From Budapest to Maastricht.
Perspectives and problems of the eastward enlargement of the euro area

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Summary
In 2004 the European Union will be enlarged to include ten new Member States, eight of them from the former Soviet bloc. These countries have made outstanding progress in terms of macroeconomic development in recent years, but there remain a number of specific problems which raise doubts as to the future monetary integration of these countries. Hungary is a case in point that illustrates both the achievements and the difficulties of the transition process. In July 2003 the Hungarian government and the National Bank of Hungary (NBH) announced in a joint declaration that Hungary would introduce the euro as national currency on 1 January 2008. The political elite, the policy-makers and the wider public take for granted the benefits of replacing the forint with the euro, while repeated turbulence on the financial markets highlights the fragility of convergence and currency reform. This article discusses various aspects of this unusual period of monetary history.

Sommaire
En 2004, l’Union européenne sera élargie en vue d’inclure dix nouveaux Etats membres, huit d’entre eux issus de l’ancien bloc soviétique. Ces pays ont réalisé des progrès exceptionnels en termes de développement macro-économique ces dernières années, mais il subsiste un certain nombre de problèmes spécifiques qui suscitent des doutes quant à la future intégration monétaire de ces pays. La Hongrie est un exemple illustrant les résultats et les difficultés du processus de transition. En juillet 2003, le gouvernement hongrois et la Banque Nationale de Hongrie ont annoncé dans une déclaration commune que la Hongrie mettrait en place l’euro en tant que monnaie nationale le 1er janvier 2008. L’élite politique, les décideurs politiques et le grand public considèrent comme allant de soi les avantages de remplacer le forint par l’euro, alors que plusieurs turbulences sur les marchés financiers accentuent la fragilité du processus de convergence et la réforme de la monnaie. Cet article présente divers aspects de cette période peu commune de l’histoire monétaire.

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Introduction

Eight of the ten countries due to join the EU in 2004 are from the former Soviet bloc. These eight countries underwent a period of decline in the early 1990s, experienced a period of recovery in the late 1990s, and some of them have seen outstanding macroeconomic improvements in recent years. However, a number of specific problems remain which raise questions as to these countries’ future monetary integration. In the first part of this paper, I will discuss these general macroeconomic and financial problems that will continue to cause problems for the foreseeable future. In the second part, I examine the case of monetary transition in Hungary. Hungary is a case study in both the achievements and the difficulties of economic development. As regards currency reform, we will see that, other than declarations, the political elites and the policy-makers do not view the adoption of the euro as a high priority, and do not resist measures that reduce the likelihood of a rapid transition to the euro.

Macroeconomics between transition and integration

In 2004, membership of the European Union becomes a reality for eight central and eastern European countries. These countries went through a period of painful economic adjustment in the first half of the 1990s, followed by a convincing recovery period. Growth rates well above the west European average helped to improve both fiscal and monetary equilibrium, and this led to ambitions in these countries to introduce the euro soon after joining the EU. However, a number of factors challenge the sustainability of these macroeconomic improvements, and favour a more cautious attitude towards monetary reform. This section discusses the criteria for joining EMU and some of the factors that make it hard for the post-transition economies of central and eastern Europe to fulfil them.
Conditions for joining the Economic and Monetary Union

When the 12 national governments of the European Community designed the Maastricht Treaty, they set out the reference levels for introducing the single currency in individual countries. The same monetary, fiscal and exchange-rate criteria apply for the countries that join the European Union in 2004. These criteria, together with their reference periods, are as follows:

**Price stability**: Inflation must not exceed by more than 1.5 percentage points the average rate of inflation (measured as the HICP) of the three EU member countries with lowest inflation. **Reference period**: average for the 12 months preceding the assessment.

**Fiscal deficit**: Ratio of the budget deficit to GDP must not exceed 3%, and has to be sustainable. **Reference period**: calendar year preceding the assessment.

**Gross government debt**: Ratio of government debt to GDP must not exceed 60%, or must be declining permanently. **Reference period**: calendar year preceding the assessment.

**Long-term interest rates**: Interest rates must not exceed by more than 2 percentage points the average interest rate of the 3 EU Member States with the lowest inflation. **Reference period**: average for the 12 months preceding the assessment.

**Exchange-rate stability**: membership in ERM II without any severe tension, exchange rate floating within a +/- 15% fluctuation band, but close to central parity against the euro, no devaluation is allowed, but central parity can be revalued.

The Stability and Growth Pact of 1996 added further directives for the implementation of the common macroeconomic policy of countries in the euro area and set out sanctions for countries that violate them. However, beyond these most frequently cited macroeconomic criteria, there are some important institutional ones we must not forget about. Central banks must be independent from the national political process. Member countries must adopt legislation so that their central banks can be incorporated in, and carry out the tasks assigned to, the common system of central banks under the European Community Treaty and the Protocol on the Statute of the European System of Central Banks (ESCB).

If a country does not meet the criteria, it is granted a derogation, and becomes a non-participating member country. It will be exempted from the introduction of the common currency, the implementation of a common monetary policy, and the rights and obligations associated with the ESCB. This is, however, a scenario acceding countries want to avoid in the long term, due to their evaluation of the euro as fundamentally positive, and of the criteria as logical and achievable.

**Doubts about disinflation**

Acceding countries will find it particularly challenging to follow the rules and the convergence path set by the Stability and Growth Pact. Although inflation has been subdued
in the past 18 months (2002-2003), low inflation has mainly been a phenomenon accompanying sluggish demand conditions and deflationary trends in the euro area.

In some countries disinflationary goals have been pursued as part of a balanced economic policy (Czech Republic, Slovenia); in other countries, where there was an excessive focus on inflation together with a lack of policy coordination, disinflation undermined economic growth either directly (Poland) or indirectly (through unmanageable exchange-rate volatility, in Hungary, where reckless wage policies admittedly have also played a part) in the past two years. The resulting degree of price stability is not a one-to-one function of the extent to which the disinflationary agenda was pushed (Czech and Polish data show very low, Hungarian and Slovenian data somewhat higher, inflation).

It is clear that average inflation in the EU is already too low, and that the 1.5 percentage points tolerance level, one of the Maastricht criteria, is inadequate for countries in which the Balassa-Samuelson effect\(^2\), quality improvements in industrial products, convergence in price structures and the liberalisation of previously regulated prices play a much more significant role in determining the rate of inflation than in the EU.

**Fiscal disintegration**

An even more difficult task is that of meeting the fiscal criterion: almost all acceding countries are facing difficulties because of the need for fiscal consolidation as prescribed by the Stability and Growth Pact. An unresolved issue with regard to the fiscal policy of acceding countries is how the completion of transition-related reforms and the adoption of EU standards and regulations will comply with the requirement to meet the EMU’s fiscal reference values in the forthcoming years.

The newcomers will first of all have to contribute 1.27% of their GDP to the EU budget. At the same time they will also be eligible for several EU funds. However, the eligibility for, and the magnitude of, transfers will depend on principles of additionality and conditionality, that is, on the absorption capacity of each country. Furthermore, transfers from the EU Structural Funds will have to be channelled directly into the private sector, and are limited to 4% of the GDP of the acceding country. These transfers will not have any direct positive impact on the general budget and are conditional on the government matching 50% of the resources to cover the costs.

The impact of the partial tax harmonisation is, again, quite ambiguous. Former customs duties will have to be replaced by the EU’s common external tariffs, which might result in a net loss for previously high-tariff countries. Higher income from VAT and excise duties may yield higher revenue, but on the other hand it might also be an incentive for companies to leave the country, leading to a loss in revenue. It might take a decade for the increased revenue from income tax and VAT, as an indirect result of the inflow of EU funds and the positive effect of enhanced growth, to play a significant role in maintaining the equilibrium of the state budget.

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\(^2\) The tendency for prices to rise in an economy enjoying rapid productivity growth in the industrial sector due to rapid wage rises also in the services sector where productivity growth is much lower.
Exchange-rate volatility

In the mid-1990s, it looked as though the monetary criteria, i.e. inflation and the rate of interest, would be the most difficult to meet. More recently, the fiscal criteria, i.e. budget deficit and public debt, appear to have been the more testing aspects of convergence. Suddenly, however, the difficulties of meeting the exchange-rate criterion became of interest to analysts. The reason is that the adjustment and modernisation process associated with the economic transition has not yet come to an end. On the other hand, the job of the authorities responsible for monetary stability has become harder since the euro was introduced in the west and speculative funds turned their attention towards the east. This factor may have contributed to the decision of the Czech and the Polish authorities to float their currencies instead of pegging them, although they have already faced some repercussions of that decision.

In an article for the Financial Times, a distinguished expert in this area, Charles Wyplosz, explained the danger posed by speculative flows in the post-transition period. He argued that, along with the freedom of capital flows, ERM II is not an appropriate framework for the fiscal and monetary convergence of central and eastern European countries. These countries should either be allowed to carry out a fast transition to the euro – provided they comply with the fiscal and monetary criteria – or they should be allowed the same position as the United Kingdom enjoys, i.e. being inside the single market without joining the single currency (Wyplosz 2003). The Hungarian currency crises of 2003 that we discuss later in this paper provides ample arguments to justify Wyplosz’s concern and support his proposal, though some draw the conclusion from the same developments that only a fast transition to the euro can save us from similar problems.

Additional costs of accession

The new members’ immediate costs associated with accession will also increase because accession requires a forced adjustment process to norms and standards (the acquis communautaire) devised for countries which have already undergone a long process of integration with each other and which are, with some exceptions, at a much higher level of economic development than the present candidates. The compliance with the environmental standards and infrastructure requirements of the EU entail a heavy fiscal burden: the financing of these areas is expected to amount to 1.5% of GDP in additional annual budgetary outlays.

In addition, EU accession is in many countries accompanied by joining NATO, which requires an increase in military spending and, in many cases, a complete, and therefore costly, overhaul of the entire military system. Improvement in the microeconomic environment and the general business climate is also necessary to maintain competitiveness (e.g. by extra spending on infrastructure), which, however, also works against the struggle to balance the budgets.

Two sides of the euro

One of the positive impacts that participation in EMU should have on the budget balance is that the introduction of the euro eliminates currency risk and thus reduces the
risk premiums on the national debt. Even before EMU entry, EU membership itself should bring about lower funding costs for the state debt as a reward for the successful and timely integration process. This factor is especially significant in countries with a high debt ratio, such as Hungary, Poland and Slovakia.

On the other hand, countries in the Baltic area with very low levels of debt, and consequently low debt-servicing costs, have little experience in government debt management and may lack the liquidity and depth in their securities markets necessary for a successful funding of the budget deficit resulting from the accession process. In this way, a deteriorating fiscal position may turn their previous advantage (low debt ratio) into a weakness, as higher debt levels increase the probability of monetary shocks threatening the currency board arrangement and interest payments undermine the effort to keep the overall government budget in balance.

**The case for changing the rules**

With the exception of the Baltic States, the acceding countries’ fiscal positions deteriorated significantly in the past two years, independently of the accession process. EU accession itself will create severe fiscal tensions in all of the acceding countries, in a period in which it is required that the nominal convergence process be sustained. There are currently several, often contradictory, demands on national budgets, which, assuming no other sources of finance, must ultimately result in the cutting of current entitlements in the government budgets (at least in real terms). Therefore the possibility of excluding expenditure on co-financing and/or public investment from figures of the public sector deficit should be considered.

Another possibility would be to obtain additional funding from the European Investment Bank in the form of loans. The privileged countries would only have to pay interest in the first couple of years, and the principal would be gradually repaid after six to eight years. The attainment of the Maastricht goals on the general government deficit are further complicated by the unfavourable external conditions as nominal growth rates in acceding countries are being curbed as a result of deflationary trends and sluggish growth in the EU. The significance of the trends in these countries’ single most important trading partner, Germany, and therefore the responsibility of the European Union, must be taken into consideration when examining the acceding countries’ difficulties in meeting the convergence requirements.

In principle, the rules of the transition have been laid down, but, with reference to new circumstances, and, with sufficient political will, they should be renegotiable. In this context, it is worth noting that the leaders of the EU must be reminded that they displayed an extreme lack of generosity when the financial framework of the enlargement was elaborated. This contributed to the falling popularity of the EU in the region (witness the low turnout at referenda on EU accession), and the strengthening of the US orientation of these countries. Wyplosz goes even further in the discussion of the potential consequences of western European attitudes: he warns that, if the rules do not change, the west will again be responsible for the crises of central and eastern Europe (see Wyplosz 2003).
Timing euro-area accession

This brings us to the crucial question of the timing of the adoption of the single currency and compliance with the EMU reference values in the preceding years. It is clear that the decisive factor in this case would be the attainment of the deficit criterion, which is especially difficult in the midst of a global recession and the short-term negative balance effects of EU accession. Excessive pressure to meet the convergence criteria is very likely to create domestic policy inconsistencies, leading to harmful volatile exchange rates and possibly interest rates, too.

Furthermore, the crucial issue of finding the parity at which the conversion to the euro should take place is far from being settled in most cases. It follows that the conditions for a responsible ERM II entry are not in place, not to speak of an early EMU entry. Therefore, the process of joining the euro area should not be hastened. A slower approach should not be viewed as a sign of weakness or lack of political commitment, but rather as a sign of a responsible attitude towards a sustainable and consistent convergence process.

We may expect, however, that in the long term the choice will be not only between fast or slow transition to the euro. The longer the transition takes and the more difficulties arise during the process, the greater will be the possibility of developing other options. Creating a regional currency that would be pegged to the euro is one theoretical option for the Visegrad states. They would thus be prevented from applying competitive devaluation against each other, but be allowed to carry out exchange-rate adjustment vis-à-vis the euro if necessary. In the event that the sterling area (i.e. the UK) and the krona area (i.e. Sweden and Denmark) survive in the long term, a central and eastern European currency area would also have a constituency.

The case of Hungary

In July 2003 the Hungarian government and the National Bank of Hungary (NBH) announced in a joint declaration that the country would introduce the euro as national currency as of 1 January 2008. This brave announcement took place at a time when the government was struggling to reduce a serious deficit of the state budget that exceeded 9% of GDP in 2002. The exchange rate of the forint has not been stable either in recent years. Following a period of constant appreciation, the national currency has just survived two speculative attacks within the space of six months, and they took place in opposite directions. Thus, the actual picture is much more complex than would appear from official statements.

3 The non-introduction of the euro may look attractive for Norway as well which could thus join the EU and remain in a sub-region with Denmark and Sweden.
Financial stabilisation in the late 1990s

During the reconstruction period of the late 1990s, the rate of inflation fell markedly from its peak of 1995, when the crawling band exchange-rate regime was introduced. Under this regime the central bank devalued the forint every month at a rate that was also pre-announced but reduced gradually as inflation decreased. However, progress with disinflation in 1999-2001 turned out to be disappointing. Average inflation for 2000, at 9.8%, barely budged from the 10% recorded for 1999 and was well above the government’s target range of 5-7%. The reversal of the disinflation trend in mid-2000 initially reflected exogenous supply shocks – including higher world oil prices and the weaker euro. At the same time, core inflation was also rising, reflecting in part an increase in unprocessed food prices as a result of growth in external demand, but also the fact that domestic factors have been increasingly at play.

In recent years, monetary and exchange-rate policies have had to cope with the competing challenges of inflationary and capital inflow pressures. Early in 2000, heavy capital inflows kept the Hungarian forint at the strong edge of its narrow band, forcing the central bank to cut interest rates. By mid-2000, interest rates had been cut by more than 300 basis points, while the monthly rate of crawl was cut only once, from 0.4% to 0.3% in April 2000. This loosening of the monetary stance occurred against a background of a rekindling of inflation, a tight labour market, and strong economic growth. When capital market pressures subsequently cooled, and in response to an unforeseen jump in inflation in September, the National Bank of Hungary (NBH) increased its key policy rates by 1 percentage point. In the first two months of 2001, amid a steady increase in core inflation, capital inflows prompted the central bank to cut rates twice, by a total of 50 basis points. With a view to tightening monetary conditions, the monthly rate of currency devaluation was lowered from 0.3% to 0.2%, from 1 April 2001.

Financial destabilisation

These developments were followed by the introduction of a new exchange-rate regime. On 4 May 2001, to allow monetary policy more room for manoeuvre to fight inflation and to take a first step toward conformity with ERM II, the crawling band was widened from ±2.25% to ±15% (Figure 1). At the same time, the NBH proposed to accelerate the capital liberalisation process through relaxing the restrictions on short-term capital flows and derivative transactions between residents and non-residents. A few months later the crawling of the exchange rate was completely eliminated and the forint was fixed against the euro. The wide band, however, allowed the forint to appreciate by about 10-12% in the next year. By the end of 2002, the exchange rate was pushed to the upper limit by the monetary austerity applied by the National Bank to counterweight fiscal imbalance. The widened exchange-rate band and the appreciation of the currency significantly jeopardised the competitiveness of small and medium-sized companies. Furthermore, the lack of financial knowledge (hedge techniques, futures products, forward markets) of the economic actors can cause serious problems if the exchange rate fluctuates widely (e.g. the effects of a financial crisis in an emerging world country such as Turkey).
The general government deficit was successfully kept under control during the growth period of the late 1990s. By 2000 the deficit came in at 3.5% of GDP, in line with the government’s target. The subsequent years, however, brought a progressive loosening in fiscal policy. The right-wing government attempted to disguise the emerging deficit through various techniques, but the new government in 2002 had no choice but to introduce EU standards and attempt to create a clean balance sheet. This resulted in the rise of the budget deficit to more than 9% of GDP in 2002 (Figure 2).

The current account showed a similar trend during the same period. External competitiveness remained strong, with the external current-account deficit narrowing in 2000. Industrial labour productivity – up by almost 17% in 2000 – far outpaced real wage gains, leading to a depreciation in the real effective exchange rate (based on unit labour costs) over the year. Rising export market shares and strong corporate profitability in the export sector also support this assessment of solid competitiveness. During most of the year, export growth exceeded that for imports, tourism revenue boosted the services account, and fiscal policy was tighter than budgeted, contributing to an improved external position. Thus, despite the worsening of the terms of trade, the external current-account deficit narrowed to 3.3% of GDP in 2000, down from 4.4% a year earlier. However, the current-account deficit started to widen again in both 2001 and 2002.

With credit ratings approaching advanced economy levels, Hungary maintains ready access to external financing – but external debt levels remain high. Spreads on sovereign benchmark bonds are among the lowest in the region, and, attracted by Hungary’s strong economic fundamentals and convergence prospects, foreign investors’ share of
holdings of forint-denominated government securities have reached record highs. However, in contrast to 1999, strong net foreign direct investment (FDI) inflows were more than offset in 2000 by substantial portfolio equity outflows. Net external debt, as a proportion of GDP, is now almost half its 1995 level, gross external debt has fallen over the same period, and the debt-service burden has shrunk significantly. Nevertheless, external debt, at about 60% of GDP on a gross basis, remains high, although the public sector share has declined substantially, while private sector debt, mostly that of foreign-owned corporations, has increased from low levels.

**Euphoria and positive speculation**

The 2002 election campaign in Hungary was extremely heated. However narrowly, the left-of-centre coalition defeated the right, and announced a politics of reconciliation. The right, however, was not receptive to this. Street demonstrations challenged the results of the elections, and the new prime minister was attacked on the grounds of his service as a secret agent in the counter-espionage of the state socialist regime between 1978 and 1982.

The coalition’s position was weakened by a few national institutions where the right-wing government had appointed chief public servants between 2000 and 2002, with mandates lasting for a number of years ahead. Such offices include that of the supreme attorney, the chairman of the financial inspection authority, and the governor of the...
National Bank of Hungary. This background is vital for an understanding of the policies of the three institutions. The latter institution is the most important for this analysis. Since 2001, the Bank had operated on an inflation target principle to impose monetary austerity in the face of rising inflation. Following the elections, the Bank twice increased interest rates, despite the constant decline in the rate of inflation. This attitude demonstrated that the Bank was actually aiming to undermine the government’s attempts to fulfill its electoral promises. On the other hand, the government did not want to renge on its pledge to the electorate because municipal elections were scheduled for October 2002 and the right was actively challenging the legitimacy of the coalition.

By the end of spring 2002, it was clear that the state budget deficit would be higher than expected. By the end of the summer, it looked as though it would exceed 6% of GDP. By the end of the autumn, it was made known that, because of book-keeping corrections, the deficit was to be between 9% and 10% of GDP. However, that was the very time when the referendum in Ireland allowed the ratification of the Treaty of Nice, and the accession treaties were about to be signed in Copenhagen. Confirmation of EU enlargement generated an euphoria of portfolio investment towards Hungary and other countries in the region. The wilier central banks responded to that situation by cutting interest rates substantially. The National Bank of Hungary, however, ruled out that option, because of its alleged fear of inflation and the consequences of the serious budget deficit of 2002. Thus, while the strong forint and the high interest rates were already strangulating the Hungarian economy, the markets expected further appreciation of the forint, and even a revaluation by shifting the band of the forint/euro parity downwards. In January, there was a massive inflow of funds, increasing the foreign-exchange reserves of the NBH by 50%, before the bank eventually widened the so-called interest corridor and in effect lowered the rates on deposits.

**Disappointment and negative speculation**

Between January and June 2003, the financial markets made a 180 degrees turn in their attitude to Hungarian economic policy and financial sustainability. In June a minor currency crisis forced the central bank to increase interest rates from 6.5% to 9.5% in order to prevent a dramatic fall in the value of the Hungarian currency. This time, the currency crisis emerged from negative speculation against the forint, stimulated by a package of minor cuts in public expenditure and a small devaluation of the forint. In the first half of 2003, the fundamentals of the Hungarian economy also changed. The slowdown in the economy became apparent and the current-account deficit widened to a disturbing extent. Macroeconomic analysts of the markets and the government realised that the international economic recession was lasting much longer than expected. Economic growth in the euro area fell below 1%, and Germany, Hungary’s most important trading partner, produced virtually zero growth. Through falling demand for imports, the slowdown in Germany determined the growth opportunities for Hungary as well. It is thus a major achievement, if not a miracle, that the Hungarian economy in both 2002 and 2003 produced a growth rate of around 3%.

However, compared to other countries in the region, the Hungarian growth figures looked unimpressive. Between the first quarters of 2002 and 2003, Russia grew by 6.8%,
Slovakia by 4.1%, Lithuania 9.4%, Latvia 8.8%, and Estonia by 5.2%. Only the Czech and the Polish figures, i.e. those most comparable to the Hungarian case, demonstrated a major slowdown. During the ‘golden age’ between 1996 and 2000, average annual export growth was about 20%. In the recession period, this figure fell to about 3-4%. In 2003 the deficit on the current account was expected to exceed 5.5% of GDP, i.e. 4bn.

All the bad news came to a head when the government and the Monetary Council decided to shift the fluctuation band. The forint would have fallen slightly anyway, since the Bank had completed the sales of the funds that came in in January. However, the incoherent government measures triggered panic, and the outflow of speculative funds was only halted by raising interest rates twice, that is, through another blow to the real economy.

The emerging instability sharpened the debates amongst experts over the appropriate convergence strategy. While both the government and the NBH insisted on ‘accession as soon as possible’, György Surányi, former governor of the NBH voiced an opposite opinion. Surányi had proposed to eliminate the budget deficit of 2002 by using inflation as one of the tools, and criticised the inflation targeting policy of the NBH that was supposed to cement the convergence programme. Another learned expert, Gábor Oblath of Kopint-Datorg research institute, elaborated a scheme to achieve rapid transition to the euro and support it with a social pact with the trade unions. However, the trade unions did not want to be partners in a programme that would impose a long-term constraint on wage increases, and Oblath’s proposal remained on paper.

The possibility of joining ERM II and spending a short or long time within it has also become a subject of analysis and speculation. János Kun is one of the experts proposing that ERM II should be joined as soon as possible, but that the introduction of the euro should then be delayed, since in that system members can expect the ECB to provide support in periods of currency instability. On the other hand, Judit Neményi and László Antal insist that Hungary should spend as short a time in ERM II as possible, by both delaying accession to it and then introducing the euro if the test period provides positive results. Most of these positions are based on concerns not only about the long-term perspectives but primarily with the short-term policies of stabilisation and adjustment.

**Currency reform as confidence-building**

In July 2003 the government launched the financial operations related to the 2004 budget. Because of the slower than expected GDP growth and the larger than expected deficit for 2003, the drafting of the budget and the continuing reduction of the deficit demanded sharper corrections in both spending and revenue than had been previously envisaged. Even the Ministry of Finance was taken by surprise by the gap between expectations and real opportunities. The final draft for the budget policies was produced in the run-up to the scheduled government meeting, literally within two or three days.

In order to restore credibility in the face of a number of negative developments, the Hungarian government and the National Bank of Hungary announced in a joint declaration that the country would introduce the euro as national currency as of 1 January
2008. The agenda attached to this announcement was evaluated as voluntarist by most observers, but gave the government a tool to rely on in the debates over the budget and general policy in order to enforce discipline. The joint announcement was also seen as a message for the financial markets about the determination of the government to bring the budget back towards balance and respect the convergence programme which is the basis for the long-term calculations of most portfolio investors.

It should be noted that other governments in central and eastern Europe have been largely cautious in making a firm commitment to any specific dates for the transition to the euro. What is even more striking is that in Hungary no public assessment of the costs and benefits of the monetary reform, comparable to the five tests in the United Kingdom, has taken place. Both the NBH and the Ministry of Finance have produced materials about joining EMU, but the political elites, the policy community and the wider public take it for granted that the introduction of the euro would be beneficial.

On the other hand, all parties soon saw that a transition to the euro would demand substantial sacrifice. The budget for 2004 proposed tax increases as well as cuts in expenditure, and the lay-off of some 10 000 public employees was ordered. Even the prime minister had to abandon his position on motorway construction, which he had treated as the only untouchable item in the plans for the 2004 budget. The road to the euro as a way of national sacrifice has begun. However, the apparent adjustment did not save the country from another fall in the exchange rate of the forint at the end of November 2003. This fall was halted by a 3 percentage point increase in the base rate by the central bank. This emergency base rate increase seemed inevitable in the circumstances, but it also destroyed the chances of increased GDP growth in 2004.

**Conclusions**

The transition from national currencies to the euro is the final phase of economic transformation in post-communist central and eastern Europe. It follows, though not necessarily rapidly, accession to the EU. In spite of declarations, the political elites and the policy-makers in the Visegrad countries do not view membership of the euro as a high priority, and do not resist measures that reduce the likelihood of a rapid abolition of national currencies. Some of them have deliberately slowed down the convergence process in order to maintain greater room for manoeuvre, while in other cases macro-economic fundamentals prevent governments from implementing a rapid currency reform.

Hungary has been a case where the policy community has developed unity around the need for introducing the euro, while deteriorating fundamentals and disunity on policies have created an unstable terrain for the transition. Impressive development in the late 1990s was followed by fiscal and monetary disintegration. By 2003, the finances of Hungary have become more fragile than the economy itself, while it has been understood that convergence demands a higher level of policy coherence as well some sort of
social contract in the medium term. The Socialist-Liberal government staked their credibility on introducing the euro in 2008, and on achieving the macroeconomic adjustment required for doing so according to EMU rules. However, it still makes sense to consider alternative monetary arrangements for east-west integration within the EU, which would result in a different path or a different outcome for Hungary as well by the end of the decade.

References