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Comparative Political Economy

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Economic Growth in Hungary and Ukraine

I. Introduction

In this paper, I will examine and compare institutions' impact on economic growth in Ukraine and Hungary. This is an important topic and set of countries to research as both countries have had tremendously different experiences in their transition from socialist command economies to capitalist market ones. Analyzing the differences and similarities between the processes that produced or slowed economic growth between these two countries could provide terrific insight into the best or worst methods for introducing former socialist countries into a world of globalized free markets.

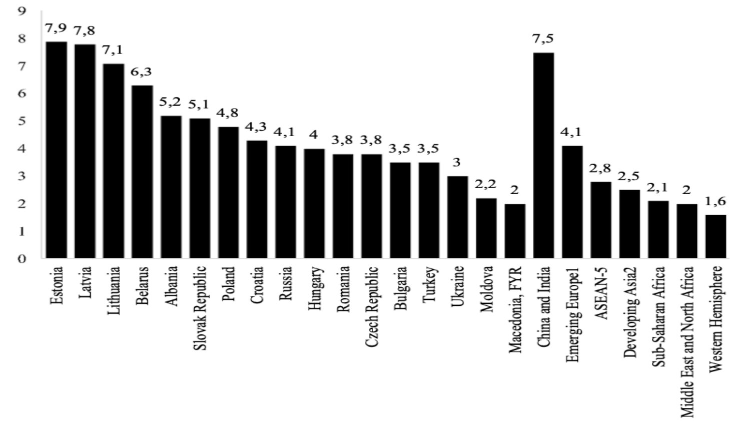
I argue that the institution of economic reform and regime change, finances, and European Union (EU) integration has caused more economic growth to come about in Hungary as compared to Ukraine because of the difference in reform speed, foreign investments and ownership, and connection to established trade networks. These institutions are crucially important for each country's growth as they relate to how quickly each country adopted growth-producing market reforms, sophisticated financial structures, and relationships with positive trade centers. In Hungary, the quicker pace of economic reform allowed its private sector and financial institutions to obtain momentous technological transfers and business techniques from more advanced economies, and EU integration allowed the country to enter a vast market from which it greatly benefitted. In Ukraine, the slow speed of economic reform has left its economy lagging behind other transition economies that enthusiastically jumped into privatization and global competition, and this, in turn, has left Ukraine wholly out of EU integration and without many substantial trade networks to exchange with due to the abandonment of its traditional trade relationships from the Soviet era.

The rest of this paper will be organized as follows. First, I will analyze the speed at which Hungary and Ukraine each implemented economic reforms and reforms' effect on economic growth. In the next section, I will look at how EU integration, or the absence thereof, has impacted each country's prospects for and realization of economic growth. Afterwards, I will investigate how significantly financial institutions have driven growth in each country. I will then conclude the paper with a summarized comparison of the two countries' economic growth and mention some challenges for these countries' future economic prospects.

II. Process of Economic Reform and Regime Change

When it comes to economic reform following Hungary and Ukraine's regime transitions, Hungary seems to have taken a more effective approach to adopting market economics than Ukraine has. Much of this is due to the fact that Hungary's reforms and transition did not severely dismantle its trade network, but in Ukraine, the dissolution of the Soviet Union meant that Ukraine had to leave behind much of its traditional trade relations while struggling to find new partners that could make up for this massive loss. Hungary also got a headstart as it began reforming decades before Ukraine could, and this allowed Hungary to take a much more disciplined approach to its economic transition than Ukraine, which was left desperately trying to pick up the pieces of its tattered economy. Finally, the two countries' different privatization processes yielded more growth in Hungary than Ukraine solely due to the greater amount of technological transfer. For these reasons, Hungary had an immensely easier and less overwhelming task of embracing market economics than Ukraine did, and this has allowed for reforms to drive more growth in Hungary than in Ukraine.

Figure 1. Emerging Europe and Selected Regions: Real Per Capita GDP Growth, 1995-2007 (annual percentage change in purchasing power parity terms)



In Hungary, the state began a "gradual transition to a market economy in the 1960s," and this early procession has given Hungary important maturity and wisdom to drive economic growth through reforms (Simon 197). The gradual approach adopted by Hungary has enabled it to take a "disciplined approach to paying its existing foreign debts," which has enhanced Hungary's business environment and attracted "more FDI… [which] has gone into high-technology sectors" (Simon 209). This has allowed Hungary to experience incredible growth as it maximizes investment returns with its highly educated population, which was able to make great use of newly introduced technologies brought about by foreign investments. FDI and technological transfers additionally empowered Hungary to begin exporting more goods through its already-established trade network, and Hungary's "economic growth [from] 1961-2008" was characteristically driven by a policy encouraging "investment and export-led growth" (Simon 211). Along with this, Hungary's openness to international trade and investment lent itself greatly to facing the economic pressures of globalization. Hungarian privatization was largely based on foreign ownership, and this drove much "technical progress," which "was the most important macroeconomic growth factor" for Hungary (Simon 227). The introduction of advanced technologies by foreign owners allowed Hungarian businesses to grow as it provided better managerial practices, machinery, and competition. Hungary, then, became much more accustomed to the pressures of a globalized market economy very early on, and this gave Hungarian businesses the essential ingredients to drive economic growth.

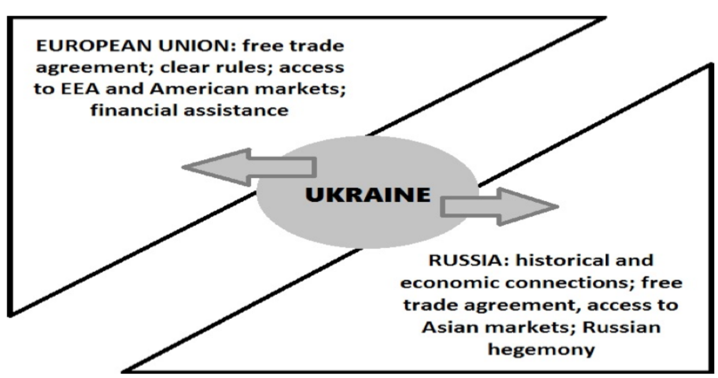
In Ukraine, the story of economic reform is almost opposite of that in Hungary. Ukraine essentially began its reforms from nothing in the mid-1990s, for by "the end of 1992, 36.1 percent of" Hungarian firms were privatized and "the percentage was only… 0.0" in Ukraine (Brown et al. 70). Being about three decades behind Hungary's reforms, Ukraine had less choice when it came to repaying debts and economically recovering. In losing its connection to members of the Soviet Union, Ukraine's "foreign trade in most important sectors decreased almost by two thirds," and this has tremendously decelerated growth and left Ukraine scrambling to find markets for its exports (Greta and Pakosz 80). This loss left Ukraine to deal with enormous debt and credit burdens, which increased its reliance on whatever raw goods could be exported and inefficient corporate practices from the Soviet era. Ukraine's "public debt and banking crisis" has made efforts to reform ineffective and nearly impossible to achieve, which has further made the state reliant on international organizations like the IMF for financial assistance and exacerbated debt problems (Greta and Pakosz 76). Because of this, Ukraine has had to endure a "low level of technological and innovative development," which not only hinders economic growth but drives brain drain, as skilled workers cannot realize their potential, and increases Ukraine's dependence on raw goods (Fyliuk 62). "Raw materials… still dominate Ukrainian exports," and these goods contribute nothing to economic growth as they are subject to global pricing pressures and have merely led to a "deterioration in [Ukraine's] trade balance" (Fyliuk 62). On top of this, Ukraine's voucher approach to privatization, which gave large investment discounts to domestic workers, has greatly reduced technology transfers to Ukraine and allowed for "unmonitored managerial control" and "unfettered asset stripping," which breeds growth-stunting corruption and drains important resources from Ukraine's economy (Brown et al. 72). The collapse of the Soviet Union and Ukraine's traditional trade networks has left its economy in a desperate state of immobility as debts and trade struggles have halted any growth-producing effects through economic reform. Hungary not only reformed its economy in a quicker and more effective way, but it also had a much easier time transitioning to market economics as it had a healthy support system of foreign investors and established trade partners. It is for these reasons that Hungary exports higher value goods than Ukraine and has yielded more growth from reforms and regime change.

III. Integration with the European Union

The next institution that has impacted Hungary and Ukraine's prospects for economic growth is integration with the European Union. Accession to the EU, for one, gives member countries access to the EU's vast single market, but it also gives member countries the ability to improve trade relationships and receive technological guidance from other member states. As a result, Hungary's accession to the EU has granted it the ability to receive growth-producing investments, increase export flows to neighboring countries, and obtain significant technologies and practices from advanced economies. On the other hand, Ukraine has missed out on all these opportunities, which has impeded growth by complicating its trade situation and diminishing its ability to acquire vital foreign investments and technologies.

Hungary achieved EU accession in 2004 due to its apparent willingness to implement reforms that the EU held in high esteem. Hungary "followed a set of economic policy prescriptions promoted by international institutions," and this demonstrated Hungary's ability to become a stabilized polity deserving of EU membership (Baran 8). EU accession has somewhat hurt Hungary's labor market though, for more Hungarians were able to migrate westward with their newly attained mobility to western Europe. After EU accession, Hungary experienced "increased east-west migration" of its laborers, and this development "was a decelerating factor in [Hungary's] growth process" (Baran 17). However, this outflow of human capital has been mostly offset by the influx of EU capital infusions and investments. Hungary's EU accession "played a supporting role in the [economic] catching-up process" as it "attracted foreign investors" and "increased [Hungary's] capital stock" (Baran 18). This not only created more support for Hungary's growth-producing industries but also "facilitated substantial trade flows" and "technology transfer" (Baran 18). Mihaela Simionescu further found that FDI proved to be "an important determinant of economic growth" in Hungary, so any increases in such investments are directly tied to increases in Hungary's economic growth (54). In fact, Hlavacek and Bal-Domanska found that "foreign direct investment was higher following the accession than before," and Hungary "received the highest investments thanks to developed economic links" with nearby EU members (296-7). Evidently, EU integration has greatly augmented Hungary's economic growth as it has enabled increased trade, capital mobilization, and technological transfers that directly relate to an economy's ability to produce and sustain growth.

Conversely, Ukraine has received some sympathetic attention from the EU in attempts to create opportunities for economic growth and trade, but Ukraine's slow pace of economic reform and seeming unwillingness to fully adopt prescribed economic policy has shut Ukraine off from the benefits of EU integration. Ukraine's economy retained some of its past socialist characteristics, especially with the proliferation of Ukrainian state-owned monopolies, and this, along with relatively high levels of corruption, has certainly damaged Ukraine's ability to reach a point where the EU would accept them as a new member. Even as recently as 2014, the Ukrainian National Central Bank (NCB) "resigned from carrying out daily auctions of foreign currencies" which was a practice "demanded by the IMF" (Greta and Pakosz 82). Along with this, Ukraine has yet to "adopt the acquis communautaire," so without these kinds of reforms Ukraine will have no chance of integrating with the EU (Greta and Pakosz 86). Obviously, Ukraine must follow such prescriptions more closely and reduce its corruption if it ever hopes to achieve EU membership, for without doing so, Ukraine misses out on "money for innovations" and "moderni[z]ation of the R&D base," which would both immensely contribute to sustained economic growth (Greta and Pakosz 86). Even without these reforms, the EU has lent a helping hand in trade relations by providing "tariff reductions," but this has not provided a source of sustained growth as "quotas for Ukrainian products were exhausted" and demand for Ukrainian exports quickly fell (Greta and Pakosz 84). No matter the benefits that the EU could provide for Ukraine's economic stabilization, regional variations within Ukraine have made appealing for EU membership even more complicated. In Eastern Ukraine, there is a "notable residual 'Soviet' identity" that clings to Soviet-era production systems that once provided for much economic growth, but in Western Ukraine, there are prevalent "anti-Moscow perceptions" that lend themselves to supporting EU membership and the enhancement of market economic structures (Kallioras and Tsiapa 78).



In the end, Ukraine and its considerable financial struggles, which limits its ability to effectively carry out economic reforms, have held Ukraine back from securing EU membership, but nonetheless, Ukraine's failure to fully integrate with the European Union and its markets has greatly inhibited economic growth. While Hungary's EU integration has created lasting and sustainable opportunities for economic growth, Ukraine has consistently struggled to find other paths toward growth without the help of advanced EU economies.

IV. Role of Financial Institutions

Lastly, differing financial institutions between Hungary and Ukraine have generated differing amounts of growth. The absence of immense debt has enabled high capital liquidity that can finance growth-producing industries in Hungary, and foreign ownership of Hungarian banks has yielded sophisticated banking techniques that can support economic growth in the corporate sector. The same does not go for Ukraine though, for banks own much of the state's debt and inefficiently run in a manner that only serves to prolong the existence of Ukrainian banks. Another glaring issue is the difference between the two countries' currencies, for Hungary greatly benefits from not having to create its own independent monetary policy whereas Ukraine is forced to deal with the complications that arise from this problem. For these reasons, Hungarian financial institutions have a greater capacity to finance growth-triggering endeavors, but Ukrainian financial institutions are unable to contribute to any economic growth as a result of their crippling debt burdens and financial responsibilities.

Because of Hungary's aforementioned headstart when it came to economic reform, financial institutions in Hungary have grown to be mature institutions capable of providing services and financing conducive to economic growth. Hungary's "two-tier banking system was set up in 1987," and in 1989, the Budapest Stock Exchange opened, "which was the first of its kind in the region" (Mero 298). With this development, Hungarian banks moved away from solely central activities based on the state's commands and instead moved toward more commercial functions, and this would fulfill the much needed function of financing important industries and private businesses that could then go on to drive economic growth. The financing of the corporate sector has worked to "establish a healthy corporate financing structure which stimulates and sustains economic growth," so Hungarian financial institutions' lending habits have been essential in driving productive economic growth (Mero 311). As mentioned before, stock market capitalization is a necessary factor in private businesses' ability to contribute toward economic growth. In Hungary, the creation of a stock exchange coupled with its "level of capital-market liquidity" has enabled "increasing volume[s] of market capitalization" (Mero 315). This situation has not only allowed for private businesses and citizens to drive economic growth through market capitalization and its financing functions but has also given the Hungarian economy the proper level of financial mobilization to continue funding growth-generating industries. As the situation goes for Hungary's privatization, banks have also been subject to foreign ownership, but this has only increased their effectiveness and ability to finance economic growth. Hungary's two-tier banking system initially struggled due to its novelty, but by allowing foreign banks to enter the market, greater quantities of foreign capital led to Hungarian banks "providing services that could meet international standards" themselves (Mero 317). As a result, "both the regulatory and institutional weaknesses were eliminated" in Hungary, and with proper capital and supportive institutions, economic growth became a much simpler goal to achieve for banks and overall financial institutions. For these reasons, Hungary's financial institutions have been greatly capable of creating opportunities for economic growth within the economy.

Financial institutions in Ukraine have not been so well-equipped in effecting economic growth as they have had to deal with burdensome tasks that do not leave much room for creative lending. For one, Ukraine must construct its own monetary policy as it has not integrated with the EU's euro, and this has consistently left the Ukrainian economy in an extremely precarious state. Because of the National Central Bank's non-compliance with international organizations' economic prescriptions, the "exchange rate of the Ukrainian currency fell" for an extended period of 2014, and Ukraine "was very near to bankruptcy" as "foreign currency reserves also dramatically decreased" (Greta and Pakosz 82). This alone greatly limits the Ukrainian economy's ability to grow as it directly weakens Ukraine's position in all trade relationships and reduces their terms of trade. Financial assistance from various states and international organizations certainly alleviates some of these economic struggles, but financial assistance is "not enough to support the country's competitiveness" in more growth-generating sectors of the economy and does not "achieve long term sustainability" (Greta and Pakosz 83). Even bank loans, which should finance industries that create economic growth, are "negatively related" with economic growth (Kerimov 79). This is, in part, due to banks' immense "credit burden" and its "detrimental effect" on economic growth (Kerimov 80). This burden makes Ukrainian banks much more wary when it comes to lending and curtails their ability to finance any sort of production activities. As a result, banks "contribute the least to economic growth" as any given credit does not go toward "productive investments" that would reinforce sustained economic growth (Kerimov 81). Furthermore, the Ukrainian stock market cannot drive growth as "its low liquidity and number of participants" renders it incapable of acting as a source of financial resources (Kerimov 81). Thus, capital in Ukraine is often immobile due to its holdings in state debt and the near nonexistence of the Ukrainian stock market. Ukrainian financial institutions can only do their part in keeping the country out of bankruptcy, economic crisis, and banking collapse. So, while Hungary has been able to free its financial institutions from some of the burdens that excessively complicate its role in driving growth, Ukrainian financial institutions have had to navigate muddy waters while not having much resources to produce anything much other than their own survival.

V. Conclusion

To conclude, it is fairly clear that my chosen institutions for Hungary and Ukraine have more demonstrably supported economic growth in Hungary than in Ukraine. With economic reform, Hungary was able to implement reforms in a gradual, relaxed fashion that let the state take a disciplined approach in producing economic growth despite transition troubles, but in Ukraine, abrupt economic transformations damaged its ability to drive economic growth through investment, trade, and technological development. EU integration has manifestly helped Hungary achieve economic growth through its introduction of advanced technologies, foreign investment, and expansive trade markets, but since Ukraine has not been able to realize any sort of integration with the European Union, it has lagged in economic growth as it has been shut out from crucial trade and investment networks that would strengthen various economic sectors. Finally, financial institutions in Hungary have come to be major contributors to economic growth due to their maturity, foreign involvement, and growing amounts of mobile capital, but Ukrainian financial institutions have been stuck dealing with debt crises, credit burdens, and monetary responsibilities that drown out their ability to contribute to any sort of economic growth. Nowadays, the current economic situation in each of these countries is proving to be complex and unhopeful. War in Ukraine has significantly halted economic activity, pushed many workers out of the country, and closed off many possibilities for the country to engage in trade. The IMF predicts that the Ukrainian economy "will fall by a whopping 35%" because of the war, and it is hard to imagine that its economy will recover from such a hit anytime soon (VOA News). Conflict has similarly created economic uncertainty in Hungary, for the war and its sanctions will "reduce Hungary's exports" with both Russia and Ukraine and supply chain interruptions will cause great uncertainty in trade as well (Daily News Hungary). Conflict in the region will thus be likely to only produce negative effects for both economies, but only time will tell with these matters.

In all, my institutional comparisons may seem to paint more of a positive economic picture for Hungary than Ukraine, but there may be various Ukrainian or Hungarian institutions outside the scope of this paper that are more or less effective in driving economic growth. Either way, my choice of institutional comparisons between these two countries seems to point toward more economic growth coming about with greater adoption of market economics following transitions away from socialism, for Hungary fully enveloped itself with reforms, western integration, and financial liberalization with seemingly successful results for its economic growth. Ukraine has mostly had to come to terms with its legacy of socialism, but there seems to be much work to be done for the state to drive any sort of economic growth through market economics.

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