The EU moves to punish Hungary

Punishment beckons for Hungary for allegedly breaching core European values. Economic reaction has so far been muted, but reputational damage could hit investment

Viktor Orban, Hungary's Prime Minister at the European Parliament, September 2018

The decision

Hungary is closer to facing censure by Europe for allegedly flouting EU rules. Although we don't see any short-term direct economic consequences from the move, the reputational damage to Hungary and its Prime Minister, Viktor Orban (pictured), could affect investment and rating decisions.

On Wednesday, the European Parliament (EP), approved the Sargentini Report which 'comprehensively lists' a series of issues said to breach the values of the European Union, not least the functioning of the constitutional and electoral system, freedom of expression and interference in academia.

A prolonged investigation period now starts

A total of 448 MEPs voted in favour of the report with 197 against and 48 abstaining, translating into a 69% majority, above the two-thirds needed to trigger the Article 7 procedure. Poland, which says it will block any sanctions against its near-neighbour, went through a similar process in January this year.

We need to highlight that this is still only the preventive phase of the whole Article 7 process; the talking is only now about to start and the European authorities will want to avoid any possible sanctions. The parliamentary vote now pushes the issue in front of the European Council and a proposal will be sent to the EU member states. A prolonged investigation period now starts, where the Council will hear the views of the Hungarian authorities. They'll attempt to assess whether there is a clear risk of serious breaches of the rule of law in Hungary or not. If it feels the concerns are grounded, the Council will vote to push the issue into the next phase. That's where Poland is right now.

Economic and reputational consequences

The recent decision does not have direct consequences as far as the 2014-2020 EU programming period is concerned, but it can put additional pressure on the Council to adopt a more cautious approach regarding the investigation and audit on Hungary's usage of EU funds. In a worse case scenario, it could jeopardise the expected inflow from the EU in 4Q18 with a prolonged discussion on the issues. Even then, we don't see it as a real game changer, as the Ministry of Finance and the Debt Management Agency seems to be prepared for that and it's clear that Hungary will meet with all the fiscal rules including the one-twentieth rule on debt reduction and the 3% of GDP deficit rule.

Market reaction has so far been muted

The market reaction was rather muted with HUF, bond yields and the local stock market being relatively stable. Reputationally, the whole process could have a negative effect on investment and ratings decisions. At this stage, however, it's difficult to calculate the effect on the real economy. The highest long-term risk comes from talks regarding the common European budget for 2021-2027, where the EU funds might be tied to a 'rule of law' clause. However, the new ruling must pass unanimously and secondly Hungary has to go through an 11-step process, which we'll detail below, and any eventual sanctions have to be passed unanimously by the European Council so don't hold your breath.

How close is Hungary to get a real punishment?

That's because Hungary is still far away from there; the vote on the Sargentini report was just the **first step** of the 11-step process. In the **second step** – so from now on – the European Council will start its hearings and can pass a proposal by vote to initiate Article 7 proceedings. The Council may pass this proposal by a qualified majority vote, meaning at least 22 of the 28 member states must support the decision. If six member states vote against it, the procedure could be blocked.

The process will drag on

The **third step** is where the European Council initiates Article 7 proceedings and the Council and the Commision together start a thorough investigation regarding which points of the rule of law has been violated. The **fourth step** sees consultations held between the counterparties and the concerned country. The **fifth step** contains a formulated opinion by the European Commission about the alleged violation of the rule of law. Hungary can go pro-active here, taking corrective measures itself, or can refuse the EC's opinion. As a **sixth step** (if Hungary refuses to react to the fifth), the Commision will make recommendations to which Hungary may respond by either respecting these recommendations or by ignoring them. Obviously, if Hungary refuses to change anything, we go to the **seventh step** where the Council officially activates the next steps in the Article 7 process. The **eighth step** is where the preventive mechanism starts, where the Council will need to vote with a four-fifths majority that there is a clear risk of a serious breach by Hungary.

> *Any eventual sanctions will require unanimous backing*

Step nine comes when the EP or the Council proposes the opening of the sanctioning mechanism, but with this, we quickly reach **step ten**, where the Council must decide *unanimously* that there is a serious and persistent breach by the accused country. Then, a qualified majority is needed in the Council to in practice suspend rights of the accused country, including voting rights. With this, we reach **step eleven**, the official closure of the proceedings.

It is unlikely we'll get to that point, not least because of Poland's support for Hungary, which has said it will oppose any sanctions that may be imposed on the country. And it's not clear when the next steps will be taken or what the eventual consequences will be.

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