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*Csaba Lentner*

# The Taxonomy of Success

## Review of a Book by György Matolcsy

Summary

This review puts under the microscope the book by György Matolcsy, Governor of the National Bank of Hungary, and the successful economic policy lurking behind it. This monograph is richly illustrated with elements from economic history and familiarises the reader with Hungary's achievements in the field of fiscal and monetary policies, and their academic taxonomy.

**Journal of Economic Literature (JEL) code:** E5, H6, G01, P10, Y3

**Keywords:** economic policy, fiscal policy, monetary policy, Hungary

### Introduction

Academic theoreticians frequently struggle with the problem of translating their intellectual creations into practice. On the other hand, practical specialists often face the question of the extent the systems developed by them can pass the scientific test. However, in this case these two challenges and the good solutions elaborated for them seem to have been tackled simultaneously. In front of our eyes and now also read from a book, given that this is a review of György Matolcsy's book entitled *Balance and Growth,* which is compared to the practice followed and results achieved in the past few years.

The book was published in 2015 in Hungarian and English and, in essence, it is his lifework. And not merely in a scientific sense. The author, Governor of the National Bank of Hungary, former Minister for National Economy between 2010 and 2013, and Minister for Economy between 2000 and 2002, is the person who dreamed up and implemented the Széchenyi National Development Plan of Hungary. These governance experiences and the related scientific attitudes to the methodology of governance have always been present and had their impact felt simultaneously in Matolcsy's work.

Dr Csaba Lentner, professor, Head of the Institute of Public Finances, National University of Public Service (Lentner.Csaba@uni-nke.hu).

From the mid-1990s, he led a conservative economic workshop, where he established a solid grounding in economic theory for his service as a minister at the turn of the millennium, and then in the period between 2002 and 2010, once again a researcher, he built the theoretical framework for Hungary's economic improvement, and, with the approach of the general elections, a government programme (Matolcsy et al., 2008). Returning to the position of Minister for National Economy in 2010, he implemented a successful fiscal consolidation and created the fundamental conditions for growth. Once he has re-established fiscal health, he was appointed to head the central bank, which had been pursuing a homogeneous monetary policy for more than twenty five years. To adjust to international changes and Hungary's economic and social demand, he introduced unconventional instruments. In other words, he restored the refinancing[1] capacity of the real economy and ensured additional monetary tools[2] for reducing government debt in a way that the contribution by the new government and György Matolcsy as minister and governor of the central bank were at all times characterized by a stable economic policy and an accelerated tempo of activity.[3]

## Why this hyperactivity?

For one thousand and one hundred years, the Hungarian nation and Hungary have been characterized by a phase delay and the consequent desperate attempts at convergence. The conquest of the territory of Hungary took place among European nations who had inhabited the area for several centuries and formed various states. Then Hungary's sovereignty was lost in 1526. This entailed a gap in national influence on economic policy, and for the next five hundred years our relations were characterized by a series of struggles for liberty and attempts at convergence and independence which, at times, also involved economic reforms. After World War I, territory, people and economic strength were lost. World War II was followed by forced inclusion into the Soviet bloc. By the end of the 1960s, reserves of domestic resources had run out, so then market elements were used to boost the planned economic system.[4] From the early 1970s, external indebtedness was inevitable to offset the waste of resources and losses made by the planned economy regime, in other words, the power of the communist élite was extended for two decades with the help of Western loans. In the current era, an effort has been made at convergence by importing the "raw" Anglo-Saxon neoliberal market economy model, gradually increasing the government debt from USD 20 billion at the time of the change of regime to USD 140 billion, while as a result of the unreasonable and fast privatization of state property, the nation was deprived of its wealth, which was still worsened by the population's USD 40 billion of indebtedness through foreign currency loans taken out after 2004. All the frenzied neoliberal reform actions taken in the past few decades have failed one after the other.[5] Our transition to a market economy ran aground.[6] However, relying on appropriate social support (and expectation), from 2010 the new government was in a position to take action. It was obvious that if we continued to use the economic policy means that led us to the crisis we would hardly recover from it. So we needed a new method of economic policy, determination and, most of all, social support.

### The essence of the New Hungarian Model

Unless public finances are balanced, economic growth and convergence remain vain hopes. There was a requirement for the inclusion of international companies and banks in public financing – in other words, in the payment of taxes and contributions according to their capabilities – and, simultaneously, for lowering taxes payable by domestic businesses and the population,[7] for streamlining government expenditures, and for a strict control of public funds, with the aggregate result that Hungary was released from the European Union's Excessive Deficit Procedure. Without IMF loans and economic policy expectations[8], public finance positions were consolidated from Hungary's own resources. The government ensures room for manoeuver for the operation of market participants through the active economic policy framework of influencing[9] and regulation[10].

It should be emphasized that there were reasons for the changes. By the second half of the 2000s, Hungary's economy was facing increasingly conspicuous growth problems, a considerable budget deficit, a high sovereign debt and current account deficit. Certain periods were characterized by economic growth, others by financial equilibrium. However, the two – equilibrium and growth – never coincided. After 2013, they did.

Since 2013, fiscal policy has been strengthened by reinforcing the elements of monetary mechanisms. The National Bank of Hungary is characterized by a more active citizenship manifest in the system of multiple mandate objectives. The central bank's aim is to serve the common good at a macro-economic and social level. In the interest of the common good, it uses the available instruments to curb inflation and promotes economic growth and the maintenance of financial equilibrium. The first step in the change of monetary regime was the cycle of interest rate cuts launched by the external members of the Monetary Council in the summer of 2012.[11] The first phase of interest rate cuts lasted until July 2015, and saw the refinancing base rate fall to 1.35 per cent, the lowest rate in its 90 years of history, which then further dropped to 0.9 per cent by May 2016 as a result of repeated rate cuts. The cycle of interest rate cuts reduces commercial banking rates and supports economic growth, while also facilitating the achievement of the central bank's targeted medium-term inflation rate. Moreover, this also triggered a positive change in the market for government securities and improved the safety of government debt financing.

The Funding for Growth Scheme was launched with a method similar to the Funding for Lending Scheme of the Bank of England or to certain elements in the Quantitative Easing (QE) applied by the Fed. The FfG Scheme substantially improved access to loans for small and medium-size enterprises and agricultural producers, and so the corporate lending market regained impetus and could play a significant role in the unfolding of a change in investments.[12] Access to loans opened up for 31,000 business entities, who borrowed more than two thousand billion forints. This scheme contributed to economic growth and an increase in employment and, together with the beneficial impacts of the cycle of interest cuts, it has catalysed economic growth in the past few years.

The Self-Financing Programme launched in the spring of 2014 and was aimed at encouraging the purchase of liquid assets acceptable as collateral in order to reduce the country's external vulnerability by cutting the gross external debt. The programme intensified commercial banks' purchase of government securities, which in turn also contributed to the mitigation of long-term government security yields and so the (interest) costs of financing public spending fell.[13] One of the most significant actions taken by the central bank to achieve stability and ensure the efficient operation of financial markets was the consolidation of retail foreign exchange loans by the central bank and the government,[14] which improved the financial equilibrium for households and banks alike.[15] The integration of the Hungarian Financial Supervisory Authority into the central bank and the introduction and operation of macro-prudential instruments also strengthened financial stability. The new system allows the National Bank of Hungary to prevent the building up of harmful risks at the level of the national economy, and to balance the financial system's capacity to finance the economy.

The central bank has made an effort to support the government's economic policy. This monetary policy does not interfere with the independence of the central bank. What is happening is that the Government and the central bank are thinking in terms of a complex and unconventional system of public finance assets that serves the common good, as the fundamental goals of these two public finance authorities are identical.[16] In order to grow, the real economy needed an appropriate expansion of the loan portfolio, which was accomplished by the central bank through its Funding for Growth Scheme. International experience shows that central banks only assume an "extreme" role in bridging crises and boosting economic upturn.[17] However, maintaining the optimum level of commercial loans falls within the competence of the market and is increasingly a fiscal category. As a signal for these future processes, in November 2015, the central bank announced and then, in early 2016, launched its Growth Support Scheme, in an effort to use its more moderate means to keep the economy on a sustainable development trajectory. In addition to the gradual phasing out of the Funding for Growth Scheme, the purpose of the Growth Support Scheme is to encourage commercial banks to increasingly satisfy the borrowing demand of participants in the real economy. Besides the third phase of FfG, the Growth Support Scheme also comprises the Market Lending Scheme, which uses various risk and liquidity management tools to boost commercial banks' lending activity. Through the Growth Support Scheme, net corporate lending, and especially loans to small and medium-size loans, may further increase.

After 2013, in addition to undertaking intensive development of the economy, the central bank also helped fiscal stabilization through various channels. On the one hand, base rate cuts and the Self-Financing Programme contributed to the moderation of government security yields and interest expenses to a major extent. Between 2008 and 2015, interest payments were reduced by nearly 1 per cent of GDP.[18] On the other hand, the central bank's Funding for Growth Scheme had a beneficial catalysing impact on economic growth, and through an increase in the taxable amounts, it helped maintain the budget deficit below the level of 3 per cent that had been achieved by 2013.

As a result of the change of the monetary regime and responsible management, the National Bank of Hungary has been achieving a public accounting and national economic profit since 2013.[19] It pays part of the profit, taken in an accounting sense, to the central budget, and in the spirit of corporate citizenship it uses another part for the renewal of financial thinking, financial culture and the financial and economic refashioning of higher education. It supports higher education as an economic sector that produces new knowledge capital to the debit of its own profit rather than using budgetary funds or the taxpayers' forints, i.e. public financing.[20] It supports the intellectual and academic workshops that create new and sophisticated knowledge capital to replace the old and obsolete system.[21]

## Summary

*Balance and Growth,* a 644-page book by György Matolcsy, is divided into 24 chapters and describes the policy changes listed in this review and their impacts. You will not be able to put it down once you start reading it. It is about our daily life and economic relations, and explains them both in scholarly terms and in an easy-to-understand language.

This makes the monography an academic outline of the practical system, and so the appreciative reader cannot avoid judging the current practice. Therefore it is perhaps even more objective and comprehensive if we do not predict the expected reception from the opinions of individual researchers, intellectual schools or parties. Recently, one of the international rating agencies[22] evaluated Hungary's economic policy of the past few years. In their notice they list the factors underpinning the upgrading and specify the extent to each factor contributes. Based on the latter, there are two categories:

– factors considered as highly significant ("high"),

– factors that justified the upgrading to a lesser extent ("medium").

The "high" category includes a reduction in external vulnerability, in other words, the rating agency upgraded debtor rating primarily for this reason. They traced back the reduction in external vulnerability to 5 factors:

1. High surplus in the current account balance – this can be considered a structural feature.

2. Influx of funds from the European Union – for the most part, this is also a feature, although in this case, the very high ratio of drawdown can also be considered a Hungarian success.

3. Reduction in the external debt to banks – this is partly due to an endowment, but the National Bank of Hungary also targeted numerous programmes (e.g. during the conversion of foreign currency loans to forint loans, when the National Bank of Hungary offered conditional facilities, as a prerequisite it required reduction in the short-term ex-

ternal debt to banks, and certain macroeconomic prudential regulations also had such indirect effects).

4. The Self-Financing Programme – the rating agency specifically highlights this central bank programme, which is a fairly significant recognition for the scheme (and could well end the relevant debate stirred in the Hungarian media).[23]

5. The conversion of foreign currency loans to forint loans – naturally, this programme is not exclusively run by the National Bank of Hungary, however, the central bank was the catalyst of the process and provided the required nearly EUR 10 billion worth of currency for the conversion.

Thus, overall, the upgrading was due partly to improvement in the structural fundamentals of the economy and partly due to the successes of the specific economic policy programmes – and the schemes launched by the National Bank of Hungary were especially emphasised in the latter group, while debt cutting and the budgetary processes can be classified in the other category ("medium"), which means that despite their positive effects, they contributed less to the upgrading.

This book by György Matolcsy is about the economic policy innovations leading to success, in other words, the manner and instruments applied in achieving this success. It is worth reading.

*György Matolcsy: Balance and Growth. Kairosz Kiadó, Budapest, 2015, 644 pages.*

## Notes

1 By ensuring longer-term loans at a lower than market rate for the investments of less well-capitalized and liquid businesses and agricultural producers. For a more detailed explanation and the significance of this financial category, see Lentner, 2016.

2 Low interest rate, the expansion of supervisory powers, a Self-Financing Programme, the Funding for Growth Scheme, and the creation of an efficient system of financial customer protection.

3 With strong political, government and Prime Ministerial support. Quoting Prime Minister Viktor Orbán, "one of the most important parts of economic policy is policy". In other words, the implementation of clear political value principles and their good political communication by competent persons, and political support for fruitful actions and concept makers are indispensable for success.

4 The New Economic Mechanism of 1968 put market elements into operation in a limited way that would not violate the basis of the planned economy. In the early 1970s this new trend lost a significant amount impetus as a result of the political restoration.

5 The avid enforcement of the New Public Management DPM paradigm, i.e. in the spirit of decentralisation, privatization and the operation of the state with a management approach (to maximize profit). In the real economy and in finances, deregulation was undertaken and the loss-making sectors were eliminated without pondering their social effects. Recurrent tightening and austerity measures were imposed on residents, the most significant being the 1995 economic policy adjustment package and the convergence adjustment package launched in the autumn of 2006.

6 In my opinion, a stagnant "transitional" economic policy prevailed between the late 1980s and Hungary's accession to the European Union, although accession did not bring along consolidation and, what is more, the macro-economic and equilibrium data deteriorated, and so I would rather extend the period of homogeneous Hungarian economic methodology to 2010.

7 Halving the corporate income tax rate levied on (typically domestic) businesses with net sales revenues up to HUF 500 million, and cutting personal income tax from 36 to 16 and then to 15 per cent.

8 By the elimination of the mandatory economic policy consultation (literally meaning: force) according to Section IV of the IMF Statute, with the most frequent element being the budget

tightening policy imposed on residents from Africa to Central Europe.

[9] The generation of domestic solvent demand, opening to the East – as a result of government actions.

[10] Bank regulation, financial customer protection, and fiscal and monetary mechanisms.

[11] This was the time when the members delegated to the Monetary Council by the Orbán regime attained a majority.

[12] The FfG also provides an opportunity for prefinancing the investment funds frequently difficult to draw down from the European Union.

[13] For more details about the Self-Financing Programme, see Kolozsi, 2015.

[14] It started in 2011 with the granting of prepayment and final repayment and the setting of an exchange rate cap, continued with the strengthening of financial customer protection, and was completed, at the end of 2014, with the conversion of foreign currency loans into forints using the central bank's foreign currency reserves.

[15] For more information about the foreign currency loan consolidation, see Lentner, 2015.

[16] Separately, with their own particular instruments.

[17] See, for example, the interest rate policy and other monetary tools adopted by FED after the QE period.

[18] For a comparison: it increased by nearly one per cent in Romania and by 2 per cent in Slovenia in the same period.

[19] The accounting profit, or the profit recognized in the annual report, and the economic profit, whose effects are enjoyed by families relieved from exchange rate exposure, businesses contemplating investment and public finances.

[20] However, this is done in a way such that only the interest paid on the capital available for the various Pallas Athene foundations is allowed to be used as resources for the support.

[21] Similarly, it backs other intellectual workshops provided that they are capable of renewal and the generation of new scientific results.

[22] Quoted from the May 2016 upgrading by Fitch Ratings, which classified Hungary among the countries recommended for investment, https://www.fitchratings.com/site/pressrelease?id=1004883. Since then, Fitch's favourable rating was followed by another agency (Standard and Poor's), and so Hungary has been upgraded to investment-grade.

[23] See, for example, the article entitled Aim and Reality by György Surányi, former central bank governor, in: *Népszabadság*, 14 May 2016.

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