

Monetary policy issues in Hungary on the eve of EU membership

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1. Introduction

This paper recounts the evolution of Hungarian monetary policy since the mid-1990s, paying particular attention to the recent experience with inflation targeting and a wide-band exchange rate regime resembling the exchange rate mechanism of the European monetary system, the so-called ERM II. This experience on the eve of EU membership is important because the Hungarian authorities believe that the benefits of an early adoption of the euro outweigh the possible costs. Consequently, the government, supported by the MNB, has declared that Hungary wants to join ERM II as soon as possible after EU membership in May 2004, with a view to adopting the euro in January 2008. As a result, the attention of monetary policy in Hungary is increasingly shifting to the next step of the integration process, the adoption of the euro. One can distinguish two basic strategies for the adoption process. One involves setting a date for joining EMU as quickly as possible, while the second may be considered as the “put the house in order first” strategy.

The first approach has two main arguments in its favour. First, the target date for the adoption of the euro and, by extension, for the ERM II entry exchange rate would provide an anchor for market expectations. Second, the necessity of meeting the Maastricht criteria by the target date could act as a disciplinary force for government policies. The main problem with this approach is that quick adoption of the euro may not be feasible, either because the political and social consensus is not strong enough to ensure that the Maastricht criteria will be met in the short time required, or because meeting the criteria might require very restrictive macroeconomic policies which might, in turn, delay the implementation of necessary structural reforms.

The main advantage of the second approach is that it leaves domestic policymakers greater flexibility in implementing structural reforms. Its main disadvantage is that it weakens external pressure on policymakers to implement reforms. Moreover, the strategy of putting the house in order first might increase the risks associated with the volatility of foreign capital flows.

Choosing between the two strategies is not straightforward. Each country has to make its own decision, taking into account its specific conditions. The MNB therefore prepared an analysis of costs and benefits of Hungary's euro area membership.² The study finds that Hungary satisfies many of the criteria for an optimal currency area with respect to EMU, and that it is comparable in this respect with the less developed euro area members. Thus, Hungary could live with the common monetary policy of EMU at least as comfortably as several other euro area members. Adopting the euro would have a positive impact on Hungarian economic growth through several channels, the most important one being elimination of exchange rate risk and reduced transaction costs, which would lead to increased foreign trade, lower real interest rates and greater integration of financial markets. According to estimates presented in the study, euro area membership could raise the growth rate of Hungarian GDP by 0.6-0.9 percentage points per year in the long run.

2. The crawling peg, 1995-2001

In March 1995, following a period of increasing external and internal imbalances, Hungary adopted a preannounced crawling peg exchange rate regime. Monetary policy operated within a narrow ($\pm 2.25\%$)

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² See Csajbók and Csermely (2002).

exchange rate band by progressively decreasing the rate of monthly crawl from 1.9% in March 1995 to 0.2% by April 2001. The interest rate was also progressively reduced. This policy proved to be successful, with the inflation rate dropping from 31% in June 1995 to 10.3% by the end of 1998 and competitiveness improving. By 1997 the regime had gained credibility and capital inflows had pushed the exchange rate to the strong edge of the band, necessitating sterilisation by the central bank. The MNB used various instruments to mop up excess liquidity, while keeping in place capital controls to discourage short-term capital inflows. The exchange rate regime performed well in the face of shocks to emerging markets such as the Asian and Russian crises.

While this monetary policy framework helped bring inflation down to single digit levels, it proved to be inappropriate for further disinflation. Even as the rate of crawl decreased from 0.6% to 0.2% per month between 1999 and 2001, the inflation rate stayed in the range of 9-11%. There was no more room for monetary tightening as the yearly rate of crawl, at less than 3%, was already negligible. There was increasing concern that inflationary inertia could set in. The cost of sterilisation also placed an increasing burden on the budget.

3. Inflation targeting, 2001-02

In May 2001, the MNB and the government decided to widen the exchange rate band to $\pm 15\%$ and adopt an inflation targeting (IT) regime. This move was followed in June 2001 by the elimination of the remaining exchange rate controls to facilitate hedging against the increased exchange rate risk. The adoption of inflation targeting also meant a new nominal anchor for monetary policy. While the previous monetary regime was anchored to the exchange rate, in the IT regime the inflation targets themselves became the new anchor. Soon after the announcement of the new regime, the MNB, together with the government, determined the inflation targets for end-2001 and 2002 (7% and 4.5%, respectively). The inflation targeting framework was designed to tolerate a $\pm 1\%$ deviation from the central target, which was set in terms of headline CPI for at least six quarters ahead. The MNB subsequently started to issue a *Quarterly Report on Inflation*.

As was expected, the forint started to appreciate significantly against the euro following the widening of the exchange rate band. Within the new framework, the appreciating exchange rate was expected to lead to disinflation. The economy had got used to a very rapid pass-through during the years of the crawling band. It was, however, uncertain how this would change in the new regime. The main issues were whether switching the expectations anchor from preannounced crawl to inflation targets would work, and how strong the pass-through might become when market participants experienced a continuously appreciating currency after years of gradual depreciation.

In the first years of the new regime the targets for disinflation were met. By December 2001, inflation had dropped to 6.8% (from 10.8% in May), just below the target of 7% (Graph 1). It has to be noted, however, that external factors (declines in oil and food prices) also played a significant role in the disinflation.

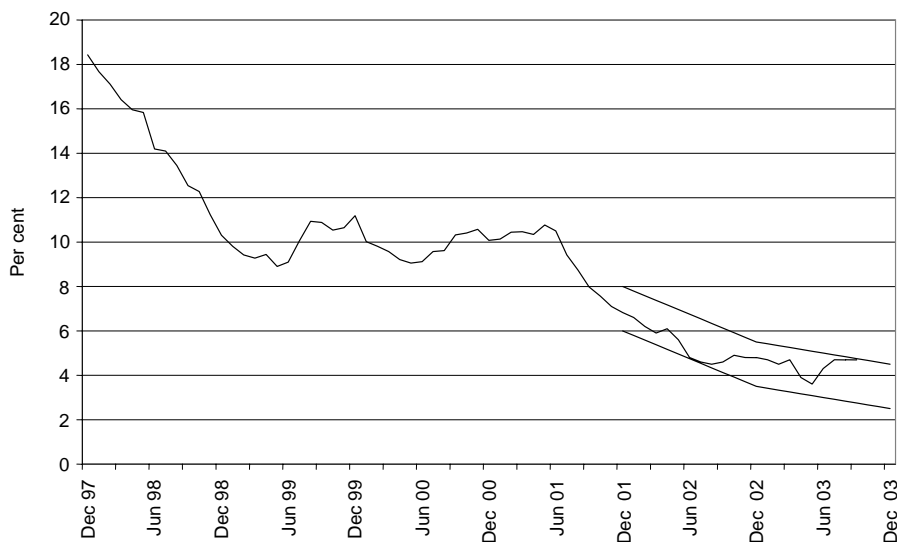
By the end of 2002, inflation had declined to 4.8%, again meeting the target of 4.5% ± 1 percentage point. During this period, the currency remained on an appreciating trend and capital inflows into the forint bond market became even stronger, exceeding EUR 3 billion in 2002. The average maturity of foreign holdings was increasing in parallel with the outstanding stock of forint-denominated bonds (Graph 2), reflecting the convergence play strategy of investors. Market optimism was boosted by the successful conclusion of EU accession talks at the Copenhagen summit in November 2002.

Beneath the surface, however, serious tensions had started to build up in the economy. 2002 was an election year in Hungary, which led to a loosening of fiscal policy. As a consequence, in 2002 the deficit of the general government almost doubled, reaching 9.2% of GDP.

There were also other problems that made the conduct of monetary policy a challenging task. The original strategy of inflation targeting was built on the exchange rate pass-through mechanism, as is quite common in emerging market IT regimes. The Monetary Council had regularly communicated a narrow (approximately 2% wide) "desired" exchange rate band, which would lead the economy to a path consistent with the inflation target. The market found these guidelines credible and useful, with the market rate remaining within these bands. However, the impact of tight monetary conditions on consumer prices turned out to be weaker than expected due to the unexpected fiscal expansion and high nominal wage growth. Thus, the central bank had to announce ever stronger levels of the

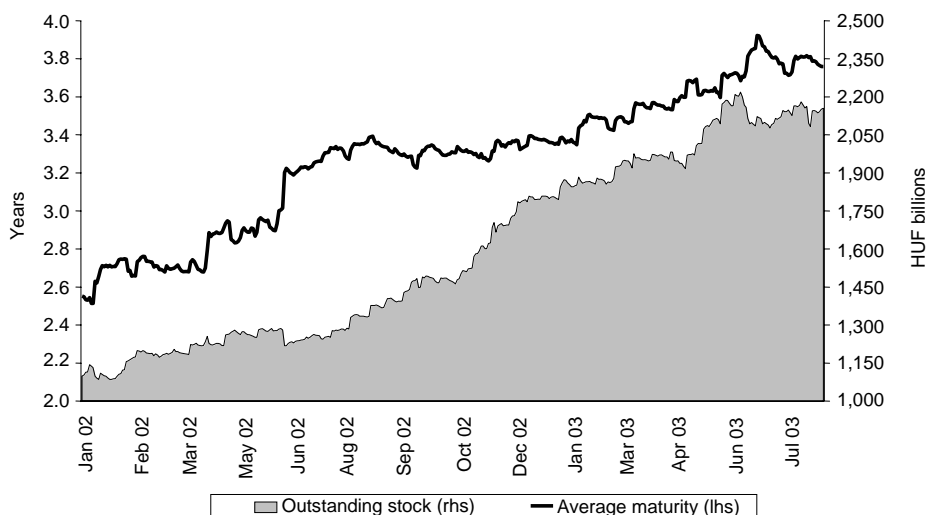
exchange rate consistent with the inflation target. By the end of 2002, the “desired” level of the exchange rate needed for reaching the inflation target had moved close to the strong edge of the exchange rate band (Graph 3).

Graph 1
Inflation rate and targets



Source: Central Statistical Office.

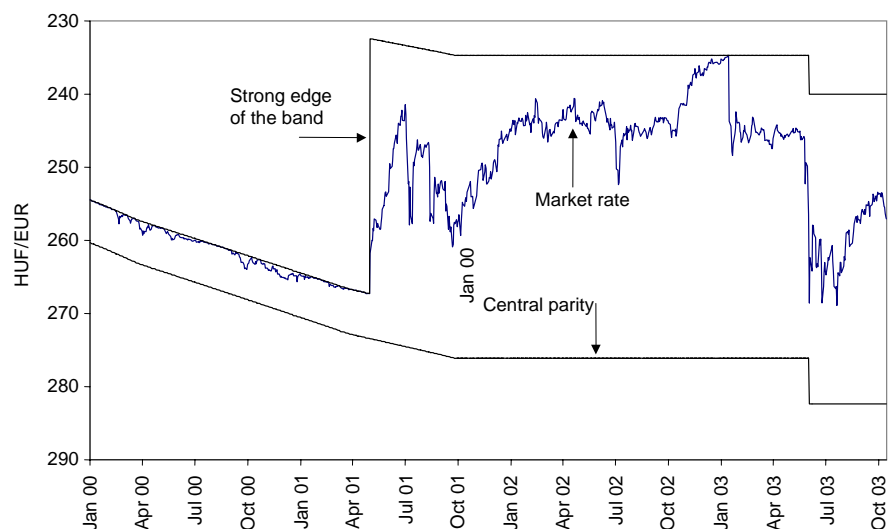
Graph 2
Outstanding stock and average maturity of non-residents' government securities holdings



Source: MNB.

Graph 3

Exchange rate of the forint (inverted scale)

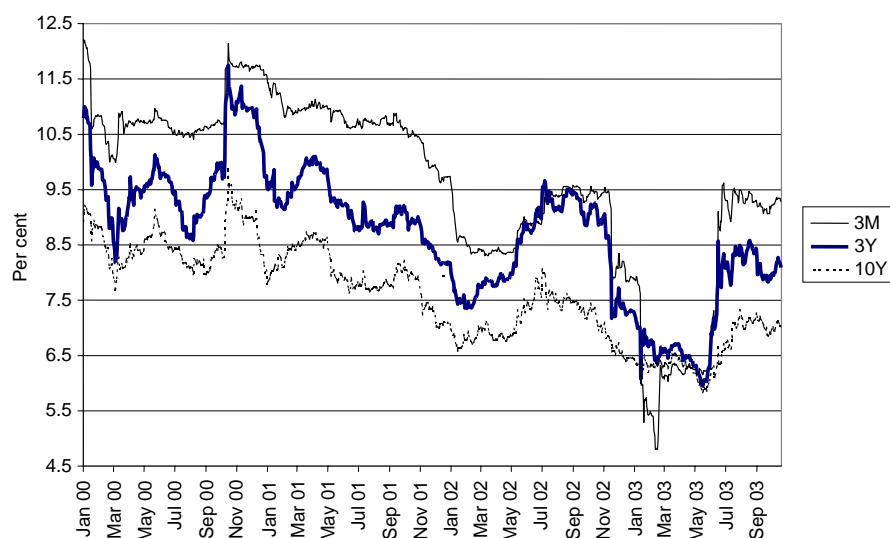


Source: MNB.

By early 2003 market players, especially foreign investors, had come to the conclusion that to reach the inflation target the authorities would lift the strong end of the band and let the forint appreciate. In mid-January, there was a speculative capital inflow in excess of EUR 5 billion within two days in the expectation that the exchange rate would be allowed to appreciate beyond the upper band. However, speculators apparently neglected legal arrangements concerning the responsibilities for the exchange rate regime, which state that any change in regime, including the change in the bands, needs a consensus between the MNB and the government. The government was opposed to widening the exchange rate band because of concerns that the stronger forint would hurt competitiveness. It was therefore decided to defend the upper band by intervention (buying foreign exchange against the forint) and to cut interest rates drastically, thereby demonstrating to the market the MNB's commitment to maintaining the exchange rate band. After these actions, both policymakers and market participants started to adjust to the new situation, with the exchange rate stabilising some 4-5% below the strong edge of the band. As a response to the large interest rate cuts, the short end of the yield curve shifted downwards significantly, with the three-month benchmark rate falling to the level of long yields at about 6.2% (Graph 4).

Graph 4

Benchmark government securities yields



Source: Government Debt Management Agency.

In early June 2003, the government initiated a 2.2% devaluation of the exchange rate band in order to cap the strong edge of the band at HUF 240 per euro, instead of the previous level of HUF 234.7 per euro (Graph 3). The aim was to assure exporters that the currency would not be allowed to appreciate beyond the new upper edge of the band. This move disturbed the markets, as it was interpreted as a loss of commitment to disinflation. As a result, the exchange rate depreciated by 5% on the day of the devaluation. To stop a further depreciation and to demonstrate commitment to disinflation, the MNB hiked interest rates by 300 basis points in June.

In July, the government and the MNB declared that Hungary aimed to join the euro area by January 2008 and ERM II as early as possible after EU accession in May 2004. This commitment would require very tight fiscal and incomes policies in the coming years. The 2004 budget submitted to parliament foresaw a reduction in the deficit, but the budget plans caused some disappointment among market participants, as it focused on increasing revenues instead of reforming public expenditure. The exchange rate did not respond positively and long-term yields did not decrease. The market is still hesitant at the time of writing and is looking for visible signs of fiscal tightening. One positive sign is that the wage guidelines agreed with the trade unions will, if respected by all interested parties, help the disinflation process.

4. Conclusions

Some conclusions can be drawn from the Hungarian experiences.

1. Smooth transition to a successful inflation targeting regime is possible even for countries lacking experience with traditional channels of monetary transmission. The example of the MNB in 2001 and 2002 shows that well chosen inflation targets can be reached, even if there is little a priori knowledge of the exchange rate pass-through of an appreciating currency.
2. The Maastricht criteria require parallel attainment of price and exchange rate stability. However, in some situations central banks in accession countries cannot target price and exchange rate stability at the same time. In Hungary, for instance, monetary policy had to rely to a great extent on the exchange rate pass-through in the process of disinflation. Keeping the exchange rate stable when price stability has to be reached from a starting point of high inflation could thus prove quite challenging.
3. The recent Hungarian experience clearly underscores the importance of an appropriate mix of monetary and fiscal policies to reach and maintain price stability. If fiscal policy runs unsustainable deficits the central bank is left with no good options: it can either respond to the loose fiscal policy by creating tight monetary conditions (which can lead to excessive loss of output and prolonged conflicts with the government) or risk its own credibility by accommodating the fiscal loosening and thus loosening its commitment to price stability. In other words, there is no good monetary policy if policymakers cannot see eye to eye on the objective of price stability and on the best policy mix to achieve it.

References

Csajbók, A and Á Csermely (eds; 2002): "Adopting the euro in Hungary: expected costs, benefits and timing", *MNB Occasional Papers*, no 24.