Hungary's Investment Profile – A Macroeconomic Background

Csaba Moldicz

In the early 90s, after the collapse of the centrally-planned economic and the non-democratic, centralised political system, Hungary underwent a painful economic and political transformation which had led to the complete transformation of the domestic institutional system, the dominance of private business, integration into the global production networks and to the emergence of a new economic structure. Since the beginning of the nineties, Hungary has been the only country in the Central European region in which every one of the elected governments has been able to fulfil their mandate (except for a few changes of government heads), hence political stability has been one of the most important long-lasting characteristics of Hungarian domestic politics. This remarkable political stability has been coupled with the inflow of foreign direct investment in the production and services sectors alike, which are the cornerstones of the rapid structural modernisation of the economy. The relatively favourable domestic and international environment, however, changed after the economic crisis of 2008, and some very serious challenges started to surface, the solution of which required adjustments in the economic policy in order to restore macroeconomic equilibrium and meet the increasing global competition in recent years.

Structural problems and macroeconomic imbalances prior to 2008

Despite early successes in economic transformation, the global financial crisis in 2008-2009 exposed long-term problems and deep imbalances in the economy. In the period before the global financial and the European debt crisis, Hungary had developed several economic weaknesses, which remained concealed under the then favourable international economic environment.

1. Following the late nineties, economic growth had continued to be robust in Hungary until 2005 (although average growth rates were lower than in the majority of the CEE countries), but this relatively favourable expansion was coupled with large imbalances. Current account deficit was high (4-8 precent of the GDP) public and private debt had been rising steadily before 2008. Traditionally, growth tends to coincide with

imbalances on the current account and with growing indebtedness in the Hungarian economy. It took severe financial and real economy adjustments to break down this vicious circle and to turn the current account deficit into a surplus in 2009 and maintain it along with relatively favourable economic growth figures in European comparison ever since. A similar problem was observed with respect to public deficit. Hungary persistently maintained a high budget deficit even during periods of rapid growth. This was different from several other countries in central Europe where rapid GDP growth, in most cases, was coupled with improving budget positions and debt indicators. This structural weakness had left Hungary vulnerable to international demand shocks.

2. The other feature of the pre-2008 period was the imprudent regulation of the banking sector which had led to the over-indebtedness of private households and firms. After the eruption of the credit crisis, the lack of domestic savings and lack of confidence in the international financial markets stopped the money flowing into the Hungarian economy. International financial liquidity was of utmost importance for the country since a large share of its public and private debt was denominated in foreign currency. The excessive state and private indebtedness exposed the country to international financial risks.

3. Another long-term problem which had not been successfully tackled yet by policy-makers was the low employment rate. Large segments of the labour force had been hard hit by the economic transformation of the nineties and made their knowledge and skills obsolete in the new economic structure. Thus they were unable to find a job or acquire new skills required by the business sector. In addition to the permanently high budget deficit, the low employment and labour market participation rate was yet another important reason behind the relative over-taxation of the Hungarian economy (including households and the corporate sector too) in comparison with its major competitiors. Hungary had an internationally high share of income centralization and redistribution ratio, which was not reflected in the quality of public services.

4. The economic model which had been built on external foreign financing was shaken by the credit crunch evolving from 2008. Hungary was the first country to apply for IMF funds, almost immediately after the collapse of Lehman Brothers in 2008. This step was a clear confession of the fact that despite the rapid modernisation which the economy had undergone in the previous two decades, the external vulnerability of the economy remained unchanged.

New trends and economic policy changes after 2008

Several conclusions were drawn from the economic shock during the economic and financial crisis. First, experiences triggered the need to remove the dependence of economic development on external debt generating funds. As a result, the objective since then has been to broaden the basis of economic growth and to include international trade, capital, and loan connections and the domestic demand factors in a more balanced way, which includes active labour market intervention too. The second conclusion was that the macroeconomic balance must be restored by controlling the budget deficit and decreasing public and private indebtedness.

After the parliamentary elections in 2010, the newly formed government was able to adopt and implement regulations reforming the entire economy. After the growing political uncertainties of the post-2008 economic crisis, political stability was now a very important factor and precondition to making any major reform. This political stability came in the form of an unprecedented two-thirds majority the government enjoyed between 2010 and 2014, and this level of power was more or less maintained after the 2014 elections too.

One of the features of the new economic policy that has emerged since 2010 is the application of the reasoning of economic theories which seeks to explain the risks and problems through the negative impacts of a liberalized international economic environment. This policy seeks out to have capacity, power and independence to define the directions of domestic development, give preference to domestic companies over stronger foreign competitors, and provide protection against foreign monopoly or oligopoly situations. At the same time, this principle acknowledges the importance of foreign-owned manufacturing firms in the Hungarian economy by concluding so-called “strategic agreements” – instruments that express the government’s intentions to promote their continued operation in Hungary.

The other objective was to strengthen the power of domestic economic policy decision making and broaden its room for manoeuvre. The government’s role in shaping the economy had increased after the crisis and included direct and indirect involvement in economic processes. The primary objective of this approach is to increase independence from international influence, which was, for example, demonstrated by the early repayment of the IMF loan and the adoption of a more critical approach to EU decision making practices. This goal was also an important factor behind the growing emphasis on trade and economic relations with countries which had previously been neglected or had not been considered important to Hungarian external economic relations.

With respect to domestic economic challenges, the economic policy attempted to find a solution to the low employment rate (which was very low in European comparison) too. In 2010 the employment rate was only 55.9 percent, while the EU average was close to 69 percent. By 2014, the difference was reduced to only 1.5 percentage points. (EU: 68.2 percent; Hungary: 66.7 percent) Reducing the average corporate tax and introducing new forms of taxation, and deregulating the labour law were also important elements of the reforms designed to increase labour market participation. In addition to this, the other fundamental pillar of this policy was to cut social benefits and transform them into work opportunities. As a result, a public works scheme was set up securing around 250,000 publicly financed jobs. After a peak in 2010, the Hungarian unemployment rate was improving between 2010 and 2014 resulting in favourable data in EU comparison. (EU: 10.2; Hungary: 7.7 percent in 2004) In order to reform the labour market and to increase participation rates, not only demand conditions were supposed to be altered, but the supply side had also to be uprooted. To this aim reforms in the educational system were also introduced. The major objective of this transformation from a labour market perspective was to adjust the output of the education system to better suit the needs of the industry, which is still the backbone of the Hungarian economy. (See more details on the major directions of change in Hungarian higher education on page: 55.)

Special measures were also introduced in order to increase birth rates in Hungary. Family friendly taxation was put in place in 2010, in particular for families with more than two children. Since demographic trends are difficult to change, the challenge presented requires a complex solution.

After 2010, low domestic savings coupled with high indebtedness were extremely urgent issues to deal with. (High indebtedness in foreign currency was not only a characteristic within the housing market, but it was also apparent in other sectors of lending.) To reverse indebtedness, from 2010, several saving schemes have been introduced and a financial deleveraging process of the private households has been supported by different state schemes and policies. One of the most notable and successful measures was the stimulation of savings by relatively high (In international comparison) interest rates on government bonds. Other measures were aimed at the restructuring of foreign currency debt into domestic currency denominated liabilities. At the same time, the deleveraging process of the banking sector had already been started in 2009. In order to prevent excess-lending, new legislation was adopted restricting lending in foreign currencies and irresponsible lending practices. These measures have helped decrease the domestic financial vulnerability of the country, which is a very important factor in economic stabilisation.

Another feature of the economic policy was the introduction of special taxation on several economic sectors with high potential to generate revenues and profits in order to secure funds to finance the much needed reduction of the payroll and also to manage the parallel problem of high budget deficit. The new sectoral taxes were levied on the banking-, energy-, telecommunication sector, and retail chains. Sectoral taxes had not been mainstream economic policy instruments in Europe prior to the economic crisis, but since then several economic policies have applied similar measures (although their objective and particulars may vary widely in the countries that have applied such instrument). Another source of funding came from the nationalization of the private pension funds.[1] These private savings had made the financing of the public pension scheme difficult in view of the budget deficit reduction requirements during the period of low growth and recession after 2008. (Hungary had to decrease its budget deficit in order to be eligible for EU transfers, a very important source in financing public investments.) This step was also heavily criticised by international economic organisations, but not many viable options were offered in place. In recent years, a number of countries introduced similar, although slightly different measures (mostly because they did not find alternative and sustainable source to increase budged revenues). As a result of this strategy, the country has been able to keep the budget deficit under control and since 2012 the deficit has steadily remained below 3 percent of the GDP. This is a remarkable achievement after several decades of very high budget deficit, particularly in a period when most EU countries are still facing the challenge of relatively high budget deficit and the incessantly spiralling government debt problem.

Table 1

General government deficit (percent of GDP)

	2011	2012	2013	2014
EU28	4.5	4.3	3.3	3.0
Hungary	5.5	2.3	2.5	2.5
Portugal	7.4	5.7	4.8	7.2
Spain	9.5	10.4	6.9	5.9
Italy	3.5	3.0	2.9	3.0
Greece	10.2	8.8	12.4	3.6
France	5.1	4.8	4.1	3.9
United Kingdom	7.7	8.3	5.7	5.7

Source: Eurostat

1 Compulsory private pension fund system was introduced in several Central and Eastern European countries in the nineties in order to diversify pension savings.

Table 2

Public debt (percent of GDP)

	2011	2012	2013	2014
EU28	81.0	83.8	85.5	86.8
Hungary	80.8	78.3	76.8	76.2
Portugal	96.2	111.4	126.2	129.0
Spain	69.5	85.4	93.7	99.3
Italy	116.4	123.2	128.8	132.3
Greece	172.0	159.4	177.0	178.6
France	85.2	89.6	92.3	95.6
United Kingdom	76.6	81.8	85.3	86.2

Source: Eurostat

The policy changes also affected the country's external economic strategy. After 2008-2009, fiscal and monetary policies in the centres and large countries of the world economy (US, China, Russia, India, Indonesia and Western Europe etc.) had successfully mitigated the risks of another global credit crisis. In the Eurozone, however, this could not prevent a new wave of crisis, which deepened with the financing problems of Greece in early 2010 and the crisis had also hit other Eurozone countries (often called PIIGS[2]). This crisis affected the Hungarian economy adversely through two channels: (1) the demand for Hungarian exports remained relatively weak, and (2) European financial uncertainties curbed the demand for Hungarian assets which contributed to exchange rate volatility. In response to this challenge, a concerted policy to diversify Hungarian trade relations was put in place. The main goal of this policy change was to boost Hungarian exports into fast growing regions and economies and encourage investments from these countries in Hungary. (See more on this diversification strategy on page 17.)

Conclusions

In recent years the Hungarian economic policy changed enormously compared to the previous decade. This was partly caused by the unprecedented external global economic hardships, and – more specifically – those sustained by Hungary's most important economic partners in the European Union. Not only do these challenges force countries to seek new methods and instruments of crisis management, but they also

2 PIIGS: Portugal, Italy, Ireland, Greece, Spain

question mainstream economic theories underpinning current economic policies.[3] It is not clear at the moment which strategies may be the best in this fast-changing economic environment. The Hungarian strategy seems to be successful in several respects at this moment (financial stabilisation especially) but there are several challenges remaining (most importantly sustainability concerns) which require continuous economic policy responses. Looking at the data, the following conclusions can be drawn:

Growth: GDP growth in the Hungarian economy between 2010 and 2014 was greater than the EU average, but it was not really remarkable in comparison with some of the other Central European countries. In 2014, however, the GDP growth was the third fastest in the EU (only Ireland and Luxembourg were able to deliver better results). The coming years are burdened with several risk factors, but if no major external shock occurs, a 2-3 percent annual GDP growth can be realistically maintained.

Financial stability: In this respect, the country has been very successful. Not only was the growth of government debt curtailed, but the trend was reversed after 2010. In 2010, general government debt was 80.9 percent, in 2014 only 76.9 percent. This result is remarkable given the increasing trend in a number of countries (See *Table 2*) Similarly, the government has been successful in balancing the government budget and since 2012, the annual government deficit has been below 3 percent of GDP – a major achievement in macroeconomic stabilisation.

Labour market: "The number of employed rose to an all-time high and unemployment rate dropped to an all-time low in 2014. (European Commission 2015b) Along with substantial gains in productivity, in particular in manufacturing, average monthly earnings before taxes were up by 16.2 percent on 2011. Also, the real adjusted gross disposable income of households per capita improved between 2010 and 2014. It does not mean that Hungarian wages are high in international comparison. On the contrary, one of the crucial challenges in the coming years will be related to the much-needed expansion of incomes. We may expect that growing purchasing power provides excellent opportunities for foreign firms to export to or invest in Hungary in an effort to satisfy growing domestic demand.

3 See the current global debate on the role of state in the economy and the design of the best economic policy. Neoliberal mainstream theory lost its credibility in recent years, but no new, effective, economic theoretical framework has yet crystallised.

Investments: The Hungarian property market began recovering in 2014, but continues to remain an undervalued sector in comparison to the Western European ones. The same is true for the very liquid Hungarian stock market, which lists most strategically important Hungarian firms. Due to investments in manufacturing, Hungarian industry is highly competitive. Skilled labour, modern infrastructure (the network of motorways is fully built up) and the central location in Central Europe have been very strong incentives for foreign investors to show interest in the Hungarian economy. The deregulation of the labour market and the joint efforts of higher education and industry, the new tax schemes and tax reductions also invite investors in the Hungarian economy. The European Union plays an important role in financing public investment projects in Hungary, and this will continue over the next five years. As a result, the country's infrastructural network is expected to further improve in the coming years along with the overall competitiveness.

Table 3

Economic indicators 2010-2014 (percent of GDP)

	2010	2011	2012	2013	2014
Real GDP growth (percent)	0.8	1.8	–1.5	1.5	3.6
Investments	20.4	19.8	19.1	19.9	21.4
General government gross debt – annual data	80.9	81.0	78.5	77.3	76.9
General government deficit/surplus	–4.5	–5.5	–2.3	–2.5	–2.5

Source: Eurostat

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