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THE MAIN OBJECTIVE: LASTING GROWTH

**The Hungarian central bank, says János Kornai, is on the wrong track
if it one-sidedly tries to curb inflation**

Lasting growth is the main purpose behind economic policy. It is not permissible to force growth in ways that overbalance the economy, or try to accelerate growth by stimulating domestic demand at the cost of deterioration in the export performance and the balance of payments. Equally damaging is a unilaterally monetarist policy of seeking to curb inflation at any price, because that can entail unacceptable sacrifices of growth. That is how Professor János Kornai, an economist who commands great respect all over the world, evaluates the situation in the Hungarian economy.

There have been some stormy events in the financial world in the last few days. What are the factors in terms of which you would explain the build-up of strong speculation against the forint?

Before I can answer that question, we will have to consider the economic situation. How do we stand at the turn of 2002 and 2003? What economic policy would I consider appropriate to this situation? I would like to relate the events of the last couple of weeks to that.

There are some notably favourable features in the way the economy is developing. Let me pick out just one of them: the considerable fall in the inflation rate. The annual rate of inflation in 2001 was 9.2 per cent, while last year it was only 5.3 per cent. There are both external and internal effects reflected in this achievement.

Distortions

More and more people have been expressing the opinion that the structure of growth is becoming distorted.

Yes, there certainly have appeared some disquieting phenomena, some unfavourable tendencies that could cause serious problems in the medium and long term. The rate of growth is falling: it was 5.2 per cent in 2000, 3.8 per cent in 2001, and according to the most recent calculations, 3.3 per cent in 2002. That is no mean achievement either, because it appreciably exceeds the average for the Euro region. Growth is being curbed because the awaited recovery has not occurred in the world economy, including our main markets, and signs of recession or stagnation have appeared instead. But

contributions to the slowdown have come from internal effects as well, to which we will return later when discussing investment.

The composition of GDP absorption has deteriorated. It is especially important for macroeconomists to focus their attention on the ratio of investment to consumption. There has been a noticeable shift in this, to the detriment of investment. A particularly damaging aspect is that investment by companies has declined considerably. Another unfavourable tendency is that the savings rate has fallen.

The purchasing power of the population, the household sphere, has run away. Wages have not simply increased, but jumped in the last year and a half to two years. Precisely at this juncture, parallel with the rapid rise in nominal wages, consumer credit has begun to expand. That is not a mistake in itself, for widespread consumer credit is part of the normal functioning of a market economy, but this expansion is happening at a bad moment in our case because it is coinciding with wages increasing to an economically unjustified extent. Part of the problem with individual demand is a dizzying expansion in credit for housing purchases. Here too, the same problem applies that I mentioned just now with consumer credit. In itself, there is good reason, in the financing of housing construction, to have a marked shift in the ratio of prior savings to credit, in favour of the latter. Except that the shift is occurring at a bad time. The stock of housing credit is expanding too fast and the credit conditions are too lax.

One of the gravest problems is that the budget deficit last year was extremely high, unacceptably great.

Hungarian exports face serious difficulties. The situation of small and medium-sized firms seeking to export has worsened especially.

The most important indicator is the deteriorating trend in the balance on the current account, where according to the latest estimates, the deficit in 2002 was about 6 per cent in relation to GDP. Although there are no binding rules, there is a general rule of thumb in macroeconomics: the red light goes on if this indicator climbs above 5 per cent. Taking all these negative aspects together, the general picture is clear: Hungary has forsaken the export-led, sustainable growth path that allows external and internal equilibria to be maintained. There are dangers threatening both the external and the internal equilibria. That is the main problem. That general picture has to be the starting point for a deeper analysis.

Statements from the National Bank of Hungary keep emphasizing that the central bank has the task of curbing inflation.

That is a one-sided approach. Let us disregard the National Bank for a moment and discuss the question more generally. The main aim of economic policy as a whole is lasting growth. That is the most comprehensive goal. When I wrote a series of articles for the *Népszabadság* in 1994 about the heightening macroeconomic tensions and the economic policy around that time, I gave it the title, ‘The most important thing: lasting growth’. That is the most important notion now as well, because governments and finance ministers and National Bank presidents may come and go, but the main purpose of economic policy remains, once and for all and invariably, to promote lasting growth. That and only that permits development, constant technical renewal, rising living standards, amelioration of injustice in income distribution, employment growth, development of backward regions and sectors, support for education, science and the arts, and development of health care. Amidst lasting growth, all problems can be resolved eventually without creating new ones. Under conditions of stagnation or recession, on the other hand, the situation of one segment can be improved only at the expense of another segment. Lasting growth cannot be an idea we sometimes pick up because it is politically popular and sometimes drop again in favour of emphasizing something else. It is the main overall purpose invariably and at all times.

Each player has his own task. Not just the National Bank, but the environmental authority or the agriculture ministry as well. But none of these can say it is just interested in the environment or just concerned with agriculture and intends to subordinate the general task to its own, narrower sphere of interest. No one institution or authority has the right to place its task so much to the fore as to endanger the performance of the main, general task.

So lasting growth remains the most important criterion.

All partial aims and all conditions impeding economic policy are subordinate to the main aim of lasting growth. Of these, I would like to emphasize the requirements of equilibrium. Alongside the word ‘growth’ in the main objective I have identified is the epithet ‘lasting’. It is impermissible to force growth to such an extent that the balance of the economy is upset. The distorted ‘Hungarian model’ (or the populist economic policy, to use the more apt, internationally recognised term) in which an attempt is made to maintain or accelerate growth by stimulating domestic demand, while export performance and the balance of payments deteriorate, is undermining precisely what makes growth sustainable. The inordinately monetarist economic policy of extreme conservatives, seeking to

speed up disinflation at any cost, can cause unacceptable sacrifice of growth. Macroeconomic policy is a science (and an art) that entails constantly reconciling competing partial assignments: going for growth, raising living standards, reducing inflation, improving the situation on foreign markets—and doing so in such a way that these are subordinated to the requirements of the great general objective of sustainable growth.

Unfounded accusations

The National Bank and the parliamentary opposition are accusing the government of trying to speed up inflation.

It is not a real professional argument, just an unfounded accusation to say that everyone who fails to subordinate everything to reducing inflation at a forced pace ‘wants inflation.’ That statement has indeed been heard several times. Of course, there cannot be any question of that. Sober economic analysis involves weighing several requirements at once, with a prominent place among them going to the task of slowing inflation. The intention is to arrive at the most favourable possible combination of these requirements, in which all of them are subordinated to a common main purpose, the underlying requirement of lasting growth.

But the law on the central bank states in so many words that the prime objective of the National Bank of Hungary is to arrive at and maintain price stability. The bank points to this when insisting on a strong forint.

I have two comments to make. You cannot state in every law that lays down the rights and duties of an institution that it should also consider the general objective. That it should do so is self-evident. And it is self-evident particularly in the case of a body that economists have to govern.

But let us stay with the letter of the law. This refers to price stability, with a justified degree of generality. One of the damaging effects of a faulty monetary policy is that it undermines stability. The following secondary effects come into operation.

One of the causes of the macroeconomic tensions is the budget deficit. The budget is the responsibility in the first place of the government and Parliament. But the central bank is not a passive onlooker in the fiscal game. Under the monetary policy followed hitherto, growth has been impeded by too high a rate of interest and an overvalued forint. Now the volume of budget revenues largely depends on the growth. Under a given taxation system and level of fiscal discipline, higher growth will mean greater revenues and lower growth smaller revenues. If interest rates are too high, that places a greater burden on the budget, which contributes again to the budget deficit. You cannot

criticize the high budget deficit as an outsider, so to speak, while simultaneously ruining the chances of reducing it.

One of the most important conditions for lasting maintenance of price stability is to secure the external equilibrium of the economy. If that is upset, it can usually be righted again only by measures involving a jump in the price level. There are many scenarios for crisis and stabilization, but almost every one of them shares the feature that a serious deterioration in the balance of payments is followed by drastic devaluation, either executed preventively by the government and the central bank, or prompted spontaneously on the markets. Now the trauma of a big devaluation is followed inescapably by a jump in domestic prices. Such a sequence of events cannot be allowed to ensue—that is a fundamental part of the requirement of price stability. And it follows directly from this line of argument that the National Bank is not just responsible for decimal points in the domestic inflation rate. It also has a legally defined responsibility for the present and future development of the balance of payments. If there is trouble with the balance of payments, the National Bank cannot point accusingly at anyone else, for according to the letter and spirit of the law on the central bank, it bears full responsibility for it along with the government and other institutions.

A succession of mistakes

What conclusions could be drawn from analysing monetary policy from this point of view?

Unfortunately, it has to be concluded that a succession of mistakes has been made. The analysis can be made from two points of view. One is to say what effect the monetary policy has had on the speculation activity in the short term. This has largely been the focus of press attention in recent weeks. The other, more important aspect is what effect the monetary policy has had on exports and the current account, and on achieving the main objective of lasting growth. I will take in turn all the things that I for one consider a mistake.

It was a mistake to leave the widening of the exchange-rate band too late. The National Bank put forward a proposal much earlier for widening the band, at a juncture when the external and internal conditions for doing so were exceptionally favourable. The proposal was blocked by the government of the day and its finance minister, Zsigmond Járαι. When the same government and the National Bank, now chaired by Zsigmond Járαι, decided to make the change after all, both the external and internal conditions for doing so were far less favourable.

It was a mistake to fail to combine the widening of the band with a drop in the interest rates. That

would immediately have sent a message to potential foreign investors that the Hungarian financial market was not going to be a paradise for speculative capital. Failing to do and obstinately sticking to the high interest rates was a veritable invitation to an influx of speculative capital. It is grotesque to be celebrating as an act of heroism success in beating back a speculative attack for which the monetary policy-makers had left the door wide open, so positively inciting it.

It was a mistake to allow the exchange rate to go to the edge of the band. Appreciation to some extent was to be expected, indeed not just to be expected, but economically justified and even desirable. But the appreciation that occurred went beyond the proportions justified at present. What would the justified extent be? There is no ready-made mathematical formula for that. On one occasion, I asked Stanley Fischer, one of the most famous exponents of theoretical macroeconomics working with mathematical models, who had spent many years as a senior economist and director with the IMF, whether some numerical formula could be found to decide a suitable rate of exchange. He replied that he did not think it was possible. The most important thing was to observe the balance on the current account. If the trend in that was unfavourable, if there was a threatening increase in the deficit, it almost certainly indicated that there was a problem with the exchange rate. Now the uneasy feeling caused by the deficit of the current account prompts me to say that there is trouble with the exchange rate. It seems to be too high and it should not have been allowed to reach the edge of its band. I cannot give an accurate figure, but the correct position would be somewhere halfway between the middle of the band and the edge.

One essential element in central-bank policy everywhere is communication. It is not immaterial what message the bank leadership sends to the market.

That is right. And I would continue the list of mistakes with that one. It was a mistake for the leadership of the National Bank to issue a succession of self-confident, but untenable statements. The kind of conversation we are having now is not a suitable occasion for presenting the reader with quotations in chronological order. However, it can be said that serious damage is caused to the prestige and credibility of the central bank and its monetary policy if its president announces to the public in the afternoon that he is not prepared to alter the interest rate, then a few hours later, the central bank reduces it by one percentage point, and a day later, a second reduction of the same magnitude is made. The possibility cannot be excluded (although it is by no means certain) that the central bank 'made a profit' on its clever rebuttal of the speculative attack. The trouble is that a country's central bank is not a profit-maximizing enterprise. If it were, it would be able to do some

wonderful deals with the ‘insider information’ available to it! The most important gold reserve the central bank holds is its credibility. In the past, the presidents of the bank and the members of the collective bodies responsible for monetary policy showed great self-discipline in the most difficult hours, reinforcing the bank’s credibility with fair and moderate statements. The main damage that the successive mistakes of monetary policy have caused cannot be measured in forints or euros, or the figures available at a given moment. The main damage has been undermining its credibility and weakening confidence in its competence and cool professional expertise.

And here I would like to say a word about the speculative attack itself. Its occurrence could be predicted by any expert. The most that could not be forecast was the day and time on which it would begin. Some emphatic warnings were given, not least in the columns of the *Népszabadság*, but all in vain. I can say it was a depressing feeling for me and many colleagues of mine to see this coming and to watch helplessly as the event happened.

The position of the budget

The National Bank argued throughout that fiscal policy was loose and wages were running away. Restrictive conduct was compulsory for monetary policy-makers in that situation.

It would be wrong to dismiss this argument out of hand. As I mentioned earlier, there are grave and disquieting aspects of both these phenomena. Let me begin with wages. All those whose earnings have risen feel, justly, that they deserved their pay increase. For several groups, the adjustment should have been done a very long time ago. Nonetheless, economists are obliged to add up the combined effect of all the pay increases. The result is that real wages rose by 14 per cent, while productivity rose by only 3.5 per cent. This is economically impermissible. This year again, a pay increase is predicted that will exceed the increase in productivity. This in itself will disturb the equilibrium. The last government tried to conceal part of the budget deficit in 2002 by seeking to account for some big items of spending ‘outside the budget’. The new financial regime, as good bookkeepers, have placed these items back in the budget system, which increased the deficit by a good few percentage points. Such ‘trick solutions’ will not occur again, let us hope, and we can expect that some of the significant items behind the leap in the deficit last year will not recur. But still, the deficit planned for this year is still quite high. The budget targets seem to be tight. There are expert debates going on about how to calculate certain items of revenue, which could in themselves produce an error of one or two percentage points. However, I see the main uncertainty not in that debate, but in the relation between

revenue and GDP. If the growth is as much as the compilers of the budget expect or more than that, we may not find there is unpleasant surprise on the revenue side. On the other hand, if the growth turns out to be less, the fiscal policy-makers will have to cope with greater problems than they expected. It would be reassuring if the budget possessed greater internal reserves, in other words, if it had been bolder and stricter on the expenditure side.

Can there be a material change in the budget situation without real reforms?

Going beyond the budget for 2003, much greater effort needs to go into deeper fiscal reforms and the kind of structural changes that have fiscal effects. There was a noticeably favourable trend in the ratio of government expenditure to GDP, right up to 2000. To put it concisely, the economic weight of the state was decreasing within an expanding economy. That favourable trend has not just ended, it has been reversed. It is an urgent task to ensure a return to the earlier, favourable trend of reducing the ratio of government expenditure to GDP. One illustration of this, and a serious problem in itself, is housing policy. In a market economy based on private property, movements in housing construction, purchases and sales depend basically on market forces. It is right that the state plays a part, for instance by providing the legal foundations for housing loans and ensuring legality. Much more needs doing with the latter, because the housing sphere has become one of the hotbeds of corruption. It is also justified on grounds of social solidarity for the state to use taxpayers' money to help the homeless put a roof over their heads, to support the efforts of those with small means, those living in poor housing and young people starting out in life to set up a home. But I feel it is morally outrageous for the state to give presents of taxpayers' money to well-to-do people for housing construction. Apart from the distributive considerations and the criticisms on moral grounds, a minefield was laid from the fiscal point of view under the previous government, and the new government is watching idly to see what will happen, doing nothing to clear the mines. Even if it will be unpopular with many people, it is high time to do something in this respect.

You are endorsing the reactions of the National Bank with your fiscal and wage-policy criticisms.

Not at all. The fact that serious mistakes have been made in fiscal policy and income policy and that too little has been done so far to overcome those mistakes does not mean that the problems should be compounded by pursuing an erroneous monetary policy. What has been done in monetary policy has not helped with the income policy or the fiscal policy. On the contrary, it could worsen the

detrimental aspects even further, either immediately or through spillover effects that appear later. A restrictive policy applied in a doctrinaire fashion may look spectacular, but it does not act as a real counterweight or corrective.

Many people are saying that the International Monetary Fund or the European Central Bank, and the European Union was more or less expecting just the reaction from the National Bank of Hungary that it made.

Economists are not all of one opinion; there are debates within the profession. As I said just now, there is quite wide agreement about the general objective, but there are much bigger differences of professional opinion over how to correct a macroeconomic situation that has taken a turn for the worse. Many staff members of the big international financial institutions, and similarly, many writers on international economic papers are inclined to propose a standard therapy, at least as a first approach. It is rather like a patient phoning the doctor and asking what to do about his or her constipation. In that case, if the doctor is prepared to give a diagnose and recommend a treatment over the phone, the answer will probably be that the patient should take a laxative. But if the doctor has an opportunity to examine the patient scrupulously and expertly, it may turn out that the symptoms point to some special illness calling for a specific treatment. The standard treatment, if the fiscal policy is lax, is to try to counteract that with monetary policy. But as I have been trying to explain, there is a more complex clinical picture in this case calling for treatment that differs from the standard formula. I am sure this can be explained to serious experts of the international financial institutions or journalists with respected financial papers, prepared to go beyond the simplified dogmas. Neither the IMF nor the European Central Bank is infallible. Wise representatives of them do not claim to be that. Above all, what they expect of those turning to them is that they should prepare a thorough diagnosis and have a carefully compiled, purposeful plan of action for solving the problems, not that they should apply doctrines in a mechanical, simplistic way.

The argument usually advanced for a rapid fall in the inflation rate is that Hungary's accession to the EU also entails a duty to become a member of the Monetary Union. That obliges us to meet the strict financial requirements of EMU before we enter it. Various deadlines are mentioned, sometimes 2006 and sometimes 2007, by which time we should have reached the very low rate of inflation required for introducing the euro.

That argument presents the requirements in a distorted way. When Hungary signs its accession, it will commit itself to joining EMU, the Economic and Monetary Union, so that the euro will become the currency in this country as well, instead of the forint. However, it must be added very emphatically

that neither the EU nor the European Central Bank has prescribed any kind of deadline for that and the Republic of Hungary has not committed itself to one. No one in Brussels or Frankfurt is calling on us to push things. You cannot arbitrarily cite deadlines set with excessive zeal as an argument for reducing the rate of inflation at a forced pace, in a way that places other requirements in jeopardy. To give just one example, you can postpone for a while economically justified rises in officially set prices to make the progress in combating inflation look more impressive as it happened with gas prices and with fares for public transport. It is wrong to demand that all officially determined prices should rise only by the targeted average rate of inflation. We cannot bear indefinitely the erosion of efficiency that results from faulty relative prices or allow the budget to bear the loss caused by an artificially depressed price. The faults in the distribution of income have to be righted not with distorted prices, but with redistributive income assistance from the state, where that is justified. That is the European style of economic policy. What the European Union and the Monetary Union expect is that we should join with a healthy economy, not with one that has been artificially made up to look healthy. If we can really push down inflation by 2006 or 2007, and not just do it artificially or just appear to do it, that will be a fine achievement. But if we can only meet the very strict requirements for introducing the euro at a later date, no one is going to be angry with us for that and we will remain full members of the European Union nonetheless. The European financial world will have the patience to wait while we really become mature enough for the euro.

The independence of the National Bank of Hungary

Doesn't all the criticism of the central bank being heard these days jeopardize its independence?

It would be wrong for the government to put pressure on the central-bank leadership, for instance by calling on its president or the members of its Monetary Council to resign. According to the law, the central bank is independent of the government and that legal stipulation has to be observed without fail. Once the president and the members of the Monetary Council have been appointed, not even Parliament can set specific prescriptions for them. The National Assembly cannot lay down by law how many points' reduction should be made in the base interest rate. However, that does not mean the central bank leadership is a state within a state. The principle of accountability has equal standing with the principle of independence. I am not thinking here of the kind of accounting that the State Audit Office carries out when it examines the accounts or the staff management of the National Bank. Like every other state institution without exception, the National Bank of Hungary has a legal, political and moral responsibility to the Republic of Hungary and the Hungarian people. If it makes a mistake, it causes harm to the republic and the people. Parliament has not only a right, but a duty to call it to account. Far from conflicting with the principle of independence, that is in complete accordance with it.

I do not know what the practice in other European countries is in this respect. What I have seen with my own eyes is how the requisite committees of the US Congress summoned the president of the Federal Reserve Board, who gave them a detailed report on the situation of the country and the activity of the Federal Reserve. These appearances were often televised live, with senators and representatives asking technical, factual, but often quite sharp questions and making appreciative or critical comments. The governors of the US Federal Reserve do their job in the knowledge that they have a duty to report to the political sphere and to the public. So in that deeper sense, they are not 'independent'.

There is another comment I would like to make now that independence has been mentioned. I have gained the impression that the right of independence is being confused with the right to act autocratically and arbitrarily. It is as if the leaders of the National Bank thought they were independent not just of the government, but of the market as well. There is great power in the hands of those running monetary policy, but there are not only legal, political and ethical constraints on that power, but actual economic and market constraints on it as well. The central bank can exert strong influence on the market processes, but it is not an absolute ruler over them. The centralized

command economy is over. The exchange rate does not remain, once and for all, at whatever figure the National Bank in Szabadság tér decides. If the bank takes an unrealistic decision, it may be able to foist it on the market for a time, but sooner or later, the market will prevail and force an adjustment of the decision taken in the seclusion of an office. That is what has happened now. Unfortunately, such conflicts between bureaucratic decisions and market realities have quite bitter consequences. In the case we have been suffering (and in many other cases), the first thing is that speculators exploit the margin between the unrealistic and realistic prices (interest rates, exchange rates etc.), to their own advantage. That kind of speculative attack is what forces the adjustment to be made. How much wiser it would have been to be a step ahead and to have set a realistic interest rate and exchange rate voluntarily, cautiously, perhaps in several steps.

The responsibility of the government

Ultimately, what conclusion has to be drawn?

It can be clearly seen who exercise a decisive influence on the course of events. Much has been said here about the responsibility of the National Bank, but still, mention in the first place has to be made of the government. The government, primarily, will have to restore the fiscal balance, stand up more vigorously to the running away of domestic demand, encourage savings, reduce radically the deficit of the current account, and so on. The government will have to draw up a comprehensive concept outlining for several years ahead the government measures required for lasting growth. It is very important that the political parties behind the government should back such policy to the full. Politicians in the government coalition should refrain from putting pressure on the government to go further in the easy spending of state funds.

The responsibility of the National Bank has been given great emphasis in our discussion, and it cannot be emphasized enough. But that does not conclude the list of those with great influence on the economic situation. I would pick out here the role of the representatives of various interest groups, including the trade unions, who will have to go beyond the narrow task of defending their interests, at least in the present tight situation, and show self-restraint. The parliamentary opposition can do a lot of harm, but they can do a lot of good as well. They will do harm if they inflame public opinion by making irresponsible demands and impede the imposition of fiscal discipline. And they will do even more harm if they fence in the efforts at stabilization, attacking from two sides, on the one hand supporting the restrictive policy of the National Bank, with its forced and one-sided

methods of pushing down inflation, and on the other using populist rhetoric to demand an increase in state expenditures that stimulates inflation. For on the one hand, the opposition endorses an interest and exchange-rate policy that destroys small and medium-sized businesses, and on the other, it is incensed at the government for not giving small and medium-sized businesses enough support. The bigger the economic difficulties faced, the greater is the need for national cohesion in combating them.

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