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A JOURNEY IN TIME ABOUT DEBT FINANCING[1]

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I haven't been a very close friend of Werner. Our acquaintance started during our years at Rajk College (in the mid-70s) and continued in sporadic informal conversations over the last decades. Conversation was dropped and picked up again. At times we were in complete accord and at times we debated fiercely. I was honoured that it was Werner who reached out to me repeatedly after pauses. Our last conversations took place in spring 2020. Then, we were thinking together about possible policy responses to the inevitable economic recession. This is a recollection of those conversations two years ago. A lot has changed since then, and one can see many things more clearly. What seemed to be rational based on the available information and state of affairs back then may prove to be harmful under the current circumstances. The reader is therefore requested to look at these lines as if we were in the spring of 2020 and form an opinion based on the information that was actually available at that time.

Let me list a few highlights of our conversations' immediate historical context:

4 March 2020	The first COVID case is recorded in Hungary
11 March 2020	Declaration of a state of danger, adoption of a special legal order
16 March 2020	Schools are closed, restrictions on the opening hours of shops and restaurants
27 March 2020	Introduction of lockdown measures
7 April 2020	The Government announces a comprehensive crisis management action plan
10 April 2020	Declaration of the 'fifteen' in response to the Government's action plan

Upon drafting the declaration of the 'fifteen', there was strong consensus about a number of questions. It was obvious for everyone that a simultaneously appearing demand and supply shock would give rise to a massive economic recession. With shops closed, trucks stuck at the borders, jobs lost, etc. there will be a 5 or

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10 per cent downturn in 2020 – so were we speculating. We also agreed that the budget deficit would be well above the target due to the personal income tax, VAT and corporate tax revenues lost on the crisis. It was also agreed that budget expenditure should be increased to alleviate the crisis, as a reallocation of expenditure alone could not sufficiently compensate for loss of demand. But what level of deficit would still be affordable? And how could it be financed? There was no consensus on that. A discussion was started by the central bank faction of the Fifteen, with Werner, *Júlia Király,* honorary member *Judit Neményi, Gábor Oblath* and myself – without any conclusion. I continued it with Werner separately, but we could not arrive at a conclusion either.

Werner was cautious and called for prudence. He started from the assumption that the affordable level of deficit should be tailored to the financing capacities of domestic income holders. Deficit exceeding that capacity would lead to external indebtedness. He tried to estimate the savings potential of households and corporations based on 2019 financial accounts. He concluded that the financing needs of the general government and the corporate sectors could be met at a deficit ratio increase of about 2 percentage points; entirely foreign funds should be raised for any deficit in excess of that. I proposed that forced saving[3] and investments put on hold due to the crisis would allow for a substantial savings surplus in both sectors, and therefore, a higher deficit. I had reservations about foreign indebtedness not because of the growing exposure it would entail, but its feasibility. Every country is in the same boat, major aid packages are announced, and the funds needed for those packages are raised on the international financial markets. We were up against competition, and I feared that Hungary would not be able to secure external funds at all, or only at unreasonable prices.

I believed that additional budget expenditure was necessary, but the higher deficit it would give rise to could not be financed from the market. Now, if households' savings are insufficient and foreign funds are not accessible, another way to consider is central bank financing of the deficit. Additional expenditure to defuse the crisis seemed top priority to me. I considered that the consequent increased deficit could be financed by the central bank by crediting the State's account or by purchasing zero-coupon perpetual government bonds. Werner did not approve of my proposal. We agreed that no extra funds could be acquired for the budget from secondary market purchases, as the consideration for the bonds was already

3 Despite the substantial negative revenue shock, the net financing capacity of households grew from the previous 5% to 6–6.5% of the GDP by early 2020. That growth was equally due to the loan repayment moratorium, purchases not made due to the closing of shops and lockdown measures, and to prudence because of the crisis.

collected upon initial offering. The main reason for secondary purchases is to put downward pressure on sovereign debt market yields, keep interest costs on sovereign debt low and stimulate the economy through low cost of capital.

Werner argued that even though crediting the State's account would allow for higher public expenditure, at the end of the day, balance between the sectors would have to be maintained. Consequently, the extra funds from the central bank may indeed result in an increased financing capacity of households and corporations, but if they don't, we would be left with foreign indebtedness, and more importantly, inflation. I called attention to the fact that crises discourage borrowing, therefore, the money multiplier decreases, and as low rates of interest encourage cash holding, the velocity of money decreases. On that basis, I concluded that increasing the money supply by monetary financing would not necessarily drive up inflation. Especially when there was missing demand and high capacity surpluses in the economy due to the crisis. And if the transformation of increased retail savings into consumption would begin sometime in the future, the resulting inflationary pressures could be addressed by standard central bank instruments.

The deficit to GDP ratio was 9% in 2020, due mostly to income lost on the crisis and not to additional expenditure. No definitive crisis mitigation took place. Accordingly, in Q2 2020, GDP contracted by 13% year over year. Yet, higher deficit did not come hand in hand with either higher inflation or increased external indebtedness. It seems that both of us had been wrong. Contrary to Werner's expectations, inflation did not go up (then) despite the higher deficit (since it was due mainly to income lost and not to expenditure increased to boost demand), and contrary to my expectations, the State raised funds on the domestic sovereign debt market to cover the deficit. But could that actually be considered market funding? In early May 2020, the central bank of Hungary MNB launched a government securities purchase programme and almost at the same time offered commercial banks a five-year fixed interest rate lending facility available at base rate. Using that lending facility, commercial banks purchased government bonds for financing the deficit at the primary markets and sold them next day to the central bank. Commercial banks acted as straw buyers for the central bank, which was actually financing the budget. Until September 2021, MNB purchased government securities of HUF 3,000 bn and provided HUF 2,600 bn in five-year lending facilities. It was like an ATM, where a loan taken at base rate or below (0.75% to 0.9%) could be exchanged for government bonds of a 1.5% yield. And they made no secret of it. As then Deputy Governor *Márton Nagy* said in an interview 'credit institutions may use these funds for retail and corporate loans, but also for purchasing government securities.' Over the 1.5 years between spring 2020 and autumn 2021, commercial banks seized that arbitrage opportunity and used just a fraction of the loan taken up to increase corporate lending[4]. Instead of financing the real economy, the MNB funds were an indirect means of financing the budget deficit. As I see it, that is monetary financing just as much as it would have been if the central bank had bought government securities directly.

In spring 2020, I found helicopter money the most efficient means to tackle the demand crisis.[5] I was of the view that expanding the monetary base would not lead to increasing inflation due to the then current macro environment. In that environment of a decreasing money multiplier, decreasing velocity of money and low baseline inflation, the inflationary risks of monetary financing were moderate. And the benefits were more pronounced. Provision of money based on citizenship has a countercyclical effect as it blocks the decline of demand and offers at least partial compensation to those suffering the heaviest loss of earnings. As opposed to this, upon announcing the great aid package, the Prime Minister of Hungary called a 3% budget deficit a red line not to cross in a radio interview.[6] The aid package – the greatest in Hungarian economic history – did little to hinder the fall of demand. And now that an above 6% growth rate would allow it, very few substantive measures are taken to curb the high level of deficit. On the contrary, in autumn 2021 and the first months of 2022, consumer demand in the household sector – which is returning to normal anyway – is fuelled by extraordinary amounts of budget expenditure. It seems that the Government pursues a policy of tolerance for high levels of deficit when times are good, but switches to zero-tolerance in times of crises. That was and continues to be a procyclical policy. The concerns Werner had in spring 2020 came to materialise in autumn 2021 when growing deficit – aggravated by other factors – resulted in inflation. In autumn 2021, there is no macroeconomic rationale behind the Government handing out money similar to helicopter money. The economy is growing fast, wages are increasing vigorously, there is no crisis, and there is no widespread revenue shock the gravity of which would need to be alleviated. What would have been instrumental in spring 2020 is extremely harmful in autumn 2021 as it will set the newly elected government on an extremely hard road to budget correction.

4 Corporate lending in this period increased by HUF 550 bn. The increment in the preceding 1.5 years period (between autumn 2018 and spring 2020) had been HUF 1,380 bn.

5 See Péter Bihari (2020): Helikopterpénz kell Magyarországra a koronavírus ellen [Hungary needs helicopter money to tackle the Corona virus], www.portfolio.hu, 30 March 2020. https://www.portfolio.hu/gazdasag/20200330/helikopterpenz-kell-magyarorszagra-a-koronavirus-ellen-422750.

6 On radio station *Kossuth Rádió* on 10 April 2020.