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New Trends in Foreign Direct Investment Flovs in Hungary

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SUMMARY
FDI flows to Hungary have slowed down in recent years, while FDI outflows have grown significantly. A change in capital flow trends is influenced by the termination of the privatisation process in Hungary. It is still open to interpretations whether the deterioration of the net FDI balance is also due to loss of international competitiveness of the country. Based on surveys on strategic decisions of major corporations, the study concludes that in the period of 2000 to 2003 mostly firm and region specific factors shaped the capital outflows. However, a further deterioration of FDI balance would be detrimental to the development of the Hungarian economy. Sources and sector targets of further FDI inflows in the period directly before and after the accession to the EU are expected to differ significantly from those in the 1990s.

INTRODUCTION

Foreign direct investments (FDI) have played a key role in most Central Eastern European (CEE) economies, and in particular in the Hungarian economy. Their significance is well known to policy markers and the general public: direct investments alongside with other forms of foreign capital add to the stock of capital of the recipient economy, thus lessening the relative capital shortage so typical of all countries in transformation. FDI differs from other types of capital flows since a foreign direct investor – by definition – brings in non-debt creating funds as well as the potential of technological spillover from the foreign owner to the domestic economy. FDI is generally regarded to be a long-term commitment as compared to a portfolio investment which by nature tends to be more volatile (see e.g. Krugman/Obsfeld, 2000).

With this background it is clear why Hungarian decision makers have mostly followed policies supporting the inflow of FDI ever since the change of the political regime after the 1990 free elections. FDI can be supported, among others, by favourable tax climate; but perhaps the most robust policy vehicle has been the choice of privatisation techniques: direct sale of state assets promotes the inflow of foreign funds, in contrast to restitution or management buy-out or voucher schemes.

The Hungarian privatisation policies have used various ways (with the notable exception of voucher-type distribution of property titles) to bring state property into the private sector, but the main technique applied has been the sale for cash – a method that has naturally proved to favour cash rich foreign firms and funds. Once in the country to acquire former state owner firms, these market players have frequently considered further investments opportunities in the form of 'greenfield' projects. The presence of foreign players in the Hungarian economy from a rather early date has been instrumental in harmonising the domestic business practice with the international standards. A sizable FDI sector therefore accelerates the diffusion of Western type practice in the public administration.

The Hungarian case of absorbing massive FDI into the domestic economy is not unique in the CEE region, although the country as investment target certainly stood out among other economies of comparable size and level of development in the early and mid-1990s. The ownership structure of the corporate sector of Hungary has changed dramatically during the 1990s (see Table 1). The share of foreign owners in the registered capital of the Hungarian economy increased particularly fast in the middle of the decade.[1] The data, however, lend themselves to two different interpretations; the one being that the Hungarian economy has been successful in absorbing foreign capital so intensively; the second, and more sceptical, reading of the facts is that domestic businesses have not been able to maintain or build up their capital base – hence the swift contraction of their relative share in overall capital base of the country.

VIEWS ON CAUSES AND CONSEQUENCES OF CHANGES IN FDI FLOWS

In fact, it is hard to tell if 40 or 50 per cent foreign ownership in the corporate sector is too much, just good or should still be well increased. The Hungarian figures do not stand out as exceptional in comparison to other countries' data on the relative significance of FDI. The stocks of FDI on a per capita basis are, for example, as high or even higher in the Czech Republic and Estonia, Hungary being only the third: in 2001 the corresponding data are USD 2 604; 2 311; 2 311 respectively (UNCTAD, 2002). True, there is hardly any reliable yardstick to go by; international comparisons are of limited value due to methodological ambiguities in comparing such data, and also because should some hurdle rate for 'healthy' foreign ownership ration exist, that must depend on size, structure of the economy compared, and also on socio-political conditions of the society involved.

Whatever one feels about the fast and seemingly easy penetration of foreign direct capital to the Hungarian economy, the trends suddenly changed at the turn of the decade as a result of changes in key areas influencing capital movements. One of the factors is change in the global climate, namely: the size of FDI flows worldwide declined after a peak in 2001. This factor, however, cannot explain much in itself, as Hungary has had a relatively small portion from world capital flows, while other CEE countries managed to increase their share of worldwide FDI at the same time, indicating therefore that the decline in general supply of capital should not be seen as responsible for what happens to one particular small country, such as Hungary.

There is an obvious factor at play: the end of large-scale privatisations in Hungary, while late-comers entered their privatising phase at that very time. The share of privatisation revenues within overall FDI has been well below the 20 per cent ratio in the case of Hungary (reaching practically nil in 2002), but this ratio exceeded 40 per cent in, say, the Czech Republic in 2002, or even 80 per cent in that year in Slovakia.[2] A certain decline in net capital inflow into the Hungarian economy may therefore be partly explained by the fact that having sold most of the state assets, Hungary will not import much FDI through further privatisation.

Absorptive capacity of a country may also change in time. There are views in the business and research community in the country that the flattening of (and later slight decline in) FDI-type inflows is due to loss of international competitiveness of the country (ICEG, 2003). It is certainly true that wage costs have been radically growing in Hungary during the period of 2001 to 2003: unit labour costs in Euro have grown annually between 10 and 20 per cent in these three years. However, labour costs are but one factor for a firm in its choice of location for a new investment (or for re-investing in an existing one). Studies and market research reveal that the motivations of potential investors are much complex, and include a set of institutional factors (quality of labour force, general infrastructure, efficiency of the legal system and presence of corruption in the country, market size and the purchasing power of the population). [3] Yet, there is an obvious factor that shapes the size and composition of FDI in the Hungarian (and other CEE) economy, namely the capital export of the country. Certainly, in the case of Hungary, this is the most important single factor that explains the sharp decline in the balance of FDI-flows. Year 2002 and 2003 were the very first years of sizable capital export from Hungary, by domestic and also by dominantly foreign owned firms. The current account statistics reveal that in year 2002 the balance of direct capital flows (investment into shares and other equities) stood at EUR 1077 million as the outcome of inflows of EUR 1281 m and outflows EUR 204 m. In comparison, during the 8 month of Jan-Aug of 2003 the final balance is only EUR 273 m as a result inflow of EUR 812 m and outflow of EUR 540 m (KSH, 2003). The year 2003 may go down into economic history as the first year when the country is a capital importer.

MOVERS OF CAPITAL MOVEMENTS: AN OVERVIEW OF CORPORATE STRATEGIES

Is capital export a sign of growing maturity of the Hungarian economy? Certainly the bulk of FDI flows take place among countries of the developed, industrialized 'triad' of the world, and being both exporter and recipient of FDI is characteristic of a more mature economy. Or: do capital outflows signal a decline in the attractiveness of the country? If, for instance, Hungarian companies start exporting capital to neighbouring countries because they find the fast growing Hungarian wages already too high, the answer could well be confirmative.

In this respect it is important to look at the company specific factors of the FDI outflows. The most important source of capital export from Hungary has recently been MOL, the Hungarian oil and gas corporation; market leading bank OTP, the national telecom champion MATÁV, as well as an expanding hotel firm, chemical and pharmaceutical businesses.

The case of MOL is a good illustration of regional expansion. MOL in 2000 paid 270 million USD for the first lot of the shares in its Slovak counterpart, Slovnaft. In 2002, under the second part of the deal, MOL invested a further 360 million USD, increasing its share to a dominating 67.8 per cent in Slovnaft. Next, MOL acquired 25 per cent of Croatia' market leader oil and gas corporation, INA in 2003. These steps have certainly nothing to do with capital flight, they rather represent strategic moves to build up a company that is big enough to compete in Europe, or rather that is sizable enough not to remain itself an easy target for acquisition by much larger firms. One should keep in mind that MOL may be a big company in the Hungarian context but its market capitalisation of about 3 billion USD is being dwarfed by the market value of BP (app. bn 50 USD) or Shell (app. 100

billion USD). It is telling that the annual refinery capacity of MOL is about 11 million ton, as opposed to Austria's OMV of 13.4 million ton, Croatian INA's 10 million ton, Poland's PKN Orlen's 13.5 million ton, Slovnaft's 5.4 million ton - all too small on their own to withstand competition and acquisition from cash rich Western multinationals or Russian oil giants (Financial Times 2001). Similarly, OTP invested in a medium sized Slovakian bank in 2002 (now Banka Slovensko a.s., member of the OTP Group), and recently acquired a major local bank in Bulgaria. OTP stands out in Hungarian business life as a former state owned semi-monopoly that has been successfully turned into a profit making venture through privatisation and reorganisation under Hungarian management. This bank has followed a cross-border strategy in a region that covers some of the former planned economies as well as Austria (where at present OTP is bidding for a local financial institution).

There are other cases of regional expansion by Hungarian companies, both under local management and firms in foreign property, registered in Hungary and strategically controlled by the foreign owners.[4] However, these cases of capital exports from Hungary provide only a partial explanation for the deterioration of Hungary's net balance of FDI. In the pre-accession period, a steady increase of inflows could be expected. Other countries in the region (most particularly Poland in the period 1999 through 2002, the Czech Republic in 1999 through 2002, and Slovakia since 2000) have certainly absorbed sizable net inflows, with or without privatisation-linked transactions. Are there still elements of capital flight from Hungary?

A survey of transactions reveals various cases. One such case is that of the multinationals. Some major corporations have received generous tax reduction schemes since 1990 or even before, with a time span extending into the years when Hungary will have been an EU member state. During the accession negotiations in 2002, the EU called for the termination of such investment support schemes, as they do not fit into the Community's policies concerning 'state aid'. A compromise solution reached in December 2002 put a ceiling to the overall amount of tax concessions available for the big foreign investors (thus meeting the demands of the EU), without an abrupt change of the tax regime under which these firms had come to Hungary. As a result, no such major firm declared a termination of its core activity in Hungary.

Yet, certain plants have been closed since that (Mannesmann, IBM) under relocation schemes; new locations are reported to be in the Far East. Whether these and similar moves are a reaction to the less generous tax treatment or they are motivated by other economic trends is hard to tell. Meanwhile Hungary experienced a nominal appreciation of the currency (HUF), and at the same time a two-digit increase of the nominal wage level; the combined effect of those resulted in the steep increase of unit labour costs in EUR or USD - a reason enough to move labour intensive, low value added production east of Hungary (or sometimes east *within* Hungary).

At the same time, new sources of FDI have also been reported. One significant, albeit underreported, source of foreign capital is the reinvested profit. Since inflows into the Hungarian economy started rather early, a great number of foreign owned ventures have by now entered their profitable life cycle; a part of the profit made will always be reinvested if conditions are deemed suitable. Statistical reporting on such corporate behaviour is notoriously unreliable, but market analysts believe that over half of the profit made has been reinvested here rather than been repatriated.

Small and medium sized enterprises (SMEs) are also among the new drivers of capital inflows to the Hungarian economy. Individually, an SME does not invest much, but their number has been on the increase lately, and their investment activity has intensified in spite of the recent sluggish FDI-trends. The full membership of a present candidate country will further reduce country risk, and at the same time will highlight the investment opportunities among a large number of potential investors - that is in the SME sector.

Finally, a glance at Table 1 reveals that certain sectors have not been so far the target of foreign direct investments: agriculture, health and some other services. The EU membership terminates or gradually phases out previous restrictions for FDI to enter these sectors. One can thus expect inflows of FDI into sectors not frequented before.

Conclusion

The dip in net FDI inflows is due to many economic factors, some unrelated to the EU-enlargement process, some – the wage increase, change of the tax code, increased environmental and social standards in industry – are clearly influenced by the accession to the Union. Similarly, capital export from Hungary, mainly to the east and south of the country, is also driven by multiple motives, the most important now being the expansion policies of large to medium sized firms. The fact that Hungary started to privatise the former state owned firms sooner than the neighbours some of them are now in the middle of the process explains why major Hungarian business firms have become active in M&A and privatisation transactions in year 2000 and after. It is probable that the process will continue for the years to come; capital export from Hungary in on the whole laudable.

Yet, this capital outflow coincides with a persistently high trade deficit, budget deficit, and a general worsening of key macroeconomic figures (with the exception of the unemployment rate - until mid-2003). FDI is but part of overall capital flows, and as such should not be relied upon in financing the Hungarian economy. However, the drying up of FDI finance may lead to more reliance on debt-creating funds – a trend not welcomed by the capital market. Higher debts ratios, particularly more government debts do not help Hungary's entry into the EMU, either. Our conclusion therefore is that policy makers should now reconsider priorities: less emphasis on domestic consumption and consumer driven growth, and more attention given to incentives for investment, by domestic and foreign participants alike.

TABLES

Table 1

Share of Foreign Capital in Hungarian Corporations

	Foreign share of owners' equity				
	1993	*1994*	*1996*	*1998*	*2000*
National average	*15,7*	*18,9*	*32,3*	*39,3*	*42,9*
Agriculture	2,4	3,5	6,1	7,1	8,6
Mining	17,8	17,8	36,1	27,8	39,2
Manufacturing	30,9	37,0	52,5	59,7	64,5
Food industry	43,4	48,0	51,4	62,8	59,5
Machinery	36,8	43,8	64,9	64,3	54,9
Electric, water, gas	0,5	0,4	21,7	31,2	27,0
Commerce	22,3	27,8	36,5	45,8	38,6
Transport, telecom	13,8	15,5	23,1	31,0	31,8
Financial services	14,9	19,4	46,6	48,8	56,9
Education	10,0	10,0	14,8	10,5	6,0

Source: Foreign Direct Investment in Hungary. HCSO, 2001.

Table 2
Stock of FDI in the world, the EU and in transition countries
Million USD

	1990	**1995**	**2000**	**2001**
World total	1871,6	2911,7	6258,3	6845,7
European Union	733,3	1115,1	2382,0	2648,7
Accession countries	2,9	31,3	89,4	110,2
Poland	0,1	7,8	33,6	42,3
Czech Republic	1,4	7,3	21,6	26,8
Hungary	***0,6***	***11,9***	***19,8***	***23,6***
Slovakia	0,1	0,8	4,6	6,1
Slovenia	0,7	1,8	2,8	3,2
Estonia	0,0	0,7	2,6	3,2
Lithuania	-	0,4	2,3	2,7
Latvia	-	0,6	2,1	2,2

Source: UNCTAD, World Investment Report 2002.

Endnotes

[1] The content and reliability of such statistics always invite some scepticism. National origin of owners are hard to determine both at closely held and at publicly traded corporations. Certain capital movements such as loans from parent company to subsidiaries are not easy to classify. National agencies differ in as much some of them register as FDI not only cash transfers but also in kind contributions or even further investment promises made. The Hungarian practice has been rather strict in this respect by registering the factual cross border movements of funds into functioning or new ventures as FDI if such funds exceed the 10 per cent share – a hurdle that distinguishes the FDI and the portfolio investors. The Hungarian Statistical Office changed its methodology in 2002, thus later figures are not fully comparable with the figures in Table 1; the message of the table remains, however, clear.

[2] See e.g. A magyar működőtőke-áramlás alakulása regionális összehasonlításban /Hungarian FDI in regional comparison/. /3/

[3] See e.g. a study made by Ernst & Young about motives of German investors in the CEE region. The comprehensive evaluation of companies with investment plan in the region is that Hungary offers the best overall investment climate, followed by the Czech economy, Poland, and finally by Russia. This is in spite of the fact the Hungary got the highest mark only for one factor (the infrastructure), being second or third for other factors. Relative wage costs are seen as the highest, and the limited size of the Hungarian market also puts the country at a disadvantage compared to others. /2/

[4] See our study: *Bod Péter Ákos - Cséfalvay Zoltán*: Tőkeáramlás a Kárpát-medencében. /1/.

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Zusammenfassung

Der direkte Kapitalimport nach Ungarn hat abgenommen, während der Kapitalexport in letzter Zeit erheblich zugenommen hat. Die Umkehrung des Trends hängt mit dem Abschluss der Privatisierung zusammen. Fraglich ist aber, ob die Verringerung des Kapitalimports keine Ursache für die Schwächung der wirtschaftlichen Konkurrenzfähigkeit ist.
Der Aufsatz demonstriert auf Grund der strategischen Entscheidungen der Großunternehmen: die Kapitalexporten wurden von unternehmensspezifischen und regionsspezifischen Faktoren in den Jahren 2000-2003 beeinflusst. Die weitere Verringerung des Kapitalimports ist aber vom Standpunkt der Entwicklung der ungarischen Wirtschaft nicht wünschenswert. Die Quellen und die Zielsetzungen des unmittelbaren Kapitalimports sind in der unmittelbar vorausgehenden oder auch folgenden Periode des EU-Beitrittes teilweise andere als sie in den 1990er Jahren waren.

Összefoglaló

A magyar gazdaság közvetlen tőkebeáramlása lassult, a tőkeexport erőteljesen megnőtt az utóbbi időben. A trend megváltozása összefügg a privatizáció folyamatának lezárultával. Kérdéses azonban, hogy a tőkeimport mérlegének romlása nem oka-e a gazdaság versenyképessége gyengülésének. A tanulmány nagyvállalatok stratégiai döntései alapján bemutatja: a tőkekiáramlást vállalat-specifikus és régió-specifikus tényezők formálták 2000-2003 során. A tőkemérleg további romlása azonban nem kívánatos a magyar gazdaság fejlődése szempontjából. A közvetlen tőkebeáramlás forrásai és cél-ágazatai az EU-csatlakozást közvetlenül megelőző és követő időszakban részben mások, mint voltak az 1990-es évtized során.

Keywords: Central Eastern Europe, FDI, mergers & acquisitions, EU accession