INTERNATIONAL RELATIONS

FOREIGN ECONOMIC RELATIONS

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The past of foreign economic relations

From the Middle Ages to the end of the Austro-Hungarian Monarchy

In the Middle Ages and early Modern Times, long-distance trade with foreign countries was limited to exports of small, high-value commodities (salt, wine, gold, silver and copper), due to poor transport conditions. Driven cattle became the main export of Hungary in the 15th and 16th centuries, finding buyers mainly in the cities of Austria, Moravia, southern Germany and northern Italy. Long-distance trade to Hungary primarily involved the importation of textiles, spices, silk, passementerie, metal and glassware.

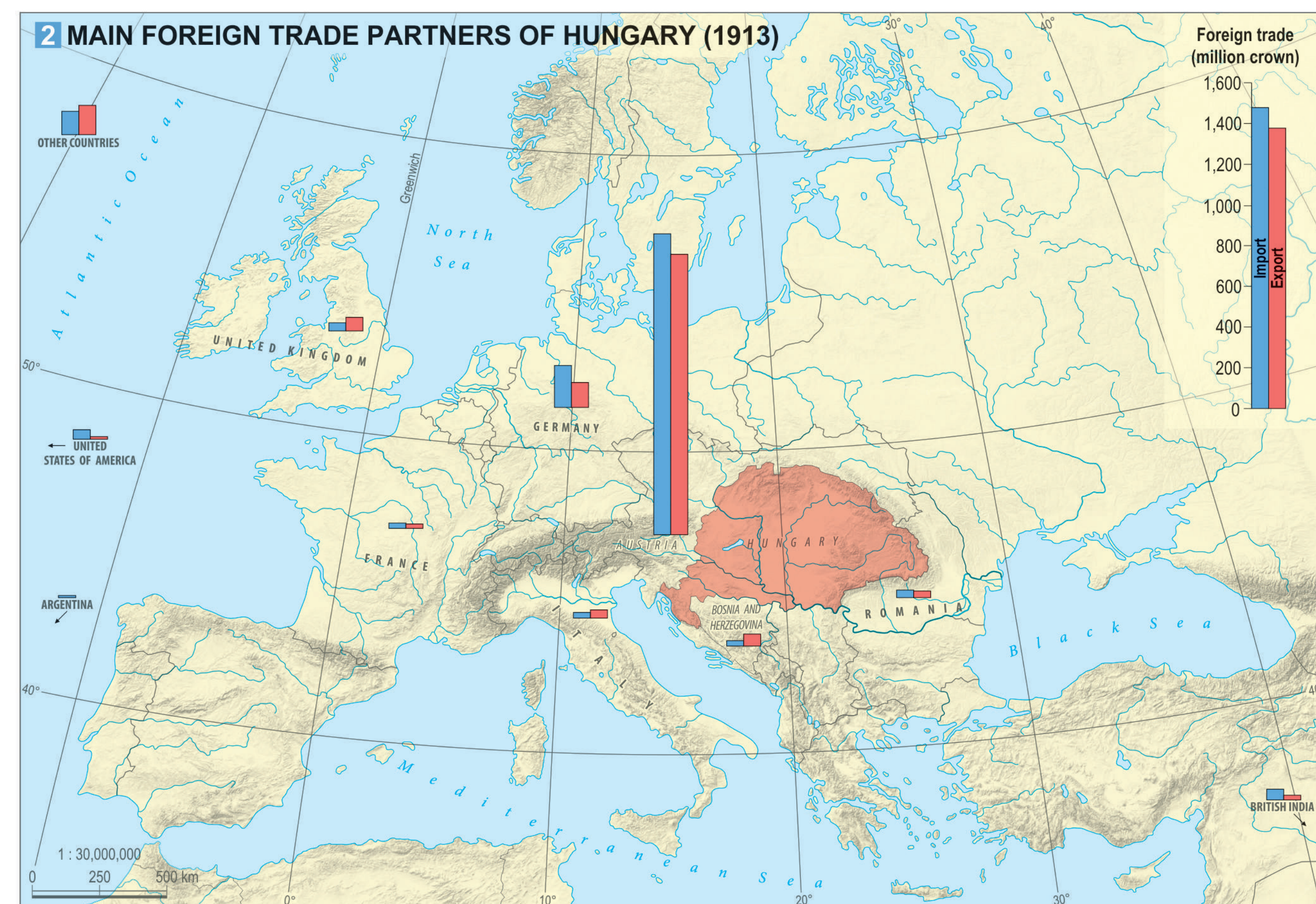
Foreign trade in these centuries was particularly hampered by logistical, geopolitical and market factors: the lack of river regulation and navigable canals, impassable roads in long periods of the year, low-capacity and slow transport vehicles; constant warfare, a century and a half of Ottoman occupation of large parts of Hungary; the shift of the main trade routes to the Atlantic coast as well as the hectic price fluctuations of agricultural products bound for export.

Regular shipping on major rivers and canals made it possible to transport large quantities of crops, live animals and wool over long distances. Besides traditional products, *grain* and then *flour* became the most important *export products* of the Kingdom of Hungary from the mid-19th century. *Two thirds of imports* from the Austrian provinces were *wool, cotton and linen fabrics*, and more than half of imports from third countries were colonial products. In the first third of the 19th century, the share of the *Austrian provinces* in Hungarian exports exceeded 90%, while it was close to 90% in imports.

The internal customs frontier between Austria and Hungary was partially removed on 1 October 1850 and then completely dismantled on 1 July 1851. The *customs union* was maintained by the Austro-Hungarian Compromise of 1867, which created a secure internal market of 50 million consumers protected by high external tariffs for the owners of large estates. The so-called mercantile circles of Hungary, however, constantly complained about the competition of Austrian, Czech and Moravian industry, which was more advanced than the Hungarian one. The renewal of the customs union every ten years caused sometimes severe disputes between the Austrian and Hungarian governments, but in the end the customs union with the common central bank and currency remained in place for the entire duration of the Dual Monarchy. The share of agricultural commodities in Hungarian exports fell from 90% to 64–65% by the end of the dualism era, as the proportion of manufactured goods increased, mainly due to the rise in exports of food products. Industrial finished products (mostly textiles) still prevailed in imports. Three quarters of foreign trade continued to take place with the countries of the *Monarchy*. *Germany* ranked first in trade with countries outside the Austro-Hungarian customs zone.

1 HUNGARIAN WHEAT AND FLOUR EXPORTS (1882–1913, %)

Period	Wheat exports		Flour exports	
	Austria	Markets outside the unified customs area	Austria	Markets outside the unified customs area
1882–1886	77.4	22.6	59.5	40.5
1912–1913	99.6	0.4	95.8	4.2



2 MAIN FOREIGN TRADE PARTNERS OF HUNGARY (1913)

From the 1870s onwards, the major grain-exporting countries (United States, British India, Russia) returned to the European markets after settling their conflicts, which meant that Hungarian grain was largely pushed out of Western Europe XI. 2. 1..

Foreign capital played an important role in the modernization of Hungary, in the creation of its infrastructure and manufacturing industry, mainly coming to the country through the subscription of Hungarian securities. Germany accounted for a third of foreign trade with third countries, and by the turn of the 19th and 20th centuries nearly half of foreign capital came from here. Foreigners have been much less active in direct working capital investment.

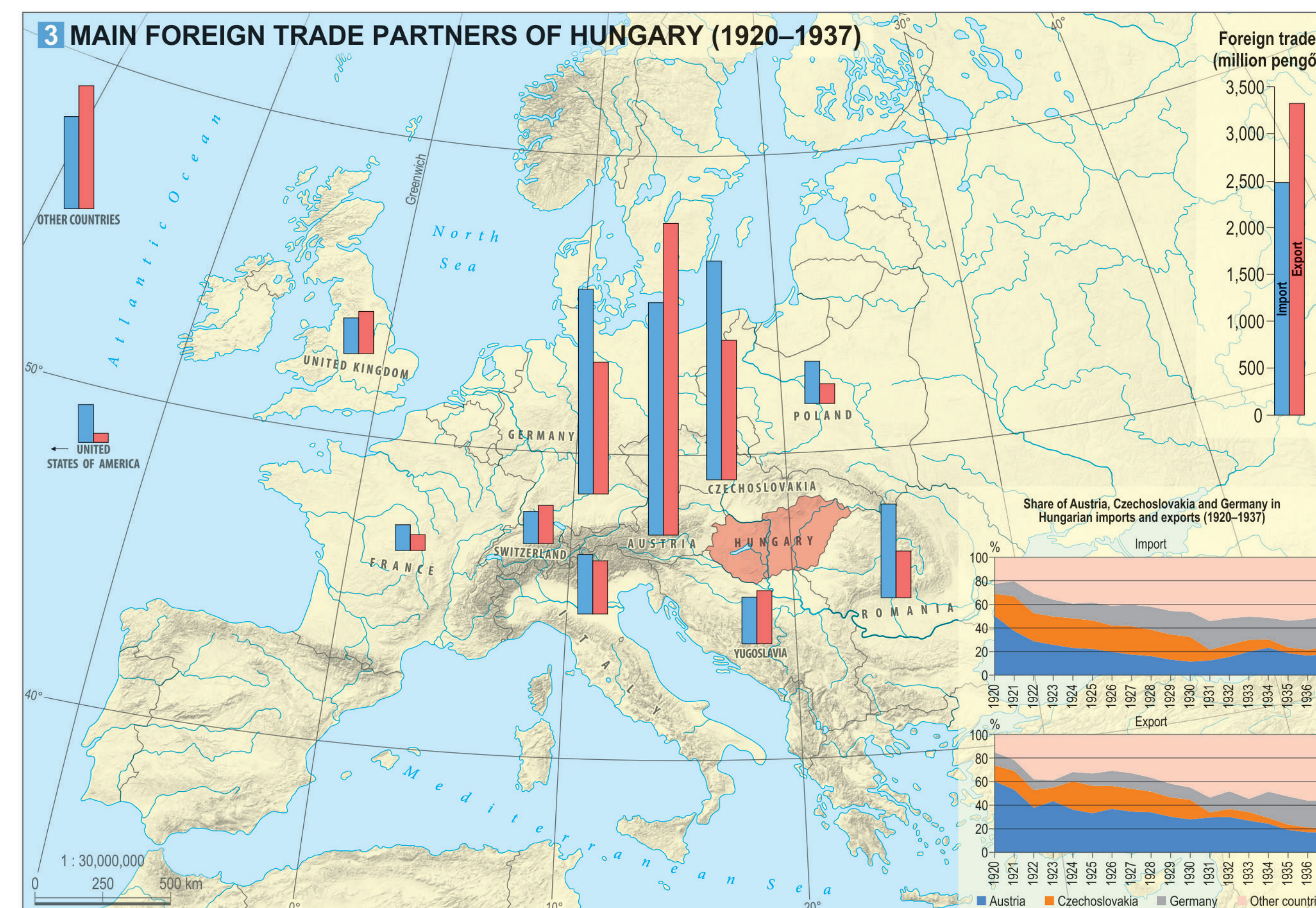
The Hungarian trade balance of goods was in deficit for two decades after the Compromise in 1867, but then became generally favourable from 1886 to 1905 (trade surplus). Then, however, there was a deficit until the outbreak of WWI XI. 2. 2.. With the exception of a few years, the balance of payments was in surplus in trade with third countries, but in intra-Monarchy trade it was generally unfavourable, because the deficit in trade in goods was not compensated by other items in the balance of payments.

The Treaty of Trianon and its consequences for trade in goods

After the disintegration of the Monarchy and the partition of the territory of Hungary, foreign trade gained special importance in the national economy of Hungary, which became a country *with an open structure, poor in raw materials and with a small domestic market*.

Before WWI, less than 13% of Hungary's national income on average was generated by trade with countries outside the Austro-Hungarian customs zone. By contrast, Hungary suddenly found itself on the world market in 1920, becoming dependent on foreign trade. As a consequence of the Treaty of Trianon (1920), many basic raw materials, the import of which was (should have been) compensated by exports, were almost entirely or mostly transferred to the successor states. In the interwar period, the Hungarian economy was particularly dependent on *the development of the global economy*. Most exports consisted of *unprocessed agricultural products*, whose terms of trade relative to finished industrial products deteriorated significantly, especially during the years of the Great Depression. The technical level of Hungarian industrial products, the international competitiveness of the Hungarian economy did not reach the standards of the developed countries of the world. Therefore, and because of the debt service of foreign loans received in the 1920s, the *balance of trade*, and especially the *balance of payments*, was disrupted, which led to the country's indebtedness, and caused a de facto bankruptcy at the height of the Great Depression in 1931. Hungary became insolvent in its external payments.

The autonomous customs tariff, which entered into force on 1 January 1925, provided protection mainly for industrial companies with an average of around 30%. Hungary's most important trading partners remained *Austria* and *Czechoslovakia* in the 1920s. In the first half of the 1920s, these two countries were the main destinations of Hungarian exports and accounted for about half of Hungarian imports. Germany's weight in Hungarian trade increased after 1933 XI. 2. 3.. The expansion of the German Reich, the annexation of Austria and the Czech lands further increased its weight in Hungarian foreign trade to 52–53% by 1938–39. The conquest also affected the enterprises of the annexed countries abroad. Therefore, by the time of WWII, Germany became the owner of about half of the foreign-owned businesses in Hungary. After Hungary had entered a state of war with the United Kingdom and the USA, relations with the Allied Powers were essentially severed. Outside the Axis powers, Hungary only had access to raw materials and finished products from neutral states. The bulk of external trade during this period was carried out with the Axis powers. (Germany, the Protectorate of Bohemia and Moravia as well as Italy accounted for 79.4% of the turnover in 1942. This figure fell to 75.3% in 1943 due to the landing of Allied troops in Italy.) In the interwar period, the Hungarian trade balance was in deficit until 1929, while from 1930 onwards – with the exception of 1940 – it was in surplus. The Hungarian trade surplus accumulated in German–Hungarian foreign trade exceeded one fifth of the Hungarian national income in 1944. In 1943, Germany reduced the claim arising from the Hungarian surplus deliveries by handing over Hungarian securities in Germany's possession worth 35 million pengős.



3 MAIN FOREIGN TRADE PARTNERS OF HUNGARY (1920–1937)

Capital movements in the interwar period

The post-WWI hyperinflation was brought to a halt by the mid-1920s with the help of the stabilization plan of the League of Nations' Finance Committee and the issue of a *rescue loan* on the international monetary market. The *pengő* as the new currency, which replaced the korona, was introduced at the end of 1926, with a parity of 0.2632 grams of gold.

Between 1925 and 1929, the government, banks, municipalities and a few large Hungarian companies borrowed financial loans with a nominal value of around 1 billion pengős on the international financial markets, usually secured by mortgages. After WWI, new investors (United Kingdom, USA, Switzerland, Sweden) replaced the former capital exporters (Austria, Germany, France) in the Hungarian economy. The same countries also excelled in investing in working capital.

Hungary's total *foreign debt* at the end of 1931 amounted to some 4.3 billion pengős, nearly 60% of which was long-term debt. About half of the latter originated before WWI, while the majority of short-term debts arrived in Hungary after the stabilization XI. 2. 4. XI. 2. 5..

At the time of the *Great Depression*, foreign trade was far from generating enough surplus to cover the debt service on the loans that had been borrowed earlier, while the reserves of the central bank were also dangerously depleted. The government therefore imposed *exchange controls* on 16 July 1931 and a *moratorium on transfers* at the end of December 1931. Hungarian debtors transferred their foreign loan repayments to the National Bank of Hungary (MNB) in pengő, while MNB made further transfers, depending on the country's liquidity situation. From 1932 onwards, the government concluded with short-term creditors so-called credit freezing agreements, which were extended year by year. Despite the moratorium on transfers, Hungary's foreign debts fell from 4.3 billion pengős to 2.5 billion pengős by 1937, mainly due to the devaluation of the currencies of the creditor countries. As the country's liquidity situation improved, MNB started to partially pay debt service on foreign loans in 1937. When, in 1941, the state of war was declared between Hungary and the United Kingdom and the United States, its two largest creditors, British and American loan repayments were suspended.

4 FOREIGN DEBT OF HUNGARY AT THE END OF 1931

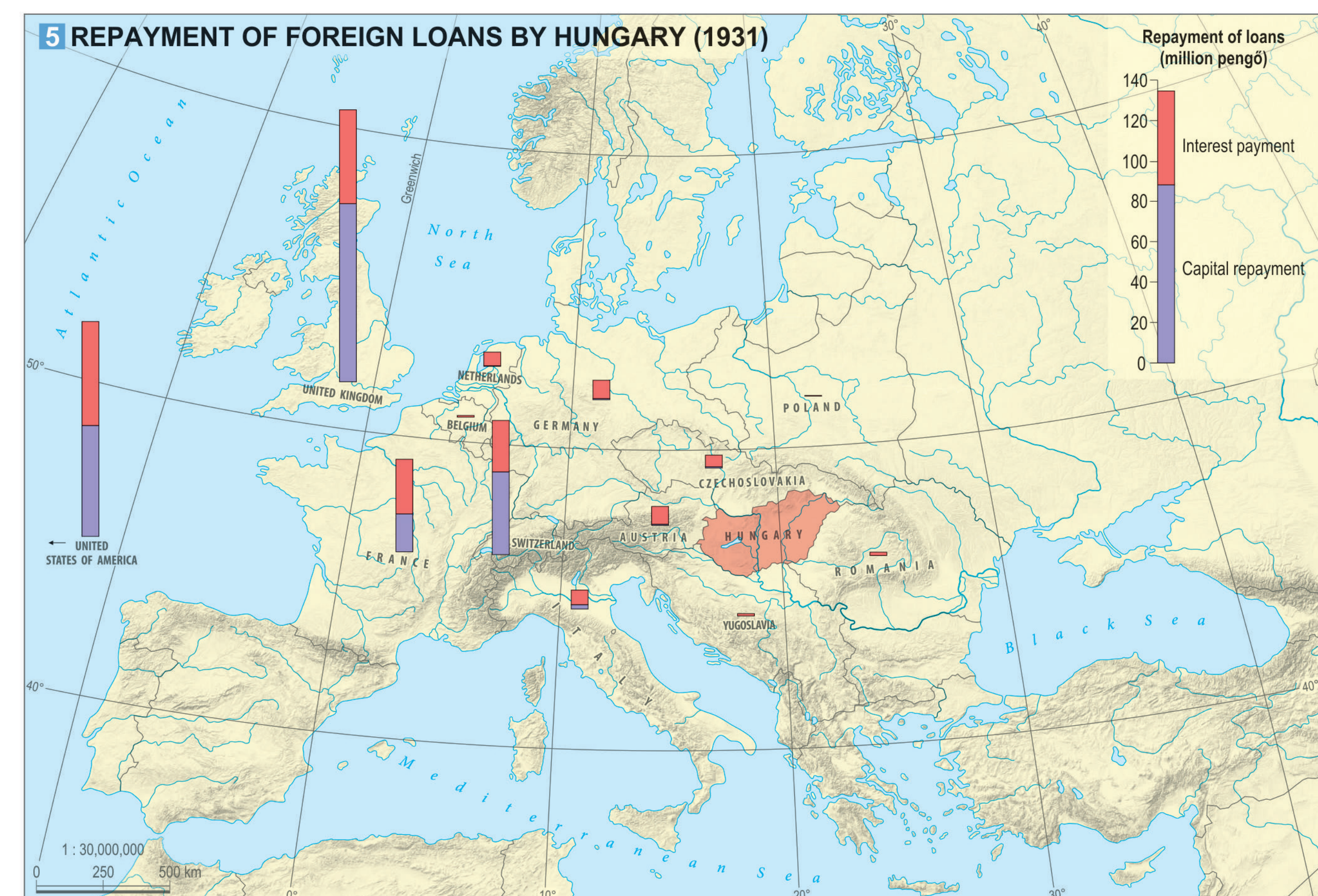
	Long-term	Short-term	Total
	debt (million pengő)		
Government debt	1,251.9	245.7	1,497.6
Non-government public debt	516.1	124.6	640.7
Debt of the National Bank of Hungary		145.1	145.1
Private debt (banks, companies etc.)	702.8	1,322.9	2,025.7
Total foreign debt	***2,470.8***	***1,838.3***	***4,309.1***

In order to increase exports, many countries abandoned the gold standard in the 1930s and devalued their currencies, some of them several times. Hungary did not officially change the parity of the pengő, because devaluation would have meant the revaluation of its large debts. Instead, it used a premium on exchange (agio) from 1932.

During the Great Depression, many countries signed *barter trade and clearing agreements* that eliminated cash payments. Hungary concluded bilateral clearing agreements with Austria and Switzerland in 1931 and with Germany in 1932. The balance in bilateral trade was ensured by matching reciprocal deliveries without the circulation of currencies. The clearing system already covered more than two-thirds of foreign trade by 1937–38.

Withdrawal of capital without compensation after 1945

Hungary, devastated by war, could not rely on foreign funds. The only exception was a loan of USD 15.9 million in 1946–47, which could be used to buy redundant US war stocks, such as hundreds of railway locomotives. At the end of WWII, only a small part of the estimated USD 200 million of Hungarian property was repatriated that had been brought to the German Reich. Meanwhile, the Soviet occupiers extracted capital, including entire factories stolen as military booty, on a scale far beyond the country's capacities. The armistice agreement of 1945 obliged Hungary to make *reparations* worth USD 300 million in the form of goods, mainly to the Soviet Union and to a lesser extent to Yugoslavia and Czechoslovakia XI. 2. 6.. The acquisition of Soviet ownership in several Hungarian companies also meant capital withdrawal. Hungary was obliged



5 REPAYMENT OF FOREIGN LOANS BY HUNGARY (1931)

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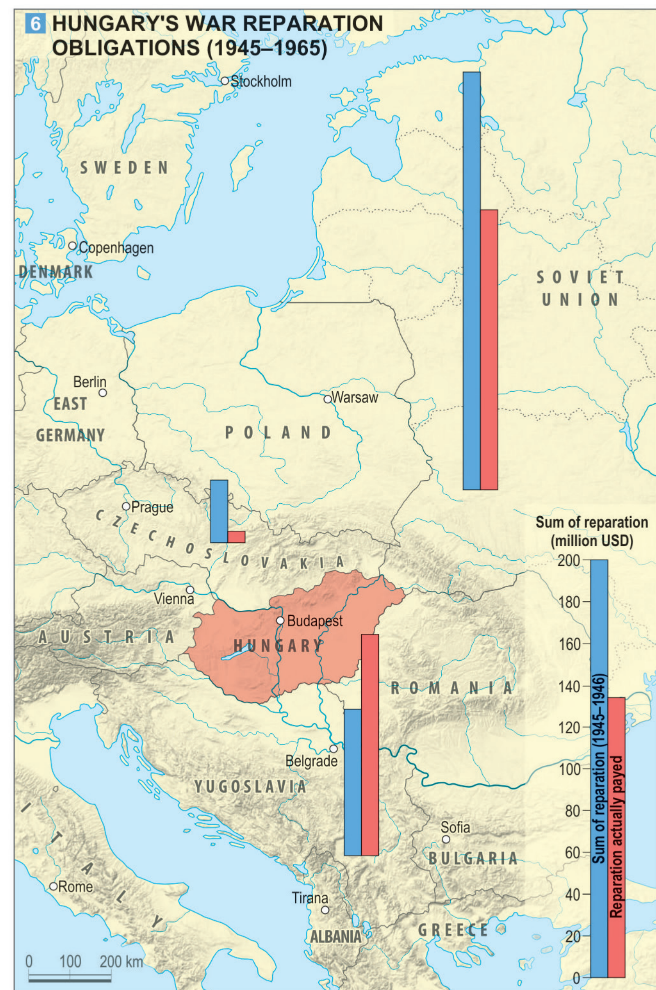


6 HUNGARY'S WAR REPARATION OBLIGATIONS (1945–1965)

to compensate the Western allies for two thirds of the war damage to their property in Hungary in forints. The countries concerned made claims of about 3 billion forints under this heading until autumn 1948, two thirds of which were filed by the USA and United Kingdom. Hungary settled this debt later in the framework of global compensation agreements with the Western powers.

Mainly upon the demand of the USA, Hungary was forced in the Paris Peace Treaty of 1947 to renounce its claim of 2 billion reichsmarks that had been accumulated in its trade with Germany during WWII. The sum lost in this way exceeded one fifth of the Hungarian national income in 1944. *German property in Hungary* (or that classified as such) *was assigned to the property of the Soviet Union* as war reparations under the Potsdam Agreement. These companies used a part of their profits in Hungary and transferred 675.3 million forints. Hungary bought back the Soviet assets between 1947 and 1955. The country settled 999.9 million forints of the 3,965.5 million forints purchase price in cash, 791.3 million forints by delivery of goods, while the Soviet Union waived 2,174.3 million forints.

The Western powers made the establishment of trade relations with Hungary subject to the condition that Hungary would recognize and, repay the loans that had been frozen during the Great Depression and its new debts incurred after the war. The compensation negotiated in the financial and property treaties was gradually settled by cutting out 4 to 9% of Hungarian exports to the country concerned. By the end of March 1967, Hungary had agreed on a total of USD 140.5 million in reparations, most of which (USD 130.9 million) had already been paid. Hungary agreed with Austria, the UK and the USA to settle its debts by 1975.

New orientation in foreign economic relations after World War II

After WWII, there was a major *shift* in *foreign trade flows* in favour of the *countries that later became members of the Eastern Bloc*, above all the Soviet Union. Until the late 1970s, 60 to 70% of foreign trade was carried out with these countries, including 25 to 30% with the Soviet Union. Machinery, equipment and instruments accounted for 50 to 60% of Hungarian exports to the Soviet Union, while 80 to 90% of imports consisted of raw materials. Western imports included so-called 'deficit' raw materials (non-ferrous metals, cotton, leather, fertilisers), machinery and equipment, and until the mid-1960s, to a lesser extent, agricultural products. In return, Hungary exported meat, animal products, light industry articles, chemical raw materials and semi-finished metallurgical products.

Foreign trade gradually became a *state monopoly* from the period of the first three-year plan (1947–1949). Export and import activities were thus basically restricted to state-owned foreign trade enterprises, but only in the range of products defined for them. This system not only isolated manufacturing companies from the impact of foreign markets, but specialization also excluded the possibility of competition between foreign trading companies. Only a few flagship enterprises (e.g. Medicor, MOM, Bábolna State Farm) were granted direct rights to export or import. The number of companies qualified to do so increased significantly after 1980. However, until the end of the state monopoly in 1990, the bulk of external trade was handled by about forty companies specializing in that field.

Price compensations and levies in foreign trade permanently separated external and internal prices. Therefore, Hungarian companies did not directly experience any eventual disadvantages in their international competitiveness. Another basic element of the system was the *monopoly on foreign exchange*. The mechanism of the plan-rule system, as set out above, institutionally separated the domestic and foreign economies. The situation changed gradually only after the introduction of the *economic mechanism reform* (originally intended as a regulated market) announced in the *mid-1960s*. The *openness of the real economy*, the ratio of foreign trade to national income (or GDP), increased significantly. At the same time, the previous restrictions eased only moderately. The lack of institutional openness limited adjustment to the external economy and the orientation function of international competitiveness.

The Council for Mutual Economic Assistance (COMECON)

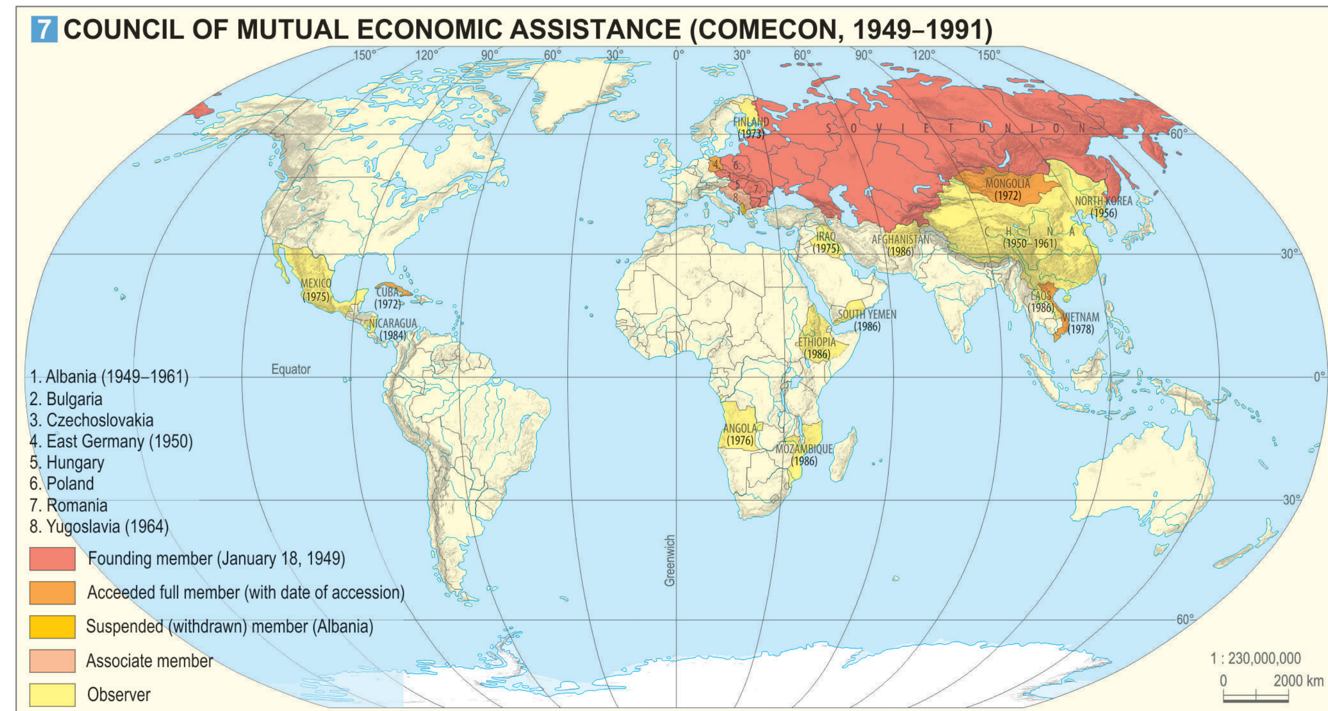
The Council for Mutual Economic Assistance of the countries of the former Eastern Bloc, the *COMECON*, was founded by Bulgaria, Czechoslovakia, Hungary, Poland, Romania and the Soviet Union in Moscow on 18 January 1949. Albania, the German Democratic Republic, Mongolia, Cuba and Vietnam joined later. At certain times, Yugoslavia participated in the work of COMECON as an associate member and a number of other countries as observers XI. 2. 7..

Cooperation between the socialist countries was initially based on annual, later five-year bilateral inter-state trade agreements. Deliveries, which were mostly recorded in natural indicators, were put into concrete terms by foreign trade and production companies in contracts under private law. The prices used to settle accounts among themselves were frozen after 1950. It was decided in 1958 to filter out cyclical fluctuations in the world market, while enforcing permanent price changes in the medium term. From 1975 onwards, the average world market prices of the previous five years were applied every year, which led to a significant deterioration in the terms of trade between the Soviet Union and Hungary, as was also the case in the trade with Western countries. The *International Bank for Economic Cooperation* (IBEC), established in 1964 and the introduction of the *transferable rouble*, were to be responsible for multilateral payments between member states. However, they could not fulfil this function because the different pricing, tax rules, subsidy and deduction systems applied in each country meant that the trade surplus generated in one country could not be used to settle debts with a third one. Despite the many obstacles, 35 to 40% of joint trade was already based on some kind of inter-state spacialization agreement or production cooperation in the 1980s. Specialization progressed mainly in the manufacturing of military products. After the termination of the Soviet–Hungarian joint venture companies in 1954, only very few socialist joint ventures were established.

Structural changes in foreign trade, deteriorating terms of trade from the 1970s

The trade volume with the COMECON countries declined from the second half of the 1970s, while economic efficiency and the terms of trade were deteriorating. The share of COMECON countries in Hungarian imports fell from 64.8% in 1967 to 48% in 1981 and in exports from 65.1% to 54.4%. Moreover, the composition of trade also worsened for Hungary. The Soviet Union announced that it was ready to supply additional quantities of raw materials and energy carriers, which were the most important for Hungary, only in exchange for a contribution to investment. In the mid-1970s, 11–14% of Hungarian exports to COMECON countries were in convertible currencies, accounting for 15% of total dollar receipts in 1976 and more than 18% in 1977.

The distribution of foreign trade *by country groups* changed significantly by the time of the regime change XI. 2. 8.. Until the mid-1970s, with the exception of a few years, the split between socialist and 'capitalist' (i.e. Western) foreign trade was roughly two-thirds to one-third. The Soviet Union accounted for about 30% of the total, while the COMECON members for about 60%. This ratio shifted significantly by the time of the regime change. The share of the former socialist countries of Central and Eastern Europe in Hungarian imports had fallen significantly by 1990, while that of the market economy countries exceeded 63%. The Soviet Union (after its break-up, the successor states) continued to dominate imports of certain products (electricity, oil, natural gas, iron ore, timber, etc.).



7 COUNCIL OF MUTUAL ECONOMIC ASSISTANCE (COMECON, 1949–1991)

8 FOREIGN TRADE ACCORDING TO COUNTRY GROUPS (1981–1990)

Country groups	Import (%)			Export (%)		
	1981	1985	1990	1981	1985	1990
Non-market economies	52.6	55.8	36.9	59.9	60.4	37.7
of which: Eastern European countries	41.5	44.2	27.9	47.8	47.9	28.2
Market economies	47.4	44.2	63.1	40.1	39.6	62.3
of which: developed countries	40.7	39.4	53.2	28.5	29.1	54.2
of which: developing countries	6.7	4.8	9.9	11.6	10.5	8.1
All countries	*100.0*	*100.0*	*100.0*	*100.0*	*100.0*	*100.0*

Similar changes can be observed in *exports*, with the difference that the relative significance of market economy countries – especially the developed ones – was much smaller than in imports in 1981 and 1985. The main reason for the former lies in the unsatisfactory competitiveness and technical quality of Hungarian industrial products at that time. Besides that, the discriminatory measures of the European Communities (import levies, high customs duties) created obstacles to food exports that were difficult to overcome. Due to the disintegration of COMECON and the drastic deterioration in the solvency of the socialist countries in transition, the weight of Hungary's former main trading partners in exports also declined significantly by 1990.

Regarding imports, the share of machinery, vehicles and industrial consumer goods increased, in addition to energy products. This could have been compensated for by semi-finished and material products as well as consumer goods, but they were inadequate for domestic conditions. Therefore, the share of these products increased in Hungarian exports.

A fundamental feature of the performance of a national economy is the evolution of its international competitiveness, which is also indicated by the dynamics of the *terms of trade*, among other factors. From the early 1960s – in line with the world economic conditions of the time – the terms of trade of the Hungarian economy, predominantly exporting medium-quality manufactured products and importing raw materials, improved until 1973 XI. 2. 9.. From autumn 1973, however, profound changes took place in the world economy. Medium-quality industrial products depreciated in international trade, while raw materials, in particular hydrocarbons and high-tech industrial products appreciated. As a result, the turnover-weighted average prices of Hungarian imports rose much faster than export prices, i.e. more and more exports had to be made per unit of imported products. The *terms of trade* of the Hungarian economy *deteriorated* by almost 30%. This process reflected the fundamental structural weaknesses of the economy and led to a dramatic decline in the external balance, with debts growing to an increasingly unmanageable level XI. 2. 10. between 1960 and the mid-1980s.

After WWII, the General Agreement on Tariffs and Trade (GATT) embodied the basic set of rules and standards governing international trade relations based on the principles of a market economy. In Hungary, the *reform of the economic mechanism*, which started in 1968, created the conditions for *accession* to the GATT. The Hungarian *'mechanism reform'* included the development of a new customs policy and tariff regulation. This played a decisive role in enabling Hungary to become a party to GATT in 1973 in the normal way, i.e. by 'paying' for the tariff concessions it had received. (Romania joined in 1968 and Poland in 1971, but they had to commit themselves to a constant quantitative increase in imports in exchange for the most preferential tariff concessions.) Following the accession to GATT, the Hungarian tariff rate was reduced from 34% to 18%. In the negotiations for a *further liberalisation of world trade* (1973–79: Tokyo Round; 1986–1994: Uruguay Round), Hungary was already a fully-fledged participant, including the commitment to further gradual reduction of the average tariff level. After the regime change, with the dissolution of COMECON in 1991, the rules of GATT became the norm for all Hungarian foreign trade. Hungary is one of the founding members of the World Trade Organization (WTO), which replaced GATT and started operating in 1995.

Under pressure from Moscow, Hungary was not allowed to de jure recognise the *European Communities* until 1988. Nevertheless, Hungary was the first among the socialist countries to sign a *comprehensive trade and economic cooperation agreement* with the European Communities in 1987. This accord also included the dismantling of many of the discriminatory measures against Hungary in a short period of time, which was followed by the establishment of diplomatic relations between the parties on 8 August 1988.

Foreign loans, indebtedness

Hungary was only granted long-term loans by the Soviet Union from 1948 until the mid-1960s, but most of them had to be used to purchase weapons and to mine the uranium deposits in the Mecsek Mts in south-western Hungary. The consolidation of the system and the preservation of its solvency were ensured by a 10-year *loan* of about 1.2 billion roubles, equivalent to about 10% of the national income of Hungary at the time, *granted by the socialist countries* in 1957 at 2% interest. The loan, worth around USD 300 million, allowed Hungary to avoid total bankruptcy after the Soviet intervention and communist restoration that crushed the 1956 revolution. Hungary, with its open structure, shortage of raw materials, small domestic market and low international competitiveness, fell systematically into debt after WWII. Until the late 1970s, the most challenging problem of accumulating debt denominated in Western currencies was not its absolute amount and its ratio to national income, but its composition by maturity.

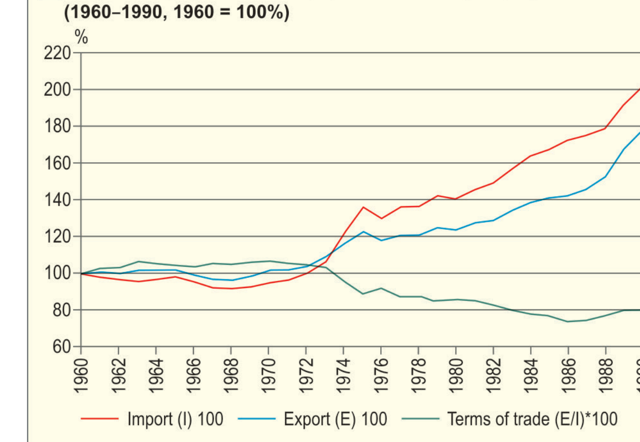
Hungary's economic situation made it indispensable, and the reparation agreements with Western countries made it possible to borrow loans from the latter. In addition to short- and medium-term loans for the purchase of bread grain and fertilisers in the early 1960s, Hungary borrowed medium-term loans from the West to import investment assets for the first time during the second five-year plan (1961–1965).

The first period of accumulating external debt, following the revival of Hungary's broader external trade relations and in parallel with the oil and commodity price shocks, fell between 1973 and 1979. At that time, the political leadership, assuming that the crisis would be a short, temporary period in the world economy, financed the deficit in the balance of payments by borrowing abroad instead of taking restrictive measures. It became clear a few years later that there were enduring changes in the world economy that negatively affected the terms of trade for Hungary.

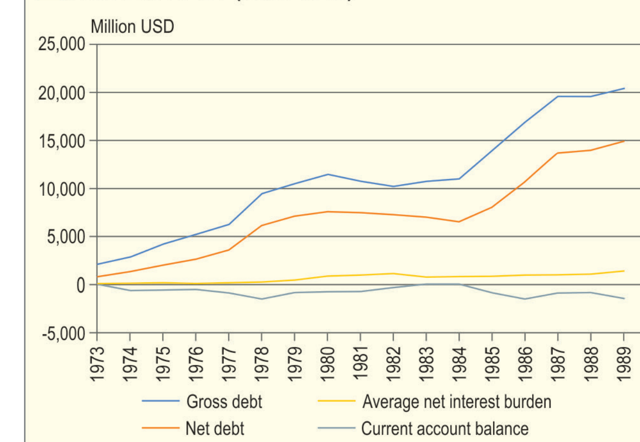
The price of energy and raw materials in general also *rose significantly* in the trade with the Soviet Union. Due to deteriorating terms of trade, and despite export volumes growing much faster than imports XI. 2. 11., Hungary's trade balance remained negative for the entire period after 1973 until the regime change.

Therefore, a *partial shift in economic policy* took place in 1979. The objective of growth was subordinated to restoring equilibrium in the economy. Internal demand was curbed. Consumer price subsidies were reduced with cutbacks in public and corporate investment. Despite protests from the Soviet leadership, Hungary joined the *International Monetary Fund* (IMF) and the *International Bank for Reconstruction and Development* (IBRD) in 1982. The turnaround brought temporary success: the growth of net debt not only stopped between 1980 and 1984, but also fell. *The confidence of international investors returned*, the withdrawal of foreign deposits from the National Bank of Hungary slowed down, allowing *Hungary to gain access to new foreign loans*.

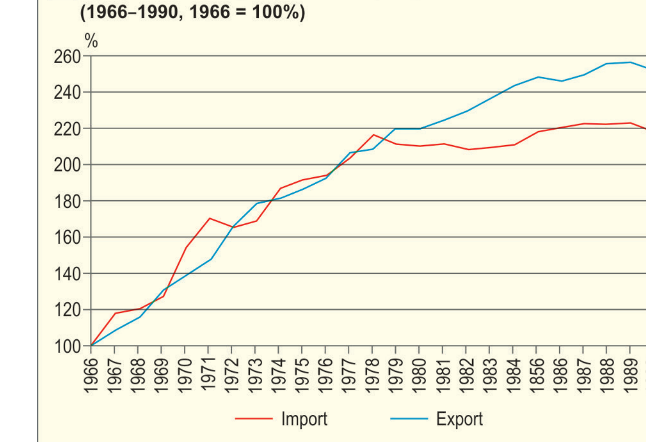
From 1985 onwards, however, Hungary's *gross debt denominated in Western currencies rose* from USD 11.5 billion in 1980 to almost USD 20.4 billion by 1989 – mainly because of the exaggerated expectations of the



9 PRICE INDICES AND TERMS OF TRADE INDICATORS (1960–1990, 1960 = 100%)



10 FOREIGN DEBT (1973–1989)



11 VOLUME OF EXPORTS AND IMPORTS (1966–1990, 1966 = 100%)

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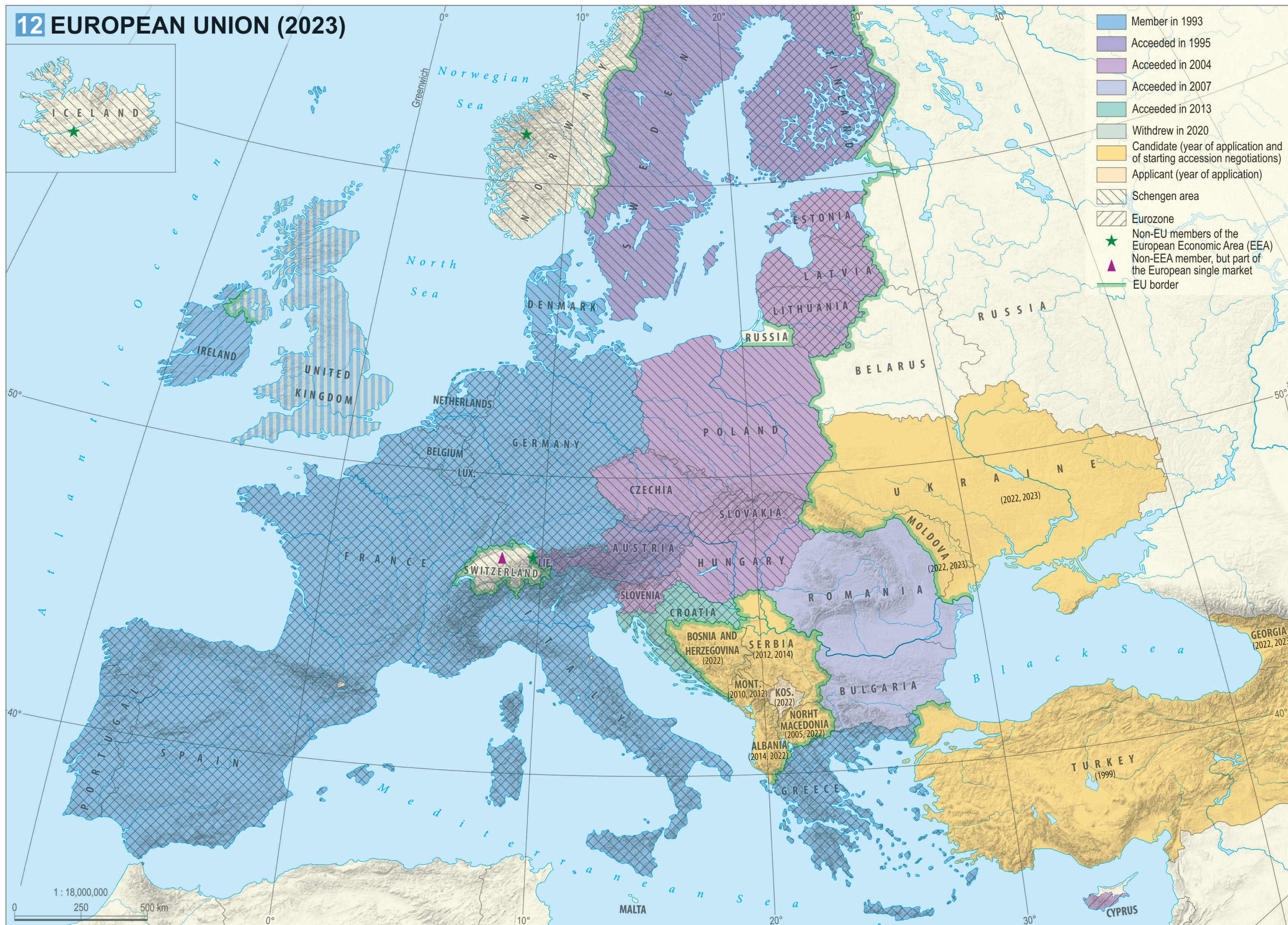


12 EUROPEAN UNION (2023)

13th congress of the state party and the hasty 'dynamization'. Meanwhile, the country's exports to Western countries remained unchanged at USD 5 billion per year XI. 2. 11.. The imbalance swelled to uncontrollable levels by the end of the 1980s. The collapse of the system became inevitable by 1990, also in terms of foreign trade.

Trade policy after 1990

Free trade agreements, European integration

The regime change, including the *transition to a market economy* (privatization, liberalization, deregulation) also meant fundamental shifts in external economic relations. This process, together with the disappearance of the formerly dominant role of COMECON made it politically possible and economically necessary for Hungary to *conclude preferential trade agreements* with its major partners, providing mutual advantages.

Negotiations with member states of the *European Communities (EC)* and the *European Free Trade Association (EFTA)* started as early as 1990. An important difference is that the EC and Hungary set the objective of a *comprehensive association agreement*, which, in addition to trade in goods, also provided for the liberalization of services and investment as well as defining the guidelines and conditions for political and economic cooperation. With the EFTA, however, the aim was to develop a traditional free trade agreement to remove tariffs and other restrictions on trade in goods. A common point is that trade liberalization was implemented asymmetrically with both the EC and the EFTA, with a longer transition period for Hungary in order to facilitate the transition to a market economy and to take account of differences in the level of economic development. The association agreement between Hungary and the EC entered into force in 1994, but the EC granted trade preferences under the so-called interim agreement as early as 1991.

As the EC and EFTA launched similar negotiations with Poland and Czechoslovakia in addition to Hungary, it was logical that the three (after the split of Czechoslovakia in 1993, four) 'leading reform countries' of Central Europe should focus on developing trade among themselves, besides the Western orientation. The former element of cooperation was already anchored in the joint Visegrád Declaration adopted in 1991. The *Central European Free Trade Agreement (CEFTA)* that entered into force in 1994 was established in this spirit, and extended the same trade preferences among the parties that had been granted to the EC and EFTA XI. 2. 14..

Hungary pursued an active trade policy with other partners as well. It concluded free trade agreements (FTAs) with Israel (1998), Turkey (1998), Latvia (2000), Lithuania (2000), Estonia (2001) and the Federal Republic of Yugoslavia (Serbia and Montenegro, 2002).

Hungary, together with the nine other countries in the region, became a member of the EU on 1 May 2004, which was the biggest ever enlargement of the EU XI. 2. 12.. This historic event was the climax of the process of regime change. With the accession to the European Union, Hungary also had to give up its previous FTAs concluded at national level, but became a party to the international trade agreements established by the EU and the market access preferences they provide. A key area of the integration acquis is the internal market and its regulation. *The external economic performance* (trade in goods and services, working capital flows) *of Hungary as an EU member is largely achieved in an internal market free of border controls and additional barriers (European Economic Area, EEA).*

Investment protection agreements

Because of the scarcity of resources in the Hungarian economy, the need to allow and encourage *investments by foreigners* in the form of working capital emerged as early as the 1980s. However, potential foreign investors were rather sceptical about the system of economic governance in the former socialist system. To overcome this, Hungary initiated bilateral investment protection agreements, initially with its main partners in Western Europe. The first agreement of this kind was signed with the Federal Republic of Germany in 1986. The investment protection agreements guaranteed that

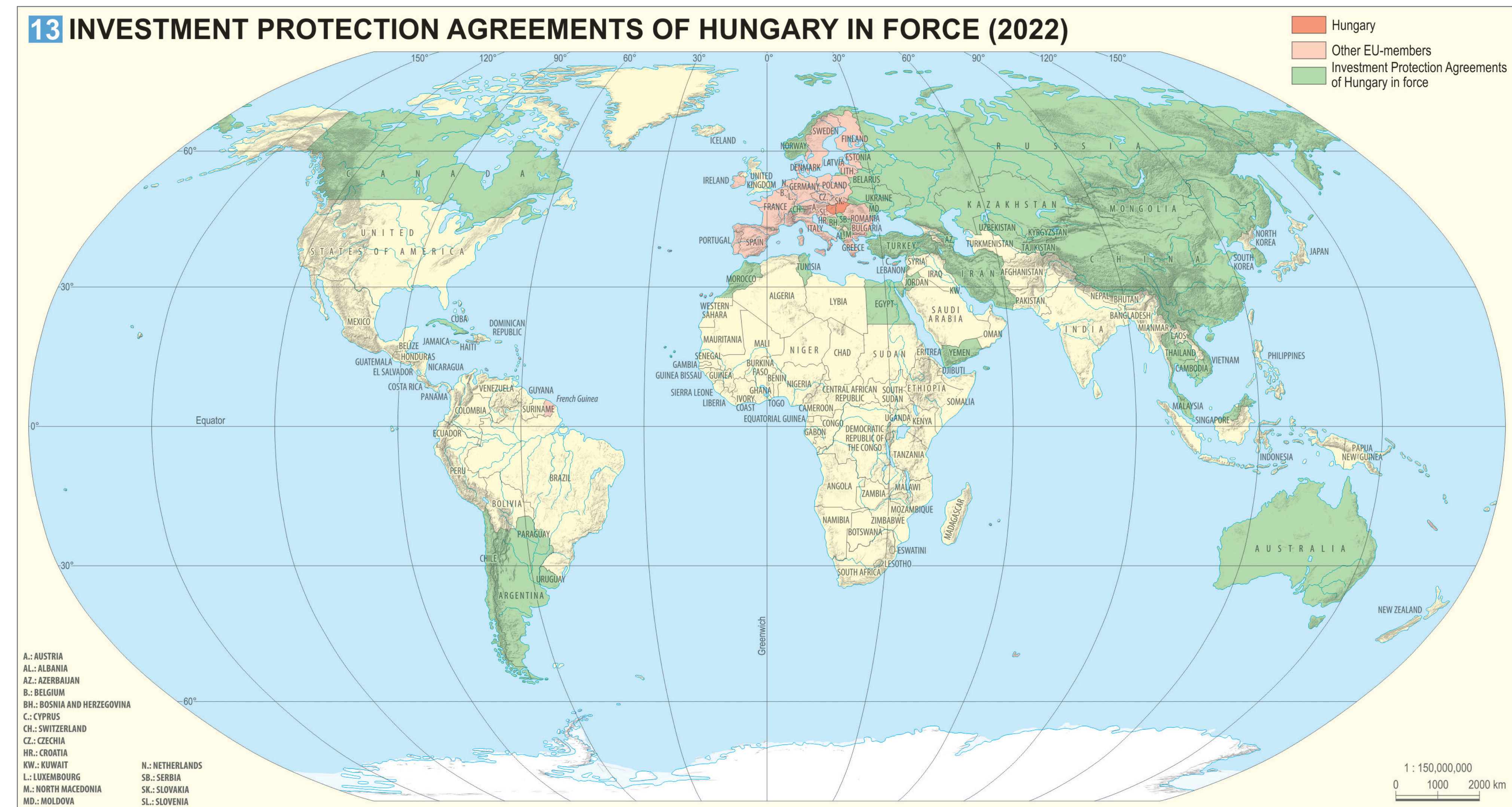
- the Hungarian state does not apply less favourable operating and tax rules to foreign investors and their investments in Hungary than those applied to domestic competitors;
- the profits generated can be transferred from the country in a convertible foreign currency;
- the nationalization or expropriation of investments should only take place in public interest, within a transparent framework and with proportionate financial compensation; and
- in the event of a breach of the agreement, the foreign investor concerned may seek international arbitration against Hungary to claim compensation for the material damage suffered.

The number of investment protection agreements increased steadily. By the end of 2020, Hungary had concluded 66 such agreements. The Treaty on the Functioning of the European Union (TFEU) put the regulation of foreign direct investment under EU competence. However, the European Court of Justice ruled in 2017 that investment protection agreements between EU members were incompatible with EU law and ordered their termination. Therefore, the number of agreements in force decreased. Given the fact that the protection of foreign investments in Hungary is guaranteed by both the Fundamental Law of Hungary and the EU legislation, Hungary concluded and negotiates investment protection agreements with those partners where this instrument is needed to protect the foreign investments of Hungarian economic actors XI. 2. 13..

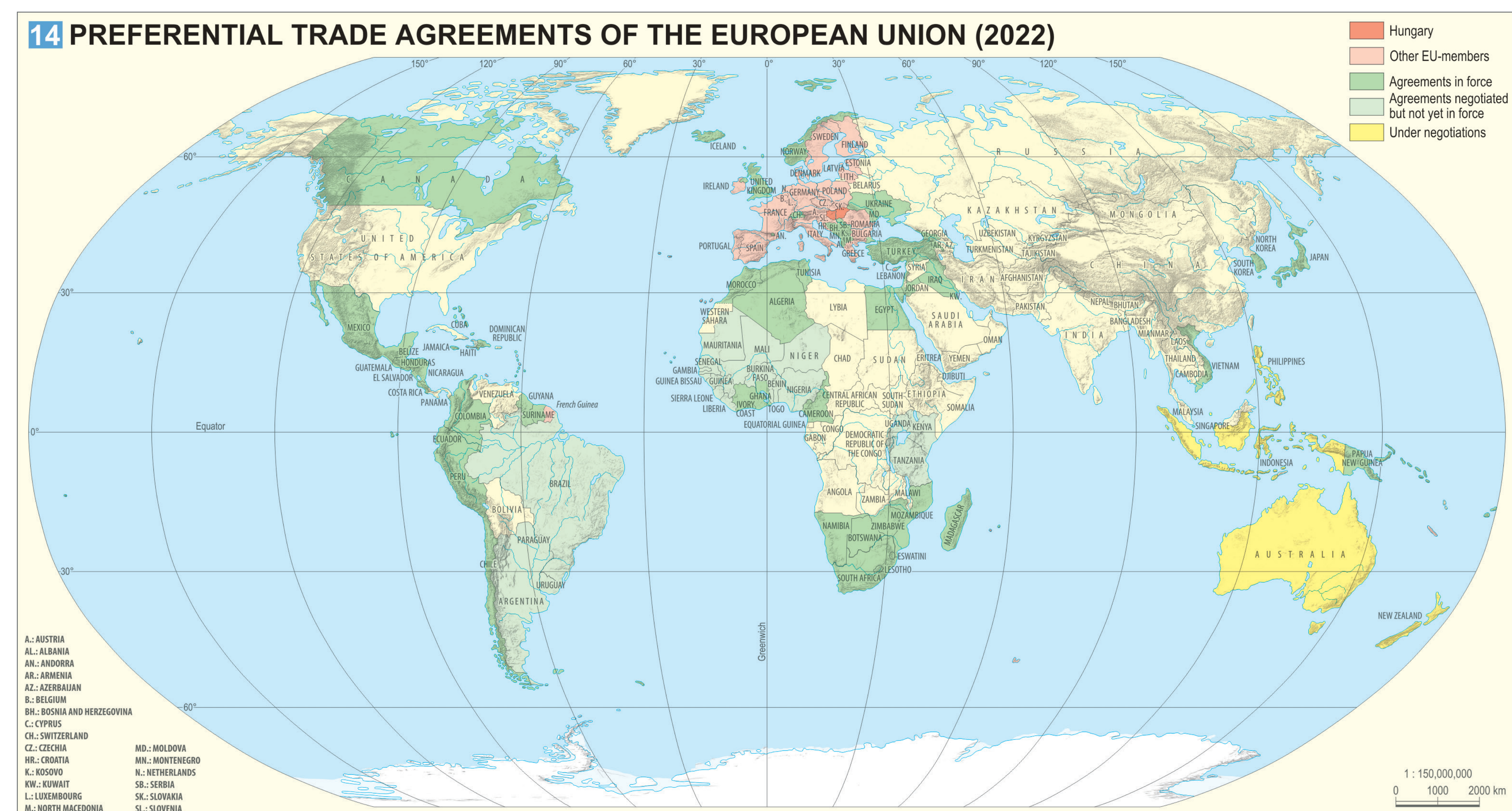
The common commercial policy of the European Union

Commercial policy – the regulation of trade relations between the EU and its external partners – is one of the EU's core common policies. By joining the EU, Hungary fully transposed and applies EU legislation on the common commercial policy and the provisions of international treaties on this subject. Customs duties are the primary trade policy instrument for regulating trade in goods. Following the adoption of the EU's common customs tariff and customs regulations, the average level of customs duties on imports of goods from third countries fell significantly (by almost 50%) in Hungary from 2004 onwards. At the same time, the EU's measures to protect European producers against unfair or distorting imports were applied to the territory of the new member states.

The EU accession did not change the basic objectives of Hungarian trade policy, i.e. to develop the export of goods and services and to ensure favourable external market conditions, to encourage foreign direct investment and investment by domestic companies abroad, as well as to provide effective protection against unfair trade practices by partners. However, the range of instruments available was modified and



13 INVESTMENT PROTECTION AGREEMENTS OF HUNGARY IN FORCE (2022)



14 PREFERENTIAL TRADE AGREEMENTS OF THE EUROPEAN UNION (2022)

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XI. 2.

expanded. The enforcement of Hungarian interests became a two-step process. Hungary's offensive and defensive foreign economic interests must first be accepted by the EU member states in order to be integrated into a single common position. Because of the exclusive competence of the EU in trade policy, the representation of these EU interests and positions in bilateral and multilateral negotiations with third parties is carried out by the European Commission, under a mandate from the member states.

In 2022, the EU was the world's largest exporter of goods and third largest importer (behind the United States and China), and the most important player in international trade in services. This means that the EU remained the world leader in trade in goods and services with a 16.2% share in 2021. Accordingly, the EU has a strong interest in ensuring open and fair conditions of competition, based on international rules, for both trade in goods and services. While the EU sought to establish preferential trade relations with the rest of the continent until the late 1990s, in the following decade it began negotiating bilateral or regional free trade agreements with an increasing number of partners. In 2022, 77 countries have such agreements in force or in application, and many more are in the process of concluding or awaiting approval XI. 2. 14..

Developments in Hungary's external economy after 1990

The structure of trade in goods

Developments in foreign trade show the impact of the transformation to a market economy. Privatisation and the disintegration of COMECON strengthened cooperation with Western European countries. During this period, *the Hungarian economy became more open* and one of the most affected by the process of globalization. In addition to a further increase in the openness of the real economy, the Hungarian economy became institutionally open to the global economy in the process of market economy transformation.

The pattern of Hungarian trade in goods changed dramatically in the ten years following the regime change. The share of raw materials in total Hungarian imports shrank to a fraction of its previous level (over 50%). The *share* of imports of foodstuffs also fell, while the combined share of *processed products, machinery and transport equipment increased* from 30% to over 80%. Similar developments and shifts took place in *exports*. For instance, the share of agrifood exports halved to less than 10%. The ratios of these commodity groups did not change significantly over the twenty years prior to 2023.

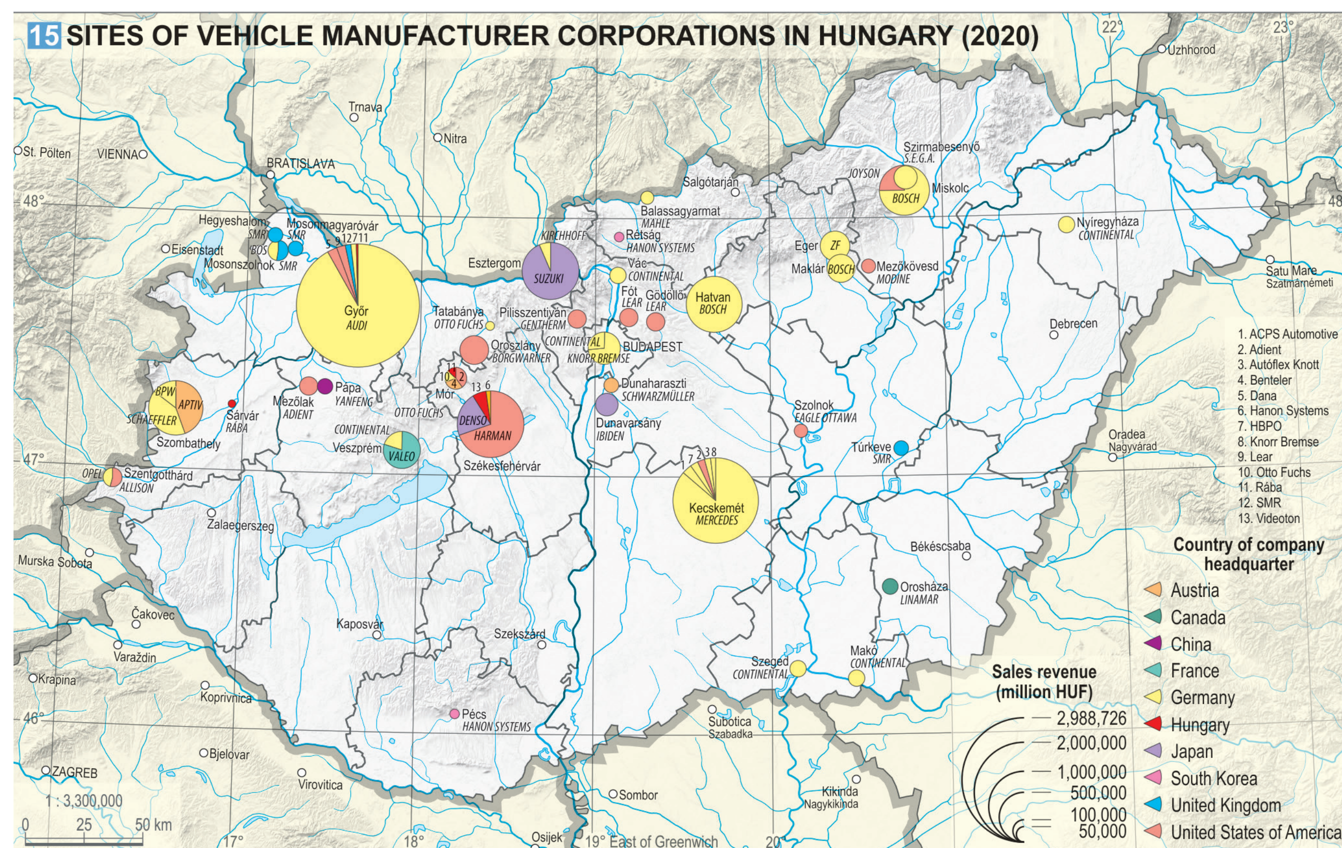
However, the sectoral breakdown of industrial exports underwent a considerable shift. While the clothing sector accounted for 15% of exports of manufactured products in 2000, its share fell to 2.5% by 2021. The proportion of iron and steel products also decreased (from 17.7% to 13.5%). However, the *share of pharmaceuticals and medical products* in exports of manufactured products *increased* from 4.5% to 16% over the same period. The road transport equipment and electronics sector shows a *continuous and dynamic development* in the main group of *machinery and transport equipment*, which represents the largest share of Hungarian exports. Road vehicles, combustion engines and other components accounted for nearly a quarter of total Hungarian exports in 2021. Electrical machinery and equipment made up 15%, while communication equipment contributed 10%.

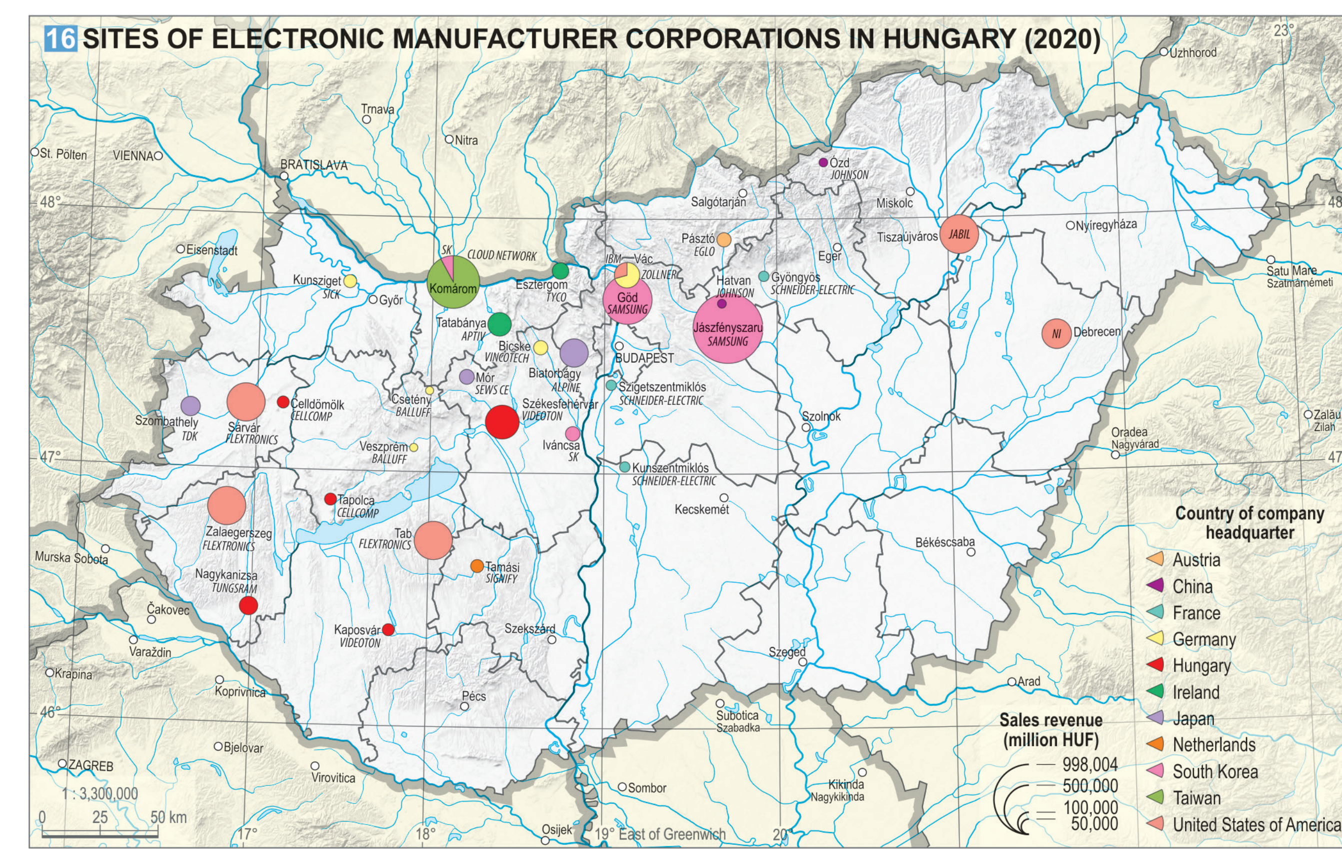
Hungary was the 34th largest exporter (0.7% share) and the 33rd largest importer (0.6% share) of goods worldwide in 2021.

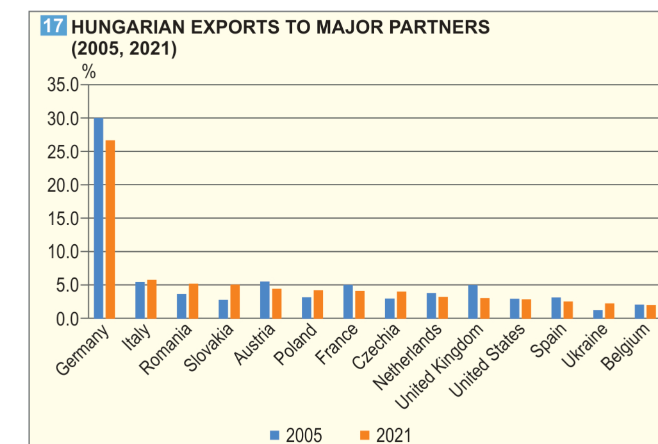
The role of *foreign-owned companies* in Hungarian trade is dominant, representing around 80% of exports. Foreign-owned companies with 250 or more employees are highly export-oriented, with two-thirds of their revenues coming from exports. Hungary is strongly integrated into international production chains in the *automotive and electronics sectors*. Exports account for over 90% of the sales of the largest Hungarian companies in this sector XI. 2. 15., XI. 2. 16.. Many of the world's leading electronics and automotive companies (e.g. Samsung, Flextronics, Jabil, Audi, Suzuki, Mercedes) established branches in Hungary. The main markets for the products manufactured in Hungary are typically the countries of the EU and its free trade partners. Accordingly, transport infrastructure (road, rail, air) plays an essential role in the choice of location, alongside labour supply and local incentives.

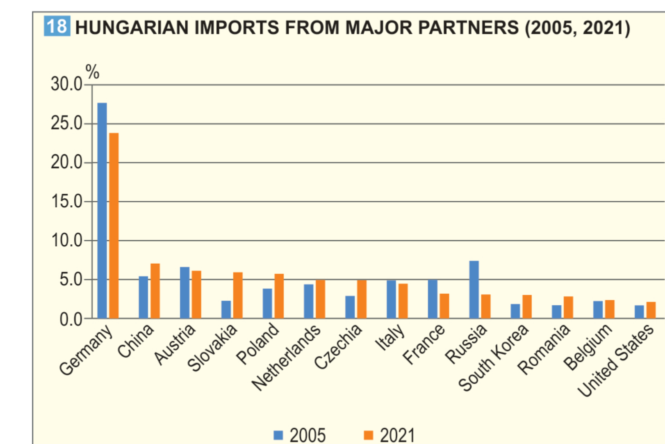
The largest trading partners

The disintegration of COMECON and the switch of trade transactions to convertible currencies caused a fundamental rearrangement of trade flows in a very short period of time. *Germany again* became the most important export market and source of imports in Hungarian foreign trade, typically with a share of around 25% or more. *Russia's* importance in Hungarian foreign trade (excluding imports of energy products) had already declined sharply in the second half of the 1990s, while trade with *Western European partners* and the *United States* grew dynamically. Central Europe's share


15 SITES OF VEHICLE MANUFACTURER CORPORATIONS IN HUNGARY (2020)


16 SITES OF ELECTRONIC MANUFACTURER CORPORATIONS IN HUNGARY (2020)


17 HUNGARIAN EXPORTS TO MAJOR PARTNERS (2005, 2021)


18 HUNGARIAN IMPORTS FROM MAJOR PARTNERS (2005, 2021)

19 EXTERNAL TRADE IN GOODS OF HUNGARY WITH EUROPEAN COUNTRIES (2005)

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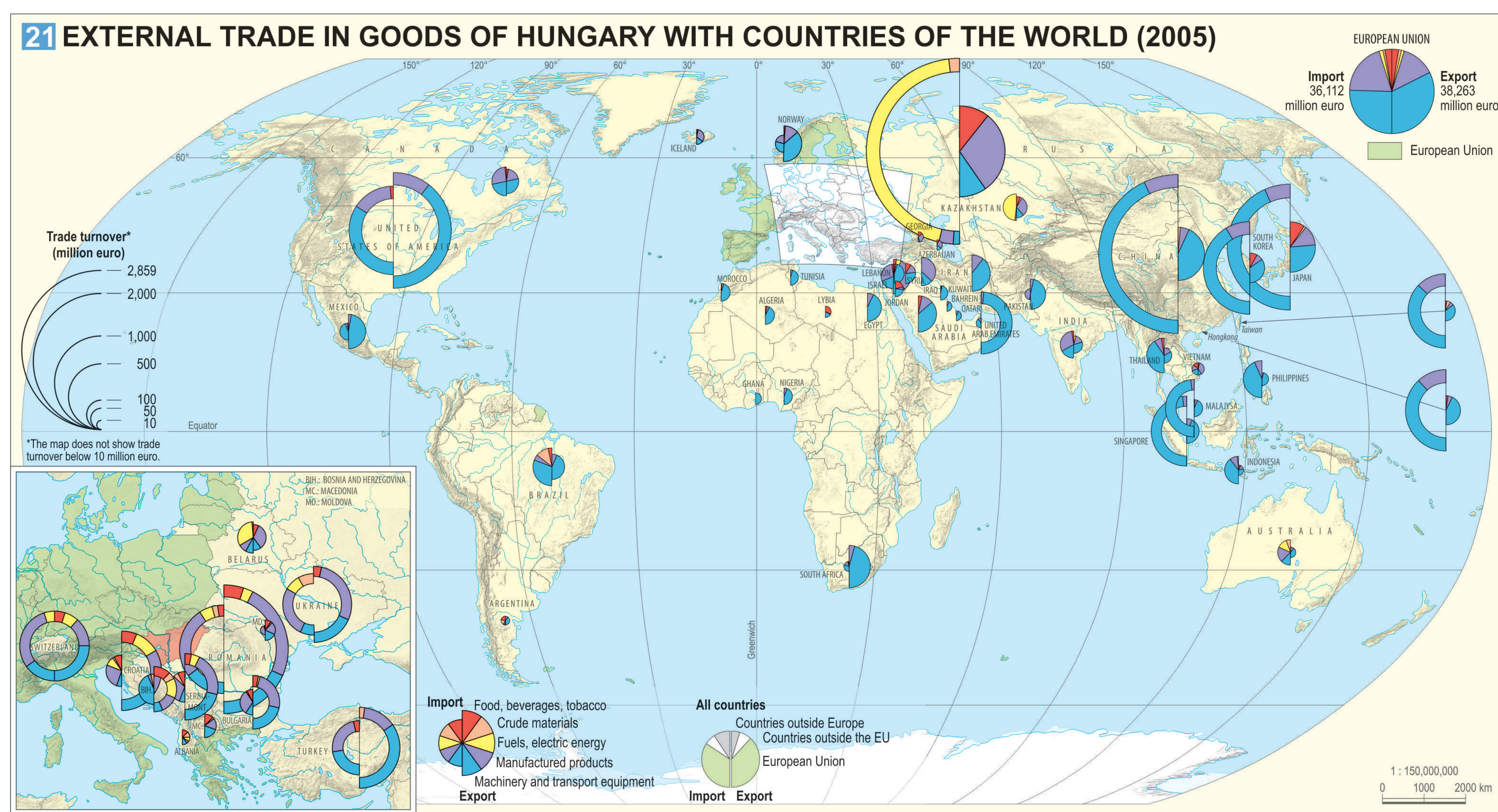
20 EXTERNAL TRADE IN GOODS OF HUNGARY WITH EUROPEAN COUNTRIES (2021)

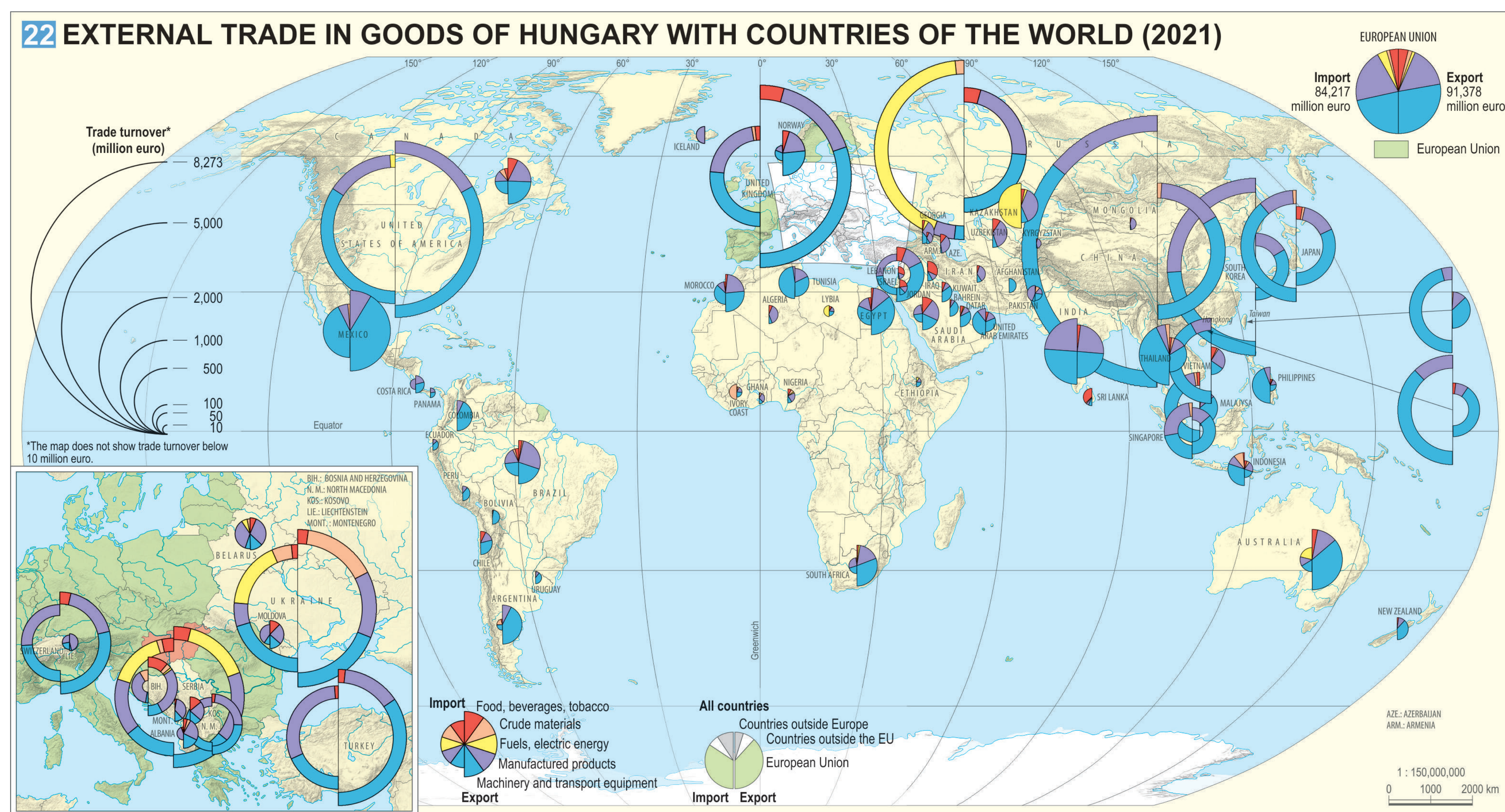
Trade turnover (million euro): 31,919; 30,000; 20,000; 10,000; 5,000; 2,000; 1,000; 500; 100; 50; 10

Import: Food, beverages, tobacco; Crude materials; Fuels, electric energy; Manufactured products; Machinery and transport equipment. Export

EU border

1 : 14 000 000





in Hungary's trade started to grow after the Visegrád Group concluded the Central European Free Trade Agreement (CEFTA) in 1992 to re-establish trade links. Other countries of the region joined CEFTA later. However, this development only became spectacular after these countries acceded to the European Union. The share of Hungarian trade in goods with the Visegrád partners doubled to 15% by 2021. With the addition of other neighbours, we find that Hungary already generated almost a quarter of its trade in the *Central European region* in 2021, approaching Germany's share. On the import side, the most significant increases are related to China and South Korea, mainly due to the rising demand for industrial consumer goods as well as manufacturing machinery, equipment and components. The European Union dominates the relational structure of Hungarian foreign trade. More than three quarters of Hungary's exports go to EU countries and 70% of imports come from there. It is noteworthy that there is a continuous and significant (EUR 7–10 billion per year) Hungarian surplus in trade with EU member states XI. 2. 17. XI. 2. 18. XI. 2. 19. XI. 2. 20. XI. 2. 21. XI. 2. 22..

Trade in services

Trade in services showed continuous expansion over the three decades prior to 2023. Its largest component was *business services*, followed by *transport* activities and *tourism*. The value of exports of services reached 25% of exports of goods by 2018. Nevertheless, this was reduced later by the decline in the sectors of transport and tourism due to the Covid-19 pandemic in 2020–2021. The positive balance of trade in services became significant after Hungary's accession to the EU, amounting to over EUR 8 billion annually in the period 2017–2019 XI. 2. 23. XI. 2. 24.. Business services consist of highly heterogeneous activities.

The most important categories in Hungary's foreign trade include accounting, business consulting, public relations and computer, scientific and engineering services, fees for intellectual property rights as well as research and development. Exports and imports of business services are roughly balanced, with a significant Hungarian surplus coming from the transport and tourism sectors. As a result, Hungary's trade in services

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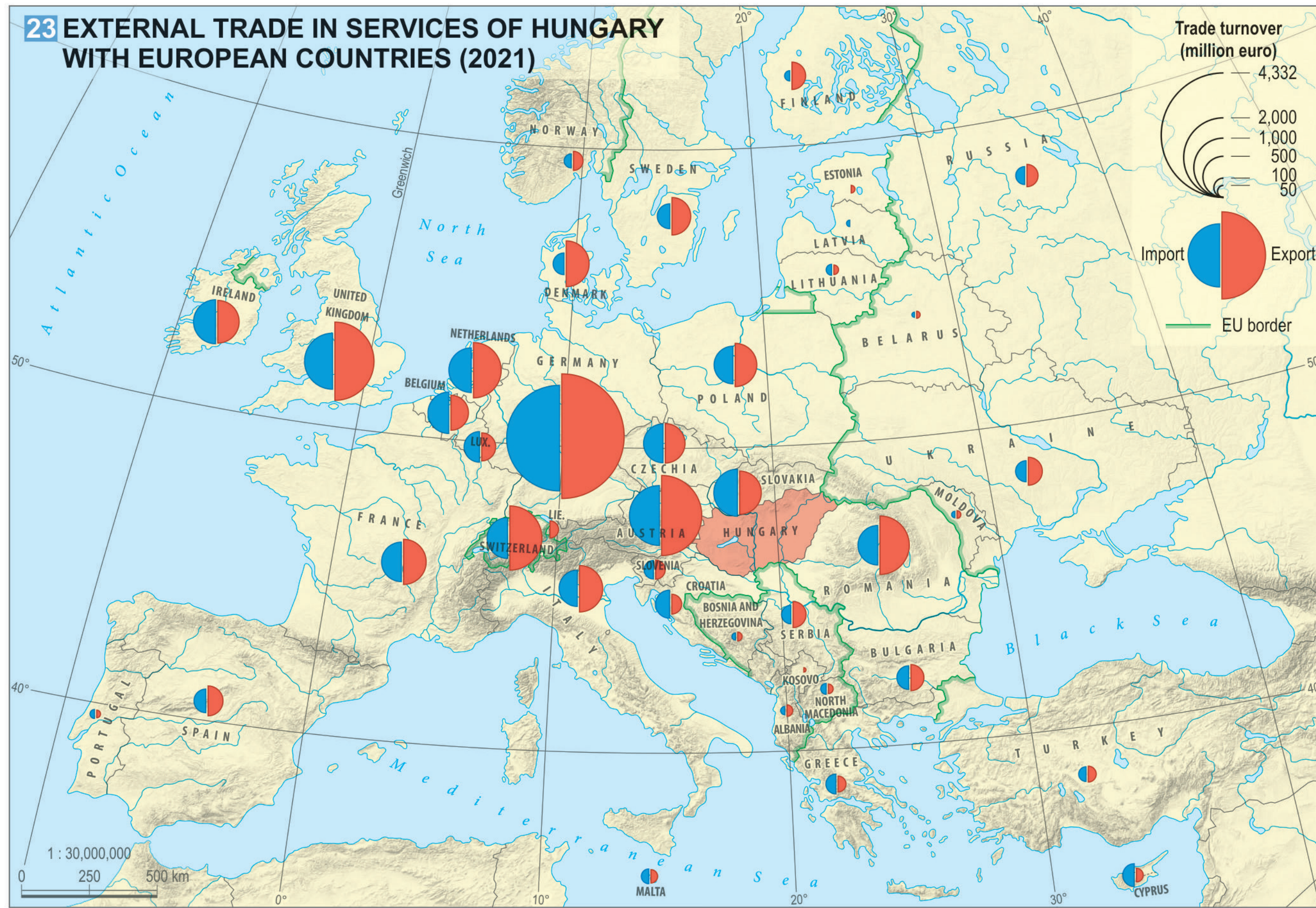
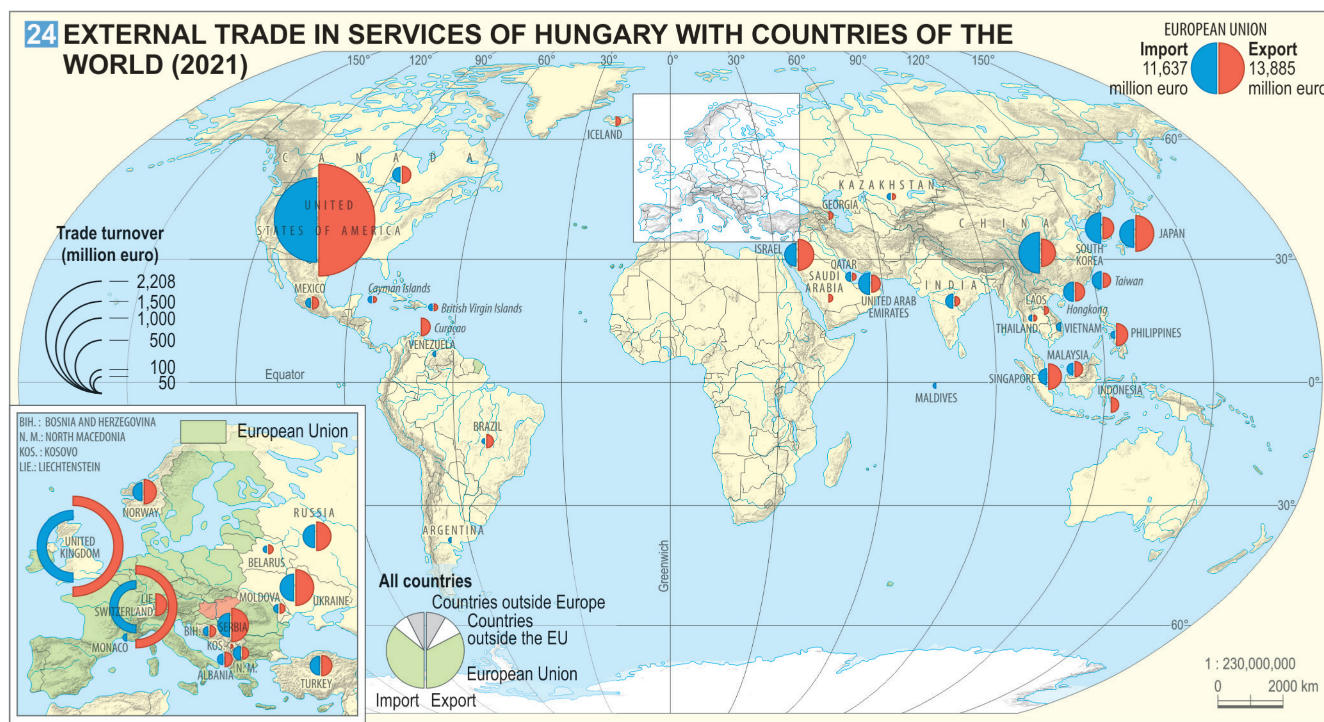
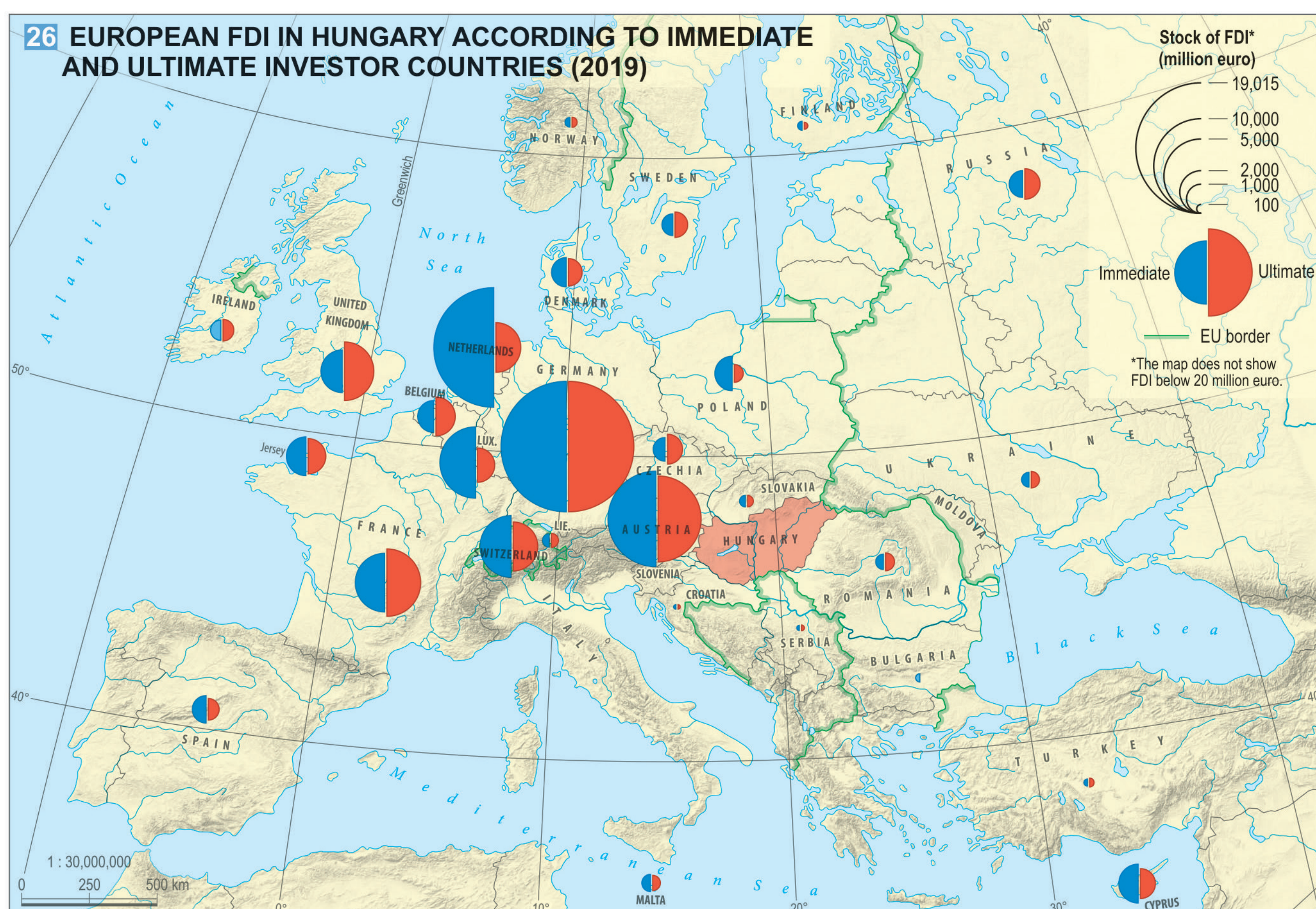


23 EXTERNAL TRADE IN SERVICES OF HUNGARY WITH EUROPEAN COUNTRIES (2021)



24 EXTERNAL TRADE IN SERVICES OF HUNGARY WITH COUNTRIES OF THE WORLD (2021)

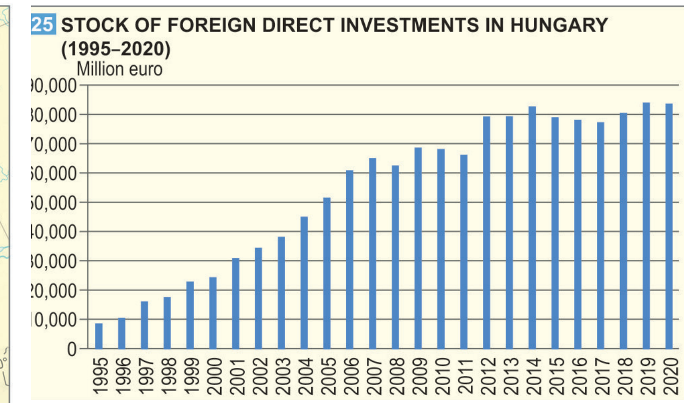


26 EUROPEAN FDI IN HUNGARY ACCORDING TO IMMEDIATE AND ULTIMATE INVESTOR COUNTRIES (2019)

is also highly Europe-centric, but much less concentrated in the EU than trade in goods. Compared to the latter, trade in services is significantly more important with the United States, the United Kingdom and Switzerland.

Foreign direct investments

Hungary was the first among the countries in transition in Central and Eastern Europe to open up to foreign direct investment (FDI) in 1989. The value of Hungarian FDI stock was already growing rapidly



25 STOCK OF FOREIGN DIRECT INVESTMENTS IN HUNGARY (1995–2020)

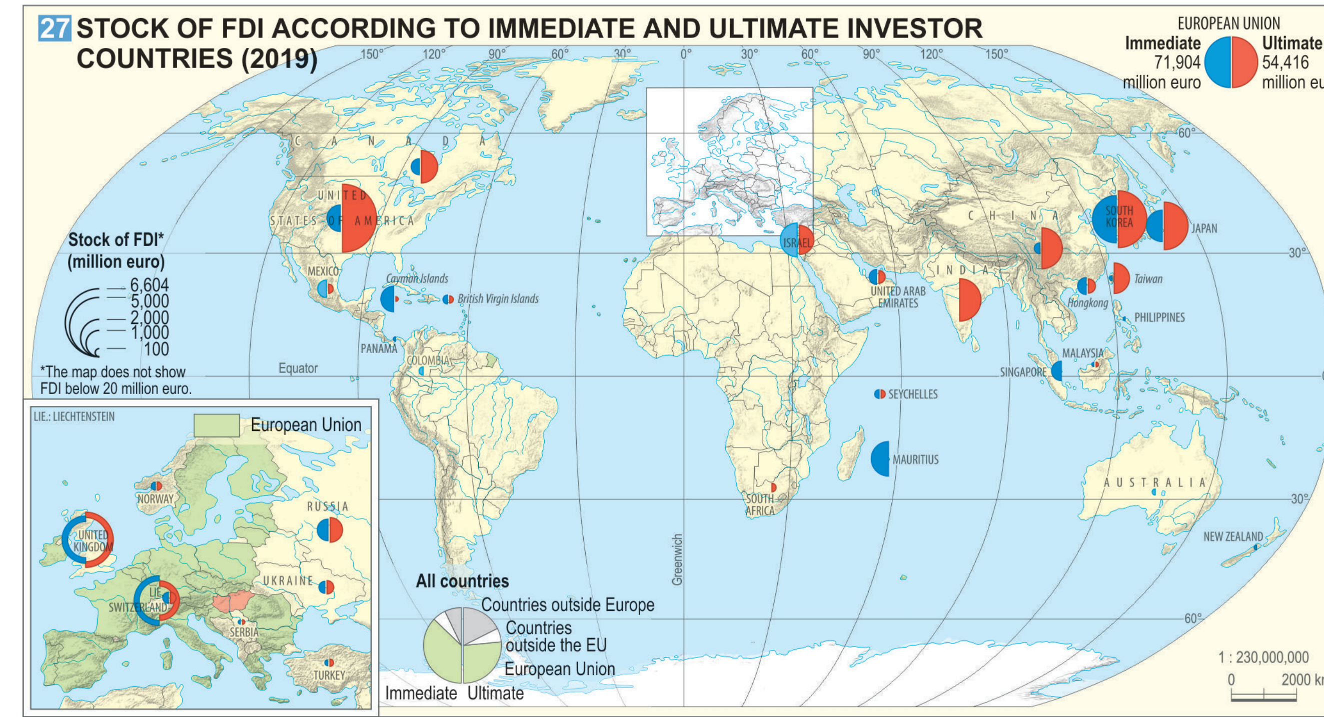
in the early 1990s. A major factor in the capital inflows during the 1990s was the rapid pace of privatization, with EUR 4.6 billion of investment coming into the country between 1991 and 1997. Around 85% of state-owned enterprises were privatized, sometimes at relatively low prices. Reinvested earnings started to play a larger role from 1997, in addition to greenfield investments. The FDI first exceeded EUR 10 billion in 1996, and then surpassed EUR 83 billion in 2020 XI. 2. 25..

According to 2019 data, the majority (86.8%) of foreign working capital invested in Hungary came from Europe. As regards direct investment, Germany, Austria, the Netherlands, Luxembourg and Switzerland are the most important. Asia's share amounted to 8.2%, while the Americas and Africa contributed 2% each. In fact, foreign ultimate owners often invest in Hungary not directly, but through a Western European company (e.g. Dutch, Luxembourg, Swiss). Data collection by country of ultimate owner does not have a long record. Based on this, the United States ranked third in terms of FDI in Hungary in 2023, while South Korea joined Japan in the top 10, with the Netherlands and Switzerland dropping significantly. Europe's share of final investment in 2019 was 64.8% XI. 2. 26. XI. 2. 27.. In the sectoral structure of FDI stock in Hungary, the manufacturing industry (e.g. vehicles, pharmaceuticals, rubber, plastic products, computers, electronics) represents a particularly large share.

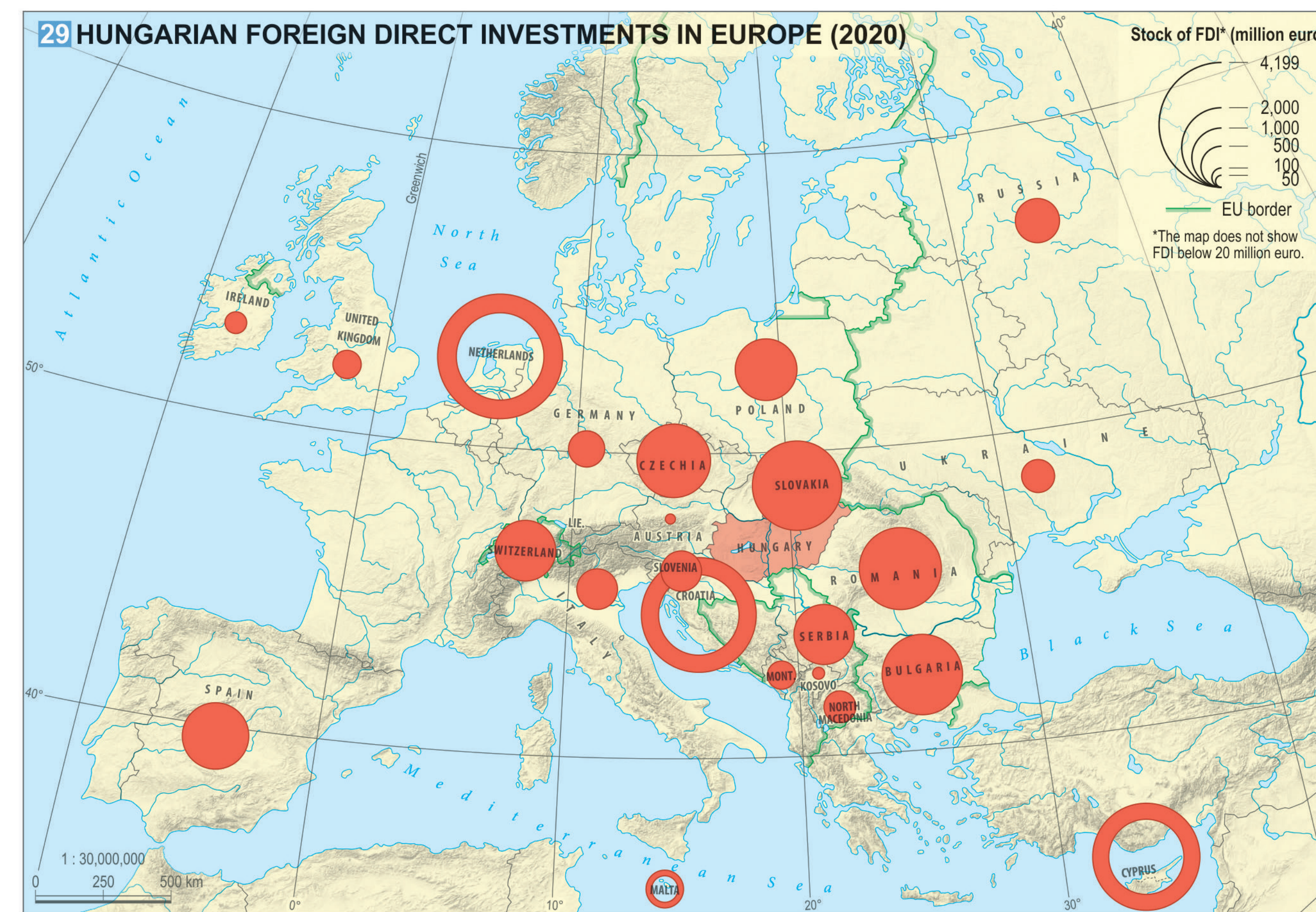
The foreign investment of Hungarian enterprises started to show in the early 2000s and grew to EUR 30 billion in 20 years XI. 2. 28.. Working capital exports, like imports, reflect a strong European concentration. However, the dominant destinations for capital export differ significantly from the country structures for trade and capital imports. More than half of Hungary's European capital exports go to countries in the Central European and Western Balkans regions. Geographical and cultural proximity, market knowledge, economic development similar or slightly less advanced than that of Hungary are strong incentives for companies to expand. A significant part of Hungarian working capital exports is linked to large companies such as MOL, OTP Bank, Richter, Master Goods, Innomed, Danubius or Jász-Plasztik. The activities of outsourcing mother companies are diverse. The types of investment include the establishment of a new company or acquisition of an equity stake XI. 2. 29. XI. 2. 30..

The current account

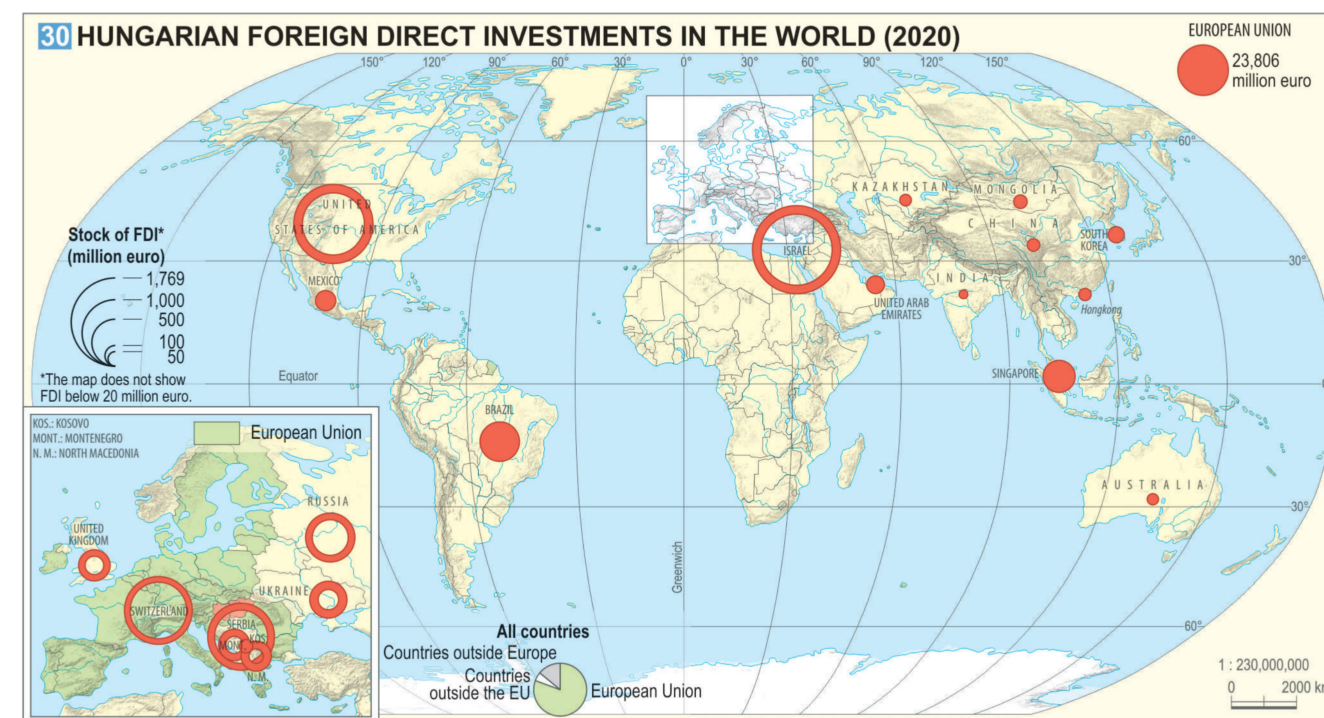
The current account is an accurate reflection of the imbalances that arose in Hungary's external economy from the 1970s onwards. In the period of the transformation crisis that followed the regime change, the difficulties with the current account continued to grow. The collapse of the former export markets in Eastern Europe led to a serious structural crisis in the processing industry, a forced fall in output and the need to consolidate the commercial banks that financed the processing companies. The simultaneous (twin) deficits that appeared in the budget and the current



27 STOCK OF FDI ACCORDING TO IMMEDIATE AND ULTIMATE INVESTOR COUNTRIES (2019)



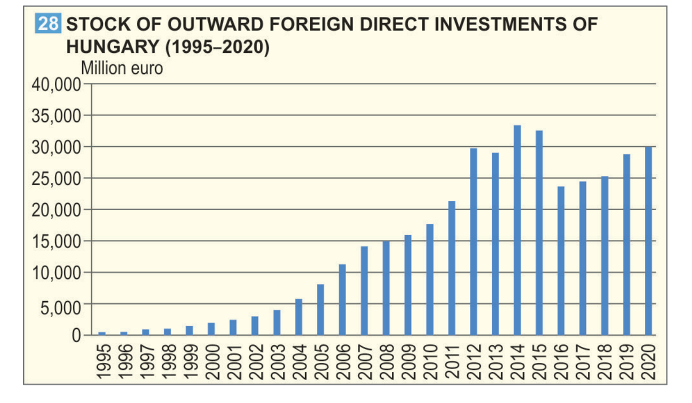
29 HUNGARIAN FOREIGN DIRECT INVESTMENTS IN EUROPE (2020)



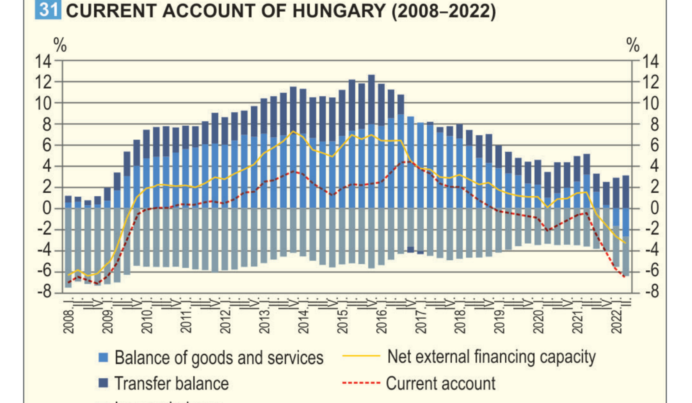
30 HUNGARIAN FOREIGN DIRECT INVESTMENTS IN THE WORLD (2020)

account in the mid-1990s required a macroeconomic adjustment: the situation involved a temporary forced restriction of domestic demand. The adjustments increased the confidence of international financial institutions and foreign investors. Exports grew strongly, but the deficit in the balance of foreign trade remained. However, the latter was mostly covered by foreign working capital inflows from the second half of the 1990s onwards.

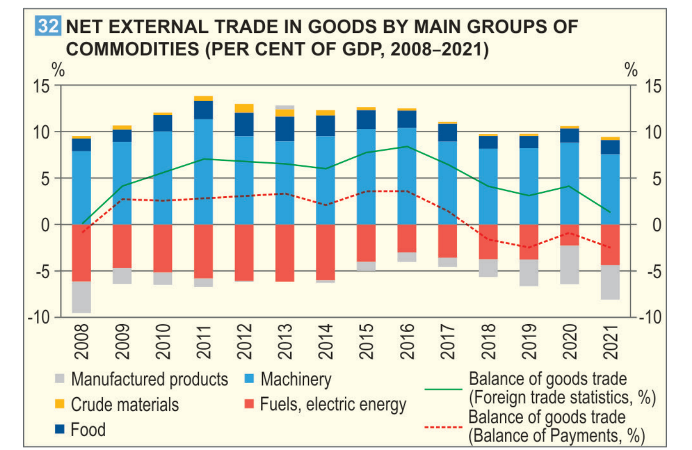
After the turn of the millennium, imbalances emerged again. The foreign trade balance showed a widening deficit due to growing domestic consumption. After Hungary's accession to the EU, the situation deteriorated further, with initially limited transfers from Brussels. Another macroeconomic adjustment was required. At the same time, the world economy experienced the deepest financial and economic crisis since WWII from 2008 onwards. The crisis forced a strong adjustment of the balance of payments in the Hungarian economy. The balance of Hungary's trade in



28 STOCK OF OUTWARD FOREIGN DIRECT INVESTMENTS OF HUNGARY (1995–2020)



31 CURRENT ACCOUNT OF HUNGARY (2008–2022)



32 NET EXTERNAL TRADE IN GOODS BY MAIN GROUPS OF COMMODITIES (PER CENT OF GDP, 2008–2021)

goods and services showed a modest surplus by 2008 XI. 2. 31.. One of the important factors in the current account deficit was the repatriation of profits, which was based on the substantial amount of FDI that had previously taken place. If the stock of FDI is high, which is also the case for the Hungarian economy, other components of the balance of payments can also create equilibrium: above all, the surplus in the trade balance of goods and services, the additional inflow of working capital and the local investment of the profits generated. The current account had reached equilibrium by early 2010. At the same time, the room for manoeuvre was further increased by transfers from the EU. The Hungarian economy's financing capacity improved at this time.

The balance of current account continued to improve in the 2010s. There was a significant surplus in trade of goods and services, while the deficit of the income balance narrowed. Regarding the trade in goods, there was surplus in the groups of machinery, raw materials and foodstuffs, while a deficit emerged in the trade of energy and processed products. Regarding trade in goods, there is a surplus in the groups of machinery, raw materials and foodstuffs, while there is a deficit in the trade of energy and processed products XI. 2. 32..

By the mid-2010s, the Hungarian economy had an external financing capacity of around 6–7% of GDP, which was never achieved in the last century. In the early 2020s, however, the surplus of trade in goods and services narrowed. Moreover, there was an increasing deficit in the trade of goods according to the national accounts. This was further exacerbated by the Covid-19 crisis and the shock of the war in Ukraine as well as the energy crisis that arose as a consequence of the previous factors.

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