

**On the Road to Euro:
Monetary Policy Challenges in the New EU Members**

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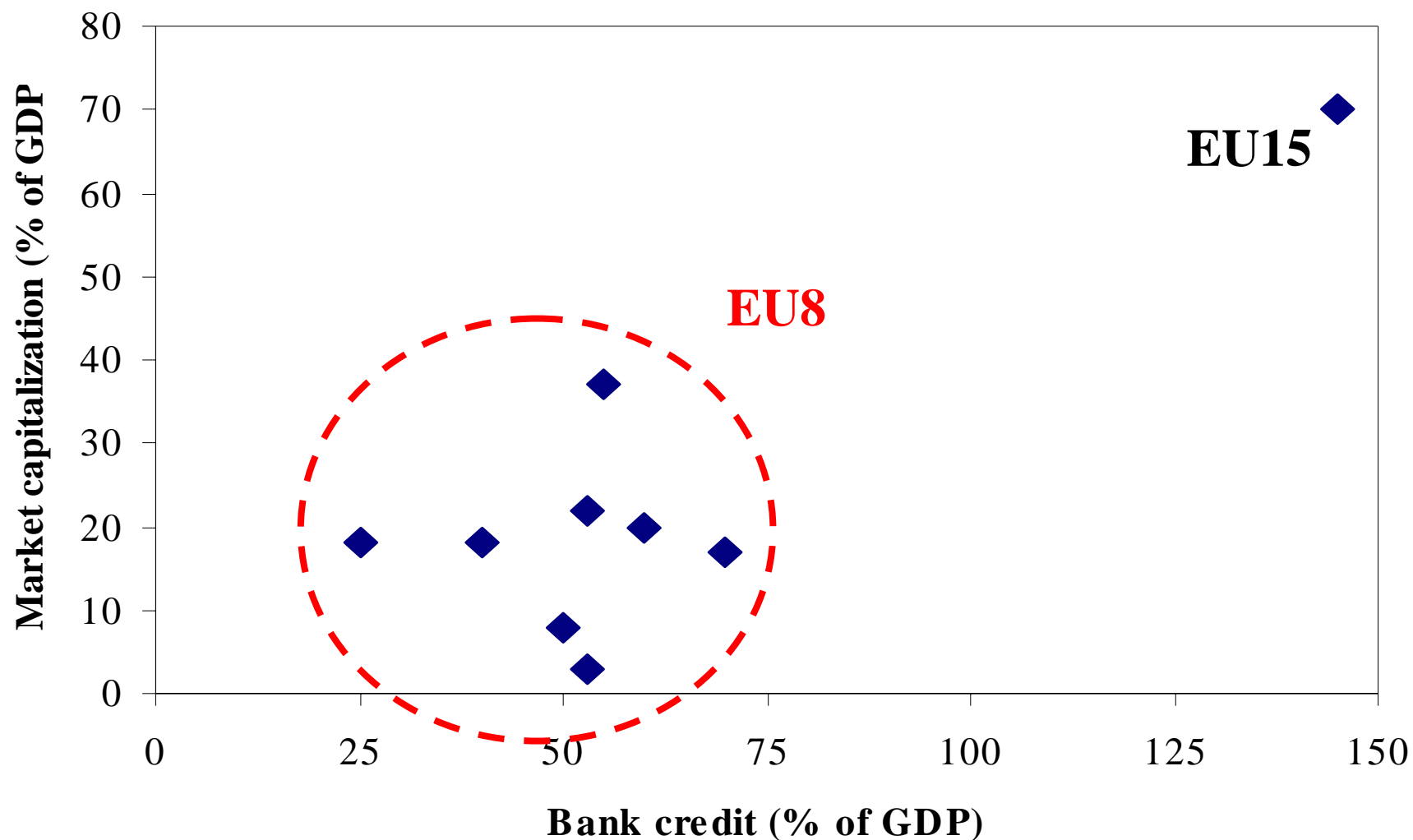
Outline

- **Policy environment**
- **Inflation-targeting framework**
- **Exchange rate-based framework**
- **Comparative trends**
- **Outlook, scenarios**

Policy environment

- **Openness to capital flows**
- **Shallow domestic financial markets**
- **Macroeconomic and financial volatility**
- **Equilibrium real appreciation (B-S effect)**
- **EU membership**

Financial intermediation, 2003



Monetary policy framework: two approaches

- Inflation-targeting framework
 - *Poland*, with free float
 - *Czech R, Slovakia, Romania*, with FX intervention
 - *Hungary*, with wide XR band [dropped Feb 08]
- Exchange rate-based framework
 - *Estonia, Lithuania, Bulgaria*: CBA
 - *Latvia*: fixed XR
 - *Slovenia*: managed float, M3 targeting [Euro since 2007]

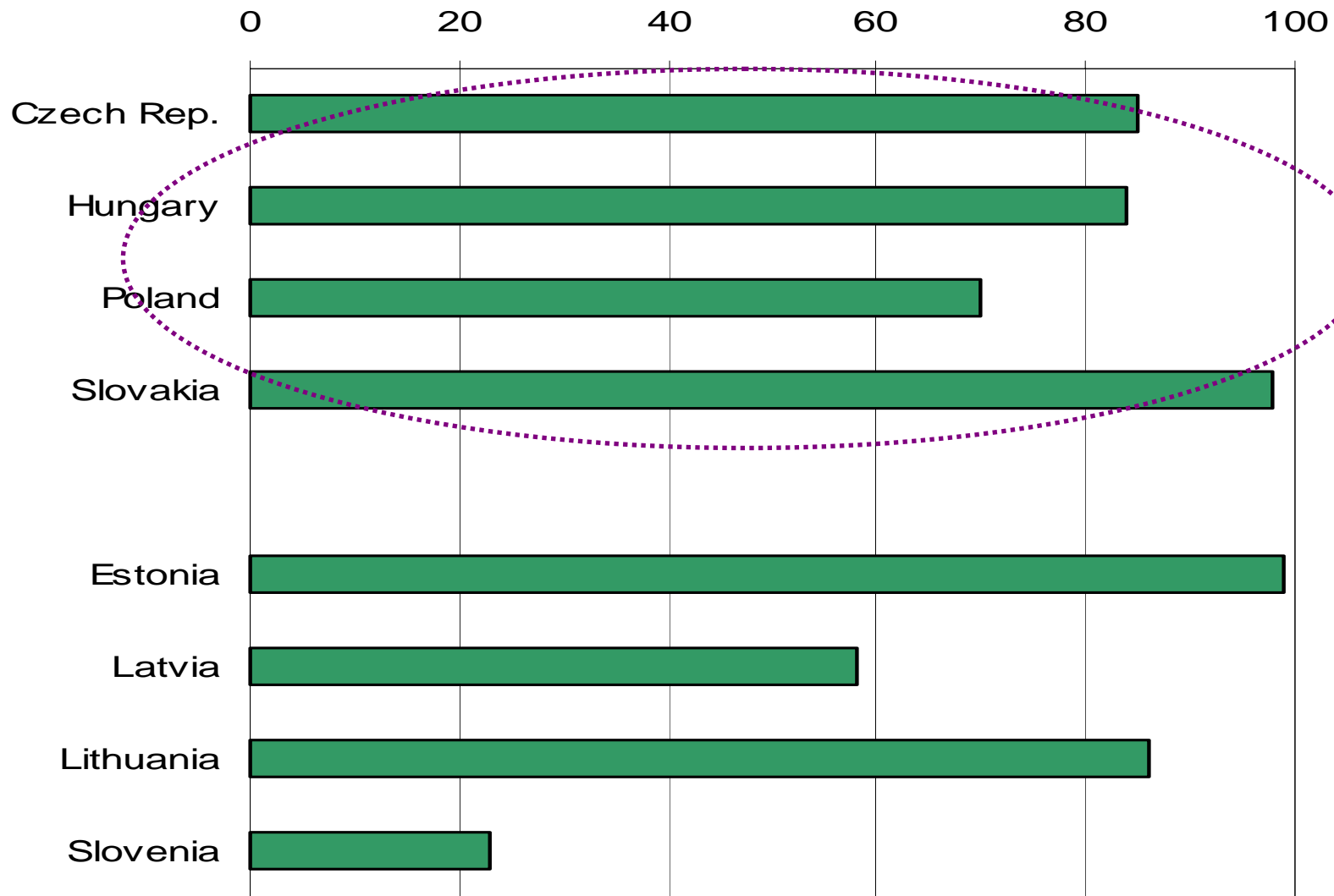
Inflation targeting: institutional features

- **Mandate: price stability**
- **Instrument independence of MPC**
 - policy interest rate
 - communication
- **Accountability, transparency**
 - inflation report
 - stability report
 - minutes of MPC meetings
 - frequent contacts with the media

Inflation targeting: institutional features

- **Consistency with ECB standards**
- **Financial sector soundness**
 - effective banking supervision, prudential regulation
 - banks mostly foreign-owned
 - cross-border supervision largely untested

Foreign-owned banks, 2005



Market share (% of total banking assets)

Inflation targeting: technical features

- **Target**
 - Initially: disinflation path
 - CPI inflation of 2 ½ to 3% (incl. B-S effect)
- **Inflation forecasting**
 - standard macro model-based forecasts
 - disaggregated ST forecasts, incl. expert opinion
 - structural DSGE model in some countries
- **Monetary transmission mechanism**
 - weak credit channel
 - strong exchange rate pass-through

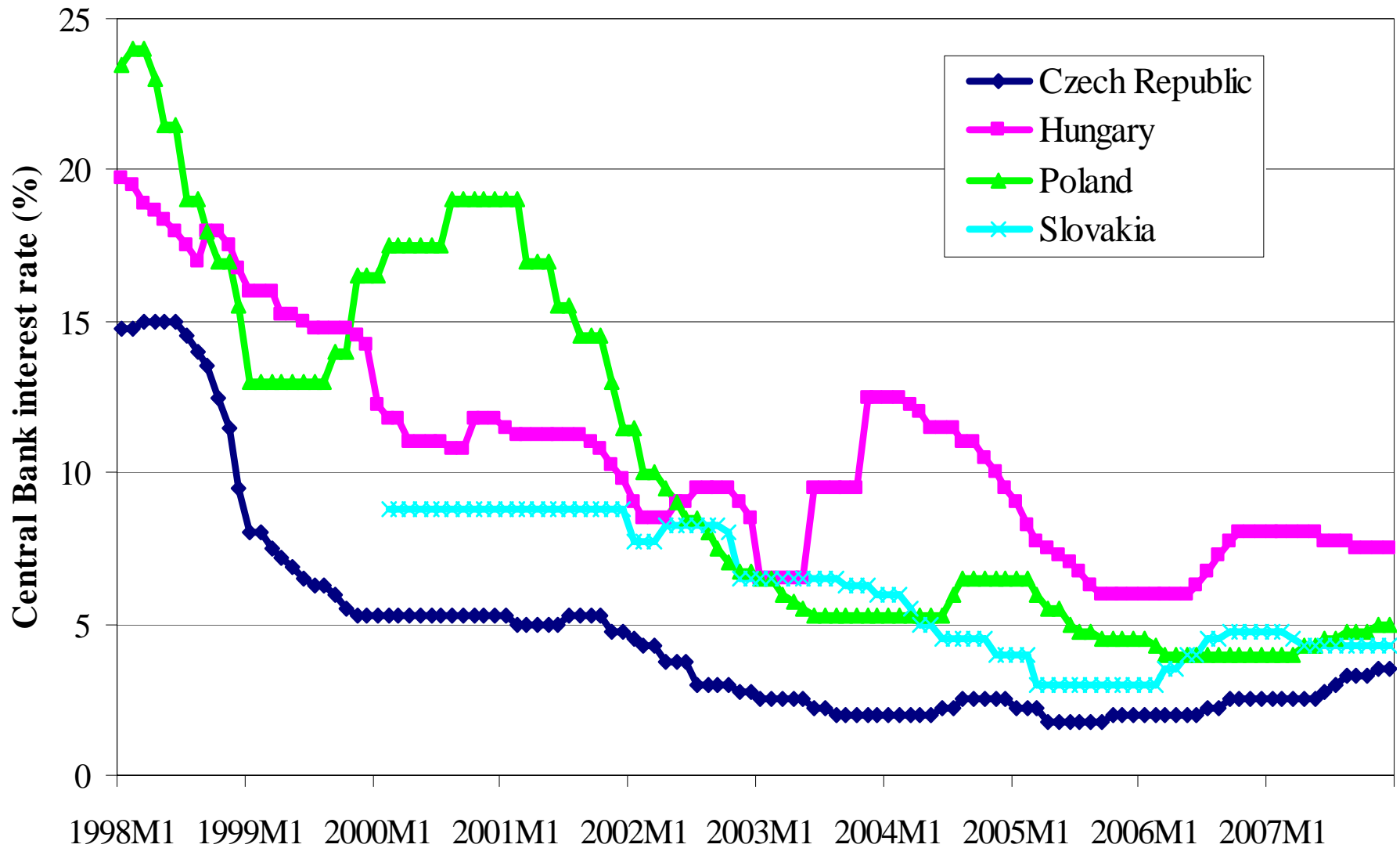
Inflation targeting: experience

- **Initial teething problems**
 - dual targeting (inflation & exchange rate)
 - slow response to changing risk premium
 - limited transparency
 - lack of clarity in target
- **Institutional hiccups**
 - occasional challenges to MPC independence
 - changes in composition of MPC

Inflation targeting: experience

- **Policy reaction function**
 - smoothing behavior
 - response to inflation forecasts
 - response to price shocks, to changing expectations
 - response to shifts in risk premium
 - fear of floating ?
- **Favorable tailwinds**
 - effects of globalization
 - price competition from EU membership

Policy interest rate



Inflation targeting: challenges

- **Fiscal indulgence**
 - strong deficit bias, especially in Hungary
 - debt sustainability problem
- **Currency substitution in domestic borrowing**
[a.k.a. liabilities' euroization]
 - undermines credit channel
 - erodes effectiveness of monetary policy
 - increases exposure to currency risk
- **Coping with shifts in investor sentiment**
 - changes in risk premium
 - volatile, but appreciating exchange rate

Inflation targeting: challenges

- **Inflation expectations**

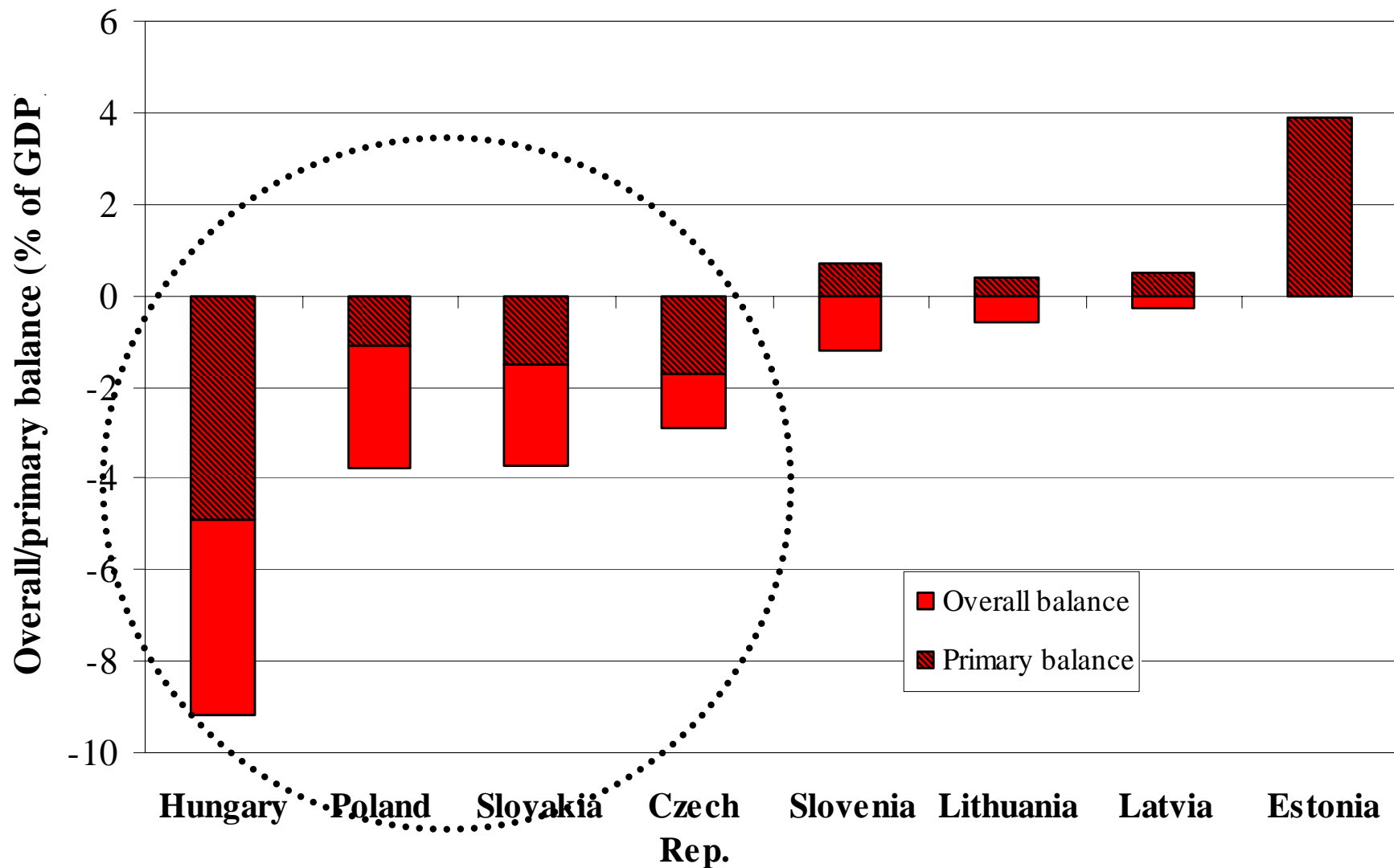
Sources: internal price shocks (admin. price & VAT hikes)
current headwinds (commodity price pressures)

- **Moral hazard**

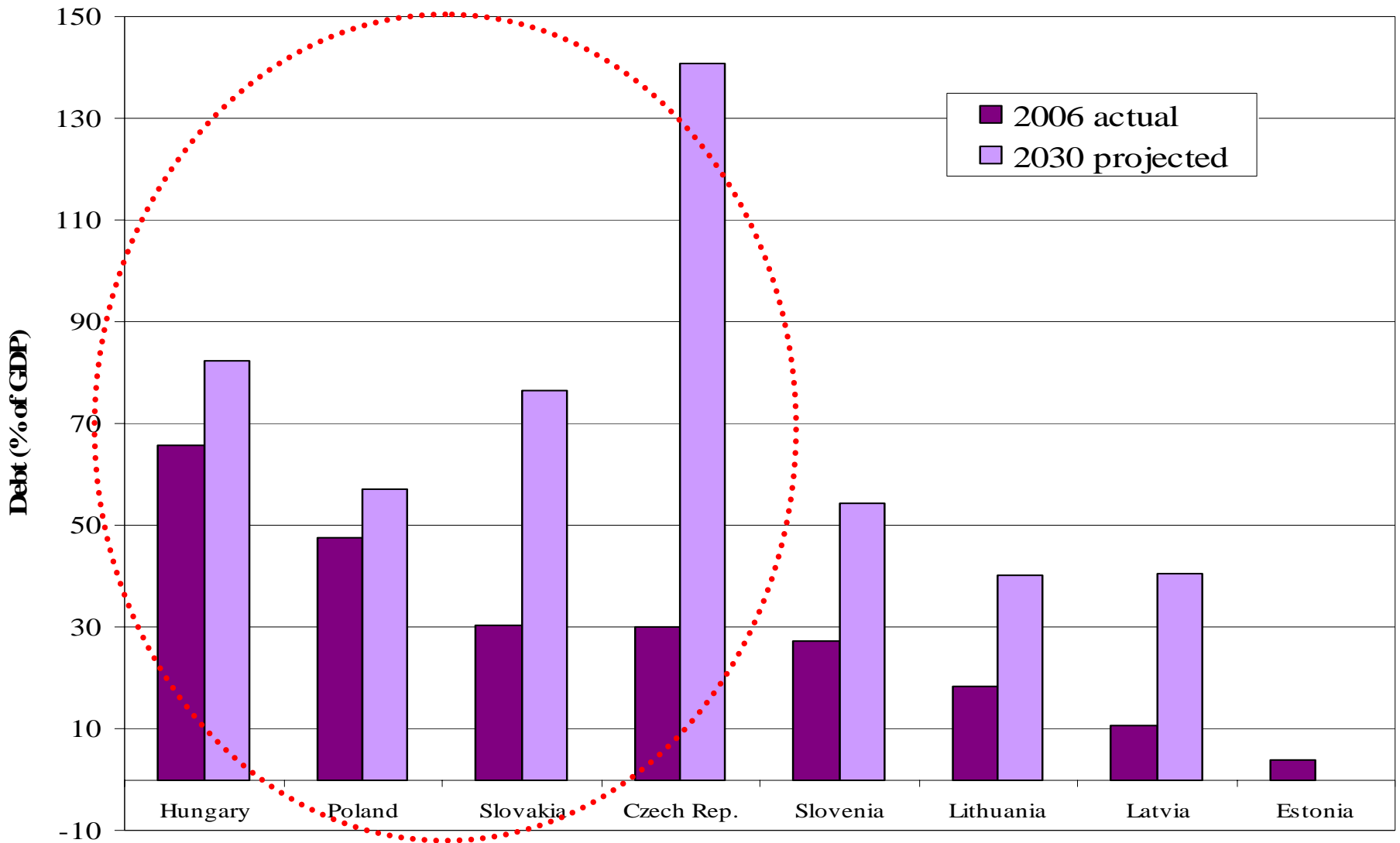
Causes: credible monetary policy
penumbra of EU membership

Players: utility-maximizing governments
carry-trade investors

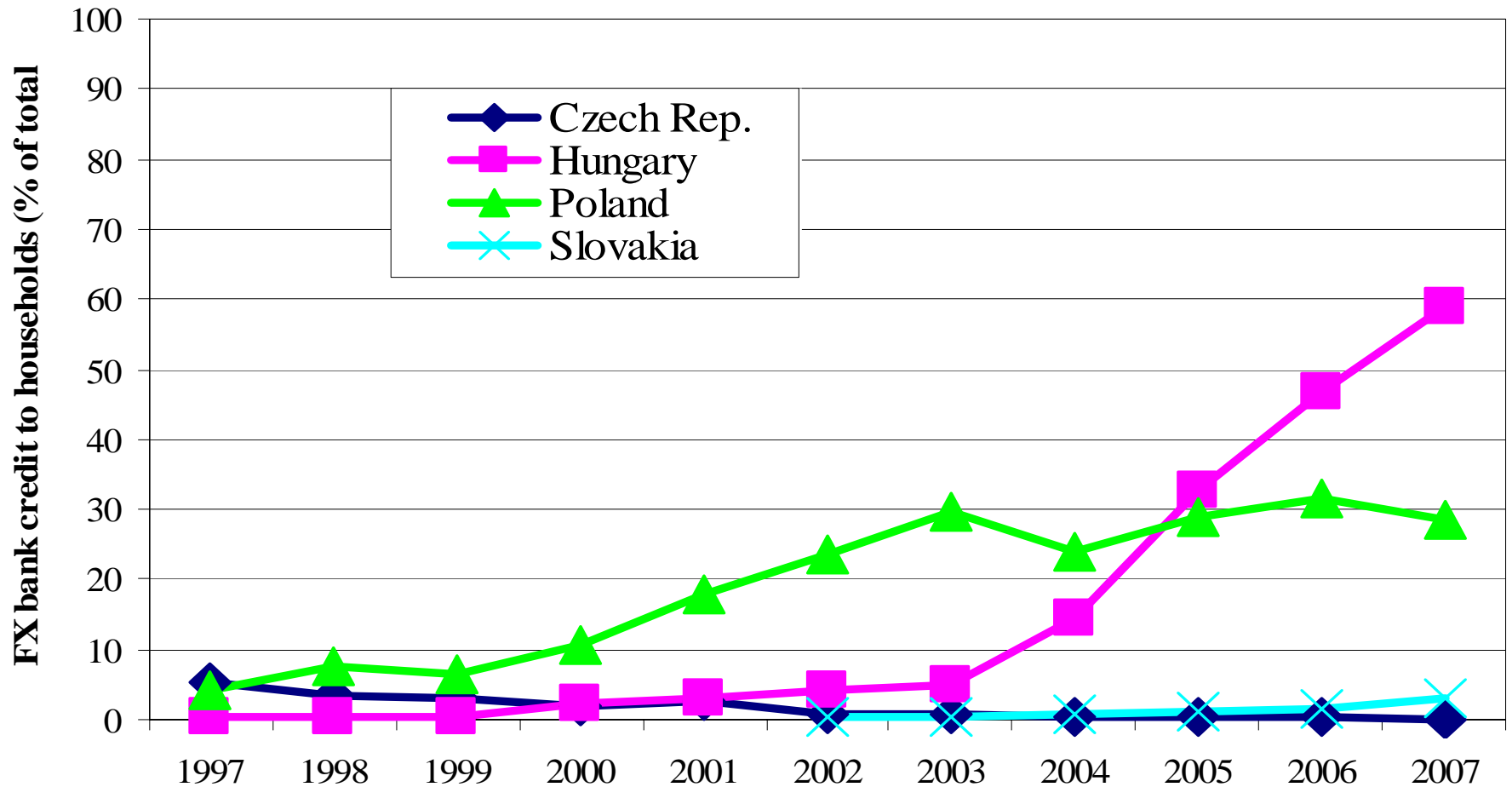
General government balance



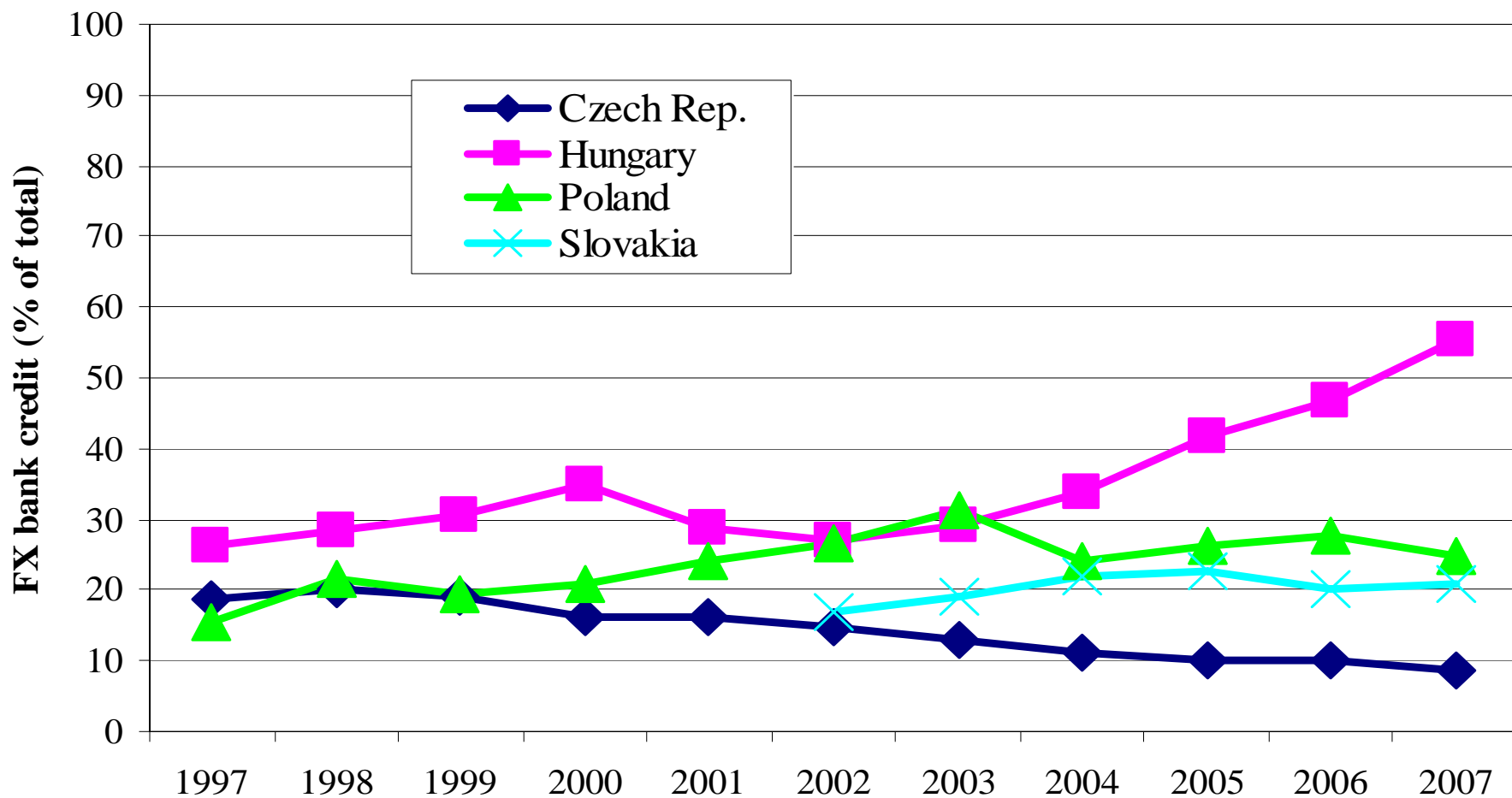
General government debt



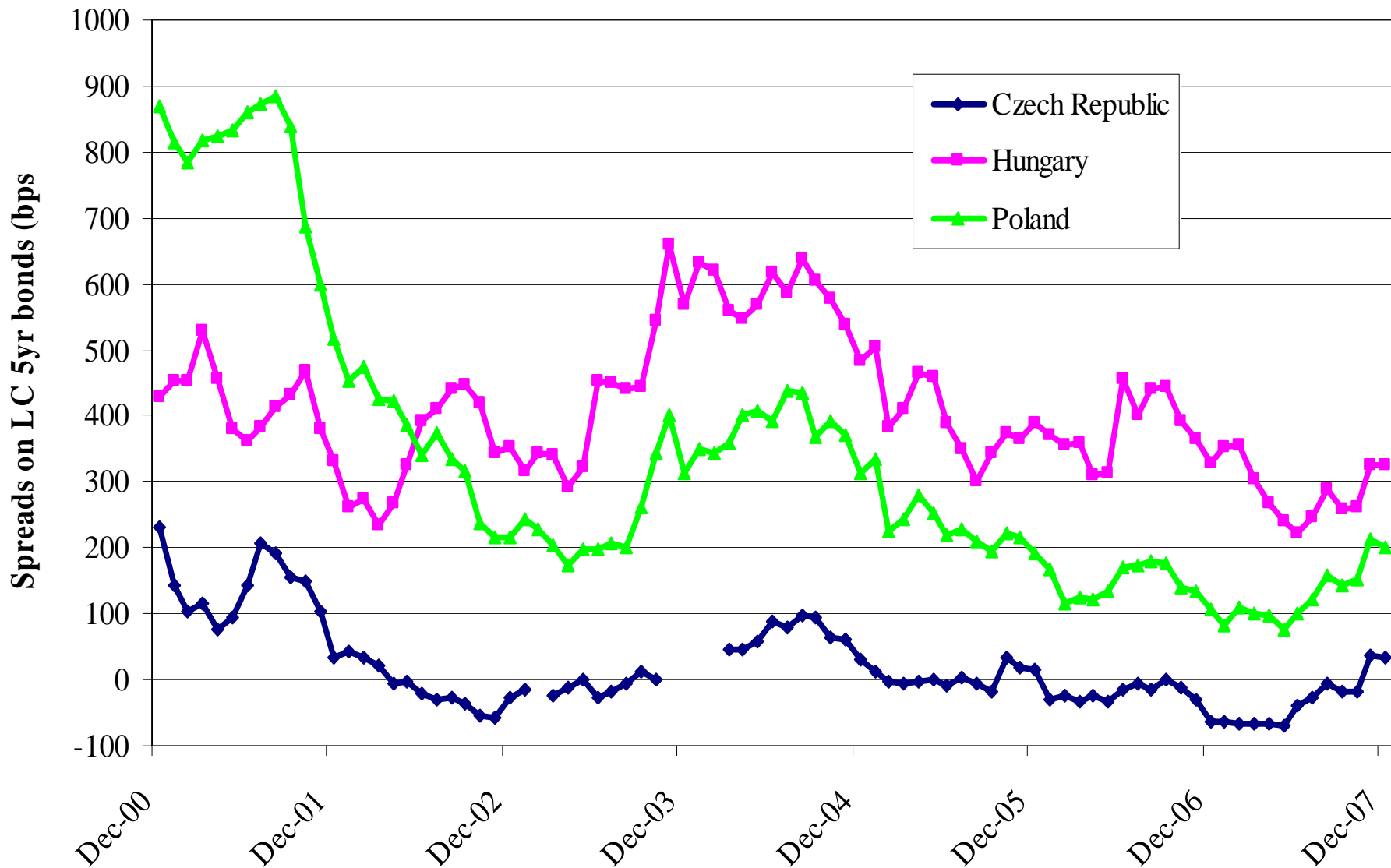
FX credit to households



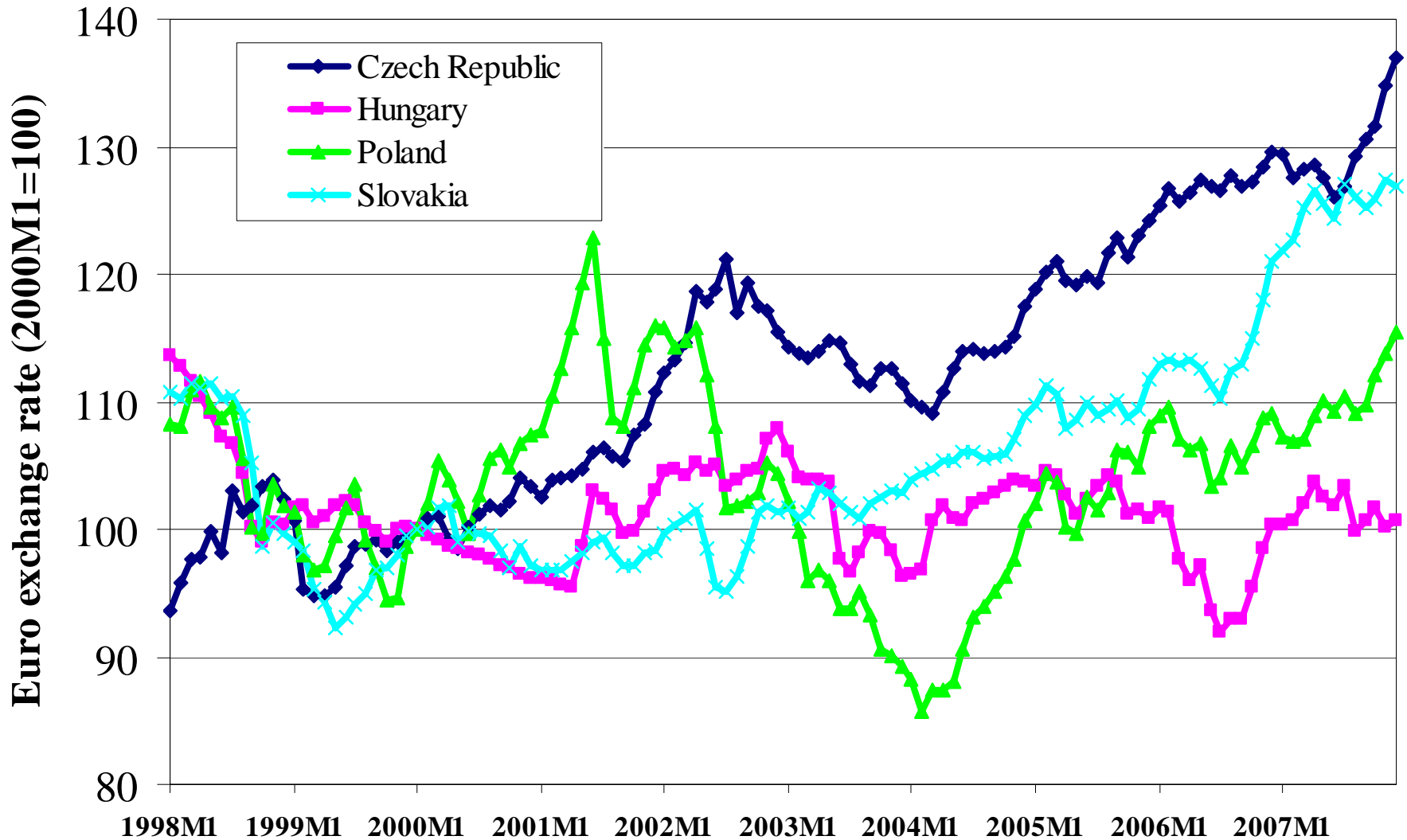
FX credit to households and firms



Spread on government bonds



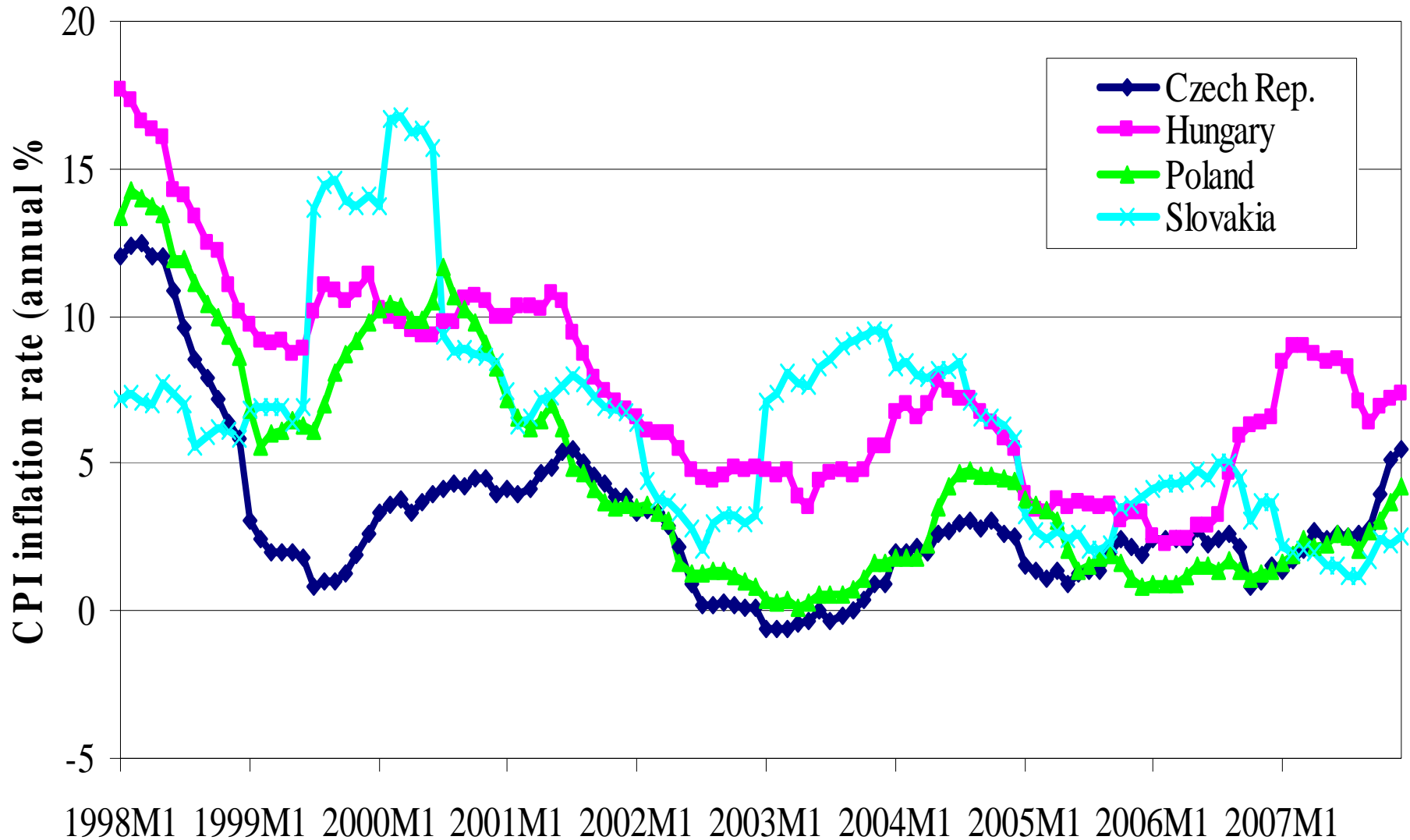
Exchange rate



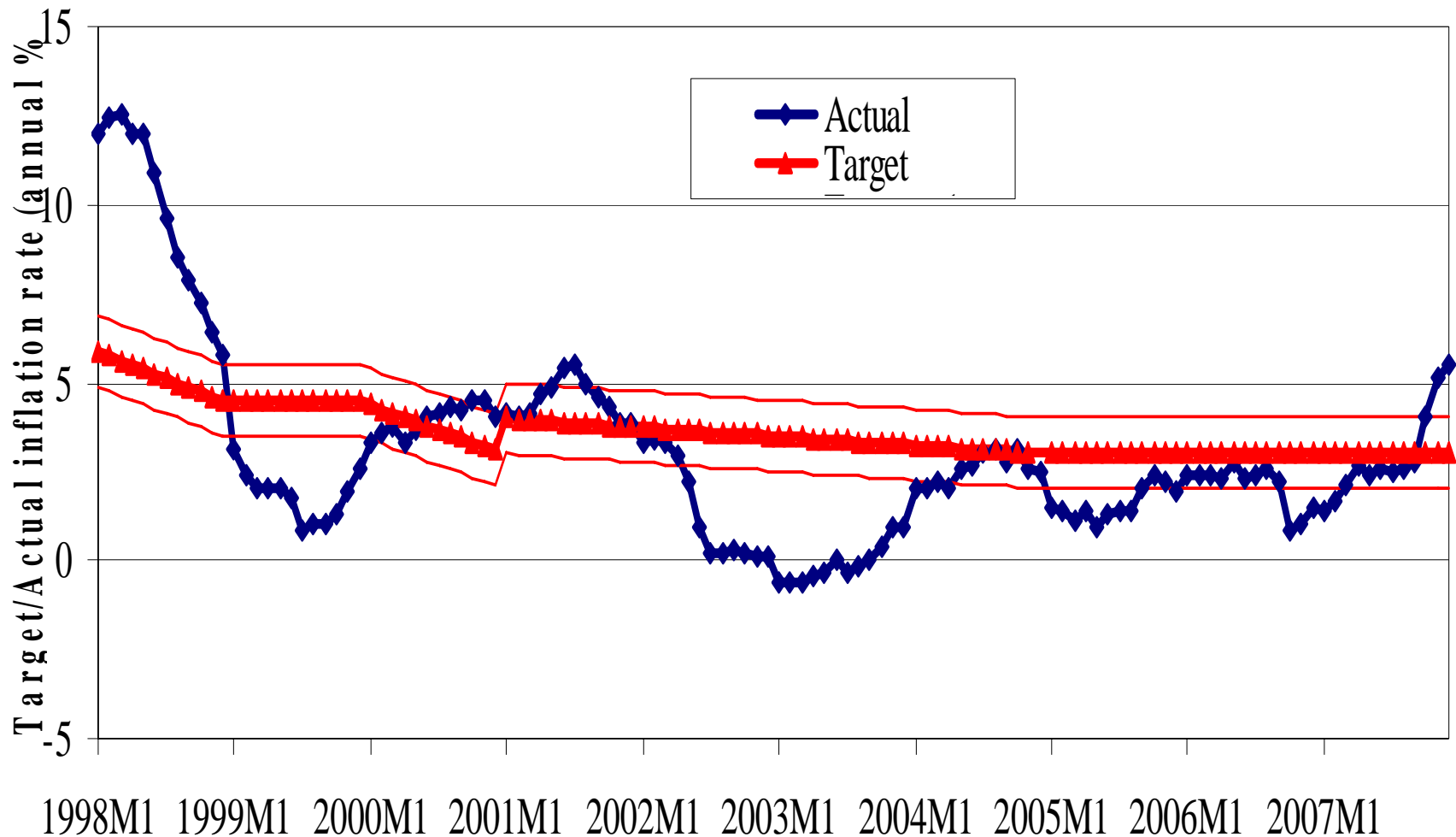
Inflation targeting: performance

- **Macro performance**
 - successful initial disinflation
 - targets missed largely due to price shocks
 - recent rebound of inflation
 - uneven growth; output cost of monetary tightening ?
- **Financial outcome**
 - some countries vulnerable to crisis
- **Euro adoption**
 - Slovakia in ERM2, ready to qualify for euro
 - other countries missed target dates

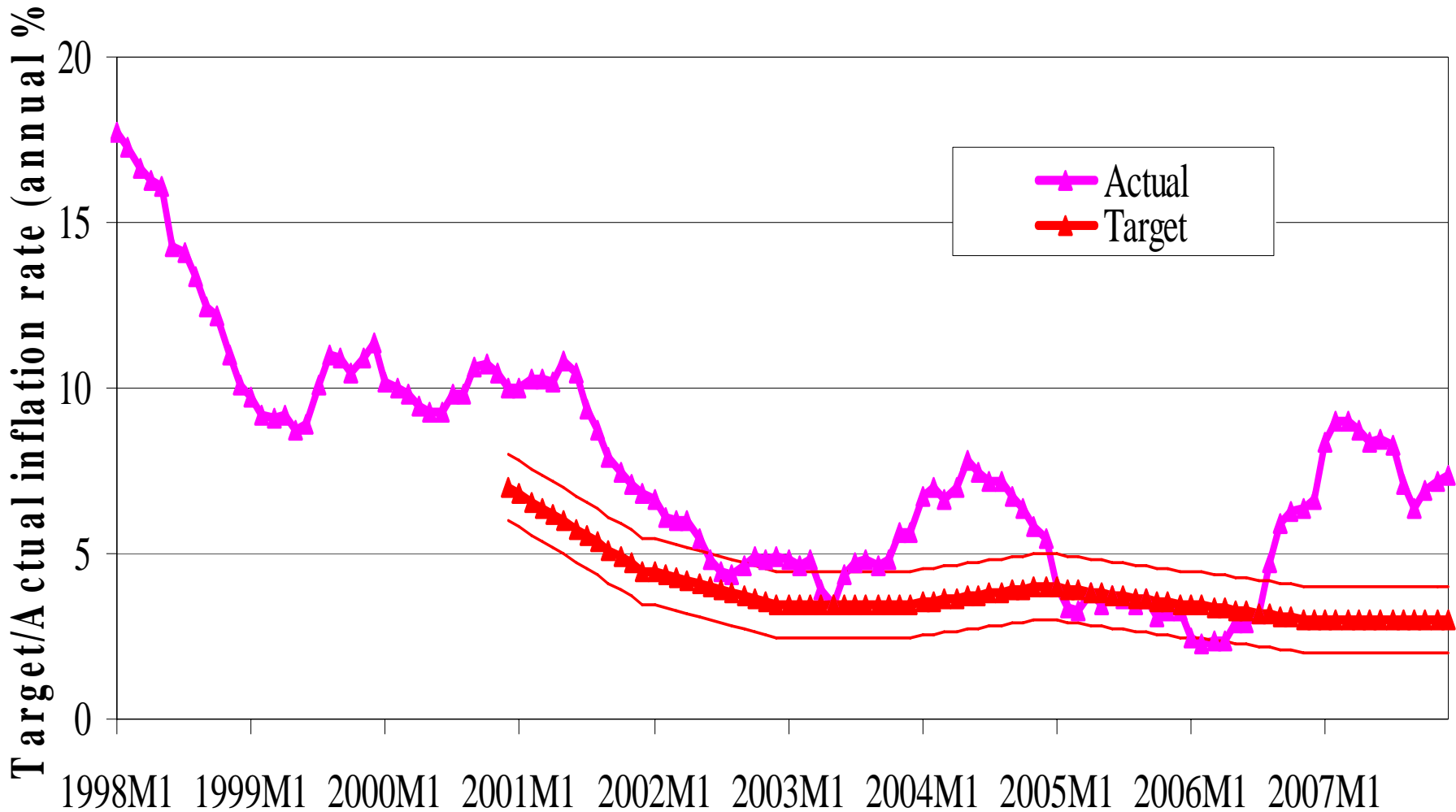
Inflation rate



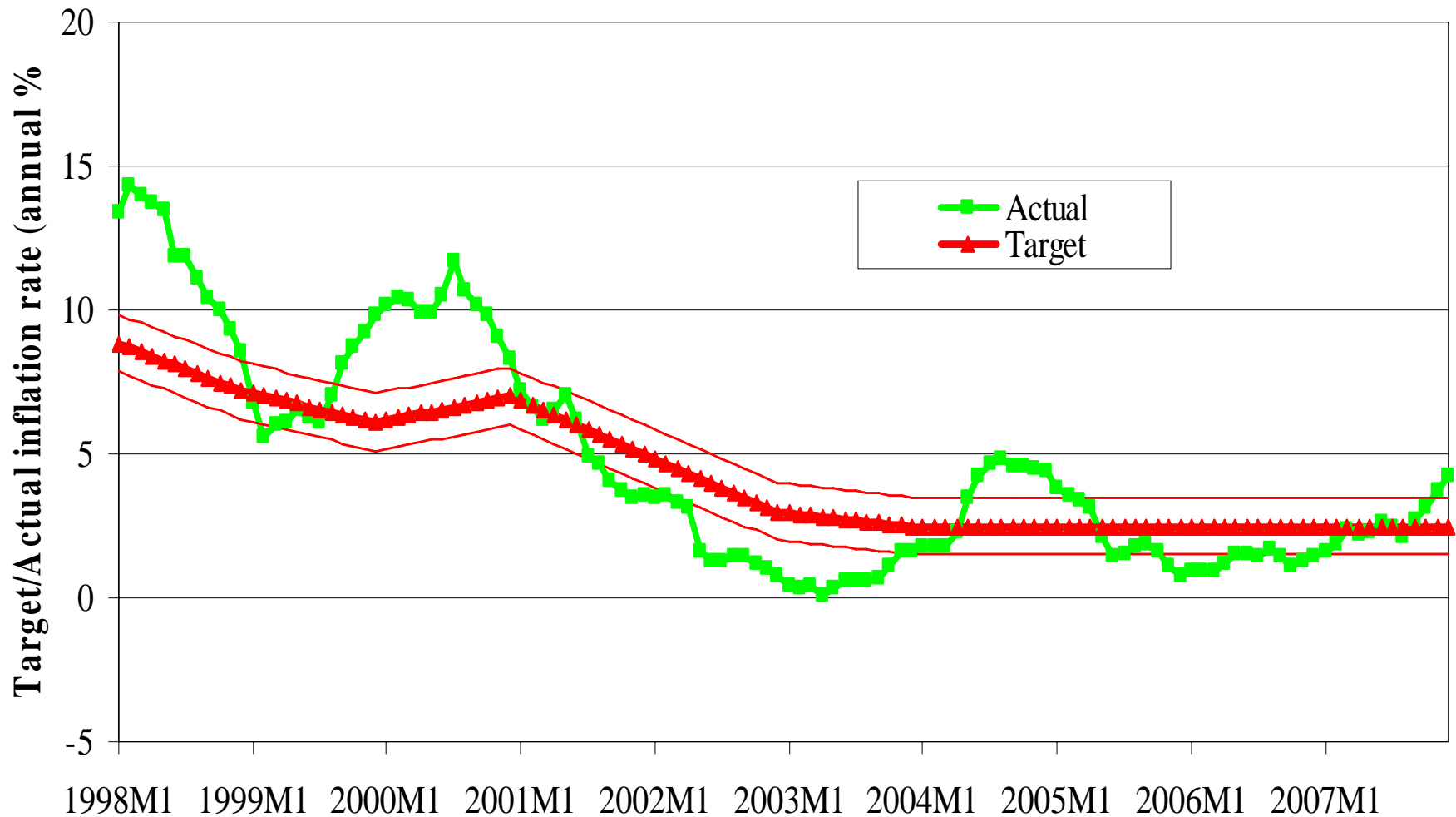
Inflation rate: Czech Republic



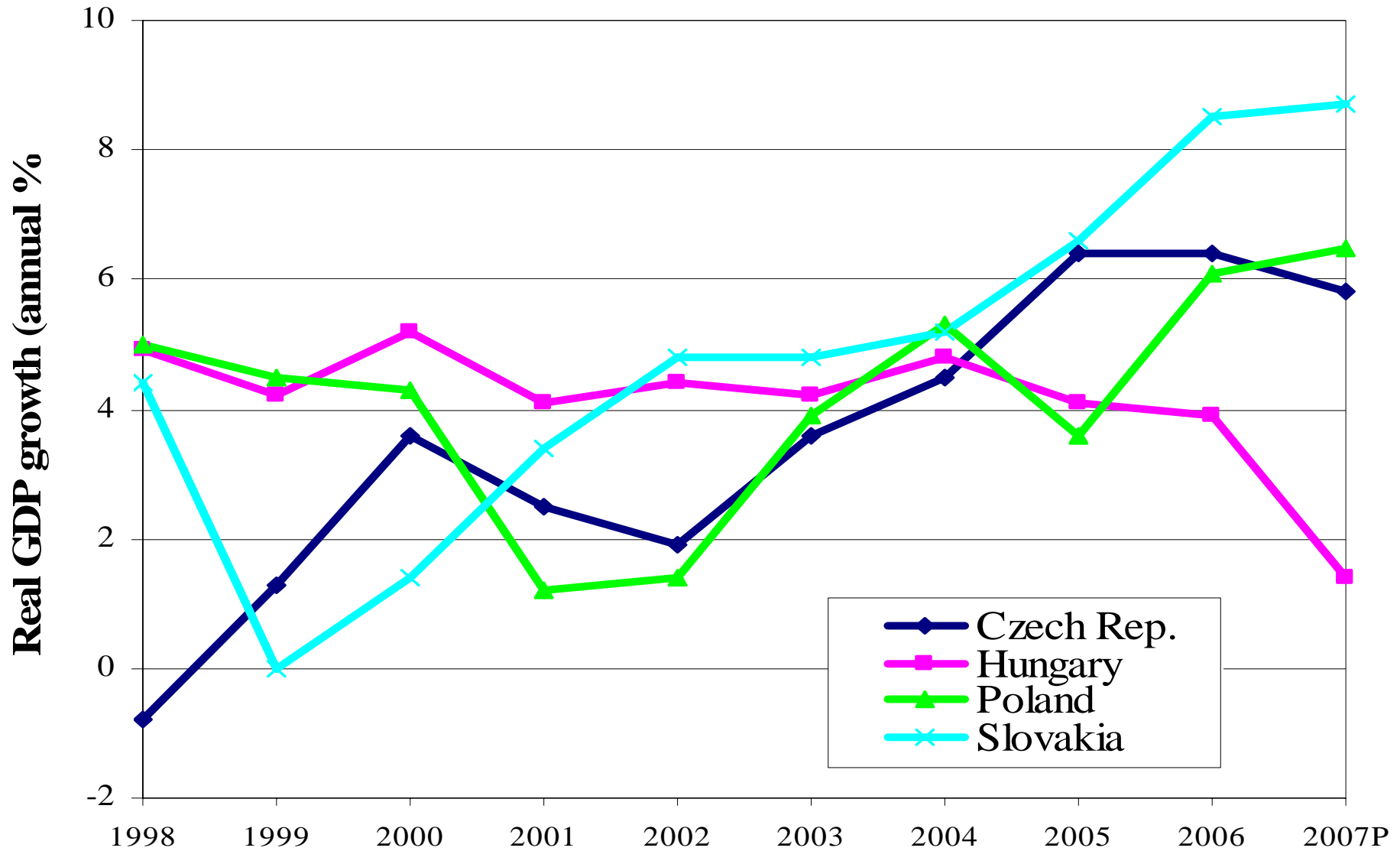
Inflation rate: Hungary



Inflation rate: Poland



Growth rate



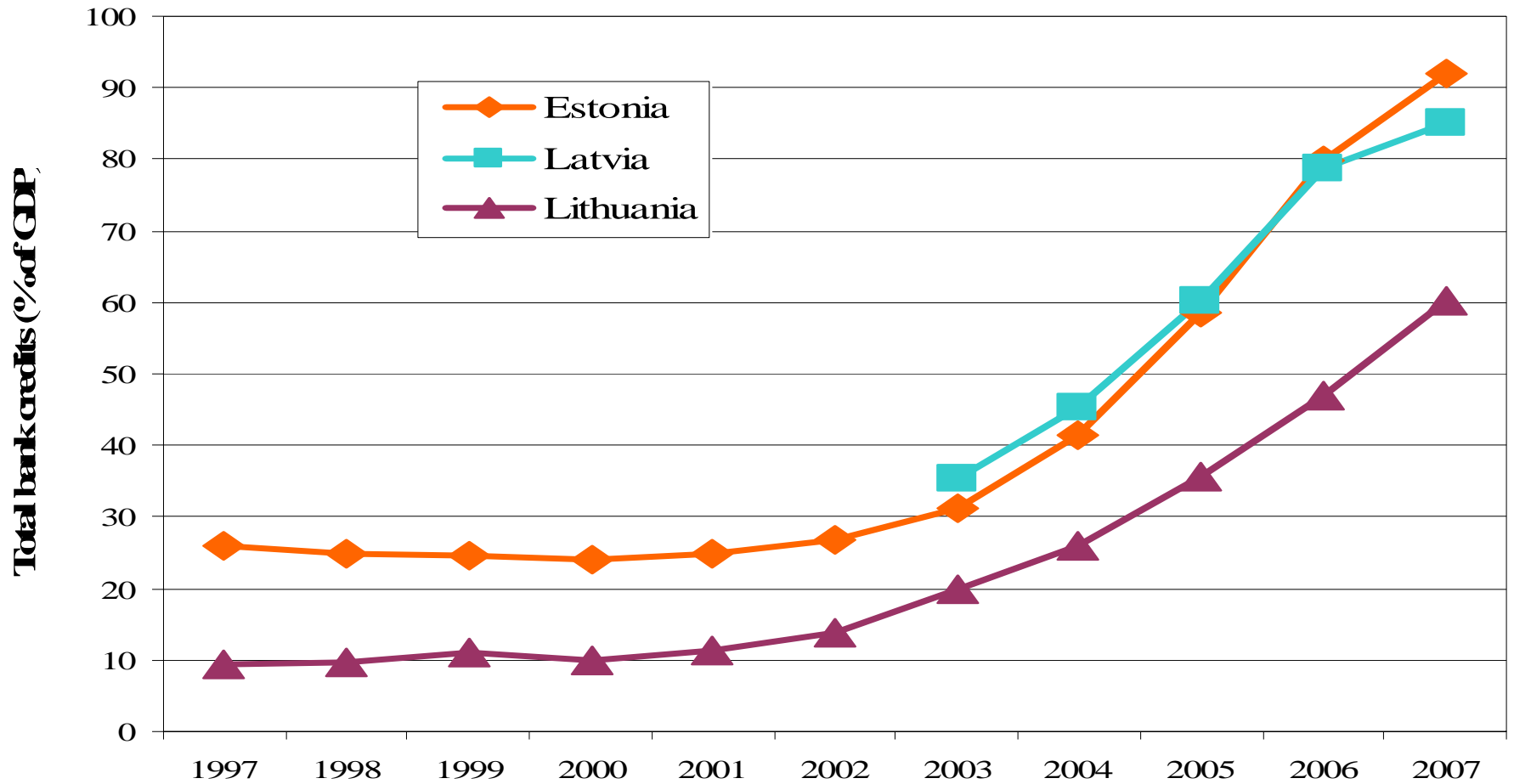
Exchange rate-based framework

- **Features**
 - XR as anchor, requires strict policy consistency
 - transparency (except for soft peg in Slovenia)
- **Financial system**
 - prudential banking regulations
 - banks foreign-owned, except in Slovenia
 - cross-border supervision largely untested
- **Experience**
 - no scope for monetary control
 - vulnerable to speculative attacks

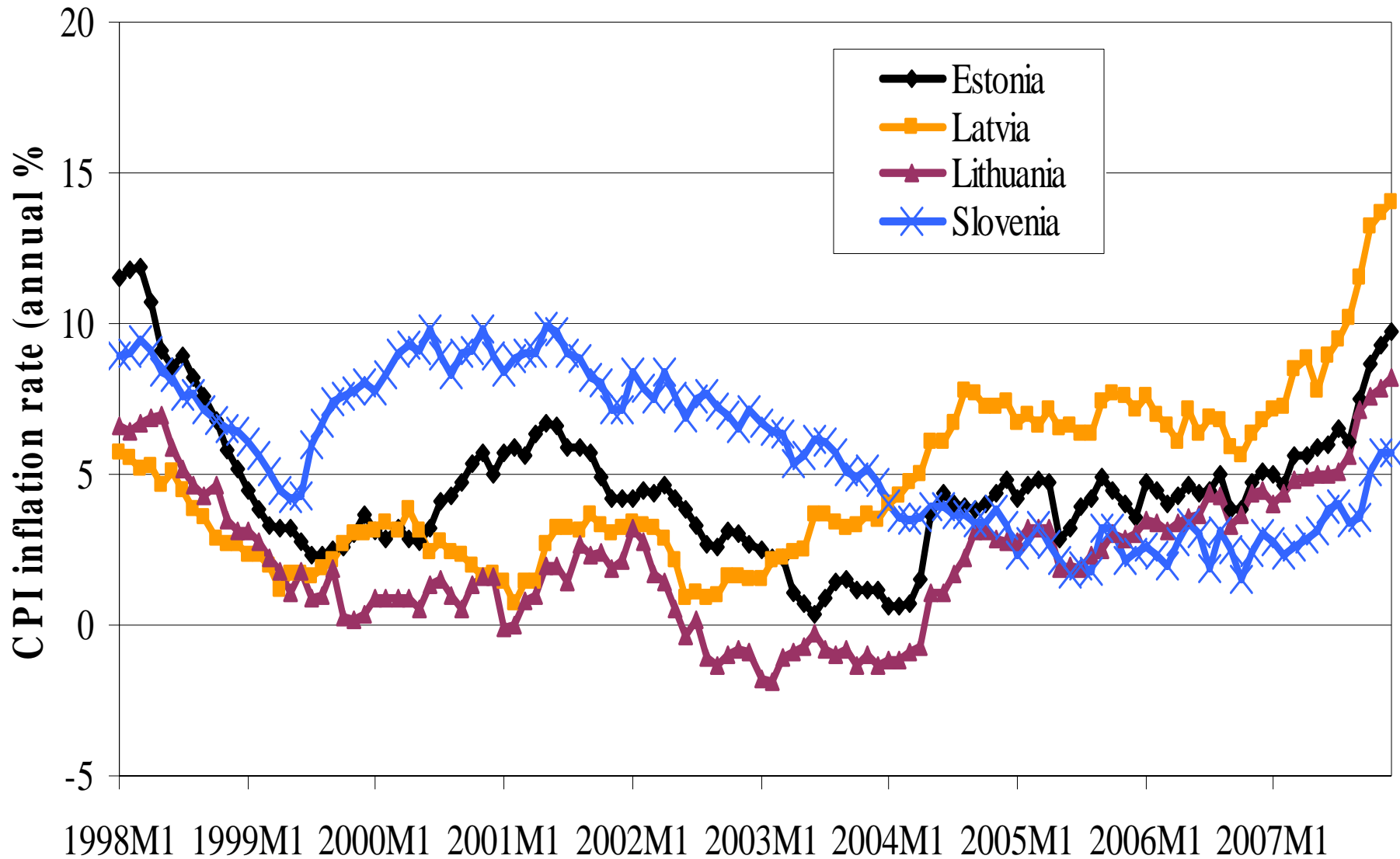
Exchange rate-based framework

- **Challenges**
 - private sector credit boom
 - containment of inflationary pressures
 - soundness of banking system
- **Performance**
 - disinflation, followed by sharp rebound of inflation
 - high investment, output growth
 - large external CA deficit (except in Slovenia)
- **Euro adoption**
 - only Slovenia joined euro area
 - others remain in ERM2, target dates elusive

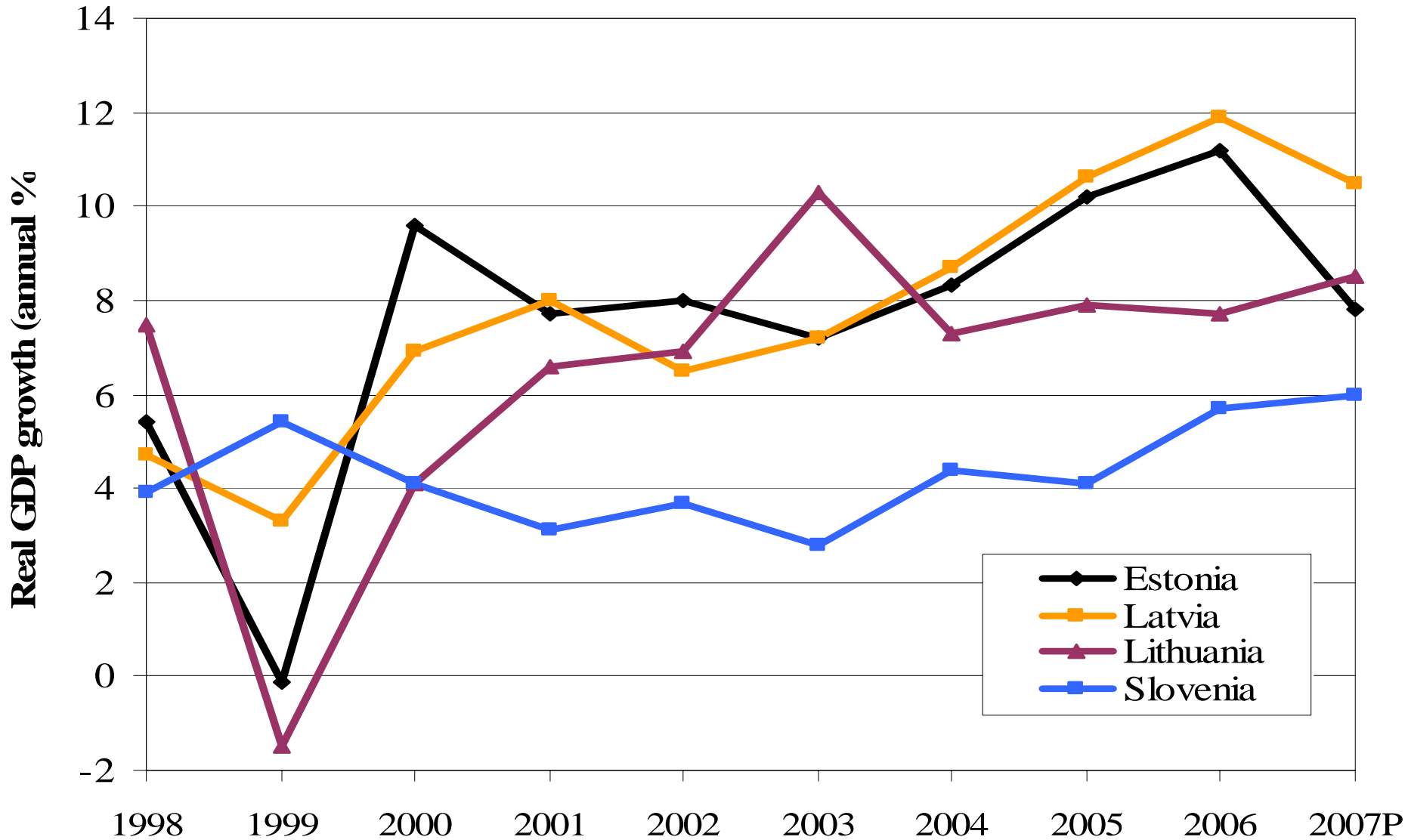
Credit expansion



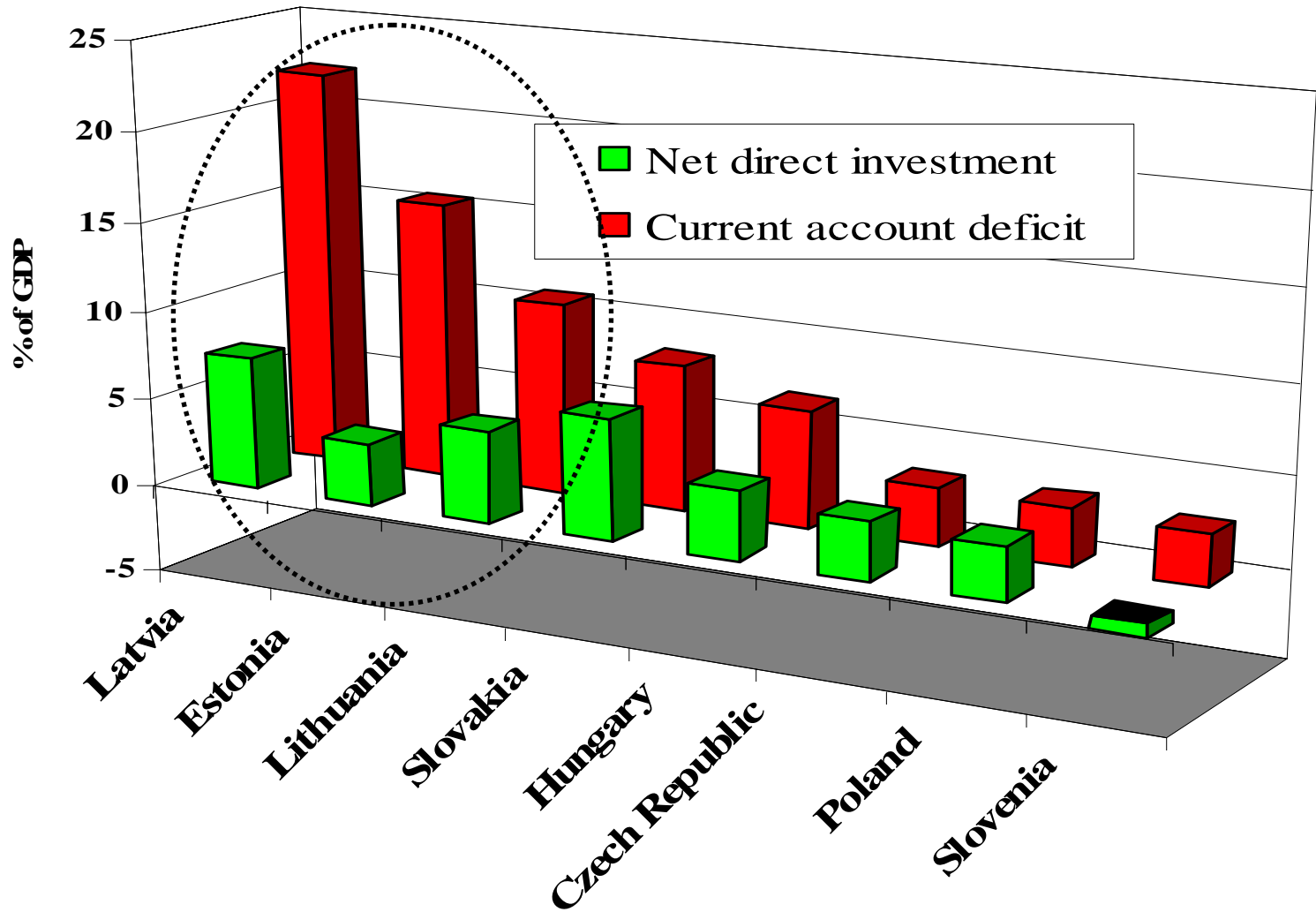
Inflation rate



Growth rate



External imbalance, 2006



Comparative trends

Output growth

High growth: Baltics & Slovakia

Low growth: Hungary

Inflation

Low inflation: Czech Rep., Poland

High inflation: Baltics

Fiscal position

Near balance or surplus: Baltics

Large deficit, indebtedness: Hungary

External position

Large net assets: Czech, Slovakia.

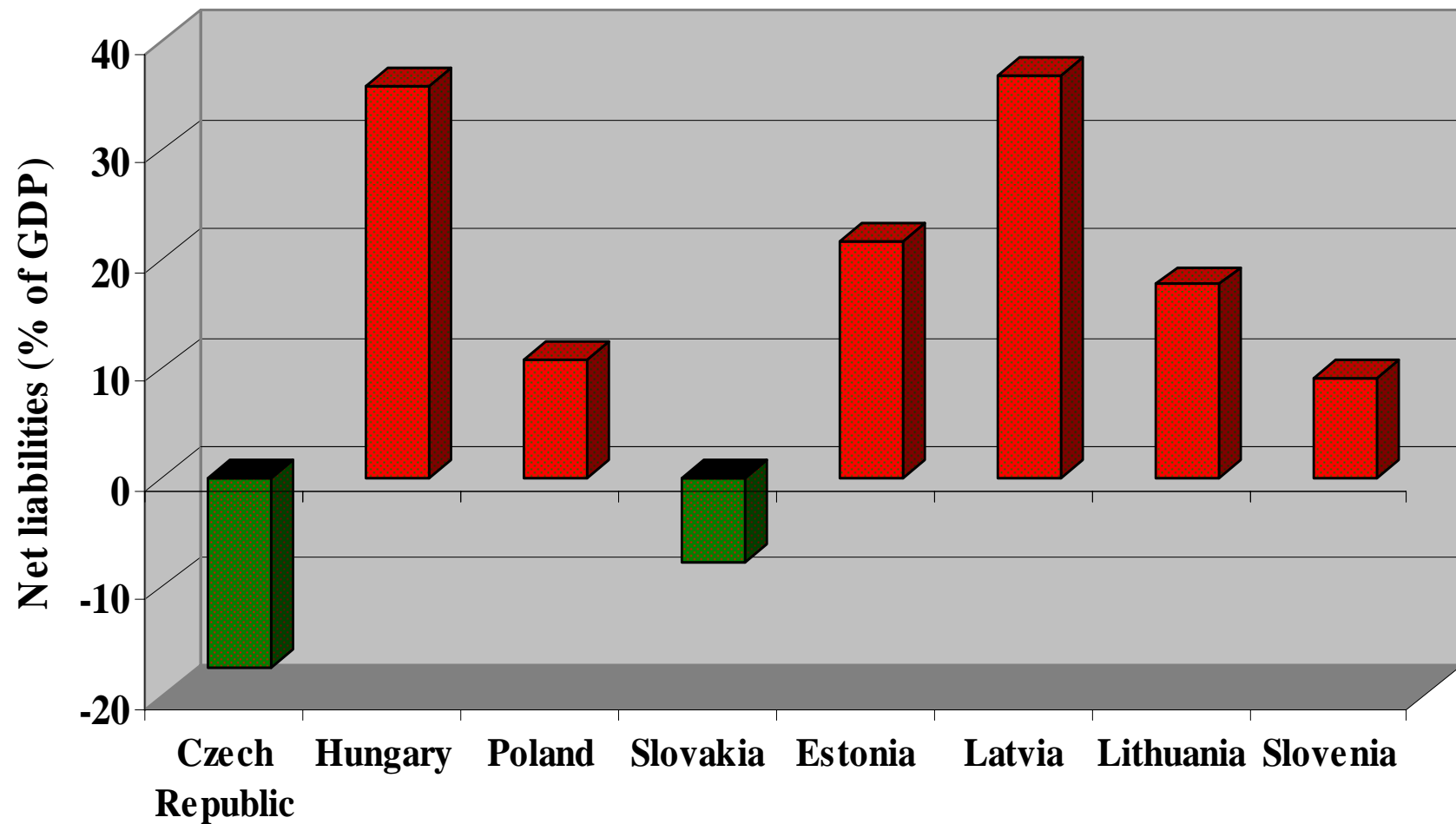
Large net liabilities: Latvia, Hungary.

Perception of Maastricht convergence and of risk

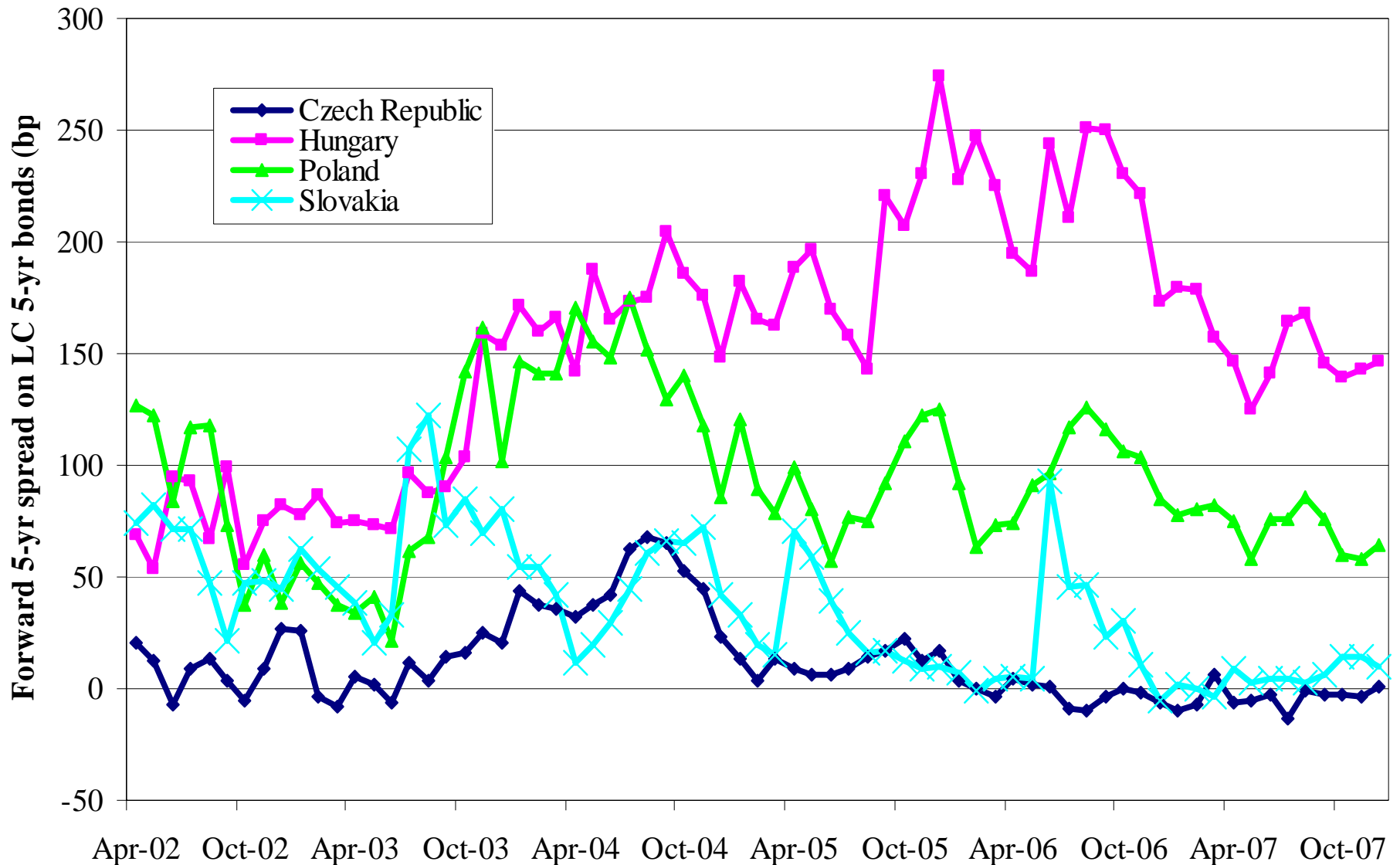
High risk: Baltics, Hungary

Low risk: Slovenia, Czech Rep., Slovakia.

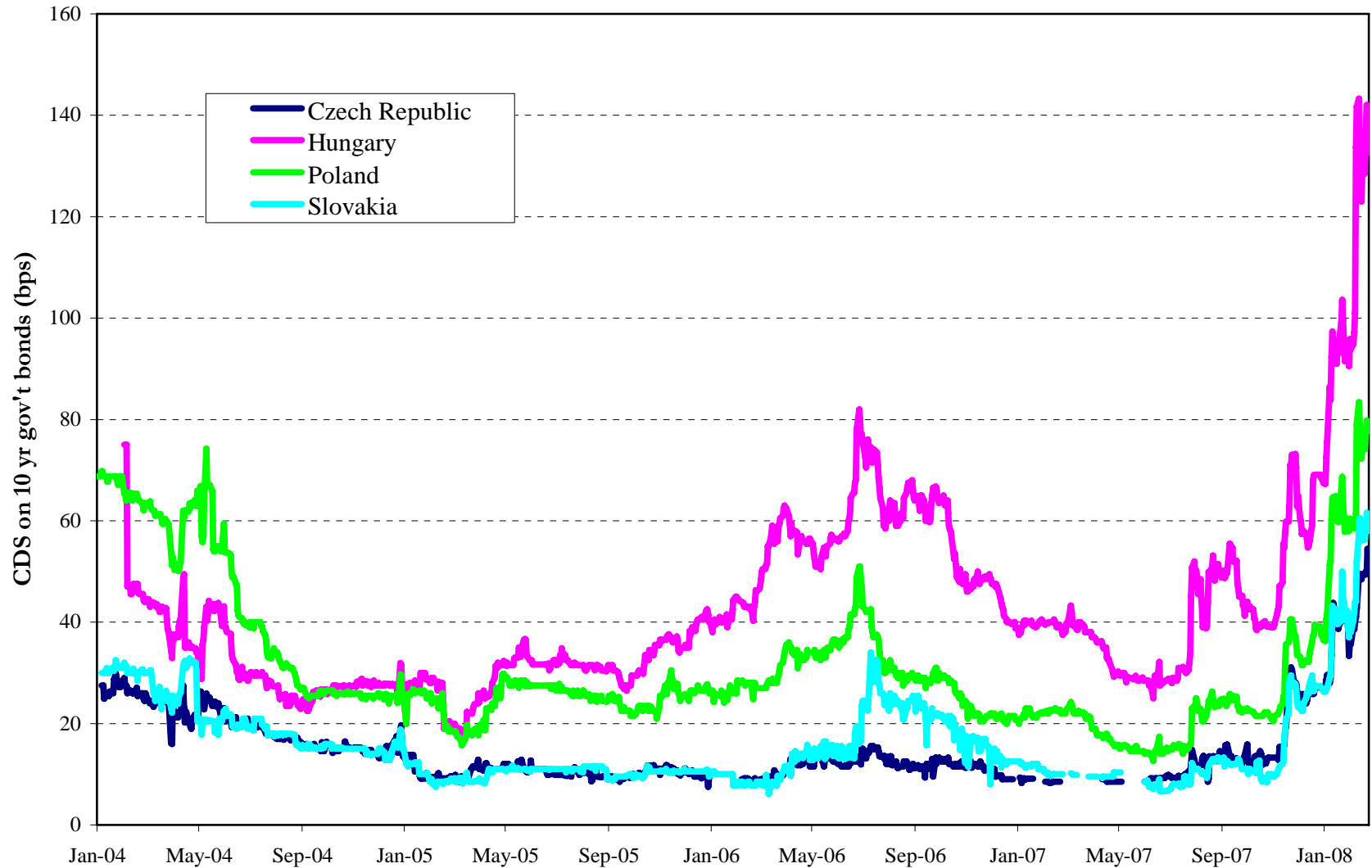
External indebtedness, 2006



Forward spread on government bonds



Spread on credit default swaps



Outlook, scenarios

Euro entry

Participation in ERM2, low LT bond rate, low inflation rate, fiscal discipline, supported by reforms

Catch-22

Participation in ERM2, fiscal discipline, but unable to meet Maastricht inflation criterion

Muddling-through

Sound monetary policy, but indulgent fiscal policy

Financial crisis

Weak fundamentals, in the face of financial turbulence

*There's many a slip twixt
the cup and the lip*

Ben Franklin