

Werner Riecke

## **The challenge of nominal convergence, implications for economic and monetary policy and financial stability in the new Member States – Lessons from Hungary's experience**

The title of this session of the Brussels Economic Forum uses the expression “New Member States” instead of “Accession or Acceding Countries” signalling that the enlargement of the EU will happen by the end of next week and a lot of the discussions are already addressing the challenges ahead of us in the near and medium term. In the area of economic and monetary policy these discussions are about real and nominal convergence, the economics of the catching up process, timing and sequencing the steps leading to full membership in the Economic and Monetary Union. Simply speaking, how to get into the euro zone, when and, last but not least, why?

I will touch upon four points in my presentation:

1. Recent developments in Hungary's monetary and exchange rate policy
2. The lessons we have learned and the lessons we should have learnt
3. The dilemmas Hungary and probably the other CEE countries are facing in their efforts to comply with the Maastricht criteria, and finally
4. Are there any recommendations or guidelines for economic and monetary policy for the next few years ahead of us?

What I am going to say reflects my own views, based on almost 15 years spent in the National Bank of Hungary, among these 15 years 6 years as member of the decision making body. And what I am going to say, I believe, is fully true for Hungary and may be partially true for other CEE New Member States.

### **Recent developments in Hungary**

In 1995, as a part of a serious fiscal adjustment package, Hungary introduced a narrow banded, pre-announced crawling peg devaluation exchange rate system. I still believe that this was the right decision at the time. The crawling peg system did help to restore the confidence of money and capital markets within a relative short time, it led to a remarkable development of the government securities market, it made exchange rate risk calculations comfortable for the traded sector and it served as a guide to, but not necessarily the main instrument of a gradual, but sustainable disinflation process.

This kind of exchange rate arrangement leads to vulnerability by definition, but Hungary was lucky to survive such external shocks as the Asian crisis of 1997 and the Russian crises of 1998. Even the end of the system was not triggered by a crisis, but by a conscious joint decision of the Hungarian government and the central bank.

The sustainability of the narrow band was based on some institutional arrangements. The  $\pm 2\frac{1}{4}\%$  intervention band left some room for interest rate policy and until the end of this arrangement a few restrictions on short term capital movements were still in place. But I think, the real, secret reason behind the sustainability of such a vulnerable exchange rate arrangement was threefold. There was no serious tension between monetary and fiscal policy, neither the Hungarian government, nor the MNB (National Bank of Hungary) did have an

explicit inflation target at that time and the hidden goal of monetary policy, never officially declared, was real exchange rate targeting.

Under these circumstances, knowing that real appreciation is an unavoidable process in the emerging countries, the exchange rate arrangement became obsolete: inflation stagnated around 10% from the end of 1999 to the beginning of 2001.

In the first half of 2001, partly due to the run-up to accession, many things happened almost simultaneously in the area of monetary policy. A new Act on the Central Bank was enacted increasing its independence and giving it the clear mandate to achieve and maintain price stability. The intervention band was widened to  $\pm 15\%$ , remaining restrictions on capital mobility were abolished, pre-announced devaluations were stopped and the MNB introduced a fully fledged inflation targeting system. Within the exchange rate arrangement we were shadowing ERM-II.

In the first months of the new system we saw a – partly expected – nominal appreciation of the Hungarian currency; the disinflation process got a new momentum and within two years CPI inflation went down from the 10% mark to 3.6% in May 2003. Although this was not an exceptionally low value compared to the performance of other New Member States, such a low value has never been seen for 18 years in Hungary. Until the end of 2002, the inflation targeting system worked exceptionally well, we succeeded in hitting inflation targets within the tolerance band of  $\pm 1\%$ .

At the end of 2003, the exchange rate reached the stronger end of the band and, in January 2003, Hungary faced something that was probably unique in the history of exchange rate developments: as a result of a speculative appreciation attack, the central bank had to buy 5 billions of euros to prevent the exchange rate from breaking the stronger side of the intervention band. Foreign short-term investors did bet on an upward shift of the band or a change to a floating system. Neither???? took place and the attack was countered by appropriate monetary policy steps, a temporary sharp reduction of the policy rate, and a widening of the O/N interest rate tunnel.

The remaining part of last year was much less glorious. In June the government initiated – and the MNB agreed to – a downward shift of the intervention band, leading to a nominal depreciation of the currency on the markets, that was much higher than any intention has been behind this policy measure. Longer-term investors became confused about the real intentions of Hungarian economic policy and ever since that time the MNB is faced with the task of rebuilding lost credibility from scratch.

Speculative attacks aiming at weakening the currency have become a real danger and sizable interest rate hikes were needed to cover the increased risk premium on the Hungarian currency.

The deficit in general government was close to 10% in 2002, and 6% in 2003, respectively. We had real wage increases exceeding 10% for two subsequent years and we have probably used up the competitiveness reserves we achieved by widening the band. In recent years, we did not approach, but moved away from Maastricht. (The budget deficit is still above 3%, the debt ratio went from slightly above 50% to close to 60%, inflation is going up and expected to peak in the middle of this year, the whole yield curve went up in the second half of 2003 and

exchange rate volatility increased.) Two subsequent pre-accession programs became obsolete before Commission experts could start to read them.

Previously given serious commitments regarding Hungary's ERM-II and euro zone entry are now being reconsidered.

But Hungary is far from any serious crisis and at the beginning of this year there are signs that Hungary's economic and policy goals will become increasingly realistic and better harmonized, commitments are given more carefully. The risk premium is already coming down, the exchange rate has become stronger and the inflation target for 2005 (4% by December) seems to be achievable.

### **There are lessons we have learnt and there are lessons we have yet to learn**

Time allows me only to concentrate on the most important lessons and I will list them only in short, without elaborating too much on them.

One main reason behind Hungary's capital and exchange rate market troubles is probably the conflict between the existing habitat of economic policy to remedy external and internal disequilibria by accepting higher inflation or even initiating surprise inflation and the monetary policy that tries to comply with its newly given mandate of achieving and maintaining price stability. Until the end of 2003, the MNB, authorised by the Act, stated its own inflation target that was neither agreed, nor disagreed by the government and it was not really integrated into the government's medium term economic policy. There is common understanding for the inflation target of 2005 only. But we are still missing a joint public declaration on the disinflation path and the meaning of price stability for Hungary.

Cooperation between the government and the central bank should include nothing more than the agreement on the goal. Anything that goes further, in most cases a request that the central bank should support economic policy, promises on fiscal consolidation, with immediate interest rate cuts, indicates the threat of an upcoming currency crisis according to economic history.

Giving up goal independence has to go together with full instrument independence. And, in this respect, there is a potential conflict in the Hungarian legal regulation, because the exchange rate system (which is now shadow ERM-II.), and all its parameters can only be changed in agreement with the government. Also, there is a practical conflict: the exchange rate arrangement may prevent the central bank from achieving its inflation target. In other words, the trinity of impossibility applies; one cannot achieve exchange rate and price stability at the same time. We had to learn, that even  $\pm 15\%$  might not provide enough exchange rate flexibility to achieve the inflation goal. Among the CEE New Member States only Hungary has limited exchange rate flexibility; all other states have floating or managed floating systems, except for those with a currency board.

One more point: Hungary can be proud of its highly developed and liquid government securities market, where even 15-year fixed rate maturities are issued. The presence of foreign investors on this market is remarkable. But rumours on the foreign exchange market usually spread over to the securities markets and vice versa. That's another reason why we need a sustainable, transparent economic policy; this way we can gain from convergence play. But looking at Hungary's small, open economy, we have to recognize at its present stage of

development that a 60% debt/GDP ratio is too high and makes the bond market vulnerable, too. If we take the average of the New Member States, 40% seems to be more reasonable. Achieving that may be a better guideline for fiscal policy than to calibrate yearly budget deficits. What's now happening in Hungary: increasing reliance on foreign currency denominated debt issues is probably not the right solution to the financing problem.

There is one conclusion that we have drawn from 2003: there is no perfect economic and monetary policy that can provide full protection to a small, open economy against any kind of currency crisis, the only solution is to join the euro zone as soon as possible. This leads us to the Maastricht criteria.

### **Maastricht dilemmas**

Although it may not be wise for politicians of the New Member States to start Membership with putting into question the Criteria, they are nevertheless subject to sound economic analysis. We may say that these criteria did represent a consistent framework for a prudent economic policy for the Old Member States at the time the Treaty was designed and in the run-up to the monetary union. For the New Member States they create some serious dilemmas. Let me be short:

On the one hand, the criteria on *long-term interest rates* is self-fulfilling, if all other things go right. On the other hand, long-term interest rates reflect long-term inflation expectations in a large, closed economy only. In small open economies the long-term bond yield may be driven by the medium term exchange rate expectations of foreign fixed income investors.

Regarding *the budget deficit criteria* there are arguments for temporary higher deficits in emerging countries. If the reason behind the 3% limit is to prevent the debt ratio from increasing, the New Member States may be allowed to run higher deficits until they apply for the Euro. With lower basic debt ratios and higher growth expectations, it would not lead to an increasing debt ratio even if the annual deficits are slightly above 3%. This would give room for higher public investment and structural reforms. It, however, does not apply to Hungary, where the debt ratio is already close to 60% as compared to 40% in the CEE New Member States. In addition, the financing capacity of private households got close to zero in 2003 in Hungary and it is not expected to increase significantly, so the impact of the budget deficit is felt in the external accounts and due to higher nominal interest rates there is a crowding out effect which hurts growth, too.

I have no more to say about the *debt criteria*; 60% is the upper limit in the Treaty, but for the New Member States a significantly lower value should be targeted.

The *inflation criterion* hides a technical or legal and – in connection with ERM-II membership – an economic problem. The treaty states that the inflation rate of the euro candidate should not exceed the average of the 3 best performing EU member countries by more than 1.5%. Looking at recent inflation statistics, there is a high probability that at least 3 out of the 25 member states, among them non-EMU ones, will have their inflation rate close to zero. If we use a narrow interpretation of the criterion, the take-over of the Euro needs an inflation rate below the average inflation of the monetary union. This is something that has to be clarified.

A more serious economic problem is the achievement of price stability together with the requirement of maintaining exchange rate stability within ERM-II. Again, this reminds us of the trinity of impossibility. The most evident sign of the catching up process is the Balassa-Samuelson effect, which makes real appreciation unavoidable. This real appreciation may happen through a trend nominal appreciation of the currency or through inflation that is 1 to 2 percentage points higher than the euro zone average.

A successful stay for 2 years in ERM-II seems to be achievable, if we define price stability for the New Member States as an inflation rate around 3% and in addition, if the central bank has already managed to bring down inflation to that value with subsequent inflation targeting.

### **A guideline to economic and monetary policy for the years ahead of us**

We should not give up the goal of an early entry into the euro zone. Beside the results of any cost and benefit analysis, there is one big gain: we can get rid of the possibility of any future currency crisis.

Studying Hungary's Maastricht relevant indicators we found that these numbers are either in line or appear to be even better than those of many other countries now in the euro zone 3 to 5 years before joining the Monetary Union. For Hungary, membership in the Monetary Union between 2008 and 2010 seems achievable.

The question is how to get there and how to avoid the trap inherent in ERM-II.

My recommendations – that apply to Hungary only – are the following:

Restore the credibility of the inflation targeting system introduced in 2001.

Establish a clear public agreement between the government and the central bank on the desired disinflation path; do not modify the inflation target already declared for 2005 December, which is 4%.

Give the central bank full instrument independence, having seen that shadowing ERM-II has been rather counterproductive in the last one and a half years.

Apply for ERM-II not earlier than needed and only when a degree of price stability has been reached, that is, compatible with a stable nominal exchange rate; this could be something around 3%. Once this stage is reached, the central bank can put less emphasis on inflation targeting and more on supporting exchange rate stability.

Implement a more ambitious fiscal consolidation program, which is aiming at reducing external imbalances and targeting a significant reversal in the trend of an increasing public debt per GDP ratio. This would decrease the degree of vulnerability of the Hungarian forex and bond market.

It does not make much sense to discuss the exact interpretation of the assessment criteria now. This issue will be raised anyway, when we get there.

Thank you for your attention.