

Financial assistance for Hungarian crisis management – a case study

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*“The whole of the Balkans is not worth the bones of a single Pomeranian grenadier”
(Otto von Bismarck)*

Following the Lehman bankruptcy, which marked the end of the ‘evolutive’ stage of the global economic crisis and escalated it to what can be described, without exaggeration, as a full-blown emergency, Hungary was among the first compelled to seek assistance (in the form of a loan, not aid) from the international financial organisations and the European Union. More than two years have passed since the signing of the agreement. This paper focuses on Hungary, which has been hard-hit by the current global economic recession, and foreign analysts were afraid that Hungary could become the scene of a major financing drama. In this country there were prior mistakes in economic policy that increased its vulnerability to external shocks. Hungary has turned to the IMF for financial assistance and carried out a complex, multi-approach program from 2008. The government’s responses to the downturn, along with IMF conditions for assistance, are also seen to have caused harm with pro-cyclical policies. This paper describes the Hungarian crisis management alongside the Standby arrangement’s guideline to the Hungarian budget restriction steps. The official response to the crisis seems to have made matters worse. European countries chose fiscal assessments which contain the reduction of the debt and budgetary expenses, and decided on reform programs in order to change the state budget structures since May 2010. The fiscal policies of member states of the European Union (Germany and France) – in light of the Greek public debt crisis – were directed to restrictions rather than easing moves. EU institutions were committed to implement sanctions, including the transformation of the rules concerning liquidation of the European Union.

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1. Introduction

The International Monetary Fund¹ in the Letter of Intent and Technical Memorandum of Understanding² concluded: “*Hungary has emerged from a severe*

¹ In my study I use as primer source articles and studies from IMF’s and European Commission’s archives (www.imf.org; www.ec.europa.eu).

² (IMF 2010) <http://www.imf.org/external/np/ms/2010/102510.htm>

crisis, but the recovery is fragile. The combination of improved policies and significant adjustment in the context of the IMF/EU-supported program, the availability of large and upfront official financing, and an easing of global financial conditions brought a faster-than-expected stabilization.” During the international financial crisis, the first IMF-supported program among the new EU member states started with Hungary in late 2008. It was clear that the sustainability of this program depended heavily on the chances to ensure that Western European banks remained engaged in their host country, in Hungary.

Hungary was in a fragile economic condition when the financial crisis broke out. In November 2008, acknowledging the government’s commitment to maintain the fiscal consolidation process and to prevent a more severe financial market crash, a joint financial assistance of up to 20 billion euros was provided to Hungary, bound to policy conditions. In order to counteract the decreasing revenues caused by declining output, the government also implemented a mix of structural and temporary expenditure saving measures. An important goal was to ensure that these programs would not be perceived as a private sector bailout. Hungary is an open, export-driven economy. As a consequence, the global slowdown and faltering demand in its main export markets has had a negative impact on economic growth, especially in the export-orientated automotive and consumer electronics sectors. In 2009, the Hungarian economy shrank by 6.3%. This was attributable to three factors: the slump in agricultural output following the sector’s outstanding growth in 2008; the increasingly rapid decline in other sectors that began as early as 2008; and, finally, the continuing downturn in the construction sector that began two years ago (although at that stage, it was limited to only 5%). While the rest of the world has loosened fiscal policy, Hungary’s cyclically adjusted primary budget balance has improved to 4.5% of GDP in the past two years. As a result, Hungary is in the unique position of not being required to tighten fiscal policy as growth recovers, suggesting that medium-term growth prospects are particularly favourable.

2. Background

2.1. The economic environment in Hungary before the crisis

Let’s begin the story in the summer of 2006 from when the international financial markets and the business community had lost their trust so the Hungarian economy had been brought to the edge of the abyss by years of highly irresponsible and inconsistent economic policy – and not so much by the oft-cited lack of structural reforms, although this was of course also a factor. As the consequence of long years of lax budgetary and incomes policies, and the ostensibly strict monetary policy intended to counterbalance this, the dangerous deterioration in the external and internal financial equilibrium was increasingly plain to see (Surányi 2010, p. 21.).

GDP growth in Hungary was driven by the expansion of exports and investments. Between 2001 and 2008, export growth was exceptionally high at 11.5% per annum, and the structure of exports showed an upward trend. After 1998, the share of technology-intensive and high-value-added sectors such as machinery, transportation equipment and ICT products grew significantly³. In the summer of 2006, despite the (overly) benign global money and capital-market environment, the prospect of a fatal deterioration in the external and internal balance made an economic correction inevitable. The program drawn up and launched after the elections was extremely painful, and not only in terms of the specific measures that it entailed. The acceptance of this program, and adapting to it, was even more difficult for everybody than is customary at such times. In the light of the previous years' highly effective propaganda, the deliberate misleading of public opinion, the serial self-deception, and finally the unrealistic election promises made by virtually every side, the correction and austerity measures were, without a doubt, a source of great disillusionment.

The convergence program was implemented in the face of strong opposition⁴, against the backdrop of a deep crisis of confidence, in a highly debatable structure, and without the requisite professional groundwork. However, the program intended to achieve a massive fiscal correction after a lengthy period of procrastination, and for this reason it was quite justified. In the space of two and a half years, the budget deficit was forced down from over 11% to 3–4% of GDP. Although the structure of the corrective measures is highly controversial, another important and favourable aspect of the program – besides the quantitative correction achieved – nevertheless deserves highlighting. After many years, the budget deficit not only came into line with the program that had been approved by Parliament, but in every year was visibly lower than this. In other words, the unpredictability of fiscal policy, which had previously made it impossible to coordinate fiscal and monetary policy, was finally eliminated. In the light of the antecedents, this was perhaps the most important change to the substance of government policy. Besides the quantitative fiscal correction, therefore, another commendable change was the strengthening of fiscal discipline, which led to greater predictability and less uncertainty.

Despite exceeding the targets for improving the fiscal balance, the perception of the Hungarian economy did not improve, or least not by any significant degree. Besides the loss of political and personal credibility, a key factor in this was probably the considerable slowing in growth that was a short-term side-effect of the correction. In the light of neighbouring countries' burgeoning economic growth – which, incidentally, was often unsustainable there, too – the annual 1–2% rate of expansion in the Hungarian economy was judged to be conspicuously weak. In addition, due to the unfavourable structure of the correction, even this virtually non-existent growth was accompanied by an unsustainable external financing

³ ITD Hungary archives http://www.itdh.com/engine.aspx?page=ItDh_Economy

⁴ Prime Minister's archives www.miniszterelnok.hu

requirement of 8–9% of GDP, and a rise in the foreign debt that appeared unstoppable as a result.

From 2006, Hungary's economic development had slowed and GDP growth remained below 4% as fiscal consolidation became the focus of economic policy. The government's austerity programme reduced Hungary's large budget deficit, but reforms dampened domestic consumption, slowing GDP growth to less than 2% in 2007 and 0.6% in 2008.

Each country in Europe and elsewhere was hit by two forms of the crisis, one was the financial crisis and the other was a real economic crisis. This latter was partly the result of the financial crisis. In October-November 2008 Hungary was projected worldwide in the press as the next Iceland, speeding towards collapse. But Hungary had another severe problem besides the double crisis: the crisis of indecision, missing the opportunity to carry out relevant structural reforms for the past 10 years. All the analyses started by saying Hungary is severely indebted – but according to professor Surányi⁵ this statement⁶ simply isn't true. The analysts assumed that foreign debt amounted to approximately 100 percent of GDP, however, 40–42 percent of this consisted of foreign direct investments made by the likes of General Electric, General Motors, Audi, Intesa Sanpaolo, Raiffeisen, KBC, IBM, and Fiat in Hungary for business purposes. There was absolutely nothing negative about that – in fact, it casted the country in a rather positive light. Before the crisis, Hungary was already heavily indebted close to 70% of the GDP and its growth potential had shrunk towards the end of the 1990's to roughly 2%. According to professor Surányi: *“the gross debt of Hungary denominated in foreign currency does not exceed 50 percent of its GDP. In no way can this be regarded as particularly high. The Hungarian authorities are not able to communicate these facts through international forums in a convincing way to analysts, researchers, investments banks and market players.”* Despite the fiscal stimulus that raised the general government deficit to 9.3% of the GDP in 2006, GDP grew by only 4% in that year. That was coupled with a huge budget deficit in 2006 which almost reached 10% of GDP, an obviously unsustainable level. The growing deficit prompted the second Gyurcsány government under pressure of the EU to decrease the budget deficit. Consequently, the budget deficit declined from close to 10% in 2006 to 3.8% by the end of 2008. But parallel to that there had been a huge sacrifice in GDP growth. The previous years' huge deficit and low growth, the huge differential in domestic and international currency interest rates, and the high level of indebtedness of the population in foreign currency which made the country largely exposed to foreign exchange moves preserved the country's bad international evaluation. Thus, all of this made Hungary very vulnerable at the beginning of the financial crisis. In

⁵ Former Governor of the National Bank of Hungary

⁶ How big is Hungary's problem? – Interview with György Surányi www.portfolio.hu November 14, 2008

early October 2008, Hungary was quite severely hit by sudden panic in financial markets and a credit crunch. They had a certain routine for how to deal with such situations. Thus, Hungary was very quick in October 2008 to turn to the IMF for a stand-by loan facility. This was an unusual step by a country who was a member of the European Union. But the government was determined to do that in order to have a big enough buffer to prevent the collapse of the national currency.

In the autumn of 2008, in a context of reduced risk appetite linked to the global financial crisis, financial market conditions in Hungary rapidly deteriorated to the extent that the external financing needs of the government could no longer be met through market channels. In November 2008, acknowledging the government's commitment to maintain the fiscal consolidation process and to prevent a more severe financial market crash, a joint financial assistance (a combination of the IMF and the European Commission and the World Bank) up to 20 billion euros was provided to Hungary, linked to severe policy conditions (fiscal adjustments). The conditions were the following:

- keeping nominal wages in the public sector constant throughout 2009
- eliminating the 13th monthly salary in the public sector
- capping the 13th monthly pension payment for pensioners and eliminating the 13th monthly pension payment for all early retirees
- postponing the indexation of selected social benefits⁷

In order to counteract the decreasing revenues caused by declining output, the government also implemented a mix of structural and temporary expenditure saving measures⁸. The loan and accompanying measures have helped to consolidate the situation, but at a very weak level. This hurt 1.7 million families in Hungary out of the 4 million families who had foreign currency debt. The country was in a very shaky position throughout the winter. The Hungarian people endured huge austerity adjustment measures that really cut standards of living without mass grievances.

The Hungarian macroeconomic data can be found in the Table 1.

⁷ www.miniszterelnok.hu

⁸ European Commission archives

http://ec.europa.eu/economy_finance/eu/forecasts/2010_spring/hu_en.pdf

Table 1. Hungary: Main Economic Indicators

	2003	2004	2005	2006	2007
Real economy (change in percent)					
Real GDP	4.2	4.8	4.1	3.9	1.3
Private consumption	7.8	2.8	3.6	1.9	-1.9
Gross fixed investment	2.2	7.6	5.3	-2.5	0.1
Exports	6.2	15.6	11.5	19	14.2
Imports	9.3	13.4	6.8	14.7	12
CPI (end year)	5.7	5.5	3.3	6.5	7.4
CPI (average)	4.6	6.8	3.6	3.9	7.9
Unemployment rate (average, in percent)	5.9	6.1	7.2	7.5	7.4
Gross domestic investment (percent of GDP) 1/	25.2	25.9	23.6	23.1	23
Gross national saving (percent of GDP, from BOP)	17.3	17.5	16.8	17	18
General government (percent of GDP), ESA-95 basis 2/					
Overall balance	-7.2	-6.4	-7.8	-9.2	-5.5
Primary balance	-3.4	-23	-3.9	-5.5	-1.7
Debt	58	59.4	61.7	65.6	66
Money and credit (end-of-period, percent change)					
M3	12	11.6	14.6	13.7	11.1
Credit to nongovernment	34.4	19.2	18.9	17.1	17.3
Interest rates (percent)					
T-bill (90-day, average)	8.2	11.1	6.8	7	7.6
Government bond yield (5-year, average)	6.4	9.7	8	6.9	7
Balance of payments					
Goods and services trade balance (percent of GDP)	-3.8	-2.7	-0.5	0.4	2.5
Current account (percent of GDP)	-7.9	-8.4	-6.8	-6.1	-5
Reserves (in billions of US dollars)	12.8	16	18.6	21.6	24
Gross external debt (percent of GDP) 3/	61.6	67	75	90.5	96.4
Net international investment position (in percent of GDP)	77.2	83.5	92.4	100.9	100.5

Source: www.imf.org

2.2. The budget deficit and the financial crisis

The deep global recession has focused attention on the need for counter-cyclical fiscal policy. The fiscal stimulus requires a careful evaluation of fiscal space and available financing (Kandil–Hanan 2010, p. 3.). The half of the large increase in budget deficits in major economies around the world is due to collapsing tax revenues and to low (often negative) growth. Less than ten percent is due to increased discretionary public expenditure, as in stimulus packages (Galbraith 2010,

p. 2.). Can governments afford the cost of the fiscal stimulus, hoping for higher revenues once recovery is at full speed to service the new debt and ensure sustainability? While fiscal expansion may be necessary to stimulate economic activity, not every country has the resources to finance fiscal stimulus.

Some countries, like Hungary, do not have enough fiscal space to run countercyclical policy during a recession with limited access to financing from international capital markets, and high concerns about policy credibility and debt sustainability⁹.

It is important to realize that, while the direct costs of the financial crisis on governments may appear large, they are in fact relatively small compared to indirect costs arising from losses of tax revenues and increased expenditure to provide demand stimulus. Financial rescue programmes, including capital injection, treasury purchase of assets and lending as well as upfront government financing are amounting and a significant part of this is likely to be recovered (Cecchetti et al 2010, p. 2.).

By contrast, overall fiscal balances have been deteriorating sharply – by 20–30 percentage points of GDP in just three years in the world. And, unless action is taken almost immediately, there is little hope that these deficits will decline significantly by 2011. So, in the absence of immediate corrective action, these deficits will persist even during the cyclical recovery (Cecchetti et al 2010, p. 3.).

2.3. The EU Commission delivers a comprehensive package of legislative measures

Fiscal assessments have to be considered against the background of the sharp economic and financial crisis which has had a major impact on public finances. Reflecting the working of automatic stabilizers and discretionary stimulus measures implemented in line with the European Economic Recovery Plan (EERP) to cope with the exceptional economic circumstances, a large majority of Member States is currently subject to the excessive deficit procedure following corresponding Council decisions in 2009. This implies that the medium-term budgetary strategies of these countries have to be assessed against the background of the recommendations to correct their excessive deficits by the deadlines set by the Council. For most countries this year will mark a fiscal consolidation process consistent with the recommendation set out in the Excessive deficit procedures (EDPs). According to Council Regulation (EC) No 1466/97 on the strengthening of budgetary surveillance and the surveillance and coordination of economic policies, EU Member States must submit updated macroeconomic and budgetary stability programmes. This

⁹ In Hungary, the Government Debt Management Agency Private Company Limited by Shares (Államadósság Kezelő Központ Zrt. – ÁKK) is responsible for debt management. ÁKK is 100% state owned and the Minister Responsible for Public Finances being the Minister of National Resources exercises the shareholders' rights. The Minister Responsible for Public Finances manages public debt through ÁKK under the regulations of the Public Finances Act.

regulation is also referred to as the 'preventive arm' of the Stability and Growth Pact¹⁰.

The European Commission adopted on 27/09/2010 a legislative package containing the most comprehensive reinforcement of economic governance in the EU and the euro area since the launch of the Economic and Monetary Union. Broader and enhanced surveillance of fiscal policies, but also macroeconomic policies and structural reforms are sought. The recently agreed "European semester" will integrate all revised and new surveillance processes into a comprehensive and effective economic policy framework. The proposals are the concrete translation of the recent Commission communications on economic governance dated 12 May and 30 into legislative proposals. All these reforms are compatible with the existing Treaty of Lisbon and should ensure that the EU and the euro area benefit from more effective economic policy coordination. That should give the EU and the euro area the necessary capacity and strength to conduct sound economic policies, thereby contributing to more sustainable growth and jobs, in line with the Europe 2020 strategy. The legislative package is made up of six pieces of legislation: four proposals deal with fiscal issues, including a wide-ranging reform of the Stability and Growth Pact (SGP), while two new regulations aim at detecting and addressing effectively emerging macroeconomic imbalances within the EU and the euro area. For Member States of the euro area, changes will give teeth to enforcement mechanism and limit discretion in the application of sanctions. In other words, the SGP will become more "rules based" and sanctions will be the normal consequence to expect for countries in breach of their commitments.

1. A Regulation amending the legislative underpinning of the preventive part of the Stability and Growth Pact (Regulation 1466/97):

The preventive part of the SGP is meant to ensure that EU Member States follow prudent fiscal policies in good times to build up the necessary buffer for bad times. To break off with past complacency in good economic times, the monitoring of public finances will be based on the new concept of prudent fiscal policy making that should ensure convergence towards the Medium-Term Objective. The Commission may issue a warning in case of significant deviation from prudent fiscal policy for the euro area Member States.

2. A Regulation amending the legislative underpinning of the corrective part of the Stability and Growth Pact (Regulation 1467/97):

The corrective part of the SGP, is meant to avoid gross errors in budgetary policies. The regulation is amended so that debt developments are followed more closely and put on an equal footing with deficit developments as regards decisions linked to the excessive deficit procedure. Member States whose debt exceed 60% of GDP should

¹⁰ European Commission (2008b)

take steps to reduce it at a satisfactory pace, defined as a reduction of 1/20th of the difference with the 60% threshold over the last three years¹¹.

3. A Regulation on the effective enforcement of budgetary surveillance in the euro area:

Changes in both the preventive and corrective part of the SGP are backed up by a new set of gradual financial sanctions for euro-area Member States. As to the preventive part, an interest-bearing deposit should be the consequence of significant deviations from prudent fiscal policy making. In the corrective part, a non-interest bearing deposit amounting to 0.2% of GDP would apply upon a decision to place a country in excessive deficit. This would be converted into a fine in the event of non-compliance with the recommendation to correct the excessive deficit. To ensure enforcement, a "reverse voting mechanism" is envisaged when imposing these sanctions: this means that the Commission's proposal for a sanction will be considered adopted unless the Council turns it down by qualified majority. Interests earned on deposits and fines will be distributed among euro-area Member States neither in excessive deficit nor in excessive imbalance. The changes are devised so that they should facilitate the eventual move to a system of enforcement linked to the EU budget as foreseen in the Commission communication of 30 June¹².

4. A New Directive on requirements for the budgetary framework of the Member States:

Since fiscal policy-making is decentralized, it is essential that the objectives of the SGP are reflected in the national budgetary frameworks, i.e. the set of elements that form the basis of national fiscal governance (accounting systems, statistics, forecasting practices, fiscal rules, budgetary procedures and fiscal relations with other entities such as local or regional authorities). The directive sets out minimum requirements to be followed by Member States.

5. A New Regulation on the prevention and correction of macroeconomic imbalances:

The Excessive Imbalance Procedure (EIP) is a new element of the EU's economic surveillance framework. It comprises a regular assessment of the risks of imbalances based on a scoreboard composed of economic indicators. On this basis, the Commission may launch in-depth reviews for Member States at risk that will identify the underlying problems. For Member States with severe imbalances or imbalances that put at risk the functioning of EMU, the Council may adopt recommendations and open an "excessive imbalance procedure (EIP)". A Member State under EIP would have to present a corrective action plan that will be vetted by the Council, which will set deadline for corrective action. Repeated failure to take

¹¹ European Commission archives http://ec.europa.eu/ireland/press_office/news_of_the_day/eu-economic-governance-legislative-measures_en.htm

¹² European Commission archives http://ec.europa.eu/ireland/press_office/news_of_the_day/eu-economic-governance-legislative-measures_en.htm

corrective action will expose the euro area Member State concerned to sanctions (see the following point).

6. A Regulation on enforcement measures to correct excessive macroeconomic imbalances in the euro area:

Like in the fiscal field, if a euro-area Member State repeatedly fails to act on Council EIP recommendations to address excessive imbalances, it will have to pay a yearly fine equal to 0.1% of its GDP. The fine can only be stopped by a qualified majority vote ("reverse voting", see above), with only euro-area Member States voting. These proposals will be examined by the Council, the European Parliament and the Economic and Social Committee. The Commission calls all parties to work towards a speedy adoption of these proposals (European Commission 2010)¹³.

The Council of the European Union decided to establish a European stabilisation mechanism. The mechanism is based on Art. 122.2 of the Treaty and an intergovernmental agreement of euro area Member States. Its activation is subject to strong conditionality, in the context of joint EU/IMF support, and will be on terms and conditions similar to the IMF¹⁴.

3. The medium-term financial assistance from the EU and the Stand-by Arrangement with the IMF

The loan raised from the international institutions – to put it in somewhat simplistic terms – was used to top up the currency reserves (in other words, from the perspective of the real economy it hardly represented any real direct easing of the situation). It was the failure to top up reserves for many years during the preceding period of unprecedented market liquidity that fundamentally limited the range of available monetary-policy responses to the crisis. To put it another way, one could confidently state that all the weaknesses of the Hungarian economy – such as the relatively high level of external indebtedness, the high public debt, the overly extensive and badly-structured fiscal redistribution of funds, the extremely rapid and unfavourably-structured growth in forint and foreign-currency lending (and not so much its actual stock and currency structure), the significantly overvalued forint, the high positive real interest rates and, last but not least, the severe drop in the economy's potential growth rate, which is partly attributable to a combination of all the above factors combined – still don't go the full way to explaining the panic of autumn 2008. The urgent call for outside assistance by the government and the central bank, in contrast to the other countries in the region, was chiefly precipitated by the critically low level of foreign exchange reserves.

Only from this starting point is it possible to understand the responses of Hungary's economic policy to the crisis, even if one can't agree with them.

¹³ European Commission (2010a)

¹⁴ Council of the European Union presse release 9596/10

Unusually, it is worth starting the analysis from the monetary-policy side. After the Lehman bankruptcy, the markets – far more than the aforementioned analysts – were aware of the Hungarian economy's vulnerability (to external factors). In the absence of abundant currency reserves, the Hungarian money and capital market, and thus the forint, became a soft target for market speculation. Unarmed in the absence of sufficient international reserves, at the mercy of the markets and incapable of intervening effectively in the market using its own resources, the MNB watched from the sidelines as events unfolded: the dangerous weakening of the forint exchange rate, the jump in market interest rates and risk premiums, the second drying-up of the government securities market in the space of a year (March and September-October 2008), and the increasingly oppressive shortage of both forint and foreign-currency liquidity in the banking system.

For a few drama-filled days in autumn 2008, the central bank, which until then had argued in favour of a strong forint for the weak economy (and which believes that the exchange rate has no impact on exports – sic!) watched in paralysis as the forint began to spiral downward. Then, and this time with good reason, it raised the reference rate by 300 basis points, the only central bank in the region to do so. But the question needs to be asked again: why didn't it also intervene in the currency market, why didn't it extend generous liquidity support, either in forint or foreign currency, to the banking sector, and why didn't it step in and create liquidity (through open-market transactions) in the secondary government securities market? There are probably two reasons for this. One is the aforementioned technical factor, the lack of sufficient foreign exchange reserves. The other is a broader matter of principle, which may also have contributed to the shortage of reserves in the first place.

Even in August-September 2008, out of principle, the MNB refused to entertain even the suggestion of any currency market intervention. Naturally, nobody seriously believes that it is possible, through intervention, to permanently reverse the basic processes that are determined by fundamentals. Nevertheless, the purchase and sale of currency in the market is one of the available monetary-policy means of influencing market liquidity. It is certainly no coincidence that it features in the monetary-policy arsenal of all serious central banks (with the exception of the MNB prior to January 2009). If the central bank has sufficient reserves, and these can be easily mobilised, then it has the means of limiting and discouraging market speculation to a certain degree. In the years prior to September 2008, the central bank, in a stable environment – while avoiding any unrealistic strengthening of the forint – could have topped up the currency reserves to the necessary level (if it hadn't been focusing one-dimensionally on suppressing inflation at any cost). This would naturally have cost money, a lot of money in fact (indeed, it would have resulted in a slightly higher, but sustainable and therefore credible, rate of disinflation), but it would still have been less costly than the damage caused by a monetary policy that was paralyzed by the lack of reserves.

The worst aspect of the lack of reserves was not simply the shame arising from the fact that – tarring ourselves with the same brush as the ‘undesirables’ – we immediately had to turn to the IMF in October 2008 for credit with which to top up the reserves. This in itself would perhaps have been bearable. The low international reserves, however, prevented the central bank from performing one of its basic functions. Even over a short, 3–6-month horizon, the central bank was incapable of guaranteeing the liquidity of the Hungarian financial system without any major hitches; in other words it was only partially able to fulfil its role as the ‘lender of last resort’ (Surányi 2010, p. 22.).

The fiscal and monetary policy-leaders, the Minister of Finance of Hungary and the President of the Hungarian Central Bank requested that the International Monetary Fund support their program through a Stand-By Arrangement (SBA) for a period of 17 months in the amount of SDR10.5 billion (€12.5 billion). The Managing Director of the IMF, issued the following statement on the 13th October 2008 on Hungary:

“Against the background of global financial turbulence, Hungary's government securities market and some other key markets have experienced stress over recent days. These pressures emerged despite the country's improved macroeconomic and financial policies of the past years, which include a strengthening of its fiscal position, a narrowing of the current account deficit, and a cautious implementation of monetary and exchange rate policies.” (...)

“The authorities have responded to the recent turmoil in global markets through a continuation of their macroeconomic convergence program, coupled with enhanced monitoring of financial sector developments and increased deposit guarantees, which were augmented in line with an EU-wide move.” (...)

“To complement these efforts, we are in close dialogue with the Hungarian authorities and the EU to discuss further responses to the current challenges, including possible technical and financial support by the IMF. I have informed the authorities that the IMF stands ready to assist their efforts. We will provide technical assistance as needed and, in the context of a supportive policy setting, are ready to undertake discussions on possible financial assistance, responding rapidly.”¹⁵

For a period of 17 months from November 6, 2008, Hungary had the right to make purchases from the Fund in an amount equivalent to SDR 10,537.5 million. Hungary's right to engage in the transactions covered by this Arrangement can be suspended only with respect to requests received by the Fund after (a) a formal ineligibility, or (b) a decision of the Executive Board to suspend transactions. The formal purpose is to suppress or to limit the eligibility of Hungary.

¹⁵ IMF (2008a)

Their main objectives were:

1. to reduce the government's financing needs and improve long-term fiscal sustainability,
2. to maintain adequate capitalization of the domestic banks and liquidity in domestic financial markets,
3. to underpin confidence and secure adequate external financing.

Fiscal consolidation in 2006–2008 was the cornerstone of the government's efforts to reduce macroeconomic vulnerabilities. As a share of GDP, primary government expenditures in 2008 were reduced to below the level envisaged in the budget.

The revised budget envisaged a general government deficit of 2.5 % of GDP, which implied a structural fiscal adjustment of about 2.5 % of GDP. Revenues, which were difficult to project precisely in the critical environment, were expected to decline somewhat as a percentage of GDP, reflecting the slower growth of the tax base and the effect of the spending measures outlined below. The tax cuts were envisaged for 2009¹⁶.

The necessary adjustment focused on the expenditure side, which seems consistent with the need to reduce Hungary's comparatively large public sector as a share of GDP. Specifically, primary government expenditure (which excludes interest payments) was reduced by 2 percentage points of GDP compared to 2008. This was achieved by 1) keeping nominal wages in the public sector constant throughout 2009; 2) eliminating the 13th-month-salary for public servants; 3) capping the 13th-month pensions and eliminating the 13th-month pensions for early retirees; 4) postponing the indexation of selected social benefits; and 5) trimming operating expenditure allocations to all ministries across the board.

Within the government's expenditure envelope, the government gave priority to investment projects co-financed by EU funds and programs designed to support small and medium-sized enterprises. The program was primarily monitored through the primary cash balance of the central government including social security and other extra-budgetary funds (a quarterly performance criterion)¹⁷.

The EU medium-term financial assistance to Hungary was also decided on in November 2008. Hungary received three instalments of the EU €6.5 billion balance of payments loan: two instalments of €2 billion each on 9 December 2008 and 26 March 2009 and a further €1.5 billion on 6 July 2009. In view of the improved access to market financing, Hungary did not (draw) call for on EU and IMF assistance upon the completion of the reviews in November 2009 and February

¹⁶ www.imf.org

¹⁷ IMF (2008b)

2010. The EU assistance was granted for a period of two years until 3 November 2010¹⁸.

The mission welcomed the government's commitment to the 2010 deficit target of 3.8 % of GDP and recognized that following the budgetary slippage in the first half of 2010, a number of steps will be taken to correct the situation, including sizeable revenue-enhancing and expenditure-saving measures. The corrective measures considered so far still fall short of the required adjustment and are largely of a temporary nature.

However, the government was not in a position to respond to a number of open questions at the time of the mission. The government also has to make increased efforts to bring the deficit under 3 % of GDP in 2011 on a sustainable basis. This was required under the European Council's excessive deficit procedure recommendation. In the area of structural reforms, some measures were implemented by both the outgoing and the incoming governments. Nevertheless, rather than realizing durable savings in the area of long-distance public transport in accordance with the balance of payments assistance conditions, budget transfers to this sector are expected to increase compared to 2009.

The Commission services also voiced concerns that the 0.7 % of GDP pre-tax financial sector levy which has since been enacted as a temporary source of revenue could, in its current form, have a significantly negative impact on the country's investment climate and economic growth. The mission urged the authorities to review some features of the levy in this regard. In addition, it was considered that several items in the same complex bill, as it remained before the Parliament through the duration of the mission, may potentially not be in compliance with EC law. The mission further recalled the government's obligation to respect the full independence of the central bank, including its operations. The Commission services, together with the International IMF, are ready to resume the talks whenever the authorities consider that this would be productive. As with the balance of payments assistance that was extended to Hungary in 2008, a possible successor program would have to be anchored in credible commitments to sound fiscal policy. This is a necessary condition for ensuring sustainable growth and for reducing the vulnerabilities that stem from Hungary's high public debt to GDP ratio. It is also indispensable for allowing the government to meet its obligations under the excessive deficit procedure.

During 2008, the international financial crisis severely reduced Hungarian access to foreign capital. This has led to difficulties in the banking system (including foreign banks operating within the country as well as local banks). The results in the financial account of the balance of payments – a deficit of 5.9 billion euros in 2009 (6.6% of GDP), as compared to a surplus of 10.6 billion euros in 2008

¹⁸ European Commission archives

http://ec.europa.eu/economy_finance/articles/financial_operations/2010-08-05-hungary-review-postponed_en.htm

(10.1% of GDP) – show how drastically conditions tightened in the international financial environment. Finally, Hungary requested IMF support to help face the crisis in the financial and foreign exchange markets. The stand-by arrangement signed with the Fund included measures to bring the government deficit, as a percentage of GDP, down to 3.4 in 2008, and to 2.5 in 2009. Hungary's projected GDP growth rate fell to only 1.8 percent in 2008, and to –1.0 percent in 2009.

As time went by and the crises (both international and domestic) worsened, the estimates were revised. The government deficit would now reach 3.9% of GDP (up from the previously estimated 2.5%); GDP growth in 2008 would hit about half of one percent in 2008, and –6.7% in 2009. In Hungary, tolerance for public deficits was limited and the government continued to pursue fiscal restraint. Even though the IMF accepted upward revisions of the fiscal deficit target, the prevailing goal continued to be one of containing spending. This trend has continued in spite of the obvious consequences that the international situation is having on the domestic economy.

At the end of 2008, a drastic fiscal responsibility law was approved by the Hungarian parliament, and the legislation included strict guidelines on spending. Among those guidelines are that the budget must define a primary balance target two years in advance, and the target cannot be a deficit. Second, the law sets strong guidelines for the evolution of public debt. Finally, every year, the budget must define the extent to which primary expenditures of the central government may change in real value in the following year. Of course Hungary's political instability has not improved business or investor confidence. At the end of March, Standard and Poor's lowered credit ratings of Hungary to "BBB minus" from "BBB". The ratings agency expected GDP to contract by 6% in 2009, and by 1% in 2010 (Cordero 2009, p. 13.).

4. The Hungarian government and the IMF relation in 2008–2010

4.1. From fiscal consolidation to fiscal responsibility – government's policies to alleviate the impact of the crisis on the labour market

The Hungarian measures include guarantees, recapitalisation measures and loans and are aimed at strengthening confidence in the markets and, above all, financing the real economy in a period of crisis. Guarantees are based on Law CIV of 2008 on the strengthening of the financial intermediary system, which came into effect on 23 December 2008, and Government Decree 89/2009 (IV.14.) on procedural regulations for the provision of State guarantees in the interests of financial system stability, which entered into force on 15 April 2009. The maximum total amount committed to State guarantees is HUF 1 500 billion (approximately EUR 5.3 billion).

Guarantees may be sought by sound credit institutions (any banks and specialised credit institutions specified under the Law on credit institutions) with a registered office in Hungary.

Eligible under this scheme are the debts of a credit institution vis-à-vis its creditors denominated in EUR, CHF or HUF and payable in the same denomination that arose between 23 December 2008 and 31 December 2009 and that are based on a loan agreement or debt security. The scheme was available until 31 December 2009; it covers debt instruments at a maturity between three months and five years. The conditions include rules on the remuneration and duration of the measure, the nominal and issuance value of the shares, controlling rights of the State and restricting management remuneration. Other conditions vary and are specified in the individual guarantee agreements. Under the scheme, the Government either has the right to subscribe capital in the credit institution concerned or the credit institution must issue shares carrying specific veto rights.

Recapitalisation is based on Law CIV of 2008 on the strengthening of the financial intermediary system, which came into effect on 23 December 2008. The maximum amount committed to the scheme until 31 December 2009 is HUF 300 billion (approximately EUR 1 billion) in accordance with Law XVII of 2009.

The same institutions that are eligible under the guarantee scheme are eligible under the recapitalisation scheme. Recapitalisation may be granted by convertible dividend preference shares and preference shares carrying specific veto rights.

State loans based on Law XXXVIII of 1992 on general government financing are introduced by Law IV of 2009 on the State warranty concerning mortgages. These regulations came into effect on 11 March 2009, under which the State may provide eligible institutions (see the definition set out above in the section on guarantees) with loans. The conditions vary and are detailed in each loan agreement.

According to a loan agreement between the State and FHB of 25 March 2009, the bank was granted a total amount of EUR 400 million in two tranches (1 April 2009 and 30 April 2009) until 11 November 2012, with a market interest rate. According to a loan agreement between the State and Magyar Fejlesztési Bank Zrt. of 14 April 2009, the bank was granted an amount of approximately HUF 170 billion (approximately EUR 600 million), with a market-based interest rate (Petrovic–Tutsch 2009, pp. 45–46.).

Fiscal consolidation in 2006–2008 was the cornerstone of the Gyurcsány government's efforts to reduce macroeconomic vulnerabilities. The necessary adjustment was focused on the expenditure side, which seems consistent with the need to reduce Hungary's comparatively large public sector as a share of GDP. Specifically, primary government expenditure (which excludes interest payments) was reduced by 2 percentage points of GDP compared to 2008.

The Gyurcsány government in 2006 became committed to maintaining fiscal discipline in the long-term, recognizing that this is a key element in retaining investor's confidence. It therefore intended to continue budget consolidation in the

2010 budget and beyond; new medium-term fiscal targets were included in the convergence program and in their medium-term fiscal framework. To put fiscal sustainability on a permanent footing, the government submitted a draft on fiscal responsibility law to the parliament, which established fiscal rules on public debt and primary deficit, strengthened the medium-term expenditure framework (rolling three-year expenditure ceilings) and created a fiscal council to provide independent and expert scrutiny. See Table 2.

Table 2. The Structure of the EU-IMF loan package billion EUR

20.0	TOTAL EU-IMF CREDIT FRAME		
»	5.8	Has not been drawn	
»	14.2	Drawdowns	
	»	1.4	Total drawdowns by the Central Bank
	»	12.8	Total drawdowns by the Government
		»	4.9 IMF/stabilising the banking system
		»	2.4 IMF/financing the maturing debt
		»	5.5 EC/financing the maturing debt

Source: Government Debt Management Agency Private Company Limited by Shares (ÁKK Zrt.)

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Table 3. Disbursements from the International Loan Package in 2008 and 2009 EUR billion

	Q4 2008	Q1 2009	Q2 2009	Q3 2009	Q4 2009	2010	Total
IMF/ stabilising the banking system	4.9						4.9
IMF/financing the maturing debt		2.3		0.1			2.4
EC/financing the maturing debt	2.0	2.0		1.5			5.5
Total drawdowns by the Government	6.9	4.3	0.0	1.6	0.0	0.0	12.8

Source: Government Debt Management Agency Private Company Limited by Shares (ÁKK Zrt.)

After escaping the danger of a financial meltdown in October 2008, the Hungarian Government concentrated on creating a balance between two challenging tasks.

First, in order to restore the financial credibility of the country it had to carry on with the implementation of austerity measures prescribed by the IMF agreement. Second, it had to fix upon policies which would prevent bankruptcies on a large scale, high unemployment and social unrest resulting from both the effects of the crisis and fiscal tightening. In late October 2008 the Prime Minister convened a National Summit of the leaders of political parties, social partners and representatives of the academic community to agree upon an adequate crisis management strategy. Following this, the cabinet's crisis management package was in place within a few weeks. Efforts to preserve workplaces and to slow down the loss of jobs in hard hit regions were high on the list of the programme. It was put forward that in cases when layoffs could not have been prevented, it was the duty of local and central labour offices together with local governments to assist the re-employment of redundant workers.

In November a special task-force called the "Governmental Centre for Crisis Prevention and Management (GCCM)" was set up, headed by the Prime Minister with the participation of selected ministers and with an agenda of having meetings every second week. The task of this body was to elaborate the details of the crisis management package, to coordinate and supervise implementation and to report to Parliament and social partners on the outcomes of actions. The government assured transparency by establishing a homepage to provide online information on all the major steps of crisis management¹⁹.

In April 2009 the prime minister resigned and a new, so-called crisis-management cabinet was formed the head of which became the former Minister of Economy and Regional Development. A new programme for the short-term crisis management of the national economy was introduced²⁰. Chapters related to employment and regional issues remained by and large the same as were envisaged in the programme of the previous government. The main related points were as follows:

Job preservation programs aim at avoiding the escalation of mass layoffs and offer firms five forms of assistance:

- scope for the partial reduction of wage costs and social contribution tax;
- support for introducing part-time work and abridged working time;
- a subsidy for training and retraining costs;
- the provision of labour market services in the event of job losses;
- a subsidy for the commuting and residential costs for job seekers.

¹⁹ Speaker of the Hungarian Government's archives <http://www.kormanysovivo.hu>

²⁰ The Government's Crisis Management Program and a list of the completed actions can be downloaded from: http://www.kormanysovivo.hu/news/show/news_1734?lang=hu

Firms which apply for participation in this programme are obliged to maintain employment of their redundant workers for at least two years and also to keep their other employees. Only those firms are qualified which show evidence of their longer term viability and can prove that their recently occurred redundancies are the direct consequence of the economic crisis.

Job creation programs implemented to prevent further deterioration of employment and increase participation rates in backward regions. On the eve of the outbreak of the crisis, the Government elaborated a proposal for Parliament to change the eligibility criteria for regular social allowances in the framework of the so-called “Pathways to Work” plan. The initiative aimed at motivating inactive and long-term unemployed people living on social assistance to improve their employability and return to work. The idea was that those non-employed who receive social benefits and are able to work should get involved in public work schemes or should be assisted by training or labour market services. The proposed programme coupled social benefit incentives and active labour market measures with stricter control on the availability for public work of the affected persons.

More funds to finance active labour policies in hard hit regions. An additional resource of HUF 20 billion was earmarked for regional labour centres to assist the re-employment of those who lost their jobs due to the economic crisis.

More funds for job creation programs, especially SMEs working in backward regions. The eligibility criterion for participating in this scheme was a commitment to create at least two new workplaces. Non-repayable financial support could be claimed for buying new machines, equipment or know-how.

Local employment development programs in disadvantageous regions. HUF 97 billion was allocated for local employment development programs in the 33 least developed regions. Another HUF 30 billion was provided for the management of local employment crises in micro regions.

4.2. Fiscal policy and structural fiscal reforms

A core objective of the program was to buttress Hungary’s commitment to sustainable public finances by containing the government’s short-term financing need and credibly reducing it over the medium term. To this end, in June 2009 the Bajnai government adopted and continued to implement a comprehensive package of entitlement, public service, and tax reforms, aimed at permanently reducing public expenditures and stimulating potential growth. By better anchoring market expectations and creating room for a cautious reduction in policy interest rates, these measures allowed Hungary to take full advantage of the ongoing stabilization of global financial conditions. Over the medium term, the combination of fiscal discipline, higher growth, and lower interest rates were expected to put the public debt-to-GDP ratio firmly on a declining path.

The Bajnai government remained fully committed to its general government deficit target (Maastricht definition) of 3.9% of GDP in 2009. It expected higher

spending by line ministries and on health care and unemployment benefits, as well as lower corporate tax revenue, to be offset by lower interest expenditures and a reduction in identified contingency reserves.

The budget adopted by parliament on November 30, 2009 was consistent with the aim to reduce the general government deficit to 3.8% of GDP in 2010. Compared to the draft that was submitted to the parliament, the adopted budget allocated part of the specific reserves to higher spending on healthcare, school meals, and education (the latter two helped to reduce pressures on local government spending) and to a reduction in the VAT on district heating. Consistent with the Bajnai government's commitment to gradually reduce the public transport system's need for government support, measures were taken aimed at improving the financial situation of the sector. These measures included eliminating the redundancy between railway and long-distance bus lines, and implementing efficiency gains (including in procurement procedures).

The budget contained appropriate buffers to mitigate fiscal risks in 2010. The government strengthened expenditure control by assigning treasurers to line ministries. In addition, the remaining amount of specific reserves was added to the stability reserve, bringing overall budgetary reserves to 0.8% of GDP. Any extra revenues that could result from a better than projected macroeconomic performance were used to boost reserves available to deal with risks and to reduce the adjustment in spending that were needed in 2011 to bring the deficit (Maastricht definition) below 3% of GDP.

The Bajnai government intended to review expenditure rationalization aimed at improving the efficiency of the delivery of public services, possibly with the International Monetary Fund's technical assistance.

4.3. Risks of the budget

The downside risks to the fiscal target in 2010 (see also table 4.) include the uncertainty surrounding tax revenue and interest payments projections, the financial performance of MAV (Hungarian State Railways), BKV (Budapest Transport Company) and Malev (Hungarian Airlines), and spending by local governments in an election year. Furthermore, there was a possibility that Eurostat may decide that revenues related to the shift from the second pillar to the first pillar of the pension system would count towards the 2009 fiscal balance. To mitigate these risks:

- treasurers assigned to line ministries should reduce overspending risks by keeping spending in line with budgetary commitments (in contrast to 2009 when the treasurers were assigned towards the end of the year).
- the government discussed the MAV business plan that was prepared in December 2009 in collaboration with the company. While progress has been slow, it expected final adoption by the Ministry of Transport on behalf of the state by end-March 2010. Should risks materialize nevertheless, the policy response would include both the use of budgetary reserves, which amount to

about 0.5% of GDP, and the implementation of identified additional spending cuts of 0.2% of GDP.

Any extra revenue that could result from a better-than projected macroeconomic performance was supposed to be used to boost reserves, which were being kept available to safeguard against risks and to reduce the necessary adjustments in spending them in 2011. Also, any additional revenue that could result from the sale of emission credits accrued under the Kyoto protocol was planned to be either spent on new environmental projects or saved for such projects in later years.

Table 4. Maturity profile of the central government debt

Instruments	Debt stock
Forint debt	10,677.4
Publicly issued HUF bonds	7,899.1
HUF bonds issued by private placement	422.6
Discount Treasury Bills	1,534.9
Retail securities	335.6
HUF loans	485.2
Foreign exchange debt	9,478.2
Foreign currency loans raised abroad	4,437.2
Syndicated and other foreign currency loans	28.7
Foreign currency loan taken over from NBH in 1997	0.0
Domestic foreign currency loans	0.0
Foreign currency bonds	5,012.3
Kingdom of Hungary 1924 issue	0.0
Total	20,155.7
Other debt	314.8
Total central government debt	20,470.5

Source: Government Debt Management Agency Private Company Limited by Shares (ÁKK Zrt.)

To ensure the consistency of budget procedures with the Act on the legal status and financial management of budgetary institutions adopted in December 2008, the Bajnai government adopted and published in December 2009 a government regulation on the implementation of the Act. It adopted a government regulation relative to the rules on the advance payment of EU subsidies, aligning these rules with best practices.

5. The relationship between the new Hungarian government and the IMF in 2010

Since in Hungary the national elections were approaching, the rhetoric connected to the IMF and the loan was very aggressive. But the rhetoric does not describe well the facts of the inner situation of the country's real domestic conditions, and they do not take note of the country's exterior constraints, consisting of rights fixed in contracts and obligations.

For the sake of avoiding a financing crisis, the elected Parliament completed partial harm averting. In early July 2010 the Hungarian government decided to levy a new tax on banks and other financial companies that would raise some 855 million dollars in 2010 and 2011. Foreign banks, who made a fortune during Hungary's bubbly growth years prior to the crash in 2007, protested and lobbied, but – despite having the IMF on their side – they did not succeed.

On 17 July 2010 the negotiations between the IMF, the Commission and the Hungarian Government on extending the standby credit facility previously granted to the country to 2011, were suspended. According to reports in the press, the government did not present a complete economic schedule for 2011 supported by figures, and regarded the requirements imposed under the supervision process as serious intervention in the country's economic policy.

It is well known that, without the loan of EUR 6.5 billion which the EU extended in November 2008 with exemplary speed, Hungary's national currency would not have survived the speculative attacks which followed the world economic crisis²¹. However, the government refused to give in to IMF demands for further budget deficit reduction and negotiations were suspended by the Commission.

The suspension of the negotiations has sent an inauspicious message to the currency markets and government bond markets: following the announcement, the exchange rate of the forint began to plunge in relation both to the Swiss franc and to the Euro, causing damage valued in billions HUF to a mass of Hungarian citizens, who are saddled with a huge outstanding debt.

We can not know why exactly the Commission delegation left the negotiations with the Hungarian Government prematurely. Also it is still a unknown on what conditions will the Commission return to the negotiating table with the Hungarian Government delegation.

There is a critical threshold, beyond which the regularly recurring breakdowns jeopardize the stability of the Hungarian state's financial life. This is when there are no more single and independent cases, but there is a tendency.

²¹ IMF (2008c)

6. Looking forward: Western European markets' fears about the propagation of the risk

The Western European governments have made declarations on the stability of the Western European banks. All the Western European banks present in Hungary have publicly reaffirmed their strategic commitments. The quality of assets will deteriorate to an extent, but the banks are too stable and too capital-strong at present not to be able to cope in such an event²². Prime Minister Viktor Orbán was forced to backtrack from election pledges to put pro-growth measures ahead of budget discipline after the forint plunged on June 2010 on investor concern about Hungary's fiscal health²³. The country agreed to reduce its deficit to 3.8 percent of economic output this year to qualify for an International Monetary Fund-led bailout.

The IMF and EU walked away from talks with Hungary on July 2010, saying the government wasn't doing enough to control its budget deficit. Their departure froze emergency funding for Hungary, not necessary to be used at the moment, but could be a problem later if funding costs spike²⁴. After this the prime minister came up with a new tactic - to separate the discussions led by the IMF from those with the EU. Hungary is in line to adopt the Euro and at this point is closer to meeting some of the currency union's debt and deficit targets than more heavily indebted member states like Greece and Spain. Its primary goal is to reach less than 3% budget deficit, which is a compulsory precondition to adopt the Euro.

Hungary, after getting the IMF support had not been able to go to the financial markets for a long time to take debt, that's why the IMF loans came in handy. Is there any justification for secret meetings on deficit reduction? Secrecy breeds suspicion. Suspicion leads to incertitude. Incertitude affects financial markets. Kopits György, chair the Budget Council said: *„Markets are jitterish, they don't know where the next land mine is going to explode. They don't know what's happening, and there is very low tolerance for even a new government to take the reins on and to really outline a full fiscal strategy.”*²⁵

With a stabilizing economy and a strong political mandate, the new Hungarian government has a historic opportunity to create the conditions for sustainable growth and sound public finances. Their economic program includes several encouraging elements. But, amid large underlying vulnerabilities, it relies to a substantial extent on temporary and distortive measures that may jeopardize medium-term fiscal sustainability, increase uncertainty, and ultimately harm growth.

The global recovery and the recent increase of global risk appetite may well prove temporary. Amid Hungary's high external and public debt, a change in

²² How big is Hungary's problem? – Interview with György Surányi www.portfolio.hu November 14, 2008

²³ Bloomberg 2010

²⁴ Street Journal 2010

²⁵ Reuters 2010

investor sentiment would compound financing risks as large sovereign redemptions fall due in 2011–14. Also domestic demand will suffer if the Swiss Franc, whose value directly impacts households' debt servicing costs, strengthens further. Finally, there is a risk that the authorities will not take the necessary measures to restore fiscal sustainability. The associated policy uncertainty could lead to a more cautious behaviour by foreign investors (IMF 2010).

7. Conclusion

In my analysis I tried to look a bit deeper and focus at the situation that is actually facing the country. The Hungarian update reports the introduction of the fiscal responsibility law, which sets a new fiscal rule for the central government, establishes a new independent fiscal institution and contains some other regulations improving the domestic fiscal framework. Some of these new regulations were implemented in 2009 while others, such as the new fiscal rule, entered into force in January 2010. This fiscal responsibility law is expected to promote transparency and a medium-term fiscal planning.

Following another provision of the new fiscal responsibility law, the government shall provide to the Parliament detailed information about budgetary measures to fulfil its medium-term fiscal plans for at least three years. In February 2010, the government should release this information for the period 2011–2013 (Ayuso-i-Casals 2010, p.41.).

It is perhaps no coincidence that the Hungarian economy is once again, on its own, decoupling from the general trend in the region. In contrast to the neighbouring countries (this time also including Austria, Germany and Italy), in the third and fourth quarter we were the only country that once again reported a negative quarterly growth figure. It comes as little comfort that the others aren't displaying robust growth either, although at least they are perhaps over the worst. By stepping up to the plate and performing the budgetary correction, the government has undoubtedly pulled the country back from the edge. Hungary's economic policy, however, continues to be founded on an incorrectly-structured fiscal and monetary-policy mix. Sometimes the inevitable strictness of the fiscal policy is manifest where it shouldn't be (an example of this is the scrapping of 'social policy' loan subsidies in the housing market), or at other times it is relaxed precisely where the opposite would be justified (an example of this being the abolition of the fixed-amount healthcare contribution). Monetary policy, as regards its principles – the exchange-rate policy, after a few aberrations, now stands as a refreshing exception to this – displays consistent continuity with past years: the monetary authority is not even examining the possibility of how, in an especially grave situation, to mitigate the crisis in the real economy through the renewal of the monetary-policy devices at its disposal.

The fiscal consolidation, although successful in quantitative terms, did not lead to economic growth, higher employment or the conditions for a better standard of living, and hardly improved the low growth potential of the Hungarian economy. With a degree of bluntness, one could say that the emergency operation was a success, but it remains uncertain whether the patient will live to see tomorrow or the day after. A rethinking of budgetary and monetary policy, and the comprehensive restructuring of the economic-policy mix, are essential in the interests of halting a rift of historic proportions, and the social disintegration of the country (Surányi 2010, p. 23).

In the context of an absence of fiscal space and financing difficulties, the policy response consisted of continued fiscal consolidation. The Hungarian governments could not afford the cost of the fiscal stimulus, hoping for higher revenues once recovery is at full speed to service the new debt and ensure sustainability. The Hungarian governments cut down the government activities, developed a more incentive tax-and-subsidy-system, implemented the structural and process changes needed for the growth.

The Hungarian economic policy is again credible, and there is certainly a visible shift in opinion, a strengthening confidence towards Hungary in the financial markets. The trend is positive; the decline of the Hungarian economy was not too dramatic, and the macro-economic data are better than expected.

However, this confidence is not fully served yet. Presently, the Hungarian government has to submit the budget to the parliament. The forecasted budget deficit in 2011 is 2.9%, which will be one of the lowest in Europe. The average European budget deficit next year will be much higher than that. There is a risk that Hungary may be unable to raise sufficient funds on financial markets in 2011 if global conditions deteriorate and the government fails to extend its International Monetary Fund program. If external conditions deteriorate and Hungary's weaker fiscal position triggers further downgrades, external funding may dry out in the absence of a safety net.

The most recent IMF study concludes: "Distortive policies such as Hungary's outsized financial sector levy are harmful to the economy. The levy is large at 0.7 percent of GDP (more than three times the largest such tax elsewhere), serves exclusively fiscal purposes, and for less profitable banks amounts to a de-facto expropriation of capital. Its design places a disproportionate payment burden on foreign banks. At this juncture, the payment obligation across institutions has been fixed for 2010 and 2011 but remains undetermined for 2012 and beyond. The risk is that uncertainty about the future design of the tax leads banks to reduce their balance sheet size over time, with negative repercussions for credit supply and economic growth. To minimize the prospect for adverse reactions from banks, we suggest that the government send a clear and credible signal that the levy will be substantially reduced and/or aligned with emerging EU standards after 2011. The government's strong political mandate presents an historic opportunity to address fundamental

constraints to Hungary's growth and to bring fiscal policy sustainably back on track." In my opinion Hungary is not stigmatized by the latest IMF loan. It would be good if the analysts would probe a bit deeper and look at the state that the Hungarian economy is actually in. The agreement concluded with the IMF and the fact that Hungary is a member of the European Union provides some degree of help and protection against the breakdown.

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