



Robert Schuman

Miami-Florida European Union Center of Excellence

The Hungary on the Greek way

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**Vol. 12, No. 1
January 2012**

Published with the support of the EU Commission

The Jean Monnet/Robert Schuman Paper Series

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Hungary on the Greek way

Another EU country joins the PIIGS club of economic disaster

Hungary had a leadership role in the 1990s amongst Eastern European countries in terms of political and economic development towards democracy and market capitalism. Back then the country was eminent in terms of socio-economic transition from state socialism towards market capitalism, adopting the Western model of living and thinking seemingly the fastest from the group of countries often referred as “New Europe”. The development culminated at the end of the decade: Hungary along with the Czech Republic and Poland was in the first group of the NATO enlargement in 1999, and also in the first group of the EU enlargement in 2004. Back then the future looked bright, the country was on the way to introduce the Euro as early as 2007, meeting all the needed economic criteria.

What has happened since then is a different kind of story. As the privatization of the previously 100% state owned economy together with different austerity measures in the mid-90s moved the country onto the right and sustainable track of economic development, the country produced 4-5% GDP growth yearly in the late-90s. This prospect of “welfare” gave birth to a richer state which started to extend higher benefits to its citizens during the early 2000s. And this is exactly where things went wrong. Due to political populism and the overestimation of the country's growth prospects governments started to spend far beyond their capabilities, making huge deficits and a rapidly growing debt. Although decision makers were well-informed about economic facts, the fierce political competition between the country's political parties for power did not allow space for economic maneuvering and for new austerity measures. Only spending more and promising to spend even more was imaginable. Soon this downward economic spiral led the country to something we could call “the death of the early-born welfare state.”

As early as 2008 the country faced its second IMF bailout, because its debt reached a non-sustainable level and the risk of economic collapse was higher than ever. (The first IMF bailout of Hungary was in 1982, due to very similar reasons but in a very different political environment. That time the economic weakness of the country forced it to open up westwards, which can be seen now as a positive step.) With the IMF loan short-term stability returned, and bankruptcy was avoidable, but together with the loan came the conditions which required new austerity measures and far less spending from the government, which had no way to avoid these measures in the new situation and had to execute them.

At this point we reach the original sources of the current crisis of the country. The austerity measures had their political price: the socialist government which implemented them under IMF pressure in 2008-09 lost the elections in 2010 in such a way that the opposing nationalist party got a two thirds majority in the parliament making them able to form a government practically without any possible obstruction from their opponents. (In the Hungarian political system a two thirds majority in the parliament can give a government almost absolute power, since it is enough to change all the important laws, even the constitution.) With such a power at hand one could imagine that the way opened up for the new government to put the country back on track, and give the economy a healthy restart. Theoretically this could have happened, but in reality the power of populism is even stronger than the power of a two-thirds government. Learning from the brutal loss of their opponents, the new government made austerity a taboo word, and the IMF shortly became the country's main enemy. IMF conditions were seen through the populist eyes of the new government as colonial tools to keep Hungary under foreign rule, and Hungary begun its “war of economic independence.”

The first step was to get rid of the IMF assistance as soon as possible to make the country be able to maneuver freely, and to start spending again at the cost of a rising debt. The IMF was “sent home” by

2010, but fortunately the rise of the debt was so strictly forbidden by the EU that even the two-thirds of the government had to comply. After the first attempt to spend more failed, the government did not give up, and began what we call now “unorthodox economic policy.” The core element of this policy is quite easy to describe: get as many financial resources to the government's hands as possible from inside the country since the outside resources (debt financing and the IMF) are gone. The unorthodox policy contains the following steps until now: a huge bank tax together with other anti-capital measures, the elimination of the private pension funds and taking the savings back to the state, food tax on the unhealthy products, elimination of the beneficial “easy taxation system” for small businesses, and several other new tax forms coming on the way. The biggest change among these policies was the pension funds overtake, which helped to avoid bankruptcy in 2011 but as it was only a one-time possibility it will not help in the future. The other measures taken could make a better government fiscal balance on the short term, but on the long term they are only demotivating the enterprises in the country and slowing the already miserable GDP growth, which impacts the government with even smaller tax revenues.

And here we reach the current crisis of Hungary which comes increasingly visible in the last few months. As international investors and rating agencies follow closely the Hungarian developments of nowadays they come more and more to the same conclusion as above. The one time savior belt of the pension funds cannot give protection to the government balance forever, and Hungary already finds it hard to finance itself from the markets as the latest bond-auctions were unsuccessful. These negative developments projected to the future can give rise to worries and rumors on international markets that the country will default on its debt as early as this summer. Mark Gongloff of the Wall Street Journal quotes RBC emerging-markets analysts saying that the tipping point is near for Hungary: ¹

“Trends in Hungary are becoming quite concerning and dynamics suggest Hungary may be approaching a crisis sometime soon. Today’s poor 12 month Tbill auction is a window into the financial pressures building in Hungary. ...

The weak demand in short-term government debt offerings suggests that refinancing risks are rising and certainly the cost has soared over the past couple of months. Most emerging markets have shaken off the old destabilizing forces of the past and have been able to guide rates lower when global growth has slowed. However, in Hungary’s case this is still a dynamic which, born of its unbalanced policies, results in Hungary’s becoming caught in a vicious cycle when global economic/financial conditions deteriorate.

A rating downgrade, in our opinion, is becoming likely and tail-risk events... are becoming much more probable of materializing in coming days/weeks.”

While David Keohane of the Financial Times writes more openly, assuming “tail-risk events” as a possible default without the IMF's help:²

“Fitch revised Hungary’s rating outlook to negative on Friday night, reminding investors of the very real possibility that the big three ratings agencies will downgrade the country’s debt to junk in the very near future.

...

A full ratings downgrade is imminent. Soon after Fitch’s Friday night announcement, S&P also put the county on a negative outlook. S&P also rates Hungary BBB-. Citi argued in a note on Monday that Hungary might have the reserves to cover debt maturities and its fiscal deficit until about mid-2012 but that without the availability of market funding the government would have to turn to the IMF or start QE at significant sizes by the second half of 2012. Based on the political rhetoric, we believe Hungarian assets would have to suffer sharper devaluation before the government changes its unwelcoming attitude towards the IMF.”

1 <http://blogs.wsj.com/marketbeat/2011/11/10/hungary-the-next-european-crisis/>

2 <http://blogs.ft.com/beyond-brics/2011/11/14/hungary-i-dont-like-mondays/>

The more and more obvious signs of economic weakness already raised serious concerns amongst international investors: The CDS level of Hungary hit a record high in late October 2011, and has not decreased ever since. The several unsuccessful bond-auctions in the last few months forced the country to raise bond rates to record high levels as well, and now the rates are even higher than Italy's.

CDS level of Hungary (USD):³



Another serious sign of weakness is the HUF/EUR rate, which hit a record high of 317 in November, which is closely similar to the level of the 2008 debt crisis times, and means a huge devaluation of the country's currency:⁴

As it looks now, the populist “war for economic independence” comes soon to its end in Hungary with the IMF's third bailout more and more unavoidable. The question is only what costs it will take this time:



if the government fights until its last breath it will harm the economy not only inside the country, but possibly Europe- and world-wide as well. Is Hungary following the Greek example? Let's hope not: the latest news from the country indicate the government's intention to re-engage with the IMF, which would be the wisest thing to do in the current situation, and the sharp drop at the end of the second graph shows that this intention already has given the HUF market some confidence. But until this intention materializes as an official agreement between the parties (which could take a long time given the government's anti-IMF sentiment), the question of fatal destabilization is still pending.

Dániel Gugán is currently a PhD candidate in International Relations and lecturer at the Corvinus University of Budapest (Hungary). He obtained his Master degree in 2007 in International Relations and Economics from the Corvinus University of Budapest. He is currently a visiting researcher at the University of Miami. His research focuses on the European Union's external policies, international political economics, transatlantic relations and the European Neighbourhood Policy. Since 2007 he worked for online journals writing analyses about issues in international politics and economics and he spent two years working on an EU project as financial manager. Daniel started his PhD studies in 2009 and he is currently working on his dissertation, which focuses on Euro-Mediterranean relations and the European Neighbourhood Policy.