Hungary's External Economic Strategy – The Need for Diversification

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In the early nineties, immediately after the political and economic systemic changes, the demand in Hungary's most important export markets (the Former Soviet Union and other Central and Eastern European countries) collapsed due to the unfolding transformational recession.[1] The need for the rapid reorientation of trade was now a pivotal objective and the logical choice was the geographically close markets of the Western European countries. In order to facilitate external trade with this region and to get additional development incentive, the unquestionable priority of the country was now to join the European Union, a large single market, as soon as possible. Other regions in the external economic strategy became unimportant. Along this objective, attractive investment opportunities had surfaced for large firms to take over the domestic markets (in every Central and Eastern European – CEE – country) from insolvent local firms through privatization from the early 90s. In addition, export-oriented greenfield investments (Foreign Direct Investments – FDI), attracted by cheap labour and other cost related incentives, also started to increase. FDI was promoted by economic policies in the region, especially in Hungary, due to the scarcity of domestic investment financing. The sudden rush of western business into the region had resulted in several positive structural changes (and a number of negative consequences),[2] and created the basis for an export-led development pattern. This was the case in each of the CEE countries, leading to strong competition for FDI, not least because of the expectation of associated economic benefits in terms of export performance, economic structural change, employment, growth and competitiveness. As a result, for

1 This term was introduced into the economic literature by János Kornai describing the phenomenon developing in all the post-socialist countries in Central and Eastern Europe. He believed that there were similar causes and a common pattern behind this unfavourable development which was different from the usual cases described in the economic cycle theories. Later this term was widely used for economic crises emerging due to the transition from the socialist to the capitalist system.

2 See more on the positive and negative impacts for example: "From plan to market: The transition process after 10 years" (contributors: Berend, I., Svejnar, J., Berglöf, E., Welfens, P., Gomulka, S., Kopits, G., Malle, S., Menzinger, J., Grigoriev, L., Landesman, M., Hare, P., Nagy, A., Elman, M.), *Economic Survey of Europe*, No. 2/3 (1996). The assessment of the transition based on the Washington Consensus and the impacts of the chosen transformation method in individual countries remains controversial.

almost two decades, Central Europe's pre-crisis economic model, including Hungary's strategy was based on export orientation led by large inflows of foreign direct investment with the leading role being played by the European Union in both trade and FDI.

The role of export-orientation – theoretical considerations

Development model questions, the issue of export-orientation, important substitution or other trade related aspects are always in the forefront of the economic and political thinking of countries where convergence towards more advanced regions is amongst the most important economic issues. In the case of emerging markets, export-oriented (or export-dependent) economic development is, in most cases, vital for achieving a certain degree of catching up, although in the long run export constraints may be significantly different from country to country. A large domestic market (or more precisely, significant and rapidly increasing domestic purchasing power) can partly substitute the role of export in GDP growth. Countries with small domestic markets, however, are much more likely to be forced to maintain export orientation in the long run at any price. Some of the heavily exporting countries (measured either in terms of export volume or export/GDP) rely on cheap labour (China etc.), the availability of crucial natural resources (Russia, oil-exporting countries, etc.) or the economies of scale. The impact of export, when based on economies of scale, can be crucial for smaller countries, where even a very limited number of large, export-oriented firms can significantly impact on GDP growth (and jobs). (Of course, the factors on which strong export performance is based may be mixed.) The prospects of these country groups differ with respect to export potential and FDI relations in the coming decade.

1. Cheap-labour countries can face increasing difficulties in a post-crisis world. Although cost factors are still important, at the same time, the speeding up of technological development renders labour force skills even more important as the wage level starts to increase parallel with the growing per capita GDP. This change is clearly reflected in the intensification of reshoring of industries from developing countries to developed nations for example.[3] This applies mostly to the relatively large

3 Paul A. Krugman, Robots and Robber Barons: "[...] one of the reasons some high-technology manufacturing has lately been moving back to the United States is that these days the most valuable piece of a computer, the motherboard, is basically made by robots, so cheap Asian labor is no longer a reason to produce them abroad." *The New York Times*, December 10, 2012. http://www.nytimes.com/2012/12/10/opinion/krugman-robots-and-robber-barons.html?_r=1& (last retrieved: 25 March 2014) The BCG report on the significant impacts of reshoring projects from 2015 onward: http://www.bcg.com/media/pressreleasedetails.aspx?id=tcm:12-144944

emerging countries that need to change their underlying development model and promote a smooth transition to a much more domestic demand based strategy.

2. The position of exporters of natural resources seems to be strong, especially when we take into account that even after the commodity price increase witnessed during the last decade, future price developments for most of these commodities remain rather favourable. (Obviously, these countries also try to diversify their economies, which is quite clear, for example, in the case of several oil-exporting countries in the Middle East.)

3. The third group consists of export-oriented small countries that do not possess easily exportable natural resources, and have very high export openness (export/GDP) reaching 75-90%. This is the case in several Central European countries, including Hungary. Their economic development mostly depends on export performance. If firms in these countries are to increase sales and create more jobs, there is simply no other alternative to internationalization. And as the exports of these countries, whose domestic purchasing power is limited, are mostly based on the performance of FDI-related manufacturing and services firms, they have to elaborate strategies that preserve and strengthen this export orientation. (This does not mean the negligence of domestic demand factors, such as consumption and investment, but rather indicates that their role is to balance the growth pattern, rather than replace export orientation).

As Hungary cannot compete with really low wage countries (though wages are still low in international – European – comparisons), long-term sustainable strategies cannot avoid upgrading technological capabilities to maintain or increase current export levels. The other possibility is to find new markets and promote the internationalization of more and more small and medium sized domestic firms. The simultaneous application of these two strategies may be a starting point for the external economic strategy of Hungary in the future.

Geographical and sectoral diversification

Today's global political and economic environment cannot be described with the simple terms of the bipolar world's traditional centre-periphery relations when political support of large powers – in order to gain more international influence – helped the economic development of less developed states. The picture is further complicated by the transnationalisation of business activities as a result of increasing global

competition and by the surge of regional integration initiatives that sometimes overlap each other in terms of scope or geographic location. Peripheral or semi-peripheral countries in this sense no longer serve as the background territories for only one economic or political centre, but are influenced by several at the same time (although the level of political and economic influence varies from one centre to the other, not least because of geographical distances or ideological reasons). This is the very position of Hungary at the moment. It is clear that each country will always have a major international trade and capital partner (which in the Hungarian case is certainly the European Union), but countries consider other relations important too, which has been increasingly true in the past few years when the more advanced countries, notably members of the Eurozone, have been facing massive financial instabilities and growth problems.

For Hungary, an export-oriented strategy will undoubtadly remain one of the most important elements for balanced economic growth in the coming decade. Domestic demand without significant export performance is insufficient to deliver sustained economic growth. Export openness, however, in most cases carries substantial risks. At the beginning of the economic crisis in 2008, export-oriented countries, such as Hungary, had been hit most severely. But the implications of this external demand shock were different from the earlier ones because international trade today is different from the pattern prevailing prior to the turn of the millennium. According to WTO estimates, close to 55 percent of the world's non-fuel trade is conducted in intermediate products. And it is mostly a result of the growing importance of the global value chains in which large multinational firms have dozens of subsidiaries in various countries and these subsidiaries trade with each other. Ultimately, demand for exported intermediate products in the Hungarian case is not necessarily defined by the demand in the importing country (Germany is by far the most important destination of Hungarian products, close to 30 precent of Hungary's export end up in Germany and about one fourth of FDI stock in Hungary has been sourced from this country. Despite hard efforts to open up to third countries in trade and investment, the concentration ratio is predicted to further grow – unless a major economic shock takes place.)

The growth of the supply chain has increased the exposure of Hungary to final demand outside Europe, to an extent that is no longer captured by bilateral trade statistics. Spillovers from aggregate demand and policy actions in the rest of the world are now much greater than ever before. Conversely, German domestic demand spillovers to Hungary remain relatively small. (IMF 2013: 2-3) A significant share of bilateral trade between Germany and Hungary is performed in intermediate goods: final demand in Germany is not the main determinant of exports to Germany. As a

result of this pattern, export orientation has made the country part of a large international network, which can mitigate external shocks.[4] Yet export performance rebounded very quickly after the 2008 crisis since it was not the ailing demand of the European Union, or of the Eurozone in particular that defined demand for Hungarian products. Exposure to international economic developments and demand may still make a country vulnerable to external shocks. However, when countries which import Hungarian intermediate products re-export finished goods containing the intermediate product that had originally come from Hungary, the ensuing positive impacts of such re-export translate to improved Hungarian export figures. Hence any increased demand for, let's say, German export products, will also improve Hungarian output. This indirect export due to the activity of multinational firms, mainly in the manufacturing sectors, has changed the nature of dependence on international trade and transformed it into stronger dependence on the strategy of multinational companies. Interestingly enough, the expansion of multinational firms and their global optimisation strategies have also led to increased presence of several Far Eastern emerging countries in international trade mainly through growing exports in intermediate products. (Of the six largest exporters of intermediate goods, four are from the Far East: China, Japan, the Republic of Korea, and Hong Kong followed by rapidly developing other countries from the region).

Owing largely to the operation of foreign firms, Hungary has been strongly integrated into this production network and its export openness increased rapidly from 20-22 percent at the beginning of the economic and political transformation to close to 80 percent by 2014. The relational and product structure of exports was mostly influenced by large European firms (which otherwise also nurture trade and investment relations with several Asian countries). All these have led to the significant concentration of the export sector and by today about 30-32 percent of Hungarian exports come from the automotive industry and according to estimates, about 10 percent of the output directly depends on the performance of this sector. The geographical pattern closely mimicked the foreign direct investment pattern and this has led the European Union, and Germany in particular, absorbing the lion's share of Hungarian exports.

4 The success of export-led growth strategy depends on several factors and there are a number of risks and challenges inherent in such a strategy. For a comprehensive list of arguments for and against export-led economic strategy in small countries see: Andras Inotai, "Sustainable growth based on export-oriented economic strategy", *Economic policy analyses* (FES-EPI, April 2013) pp.3-8. http://library.fes.de/pdf-files/bueros/sofia/10070.pdf

Table 1

Share of exports to the EU-28 (percent of total export)

	2009	2010	2011	2012	2013	2014
EU-28	66.9	65.4	64.5	62.8	62.1	63.3
Czech Republic	85.2	84.3	83.4	81.3	81.1	82.2
Hungary	80.2	78.4	77.4	77.4	77.8	79.8
Poland	79.9	79.3	78.2	76.2	75.0	77.1
Slovakia	86.3	84.7	85.1	84.1	82.9	84.4

Source: Own calculation, using Eurostat data

This heavy reliance on a single region and one or two sectors has made the country vulnerable to the developments in the EU, mostly in the Eurozone and the car industry. It is this very pattern that calls for the diversification in terms of geography and product structure. But diversification is extremely difficult in a period when most trade is conducted by multinational firms and in intermediate products. The objective of diversification and creating improved relations with geographically distant countries and regions is to forge social, economic and cultural relations with them. More specifically, the diversification strategy envisages a three-pronged approach towards the countries of South-East Asia. The first objective is to renew political contacts and understanding. The second is to achieve enhanced economic interaction in investment and trade, science and technology, and in tourism. And thirdly, we aim to promote cultural, educational exchange and the flow of information.

Future prospects

Today competitiveness is more and more linked to the operations of large firms. For relatively small countries like Hungary, it is imperative that they attract high value added production or service firms, and secure a business-friendly environment and stability in economic management. This has been and must remain an important cornerstone of development strategy. But the sources of capital, the origins of foreign firms must be much more diversified and balanced. Excessive concentration of the source of capital will always involve risks – this is one of the first lessons of economic history and portfolio theories.

At the same time, the relevance of smaller firms may be increasing. The creation of a business-friendly and innovative environment is more and more important to support small and medium sized domestic firms such as high-tech companies or technology

intensive enterprises in the food processing industry. Enabling them to become competitive on a global scale and launch their internationalisation strategies successfully is an ever important economic policy objective. In the South East Asian region, we have examples for successful strategies building either on the activity of very large firms (South Korea) or on small and medium sized firms (Taiwan). A combination of these two models may be applied in Hungary taking into account the local conditions.

Structural upgrading is even more crucial since in Hungary (and in several other Central European countries) a large share of exports and thus the GDP are very much dependent on the automotive industry. This excessive dependence has until now proved to be fruitful as it has greatly contributed to successful restructuring. Recent weeks, however, have clearly exposed the vulnerability of this strategy.[5] The other risk related to this sector concerns the strategy of China. What happens if Chinese car makers opt to step up exports of their cheap products to Europe? How could this possibly impact the Hungarian and more broadly the Central European economy? A much more diversified product structure would therefore be desirable.

As for the geographical pattern, Hungary must try to diversify its international trade and capital relations – following the examples of more advanced countries, such as Germany, or several less advanced states such as Latin American countries, which have been able to strengthen their relations with Southeast Asia or Australasia. Logically, the bigger Asia's economic power can grow, the greater will the focus be on Eastern markets. The central authorities' involvement in Hungary in the facilitation of external economic relations that are planned to be diversified towards geographically distant countries should be viewed as a positive effort to strengthen economic relations with distant regions, where – more often than not – the right personal contact, or government interest and support can contribute to building a good investment climate and stronger trade links.

In the future, this may result in new offers and probably favourable framework conditions. It is a necessary but not sufficient prerequisite for a real breakthrough in terms of intensifying trade and investment. What is needed is a genuine, grassroot cooperation spanning across several domains including higher education, joint research, cultural exchange, dissemination of information and the likes through the active involvement of business, academia, NGOs, civil society, students etc. Without such a multifaceted approach, government strategies cannot work successfully. What

5 The Volkswagen scandal may have a negative impact on the Hungarian processes due to the exposure of German car makers.

we can realistically expect is a step by step approach and improving business conditions with several geographically distant countries. Indonesia is a very promising country for Hungary in terms of trade perspectives. We may realistically be able to identify sectors in which Hungarian exporters – even other than multinational firms – will find opportunities to satisfy the world's fourth largest market in terms of population. Indonesia might serve as an entry point to the wider region. And *vica versa*, if areas of common interest are identified, Hungary may serve as an entry point for Indonesian business, products and services to the larger European market.

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