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Hungary's Economic Performance Following EU Accession: Lessons for the new EU Members Bulgaria and Romania

Hungary's economy had achieved a very successful transformation during its transition in the 1990s. In 2001 the global slowdown did not affect the country's economic performance. However, in 2002 the Hungarian economy started experiencing a "slight slowdown" that persisted in 2003[1]. Output growth was slow, external current account deficit and general government deficit widened[2]. Contrary to some Hungarians' high expectations, EU accession alone has not brought an economic miracle all of a sudden.

The goal of this paper is to draw lessons for the new EU members Bulgaria and Romania by examining Hungary's economic performance following accession. Taking into account Hungarian economy's interdependence with Euro-area economy as well as Hungary's domestic macroeconomic policy, the paper presents: first – the country's economic benefits after accession – FDI, output growth, trade, disinflation and increased labor force participation, and secondly – its particular economic weaknesses - twin deficits and increasing unemployment rate. Finally, having examined Hungary's economic development in the post accession period, the paper suggests some problems that Bulgaria and Romania should expect and

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[1] Hungary Economy, 2005, p. 11.

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in view of their solutions it recommends appropriate macroeconomic policies.

In 2004 following EU accession, and moreover in the first half of the year when Euro-area economy "bounced", Hungary marked a record of FDI for the last decade. Since EU accession implies secure environment for investors, it is not surprising that an estimated EUR 3.7 billion foreign capital entered the country in 2004[3]. Among the attracted foreign investors were the Netherlands, Germany, Belgium, Austria and Japan. Foreign companies' production amounted to 90% of Hungary's exports in 2004[4]. FDI has stimulated Hungarian economy through "technology transfer, managerial skills, access to markets, training for staff, and lower environmental impact"[5]. Foreign investors have also been involved in one of the key elements of transition – restructuring of firms[6]. However, foreign investments decreased with around 0.2 bn in the second half of 2004[7]. An IMF staff attributes this decrease to the weakening of euro-area economy. Their report informs that "Hungary's short-term economic developments remain tied to the fortunes of its main European trading partners"[8]. According to Hungarian Economy Ministry, FDI will rise closely with the speed of GDP growth in the future[9].

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[2] Hungary Economy, 2005, p. 12 (economy.pdf).
[3] *Riding the wave of FDI,* Euromoney, London, Apr 2005, p. 1.
[4] Ibidem.
[5] A. Bevan, S. Estrin and H. Grabbe, *The impact of EU accession prospects on FDI inflows to central and eastern Europe*, p. 4, http://www.one-europe.ac.uk.
[6] Ibidem.
[7] IMF Country Report No. 05/213, 2005 International Monetary Fund June 2005, p. 26.
[8] Ibidem.
[9] *Hungary sees FDI rising to at least EUR 4.5 bn in 2006*, www.portfolio.hu.

In the first half of 2004, investment boom and “a bounce in the Euro-area economy” contributed to Hungary’s GDP high growth rate of 4%[10]. However, in the second half of the year, weaker investment, decreased demand prospects in the Euro-area and a “moderating consumption growth” resulted in growth slowdown[11]. The economy recovered in the second and third quarters of 2005. Government spending on motorways and other infrastructure projects stimulated GDP growth, but net exports have been its main driver[12]. The overall expansion of Hungarian economy in 2005 of 4% compared to 1.3% in the Euro - zone and 1.6% in the EU can be explained by Solow’s theory that a less advanced economy grows more rapidly than a more advanced one[13].

GDP growth has been additionally increased by trade effects of EU membership. The abolition of trade barriers with old EU members has boosted Hungary’s trade. The country’s trade performance was impressive given the increased competition posed by its EU membership[14]. During the first year of accession, Hungary increased its trade with incumbent EU-member states, with the new members as well as with countries outside the Union. The quantity of exports to the European Union increased by 6.8% year on year in the first 11 months and the EU-25 imported by 1.8% more in the same period. Imports from countries outside the EU increased by 22.4% from January-November 2004 and exports to these countries rose by

[10] IMF Country Report No. 05/213, op. cit., p. 4.
[11] Ibidem, p. 5.
[12] Quarterly Economic Report, World Bank EU8, February 2006, p. 7.
[13] *Hungary GDP up 4.1% year in Q4 vs. +4.5% in Q3*, www.portfolio.hu.
[14] *Country Profile 2005,* The Economist Intelligence Unit Limited 2005, www.eiu.com, p. 50 (YesHUNGARY).

27.8% year on year[15]. Similar to GDP growth rate, exports declined in the first quarter of 2005 when Euro-area economy weakened. However, they started to increase in the second quarter[16].

An IMF report finds that "intensified import competition" has partly contributed to disinflation. Immediately after Hungary's accession into the EU, higher oil prices, the higher value-added tax (VAT) and excise tax increase pushed inflation in early 2004[17]. However, effects of tax rate did not last long and inflation restored to lower levels, reaching 3.2% in February 2005[18]. As a response, appropriate monetary policy aiming at reduction of interest rates was conducted[19]. Thus, the favorable change in inflation persisted throughout 2005. An OECD survey suggests that the planned cut of the standard VAT rate from 25% to 20% could lead to a significant reduction of inflationary pressures in 2006[20]. All in all, Hungary's variation of inflation can be attributed to both implications of EU membership such as "increased import competition" and domestic macroeconomic policy.

While FDI, GDP growth, exports and inflation have developed evident positive tendencies since EU accession, unemployment has had ambiguous development. On the one hand, unemployment rate has risen in both 2004 and 2005, starting with 6.1% in 2004 and reaching an average of 7.1% in 2005[21]. The

[15] *Hungary stats office revises Nov trade gap down by EUR 14 m*, www.portfolio.hu.
[16] IMF Country Report No. 05/213, op. cit., p. 5-6, 11.
[17] Ibidem, p. 26-27.
[18] *Country Profile 2005*, op. cit., p. 40.
[19] IMF Country Report No. 05/213, op. cit., p. 27.
[20] *Country Profile 2005*, p. 40.
[21] Ibidem, p. 39-40.

average unemployment rate in Hungary was lower than the averages of EU-15 and EU-25 in 2005 but it was the highest in the region[22]. The necessity of government's action as regards labor market reforms remains. On the other hand, following EU accession Hungary's "perennial" low labor force participation and long-term unemployment showed positive signs. In 2004, the number of economically active people increased by 45, 000. Later in 2004-2005 a 15% decrease of long-term unemployment as a share of total unemployment marked again a positive change that was lacking in the years of transition[23].

Despite significant inflow of FDI, good performance of exports, disinflation, increased labor force participation and ultimately high GDP growth, Hungary's current account deficit has continued to grow since 2004 partly as a result of the inefficient fiscal policy. This growth would not be a problem if it were a result of catch up – or income convergence – process. A country catching up to the economic level of advanced countries can grow "relatively rapidly" while "spending more than its current income" and "borrowing capital from the rest of the world and, hence, running current account deficits"[24]. However, an IMF study suggests that Hungary's current account deficit in 2004 was larger than the level predicted by the model[25]. BNP analyst Michal Dybula expects "further widening" of the current account deficit in 2006 as a result of increased domestic

[22] Country Profile 2005, op. cit., p. 39-40.
[23] Ibidem, p. 39-40.
[24] IMF Country Report No. 05/213, op. cit., p. 18.
[25] Ibidem, p. 18.

demand, "fuelled by loose fiscal policy"[26]. Therefore, he has stressed the necessity of stringent fiscal policy for the reduction of the current account deficit and has expressed hope for slower disinflation due to VAT decreases[27].

The loose fiscal policy conducted by governing Socialists has posed the risk not only to current account deficit but also to timely adoption of the euro by 2010. According to the World Bank's statement the loose fiscal policy led to increase in general government deficit:

"Hungary's public sector deficit (GG or general government deficit) in 2005 increased by about 1 pp of GDP to 7.4% of GDP, more than 2 pp of GDP higher than planned owing to expenditures overruns (on pensions and pharmaceuticals) and the EU's rejection of plans to shift the costs of motorway construction off budget"[28].

Critical of Socialists' lack of fiscal discipline, the right-wing former financial minister Varga has been worried about analysts' predictions of 8%-10% general government deficit in 2006[29]. He notes that "Brussels [...] and analysts take Hungary's macroeconomic figures less and less seriously"[30]. Such worries have also been justified by a 2005 IMF report suggesting the risk of euro adoption delay if the government does not implement "sustainable fiscal reforms"[31].

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[26] *Analyst view: Hungary Dec trade deficit to grow EUR60M yr/yr in Dec 2005*, www.portfolio.hu.
[27] *Global trends offset Hungary fiscal risk – BNP Paribas*, www.portfolio.hu.
[28] *Hungary fiscal targets optimistic, expenditure measures questionable*, www.portfolio.hu.
[29] *Hungary needs kick in the butt, former FinMin says*, www.portfolio.hu.
[30] Ibidem.
[31] IMF Country Report No. 05/213, op. cit., p.5.

Finally, apart from serving as an example of the overall economic improvement (GDP growth, more trade, great inflow of FDI) following EU accession, Hungary's two-year experience of an EU member can teach the new EU members Bulgaria and Romania what economic challenges to expect after accession and how to meet them. Presently, both Bulgaria and Romania have high current account deficits[32]. In Hungary's case the high current account deficit has continued to be a problem after EU accession. Therefore, similarly to Hungary, Bulgaria and Romania should maintain tight fiscal policy. Following the advice of the IMF experts for maintaining a budget surplus to "counter" the problematic current account deficit and to "safeguard against rising imports"[33], Bulgarian governing elite should be careful when they increase VAT and excise taxes. Last but not least, Hungary's post-accession experience should alert the new members of the possibility that unemployment may not be alleviated by the benefits of EU membership. Therefore, domestic reforms of labor markets should remain an important element of Bulgarian and Romanian governments' reform agendas after accession.

In conclusion, Hungary's economic performance after entry into the EU has significantly improved though the country's domestic economic policy after accession and the economic connection with the Euro-area have not always been favorable. In the second half of 2004 and early in 2005, FDI, exports and GDP growth weakened partially due to a slowdown of the Euro-area economy. However, as a whole, great inflows of FDI, extended trade and an incre-

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[32] Rom*ania sees big current account deficit,* United Press International; *Mind the Gap, Bulgaria*, Volume 97, Oxford Business Group 2005, 17.02.2006.

ase in labor force participation have positively marked the two-year post-accession period. Experts expect this tendency to continue in the coming years. No less important than the interdependence with the Union's economy has proved to be Hungary's domestic economic policy. Governing socialists' loose fiscal policy not only has contributed to a problematic current account deficit, but also has threatened Hungary's timely entry into the Euro-zone. The National Bank of Hungary's monetary policy in 2004 has proved appropriate to maintain disinflation. Now the necessity of government's action to improve labor utilization remains. Judging from the examined two-year experience, Hungary's economic performance will continue to vary with the benefits and challenges posed by the Euro-area economy as well as with the economic policy adopted at the national level. The EU members Bulgaria and Romania should take seriously the important lessons drawn from Hungary's post-accession period. Namely, accession does not solve macroeconomic problems all of a sudden. First, unemployment may not be decreased by entry into the EU. Secondly, there might be inflationary pressures following accession but at the same time import competition from the EU can help the achievement of disinflation. Thirdly, the necessity of appropriate monetary policy at the national level remains since entry into the EU does not equal entry into the Euro-zone. Finally, Bulgaria and Romania should expect variation of their economies due to fluctuations of the Euro-area economy.

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[33] *Mind the Gap, Bulgaria*, Volume 97, Oxford Business Group 2005, 17.02.2006.