KCS Group Europe

KCS Country Risk & Threat Advisory

KCS Group Europe
Risk & Threat Advisory Paper

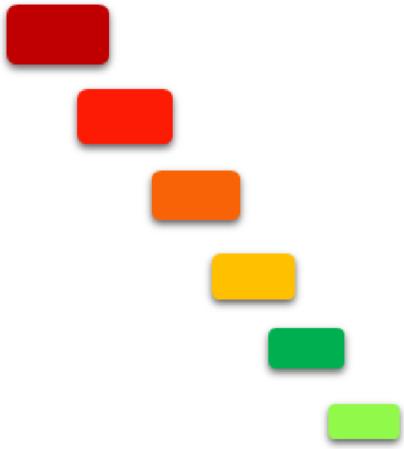
Political Risk Advisory Briefing: HUNGARY
October 2021

Political Risk Advisory Briefing: Hungary

Country:	Hungary
Population:	9,728,337 (July 2021 est.)
GDP:	$163.5bn USD

HUNGARY has a Possible risk rating of 3.

6	**Very High**	The assorted threats described in the report are almost certain to have a derogatory effect.
5	**High**	The threats are extremely likely to negatively affect the business.
4	**Very Possible**	There is a strong likelihood of problems arising in this country.
3	**Possible**	There is a fair chance of problems arising in this country.
2	**Low**	There is a low likelihood of any threats impacting business.
1	**Very Low**	There are virtually no impediments to successful business in this country.



Political Landscape

The political situation in Hungary has become increasingly authoritarian over the past decade, with Viktor Orban cementing his position across three separate landslide elections. His all-conquering Fidesz-KDNP coalition, currently holding 133 of 199 National Assembly Seats, has overseen a virulent shift towards right-wing conservatism, a concerted backsliding on democratic and liberal European values and the wholesale dismantling of Hungary's independent institutions. This ironclad majority allows the government to push through key legislation without needing cross-party agreements and has thereby increased its control over state institutions to the detriment of civil society, checks and balances.

They, along with Poland, were the only countries to veto the EU's rule-of-law mechanism last year, whilst also being the two found guilty of violating Article 7.1 of the Treaty on European Union. The EU vote, stating that the Hungarian government was a *"systematic threat to democracy*" passed with a two-thirds majority. In short, the Hungarian government has consistently violated the EU's founding values, including respect for basic human rights, the rights of minorities, the rule of law, freedom, democracy, and equality.

Perhaps unsurprisingly, Hungary has concurrently witnessed the sharpest drop among EU countries in the annual Corruption Index, compiled by Transparency International, meaning it is now one of the worst performers in Europe. Hungary has dropped 11 points since 2012 - scoring 44 out of a possible 100 - to compare with the likes of Senegal and Romania. Undoubtedly, it has become more prone to corruption. Business interests should be aware that this is not simply a by-product of Orban's tenure but represents the express aim of his party: to centralise political and economic power whilst destroying any opposition to his rule, whether that be from opposition parties, grassroots activism, the judiciary, or the media. And yet, with an election due early next year, a disparate raft of opposition parties have now banded together and are currently neck and neck in the polls, thereby representing a serious challenge for the first time.

The Business of Politics & The Politics of Business

Any group looking to operate in what is, conversely, an attractive economic environment, must acknowledge the possible risks, weaknesses and threats associated with falling out of political favour at local or national level. Where political interests trump the fair tendering of contracts, one should not expect a fair hearing, least of all from an impartial judiciary. This is particularly relevant where major public investment is concerned. To this end, in what is evidently a political move, Orban has heavily courted both Russia and China to counter what he sees as the EU interfering in his domain. Where business is concerned, this primarily revolves around a growing number of public loans and infrastructure projects that will naturally concern foreign business interests.

The primary example is a recently signed loan agreement with China that sets in motion Europe's first major Belt & Road Initiative infrastructure project (OBOR), tasked with modernising the rail link from its capital Budapest to Belgrade in Serbia. It will eventually link to the port of Piraeus in Greece. The bulk of the $2.1 Bn USD funding required will come from China, with Hungary putting up only 15% of the cost upfront. Perhaps most telling, though, is that Hungary has procured vast amounts of the Sinopharm vaccine from China (as well as Sputnik V from Russia), in direct contravention of EU wishes and policy. In Europe, Hungary has one of the highest number of people vaccinated – a real coup for Orban and another bloody nose to Brussels from Budapest.

Similarly, in 2014, the Russian state-owned company Rosatom was awarded the contract to upgrade the country’s only nuclear power station. Meanwhile, public contracts and even EU-funded tenders are rigged and awarded to those in Orban’s inner circle, including old friends and his son-in-law. Hungary’s creeping ‘state capture’ by elites has been steadily increasing since 2010. While Hungary does not have any singular industry on which it is reliant, the principle that Orban’s cronies are slowly, but surely, bringing swathes of business under their auspice, meaning that corrupt control becomes more widespread and standardised – something extremely worrying for businesses and investors. Unless something changes drastically, foreign firms looking to secure large public contracts will be unable to escape doing business with these Orban-reliant companies. As a result, companies involved should be aware that they may find themselves tainted in increasingly fraught economic, legal, and reputational situations, however innocent they may feel and good their intentions.

Orban is playing a dangerous game of diplomatic musical chairs and, despite Hungary’s increasingly poor reputation in the West, it has paid off thus far. Business interests should be careful not to put all their eggs in one basket by becoming too politically involved or intrinsically linked to public officials. In the long term, railing against neighbours whilst praising Moscow and Beijing, may well leave Orban and his party isolated. Increasingly fraught relations between the likes of Poland and Hungary and the EU threatens to dominate the bloc’s agenda in much the same way that Brexit did for the previous half a decade. In this case, it is an existential battle over the primacy of two very different systems. One the one hand, an increasingly authoritarian model committed to weakening democratic norms, media laws, human rights, and the separation of powers, on the other, rigidly committed to its founding principles yet one who cannot afford to further alienate parts of its membership. Orban knows this all too well and is pushing the EU to the limit, as it threatens to withhold COVID recovery funding for breaching the rule of law. He has characterised it as foreign meddling in the run up to the election – the classic siege mentality that has worked so well for him in the past.

The election campaign will be centred around this struggle, the economic recovery from the coronavirus pandemic and its high death toll. Despite a rapid rollout of a variety of vaccines, Hungary has suffered one of the higher Covid death tolls in Europe. Not only will the economic fallout be a great burden on the economy, as it will everywhere else, but the public anger and concern levelled at the actions of the "strongman" who leads the country may be tangible. Orban knows he is not untouchable in this regard – he has already begun to provide large tax rebates to portions of the electorate - particularly when one considers his challenger to help stem any drop-in support.

His official challenger in elections to be held early next year, Péter "MZP" Márki-Zay, has confounded expectations in defeating more established rivals, despite lacking a movement or party of his own. These rivals, the "insider" types that Orban has successfully mocked and kept at bay for over a decade, have since joined his United Opposition raft in a tactical ploy, despite their vastly different political leanings. This label cannot, however, be levelled at MZP and thus he presents a unique problem to Orban. Theirs is an interesting overlap – MZP in the past has described himself as a disappointed Fidesz voter. Yet, while he describes himself as a conservative, he is also pro-EU, would adopt the euro, would guarantee the rights of the media and has defended LGBT rights. He has, however, been noticeably quiet on the major issue in Hungary of migration – this may well be the stick with which Orban attacks.

Despite the media environment and public institutions being dominated by pro-Orban groups, the polls put the candidate's neck and neck. Previous results have also shown that Orban may be past his high-water mark. Voters in Budapest gave Fidesz a bloody nose in October 2019, when the party lost the mayoral election – the first major loss for the party since coming to power. The victorious mayor was even one of those who withdrew and ultimately backed MZP. Whether this is a sign of what is to come and how the country at large increasingly feels, however, remains to be seen.

Economic Landscape & Investments

Unsurprisingly, Hungary's GDP contracted sharply in 2020 thanks to the effects of COVID-19. Prior to the pandemic, the economic outlook of the country was extremely promising, at both a micro and macro level. Recent years have seen strong and continued growth, particularly where household income and exports are concerned. According to the IMF, the country's economy is estimated to have contracted by 5% in 2020 but is expected to recover by 4.3% and 5.9% in 2021 and 2022, respectively. The Florint has also lost a great deal of its value in the past year and continues to do so. Quite how the post-pandemic world will recover, in which directions and at what speed, of course, remains the subject of great debate and contention.

Hungary ranks 52nd out of 190 countries in the World Bank's Doing Business 2020 report, compared with 53rd in 2019[1]. In fact, Hungary has remained stable at around this sort of position for many years. The report claims that Hungary is exceptional where registering property, trading across borders, getting credit and in ease of enforcing contracts. The businesses have found considerable issues in the protection of minority investors, the acquisition of construction permits and electricity. The ease with which one can pay taxes has improved sharply in recent years – although the question of who exactly benefits from these taxes, remains.

Industry currently accounts for over a quarter of the country's GDP and employs a third of the working population. Much of this is focussed on strong electrical and automotive sector in the country, with the likes of Audi and BMW maintaining a presence. Hungarian industry is very open to foreign direct investment (FDI), with manufacturing almost consistently ranking as the top receiver of FDI - Hungary is widely considered to be the gateway to central and southern Europe. Given that it is also fully integrated into the EU supply chain, it is a very attractive market for foreign investment. The comparatively cheap and well-educated labour force only boosts these positives. The services sector contributes over half of GDP and employs almost all of the remaining workers. Trade, tourism, and finance account for the largest share of activity and employment within the sector. Elsewhere, the agricultural sector, which used to be the primary sector of the economy, now represents less than 4% of GDP.

Foreign business interests should also be aware of the numerous public investment opportunities available in the coming years, predominantly in the sectors of rail and energy. Many of these relate to the Three Seas Initiative that involves many of the countries in Eastern

[1] https://www.doingbusiness.org/en/data/exploreeconomies/hungary

Europe between the Adriatic, Baltic and Black Seas. Along with China's OBOR Initiative, this may very well revolutionise the region's economic prospects and give more freedom (particularly from Russia) to trade with those farther afield – the legacy of the Cold War still looms large in these countries: whilst gas and troops were easily moved east-to-west, the same cannot be said of north-to-south, or vice versa.

It has hamstrung the links between these nations ever since. Now, the region will see huge investment in telecoms, roads, railways, ports, fibreoptic cables and bridges. While this will create immense opportunity, one must refer back to earlier in this piece and the strong interests of China in tying themselves into the project and region for the foreseeable future. How the tendering of contracts is rolled out in the coming years should be heavily scrutinised – inevitably, politics and politicians will have their own agendas to protect and promote, most of all in Hungary.

Other areas of infrastructure in Hungary - in particular, the road network and public transport - are still in major need of redress, despite prior injections of EU money. The EU commission itself consistently ranks Hungary as one of those falling short by almost every metric where mobility and transport are concerned[2]. Investment in these types of projects has fallen across Europe, but Hungary still remains one of the main offenders in spite of the fact that it, along with Poland, receives the most funds. Public works are also, by their nature, decided by politicians, and subject to corruption, which drains the money away.

Orban's taste for vanity projects inevitably alters the funds available for basic necessities towards the likes of a needless football stadium in his childhood village of Felcsut. Furthermore, in a post-COVID world where public debt is high, funds for large public infrastructure projects may well be tight at a national and EU level.

The Social & Media Spheres

The executive, legislature, judiciary, and the dominant media majority are all under Viktor Orban's control. Independent media remains the last obstacle to absolute power, but even that has been greatly diminished since 2018. In that year, the Central European Press and Media Foundation (CEPMF), an association of almost five hundred media outlets in Hungary, was passed without financial compensation to an oligarch called Lorinc Meszaros, a childhood

[2]https://ec.europa.eu/transport/facts-fundings/scoreboard/countries/hungary/investments-infrastructure_en

friend of Orban. Since then, only a few free voices stand against the government's harmful narratives and fake news remain.

Similarly, the Hungarian government's attacks on institutions, NGOs, ethnic minorities, and activist groups (most notably Jews, Roma, the LGBT+ community and those associated with Orban's least favourite George Soros) remain integral to its political agenda and the creation of a hostile environment. The Central European University (backed by Soros) was forced to close and move to Vienna, whilst the government has ended the legal recognition of transgender people and amending the constitution to ban adoption by same-sex couples. Note that a new state university, slated to open in 2024, will also be funded by China. School and university curriculums have also been aligned with government policy in order to unduly influence citizens on issues such as politics, gender roles or refugees. In a world where these types of policies are enacted, social media (particularly in the West) is quick to condemn. This toxic atmosphere will inevitably reach a crescendo, either at the ballot box or in the streets.

Where businesses are concerned, many often think that these types of issues are irrelevant or simply background noise. However, the increasingly bitter "culture wars" fought online and in the media these days, do not capture just PEPs and those who espouse support for these policies. They also drag in those deemed guilty by association – public or private. Activist groups now know that the best place to hit someone is in their pocket and in the public consciousness. While companies may not find too many of these issues within Hungary itself, the internet means that borders are irrelevant in shaping the narrative elsewhere.

Businesses must understand that their brand can very quickly become toxic as a result, not just in the public sphere but where other companies are concerned too. The long-term impacts on a company can be vast.

Terrorism & Security

Despite the virulent anti-refugee sentiments permeating the political landscape in the aftermath of the European migrant crisis, and the erection of border fences, Hungary has not been subjected to the types of attacks seen in other European nations.

Although it captures less press, the far more prescient issue is organised crime and the criminal gangs operating in-country. Born out of the shortages of the Soviet system, and the resulting black market, groups grew exponentially with the rise of privatisation and the political vacuum of the 1990s. Their activities do not heavily relate to the extortion of foreign business interests, but rather prostitution, racketeering, smuggling and the trafficking of individuals, guns, narcotics, and tobacco.

Business interests should, however, have robust measures in place - both to prevent exposure to these groups and closely monitor the situation. With the rise of corruption in Hungarian politics and public life, it is a given that these groups will seek to embed themselves and take advantage whenever and wherever the opportunity presents itself.

Summary

Hungary serves as the gateway and lynchpin to Central, Eastern, and southern Europe. More developed than most of these neighbours, its rapid economic growth, diversified economy, and skilled labour force serve to make it an ideal base and springboard into the region. Whilst the political landscape leaves much to be desired, it can be managed and monitored in a way that mitigates and protects one from exposure to undesirable risks, weaknesses, and threats, whether they be in Hungary or abroad.

The tactics of state capture utilised by Orban and his cronies is, of course, an obvious and worrying trend. They will not, however, endeavour to scare away foreign firms and investment, particularly at a time of such economic uncertainty. The question remains, though, as to which firms they will be – particularly where the lucrative and vast energy and infrastructure projects are concerned. In a country like Hungary, it is essential that one knows the lay of the land, its politics, economy and, crucially, where they intersect.

With the election less than half a year away, the political atmosphere will become increasingly toxic and hostile. Naturally close neighbours and the EU will look on with bated breath, as will Russia and China, as the direction of the country comes to the fore. Both political coalitions, the voters, and those stakeholders with interests in the country, will all fear either the continuation, or distinct break, from the past that this crucial vote offers.

How can companies take advantage of the situation in Hungary?

- Stay abreast of the geopolitical landscape and events, particularly where FDI (public or private) and political interests intersect.
- Be prepared for flexibility and adaptability in what is a changeable market given the strong political influences, corruption, and nepotism at play.
- Secure a local partner/overseer with a strong understanding of the political landscape to open doors and provide support, but one which is known to act with integrity (i.e., a non-PEP).
- Closely monitor online trends – not just economic but political, social cultural - both in and outside the country.

Snapshot Overview

Strengths • Economic Potential & Trained Workforce • Diversified Services & Manufacturing Base • Rising Household Incomes & Exports • Falling FDI – Less Competitors • Some high-quality infrastructures	*Weaknesses* • Nepotism & Corruption • Rule of Law/Checks & Balances • Ageing Population & Brain Drain
Opportunities • Some public infrastructure needs an overhaul – EU and public money available? • Three Seas Initiatives • Investment in Rail & Energy sectors • Rapid Economic Growth – To what extent will this return to pre-COVID levels?	*Threats* • Authoritarianism • Loss of Checks and Balances • Online/social media-induced reputational damage (by political associations) • Social Cohesion

GREY AREA DYNAMICS

Over the years, KCS has made it their business to find workable solutions to impossible problems. To do this, KCS has sought to clearly establish the intelligence gap between perception and reality.

In today's market where terrorism, organised crime, cybercrime and government sponsored cyber espionage and war appear to confront us daily, we need reliable tools to identify the risks well in advance. It was for these reasons that KCS created and developed the analysis of risk by Grey Area Dynamics or GAD's, as they are often referred.

GAD's are all the risks, weakness and threats that will, at one time or another, interfere, disrupt or at worst close down businesses. In the projects and work in which KCS have been involved in all over the world, it has been evident that the GAD's identified, can and do kill. This method of risk assessment and measurement goes well beyond standard due diligence and is a collective description of factors, which can be passive and non-passive, legal and illegal. Because GAD's are difficult to quantify or assess from a purely economic viewpoint, these considerations do not normally feature in most credit ratings, investment and banking reports, which focus only on sovereign risk.
The main categories of Grey Area Dynamics usually encountered are:

Passive/Legal

- Language & Dialects
- Local Customs & Traditions
- Local Staff – motivation and training
- Tribalism and Integration
- Cultural & Local sentiment
- Regulations, Taxes and Duties
- Currency & Capital exposure – payment methods and banking practice
- Environmental Hazards
- Pressure Groups
- Media Relations

Non-Passive/Legal

- Industrial & Labour Relations
- Absence or effectiveness of Legal Safeguards

- Government Policy and Nationalisation
- Overt and disguised/beneficial ownership
- Bureaucracy and Local Government
- Public or Media hostility

Passive/Illegal

- Bribery & Corruption
- Vested Interests and Cronyism
- Patronage
- Product diversion
- Parallel Trading
- Hidden Barriers to entry

Non-Passive/Illegal

- Counterfeit & Fraud
- Pilferage
- Unfair Market Competition
- Product Piracy
- Ethics and Corporate Espionage
- Organised Crime
- Threats to physical assets
- Kidnap & Extortion
- Religious Extremism
- Terrorism
- Civil Unrest
- Product Contamination

For a risk assessment to be thorough, it must encompass the potential for a broad array of economic, political and business situations that might affect a business venture. Evaluations limited just to political issues or financial factors may be completely misleading.

The degree of severity of a risk portfolio will also depend on the origin of the investing entity; for example, European companies often face different risk profiles to American corporations considering the same investment opportunity.

Grey Area Dynamics pose a challenge of diagnosis[3]. The key to avoiding problems before they occur or solving them after they have begun to take a toll on performance, lies in their early identification and evaluation. Ignoring the impact of GAD's can be a costly business.

[3] KCS Group Europe won the European Service Provider of the Year, 1999-2000 at the European Risk Management Awards magazine International Risk Management for their work on GAD's. In 2004, the company won an award for Product of the Year from StrategicRisk.