Bent into submission?

Foreign investors, domestic investors, and populist governments

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Abstract: Do populist governments bend to the preferences of bondholders on their economic policies? International political economy has long been interested in how financial investors constrain governments and their policy decisions. Populist governments should be a "least likely" case for the market discipline hypothesis. Populist parties typically run on platforms that scapegoat wealthy elites, including foreign bondholders, as "enemies of the people" and hence should be more resistant to changing policy positions in the face of market pressure, given their reluctance to alienate their base. Employing most different systems case studies of the 5 Star/Lega coalition in Italy and Viktor Orbán's government in Hungary, we find that populists do bend to market pressure, but that this "disciplining effect" does not stem primarily from foreign investors. Rather, it was the inaction of *domestic* investors in bond auctions that caused these governments to reverse course on headline economic policies. Because domestic investors served as both governments' "buyers of last resort", they needed to maintain their favor amidst foreign capital flight.

Keywords: Populist governments, international political economy, bond markets, foreign investors

Introduction:

How do populist governments respond to market pressure against their economic policies, particularly those involving sovereign finance? Over the past three decades, populist parties have become increasingly successful electorally, in some cases becoming formal coalition partners in the governments of mainstream parties or informal partners through confidence-and-supply arrangements. On rarer occasions, populist parties have commanded full control over government, granting them authority to dictate national policy.

Yet when populist parties control governments, even with few institutional checks against them, they are subject to a constraint that they could conveniently ignore while serving in opposition – the whims of financial markets. Bond investors are gate keepers of sovereign finance, which grants them considerable influence over governments' economic policies. A large literature in international political economy (IPE) explains why market actors have accumulated such power over sovereigns over the past five decades. As governments increasingly rely on borrowed funds (particularly from foreign investors) they succumb to greater pressure to shape their fiscal and monetary policies around the preferences of bond holders (Andrews, 1994; Strange 1996; Cohen, 1999; Rodrik 2011, Streeck 2014; Kaplan and Thomsson, 2017). However, much of this "market discipline hypothesis[1]" literature has focused on governments of mainstream parties, whose more pragmatic approach to governing has proven malleable to the concerns of market actors, particularly during times of panic.

In this paper, we ask whether populist governments are similarly likely to bend to market pressure when investors raise concerns over their macro-economic policies, and if they are, which type of actors are most effective in forcing government U-turns on headline economic policies. Populist governments should be more resistant to market pressure for three reasons. First, their political modus operandi scapegoats elites, including financial and economic elites, as enemies of "the people" (Mudde, 2010; Halikiopoulou, 2018). Second, political support for the far right is a by-product of economic malaise (Hopkin, 2020). Given that populist governments champion "the people" who have been "left behind", one would expect that they would prefer to prioritize their voters' interests over investors, particularly if these investors are foreign bond holders. Reversing course on headline policies in response to the behavior of market actors would signal the weakening and subordination of their populist policies, potentially de-legitimizing their rule.

Third, a more recent literature on financial nationalism (Johnson and Barnes, 2015 and 2024, Oellerich and Bohle, 2024), highlights that once populists enter power, they often attempt to re-engineer financial markets so as to reduce the influence of foreign investors and entrap domestic investors (and central banks) into supporting their sovereign financing needs. Recent work has empirically documented how bond markets negatively react to far-right populists entering government (Johnston, 2024), yet anecdotal evidence highlights that populist governments have a mixed track record in responding to market pressure by changing their policies. Some cave to market panic - for instance Giorgia Meloni diluted her proposed windfall tax on bank profits, once

[1] While this hypothesis falls under a number of different names, including the "golden straightjacket" hypothesis and the capital mobility hypothesis, the conclusion is the same.

bank shares tumbled in Italian stock markets after the tax's announcement (Kazmin, 2023). But others remain defiant, even when populist policies result in significant and prolonged economic self-harm. The populist Eurosceptic wing of the UK Conservative Party ensured Brexit was brought to fruition, even though it considerably weakened the value of the pound, the UK's credit rating, and the country's long-term growth prospects.

Using a most-different case study design of the populist 5 Star/Lega coalition in Italy and Viktor Orbán's Fidesz's government in Hungary, we find that populists do bend to market pressure, but that this market-disciplining effect does not stem primarily from foreign investors and their threats of exit. We find that while governments in both countries repeatedly defied and chastised foreign investors (and in the case of Hungary, orchestrated a reduction in the influence of foreign investors through deliberate financial subordination), it was the power of *domestic investors* that caused these governments to reverse course on headline policies. In Italy, the 5 Star/Lega coalition government watered down its "People's Budget" not in response to threats from the European Commission about the launch of the Excessive Deficit Procedure (EDP) or foreign capital flight, but rather after demand for Italian bonds from domestic investors collapsed in the November 22, 2018, BTP Italia bond auction. In Hungary, domestic bondholders' increasing reluctance to finance the government in the face of high inflation in 2022 forced the Orbán government to renege on major election spending commitments and compromise with EU demands. In other words, it was not the actions of footloose foreign investors that led to policy reversal, but rather the "bowing out" of domestic investors with a vested interest in the sovereign's solvency. Because domestic investors served as both governments' bond "buyers of last resort", these governments needed to maintain their favor in order to borrow.

Our paper proceeds as follows. The next two sections briefly review the IPE literature on the market discipline hypothesis and the structural power of foreign investors, as well as recent comparative political economy (CPE) literature on the economic policies of populist governments. We then theorize under what conditions populists might bend to market discipline. Next, we present our case studies and demonstrate that, despite the considerable economic and political differences both governments faced, both the 5 Star/Lega coalition and the Orbán government were similarly pressured by *domestic investors* to alter key components of their policy agendas. We conclude with a discussion of how our findings speak to broader debates on the disciplining power of capital and the malleability of populist governments' policy agendas.

Market constraints on government autonomy: Are financial investors all powerful?

Financial liberalization and the removal of capital controls since the 1980s has considerably increased the power of capital. As governments turned to finance deficits via borrowing rather than through taxation, they became pressured to orient their policies to the preferences of their investors, even if these were at odds with what voters preferred (Cohen, 1999: pg 126). The logic behind this "market discipline hypothesis" is straightforward. As the ease of buying and selling bonds increases, fickle bondholders can shed assets that they perceive to conflict with their level of appetite for risk. If governments pursue policies perceived as inflationary or deficit prone (even though those policies might be electorally popular), bondholders may shift the bonds of these sovereigns out of their portfolios, reducing demand and increasing yields. Hence, it is in governments' interests to not deviate too much from what their bond investors want in order to safeguard their access to borrowing and limit rises in debt servicing costs (Andrews, 1994; Strange 1996; Rodrik 2011, Streeck 2014)[2].

Others doubt whether global investors can constrain the actions of governments quite so easily. IPE scholars highlighted that international bond investors did not "cut and run" quickly upon worrisome political developments such as the election of left governments advocating expansionary spending policies and greater state intervention, even in developing countries where financial market constraints are arguably stronger. When examining market reaction to the electoral successes of the left populist Lula da Silva in Brazil, for example, both Hardie (2006) and Jensen and Schmith (2005) noted that international bond investors *increased* their holdings of Brazilian bonds after Lula's electoral victory, and that average returns on the Brazilian stock market were largely unchanged. Brooks, Cunha and Mosley (2022) similarly find that while (left) government partisanship impacts *volatility* in bond spreads, it does not impact *average* risk premia within them, while Mosley, Paniagua, and Wibbels (2020) found that country-specific factors had no impact on sovereign spreads after accounting for global financial market conditions like changes in liquidity.

One possible reason why empirical evidence supporting the market discipline hypothesis remains inconclusive is because this hypothesis does not fully account for *who* is investing in government bonds. A large literature on the structural power of finance has revealed that investors' appetites for risk and returns are hardly uniform. Distinctions have been made in the risk appetites of different types of "bond vigilantes", particularly in regards to where they are domiciled. Foreign investors are perceived to be more fickle than domestic investors because they face lower exit costs, demonstrate less "loyalty" to a sovereign, and hence are less likely to become a captive audience to the economic policies of governments whose bonds they hold (Cohen, 1999; Rommerskirchen, 2020: pg 5). Consequently, foreign investors often place sharper constraints on sovereigns' policy choices through threats of capital flight and the cessation of new funding than do their domestic counterparts.

However, not all governments are so beholden to foreign bond holders. Domestic investors tend to be more patient than their foreign counterparts and have proven more willing to hold their governments' bonds, even through times of economic turmoil and uncertainty (Kurzer, 1993; Andritzky, 2012). Kaplan and Thomsson (2017) highlight that domestic banks in particular have incentives to be patient with government, because their heavy exposure to sovereign debt directly links their profitability to the government's financial health. Through their reliance upon domestic markets, whose health is also linked to government solvency, domestic investors become a captive

[2] Governments in advanced market economies played important roles in unleashing financial liberalization and enabling capital mobility. As Helleiner (1995) points out, states actively embraced globalization, in part due to difficulties with retaining a system of inflexible capital controls.

audience to governments, weakening their structural power (Culpepper and Reinke, 2014)[3]. Domestic and "dependent" investors, in other words, loosen the constraint of market discipline and provide governments with greater "room to move" on their fiscal policies, even when their borrowing costs rise.[4]

Liberal markets meet illiberal politics: Investor discipline in a least likely case?

One assumption that most IPE scholars working on the politics-market nexus hold is that governments care about market reactions and hence *should* respond to market pressure *if* it arises. But despite a vast literature that has examined how market actors evaluate governments and their policies, studies documenting whether governments *actually* respond to market discipline are fewer and far between. More recently, Rommerskirchen (2015 and 2020) and Johnston and Barta (2023) have found that governments do respond to market pressure, but that such responses are heavily dependent on context. Rommerskirchen found that "market punishment" only caused governments to engage in austerity if they were within the Eurozone, presumably because of their exposure to the European debt crisis, (2015) or had large foreign investor bases (2020), while Johnston and Barta (2023) found that government responsiveness to downgrades from credit rating agencies only emerged since the 2008 Global Financial Crisis, and, at least in the long run, was largely limited to countries that were highly indebted. Yet these works largely focus on governments led by *mainstream parties*, who are cognizant of the consequences of market panic because they (may) have had experience in managing public policy during times of economic/financial crisis.

Might populist governments react differently to the demands of bond holders? Before the past two decades, most populist parties enjoyed the privilege of serving as protest parties in opposition, avoiding the costs of governing. Hence, they could advocate unconventional (and untested) economic policies, because these policies were unlikely to come to fruition. Yet as these parties enter power, populists potentially encounter a Faustian bargain with markets. Populist parties must decide whether they want to betray their voters and abandon policies that markets dislike to preserve privileged access to sovereign borrowing, or to defy the preferences of investors at the expense of higher borrowing costs. Succumbing to market pressure, especially if it involves a reversal in policies demanded by their base, would be particularly harmful to the legitimacy of populist governments, because not only would it make these "strongmen" appear feeble, but they would also appear beholden to the very elites they publicly scorn.[5]

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[3] Not all political economists perceive domestic investors as captive audience who are less capable of punishing their own governments than their foreign counterparts. Focusing on emerging market economies, Cunha (2024) finds that domestic investors respond more strongly (and punishingly) to elections than foreign ones.

[4] Rommerskirchen (2020) found that (rising) bond spreads only lead to fiscal consolidation when the size of a sovereign's foreign investor base is larger than 10% of bondholders (pg 15).

[5] Cohen (2020) finds that once far right parties enter government, they are unable to reap electoral rewards from voters with high "political dissatisfaction", suggesting that if they decide (and are able) to enter government, they jeopardize their "anti-establishment" appeal (pg 671).

In contrast to their mainstream party counterparts, we expect populist governments to discount the concerns of investors over the demands of their voters. Far-right populism has emerged in part as a reaction to economic anxiety generated from the inequalities and (geographical) disparities that advanced stages of capitalism has unleashed upon electorates in high-income countries (Halikiopoulou and Vlandas, 2019; Hopkin, 2020; Bolet, 2020). Because they represent the interests of those who have been left behind socially and economically, (far-right) populist parties tend to champion policies (trade protectionism, economic nationalism, and welfare chauvinism) that refute neoliberalism (Rathgeb, 2024; Johnston, 2024)[6]. Foreign investors should draw particular ire from far-right populist governments, given their elite *and* non-native status.

We predict that the capacity of far-right populist governments to better withstand market discipline, especially in higher income countries whose level of (financial) development provides sovereigns with a "seal of approval" that those in developing countries do not enjoy (Brooks, Cunha and Mosley, 2015), stems from two sources. One is electoral and the unique pressures that come with placating their political base. Voters for far-right populist parties are not wedded to the ideology of free markets, but rather are more supportive of an authoritarian and interventionist state. These populist voters support trade protectionism (van der Waal and de Koster, 2018) and a "chauvinist" welfare state that provides generous social consumption for natives (particularly for the elderly – see Busemeyer et al, 2021). Unsurprisingly, the economic policy positions of populist far-right parties reflect these voter preferences (Fenger, 2018; Rathgeb, 2024; Johnston, 2024, pg. 9). Because their voters are openly hostile to financial elites, we expect that populist governments will similarly be hostile to market discipline, especially if discipline is strongly influenced by the behavior of foreign investors (going into further detail below, both populist governments we examine in our case studies routinely antagonized speculators, ratings agencies, "Western banks" and "foreign investment funds" when commenting on market reaction to their policies).

Secondly, populist governments may also withstand market pressure institutionally, by actively orchestrating financial nationalist policies that reduce the influence of foreign investors. Financial nationalism represents a view of the world that is nationalist in its motivation for political action, financial in its policy focus, and illiberal in its conception of political economy (Johnson and Barnes 2024). Financial nationalists identify the use and control of central and commercial banks, state-owned and development banks, national currencies, monetary policy and exchange rates, portfolio and FDI flows, taxation, sovereign debt and lending, international reserves, financial regulation, and international financial institutions as tools through which to advance their goals Because populist parties – at least those on the far-right end of the political spectrum – embrace authoritarianism and nativism, they are more likely to advocate for and implement policies that increase government control over the economy in order to favor their core supporters.[7] The privileging of "insider" domestic financial institutions and economic actors over foreign ones is at

[6] Johnston (2024) finds that not only do markets respond negatively to far-right parties entering executives in high-income countries, but these borrowing cost "penalties" also transfer to the mainstream right parties who opt to govern with them.

[7] More recently, Rathgeb (2024) highlights that the economic policies far-right parties deploy are heavily dependent on a country's institutional context, specifically the organization of the welfare state and country's growth model.

the core of financial nationalism (Johnson and Barnes, 2015 and 2024). Financial nationalist policies that (far right) populists have deployed to limit the influence of outsiders include issuing debt in domestic rather than foreign currency, infringing on central bank independence, issuing long-term capital controls, and reducing the influence of foreign banks and investors, in some cases through partial nationalization (Johnson and Barnes, 2015 and 2024; Ban and Bohle, 2021; Oellerich and Bohle, 2024). Such efforts, if successful, can reduce the share of governments' foreign investor base and increase the weight of its captive domestic investors. Foreign investors' threats of exit – and the subsequent need to curtail it – thus become diminished, as the state is less reliant on them for its financing needs.

At the same time, reducing the power of foreign capital can make populist governments more beholden to domestic interests and investors when issuing bonds. While these investors may be more "patient" than foreign investors, their patience may have its limits. Cunha (2024) argues and empirically demonstrates that because domestic investors are better able and more willing to monitor what their governments do (as their financial interests are more intricately tied to domestic policy than those of foreign investors), they can place greater constraints on governments than their foreign counterparts. We speculate that if populist governments increase their reliance on borrowing from domestic sources, this too could potentially increase the structural power of domestic investors. By concentrating their funding base in this way, populist governments that pursue financial nationalism become increasingly dependent on domestic investors for their financing needs. If domestic investors lose interest in purchasing domestic bonds because of risky policies (particularly those that could jeopardize debt re-payment), populist governments will be simply unable to borrow. Moreover, this market disciplinary effect can happen passively rather than actively. Domestic investors' decisions to bow out of domestic bond auctions can be devasting to the financing needs of government, regardless of whether these investors pursue exit and shift their portfolios towards foreign securities.

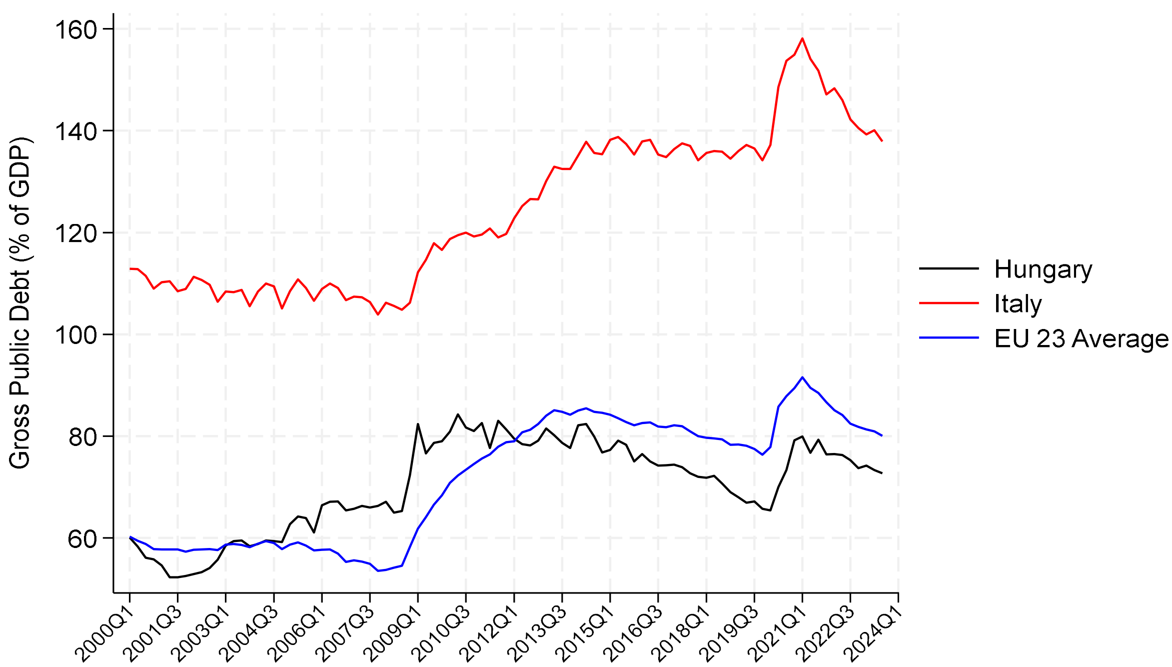
Governments whose executives are exclusively controlled by populist parties are a rare occurrence, particularly in high-income countries. We use a most different case study design of the Lega/5 Star coalition in Italy and Viktor Orbán's Fidesz government in Hungary to examine the constraints that foreign and domestic investors place on populist governments. We anticipate that despite the economic, political and institutional differences they face, both governments should actively resist market discipline and rebuke foreign investors. At the same time, we expect these governments to be especially beholden to the preferences and needs of domestic investors, who we predict will be the most likely actors to pressure these governments into reversing policy course. The next section explains why these cases serve as a suitable most-different systems design, while the following sections trace market reaction to their headline economic policies.

Succumbing to domestic bond "vigilantes"?: A comparative case study of the populist governments in Italy and Hungary

What lends the Lega/5 Star and Orbán governments to a most different case study design is that both of these cabinets radically diverge on a number of independent variables, yet demonstrated similar reversals on some of their most substantial policies in the face of domestic bond market pressures. Differences in independent variables suggest that the Lega/5 Star coalition would be more likely to bend to bond market pressure, while Orbán's government would have been better insulated. Yet despite their significant differences (which we outline below), both governments eventually found themselves "disciplined" by domestic investors.

Both Italy and Hungary had radically different fiscal and financial fundamentals. Italy was one of the EU's most highly indebted countries, both before and after the Euro-crisis (see Figure 1). Roughly 35% of Italy's public debt was externally held between 2000 and prior to the start of the COVID pandemic (IMF, 2023). Public debt in Hungary, in contrast, never exceeded 85% of GDP. While the country witnessed a jump in public debt at the onset of the Global Financial Crisis in 2008, Orbán's II-IV cabinets successfully managed to reduce Hungary's public indebtedness throughout the 2010s (see Figure 1). Externally held debt in Hungary fell from nearly 65% in 2011 to just over 30% by late 2020 (see Figure 4).

Figure 1: Quarterly public debt (2000-2023)



Source data: OECD (2024a) Quarterly Account. EU23 includes the original EU25 countries minus Cyprus and Malta (the OECD does not have quarterly debt data for these countries, or for countries that acceded to the EU after 2004).

Net external lending/borrowing also significantly differed between the two governments, and was far more volatile in Hungary than in Italy. During the 2000s, both countries were external net borrowers but to much different degrees. Net external borrowing in Italy was 0.9% of GDP, while it was 7% of GDP in Hungary (EU AMECO, 2024). Both countries became net external lenders in the 2010s, also to much different degrees (net lending in Italy was 1% of GDP, while in Hungary it was 3.4% of GDP – ibid). The size of both countries' financial sectors was also notably different.

During the 2000s and 2010s, Italy's private credit sector as a percentage of GDP was double that of Hungary's (80% vs 43% - World Bank, 2024). Both countries were also distinctly different in their monetary autonomy, with Hungary having much greater room to maneuver when instability emerged within sovereign bond markets. As a result of its Euro-area membership, Italy lost all recourse to independent monetary policy (another factor that made the country particularly vulnerable to financial market pressure). In contrast, Orbán had actively undermined the National Bank of Hungary's independence, taxed foreign banks, and reduced Hungarian debts in foreign currencies (particularly for household mortgages – see Bohle, 2014) to engineer financial subordination, allowing him to resist IMF and EU pressure for financial and fiscal reforms (Johnson and Barnes, 2015; Mabbett and Schelkle, 2015; Méró and Piroska, 2016).

Both countries also diverge significantly on their political institutions, impacting the ease with which their governments could withstand market pressure and steer through their preferred policies. Again, these differences suggested that Italy should be more vulnerable to bond market pressure than Hungary. Though the Lega/5 Star coalition held a majority of seats in the Chamber of Deputies and the Senate after the 2018 general election, the government faced much higher legislative fractionalization and effective number of parties, as well as stronger and more numerous checks and balances, than Orbán's cabinets, particularly after its 2014 electoral super-majority allowed Fidesz to legally amend the constitution to consolidate its control of government (Armingeon et al, 2023; Kelemen, 2017: pg 219)[8].

Despite these differences, however, the market managed to discipline both governments, causing them to yield on their preferred policies and adopt more moderated stances. It is important to note that market discipline of these populist governments was not a foregone conclusion, even for Italy where market discipline was most likely to be effective. For months, the Lega/5 Star government actively berated bond market investors (and the EU Commission), claiming that their People's Budget would not be modified because of the actions of bond speculators or threats from the European Commission over compliance with the EU's fiscal rules. As we outline below, when the coalition's U-turn on its People's Budget came in late November 2018, it was after *six months* of rising spreads, mass bond sell-offs by foreign investors, and the intensification of the sovereign-bank link as Italian banks were forced to purchase bonds dumped on the secondary market. Likewise, Orbán's fiscal and financial policies were probably *the most* insulated from market pressure in advanced market economies, the result of over a decade of financial nationalism (Johnson and Barnes, 2015 and 2024). But when domestic investors refused to buy enough forint-denominated debt to cover the government's budgetary commitments and pushed up yields precipitously in the highly inflationary environment of 2021-22, the government was forced to introduce fiscal consolidation, return to forex bond markets, and capitulate to EU demands to preserve its access to EU funding.

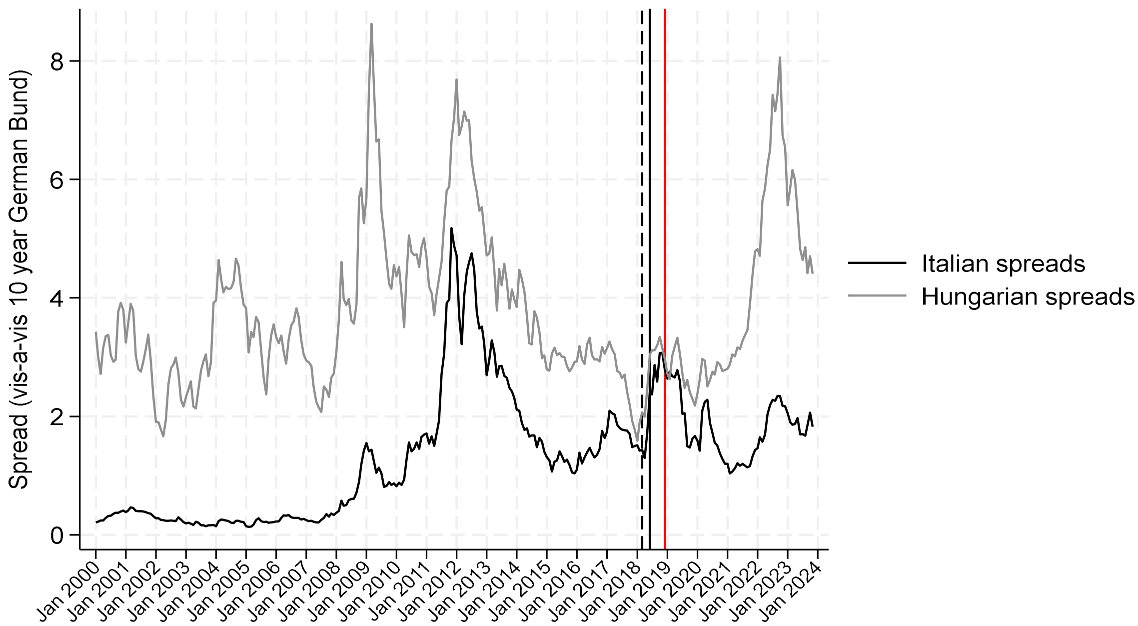
[8] Because neither party held over 40% of seats in the Chamber of Deputies, the Lega/5 Star coalition's rule was particularly vulnerable to political infighting. Disagreements between the two parties on the construction of a high-speed train line between Turin and Lyon eventually triggered a fall in the government in August 2019 (Gasseau and Maccarrone, 2023; pg. 194)

Italy's "People's budget"

Even before the March 2018 general election, it was clear to market actors that populist parties were on track to assume a notable influence on government policy in Italy. In its April 27, 2017 downgrade of Italy to BBB (placing Italian debt just two notches about junk), the credit rating agency Fitch explained that political risk in the country had increased as did "the possibility of populist and euro-sceptic parties influencing policy", noting that the possibility of a Lega/5 Star government would "increase the pressure for fiscal loosening" (Fitch, 2017). Both La Lega's and 5 Star's electoral campaigns centered around hostility towards the European Union (Conti, Pedrazzani, and Russo, 2022) and towards reversing the reforms of prior governments whose policies were passed in an attempt to appease markets during the height of the Eurocrisis. Mario Monti's Fornero reform was explicitly singled out; the pension reform was introduced unilaterally, equalized the retirement age for women and men to over 66.5 years and abolished seniority pensions, something which the Lega vehemently opposed (Afonso and Bulfone, 2019: 247). Lega and 5 Star were the only two major parties that openly campaigned on lowering the retirement age (Maggini and Chiaramonte, 2019 pg. 81) and were unabashed in their criticism of the Euro and the EU's fiscal rules, as they advocated for increasing deficit spending to finance their social and tax policies (Gasseau and Maccarrone, 2023: 188). Though the 2018 Italian election yielded a hung parliament, it was clear that 5 Star and the Lega would either be in the new government or significantly influence it – both parties captured roughly 55% of seats in the Chamber of Deputies and 54% of seats in the Senate (Paparo, 2018; 69).

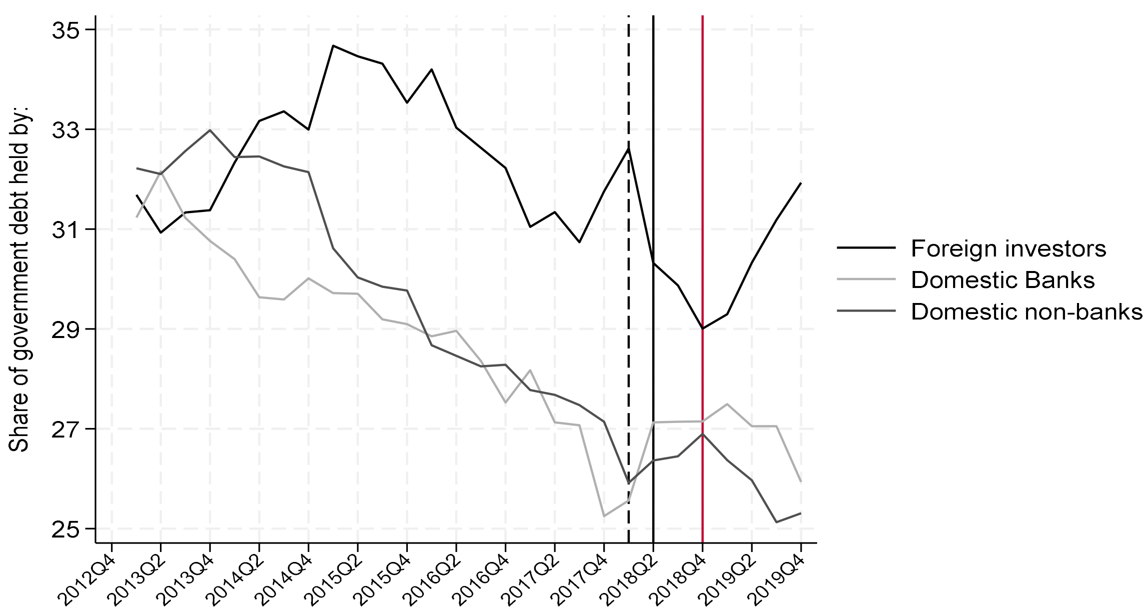
Coalition negotiations between the two parties took roughly three months to conclude before Western Europe's "first populist government" assumed power (on June 1). Unease about Italian bonds seeped into markets after the March election - between April and June, spreads rose by over 112 basis points (OECD, 2024b – see Figure 2), which was largely driven by the portfolio decisions of foreign investors. After election results became clear, foreigners immediately began to sell Italian securities – most of them government bonds – while domestic investors increased the shares of foreign assets in their portfolios (IMF, 2019: pg 8). Italian banks were the domestic investors who stepped in to buy the majority these bonds – by April alone, domestic banks bought €45 billion in government securities (ibid, see also Figure 3), which would expose their capital ratios and funding costs to rising Italian spreads and reinforce the sovereign-bank link.

Figure 2: Italian and Hungarian spreads (monthly), 2000-2024



Source data: OECD (2024b) monthly accounts. Note: Dashed black line is the month (March) of the 2018 election, solid black line marks the start of Conte's first cabinet (June 1st). Red line marks the approval of the revised budget (December, 2018).

Figure 3: Holders of Italian general government debt (quarterly), 2013-2019



Source data: IMF (2023). Note: Dashed black line is the quarter (Q1) of the 2018 election, solid black line marks the start of Conte's first cabinet (Q2, 2018). Red line marks the approval of the revised budget (Q4, 2018).

Turbulence rose further in May when La Lega and 5 Star unveiled their governing "Contract" on the 18th. Though both parties had toned-down their anti-EU rhetoric (removing any discussion of an 'Italexit' from their policy agenda), the contract included the introduction of a flat tax (a key priority for La Lega), a universal basic income (a key policy priority for 5 Star) and the reversal of the Fornero reform (a priority for both) (Conti, Pedrazzani, and Russo, 2022; Codogna and Merler, 2019: 298-299). A week later Moody's placed Italy's Baa2 credit rating (just two notches above junk) on review for a downgrade, citing a material weakening of Italy's fiscal position in the new contract for government as its sole reason for doing so (Moody's, 2018a). Spreads rose, placing further pressure on Italian banks, whose shares dove sharply: five of the ten worst-performing stocks on the Italian stock exchange (FTSE Milano Indice di Borsa) in May were those of Italian banks (Cornish, 2018).

Perhaps because of uncertainty within financial markets, Conte's government did not provoke immediate confrontation with Brussels upon the conclusion of deliberations under the European Semester in early summer. In its June 28th meeting, the European Council (which also included Conte as Italy's Prime Minister) endorsed the Commission's recommendation that Italy had to increase its structural balance by 0.6% in order to comply with the EU's fiscal rules (Fabbrini and Zgaga, 2019: 285). These commitments, however, were openly abandoned just several weeks later. On September 27, the coalition published its *Update to the Economy and Finance Document* – rather than committing to a 0.8% deficit in 2019 and a balanced budget in 2020, the government planned to run a deficit of 2.4% of GDP in 2019, 2.1% in 2020 and 1.8% in 2021, a blatant violation of the EU's fiscal rules (Codogno and Merler, 2019: 299). Sell-offs of government bonds by foreigners intensified – between the second and third quarter of 2018, €72 billion in Italian securities (80% of which were government bonds) were removed from the portfolios of foreign investors, which widened Italy's Target 2 balance to its highest levels since the launch of the Euro (IMF, 2019: 8). By October, bond yields on the 10-year Italian treasury bond were over 3 percentage points higher than that on the 10-year German bond, a level not seen since the most intense moments of the debt crisis in 2012 (OECD, 2024b – see Figure 1). On October 15, fiscal loosening was further solidified as the government released the Draft Budgetary Plan (DBP), which kept intact its policy promises for a flat tax, universal basic income and the reversal of previous pension reforms (Gasseau and Maccarrone, 2023; pg 193). Just four days later, Moody's downgraded Italy to one notch above junk (Baa3), justifying its move on account of the budget and the country's "higher susceptibility to political event risk than ever before" (Moody's, 2018b). Standard & Poor's similarly cited these concerns when changing Italy's credit rating (at BBB) outlook to negative on October 26 (S&P, 2018)

Salvini and Di Maio knew the Commission would reject the budget (the Commission did exactly this a week later from the DBP's release on October 23, the first time it had rejected a member-state's budget since being granted this power in 2013 - Gasseau and Maccarrone, 2023; pg 193). Yet both remained defiant not only against the EU but also increasingly against financial markets, and particularly against foreign investors. Di Maio claimed that the government "would no longer satisfy rating agencies and financial markets while stabbing Italians in the back" and that when faced with a choice between bond yields and the Italian people, that he would "choose the Italian people" (Riegert, 2018; Ewing and Horowitz, 2018). Similarly, just one day prior to the downgrade from Moody's, Salvini asked "Should I change my policies – my agreement with Italians – on the basis of what some speculators decide in the morning? No." (Follain et al, 2018). After both the Moody's downgrade and the Commission's rejection, Salvini became more tenacious on his commitment to the People's Budget, claiming that "no one will take one euro from this budget" (Aljazeera, 2018). Di Maio made similar claims in early November. Despite growing market panic around Italian bonds, and the subsequent pressure it placed on already fragile Italian banks that increasingly had to buy them as they were sold off by foreign investors, he claimed "The budget will not change, neither in its balance sheet nor its growth forecast" (France24, 2018). In response, the Commission initiated the first step towards opening the (debt-based) Excessive Deficit Procedure against Italy on November 21, claiming that sanctions against the government were now "warranted" (European Commission, 2018, pg 21).

The Lega/M5S had defined itself on opposing the EU's fiscal rules. Yet in late November, the government changed its tone on its budget and reversed course. The coalition government could easily anticipate the actions of the European Union against the budget. They did not anticipate, however, how domestic investors would react to these events. The November 22, 2018, bond auction of the BTP Italia sent a dramatic signal to the Lega/MS5 coalition about the realities of its borrowing capabilities, and domestic investors' tolerance of their spending policies. In 2012, the Ministry of Economy and Finance (MEF) introduced the issuance of the BTP Italia, the first Italian government security that was indexed to inflation and was conceived to meet the needs of retail investors (MEF, n.d.). These bonds (whose maturities range from 4-8 years) are auctioned twice a year (with the exception of 2012, where there were three auctions). In the 6th issuance (released April 17, 2014) bonds were auctioned in phases, with the first phase going to retail investors and the second phase going to institutional investors (which include pension funds and asset managers). The regularity of their issuance, and the details of their placement by the MEF immediately after they are concluded, allows one to effectively track the impact of politics on demand for Italian debt in primary markets among foreign and domestic buyers. Table 1 provides details for each issuance wave, including the total amount of bonds sold, its coupon rate and length of maturity, (for issuances after 2013) details on the sales in its first and second phases, and the total amount of bonds in the issuance that went to foreign and domestic investors.

Table 1: BTP Italia Issuances (2012-2018)

					First phase				Second phase			Total sale	
Issuance	Date (closed)	Amount Sold (billons of €)	Coupon Rate	Maturity	Number of concluded contracts	Share of contracts less than €20,000	Total turnover allocated (billions of €)	Share going to domestic investors	Number of contracts	Total turnover allocated (billions of €)	Share going to domestic investors	Amount bought by domestic investors (billions of €)	Amount bought by foreign investors (billions of €)
1st	3/23/2012	7.291	2.45	4 years	133,479								
2nd	6/8/2012	1.73		4 years	44,688	61							
3rd	10/18/2012	18.017	2.55	4 years	186,698	57							
4th	4/16/2013	17.056	2.25	4 years	196,509	50	17.056	88					
5th	11/6/2013	22.27	2.15	4 years	299,588	46	22.27	92					
6th	4/17/2014	20.564	1.65	6 years	170,217	50	10.068	95	1054	10.496	76	17.542	3.022
7th	10/23/2014	7.505	1.15	6 years	82,642	50	4.572	~100	359	2.933	96	7.388	0.117
8th	4/16/2015	9.379	0.5	8 years	75,374	45	5.379	~100	687	4	88	8.899	0.480
9th	4/7/2016	8.014	0.4	8 years	54,635	45	4.214	93	550	3.8	89	7.301	0.713
10th	10/20/2016	5.22	0.35	8 years	31,019	46	2.219	95	293	3.001	98	5.049	0.171
11th	5/19/2017	8.59	0.45	6 years	55,945	49	3.189	92	427	5.401	74	6.931	1.659
12th	11/16/2017	7.11	0.25	6 years	62,563	47	3.757	98	557	3.35	84	6.496	0.611
13th	5/17/2018	7.709	0.4	8 years	62,728	47	4.057	98	286	3.652	73	6.642	1.067
14th	11/22/2018	2.164	1.45	4 years	31,011	68	0.863	~100	55	1.301	93	2.073	0.091

Sources: Various MEF official communications (see Appendix A for full details)

The 13th issuance of the BTP Italia was auctioned on May 17, just one day before the unveiling of the Lega and 5 Star's governing contract. BTP's 14th issuance, auctioned on November 22, was the first under the populist government at perhaps at its most defiant moment in its defense of its budget. Prior to the 14th issuance on November 22, 2018, financial analysts believed that the government would be able to sell €8 billion at the offering, not far off from what was sold in the 13th issuance (Ainger and Hirai, 2018). The coalition government tried to spur interest in the auction amongst domestic investors, with Salvini even advocating for the introduction of financial nationalist policies like tax breaks to Italians for purchasing government bonds to limit the share of Italian debt going to "foreign investment funds" (Riley and DiDonato, 2018). It is important to emphasize that the overwhelming majority of BTP Italia issuances were purchased by domestic investors (on average, over 90% of the issuances are purchased by domestic retail and institutional investors). Foreign investors rarely purchased over a billion Euros in debt within singular issuances (see Table 1); if their purchases ceased, the Italian government would still be able to raise ample funds at its regular bond auctions from domestic audiences.

However, the November 22 auction proved that even Italian investors had their limit. Despite its higher coupon rate reflecting elevated political risk, the sale (€2.164 billion) was only a fourth of the amount that the government anticipated it would raise. Contract bids plummeted: contracts from retail investors declined by 50% relative to the 13th issuance (with an ever greater share of those contracts requesting smaller bond amounts – 68% of contracts in the first phase were for debt amounts of €20,000 or less, compared to only 47% of contracts in BTP Italia's May 17 auction). Contracts from institutional investors declined by 80% (see Table 1). Crucially though, domestic purchases declined by almost 70% from the previous auction and were a mere *quarter* of the average of domestic purchases from the prior eight auctions. The "People's budget" would simply not be viable unless the coalition government could raise sufficient funds from domestic investors – the result of the November BTP Italia auction indicated they might not be able to do so.

Di Maio and Salvini could not ignore the implications of being shunned by domestic bond investors (and potentially shut out of bond markets), particularly given Italy's high level of indebtedness and ever rising debt servicing costs resulting from the budget stand-off. The day after the 14th BTP Italia auction, Di Maio announced that he saw "room for dialogue" on Italy's budget plans with the European Commission. After claiming so, Italian bond sales in the secondary debt market rallied (Ainger and Hirai, 2018). After a meeting with Commission officials, the Conte government scheduled a budget law on December 12 that reduced the deficit from 2.4% to 2.04%, a number which would avoid the Excessive Deficit Procedure and comply with the EU's fiscal rules; the law would later be approved by the Italian Parliament on December 29 (Fabbrini and Zgaga, 2018; pg. 286; Gasseau and Maccarrone, 2023: pg 195). Cuts to the budget – worth €7 billion in total (Fortuna, 2018) - were largely placed on 5 Star's universal basic income proposal and the proposed reversal of the Fornero pension reform (Tondo and Giuffrida, 2018)[9]. With the approval of the budget, Italian bond spreads fell, and holdings of Italian debt by

[9] Conte also introduced new revenue measures, which included selling off more state assets than in the prior version of the budget, to produce a deficit that complied with the EU's fiscal rules (Fortuna, 2018).

foreign investors rose (see Figures 2 and 3), indicating that markets had regained confidence in government securities. Crucially though, this *recovery* in confidence among *foreign* investors was only made possible because of the severe implications of the *loss* of confidence from *domestic* investors a month earlier.

Hungary: The Limits of Financial Repression

The Hungarian government has pursued financial nationalist policies ever since Viktor Orbán and his Fidesz party came to power in 2010, creating a "financial vertical" that consolidated state control over the central bank, credit provision, and domestic financial institutions (Johnson and Barnes 2015, Karas 2022). As Orbán boasted in his February 2014 State of the Nation address, "we have had enough of the politics that is forever concerned with how we might satisfy the West, the bankers, big capital and the foreign press. . . . Over the past four years we have overcome that … subservient mentality."[10]

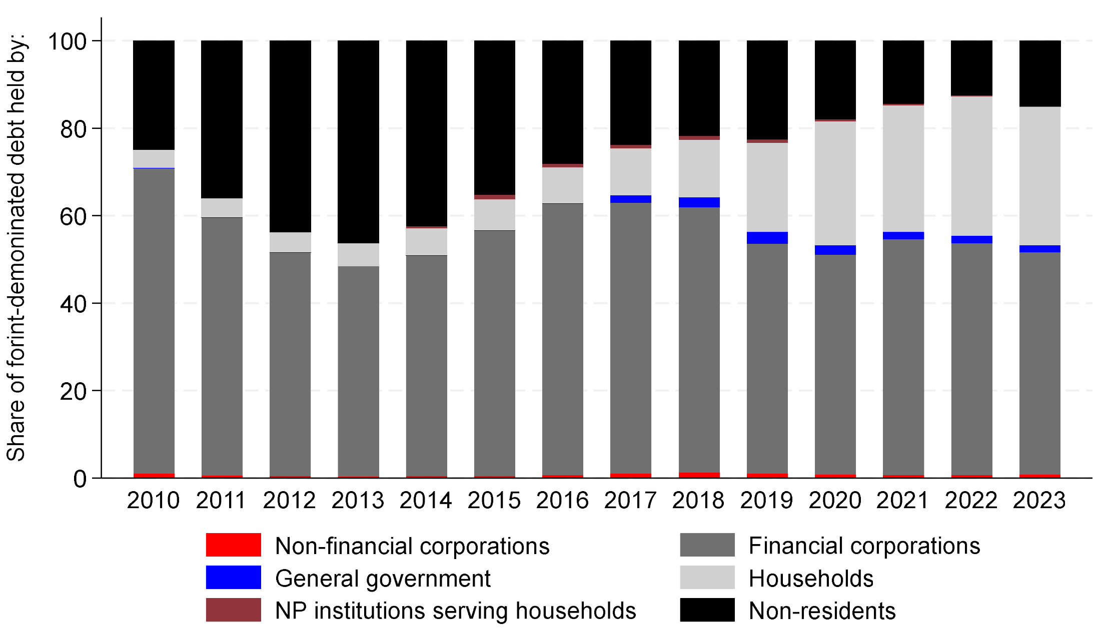
As a key part of this strategy, the Orbán government significantly increased domestic ownership in the banking sector, shifted its government debt into forint, and relied increasingly on domestic financial institutions and households to finance that government debt. When Fidesz came to power, over 85% of the Hungarian banking sector was foreign owned; that percentage had already fallen below the government's 50% target by 2014 through a combination of foreign exit and domestic acquisition. Although foreign bond investors had continued to finance Orbán's heterodox economic policies in the 2010s despite Hungary's bond ratings falling below investment grade from 2011-15, the Orbán government felt that empowering domestic bondholders would give it even greater policy control and free it from the potential threat of foreign "bond vigilantes." Forex-denominated government debt fell precipitously from over 50% of the total when Orbán took power to around 15% by 2020.[11] While foreign investors held nearly 65% of Hungary's total government debt in 2011, this had fallen to just over 30% by late 2020 (National Bank of Hungary, 2024 – see Figure 4). Moreover, while non-resident investors held 44% of Hungary's forint-denominated government debt in 2012, this percentage steady declined as well and was only 14% by 2021 (ibid – see Figure 5).

[10] Viktor Orbán, State of the Nation address, 14 February 2014, https://2010-2014.kormany.hu/en/prime-minister-s-office/the-prime-ministers-speeches/prime-minister-viktor-orban-s-state-of-the-nation-address
[11] See Gergely Kiss, "National debt: a situation not seen since 2010," 24HU, 22 January 2024.

Figure 4: Holders of Hungarian total general government debt (quarterly), 2010-2023

Source: Authors calculation using data from the National Bank of Hungary (2024)

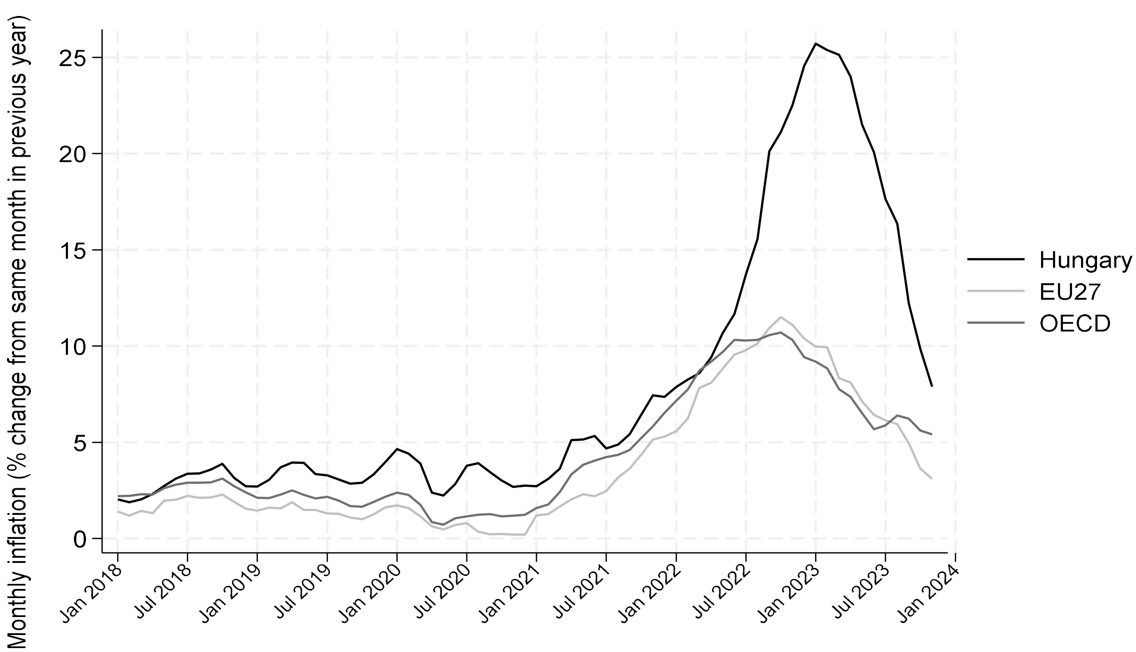
Figure 5: Holders of forint-denominated Hungarian government securities (over 1 year maturity), 2010-2023



Source: Authors calculation using data from the National Bank of Hungary (2024). NP indicates non-profit.

In sum, over the course of two decades the Orbán government completely transformed Hungary's government debt structure from one heavily reliant on foreign investors and currencies to a forint-centric, domestic base, substantially increasing the structural power of domestic finance in Hungary. But while domestic bondholders may typically be more patient than foreign ones, they too have their limits. As both inflation (see Figure 6) and government financing needs rose in Hungary in 2021-22, domestic investors facing unpredictable returns lost their appetite for forint-denominated bond holdings even as yields rose significantly (Figure 2). As a result, the Orbán government was forced to pull back on key election spending promises, return to foreign bond markets, offer more attractive inflation-linked forint bonds to lure domestic investors, and attempt to secure endangered EU funds by agreeing to implement rule of law reforms and support EU financing for Ukraine's war effort. Notably, Hungary's international bond ratings remained investment grade throughout this crisis and foreign investors exhibited relatively strong support for Hungarian forex bonds. Once inflation began to subside in 2023 the government then punished recalcitrant domestic investors through financial repression policies intended to force banks and households to invest in government bonds.

Figure 6: Monthly inflation in Hungary, the EU and OECD (2018-2023)



Source: OECD (2024c)

The Looming Crisis, 2020-21

Hungary's failure to control inflation and the government deficit after the 2020 Covid shock and in the leadup to April 2022 parliamentary elections made the Orbán government's heterodox economic model vulnerable for the first time since its consolidation over a decade before. While

Covid-driven inflation hit countries around the world, Orbán's pre-election spending added significant fuel to the fire. This spending included tax breaks representing 3-4% of GDP, wage hikes, an extra month of pension payments, and bonuses for personnel in the armed forces, among other extravagances.[12] At the same time, the EU finally began to critique Hungary's rule-of-law deficiencies by delaying disbursement of funding tranches rather than with mere words. Despite Orbán's bitter criticism of the EU, Hungary has long been a leading per-capita recipient of EU funding, which represented an important revenue source for the government. Nevertheless, Orbán insisted that Hungary's strong economy would enable it to rebound quickly from these setbacks.

The Hungarian government turned to the bond markets to help meet its precipitously rising funding needs, raising its planned domestic bond issuance by nearly a trillion forint (roughly $2.8 billion) in 2021 (ÁKK 2021). But domestic investors were not on board with this plan, with commercial banks actually reducing their government bond holdings in 2021 and households reluctant to increase their purchases at anywhere near the government's desired rate. As the ÁKK government debt agency noted in its 2021 annual report, rather than rolling over their debt "the redemption of retail securities and domestic bonds exceeded the original plan by 28-39 percent due to higher buy-backs during the pandemic in the Hungarian State Treasury and retail banks," with total debt redemption 11% over the ÁKK's target (ÁKK 2021, p19). The Hungarian National Bank's (MNB) QE program initially propped up the domestic bond market and its balance sheet exploded, with its debt holdings rising from 42.2 billion forint in 2020Q1 to 3618.6 billion in 2022Q1 (ÁKK 2021, p23). But with its bond purchase program ending in late 2021, the government could no longer rely on this support.

The ÁKK noted that "the year 2021 was again an extraordinary year…During the year government securities' yields increased substantially in all maturities. Long term yields went up due to increasing inflation rates and expectations in developed economies and phasing out the government bond purchase program of the National Bank of Hungary, while short term yields increased following the policy rate hikes of MNB from June 2021," (ÁKK 2021). Prior to the crisis the ÁKK government debt agency had a target band for forex debt of only 10-20% of the total and had not issued any new forex debt since 2018. It had also targeted domestic retail holdings of forint securities to reach 11 trillion HUF by 2023, buoyed by an incentive program introduced in June 2019 that made income from government securities tax-free for households (ÁKK 2021). In the face of crisis, neither of these targets would hold. The government was forced to turn to foreign markets because domestic investors were reluctant to finance the government in the quantities necessary to meet its spending plans. After a single euro issue in 2020 the ÁKK had not planned to issue any forex bonds in 2021, but in the end issued four of them for a total of 2.7 billion euro (in USD, euro, and renminbi), in great part to "pre-finance" planned 2022 government spending. For the first time since 2011, the share of government debt held by foreign investors rose rather than fell (Figure 4).

[12] Tamas Csonka, Orban faces perfect economic storm of his own making, 3 October 2022, bne IntelliNews

In great part because of this pressure from domestic bond markets, the Orbán government announced in December 2021 that it would reduce its 2022 deficit target to 4.9% of GDP from 5.9%, postponed its purchase of Budapest's international airport, and froze $1 billion in other planned investments. Analysts observed that "with tax cuts and big state expenditure due in the first quarter ahead of an election in April, the government is likely trying to mute pressure on the local government bond market where yields have increased in past weeks … [Because of unfavorable market pressure] the ÁKK has reduced planned forint denominated bond sales at auctions [in 2022] substantially."[13] Earlier in the fall the government had also announced that it would introduce price caps on fuel and six basic food items to shore up public support and administratively reduce inflation, which had hit over 7.5% per annum by end 2021 (see Figure 6).

The Russian Invasion and Runaway Inflation, 2022

Russia's February 22 invasion of Ukraine and the subsequent market panic and energy price spikes came at the worst possible time for the Orbán government, right before the April 2022 parliamentary elections and as it was attempting to get its difficult fiscal situation under control. The forint fell to record lows against the euro and the MNB hiked interest rates by 1% in March. This began a cycle of forint depreciation, MNB interest-rate hikes, and accelerating inflation that saw the Hungarian inflation rate diverge significantly from that of the EU as a whole, taking off after the invasion and reaching a peak of over 25% annually by January 2023 (see Figure 6).

Hungary's domestic bond market did not react well to these developments. At its March 7 auctions the ÁKK was forced to lift the mandatory market-making requirements for Hungarian primary dealers, with ÁKK head Zoltan Kurali saying that "it would be useless to let primary dealers punish one another by pushing yields higher and higher by trying to fulfil their obligations."[14] The domestic bond market was rocked again in early April after the European Commission announced a new disciplinary procedure against Hungary for its rule-of-law failures, with the ÁKK forced to reduce its already low offerings of its benchmark 10-year forint bond by a third.[15] While sales somewhat recovered in volume afterwards, yields exploded (see Figure 2). In May rising inflation prompted households to sell off high quantities of government securities and the MNB temporarily resumed its purchases to prop up the market.[16] The ÁKK introduced a new inflation-linked bond in June to attempt to lure investors back to the market. Nevertheless, despite increasing government spending needs, by July 2022 retail investors held 64 billion forint *less* in government bonds than they had held at the end of 2021.[17]

[13] Krisztina Than, Hungary trims 2022 budget deficit target to shield local bond market, December 17, 2021, Reuters
[14] Gergely Szakacs and Krisztina Than, Hungary's debt agency steps in to support bond market as forint plunges, 7 March 2022, Reuters.
[15] Hungary: State debt manager forced to cut bond sales on primary auction, 7 April 2022, EmergingMarketWatch
[16] Hungary: Non-residents reduce government security holdings by HUF 126.3bn in March, 9 May 2022, EmergingMarketWatch
[17] Hungary's debt manager fulfils pro-rated financing target by H1, 4 July 2022, bne IntelliNews

The Hungarian government was increasingly forced to react to this market pressure. At a press conference after Orbán's Fidesz party retained its super-majority government in the April 2022 elections, Orbán insisted that he stood behind his extensive spending promises and that Hungary would not need to engage in fiscal consolidation.[18] This bravado, however, faded quickly. On May 24 Orbán pleaded economic woes as justification for extending the pandemic-origin state of emergency in Hungary, allowing him to rule by decree.[19] A few days later the government introduced spending cuts and new "windfall taxes" of over $2 billion on banks and other major companies.[20] Hungarian bankers complained bitterly about this revenue grab, while markets were not sufficiently impressed to firm up substantially. As Economic Development Minister Marton Nagy lamented, "these announced steps strengthen further our shock absorbing capacity. This is not properly reflected by the financial market reactions, like government bond and foreign exchange market movements in the last days."[21]

With domestic bond markets reacting poorly to Orbán's windfall taxes and EU funding increasingly in question, in July the Orbán government introduced much more serious fiscal measures that involved reneging on core electoral spending promises. These tax hikes (including on small businesses) and cuts in energy subsidies, ministry spending, and investment amounted to a reduction of 10% in the original 2022 budget. Demonstrations rocked Budapest in late July in response to the announcements. The *Financial Times* cited a mechanic from Budapest's complaint that "I thought [Orbán] had our best interests at heart. For him to turn around and just slap us with higher taxes and energy bills and pretend it's business as usual, that told me he is not the defender of the people."[22]

In its search for funding, despite its ideological aversion to doing so the Orbán government once again had to turn to foreign bond markets. As the European Commission's 2023 country report noted, "due to decreasing domestic demand for government securities in 2022, debt management had to rely increasingly on foreign borrowing," (European Commission 2023, p5). In June the ÁKK substantially lifted its original 2022 forex borrowing target and issued $3.8 billion worth of USD and euro bonds.[23] At the same time, the ÁKK affirmed that it would keep the total forex debt ratio below 25% and that this would be the last forex bond offering for 2022.[24] International investors reacted enthusiastically, with the bonds oversubscribed and yields reasonable.[25] Meanwhile, as the domestic bond market continued to stall, in late September 2022 the Orbán government introduced two domestic bonds that it hoped would better attract subscribers, the

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[18] Tamas Csonka, Orban faces perfect economic storm of his own making, 3 October 2022, bne IntelliNews
[19] 25 May 2022 Emerging Markets Monitor EMDN Fitch Solutions, Inc
[20] Anita Komuves, CEE MARKETS-Forint, stocks weaker after Hungary announces windfall taxes, 27 May 2022, Reuters News
[21] Hungary's new windfall taxes "temporary and targeted" -minister, 30 May 2022, Reuters News
[22] Marton Dunai in Budapest and Jonathan Wheatley, Hungary's economic woes force Viktor Orbán to bow to EU and investors, 27 July 2022, Financial Times (FT.Com)
[23] UPDATE 2-Hungary issues FX benchmark bonds worth $3.8 bln, minister says, 9 June 2022 Reuters News
[24] ÁKK raises 2022 FX issuance target by up to EUR 2.5 bln, 8 June 2022, Budapest Business Journal
[25] Finance minister: Success of FX bond issues shows investors' trust in economy, 9 June 2022 MTI Daily Bulletin - News in English

Bonus Hungarian Government Security (BMÁP) with an initial annual interest rate of 11.32% and a revised inflation-linked bond (PMÁP) with an initial interest rate of 11.75%.[26] The ÁKK also went back on its claim that its June 2022 forex offering would be the last of the year, floating both a green euro bond and a privately placed bond (its first ever) in November.[27]

While the Orbán government had previously asserted that it could press on and raise money on the market to replace any lost EU funds if necessary, the government's rhetoric changed markedly over the course of the year as both domestic and foreign investors began to focus on the increasingly precarious state of Hungary's EU funding. When forex and domestic bond yields spiked in the latter half of the year due to increasing indications that the EU would suspend Hungary's Cohesion funds and that Hungary might irrevocably lose access to EU Recovery and Resilience Facility (RRF) funds, the Orbán government was forced to make formerly unthinkable compromises with the EU. The government verbally committed in September to meeting all 17 of the rule-of-law targets required to access EU Cohesion funds.[28] The RRF remained of special concern, as failing an EU agreement on its Resilience and Reform Plan by the end of the year Hungary would irrevocably lose access to 70% of the funds.[29]

Under extreme market pressure, the Orbán government agreed on December 12 to a package deal with the EU under which Hungary accepted EU financing for Ukraine and a global minimum corporate tax in exchange for approval in principle of Hungary's Resilience and Reform Plan, paving the way for Hungary to potentially receive the RRF funds of more than 5.8 billion over five years.[30] While this deal avoided a potentially catastrophic bond selloff, much of Hungary's Cohesion funding and the RRF funds themselves would remain frozen until Hungary met stringent EU-defined targets, most importantly those involving rule of law issues (European Commission 2023). The Orbán government could thus not immediately count on EU funding to fill its budgetary holes. An ÁKK announcement the following week reconfirmed that the government would maintain its fiscal discipline in 2023 to reduce inflation and satisfy bond markets, while also admitting that it would miss its 11 billion target for retail securities volumes and would raise the forex debt target cap to 30%.[31]

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[26] Hungary: Hungary to have to tap USD financial market in beginning of 2023 – AKK, 30 September 2022, EmergingMarketWatch and Erste Group - CEE Bond Market Report: Bottom fishing may start soon - Oct 10, 2022, Hungary, 10 October 2022, http://reports.aiidatapro.com/brokers/Erste/298474.pdf

[27] Hungary goes private but ends up under ESG spotlight, 1 December 2022, GlobalCapital, Euromoney Institutional Investor plc.

[28] CEE MARKETS-Hungary's eurobonds hit by EU executive's recommendation to suspend funds for Budapest, forint rebounds, 19 September 2022, Reuters News

[29] Erste Group - CEE Economies Special Report - Hungary: EC to block some Cohesion funds, 29 November 2022, Emerging Markets Broker Reports Central Eastern Europe, http://reports.aiidatapro.com/brokers/Erste/306401.pdf

[30] Gergely Szakacs and Anita Komuves, Hungary's last-minute funding deal with EU averts market selloff, December 13, 2022, Reuters

[31] Hungary: Government plans HUF 3,409bn of net debt issuance in 2023, 20 December 2022, EmergingMarketWatch

Reluctant Investors and Financial Repression, 2023

Despite the EU deal and the government's reluctant fiscal conservatism, domestic bond investors still shied away from government markets in early 2023 as inflation was peaking. While the ÁKK successfully floated $4.25 billion of USD bonds on January 5,[32] it had to reduce the issuance of its benchmark domestic bonds in its January and February auctions because of low demand.[33] Fed up with the recalcitrance of domestic investors, the Orbán government turned to its financial nationalist playbook to engage in more comprehensive financial repression, this time involving more sticks than carrots. On May 31 the government announced a series of measures to both cajole and force domestic banks and households to invest in Hungarian state debt instruments. Money sitting idle in savings accounts would now be subject to a 13% "social contribution tax," households could buy bonds without fees, and banks would be required to inform customers regularly about the potential returns on government bonds as opposed to deposits. Investment funds would be required to hold a significant proportion of their assets in government securities. Banks that increased their government bond holdings could earn a partial break on the windfall tax levies that had been introduced the previous year.[34]

With these measures, the government expected to raise 1.8 million forint in new investment and lower bond yields, which in turn would reduce the government's interest-rate burden. As Economic Development Minister Márton Nagy claimed in relation to the new rules on bank deposits, "we are steering the population towards forms of saving where money retains its real value. There is also the issue of self-financing as a strategic objective."[35] As for the banks, Nagy noted that to be eligible for the halving of their windfall tax obligations some would need to increase their government securities holdings by 40-50%. Not surprisingly, the Hungarian bankers' association bitterly protested.[36]

The measures were successful inasmuch as they quickly led to yield declines (see Figure 2)[37] and an increase in household ownership of government bonds.[38] In October the Economic Development Ministry declared that its financial repression strategy had been "extraordinarily

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[32] UPDATE 2-Hungary issues $4.25 billion worth of dollar FX bonds, 5 January 2023, Reuters News

[33] Hungary: State debt manager reduced bond float on primary auction, 26 January 2023, EmergingMarketWatch and Hungary: State debt manager forced to reduce bond issuance on primary auction, 23 February 2023, EmergingMarketWatch

[34] Hundreds of billions from retail investors could flow to government securities from the HUF8 trillion held in bank deposits, Economic Development Minister Marton Nagy said, bne IntelliNews, 2 June 2023

[35] Charles Szumski, Hungary looks for alternatives to frozen EU funding, EURACTIV.com with Telex.hu , Jun 7, 2023

[36] Hungary: Measures to raise demand for government bonds in excess of HUF 1,800bn, 1 June 2023, EmergingMarketWatch

[37] Erste Group - Macro Outlook Hungary: Challenges after challenges- Jun 19, 2023, Bond Yields, 19 June 2023, Emerging Markets Broker Reports Central Eastern Europe, https://reports.aiidatapro.com/brokers/Erste/335574.pdf

[38] Hungary fulfils 64% of issuance target at end of June, 4 July 2023, bne IntelliNews

effective," generating demand for 1.2 billion forint of government securities from households,[39] although market analysts noted that this was well under the 1.8 billion originally anticipated.[40] But the ÁKK once again had to turn to foreign investors to fill the domestic funding gap, issuing its largest-ever euro bond in September 2023 and raising its 2023 foreign financing plan.[41] In continuing efforts to mobilize household savings, Finance Minister Mihaly Varga announced in November 2023 that the government would pre-emptively create a securities account for each Hungarian citizen.[42] Having been disciplined by its domestic bondholders in 2021-22, the Orbán government responded by disciplining its bondholders in return.

Conclusion

The rise of populism has led to a shift towards illiberal democracy, even in high-income countries (Mudde, 2021). Populists turned autocrats have radically altered political institutions, eliminating checks on their power (such as in Orbán's Hungary or Erdoğan's Turkey). While these efforts have enabled populists to deliver on their policies, we argue and demonstrate that financial markets still remain an important constraint on populist governments. In line with the market discipline hypothesis, we find that markets do constrain populists' macroeconomic policies, but that these constraints do not work through foreign capital flight. Rather populists are constrained by inaction from domestic investors, an audience their policies are designed to privilege and in extreme cases, hold captive.

Our findings have implications for a large literature in IPE on the government/market nexus within an increasingly globalized and financially integrated world. IPE scholars focusing on the influence of foreign investors highlight that bondholders' power comes from "exit, voice, and loyalty" (Cohen, 2003: 126). Our findings suggest a fourth "threat" should be added to this list – inaction. Domestic investors (largely banks and households) in Italy and Hungary exerted their power over populists' economic policies not through exit or voice, but through the deliberate refusal to purchase more government bonds. Foreign investors used the option of exit (willingly in the case of Italy, coercively in the case of Hungary), but populists did not bend in their borrowing decisions to their capital flight. Rather, it was a loss of appetite for bonds among domestic audiences that forced these governments' hands. These findings complement recent work from Raphael Cunha (2024), who raises attention to the "underappreciated role" (and underappreciated power) of domestic investors in an era of globalized capital and asset managers.

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[39] Daily News Hungary · 11/10/2023 · Business Measures to boost demand for government securities 'extraordinarily effective' in Hungary, https://dailynewshungary.com/measures-to-boost-demand-for-government-securities-extraordinarily-effective-in-hungary/

[40] Hungary: Net budget borrowing requirement increases to HUF 4,113bn – AKK, 5 September 2023, EmergingMarketWatch

[41] Hungary lands biggest ever euro tranche, 6 September 2023, GlobalCapital

[42] Faced with rising debt burdens, Hungary's state debt manager phases out popular government bond, 27 November 2023, bne IntelliNews

Our findings also have implications for an emerging literature in CPE on the economic policies of populist parties and the rise of economic nationalism (Johnson and Barnes, 2015 and 2024; Rathgeb, 2024; Oellerich and Bohle, 2024). These works have meticulously dissected the content of populists' economic policies, how they are shaped by domestic institutions, and how international actors can unwittingly enable them, but have not explored how markets might discipline them in practice. Empirically there is good reason for this, as few populist parties have managed to obtain full control over government and fully implement their policy agenda. In examining two of the few cases of Europe's truly "populist" governments, we can observe the pathways market discipline takes in bending economic nationalists into submission. Ironically, populists in these countries were not forced to change course because of the behavior of the outsiders that they so disparage, but because of the loss of confidence among insiders whose interests they champion.

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