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Hungary's entry into the euro area: Lessons for prospective members from a monetary policy perspective

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Abstract

This paper evaluates the conduct of monetary policy in Hungary using standard Taylor rules as well as extended rules that incorporate real exchange rate effects. Moreover, we explicitly consider the impact of future euro area entry by estimating instrument rules that permit an influence from Maastricht Treaty inflation requirements via the estimation of Markov switching models as well as by estimating a differential rule vis-à-vis the existing euro area. Lastly, the paper also considers the impact on policy rules from the large data revision that affects real exchange rate and output estimates. I find that interest rate setting behavior in Hungary does not resemble that of the euro area. Also, counterfactual experiments reveal that the potential macroeconomic costs of entry into the euro area sooner rather than later may be lower than if membership in the single currency area is delayed beyond 2008.

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1. Introduction

In May 2004 Hungary, along with nine other states, joined the European Union (EU). Since there were no derogations, Hungary will someday join the euro area (EA). The only question is when. Participation in European Monetary Union (EMU) consists of several steps, namely

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adoption of the *acquis communautaire* and meeting the relevant Maastricht Treaty provisions. The former conditions involve, in essence, the requirement of central bank autonomy prior to accession, and meeting the strictures of the Stability Growth Pact (SGP) following accession (see http://europa.eu.int/comm/enlargement/negotiations/chapters/chap11). The Treaty provisions are well-known (e.g., see ECB, 2004). While it is debatable whether the National Bank of Hungary (MNB) is sufficiently autonomous, particularly in light of recent events concerning governance questions (e.g., see Newsmakers, 2005), the EU at least has closed the book on this stage of the process (though not the ECB; see ECB, 2004, p. 58). It should be emphasized, at the outset, that while the paper focuses attention on the Hungarian experience, the broad findings reported below are likely to reflect considerations that are common to all states that joined the EU in 2004. It is useful to note that, as of this writing, there are recent EU members that are keen to join the EA as quickly as possible (e.g., Estonia, Lithuania, Malta) while others, such as Poland, the Czech Republic and Hungary, have indicated a desire to possibly delay adoption of the euro. Decisions hinge not only on Maastricht and SGP considerations but also on a perceived trade-off, as it were, between the benefits of EA membership (e.g., relatively lower nominal interest rates, improved access to credit markets) versus the short-run benefits of greater fiscal and exchange rate flexibility on generating improved economic growth.

While the road to the euro involves fulfilling conditions that cover both fiscal and monetary policies, this paper focuses on the monetary policy challenges facing Hungary as it seeks to join EMU. Optimism that the date of entry might be as early as 2008 has been replaced with skepticism that even 2010, or 2012, are feasible dates for euro adoption (e.g., Associated Press, 2005; MTI, 2005; Miller, 2006).[1] Three provisions of the Maastricht Treaty are particularly germane to our analysis. They are: the price stability objective, that is, attaining an inflation rate that does not exceed the reference value,[2] the absence of severe tensions in the nominal exchange rate over a 2-year period following membership in the new exchange rate mechanism (called ERM II), and a nominal long-term interest rate that does not exceed the reference value.[3] Within these limits we examine, using a mixture of estimates of instrument rules and counterfactual experiments on these same rules, how the conduct of monetary policy has evolved in Hungary since 1996, and the interest rate prospects if Hungary were to join the euro area in the not too distant future.

Why adopt such an approach? For good or ill, evaluation of central bank behavior is thought to be usefully summarized via the device of reaction function estimation. While no central bank rigidly follows such rules, there is growing acceptance that interest rate setting behavior in a reasonably transparent and accountable central bank can be reasonably summarized via estimates of Taylor type rules (e.g., Poole, 2005). One could interpret the similarity of reaction functions with the existing euro area and the new member states[4] (NMS) as an expression of the latter group's desire "... to show they were normal countries and now want to join the euro to show they are good Europeans" (The Economist, 2006).[5] Hence, the paper posits that

[1] The year 2010 apparently still remains the notional target for the switchover to the euro (see HVG, 2006). Bulir and Hurnik (2006) make the case that the inflation criterion appears to be unnecessarily tight.

[2] The reference value is 1.5% above the inflation rate of the three best performing Member States.

[3] The reference value is 2% above the comparable long-term interest rate in the three best performing Member States.

[4] These are the countries that joined the European Union on 1 May 2004. They are: Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovak Republic, and Slovenia.

[5] Similarities in the performance of monetary policy evaluated through the lens of instrument rules only reveal tendencies toward success at meeting the conditions required for euro area entry. Actual decisions are made at a particular moment in time, which is problematic, but the issue is beyond the scope of this paper.