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Hungary, the euro and the crisis

András Simor
Governor
Magyar Nemzeti Bank

28 March, 2009
Prague

Outline

- Pre-crisis assessment of costs and benefits
  - Benefits of euro for HU?
  - Is HU + Eurozone = OCA?
- How the crisis have changed…

  …the balance of costs/benefits

  …the prospects of meeting the Maastricht criteria
- Conclusion

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€ in HU - Benefits

- Reduction in transactions costs
- Trade expansion: growing access to the single market, deeper economic integration
- Falling real interest rate: smaller risk premium, lower interest rates
- Greater macroeconomic stability
- Reduction in external vulnerability: immunity to currency crises

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€ in HU – costs (OCA)

- Economic requirements: optimum currency area (OCA) criteria. OCA deals with two issues:

  (1) How likely asymmetric shocks are?

  (2) Are there alternative mechanisms to deal with asymmetric shocks, if monetary policy is no longer around?

- Probability of asymmetric shocks is low, because…
  - Close trade integration
  - Similar sectoral structures
  - Synchronised business cycles

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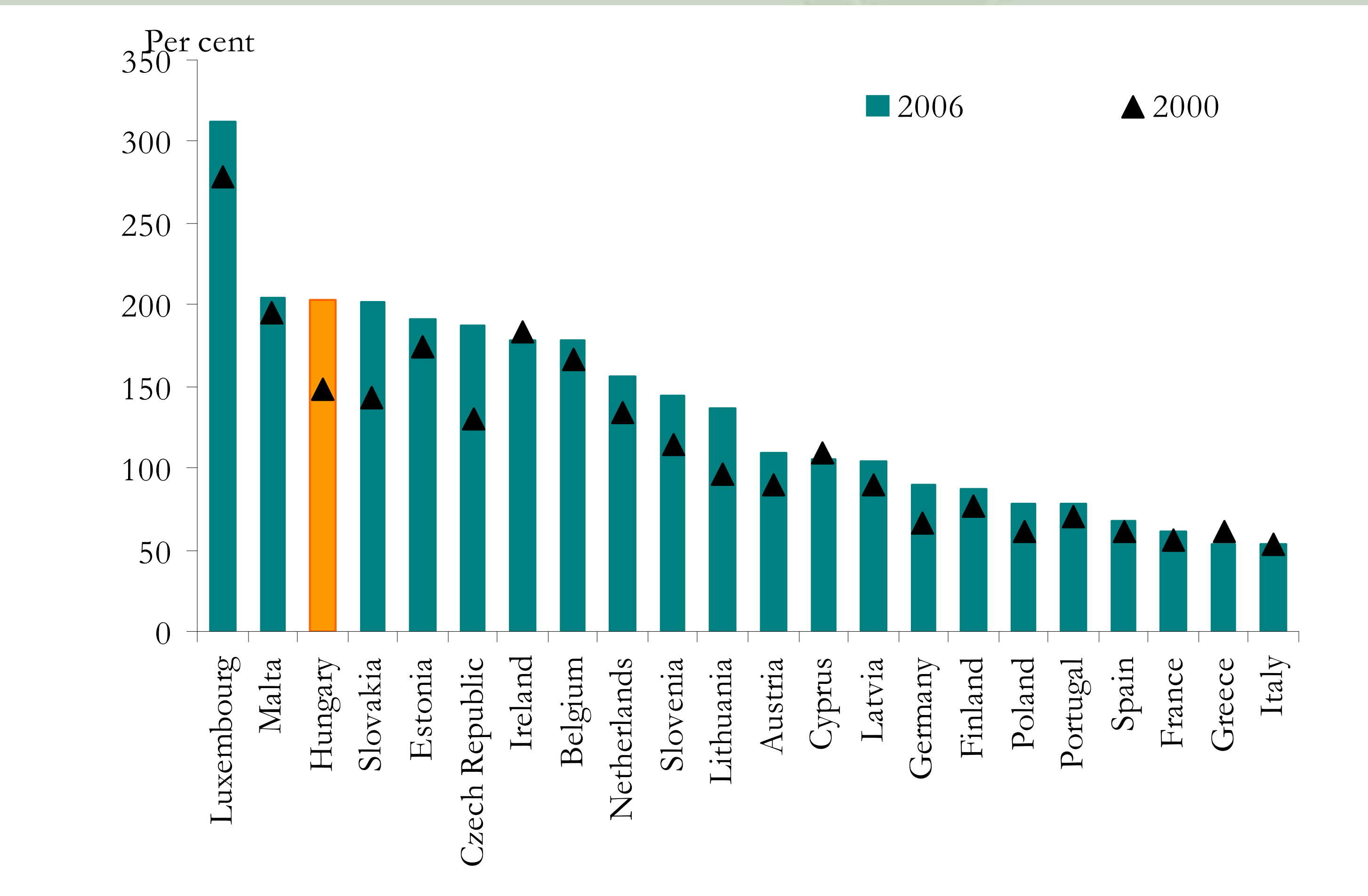
A very open economy…
(Exports+imports)/GDP



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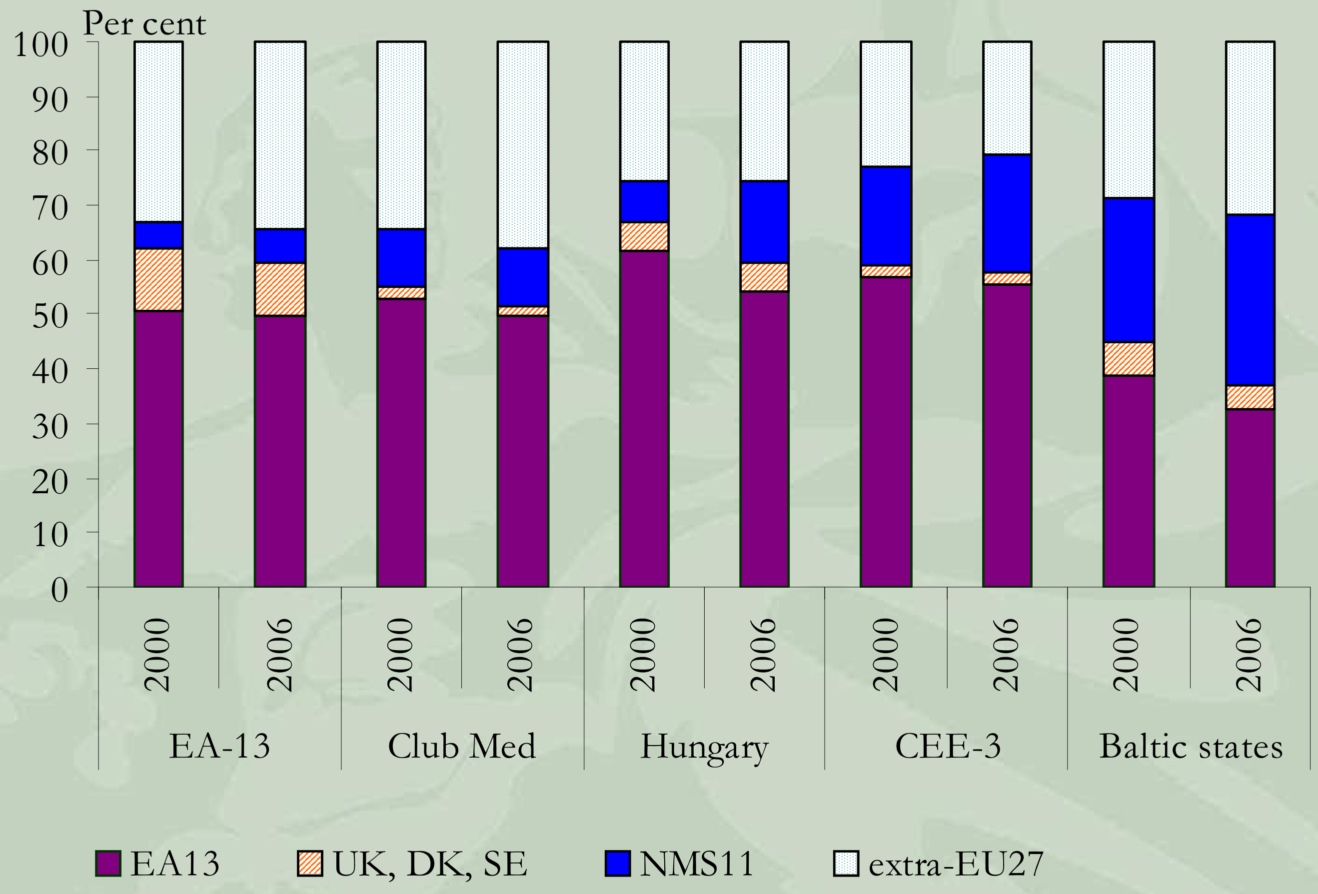
with trade oriented mainly to eurozone

(% of foreign trade by trading partners)



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€ in HU – costs (OCA)

- Alternative ways to handle asymmetric shocks?
  - Fiscal policy – on track to adjust, BUT: is it permanent?
  - Flexible wages, BUT: low employment and participation
- Both are manifestations of a „premature welfare state" (high redistribution with a large share of social transfers)
- A thorough structural reform is needed to curb welfare expenditure and ease the tax burden
- Safer to do it before the euro, as reform incentives in eurozone may be weaker

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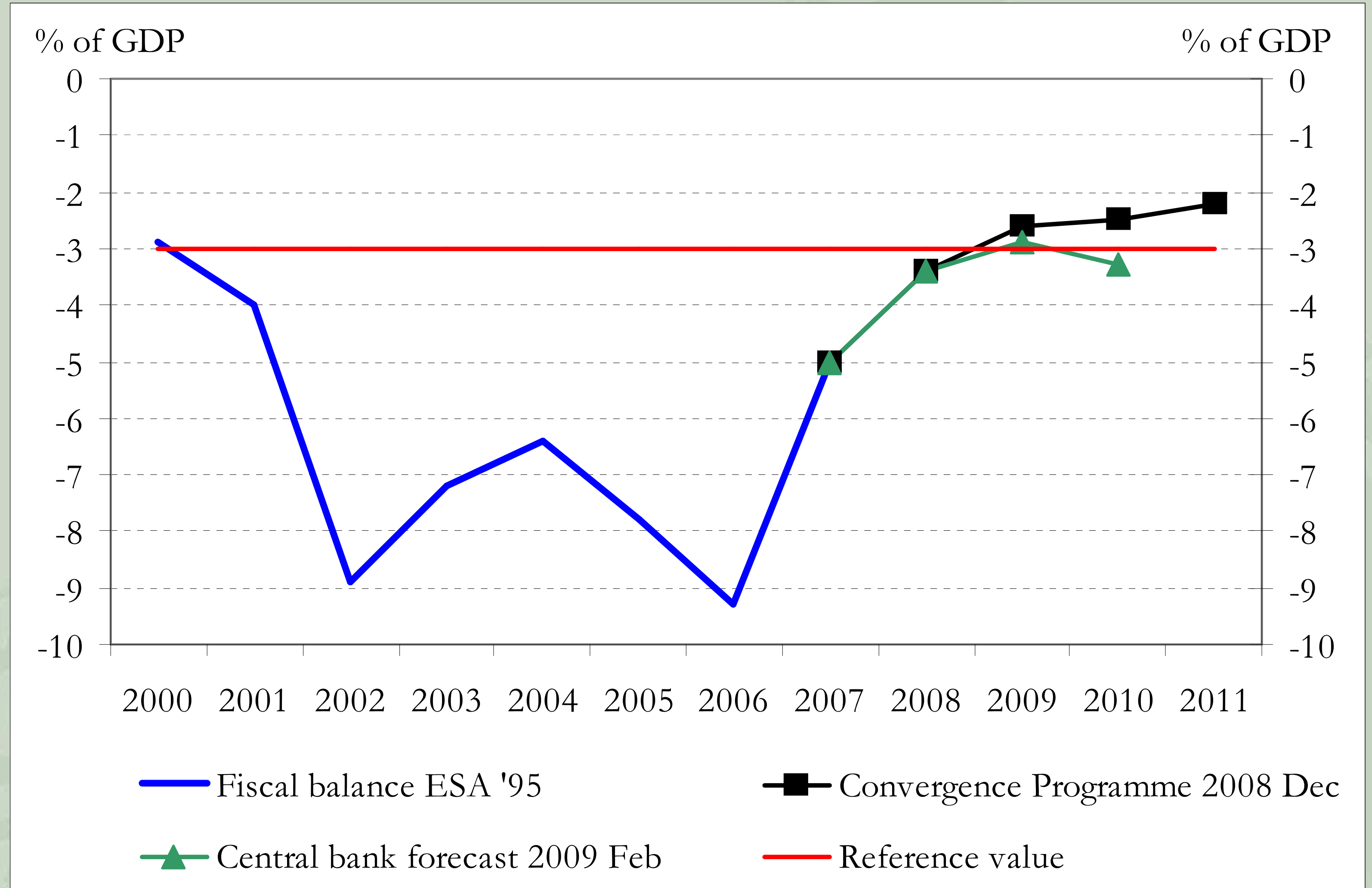
Fiscal performance and outlook



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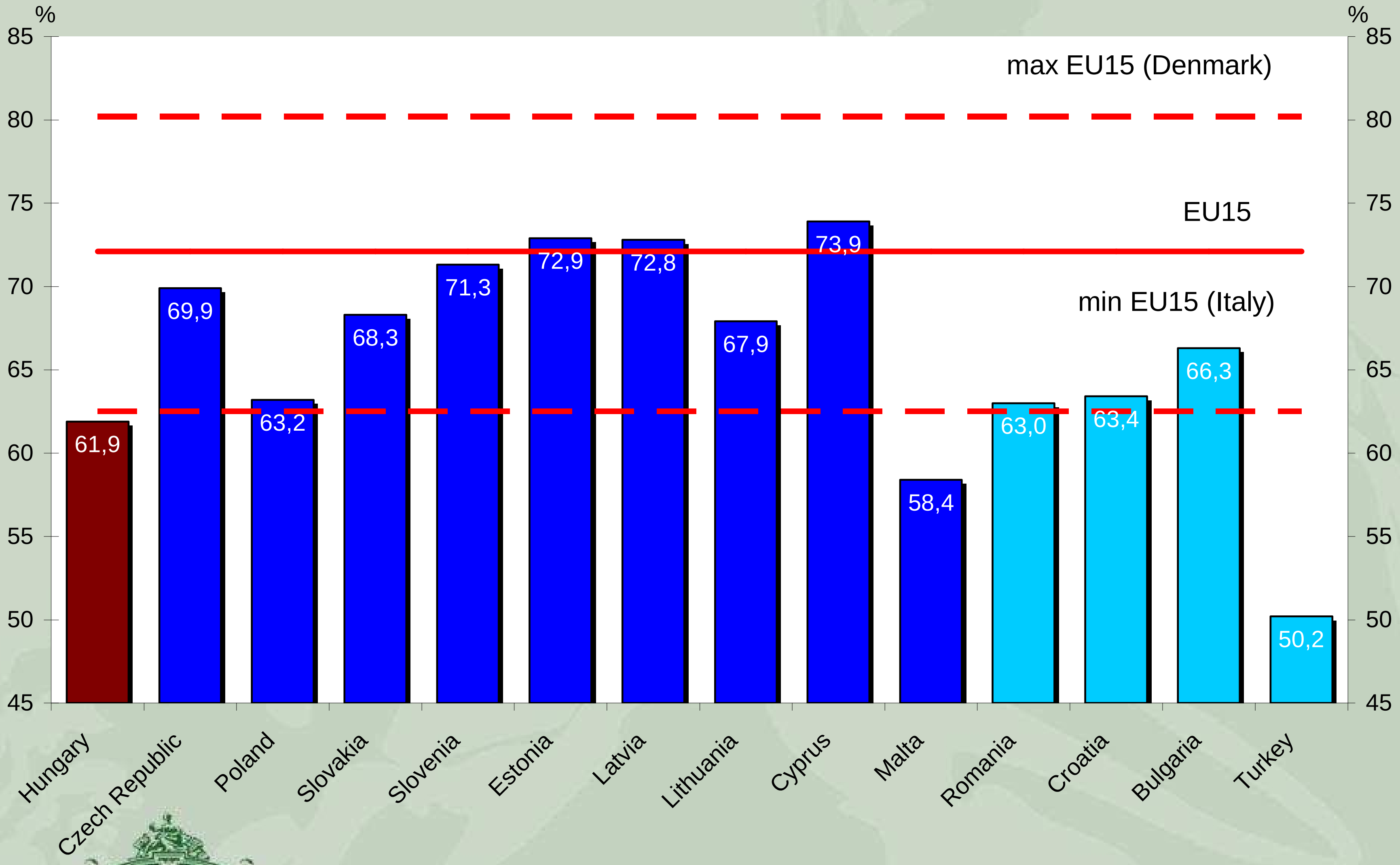
Low participation – wrong incentives?



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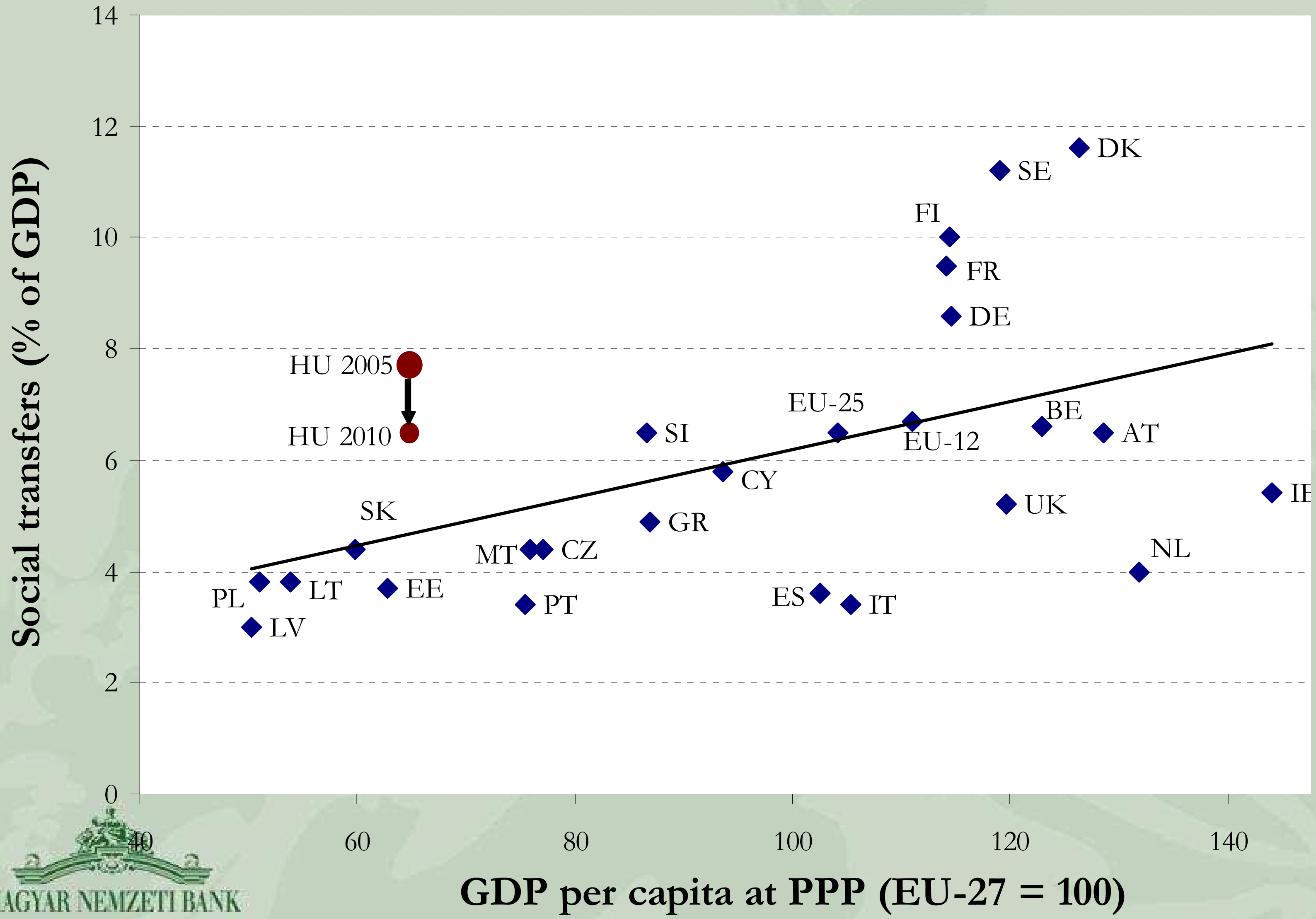
„Premature welfare state”?



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€ in HU - the MNB position before the crisis

- Costs/benefits show a net gain from € in HU…
- …which suggests an „as soon as possible" strategy…
- …with one condition: structural reforms (especially to scale back the overly generous welfare state) should be safely on track before entering euroland

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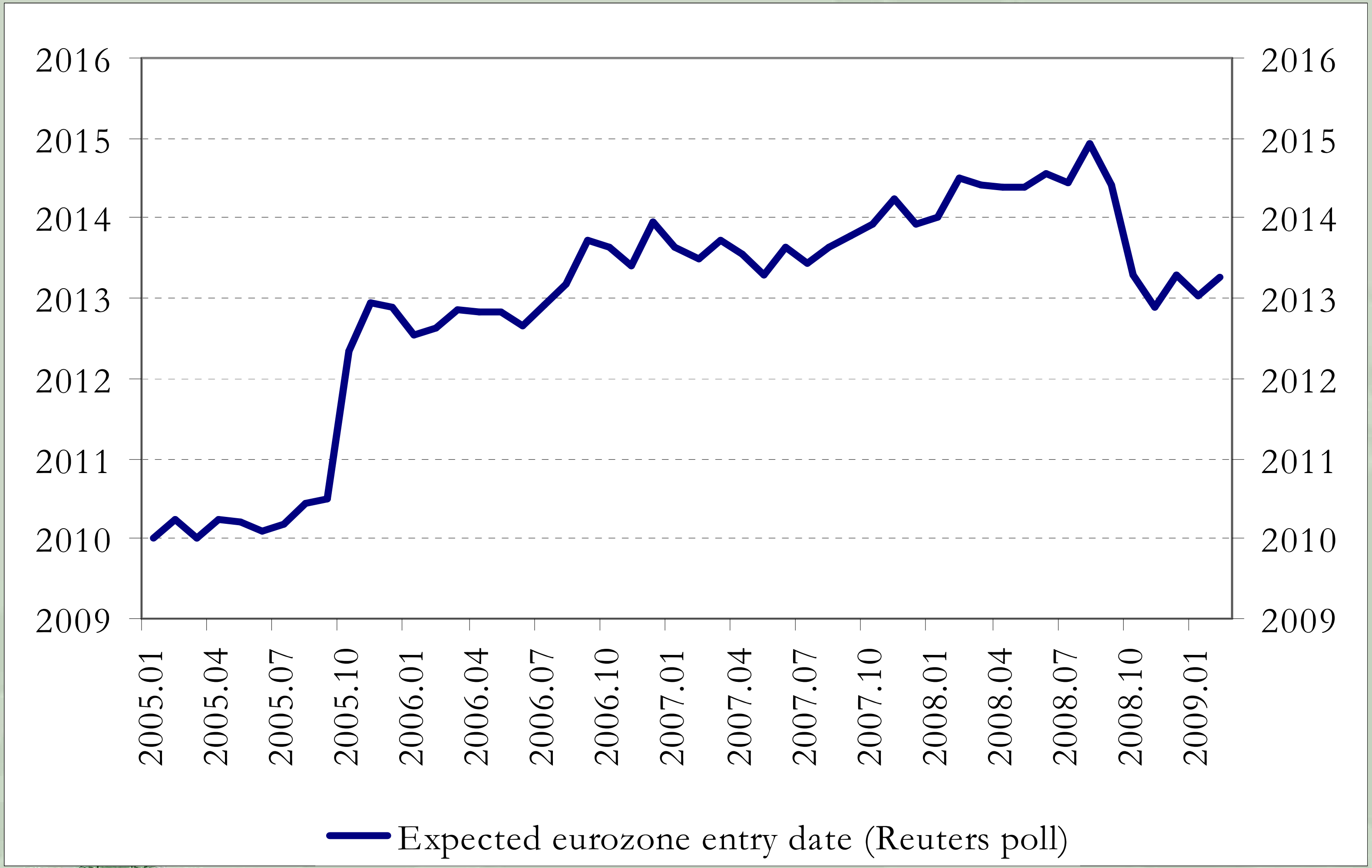
How the crisis may change the € strategy?

- ‘Carrot’: The beneficial effect of euro in protecting from excessive currency volatility (speculative attacks) is much more visible for politicians and the public
- ‘Stick’: Global deleveraging → external financing more difficult → financial markets are forcing stronger fiscal adjustment, may eventually force out a thorough structural reform
- Both ‘carrot’ and ‘stick’ incentives are more pronounced, suggesting quicker euro adaption

Stronger incentives are reflected in market expectations of € adoption date



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The crisis and meeting Maastricht

The crisis may help in meeting the

- deficit criterion - forcing more disciplined fiscal behaviour
- inflation criterion – recession may speed up disinflation

But it is causing problems in meeting the

- interest rate criterion – sizeable increase of CDS spreads in CEE
- debt criterion – higher interest rates, depreciation and recession weigh heavily on debt dynamics

Finally, at the current juncture it is much harder than usual to tell

- the rate of potential growth,
- the sustainable current account deficit and
- the equilibrium real exchange rate

→ Finding an appropriate ERM II rate now is more difficult than usual

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Conclusion

- Post-Lehman, the € for Hungary is more attractive than ever
- Indeed, the crisis may help eliminate the only remaining risk of a quick entry – it may force out the necessary structural reform
- The effect of the crisis on meeting the Maastricht criteria is mixed – in particular, CDS spreads have to decline heavily in the future to have a chance
- A credible euro strategy may help in that, creating a „virtuous cycle"

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Thank you for your attention!