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***It Takes Two to Tango: The Role of the European Union and Domestic Governments in the Making of Central Bank Reform in Hungary***

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# It Takes Two to Tango: The Role of the European Union and Domestic Governments in the Making of Central Bank Reform in Hungary

İlke CİVELEKOĞLU\*

## ABSTRACT

This article addresses how the Hungarian Central Bank gained autonomy in its operations from ruling politicians. While stressing the substantial influence of external actors in exercise of this reform, the article also demonstrates the limits of external influence by shedding light on the domestic political costs of this reform. The high costs of central bank reform in the calculations of the ruling politicians allowed the Central Bank of Hungary to gain partial operational autonomy in 1991, which fell short of fulfilling the Copenhagen criteria for EU accession. The article discusses how partial reform furthered in Hungarian context by unpacking the interplay between domestic and external actors.

**Keywords:** Central Bank Reform, EU Accession Criteria, Hungarian Politics

## Macaristan Merkez Bankası Reformunun Oluşum Sürecinde Avrupa Birliği ve Macar Hükümetlerinin Rolü

### ÖZET

Bu makale, Macaristan Merkez Bankası'nın siyasi etkilerden kurtuluş ve operasyonel bağımsızlığını elde ediş sürecini irdelemektedir. Makalede, reformun gerçekleşmesinde dış aktörlerin yadsınamaz etkisine vurgu yapılmakla beraber, bu etkinin sınırları, özellikle iç siyasette bu reforma nasıl bakıldığıнын altı çizilerek tartışılmaktadır. Macaristan Merkez Bankası reformu, iktidardaki siyasetçiler açısından siyasi bedelinin yüksek olması sebebi ile 1991 yılında kısmen gerçekleştirmiş ve böylelikle Macaristan Merkez Bankası, Avrupa Birliğine (AB) üyelik için gerekli Kopenhag Kriterlerinin gerisinde kalmıştır. Bu makale, kısmen bağımsızlığını kazanan Macaristan Merkez Bankasının zaman içerisinde nasıl AB Kriterleri ile uyumlu hale geldiğini, iç ve dış politik aktörlerin karşılıklı etkileşimi üzerinden tartışılmaktadır.

**Anahtar Kelimeler:** Merkez Bankası Reformu, AB Kriterleri, Macar Siyaseti

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Do external actors have the coercive power to make domestic governments accede to institutional change, and thus, subordinate their economic policymaking power to an autonomous central bank, when such a decision is likely to clash with the electoral interests of ruling politicians? This article aims to respond to this broad question in the specific instance of Hungary by exploring the variation in the Hungarian Central Bank (*Magyar Nemzeti Bank* - MNB) autonomy since the 1990s in light of the EU accession criteria.

Central banking reforms are significant institutional changes in monetary governance. An independent central bank restrains the hands of politicians in economic policymaking and thus affects their electoral chances. Ruling politicians, therefore, become reluctant to delegate their authority in monetary policymaking to this institution. By analyzing the underpinnings of central bank reform one can better understand “when” and “how” such a politically costly micro-institutional change occurs, and, equally important, “whether” the level of central bank autonomy varies over time. With its focus on the varying degrees of autonomy, this article demonstrates that central bank autonomy is not a dichotomy, but rather it is a spectrum, which makes us talk about altering levels of autonomy not just across countries but also within them.

The article suggests that such institutional change is more likely to occur when international actors provide material incentives to domestic politicians. Domestic variables are essential to explain the *extent* of institutional change that takes place. In the Hungarian case, the international incentives provided by the International Monetary Fund (IMF) loans to achieve the transition to a market economy and the prospective European Union (EU) enlargement triggered the 1991 central bank reform. Back then, the interests of ruling politicians in Hungary did not converge towards the MNB’s priorities of low inflation, low deficit and lower debt. Therefore, the politicians wanted to maintain as much power as they could to skew the power balance to themselves in monetary governance at the time of reform. Consequently, the central bank reform granted only partial autonomy for the MNB and fell short of fulfilling the criteria set by the EU.

This article argues that in case the interests of ruling politicians do not allow for more than a partial reform, the prospects for further change expand only when international institutions pressure non-compliant governments by withholding the incentives they yield. The EU accession talks with candidate states manifest a successful example of such pressure, as the EU refuses to grant membership to these states until they fulfill the required criteria fully and overcome all of their deficiencies. It was due to the EU pressure that the MNB became compatible with its counterparts in the EU member states in 2001.

The Hungarian example holds important implications for diffusion of central bank independence (CBI) in emerging markets. Hungary is a representative case in that with its embracement of Western reform ideas in its post-communist stage from early on, an explanation of central bank reform in Hungary has the advantage of suggesting

inferences that can be generalized to other post-communist countries, such as Poland, Czech Republic and Slovakia that had similar starting conditions.<sup>1</sup> The major weakness of the previous studies is that they do not problematize how much institutional change occurs after reform and, more importantly, whether this change alters over time. This article aims to fill this void with special reference to the Hungarian case.<sup>2</sup> Additionally, the Hungarian case is an outlier in the sense that although the country was overwhelmingly in favor of emulating Western institutions at the time of transition to democracy and market economy, it took a long time for the MNB to become fully compatible with central banks of the EU member states.

The article aims to contribute to international relations discipline by problematizing the role of international organizations in making micro-institutional change in monetary governance. In particular, it assesses when, how and to what extent international institutions are able to influence transformation of central banks in a domestic context. As we know, neoliberal institutionalism in international relations problematizes the restraining, regulating and coordinating influence of international organizations on state behavior by focusing on the role of incentives – in the form of financial assistance, security and etc. – in making states act in a particular way.<sup>3</sup> With its focus on the role of the EU conditionality that links institutional reform to membership, this article borrows from neoliberal approach to explain the statutory change at the MNB. Additionally, the article addresses the self-interested and cost-benefit calculation based action on the part of ruling politicians to explain the variation in the MNB's autonomy over time and hence, domestic compliance with external actors' demands.

The article is organized as follows. The first section outlines why CBI is important in an age of globalization with reference to international organizations. The second

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- 1 Given space limit, the article is able to trace the causal process in the Hungarian case only. As for the weakness stemming from single case study, variation in the dependent variable through intracase comparison assists in overcoming the selection bias and helps to increase the external validity of the argument.
  - 2 For good works on issue of CBI in developing countries, see Caner Bakir "Policy Entrepreneurship and Institutional Change: Multilevel Governance of Central Banking Reform", *Government: An International Journal of Policy, Administration and Institutions*, Vol. 22, No. 4, October 2009, p. 571-598; Rachel A. Epstein, *In Pursuit of Liberalism: International Institutions in Post-communist Europe*, Baltimore, John Hopkins University Press, 2008; Simone Polillo and Mauro F. Guillen, "Globalization Pressures and the State: The Worldwide Spread of Central Bank Independence", *American Journal of Sociology*, Vol. 110, 2005, p. 764-1802; and Sylvia Maxfield, *Gatekeepers of Growth: The International Political Economy of Central Banking*, New Jersey, Princeton University Press, 1997. Among these works, Bakir's article stands out with its focus on how much independence has occurred after the reform. His article is single case study and it deals with CBI in Turkey.
  - 3 For some prominent works in the literature, see Celeste A. Wallander, "Institutional Assets and Adaptability: NATO After the Cold War", *International Organization*, Vol. 54, No. 4, Autumn 2000, p. 705-773; Andrew Moravcsik and Milada Anna Vachudova, "National Interests, State Power, and EU Enlargement", *East European Politics and Societies*, Vol. 17, No. 1, 2003, p. 42-57; Judith Kelley, *Ethnic Politics in Europe: The Power of Norms and Incentives*, Princeton, Princeton University Press, 2004.

section addresses major explanations on CBI in the literature and why they cannot take us very far in understanding the mechanisms by which this specific change occurs in different contexts, including Hungary. The third section provides a theoretical framework to explain CBI in emerging markets of the EU zone in general and in Hungarian context in particular. The final section discusses the variation in Hungarian Central Bank since 1990 along the theoretical argument.

## Why Does Central Bank Autonomy Matter in Current Times?

In the early 1990s, when international financial institutions and advanced capitalist countries threw their support behind financial liberalization, the expectation was that integration with global financial markets would enable states gain access to wider pool of capital and thus would compensate for their lower domestic savings rates. Consequently, financial liberalization would lead to faster investment, higher output and therefore faster growth and greater efficiency.<sup>4</sup> Yet, what most of the countries got in return for opening up their capital accounts were short-term inflows, which were not only unfavorable to long-term investments but also highly volatile in the presence of rapid move of capital. In an attempt to finely balance the benefits and risks of financial liberalization, proponents of neoliberalism recognized that a strong regulatory framework with its built-in automatic stabilizers and strong safety nets is essential to allow countries to better absorb the shocks.<sup>5</sup> The emphasis on increasing the regulatory capacity of the state called for building key institutions in emerging markets, such as autonomous bank supervision agencies, and above all independent central banks.<sup>6</sup>

As the East Asian crisis illustrated the dangers of weak regulation of finance, the preconditions for prudent financial liberalization became stringent in the International Monetary Fund (IMF) programs as the Fund started to demand institutional reforms for regulation in exchange for its economic support.<sup>7</sup> The concern with enhancing the regulatory capacity of states in an age of financial liberalization was apparent also in the enlargement framework of the EU as the organization emphasized an autonomous central bank, besides other supervision institutions for its prospective members in Central

4 For advantages of financial liberalization in emerging markets, see Peter Kingstone, "Why Free Trade Losers Support Free Trade: Industrialists and the Surprising Politics of Free Trade Reform in Brazil", *Comparative Political Studies* Vol. 34, 2001, p. 986-1010; Lawrence Summers, "International Financial Crises: Causes, Prevention, and Cures," *American Economic Review, Articles and Proceedings*, Vol. 90, May 2000, p. 1-16.

5 Joseph Stiglitz, "Capital Market Liberalization, Economic Growth and Instability", *World Development*, Vol. 8, No. 6, 2000, p. 1075-1086.

6 John Williamson, "Development and the Washington Consensus", *World Development*, Vol. 21, 1993, p. 1232-1239.

7 For a detailed discussion of what the IMF required the East Asian countries to change in the aftermath of the crisis for better regulation of finance, see Gregor Irwin and David Vines, "International Policy Advice in the East Asian Crisis: A Critical Review of the Debate", Dipak Dasgupta and David Wilson (eds.), *Capital Flows Without Crisis? Reconciling Capital Mobility and Economic Stability*, London, Routledge, 2001, p. 58-73.

and Eastern Europe in the pursuit of establishing a well-functioning internal market.<sup>8</sup> In line with the increased interest in prudential regulation and its institutions, the works on merits of an independent central bank multiplied in the literature.<sup>9</sup>

## Major Explanations of CBI in the Literature and Their Problems

### *Sectoral Groups as Demanders*

This approach problematizes the political strength of different sectoral groups and argues that central bank autonomy is likely only when there is a coalition of interests in society that are politically capable of protecting it. In the literature, Posen is known for his firm support for the society-centered approach.<sup>10</sup> Accordingly, central bank independence is possible when societal actors such as finance capital that benefit from low inflation support it. Recently, Jacoby made a similar argument and argued that “for effective institutional change to persist and perform, it must be pulled in by societal actors, rather than decreed by policy-makers alone.”<sup>11</sup>

Scholars arguing from the societal actors’ perspective draw heavily upon sectoral interests and preferences. Although this approach makes us look at the issue from the side of “policy demanders”, it would be a fallacy to portray politicians as passive yes-men. Rather, an explanation that elucidates how politicians decide on their policy choices in the presence of different constituency demands and heterogeneous preferences over monetary and fiscal policies needs to be stated. This article aims to accomplish this goal. Additionally, the explanation suffers from empirical weaknesses. In post-communist European states, central banks managed to obtain their independence and maintain it although they have long been weakly supported by domestic groups.<sup>12</sup>

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8 See the Protocol on the Statute of the European System of Central Banks (1992) for the requirements on the current members of the EU back then for financial regulation in detail. Also, see the EU Single Market White Article (1995) and economic conditions of the EU Copenhagen criteria (1993) for the requirements that the CEECs had to fulfill in pre-accession era. The latter documents mention the institutions that the prospective members states need to develop in the pursuit of well-functioning market economy.

9 Many studies on central bank independence have revealed strong and positive correlations between central bank independence and lower inflation rates in advanced markets. See Alexander Alesina and Lawrence Summers, “Central Bank Independence and Macroeconomic Performance: Some Comparative Evidence”, *Journal of Money, Credit and Banking*, Vol. 25, 1993, p. 151-62; Sylvester Eijffinger and Jakob De Haan, *The Political Economy of Central Bank Independence*, Princeton, Princeton University, 1996. The benefits of central bank independence, however, are not limited to decreasing inflation. As Mosley argues, given investors’ preferences for healthy macro-indicators, delegation of monetary policy to an independent central bank can help governments enhance investors’ confidence and, thus, lower the likelihood of capital outflows. For details, see Layna Mosley, *Global Capital and National Governments* Cambridge, Cambridge University Press, 2003, chapter 4.

10 Adam Posen, “Do Better Institutions Make Better Policy? Review”, *International Finance*, Blackwell Publishing, Vol. 1, No. 1, 1998, p. 173-205.

11 Wade Jacoby, *Imitation and Politics: Redesigning Modern Germany*, Ithaca, Cornell University Press, 2001.

12 See Juliet Johnson, “Postcommunist Central Banks: A Democratic Deficit?” *Journal of Democracy*, Vol. 17, No. 1, 2006, p. 90-103.

### *Partisanship Arguments*

In the literature partisanship arguments shed light on the link between the political parties and the central bank status. Way, for instance, argues that leftist governments intervene extensively in the economy to influence market outcomes and redistribute income. Consequently, where left-leaning parties dominate government, an independent central bank is likely to clash with the partisan goals of these governments and therefore, left party governance lowers the chances of an independent central bank.<sup>13</sup> Empirically, however, we know that this is not true. Under the Social Democrat government of Gonzales, Spain granted autonomy to its central bank in 1994.

The literature on the preferences of right parties does no better. The conventional view in the literature claims that where right-wing parties dominate, the government's relatively restrictive, noninterventionist strategies enhance the autonomy of central banks.<sup>14</sup> In emerging markets, however, these arguments become dubious given that right-wing governments could be populist and hence, refrain from losing their fiscal power. In Hungary, the right-wing coalition government in early 1990s constitutes an example of such parties and based on their institutional preference of a partially independent central bank, one can suggest that arguments developed for the advanced economies might not always hold for other markets.

### *Coalitional Arguments*

Coalitional arguments suggest that governments made up of multiple political parties prefer an independent central bank so as to use its credibility to prevent any intraparty dispute over monetary policy that can lead to a cabinet collapse. In multiparty governments, monetary policy decisions are made in one ministry, usually the finance ministry. Then disagreements about the course of monetary policy within a coalition government, where one party has the most information and/or expertise about policy, can make the coalition collapse.<sup>15</sup> Bernhard and Leblang argue that an independent monetary institution can increase the cabinet durability for coalition governments by taking away the monetary policy instrument tool that the governments can manipulate.<sup>16</sup>

This argument encounters empirical weaknesses. In Hungary, all governments throughout the 1990s have been coalition governments, but instead of delegating authority to the MNB – as this argument would expect – they all chose to keep it as dependent as possible. The situation was no different in Poland. When the social democrat-led coalition government came to power after the 1993 elections, it called for changing the status of the Central Bank of Poland to make it less independent.<sup>17</sup>

13 For details see Christopher Way, "Central Banks, Partisan Politics, and Macroeconomic Outcomes", *Comparative Political Studies*, Vol. 33, No. 2, March 2000, p. 196-224.

14 Please refer to William Bernard, *Banking on Reform: Political Parties and Central Bank Independence in Industrial Democracies*, Ann Harbor, University of Michigan Press, 2002 for right-wing parties' preferences in European context.

15 For a detailed discussion, see Lucy Goodhart, *Political Institutions and Monetary Policy*, unpublished manuscript, Harvard University, 2000.

16 William Bernhard and David Leblang, "Democratic Institutions and Exchange-Rate Commitments", *International Organization*, Vol. 53, No. 1, 1999, p. 71-97.

17 For details, see Rachel Epstein, "Cultivating Consensus and Creating Conflict: International

### ***Economic Openness Arguments***

In contrast to the domestic level explanations, the economic openness argument as suggested by Maxfield<sup>18</sup> holds that, in middle-income countries, governments choose to grant autonomy to their central banks as this helps lower expectations of inflation and reduce the cost of borrowing in international markets. Accordingly, the more an economy is financially integrated with world markets, the more likely it is that government's need for finance will yield CBI since only through delegating authority to the central bank, as Maxfield claims, can politicians signal to foreign investors that the government is committed to "desirable" (read as non-inflationary) economic policies.

Despite its plausibility, the "creditworthiness" argument of Maxfield is problematic in the sense that most of the countries that opted for a statutory change, in her analysis, were also being monitored by international institutions in those years. Hence, it is possible to argue that it was these institutions, rather than the search for international creditworthiness in global markets, that triggered a central bank reform in these countries. This is most apparent in the case of Eastern and Central European countries since these countries were under the IMF stabilization program to become full market economies in the 1990s. As the East Asian crisis in 1997 illustrated the dangers of weak regulation of finance, the preconditions for prudent financial liberalization became stringent in the IMF programs. In exchange for its economic support, the Fund called for building key institutions, such as autonomous bank supervision agencies, and above all independent central banks in developing countries.<sup>19</sup> Besides the IMF, one should also consider the role of the EU in understanding the statutory reform in these countries, since in the early 1990s there was already a hard-won consensus to institutionalize central bank independence in the European Community. Maxfield's explanation fails to rule out this competing argument.

### **What Explains the Central Bank Legal Reform in the EU Candidate Countries?**

In contrast to the domestic level explanations that dominate the literature or purely system-level explanations, this article builds on a burgeoning literature that combines international and domestic explanatory variables to account for central bank reform. This article rests upon the idea that without material incentives offered by international organizations, it is unlikely for politicians to consider a change in the status of their central banks. These "incentives" can be either economic, referring to loans that help support domestic economy, or political, which takes the form of accession to key regional blocs. The role of international incentives is essential as ruling politicians lack any incentive

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Institutions and the (De)Politicization of Economic Policy in Postcommunist Europe", *Comparative Political Studies*, Vol. 39, No. 8, October 2006, p. 1019-1042.

18 For theoretical discussion on the link between economic openness and central bank autonomy, see Maxfield, *Gatekeepers of Growth*, p.35-50.

19 For an excellent discussion on the IMF's institutional requirements that developing countries need to fulfill for economic aid, see Williamson, "Development and the Washington Consensus", p. 1232-1239.



to consider a change in the status of their central bank for a couple of reasons. First, an autonomous central bank is unlikely to monetarize government deficits. In addition, an autonomous central bank is a restraint on the level of spending that a fiscally expansionist government plans to implement due to its control over money supply and its focus on price stability in economy. This is why a “push factor” by international organizations becomes necessary to make ruling politicians consider a statutory change in their central bank.

When it comes to central bank reform in Europe, it is the IMF and the EU that exert pressure on states by conditionally linking necessary reform in the status of central bank to the particular reward they wield, whether this be a significant amount of loan or full membership in the union.<sup>20</sup> It is important that the incentives offered by the international institutions must not be free; in the issue area of central banking, conditionality means that politicians have to reform the status of their central bank in order to receive the particular incentive in place. Equally important, the ruling politicians in question must view this incentive beneficial enough to choose to comply with its condition. That is to say, ruling politicians should be dependent on this incentive so that benefits of compliance outweigh costs of defiance for them. This article argues that when both of these conditions (conditionality and dependence) are present, international incentives are able to initiate this micro-institutional change (see Table 3).

While material incentives offered by international actors explain “when” and “how” central bank reform is initiated, they are, *on their own*, insufficient to determine “how much” institutional change occurs. As previously noted, in Hungary the initial reform in 1991 failed to result in a strongly autonomous central bank in its operations, despite the IMF pressure and the prospective EU membership. Thus, the presence of international material incentives is no guarantee that the resultant reform will lead to a bank that is fully independent of political pressures in its operations. Hence, some other explanation is necessary to understand why countries might fail to comply fully with external actors’ demands in the first place.

This article claims that, in the absence of government commitment to diminish the underlying causes of budget deficit and inflation in an economy, the ruling politicians will be hesitant to accept a fully autonomous central bank as they need to rely on the central bank’s resources to monetarize their deficits. Moreover, they will be unfriendly to the idea of restraining their fiscal spending in line with inflation targets set by an autonomous party. Hence, the level of central bank autonomy is likely to increase, when government is willing to converge towards the central bank goals of low inflation and low deficit in its economic policies (see Table 3).

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20 For IMF conditionality see James Vreeland, *The IMF and Economic Development*, New York, Cambridge University Press, 2003 and for the EU-based conditionality, refer to Mileda Anna Vachudova, *Europe Undivided: Democracy, Leverage and Integration after Communism*, Oxford, Oxford University Press, 2005; Frank Schimmelfennig and Ulrich Sedelmeier, “Governance by Conditionality: EU Rule Transfer to the Candidate Countries of Central and Eastern Europe”, *Journal of European Public Policy*, Vol. 11, No. 4, 2004, p. 661-679.

However, disinflationary policies can be highly unpopular with the masses in a national setting. When ruling politicians cannot derive support from their electoral constituencies for disinflationary policies, they then find themselves confronted with a severe dilemma: while international incentives at interstate level require them to undertake central bank reform, the political costs of this institutional reform on the domestic level make these actors reluctant to proceed. What happens then? In the light of Hungarian case, this article argues that when the policy priorities of governments and central bank do not match, ruling politicians undertake a partial change to maintain as much power as possible in their hands vis-à-vis the central bank. When the reform falls short of satisfying the EU's accession criteria, pressure from the EU becomes necessary to ensure full compliance.

**Table 1** Depiction of Theoretical Argument and its Application to the Hungarian Case

		Incentives yielded by international organizations	
		Absent	Present
Domestic costs of central bank reform	Low	<b>No change in legal status</b>	<b>Strong autonomy</b> Hungary (1998-2002)
	High	<b>Opposition to central bank</b> Hungary (2002-2010)	<b>Partial autonomy</b> Hungary (1990-1998)

The question that needs to be addressed here is how the EU defines and operationalizes central bank independence in candidate states for accession and in turn, what partial reform stands for. Based upon the documents of the organization, in order for a candidate state to have full alignment with the EU criteria, and thus, a strongly autonomous central bank, the central bank needs to set price stability as its key objective; it should be prohibited from lending to the government at any cost; it should have the discretion to determine the instruments of monetary policy, meaning interest rates as they affect level of investment, inflation and the amount of capital inflows coming into the

country – and exchange rates, which are critical for the competitiveness of the economy.<sup>21</sup> In this article, anything that falls between no legal autonomy and full alignment with the EU criteria is considered to be partial reform, where the bank enjoys limited autonomy from ruling politicians (see Table 2).

**Table 2** Defining and Operationalizing the Dependent Variable

<p><b><i>Variation in the MNB's autonomy</i></b>                  The level of independence the MNB holds from political interference and pressure over time  <i>Operationalization:</i>                  - Is price stability set as its key objective?                  - Is the Bank prohibited from lending to the government at any cost?                  - Does the Bank have the discretion to determine the instruments of monetary policy, i.e. interest rates and exchange rates</p>
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**Table 3** Defining and Operationalizing the Independent Variables

<p><b><i>Incentives provided by international institutions</i></b>                  Economic and/or political benefits offered to the negotiator state  <i>Operationalization:</i>                  - The condition of amending the status of central bank is stated explicitly and prominently in the treaty or in the program of international institution(s)                  - The politicians demonstrate willingness to sign or conclude an agreement with the international institution to obtain the incentive it offers</p>
<p><b><i>Domestic Political Costs of an Autonomous Central Bank</i></b>                  The costs of proceeding with disinflationary policies in order to ameliorate macroeconomic instabilities prevailing in the economy  <i>Operationalization:</i>                  - Is there an electoral support for such an economic policy?</p>

The argument introduced here differs from constructivist arguments to CBI. Epstein, in her book on central bank independence in post-communist Europe, refers to constructivism by arguing that international institutions maximize their influence over domestic reform when domestic actors –who are uncertain about how to make policy

21 For details, see Maastricht Treaty and the Protocol on the Statute of the European System of Central Bank and of the European Central Bank-constituting a part of the Treaty establishing the European Community. Article 105 of the Treaty and Article 2 of the Protocol talk about price stability in particular, while Article 108 of the Treaty and Article 7 of the Protocol define the rules on the prohibition of national central bank from taking instructions from governments. Additionally, certain provisions of the Maastricht Treaty as well as Article 22 of the Protocol talk about prohibition of “monetary financing and privileged access”. That is, they define as illegal overdraft facilities or any type of credit facility between a national central bank and governments/public authorities, as well as prohibit the Bank from direct purchases from public sector entities. Finally, any financing of public sector obligations vis-à-vis third parties is proscribed. The EU also demands, although in lesser extent, provisions on security of tenure of members of the national central bank’s decision-making bodies, mentioned in Article 14.2 of the Protocol. For original documents visit: [http://europa.eu/legislation\\_summaries/economic\\_and\\_monetary\\_affairs/institutional\\_and\\_economic\\_framework/o10001\\_en.htm](http://europa.eu/legislation_summaries/economic_and_monetary_affairs/institutional_and_economic_framework/o10001_en.htm).

- seek association with the values and status embodied by the international institutions that are undertaking policy transfer.<sup>22</sup> Different from the argument offered here, Epstein suggests that politicians accede to demands of international institutions because of non-material factors of salience of approval and the need for social association at times of transition, when politicians are uncertain about what best serves their interest. The discussion of the Hungarian case below demonstrates why the competing argument of Epstein does not hold.

## **Re-thinking the Variation in Central Bank Autonomy in Hungary**

The first legal reform to supply the MNB legal autonomy for the first time in its history occurred in 1991 in the presence of external actors and the material incentives they wielded.<sup>23</sup> In the aftermath of the downfall of communism, “Return to Europe” quickly became the major slogan of transition in Hungary and it implied that integration into the West European and Atlantic organizations, namely the EU and NATO, would constitute the major foreign goal of the country in this new era. The Western European governments, on the other hand, while reluctant to openly commit themselves to a quick eastward enlargement of the EU, were not indifferent to developments there. Very quickly, the EU extended some programs that would assist the transformation process in Eastern Europe to signal its interest in the region’s future. In Hungarian context, these signals involved the Phare Program (1989) and the Association Agreement (1991). Although they mainly aimed at supporting the establishment of a liberal economy by providing expertise and financial aid,<sup>24</sup> in Hungary as well as elsewhere in the region, such measures were interpreted as signals of the EU’s willingness to admit the newly liberal democrat states of Eastern Europe into its club.<sup>25</sup>

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22 Epstein’s argument resembles Woods’ argument in the sense that Woods also considers international organizations’ capacity to transmit policy through ideas and technical expertise in times of uncertainty. Different from Epstein, Woods problematizes the role of sympathetic decision-makers at domestic level to persuade governments to emulate international organizations’ solutions. For details of Epstein’s argument, see Epstein, *In Pursuit of Liberalism*, p. 1-32. For Woods’ argument, see Ngaire Woods, *The Globalizers: The IMF, The World Bank, and Their Followers*, Ithaca, Cornell University Press, 2006, p. 65-83.

23 In the 1990s, not just the central bank but whole banking sector in Hungary was reformed. For an account of banking sector reform, see Gyorgy Szapary, “Banking Sector Reform in Hungary: Lessons Learned, Current Trends and Prospects”, paper presented at *The Seventh Dubrovnik Economic Conference*, Croatia, 28-30 June, 2001.

24 The EU signed Association Agreements with Visegrad countries of Hungary, Poland and back then what was called Czechoslovakia in November/December 1991. However, the formal launching of these agreements did not happen until the Essen Summit of December 1994. At Essen, Association agreements turned into European Agreements, providing economic and technical cooperation, financial assistance and the creation of a structured political dialogue to help these countries achieve full membership. In many cases, funding was provided through the Phare Program, which earmarked 582.8 million ECU between 1990-1995. With the extension of Phare to additional recipients, Hungary’s share declined from 20% in 1990 to 8.6% in 1994, by which time the funding had stabilized at around one billion ECU. For details of Phare Program, refer to [http://ec.europa.eu/enlargement/key\\_documents/phare\\_legislation\\_and\\_publications\\_en.htm](http://ec.europa.eu/enlargement/key_documents/phare_legislation_and_publications_en.htm).

25 According to Andor, the rulers of the ex-socialist countries strongly believed that the EU would automatically include them. Indeed, one can hardly blame them for their contentions given in Copenhagen Summit of 1993 the EU announced that the Association Agreements would eventually lead to full membership. For details see Lazlor Andor, *Hungary on the Road to the*

It is important to note here that despite its financial help, the EU did not preoccupy itself with overseeing the economies of these countries, as there was a conscious decision in the EU to leave the guiding role of transition to the IMF. The governments in transition states, on the other hand, had no objections to the involvement of the IMF in their economies as they saw this as compatible with their attempts to join the EU. Hungary was no exception. At a time when the country was seeking the political recognition of the EU as an official candidate, Hungarian politicians had all the incentives to follow the IMF prescriptions to make the country's candidacy stronger. More importantly, Hungary was dependent on the economic assistance that the IMF could provide in early 1990s due to imbalances in its external position.<sup>26</sup>

As this article argues, the material incentives provided by external actors (IMF economic loans in the short term and the EU membership in the long term) triggered a central bank reform in Hungarian context. The enactment of the new central bank law was premised on two assumptions: First, the law would help the country strengthen its position *vis-à-vis* the EU in its push for candidate status by demonstrating its commitment to institutional requirements of a well-functioning market economy. After all, undertaking a central bank reform would help Hungary fulfill an important condition of the Maastricht Treaty, which has set central bank independence as the norm for the EU states. Secondly, and more urgently, the Act would help Hungary fulfill the conditions stated in its stand-by agreement with the Fund to receive economic assistance, necessary to correct its external imbalances.

Although the new law granted autonomy to the bank for the first time in its history, the change was partial in EU terms as the bank lacked the right of *not* financing the state deficit. Nor the MNB was able to openly target price stability as its primary goal. Instead, the priority of the bank was now a rather vague goal of defending "the value of the national currency." The major benefits of the reform in economic sphere involved empowering the MNB in formulation of monetary policy as the Act formalized its preeminence in using the monetary tools.<sup>27</sup>

The partialness of the reform stemmed from the fiscal stand of the newly elected, first democratic government, which can be characterized by its accommodative stand to the growing deficit—despite the discontent of the IMF. After all, what brought the conservative right-wing coalition government of Antall to power was its declared commitment to "market socialism", which promised a smooth transition to neoliberal economy, without sacrificing

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*European Union: Transition in Blue*, Connecticut, Praeger, 2000, p. 73-115.

26 As the gross foreign debt constituted almost 57% of the GNP, Hungary did not have an option but ask for the IMF's help in its transition stage. For a good account of the Hungarian economy at the onset of transition process, see David Barlett, *The Political Economy of Dual Transformations: Market Reform and Democratization in Hungary*, Ann Harbor, The University of Michigan Press, 1997, p. 35-76.

27 The MNB was allowed to lower or raise the exchange rates up to a certain level (5%), above which it was required to seek the approval of the government. Hence, it had pretty much flexibility to alter the exchange rates on its own. Additionally, the MNB had the power to set interests rates at its own.

the welfare provisions.<sup>28</sup> The heavy cost of financing the welfare state was apparent in figures; at the onset of transition, total social expenditures were exceeding 25% of GDP and in 1992, 4.2 million workers were supporting 2.7 million pensioners in the country. Thus, the maintenance of communist regime's social security benefits was exerting a substantial pressure on the government budget. In the presence of rising unemployment and increasing prices, Hungarian people resented the costs of adjustment.<sup>29</sup> Given the massive discontent with market reforms, proceeding with large-scale adjustments in welfare state would prove to be costly for the Antall government in electoral terms.

As this article suggests, in the absence of electoral support for disinflation policies, the domestic political costs of central bank reform remained high because the government was unwilling to lose its control on MNB's resources due to its dependence on the MNB's resources to finance its debt. Consequently, the 1991 Central Bank Act did not entirely eliminate the direct financing of government but limited it to 4% of annual tax recipients, which would decline to 3% by 1994. Despite its incompleteness, however, the reform allocated some maneuvering space to the MNB in its relationship with the government for the first time in its history. When the Antall government appealed to the bank for special financing lines to support the major loss-making state economic enterprises in 1991, the bank was able to turn down these appeals.

In the mid-1990s, the risk of a serious economic crisis arising from Hungary's fiscal and current account deficit made the subsequent left-liberal coalition government led by Horn realize early on that Hungary had reached the limits of the "possible".<sup>30</sup> In 1994, the current account deficit stood at a historically high level of 9% of the GDP, while the budget deficit constituted approximately 7% of the GDP. Moreover, the budget deficit displayed a continuously widening trajectory; in March 1995 the government has

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28 Under the communist regime retirement age was low; women could retire at 55 and men at 60. These provisions became the target of the IMF with the downfall of the regime. Although the government in October 1991 proposed an increase in retirement age, it back paddled soon after. In healthcare, the government was again reluctant to address the problems and undertake draconian changes. No reforms were made in areas involving co-payments for medical treatment and medicine, overcapacity of hospital beds and so on. As for education, no increase in tuition fees was adopted. For a detailed discussion, see Frank Bonker, *The Political Economy of Fiscal Reform In Central Eastern Europe*, Cheltenham, UK, Edward Elgar, 2006, p. 102-104.

29 Antall realized early on how hard it would be to proceed with necessary structural reforms; after his attempt to increase the energy prices as part of price liberalization process in late 1990, "gas riots" – the most extensive street demonstrations since 1956- broke out in different cities of Hungary, which made Antall government to drop the idea quickly. In the presence of rising unemployment and increasing prices, Hungarian people resented the costs of adjustment.

30 The coalition government was formed by the left-wing Hungarian Socialist Party (MSZP) and the liberal Alliance of Free Democrats (SZDSZ) under the leadership of the former in 1994. The government represented the left-liberal camp and modification of political positions. For details on this government, see Umut Korkut, *Liberalization Challenges in Hungary: Elitism, Progressivism and Populism*, New York, Palgrave MacMillan, 2012, p. 38-41 and Gabor Toka, "Hungary", Sten Berglung, Thomas Hellen and Frank Aarebrot (eds.), *Handbook of Political Change in Eastern Europe*, Cheltenham, Edgar Elgar, 1998, p. 255.

already reached half of the annual plan budget deficit. As a result, the Horn government announced in March 1995 an austerity program, known as the Bokros Package, to cut down the budget deficits and control the inflation.<sup>31</sup>

In the absence of electoral support for disinflation, it was politically costly for the Horn government to launch it. After all, the Hungarian Socialist Party (MSZP) under Horn represented the “losers” of the transition – pensioners, blue-collar workers and public sector employees.<sup>32</sup> The risk of crisis, however, left the government with no choice but proceed with severe measures to gain the seal of approval from the IMF and avoid the crisis. Additionally, the Horn government calculated that the targeted reduction of the public debt with the Bokros Package would improve the country’s prospects for the EU accession.<sup>33</sup> The prudent disinflationary posture of the government facilitated further change in the MNB’s autonomy along the EU criteria. The Central Bank Act in 1996 required that the Bank would no longer provide credit to the government – apart from a small temporary facility.<sup>34</sup>

The launching of accession negotiations in 1998 motivated the succeeding conservative coalition government under the premiership of Orbán to qualify Hungary to join the EU during his tenure.<sup>35</sup> In contrast to the fiscal expansionism of the early years in office, Orbán made a shift in his economic policies and adopted a tight stand as the recession in world markets hit the country after 2000 and undermined the viability of the export-led trajectory for growth. Consequently, Orbán decided to side with non-tradable sectors, which included, above all, property and construction businesses for economic growth and represent their interests in office.<sup>36</sup> As these groups pressed for fiscal discipline in order to pay lower taxes and social security contributions, Orbán responded with cuts in spending. His policies helped him gain credibility as the EU was closely watching the fiscal health of the country.

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31 According to the Package, deficits would be lowered through cutting real wages by 12% for workers in public sector and reducing the civil service employment by 15%. For details, please refer to David Barlett, *The Political Economy*, ch. 6.

32 Faced with the dilemma of how to declare the austerity package without alienating supporters, the reformist left-wing MSZP advocated the adoption of “making liberal policies now and social policies later” solution, which made the timing of social policies dependent on economy recovery. See Diana Morlang, “Hungary: Socialists Building Capitalism”, *The Left Transformed in Post-Communist Societies*, Maryland, Rowman & Littlefield Publishers, Inc., 2003, p. 61-99.

33 At the Copenhagen Meeting of the European Council in June 1993, the European Council decided that the associated countries of Central and Eastern Europe could become members of the European Union as soon as they were able to fulfill the relevant political and economic obligations.

34 Please refer to Carlo Cottarelli, “Hungary: Economic Policies for Sustainable Growth”, *IMF Occasional Article no.159*, Washington, International Monetary Fund, 1998 for details. The article is also available at <http://www.imf.org/external/country/hun/index.htm?type=42>.

35 The government was made up of three right-wing parties of the leading Hungarian Civic Union (Fidesz), Hungarian Democratic Forum (MDF) and Independent Smallholders’ Party (FKGP). For details on the position of government and the identity transformation of Fidesz from a liberal into a conservative party, see Korkut, *Liberalization Challenges in Hungary*, p.46-47 and Agnes Batory, “The Political Context of EU Accession in Hungary”, *The Royal Institute of International Affairs*, Briefing Paper, November 2002, p.4.

36 See Bela Greskovits, “The First Shall Be the Last? Hungary’s Road to EMU”, Kenneth Dyson (ed.), *Enlarging the Euro Area: External Empowerment and Domestic Transformation in East Central Europe*, Oxford University Press, 2006, p. 178-197.

To lower the opposition from society, the change in posture was presented to the masses as a price to pay on the thorny road to EU membership. As this article argues, in the presence of constituency support, the government committed itself to tight fiscal policies for lower deficit and lower inflation. Once the policy priorities of the MNB and the government converged, the government quickly carried out remaining statutory changes in the MNB to align it with the EU criteria. In July 2001 came the final revisions in the MNB's statute that made the Bank compatible with its counterparts in the EU zone.

**Table 4** Variation in Central Bank Autonomy in Hungary

Hungary	Incentives	Domestic Costs	Central Bank Independence
1990-1994 government (MDF+FKGP+KDNP)	<i>Present</i> - IMF Stand-By Agreement -EU Enlargement- (candidacy status in 1994)	<i>High costs</i> - no constituency support for disinflationary policies	<i>Partial Autonomy</i> (1991 Central Bank Act)
1994-1998 government (MSZP+SZDSZ)	<i>Present</i> - EU Candidacy	<i>High costs</i> - no constituency support for disinflationary policies	<i>Partial Autonomy</i> (1996 Amendment)
1998-2002 government (Fidesz+FKGP+MDF)	<i>Present</i> - EU Membership (accession talks begin and end)	<i>Low costs</i> -electoral support for disinflation	<i>Strong Autonomy</i> (July 2001 Act)

The closure of negotiations in 2002 and subsequent entry of Hungary into the EU in 2004 does not, however, mean that its obligations ceased to exist. Since the new wave of accession, the countries have had no right to opt out of the European Monetary Union (EMU), so Hungary was not only required to fulfill the accession criteria but also conduct an economic policy compatible with the EMU upon its accession to the EU.<sup>37</sup>

37 As explained in Article 109 of the treaty establishing the EC and as defined in protocol 6 of that treaty, these criteria comprise of: 1) The inflation criterion (an inflation rate not more than 1.5 per cent higher than those of the three best performing EU countries over the latest twelve months). 2) The fiscal convergence criteria (a country that wants to participate in the EMU may not have a government budget deficit higher than 3% of GDP or a government debt ratio of more than 60 per cent of GDP). 3) The interest rate criterion (an average nominal long term interest rate that does not exceed by more than two percentage points that of the three best performing members states in terms of price stability). 4) The exchange rate criterion (participation in the Exchange Rate Mechanism (ERM) of the European Monetary System within the normal fluctuation margin without severe tensions for at least two years). The official treaty is available at the EU's website <http://eur-lex.europa.eu/en/treaties/dat/11992M/htm/11992M.html>. For a good discussion on the requirements of the Stability and Growth Pact and the criticisms to the Pact, see Gabor Orban & Gyorgy Szapary, "The Stability and Growth Pact From the Perspective of the New Members", *MNB Working Paper*, No. 4, 2004; and Laszlo Csaba,



The Hungarian governments throughout the first half of the 2000s failed to comply with the EMU criteria as the government budget deficit remained well above the 3% reference value. The Hungarian governments had no genuine interest in joining the Euro zone as there was significant opposition in Hungarian society to adopting the Euro, due to adverse effect it would have on economy.<sup>38</sup> The European Central Bank (ECB), on the other hand, was hesitant to admit new states to the Euro zone as it had concerns about the impact of these less-developed transition economies on the stability of the monetary union.<sup>39</sup> This article holds that international institutions are likely to exert pressure on domestic governments via material incentives, when domestic actors are willing to conclude an agreement with the international institution to obtain the incentive it offers (see Table 3). The shallow commitment of Hungary to the monetary union meant that international incentives were no longer present to keep the Hungarian governments on a path of tight fiscal discipline in the aftermath of the accession.

What happened to the institutional autonomy of the MNB once the material incentives were removed from the table in the post-accession era? As this article argues, the government did not hesitate to oppose the MNB's autonomy, when the bank's posture clashed with the government's economic strategy. As the ruling politicians diverged from tight budget discipline and criticized high interest rates, the government deemed strong autonomy of the MNB to be costly. When the left-liberal coalition government under Medgyessy opted for expansionist fiscal policies at home, the MNB's efforts to pursue disinflation turned the bank into a political target for the government.<sup>40</sup> The two had different views on monetary policy too. While the government demanded lower interest rates for a more competitive forint, the MNB insisted on high interest rates to control domestic demand and lower inflation. Indeed, this difference proved to be costly for Hungarian economy. The insistence of the MNB on tight monetary policy in the absence of a credible disinflation commitment by the ruling government magnified hot money inflows and caused speculative attacks on the forint in 2003 and 2004. Medgyessy began to view the governor of the MNB more as a political opponent than as an official of an autonomous state institution, pursuing the task assigned to him by law.

The government could not openly attack the economic independence of the bank since it would attract sharp criticisms from the EU. Thus, the government decided on an indirect way of controlling the MNB by increasing the number of its representatives in the decision making council of the MNB. Soon after the accession in May 2004, the government enacted a new legislation on central bank in December 2004, which extended

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"Ready, Steady, Go? How Prepared Are the New EU Members for Full Integration?", *Intereconomics*, Vol. 39, No. 2, March/April 2004, p. 69-75.

38 EOS Gallup Europe, *Introduction of the Euro in the New Member States*, Wave 2, Brussels, European Commission.

39 For a good and detailed discussion on this issue, see Juliet Johnson, "Two-Track Diffusion and Central Bank Embeddedness: The Politics of Euro Adoption in Hungary and the Czech Republic", *Review of International Political Economy*, Vol. 13, No. 3, August 2006, p. 361-386.

40 The government that was composed of the leading left-wing Hungarian Socialist Party (MSZP) and the liberal Alliance of Free Democrats (SZDZ) under Medgyessy's premiership stressed more responsiveness to welfare considerations at domestic level. Thus, MSZP leader Medgyessy was willing to tolerate a somewhat higher inflation to mitigate the pressure on welfare issues. The MNB, however, supported tight fiscal policy for price stability. For details see Greskovits, "The First shall be".

the Prime Minister's authority to appoint members to the monetary council. With this new law, the Medgyessy government was able to alter the balance of power between the MNB and the government to its advantage.<sup>41</sup>

## Conclusion

This article demonstrated that international organizations play a key role in triggering central bank reform with the material incentives they yield, when Hungarian politicians are reluctant to undertake this reform. The extent and pace of central bank reform, however, is determined by its political costs in the calculations of ruling politicians. This article challenges the competing rationalist-constructivist approach of Epstein on the grounds that the attempts of the Antall government to preserve the oversight of monetary policy as much as possible with the 1991 central bank reform demonstrates that Antall was not so 'uncertain' about what best served his interests and he was not so ready to give in to the demands of international institutions for social approbation. The shift from partial to strong autonomy in Hungarian context occurred when the government was able to construct an inflation-averse coalition and implement strict fiscal policies in the early 2000s that helped lower the costs of furthering statutory power of the MNB.

The strong autonomy of the MNB became subject to political attacks when the accession to the EU in 2004 removed all the incentives from the table and raised the costs of tolerating the MNB's power for the government. Electoral demands for less tight monetary policies raised the political costs of CBI and led to a clash between the government and the MNB due to the latter's insistence on not lowering interest rates. In the absence of international incentives, the clash led to circumscription of the institutionalized power of the MNB with the 2004 December Act.

As central bankers of the post-communist EU states press strongly for a rapid adoption of the Euro, while the political leaders remain reluctant, the tension between governments and central banks can trigger political attacks on the institutional power of the latter, as in the case of Hungary in 2004. In the absence of the EU's ability to withhold membership, compliance with the tough conditions of the Stability and Growth Pact make governments confront their central banks that insist on a rapid European Monetary Accession (EMA) through tight fiscal and monetary policies. Hence, the issue of central bank autonomy continues to matter in the post-accession period as it is subject to further challenges and amendments in this new era.<sup>42</sup> A broader academic challenge for the future is to examine how the political battle of central bank states will result for the bank's statutory autonomy.

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41 The new amendment expanded the size of the MNB's Monetary Council from 9 to 13 members, where four new members would be personally appointed by the Prime Minister.

42 For further reading on the power of the MNB in the euro age, see Bela Greskovits, "Estonia, Hungary and Slovenia: Banking on Identity", Kenneth Dyson and Martin Marcussen (eds.), *Central Banks in the Age of the Euro: Europeanization, Convergence and Power*, Oxford University Press, New York, 2009, p.203-221. For further readings on Europeanization and central bank literature, refer to Juliet Johnson and Rachel Epstein, "Uneven Integration: Economic and Monetary Union in Central and Eastern Europe", *Journal of Common Market Studies*, volume 48, no. 5, 2010, p.1235-1258; Juliet Johnson and Rachel Epstein, "The Czech Republic and Poland: The Limits of Europeanization", Kenneth Dyson and Martin Marcussen (eds.), *Central Banks in the Age of the Euro: Europeanization, Convergence, and Power*, p. 221-240 and Rachel Epstein and Ulrich Sedelmeier, "Beyond Conditionality: International Institutions in Postcommunist Europe after Enlargement," *Journal of European Public Policy*, Vol. 15, No. 6, September 2008, p.795-805.

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