Integration into EU and EMU: Challenges of Real and Nominal Convergence
National Bank of Hungary's Approach

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- The main economic policy challenge for applicant countries is to find the optimal policy mix during the convergence process. Although the uncertainty surrounding the exact timeframe for accession makes economic policy optimizing difficult, Hungary has a clear-cut medium-term economic strategy aimed at the fulfillment of the convergence criteria after EU accession (by 2004) and joining monetary union as soon as possible, i.e. by 2006. The economic policy goals of Hungary, namely maintaining the conditions for macroeconomic stability and sustained growth, coincide with EU requirements.

- At the present stage of Hungarian economic development, combined with an economic policy aimed at further convergence, meeting the Copenhagen criteria of EU accession is within reach, as indicated, i.e., by the continuously improving assessments in the successive Regular Reports by the Commission. Looking at the economic performance of some of the present member states – that acceded to the EU in previous rounds of enlargement – at the time when they were at the same distance from EU and EMU membership as Hungary is now, one can observe that they showed similar, in some cases even larger, deviations from both nominal and real criteria. Furthermore, the high degree of economic integration of Hungary into the euro area suggests that the conditions required in terms of the optimal currency area theory have been at least partly met. E.g., the share of exports to the euro area within the total exports of Hungary exceeds 70 %, the synchronization of business cycles is quite strong, etc.

- Although there is no formal requirement to comply with the Maastricht convergence criteria at the pre-accession stage, to be able to fulfill them after EU accession demands an appropriate economic policy already before accession. This economic policy will be presented in the consecutive Pre-Accession Economic Programs, which should be seen as a kind of convergence program of candidate countries. Maastricht criteria are interdependent and it shouldn't be an obstacle for economic policy to achieve them at once. Options for economic policy only arise regarding the time horizon of convergence.

- While establishing monetary stability involves trade-offs in the short run, stability contributes to economic growth in the long term. Long-term gains will compensate for the short-term cost of disinflation. According to our calculations joining the common currency area would increase Hungary's growth potential by 0.3-0.9% p.a. This is due to lower transaction costs, even higher trade integration and lower interest rates.

- Thus Hungary should not wait for obtaining a higher level of income before joining the EU and later on, EMU. In line with its primary objective as defined by the

recently adopted new central bank law, the National Bank of Hungary – in agreement with the Government – has embarked on a gradual, but ambitious medium-term disinflation strategy. The strategy aims at the fulfillment of the inflation criterion by 2004-5, with inflation targets of 7 % and 4.5 % by the end of 2001 and 2002, respectively (with a tolerance band of +/- 1 %). Furthermore, the Bank recommended the Hungarian Government to agree on inflation targets of 3% and 2% by the end of 2003 and 2004, respectively. Within its new monetary and exchange rate framework, the NBH relies on some nominal appreciation of the exchange rate in meeting the inflation targets.

- After joining the monetary union, the higher equilibrium inflation rate due to the catching-up process can not be interpreted as a threat to monetary stability, because of its origin (structural and real) and its nature (as being an upward convergence of prices in countries with lower price levels). Furthermore, as the catching-up process continues, the basis of higher inflation rate gradually fades, and the inflation differential will diminish in the process. Both increased competition within the single market and Hungarian economic policy oriented towards fiscal discipline can be effective means to ensure that regional inflation remains compatible with the price stability definition of the euro area.

- The Treaty, while assigning to the ECB the primary objective of maintaining price stability, leaves the precise definition of price stability in the competence of the ECB. Close to three years of experience with the single monetary policy indicates that inflation differentials among the present member states constituting the euro area are substantial. It is worth to recognize: that inflation differentials among member states are today higher, then they have been at the time, when the eleven first round applicants for the adoption of the common currency had been selected. Therefore, the current definition of price stability as set by the ECB may become subject of reconsideration independently of the newcomers to EU and EMU.

- The higher equilibrium inflation rate in rapidly growing countries would not be a sign of deteriorating competitiveness, because real appreciation is a consequence of the improving competitiveness of these countries. This effect would also be felt if rapidly converging countries were not allowed to enter EMU and their nominal exchange rates would appreciate further. Thus, it would not pose a threat to the internal market, because it would be just a reflection of better relative economic performance. Staying outside of EMU until a certain level of real convergence is reached, could cause even more harm to the internal market because of the concomitant exchange rate risks and other uncertainties (higher risk premium, reversibility of the integration process, threat of large step devaluations etc).

- I am not advocating higher inflation rates for accession countries as an unavoidable phenomenon after joining the EU and the EMU. Real convergence is an ongoing process, while the adoption of the euro is at least five years from now. As a matter of experience from former EU enlargements, real convergence will not slow down, but rather accelerate after EU accession and after becoming part of EMU. The only thing I am trying to explain is, that regional inflation differentials do exist within the euro area and will be persist in the future. They are not hindering a successful single monetary policy. On the other hand, keeping accession countries out of the euro

area as long as real income differences exist does not make a stronger euro, but rather a weaker internal market. Such an approach may in addition even slow down the process of real convergence.

- Summing up, there are no economic reasons for a delay in joining EU and, subsequently, EMU. At least, this is Hungary's position, and that will be the main driving force of our economic and monetary policy in the forthcoming years.