Managing the Crisis |

Hungary Country Report

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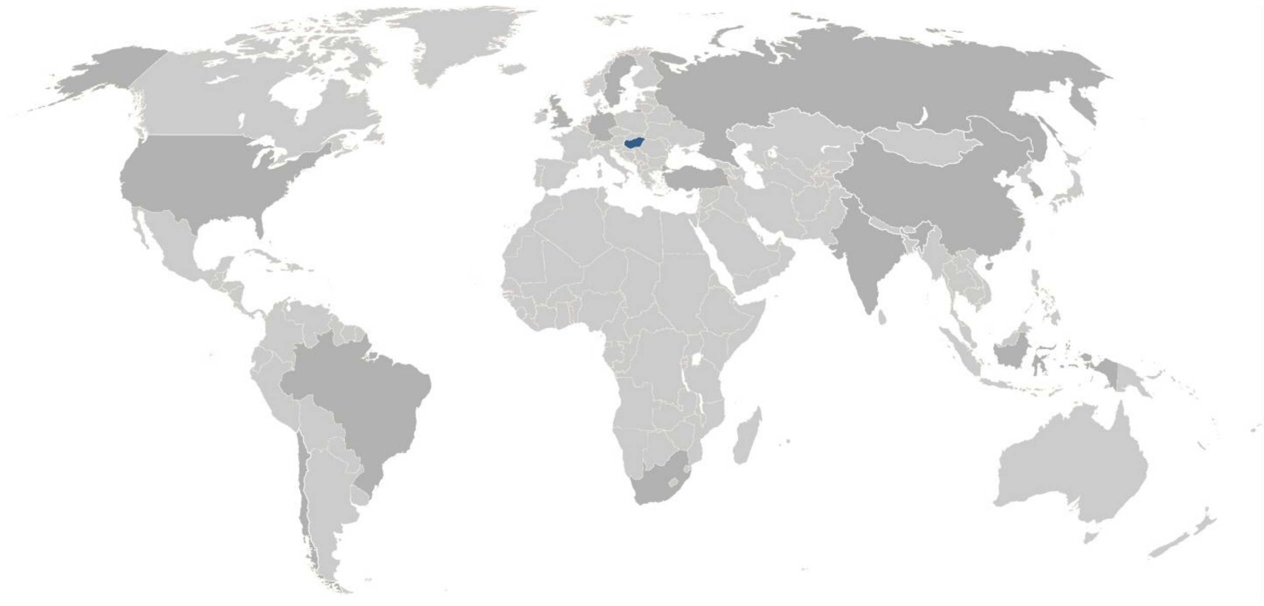

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1. Risk Exposure at the Outset of the Crisis

- What was the structure of demand (e.g., share of private/state consumption, gross capital formation, exports and imports in GDP/GNI)?
- To what extent was the economy exposed to macroeconomic imbalances (e.g., foreign debt, trade or fiscal imbalances)?
- Was/is the financial system primarily bank- or market-based?

Economic structure and macroeconomy

Throughout Hungary's political and economic transformation during the last two decades, its economy has been export-oriented. Exports and investments, both mainly managed by transnational companies located in Hungary (and increasingly by their domestic and foreign-owned subcontractors), have driven the country's economic growth. In 2008, the service sector contributed about 66.2 percent to GDP, while manufacturing and the construction industry provided a combined 29.5 percent (24.9% and 4.6% respectively) and agriculture 4.3 percent.[1] More importantly, Hungary's economic microstructure underwent rapid modernization through the concentration in the last two decades on medium- and highly skilled labor and technology, which has made it the leader among transforming economies in terms of technology-based exports. Indeed, two-thirds of its exports have consisted of machinery, electronics, transport equipment, optical instruments and pharmaceuticals.

In 2008, final consumption represented 75.1 percent of GDP, with 65.6 percent being that of households and 9.5 percent of government (including local self-governments). Gross investments comprised 23.7 percent of total GDP. Both exports and imports reveal a very high level of economic openness. The share of foreign trade in GDP reached more than 150 percent, and is equally split between exports and imports.

The decade of rapid economic growth that came on the heels of Hungary's successful stabilization program in 1995-1996 was based on questionable economic premises. As a result, the economy accumulated high levels of domestic and external imbalance. The fundamental problem was that after 1997 (year of one of the first comprehensive pension reforms in Europe) the government did not take advantage of the high-growth period to implement further budgetary reforms. Just the opposite, new and costly programs (support for private construction, social welfare programs, high wage increases in the overstaffed public administration, ambitious highway construction) put

[1] All statistical data if not otherwise indicated are from the monthly bulletins of the Central Statistical Office (Központi Statisztikai Hivatal. A KSH jelenti).

additional burdens on the expenditure side of the budget. This occurred without the government implementing more effective tax collection or ensuring other sources of state income. In addition, the monetary policy was unilaterally oriented on the inflationary target and supported the high value of the national currency by offering unnecessarily high interest rates to domestic and mainly foreign creditors/depositors. As a result, the budget deficit in October 2006 reached 9.2 percent of GDP and required the immediate introduction of an austerity program. Within two years, mainly because of heavy budgetary cuts, the budget deficit fell to 3.4 percent of GDP. Still, the lack of domestic savings to finance the decreasing but still significant budget deficit and the rapidly growing exposure of consumer credits raised in foreign currency (due to huge differences between the interest rates in the national currency and in other major currencies, mainly Swiss francs and euro) contributed to Hungary's rapidly growing external indebtedness. By the end of 2008, gross external debt amounted to €98.5 bn, or almost 100 percent of GDP. Net debt climbed to €54.4 bn. This figure and the fact that net debt was less than three-quarters of commodity exports reflect a much better position than at the beginning of the transformation in 1990. The big difference, however, was that while in 1990 almost 100 percent of the debt fell on government and the National Bank (Magyar Nemzeti Bank, Hungary's central bank), in 2008 the debt of these actors was only 26 percent of the total while that of private enterprises and particularly of households accounted for 74 percent. Simultaneously, the foreign trade deficit, reaching €3 to 4 bn (or 3–4% of GDP) was gradually reduced. In 2008, for the first time in more than a decade and as a result of several years of double-digit export growth, foreign trade became fully balanced (exports covering 99.7% of imports).

Hungary's financial system is market-based and about 80 percent is owned by foreign banks (mainly from other EU countries). During the last decade, this ownership structure was considered to be a factor in reducing external vulnerability and increasing domestic (and international) competitiveness.

International constraints before the global financial crisis were not linked to the IMF, since the stand-by agreement could be set aside following the success of the Bokros package in the mid-1990s. Nevertheless, other constraints remained. First, until now very little attention has been devoted to the impact of the external environment on transformation (not only in Hungary, but in all Central and Eastern European countries). Whereas economic transformation was constant all over Europe in the last two centuries, the transformation of Central and Eastern European countries is the first to have been embedded within globalization. Thus, any success story had to combine transformation priorities with globalization pressures. Secondly, the priority list and sequencing of EU accession and transformation, although mutually enforcing, did not overlap perfectly. Understandably, priority was given to EU accession and some economic priorities (including sequencing) were put on the back burner. In sum, globalization and EU integration generated and to some extent imposed constraints on Hungary's pattern of economic development. Following accession to the European Union, the second element started weakening, while the first remained fully in place.

- What was the government's economic record (e.g., growth, unemployment rate, inflation and fiscal position) prior to the crisis?
- What was on the economic agenda prior to September 2008 (e.g., anti-inflation, efficiency-oriented, redistributive, supply vs. demand-side policies)?

Policy priorities prior to crisis

In October 2006, the Hungarian government introduced a credible austerity program in order to dramatically decrease the budget deficit. The austerity program was not the result of domestic coordination but was enforced by the international community. In two years, the program succeeded in cutting the budget deficit from 9.2 to 3.4 percent. As a result, GDP shrank rapidly from an annual average of four percent to 1.2 percent in 2007 and 0.6 percent in 2008 (the latter already reflecting the impact of the first months of the global financial crisis). Inflation jumped to eight percent in 2007 but began decreasing in the next year (to 6.1%). Unemployment rose only moderately, since the pre-crisis situation was characterized by a favorable external environment and high export growth. The austerity program also led to slightly lower levels of employment in public administration. Although the government successfully stabilized the budget, structural rigidities continued for several reasons. First, the urgency of remedying the very serious budgetary imbalance did not allow decision-makers the time to elaborate and implement longer-term structural reforms (e.g., in health, education, pension, taxation, public administration), even in cases where these reforms had been adequately prepared. Second, half-hearted and ill-communicated reforms fell victim to a referendum in March 2008 that was fueled by the populism and demagogy of the opposition. Third, Hungary's thoroughly rigid labor market, which is characterized by one of the lowest levels of activity rate among the OECD countries and a very high level of officially unemployed young people without sufficient education, could not be addressed adequately. Finally, "early-born consumerism"—a term coined by this author with reference to János Kornai's famous analysis of the "early-born social welfare state" two decades ago—did not make the situation easier.[2] During the first year of the austerity program (2007), when private consumption sank by 1.9

[2]For more on the "early-born welfare state, " see János Kornai, "Posztszocialista átmenet és az állam. Gondolatok a fiskális problémáról," (Post-socialist Transition and the State. Reflections on the Fiscal Problem), *Közgazdasági Szemle* 6 (1992): 489-512.

percent (as compared to public consumption, which fell by 4.5%), the stock of credits taken by private households in convertible currencies jumped by 30 percent. In fact, the population's behavior reflected the overall expectation, strengthened by the government's overly optimistic communication, that the austerity period would be quickly over.

Before September 2008, Hungary's economic agenda indicated a mixture of different priorities. The National Bank continued to insist on its anti-inflationary policy, despite the fact that inflation ceased to pose the greatest threat and the forint's artificially high exchange rate could do little against domestic sources of inflation. Manufacturing—mostly foreign-owned—was based on efficiency-orientation, which yielded substantial gains in structural modernization, technological development and external competitiveness (despite the artificially high exchange rate). Until 2006, the government pursued a redistributive economic and social policy that resulted in budgetary expenditures for social purposes that were several percentage points higher (21% of GDP) than in other transforming countries with similar levels of economic development and performance.

- How stable was the executive branch in the years/months prior to September 2008 (e.g., credibility/legitimacy of leaders/parties in government, cabinet stability/reshuffles, parliamentary/electoral support)?
- How much room did fiscal conditions provide for a major stimulus (e.g., budget surpluses/deficits, conditions for issuing additional treasury bonds)?
- How much room was there for monetary policy initiatives (e.g., pre-crisis level of interest rates, required reserve ratios, flexibility of foreign exchange rate regime)?

Executive, fiscal & monetary capacities to respond to downturn

For the first time in the post-1989 period, parliamentary elections in the spring of 2006 led to the reelection of the previous coalition composed of socialists and liberals. A larger majority than in the 2002-2006 period seemed to provide a relatively smooth foundation for developing a prudent economic policy. However, several negative factors reduced the government's scope of action. First, any fundamental reform required a two-thirds majority that could not be achieved on any issue (not even for badly needed reform of the self-government structure, the biggest items of budgetary expenditure). Second, the opposition's continued pursuit of political demagoguery led to civil unrest and boycotts of the National Assembly, both of which facilitated an overall deterioration of the social atmosphere. Third, the publication in September 2006 of the prime minister's infamous "lying speech" has undermined the legitimacy and credibility of the government in general and that of the major coalition partner, the socialist party, in particular. Fourth, the coalition between socialists and liberals—never an easy exercise—began suffering an increasing number of internal conflicts, which finally resulted in the coalition dissolving in early 2009. Fifth, self-government elections in the autumn of 2006, half a year following the parliamentary elections, resulted in a landslide victory for the opposition (with a majority of about 70%). As a consequence, a very delicate situation emerged with a socialist-liberal parliamentary majority and government on the one side, and a politically powerful (non-cooperative, demagogic and sometimes even hostile) opposition on the other. The government's rapid loss of credibility and the equally rapid increase of the opposition's populism and demagoguery became manifest in the March 2008 referendum when a large majority of the population voted against all reforms (including those with very small potential changes).

By 2008, there was little manoeuvering room for Hungarian fiscal policy. Due to international pressure on Hungary to continue reducing its budget deficit when most other countries went in the opposite direction, no major stimulus could be expected in the aftermath of the financial crisis. In addition, domestic savings reached a historical low, due to (partly irresponsible) consumer behavior and an erroneous evaluation of the overall economic situation, which was in part fueled by a volatile exchange rate and, until October 2008, favorable conditions for borrowing in foreign currency. As long as foreign liquidity was available, the only (and suicidal) stimulus consisted in low-interest foreign credits (mainly for consumption purposes and much less for investments).[3]

The Hungarian National Bank's monetary policy created a trap situation. Since foreign liquidity could only be made available by keeping the interest rate for forint deposits high (with a substantial and artificial margin to the interest rate of major currencies), any cut of the interest rate would have entailed the real risk of capital flight and rapidly depreciating national currency. The banking sector's reserve ratio was higher than the required minimum (11% as compared to the obligatory 8%), and because of the ownership structure its liquidity position was very good. The exchange rate regime was highly flexible, first with a margin of +/- 15 percent and, after February 2008, without any margin (i.e., unrestrained, free-floating). Over several years, eventual volatility due to external speculation could be easily kept under control within the established margins (between HUF 240 and HUF 324 to the euro, with a central rate of HUF 282).

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[3] Before the financial crisis, the share of foreign depositors pointed to a permanent increase in the stock of HUF-denominated state bonds. This had two important impacts. On the one hand, it contributed to the deepening of the financial market (a positive institutional change). On the other hand, it increased the vulnerability of the system. See here Judit Neményi, "A monetáris politika szerepe Magyarországon a pénzügyi válság kezelésében (Role of the monetary policy in managing the financial crisis in Hungary)," *Közgazdasági Szemle,* vol. LVI, May (2009): 393-421. The indebtedness of private households, although rapidly growing until the autumn of 2008, did not reach the same indicators as registered in several EU member countries. See here Magyar Nemzeti Bank, "Jelentés a pénzügyi stabilitásról (Financial Stability Report)," April (2009) .

- To what extent has the country been exposed to global financial market risks, particularly contagious/toxic financial instruments (e.g., open capital account, floating or pegged/fixed currency)?
- How important was/is the financial sector for the national economy? What was/is the extent of interdependence between the financial sector and real economy?
- To what extent was the economy integrated into regional/global trade flows? How dependent was the economy on foreign demand for manufactures and commodities?
- Did property, equity or other markets display excessive growth and a bubble-like situation prior to September 2008?
- In what condition was the banking sector (e.g., size/structure of banking sector, non-performing loans, capital adequacy ratios of major banks, if available)?

Exposure to specific market and trade risks

Hungary was not directly exposed to either contagious or toxic financial instruments or to a bubble in the construction market. On the one hand, during the pre-crisis period, foreign (largely EU-located) banks were considered the guarantors of financial market stability (certainly more than undercapitalized domestic banks). Of course, it was not known to what extent foreign banks located in Hungary were involved into toxic businesses in their global operations. On the other hand, the ownership structure of the Hungarian housing market and the stagnating or moderately rising housing prices (including rentals) did not allow any bubble-generation. At the same time, the country's open capital account and (almost) freely floating currency left the economy highly exposed to financial speculation. However, free-floating should not be equated with "unlimited." If speculation reaches a certain level and the currency starts to fall sharply, the National Bank will consider intervening in order to curb potential inflationary impacts of a too rapid depreciation of the national currency. Still, it has to be stressed that there is no fixed exchange rate level where intervention should start (i.e., implicit exchange-rate targeting). A high budget deficit (predominantly financed by foreigners who were ready to buy Hungarian government bonds over many years at a high real interest rate) and rapidly growing indebtedness of citizens (private consumers) in foreign currencies gave sufficient motivation for international speculation against the floating national currency.

In regional comparison, the institutional and microeconomic depth of the financial sector in Hungary has been outstanding. It has been an important factor not only in terms of GDP but, more importantly, anchoring sustainable economic development and structural modernization. More than 80 percent of the banking sector is owned by strategic foreign investors. Most investments in the real economy have been financed not only by foreign-owned banks but also by money borrowed on the international financial market and not as a result of domestic savings. Thus, the high level of integration between the financial sector and the real economy produced a similarly high level of integration between the real economy and international lenders.

The Hungarian economy is one of the most open and integrated economies among EU members (old and new) and even worldwide. Exports account for more than 75 percent of the GDP (similar figures hold for imports). Thus, the degree of openness (X+M/GDP) is about 150– 160 percent. All modern(ized) production sectors have been predominantly based on exports, due to both the limited size of the domestic market and the export-oriented strategy of multinational companies. In the pre-crisis period, several sectors revealed relevant and sustained competitiveness. In 2008, manufactured goods represented 97 percent of total industrial exports, led by transport equipments (27.3% of total export sales) and electronics and computers (26%). Smaller but still important contributors to exports were electrical machinery and metal manufactures (each representing 7.4%), as well as rubber, plastics and non-metallic products (5.2%), other machinery (4.5%) and food and agricultural goods (4.3%). Before the crisis hit, almost three-quarters of manufactured goods were exported, with outstanding export ratios (above 90% of production) for transport equipment, computers and electronic products as well as electric machinery. It must be noted that a growing portion of exports was directed not to the first destination (as reflected in foreign trade statistics) but to the global markets of the respective transnational companies. Therefore, exports were geographically much more diversified than indicated by bilateral foreign trade statistics.

Property, equity and other markets did not indicate excessive growth, let alone a bubble-like situation. The only exception was a skyrocketing volume of credit taken on by private persons in foreign currencies.

The banking sector was mainly owned by strategic foreign investors mostly from selected EU member countries (e.g., Austria, Belgium, Italy, Netherlands, to a lesser extent Germany and France). National ownership was limited to the National Bank of Hungary, the Hungarian Development Bank (100% state ownership) and OTP, the largest Hungarian bank undergoing substantial regional expansion, which has a mixed ownership structure but is clearly under Hungarian control and management.

By the end of 2008, the capital-adequacy-ratio of the Hungarian banking sector was 11 percent, significantly higher than the regulatory minimum (8%). At the outbreak of the crisis, non-performing loans represented less than five percent, thanks to the (comparatively) high collateral of housing and durable consumer goods credits, the stable employment of borrowers and a high exchange rate, although the latter fell between July and mid-October of 2008. As a result of constant increase over years, the share of foreign currencies in the total credit volume reached 70 percent by the autumn of 2008, growing from less than five percent in 2003. Higher foreign currency shares could only be registered in Latvia (almost 90%) and Estonia (above 80%). The 70 percent average figure includes more than 90 percent of foreign-currency indebtedness of private citizens and a less than 70 percent foreign-currency indebtedness of the enterprise sector.

The main reasons for Hungary's financial crisis were its sustained huge budget deficit and its high level of external indebtedness, which the private sector mainly generated through consumer and enterprise credits in foreign currencies. Since domestic savings could not cover the deficit, Hungary's external vulnerability rapidly increased. With the National Bank's foreign exchange reserves being the only option should the government fail to refinance national debt (due mainly to expiring government bonds and other credits), a weak reserve position was considered too risky. It was precisely this reserve position that the massive IMF-ECB-WB credit in the autumn of 2008 targeted.

Structural or policy advantages and disadvantages

- Did policymakers/executive agencies have any experience in handling financial crises? Did this experience play a role in the 2008-09 policy response?
- Were there independent regulatory institutions or prevention/response schemes in place to contain financial risks?
- Were there internal veto players (e.g., federalist powers, courts) or international obligations that thwarted swift action on the part of the government?
- Have executive powers been extended in times of crisis? Has this been based on formal or informal mechanisms?

Hungary did not experience a similar financial crisis in the past. First, the Asian crisis of 1997 and the Russian crisis of 1998 had indirect and short-term impacts only and did not precipitate any substantial change in Hungary's financial-monetary strategy (e.g., the need for accumulating large foreign-exchange reserves, as it happened in East Asia). Secondly, the external debt crisis in the first years of transformation (1990 – 1995) was mainly home-made and largely the result of ambiguous (but in microeconomic terms up to now favorable) structural modernization and semi-market economic developments before 1989. In 1990, net foreign debt amounted to three years of export revenues, in contrast to 8 months of exports in 2008. More importantly, in 1990 almost 100 percent of the external debt was held by government and the National Bank, as compared to 26 percent in 2008, when almost three-quarters of the debt had been accumulated by the enterprise sector and, even more, by private citizens. This massive accumulation of private debt contributed to Hungary's dangerously increasing external financial vulnerability (together with expiring short-term credits and bonds).

The Hungarian Financial Supervisory Authority (HFSA, PSZÁF in Hungarian) is the integrated supervisory agency. ("Integrated" means here that the HFSA supervises all financial sectors, including banking, the insurance sector, capital markets, and pension funds). It is a government agency with independence declared and ensured by law. Concerning licensing or day-to-day supervision (on-site and off-site as well) the authority has to focus on all types of risks referred to in the specific laws (e.g., banking, insurance and capital markets). Risks include credit, market, liquidity and operational risks. The HFSA is a member of the EU supervisory network and has a smooth, cooperative record void of intervention by any domestic actor.

In October 2008, domestic veto players did not directly impede or interfere with crisis management. However, some veto players did contribute to the poor economic situation as the crisis broke out. First, in the March 2008 referendum, the opposition successfully rallied the population to reject the government's half-hearted reforms in health care, education and public administration that were designed to reduce the budget deficit. Most probably, implementing such reforms would not have pre-empted the October 2008 crisis, but they would have provided the country with better means to face the crisis. Second, the main political parties continued to hinder a reorganization of the country's local government structure. In a country of 10 million people, the existence of more than 3,000 self-governments underscore an inefficient public administration. In fact, any change to the current situation would have required a two-thirds majority in the National Assembly, a possibility hindered by one of the major parties holding control over the majority of self-governments. Third, and most importantly, the very high level of demagoguery, populism and short-term interests has served as a mental barrier to implementing an efficient anti-crisis plan, but can become an even bigger political and psychological obstacle to clear in the post-crisis situation.

In the first months of the crisis, executive powers grew in two ways. First, the previous prime minister (Gyurcsány) was replaced by another one (Bajnai), who could fully focus on crisis management without becoming embroiled in daily and highly inefficient political debates with the persistent populist criticism coming from the opposition. The introduction of a new finance minister and some other ministers has definitely strengthened the institutional and professional foundation of efficient crisis management. In April 2009, the new government created a crisis management cabinet that meets on a weekly basis. A special office supervises the implementation of the crisis management program.

- How strongly has the national economy been hit during the period under review? Where has it been hit most severely thus far (e.g., growth rate, production, trade, employment)?

Initial impact of economic downturn

The Hungarian economy has been seriously hit by the crisis. Overall and substantial decline is the outcome of three principle factors: (a) the stabilization of the budget irrespective of the financial crisis, (b) the consequences of the financial crisis, (c) the dramatic decline of foreign trade due to the high level of openness (which was a big advantage in the last years) and the collapse of international trade. GDP growth turned to negative already in the last quarter of 2008. Exports (and imports) also started to decline in the same period. For 2009, a six to 6.5 percent decline of GDP is predicted. In the period between January and August of 2009, industrial production decreased by more than 20 percent, mainly due to the sharp decline of exports (by 24.5%) and the less dramatic but substantial decline of domestic consumption (by 12.7 %). Leading production and export sectors were hit more severely and employment rates began to gradually sink. During the same time period, official unemployment increased from 7.5 to above 10 percent, adding about 100,000 people to the stock of unemployed from a year ago (317,000). At the same time, the activity rate, already one of the lowest among the EU member countries in the last decade, declined further from 57 percent to 55.7 percent.

2. Agenda-Setting and Policy Formulation

- When did state organs (e.g., government, central bank) begin setting a crisis response agenda? How long did it take to adopt the first crisis measures?
- Who were the driving forces (e.g., government, central bank, foreign actors, media, trade unions, employers` associations) in getting stabilization/stimulus policies started?
- Were these measures launched as executive orders or parliamentary laws? How closely did constitutional bodies (e.g., executive, legislative, central bank) cooperate?
- What kind of role did sectoral or regional lobbies play in policy formulation?

Agility and credibility

Because Hungary belonged to the countries hardest hit by the financial crisis of October 2008, state organs were forced to react immediately. Three factors explain the urgency with which agenda-setting was pursued. First, in order to avoid a full collapse of the financial system, its extreme vulnerability had to be addressed. The maximum limit in guaranteeing deposits was immediately increased (the legal modification was submitted to the National

Assembly on October 10, and in force on October 14, 2008). Also, on October 22, 2008, the National Bank of Hungary raised the prime rate from 8.5 percent to 11.5 percent in one step. Second, several items of the submitted (on October 18) budget proposal for 2009 had to be redrafted and approved by National Assembly on December 21. Third, the rescue package put together by the IMF, ECB and World Bank in the amount of $26.2 bn contained immediate measures. All related policy steps focused on the urgent need to stabilize the financial system and sustain external financing for a highly vulnerable economy. A more comprehensive set of anti-crisis measures followed in April 2009. These measures contained both longer-term structural reforms and limited stimulus packages.

The driving forces behind stabilization policies were the government, the National Bank and external actors. The media continued to play a dubious role, often employing populist rhetoric that paradoxically characterized the IMF package as a new form of "exploitation" at the hands of "foreign lobbies," while simultaneously accusing the government of increasing citizens' financial and social burden instead of concentrating on ambitious new developments to be financed by higher deficits. The irrationality of such a proposal within the context of the crisis was more than obvious, and yet, neither the government nor the influential media provided a clear explanation as to why such tactics were not only impossible but highly irresponsible. Trade unions, except some in areas of public administration (e.g., teachers, police and doctors) or state-owned companies (e.g., railways, urban transportation) do not play an important role in the Hungarian economy. MÁV, the trade union for the state-owned railways, has been the only "militant" opposer to reforms, having conducted several strikes without offering any constructive or forward-looking plan. In March 2009, the employers' association initiated and directed the "Reform Alliance," an initiative that includes business leaders, experts and scholars provided suggestions emphasizing a forward-looking strategy based on new stimuli and a radical redistribution of budget expenditures.[4] Some elements of these recommendations have been included in the government's action plan.

Most of the stabilization measures were launched as parliamentary laws. Despite previous differences in opinion among the two coalition parties (and within the Socialist Party) about the contents and speed of stabilization measures, members of the National Assembly of both parties showed an unprecedented unity in approving the government's plans. This discipline continued even when the smaller coalition party, the Hungarian Liberal Party (SZDSZ), left the government. All anti-crisis proposals have been approved

[4] László Békesi, Attila Chikán, and Péter Oszkó, "A Reformszövetség tézisei és javaslatai (Theses and Recommendations of the Reform Alliance)," Budapest, February 21, 2009.

with the support of the SZDSZ members of the National Assembly (including the budget for 2010). The opposition, which has repeatedly rejected the draft laws, has nonetheless failed to slow, let alone hinder the laws being approved and implemented. Nevertheless, its leading representatives continue to emphasize that, once their party comes to power (which is probable) in the spring of 2010, all policy measures taken by the current government, mainly incorporated in the 2010 budget, will be withdrawn.

During the first year of the government's response to the financial crisis, sectoral or regional lobbies have generally remained passive. This passivity can be explained partly by the fact that such lobbies in Hungary have traditionally been weak (with the exception of some public administration trade unions and those for some state-owned companies) and partly by the fact that the urgent need for stabilization is generally understood and/or accepted among such lobby interests. However, only the Reform Alliance offered cooperation, which was itself half-hearted. Open conflicts emerged only with the railway trade unions. Another and potentially more important conflict could arise between the government and the self-governments representing regional and local interests as they go about approving and implementing the 2010 budget, in which allocations to self-governments are set to be significantly reduced (by about HUF 70 bn, or €260 mn). It should be added that most self-governments debts, some of which are in foreign currencies, have increased in the last years, and they now lack any remaining major assets that could be privatized to finance their shaky situation.

- Did policymakers actively consult domestic and/or foreign experts outside of government?
- Did the government actively seek collaboration with other governments or international organizations?
- Did the government participate in multilaterally coordinated rescue efforts?
- Was the government curtailed in its response through IMF support programs?

Consultation with external experts and openness to international collaboration

The sudden nature and immediate negative impact of the crisis on the Hungarian economy left the government very little time to consult in-depth non-governmental experts. Coming during the tail end of a period in which the Hungarian government (had rather quickly) cut its budget deficit from 9.2 percent in October 2006 to 3.4 percent by the end of December 2008, the crisis' "surprise" effect was tremendous. The Hungarian government therefore sought primarily foreign expertise, which resulted in a rapid support scheme announced by the IMF (together with the ECB and the World Bank). Whereas cooperation with international partners—conducted behind the scenes—went smoothly, consultation with domestic actors remained very limited. Cooperation with domestic actors is weak in large part because of the deteriorating relationship between the government and opposition underway since 2002.

The European Commission also initiated steps to include Hungary (and other Central European new member countries with flexible exchange rates) under the umbrella of the European Central Bank. However, in contrast to its approach to the Danish krone, the ECB did not extend its support to the national currency-denominated government bonds of Hungary, the Czech Republic, Poland and Romania and was not ready to counteract the (temporary) "financial blockade" imposed by foreign banks and financial institutions. More effective was the Hungarian government's effort to restart liquidity flows from the parent banks to subsidiaries which have provided the lion's share of the profit in recent years. As a result, in May 2009, parent banks of the six largest foreign banks operating in Hungary made a joint declaration (with the European Commission in the background) to maintain their overall exposure to Hungary and ensure "prudent capitalization of their subsidiaries."[5]

The IMF package of October 2008 was the only and decisive multilaterally coordinated rescue effort. There were, however, three other initiatives worth mentioning. One, launched by Austria at the end of 2008, aimed to protect its high stake in Central and Eastern European banks and its high exposure to debts (about 80% to 100% of Austrian GDP). The effort was silently backed by Hungary (and other countries of the region) but was not accepted by the European Commission. A second coordinated action involved the common verbal warning (intervention) issued by the central banks of Hungary, the Czech Republic and Poland in March of 2009 to those involved in international speculation—an endeavor which had seemed to substantially contribute to the rapid depreciation of the respective national currencies. Finally, the Hungarian prime minister (Gyurcsány) presented in Brussels a unilateral proposal for a special rescue plan for all new member countries in general, and in particular for those without a currency board. Insufficiently coordinated with neighboring countries in the same predicament, this proposal fell on more-or-less deaf ears. The rescue package offered by the IMF and accepted by the Hungarian government was the *sine qua non* of avoiding financial collapse and restoring financial stability.

[5] Reuters, "Foreign Banks Pledge Support for Units in Hungary," http://www.reuters.com/article/idUSLK27478520090520 (accessed November 20, 2009)

3. Policy Content

- How large is the stimulus package as expressed as a percentage of GDP (including compensations to those hit particularly hard by the crisis through social/labor policies)?
- The stimulus is spread over a period of how many years?

Scope of stabilization and stimulus policies

Given the state of its economic affairs, the Hungarian government had to concentrate on stabilizing the situation before any stimulus policies could be initiated. Its crisis management program included the following four broad goals:

- to manage the impacts of the crisis immediately and comprehensively;
- to rebalance the economy by reducing further the budget deficit, followed by reducing the public debt and the diminishing current account deficit;
- to restore confidence in the country's economy (among both external financial markets and the Hungarian public),
- to stimulate sustainable economic growth, paying special attention to higher output, while at the same time minimizing the economic and social impacts of (temporarily) higher unemployment.[6]

Any plans for a stimulus program were subordinated to the need to successfully manage the crisis in the short term and re-establish internal and external economic balance. The government's unprecedented task consists to date in mitigating the direct negative consequences of the crisis while paving the way for post-crisis sustainable development. The degree of openness of the Hungarian economy and the current budgetary situation are factors constraining the manoeuvring room of economic policymakers. Given the prevalence of populist demands for artificial stimulation, the government could not sacrifice its key achievement of recent years: the stabilization of the budget. This left the government with precious few instruments to stimulate the economy, namely EU transfers and budget savings that freed some resources for financing well-defined priorities.

The targeted budget deficit for 2010 is 3.9 percent. If met, this would be one of the lowest deficits among the EU-27. As a result, public debt, which is

[6] For details of the program see Magyar Köztársaság Kormánya (Government of the Repulic of Hungary, "Válságkezelés és bizalomerősítés. A válságkezelő kormány egyéves cselekvési terve" (Crisis management and confidence-strengthening. One year action plan of the crisis managing government); Budapest, April 20, 2009.

still increasing and is expected to reach 80 percent of GDP in 2010, will start returning to the Maastricht level of 60 percent as of 2011—years earlier than the levels projected for most EU member countries. At present, further budgetary restrictions seem unavoidable. In 2009, the impact of restrictions is expected to be around HUF 400 bn (€1.5 bn) and in 2010 another 900 bn (€3.3 bn). The amounts represent about 1.5 percent and 3.3 percent of GDP respectively. The above savings, together with the hopefully accelerated availability of EU transfers, will provide resources of HUF 1,400 bn (€5 bn, 5% of GDP) for supporting business activities and protecting jobs. The government has also launched a special program of HUF 1,800 bn (€6.5 bn, 6.5% of GDP) to support the construction industry with the aim of starting or completing 600 important investment projects.

The stimulus is expected to start in the second half of 2010 and to be spread over several years (the exact timeframe has not been established). The delay is due to two main factors. First, despite the accelerated access to EU funds, the flow of money needs substantial time and has to take into account that the cohesion fund (like most other EU funds) is based on post-financing rather than pre-financing. Second, budgetary restructuring has to free up domestic resources if it is to finance any stimulus package. Even the use of the EU transfer is linked to national co-financing, the sources of which have to be created before the EU money can be utilized. In fact, the EU cohesion fund is proving to be the major anti-crisis financial instrument in Hungary. In addition, this money can be used without any previous consent by the IMF. Apart from EU transfers, Hungary can only generate additional resources for any stimulus package if money becomes disposable from the restructuring of the budget (either higher income or lower expenditure or the combination of both).

Targeting and coverage of policy tools

- How is stimulus spending distributed across sectors? How and to what extent is the financial sector supported (e.g., through loans, guarantees, capital injections)?
- Which industrial and structural policies (e.g. corporate tax cuts, subsidies, company bail-outs) can be observed?
- What kinds of measures target the expansion of public spending on infrastructure? Which ones are designed to sustain business and consumer spending?
- Are policies in support of businesses adequately targeted and delineated (e.g., at creating employment, supporting competitive firms)?

Hungary avoided a major banking crisis by making use of different instruments. First, the stand-by agreement with the IMF at the beginning of the crisis proved crucial. By the end of June 2009, about €8.6 bn out of the total IMF credit of €12.7 had been used. Almost half of the sum total (€6.5 bn) ultimately served to refinance the country's external debt through the repurchasing of the stock of expiring state bonds. The rest was used to help stabilize the banking system by partially recapitalizing the Hungarian Development Bank and making a symbolic contribution to the recapitalization of foreign-owned banks. Second, after having temporarily suffered a liquidity dryout, foreign-owned banks began financing their subsidiaries in Hungary once again—without the need for additional intervention on the part of government. Third, financial stabilization substantially reduced the outstanding foreign-currency denominated debt of Hungarian citizens. Improving the exchange rate of the HUF (from 310 to 270 per euro) reduced the outstanding external debt stock of Hungarian families by HUF 400 bn (€1.5 bn). Other factors also proved crucial, including:

- the government and the National Bank introduced several new facilities to avoid a critical level of bankruptcy among private citizens (and families). The measures included instituting longer repayment periods. Higher monthly repayments due to a deteriorating exchange rate have been avoided by extending the period of repayment from about 10 to18 or 20 years, which is still a relatively modest period compared with mortgage obligations in other countries;
- encouraging foreign currency debtors to change to HUF-based credits. The National Bank introduced a six-month swap tender in the amount of €5 bn, of which the domestic banking sector readily applied for a sum of €3 bn;
- stimulating inter-bank liquidity flows, including agreements with foreign-owned banks;
- stabilization of the exchange rate;
- placing restrictions on additional credit-taking, particularly in foreign currency (the credit/deposit ratio that had reached 150 percent in October 2008, started to decline rapidly in the second half of 2009;
- special treatment of persons unable to service their private debt due to unforeseen developments (mainly through a job loss);[7]
- elaboration and enforcement of a new “behavior code” for banks.

Before any structural development priorities could be set, the government had to restore budget equilibrium. In the public sector, this has meant that nominal gross wages have been frozen for the next two years. In addition, the traditional bonus equivalent to one month’s basic salary (the so-

[7] For details, see Law No. IV of 2009, published on March 10 of the same year, but enacted on July 28, after being approved by the European Commission . It must be noted that while there are 700,000 mortgage contracts in Hungary, the total number of citizens with such contracts is substantially lower. Before the crisis, many individuals made use of the extremely favorable conditions for taking credits in a foreign currency and started several ventures at the same time. Moreover, an unknown (but large) segment of the credit-takers had very ambitious plans of construction (houses up to several hundred square meters). Therefore, government support (or, in other words, the utilization of tax-payers’ money for bailing out irresponsible citizens) had to be very much target-oriented to avoid the aforementioned traps.

called13th month salary) has been abolished in order to save jobs in public administration, and the monthly wage of government members was reduced by 15 percent. Persons in leading positions and employed in majority state-owned companies were asked to pay part of their salaries (totaling more than HUF 2 mn per month) into a special crisis fund established by the government. Per diem allowances for traveling abroad were also reduced. Costs connected with memberships in boards of directors or supervisory boards of state-owned firms were reduced by 50 percent. In addition, a large amount for special bonuses (generally to be paid after several years in service or before retirement) for leading positions in public administration were suspended. Although the need for structural policies was acknowledged from the very beginning of the crisis, the financial instruments needed to implement them were not immediately available. It took several months before the government could generate the necessary resources and international confidence to announce its stimulus packages. Targeting the double objective of job creation and enhanced competitiveness, the following sectors have been identified as priority development areas:

- road transportation;
- logistics;
- pharmaceutical industry and biotechnology;
- info-communication technologies.[8]

Each program is incorporated into an "action plan" that was approved in the summer of 2009 and requires ongoing coordination among different ministries. Special programs have been approved for agriculture (i.e., credit programs, bank guarantees for the food industry), tourism (i.e., a special VAT rate) and, as already mentioned, the construction industry. Except for the one targeting the construction industry, no action plan has been provided a concrete sum of money. The necessary financial resources have to be raised outside the central budget either through normal credit lines or by participating in EU-financed projects. Special attention will be paid to small- and medium-sized companies (SMEs) by intensifying the financial activity of the Hungarian Development Bank, starting special programs with preferential financing, and granting credits for enterprise development. Other means of focusing on SMEs, such as bank guarantees and recapitalization, will be provided through the New Hungary Development Plan.[9] This plan is based on the availability of €22.4 billion in EU transfers to be provided by

[8] Ministry for National Development and Economy, "Ágazati akciótervek" (Sectoral Action Plans) October 8, 2009, http://www.nfgm.gov.hu/print/feladataink/akciotervek/agazati_akciotervek.html (accessed November 20, 2009).

[9] The Government of the Republic of Hungary. "The New Hungary Development Plan 2007-2013" (National Strategic Reference Framework of Hungary). Accepted by the Hungarian Government on October 25, 2006.

the EU's financial framework between 2007 and 2013. Several development programs that draw upon a comprehensive development strategy and national co-financing have been elaborated within this framework to facilitate the modernization of public administration, growth, employment, competitiveness, environmental protection, education and training, and physical infrastructure development.

Public spending on infrastructure is largely linked to EU transfers. The Hungarian government contributes to this through co-financing, which can fluctuate from 15 percent to 50 percent, depending on the type of project and transfer involved (e.g., regional policy, cohesion policy, cross-border cooperation, etc.). Most infrastructure projects fall within the areas of road and railway transportation, urban transportation and environment.

In order to alleviate the fiscal burden on employers and stimulate job creation, employers' employment-related contribution to the central budget has been reduced by five percent. An additional five percent reduction will follow in 2010. Tax declarations for business will be simplified. Personal income tax reform includes raising the bottom-line of tax payment to an annual income of HUF 1.9 mn in 2009. In 2010, tax rates in both the lower and upper brackets of tax payment will be substantially reduced (from 18% to 15%-17% in the lower and from 36% to 32% in the upper bracket). More importantly, personal income taxed in the lower bracket will be extended from HUF 1.9 million to HUF 5 million in 2010, and to HUF 15 million as of 2011, which will favorably affect 90 percent of taxpayers. Policies in support of business are more adequately targeted and delineated than before. But it is not easy to harmonize both priorities, namely job creation and competitiveness. Indeed, like the business sector, the labor market is also characterized by a high level duality. Job creation should therefore envisage both greater competitiveness and the absorption of "idle" labor—in other words, the relevant reduction of inactive persons by incorporating them into the official labor market. Since many of these individuals lack the necessary skills (and flexibility, personal attitude, etc.), creating this dual labor market will be difficult. Concerning the enterprise sector, the potential multiplier (spillover) effects of any project to be financed with EU transfers should become part of the feasibility study. Hungary's "entrepreneurial density" is several times higher than that found in developed EU countries. A more competitive, healthy and socially just entrepreneurial sector would need substantial reform in order to reduce the number of non-viable companies, stimulate mergers and acquisitions (i.e., facilitate concentration), and to develop a monitoring system that is more effective in battling tax fraud and corruption.

- Are stimulus measures influenced/limited by pre-crisis development strategies (e.g., industrial policies) or have novel/additional (e.g., environmental) policy objectives been inserted?
- Is the response to the crisis grounded in a broader developmental perspective (i.e., crisis as development opportunity) or predominantly short-term political constituency logic?
- Do stimulus policies address prevailing structural deficits and future growth potential?

Development as an objective of stimulus policies

The global financial crisis neither fundamentally altered the core of Hungary's structural modernization nor thwarted its process of catching up with the more developed EU members. All major programs elaborated in cooperation with the respective EU authorities have remained in place. In fact, projects in Hungary that are cofinanced by the European Union have become even more important, given the Hungarian government's lack of additional budgetary resources. Since the Hungarian economy is based on modern sectors, further industrial/structural policy should not single out new sectors but should deepen the current structure's capacity for value-added and technology-incorporating products and activities. Two additional sectors in need of resources must be noted here: agriculture and environment-related activities. As a "forgotten" sector, agriculture has been the main victim of Hungary's transformation in the last twenty years, and remains hostage to short-sighted domestic and party-political controversies. Whereas agriculture accounts for less than 5 percent of GDP, people engaged fully or partly in agricultural activities represent at least 20 percent of voters. Environmental industries are adequately represented if judged only by the number and size of projects. Little emphasis, however, has been placed on creating an environmental sector that could meet an increasing share of the demand in environmental development. Crisis management and the subsequent identification of structural priorities do not reflect the importance of environmental industries in post-crisis sustainable growth and environment-friendly development.

Within the Hungarian economic context—especially given the fact that the government had to react so quickly to prevent economic and financial collapse—there has been no means of transforming the global financial crisis into a development opportunity. Once financial stability appears to have returned, longer-term perspectives will have to be elaborated. Compared to other countries that have dismantled the instruments needed to bail out entire sectors, sustain non-competitive modes of production and labor by creating a substantial budget deficit and ballooning public debt, Hungary may be better-positioned in the post-crisis period. However, the lack of a future-oriented approach among party politicians in Hungary and their inability to reach a consensus on longer-term objectives constitute a major problem.

Another problem is the low level of concern for the future found within society, which is an obvious consequence of the "premature consumer behavior."

At present, neither the financial resources nor the potential impact of sectoral priority programs are known. In sectors other than the agriculture sector and environmental industry, structural deficits should be eliminated or mitigated, and future growth potential should be created within the current manufacturing structure by increasing domestic value added, enhancing technology, and improving other competitiveness factors. Doing so should entail a continuing process of upgrading transnational companies located in Hungary, deepening cooperation between large and smaller companies (both foreign and domestic), and the stimulation of new firms with growth potential while adhering to the EU rules of competition.

National bias and protectionism

- Has the stimulus included "buy national" clauses? Have import-restricting mechanisms been newly established or re-established?
- Has the country's executive/central bank manipulated the exchange rate or intervened in the foreign exchange market (if so, in which direction)?
- Have there been measures to prop up export industries (e.g., tax rebates, direct export subsidies)?

The Hungarian government has not introduced any overtly "national" measures. As an EU member state, Hungary does not have any means of restricting the free flow of trade or capital within the EU framework. In the extra-EU context, Hungary has generally applied very low common external tariffs.

Hungary has a free-floating currency; the forint's previous +/- 15 percent margins were abolished in February 2008—before the crisis. The National Bank can do very little to limit the volatility of the exchange rate. Indeed, it intervened only once—verbally and in cooperation with the Czech and the Polish central banks—in March of 2009, when the forint and other regional currencies reached a record low.

About 80 percent of exports are carried out by transnational firms operating in Hungary. If the inputs by local small- and medium-sized subsidiaries are included, the share may be even higher. Foreign (and domestic) firms still enjoy some benefits linked to job creation or setting up new production facilities in underdeveloped regions of the country. Most of them will expire between 2009 and 2011 due transitional rules negotiated with the European Union prior to accession. No additional instrument has been used to counteract the dramatic decline of exports that began in the last quarter of 2008. Theoretically, the only efficient means of doing so would have entailed a ten to fifteen percent devaluation of the forint from its artificial peak in June of 2008 (i.e., from HUF 240/euro to HUF270-275/euro). Interestingly, the exchange rate benefit did not mitigate the drop in exports in markets with appreciated currencies (mainly the eurozone). The reasons for this should be explored through more in-depth analyses.

Social protection

- Which labor market policies have been enacted (e.g., unemployment benefits, rise in public-sector employment)?
- Which social policies have been included (e.g., expansion of support, additional investment in health and education system)?
- Which measures have been taken to support purchasing power (e.g., consumer checks, tax cuts, cash transfers)?

Budgetary constraints and immediate external stabilization pressure have not only prevented Hungary from applying large-scale stimulus packages, but they have seriously limited the scope of social policies as well. The Hungarian government has also implemented a very expensive social policy in the last few years that has been accompanied by a low activity rate, an inefficient and overstaffed public administration system, and rapidly increasing external debt. At the outbreak of the crisis, social expenditures amounted to 21 percent of GDP, several percentage points higher than that found in countries with a comparable development level (e.g., Czech Republic, Slovakia, Poland, the Baltics). Slovenia alone had a similar share of social welfare expenditures in GDP (more developed EU members generally report about 25%). In addition, the structure of social welfare costs has not facilitated higher activity levels on the labor market. Family allowances, sick leave, housing support, early retirement schemes and disability pensions have substantially exceeded the economy's performance capacity and contributed to the external financing of social expenditures. Hiring in the overstaffed public administration has been halted. At the same time, several projects targeting increased public sector employment (e.g., public works, rural environment,) were started well before the crisis. In order to protect existing jobs, several measures were taken, including:

- abolishing the "13th month" salary bonus in order to avoid massive redundancies in public administration;
- introducing the 4+1 formula (four days of work and one day of training in a week) in several companies in order to save about 50,000 jobs that were based on EU transfers totaling HUF 20 bn (€720 mn) and launched in May 2009;
- stimulating part-time employment;
- supporting the creation of new jobs (by wage support);
- introducing comprehensive retraining programs for employees who lost their job as a consequence of the crisis;

- accelerating job-creation programs in EU-cofinanced operative programs;
- updating the legal environment by approving a law on regulated labor relations.

The government was forced by circumstances to simultaneously consider large-scale and ill-targeted social policies, cut previous benefits, and restructure basic social priorities. Doing so produced the following results:

- sick leave benefits were reduced by 10 percent (from 70% to 60% of salary);
- family allowance amounts were frozen for a two-year period;
- the age of entitlement recipients was reduced from 23 to 20 years;
- in order to encourage young women to return to the labor market, the entitlement periods for two different kinds of child allowances were reduced from three to two years; at the same time, an extended nursery and kindergarten program was launched
- the highly ineffective housing subsidy program that had stimulated speculation was suspended
- compensation for heating costs to low-income families will be gradually phased out
- subsidies for child care and children’s meals in schools have been extended.

Hungary’s pension system is another social policy area in which reforms have been introduced. In the wake of the economic turmoil, the government has decided to gradually increase the pension age to 65 years. Pension benefits in 2010 will not continue to increase according to the “Swiss formula” (which assumes parity in wage and inflation increases) and the adjustments for 2009 have been rescheduled. Further steps include canceling the second part of the 13th month pension, and moving to a scheme in which “pension premiums” are linked to effective GDP growth in a given year. Restrictions have been introduced to counteract the large-scale (mis)use of early retirement. Equally important, the entire system of disability pensions will be revised, as there are more than 600,000 persons receiving such benefits in Hungary. The government will replace the previous and highly distorted housing support system with a more well-defined project targeting beneficiaries below 35 years old or those 45 or younger with dependents. The support will focus on a preferential interest rate to be paid for housing credits in local currency.

Personal income tax reform is the key policy intended to support purchasing power. As already mentioned, the lowest taxable annual income will increase from HUF 1.9 mn to HUF five mn in 2010. As of 2011, annual personal income not reaching HUF 15 mn will be subject to a tax rate of 17 percent. The current tax rates of 18 percent and 36 percent will be reduced to 17 percent and 32 percent, respectively. According to the government's calculations, more than 1.3 mn people in 2009 had at their disposal a net additional sum of HUF 36,000 (€135). Starting in 2010, 90 percent of the taxpayers will belong to the lower income bracket requiring a 17 percent tax rate. As a result, annual disposable incomes will be increasing by one-and-a-half months of salary. Based on an average employee salary of HUF 200,000 (€740), this equals a net increase of HUF 180,000. Tax increases in other areas will compensate for this lower tax burden. The most important measures include an increased VAT (25% as of July 2009, 18% for some basic commodities and services), a five to six percent increase of excise duties (mainly alcoholic drinks and tobacco), the introduction of a property tax, which is an important instrument in achieving more equitable redistributions of welfare, and the domestic taxation of income and property transferred into different tax shelters.

4. Implementation

- Does the government actively communicate and justify the rationale/goals of its stimulus policies to the public?
- Over time, how has the public responded to the government's management of the crisis (e.g., consumption/investment trends, public opinion polls)?

Political communication

Beginning in October 2006, the government tried to communicate the necessity of its austerity policy and the steps it was taking to bring down the budget deficit to acceptable levels. At the time, much of the public viewed the austerity program as a provisional measure long completed by 2008. In fact, private borrowing in foreign currencies hit new records in the first full year (2007) of the austerity program, as many hoped for a quick return to sustained and higher growth. The severe impact of the global crisis in October 2008 took Hungarian society by surprise. Only two years after the first austerity program had been announced in October 2006, another announcement introducing additional tightening failed to fully reach a partially apathetic public prone to demagoguery. As a result, the government faced devastating defeat in the March 2008 referendum on health care, education and other reforms, and the opposition inflamed passions through the use of unprecedented populism. The government's credibility in crucial segments of society suffered, partly because of its own failure to communicate its achievements, difficulties and new challenges, but also because of the harsh "counterwind" generated by the political opposition and selected interest lobbies. Following on the heels of two major stabilization packages, the communication of rather moderate stimulus policies made little impact.

Opinion polls clearly show that a large part of the citizenry does not believe the government's bold-to-unique measures to stabilize the economy and regain confidence did much to help them. This view stands in direct contrast to that among international observers, who consider the Hungarian management of the crisis a success. In fact, the domestic popularity of the government and the new prime minister continued to sink.

There appears to be a high level of ambiguity or even hypocrisy within public opinion. On the one hand, Hungarian society has become much more rational concerning its credit-taking and consumption patterns. As it turns out (though close observers have known this for many years), the population's economic and financial reserves have been much higher than anticipated both by public complaints and official statistics. The gap in GDP per capita between the Czech Republic and Hungary is much smaller than reported, and presumably better-off countries such as Slovakia and Estonia do not have higher living standards than Hungary. On the other hand, the widespread illusion that the (in 2008) opposition would immediately resolve all problems and restrictions could not be dispelled. Patterns of overconsumption, combined with an irresponsible approach to the future continue to characterize the vast majority of supporters of the current opposition. At the moment, no government or independent expert-driven communication promises any significant turnaround.

- How large has the time lag been between adoption and implementation of selected major stimulus components?
- What are the reasons for delay in implementation (e.g., legal barriers, insufficient capacities, corruption)?
- Have sectoral or regional interest groups influenced the workings of policy implementation in any way?

Modes and time frame of implementation

When assessing the Hungarian government's performance, one must differentiate between its management of the crisis and the stimulus package introduced. The Hungarian government acted immediately, both on various levels of domestic economic policy-making (e.g., government measures, National Bank actions) and within international fora (e.g., obtaining support from the IMF, ECB and World Bank a few days after a highly critical economic situation emerged). Further crisis management measures quickly followed. Several laws regulating financial services, the stability of the banking sector and the position of indebted persons were submitted to the National Assembly between October 10th and 18th of 2008. These laws went into force by December of the same year. Other proposals to restructure the 2009 budget emerged shortly thereafter. Another set of proposals with long-term consequences for the Hungarian economy were submitted in the spring of 2009. After having long been delayed, these long-term proposals were largely approved before the summer. During the first few difficult months of the crisis, stimulus measures were kept on the back burner.

Most of these measures have been incorporated into the budget for 2010 which—in contrast to previous years—was submitted to the National Assembly two months earlier than usual. This was done in order to provide members sufficient time to discuss the major items and introduce, if necessary, modifications—without jeopardizing the deficit target of less than four percent in 2010. In addition to the several dozens of budget modifications proposed by the governing party and its previous coalition partner, the opposition parties proposed more than 1,500 modifications to the budget. But only some of these modifications have been incorporated into the final budget draft eventually approved by a clear majority in the National Assembly. The lion's share of the modifications either lacked reasonable arguments or called for an increase in spending without stating where the additional resources should come from. Another larger set of modifications had little to do with the budget and served the needs of a populist campaign.

In sum, the government was forced to be quick and decisive in introducing most measures, including some rather unpopular ones, such as the elimination of the 13th month salary and pension. An appropriate form was found to combine most of the proposals into a draft law requiring a simple majority in the National Assembly, which, in an unprecedented show of bipartisanship, approved the law unanimously. President Sólyom slowed the process somewhat by demanding time to "study" selected draft laws, which he then sent back to the National Assembly for reconsideration, but this didn't cause any lasting harm. Generally, the second-round decision ignored the president's complaints.

The stabilization program in general and the 2010 budget in particular may have substantial effects on the income and welfare positions of several interest groups. The only clear winner is the health care system, which will receive more resources in net terms (when adjusted for inflation). In nominal terms, public security and the protection of order will receive a two percent increase. The largest cuts will be registered in social welfare expenditures (HUF 156 bn / €570 mn) and education (HUF 130 bn / €480 mn). In addition, cuts to subsidies for private household energy consumption will result in savings of HUF 55 bn, while abolished support for housing will reduce the central budget's expenditure by HUF 48 bn and the new pension system by HUF 80 bn in 2010 (i.e., €205, €180 and €300 mn, respectively). In addition, one must mention declining environmental expenditures (by HUF 85 bn /

€315 mn) and, following many years of inertia, cuts made to subsidies to the state-owned railway company and to firms operating urban transportation (by HUF 40 bn / €150 mn). Moreover, agriculture will have to reckon with considerably less national support (reduced national co-financing accompanying the yearly growing direct payments from EU sources) for which EU transfers can partly compensate (for the main items of the 2010 budget see Table 1).

Since most of the measures will become effective as of January 2010, it is not possible at the time of this writing to identify the potential impact of sectoral and regional interest groups on the government's policy implementation. In recent months, the following three lobbies showed clear interests:

- the entrepreneurial sector, in the framework of suggestions formulated by the Reform Alliance for more business reforms and less social welfare spending;
- the influential trade union of railway employees (though its support is waning and it faces increasing opposition within society);
- the chamber of doctors, whose interests have received ambiguous support.

In the latter two cases, the direct or indirect support by the opposition party cannot be denied. Self-governments have formed an emerging interest group, but their budgets are likely to be reduced most significantly. Self-government subsidies from the 2010 budget have been reduced by four percent as compared to 2009, spelling for a net reduction of HUF 70 bn (€260 mn). Because more than 70 percent of the self-governments are in the hands of the opposition, this battle may be heavily loaded by short-sighted political considerations. In addition, as a result of irresponsible economic policies, a large number of the self-governments (both led by socialist and opposition mayors and councils) are struggling with huge deficits—partially in foreign currency—and lack any major assets still to be privatized that could bring income.

In most cases, the 2010 budget is expected to have both positive and negative impacts on different segments of Hungarian society. The main potential impacts have been summarized below.

Table 1: Budgetary impacts

Main categories	Expected benefits	Expected losses
Employees	growing net disposable income due to lower personal tax; lower wage burden contributes to safer workplace	higher VAT raises regular expenditures; selected subsidies will be cut or abolished
Enterprises	lower wage costs; overall tax burden reduced	private demand likely to fall due to austerity budget
Families	higher disposable income due to lower wage burden; target-oriented programs to bring women back to the labor market; higher capacity of nurseries and kindergartens for children; family-level tax allowance will be maintained	higher VAT increases costs of living; family allowance will remain frozen for two years
Future pensioners	pension is likely to preserve its purchasing power	rising pension age
Credit-takers in foreign currency	exchange rate risks are supposed to decrease	

Source: A Kormány válságkezelő programja (2009): 26.

- Beyond emergency stand-by programs with the IMF, has the government collaborated with other governments or international organizations in implementing its response to the crisis?

International or regional cooperation

The stand-by program with the IMF set the basic framework for cooperation with (other) international organizations. Hungary established additional contacts with the European Commission and the European Central Bank, with some (delayed) support for the region outside the IMF project, but without any comprehensive plan such as a bail-out or additional plan allowing for a stimulus. The government's cooperation with the parent banks of subsidiaries operating in Hungary proved more successful. In addition, Hungary reached a verbal agreement with the Czech and Polish governments at the height of the exchange rate crisis, which was fueled by international speculation against all freely floating national currencies of the region. The government's regular consultations with different governments, banks, effective and potential foreign investors and international rating agencies in communicating its crisis management and stabilization program proved to be its most successful activity, as this resulted in a regained confidence and trust in its program. However, unlike other countries in similar situations, the Hungarian opposition continued to seize any opportunity in international settings, and particularly in selected European Union fora, to lambast the government's actions.

5. Funding, Tax and Monetary Policies

- Has the government initiated tax reductions/incentive schemes?
- Have these been aimed at the private and/or the corporate, domestic or the foreign sectors?

Tax policies in support of stimulus/ stabilization

Since the beginning of the crisis, the government has pursued two goals with its tax policies. The following steps have been taken to help stabilize the budget: a five percent VAT increase (as of July 2009), the taxation of private property—that is, immobile assets such as housing, luxury cars and yachts—and the taxation of money transferred to tax shelters. Other steps taken, such as the abolition of 13th month bonus and pension-related measures (see "modes and time frame of implementation), have acted as "indirect" tax increases. On the other side of the fence, employers' tax burdens will be reduced in two steps and, more importantly, personal income tax will be substantially reduced in order to leave more money (net income) at citizens' disposal. Thus, both additional burdens and tax reduction schemes affect the private and the corporate sector alike. There is no difference between the domestic and the foreign corporate sector, except for the special tax holiday agreements signed with large transnational companies many years ago. However, these agreements are scheduled to expire between 2009 and 2011.

- What kind of policies did the central bank contribute to the national crisis response? Which unconventional measures were used to fight the crisis?
- If an independent national monetary policy is not feasible, were there substituting measures in the country's exchange rate policy?

Monetary and currency policies in support of stimulus/ stabilization

When the crisis hit Hungary it unleashed massive speculation against the forint. The National Bank responded by increasing base interest rates by an unprecedented 300 basis points, from 8.5 percent to 11.5 percent.[10] The National Bank also raised the guarantee limit for private deposits and tightened conditions for borrowing in foreign currencies. Evaporating liquidity—which had been supplied primarily by foreign banks—combined with the failed placement of a Hungarian state bond program on the international financial market (similar to the Polish and Czech experiences) forced Hungary's banks to open up new high-profit margin opportunities for poten-

[10] Interest rates reached their peak in November 2003 at 12.5 percent. This was followed by a policy of gradual interest rate reduction—which was probably slower than what inflation would have permitted—until September 2005, when they reached six percent. As of June 2006, rates began climbing from 6.25 percent to reach 8.5 percent by May 2008.

tial depositors. Rigorous competition among the banks began attracting available private liquidity, mainly in euros (receiving up to a 6% interest rate) but also in forints (receiving up to 13%), both of which were well above the official prime rate.[11] Given the macro-financial state of affairs, Hungary's international debt and its need for EU transfers, the government decided against taking any unconventional measures. Instead, it took two important steps, the first being the IMF standby agreement, which stabilized the Hungarian economy by increasing the National Bank's foreign reserves from €17 bn in September 2008 to more than €30 bn by August 2009. In a second step, the government reduced the bureaucracy involved with EU transfers and allowed for their accelerated flow, as stipulated in the financial framework covering the period between 2007 and 2013.

On the surface, national monetary policy remained independent, since Hungary did not follow (was not forced to follow) the path taken by the Baltics, Bulgaria or selected western Balkan countries. Hungary's free-floating exchange rate system has been a blessing and a curse at the same time. On the one hand, it has not prevented the National Bank from taking unconventional measures if necessary (though it has not done so since the crisis began). On the other hand, the free-floating system opened up the forint to speculation, which led to a highly volatile exchange rate, particularly from June 2008 through March 2009. Toward the end of 2009, things began to calm down as the forint oscillated between EUR/HUF 265 and EUR/HUF 275. In short, the government and the National Bank have the monetary tools to influence the forint's exchange rate levels. But Hungary's economic openness and high levels of external debt mean that the government is reliant on the active support of the IMF and the European Central Bank in cases where problems arise due to large-scale speculation.

[11] The program included fresh money only and did not include previously deposited money. In addition, it was a short-term program limiting high interest-rate payment for a maximum period of three months. In fact, starting in late spring of 2009, markets became much less turbulent and liquidity channels were reopened between parent banks and their subsidiaries and in terms of entrance to the international financial markets (i.e., new bonds were issued at much lower premium—about 100 basis points in the case of Hungarian bonds).

- Relative to conditions at the outset of the crisis, does stimulus funding have a solid foundation in monetary policy or in bond/credit markets?
- Is the program part of the normal budget/integrated into the budgetary cycle, or is it financed primarily from sources outside of the formal budget?
- Is there cross-level burden-sharing between center and regions (e.g., debt issuance, fund transfers)?
- Is financial aid given to banks/companies/households in a discretionary way or based on well-defined formulas (e.g., conditionalities)?
- Did the government make credible commitments to terminate its expansionary fiscal and monetary policies under (what kind of) post-crisis conditions?

Credibility of funding mechanisms

As per the IMF standby arrangement, Hungary did not introduce expansive monetary and fiscal measures. This may be a potential benefit for managing the post-crisis situation as Hungary will likely go into recovery (as of 2011) with a low budgetary deficit and declining public debt.

EU transfers and co-financing from the national budget overwhelmingly comprise Hungary's stimulus funding, none of which has derived from money raised on international bond or credit markets. There are no external budget resources available, and no special external budget funds have been created.

Revenues for the annual budgets of 3,170 self-governments in Hungary have two main sources: their own income (about 60%) and regular support from the central budget (about 40%). In 2009 and 2010, many self-governments will face serious financial problems due to plans to reduce central budget support somewhat (by 4% in nominal, approximately 8% in real terms) and to their expected revenue contraction as a result of fewer taxes being paid. To date, there are no plans to cut self-government spending. In fact, their expenditures are more likely to increase. Most self-governments are running on deficit spending. From 2005 to 2008, nearly 80 percent closed their annual budget with a deficit. In order to overcome the gap, most of them issued variable interest rate bonds, often in foreign currency. Although the largest share of these credits was supposed to be used for further investment (71%), current operational costs required 10 percent and debt management another 19 percent.[12] The following measures could help remedy the self-governments' increasingly critical financial situation:

[12] Self-governments have been allowed to take credits and to issue bonds from 1990, though without state guarantee. Their indebtedness began skyrocketing after 2005 (when assets to be privatized became scarce). Their total indebtedness reached HUF 695 bn by the end of 2007 (and probably about 1,000 bn by the end of 2008), or 2.5 to 3.5 percent of GDP. This indicator is much more favorable than the same figure for Italy (8%), France or the Netherlands (6% each). http://www.origo.hu/print/uzletinegyed/magyargazdasag/20080403

- Reduce the number of self-governments from 3,170 to about 500. A two-thirds majority-based draft law of this nature was submitted to the National Assembly, only to be rejected by the opposition. A reduction of this scale would spell for an immediate savings of a minimum of HUF 550 bn (nearly €2 bn). In some depressed regions it would also lead to increased unemployment, some school closures (for non-viable institutions), reduced health care and social services, and fewer railway connections.
- Transfer certain budgetary competences to the central budget. The self-governments will resist this kind of move for fears of their independence being compromised.
- Improve coordination between local and regional governance structures. The regional authorities established to meet NUT-2 status requirements and manage EU transfers should be compelled to coordinate efforts with other regions.
- Facilitate voluntary community building among the smaller self-governments in order to reach the critical minimum of rational operation and to be able to replace costly and fragmented local investments by access to EU funds (plus national co-financing).

Apart from the selected banks that have been partially recapitalized by the injection of IMF funds, no other financial support has been provided to banks or companies. The available resources for businesses are overwhelmingly linked to EU transfers that have well-known evaluation criteria and conditions. Improvements to the EU transfer system could be made (and the failure rate reduced) if evaluations contained feasibility studies on the potential spill-over effects of projects submitted for support. The government has set up a modest “solidarity fund” in the amount of HUF 1 bn, which is intended to grow through the voluntary offers of high-income public servants, directors of state-owned entities, and any other citizen wishing to contribute. This fund is slated to provide those individuals and families hit particularly hard by the crisis with a one-time imbursement of HUF 20,000 to 50,000 (€75 to €185). The conditions have been clearly set (e.g., average income, loss of job, previous record of employment, etc.) and payment has to be carried out by the local self-governments. Still, some attempts of abusing/misusing this fund have already been reported.

6. Feedback and Lesson-Drawing

- Have there been revisions or additions to the original policy packages or a sequence of distinct stimulus policies in response to unexpected new developments?

Policy feedback and adaptation

The original policies envisioned to achieve financial stabilization have not been watered down in implementation. Although more than 1,500 proposals to modify the 2010 budget by increasing funds for selected targets have been presented (mostly by the opposition), only a small number of them have been incorporated into the final budget draft. These modifications have been offset with appropriate cuts to other items. The "crisis managing government" (as the prime minister referred to his own government) was able to stick to the original budget deficit figure of 3.8 to 3.9 percent of GDP. In addition to preventing its budget deficit level from increasing, the government also boldly restructured some of the more sensitive social welfare items in the budget and achieved an unexpectedly high trade surplus (about €4 bn) in 2010. A more-or-less balanced current account has improved overall prospects. As a result, international financial channels opened up to Hungary and the country was able to place and sell government bonds totaling €1 bn in July 2009 under favorable conditions. The fourth installment of the IMF credit in the amount of €1.4 bn has therefore not been invoiced and a much smaller amount of €55.4 mn was drawn instead. According to the latest IMF revision in September of 2009, the IMF credit line has been extended to October 5, 2010. This means that the remaining resources can be used by the new government following the national elections, likely to be held in April 2010.[13]

Unexpected new developments include the National Bank's rapid and continuous reduction of the interest rate (from 10.5% in December 2008 to 7% in October 2009), as well as regained confidence in the Hungarian economy on the part of international financial organizations and credit institutes.

Considering these favorable but nonetheless provisional developments, the government did not change its targeted budget deficit for 2009 and 2010. At the same time, the government took steps to provide itself a bit more latitude in developing stimulus policies, but has not—to date—given any meaningful or effective financial support to priority areas. The rapid growth of unemployment might force some compositional changes being made to the

[13] In addition, due to the IMF's two-stage recapitalization of the banking sector, as a member, Hungary is entitled to received another $1.6 bn. For more detail see: *hvg*, September 12, 2009. p. 83.

stabilization package, but not at the expense of increasing the deficit target. Despite political pressure to act otherwise, the government has repeatedly stressed that it will not sacrifice the 2010 budget to electoral politics.

- Has major institutional reorganization/capacity-building been undertaken in financial supervision?
- Do we find new institutions that were not in place prior to the crisis (e.g., bad banks)?

Institutional restructuring

At the same time as the Hungarian Financial Supervisory Authority (HFSA) conducted negotiations with international institutions (i.e., the IMF, World Bank, EU and ECB), the National Assembly granted it new powers of oversight over domestic financial institutions that were slated to receive government money in the form of capital or guaranteed liquidity. The HFSA set up special task forces (i.e., working groups) to monitor key players' liquidity on a daily basis. A new project has since been launched to pursue in-depth supervision of the eight largest banking groups. However, as of this writing in November 2009, the HFSA has not been able to expand its capacity through additional personnel or outsourcing, and its area of competence has not been broadened.

No special bank has been established to deal with non-performing credits. This task has remained under the authority of individual banks. Thanks in part to partial recapitalization deriving from the IMF credit, and in a much larger part to the fact that parent banks' liquidity sources have reopened, individual banks in Hungary have been able to manage problems associated with non-performing credits. It should be noted that despite the very high number of borrowers in foreign currency (approximately 1.7 million transactions as of 2009), the default rate has remained very low, which is in part due to the high level of collateral. It is unclear how this will develop over the next months and years.

7. Tentative Economic Impact

- What do major economic performance indicators tell us about the short-term effectiveness of the crisis response (e.g., growth rate, unemployment rate, industrial output, private consumption, consumer/producer confidence, inflation, exports, bank balance sheets, credit squeezes)?
- How has the political logic of crisis management (i.e., crisis as an opportunity to broaden political support) worked out for the major decision-makers so far? How has the reputation of major government leaders at the center of the crisis response evolved (e.g., based on polls, election results, backing within their political party)?

Economic and political effectiveness of the crisis response

The government successfully averted Hungary's financial and economic collapse in the short term. The attempts to stabilize the budget and Hungary's debt position have been successful. Within a single year, from 2008 to 2009, the National Bank's official foreign reserves grew from €16 bn to more than €30 bn. Other measures and communication taken by the government contributed to enhanced international credibility. There have been costs associated with these measures, however, as GDP is expected to have contracted by 6.5 percent to 6.7 percent for the entire year of 2009 and near-stagnation (-1% to +0.5%) is forecasted for 2010. Another burden-bearer is the labor market, where official unemployment has grown rapidly, exceeding the ten percent mark in October 2009. It is predicted to reach 11 percent by mid 2010. Private consumption fell by 4.2 percent in the first eight months of 2009 (as compared to the same period a year ago), mainly because real income dropped by 2.1 percent (resulting from 0.3% income growth of private business and from a 7.9% reduction of sectors belonging to the central budget) and borrowing in foreign currency declined spectacularly. Following several years of falling or even negative national savings, the savings rate began to during 2009. It should be noted that collapsing external demand rather than declining domestic demand has been primarily responsible for the two-digit decline in manufacturing output. Inflation throughout 2009 remained below four percent, despite the increase of the value-added tax from 20 to 25 percent introduced in July 2009. Hungary's trade balance improved dramatically and its traditionally huge current account deficit disappeared. As a result, the country's debt financing capacity took a qualitative step toward sustainable stability. The banking sector can now survive short-term negative impacts, although further challenges may lie ahead. Higher unemployment levels and recapitalization problems with SMEs could lead to an increase of bad and non-performing debts.

Continued successful stabilization depends on two factors. First, the government's austerity policy and continued strict budget constraints are essential. Second, global economic recovery is necessary if the government is to have the latitude to implement policies targeting sustainable and higher-growth development. Without the latter, an open, small and vulnerable economy will not be able to restart growth and raise income levels.

A growing part of the population seems to recognize the positive short-term results of the government's crisis management. Nevertheless, this has not (yet) manifested itself in growing political support for the government (and even less so for the governing socialist party). In fact, the opposite has taken place. There are several criticisms, including the partly justified complaint that the socialist-liberal government that was in power from 2002 to 2008 is to blame for the current economic malaise and anger over old and new corruption affairs. Growing populism and the absence of reform-mindedness among large parts of the population have created conditions conducive to increasing the popularity of FIDESZ, the major opposition party, and the far right. In October 2008, the ruling socialist party registered 20 percent of voters' support; the major opposition party, FIDESZ, had 31 percent and the extreme right party ("Movement for a Better Hungary") was reported to have just one percent. In the late summer of 2009, with most of the short-term stabilization measures already implemented, the socialists registered only 13 percent, whereas FIDESZ received 40 percent and the extreme right six percent. All other parties (e.g., the liberals, Democratic Forum, an environment-related party) each received one percent, which is far from the five percent needed to obtain seats in the National Assembly. Although public perception of the government's ability to manage the crisis increased between the spring and autumn of 2009 (from 29% to 34%), meaningful public support is still absent.[14] In a similar fashion, and despite continued successful stabilization, the newly installed Prime Minister Bajnai has seen his support fall from 31 percent in April 2009 to 26 percent by October 2009. In contrast, support for FIDESZ's leader, Viktor Orbán, has increased during the same time period from 43 percent to 47 percent, making him the most supported popular politician in Hungary right now. Ferenc Gyurcsány, the former prime minister, registered a support of 19 percent in October 2009, down from 30 percent a year before.[15]

[14] Figures from the opinon poll conducted by Nézőpont Intézet (Viewpoint Institute) and presented on October 28, 2009. http://www.origo.hu/print/itthon/20091028 -kozvelemenykutatas (accessed November 20, 2009).
[15] Figures from Sonda Ipsos, monthly poll (November) http://www.ipsos.hu/site/graph?type=2

- Is there early evidence that the structure of the economy will change (e.g., greater role of the state, changes in sectoral shares in GDP)?
- Could old structural imbalances be aggravated? Can we already identify new structural imbalances? Have previously existing imbalances been tackled?

Structural distortions

As already noted, the absence of a major stimulus package may prove to be a medium-term advantage in several ways. First, artificial financial injections associated with stimulus programs generally help uncompetitive businesses and sectors to survive, and facilitate neither the transformation of outdated production nor the demise of vested interests linked to traditional economic activities. Second, the lack of financial stimuli meant that Hungary has seen no "budgetary bubble" or increasing public indebtedness, which is a common feature of most EU (particularly Eurozone) member countries. As a result, Hungary's financial latitude may be less constrained in the future, provided that the path designed by the economic stabilization program is continued and budget discipline is maintained. In addition, given the continuous pressure to maintain budgetary equilibrium, the government may have a better chance of introducing indispensable and long-overdue structural reforms. In a positive scenario, public support for such reforms could grow, although this is highly uncertain at the moment.

No major shift in the sectoral shares of GDP can be expected. If a comprehensive agricultural policy were finally to be implemented, agricultural output and agriculture-related activities (e.g., water economy, rural development, new forms of employment) could comprise a somewhat higher share of GDP, expanding from the current 4.3 percent to a maximum of 5.5 to 6.5 percent. Services will continue to contribute significantly to GDP, as the share of manufacturing is unlikely to drop in the post-crisis global and European environment. Whatever the opinion of some experts, as a small country, Hungary cannot—and should not—cauterize or place restrictions on its openness to global commodity, service and capital flows. It should, however, take steps to geographically diversify its exports further, both directly and indirectly, through global marketing channels and transnational companies. Other steps include increasing the value-added and technology-content of export-oriented production, and enhancing cooperation between transnational companies and SMEs operating in Hungary for global and European markets. The state's share of gross output value is unlikely to increase. Most companies have already been privatized and some remaining firms are on the privatization list. Renationalization, except in some special cases, is hardly viable. Indirectly, however, the state could play a more important role as an effective regulator, macroeconomic stabilizer and the generator of a favorable framework for investment activities and savings.

Prudent macroeconomic policies can encourage stabilization and sustainable economic development while avoiding previous structural (financial) imbalances. Such policies could also mitigate problems arising from domestic policy mistakes (e.g., incontrollable levels of private indebtedness in foreign currencies). At the same time, it should be emphasized that Hungary, similar to other small and very open economies, will remain vulnerable to external shocks. The best economic policy should aim at limiting vulnerability as much as possible. Policies that artificially protect the country from external and unforeseen developments would quickly lead to a rapid fall in real income, deteriorating living standards and growing social and political instability. In the next period, the government will have to confront already high and ever-increasing levels of unemployment. This is perhaps the most important economic challenge, as unemployment is accompanied by historically low activity rates among the able-to-work population. Previous external imbalances (e.g., external debt, current account) are likely to shift toward potential internal imbalances, which are at once an economic issue (e.g., the labor market) and a political issue (e.g., domestic political stability and the impact of domestic political priorities on regional stability). Another imbalance may emerge if the planned trajectory of budget consolidation falters. The following scenarios could result in budget consolidation taking a different course than planned:

- an overstretched budget with less income then expected and/or more expenditure then planned;
- politically motivated interest groups (e.g., the self-governments, railway workers, urban transportation, doctors, public administrators) fearing losses due to budgetary adjustments could exercise strong resistance;
- policies that lead to rapidly increasing budget deficits could undermine the restored international confidence in Hungary’s economy and threaten the forint’s exchange rate.

Although the 2010 budget contains several large-scale structural buffers, uncertainties about the path ahead linger. The Budgetary Council, created after the crisis as an independent body tasked with supervising government spending, criticized the budget’s tax income plans, emphasizing that the projected economic growth rate (-0.6% for 2010) renders the budget’s projected revenues questionable.

8. Concluding Remarks

When the global financial crisis of October 2008 broke, Hungary was in a very precarious economic situation. Although the government had introduced major budget cuts from 2006 to 2008, these cuts could not prevent the flood of international speculation that took place and which threatened to collapse the country's economic and financial system. Immediate support from the IMF, ECB and World Bank allowed Hungary to avert the most dramatic scenario. Nevertheless, the crisis underscored several weak points in the Hungarian system that could no longer be ignored, including:

- an extremely high exposure to foreign currency debt (mainly citizens);
- high levels of external debt financing;
- inflexible labor markets with a high share of inactivity;
- ambitious social welfare programs that overestimated the national economy's performance and were to a large extent financed by foreign credits;
- low-productivity levels and largely rent-seeking domestic SMEs;
- premature consumerism sustained by (primarily) citizens taking on too much credit, which led to a negative savings rate in a country targeting fast-track modernization;
- rancorous conflicts between major political parties;
- dangerous ideology-based polarization of the society.

The government's stabilization program was accompanied with measures seeking to generate sources of sustainable growth for the future, but did not include any ambitious and large-scale stimulus packages like those seen in several other EU member countries. The stabilization program was to address some of the basic shortcomings that had accumulated during more than a decade of mistaken economic policies issued by several governments. These problems include the prevalence of overstaffed and inefficient state and self-governments, overstretched (high-cost) social welfare programs, and low levels of employment coupled with high levels of indebtedness.

Little could be done to stem the losses generated by the collapse of international trade, particularly in sectors in which Hungary had been specializing during the last decade. Indeed, the dramatic drop in trade exacerbated the duality of the Hungarian economy, both in terms of exports and the labor market. Continued successful stabilization requires further measures, such as:

- revitalizing international trade and demand for Hungarian goods on major partner markets;
- communicating a credible economic policy while securing international confidence in the Hungarian economy so as to attract additional foreign resources and decrease the volatility of the forint;
- moving carefully toward growth-generating policy instruments while maintaining stability.

On the one hand, a number of positive developments for the short and medium term can be identified, including:

- a successful stabilization program;
- sustained microeconomic competitiveness, as reflected in foreign trade and surplus figures, as well as the expansion of Hungarian capital in neighboring countries;
- sufficient funds available to compensate for losses due to bold reforms;[16]
- no additional budgetary or public debt burden has been accumulated;
- steps have been taken to restructure an outdated social welfare system;
- a changing mindset among some sectors of society demonstrating an openness to reform.

On the other hand, there are several persistent challenges and risks (economic and otherwise) for post-crisis Hungary, including:

- delayed economic growth in major export markets;
- fears of a W-shaped recovery;
- fears of renewed and uncontrolled international speculation against currencies of the region, including the forint;
- those fearing Hungary's openness will attempt to change/limit its degree of incorporation into global trade, capital and business networks, and they will support their arguments by pointing to sectoral specialization and the dual structure of the economy;
- new policies requiring much higher budget deficits could be introduced that finance largely uncompetitive and subsidy-oriented domestic small- and medium-sized companies (another hotbed of further corruption);
- the 2010 budget could prove unsustainable if incomes are smaller than projected and if powerful lobbies succeed in altering approved

[16] According to the Legatum Institute's most recent ranking of prosperity, Hungary ranks 27th among 104 countries. It ranks slightly above average in the areas of entrepreneurship and innovation, education, and economic fundamentals, whereas it ranks somewhat below the EU average in the areas of health, security and governance. Legatum Institute, as quoted by *Világgazdaság*, October 27, 2009.

budgetary restrictions;

- the upcoming elections (spring 2010) have prompted a great deal of economic insecurity;
- intransparent measures in the opposition's economic program that are driven by populist goals (e.g., creation of 10 million jobs (in ten years), rejecting the approved 2010 budget and calling for a 7 percent budget deficit rather than the planned-for 3.9 percent, and introducing an energy program to wean Hungary off of imported energy in 20 years);
- the opposition's misuse of democratic institutions and odd interaction with international actors (including the IMF and the European Union);
- a deeply divided society lacking social capital;
- the fact that large portions of Hungarian society are quite open to nationalism, ethnic bias and political extremism could hinder the continuation of open-minded, liberal economic policies and jeopardize regional stability, which threatens political and economic stability—not to mention sustainable growth.

Thanks to the coordinated and well-timed steps taken by the international financial community, financial and economic chaos in Hungary has thus far been avoided. Yet the threat of political instability and further economic turmoil persists. It is unclear whether the international political community—in particular the European Union—will step in to prevent political instability from growing.

Annex Table

Draft budget (to be approved by the National Assembly) for 2010

Main items	2009 (HUF bn)	2010 (HUF bn)	Change in %
State functions	2,145.4	2,082.9	- 3
defense	240.8	224.5	- 7
protection of order and public security	484.1	493.9	+ 2
overall public services	1,420.3	1,364.4	- 4
Welfare functions	10,855.3	10,689.5	- 2
education	1,994.6	1,865.5	- 7
health care	2,087.8	2,344.7	+ 11
social security and social support	5,834.0	5,678.2	- 3
housing	524.6	443.5	- 18
entertainment, culture, religion	414.2	357.6	- 16
Economic functions	2,392.3	2,050.7	- 17
heating, energy, combustible	11.6	8.5	- 36
mining and industry	45.7	36.0	- 27
agriculture, fishery, forestry	360.6	281.4	- 28
transportation and communication	977.2	854.4	- 14
other economic activities	617.3	565.4	- 9
environmental protection	389.9	305.3	- 28
Management of public debt	1,208.8	1,215.8	+ 1
Other items not linked to any function	697.7	715.3	+ 2
Total expenditure	17,299.6	16,754.3	- 3
Total income	16,514.9	15,693.9	- 5
Balance	- 784.7	- 1,060.3	+ 26

Source: Ministry of Finance, as published by http://www.klikkbank.hu/print/valsag/20090911-koltsegvetes-2010

Study Context

The Bertelsmann Stiftung has a long tradition of assessing the quality of governance and devising evidence-based policy strategies for decision makers.

The **Transformation Index (BTI)** monitors political management, democratic quality and economic development around the world. The BTI encompasses all 128 developing nations and countries in transition that have a population of more than two million inhabitants, and have not yet attained fully consolidated democracy and a developed market economy.

The **Sustainable Governance Indicators (SGI)** offer a complementary focus on the OECD member states. The SGI evaluate the sustainability of political action in 15 different policy fields (from economy, labor, and education to environment, research and development), the quality of democracy and questions of strategic management capability in each of the 31 OECD countries.

The study *Managing the Crisis* is a joint initiative of the two projects.

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