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Hungarian Foreign Direct Investment Outflow to the Southeast European Countries

Hungary became a significant foreign investor in the Southeast European region. Some large Hungarian enterprises gained a foothold in mainly Bulgaria, Croatia, Macedonia and Romania. This process is unique among the CEE countries and it only began in this decade or a few years ago. In the future, the increase of the foreign activity is expected to continue due to the progressing privatisation process, the high economic growth and the improving business climate.

Background

In the new millennium, the Hungarian enterprises started to increase dynamically their external activities through foreign investments, basically in neighbouring countries. While in the previous decade, the stock FDI outflow amounted to approximately EUR 800 million and the share of South Eastern Europe was less than 10%, this picture has changed in this decade. Enterprises from Hungary latched on to the privatisation process progressed in the neighbourhood and the FDI outflow started to grow. In this case, MOL, the Hungarian oil company was the forerunner by buying shares in Slovnaft in the Slovak Republic.

After that, other large Hungarian companies have also started to “shop” in the region. In 2001, the Hungarian telecom company (MATÁV) bought the Macedonian telecom company (Maktel) and the fact that Hungary is still the largest investor in Macedonia reflects clearly the magnitude of this acquisition.

In 2002, Romania had the second largest share in Hungarian FDI outflow, however, in case of Romania, generally smaller investments occurred. The main Hungarian investors were MOL, Dunapack, TVK, Zalakerámia and the Danubius Group. This year, the stock FDI that came from Hungary increased to EUR 150 million in Romania (now, it is approximately EUR 700-750 million).

Table 1.
Evolution of Hungarian FDI outflow, 1998-2003 *(stock, million euro)*

	1998	1999	2000	2001	2002	2003
Albania	0,0	0,0	0,1	0,1	0,0	0,0
Bulgaria	0,0	1,5	4,1	0,8	11,4	352,0
Croatia	7,7	12,2	17,6	23,5	51,7	509,0
Macedonia	0,0	0,0	0,0	319,9	281,2	285,6
Romania	61,2	64,6	65,7	95,4	151,6	234,1
Serbia and Montenegro	0,0	0,0	0,0	0,4	0,3	0,3
SEE-6	69	78	88	440	496	1381
TOTAL	582	810	1326	1675	1908	3275
Share of SEE-6 in total (%)	11,8	9,7	6,6	26,3	26,0	42,2

Source: national banks, own calculations

In 2003, the pace of outflow of Hungarian capital increased further and FDI outflow reached EUR 1,3 billion. In that year several significant acquisitions occurred: firstly, OTP Bank privatised the largest Bulgarian commercial bank (DSK), secondly, MOL bought shares in the Croatian oil company (INA). The amount of these two investments exceeded EUR 800 million. On the other hand, the investment activity in Romania also continued.

The result of this process was that Hungary became an important investor in these countries and its share in total FDI increased. As it was mentioned, in Macedonia Hungary is the largest investor, while it is the fourth in Croatia, the sixth in Bulgaria and Hungary is in the TOP15 in Romania, too.

In spite of the fact that OTP failed to privatise Jubanka in Sebia, the Hungarian bank led the foreign investment activities in 2004. OTP bought the Romanian RoBank and the Croatian Nova Banka. Both banks are good bases to gain a foothold and start to increase market share. The activities of MOL and MATÁV were moderate last year, thus the amount of FDI outflow lagged behind the value of 2003, however, it remained significant.

TABLE 2.
FOREIGN DIRECT INVESTMENT IN SEE COUNTRIES, 1998-2003 *(stock, million euro)*

	1998	1999	2000	2001	2002	2003
			end of year			
Albania	394	435	578	786	929	1 107
Bosnia-Herzegovina	67	244	390	509	774	1 155
Bulgaria	1 597	2 403	2 257	2 758	3 662	5 000
Croatia	1 903	2 578	3 560	4 706	6 711	11 351
Macedonia	203	235	410	851	929	1 024
Romania	4 418	5 469	6 480	7 638	9 022	12 764
Serbia and Montenegro	853	965	1 015	1 180	1 655	2 915
SEEC7	**9 435**	**12 329**	**14 690**	**18 428**	**23 682**	**35 316**

Source: national banks, own calculations

There are many reasons why Hungarian companies started to increase their foreign activities:

Firstly, on the one hand, these enterprises have stable and strong position in Hungary and they are able to do foreign acquisitions. On the other hand, these enterprises were beginning to overgrow the domestic market, which is relatively small.

Secondly, in the new decade, the region of Southeastern Europe started to become a politically and economically stable area, thus the SEE region became more attractive to foreign investors.

Thirdly, these countries are still going through the restructuring process of the economy. Privatisation process is still ongoing and several attractive state-owned enterprises were privatised in the last few years and there are still others which are waiting for privatisation. Privatisation is an effective tool to increase foreign direct investments for these countries.

Fourthly, the pace of economic growth is high in these SEE countries. GDP growth reaches 4-8% in several SEE countries which results in dynamic market growth as well. Due to this fact, foreign investors are able to gain more profit in these countries than in their domestic markets. On the other hand, in most cases, the cost of workers is also lower than Hungarian level, while taxes are generally attractive to foreign investors.

Finally, the fact that these countries are in the neighbourhood also means that this area is a natural, favourable investment target for Hungarian companies. On the other hand, the border of the EU also came closer to the SEE region owing to the EU enlargement.

The dynamic increase of FDI outflow is not a usual process in CEE countries. Between 2001 and 2003, Hungary had more than 50% share in five CEE countries' - Czech Republic, Hungary, Poland, Slovakia and Slovenia - FDI outflow, which is quite remarkable. However, that was the result of basically three large companies' foreign activities. On the other hand, not only these large enterprises, but smaller sized companies also participated in foreign expansion, mainly in Romania.

OUTLOOK

It is clear that this process is has not ended yet, the privatisation process of these economies is still not finished. These large Hungarian companies are planning to expand further in the future. In case of MOL, it was published at the end of the year that the Hungarian oil company would buy the Romanian petrol station network of Shell. In 2005 MOL plans to increase its share in Croatian oil company (INA). In Serbia, MOL will be expected to tender to Naftna Industrija Srbije (NIS), while in Bosnia-Herzegovina, the MOL-INA consortium is interested in Energopetrol.

The case of OTP Bank reflects that the external expansion is profitable. That is why the OTP Bank continues the expansion and now turns to Serbia. The Hungarian bank has subsidiaries in Slovakia, Romania, Bulgaria and Croatia but not in Serbia. That is the reason why OTP Bank seeks the opportunity to invest in Serbia. In 2005, Novosadska Banka and Continental Banka are expected to be sold, thus the Hungarian bank can expand further.

MATÁV, the Hungarian telecom company has been “silent” since the Macedonian investment but now the privatisation of Montenegrin telecom company (Telekom Crne Gora) has drawn the Hungarian telecom company’s attention. Thus, Matáv has submitted a binding offer in the public tender process for the sale of shares of the company. Decision will be made in the future, but MATÁV has good chance to win.

Other Hungarian economic actors are ready to appear in SEE countries. For example, TriGránit plans to invest approximately EUR 1 billion in Romania, the company will build a mall in Cluj among others. It is obvious that the large companies will keep the largest share in Hungarian FDI outflows but other economic actors are expected to follow them, thus the significant foreign direct investment outflow to the region is expected to remain.

Western Balkan Countries: Outlook for 2005

Albania

Albania has experienced robust economic growth in recent years. The year 2004 was closed with a 6 percent real GDP growth rate. That is exactly the same rate as observed in 2003. The main engines of growth in 2004 were the construction industry and agriculture. Industrial output grew by 3.5 percent in 2004. Economic growth is expected to remain strong also in 2005 and 2006, reaching 6.5 percent and 6 percent, respectively. Industrial production is expected to grow by 4 percent in 2005. The growth rate of agricultural production and construction output is also expected to rise in 2005, reaching 3.5 percent in case of the former and 11 percent in case of the latter (the rates of increase in 2004 were 3 percent and 10.6 percent respectively). A reduction in the unemployment rate could be observed compared to the previous year, as the rate of unemployment in 2004 reached 14.8 percent. In 2005 and 2006 the reduction is expected to continue, with an expected unemployment rate of 14.5 percent and 14 percent respectively.

The consumer price index reached 2.9 percent in 2004, which was in the middle of the 2 to 4 percent target range set by the Bank of Albania. CPI is expected to rise in 2005 reaching 4 percent, which is the barrier of the target range. By 2006 it is expected to decrease slightly to 3 percent. The exchange rate of the lek against the US dollar was appreciating during 2004. This was mainly the result of inflows of foreign exchange from tourism and from Albanians living outside the borders of the country. Therefore the central bank had a chance to lower the interest rates. After five reductions during the year 2004 was closed with a basic interest rate of 5.25 percent.

The current account deficit, as a percentage of GDP, increased compared to its value of 6.6 percent in 2003 to 6.8 percent in 2004. It is expected to widen further to 7.1 percent in 2005 and to 7.2 percent in 2006. At the same time planned privatizations in 2005 (for example the privatization of Albanian telecom) are going to be a source of large FDI inflows.

Bosnia and Herzegovina

2004 was a year of increased real GDP growth in BiH. The real GDP growth rate reached 5 percent and the increase is expected to continue in 2005 to 5.5 percent. The rise in industrial output was stronger in the Federation (14 percent) than in the Republika Srpska (8 percent). The growth rate of industrial output is expected to be somewhat lower in 2005, in both entities (7 percent, and 6 percent respectively). Economic growth is also supported by the developments in the euro zone, as interest rates are expected to rise slowly. The increasing competition in the almost fully privatized banking system is also putting a downward pressure on interest rates, which in turn is supporting economic growth in BiH.

At the same time, despite the favorable growth performance, unemployment remains a serious problem. The unemployment rate was estimated to be 42 percent in 2004, and it is expected to stay about the same in 2005. However, the employment statistics are highly unreliable and the gray economy is still quite large in BiH, giving jobs to people, but not becoming visible in the statistics. There are also refugees returning to the country as a result of stabilization, and they are contributing to the increase in the number of unemployed. Therefore high unemployment is expected to remain a serious problem in BiH for some time to come.

Inflation was not a problem in BiH in 2004. In the Federation CPI reached 0.2 percent and in Republika Srpska it reached 2.2 percent. No significant rise in CPI is expected in 2005, as fiscal policy is tight, and the currency board operates effectively.

The current account deficit remained large in 2004, reaching 25.5 percent of GDP. In 2005 a small decrease is expected, to 22.5 percent of GDP. This will be the result of the start of negotiations with the EU on the Stabilization and Association Agreement. Some of the preconditions of signing the agreement are political, but economic reforms and technical requirements should be also implemented. These changes will also affect the current account, contributing to the decrease in the deficit.

The level of foreign debt does not seem to be a problem in BiH. As a percentage of GDP it reached almost 35 percent in 2004, and it is expected to remain at that level in 2005. As foreign debt is mostly owed by the government, the restrictive fiscal policy guarantees that the level of debt will not rise.

Macedonia

Economic growth in Macedonia, in 2004 was weaker than in the previous year. It reached only 1.5 percent. This was mainly the result of restrictive fiscal and monetary policy, as well as structural problems. Growth is expected to remain weak in the medium term, until the structural problems are solved. In 2005 real GDP growth is expected to be 3 percent. Industrial output declined by 12 percent in 2004. In 2005 it is expected to increase by 6 percent. Unemployment is a serious problem in Macedonia, with the unemployment rate reaching 35 percent in 2004. In 2005 it is expected to decrease slightly, to 33 percent.

Consumer prices were decreasing in 2004, by 0.3 percent. In 2005 this tendency is expected to be reversed, with CPI reaching a low positive level. It is expected to be 1.2 percent, while in 2006 it is expected to rise to 2 percent.

In 2004 the current account deficit reached 6.1 percent of GDP. In 2005 it is expected to decrease slightly, to 6 percent, while in 2006 it is likely that it will rise to 6.3 percent.

Monetary and fiscal policy is likely to remain restrictive in 2005. The de facto pegging of the denar to the euro is expected to continue. In 2004 a policy of raising interest rates began. Political uncertainty is also a factor which will continue to restrict growth in 2005, similarly to 2004.

Serbia and Montenegro

Economic growth was increasing in Serbia and Montenegro last year. In 2004 real GDP grew by 4.5 percent. The main driving forces of the stronger GDP growth were the growth in industrial output, which was above 5%, and also the rise in wages, which resulted in higher private consumption and the rise in retail sales. Economic growth in 2005 is expected to be between 4 and 5 percent. The rate of unemployment decreased in 2004 to 32 percent. It is expected to be about the same in 2005.

CPI in 2004 was higher than the target set by the central bank (8.5 percent), and reached 10.5 percent. It is also expected to be around 10 percent in 2005. In order to fulfill the promises made to the IMF, the budget deficit should be reduced to 2.5 percent. This would increase the stability of the dinar and also put a brake on inflationary pressures. However, in 2004 the budget deficit reached 3.3 percent and in 2005 it is expected to be only slightly lower (3.2 percent). High oil prices and the increase in electricity rates were also in the way of attaining the inflation target in 2004.

The deficit of the current account (as a percent of GDP) was slightly lower in 2004 (11.3 percent) than in the previous year (12.6 percent), but still at an unfavorable level. The trend of reduction is expected to continue in 2005, with the deficit reaching 9.7 percent.

Foreign debt, as a percent of GDP, has been decreasing in recent years. In 2004 it reached 60.7 percent. A debt rescheduling agreement was signed with the London Club in 2004. This will have a very favourable effect on the debt structure of the Federation.

Candidate Countries Performed Well Last Year – Outlook for 2005

In case of the EU candidate countries, 2004 was a quite interesting year from several aspects. Bulgaria and Romania were able to conclude the accession negotiations with European Union and at the EU Summit in December the Council recommended that Bulgaria and Romania should be members of the European Union in 2007.

Background

Conclusion of negotiations was a pretty good performance for Romania because at the beginning of 2004, there were still nine negotiation chapters open, while Bulgaria was able to close the negotiations in the middle of 2004. However, Romania closed all the open chapters during the year due to the strained negotiation process. The result is that the accession treaties are planned to be signed in April 2005 in case of Bulgaria and also Romania.

Good news for Croatia is that the country became an official candidate country in 2004, and at the abovementioned EU Summit the EC recommended that the accession negotiations with Croatia would commence on 17 March 2005.

In 2004 Bulgaria and Romania joined the Euro-Atlantic military organisation, the NATO, which is another step in Euro-Atlantic integration of these countries. Croatia also applied for fully-fledged membership that year.

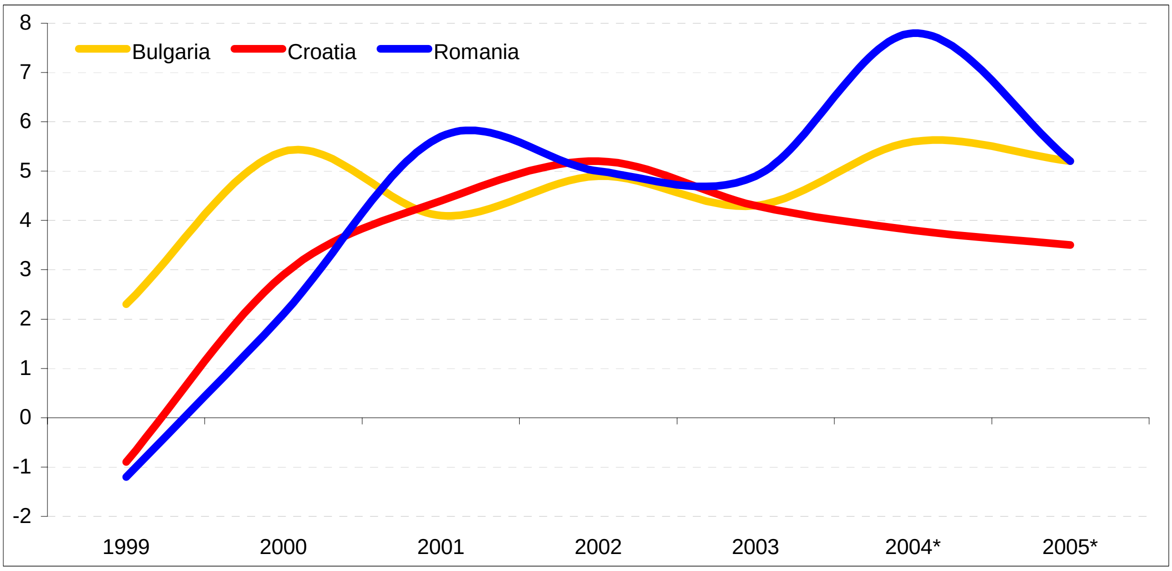
Continuing the political aspect, two of the candidate countries held elections in 2004. In case of Romania, both parliamentary and presidential elections were held at the end of the year. It was a surprise that at the second round of the presidential election the opposition candidate (Basescu) won the really close battle. However, the changes of the government and the president are not expected to result in a significant change in the economic policy of Romania.

In Croatia, the first round of the presidential election has been held and it seems that the present President Stjepan Mesic will be able win his second presidential term in the second election round on 16 January 2005. In Bulgaria, parliamentary elections will be held in 2005 and it seems that the government party will not be able to keep the leadership.

In economic terms, these three Southeast European candidate countries performed well last year. In the first nine months of 2004, Romanian GDP grew more than 8%, which is outstanding in the economic history of Romania since the transition. The excellent performance is mainly due to the robust growth pace of the agriculture sector (almost 20%), which is a result of the fact that 2003 was not favourable for primary sector when drought lowered its performance. On the other hand, the growth of services, industry and construction also reached 6% or more during this period. On the demand side, mainly private consumption and gross fixed capital formation were the engines of the economy, while the growth rate of import overpaced that of the export. Accordingly, domestic demand fuelled basically the Romanian economy in 2004.

In Bulgaria, GDP growth rate was approximately 5.5-5.8% last year, which reflects another excellent economic growth rate. Bulgarian economy is in a good shape, on the supply side, services (tourism) and agriculture had an important role in achieving this performance last year. On the demand side, gross fixed capital formation and foreign trade were the main engines of the economy, while private consumption has a declining role in economic growth due to the restrictive monetary (credit) policy.

GRAPH 1.
GDP GROWTH IN SOUTHEAST EUROPEAN CANDIDATE COUNTRIES, 1999-2005 *(%)*



*Source: national bank, statistical institutes, own calculations; *Forecast*

In Croatia, the economy increased at a slower pace than in the other two candidates, however, GDP growth reached approximately 3.8% due to the fact that the tight monetary policy limited investment activities and household consumption in 2004. Last year domestic demand remained the main engine of economic growth but the decreasing trend of consumption and investments resulted in decreasing economic performance. However, the condition of the economy improved. While exports grew in a two-digit figure in the first ten months of 2004 (15.5%), imports showed lower growth rate (7%).

To summarise the processes in 2004, the economies of candidate countries performed well in 2004, their growth rate generally overpaced that of the EU and even that of the new CEE Member States, while their European integration progressed too.

OUTLOOK

In 2005, most of the tendencies of 2004 will continue according to our expectations. Considering the political aspect, as it was mentioned earlier, accession treaties will be signed in April 2005. On the other hand, Croatia will launch its negotiation process with the EU in March 2005. It means that spring of 2005 will be hallmarked by European integration. It is an interesting factor that in Croatia local elections will be held, while in Bulgaria the parliamentary election will seal the middle of the year.

From the economic aspect, in Romania domestic demand remains the main engine in 2005. Both private consumption and gross fixed capital formation will play an important role in this year. The latter will boosted by inflowing foreign direct investment related to privatisation process and “greenfield” investments. The closing date of accession will make Romania - and Bulgaria - more attractive economies, thus the increase of FDI is expected in the future. On the other hand, the base effect that supported the outstanding growth last year will be eliminated this year, thus economic growth will fall back to approximately 5-5.2% in 2005.

In Bulgaria, the investments remain an important engine of the economy, while private consumption is expected to increase. In an election year the government is likely to increase real wages and loosen fiscal discipline. Thus, the import side of the foreign trade balance is expected to worsen and foreign demand will play less important role in economic growth. On the whole, GDP growth remains robust but a little lower than in the previous year, approximately 5-5.2%.

In Croatia, monetary policy is expected to remain strict, thus the role of the consumption will decrease further in economic growth, while the effects of large public investment projects also diminish this year. That is the reason why the Croatian GDP will grow at a slower pace than in the previous year, approximately 3.2-3.5% in real terms.

Radical Tax Reform in Romania: 16% Flat Tax Rate from 2005

Romania's new centrist government approved a significant tax reform aimed at reducing the size of the black economy and boosting foreign direct investment in the EU candidate country. The former income tax bands ranging from 18 percent to 40 percent, and the 25 percent corporate tax were replaced by a 16 percent flat rate tax. With this move Romania has joined countries in Eastern and Central Europe like Slovakia, the Baltic states, Ukraine, Serbia and Russia.

The proponents of the flat tax rate usually emphasize the simplicity, efficiency and fairness of the system. Concerning the efficiency, the implementation of a flat tax definitely reduces the time and costs of completing a tax form. Taxpayers could save time and money that is currently paid to tax advisers, while fiscal specialist would be able to switch to a more productive form of the economic activity. Flat tax also eliminates special interest lobbying, which is responsible for the growing complexity of the tax system. Last but not least, according to the proponents the flat tax, it substantially reduces tax evasion by lowering the opportunity cost of avoiding taxes. Economists backing the idea of the flat tax rate claim that this form of tax collection raises government revenues as a result of the more dynamic economic growth and less tax evasion. They also state, based on the Laffer Curve theory, that the progressive tax system with its too high rates prevent people from working extra hours, reinvesting or saving. According to them, a lower tax rate would increase tax revenue by creating more incentives to work and invest. Concerning the fairness of the flat rate tax system, it is obviously more difficult to say anything, because there is no ultimate criteria of the fairness. Proponents of the flat tax rate system say that it eliminates double taxation on savings and investment, since all kinds of income are taxed only once. Income from dividends, capital gains or interest are not subject to personal income tax, because they are already taxed at the business level. According to those who point to the fairness of the system, the flat tax rate also provides room for some progressivity, because it gives allowances to low-earning individuals.

The flat tax rate has recently become popular in Eastern Europe. Estonia implemented a flat income tax of 26% in 1994, the reform contributed to the high economic growth and to the significant FDI inflows. Following the increasing regional competition Estonia ratified a legislation to lower its flat rate from 26% to 20% by 2007. The other two Baltic countries quickly followed Estonia's example, Lithuania introduced a flat income tax rate of 33% in 1994, (while the top corporate tax rate is at 15%) and Latvia implemented a flat income tax rate of 25% in 1995 (the corporate tax rate has just been lowered to 15%). Russia introduced a 13% flat tax rate in 2001, and it was followed by the introduction of a 24% corporate tax from 2002. The move resulted in a constant expansion of the government tax revenue, mainly due to the less tax evasion. In 2003 Serbia, Ukraine and Slovakia opted for the flat tax rate system, and implemented a 14%, 13% and 19% tax rate respectively. In Slovakia the reform proved to be success story, the new system replaced an old one, which included 90 exemptions, 19 sources of un-taxed income, 66 tax-exempt items, and 27 items with specific tax rates. In Slovakia the tax revenues in 2004 proved to be 7.3% higher than originally planned, revenues from corporate tax and personal income tax significantly overshot the initial target -by 34.6% and 35.6% respectively. It is not sure that the increase of the tax revenues can be fully attributed to the tax reform, because the high growth rate of the economy also played an important role, but the new tax rate certainly contributed to the better results.

TABLE 3.
TAX KEYS IN THE NEIGHBOURING COUNTRIES AND IN THE BALTIC AREA

Country	Flat tax rate
Romania	16%
Slovakia	19%
Russia	13% (income), 24% (coporate)
Ukraine	13%
Serbia	14%
Latvia	25% (income), 15% (corporate)
Lithuania	33% (income), 15% (coporate)
Estonia	26%

Following the Eastern European examples the new Romanian government put the big-bang tax reform along with the strong anti-corruption commitment in the center of its campaign during the election. The youngest government that Romania has had in the 15 post-communist years seems to be determined, however the implementation of the new flat rate tax system from January 1 is still doubtful. Though Ionut Popescu, the new Finance Minister, a 40-year old economist promised to introduce the new system from January 1 and claimed that the new system is necessary to clean Romania's shadow economy and attract more FDI to the country. There is a significant tax competition in the region, and Romania still has a lot to go to catch up with the CE4 countries regarding the per capita FDI.

Some analysts warned that the tax reform could endanger the fiscal developments by leading to a higher budget gap. Finance Minister Ionut Popescu replied to the worries and said that the government dares an extremely courageous tax reform, but it also aims to keep all the macroeconomic indicators on track and prevent the economy from overheating. The IMF, Romania's top economic mentor prescribed an 1.5% deficit to GDP ratio for 2005. Popescu stated that the estimated revenue shortfall (around 30 trillion lei-$1.05bln) would be offset by the postponing of an already approved 2 percentage points cut in social security contribution from the current 49.5%, and by increased VAT revenues as consumption picks up.

He added that postponing the cut by one year amounts to about 9 trillion lei, and he also announced that taxes on dividends, (currently at 5% for individuals and 10% for companies), and the 1% tax on securities transaction will remain unchanged.

The tax reform could influence the CPI developments as well, and some concerns had been raised that the drastic tax cut would add fuel to the already buoyant economy. The economy is expected to grow by approximately 8% this year, while the central bank is aiming to cut inflation to 7% from the under 10% rate of end-2004. Finance Minister Popescu said in connection with the CPI developments that the government would respect the central bank's independence, and the disinflation would be their common goal as they try aim to push the CPI down to 3% by 2008.

The introduction of the flat tax rate could be beneficial for the Romanian economy, it will definitely reduce the size of the shadow economy and tax evasion. However, the flat tax rate system in general might hurt the social cohesion. According to the proponents of the system the flat tax rate could also provide progressivity, because of the implementation of some allowances for the low income individuals. However, too many allowances bring up the problems of the old tax system, nevertheless without the allowances the flat rate system could be regarded as unfair. According to a regional analyst of Morgan Stanley, "taxing the rich at a relatively high rate is of crucial importance to maintain social cohesion, and thus to make capitalism work." Severe tax competition could be a dangerous by-product of the growing regional competition.