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Long-term Strategies for the Central and Eastern European Candidate Countries after their Entry to the EU

Long-term Strategies for the Central and Eastern European Candidate Countries after their Entry to the EU

Papers of Participants of the Summer School “Long-term Strategies for the Central and Eastern European Candidate Countries after their Entry to the EU”

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Preface by

Dr. Michael Jandl

In the spring of 2002 the negotiations for the 5th Enlargement of the European Union had entered a difficult phase. After successfully closing about two-thirds of all chapters in the negotiation process, the most difficult chapters (agriculture, competition policy, structural funds and the budget) were now up for negotiation and led to substantial haggling between the negotiation partners. However, it was clear to everyone that even the most controversial issues defining the terms of the accession process would eventually be resolved and would give way to the start of the most significant political development in Europe since the end of the Cold War: the full integration of the former communist countries of Central and Eastern Europe (CEE) into the structures of the European Union. With that goal in mind, policy-makers in the European Union and the Candidate Countries concentrated their efforts on successfully closing the negotiations for enlargement by the end of 2002 so that – leaving enough time for the lengthy ratification process of the accession treaties – the new members could then join the EU in 2004 and participate in the elections to the European Parliament in that same year.

While the precise terms and conditions of the accession process were already taking shape, the more difficult question had become: What comes after that? In particular, for policy-makers in the CEEC preparing for their integration into the EU, the question now is: what policies are called for to best prepare our economies for the new challenges the Common Market will pose? Obtaining clear answers to this question will determine whether or not the enlargement of the EU to Central and Eastern Europe will be judged a success or a failure.

To contribute to this debate, and to provide young academics from the region the opportunity to learn from eminent economic experts in a relaxed atmosphere, the Institute for the Danube Region and Central Europe (IDM) in cooperation with the Fachhochschule Eisenstadt for International Business Relations organised a special summer school on the topic “Long-term strategies for the Central and Eastern European Candidate countries after their entry to the EU”. This special summer school for postgraduate students specialising in the economics of EU-enlargement took place from 27th April to 11th May 2002 in Eisenstadt, Austria. A total of 18 participants from 9 European countries took part in the program. The seminars were all held in English and were taught by 15 internationally renowned experts from the fields of academia, politics and business. Five subject areas were covered: Structural Policy, Monetary Policy, Agricultural Policy, Trade Policy and Foreign Direct Investments. All participants had to present their own research papers on a selected topic in one of the five subject areas. Following the presentation, there was room for critical discussions and suggestions for improving the research papers. In the follow-up to the summer school the revised papers were then collected and edited. From all the submitted papers an expert panel selected 14 research papers to be of sufficiently high quality to merit publication.

Exchange Rate Policy in Hungary

Peter Halmosi

After the change in 1989, political and regulatory changes were the main targets of the government's economic policy and, within monetary policy, exchange rate policy was the only area whose tangential role was not argued with. The main aim of exchange rate policy in the 1990's was to hinder the acceleration of inflation and maintain the competitiveness of exports. The question of whether these goals are reconcilable was justified at the beginning. There was a great danger that accelerating inflation would lead to growing pressure for devaluation of the currency through increasing costs, then after the devaluation it could stimulate inflation by increasing import prices and start a so-called price-devaluation-price spiral. The economic transition was not going without a hitch.

An important milestone in Hungarian monetary policy was the LX regulation of 1991 by the Hungarian National Bank (MNB) which defined the tasks of monetary policy:

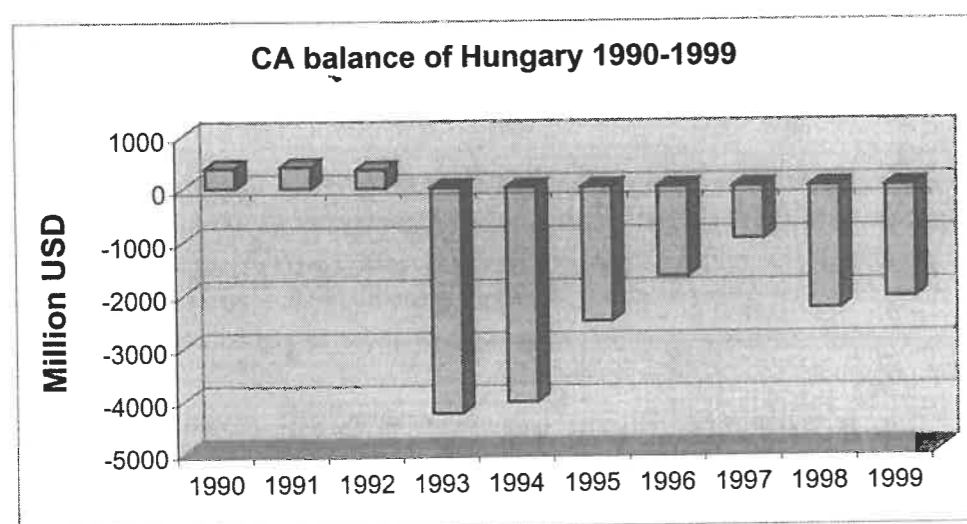
- a) Stabilising the purchasing power of the national currency;
- b) Operating the domestic payment system;
- c) Striving for internal and external financial balance, stable development and international integration of the national economy.

To achieve this, the MNB was able to influence the supply and demand of money and credit through instructing monetary institutions. At the same time, foreign credit withdrawals were no longer made through MNB as before, but through companies as well as through local and central government and, since 2002, households which have also been able to apply for foreign exchange credit. However, their obligation of informing the MNB remained in some cases. Since then, the MNB is no longer responsible for any positive or negative changes in the cumulated national deficit.

Through the law, the MNB was given regulatory means to defend the exchange rate. It really needed this because there was great pressure on the Hungarian current account in the early 90's: a huge import surplus originated from the so-called „lacking economy” which was a feature of Hungary in the 80's and which caused serious displacement in the structure of trade and was also accompanied by high inflation. These inflationary pressures led to the devaluation of the national currency. At the beginning, this was carried out in big steps without warning and so was unpredictable. Later, any correction of the exchange rate was made at certain periods: through bigger devaluations at the beginning of the year and then smaller corrections at other times of the year, the MNB tried to increase the degree of estimation. The first step in breaking inflationary expectations was the opening of the foreign exchange rate market in 1992, where market effects played a role in determining the exchange rate. In 1990, a new currency basket was introduced based on the foreign exchange system of exports and imports. Since December 1991, this basket has consisted of the US dollar and the

ECU in a 50-50% split. As the ECU stabilised in 1994, the structure of the basket was changed to 70% ECU and 30% US dollars. After the introduction of the Euro, the ECU was replaced and since January, 2000 the exchange rate of the Hungarian forint (HUF) has been 100% based on the EURO. Subsequent to the devaluation of the Hungarian forint, competitiveness improved in 1992, but it was subsequently appreciated in 1993 and inflation stopped decreasing.

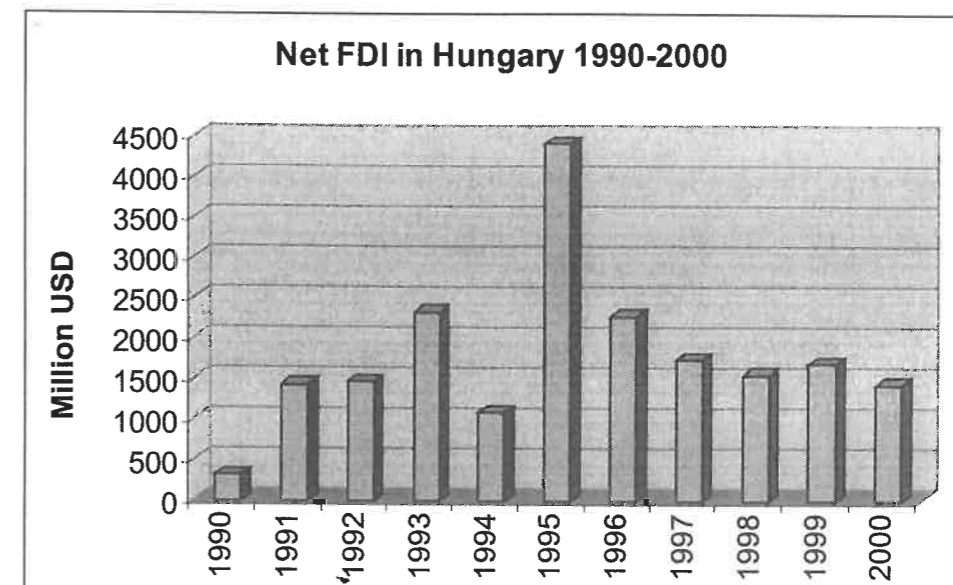
Following the collapse of the Eastern European trade current account showed a surplus between 1990-1992 although experts expected a deficit. This also contributed to the appreciation of the forint. Real resources seemed to have run out by 1992, so the government's only possibility was to attract direct foreign investment or to devalue the currency in order to boost exports. The current account in the 90's was as follows:



Source: stats.unctad.org

With a view to increasing the competitiveness of exports, MNB devaluated the currency by 1,0-15,0% 21 times between 1990-1995. In 1993, MNB reckoned that many single external factors were also contributing to the deterioration of the current account and, thus, there was no need for significant devaluation because that would not improve the trade balance and the current account, but rather, speed up inflationary pressures. The MNB then decided to make smaller devaluations leaving room for real appreciations. At this time, MNB considered real appreciation as a way of slowing down inflation.

In the early 90s, significant amounts of foreign capital flowed into the country due to high nominal interest rates (that also contained positive real interest), which is illustrated in the next table:

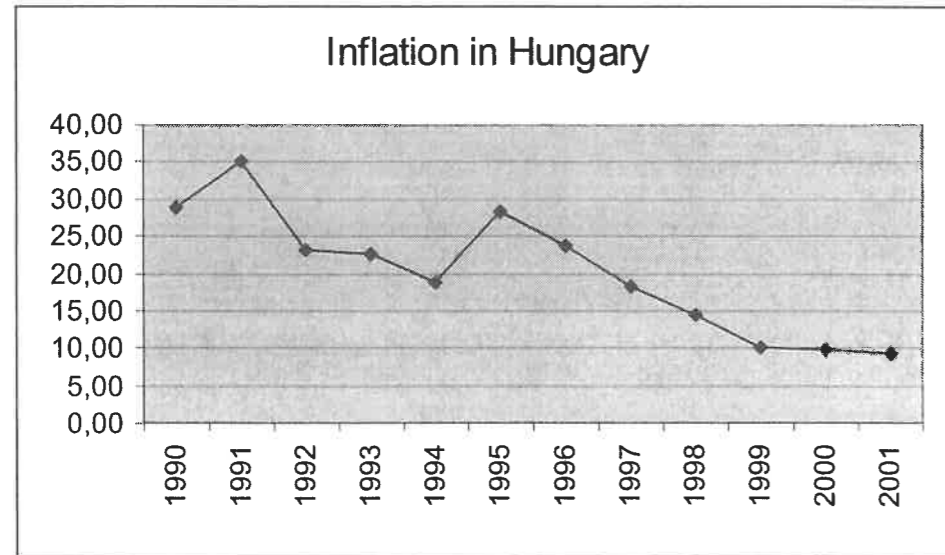


Source: stats.unctad.org

One part of this incoming capital was direct investment in companies, financial institutions, but the other part was speculative capital in order to obtain high returns on interest. This can be seen from the net FDI during this period: after the Mexican crisis in 1994, capital flowed out of the country, then after the reform program in 1995, capital streamed into the country again, earning even higher returns. There was no significant capital withdrawal during the Russian and Asian stock market crisis of 1997-98 as the largest share of foreign capital was no longer speculative but was working capital at that time. We can conclude that foreign capital investments play a big role in establishing the current account balance but they also cause economic instability.

By 1994, commercial banks started to be clear concerning the devaluation strategy applied by MNB and so the actual devaluation had no effect. The goal of the 1995 reform program, which is also called the "Bokros-packet", was stability and repairing prices. The applied strategy involved decreasing the level of real wages and government expenditures. The reform did not decrease aggregated demand, but has changed its structure in favour of boosting exports. The key points of the new strategy were: decreasing government expenditures, increasing consumer taxes and VAT, introducing import levies and a crawling peg system. The goal of the crawling peg system was to end speculation by stating the exact timing and extent of devaluation. As participants knew the extent of devaluation, they couldn't speculate as before when they were able to estimate the time but not the extent of devaluation. The danger of real appreciation no longer existed which meant that the Hungarian Central Bank renounced its strategy of curbing inflation through real appreciation.

In the crawling peg system, MNB had an intervening obligation at the corners of a fix band (+/- 0,5% at the beginning) but also had the right to intervene within this band. The official exchange rate was successfully maintained so speculation against the forint has disappeared. The continual devaluations caused significant nominal depreciation which improved the overall exportability of production. Also, inflation started to decrease as we can see from the following table:



Source: www.mnb.hu

Inflation slowed down after 1995 due to the crawling peg system and 8% import levy. Consequently, imports have decreased and exports have started to grow. But there were inherent dangers with the crawling peg system as well: on the one hand the decrease of interest rates was a delicate matter because it could have resulted in the outflow of capital (at this time investors were achieving high positive real interest on investments in the forint, but on the other hand the government had to follow a strict fiscal policy which was hindered by the necessity of moderating structural tensions.

The stabilisation program redistributed household incomes and government incomes in favour of companies and foreign investors. This brought about serious social problems, but fortunately didn't force the government to relinquish its strategy. The recovery of the economy really started in 1996. The signs of this was the declaration of convertibility of the forint and also joining the OECD. In 1997, the economy developed significantly without any deterioration of the external balance but a rise in the interest rates of state bonds meant pessimistic inflationary expectations. In the decrease of inflation, the smaller current account deficit also played a role in 1998. The inflationary expectations of participants decreased which meant the growing credibility of forecasts as we can see in the next table¹:

	1995	1996	1997	1998
Forecast of MNB	26,5-28,0%	20-25%	18-19%	13-14%
Forecast of research institutes	28-33%	22-22,5%	19-21%	13,5-15%
Facts	28,2%	23,6%	18,4%	14,3%

Source: www.mnb.hu

¹ 1995-96:y/o/y inflation, 1997-98: dec/dec inflation.

After the Asian stock market crisis, the participants in the economy reckoned on appreciation, but the Hungarian National Bank considered it to be unnecessary and allowed bond yields to moderate faster by suspending subscription of interest, which resulted in the decline of yields all along the yield-curve. The Russian crisis made even the biggest stock markets waver and destroyed trust in the transition economies, but the uncertainty related to the elections was at least as important in the case of Hungary because, when the government was replaced, monetary policy also shifted. The change in prices on the Budapest Stock Exchange demonstrated this.

Before any transition country enters the European Union, the fulfillment of the Maastricht convergence criteria is necessary. These countries now consider inflation as the biggest problem, so during the run-up to EU enlargement they are fighting strongly against it. In 1999, Hungary committed itself to joining the European Union in 2004, which meant that the main goal of MNB became fighting and containing inflation. This involves external effects that moderate inflation (e.g.: the decrease of energy prices on the world market) and resisting those effects that tend to increase inflation. In 1998, MNB tried to achieve this by reducing the extent of devaluation more rapidly. Besides reducing inflation, MNB is committed to maintaining external balance, because it helps defend against speculation. To maintain external balance, real appreciation of the exchange rate has to be prevented. Nevertheless, greater productivity growth than that of foreign trade partners during the economic catching-up process is unavoidable, which may lead to real appreciation of the exchange rate but is a problem only if it is long-lasting.

As opposed to the crawling inflation of the 80's, the rise of consumer prices was well above 10% until 2000. This was not the consequence of a mistaken monetary policy, but rather of the necessary structural transformation. On the basis of the MNB's forecast, inflation should be 5,0% in 2002 and 3,9% in 2003 which is an improvement, although the current account is expected to deteriorate. Some experts ask why the MNB does not devalue the currency now more than 2 years before the country's entrance into EMU so as to improve its current account (expenditures relating to joining the EU make it inevitable), because there would be sufficient time to cope with the inflationary effects. Although the question is justified, MNB still doesn't plan to take this step. The reason for this can probably be found in retaining trust and credibility through its monetary policy. From 1995 until November 2001, Hungary applied a crawling peg system and managed to establish a feeling of confidence it wouldn't like to lose. Hungary needs trust in its monetary system in the future because of the uncertainty related to the change of government, so we can understand that trust is more important for the economy than improving the current account. A sign of this trust is that neither the terrorist attack against the USA on September 11th nor the financial crisis in Argentina caused any lasting loss of trust.

The main goal of Monetary Union is real convergence which can be achieved through various approaches, but policy makers shouldn't force it because it could end up in real divergence. As theorists have pointed out, achieving both nominal and real convergence is not feasible at the same time. Countries would rather pursue nominal convergence which can support burdens for the future. An early enlargement of the EU would thus increase the differences in the standard of living among Eastern and Western countries, and could cost a lot more to the community to restore the balance. I think that factors such as trust and credibility are important for Hungary today and that policy makers must maintain this in the next two years so as to enjoy the fruits of membership after 2004 and 2006 respectively.

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Evolution of the Exchange Rate System during the Transformation of Poland's Economy

Krystyna Mitreęa-Niestrój

THE SIGNIFICANCE OF EXCHANGE RATE POLICY FOR POLAND'S ECONOMY

The early 1990s were marked by a number of significant changes to Poland's economy. The transition from a centrally planned economy to the free market, along with Poland's future integration into the European Union, resulted in the growing importance of the national currency exchange rate as a strategic price in the country's economy. As a strategic price, the exchange rate usually has a substantially greater impact on the domestic market than the prices of specific goods and financial instruments. While in its essence a market category, any currency exchange rate will at the same time fall (due to its critical macroeconomic effects) within the category of parameters that are, to a lesser or greater extent, controlled by overall economic policy. The amount of regulation will vary, depending on the structural characteristics of the economy, on the nature of the risks it may be exposed to, as well as on its integration with the external environment. It should be underlined here that it is the country's economic priorities and long-term monetary stability in particular, that are the key factors in determining this policy. The significance of exchange rates for an economic system is also illustrated by the fact that it is one of the key parameters in the decision-making process, and the most important instrument available to governments seeking to influence foreign trade. In addition, it has a pronounced effect on the expenses and revenues of business entities involved in international exchange — exports as well as imports¹.

All of these factors combine to determine a country's exchange rate policy. This policy can thus be held to represent a response to real processes taking place in the economy itself and also in its environment. While it inevitably imposes certain limitations, the optimum exchange rate policy will improve economic efficiency. There is no ideal exchange rate model which can be applied in every country - a very good example is the situation in CEEC during transition. The exchange rate mechanisms evolve over time in response to changes in the internal and external economic environment of a given country.

In a country like Poland - that was (and still is) working its way toward a true market economy, the selection of an exchange rate system posed a serious challenge for monetary policy makers. The most important long-term objective was to achieve monetary stability that would be capable of producing a sound and realistic exchange rate.

The experience of many market economies, and of emerging economies in particular, clearly demonstrate that there are certain general criteria for the successful application of an exchange rate mechanism. It is true in principle that the application of fixed rate systems is fairly justified in countries with highly unstable money markets. Fixed rates are only

¹ K. Zabielski, *Finanse międzynarodowe*, PWN, Warszawa 1994, p. 11-12.