New Europe Economic Dossier aims to provide a structural view on the evolution of the various countries in the region, highlighting the main achievements and the open challenges. Each issue is dedicated to a specific country and includes an analysis of the economic situation plus an interview to a leading figure for the future of the country. The dossier is edited by the New Europe Research Network of UniCredit.

by Márta Szegö

Hungary on the road of transition

Since 1968, Hungary has been playing a pioneering role in the eastern block in terms of its reform initiatives and, by the turn of 1989/90, it was already in the possession of several elements of the market liberalisation toolkit. From 1987, a system of commercial banking was re-established, with several foreign participants; the evolution of the private sector was supported by the Companies Act; the doors were opened for foreign direct investments, and trade had become largely liberalised. And in June 1990, the Budapest Stock Exchange launched operations, the first of its kind in Central and Eastern Europe.

In the one and a half year that followed the first free parliamentary elections, financial legislation such as the Accounting Act, the Financial Institutions and the Central Bank Act, and the Bankruptcy Act were enacted, mostly harmonised with the European Union. The rapid establishment of a market economy framework provided a stepping stone for Hungary to receive foreign capital investment, but it could not escape a significant social-economic-financial crisis which was associated with the transformation. Consistently high inflation, unemployment, and an approximately 18% drop in GDP, a serious budget and balance-of-payments deficit, and bank consolidation characterised the first half of the Nineties. In the spring of 1995, a stabilisation package containing strict austerity measures put an end to the crisis. By 1995, the major direct investment projects of the previous years – greenfield projects and privatised industries – projects from Audi, Philips, IBM, General Electric, Nokia, etc. became operational. The Hungarian economy began a path of export-driven growth. During the same period, the large Hungarian State-owned banks became privatised by foreign trade investors and, due to the transfer of technology and the transmission of management know-how, there was a deep-rooted renewal in both industrial and commercial networks and in the sector of financial and business services. Nowadays foreign ownership, with its share of 80-90% in some economic sectors including banking, the automotive industry, and electronics, plays a decisive role; the presence of foreign companies is significant in the chemical industry and precision engineering as well. Multinational companies exercise a certain magnetism on their suppliers to enter the country and set up their sites here. At the same time, global competition has re-examined investment in Hungary, and economic restructuring entered a new phase in the early 2000's. Investors in the assembly/manufacturing sectors requiring unskilled cheap labour, and labour-intensive light industries relocated their production capacities to South-eastern Europe and the Far East, mainly China. While in the high-tech manufacturing sectors, research and development centres were launched in order to take advantage of Hungary's favourable features. The lower wages for intellectual jobs in business services attract investment nowadays: several companies that operate worldwide have brought their software development, call centers, or bookkeeping here. Due to Hungary's geographical location, an increasing number of global companies have set up their logistics distribution centres here as well.

Since the spring of 2004, Hungary has been a member of the European Union.

This, parallel to the country's traditional business partnerships with Germany, Austria and Italy, placed the exploration of local business opportunities in the focus of attention for more distant member States as well. There was also a change in tourism: visitors arrive from an increasing number of member States to explore the East European region. In order to exploit the country's capabilities, we became a target country for spa, wine, cultural, and eco-tourism. The full-scale opening of the market exposed local producers to significant competition. Their response was an attempt to gain ground on the European Union market with Hungarian specialities, the so-called "hungaricums", or uniquely-Hungarian products. In the area of traditional agricultural goods, this challenge stimulated entrepreneurship oriented towards higher quality goods (meat products, quality wine, special Hungarian spirits, fruits,

MACROECONOMIC DATA AND FORECASTS

	2003	2004	2005f	2006f	2007f
Nominal GDP (bln HUF)	20,413.5	21,654,0	23,308,4	25,036,7	27,074.0
Real GDP, yoy % change	4.6	4.1	4.0	2.3	2.8
- Personal Consumption, yoy % change	3.1	3,0	2.5	-1.0	0.5
- Investment, yoy % change	8.4	8.6	3.0	5.2	5.7
- Government Consumption, yoy % change	0.9	0.5	1.5	-4.1	-2.0
- Export, yoy % change	16.4	11.0	12.0	11.6	10.0
- Import, yoy % change	13.2	9.3	10.5	8.5	8.5
Inflation (CPI) yoy, eop	5.5	3.3	6.5	5.4	3.8
Average	6.8	3.6	3.8	6.4	4.3
Exchange rate /€, eop	245.9	252.7	280.0	275.0	270.0
Average	251.7	248.5	269.0	278.0	273.0
2 week Repo** eop	9.5	6.0	7.8	6.8	6.3
Current Account/GDP %	-8.9	-7.5	-8.5	-8.0	-7.5
FDI/GDP %	3.9	4.2	3.5	3.5	3.0
Public Debt/GDP*%	57.0	58.0	60.0	59.0	59.0
General Government Balance/GDP*%	-5.4	-6.1	-10.0	-6.5	-4.5
Public external debt /GDP %	70.1	77.0	79.0	75.0	70.0

F= Forecast
** Repo = Repurchase Agreement

and canned fruits). Naturally, these endeavours can only become a success on the European markets with a sufficiently capital-intensive marketing approach.
In its preparation for EU membership, Hungary was a beneficiary of financial assistance from the Community until 2006, but the EU budget for 2007-2013 already supports adjustment and the improvement of private-sector competitiveness with significant financial funds.
Large infrastructural investments will follow in the country's road and railway transport network, as well as in the development of the utilities networks in the countryside. This is expected to add fresh impetus for Western European capital investors who want to profit from this investment boom. By 2013, Hungary should most probably outstrip definitely its agro-industrial status and become an economy characterised by modern, high-tech industrial and human capital service sectors. With the renovation of their extremely rundown properties, Budapest and other major cities should regain the patina of the Monarchy era, while new development projects create decent architectural values, both in terms of residential and business properties, in a 21st-century environment.
Thanks to an average annual growth of 3-4%, the GDP exceeds the level of the year 1989 by about 32%. However, this raw statistical indicator is insufficient to describe the changes that have occurred in the quality of life.
The current Hungarian automotive environment, the commercial network, the hospitality industry, the supply of goods, communication tools, the range of financial investment products, and the tourism opportunities available due to the convertible forint have nothing in common with previous decades.
At the same time, the transformation has significantly widened the scope of income differentiation and given rise to major social tensions. None of the political forces, alternating in four-year election cycles were courageous enough to take a risk by putting an end to the paternalistic role of the state via radical reforms in line with a market economy. By 2006, the budget deficit rose to an unacceptable size, possibly topping 10% of the GDP, and its financing became critical. The reform of the healthcare system, the pension system, education, and State-owned utilities (railways, public road transport, motor roads) can no longer be postponed. The Socialist-Liberal coalition, re-elected in May 2006, started this thankless series of reforms, which of course met with major social resistance. The outcome of the reforms will decide whether or not macroeconomic stability can be maintained and whether the introduction of the euro can still be considered realistic for Hungary in the foreseeable future.

Interview with István Hamecz, managing director of National Bank of Hungary

What are the causes of the persistent balance of payments problems? How can they be resolved?
Hungary has had a current account balance of payments deficit in every year since 1993. (*See Chart 1.*) Taking the recessionary period of 1990-1992 out, which was mainly due to the transition from a State-owned economy to a capitalist one, we have had a persisitent balance of payments deficit throughout the 70s and the 80s. Sometimes that deficit has been modest in size;

at other times it has been very large. Since at root a balance of payments deficit is an excess of investment over saving, any attempt to reduce the deficit must either look to reduce investment or to increase saving. Reducing investment is hardly an attractive policy option, which leaves us with the question of how to increase savings. The key issue here is domestic savings behaviour. To the extent that domestic savings are insufficient to fund the nation's investment needs, we must rely on foreign savings. And if we are reliant on foreign savings, we must, by definition, continue to run a current account deficit.

One way of reducing the balance of payments deficit might be to decrease the public sector deficit. With the new Convergence Programme the government aims at the 3 % deficit level by 2009. In the medium term, however, a balanced budget would be better to increase national savings to a level which is compatible with a sustainable external deficit. One goal of the much talked about structural reforms is to increase private savings by providing people incentives.

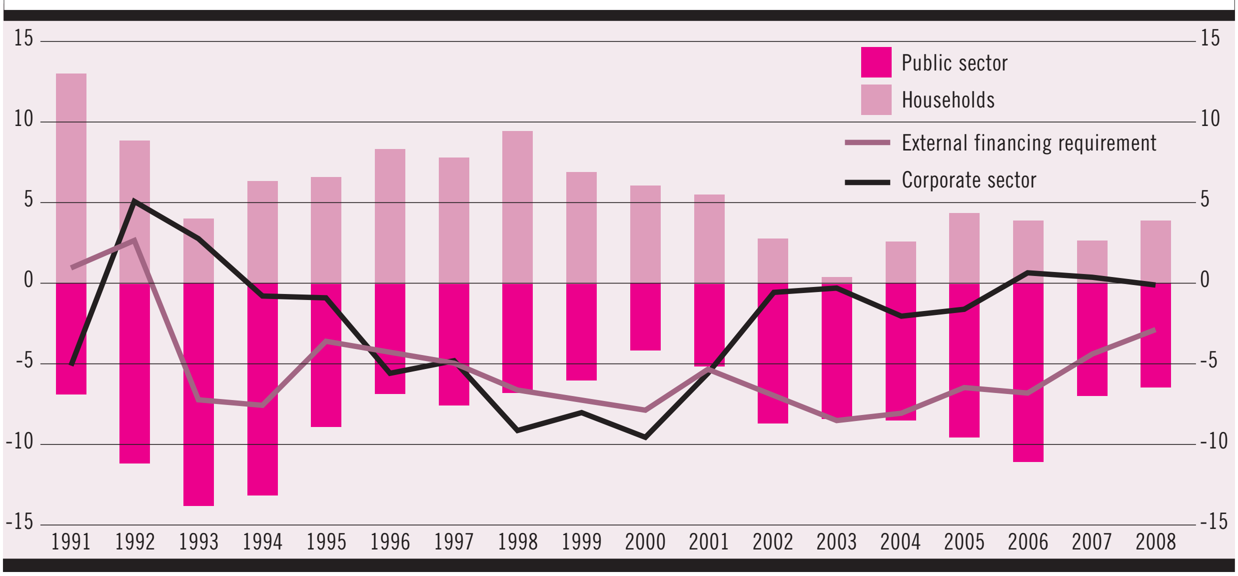
Household saving in Hungary were never high, but currently are at an extremely low level, which is mainly due to the rapid growth of retail lending. Obviously, this sort of strong growth in lending to households cannot continue indefinitely, but while it does there is likely to be pressure on our external accounts. All the studies confirm that the current rapid credit growth in the new member States can be considered as an equilibrium phenomenon.

How can monetary policy contribute to restoring financial equilibrium in Hungary?

In Hungary there has been a tendency to attribute to monetary policy an influence on the economy out of all proportion to the reality. The reality is that, beyond the contribution they can make by maintaining inflation at a low level, central banks can not have any substantial effect on trend growth in output or trend growth in employment. As we saw financial disequilibrium has been persistent through all kinds of monetary policy. There is a consensus among central bankers that monetary policy is a poor instrument with which to target a balance of payments deficit. By contrast, the policies of governments can have a material influence on both.

Monetary policy have an important, but essentially "background", role in allowing the

1. THE HUNGARIAN EXTERNAL FINANCING REQUIREMENT AND ITS COMPONENTS



economy to achieve its longer term growth potential. The focus of monetary policy on the single objective of price stability is key to convincing savers and investors that, in taking their decisions, they do not need to factor in a large inflation risk. It is only in that way that we can get sustainably lower interest rates.

Monetary policy aimed at stable prices assists growth in output and jobs by helping the price system, which is at the heart of the market economy, work more effectively.

Monetary policy aimed at stable prices assists the economy by helping to smooth business cycles.

Prices which are, on average, stable assist the pricing system to work effectively, and thereby help to ensure that investment takes place in the most economically sensible places. Prices which are, on average, stable tend to encourage saving, and thereby help to finance additional investment. These are the potential, although indirect, contribution the MNB can make in restoring financial equilibrium.

What is the euro strategy of the MNB?

The starting point of our monetary strategy is based on future EMU membership. Economic analysis suggests that the eurozone will be, in most respects, as much an optimal currency area for Hungary as for less developed current eurozone member countries. Adopting the euro will likely have a sizeable positive impact on Hungarian economic growth. Due to the significant net gains, the MNB has long been in favour of joining the EMU at the earliest possible date.

However the necessary adjustments needed in the economy to meet the Maastricht criteria have to be taken into account. While it is straightforward from an economic point of view that convergence requires gradually decreasing inflation and fiscal deficit, exchange rate stability is a more complex issue. Being an EU member, Hungary will have the opportunity to participate in the ERM II exchange rate regime, which is often regarded as the "ante-chamber" to the euro, as exchange rate stability requirement in the Maastricht criterion is based on a two-year performance in the regime. The opinion of the MNB on ERM II is based on economic considerations implying that sound fiscal policy is a prerequisite for the smooth operation of a fixed exchange rate regime. Thus, ERM II entry would carry risks as long as the government's fiscal consolidation program has not established sound credibility among financial market participants and it is contradicting monetary policy objectives. As soon as fiscal credibility is re-gained, reflected both in the achievement of deficit targets and decreasing long bond yields, ERM II entry becomes a safer option for Hungary, making it possible to join the eurozone within a short period of time.