

## The Hungarian Economic Policy after 2010 – The Quest for the Holy Grail

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The Holy Grail in economics symbolizes the search for a general recipe for solving the economic problems of developing middle income countries. Classic economists of the 18th and 19th century, focusing on microeconomics, did not pay too much attention to macroeconomic matters and questions of economic development. The Great Depression can be viewed as a turning point in economics since John Maynard Keynes and the Neo-Keynesian economists highlighted the overall and specific importance of state policies in economic crises. However, only after World War II, economists did start to address economic development issues by searching for reasons of backwardness, and policies to jumpstart the economic growth of nations. Thus, after 1945, development economics became one of the emerging subfields in the study of economics. Since then, its main goal has been to define the basic pre-conditions of rapid economic development, offering pragmatic answers to problems of underdevelopment.

The 1980s and the 1990s were dominated by neoliberalism which offered “one-size fits all” solutions. One of the most popular recipes was the Washington Consensus dating from 1989 and dominating the 1990s and the period up to 2008-2009. This paradigm that lost much of its popularity after the Global Financial Crisis, rested on two main pillars: more competition and smaller state (Ostry–Loungani–Furceri, 2016, pp. 38-41), whereas opening the economy often led to externally financed economic growth in many countries. This growth was fueled in good times by foreign direct investments and in tough times by foreign credits creating financial bubbles. The provisions stipulated by the Washington Consensus also included privatization, open trade policies and deregulation.

After the crisis, this approach has fallen from the pedestal. One of the main consequences has been the end of the growth model dependent on foreign finance, as in the case of Iceland and the Eastern European countries. Moreover, another element which has changed the economic policies of the post-Great Crisis period is the renaissance of industrial policies, bolstering the notion that competent bureaucrats are able to manage state involvement in productive sectors.

This paper investigates the characteristics of the Hungarian economic policy after 2010. First, the paper gives a brief overview of economic problems and typical solutions before 2010 as well as of the effects of the Global Financial Crisis. Second, I will examine the economic policies implemented after 2010 in order to summarize the key features of this new economic policy.

## 1. Economic policy before 2010

In the early 1990s, after the collapse of the planned economic and the non-democratic, centralized political system, Hungary underwent a painful economic and political transformation which led to the complete transformation of the domestic institutional system, the dominance of private enterprises, the integration of the newly emerging sectors into the global production networks and to a new economic structure. Between 1990 and 2010 the Hungarian economic policy could be characterized by a willingness to adapt the global mainstream approach to the main questions of the economy. Even though this view was based mostly on the Washington Consensus, Hungarian governments failed to reach a balanced budget, to modernize education and health care, and to implement other crucial reforms in order to enhance the economy's competitiveness.<sup>1</sup> After 2008, several framework conditions of the economic policy changed, which then was coupled with new emphasis on the economic policy unfolding after 2010. This fundamental shift in strategy today has created a new macroeconomic path, improved the country's financial balance and led to the transformation of the external economic strategy. Moreover, this change has also triggered fierce debates among experts regarding its suitability and the applied instruments.

After the painful economic transition, Hungary became one of the most globalized economies in the world. The very rapid and deep internationalization of the economy is probably the most important development creating a completely new framework for economic policy and business life in Hungary. According to the KOF index of economic, political and social globalization, Hungary ranked 11<sup>th</sup> in the world in 2015.<sup>2</sup> According to the sub-index measuring the scale of economic globalization, Hungary

<sup>1</sup> These two elements are the first two points of the Washington consensus.

<sup>2</sup> The index of the Swiss Federal Institute of Technology measures actual economic flows, economic restrictions data on information flows, data on personal contact, and cultural proximity. As it can be seen, the index is not confined to the economic sphere; it also includes the social and political dimensions of globalization.

moved into the 7<sup>th</sup> place in 2015.<sup>3</sup> Due to insufficient source of capital and technology domestically, the transition in the 1990s noticeably developed asymmetric dependence on Western European economies through capital and trade relations – not an unknown development in the history of Hungarian economy. This dependence clearly appears in the structure of regional supply chains, in which Hungary, mainly focusing on assembling, struggles to move up the added value chain.<sup>4</sup>

At the same time, it was not only the economy and the society that went through a dramatic transition, but the system of economic and security alliances also changed considerably. After the dismantling of the bipolar world, the country became part of Western Europe by joining the NATO in 1999 and the EU in 2004. This system of political and economic alliances has guaranteed stability and increased security against international political threats. Due to the lack of major conflicts, political disputes with neighbors, the country can be characterized by external and internal stability. 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 fulfill their mandate (except for a few changes of government heads). Up to the global financial crisis in 2008, societal stability has been coupled with the continuous inflow of foreign direct investment in the production and services sectors alike, which are the cornerstones of the rapid structural modernization of the economy.

The relatively favorable domestic and international environment, however, changed after the economic crisis of 2008, and some very serious challenges started to surface, the facing of which required significant adjustments in the economic policy in order to restore the macroeconomic balance and meet the increasing global competition of recent years.

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 betrayed several economic weaknesses, which could remain concealed under the surface due to a favorable international economic environment, low international interest rate, and international financial liquidity.

<sup>3</sup> This sub-index looks into the indicators like trade, foreign direct investments, portfolio investments, income payment to foreign nationals in percent of the GDP and hidden import barriers, mean tariff rate, taxes on international trade and capital account restrictions.

<sup>4</sup> However, this is not a novelty in the development of the Hungarian economy, since before World War II, the country similarly relied on the import of technology and capital in its development.

### 1.1. Large imbalances

Following the late 90's, economic growth 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 favorable expansion was coupled with growing and large imbalances. The current account deficit was high (4-8 percent of the GDP), but up to 2004 and 2005, this deficit was financed by foreign direct investments. Around these years, however, the current account deficit began to be financed by foreign credits which brought about the growth of imbalances and financial vulnerabilities. Along with growing government budget deficits, private households and domestic firms started getting indebted first in domestic, later in foreign currencies which resulted in emerging exchange rate risks, too. The outcome of this change was a steady rise of public and private debt before 2008.

In the Hungarian economy, prior to the 2008 crisis, growth tended to coincide with imbalances on the current account and with growing indebtedness. After 2008, deficit financing became almost impossible, and it took severe financial and real economy adjustments to break this vicious circle and to turn the current account deficit into a surplus in 2009, and maintain it along with relatively favorable economic growth figures in European comparison ever since. However, it is not unique in the region, since current account surpluses have also characterized other countries (Slovenia and the Czech Republic) after 2008. What is unique, except for the Baltic States, has been the pace and the extent of the improvement which was mostly caused by the desperate financial situation of the country immediately after the collapse of the Lehman Brothers (See Figure 1).

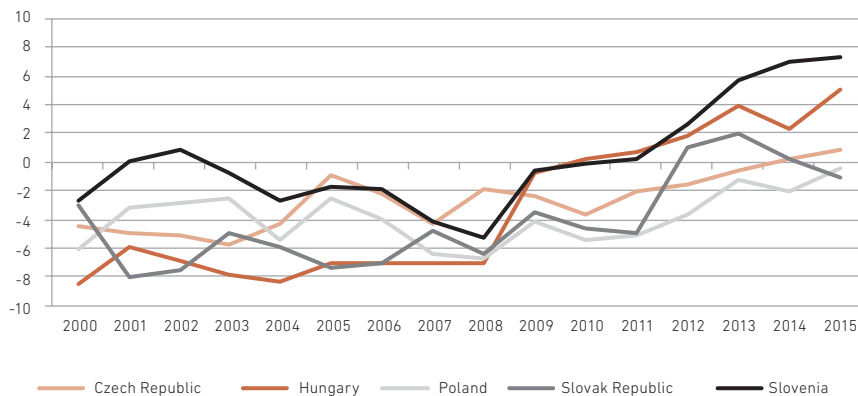
### 1.2. Growing debts

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. In addition, parliamentary election cycles cause budget deficit hikes from every four years, which is probably much more evidently than in any of the other Central European countries.

This structural weakness leads to another problem, namely, public budget deficits. Furthermore, following higher inflation rates induced the tightening of money policies. However, the Central Bank of Hungary failed to hit the target of lower inflation

Figure 1

## Current account balances in CEE countries (% of GDP)

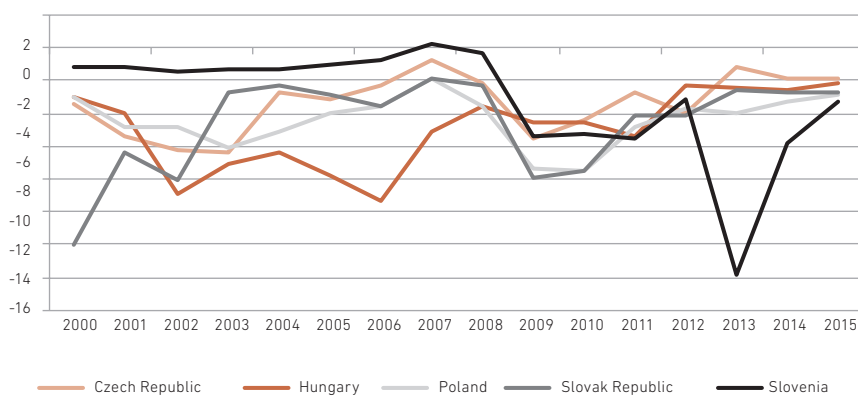


Source: IMF database

and of cooling off the economy, since deregulated financial markets allowed private households and firms to borrow foreign currencies on a massive scale. Big budget deficit followed by periodically returning austerity packages and high interest rates created a vicious circle as growing indebtedness became a prevalent feature of the Hungarian economy. This left Hungary vulnerable to international demand shocks before the Global Financial Crisis 2008-2009.

Figure 2

## General government net lending/borrowing (% of GDP)



Source: IMF database

### 1.3. Fragile banking sector

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. The competition among financial institutions for acquiring new clients, continuously exerted a downward pressure on the standards of credit risk assessment. After the eruption of the credit crisis, the lack of domestic savings and confidence in the international financial markets stopped the money flowing into the Hungarian economy, immediately leading to the strong depreciation of the currency. The 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.

### 1.4. Low employment rates, low potential growth

Another long-term problem which had not been successfully tackled by policy-makers for decades was the low employment rate. Large segments of the labor force had been hard hit by the economic transformation of the nineties, and their knowledge and skills were soon rendered obsolete in the new economic structure. Thus, they were unable to find a job or acquire new skills required by the business sector. Consequently, unemployment soared at a staggering rate, reaching 12.1 percent in 1993. The drop-in employment rate followed after 1990 immediately, hitting the bottom in 1996 (52 percent).<sup>5</sup> However, in spite of smaller advances, Hungary's employment rate along with Greece remained one of the lowest in the European Union before the Global Financial Crisis, thus condemning the economy to a relatively low potential growth.

### 1.5. High taxation rates

In addition to the need of relatively high budget revenues, the low employment and labor market participation rate was yet another important reason behind the relative over-taxation of the Hungarian economy in comparison with its competitors. The overall tax-to-GDP ratio in the EU28 stood at 39.2 percent in 2008, which was only slightly lower than the Hungarian indicator. In addition, it must be remembered that

<sup>5</sup> KSH 2010: Magyarország a változások tükrében 1989-2010. p. 10. [online form:] [https://www.ksh.hu/docs/hun/xftp/idoszaki/mo/mo1989\\_2009.pdf](https://www.ksh.hu/docs/hun/xftp/idoszaki/mo/mo1989_2009.pdf)

developed countries usually have higher rates, thus in comparison with Poland, the Czech Republic, Slovakia and Slovenia, the position of Hungary was more negative. Another frequently used indicator is the tax wedge, which measures the shares of employee earnings taken by governments. This indicator also revealed weaknesses. The Hungarian tax wedge (54.1 percent) was the second highest among the OECD countries in 2008. Only Belgium (56 percent) overtook Hungary, but scores of more advanced economies (Germany, France, Austria, Italy and even the Scandinavian countries)<sup>6</sup> had lower tax wedges.<sup>7</sup>

Table 1

**The overall tax-to-GDP ratio in 2008 and in 2012 (%)**

	2008	2012
EU28	39.2	39.4
Hungary	40.3	39.2
Poland	34.3	32.5
Czech Republic	34.4	35.0
Slovakia	29.1	28.35
Slovenia	37.3	37.6

Source: European Commission 2014: Taxation Trend in the European Union. Data for the EU Member States, Iceland and Norway.

The economic model, which had been built on external foreign financing, was shaken by the credit crunch evolving from 2008. Hungary was one of the first countries to apply for IMF funds, almost immediately after the collapse of the Lehman Brothers in 2008. This step was a clear confession of the fact that despite the rapid modernization, which the economy had undergone in the previous two decades, the external vulnerability of the economy remained unchanged. It must be added that economic pressures had already been building up before 2008. Policies measures taken in 2006-2007 failed to achieve the desired effects of balancing the economy and curtailing the debt tide. All of these trends also suggested that, compared to other CEE countries, the GDP growth had been much less sustainable, and it had mostly been based on debt financing. Public dissatisfaction was clear, and it led to a change in the economic policy of the country.

<sup>6</sup> The tax wedge was 52 percent in Germany, 49.3 percent in France, 48.3 percent in Austria, 46.5 percent in Italy and 44.6 percent in Sweden in 2008.

<sup>7</sup> [online form:] <http://www.oecd.org/ctp/oecdstaxingwagesshowssmallreductionintaxesonindividualwageearnersin2008.htm>

## 2. New trends and economic policy changes after 2008

The crisis created a new external and internal environment, which led to the reevaluation of the country's previous economic model. The following conclusions were drawn from the economic shock.

- Firstly, experience demonstrated the need to build economic development less on external debt generating funds in order to prevent an unsustainable current account position in times of unstable international financial liquidity.
- Secondly, it became clear that the economic growth must be based on a broader basis. International trade and the domestic demand factors – both investments and consumption – must be included into the growth model in a more balanced way, including active labor market intervention and sustainable credit financing.
- The third conclusion was that the macroeconomic balance must be restored by controlling the budget deficit and decreasing public and private indebtedness at any cost.

The focal point of all of these conclusions was to weaken international dependence and widen the room for the maneuvering of domestic fiscal and monetary policies. After the parliamentary elections in 2010, the newly formed government was able to implement and adopt regulations reforming the entire economy. After the growing political uncertainties of the post-2008 economic crisis, political stability became a very important factor and a precondition to making any major reforms. This political stability crystallized in the form of an unprecedented two-third majority the government enjoyed between 2010 and 2014, and this level of power was more or less maintained after the 2014 elections, too. It is not an overstatement that this economic policy had several new, previously unimaginable features and was accompanied by heated debates regarding its instruments. In order to manage the above-mentioned problems and achieve the new economic policy objectives, a number of priorities must be set up.<sup>8</sup>

<sup>8</sup> For another summary on the basic principles of the new Hungarian economy see Novák, 2015, p. 7.



## 2.1. Preference of domestic firms

As mentioned earlier, the level of economic globalization in Hungary is very high in international comparison. Given the small size of the economy and the capital problems of domestic firms, this global integration was carried out by large international firms. This type of integration resulted in overwhelming dependence on foreign firms in almost every field including international and domestic trade, manufacturing and network services. Thus, it is no surprise that one of the arguments of the new economic policy is to explain the risks and the problems through the negative impacts of a liberalized international economic environment.

This rather protectionist policy seeks 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. However, as the experience of advanced countries demonstrates, there is no difference in foreign or domestic monopoly and oligopoly situations, when it comes to their long-term adverse effects on competitiveness.

## 2.2. Re-industrialization

At the same time, the principle of preferring domestic firms acknowledges the importance of foreign-owned manufacturing firms in the Hungarian economy by concluding the so-called “strategic agreements” – instruments that express the government’s intentions to promote their continued operation in Hungary. The logic behind the distinction between “bad” and “good” foreign firms relies on the principle of the country’s re-industrialization. Re-industrialization is a key element of the Irinyi-plan,<sup>9</sup> which was formulated by the Ministry for National Economy (Nemzetgazdasági Fejlesztési Minisztérium) in 2016. The main goal is to raise the percentage of manufacturing in GDP from 23.5 percent to 30.0 percent in 2020.<sup>10</sup> At the same time, the Irinyi-plan highlights seven key sectors:

<sup>9</sup> Nemzetgazdasági 2016: Irinyi terv. Az innovatív iparfejlesztés meghatározásáról. [online form:] <http://www.kormany.hu/download/d/c1/b0000/Irinyi-terv.pdf>

<sup>10</sup> A stronger emphasis of manufacturing activities is in line with the industry policy goals of the European Commission. See European Commission 2014: For a European Industrial Renaissance. Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions for a European Industrial Renaissance (Com/2014/014 Final)

1. Commercial vehicle industry
2. Specialized machine- and vehicle industry
3. "Health industry"
4. Food industry
5. "Green industry"
6. ICT sector (in particular shared service centers)
7. Defense industry.

The key sectors prioritized by the Ministry also include services. That is why it can be argued that the term "reindustrialization" is misleading, since it doesn't reflect the changing nature of production and the growing importance of combining production and services. An additional problem is when it comes to the measurement of economic activities, and a distinction of manufacturing and services can be traced back to the growing servitization of the manufacturing sector. Servitization transforms simple production into value led manufacturing, emphasizing continuous service and support activities. Adding the fact that there is a new industrial revolution emerging based on a growing utilization of robots, the formulated goals are unlikely to be achieved. The new economic policy is well aware of the growing importance of technology, education and human resources.

### 2.3. Managing asymmetric dependencies

One of the economic policy goals was to strengthen the power of domestic economic policy decision-making and broaden its capacity for maneuver. The government's role in shaping the economy 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 in order to get rid of any form of control from international financial organizations and the adoption of a more critical approach to EU decision-making practices. The easing of dependencies was also a crucial factor behind the growing emphasis on trade and economic relations with countries which had previously been neglected or had not been considered important to the external economic relations of Hungary.

The new economic policy after 2010 also addressed the country's external economic strategy. After 2008-2009, fiscal and monetary policies of 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, a crisis that also hit other Eurozone countries (often called PIIGS<sup>11</sup>). This crisis affected the Hungarian economy adversely through two channels:

- the demand for Hungarian exports remained relatively weak;
- the 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 implemented. 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. The “Eastern opening policy” was based on the idea that China’s, Indonesia’s and other emerging Asian markets’ resilience to the external financial shocks had the potential to mitigate the devastating effects of the economic crisis in Hungary effectively. After the launch in 2011, the strategy was revised in 2012 by adopting a broader growth strategy in the so-called Széll Kálmán plan.<sup>12</sup> The strategy points out the importance of trade and investment diversification. The goal is to double the export of Hungarian small and medium enterprises to the targeted regions where China, Russia and India are the most important partners. Since the launch of the Eastern opening policy, there have been several initiatives, academic conferences, and political meetings to encourage different forms of economic cooperation between China and the Central European region. Still, there is a strong controversy and criticism around this policy, arguing that the main trade patterns have not changed since 2011. Why the main trade patterns of Hungary are unlikely to be changed by a government policy, the answer can easily be found in the Hungarian exports structure in which the share of multinational companies is dominant. Nonetheless, the policy of Eastern opening is a long-term strategy, where cooperation in higher education, larger projects of infrastructure can bear fruits in the short run. (See for example the One Belt and One Road initiative of People’s Republic of China!)

<sup>11</sup> PIIGS: Portugal, Italy, Ireland, Greece, Spain

<sup>12</sup> [online form:] [http://index.hu/assets/documents/belfold/szkt\\_2\\_0.pdf](http://index.hu/assets/documents/belfold/szkt_2_0.pdf)

## 2.4. Raising employment and labor market participation

In order to address one of the most acute domestic economic challenges, the economic policy attempted to find a solution to the low employment rate, too. In 2010, the employment rate was only 55.9 percent, while the EU average was close to 69 percent. By 2015, the difference was reduced to only 1.2 percentage points. (EU: 70.1 percent; Hungary: 68.9 percent). The cut of the average corporate tax,<sup>13</sup> introducing new forms of taxation, and deregulating the labor law were also important elements of the reforms designed to increase labor market participation. In addition to this, the other fundamental pillar of this policy was to transform social transfers into work opportunities and work-related benefits. As a result, a public works scheme was set up securing around 220.000 publicly financed jobs offering a minimum wage during 2015. The costs of the public work scheme were approximately 270 billion HUF in 2015, however, not because of the costs, the efficiency of the program is questionable, since 85-90 percent of those who took part in the program have not been able to enter the private labor market later.<sup>14</sup>

Still, even if we exclude those working abroad or in the framework of the public work scheme, the number of employees increased by 1.6 percent in 2015.<sup>15</sup> Including the above-mentioned groups of workers, the growth of employees reached 2.7 percent the same year. Improving labor market conditions are reflected in better unemployment rates, too. After a peak in 2010, the Hungarian unemployment rate recovered between 2010 and 2016 resulting in favorable data in EU comparison (EU: 8.2; Hungary: 4.4 percent in December 2016).

In order to reform the labor 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 labor market perspective was to adjust the output of the education system to better suit the needs of the labor market. Several changes have been introduced in order to reform the educational sector, which was followed by heavy debates and with subsequent modifications. The outcome of these changes still remains to be seen. One of the most important reforms was the growing role of the so-called dual education, which tries to get theoretical

<sup>13</sup> The corporate tax is 19 percent, however, there is a reduced tax rate applied (10 percent) under a certain amount of revenues.

<sup>14</sup> Pénzügykutató 2016: Lassuló növekedés, javuló egyensúly. A magyar gazdaság helyzete és kilátásai (2015-2006) p. 5 [online form:] [http://penzugyutato.hu/sites/default/files/files/Penzugyutato\\_Prognozis\\_2016%20marc\\_Sajtotaj.pdf](http://penzugyutato.hu/sites/default/files/files/Penzugyutato_Prognozis_2016%20marc_Sajtotaj.pdf)

<sup>15</sup> According to the HCSO methodology, those who work abroad are included in the employment rate.

knowledge closer to practice by offering classroom education and work placement at the same time in higher education.

Special measures were also introduced in order to increase birth rates in Hungary. In Hungary, as opposed to Indonesia, currently the very low birth rates and their negative future implications on the labor market cause long term problems. A family-friendly taxation was implemented in 2010, in particular for families with more than two children. Since demographic trends are difficult to change, the challenge still requires a complex solution and this remains a challenge for the future, too.

It is clear that migration to other more developed EU countries and the shrinking population pose were a double challenge to the Hungarian economic policy in the long run; since the adverse effects of these trends can already be observed in labor scarcity in different segments of the labor market, especially in certain job categories, including both low and high skilled jobs.

## 2.5. Dealing with indebtedness

Low domestic savings coupled with high indebtedness have been further unfavorable features of the economic environment for the long term, which were extremely urgent issues to deal with after 2008. (High indebtedness in foreign currency was not only a characteristic in the housing market, but it was also apparent in other sectors of lending). To reverse indebtedness, since 2010, several saving schemes have been introduced and a financial process of deleveraging 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 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 started in 2009. In order to prevent excess-lending, a 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 has been a very important factor in economic stabilization.

As a result of these policy measures, the net savings of private households reached 8.0 percent of the gross domestic product, while those of the private enterprises reached 4.6 percent of the GDP in 2015. However, the net saving position of

enterprises is inimical to economic growth. In this sector, the net borrowing position is to be favored, since it means more investments, jobs and higher GDP growth.

## 2.6. Taxation and economic policy priorities

Hungary was ill famous about high taxation of the economy, which, however, was coupled with low tax collection efficiency. In addition to this, high budget deficit always prevented the major reforming of taxation policy. Revenues always had to be high to cover the relatively high spending. The new Hungarian economic policy adopted a very important reform in the tax system, and it began using taxation as a stronger tool of economic policy. One of the major changes was to shift from direct taxation to indirect taxation including personal and corporate taxes. As an important instrument a flat rate of personal income tax was introduced with preferences given to families. At the same time, direct taxes, most importantly the VAT was increased. These steps were coupled with measures aimed at more efficient tax collection. After a few years of operation, tax revenues increased significantly, while the average taxation of the economy slowly but decreased.

Another important part of the policy was the introduction of special taxation in several economic sectors with high potential to generate revenues and profits in order to secure funds to finance the much-needed tax reduction on labor after 2010, and to manage the problem of high budget deficit, which was a burning issue in the years after 2010. The new sectorial 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, and it was heavily criticized by the affected companies and at the EU level, too. Even if critics in some cases proved to be justified, since then several countries started to apply more or less similar measures (although their objectives may vary widely in the countries that have applied such instruments).

Here we must refer to another policy measure, which also aimed at managing the budget deficit. This was the nationalization of the private pension funds.<sup>16</sup> 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. It was because pension contributions were paid into the state funds

<sup>16</sup> Compulsory private pension fund system was introduced in several Central and Eastern European countries in the nineties in order to diversify pension savings.

and the private funds in parallel, but pensions were paid out only from the state funds given the short operation of the private scheme (since the late nineties). Of course, private pension funds would manage this financing problem in the long run, but the economy faced short term financial instability, which had to be managed somehow.

Table 2

**Public debt (% of GDP)**

	2011	2012	2013	2014	2015
EU28	81.0	83.8	85.5	86.8	85.2
Hungary	80.8	78.3	76.8	76.2	75.3
Portugal	96.2	111.4	126.2	129.0	129.0
Spain	69.5	85.4	93.7	99.3	99.2
Italy	116.4	123.2	128.8	132.3	132.7
Greece	172.0	159.4	177.0	178.6	176.9
France	85.2	89.6	92.3	95.6	95.8
United Kingdom	76.6	81.8	85.3	86.2	98.2

Source: Eurostat

The privatization of the pension funds was heavily criticized by international economic organizations, though not many viable options were offered instead. In recent years, several countries introduced similar, although slightly different measures (mostly because they did not find alternative and sustainable sources to increase budget 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 problem of an incessantly spiraling government debt.

Table 3

**General government deficit (% of GDP)**

	2011	2012	2013	2014	2015
EU28	4.5	4.3	3.3	3.0	2.4
Hungary	5.5	2.3	2.6	2.3	2.0
Portugal	7.4	5.7	4.8	7.2	4.4
Spain	9.6	10.4	6.9	5.9	5.1
Italy	3.5	2.9	2.9	3.0	2.6
Greece	10.2	8.8	13.0	3.6	7.2
France	5.1	4.8	4.0	4.0	3.5
United Kingdom	7.7	8.3	5.6	5.6	4.4

Source: Eurostat

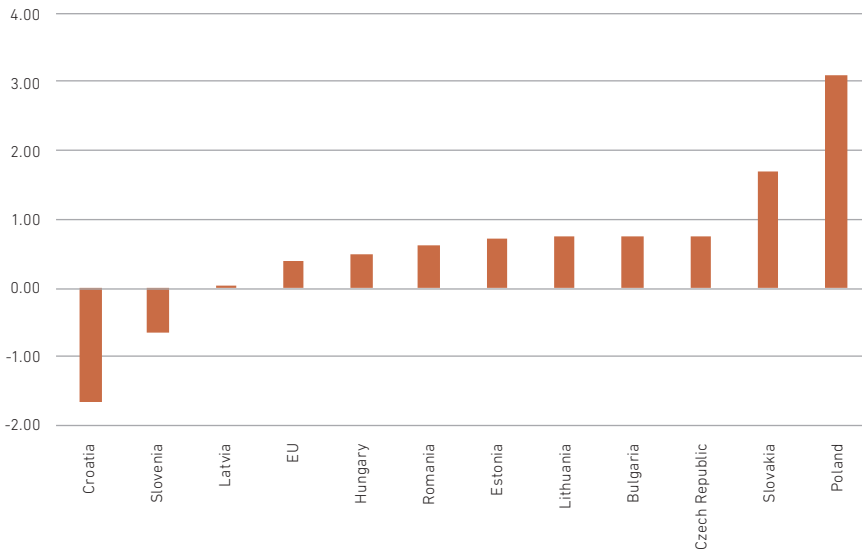
### 3. Current and future challenges

The measures and new priorities described above created a coherent economic policy framework. Although several elements of this framework can be criticized and the long-term outcomes may be questioned, the stability of the tools and objectives of this policy are remarkable after several decades of continuously changing strategies and policies. Given this backdrop and emphasizing the importance of the achieved macroeconomic stability, external and internal financial stabilization, it is important to consider those areas in which further reforms, new strategies and instruments are required, and locate those uncertainties that may jeopardize the currently relatively favorable path of economic development.

The GDP growth in the Hungarian economy between 2010 and 2015 was greater than the EU average, but it was less remarkable in comparison with some of the other Central European countries. In addition to the relative weakness of the growth after 2008, its volatility must be also considered. Overall, it must be emphasized, however, that the performance of the economy in the recent two-three years has been much more favorable in European comparison than in the preceding years.

Figure 3

#### Average real GDP growth between 2009 and 2015 (%)



Source: own calculation based on Eurostat data



The growth in recent years is due firstly to growing employment, while productivity could only grow marginally (0.3 percent), which demonstrates an extensive growth path. Another important factor was the changing role of demand factors in GDP growth. In 2014-2015 the role of investments was very important mostly due to the rapid inflow of EU structural and cohesion resources financing public investments. As the EU 2007-2013 financial frame ended, the sudden stop of inflow of EU funds caused GDP to slow down in 2015, and the role of private consumption and net export became more important. EU funds will increase again in the coming years, in order to maintain the growth rate. The Central Bank of Hungary launched credit programs to boost liquidity and investments over the last years. At the same time, new housing scheme was initiated with the objective of boost the construction industry. Although 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. One of the risks that may bar a remarkable growth appears in connection with labor market trends.

Labor market trends seem to be an important risk factor for future economic growth and even for the competitiveness of the whole economy: "The number of employed rose to an all-time high and unemployment rate dropped to an all-time low in 2014" (European Commission 2015b). This positive development, however, was increasingly coupled with labor shortages in several sectors including both high skilled (e.g. ICT) and services sectors (e.g. plumbers, carpenters, etc.) This labor shortage in several sectors has been caused by several parallel factors including the negative impacts of the economic crisis, uncertainties in connection with the economic policy changes after 2010 and very low wages in international comparison. All of these sectors led to the growing outflow of labor to other EU member states. At the end of the day, the massive economic migration from the country started to push up wages in an increasing number of the economic sectors. This does not mean that Hungarian wages are high in international comparison at the moment, but in the coming years the further increase of incomes will definitely continue. We expect that the growing purchasing power provides excellent opportunities to foreign firms to export to or invest in Hungary in an effort to satisfy the growing domestic demand.

As described above, financial instability, large budget deficit and growing public debt have long been the most serious problems in the Hungarian economy. They not only caused vulnerability of the exchange rate, especially during international liquidity problems, but also caused growth problems through different channels, public investment barriers due to financing debts, etc.). In this respect, the country has been very successful. Not only was the growth of the government debt curtailed, but

the trend was reversed after 2010. In 2010, the general government debt was 80.9 percent, while in 2015 it was only 75.3 percent. Independently from the instruments with which the government achieved this result, in international comparison it is a remarkably high performance, which has improved the international position of the country. Similarly, the government has been successful in balancing the government budget, and since 2012 the annual government deficit has been below 3 percent of the GDP – a major achievement in the macroeconomic stabilization, and it is better than the majority of the EU member states. This stabilization – which caused temporary uncertainties in the business environment – is a very important precondition for trends favorable in the future. Although we can list several concerns about the future sustainability of this financial stability, currently, risks originating from the domestic economy are negligible. International economic problems obviously can impact the country's financial stability, but due to the changes in the past few years (transition from external financing towards domestic financing, improving the efficiency of tax collection, cheap financing because of the very low interest rates) the country would be much more resilient to external shocks than it had been prior to the 2008 economic crisis.

Investments, most importantly large and continuous private capital activities are necessary conditions of sustainable growth and improving competitiveness. Trends in investments in recent years have both favorable and challenging aspects. Because of the scarce capital and high domestic interest rates in the nineties, which was coupled with close to unattainable public debt level, foreign direct investments became the major instruments of structural change and economic upgrading. Due to significant investments in manufacturing, the Hungarian industry became highly competitive, and today the automotive industry is the most important export sector of the country. Well-known car makers are assembling vehicles in Hungary making up very large portion of the Hungarian export (Mercedes, Opel, Audi, Suzuki). Skilled labor, modern infrastructure (the network of motorways is fully built up) and the central location in Central Europe have all been very strong incentives for foreign investors to show interest in the Hungarian economy. Other manufacturing sectors and services also benefitted from FDI, which is the most important channel of technology transfer to the country. After the economic crisis and the change in the economic policy after 2010, the inflow of FDI became very volatile. But recently the macroeconomic stabilization of the country started to attract an increasing inflow of foreign capital again. FDI will remain an important mechanism of economic development.

The deregulation of the labor market and the joint efforts of higher education and industry, the new tax schemes and the tax reductions also attract investors to the

Hungarian economy, sometimes leading to very concrete cooperation between large foreign firms and the higher education. A very important aspect of investment financing is that the European Union plays an important role in financing public investment projects in Hungary, and this will continue over the next five years. EU transfers to less developed member states and regions are a very important source of capital in managing development level differences across the European Union. In recent years, these transfers amounted to 4-6 percent of the GDP.

As a result, the country's infrastructural network is expected to further improve along with the overall competitiveness. Thus, FDI and the large EU funds together have contributed to the financing and modernizing the Hungarian economy tremendously in the past two decades. Parallel with this, in the last 5-6 years in line with the changes in the Hungarian external economic strategy, the objective of foreign capital investment diversification became a priority. As a result, an increasing number of Far Eastern investments have taken pace in the country in addition to traditional capital investors, like Western European firms. Since this diversification of FDI according to its origin is an important government strategy, this trend I expect this trend to continue in the future offering attractive opportunities for Eastern and South East-Asian investors.

In conclusion, regarding investments, there are several challenges and opportunities to be considered. First of all, although EU transfers are very important sources of development in the country, these transfers have a "crowding out effect" on private investments. This means that in many cases firms are investing in areas for which this money is available instead of sectors or demands coming directly from the market. This problem must be addressed in coming years, since EU-transfers are set to decelerate after 2020. To put it bluntly: EU transfers may cause firms to make efforts to secure EU public funds instead of taking risks and satisfying the market demand in competition. Secondly, private investments are linked to public and EU-funds, while investments not linked to EU transfers are declining. Due to these trends, aggregate investments increased only slowly in 2015. (In 2015 it was 3.8 percent compared to 2014; 2014: 19.3 percent compared to 2013).<sup>17</sup>

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. Similar to Indonesia's economic policy and strategy change due to the 1998 financial crisis, 2008 meant a turning point for Hungary, which forced

<sup>17</sup> Based on KSH data

economic policy to change considerably and introduce several new instruments. Not only do these challenges force countries to seek new methods and instruments of crisis management, but they also question mainstream economic theories underpinning current economic policies. After the 2008-2009 crisis, the global debate of economists has revolved around the role of the state in the economy and the design of the best economic policy. Mainstream economic theory lost its credibility in recent years, but a new and effective economic theoretical framework has not crystallized yet. Neo-Keynesian policies of the post-crisis period soon found their limits due to the once again ballooning public debt. To counterbalance a growing debt and boost economy, there are two main lines of policy measures which also characterize the Hungarian economic policy.

1. The American style quantitative easing (QE) and extreme low interest rate policy has begun to be implemented in advanced countries where there has been room for such a policy and in Hungary after 2010.<sup>18</sup> Up to this point, QE and low interest rates have been successful in countries, where they could be linked to a competitive business environment and/or to the improving of competitiveness (US, Canada Australia, Germany). This is not the case in Hungary, where reforms have only been partly successful.
2. The other channel of adjustment has been a more frequent usage of exchange rate policy. Apart from Eurozone countries, measures to weaken own currency can be found in most of the advanced and emerging countries, leading to a counterproductive global business environment. Nonetheless, the main argument against weak currency policy is that its anticipated benefits are less likely to show up in a globalized world economy where due to the emergence and dominance of global supply chains, exports are often preceded by substantial amounts of imports. This applies to countries where the internationalization of domestic economy is high and to countries where scarcity of natural resources is an inherent feature of the economy. Both of the above-mentioned conditions can be found in Hungary: the economy is globalized and there is a lack of natural resources, hence weakening the own currency can only produce partial and short-time results.

There are other special elements which distinguish the Hungarian economy policy from those of mainstream advanced countries. The preference of domestic firms and the policy of re-industrialization are policies bound to fail since they cannot be aligned

<sup>18</sup> Members of the eurozone have been more restricted in their policies, since they do not own an own currency.

with deep internalization and servitization processes, which push countries further toward clever and green economies. The utilization of taxation as integral part of economic development can be more successful. However, there is always the risk that measures taken will distort the economic structure in the long run. Policy measures are more likely to be influenced by powerful business interest groups, and aspire to strengthen the rent-seeking behavior of market players.

However, the weakening of asymmetric dependencies mainly based on sound public budget and a deleveraging process in the private sector can bring more stability, creating the fundamentals of a fast catching-up process. The overhaul of the external economic strategy is a very long-term strategy; results can only be anticipated in 10-15 years' time. The measures taken until now to improve employment and labor market participation only pushed society towards higher labor participation. However, this special labor market is being subsidized by the state, and this policy has failed to help people enter the regular labor market.

It is not clear yet 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 (the financial stabilization especially), but there are several challenges remaining (most importantly sustainability concerns) which require continuous economic policy responses.

We cannot ascertain with full confidence that the Hungarian economic policy has found the Holy Grail of economics, the simple recipe of how to catch up with the most advanced countries, but it is clear that in the recent years the pragmatic approach of the economic policy did contribute to the restoration of the macroeconomic stability and help lay the foundations of a rapid economic growth path in the future.

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