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Hungary and the eurozone crisis: a comedy of errors?

Abstract: The spill-over of the global financial crisis has uncovered the weaknesses in the governance of the EMU. As one of the most open economies in Europe, Hungary has suffered from the ups and downs of the global and European crisis and its mismanagement. Domestic policy blunders have complicated the situation. This paper examines how Hungary has withstood the ups and downs of the eurozone crisis. It also addresses the questions of whether the country has converged with or diverged from the EMU membership, whether joining the EMU is still a good idea for Hungary, and whether the measures to ward off the crisis have actually helped to face the challenge of growth.

Keywords: Hungary, eurozone crisis, EMU membership, growth

General remarks

The crisis of the management of the European Monetary system has become one of the hottest topics in the aftermath of the global financial crisis. While in the pre-crisis period conventional wisdom held the EU to be a safe haven, well-equipped to protect its members from external shocks, the procrastination of both national crisis and EU-level crisis management raised doubts against this insight. Sceptical voices, conventionally associated with the Anglo-American mainstream of the economics profession, spread into continental Europe and policy-making alike.

In this short essay we investigate how Hungary has withstood the ups and downs of the eurozone crisis. We pose the question of whether

the country has converged with or diverged from the EMU membership, which was taken upon as a contractual obligation in the accession agreement of December 2002. We may also ask if joining in the EMU is still a good idea for Hungary; furthermore, it is asked if the measures implemented to ward off the crisis have helped to face the challenge of growth.

1. Caught in the storm, longer than ever thought

In 2008 Hungary has just come out of a period of external adjustment triggered by the fast growth of external debt and the need to curtail the explosion of fiscal deficit. On its own, Hungary's debt/GDP ratio at the end of 2007 was been exorbitant – 67% of GDP, just above the average of the eurozone's 66.3% – but the trend was clearly unsustainable and showed no convergence to the Maastricht criterion of 60%. It was all the more disquieting as the starting point in 2001 had been slightly below 52% and thus the most important criterion was missed just at the time when GDP growth was over 4.5% in the entire decade¹.

Having managed the external adjustment in 2006-2007, the overall expectation in Hungary was that of recovery. Recovery was seen as quasi-automatic given the favourable global conditions². But the writing already appeared on the wall. Following the collapse of the British investment bank Northern Rock in June 2007, basically all informed analysts knew that we were sitting on a volcano. It was to erupt, the question being not if, but when. However, the decision-makers of the period³ considered the subprime crisis as a basically intra-US affair. As they put it, the tornado marches on a different root and Europe is touched only by its rim.

1 Source (unless otherwise indicated): *ECB Statistics Pocket Book*, Frankfurt am Main, June 2012.

2 For details see: L. Csaba: *Hungary: the Janus-faced success story of transition*, [in:] A. Fosu (ed.), *Developmental Success: Historical Accounts from More Advanced Countries*, Oxford, Oxford University Press, 2012, pp. 252-277.

3 J. Király, *A tornádó és a hurrikán – a 2007. év válságos hatásai* [The tornado and the hurricane – the crisis-ridden year of 2007], [in:] L. Murakózy (ed.), *A jelen a jövő múltja* [Present is the past of future], Akadémiai Kiadó, Budapest 2009, pp. 295-332.

Furthermore, the Socialist government was intent to showboth the domestic and external audiences that the crisis was over. Therefore the fiscal plan for 2009 was formulated in an extremely optimistic manner, in terms of growth and financing. Submitting a fiscal plan based on a 3% growth forecast for 2009 in October, weeks after the collapse of Lehman Brothers, was asking for trouble. And external markets did react swiftly, attacking the exchange rate in an aggressive manner. The collapse could only be averted by a blitz stand-by loan, orchestrated together by the IMF, the EU and the World Bank. Both its size – €20bn – and the involvement of the Washington Twins in managing the affairs of a respectable EU member-state constituted major innovations for the period.

In other words, economic policies from the minute of agreeing to the bailout were subordinated to meeting quantitative targets of debt servicing, irrespective of any other broader considerations. The caretaker Bajnai government was eminently fit to manage this task. While cultivating the image of technocratic managers – not unfamiliar for the post-transition Left – they were supported by the Socialists only and by two centrist parties, rightly fearing early elections. All in all, the administration did not have to care about socio-political concerns, while the centre-right opposition Fidesz did not have to care much about economic exigencies and could put the entire blame for suffering on the Left.

The price to be paid in the second half of the electoral cycle when governing parties refused to step down despite their loss of legitimacy⁴, was heavy. In 2009, the GDP dropped by 6.9%, the debt ratio jumped to 72.9%, unemployment jumped to 10% against barely over 7% in the preceding period. Oddly enough for a contracting economy, inflation remained at 4% (HICP, y/y), when at the same time the euro area barely escaped deflation with 0.3% annual inflation in 2009.

Let us underscore what can be documented by a broad survey of sources: Hungary has not entered a crisis because of the spill-over of the global financial crisis in the last quarter of 2008. The country was

4 The infamous 'lie speech' of the then Premier in May 2006 – leaked to the press in September only – triggered 6 weeks of violent street protests, calmed down by the opposition by calling for referenda on social matters. The latter was won, by a majority of 85% on 9th March 2008. This would, in theory, have called for a resignation of the government. But they were sticking to power, irrespective of the consequences – including their devastating defeat two years later and the annihilation of the two centrist formations, the heroes of early transition years, MDF and SZDSZ.

already on a slowing track from 2004 onwards and the growth in 2004-2006 could only be sustained owing to the accumulation of external debt. In 2006-2008 adjustment did happen, but structural and institutional weaknesses have not been remedied. The government produced a large number of reform projects, but their implementation was in reverse order to the breadth of the initiatives, covering all walks of life. By contrast, the caretaking Bajnai government did address some of the overdue issues. These included the increase in retirement age, cutting disability and early retirement schemes, cutting central administration and severing tax collection. These measures have, for a variety of reasons, survived the change of government and have been intensified by the Széll Kálmán Plans – no 1 and no 2 – of the centre-right government in 2010-2012.

2. Inflated expectations – improvised solutions

As follows from the sketchy overview produced above, the centre-right attained a landslide victory in 2010. In an unprecedented manner, they won both the national and municipal elections with a convenient margin, in theory allowing the new coalition to do whatever they wished in terms of change, reform, restructuring.

‘Life is not as it is in books.’ First, a double majority implied that the most difficult items of public finance, relating to municipalities, welfare provision, public firms and the like could not be easily touched upon as fellow party-members were running those too. Second, already by June 2010, i.e., upon the formation of the new government, the external environment had turned quite sour. The allies of the country, who were funding it under the still running IMF/EU stand-by agreement made no secret of judging the government on its fiscal conservatism. While one may puzzle on the theoretical rationale of the insistence, the evolving Greek crisis and the new rescue package and related items⁵ have clearly dominated over country-specific considerations or considera-

⁵ J. Featherstone, *The Greek sovereign debt crisis and EMU: a failing state in a skewed regime*, *Journal of Common Market Studies*, Vol. 49, 2011, No. 2, pp. 193-217; see also: A. Visvizi, *The crisis in Greece and the EU/IMF rescue package: determinants and pitfalls*, *Acta Oeconomica*, Vol. 62, 2012, No. 1, pp. 15-40.

tions of the business cycle. European governance gradually learned new forms of tight coordination, such as the European Semester and many others. Withdrawal of EU funds from fiscal trespassers was mandated.

The second Orbán government was taken by surprise as the above events unfolded. Their original platform included major restructuring, even at the cost of temporary fiscal deterioration, in line with international experience. While it was supposed to run to 7%, which would have been in line with the 6.6% actually achieved in the EU-27 in 2010, this idea was considered by the EU Commission as a dangerous derailment, as a drift toward populism. Therefore – also by virtue of the terms of the inherited stand-by agreement – the room for manoeuvre has been narrowed.

The surprise component is perhaps the strongest single explanatory factor of what was later termed ‘unorthodox policy measures’. The government resorted to a series of poorly prepared, improvised measures in order to meet the stringent deficit criterion of 3.8%⁶. These included raising the value added tax during the calendar year, cutting expenditure items, and not least nationalizing the previously compulsory private pillar in the pension system. The latter generated sizable revenues for 2010 and even more for 2011, thus allowing the country to record a headline surplus (sic!) of 4.3%. The ratio of public debt to GDP grew only slightly, i.e. to 81.3% by 2010 and started to decline to 79.3% in 2011, further declining somewhat in 2012⁷. Sectoral taxes were imposed, both in 2010 and 2011, on banks, retail chains, the pharmaceutical industry and telecommunications. These did generate revenues; however, they were distortive and one-shot measures, heavily criticized not only by the European Commission but also by top politicians from France, Austria and Germany, intervening in favour of their respective banks and corporations, both directly and at the EU fora.

While these measures did suffice to make both ends meet, broader restructuring – such as re-tailoring public administration or of public firms, especially in the transport sector – fell victim to the pressure of daily fiscal improvements. As global and European upswing gave way to stagnation and uncertainty, especially on the financial markets, conditions for growth and the ensuing improvement of the employment

6 The actual final number was 4.2%, an innocent slip against the major deviations in Greece, Portugal and Spain, but also in France and the UK in 2010-2011.

7 These numbers are extremely sensitive to exchange rate volatility, which has indeed been a problem for Hungary during the entire period of scrutiny.

situation failed to materialize. Especially the latter proved painful, with Hungarian unemployment rates – traditionally way below EU standards – reaching the EU average of 11% and getting stuck. This happened at a time when the centre-right government was elected on a ballot promising to create 1 million new jobs in a decade. In the first two years, only 80 thousand were created, a mere four per cent. This of course created serious social strains and disenchantment, especially among the young, the better qualified and the more mobile. The comprehensive country report of the OECD⁸ has rightly stressed the lack of employment and employability as one of the major structural weaknesses in the Hungarian economy, which is to be seen at the root of the fragility of fiscal improvements in the medium term and beyond.

3. The return of the IMF/EU tandem in shadow boxing

It could be seen from the sketchy overview above that the relationship of the centre-right government and the international organizations has been strained from the very outset. The idea to disregard fiscal targets angered the IMF. In return, the Hungarian government launched what it called a “freedom fight” and, in one of its first moves in June 2010, terminated the stand-by agreement of 2008. . Simultaneously, the conflictual relationship with the European Commission intensified. This happened in part owing to disagreements over the economic strategy implemented, and in – perhaps larger – part, due to dissimilar approaches to a series of non-economic issues, including retroactive legislation, media laws and changes in the judiciary system. The adoption of the new Basic Law of Hungary, making references to the Christian roots of the nation, supporting explicitly the concept of marriage as a liaison between man and woman only, as well as making historic and emotional references, stirred heated debates in the European Parliament, whose co-decision powers have been considerably extended by the Lisbon Treaty of 2009. Also the Commission saw the crisis management as a window of opportunity to enhance its own influence at the expense of national governments. This is particularly true given the fact that the Lisbon Treaty called the Commission the guardian of all European val-

8 OECD, *Hungary – March 2012*, OECD Economic Surveys, Paris 2012.

ues. Accordingly, Brussels sought to interpret its own prerogatives in an extensive manner. While the process of severing fiscal and banking regulations has gradually reinforced the federalist elements⁹ in the institutional structure of the EU, in the debate over who is compelled to do what and when anything is but settled. For instance, the Commission's initiative of January 2012 to withhold cohesion funds from Hungary was seen as legitimate in terms of the Six-Pack package on fiscal stringency adopted only two months earlier. However, the subject of the controversy was not an actual statistical figure, but a forecast for 2013, i.e., an event yet to be materialized. While the Commission did not consider the Hungarian measures sufficiently sustainable, the Hungarian government disagreed. The solution came in May 2012 when the new medium-term fiscal plan, integrated in the more general Széll Kálmán 2.0 Plan, convinced the Commission's experts of the plausibility of sustainable improvements.

The government was forced to request an IMF/EU rescue package in mid-November 2011. It happened as the Greek crisis escalated, once again triggering tremors reaching from Spain to Romania, all across the European periphery. The exchange rate of the forint plummeted from 280 Ft/euro to 323 Ft/euro; spreads, bond yields and CDS skyrocketed. Hungarian government bonds were sold at close to 11% yield in a country that recorded growth of only 1.1% on a year-to-year basis¹⁰. Under the panic generally ruling in Europe an IMF/EU rescue package, whose nature was unspecified, was asked for.

Oddly enough, while the IMF was quick to fix the real crisis cases, such as Bosnia, Belarus, Egypt and even Spain, negotiations with Hungary tiptoed until 17 July 2012, when a delegation of the creditors arrived in Budapest. One may wonder why it took 7 months to get down to business. The answer lies in the changing role of the European Union.

The EU as it stands today is far more than a free trade area with a single currency, as portrayed in the British press. The EU has developed into a truly political institution with wide-ranging prerogatives in a number of areas, from social policy to environmental protection, deciding over legal claims and sustaining peace in Macedonia. It is far from settled in legal and political terms how far the EU can go in ap-

9 H. Berger et al., *Euro Area Policies – Selected Issues*, IMF Country Report, No. 12/182, Washington DC, 03.07.2012, offers an analytical overview of major issues.

10 Even if we consider that the rate of forint inflation was close to 5%, the real rate of interest far exceeded the rate of growth, which is clearly unsustainable in the long run.

plying the community method, i.e., supranational prerogatives. Some considered it a too far reaching method even before the adoption of the Fiscal Compact of March 2012 and the European Stability Mechanism in June 2012¹¹. Just because of the unsettled nature of affairs, the Commission does have a leeway, much greater than conventionally, in re-interpreting its own prerogatives and deciding over its own competences. In this case, the Commission clearly wished to signal its eagerness to exhaust in full the potential vested in it by the European Semester, by the Six-Pack package and the Fiscal Compact, as well as the cross-border banking regulations. These constitute the fiscal discipline component, against which net contributors, from Germany to Finland, agreed to soften the stance on the mutualisation of debts, issuing Eurobonds and targeting the bailout of Spanish banks, originally prohibited by the statutes of the ECB.

Given that the Greek drama was far from over, it was further complemented by the Spanish and Romanian cases, with Italy suffering continuously from distrust of the markets due to its exorbitant – close to 123% – debt/GDP ratio, and by May 2012 time had come to discontinue the play for the general audience. While the question-marks on Hungarian fiscal sustainability have not been fully addressed, the Commission agreed – following a visit by the Hungarian Premier to Brussels in May 2012 – to launch negotiations in substance. It happened later with the 8 weeks of additional delay reflecting the remaining discontent.

In short, although the seven month of wrestling may be considered an insubstantial issue, it played an important role in putting the Hungarian credit deal eventually on the agenda. While jabs were big, pain was next to nil, with Hungary remaining on the international capital markets, while Cyprus, quite unexpectedly, collapsed in June 2012.

4 • Assessment and outlook

As we have seen, the evolving crisis of the EMU – especially in terms of governance – has implied an external shock *par excellence* for the Hun-

11 For an extensive review of those doubts see: F. Scharpf, *Monetary union, fiscal crisis and the pre-emption of democracy*, *Zeitschrift für Staats- und Europawissenschaften*, Vol. 9, 2011, No. 2, pp. 163-198.

garian economy and policy-making all over the period of 2008-2012. The spill-over of the global financial crisis triggered the bailout package. Later, the indecisiveness in managing the Greek debt created animosities within the EU. Finally, the return to the umbrella of the IMF/EU twins proved to be more of style than of substance. The evolving new governance structures in the European Union pose new challenges to managing economic matters in Hungary as well. The idea of a fiscal and banking union to be finalized by December 2012 is a tall order, both on its own as well as in terms of its implications for the country proper.

We do not share the view of doomsayers, fantasizing about the breakup of the eurozone. If we consider that ever since the launch of the European Monetary System – with very few exceptions – fixed exchange rate regimes have survived for over three decades, we do not see any reason to expect a major reversal. A peg sustaining decades – as it was the case of the Belgian Franc or the Dutch guilder against the D-Mark – makes the difference across currencies purely notional. Outsourcing monetary policy to a supranational authority, shielded from political interventions – be that from Oskar Lafontaine or Silvio Berlusconi – has proven to be a major success, contributing to the broadening of the scope of the single market. Those with good macroeconomic indicators – as Finland or Slovakia – profit from being part of a big market and are freed of the labours of sustaining price stability. Those with major problems – such as the southern cone or Ireland – would follow suicidal policies if they were to opt for re-introducing their former weak currencies, which would depreciate, thus sending asset prices to the cellar. Selling out the country in response to changed price signals is thought a text-bookish example, but watching the news coming from the Mediterranean would advise anybody against buying this pale wisdom as a policy relevant consideration. Furthermore it is quite evident that it is trespassers – and not those playing by the rules – that ran into trouble.

From this angle we may well ask if Hungary should still strive for joining the single currency as long as its architecture seems to be in crisis. Recent analyses¹² unanimously favour meeting the criteria. Not primarily for obtaining the advantages of the single currency, but because of the obvious benefits accruing from the macroeconomic framework which is conducive to sustainable public finances and price stability. The latter may serve as a major pre-condition for reviving growth.

12 J. Neményi, G. Oblath, *Az euró bevezetésének újragondolása* [Rethinking the adoption of the euro], *Közgazdasági Szemle*, Vol. 59, 2012, No. 6, pp. 569-684, with 13 comments by experts.

Let us note that Hungary has never been closer to meeting the Maastricht criteria than today. The commitment to keep deficits below 3% of GDP as well as the continuous fall of debt/GDP ratio is anchored in the new Basic Law of 2011. This arrangement is being enforced by a new Fiscal Council, composed of the governor of the central bank, the chair of the State Audit Office and a respectable university professor, who served 9 years as vice chair and 9 years as chair of the state audit office¹³. Moreover, the strategy of the government is explicitly built on reducing the debt rate in order to render public finances sustainable. The current account has been in surplus for the fourth consecutive year. Under peace times the rate of exchange is relatively stable between 290 and 270 Fts per euro. Real rates of interest are historically not high, roughly 1.5% in Fts terms. The weak point is inflation, running close to 6% in 2012, reflecting the costs of delayed price adjustments in administered prices as well as increases in indirect taxes designed to raise fiscal revenue. The convergence plan, if its targets were delivered, would allow meeting all the Maastricht criteria by the end of 2014, rendering the adoption of the single currency by Hungary feasible by 2016, i.e. after a preparation of two years.

It should be noted, however, that the government is less than enthusiastic about this idea. Having burnt its fingers repeatedly – with the first euro target date being 2006, declared by the first Orbán government in 2001 – caution rules. Following the examples of Poland and the Czech Republic, the government does not intend to “hasten in the euro-zone”, and wishes to sit out the outcomes of the solution of the crisis. Declarations of those responsible refer to 2020 and beyond as possible target date.

Let us note: the “convergence game” by its nature is an exercise limited by time. Governments and central banks may anchor expectations only if those are within reach for the median players – households, firms, capital market participants, investors, political parties and social partners alike. Given the decisive role of the electoral cycle, a deadline reaching beyond the mandate of the successor of the current government cannot be taken seriously. Thus the possibility of anchoring expectations and thereby launching virtuous circles is unlikely to materialize, due to lack of credibility and lack of foreseeable perspectives. Whenever

13 The previous fiscal council, set up in 2009, was an independent research institute with personnel of about 60 highly qualified analysts, including three academics. This body had no veto power and was abolished by the new majority in 2010.

convergence games were played, be it the original D-Mark zone, or later the accession of the countries of the south and east, the precondition was the time constraint of 3-4 years at maximum.

Therefore, we may come to a paradoxical conclusion. On the one hand, Hungary is close to meeting EMU criteria. Being a small, open, vulnerable country, with exports and imports together accounting for more than 160% of GDP, it would greatly benefit from joining the EMU. All the more so, as 70 plus % of external trade is transacted with EMU countries. On the other hand – not least owing to the procrastination and ups and downs in crisis management in 2008-2012 – the willingness as well as the credibility seems to be missing.

From this it also follows that Hungary is most likely to follow a less enthusiastic approach to the fiscal and banking union, as the traditional alliance with Germany and the warming up of its relationship with France would suggest. While small countries, like the Netherlands or Belgium, or Ireland have tended to be in favour of more supranationalism and a strongest possible Commission to countervail threats inherent in enhanced intergovernmentalism of the recent years, this situation is gradually on the change. Not least because of the ever growing frequency of decisions taken in narrow informal groups, small members – from Estonia to Cyprus – tend to be more often caught foot dragging. Ireland with her recurring referenda on a variety of issues is a telling case in point.

Therefore, it is both conceivable and probable that Hungary will take a more assertive stance than earlier, especially if forms of closer governance include more supervision without possibilities to ask for remedial actions. The recapitalization of Spanish banks in July 2012 included restructuring the supervision, re-allocation of competences to European organs and a loss of control by fiscal authorities – and by implication, of elected MPs – over major expenditure elements and conditions for their realization in favour of European technocratic bodies. This is clearly a case indicated by Fritz Scharpf¹⁴ on hollowing democracy; thus old issues of accountability, transparency and burden sharing pop up, without however being resolved. Therefore, the reserved attitude looks justified. Hungarian banks did not have to resort to public international funding, as their Irish, Portuguese, Spanish, Italian, Greek, Estonian and Cypriot counterparts. Thus the country has limited if any interest in transferring either regulatory or financial sovereignty to a banking

14 F. Scharpf, *Monetary union...*

union. Also in terms of public debt, while according to Eurostat 2012 numbers for public debt were 88.2% for the eurozone and 83.4% for the EU-27, Hungarian indicators improved to 79%, as one of six exceptional cases¹⁵. Attempts to employ punishment for future misdeeds should be a warning sign to anyone.

¹⁵ As reported in: portfolio.hu, 23 July 2012 /online financial daily, bilingual/