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## The Hungarian economy: a hostage of populism<sup>\*</sup>

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*Once the model economy of transition, Hungary has been struggling with much higher public and private debt and significantly worse growth performance than its peers in the region. A deteriorating exchange rate, increasing yields on government securities and soaring CDS spreads have recently forced the Hungarian government to seek financial assistance from the IMF and the European Union. This research note has the intention to discuss the current problems of the Hungarian economy from a historical perspective.*

### The promising beginnings

*The 1968 reforms*

Hungary entered the transition with justified self-confidence. Compared to its peers in the region the country enjoyed much better initial conditions. While formally Hungary had a planned economy based on the same ideological foundations as other countries in Soviet-dominated Central and Eastern Europe, the economy underwent a few cautious reforms already as early as 1968.

Under these economic reforms, five-year and annual plans were formally preserved but the detailed instructions from the Planning Bureau to the enterprises – what to produce, with what inputs, and to whom to deliver, at what price – were partially replaced by quasi-market conditions. From 1 January 1968 the government was to achieve its economic goals through normative regulation and not by discretionary decisions. Enterprises were allowed to purchase inputs and sell their outputs at partially liberalized prices on the domestic market. Nevertheless, bankruptcy of an enterprise or tolerance of open unemployment was further out of question. The state monopoly in foreign trade remained strictly untouched as well.

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Probably due to the immense inefficiency of the classical central planning system, the fairly modest liberalization of the Hungarian economy brought about spectacular success: accelerated economic growth and, more importantly, a significantly improved supply of goods in retail trade. The latter is reflected in the term 'goulash communism' coined in those years. After four successful years, following pressure from the orthodox wing of the communist party, several achievements were withdrawn and the basic philosophy of the economic reform, normative regulation, was abandoned. Though there was no return to classical central planning, the increasing interference of the communist party into the realm of the economy decisively weakened the initial efficiency-improving effects of the 1968 economic reforms.

### *The 1981 reforms*

A second wave of reforms was launched in 1981. Rising oil prices, first in 1974 and then again in 1981, had fundamentally changed the international environment of Hungary. Based on the apparently advantageous cheap oil deliveries from the Soviet Union, the Hungarian economy fatally missed the opportunity for an early adaptation to the changed conditions in the post-oil crisis world economy. The country's export supply had become more and more obsolete in the light of the rapid technological change having taken place in the West. As a considerable part of Hungarian imports was already purchased from the West, deteriorating export competitiveness led to increasing trade deficits and growing foreign debt. The government measures to address the problems caused a decline in living standards. The 1981 reforms were intended to channel the growing popular discontent into constructive directions.

This reform opened the door to small-scale private initiatives. Various legal forms of entrepreneurship were established and the citizens were invited to generate supplementary personal income either as entrepreneurs, using the physical assets of the further on state-owned enterprises, or as greenfield investors. Within a very short time a broad scale of entrepreneurship appeared in the country ranging from individual part-time taxi drivers to small cooperatives with dozens of partners in agriculture, industry and services. Nevertheless, changing the state ownership of enterprises established before the reform remained taboo up to 1989.

### **Pains and gains of early transition**

By 1986 it became clear that the prevailing institutional framework originally designed for a centrally planned economy could not be maintained. In 1986-1987 a new tax system compatible with the requirements of a market economy was introduced and five new commercial banks were established from various departments of the National Bank of Hungary.

With this the lending monopoly of the central bank<sup>1</sup> was broken and simultaneously the strict state monopoly of foreign trade was loosened. A cautious step was made to entice foreign-owned enterprises to create joint ventures with Hungarian firms.

Thus, by 1989/1990, the years of the communist system's collapse, Hungary was practically in the antechamber of a market economy, by far better equipped to enter transition than the GDR, Czechoslovakia or Romania and Bulgaria with their inexorably rigid orthodox centrally planned systems.

Although the institutional preconditions for a successful transition were in place, the developments in the real economy overshadowed them. Hungary, similarly to other countries in early transition, suffered a 20% GDP drop in 1990-1993.<sup>2</sup> The reasons were the same everywhere: First, a simultaneous collapse of the protected export markets in the Soviet Union and other former socialist countries of the region. Second, along with the radical liberalization of imports from the West, the emerging sharp competition on the domestic market crowded out a substantial part of products and services supplied by domestic enterprises.<sup>3</sup> Between 1990 and 1993 gross industrial production dropped much more strongly (by 30%) than GDP. In agriculture the decline amounted to 33%. The unemployment rate jumped from a negligible level in 1990 to over 13% in 1992. Average real net monthly earnings dropped by 16% over 1990-1993. In 1989 not more than 11-12% of the population lived below the minimum subsistence level, by 1993 this ration increased to one third. Nevertheless, these figures based on official statistics are biased, reflecting a worse-than-real situation since unreported economic activities were playing an increasing role in Hungary, with hidden incomes for a very wide stratum of the society.

Transition's 'creative destruction' had first shown its destructive side. About one million jobs were lost within a few years; this constituted a social trauma, even if in the previous regime the statistics showing full employment were misleading, as they were silent about the huge in-door unemployment. Early retirement, disability retirement, employment in the shadow economy and certainly registered unemployment were the optional channels for those leaving the registered labour market. Especially hardly hit were the unskilled workers in the eastern ends of the country where the inefficient big state enterprises closed down and agricultural cooperatives were dissolved soon after the start of transition. That was the beginning of the pauperization and the current misery of the Roma minority being overrepresented among the unskilled and in the north-eastern and eastern regions of Hungary.<sup>4</sup>

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<sup>1</sup> Except for lending to households, where the OTP bank had quasi-monopolistic position.

<sup>2</sup> The sources of statistical data in this article are, unless otherwise indicated, the Central Statistical Office of Hungary, the National Bank of Hungary and the wiiw database drawing on national statistics.

<sup>3</sup> The Hungarian economist János Kornai coined the term 'transformational recession' in his article 'Transformational Recession: The Main Causes', *Journal of Comparative Economics*, Vol. 19 (1994), pp. 39-63.

<sup>4</sup> For a review of developments in the transition countries see László Csaba (1995), *The Capitalist Revolution in Eastern Europe*, Edward Elgar Publ. Co, Cheltenham (UK) and Northampton (US).

At the same time modernization of the economy gained momentum. Ten thousands of new companies were founded, hundred thousands of one-person-entrepreneurships appeared. State-owned enterprises were first transformed into companies, then privatized in whole or by segments either to the management, the staff or foreign investors.<sup>5</sup>

Due to the urgent need for foreign currency in order to secure the servicing of foreign debt inherited from the previous regime, the Hungarian government was much less shy than other countries in the region concerning the involvement of foreign capital.<sup>6</sup> Hungary had a far higher share in FDI inflows from the West to the former socialist countries than would have been proportional according to the number of inhabitants or economic strength measured in GDP. In turn the modernization of industry took off rapidly and very soon the composition of Hungarian exports underwent a dramatic rearrangement. Earlier, exports to the West had been dominated by raw materials, agricultural and food products, semi-finished products and very simple consumer goods. Engineering products, which had represented more than half of the deliveries to the protected CMEA/COMECON markets, had hardly a more than 10% share in exports to the West. As transition progressed, the share of engineering products gained significance in exports to the West and within a few years it became the largest single commodity group accounting for nearly half of the deliveries.<sup>7</sup>

By 1993 it seemed that Hungary had overcome the transformational recession. From about the second half of that year the government, in view of the forthcoming elections and its low popularity, tried to foster the take-off of the economy via relaxing the rigour of the monetary policy (efforts were made to push down the interest rates), by a generous income policy (7.2% real wage increase in 1994) and rising budgetary expenditures. In addition, the government insisted on maintaining the anti-inflationary exchange rate policy which led to the real appreciation of the forint after 1991 and gradually undermined the competitiveness of the export sector. Economic growth resumed, but with very uncomfortable side effects: both the fiscal balance and the foreign equilibrium were seriously deteriorating. In 1994, while the GDP was increasing by less than 3%, the current account deficit reached 9.4% and the general government deficit 8.2% of the GDP. Although the conservative government lost the elections in spring 1994, the new socialist-liberal government headed by Gyula Horn hesitated to undertake the unpopular task of stabilization. By early 1995 the growth path became unsustainable: the rollover of foreign debt, a crucial issue for Hungary, became very expensive, clearly indicating the evaporation of the international

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<sup>5</sup> Péter Mihályi (1993), 'Hungary: a unique approach to privatization – past, present and future', in: I. Székely and D. Newberry (eds), *Hungary: An Economy in Transition*, Cambridge University Press, pp. 84-117.

<sup>6</sup> Péter Mihályi (2001), 'Foreign Direct Investment in Hungary: The Post-Communist Privatization Story Reconsidered', *Acta Oeconomica*, Vol. 51, No. 1, pp. 107-129.

<sup>7</sup> Sándor Richter (2001), 'Transition and regional economic cooperation in Central Europe', in: K. Liuhto (ed.), *Ten years of economic transformation*, Lappeenranta University of Technology, Studies in industrial engineering and management, No. 16, pp. 167-186.

investors' confidence in Hungary's ability to cope with the mounting problems. The danger of the country's insolvency became imminent.

### **The 1995 stabilization – the 'Bokros package'**

In early March 1995 the head of the socialist-liberal coalition, Gyula Horn, appointed Lajos Bokros as Minister of Finance and empowered him to launch a radical stabilization programme. Simultaneously a new governor was appointed to the National Bank of Hungary, György Surányi, who figured as an important ally of Mr. Bokros in the elaboration and implementation of the stabilization programme. Important parts of the so-called Bokros package were a 9% devaluation of the forint, reform of the exchange rate regime by the introduction of a crawling peg, an 8% surcharge on all imports except for investment goods and energy, and radical cuts in fiscal expenditures. Although some important elements of the package were later nullified by the Constitutional Court, the remaining part was sufficient to facilitate a radical turnaround. With an over 12% drop in real wages in 1995 private and public consumption diminished, net exports improved. Measured in unit labour costs, the international competitiveness of Hungarian exporters improved substantially.

As a consequence of the radical economic policy measures, domestic and foreign equilibria improved spectacularly. Helped by huge privatization revenues, net foreign debt dropped by one quarter between the end of 1994 and the end of 1996. Net interest payments on foreign debt, as a per cent of exports of goods and non-factor services, fell from 12% in 1994 to half that value by 1996. The improvement in the public finance equilibrium was also impressive: the 1994 general government budget deficit was reduced to one third by 1996. Public debt decreased from 86% of the GDP in 1994 to about 74% by 1996. Despite the strong decline in domestic demand, GDP did not cease to grow, even if the growth rates were modest both in 1995 (1.5%) and 1996 (1%).

Although the stabilization proved to be successful, the price that had to be paid was high. Following the devaluation, inflation hiked to close to 30% in 1995 and even in 1996 it was higher than prior to the stabilization programme. Investment, with an over 10% growth rate before the stabilization, declined by more than 5% in 1995 and 4% in 1996. It must be mentioned that the decline in real wages in general and the especially strong cuts in the public sector made a huge part of the population desperate. The government's popularity sank dramatically, the 'father of the stabilization', Lajos Bokros, became an object of general hate. Within less than a year after becoming minister of finance, he was dismissed from office as he was not ready to assist in watering down his programme, which contained the initiation of further, obviously unpopular reforms of the public sector.

## The rise and triumph of populism

### *Populism – the first episode*

After the successful stabilization in 1995-1996 Hungary entered a sustainable growth path that enabled a rapid modernization of the economy based on massive inflows of FDI and, relying on the output of foreign-owned firms, a robust expansion of manufactured exports, primarily that of transport vehicles, telecommunication equipment and computers. This period (1997-2000), the 'golden years' of the post-communist Hungarian economy, came to an end in mid-2001 with the start of the campaign for the next year's general elections. As an overture, the government raised the minimum wage in two steps by 60% in real terms. An irresponsible competition between the two major political parties of the era – the governing centre-right Fidesz<sup>8</sup> party and the then opposition centre-left Socialist Party – began, with both parties offering election gifts going far beyond the opportunities allowed by the performance of the Hungarian economy. This campaign marked the beginning of devastating political cycles in the economy which have been greatly affecting developments in Hungary ever since.<sup>9</sup>

In 2002 the Socialist Party won the elections with a very narrow margin. The new government (again a socialist-liberal coalition) got immediately under heavy pressure by the opposition which questioned the legitimacy of the election results and the integrity of the new Prime Minister.<sup>10</sup> In this atmosphere the government came under siege and not only fulfilled its unrealistic election promises but even topped them. Among other measures, the wages of public sector employees were raised by 50% and a 13<sup>th</sup> month pension was introduced. Remarkably, the then opposition Fidesz party voted with yes in the parliament to those changes which, though provisionally improving the standard of living, became the main cause of deteriorating public finance balances.

The summary impact is clearly reflected in the statistics: in the period 2001-2005, as a consequence of the expansionist fiscal policy, household consumption rose by 33% while GDP increased by 18% only.

The extremely favourable conditions for external financing had been disguising for years that the growing fiscal and external imbalances necessitated a fundamental revision of the economic policy pursued since mid-2001 and that the long-due reforms in various segments of state redistribution could not be further postponed either. Ferenc Gyurcsány, who followed Peter Medgyessy as Prime Minister in 2004, was aware of this but did not want to jeopardize the Socialist Party's success at the forthcoming 2006 elections.

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<sup>8</sup> The Hungarian abbreviation of Alliance of Young Democrats.

<sup>9</sup> It must be mentioned here that politically motivated stop-go cycles characterized the pre-transition Hungarian economy as well. Certainly not elections, but party congresses of the communist party figured as milestones of political cycles.

<sup>10</sup> A few weeks after the elections it turned out that the new PM Péter Medgyessy had been an officer of the Hungarian secret service in the communist era.

The 2006 election campaign was again characterized by promises made by the political parties, while the governing socialist-liberal coalition remained silent about the extent of the fiscal troubles and the unavoidable corrections to be implemented after the elections. The opposition party Fidesz campaigned with the slogan 'we live worse than four years ago' and promised everything and a bit more if they were to win the elections, despite the obvious fact that excessive private consumption (relative to the actual performance of the economy) was the main component of the mounting and unsustainable fiscal and external imbalances in the economy.

#### *Coming down from the clouds – the 2006/2007 consolidation*

In spring 2006 the socialists won the elections. It turned out soon that the fiscal deficit was much larger and the outlook was much worse than the one communicated by the government before the elections. After years of lax fiscal policy the old-new socialist-liberal coalition was compelled to start a period of painful corrections. However, the era of restrictions and reforms started under a bad omen: in a speech, held in a closed circle of socialist politicians, and which was later leaked to the press by unknown persons, the prime minister acknowledged that he had been lying about the extent of the troubles in public finances before the elections. This triggered violent protests in Hungary, and from that point the opposition regarded the prime minister, the government, the economic policy measures made and the reforms initiated as illegitimate.

Despite the extreme political pressure exerted by the opposition, the government began with the consolidation of the economy. It submitted a revised convergence programme to the European Commission. After years in which general government deficit targets had systematically been set too low (only to be missed thereafter anyway), the new Hungarian government decided to hit rock bottom with the budget. Shifting from the policy of excluding as many items from the general government expenditures as possible, the new figures in the amended convergence programme included the earlier hidden items, comprising the outlays for the army's new fighter planes, public-private-partnership expenditures for high-way construction and the financing of the private pension funds.

The consolidation package included, among other measures, cuts in the staff of the ministries and a 4% solidarity tax levied on companies' pre-tax profit, *de facto* raising the corporate income tax rate to 20% from 16%. Individuals earning more than EUR 2000 a month were also charged with the solidarity tax. The bulk of the burden, however, fell on the broader public. The preferential 15% VAT rate was raised to 20%, leading to price rises primarily of food, public transport, utilities and energy. Subsidies on gas and electricity prices were radically cut, with partial compensation only for the neediest households.

With the help of the austerity package the Hungarian general government deficit was reduced from about 10% of the GDP in 2006 to below 4% by 2008. Despite this spectacular success, the socialist-liberal coalition had the intention to go further and start with those reforms in the public sector that were to secure a longer-term sustainability of low budget deficit through substantial improvements in the efficiency in public health care, higher education, the pension system and the local governments.

The first stage of reforms in the health care system was introduced, including a consultation and a daily hospital fee. The next stage, a streamlining of the institutional system, was elaborated. Plans for the introduction of a tuition fee in higher education were also in preparation, along with a new design for local governments' financing.

Due to clumsy communication of these reforms, disaccord between the coalition parties in several important details and, perhaps most importantly, the aggressive demagoguery of the opposition Fidesz party, popular support for all these changes proved insufficient. The opposition argued that both the fiscal consolidation and the reforms were unnecessary and unacceptable. In a referendum on the abolishment of the newly introduced fees in health care and the envisaged tuition fees, the government suffered a landslide defeat in March 2008. From that defeat the Gyurcsány government never recovered and soon the ruling coalition broke up, leaving the long-due reforms of the public finance subsystems again unrealized.

#### *The international crisis and the 2009 consolidation*

While the cause of reforms got ploughed, the real economy survived the shock of the consolidation. Due to shrinking domestic demand, economic growth decelerated to below 1% in 2007; however, GDP data for the first two quarters of 2008 already hinted at an incipient upturn in growth, indicating that the Hungarian economy had managed to pull through the most painful stage of fiscal adjustment. Recovery, however, was rudely interrupted by the international financial crisis in the middle of 2008.

Despite the progress Hungary had achieved in curbing fiscal deficits in both 2007 and 2008, the country's image as one of the most vulnerable emerging market economies had persisted. In mid-October 2008, amidst the enormous volatility surrounding the forint (HUF) exchange rate, the market for Hungarian government bonds dried up despite the skyrocketing yields offered. Sovereign CDS spreads rose sharply. Owing to the dependence of the Hungarian economy on external financing in rolling over its huge debt (public and private external debt amounted to 114% of the GDP at end-September 2008), the threat of insolvency loomed large. It was only averted with the help of a EUR 20 billion financial



package (EUR 12.5 billion stand-by agreement with the IMF, EUR 6.5 billion from the European Union and EUR 1 billion from the World Bank)<sup>11</sup>.

The main conditionality of the stand-by agreement was the reduction of the general government deficit to 2.6% of the GDP in 2009, under the assumption that the GDP would contract by 0.9%. However, along with the continuous and increasing deterioration of the international environment and of the growth prospects of the main trading partners, first of all Germany, it became obvious that Hungary with its shrinking domestic and external demand would suffer a much stronger GDP decline than previously assumed. With the recession-related decline of the general government revenues and the unchanged level of expenditures, even the meanwhile upward revised deficit target for 2009 proved impossible to achieve without immediate fiscal policy steps.

In spring 2009 the next wave of fiscal consolidation was launched by a new, technical government headed by Gordon Bajnai. The measures included, among other things, the abolition of the 13th month pension, a pension indexation which follows only the inflation, and the gradual raising of the retirement age from 62 to 65 years. Sickness allowance was reduced from 70% to 60% of the salary. The standard VAT rate was increased from 20% to 25%. Due to the consolidation measures the general government deficit (-4.5%) was one of the lowest in the EU in 2009. This figure was nominally nearly identical to the 2008 deficit but due to diminishing tax revenues caused by the recession a considerable fiscal adjustment with painful pro-cyclical effects had to be accomplished in order to fulfil that target.

Hungary's external financial position improved significantly in the second half of 2009. The government managed to return to market-based financing of public debt. Yields on forint-denominated government bonds fell to pre-crisis levels. That enabled the government to stop drawing IMF/EU/World Bank resources while the stand-by agreement was prolonged up to October 2010. Nevertheless, the successful consolidation achieved by the Bajnai government within 13 months could not efface the painful restrictions, aborted reforms and the loss of credibility due to acknowledged lies before the 2006 elections. Fidesz attained a landslide victory at the 2010 general elections, obtaining a two-third majority in the parliament – sufficient to change any laws including the constitution.

### *Populism – the second episode*

After eight years in opposition, Fidesz entered the scene with fundamental criticism of the second Gyurcsány and the Bajnai governments' fiscal stability oriented economic policy. The new Prime Minister Viktor Orbán outlined ambitious goals for the economy: stimulation of growth through radical tax cuts, the creation of one million new jobs within ten years, an

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<sup>11</sup> The World Bank finally did not participate in the implementation of the programme.

accordingly raised wage bill and consequently additional tax revenues. As an outcome of this policy the government expected a new, higher growth path of the economy (5-7% expansion annually). The feasibility of this programme in a highly indebted country struggling with chronic structural fiscal deficits was not discussed with the expert community. The key problem of the Hungarian economy beyond persistently slow growth – namely the outstanding reforms of the inefficient and wasteful state redistribution, seen by experts as the main cause of the country's structural fiscal deficit – was not addressed at all.

A precondition for the implementation of the government programme was to find a leeway in the fiscal policy, since the widening of the initial budget deficit seemed unavoidable as a consequence of the planned radical tax reduction. Immediately after its inauguration, the Orbán government made serious efforts to sell the idea of a 6-7% fiscal deficit for 2010 instead of a less than 4% one as prescribed in the country's convergence programme and the stand-by agreement with the IMF and the EU. This attempt, with regard to Hungary's miserable pre-2006 track record concerning fiscal deficits, coupled with the Europe-wide panic of the summer 2010 caused by the developments in Greece, did not have any chance to come through with the EU or the IMF.

At that point the government had two options:

- either to retreat from the central element of its programme, postpone the plans for a radical tax reduction and focus the efforts on other components of the programme while continuing the fiscal consolidation launched by the Gyurcsány and Bajnai governments, respectively, in 2006-2009;
- or to push through the tax reduction while observing the deficit targets of the convergence programme and the IMF/EU stand-by agreement. This option necessitated the raising of new resources to fill the gap that would open up on the revenue side of the budget due to the radical tax reduction.

Orbán's government decided for option (b); this decision has determined the developments since then.<sup>12</sup>

In 2011 the radical tax reduction came into force: the personal income tax with a unified 16% rate became 'flat' (earlier there had been two rates, 17% and 32%). The corporate tax rate for the SME sector was cut from 19% to 10%. Some other minor taxes were reduced as well. The other side of the coin: first, financial institutions were charged with a temporary levy; second, specific temporary taxes were introduced for the largest (predominantly foreign-owned) firms in the energy, telecommunications and retail trade sectors. Finally, the

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<sup>12</sup> For a short but comprehensive analysis of the political and economic activity of the Orbán government's first eight months see János Kornai's contribution in the 7 January 2011 issue of *Népszabadság*, under the title 'Számvetés' (Taking stock). The English translation of the article is available under [http://nol.hu/gazdasag/janos\\_kornai\\_taking\\_stock](http://nol.hu/gazdasag/janos_kornai_taking_stock) (downloaded on 7 September 2011).

nationalization of the accumulated assets of the mandatory private pension funds (about EUR 11 billion) was announced. About one fifth of these one-off revenues were channelled into financing current budget expenditures in 2011, the rest was earmarked for a reduction of public debt.

The main problem with this scheme is that the newly introduced items on the revenue side all are temporary. The levy on the financial institutions and the taxes on three other sectors were promised to be phased out from 2013 onwards. Revenues from the assets of the nationalized pension funds improved the fiscal stance only in 2011. By contrast, the revenue-diminishing effects of the tax cuts remain, raising the danger of severe fiscal imbalances in the medium run.

In May 2011, nearly one year after its inauguration, the government dropped its philosophy 'first economic growth and then a balanced budget' and with an overnight turn it declared war on public debt. In the new 'Széll Kálmán Plan' it announced far-reaching steps in various segments of the pension system, social welfare system, education and culture. The government's measures included the shortening of unemployment benefits to 3 months, compulsory re-activation of members of certain occupation groups that benefited from early retirement systems, plans to diminish the number of universities, etc.<sup>13</sup> For 2011 the nationalized assets of the private pension funds ensured a moderate fiscal surplus (assessed to amount to 3.5% relative to the GDP; however, without the one-off effect of the pension funds' assets, the fiscal balance would have shown a deficit of 5% to 6%).

While in the larger part of 2011 the government had no difficulties with the rollover of the public debt, this changed by the end of the year.<sup>14</sup> A weakening of the forint to the level of the worst days of the 2008/2009 crisis, increasing yields on government securities and towering CDS spreads have been clear indications of vanishing confidence of international investors. The danger of insolvency forced the government to turn to the IMF and the EU for support. Such a step is generally uncomfortable for any government in the world, but it is a political disaster for a government which still boasted to dump the IMF from Hungary a few days before announcing the need for assistance from the same organization.

The second week of January 2012 proved to be the climax of the tensions around Hungary. The European Commission announced that Hungary would remain under the extensive deficit procedure as the planned fiscal deficit for 2013 was not underpinned with measures ensuring sustainability. As Hungary has been under the extensive deficit proce-

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<sup>13</sup> For a comparison of this turn in the Fidesz government's economic policy with the 1995 stabilization see the article of Lajos Bokros in the Hungarian weekly *Élet és Irodalom*, 11 March 2011, under the title 'Két csomag' (Two packages), [http://es.hu/bokros\\_lajos:ket\\_csomag:2011-03-10.html](http://es.hu/bokros_lajos:ket_csomag:2011-03-10.html) (downloaded 9 September 2011).

<sup>14</sup> For an analysis of responsibility for Hungary's current level of indebtedness see Lajos Bokros, 'Államadósság: bűn és bűnhődés' (Public debt: crime and punishment), *Élet és Irodalom*, 2 September 2011, [http://es.hu/bokros\\_lajos:allamadossag:2011-08-31.html](http://es.hu/bokros_lajos:allamadossag:2011-08-31.html) (downloaded 9 September 2011).

ture since its accession in 2004, the time of painful sanctions, including suspending Cohesion Policy transfers, may have set in. This latter may lead to the loss of EU transfers up to nearly 0.5% of Hungary's GDP. Further, the European Commission also announced to launch legal action (infringement proceedings) against Hungary over selected laws approved at the end of 2011 (law on the central bank, pension age of judges, administration of data authority). Other controversial laws may be addressed later.

## **2012: Farewell to populism?**

The situation of the Orbán government is difficult. This is not because the economic situation of the country is so dramatic: public debt is relatively high but not higher than the EU average, the current account has a considerable surplus, and the fiscal deficit is a problem but much less so than Greece, Italy, Ireland, Portugal or Spain. The real concern is the lack of credibility. International investors' confidence is indispensable for rolling over Hungary's public debt, and these investors seem to have lost faith in the government's readiness to undertake the fiscal reforms necessary to secure a sustainable general government balance within the SGP framework in the coming years and restore basic norms of the rule of law which were jeopardized in a few instances (e.g. retroactive taxation, nationalization of private pension funds' assets, repayment of forex credits at fixed exchange rates) in the first nearly two years of the Fidesz government.

Without regaining its international credibility, Hungary cannot avoid insolvency. In the current circumstances Hungary's credibility cannot be restored without an agreement with the European Union and the IMF. There is no doubt that both organizations will stick to a new transparent, sustainable fiscal policy which is void of ad-hoc and one-off measures and interference in private contracts. The elaboration of a feasible fiscal consolidation scheme for the next three years with foreseeable revenues and expenditures, with beginning reforms of the main redistribution subsystems, and the consolidation and streamlining of the Budapest Public Transport Company and the State Railway Company will be unavoidable, but painful measures.

Such decisions are certainly never an easy task for any government in any country, but in Hungary political factors add an extra portion to the mere economic aspects. Before the 2010 elections the Fidesz party had built its whole image on promises to pursue an economic policy applying no restrictions and avoiding reforms, which were declared unnecessary. They mercilessly attacked the previous governments for the indeed painful but unavoidable consolidation measures and the initiated reforms. With a minimum of responsibility and foresight, keeping in mind that they would have to cope with the same problems once they were to sit in the government, Fidesz could have won the elections and simultaneously could have left all options open for the economic policy to be pursued later. True, attaining the two-third majority would then have been jeopardized.

The citizens of Hungary have remained surprisingly passive while critical elements of democracy have been demolished or weakened.<sup>15</sup> Even the nationalization (practically confiscation) of the private pension funds' assets and the deterioration in the income position of a considerable part of households as a consequence of the new flat tax left the population apparently indifferent. However, the autumn 2011 may prove a watershed in this respect, with significant street demonstrations since then.

2012 will be a year of harsh restrictions in view of the planned fiscal deficit target (less than 3% of GDP). The fiscal adjustment compared to 2011 may amount to over 5% relative to the GDP. In 2013 the sector-specific taxes will probably have to be phased out, the levy on banks reduced to half. With the forthcoming EU/IMF agreement, no room for the unorthodox economic policy will be left. Now comes the hour of truth: no PR magic can sell the unavoidable corrective steps in the fiscal policy as 'non-restrictions'. At one point in the near future the government, and personally Mr. Orbán, will have to acknowledge that the dreams Fidesz sold as its election programme in 2010 cannot be translated into a feasible economic policy. After the collapse of the first episode (2002-2006) of populism there necessarily follows the collapse of the second populist episode, exercised by Fidesz since spring 2010.

Should Hungary wish to back out of the blind alley it has been trapped in since the beginning of the previous decade, a farewell to populism of any political colour and to irresponsible election promises is indispensable. Only by making a clean slate in this respect there is a chance for a new beginning and a return to the club of the prospering post-transition Central European countries Poland, the Czech Republic and Slovakia.

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<sup>15</sup> See for details János Kornai, 'Taking Stock', [http://www.nol.hu/gazdasag/janos\\_kornai\\_taking\\_stock](http://www.nol.hu/gazdasag/janos_kornai_taking_stock) (downloaded 16 January 2012).