THE HUNGARIAN CRISIS: AN AUSTRIAN SCHOOL EXPLANATION

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Abstract: *The Hungarian model was heralded as one of the most successful post-socialist way of integration into the globalised world economy and European economic area in the nineties. Currently, Hungary is suffering from a full-blown crisis 1996 onwards. Increasingly large number of Hungarians is losing their faith in political parties, institutions, democracy and in market economy. The government, elected in 2010 by supermajority and still enjoying a broad support despite the deepening recession, condemns the development path taken after 1989 and openly rejects the wrong model of the last 20 years. The government intends to build a new economic model following a model, which one can call a model of economic nationalism as the only way out of the crisis. The paper intends to portray, through the case of Hungary, how economy and politics is interconnected, and why political elites are choosing a credit fuelled development path. The paper intends to portray how a credit fuelled growth was induced by politics and ended up in tears. Moreover, the paper describes the consequences of pro-etatist shift in the public sentiment due to the alleged "market-failure", which was in reality a crisis, at first place, created for political purposes by political means. This article, based on the Austrian business cycle theory, argues that the tragedy of Hungary was that it went through a government inspired spending binge in the first half of the 2000s. The deficit spending of the government was accompanied by the expansion of credit by the commercial banks, mostly denominated in Swiss francs. The combined effect of deficit spending and credit expansion was the build-up of debt and loss of cost competitiveness. The 2008 crisis ended the credit fuelled development path and has started the long and painful period of deleveraging crisis. On the other hand, the Hungarian crisis is a post-Keynesian crisis. It had broken out when the state was already heavily indebted and the managerial state fully developed within the constraints of the capabilities of the Hungarian economy. The paper argues that Hungary has chosen the wrong path by opting for economic nationalism and blaming "markets" for the crisis.*

Keywords: *macroeconomics, CEEC, economic crisis, Keynesian deficit spending, Austrian economics, Hungary*

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The Hungarian model was heralded as one of the most successful post-socialist way of integration into the globalised world economy and European economic area in the nineties. Currently, Hungary is suffering from a full-blown crisis 1996 onwards. Increasingly large number of Hungarians is losing their faith in political parties, institutions, democracy and in market economy. The government, elected in 2010 by supermajority and still enjoying a broad support despite the deepening recession, condemns the development path taken after 1989 and openly rejects the wrong model of the last 20 years. The government intends to build a new economic model

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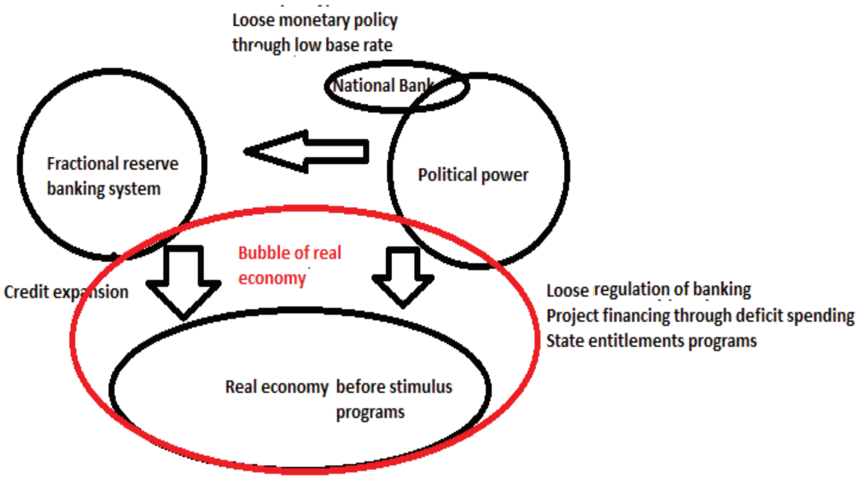
This article, based on the Austrian business cycle theory, argues that the tragedy of Hungary was that it went through a government inspired spending binge in the first half of the 2000s. The deficit spending of the government was accompanied by the expansion of credit by the commercial banks, mostly denominated in Swiss francs. The combined effect of deficit spending and credit expansion was the build-up of debt and loss of cost competitiveness. The 2006 Hungarian budget crisis halted the deficit spending, but induced further credit expansion through the banking system. The 2008 worldwide crisis ended the credit fuelled development path and it has started the long and painful period of deleveraging crisis in Hungary. On the other hand, the Hungarian crisis is a post-Keynesian crisis. It had broken out when the state was already heavily indebted and the managerial state fully developed within the constraints of the capabilities of the Hungarian economy. Thus the government had not opportunity to overcome the crisis through deficit spending, following the Keynesian script. The paper argues that Hungary has chosen the wrong path by opting for economic nationalism and blaming "markets" for the crisis. Following the tenets of Austrian economics theory, the paper argues that statist economic nationalism would only deepen the crisis through creation of regime uncertainty and as a consequence of ever increasingly curtailing of freedom of private business through selective regulation, cartelisation and through punitive taxation.

The Austrian business cycle theory

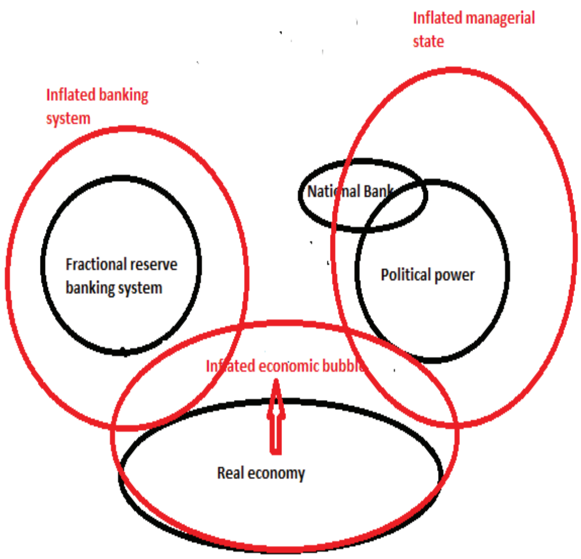
The heart of the austrian business cycle theory, first developed by Mises (1921) is the phenomena of not savings based credit expansion engineered by the state through deficit spending and the fractional reserve banking system, enabled by the loose monetary policy of central bank. The boom is followed by bust, a credit-crunch. Market processes are inevitably ending the boom sooner or later and causing a painful deleveraging process, undoing of malinvestments generated by the artificially generated and unfounded credit boom. This deleveraging process causes a wider political crisis. The cycle of unfounded and unsustainable boom and consequent crisis and deleveraging process is the heart of the Austrian business cycle theory (see more: Ebeling, 1978). According to this theory, the credit boom instigated by the fractional reserve banking system, without previous savings, creates an artificial boom. None the less, the arrival of the managerial state and the base rate policy of national banks creates previously unseen power to induce an expansion of economic booms through deficit spending by the state and the credit expansion by the banking system (see: Figure 1.).

Figure 1:



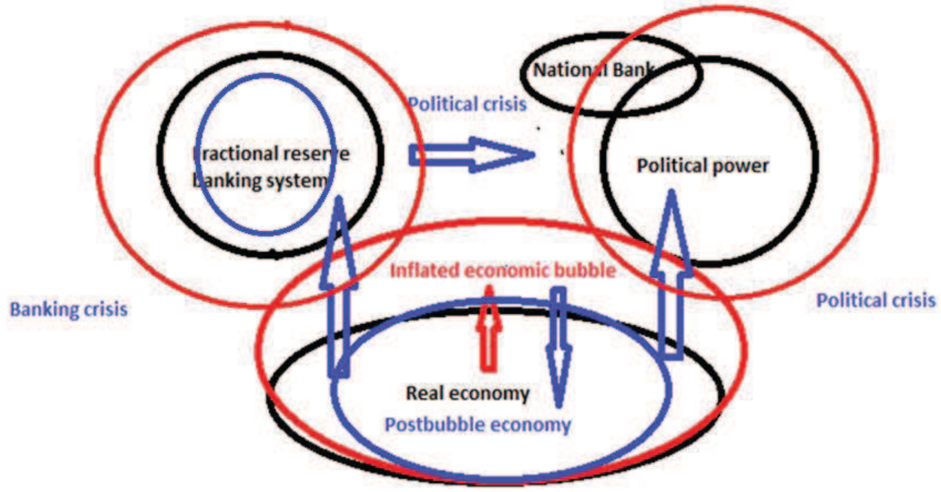
The credit and cheap financing boom distorts the calculations of the entrepreneurs, consumers and the state. Entrepreneurs, due to cheap credit and abundant orders, are overestimating the future trend of volume of capital offered to invest and that of consumption. Consumers are developing falsely optimistic scenario of real wage growth and entering into a spending binge. The boom, leads to malinvestments (Mises, 1949), a cluster of entrepreneurial errors (Rothbard 1962). The state, which initiated the boom through deficit spending and credit expansion, in turn is experiencing a revenue growth. The revenue growth induces further expansion of public investment and entitlement programs, the rise and extension of managerial state (Gottfried 2001). As a consequence, there is a parallel and mutually reinforcing inflationary growth of the real economy - consisted of enterprises and consumers – the fractional reserve banking system and the managerial state is taking place at the expense of debt accumulation and building up of credit pyramids. A kind of Ponzi-scheme style expansion is taking place across the economy, in which growth is based on ever growing credit expansion schemes. The seemingly never ending growth is going ahead causing an ever increasing rise of consumption, until there is not emerging an external obstacle, which would turn the tide. Overconsumption in a finite word inevitably leads to price inflation and/or rises of asset prices. Price increases and/or interest rate rise by the central banks as response to price increases are bursting the bubble (see: Figure 2.).

Figure 2:



Economic actors are facing with the moment of truth: they have mistakenly incurred debt to finance long term projects, which are now turned to be unsustainable due to asymmetric price changes. Entrepreneurs, in turn, are realising that earlier investments are not sustainable, do not produce the expected revenue stream and consumers are unable to meet with credit instalment payments. They immediately draw the conclusion: they should cut back consumption, terminating the half-ready investment projects and cut costs and expenses. The crisis of the real economy begins, which quickly had its impact on the banking system. Credit translates into unsustainable debt. Faltering instalment payments are provoking shortage of bank capital, runs on banks, and may lead to full-swing banking crisis. The collapse of credit further increases the crises of the real economy. Banking crisis feeds the deeper and deeper crisis of the real economy. This leads further to wage cuts, unemployment, the collapse of livelihood and stability of wide sections of the society. Through instability of livelihood, the crisis of the real economy translates into political crisis. The black swan (Taleb 2010) event is becoming reality: the artificial boom based on unfounded credit expansion turns into overall crisis present in the real economy, banking system and in the political system. (see: Figure 3.).

Figure 3:



The Hungarian crisis is a post-Keynesian crisis. It broke out when the state was already heavily indebted and the managerial state had fully developed within the constraints of the capabilities of the Hungarian economy.

The characteristics of the post-socialist Hungarian model
In the early nineties had formed the three most important feature of the post-socialist Hungarian economy: 1) highly efficient export oriented FDI sector with low level of interconnected local supplier base 2) non-efficient and partly tax-evasion based domestic SME sector serving local markets and in fierce competition with foreign products and service providers, 3) a relatively large welfare state and state bureaucracy.

Tensions of the Hungarian model
There were three major sources of tensions of the emerging model. First, it have emerged the widespread feeling of fear from insecurity, the sensation of exploitation and anger with the increasing inequality after many decades of relative equality. Secondly, the takeover of flagship firms by multinationals, the low effective tax level on FDI operations. It created a feeling of negative discrimination of domestic entrepreneurs and the sensation of being exploited by foreign companies, by large multinational companies. Thirdly, the benefits of recovery have spread unevenly within the country. Large areas of the country remained depressed, especially, far away from the Western border of Hungary, from highways and rural areas far away from revitalised industrial centres.
The segmented success of Hungary in building a post-socialist economy is increasingly translated into political tensions. There had been formed two major blocks of political parties following the democratic transition. One block was formed by the alliance of left wing MSZP (Hungarian Socialist Party) together with the progressive liberals. The other block was formed around the right wing FIDESZ (Alliance of Young Democrats). MSZP adopted a pro-European third way policy, influenced by Tony Blair, and argued for extensive welfare state combined with open

market economic order. FIDESZ increasingly adopted economic nationalism, claiming that the state should support domestic entrepreneurs and reinforce state participation in the public service sector.

The derail of the original model and turn to state led development model based on deficit financing and debt build up

Around 2000, was the turning point. The FIDESZ led government, elected in 1998, followed a prudent economic policy. None the less, this policy was heavily criticised by MSZP, which demanded “welfare transition”. Facing with loss of popularity, the FIDESZ turned to Keynesian-style state financed economic development policy too boost consumption. In the heated 2002 elections campaign, MSZP outbid the governing FIDESZ by promising wide scale welfare measures. The MSZP has implemented all the headline pledges made in the elections campaign and continued the Keynesian policy of deficit spending.

Joining the EU, in 2004, meant that Hungary should have observed the conditions set by the European Stability Pact (ESP). The government had to introduce various packages to reduce budget deficit 2003 onwards. This policy change, however, led to rapid loss of popularity of the government. In autumn 2004, facing with the possibility of losing elections in 2006, MSZP has opted to change and returned to debt build up to finance the rapid increase of the internal consumption. Commercial banks, to circumvent the restrictive monetary policy of the national bank, had expanded credit employing a scheme based on Swiss franc. The government had not intervened, despite having receiving warnings about the potential negative consequences of building up debt in foreign currency.

Crisis and the collapse of the post-socialist development model

MSZP easily won the 2006 elections. Winning the elections, however, the re-elected government had to meet with the EU demand to introduce severe cuts in budget spending. The sudden U-turn of the government was a bolt from the blue. Things were made worse by leaking out a speech of the Prime Minister in autumn 2006, in which he admitted in a closed meeting, that the government lied during the elections campaign and mislead the electorate to gain re-election. The speech provoked a deep political crisis. The outbreak of the 2008 crisis made things worse. The fall of the Hungarian economy was especially deep as the state continued to cut costs.

In this period, the FIDESZ followed a staunch opposition policy. Opposed any reform, and demanded Keynesian style measures to redress the crisis. FIDESZ promised a strong state, which would support Hungarian entrepreneurs and middle classes instead of unbridled neoliberal policies.

The “revolution” of economic nationalism

The 2010 elections were won by FIDESZ with two-third majority. The supermajority allowed to the government to break free from any constitutional limit and the government put forward a goal of re-organising Hungary. FIDESZ used the supermajority to implement economic nationalism (see Mises 1944) and to assist the strengthening of a loyal entrepreneurial class through covert and explicit cartelisation of certain sectors of the economy. The stated goal of the government is to create a new and more indigenous growth model based on strong government after the alleged the failure of the globalised and FDI dominated post-transition societal model, which only served to exploit the Hungarian nation by foreign companies and speculators, especially in public services, banking and retail trade sector. This strategy required selective legislation at the expense of neutral concept of rule of law.

There were, however two constraints on the government. In one hand, given the lack of competitive domestic industrial base, the government is forced to support the presence of manufacturing FDI and limit economic nationalism to service sectors. Secondly, EU insisted to maintain budget deficit at 3% for 2011 and at 2.5% for 2012, and thus effectively blocked the initial plans of FIDESZ to finance through deficit spending the re-engineering plans. To circumvent financial limits set by the Commission, the government acquired the accumulated wealth of private pension funds. The ending the private pillar of pension system also had the beneficial effect that it had lessened the annual deficit of the budget by 1-1.5% of the GDP, easing the meeting with the strict conditions set by the Commission. Additionally, the government levied special taxes on a number service sectors, mostly dominated by large multinational firms, to increase her revenue. It is rumoured widely in the financial press that the special taxes are also serving to implicit putting pressure on these companies to leave Hungary and hand over their markets to domestic companies.

The results of three years of re-engineering are mixed. Politically, economic nationalism is a winning ticket. The government has retained a relatively huge support despite the recession. Economic nationalism proved to be a successful strategy when large segments of the population lost their hope in the globalised market economy, and put the blame on foreign speculators and banks for the crisis. A large section of the population hopes to come out from the crisis by ending the exploitation by foreign companies.

None the less, the economic results are increasingly contradicting to these hopes. The Hungarian economy 2011 onwards fell into recession. Investment has fallen to a very low level. It is widely argued that regime uncertainty (Higgs 1997) is the major reason for the low investment level caused by cartelisation in certain sectors, legal uncertainty created by ever changing and selective regulation, fear of seizure of wealth through punitive taxation. Hungary is increasingly becoming an outlier in the region, caused by inward looking policies and ever deepening recession. Economic nationalism is increasingly at odds with the European regulation ensuring the operation of the European single market.

Discussion: Austrian economic cycle theory and its interrelationship with politics

The paper through the example of Hungary showed how develops an unsustainable, credit fuelled economic model mediated through party competition for power in a democratic system. Winning in the next elections is an unquestioned priority for political parties. For governing parties one of the major arguments for re-elections is economic growth. Thus governments do their best to engineer growth with “good” government policies and redistribute the dividends of growth for those layers of the society, which deemed to be important for the re-election for the governing parties. It was the reckless attitude of the major political parties to secure political power for themselves is the major culprit for the excessive debt build up for the state and for allowing the banking system to offer forex based credit for consumers and companies. Six years of party resulted in a long agonising recessionary period. During the long recession, the MSZP led government was unable to unleash

Keynesian anti-cyclical deficit spending due to the high government debt level and had to implement austerity measures, which deepened the recession.
The impact of debt crisis and the long crisis, however, had undermined popular trust in markets, which was anyway low given the low trust nature of the Hungarian economy (Bartha 2012). The FIDESZ ably exploited the wishes of the population for a quick fix and made to believe that a strong government could overcome the crisis and ensure security. Winning the 2010 elections, FIDESZ implemented the policy of economic nationalism, and pursued a blame game against banks and foreign investors. Blame game and feeding the hope for development through profit-repatriation from foreign actors is provided an opportunity for the government to legitimise crumbling down of rule of law to be able to legislate special punitive taxes and renationalisation in selected public service sectors. Punitive taxes afforded new sources of revenue for the government. Another source of additional government revenue came from acquiring the private pension funds by the government through punitive legislation. With these measures, the government was able to upkeep the active managerial state providing justice and offering paternalistic protection. Unfortunately, for the long term prospect of Hungary, economic nationalism and the crumbling down of rule of law, which is a necessary consequence of omnipotent government, regime uncertainty is undermining business confidence and reducing long term growth potential of the country. Increasing isolation, ever deepening recession is the price for economic nationalism. None the less, a selectively punitive high tax regime, the ever increasing fear of arbitrary state intervention may just works against the hopes of average Hungarians, that state could reignite growth.

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