Andras Simor: The euro and the enlargement – challenges ahead

Speech by Mr Andras Simor, Governor of Magyar Nemzeti Bank (the central bank of Hungary), for the panel on "The euro and the enlargement: challenges ahead", at the Fifth ECB Central Banking Conference "The Euro at Ten: Lessons and Challenges", Frankfurt am Main, 14 November 2008.

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I am glad to be invited to this panel. It seems to me that "euro enlargement" in the past couple of years featured prominently on the agenda of various European conferences and policy fora and, as such, ended up a bit over-discussed. However, the recent bout of the financial crisis has definitely put this topic in a new perspective. My impression is that a number of New Member States, as well as some of the old opt-outs, that were seriously affected by the crisis now wish that they were already in the eurozone when this latest, most severe episode erupted. I would not be surprised if, as a consequence of the crisis, ambitions for speeding up the eurozone entry process intensified in these countries. This panel discussion is a good opportunity for me to present the motivation, arguments and concerns that an "out" country may have in this respect. Naturally, I can only speak on behalf of Hungary, or more precisely the Hungarian Central Bank. It may not be a typical view as this country was perhaps the most spectacularly affected by the crisis among the New Member States. Nevertheless, I think at least some elements of this view are shared by our Central Eastern European peers.

I would like to touch upon three major topics.

First, how we, at the Hungarian Central Bank saw the "pros and cons" of a quick euro strategy before the crisis.

Second, how the crisis has changed this assessment.

Finally I would like to say a few words about the Maastricht criteria and the way we envisage to meet them.

The Hungarian Central Bank has long been a proponent of an "as soon as possible" eurozone entry strategy. We made our first comprehensive cost-benefit analysis back in 2001. The analysis suggested that Hungary constituted an optimal currency area with the eurozone, at least to the extent that some peripheral eurozone member countries did. The benefits appeared to be large, stemming from trade creation and the disappearance of a sizeable currency risk premium. At that time fiscal policy seemed broadly on track. We had just introduced inflation targeting which showed some early success in breaking inflation inertia. In the eurozone itself, there were no signs of divergence, either. All this suggested that a quick eurozone entry was doable and worth pursuing. The future looked rosy.

However, things turned out to be quite different. An unprecedented fiscal expansion in 2002-2006 shed a cruel light on the structural and institutional weaknesses of the Hungarian public finances and slowed down the disinflation process. The country was drifting away from meeting the Maastricht criteria and the expected date of entering the eurozone was moving further and further out in the future. At the same time, news from the euro area caused some discomfort too, as growth in some less developed member countries slowed down so much that their real convergence stopped or even reversed.

Having had this experience, it is not surprising that when we did our review of the costs and benefits of the euro this year we were a bit more cautious than seven years ago. Although our basic conclusion remained the same, that is, we still think that Hungary should join the eurozone as soon as possible, clearly we had become more aware of some risks involved in the quick euro adoption strategy.

Let me elaborate on two of these risks.

The first is entering the eurozone without sufficient progress in structural reforms; the second is the problems caused by potentially large capital inflows after the common currency is introduced.

It is a commonly shared view that efficient labour and product markets, which help a country's dynamic adjustment to asymmetric shocks, are essential for success within a monetary union. In terms of labour and product market reforms Hungary still has a lot to do. Although nominal and real wages are more flexible than in the core eurozone, the employment rate is one of the lowest in the EU. Our analysis suggests that this may be related to wrong incentives hindering labour supply, such as generous early retirement and maternity leave schemes and a very high tax wedge. These are in turn manifestations of a bigger problem, "the premature welfare state", which is weighing heavily on potential growth on the one hand, and is a source of a chronic fiscal imbalance on the other. Our fiscal and labour market weaknesses are deeply interconnected and we have to address them together in a wide-ranging structural reform.

Scaling back the overly generous welfare state is painful and the political willingness to do so is not so strong, so when this structural reform will take place is rather uncertain.

The question is, can we afford to enter the eurozone if this reform is not yet completed? This brings us to the territory of political economy, more precisely to the issue of whether the euro fosters or hinders structural reform. Although this issue has received a lot of attention recently in both theoretical and empirical work, my impression is that so far no consensus has emerged. What this means for the euro strategy of Hungary is that probably we should not risk entering the eurozone until this crucial structural reform – that is, the scaling back of overly generous the welfare state in order to increase the labour supply, foster potential growth and stabilize public finances – is completed or is at least safely on track.

The second risk, which frequently took the centre stage in debates on euro accession, is that of large and potentially disruptive capital inflows. The starting point of the argument here is that the catching-up process of New Member States is about to continue for a long period even after they introduce the common currency. The catching-up entails a real appreciation, which, once the exchange rate is irrevocably fixed, translates into higher inflation and lower real interest rates. Low real interest rates may in turn trigger excessive demand fuelled by an unsustainable credit boom financed from foreign borrowing. When the inevitable correction comes, there is no independent monetary policy to smooth the adjustment and a serious bust follows the boom. Such boom-bust patterns were clearly observable in some first-wave eurozone members like Portugal, Ireland and Spain. Better wait with euro adoption, the argument goes, until catching-up is more progressed and the equilibrium real appreciation is smaller.

I have one observation to this argument. We cannot ignore the fact that the financial integration of the New Member States to a large extent had already taken place. The banking sectors in these countries are owned predominantly by euro area banks. In the past couple of years of abundant global liquidity, cross-border lending by parent banks in foreign currency was available in virtually unlimited quantities. This practically meant that foreign (euro or Swiss franc) interest rates had become the point of reference for domestic consumption and investment decisions well before the euro was introduced, pushing down the effective real interest rate. It is obvious by now that the credit boom that was envisaged to take place after eurozone entry actually arrived much earlier. The only difference was that, not having the common currency yet, it left us with a sizeable currency mismatch. Staying out of the eurozone did not prevent us from running into the boom. Now that we have to face the bust, it is not clear either whether having an independent monetary policy places us in a better position to smooth the adjustment. That is because the effectiveness of monetary easing and the subsequent depreciation is seriously limited by the negative wealth effect on the sizeable unhedged foreign currency liabilities the private sector had accumulated. In short, with integrated financial systems, large capital flows have been taking place in New

Member States regardless of the fact that they have not yet introduced the euro. Euro adoption does not carry an extra risk in this respect, on the contrary, it may help eliminate potentially dangerous currency mismatches. It is important to see that in this respect, it would eliminate a source of instability from the point of view of the eurozone parent banks as well.

Let me now turn to the implications the current crisis may have on euro adoption strategies.

First, the crisis clearly illustrates that having your own currency may be more of a source of shocks than a shock-absorbing device. You may say that Hungary deserved what it gets now, but there are other countries with more sound fundamentals that are undergoing serious stress.

Second, the crisis is an obvious indication that the years of abundant global liquidity are over. We are probably in the middle of a credit contraction globally and the chances of another credit-boom evolving in the foreseeable future are minimal. The risk of a credit-fuelled boom-bust, should a country enter the eurozone in the next couple of years, is greatly reduced.

Third, the crisis may have increased the disciplining power of financial markets. The deleveraging process that we are going through implies a thorough repricing of risk. Just like in other asset classes, there is increased differentiation among government bonds based on the issuers' risk profile. This is well illustrated by the unprecedented differences we currently see between CDS spreads on bonds of euro area sovereign issuers. Countries with weaker public finances, and Hungary is obviously one of them, will receive stronger incentives from the financial markets in the coming years to put their fiscal house in order. This means that the crisis may actually speed up the most important structural reform in Hungary, the much-needed scaling back of overly generous the welfare state. From the euro strategy perspective this would be good news, since, as I said before, we think that adopting the euro without going through this painful reform carries the risk of a prospective underperformance in the eurozone.

All in all, this crisis has evidently demonstrated that the banking sectors of the euro area and the New Member States are deeply integrated, has greatly reduced the chances of credit booms in the forthcoming years and may exert an extra disciplining power in countries prone to fiscal misbehaviour in the future. For these reasons, I think it may act as a catalyst for the euro accession process. Importantly, it should be let to act as a catalyst, that is, it should not be used as an excuse to make the entry criteria, or their interpretation, more stringent.

Finally, let me turn to the prospects of meeting the criteria in Hungary and, more specifically, what I think this implies for our euro strategy.

Currently, there is no official target date for euro adoption in Hungary. Popular support for the euro is relatively strong, and it probably intensified further after the recent currency turmoil. All the major political parties agree on the desirability of introducing the common currency.

However, at the current juncture, Hungary does not meet any of the Maastricht criteria.

Government and Central Bank officials, including myself, repeatedly expressed that the earliest date to start talking about a roadmap to eurozone may be somewhere in 2009. Given Hungary's not too convincing track record regarding the fiscal balance and inflation, an ERM II entry is only reasonable when the prospective meeting of the Maastricht criteria is safely on track.

Hungary's Convergence Programme envisages meeting the fiscal deficit criterion by 2009, but chances are that this could take place as early as this year (albeit only by a narrow margin). As a reaction to the recent bout of the global financial crisis and the deteriorating prospects for external financing, the government decided to withdraw the draft 2009 budget and rewrite it so that the deficit reduction next year is more pronounced. In addition, the IMF rescue package came with conditions which implied further expenditure-cutting measures. The Central Bank's latest inflation forecasts imply that the Maastricht inflation criterion may be met by 2010. These developments mean that the chances of meeting the entry criteria

relatively quickly has improved somewhat, which implies that, in principle, we should not wait with ERM II entry too long.

On the other hand, the financial turmoil has undoubtedly reached Eastern Europe. As a result, currently there is extreme uncertainty in the New Member States regarding the future course of such fundamental things as financial intermediation, credit growth, the exchange rate and real convergence in general. These are all very important factors that have to be taken into account when making a decision on the euro strategy or indeed on ERM II entry itself. It is therefore worth waiting with setting out very specific euro adoption plans for Hungary until the dust settles at least a little bit.

In the meantime, the Slovakian experience with the euro, starting next year but showing its implications already in the recent unfolding of the crisis, will provide a good natural experiment for the other New Member States, and will no doubt be closely watched.