

**HUNGARY AND THE CRISIS OF THE EUROZONE:  
A COMEDY OF ERRORS?**

*/forthcoming in: VISVIZI,A.- STEPANIEWSKI,T.eds: Yearbook of the Institute for East-Central Europe, Lublin, Poland, 2012/*

BY László CSABA<sup>1</sup>

**ABSTRACT:** The spillover of the global financial crisis has uncovered the weaknesses in the governance of the EMU. Being 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 complicated the situation. The relative deterioration of the position of other countries has paradoxically improved the relative position of Hungary by 2012. Still, a cooling to new EU initiatives on banking and fiscal union is likely.

\* \* \* \* \*

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 and EU level crisis management has raised doubts against this insight. Skeptical voices conventionally associated with the Anglo-American mainstream of the economics profession have 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 posit the question if the country converged or diverged to EMU membership, which was taken upon as a contractual obligation in the accession agreement of December, 2002. We may also ask if joining in is still a good idea, further if

---

<sup>1</sup> Professor of international political economy/Central European University and Corvinus University of Budapest/ and member of the Hungarian Academy of Sciences. Personal web: [www.csabal.com](http://www.csabal.com)

the measures to ward off the crisis have actually helped overcome the challenge of growth.

### *1. Caught in the Storm, Longer than Ever Thought*

In 2008 Hungary has just been over 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 has not been exorbitant – 67.0 pc of GDP, just above the average of the eurozone of 66.3 pc – but the trend was clearly unsustainable and showed no convergence to the Maastricht criterion of 60 pc. It was all the more disquieting as the starting point in 2001 was slightly below 52 pc, thus the most important criterion was missed just at the time when GDP growth was over 4.5 per cent in the entire decade<sup>2</sup>.

Having managed the external adjustment in 2006-2007 the overall expectation was that of recovery, which was seen as quasi-automatic under the favorable global settings/on the contemporary debates and disenchanting outcomes<sup>3</sup>. 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, decision-makers of the period<sup>4</sup> 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.

Furthermore the Socialist government was intent to show, both to the domestic and external audiences, that the crisis is 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 3 pc growth forecast for 2009 in October, weeks after the

<sup>2</sup> Source/unless otherwise indicated/: *ECB Statistics Pocket Book*, June, 2012. Frankfurt am Main.

<sup>3</sup> For details cf L.Csaba: *Hungary: the Janus-faced success story of transition*, In: A.Fosu(ed.): *Developmental Success: Historical Accounts from More Advanced Countries*. Oxford-New York: Oxford University Press, pp252-277.

<sup>4</sup> Király,J.: A tornádó és a hurrikán – a 2007.év válságos hatásai/The tornado and the hurricane- the crisis-ridden year of 2007/. In: L.Muraközy,(ed.): *A jelen a jövő múltja/Present is the past of future/*. Budapest: Akadémiai Kiadó, pp295-332.

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* standby loan, orchestrated together by the IMF, the EU and the World Bank. Both its size – 20 bn euros – and the involvement of the Washington Twins in managing affairs of a respectable EU member, were 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 two centrist parties, rightly fearing early elections. All in all, the administration did not have to care about socio-political concerns, while the center-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 legitimacy<sup>5</sup>, was heavy. GDP dropped by 6.9 pc in 2009, the debt ratio jumped to 72.9 pc, unemployment jumped to 10 pc against barely over 7 pc in the preceding period. Oddly enough for a contracting economy, inflation remained 4 pc/HICP, y/y/, when the euro area barely escaped deflation- with 0.3 pc annual inflation in 2009.

Let us underscore, which can be documented by a broad survey of sources: Hungary has not entered a crisis because of the spillover of the global financial crisis in the last quarter of 2008. The country was already on a slowing track from 2004, and growth in 2004-2006 could only be sustained owing to the accumulation of external debt. In 2006-2008

---

<sup>5</sup> The unfamous '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 pc on 9 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/:

adjustment did happen, but structural and institutional weaknesses have not been remedied. The government produced a large number of reform projects, but 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 of 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 center-right government in 2010-2012.

## *2. Inflated Expectations – Improvised Solutions*

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

'Life is not as it is in books'. First, a double majority implies 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, the external environment turned quite sour, already by June, 2010, i.e. upon the formation of the new government. Allies of the country, who were funding it under the still ongoing IMF/EU standby made no secret of judging the government on its fiscal conservatism. While one may wonder the theoretic rationale of the insistence, the evolving Greek crisis and the new rescue package and related items<sup>6</sup> have clearly dominated over country-specific considerations or considerations of the business cycle. European governance gradually learned new forms of tight coordination, as the European semester and many others. Withdrawal of EU funds from fiscal trespassers were mandated.

---

<sup>6</sup> J. Featherstone: The Greek sovereign debt crisis and EMU: a failing state in a skewed regime. *Journal of Common Market Studies*, vol.49.no.2/2011/, pp 193-217. cf also A. Visvizi: The crisis in Greece and the EU/IMF rescue package: determinants and pitfalls. *Acta Oeconomica*, vol.62.no.1/2012/, pp15-40.

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 pc, which would have been in line with the 6.6 pc actually achieved in the EU-27 in 2010, this idea was considered to be a dangerous de-railment, a drift into populism by the EU Commission. 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 pc.<sup>7</sup> 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, allowing the country to register a headline surplus/sic!/ of 4.3 per cent. The ratio of public debt to GDP grew only slightly, to 81.3 pc by 2010 and started to decline in 2011 to 79.3 pc, further declining somewhat in 2012.<sup>8</sup> Sectoral taxes were imposed, both in 2010 and 2011 on banks, retail chains, the pharmaceutical industry and telecommunications. These though did generate revenues, however they were distortive and one-shot measures, heavily criticized not only by the EU Commission, but also by top politicians from France, Austria and Germany, intervening in favor of their respective banks and corporations, both directly and at 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

---

<sup>7</sup> The actual final number was 4.2 pc, an innocent slip against the major deviations in Greece, Portugal and Spain, but also in France and the UK in 2010-1

<sup>8</sup> These numbers are extremely sensitive to exchange rate volatility, which has indeed been a problem for Hungary during the entire period of scrutiny.

gave way to stagnation and uncertainty, especially on the financial markets, conditions for growth and the ensuing improvement of the employment situation failed to materialize. Especially the latter proved painful, with Hungarian unemployment rates – traditionally way below EU standards – reached the EU average of 11 pc and stuck in. This happened at a time when the center-right government was elected on a ballot promising to create 1 mn new jobs in a decade. In the first two years, only 80 thousand was created, a mere four per cent. This of course creates serious social strains and disenchantment, especially among the young, the better qualified and more mobile. The comprehensive country report of the OECD<sup>9</sup> has rightly stressed 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 for the medium run 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 center-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 terminated the standby of 2008, as one of the first of its measures in June, 2010. Parallely to it the conflictual relationship to the EU Commission has intensified. In part owing to disagreements over economic strategy, but in larger part due to dissimilar approaches to a series of non-economic issues, including retroactive legislation, media laws and changes in the judiciary system. 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 liason between man and woman only, as well as making historic and emotional references, have stirred heated debates in the European Parliament, whose co-decision powers have considerably increased by the Lisbon Treaty of 2009. Also the Commission saw crisis management as a window of opportunity to enhance its own influence at the expense of national governments.

---

<sup>9</sup> OECD Economic Surveys: *Hungary- March, 2012*.-Paris, a publication of the Secretariat.

With reference to the Lisbon Treaty calling the Commission the wardian of all European values, Brussels tended to interpret its own prerogatives in an extensive manner. While severing of fiscal and banking regulations have gradually reinforced the role of federalist elements<sup>10</sup> the debate over who is compelled to do what and when is anything but settled. For instance, the Commission 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. The Commission considered Hungarian measures not sufficiently sustainable, while the government disagreed. The solution came by May, 2012 when the new medium term fiscal plan, integrated in the more general Széll Kálmán 2.0 Plan, convinced the experts of the plausibility of sustainable improvements.

The government was forced to ask an IMF/EU rescue package in mid-November, 2011. It happened as the Greek crisis escalated, once again, triggering tremors from Spain to Romania all across the European periphery. The exchange rate of the forint plummeted- from 280 Ft/euro to 323 Ft/euro, spready, bond yields and CDS all skyrocketed. Hungarian government bonds were sold at close to 11 pc yield in a country which grew by 1.1 per cent only on a year-on-year basis.<sup>11</sup> 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, as in Bosnia, Belarus, Egypt and even Spain negotiations with Hungary tiptoed until 17 July, 2012, when the delegation of the creditors arrived to Budapest. One may wonder why did it take 7 months to get down to business. The answer lays in the changing role of the European Union.

---

<sup>10</sup> H.Berger et al, *Euro Area Policies – Selected Issues*. Washington,D.C, IMF Country Report no12/182- July 3, 2012 offers an analytical overview of major issues.

<sup>11</sup> Even if we consider that the rate of forint inflation was close to 5 pc, the real rate of interest far exceeded the rate of growth, which is clearly unsustainable in the long run.

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 using the community method, i.e. supranational prerogatives – some considered it too far reaching even before adoption of the fiscal compact of March, 2012 and the European Stability Mechanism in June, 2012.<sup>12</sup> 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 competences. In this case the Commission clearly wished to signal its eagerness to exhaust in full the potentials 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 softening the stance on the mutualization of debts, issuing eurobonds and targeted bailout of Spanish banks, originally prohibited by the statutes of the ECB.

Given that the Greek drama was far from over, furthermore it was complemented by the Spanish and Romanian cases, with Italy suffering continuously of distrust by the markets due to its exorbitant – close to 123 pc – debt/GDP ratio, by May, 2012 the time has come to discontinue the play for the general audience. While 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 – to launch negotiations in substance. It happened later – the 8 weeks reflecting the remaining discontent.

In short, we called the wrestling of the 7 months shadow boxing insofar as no substantive issue that ever relates to a credit deal was even put on the agenda. While jabs were big, pain was next to nil, with Hungary remaining only the international capital markets/while Cyprus, quite unexpectedly, has collapsed in June, 2012/.

---

<sup>12</sup> For an extensive review of those doubts cf. F.Scharpf, *Monetary union, fiscal crisis and the pre-emption of democracy*, „Zeitschrift für Staats- und Europawissenschaften”, vol.9.no.2./2011/, pp163-198.

#### *4. Assessment and Outlook for the Future*

As we have seen, the evolving crisis of the EMU –especially in terms of governance – has implied an external shock *par excellence* for Hungarian economy and policy-making all across the years 2008-2012. The spillover of the global financial crisis triggered the bailout package, later indecisiveness in managing the Greek debt created animosities with the EU, finally the return to the umbrella of the IMF/EU twins have proven more style than 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, and in terms of implications for the country proper.

We do not share the view of doomsdayers, phantasizing about the breakup of the eurozone. If we consider that ever since the launch of the EMS – with very few exceptions – fixed exchanged rate regimes survived over three decades, we do not see any reason to expect a major reversal. A peg sustaining decades – as 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 labors of sustaining price stability. Those with major problems – 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, sending asset prices to the cellar. Selling out the country in response to changed price signals is though a textbookish example, but watching news coming from the Mediterranean would advise anybody from buying this pale wisdom as a policy relevant consideration. Furthermore it is quite evident that it is trespassers, not those playing by the rules which ran into trouble.

Under 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 analyses<sup>13</sup> unanimously favor 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.

Let us note, that Hungary has never been so close to meeting the Maastricht criteria than at the time of writing. The commitment to keep deficits below three per cent of GDP as well as the continuous fall of debt/GDP ratio are 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 office.<sup>14</sup> Moreover the strategy of the government is explicitly built on reducing the debt rate, in order to render public finances sustainable. 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 per cent in forint terms. The weak point is inflation, running close to 6 per cent in 2012, reflecting the costs of delayed price adjustments in administered prices and also increases in indirect taxes to raise fiscal intakes. The convergence plan, if its targets were delivered, would allow for meeting all Maastricht criteria by the end of 2014, rendering the adoption of the single currency feasible by 2016, after a preparation of two years.

It should be noted, however, that the government is less than enthusiastic. 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

---

<sup>13</sup> J.Neményi and G.Oblath, *Az euró bevezetésének újragondolása/Rethinking adoption of the euro*, *Közgazdasági Szemle*, vol.59.no.6./2012/,pp 569-684 with 13 comments by experts.

<sup>14</sup> The previous fiscal council, set up in 2009, was an independent research institute with a personnel of about 60 highly qualified analysts, composed of three academics. This organ had no veto power and was abolished by the new majority in 2010.

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, can not 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 convergence games were played, be that the original D-Mark zone, or later acceding 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 more than 160 pc of GDP, she would greatly benefit from joining in. All the more so, as 70 plus per cent 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 seem to be missing.

From this it also follows, that Hungary is most likely to follow a less enthusiastic approach on fiscal and banking union, as the traditional alliance to Germany and the warming up of relationship to France would suggest. While small countries, like the Netherlands or Belgium, or Ireland have tended to be in favor of more supranationalism and a strongest possible Commission to countervail threats inherent in enhanced inter-governmentalism 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 in 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 is to take a more assertive stance than earlier, especially if forms of closer governance includes more supervision without possibilities to ask for remedial actions. The recapitalization of Spanish banks in July 2012 included re-structuring 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 favor of European technocratic organs. This is clearly a case indicated in the earlier cited Fritz Scharpf on hollowing democracy, thus old issues of accountability, transparency and burden sharing prop 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, Portuguse, Spanish, Italian, Greek and Estonian and Cypriot counterparts. Thus the country has limited if any interest in transferring either regulatory or financial sovereignty to a banking union. Also in terms of public debt, while according to Eurostat 2012 numbers for public debt was 88.2 pc for the eurozone and 83.4 pc for the EU-27, Hungarian indicators improved to 79 pc, as one of the six exceptional cases<sup>15</sup>. Attempts to employ punishment for future misdeeds should be a warning sign to anyone.

---

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