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Challenges to the Hungarian Economy

Inside the EU but Before Introducing the Euro

I welcome the request to express my views in the renewed finance journal that is a combined effort of previous and current owners and other finance organizations. My opinion is focusing on our common initiatives, economic gap-reduction efforts, and the challanges of public finances with possible solutions.

In less than twenty years Hungary, together with several of its Central European neighbors, has managed to navigate a road no one would have dared to dream of in the preceding four decades. That road had simply been impossible: it required breaking away from the back of the pack, the countries drifting along the periphery, and catching up to the world's frontrunner nations.

In Hungary today, we simplify matters by saying we are catching up to Europe. Actually, what we are doing is not catching up to Europe alone but joining the ranks of the advanced nations, which is a much broader field.

TWENTY YEARS AGO

Twenty years ago Hungary was part of an East European integration that was slipping farther and farther behind and struggling to cope with crisis after crisis. Its operative problems were manifested in increasingly serious forms and instead of being able to offer subsistence to the peoples of the participating nations, they had to contend with deepening depression and despair.

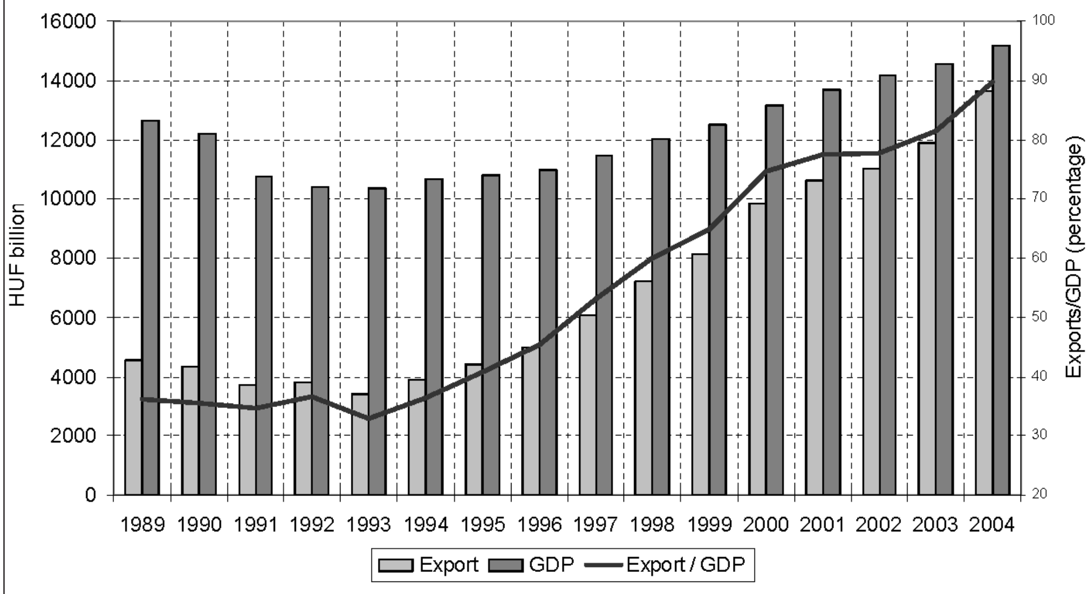
Hungarians always were creative in their ability to cope with difficult times, and managed to live better under quite bleak conditions. Therefore, the problems and contradictions were not as acute as elsewhere, or at least, the people not have to confront them as bluntly as did residents of some of our neighbors. Nevertheless, the economy was moving in a very wrong direction. For quite some time the country teetered on the brink of bankruptcy as state-owned companies swallowed up a good portion of revenues and sharp distinctions were made between exports to the east and to the west. In an attempt to access foreign exchange, a Herculean effort was made to increase "capitalist" exports, to use the terminology of the time, but the cost was high.

Two decades later, the country was at the end of an incredible journey. It had switched from membership in an eastern integration to a western one, from Comecon to the European Union, and from languishing within a non-functioning and unsustainable system to surging forward in a competitive and rapidly advancing one.

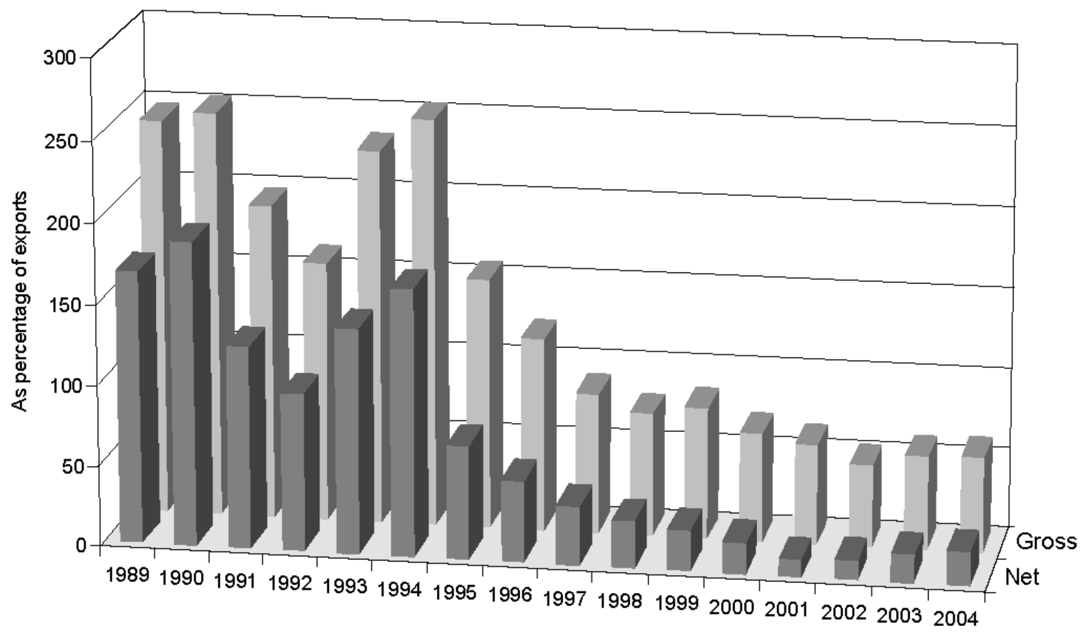
Back in those past decades, Hungary's exports to countries that paid in dollars amounted to barely a few billion dollars. Today its exports are valued at EUR 40–50 billion and at least 70 percent of them go to the EU15. Back then; the country had a truly obsolete production pattern. Today, it is typical of the most advanced nations of the world. It would be lengthy to list all the fundamental changes that have taken place over that period.

Exports to GDP Ratio

(consistent prices for 2000)

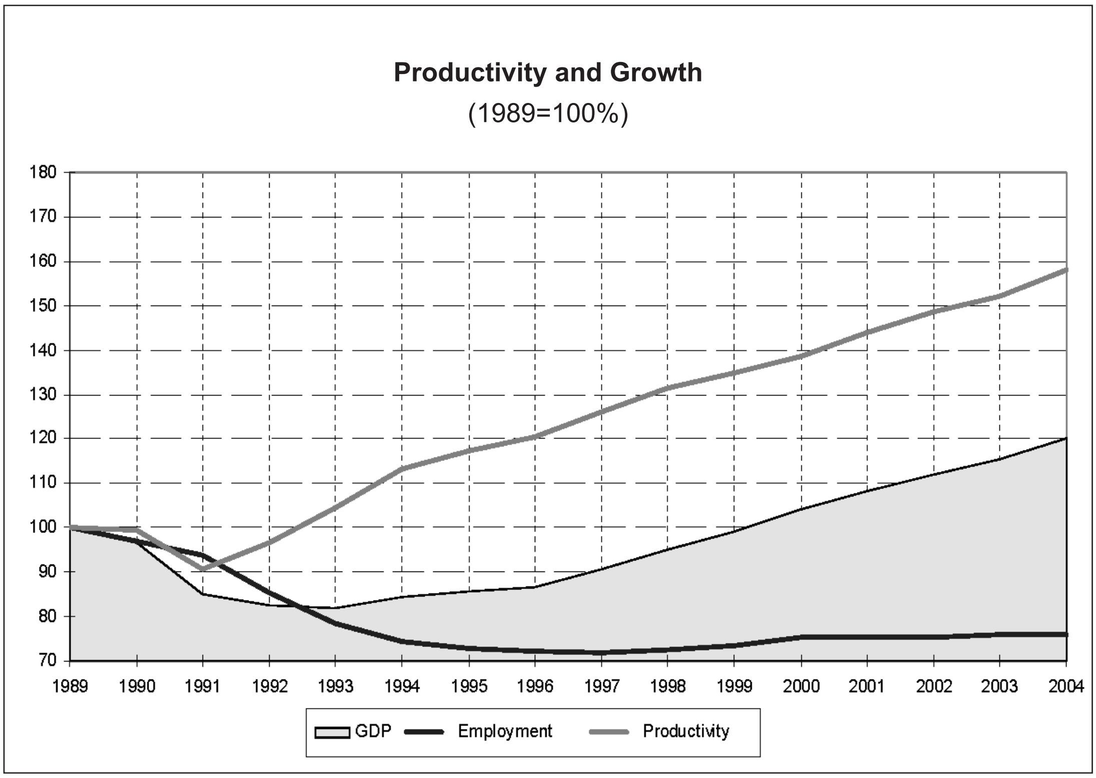


Foreign Exchange Debt Trends



WORKING HARD TO CLOSE THE GAP AFTER THE REGIME CHANGE

Of course, Hungary's problems remain quite significant. It still has many concerns to resolve, but the type and severity of those concerns is changing. The regime change has been completed, the economy is functioning well, and conditions for continued potent development through the next few decades are promising. Limiting ourselves to statistics, we can see that over the past 15 years productivity turned around from an initial decline to grow by over 50 percent. Obviously, this is related to a drop in employment. The country's foreign debt as a percentage of its exports dropped by a large magnitude and today we are well past worrying that paying off our foreign currency debt might be a problem. What happened in this area is something that many people never would have believed possible. The economy grew so rapidly and revenues from exports picked up so sharply that the country actually outgrew its foreign exchange debt. In other words, our revenues far exceed the amount we owe.



There were many changes in government-level economic operations as well as in public finance. However, the public sector never took off the way the private sector did. In fact, the opposite is true. The transformation was slow and burdened with substantial social and political dispute, which have often been unproductive without leading us closer to solution.

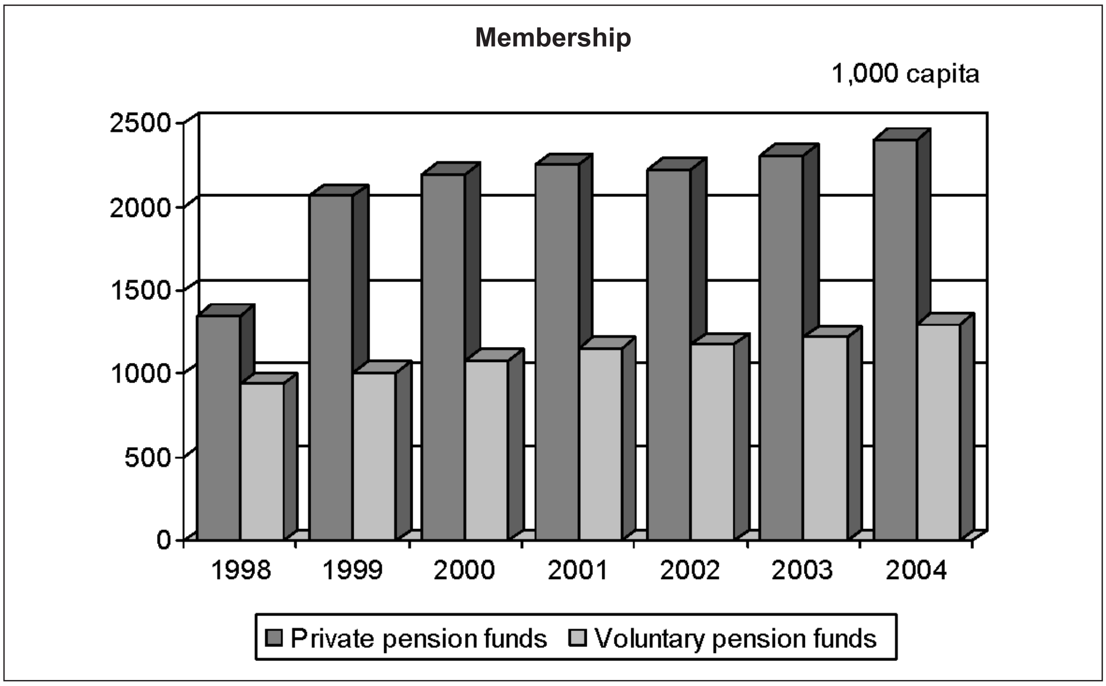
Hungary is clearly not the only country where this has happened. There are many similar examples in the more advanced countries of Europe, but that is no consolation.

We have known for quite some time that we need to take basic measures to transform government economic operations. There have been several periods of consolidation in public finance over the past 15 years. However, none proved to be permanent and we were unable to maintain or build on what we have achieved. The main reason was that the consolidation measures never transformed or updated the major government distribution systems, aiming to make them more efficient. The reforms were not followed by periods of stabilization so the financing problems picked up and became acute again and again.

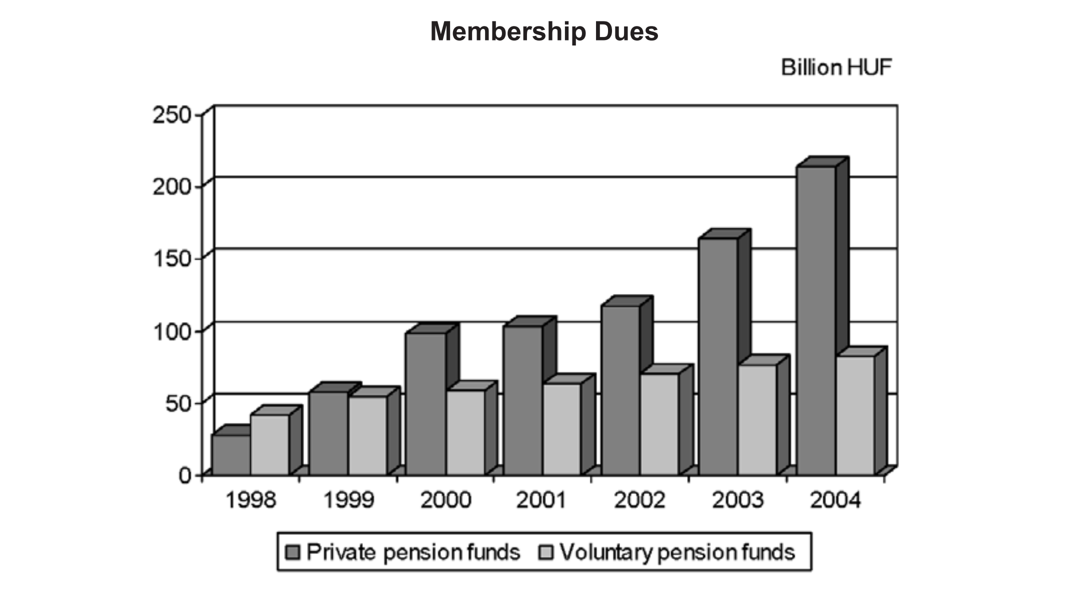
REFORMS – SO FAR

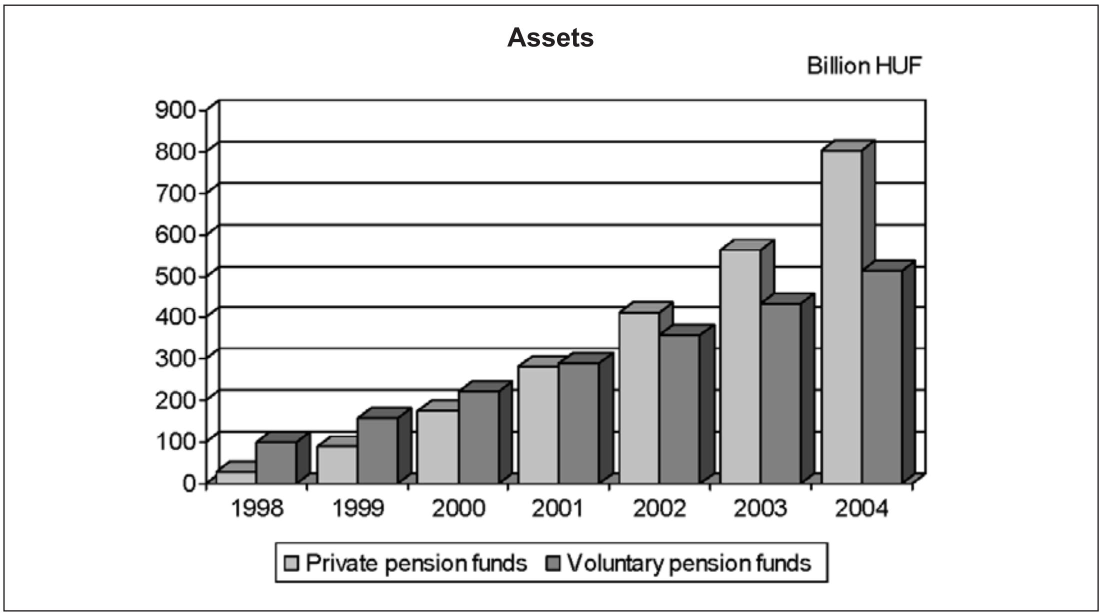
However, it would be unfair to say that nothing had changed regarding reforms. To date, the most progress we made has been in transforming the pension system. There was a great deal of debate during the preparatory phase. The question was how much of the old system to retain now that we were aware of its shortcomings. The state pension system, which operates on a foundation of mandatory contributions and central distribution, does not really offer incentives to working people to pay the contributions. They are not the ones who receive the money they contribute, since today's contributions are used to cover today's pensions.

Considering this fact from a self-interest point of view, it would have been best to design a system in which the amount of pension people receive is fully dependent on the amount they contribute to the fund. However, Hungary was not in a position to introduce a change of that magnitude. Although it would have been fairer to higher-income people, it would have essentially left out the less fortunate strata of society which would have generated huge amounts of tension. Therefore, nearly a full year before 1998 parliamentary elections a decision was made to establish a mixed system. The old system of mandatory contributions and central distribution has been retained, which takes a huge part of the edge off social injustices and reduces differences. At the same time, a mandatory private pension insurance fund has been established to give an incentive to people with high incomes to pay contributions in return for which they will receive a higher level of benefits while on retirement. There is a third element to the system as well. This one is voluntary and based on the idea that most people plan for the long term. While still young, they realize that eventually therefore they will grow old, and so they are willing to begin to put aside money well before that happens. The state has offered and continues to offer tax concessions to encourage people to make payments to the private pension system.



The system proved to be viable and contributions to private pension funds grew significantly. In past years, the decline in inflow to the state pension system triggered by the shift to the private one – which the central budget has to make up for to pay today's pensions – slowly crept up to 1 percent of GDP. Then, it boomed and it is now significantly more than that. The amount of money paid into the mandatory private pension fund is growing by HUF 200-250 billion/year (about EUR 800 million – 1 billion), while the amount of money distributed by the government pension system is somewhere around HUF 1,500-2,000 billion/year (about EUR 6-8 billion).





The pension reform, however, was discontinued. In fact, following 1998, there were several attempts to halt it altogether. The main reason was that this type of reform costs money. If the central budget spends money on an effort like this, whatever government is in power has fewer opportunities to finance its own day-to-day projects. However, this reform could not be halted. It would have caused a tremendous amount of damage and people would have learned to distrust any and all long-term measures. Nevertheless, the next steps to continue the process were not taken.

Main Factors of Pension Fund

Main features	Type of fund*	1998	1999	2000	2001	2002	2003	2004
Number of Funds	MNYP	38	30	25	22	19	18	18
Number	ÖNYP	190	145	116	98	90	83	75
Membership	MNYP	1346.7	2064.1	2193.4	2252.7	2225.4	2304.8	2402.2
1,000 capital	ÖNYP	939.3	1007.4	1080.6	1153.1	1180	1218.4	1249.4
Membership dues	MNYP	28.6	57.7	98.2	104.1	117.3	163.9	214.3
Billion HUF	ÖNYP	41.8	55.2	58.6	64	70.9	76.7	82.8
Assets	MNYP	28.8	89.8	175.6	283.1	413.1	561.4	803.5
Billion HUF	ÖNYP	101.5	159.6	224.3	291.5	358	434.4	512.4

*Key:

MNYP: Private pension funds
ÖNYP: Voluntary pension funds

Compared to pensions, comparatively little was achieved with the other subsystems of public finance. This was particularly true with regard to the economic operations of local governments where any decision to alter the system requires a two-thirds majority vote by Parliament. Professional circles, irrespective of the political party they support, agree that the next steps must be taken. Things absolutely have to change. The same is true for healthcare.

As time goes by and unfavorable experience builds, demand for reform is growing throughout society. We cannot say that at this point everyone is vociferously demanding fundamental change. However, there certainly is growing dissatisfaction with the systems operating at present because of their very low levels of efficiency.

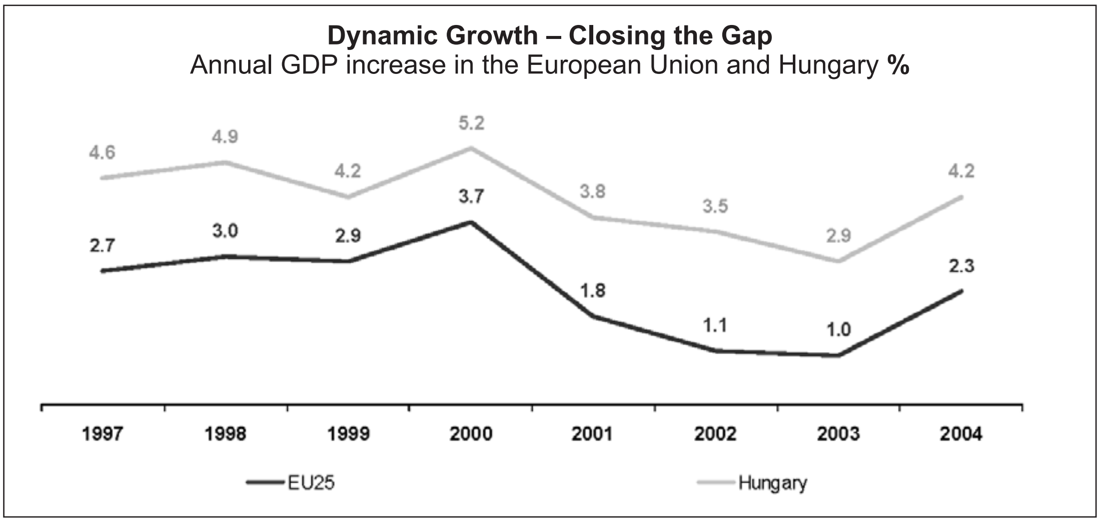
REFORMS – WE ARE NOT READY TO LIKE THEM, BUT WE ARE STARTING TO REALIZE WE NEED THEM

The public mood is changing though it is quite difficult to gauge what average people think about the reforms. There was a time when even the “reform”word generated some rather unpleasant feelings, since people associated it with constraints, belt-tightening, and a worsening situation.

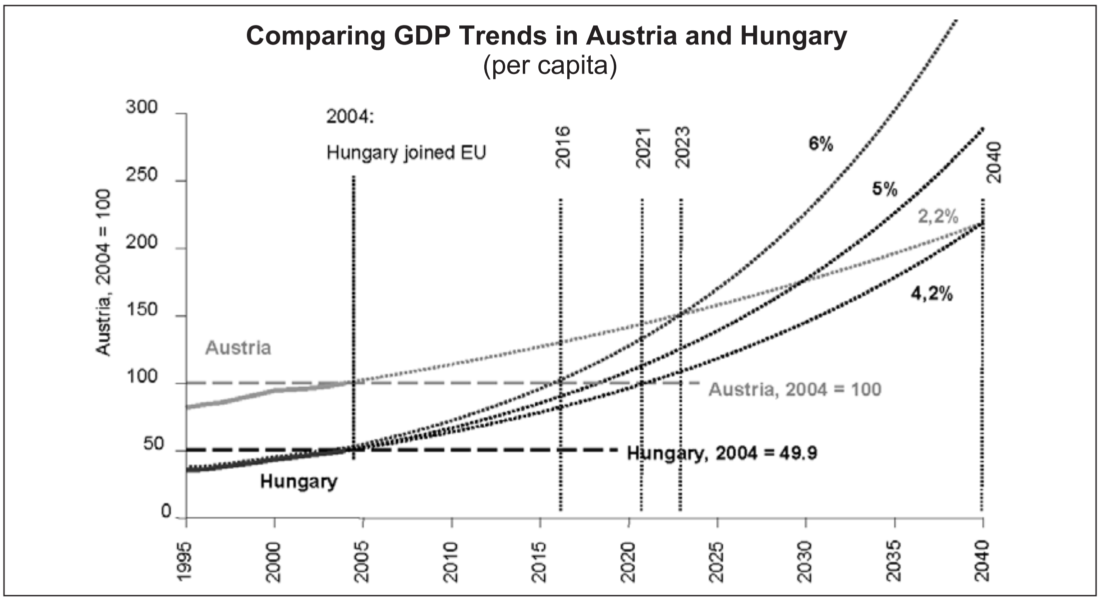
Reforms really do have an unpleasant side since they trigger significant changes. The result of those significant changes is that certain interest groups – currently operating in a wasteful manner, consuming large amounts of government monies and enjoying the benefits of systems that perform very poorly – will find themselves significantly worse off. They are unlikely to ever voice support for issues that will change their status. Nevertheless, the vast majority of people are beginning to find it obvious that something has to be done.

Once voters no longer consider reform to be a dirty word, politics will not be afraid to face the idea. This may be part of the reason why the subject is once again on the table and considered not only among professionals like analysts and economists. Newspaper articles, radio and television programs also have been spotlighting the issue, which suggests that a more general demand for reform is evolving.

Meanwhile, the need for reform has become much more obvious within the economy, where, given unchanged conditions, it is already comparatively difficult to adhere to basic priorities. The priorities are to promote rapid economic growth, significantly increase economic competitiveness, substantially cut taxes and quickly reduce deficits in both the budget and the current account balance, to have a low inflation rate, and in parallel with this, to quickly reduce the development gap through high-speed infrastructural growth. By becoming a member of the European Union, Hungary has gained infinite opportunity, but it has also been forced to face some serious constraints.



Its opportunities are infinite, since in a historically short period it can become a wealthy country – in the sense that we now consider Belgium, Switzerland, or Austria wealthy. The dispute on this point is whether it is going to take twenty years or fifty. Nevertheless, in historical perspective it is still a very short time, especially if we consider that this is a chance that was never offered to us in past centuries.



At the same time, we are also being forced to face some serious constraints. When we joined the EU, Hungary agreed to meet some very stringent requirements within just a few years. The name used to summarize those requirements is Maastricht; in other words, a set of criteria designed for the advanced nations of Western Europe. These countries underwent rapid development in the post-World War II decades, and in the meantime established the European integration step by step. They took each step at a time and finally reached their present status, in which they were able to introduce a common currency and hold to the stringent fiscal requirements. Hungary and the other Central and East European countries do not have that amount of time at their disposal. After spending forty years parked on another track, they had only the past two decades to push forward and approach the highest peak of integration ever attained. We are now at the gateway of introducing the euro, but we need to realize that many things just did not fit into those 20 years. This time was not enough to build a sewage network, or to establish a state-of-the-art road and railway network, a central motorway network and many other things that are essential for reducing the development gap and becoming an advanced country. It was not even enough for many parts of the country to link up to the dynamic economic circulation that is typical of other areas. In other words, Maastricht was not designed for the countries that recently joined the EU, and even the older members have faced compliance problems. Not only have Portugal and Greece had problems, but also Italy, Germany, and France.

Convergency Criteria

Stability:
Increase in the consumer price index may not differ more than 1.5 percent from the average price index of the three countries with the lowest price indexes. (Calculations are made for the previous one year period).

Interest policy:
The nominal interest rate of long-term government bonds may be no more than 2 percent higher than the interest rates of the three most stable countries.

Exchange rate policy:
In the two years prior to entry, the currency exchange rate may not deviate by more than plus/minus 2.25 percent the initial central exchange rate, a range established by the ERM.

Budget policy:
The current public finance deficit may not exceed 3 percent of GDP and the national debt may not exceed 60 percent of GDP. This criterion is to be applied in a flexible manner. If the long-term trend of the deficit or the debt is a declining one, a higher rate may be accepted temporarily.

If the only countries that find the regulatory system too rigid were the ten new EU members, then clearly no one would have thought that Maastricht might have to be modified to become more flexible. Nevertheless, since the problem has affected a larger circle, the issue did come up on the agenda and regulations were relaxed to a certain degree, allowing some factors to be kept in mind when performing the evaluations. For Hungary, the pension reform it undertook and the current major costs were considered, while for Germany the large amount it had to spend on its eastern regions was taken into account. However, no further refinements are expected. The requirements have to be accepted as objective conditions applied in all fairness.

THE BUDGET – NOT JUST AN ACCOUNT BALANCE

There have been professional suggestions made on how a tight budget policy could be consistently executed. Of course, these professional suggestions have totally ignored the political aspects. They view the budget solely as an account balance into which various mechanisms need to be built, to assure that any deterioration in balance can be halted at a certain level. Their assumption is that politics will never be able to resist the singing of the Sirens; that politician interests are conducive to spending and not saving. Therefore, they say, the system and the rules have to be airtight, to make sure that the government cannot change them, no matter how greatly it is tempted. The professionals want to see fiscal regulations enacted into law with some portions possibly set down in the Constitution to limit the motion of a particular budget index or several indicators. The indicators in question could be the budget balance, debt, expenditure, or tax revenue trends.

Designing a system like this is not a waste of time. Although it cannot work miracles, it can help decision-makers, budget planners and executors in their efforts. First, it cannot resolve the basic problems. Second, the budget cannot be stripped down into a mechanical account balance. The budget and public finance operations are the hub of all governments' economic policies. The budget is the gauge through which we can actually discern what portion of an announced economic policy is implemented, what portion is not, and what the outcome of the implemented portion is. As such, it becomes a center of contention between various political interests. In fact, every single point of contention is somehow connected to the budget, and the budget itself is the result of a variety of compromises that differ in type, nature, and scope. Some of these compromises rest on a foundation of economic rationality. For others, this is only partly true, while still other compromises are in no way related to economic rationality. None of this is unique to Hungary, this is the way budgets are constructed all over the World. It cannot even be said that things are different in the European Union. There too, we see that the most important budget regulatory decisions in part reflect rational considerations and in part relay the relationships between the various interest groups. It would be idealistic to call for keeping budget operations separate from politics when the budget is the crux of all political administrations.

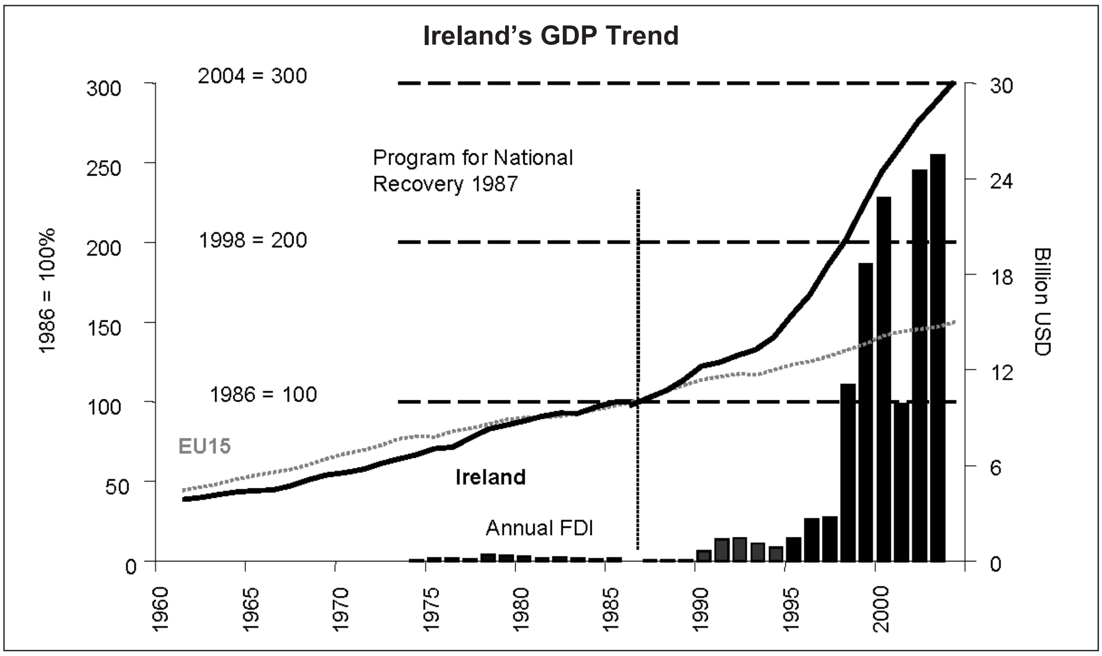
The realm of politics has to recognize the futility of erratic distribution and come to terms with the unavoidability of less popular measures to treat the problem at its roots.

Both politics and society are progressing along this road. Both are beginning to recognize that it is essential to move forward in a variety of important areas including healthcare, education, and local government. They are realizing the need to restrain the underground economy and to improve tax-payer ethics and tax-consciousness. We do not expect people taking their healthcare reform demands to the streets, but surveys have shown that residents give top priority to receiving high standard healthcare. However, whether they are truly willing to pay the necessary taxes and contributions to achieve this is another question. So far, they have not been asked to pay.

We have to admit that the current system offers no incentives to contribute to public funds, since everyone receives the same quality of service (at least in principle) indifferent to the amount of taxes or contributions they pay. This fact was recognized a long time ago, but nothing has been done in past years to change it. An important step in this direction was the government decision made as part of its new 100-Step Program. Under this program, as of next year, the health insurance fund will record contributions according to the person making the payment. The people who pay and who do not pay will be tracked by name. Some estimates claim that about half a million people with some form of income that should be paying contributions, do not. These freeloaders sidestep the costs while taking advantage of the services, which gives them the best of both worlds. Everyone else, the people who pay, are worse off because of them, since what others contribute has to be spread thinner and that means a lower level of services for all.

WILL WE SEE POLITICAL CONSENSUS ON BASIC ISSUES?

This is only the beginning; there is a need for additional and significant steps. Everyone along the entire range of the political palette knows this, and all have said so. A time might even come when they all say so together, in other words, when a desirable political consensus is reached on certain basic issues. We have still to figure out what those basic issues might be; but we do know that those countries which have been able to develop rapidly and move forward significantly, in remedying their economic and social problems, are those in which the political parties and leaders managed to achieve this type of cooperation. The best example is Ireland, where development did not really get underway right after it joined the EU. EU membership of itself was not enough to trigger the growth, which really accelerated in the wake of social consensus.



Closing the economic gap will be much slower than desired, until we reach that economic consensus. The various political forces are strong enough to thwart the aspirations of their opponents, but do not have the strength to push forward with their own plans.

It would be worthwhile to agree on certain basic values around which cooperation and not opposition could become the decisive factor. When setting down those basic values, the sole consideration should be that they serve the long-term interests of Hungary and Hungarians. We need to define the basic points supported by the entire community, support that any person or group opposing them will have to contend with. Right now, we are only beginning to define them, but if we manage to progress, we can begin to hope to accelerate reforms.

Hungary's ability to reduce the development gap depends on whether or not the political parties, with the power to decide on the most important measures of these reforms, can come to an agreement. If they do agree, it will certainly speed up the gap-reduction, especially if the necessary decisions are made timely. The players who define political life bear a fundamental responsibility for defining those basic values, doing the groundwork, and reaching national consensus. I hope that the broadest circles possible recognize the responsibility and act in this spirit.