András Inotai*, July 15 2015

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Looking behind the curtain: what about the Hungarian „economic miracle"?

In the last period, the Hungarian, and partly also the international media are full of positive economic developments in Hungary. In fact, GDP grew by 3.6 per cent in 2014, the second highest among the EU-28 after Ireland. Also, for 2015 a growth of 3.2 per cent is forecast, almost the double of the EU-28 average. As a major achievement, after one decade starting with the accession in 2004, Hungary could leave the EU's excessive deficit procedure and produce a budget deficit below 3 per cent in 2014 (and most probably sustainable in 2015). This places the country in the middle-field of the new member countries and definitely into the frontline if all EU members, not least as compared to the Eurozone countries. Official unemployment rate has been continuously falling in the last years. Inflation is near zero, partly due to rapidly falling energy prices and constrained domestic demand. The prime interest rate set by the National Bank of Hungary reached historically low level. At the same time, trade and current account balances register large surplus, an important factor of (re)financing external debt. Also, not without some fluctuations, external debt between 76 and 80 per cent, the highest among the new member countries excepting Croatia, shows a declining path, and the burden of refinancing has been eased in the last year. Finally, after a rather long period of hesitation, Moody's has partially upgraded Hungary by changing the negative outlook to stable, but without taking out Hungary of the category of countries not recommended for investors.

On the other hand, most of the internationally recognized institutions seem to be much less convinced of the „miracle" in general, and its sustainability, in particular. It is a justified question, why international credit rating agencies remain untouched by the obviously positive economic developments in Hungary and as of today have been delaying any meaningful upgrading. More importantly, Hungary's position in different international comparisons has worsened. The World Bank's Doing Business ranking puts Hungary on place 54 (among 189 countries), but just on place 128 concerning the protection of investments. Concerning the Happiness indicator, Hungary reached place 110, among 156 countries. In international competitiveness, the decline is alarming, from place 48 (among 148 countries) in 2011 to place 63 in 2013. Moreover, the recently published Sustainable Governance Indicator report containing relevant data on the 41 OECD countries and regularly published by the Bertelsmann Foundation puts Hungary on place 41 concerning democracy, place 35 in policy performance (within it rank 38 for economic and rank 39 for social policies) and place 38 in governance (including rank 40 in executive accountability). In addition, the latest report (April 2015) of the German-Hungarian Chamber of Industry and Commerce did not recognize the „miraculous" macroeconomic performance of Hungary either. In regional comparison, the country remains in the (lower) middle-field, business confidence is lacking, and several German companies would not come again to Hungary or, if already here, would not consider to make further investments, due to serious restrictions and higher taxes in most service sector areas (banking, telecommunications, public utilities, retail trade). Claims about corruption, intransparency, uncalculable policy measures can be heard and read almost every day.

How can this discrepancy be explained? Has the Hungarian government after 2010 really created a „miracle" based on its often publicized „unorthodox economic policy"? And if yes, to what extent is it sustainable, and which have been and most probably will be the costs of the „miracle"? This personal survey is a strictly economic one, although the author is fully aware of the political, social and psychological roots and (potential) consequences of „miracle-making". However, the analysis of these interdependences should be the topic of another and longer study.

1. *Factors of GDP growth*

Before going into details, it has to be stated that – despite the 3.6 per cent growth in 2014 – Hungary still did not reach the pre-crises (2008) output level. While Poland indicated a 17 per cent and Slovakia an 8 per cent cumulative GDP growth between 2008 and 2014, Hungary's figure was 98 (and the Czech

Republic's 99). Among the factors of GDP growth, exports proved to be the key engine of growth, while domestic consumption represented a modest growth and investments still could not recover from the dramatic decline after 2008 and further deteriorated by anti-capital „freedom fighting" of the government after 2010. As compared to neighbouring countries, the growth of Hungarian exports (10 per cent between 2008 and 2013) was lagging behind the respective Slovak (34 %), Polish (31 %) and Czech (22 %) figures. Even in the leading Hungarian export market, which is Germany, Hungary's relative position has been weakened vis-a-vis Poland and the Czech Republic. Export-driven growth was increasingly characterized by structural deformation caused by the unilateral concentration on car manufacturing (new Mercedes plant, Audi, Suzuki). As a result, the previously well diversified export structure started to resemble the late-comer Slovak „pattern", not only embedding higher vulnerability in case of any future crisis but also largely exposed to the next wave of Chinese export drive to Europe which will definitely include the not yet challenged European car market.

Similar to other EU members, but with a politics-driven communication campaign, in 2012 the Hungarian government announced its „opening to the East" policy. The underlying argument was correct: if the EU markets are stagnating and a small and open, export-driven economy needs growing markets, a turn to extra-EU opportunities, mainly offered by emerging and rapidly developing countries is justified. However, for several reasons, and despite nebulous commitments, the Hungarian policy proved to be less successful. Between 2008 and 2013 the intra-EU share of the EU-28 in EU-exports fell from 67 to 62 per cent, a clear sign of geographic reorientation without denying the priority of the EU markets. In Hungary, the change resulted in a shift from 78 to 76 per cent of intra-EU and from 22 to 24 per cent of extra-EU exports. In other neighbouring countries, without any politically motivated campaign, this shift was more successful. As a clear proof of failure, Hungary's exports to Asia amounted to 6.6 per cent of total exports in 2011 and to just 5 per cent in 2014. More successful proved to be the opening up to the East in imports. Definitely not in imports of commodities, but of anti-democratic, anti-Western, anti-EU „values". Most recently, a new „opening to the South" (Africa and Latin America) was announced, with a total share of 2.1 per cent in Hungarian exports. For this purpose, a number of Hungarian „trading houses" will be established in selected countries, without any knowledge of markets and exportable commodities but with quite convenient jobs for close friends of the government. It has to be mentioned that Hungary's exports outside the EU are dominated by goods produced by transnational companies in Hungary (e.g. 90 per cent of exports to China). Or, commodities made in Hungary are first exported to Germany and contribute to German exports to third countries.

As a second factor of explaining GDP growth, domestic consumption has modestly recovered in the last two years. A 4 per cent income increase accompanied by almost no-inflation mainly generated by the halving of oil prices was one factor. However, there have been several other components of higher domestic demand which can hardly be sustained in the future.

First, mainly for political reasons (before the parliamentary elections of 2014) the government reduced the utility prices for private consumers (electricity, heating, water) in order to leave more money with the households (without considering social aspects, similar to the introduction of the flat income tax in 2011). The potential and very likely consequences of lower revenues that will hardly be able to finance even the most important maintenance investments have been set aside, as well as the additional costs of nationalizing previously internationally-led public utility companies (very much according to the logic of „freedom fighting") have not been calculated.

Second, many Hungarian households have been bailed-out of the Swiss Franc denominated debt trap at an exchange rate of HUF 256 against CHF 1 before Switzerland abandoned its Euro-linked exchange rate policy in January 2015. However, previously many politicians (from different parties) were given the possibility to make the same conversion at an exchange rate of HUF 180 to 1 CHF. In addition, debtors in CHF outside the housing sector (e.g. car buyers) were not included into the conversion programme. It has to be added that the bail-out project cost about 2 bn Euro for the banking sector and had to be financed by official reserves of the National Bank of Hungary. Finally, many bailed-out persons expected much better terms of continuing debt-financing in Hungarian forints than their new accounts indicate.

Third, the historically low level of interest rate on traditional savings (considering the bank costs, practically zero or negative interest rates) initiated a massive outflow of money both into Euro (capital flight) and to alternative investments, such as housing (housing prices grew by 20 per cent in the last years), durable consumer goods, government bonds and stock exchange. At least in the two latter cases not without risk well beyond the financial sphere.

Low level of investment activities is the most critical point of the „miracle". In fact, investment activities are still far below the 2008 figures despite the spectacular increase of mainly EU-financed public investments. Excluding some large private sector investments in the car industry based on agreements signed before 2010 (Mercedes, Audi), private investments are almost non-existent. The lack of investments due to the loss of confidence of both foreign and domestic potential investors, is seriously jeopardizing the sustainability of competitiveness, since small but continuous „modernization investments" would be necessary to permanent upgrading of competitive production and service activities. Interestingly, continuously declining interes rates were not able to generate massive new investments. Indeed, indebted private companies made broad use of the National Bank's offer to change higher-interest rate debts into lower-interest rate debts. However, it did not launch a new wave of investments, due to prevailing legal and economic uncertainty and the reluctance of most banks to lend money while being forced to consolidate their own budget after various haircuts suffered by „unorthodox" government measures.

In sum, the Hungarian „growth miracle" seems to be unsustainable for several reasons.

First, in 2014 agriculture (with about 5 per cent of GDP) reported record output which cannot be repeated this year (already in the first quarter of 2015 agricultural output dropped by 12 per cent).

Second, the car industry (mainly the so-called Mercedes impact) is about to reach its peak performance (working in three shifts around the clock). Other industrial sectors as potential future drivers of manufacturing growth cannot yet be identified.

Third, and most importantly, EU money has been the key engine of the „miraculous" growth between 2013 and 2015. In the Multiannual Financial Framework (MFF) covering the period between 2007 and 2013 Hungary was entitled to have access to about Euro 23 bn, or more than Euro 3 bn a year. Out of this sum, annually about Euro 1 bn has to be deducted due to the Hungarian contribution to the common budget. In contrast, this transfer does not include direct payments to farmers (Common Agricultural Policy) and several other payments outside the cohesion fund. Since the available money has not been used evenly across the seven year period, due both to budgetary rules (application, long preparatory periods) and to the negligent attitude of the Hungarian government after the political change in 2010, characterized by institutional uncertainties about who is really entitled to manage the EU funds, a large part of the available money had to be used in the last three years (from 2013 to 2015, being 2015 the last year of having access to funds of the 2007-2013 MFF period). In consequence, as of 2013, the government started to make a lot of attempts at getting the most of the money, without any consideration of its longer-term multiplier effects. Still, it can be assumed that on the average of 2013-2015, more than the annual amount of Euro 3 bn has arrived. This amounts to at least 3 per cent of the Hungarian GDP. Just the inflow of the EU transfers could produce a statistical growth rate of 3 per cent. However, this „honey-moon" period will be over at the end of 2015. Of course, a new transfer channel is already opened within the MFF 2014-2020, but access to money will need a longer period of preparation. Therefore, new money will start flowing slowly and will certainly remain below average (still about Euro 3 bn annually) at least in 2016 and probably also in 2017. In addition, several rules of the game have been changed and instead of a one-way support, part of the transfer will have to be returned to the EU. Moreover, the government has to be prepared to a two-way flow of money, because, at present, several procedures and investigations initiated by Brussels are in process, and more are expected to come due to Hungarian policy measures that violate several basic EU rules of competition (from retail trade through energy to various services) and the already ongoing anti-fraud (anti-corruption) investigation by OLAF (one just against the son-in-law of the prime minister). In sum, it is not unlikely that the net transfer of EU money to Hungary in 2016 will be near to zero (or even negative, due to higher punishment than transfer). In any case, the key element of the „economic miracle" is disappearing, with the most serious consequences on construction and partly public work (leading to statistically higher employment rate), since both areas have almost exclusively been financed from EU funds. Also, the small- and medium sized entrepreneurial sector could be seriously hit, since, between 2007 and 2013, about 80 per cent of its total external financing has arrived from EU transfers. The only exception will be the continuous flow of direct support to agriculture, which has become a key political and financial issue for the current government how to put close friends into the position of new landowners.

2. *Reduction of budget deficit*

At first sight, the reduction of budget deficit below 3 per cent of the GDP seems to be a success story. However, the way in which it has been implemented, has not only questioned the sustainability of the „miracle" but has undermined the medium- and longer-term growth prospects of Hungary.

First, one of the first measures of the „unorthodox" economic policy was the imposition of special and several times discriminatory taxes on selected sectors, mainly dominated by foreign comanies (energy, telecommunications, retail trade, banking). Although, for various reasons, most of the affected firms remained in Hungary, they stopped or seriously cut their planned investments, with negative impact on future growth and job creation. In addition, several legal processes are on the way because companies have indicted the government at the respective EU bodies on violating basic rules of competition. Some jugdements are already known, obliging the Hungarian authorities to restore conditions of competitiveness and/or paying indemnization. Many others are likely to follow. Moreover, the government once having come to power promised the simplification of the tax system. In contrast, in the last years not less than about 70 new taxes have been introduced, most of them making normal business more complicated or even making investments impossible.

Second, as one of the first steps which would have been unimaginable in any democratic country, the government, at one strike, nationalized (in better terms „bolshevized") the private pension funds representing Euro 11 bn (or 10 per cent of the Hungarian GDP) in 2011. For there was no massive protest by 3 million people involved in this scheme (a topic that throws light on one of the most important non-economic factor of „economic miracle"), the government correctly calculated that if such a measure does not provoke resistance, practically everything can be done as long as it is at power. Up to today, we do not know what has happened with this money. Most probably, part has been used for budgetary consolidation and another part to reduce – with very ambiguous results – the external debt. We do not know whether some money is still available for future budget consolidation.

Third, dramatic cuts have been implemented in the expenditure side of the budget. On the one hand, the gap generated by the introduction of the flat income tax (economically irrational and socially immoral) has caused a budgetary revenue fall by about Euro 2 bn. This gap had to be filled by other incomes and by special savings. Beyond a number of areas cutting social welfare payments and unemployment benefits, both leading to increasing poverty and growing income and social gap within the Hungarian population, the farthest-reaching negative consequences can be identified in the dramatically underfinanced healthcare and educational system. Budgetary support for both of them has been cut from year to year, and the 2016 budget includes just these two items with declining budgetary support (even in nominal terms), namely healthcare and education (against a dramatic rise of budgetary support for police and antiterrorist activities). Moreover, education has been practically nationalized and the obligatory period of learning reduced to 16 years – in order to create a large amount of unskilled workers who, as the government believes, fit into and can be adjusted to a „modern slavery system", a desired background of and support to a long-term authoritarian regime. Instead of increasing the number of university students, several disciplines have been cancelled (e.g. international relations), renowned universities will be split and reorganized (the respective government decree is expected to become public before end-August). In sum, the human resource basis of the country, the fundamental medium- and longer-term factor of sustainable development and international competitiveness is dramatically threatened.

3. *Labour market, unemployment*

Again, at first glance, the labour market reveals one positive development. According to official statistics, previously double-digit unemployment rate has come down to 7 per cent, while long-term and structural unemployment remains high and the activity rate of the population is still at 67 %, below the EU-28 average (72.3 %), let alone the Czech Republic (73.5), Austria (75.4) or Germany (77.7).

At a closer look, the „employment miracle" reflects the classic way of deliberate mis-communication of the government.

First, employment data include also most Hungarian citizens who are working abroad. Their number has skyrocketed in the last five years and reached about 400 to 500 thousand persons (about 4-5 per cent of the population and 7 to 9 per cent of the active population). It is twice as much as the number of emigrants after the 1956 revolution. In fact, in the past Hungary has not been an emigration country (like Poland, ex-Yugoslavia or the Baltics). Even after the 2004 accession to the EU outflow of Hungarian labour remained modest and concentrated on higher-skilled sectors (computer engineering in Ireland and the United Kingdom, doctors in Sweden) or focused on commuting in border-near Austrian regions. The dramatic turn-around occurred after 2010 and can hardly be attributed just to economic reasons. Namely, wage differences between Hungary and the old EU member countries existed from the very beginning, and, maybe, in some sectors they have been narrowed in the first decade of EU membership. The unanimous driving motive of going out of the country were the increasingly suffocating political and human climate and the growing sense of apathy, frustration and hopelessness. As a consequence, already today, we can experience a lack of skilled workers in many sectors. Already in the near future, this may become one of the major obstacles of attracting foreign and domestic capital, upgrading economic activities and sustaining international competitiveness (beyond the well-known anti-capital government policies).

Second, employment figures cover also people employed in public works. Although it cannot be objected to bring unemployed people back into the labour market (almost totally financed by EU money), but the humiliating conditions of such activities are nearer to a „labour camp" than to a normal employment. Let alone the fact that these, mainly unskilled people cannot be integrated into a competitive labour market without education, training and retraining. Needless to say, current public work schemes do not envisage such programmes.

Third, the private sector (excepting the one-for-all car industry impact) does not offer more jobs, due to uncalculable future, lack of money and sometimes lack of reliable labour force.

Concluding remarks

For a number of reasons, as indicated in this paper, the Hungarian „economic miracle" is not sustainable. In fact, it never had been a „miracle" as reflected by macro-statistical figures and permanent government propaganda. The once-for-all factors of growth cannot be repeated or sustained. The real question is, when and in which form the unsustainability of the current economic policy will become manifest. The more the „miracle" will, at any price, be artificially sustained, the higher will be the costs and the lower the chance to find an economic development path which offers more sustainability, rebuilding competitiveness and create more social justice. The success, however, does not depend any more on a rational economic policy but on the adjustment capacity of the Hungarian society and its readiness to change mentality and behaviour. Unfortunately, the most important victim of the „economic miracle" has been the mentally contaminated society – and it can turn out to be the main barrier to healthy, although costly, changes. However, the analysis of this issue falls much beyond this economy-centered paper.

***András Inotai** *is research professor and research director of the Institute of World Economics of the Hungarian Academy of Sciences, where he was General Director before.*

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