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Is Hungary's economy collapsing?

Strolling down Andrassy Street in Budapest, the exclusive restaurants, pavement cafés, expensive shops and the magnificent building of the Opera, offer no clues that Hungary may be going through the early stages of a serious economic crisis. The scene reminds you more of Paris or some other wealthy South European capital than of a country which rid itself of the communist system at the same time as Poland. And yet...

Two weeks ago, the National Bank of Hungary was forced to raise its base rates by three percentage points in the course of ten days. On 4 June, after a slight weakening of the forint, the NBH raised the 'floor' of the band of acceptable exchange rate fluctuations to the Euro by 2.3 percentage points, from 235 HUF/EUR to 240. No one understands why this was done. Until then, the forint had been stable for many months at around the 246 HUF/EUR level. This was very close to the lower (appreciating) border of the band. A slight weakening of to 255 HUF/Euro at the beginning of June left the exchange rate of the Hungarian forint still significantly above the central parity of the band (276 HUF to the Euro). Raising the lower limit of the band, however, caused a sharp drop in the forint's value, to 270 HUF/EUR. On Monday, 9 June, the NBH reacted by raising interest rates by a whole percentage point. This had no effect, so ten days later, the NBH raised its rates by a further two percentage points. President Jarai of the NBH and finance minister Csaba jointly stated that their "preferred" exchange rate was "between 250 and 260 HUF/EUR".

So by mid-July, despite a three percentage point increase in the base rate, the Euro rate still hovered around the 265 HUF mark. Pressure on the forint continues, and the Hungarian economy finds itself in serious difficulties. The NBH's intervention rate is currently 9.5% (which is over four percentage points higher than in Poland), inflation is likely to be over 5%, and the current account deficit is greater than 5% of GDP (the limit above which, according to analysts, there is "increased risk" of a currency crisis).

What caused this sharp downward spiral of Hungary's economic fortunes? There are three categories of reason. The first, most proximate, reason is errors in managing day to day economic policy (moving the floor of the exchange rate band); the second reason is the adoption of an inappropriate exchange rate system and weak budgetary policy; while the third relates to the "deepest determinants" of Hungarian economic policy – the structure of the political system and the dominant ideology of "economic gradualism".

The ruinous effects of forex intervention

It was an evident mistake to raise the floor of the forint's fluctuation band at a time when it still found itself strongly on the appreciation side of its central parity. The decision was the result of pressure from the industrial lobby within the government on the finance ministry and the central bank. The intention was to increase the competitiveness of Hungarian industry, whose output had practically not risen for 18 months. To this day, it is unclear as to why the NBH, whose independence is strongly

guaranteed in law, agreed to such a measure. In any event, the market interpreted the move as proof of the strong position of the industrial lobby within the government and the NBH's submissiveness to government. Investors began to flee the forint, fearing that similar measures would be repeated. To stem this flight, the NBH had to raise its rates from 6,5% to 9.5%. Unfortunately, this failed to stabilize the forint at the level preferred by the monetary authorities and the government.

Yet the greatest irony of the Hungarian situation is that in January, a mere six months ago, the forint was subject to a speculative attack aimed at forcing its *appreciation*. At that time, during the space of a few days some 5 billion euro flowed into Hungary (increasing the NBH's international reserves by some 60%). At that time the NBH wanted to appreciate the forint's fluctuation band. However the government (whose permission was needed for such a step) refused. This was the first victory of the industrial lobby. Fearing that international banks would throw another 5 billion euro at the forint within the next few days, the NBH was forced to cut its official interest rate by one percentage point to 6.5%. In fact the NBH reduced its money market intervention rate by a further three percentage points – to 3.5%. These were further victories for the industrial lobby.

We can draw a number of conclusions from the Hungarian experience:

1. Had it not been for the political victory of the industrial lobby over the NBH (i.e. had the fluctuation band been removed or appreciated if in January), Hungarians would have a forint with more or less the same external value as it has today, though interest rates would be at least two percentage points lower. The 'victory' of the industrial lobby has resulted in far worse competitiveness for Hungarian industry and probably lower economic growth.

2. Had the government of Poland's attack on the National Bank of Poland in 2001-2002 been similarly successful, then it is entirely possible that Poland would have suffered the same consequences – the same exchange rate for the zloty as at present, thought with higher interest rates and higher inflation.

3. Interventions on the currency market are *ineffective*, even when they are *unsterilized* (that means they take the stronger form, involving changes in interest rates). In the Hungarian case, the interest rate changes were very large, totaling five percentage points over five months.

4. Experience has proved once again that the ERM system (on which the Hungarian exchange rate system is modeled) is inherently unstable. This is important in that the European Commission is encouraging the new central and east European members of the EU to join the ERM2 for a long period after their accession.

Hungary's unholy trinity: the budget deficit, inflation and the current account

During its period of rapid economic growth (from 1998 to 2001), Hungary never managed to reduce its budget deficit below 4% of GDP (compared with the 2% achieved by Poland in 2000). Generally, the deficit hovered at around 5% of GDP, and in 2002 it reached 9% of GDP! This was the result of the intense political infighting between the left and right, each with similar support among the electorate. Last year, an election year, the right-wing government of Victor Orban increased the minimum wage by a (trifling!) 100%. It gave local authorities around 2% of the GDP in guarantees for infrastructure investments and similar projects. After taking power, the victorious coalition of post-communist socialists and liberals, determined not to be out-done, raised public sector pay by 50%!

The result of these policies is an inflation which stubbornly refuses to drop below 5% and a dramatic growth in the current account deficit. It was the specter of rising

inflation that forced the raising of interest rates in defense of the forint's exchange rate, even though it remained on the appreciation side of the band. As for the current account, the deficit rose from 2% of GDP in 2001 to 6% in 2002.

The Hungarian government plans to lower the public sector deficit from last year's 9% of GDP last year to 4.5% this year, but it is difficult to accept such plans as realistic. Although two percentage points of that deficit consisted of one-off payments, the European Commission considers that lowering the remaining expenditure by 0.5% of GDP a year is the maximum that can be expected.

From many points of view, Poland is in a better situation than Hungary. It has stable, low inflation, a rational and transparent exchange rate policy, base rates lower by four percentage points, a lower (though we don't yet know by how much) public sector deficit, and a somewhat lower current account deficit. What is interesting is that despite a more restrictive (I would say responsible) macroeconomic policy in Poland, the two countries have nearly exactly the same economic growth rates (of about 2.5-3%) this year. The difference is, that Poland's growth rate can be expected to grow, and while Hungary's is likely to falter.

Unfortunately, the very same forces that led to the destabilization of the Hungarian economy are active in Poland as well. How often do we hear calls for increasing the budget deficit, when it should in fact be lowered? How often do we hear arguments in favor of forex intervention, in order to increase the competitiveness of Polish industry? The Hungarian example shows how badly this can all end: with much the same exchange rate and much higher interest rates for businesses and families.

NOTE: since this article was written, the Polish government has prepared a budget for 2004 that has a considerably larger deficit than expected, and one which is even larger than the Hungarian deficit for next year. While this does not detract fundamentally from the harsh things said in the article about the Hungarian economic situation, it makes the relatively complimentary statements about the Polish situation no longer relevant.

Box: The Hungarian labour market

Hungary performs much better Poland in one area – its unemployment is around 6% of the workforce, compared to 18% in Poland. It is worth considering why. It mainly results from a labor code which offers far less protection to employees, encouraging employers to take on more workers. Second, Hungary's laws on rented accommodation do not strongly protect tenants, which increases the amount of housing available for rent and enables more geographical labor mobility. Third, there is the special role of Budapest in Hungary – a city the size of Warsaw in a country with a population four times smaller than Poland's. Budapest employs a third of the country's labour force in what is effectively a single location. Poland cannot quickly increase Warsaw's population to 10 million (although there is no doubt that this is would be one way of reducing Polish unemployment). It could however, energetically liberalize the labor and the rented accommodation markets.

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