



ICEG EUROPEAN CENTER

NEWS OF THE MONTH

on EU-10 and CIS

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News of the Month, on EU-10 and CIS

The ICEG European Center issues its monthly publication, which includes 2-4 brief analyses on macroeconomic and microeconomic issues. The publication focuses on two groups of countries: *Commonwealth of Independent States - CIS* (Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyzstan, Moldova, Russia, Tajikistan, Turkmenistan, Ukraine and Uzbekistan) and the ten post-soviet *New Member States of the European Union – EU-10* (Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia).

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About us

ICEG European Center is an independent economic research institute based in Budapest, Hungary. The Center was founded by Dr. Pál Gáspár in 2001.

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Table of Contents

Will nationalization of gas system in Moldova change prices for natural gas supplies? _____	4
Context of the macroeconomic adjustment in Estonia _____	9
An emerging multinational: Kész Ltd. _____	14
Hungarian parliament passed the budget bill 2010 in December _____	19

Will nationalization of gas system in Moldova change prices for natural gas supplies?

Liliya Levandovska

Background

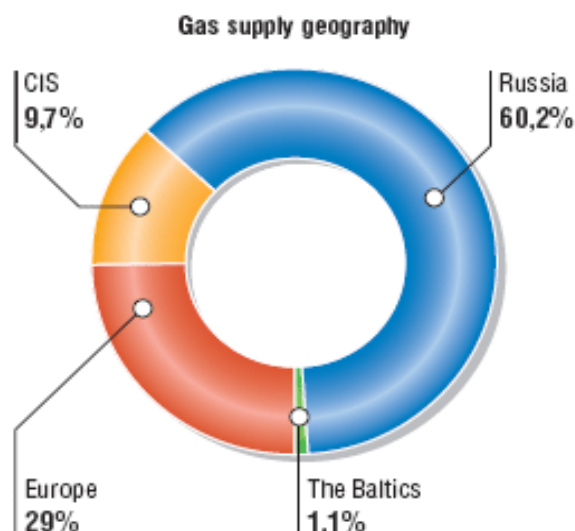
Among CIS countries the Republic of Moldova may be considered as an important player on international arena. In fact, it was the first post-Soviet country to join Council of Europe and currently it participates in a number of international organisations, such as the United Nations, the World Trade Organisation, the Organisation for Security and Cooperation in Europe, the North Atlantic Cooperation Council, the International Monetary Fund, World Bank, the Francophonie and the European Bank for Reconstruction and Development.

Nevertheless, specific territory division issues and Moldovan dependence on its neighbours in the sphere of gas supplies entail difficulties in relations with neighbouring states as well as hardships in the country's economic growth. The existence of a frozen conflict (part of the territory of the Republic of Moldova – Transnistria – is de facto run by an independent government, not officially recognized either by UN or other world states) complicates quick and effective reforms. It is especially evident in foreign policy and gas supply areas.

When we analyse potential developments in terms of gas prices for Moldova negotiated with Russia for the next years, we should have an understanding of how the gas supply system functions in Moldova. The Republic of Moldova is totally dependent on gas supplies from Russia. Joint Stock Company Moldova-gaz is a part of the energy complex of the Republic of Moldova and its main functions include providing energy and gas for the national economy and the population. The company was founded in 1999. Core capital equals to \$118,3 million. The main shareholders are the Russian OAO (Open Joint Stock Company) Gazprom, the government of Moldova and the administration of Transnistria. Gazprom owned 50% plus 1 share, but in 2005 Transnistria officially turned its shares to shareholders from Russia, thus currently Gazprom holds 63.4%, while the Agency of Public Property at the Ministry of Economy and Trade of Republic of Moldova is entitled to 35.33% shares. It is worth mentioning that the practical management of gas system on the territory of Transnistria is controlled by authorities in Tiraspol.

Gas supplies and exports

The possibility to impose a great impact on the politics in the CIS region by gas ultimatums and, as in the case of Moldova and Georgia (which withdrew from CIS Membership in 2008), to support the acuity of frozen conflicts on their territory, provide Russia with powerful tools of intrusion into internal affairs of neighbouring states.

Chart 1. Gas-distribution by geography

Source: Russian Profile, available: <http://www.russiaprofile.org/page.php?pageid=resources-business-russiancompanies-gazprom.wbp>

Chart 1 shows the gas supply geography of Gazprom. As we can see, about 10% goes to CIS countries. Certain CIS Member States, in particular, Belarus, Ukraine and Moldova (as well as Georgia), are 100% dependent on Russian supplies. Such dependency may be one of the reasons for unstable relations with Russia and it encourages the Russian government to make openly unfriendly comments, declarations and even take actions concerning its neighbours.

Moldova practically handed its national gas system over to Gazprom relying on the promises that gas prices would be increasing gradually in order to correspond to the “average European” level (debates are still going on concerning Russia’s data for calculating this “average”). While pressing for receiving control over the Moldovan gas network, Russia stated that such a scheme is typical for CIS countries; however, it is not the case. Besides, the prices for most countries of the region have not changed gradually.

As for the scheme of supplies, we should take into account that, like most countries of Europe, the Republic of Moldova receives gas via transit from Ukraine. It also exports natural gas to Balkan states. Consequently it was also affected by “gas wars” between Russia and Ukraine of 2006 and 2009. Noteworthy, potential negative outcomes of gas cuts in Moldova were alleviated by Ukraine’s gas supplies out of its own reserves.

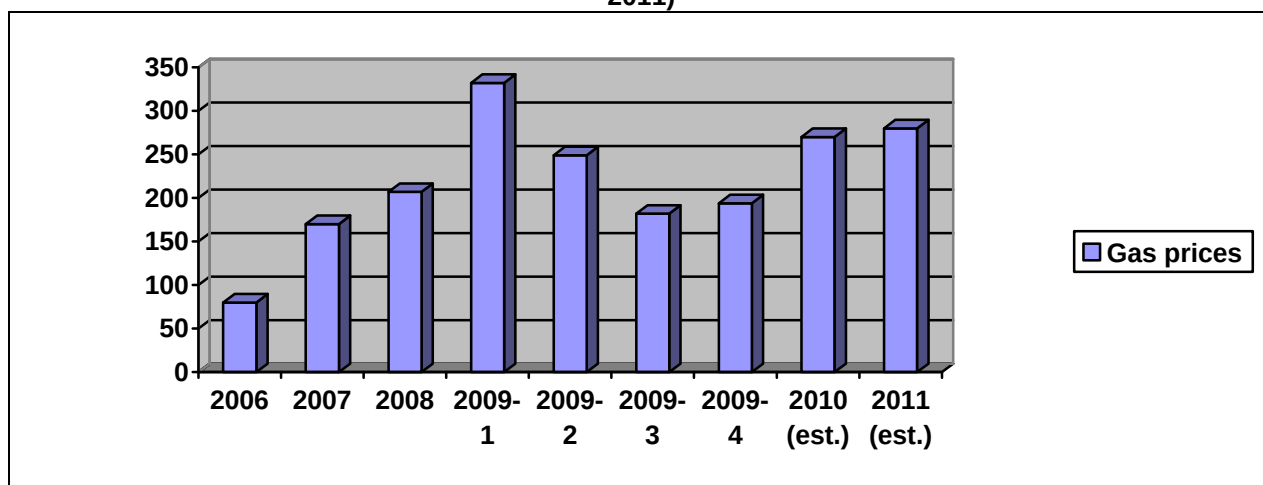
Moldovagaz pipelines need investment and modernisation according to European standards as there have been recent cases of large breakdown and explosion, the last one being on November 9th, 2009 causing difficulties for gas exports to Balkan states.

Recent rapid gas price increase

The main agreements concerning gas prices were signed in 2006. According to them, in 2007 Moldova had to pay \$170 per 1.000 cubic meters of Gazprom's gas (comparing to \$80 in 2006) and the gradual increase should follow the next scheme: 75% of the price in 2008, 80-85% in 2009, 90% in 2010, and then 100% of the "European average price" in 2011 (excluding transportation costs). Such agreements were highly unfavourable for Moldova, especially if we take into account that the transit price for export gas remained unchanged at the level of \$2.50 per 1,000 cubic meters for every 100 kilometres on Moldovan territory.

According to the contract, the gas price is defined quarterly based on the agreed formula and taking into account the average gas price exported to other European countries over the 9 months prior to the supply period. The price also includes a discount ratio for Moldova (about 0.8) and changes in black oil and gas prices on the world market. The fact that gas prices are tied to oil and gas products reveals a negative tendency of market realia distortion on behalf of Gazprom. Price dynamics according to this agreement are shown below.

Table 1. Prices set for Russian gas for the Republic of Moldova for 5 year period (2006-2011)



Source: own estimates according to the gas agreements signed between Russia and Moldova in 2006.

However, this graph does not include the increase of gas transit price on Ukrainian territory by 60% which was negotiated in Yalta on November 19th, 2009. Ukraine and Russia agreed that in 2010 transit tariff will reach its market value and there will be no privileges nor in terms of gas consumption, neither gas transit prices (according to a previous agreement the transit price remained on the level of 2008 in return for 20% discount on gas price for Ukraine). Such a rapid raise affects Moldova directly as all gas supplies arrive through the territory of Ukraine. So far the government of Moldova has not reacted to this issue; gas price increase for national consumers is most likely to be the solution taken.

Moldovan economists observe that the average price for natural gas supplied from Russia increased by 44.7% during the first 9 months of 2009 (comparing to the same period in 2008) – from \$207 to \$300 and total cost of Russian natural gas increased by 31.4% regardless the 10,7% decrease of gas volume import and 10,6% consumption decrease. The largest consumption percentage – 43% - includes energy sector enterprises, citizens – 31.1% and budget institutions – 4.5%¹.

When we analyse Moldovan-Russian gas relations, we cannot avoid discussions about the debt for gas supplies. In 2004 officially recognised debts to Gazprom already exceeded \$1 billion and in 2006 Transnistria was already indebted to \$1.2 billion. Surprisingly enough, these debts were not the subject of Gazprom's pressure on Moldova. In 2008, the debt accumulated to \$65 million and taking into account previous debts, total amount owed by Moldova equals to another \$380 million, while Transnistrian debt amounts to 1.8 billion. The debts were not restructured and the agreement of 2006 does not differentiate between Chisinau and Tiraspol debts. Though Chisinau authorities duly paid for gas supplies for almost the last 10 years, they lack tools and instruments of fining institutions and citizens from Transnistria who do not pay for gas consumption.

Nationalization of Moldovagaz – populism or necessity

Moldova-Russia and Moldova-Transnistria gas relations bring us to the subject of national gas networks and its correlation with political and economic implications for the country.

Due to the results of early parliamentary elections in July 2009 the rhetoric of discussions about Moldovagaz has changed. Declarations concerning nationalization of "Moldovagaz" were made by leaders of certain political parties. Without doubt, both from political and economic point of view for any country having the possibilities of gas transit on its territory it is beneficial to own its strategic transit enterprises. It will lessen political tensions and increase investments in national gas economy as well as improve regulations and tariff setting. Experts believe that nationalisation is possible from the legal point of view, as the government of Moldova only needs to buy out the shares from Gazprom. They also foresee the reluctance of Gazprom in this issue which will leave Chisinau the choice of waiting till Gazprom breaches the contract (the latter is highly improbable) and demanding legal remedies in the form of Moldovagaz shares. We can predict a rapid gas price increase in the case if nationalisation is to be implemented along with other obstacles in terms of exports and imports (precedents concerning restrictions for Moldovan wine on Russian territory are well known).

The EU is likely to support Moldova in its endeavours as Russia proved to be a rather unreliable partner as the EU's main gas supplier in 2006 and 2009; the EU seeks a certain degree of

¹ Administrative Board of the National Agency for Energy Regulation, Republic of Moldova
<http://www.anre.md/news/index.php?vers=2&sm=56&ct=230>

diversification in this sphere. As Fig.1 (above) shows, about 30% of gas supplies are sent to EU Member States.

In order to avoid excessive intrusion into its internal affairs, the government of Moldova should cooperate with the EU in the sphere of pipeline modernization as well as adhere to the coherent and consistent foreign and internal policy. Such steps will lead to the stabilisation of the economy in general and the gas supply market in particular. Gas network nationalisation and/or negotiations concerning market ways of gas price setting may serve as the means for better tariff regulation; however, it may be premature to discuss this issue, as there is lack of relevant consensus inside the country.

Context of the macroeconomic adjustment in Estonia

Ágnes Magai

For several years before the financial crisis Baltic economies registered the highest GDP growth in the EU. However, the unsustainable growth mainly driven by credit-supported domestic demand came to a halt in 2008 and hard landing of the region proved to be unavoidable. The global financial and economic crisis hit the Baltic States especially hard, because these small open economies entered the crisis with severe macroeconomic imbalances.

The current analysis deals with Estonia's macroeconomic adjustment in the era of the crisis. Firstly, it discusses the booming years before the slowdown. Secondly, it describes the effects of the crisis. It analyses the main GDP components both on expenditure and production sides. Thirdly, it gives a short description about labour market developments as social consequences of the recession. Finally, it gives a picture about the economic outlook based on the forecast of the Estonian Ministry of Finance.

Credit growth driven booming years

Estonia's economic slowdown started already before the collapse of global financing and trade, in the second half of 2007. GDP growth then turned to be negative in the first quarter of 2008 and decline accelerated during the first three quarters of the economic crisis. In the first quarter of 2009 GDP fell by 15% and in the second by 16.1%. It appears, however, that decrease has decelerated; contraction of GDP in the third quarter was 15.6%.

Earlier years' high domestic demand driven economic growth (8.5% on average between 2000 and 2007) in Estonia has already brought the risk of correction. The fixed exchange rate regime enabled cheap credits in foreign and domestic currency which caused extremely high credit growth in peak years. The average annual growth rate of credit to households and corporations reached 38% and 30%, respectively, between 2002 and 2008. These credits were mainly used to finance private consumption and investment (both in household and corporate sectors).

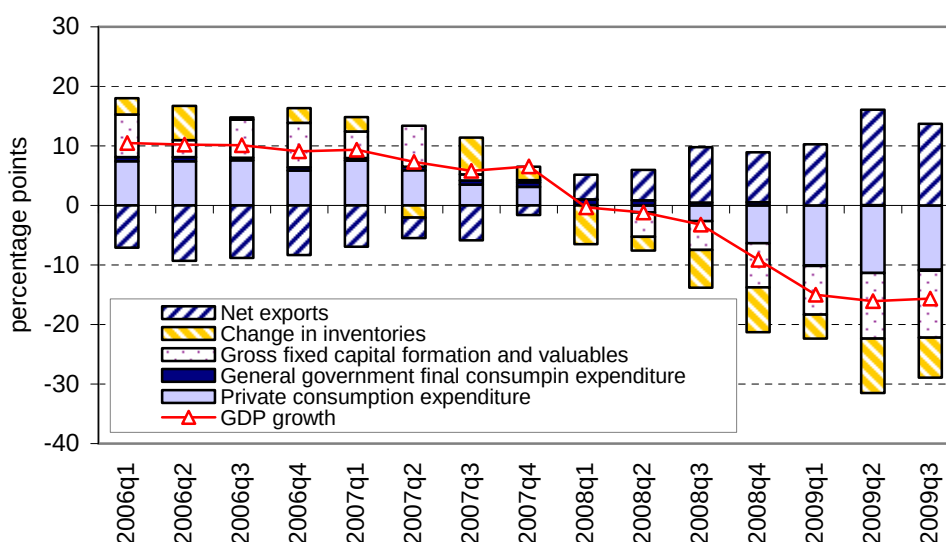
Private consumption grew by nearly 10% on yearly average and its contribution to GDP growth remained continually above 5% points in the period 2002–2007 (see *Chart 1.*). Retail trade data also underpin the high level of consumption: wholesale and retail trade grew in certain years by more than 20% in this period. Especially the volume of motor vehicles, clothing and other manufactured goods increased.

Good prospects on the real estate market, cheap credits, increasing disposable income all encouraged people to invest in housing market. The number of dwellings per 1 000 inhabitants almost reached 480 in 2008, while at the beginning of 2000s it accounted for about 450. The high

household investment rate also reflects the overheating of the real estate market (It reached its record level with 15.3% in 2006). The corporate sector's investment activity also gained momentum: business investment rates remained about 10% points higher than the EU average until 2007. Gross fixed capital formation growth was mainly driven by increasing activity in real estate and business activities, transport, retail and manufacturing sectors.

Additionally, another driving force behind robust growth was the strong demand on the main export markets during these years.

Chart 1. Contribution to GDP growth (expenditure side)



Source: Statistics Estonia, own calculations

Slowdown of the economy strengthened by the crisis

The adjustment of the Estonian economy started in mid-2007. Strong downward correction in domestic demand pushed the economy into recession in the first quarter of 2008. This can be partly explained by declining lending activity caused by the global financial turmoil. Earlier solid contribution from construction, financial intermediation, manufacturing and retail trade started to decrease.

In the second half of 2008 slowing domestic demand was complemented by a sudden deterioration in the conditions of external environment. The deepening recession of main trade partners, especially Finland, Sweden and Latvia, has put on additional pressure on the Estonian economy. The fall of exports of goods has been extensive, export revenues have fallen sharply, which proved to be determining in such a small open economy like Estonia. Transit goods (mineral fuels, means of transport and machinery) accounting for a large part of total exports have experienced the biggest fall. However, due to sharper decline in imports (because of falling private consumption

and smaller demand for inputs for producing export goods) than exports, goods and services balance has improved during the first three quarters of 2009.

Rapidly decreasing employment and shrinking real wages have brought along a drop in disposable income. Consumers have become more cautious than during booming years and, of course, credit supply has further contracted. This manifested in accelerating decline of private consumption and household investment. Retail trade data and new car registration² also reflect the significant fall in private consumption expenditure.

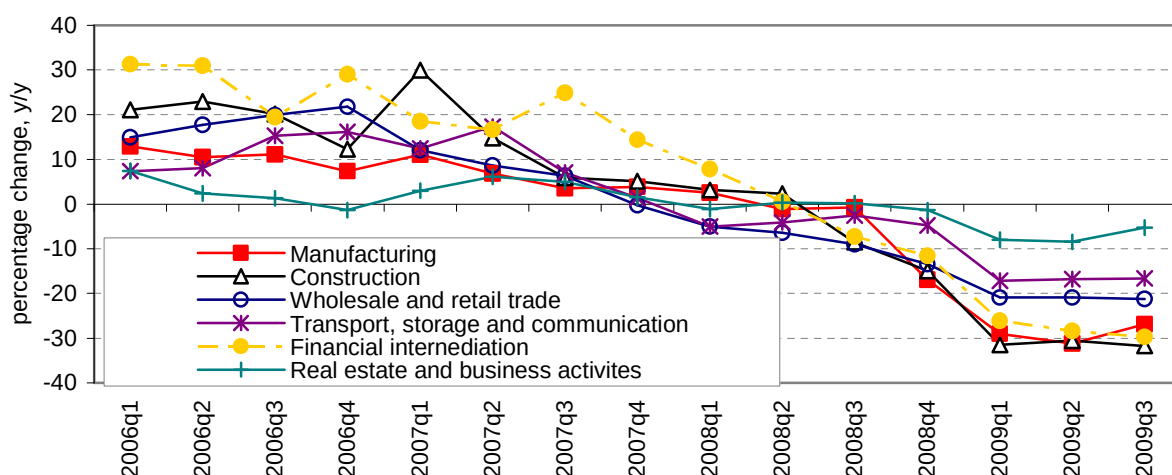
Adjustment in the corporate sector proved to be unavoidable, as well, especially after the sharp decline of export markets. The enterprises have responded to the deteriorating economic situation by decreasing production, layoffs and postponing investments.

Tightened lending conditions, decline in profitability, low level of capacity utilisation and gloomy prospects have caused further shrinkage in corporate investment. Gross fixed capital formation decreased by 37% in the third quarter of 2009 (by 39% in the second quarter), in which non-financial corporations played the biggest role. Inventories in retail trade and manufacturing have decreased continuously fast, contributing to GDP growth negatively (see *Chart 1*).

Taking into account the production side in a more detailed way, dramatic adjustment of several sectors can be observed. The value added has increased only in two sectors: in public administration and in fishing, whereas the value added of sectors with large weight has decreased significantly since autumn 2008.

The most affected sectors are the over-expanded ones during the boom years, namely retail and wholesale trade, real estate activities, construction and financial intermediation (see *Chart 2*).

Chart 2. Value added in the most important sectors



Source: Statistics Estonia

² According to ACEA statistics registration of new cars in the first ten months of 2009 declined by 66%, which is among the highest in Europe.

In earlier years soaring construction suffers particularly in the era of the crisis. Its value added was more than 30% less in the first three quarters of 2009 as compared to the same period of 2008. Value added of financial intermediation has further declined. Retail trade, accounting for about 15% of total value added, fell by more than 20% in the first three quarters of 2009.

Via trade channel the most vulnerable sector is manufacturing (representing about 15% of total value added). Its output declined by slightly less than 30% in the first three quarters of 2009, however, the decrease decelerated in the third quarter.

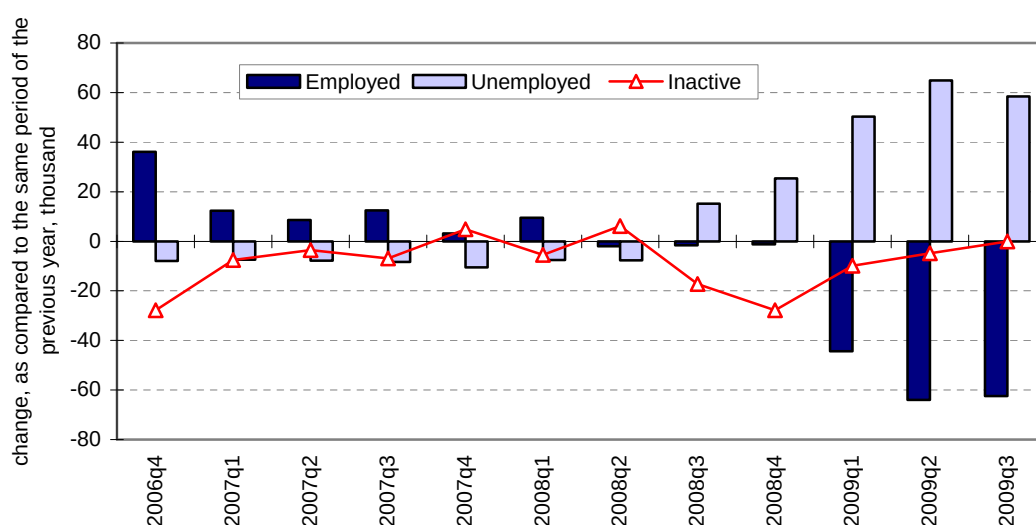
Booming years' high growth of consumption and investment resulted in large private sector savings-investment imbalances, namely high external deficits. By contrast, economic downturn has contributed to the improvement of external balance. Current account balance has turned to surplus because of falling import volumes and decreasing profits of foreign companies. Furthermore, increasing inflows of EU funds has increased surplus of the current transfer and capital account.

In contrast to earlier years' high inflation, the fundamental disinflation process rooted in the recession, including particularly the sharp fall in domestic demand, has resulted in decreasing consumer price indices.

Labour market developments

Since the first signs of the crisis employment and wage adjustment has emerged in the Estonian economy. In order to reduce costs, beside layoffs many companies have implemented flexible forms of work, such as part-time employment. However, the number of employed persons has rapidly decreased since autumn 2008 (see Chart 3).

Chart 3. Change in employment, unemployment and inactivity



Source: Statistics Estonia, own calculations

In the third quarter of 2009 employment fell by more than 9% on yearly basis. The most affected sectors are construction, real estate and manufacturing. The current developments don't give hope for employment growth in construction and retail trade, on the one hand because of oversupply in the immobile market, on the other, because of moderated consumption. Employment in manufacturing depends basically on the recovery of external markets.

Whereas unemployment rate was below the EU average in mid-2008, the number of unemployed persons exceeded 100,000 in the third quarter of 2009 and unemployment rate crept above 15%. However, in the second and third quarters of 2009 the unemployment growth slowed down. The number of economically active people has increased during the year, mainly due to the growing number of young people entering the labour market.

Estonian workers experienced very high gross wage growth during the booming years. The slowdown of wage growth started at the end of 2008 because of constraining bonuses. During 2009, however, basic wages also declined. On the one hand, this can be considered as a correction of recent years' rapid wage growth. On the other hand, weak demand in export markets, falling domestic demand, shrinking profitability and the increasing number of unemployed has led to the decrease of wages.

Conclusions

The Estonian economy has rapidly adjusted to the new circumstances caused by the global crisis via two channels. The shrinkage of domestic demand has accelerated since autumn 2008, the decline of private consumption, investment and stocks has been severe. The deterioration of main export markets has caused a significant fall in industrial output and exports. It can be considered positive that the slumping of the economy has contributed to the improvement of the external balance; the current account balance has remained in surplus during the first nine months of 2009. The main negative social consequence of the crisis is the decreasing number of employed and increasing unemployment.

According to the 2009 forecast of the Estonian Ministry of Finance the Estonian GDP will decline by 14.5% in 2009 and by 2.0% in 2010 and modest economic growth predicted only in 2011. Increasing unemployment, wage cuts as well as weak lending activity determine the further decline of private consumption. Fall of investment is also expected to continue next year. Therefore the resumption of economic activity will be led by the exporting sector that is largely dependent on the recovery of main trade partners. The adoption of the euro in 2011 will further support the revival of the economy.

An emerging multinational: Kész Ltd.

Gina Asztalos

After the collapse of the Soviet Union the process of the reintegration of Central and Eastern Europe (CEE) into the world economy has started immediately after transition had started. Liberalisation in trade and capital flows became the first vehicles of that reintegration. From the mid-1990s outward foreign direct investment (OFDI) has gained importance.³ Soon afterwards, these countries expanded their influence and set up subsidiaries abroad, mainly in the neighbouring countries. The leader in OFDI among the Visegrád countries was Hungary. The Visegrád countries are the fastest developing, most industrialised and westernised among the newly emerging country markets of the CEE region. Companies from those economies have been actively involved in the process of attracting FDI, as well as trying to internationalise their own activities.

In Hungary, OFDI has been increasing since 1997; as a consequence, Hungary has become one of the main investors in the CEE region. Among the most important fields of Hungarian OFDI (energy, pharmaceutical, banking sector), quite important examples of OFDI exist in construction. Internationally, the construction industry is considered inward-looking, but Hungarian construction firms have established a foreign presence. The wholly Hungarian-owned KÉSZ group is one of the most influential actors in this market with more than 1000 employers.

The KÉSZ Group, history and structure

In the early 1980s Mihály Varga established the Komplex enterprise that was converted into limited form in 1991. The firm specialised in engineering and structure installation. Issued capital amounted to Euro 115,000. KÉSZ showed an increasingly good performance with its yearly turnover of Euro 1,117,000 in 1991. Its services embraced a wider range of activities. The number of employees and member companies also increased.⁴

In 1996 KÉSZ faced a turning point. The company gained an important role in the Hungarian construction market by achieving an annual income of Euro 26 million. They won several projects of international investors. From that point, KÉSZ pursued continuous growth and entered new markets. It achieved 2nd place in the Hungarian construction market regarding its yearly turnover. It entered the international market by setting up the first KÉSZ subsidiary in Romania in 2001 that was followed by the KÉSZ Ukraine construction enterprise in 2002. In order to operate the Ukrainian factory, they joined forces with two other Hungarian companies (ASA Kft., Ferrobeton Zrt.) to establish 3 Beton Kft. In 2003, its subsidiaries were established in Croatia and Serbia-

³ www.unctad.org/en/docs/iteit20032_en.pdf

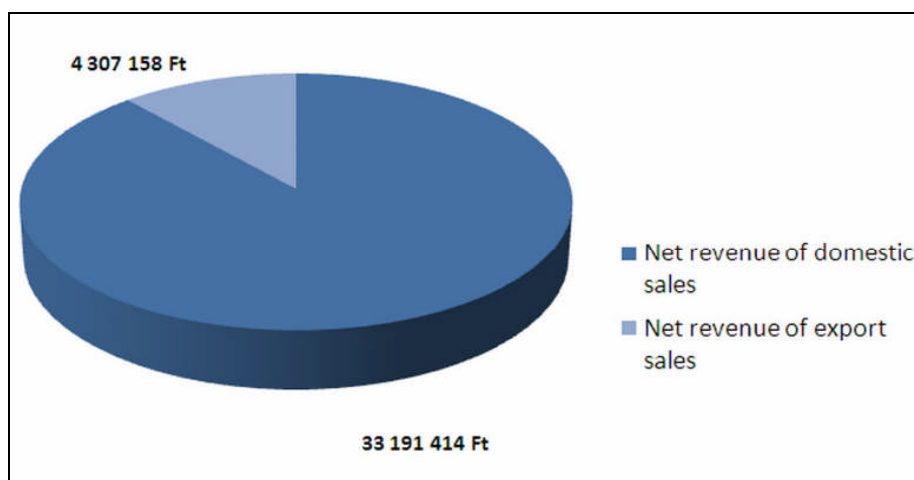
⁴ www.kesz.hu/en/Bemutakozunk/5/2

Montenegro. The company name was changed to KÉSZ Central European Construction and Installation Ltd. due to the expansion strategy abroad and the extending scope of activities. The company gained an international role with individual projects in Switzerland, Turkey, Slovakia, Austria, Serbia, Romania, Moldavia and Ukraine and also delivering substantial exports. KÉSZ delivered outstanding achievement with a turnover of Euro 140 million in 2004 and it joined domestic PPP projects of high significance.⁵

The year 2007 was of outstanding significance for the group in several aspects. Besides the fact that it had a turnover of almost Euro 260 million, the company celebrated its 25th anniversary. On the other hand, the restructuring of the group is also of great importance: from 01 January 2007 the parent company KÉSZ Ltd. and its subsidiaries have been operating in a holding structure. The restructuring process was basically aiming at profile clarification, the separation of processes and transparency of the propriety relations of the subsidiaries. Parallel with the structural reorganisation, KÉSZ got a new image, a new logo that represents the changes, linking the past 25 years with present and future. The market conditions and the continuous development of the company made it possible to further expand internationally and establish its third subsidiary company abroad, located in Sofia, Bulgaria. Furthermore, in 2009 it won the project of reconstruction and development of the Budapest Ferihegy Airport.⁶

As of 2009, the Company's financial figures are rather prosperous, showing almost Euro 130 million net profit along with more than Euro 82 million fixed assets (domestic and foreign together) and operating with almost Euro 15 million own capital.⁷ The company's net consolidated turnover from domestic sales was HUF 33 191 414 000 in 2008, and the proportion of exports broke the level of 4 billion HUF. Its foreign enterprises could book a turnover of more than HUF 5 billion.

Chart 1. KÉSZ Group net sales revenue in 2008 (in thousand HUF)

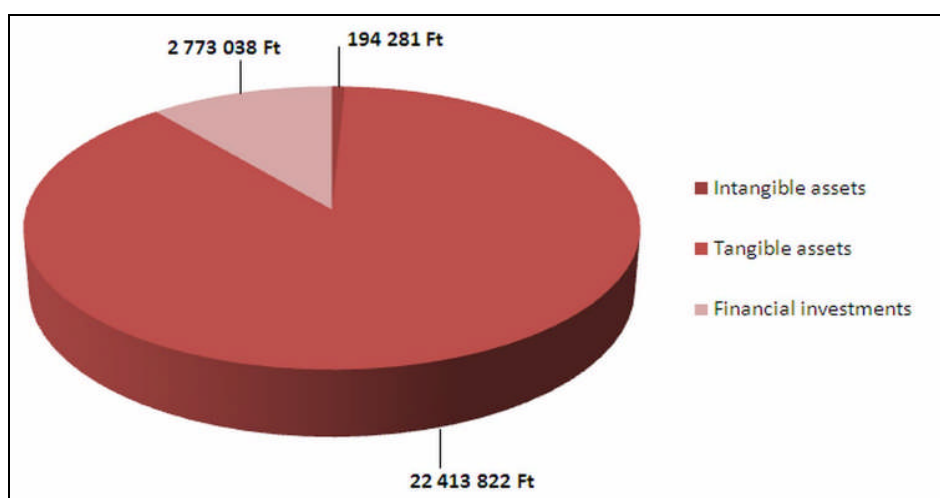


Source: <http://www.kesz.hu>

⁵ www.kesz.hu/en/Bemutakozunk/5/2

⁶ www.kesz.hu/en/Bemutakozunk/5/1

⁷ www.kesz.hu/en/Bemutakozunk/5/1

Chart 2. KÉSZ Group assets in 2008 (in thousand HUF)Source: <http://www.kesz.hu>**Table 1. Selected financial data**

Current assets (HUF 2,992 mil)	Own Capital (HUF 4,954 mil)	Fixed assets (HUF 48,064 million)
<i>Inventories (HUF 5,368 million)</i>	<i>Signed-up capital (HUF 3,535 million)</i>	<i>Intangible assets (HUF 24,076 million)</i>
<i>Debtors (HUF 14,199 million)</i>	<i>Capital reserve (HUF 16 million)</i>	<i>Tangible assets (HUF 21,379 million)</i>
<i>Securities (HUF 1,317 million)</i>	<i>Net profit (HUF 577 million)</i>	<i>Financial assets (HUF 2,609 million)</i>
<i>Funds (HUF 2,107 million)</i>	<i>Outside stock holders (HUF 824 million)</i>	

Source: <http://www.kesz.hu/en/Bemutakozunk/10>

As a result of the 2007 structural changes, KÉSZ Kft. and its subsidiaries established a real holding organisation. Their goal is to develop an efficient strategy for the KÉSZ company group and to develop the holding to a point where it becomes an important economic actor. Their activities are organised on the domestic and international markets using modern, human-centered methods, and environment-aware technologies.

KÉSZ Holding Inc. is the leading company of the KÉSZ Group. The holding creates medium- and long-term strategies and development concepts, ensures financing, and manages effective operations. KÉSZ Industrial Manufacturer Ltd. is one of the dominant actors in the Hungarian construction industrial market, a significant actor in the market of the Central European region. KÉSZ Real Estate Ltd. is dealing with property development and facility management, while KÉSZ&GO Ltd. is dealing with the management and letting of fleet. The company is at its clients' disposal with brand-free fleet offers in its Kecskemét and Budapest premises. Last, but not least, the financial-accounting service-providing subsidiary of KÉSZ Group is KÉSZ Consulting Ltd.^{8 9}

⁸ http://www.kesz.hu/en/Kesz_csoport/16⁹ Dilek Aykut & Andrea Goldstein, 2006. "Developing Country Multinationals: South-South Investment Comes of Age," OECD Development Centre Working Papers 257, OECD, Development Centre.

Features of internationalisation

As other emerging multinationals, also this firm set up its subsidiaries in neighbouring and/or geographically close countries. The international subsidiaries of KÉSZ are concentrated in the Eastern European markets. Regarding the company's future ambitions, KÉSZ Holding's objective is to firmly expand on the Central and Eastern European construction markets and will reach this objective by establishing companies in new countries.¹⁰ Concerning the market entry mode and form, acquisition of foreign firms proved to be somewhat more popular than greenfield investment. Hungarian companies prefer 100 per cent ownership and the dominant legal form of the affiliates is a limited company this is valid for our case study company, too.¹¹

KÉSZ Group's most important foreign subsidiary is S.C. KESZ S.R.L., which was established in 2001 due to the boost and strengthening of investments in Romania. In the beginning, this enterprise implemented minor investments. Its development has accelerated thanks to its Hungarian parent company's background and professional support. Market expansion made it indispensable to develop the organisation of this subsidiary, so new offices were set up. Its new office in Székelyudvarhely won an EU Phare tender for modernising 17 schools. Today, the company's scope of activities covers the entire spectrum of construction. The company has gained extensive experience in the know-how and acquired significant technological background, so now it can carry out independent installation projects.

The first Ukrainian subsidiary was established in 2002. KÉSZ Group was among the first foreign companies in the Ukrainian market to purchase a factory lot. During the first few years of its operation, the company was primarily engaged in constructing structures, but later on, it became involved in the tourist industry as well. In 2005, KÉSZ Group established its second Ukrainian subsidiary, KÉSZ UA whose primary goal was to gain ground in the capital and the Eastern Ukrainian region. The new company developed rapidly and soon won significant projects in the construction market. In 2005 the KÉSZ UA Kiev subsidiary was established which primarily serves the gaining of a relevant market share of the company in the capital and the Eastern Ukrainian Region. The new subsidiary rapidly developed, and soon won rather significant projects in the construction market. In 2007 KÉSZ Group opened its office in Bulgaria, Sofia. The Group is planning to step out on the Polish and Slovak markets, too.

Thus, we can conclude that the company's decision to go international depends on and results in so-called home and host country impacts.¹² First, let us take the home-country factors, namely those of Hungary. Besides the already mentioned increased possibilities to create long-term strategic relationships with global partners, the most important domestic factor was the company's

¹⁰ <http://www.kesz.hu/en/Bemutakozunk/6/1>

¹¹ http://www.kesz.hu/en/Kesz_csopot/15/1

¹² Svetlicic, M, Jaklik, A and Burger, A. "Outward FDI from new European Union Member States" manuscript, Faculty of Social Sciences, University of Ljubljana, (November 15, 2006)

financial situation and development. The company could make considerable profits that could be invested in Hungary or abroad. The latter was attractive especially because competition was strong and the home market was saturated. Turning to host-country factors, the most important is the prospect of increasing market share. This is partly connected to the specificities of the sector. Market opportunities in the region are extremely important for an investor. Future market expansion and economic growth in neighbouring countries could provide good opportunities. The ongoing privatisation process in these countries offers chances of participation. Labor costs and productivity also played a role in the investment decisions of KÉSZ; the development of the local infrastructure is also an important factor.

Furthermore, as transport and communications improve, so will the conditions for investment. Another major factor that is worth considering is the economic policy of the host country. The macroeconomic situation is less stable in Eastern European countries than it is in Hungary and inflation is higher. Having experienced these conditions earlier makes the company able to cope with these difficulties. Certainly, legal and political stability and decreasing bureaucracy are important host-country factors alongside the economic conditions. It is now clear that the main objective of KÉSZ for establishing affiliates abroad is the acquisition and expansion of market share and strategic considerations. Such expectations have already been realised: this is reflected in the increased market share, exports and production. Similarly to other emerging TNCs, KÉSZ Holding also follows the strategy of the horizontal or in other words the market-seeking type of expansion.¹³ The KÉSZ Holding has a list of intangible assets that is not at all special compared to nearly any other company's and may seem to be a little bit bookish, however, it is worth considering from the point of view of enabling the company for the quick and successful internationalisation: „spirit of enterprise, dynamism, effectiveness, teamwork, expertise, reliability, co-operation, reliable performance, controlled processes”.¹⁴

Besides the above mentioned, some other knowledge advantages may help the company to expand internationally. First of all, it is inevitable for the company to have some knowledge about the region and links in the region may foster its growth. Furthermore, the first mover's advantage of being in Hungary is also one of the essential elements to be successful internationally. Last, but not least, the Company must be aware of the special post-transition situation and its impact on the construction market.

¹³ Dilek Aykut & Andrea Goldstein, 2006. "Developing Country Multinationals: South-South Investment Comes of Age," OECD Development Centre Working Papers 257, OECD, Development Centre.

¹⁴ <http://www.kesz.hu/en/Bemutakozunk/6>

Hungarian parliament passed the budget bill 2010 in December

Olivér Kovács

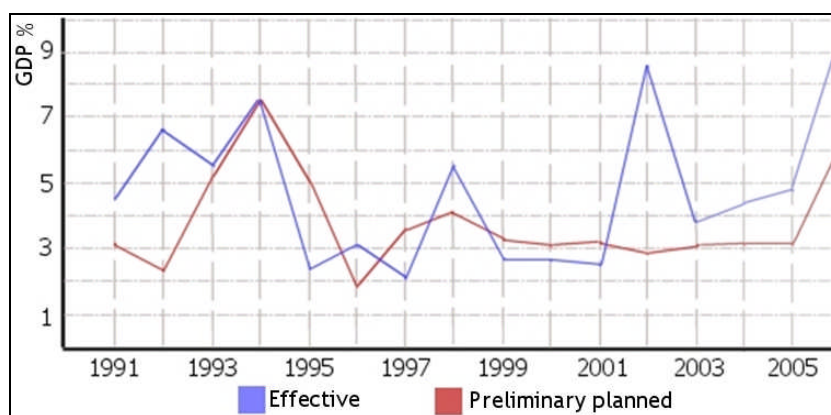
Introduction

It is increasingly accepted that fiscal sustainability positively contributes to the economic growth in the long run. The crown jewel of a sustainable fiscal policy can be the passed budget law. In Hungary, the parliament accepted the corner numbers of 2010 budget bill on 1 December. This budget yet can be ranked to the queues of austerity budget laws which have been made by the government since autumn 2006. As a result of stern internal and external pressure, Hungary has to continue maintaining the strict fiscal discipline to preserve its solvency. It is reflected by its targets. The preliminary planned budget deficit is 3.8% of GDP for the next fiscal year, the shrinkage of GDP is 0.6% and the annual average inflation is 3.9%. The frugal state operation law stipulates various anchors for the period 2010-2012. The primary balance target is 1.8 per cent of GDP for 2012. Furthermore, the gross sum of the revised primary expenditures of the central government in 2012 might lift with less than the half of the real GDP growth compared to the gross sum 2011.

Yet another consolidation

Nearly 11 years after the so-called Bokros-stabilisation package, the government decided in 2006 to impose austerity measures in order to stabilise the condition of public finances due to the huge budget deficit and public debt. It bears the stamp of the unsustainability of years-long lax fiscal policy and inadequate economic policy. The implemented consolidation has been aiming at the correction of excessive deficit to be closer to 3% of Maastricht Treaty, to dampen the gap between dreams (expenditures) and reality (revenues). Inadequate fiscal policy *per se* deteriorated the credibility, furthermore the apparent discrepancy between the previously planned and effective budget deficits played a substantial role. Spikes illustrate the soaring deficits in election-years (1998, 2002, and 2006).

Chart 1. Effective and preliminary planned budget deficits in Hungary



Source: Data stems from Hungarian Budget laws and National Statistics Office

Table 1. Fiscal developments in 2006-2009 periods (% of GDP)

	2006	2007	2008	2009	2010
General government deficit	9.2	3.4	3.4	3.4	3.8
total revenues	42.6	44.8	46.5	47.4	48.2
total expenditures	51.9	49.7	49.8	50.8	52
Government gross debt	65.6	65.8	73	80.3	82.3
Primary balance	-5.3	-0.9	0.8	1.4	0.8
Cyclically adjusted primary balance	-10.5	-5.7	-3.9	-3.4	-3.3
Real GDP growth (%)	3.9	1.1	0.5	-6.3	-0.3
Convergence programme	2006	2007	2008	2009	2010
General government deficit	9.2	5	3.4	2.6	2.5
Government gross debt	65.6	65.8	71.1	72.5	72.2
Real GDP growth (%)		1.1	1.3	-0.9	1.6

Source: European Commission, national convergence programme and budget laws.

Table 1 shows that even if the contraction of real GDP growth has been important due to the austerity fiscal measures and the global financial crisis, a distinct improvement can be recognised in the course of general government deficits and it is entailed with a sharp reduction in the cyclically adjusted primary balance (CAPB). However, we cannot overlook the fact that government gross debt has been permanently rising. Does it bring into question the appropriate choice and implementation of fiscal adjustment measures?

More precisely, according to the prevailing view and international empirics, fiscal consolidation can be successful if the government focuses on the expenditure side. Economic studies concerning the experiences of OECD countries pointed out that fiscal consolidations focused on the revenue side with temporary one-off measures were unsuccessful.

On the opposite side, fiscal consolidations focusing primarily on spending cuts, transfers and government wage bills had better chance of being successful in terms of long lasting deficit improvement. The revenue-side attempts were unsuccessful in each country, because of their unsustainable nature, which causes unsatisfactory fiscal performance.

If we take a glance at the major measures on the revenue and expenditure sides, we can see important changes in several places, but they still primarily focus on the revenue side. The expenditure-related pivotal structural problems remain, such as excessive public payroll, overstuffed public administration, application of social security programmes without high diligence, and overall deficiency of cost-awareness in the management of public resources.¹⁵

¹⁵ See Kopits (2008): The Political Economy of Fiscal Reform in Central and Eastern Europe. OECD Journal on Budgeting, Vol. 2008/3

Table 2. Fiscal measures on the revenue and expenditure sides

Revenue	Expenditure
2006	
• 5 % cut in the upper level of VAT rate • 2 % cut in the higher rate of personal income tax • an increase of the lower tax bracket by HUF 50 000 • cancellation of some exemptions (-0.1 % of GDP) • 100 % of local business tax deductible from corporate tax base • a decrease of the rate of corporate tax to 10 % for micro companies (up to HUF 5 million annual revenue) • abolition of the lump sum health insurance contribution (-0.05 % of GDP) • Increase in registration and excise duties to partly compensate VAT revenues losses (+ 0.2 % of GDP) • Introduction of luxury tax (property tax on real estate worth more than HUF 100 million) (negligible)	• 1 percentage point of GDP decrease in public investment expenditures • 0.4 percentage point of GDP expected decline in interest expenditures • setting an "emergency" budget reserve against a possible departure from the 2006 target • unused appropriations frozen at their end-2005
2007	
• Increase of the lower tax bracket by HUF 150 000 (- 0.1 % of GDP) • Introduction of the minimum expected profit tax for corporations (0.2 % of GDP) • Introduction of a 4 % 'separate tax' for personal incomes (0.1 % of GDP) • Increase in the rate of employees' healthcare contribution from 6 % to 7 % (0.2 % of GDP) • Introduction of co-payments in healthcare services (0.1 % of GDP)	• 0.9 percentage point of GDP decrease in public investment expenditures • Freezing the public wage bill at the end 2006 level and cuts in operational expenditures of public administration (- 0.6 % of GDP) • Cuts in universal pharmaceutical and gas price subsidies (- 0.5 % of GDP) • Increased subsidies (+ 0.2 % of GDP) and capital injections (+ 0.4 % of GDP) to the national railway company in the context of a restructuring plan
2008	
• Increase in the limit on investment related spending to be exempt from corporate taxation from 25% to 50% up to a maximum of HUF 0.5 bln (-0.05% of GDP) • Extension of the preferential corporate tax rate (10% instead of the standard 16%) for small and micro companies that invest and/or create jobs (-0.08% of GDP) • Merger of two different types of personal income tax credits (-0.12% of GDP) • Social security contribution - base broadening	• Increase in EU funds co-financing expenditures (0.2% of GDP), overcompensated by the reduction in motorway investment projects (-0.3% of GDP) • Indexation of pensions through the Swiss-indexation mechanism and the implementation of the long-term pension correction programme (+0.2% of GDP) • Savings on the operational expenditures of public administration (-0.3% of GDP) • Cuts in public education expenditure as a result of the new financing mechanism encouraging school mergers (-0.15% of GDP)

Source: European Commission

Incomplete fiscal development?

Beyond doubt, fiscal consolidation has been started in Hungary for roughly three years, and even if its achievements are observable in numeric sense (especially in the case of the general government deficit), the composition of austerity budget bills was not in line with the above mentioned international experiences. There is a broadly accepted view that fiscal adjustment relied primarily on the revenue side, and, according to our basic thesis, it does not provide sustainability in itself.

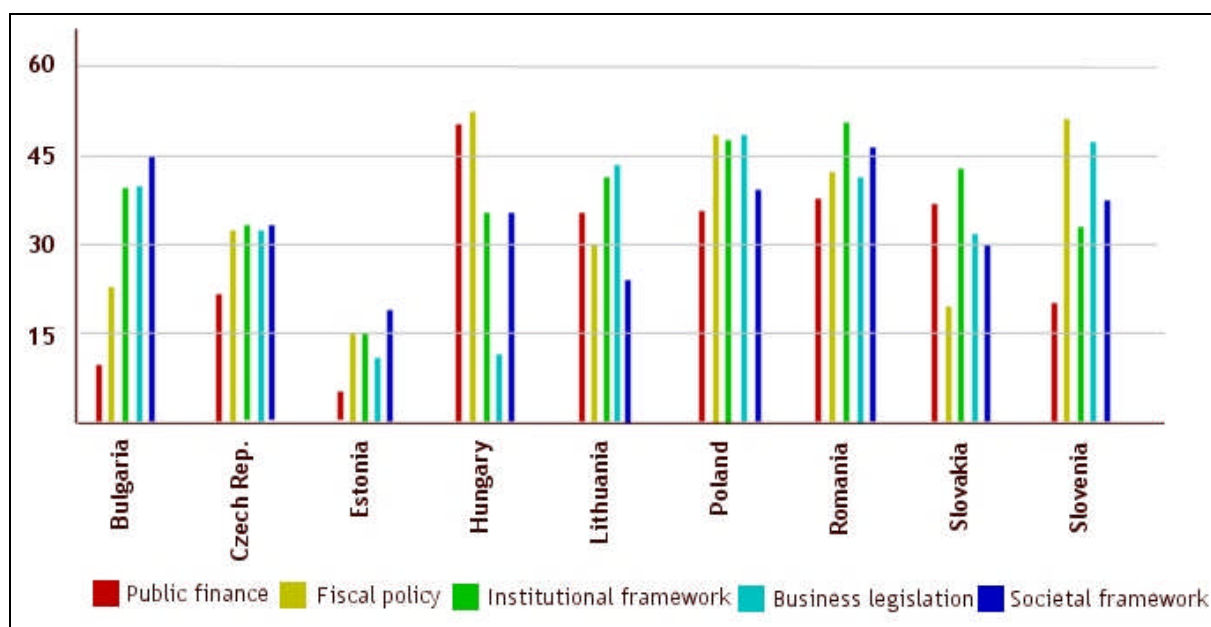
If we take into account the necessity of structural reforms, the Hungarian economy cannot be treated as a durably stabilised one from the aspect of fiscal policy. Studies also emphasise the

importance of structural reforms whose aim is to convert unsustainable social security sub-systems (encompassing the pension and health care systems, education) into financially sustainable.

Under this angle we can claim with reasonable certainty that the outlook suggests pent up growth capacity, which is attributable to the lack of structural reforms. That is why we cannot prognosticate a flattering fiscal performance in the long run.

IMD (an organisation located in Switzerland) yearly compiles and issues its competitiveness index, which among other things measures government efficiency by various parameters (e.g.: fiscal policy). These indices are not perfect, as institutional efficiency is hard to be expressed by sheer numbers. Nonetheless it might be a good compass, which helps to compare the situation of Hungary to that of other countries.

Chart 2. Sub-factors of government efficiency index 2008



Note: lower value means better government efficiency. IMD does not investigate the case of Latvia.

Source: Data stems from IMD The World Competitiveness Scoreboard 2009

The most notable fact is that Hungarian public finance and fiscal policy indices are by far the worst compared to other Eastern European countries (except Latvia). It partly originates in the absence of a duly implemented fiscal institutional reform reflecting the lack of structural reforms of welfare systems.

The new budget in the light of New Political Economy

While we do emphasise that the budget bill 2010 also reflects the prudent instructions of IMF and the World Bank, and it is judged appropriate by the Fiscal Council Republic of Hungary, in the long run we have to underpin the necessity of further budgetary and welfare reforms to escape from the trap of structural deficits, to dampen the high state concentration and to make fiscal policy more flexible.

The first step has been taken by the budget bill 2010 and with the previously formulation of the Fiscal Council and fiscal rules. Its verification can be seen if we take into account the theories of New Political Economy referring to the budget process.

The entire budget process was girdled with massive opposition by the right-centre party, because the planned budget law does not provide big fiscal latitude with its deficit target for the next government in 2010. This phenomenon is in accordance with the suggestions of the New Political Economy literature. This theory embraces the role of political and institutional factors in the assessment of countries' fiscal policy. The theory assumes that parties are trying to make some strategic steps in order to induce inconvenient circumstances for the incumbent government. These actions concern the preparation, planning, voting and execution phases of budget bill. The opposition party always tries to facilitate deficit-bias and debt growth during the first few years of the current government, then again – if it has big chance to win the forthcoming election – it strives for better budget conditions through influencing the above mentioned stages of the budget process by corrective proposals.

Outlook and conclusions

The passed budget law did not become loose, its fiscal targets have been made in the sense of fiscal discipline. This is a distinct improvement in the recent practice of the Hungarian budget process. While recent efforts to reduce the deficit partially reflect external pressure from the EU, the real question has not changed: when will the inevitable structural reforms arise? Will the next government want to commit itself to fiscal sustainability or will have a bigger willingness to insist on maintaining the *status quo* instead of meeting the requirements of international organisations and preparing the economy for the end of the global slowdown through structural reforms? It will be crucial how the Hungarian government will imagine the further institutional reforms of budgeting encompassing budget procedures to evolve its better effectiveness and greater level of internal pressure for sustainability in the long run.