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Crisis management in Hungary

Theoretical analysis

Hungary is currently burdened with crisis, in fact with several types of crisis. The economic crisis has unfolded after the global economic recession, triggered by the international financial crisis, reached Hungary. This is a natural consequence in a country where the export-import ratio accounts to 70 percent of the GDP. In addition, the country must overcome a serious financial crisis, which in part can be attributed to the financial crisis evolving in the international arena. In a financial crisis lenders are always cautious. They place the debtors' solvency under greater scrutiny, and countries burdened with economic and payment problems are given loans only at more stringent terms and conditions, if at all. This can also lead to a decline in production, since in such a case the decrease in imports, which are indispensable for the economy, may also trigger a drop in the GDP. In the absence of loans imports may plunge, and may bring economic performance down, too. This problem primarily affects countries that are heavily indebted, whose level of development is intermediate at best, and whose public finance balance has been negative for a longer period of time. The Hungarian economy is characterised by especially these features.

On top of all this, the problem is not only that Hungary cannot evade the global financial and economic crisis in a globalising world economy, but also that due to its internal and external balance situation, Hungary is very much exposed both to economic and financial crises.

The correctness of this statement can be explained with special factors, too. These factors are in part related to mistakes made in the economic and monetary policies, and in part to the fact that the economy is characterised by structural weaknesses that lead to permanent bad results in production efficiency as well as propensity to save, and which remind us of the repeatedly cancelled reform.

Yet, the factor that causes the gravest problem in Hungary is politics. The country has reached an internal political state that the world is less and less able to comprehend. Political animosity now dooms almost every sensible initiative to failure. The country is burdened with several serious problems: the economic crisis, the financial crisis which is threatening the country with financial bankruptcy, the repeated stagnation of the reform process, and finally the political crisis devouring the country. The latter threatens not only with shoving the economy into deep recession, but also with making everyday life unbearable.

This paper is about crisis management. Consequently, its main subject is the economic and financial crisis. It also addresses the problem of the economic reform, inasmuch it is related to crisis management. The article

devotes the least attention to the political crisis. That is already a politologists' affair. I would rather make references as for what disadvantages policy-making triggers in the management of the recession and the financial crisis alike.

Since the subject is rather complex, for the sake of simplicity I divide the issues to be discussed into separate sections. First I will discuss recession and the management thereof, since several conclusions drawn in this respect will be needed for the analysis of the financial crisis. But it cannot be ignored in the first step that the country's financial status is unstable. In part this explains that even the management of the economic crisis is characterised by specific features in Hungary. It turns out that we are in no way in the position to do what large economies can do, and are equally unable to do what relatively smaller countries with more stable finances can attempt.

The financial crisis is on our tail, too. In such a case crisis management must *a priori* be out of the ordinary. The following section provides an analysis of this. It is not at all sure that at such a time the country should first of all concentrate on the mitigation of the economic crisis, i.e. to ease the decline in production. The radical and fast improvement of the financial balance may come into the foreground. The notion of crisis management can be used in this case, too, albeit with a different meaning. In this case crisis management deepens the economic crisis itself, no matter what serious troubles are caused by the recession. Although recession-mitigating measures can be applied, the overall efforts are directed towards a different goal, and not towards the mitigation of recession. It would be beneficial to use two different terms in the two cases, but for the time being no such clear terminological distinction is available.

Under the threat of financial or state bankruptcy all other problems are secondary. Even the growing rate of unemployment due to recession is qualified so, since state bankruptcy would cause a much graver crisis and sharper decline than recession by itself. Production could fall by as much as 10 to 20 percent instead of a few percentage points. Therefore, it must be stated: at such times crisis management deepens and not mitigates recession, yet it prevents the collapse of the economy, which would trigger – among other dramatic consequences – a drastic decline in economic performance. Therefore, it can also be stated, that crisis management decreases the rate of decline, but *in this secondary meaning*, and not in the usual context, i.e. in the case of recession not threatening with financial bankruptcy.

Since recession and state bankruptcy triggered crises differ in terms of content, the policies to be followed are mostly different, too. Different reform and public finance policies are needed, the public finance deficit is judged differently, and the monetary policies to the pursued are also different.

In this paper the first topic of discussion is how the economic crisis can possibly be mitigated, and then comes – also for the sake of sharp contraposition – the analysis of the grave financial crisis, the impact of which on the economic crisis must naturally be monitored. At the end of the paper we can draw the lessons for the Hungarian practice.

Crisis management, including the prevention of financial bankruptcy, cannot be separated from the spontaneous economic processes. Therefore, we cannot start the analysis by discussing the necessary or recommended economic decisions right away. Crisis management is understood well by those who are aware of the automatism inherent in an economic crisis. Economic policy may make use of this automatism. This holds true for getting through the crisis, too, independent of the fact, what therapy had to be used during the crisis: a simple crisis management procedure or a much more

complicated one, applicable for the prevention of financial bankruptcies. The following section provides a brief summary on the spontaneous mechanism that can be witnessed in any crisis irrespective of the underlying causes.

THE SPONTANEOUS CRISIS MECHANISM

A major feature of the spontaneous mechanism is that the recession it triggers is never an endless process. It is typical that after reaching the bottom, economic performance begins to improve again by itself, without external intervention, and where exactly the bottom depends also on the automatism. In this mechanism the movement of the savings and consumption ratios in opposing directions, the actual and expected values of the interest and the profit rates, as well as foreign trade may play the most crucial roles. Often, but not always, the changes in foreign exchange rates also have such an impact.

THE BOTTOM OF RECESSION Here the most important factor is that in the period of recession the national savings rate begins to fall, however this is accompanied only by a smaller reduction in the rate of investments.

Future funds and incomes are always valued less than the current funds and incomes. Therefore, changes in the real interest rate and the present value of the profits attainable with the investments, i.e. the value of the *future* profit discounted (reduced) with the *current* interest rate, play crucial roles in investments. If this rate is compared to the capital increment, one obtains a profit rate that shows – compared to the current interest rate – whether it is worth making investments, or not. (If the profit rate so calculated is greater, it is worth making investments). It is not sure that the profit rate so calculated significantly drops at the time of recession, because this is not identical with the current, actually realised profit rate. The expected future profit and profit rate can be really high, in which case the discounted present value is also high. Yet, one must calculate with the current interest rate, since this represents the *opportunity cost* of the current investments.

Since in a crisis the real interest rate falls, sooner or later the profit rate calculated on the basis of the discounted present value of the future profit will be higher than the real interest rate. Then investments stop to decline, and will soon resume growth. The less is the fall in the interest rate limited by the monetary management, the sooner this happens.[1]

At the same time, national and household savings are characterised by other movements, i.e. by the *definite* drop in the savings rate. This process is influenced by several spontaneous factors. Households curb their consumption at a slower pace than their incomes reduce: they use former savings, borrow credits, or rely on assistance from relatives and friends. Somehow people must make both ends meet, and during a crisis this leads to a reduction in the national savings rate. Since routine consumption levels are difficult to reduce, the decline in income and GDP can only entail a reduction in the savings rate. The falling savings rate and the *no longer* falling, possibly growing investment rate begin to reach a state of equilibrium. In fact, planned investments may even exceed the level of savings. From this moment on the economy must pick up.[2]

Several other spontaneous factors contribute to the fact that consumer expenditures are rigid downward, and that the contraction spiral has certain limitations. In countries at middle or high level of development the *service sector* has a dominating role.. The purchase of certain consumer services – for example gas, water, electricity bills, insurances, healthcare costs, etc. – must be covered in any case.. *Foreign trade* may also contribute to keeping recession under control. If recession does not appear in

the different countries *concurrently*, a continuing growth in exports confines the decline in aggregate demand.[3] The crisis mitigating effect of the state is significant, too. If the *state* does nothing more than it did before the recession, the decline in demand is hindered by the mere maintenance of its expenses.

It must be kept in mind that if production falls for any reason, this will induce further decline in production and demand alike. A cumulative process deepening the recession starts, the extent and strength of which can differ depending on the aforementioned factors.

Let the recession be primarily of 3 percent relative to GDP. This leads to a decline in the income of many individuals, which in turn induces a *new* drop in demand. However, due to the above listed factors, this secondary process may be of relatively small scale. If, for instance, in the second step the decline equals one fourth of the former one, and subsequently each decline equals one fourth of the preceding one, the maximum drop in demand at national level can be 4 percent. (This is a geometric sequence the first element of which is 3, its quotient is 1, and the sum is 4. However, if the induced reduction always equals half of the preceding decline, *in the given example* the drop in demand can reach maximum 6 percent).[4]

However, this calculation is correct only if the economy was stagnant before the recession set in. Yet, stagnation is seldom followed by a recession, it is usually preceded by a growth in production. This must definitely be taken into account.

If the prior annual growth rate of production was exactly 4 percent, it may happen that in the case of the given numerical example the growth of economic performance is replaced not by a decline in production, but only stagnation. If the concept of recession is linked to the decline in production, one cannot speak about recession in the given example.[5] In fact, the recession-mitigating effect of former growth cannot be fully enforced. However, this effect must by all means be taken into account.[6] At the beginning of the recession the repercussions of the preceding growth are still strong, however they fade with time. Consequently, the more protracted the recession is, the less one can rely on the recession-mitigating repercussions of the former economic growth.

POSSIBLE WAYS TO BOOST THE ECONOMY IN A RECESSION

A key player in boosting the economy is public finances, but first of all the central budget. In addition, a major role is played by the central bank. So the main tools for boosting the economy are the budgetary and the monetary policies. Here the term "economic revitalisation" is used in a broader sense, to include its role in the alleviation of recession, and naturally the impact that already implies leaving the recession behind.

In fact, here we face essentially the same interrelations as in the previous section. When alleviating recession, the state budget hinders the emergence of the multiplier effect that deepens the crisis. Even by possible increasing its expenditures, the state prevents the drop in the national savings rate, and accordingly, prevents a major drop in consumption expenditures. Therefore, at times of recession the aggregate demand can be higher due to the state's activity, and the decline can be smaller than it could be reached merely on the basis of the spontaneous processes. In addition, after passing the lower turning point, the economic activity of the state may even strengthen the process of recovery.

Public finances, including the state budget, are recession-mitigating factors by their mere existence. The numerical value of the income multiplier is a *priori smaller* owing to the system of income taxes, wherefore the decline in

output is smaller in case of a recession. The reason behind this is that the income that gets into the state budget in the form of tax is immediately redirected into the economy, provided it is spent by the state. This means that no further decline is induced by the original expenditure cuts. Consequently, the larger the ratio of budgetary revenues and expenditures to the GDP, the smaller the multiplier is, and the milder the economic crisis can be. The multiplier effect that would deepen recession is contained by the state budget.[7]

At the same time, this role of the state means that the *balance* of the central budget fluctuates even if it does not reflect the intention of the government. The budget includes *built-in stabilisers,* such as the system of progressive personal income taxes, or the unemployment benefit. At times of recession the latter increases causing expenditures to rise, and due to the former, tax revenues drop at a faster pace relative to the GDP. Both stabilisers are deficit increasing factors, and both restrict the decline in consumption in a recession. They are added to the spontaneous processes that alleviate recession. At times of recession they also entail a drop in the national savings level. (A growing budget deficit implies an increasing deduction from the value of savings on national level).

The government may take so called *discretionary measures,* too. With a view to preventing the deepening the crisis it may reduce the tax rates and/or increase its expenditures. This means that state budgetary revenues and expenditures can change not only because of the built-in stabilisers. The growth in expenditures or drop in revenues so induced can be drastic, too. Many discretionary measures are available and can be used. The state or the local budgetary organisations may launch public work projects, may provide support to some companies, for instance to small and medium-sized enterprises, may encourage the accelerated development of the infrastructure by using state funds, etc. These discretionary measures also result in the following: the public finance deficit may grow or its balance can deteriorate, the national savings rate may decrease, the crisis will be less profound, economic recovery may begin sooner.

Monetary policy, striving to alleviate recession and strengthen economic recovery may also have an important role here. Within this context a major effect is attributed to the interest policy of the central bank. In a recession it is reasonable to reduce the prime rate of the central bank, since this entails a drop in the general – market – interest rates. At such a time the spontaneous mechanism itself also induces a reduction in the interest rate, and the central bank may reinforce this trend. The impact mechanism has already been presented: the current interest rate necessarily falls below the discounted present value of the future rate of profit. The smaller the current interest rate is, the less may be the discounted present value of the future profit and profit rate relative to its forecasted size. Under the impact of the monetary policy the economy can reach the lower turning point sooner, and investment projects can commence more easily.

Another important part of the monetary regulation is the exchange rate policy. If we look only at the spontaneous mechanism, the exchange rate has no specific direction in a recession: it can either increase or decrease. The reduction of the interest rate makes the exchange rate come down, since at this time the flow of money capital from abroad slows down, the external demand for the Hungarian currency shrinks, and the exchange rate may fall. This trend facilitates overcoming the recession: a drop in the exchange rate boost exports and as a concomitant increases demand. But recession can hit all countries concurrently, and may trigger a decrease in the interest rate everywhere. In this case the exchange rate does not necessarily have to fall.

And if the internal interest rate is reduced to a smaller extent than interest rates abroad, or if Hungarian financial investments are deemed less risky by the international money capital, or the central bank may strive for increasing the exchange rate, the exchange rate may grow despite the recession. This scenario is not favourable for the elimination of the recession.

Therefore, the direction of exchange rate changes is uncertain. However, one thing is absolutely sure! In a country whose economy heavily depends on foreign trade – both in terms of exports and imports – in times of recession it is not recommended to increase the exchange rate or maintain the overvalued exchange rate. This may lead to the prolongation of the recession!

Recession itself is an inflation-curbing factor. In this case it is less necessary to pursue the policy of "expensive money". The turnaround can basically be triggered by the investments, which require a decline rather than increase of the interest rate. In this case special attention is required to ensure that the policy aiming at stability in prices should be implemented at the expense of curbing investments.

General demand boosting measures for open and heavily foreign trade dependent economies represent serious risk factors in a global economic crisis. At such times deficit increasing policies are not really effective, whether implemented through the increase of state expenditures, or through tax reduction. However, it is advantageous if the interest rate falls at times of recession, since then the opportunity cost of the investment projects is smaller, and the discounted present value of the forecasted profit and profit rate is relatively higher.

The points discussed above are valid in general. Most often they hold for most countries. However, this does not mean that they are valid in each and every country. There are extraordinary situations and economies that are in especially unfavourable situation. In such cases out-of-the-ordinary economic policies may be justified, or even mandatory. It has to be emphasised now since the next section is about the problems of crisis management in Hungary, where two specific features must be kept in mind: Hungary is a small or at best medium-sized economy, struggling with serious financial balance problems.

ABOUT CRISIS MANAGEMENT IN HUNGARY

Problems of general demand stimulation

In theory, aggregate demand can be encouraged through the budget policy. If public finances spend more, the encouragement is direct, and its joint impact with the income multiplier can be significant. The demand side can also be encouraged through tax reduction, by maintaining the public finance expenditures.

These proposals are repeatedly raised, no matter if it is about making economic growth more dynamic or about revitalising the economy in a recession. Tax reduction is considered as a universal tool, but also as one that can be successfully used in any situation. Even in restoring the budget balance.

Now we are going to discuss why – in the midst of the current recession – it would be a wrong decision to stimulate aggregate demand in Hungary merely through tax reductions, or through the increase of state expenditures. The answer in brief is the following: both measures would seriously deteriorate the economic equilibrium, which can by no means be assumed in the current financial situation of the country. Public finance deficit would increase, and the stronger the stimulation, the greater the deficit would become. The current balance of payments would deteriorate, because the demand impulse would increase imports, while exports

would grow only slightly if at all. These measures would hardly affect the GDP. The explanation behind this is the following: the ratio of commodity exports and imports to the GDP in Hungary totals 66 and 67 percent, respectively, while the figures related to services are 12 and 10 percent. The combined ratios equal 78 and 77 percent, respectively. At the same time, there is recession both in the world economy and Europe. Therefore, it is not that exports cannot be accelerated, but that the decline in exports causes problems. On the other hand, imports may even accelerate due to demand stimulation, this however is not likely to happen owing to the recession. In an export oriented economy a major precondition for GDP growth is the expansion of exports, but exports are expected to decline, for the time being.

Consequently, demand stimulation would not speed the economy up. On the other side though, the public finance deficit would rise spectacularly. Revenues would be reduced by the smaller tax rates, and since GDP would not grow, in fact, it would decrease due to the crisis, nothing would compensate the tax rate reduction. On top of all this, the foreign trade balance and the balance of payments would considerably deteriorate.

Compared to this, the situation is significantly different in countries with a large internal economy. The greater the internal economy, the less risky it is to apply demand-inducing policies in a recession. For the sake of a sharp contraposition let us see the economy of the US, where the ratio of commodity exports and imports to the GDP totals 7.8 and 14.1 percent, respectively, while the ratio of service exports and imports to the GDP equals 3.1 and 2.6 percent. The combined ratios are 10.9 and 16.7 percent respectively.[8] This means that the export *ratio* is 1/7th of the Hungarian ratio, while the import ratio is 1/4th-1/5th of the Hungarian one. Therefore, demand incentives in the US boost internal production and employment, or reduce the rate of reduction of employment rather than generating imports. Also, a much smaller portion of the increased production can bump into the limits to exports than in Hungary, since a much greater portion of the GDP can be sold to internal customers. The difference is not so sharp if we look at the countries of the eurozone. Here in certain *large* countries the export ratio is around 20 to 30 percent, but even that is much smaller than in Hungary. So the use of demand stimulation is justified in the larger European economies too. We can state right away: condemning statements, e.g. that in crisis management Hungary goes against Europe, are not necessarily justified.[9]

Revitalising the economy from the demand side is all the more difficult since, for the time being, Hungary has little or no access to external – mainly long-term – loans on the international money and capital market, while it must pay the instalments of existing loans in time. The extreme credit crunch is caused by the international financial crisis, and also, even before that happened, by the fact that Hungary was assigned a low rating by the international credit rating institutions.

Getting a loan today is difficult for each country, and it is especially difficult for Hungary. This is why it is crucial for us that the assessment of the Hungarian economy by the international money market should not deteriorate further. On the contrary, we should strive to improve our rating. This excludes all decisions that would further worsen the financial balance of the country. Boosting demand by increasing the public finance deficit would exactly be such a decision.

Large-scale tax reduction without cutting expenditures is accompanied by a growth in public finance deficit all over the world. In our case, under the circumstances of the current financial crisis, this would lead to even more stringent borrowing conditions. (This is the

least that would happen. The consequences would be dramatic, as it will be discussed later). A long-term consequence would be that debts that fall due on a continuous basis could only be repaid from the foreign currency reserves, as well as from the stand-by loans extended by the IMF, the World Bank and the ECB. The amount of these loans is sizeable, however, if they remained the only source of coverage, the entire credit line would be soon used up. For the time being Hungary's annual debt service (including interest and principal repayment) amounts to EUR 10 billion a year on average, which is not a very large sum compared to the GDP (around 11–12 percent). However, the debt service represents a considerable sum compared to the stand-by loans and the foreign currency reserves (around 40–50 percent).[10]

It must be added: trust suffers a blow even when the foreign currency reserves decrease at a quick pace, and/or the stand-by loans are used for debt repayment extensively and very soon. Therefore, not only must we refrain from wantonly starting an expansive budgetary policy under the slogan of crisis management, but we must also continue the stabilisation of the economy by *gradually* liquidating structures entailing lavish spending. These measures will appear in public administration, education, social benefits given on a universal basis – that is not on the basis of the principle of need – and in the pension system. In other words, we cannot escape reforms. If problems were caused only by the economic recession, it would be reasonable to implement the reforms selectively within the framework of crisis management. First of all those reforms should be applied that do not trigger a general income reduction. Unfortunately, the situation is more serious than that, as will be analysed further down in this paper.

Another possible tool for demand stimulation is the interest rate policy. A reduction of the base rate by the central bank is soon followed by a drop in the market interest rates. This improves entrepreneurial willingness, enhances the demand for investments and may increase employment again. An increase or slower decrease can occur in both main elements of aggregate demand, i.e. investment and consumption demand, since in this case the interest rate of both short- and long-term loans shows a downward trend, even if not to the same extent.[11]

Interest rate reduction certainly has a stimulating effect on the economy. However, it has just been concluded about the stimulation of aggregate demand that this is not without conflicts in small countries that are sensitive to foreign trade. It may boost foreign economies instead of the internal one. However, there is a significant difference between stimulation with public finance deficit and with interest rate reductions!

The rise in public finance deficit itself is a direct demand increasing factor, but this does not hold for interest rate reductions. Increasing the deficit encourages consumption rather than investments, since most state expenditures serve purposes other than investments. And because Hungary is a small country, a higher deficit mostly boosts imports without encouraging investments. In fact the latter are obviously hindered, since the deficit increases or keeps the average level of interest rates high. Interest rate reduction has an opposite effect, because it mostly facilitates the rise in investments.

The conclusion of the previous sections was especially that the turning point mostly depends on the fact that the planned investments begin to exceed the size and ratio of savings. This is the time when production may start growing. While in small economies an increase in the budget deficit deteriorates the economic equilibrium even at times of recession – and can only very slightly be regarded as a stimulating factor –, interest rate reduction is

rather an economy stimulating instrument. On top of that, falling interest rates have a very important secondary effect, which is favourable for economic recovery, too.

If the average interest rate falls, the HUF exchange rate must follow it sooner or later, which is beneficial to the internal and external markets. A declining exchange rate mitigates the possible overvaluation of the national currency. The forint was strongly overvalued for many years! Therefore, the depreciation of the forint can be beneficial to the *domestic production and the demand for it,* too. Compared to the former situation, it makes imports more expensive and exports more competitive. Until recently foreign producers enjoyed a price advantage over domestic producers due to the overvalued Hungarian currency. If their price advantage shrinks as a result of the spontaneous depreciation of the home currency triggered by the interest rate reduction, the competitive edge of foreign producers will decrease, and customers will buy more domestic products. The demand will grow for domestic goods, and will relatively decline for foreign products. At the same time, domestic production may either grow or at least decline at a slower pace, and the situation may improve in terms of production and demand alike. These changes will occur in any case, even in recession, albeit to a much smaller extent.

It can be stated that although the consequences of general demand stimulation are different in the small countries relative to the larger ones, it is advisable to use interest rate cuts as a tool. In contrast with this – taking into account Hungary's shaky financial situation – demand stimulation is expressly detrimental, if this is achieved by increasing the expenditures and/or decreasing the revenues of public finances!

The above-written is only the first approach to the problems of crisis management in Hungary. We are already aware of the fact that general demand stimulation is not a workable solution. However, applying monetary incentives could be acceptable. We must take a step further: what should be done in the framework of crisis management taking into account the present economic situation, the imbalance and the financial instability of the country, *but still ignoring the imminent risk of a state bankruptcy?* What should be done with the economic reform? Present-day proposals on crisis management first of all include reform steps deemed to be necessary as if crisis management was equal to the consistent implementation of the economic reform. This already takes us to a more concrete assessment, but not a final discussion of the possibilities of the government policy.

THE POSSIBILITIES OF GOVERNMENT POLICY IN CRISIS MANAGEMENT IN HUNGARY

Potential internal and external sources. Methods of demand stimulation

In the course of crisis management the government of a small national economy, theoretically that of Hungary, too, may pursue an economy boosting policy, but not in any manner. State resources can be used for such purpose, and local governments play an important role relying on local sources. Since Hungary is a net recipient of EU funds, the utilisation of EU funds may also come in handy. All in all, however, the amount and ratio of available resources are small. A major amount can be ensured by EU funds, however the net total value can at best reach around 2 percent of the GDP on an annual average.[12]

In a small country like Hungary, economic policy aiming at alleviating recession must be increasingly *targeted!* It should support activities that are suitable for enhancing employment on other fields, too through their secondary effects. Subsidies should be given to

areas where production can first of all rely on the internal market, where the business activity does not heavily depend on exports and imports, i.e. where production growth – even if it does not take place overnight – mostly relies on domestic production capacity and demand.

It is also important that the resulting development should improve the conditions for sustainable growth. Such activities and areas include the modernisation of network infrastructure: town and railway transport, road construction, canalisation, water management, commodity management, warehousing. A similar effect can be obtained through regional development. Environmental protection, education and healthcare must be mentioned separately. Since employment plays a central role in containing processes that deepen recession, the subsidies should first of all be channelled to small and medium-sized companies that account for most employment. In other words, there are plenty of opportunities that do not threaten with the risk that resources spent on giving incentives to the economy would mostly stimulate economies of the other countries rather than domestic performance.

EU funds, for the most part, promote domestic economic performance, either immediately, or in the long run. These resources – with the exception of agricultural subsidies that are in need of a major reform according to the general opinion – are designed for infrastructure development, including the modernisation of network infrastructure, environmental protection, the convergence of underdeveloped regions, the promotion of the competitiveness of small and medium-sized companies, as well as the enhancement of the quality of education and healthcare. These are typical areas that are very much suitable for crisis management in the economies of small countries, too. In fact, they can be most efficiently used in these countries to counterbalance processes aggravating the crisis.

If all goes well, EU funds available as targeted support for economic stimulation may reach around 1.5 percent of the GDP.[13] The impact of these funds on the alleviation of the crisis is not negligible. If we assume that the multiplier of the utilisation of EU funds is 2, which is a realistic assumption, the recession at national level can be alleviated by 3 percent of the GDP. This means that if the GDP decline would be 3 percent, the drop in performance could be avoided. This statement is not about the expected actual depth of recession, but only about its alleviation! Although the volume of EU funds available is more or less known, – much less information is available about the dynamics of the inflow of these funds – and similarly the numerical value of the multiplier. However, we have no substantiated knowledge about the expected depth of the crisis, since it is even less known how strong the intensity of the factors inducing a drop in performance may be. The related estimates are today uncertain in each and every country. For example, if recession was otherwise 6 percent, based on the given figures we would need to count with 3 percent of the current recession. It is probable that the actual rate of recession will be significantly larger even than that.

In theory, the government can rely on other tools, too in its efforts to alleviate the crisis. It can use budgetary tools, but since ours is a small economy, it cannot do so in any manner: economic stimulation must be targeted in all cases! In other words, if budgetary tools are available, they must be used for supporting the above listed areas and sectors, i.e. network infrastructure, environmental protection, small and medium-sized companies, education, etc. We can also count with the direct and secundary effects thereof in relation to changes in national output and employment. The question is how big these budgetary and local governmental resources can be.

This largely depends on the balance of pub-

lic finances. If public finances were in balance or surplus, a significant amount and share of resources could be spent on economic stimulation, even totalling 3 to 5 percent of the GDP. Even by borrowing loans by the state or the local governments. For example, if public finances were in balance now, the country could undertake a deficit equalling 3 percent of the GDP (compatible with the Maastricht criteria) for the sake of economic stimulation. (Subsidies can be granted in several forms: cash transfers, preferential term loans, interest subsidies, provision of guarantees. The actual form is determined by the nature and circumstances of the given development objective). In most former socialist countries public finances are in the negative, however the rate of deficit is usually smaller than in Hungary. Hungary is still unable to meet the 3 percent deficit requirement, which a *priori* represent a strong obstacle to the economic policy in alleviating the crisis. This obstacle could be even stronger if the country strived for the reduction of the public debt, since in this case it would be mandatory to achieve a surplus in the entire budget.

The reallocation of resources can help to some extent. The state has used resources for development, subsides and other expenditures even before. Part of these resources can now be reallocated from the former objectives to objectives that are more relevant for crisis management. (For example, providing more support to small and medium-sized companies). Reallocation can also have a time dimension: subsidies planned to be disbursed later can be brought forward. We can hear about rather large-scale reallocations. I am not in the position to judge the reality of reallocations, or whether larger-scale reallocations are possible or not. Also, I do not know to what extent EU funds can be reallocated, since these funds can be won in tendering procedures, which largely determines the structure of their utilisation.

The positive effect of the reallocations cannot be questioned if their utilisation is well targeted. In this case the benefits of the reallocations are bigger than their costs. However, it must be known that their crisis-alleviating effect is smaller than the scenario, which really assumes the utilisation of *additional* resources.

In the case of any reallocation, fund withdrawal occurs in time and/or space, which either entails a drop in demand and performance, or prevents demand and performance growth, somewhere. This is to be compensated by demand and performance growth that occurs in the preferential areas due to targeted reallocation. This means that *performance decline and growth occur* concurrently. The balance can be positive, and recession can be milder if the performance and demand generating effect of the reallocation will be greater on the *domestic economy* than the loss it caused elsewhere. In short: if the reallocation is well targeted. But is it somehow possible to ease the scarcity of funds? This may seem possible, moreover not only to a small extent.

Reform and crisis management

For a long time, the biggest problem of the Hungarian economy has been that public finances undertake too big a burden, and are oversized. The share of income transfers is too large, partially because they are not based on the principle of need. The conditions of retirement are too lax, which contributes to the large and increasing number and share of pensioners, which – under the given pension insurance conditions – puts an excessive burden on public finances and the entire economy. The number of participants in higher education has tripled or quadrupled, which has entailed the multiplication of the amount and share of the financing liabilities of the state. However, resistance to changes is strong, and what's more, it enjoys political support. Healthcare is

becoming more and more cost intensive worldwide, and Hungary is no exception. This would require the restructuring of healthcare in a manner that would increase the cost sensitivity of healthcare institutions, and would require larger financial contribution, and more economical use of services by the population. Finally, the institutional system of public administration and the maintenance costs thereof have become too big. Through the considerate restructuring of public administration the number of state agencies, local governments and staff, and consequently, the operational costs can be reduced, and concurrently, institutional efficiency could be enhanced. Reforms designed to solve these problems are long overdue.

Together with the public finance reform, if implemented on the basis of thorough preparations, significant expenditures could be saved relative to the GDP. The extent of reallocations could also be increased. Some of the resulting savings could also be used for tax reduction. Iit has been just concluded: balanced public finances – and smaller tax burdens – could also increase the amount and share of funds usable in crisis management.

This is why many experts come up with the idea: Hungary can even capitalise on the crisis. Necessity can force decisions that could earlier not be adopted and enforced, and which now – if implemented – can be expressly beneficial for Hungary *in the long run.* We can prepare the conditions for dynamic economic growth, while acquiring more funds already in the near future by restoring equilibrium. And this comes in useful in crisis management.

For now I am not investigating whether the political and social preconditions exist for the above listed changes. Are they likely to be adopted by the Parliament in the current political situation and under the current parliamentary power relations? Nor will I investigate whether the political and social circumstances can prevent the implementation of the changes listed above. Here I confine myself to outlining the economic interrelations only.

All those people who expect that the real solution will be achieved through the implementation of the sooner or later indispensable reforms are of the opinion that public finance reforms allow for both expenditure and tax cuts, and the two together will not result in a decline. If this was the result, reforms could not be part of the crisis management – *if the question is clearly about setting limits to the decline in production, and there is no danger of a state bankruptcy.* I myself do not dispute, but on the contrary, emphasise the necessity of reforms. But I am of the definite opinion that – *if there is no imminent state bankruptcy* – and certain reform steps would trigger a decline in aggregate demand, they should be postponed in times of crisis. If the tasks is really only to alleviate recession, it should not be further aggravated by reforms, either by tax hikes or expenditure cuts.

At the same time, however,, the restructuring of taxation is also an important part of the reform process, and it does not induce a decline in demand. Similarly, restructuring the public finance expenditures can also be part of the reform, if this entails the reduction of useless expenses for the benefit of useful and socially necessary expenses. In this case, neither the revenue, nor the expenditure side of public finances – the restructuring thereof – leads to a decline in aggregate demand, wherefore it is compatible with alleviating the crisis. Consequently, the reform is not necessarily incompatible with crisis management.

I am almost sure that most experts believe that crisis management – here the question is about alleviating the recession – applied in conjunction with the reform *should not trigger a further drop in the GDP.* And most people also think: for the sake of it, it is sufficient to achieve that the drop in expenditures entailed

by the reform should be accompanied by tax reductions. It seems that this is already compatible with crisis management. They are convinced that tax reductions will induce a rise in demand equalling to the decline in the aggregate demand that may result from the reform. These two factors together can lead to better economic efficiency, which implies an advantage for the process of growth in the future.[14] However, a grave problem is – and, as far as I can see, this is often ignored – that *if the reform really leads to reduced expenditures and tax receipts during the recession*, the amount of GDP cannot remain unaffected no matter how considerately *public finances have been streamlined!* The GDP will decline *in this case, and for this reason, too!*

Decreasing income centralisation and aggregate demand

A reduction in expenditures immediately decreases the aggregate demand *with the amount equalling the reduction.*[15] However, tax reduction by itself does not yet mean an increase in demand; it merely indicates a *possibility* for this.[16] (Flexible demand response is totally improbable especially during a crisis.) Although it induces a rise in demand, but always a smaller one than the tax cut itself was in the first step. The surplus from tax reduction is not entirely spent on purchases, since part of the after-tax income is used for savings. This means that in the first step, since the reduction in expenditures is greater, there must be a drop in aggregate demand. In what follows happens the following: both the cuts of expenditures in public finances and the rise in aggregate demand caused by the cuts in taxes lead to further changes in demand. A rise in demand is induced on account of the excess demand caused by the cut in taxes, and an induced drop in demand is caused owing to the curtailment of public finance expenditures.[17]

The changes *induced* in the rise in demand by tax cuts, and the changes induced in the decline in demand by the reduction of expenditure equalise each other. In other words, *the reduction of expenditures is increased by further reduction* equalling the size of demand rise that appears after the tax cuts. So eventually the aggregate demand declines exactly in the amount by which public finance expenditures are curtailed. This *reduction is independent of the intensity observable in the secondary processes.* The only thing that matters is the amount of the change in public expenditures *in the first step*. On the tax side there is no such change – only induced changes occur here – while on the expenditure side changes occur due to expenditure cuts *and* induced changes. Therefore, the final result is the following: although the equal reduction of taxes and expenditures does not deteriorate the balance of public finances, it remains the same, but induces a drop in aggregate demand! The GDP also shrinks, and recession turns out to be deeper. *What is true for the public finance balance, – which indeed remains the same – does not hold for the aggregate demand, because that does change; in the given case decreases!* For us this means that if the containment of the centralisation of incomes by the state is not necessitated by something, for example by the risk of state bankruptcy, reducing the degree of centralisation should not be the objective, when the economy is in recession. And when the only problem is the recession, the main task is really to alleviate the recession.[18] This problem did not arise so sharply until recently. No wonder. Earlier Hungary was not saddled with a presumably deep global economic crisis accompanied by a grave financial crisis. *So far*, for nearly two decades, Hungary has failed to implement the otherwise indispensable reforms. If the current problem was really fighting the recession only, it could not be understood why the reform was so urgent,

why couldn't we wait one or two years with that! Why should we make up for all defaults just at the time of recession?

However, certain reforms can be implemented even in this case, and those *must* indeed be implemented. Such reforms are rather plentiful, and include changes affecting the *tax structure*, and the *composition of expenditures.* They may strongly influence the behaviour of companies, the population and the various institutions. These changes are so numerous and significant that neglecting the reform would be out of question even if alleviation of recession was the only task.

Structural changes of revenues and expenditures

The corporate sector's ability to react to changes is essential. This can be influenced by the restructuring of the system of taxation. First of all the *tax structure* could be reformed. This is significantly justified by the fact that the difference is too big between the total costs of employment for the companies and the actual net wages the employees pocket after the deduction of taxes and contributions.

On an abstract, theoretically, the optimum case would be if the two values were identical. This would provide the greatest incentive for seeking and offering employment for companies and wage earners alike. However, these amounts can never be equal, since tax must be paid for instance due to the requirements of economic development, and due to the fact that taxes are used to cover the costs of income transfers that protect the poor, and the indispensable social security costs. We can only say: in terms of employment and corporate initiatives the smaller the difference between these two values the better. The real value of profits and wages alike could be higher.[19]

This difference is decreased by the reduction of wage-related contributions to be paid by the employers, which can be followed by the reduction of the personal income tax rates, too. The increase in the VAT and excise tax rates can be linked to this change: the basic principle is that the reduction of income taxes and contributions causing a narrowed tax wedge should not lead to shrinking state revenues. Therefore, in addition to increasing the VAT rate, it may become necessary to revoke personal income tax allowances and/or to introduce the value-based property tax. The boosting and economy stimulating effect thereof can be felt primarily after the start of the recovery in economy.

It is true that this is not the ideal solution. The foundations for narrowing the tax wedge are ultimately made certain by the expenditure cuts, and as for the wage-related contributions, their reduction should be based on the reform of the pension system. *Lajos Bokros* is right in saying that the important thing is not only the overall reduction of wage-related contributions, but also how this reduction will be spread among the three elements of employers social insurance contributions. It is essential to maintain the integrity of the principle of insurance in the course of the reform process. However, this can be ultimately fulfilled if, for instance, the pension reform, which affects the expenditure side, too, can also be implemented. And this, if the government *really* considers that its task is to alleviate recession, can hardly be implemented in a recession. Not even if we disregard the other important social and political problems related to this issue.

Other changes can also be made within the system of taxation, in the framework of the reform. Among others, cancelling the tax allowances which are incompatible with social equity and deteriorating rather than improving the economic performance. Along with it, income tax rates should be reduced to the same extent. These measures can include the increase

of property-based tax *on the basis of its thorough preparation* together with the decrease of income taxes. Or repealing the local business tax and replacing it by other tax types, or by the abrogation of the tax exemptions. A lot of other examples could be listed, too. The point is that the tax structure should be changed so that it would encourage performance, already now, at the time of recession.

Within the framework of crisis management designed to alleviate recession, progress can be achieved in the completion of tasks affecting the expenditure side of public finances, too. The background materials of the Reform Association emphasise the need for the significant and fast reduction of lavish expenditures. First of all the maintenance costs of public finances, the budgetary subsidies to certain state companies that operate lavishly, and the restructuring of the system of public administration are focused. If savings could be realised here, aggregate demand would fall even if the tax burdens were eased proportionately. The situation is different if the savings so yielded are *used for crisis management on a continuous basis.* For example for job retaining subsidies at places where the activity is otherwise efficient, or for infrastructure development projects that otherwise would not be supported for the shortage of funds. Or these savings can be reallocated for the improvement of healthcare or education, as well as environmental protection. Consequently, socially useless expenditures can become useful in a different expenditure structure. On top of that, such decisions fit into the reform process to be implemented in the course of several years. These considerations are not given sufficient emphasis in any reform proposal, which is no wonder. Expenditure cuts are preferred in the belief that they, when combined with tax cuts, do not decrease the aggregate demand.

It must be acknowledged: the alleviation of the recession is not beneficial to *a comprehensive and consistent reform process,* but it is by no means about abandoning the reforms! The proposals pertain to five years and not for one or two years, during which the steps to be taken are being scheduled. The tasks *could* also be scheduled with regard to the crisis and the requirements of the alleviation of the recession. However, the proposals contain schedules without taking into consideration whether they are to be implemented in the year of economic crisis or already in the period of growth. In terms of the alleviation of recession the proposals cannot even be regarded as ones for crisis management.

As soon as the recovery begins, streamlining the public finances can be brought to the foreground. Then expenditures *and* tax revenues *can and must be* reduced! It is true, the effect of tax cuts on demand will remain smaller than that of expenditure cuts. Smaller, because tax cuts increase the savings planned. Yet, aggregate demand does not fall, since *the commencing investments absorb the increasing savings!* By this time, without the higher share of planned savings investments could grow only if external resources were involved more extensively, provided that keeping inflation down continues to be an objective.[20] Therefore, it does matter whether reforms that also contain the reduction of the weight of public finances are intended to be implemented during or after the time of recession!

Therefore, during the alleviation of recession the crucial rule is: reforms affecting public finance revenues and expenditures can be realized in a recession, too, however it must be ensured that *the changes come to an end of zero balance both on the revenue and the expenditure side.* They should not cause temporary major decrease on any side. This is required by the simultaneous use of the policy aiming at reducing the depth of recession and the reform applied at the same time. This is how the two can be compatible.

THE RISK OF STATE BANKRUPTCY AND CRISIS MANAGEMENT

The definition and possible consequences of state bankruptcy

One can speak about state bankruptcy when the state is unable – in part or in full – to meet its debt repayment and current payment obligations. The larger the state's share in the national income, and the higher its debt rates, the graver the consequences are. A possible state bankruptcy would have serious consequences in Hungary, since nearly half of the GDP goes through the public finances, and the rate of public debts has already exceeded 70 percent of the GDP. For the time being this rate is increasing.

The consequences also depend on the distribution of public debts. The situation is more severe if a considerable portion of the debt is external debt. In this case debt repayment in the national currency is out of question. Even if external insolvency only threatens to occur, the exchange rate of the national currency begins to fall. The quickly falling exchange rate may speed up inflation due to the rise in import prices. In addition, the conditions of external borrowing become more stringent. At best only short-term loans are available with increasing interest rates from abroad, which further deteriorate the position of public finances. The rate of the deficit will grow even higher, the need for external loans will grow, and the stock of external debts will increase at an even higher pace. The result can be the complete refusal of such loans, and then state bankruptcy does really occur.

If a major part of public debt is made up of internal debts, the situation is somewhat easier. In this case the debt is denominated in the national currency, which is more accessible for the state. Much more accessible, if the central bank can provide loans directly to the state. Thus, the state can make repayments, however at the expense of diluted cash flow and accelerated inflation. If this possibility is non-existent, because borrowing directly from the central bank is banned, the state must sell its securities on the secondary market. It can do so with more or less success, but definitely by undertaking increasing interest rates. The amount of money put into circulation is growing quickly in this case, too, since the banks need increasing loans from the central bank, and the velocity of money also increases. The central bank either satisfies, or not the demand for money of the private sector. Usually, certain adjustment can be expected from the central bank. In this case it is less probable that the state will become insolvent. Whether this happens or not depends on how willing the central bank is for the creation of base money. In case the central bank is willing to do so, inflation speeds up, and nominal interest rates show an upward trend. This process must sooner or later be halted. Either drastic restriction or state bankruptcy will occur.

The situation is made more complicate by the fact that not only the state, but also the private sector may have external debts. Banks and companies, and even the population can also borrow external loans, most often through the intermediation of banks. External borrowing by the private sector is not restricted if there is a free flow of capital between the countries. The external debt can significantly rise in this case, too, if the conditions of foreign currency borrowings are much more favourable than those of internal loans. In Hungary this usually appears as a difference between the nominal interest rates of the HUF and those of the foreign currency denominated loans. In Hungary the majority (around 70 percent) of loans owed by the private sector is denominated in foreign currency, i.e. the debt of the private sector has been generated mostly by external borrowings! Within the net external debt stock of the coun-

try the debt of the private sector is currently nearly double that of the public finances! Without knowing this fact one cannot understand the current monetary position of Hungary.

Now we have to consider what would happen if the Hungarian state was no longer able to repay its debts currently due for being unable to get external loans because of the lack of confidence? The exchange rate of the forint would start to fall. As a result, the repayment obligations of foreign currency debtors would increase steeply in HUF, much faster than before. Plenty of debtors would be unable to pay the due instalment, wherefore banks managing foreign currency loans would go bankrupt one after the other. This would be accompanied and/or followed by a stampede of depositors rushing to withdraw their savings from the banks. With the partial security system in place this would be impossible to implement under any guarantee. Depositors would lose most of their money. The bankruptcy of the banks would bring the state into an even more serious situation. The exchange rate of government securities would fall, and the state would really have no source of borrowing. Therefore, the drastic curtailment of state expenditures would be unavoidable, which would be followed by a plunge in production and a big jump in the unemployment rate: this would mean the beginning of a seemingly unstoppable contraction spiral.

In addition to state bankruptcy and the concomitant financial collapse, the economic crisis itself could attain a catastrophic size. The recession would reach even 20 to 30 percent instead of 5 to 10 percent, which would be very difficult to overcome.

Therefore, all efforts must be made to prevent state bankruptcy and financial collapse. The concept of crisis management is assigned a new content! It requires decisions that must be avoided in the management of the well-known recessions. One must often act contrary to the logic of recession management! However, this does not mean that – for instance in a small country – all the knowledge applicable in recession management should be rejected. Rather, and mostly it means that several unconventional decisions must be made, even such that do not comply with, or even contradict to the practice of countries in which the main task is the alleviation of recession, and not the prevention of state bankruptcy. This must be kept very much in mind if we are to inspect the crisis management proposals dealing with the current situation.

Reform and economic policy at a time of looming state bankruptcy

Since state bankruptcy is always preceded by overspending by the state, its prevention always involves significant reduction of the public finance expenditures. And it must be added right away: in this case expenditure cuts are either not accompanied by the reduction of the overall tax burden, or this reduction is considerably smaller than the curtailment of expenditures. This is a straightforward concomitant of overspending by the state, which triggered the threat of state bankruptcy. The most important thing is: *at this time expenditures must be curtailed even if recession occurs simultaneously!* This is exactly the situation in the present-day Hungary, where economic performance falls under the influence of the global economic crisis, unemployment rises, and state bankruptcy looms due to the international financial crisis and the increasingly prudent international lending practice. Hungary has double trouble, the more serious of which is not recession, but rather the potential state bankruptcy. Without this nothing can be understood from what should be currently done within the framework of economic policy.

Crisis management proposals that have been published since the beginning of the year all recommend the immediate reduction of expenditures. The estimated extent of expenditure cuts is rather sizeable. The material prepared by the Reform Association calls for a total expenditure cut of HUF 1,325 billion in five years, of which HUF 355+470=825 billion should be curtailed in 2009 and 2010. This represents an annual expenditure cut of 1.3 percent and 1.7 percent compared to the GDP. In addition, expenditures must be frozen at real value. If the GDP was growing, this freeze would be a balance improving factor in public finances, depending on the growth rate of the GDP. With the same tax burdens in place, a growing GDP induces surplus revenue. According to the calculations of the Reform Association, the freeze of expenditures at real value yields HUF 170 billion savings in 2010 – 0.6 percent of the GDP – and a total savings of HUF 1,623 billion in the period lasting until 2013. Together with the actual expenditure cuts, the two items account to HUF 2,948 billion in five years, calculated at the 2009 price level. The value for 2009-2010 is nearly HUF 1,000 billion, i.e. HUF 355 billion in 2009 (equalling 1.3 percent of the GDP), and HUF 640 billion in 2010 (equalling 2.3 percent of the GDP). This deepens economic recession even if expenditure cuts would be accompanied by proportionate tax cuts.[21]

If the total tax burdens were reduced exactly by the amount of the expenditure cuts, the economic crisis would deepen by the rate of the reduction of expenditures. In other words, the performance would drop by 1.3 percent in 2009, and by 1.013x1.023=1.036, i.e. by 3.6 percent in 2010. But if the rate of tax reduction is smaller than that of the expenditure cuts, recession is even more intense. The production drop so *induced* may reach even 4 or 5 percent by 2010 *compared to the assumed case* of the absence of expenditure cuts. Eventually, the result depends on the proportionate relationship between tax reduction and expenditure cuts, on how strong the induced changes caused by the primary expenditure cuts are, and on when the world economy starts increasing again.. The latter is essential since the size of induced changes may be different depending on how strong impacts affect the economy in the meantime. This impact also depends, for instance, on how Hungarian exports will develop in response to the development of external demand. But at any rate, the depth of recession significantly depends on the curtailment of expenditures. If in a recession the production level would otherwise be 5 percent lower than initially, the drop in production combined with expenditure cuts can reach even 9 or 10 percent! And, in accordance with it, the level and share of employment and unemployment would also be different.

These data and calculations show that expenditure cuts by themselves cannot be regarded as crisis management at all, if we think only of the changes of the recession depth. This must be stated openly, and what's more, must be clearly emphasised. This statement, or even more emphasizing it is missing from almost each material on the crisis management. The only exception is the study written by Lajos Bokros, who says that in Hungary the realistic alternatives are "deepening crisis, protracted recession or open, immediate bankruptcy".[22] With this Bokros actually states that in order to prevent the state bankruptcy *no anticyclical public finance policy can be pursued* in Hungary. what is more, we must implement expenditure cuts which *deepens* the economic crisis.

In the current situation the use of terminology is of crucial importance. State bankruptcy creates a *"crisis situation"*, and the state of recession is also a *crisis*. But the two require different measures! Proposals that have been published or submitted thus far refer to crisis management, while they actually mean to pre-

vent the state bankruptcy. However, all those people who link the concept of crisis management to the alleviation of economic recession do not understand the proposals for the radical curtailment of expenditures. As we could see, in recession expenditure cuts decrease economic performance,[23] even if accompanied by tax cuts.

This lies in the background of all objections that cite US and Western European counter-crisis measures in contrast with the Hungarian proposals on crisis management. In these economies the emphasis is less on curbing expenditures, and more on boosting demand. State bankruptcy is not an imminent threat in these countries. There are several reasons why Hungary cannot do what other countries can, but the number one reason is looming state bankruptcy. The absence of the proper use of terminology, and the absence of proper word composition have created a chaos in the heads of the people even before. The bigger problem is that in this manner government measures become incomprehensible, and austerity measures seem to be senseless. These measures can even seem to serve the intentional oppression of the population, especially those that are related to the pension system or suffer the curtailment of social expenditures. In a best-case scenario the consequence is the questioning of the competence of the government, if it acts in accordance with the proposals. Since in a "crisis" expenditures need to be increased rather than decreased – they claim. Therefore, the reception of balance-restoring measures by the population also depends on how exact the use of terminology, and how circumspect the analysis are. Keeping this in mind we can start investigating what we could do within the framework of economic reform if the primary task is the prevention of state bankruptcy.

We must start with the seemingly paradox statement that in this case the reform process can be *comprehensive and entirely consistent!* In this case it is out of the question that reform steps excluding expenditure cuts should be implemented in a crisis. Here, the question is not about a crisis management aiming at the alleviation of economic recession! If the considerable reduction of expenditures is inevitable for the prevention of state bankruptcy, merely for economic considerations it is perfectly all-right to implement a comprehensive reform, which includes, among other things, the curtailment of state expenditures and also the significant curtailment of consumption. What is more, in such cases the most obvious method for the prevention of state bankruptcy is the implementation of the comprehensive reforms already postponed for a long time. It is definitely an advantage when expenditure cuts also mean that the efficient use of resources becomes part of the economic automatism, so that the system of economic institutions would not regenerate disproportions on a continuous basis. Especially this is what substantiates the economic reform that otherwise entails expenditure cuts now.[24] Therefore, by combining the reform and the prevention of state bankruptcy, *two birds can be killed with one stone.* Although the reform somewhat contradicts to simple crisis management, it definitely helps prevent state bankruptcy!

The comprehensive reform, as a tool for preventing state bankruptcy, also implies that there is no need for the application of the "principle of across-the-board cuts". Expenditure cuts must be differentiated. Often this makes even more painful and unpopular decisions inevitable, like the withdrawal of the 13th month's pension, which is not at all compatible with the established, or even more with the expectable system of contribution payment, as well as with the principle of insurance. The latter means that the contributions paid must cover the pensions disbursed on an annual basis, which a priori contradicts the introduc-

tion of the 13th month's pension. The contradiction is even be greater if pension contributions are reduced with a view of narrowing the "tax wedge", which is otherwise required in order to increase the willingness both to employ workers and to seek jobs. This means right away that initially annual pension payments would decrease at a significantly larger rate than the total public finance expenditures. But the reform itself and the prevention of state bankruptcy would be in harmony with each other. It would be a similarly painful decision if the system of the pension payments was linked to the payment of contributions, i.e. that at least in the medium run the amount of pensions would be adjusted to the amount of contribution revenues at national level. This would prevent the future deficit of the Pension Insurance Fund, since this new automatism would prevent overpayments – at least a permanent overpayment by the Pension Insurance Fund. On the other hand, adherence to the principle that would strictly link initial pensions to former contribution payments would encourage the propensity to pay contributions.

The withdrawal of the 13th month's salary of the public employees has similarly a dual impact: prevents the state bankruptcy but currently deepens the recession. And several other examples could be cited, such as making the system of childcare allowance and childcare fee more stringent, or the strict application of the principle of means-tested disbursement in the framework of social benefits.

All this does not mean that proposals made for the alleviation of the economic crisis, and investigated earlier in this paper cease to be valid. Most of these proposals do not contradict the prevention of state bankruptcy. For instance, what this article states about the reallocation of resources or about the utilisation of EU funds among targeted anti-crisis measures can also be used within the framework of the prevention of state bankruptcy. Similarly, everything that was determined in relation to the modification of the tax structure is valid. Since the latter serve the enhancement of economic activity and the more efficient utilisation of resources, and at the same time, if implemented, they ensure that the external economic impulses will trigger the revitalisation of the internal economy sooner. What we said in connection with the structure of public finance expenditures can also be applied. The task is not merely the curtailment of expenditures, but also the replacement of useless expenditures with useful ones.

All this draws attention to the fact that putting the prevention of state bankruptcy in the foreground does not mean that the alleviation of recession can be ignored. It rather means that measures that reduce expenditures and measures that encourage the internal economy must be taken simultaneously. Naturally, the impact of expenditure cuts is greater initially. This means that the depth of recession depends on the resultant of the two opposite effects. While in Hungary state bankruptcy is a much larger threat than recession, expenditure reducing measures are a necessity.

Consequently, recession will probably be graver and deeper in Hungary than in countries where the only problem is the recession management. The majority of the policy aiming at reducing the expenditures can be expected only afterwards, and recession has already been forecasted to reach 4 or 5 percent. The economic crisis will be even deeper due to the further curtailment of state expenditures. This is why we must calculate with another special correlation too, that cannot be or can hardly be managed by us.

Full employment surplus/deficit and crisis management

In Hungary the GDP declines for two main reasons. One reason is the recession itself, the

other is the prevention of the threat of state bankruptcy, i.e. the reduction of public finance expenditures. The latter is unusual in the case of economic recessions. Especially in large economies, efforts are made to increase state expenditures within the framework of the crisis management policy.

If production declines due to expenditure cuts, tax revenues plunge, and even the curtailed expenditures prove to be larger than the tax revenues, which turn out to be smaller than before, i.e. the deficit is reproduced. Everything can be started anew. Expenditures must again be slashed with a view to restore the balance. A downward spiral starts, which in theory lasts forever, but the absolute value of reduction decreases in each step, like in a descending geometrical sequence. Despite this fact, this process seriously disturbs the balance of public finances, too. Of course, the reaction to the reappearing deficit shall not necessarily be the reduction of expenditures again: also taxes can be raised. However, this also triggers a decline in production, since the share of purchases will be necessarily smaller due to the smaller after-tax income. Consequently, aggregate demand falls, and so do tax revenues and the GDP.

Before the birth of the Keynesian theoretical system the principle of a balanced state budget was considered as a golden rule. At that time it was a natural reaction to strive for a break-even state budget. One tool for this was tax increase. In contrast with this, *Keynes* proved that in an economic recession one must not be afraid of deficit-ridden public finances. In case reserve capacity is available, the deficit does not cause inflation, but keeps the aggregate demand, and thus production at a higher level in real sense, too. Due to the latter, the size and rate of the deficit will eventually be smaller.

This consideration serves as a basis for the "full employment surplus/deficit" category, and at times of economic crisis this is how public finances operate in developed countries. If the public finance deficit rises due to economic recession, the state does not restrain its expenditures, and nor does it increase the tax burdens. It covers the increasing deficit from loans. Consequently, the system works as an automatic stabiliser. In this case the deficit increment does not prove that the state increases the deficit on purpose since this increment is the result of the decline in production. Policies can not be judged on the basis of the deficit experienced at a certain moment. Judgement can be made if we examine right away: how big the deficit ratio would be in case of full employment. Since the deficit falls under the impact of greater economic performance, it is possible that the actual spending by the government would not entail a deficit in case of full employment. Then policy-makers cannot be accused of overspending.

This is the background of the full employment deficit/surplus category.[25] As a result, the financial government may pursue a more flexible policy, not making the mistake of stepping on the brake even if that is not necessary.

The problem is that this type of flexible policy, which is beneficial at times of recession, can be applied only in those countries in which the stability of the economy is not seriously questioned. However, tolerance can hardly be expected from the international money and capital market in case of looming state bankruptcy. If in this case the government does not follow a restrictive policy, by increasing taxes or reducing expenditures, instead it asks for more loans, the capital market's response can be the rejection of giving loans or a drastic deterioration of the borrowing conditions. This can also bring state bankruptcy closer, or may even trigger it. A country with a bad reputation can manage its finances under much more difficult conditions than the others. Bad reputation must be forestalled.

Hungary is currently in such a situation.[26]

social constraint, i.e. what and to what extent the society is willing to tolerate. For example, at the current level of social tensions it is hardly advisable to introduce a single-rate income tax, or make the payment of the healthcare contribution of fixed and raised amount universal, which is to be paid by pensioners, too at the time when the 13th month's pension is withdrawn. A lot of people and many experts would support the introduction of the "flat rate" tax. But what would it mean in practice, under the conditions of the extremely unequal distribution of income?

Some *monthly* salaries total HUF 4 million before taxation, not including bonuses. (Much larger monthly salaries exist, too.) If a 20 per cent "flat rate" tax was introduced, our man with a monthly salary of HUF 4 million could pocket a monthly surplus of HUF 800,000 after taxation, if the marginal rate was formerly 40 percent. On the other side, the income of people with small pensions falls due to the withdrawal of the 13th month's pension. Or let us see the system of price subsidies. It has been raised lately that price subsidies to distance heating may be withdrawn, even in case of people in dire situation. A necessary precondition for this would be the ability of the consumer to use an alternative heating solution, or to save on consumption. But what can people do who receive small pensions and live in blocks of flat? At best they should move, but even this is not an option, since they have nowhere to move. Let us compare their situation with those who – according to certain proposals – should pay income tax at the lowest rate up to an annual income of HUF 15 million, and as a result, those whose income is close to the upper limit would be happy to receive HUF 200–250 thousand more in a month. And they would deserve this due to the mere fact that hopefully they would increase their savings.

Tensions must not be allowed to turn into a social explosion. There is no doubt that the reforms that play an important role in the prevention of state bankruptcy, too, must be implemented, and that state expenditures must be radically decreased. But the same attention must be paid to the social constraint as to the elimination of efficiency-deteriorating factors and to the elimination of excessive income centralisation. It is possible that under the conditions of capitalism, too, better-off people should be burdened more than envisaged earlier, if public finances are to be streamlined and state expenditures are to be curtailed. An important factor of the difficulties is that the higher economic elite turned out to be too greedy. It is irritating especially in the current situation, what salaries the executives of certain sectors can take home, and how big severance pay they are entitled to. This also brings the society's willingness to tolerate to its tolerance threshold. The situation can be aggravated to the point where these two are no longer compatible.

DILEMMAS OF THE MONETARY POLICY DURING THE PREVENTION OF STATE BANKRUPTCY

The specific situation of the Hungarian monetary policy

As we have emphasised, in case of a recession, recovery requires a low interest rate already at the very beginning. The Hungarian economy is in deep recession. At the same time, it must act to overcome the threat of state bankruptcy. However, due to the latter neither the nominal, nor the real interest rates can be low. Interest rates in Hungary were not low even in the period preceding the recession and the threat of state bankruptcy.[27] This is related to the inflation-targeting monetary policy regime, which was introduced in 2001.

Within this framework the National Bank of Hungary strove to suppress the rate of infla-

We have to take into account not only the fact that state expenditures must be curtailed at the time of recession due to the serious financial imbalances, but also the fact that we cannot rely on the operation of the most automatic stabilisers either, which would otherwise alleviate recession. This also explains why the economic recession will probably be greater in Hungary than in countries that are similarly sensitive to the external market, but are financially better off.

Limitations to be considered during the prevention of state bankruptcy, too

Not all measures can be taken, not even if the reform is implemented consistently, during the prevention of state bankruptcy. Compromises are always needed. They are justified by mere economic considerations, and even more by the level of tolerance of the population.

The smaller problem is the compromise that is related to the economic considerations. The economic reform is mostly necessitated by the need for supporting the improvement of economic efficiency, the enhancement of cost-effectiveness and dynamic economic growth. These are indeed important objectives. Economic policy tools have never and nowhere in the world been strictly subordinated to the achievement of better efficiency and longer-term and fast economic growth. Such a policy requires a lot of concerted actions and economic decisions, and this can nowhere be experienced in a perfect form. Let me cite a few examples for better understanding:

Let us suppose that the government encourages investments and savings. For the sake of the latter it applies a “flat rate” income tax. What is more, it does so through consumption based taxation, which means that savings can be deducted from the tax base. Corporate profit tax is either nonexistent, or its rate is low. The value added tax is also a single rate tax so that different rates would not disturb the efficient allocation of resources. The entire tax system is degressive in nature, in order to the sources of investments be more easily increased. The inclusion of incomes in the public finances is either relatively moderate, or shows a decreasing trend. The rate of social security contributions is low, self-support is encouraged by the moderate level of pension benefits and the method of financing in the social security system. An increasing portion of public finance revenues is used for developing the infrastructure, since in this way direct capital imports can be greater and more sustained. The policies are continuously designed to ensure the internal and external balance and so, financial problems do not hamper the growth process. The monetary policy is subordinated to the targets of price stability, the external balance and economic growth, so that it can serve all three objectives concurrently. The funding of public finances directly by the central bank is out of the question.

There is something, or in fact there are always a few things that are missing from this list.. Their concurrent presence would serve efficiency and economic growth. But the items listed are not omnipotent. If technological development is not fast enough and/or the workforce is poorly skilled, if the trade structure corresponds only to a low level of development, neither higher level of efficiency nor a faster growth can be achieved. On the contrary, the result will be just a deteriorating efficiency: an increasing investment ratio with inadequately qualified workforce rather entails decelerating growth and increasing capital intensity. The result will be just the opposite of what we have expected. Efforts prove to be futile, and the reform misses the target. This is where economic constraint appears, which may even turn into political tension.

Even more significant is the political and

tion when public finances were permanently and largely in deficit, and income policy was expansive. Average nominal wages increased by 12 percent on average, while the GDP grew only by 4 percent a year. This should have triggered high inflation. This is what the National Bank of Hungary intended to forestall relying on the interest rate policy, since in theory, high interest rates lead to the drop in the demand for loans, and thus for money supply, and consequently curb inflation. However, this mechanism cannot function well if there is a free flow of capital between the countries, if the interest rate is significantly lower abroad, and if the exchange rate of the HUF is rigid downwards. No wonder that in the foreign currency denominated loans have become a determining factor in Hungary. Consequently, Hungarian companies and households borrowed – mostly through the banks – first of all loans based on foreign currency wherefore, despite the high HUF interest rates, the total demand for loans continued to rise quickly, and the inflation rate decreased only sluggishly.

Due to the high domestic interest rates, Hungarian government securities have become much sought after by foreign money investors. The demand by money investors for the Hungarian currency permanently rose, which kept the exchange rate of the HUF high despite the fact that inflation in Hungary was much faster than elsewhere. We can even say that it was this speculative demand for the HUF that effectively restricted the domestic rate of inflation, since a high and overvalued exchange rate is always an anti-inflationary factor. By this way the competition of foreign producers is more apparent. Stronger competition and the accompanying rise in the aggregate supply keep the domestic price level under pressure.

The result of the entire process: somewhat decreasing inflation rate, an internal interest rate level much higher than the external one, increased indebtedness of companies and households in foreign currency denominated loans. For a larger part, the latter explains why the private sector's external indebtedness is twice as high as that of the state.[28] Without this it cannot be understood why the financial situation of the country has become so unstable, and why state bankruptcy is looming. If foreign currency debtors cannot repay their debts due to the rapid weakening of the HUF ensued in the past year, banks can go bankrupt and will no longer be able to finance the state either. Hungary would be much better off if the population and the companies had been more prudent when borrowing foreign currency denominated loans, because in this case the share of bad debts would be much smaller at the banks.[29]

In such a situation the NBH is not able to pursue a substantiated interest rate reducing policy.[30] If the threat of state bankruptcy is large, foreign banks are willing to lend only with high interest rates, if even at all. Today the risk margin of borrowings is very large. In the past months this margin occasionally exceeded 6 percent. This means that for instance the German state receives a loan on the international money market at an interest rate of 3 percent, the Hungarian state can hope to get a loan only at a 9 percent interest rate if at all. And since the different interest rates influence one another, the business interest rates must also be high, moreover even higher than 9 percent. However, already a nominal interest rate of 9 or 10 percent seems to be so high with an inflation rate of 3 or 4 percent that it renders the chance of recovery almost hopeless, even if state bankruptcy can be averted and the management of recession starts to become the main task.

If the current interest rate is very high, the yield rate calculated on the basis of the discounted future yield is almost always smaller than that. The conclusion is understandable: so

that recovery would start on a solid basis, the current interest rate must be significantly reduced. But for the time being the risk margin is a determining factor of the interest rate, i.e. it is that first of all should be reduced. However, this becomes possible only after the threat of state bankruptcy dissipates, and that is not expected to happen without the radical curtailment of public finance expenditures.

During the analysis of the monetary policy it can also be concluded that for the time being crisis management cannot be restricted to the alleviation of the economic recession. If only the latter was the task, it would not be wise to reduce state expenditures as long as the recession lasts. The conclusion is that we come to manage the recession also through the preliminary prevention of the state bankruptcy. The therapy begins with the curtailment of public finance expenditures, which initially deepens the economic crisis. Recovery can start only from this lower level. So that recovery could later really start, we must accept the fact that in the beginning we must take measures that *deepen rather than alleviate recession!* What is more, this needs to be done urgently.

The current situation cannot be maintained for a longer time. Foreign investors may lose patience at any time. Furthermore, it is a rule of thumb that the real interest rate burdening the public debt should not be higher than the growth rate of the economy. In fact, this rule holds true in the case of the external indebtedness of the country, too. The greater the internal and external indebtedness, the more serious obstacle is generated by this rule. Likewise, the lower the growth rate of the economy, the stronger this rule must be adhered to. On top of this, we must take into account the Maastricht criterion according to which public debts must not exceed 60 percent of the GDP if a country wishes to join the EMU. The euro could be the official currency of Hungary if we have already met these conditions.

For the time being, public debts in Hungary exceed 70 percent of the GDP, while the ratio of the country's net external debt – calculated in euro, taking into account the significant devaluation of the HUF- is almost 60 percent of the GDP. And the GDP is falling instead of growing. Even if we count with stagnating GDP, due to the debt ratio the problem is not simply that the debt is rising, but that *it is rising too fast* due to the high real interest rates. If we assume the internal indebtedness to be 70 percent, the public debt/GDP ratio increases by at least 4 percent each year just because of the interest rate burdens, although that should significantly decrease. This itself represents a risk of state bankruptcy, and this is what makes fast decision inevitable. A fast decision assumes considerable curtailment of the expenditures. This is just what makes it possible to significantly decrease the risk margin, and hence the internal interest rate.

However, the reduction of the interest rate is also accompanied by effects that imply risks for the domestic economy. First of all the effect on the exchange rate must be emphasised. If we examine the expected changes in the interest rate, we must count with at least two uncertainty factors. One is the situation of foreign currency debtors, which represents a serious problem already today. The other uncertainty factor is linked to the HUF/EUR exchange rate, which becomes especially topical if Hungary joins the eurozone.

Given other factor, if the interest rate falls, the exchange rate sooner or later tends to fall too. The lower interest rates reduce the demand for the securities denominated in HUF and this leads to a drop in the exchange rate of the Hungarian currency. But the interest rates can be reduced only after state expenditures have been curtailed! This however has an opposite effect: it increases the exchange rate of the Hungarian forint because improves the trust in the maintenance of financial stability.

This means that there are two counteracting effects at the same time, and it will turn out which of them is stronger.

Based on the two counteracting effects it is almost certain that the HUF/EUR exchange rate will not return to the former level of HUF/EUR 250–260. The exchange rate of the euro will be significantly higher, and the exchange rate of the HUF will accordingly be significantly lower than that. This is also supported by the fact that *for a longer period of time* the exchange rate cannot be independent of the changes of the external and internal price levels. The rate of inflation has been significantly higher in Hungary than in the countries of the eurozone for a long time. It may happen that by the time the domestic interest rates reduce to the average interest rate level of the eurozone, plus to the amount of the risk margin that has significantly shrunk in the meantime, the exchange rate of the forint may be *somewhat, but not much* smaller than now. The opposite may also happen. However, the exchange rate is not likely to plunge further if the internal and external balances can be restored successfully.

It is difficult to say anything more exact about the actual level of the exchange rate. It will probably be close to the current exchange rate. And this is bad news for the foreign currency debtors. But the actual level of the exchange rate does not depend on what would be beneficial to a certain group of debtors. If the monetary management tried to pursue a voluntarist exchange rate and interest rate policy in support of the foreign currency debtors, it would trigger adverse economic consequences just like the inflation-targeting monetary policy regime that has been former rigidly applied under the economic conditions of Hungary. On the one part, the non-decreasing HUF exchange rate and on the other part the excessively high interest rates led to the result that the foreign currency debts of the private sector have swollen so much.[31] One of the important preconditions for overcoming the economic crisis is especially that the exchange rate must not be artificially kept at a high level.

The expectations related to the exchange rate of the forint are also largely influenced by the need for joining the eurozone as soon as possible. This is explained not only by the fact that the multilateral exchange rate of the euro fluctuates much less than that of the HUF, wherefore the significance of the risk factor would be much smaller. An equally important motivating factor of the expectations is that the HUF/EUR exchange rate should be favourable when Hungary joins the eurozone. By this everybody thinks of a high HUF exchange rate, to exchange the least possible HUF amount for one euro.

If the exchange rate is higher, we receive more euros for our money we have saved, our salary can be higher in euro in accordance with the better exchange rate, and similarly, the euro-value of pensions and subsidies can also be higher. It is true that the actual exchange rate can be discussed with the ECB before Hungary joins the eurozone, however, a higher rate can be more easily achieved if the exchange rate was higher even before.

However, the higher multiplier applied when a country joins the EMU-is far from being such a great advantage as expected. It is true that in this case nominal wages, pensions and other payments which increase the consumption of the population can be higher in euro than in the case of a smaller multiplier. However, *prices must also be multiplied with this number,* wherefore the new level of prices and wages eventually break even.[32] The same holds for savings, too. If the stock of savings is larger in euro due to the larger multiplier, it will meet a similarly higher euro price level on the domestic market. If wages paid in euro are somewhat higher, the wage costs of the companies will also be higher accordingly. Even this itself entails a higher

price level; since following from the *macroeconomic linkages* ultimately the wages represent the greatest costs of production.[33]

Obviously, in certain aspects the price multiplier, i.e. the HUF/EUR exchange has reality indeed. Here we must take two correlations into account.

FIRST, it is not true that the population can spend its income on the domestic market only. People can buy things abroad, primarily when they travel abroad as tourists. The external euro price level is practically left unaffected by the HUF/EUR conversion. It is better for the citizens if they can travel abroad cheaper, and can buy things cheaper than at the domestic euro prices. But it must be kept in mind that the part of income that is spent abroad represents a small ratio of the total income and savings of the overwhelming majority of the population.[34] It does not significantly affect the situation of the population.

SECOND, the impact which is beneficial for the population in a certain sense is counterproductive in the corporate sector, primarily at small and medium-sized companies. Here, the effect arising from a higher conversion rate is rather disadvantageous. If the exchange rate is determined on the basis of the overvalued Hungarian currency, the internal price level will be accordingly higher. But in this case the internal price level of goods to be exported represents a competitive disadvantage for the domestic producers and exporters. Exporters can sell abroad only with discounts and/or in smaller quantities, while foreign competitors can sell more products at a good price and with a larger profit in Hungary. This is disadvantageous for the foreign trade and the balance of payment, for the employment, and the utilisation of capacities, and ultimately for the economic growth. At times of recession it hampers the recovery of the economy. Practically the same situation occurs as when commercial and payment relations are mediated by an *overvalued exchange rate.* Just because no currency conversion is needed, the basic interrelationships do not change.

We must draw the following conclusion: it is more advantageous if the HUF/EUR conversion rate at the time of Hungary's accession to the eurozone is adjusted to an exchange rate at which the forint is neither over- nor undervalued! This is the clearest and most advantageous scenario both for crisis management and for long-term growth prospects. It would prepare Hungary's recovery from the economic crisis well, which will sooner or later occur. The central bank's lower prime rate relying upon the already prevented state bankruptcy, and the resulting market interest rates entail the same effects.

To this we can add what was said about the operation of the automatism coming into play in any spontaneous crisis mechanism and putting always an end to the crisis: with some time planned investments reach, and then start exceeding the level of savings, wherefore aggregate demand exceeds the aggregate supply again, opening the road for the increasing utilisation of production capacities: production begins to rise. This process is largely assisted by the reform, including, for instance, the restructuring of the tax system so that it would encourage both the companies and employees for engaging in entrepreneurship and employment. To all these are connected the tools the government can use, in Hungary too, for stimulating economic activities.. (Utilisation of EU funds, provision of targeted subsidies by using additional resources and, reallocation of resources).

Converting disadvantages into advantages

In many countries, but especially in those having a large internal economy, or in those where

public finances had not seen distress before, raising the demand artificially through state spending[35] can significantly contribute to recovery. This is not possible in Hungary: due to the threat of state bankruptcy we must act on the contrary, and a very disciplined budgetary policy must be pursued for years even after the elimination of the threat. Can we still believe in a radical turnaround either in terms of changes in the aggregate demand, or in terms of production and employment? Is spectacular recovery possible in Hungary, too after the former bad financial situation and the elimination of the threat of state bankruptcy? It is possible, however we must add that only on the basis of the restoration of the financial balance, and largely under external impacts.

Since in the globalising world economy the international economic relations are very intense, recovery will start almost simultaneously in most countries. This provides an important conclusion for Hungary.

We could see that state measures designed to alleviate recession by boosting demand are more effective in larger than in smaller national economies. The situation is inverse if we look at the international impact of the evolving recovery. In a large country, for instance in the US economy, the impact of the evolving global recovery on the internal economic situation is relatively moderate due to the low export ratio. The ratio of commodity exports (excluding services) relative to the GDP was 7.8 percent in the US in 2006-ban. If owing to the global recovery the rate of exports grows from 0 percent to 10 percent within a single year, it will induce a rise of 0.78 percent in the aggregate demand at national level. However, in Hungary, where commodity exports relative to the GDP totals up to 66 percent, a 10 percent growth in exports may increase the aggregate demand by 6.7 percent. The external demand impulse increases the aggregate demand proportionate to the size of the export quotient: in the case of Hungary 8.5 times more than in the US. If we compare Hungary to the large European economies, the impact is almost triple the one that manifests itself with them.[36]

Since the global economic crises unfolded and reached Hungary, impatient statements have been often made: we are going against Europe in crisis management. Or “leftist economic policy should strive to stimulate demand rather than to take austerity measures”.

The problem lies not only in the fact that demand stimulation could be of little efficiency, but also that it would deteriorate the external and internal balance. Further problem is, and this is the bigger one, that due to the threat of state bankruptcy the repayment of existing loans can mostly be ensured only by using up the standby credits extended by the ECB, the IMF and the World Bank. In such a situation it would be cutting our own throat to apply the method of intense and general demand stimulation. This can be considered neither a leftist, nor a rightist economic policy. This would simply be a bad economic policy!

At the same time we can enjoy the benefist that the demand stimulating policies of large countries may bring to us. The turnaround of their economies will trigger the recovery of the Hungarian economy too, if we also take efforts to improve the underlying conditions. High import and export quotients are in part disadvantageous in crisis management, because when taking demand stimulating efforts we can end up as if we poured water into a bottomless barrel. But the high export quotient is also an advantage if we look at the impact of external demand impulses on the *ev olving recovery*. The high ratio and the acceleration of exports may hot up the Hungarian economy, however the extent of this recovery will very much depend on how considerate the reforms were during crisis management and afterwards, how consistently they were implemented. The turnaround can be spectacular in Hungary, too, but prima-

rily on the basis of commencing the external boom. All in all, small economies are not a priori disadvantaged compared with large economies.

THE PRICE OF THE CRISIS. THE QUESTION OF RESPONSIBILITY

For the time being, the economic crisis, the potential state bankruptcy and preventing it, as well as the related economic and social costs must be tackled simultaneously. It is difficult to give even a rough estimate of these costs (losses). of crises. It is mostly determined by the unrealised economic performance. And it cannot be expressed in money terms what the uncertainty of living conditions resulting from the crisis causes to people.

Estimating the economic costs is very difficult since we should know exactly the development of two curves. One of them is that of the actual economic performance, and we do not know how it will change, not even in the near future. The other curve represents the performance that would have been observed without the crisis. For the lack of a better solution, the latter can be estimated by the extrapolation of the former production curve. It is a special problem, that production in Hungary declines not only because of the economic crisis, but also because of austerity measures taken – or to be taken – to prevent the state bankruptcy. And it is *ab ovo* impossible to determine, even approximately, what consequence a state bankruptcy would have on production.

The forecasts change from month to month about the expected decline in production, and we do not know how far the end of the tunnel is. What is more, we must be aware of the fact that we have not reached rock bottom yet; expenditure cuts are yet to come. We can only make predictions, the reliability of which is small. Therefore, I say that the decline in production may be between 5 and 10 percent, and the worst is not likely to happen before the end of this year, since the full restoration of the economic equilibrium is yet to come. If production dropped by 10 percent right away, and would remain at that level for a year, the annual loss would total HUF 2,700 billion. But production does not fall by 10 percent immediately. This happens only gradually. Therefore the loss is smaller that HUF 2,700 billion. On the other hand, however, the output would have risen, even if only, say, by 2 percent in a year. In Hungary, every one percentage economic growth means a surplus of HUF 270 billion annually, for this reason the calculated loss incurred owing to the crisis can even be bigger.

But this is not yet the end of the problem. Also the interest burdens are now rising at a faster pace for several reasons, but primarily due to the looming state bankruptcy. If we get a loan, we get it at a much higher interest rate than earlier.. If we do not get loans, we fulfil our repayment obligations from the stand-by loans extended by the IMF, the ECB and the World Bank. The interest of the latter is much lower, but an interest must be paid on the total amount of stand-by loans.. This is a burden that would not have occurred if Hungary's finances had not been so poor. This also adds a few hundred billion in HUF to the costs of the crisis. If we take only these items into account, i.e. the unrealised production growth, the decline in production, the increased interest burden, and also the fact that production declines gradually and not abruptly, and if we count with only one year, the minimum loss will total HUF 2,000–2,500 billion. Of course, the total cost can be even greater than that. This figure can at least provide a rough estimate about the *material* cost of the crisis. This amount is at least 4 or 5 times bigger than the cost of the new Budapest metro line under construction. Of course, a significant part of the loss occurs due to recession, and must not be attributed entire-

ly to the specific Hungarian problems, such as the prevention of state bankruptcy.

And the losses are even greater if we consider the discomfort and uncertain living conditions of the population, the passions that have gone uncontrolled in part due to the crisis, or the turning of the people to false prophets. The impacts thereof are at least as bad as those of actual material losses.

Can anyone be held responsible for all this? It must be taken care not to seek persons or parties being responsible for the recession ensued owing to the global economic crises. We are prone to lump everything together. It must also be kept in mind that not all consequences of an economic policy can be foreseen. It is all the more so, because the same expansive budgetary policy brings about quite different consequences depending on how the conditions of the dynamics of economic growth in short and medium term will change. And it is extremely difficult to forecast economic growth. Economic policy makers cannot usually be accused of purposeful malice, all the more of lacking the necessary competence.

Stating this well in advance there is no doubt that the government in office is to be held responsible for losses caused by the economic policy, also for the mistakes committed since 2002. The greatest economic mistake has been lavish budgetary spending, which was aggravated by all those decisions that led to the too rapid increase of nominal incomes. The mistakes also include the omissions having left those structures unchanged that continually generated the too fast increase of consumption, and contributed to the mismanagement either in the public, or in the private sector. Beyond doubt, these omissions played a crucial role in the fact, that public finances and the current balance of payments have been permanently and extensively in deficit, that the debt of the state and of the country has swollen, and the state bankruptcy has become looming.

The opposition was and is deeply indignant. This indignation would be fully righteous if the best had been done to prevent the senseless overspending. But, instead, we could always hear: “we would give even more”. The indignation would be righteous if the opposition would not have demanded the fulfilment of the unrealistic promises made by the winning parties during the election campaign, and the parties in opposition itself would have been moderate in their promises. Instead of that, they promised even much more, and after being defeated – disregarding the realities -the full implementation of the promises was by them demanded instead of a sober policy! The fuss that went on over the gas prices for four years was tragicomic. The governing party promised, that no gas price hike would happen, and in the largest opposition party's view natural gas does not even have a world market price, gas price should depend on the Prime Minister's decision, and he should not raise this price. In this country some people can and could make a – good – living with such “arguments”.[37]

The opposition should bombard the government with concrete programmes, and present a realistic alternative to the people. It should not only claim that taxes must be radically reduced, and refer only to winding up the squandering state bureaucracy when talking about expenditure cuts.

According to the figures prepared by the senior officials of the Political Capital Research Institute, the costs of the promises made by the largest opposition party totalled HUF 2,800 billion on average annually in the election cycle of 2002–2006, while the costs of promises made by the winning party equalled HUF 1,900 billion. These promises could have been fulfilled without causing harmful consequences only at an annual growth rate of 13% and 9% respectively, taking into account the annual size of the GDP. This means that even the annual growth rate of 7 percent would have been

insufficient. Nothing was coordinated.. There was no harmony between the individual objectives, and thus between the expected dynamics of economic growth and the promises. The promises had nothing to do with real connections valid in the economy. The fact that the growth rate and the rate of investments are correlated – through capital efficiency – and that savings and the growth rate correlate with each other was also neglected. The fact that one cannot really predict the rate of growth without having information on the qualification of the workforce, the professional composition of wage earners, and the changes of this composition is a rather known problem, but it was fully ignored in the competition of promises. The fact that economic growth requires market expansion, too, and in an open economy, such as the Hungarian, this first of all means the expansion of the external market, also became a neglected issue. The fact that one of the major preconditions for exports, which play an important role in the growth process, is the improvement of the external competitiveness was not given attention, and did not influence the piles of promises. Only bidding was important. Economic arguments did not count at all, the only thing that mattered was defeating the opposing party. Seizing power was more important than anything else.[38]

In such a case the party winning the elections gets into a difficult situation, and – paradoxically – the loser benefits. Of course, the winner does not have to fulfil all of its election promises, but it is exposed to attacks by the loser. The latter is not called to account for performing its promises. It can claim that on the basis of another strategy, by choosing the key steps differently, the citizens would not have been deceived. the citizens. It does not come to light that such omnipotent key steps do not exist. They can say that on the basis of these key steps – e.g. through radical tax reduction, and thus the encouragement of the entrepreneurship, and consequently, through the stimulation of the economy – their promises would have come true. The majority of the population is happy to hear that. It is much easier to make statements that sound well for the majority of the population accept than to prove, such statements have not any ground. The latter, namely requires explanation and understanding a good deal of complicated economic interrelationships, and this is that almost hopeless to successfully achieve.[39] At such a time, the loser gets into an advantageous position and it can easily be capitalised on if acting incorrectly.

Unfortunately, in the past 7 or 8 years politics has practically failed. The number of disillusioned people is growing. If people were able to understand what is happening and what has happened, if people would be aware of the real economic interrelationships, they would have become disappointed with both leading parties. In the current complex world people, unfortunately, cannot be wise enough. They have rather a hindsight wisdom. And since this is the case, politicians have a tremendous responsibility. In the current situation each and every party should first of all to *look at itself!* Thus we could better hope in overcoming our problems.

SUMMARY

Crisis management can be interpreted in several ways. In the present-day Hungary it refers to a situation in which the country suffers simultaneously from a global economic crisis that affects Hungary, too, and the financial crisis occurs in a serious form, with state bankruptcy looming. At the same time, the Hungarian economy's sensitivity to the external economy is well above the average in international comparison.

Due to the specific situation of Hungary, the economic recession itself cannot be alleviated simply by demand stimulation. Due to the large export and import quotients this would

hardly trigger any internal recovery. Instead it would entail the strong and quick deterioration of public finances and the balance of payments. The alleviation of recession must be targeted, and must mainly support sectors that are only slightly export and import dependent, that are less prone to increase the aggregate supply but restrict the decline in demand, and that improve the growth potential in the longer term. These sectors include the infrastructure, education and healthcare, in the production sector mostly the small and medium-sized companies, the import and export sensitivity of which is much smaller than average.

Due to the threat of state bankruptcy, the number one task is not the alleviation of economic recession. State bankruptcy, if it occurred, would lead to a much greater setback than the recession itself. On top of that, the recovery of the economy would start more painfully owing to the lack of trust. Therefore, the economic policy, if it recognises the actual situation well, and acts accordingly, is forced to make decisions that are incomprehensible from the aspect of the simple mitigation of crisis. The most urgent task is reducing the expenditures of public finances, since only this can restore the financial balance within a short period of time, and along with it the trust, that is inevitable for financing the economy by the international money market. However, expenditure cuts rather aggravate than alleviate the economic recession! This means that the alleviation of recession, albeit not needless at this time either, is pushed into the background during "crisis management".

The strong curtailment of state expenditures – taking into account also the induced effects accompanying each expenditure reduction – reduces the aggregate demand by an amount bigger than the value of the expenditure cut itself. Therefore, in the Hungarian economy the expected decline in demand will be around twice as much as the amount of expenditure cuts, taking into account the propensity to saving on national level that mostly determines the intensity of secondary changes (along with it the *income multiplie*r in the professional terminology), and furthermore the average income tax rate, too. So, for instance, if public finance expenditures are reduced at a rate equalling 3 percent of the GDP in a given year, this alone leads to a 6 percent drop in the GDP. Naturally, this rate can be reduced by the parallel programmes designed to alleviate recession.

The prevention of state bankruptcy causes a serious decline in production, but the decline would be even greater if the bankruptcy really occurred. Its rate would be two-digit, and might reach 20 percent, or even more. So if state bankruptcy looms, the remedy measures can be righteously called crisis management, since they forestall a much greater decline that they themselves cause. At the same time the population must be informed about this, and the restrictions causing the drop of economic performance additionally must be justified. Otherwise it would be incomprehensible why the government restrains or even reduces the demand at the time of recession. The clarification of this problem was mostly omitted from the proposals made for crisis management, which is a serious mistake.

The economic reform, which has been postponed since long and interrupted several times, is also shown in a new perspective, especially in relation to crisis management. One of the objectives of the reform is to reduce the ratio of redistribution by the state. This goes together with expenditure cuts that are in part supported by tax reduction. Whether or not tax reduction is applied, reducing the share of redistribution *in a recession* leads inevitably to a further decline in production, although the drop in production is smaller if also tax reduction is carried out. Therefore, if the recession management was the only task, it would be advisable to implement only those elements of

the reform that do not cause a further drop in aggregate demand. These include the parts of reform affecting the tax structure and the structure of expenditures. Those (otherwise numerous) reform elements that induce a temporary drop in demand should be implemented after the economy starts rising.. This however is not a really good solution, because the reform elements are strongly correlated. It can only be considered as "second best" solution. But it can be undertaken, since crisis alleviation is an important task, and the reform cannot be implemented within a short period of time anyway.

The situation is completely different if crisis management includes the prevention of state bankruptcy, too. What is more, if even this can be regarded as the major task. Since expenditures should not be decreased on the basis of the principle of across-the-board cuts, in the given situation the best solution is if expenditure cuts give stimulus to the cost-effectiveness, the economic efficiency and the reasonable savings. By this way we can eliminate the petrified structures that continuously lead to state and corporate overspending. And this is that expresses the essence of the reform. Therefore, in our current situation the contradiction between crisis management and reform is only apparent, and the best tool for the prevention of state bankruptcy is exactly the reform.

In one aspect, however, expenditure cuts and the implementation of the reform imply a serious contradiction. The question is who should be burdened with the expenditure cuts. Two fundamental problems arise here: the first is that most – but by far not all – public finance expenditures are targeted towards people with modest incomes. Therefore, they are more affected by expenditure cuts. The second problem is that we live in a capitalist economic system. It would be possible to introduce budgetary and tax policies that would directly and definitely burden the companies and the people enjoying high income, therefore, mostly capitalists. This would be in line with the demand according to which the rich should assume the largest possible burden of crisis and crisis management. But usually the rich can more easily find loopholes to evade taxation, and on the other hand it is a question how profit oriented production would react to more stringent taxes. Production may fall or hardly increase. The negative effects would again hit low-income people the hardest. Capitalism is as is. This is what we opted for at the transformation of the political regime. We cannot go in and out of the capitalism as we please. The best is when economic policy fosters the growth of economic performance, and this cannot be achieved by applying an anticapitalist policy.

However, we must refrain from exaggerations. In the current situation it would be a bad decision to introduce a single tax rate, which would affect poor people disadvantageously, furthermore would provide an irritatingly large income surplus for the rich. In certain cases we must deal with reducing the subsidies cautiously to prevent a significant share of the population from getting into a hopeless situation. People living in houses with distant heating have no options, they are unable to react to changes in the heating tariffs. The situation is similar with the property tax. If the minimum property value to be taxed is set at a too low level, hundreds of thousands or millions of people can find themselves in an absurd situation. A considerable portion of home-owners has been unable to cover the maintenance costs even until now.. This means that social aspects form a strict limit in capitalism, too. The dynamics of long-term growth is important, but life must go on even before the growth process begins to speed up.

When making decisions one must rely on the macroeconomic correlations, which are always affected by the economic policy. In the course

of crisis management this is especially topical. Expenditure cuts also accompanied by tax reduction bring about a decline in economic performance at times of recession. This does not hold in the case of recovery, because then the planned and actual investments are neither given, nor declining. Therefore, the reform process can also differ in terms of content in a crisis situation and in recovery, if the only task is to alleviate recession.

The expectable impacts of economic decisions cannot be well assessed without a proper knowledge of macroeconomic correlations. The lack of necessary knowledge of the macroeconomic linkages also explains that the proposals referring to the crisis management typically do not contain what type of crisis management is expected from the prevention of state bankruptcy. Therefore, the boundary between the management of recession and the prevention of state bankruptcy becomes blurred. This is typical for the latest crisis management programmes, too.

The situation and task of the monetary policy is also unique, if the main task is the prevention of state bankruptcy. When alleviating recession, the rule of thumb is to decrease the base interest rate, while in case when state bankruptcy is imminent, the otherwise high base interest rate can even be increased.. This drives the level of market interest rates up. This may happen due to the risk margin that may have risen because of the threat of state bankruptcy. Monetary management itself cannot resolve this problem; the way out of this bad situation is the powerful reduction of state expenditures in this case, too. This increases the trust of the domestic and mostly the external money investors, and will make it possible to lower the base interest rate. Therefore, monetary policy may even further aggravate the recession for some time, which may make expenditure cuts more urgent just during the time of economic crisis.

If state bankruptcy looms, the exchange rate of the national currency falls despite the fact that both the base interest rate and the market interest rates are high. This can also happen if inflation is shrinking rather than growing. It seems as if everything turned upside down. This condition ceases to exist when state bankruptcy is forestalled. Then the base interest rate can be reduced, public finance expenditures do not need to be further curtailed, the economic policy begins to resemble that of other countries. However, it cannot be completely identical with the policies of other countries if the country in question is a small country. It is not advisable to increase its public finance deficit again.

Each crisis lasts for a temporary period, even the financial and economic crisis, too that Hungary is currently suffering from. Our situation is unique even after we reach the lower turning point. The growth of exports will play a determining role in the unfolding recovery. The economy can very much be accelerated by the external boom, and due to the 2/3 export quotient, the GDP may temporarily grow rapidly. This means that overly pessimistic forecasts are not substantiated either. A significant recovery requires, however, that the companies' ability to react should be adequate, wherefore efforts should be made to improve this ability by means of elaborate and feasible reforms already during the recession.

Naturally, the reform process may be stopped, unfortunately this is very much possible. We do not know what policy the new government will pursue after the elections. A researcher cannot do anything about it. All he/she can do is to write down what he/she finds right and necessary according to his/her firm belief. What actually will happen is the responsibility of policy-makers, as it has also been so before.

Accusations have no sense according to which the country is going against the practice of the economies of other countries, the crisis

management is ill-conceived, since the aggregate demand should be stimulated and not restrained, the solution should be a significant tax reduction, and a leftist government should pursue a demand stimulating policy, especially during recession. Certain critics are very self-confident, they propose "obvious" solutions without understanding the specific situation of the country, and without having a sound knowledge about the basic macroeconomic relations.

In economics it is also a fundamental requirement that one must continuously keep the specific characteristics of the country in mind. And, one should not mix the short and long periods, and confuse the micro- and macroeconomic relations. At the same time one should be well aware of what transition exists between the general and specific, the short- and long-term, as well as between the micro- and macroeconomic connections.

In politics we can observe the continuous negligence of these fundamental requirements, mostly because of the deficient economic skills of – unfortunately – the majority of Hungarian politicians who want to have a say to most of the fundamental economic problems. This holds true for crisis management, too. For example, if someone does not pay attention to the specific features of the different countries, he/she can easily draw the conclusion that general demand stimulation should be targeted in a small country, too, struggling with financial difficulties. By demanding the radical cut of tax burdens – without even stronger expenditure cuts – one actually does so. Such claims are of course popular, and seemingly they are right, too. However, appearances are deceptive. It is possible that people who come forward with such demands do believe in what they say. Not understanding why their demand is unfeasible, they may even call their opponents talentless. However, occasionally the error is not in the other party's mindset.

We must get rid of this attitude in the interest of everyone. The greatest joy always comes from understanding something well. It helps us becoming tolerant. For the time being we cannot really be optimistic. Tolerance is not accustomed to in the present-day Hungary. It may be because this requires much more and deeper knowledge, and consequently, much more work and intellectual efforts than animosity. In fact, the truth is that the latter requires no intellectual efforts at all.

Notes

[1] It must be noted that the fall in the interest rate does not always trigger a turn, for investments are influenced by many other factors, too. A lot depends on what investors believe about the future of the market. An influencing factor is the political climate, the expected global economic boom, and to a significant extent: how much investments are encouraged by the results of technological development. However, the size of the real interest rate is an important factor. It is definitely true that its fall encourages, while its rise restrains investments. The drastic rise in the real interest rate can deteriorate the propensity to invest even if other factors, such as technological development, would justify the growth of investments.

[2] This is really the consequence of the different changes in the planned savings- and investment rates. What is not saving is consumption. The amount of the GDP over consumption can be sold if there is a demand for it owing to the investments. The surplus of planned investments over savings provides a guarantee even for it. What is more, this surplus allows for not only the perfect realisation of the given production, but also the sale of the increasing output. The turn depends really on the relative changes in savings and planned investments.

[3] Naturally, the situation of a country can be largely deteriorated by a recession occurring in other countries if its exports are high relative to the GDP. In this case the decline in exports significantly aggravates the crisis. This means that the impact of foreign trade can be different. At present exports aggravate the recession Hungary.

4 In this example the decline in demand can reach four percent only in an infinite number of steps. However, the biggest part of the decline takes place already in the first 3–4 steps (3+0.75+0.1875+0.0468=3.98). The described process is called income multiplier in the literature. It directly shows the relationship between the total changes it triggered and the original change. In this case this is 4:3 = 1.33. The latter figure is the numerical value of the multiplier. The multiplier has a role both in the growth and decline in demand. The larger the fluctuation in production and demand, the larger the numerical value of the multiplier. Important: if we work with nominal values, the presented correlation is literally true. If the topic is about changes in the real GDP, only the downward impact is true literally, the upward impact is not, since in the upward direction and at real value a restricting factor of the income multiplier is the competitive and unutilised production capacity. If the utilisation thereof has reached full swing, the income multiplier can be used to explain only a nominal GDP growth, since from now on it can cause only inflation. [About the income multiplier: Dornbusch, R. – Fischer, S. (1994) pages 65–75; Samuelson, P. A. – Nordhaus, W. D. (1999) pages 226–241; Case, K. E. – Fair, R. C. (1996) pages 647–666]

5 The use of terminology is not uniform. One can speak about recession even if economic performance does not decline, but the growth rate falls back to half or one third of the original level, i.e. drops significantly. There is certain logic behind this. It can be observed quite often that economic growth occurs exclusively due to a rise in productivity, i.e. the growth rates of production and productivity are identical. If the growth rate then falls, and productivity remains the same, employment must fall and unemployment must rise. Deteriorating employment exercises pressure on wages and the price level, while the latter exercises pressure on economic expectations. Later on this may even lead to an absolute reduction in economic performance. There is no Chinese wall between the drop in the rate and the absolute decline of production. This is why the use of terminology is not uniform.

6 Some of these subsequent effects of former growth: If certain investments have already commenced, they must be continued. This is especially true if the investments are substantiated by the future desired capital stock. This represents a demand maintaining factor, since people employed here remain to be earners. Infrastructure development is based on plans spanning many years, and the interruption of its development would yield more damage than benefit. Contracts must be fulfilled even if recession occurs. An important part of the temporally influential growth process is the fulfilment of export obligations.

7 However, it must be noted here that the state budget while maintaining its expenditures cushions the fluctuations and alleviates recession. The greater the weight of the state budget is, the more this is possible. But what is beneficial from this aspect, is detrimental for the longer-term dynamics of the economic growth! It is because it takes income away from the private economy, and spends most of this money on non-investment purposes. Therefore it cannot be said that the greater the weight of public finances is the better it is in all aspects.

8 Eurostat, 2006 figures

9 I already finished writing this paper when the writing by Helmut Schmidt, former Chancellor of Germany on the current global economic crisis was published by the Hungarian daily Népszabadság. The subsequent insertion of this footnote cannot be omitted. When discussing the causes of the current crisis, H. Schmidt stresses that: a country with a larger internal economy may be more successful in pursuing a demand-stimulating economy than a smaller country, because the export quotient of a large economy is much smaller. "The enormous expansion announced in the United States that would lead to a budget deficit will be more successful than the European incentive programmes. Since having a minor foreign trade quotient the vast US economy is much less dependent on the demand present on the world market than any of the larger European states." Schmidt, H. Népszabadság, Hétvége. 31 January 2009, page 2. I.e. the author believes that there is no sufficient guarantee for the success of demand stimulation by the state in the economies of the large European countries either.

10 Here we must face the problem that the tolerable rate of debt service is not independent of the concrete circumstances. A 10 percent debt service relative to the GDP – while commodity and service exports make up three quarters of the GDP – is not considered significant under normal international financial conditions, and with an economic policy respecting the stability requirements in place. But if this trust was shattered earlier, plus a global financial crisis has unfolded, the 10 percent ratio can be considered more negatively than a 20 to 30 percent ratio earlier. What could be easily solved with the help of roll-over credits, can later, under different circum-

stances, prove to be a too difficult task. The conclusion is that it is not advisable to make decisions on the basis of mechanical comparisons.

11 The interest mechanism cannot be presented in detail here. Although the central banks, including the NBH, exercise a direct influence on the interest rates of short-term loans, they also influence the interest rates of long-term loans through the market competition. The "yield curve" is related to this mechanism, which presents the market interest rates relative to the term of the loans. If, for instance, the central bank increases the base interest rate, the entire yield curve may shift higher with time. In the meantime, the steepness of the yield curve may naturally change, which means that the interest rates linked to the different maturity dates can rise differently, or can drop to different extents when the base interest rate is decreased. A major cause behind this phenomenon is the change in the risk factor. In general, risks are more numerous if the maturity is longer. [Garner, C. A. (1987); Malkiel, B. G. (1970); Kohn, M. (2003)]

12 Hungary, like any other member state, must also make financial payments to the EU. The value of gross subsidies equals around 3 percent compared to the GDP. If we deduct from this sum the amount of mandatory contribution, which totalled nearly HUF 190 billion in 2007, and if we also take into account that the precondition for the disbursement of the subsidies other than the agricultural ones is the elaboration of projects approved by the EU, we can be content if the amount of the net subsidies reaches 2 percent of the GDP.

13 This should be interpreted as an annual average. The size of subsidies received in the different years can vary. Since it can be assumed that the current recession will not last longer than 1–1.5 years either, it would be beneficial if Hungary could utilise the majority of the subsidies in 2009. But the problem is that the drawdown of EU funds takes place at a very slow pace even though the proposals are very elaborate.

14 If the level of income concentration in public finances falls, several expenditures must be paid from private rather than public sources. For this reason the subsistence index of the population rises, and the larger after-tax income will not provide for savings proportionate to the tax reduction. It is a general opinion that in Hungary the total tax burden should be reduced by at least 5 percent relative to the GDP. For this reason, too, the savings rate will not grow by 5 percent of the GDP, but only at a more modest rate, by around 2.5 percent. On the basis of the growth correlations, the expected efficiency of investments, and the 5/1 capital intensity, this could yield at best a 0.5 per cent surplus in the growth potential.

15 The following must be kept in mind: a significant reduction can be achieved only if the large supply systems (healthcare, pension system and transfers) are restructured. Since all of the money channelled into these systems is spent on purchases fully and immediately, the reduction equals the decline in aggregate demand. However, the reduction of taxes (PIT, wage contributions) counterbalancing the drop in expenditures – generates only induced growth in purchases. Part of the income that consequently becomes available is saving, and does not increase the volume of purchases. (Understanding this issue is easier if we also take into account that people receiving the transfers or pensions and people that realise additional income due to the tax cuts are not the same. For example, multinational companies do not increase their expenditures just because the rate of wage contributions decreases. Especially not during a crisis.) In a crisis it is excluded a priori that a surplus in the planned savings is quickly absorbed by the growing investments. On top of that, the multiplier must be taken into account on both sides of public finances.

16 The situation is different in the case of the reallocation of resources. Funds generate demand equal to the size of the reallocated funds in the target area. Therefore, in case resource reallocation is really well-targeted, it alleviates recession. But this does not hold for equal tax and expenditure reductions.

17 It is not easy to concede either. The essence can be relatively easily understood in relation to the decline of commodity purchases by the state. If such purchases drop by 100 units, the aggregate demand falls by exactly 100 units. However, if public wages drop by 100 units, the decrease in the wages to spend is much smaller due to taxation, social security contributions, etc. But these amounts are to be spent, too, wherefore if wages decrease, all wage related expenditures must drop to the same extent.
Let us assume that the rate of induced purchases is always 0.5 relative to each preceding change in income. Then the total rate of induced changes is, either in the ascending, or descending order: $0.5+0.25+0.125+0.0625+\ldots\ldots=1$. We obtain an infinite descending geometric sequence, the sum of

which to infinity is 1, which can never be reached, although we can get very close.to it. This means that due to the expenditure drop – which we assume to be 1, too – the decline in demand shall be 1+1=2. The total growth in demand generated by a tax reduction exactly equalling the drop in expenditures is only 1, and is exclusively induced demand growth. (Tax reduction itself cannot be regarded as purchases). The difference between the two changes is exactly 1, i.e. equals the size of expenditure reduction. Therefore, the numerical value of the multiplier is 1. In other words, if the expenditures and tax revenues of public finances change at the same rate, the numerical value of the multiplier will always be 1, independent of the strength of the secondary effect. This correlation is called "balanced budget multiplier" in literature, since it is assumed that the budgetary decisions do not change the balance of the budget. Case, K. E. – Fair, R. C. (1996) pages 651–663]

[18] A nearly 5 percent reduction in expenditures and taxes would finally lead to a further 5 percent drop in the GDP. In relation to the implementation of the reform, today it is especially important to think over the correlations linked to the streamlining of public finances.

[19] As a result, not only employment, but investments could also grow, since the interest rate and the relative size of the profit rate would be more favourable for investments. The difference discussed above can be reduced by the decrease of direct taxes on profits and wages, as well as of wage related contributions.

[20] Since inflation creates an opportunity for increasing the savings rate through forced savings. Then inflation helps in driving real wages down, consumption shrinks, and income that becomes available in this manner may be absorbed by investments. It is clear that in this case the savings surplus is not intentional, but forced savings.

[21] Theses and proposals of the Reform Association, (2009); Improvement of the growth potential and competitiveness of the economy through restructuring the tax system, Reform Association (2009). Other committees have also made similar, but not so comprehensive proposals. The Alliance of Free Democrats (SZDSZ) and the Hungarian Democratic Forum (MDF) have also submitted separate proposals to the National Assembly for the reduction of expenditures, among other things, [SZDSZ (2009); MDF (2009)]
It must be noted that the Reform Association does not count with a further significant fall of the GDP. However this leads to complications. For example, so that public finance deficit decrease to the required level, even greater expenditure cuts would be needed. The freeze of some expenditures at real value entails a rise in the share of these expenditures compared to the GDP, which continues to shrink. In other words this means that the Reform Association was not radical enough in its proposals for expenditure cuts. I am not dealing with this issue any longer. I just reiterate the opinion that in the current situation major expenditure cuts are unavoidable in Hungary despite the recession.

[22] Bokros, L. (2009)

[23] This is not clear in the materials of the Reform Association either. A merit of the proposal of the Association is that it tries to present the possible impact of the proposed expenditure cuts on the public finance balance in the period until 2013. Attention is paid to the fact that with time expenditure and tax cuts should balance each other. However, since even balanced cuts may lead to a drop in production, it can be disputed whether the expected expenditure/GDP ratio is forecasted right. [Reform Association. (2009a; 2009b)]

[24] Naturally, the reform itself would not trigger expenditure cuts sufficient for the prevention of state bankruptcy. Expenditure should be reduced in addition to the implementation of the reform.

[25] [Dornbusch, R. – Fischer, S. (1994) pages 78-81] In the great depression of 1929–1933 the decline in GDP in the US was very strong and long-standing in part due to the fact that the government – in compliance with the prevailing conservative theory – strove to keep the central budget in balance. Such efforts could also be witnessed in certain states of the US. Yet, both the central and all the state budgets were in deficit under the impact of the crisis, but by 1932–1933 the balance was already "full employment surplus". This meant that the policy of the central government and those of the individual states were rather restrictive than demand expanding; budgetary revenues were increased instead of being maintained. Another mistake was the following: due to the intense strengthening of the influence of risk factors, the need for cash grew quickly, and the monetary policy of the Fed was not adjusted accordingly. [Friedman, M. – Schwartz, A. J. (1960); Gordon, R. A. (1974)] Economic policy was characterised by conservative or instinctive decisions. At this time the Keynesian theory of crisis management did not exist yet. Keynes' main

work, "The General Theory of Employment, Interest and Money" was published only in 1936.

26 "According to the analysis conducted by The Economist about 17 countries that are thought to be the most problematic, after the Republic of South Africa Hungary is the second country that is most likely to go bankrupt due to its external debts." ECOSTAT. (2009) page 22

27 For most of the time this does not pertain to interests paid on private deposits. The nominal interest rate was relatively high, but due to the high rate of inflation the real interest rate achievable by the population was often (significantly) negative. This draws attention to the fact that the banking sector was – and is still enjoying – monopoly on the market of private deposits. For most of the time, Hungary is the country of low deposit interest rates, high household loan interest rates and of a very wide interest margin. The latter is especially disadvantageous for savings and the dynamics of economic growth. Éva Várhegyi gave a thorough analysis on the monopolistic position of the Hungarian banking sector on the market of retail deposits. [Várhegyi É. (2005)]

28 The state's share has risen in the last year due to the stand-by loans extended to the state by international financial organisations.

29 The much lower interest rates on foreign currency denominated loans, while the HUF exchange rate did not show a downward trend, disoriented the population and companies alike. This significantly contributed to the fact that the share of foreign currency denominated loans rapidly rose. This process started after the introduction of the inflation-targeting monetary regime, and lasted until the end of the third quarter of 2008. Then, when the exchange rate of the forint began to plunge, the momentum broke. Everybody learnt that the exchange risk cannot be ignored. If the exchange rate had showed a downward trend, much less loans would have flowed into the private sector, and today we would not have a headache because of the foreign currency debtors. The financial situation of the entire Hungarian economy would be much more favourable than today.

30 The base interest rate in Hungary has gone through the roof compared to the prevailing base interest rates of the central banks of developed countries. ECB reduced this rate to 1.5 percent by March this year, while the US FED decreased the rate to 0.25 percent. In April 2009 the base interest rate of the NBH was 9.5 percent. ECOSTAT (2009)

31 NBH does not acknowledge its responsibility in this respect. It is not disputed that there was a too big difference between the HUF interest rate and the interest rates of other currencies especially the interest rates of credits obtained from developed economies. Lately, the NBH argues that the reason for the difference in interest rates was the risk margin: i.e. we were not able to obtain foreign loans at lower interest rates, and/or at lower yields foreign money investors do not buy longer-term government securities. It cannot be disputed that since the onset of the international financial crisis the domestic interest rates have been primarily determined by the unfavourable rating of Hungary's solvency. However, it is not right to flash back it on the former years: if we go back in time, we can see that the base rate of the central bank, which was always high by international standards, and the Hungarian market interest rates built on that base rate are not simply the concomitants of the high risk premium. If this was the case, it could not be understood why the nominal exchange rate of the HUF did not show a downward trend despite the fact that inflation was much faster than abroad. Compared to 2001–2002, the nominal exchange rate was rather rising. And we could by no means understand why the significant increase in the base interest rate (by a total of 100 base points) in the spring and early summer of 2008 was followed by a quick rise in the exchange rate of the HUF. This cannot be explained by the repeal of the exchange rate fluctuation bands. Something must have driven the exchange rate of the HUF upwards, and this was the interest rate policy of the NBH. The increase of the base rate fitted into the inflation-targeting policy pursued by the NBH, since it expected that the growing exchange rate will bring the inflation rate further down.
Naturally, risks have many factors. For example, if the national currency becomes overvalued due to the interest rate policy of the central bank, the risk of devaluationis more probable! And this is a major element of the risk factor! In response, on the market the interest rate begins to increase spontaneously, or the yield curve moves upwards. It may happen that the risk curve and the exchange rate curve almost exactly overlap when presented in the same diagram. However, this does not prove anything! In the said case the same erroneous policy exerts the same impact on both curves!

32 It is another question that experience shows that the competition between sellers and buyers are

most often won by the sellers during the conversion to the euro. Sellers try to achieve higher prices than would be justified by the multiplier, and this is difficult to check. However, this can happen in any case, independent of the size of the multiplier!

33 The used materials, energy and semi-finished goods are inputs coming from the former production stages. Their price is partially diluted in the wage costs and the related contributions, yet at corporate level they are accounted as material and energy costs. And this happens exactly the same way at each stage of production, no matter how many stages we go back. Therefore we can say that material and energy costs and the costs of semi-products taken over are mostly wage costs in disguise.

34 It may happen, moreover is probable, too, that the price levels will start equalizing after HUF having been converted to euro. However, this is a slow process. "One market and the same prices" exist only in the theoretical models. If equalisation existed, there would be no general price disadvantages in competition. But then, for this reason, it would not make sense to strive for the highest possible conversion rate.

35 This is done the same way now, too. It is estimated that in 2009 the public finance deficit of the US will be over 12 percent relative to the GDP. The average deficit in Western Europe is expected to be 4 percent, but it will be much higher in certain countries (more than 6 percent in Spain, slightly less than 6 percent in France. The example of Ireland is extraordinary, with an expected deficit of 11 percent. Ireland is a small economy, but has formerly been the country of long-term economic miracle. And each country will experience a steep rise in deficit by 2009. ECOSTAT (2009)

36 The actual proportions can be disputed, since exports include the total production costs of the exported goods, while the GDP only contains the added value. Therefore, the internal impact of the actual demand impulse is smaller than the presented calculations. But as far as the differences between the countries are concerned, the calculations are correct. This means that in Hungary the impact of the external demand impulse on the aggregate demand is nearly seven times bigger than in the US, and two or three times bigger than in countries such as England, Germany and France.

37 A few examples of promises made before the 2002 elections. Fidesz: 10 percent tax and contribution reduction, and at the same time reduction of the public finance deficit below 3 percent; average wages will double; survivor's pensions will be increased by 50 percent; nearly HUF 610 billion will be spent on the healthcare reform; 600 kms new highways. MSZP: reduction of the PIT rates, while leaving the marginal rate unaffected; elimination of the healthcare contribution of fixed amount; average wages will significantly grow, the wages of public employees will grow by 50 percent; HUF 600 billion will be spent on the consolidation of the healthcare system; 800 kms of new highways; construction of metro line No. 4 in Budapest; survivor's pensions will be increased by 50 percent. A Pulai and K. Szabados remark: Fidesz has a leading edge in the competition of promises. A. Pulai A. – K. Szabados: (2002)
Promises made in the election campaign of 2006. Fidesz: At that time the country echoed with the Fidesz claiming that the economic situation was critical and the country was in decline. Yet, they expected the way out through new reliefs, free benefits and budgetary expansion. Viktor Orbán declared a 10 percent reduction of the social security contribution – from 29 percent to 19 percent – and then promised to introduce the 14th month pension. On top of that, Fidesz promised the construction of four new bridges in Budapest over the Danube, the construction of metro line No. 5, the extension of the underground line to Buda. Furthermore, it promised a PIT reduction totalling HUF 210 billion, and many other things, including, for instance, the reduction of commuting costs of motor vehicle owners living in the countryside, free internet access for the hearing impaired, a 10 percent reduction of electricity costs, free medication for people suffering from certain groups of diseases, for children under 3, and for elderly people. The MSZP fell much behind the Fidesz promises, but it also came forward with tax reductions, mostly under the pressure by the coalition partner. It again promised motorway construction, as well as early pension benefits to permanently unemployed people over 55.

38 Mostly this explains the demand for the performance of the otherwise unperformable election promises, too. This is what I indicated in my book on sustainable economic growth, which was published in 2003. "The repeated collision of the political forces that puts power interests in the forefront, the loser urging the winner to perform the exaggerated promises evidently to make the latter fail, or at least lose the next elections, can only lead to one result in the long run: actual growth will drop below the potential growth" T. Erdős: (2003). page 494.

[39] It is often said: "The people are more sober-minded than the politicians." This is true, albeit only after a long time. The people usually learn by their own mistakes what was true and what not. People can be temporarily deceived, they easily believe the unbelievable, if they are promised what they would like. Correlations have by now become very complicated in economics, too. They are not and cannot be understood by the majority of the population. This is why wisdom is non-existent in many if a long period of time is required for the accumulation of experience. This raises the responsibility of politicians and intellectuals in general: they should not state things that are not true, and they must encourage the population not to believe everything.

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