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Government-MNCs relations and their influence on competitiveness and inward FDI in Hungary: An analysis of the effects on the banking sector

Valentina Lisi

Master of Arts in
Interdisciplinary Research and Studies on Eastern Europe
MIREES (LM 52)

GRADUATION THESIS
In
FDI and development policy in Eastern Central Europe

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Introduction

Ever since the beginning of the transition period from a state-planned to a market-oriented economy, Hungary has been a frontrunner in attracting Foreign Direct Investment (FDI) in the Central Eastern European (CEE) region. Initially, the reasons were to be found in a privatization process mainly based on the sale of state owned enterprises' assets to foreign investors, but later the country continued attracting investment thanks to its several factors of attractiveness, as well as favourable policies towards the inflow of FDI. However, since the mid-2000s Hungary has begun to lose the benefits of its first-mover position and after the outbreak of the financial crisis, the country has started accumulating increasing competitive disadvantages compared to its peer economies, despite the fact that the importance of such investments remained high. However, since the year 2012 positive signals were registered in the inflow of FDI, and also the economic outlook of the country – after the recession experienced in 2012 – is slowly but steadily improving despite the fact that several important structural reforms still need to be implemented.

Nonetheless, especially in foreign media, this change of tendency is usually not adequately reported. The Orbán government, clearly devoted to clawing back the national sovereignty of the country through the implementation of what has been often depicted as a Putin-like regime, has been strongly criticised in the European institutional environment,[1] by the USA and many EU member states as a consequence of the controversies over political reforms deteriorating democratic values in the country.[2] However, especially domestically or within rightist political forces internationally, it has been often appreciated for its fight against international financial organizations and the multinational companies that since the beginning of the transition phase have dominated the Magyar economy. Indeed, the rhetoric against multinationals is present and noticeable in the country, both in the political debate and in the public opinion. Not without reason, it represented one of the main elements in Orbán's political campaign, as it is proved by the "unorthodox" measures put in place in 2010 against the most foreign-dominated sectors of the Hungarian economy.

However, given the circumstances, it is quite obvious to wonder which elements have made possible the increasing inflow of FDI of the last two years and, consequently, to what extent it has been possible for an economy so highly dependent on foreign capital to pursue a strategy more or less friendly to business – especially taking in consideration that it still owes much to the multinationals present on its territory in terms of job creation, inno-

[1] The Wall Street Journal – Emerging Europe, Hungary's Constitutional Changes Threaten Democracy, Venice Commission Says, http://blogs.wsj.com/emergingeurope/2013/06/15/hungarys-constitutional-changes-threaten-democracy-venice-commission-says/.

[2] Sadecki Andrzej (2014), In a state of necessity. How has Orban changed Hungary, OSW, p.5., http://www.osw.waw.pl/sites/default/files/pw_41_in-a-state-of-necessity_net.pdf.

vation and contribution provided in the catch-up process towards the most developed economies in Europe.

Given these assumptions, the main purpose of the research is to pinpoint the measures implemented since 2010 towards foreign investment (incoming and already established) in the country and to understand the results that these economic policies have had on the competitiveness of the country in an international comparison as well as on the inflow of FDI and the performances of the MNCs already settled in the country. Moreover, a case study has been carried out about the results obtained in terms of profitability and the causes of distress in the Hungarian banking sector, which is characterised by a high percentage of foreign presence (about 90%) and has been extensively targeted by the political authorities in the last four years. Indeed, although the sector chosen cannot provide a representative outlook of the effects of the economic policies on foreign dominated sectors, it represents an interesting case because of its peculiarities. These include banks poor performances in terms of profitability also in a regional comparison, the stubbornness of the punitive measures implemented by the government against them, as well as the *Fidesz* agenda related to the attempt to reduce drastically foreign ownership in the sector.

In order to reach the abovementioned objectives, the research aims to explore the following questions:

1. What are the main results of governmental economic policies on the competitiveness of the country and the inflow of FDI in Hungary?
2. To what extent do the economic policies of the 2010-2014 government reflect the rhetoric against multinationals?
3. Which characteristics of the banking sector can explain its low level of profitability? Are government policies the cause of the banking sector's below average performance? If yes, to what extent?

Unfortunately, in some cases data available has not provided the chance to build strong relations between the measures implemented and the performances of the economy. This is also related to the current nature of the topic addressed, in which developments are strictly enclosed within the years 2008 and the political elections occurred in April 2014. However, in some circumstances where the effects of such policies were more tangible – as in relation to the consequences of taxation on Hungarian banks' profitability – relations between results and economic policies were more easily outlined.

The literature of the work includes both primary and secondary sources, meaning documents, statistics, books, papers and reports. In dealing with particular contemporary issues newspapers were also referred to as a source. In addition, five interviews were carried out (personally or by emails) at the Hungarian Investment and Trade Agency (HITA), at the Italian Trade Agency in Budapest, with Hungarian researchers, as well as with a Unicredit's economic analyst. In particular, as far as the theoretical part is concerned, the methodology used includes the study of the literature already existing concerning the topic of the international competitiveness of nations and the governmental influence on the attractiveness of a country, as well as the literature focusing on the economic developments of the Central European countries after transition. In addition, in order to analyse the performances of the country in relation to the topic and to find information regarding the economic policies implemented in this concern mainly papers, documents, and reports published by International Organizations and professional service firms (UNCTAD, WEF, OECD, European Commission, Deloitte, PwC, KPMG, etc.) were consulted. The information regarding the Hungarian banking sector is provided mainly by the Central Bank of Hungary (MNB), the Hungarian Banking Association and research centres of the major banking groups active in the country and in the region such as OTP, Unicredit, Raiffeisen and Intesa Sanpaolo. However, also opinions shared by economic analysts of the financial sector and journalists were duly taken into account.

The topics addressed in order to provide an answer to these questions are organized in four chapters. First of all, the work provides the theoretical framework needed to address the issue, namely, the concept of competitiveness of nations and the determinants of FDI attractiveness, the role played by the government in such factors and concerning the efficiency of international banking in a given country. Secondly, Chapter 2 aims to transfer this theoretical knowledge to the case of Hungary by providing the economic outlook of the country, primarily its degree of competitiveness as set by the major publications in this concern and the developments in attracting foreign capital and investment in the last years. Consequently, Chapter 3, which likely represents the main focus of the research, is devoted to an overview of the economic policies of Viktor Orbán's government between 2010 and 2014 and the reasons behind them. This includes specific policies towards FDI, meaning investment promotion policies or singular agreements with major foreign investors in the country as well as the implementation of policies which are not strictly related to MNCs but that are somehow extensively influencing their profitability and productivity, such as the windfall taxes on specific sectors and programs like the Funding for Growth Scheme. Finally, Chapter 4 provides analysis of the Hungarian banking sector performances. It compares Hungarian results with the ones of neighbouring countries in the region and investigates the causes of its negative profitability levels in order to understand how influential the economic policies implemented and the political discussion around banks in Hungary have been in this concern.

Chapter 1. The influence of the government on the international competitiveness of Nations

In order to analyse how the role that Hungary played in attracting foreign investors changed during the years and to examine the influence of the governmental policies in Hungary on the real effects of the country's economic performances, it is necessary to understand the theoretical framework related to these issues. How does a country attract investments? Why does a multinational company direct its choice to a specific market instead of another to set its business? Which roles do the state and the political institutions play in attracting investments? Which policies can they implement in order to make their country more competitive and attractive to foreign investors and which are useful to keep them satisfied with their choice in the long term?

This chapter aims to provide an answer to the aforementioned questions through an analysis of the main theories concerning the competitiveness of nations and the factors determining it. Moreover, it will give an overview of the different ways in which states are creating a business-friendly environment – or repelling FDI, according to their specific economic strategy – by both analysing the economic, administrative and institutional factors shaping the market and also the specific promotion policies that governments can implement in relation to the attraction of FDI. The last section of the chapter will be devoted to the analysis of the influence of such policies in the banking sector, which needs further explanation because of its particular features and because it will be the focus of the case study included in the last chapter of this research.

1.1. The International Competitiveness of Nations

1.1.1. Definition of the concept

The international competitiveness of a nation is a determining factor for the economic performances of a country, its growth, development and success in raising income levels and providing opportunities for its people. It is indeed the factor that makes a nation attractive for a multinational company willing to invest abroad, and that leads the choice about the

country hosting the investment, since the more an economy can be considered competitive, the greater is its potential of growth over time. Moreover, FDI themselves can have a positive effect on the productivity and competitiveness of a nation, especially if well integrated and producing positive spillovers into the hosting economy.

Globalization and increasing economic interdependence among states have pushed research centres, international organizations and the academic world to increase the focus on the real capacity of a nation to attract investments, considered as one of the main drivers of economic prosperity, and to understand what key factors are leading them. Among the others, IGOs such as the Organization of Economic Cooperation and Development (OECD), the World Bank, the IMF and the United Nation Conference on Trade and Development (UNCTAD) publish annual reports describing the global current conditions of national competitiveness, ranking countries' efficiency from this point of view and analysing the global trends in the present, as well as possible outcomes in the future.

Nonetheless, this profusion of publications, coupled by a lack of theoretical framework concerning the matter, makes it somehow more difficult to determine and find a unique definition of what the international competitiveness of nations is and from which factors it is determined.[3] Indeed, it rather seems to be a complex phenomenon that touches a multitude of economic aspects, which cannot be captured easily within one overarching definition or theory, and that cannot be considered the result of fixed and given determinants or factors.[4] In fact, as already mentioned, the studies in the field are always based on different indicators and parameters as determinants of the competitive advantages of a nation. This leads to different results, even if similar, when it comes to rankings listing the best performing countries in the world in terms of competitiveness and doing business.

According to the World Economic Forum, the International Organization for public-private cooperation headquartered in Geneva, the concept of global competitiveness can be described as "how a country creates the best economic, social and environmental conditions for economic development. It measures what makes real this development: things like policies, institutions and productivity. It monitors the vital elements that make a country productive and benchmarks each nation's performance".[5] The OECD defines the same concept as 'the degree to which a nation can, under free and fair market conditions, produce goods and services which meet the tastes of international markets, while simultaneously maintaining and expanding the real incomes of its people over the longer term.[6]

In any case, the existing definitions of national competitiveness usually present as a common term the capacity of a country to create welfare and good and sustainable economic conditions through productivity. In fact, as Michael Porter pointed out in his book "the Competitive Advantage of Nation" in 1990, "the only meaningful concept of competitiveness at the national level is national productivity",[7] meaning that the rising standard of living of a country's population depends on the real ability of a nation's firms to achieve and to increase over time a high level of this measure. The higher the productivity with which a nation's resources, such as labour and capital, are located and employed in relation to the outputs, the higher is the competitiveness of the nation itself compared to others.

[3] Mitschke Andreas (2008), The Influence of National Competition Policy on the International Competitiveness of Nations. A Contribution to the Debate on International Competition Rules, Physica-Verlag - A Springer Company, p. 91.

[4] Ibidem, p. 107.

[5] World Economic Forum, What is competitiveness?, http://www.weforum.org/issues/global-competitiveness.

[6] OECD (1992), Technology and the Economy: The Key Relationships, Paris.

[7] Porter Michael E. (1990), The competitive advantage of Nations, Macmillan, London, p. 6.

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This idea helps in the introduction of an important distinction between the natures of the two different levels in which the competitiveness of a nation is built: the *micro and macroeconomic levels of productivity*. The first is related to the efficiency of enterprises within the country and it can be an important determinant for investments, especially in the case of market and strategic assets seeking FDI (usually positively influenced by the presence of a competitive environment, such as clusters). The latter refers to the international competitiveness of the whole nation or economy. It can be easily described as the *location* specific advantage of a country theorised by Dunning in 1993 in the framework of the eclectic paradigm.[8] To sum up, trying to give to these two aspects of the same phenomenon a clear and straightforward definition, the micro level can be defined as the "international competitiveness of domestic enterprises", while the macro as the "location attractiveness of the nation".[9]

There is still a controversial debate going on in the academic environment in relation to the nature of competitiveness, meaning whether it can be defined only as a microeconomic concept or also as a macroeconomic one.[10] In effect, some scholars claim that nation economies do not compete among each other in order to welcome the best investment or to place their own national products abroad, but that rather it is enterprises within the nation-state that are doing so, thus creating a productive national economic environment able to compete in efficiency and effectiveness with others around the globe.

Nonetheless, the major role played by national industrial policies in influencing the competitiveness of economies cannot be neglected. Indeed, the effects of governmental policies can be seen in both ways, positively or negatively, regarding the performances of a national economy, not only on the macro environment and on the major economic indicators of a country, but also at the micro level through specific policies affecting the productivity of domestic and foreign companies based in the country. This factor demonstrates how the competitiveness of nations has also much to do with the political environment of a country.

1.1.2. Determinants of a country's location attractiveness

Which are the factors and the determinants increasing the location attractiveness of a country? Why does a foreign company willing to invest abroad choose a national econo-

[8] Dunning John H. and Lundan Sarianna M. (2008), multinational enterprises and the global economy, Edward Elgar. Cheltenham, UK – Northampton,MA, USA, p. 137.

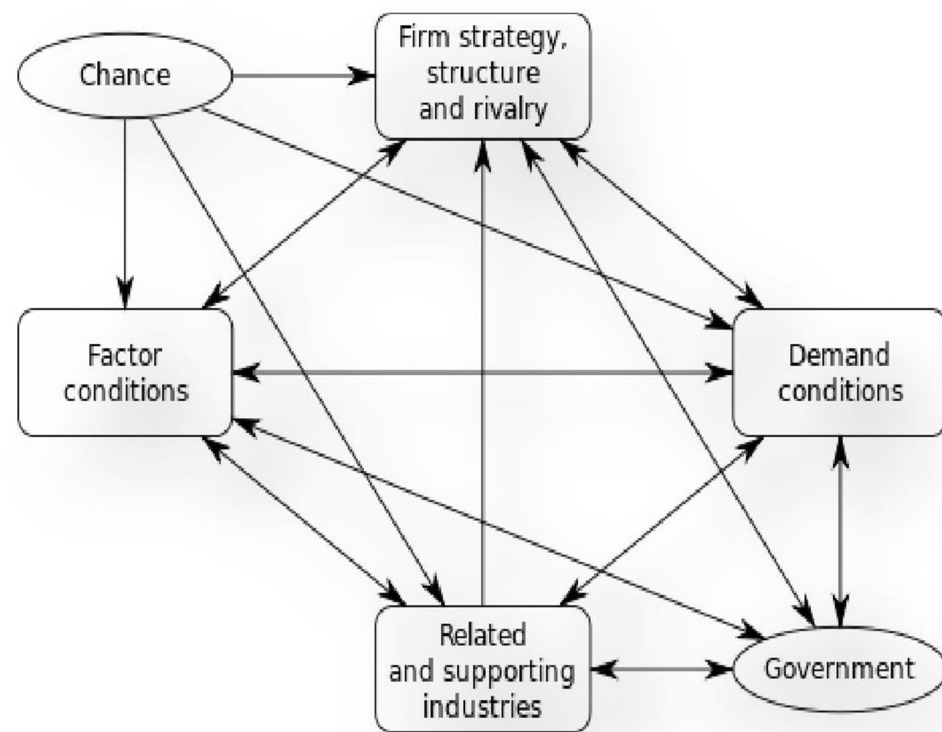
[9] Mitschke Andreas (2008), The Influence of National Competition Policy on the International Competitiveness of Nations. A Contribution to the Debate on International Competition Rules, Physica-Verlag - A Springer Company.

[10] Ibidem, p. 103.

my instead of another? As already mentioned, it is not easy to give an answer to these questions. The academic literature is not clearly united in this regard, as understanding and defining these factors has been the centre of the discussions among economists for hundreds of years. Moreover, the decisions of companies starting a process of investment abroad are moved by different strategic reasons, which could make interesting and favourable a specific location for a company but definitively inadequate the exact same destination to another, which might be looking for different features in the economy hosting the investment. For instance, companies investing in the United States were mainly attracted by the large market size, while foreigners investing in Singapore focus on the availability of good infrastructure, skilled labour and political stability.[11]

In the economic literature concerning the determinants of national competitive advantage, the so-called Porter's Diamond, first published in 1990 in his "The Competitive Advantage of Nations", provides a clear study of these factors and remains one of the most comprehensive explanations in this regard (Fig. 1.1).

Figure 1.1 Porter's diamond model



Source: Porter, 1998

However, despite the relevance of the Porter's approach to the competitiveness of nations, several criticisms have been moved to his diamond model, especially because it seems to be too focused on the entrepreneurial aspect of the economies considered, and less on other factors influencing more the macro level than the individual one. Moreover, the model should also be con-

[11] Blomström Magnus (2001), The economics of international investment incentives, OECD, p. 167., http://www.oecd.org/daf/inv/investment-policy/2487874.pdf.

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textualized to the current tendencies that make the contemporary world a much different place from the 1990s' environment. In fact, the outbreak of the global financial crisis led the state to obtain a greater influence in determining the economic strategies to be implemented within the country in order to confine the negative effects of the downturn on the economy and its citizens. In addition, the increasing role of the developing economies in terms of global international trade and flows of inward and outward FDI is a factor that is shaping the way in which a country can be considered productive nowadays. Indeed, developed economies are forced to offer more in terms of innovation and technology in comparison to their developing counterparts.[12] For all these reasons, a contemporary look at the determinants of competitiveness cannot avoid taking into consideration these important drivers of change in a modern society.

The *Global Competitiveness Report*, published every year by the World Economic Forum and considered as one of the most comprehensive assessments of national competitiveness worldwide, offers a detailed analysis of the determinants taken into consideration in order to assess the level of productivity of countries all around the globe. It sets the level of prosperity and the rate of return obtained from investments in a country, and consequently also the competitiveness of an economy. Well aware of the hundreds-years discussions going on among scholars concerning the factors to be taken in consideration in relation to the topic, the WEF has compiled a list of twelve pillars grouping the various factors building the attractiveness of a country. Those factors are not exclusive in this process of creating competitiveness. They are rather reinforcing each other since they are often more effective when working together. The Global Competitiveness Index (GCI), a tool used by the WEF since 2005 in order to analyse the microeconomic and macroeconomic foundations of competitiveness, captures this open-endedness of factors and creates relations among the different components.[13] The GCI, in fact, divides the already mentioned twelve pillars in three different groups – as shown in Table 1.1 – since not all of them are equally important for diversified economies around the world at different stages of development.

Table 1.1 The Global Competitiveness Index

Global Competitiveness Index		
Basic Requirements	**1) Institutions**	**2) Infrastructures**
Group of determinants mainly important for factors-driven economies, or in other words, economies at their first stages of development. In this case the level of attractiveness is based on the countries factors' endowment, such as unskilled labour or natural resources	Legal and administrative framework within which the business sector, but also the population and the government, are interacting to generate wealth	Important in determining which kind of economic activities can be implemented within the country and in which location they would be more profitable and effective
	3) Macroeconomic environment	**4) Health and primary education**
	Economic performances of a country and is of extreme importance for the business sector and for the ability of the state to offer the services needed for its population	Both influencing the quality of workers' life and productivity

[12] World Economic Forum (2013), The Global Competitiveness Report 2013-2014, Full data edition, Geneva, p. xiii.

[13] World Economic Forum (2013), The Global Competitiveness Report 2013-2014, Full data edition, Geneva, p. 4.

	5) Higher education and training	**6) Goods market efficiency**
	Crucial for economies that want to move up the value chain beyond simple production processes and products. To do so countries are expected to nurture pools of well-educated workers who are able to perform complex tasks and adapt rapidly to a changing environment and the evolving needs of the production system	Efficient goods markets are well positioned to produce the right mix of products and services given their particular supply-and-demand conditions, as well as to ensure that these goods can be most effectively traded in the economy
Efficiency enhancers **Determinants related to those economies that are facing the efficiency-driven stage of development, characterised by a higher level of productivity, higher wages, and as a result, also a better quality of products**	**7) Labour market efficiency**	**8) Financial market development**
	Essential to ensure that workers are allocated in a flexible and efficient way, also guaranteeing wage fluctuation without harming the population	A sound and well-functioning financial sector for economic activities allocates the resources saved by a nation's citizens, as well as those entering the economy from abroad, to their most productive uses and it channels resources to those entrepreneurial or investment projects with the highest expected rates of return
	9) Technological readiness	**10) Market size**
	It measures the agility with which an economy adopts existing technologies to enhance the productivity of its industries, with specific emphasis on its capacity to fully leverage information and ICTs in daily activities and production processes for increased efficiency and enabling innovation for competitiveness	Particularly important for domestic and foreign companies that can benefit from the economy of scale
Innovation and sophistication factors **Determinants specifically related only to innovation- driven economies that have already achieved a high level of development characterised by extremely high wages, which can be sustained only with the production of unique and innovative goods and services**	**11) Business sophistication**	**12) Innovation**
	Quality of individual firms' operations and strategies, as well as the quality of a country's overall business network (heightened when it assumes the shape of clusters)	It refers to innovation of the technological type, but also in terms of knowledge and research

Data from: Global Competitiveness Report 2013-14, World Economic Forum

The two analyses reported in the chapter by Porter and the WEF have different approaches to the determinants of competitiveness and cannot be compared, but still they can

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help in having a broader image of these factors, since the former is more theoretical, while the latter is based on measurable data included in an index able to create and produce a list of the countries around the world per level of competitiveness.

What is new in the most recent analysis concerning the issue is the increasing importance of elements such as technological improvements and innovation. This is particularly true for developed economies challenged in their ability to attract investment by developing countries. For this reason, they are requested to offer the benefits given by what they only can produce, meaning high quality products and knowledge. In this context, the role of the government and its interest in attracting investments seems to be increased as an outcome of globalization, regionalization, and trade liberalization policies promoted by organizations such as the WTO or the EU, which are actually making the world economy much more integrated and levelled in terms of regulation than before, and making factors such as the size of the market less and less important as a decisive justification for investing abroad.

These tendencies resulted often in the implementation of economic policies devoted to increase the attractiveness through economic incentives and other kinds of policies that might offer attractive results for investors and that would be in these new conditions more influential than how they used to be in the past.[14] Viewed in these terms, the role of the investment promotion policies and the government might be much more influential in determining attractiveness compared to what Porter specifies in his book. It is interesting to acknowledge how John H. Dunning in 2008 also reaches the same conclusion. In fact, in order to contextualise his work with new tendencies of the last decade, he revisits the role of institutions within his eclectic paradigm, since their influence on location attractiveness of countries is increasingly crucial in a world where the Ownership advantages are becoming more and more available and can be more easily transferred between countries.[15] Because of this increasing importance, the following part of the chapter aims to offer a theoretical framework of the ways in which the state can affect the attractiveness of a country and influence the inflows of FDI, as well as the performances of MNCs already settled in the country.

1.2. How political institutions attract FDI

Several are the ways in which the state and political institutions can influence the attractiveness of the country. As already mentioned in the previous section, according to John H. Dunning the role of institutions has become increasingly important in the economic activities of MNCs worldwide, but what exactly does he mean by the term "institution"? The definition he adopted in his work has advanced an understanding of institutions at the macro level, meaning both formal rules, like constitutions, laws and regulations, and informal con-

[14] Sass Magdolna (2003), Competitiveness and economic policies related to Foreign Direct investment, Ministry of Finance, p. 7.

[15] Dunning John H. and Lundan Sarianna M. (2008), multinational enterprises and the global economy, Edward Elgar. Cheltenham, UK – Northampton,MA, USA, p. 138.

straints, such as behaviours and conventions undertaken by both the political and the civil forces within the country. In order to be effective, a study on the interdependence between firms and national-level institutions has to take into consideration both the formal and informal aspects already defined.[16] Indeed, states and governments can influence the performances of MNCs and the inflows of FDI on different levels, starting from a very general and macro one, given by the political framework within which the firms will have to interact once settled, reaching very specific policies and attitudes towards particular economic sectors or type of investments. In fact, they can also implement incentive policies or, by contrast, *FDI repelling* activities, on the basis of the strategy followed by the government in power.

1.2.1. Government related factors of attractiveness

According to research carried out by Nathan M. Jensen, the nature of the political regime plays a significant role in the decision of the country that will host the investment. It seems that democratic institutions, more than authoritarianism, play a positive role in attracting FDI because of their tendency to build and implement market-friendly policies in the present and in the future. In this concern, democracies are more likely to keep the promises concerning the implementation of market-friendly policies made to their electorate, and this continues in the future because of the "audience costs" related to political elections and the usual will of politicians of staying in power as much as possible. This leads democratically elected politicians to be more careful in relation to the type of promises they make and to respect the ones already made in order to keep their reputation clean, a factor that authoritarian leaders do not have to worry about.[17]

Indeed, it is the political risk related to the investment that leads extensively the choice of the country destination. FDI is extremely mobile ex ante, when the final destination of the investment is not defined yet and several determinants can still influence it, but also highly immobile ex post. This leads to the necessity for MNCs investing in a new country to take in serious consideration the political environment within which they will interact in the future, considering also that once multinationals have sunk their investment, governments will have the incentive to renegotiate the contracts with the company or to expropriate income streams unilaterally.[18] In this regard, even if veto players and audience costs can be relevant, not only the nature of the political regime plays an important role. The political stability of a country, the performances of its government and its reputation, also need to be considered.

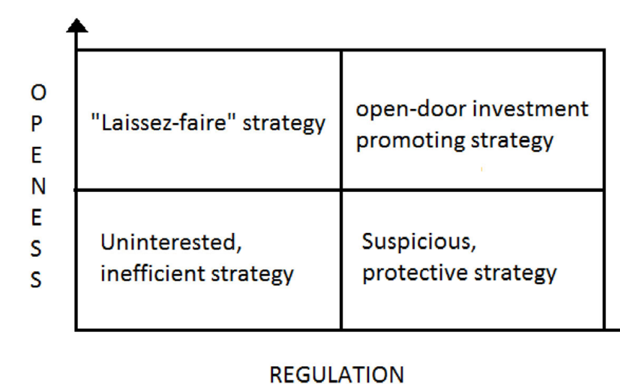
In this concern, the International Institute for Management Development (IMD) publishes every year in the World Competitiveness Yearbook a ranking of 60 selected countries, listed on the basis of criteria grouped under four main factors (divided into twenty sub-factors): economic performance, government efficiency, business efficiency, and infrastructure.[19] The "government efficiency" list of criteria is actually providing good insights on what MNCs should look at while analysing the politically related context of a destination, meaning all those tendencies and policies that are not directly related to incentives or strategies toward multinationals and FDI, but that represent conditions somehow relevant for the success of the investment, which means:[20]

- Public finance: measuring the level of indebtedness of the government (domestically and abroad), its budget surplus/deficit, the interest payment and the general expenditure of the government;
- Fiscal policy, or in other words, the tax system imposed on personal incomes and corporations, direct and indirect;
- The institutional framework: linked to Central Bank performances (short-term interest rate, spread, exchange rate stability, foreign currency reserves and, in general, Central Bank policies) and the state efficiency (transparency, bureaucracy, legal framework, bribing and corruption, etc.);
- Business Legislation: determining the level of openness of a country through tariff policies, protectionism, public sector contracts, and capital markets, but also competition and regulations, meaning state subsidies to enterprises, competition legislation and the ease of doing business, as well as the labour regulations;
- Societal Framework: taking into account factors and measures such as the Gini index, the judicial sector, the ageing of the society or gender inequalities, etc.

All these factors are influencing the competitiveness of a nation and are directly related to state policies and characteristics that condition any kind of investment, foreign or domestic, but that are not specifically describing the strategy of a nation in relation to MNCs, even though they can be effective in attracting or repelling FDI.

In particular, there are four broad and partially overlapping strategies that a government can decide to adopt in relation to multinational companies within its borders. As showed in Figure 1.2, they can vary in the degree of regulation of incoming investments - whether they only have a laissez-faire approach or regulated one - and openness.[21]

Figure 1.2. Governmental strategies towards foreign investors



[16] Ibidem, p. 129.

[17] Jensen Nathan M. (2006), Nation-States and the Multinational Corporations, Princeton University Press, Princeton and Oxford, pp. 2-14.

[18] bidem, p. 46.

[19] IMD, World Competitiveness Center, Factors and Criteria, http://www.imd.org/wcc/wcc-factors-criteria/.

[20] IMD, World Competitiveness Center, Government efficiency, http://www.imd.org/uupload/imd.website/wcc/GO_list.pdf.

[21] Cohen D. Stephen (2007), Multinational Corporations and Foreign Direct Investment, Oxford University Press, Oxford, pp. 154-155.

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Certainly, there are several reasons that could induce a government to undertake a certain strategy instead of another. As far as a positive attitude toward MNCs is concerned, it can be driven by the positive spillover effects that FDI usually means for a country, especially in terms of technological innovation and share of knowledge, which can positively influence domestic firms and thus the productivity of the whole economy. However, it can be also related to specific needs, as proved by the experience of transition countries that used to be part, or within the sphere of influence, of the Soviet Union, and that at the time of its collapse had to move from a central-planned economy to a market-based one, also through extensive privatization of their state-owned companies. For instance, in this regard the Hungarian example showed how in conditions of serious lack of capital within the borders, the solution to proceed in this process of privatization was found in the hosting of foreign capital by attracting FDI.

1.2.2. Investment promotion policies

Within the FDI's attraction activities that nation-states put in place it is possible to distinguish several types of investment promotion policies with different natures. Some of them deal with the regulation concerning incoming investment, or are providing guarantees for the MNC entering the market. However, among the others, a special focus should be addressed towards the controversial topic of state incentives granted to multinational companies, as their real effectiveness in attracting FDI has often been questioned in academia.

Incentives can be defined as policies implemented by the government within the framework of the state industrial policy in order to influence multinational corporations to engage in activities to a greater degree than what they would have probably done in a free market situation with no government intervention.[22] The OECD uses the definition proposed by UNCTAD in 1994, stating incentives are "measures designed to influence the size, location, or industry of a FDI investment project by affecting its relative cost or by altering the risk attached to it through inducements that are not available for comparable domestic investors", and also underlining the discriminatory nature of such policies.[23]

Even though these incentives can vary significantly case-by-case on the basis of the negotiations between the hosting country and the specific corporation, the standard benefits offered by a state can be divided into:[24]

- Fiscal incentives: devoted to reducing the burden of the foreign corporation's tax expenses through tax holidays for a fixed number of years, reduction of the standard corporate taxes, accelerated depreciation allowances, tax credits for domestic reinvestments of profits, exemptions in the VAT for capital goods and raw materials purchases and exemptions from corporate taxes for income derived from exports;

[22] Cohen Stephen D. (2007), Multinational corporations and Foreign Direct Investment: avoiding simplicity, embracing complexity, Oxford, Oxford University Press, p. 165.

[23] OECD (2003), Checklist for Foreign Direct Investment Incentive policies, p. 12., http://www.oecd.org/daf/inv/investment-policy/2506900.pdf.

[24] Cohen Stephen D. (2007), Multinational corporations and Foreign Direct Investment: avoiding simplicity, embracing complexity, Oxford, Oxford University Press, pp. 165-166.

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- Financial incentives: related to the disbursement of direct grants and non-repayable subsidies offered to foreign corporations in order to contribute in the reduction of tangible costs and expenses of starting a business;
- Other: this catchall category includes incentives with very different natures to be offered to MNCs. They include the implementation of policies such as the exemption of import duties on raw materials and capital goods, subsides on water or energy, preferential access to government contracts that could even provide guarantees against the entrance of new foreign enterprises in the country, thus confirming those theories claiming how FDI can harm international trade.

The theoretical point of departure used to justify these kinds of policies from the part of the state is that domestic firms have some kind of advantages compared to foreign corporations just established in the country because of their higher level of knowledge of the local environment. Thus, incentives would help MNCs in reducing the gap of competitiveness between indigenous and foreign-owned companies within the borders of a given state, even though big foreign-owned corporations are very likely more competitive than both large and medium-sized domestic firms, despite the fact that they have just entered a new market. This aspect actually shows how it is almost impossible to apply the theory of perfect competition in situations in which MNCs and FDI are involved.[25]

Sometimes incentives can serve the scope of economies that for given reasons might not be attractive enough for investment, presenting structural problems that could not be addressed in the short term,[26] but also the scope of countries that are indeed attractive but are competing with economies offering a similar investment environment, geographic location and natural resources.

However, the lack of real effectiveness of incentive policies often verified when their costs are even higher than the real benefits they produce for the whole economy is one of the reasons why the economic literature has always been rather sceptical in this concern. Indeed, it claims they represent a useless cost, since MNCs are more concerned about the general economic environment in which they will invest than specific cost reductions that might not be very beneficial in the long run. In fact, the basic aim for the implementation of an FDI promotion program by the state should be to maximise the long-term benefits of foreign companies' presence in the country. It is a natural consequence that, in order to do so, the state has to be able to keep the costs at the lowest possible level and to be sure that the benefits of the programs are always higher than the costs.[27]

Nevertheless, in defence of the process of implementation of those policies, even when erroneous, it can be argued that the estimation in advance of the real cost/benefit ratio of any given incentives package is a very imprecise activity, since the results of those policies can only be estimated *ex post* and cannot consider how the well-being of the economy would change in the presence or absence of the given investment *ex ante*. In fact, such predictions could be done in terms of direct and visible benefits for the economy, like the number of jobs created or amount of

[25] lomström Magnus (2001), The economics of international investment incentives, OECD, p. 166, http://www.oecd.org/daf/inv/investment-policy/2487874.pdf.

[26] ECD (2003), Checklist for Foreign Direct Investment incentive policies, p.7.

[27] Ibidem, p. 15.

capital flowing into the country, but definitely it cannot consider other investment-related advantages (or disadvantages) such as positive spillover effects in the market (or the lack of them).[28]

Other forms of investment promotion policies, however, are not specifically related to the offer of real economic incentives towards multinationals, both of the financial or fiscal type. They can also include special types of regulation for foreign-owned firms and they can sometimes be used in both ways, as a repellent for investment or as an incentive - by providing guarantees - according to the government's strategy towards FDI. Indeed, a nation-state can apply outright across-the-board bans to investment, or only in specific given sectors where there is a major concern to improve the local companies' abilities and profitability. By consequence, if a state can use regulation to liberalize entry requirements, which is the major trend nowadays, it can also use law in order to block investment targeting the country. In fact, even though outright bans are not popular (maybe almost not-existent in present days) and considered extremely expensive in terms of benefits for the nation, bans for foreign investment in specific sectors are put in place more often.

Despite the fact that states might still resort to other indirect ways to favour national companies, for instance favouring firms within the country on the basis of their size, the fact that the WTO is by now a truly worldwide organization means that several types of guarantees favouring international trade, coupled with the actions of other IGOs such as the EU or the proliferations of regional and bilateral agreements concerning the issue, are levelling the corresponding legislation.

As already mentioned in this chapter, the direct consequence of this condition of countries offering increasingly similar legislation is that the way governments interact with the business sector is becoming more important. As clearly pointed out by the last *World Competitiveness Report*, in fact, one of the main messages resulting from the current changing conditions in terms of competitiveness and growth is the need for cooperative leadership among business, government and civil society. This is seen as the only way to ensure the global economy to get back on track.[29]

1.3. Multinational Banking and government regulation

Among the different sectors in which FDI has developed in years, the banking sector needs a special focus in this chapter, especially in relation to the phenomenon of multinational banking and its relationship with governments. Indeed, it would be a mistake to limit the discussion of multinational corporations to industrial and productive corporations, since banks also operate on a global basis and, if anything, have more economic power than the industrial corporations do, as they depend on banks as a primary source of financing. Also

[28] Cohen Stephen D. (2007), Multinational corporations and Foreign Direct Investment: avoiding simplicity, embracing complexity, Oxford, Oxford University Press, p.166.

[29] World Economic Forum, Global Competitiveness Report 2013-2014, Jennifer Blanke, http://www.weforum.org/issues/global-competitiveness.

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their political influence is more relevant compared to sectors such as manufacturing or trade, and their activities are often linked to the governments' economic policies.

In fact, the financial sector differs from all the others since it influences all other sectors through its lending policies, as well as a large number of private individuals through their deposit-taking function and the general monetary and financial conditions of a country. This can be also considered as one of the reasons why it usually receives a much higher level of attention from political institutions and regulators.[30] Indeed, multinational banks can support and facilitate multinational companies in several different ways, including financing imports and exports (traditional international banking task), trading foreign exchange and currency options, borrowing and lending in the Eurocurrency market, organizing or participating in international loans syndications, underwriting both Eurobonds and foreign bonds, supplying information and advice to clients, including multinational firms.[31]

In addition, the effects on the host countries can be varied from what other types of MNCs would produce. FDI in banking and finance, in fact, produces several concerns and benefits for the host country. The productivity spillovers and technology transfer in this sector can be indeed present, but a change in the terminology used is needed. For instance, more than "productivity", international banks entering a new market are modifying and influencing positively the "efficiency" of local banks (especially in emerging economies where the level of competitiveness might be lower for domestic-owned banks than for foreign ones), mainly because of the changed competitive structure.[32]

The specific nature of multinational banks also leads to another consideration concerning why they decide to open new branches in a given country. Actually, in the financial sector, FDI has always been only one of the possible scenarios among all the likely institutional and contractual arrangements. For instance, agent-type relations among banks provide the possibility to engage in financial activities abroad without running the risks related to the opening of a new branch in a foreign market.[33] However, the changed conditions occurred in the 60s due to financial innovation and improvement in technology helped in changing the transaction costs structure and provided more incentives to internalize business through opening of new branches instead of continuing international financial operations through market relationships. Moreover, during the first wave of expansion of international banks in the nineteenth century, very often FDI in the sector was extensively encouraged by governmental actors, as happened in Japan, where the government was willing to establish a Japanese multinational bank and was ready to finance its operations. Indeed, in the international banking sector, according to the great part of the literature on the topic, the role of the government has always been very influential. This is true in relation to the decision process,

[30] Jones Geoffrey (1990), Banks as multinationals, in "Banks as Multinationals", Jones Geoffrey (eds.), London, Routledge, p. 8.

[31] Eiteman David K., Stonehill Arthur I., Moffett Michael H. (1995), Multinational Business Finance, 7th edition, Addison-Wesley Publishing Company, Inc., p. 412.

[32] Goldberg Linda (2004), Financial-Sector Foreign Direct Investment and Host Countries: New and Old Lessons, in "working papers", National Bureau of Economic Research, Cambridge, p.7., http://www.nber.org/papers/w10441.pdf?new_window=1.

[33] Jones Geoffrey (1990), Banks as multinationals, in "Banks as Multinationals", Jones Geoffrey (eds.), London, Routledge, p. 6.

meaning where to invest and the activities and operations to undertake, but also on the opposite side, considering the host country regulations.

One of the peculiarities of multinational banks is that they actually operate on two distinct levels: the supranational and the national market. Thus, the two different motivations leading to multinational banking might also produce varied implications for economic welfare. MNBs, in fact, can provide a positive contribution in a national retail market because of improved competition in a developed economy only if regulators allow them to compete actively with local banks.[34] However, a massive penetration of foreign banks in a country or region, as in the case of transition economies after the fall of socialist regimes, might also harm the development of a national banking network that might be seriously challenged by the presence of highly competitive multinational banking groups. This condition might lead the government to implement stricter regulation of the sector, in order to try to strengthen the local financial market, as it has been the case in Hungary.

These conditions are met not only in the banking sector, but also in general as the weakness of the domestic market due to an exaggerated presence of foreign companies can actually expose the country to exterior shocks in a higher level than in the presence of a strong domestic market. A positive example in this concern, for instance, is represented by the good performance of Poland compared to Hungary after the outbreak of the crisis. As discussed in the following chapters, this might be one of the reasons why Hungary has adopted unfriendly policies towards MNCs in the last few years while focusing on programs aiming to develop small and medium-sized domestic companies, most likely owned by locals rather than foreign investors.

To conclude, in this chapter several elements have been introduced in relation to the concept of competitiveness, its determinants and the role played by the government in influencing them. As different theories in this concern have been analysed, it has been possible to see how different approaches to the subject might result in different perceptions of the determinants themselves and their importance. More than anything, the role played by the government in this concern seems to create discrepancies in the literature, being sometimes recognised as an element which is influencing all the determinants of competitiveness (as stated by Porter) and in other cases being associated with specific determinants of an institutional nature. Table 1.2 aims to put together all the elements discussed as main determinants of competitiveness in order to visually clarify the content of the chapter as well as to identify the main elements that will be further analysed in the following parts in relation to the Hungarian case. They have been divided into three different levels: micro, macro and institutional. In fact, although the Orbán government between 2010 and 2014 represents the focus of this research, not only institutional determinants, meaning the factors strictly related to the government behaviour and efficiency, will be addressed in this work. Indeed, the influence that institutions are playing, even if indirectly, on all the other determinants through legislation, transparency, reputation, Central Bank's decision and so forth will be also addressed as they also represent important indicators of a government's activity in a given country. For this reason, the following chapter aims to transpose what has been defined theoretically to

[34] Gray J.M and Gray H.P. (1992), the Multinational bank: a financial MNC?, in "Multinational and international banking, Jones Geoffrey (eds.), Edward Elgar Publishing Limited, p.40.

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the practice in the Hungarian case study, also introducing the reader to the main features of the Hungarian economy and its strengths and weaknesses.

Table 1.2. Summary table of competitiveness' determinants

Micro level	Macro level	Institutional level
• Firms' strategy • Firms' structure • Firms' productivity • Technological readiness • Innovation	• Market size • Demand conditions • Related and supporting industries (clusters) • Infrastructures • Macroeconomic outlook • Health and primary education • Higher education and training • Financial market development	• Political regime • Legal and administrative framework (transparency, bureaucracy, bribing and corruption) • Political stability • Public finance • Business legislation and investment promotion • Fiscal policy • Judicial framework

Chapter 2. The Hungarian international competitiveness and economic performances

The outbreak of the global financial crisis in 2008 has hit the Hungarian economy more extensively in comparison to other members of the European Union. The late 2000s were years in which Hungary had to struggle in order to recover from several economic and financial issues which could have crippled the country. Also, the significant level of political instability, reaching its peak at the time of the scandal associated with the Hungarian Socialist Party-led (MSzP) government in 2006, left a serious legacy in the Hungarian political scene which is still ongoing nowadays and that at least partially created the conditions for the triumphal victory of the *Fidesz* party led by Viktor Orbán in 2010.

The political opposition, seriously damaged by several scandals, mismanaged the economy during the time of its mandate and increased further the budget deficit, exposing extensively the country to the crisis. Nowadays, it is still incapable of creating a constructive debate and it has been marginalised from the political decision making process of the country. This, coupled with a system of checks and balances made almost non-existent because of the two-third majority gained by *Fidesz* in the unicameral Parliament in 2010 – and its consequent permeation of the political and administrative institutions in the following four years of government – has led to a great deal of controversy abroad. In particular, in the EU institutional environment, the Orbán's rule provoked discussions on the limits of democracy and the rule of law.[35]

The political and economic turbulence of the last years has certainly affected Hungary's image in the eyes of foreign investors and its level of attractiveness. However, despite the negative conditions recently, many of the numerous reasons that made Hungary such an appealing destination until the mid-2000s are still present, and new opportunities have been created. Among the others, its strategic position in the heart of Europe represents one of the major strengths for economic activities in the country, providing them with a logistical proximity particularly favourable for export activities. The geographic location gives the chance to reach 20 different nations and an area inhabited by 250 million consumers within a range of 1000 kilometres, thus compensating for the disadvantage of a small domestic market. Moreover, although the advantageous geographic position is a common feature for the competing Visegrád countries in the region, Hungary is determined to benefit from this opportunity by preserving and improving it. This is proved, for instance, by the engagement

[35] Sadecki Andrzej (2014), In a state of necessity. How has Orban changed Hungary, OSW, http://www.osw.waw.pl/sites/default/files/pw_41_in-a-state-of-necessity_net.pdf.

of the government in the renewal and development of road transport, in which important investments have been allocated with the help of the European Union.[36] Moreover, favourable taxation, especially direct, as well as a good ratio between the quality and cost of the labour force, still represents an important competitive advantage for the country.

The analysis of the points of strength and the weaknesses of the Hungarian economy will be the focus of the first half of the chapter, aiming to provide an outlook of the economic performances of the country since the outbreak of the global financial crisis and of the changes in its degree of competitiveness during the years. The second part will be devoted to the study of Hungary's foreign capital structure and its performances in attracting FDI in terms of stock and flows in comparison to its major competitors in the region.

2.1 Macroeconomic outlook

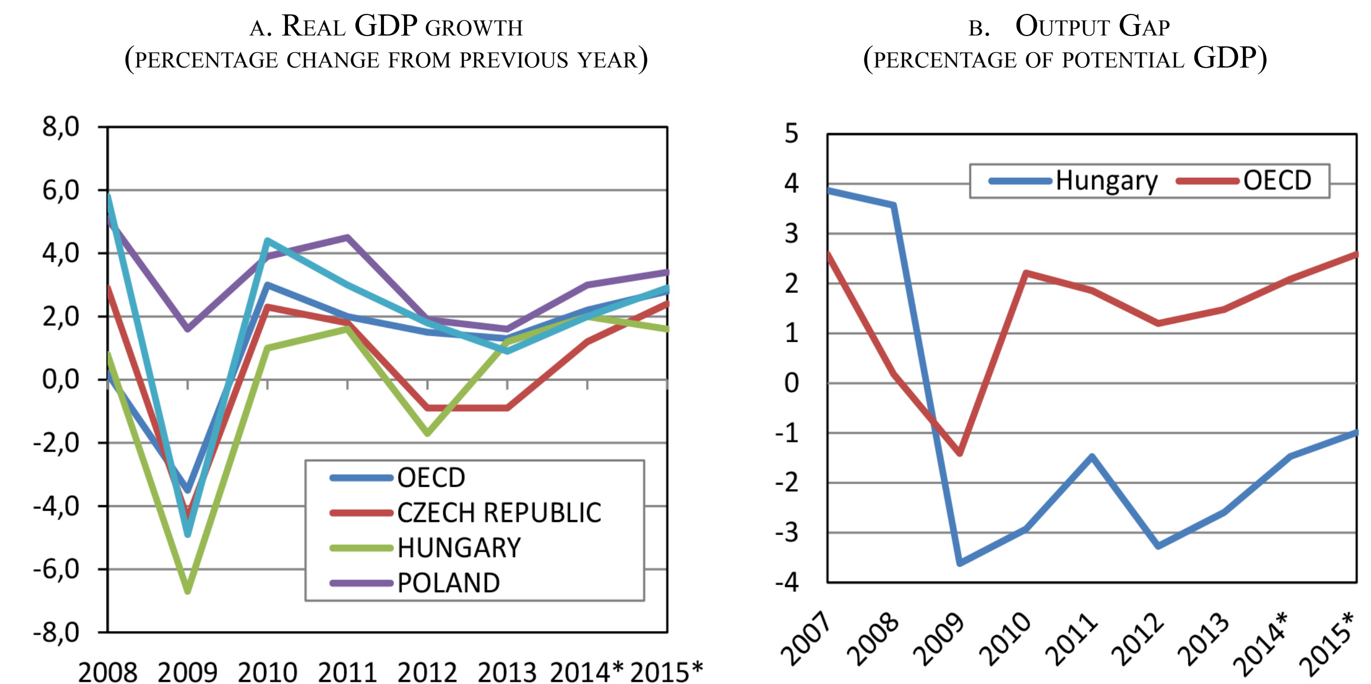
2.1.1. GDP growth

The Hungarian macroeconomic outlook is registering positive signals of recovering after the dark years that followed the outbreak of the crisis. After being in recession in 2012, Hungary has registered a positive *GDP growth* in 2013, although quite modest. Among the NMS in recession (Croatia, Slovenia, Czech Republic and Hungary), it was the only country exiting recession, while the other economies continued to decline, most notably Slovenia.[37] Only in the fourth quarter of the year Hungary reached 2.8% growth compared to the same period in 2012. In total the real GDP growth was 1.2% in 2013, almost at the same level of other OECD countries' average (1.3%) (Figure 2.1.a). However, despite the good performance, also in relation to other V4 countries such as the Czech Republic (-0.9%) or Slovakia (0.9%), the growth has not reached yet its highest potential. According to the last OECD's economic survey of Hungary, the growth potential is still held back by the low level of investments influenced by policy instability and the process of deleveraging typical of the years following a financial crisis, and other distortions in the labour and product markets, underlining the necessity of further structural reforms.[38]

Indeed, according to the European Bank for Reconstruction and Development (ERBD) - which lowered the Hungarian GDP forecast for 2014 to 1.6% against 2.0% predicted by OECD - the good performance of the last quarter of 2013, even if positively welcome, has to be considered as an outcome mainly driven by the increasing domestic demand supported by factors such as the government-mandated utility price cuts and the disbursement of European Union funding at the end of the 2007-2013 budgetary period.[39] [40] Nonetheless, as shown by data published by the Hungarian Central Statistical Office, the GDP growth of the first quarter of 2014 in comparison to the corresponding quarter of the previous year in Hungary was also very positive, being the highest in the region (+3.5%) together with the Polish one.[41] The disaggregated GDP data, in fact, shows how the private consumption has increased from 2012 to 2013, revealing an increase of the disposable income within the private sphere. As far as gross fixed capital formation is concerned, it is rather low and it becomes even worse when it comes to housing, a sector in continuous decline in the country. (Table 2.1).

The deviation of actual GDP from the potential GDP remains negative, very far from the level of the pre-crisis performances, although modest signs of improvement in the next years have been predicted (Figure 2.1.b). It follows that long-run sustainable and equitable growth is still one of the major challenges of the country, a problem that needs to be addressed in order to get back on the path of convergence towards high income levels, as well as to reduce social disparities.[42]

Figure 2.1. Real GDP growth and output gaps



Data from OECD Economic Outlook: Statistics and Projections (database)

[36] Hungarian Investment and Trade Agency, ITL Group (2014), Ungheria 2014 - Guida agli investimenti, p.41.

[37] Astrov Vasily, No Take-off in Central, East and Southeast Europe so far, in Monthly report 11/13, Vienna Institute for international Economic Studies (Wiiw), p. 1.

[38] OECD (2014), OECD Economic Surveys. Hungary 2014, p. 14.

[39] Budapest Business journal, EBRD lowers Hungary GDP forecast for 2014, May 15, 2014. http://www.bbj.hu/economy/ebrd-lowers-hungary-gdp-forecast-for-2014_79662.

[40] The Fidesz led Hungarian government has put in place during its first mandate the reduction of household utility rates of 20% achieved in two equal steps, the first in January and the second in November 2013. The cuts in electricity, gas and heating decided by the Prime Minister Viktor Orbán were based on the principle that utility prices should not exceed the European average and must be affordable for Hungarian families, considered to pay an excessive amount of bills in energy relative to what they earn. The full-year benefit to regulated-price consumers only in electricity from the 20% total cut should near HUF 100 billion (over 0.3% of GDP) and HUF 90 billion for gas price cuts. In January 2014, less than 4 months before the political elections of the 6th of April, a third round of cuts in utility rates was declared. The state is in drive to increase its influence in the sector also through acquisitions.

[41] Hungarian Central Statistical Office- KSH, http://www.ksh.hu/?lang=en.

[42] OECD (2014), OECD Economic Surveys. Hungary 2014, p. 16.

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Table 2.1 GDP indicators and projections

Annual percentage change, volume (2005 price)

	2010 Current prices (billion HUF)	2011	2012	2013	2014	2015
GDP	**26513**	**1.6**	**-1.7**	**1.2**	**2.0**	**1.7**
Private consumption	14074	0.4	-1.6	0.5	1.4	1.2
Government consumpti	5827	0.0	-1.2	-0.6	-0.2	-0.1
Gross fixed capital formation	4920	-5.9	-3.7	0.0	1.1	1.4
Housing	659	-27.4	-11.8	-9.2	-2.6	-0.9
Final domestic demand	24821	-0.1	-1.9	0.2	1.0	1.0
Stockbuilding[1]	190	0.4	-1.5	1.0	0.2	0.0
Total domestic demand	25012	0.1	-3.7	1.6	1.2	0.9
Exports of goods and services	22552	8.4	1.7	3.9	5.2	5.5
Imports of goods and services	21050	6.4	-0.1	4.6	4.5	5.1
Net exports[1]	1502	2.1	1.6	-0.3	1.0	0.8

1: contribution to changes in real GDP

Source: OECD (2014), OECD Economic Surveys. Hungary 2014

2.1.2. The current account

The Hungarian *current account* has continued registering positive results since 2010. Already after two years from the outbreak of the crisis, its current account balance turned out to be positive and in 2013 registered 3.0% as a percentage of GDP, compared to 0.1% of the average of the other OECD countries.[43] Also in comparison to the rest of the V4 countries, Hungarian performances in this regard remain consistent. This is true also when it comes to forecasts for the following years, when the surplus of the Hungarian current account is still predicted to be much higher than anywhere else in the region (Figure 2.2).

The current account surplus of the Hungarian economy mainly originates in the high reliance of the country on exports. Final data from 2013 shows a EUR 7 billion surplus in the *balance of trade* (+5.3% compared to the previous year). In particular, trade towards foreign destinations has significantly increased in terms of transport machinery and equipment. The automotive industry remains competitive and leads exports, thanks also to the production of new models, thus increasing imports of raw materials such as rubber and plastic and also gasoline and diesel engines.[44] It is not a case that export-oriented industries in the last four years have been the main target of the promotion policies put in place by the government in order to attract investment in the country. Moreover, the monetary policy pursued by

[43] OECD (2014), OECD Economic Outlook: Statistics and Projections (database).

[44] Ministero degli Affari Esteri, Diplomazia Economica Italiana, Info Mercati Esteri, quadro economico, http://www.infomercatiesteri.it/quadro_macroeconomico.php?id_paesi=97.

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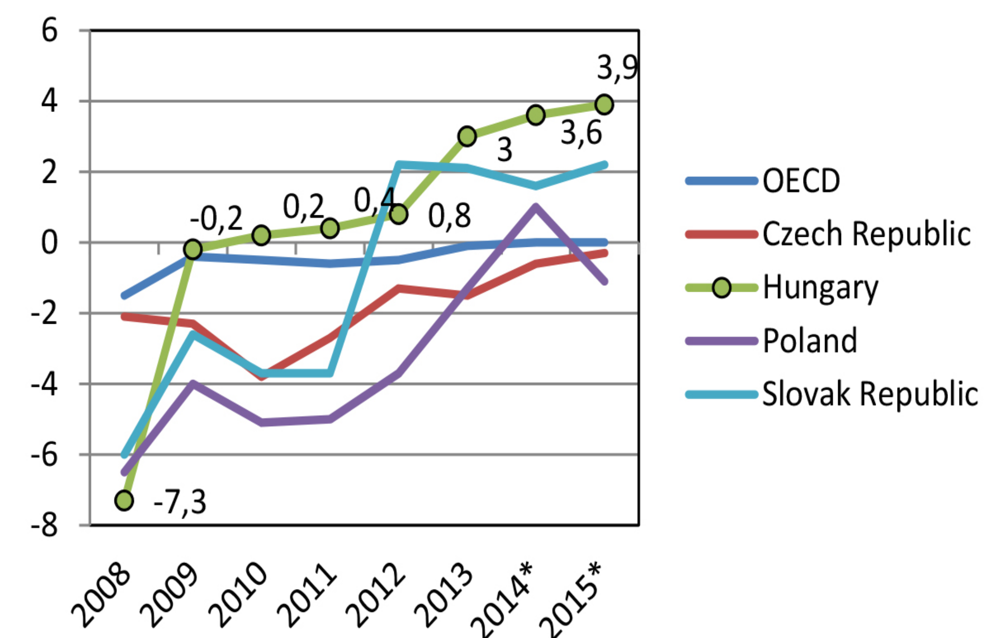
the Central Bank has also helped extensively in this concern. Fluctuations of the exchange rate between the Hungarian Forint and the common currency have determined a 0.6% improvement in the ratio of export prices to import prices.

A positive current account position is an important indicator of a country's economic activity. The Hungarian surplus in this case tells us that the Magyar economy has a creditor position in relation to other countries to which it exports its product. This means that it is actually producing more resources, later offered to other economies, than what is needed for its local market. However, this condition is not that surprising when thinking of Hungary's particular features, including a small local market and a consistent presence of export-oriented, technologically-developed industrial giants, whose final scope has never been that of serving the local market, but rather of saving costs of production and transportation thanks also to low labour costs and a favourable geographic location.

Moreover, the current account position of the Magyar economy has not to be taken exclusively as a positive signal, but also as a consequence of the fact that usually an expansion of the current account surplus in time of economic recession might indicate shrinking imports coupled with expanding exports towards stronger economies. Also, incoming investment, registered under the *income* item in the current account, serves as a debit in the current account in the short run, but is creating new sources for investment and development in the long period. It follows that a low level of foreign investment in the country reduces the deficit of the country but can harm future development.

In other words, exports leading the surplus in the nation's current account and the economic growth of the economy also balance the performance of the country regarding other components of the Hungarian balance of payments (capital account and financial account) characterised by low level of investments and high indebtedness, two very important features of the Magyar economy in the years following the economic crisis.

Figure 2.2 Current account balance of CEECs, % of GDP



Source: OECD statistics

2.1.3 MNB's monetary policy

The Central Bank of Hungary (Magyar Nemzeti Bank, MNB), is pursuing the main objective of creating a long-term sustainable economic growth by keeping price stability through the conduct of predictable and credible monetary policy. The result is the pursuing of a policy which would maintain a low and steady level of *inflation*. While the European Central Bank sets price stability at around a 2% inflation rate, the MNB has set as a main objective the achievement of a 3% inflation rate. This means that even if in line with international practice, the inflation target is slightly higher than the one set by the EU. According to the MNB however, this difference is due to the process of catching up, which characterises the Hungarian economy, but that could move forward during the path of convergence or because of a possible will to join at some point the common European currency (a possibility not considered yet).[45] In 2013 the core inflation was 3.3%, while predictions for 2014 and 2015 are respectively 3% and 3.5%.[46] Nonetheless, the inflation rate in the last months (April and May 2014) has reached historically low levels (-0.1%). The deflation was mainly due to further price cuts in the gas utility sector (6.5%), as well as a lower increase in food prices than expected (only 0.2%). The last component in particular can be an important indicator of low consumption in the country, which would have maintained prices at lower rates than expected. However, even if the inflation rate is foreseen to stay around 0% in 2014, it seems it will increase and stay in the 2-3% band next year, getting closer to the objective set by the MNB.[47]

In addition, in April 2014 the *interest rate* set by the Central Bank has reached its historical low (2.4%), when only in August 2012 it was set around 7%. The measure has been adopted in order to boost economic growth, especially considering the still low inflation rate, but according to the OECD Economic Survey on Hungary, this factor calls for extreme caution, given that further rate cuts could lead to a higher money demand and the consequent depreciation of the Forint, which has been avoided in the last two years. Such depreciation, in fact, would prove extremely damaging, especially considering the still high level of indebtedness in foreign currency of the country, a particularly sensitive issue for the Hungarian financial stability, which will be further examined in this chapter and later in relation to its consequences on the performances of the banking sector. However, the final part of the section devoted to the analysis of the macroeconomic outlook of the country will address briefly the main features of the labour market, which are also an important indicator of a sound macroeconomic environment and consistent tools for understanding the degree of wealth of the Magyar population during the years following the outbreak of the crisis.

[45] Magyar Nemzeti Bank, quarterly report on inflation – March 2014, http://english.mnb.hu/Root/Dokumentumtar/ENMNB/Kiadvanyok/mnben_infrep_en/mnben-inflation-20140327/MAR_2014_INF_Report_PUBLIK_ENG.pdf.

[46] Ibidem, p.5.

[47] Portfolio.hu, Instant view - Hungary's inflation remains in negative territory, http://www.portfolio.hu/en/equity/instant_view_hungary_8217_s_inflation_remains_in_negative_territory.27897.html. (last access June 12, 2014).

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2.1.4. The labour market

The Hungarian labour market is offering a skilled and productive labour force. The education system provides a high education level in its major university centres located in Budapest, Pécs, Debrecen and Szeged. 61.2% of the population between the age of 25 and 54 registers a higher than average level of education, against the 47.6% of the European average. The data becomes even more satisfying when it comes to the population between 20 and 24, whose percentage of higher educated people reaches 83.3%. However, the costs of labour are still rather low if compared to the rest of Europe.[48] The average wage of the whole country – obviously it can change very much according to the region taken in consideration – is about EUR 758. The average worker salary per hour is also quite low compared to other countries in Central Europe.[49] This of course creates opportunities for investors, but implies lower living standards for the Hungarian workforce in relation to what they could expect somewhere else. Moreover, the mismatches in the labour market remain very high between unskilled and educated workforce, as well as within different geographic locations of the country. It follows that tackling labour mismatches could yield large benefits in terms of employment and productivity by improving the allocation of labour resources.[50]

One of the main objectives of the government in the last years has been the creation of job opportunities. In this regard, the state has put in place a new labour code and a new act on vocational training. Moreover, governmental efforts to boost employment among specific categories of workers were provided by the implementation of the Job Protection Action Plan, thought up in order to cut contributions payable by employers (normally 28.5% of the salary) for five prioritised employee groups among which are people below the age of 25, unskilled workers, older employees, returning mothers, career starters and long-term unemployed (Table 2.2).

As the implementation of the plan proves to a certain extent, the Prime Minister is devoted to the creation of a "*workfare society*". This leads to the implementation of a set of active policies introduced with the purpose of the re-integration of the inactive population in the labour market in order to reduce the costs of social security cushions, which is too expensive and not very efficient in a country presenting a consistent public debt. The attempt is clearly showed by the implementation of public works programs, available since the early 2000s but massively scaled up after 2009, drawing the possibility for people unemployed for more than 180 days to lose their benefits unless they agree to do public works. The program, organised by the Minister of the Interior, includes both part-time and full-time jobs; participants are mostly employed by municipalities and government-owned companies, although their wages are paid by the central government for an amount three times higher than social benefits, but lower than the minimum wage.[51] The program, however, has not provided consistent signs of im-

[48] Hungarian Investment and Trade Agency, ITL Group (2014), Ungheria 2014 - Guida agli investimenti, p.43.

[49] Eurostat, data and statistics.

[50] OECD (2014), OECD Economic Surveys. Hungary 2014.

[51] OECD (2014), OECD Economic Surveys. Hungary 2014, box 2.1, p. 86.

provement in the Hungarian labour market, since reintegration of participants into regular employment is still very low and has registered only a slight increase, thus proving to be only a short-term solution to the problem and not even particularly efficient.

Table 2.2. Job Protection Action Plan

<table>
<tr><td>Type of employees</td><td>Contribution payable from 2013
(Up to gross wage of HUF 100000)</td></tr>
<tr><td>Below the age of 25 years*</td><td rowspan="3">The contribution payable will be halved
(from 28.5% to 14%)
*entrants are exempted for 2 years
(from 28% to 0%)</td></tr>
<tr><td>Above the age of 55 years</td></tr>
<tr><td>Unskilled</td></tr>
<tr><td>Long-term unemployed</td><td rowspan="2">Initial two years: no contribution payment will be required (28.5% --> 0%)
Third year: half of the contributions is to pay (28.5% --> 14%)</td></tr>
<tr><td>Mothers with small children</td></tr>
</table>

Source: HITA – Hungarian Investment and Trade Agency

Consequently, although the measures put in place can be considered as a good start, according to an OECD analysis, the country has failed to provide a solution to the high level of unemployment, even if it decreased in the last years. In addition to that, also the *employment rate* in Hungary is still well below the standards of other OECD countries, as well as CEECs, revealing that the unemployment rate is not a good indicator of the labour market conditions in Hungary because of the low activity rate. Indeed, more than anything it appears particularly necessary to find more serious measures to boost employment among low-skilled and low-income workers in the first place, as well as youth, Roma people, women of childbearing age and disabled people,[52] which are groups likely to contain members who are not even looking for a job, thus maintaining the unemployment rate at low level and also decreasing significantly the employment rate of the country. Nonetheless, greater commitment to the topic remains a key factor of the *Fidesz* party during its second mandate.

Summing up what was analysed in this section about the Hungarian macroeconomic outlook, it seems that economic dynamics in Hungary continue to be driven almost exclusively by net exports accompanied by further improvement in external balances. GDP growth is still generally too low and based on exports more than real structural improvements within the country, thus being insufficient to bring down unemployment and induce a meaningful increase in wages and incomes. In this regard, still more effort has to be put in place, in a market where, until this moment, the programs implemented by the government have mainly represented a façade-like solution to the problem. Also, institutional conditions for a more robust economic growth will likely remain unfulfilled in the coming years.[53] The very low inflation rate of the last months can also represent a possible source of concern, but the Central Bank appears very positive in this regard on the ability of the country to reach the expected results.

[52] OECD (2014), OECD Economic Surveys. Hungary 2014, pp. 34-36.

[53] Astrov Vasily, No Take-off in Central, East and Southeast Europe so far, in Monthly report 11/13, Vienna Institute for international Economic Studies (Wiiw), p. 1.

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Quite obviously, this bleak picture of the last years has influenced consistently the level of competitiveness of the country in a national comparison, although some of the points of strength of the economy keep doing their part. The recent improvements in economic conditions of the country, however, are increasing investors' trust in Hungarian possibilities, although the main issue in this concern remains tied to the political and institutional environment of the last years, which continues to seriously affect the image of the country abroad.

2.2. An analysis of Hungarian competitiveness: points of strength and weaknesses

The *World Economic Forum Global Competitiveness Report 2013-2014* ranks the competitiveness of 148 countries by providing them with a score from 1 (minimum) to 7. It sets the Hungarian economy at the 63rd place, with a score of 4.2, a position on the skids in comparison to those of 2012-2013 (60/144, score 4.3) and 2011-2012 (48/142, score 4.4). The Hungarian stage of development is positioned as in transition between an efficiency-driven and the most advanced stage of an innovation-driven economy. In comparison to other economies classified at the same stage of development, its performances appear almost in line, with a slight advantage in relation to the factors "innovation", "market size" and "technological readiness"[54] (Fig.2.3). In the region, however, Hungary ranks worse than Poland (42), the Czech Republic (46), and Slovenia (62), remaining in a higher position only in comparison to the Slovak Republic (78).[55] Indeed, since 2005 Poland is the country that grew the most, while Hungary's position has slipped consistently, taking in consideration that it was the third after only the Czech Republic and Slovenia.[56]

Of the 12 pillars on which the *Global Competitiveness Index* is calculated (see Chapter 1), the ones that are providing Hungary with significant competitive advantages are "Infrastructures" and "Health and primary education" - included in the "Basic requirements" group of pillars. As far as the efficiency enhancers are concerned, in general terms results are quite positive, but apart from the already mentioned pillars of "Higher education and training", "Technological readiness" and "Market size", serious improvements need to be achieved. Also, the innovation factor is quite positive, especially if we keep in mind that Hungary is still in a transitory stage of development towards becoming an innovation-driven economy (as Slovenia and Czech Republic already are).[57]

As pointed out by Vakhal in his analysis of Hungarian competitiveness – also based on data from the WEF Global Competitiveness report from 2005 to 2012 – Hungary has particularly developed its capabilities at the level of basic requirements but has not done enough

[54] For a description of the three factors/pillars and a review of the Global Competitiveness index and how it works see par. 1.1.2.

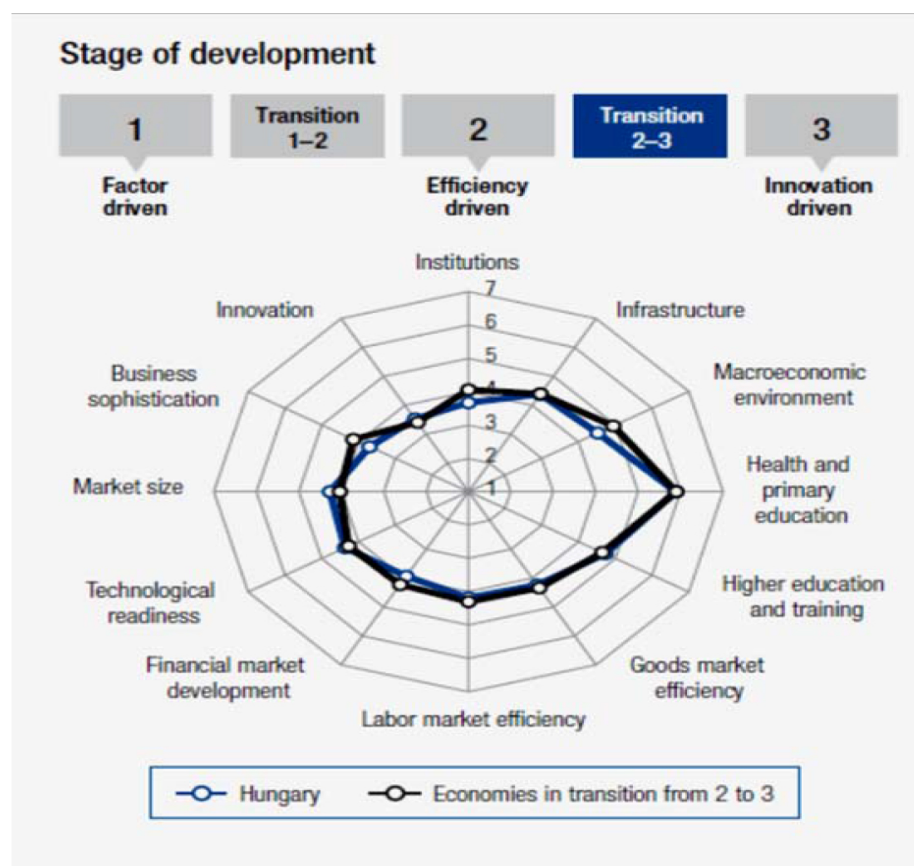
[55] World Economic Forum (2013), The Global Competitiveness Report 2013-2014, Full data edition, p. 212.

[56] Vakhal Peter (2012), The development of Hungarian competitiveness on the basis of the World Economic Forum's Global Competitiveness Index: cause-and-effect relationships. Budapest, Tárki.

[57] World Economic Forum (2013), The Global Competitiveness Report 2013-2014, Full data edition, p. 212.

at the level of efficiency enhancers, which are those necessary for the economic growth of the country. This is still positive, if we consider that improvements at a lower level are the starting point and the basis for the development of more articulated factors. However, this condition is not always met, and changes in pillars, even if small, can cause unpredictability and instability. In Vakhal's view, in fact, long-term equilibrium growth in competitiveness requires *predictability*, a factor that Hungary has not reached yet and on which it should focus more in depth.[58] However, it is also important to stress that new conditions for increasing stability and predictability of policies have appeared in the light of the results of the new elections 2014. In fact, the second consequent election of the Orbán-led *Fidesz* Party could cause a certain degree of policy continuity, possibly also in consideration of the fact that the country's economic conditions are much less dark today than in 2010.

Figure 2.3 Hungarian stage of development according to the GCI



Source: WEF Global Competitiveness Report 2013-2014

Hungary, however, has other points of strength that are contributing in increasing its level of attractiveness for investors. As already analysed in the first paragraph of the chapter, the macroeconomic outlook, increasingly positive in comparison to the years following the crisis, is already creating new opportunities in investors' eyes. Moreover, as reported by the *Doing Business report on Hungary* of 2014, the country improved its position in comparison to the best performers during the years from 2005 to 2013 (Fig 2.4).[59] In particular,

[58] Vakhal Peter (2012), The development of Hungarian competitiveness on the basis of the World Economic Forum's Global Competitiveness Index: cause-and-effect relationships. Budapest, Tárki, p. 133.

[59] The World Bank, Doing Business 2014, Economy profile Hungary, p. 9, http://www.doingbusiness.org/data/exploreeconomies/~/media/giawb/doing%20business/documents/profiles/country/HUN.pdf?ver=2.

serious improvements have been observed when it comes to registering properties and the bureaucracy needed in order to start a new business. In this particular case, data is extremely competitive, not only in comparison to other CEECs, but also in relation to other OECD economies (Table 2.3).[60]

By contrast, if these positive conditions that Hungary is offering in carrying a business are taken in consideration, it is also true that on the other side the WEF stresses important drawbacks in this area that need to be further investigated. These are mainly related to *governmental policies and performances*, thus showing how the governmental side of the issue can highly influence the competitiveness of a nation. Indeed, the most problematic factors are related once again to *policy instability*, but also *tax rates and regulations*, *inefficient government bureaucracy and corruption*.[61] Moreover, most of the indicators just enumerated have also been included in the recommendations made by the 2014 OECD economic survey about Hungary, which stresses how the country should work consistently on the attempt to reduce its administrative and regulatory burden. Although the implementation of two specific programs helped in improving the situation in the business environment – the Magyary programme and the Cutting Red Tape programme – still the reduction of the flow of new regulation while improving its quality and transparency would help further.[62] Also, an improvement of the institutional quality should be achieved, since the perception of the efficiency of legal and political institutions is weak in the country, especially when it comes to separation of powers and judicial independence.[63]

In addition, another important weakness in the business environment harming the competitiveness of the country is given by the highly difficult *access to credit*.[64] Indeed, the problem of access to financing is a real issue in Hungary. Concerning this, the country is performing considerably worse than Poland or Slovakia in terms of regulations and institutions supporting lending and borrowing and is also below the average of European and Central Asian countries.[65] The issue, however, in this case is related to the serious condition of the financial market in the country, which deserves further and deeper explanations provided in the following section and in the case study analysed in Chapter 4.

[60] The World Bank, Doing Business, Ease of doing business in Hungary, http://www.doingbusiness.org/data/exploreeconomies/hungary#starting-a-business.

[61] World Economic Forum (2013), The Global Competitiveness Report 2013-2014, Full data edition, p. 213.

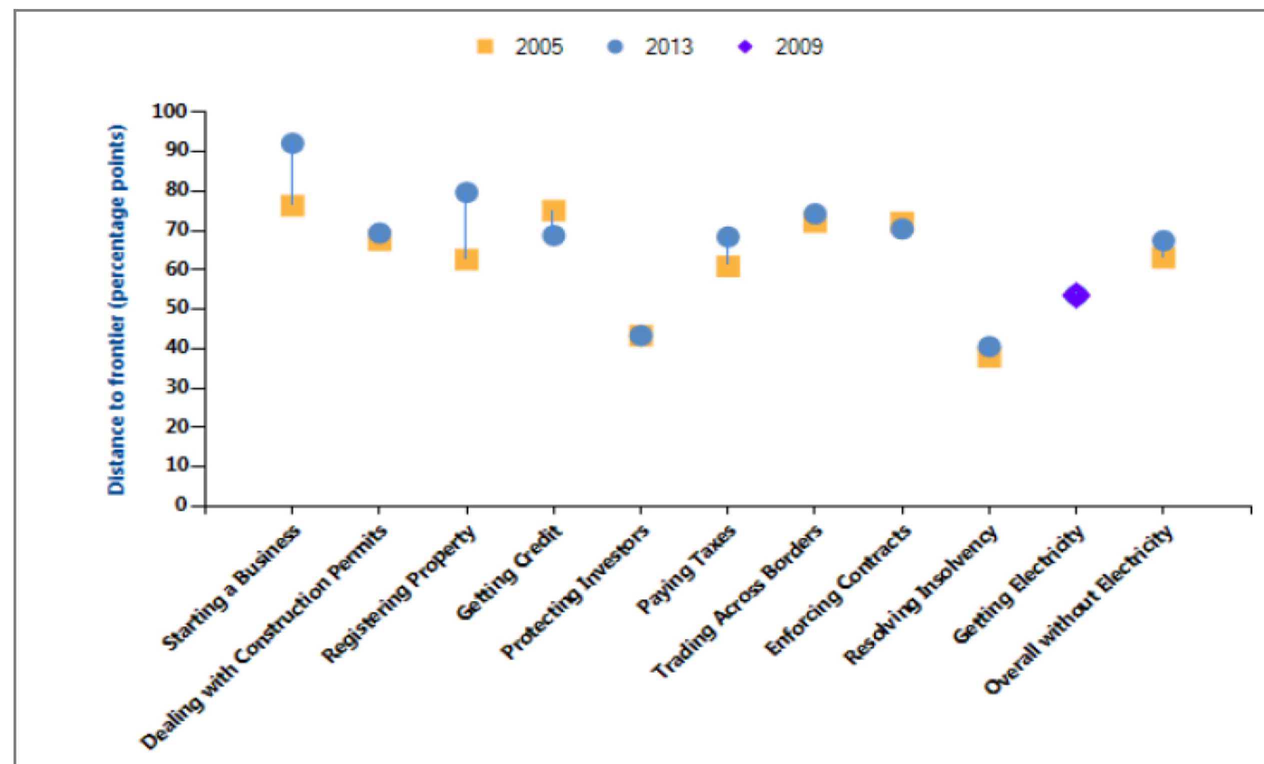
[62] OECD (2014), OECD Economic Surveys. Hungary 2014, p. 58.

[63] Ibidem, p. 63.

[64] World Economic Forum (2013), The Global Competitiveness Report 2013-2014, Full data edition, p. 213.

[65] The World Bank, Doing Business 2014, Economy profile Hungary, p. 51, http://www.doingbusiness.org/data/exploreeconomies/~/media/giawb/doing%20business/documents/profiles/country/HUN.pdf?ver=2.

Figure 2.4 Distance to the frontier in the area measured by Doing Business (2005-2013) *



*The measure shows how far on average an economy is from the best performance achieved by any economy on each *Doing Business* indicator since 2005, except from the getting electricity indicator (starting in 2009). 100 is representing the best performance (frontier).

Source: Doing Business 2014, Economy profile: Hungary

Table 2.3 Ease of starting a business in Hungary and comparator economies

Indicator	Hungary	Czech Republic	Poland	Slovak Republic	Europe and Central Asia	OECD
Ranking	**59**	146	116	108	-	-
Procedures (number)	**4**	9	4	7	5	5
Time (days)	**5.0**	19.5	30.0	18.5	12.8	11.1
Cost (% of income per capita)	**8.6**	8.2	14.3	1.5	6.7	3.6
Paid-in Min. Capital (% of income per capita)	**9.4**	29.5	12.6	19.3	3.5	10.4

Data from World Bank, Doing Business in Hungary 2014

2.3. The Hungarian "original sin": the high reliance on external sources of financing

2.3.1. General outlook of the Hungarian external debt conditions

As already discussed in the previous paragraphs, one of the long-lasting problems of the Hungarian economy is represented by its incapability to generate sustainable development. This is caused by several structural problems of the economy, among which are the low level of investment and the low activity rate. Moreover, its macroeconomic growth, quite consistent in the pre-crisis years, has often resulted from an increased use of external capital more than the real productivity of the country, which has produced a persistent and worrying degree of indebtedness. In fact, the high indebtedness of the economy – taking into consideration both the debt in foreign and local currency, state and private – has hampered Hungarian possibilities for a secure and sustainable growth and also exposed extensively the economy to the conditions of the international financial market.

According to IMF statistics, in 2012 the *public debt* was 79.2% of GDP, the highest in the Central Eastern European region – as it has always been since the 1980s – even if in decline since 2010.[66] The AKK, the Government Debt Management Agency, sets the stock of public debt in April 2014 at HUF 24.586,6 billion, of which HUF 14,259.3 billion (58% of the total) is Forint denominated debt while the equivalent of HUF 10,232.6 billion (42%) is the foreign exchange denominated debt. It follows that the governmental debt in the country is very high in a regional comparison, both in internal and external terms.

However, Hungary is moving forward in the reduction of the debt as proved by its decreasing level of public deficit. In this concern the economic policies of the Orbán government had a consistent role, being often clearly devoted to the reduction of the debt, as analysed in Chapter 3 in relation to the implementation of the windfall taxes. Together with Italy, Latvia, Lithuania and Romania, in June 2013 Hungary has closed the Excessive Deficit Procedure opened by the Council of the European Union in July 2004 (it was the longest procedure among all the member states), bringing the deficit under the level of 3% of the GDP at the time of the procedure closure.[67] It is important to mention also that Hungary was the first EU member state to which the European Commission ever applied its strictest instruments as part of the excessive deficit procedure, namely the suspension of part of the funds from the Cohesion Fund.[68]

[66] IMF Data Mapper, Historical Public Debt database, http://www.imf.org/external/datamapper/index.php.

[67] Council of the European Union, Document N. ST 11230 2013 INIT, Council closes excessive deficit procedures for Italy, Latvia, Lithuania, Hungary and Romania, http://register.consilium.europa.eu/doc/srv?l=EN&f=ST%2011230%20 2013%20INIT.

[68] Sadecki Andrzej (2014), In a state of necessity. How has Orban changed Hungary, OSW. p. 21, http://www.osw.waw.pl/sites/default/files/pw_41_in-a-state-of-necessity_net.pdf.

Contrasting data from the first quarter of 2014 shows how actually the gross consolidated government sector debt calculated in nominal value increased, as reported by the National Bank. However, according to National Economy Ministry State Secretary Gábor Orbán, the high level of government-related expenditures in comparison to previous years has to be attributed to the attempt to guarantee financial stability by financing the public debt in a secure way and reducing the debt in foreign currency. In any case, the government position in relation to the issue is that the Hungarian public debt is on the path of reduction, disregarding singular contrasting performances, which should not be considered as a trend.[69] In any case, the reduction of the public external debt in the name of an increase of the Forint denominated one would be considered a positive move in terms of stability of the country's financial situation.

As far as the *country's total external debt* is concerned (both public and private), according to data on the Balance of Payment published by the MNB in 2014, it is currently on the path of reduction. The net external debt reached levels below 35% of GDP, thus proving the decreasing reliance of the country on external funding and the strengthening capacity to self-financing of the economy. This is mainly due to outstanding net lending and the inflow of FDI. This, however, is not outstanding even if positive,[70] and the just mentioned reduction of the government's external debt – also produced by the increase in foreign exchange reserves owing to the inflow of EU transfers.[71] However, the gross external debt remains particularly high, amounting to 90% of GDP, proving how Hungary's external debt reliance is still consistent,[72] as it was historically.

2.3.2. Hungarian reliance on external funding from the 70s until today

The Hungarian high level of external public debt has roots in its socialist past. Borrowings in hard currencies started in the country more than forty years ago. In fact, Hungary has always been quite open in comparison to its neighbours in the region – besides Poland – in dealing with foreign borrowings and imports of Western technologies already since the implementation of the New Economic Mechanism (NEM) in 1968 and throughout the 70s and 80s.[73] The reasons behind this phenomenon had to be investigated in the structural distortions typical of planned economies, whose chronic lack of capital led to a consistent inflow of international resources. Foreign capital began to act as a substitute for lacking domestic savings, partly due to the fact that until the 1980s socialist planned economies had only underdeveloped banking systems, with no stock exchange or other key financial institutions

[69] Budapest Business Journal, Debt rises to all-time high, government spins figure, http://www.bbj.hu/economy/debt-rises-to-all-time-high-government-spins-figure_79837. (last access June 20, 2014).

[70] See section 2.4.1.

[71] MNB, Report on the balance of payments July 2014, p. 3.

[72] Ibidem.

[73] Åslund Anders (2007), How Capitalism was built. The Transformation of Central and Eastern Europe, Russia and Central Asia, Cambridge, Cambridge University Press, pp. 19-20.

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provided in market based economies.[74] In similar conditions of absence of financial instruments, even small budget deficits could cause serious damage, which had to be repaid by loose monetary emissions, and – as actually happened – by foreign help.[75]

Until the end of the 80s, practically only loan-capital entered the country. The capital structure changed consistently only at the time of the transition from planned to market economy and during the process of privatization, when global debt finance began to be replaced by equity finance, mainly Foreign Direct Investment.[76] However, foreign borrowings and external debt continued to characterise the Hungarian economy extensively and became one of the major causes of financial distress at the time of the outbreak of the global financial crisis. Hungary was one of the first emerging markets to suffer from it, since the high level of external debt (97% of GDP in 2007) and consistent mismatches of the balance of payment had extremely negative consequences on investors' trust in Hungarian assets. Thus, the level of deleveraging hit the country to a greater extent than other emerging economies.

In this context, Hungarian authorities applied to the EU, World Bank and IMF for financial assistance. Multilateral help was provided with an overall amount of EUR 20 billion, of which EUR 6.5 billion from the EU, EUR 1 billion from the World Bank and the remaining SDR 10.5 billion (around EUR 12.5 billion) from the IMF through a Stand-by arrangement (SBA) approved in November 2008.[77] The IMF's SBA is a lending instrument for emerging and advanced economies granted in order to provide a quick help for countries' financial needs. Even if non-concessional, it is granted at a lower rate than what these countries would have to pay for a loan granted on private markets. Hungary's 17-months SBA was designed in order to facilitate the rapid reduction of the market financial stress after the 2008 turmoil, which had to be coupled with appropriate reforms in the banking sector and government finance. The final objectives were the reduction of public debt and an increase of banks' liquidities and adequate levels of capital.[78] Such policies, however, which are not exactly in line with the "unorthodox" campaign implemented by the *Fidesz*-led government as Prime Minister Viktor Orbán defined it, led to the repayment ahead of schedule of the EUR 2.15 billion still owed to the IMF from the 2008 SBA on the 12th of August 2013. In this way, the government has repaid the debt by actually resorting to an unknown source of financing[79] more costly than the repaid loan and relying on the chance for the country to go alone on global financial markets. However, the government has advertised the savings made in interest rates owed to the IMF as a big success of this

[74] Bod Péter Ákos (2011), A not too original sin, Hungarian Indebtedness in foreign currency, in "Hungarian review", Vol. II, No. 6.

[75] The issue of Hungarian borrowings in foreign currencies will be further developed in Chapter 4, in relation to their consequences on the performances and activities of the Hungarian banking system.

[76] Bélyácz Iván and Mónika Kuti (2009), Foreign Direct Investment and external debt in Hungary: an attempt to examine the macroeconomic capital structure from a new perspective, in "Society and Economy", vol. 31 n.2, pp. 211-212.

[77] European Commission, Economic and Financial Affairs; Financial Assistance in EU member states: Hungary, http://ec.europa.eu/economy_finance/assistance_eu_ms/hungary/index_en.htm. (latest access on June 06, 2014).

[78] International Monetary Fund, News, https://www.imf.org/external/np/sec/pr/2008/pr08275.htm. (latest access on June 05, 2014).

[79] East Journal, UNGHERIA: Le due facce di Viktor Orban. Liberista sfegatato ma non liberale, http://www.eastjournal.net/ungheria-le-due-facce-di-viktor-orban-liberista-sfegatato-ma-non-liberale/46556.

strategy, showing the "propaganda" nature of the move. Indeed, through this move the government has sought to end what has been clearly stated as an undue foreign influence on Hungarian economic policies. This last point was also stressed by the open request made by the Magyar Nemzeti Bank head Gyorgy Matolcsy - former economy minister and current central bank governor - to the IMF Managing Director Christine Lagarde calling on the fund to close its representative office in Budapest since it was not necessary any longer.[80] On this occasion, the Orbán government clearly acted in name of its protectionist ideology against the interest of the economy, and the IMF-campaign ran in local media strengthens this position.[81]

That being said, regardless the early repayment, the indebtedness of the country today remains high and its levels of growth are not only affected by the debt itself, but also by its composition and the way it has been used during the years - an explanation that will be provided in the following section.

2.3.3. Hungarian macroeconomic capital structure: foreign indebtedness and inward FDI flows as two sides of the same coin

In order to understand why the economic crisis has hit Hungary to a greater extent than its peer economies, it is probably not enough to blame its high external debt as a cause of such a condition. The economic downturn of the country has also been affected by what has been called the "unbridgeable efficiency gap" of its economy by the researchers Bélyácz and Kuti in 2009.

Indeed, external debt is only one side of the coin, since the composition of *external macroeconomic capital structure* consists of both *global equity* – whose main voices are represented by FDI and portfolio equity – and *gross external debt*, which together represent the liabilities side of the International Investment Statement.[82] The distinction is particularly important, since the external capital structure of a country determines its proneness to financial crisis.

In their theory, Bélyácz and Kuti stress the relevance of the *total external liabilities to GDP ratio* in the country from the mid-90s to the years approaching the financial crisis, thus showing how the financial conditions of the economy were much more dramatic in this concern than in other CEECs. During the time frame considered, the ratio had continuously increased and, in the mid 2000s, it began to grow at twice the speed. In fact, if in 2007 the ratio liabilities-GDP had reached 120% in most of the countries, in Hungary the same level stood already at 170%.[83]

[80] Der Spiegel online, 'No Longer Necessary': Hungary Wants to Throw Out IMF, http://www.spiegel.de/international/europe/hungary-calls-on-imf-to-close-its-budapest-office-a-911250.html.

[81] Reuters, Hungary wants to repay IMF loan early and close fund's office, July 15 2013, http://www.reuters.com/article/2013/07/15/us-hungary-centralbank-idUSBRE96E07U20130715.

[82] Bélyácz Iván and Mónika Kuti (2009), Foreign Direct Investment and external debt in Hungary: an attempt to examine the macroeconomic capital structure from a new perspective, in "Society and Economy", vol. 31 n.2, p. 212.

[83] Ibidem, p. 217.

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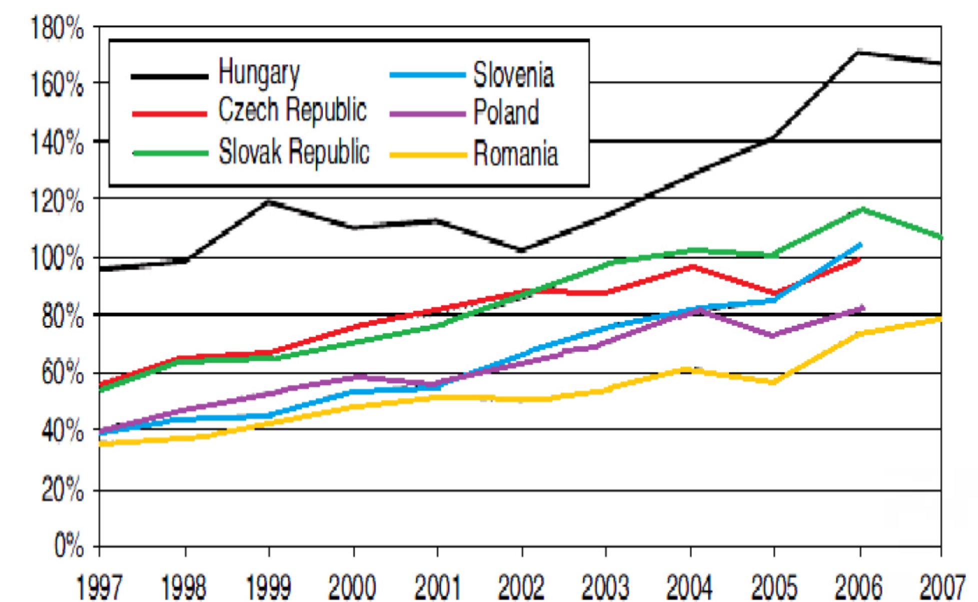
Figure 2.5 External-Liabilities-to-GDP ratio



Source: Bélyácz Iván and Mónika Kuti (2009)

However, the composition of external capital flowing into the Hungarian market has changed consistently over the years, especially since the beginning of the transition period. In fact, as already mentioned, in those years the FDI stock became a more and more significant factor, while the portfolio equity has always played a minor role in this concern. Moreover, after the liberalization of foreign borrowing in the mid-90s, foreign loans granted to commercial banks and companies became increasingly common, especially from mid-2000s, when they were provided by foreign-owned banks quite easily and at low costs. Of course, this led to a consistent switch in the institutional structure of total liabilities: the National Bank was no longer the only institution with the exclusive right of borrowing in foreign currencies, but also the government, commercial banks and companies could enter the international capital market as borrowers. Indeed, in 2007 the National Bank's external debt was at its lowest point (42%), while the commercial banks' was at its highest, with a share of 39% foreign borrowing of the total external debt.[84]

Again, according to Bélyácz and Kuti, the efficiency of the external capital structure is based on the condition that liabilities must comply with the following requirements: need for profitable investment, need to pay the user costs to finance providers and the obligation to pay back the debt. These conditions determine the sustainability of a country's international investment position. Especially when it comes to long-term loans (FDI is considered as capital and do not share this condition), if the resources are used in order to finance consumption or non-profitable investments, the sustainability of the economic growth is seriously challenged. In particular, an increased trend in the liabilities/GDP ratio, as occurred in this case, is an important indicator of the deterioration of the efficiency of the macro-capital structure, meaning that the level of capital needed in order to produce a unity of GDP grows continuously. However, a decrease in the cost of external liabilities, which before the crisis followed international

[84] Ibidem, pp. 219,220.

paths, improved the efficiency of the macroeconomic picture of the country due to the fact that external debt had relatively low costs. Nonetheless, it is also true that any increase in the interest rate would expose the country extensively. At the same time, it is important for the country to be able to produce the amount of cash necessary to pay back the interests due to borrowers, an element which can heavily influence the credit market conditions.

What follows is that FDI, even if considered as capital, cannot be profitable enough to secure such types of situations, especially considering that decisions related to it are taken by singular private companies, which can dispose of profits as they prefer and cannot act as a security against the excessive recourse to external debt.[85] An analysis of the GDP main components during the time frame already defined shows a minimal growth of investment, thus proving how *the external debt and the high reliance on FDI did not bring the expected result or the structural reforms needed for sustainable growth of the country*, due to the fact that those resources were mainly used for other less profitable purposes.

To sum up, if important benefits came as a consequence of external finance and FDI, especially in relation to the process of catching up with more developed economies, it is also true that this excessive reliability on external help has created serious distortions in the economy and has reduced the profitability of important resources such as FDI, since a high debt caused by excessive public spending cannot be solved by increasing the flow of FDI in the country. The efficiency gap widening in the 2000s has certainly hit Hungary, leading to a need for serious structural reforms in the country, which has not yet been solved, although steps in this direction have been taken. Orbán's government has seriously taken up the cause of the reduction of public debt, especially when it comes to debt denominated in foreign currency. The desired reduction of foreign influence in the Magyar economy is also visible in the strong commitment to reduce the dominance of MNCs in the country. However, foreign capital under the form of FDI is still flowing into the country and, despite the declining performances in relation to the times of high attraction of foreign investors, it still represents an important resource for the country. For this reason the last part of the chapter is entirely devoted to the analysis of the inflow of FDI in Hungary since the beginning of transition, also providing a comparative approach through the analysis of such dynamics in the Central European region.

2.4. Inward FDI in Hungary: key facts

2.4.1. Developments in FDI inflows

FDI has always played a major role in Hungary since the beginning of the process of transition towards market economy. As one of the first countries taking this path after the fall of socialism, it benefited extensively from its position as first mover. The country definitely attracted a considerable amount of investment in relation to the size of its economy, which is relatively small in global terms despite the fact it is one of the largest in the region. During

85 Ibidem.

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the first decade of implementation of market conditions, it enjoyed the largest FDI flow (first in absolute terms and then in per capita terms) of all the previous CMEA economies on the path of transition.[86] Moreover, until 2006 there were substantial inflows of FDI in the country, as well as *net FDI*[87] (as showed in the Figure 2.5.), but soon after the Hungarian economy began to lose its particular favourable position of first mover and many of its competitive advantages were seriously reduced, if not challenged, by its increasingly competitive neighbours. For instance, the Czech Republic registered higher FDI inflows almost every year during the 2000s, even though its economy presents similar characteristics to Hungary in terms of population and size.[88]

This slowdown in net FDI has worsened since the outbreak of the financial crisis, which hit the country more extensively than its peer economies (Figure 2.4). The general slowdown in the inflow of FDI, however, stopped in 2012, when Hungary reached an all-time high of EUR 10.8 billion. Yet, this data needs further explanation, since such outstanding results, even exceeding pre-crisis levels of transactions, is heavily distorted by the presence of *capital in transit*[89] in the calculation. Indeed, the *net FDI balance,* obtained by subtracting the data on direct investment abroad from the direct investment in Hungary, shows much more modest results (Figure 2.5), even though not completely dissatisfactory (the flow has doubled in comparison to 2011 performance but still has not reached pre-crisis levels).[90] Indeed, in 2012 the FDI balance was EUR 2 billion, while during the peak reached in 2004 the same indicator was EUR 4.5 billion. Presumably, the reason behind such a consistent amount of capital in transit is to be found in the idiosyncrasies of the Hungarian tax system, which would make it more profitable for certain corporations to provide intercompany loans to their Hungarian affiliates for tax optimization purposes that soon after are directly transferred abroad.[91] In addition, it is also important to mention in this context that the amount of incoming FDI already deprived by the capital in transit is also characterised by a consistent amount of investment flowing into the banking sector in order to recapitalise the losses registered by banks. It follows that the adjusted data on FDI flows into Hungary is much different from raw data, as shown in Table 2.4.

86 Sass Magdolna (2004), FDI in Hungary: the first mover's advantage and disadvantage, in "EIB papers" Vol. 9, No. 2 2004, p. 63.

87 Data obtained following deduction of FDI outflows.

88 Kalotay Kálmán and Sass Magdolna (2012), Inward FDI in Hungary and its policy context, in "Columbia FDI Profiles, Country profiles of inward and outward foreign direct investment issued by the Vale Columbia Center on Sustainable International Investment", Vale Columbia Center on Sustainable International Investment, p. 6, http://www.vcc.columbia.edu/files/vale/documents/Profiles-_Hungary_IFDI_19_Oct_2012_-_FINAL_0.pdf.

89 Transit of capital within different branches part of a group. Even if accounting as FDI when arriving in the economy, such amount of capital is redirected towards a third country at very short notice. Therefore capital in transit is registered both in data about inward and outward FDI flows, which means that they do not influence the amount of net FDI in the country but do change the amount of inflow and outflow singularly.

90 Portfolio.hu, The Million-dollar question: Is FDI coming into Hungary? 22/04/2014, www.portfolio.hu.

91 MNB, Report on the Balance of Payments July 2014, p. 23.

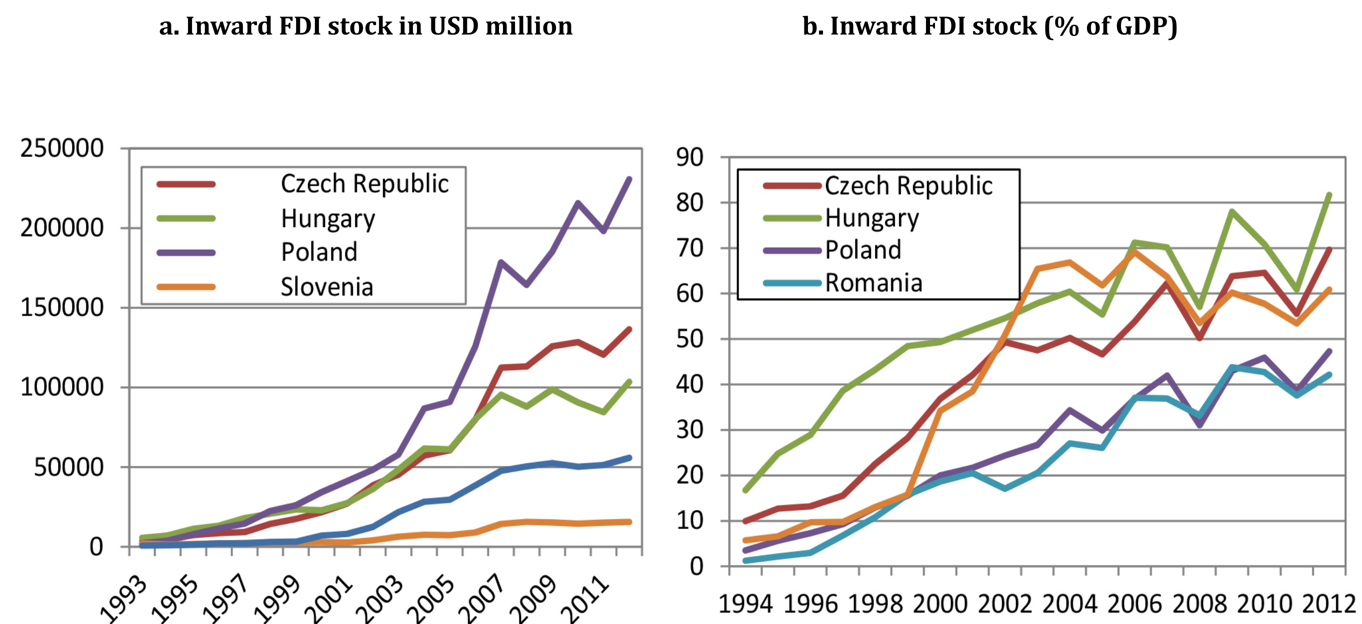
Table 2.4 FDI inflows from 2008 to 2013 (EUR million)

	2008	2009	2010	2011	2012	2013
1 - FDI "raw data"	4190.7	1476.1	1674.7	4131.1	10850.9	2316.5
2 - Asset Portfolio restructuring	0.0	0.0	0.0	0.0	3000.0	0.0
3 - Capital in Transit	1080.8	188.1	409.1	2613.2	3934.8	533.2
4 - FDI "adjusted" (1-2-3)	3109.9	1288.0	1265.6	1517.9	3916.1	1783.3
5 - Capital injections in banking	420.1	756.6	643.0	1186.0	1509.8	1150.8
6 - FDI "adjusted 2" (4-5)	2689.8	531.4	622.6	331.9	2406.3	632.5

Source: Portfolio.hu, The million-dollar question: Is FDI coming to Hungary?

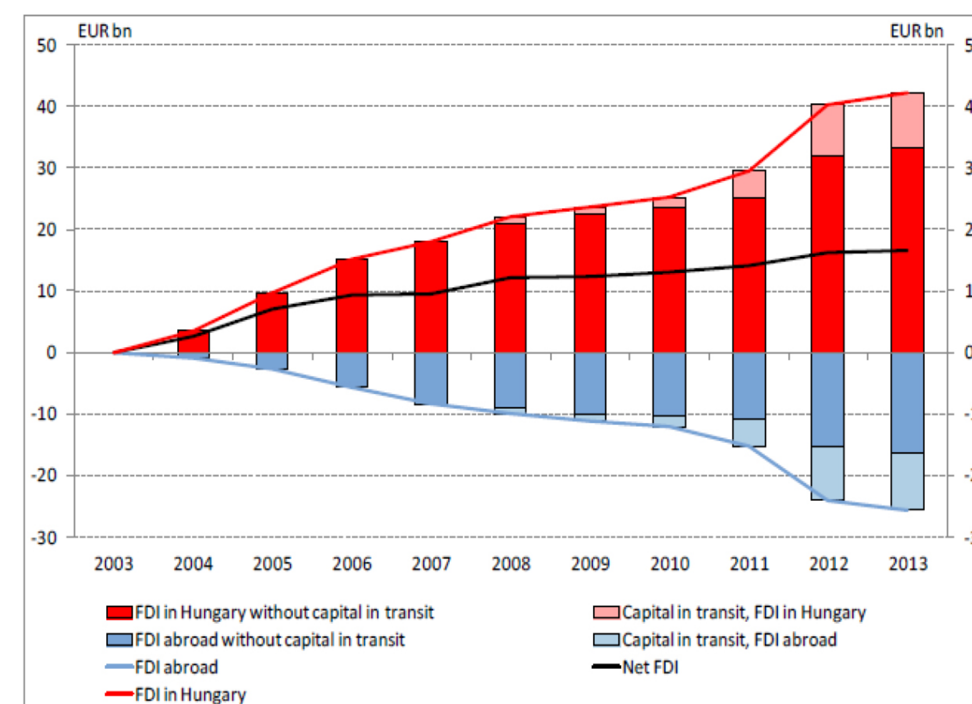
Figure 2.6 Inward FDI in Hungary in comparison to other CEECs

a. Inward FDI stock in USD million **b. Inward FDI stock (% of GDP)**



Data from UNCTADstat

Figure 2.7. Gross values of net FDI (cumulated transactions)



Source: MNB Report on the Balance of Payment 2014

However, the changes in the amount of incoming FDI during years were also accompanied by a shift in the factors' composition of investments, meaning that since 2006 the majority of inflows has consisted of reinvested profit generated by the already established Hungarian affiliates of MNCs, rather than fresh FDI. Cumulated equity capital transactions have decreased consistently since 2009, being replaced by substantial amounts of intercompany loans. In other words, this shift underlines an important change in the funding structure of multinational companies in the country, which could be explained by supposing that the interest paid to a loan is providing to the corporation easier and more accurate control in comparison to the annual profit of a company. [92]

Also, the motives for investing in Hungary seem to be changed consistently during the years. The final scope of MNCs choosing the country during the first years of transition was in fact related to market-seeking purposes. Companies were attracted by the newly developing market and the business friendly environment, particularly open to foreign investors in order to favour the process of privatization and development of the economy. During those times also the large incidence of bankruptcy of indigenous firms (only 20-25% survived), as well as the limited contribution in fixed capital formation of survivors, contributed extensively to the increase of foreign-owned firms in the country.[93] However, gradually investment activities became increasingly oriented towards efficiency-seeking types of FDI, and thus focused on the attempt to reduce the burden of production costs. This factor in particular has certainly had an effect on the sector composition of FDI in the country, which will be analysed separately in the following section.

[92] Ibidem, p. 24.

[93] Sass Magdolna (2004), FDI in Hungary: the first mover's advantage and disadvantage, in "EIB papers" Vol. 9, No. 2 2004,p. 64.

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2.4.2. FDI breakdown by sector and country of origin

At the beginning of the 90s, it was mainly the manufacturing industry the attraction for investors. The sector remained important during the 2000s as well as nowadays, but its share in relation to the total FDI stock decreased consistently. By contrast, the service sector gained importance starting from the 90s thanks to privatization, but later developed extensively because of the widespread activities after 2000, like wholesale or retail (attracting the largest share of FDI in services).[94] If only considering the years from 2008 to 2012, the stock of FDI in the sector has grown from about EUR 39 billion to 56 billion, a consistent increase in comparison to other sectors in the same period of time (FDI in manufacturing even decreased). Nowadays, the share of foreign-owned subsidiaries in total (and business) R&D is amongst the highest in OECD.[95] Overall, the country has a larger share of FDI in tradable industries, but also non-tradable service industries are extensively characterised by the presence of foreign affiliates. This is particularly the case of the financial sector, as well as telecommunications and retail (big supermarkets).[96]

In this concern, it is important to mention that *FDI in the banking sector* has seen an important boost with the onset of the crisis. However, this move has to be related to the capital injections needed to finance the losses reported by banks, as already seen in Table 2.4. The corporate sector, by contrast, experienced a decline in relation to the banking one in fresh FDI attraction, but it could also rely more extensively on the presence of different ways of funding activities, including foreign loans (also non-intercompany ones).[97] It is worth mentioning, however, that the analysis of FDI by activity since 2008 is not an easy task, especially because of the increased incidence of capital in transit and portfolio reallocations, which often include different activities.

According to PwC Hungary, however, in 2014 the leading sector is still the automotive one, presenting important giants, such as Mercedes, Audi, Opel, Suzuki and Bosch. It also collaborates extensively with the education system, focuses on R&D and employs a total of 115,000 people. The most traditional and acknowledged sector also attracting huge amount of investment is still related to the world of pharmaceuticals and medical technology, while the best performance among all is coming from a relatively new market: the Shared Service Sector industry, which is nowadays a real brand of investment in this kind of activity in Central Europe.[98] Finally, FDI also rose by nearly

[94] Kalotay Kálmán and Sass Magdolna (2012), Inward FDI in Hungary and its policy context, in "Columbia FDI Profiles, Country profiles of inward and outward foreign direct investment issued by the Vale Columbia Center on Sustainable International Investment", Vale Columbia Center on Sustainable International Investment, p. 3.

[95] Sass Magdolna, Interview.

[96] Kalotay Kálmán and Sass Magdolna (2012), Inward FDI in Hungary and its policy context, in "Columbia FDI Profiles, Country profiles of inward and outward foreign direct investment issued by the Vale Columbia Center on Sustainable International Investment", Vale Columbia Center on Sustainable International Investment, p. 3.

[97] MNB, Report on the Balance of Payements July 2014, p. 25.

[98] PwC, investing in Hungary, http://www.pwc.com/hu/en/publications/investing-in-hungary/index.jhtml.

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EUR 2 billion in trade and the energy sector,[99] despite the increasing state intervention in the sector in terms of taxation as well as price cuts and takeovers.

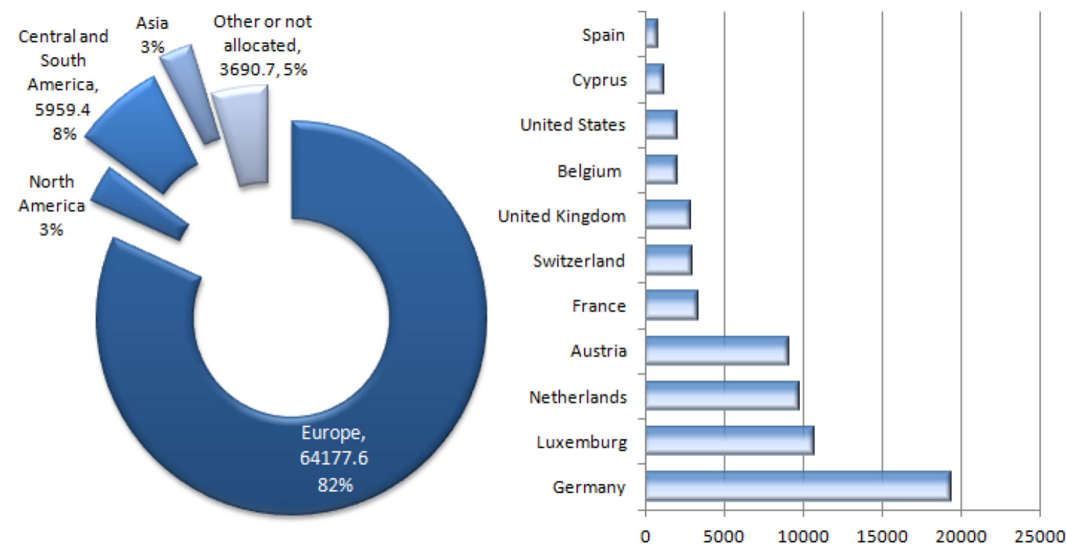
As far as FDI origin is concerned, not surprisingly, it is possible to acknowledge how investors from the EU dominate the scene, a common feature for European member states. In particular, Germany is the largest investor, followed by Luxembourg, Netherlands, the neighbouring Austria, and France. On a global level, the United States is significantly involved in investment activities in Hungary, but also Central America and other emerging markets are gradually increasing their interest in the area (Fig. 2.6). This is the case of China, as proved for instance by Viktor Orbán's three-day official visit in February in the country.[100] The Prime Minister clearly invited Chinese investors to choose Hungary for their economic activities, not only because of possible benefits coming from their technological development, but especially because of lack of resources at home, even though important activities from China have been already settled in Hungary for years (Huawei, ZTE, Wanhua). In addition, the Hungarian tendency to look eastwards, more than within European Union borders, is also underlined by the Eastern Opening strategy presented in Chapter 3.

To conclude, it is quite visible from the analysis of the sector composition and the origins of FDI that governmental strategies did have their effects to a greater or lesser extent on the inflow of FDI in the economy. Indeed, if in relation to the country of origin the geographic position definitely plays a greater role, the relations carried out by Orbán internationally also play their part. Moreover, although the data collected does not allow for creating a direct causal relation among governmental policies and the effects on the sector composition of FDI, the connection among the great effort put in the promotion of investment in the automotive and SSCs sectors and the results is still relevant, while the connection between the losses reported by the banking sector (also because of consistent taxation) and the inflow of capital devoted to balance these losses is also quite significant. The media, especially abroad, has often depicted the Orbán government as being against the inflow of FDI into Hungary and acting with nationalist purposes in order to boost the Hungarian economy at the expenses of foreign firms, but as already seen this is not always true, especially in certain specific sector. For this reason, and with the purpose to better understand the governmental attitude towards foreign investors, the next chapter will address in the detail the policies of the *Fidesz* government from 2010 to 2014 in this concern.

[99] MNB, Report on the Balance of Payements July 2014, p. 28.

[100] China Daily, Orban welcomes investment in Hungary, http://usa.chinadaily.com.cn/epaper/2014-02/14/content_17283553.html, (last accessed 17/06/2014).

Figure 2.8. Stock of FDI in Hungary by region and country of origin in Euro million, 2012



Data from Magyar Nemzeti Bank (MNB) statistics

Chapter 3. Business-government relations: Viktor Orbán's economic policies towards foreign investors

3.1 Introduction: the rhetoric against multinationals

The Orbán's rule marked the beginning of a process of real transformation in relation to the previous legislations from many different aspects. The economic downturn of the late 2000s highlighted the necessity of a radical change in the economic policies implemented by the socialist governments until that moment. Not surprisingly, deficit reduction steps became a priority for the newly elected *Fidesz* government in 2010. Yet, its engagement to put in place such reductions at the expenses of the business sector sounds rather unexpected for a center-right political party and member of the European People's Party (EPP). In fact, while in many other European member states austerity affected substantially social policies, the Prime Minister Viktor Orbán always stood against political measures that would seriously damage wage earners and pensioners by pursuing a contrasting economic policy based on the willingness to burden also on the business sector in order to rebalance the budget. Orbán himself stressed the non-conventional features of these measures by defining them as "unorthodox" methods thought to reduce public debt and economic discrepancies while boosting the economy.

Specifically, high levies on banks were the first move on the path towards fiscal consolidation, followed by a second package including a surtax on telecommunication companies, energy and retail, in particular big foreign-owned supermarket chains. The choice to increase the fiscal burden on these sectors was mainly justified by the extra profits they made until that moment, which led the government to oblige them to contribute more to the costs of crisis management. Indeed, for the first decades of transition, the large foreign-owned companies enjoyed their best times and policies in the name of free market values and the necessity for a rapid and efficient transition to the new market model, thus being favoured in many different ways, including tax holidays or other kinds of investment promotion policies. This approach could be represented also by the high presence of foreign firms active also in sectors often under state control, namely energy or water management, such as Electricité de France and the German RWE and E.ON.[101]

By contrast, this tendency has been definitely averted by Viktor Orbán, who did not limit its action to the imposition of taxes in the corporate world, but also consistently increased the state presence in this very same context. Particularly, in the just mentioned ener-

[101] Bod Péter Ákos (2011), On business-government relations: the Hungarian case, in "Hungarian review", Vol. II, No.5, p. 18.

gy sector, spectacular takeovers occurred, as in the case of the Hungarian MOL,[102] or from foreign firms such as RWE, E.ON and the Italian ENI.[103]

However, it would be too naïve, or even biased, to provide as an explanation for taxes on the corporate sector only the simple will not to burden on the "people" or small local companies, thus increasing their economic power and revitalizing the market. The sectors targeted are in fact the ones with the largest share of foreign-owned equity – for banks, foreign equity stood around 90%, in wholesale and retail 40%.[104] This is of course part of the specific strategy of a government that has been largely depicted, especially in foreign media, as particularly nationalist and overprotective of state sovereignty, and that has put in its rhetoric against multinationals a great emphasis in its political campaign.

Nonetheless, important exceptions to these tendencies have to be considered. Indeed, the large share of foreign equity, as well as the presence of foreign giants, also extensively characterises the manufacturing sector and the Shared Service sector in the country (possibly the new showpiece of the Hungarian economy in attracting FDI). However, they have not shared the same fate as the other mentioned industries: investment in these cases is often encouraged and important singular agreements with the government have been signed in the past years.

These particular cases provide significant insights regarding the contrasting position towards MNCs and FDI taken by the government in the last years, which could even be defined as selective in relation to the nature of foreign investment promoted. Analysed in this light, the strong rhetoric against big multinationals, one of the points of strength of the Orbán's government, seems to be motivated by different reasons than the will to empower domestic companies at any price. Among them, certainly the willingness to meet the popular will acquires significant weight. In fact, the public attitude towards FDI and huge enterprises investing in the country has changed consistently since the beginning of transition. Initially they were welcomed for the jobs offered, as well as for driving the change towards a westernised economic model, but in later years the difficulties encountered by the local firms in the new market conditions and the low level of MNCs' integration with the local economy spread the sentiment that these giants were dominating the economy while reducing the Hungarian population's possibilities for development. Even more problematic, in Hungary the perception against the financial sector after the outbreak of the financial crisis, which could be defined as a common feature within the EU member states most affected by the global crisis, was worsened by the issue of the loans in foreign currencies (see Chapter 4). For all these reasons, the introduction of business unfriendly policies in specific sectors was a rather cunning choice for the Orbán's cabinet, especially in terms of public support and within the national political scene, the one the Prime Minister seems to care more about. However, it also produced significant effects in many other spheres and produced challenges for the government from an international point of view, like the loss of investors' trust, as

[102] MOL is a leading Hungarian oil and gas company in the region with a very articulated ownership structure. Today ¼ of the ownership is in the Hungarian state hands. The government bought back a 21% stake in MOL from Russia's Surgutneftegas for a price of EUR 1.88 billion.

[103] Sadecki Andrzej (2014), In a state of necessity. How has Orban changed Hungary, OSW. p. 21, http://www.osw.waw.pl/sites/default/files/pw_41_in-a-state-of-necessity_net.pdf.

[104] Bod Péter Ákos (2011), On business-government relations: the Hungarian case, in "Hungarian review", Vol. II, No.5, p. 17.

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in 2011/2012 major rating agencies such as Moody's or Fitch reducing the rating for Hungarian bonds to the non-investment grade because of policy instability and high levies on foreign-dominated sectors.

In addition, relations with European institutions were strongly affected by the nature of the measures undertaken. Indeed, membership in International Organizations, such as the European Union and the World Trade Organization, limited consistently the government's choice of corrective measures, since business legislation cannot discriminate on the origins of the economic activities of the country. Nonetheless, taxation is still an issue under national sovereignty control, and despite several disputes with the European Commission, methods to bypass limitations without breaking EU law were found.

The chapter provides an overview of the measures introduced by the Orbán's government from 2010 to April 2014 and the political context in which they were introduced. This includes specific policies towards FDI, meaning investment promotion policies or singular agreements with major foreign investors in the country, as well as the implementation of policies, which are not strictly related to MNCs but that are somehow extensively influencing their profitability and productivity, such as windfall taxes on specific sectors or programs like the Funding for Growth Scheme. The immediately following part is devoted to the analysis of the fiscal policies for businesses with a specific focus on the case of the windfall "crisis" taxes, which have been mentioned in this work several times because of their importance in the context. In the following, the measures favourable to business and promotion policies will be addressed.

3.2. Orbán's business legislation and fiscal policy

The economic policies implemented during Orbán's rule led to big changes in the Hungarian fiscal system and legislation. Although such policies were not always part of a specific strategy, they were mainly related to the objectives of stimulating economic growth and consolidating public finances. Between 2011 and 2013, eleven law packages were adopted, which aimed at stabilising the budget situation.[105] Among others, the following fiscal policies implemented since 2010 were proposed to alleviate the burden of the economic downturn on households and SMEs.

A flat-rate *personal income tax* of 16% was introduced in 2011, replacing the previous system based on the presence of two different thresholds to be applied according to the income level (18% and 36%). The cut, although helpful for households in general, was mainly fruitful for higher incomes, whose amount of taxes due decreased consistently.[106] It would be different, however, if the flat-rate were decreased even more (to only 10%) during the newly elected second consequent *Fidesz* government, as declared by the Prime Minister himself.[107]

[105] Sadecki Andrzej (2014), In a state of necessity. How has Orban changed Hungary, OSW. p. 21, http://www.osw.waw.pl/sites/default/files/pw_41_in-a-state-of-necessity_net.pdf.

[106] Ibidem,. p. 20.

[107] Portfolio.hu, Hungarian PM Orbán confirms long-term committment to sectoral taxes, http://www.portfolio.hu/en/economy/hungarian_pm_orban_confirms_longterm_committment_to_sectoral_taxes.27911.html. (last access on June 26, 2014).

In 2011 the c*orporate income tax* was also reduced, becoming the lowest corporate tax of the whole CEE region. However, in this case the reduction was valid only for firms with registered income up to HUF 500 million (around EUR 1.6 million), whose tax rate was lowered from the previous single tax rate of 16% to 10%. In the case of firms with higher income, the tax has been increased to 19%.[108] [109] In addition, small and medium businesses enjoy some other kinds of advantages, such a tax credit that applies for those companies qualified as SME on the last day of the tax year when signing a loan agreement. They may use a tax credit based on the interest of the loan granted by a financial institution after 31 December 2000 for the purchase and production of tangible assets. The tax credit for the loan is 40% of the interest in the tax year, with a cap of HUF 6 million.[110] These measures, accompanied by the Job Protection Action Plan (table 2.2), make Hungary a favourable place to set business activities in terms of direct taxation for corporations in relation to other Visegrád countries.

Nonetheless, the missing fiscal revenues - the outcome of the aforementioned reductions - were balanced by the imposition of other methods, among which the increased *VAT rate* from 25% to 27%, which reached the highest level in Europe, thus harming mainly final consumers. Moreover, damage to families and wage earners comes indirectly from other increases in certain service prices. In this regard, the windfall taxes also had some sort of negative effect on family expenses, since the burden of taxes on corporate actors is definitely relapsing on the final consumer at least to a certain extent, as we will see later in this chapter. In other words, if low direct taxation (both for businesses and households) can be defined as a positive feature of the Hungarian fiscal system, the indirect one is levelling that advantage. Moreover, the commitment to taxation of large (especially foreign owned) companies has been constantly put in place by the state, especially after the achieved reduction of the budget deficit.

3.2.1. The case of the windfall taxes

This work mentions several times windfall taxes. Now it is time to explain them more in depth. Specifically, what do we mean by windfall taxes? How were these taxes conceived of in Hungary? To what extent did they affect the sectors concerned?

Windfall taxes can be defined as taxes levied by governments against those economic sectors that, more than others, experienced above-average profits in a national economy. Thus, it is possible for a government needing to balance its budget to ask for extra money from those companies that can afford to contribute to the financial stability of the state. However, as it is often the case in dealing with fiscal issues, economists' positions can be rather different regarding their effectiveness for the good of the national economy as a whole. In fact, if one side of the coin represents the possibility for the state to use promptly the reve-

[108] Sadecki Andrzej (2014), In a state of necessity. How has Orban changed Hungary, OSW. p. 20, http://www.osw.waw.pl/sites/default/files/pw_41_in-a-state-of-necessity_net.pdf.

[109] Hungarian Investment and Trade Agency, Doing Business in Hungary 2013, RSM DTM Hungary, p. 38, http://www.hita.hu/en/Content.aspx?ContentID=d6b7edb4-17aa-42a4-8d70-470fa0f74895.

[110] Ibidem, p. 39.

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nues of the taxes in order to fund social programs, it is also true that high levies on companies can harm their willingness to reinvest profits, thus contrasting conditions for innovation and sustainable economic growth. In Hungary in particular, these taxes have contributed to fiscal consolidation, more than serving social purposes, and they have also reduced the predictability and simplicity of the tax system.

Moreover, even though some of them, namely the tax on banks, should have lasted only for two years as declared at the time of their implementation, Prime Minister Orbán has recently stated his long-term commitment to special taxes claiming they will last at least as long as the *Fidesz* party will be in power.[111] The contrasting positions assumed are also harming the predictability of policies in the country, which, as already stated in the previous chapter, is one of the most problematic issues in doing business in the country. Not surprisingly the 2014 OECD report on Hungary suggests as a key recommendation for government fiscal policy to "gradually scale down the special taxes introduced over recent years. Instead, rely on more growth, equity and environmental-friendly instruments, such as recurring municipal property taxes and taxation of energy use, and reform family benefits".[112]

Going into detail over the sectors concerned, the *energy sector* is the one that, together with the financial institutions, was hit the most by the Orbán's government. Indeed, in the previous years it has been affected by extensive state intervention in the acquisitions of private companies' shares, and it was subject to price cuts imposed to electricity and gas providers.

In the years between 2010 and 2012 more than HUF 284 billion were taken from these businesses as tax revenues of the state (Table 3.1). Two different types of taxes are affecting this specific sector: the *income tax on energy service providers* (also known as Robin Hood tax) and the *surtax on energy trade services*. The first is charging the owners of public utility lines, which in most cases is also the provider of the utility itself. This includes water supply, natural gas, heat and electricity supply and telecommunication service lines located in public areas or sections of land not qualifying as a public area. The latter intends to integrate external environmental damage into energy prices, promoting energy saving and creating conditions supporting these criteria in the taxation of electric power, natural gas and coal, thus resulting in environmental protection and energy management.[113] Therefore, it would be interesting to understand if the revenues gained from such kinds of taxes have been used to fund social projects in environmental protection or some other issues related to the cause, or if their main purpose was only the financing of the state deficit. Moreover, the price cuts in energy implemented by the government in the 2010-2014 legislation can also be a possible cause for inefficiency in the everyday usage of energy, especially for consumers whose costs have been reduced, thus not only harming competitiveness for firms in the sector, but also having negative repercussions on the environment.

[111] Portfolio.hu, Hungarian PM Orbán confirms long-term committment to sectoral taxes, http://www.portfolio.hu/en/economy/hungarian_pm_orban_confirms_long-term_committment_to_sectoral_taxes.27911.html, (late access on June 28, 2014).

[112] OECD (2014), OECD Economic Surveys. Hungary 2014, box. 2, p. 27.

[113] Hungarian Investment and Trade Agency, Doing Business in Hungary 2013, RSM DTM Hungary, p. 57, http://www.hita.hu/en/Content.aspx?ContentID=d6b7edb4-17aa-42a4-8d70-470fa0f74895.

The strong reliance on windfall taxes has been highlighted recently in the context of the approval of the so-called *"advertisement tax"* on the 11th of June 2014.[114] Indeed, if the imposition of taxes on retail, telecommunications and banks in 2010 was justified by the difficult financial situation of those times (de facto they are also known and referred as "crisis" taxes), a levy on media sector, which is also consistently foreign owned, is strongly proving the commitment of *Fidesz* to make the rhetoric against multinationals work, especially if the measures have been approved in times of economic recovery as in this case. In addition, such spectacular actions are always overtly advertised and often directed towards specific business sectors marked by a certain degree of exposure. This is an element that would suggest the weight granted to these measures in shaping public opinion.

The approved tax, in particular, will be applicable to media companies, publishers, outdoor advertisement firms and online advertisers.[115] It has been thought of as a graduated tax, which after 31 days from its approval will be applied on the basis of companies' revenues from that year on. It is planned as follows: media outlets making between HUF 500 million and HUF 5 billion must pay 1% of all their advertising revenue in tax, while those in the highest bracket, with HUF 20 billion in advertising revenue, must pay 40% of these revenues in tax.

Quite obviously the tax has not been welcomed by European institutions. It is not the first time that they have stood against this kind of measure sought by the Orbán's cabinet, but in this case there is another risk that is worrying Brussels. This is related to media independence and freedom of speech. Specifically, the fear streams from the idea that a free, independent and pluralistic media relies on the income from advertising to invest in program production and quality, conscientious journalism. The possibility that such a levy on the sector would provide even more bargaining power to the government towards media companies, thus harming their degree of independence, must also be taken into consideration. In addition to that, new criticisms to the measure were raised because of a late amendment to the law saying that this year's advertising tax bill can be reduced by 50% for media firms reporting losses from earlier years in corporate tax or personal income tax. Opposition parties said the amendment clearly favours television broadcaster TV2, which is said to be friendly to the ruling party, while remaining clearly against the huge RTL Klub, Hungary's most watched private television station owned by the German RTL.[116] According to Bloomberg, the channel alone would raise more than 50% of the amount that the government will gain thanks to the tax,[117] especially as the tax is very steeply progressive, especially in the upper band.

A similar critique has been moved against the government in relation to the *windfall tax on retail* since the time of its implementation in 2010. It seems that in this case more than

[114] Budapest Business Journal (BBJ), Parliament approves advertisement tax, http://www.bbj.hu/politics/parliament-approves-advertisement-tax_80840.

[115] Portfolio.hu, Hungarian lawmakers pass bill on new advertising tax, http://www.portfolio.hu/en/economy/hungarian_lawmakers_pass_bill_on_new_advertising_tax.27900.html.

[116] Portfolio.hu, EU commission examines Hungarian media tax, publishers, TV association protest, http://www.portfolio.hu/en/economy/eu_commission_examines_hungarian_media_tax_publishers_tv_association_protest.27914.html.

[117] Bloomberg news, Hungarian Media Go Dark as Orban Tax Clamps Down on Press, http://www.bloomberg.com/news/2014-06-06/hungarian-media-go-dark-as-orban-tax-clamps-down-on-press.html.

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others, the discriminating factor against multinationals is centered on retail companies part of a foreign group rather than local ones. Specifically, the tax has been depicted as contrary to the principles of freedom of establishment and equal treatment by the Hungarian sport goods retailer Hervis - part of the Austrian group SPAR Oesterreichische Warenhandels AG active also in food retail activities in Hungary.[118]

The European Court of Justice has deliberated on the issue two different times on the 5th of September 2013 and on the 5th of February 2014. According to the Advocate General's non-binding opinion of September 2013, the retail tax is not contrasting the EU laws on the subject, given that "the distinguishing criterion of related undertakings, according to which the turnover of other companies in the group is taken into account, whereas integration in a franchise structure is irrelevant, cannot justify the assumption that there is covert discrimination".[119] That being said, the Hungarian legislation on the special tax, even if not directly discriminating against companies (thus being in compliance with the European law), actually differentiates indirectly between taxable persons on the basis of whether they belong to a group or not. In fact, the tax is levied in equal circumstances for all the companies engaged in the retail trade in the country. However, the criterion of differentiation has the effect of disadvantaging undertakings linked to parental firms in other member states, compared with undertakings which are not part of a group, such as stores registered as independent franchises (in this case the tax base is limited to the turnover of the taxable person taken individually).[120] According to Herver, calculating its tax liability with the group's total turnover in Hungary taken into account, the tax rate applied to the Hungarian retailer was much higher than it would have been had only its own turnover been considered. By contrast, retail stores members of Hungarian groups were not exposed to the same problem, being mainly registered under franchising agreements.[121]

Slightly different is the case of the *tax on telecommunication services*. This levy, commonly known as *telephone or SMS tax*, is payable by natural persons, legal persons, business associations without legal personality or other organizations providing telecommunication services in Hungary. The tax base is the time of calls initiated from the call numbers and the number of text messages sent. The tax rate is HUF 2 for each minute in the case of initiated calls and HUF 2 for each text message sent. After being raised in 2013, the cap on the tax chargeable is HUF 700/call number for individuals and HUF 2500 for non-individuals. The final increase occurred in August 2013 set the tax for other subscribers to HUF 3 per minute or message with a monthly ceiling of HUF 5000.[122]

In this case, the tax under question was defined as illegal by the European Commission, following several letters of complaints received from the countries of origin of the

[118] KPMG, Hungary - Special tax imposed on retail trade, http://www.kpmg.com/global/en/issuesandinsights/articlespublications/taxnewsflash/pages/hungary-special-tax-imposed-retail-trade.aspx.

[119] Court of Justice, Press release No. 98/13 Luxembourg, 5 September 2013, http://curia.europa.eu/jcms/upload/docs/application/pdf/2013-09/cp130098en.pdf.

[120] Court of Justice of the European Union, Press release No. 14/14, Luxembourg, 5 February 2014, http://curia.europa.eu/jcms/upload/docs/application/pdf/2014-02/cp140014en.pdf.

[121] KPMG, Hungary - Special tax imposed on retail trade, http://www.kpmg.com/global/en/issuesandinsights/articlespublications/taxnewsflash/pages/hungary-special-tax-imposed-retail-trade.aspx.

[122] OECD (2014), OECD Economic Surveys. Hungary 2014, box 1.2, p. 61.

companies affected. The EC even formally turned to the European Court of Justice in 2012, but the case was withdrawn from the EC itself when the Court decided in favour of France in a similar case. However, the reason behind such an action by the EC was that EU telecoms rules allow sector-specific charges only to "cover the specific costs of regulating the sector, and not to generate additional revenue for the central budget". The EC also stated that "increasing the financial burden of telecom operators could have an impact on consumers' bills, distort competition and impede investment in a sector expected to drive growth under the Digital Agenda". [123]

To sum up, if the country membership in organizations like the EU and the WTO, which are based on non-discriminatory principles, obliged somehow the government to avoid discriminating against companies on the basis of their country of origin, different methods have been adopted in order to obtain the same effect. It is possible to state that there is no error in defining these levies as measures crafted meticulously in order to harm the big multinationals without openly breaking regulations, first of all, through the taxation of specific sectors characterised by the high presence of foreign ownership, secondly, through the implementation of tricks such as the substantial difference between defined tax rates for SMEs and large companies (usually multinationals) or the definition of the base for tax calculation set as the income of a whole group rather than the singular branch. Indeed, the multinational companies in the sectors concerned were affected by the levies in a larger share than domestic ones, to which such levies were not even applicable in certain circumstances. Moreover, as if to prove the rule, the discriminating factor seems also to be very likely in the implementation of the new "advertisement tax" on the media.

As far as the effectiveness of these measures is concerned – despite dissatisfaction in the business environment, the great level of controversy caused abroad and several contrasts with the EC – it is quite evident that the taxes served consistently the purposes of reduction of the government budget deficit. In total, taking into account also revenues from the financial sector, the government was able to collect every year an amount in taxes ranging from 1% to 1.8% of the GDP (table 3.1). Considering that in 2012 the government budget deficit amounted to 2.1% of the GDP, 1% of the GDP gained in windfall taxes appears as a substantial solution to reduce the debt burden quickly in years. Analysed in these terms, the fact that the amount paid year by year by the financial sector accounts for about half of the total revenue of windfall taxes appears even more substantial. For this reason, the peculiarities of the measures implemented in this concern will be singularly addressed in the following chapter entirely devoted to the condition of the banking sector in Hungary and its relation with Orbán's government from 2010 to 2014. However, data about taxes in the sector have been also included in the tables present in this section for clarity reasons, as well as in Table 3.2 listing all the taxes implemented in the last years on specific sectors.

To conclude, this section describing in depth the fiscal measures implemented "against multinationals" has clearly showed how the battle against MNCs is bitter and constant in the country. However, there is also another side of the coin that needs to be further investigated. Indeed, there are also several other ways in which the executive power is actually attracting multinational companies in the country, especially if they better serve for the good of the nation than small, local companies. This becomes particularly true, for instance, when huge plants have the capacity to provide numerous jobs (reducing the unemployment rate is a goal of the government) or are able to create innovation to a greater extent than less competitive companies. The following part of the chapter will analyse these programs available for foreign investors, first having a look at the investment promotion policies and incentives available, and then describing some of the main agreements between big foreign investors and the state in the last years.

[123] European Commission - Press release, Digital Agenda: Commission refers Hungary to Court for failure to end special tax on telecom operators, http://europa.eu/rapid/press-release_IP-12-286_en.htm?locale=en.

Table 3.1. Windfall taxes on specific economic sectors
*** Preliminary budget data**

Sector	Paid amount (billion HUF)			
	2010	**2011**	**2012**	**2013**
Energy	81.2	115.9	87.2	98.3
Telecommunication	58.6	51.3	62.9	61.7
Retail	28.9	21.6	33.3	2.2
Finance	192.3	195.9	94.6	373.9
Total	**361.0**	**384.7**	**278.0**	**536.7**
% of GDP	**1.4**	**1.4**	**1.0**	**1.8**

Source: OECD (2014), OECD Economic Surveys. Hungary 2014

Table 3.2. Selected sector-specific taxes

Sector	Tax name	Year of implementation	Description
Energy	Income tax on energy service providers	2009	Calculated on pre-tax profits The tax rate, initially set at 8%, was raised in November 2012 to 31% Since 2013 applicable also to electricity and natural gas providers
	Surtaxes payable by certain economic sectors	2010	Retroactively covering 2010, and phased out, as planned, at end-2012 Based on a schedule of progressive tax rates
	Tax on wires and pipelines	2013	Falling on the owners of utility networks Rate of HUF 125 per meter of ducts providing for electricity, natural gas, heating, water and wastewater services

Tele-communications	Surtaxes payable by certain economic sectors	Dec 2010	Retroactively covering 2010, and phased out, as planned, at end-2012 Based on a schedule of progressive tax rates
	Tax on wires and pipelines	2013	Falling on the owners of utility networks The marginal rate is progressive on the length of the network, ranging from HUF 25 to the standard HUF 125 per meter
	Telecommunication tax	2012	Set at HUF 2 per minute of calls and per SMS/MMS, with monthly caps per calling number of HUF 700 for private individuals and at 3HUF per minute/SMS and HUF 5000 cap for other subscribers
Retails	Surtaxes payable by certain economic sectors	2010	Retroactively covering 2010, and phased out, as planned, at end-2012 Based on a schedule of progressive tax rates
Finance	Extra tax on selected financial institutions	2007	Special tax on interest income from state-subsidized loans
	Levy on financial institutions	2010	Calculated on the adjusted balance sheet amount at end-2009 0.15% rate applied up to HUF 50 bl 0.53% rate beyond HUF 50 bl (Insurance companies excluded since 2013)
	Financial transaction tax	2013	Levied on most transactions of financial institutions and the Treasury, including money transfers, cash withdrawals and amortization of loans, among others
	Insurance tax	2013	Consumption-type tax falling on insurance premia (except for life insurance)

Data from OECD (2014) Economic survey. Hungary 2014, box 1.2

3.3. Investment promotion policies: nature and effectiveness

3.3.1. Historical changes in investment promotion strategies

Investment promotion policies have always played a significant role in Hungary. Since the 90s investment projects of outstanding importance in terms of job creations and capital invested received consistent and generous government assistance, which

was decisive for the investors' choice to come to Hungary rather than other similar neighbouring economies.[124]

Already in 2004, Magdolna Sass distinguished three periods of FDI promotion policies implemented in the country on the basis of the different economic and political circumstances, as well as government FDI strategies. The first, starting with the transition and ending in 1996, was mainly defined according to the objective of attracting a few major investments, thus being focused on individual bargains and high incentives in comparison to the other CEECs. Once big investments settled in the country, the necessity to increase the FDI related benefits for the host economy (industrial and regional development, job creation, R&D promotion, strengthening the trade balance, etc.) led to a shift of strategy towards MNCs, thus causing a consequential change in the promotion policies implemented. Thus, the second period going from 1996 to 2003 was focused on the will to increase promotion activities for export-oriented companies and large investments in manufacturing, plus increasing backward linkages with local companies. The incentives became more transparent and less generous, being particularly conditioned by the efficiency and performances of the companies that would have benefited from them. Until that moment, the main tools of the FDI policy were focused on fiscal benefits and the unique regulation of the so-called Industrial Free Trade Zones (IFTZs), established in Hungary already in 1982. Thanks to IFTZs, any company could set up its own zone without geographical restrictions of any kind under license by the customs and finance authorities. Specifically, IFTZs were considered extra-territorial for purposes of duties, foreign exchange regulations and other legislation, which means that under this provision the dutiable goods and means of production were not subject to customs duties and value-added tax.[125] Being particularly favourable for export-oriented businesses, many IFTZs were established in the country. Many important investments were carried out in IFTZs, such as Audi, IBM, Nokia, Ford, Sony, etc.

Nonetheless, the IFTZs had to be abolished when Hungary entered the European Union. In fact, the third period in investment promotion policies, started in 2003 with the latter stages of the accession process, saw a complete restructuring of the whole incentive system, which had to be levelled to European provisions. But if from a certain point of view this element could have been beneficial to Hungary, especially considering that almost since 1998 it was providing less generous incentives in relation to other CEECs, it is also true that the only advantage possessed by the country, the IFTZs, was practically abolished.[126] After joining the EU, incentives started to be regulated by the EU itself. It follows that nowadays the incentive system is currently under revision because of the new seven years budgetary period started after the 2007-2013 one. Specifically, the new system is expected to be applied from the 1st of July 2014, which means that the system reported in the following section could be subject to substantial changes during the year.[127] However, for the purposes of the

[124] Sass Magdolna (2003), Competitiveness and economic policies related to Foreign Direct investment, Ministry of Finance, p. 9, http://pdc.ceu.hu/archive/00002569/01/3_eng_040223.pdf.

[125] Sass Magdolna (2004), FDI in Hungary: the first mover's advantage and disadvantage, in "EIB papers" Vol. 9, No. 2 2004, box 1, p.75.

[126] Sass Magdolna (2004), FDI in Hungary: the first mover's advantage and disadvantage, in "EIB papers" Vol. 9, No. 2 2004, p. 76.

[127] HITA, interview March 2014.

research that is focusing on the policies implemented in the country in the last four years, the analysis of the 2007-2013 promotion scheme is sufficient in order to understand nature and scopes of the incentives offered.

3.3.2. Investment promotion policies nowadays

Since 2010, investment promotion policies in the country have been carried out by the Hungarian Investment and Trade Agency (HITA), the Hungary's Investment Promotion Agency (IPA). The activities performed are in line with government purposes, since the agency is actually a central organization subordinated directly to the Prime Minister.128 Such activities do not include only investment and trade promotion. For instance, support for subcontracting is also an important activity carried out with the purpose of **integrating foreign companies investing in Hungary to the national economy and**, therefore, enhancing business between foreign Original Equipment Manufacturers (OEMs) and Hungarian suppliers.[129]

Before 2010, the Hungarian IPA was named ITD Hungary. After the creation of the new government, ITDH was replaced by the new agency. Although it is extremely hard to find information about the ITDH on the Internet, according to HITA the two agencies carry out the same kind of investment promotion activities. Moreover, a certain degree of continuity of activities is also provided by the fact that many employees of ITDH also stayed in HITA, thus sharing their experiences with those newly employed by the agency. Nonetheless, the presence in the agency of young professionals and consultants suggests that also a consistent process of innovation and renewal took place during the transition between the two organizations, whose reasons for replacement would be an interesting topic for further research.

The legal basis for all the investment subsidies within Hungary is provided by the common legal framework of the European Union. The *incentives* offered to possible investors are mainly of a *fiscal and financial nature*. Eligibility criteria are associated with development objectives such as job creation and the amount of capital invested. Although the incentives package is not differentiated on the basis of the economic sector of the business, slight differences can be found in the package offered to specific sectors and on the basis of the European funds at their disposal (e.g. they are mainly provided for manufacturing activities and less for SSCs).[130]

The system of incentives for the budget period 2007-2013 was based on incentives of a *financial nature* when the government decided singularly on the provision of certain funds (whose amount is not fixed) to specific investments, in case of job creation subsidies (from HUF 350 to 900 million per project) and training subsidies. *Fiscal incentives* are allowed in circumstances such as in the case of the development tax allowance for businesses already

[128] HITA, http://www.hita.hu/en/Content.aspx?ContentID=acecbc06-9776-4d34-874b-01e7639b61a8.

[129] HITA supplier department, http://www.hita.hu/en/Content.aspx?ContentID=609b3cf9-8727-42cf-b40b-0bc7c0ef8936.

[130] Ibidem.

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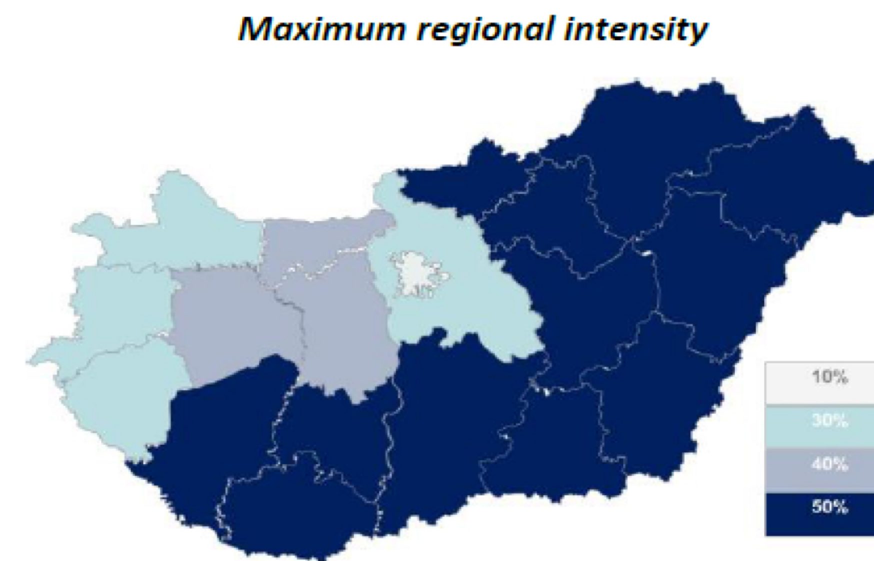
settled in the country with an exemption reaching the 80% of the corporate tax payable for ten years following the fulfilment of the investment.[131]

If significant changes did not occur in the structure of the incentives system during the period of time in focus, consistent changes have occurred in relation to the *regional localisation* of the activities that the Hungarian Investment Promotion Agency and the government wish to attract. In fact, being the capital already extensively developed, especially in certain sectors like Shared Service Centers activities, incentives are more favourable for companies willing to invest in underdeveloped regions of the country, namely the Southern and Eastern countryside regions. Moreover, the strategy, extremely helpful for an even development of the area, is also in line with the principles set by the EU in relation to the development of areas external to the major economic centers of the country. The maximum regional subsidy intensity ratios have been set by the European Commission as shown in Fig. 3.1, which means that up to 50% of the eligible costs of a large investment can be subsidized when it is located in the regions of central focus for the development plan of the country. In addition for medium (less than EUR 50 million) and small (less than EUR 10 million) sized investments, the regional intensity region is increased respectively by 10% and 20% in relation to the normal ratio set for eligible large investments.

Figure 3.1. Maximum regional intensity ratio set by the European Commission



Source: HITA, Incentives in Hungary 2013

As far as the *effectiveness of incentives* is concerned, the enlargement eastwards of the European Union and the consequential levelling of legislation led to theories in which the role of investment promotion policies would have been increasingly important for foreign investors in order to make the decisive difference among countries, especially when they present consistent similarities, as in the case of CEECs.[132] However, being that this is the

[131] HITA, investment, http://www.hita.hu/en/Content.aspx?ContentID=220482e5-5231-4d5f-bf8a-bbe11268d14a. (last access July 6th 2014).

[132] Sass Magdolna (2003), Competitiveness and economic policies related to Foreign Direct investment, Ministry of Fi-

framework of incentive schemes based on EU policies within European Member States, it means that much of the legislation in this concern has become very similar. Indeed, incentives offered in similar economies, such as Czech Republic and Slovakia, are also structured in similar ways, even though differences can be found. In general terms, the sectors in focus benefitting of incentive programs are almost the same in the region (manufacturing, R&D and Shared Service Centers and in the case of Slovakia also tourism), as well as the eligibility criteria at the basis of the provision of incentives.[133] [134]

Because of this levelling, the practice experienced nowadays by the Hungarian Investment and Trade Agency suggests that other parameters are taken into consideration while deciding the location of a certain project. These include workforce, education, cost saving in the long run and availability of infrastructure. Indeed, it is important to keep in mind that the sustainability of a specific project is a key element of the project itself, and profitable, but exhaustible incentives could not be enough when flanked by the unpredictability of policies or unfavourable taxation, which are both tools in state hands. Yet, there are some cases in which incentives decide, especially when it comes to important singular agreements with large investors, but in some other circumstances their role is quite marginal. A good example is provided, for instance, by those sectors which are relying extensively on factors such the cost-efficiency ratio of the workforce, or on specific skills like the foreign languages spoken, for which incentives cannot do much, as in the case of offshore outsourcing activities.[135]

Investment promotion, however, does not only relate to incentives of a financial or a fiscal nature, such as subsidies or tax holidays offered to incoming investors and it is not only related to promotion of completely new investments in the country. For instance, *expansion assistance* and *aftercare services* are usually offered by IPAs to foreign companies already settled in the country. In this case, HITA is actually working as an intermediate body for the government to understand to what extent the experience of these companies can be rated as positive and how it can be improved. Also, expansion projects are highly supported and in some cases incentives and subsidies for job creation are available for expanding companies when they meet the fixed requirements.[136] In addition, it is important to stress that all those companies already settled in the country, even if foreign owned, can actually benefit from the programs and financial help offered by the state to the corporate sector. For instance, the Funding for Growth Scheme implemented by the Hungarian Central Bank is a tool that can be used indiscriminately by local and foreign enterprises meeting the requirements necessary in order to access to funds provided by the Central Bank. For this reason, the following section is devoted to the explanation of the functioning of this fund and an assessment of the results of the first part of the program, in order to provide a good example of the improvements made in the last years in business-government relations and access to credit.

To sum up, in this section the changes in investment promotion policies since the beginning of transition were defined. What comes as a result of the analysis is that until the

nance, p. 7, http://pdc.ceu.hu/archive/00002569/01/3_eng_040223.pdf.

133 Sario, investment incentives http://www.sario.sk/en/invest/investment-incentives.

134 CzechInvest, investment incentives http://www.czechinvest.org/en/investment-incentives-new.

135 HITA, interview March 2014.

136 HITA, interview March 2014.

conclusion of the process of European integration the role of the state and the government's strategies in relation to incoming FDI were much more consistent in defining the incentive scheme. In fact, the great influence of the European Union in relation to incentives' legal framework also suggests that, as a matter of fact, these policies are not completely under direct control of the state. It follows that it is not possible to define a big change in FDI strategy in this regards between the governments in power after Hungary joined the EU, even though an important point of distance from the governments preceding Orbán's executive is represented by the change of the Hungarian IPA. Moreover, it is also important to add that, according to the investment incentive schemes for the budgetary period 2007-2013, the government has still the right to singularly decide on the provision of incentives to certain companies (that, however, have to meet fixed conditions in order to be eligible, a factor which also acts as a sort of guarantee against discrimination). As a consequence, the aforementioned levelling of policies suggests that possibly other measures should be taken in consideration in order to better understand governments' FDI strategies, such as taxation (as already seen in the previous section in relation to windfall taxes) and singular strategic agreements signed case by case with specific incoming investors or companies expanding their activities in the country.

3.4. The Funding for Growth Scheme (FGS)

The *Funding for Growth Scheme* modelled on the *Bank of England's Funding for Lending Scheme*, has been announced by the Magyar Nemzeti Bank in April 2013 and launched in the beginning of June.[137] The program is an integral part of Hungary's monetary policy. It addresses a key issue for the development and economic growth of the country after the emergence of the financial and economic crisis: that is the limited opportunities for companies operating in Hungary to access credit, thus boosting growth. In particular, the availability of long-term loans significantly decreased for SMEs because of both the weakening risk tolerance of banks on the supply side and the growing difficulty of accessing long-term funds. Moreover, nominal interest rates for credit-worthy SMEs were very high, which made it more difficult for viable companies to operate, making them less competitive than companies with access to more favourable financial resources. Consequently, the *Scheme* was launched with the objectives of easing the persistent market disorder observed in SME lending by helping them to access Forint-denominated loans, strengthening financial stability and reducing the external vulnerability of Hungary, in other words, reviving corporate financing in the country.[138]

The program is based on three pillars, two of which devoted to loans for SMEs. Specifically, under pillar I, the MNB provided refinancing loans with a 0% interest rate to the

137 Bloomberg, Hungary Central Bank Expands Funding Plan to Boost Growth, http://www.bloomberg.com/news/2013-05-29/hungary-central-bank-expands-funding-plan-to-boost-growth.html (last access July 07, 2014).

138 MNB, press releases 2013, launch of the MNB's Funding for Growth Scheme, http://english.mnb.hu/Sajtoszoba/online/mnben_pressreleases/mnben_pressreleases_2013/mnben_pressrelease_20130430.

participating credit institutions, which could further lend these loans to SMEs with an interest margin capped at 2.5%. The only purposes of the loans could be exclusively investment (the most verified case), working capital financing, pre-financing EU funds, or the redemptions of existing Forint denominated loans. On the other hand, pillar II was destined only for the redemption of foreign currency loans. The overall amount made available by the Central Bank is 750 billion Forints (about EUR 2.4 billion), of which approximately 701 billion (93.5% of the overall amount, about 10,000 contracts) were allocated by credit institutions at the end of the first phase of the FGS because of the active interest showed by enterprises. Overall, greater interest was shown for loans provided under pillar I than pillar II. This is the reason why a small amount of funds from pillar II were granted under pillar I conditions. At the end of the first phase, credit institutions provided loans under pillar I to 111% of the amount originally destined to it.[139]

On the basis of the first phase's assessment published by the MNB, taking into account both data and feedback received by credit institutions and representatives of the business sector, the short term objectives of the *Scheme* were fulfilled, namely to ease financial support for SMEs and strengthen competitiveness among credit institutions, which means that the FGS managed to mobilise the market of lending to SMEs on both the demand and supply sides. Indeed, the access to ten years of credit at the maximum interest of 2.5% (before it was an average 5.9% for investment loans and 5.8% for working capital loans) gave the chance to enterprises to expand and smooth the operation of their business activities, thus increasing their profitability. In addition, also small and medium sized banks, as well as cooperative credit institutions were favoured by the allocation mechanism and the option to switch banks, which increased the share of these kinds of credit institutions among SMEs loans portfolio. The type of contract was on average under HUF 50 million, so that even if higher in comparison to typically provided loans, it was quite low in relation to the upper limit of possible disbursement fixed as HUF 3 billion.[140]

Loans provided under the FGS were disbursed indiscriminately for all the economic sectors, but turned out to be more beneficial for *agriculture*, the *manufacturing industry and trade*, which account for a dominant share. In addition, they also helped in providing a more even distribution of funds among the different economic regions of the country. Usually 56% of total SME loans were located in Central Hungary, while under the *Scheme* the share decreased consistently to 41%. The regions benefiting more from the shift were the Southern and Eastern regions of the country, which are the areas of major focus for development plans, as already seen in relation to incentives and subsidies promoted for new investors. Taking into account the success of the first phase of the *Scheme*, the MNB decided to continue with the program, continuing its implementation time at least until the end of 2014. However, in the second phase of the program the focus shifted slightly by putting greater emphasis on the stimulation of economic growth through the provision of new loans for investment.[141]

[139] MNB, Analysis of the first phase of the Funding for Growth Scheme, http://english.mnb.hu/Root/Dokumentumtar/ENMNB/Monetaris_politika/fgs/FGS_analysis.pdf.

[140] Ibidem.

[141] Bloomberg, Hungary Central Bank Expands Lending Plan to Boost GDP, http://www.bloomberg.com/news/2013-09-11/hungary-central-bank-expands-lending-plan-to-boost-gdp.html.

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The success of the program has been extensively promoted by the MNB, but a certain degree of satisfaction has been also shown by the banking sector itself that thanks to the FGS was able to breathe a sigh of relief by benefitting from the consistent amount of contracts signed. The program has been welcomed by many banks willing to support the corporate sector, and even more by the enterprises whose interest for the program was substantial. Moreover, there is also the chance that the deterioration in bank credit portfolios' quality will slow down as a result of easing debt servicing burdens, thus the *Scheme* may also improve banks' lending capacity through the balance sheet position of the credit institutions.[142]

Therefore, it seems that the Hungarian government is actually trying to provide concrete solutions to the hard economic conditions the country had to face. Even if the focus in recent years has kept being on measures helping Small and Medium Sized enterprises, however, this does not exclude other measures put in place also for the benefit of larger corporations, which most often implies foreign-owned companies. In these cases, the rhetoric against multinationals has been once again contradicted in practice as proved by several important individual agreements signed by the Prime Minister with major foreign corporations in the country.

3.5 Strategic cooperation agreements

As already mentioned in this work, the strategy the Orbán's government started in 2010 towards FDI and foreign owned companies in the country has been quite differentiated. The positions taken varied consistently on the basis of several factors. They range from the size of the company concerned - as the measures implemented in favour of the SMEs show to a certain extent - to the type of activities carried out and the sector concerned. Indeed, if the practice suggests that big foreign owned companies are not particularly welcomed in the country - especially in those sectors where further improvements of local companies could finally occur if not challenged by the presence of big corporations with high percentages of market share - in other fields MNCs have been openly supported by the government with specific agreements and sets of incentives created with the twofold objectives of benefitting the economy and increasing the company's profitability. This is especially the case of enterprises dealing with particularly innovative and research-based activities, which very often are also consistently export oriented. Therefore, the positive performances of such industries, even if often detached from the local economy and supply chains, are extremely important in terms of Hungarian development and competitiveness, not only at a national level but also in a regional and global context. Moreover, they serve the purposes of the country not only in terms of research and innovation but also in the numbers of exports, capital invested and personnel employed. In fact, these big investors usually respond to the main features of FDI of the vertical type, meaning that MNCs are locating different stages of production in different countries in order to reduce costs and export a great quantity of the production rather than serve the local market (which is usually the target of horizontal FDI).

[142] MNB, Terms and Conditions of refinancing loans in Pillar I and II of the first phase of the Funding for Growth Scheme, p. 1, http://english.mnb.hu/Root/Dokumentumtar/ENMNB/Monetaris_politika/fgs/NHP_termektajekoztato_EN.pdf.

We have already seen the great focus on the vertical FDI type in the framework of investment promotion, but it is particularly true also in relation to several strategic agreements signed by Orbán with big foreign-owned companies in the country. Indeed, despite the rhetoric against multinationals, the hostile feelings among Hungarians in this regard, and the economic re-nationalization of the last years, the Orbán government acknowledged the importance of these "giants" in Hungary, and actually maintained during its four years mandate tight relations with major investors in the country. The executive power signed strategic cooperation agreements with 43 companies (including 13 with representatives of the automotive sector). Moreover, the Prime Minister has personally signed agreements with Audi, Daimler, Coca-Cola, and Suzuki, among other companies.[143] Other major names on the list include Hankook, Nokia, IBM, Tesco and Microsoft. However, it seems clear that the great government commitment to tighten relations is in the automotive sector, as proved by the number of agreements signed in this context. The next section will specifically provide a closer look to cooperation among government and important carmaker corporations in the country given the relevance of their economic activities for the competitiveness of the country.

3.5.1. The strong commitment to supporting the automotive industry

The strong reliance of the government on the automotive sector is actually not a big surprise considering its history and relevance in Hungary, the country in the EU with the highest share of automotive industry in the GDP (4%). The country extensively relied on the companies investing in this type of business since the beginning of transition, and constantly continued to do so during the socialist governments, as well as nowadays under Orbán's rule. Today the sector is constituted of 90% by foreign investors, including well-known names like Opel, Audi, Suzuki and Mercedes Benz. Although numbers in domestic sales are not impressive – but rather discouraging considering that car registrations are at the lowest levels in Hungary in comparison to the rest of the EU – exports of the sector account for 20% of the total amount.[144] The attitude assumed by Viktor Orbán in this context has proved to be rather prone to compromise. It is visible in Hungary's more flexible labour code introduced under pressing from corporations and in the three years vocational training designed on the companies' desire to better train their employees using the example of the German model. Also, the direct provision of financial incentives (granted to Daimler and Audi) is an important tool used by the government.[145]

Among the strategic agreements signed, the one undertaken with *Audi Hungaria Motor kft,* the German plant settled in Győr in North-West Hungary, represents an interesting and illustrative case of government relations with particularly profitable and

[143] Sadecki Andrzej (2014), In a state of necessity. How has Orban changed Hungary, OSW. p. 23, http://www.osw.waw.pl/sites/default/files/pw_41_in-a-state-of-necessity_net.pdf.

[144] The Polish Institute of international affairs (PISM), Is the Automotive Industry the Remedy for Hungary's Economic Problems?, Bulletin n. 55, 22 May 2013, http://www.pism.pl/publications/bulletin/no-55-508.

[145] Ibidem.

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reliable businesses in Hungary. The famous carmaker is one of the largest corporations and employers in the country (9000 people are directly employed by the company) and among the best performers in terms of revenues and exports. It accounts for a total investment volume of more than EUR 6.7 billion.[146] In addition, the company represents for the Magyar economy a successful story in terms of levels of satisfaction showed for the activities carried out since 1993, which have been subject to constant expansion since then. In particular, the enlargement of the Győr factory announced in 2010 and occurring in June 2013, exactly twenty years after the settlement of the company in Hungary, brought the original plant from measuring 240,000 square meters in 1994 to its current size of approximately four million square meters, which makes Audi Hungaria the country's biggest manufacturing company and the largest engine production plant in the world. Moreover, approximately EUR 900 million were invested in the expansion and 2,100 new jobs created. Also the activities carried out were diversified, since the plant – originally involved in engine manufacturing and a vehicle assembly line – became a vehicle production plant encompassing the entire manufacturing process of three different car models.[147]

The "strategic partnership agreement" signed between Viktor Orbán and Audi ensured an even greater degree of engagement of the company with the country. Audi is thus continuing its successful cooperation with the Hungarian government, proving through the agreement its commitment to the shared goals of dual education promotion, university cooperation, research and development, innovation and jobs creation and protection.[148] On the other side, the company is receiving from the state a great amount of financial incentives (according to Reuters about EUR 133.3 million), whose compliance to the European law has even been questioned and probed by the European Commission, especially in order to understand whether such a large amount of state aid is necessary for the profitability of the investment and is not harming competitiveness in the country and in the Central European region as a whole.[149]

However, acknowledging the great disparities in the actions and attitude undertaken by the government in the automotive sector in comparison to the ones towards banks, energy, retail and telecommunications, it is quite obvious to wonder what might be the reasons for such undeniable discrimination. Furthermore, if it is true that the automotive industry is a great resource for the country, it is also true that it is not advisable for an economy hit by the crisis and still on the way to recovery to rely extensively on a specific sector, thus being excessively exposed to possible downturns of the industry itself. It is also important to add to this consideration that very often the expected positive results were not even met despite all the investment supported by the government. The numerous strategic agreements signed by the government have not created the amount of jobs promised, or at least not yet. Indeed, the picture is not homogeneous and if some companies like Audi

[146] Audi Hungaria, prifile, https://audi.hu/en/profil/uzleti_eredmenyek/.

[147] Audi Hungaria, news, Jubilee: Audi Hungaria successful 20 years, https://audi.hu/en/hirek/reszletek/314_jubilee_audi_hungaria_successful_20_years/.

[148] Ibidem.

[149] Reuters, EU starts probe into Hungarian state aid for Audi, last access July 11, 2014, http://www.reuters.com/article/2014/07/09/eu-audi-competition-idUSL6N0PK3JG20140709.

have satisfied the expectations, other like Nokia performed much worse in this concern. Moreover, it seems that among the companies that signed strategic agreements with the government further cuts will be coming in the near future.[150]

It follows that the reasons for the government's attitude are not only to be found in the authorities' belief that *re-industrialisation* is an important condition for economic recovery, but also in other fields, namely *foreign affairs and economic diplomacy*. In fact, the preference for the automotive industry can also be explained by the attempt by the Hungarian diplomacy to tighten relations with the country that more than others is present in this industry and that holds the highest share of the capital invested in Hungary by foreign investors in all the economic spheres of the country: Germany. Indeed, the hope for Hungarians seems to lie on the possibility that welcoming and facilitating German investment in the country means that a consequential political rapprochement would follow with a partner strategically important to obtaining significant backing in European institutions. The rapprochement, however, appears quite unlikely, considering the disagreement of German authorities to political changes occurring in the country under Orbán's rule.[151] However, the level of German investment consistently growing after the global crisis[152] shows that relations keep being successful at least in economic terms. Improved relations with Germany were not the only focus of the Prime Minister during his 2010-2014 mandate. The same approach, characterised by high reliance on investments in order to tighten up relations with countries of interest, was adopted also in the "Eastern opening" approach explained in the following section.

3.5.2 The Eastern Opening

The need to attract investment to give new chances of recovering to the damaged Hungarian economy was flanked by the growing distance taken by the Prime Minister in relation to Western countries and was also helped by the increasing role of the V4 countries and their level of cooperation within the European environment. By contrast, Viktor Orbán put much greater effort in Hungary's newly born (or revealed) relations with Eastern partners, including China, Azerbaijan, Saudi Arabia and Russia. This tendency in Hungarian international relations, also known as "*Eastern opening*" or "*Eastern wind doctrine*" – the latter stems from Orbán's November 2010 speech stating that "Hungary is anchored in western waters, but the wind in a world economy blows from the East"[153] – actually brought the accomplishment of important projects such as the agreement signed with Putin in January 2014 on the enlargement of the Paks nuclear power plant. The agreement will grant a loan

[150] Index.hu, Nem sok munkahelyet hoztak a kormány barátai, http://index.hu/gazdasag/2014/08/04/strategiai_szovetseg/, (last access 05/08/2014).

[151] The Polish Institute of international affairs (PISM), Is the Automotive Industry the Remedy for Hungary's Economic Problems?, Bulletin n. 55, 22 May 2013, http://www.pism.pl/publications/bulletin/no-55-508.

[152] MNB, Report on the balance of payments, July 2014, http://english.mnb.hu/Root/Dokumentumtar/ENMNB/Kiadvanyok/report-on-the-balance-of-payments/2014/2014_07/BOP_report_2014Q1_WEB.pdf.

[153] Kałan Dariusz, Relationship of a Special Significance? A Chinese Direction in Hungary's Foreign Policy under Viktor Orbán, in Croatian International Relations Review, XVIII (66) – 2012, http://www.pism.pl/files/?id_plik=11238.

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of around EUR 10 billion for thirty years for the construction of two new units of the nuclear power plant in the town of Paks. Even if the plant will remain Hungarian owned, the financing will see an important increase of Russian influence on the Hungarian energy sector and a stronger presence of the Russian state-owned Rosatom in Europe. In other words, the increasing rapprochement occurring after the unfriendly relations following the collapse of the Soviet Union and the end of the Hungarian socialist regime will have a consistent weight not only in economic terms but also in politics. It seems, in fact that the Russian political and economic style has become increasingly appreciated by Budapest authorities.

Moreover, the Eastern opening is not only related to improvements in relations with Russia. They are flanked by the tightening relations with China, which are considered of extreme importance for the government both for economic reasons and in order to gain a strategic position in Central Europe as a bridge to the far East (in this concern competition with Poland is quite high).[154] It is important to mention, however, that such a strong commitment has not yet produced the hoped results in terms of inflow of FDI: of the USD 2-2.5 billion invested in Hungary about half was invested by Wanhua Industrial Group, which in 2010 became a strategic investor in the Hungarian chemical industry, thus making Hungary the only country among the new Eastern member states of the EU with a stock of more than EUR 1 billion of Chinese FDI. Also, simple trade among the two countries reached its peak in 2010 and 2011 (thus being possibly more the result of the actions undertaken by the previous Ferenc Gyurcsány and Gordon Bajnai's governments). In fact, outward FDI from China to Hungary and Central Eastern Europe in general definitely cannot be considered as a particularly new trend. Chinese investors showed their interest in the whole Central European Region, and not only Hungary, before the establishment of the Orbán's government in order to get access to the European market and favour the transfer of technology. The investment in Hungary and Romania of the Chinese telecoms company Huawei is one of the most stunning examples of the movements of Chinese technology into the region. That being said, the interest of the executive power to further deepen this cooperation cannot be neglected, including Chinese investors among the "welcomed" in the country, also because of the nature of the investment carried out.

To summarise what stated in relation to the governmental strategies towards FDI of the last four years, it is possible to state that Orbán's policies in relation to incoming and already established foreign investment in the country were highly differentiated in the time period from 2010 to 2014. They changed substantially on the basis of several factors. One of them is the *dimension* of the business concerned, since special attention was paid especially to SMEs and much less to large companies. This tendency, however, has been averted when the large companies were the product of huge capital invested in the country in sectors generating high added value activities and great amount of exports, job creation, and innovation – in other words presenting the typical features of vertical FDI – such as in the case of the automotive sector. In other cases, big foreign companies have been targeted by unfriendly business policies such as specific taxes on foreign dominated sectors, especially when the taxation of these companies would have led to a greater level of public support or when such targeted businesses were contrasting the interests of local companies in that

[154] Ibidem.

very same market (even more if they were close to government positions), thus harming the principle of fair competition in the country. Moreover, to a certain extent economic policy in this concern was not only moved by economic reasons. As it is normal to expect, in fact, economics and politics are always connected, as shown by the influence of the Hungarian foreign policy of the last four years on the economic strategy pursued.

Therefore, in very general terms, it is possible to state that foreign policy and the will to support industrial investments while punishing the financial ones, especially in banking, coupled with the will to increase governmental influence in specific, mainly foreign-owned, sectors were the elements that more than anything guided the business-government relation in the country. What is worth mentioning, however, is that such an economic strategy towards foreign investors does not always represent clear cut in relation to past governmental strategies in this concern. In fact, if the rhetoric spread against multinationals and the case of the windfall taxes on specific economic sectors can be definitely depicted as a big turn initiated by the Orbán's cabinet, the investment promotion policies carried out by the Hungarian Investment and Trade Agency did not change consistently, besides the different regionalization of the activities. Moreover, even though the high number of strategic cooperation agreements with big multinationals in the country is representing an important aspect of the last four years of government, such kinds of business-government cooperation is not a new issue in the country. The previous socialist governments also were inclined to pursue this type of strategy, as shown, for instance, by the long lasting collaboration with Audi, which has seen a succession of several executives in its Hungarian history.

However, probably the main point of distance in relation to previous governments remains the attitude towards the financial sector, which has been the target of a series of policies guided by a combination of rhetoric against multinationals and the will to increase state influence in the sector, hate against the financial world and European institutions and, in general terms, the exploitation of a scapegoat against several structural problems of the Hungarian economy. For these reasons, the following and conclusive chapter of this work will be devoted to the analysis of the banking sector because of its peculiarity in the Hungarian case. In fact, the chapter is not meant to provide an analysis of a representative sector among all the others. By contrast, it will be the focus of the case study because of its peculiarity both in a Hungarian context and also from a Central European regional perspective.

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Chapter 4. Orbán vs banks: an analysis of the Hungarian banking sector's performances and causes of distress

The Hungarian banking sector has registered negative results since June 2009 after the outstanding profits of the years preceding the crisis. Its outlook is considerably more alarming in many aspects than what would be considered acceptable for one of the most developed economies in the Central Eastern European region. Several were the external conditions which played a role in banks' distress. Some of them are related to the punitive *governmental measures* on the whole financial sector (and to a greater extent banks) already mentioned in the previous chapter and further analysed in this context, whose degree of stubbornness somehow makes this particular case study more interesting than others. However, unfavourable policies were flanked in the last years by other major changes which also played their role in shaping the performance of the banking sector in the country. Among them, the deterioration of the external environment caused by the protracted debt crisis in the Euro zone, as well as the slow or even negative growth rate of the Hungarian economy after 2008, contributed extensively to the increase of a *high ratio of non-performing loans* in the country. Moreover, the original sin of the sector, which is the *high reliance on foreign currency* in funding and lending activities, extensively exposed the sector to the depreciation of the Forint and to the measures implemented by the government in order to protect Hungarian borrowers of foreign currency loans and help them in paying back their mortgages.[155] However, the improving macroeconomic conditions both in the country and in the Euro zone are also having effects on Hungarian banks, whose performances nowadays seem to be more than usually delineated within a duality given by good level of capitalisation and improvements in terms of liquidity and loans granted coupled with continuing bad results in profitability.[156]

These major causes of distress of the Hungarian banking sector will be analysed in depth in this chapter. In fact, after providing a general outlook – also in comparison to the conditions of the same sector in other Central European economies – the issue of the high reliance on funding and lending in foreign currency, as well as the fiscal measures implemented against the sector will be addressed. The purpose of the analysis is to understand and recognise the extent to which this set of problems had on the bad results of the sector, especially when it comes to the unfavourable taxation implemented since 2010 by the Orbán government and its effectiveness and usefulness for the growth of the Hungarian economy as a whole.

Unfortunately, given the current nature of the topic addressed, it has not been always possible to include official statistics in the English language on the sector from the last and

[155] CIB Group, Sustainability Report 2012, p. 12, http://www.cib.hu/system/fileserver?isFlashCompliant=true&session_id=reb9XxL5gNxBsSlkemrfvqoj&flashVersion=4&b=121&w=1366&h=768.

[156] Hungarian Banking Association, Report on 2013 activities of the Hungarian Banking Association, Executive summary.

current year, which would have been particularly useful in order to study the effects of the Financial Transaction Tax or the Funding for Growth Scheme implemented both in 2013. This aspect somehow led the research to focus on data provided by secondary resources – sometimes even reporting slightly different results on the basis of the calculations used – such as reports published by large banking groups in the country, like OTP, CIB and Raiffeisen. The reports on financial stability published by the Hungarian Central Bank and the reports published by the Hungarian Banking Association combined also were useful tools used for the purposes of the research.

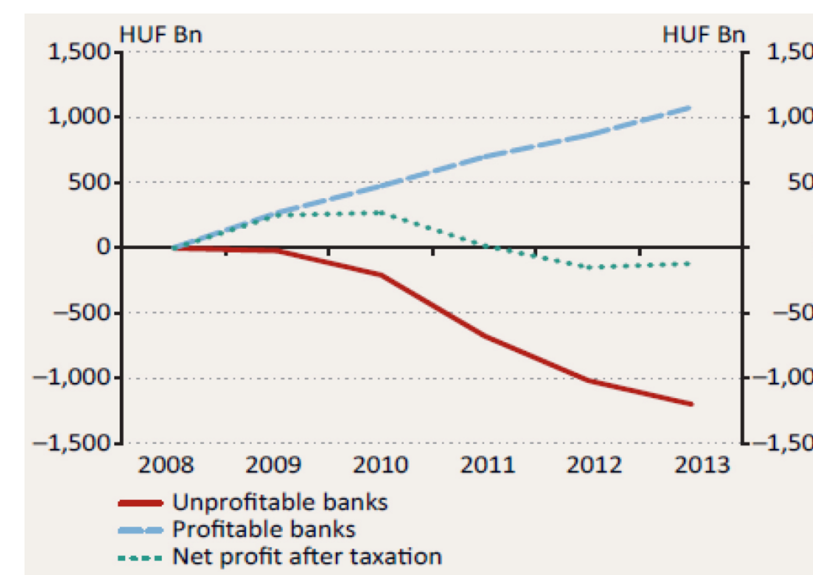
4.1. Banking sector outlook since the outbreak of the crisis

The deteriorating quality of Hungarian banks' assets is mainly due to consistent burdens on their profitability. Since 2009 *net profitability* saw declining results in each consecutive year until 2011, when they entered into loss for an amount of EUR -0.3 billion. The analysis carried out by Deloitte on the sector defines as the main cause of such plummeting profitability the worrying increase of the cost of risk growing at 50% annual rate in the years 2008-2011. Therefore, neither the revenue side, which expanded at an annual rate of 1.4%, nor the cost-to-income ratio, which remained stable, was able to offset this negative effect.[157] Moreover, losses were registered in the sector also in 2012 and 2013. In fact, according to data published by the MNB, during the year 2013 the Hungarian banking sector did report profits (HUF 114 billion), but this was the result of a one-off item, specifically the relief of external liabilities by a parent bank (which stood around HUF 120 billion), which brought profits to around 0.[158] In addition, it is important to add to this statement that the data taken in consideration in this case was pre-tax profitability (rather than net-profits), meaning that this very same amount reduced by the amount of taxes due turned profits into red also in 2013. According to the estimation provided by the Hungarian Banking Association, such loss would be set around HUF 118 billion,[159] which is actually very close to the estimation for the levy on banks for the same year amounting to approximately HUF 128 billion (See par. 4.2). To the extraordinary tax, it has to be added also the Financial Transaction Tax of 2013 (HUF 215 billion, only partly included in banks' pricing), plus other burdens imposed on banks, and the increase in provisions due to the deterioration of the portfolio quality (HUF 302 billion). Such extensive taxation has been levelled to a certain extent by the reduction of costs (reaching pre-2007 levels) and in higher service costs, but their burden remains quite substantial on profitability results. The diagram reported in Figure 4.1. shows how the net profitability of the sector after taxes draws a declining line during the last years, falling into loss since 2011. However, it also shows that there are significant discrepancies between banks reporting pre-tax profits and those reporting losses.

Looking at disaggregated data, *net interest income* remains the main source of revenues (Fig. 4.2) Based on international data (consolidated with foreign subsidiaries and domestic financial enterprises) interest income by total assets is substantial and has even risen lately. In 2009 it accounted for 60% of total income and even increased in the following years, reaching its peak in 2010 (84%).[160] According to the MNB position, such a high level of interest income is due to high prices, that even if set in order to lighten the fiscal burden might still be too high or be a sign of lack of competition. Taxation is quite substantial indeed, but the costs due to the implementation of the FTT in 2013 (included in the item "other costs" in the diagram) have been reduced by the imposition of higher costs of the services provided, as proved by the increased net profits from *commissions and fees*, especially in the last quarter of the year 2013.[161]

Despite the high revenues from interests just mentioned, it is also important to stress that the Hungarian banking sector in the last years experienced very poor performance in terms of lending. *Corporate lending* was very low because of the weak economic outlook, the low appetite for investment and the low level of FDI of the previous years. This is why access to credit became a major concern for policymakers in order to sustain economic growth. The Funding for Growth scheme explained in the previous chapter is the most important tool used by the authorities in this concern. Indeed, corporate lending did increase after the implementation of the program, but not extensively, and only for the SME's segment.[162] Also *retail lending* is still decreasing and in 2013 saw a 5.5% reduction in comparison to end-2012.[163]

Figure 4.1. Cumulated net profits of profitable and unprofitable banks since 2008



Source: MNB, Financial stability report May 2014

157 Deloitte (2012), The Banking Sector in Central Europe - Performance Overview, Deloitte Center for Financial Services in Central Europe, p. 46. http://www.deloitte.com/view/en_PL/pl/insights/Center-for-Financial-Services/focus-area/Industry-outlook%20%20/a5af84921549b310VgnVCM2000003356f70aRCRD.htm#.

158 MNB, Financial Stability Report May 2014, p. 14, http://english.mnb.hu/Root/Dokumentumtar/ENMNB/Kiadvanyok/mnben_stabil/stabilmnben_stab_jel_201405/Stabjel_201405_EN.pdf.

159 Hungarian Banking Association, Report on 2013 activities of the Hungarian Banking Association, p. 8.

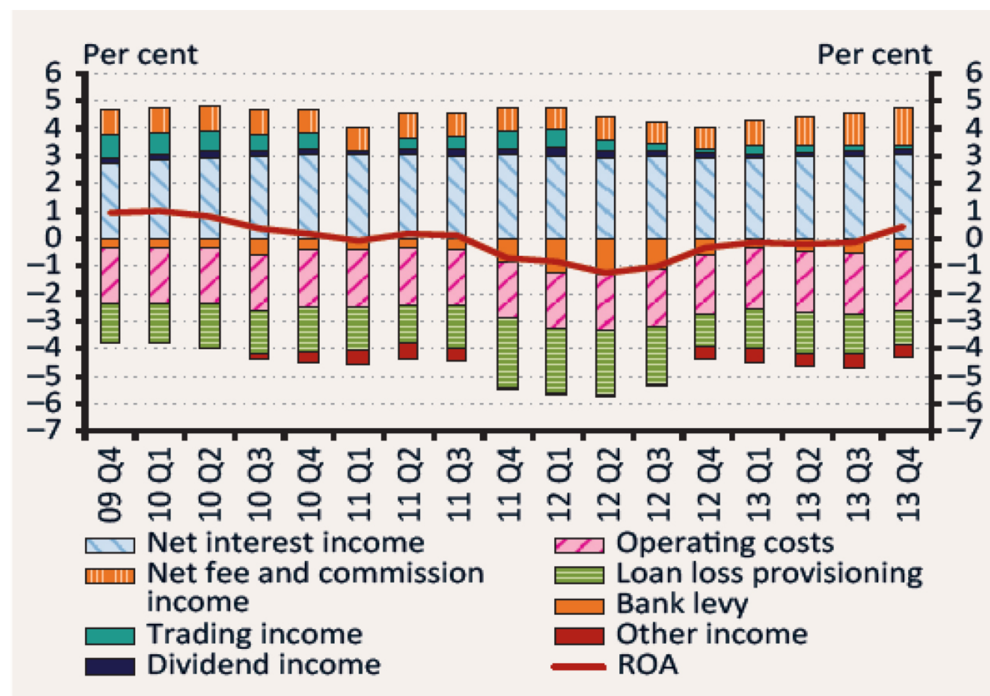
160 Deloitte (2012), The Banking Sector in Central Europe - Performance Overview, Deloitte Center for Financial Services in Central Europe, p. 46.

161 Ibidem, p. 59.

162 Hungarian Banking Association, Report on 2013 activities of the Hungarian Banking Association, p.9.

163 Ibidem, p.11.

Figure 4.2. Aggregate 12-month main rolling profit items of the banking sector and branches as a proportion of the 12-month average balance-sheet total



Source: MNB, Financial stability report May 2014

Reduction of costs – both of a fiscal and administrative nature – was pursued in the sector also through consistent *cuts in the number of employees* in the sector (about 4000 in the years from 2008 to 2011). Only the Hungarian branches of the CIB bank group saw a significant reduction of employees amounting to about 25% of the total headcount: people employed in the Hungarian branches of the group were 3675 in 2008 and were reduced to 2755 in 2012.[164] The reduction in the headcount has been defined by the group as an unwanted effect of the crisis, mainly a consequence of the reduction of CIB branches within the country in the last years.[165] Indeed, the forced cost saving strategy of branches' reductions has been applied on a national level by other bank groups, for a total cut of 86 branches until 2012 (about 5% of the total amount).[166] Such a reduction, however, does not change the concentration of the market, which is steadily in the hands of specific groups and has remained quite stable in the last years. The following section will have a closer look to the aspect of market concentration, which is also one of the causes of low profitability in the country.

4.1.1. The market structure

The market presents an important similarity with the peer economies in the region, which is represented by the large amount of shares in the hands of the ten largest banks in

[164] CIB Bank, sustainability report 2012, Key performance indicators of the CIB group, p. 4, http://www.cib.hu/system/fileserver?isFlashCompliant=true&session_id=reb9XxL5gNxBsSlkemrfvqoj&flashVersion=4&b=121&w=1366&h=768.

[165] CIB Bank, sustainability report 2012, p. 18.

[166] Deloitte (2012), The Banking Sector in Central Europe - Performance Overview, Deloitte Center for Financial Services in Central Europe.

the country, detaining 75.1% of the sector's total assets. Despite the high concentration, significant differences are still present among the ten. *OTP Bank* is the undisputed leader in the sector with 26.5% consolidated market share divided between OTP and OTP mortgage (about 5% of the share), and its dominant position is in almost all the major categories including assets, equity, loans and deposits. The bank belongs to the group of formerly Hungarian-owned companies, like MOL and Richter, that were privatized through the stock exchange and are now under dispersed foreign-majority ownership, but not under foreign control (strategic decisions are taken by the Hungarian management).[167] The OTP's dominant position in the market is also underlined by the fact that its market share matches one of the three largest banks after OTP put together.

Table 4.1 shows the first ten major banks, their shares, profits, parent groups and other measures of their economic activities in the country in the year 2011, thus giving the chance to see how banks performances looked like during one of the worst years for their economic activities, especially taking in consideration that the levy was implemented only one year earlier (their activities were probably not yet adjusted to the new fiscal situation) and that the outlook of the whole Hungarian economy was also quite negative at the time.

Table 4.1. Top ten banks' financial results (2011)

Name	Market share %	Assets (EUR bn)	Loans (EUR bn)	Deposits (EUR bn)	Net profits (EUR m)	RoA %	RoE %	# of branches	Capital group
OPT	19.5	24.3	10.3	12.2	396.4	1.6	10.0	377	OPT
Erste	8.3	11.6	8.3	4.3	-534.8	-4.6	-84.0	142	Erste
K&H	9.3	10.4	5.2	6.2	15.9	0.2	2.5	236	KBC
MKB	7.7	9.7	6.4	4.6	-398.6	-4.1	-142.3	88	Bay. Land. Bank
CIB	7.3	9.0	6.8	4.9	-199.5	-1.5	-15.3	120	Intesa Sanpaolo
Raiffeisen	6.6	8.2	5.5	5.1	-318.1	-3.9	-55.2	132	Raiffeisen
Unicredit	4.9	6.1	4.1	3.8	52	0.9	7.8	132	Unicredit
OTP mortgage	4.8	5.9	5.3	0.0	-106.4	-1.8	-34.5	380	OTP
MFB	4.0	5.0	1.4	0.2	-105.1	-2.1	-12.4	101	State-owned
Budapest Bank	2.7	3.4	2.3	2.6	32.7	1.0	7.2	102	GE capital
Market	100.0	124.6	70.9	52.8	-265.7	-0.2	-2.5		

Source: Deloitte center for financial services

In an international comparison, the concentration of the market has not reached high levels, although numbers can be misleading. For instance, the MNB underlined the fact that the first three groups are still detaining less than 50% of the market share, which is quite

[167] Kalotay Kálmán and Sass Magdolna (2012), Inward FDI in Hungary and its policy context, in "Columbia FDI Profiles, Country profiles of inward and outward foreign direct investment issued by the Vale Columbia Center on Sustainable International Investment", Vale Columbia Center on Sustainable International Investment, p. 5.

good looking at data from neighbouring economies.[168] Also, the market analysis carried out by the Raffeisen group shows that in Hungary and Poland in 2011 and 2012 the presence of the first five largest groups is set around 50%, while the ratio is higher in the Czech Republic and Slovakia.[169] [170] However, the substantial difference among the first group's share, OTP, and the following ones (Erste, K&H, MKB and CIB) suggests that the concentration around 52/53% is more likely the result of their combined market shares being much lower than OTP's one, while the market share of the first group is still quite substantial, as it is also from a regional perspective (the only similar high concentration in the hands of the first ranked bank is held only by UniCredit in Croatia). In other words, if in other peer economies the concentration among the top banks in the country can reach higher levels than in Hungary, this is a consequence of a more levelled division of shares among them, while in the Magyar banking sector the concentration is lower among the top banks ranked from 2 to 5, and higher than usual when it comes to the OTP group. Nonetheless, concentration is much more substantial in specific sub-markets. For instance, as far as deposits are concerned, in 2011 OTP was owing almost three times the amount held by Erste. Also, in housing loans the share of the three largest banks was about 53% in January 2014, in comparison to corporate loans, whose level of concentration is much lower (about 35%).[171]

The aspect of high concentration, coupled with the low profitability level of the sector, can also be the possible cause for the consolidation of big companies which could strengthen their position in the market through further acquisitions as they are able to exploit synergies in order to improve cost efficiency. As a result, the problem of "the-too-big-to-fail" company could emerge in the market, harming competition, as well as limiting possibility for entry of new institutions in the economy.[172] Nonetheless, competition should still be secured to a certain extent by the very low degree of state presence at the moment (the Treasury only owns shares in MFB bank) and well established branches of foreign groups, such as Erste, Intesa Sanpaolo, UniCredit and Raiffeisen, which despite the difficult times experienced in Hungary and the reduction of their exposure towards the country of about 30% since 2007, are still active in the Magyar economy. It seems that this engagement will be also confirmed in the coming years, showing a certain degree of confidence in the future and in further market improvements. Nonetheless, this presence could also be challenged by the agenda of the government, which in the last years did not miss underlining its desire to increase Hungarian shares in the sectors by even stating that 50% of the banks in Hungary should be Hungarian owned,[173] as it will be further explained in the section related to governmental action in the sector.

[168] MNB, Financial Stability report May 2014.

[169] The report sets this share around 52% because it counts OTP mortgage (8th in the ranking of major banks in Hungary) as a separate bank from OTP Bank. By contrast, considering the two banks are part of the same group together, such ratio would be higher than 5 percentage points, thus almost matching the same ratio in the Czech Republic, but still being much lower than in Slovakia.

[170] Raiffeisen Research, CEE Banking Sector Report Banking Sector Report May 2013, p. 12, http://www.rbinternational.com/eBusiness/services/resources/media/829189266947841370-829189181316930732_829602947997338151_829603177241218127-902924031462552274-1-2-EN.pdf.

[171] MNB, Financial Stability Report May 2014, p. 65.

[172] Ibidem, p. 67.

[173] Bloomberg, Hungary wants to curb foreign banks amid EU democracy clash, http://www.bloomberg.com/news/2013-03-12/hungary-threatens-to-take-over-foreign-banks-amid-clash-with-eu.html.

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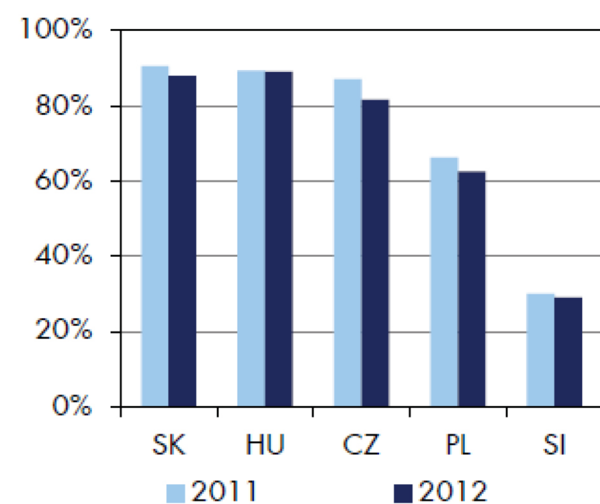
However, if the high presence of Western European investors in banking activities is very high in the country, it is not only a typical condition of the Magyar banking sector, but can be considered as a common feature also in the rest of the Central Eastern European region (especially when it comes to Austrian, French and Italian banking groups). Quite obviously, this is not the only characteristic shared by the banking sectors of these similar countries, even though the Hungarian one, and its negative performance, distances itself by several degrees from its peer economies. The following section is devoted to the analysis of these differences in relation to other CEECs in order to better understand in a comparative perspective the seriousness of the market conditions.

4.1.2. The worrying comparison between Hungarian and peer economies' banking systems

As it would be quite logical to presume, the banking systems of the Central Eastern European countries developed through similar paths, especially in light of their common past. As already mentioned, similarities in the area concern important features such as the prominent presence of foreign investors in the ownership ratio (Figure 4.4) – which highly exposes CE and SEE economies to developments in the Western European banking sector and increases dependence on cross-border banking flows in general – but also the rapid growth experienced during the run-up to the financial crisis. Also, the high quality and innovation of the services offered in comparison to Western economies is the product of a relatively recent process of development, which gave CEE banks the chance to skip the initial stages in order to directly arrive at the newest solutions concerning efficient and innovative banking systems.

Nonetheless, relevant discrepancies are observed in the ways this sector developed in different countries. They are often consequential to: different or opposing strategies undertaken in relation to foreign wholesale funding; the ability of self-funding or, conversely, outright dependence; the structure of the loanbook and its degree of reliance on FX loans. Hungary is the country that more than others differentiated its choices in comparison to its well-performing neighbours about the above mentioned strategies and, after the outbreak of the economic and financial crisis, has bitterly begun to pay for this choice. Today, if in general terms banks in CEE outperform those of the Euro zone, clearly Hungary is not giving a positive contribution in this regard.

Figure 4.3 CEECs' foreign ownership as a percentage of total assets



Source: Raiffeisen RESEARCH

The profitability indicators RoA and RoE reported in the region since 2008 are clearly depicting the image of what has just been stated (Figure 4.5.a and 4.5.b). In these terms, in fact, Hungary is very far from the rest of the V4 group. Moreover, its performance is also consistently below average of SEE economies such as Romania and Bulgaria. Looking at the diagram, however, it is possible to recognise how such a decline in profitability levels did not occur immediately with the crisis in 2008, probably because of the agreement signed with the IMF at the end of the year. In 2008 and 2009, the Hungarian performance was not much worse than in Poland or Slovakia in terms of RoE, and usually more profitable than in other countries in terms of RoA. The great fall is clearly beginning in 2010 and constantly continues in 2011 and 2012. Therefore, it is clear that the bank levy introduced in 2010 actually had consistent repercussions on the profits of the Hungarian banking sector, although it certainly cannot be considered the only cause. Indeed, Figure 4.5.c. shows how the ratio of non-performing loans on the total of loans granted increased more rapidly in Hungary than elsewhere in the Visegrád group, also reaching double levels in comparison to Slovakia and Czech Republic. In fact, the amount of the average NPL in the CE region in 2012 stood around 8% and Hungary and Slovenia are the only countries increasing the average. Without Hungary, the ratio would have been 6.4% in the region.[174]

In addition, the *loan-to-deposit ratio*, a commonly used statistic in order to assess bank's *liquidity*, is extremely high in Hungary, although it has improved in the last years (from 135% in 2011 to 107% in 2013). Indeed, the statistic shows how banks' liquidity in the country is very low, with the deposits less than the total amount of loans, while in Czech Republic, Croatia, Slovakia and Serbia such amounts are always within 90% and 105% percent, thus being a much more well-balanced in comparison.[175] A big difference is visible also in the *operational efficiency* of banks in the region. In the Czech Republic and Slovakia excellent *cost-to-income ratios* were registered, 45% and 48.8% respectively in 2011, while in

[174] Raiffeisen Research, CEE Banking Sector Report Banking Sector Report May 2013, p. 18.

[175] Deloitte (2012), The Banking Sector in Central Europe - Performance Overview, Deloitte Center for Financial Services in Central Europe, p. 9.

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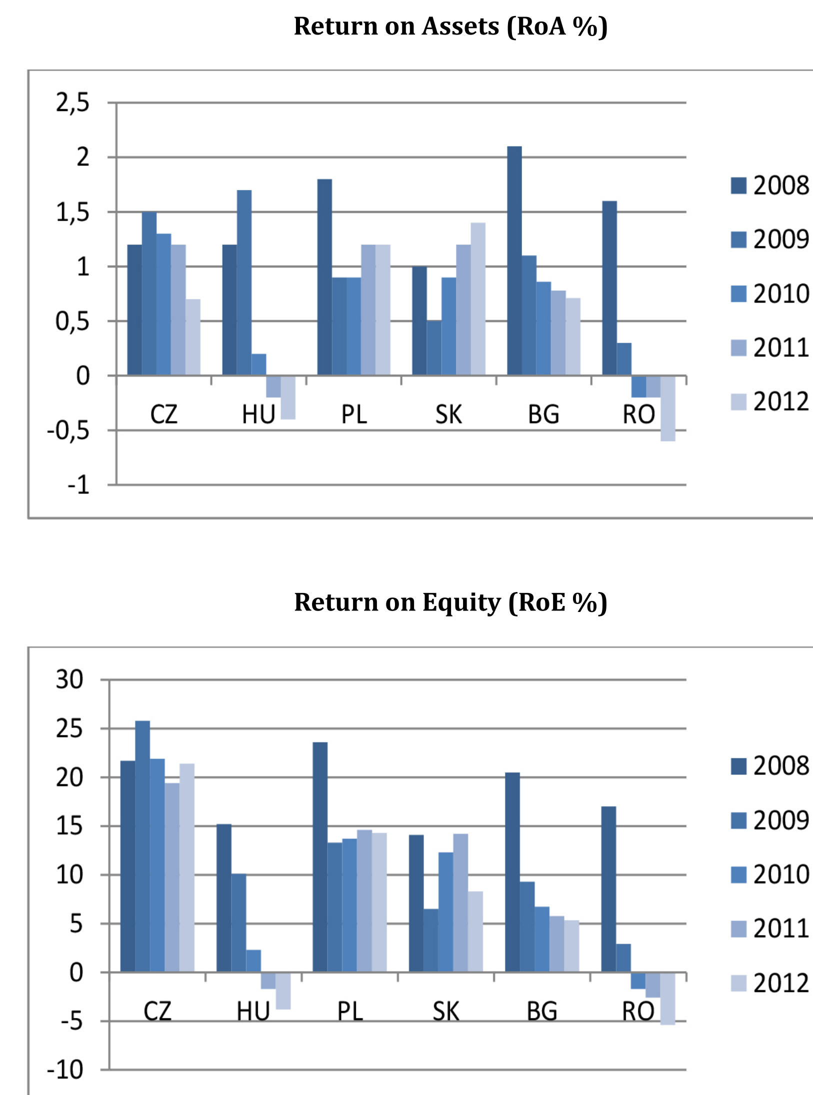
Hungary this statistic was set at 62% in the same year and remained stable with a 0% variation from 2008 to 2011, with absolutely no signs of improvements.[176]

To strike a blow to Hungarian banks, such bad results were not only caused by the companies' performances themselves. In no other country in the region have banks been exposed to such an unfavourable taxation as in the Hungarian case. For instance, despite one of the highest levels of profitability in the region, in Slovakia a levy on the banks has been introduced only in 2012, but even when the flat-tax rate was increased from 0.1% to 0.4% the foreseen amount to be paid by Slovak banks for the year 2013 was about EUR 200 million, while in Hungary in the same year banks paid into state coffers more than double the same amount (HUF 128 billion equals about EUR 400 million, with a 0.53% rate calculated on total assets rather than profitability).

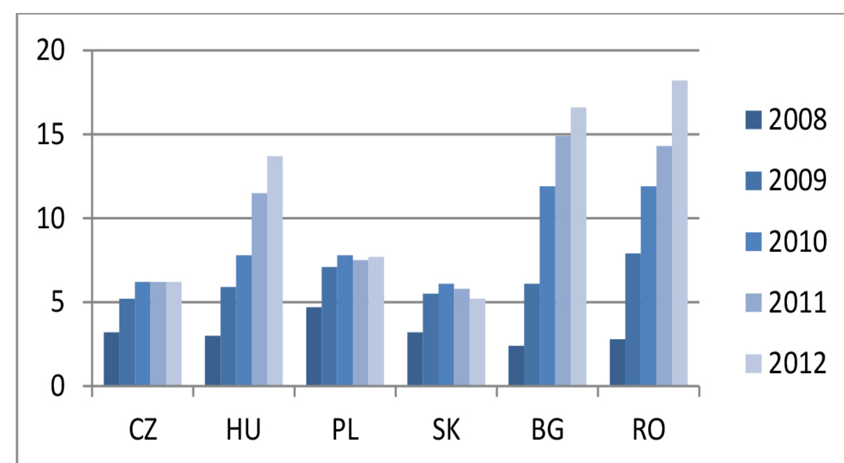
The following section is indeed devoted to the analysis of these fiscal measures burdening the sector, which have mostly been implemented after 2010, during the *Fidesz*-led government. The specific taxes on the financial sector, especially banks, have to be added to the measures implemented in other specific economic sectors already analysed in Chapter 3, even though they are standing for the consistent amount in comparison to other windfall taxes and for the heavy environment and bad business-government relations in which they have been implemented.

Figure 4.4 Profitability indicators and non-performing loans in CEECs' banking sectors



[176] Ibidem, p. 47.

Non-performing loans (% of total loans)



Data from Raiffeisen research. Calculation made by the author

4.2. Orbán vs banks: fiscal measures and public debate

4.2.1. Fiscal measures against financial institutions

As previously stated in this work, the financial sector is the one that more than others was targeted by the Orbán's fiscal policy in the last years. However, taxes on the sector were provided for by law already since 2005 through the so-called *extraordinary tax on financial institutions*, later replaced by the *extra tax on selected financial institutions* in 2007 (Table 4.2). In 2010, taxes on the sector were expanded with the introduction of the *levy on financial institutions*, the highest among all the different crisis taxes, which became effective on the 13th of August of the same year. The April 2012 convergence program sets the task of halving the levy in 2013 and further reduction in 2014. In October 2012, however, the authorities decided to postpone the halving to 2014, and one month later they decided to retain the tax indefinitely and in full.[177]

The tax is set as follows: a 0.15% rate is applied up to HUF 50 billion, beyond which the marginal rate rises to 0.53%. In 2012 some measures to lighten the burden of the levy were introduced, including the possibility of deducting some losses from the foreign exchange mortgage early repayment scheme (which allowed debtors to pay off their mortgages at a concessionary exchange rate) and from debts overdue more than 90 days the same holding for the increase in the credit portfolio towards SMEs (which has remained deductible to date). Insurance companies, however, have been exempted from this tax since 2013 and a consumption-type *insurance tax* was introduced instead.[178]

The levy on financial institutions alone amounted to HUF 187 billion (around EUR 600 million) in the year 2011 alone. In general terms, the levy has raised around EUR 500 million every year since its implementation. To better understand the relevance of such an amount it can be useful to put things in perspective: the consolidated net profit of the banking sector in 2009 was close to EUR 800 million.179 The affected financial organizations are banks, specialized credit institutions, insurance companies, financial businesses, investment businesses, the stock exchange and businesses managing investment funds and venture capital funds.[180]

The method for calculating the tax (the tax base and the tax rate) is different for the various financial institutions. For example, for credit institutions the tax base is the adjusted balance sheet total based on the annual report compiled on 2009.[181] It is worth mentioning that one of the peculiarities of this levy is that it does not consider the profitability of a given bank, which means that being based on the total assets of the year 2009, it must be paid unconditionally also by loss-making institutions (besides the already defined cases entitled to deductions introduced only in 2012). This is a point of distance from what is commonly considered a windfall tax, since it is usually implemented with the scope of targeting the most profitable companies and letting them contribute to the recovery of public finances.

This same kind of levies on finance is not only a characteristic of the Hungarian fiscal system. The necessity to let financial institutions contribute more extensively to state budget imbalances was felt also in other European member states including France, Germany and the neighbouring Austria, Romania, Slovakia and Slovenia.[182] Nonetheless, the measures implemented are very different from one country to another, but in Hungary they reach the highest rates in terms of percentage of GDP and tax rates (the upper band is the highest among the mentioned countries[183]), especially in relations to the total assets of the financial sector (the HUF 120 billion levied on credit institutions amounts to over 40% of the sector's earnings before taxes for 2009).[184] The reasons for such a high levy could be related to the most worrying financial situation of Hungary in comparison to other member states, but certainly other reasons played their role in the choice to tax so extensively the sector. In fact, again in this case, the will to tax multinational companies was never hidden by the Prime Minister himself. Among different financial institutions it was mainly the banking sector that was mostly foreign-owned. As already mentioned, this factor led Orbán to even state that at least half of Hungary's banking sector should be controlled by Hungarian capital, while at that time of the declaration it was 90% owned by foreign capital.[185]

Also, the Financial Transaction Tax (FTT) introduced in 2013 is not only a Hungarian peculiarity. Eleven member states of the Eurozone, including Slovakia and Slovenia, proposed to engage in a procedure of enhanced cooperation on a common FTT harmonized

177 OECD (2014), OECD Economic Surveys. Hungary 2014, box. 1.2, p. 61.

178 Ibidem.

179 Deloitte, The Banking Sector in Central Europe Performance Overview, p. 51.

180 Hungarian Investment and Trade Agency, Doing Business in Hungary 2013, RSM DTM Hungary, p. 56, http://www.hita.hu/en/Content.aspx?ContentID=d6b7edb4-17aa-42a4-8d70-470fa0f74895.

181 Ibidem.

182 KPMG, Bank Levies - comparison of certain jurisdictions, Edition IX.

183 Ibidem.

184 Magyar Nemzeti Bank, Report on Financial stability November 2010, box 7, p. 46.

185 Sadecki Andrzej (2014), In a state of necessity. How has Orban changed Hungary, OSW, http://www.osw.waw.pl/sites/default/files/pw_41_in-a-state-of-necessity_net.pdf.

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among them.[186] The harmonized taxation, however, has not been imposed yet, and Hungary would not take part in such a process. Indeed, Hungary already has its FTT, which entered into force in 2013 and it is still a peculiarity of the Hungarian fiscal system in the whole of Europe. It is levied on transactions of financial institutions and the Treasury. Nonetheless, according to the *MNB Financial Stability Report* of November 2012 (at the time the tax was not active yet) the tax implemented in Hungary would have been more in line with what, in the international practice of financial transaction taxes, has been defined as a Bank Transaction Tax. Indeed, the tax has been thought up in order to target mainly retail and corporate bank transactions.[187] Moreover, the tax is actually overlapping with the levy on financial institutions, while it was initially supposed to replace it. The initial rate was set at 0.1%, but it was increased first to 0.2% (0.3% for cash withdrawal) and later to 0.3% (0.6% for cash withdrawals). The ceiling set to HUF 6000 per transaction was later abolished only for cash withdrawals.[188]

Not surprisingly, the costs of this tax were in practice shifted from banks to customers by increasing certain service costs. This is the reason why a new amendment to the law applied on November 2013 attempts to limit this phenomenon by making individuals entitled to two free, cash-withdrawals per month (on which banks are paying FTT) up to a total of HUF 150000. The amendment is applicable from February 2014.[189] At the sector level the regulation is expected to cause HUF 36-40 billion (EUR 120-130 million) direct loss in fees. Also, the MNB expressed already in November 2012 its concern on the efficiency and usefulness of this type of levy on the Hungarian economy. It stressed also the fact that it is a practice rare, if not unique, in developed economies and that the longer the period of implementation of such measures, the worse the effects on profitability of the sector and willingness to lend by financial institutions, consequently harming the population or even boosting the black economy.[190]

In general terms, the levy on the financial sector did not affect only financial institutions. It has contributed to depressed credit in the country by reducing banks' profitability, but also adding to uncertainty, possibly even to a greater extent that in all other countries seriously affected by the financial crisis. As already seen in Chapter 2.2, the difficult access to credit remains one of the main weaknesses of the country for foreign investors and also for the population.

On the governmental side, the tenacity in fighting finance, especially banks, has found consistent support among the civil society, whose feeling of resentment against this world is even greater than in the rest of Europe affected by the crisis because of the issue of the mortgages in foreign currency. From this point of view, it is safe to state that Orbán has been able to score several points for the benefit of his cabinet: in this way he managed to obtain a consistent amount of taxes in order to reduce the high debt of the country and to implement popular policies by taxing a sector that is unpopular for many reasons, among which is the high presence of foreign-owned companies. The political debate around the issue is indeed very

[186] European commission, Taxation and customs union, http://ec.europa.eu/taxation_customs/taxation/other_taxes/financial_sector/index_en.html.

[187] MNB, Report on Financial Stability November 2012, box 5., p. 35.

[188] OECD (2014), OECD Economic Surveys. Hungary 2014, box. 1.2, p. 61.

[189] Ibidem.

[190] MNB, Report on Financial Stability November 2012, box 5., p. 35.

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active since the beginning of the Fidesz-led government mandate and has created a great degree of controversy in the country among the political forces opposing the executive power.

Table 4.2. Breakdown of state revenues from taxation of the financial sector (billion HUF)

	2008	2009	2010	2011	2012	2013
Finance	**12.6**	**12.6**	**192.3**	**195.9**	**94.6**	**373.9**
Levy on financial institutions	-	-	182.3	186.5	84.9	139.1
Extra tax on selected financial institutions	12.6	12.6	10.0	9.4	9.7	8.1
FTT (excluding Treasury)	-	-	-	-	-	200.5
Insurance tax	-	-	-	-	-	26.5

*Preliminary budgetary data

Source: OECD (2014), OECD Economic Surveys. Hungary 2014

4.2.2. The current political discussion on banks

If the rhetoric against multinationals has been highly supported by the Prime Minister Viktor Orbán in sectors like retail, energy and telecommunications (see Chapter 3.1), it proved to be even bitterer when it comes to the Hungarian banking sector. The Hungarian online journal *Portfolio.hu* has defined government-banks relations during the year 2013 in the country as "replete with tragicomical and irrational elements",[191] and with reason. Besides the implementation of the Financial Transaction Tax and the will to help foreign currency debtors, apparently a usual move in time preceding political elections, on March 2013 Orbán was openly declaring: "*It is an unhealthy situation that foreigners have such a high degree of ownership in Hungary's banking system. While respecting international treaties and relevant economic norms, we must strive to increase the Hungarian ownership ratio within the Hungarian banking system. The government has a target number - we would like at least 50 percent of the Hungarian banking system to be in Hungarian hands*."[192]

An analysis of this statement actually provides several important elements of the *Fidesz* agenda in relation to the topic, which include: (1) the will to curb foreign influence on the Hungarian banking system through an increase of the Hungarian ownership ratio, meaning (2) acquisitions of mostly foreign owned banks by Hungarian banking groups. Orbán has also un-

[191] Portfolio.hu, 2013 Year in Review: Hungary's crusade against banks, or the last straw that breaks the camel's back, 31 December 2013.

[192] Bloomberg, Hungary wants to curb foreign banks amid EU democracy clash, http://www.bloomberg.com/news/2013-03-12/hungary-threatens-to-take-over-foreign-banks-amid-clash-with-eu.html.

derlined (3) the will to respect international treaties and relevant economic norms while pursuing such objectives, even though it is quite obvious to wonder: how can he do so?

The analysis of the Hungarian banking market has showed how, despite the huge resources and market share detained by OTP bank, among the ten most important banking groups in the country only two can be considered as Hungarian (OTP and MFB), and not even both of them are mostly Hungarian owned. In fact, if OTP can be considered Hungarian because of its management, it has still to be taken into account the fact that its ownership structure presents about 63% foreign assets.[193] These considerations make it almost natural to wonder about the real possibility in economic and financial terms for Hungarian investors to find the resources needed in order to buy foreign subsidiaries. Such acquisitions could then happen most probably only through consistent state help, which would definitely harm competitiveness and break international laws, or through being bought directly by the state. Indeed, already in 2012 Hungary's state-owned development bank MFB bought a stake in Takarekbank, a network of savings co-operatives, from Germany's DZ Bank AG with the purpose of building a network (with the inclusion of the post office and other state institutions) to help ease the country's funding shortage "on a national level".[194]

That being said, it is also true that the damages in the sector brought about by Orbán's decisions through taxation and support to foreign loans borrowers are also helping the realisation of his political agenda in the sector. The aim to minimise the losses reported by banks since 2011 actually meets the objective to shift at least 50% of banks' ownership in the country into Hungarian hands. Indeed, some major groups in the country like Raiffeisen or CIB have expressed that they might consider an exit from the market in Hungary, and they are not the only cases. It follows that it is rather likely that in few years from now Hungary's banking sector could be very different from what we know it to be today.[195] However, until the end of the year 2013 none of the large foreign-owned banks had left the country and the small ones that did so could not be considered to have their main core activities in the country. There was, however, a large number of exits among foreign banks with very low Hungarian participation, even though they could not be considered major foreign actors in the country, such as Italy's Banco Popolare, Germany's WestLB, the English HSBC and the French Credit Agricole.

A different condition, however, is the one faced by the MKB bank, the fourth largest bank in Hungary belonging to the group Bayerische Landesbank, Germany's second biggest state-owned lender. According to Bloomberg, the Hungarian government, in fact, is buying the Hungarian branch of the group, MKB Bank Zrt, for only EUR 55 million, for a company that since 1994 has cost it about EUR 2 billion. The move would be the consequence of a necessity for the company to fulfil a condition of its 2008 bailout and it should be concluded in September 2014. Moreover, as part of the deal, BayernLB will waive EUR 270 million in loans owed by MKB, thus moving "one more step to re-

[193] Portfolio.hu, Overhaul of Hungarian banking sector kicks off - 7 facts about Orbán's dream, December 2013.

[194] Ibidem.

[195] Portfolio.hu, 2013 Year in Review: Hungary's crusade against banks, or the last straw that breaks the camel's back, 31 December 2013.

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solve BayernLB's legacy issues", as declared by the Bavarian Finance Minister Markus Soeder at a conference held in July 2014.[196]

Quite obviously Hungary's purchase of MKB perfectly matches with Prime Minister Viktor Orbán's agenda of having a banking industry at least half locally owned. It follows that the strategy to be pursued in order to achieve such an objective is, as in this case, to buy the Hungarian branch of foreign banking group in order to finally sell it on the market to local investors. Indeed, this is what the Hungarian Economy Minister Mihály Varga said in relation to the sale of MKB to the state: "our aim is to create a stable, strong banking system, in which local ownership may increase gradually and the purchase of MKB Bank is a first step".[197] However, until that moment, which could also be quite hard to be reached considering the financial conditions of the market, the bank will continue to be state-owned, thus harming competition and increasing consistently the state presence in the sector, a presence that was already on a growing path in the last years through asset acquisition in other banks.

Nonetheless, an interesting forecast based on the market's conditions made by the aforementioned journal *Portfolio.hu* shows how, despite the increasing influence of the state in the sector, the objective set by the government in relation to the share of locally owned banks would not be reachable earlier than 2020, or even never. In other words, the objective fixed is perplex in relation to its possibility of success; however, the government is already moving on this path and it is pursuing a specific and active strategy that sees the exploitation of state finances first in line in the acquisition of foreign owned banks.

Moreover, the interest of the government in influencing according to its purposes the sector is not only visible in the fiscal policy implemented and in its increasing presence in the market. There is also a third important cause of distress for the sector in which the government is also playing an important role, which is represented by the programs studied in order to help borrowers in foreign currency. As already analysed in Chapter 2.3, the level of indebtedness in foreign currency and the high reliance on external capital has been one of the major reasons for the downturn not only of the financial sector, but also of the Hungarian economy as a whole, starting from families and corporations to the government itself. For this reason, the following section of the chapter will be devoted to the analysis of this tendency, but with a closer look at its effects on the banking sector and on the relations with the government in this concern.

4.3. The dominance of foreign currencies on banks' funding and lending activities

The *funding structure* of the Magyar banking sector is characterised by a consistent lower level of deposits in comparison to other CE countries, where it seems that the economic crisis did not affect too much this aspect. However, few deposits coupled with a high

[196] Bloomberg News, BayernLB to Sell MKB Bank to Hungary for $74 Million, http://www.bloomberg.com/news/2014-07-24/bayernlb-to-sell-mkb-bank-to-hungary-for-74-million.html.

[197] Ibidem.

demand for loans, proved by the high loan-to-deposit ratio, have led Hungarian banks to rely consistently on other forms of funding in order to deal with insufficient liquidity. Such forms include wholesale funding and interbank loans, which being often granted among branches of Western European groups brought easy inflow of foreign currency loans in the system in order to provide for the lack of domestic savings of the market that, even if larger than in other similar economies, was evidently less profitable under this point of view. The practice was later undertaken also by local baking groups and soon became common in the country.

The high reliance on foreign funding is still a big issue in the system. It has historical roots, but it is still extensively affecting the country nowadays, especially because it cannot contribute to the creation of the same degree of stability and liquidity provided by deposits. Moreover, quite obviously, funding in foreign currencies also had important repercussions on the lending activities of the banks, whose loanbooks were dominated, and to a certain extent still are dominated, by *loans in foreign currencies*, mainly the Swiss Franc and Euro. On a positive note, market analysis asserts the growing incidence of local currency lending in opposition to an FX loan stock which is gradually melting away, even though 55% of total loans were denominated in FX in 2012.[198] In absolute terms, FX loans in Hungary amounted to around EUR 37,348 million and decreased to 27,401 million in 2012.

In any case, since the time of liberalization of FX loans in Hungary in the 90s, such lending activities have never had consistent repercussions on borrowers and the banking sector as after the outbreak of the economic crisis. Indeed, before that moment and the massive depreciation of the Forint, FX loans did help extensively in banks reaching their high levels of profitability, but also had positive effects on growth, more than anything on investments. Interesting research carried out on this matter and published this year by Marianna Endrész and Péter Harasztosi actually investigates the impact of foreign currency lending on real investment before and after the crisis, and answers the question of whether the investment performance of the Hungarian firms would have been lower in the absence of foreign lending. It turned out that before the crisis FX lending increased investment rates by a significant amount, more than 10 percentage points. However, at the end of 2008, firms with FX loans had an investment rate 4-5 percentage points lower than would have been in the absence of FX debt, and the impact of FX lending was even stronger for more liquidity constrained firms, both in the pre- and the post-crisis periods.[199]

In other words, if corporations benefited in the pre-crisis period of FX loans granted at a low interest rate in order to carry out their investment activities (Figure 4.6.), thus boosting economic growth, after the crisis and consequent depreciation of the Forint (Figure 4.7), this practice had serious negative effects on investment activities in the country, also increasing the non-performing loan ratio. Moreover, also consumption was reduced consistently in the household segment, given the loss in families' purchasing power.

Moreover, the serious appreciation in the last years of the Swiss Franc, and to a lesser extent of the Euro, against the Forint not only reduced significantly the possibility for borrowers to pay back their loans, but it also increased the disdaining feelings against financial

[198] Raiffeisen Research, CEE Banking Sector Report Banking Sector Report May 2013, p. 34.

[199] Endrész Marianna, Harasztosi Péter, Corporate Foreign Currency Borrowing and Investment. The Case of Hungary, in "MNB working paper 1, 2014".

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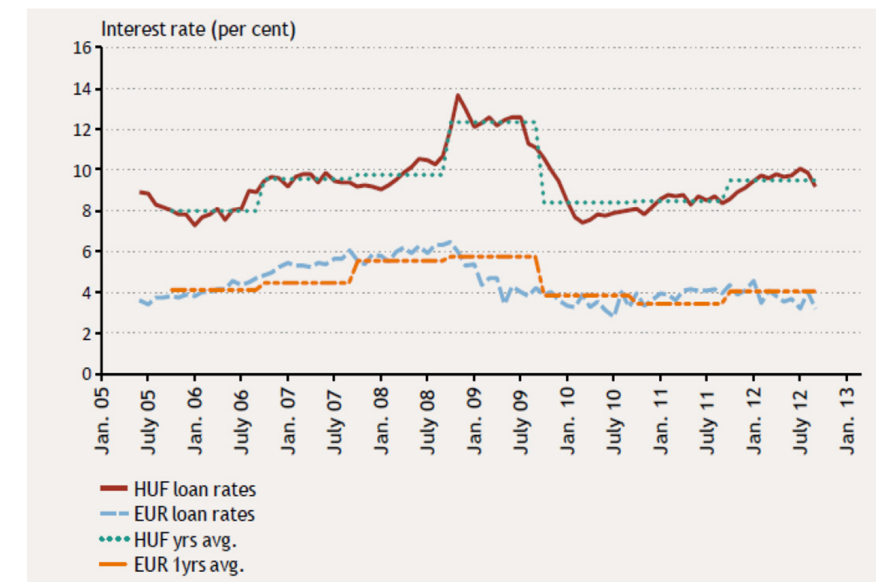
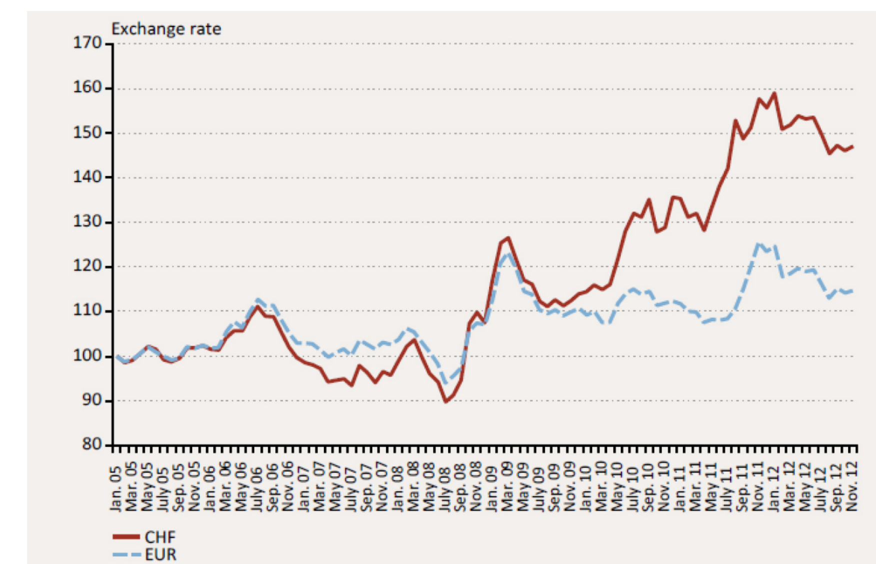
institutions from the side of borrowers. Indeed, such feelings spread among the population since loans in foreign currencies were extensively advertised by commercial banks while failing to provide the needed information about the risks connected with the possibility of currency fluctuations. The practice became so common that in 2011 every third Hungarian family serviced a loan denominated in foreign currency. However, given the extent of the phenomenon, the warning role that political institutions should have played in this concern, especially when the practice started to become very influential, did not occur at the right time, despite the warning remarks by the Hungarian Central Bank.

Figure 4.5. Actual lending rates of Hungarian banks by currency of loan



Source: MNB working papers

Figure 4.6. The depreciation of HUF against CHF and EUR (January 2005=100)



Source: MNB, working papers

Nonetheless, if no intervention occurred before the crisis, the state did not miss the opportunity to intervene once things were already going wrong. Since no regulation was com-

ing from banks themselves – both the costs of fluctuations of the exchange rate and the interest rate were in borrowers hands – or from any other kind of regulatory control, the state decided to step in. The Orbán government, whose pro-growth objectives were in contrast with low investment and consumption levels, undertook different programs in order to alleviate the burden of FX loans consequences on households' shoulders. The following section will provide a general overview of these programs and their effectiveness.

4.3.1. Government FX loans' repayment schemes and programs since 2011

The early FX mortgage repayment scheme that allowed the possibility of early repayment of loans in foreign currencies at stipulated favourable exchange rates was implemented by the government in October 2011. This program was open for five months until February 2012 and provided the chance to borrowers to repay 170,000 loan contracts denominated in foreign currency,[200] corresponding to the higher-than-expected participation of 24.1 percent as a proportion of total outstanding loans. By the closing of the early repayment program, households had repaid foreign currency denominated loans amounting to approximately HUF 1,350 billion at market value. In particular, Swiss franc debtors (with 96% of the repaid loans) accounted for the highest proportion of those who seized the opportunity of early repayment.[201] This repayment increased extensively households deleveraging and also entailed losses in the banking sector equal to the difference between the amount of repaid loans at fixed exchange rate and the amount at market rate, which means HUF 333.6 billion for banks and HUF 370 billion for total credit institutions.[202] In only the first three months of the program the banking sector was reporting an annualized RoE of -50%. The sources of repayment of such households loans were mainly bank deposits and securities (about HUF 600 billion) but also new borrowings in local currency were granted to serve the purpose for an amount of HUF 310 billion.[203]

The measures undertaken by the Hungarian government in order to improve the situation of households with foreign currency-denominated loans did not stop the early repayment program. Some of these measures were also defined within the framework of the agreement signed on the 15th of December 2011 between the government and the Hungarian Banks Association. The agreement was an achievement, if only due to the mere fact that the government and banks decided to put aside their contentions to seek a compromise. However, part of the content of the agreement has not been followed by the government in relation to the stated reduction by 50% of the levy on banks in 2013 and its cancellation in 2014.[204]

The program included measures such as: the conversion of default borrowers' mortgage loans that were more than 90 days overdue on 30 September 2011 from foreign currency-denominated (CHF, EUR and JPY) to forint-based loans; the reduction of payments of foreign currency borrower's obligations reduced for a temporary period of up to 60 months, in which borrowers repay the foreign currency-based mortgage loan at a fixed exchange rate (HUF/CHF 180, HUF/EUR 250 HUF/JPY 2.5), while the difference between the fixed exchange rate and the actual exchange rate is only paid after the grace period has expired.[205] As set by the agreement with banks, this burden on financial institutions would have been lighten by the agreed reduction on the bank levy to be paid for the year under focus (e.g. 30% reduction on the amount to be paid in 2012 to reduce losses resulting from loans paid back at a fixed exchange rate).

The results of these programs are obviously not available yet, but data about the first results of the *Exchange rate cap scheme,* according to MNB data as of the end of December, saw the number of contracts concluded amounting to 173,144, representing 32% of those eligible. Therefore participants in the scheme were relieved of HUF 26.3 billion in interest. The interest difference is shared on a fifty-fifty basis by the banking sector and the state.

To conclude, it is clear that the Orbàn's government has put great effort into the issue, and it is continuing doing it in its new mandate, as shown by the public statement made by the National Economy Minister Mihály Varga on the 7th of July 2014, according to which "All foreign-currency denominated loans would be eliminated from the Hungarian lending market by converting them to forint loans by the end of 2014".[206] The issue of FX loans is then not over yet, but what is visible in relation to the issue is that the government and banks have tried to cooperate in order to solve the issue, as the agreement between the banks' association and the executive power showed to a certain extent. Common points were not always achieved, but this is however a good sign of improvements of the relations among the actors. If something is very much needed in this regard it is indeed a greater level of collaborations among banks and the government, which does not mean that banks should be favoured in comparison to other corporations, but that good solutions to sustain growth by supporting lending activities should also be studied and implemented. In this regard, the *Funding for Growth Scheme* of the MNB has proved to be once again a good example, since it allowed the support of the segment of the corporate sector more in need, but also increased the lending activities for banks, thus actually promoting economic growth.

4.4. Was it really worth it?

To briefly summarise what has been stated in this chapter in relation to the banking sector, it can be said that the economic crisis for the Hungarian banks mainly meant diminished capacity for borrowers to pay back loans, thus deteriorating the quality of the portfolio; difficult access to funding (interbank and wholesale markets vulnerable); and, punitive mea-

200 Deloitte (2012), The Banking Sector in Central Europe - Performance Overview, Deloitte Center for Financial Services in Central Europe.

201 MNB, Report on Financial stability April 2012, p. 34.

202 MNB, Early repayment statistics, https://felugyelet.mnb.hu/data/cms2323218/full_repayment_data_120312.xls.

203 MNB, Report on Financial stability April 2012, p. 35.

204 Ibidem, p. 49.

205 CIB sustainability report 2012, p. 12.

206 Budapest Business Journal, No FX loans by year's end, http://www.bbj.hu/economy/varga-no-fx-loans-by-years-end_82044.

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sures taken by the state, which have been heavier in Hungary than elsewhere and reduced consistently the profitability of the sector. In particular, after analysing the difficult relations between the banking sector and the government in the last four years it seems legitimate to ask the following questions: has it been profitable for the government to pursue this strategy? In general terms, did the Hungarian economy actually gain from it or did it suffer instead? In other words, was it really worth it?

Certainly, to provide a satisfying answer to these questions many factors should be taken into account, both directly and indirectly, anyway it is possible to draw some general lines at least in relation to the most important and direct consequences that these measures caused or could lead to in the future. Regarding the effects on the state deficit of the bank levy, it is quite clear how the taxes (amounting to at least 1% of the GDP in the last years) have proved to be an efficient and quick solution to reduce the persistent budget deficits that finally stopped exceeding 3% of the GDP limit set by the EU. In addition, the political benefits that Orbán could have gained in this game in terms of public support are worth mentioning once again.

Nonetheless, there are also some direct drawbacks for the banking sector and indirect ones for the whole economy that should also be taken into account. The analysis made by Deloitte in 2012 in this concern sets four major possible negative consequences brought about by persistent negative regulation. They include:[207]

1. Lower net earnings for banks translating directly into lower potential growth rates as they accumulate equity at a lower rate, and vanishing equity is also increasing the risk of deleveraging with all the negative repercussions that it involves;
2. Diminished capacity to lend is already a reality in the country, but it could evolve on a negative path, leading to outcomes such as the exclusion of certain groups of customers and the discouragement of financial intermediation;
3. The low level of profitability will have serious consequences on the ability of banks to bolster their Capital Adequacy Ratios, which is a vital factor for weaker banks in period of uncertainty in order to protect depositors and promote the stability of the system;
4. The inferior profitability reduces the keenness of investors to supply capital, with all the negative consequences that involves in the future development of the sector.

Looking at the estimation for the current year of the banking sector performances, according to the survey carried out by the MNB on the nine major banks in the country, some of the points just presented are already having their effects on banks' activities. For instance, as specified in point 2, the capacity of lending is indeed decreased to an extent that many banks have stated their resilience to lending in other segments of the demand market other than SMEs (which are supported by the FGS), while the retail segment will be the one most hit in this sense in 2014.[208]

Moreover, if taxation on banks could be a solution to discourage further growth in those Western economies where this sector expanded too far, often with consistent state help, this is probably not the right choice in Central and Eastern Europe where peer economies have efficient and growing banking systems with a much greater ability to support activities for the sustainable economic growth of the country. That being said, it is also true that four years have passed since the implementation of such measures on the banking sector and the country seems to be going forward on the path to economic growth rather than the opposite - even if often to the detriment of the values of democracy and checks and balances in the country. The economic growth of the country based on the raised competitiveness of local SMEs remains one of the key objectives of the government, which to a certain extent is starting to have its effects. Probably the Hungarian economy will stop relying extensively on the domination of MNCs and the unorthodox methods will turn out to be a better tool than the measures promoted by the Troika in the last years. Possibly they will start to be the "orthodox" way to economic growth also in the European environment, which is between the need for growth and high unemployment rates. It is however too early to understand if the improving results of the last year of the Hungarian economy, modest in extent but positive, will prove to be sustainable or not. Definitely, a more flexible approach based on economic results more than ideology would be needed, as evidenced by the stubbornness of the measures against banks that keep continuing for the fourth consecutive year and for the time being are not expected to alleviate, despite negative consequences for the Hungarian economy that are visible to many. In any case, the economic results of the second consecutive *Fidesz* mandate will probably provide an answer to this query.

[207] Deloitte (2012), The Banking Sector in Central Europe - Performance Overview, Deloitte Center for Financial Services in Central Europe, p. 52.

[208] MNB, Financial Stability Report May 2014, p. 63.

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Conclusions

Talking about the Viktor Orbán government started in 2010 is not an easy task for many reasons and when it comes to its relations with the MNCs and foreign investments in the country, if possible, it becomes somehow harder. The figure of the Prime Minister seems to take on an aura of "duality", verified by the harsh criticisms collected abroad contrasted by the strong support on a national level proved by the stunning results of the 2014 political elections. Indeed, a sort of duality seems to be present also in relation to the economic policies implemented towards foreign investors in the country.

Looking at the results, in many circumstances the image created and "sold" abroad, as well as in the political campaign activities carried out, has proved to only partially meet the facts. This is the case of the rhetoric against multinationals, which was strictly applied in specific economic sectors, but was avoided in those fields where FDI could have represented an efficient solution to the country's problems, such as the low level of employment or the need to keep in equilibrium the balance of payments.

The substance of the windfall taxes against the energy, retail, telecommunication and financial sector is the most outstanding evidence of this rhetoric. The government has obtained through this move from 2010 to 2012 about HUF 1023.7 billion (about EUR 3.32 billion) and according to forecasts this amount would be doubled in 2013 and 2014 (together) because of the stunning increase of taxation on the financial sector, especially banks. Only in 2013 the windfall taxes have raised 1.8 percentage points of the total GDP of the country, turning out to be a powerful tool in order to reduce the public deficit. However, as reported in Chapter 3, this attitude towards MNCs has not been applied when it comes to vertical FDI projects, usually of large dimensions, which are very export oriented and demanding for the local workforce. It is not a case that exports in the country are led by the automotive industry (Chapter 2) and that the major agreements (including disbursement of a consistent amount of state incentives) have been signed in this field, although the expected results, especially in terms of job creation, have not occurred yet.

Indeed, if the analysis of the investment promotion policies offered by the country do not say much in terms of the governmental attitude towards foreign investors – being structured within the framework of the European legislation in this regard – the agreement personally signed by the Prime Minister and the relations carried out with Chinese, Russian, and German investors do say much more about the extent to which the rhetoric against multinationals has been applied in the last four years.

The duality and selectivity of the policies towards foreign investors, which found in the choice of the sector and in the dimension of the company to be taxed important tricks in order to protect local companies at the expenses of the "discriminated" multinationals, coupled with the image of the country presented in foreign media, certainly had an impact

on the competitiveness of the country in an international context. In fact, among the different ways in which a government can influence the competitiveness of a country analysed in Chapter 1, Orbán's policies are definitely having a great influence on many of them, starting from the political regime and the deterioration of the rule of law contested in the European environment. However, if such a relation is not easily outlined in numerical terms, important tools, such the *Global Competitiveness Index*, provide the chance to find measurable data of the influence of the government on the competitiveness of the country. Indeed, several weaknesses of the Hungarian economy in this concern are very much related to the activity of the executive, such as the low predictability of policies and the poorly perceived political and legal institutions' quality. In other cases, the results are satisfying, for instance, when it comes to the macroeconomic outlook of the country. In addition, in many cases, these improvements are more the results of one-off items than real sustainable positive changes of the economic conditions of the country.

Moreover, besides considerations regarding the institutional quality, in certain circumstances the economic moves of the government reported negative effects on Hungary's competitiveness, for instance, when it comes to the difficult access to credit experienced after the crisis. Definitely, the government is not the only actor to be blamed for this outcome, but the consistent amount of taxes, turning banks' profitability to negative results, played an important role in their lending capabilities. Such a problem has been partially addressed through the implementation of the *Funding for Growth Scheme*, but only in relation to corporate lending, while private lending still has not improved substantially.

As far as the inflow of FDI is concerned, as analysed in Chapter 2, the downturn experienced after 2008 is only partially on the path of recovery. The positive data published reporting a stunning increase of the inflow in 2012 is in fact the result of a substantial increase of the capital in transit in the country in the last years. Moreover, this result is even more restrained when subtracting the consistent inflow of FDI over the last years in the financial sector, increased substantially in order to recapitalise the losses of the foreign-owned banking groups settled in the country. It follows that the positive signals regarding the inflow of FDI are in actuality much less consistent than what has been presented in the last two years. The net inflow in the real economy is in the end positive (when considering also FDI in the banking sector), but the slight improvements are still very far from the pre-crisis levels.

The hand of the government is indeed much more visible when it comes to the analysis of the Hungarian banking sector performances. The case study reported in Chapter 4 reveals how serious the condition of the sector is in Hungary in comparison to its peer economies, a condition that is not even reporting signs of significant improvements in the near future. The profitability levels of the sector turned negative in 2011, after the implementation of the windfall taxes in 2010, and continued on this path also in the following years. That being said, taxation cannot be blamed as the only source of the problem, even though, if not eliminated, it should be reduced as soon as possible in order to boost growth and facilitate lending policies in the country. Hungarian banks are currently paying the price of their abused lending policies in foreign currencies of the last years. In this regard, the intervention and commitment of the state to solve a problem that is seriously affecting Hungarian citizens, with all the negative consequences that this fact entails, is a positive thing, even though it is

probably arriving too late and supports the wrong purposes (the issue has become particularly sensitive especially during the run towards elections). Definitely, more state intervention and control should have been put in place earlier, also during the previous socialist governments. Moreover, Hungarian banks still have consistent work in terms of efficiency to be done, at least to reach the levels of the banking systems of neighbouring economies.

To conclude, in general terms, it seems that the "authoritarian turn" of the Orbán government is affecting the country in terms of its competitiveness and image presented abroad. Moreover, the public feature of the measures implemented against multinationals in certain economic sector is also playing a consistent role in attracting investment regardless of the real destination of the investment itself. This fact should probably let the executive power think more about the costs of the sought national sovereignty that in any case can be pursued only to a very limited extent considering Hungary's membership in several IGOs and, more than anything, the EU. Orbán should pay even more attention to this factor, especially considering that in certain circumstances the "unorthodox measures" did report satisfying results for the Hungarian economy, more than the austerity burdening citizens would have done, at least in the short run. In any case, there is a recognised need for a better balance between respect for democracy and pursued economic objectives, between domestic and external factors, between populist choices and growth-friendly economic policies and therefore between short term results and sustainable growth, as well as between many other aspects of "duality" defining the Hungarian Prime Minister and the Executive. The next four years of government still in *Fidesz*'s hands will probably provide an answer to these problems. The question is: what path will the government choose to follow? It could pursue the strategy of legitimating its figure abroad, but the releases of the Prime Minister himself from end-July 2014 already show the potential tendency of the government. Indeed, according to Orbán's words "*the era of liberal democracies is over*" and the foreign influence in the country will be formally controlled and opposed by a parliamentary committee set for this purpose.[209] In Orbán's view, Russia, China and Turkey are the successful examples to be followed of the new type of illiberal states based on national foundations.[210] In other words, the path chosen by the new government seems already quite clear. At this point, doubts are related more to the real implementation of this strategy, as in the case of the rhetoric against multinationals, and to its feasibility, especially taking into account possible negative reactions at the European institutional level and within the international community. Nonetheless, certain conditions – like the weakness of the opposition, the strength of the extremist party *Jobbik*, which needs to be counterbalanced on the right side of the political spectrum, and the large majority the *Fidesz* has gained also during this mandate – have already provided to the government consistent freedom of movement within the country's borders, thus likely undermining the need for a turn towards international recognition.

209 The Budapest Beacon, Viktor Orban: "The era of liberal democracies is over", http://budapestbeacon.com/politics/viktor-orban-era-liberal-democracies/.

210 The New York Times, A Test for the European Union, http://www.nytimes.com/2014/08/02/opinion/a-test-for-the-european-union.html?_r=0.

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List of useful websites

Audi Hungaria, https://audi.hu/en

Budapest Business journal, http://www.bbj.hu/

CIB Bank, http://www.cib.hu/index?defaultLanguage=english

CzechInvest, http://www.czechinvest.org/en.

Emerging Europe Blog, The Wall Street Journal, http://blogs.wsj.com/emergingeurope/.

Eurostat statistics, http://epp.eurostat.ec.europa.eu/portal/page/portal/statistics/themes.

HITA – Hungarian Investment and Trade Agency, http://www.hita.hu/.

International Monetary Fund, www.imf.org/.

Ministero degli Affari Esteri, Diplomazia Economica Italiana, Info Mercati Esteri, quadro economico, http://www.infomercatiesteri.it/quadro_macroeconomico.php?id_paesi=97.

OECD Economic outlook: statistics and projections, http://www.oecd-ilibrary.org/economics/data/oecd-economic-outlook-statistics-and-projections_eo-data-en.

Portfolio.hu, www.portfolio.hu/en.

Reuters, http://www.reuters.com/.

Sario – Slovak Investment and Trade Development Agency, http://www.sario.sk/en.

PwC, investing in Hungary, http://www.pwc.com/hu/en/publications/investing-in-hungary/index.jhtml.

Vienna institute for International Economic Studies, http://www.wiiw.ac.at/.

World Bank Doing business, Hungary, http://www.doingbusiness.org/data/exploreeconomies/hungary.

World Economic Forum, http://www.weforum.org/.

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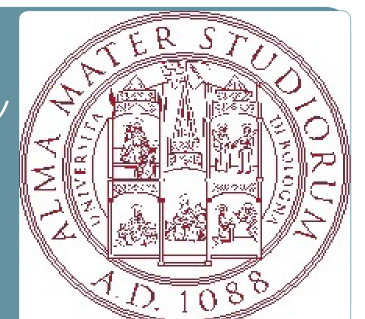

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