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Revisiting the case for Euro-adoption in the CEE countries. In focus: Hungary

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Background

- Our study published in June 2012 (in Hungarian)
- Motivation: need to revisit issues related to euro-adoption, in light of
  - fundamental change in the official attitude in HU („not earlier than 2020”)
  - changes in the external environment
    - crises within the Eurozone (EZ)
    - attempts at a new design of economic governance in the EU/EZ

Main topics

1. CEE (V4+) and the euro
   – Non-EZ countries (CZ, HU, PL) – where do they stand
     • Objective indicators (distance from Maastricht criteria)
     • Official attitudes to EZ- accession
   – 3 EZ countries: some early experiences
   – Revealed policy attitudes to macroeconomic stability (HU-V3)
2. In focus: Hungary and the euro
   – Implications of the EZ crisis
   – Changes in the EZ environment
3. Lessons and policy conclusions

1. CEE (V4+) and the euro

Non-EZ countries (CZ, HU, PL) – where do they stand

Three EZ countries: some early experiences

Fulfillment of Maasticht criteria according to the 2012 Convergence Report

	Price stability (%)	Deficit/GDP	Public debt/GDP	Long term interest rate (%)	Exchange rate	Central bank indepen-dence	
Reference value	3.1	3	60	5.8	ERM II	compliance with the Threaty	
Czech Republic	2.7↑	3.1↓	43.9↑	3.5	no	no	1
Hungary	4.3↑	-4.3 (5.2*)	80.6↓	8.0	no	no	0
Poland	4.0↑	5.1↓	56.3↓	5.5	no	no	1
Romania	4.6↓	5.2↓	34.6=	7	no	no	0

* In case of Hungary the official ESA balance turned to a significant, 4,3%, surplus in 2011.

This was the outcome of a series of one off measures, excluding them would yield higher than 5% deficit.

CEE is heterogeneous: contrasting views on euro adoption

Joining the eurozone:

Slovenia (2007) – highly developed, no debt country

Slovakia (2009) – risk reduction

Estonia (2011) – hard fix

Pro-euro:

Poland - supporting EA governance reform (though recently sceptic regarding euro adoption)

Euro sceptics:

Czech Republic – owning „other option": wait and see

Hungary – committed to fighting for sovereignty by "unorthodox" policies

Different situations explain contrasting views on euro adoption?

EA members – a) small; b) new states:

Slovakia
Slovenia
Estonia

Political consensus around, broad social support for, euro (symbol)

Non-EA EU-members – core CEE countries:

Poland – pragmatic attitude

Czech Republic – conceptually against euro: stability with own currency

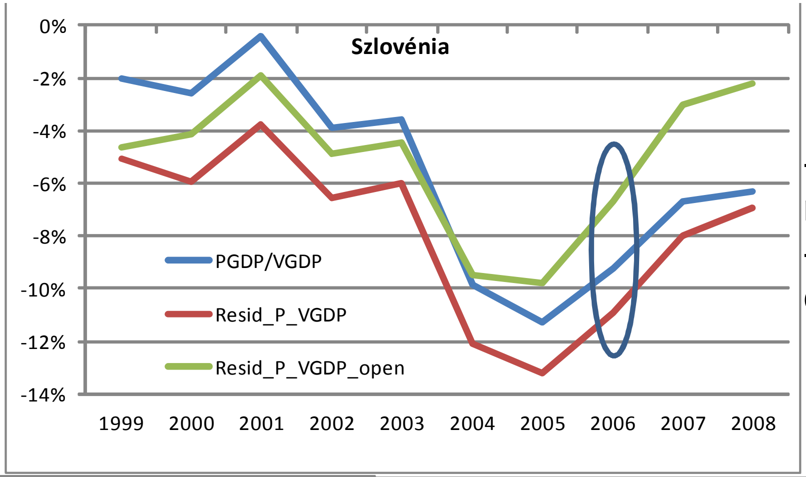
Hungary – formerly pro euro in words, but against in deeds; now against in both words and deeds

SI-SK (EE): four macro-indicators and some early experiences

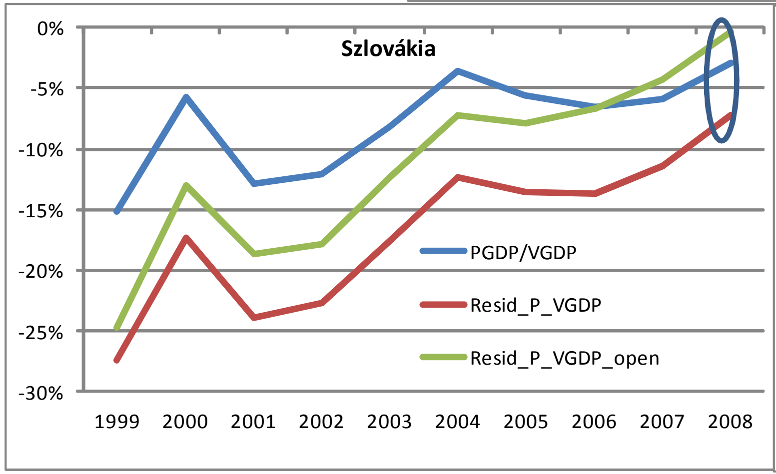
- Real exchange rate (under/overvaluation?)
  - Scope for disinflation via nominal appreciation (before accession)
  - Inflation (after accession) →
- Inflation
- Real interest rates; real exchange rate indices
- External imbalance (CA)

Our estimates of under (<0) or overvaluation (>0)

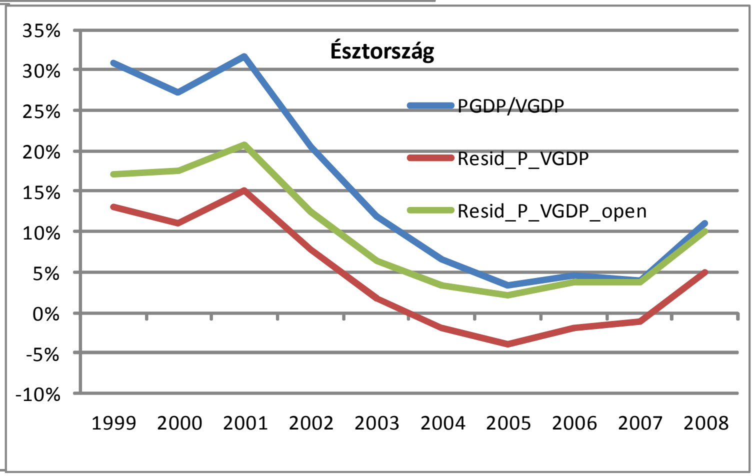
(based on: relationship between relative GDP/cap. and GDP price level; EU15=1)



- Rapid growth + wage moderation: real depreciation
- Joined EZ at undervalued exchange rate

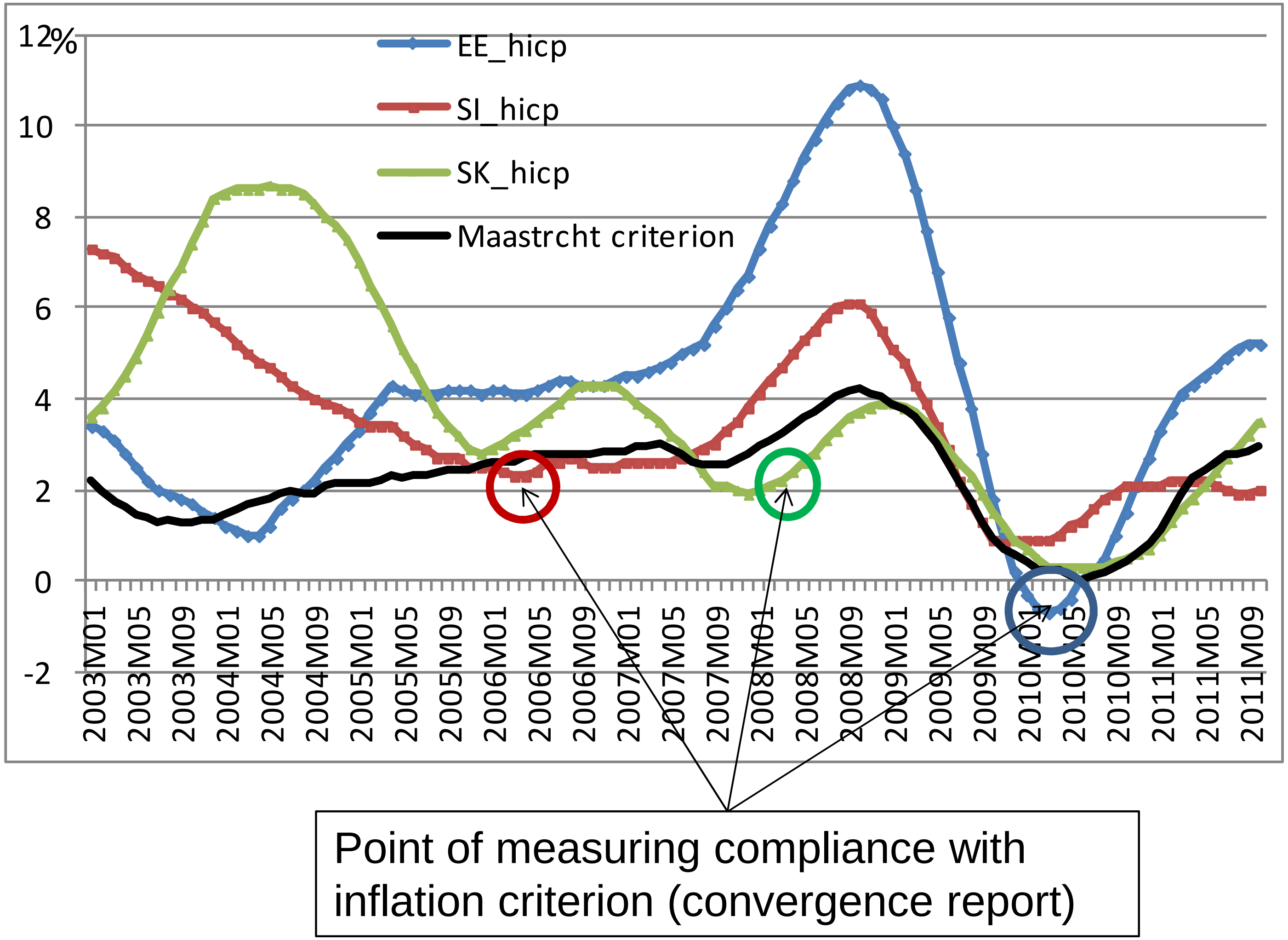


Used initial undervaluation for disinflation by nominal appreciation



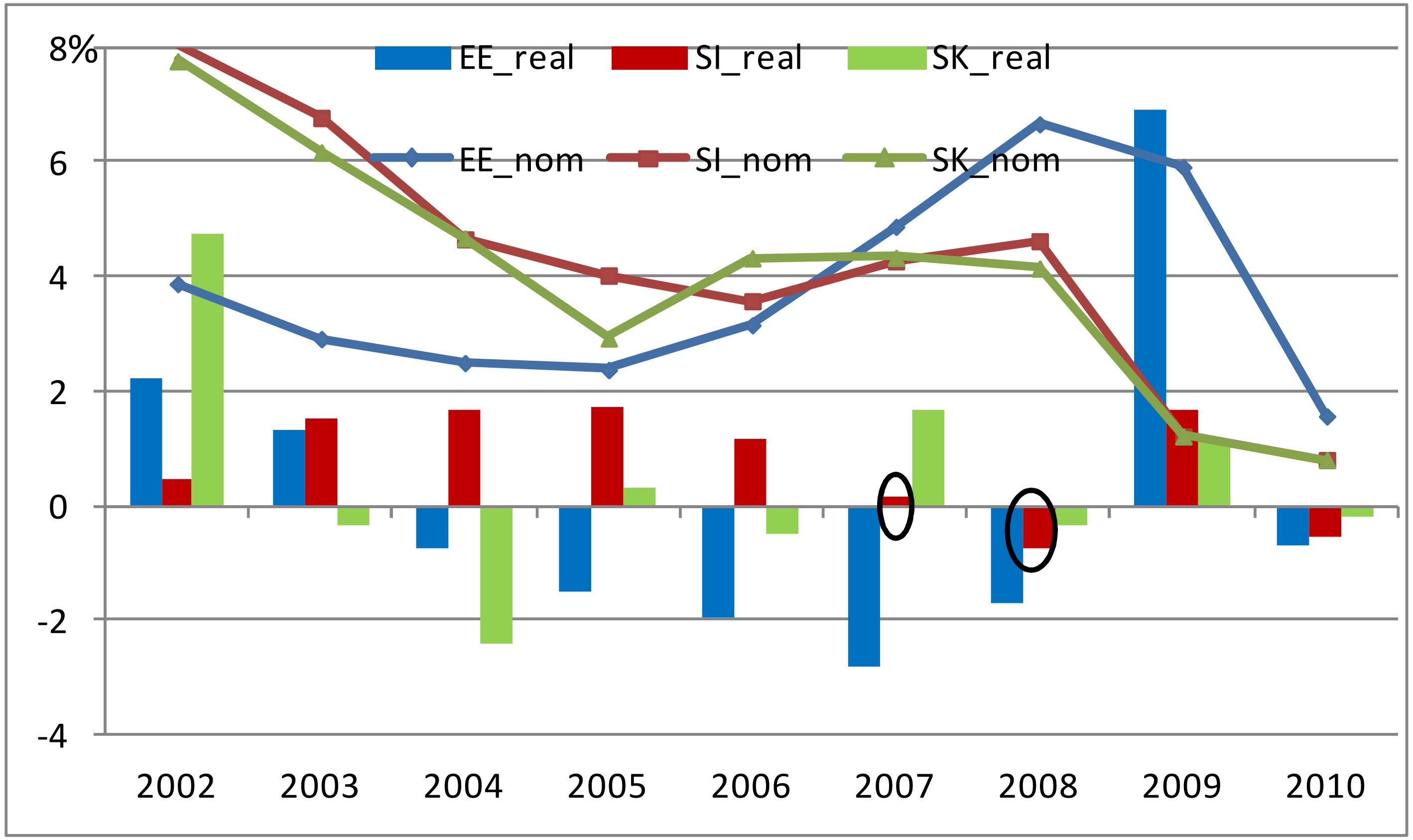
Reduced overvaluation by rapid real convergence

Evolution of the 12-month HICP and the reference value



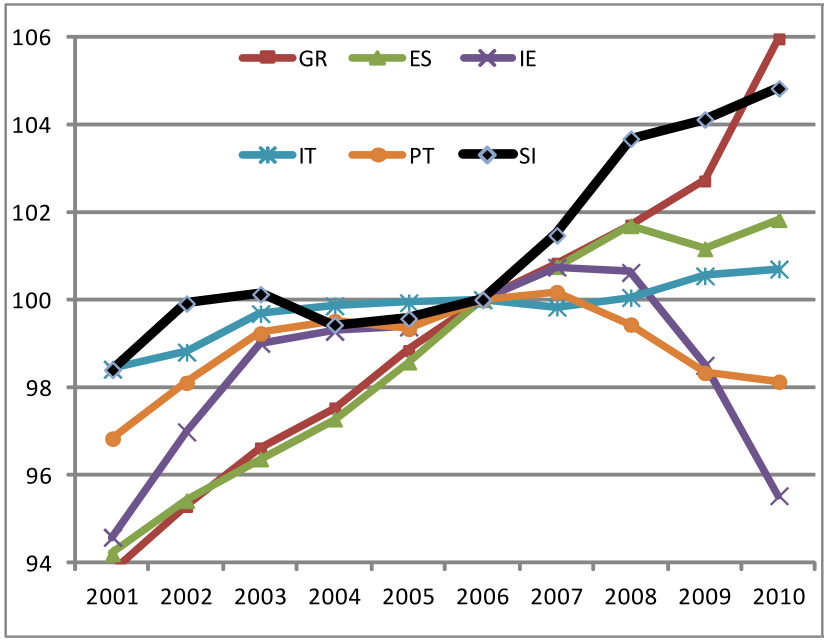
Short-term nominal and real interest rates:

in focus: SI (low/negative real interest rates following euro-adoption)

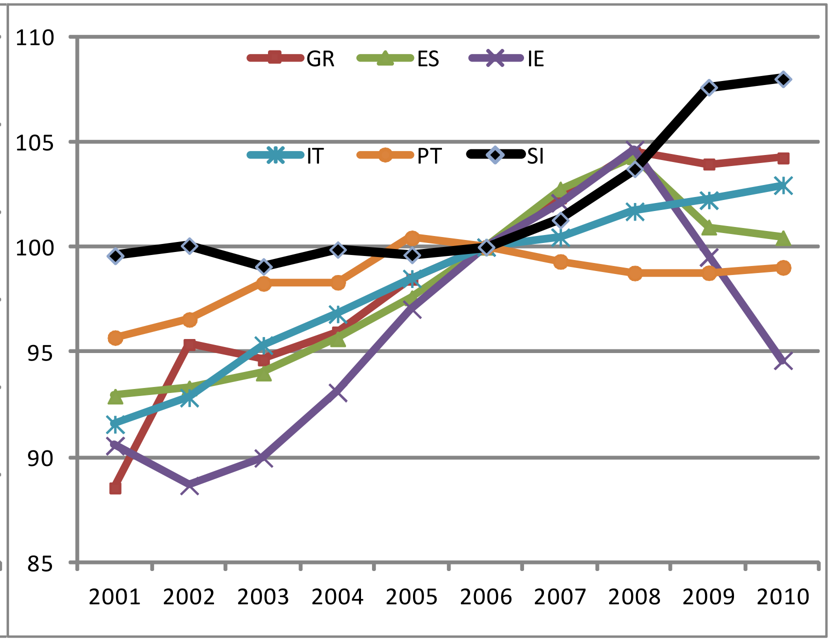


HICP-based and ULC-based real exchange rate indices (relative to the EA)

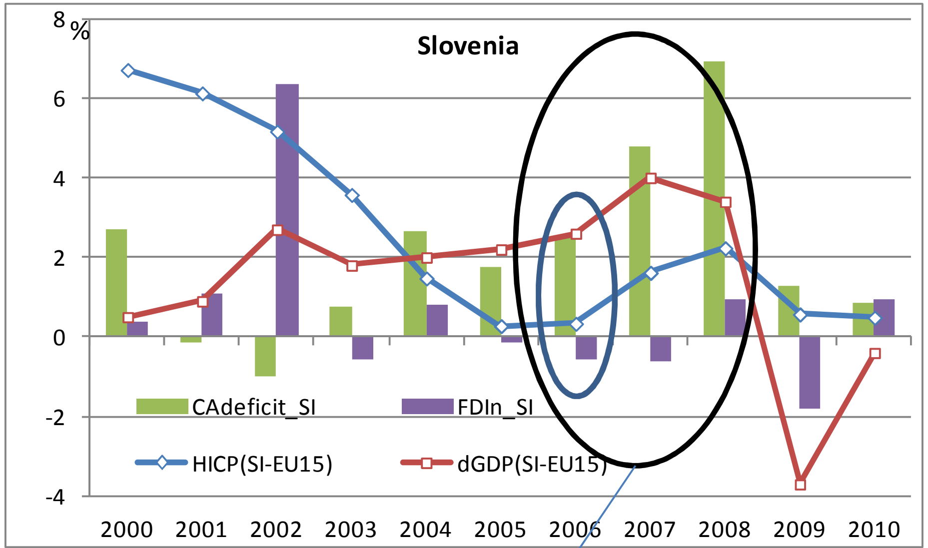
RER_hicp



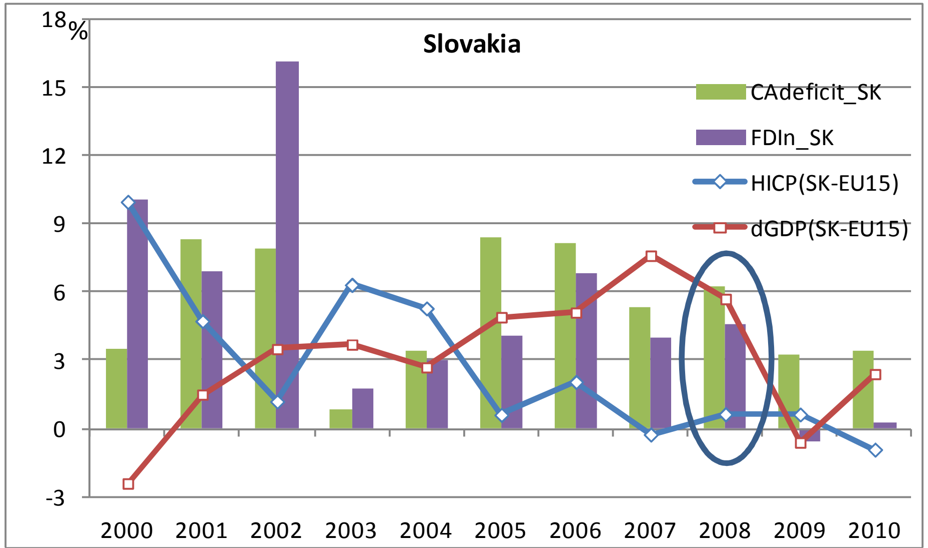
RER_ulc (total economy)

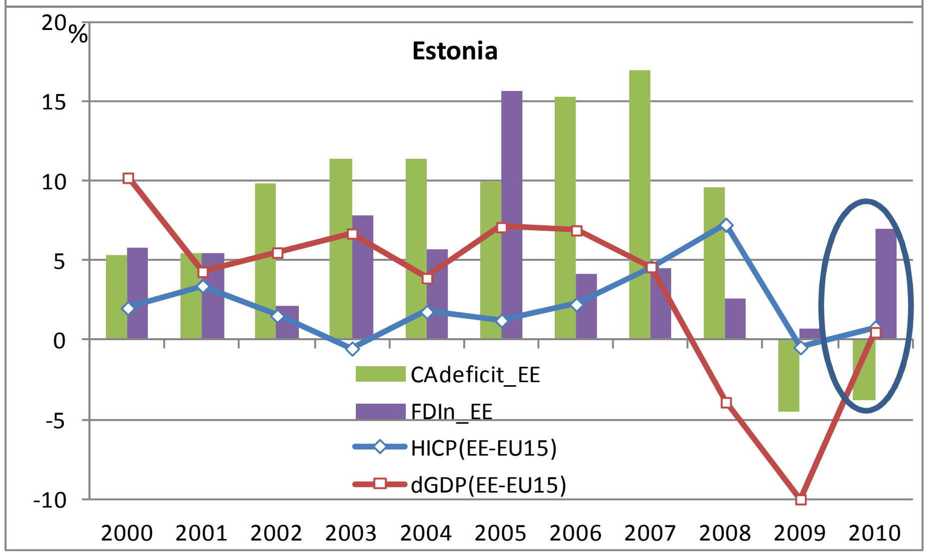


Macroeconomic developments and the current account (focus: SI)



Overheating





Summing up:

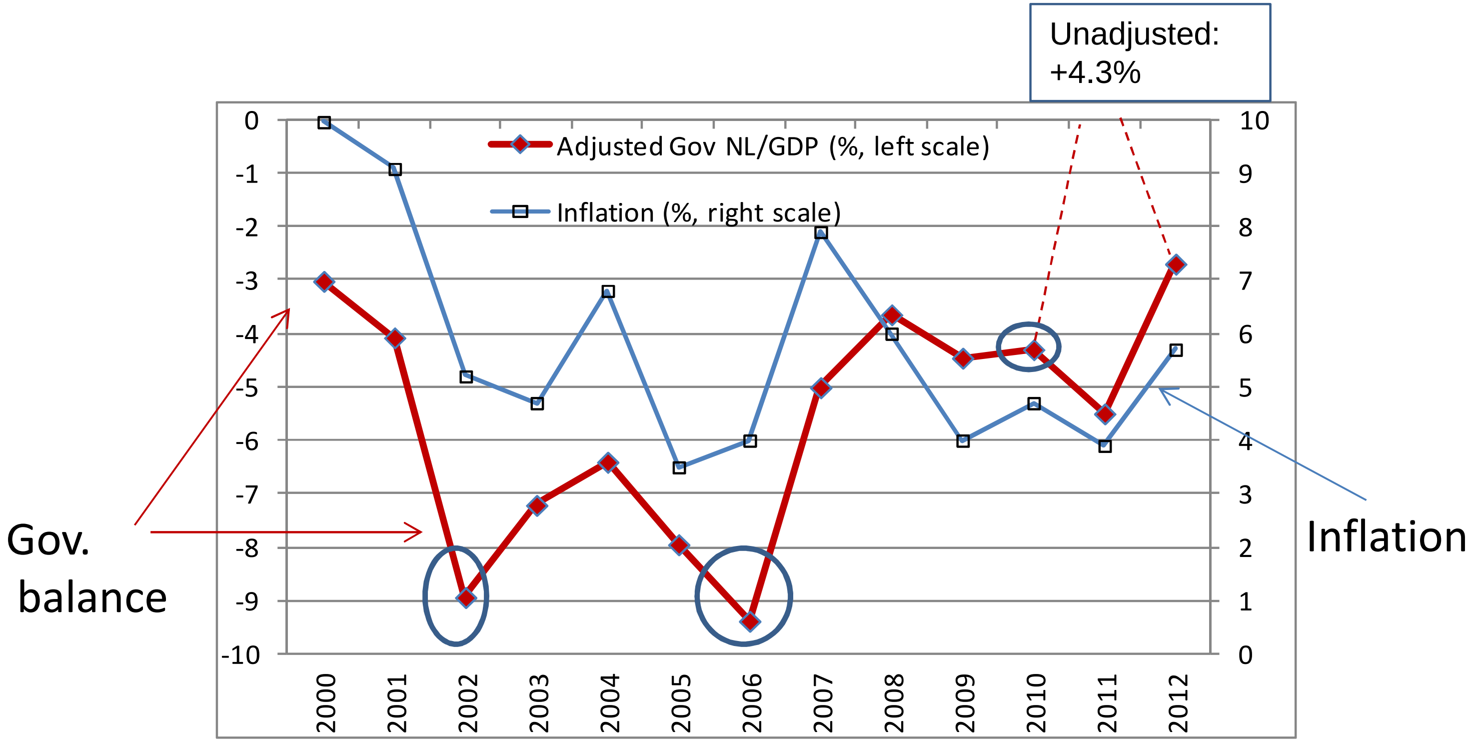
- SI: experiences clearly unfavourable
- SK: early experiences not unfavourable, but too early judge (real convergence and inflation)
- EE: not relevant for floating ER countries

HU vs. V3: revealed policy attitudes to macroeconomic stability

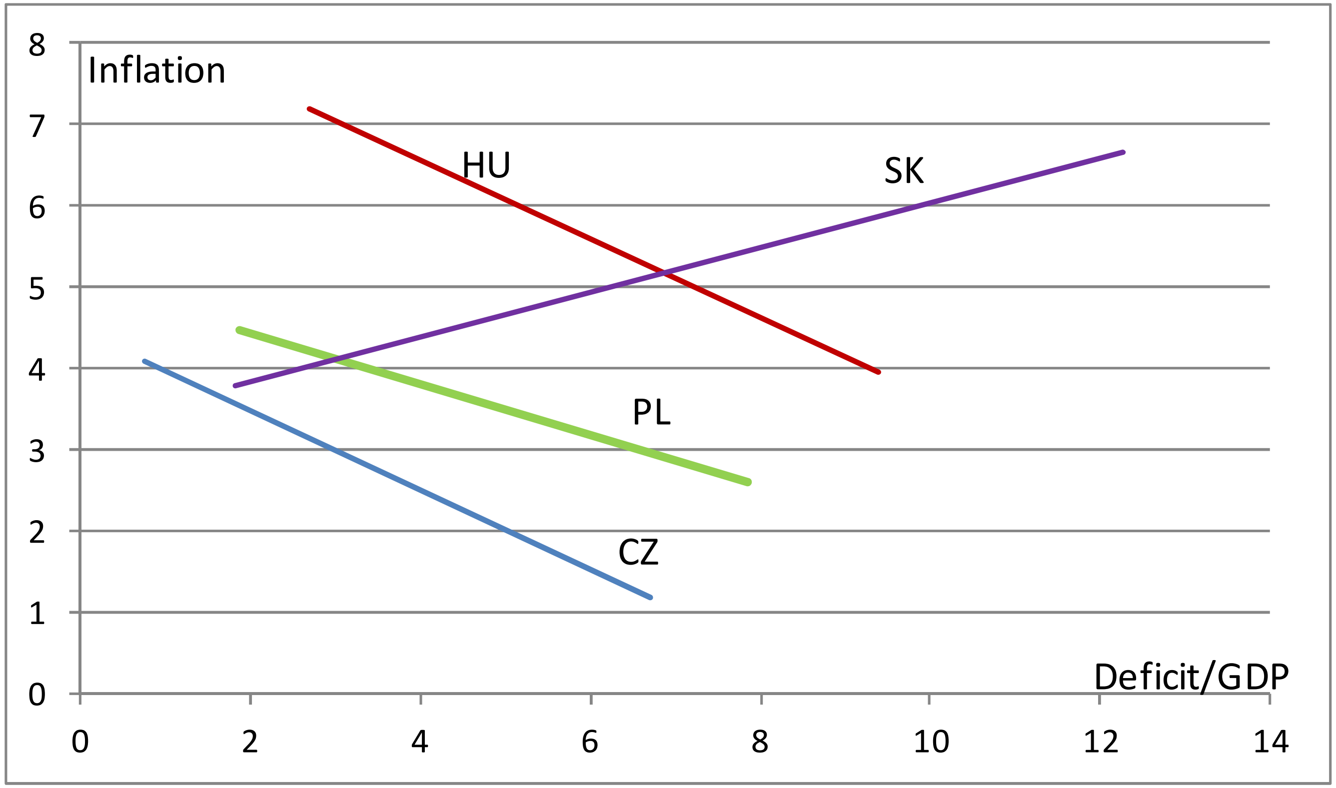
- Fiscal balance vs. inflation and growth: HU is different
- In HU: current anti-euro rhetoric + the old pattern: fiscal correction by inflation
- Past pattern in HU:
  - growth by fiscal stimulus; fiscal adjustment kills growth
  - this practice (sharply different from V3) also continues in HU

No attempt to reach overall macroeconomic stability

Government balance (left) and inflation (right scale): the co-movement continues



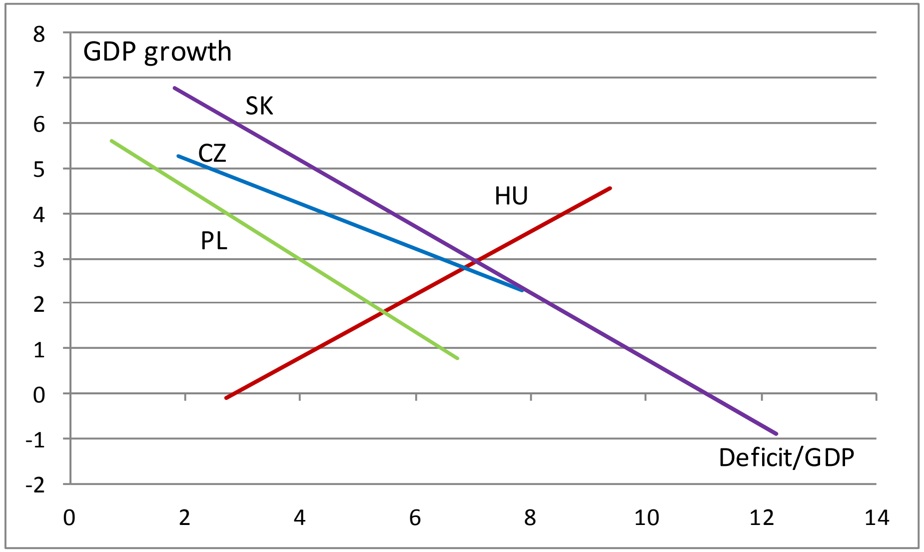
Regression lines: inflation vs. government deficit (2000-2012)

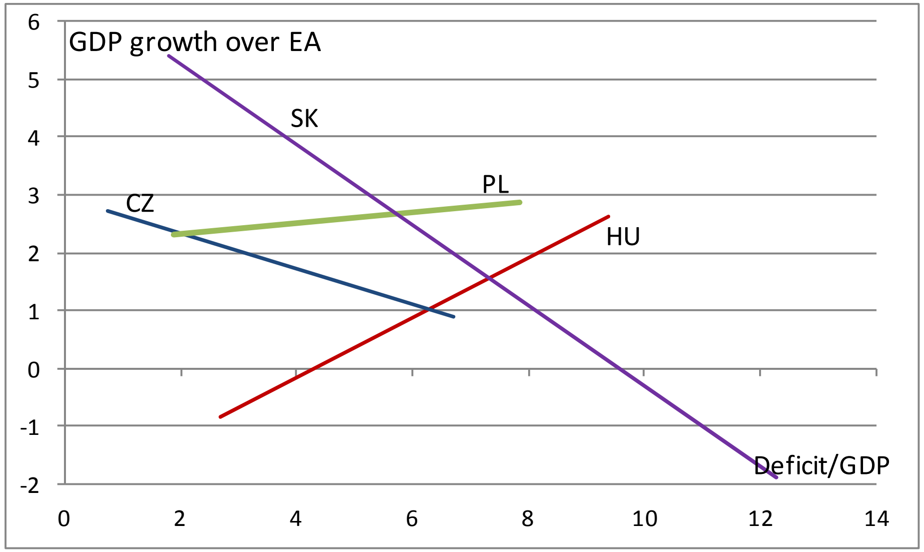


For details: see background charts →

Regression lines: growth vs. government deficit in the V4 countries

(Positive relationship only in HU)





For details: see background charts →

2. In focus: Hungary and the euro

EZ environment

Domestic issues

Recent developments in EU governance

Treaty on Stability, Coordination and Governance (Fiscal Compact)

Macroeconomic imbalance procedure

- Alert mechanism
- Corrective action

Euro Plus Pact

European Systemic Risk Board

European semester and 2020 strategy – growth enhancing structural reforms

Bank union

Completing the Stability and Growth Pact Six Pack – Fiscal Compact

1. Medium Term Objective (MTO) for budget

– balanced budget or surplus, 0,5% of GDP structural budget deficit;

– expenditure ceilings, then expenditure reduction and increase of receipts;

2. Required debt reduction: countries above 60% should decrease each year by 1/20 of the difference from the reference value, otherwise EDP starts;
3. Enforcement: deposits and fines (0.2% of GDP) for countries with no corrective action, and misreporting countries.
4. National budgetary framework is obligatory: credibility, transparency and consistency. Independent institutions like budget council are to be created.

MIP: Significant extension of EDP

Alert Report based on Scoreboard indicators with thresholds:

<u>External imbalance indicators</u>

– current account balance;
– net international investment position;
– export market shares;
– nominal unit labour costs;
– real effective exchange rates;

<u>Internal imbalance indicators</u>

– evolution of unemployment;
– private sector debt;
– private sector credit flow;
– house prices;
– general government sector debt.

<u>Additional indicators</u> (growth, gross fixed capital formation, net and foreign borrowing, FDI, labour market, fiscal sector liabilities)

MIP procedure

	Indicative threshold	Czech Republic	Hungary	Poland	Slovakia	Slovenia	Estonia
External Imbalances Indicators							
Current Account Balance	+6 - (-4)%	-2.5	-2.1	-5.0	-4.1	-3.0	-0.8
Net International Investment Position	-35%	-49.0	-112.5	-64.0	-66.2	-35.7	-72.8
Real Effective Exchange Rates	-5% EA, -11% non EA	12.7	-0.5	-0.5	12.1	2.3	5.9
Export Market Shares	0% for lower quartile	12.3	1.4	20.1	32.6	-5.9	-0.9
Nominal Unit Labour Costs	-9% EA, +12% non EA	5.1	3.9	12.3	10.1	15.7	9.3
Internal Imbalances Indicators							
House prices	-6%	-3.4	-6.7	-6.1	-4.9	0.7	-2.1
Private Sector Credit Flow	-15%	1.7	-18.7	3.8	3.3	1.8	-8.6
Private Sector Debt	160%	77.0	155.0	74.0	69.0	129.0	176.0
General Government Debt	60%	38.0	81.0	55.0	41.0	39.0	7.0
Evolution of Unemployment	-10%	6.1	9.7	8.3	12.0	5.9	12.0
In depth analysis		2	2	3	5	2	3

MIP 2012: Preventive arm, but with differentiation

Very serious imbalances, to be addressed urgently:

ES: private sector debt; large negative external position; financial sector

CY: current account; public finances; financial sector

Serious imbalances:

HU: highly negative size of the net international investment position and public debt

SI: corporate sector deleveraging; banking stability; external competitiveness

IT: high public indebtedness and loss of external competitiveness since euro adoption

FR: export performance and competitiveness in a context of increasing public debt

Imbalances that need to be addressed: BE, BG, DK, FI, SE, UK

Possible problems

- Crisis driven selection of indicators (housing – asset prices)
- Thresholds, averaging, asymmetries
  - different treatment of creditors/deficits and debtors/surpluses (CA)
  - NIIP (FDI, UK: negative NIIP with positive income transfer)
  - REER (EZ and non-EZ)
- Backward-looking analysis and delayed reactions
- Country-specific problems and „equal treatement”
- EZ oriented reform, creditors’ view dominates

The case of Hungary

Nominal and real convergence and institutions

Hungary has been diverging from Maastricht criteria

- Price stability has never been a target for the government
- (Permanent) budget adjustments induce a vicious circle:
- High country risk and interest premium
- Excessive exchange rate volatility
- Debt to GDP ratio declining to the elimination of the second pension pillar: the underlying process shows upward trend

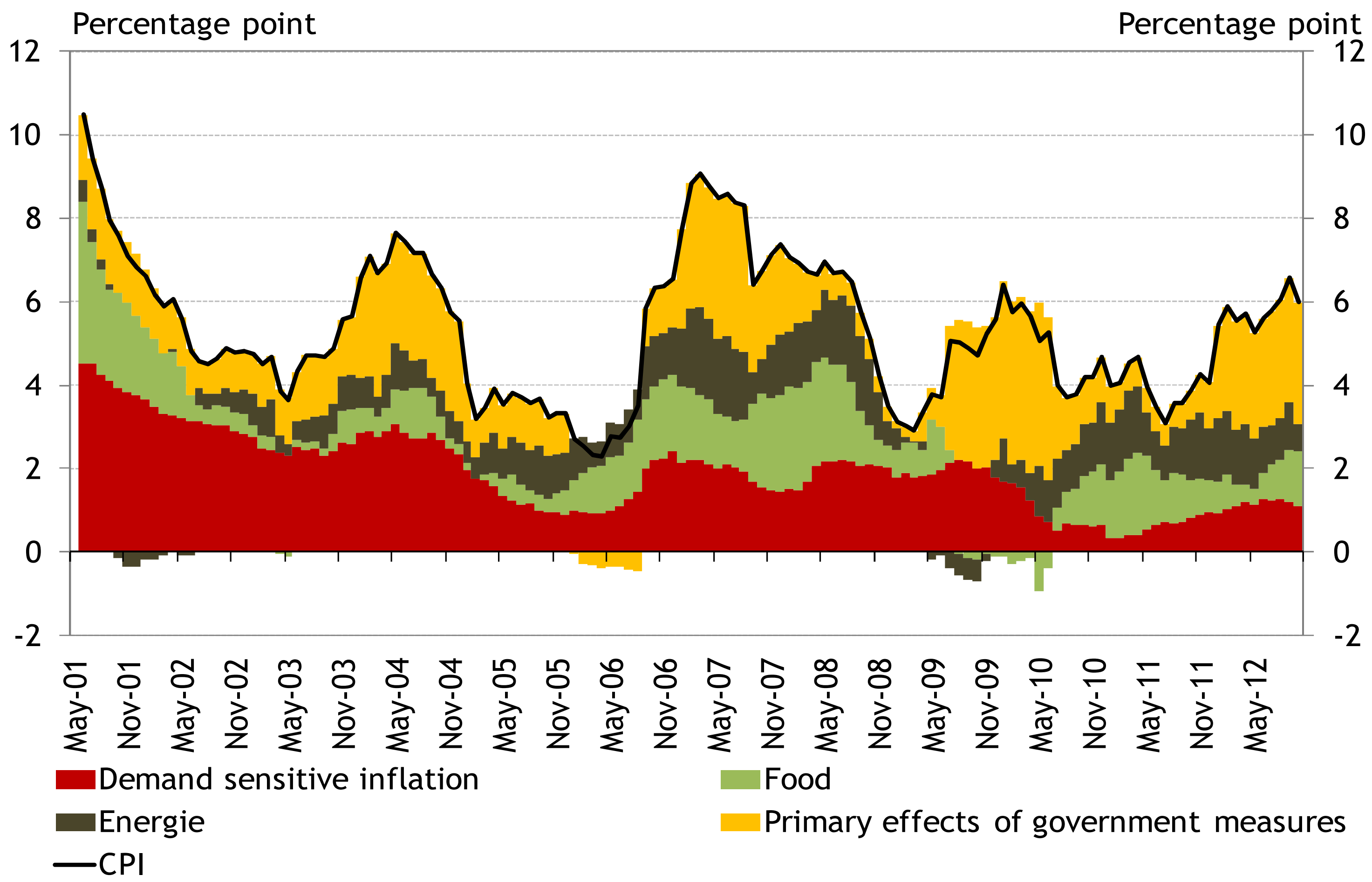
Hungary has been under EDP since 2004

Euro Pact - SGP enlarged by the Six Pack

Major problems in budget policy:

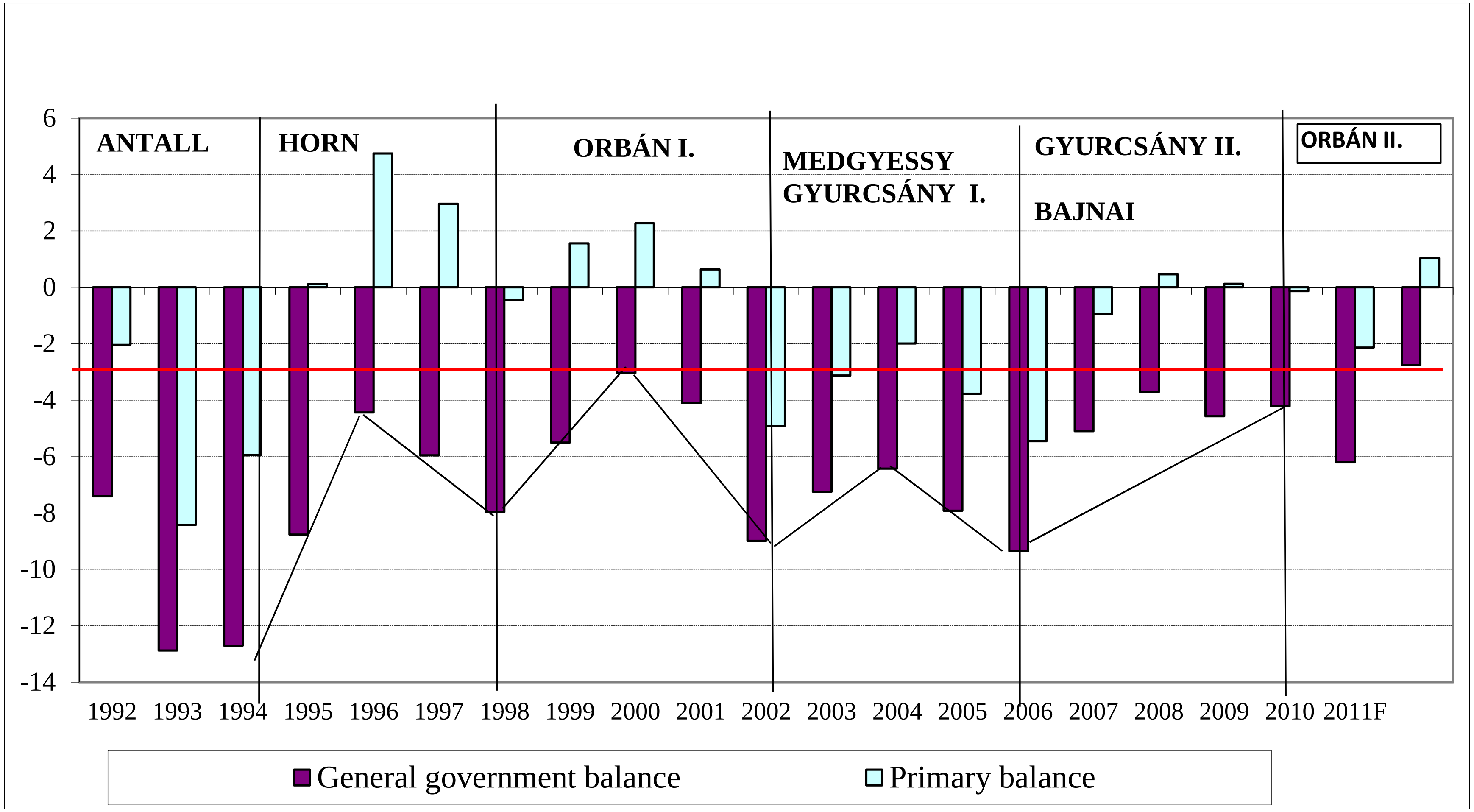
- MTO, EDP
  - Commitments are not voluntary
  - They are fulfilled by ‘innovations’.
  - Debt reduction is the “main objective”: fulfilment by one off measures.
- Counterproductive policies and improvisation. Lack of transparency.
- Sanctions are deterrent (cohesion funds): Hungarian government needs these funds at „any” price. 2012 – the year of 6 budget revisions.
- Budget institutions – Independent Budget Council liquidated in 2010

Recurrent inflationary shocks induced by government measures



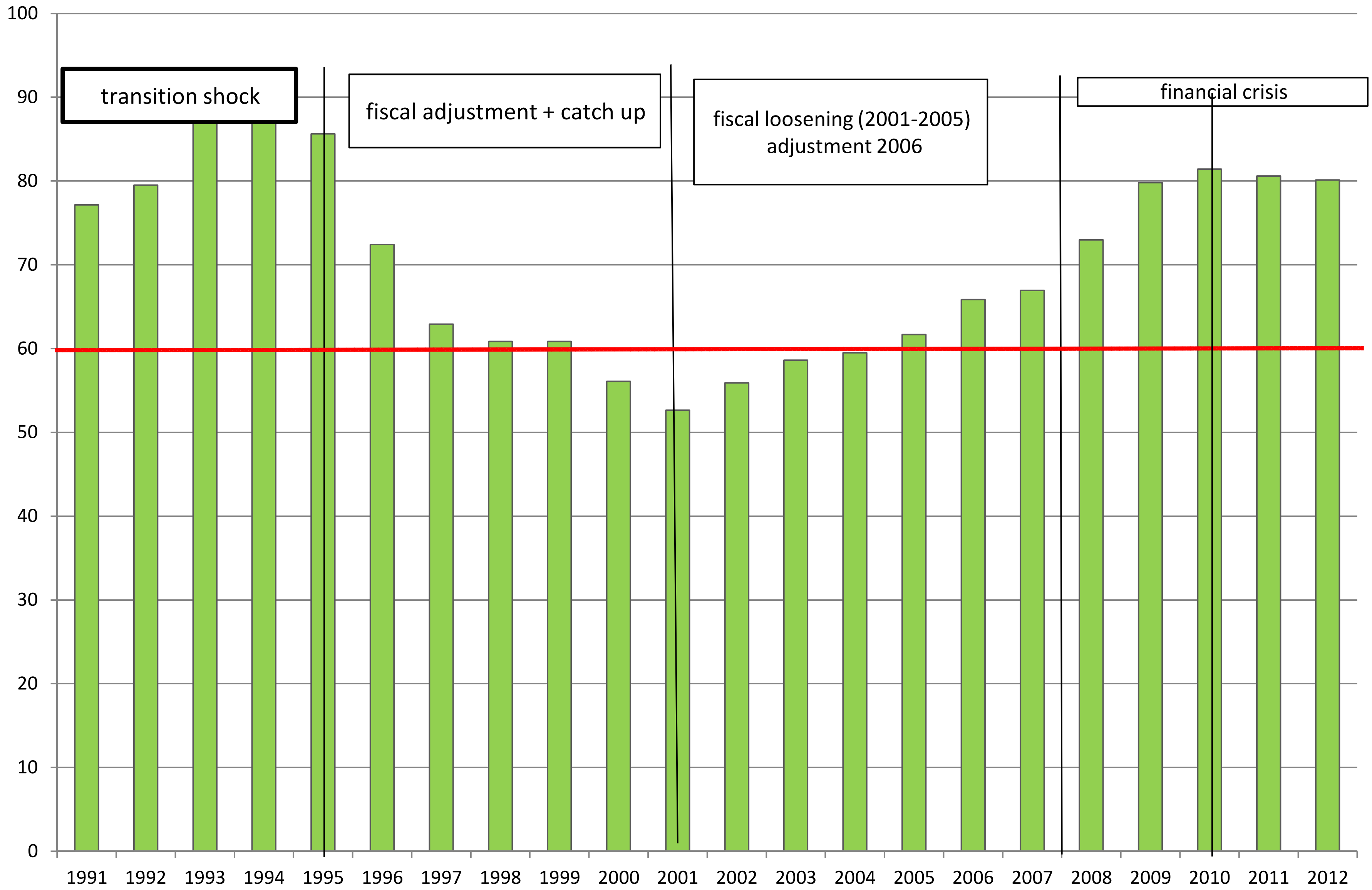
Source: Magyar Nemzeti Bank

Budget deficits* and the political cycle in Hungary

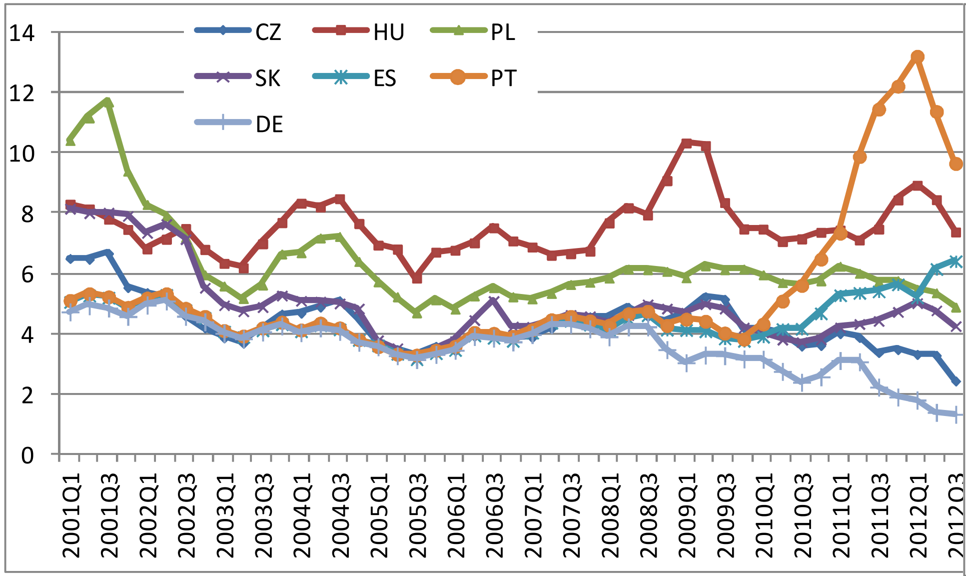


* ESA 95 deficits. The 2011 data – officially 4.1 sufficit - is corrected by the one of measures.

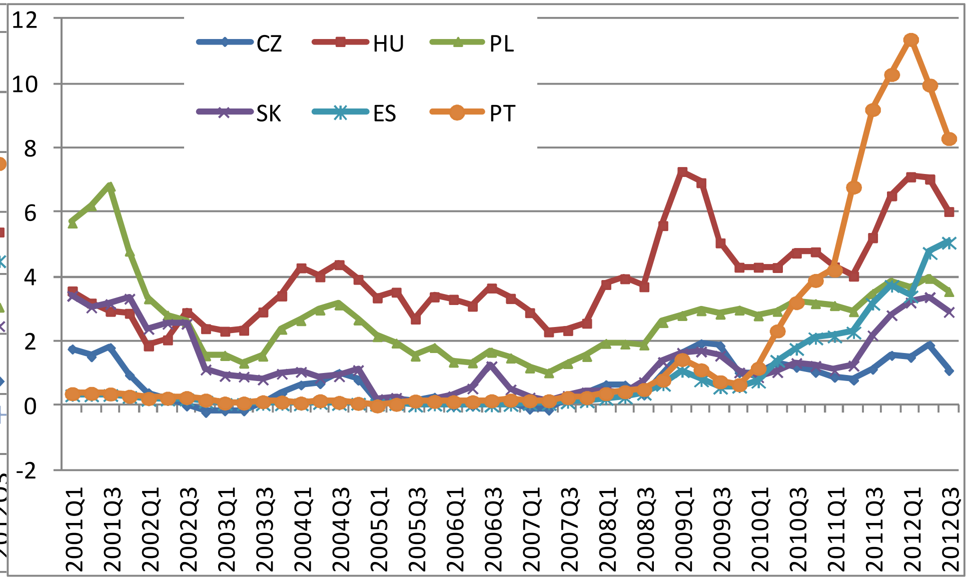
Debt to GDP Hungary



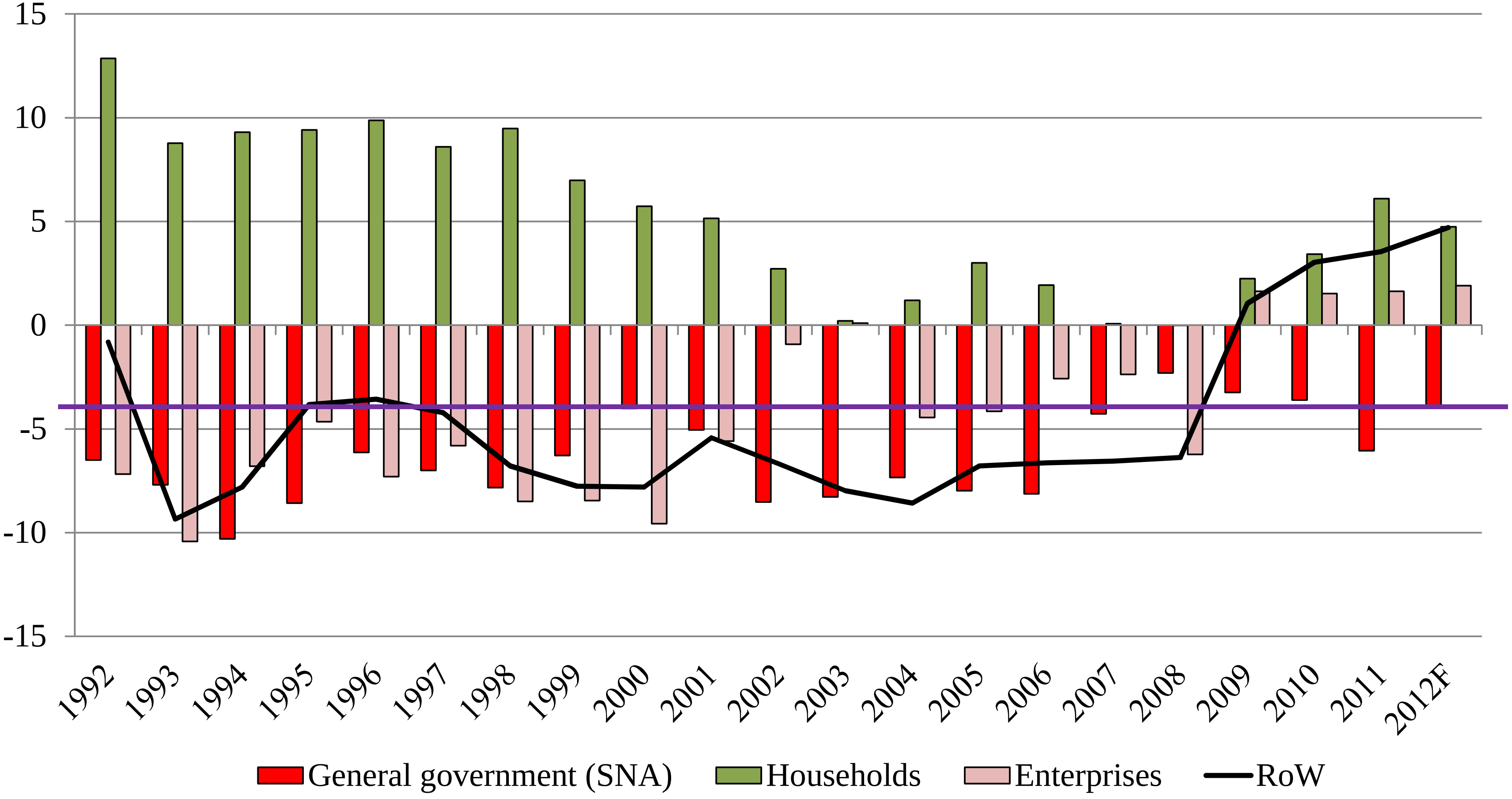
Long-term government bond yields



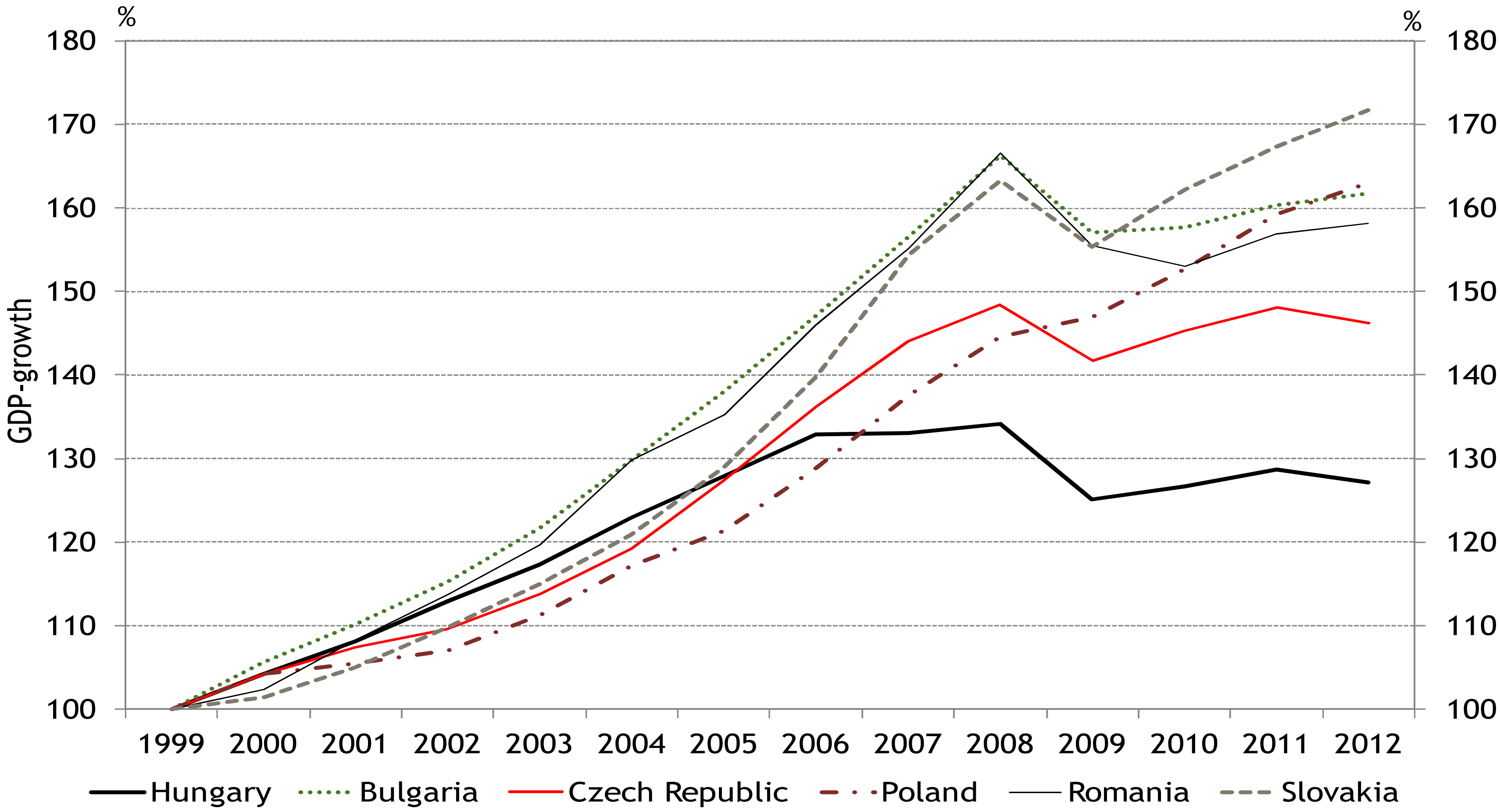
Difference vs. Germany



Macroeconomic imbalances in Hungary (investment savings balance)

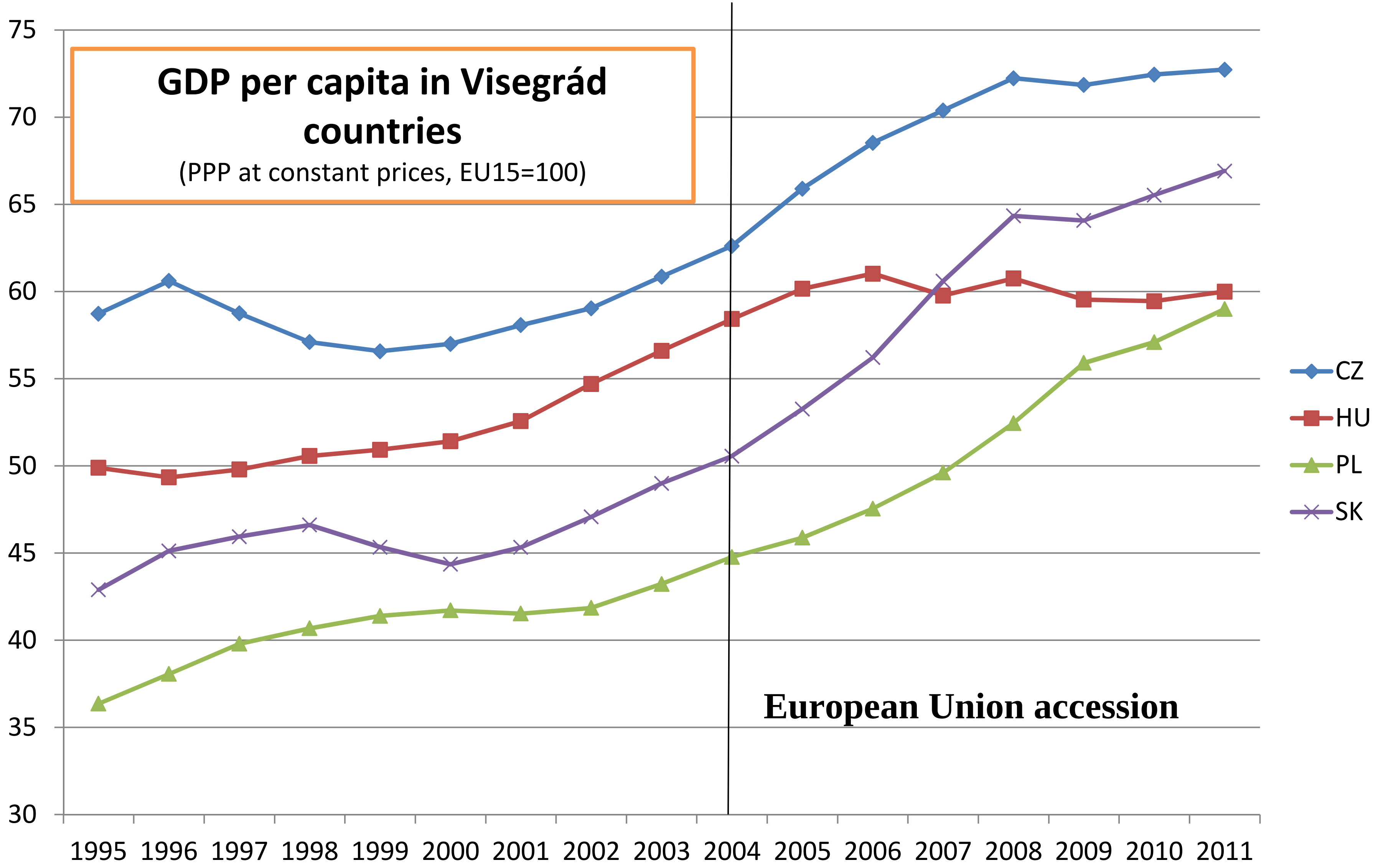


Hungary's growth problems are of major concern



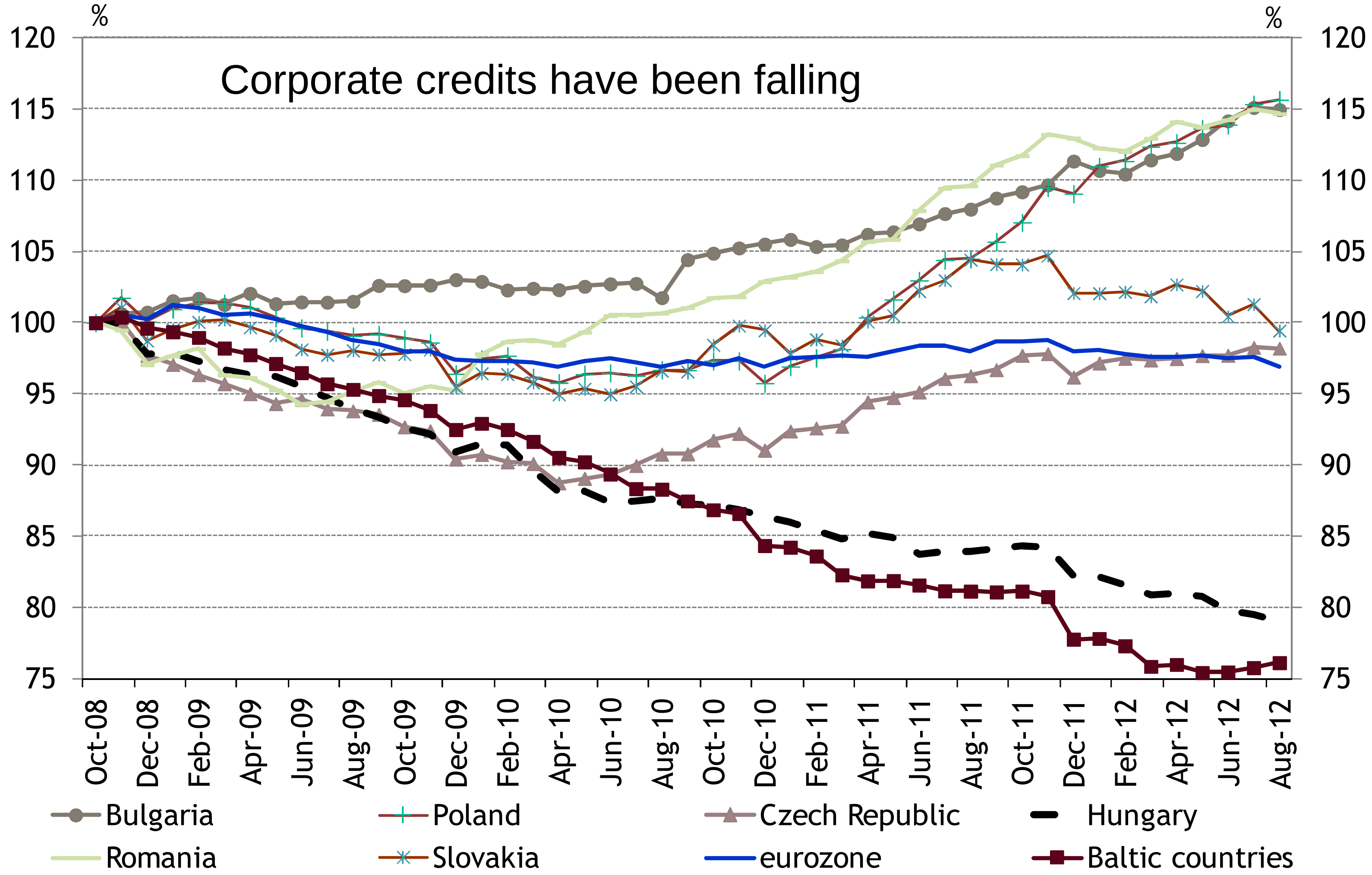
Source: Magyar Nemzeti Bank

Hungary could not profit from the EU accession



Source: AMECO database

Banking sector is “in trouble”: deleveraging + excessive taxation



Source: Magyar Nemzeti Bank

EuroPlus Pact: Hungary said 'No' for economic policy harmonization

- ***Competitiveness*** - consistency between cost of labour and productivity

Hungary: transition to the flat tax system

- ***Employment*** – flexibility, education, training, reducing cost of labour

Hungary: communal work, low investment in human capital

- ***Public Finance -*** increasing the sustainability of pensions, health care and social benefits, implementing national fiscal rules, strengthening institutions

Hungary: nationalization of the fully funded pension pillar, fiscal framework is not respected

- ***Financial stability*** – monitoring the level of private debt for banks, households and non-financial firms, bankruptcy management standards

Hungary: This is the only point where Hungary follows the same line

- ***Tax policy coordination*** – corporate tax base harmonization but respecting national tax strategies

Hungary: misleading communication, no for the "tax policy harmonization"

Summing up: Hungary's position 2012

Hungarian economy

- is far from being prepared for the EZ accession;
- has been hit seriously by the disadvantages of having its own currency;
- there are no major advantages from independent monetary policy, the room for maneuver of the MNB is constrained by large FX debt, volatility of market sentiment due to the unpredictable policies, and country risk prone to contagion effects.

The culture of stability has not gained room in Hungarian policy making.

There is no coherent long term strategy.

European requirements are taken as 'necessary evil'.

The 'Euro project' is clearly rejected.

Our policy conclusion: „about face!”

The present economic policy leads to Hungary’s falling behind the new EU countries.

Hungary’s “independence” could be achieved by meeting the old and new EMU criteria „ASAP” (medium term project).

(Euro adoption can result only in a ***short-term*** gain in credibility, if it is not accompanied by sustained stability oriented economic policy and strong internal adjustment capability.)

No new date of accession is needed!

External criteria should be completed by internal ones

1. Euro adoption would be an *appropriate strategic goal* for Hungary
2. Beside *economic policy for real and nominal convergence*
3. *Institutions* for stability and adjustment should be established

- *Competitiveness* check → wage-coordinating mechanisms + labour market flexibility
- Restoration of *credit market* → preventive macro- and micro-prudential regulation
- *Increasing fiscal space* by policies and reforms for sustainability + institutions for fiscal discipline (untouchable budgetary framework)

The EZ's prospects

Does the new coordination and governance system solve the problems?

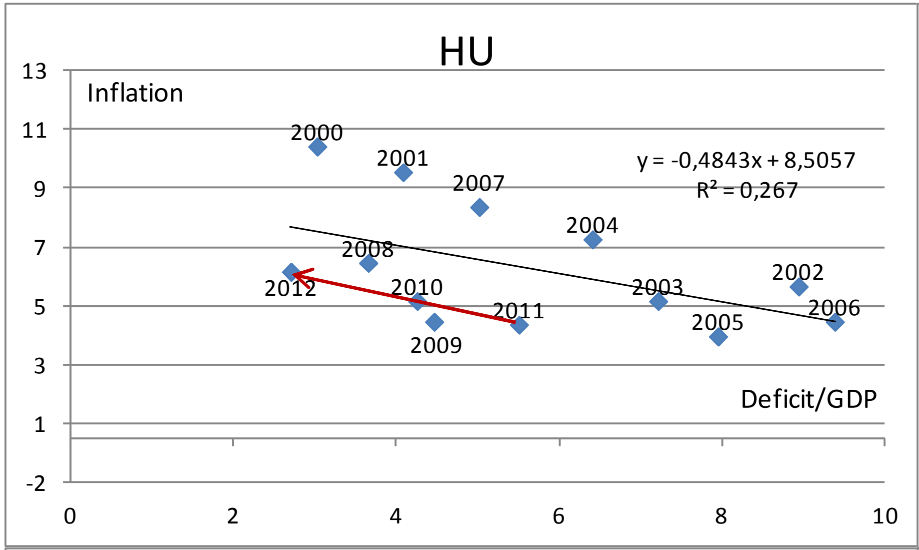
- Political and fiscal union are clearly needed – it might take too long to establish it (if at all)
- Overregulation might be as harmful as no regulation. Fiscal Compact and MIP might be too much.
- Banking sector issues are of primary importance and urgent – low speed project.
- ECB reactions have been slow.

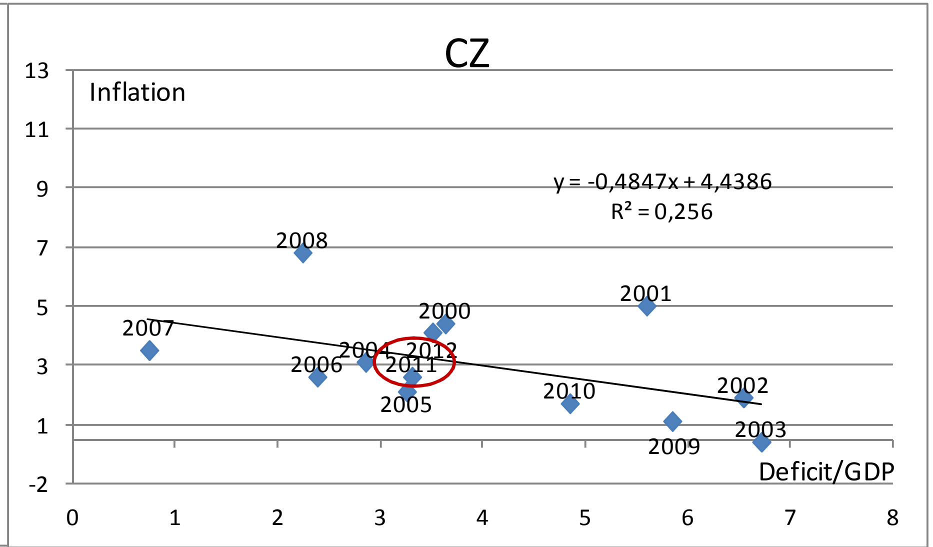
⇒⇒ For the time being the "wait and see" approach could be justified in countries with floating exchange rate regimes.

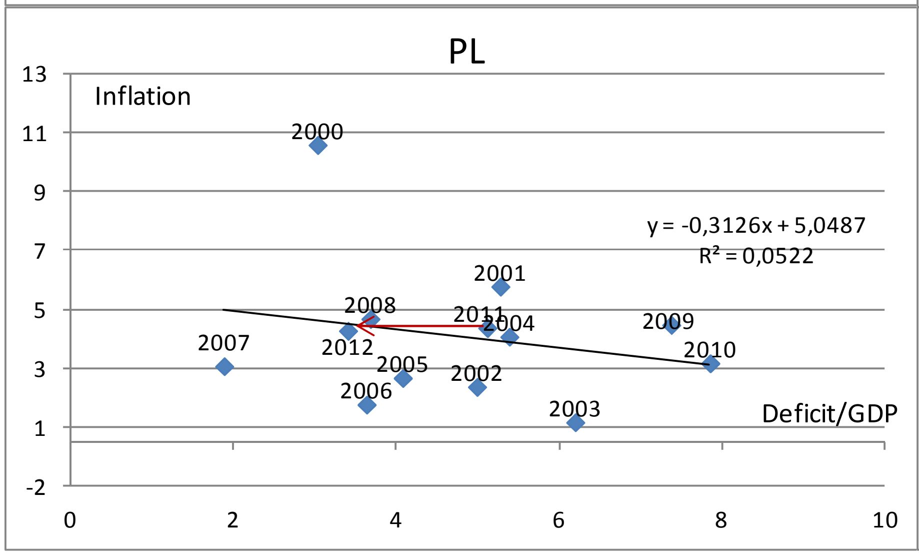
⇒⇒ "Wait and see" should not mean: waiting with the fulfilment of EZ requirements.

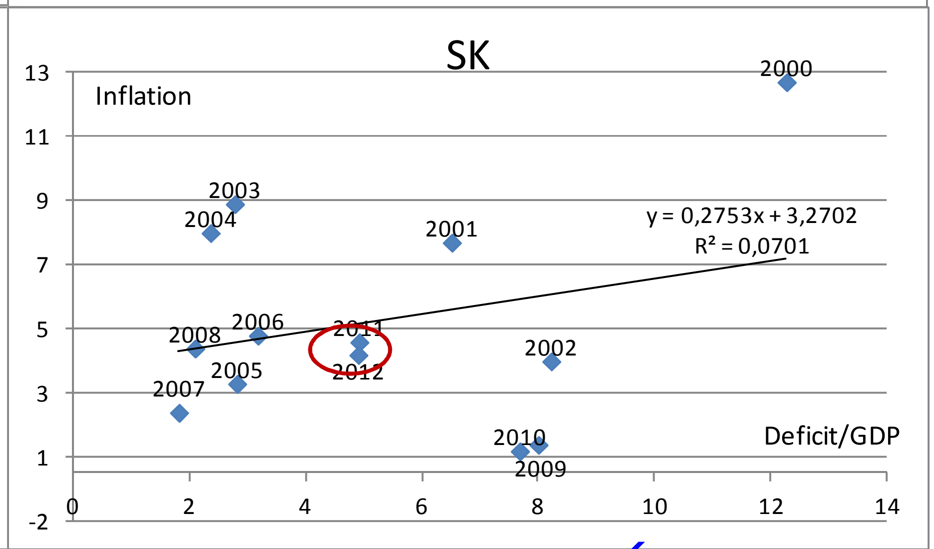
Background charts

Inflation vs. government deficit
(2000-2012)

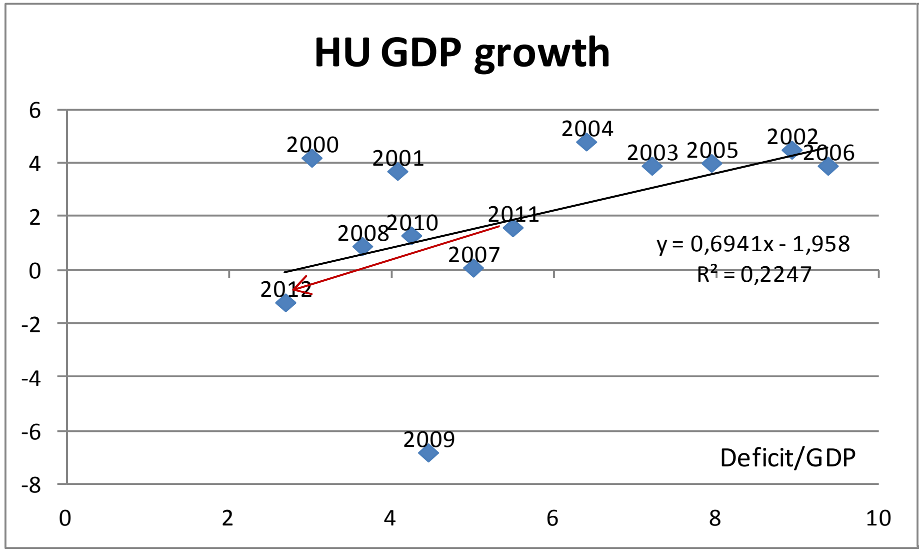


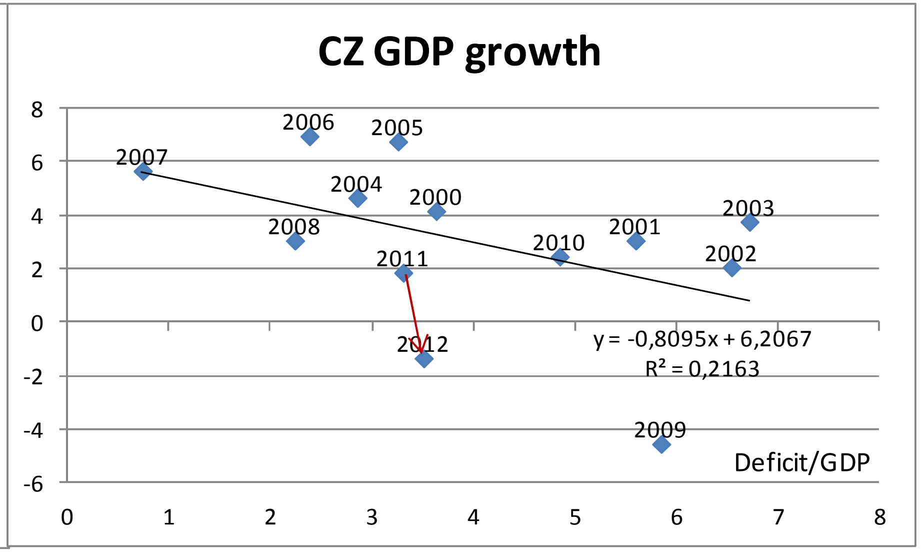


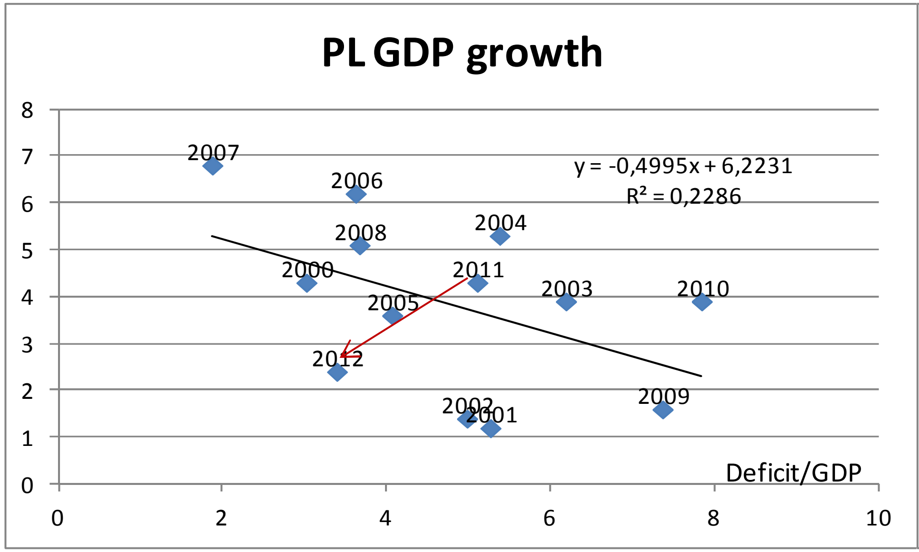


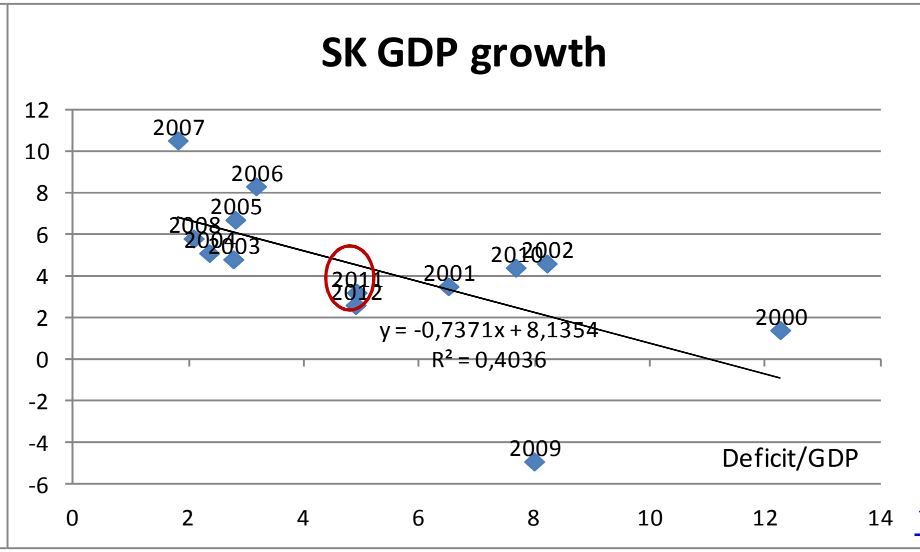


GDP-growth vs. government deficit in the V4 countries









Correlation coefficients between

Gov. Deficit (GD), GDP-growth rate; growth relative to EA; inflation (+ their change relative to the previous year)

HU	*GD*	*Growth*	*Rel Growth*	*Infl*
GD	1			
Growth	0,47	1,00		
Rel Growt	0,57	0,79	1,00	
Infl	-0,52	0,24	-0,07	1
	dGD	*dGrowth*	*'Rel Growtl*	*dInfl*
dGD	1			
dGrowth	0,12	1,00		
dRel Grow	0,37	0,67	1,00	
dInfl	-0,76	0,06	-0,49	1

PL	*GD*	*Growth*	*Rel Growt*	*Infl*
GD	1			
Growth	-0,48	1,00		
Rel Growt	0,09	0,34	1,00	
Infl	-0,23	-0,12	-0,30	1
	dGD	*dGrowth*	*'Rel Growtl*	*dInfl*
dGD	1			
dGrowth	-0,39	1,00		
dRel Grow	0,04	0,04	1,00	
dInfl	-0,33	0,21	0,21	1,00

CZ	*GD*	*Growth*	*Rel Growth*	*Infl*
GD	1			
Growth	-0,47	1,00		
Rel Growt	-0,32	0,80	1,00	
Infl	-0,51	0,13	-0,08	1
	dGD	*dGrowth*	*'Rel Growtl*	*dInfl*
dGD	1			
dGrowth	-0,55	1,00		
dRel Grow	-0,09	0,67	1,00	
dInfl	-0,60	0,34	0,14	1

SK	*GD*	*Growth*	*Rel Growth*	*Infl*
GD	1			
Growth	-0,64	1,00		
Rel Growt	-0,84	0,83	1,00	
Infl	0,26	-0,05	-0,43	1,00
	dGD	*dGrowth*	*'Rel Growtl*	*dInfl*
dGD	1			
dGrowth	-0,48	1,00		
dRel Grow	-0,59	0,86	1,00	
dInfl	-0,31	-0,04	-0,27	1,00