

Central Bank Independence and Monetary Stability in Hungary, 1920s and 1990s*

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This study compares monetary policy and inflation in Hungary in the first half of the 1920s and the first half of the 1990s. In both periods, economic and financial imbalances placed pressure on the central bank to provide inflationary finance. Eventually, in response to the resulting inflation, central bank independence was significantly strengthened. But while central bank independence helped, in neither case did it suffice to prevent subsequent instability. The central bank inevitably felt pressure to accommodate problems emanating from the banking sector, the balance of payments, the government budget and weakened sectors of the economy. The paper concludes by drawing out the implications for current legislation potentially affecting the independence of Hungary's central bank.

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1. Introduction

This study compares monetary policy and inflation in Hungary in the first half of the 1920s and the first half of the 1990s. It argues that central bank independence is necessary but not sufficient for the restoration and maintenance of price stability and, more generally, for economic and financial stability. In both episodes, economic and financial imbalances inherited from the preceding period placed pressure on the central bank to provide inflationary finance to the government, the banking system and the corporate sector. In response to the resulting inflation and disruptions it entailed, central bank independence was significantly strengthened, consistent with the economic orthodoxy prevailing in both eras. But while buttressing central bank independence helped, in neither case did it suffice on its own to prevent subsequent outbreaks of instability. Notwithstanding its strengthened independence, the

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central bank inevitably felt pressure to accommodate problems emanating from the banking sector, the balance of payments, the government budget and weakened sectors of the economy.

The implications for present-day Hungary are direct. First, governments contemplating steps that dilute central bank independence do so at their peril. Respecting the independence of the central bank does not automatically solve all problems, but Hungary's own history in the 1920s and 1990s, and monetary history more generally, shows that compromises of that independence only make matters worse. Second, even the most independent central bank cannot be expected to deliver satisfactory outcomes in the face of imbalances in the banking sector, the external sector and the real side of the economy. These problems fall to other national policy makers to solve.

2. The 1920s

Hungary emerged from World War I much diminished in territory and population. The borders of Central Europe's new nations disrupted its industry and commerce. There was social and political turmoil at the end of the war when the government of Count Mihály Károlyi was overthrown in favour of a Soviet Republic under Béla Kun and then, following a brief Romanian invasion, when a right-wing government led by Admiral Miklós Horthy took (and retained) power. Inflation was the immediate postwar order of the day. Large-denomination notes of the Austro-Hungarian Bank (the central bank of the former Austro-Hungarian Empire) were accepted as legal tender only when stamped. But because Hungary was relatively late in stamping notes, these flooded in from other successor states (*Garber and Spencer 1994*). There as yet being little in the way of fiscal revenues, the Bolshevik government during its brief (four month) tenure used its access to the printing plates of the Austro-Hungarian Bank to issue more notes; it also issued notes of its own.

The Austro-Hungarian Bank was closed down toward the end of 1919, and its functions were assumed first by a Hungarian section of the old bank and then in August 1921 by a State Note Institute under the direct control of the finance ministry. Starting in August 1921 the Institute issued its banknotes, which it exchanged for both stamped notes of the old Austro-Hungarian Bank and notes issued by the Bolshevik regime.

While Hungary owed reparations under the provisions of the Treaty of Trianon, neither their level nor the schedule for payments were known. This obviously was a source of considerable uncertainty. All the while – that is, from 1919 through 1924 – the Hungarian government ran large budget deficits, financed by borrowing from the State Note Institute. The latter was also directed by the finance ministry to make concessionary loans to banks, firms and farms to enable them to stay up and

running. The faster inflation ran, the more government revenues lagged behind, creating a classic and ultimately disastrous inflationary spiral. But unilaterally taking steps to balance the budget, and to thereby help to bring an end to inflation, would have weakened the argument that the fiscal effort required to meet the reparations burden was impossible (*Pogány 2019: p. 49*). Hence the delay in taking those steps.

Hyperinflation accelerated until March 1924, when everyone agreed that it had already gone too far. The League of Nations, in concert with the Reparation Commission and the Hungarian government, cooperated on a fiscal consolidation, a reduction of the reparations burden and an international loan. External finance became possible when the Reparation Commission abandoned its first lien on the Hungarian government's revenues so that these could be used to service commercial obligations. The loan came in July 1924, following special help from Montagu Norman, Governor of the Bank of England and de facto arbitrator of access to the London capital market (*Péteri 2002*). It was scheduled to run for 20 years and collateralised by receipts from customs duties and sugar taxes and from the government's salt and tobacco monopolies, income from which was more than sufficient for servicing the obligation.

The League's stabilisation plan took the form of two separate but linked protocols. The first reaffirmed the sovereignty and territorial integrity of the state, while the second committed the government to balance its budget and establish an independent central bank. Importantly, not only Hungary but also Czechoslovakia, France, Great Britain, Italy and Romania signed the first protocol, making the associated commitments, and by implication the independence of the central bank, more than just a commitment of the current Hungarian government. The second protocol obliged Hungary to accept the oversight of a commissioner general, who would report to the League and to a "committee of control," made up of representatives of the creditor countries, on the government's compliance with the plan, including with its commitment to respect the independence of the central bank. The commissioner general also oversaw the special account into which earmarked revenues from the customs and sugar taxes and commodity monopolies were paid. The commissioner general ultimately chosen was an American, Jeremiah Smith, Jr. (*Peterecz 2009*). Smith was a close personal friend of the influential U.S. banker Thomas Lamont, who was intimately involved in drafting the Dawes and Young Plans. The American connection underscored that Hungary's compliance with the plan was a matter of concern not just for the European signatories but also the United States, the rising economic power and, presumably, prospective source of external finance.

The Magyar Nemzeti Bank (the Central Bank of Hungary, MNB) was duly established by a law of 26 April 1924 and commenced operations two months later. Among its seven leading shareholders were the New York-based National City Bank (the single

largest shareholder) and two British banks: Midland Bank and Anglo-Austrian Bank (*Magyarics 2019*). The MNB was prohibited from extending loans and advances to the government except when these were fully collateralised by convertible foreign exchange or gold (*De Cecco 1994*). It was further required to back its liabilities with gold in the manner of a gold-exchange-standard member in good standing. The coverage ratio was set at 20 per cent for the first five years, to then be increased by a further four percentage points every five years subsequently (*Pogány 2019: p. 51*). The MNB was required to accept an external advisor nominated by the commissioner general. This external advisor was empowered to veto any policy or decision that contravened the new central bank statute (*Garber and Spencer 1994: p. 33*). Finally, within weeks of its founding the governor of the MNB, Sándor Popovics, signed a protocol with the Bank of England committing the Magyar Nemzeti Bank to peg to the pound sterling in return for an advance of four million pounds.

Thus, the autonomy of the central bank had multiple sources. It was buttressed by understandable public aversion to inflation, given the events leading up to the stabilisation in 1924, by a new state-of-the-art central bank law, by a balanced budget, by international support and oversight, by an emergency advance that replenished its reserves, and by gold-exchange-standard rules. It is hard to imagine a stronger foundation for central bank independence.

Sargent (1982) suggests that this new institutional framework constituted a convincing change in regime. As a result, he contends, the subsequent inflation stabilisation was largely costless; there was no rise in unemployment. Others (*Berend and Ránki 1985; Domonkos and Schlett 2021*) suggest otherwise. They describe a Hungarian economy suffering from high unemployment, stagnant growth and depressed industries in the wake of the stabilisation. The balanced budgets mandated by the League of Nations teetered in 1928/1929 and turned to deficit in 1929/1930. The deficit then widened further in 1930/1931 as the government introduced subsidies and public works programmes. The agricultural sector, so important in 1920s Hungary, suffered from weak global prices and what quickly came to be seen as an overvalued currency. The banks, which had extended loans to agriculture, experienced balance-sheet problems as early as 1927 and succumbed to a full-blown banking crisis in 1931 (*Macher 2018*). The country ran current account deficits all through the period, reflecting these same unfavourable terms of trade. The dire implications of this external weakness came to a head with the curtailment of foreign lending in late 1928.

Péteri (2024) describes how the MNB responded to these domestic economic problems by sterilising gold outflows instead of abiding by the gold standard rules, which would have dictated contracting the money supply. It accommodated the credit needs of agriculture and industry rather than strictly prioritising the

maintenance of gold convertibility, as seemingly required by its statute. I know of no study that can be used to determine whether the MNB was responding to pressure from the government or whether its directors chose, of their own volition, to lessen the pressure on the country's banks, firms, farms and labour market. Either way, given the severity of these other economic problems, independence was evidently not enough to insulate the central bank from these pressures and allow it to disregard these imperatives.

Given unfavourable terms of trade and the sterilisation of gold outflows, the result was reserve losses, not open inflation of the sort Hungary had experienced in the early 1920s and would again experience in the early 1990s. The MNB was able to put off the day of reckoning – the inevitable currency crisis – by securing emergency assistance in 1929 from the Bank of England and a consortium of international banks (*Péteri 2002*). But the end came inevitably in 1931, with the further decline in agricultural prices, capital flight, the financial crisis and the imposition of exchange controls (*Eichengreen 1992: p. 261*).

3. The 1990s

Following the collapse of central planning, Hungary was relatively quick to reestablish the independence of the MNB. The mono-bank system had been partially reformed already in 1987 when the commercial banking functions of the MNB were hived off to other institutions (*Jung 1995*). In 1990, the then prime minister József Antall publicly announced that the government would not attempt to directly influence the monetary policy actions of the central bank (*Bod 1994*). At the end of 1991, this position was codified into law in an “Act on the National Bank of Hungary” adopted by the Parliament. A notable feature of the act was the limit placed on the amount of direct financing the central bank could provide to the government (expressed as a share of total budgetary revenues). *Dincer et al. (2024)* compute the *Cukierman et al. (1992)* measure of central bank independence for Hungary and other countries in this period. They document a sharp increase in the central bank's legal independence between 1991 and 1992. They show that the MNB's independence was stronger than the contemporaneous global average following passage of this law. The legal independence of the central bank was then fortified further by additional reforms in 1998 and 2001. An independent study by *Ainsley (2017)* reinforces these findings.

Yet the central bank's substantial independence did not enable Hungary to avoid chronic double-digit inflation. Consumer price inflation expressed on an annual average basis never fell below 19 per cent between 1990 and 1996. Producer price inflation never fell below 10 per cent and in most years, like consumer price inflation, hovered in the 20 to 30 per cent range. (CPI inflation tended to run higher

than PPI inflation because of subsidy reductions, real exchange rate appreciation and other miscellaneous factors; see *Surányi and Vincze (1998)*). To be sure, Hungary managed to avoid the kind of hyperinflations experienced elsewhere in the Central-Eastern European bloc – and for that matter in Hungary itself in the 1920s. The country had already gone further than other Eastern bloc countries to liberalise prices in the 1980s, and active use then of the inflation tax as a way of reconciling supply and demand meant that the post-planned economy did not inherit a pronounced monetary overhang. But neither was Hungary able to bring down inflation remotely close to average European Community and OECD levels, these being the advanced-economy clubs that it aspired to join.

Some will say that it is unrealistic to imagine that even the most independent, far-sighted central bank could achieve price stability in a period marked by such extensive supply shocks and structural adjustments. This, of course, is precisely the point. At the beginning of the 1990s, the Hungarian economy was battered by a combination of supply and demand shocks: on the supply side a rise in energy prices due to doubling the price of household electricity and gas and the liberalisation of retail prices of petroleum and diesel, and on the demand side the collapse of Eastern European trade. GDP fell by some 20 per cent between 1990 and 1993, with industry bearing the brunt of the contraction. The negative supply shock was inflationary, other things equal. In addition, it made sense for the central bank to support loss-making but ultimately viable firms while their competitiveness was being restored. Inflation had the beneficial effect of reducing real labour costs, given downwardly rigid nominal wages, facilitating the improvement in competitiveness and the reorientation of trade to the West, although there was also an evident tendency for the MNB to accommodate nominal wage increases to prevent competitiveness problems from reemerging. The central bank also felt compelled to attend to the problems of a weak banking system, as in the 1920s. *Sebők et al. (2021)* note that the banks were undercapitalised and burdened with large nonperforming loans, rendering them dependent on six-month credit lines from the MNB, which the latter felt compelled to provide.

Monetary policy thus oscillated between accommodation and consolidation. When CPI inflation surged to 35 per cent in 1991, policy was tightened: reserve requirements were raised and the rate of growth of domestic credit was curtailed. But although CPI inflation fell, it remained uncomfortably high, at 23 per cent in 1992. The general government budget was in substantial deficit, especially in the period 1992–1995, just as it had been in the early 1920s. The current account of the balance of payments fell into substantial deficit after 1992, and Hungary relied on foreign investment for balance of payments stability, much as it had in the years leading up to 1929. Both trends were indicative of strong demand relative to supply, which intensified inflationary pressures. Domestic absorption rose by as much as

10 per cent in 1993, fuelled by negative real interest rates. In response, the MNB began increasing the level of interest rates toward the end of the year. But it then reversed course in 1994, reducing reserve requirements and lending to the banking sector at preferential interest rates while helping the government to finance its now even larger budget deficit (1994 being an election year). The result was rates of consumer and producer price inflation that accelerated further, approaching 30 per cent annualised in 1995. Here we see a central bank whipsawed between the imperatives of inflation control on the one hand and the financial needs of the government and the economy (not to mention the imperatives of politics) on the other.

The year 1995 then saw fiscal consolidation and reform. The budget deficit was reduced by a combination of tax increases and subsidy reductions, but this fell only from 8.4 per cent in 1994 to 6.8 per cent in 1995 (on a cash basis). Moreover, unemployment remained in the double digits, which made competitiveness a priority. The central bank now adopted a preannounced crawling peg exchange rate, where the rate of depreciation roughly matched the rate of producer price inflation so as to prevent a squeeze on the country's export industries. This preannounced crawl replaced the earlier system of periodic, ad hoc devaluations, which were increasingly anticipated in advance and therefore excited destabilising speculation. Consumer and producer price inflation fell in 1996 relative to the preceding year, but only to the neighbourhood of 20 per cent annualised. By the end of 1997, inflation was still running at 18 per cent.

A fully independent central bank concerned with only one thing would have been fully capable of bringing inflation down faster. But the Magyar Nemzeti Bank, understandably concerned with inflation but also with competitiveness, unemployment and the public finances, all of which remained problems, had good reason to move gradually, notwithstanding its legal status. In the antiseptic terminology of the *IMF (1996, p. 22–24)*, “*The relatively inertial character of inflation during Hungary’s transition process appears to be related, inter alia, to the failure to use monetary and exchange rate policies to target a sizable or rapid reduction in inflation, to rigidities in the labour market combined with soft budget constraints which served to thwart real wage adjustment, and to ongoing increase in key relative prices.*” *Bod (1994: p. 424)* puts it more pithily: “*The large degree of independence provided by the [central bank] Act is but one aspect of monetary policy. The other is the constraints imposed by the economic and financial conditions of the transition, including the heritage from the former regime.*” No doubt, the central bank's strong legal independence and limits on money financing of the budget deficit were important for credibility. There is a sound argument that things would have been worse under a weaker central bank law. But in an environment of double-digit unemployment, structural imbalances and still fragile competitiveness

that legal independence did not guarantee swift convergence to a low single-digit Western European-style inflation rate.

4. Conclusion

In early 2024, the Hungarian government tabled a draft law that would have reduced the independence of the country's central bank by giving its executive board the power to direct the bank to undertake tasks not related to its basic functions. Such a step would not appear to directly affect the Monetary Council that is responsible for the conduct of monetary policy. But broadening the central bank's mandate would complicate accountability. It would make it more difficult for the monetary authorities to explain the connection between their policy instruments and policy targets. Accountability is inextricably linked to independence: the more difficult it is for a central bank to account for and justify its actions, the more likely it becomes that its status as good steward of the economy, and its independence in practice, will be jeopardised.

In addition, the proposal in question would have given the supervisory board (a majority of whose members are political appointees) the power to audit companies that are majority owned by the central bank or one of its foundations, which invest profits from its foreign exchange transactions. This is a reminder that not only should the government respect the independence of the central bank, but also that the central bank itself should exercise rigour in limiting its ancillary activities. Wherever possible, it should return its profits and their management to the fiscal authority, so that the investment of such profits does not become a political flashpoint.

This controversy came on top of pressure from the government, responding to recessionary pressures and a deteriorating budget, for the central bank to cut interest rates. Central banks regularly come under pressure to pursue a more accommodating policy when growth is weak and the budget is in deficit. But a central bank cannot ameliorate these kinds of fiscal and real-side problems without exacerbating others, such as inflation and exchange rate depreciation. This is why the conduct of monetary policy is delegated to an independent central bank that can balance these risks and objectives in an impassionate, nonpartisan way. The controversy is also a reminder that a central bank can deliver price, economic and financial stability in the long run only with support and cooperation from ministries and officials responsible for other policies.

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