Interview with Mihály Varga, Minister of Finance

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In the more than three decades since the fall of communism, the Hungarian economy and society have undergone major transformations. What has been the role of monetary policy and fiscal policy in this? Looking back at the period since the change of regime, what would you identify as the main features and lessons of the financial policy era?

In my view, two fundamental eras need to be sharply distinguished. The first is the transition of the economic system to a market economy after the regime change. This was a difficult period. The socialists continued to look outwards, seeking to rely on foreign centres. Therefore, a kind of shifting economy developed between them and the political forces that focused on Hungarian interests. With no small amount of good intentions, it could be said that this was an era of „one step forward, one step back" for the Hungarian economy. The period between 2002 and 2010 was much more a period of going backwards. The economic policy setbacks of the Socialists' (Medgyessy-Gyurcsány) era are well remembered: their fiscal policy led to a record deficit of 9.6% and economic stagnation in 2006, in a boom year and well before the financial crisis, while they also indebted the country abroad. If we take an average, we can also see that between 2002 and 2010, left-wing governments operated with an average deficit of 6.4%. By contrast, between 2010 and 2023, deficits averaged 3.9%, despite two major global economic crises. The second major period can be identified as the era of establishing an independent, sovereign Hungarian economy from 2010 onwards. This was the time we shifted to a work-based economy, increased employment by 1 million and built the strongest family support system in Europe. All the while, we reduced Hungary's public debt every year, something that no other EU country was able to do that time. In drawing a distinction between the two eras, I should also mention the national government's basic statement that taxes should be collected, not raised. Over the years, the whitening of the economy, the more efficient collection of taxes and the tax cuts that this has made possible have also made the Hungarian economy more crisis-resistant. The significant tax cuts implemented since 2010 could not have taken place if we had not been able to collect taxes more efficiently. Today we can clearly see that it has paid off to pursue

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crisis-resilient economic policies. The figures show that the Hungarian economy is back on track for growth this year: it could expand by 2.5% in 2024, and almost all forecasts put us on the EU's podium next year.

The prevailing economic theories change from time to time, and with them certain economic and financial policy practices. One striking example is the issue of budget deficits and public debt. Why is the budget deficit important and what is its optimal value, and is it even possible to talk about a permanent optimum? What are the aspects of responsible management of the budget deficit?

In practice, there are examples of developed countries planning surplus or zero balance budgets. However, this is not the case in the world's major economies, with the US, Germany, China and Japan all running deficits of varying sizes. Especially in the current crisis-ridden period. The most important thing to note is that deficits are not bad in themselves. In fact, it is not even a problem if the nominal value of public debt is increasing, if the nominal value of the GDP is meanwhile increasing at a faster pace, and the public debt ratio is falling. If the deficit can ensure this decline at a pace, then it can also be kept within manageable limits. However, the state of the economy is particularly important. In time of recession, it is particularly helpful if the budget helps it to recover, resulting in a slightly higher deficit. For example, in 2020, during the COVID crisis, the world economy, including Hungary, went into recession. In such cases there is no question of whether the budget can be in deficit.

In fact, it should be, as the economics textbooks teach that fiscal policy should be counter-cyclical and increase the deficit, and that it should also increase debt in order to reduce the economic downturn and unemployment. Conversely, if growth is going well, the government should save for the bad times and thus operate with as low a deficit as possible.

The Ministry of Finance's task is therefore to maintain a balance between keeping the deficit manageable and the public debt financeable, while keeping these ratios on a downward path over the long term. This is not only a constitutional obligation, but also a credibility requirement.

Over the past nearly 50 years, central banks around the world have increased their independence, which is seen as a cornerstone of modern economic policy. What is the economic interpretation of central bank independence? The central bank is part of the state but independent of the government, while the success of a country's economic policy is determined by the combination of monetary and fiscal policy. What are the main challenges globally and in the European Union in ensuring consistency between monetary and fiscal policy?

First and foremost, we must make it clear that the independence of the central bank in Hungary is sacrosanct. The primary task of the central bank is to ensure financial stability and, through this, to keep inflation under control. Fiscal policy is responsible for the functioning of the economy. These two areas require different approaches. The best results can be achieved if both approaches are applied to the economy and if the two approaches can be reconciled. Ideally, monetary and fiscal

policy should be mutually supportive. Any discussions should also aim to maximise this synergy. Nevertheless, central bank independence ensures the credibility of the commitment to long-term objectives and helps to maintain the stability of financial markets and the value of foreign exchange (? nem inkább „the foreign exchange rate of our currency"?). A country's economic development is greatly enhanced if monetary and fiscal policy can work together by both „doing their job": disciplined fiscal management does not generate inflation, does not divert resources from the private sector, and the central bank can keep interest rates low while maintaining stable low inflation. In this cycle, interest rates are low, just as well as the cost of financing public debt. This helps to keep the public deficit low, boosting public and investor confidence. We can recall the years before 2010, when the opposite was the case and the misalignment of fiscal and monetary policy led to a vicious circle of high budget deficits, rising public debt, a high interest rate environment and stalling growth. As a consequence, in the 2008 global financial crisis, Hungary started to fall immediately, and was put on the IMF's respiratory device. Ensuring consistency between monetary and fiscal policy is one of the biggest challenges globally and in the European Union, especially in the challenging years of the 2020s. With energy prices and inflation spiralling out of control in the wake of the Russia-Ukraine war, governments have increased spending to help households and businesses survive, while central banks have fought inflation by raising interest rates. In this situation, the most important task for both areas is therefore to find the optimal path along which budget deficits and inflation can be reduced while maintaining economic growth. We saw an example of this when the government and the central bank cooperated successfully in bringing down war and sanctions-induced inflation from 26.2% to 3.6% in the space of a year.

Is there a conceptually different rationale behind the reform of the Stability and Growth Pact (SGP)? How does the regulatory package help Member States' growth and support sustainable convergence? How does it support the strengthening of the EU as a whole in the global economy? What other challenges remain for the fiscal policies of EU Member States?

First of all, it is important to know that the reform of the Stability and Growth Pact has introduced a different approach to economic governance in the EU. Member States will now prepare a national medium-term budgetary structural plan instead of the previous convergence programme. In this plan, Member States will have to set out the budgetary path and the planned reform and investment measures for several years ahead, and their implementation will be assessed annually. It is hoped that this will contribute to strengthening the competitiveness of Member States, and thus the Union as a whole, and make national fiscal systems more crisis-resilient. For our part, this is also the main objective of the Hungarian EU Presidency. The 3% deficit and the 60% debt rule remain in effect, but the requirements for approaching these criteria have been relaxed in many respects. The new approach is designed to help support economic growth and investment in Member States through growth-friendly, sustainable and more gradual debt reduction. Furthermore, the reform

should result in a correction of the fiscal requirements for the Excessive Deficit Procedure (EDP) in view of the increased interest expenditure during a transitional period, which should also serve to restore economic growth. In line with Hungarian interests, it has also been introduced in the rules that excess defence expenditure should be taken into account as a relevant factor by the European Commission when assessing compliance with the deficit and debt criteria. This is particularly important from Hungary's point of view, as our spending on border protection alone has already exceeded HUF 700 billion since 2015. All in all, in the short term, rule changes have brought flexibility, but in the longer term, stricter budgetary discipline is needed. The Hungarian government is committed to reducing the budget deficit and public debt, and we have taken measures to achieve the revised deficit target of 4.5% this year by rescheduling HUF 675 billion of public investment, while thousands of billions of forints of development will be implemented this year. I am convinced that such a flexible but fundamentally tight fiscal policy will play a key role in our future competitiveness.

As a fiscal policy manager, communication with economic policy actors is key. What are the differences in the preferences of different stakeholders (citizens, companies, investors, credit rating agencies, etc.)? What are the main challenges in communicating fiscal policy and, more broadly, economic policy?

Trust is one of the main pillars of the economy. Both on the part of the public and on the part of investors. First of all, we needed to reinforce it after 2010. Despite all the criticism, the work-based economic model has worked and has earned the trust of all economic operators. Communication is also based on this trust. It is about connecting with economic actors and demonstrating how the government's strategy is in line with their interests, how it helps the economy's overall performance to grow. Every situation is different, and you need to go into different depths in case of professional forums and of an audience not consisting of economists. But the fundamentals to reveal are the same: Hungary is a good place to invest and the government's actions are consistent and predictable. The statements of the credit rating agencies confirm that – now for a long time – this has been the image of the Hungarian economy in the world. Despite the war in our neighbourhood and the adverse global economic environment in Europe, all three major rating agencies recommend Hungary for investment, rating Hungary two notches higher than at the beginning of the previous decade. This is based on a combined performance of the government and the real economy, which grew out of mutual trust. ■