

# FOREIGN DIRECT INVESTMENT IN HUNGARY: WHY THE SLOWDOWN?

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## **Introduction**

Investment by businesses abroad, foreign direct investment (FDI), is widely regarded as the responsible force behind many of Hungary's successful economic policies because it brings in working capital that might otherwise be unattainable. FDI has injected approximately \$55.4 billion into the Hungarian economy since 1989, including more than \$15.2 billion from the United States. Foreign investment helps modernize Hungary's industrial sector and introduces thousands of new jobs. Foreign companies currently account for over 70 percent of Hungary's exports, 33 percent of its GDP, and approximately 25 percent of new jobs. ("Background Note: Hungary")

Beginning in 1995, Hungary had enjoyed an average annual FDI inflow of \$3.9 billion, which continued steadily until 2002 when it

dropped to \$1.7 billion. In 2002 the inflow of capital from FDI slowed so much that by 2003 it had become a net outflow of \$500 million ("Cooling Down"), indicating that disinvestment outweighed new investment. (Schweizer, "Losing Its Edge") This decline in FDI poses a significant threat to the Hungarian economy, which relies heavily on this form of foreign capital.

In this article, I explore the various factors behind the deceleration of this significant source of income. I first investigate how Hungary's growing debt has been reinforcing foreign investors' loss of confidence in the Hungarian economy through missed government budget deficit targets. I then turn to Hungary's recent European Union (EU) membership and its effects on Hungary's investment relationships with its largest partners. Lastly, I examine the repercussions of Hungary's recent wage increases on FDI inflow.

## High Debt Battles Internal Investment

### Growing Debt: A Growing Concern

The first significant factor responsible for the recent downward trend in foreign direct investment in Hungary results from the government's credibility. Not only does Hungary's large budget deficit hinder its reputation as a stable and affluent economy in which to invest, but it also reduces investors' confidence in Hungary's ability to control it.

In 2004 Hungary was forced to delay entrance into the Euro Zone by two years to 2010, but critics continue to insist that Hungary's deficit remains too large (it is the highest in the EU). Also, its revised annual targets are too high for compliance with the conditions of euro membership to be accomplished in time. According to the convergence criteria outlined in the Growth and Stability Pact of the Maastricht Treaty, before joining the Euro Zone a country must first reduce its budget deficit to a level below three percent of GDP for at least two years. Also, its public debt must not exceed 60 percent of its GDP. ("Specifications on the Implementation...", p. 3)

Hungary has overshoot its targeted budget deficit for four consecutive years since 2002, as Figure 1 indicates. The year 2002 marked the largest spread between the intended and the actual budget deficits. The government had resolved to reduce the deficit to 2.9 percent of GDP, a realistic goal had the deficit actually been declining. Unfortunately, 2002 ended with a deficit more than three times the size of the intended figure, at 9.3 percent of GDP. Although the gap between the government's targeted and actual budget deficit has since been reduced, the difference remains noteworthy. In addition, the figures for the future do not look promising, with a deficit possibly amounting to 6.7 percent of GDP in 2006, and perhaps even reaching 7.0 percent in 2007. Concerns about the 2010 adoption of the euro by Hungary continue to grow as forecasts of the government budget deficit remain consistently above the three-percent ceiling, a level that would need to be reached by 2008. (Blahó)

Although the primary unease with this large budget deficit lies in its persistence well beyond the euro limit, concerns are deepened by the continued overshooting of the deficit beyond even the revised, less-stringent government targets. Hungary's finance minister, Tibor

**Figure 1**  
**Missed Budget Deficit Targets, Hungary**

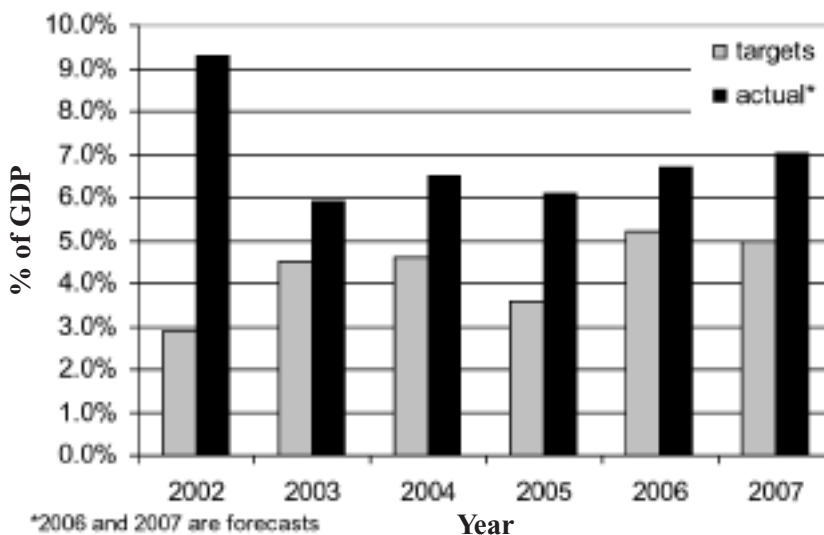


Figure created from data in Blahó and "Economist Intelligence..."

Draskovics, has tried to alleviate concern by comparing Hungary's deficit figures with those of its similarly sized neighbor, the Czech Republic, claiming that Hungary's 2004 deficit resembles that of the Czech Republic's deficit from the previous year. However, the difference lies in the fact that the Czech Republic did not overshoot its government expectations by as large an amount. (Schweizer, "Still Missing Targets")

One source of difficulty is the government's recent commitment to cutting taxes. Although this is a welcome policy among taxpayers, it may not be prudent to reduce tax revenues when the budget deficit is as far above the three-percent threshold as it is. In addition, more spending on infrastructure is needed, although this often entails expensive projects. (I will discuss this later in the article.) Hungary seems too eager to prove to its investors that it can reduce its budget deficit by setting low annual targets, when in reality Hungary is destroying credibility in its ability to control its deficit at all. Hungary needs to be more realistic with its future government targets, even if that means a more gradual and conservative approach to reducing its deficit, as has been the case in the Czech Republic. Even though the Czech Republic's deficit is within the same range as Hungary's, FDI in the Czech Republic has recently surpassed that of its neighbors — Hungary, Romania, and Bulgaria. In 2004, the Czech Republic received more than one billion euros (\$1.2 billion) more in FDI than Hungary. Moreover, Bank Austria Creditanstalt, the largest international banking network in Central and Eastern Europe (CEE), forecasts that the Czech Republic will remain more than two billion euros (\$2.4 billion) ahead of Hungary with respect to FDI in 2006. ("Foreign Direct Investment...") Such a shift in primary destinations of FDI is a signal that missing targets strongly discourages investors, who often seek politically and financially stable economies in which to invest. (Jenei)

Adding to Hungary's daunting deficit problems is a series of recent credit downgrades that it has suffered. In July 2003 Fitch Ratings, an international rating agency, placed Hungary's long-term foreign currency rating of A- and its long-term local currency rating of

A+ in the "negative outlook" category, signaling the risks of the government budget deficit exceeding its projections and the consequent damaging effects on its public finances and macroeconomic balance. (Parker, p. 12) After Hungary failed to show much improvement, in January 2005 Fitch downgraded its long-term, local currency rating one notch from A+ to A for failing to meet budget deficit targets. By the end of that same year, Hungary experienced yet another downgrade. This time Fitch downgraded both Hungary's long-term local and foreign currency ratings another notch, from A- to BBB+ and from A to A-, respectively, with a "negative outlook" comment attached to the foreign currency rating. Fitch determined that, with Hungary having overshot its government deficit targets for four consecutive years, "Public finances are now on an unsustainable path... and the government's track record doesn't transpire a great deal of confidence." ("Fitch Downgrades Hungary") Fitch is also pessimistic about Hungary adopting the euro as early as 2010, predicting instead that it will not be able to meet the Maastricht criteria for adoption until 2014. ("Fitch Downgrades Hungary") The recent history of the Fitch currency ratings for Hungary can be viewed in Table 1.

With both currency and country risks now considered higher, this most recent investment downgrade is certain to affect Hungary's ability to attract future investors. The decline of Hungary's foreign currency rating to BBB+ may be particularly detrimental as Hungary's rating has not been in the B category since 2000. The same day as the latest 2005 downgrade, the Hungarian forint depreciated on the interbank foreign exchange market to an 18-month low. ("Minutes...", p. 2) As explained by Orsolya Nyests, an analyst at Erste Bank, the largest retail network in central Europe, this indicates that "while financial markets typically pay little attention to government GDP or inflation projections, recent overshoots of the country's budget deficit have caused some concern among investors." (Schweizer, "Still Missing Targets")

After its fourth consecutive year of missed deficit targets, investor confidence in the Hungarian economy has been weakened if not

**Table 1**  
**Hungary Sovereign Rating History**

Date	Long-Term Currency Rating		Outlook/Watch
	Foreign Currency (FC)	Local Currency (LC)	
Dec. 2005	BBB+	A-	FC negative, LC stable
Jan. 2005	A-	A	FC negative, LC stable
Jul. 2003	A-	A+	negative
Nov. 2000	A-	A+	stable
Sep. 2000	BBB+	A	positive
Oct. 1999	BBB+	A	-
Jul. 1998	BBB	A	-
Jun. 1997	BBB	A-	-
May 1997	BBB-	BBB+	Rating Watch positive
Apr. 1996	BBB-	BBB+	-

Table created from data in "Fitch — Complete Sovereign Rating History," p. 3.

scarred. Hungary must resolve its large deficit issues, but hurried unrealistic government projections are not the solution, especially since, according to Fitch, "the current [budget] deficit is just too big to tackle in one electoral cycle." ("Fitch Downgrades Hungary") Unfortunately, other obstacles and trade-offs also prevent Hungary from being successful in its quest to reduce its large deficit. Hungary thus finds itself in a dilemma. On the one hand, it seeks to market itself as an attractive business investment, which requires government funds dedicated to developing and advancing physical infrastructure as well as offering enticing investment incentive. On the other hand, it is simultaneously trying to lower the large budget deficit, which necessitates reduced or perhaps even austere government spending, to adopt the euro in time.

### **Hungary's Infrastructure: Reforms Needed to Re-Attract FDI**

Developing Hungary's transportation and telecommunication infrastructure is an important facilitator of FDI, because it connects people, businesses, universities, and bordering countries. Quality long-distance transportation (mainly roads and railroads) is significant to investors because they link the developing regions of a country to the faster growing areas.

Further, short-distance transportation facilitates commuting, which strengthens local labor markets and helps reduce unemployment. ("Economic Survey — Hungary 2004...") Vilmos Skultéti, CEO of the Hungarian Investment and Trade Promotion Agency (ITDH), contends that, from the very moment that the first motorway was constructed from Budapest to Central Hungary in the late 1990s, foreign investors started to show interest. (Skultéti) Advanced and high-speed forms of transportation and telecommunication attract investors because they provide conditions under which businesses thrive, as will be discussed below. Therefore, as Hungary's competitors are adopting more developed transportation and telecommunication systems, Hungary must be careful not to fall behind.

As a leading recipient of FDI that flows into the Eastern European region, the Czech Republic is a serious competitor to Hungary as a prime FDI destination. Among other advantages, the Czech Republic's railway transportation system is often regarded as one of the most advanced in the region, whereas Hungary's railway system is inefficient and outdated. Only a fraction (2,200 kilometers) of the 7,900 kilometers of Hungarian rail tracks run electrically, and the demand for faster trains continues to grow. (Konrad) Electrically run rail lines offer faster acceleration and greater efficiency

in service. A lag in railway development is just one example of Hungary's need to invest in its transportation system in order to compete with its neighbors for FDI. Unfortunately, Hungary must also take into account its budget deficit when proposing new development projects. For instance, the recent downward pressure on the deficit has already hindered a 2.3-billion-euro plan to improve Hungary roadways. (Konrad)

In addition to the Czech Republic, Hungary also competes with Ireland in attracting FDI. Similarly sized (both countries are about the size of the state of Indiana), Ireland's rapid economic growth can be largely attributed to its FDI boom during the 1990s. Ireland continues to enjoy a generous FDI inflow partially due to its advanced systems of transportation and telecommunication. (Morrow, p. 113) Ireland has three major airports with easy access to international markets, advanced motorways (almost 96,000 kilometers of total roadways, all paved) and railways (approximately 3,000 km) that connect all major cities and ports in Ireland. Ireland also provides easy-access shipping methods in addition to one of the most sophisticated telecommunication infrastructures in all of Europe. ("Doing Business and Investing in Ireland," p. 13)

On the other hand, Hungary supports but one international airport with just two terminals and only one Hungarian airline company, Malév. Hungary is connected by a road network of 70,000 paved kilometers, which is less than 73 percent of Ireland's road network. ("Public Transportation") In addition, seven of the eight major motorways convene in Budapest and connect much less of the country than does Ireland's roadway system, which connects various major cities such as Dublin, Galway, and Shannon at opposite ends of the country. With exports accounting for almost three-fourths of Hungarian GDP, improving transportation modes, particularly roadways, to the level seen in Ireland can largely enhance investors' attraction to Hungary.

Telecommunication infrastructure is the other half of the two-part recipe for a country's infrastructure investment. Though many facets of its developing economy are still in a transition stage, Hungary has been fortunate in its telecommunication technology, mostly because

90 percent of Hungary's telecommunication sector is privatized and foreign-owned. ("2005 Investment Climate...") Regardless, Hungary's telecommunication network has failed to advance to the levels of the original 15 EU countries (the EU-15). Again, Ireland can be used as a good comparison. In 2004 Hungary had 355 main telephone lines in use per 1,000 people, whereas the number of main telephone lines in use in Ireland was 505 per 1,000 people. In addition, cellular telephone usage and internet access are increasingly becoming key components of a well-developed telecommunication network. In 2004, Hungary had 870 mobile subscribers per 1,000 people, which was still surpassed by Ireland's 945 subscribers per 1,000 people. As of 2005, Ireland had 515 internet users and 60 internet hosts per 1,000 people, while Hungary had only 305 internet users and 26 internet hosts per 1,000 people. ("The World Factbook: Hungary"; "The World Factbook: Ireland") Ireland's infrastructure might serve as a benchmark as Hungary continues to improve its transportation and telecommunication systems.

The "new" EU members (the EU-10) often look to Ireland as a noteworthy example of the achievements that these ten EU nations would like to emulate. After all, Ireland has transformed itself from one of the poorest EU members to one of the richest. However, Ireland enjoyed the assistance of \$15 billion in structural funds from the EU, which the EU has already proclaimed will not be available to the new members. Instead, the EU has offered only \$12 billion in structural funds to be shared by all of the EU-10 over three years. (Wood) Therefore, Hungary needs to find a balance between meeting future budget deficit targets and investing in its infrastructure to strengthen its competitive edge. The planned spending on infrastructure for 2006 would raise Hungary's budget deficit by almost a full percentage point, from eight percent of GDP to nine percent (if motorway spending is included in the budget). ("Interfax Hungary Business...")

Looking forward, if Hungary can adopt the euro on time, it can mean numerous benefits. First, maintaining a separate currency can be expensive. Adopting the euro would enable

Hungary to save on monetary-policy-making personnel, currency printing, and other services affiliated with sustaining an individual currency. Secondly, entering the Euro Zone will reduce speculative risk (especially that which affects a small open economy such as Hungary) from investors and currency rating agencies simply by becoming a member of a well-respected, stable single-currency area. ("Flights to Frankfurt") Fitch predicts that adoption of the euro would improve Hungary's long-term foreign currency ratings by 2–3 grades. (Parker, p. 17)

### **Has EU Membership Helped or Hurt Hungary's FDI Status?**

Hungary's problem of falling FDI is not only attributable to the difficulties it faces in tackling its enormous budget deficit, but also to its recent EU accession. When Hungary applied for membership in the EU in 1994 (Konrád and Vándor, p. 8), Hungary had perceived EU association as a way to establish investor confidence and increase trade as well as GDP. For example, *fDi Magazine* of the Financial Times group predicted that EU entry would mean simplified cross-border movement that would enable easy access to 600 million potential consumers. ("Hungary") Further, Hungary's Investment and Trade Development Agency (ITD) proclaimed that EU membership would help Hungary to stimulate domestic demand through a customs-free international market, enhance FDI inflow via greater business confidence, and improve its GDP growth with higher export sales and demand through the EU market. ("Benefits of EU Membership," p. 1)

By 2001 Hungary was absorbing one-third of all of the FDI flowing into Central and Eastern European countries, and 60 percent of its economy was being powered by its export sector. In addition, 75 percent of this export market was EU-driven. ("Hungary Country Commercial...") Seventy percent of Hungary's export businesses were foreign-owned, which generated 33 percent of its GDP. The United States owned 29 percent of these companies, and Germany owned another 26 percent. ("Hungary Country Commercial...") German

and United States companies alone were responsible for roughly 20 percent of Hungary's GDP in 2001. Once Hungary joined the EU, it assumed that its membership would attract new foreign investors in addition to increasing its FDI from two of its largest investment sources, Germany and the United States.

### **German FDI in Hungary and the Effects of the EU Monetary Policy System**

In 2001 Hungary pegged its domestic currency, the forint (HUF), to the euro. In doing so, Hungary essentially aligned its currency to the German economy, Germany being one of the largest European economies upon which the monetary policy of the euro area is based. Unfortunately, by 2002 the German economy decelerated. ("The World Factbook: Germany") From 2002 to 2003 and again in 2005, Germany's GDP grew by less than one percent. In addition, Germany's rising unemployment rate reached a record level in 2005 of 12.6 percent. ("German Jobless Rate...") Coupled with an extremely low inflation rate, which was 1.8 percent in June of 2005 with a core inflation rate of only 0.5 percent, Germany's economy has been slow to grow and thus disinclined to invest in Hungary. ("Report to Congress...," p. 13)

Furthermore, the best monetary policy for Germany's situation would be to lower interest rates to stimulate investment and raise GDP, which would in turn create jobs and reduce unemployment. However, in adopting the euro Germany relinquished control of its monetary authority. Unfortunately, the European Central Bank (ECB), the central bank for the Euro Zone, is an inflation-targeting central bank. As such, it ignores unemployment when setting interest rates. ("Inflation: The 2% Solution") The fact that the German inflation rate is below the EU average implies that the ECB sees no need to adjust interest rates to stimulate Germany's GDP growth. This leaves the German economy in a relatively stagnant state, which continues to affect its investment decisions in Hungary (Figure 2).

Clearly, the health of the German economy strongly determines the level of Hungary's

**Figure 2**  
**German FDI in Hungary vs. German GDP Growth**

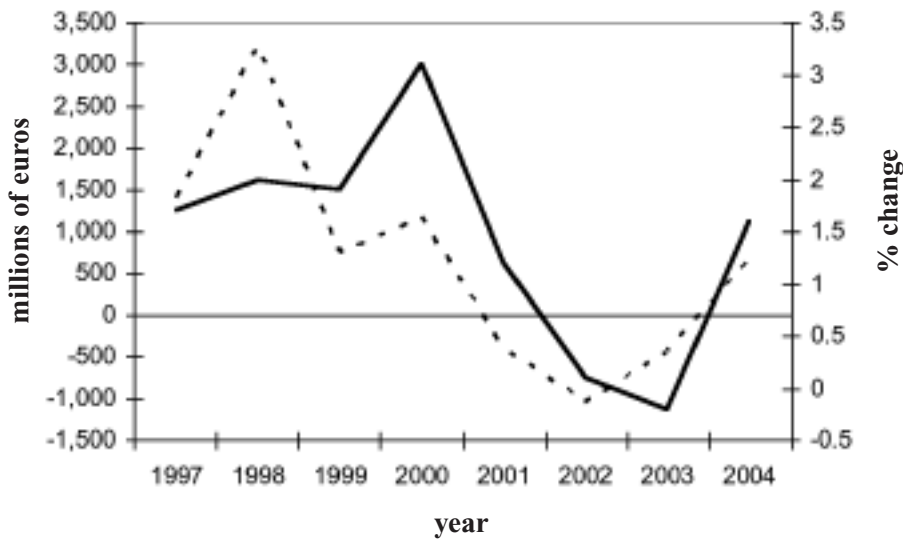


Figure created from data in International Monetary Fund and “EU Direct Investment Flows...”

FDI. Looking at patterns in United States FDI in Hungary further illustrates the importance of German FDI to the Hungarian total. United States’ businesses are responsible for almost one-third of Hungary’s FDI and have continued to invest in Hungary at an increasing rate since 2000 (Table 2). Despite this rising trend in U.S. investment, total FDI in Hungary has fallen since 2002, which is the year when German GDP as well as German FDI in Hungary began to fall. This illustrates that Germany greatly influences changes in FDI volume.

### Effects of a Minimum Wage Increase during the FDI Decrease

FDI has further dwindled as a result of recent wage increases in Hungary. In 2001, the minimum wage in Hungary was hiked 57 percent and was followed by another 25 percent increase just one year later. The statutory minimum wage is currently (as of January 1, 2006) HUF 62,500 (about 250 euros) per month, which affects a relatively substantial proportion of employees (eight percent of employees in Hungary earn the minimum wage as opposed to 1.4 percent in the United States in 2004). (“Statutory Minimum Wages...,” p. 1) These large increases are unprecedented in any

other OECD country (“National Tripartite Agreement...”) and unfortunately occurred at the same time as Hungary’s inflow of foreign investment started to slow. Potential investors have begun to bypass Hungary and take advantage of the lower wages of Hungary’s neighbors, Slovakia, Romania, and Ukraine, and even Asian countries, such as China. (Schweizer, “Losing Its Edge”) In addition, already-established investors on the outskirts of Hungary have started employing cheaper labor from outside its borders. The minimum wage in Slovakia, for instance, is about \$1.36 an hour, which is almost 30 percent less than in Hungary (at \$1.88 an hour). Adding to the competition is Romania with a minimum wage of \$0.73 an hour and Ukraine, with a minimum wage of just \$0.45 an hour. (“Pay in Europe 2006...”) Hyundai, a South Korean carmaker, for instance, has already ruled out Hungary as too expensive in its decision concerning where to build a new plant for 2007. (“Cooling Down”) Peugeot Citroën, the French carmaker, has also refused to locate an assembly plant in Hungary, opting to build in Slovakia instead. Other foreign companies have actually started to move out of Hungary. For example, IBM closed one of its manufacturing facilities in Hungary due to high labor costs and moved it to China

**Table 2**  
**U.S. and German FDI in Hungary (in Millions of U.S. \$)**

	U.S. FDI	German FDI
1999	1.408	0.955
2000	1.000	1.476
2001	2.000	-0.528
2002	2.500	-1.341
2003	2.824	-0.582
2004	3.285	0.818

Table created from data in "EU Direct Investment Flows..."; "Foreign Trade Barriers: Hungary"; and "Hungary & the United States."

(Schweizer, "Losing Its Edge"), where wages are as low as \$0.30 an hour. (Sundquist)

As investors have moved elsewhere, so too have thousands of jobs. For instance, the IBM plant that left Hungary to seek cheaper labor had employed 3,700 workers. (Ghanta) Since cheap labor is no longer Hungary's forte, Hungary must adjust its strategy for attracting FDI.

### **Recommendations and Conclusions**

FDI has been Hungary's leading force in propelling it from a communist country to a CEE leader in attracting foreign businesses. However, as Hungary's economy has developed, so too has the competition for FDI. No longer

can Hungary rely simply on cheap labor to attract investors. More complex issues must be addressed in order to ensure a future inflow of FDI. Reducing its budget deficit by keeping it aligned with its government targets is the most significant change that Hungary can achieve in order to regain its credibility and investment grade abroad. Enforcing policies of austere government spending and continued taxation can make adopting the euro in 2010 a reality. Being a part of the Euro Zone will automatically boost its credit rating, at which point FDI inflow into Hungary should rise again. This will in turn increase Hungary's revenue and enable it to allocate more funds towards advancing its transportation and telecommunication systems.

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