The Hungarian “Exception”: Lessons in Political Economy

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Outline

• Background

• Broad fiscal trends

• Exception 1.0 (in 2001-09)

• Paradigm change?

• Exception 2.0 (since 2010)

• Consequences

• Lessons
Background

Political setting: good news

• Parliamentary democracy since 1990
  – Constitutional reform (1990)
  – 5 full electoral cycles (3 socialist, 2 center-right)
  – Institutional progress, occasional backsliding

• Defining events
  – Council of Europe, GATT/WTO (early 1990s)
  – OECD membership (1996)
  – EU membership, Single Market, Schengen (from 2004)
Background

**Political setting: bad news**

- **Common denominator**
  - “Goulash populism”
  - Electoral cycle dominates economic performance
  - Zero-sum game

- **Overriding party strategies**
  - Permanent hold on power, clientelism
  - Fiscal sovereignty
  - Maximize scope for social entitlements with high taxation or borrowing
Mixed progress during the transition

- Deep reforms in the tradable sector
  - External liberalization (trade and finance)
  - Domestic liberalization (incl. financial system)
  - Privatization (incl. effective bankruptcy procedures)

- Slow reforms in the non-tradable sector
  - Public administration: bloated workforce
  - Social entitlements partially reformed

- Monetary policy: broadly successful (XR peg; IT)

- Fiscal policy: continuous stress, dominant

- EU membership → moral hazard
Background

Economic performance

- Foreign direct investment: very strong at outset
- Swings in external performance
- Near crisis in 1995 and 2008 (need for IMF stand-bys)
- Disinflation into single digits, but some persistence
- Marked deceleration in economic growth
Background

Real GDP per capita at ppp
(100 = EU27 average)
Broad fiscal trends

*Distinguishing characteristics*

– deficit bias

– time inconsistency

– pro-cyclicality

– debt sustainability problem

– lack of transparency

– non-cooperative with monetary policy
Broad fiscal trends

Fiscal Stance: Hungary

"Great Moderation"  Crisis

Percent of GDP

Eurostat

Cyclically adjusted primary deficit  GDP growth
Broad fiscal trends

Fiscal Stance: Euro Area

Eurostat

- Cyclically adjusted primary deficit
- GDP growth

"Great Moderation" Crisis
Broad fiscal trends

Public Debt

Percent of GDP

MNB

Gross Debt

Maastricht criterion

Broad fiscal trends

Public Debt

% of GDP

2004 2005 2006 2007 2008 2009 2010

Bulgaria Czech Republic Estonia Hungary Latvia Lithuania Poland Romania

Eurostat
Exception 1.0 (2001-09)

Center-left government

Expansionary stance during “Great Moderation”

• government wage hikes
• public pension hikes
• VAT rate cuts
• conflicts with central bank
• opaque fiscal and regulatory practices
Exception 1.0 (2001-09)

Center-left government

Contractionary stance during crisis (IMF-EU standby)

• wage and pension freeze
• VAT rate increase
• some streamlining of social entitlements
• rules-based fiscal framework
Paradigm change?

Rules-based fiscal framework (FRL Nov. 2008)

• policy rules: expenditure limit
debt limit

• procedural rules: pay-go rule
  MT budgetary planning

• transparency norms

• independent fiscal institution: Fiscal Council

• consistency with EU stability and Growth Pact
Paradigm change?

Expectations about Orban government

• Need to restore policy credibility
• No campaign promises, strong majority
• Good track record of first Orban government
• EU supportive ahead of Hungarian presidency
• Financial markets welcoming
Exception 2.0 (since 2010)

Center-right government

Unorthodox policy measures

• flat tax, without exempt threshold

• temporary taxes on selected activities

• record VAT rate (27%)

• nationalization of private pension funds

• tax exemption of employer-provided health insurance
Exception 2.0 (since 2010)

Center-right government

Demise of checks and balances

- limits on Constitutional Court on fiscal matters
- sharp cut in judges’ retirement age
- political appointment as head of State Audit Office
- *de facto* abolition of Fiscal Council
- reduced independence of Central Bank
Consequences

Vulnerability to crises

• Debt sustainability problem
• Spike in risk premium, junk bond status
• Costly interest bill, decline in investment, growth
• Potential loss of access to market financing

Confrontation with EU, IMF

• Indefinite postponement of euro membership
• Possible legal and financial sanctions
• Tough prior conditions for stand-by arrangement
Consequences
Consequences

Comparison with the UK

• Common features
  – fiscal sustainability problem
  – low policy credibility
  – contemporaneous election of center-right governments

• United Kingdom
  – clear medium-term fiscal target
  – front-loaded adjustment program
  – establishment of Office for Budget Responsibility

• Hungary
  – mixed and opaque policy signals
  – adoption of distortionary stop-gap measures
  – abolition of Fiscal Council
Consequences: sovereign risk premium
Consequences: sovereign default risk premium

![Diagram showing CDS spread on 10-year government bonds]
Negative Lessons

• “Exception” leads to stagnant activity, long-term sustainability problem, and vulnerability to crisis (lacking a natural resource base)

• Fitful discretionary policies and weak institutions undermine confidence

• Populist strategy and moral hazard have only short-term benefits

• Government ignores financial markets at its peril
Positive Lessons

• Fiscal sovereignty can be achieved through a predictable well-designed rules-based policy framework (lacking a natural resource base)

• Policy credibility must be home-grown

• IMF or EU can only provide financial and technical assistance, and guidelines for good practices

• Government must use every opportunity to signal paradigm change, and follow up with action, that leads to virtuous cycle
References


