

ECONOMY

General Characteristics of Economic Development

On the Semi-Periphery of Europe: an Outline of Hungary's Economic History

Whatever indicator one chooses as a basis for the international comparison in the level of economic development, Hungary's position could be assigned somewhere on the borderline between high-income and upper-middle-income countries: 0.16% of the world's population lives here, consuming 0.31% of the total goods produced. The (rather arbitrary) classification by the World Bank for 2008 considered USD 11,905 gross national income per capita (based on the official exchange rate) to be the threshold above which countries belong to the high-income group. The performance of the Hungarian economy (USD 12,810 per capita or USD 17,790 on purchasing power parity) just fulfilled this criterion. Only 15% of the world's population lives in countries richer than that. However, inside Europe, the Hungarian economy belongs to the semi-peripheral zone; in 2008 the purchasing power of GDP per capita in Hungary was only 61.6% of the EU-27 average. The battle to successfully bridge the gap between Hungary and the economically and socially most developed core nations of the continent – a highly important national target for a long time – has been fought from time to time and lost during historical cataclysms.

In the 15th century, the Hungarian Kingdom was a flourishing, strong feudal state, closely following in the footsteps of the most developed countries of South and West Europe. However, after the Age of Discovery, the geographical location of East Central Europe turned to its disadvantage. Located far away from the newly opened shipping routes, it could not benefit from the colonial trade, and subsequent accumulation of capital, thus instead of the emergence of the middle classes in society, the

feudal structure was preserved. Hungary's situation was further aggravated by the Ottoman conquest, as a result of which the country became divided into three parts, and during the 16th–17th century it became a battleground for constant conflicts. In the 18th century, when the Ottoman Empire was forced to withdraw from the Carpathian Basin, poverty-stricken Hungary, depopulated over large areas, was annexed to the Austrian Habsburg Empire with a subordinate, peripheral role. At that time, even the very survival of the nation was questionable and the attributes of independent statehood could only be gradually regained. The national awakening that heralded the beginning of the 19th century and the Revolution of 1848 as the zenith of the social and economic reforms, based on Western examples, ended serfdom and abolished the privileges of the nobility. Even though the War of Independence in 1848–49 against the Habsburgs was lost, it provided a solid base for the Austro-Hungarian Compromise of 1867 which became the starting point for rapid modernisation over the next five decades under the dual-Monarchy.

Spectacular economic growth was fuelled by massive inflows of British, French, German and Austrian capital and assisted by the swift increase in the population number and level of education. As a result of the Education Law of 1868, illiteracy became more and more restricted to the older generations. Banks and companies were established one after the other, but agriculture still remained the backbone of the economy. The agricultural sector was dominated by large estates and it was characterised by rapid technological modernisation in practice. It still pro-

vided occupation for 60% of the economically active labour force in 1910 and accounted for 44% of GDP. To process the agricultural products, an extensive food industry developed led by flour mills of international significance; more than half of the country's exports were farming produce and food. Rapid extension of the railways in the mid-19th century facilitated the bulk trade of grain, in the direction of Austria and West Europe. Within a few decades the railway network covered the whole Carpathian Basin. Its radial trunk lines converged on Budapest, the Hungarian capital, at that time experiencing a construction frenzy and industrialisation. The demands of the food industry and railway construction fuelled the emergence of different branches of the engineering industry, as well as coal mining and steel manufacturing. By 1910, industry employed 18% of wage-earners, and provided more than 25% of GDP. Immediately before World War I, in Hungary continuous large-scale construction projects were launched, and the country was characterised by a rapid spread and application of innovations. It was still lagging behind the leading states of Western Europe (the Hungarian GDP per capita was about 58–60% of the West European average), but it was well ahead of the South and East European countries.

After World War I, the Austro-Hungarian Monarchy collapsed, the customs and monetary union which provided a fertile market for economic development was abolished, and the threads of the geographical division of labour were severed. Due to the Treaty of Trianon, Hungary lost 71.4% of its former area, 63.5% of its population and became one of the smallest and weakest successor states of the Monarchy. Most of its natural endowments (mineral resources and forests) had been allotted to the neighbouring countries, as well as the transversal railway lines and cities that would have been able to counterbalance Budapest's dominant position in the urban network. After the painful adjustment to the new conditions and the economic consolidation implemented by foreign loans, the Great Depression of 1929–1933 brought repeated dramatic declines. Under these circumstances, the fact that the Hungarian economy could retain its relatively advanced position somewhere in the middle of the rank of European countries could be considered a success. The structure of the economy and the proportion occupied by

individual sectors did not change much: considerable development only occurred in the manufacture of consumer goods, in order to substitute imports, mainly in the textile and clothing industries. By the end of the 1930s more than half of exports were directed to the German Empire, and in-line with German demands, the war munitions industry enjoyed priority.

During World War II, Hungary suffered a loss of about one million people from battleground conflicts and the Nazi holocaust. Systematic plunder first by the German troops, then by the Soviet Red Army, aggravated the losses caused by the destruction of production equipment. The majority of machines which survived the war were requisitioned and removed from the country. Industry lost more than half of its fixed assets, whilst transport and agriculture incurred similar loss. In 1946, the economic performance was equal to its level of 50 years prior, and the production level would only return to that of 1942 as late as 1952.

After World War II, Hungary fell into the sphere of influence of the Soviet Union and was forced to introduce a command economy. Nationalisation of the banks, industry and trade which had already begun during the post-war reconstruction period was completed by 1950. Collectivisation of agriculture ended in 1961; in this sector the socialist 'kolkhoz' type of collective farms prevailed. Small private enterprises, mainly offering services, had only marginal role in the economy until the 1980s.

In the centralised planned economy state-owned companies were prescribed what and how much to produce. The reforms of 1968 loosened the highly rigorous regulations, providing much greater freedom to companies, giving way to market forces. However, they did not change ownership relations.

Economic strategy – especially in the 1950s and 60s – was characterised by a large-scale accumulation and the pursuit of autarchy, mainly at the expense of living standards. More than half of investment was directed into the manufacturing industry, while developments in services, infrastructure and agriculture were neglected. Large state investments supported the establishment of war-driven heavy industry – mining, metallurgy and certain branches of engineering – although these were not at all in line with Hungary's available natural resources. *Hungary became strongly isolated from the processes*

governing the world economy. External trade links tied the country to the Soviet Union as a key partner. Exports included agricultural produce, food and machinery, while raw materials and energy sources were imported. In the 1970s, Hungary's economy also gradually opened up to the western part of Europe. The rise in fuel prices led, however, to a worsening of the country's terms of trade, with an ensuing budget deficit and a slowdown in economic growth.

The socialist era, which ultimately led into a dead-end, brought deep social changes: forced urbanisation and improved education and health care systems. The macroeconomic structure reflected the emergence of an industrial society, in which by 1990 agriculture employed only 15% of the active labour force, whilst at the same time the proportion of industry, building and construction reached 38%. Yet the country was not able to keep pace with the technological and communications revolution that had transformed the world economy. The apparent successes brought about through extensive development were soon followed by a

decline. By 1990, the economic performance of Hungary reached only 50% – or according to other estimations merely 40% – of the level of the 12 most developed European countries, and was even lagging behind the South European countries which were already part of European integration. This, however, was still not the nadir. During the recession which followed the collapse of the communist regime and the peaceful economic and social transition in 1990, the country's GDP declined by more than 20% and the earlier peak would only be reached again in 2000. Although the recession in Hungary ended in 1994, relatively quickly compared to the other countries of the East Central European region, the decade further widened the economic gap separating Hungary from the western half of the continent. Hungarian society, having anticipated not only national independence and political democracy, but a tangible increase in living standards after the change of regime, was bound to be disappointed as transition required painful sacrifice.

Transition to a Market Economy: Privatisation and Capital Influx

A temporary recession during the transition and rapid changes in ownership structures were unavoidable consequences. This decline was worsened by the collapse of the Soviet Union and the abolition of Comecon. Hungarian industry and agriculture lost their most important (and protected) markets; more than half of the country's exports went to these countries in the 1980s. A large number of factories went bankrupt and more than one million jobs were lost. Unemployment – a concept that was virtually unknown during the socialist era – was skyrocketing. Social differences and spatial disparities suddenly increased. Inflation peaked at 35% in 1991 and economic decline hit a low in 1993.

The reorientation of international trading relationships was vital for opening up the Hungarian economy towards the European Union, necessitating the deepening of institutional relationships. In 1991, Hungary signed an association agreement with the European Community, the so-called 'European Agreement'

that came into force in 1994 and was aimed at phasing out tariffs and quotas hindering trade. Already by then, half of Hungarian foreign trade was taking place with the EU countries. This rate increased rapidly to the extent that nowadays *about four-fifths of the country's exports are destined for, and 68% of its import arrive from the enlarged European Union.* The preconditions set by the EU for full membership were a stable parliamentary democracy, a functioning market economy, and the acceptance of *acquis communautaire* (community law). The regime change and the establishment of the institutions of the parliamentary system were completed in the period 1989–1990, whilst full transition to a market economy based on the principles of private ownership took longer, and was completed only by 2004, the year of Hungary's accession to the European Union. Simultaneous steps aimed at European integration and adjustment to the realities of globalisation required the rapid modernisation of production, which would have been impossi-

ble without *privatisation* and the *inflow of foreign capital*. The state of Hungary's economy today is a result of these interwoven processes.

The abolition of state ownership and the privatisation of public property during the market economy transition had to be carried out without any previous experience and in a rather short time. The period of so-called 'spontaneous privatisation' in Hungary started in 1987, without any legal regulation, when the former managers of state-owned companies – including the representatives of the communist party – were able to acquire remarkable wealth. Spontaneous privatisation could not, however, result in the modernisation of these rather deteriorated and obsolete assets, nor a significant change in management style, thus the majority of these companies went bankrupt and/or became the target for foreign acquisition.

After 1990, state property was usually sold to foreign investors by tender, controlled by the necessary laws and regulations, in accordance with the rules of the market economy. Compensation vouchers were given to former owners, whose assets were originally seized by the communist regime, but they could play only a modest role mainly in rearranging agrarian property relations. The quick sale of state-owned assets – often at prices below market value – was compelled by the large amount of government debt inherited from the previous system, which exceeded 90% of GDP at the beginning of the 1990s. Revenues raised from the sale of public property should have been spent on decreasing debt levels, but successive governments were reluctant to fulfill this obligation. The role of the state as an owner of assets shrank to an even smaller proportion than it is common in West European market economies. Apart from retaining minority shares in certain firms, only some companies providing basic public services (such as the nuclear power station, the national electricity grid, the railway and the postal service) remained in state ownership. Nevertheless, government gross debt, accumulated as a result of the ongoing budget deficit exceeded 70% of GDP in 2008 and stands close to 83% by mid-2009 with the most recent increase being mainly due to the shrinking output of the economy, the decline in the recession-hit manufacturing. This is despite debt levels having shown a previous temporary decrease, when in 2001 it fell to 52% of GDP. Indebtedness is the major obstacle that hinders Hungary's accession

to the Eurozone. *Financing external debt became an enormous burden for the Hungarian economy, and this has been further aggravated by the recent global financial crisis*. Interest payments from public finances in order to service this debt, amounted to HUF 1,100 billion in 2007, or 4% of GDP.

In 1989, Hungary was the first among the East-Central European countries to open its doors to foreign direct investment, which greatly contributed to technological modernisation and increasing productivity. In the first part of the 1990s, about half the investments were associated with privatisation. The aim of these transactions was the acquisition of valuable companies in the manufacturing sector and penetration into the local market. The main attraction of greenfield investments at that time was the abundance of relatively cheap labour. Later, more and more greenfield investment was directed towards the export-oriented sectors with their higher value-added element (automotive industry, electronic engineering, precision engineering and electronics) or in the service sector, and were connected to remarkable technological transfer too. Numerous multinational companies (e.g. General Electric, Nokia and Ericsson) even founded R&D units in Hungary. Besides the direct benefits provided by the government for prospective investors, the existing infrastructure (motorways and industrial parks), a favourable geographic location (for logistics), a strong work ethic and contacts hitherto existing also proved to be factors of attraction. All of this was true mainly for Budapest and its environs, and the western region of the country, where the rate of unemployment is low, and there has been a massive demand for skilled workers.

The total inward FDI stock that has flowed into the country since the beginning of the economic transition exceeded EUR 70 billion by June 2008 and is increasing by about EUR 4 billion annually. 77% of the operating capital invested in Hungary derives from the European Union, of which the biggest investor is Germany. The service sector was the beneficiary of over 60% of foreign investment and more than a third of it was invested in the manufacturing industry. Companies registered in Hungary also invested a significant amount of capital in the regions East Central Europe and South-East Europe after the turn of the millennium. Among the notably active companies aspiring to become regional multinationals, are MOL (oil and gas industry) and OTP Bank, but mention should also be made of the pharmaceutical sector

(Richter Gedeon), telecommunications (Magyar Telekom) and hotel chains as well. Outward FDI stock in 2007 exceeded EUR 18 billion.

In contrast with the 1990s – when the influx of capital greatly improved Hungary's balance of payments – today the majority of FDI stems from the re-invested profits of Hungarian

shareholdings. A new tendency has developed for foreign investors to transfer abroad most of the profits acquired in Hungary, in the form of dividends. Besides the interest burden of the national debt, this is *the reason why the value of GNI (Gross National Income) is lagging further and further behind GDP (in 2007 by 7.7%)*.

Main Features of the Reshaped Economic Structure

During the transition to market economy, a large number of businesses were established in Hungary and presently there are about 1.2 million enterprises. Their diversification in size shows the dual structure of the economy. Most of them (57%) are private ventures and 80% of them operate in the tertiary sector. The number of companies with foreign shareholders (where more than 10% of the company is in foreign ownership) was 25,800 at the beginning of 2007. They employ more than 600,000 workers (this is one quarter of the total number of jobs in the business sector) and produce more than four fifths of exports. Their suppliers include several domestic companies. There are around 800 large companies in Hungary that employ more than 250 people. Small and medium-size enterprises – that manufacture mainly for the domestic market – play a significant role in the employment market however, their profitability lags far behind the large companies.

In the last two decades the macroeconomic structure has changed significantly, so that today agriculture contributes only 4% of GDP, industry, building and construction contributes 30%, while the service sector is responsible for 66%. During the transition period the previously underdeveloped tertiary sector progressed the most dynamically. Almost all commercial banks and the majority of hypermarkets and shopping malls are owned by foreign entities. These establishments are the landmarks of modern globalisation all over the country, and have changed patterns of consumption, introducing new financial and commercial cultures. The formerly neglected telecommunications network was also expanded and improved to meet west European standards, with the help of foreign investment.

The output of the manufacturing industry more than doubled compared to its 1989 value, its structure has undergone a remarkable modernisation and the leading position of export oriented machine industry has strengthened in every respect. With the construction of new factories by large multinational automotive companies (GM-Opel, VW-Audi and Suzuki) the local car industry was established and became a main pillar for exports. Hungary's fundamental integration into the production processes of these multinational firms has resulted in a strong dependence on international market conditions and increased vulnerability during recessionary periods. The production of household appliances, consumer electronics and communication engineering units, electronic componentry and precision instruments, have also attracted large investments. In the chemical industry, rubber and plastic manufacturing has expanded considerably. The traditionally strong pharmaceutical sector attracted investors by preserving its competitiveness in the East European markets.

There is another side to the success story: the decline or disappearance of whole companies and even industry sectors, as a result of economic transition and increased competition. All but one of the deep shaft coalmines were closed, bauxite mining shrank to a fraction of its previous size, alumina production and non-ferrous metallurgy disappeared completely. Out of the three integrated iron and steel plants in the country, only Dunaferr has been able to survive, by constantly improving its technology and enlarging its product range. The textile and shoe industries were moved to other East European and Asian countries that had offered a plentiful supply of cheap labour, thus the relative importance of these

branches sharply decreased. Food processing experienced a decline in the number of its production facilities, while the ever changing product range reflected the adjustment to the labour division conceptions of multinational companies.

The heaviest toll of the transition period was suffered by agriculture, notably there has been a sharp decline in the sector's output. During the period 1990–94, it dropped to two thirds of its previous level, and productivity has been unable to approach its levels prior to 1989. Compensation, the dissolution of cooperatives and the privatisation of assets at the end of the 1990s, allowed town dwellers without any interest in agriculture, to buy pieces of land, whilst at the same time many workers in cooperatives and state farms lost their jobs and sank into poverty. With the ownership and cultivation of land now largely divided, a land-leasing system spread. Today, large enterprises cultivate about half the arable land, which are the successors

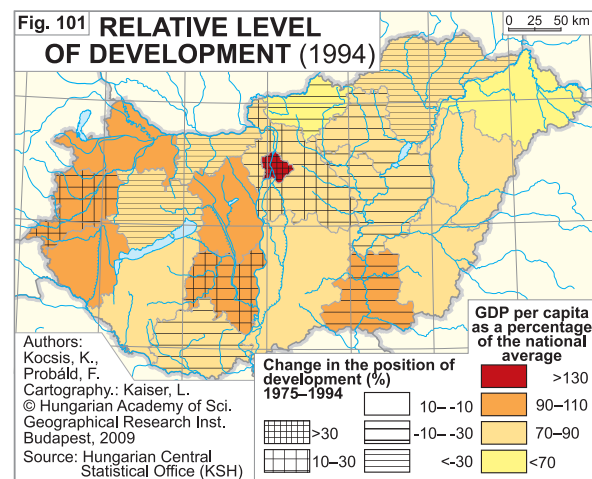
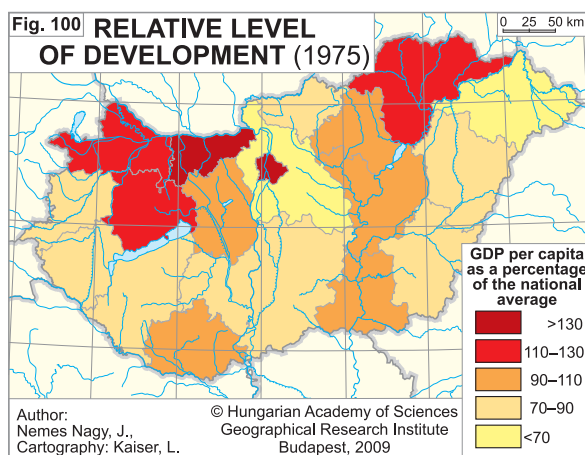
of the former cooperative farms. The majority of private farms – situated at the opposite end of the scale – are so small that they can only provide some additional income or a second, part-time job. The proportion of viable private farms in agriculture is far from the ideal. The ageing of the agricultural population and the lack of skills are just a part of the problem. The disconnect between producers and (to a great extent foreign-owned) food processing plants lead to further difficulties: smallholders have no strong collective bodies to represent their common interests, so they are in a disadvantaged position when in negotiations with wholesalers, international retail chains and the food industry in general, when selling their products. While in the 1980s around one quarter of Hungarian exports were agricultural and food products, today this number fluctuates around the 6% mark, while agricultural imports are constantly increasing.

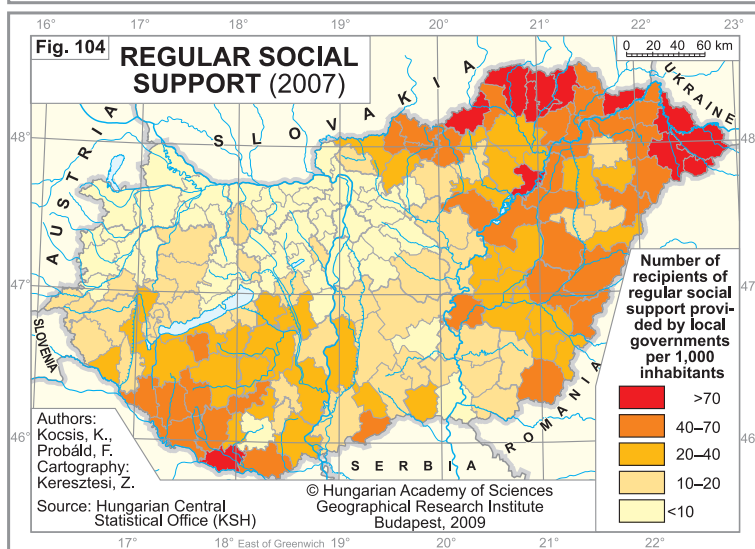
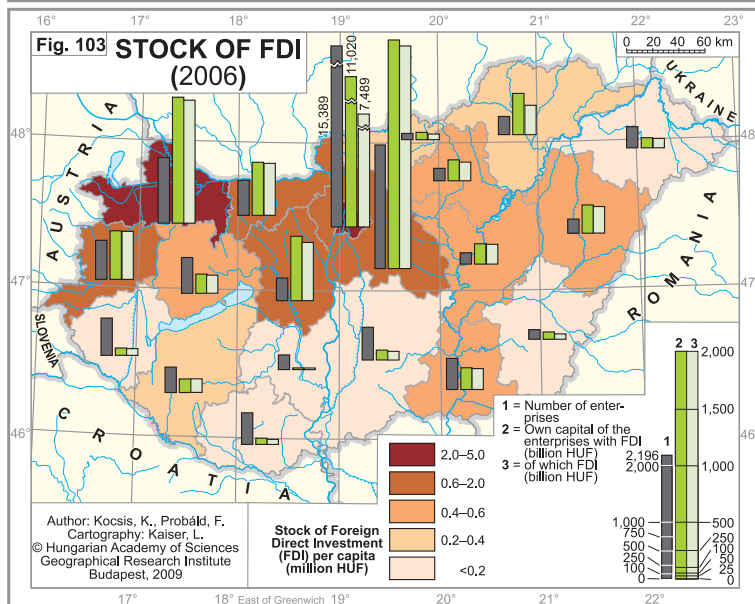
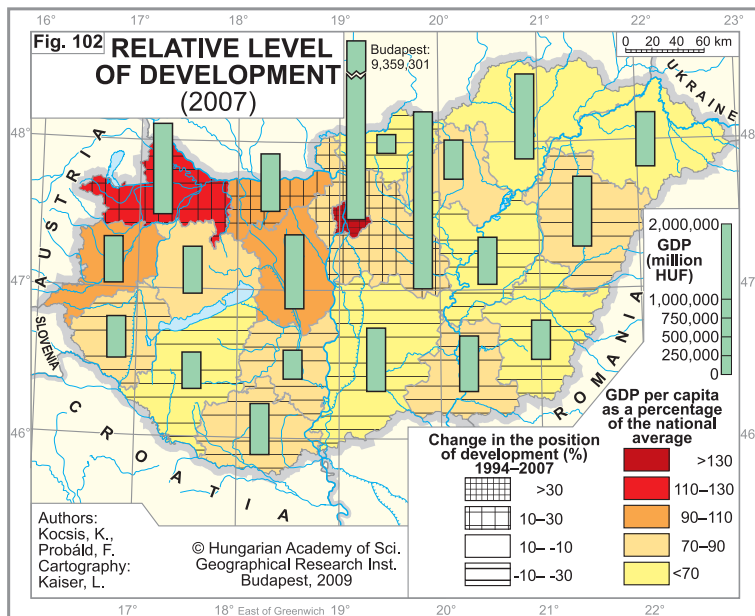
Regional Processes

The market economy transition increased social inequalities. The average income of the upper socio-economic groups (the top 10% of the population) is now about six times higher than that of the poorest 10%, which is a striking disparity even under the spotlight of international comparison. In the early 1990s, regional disparities sharply increased and subsequently

settled, showing similar trends to those visible in income disparities. The emerging new socio-economic spatial pattern largely reflects the impact of international trends and ties.

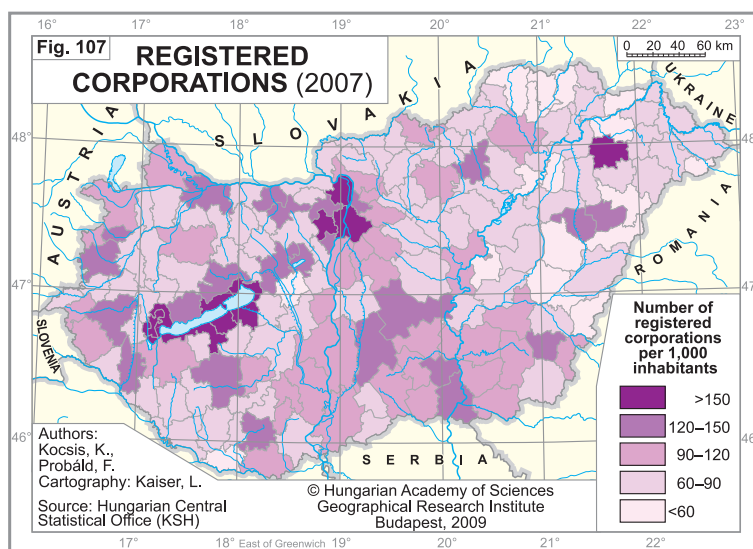
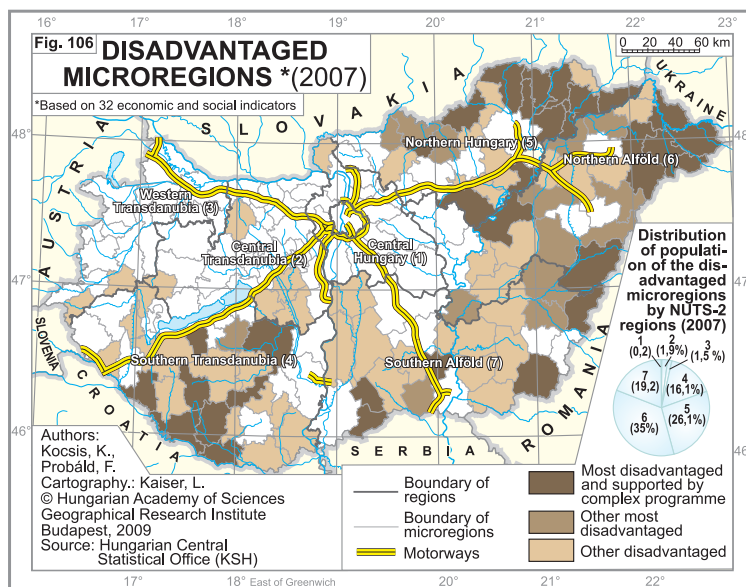
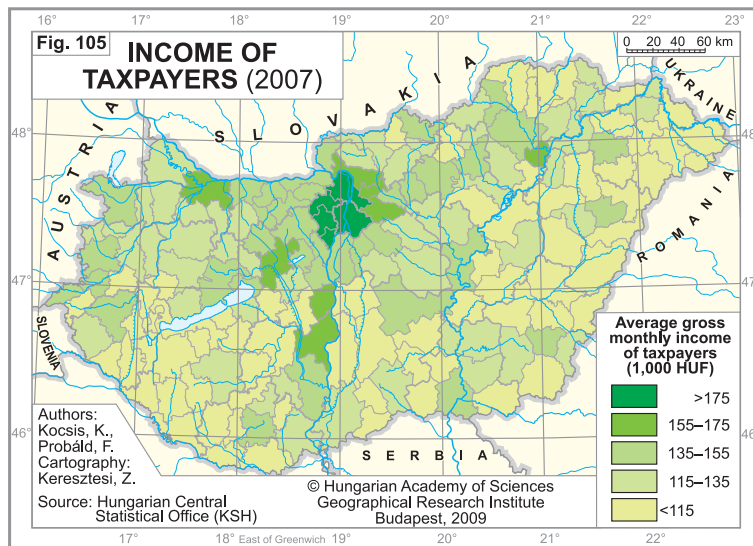
Out of Hungary's seven 'NUTS 2' statistical regions, Central Hungary (which incorporates Budapest) stands out, as the GDP per capita exceeds the national average by 64.3%





(in 2007). Its position is even higher when considering the number of enterprises and the amount of FDI per 1,000 persons. This is the sole region of the country where economic performance exceeds the average of the 27 EU countries. The agglomeration of the capital, with more than 2 million inhabitants is the most competitive ensemble of settlements, even on an international scale. It is a centre for administration, services and innovation, as well as a logistic hub. Its higher education institutions educate almost half the total number of students in tertiary education. The dichotomy of Budapest versus the rest of the country is one of the enduring and strengthening features of Hungary's spatial structure. Of the other regions, only West Transdanubia can boast economic performance which is slightly above the national average, closely followed by the Central Transdanubian region. The weakest regions by economic performance, are located in the eastern part of the country where GDP per capita does not even reach two thirds of the national average. It is therefore justified to conclude that the old east-west dichotomy, as a spatial characteristic, continues to exist.

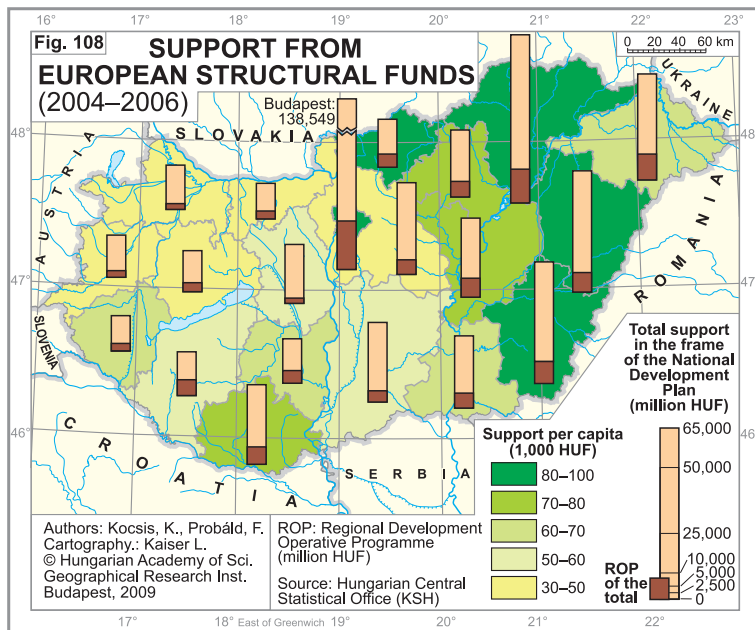
The change of regime influenced the economic development of Hungary's counties (at 'NUTS 3' level) rather differently and the last three decades have significantly realigned their rank (figures 100 through 102). In the 1970s, the counties with mining and heavy industry centres showed the best economic performance, after Budapest. Among them, the heaviest tolls exacted by the economic transition were suffered by the counties located in the northern part of the country, and especially the county of Borsod-Abaúj-Zemplén. Due to their geographical location, good accessibility and pre-existing ties, the north-western counties – Győr-Moson-Sopron and



Vas – became popular targets for foreign direct investment, following closely in the footsteps of the Hungarian capital. Their rapid connections to international networks facilitating the swift movement of their exports to the core European markets, and their traditional receptiveness to innovation have made them the winners of the last two decades (Figure 103).

On the basis of the 174 microregions ('NUTS 4' or 'LAU 1' level, figures 104 through 107) we can receive an even more precise and complicated picture. Within the relatively underdeveloped areas, microregions have a relatively better ranking whose seats are towns possessing a significant quaternary economic sector, and are well connected to globalisation networks. These microregions are mainly the large higher education centres (Debrecen, Szeged, Miskolc and Pécs). Some microregions have become famous for their tourism, showing the importance of locality and local resources. These are concentrated in the holiday regions around Lake Balaton. The most disadvantaged microregions are in the north-eastern counties and in South Transdanubia, forming large, continuous belts. The settlement network of these areas consists of small villages without large, central towns that could provide ample job opportunities. They also often stand out due to their – largely unskilled – Roma population. Because of long term unemployment and striking poverty, the majority of the inhabitants of these microregions are regularly reliant on social benefits.

The reduction of sharp differences that have arisen from the market economy transition, and an improvement to the situation of regions that are lagging behind, poses a long-term challenge for regional development policy. The magnitude of resources awarded



from EU Structural Funds since 2004 – in particular if we consider the spatial distribution of the areas where they were deployed on winning projects – is far from enough to cure the problem. Less than 20% of the EU support awarded (HUF 670 billion) that was deployed within the framework of the National Development Plan between 2004 and 2006, was spent on projects within the Regional Operative Programs (Figure 108).

Reserves of Development for the Future

Following two centuries of fruitless effort directed at closing the gap between Hungary and the European continent's core area, the accession to the European Union has improved the external conditions that influence the likelihood of achieving this target, although it still does not seem to be any closer. In the interests of enhancing success, internal reserves should be mobilised and the country's natural resources should be exploited in a more purposeful manner. From the broad range of potential options to increase the country's competitiveness, only a few are listed below:

- The rate of economically active working age population in Hungary is one of the lowest in Europe; only 57% of the 16–64 age-group (2008). Creating new jobs and increasing the economic participation of the population can be an important factor in increasing the country's GDP.

- The rate of R&D expenditure is rather low, barely reaching 1% of GDP. A considerable increase could accelerate the development of a knowledge-based economy, enlarge the scale of activities with a high value-added component, and encourage the flow of foreign capital

into these sectors. Large companies engaged in mass production need to improve the training of skilled workers, enhancing the mobility of the population by an improvement in conditions for migration within the country.

- Agricultural production is the only sector in Hungary which can rely on a plentiful supply of natural resources. The significance of this fact will gather pace in the long term, as demand for agricultural products in world markets increases, be it for food or bio-fuel crops. However, to exploit these outstanding features the sector needs a product palette which is able to flexibly adjust to market demands, farms of a viable size and an appropriate ownership structure.

- The new, post-Trianon borders scythed through the connections that gave rise to regional labour divisions, and as a result most of the border regions became disadvantaged. With the enlargement of the Schengen Zone, Hungary's borders need no longer act as a strict separation between countries. Thus new forms of economic development can arise through cross-border cooperation.

- The location of Budapest, in the heart of the Carpathian Basin, along the main route from

the western regions of the continent to South East-Europe, provides a solid basis upon which to strengthen its 'gateway' function and to become the first metropolis from the East Central European region that joins the outer circle of global cities.

The lessons to be drawn from the achievements (and failures) of economic history over the last two decades are that in order to take

advantage of the existing opportunities, particularly those afforded by EU membership, social consensus concerning national goals, as well as a responsible and consistent governmental economic policy would be required. Last but not least, the future success of Hungary is inseparable from the ability of the whole of the European Union to respond the challenges of the 21st century.