ICEG EUROPEAN CENTER

NEWS OF THE MONTH

on EU-10 and CIS

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News of the Month, *on EU-10 and CIS*

The ICEG European Center issues its monthly publication, which includes 2-4 brief analyses on macroeconomic and microeconomic issues. The publication focuses on two groups of countries: *Commonwealth of Independent States - CIS* (Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyzstan, Moldova, Russia, Tajikistan, Turkmenistan, Ukraine and Uzbekistan) and the ten post-soviet *New Member States of the European Union – EU-10* (Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia).

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About us

ICEG European Center is an independent economic research institute based in Budapest, Hungary. The Center was founded by Dr. Pál Gáspár in 2001.

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Eurozone in danger? Causes, consequences and perspectives

Ágnes Orosz

The EUR 500 bn financial aid, aiming officially at the safety of the euro against speculative attacks, accepted on 10th of May 2010 by the EU27 finance ministers gives us an opportunity to rethink why it is widely discussed whether the Eurozone is in danger? The reason why this issue is relevant from the point of our EU10 and CIS approach is that the euro, as a common objective of the new member states, fundamentally affects both the economic outlooks and the current policies. The current situation is that there is an intense debate about the crisis' and the crisis management's impact on the stability of the Economic and Monetary Union (henceafter EMU) of the European Union. Moreover the Greek crisis has led to serious fears that this is only the beginning of a deeper sovereign debt crisis that could ultimately destabilise the whole Eurozone (*de Grauwe* 2010a).

The first part of the article briefly discusses the dimensions of the current situation, the causes and consequences of the Eurozone's problem. In the second part we examine the theoretical basis of monetary unions and the question whether the EMU is an optimum currency area or not. The third part deals with the relationship between monetary and political union. In the fourth section we name a few hazard areas of the Eurozone which were listed by the time of the formation of the EMU. Several debates have accompanied the EMU since its birth, but the current problems raise the need to scrutinise the operation and the potential shortcomings of the Eurozone. The last part of this article concisely sketches the necessary actions and the possibility of secession.

Causes and consequences

The GDP growth of the Eurozone was 2.8 percent in 2007 and 0.6 percent in 2008. This slight decrease in growth was followed by a dramatic decline, the growth rate of the Eurozone was -4.1 percent in 2009 (*Eurostat* 2010). The estimations by the various international organisations for the EMU's economic growth are about 1 percent. But there are significant differences between the member states' performances, therefore policy-makers have to take these disparities into consideration.

There are member states in which the crisis has been managed by fiscal stimulus. However, in many of them, the stimulus merely was able to worsen further the prevailing fiscal indiscipline. The problems of the banking system caused by the financial crisis have ended in sovereign debt problems. The Eurozone possesses a highly integrated banking system but the sovereign debts are at national level. A further question is whether the group of deficit-stricken countries is willing to finance the increasingly large debtors or not. In fact, this process means that ultimately there is no national debt anymore; at least for the next few years, there will then be just one EMU debt (*Wyplosz* 2010).

In this case the Southern members of the Eurozone are outstandingly interesting, they are often called the „PIGS" (Portugal, Italy, Greece, Spain and frequently Ireland stands in this group as well – „PIIGS"). The Southern members of the Eurozone are often handled together but they are quite heterogeneous. „For Greece and Portugal the problem is insolvency; for Ireland and Spain, illiquidity. Italy has a higher savings rate and its foreign imbalances are much smaller". (*Alcidi – Gros* 2010).

In a currency union it is not possible any more to devaluate the currency in order to foster economic growth and to improve competitiveness. But the lack of the depreciation tool has not led to circumstances where secession becomes a realistic perspective. Secession from the monetary union has significant costs (*Eichengreen* 2007). Economic costs are for example the raise of debt service costs, the redenomination of contracts, the introduction of banking limitations and the decline of foreign investments. There are technical and legal difficulties of reintroducing the former national currency. A political cost can be that a country that exits the EMU would be seen as disregarding its commitments to other euro area members.

Now it is clear that the Stability and Growth Pact has not functioned as an appropriate tool to prevent the Eurozone from adverse fiscal developments. The current problems of the Eurozone highlight the importance to reshape the regulation and to enforce the observation of these rules. Almost each member state has violated the fiscal rules. Nowadays deficits generally exceed the 3 percent limit.

Optimum currency area – to be or not to be

The theory of optimum currency areas determines the conditions that countries should satisfy to ensure that the benefits of joining a currency union exceed its costs (*de Grauwe* 2006). What are these benefits and costs? As a result of the introduction of the common currency, economic efficiency will be improved. The most visible direct gain stems from eliminating the costs of exchanging one currency into another. The comparability of prices is an indirect gain of the monetary union. The computability of the future exchange rate reduces uncertainty which causes welfare gains and stimulates trade (*de Grauwe* 2003).

Entering the monetary union can help a traditionally high inflation country gaining credibility by pegging its exchange rate to a low inflation country (*Horvath* 2003). The most stressed cost is the loss of the independent monetary policy. In this case the member countries have to face the problem of the "one-size-fits-all" monetary policy. The core of the problem consists in non-synchronised development of the economy compared to the rest of the union. The higher is the cost the less similar business cycles the member states have (*Alesina – Barro* 2001).

Forming a monetary union can lead to a higher inflation rate because the change in relative prices can increase inflation. The Baltic EU member states are good examples for this scenario; there,

the fixed exchange rate regime and the fast convergence in real GDP per capita cause an overheating of the economy (*Darvas – Szapáry* 2008). As a result of the monetary union, the government loses its seigniorage revenue (*Alesina – Barro* 2001).

The theoretical basis of our examination is the OCA theory because on the one hand it is used to analyse whether a country should join a monetary union, but on the other hand the OCA criteria can be used to study the conditions of the secession (*de Grauwe* 2006). The OCA criteria are the following: (1) high level of factor mobility (*Mundell* 1961), (2) high level of economic openness (*McKinnon* 1963), (3) high degree of product diversification (*Kenen* 1969), (4) the similarity of inflation rates, similar degree of price and wage flexibility (*Horvath* 2003) and the similarity of the real exchange rates (*Vaubel* 1990) and (5) political commitment to exchange rate decisions (*Horvath* 2003).

It is often examined and is still an open question whether the EMU is an optimum currency area or not. Some studies written in the 1990s clearly state that within the European Union there exist a "core" and a "periphery" which hinders forming an OCA (*Bayoumi – Eichengreen* 1992a). *Bayoumi* and *Eichengreen* (1992b) find that within the European Community compared to the US regions the underlying shocks are significantly more idiosyncratic, which may indicate that the EC (today: EU) will find it more difficult to operate a monetary union. *Bordo* and *Jonung* (1999) simply claim that the European Union is a too large geographical area to form a well-functioning monetary union which means that the EMU is not an optimum currency area. *Caporale* (1993) cannot prove the existence of the "core" and "periphery" regions within the EC. This study points out that the operation of the monetary union could be rather difficult and some instruments for adjusting to asymmetric disturbances like fiscal transfers could therefore be necessary (*Caporale* 1993).

Some more recent studies have different conclusions but according to the recent developments of the OCA theory it can be easily understood. *Frankel* and *Rose* (1997) build an argument that the correlation between international trade pattern and international business-cycle is endogenous, i.e. countries with closer trade links tend to have more tightly correlated business cycles. This argument means that a country is more likely to satisfy the OCA criteria ex post then ex ante.

According to *Rose* (2009) we can conclude that "EMU seems to have had a combination of two effects: the direct consequence of increased trade, and an indirect benefit through the effect of this trade expansion on business cycle synchronization. This means that EMU may have created a virtuous circle that might make currency union closer to being sustainable. Whether the effect is big enough to make Europe an optimal currency area remains to be seen." (*Rose* 2009:258-259). EMU seems clearly to be moving along the path to becoming an optimum currency area.

The political aspect of the monetary union

History has proved that most break-ups of national monetary unions have been caused by political developments. “Political unity is the glue that holds a monetary union together” (*Bordo – Jonung* 1999:25). The Eurozone’s current problem has called the policymakers’ attention for the need to further political unification within the European Union. The crisis has reflected to a structural problem of the Eurozone, created by the fact that the monetary union is not embedded in a political union. Ideally the Eurozone member states should move towards a closer political union, but it is very unlikely to happen in a significant way in the foreseeable future (*de Grauwe* 2010b).

The largest and most important currency union is the Economic and Monetary Union of the European Union. By the time of the formation of the EMU there were intense debates about its future. The current situation reveals that some of the critics may have been right. It calls for our attention to study the formerly stated shortcomings briefly. In 1999 *Michael D. Bordo* and *Lars Jonung* pointed out some potential fault lines in the construction of the EMU. One hazard area is the lack of a central lender of last resort which stands in sharp contrast with the modern central banking. It is problematic that the EMU lacks a central authority to supervise the financial systems including the commercial banks within the Eurozone. The absence of central co-ordination of fiscal policies can lead to an emergence of asymmetric shocks by which the common monetary policy cannot fit to every member state. These shortcomings call for further examination.

To secure the stability of the euro and to avoid such a crisis as the one experienced in Greece, urgent action is needed to correct the weaknesses in procedures and institutions of the EMU, to reform the Stability and Growth Pact and to develop new policy tools.

What can we tell about the future? Is the break-up of the Eurozone possible? On the one hand secession is legally absolutely possible, but on the other hand due to its economic costs and consequences it is not conceivable. The monetary union has an inherent problem, the “one-size-fits-all” monetary policy, which is applied to still heterogeneous member states. The countries which are likely to suffer from asymmetric shocks have lost the tool to offset shocks by loosening their national monetary policy or devaluing their currency. The importance of fiscal policy has increased within a monetary union: it can no longer confine itself to pursuing medium-term, redistributive goals. Subsequently, the European Union is suffering from the inappropriate policy for federal stabilisation. The survival of the EMU depends on the harmonisation of national policies; ultimately the current situation calls for more fiscal federalism for the Single Market.

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Hungary in the World Competitiveness Yearbook 2010: changes, tendencies, components

Olivér Kovács

The main changes

IMD has been contributing to the better understanding of the competitiveness of nations for many years. The recently published World Competitiveness Yearbook 2010 (WCY 2010) serves a plethora of useful information through its rankings.

It is discernible in the current issue that – unsurprisingly – the USA (ranked 2nd in 2010) has been bereaved from the first place in the ranking list by Singapore, and Hong Kong follows on the 3rd place. The rankings are more or less in conformity with the economic performance of each country. Switzerland is close to the leading trio, as a result of its quite good performance during the crisis largely due to its strict fiscal discipline and the good investment climate which did not became torpid during the global downturn.

One strand of the economic literature emphasises the importance of the size of the financial sector within a country. Thus, the relatively big financial sector, with its substantial international investment exposure may be a potential risk channel (e.g. in the case of the United Kingdom). But, this scenario has not proved a sustainable one in the case of Switzerland, because of its healthier course of fundamentals compared to the average of OECD countries.[1] Denmark's distinguished position has proved obsolete as it was illustrated by the survey exuding pessimism referring to the current and future perspectives. Germany, the major export market of Hungary, also suffers from a high deficit and increasing debt. However, in the case of Germany, the industry has intensified the competitiveness of its exports over the past decade.

While the performance of the European economy in general, including the Hungarian one in particular, mostly depends on how the German economy will exit from the crisis, the expense of the crisis management, the high volume of fiscal stimulus is not irrelevant. After *The Great Moderation* (since the 1970s when the amplitude of cyclical fluctuations were getting less and less due to the governments' moderated activism), most governments have now trustingly used the classical Keynesian arsenal in order to stimulate their economies by massive demand push.

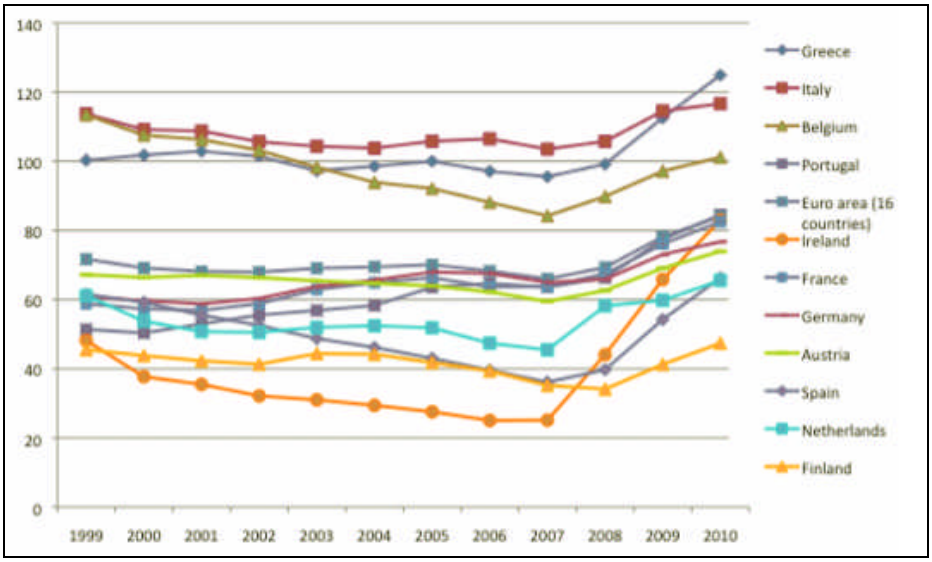
These measures, which might be treated as a relinquishment of the main policy assumptions of *The Great Moderation*, have been jolting the fiscal positions out of the still manageable risks and caused unsustainable threats. Thus, the actual deficits, government internal and external debts are soaring as unintended consequences of crisis management. Perhaps, the recognition of this

[1] The contraction of Swiss GDP was 4% of GDP in 2009 contrary to the more than 8% by OECD countries. See more: http://www.oecdepublishing.org/Keygraphs/Switzerland-frame.html 2010.06.22

churning process implied the IMD providing debt stress tests illustrating the unsustainability of nations' fiscal policy. The IMD examined the question of when the nations will be able to dampen the debt ratio to the more "bearable" 60% of GDP.

What really „matters is not only the absolute size of public debt but also the length of time required to absorb it. In the end, debt-stricken nations may suffer severe losses in competitiveness and standards of living" – states Stéphane Garelli, Director of the IMD World Competitiveness Center.

Chart 1. Gross government debt between 1999-2010 (% of GDP)



Source: European Commission, AMECO Database

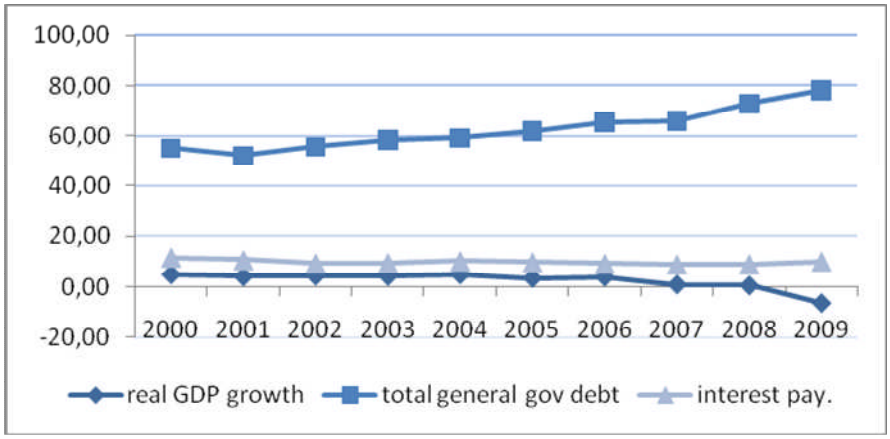
The stress test unveils the expected time horizon in which the nations seemingly will be able to reduce their debt ratio to 60% of GDP. According to the figures, Spain's debt ratio will be about 60% of GDP by 2019, three years before the Hungarian debt level will succeed in dwindling down its high share.

The improved competitiveness of Hungary

The likelihood of a potential debt crisis has increased in Hungary over the past few years. Since 2006 Hungary has been passing through a substantial fiscal consolidation which was born under the consideration of the well observable elimination of the potential economic growth by means of fiscal overspending and non-transparent practice. As a corollary of the consolidation, the Hungarian public finances have reached a better condition by 2010.[2]

[2] Since 2006 the government reduced the budget deficit by more than 6 percentage points by 2010 (3.9% of GDP in 2010). In 2007 the debt ratio was 65.8%, in 2008 it climbed up at 73%. It increased further (80.3%) in 2009, henceforward the impetus of its growing path became moderated (2010: 82.3%). *Source*: Eurostat Statistical Database.

Chart 2. Fiscal position in Hungary (% of GDP)

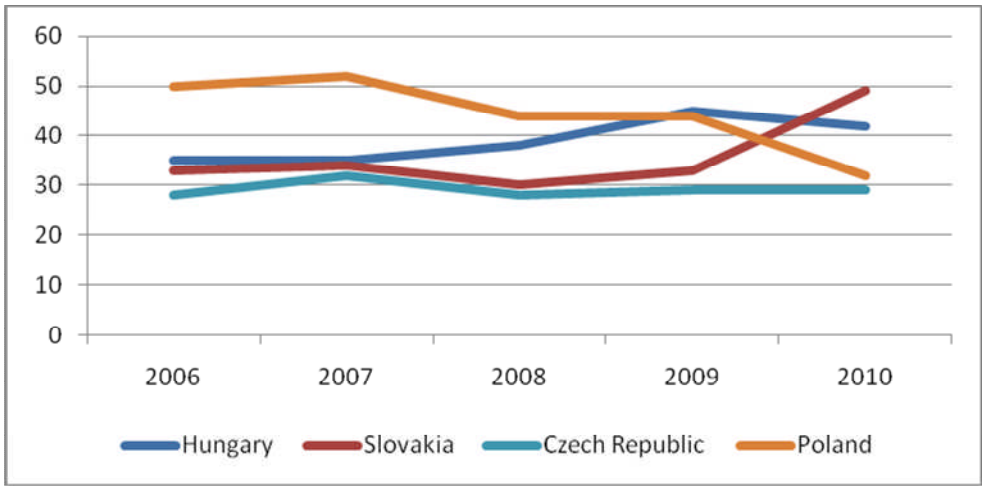


Source: IMD World Competitiveness Yearbook 2010, Hungary dataset

The overall competitiveness of Hungary developed parallel with the conjuncture. While the economic climate and the debt burden did not eclipse the consensual sustainable level (60%), Hungary was in a better position in the ranking lists (2006: 35, 2007: 35). As the economic climate worsened, due to the thriving debt triggered by the affluently overspending fiscal policy practice i.e. the lower credibility, and the austerity measures with their negative demand effects, the Hungarian competitiveness position deteriorated as well (2008: 38, 2009:45).[3] The credibility of the country has been improving slowly, but unambiguously with the more viable commitment to the fiscal discipline. This meant that the economic policy had to become pro-cyclical contrary to the regional trends where the counter-cyclical fiscal policy is the dominant.

This commitment was a major reason of the fact that Hungary's competitiveness could improve in 2010 while the competitiveness of others worsened. The current issue of the WCY 2010 reports that the newest position is 3 ranks better than it was a year before (2010:42).

Chart 3. Trends in competitiveness in the Visegrad countries



Source: WCY 2010

[3] This whole exactly reflects the main findings of empirical analyses. See for instance: *Reinhart, C. M. – Rogoff, K. S. – Savastano, M. A. (2003). Debt intolerance. NBER Working Paper No. 9908*.

In 2010 only Poland and Hungary were able to reach better competitiveness position than a year ago among the Visegrad countries. Even the Czech Republic's competitiveness is constant at its 29th place. In so far, if we take a wider range of Central and Eastern European countries, it is perceptible that Romania, Slovenia, Ukraine and Bulgaria have ended with a worse position in 2010 than in the pre-crisis period. If we take our focus under the veneer of the index, and contemplate its components, we can claim that Hungary has endured its biggest deteriorating by the economic performance. The Hungarian business efficiency is not in a flattering condition but it has visibly improved (2009: 52, 2010: 47).

Table 1. The development of the components of the competitiveness index in the Visegrad countries

		2006	2007	2008	2009	2010
Hungary	economic performance	37	38	39	33	40
	government efficiency	35	40	47	50	51
	business efficiency	33	41	45	52	47
	infrastructure	28	25	27	33	35
Slovakia	economic performance	47	42	32	34	54
	government efficiency	22	37	31	34	41
	business efficiency	31	28	26	26	43
	infrastructure	37	38	36	37	40
Czech Republic	economic performance	23	29	20	25	29
	government efficiency	29	41	33	31	33
	business efficiency	30	36	34	36	40
	infrastructure	25	27	24	25	26
Poland	economic performance	46	41	31	39	24
	government efficiency	50	52	49	44	36
	business efficiency	52	52	50	50	38
	infrastructure	39	40	37	39	36

Source: WCY 2010

By the components of Slovakia's index first and foremost the major negative factor was the sharply deteriorating government and business efficiency, and the economic performance due to its large exposure of the essentially mono-cultural industry. As for the Czech Republic, its (relative) decline is predominantly attributable to the negative progress by business and government efficiency. Just the contrary happened in the case of Poland, where the major push factor was the economic performance.

Sub-factors behind the improvement of Hungarian competitiveness

The major factor behind the deteriorating economic performance is the very dull international investment activism (*Table 2*). Hungary's international trade figures improved strikingly in 2009, and produced a positive growth rate. The overall balance of trade was 4.57 billion euros, in contrast to the former year when it was 319 million euros on the liability side. Positive and negative

processes are developing together but it seems that the positive effect was stronger to boost the competitiveness. The Hungarian banking system was stable enough to stave off the potential credit crunch. Thus, the financial intermediation for business sector did not collapse which could have caused damages on the surface of the business efficiency.

Table 2. Sub-factors of economic performance in Hungary

Economic performance (ranks)	*37*	*38*	*39*	*33*	*40*
	2006	**2007**	**2008**	**2009**	**2010**
Domestic Economy	41	44	55	53	49
International Trade	36	23	11	32	13
International Investment	14	28	4	7	25
Employment	41	43	48	52	50
Prices	40	33	48	19	27

Source: IMD WCY 2010

Table 3. Sub-factors of business efficiency in Hungary

Business efficiency (ranks)	*33*	*41*	*45*	*52*	*47*
	2006	**2007**	**2008**	**2009**	**2010**
Productivity & Efficiency	19	19	37	38	37
Labor Market	23	25	31	37	43
Finance	39	37	41	48	47
Management Practices	37	46	41	55	38
Attitudes and Values	39	49	55	55	55

Source: IMD WCY 2010

Conclusion

The newest WCY 2010 provides a wide range of information about the competitiveness snapshot of 58 countries. The global financial turmoil has hit the competitiveness potential of many countries in the post-Lehman period until 2010. Some countries rise and some fall back in the rankings. Hungary was able to manage its fiscal consolidation over four consecutive years in order to cement its credibility and financial opportunities. Therefore, in 2010 its competitiveness could attain a better position than a year before, contrary to the general trends in the Central- and Eastern European region.

The inexorably arising standpoint is that after the era of the Great Moderation the Keynesian renaissance has occupied the major policy lines as a reaction to the financial crisis, but this smuggles unintended consequences into the system causing huge deficits and debts. Thus, in all probability the resurrection of the moderated policy will sooner or later topple down the intensive utilisation of Keynesian tools.