devaluation due to the increasing fiscal imbalance and the expected adjustment measures, unknown as yet in every detail, can unsettle inflation expectations despite the best efforts of the central bank, and thus offsetting inflationary shocks may cause an output loss. It is no accident that in most countries the adoption of inflation targeting coincided with the strengthening of fiscal discipline or the compliant nature of fiscal policy. In Hungary, ever since the introduction of inflation targeting in 2001, the central bank has unfortunately had to work against a headwind in its effort to achieve its statutory objective of price stability, against a backdrop of fiscal policy which fuelled inflation with various measures, under each government, without exception. This has had a grave effect on the effectiveness of our work.

Globally, inflation targeting passed the test of the crisis with flying colours

Positive experiences contributed to the decision of several countries to adopt inflation targeting during the crisis, and the Bank of Japan and the US Federal Reserve also decided to introduce explicit inflation targets. Thus, the operation of the central banks in these developed countries came very close to the practices of inflation targeting countries.

The lessons learned during the crisis underlined the importance of anchoring inflation expectations and creating price stability. On the other hand, the crisis refined and expanded thinking about the mandates of monetary policy. In addition to traditional tools, the central bank can contribute to economic stability by macroprudential regulation affecting the systemic behaviour of banks during periods of expansion, by providing liquidity and supporting inadequately functioning market segments or by using other unconventional instruments in times of economic downturn.

The macroprudential and monetary policy functions coexist peacefully. Macroprudential instruments assist and promote monetary policy by restraining credit booms, real estate and exchange rate bubbles and overheating, while monetary policy keeps price stability in focus. The central bank's work, supplemented by these new instruments, may become more efficient in stabilising economic fluctuations as well.

And what about Hungary?

Since 2001, the Central Bank Act has required the MNB to achieve and maintain price stability. That is when the elements of inflation targeting started to appear in monetary policy. However, delivering on the price stability mandate has been hindered by obstacles throughout most of the ensuing period. Prior to the spring of 2008, the central bank had to follow a dual objective of the inflation rate and the nominal exchange rate, and was only able to react to inflation developments within the constraints of the exchange rate band. The dual objective of the central bank and the frequent conflicts between these targets compromised the efficiency of monetary policy. The dual objective was abandoned in 2008; since then, the MNB has worked within the framework of an inflation targeting regime. It strives to stabilise inflation expectations at a level consistent with the 3% target.

2008 was the year when the crisis began, and since then the central bank has had to face exceptional challenges. In a period of extremely volatile capital flows, monetary policy has given priority to safeguarding the financing of the economy. Along with interest rate policy, the MNB has employed a number of unconventional instruments to restore the efficient operation of money markets as soon as possible. After the acute stage those risks abated, even though the high level of debt and the volatile risk environment continues to demand great care in the implementation of monetary policy. On the other hand, the decisions of the central bank may gradually return to normal, as inflation and growth prospects come into focus again.

What are the current dilemmas of monetary policy?

At the beginning of the crisis, we saw that the protracted recession upset all of the price and wage-setting routines that had led to the stubborn inflation of previous years. Disregarding the effects of tax increases and commodity prices, Hungary has as low rate of inflation as its neighbours. Price stability, however, is not merely a question of the level of inflation today; rather, it depends on what economic agents think about future inflation. Even though demand continues to be subdued, we think that the disciplined price and wage-setting behaviour which the private sector has exhibited in the past two or three years is beginning to loosen up, and analysts' longer-term inflation expectations have also risen. It is to be feared that – as a result of the repeated additional price rises due to a sequence of tax measures, rising commodity prices and soaring food prices – economic agents will consider an inflation rate considerably above the target to be normal. In such a situation, it is very difficult to assess the level at which inflation will settle when the extra price increase generated by the government no longer has an effect. The various answers to this question also contribute to the division in the Monetary Council. In my opinion, when inflation expectations, i.e. the longer-term inflation outlook, become uncertain, the central bank should act much more firmly to keep price and wage-setting behaviour disciplined.

Why is price stability important now?

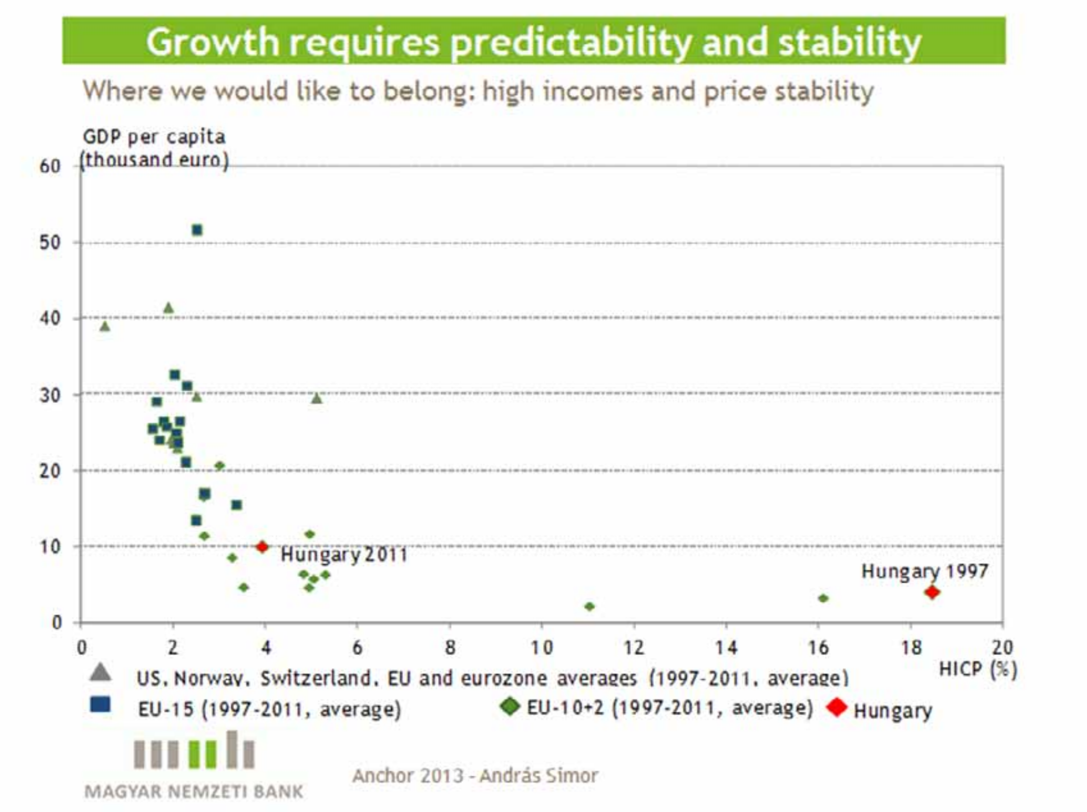
Some think that – regardless of the answer to the question of whether the high inflation will "fall or stick" – the central bank must abandon its rigid stance and give priority to growth. This is a peculiar idea in a country where economic policy in the past two decades has always seen the solution in inflating away macroeconomic problems, without any tangible improvement in growth, I might add. Indeed, we had to learn the hard way that even though leniency on inflation may appear attractive in the short term, it has never produced any welfare gain. By contrast, our neighbours – who have created price stability with consistent and tight monetary policy and a supportive fiscal policy – are leaving us behind one after the other.

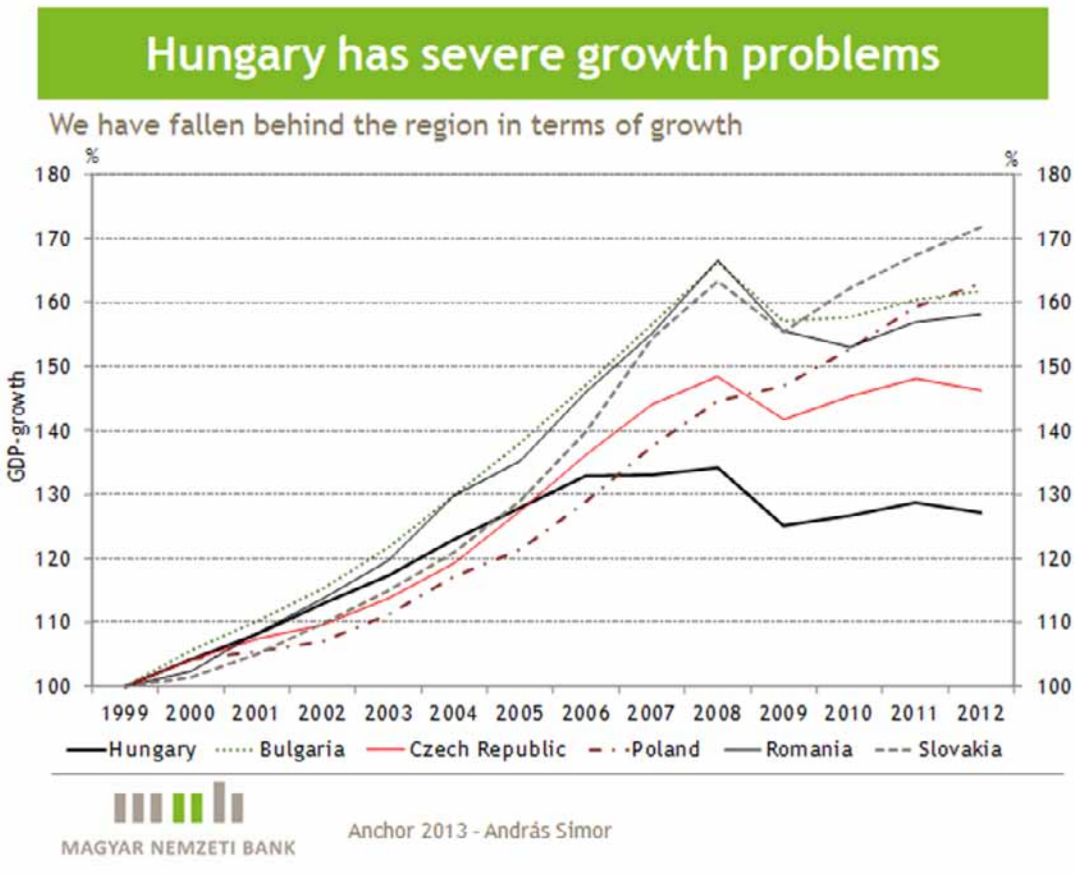
Despite these bitter experiences, some schools of economic thought still stubbornly insist that there is a trade-off between inflation and growth. Unfortunately, this is true only in one direction: overcoming inflation inertia may indeed demand substantial real economic sacrifice in a country accustomed to inflation, but no country has managed to produce any lasting growth surplus by letting inflation loose. Otherwise the countries of Europe and North America that maintain price stability would not be the wealthiest in the world and developing countries with a low inflation environment would not be the fastest in catching up. Because as soon as it becomes clear that the central bank wants to achieve higher growth by letting inflation loose, this is incorporated into the exchange rate, price and wage decisions, which in turn leads to higher interest rates in the market. Thus, monetary conditions are not effectively relaxed: we just end up in a situation that is much less predictable and much worse for growth. Consequently, monetary policy can stimulate growth only as long as it is certain not to jeopardise price stability.

International experience shows that inflation targeting is an appropriate framework – in my opinion the most appropriate one in the case of Hungary – for anchoring inflation expectations and achieving price stability. I hope that after so many dead ends and blind alleys, Hungarian economic policy will strengthen its commitment to macroeconomic stability. If fiscal policy is placed on predictable foundations, inflation targeting can be efficient in Hungary as well. The institutional framework is there.

The Hungarian economy is still characterised by deficit. Unlike in the previous period, today the primary problem is not the fiscal deficit, but rather a lack of confidence. The solution is not easy, but it is possible to find. If the lack of confidence can be addressed in the economy, fast, spectacular results would follow. To this end, we need to consult course books on economics, adapt the experiences of successful countries to the circumstances of Hungary, bring common sense back into economic policy, achieve a sustained reduction in government debt, boost the incentive for banks to lend and, *ceterum censeo*, deliver price stability.

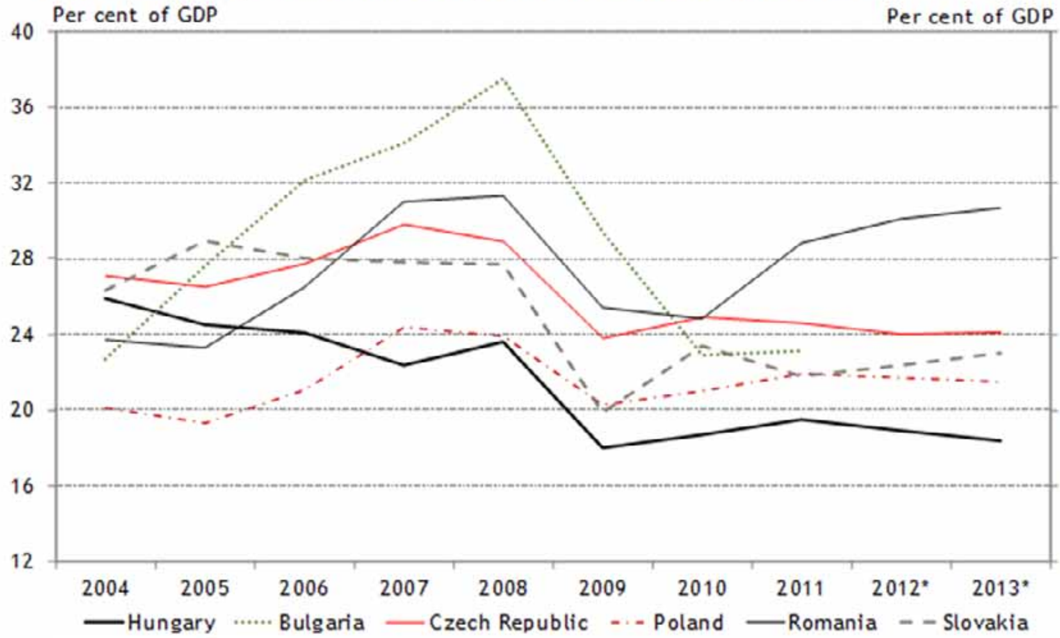
Stability, predictability and confidence: these are the best tools available to stimulate growth.





Hungary has severe growth problems

Low and falling investment rate points to structural problems



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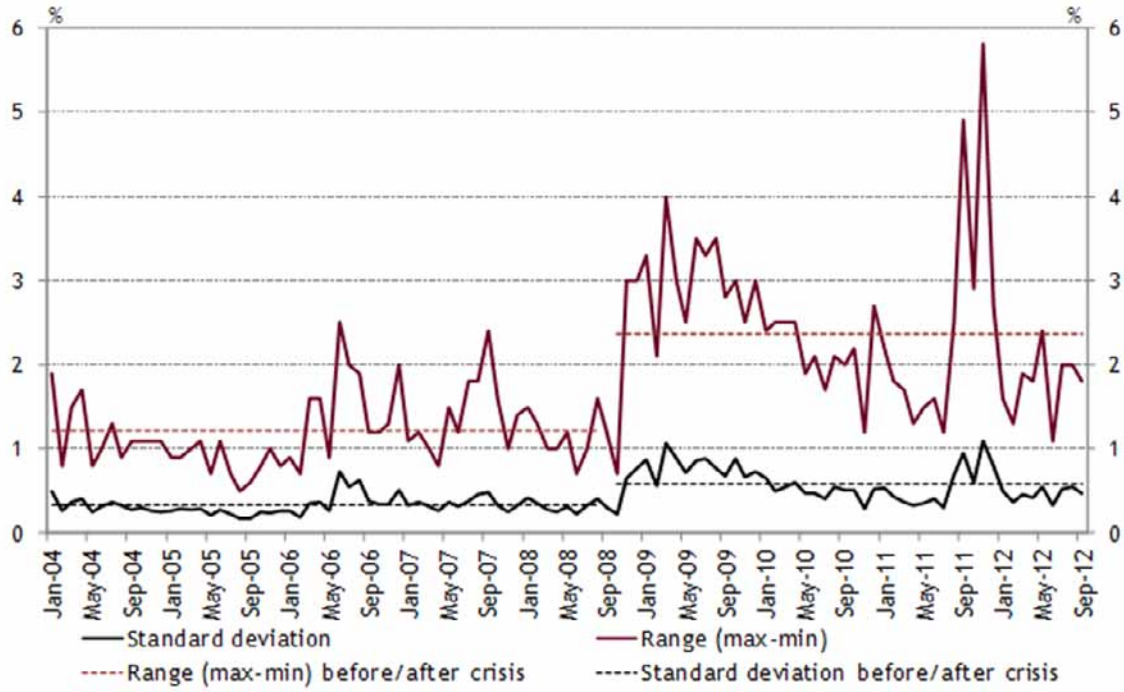
Note: Values as a proportion of GDP

We have been in a complex crisis of confidence

Uncertainty of analysts' forecasts for ***growth*** is increasing



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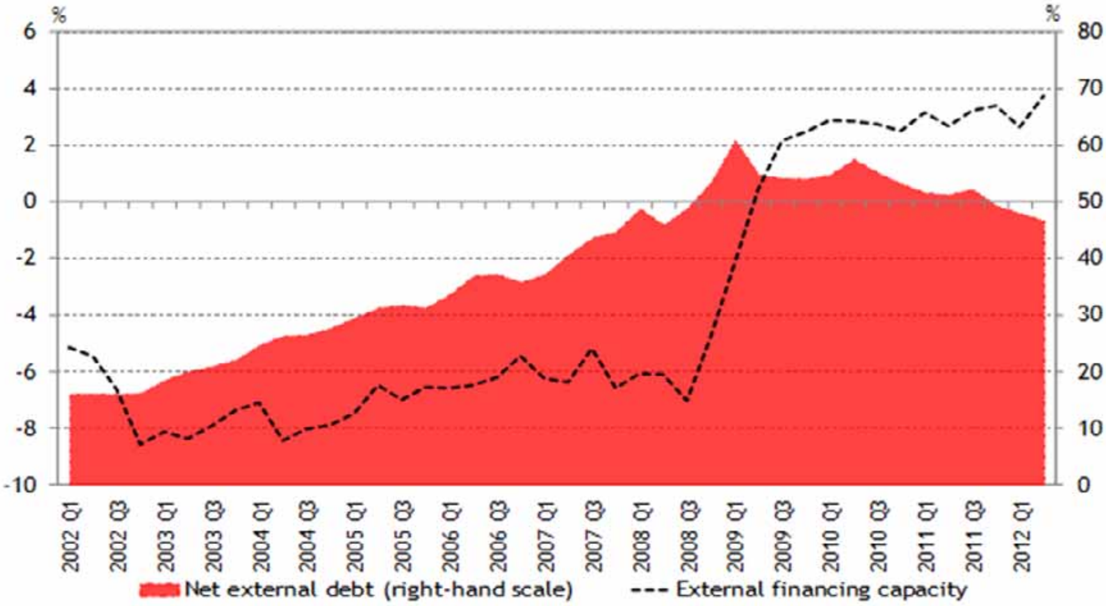
Note: Analysts' expectations two years ahead; Reuters poll

Hungarian economy is undergoing a major adjustment process

Significant improvement in current indicators, but the slow decline in debt continues cause vulnerabilities



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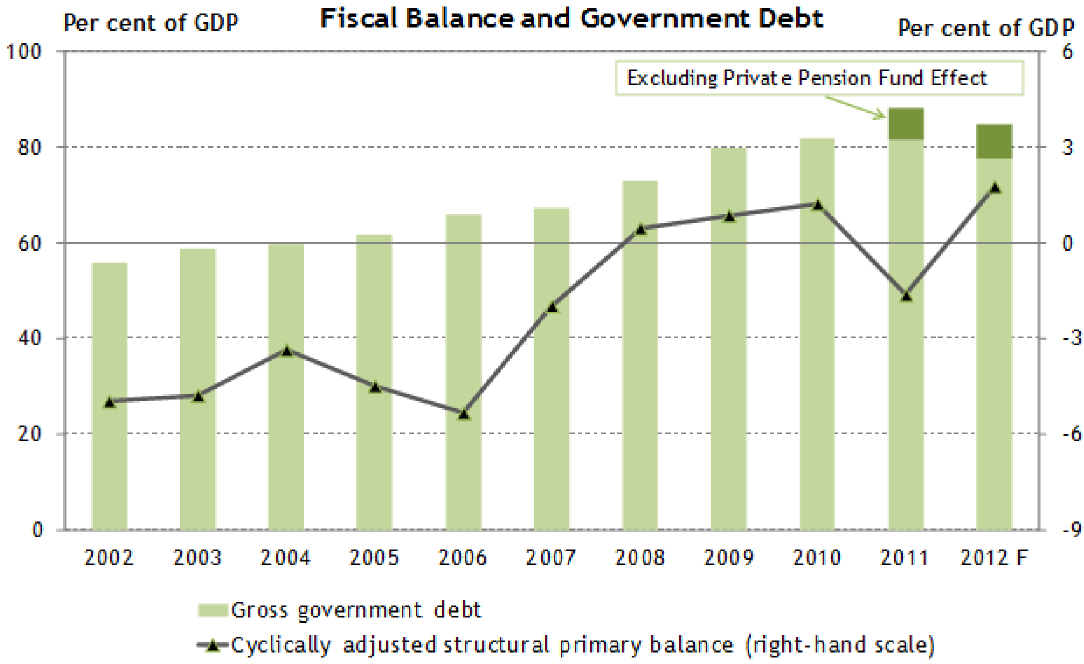
Decline in government debt is attributable to the takeover of private pension fund assets…



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Note: The amount of pension fund assets used to reduce debt has been taken into account.

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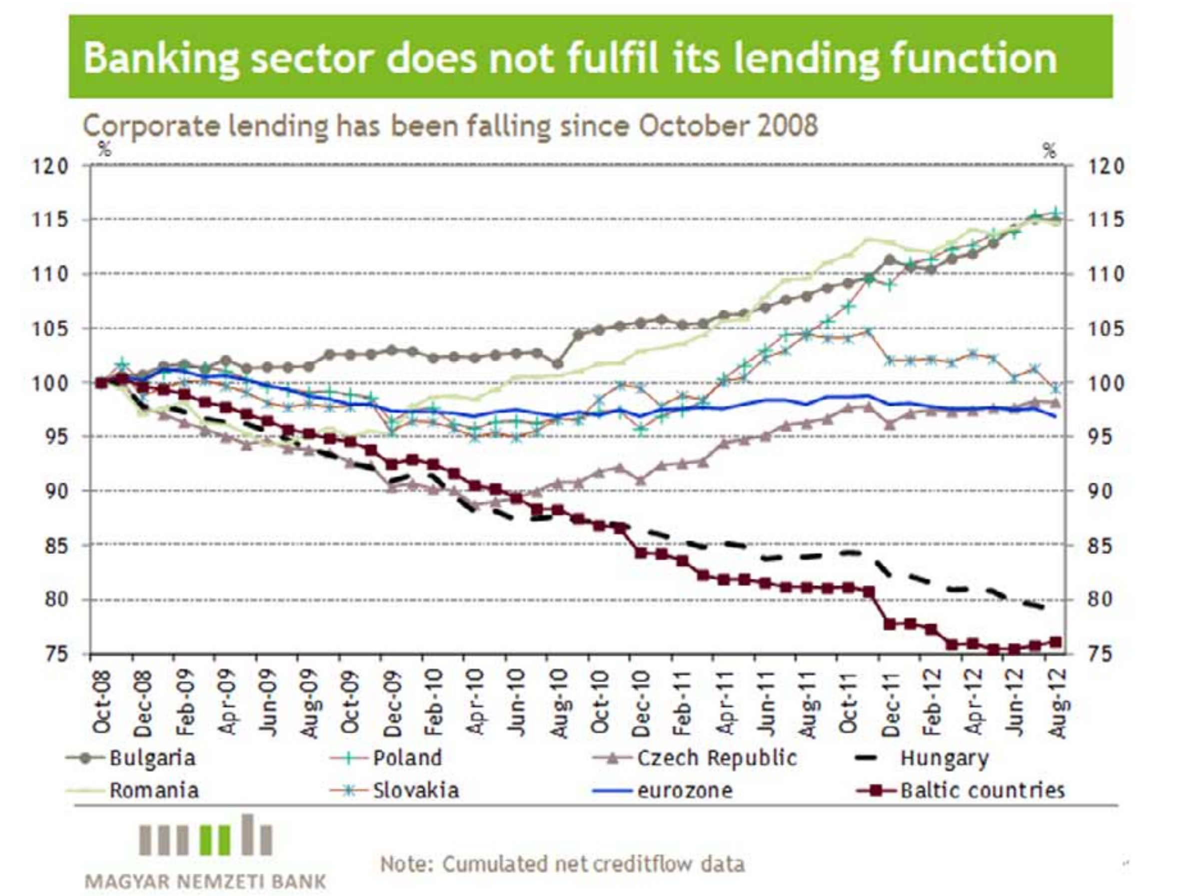
Banking sector does not fulfil its lending function
Corporate lending has been falling since October 2008
%
%
120
115
110
105
100
95
90
85
80
75
Oct-08
Dec-08
Feb-09
Apr-09
Jun-09
Aug-09
Oct-09
Dec-09
Feb-10
Apr-10
Jun-10
Aug-10
Oct-10
Dec-10
Feb-11
Apr-11
Jun-11
Aug-11
Oct-11
Dec-11
Feb-12
Apr-12
Jun-12
Aug-12
Bulgaria
Poland
Czech Republic
Hungary
Romania
Slovakia
eurozone
Baltic countries
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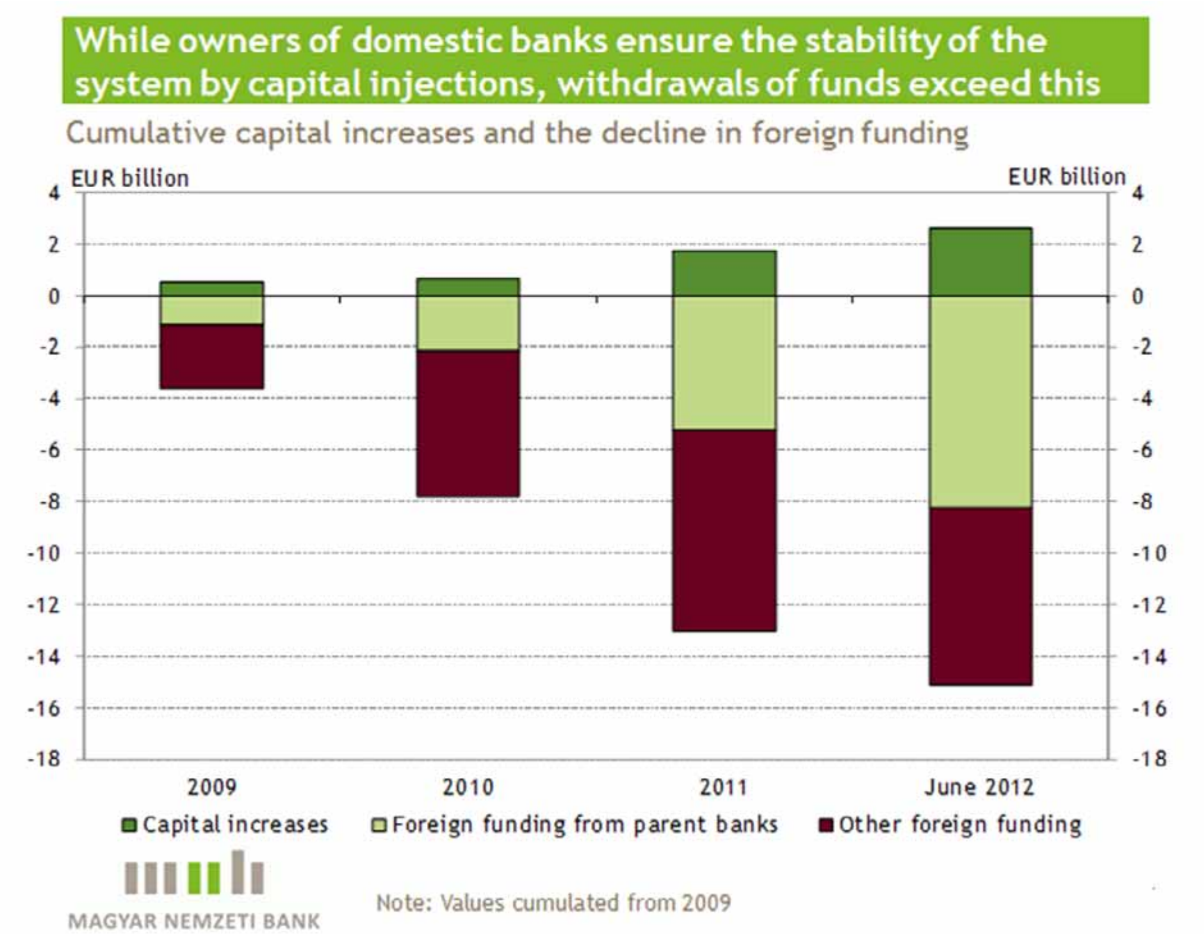
Note: Cumulated net creditflow data


While owners of domestic banks ensure the stability of the system by capital injections, withdrawals of funds exceed this
Cumulative capital increases and the decline in foreign funding
EUR billion
EUR billion
4
2
0
-2
-4
-6
-8
-10
-12
-14
-16
-18
2009
2010
2011
June 2012
Capital increases
Foreign funding from parent banks
Other foreign funding
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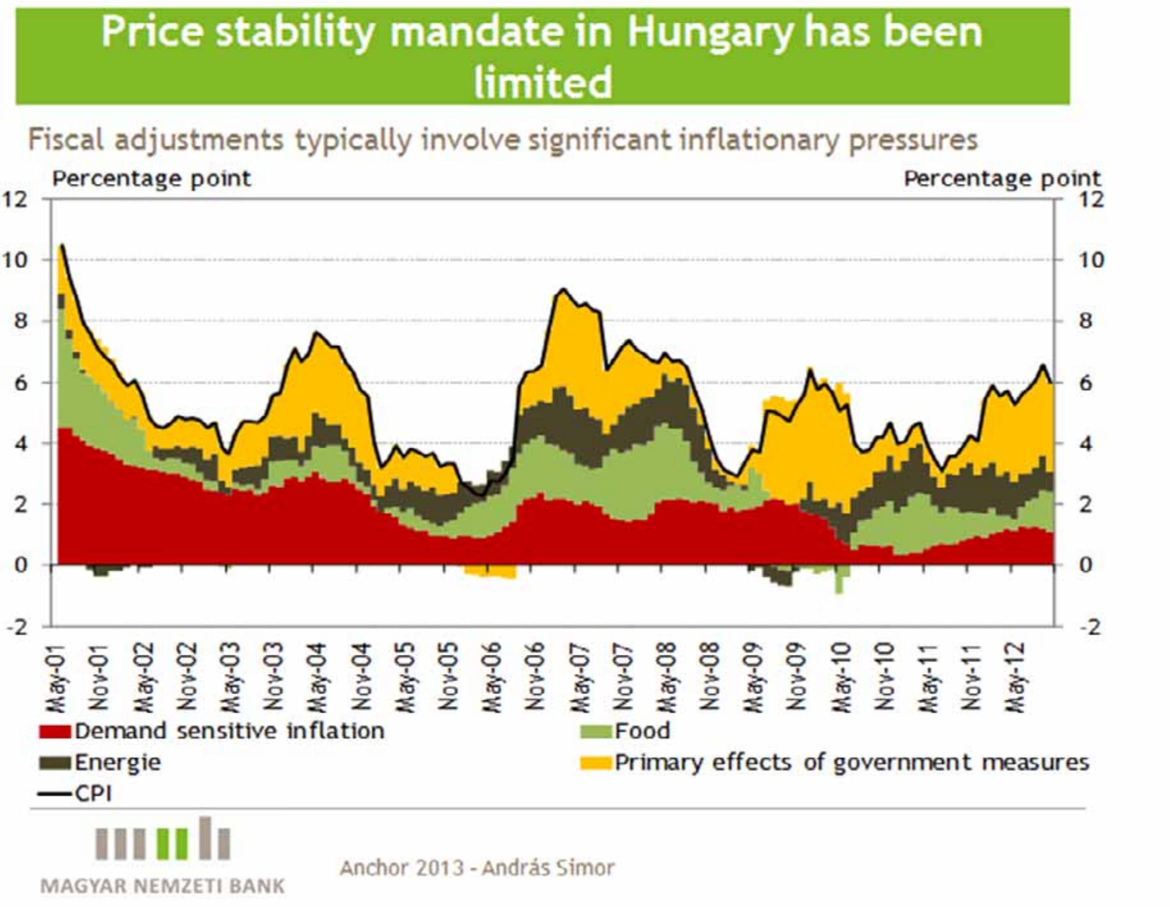
Note: Values cumulated from 2009


Price stability mandate in Hungary has been limited
Fiscal adjustments typically involve significant inflationary pressures
Percentage point
Percentage point
Demand sensitive inflation
Food
Energie
Primary effects of government measures
CPI
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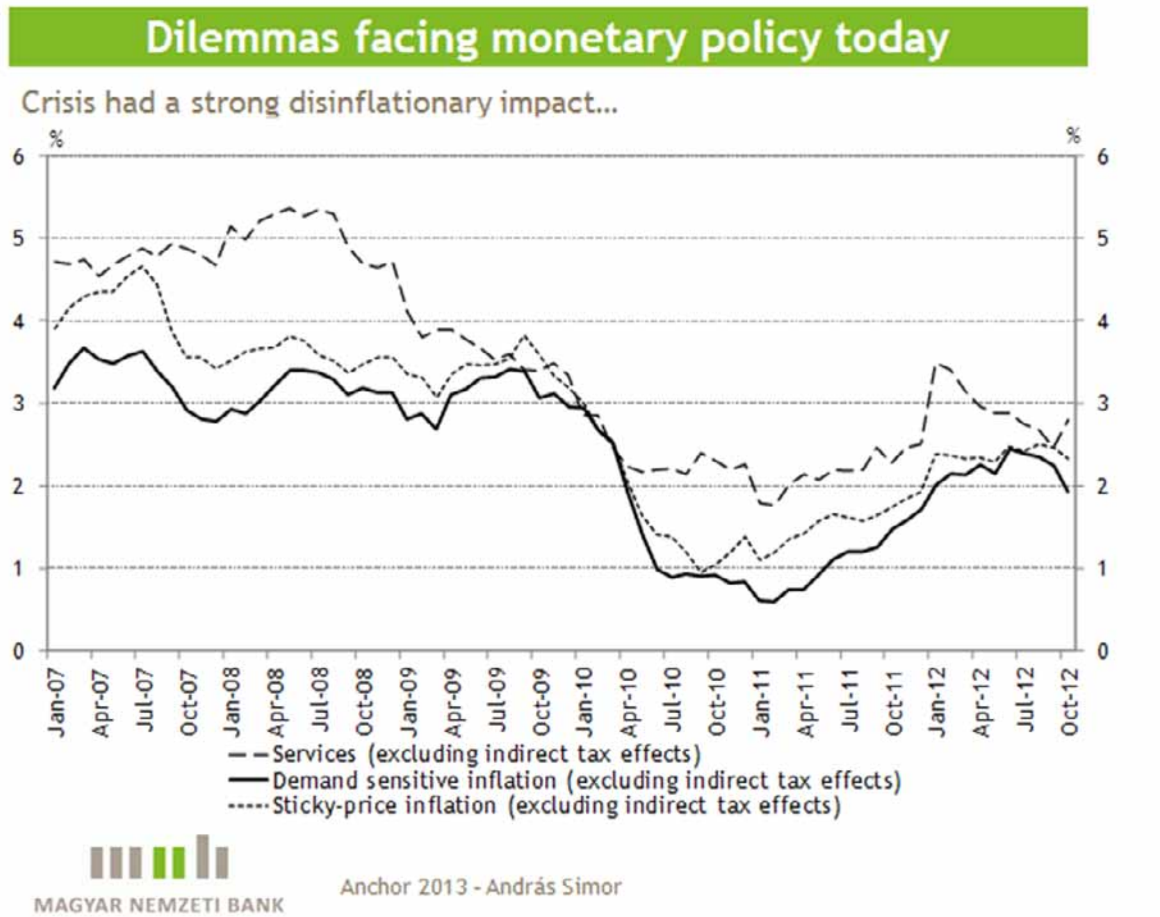
Dilemmas facing monetary policy today
Crisis had a strong disinflationary impact...
%
%
Services (excluding indirect tax effects)
Demand sensitive inflation (excluding indirect tax effects)
Sticky-price inflation (excluding indirect tax effects)
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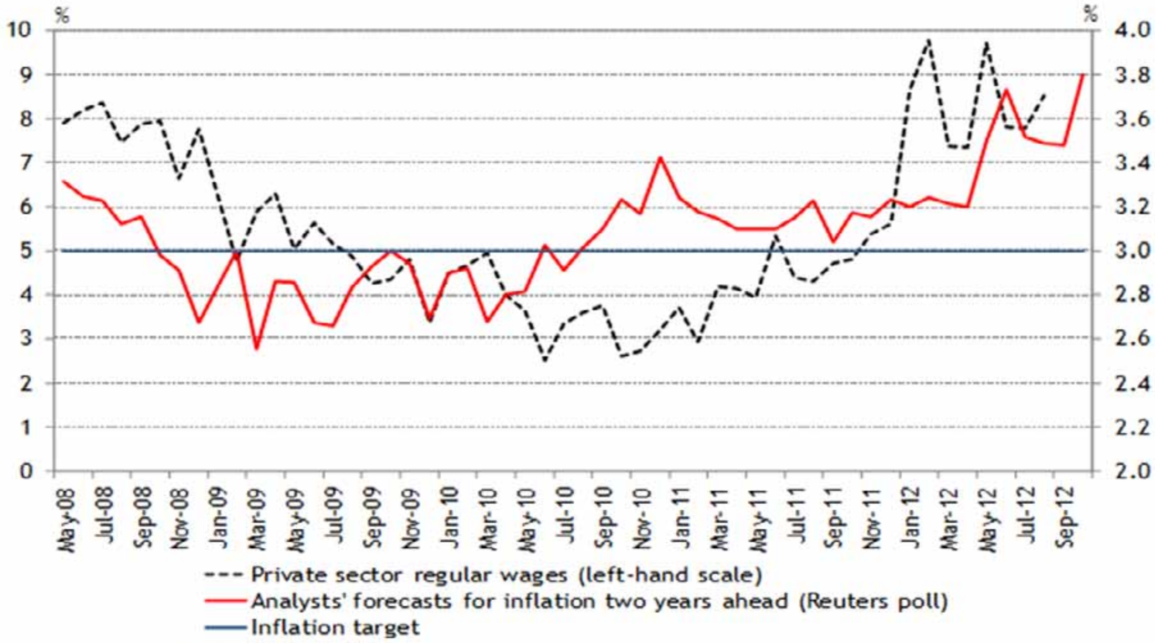
Dilemmas facing monetary policy today

... but we cannot stay at rest, as it is questionable whether inflation expectations are well anchored



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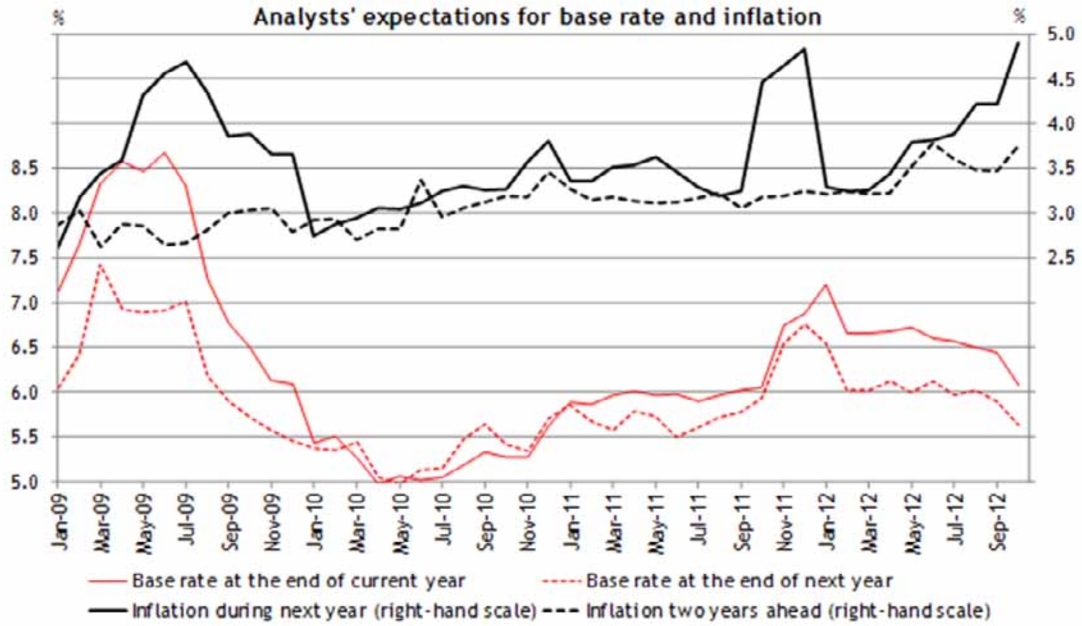
Dilemmas facing monetary policy today

Intensifying expectations of interest rate cuts have been coupled with a rise in inflation expectations



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