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Economic and National Security

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Abstract

The analysis covers the major trends of the Hungarian development path and their critical junctions, reflecting on the turbulent years of the economic regime change that followed the collapse of the planned economy, and also looking into the evolving tendencies of the first third of the 21st century. Particular attention is devoted to financial imbalances, since they have caused repeatedly social tensions in Hungarian history, or unsolved problems of the socio-economic system have manifested themselves in such imbalances. The main conclusion of the analysis is that in spite of structural modernisation and institutional progress, the Hungarian economic performance has, for a longer period, been mediocre or below the average if compared to CEE benchmark, making Hungary, a fully-fledged market economy, lose ground in the region. Demographic trends, weakness of productivity and wage growth, increasing gaps in income and wealth inequalities, emigration of skilled labour force all comprise a situation that is unlikely to trigger social crisis but it may push Hungary onto a slow growth track. Getting stuck in the process of real convergence with the more advanced European member states would weaken the legitimacy of the social order and intensify tensions between generations, social strata and sub-national regions. A centralising government can initially stabilize the economy, but high centralization may, in medium term, reduce the chances of Hungary's successful integration into evolving global trends, given that the emerging new industrial revolution requires particular cultural, intellectual and institutional preconditions.

Keywords: economic growth, economic security, macroeconomic imbalances, economic crisis, international liquidity, economic role of the state, Hungarian economic history, regime change

The issue of economic security in Hungary

Comments on matters of concept

Economic security (*gazdasági biztonság* in Hungarian) is not a generally accepted term in economics or, particularly, in common parlance. Primarily for historical, but also for linguistic and cultural, reasons, the term may carry different contents and cover a variety of areas, depending on the context in which it is used.[1] In academic literature and economic analyses it is used mainly in regard to the position of an individual or a business undertaking, in contexts such as product security, security of supply, employment security, the secure market position or secure equity position of a business firm, etc.[2]

The uncertainty concerning the meaning of the term stems from the fact that the society's particular experiences and challenges shape the context in which security aspects of the economy appear, and the context itself is also changing continuously, in response to rapid modifications in the economic and social circumstances. It is worth recalling what the US Secretary of State *George Marshall* said in the speech he delivered in June 1947 when launching what later came to be known as the *Marshall Plan*: the aid is to be provided to restore the *"normal economic health"* of the economies concerned and to revive a *"working economy"* in the fight against hunger, poverty, desperation and chaos.[3] Although *economic security* was not specifically mentioned in that speech, these keywords designated what the bolstering of the economic (and political as well as social) security of war-stricken countries meant in that particular historical situation.

Accordingly, the workability and the healthy functioning of the economy designate the desired target state, the opposite of which is *crisis, risk and threat*. The 1950s and 1960s saw rapid economic growth in both market economies and in countries based on central planning. After a while, however, *economic crisis signals* appeared, initially in market

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1 Equivalents of this adjectival combination in various languages appear in Wikipedia with a remarkably wide variety of different content elements and depths of detail. The English version of Wiki offers the shortest description of *economic security,* approaching it primarily from the aspect of the individual's *job security* and from that of the individual's role in saving and in finance in general; at a national level it refers to energy security and international competitiveness. The French equivalent defines the term from the perspective of growing living standards and continuous development, also in a concise form. The German version is more detailed, focusing primarily on the financial equilibrium of the individual or the business. The Russian form *(ekonomicheskaya besopasnost)* is the most elaborated version of the term, comprising international liquidity, capability to assert geopolitical interests, and the stability of social and economic order. It should be noted that even an act of law has been adopted in Russia on national security *(O besopasnosty – Zakon RF,* 1992), setting out the concept and the content of the term national economic security in detail.

2 The brief definition in the *Financial Times Lexicon* (applying, in principle, to both firms and states) refers to the threat of sudden disruption of economic processes and the efforts made at preventing and avoiding such threats, noting, by way of an example, complications caused by stock market manipulations or attacks against currencies.

3 *"It is logical that the United States should do whatever it is able to do to assist in the return of normal economic health in the world, without which there can be no political stability and assured peace. Our policy is directed not against any county or doctrine but against hunger, poverty, desperation and chaos. Its purpose should be the revival of a working economy in the world as to permit the emergence of political and social conditions in which free institutions can exist."*
See: www.oecd.org.general/themarshallplanspeechatharvarduniversity5june1947.htm

economies, going far beyond the scope of a sector or region. It was in the early 1970s, the years of a sudden price increase and *energy supply* insecurities caused by the first oil crisis, when the societies of the developed world had to realize that the post-war rapid economic growth could not be taken for granted. Far from that: events emanating from key industries, such as the energy sector, may cause shocks to the society as a whole. The industrialized world underwent a process of *economic restructuring* which entailed a series of sectoral, regional, employment and macroeconomic crises.[4]

The *Hungarian People's Republic* was also much affected by the oil crises that shook (and awakened) the western economies, no matter how this was officially refuted and how promises to the contrary were made. Due to the characteristics of its economic structure, its geopolitical status and social policy determinations, the Communist regime proved to be slow to respond to global changes.

It was the *world of finance* that came to be most heavily affected during the next decade, the 1980s, primarily in the developing world, but also in some of the planned economies, such as the socialist *Romania* and the *Polish People's Republic*.[5] All too frequently states went bankrupt with major spillover effects, showing how financial disequilibria could lead to crises affecting the whole society of the country concerned.[6] Hungary learned painful lessons in this aspect as well and it was only by joining international financial organizations in 1981–1982 that the socialist party leadership managed to avoid Hungary's external default. This, however, meant the acceptance of restrictions entailed by IMF membership and compliance with the terms and conditions of borrowing.

Hungary's economic security was hit hard by the *disintegration of the planned economy* and the wave of crises that came in its wake. Hungary was not the only country to face such difficulties, as all other countries in the Central and Eastern European (CEE) region sank into a *crisis affecting the entire social and economic regime* in 1989–1992. The transformation of the political regime was accompanied by an economic downturn of a scale not usually occurring in peace time. Hungary's gross domestic product (GDP) dropped by about 18% during the years of transformation recession (1990–1993). This was comparable to the loss of GDP in Poland and the Czech Republic; economic contraction in Russia, Ukraine and other former Soviet states turned out to be even much deeper (Blejer–Coricelli, 1997).

[4] From the aspect of our topic it is worth quoting what Joseph Schumpeter had to say on the nature of capitalism in a chapter of his book discussing *creative destruction: "Capitalism [...] is by nature a form or method of economic change and not only never is, but never can be stationary* (Schumpeter, 1942/1975): 82. In other words: change in itself – even if it is of an extent amounting to a crisis – is not the manifestation of defects of the market economy occurring from time to time, but is part of its very nature.

[5] Although Romania managed to pay off its foreign exchange debt by 1988, the forced repayment lead to disastrous economic and social consequences. Poland saw the outbreak of a domestic political crisis in 1980 and the Polish state quickly lost its international liquidity, for the third time in the country's 20th century history (1936, 1940 and 1981). The financial failure made life even worse in Poland: the standards of living plummeted, hundreds of thousands were forced to resort to international barter trade (as reflected by the proliferation of "Polish markets" in Hungary). It was only after a successful regime change that authorities managed to come to agreements with official lenders (1991) and later with private lenders (1993), on the terms and conditions of rescheduling. Until then, private capital looked upon Poland with reservations, the bulk of foreign funding came from the IMF, with economic policy conditions attached. Private capital flows steered clear of impoverished Romania for quite some time even after the collapse of the Communist regime.

[6] Alexandre Lámfalussy provided a detailed and extensive overview of the financial crisis in the developing world in the eighties and that of Russia in 1998 (Lámfalussy, 2008).

Social and economic transformation was inevitably accompanied by weakened *social security* (including growing unemployment, inflation and income inequalities) in all countries concerned, together with *regional* and *sectoral crises*. The size and dynamics of shocks, however, varied by country and by region; national economies responded to the new situation in a variety of ways. The shock-resistance and adaptive capacity of the Hungarian economy should be compared to countries in similar situations, facing similar challenges. In this regard *Hungary was among the best performing countries during the first decade of the new economic and political regime.*

The 1990s was a decade of rapid economic growth in most developed countries, with a growing sense of security at a global scale; core countries went unaffected by major shocks. The transformation of the transition countries, however, took a lot longer than expected. It took nearly a whole decade even for the most successful countries (the Czech Republic, Poland and Hungary) to reach their respective pre-crisis levels of GDP. Other countries faced even more severe economic and social complications in the course of transition from the centrally planned economic regimes.[7] Losses and damages caused by fraud and organized crime mounted; none of the countries concerned managed to avoid shocks originating from the financial sector, as a consequence of inadequate state supervision, the lack of experience of office holders, and of deficiencies in the institutional system.

An apparently carefree phase, promising predictable conditions, started in the early 2000s in the developed world and its peripheries – this period came to be termed later the *Great Moderation*. Year 2008 was, however, marked the outbreak of another financial crisis, with consequences reaching far beyond the world of finance. The standing of global capitalism that had been regarded as unshakeable up to that point, suffered a major blow. Since the weaknesses and deficiencies of state regulation and supervision are regarded as some of the key factors that triggered the crisis, the authorities' crisis prevention and macro-prudential activities suddenly gained importance and *governments became more active* in general.

In addition to the direct shock affecting the lending sector, the problems of *data security*, food security and the *climate change* also reached strategic levels: the advanced regions had to face a growing number of systemic risk factors. *Economy espionage* and *economic crime* are challenges no country is immune to.

Even cases amounting to *state failure* were witnessed in regions outside the developed world. In the light of these events and trends the measurement of *political risk* and its possible methods become all the more important. *State fragility* – caused by radical climate change, migration, disastrous food scarcities and/or other social and economic occurrences – became a specific research subject (Fund for Peace, 2015). The methodologies of state fragility will be utilized in this paper as well.[8]

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[7] For example, in Albania a pyramid scheme of fraud involving funds and assets worth nearly half of the country's GDP in 1996–1997 caused a major crisis, almost ending up in complete anarchy, cost the lives of some 2000 people (Jarvis, 1999).

[8] Out of a total of 178 countries Hungary is in the reassuring 141st place between Costa Rica and Latvia in Fund for Peace's list of states by fragility. This is the second best group, including Slovakia, Argentina, Italy, Latvia, Spain and even the USA, Japan and Germany. The least fragile group (ranked last in the list) includes, besides the Scandinavian countries, Austria, the Netherlands, Ireland, Switzerland and Australia. The list is put together on the basis of the following factors: demographic tensions, refugee issues, grievances of social groups, emigration, development inequalities, poverty and economic backwardness, the legitimacy of the

Content elements of economic security

This brief overview shows how any given society and its leaders have to face a wide variety of economic risks and/or threats affecting the economy even within relatively brief periods of time. It is for the very reason of the quick dynamics of social and economic processes and the variability of different types of threats that we do not attempt here to present a comprehensive definition of economic security. Suffice it to clarify, for a start, that we are going to discuss not risks affecting individuals' lives, financial, business or technical risks facing business entities or operational uncertainties of sectors or specific fields but threats appearing at the *level of the national economy* as a whole.

Our analysis is focused on the operation of the *Hungarian* society and economy. We are going to scrutinize factors relating to the economic aspects of the continuation and development of the *social and economic order.* Emphasis is laid here on potential risk factors and process contingencies, therefore this analysis is more risk aware and critical than would be a description of a desirable economic growth path or of a *"best case"* scenario. The degree of Hungary's economic security is not to be assessed against some abstract and general benchmark; what really matters is the country's position in *international ranking orders and comparative scales.* The strategic question is *how fully the Hungarian economy and society is capable of adapting to crises, disruptions and shocks; in what condition Hungary's economy appears to be from the perspective of possible risks.* A variety of normative conclusions can be drawn and recommendations can be made on the basis of the analysis.

The conventional analysis of the relationship between security and economy focuses on what *financial and other resources* a given economy can permanently dedicate to defence and law enforcement, that is, to what extent is the achievement of the state's security policy goals supported by the country's *economic power.*[9] The interactions between "economic muscle" and aspirations for power are extensively discussed in literature, with a special focus on the sustainability of the international balance of (the great) powers, along with dilemmas of the rise and fall of powers (Olson, 1982; Kennedy, 1989). The following analysis of the Hungarian economy also covers this nexus in discussing the size and structure of the general government budget, together with issues of public finances, but its main focal points lie elsewhere. This is because this conventional economy/security relationship is more valid at the levels of the European Union and NATO than for a member state. In the case of smaller countries that qualify as "dependent" in terms of security policy (such as Hungary), and countries that do not have global aspirations of their own, adequate national economic performance is required primarily for *maintaining the political system, guaranteeing social security and predictable functioning of society as a whole.* Accordingly, the effectiveness of the economy may be assessed primarily from the aspect of how these social goals are achieved.

A country lacking adequate economic performance may be weakened or even fail without any external conflict, as is proven by lessons drawn from economic and political history.

state, the standards of public services, respect of human rights, the security apparatus, divisions across elite groups, exposure to external intervention.

[9] Economic strength or economic power is a concept rarely used in economics, one that is difficult to measure, but it is, nonetheless an important factor without which no correct interpretation of processes can be given. See: Bod, 1995.

An overarching overview of the above is given by Acemoglu and Robinson: according to their argument, economic success or failure hinges primarily on cooperation involving all components of society; success is based on an *inclusive* political institution system, while failure is a result of an *extractive* type of system (Acemoglu–Robinson, 2012). The type of the political institutional regime is a key starting-point because the authors associate economic power not with the abundance of natural resources, favourable geographical locations, amount of capital available in an economy, or any other macroeconomic variable but derive economic conclusions from the *social conditions*.

The state of the fundamental social institutions being a causal variable in terms of the success of an economy is not an entirely new assertion. The critical importance of *level of development of the division of labour* and of the *exchange of activities (exchange of goods, trade, finances)* has been discussed extensively in literature on economic growth and welfare since the epoch-making work by *Adam Smith (The wealth of nations)* (Smith, 1776/1992).[10]

The connection between the strength of the economy and the security of the nation is crucial in both directions. On the one hand, when economic growth stops or even if it slows down somewhat, internal social tensions may soon start to intensify and the state's international power positions may start weakening. The strength of an economy and, consequently, the level of material welfare, are the sources of *political legitimacy*, in addition to their direct contribution to social peace and social stability. The performance of the economy plays an important role in the state's external relations as well: indirectly through strengthening *international prestige,* while directly through the *financial and material contribution* to the security alliance systems. On the other hand, social stability and a solid legal system, and a country's ability to assert its interests at an international level, are critically necessary for a country that is not rich in raw materials to be able to develop and maintain a competitive, up-to-date economy that can guarantee high living standards.

Based on these considerations and in view of Hungary's conditions, we will discuss the following important components of economic security:

- the trend of economic growth, its sustainable rate and the economy's natural growth rate;
- the state and structure of the budget, and the modalities and costs of its financing;
- international credibility and its perception; the external balance of the national economy, the size and structure of its debt;
- the efficiency and transparency of the government sector;
- the stability of the economic order (the functioning of the legal system, compliance, economic integrity, the condition of the state-business and state-citizen relations);
- the effectiveness of asserting the interests of the national economy;
- the dependence of business cycle on external factors;
- the vulnerability of the economy, growth risk factors;
- the economy's international competitiveness and its factors;

[10] Accordingly, protagonists of the modern growth theory regard the *institutional factor* of economic performance to *be on equal footing* with the conventional *factors of production* (capital, labour). In the existing world order the "wealth of nations" depends less on the availability of capital, labour, arable land or raw materials in general: endogenous factors, such as the state and condition of institutions, the social structure, the technological level, the market structure, the state and condition of the financial and physical infrastructure or the order of conflict management are much more dominant in this regard today.

- characteristics of income and wealth conditions, inequalities and their trends;
- the condition of the system of economic values, economic knowledge and capabilities;
- trends and outlooks of the availability and supply of factors of production.

In varying forms and to varying degrees each of these groups of factors contributes to the perceptions and judgements of the state and outlooks of national economic security; however, they cannot be reassuringly condensed into a particular indicator or grade.[11] It is not without good reason that the title refers to *security of the nation*: our topic involves more than the investors' security or an assessment of financial creditworthiness. Our aim is to assess, in their complexity, the social risks and uncertainties stemming from or intermediated by the economy.

The comparative concept of economic security

In an environment of a high degree of external economic, information and cultural openness a halt or even a relative decline in economic growth rate compared to the competitors may have an immediate impact on the society and economic actors. Consequently, an economic analysis should not only or not primarily focus on how the given economy is doing *in comparison with its past track record* in terms of growth and equilibrium, but how it is doing in the relevant framework of reference.

However, it is seldom self-evident which country or region counts as *relevant* in international comparison. A neighbouring country or region, or one that is geographically close, is, of course, usually more relevant than those at greater distances. Of the possible comparators those are of relevance to security that play a role in practical economic decisions taken by the members of the given society, its businesses and capital owners. In the case of Hungary, *Austria, Germany and the Visegrád four (V4) countries* are, for historical reasons, natural comparators, while other neighbouring countries *(Serbia, Romania and Ukraine)* are not included in the conventionally applied framework.[12]

The framework of comparison has a *subjective* element as well (different societies or countries for different people), but from the aspect of economic security the most important question is which comparison has an actual impact on actions of economic participants (employees, savers, businesses, consumers) and on those of political and economic decision makers. For example, insufficient income in the domestic labour market related to wages offered in benchmark countries may lead to the emigration of mobile labour force; unfavourable domestic tax regulations relative to those of countries known as alternatives for operations may trigger capital flight. Such cases illustrate that what we are talking about is not only subjective perceptions and feelings or matters of national prestige; they are true economic motivators.

[11] Political risk index or the *rating* assigned by by international credit rating institutions are examples for this but these are worked out as required for their own specific concrete purposes.

[12] However, the framework changes from time to time: as a consequence of wage increases in Romania or the impulses coming from the labour market south of Hungary the actual frameworks of comparison used by a proportion of Hungarian families may be supplemented with Hungary's southern neighbour.

Also of importance is how major international players perceive and classify a given country. Let us consider the grouping of countries to which Hungary belongs in the eyes of important institutions. At present Hungary, together with the other three Visegrád countries, is listed as a *developed* country in the official *UN* nomenclature.[13] The *International Monetary Fund* registers Hungary (and Poland) as part of the *developing world (emerging market and developing economy)*, while it has assigned the Czech Republic and Slovakia to its *advanced* category.[14] In the categorization system adopted by the *World Bank* Hungary and the other V4 countries belong to the *upper* income category *(high income)*.[15] The situation is different when it comes to the *OECD,* where Hungary belongs to the *medium* income category while the other three are assigned to the high income category.[16] Business analysts, as well as investment banking and capital market experts often refer to Hungary as belonging to the *emerging market* category, which is, of course better than belonging to the developing world but indicates a higher degree of risks than does the category of developed countries. In the EU configuration Hungary is part of the *outside the euro zone* and *inside the Schengen zone* sub-groups.

Keeping the *national currency is said to* give an extra economic policy tool to a government which may, ideally, be used as a means of protection against external shocks through a suitable exchange rate policy. At the same time, a national currency, which is globally marginal may in itself become the subject of speculation and any major exchange rate fluctuation is bound to increase business and macroeconomic risks.[17]

The economic importance of Hungary's membership of the European Union is hard to over-estimate. Accession has eased the integration of Hungarian businesses in the production chains of large enterprises with their headquarters in Europe, has led to the settlement in Hungary of large manufacturing enterprises (mostly in the automotive and electronics industries), and to the development of a sizeable logistics sector. All of these businesses require uninterrupted and quick access to the main markets; the two main components of easy access are good physical infrastructure and goods being granted crossing the state borders without border control formalities. Consequently, losing the *Schengen area status* would be a major risk factor, particularly with the automotive industry being a dominant element of Hungary's industry structure.

[13] www.un.org/en/development/desa/policy/wesp/wesp_current/2014wesp_country_classification.pdf

[14] www.imf.org/external/pubs/ft/weo/2016/01/weodata/weoselagr.aspx#a110

[15] https://datahelpdesk.worldbank.org/knowledgebase/articles/906519

[16] www.oecd.org/trade/xcred/2015-ctryclass-as-of-16-july-2015.pdf

[17] A variety of in-depth research projects were carried out concerning the pre-requisites for the introduction of the euro and its potential advantages and disadvantages in the early 2000s when Hungary was gearing up for EU membership. Researchers argued in favour of the adoption of the joint European currency, demonstrating its effects promoting economic growth. The first Orbán government was preparing for an early adoption of the euro. A new analysis was brought out (Neményi–Oblath, 2012) in the wake of the financial crisis of 2008, taking into account the changes and developments that had taken place, and an extensive professional debate unfolded in an economic periodical *(Közgazdasági Szemle)* with the participation of experts as Gábor Békés, Péter Ákos Bod, Lajos Bokros, László Csaba, Tamás Mellár, Palánkai Tibor and others. The timeliness of opinions cautiously arguing in favour of the introduction of the euro was weakened by the fact that Hungary was not meeting the majority of the accession criteria, and particularly, by an apparent lack of political support of the adoption of the euro. By July 2016 Hungary did meet the critical indicators and the minister in charge of the national economy even declared that by 2020 Hungary could join the euro zone. Nonetheless, the government in office does not seem to have the political will.

How institutions perceive a country's level of development has a strategic aspect. This aspect is whether the given country (in this case: Hungary) is a developed market economy or, to use a concept that stems from development economics literature but is used extensively nonetheless, whether Hungary is a *core country.* The majority of Hungary's economic indicators, confirmed by the above country classifications, define *Hungary* to be, at the beginning of the 21st century, *in a transitory position between the developed world and the peripheries of the European core.* Belonging to the European periphery is, of course, not the same as being in the global *periphery that is in the developing world.* It is also remarkable that certain classification schemes reviewed above assign some of the peer countries in the CEE region to a higher category. For this reason, the analysis of the Hungarian economy's risk and load bearing capacity and Hungary's financial/economic strength will have to specifically discuss changes in Hungary's position relative to the *V4 group.*

Particular attention must be paid in examining economic security conditions to the *financial aspects,* in view of the relevant historical preliminaries. The reason for this is that economic processes frequently overrun in the peripheries, causing capital market "bubbles" to develop, leading to financial panic. Other processes may also develop rapid dynamics: excessive agglomeration effects may be triggered, and energy dependence as well as import/export market dependence may reach levels that may be considered as also excessive. Waves of economically or politically motivated emigration may also develop rapidly and their effects may destabilize the state concerned.

In the age of global interdependence no nation state – particularly those in the peripheries – has sufficient control mechanisms for the management of such possible economic shocks. Once unfolded, the effective management of a financial crisis requires a high level of *confidence in the government's integrity and the legal system;* this is why the situation of social values and trust as capital also need to be analyzed.

Hungarian economy: conditions, opportunities, risks

Hungary's economy has encountered many a crises – but have we learned our lessons?

Before applying the key economic security indicators to Hungary's current conditions and circumstances, it is important to discuss antecedents and the heritage from the past. One of these is that periods of continuous and unbroken economic development were brief and rare in Hungarian history. The legal and institutional framework has been changed all too frequently in recent decades for achieving capital accumulation, growth in economic strength, build-up of wealth and organic societal development, as has been customarily in much of the developed world.

Even in the rare cases when household consumption could grow continuously at long last, destabilising processes lurked behind the impressive statistics. Like in the 1960s and 1970s: *the relative welfare under the Kádár regime was accompanied by the build-up of an immense external sovereign debt.* Incidentally, the other reformed centrally planned economies shared the same fate – see the similar story of how Poland and Yugoslavia became heavily indebted. Debt accumulation is, at the same time, a form of raising funds

from abroad, therefore the same process may be viewed from a different angle: while borrowing was used for the maintenance of the political regime, but the accumulation of debt may also be regarded as a process accompanying the inevitable opening of the economy, and modernization driven by capital imports.[18]

Its consequences, however, were clear and beyond doubt: the foreign exchange debt inherited from the Kádár regime aggravated the initial, and conflict-ridden, process of the *political regime change*. It took a long time before democratic Hungary's external debt and domestic general government debt decreased back to an acceptable level: by 2001 the government debt to GDP ratio (52%) was the only Maastricht criterion Hungary could meet. By that time the external foreign exchange debt had ceased to be a strategic risk factor, primarily as a result of the massive influx of non debt-creating *foreign direct investment (FDI).*

The historical lessons learned did not make a difference in the world of politics, however. The *"excessive consumption – government debt increase – external indebtedness"* cycle was run repeatedly in Hungary in the early 2000s. Although only temporarily, the process boosted the growth of GDP over the potential rate of growth through a demand side impetus. It has to be pointed out in this regard: a dynamic increase in economic performance measured in terms of the conventionally applied indicators of economic output (GDP, GNI), indeed, an upswing in consumption and living standards, can only contribute to social stability if growth is achieved at the expense of a significant and permanent loss of *economic equilibrium*. Therefore, in addition to factual data, account will have to be taken, from this point, of the level of and changes in the *natural growth capacity*, that would have existed, or would exist, without any forced intervention, external indebtedness and excessive exploitation of natural and human resources.

Another comment on social perception of economic processes: the so-called objective processes are perceived and evaluated by different social groups in different ways. Their behaviour is also affected by their *subjective expectations*. At the historic moment, in 1990, the majority of the Hungarian society did not regard the averting of the impending financial crisis to be the most important thing: instead, people were hoping, once four decades of seclusion from the West ended, that their living standards would reach, or at least start raising towards, those prevailing in the West (namely, in Austria and Germany). Yet it was the very historic moment at which Hungary's relative economic performance sank to the greatest ever distance from that of Austria (See table 1).

[18] In regard to the debt crisis which came to a head at the time of the regime change Ottó Hieronymi had the following to say: "Like in the case of a number of other heavily indebted countries Hungary's accumulation of such massive foreign debts and such heavy debt servicing burdens were a combined result of a variety of internal economic policy mistakes, as well as international trends. The seventies were characterized by excessive borrowing – for the most part in order to raise living standards, and to compensate Hungary's delaying, for long years – like the other socialist countries – changes in the structure of production and consumption that would have had to be carried out in the global economic situation that came about after the first oil crisis" (Hieronymi, 1990).

Table 1

Hungary's economic development compared with that of Austria (GDP/capita; Austria = 100)

1890	1913	1938	1960	1970	1980	1990	2005
60.3	60.5	74.6	56	51.6	45.9	38.2	40.1

Source: Tomka, 2011

Excessive subjective expectations on the one hand, and slowly changing economic, financial and technological conditions and circumstances on the other hand: not surprisingly, the tension between the two leads to conflicts. This was what happened in the case under review: political public opinion and voters' sentiment quickly turned against the political powers that had won the elections not long before. One of the well-known peaks of the tensions was the so-called *taxi drivers' blockade* in October 1990, which was triggered by reasons linked to the preceding political regime (inadequate national oil reserves, the fact that domestic energy prices had been kept below the world market prices, that people had precious little in the way of financial reserves), dramatic changes in the external environment (soaring international oil prices, inadequate willingness and capability on the part of the Soviet Union to supply oil) and the new government's lack of practical experience in crisis management (Kodolányi, 2016).

The energy crisis in 1990 also indicated that, unlike western economies, socialist countries (including Hungary) had failed to implement economic, price policy and technological measures and actions in the wake of the global oil crisis of 1973 that could have created less energy-intensive economic structures. The majority of these problems too were bequeathed by the centrally planned economy to the regime changing society, just like issues relating to environmental loads and pollution.

The consequences of four decades of centrally planned economy are still with us today, for example in the *high energy intensity of the economy* of the EU member states, despite improvements that have taken place in each of the countries concerned through price mechanisms and structural changes. As indicated in Table 2, the amounts of energy required for turning out 1000 euros worth of gross domestic product still vary widely, despite all of the changes brought about by an entire decade after the regime change.

Table 2

Change in energy intensity between 2004 and 2014.

Country/year	2004	2008	2014	ei2014/ei2004
EU28	152.0	137.7	122.0	80%
Czech Republic	360.3	281.9	256.3	73%
Germany	142.6	126.6	114.4	80%
Greece	135.1	127.4	131.7	97%
Hungary	275.3	255.3	219.5	80%
Austria	123.3	113.9	106.2	86%
Poland	329.7	288.3	233.7	71%
Romania	375.1	293.0	235.0	63%
Slovakia	368.6	269.7	221.2	73%

Intensity ratio: Domestic energy consumption in oil equivalent, per 1000 euros of GDP .Last column: 2014 energy intensity as a percentage of the 2004 ratio

Source: The author's editing and calculations, based on Eurostat data

The data indicate that structural differences still exist among the economies concerned: the Czech and the Romanian economy are still using twice as much energy as the EU average, while Hungary's data are somewhat more favourable. The rates of improvement are also visible: during the period under review the EU economy reduced its energy consumption by about 20% of the initial level through technical development, energy prices being kept at high levels and through changes in the economic structure (conventional industries use immense amounts of energy, while high value added services use relatively less). The improvement achieved in Hungary is in line with the EU average, but, owing to the existing conditions, it is *not satisfactory*. In the long run, household tariff regulations that are dominated by political considerations counteract any effort or intent to improve energy efficiency, which is still unfavourable in view of the prevailing European ratios. Romania, Poland, Slovakia and the Czech Republic, however, have been making remarkably rapid improvements. Intensity data may be used as proxy for the environmental load as well as for the country's *energy dependence* in net energy-importing countries.

Mention should also be made in this regard of the attitude of economic policymakers toward the so-called *productive* and the *service providing* sectors which, from the aspect of the earlier Marxian dichotomy of productive v. non-productive, makes practically no sense in a market economy, yet it is still commonly held, and not only in Hungary. Negative feelings concerning services (primarily financial services) grew stronger as a result of the crisis of 2008. The excessive growth of financialization and the rapid decline of conventional industries in the European peripheries (in Greece and Spain) really called for adjustments, but it would be amiss to return to obsolete concepts of what industry is. In Hungary, where the share of industry in total output is significantly larger than the EU average, general re-industrialization would make no economic sense. What is all the more important, however, is to increase the value added content, regardless of whether it is generated by production or – which is more realistic – by service provision. Another security aspect of relevance

to our discussion is that assembling and manufacturing processes are significantly more energy intensive than are the majority of the services that add to the utility and market price of products (R&D, quality assurance, logistics, and other business services).

Energy crises are only one among the many macroeconomic risk factors. Other dangers have also emerged along the Hungarian economic and social path, primarily in financial relationships. After the above mentioned period of growing indebtedness around 1980, the threat of default on external debt emerged at the end of 1989; and then again in the autumn of 2008 when international disorders shook financially vulnerable economies. Since these periods have been analyzed extensively, it only needs to be noted here that the amounts and ratios of the *external debt* and the *public debt*, as well as *access to capital markets,* are risk factors on which more emphasis needs to be laid in the discussion of Hungary's economic security than in the case of other, less indebted, nations of this region.

The economy's growth capacity

Growth is a central element of any macroeconomic analysis: the value added that is generated by an economy is the source of earned income and of the profits of businesses. Public revenues of the budget of a state are generated mainly through deduction by the state from such primary forms of income. The fact of growth, indeed, even a high rate of growth, does not, in itself, rule out economic and social risks, if growth is accompanied by increasing external imbalances or domestic inequalities, or economic and financial discrepancies. Therefore, after outlining a general picture, risk elements need to be discussed in particular, with an emphasis on how Hungary's growth rate responds to external shocks.

A longer time series of data on changes in Hungary's gross domestic product (Figure 1) provides a "bird's eye view" of the quarter of the century that has passed since the regime change: they show the dramatic decrease following the basis year of 1990, the subsequent relatively rapid growth, the slump following the financial crisis that broke out in the autumn of 2008 and the growth path with periods of set-backs, during the recent years.

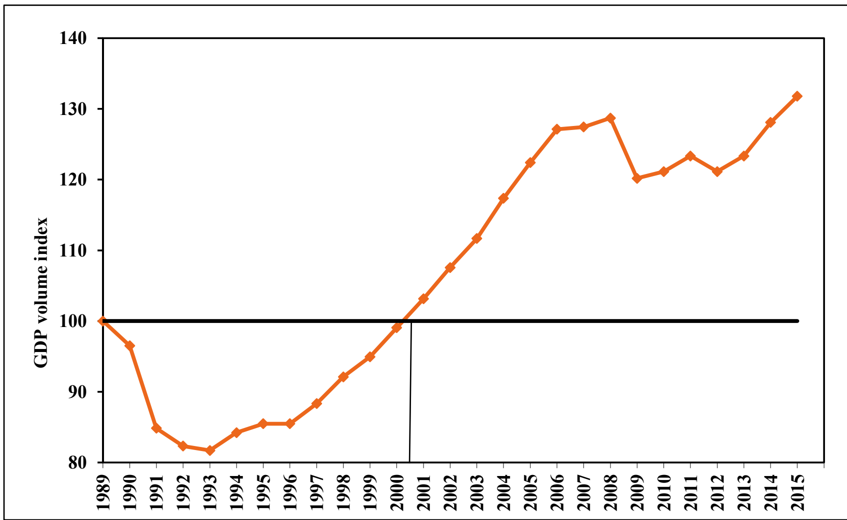

Figure 1

Hungary's GDP (1990 = 100%)

Source: Eurostat

It is worth, however, comparing *Hungarian data* to those of the relevant peer countries – including, primarily, former centrally planned economies of the Central-European region. Hungary's performance does not look convincing if compared to the performance of the comparable countries.

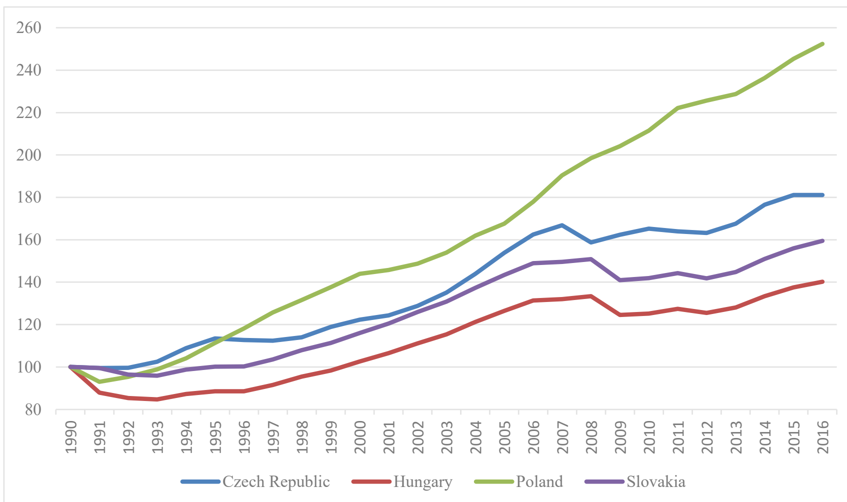

Figure 2

Real GDP figures in the Visegrad 4 group

Source: Own calculation based on IMF data

A quarter of a century's growth data show that *the other Visegrád countries produced better growth figures than did Hungary,* despite the similar initial levels of development and the past and present similarity of the relevant external conditions.[19] On the other hand, some of the other countries in which the political and economic regime was also changed suffered even more serious initial set-backs and then covered recovery paths different from those of Hungary. For example, the three neighbouring former Yugoslavian states took a starkly different course of development. Countries followed very different paths in the region, primarily after the 2008 crisis. For this reason, growth performance of different countries in recent years need to be discussed separately.

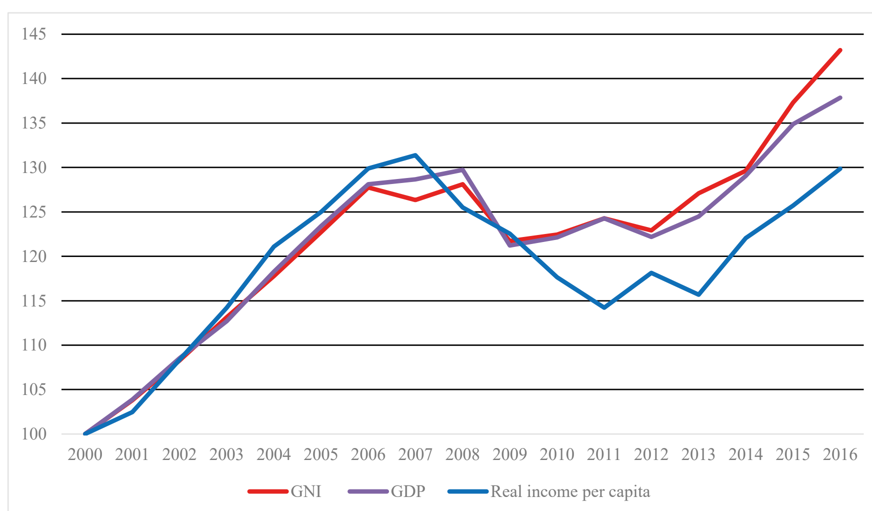

Figure 3

GDP, GNI and real income per capita in Hungary

Source: Calculation based on Central Statistical Office data

Figure 3, showing data for a shorter period of time, indicates the immediate dramatic effects of the crisis hitting Hungary in the autumn of 2008. It is also clear from the figure that Hungary's economy was not on a dynamic growth path even right before the slump of 2009. In fact the growth of the economy suddenly slowed down from the autumn of 2006 when – in response to the European Union's pressure – efforts started to be made to reduce the alarming rates of budget deficit. It is also clear that, as in the case of the crisis in the early 1990s that followed the regime change, a *sudden contraction was followed by slow and protracted recovery*. It was not until the end of 2014 that Hungary's GDP crawled back to the 2007 level: it took five years for the economy to recover from the slump of 2009. This economic performance was fairly close to the EU average but fell short of those produced by more dynamic nations of our region, including primarily Poland, Slovakia and Romania.

[19] Hungarian literature on economics took note of the importance of regional comparison. Oblath explains Hungary's relatively lower performance compared to those of the other three V4 countries with the higher degree of macroeconomic instability of the Hungarian economy Oblath, 2014).

What we have been discussing so far is, however, the GDP, the indicator of the value added that is produced in the territory of Hungary. A look at the rate of *gross national income* (GNI), which includes the income of residents in Hungary, shows that at the end of the period under review its dynamics perceptibly outperformed the growth of GDP, the most frequently cited indicator of economic performance. The faster growth of the GNI was driven by two key factors: the increase in the *EU transfers* and in the repatriation *transfers of those employed abroad*. Future changes in these underlying factors are regarded as a major risk factor of Hungarian national income.

The above macro-indicators provide valuable insight into economic performance but they are far from what people feel and see. Changes in the *real income* of people however, are of relevance to understanding the financial circumstances of the majority of the population who live from wages and salaries. Real incomes, which reached a peak before the financial crisis, also shrank rapidly but the process of their recovery appeared to be even more difficult to get started, and was even more delayed than that of the GDP and GNI: they had not reached their (not particularly high) year 2007 level even by 2015.

Meanwhile *income inequalities* grew considerably among households in Hungary: the poorest fifth and the most affluent fifth of the population earned 9.6% and 35.5% of the total income, respectively in 2007, while the corresponding figures were down at 8.6% and up at 37.5%, respectively, by 2014 (BCE, 2016). As a consequence of changes in income distribution in 2016 *more than half of the Hungarian population was still living on incomes lower than in 2006.*

More long term macroeconomic data show that the performance of the Hungarian economy during the recent somewhat longer period of time was rather short of remarkable. *After the passing of a quarter of a century Hungary's GDP exceeded the level recorded at the time of the collapse of the previous political system in 1990 by about 30% and even by 2014 it only managed to crawl back to the level measured in 2008.* This performance is not something to be proud about in the Central-European region. The 1.0-1.5% average annual growth rate achieved during the period under review makes convergence to the West – viewed as a historical basis of reference – practically impossible to achieve.

On the other hand, however, the *last years* of the series of data presented above show a significantly more positive picture in terms of growth, with GDP growth rates around or over 3% and with improving equilibrium indicators. On the basis of the more recent data one could even argue that the earlier crisis-ridden period has come to an end and the economy of Hungary is now making headway on a *growth path,* as is actually declared in convergence reports published by the government (Magyarország Kormánya, 2016).

Indeed, calculations produced by a variety of research and other institutions indicate an acceleration in Hungary's so-called *natural growth rate,* supporting positive expectations.[20] Calculations of independent sources, however, show that even the increased natural growth rate is only about *2 percent.* On the one hand, this is still below the dynamics featured by other V4 countries, and, even more importantly, it *pushes the vision of approaching the Austrian and German levels of development into such a remote future* that is beyond reach for political decision-makers.

[20] On the possible sustainable economic growth rate of the Hungarian economy see: Bod, 2016.

The estimated natural growth rate is the result of calculations that depend on the parameters of the available factors of production (labour, capital) and the projected effectiveness and efficiency of the political institution system and legal regime. The calculated value is therefore affected by factors whose changes have a direct bearing on economic order and security. These components will be discussed in more detail later on.

The general government system as a stabilising institution that carries risks as well

The Hungarian state is a key participant of the economy: redistributed primary incomes amount to about half of the total GDP in Hungary The same ratio was even higher during the period of the centrally planned economy; high rates of centralization were, however, regarded at that time as a natural feature of the Communist socio-economic system, as a consequence of the small proportion of the underdeveloped and dispreferred private sector, the dominance of state ownership and the hierarchic organization of the economy.

Most of the former centrally planned economies disposed of the majority state ownership first during the process of regime change in the early 1990s, by applying techniques of privatization and economic policy instruments stimulating the private sector, and then they built up a system with significantly lower rates of *centralization* and *redistribution*. The general government system was most rapidly downscaled primarily in the countries where income and wealth conditions that had evolved during the decades of socialism were rearranged by *high inflation rates* (Poland and Romania), or where there was a strong intent to achieve adaptation to the conditions and circumstances of market economies in the course of *state building* (primarily in the Baltic states, and Slovakia after the removal of the Mečiar government).

By contrast, transformation in Hungary was – despite all of the microeconomic shocks and those affecting the economic structure – a fairly *gradual* process in this (and only in this) regard. In terms of its redistribution and income centralization rates Hungary's indicators are more similar to those of the affluent Western and Northern European welfare states than to those of its regional competitors of similar levels of development.

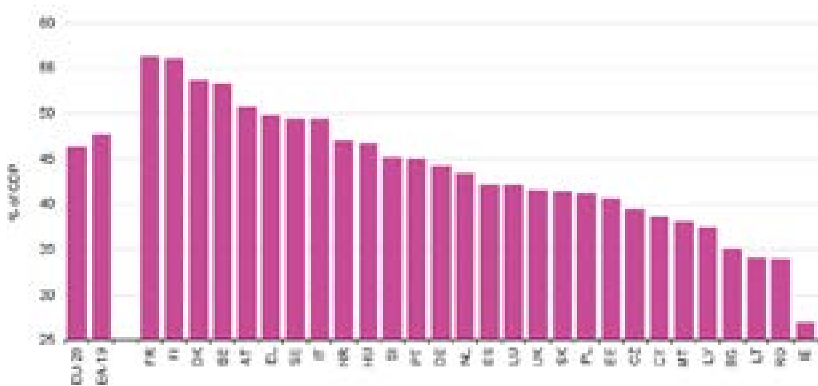

Figure 4

Relative size of budget in Europe: Total general budget expenditures as per cent of GDP

Source: Eurostat

The overbearing presence of the state may impede economic performance and increase the risk of state bureaucracy failing to use the centralized funds effectively and efficiently enough. The heavy dependence on centralization and allocation by the state increases the dependence of households and businesses from *politics* and their exposure to political changes, together with the regulatory risks inherent in the operation and functioning of the private sector.

At the same time, redistribution ratios that are higher even than those observed in Hungary, can be found in affluent European welfare states, where they do not interfere with economic competitiveness. In those countries however, businesses and households have, through long decades of organic development, got accustomed to extensive central redistribution and the associated high tax rates, while social control institutions are highly effective in guaranteeing that public monies are used in a transparent and reasonable way. The preconditions of transparent use of public funds are, however, not met in Hungary, certainly not meeting Scandinavian or German standards.

It is more difficult to keep an oversized general government system in balance than would be with lower tax rates and a smaller expenditure side, although the *deficit bias* is primarily due to institutional and political factors. From the aspect of economic security the high rate of governmental debt relative to GDP is not, in itself, a critical factor (the Belgian and the Japanese government debt ratios are, for instance, many times over the rates that would, in the case of developing or transition countries, be a source of major concerns). What is highly important is the *way debt financing* is taken care of: the risk of renewal is smaller in the case of debt in a country's own currency, financed primarily by domestic income owners.

The government debt turns into a major security risk factor when the general government debt is accompanied by *indebtedness of the private sector,* particularly when twin deficit appears: besides the general government deficit the current balance also shows a major deficit and both types of deficit begins to build up a hefty debt portfolio. Hungary's government debt ratio rapidly deteriorated in the early 2000s, while during the second part of the period under review it started to gradually improve (Figure 5).

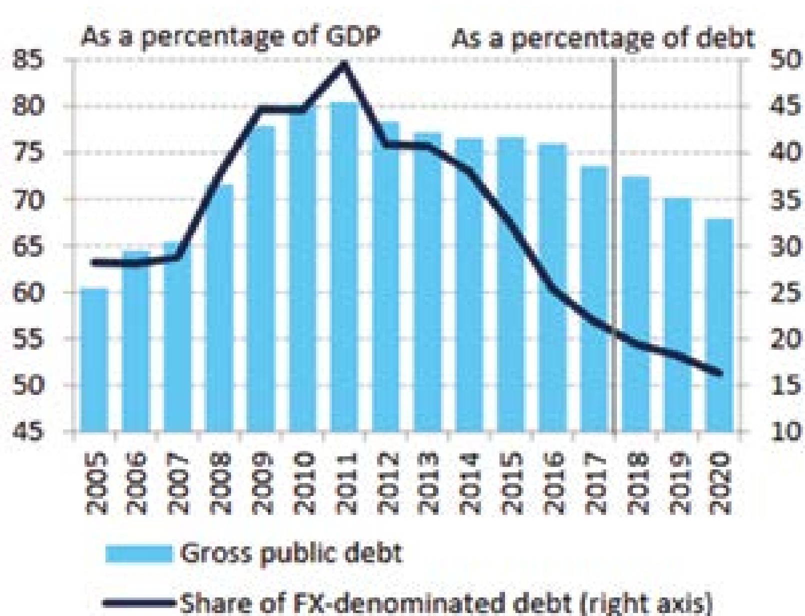

Figure 5

Gross public debt forecast calculated with unchanged (end-of-2017) exchange rate over the forecast horizon

Source: MNB: Inflation report. June 2018.

Actual data up to 2017 show that the consolidated government debt dropped to below 75% relative to GDP and, in accordance with statutory regulations, this ratio is continuously diminishing; this ratio is just below that of the EU average. Foreign exchange exposure is expected to keep decreasing considerably before it reaches the level recorded in the early 2000s. But to assess Hungary's external foreign exchange dependence, one must look at the *position of the entire Hungarian economy:* in this respect the improvement since 2012 has been even more spectacular.

As for the favourable indicators of the government debt portfolio and the annual budget deficits, reference needs to be made to the changes that have occurred in the *pension system,* which is also part of the general government system. The mandatory private pension fund, the third pillar of the pension system, was discontinued after 2010. Most of the members were directed back into the state pension system, while their pension fund savings were absorbed by the state. This then reduced the stock of official (explicit) government debt. Since then, however, those retiring may only hope to be paid public pensions from the contributions to be paid by the active generations coming after them. In other words, the corresponding amount of future claims should be added to the so-called *implicit* (not contractual) *government debt,* that is, the stock of debt that the Hungarian state owes as political and ethical (but not contractual) obligation to those paying pension contributions today. *In the all too well known demographic situation the existence and, in particular, the growth, of the implicit debt is a long term budget risk factor.*

Mention must also be made in relation to the budget of the amounts dedicated by the budget acts to *defence and police capabilities*. Among expenditures according to the international functional nomenclature (Table 3) that the Hungarian state allocates 2.3-3.0% of the Hungarian GDP to these two functions.

Table 3

Defence and police expenditures in the Hungarian general government system, as a percentage of general government expenditure and GDP

CO-FOG		**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018p**
F02	Defence	2.4	2.0	2.0	1.7	1.6	1.4	1.6	1.7	1.8
F03.a	Administration of justice	1.1	1.0	1.0	0.9	0.9	0.7	0.9	0.9	0.9
F03.b	Public order and safety	2.7	2.5	2.7	2.4	2.4	2.3	2.1	2.4	2.7
F03.c	Fire protection	0.2	0.3	0.5	0.5	0.5	0.4	0.4	0.5	0.4
F03.d	Prisons	0.5	0.4	0.4	0.4	0.4	0.4	0.4	0.5	0.6
F03	Law enforcement and public safety	4.5	4.2	4.6	4.2	4.2	3.9	3.8	4.3	4.6
As a percentage of GDP (cash-basis)										
F02	Defence	0.9	0.8	0.8	0.8	0.7	0.7	087	0.8	0.9
F03	Law enforcement and public safety	1.7	1.7	1.9	1.9	1.9	2.0	2.2	2.1	2.2

Source: Calculated from data of budget Acts

Defence expenditures make up a small proportion of the above; Hungary had a relatively modest defence budget in the period surveyed, about half of the expectations regularly communicated by NATO. What follows from this fact is this is that funding will have to be found in the long run in the budget, which is already rather extensive, for considerably increased defence expenditures, assuming that NATO commitments cannot be postponed forever. Maintaining the defence capability inside the military alliance is still cost-effective compared to other options.

International financial relationships – fundraising, liquidity

Since during peace time recurrent accumulation of external debt has been the most significant *systemic risk* factor in Hungary's recent economic history, the *external indebtedness* of the economy (i.e. not only of the public sector) needs to be reviewed. Going back only to the early 2000s: the reckless budget policies pursued between 2001 and 2007 lead to the accumulation of a massive public debt. The macroeconomic risks were increased by *retail* borrowing, and the business sector (non-financial as well as financial enterprises) also built up massive debts expecting sustained high growth, and they did so primarily by borrowing from abroad, in foreign currencies. In this way the combination of the current account

balance and the capital balance ("external financing capacity") showed an immense deficit, equalling 7–8% of GDP for years before the 2008 crisis.

The unsustainable process was decelerated by the (belated) implementation of the actions triggered by the application of the EU's Stability and Growth Pact in 2006, by deploying the *excessive deficit procedure,* but the real turnover was brought about by the financial crisis that broke out in the autumn of 2008. The external deficit vanished on the turn of 2009 and 2010.

Since then, Hungarian data have shown a surplus – indeed, a massive surplus – which we will explore hereunder in a breakdown *by income owner.* The *state* continues to be in deficit but since 2013 its size has been smaller, *households* are net savers, as usual but the most profound change has taken place in the *corporate* category, whose position has turned from net borrowing before the crisis, into a net financing position. These processes have led to the unusual situation in which domestic participants were spending significantly less than their total income; the difference is being used by the Hungarian economy for *financing the outside world* and *reducing its existing debt portfolio.* This turn of events may be viewed from two angles: the turn-around of the process of external debt accumulation reduces Hungary's external financial exposure and its dependence on private and official lenders – this increases the level of economic security. But in a country that has always been short of capital it is not a logical option to export capital and it cannot be continued in the long term without a loss of its growth potential.

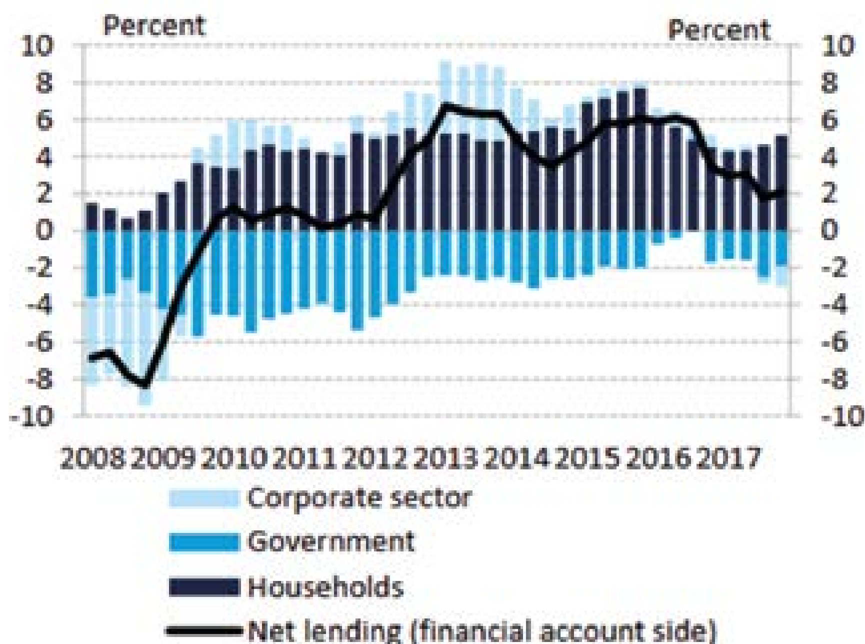

Figure 6

External financing capacity as a percentage of GDP, by sector

Source: MNB:, Inflation Report, June 2018

From the aspect of *economic processes* the same rapid improvement in the balance was driven primarily by the surplus of the foreign trade of goods and services. The total amount of Hungary's net exports had increased to 8% of GDP by 2015. The bulk of the exports ended up in EU member states.[21]

Another factor that has been profoundly affecting Hungary's financial position in turning positive is the category of on-balance sheet and off-balance sheet *international transfers*. In 2015 – when record amounts of EU support were drawn down – the surplus of EU capital transfers amounted to about 5% of GDP. In this way, although the dividend and interest income of foreign-owned businesses continue to appear in Hungary's international accounts as negative items – as in the case of all other countries in the Central-European region – the sum of the surplus of foreign trade (including agriculture, industry and services) and the income from international transfers now substantially outweighs the structural outflow of income stemming from net indebtedness.

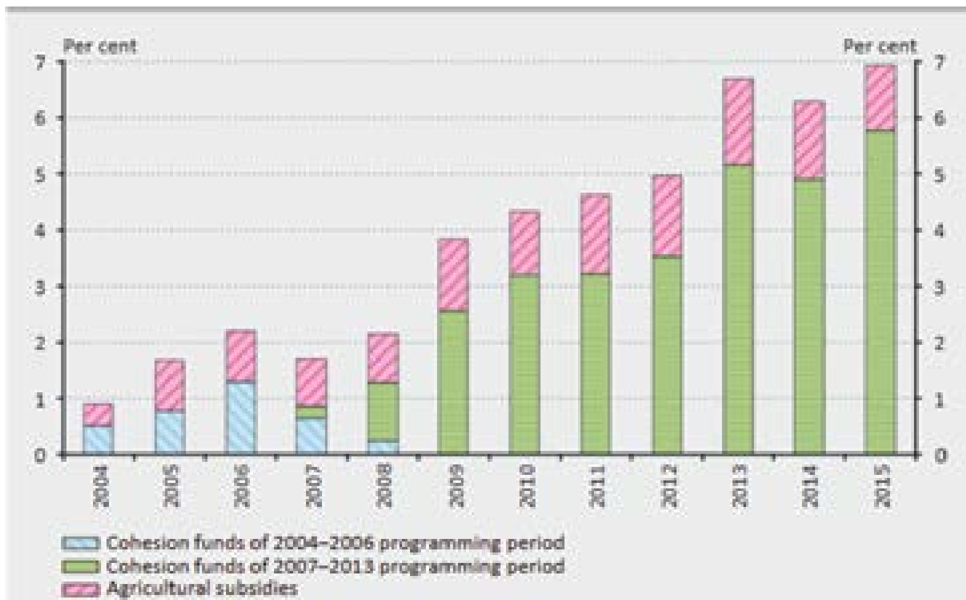

Figure 7

Gross inflows of EU transfers by programming periods, as per cent of GDP

Source: Boldizsár–Kékesi–Koroknai–Sisak 2016

[21] The deficit of foreign trade with the east – primarily: China – could not be reduced materially; indeed, the balance had grown a lot worse by 2015, and the projected slowdown of the growth of China's economy may continue to negatively impact Hungary's direct or intermediated exports.

Hungarian contributions must be subtracted from the gross amount of EU funds. Of course, owing to the relatively low level of development, Hungary massively benefits from the transfers, the net amount of which equal as much as 5–6% of GDP in certain years. While this is a widely known fact, it is less well known that after a while the state, rather than the private sector, became the main beneficiary of current and capital transfers, as is indicated by Figure 8.[22]

Figure 8

Net inflows of EU transfers by sector

Source: Boldizsár–Kékesi–Koroknai–Sisak 2016

[22] This is all the more noteworthy, because in Poland, for example, among other member states in the Central-European region, the state accounts for a significantly smaller share in the utilisation of the EU funds, as a result of which the population, the business sector and other non-governmental actors, are allocated proportionately more of those funds. Even so, Poland draws down a remarkably high proportion of the available EU funds (Boldizsár et al., 2016). It may be assumed that utilization is more reasonable and and purposeful in such a system than where the money is spent by state bureaucracy.

A variety of risk factors are to be dealt with in regard to EU funds. One is the question of what would be the result of the Central Eastern European region, including Hungary, receiving *significantly smaller transfers* after the closure in 2020 of the seven-year programme period. The aggregated demand – currently fuelled by EU funds that may be regarded as massive amounts even relative to macroeconomic proportions – would obviously decrease significantly in the next programme period. The altogether low *investment rate* would diminish and the economic actors (primarily agricultural businesses and land users) who have a substantial part of their revenues coming from EU transfers, would suffer a direct *loss of income*.

Hungary's growth rate, however, shows hardly any sign of the fact that additional funds, amounting annually to one to five percent of GDP, were used up in the economy year after year, in the period after 2008. This suggests that the economy has a better absorptive capability than its supply side adaptability: the ratio of non-productive spending must have been rather high, and substantial amounts may have "vanished" during the entire period concerned. Were it not the case, so much additional income, and, particularly, such massive investment transfers, should have perceptibly increased the GDP through enlarged stock of capital.[23]

It should also be noted that incoming transfers, whatever their structure and efficiency of their utilization, improve the external financial balance). Should the size of EU funds be reduced, such transfers will contribute less to the reduction of Hungary's foreign exchange exposure, but at the same time the macro financial effects of the repatriation of labour income will likely have grown even more significant by that time.

The external debt, the economic growth capability and other macroeconomic indicators make up only one group of components taken into account by external analysts when examining a country or a region. In addition to economic factors, organizations and institutions dealing with political risks also take account of the external exposure and the internal conditions by applying their own specific methodologies of for making projections. Hungary is ranked relatively favourably in such analyses (see, for example, the 2016 list of the Economist Intelligence Unit, in Figure 9).

[23] Another thing that follows from this is that EU transfers were to decrease significantly after 2020 (in reality, from 2022), it would also appear primarily in a decrease in macro demand and have a lesser negative impact on the amount of capital in the national economy as well as, as a consequence, on the macro supply at later stages.

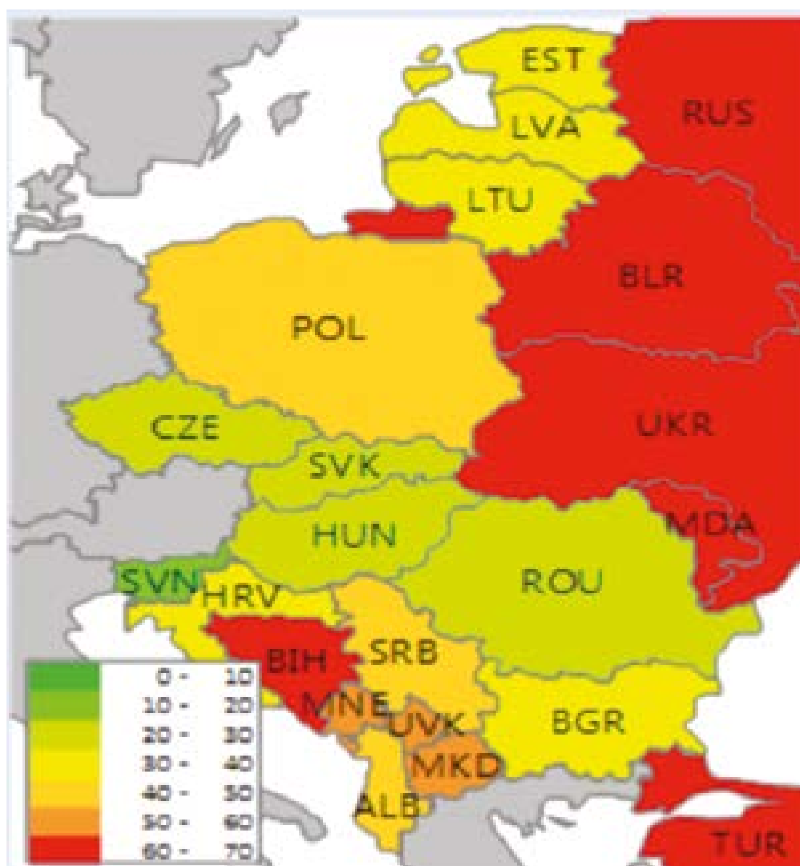

Figure 9

Political risk in the eastern segment of Europe

Source: IMF, 2016, www.imf.org/external/pubs/ft/reo/2016/eur/eng/pdf/rei0516.pdf

Slovenia with the lowest risks is followed by the category of Hungary, Romania, Czech Republic and Slovakia, while Bulgaria and Croatia are presented as countries with somewhat higher political risks. The *sovereign (country) risk rating* applied by the large credit rating institutes is methodologically more refined – though the ratings are always disputed. Hungary's rating by the three main institutions are similar (2018 data): Fitch: BBB minus; Moody's: Baa3; S&P: BBB minus. In each of the above cases the country risk rating falls in the so-called "investment grade category." In other words, financial products constituting the Hungarian state's promise to pay are no longer assigned to the "junk" category. This, however, is the least favourable rating among the V4 countries, equalling Romania's sovereign risk rating. Based on the clearly measurable national economic indicators (foreign exchange reserve, current and capital items, economic growth rate) the credibility of the Hungarian state could be rated one notch higher, but the *unpredictability* of the economic policy pursued by Hungary, as identified by economic policy analysts, is delaying the assignment of a higher rating. Frequent sudden changes in the applicable statutory regulations,

selective judgement by governments of external economic actors, and the excessively heavy dependence of economic growth on certain particular factors, such as the draw-down of EU funds or the economy's exposure to the automotive sector's cycles – these are the most frequently noted risk factors causing external analysts to take a prudent approach. At the same time, changes in international borrowing conditions and the premiums of insurance against the country's bankruptcy (CDS premiums) show that money market participants have more favourable perceptions of Hungary's capacity and willingness to pay. But of course terms and conditions of lending to the Hungarian state or businesses operating in Hungary would be even more favourable if Hungary's credit rating were investment grade. The international rating of Hungary's country risk is definitely worth thinking about – even despite the fact that the grading was improved several times between May and November 2016 – because the existing rating is the same as the rating that had been in place in the second half of the 1990s, when Hungary was not even a member of NATO or the OECD or the European integration, in short: Hungary at that time was not yet under external risk mitigating protection unlike now. Hungary's economic policy that is so difficult to understand and kept up with from the outside, a policy that is accompanied by multiple domestic and external conflicts and "engine rattle," entails some unintended effects that are causing obvious economic disadvantages.

Characteristics of the fragility of the Hungarian economy

The ratios discussed so far had to do with risks qualifying as rather prominent in view of the earlier path of the economy of Hungary. The fragility and disequilibria of member states may have consequences affecting the EU as a whole, therefore the financial crisis of 2008 and the subsequent debt crises in certain member states necessitated a joint *EU-level monitoring* of the relevant macroeconomic risk factors. In the context of such monitoring the relevant EU institutions are dealing with any possible internal imbalances of member states on the basis of a jointly applied methodology. It is worth taking a look into the analysis of the situation in Hungary (Table 4).

Table 4

Macroeconomic imbalance indicators

Description	Note	2007	2010	2012	2015	2017
Current account balance, percentage of GDP	3-year average	–7.0	–2.5	0.9	3.4	4.1
Net international investment position, percentage of GDP	annual	–88.1	–108.3	–94.4	–65.4	–54.8
Private sector debt – consolidated, percentage of GDP	annual	93.7	114.4	102.0	86.0	70.7
General government gross debt as a percentage of GDP	annual	65.0	80.2	78.3	75.3	73.6

Source: Eurostat, http://ec.europa.eu/eurostat/web/macroeconomic-imbalances-procedure/indicators

The steady improvement in the *current account balance* has already been noted here: it mitigates the external exposure of the economy even if the surplus is due to weak domestic demand. It is particularly the *lower rate of investment that should be justified by Hungary's level of development* that carries negative risks for years to come. Changes in the *net investment position* may also be interpreted in a similar way: the ratio of foreign debt to GDP has decreased substantially, indicating lower exposure, but what is behind this phenomenon is that the amount of foreign direct investment (FDI) is not expanding and it affects tie *growth potential* as well.

The rapid *decrease in the indebtedness of the private sector,* as presented in the table, is related to the fact that both households and businesses responded to economic developments and economic policy measures by increasing their savings and declining to borrow. Such a deleveraging after the financial crisis helps reduce the external exposure of Hungary, but restrained borrowing activity of private actors cast some shadow on future growth potential. The decline of the gross debts ratio of the public sector has been, modest relative to the private sector, and calls for further measures to reduce explicit public indebtedness (keeping in mind the large size of implicit debt of the Hungarian state, caused mostly by worsening demography).

New challenges facing Hungary's economy

The wide variety of data as well as business surveys and expert opinions reviewed here do not provide clear guidance concerning matters of economic security of Hungary. What helps in making sense of all these data is to consider experiences of other countries in similar situations, and to conduct a critical analysis of the earlier development path of the Hungarian economy, and to draw lessons from relevant academic literature. One may project future trends and the impacts of recent global processes only in a relatively wide range. The economy's risk bearing and shock resistance capacities are crucial, but in these respects one can make only cautious subjective estimates.

The following qualitative conclusions may be drawn, now in summary form, from the professional sources, data and expert opinions reviewed above.

- During the quarter of a century that has passed since 1990, which can rightly be considered a historic turning-point, Hungary has developed in to a *fully-fledged market economy* in terms of both its economic regime and structure. In historical terms, it has become a market economy *again,* as Hungary had been functioning before the decades of the centrally planned economy. Yet, the term of "returning to capitalism" (market economy) might be somewhat misleading as the world economy had, by the end of the 1980s, become different in some crucial aspects from the capitalism that the Hungarian economy was forced to disintegrate from after the Second World War, that is, from the image of market order that may have still have been lingering on in the memories of the older generations. Some of our existing economic security problems stem from the very fact that the Hungarian society and economy (along with a number of other nations sharing the same fate) found themselves in 1990 in circumstances for which they *had not been prepared,* and its *adaptability* proved to

be insufficient for making the transition (return) tolerable in terms of difficulties and speed, for the majority of the society.

- The consequences of the lack of preparedness and the insufficient adaptability of the society include a *dramatic decrease in labour market activity* during the first years of the regime change and slower than potentially possible re-activation through the subsequent years of economic growth. Labour market activity rates have been improving as a result of the efforts made by government after 2010, but actual reintegration into value-generating division of labour is seriously impeded by the frequent lack of employability among the unemployed, public workers and the temporarily inactive due to lack of qualifications, bad health status, inadequate motivation even during periods of economic growth when tens of thousands of vacant jobs are being advertised.
- Manifestations of social inertia include, *inter alia,* the long fixation of *inflationary expectations*. The end of rising prices was brought about by decreasing international energy and raw material prices and years of stagnation of domestic demand in 2014–2015; the trend of disinflation was even reinforced by the state's growing price regulating activity ("the fight against utility bills"). Trends of inflation have been quite hectic for a long time now, dominated largely by external factors and turns in the state's economic policy. The 3% annual inflation target under the inflation targeting system – formally announced in 2001 – was often exceeded by the actual price index many times over (with 7–8% consumer price increases), however at other times it was way below (with 0% or even negative price indices in 2014–2015). One cannot declare in full confidence that price stability – a norm and value – has been organically integrated in the Hungarian society.
- Demand for being bailed and being subsidized by the state has been strong, with the political elite ready to satisfy this demand. *Expenditures for economic purposes* (price subsidies, interest subsidies) make up a remarkably large proportion of Hungary's budget. The *quasi fiscal* type of credit stimulating programmes launched recently by the central bank (MNB) ("funding for growth programme" 1 and 2), and economic activities through its foundations (real estate development, education development, business development promotion) may also be regarded as belonging to this category. Two main risks stem from fiscal and quasi fiscal activities on a scale more extensive than those in the peer countries: (1) a massive potential expenditure side pressure on the general government budget; (2) a substantial proportion of economic actors gets accustomed to and become dependent on state assistance, and when it is terminated, they may suffer adaptation losses.
- State activity, due to its sheer size, leads to high taxation which is rather *excessive* in comparison to those observed in other countries in similar situations. High nominal tax rates and, particularly, the large number of tax types lead to increasing threat of tax evasion and fraud, and makes tax collection more expensive (in the World Bank's *"doing business"* lists and in international competitiveness ranking lists Hungary is placed in extremely unfavourable positions in regard to the evaluation of the taxation system as a business/competitiveness factor).
- The prevalence of sectoral taxes and taxes levied to small groups of taxpayers (as well as possible exemptions from such taxes) will lead to a significant increase in

the *possibility of corruption and unlawful discrimination.* A legitimate governmental endeavour that can be accomplished by selective taxation (e.g. stimulating small businesses) may easily find itself in conflict with accepted international tax harmonisation obligations (WTO, OECD, EU). Foreign-owned large enterprises on which special taxes have been levied turn to their respective governments for help, raising the issue to the level of international diplomacy.

- The application of selective instruments of the state the government's direct intervention in economic competition offer short term solutions for dealing with sudden crises involving specific companies or sectors. The state's regulatory and microeconomic activities and its operations as owner, however, lead to increased *uncertainty* perceived by economic agents, which, in turn, may reduce their investment activities. Any deterioration in the business climate immediately weakens the country's capability to attract capital and it erodes the propensity of new businesses to settle down in Hungary, while those already present may respond by repatriating their profits. New investors expect increased allowances and stronger incentives than those offered elsewhere. The number of investors coming from regions where business culture is less transparent may also increase, with all of its subsequent risks.
- Conditions in Hungary have not been approximating the norms of economically successful and competitive European core regions in terms of social attitudes, legal compliance or entrepreneurial and innovative skills; instead, they have been growing increasingly similar to those of the group of Serbia, Bosnia and Bulgaria.
- As reflected by the results of the Pisa tests, young people's achievements in terms of knowledge and skills are more like mediocre, without any sign of real improvement. This may be a critical aspect if demand for labour in sectors requiring medium qualifications and semi-skilled labour, that is, activities which can be relatively easily carried out by robots and algorithms, declines radically in Europe, due to the unfolding of what is referred to as the 4th industrial revolution. It is already apparent that industrial and service jobs that used to be regarded as sources of secure employment are starting to become unnecessary in some economies as a consequence of the development of artificial intelligence, digitising, and the virtualization of a variety of formal jobs.
- Aggregated demand was boosted by EU funds after 2008, during a period when Hungary's economy was characterized by weak domestic demand. The use of such funds is not without risk factors. Funds were spent during the preceding government term on grandiose infrastructure projects (such as the No. 4 metro line in Budapest) where external – civil – control is not possible as a result of the very scales of the projects; the risk of corruption is increased by the fact that only one or just a handful of potential contractors can undertake such projects. It was after 2010 that a policy was adopted with the aim of drawing down and spending in Hungary as much of the accessible funds as possible ("no EU fund should remain unspent"). This principle may seem rational but in fact is relegates aspects of efficiency and legality of spending of funds into secondary importance, and increases moral hazard.
- While from an economic aspect the process of the regime change was essentially completed and closed in a period of two decades, *economic performance* failed to reach a level that would have been required for enabling the whole or even just the

bulk of society to enjoy the benefits expected of a market economy. In other words, Hungary did not become a developed country in a quarter of a century – not even in the sense in which the Czech Republic or Slovenia is categorized as such, according to the majority of rating indicators or classification systems.

- Relative lagging behind other Visegrad nations first failed to draw the attention of the public or the political elite, and so it did not mobilize them, since the conventional frame of reference was made up of highly developed western market economies anyway. The process of *real convergence* with those countries *has been very slow and got stuck from time to time,* like between 2005 and 2012. Initially this only takes the form of dissatisfaction with the existing social and economic order, disappointment with expectations relating to the regime change, but when the labour markets of West European countries were opened up, Hungary also joined the group of countries in the Central Eastern European region from economically motivated migration started in earnest. By the turn of 2015 and 2016, some 3% of Hungary's labour force had left the country. This ratio is lower than in the case of Romania, Bulgaria, the Baltic states, and Poland, but the rate has been accelerating.
- Thus it is the decline in the growth rate rather than a sectoral, financial or even general economic crisis that constitute veritable macroeconomic risk (or social risk motivated by economic reasons) lies in a decrease. At the same time, the main national economic risk factors that had caused major problems earlier on (such as uncontrolled increase in the government debt, unemployment, inflation, the freezing of the credit institution system, the impossibility of financing the social security system) have only apparently vanished or been degraded to secondary importance. Some of them – such as the inflationary expectations or the excessive central budget deficit – appear to be decreasing, after the first two decades of transition. Still, too may live from the general government system – and this poses a structural pressure towards keeping state revenues at a high level. The state itself is all too ready to resort to means of intervention – this then prolongs its high demand for public revenue, necessitating high rates of taxes and income centralization. The fact that Hungary's general government budget is considerably more extensive than those of its competitors in the CEE region leads to loss of competitiveness.
- The very existence of an extensive state leads to high exposure to corruption. According to the corruption perceptions index established by a survey conducted by Transparency International, Hungary was in the 57th position among the countries concerned, indicating a deterioration in comparison to its position established in earlier years in 2016, and 66th in a year after. In terms of the risks of corruption Hungary is way behind Estonia, Poland and the Czech. Apart from Greece and Italy, as well as Bulgaria where corruption is at its worst, the situation was better in all EU member states than in Hungary.
- The failure to catch up with the developed world in medium income countries (including Hungary) causes *disappointment* among large groups of society. International experience shows that under such circumstances in democracies the social elite may suddenly lose influence, or unpredictable movements, incapable of governing the country may seize power, while in centralized and autocratic regimes upheavals may be caused by insurrections against the state power among those whose upward

mobility got stuck. In the Hungarian circumstances the real threat comes primarily in the form of *the emigration of masses of young people and those with higher than average qualifications,* and the *increase of the proportion of dependants (elderly people, working age inactive people)* and it may have serious consequences even in the short run in regard to the sustainability of the social security system, to regional issues and political activity.

- It is becoming obvious in view of the new tendencies in technological development, specifically the day-to-day consequences of the so-called fourth industrial revolution, that the *dependent market economy model* that came into being at the time of the regime change – *cheap highly trained labour combined with western capital, technology and institutional order – has depleted its development potential* in the more developed countries of Central and Eastern Europe, including Hungary, during the past two decades. *The confusing* impacts of the 2008 international financial crisis make it difficult to identify and solve the particular tasks faced by the CEE region. The European consequences of the international crisis do not facilitate the process of finding adequate forms for getting integrated in the new global economic conditions. It is clear, however, that the existing human capital, qualifications, attitudes and the given level of social confidence are not sufficient for keeping abreast of competing regions of the globe. No future lies in the growth model based on simple wage level advantage, and its continuation can easily lead to increasing social tensions.

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