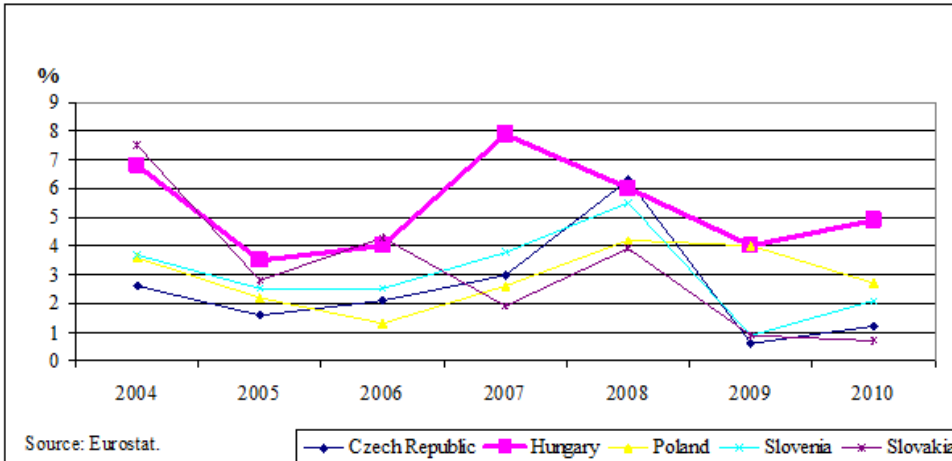


Inflation Rather Than Austerity - Hungary's Economic Strategy

By Peter Mihályi

Since its pioneering economic reforms in 1968, subsequent Hungarian governments have been less resilient to moderate inflation than their counterparts in the region. Under Socialism, upward administrative price adjustments and creeping wages served two objectives; the reduction of salient shortages on consumer markets and rewards for better work. After the 1989-1990 regime change, inflation targeting became an even more important short-term policy tool. Since hyper-inflation was not allowed to gain momentum, there was no need to resort to fully-fledged currency reform, like in many other countries. Instead, Hungarian governments were ready to accept extra-inflation as an unavoidable price for reducing the fiscal deficit.

FIGURE 1: THE ANNUAL RATE OF INFLATION (HICP)



Source: Eurostat

Experience has repeatedly proven that deliberate neglect of inflationary pressures helps to constrain budget outlays, while revenues grow by 2-3 percentage points above what was publicly envisaged. The successful austerity program of 1995 (the so-called Bokros package) used the same trick. Through a combination of devaluation and liberalisation of administered prices, the annual Consumer Price Index (CPI) rose from 18.8% in 1994 to 28.2% in 1995, while the central bank rate's annual average rose from 26.9% to 32.0%. This jump caught both individual households and firms by surprise, thus it was possible to improve both the current

account and the central government's budget balance. In addition, a good part of the accumulated state debt was inflated away as well. This inflation tolerance remained a salient characteristic of Hungarian economic policy long after European Union (EU)-accession.

Eights Years in Opposition

After a single term of Parliamentary power (1998-2002), the party of current Prime Minister Viktor Orbán, found itself in opposition for eight years. During the first four years, their main motto was "We live worse than before". Mr. Orbán's party, the Alliance of Young Democrats (Fidesz) tried to sell the electorate something saliently untrue. All statistical indicators showed that the standard of living rose dynamically between 2002 and 2006. In fact, the true problem was that Hungary lived well beyond its means. The country's net foreign indebtedness rose from 16.6% of GDP in 2002, to 34.3% in 2006. And, as it turned out later, actual GDP growth was also 2-3 percentage points higher than the econometrically calculated potential growth rate.¹

Thus, a painful and unpopular austerity program became unavoidable during the second term of the ruling Socialist-Liberal coalition. Mr. Orbán changed his tactic, too. Virtually from Day 1 after the lost 2006 elections, he mobilized a very broad camp of political forces and argued that any form of belt-tightening was unnecessary, even counterproductive. In this part professional, part ideological campaign, Mr.

¹ Contemporaneously this tension was not reflected in the inflation index, because sheer luck (weak dollar, good harvest) helped to push the CPI downwards. As Figure 1 shows, the backlash came later.

Orbán's closest ally was György Matolcsy, who already served in the first Orbán government as Minister of Economy.

Mr. Matolcsy is a prolific writer. He authored several books, writes for popular magazines, and is considered a good public speaker. Yet as a Minister, he committed himself to a strange mix of supply-side economics (including Laffer-curve microeconomics), 19th century infant-industry arguments, 20th century Keynesianism and *Soziale Marktwirtschaft* theory and 21st century anti-globalization rhetoric. In his view, the adoption of the Euro or even the efforts made by *all* previous governments to get closer to the four nominal convergence criteria were harmful, because they weakened Hungary's "natural" growth engines.

Mr. Matolcsy's arguments rest on two frequently cited facts. First, in terms of real convergence to the per capita average GDP levels of the EU-27, Hungary made very little progress between 2002 and 2009, a little more than 1 percentage point (from 61.6% to 63.0%), while Slovakia, Poland and the Czech Republic advanced by 17, 13 and 10 percentage points, respectively. The second argument refers to the extremely low rate of Hungarian employment, 55.4% among the 15-64 year age group. Among the EU member states, only Malta displays a lower figure.²

Diagnoses and Therapy

In Mr. Matolcsy's view, all of Hungary's most important problems are rooted in under-employment. If this can somehow be fixed, annual GDP growth can be pushed up to the 4-6 percent range, budgetary equilibrium will be restored automatically thanks to the rise in tax revenue and social protection expenditures will be reduced. Once Hungary manages to kick start economic growth, the accumulated debt will quickly fall in relative terms (as a percentage of GDP), international confidence will be restored and thus, debt financing will be less costly. Therefore, the Hungarian economy will grow during the next 20 years at a rate which is at least double the EU-27 average. By 2030, Hungary will surpass the then prevailing living standards of the EU-27. As it stands today, this objective – i.e. catching up with the EU-27 by 2030 – is the official goal of the present Hungarian government.

When the government was formed in May 2010, Orbán and Matolcsy solemnly declared on several occasions that 1 million new jobs will be created in 10 years, from which at least 400,000 will be in place by 2014. In achieving this objective, the Laffer curve argument (the hypothetical link

between tax cuts and additional GDP growth) was put forward. The wealth tax was abolished, personal income tax, certain rates of the social security contribution, and the tax burden of entrepreneurial profits were all reduced right at the outset. By these measures a large gap was made in the budgets of 2010 and 2011. It was assumed that the EU would tolerate a "transitory" additional 3-4 percentage point budgetary deficit from an incoming government. Once approved, 2011 will be an easier time for negotiations, mostly because Hungary holds the current six-month rotating EU presidency. Who in Brussels wants to cause extra trouble under such circumstances? This was probably a non-starter from the very beginning, but the Greek crises of 2010 made Brussels even more determined to reject this peculiar growth strategy.

In its place Plan B was born. The Orbán government resorted to extraordinary measures. It levied extra taxes retroactively upon certain industries in the order of close to 2% of GDP, and more importantly, legislated a drastic pension reform with the hope that the accumulated private pension savings in the order of 10% of GDP can be swallowed by the central budget in the course of 2011.

Nobody Can Shun Work?

After taking care of the fiscal balance for 2010 and 2011, the government turned to the labour market. During the first weeks of January 2011, the Prime Minister and his close aids made hints about "sweeping reform measures" scheduled to be announced on February 15th, 2011. The new slogan, formulated by Mr. Orbán is, "Nobody can shun work". At various public forums he stated that the era of generous and long-lasting welfare benefits for the unemployed was over. Nobody can flee into retirement before the mandatory age limit. According to one of his advisers, the number of people currently enjoying invalidity pensions can be cut from 600,000 to 300,000 through a re-assessment of health status.

In view of the already cited, exceptionally low employment rate, these objectives appear to be both straightforward and implementable to many analysts inside and outside of Hungary. Unfortunately, the Hungarian labour market situation is not as simple, as a single set of numbers may suggest. People forget that the low Hungarian employment rate is chiefly the result of a low share of part-time employment, 18.1% among

² Labour Force Survey, Eurostat Newsrelease, 4 August 2010.

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the EU-27, but only 5.2% in Hungary.³ Those who work in Hungary, work a lot. Twelve hour working days are common in many parts of the economy (retail trade, catering, construction, media, agriculture, etc.) both among managers and low-paid manual workers.

The data in Column 1, Table 1, was calculated according to the following logic. In every country, those who actually work have to provide the means of existence for all of their countrymen, whether they work or not and irrespective to the reasons of not being active (e.g. old age, ill-health, unemployment, child rearing, studies). As the results show, there is a surprisingly small variation among the countries if the figures are standardised for Hungary, as a basis for comparison. Hungarians actually work more than their French, Belgian or Italian counterparts in terms of weekly hours, calculated backwards from the reported annual total figures. Of course, these results reflect – *inter alia* - the fact that Hungarians have shorter vacations, less holidays and – as already mentioned – work much more during each working day.

TABLE 1: THE RELATIONSHIP BETWEEN WORK LOAD AND ECONOMIC DEVELOPMENT LEVELS IN SELECTED EUROPEAN COUNTRIES IN 2008-2009

Country	Weekly work load per head of population		GDP/head
	hours	percentage	1990 international dollar
	[1]	[2]	[3]
Czech Republic	18.2	127	12 868
Portugal	17.3	121	14 436
Slovakia	16.1	113	13 033
Romania	16.0	112	4 895
Norway	15.7	110	28 500
Austria	15.7	110	24 131
Poland	15.7	110	10 160
Greece	15.6	109	16 362
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HUNGARY	14.3	100	9 500
France	13.6	95	22 223
Belgium	13.5	94	23 655
Italy	13.3	93	19 909
Turkey	12.5	87	8 066

Notes: The work load figures in Column 1 are calculated for the entire population of a given country. The work load data refer to the 1Q of 2009. Development level data in Col. 3 refer to 2008.

Source: Cols. 1 and 2 are own calculations based on Data in Focus, No.35. Labour Market Latest Trends 1Q 2009, Eurostat 2009; Col.3 is taken from A. Maddison: Historical Statistics of the World Economy: 1-2008 AD, <http://www.ggd.net/maddison/>.

Analysts of the Hungarian labour markets identified the main reasons why so many people in the working age cohorts are not present in the labour market. The crux of the problem is that in the post-communist economic setting, uneducated and unskilled workers are simply not in demand - neither by

large firms, nor by the small ones. The rate of employment among Hungarians without secondary education is only 33%, about half of the EU or OECD average.⁴

There are two ways that the non-working segment of the population can be bullied back into the labour market. First, existing entitlements can be reshaped and reduced in value. While this should be easy to push through Parliament, where Fidesz has a comfortable 2/3 majority, politically it will be very difficult to deny that these are in fact austerity measures, the usefulness of which was so vehemently denied by Messrs. Orbán and Matolcsy in the recent past. The second option is much softer. The purchasing power of the various social entitlements, such as pensions, family allowances, unemployment benefits, agricultural subsidies, etc. can be gradually eroded in two to three years by induced inflation.

From the recently instituted measures of the second Orbán government, several point into this direction. The present rate is already high (4.9%), thus an additional 2-3 percentage point increase will not be shocking. Since May, there has been constant pressure on the National Bank to give up its anti-inflationary mandate and replace the present members of the Monetary Council with Fidesz-aligned cadres. After one year of successful operation, the Fiscal Council was - *de facto* - dissolved. It was announced that the adoption of the Euro will be postponed until the end of the present decade. Mr. Orbán publicly stated that he is willing to coordinate economic policy with Brussels, but he is against coordination. This means that he does not want to comply with the Maastricht inflation target even in the medium-term.



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³ In fact, this is not unique to Hungary. The corresponding rate is under 10 per cent in each of new EU member states, having a communist past.

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⁴ Once again, this is not a particular Hungarian misfortune. The situation of workers without a secondary degree is very similar in all former East European socialist countries.