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Country Report HUNGARY

Economic and Political Challenges of Acceding to the Euro area in the post-Lehman Brothers' World

Hungary and the Euro: Waiting for Godot

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The publication is a product of the Open Society Institute – Sofia within the European Policies Initiative (EuPI) and the project "Economic and Political Challenges of Acceding to the Euro area in the post-Lehman Brothers' World".

The publication comprised of nine Country Reports and a Summary Report is available on the website of the European Policies Initiative: www.eupi.eu

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The project was implemented from September 2008 to September 2009. The main outcome of the project is a publication comprised of nine Country Reports and a Summary Report.

Following a uniform structure, and addressing a set of similar questions, the nine Country Reports (Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania and Slovenia) present stylized facts about the patterns of real and nominal convergence with the euro area in nine new EU members, outline the setting and the implementation of the accession policies in those countries and emphasize the incidence of the current crisis on the strategy to adopt the common currency.

Comments are relevant to policy developments until 20 May, 2009 – the cut-off date for the submission of the last revised version of the Country Reports.

The Summary Report reviews the results of the Country Reports and systematizes some of the dominant trends they reveal. The Summary Report checks the countries' experience in dealing with the complicated concentric monetary structure inside the EU (euro area; ERM II; non ERM II countries) and pays particular attention to the evidence gathered about the political economy of the procedures in the different countries.

Each Country Report and the Summary Report include an Appendix, containing Tables that summarize significant data provided in accordance with a standardized set of indicators.

The results of the Project are correctly intelligible only if all its pieces (ToR, Summary Report, Country Reports, Appendix) are considered together.

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ABSTRACT*

This is a critical review of Hungarian convergence, stance and policies towards accession to the Euro area in light of the recent financial crisis, as well as an evaluation of required policies. Following an executive summary, the paper reviews real and nominal convergence, surveys national goals and strategies for Euro adoption and analyses relevant policy measures both before and after the crisis. The conclusion evaluates the present monetary regime and considers some alternatives to the standard Euro accession path. The paper argues that Euro adoption remains Hungary's best option, the redistribution system must be reformed to reach sustainable fiscal stance and approves calls for a mild revision in applying the Maastricht criteria. The global crisis has indeed raised the volume of potential benefits, and increased the need for a quick accession to the Euro area. There may be well-warranted reforms in applying the entry criteria. Still, instead of waiting for Godot, Hungary must do its part in its quest for adopting the Euro.

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* Data closed on 1 March, materials used for the text were closed on 1 May.

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EXECUTIVE SUMMARY

Euro is a natural part of economic integration

Hungary is a medium sized and very open European economy that has about 80% of its external trade within the European Union (EU). Most likely, Hungary would form an optimum currency area with other EU countries, especially given that most of its peers have already or will soon have entered the euro area. In 2002, the National Bank of Hungary published a cost-benefit analysis of euro adoption that has since become the reference of political and professional debates on monetary and economic policy. According to this analysis the introduction of the common currency would induce "*significant net gains in growth*" for Hungary. This is the fundamental basis for Hungary's wish to join the euro area.

In terms of income per capita, Hungary has converged to Western Europe at 1-1.5% rate per annum, a process that was halted by contractionary fiscal policy in 2007 following years of irresponsible mismanagement. Its price level has also risen; this is in line with international experience suggesting real and nominal convergence to proceed intertwined.

Entering the euro area is considered to be an integral part of European integration, and has been viewed positively by the public.

Hungary is far from Maastricht criteria, was hit hard by the crisis

Hungary has never been close to meeting the Maastricht criteria; imbalances have either manifested in high inflation or in high budget deficit. By 2008 the deficit shrank to acceptable levels, but exchange rate stability has suffered since January.

Hungary has been vulnerable because of its deeply rooted fiscal deficit and debt problem: the country has one of the largest redistribution systems in Europe. There is an excessive deficit procedure set by the European Commission (EC) against Hungary since its EU entry in 2004. The debt/GDP ratio has risen 15% between 2001 and 2008. Rising debt and low growth rates – even before the crisis – have made Hungary vulnerable to a loss of external financing sources.

The global crisis is likely to cause the economy to contract by 4-5% in 2009, making Hungary one of the worst hit countries in Central and Eastern Europe. Already, Gross Domestic Product (GDP) shrank in the last quarter of 2008. Financial markets were heavily affected, the forint fell 25% against the euro despite a rate hike.

As a result of external financing opportunities drying up and coeval capital flight, Hungary picked up a large International Monetary Fund (IMF) and EU loan package. As a result, external state debt has risen dramatically, causing Hungary's prospects for euro area entry to be even bleaker. Although IMF conditionality required meeting the 3% Maastricht criterion for the fiscal deficits / GDP ratio, the loan will not ease long-term growth problems and will make rising debt a potential barrier to euro area entry.

Monetary regimes considered as temporary till Euro

The present monetary arrangement is inflation targeting. In February 2008, the previously applied +/- 15% fluctuation band was dissolved – a fortunate event in a financial crisis. A weak end of a band of fluctuation would have attracted even more attention, and a speculative attack would have pushed the currency out of the regime, making the financial outlook even worse. This more liberal regime was supposed to help the exchange rate find its natural position versus the euro – ahead of a final fixation.

Prior to crisis, dearth of political will *and* power to govern Hungary into euro area

In such a turbulent era, conditions of and arguments for euro area accession have quickly changed. Before the crisis, there was consensus regarding the benefits of membership but there was no political will to carry out the necessary measures in 2005-2006, and a 2006 fiscal deficit of 9% of GDP prevented the country from pursuing its entry dreams this decade. The political opposition holds basically no elaborated view on euro area accession and has not put forward an economic program that would lay foundations of euro adoption.

After the crisis, the euro has been portrayed as an economic savior but political parties fell short of taking all necessary measures to achieve it. The political crisis that erupted in the wake of mounting economic difficulties and the pending general elections have all made the politics of entry rather complicated.

Crisis raised ability and willingness to adopt euro

The global crisis has most certainly affected Hungary's approach to the euro area accession process. Exchange rate stability, previously enjoyed in Hungary, has lapsed. As a reaction to crisis, improvements regarding fiscal policy were assured. However, tensions finally led to a collapse of the reigning government.

The financial crisis affected both Hungary's ability and willingness to adopt the common currency. The ability to meet the criteria has risen owing to a disinflationary environment and financial market pressure to reform public finances. The willingness must also have increased as the country learnt how hard life can be without a shield of a common currency. The fear resulting from a financial collapse due to currency mismatch has also revalued euro area entry. This may be a rather positive result of the global crisis for Hungary.

ERM-2 entry within a year is possible

To soothe nervous investors at the start of the financial crisis and after announcing the IMF stand-by credit, the government stated that either in 2009 or in 2010, Hungary would be able to join the ERM-II and noted that the government intends to set the target date of 30 September 2009. The Bajnai government seemed rather hesitant in early statements, arguing that policy measures to regain credibility must come first; euro introduction can only follow.

Optimistic take

There are ample reasons for pessimism regarding Hungary, its recession is likely to be severe, its government collapsed in March and there is modest political backing for deep reforms. Yet, we believe that euro introduction may be the very policy tool to help advance survival and elevate Hungary out of the recession.

A 2013 euro area entry for Hungary is possible provided that currency volatility eases in the first half of 2009, and the excessive budget deficits are eliminated by 2011.

There are basically two fronts Hungary needs to fight. First, it must take economic policy steps to avoid a debt trap and be able to meet the criteria by 2011. Second, it should take diplomatic steps to reach some refinement of the criteria. The optimistic scenario is much dependent on the success achieved at both stages.

I. Economic Convergence

In terms of income per capita, Hungary has converged to Western Europe at a rate of 1.4% per annum, a process that was halted by contractionary fiscal policy in 2007 following years of irresponsible mismanagement. Its comparable price level has also risen by about 3% – in line with international experience suggesting real and nominal convergence proceed intertwined. Convergence collapsed as a result of the global crisis and Hungary's acute vulnerability to the crisis.

1. Real growth, trade and investment

Hungary started real economic convergence after a major reform package, carried out in 1995 to stabilize the economy. A decline in redistribution and stabilization of state finances as well as very stable exchange rate stance helped the economy expand at a 4%-5% between 1996 and 2006.

Despite steady GDP growth, long-term conditions started to deteriorate by unsustainable policy measures first, by the centre-right government in 2001 (massive state support for mortgages) and then by the centre-left government in 2002 (massive social spending, public sector wage hikes). This was reinforced by a lack of consolidation in 2004-2005, leading to the alarming deficits both in 2002 and in 2006.

As a result of fiscal mismanagement, austerity measures were in place in 2007-2008, causing growth to slow in 2007 and collapse in 2008. Average 2007-2008 GDP growth was around 1%. See Chart 1.

Hungarian growth was driven by its unsustainable fiscal deficits and policy errors rather than its EU accession. Thus, pre-2004 and post 2004 periods do not differ. Note that the 2004 accession was ex-ante expected, and thus EU-membership induced investments (both by multinationals and domestic firms) were carried out already a few years ahead of the accession itself.

Hungary is a small and open economy, with the average (export+import)/GDP value during this period well over 100% (135% in 2008). Export growth has been strong since the early nineties, with exports rising at a 20% annual pace – save crisis times of 1997, 2002, 2008. FDI inflow has also been strong, reaching 3%-7% of GDP. Indeed the large current account deficits of 6%-8% of GDP were about 70% covered by FDI during the 1999-2007 period.

Trade integration with the EU has been strong even in the early nineties when Germany was most important trade partner as early as 1990. Trade with EU has hovered around 75%-80% since mid-nineties. Excluding raw materials such as minerals, this ratio would rise to at least 85%. In terms of FDI, top investor countries include all major EU countries, in 2007, some 77% of FDI inflow was originated in EU countries, led by 27% in Germany.

FDI stock has reached €70bn by 2008, and multinational activity has been the main driver of real development and convergence. See Chart 2.

2. Monetary developments, nominal convergence

Nominal convergence has proceeded along with real convergence. As argued by Darvas and Szapáry (2008)[1], "*A well established fact in economic theory is that richer countries tend to have higher price levels expressed in a same currency and therefore the overall inflation rate in the catching-up countries is higher and/or their nominal exchange rate appreciates as they close the gap.*" There is a wide range of works studying the theoretical background of this process, the Balassa-Samuelson effect. Égert and Halpern (2006), Égert, Halpern and MacDonald (2006) and Égert (2007) reviewed earlier results and estimated the effect for new member states[2]. For Hungary, a real appreciation trend *vis-a-vis* the Euro area of 1.1% was found. Other studies suggested rates around 1%-2% per annum.

Nominal exchange rate stability and high inflation has indeed yielded modest real appreciation. The forint-euro exchange, which is key for a small economy integrated into the EU in terms of trade and finances, has been stable with an average 3-5% fluctuation per annum. Until 2001, Hungary operated a crawling peg regime with a narrow band. In 2001, a wider fluctuation band and inflation targeting was introduced. Inflation, however, was higher than in the EU, with fluctuation between 4-10% during the 1999-2008 period. See Chart 3.

As suggested by the Balassa-Samuelson effect, nominal price convergence was steady as the country's real convergence proceeded. Hungary's price level rose to 66% of the EU 27 average in 2008, compared with just 47% in 1999. See Chart 4. This is above the estimated trend Balassa-Samuelson effect and may signal an overvalued currency.

3. Fiscal policy errors led to vulnerability

Hungarian budget deficit in ***2007*** fell to 5% of the GDP from a record high of 9.2% in 2005. This was actually much below the original target of 6.8%. The difference was due to very cautious planning that was aimed to win back market confidence. In ***2008***, the deficit shrank to 3.0% of GDP because of further cuts in administration expenditures, a reduced state infrastructure investment budget and a revenue stream a touch higher than targeted. This expectation was also below the original target of 4.5%. See Chart 5.
In the ***2009*** budget, the government first looked for a 3.2% deficit later revised to 2.6% - based on macro forecasts of 3% GDP growth for 2009. Note, that in 2009, even a 3.2% headline budget deficit would be considered as just 2.9% owing to a special EU correction mechanism. Thus, Hungary may meet the Maastricht requirement within 3 years from fiscal disaster of the 9.2% gap.

As a consequence of expansionary policies, debt/GDP rose from 55% in 2000-2002 to above 68 in 2008. Thus, real convergence in Hungary was sustained on the price of rising indebtedness, suggesting that micro fundamentals might have resulted even in a lower growth rate had there been no expansionary fiscal policies in place. Fiscal policy errors, especially between 2002 and 2006 have indeed created a rather vulnerable macro

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[1] Darvas, Zsolt and György Szapáry (2008) Euro Area Enlargement and Euro Adoption Strategies, Economic Papers 304| February 2008 - DG ECFIN, EU Commission (Euro@10 project), *page 8.*

[2] Égert B. and L. Halpern (2006), "Equilibrium Exchange Rates in Central and Eastern Europe:A Meta-Regression Analysis", Journal of Banking and Finance, 30 (5), pp. 1359-1374; Égert. B., L. Halpern and R. Mac Donald (2006), "Equilibrium Exchange Rates in Transition Economies: Taking Stock of the Issues", Journal of Economic Surveys, Vol. 20.(2), pp.257-324; Égert, B. (2007), "Real Convergence, Price Level Convergence and Inflation Differentials in Europe", Oesterreichische Nationalbank Working Paper No. 138.

condition before the crisis hit Hungary. This reinforces earlier international evidence linking poor performance and vulnerability to fiscal mismanagement[3].

4. Output and the crisis

The lack of sustainability of finances was uncovered in a shocking fashion in mid-2008, when financing of Hungarian debt became rather difficult. The global recession hit Hungary, with GDP growth stalling in third quarter of 2008, dropping to 2.3% in the last quarter of 2008.

Industrial production growth, which had often reached an annual 20% in past years, slowed to monthly rate of 5%-10% in H1 2008 before tumbling in late 2008 to early 2009. In December 2008 and January 2009, industrial production dropped 20% compared with volumes a year earlier. See Chart 6.

In early March 2009, most forecasters look for at least a 15% drop in industrial output and a GDP contraction of 6%-7%. The latest data out of Germany, a key export market, gives plenty of room for pessimism. Given that most Central European countries are set to stagnate or contract modestly, and most euro area countries are set to contract by 4%-6% in 2009, Hungary will continue to diverge in terms GDP/capita.

In the first quarter of 2009, GDP fell by 5.8% on a y-o-y basis. After this sudden drop, no major recovery can be expected this year, suggesting an annual 6% decline. Interestingly, GDP fell in most Central European economies by about 6%, suggesting that multinationals in the region cut output at a similar same pace.

[3] This is quite the IMF view, see George Kopits (2000) „How Can Fiscal Policy Help Avert Currency Crises?", IMF Working Paper No. 00/185, International Monetary Fund (IMF), November 2000

II. National Goals and Strategies for the Euro Adoption: Mundell and Maastricht Calling

1. National goals before the crisis

A commitment to adopt

Hungary is a medium sized and very open European economy that conducts 80% of its external trade within the EU. Most likely, Hungary would form an optimum currency area with other EU countries, especially given that most of its peers have already or will soon have entered the euro area. For example, Darvas and Szapáry (2008) showed that both Hungarian and euro area business cycles are very well synchronized – except for extreme fiscal austerity eras.[4]. Hungarian manufacturing output and export data are closely correlated with the monthly readings of the German IFO index. Financial markets are also quite integrated. This is the fundamental basis for Hungary's wish to join the euro area.
Furthermore, Hungary was not given any opt-out clause in 2004, making it the country's legal obligation to meet the Maastricht criteria and adopt the currency. It was not an option (like it is for the United Kingdom), but an obligation under an important international treaty.

Entering the euro area is considered an integral part of European integration, and has been viewed positively by the public[5]. There has been a deeply rooted support for the euro for two main reasons. First, being an open economy, Hungarian households and companies have often come across foreign business partners, and quoted prices first in deutschmarks and then in euros. Second, inflation has always been a problem, and many believed that adopting the euro would prevent large inflationary episodes.

Most policymakers understood that monetary independence has already been lost, financial markets are integrated and monetary policy is rather ineffective in influencing output. For instance, foreign-owned firms are responsible for about 80% of manufacturing output and 90% of export volume, and they manage their finances in euros. This makes the lending channel rather irresponsive to interest rate changes. Domestic monetary policy is capable of causing problems and inflation, but is rather ineffective in doing a job it could, in a closed economy.

The loss of monetary policy has become an even greater issued recently, as households and companies started to borrow in euros. Foreign currency loans amount to 50% of total loans in Hungary; recent mortgage loans were almost exclusively made in foreign currency.

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[4] Darvas, Zsolt and György Szapáry (2008), "Business Cycle Synchronization in the Enlarged EU", Open Economies Review, Vol. 19(1), pp. 1-19. An earlier investigation is Eickmeier , Sandra and Jörg Breitung (2005) How synchronized are central and east European economies with the Euro area?: Evidence from a structural factor model, No 2005,20, Discussion Paper Series 1: Economic Studies from Deutsche Bundesbank, Research Centre

[5] Confirmed by various Eurobarometer polls

The Central Bank's cost and benefit analysis

In 2002, the National Bank of Hungary published a cost-benefit analysis on euro adoption that has since become the reference of political and professional debates on monetary and economic policy[6]. According to this analysis the introduction of the common currency would induce "*significant net gains in growth*" and for Hungary "*the euro area would be at least as optimal a currency area as for less developed member countries of the euro area*".

Regarding the euro area as an optimal currency area, the study analyzed the possibility of asymmetric shocks in Hungary and argued that there are three main reasons why they are as likely to occur in Hungary as in other, less developed countries of the euro area. First, quantitative indicators (eg. size of trade with members of the euro area) as well as qualitative indicators (eg. export/import structure, weight of intra-industry trade) suggest that Hungarian trade and economy has already been integrated into the euro area. Second, the structure of the economy was similar to the average of the euro members hence sector-specific shocks would have a similar effect on Hungary and on members of the euro area. Third, since the mid-90's, the Hungarian business cycle has been to the same extent in accord with business cycles of developed members of the euro area, as that of less developed member countries. (Although being a small and open economy with its own currency, Hungary may be more vulnerable to emerging market financial contagion and speculative attacks on the forint, and may experience larger volatility in capital flows that affect business cycle than member countries of the euro area.)

When studying adoption of the euro, the paper found three main benefits: (1) reduced transaction costs of households and businesses, (2) growth of foreign trade and (3) falling real interest rates.

(1). Transaction costs of households and businesses include the cost of conversion (fees and charges by banks and other financial institutions), bid-ask spreads as well as administration and risk management costs of firms that are involved in foreign currency transactions.

Based on data of Hungarian foreign exchange market turnover, the size of commissions, and partly on international estimates the study estimated that "*gains from reduced transaction costs would cause a one-off rise of 0.18-0.30 pp in the level of GDP*".

(2). Growth of foreign trade: using gravity models and large panel data, the study found that forming a currency union with trading partner countries would increase "*GDP growth by 0.55-0.76 of a percentage point over the long run, through the expansion of external trade*".

(3) Fall in interest rates: to compensate non-resident investors for a volatile exchange rate, the forint interest rates include risk premium. By adopting the euro, domestic nominal rates and real rates would be lower, boosting domestic investment and, in the long-run, enhancing economic growth and convergence towards income level of EU member countries. Altogether, in the long-run lower interest rates would raise the rate of GDP growth by 0.08-0.13pp, while lower seigniorage revenues would cause an annual loss in the range of 0.17–0.23 of a percentage point in the level of GDP.

The study found that quantifiable short-term benefits (gains from reduced transaction costs) and short-term costs (losses stemming from lower seigniorage) would be equivalent. However, estimated long-term benefits would result in net gains: by adopting

[6] This subsection is review of Csajbok, Attila and Ágnes Csermely (eds) (2002) ADOPTING THE EURO IN HUNGARY: EXPECTED COSTS, BENEFITS AND TIMING, NBH Occasional papers 24

the common currency the growth rate of the GDP would increase by 0.6 to 0.9 of a percentage point in terms of a long-term (20-year) average.

Table 1a. Effect of short-term factors on (the level of) GDP as a percentage of GDP

Reduction in transaction costs	0.18–0.30
Change in seigniorage revenue	–0.17– –0.23
Net effect	0.01–0.07

Source: Csajbok-Csermely (2002)

Table 1b. Effect of long-term factors on GDP growth (percentage points)

Reduction in real rates	0.08–0.13
Expansion of external trade	0.55–0.76
Net effect	0.63–0.89

Source: Csajbok-Csermely (2002)

Overall, the study argued that the sooner Hungary joins the euro area, the better positioned it would be to protect the country from capital outflows, speculative attacks or a currency crisis. A joint program of the central bank and the government that would also adhere to the aforementioned target date for euro introduction could help stabilize the exchange rate and even make disinflation policy more credible.

Note that there have been no official updates to this study, and figures might have changed a great deal. Recent studies showed a smaller than expected gain from trade in most euro area countries.

Maastricht criteria

As stated earlier, Hungary had set to join the euro area but failed to undertake enough reforms to get close to accession itself.

Hungary has never been close to meeting the Maastricht criteria, imbalances have either manifested in high inflation or in high budget deficit. By 2008, the deficit shrank to acceptable levels, but exchange rate stability has suffered since January.

Table 2. Maastricht criteria 2004-2008

	2004		**2006**		**2008***	
Inflation	6.7	NO	3.9	NO	6	NO
Interest rates	8.2	NO	7.2	NO	8.2	NO
Public deficit	-6.4%	NO	9.3	NO	3.2(f)	Y/N
Public debt**	59% / ☐	YES	61.7 / ☐	NO	65(f) / ☐	NO
Exchange rate stability	within band	YES	within band	YES	*within band*	Y/N
Trend	Deterioration all current variables poor, debt still acceptable		Deterioration deficit skyrocketed		Mixed deficit fell, exchange rate stability ended	

*2008 values for deficit and debt are preliminary/forecasts
** For public debt, trend is denoted by signs

Euro entry timing

There is no EU regulation that stipulates that a country must fulfill all criteria of the euro area prior to joining the ERM-II. The country should, however, be very close to the target figures set by the Maastricht criteria[7].

In 2005, delay of accession was an important issue. Results of the central bank suggested that the size of financial market reactions is a function of "how far the entry date is postponed, how far current inflation is from the Maastricht-satisfying level, and whether the credibility of the central bank's target inflation path is sensitive to changes in the expected entry date".[8]

This is important, as it highlights the significance of a credible central bank commitment towards a long-term price stability that is not dependent on the euro convergence path. The bank research advised that the adoption of a constant medium term inflation target (which has been the case since), arguing that if this targeted inflation rate itself is credible by markets, market reactions of an entry delay may be mitigated by stable, longer-term inflationary expectations.

Euro entry rate

There has been much open speculation regarding the entry rate. Yet, there was some research into the question. Some argued that the Forint has become overvalued by the middle of the decade, but there seemed to be no consensus view[9]. In the lack of a true free floating period, it would have been difficult anyways. Further, Világi (2003) argued that a fair real exchange rate may be the most important factor, but there are several others to consider, such as the inflation rate, the real and the nominal wage level, the state of the foreign business cycle, or productivity[10].
In terms of market expectations, a 250 €/Ft ERM entry rate was widely expected before the crisis. After the crisis, there is basically no forecast. If anything, a weaker central rate is now expected.

2. A collection of views regarding Euro introduction (2002-2009)

Before

2001-2005: diverging target date

In 2001, Governor of the Central Bank Zsigmond Jarai announced that Hungary was preparing to join the European Monetary Union (EMU) by 2006. The central bank did a study, but politics has not caught up.

In 2003, at a joint press conference with the Bank, Prime Minister (PM) Peter Medgyessy officially announced that the government working together with the Central Bank decided that Hungary intends to join the euro area as of 1 January 2008. The Governor of the Central Bank Zsigmond Jarai emphasized that in order to fulfill all criteria, the government should lead a strict fiscal policy and in May 2004 Hungary should join the

[7] See Appendix for details
[8] Csajbók, Attila - András Rezessy : Hungary's Euro area entry date: what do the markets think and what if they change their minds?, Magyar Nemzeti Bank OP 2005/37
[9] Giannellis, Nikolaos and Athanasios Papadopoulos (2007) Estimating the Equilibrium Effective Exchange Rate for Potential EMU Members, Open Economies Review, 2007, vol. 18, issue 3, pages 307-326; Enrique Alberola & Daniel Navia, (2008) "Equilibrium Exchange Rates in New EU Members: External Imbalances versus Real Convergence," Review of Development Economics, Blackwell Publishing, vol. 12(3), pages 605-619, 08.
[10] Világi, Balázs (2003) The Optimal Euro Conversion Rate in a Stochastic Dynamic General Equilibrium Model, No 2003/11, MNB Working Papers, Magyar Nemzeti Bank

ERM-II exchange rate system. Minister of Finance Csaba Laszlo stated that the forint-euro parity could only be established after joining the Euro area and reaching an agreement with the European Central Bank (ECB). This plan soon collapsed.

In 2004, Minsiter of Finance Tibor Draskovics argued that in his opinion Hungary could join the currency union by 2010 but leaning on macroeconomic data, the government might set 2009 as a target date.

In 2005, Governor of the Central Bank Zsigmond Jarai argued that Hungary should introduce the euro as soon as possible, but in the previous 3 years, the Hungarian economy quickly diverged from this target. Mr. Jarai emphasized that Hungary remained the only member of the EU that could not fulfill any Maastricht criteria. He still considered the introduction of the common currency as a possibility for 2010 but stated that previous changes of the target date have done harm. (At the time, PM Ferenc Gyurcsany expressed his concerns about the forint being too strong.).

Later in 2005, Governor of the Central Bank Zsigmond Jarai stated that he thinks it is impossible to introduce the common currency in 2010. Although Minister of Finance Janos Veres still insisted that the appropriate deficit reducing process could lead to fulfilling the Maastricht criteria by 2008, several bank analysts argued that medium-term budget targets would not be met and the Hungarian accession to the euro area slipped to 2012-13. Yet, PM Gyurcsany stated that the government was committed to introducing the common currency in 2010. In his view, 2010 would be a realistic target date if state reforms had started after general elections (May 2006).

In 2006, after winning elections, PM Ferenc Gyurcsany announced that the convergence program would not contain a target date for euro adoption and that there are alternative programs for fulfilling the Maastricht criteria by 2008, 2009 or 2010.

Late 2006 uncertainty

In late August 2006, the gap between the government's target date and market expectations further widened. While the Minister of Finance mentioned 2011 as the earliest date of Euro adoption based on the estimates of the convergence program, analysts predicted 2013-14. However, just a month later, the Ministry of Finance argued that the government could only decide on the target date of the adoption in 2 years and schedule of the accession could only be set after restoring the balance of the budget.

Contradicting opinion surfaced in the cabinet when in an interview to Frankfurter Allgemeine Zeitung Minister of Transport and Economy Janos Koka said that if Hungary proceeds as planned by the government and in agreement with the EC (meeting the Maastricht criteria in 2009), adoption of the euro could be possible in 2011.

Governor of the Central Bank and former Minister of Finance of the Fidesz government Zsigmond Jarai stated that opposite to its goal, the convergence program of the government does not bring the country closer to the adoption of the common currency.

2007-2008 rumors about target date surface as the new Governor of the Central Bank enters

In January 2007 the Under Secretary of the Ministry of Finance Almos Kovacs stated that the government did not set a target date for the euro area entry and mentioned 2011 as the earliest at a Euromoney conference in Vienna. In February, PM Ferenc Gyurcsany made an announcement that intended to soothe investors. He announced that the government, together with the National Bank of Hungary and its newly elected governor Andras Simor, intended to prepare a joint program to fulfill Maastricht criteria and introduce the euro. PM Gyurcsany put the target date somewhere between 2010 and 2015 but emphasized that it had to be a joint decision.

Governor of the Central Bank Andras Simor stated that it is crucial to reach the goals set in the convergence program and to introduce the common currency. He added that the primary goal of the monetary policy is to reach the inflation target of the Maastricht criteria and price stability. In September he argued that representatives of interest groups and business sphere should discuss options of adopting the Euro in the next 6-12 months and then set a target date. He emphasized that in order to introduce the common currency in 2011 or 2012, Hungary must speed up the convergence program that would require serious sacrifices.

In December 2007, PM Ferenc Gyurcsany announced that in one year the government would know when to introduce the common currency.

In July 2008, Minister of Finance Janos Veres emphasized that there is no target date set, but if the convergence program was realized, Hungary would be able to enter the ERM2 in 2009 and introduce the Euro in 2011. Meanwhile analysts mentioned 2013 as the earliest realistic date for the Hungarian accession.

After

2008: The crisis hits the country

First, to soothe nervous investors at the start of the financial crisis and after announcing the IMF stand-by credit, PM Gyurcsany together with Minister of Finance Janos Veres stated that either in 2009 or in 2010, Hungary would be able to join the ERM-II[11].

On 13 November, at the crisis summit of the five parliamentary parties and major interest groups, Minister of Finance Mr. Janos Veres announced that the government intends to fulfill all criteria and join the ERM-II by 2009. Assuming that Hungary would join the ERM-II in 2009, Mr. Veres argued that the country would be able to introduce the common currency by January 2012. Note that this implied a spring 2009 ERM entry.

Later, on 16 November while giving an interview to the *Financial Times*, PM Gyurcsany argued that Hungary could join ERM-II in 2010 before general elections. He stated that if the relevant conditions were favorable, apart from fulfilling all criteria, the country should join the exchange rate mechanism. Note that this would imply a 2013 euro area entry.

On 20 November at a conference about the global financial crisis the Minister of Finance again confirmed the intent to join ERM-II as soon as possible. He argued that the EU would evaluate Hungarian macroeconomic processes in the spring and in the fall of 2009 and, depending on the judgment of the EU in the fall, negotiations about the entrance date might begin. Note that this would also suggest a 2013 euro area entry.

At the economic summit of various interest groups and the parliamentary parties held later in November, Conservative centre-right MDF argued that Hungary should accelerate the process of introducing the common currency and set a target date in order to stabilize the forint. Former coalition party SZDSZ also advocated for joining the euro area and mentioned 2012 as the earliest date.

The opposition party, Fidesz, sent mixed signals regarding its position on joining the ERM-II. In mid-November, the party hinted that it would support the government in cutting expenses and introduce the euro if the government accepted the Fidesz proposal to set up an independent Budget Council that would oversee the budget. In November, speaking to *Reuters*, the leader of the parliamentary fraction of Fidesz, Tibor Navracsics, argued that only an economic stimulus package could lead the country out of the crisis and that Hungary's most important was to restart economic growth. Therefore, cutting state expenditures was the wrong answer to the crisis. He also stated that a quick

[11] See Appendix for details

introduction of the common currency could save Hungary from bad governments and, in his view, the country would be able to join ERM-II in 2010 and introduce the euro in 2012-13.

2009: talking again about setting a target date

In February 2009, speaking to *Reuters*, PM Gyurcsany stated that before 2012 the common currency would not be introduced but he can see no reason why the adoption of the euro should be delayed after 2014.

Along with the crisis the government started to talk more about the common currency: Minister of Finance Janos Veres argued that Hungary could fulfill the criteria in 2009 and join the euro area 2 years later, but the EU could also change the criteria because of the financial crisis.

According to the most optimistic scenario prepared by GKI Economic Research Co., Hungary could join the ERM-II as early as 2009. The farthermost date of 2014 appeared in a forecast produced by Deutsche Bank.

In February the government stated that in the coming weeks and months the realistic target date of the Euro area accession could be set and speaking to the Dow Jones Newswires PM Ferenc Gyurcsany announced that the government intends to set the target date till 30 September 2009.

Spring 2009: new, Socialist government without target date

On 29 April, when meeting with EC President José Manuel Barroso, PM Bajnai stated that Hungary had to solve its own problems, should not look for loopholes regarding the introduction of the Euro and had to fulfill the Maastricht criteria in order to enter the euro area as soon as possible. As a Minister of Finance in the new cabinet, Peter Oszko stated that first he intends to deal with crisis management and does not promise to set a target date for the Euro accession before the end of 2009.

It seems that the new government will talk about euro but only once key austerity measures have been accepted and some credibility were regained.

3. Responses to the Global Crisis

The global financial crisis has most certainly affected Hungary's approach to the euro area accession process. Exchange rate stability, previously enjoyed in Hungary, is over. As a reaction to crisis, improvements regarding fiscal policy were promised. However, tensions finally led to a collapse of the reigning government.

An institutional response

In November 2008, a parliamentary majority accepted the fiscal responsibility law that had originally been proposed by former coalition partner SZDSZ. The law capping state expenditures maintains the long-term sustainability of the budget reduces state debt and enhances transparency of state expenditures. According to the new legislation, the state debt can only increase by the rate of inflation and future laws (including budgets) cannot raise the real state debt or turn over the budget balance. Reduction of budget deficit will remain the task of the governments for the next four years. As a result, the government harbored hopes that the state debt would gradually shrink.

The new fiscal responsibility act also set up a Budget Council, which will be accountable for keeping a "responsible budget". The Council will help State Audit Office to control the government by estimating the cost of each proposal, counting whether new legislation would hurt the budget balance and by preparing macroeconomic forecasts. The President of the Republic, the Governor of the Central Bank and the head of the State Audit Office each appointed one member of the Council and, in February 2009, the parliament elected the members by a significant majority for nine years.

According to the fiscal responsibility law, state expenditures cannot be raised in 2009 and can only increase by 50% of the rate of GDP growth in 2010 and 2011. By creating a Stability and Tax Reform Fund the law also ensures that if the public sector balance (excluding interest expenses) is better than expected in a given year and in the following four years, the government can only spend the surplus on tax cuts. The new legislation abolishes "creative accounting" as it also stipulates that results of state-owned companies must be included in the budget.

A political response

As a reaction to the growing discontent, Ferenc Gyurcsany resigned and in mid-April 2009 the parliament elected the former Minister of National Development and Economy Gordon Bajnai for the position of prime minister.
The new government still remained a Socialist one, but SZDSZ stated it would support the new cabinet. In the new government only two key finance positions were filled in by outsiders. The new Finance Minister became Peter Oszko, the 36-year old head of Deloitte Hungary and chief architect of an alternative economic program by employers' associations.

On 19 April PM Gordon Bajnai announced details of his crisis management package that would cut back state expenditures by 350-400 billion forint in 2009 (including restrictive measures announced February 2009 by Gyurcsany) and 900 billion forint in 2010. He argued that, in addition to the effects of the global financial crisis, Hungary must cope with other economic problems, all of which point to the inefficiency of the state and low employment rate (only 57% of people aged between 19 and 64 have a legal job in Hungary). PM Bajnai argued that in order to break out of the crisis the balance of the budget must be kept, measures enhancing the economy must be taken and Hungary should gain back investors' confidence.

On 4 May the parliament accepted the first proposals of the Bajnai-government to transform the pension and tax systems. Importantly, the 13th month pension for present and future retirees as of 2010 was abolished. Concerning the tax system, minor income tax cuts will be effective as of July 2009, while larger cuts will be taken in 2010; VAT will rise, and a discussion on a wealth tax was initiated.

PM Bajnai mentioned euro adoption as a medium- term goal without setting a target date.

In May, senior politicians of opposition Fidesz announced that if the party won next general election in 2010 it would abolish almost all the austerity measures of the Bajnai government. Overall, Fidesz would abolish all elements of the reform package that would cut state expenditures and instead boost government spending in order to enhance the economy.

Preparing for the 7 June 2009 European Parliament elections, Fidesz stated that Hungary needed the common currency but would only set a target date if the party was in power and was privy to the exact state of the budget. To introduce the common currency, Fidesz would develop a long-term economic policy that would include transforming the budget, whitening and boosting the economy as well as cutting taxes. Fidesz also blamed the previous and present Socialist governments for wavering inflation, rising state debt and the fact that the EC has applied excessive deficit procedure against Hungary since 2004. The party emphasized the need to fulfill the Maastricht criteria, maintaining that if Hungary had been in the euro area when hit by the financial crisis, the crisis of the forint could have been avoided. Fidesz concluded that Hungary will be the last among the new member states to introduce the euro.

4. The IMF/EU lifeline

On 28 October, the IMF together with the EU and the World Bank announced a joint financial support package for Hungary: the country received a $25.1 billion life belt. The package consisted of a $15.7 billion (€12.5 billion) IMF support that had to be approved by the organization's Management and Executive Board. The 17-month Stand-By Arrangement (valid till spring 2010) will be reviewed by the Board in early November[12]. The EU agreed to provide a loan of $8.1 billion (€6.5 billion) while the World Bank would lend $1.3 billion (€1.0 billion) to Hungary. The facilities will expire early 2010.

In the wake of the IMF loan package, total external debt was €114 billion: €35 billion state, €39 billion corporate and households and €40 billion financials. There are 750.000 foreign currency mortgage loans in Hungary worth a total of 4500 billion forints, over 90% of which are made in Swiss Francs.

Hungary's short term (due within a year) debt in late 2008 amounted to €26 billion. This is a sum of €4.7 billion debt by the state, €5.7 billion by corporations and households and €15.7 billion by financials. Given the size of the IMF-EU package, the aim must have been to secure financing for both the state and private sector. See Chart 7

The debt problem is indeed severe for the financial sector and raised external financing by 10 percentage points in three years, with a 7pp rise in short term financing. While the debt problem led to a halt in new loans that crippled the Hungarian economy, it is not clear why the country should spend the IMF-EU resources to bail out foreign owned banks that repatriated billions of euros in profit in past years[13].

The IMF stated that Hungary worked out a broad policy package that would help stabilization and enhance economic development in the long-run. Hence, the IMF conditionality has been much softer than usual; the IMF did not set specific budget goals for Hungary and made a few conditions only. First, the government should plan the 2009 budget so that spending targets not exceed the actually available funds (i.e. the government shall not be in need to get additional external financing). This plan must be made under pessimistic circumstances. Second, measures reducing the revenues side of the budget (eg. tax cuts) cannot be taken. It turned out that IMF also required abolishing the 13th-month salary of public servants without wage raises and pensions cuts. The government finally softened up this promise, causing disapproval on the IMF side.

The EU has applied a detailed set of conditionality rules. The 2.9% deficit target along with a set of regulatory issues were in core of the agreement:

> *"The EU financial assistance is provided in support of the new comprehensive economic policy programme adopted by the Hungarian authorities in the last week of October 2008 to restore investor confidence and alleviate the stress experienced in recent weeks in the Hungarian financial markets. Relevant elements of this policy programme were already included in the legislative amendments to the draft budget submitted to parliament on 2 November. By supporting sustainability of Hungary's balance of payments, the assistance will help the country continue and enhance the fiscal consolidation efforts started in mod-2006*

[12] According to rumors, Fidesz offered no support for the IMF deal in Fall 2008, hence the target date prior to elections in 2010.
[13] See Gy. Jaksity (2009), http://index.hu/gazdasag/penzbeszel/2009/03/13/ki_adja_a_bankot_/

> *and to make progress with fiscal governance, financial sector regulation and supervision reforms and other measures to support a prudent, stability-oriented and sustainable economic policy."*[14]

The EU agreement posited that the "*disbursement of each further installment shall be made on the basis of the implementation of the new economic policy programme of the Hungarian government which is backed by the IMF arrangement and will be included in the forthcoming Convergence Programme of Hungary.*"[15] The release of funds will be based on a positive progress evaluation by the IMF/EU with respect to a set of politico-economic criteria. A detailed table with the criteria is presented in the Appendix.

Note that there are no Euro-strategy related points in the agreement with the EU or the IMF[16]. While senior IMF officials did indeed suggest that Eastern Europe should get the chance to introduce the Euro early on, the agreement with Hungary has not made any official provision in that regard.

Finally, note that the ECB (as well as the Swiss National Bank) acts as counterparty in euro swaps (to the Hungarian central bank) without applying any conditionality.

In May, a combined IMF – EU delegation visited Hungary to discuss the state of reform measures intended to restore credibility and financing capacity of Hungarian debt. The government proposed larger tax cuts than previously envisaged and a higher budget deficit owing to a larger recession (6%-7% GDP decline versus 3-5% expected in February and 1-3% expected in November when the loan package was signed.). According to a new IMF-EU deal, the 2009 deficit may reach 3.9% of GDP versus an earlier target of 2.9% of GDP, and below 3% deficit will be required for 2011 only.

Other proposals

After the IMF package, Hungary continued to search for help. On 1 March the EU summit rejected two out of the three proposals submitted by Hungary. PM Gyurcsany suggested that (i) the EU should ease the introduction of the euro for CEE countries, (ii) a €180bn bail-out plan for CEE countries and (iii) Western European banks receiving state support should help their CEE subsidiaries.
The first two proposals were rejected also by other CEE countries, emphasizing that they are in a different, less-troubled position than Hungary. Hungary was seen as isolated. Lately, several CEE countries openly argued that they are different, and CEE countries should be considered on an individual basis.

True, some EU leaders hinted that they might consider shortening the two-year preparation period of the ERM2. However, the ECB was perceived to be against the relaxation of *any* rules and directives.

The third proposal, however, was welcomed in principle, and Austria lobbied eagerly for bank loans in the CEE region, amounting to 75% of the Austrian GDP. Austria also warned of Russian banks filtering in the region if Western European countries were unwilling to help.

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[14] Memorandum of Understanding between the European Community and the Republic of Hungary, 17-19, November, 2008 (Budapest/Brussels)
[15] op.cit.
[16] e.g. IMF Country Report No. 09/105, „First Review Under the Stand-By Arrangement and Request for Modification of Performance Criteria—Staff Report; Staff Statement; and Press Release on the Executive Board Discussion", March 2009

5. Euro vs the crisis: how the trade-off changed

The financial crisis affected both Hungary's ability and willingness to adopt the common currency. Ability to meet the criteria has risen owing to a disinflationary environment and the financial market pressure to reform public finances. The willingness undoubtedly increased as well; as the country learned how hard life can be without a shield of a common currency. The fear from a financial collapse due to currency mismatch has also revalued Euro area entry.

The ability to meet the Maastricht inflation criteria has become easier given deflationary pressures worldwide. Unemployment is rising; even nominal wages are unlikely to rise. Thus, domestic demand has collapsed, and retail sales are expected to fall 5%-10% both this year and in 2010. Of course, a weak exchange rate would prevent disinflation, as imported good prices will rise on higher costs. Nevertheless, the medium term outlook seems conducive to achieving low inflation in 2011 once the effect of the VAT hike is washed out of the annual inflation rate. Interest rates are expected to start convergence once ERM2 is seen as credible. Note, however, that an inflation surge is likely once demand becomes stronger owing to massive global monetary easing during the 2008-2010 period.

Hungary's approach to public finances must change during the crisis, regardless of the type of government that will be borne out of the political crisis. In lack of market financing, living off an IMF life-support machine, Hungary must cut structural fiscal deficit despite the need for fiscal stimulus. Fiscal policy in a small and open economy is not very effective to fight the present global crisis, while fiscal prudence can bring back external financing and reduce interest rates. Note that fiscal stimulus packages that have been advised to many countries are impossible in Hungary, as no new debt may be financed by market participants[17]. Thus, the trade-offs are rather different for large and stable countries.

While an improvement will be visible by 2011, in 2009-2010 there are difficulties, as gross deficits will be inflated by a higher debt service costs. Although most developed countries experience low financing costs on their treasury papers, Hungary must compensate risks and pay higher interest than before. Overall, by 2011, public deficit must be significantly below 3% of GDP. Debt will be 70%-80% of GDP, but the debt/GDP ratio must show initial signs that it is starting to decline after a peak in 2009 and stagnation in 2010. Should the currency regain its strength, servicing euro debt will become easier – and the debt / GDP ratio can shrink more rapidly.

In terms of willingness, the cost of rising financial instability has not been an issue given the consequence of the Euro assumption: instability will *disappear* by virtue of the act of euro area entry. This point has become more important than ever, as the crisis has hit countries within the euro area (Slovakia and Slovenia) much less hardly than other Central European countries. Given that outstanding foreign currency denominated debt is about 100% of GDP, risks posed by this currency mismatch will remain high until the Euro is introduced. Only a credible path to the euro may lure back investors into Hungarian bond market as well as into direct investments. This is true in the longer term even if a strong IMF support provides stability for the year 2009.

Overall, the ability to meet the criteria must have risen in the lack of an alternative policy, and the willingness must have increased as politicians fear a worsening of the crisis. This may be a rather positive result of the global crisis for Hungary[18].

[17] See the recent Spilimbergo, Antonio, Steve Symansky, Olivier Blanchard, and Carlo Cottarelli (2008). "Fiscal Policy for the Crisis," IMF Staff Position Note, December 29, 2008, SPN/08/

[18] Latest comments by opposition Fidesz, who is set to win a two-thirds majority during the next elections, suggest that they fail to use the global crisis as a basis for reforms and promise to overturn them.

III. Institutional and Policy Environment regarding the Euro adoption: Waiting for Godot

1. Before Crisis: Institutional readiness but fiscal chaos

Institutional preparations

In order to achieve a cost-effective euro changeover, allocate responsibilities and co-ordinate the preparation, and according to the 2007 government decision 1071/2007 (IX. 21.) on the commencement of preparations for the practical introduction of the euro and its organisational framework, the government established the National Euro Co-ordination Committee (NEC).
As a proposal-making, advisory and consulting body, the task of NEB is:

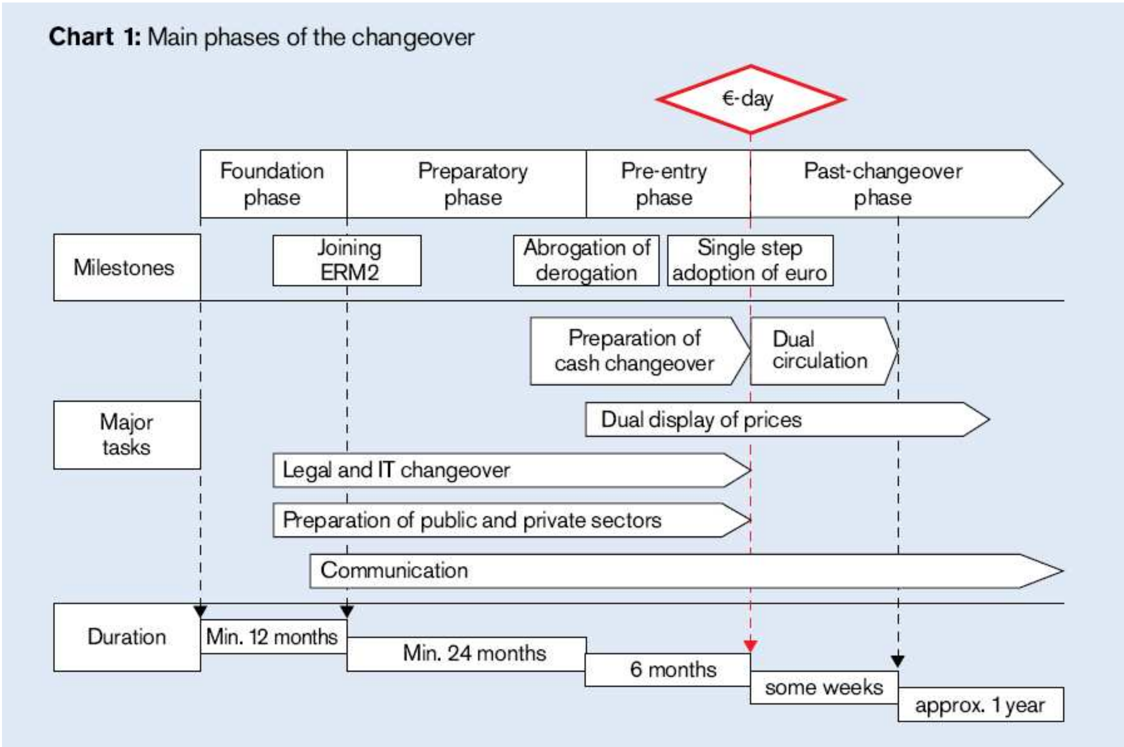
- to draw up a national changeover plan for the introduction of the common currency, setting a timetable related to the changeover in the financial, corporate and public sectors, the legal system and information technology systems, as well as consumer protection, accounting and statistics.
- to actively support with non-binding recommendations the public and private sectors in their preparations for the introduction of the euro with particular regard to information technology, price displaying and accounting systems, and the replacement of the national currency by euro and cash changeover
- to make an assessment of the costs of changeover in the public sector,
- to provide information for the preparations for the introduction of the euro related to the given stage of preparation using efficient communication means,
- to submit proposals for setting up the legal framework for the changeover, and to take initiatives for the necessary legislation with the minister in charge for the relevant regulations, at the local authorities and at the Governor of the Central Bank

The chairman of the NEC is the Minister of Finance, and the Governor of the Central Bank serves as co-chairman. Members of the NEC include the Minister for National Development and Economy, Minister of Social Affairs and Labor, Minister in Charge of the Prime Minister's Office, Minister of Local Government, President of the Central Statistical Office, and President of the Supervisory Council of the Hungarian Financial Supervisory Authority.

The wide range of public responsibilities and decisions covered by the organisational structure of the NEC provides a framework for changeover responsibilities. The NEC has set up seven sub-committees to cover sectors affected by the changeover (financial sector consumer interest, non-financial corporations, public sector, IT, legal, and communication).

The National Changeover Plan (NCP), formulated by the National Euro Co-ordination Committee, outlines the key responsibilities of the economic participants, changes in legislation relevant to the introduction of the common currency. By giving recommendations, the NCP also supports the transition of the private and public sectors. In order to assist in scheduling the work to be undertaken, it also provides a timetable, defines the responsible parties and sets the organizational structure of the National Euro Co-ordination Committee.

Note that the National Changeover Plan was approved by the government and will be reviewed at least once a year.



Source: Government Decision 1071/2007 (IX. 21.), "NAT_EN_REV_CLEAN20080917REV.pdf", http://www.mnb.hu/engine.aspx?page=mnbeuro_index

Monetary regime: survive till euro comes

The present monetary arrangement is inflation targeting. Given the openness of the country, and the strength of the exchange rate pass-through[19], the regime has been close to a dirty floating regime where the central bank used its interest rate policy as a mean to guide the exchange rate.

In 2007-2008, the central bank has moved away from close exchange rate targeting and allowed for a steady forint real appreciation. While this has helped contain inflation, it has pushed households and companies to borrow in foreign currencies with the expectation of low interest rates plus strong and even appreciating currency.

In the past five years, the Hungarian regime has had an important underlying assumption: euro area entry in always four years away from now. Indeed the first target date around EU accession was 2008. This has lent a sort of temporary nature to the regime design, making the achievement of low inflation and exchange rate stability its

[19] Jakab, Zoltán M. and Mihály András Kovács (2003) "Explaining the Exchange Rate Pass-Through in Hungary: Simulations with the NIGEM Model," MNB Working Papers 2003/5, Magyar Nemzeti Bank; Jakab, Zoltán M., Viktor Várpalotai and Balázs Vonnák (2006) "How does monetary policy affect aggregate demand? A multimodel approach for Hungary," MNB Working Papers 2006/4, Magyar Nemzeti Bank

most important feature. The crawling peg regime was followed by a fluctuation band of +/- 15% versus the euro. Both are supposed to provide stability in an open financial market environment. Given that foreigners have been holding a large share of state debt, this regime was expected to help maintain attractiveness of Hungarian assets, too.

In February 2008, the fluctuation band was dissolved – a fortunate event in a financial crisis. A weak end of a band would have attracted even more attention, and a speculative attack would have pushed the currency out of the regime, making the financial outlook even worse. This more liberal regime was supposed to help the exchange rate find its natural position versus the euro – ahead of a final fixation.

The central Bank support

The central bank supported the path towards euro and has aimed at keeping a steady exchange since 2001. Indeed, steady nominal rates and real appreciation of the currency were implied by economic policy using the exchange rate as a tool to reduce inflationary pressures. It is little wonder, despite considerable freedom since 2001 that the Forint failed to absorb external real shocks.[20] This suggests that in small and open economies like Hungary, keeping an exchange rate may not be useful, even in "peacetime."

Further, the central bank has found the inconsistency of inflation targeting and exchange rate management rather perplexing. Oftentimes, inflationary pressures would have required higher interest rates, but the fluctuation band kept the bank on the cautious side. Of course, a stable exchange rate – the euro itself – would solve this problem.

These experiences have made the central bank a core supporter of the project[21].

Domestic Politics of euro accession: avoid pain

Back in 2005 the prime minister promised to keep the 2010 deadline but argued that "it is important to have the economy ready for the common currency" and he emphasized "the need to negotiate an *appropriate* exchange rate" (that is, among Socialist politicians, a rate not too strong). As 2006 elections neared, the government started to argue that a swift run into the euro area was not worth the pain.

Regarding the view of the opposition on joining the euro area, the latest policy package of Fidesz dates back to December 2007. In the 90-page-long "Strong Hungary" text, Fidesz argues, that the early introduction of the common currency is the long-term interest of Hungary. Delaying the adoption of the euro is harmful to the Hungarian economy since benefits stemming from the euro area cannot enhance the economy. Furthermore, it puts the country at a disadvantage in terms of competitiveness (losses due to transaction costs, bank fees, etc.). In the text, Fidesz spends less than a page arguing for the euro. Although he suggests that the party accepts the advantages of the common currency, he fails to clarify its position on any details regarding the introduction.

In 2009, opposition leader Viktor Orban suggested that keeping a close date for introduction of the Euro was in the principal interest of the Hungarian economy, although, in his opinion, one should not exaggerate the importance of the actual timing. Unfortunately, there was no political support behind major reforms, revamping fiscal policy and making an effort to join the Euroarea. Back in 2005, analysts warned that the most likely case regarding fiscal policy takes no radical cuts and leads to a delay to 2013.

According to rumors, Fidesz did not support the IMF/EU package and hence, the IMF provisioned an end to the loan at 2010, just before elections.

[20] Darvas, Zsolt and György Szapáry (2008) Euro Area Enlargement and Euro Adoption Strategies, Economic Papers 304| February 2008 - DG ECFIN, EU Commission (Euro@10 project), *page 20*

[21] For details on central bank views and plans: http://english.mnb.hu/Engine.aspx?page=mnb_Euro_index

When the Bank was chaired by former Fidesz finance minister, Zsigmond Jarai, relations with the Socialist –liberal government were mixed. Before the crisis, the central bank criticized the government primarily for its loose fiscal policy. In terms of setting inflation targets and supporting the euro adoption projects, there was much less friction.

2. The position of the European institutions vis-à-vis the Hungarian Euro-strategy

European institutions have both officially and unofficially expressed doubts about the readiness to join ERM II or the euro area. Hungary has always expressed wishes to join the euro area even though the country has been far from meeting criteria. Hence, discussions were centered around two related issues instead: how to reduce inflation (an appropriate monetary policy regime) and how to lower the budget deficit. This latter has become the sole most important issue since the excessive deficit procedure initiated in 2006.

The excessive deficit procedure and Public deficit reduction

There are two diverging period, before and after 2006. Right after the EU accession, the EC was cautious on Euroarea entry. In 2004 July, the EC gave new EU members between two and four years to reduce their budget deficits to below the EU (Maastricht) limit of 3% of GDP. Hungary was given until 2008 to cut its deficit to the required level. The EC noted that "there were no clear indications about the ambitious expenditure reducing measures." If Hungary meets its deficit goals by 2008, it could join the euro area in 2010 envisaged by Hungarian authorities. In a revision of Hungarian fiscal policies carried out in July 2005, the EC retained a negative view: the EU was surprised to learn about tax reform plans given their critique about fiscal prudence. In a late 2005 meeting, the Council of EU finance ministers discussed Hungarian efforts to reduce deficit – Hungary performed the second worst after Greece in 2004. Given that an excessive deficit procedure was already underway, a negative view was feared to have serious political consequences e.g. regarding for example the use of structural grants (the potential for punishment is not clear in this respect). This has not happened. In 2005, Hungary postponed the target date. Note that having given up on 2010 was very similar to what happened in 2003 when the government first decided to revise the then 2008 date only to postpone the target by two years arguing in favor of a smoother transition.

In the 2006 Convergence Plan (CP) sent to Brussels, the government determined a new date of 2009 to meet the Maastricht criteria of a deficit below 3% of the GDP. In the plan, the government was set to cut the looming deficit by 3.3% of the GDP in 2007, 2.5% in 2008 and 1.1% in 2009. The CP was endorsed by the Council. It was assumed that if Hungary was to diverge from the figures laid down in the CP, disbursement of Cohesion Funds would once again be at stake. However, it did not happen. Hungary diverged but then began to reduce deficits.

In 2007-2008, comments from the EU (Ecofin)/ECB focused on two messages. First, that deficit reduction program must be carried out, and second, criteria will not be changed, so Hungary must put forth its best effort.

EU actors unified in putting deficit reduction first

In terms of a European approach to Hungary's take, authorities were not even required to express doubts given the distance from criteria. Thus, EC/ECB critiques have targeted fiscal policies since 2004.

Thus, Hungary's case differs from some other countries where criteria were almost met, causing European views to matter.

In terms of indicators other than the Maastricht criteria, there have been no considerable comments. Given the distance from the criteria, issues related to sustainability were not discussed. As for the interplay between the different "constituencies" in the EU (ECB, EC, etc.), there were no notable divergences complicating the negotiations, as that phase has not yet been reached.

In the past, politics and diplomacy cared about euro and EDP inasmuch it may halt EU transfers. In that respect diplomacy worked: Hungary could use funds despite breaching obligations. After the crisis, diplomacy was supposed to work to get better terms in accession, this was rather unsuccessful. While, the government stopped discussing the issue, naming the top Hungarian diplomat as new foreign affairs minister must be instrumental in looking at whether terms can be slightly altered – see next section.

3. The Impact of Crisis: Euro as our saviour

Political reactions

In November 2008, as the global financial crisis hit Hungary the hardest among Central European countries, the government along with parliamentary parties came to the conclusion that the country should join the ERM2 and introduce the euro as soon as possible.

Following the receipt of the IMF/EU loan package, both the governing Hungarian Socialist Party (MSZP) and PM Ferenc Gyurcsany noted that the crisis may lead to an accelerated Euroarea accession, and the country shall consider joining ERM2 in 2009. MNB Governor András Simor concurred suggesting that a 2012 entry may not be as impossible as previously considered. Later, Mr. Simor sounded more cautious, and argued that the disposal of the common currency would not only increase the capacity of a country to absorb global shocks but might in itself also imply a shock.

However, as Ferenc Gyurcsany resigned in April, the new PM Gordon Bajnai mentioned euro adoption only as a medium-term goal. The new Minister of Finance Peter Oszko also argued that the new cabinet needs to focus on coping with the financial and economic crisis first.

Fidesz stated that euro area accession could not be accelerated, given that a weak economy cannot fulfill the criteria. Instead, the economy should be strengthened by protecting jobs, tax cuts, supporting SMEs and using EU funds efficiently.

Overall, when the crisis abates, most parties will advocate for a 2009-2010 ERM2 entry and a 2012-2013 euro adoption. However, opposition Fidesz, the party that is likely to lead the next government, while seemingly undecided, has embraced euro introduction. In any case for ERM2 entry, a joint government-MNB decision and successful talks with the ECB and EC are required. Given the political crisis in Hungary, the new government has to focus on crisis management and there may be no elaborated plan in place regarding timing of euro introduction.

Crisis and strategy

Amidst a great deal of uncertainty, it is fair to assume that accession to the euro area is certainly one of cornerstones of Hungary's reaction to the global crisis. In terms of

institutional reaction, any new government is likely to set up a committee to oversee the procedure. This is mostly a PR tool to emphasize dedication.
In terms of policy reaction, fiscal prudence has become more important, increasing the importance of the role a new Budget Council may play.

Unfortunately, any decent policy measures in 2009 may be overshadowed by either new election preparations, elections, and setting up a new government, or the muddle through measures of accidental government with rather fragile parliamentary majority. Thus, one shall not expect a stable policy stance towards euro introduction even if a new government tried to portray one.

Alternatives? Not really

There are several alternatives to orderly euro introduction. While certain ideas keep popping up, there have been no substantial discussions of the matter. Three possible alternatives may be considered.

1. Currency board

It has been argued, that countries that adopted successful currency board arrangements (CBA) are small (like Baltics, Hong Kong) or have a limited financial local debt market (Bulgaria). Further, in countries that had national currency in the past, CBA is introduced often following a monetary and economic meltdown – as in Bulgaria. CBA works only when it becomes the basis of economic policy, anchoring expectations, and when the regime is fully supported by fiscal policies. The classic example for the difficulty of maintaining a CBA is Argentina[22]. For Hungary, this is not a realistic proposition given the scope of foreign presence of bond market. While it could serve as an anchor, it would offer a fixed rate for foreigners to take their cash out. At the moment this would quickly destroy the financial system. Further, the EU does not accept CBA as an ERM2-compatible regime.

2. Unilateral euroisation

In the past euroisation (i.e. the unilateral introduction of the euro as sole legal tender), has been considered an alternative for small, embryonic countries of southeastern Europe. In terms of people's behavior, not many people hold euro – just about 8%, unlike in several southeastern European countries (30-49%), or even the Czech Republic (20%)[23].

With the crisis, it has changed, especially following an influential IMF proposition, arguing that:
"…states in central and eastern Europe should consider scrapping their currencies in favour of the euro even without formally joining the Eurozone… The Eurozone could relax its entry rules so countries could join as quasi-members, without European Central Bank board seats"[24] In the international discussion that followed, Hungary was noted as a country where addressing the foreign debt currency overhang is very difficult without a radical move.

Once markets regained a bit of confidence, and total collapse is not the main scenario anymore, this proposition has gone out of fashion – even before gaining ground in

[22] On currency boards, an early work was Jakab, M. Zoltán (1997) A valutatanács rendszere, Bankszemle 41, pp 44-49
[23] Dvorsky et al. Euroization in Central, Eastern and Southeastern Europe – First Results from the New OeNB Euro Survey http://www.oenb.at/de/img/feei_2008_1_dvorsky_tcm14-86774.pdf
[24] "IMF says EU states in eastern Europe should adopt euro now", Financial Times, 6, April, 2009

Hungary. Given the massive political complications (the EU would not allow it), and considering Hungary's reliance on EU funding, this option remains rather unlikely.

3. Radical acceleration of the adoption of the Euro

Changing the Maastricht Treaty in a way that would somehow substantially alter the entry criteria – such as cutting the time required spent in the ERM2, or relaxing the measurements of the criteria. This has surfaced recently; it was suggested by the IMF and proposed by then-PM Gyurcsany in his ill-fated Brussels meeting in March.

While no major alteration seems likely, small modifications may be achieved. Notably, we concur with Darvas and Szapáry (2008, chapter 4.2.) \ that the application of the criteria should be slightly modified, particularly regarding inflation. The inflation criterion shall indeed be modified (applied differently) and be based on the euro area inflation rate instead of some non-member country's rate.

Further, we believe that the two year *grace* period within ERM2 should be reduced in these circumstances, or at least have it include the post-decision period of about 6-8 months. The latter would allow a 2012 entry even if extreme currency volatility remains unchanged in 2009.

As for diplomatic measures to attain these, a joint action by all CEE countries would be required. This may only happen once Hungary is not considered a pariah. Given Czech elections in the Fall, and Hungarian elections anytime between late this year and May 2010, a credible approach by countries seems likely around mid-2010. By then countries should have moved closer to meeting the criteria. We believe there is less than a 50% chance for success in altering the specificity of the two criteria described above. In terms of a diplomatic effort, one must note that the new Minister of Foreign Affairs Peter Balazs has far more experience in foreign policy than his predecessor: he was the first Hungarian member of the EC.

Conclusion: An optimistic scenario

There are ample reasons for pessimism regarding Hungary: its recession is likely to be severe, its government collapsed in March and there is modest political backing for deep reforms. Yet, we believe that euro introduction may be the very policy tool to help advance survival and lift Hungary out of the recession. Thus, we present the case for speedy ERM2 entry.

Crisis to encourage euro adoption, some alteration of criteria

Before the crisis, as a result of this belief that euro area entry in always four years away from now, there was no search for alternatives. Neither CBA nor unilateral euroization have been seriously considered

In the crisis climate the balance between pros (euro brings stability and growth) and cons of an early accession (countries are not ready and therefore inflationary pressures will be imported into the euro area) has been tipped towards the pro side. Indeed, the best way for CEE countries to survive the recent turbulence would be flagging euro accession in sight.

While the entry criteria are unlikely to change (see Appendix), key European governments are likely to be supportive should CEE countries be perceived as determined. It is true that the ECB has been putting inflation first and arguing that CEE countries would add to euro area inflation. Given the special circumstances, several ECB officials must have moved towards the importance of financial stability. Euro adoption is a great way to enhance stability.

How is ERM2 accession done? – learning from Slovakia

In a sudden move Slovakia joined ERM2 on 25 Nov 2005 much earlier than the market expectations of spring 2006. The central parity was basically set at the actual market rate of 38.5 SKK/€. Having appreciated between 2002 and 2004, it was traded in the 38-40 koruna range in 2005. Market commentators look for an EMU entry rate of 35-36SKK/€. However, the koruna firmed between the ERM2 entry fix and 2008 July fixing of the actual accession rate of 30.12. Thus, the koruna firmed a total of 22% - first within the ERM2 system and then following a reset of the parity. Indeed, the idea is to join ERM2 at a rate that allows some flexibility but where deviation is tolerated (even encouraged) on the strong side only.

As for Slovakia, back in 2005, an Organisation for Economic Co-operation and Development report suggested that the country should consider an early entry to the ERM2 mechanism to avoid excessive exchange rate appreciation. On the one hand, timing should not be very close to elections, so that political uncertainty did not lead to greater volatility thus preventing monetary authorities from finding the "fundamentally warranted" exchange rate. On the other hand, every fixed exchange rate regime is risky and spending more time than necessary in a fixed regime may come at the cost of a speculative attack.

Overall, there are three key lessons from the Slovakian accession story. First, fiscal reforms are needed to keep a low budget deficit for several years. Second, ERM2 accession comes about three years prior adopting the euro, somewhat ahead of market expectations. Third, the exchange rate central parity is fixed close to actual market price but may strengthen as much as 20%.

Expectations for CEE – room for optimism

The crisis has increased the value of euro introduction as a safety net during the crisis. Further, the lack of euro introduction on the horizon might cause a great deal of trouble in the region, hurting local as well as European interests. Thus, policymakers should set a target for 2013 entry.

A January 2013 euro area entry by Hungary along with the Baltic States, Poland and the Czech Republic is possible provided that (i) currency volatility eases in the first half of 2009, and (ii) national budgets remain balanced and/or reduce deficits in 2011-12.

CEE countries should try to survive turbulent times in the first half of 2009 and start discussing euro area entry. Adopting the common currency would free these economies from a key and present threat of being indebted in a foreign currency – large exchange rate movement may put enormous pressure on banks and households alike. With appropriate EU support, several countries may join ERM2 in 2009/2010 and adopt the euro as of January 2013.

Duties for Hungary

There are basically two fronts Hungary needs to fight. First it must make economic policy steps to avoid a debt trap and be able to meet the criteria by 2011. Second, it shall make diplomatic steps to reach some refinement of the criteria. The optimistic scenario is greatly dependent upon success achieved at both stages.

In its quest to introduce the euro, Hungary must first start discussing the issue, thereby raising the probability of the optimistic event. A credible process itself would help the currency appreciate, thus anchoring expectations and establishing a decent entry level exchange rate. Of course, this requires a stable government, one that can make credible decisions.

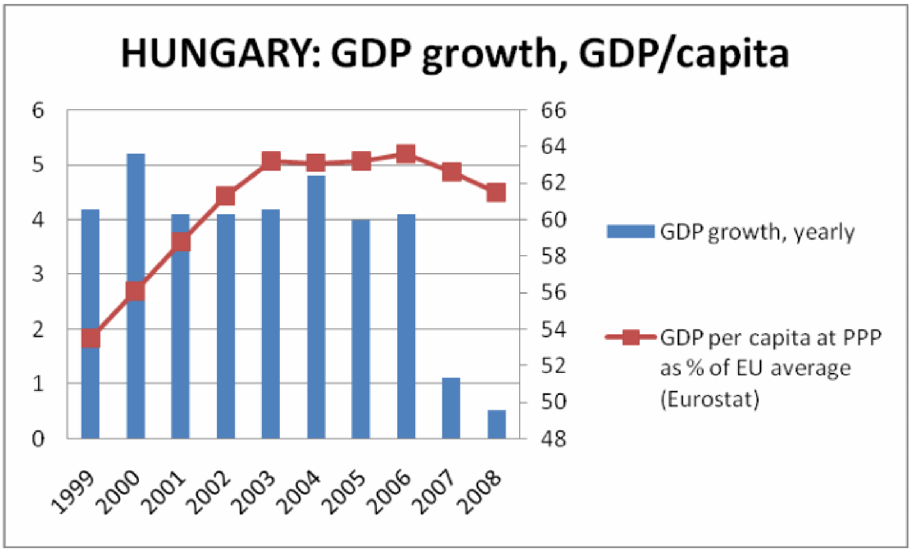
Table 3. Euro Accession schedule: an illustrative example

Period	Key feature of the period	Policy targets	EURHUF
2009 H1	Uncertainty at financial markets	Avoid excessive volatility	280-330
2009 H2	Defining a target date	Draft a credible schedule	280-300
2009 Q4-2010 Q1	ERM2 entry	Find an appropriate central parity	270-280
2010 Q2-2012Q1	Sustain ERM2	Meet Maastricht criteria (budget deficit, inflation)	250-280
2012 July	Fix EURHUF	Deciding the fixing rate	240-260

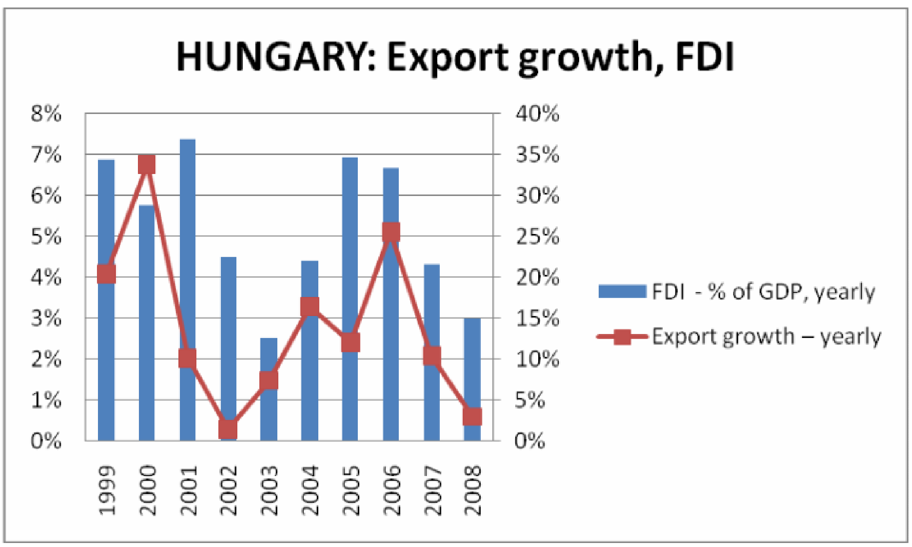
Appendix

Charts and Tables

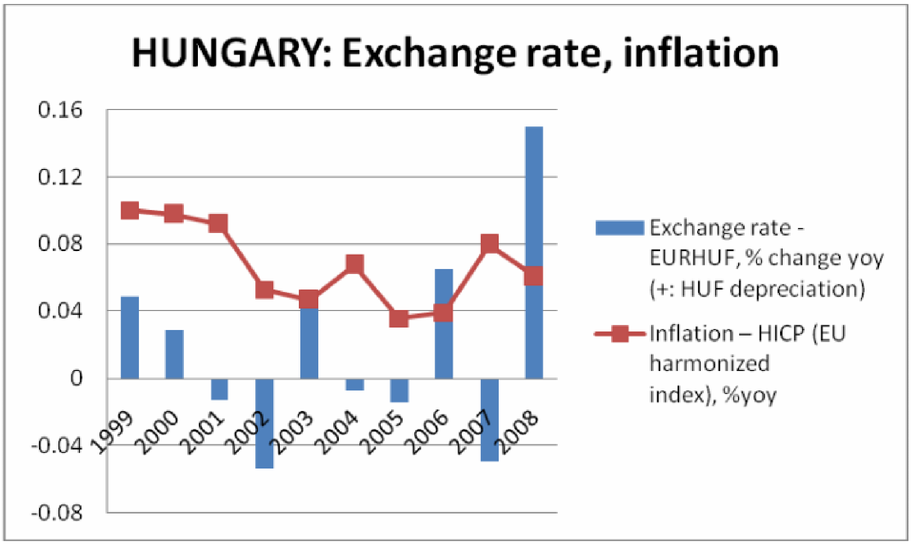
01. Chart



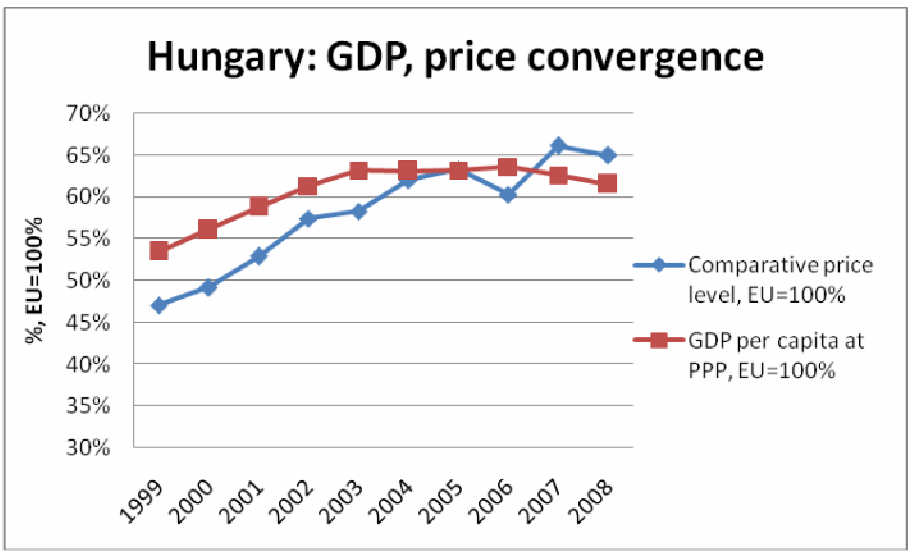
02. Chart



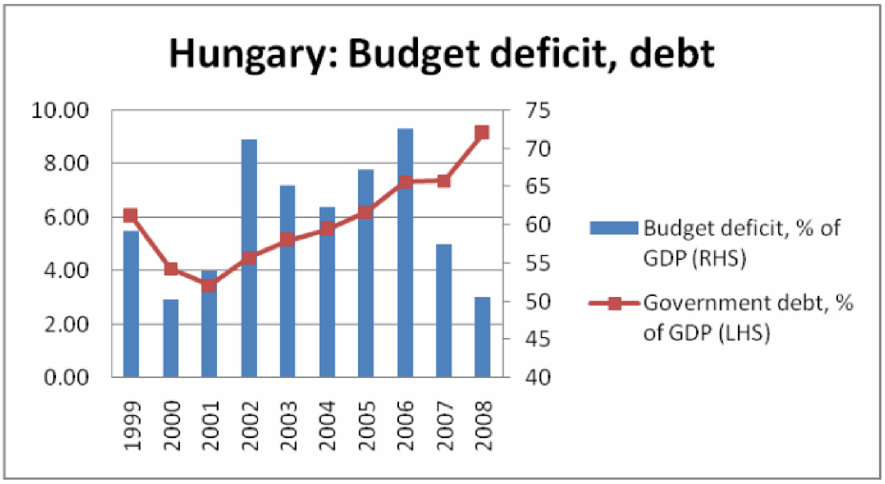
03. Chart



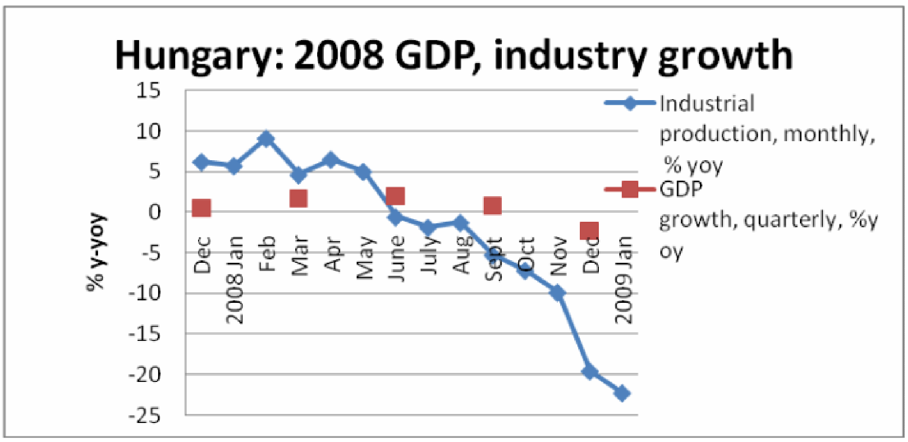
04. Chart



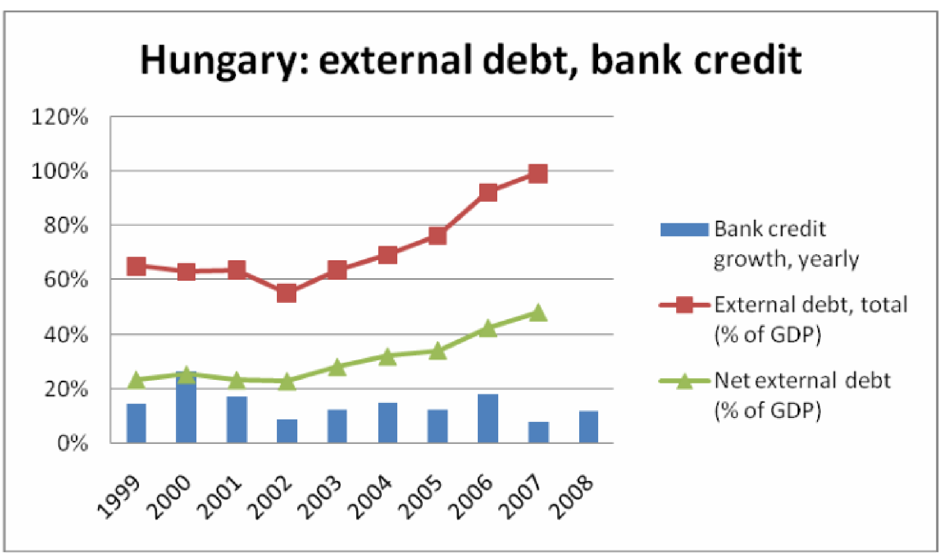
05. Chart



06. Chart



07. Chart



Yearly data, 1999-2008 (for countries that joined EU in 2004); 2002-2008 (for countries that joined EU in 2007)

	1999	2000	2001	2002	2003	2004	2005	2006	2007
HICP (EU harmonized inflation index)	10.01	9.78	9.19	5.28	4.67	6.75	3.58	3.92	7.98
Budget deficit/surplus - % of GDP (General Government Budget Balance)	61.1	54.3	52.1	55.7	58.0	59.4	61.7	65.6	65.8
General Government Gross debt, % of GDP	61.1	54.3	52.1	55.7	58.0	59.4	61.7	65.6	65.8
Long-term interest rates (10-year government bonds) – end of year	9.91	8.55	7.94	7.09	6.83	8.19	6.60	7.12	6.74
Exchange rate - % change against the Euro	0.05	0.03	-0.01	-0.05	0.04	-0.01	-0.01	0.07	-0.05
Price level compared to the EU average (Eurostat)	47.1	49.2	52.9	57.4	58.3	62.0	63.3	60.3	66.1
GDP per capita at PPP as % of EU average (Eurostat)	53.5	56.1	58.8	61.3	63.2	63.1	63.2	63.6	62.6
GDP growth	4.20	5.20	4.10	4.10	4.20	4.80	4.00	4.10	1.10
Employment rate (15-64)	55.6	56.3	56.2	56.2	57.0	56.8	56.9	57.3	57.3
Export growth	0.20	0.34	0.10	0.01	0.07	0.16	0.12	0.25	0.10
Current account - % of GDP	-7.84	-8.36	-6.01	-6.96	-7.94	-8.60	-7.49	-7.54	-6.44
FDI - % of GDP (+ % of FDI coming from EU countries, if data exist)	0.07	0.06	0.07	0.04	0.03	0.04	0.07	0.07	0.04
FDI from EU countries - % of GDP									
External debt (private + public) - % of GDP (+ net external debt, if data exist)	65.22	63.16	63.74	55.30	63.76	69.33	76.53	92.42	99.36
Trade with EU countries, % of total	82.40	81.30	80.90	81.80	81.20	79.40	76.50	74.30	73.60
Bank credit growth (% change)	0.14	0.26	0.17	0.09	0.12	0.15	0.12	0.18	0.08
M2 (% change)	0.17	0.14	0.14	0.15	0.15	0.12	0.12	0.14	0.07
Interbank interest rates, monthly averages for the correrspondind year		11.05	10.90	8.86	8.25	11.50	7.07	6.43	7.64
Share of deposits and credits denominated in Euro							0.08	0.07	0.04

EU banks ownership of local banks, % of total assets									
Stock market index	6722.97	8738.56	6898.90	7757.08	8389.83	11766.66	19032.13	22495.92	26132.88
World bank doing business ranking	na	na	na	na	na	na	na	na	na

Monthly (sarting from June 2008) and quarterly (starting from IQ 2008) data. According to the frequency (monthly; quarterly) of their issue

	2008/06	2008/07	2008/08	2008/09	2008/10	2008/11	2008/ 12	2009/01	2009/02
GDP growth, % change from the same quarter of the previous year	2.00			0.80			-2.30		
Industrial production, % change from the same period of the previous year	-0.60	-1.90	-1.30	-5.30	-7.20	-9.90	-19.60	-22.30	
Unemployment rate	7.80	7.80	7.90	7.90	8.00	8.20	8.50		
HICP (EU harmonized inflation index), % change from the same month of the previous year	7.00	6.90	6.90	6.80	6.60	6.40	6.00		
Exchange rate - % change against the Euro, monthly	-0.02	-0.04	0.02	0.02	0.07	0.03	0.00	0.06	
Government debt - % of GDP	0.60			0.60			0.68		
Long-term interest rates (10-year government bonds)	8.50	8.11	7.77	7.99	9.57	9.41	8.31		
Export growth – monthly data compared to the same period of the previous year	0.09	0.09	0.00	0.10	-0.02	-0.09			
Current account - % of GDP									
FDI - % change compared to the same month of the previous year	0.26			0.43					
External debt (government + private) - % of GDP	na								
Bank credit growth, % change from the same period of the previous year	0.37	0.29	0.31	0.37	0.54	0.41	0.43		
M2, % change from the same period of the previous year	0.093	0.132	0.089	0.093	0.092	0.101	0.101		

Interbank interest rates	7.749	7.869	8.444	8.504	8.863	11.282	10.122		
Stock market index	21322.8	20897.3	20816.9	19324.4	14806.6	12364.4	12446.3		

Conditions of Adopting the Euro

The Maastricht criteria obliges states willing to introduce the euro to keep budget deficit below 3% of GDP, public debt below 60% of GDP, to have an inflation rate within 1.5% of the three EU countries with the lowest rate, to have long-term interest rates within 2% of the three lowest interest rates in EU, and to keep exchange rates within the fluctuation margins of ERM2. In case of high debt, a downward trend is acceptable. As for inflation, a sustainably low inflation rate is required (i.e. no tricks). Note, that according to the EU, if a state is able to fulfill target numbers for 2 years, it can automatically enter the Euro area. There is no such EU regulation, a country must fulfill all criteria of the euro area when it joins the ERM2, but it should be very close to the target figures set by the Maastricht criteria.

ERM2 is the exchange rate mechanism (European Exchange Rate Mechanism) of the EU that is aimed at preparing would be euro area members to a fixed exchange rate regime. In ERM2, currencies are pegged to the euro and are allowed to float within a +/- 15% band. A country needs to spend at least two years in ERM2 without major disruption to prove readiness to monetary union[25].

The ERM2 can be regarded as entrance to the euro area; it is designed to help countries converge to the euro area. In the framework of the ERM2, an exchange rate is set and a +/-15% band is established where the currency is able to fluctuate. Primarily it is the task of the country's central bank to keep the currency in the band, but the ECB also guarantees and keeps the rate within the band (i.e. the ECB intervenes in financial markets to keep the currency within the band). Within the system, there is the possibility for exchange rate realignment – i.e. entry with a given rate and devaluation or revaluation of the central parity – upon the agreement of both parties – the central bank of the country and the ECB. Within the band, firming of the national currency versus the euro is welcome but depreciation is seen as a lack of readiness as it signals an inflationary pressure. This is why the band is not really symmetric; central bank intervention may be expected within the band if the currency weakens by more than 2.25%.

[25] As for the new member states: Cyprus, Malta, Slovakia and Slovenia are in the 16-member Euro Area, while Estonia, Latvia, and Lithuania are in the ERM2 system. (Indeed small and open economies find the most use of joining.)

EU Conditionality

Firs installment (released in 2008)		**state of play**
Fiscal	2009 budget with a 2.6% of GDP target	ok
	eliminate the 13th monthly salary for all public servants in 2009	ok with a cheat: hiked low wages
	capping the 13th monthly pension at HUF 80.000	ok

Second installment (released in March)		**state of play**
Fiscal	2008 deficit below 3.4% of GDP	ok
	2009 budget with a 2.6% of GDP target	ok
	Fiscal governance reform (see text in chapter III.3.)	ok
Financial sector	Support to domestic banking sector	done /in process
	monitor bank needs, establish funds	done /in process
	Strengthen supervision (esp. registry and currency exposures)	in process
	Agree with local banks on assistance in restructuring household debt	Mostly done
Structural reform	Labor market reforms, active policies	partly done

Third installment (to be released mid-2009)		**state of play**
Fiscal	further confirmation of progress regarding the previous installment	new agreement, higher deficit goals
Financial sector	Strengthen supervision - regarding brokers and prudent loan-to-value ratios for mortgage loans	N/A
	MNB and FSA capacity building in assessing solvency and liquidity issues	N/A
Fiscal reform	Fiscal Council appointments	done

Fourth installment (to be released end of 2009)		**state of play**
Fiscal	2010 draft budget proposal by 30 September, in line with agreement	might be difficult, given usual delays
Financial sector	Strengthen cross-border supervision	N/A
Structural reform	Take steps to improve sustainability of pension reform	in process

General concerns (monitored quarterly)		
Inflation	Progress towards price stability	
Structural reform	Lisbon strategy recommendations	

Source: EU Agreement, 17-19 November 2008