IEER Monthly Bulletin of Economic Trends May 2013

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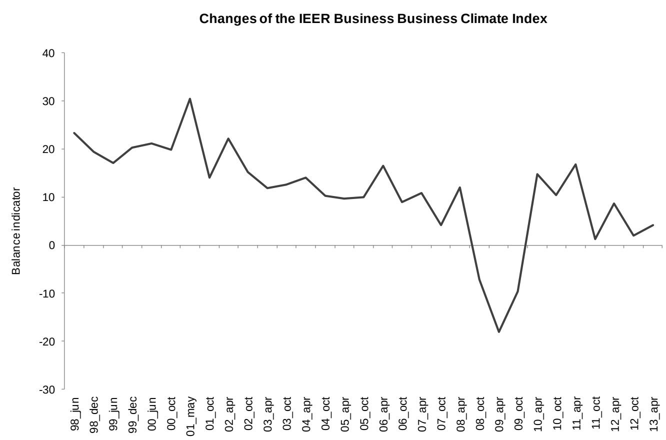
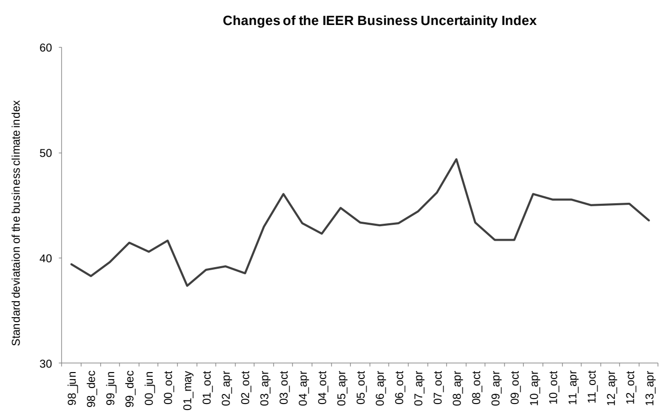
April 2013 was the thirty-first occasion of the HCCI Institute for Economic and Enterprise Research (IEER) business climate survey which is based on the cumulative response of more than 14,000 companies and conducted in April and October of each year, with the participation of regional chambers. It is the largest and most extensive business climate survey of its kind in Hungary. The research is part of the 14 million enterprise-wide Eurochambres survey of the European economy. In April this year 3,500 firms filled out our questionnaire -- our study is based on these responses.
The IEER business climate index rose 2.3 points from the October level of 1.9 points, and now stands at 4.2 points. This is still characterized as a weak positive result, which is underscored when the data is compared to the level in April of each year: this is the second lowest level since the start of the study (1998). The value of the uncertainty index is at the 43.6-point level. This suggests that within the business community there is still no clear or unanimous opinion of current trends. In addition, together with data available on the current performance of the Hungarian economy and the IEER business climate data, our attention is drawn to the slight decrease in uncertainty surrounding the current year.

The business climate index, excluding companies engaged in retail (0 points), increased in all sectors since October (construction: -13 points, services: -5 points), however a positive value was only recorded among companies in the industrial sector (17 points). Looking at companies by ownership structure, we can conclude that businesses with predominantly foreign ownership had a positive outlook (23 points), whereas companies predominantly domestically owned were unchanged (0 points), while entirely Hungarian-owned firms had a negative score (-4 points). Based on the export activity of businesses, we can conclude that firms with links abroad were optimistic (those that produce mostly for export at 24 points, those with only a part of their sales for export achieved 15 points) while companies that produced only for the domestic market had pessimistic expectations for the next six months (among them the score was only -13 points). By company size, firms in categories with less than 50 people had a negative outlook (those with less than 9 employees at -31 and with those in the 10-49 range at -10), whereas those with a larger number of employees recorded a positive value (50-249: 6 points, more than 250 employees: 19 points).



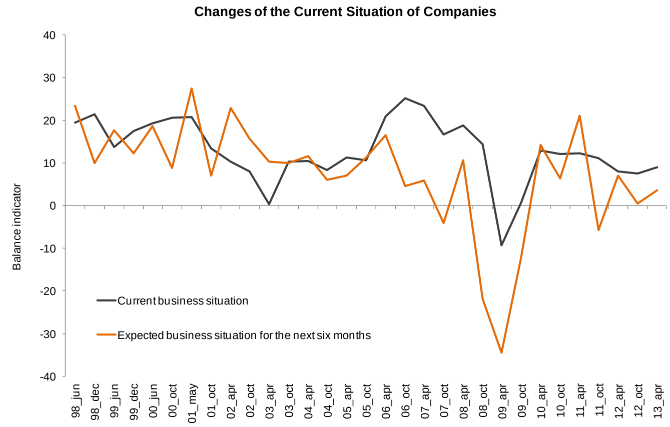
Currrent and expected business situation

The current business situation of companies was more favourable by 1 point compared to last year's results, with the index rising to nine points. The most favourable situation was reported by industrial companies (24 points), while construction firms reported the least favourable (-16 points). This clearly shows the positive impact of foreign relations in terms of a company's business situation: primarily exporting firms or those predominantly owned by foreigners appeared higher on the corresponding indicators than those that produced only for the domestic market as well as those that are primarily domestically owned (42 and 39 points, and -10 and -3 points respectively). Based on number of employees, there are significant differences within the index, with those up to 9 employees extremely negative, characterized by a value of -35, while among companies with 10-49 people it



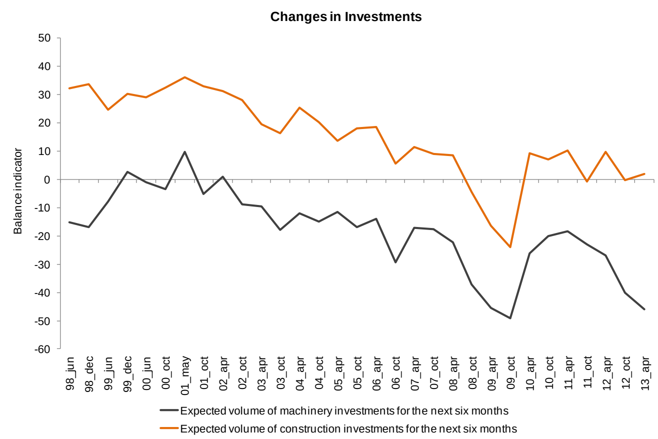
was -12 points, companies with 50-249 employees at 10 points, and large enterprises with over 250 employees at 28 points.

Looking at business expectations in terms of economic sectors, only those among industrial companies had a positive score (18 points), whereas other sectors were characterized by pessimistic expectations (retail: -1 point, services: -4 points). The construction industry continues to be characterized by a very poor outlook (-22 points). As with the current business situation, again mostly foreign owned (28 points) and export-oriented firms (34 points) were found to have the most positive expectations due to foreign influence and ties, while the score of those companies with a minority foreign-ownership fell into the negative range at -22 points. The score of those with less than 50 employees were negative (those with less than 9 and with 10-49 employees were at -36 and -14 points respectively) while larger sized firms has a positive value (50-249 employees: 4 points, over 250 employees: 20 points).

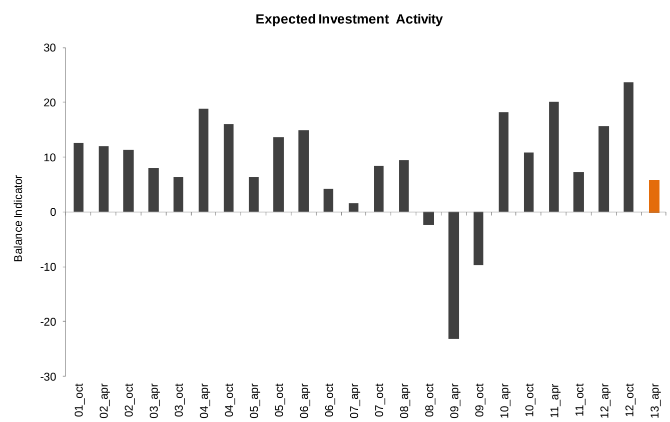


Investments

The indicator for planned investments over the next six months dropped to 6 points from its 24-point peak of last October, reaching a three-year low. Hence, for the next six months a decline in investment activity can be expected.



Among industrial companies, the contraction in investments was signified by a negative value of the index (-2 points), while for other sectors it was characterized by a positive value (construction: 11 points, retail: 21 points, services: 6 points). By export activity, the investment climate declined for every business segment, especially among companies characterized by foreign sales, but the index is still in the positive territory at about 6-7 points for each group. The same can also be said for the breakdown based on ownership structure, however in the case of partially foreign-owned enterprises with a minority stake the indicator fell back to a negative level (-17). In addition, with the exception of micro-enterprises (4 points), the index fell for all categories of employee numbers, but remained in the positive territory (10-49: 12 points, 50-249: 2 points, 250 or more employees: 7 points).



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Investments and the ability to attract capital in the Visegrad countries

The following analysis deals with developments in the amount, cost and efficiency of investments in the Visegrad group of countries; we also deal with integrally related issues of external balance and changes in the position of external financing.
The key finding, which motivated us to write this analysis, is that since the beginning of the financial crisis investments in Hungary have fallen short, and as a result the country lags significantly behind other countries of the region. In Hungary, investment efficiency is also lower, even though this can't be justified either through cost or productivity conditions. In conjunction with this our financial capacity is positive, in which a high export surplus plays a key role.

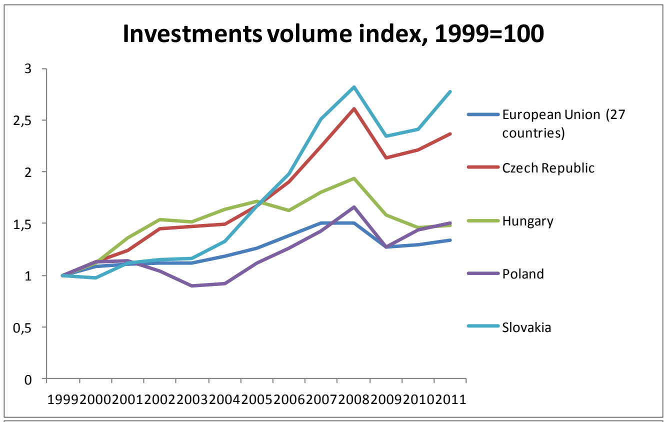
The analysis deals with a regional comparison of investment volumes, the development of investment-related prices and costs, and sources of financing investments. In the first chart trends in the gross fixed capital formation volume index since 1999 can be seen. In this chart comparisons are made to the level of 1999, so the growth rates are clearly visible. However, it is interesting to see what this means in proportion of GDP (not on a volume-volume, but value-value basis). In the case of Poland and Slovakia, between 1995 and 2011 GDP increased along with investments during the period, with both surpassing Hungary. In the Czech Republic and Hungary, investments decreased proportionally to GDP; despite the decline in the Czech Republic, however, it still has the highest share of investments relative to GDP.

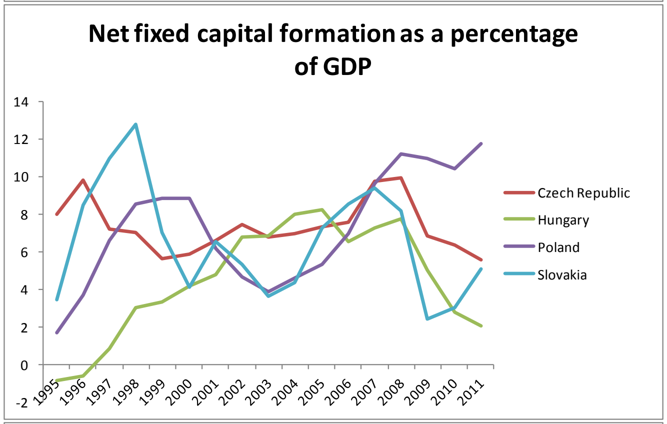
It's useful to adjust the amount of investment by the amortization, in this way we get net fixed capital formation. This involves such tools for the production of capital goods which doesn't simply replace old, deterioratied ones, but also offers new capacity. Currently Poland is performing remarkably well, with a net fixed capital formation of 12% of GDP. Hungary is able to improve the stock of fixed capital at less than 2% of the GDP.

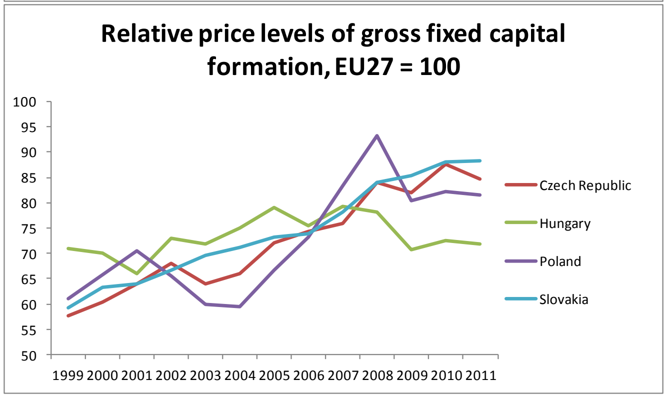
We now examine three factors that may affect the development of the gross and net amounts of investment: their cost, wages and level of taxation.

We are foremost interested in a comparison between countries of investment cost levels. Here the cost of the means of production and gross fixed capital formation are shown on the third chart compared to the EU average (these data are available only since 1999.) We see that at the beginning of the period, Hungary had the highest level of investment cost; by the end of the period, however, other countries in the region have become relatively more expensive while Hungary has become relatively cheaper.

Production requires labour, skills, infrastructure and financing, suppliers and outlets, as well as many other less tangible factors. The overall burden of total wages and benefits are well recorded and compared. Unfortunately,







macro-related statistical indicators include the costs of labour and related skills along with wage-related costs as well as employment taxes (paid by employees) and additional employee benefits; meanwhile, it does not include taxes paid by employers. This amount we can add as a proportion of the total cost of production, or as a proportion of total work time.

We can observe the important characteristics of individual countries on the fifth chart: here we draw attention to the tax burdens on production and imports. The lowest level can be seen in the case of the Czech Republic and Slovakia: it was staying at around 10%. The EU average was slightly higher. For Poland, the rate was typically 13-14%, and for Hungary it was 14-15%. This is merely one important aspect for investors deciding which country to choose as a target destination within the region.

We can only assume on the basis of cost, wages and levels of taxation. There is other more important and direct ways to check whether it is worth investing in a country or not. For this the rate of return on capital is appropriate, which is the proportion of net operating surplus to net fixed capital stock. In this way we filtered from the indicator the impact on fixed capital of quantitative and compositional differences. We assume that this ratio indicates how much you should invest via equity instruments, that is, to invest in certain countries.

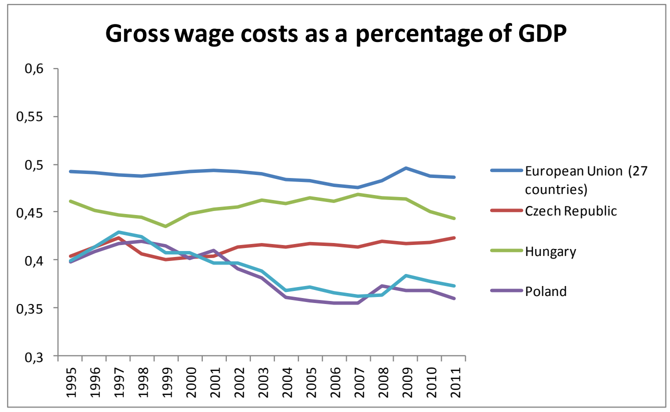
On an average level, Poland and Slovakia achieve extremely high rates of return (15-18%). Hungary lags behind them, but offers higher returns than the EU-27 average and the Czech Republic. The levels of return changed significantly during the period, but the country order remained the same.

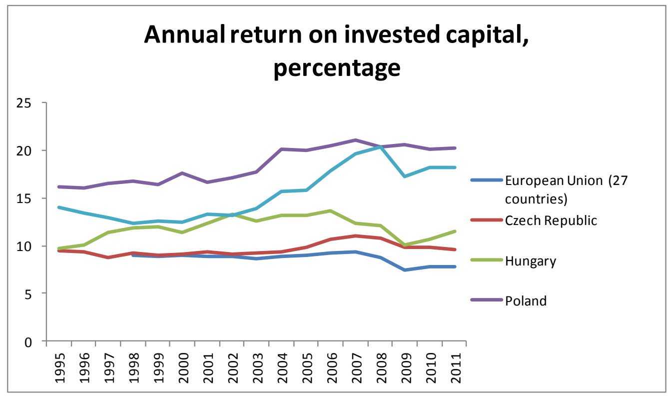
Since gross savings in the region are typically lower than the amount of gross investment, an important question is how we can involve external sources. The difference is typically equivalent to 5-8% of the GDP. This means that a corresponding amount of foreign investment is needed for financing. This may include public debt, loans from abroad, but also property and shares acquired by foreigners in the country.

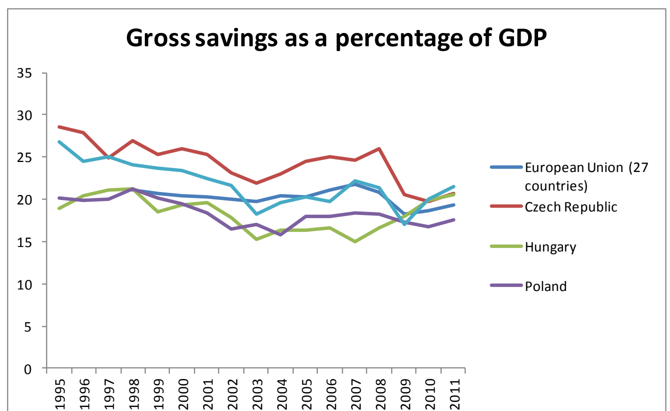
The Czech Republic was able to reach a higher savings rate for the full length of the period than any other country in the region or compared to the EU-27 average. At the beginning of the period this was 28%, and by the end of the period it was only 22%. Slovakia and the EU-27 were lower, at 20-26%, while Poland and Hungary had an even lower savings rates of 16-20%.

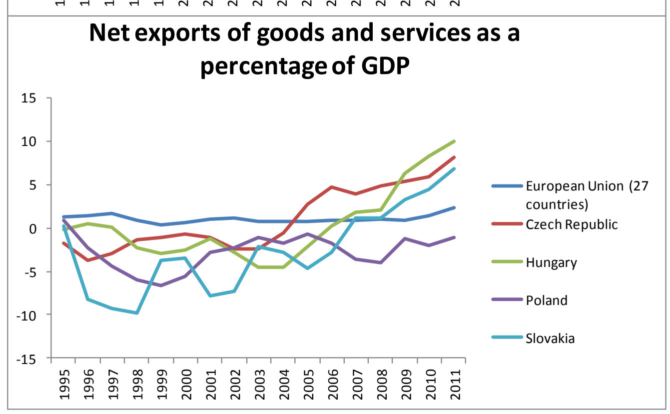
The volume of investments financed from abroad is not equivalent with the fiscal situation abroad. Foreign liabilities and assets accumulated for investment activities are partially or wholly offset by the amount of exports and the outflow of income earned by foreigners.

Net export value is the difference between total exports and imports. This value is typically higher in the case of the small

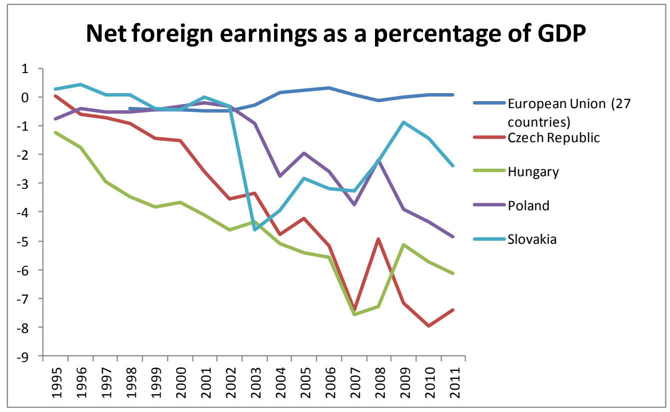






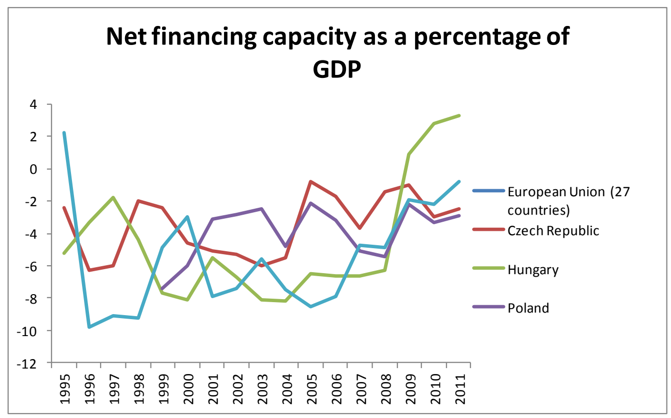


internal markets of Slovakia and the Czech Republic as well as Hungary as opposed to Poland, which has a larger internal market. Exports are one of the most important sources of growth in the economy since it is much faster to increase external demand than domestic demand, because in the case of the former it is not necessary to increase domestic revenue. On the other hand, what is also important in terms of exports is the intended destination and to what extent it is sensitive to the earning fluctuations of the target county.

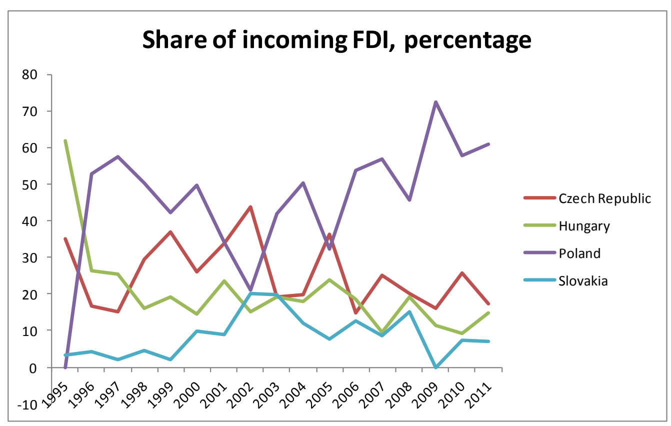


As shown on the chart, each of the countries studied have negative income earned abroad, in other words, foreigners are entitled to a portion of the income generated. This is in large part yields on foreign capital stock, yet the international flow of labour income is also accounted for here. The NFI (net foreign investment) is a part of current transactions recorded for the current account, similar to net exports. It encapsulates eligibility based income earned following the primary factors of production; that is, property rights or work-related.

The amount of the current and capital accounts are key indicators of a country's foreign relations. This is called net borrowing ability. The name comes from the fact that this index shows that in the course of real economic affairs how much more financial claims we have than debts.



During the period negative values were typical for all of the Visegrad countries and the EU as a whole. In other words, it was typical that we rely on foreign sources of funding. An exeption for Hungary has been the past three years, that is, since 2009, and for Slovakia since 1995. This means that despite the fact that external sources of funding play an important role in investments, from a foreign perspective our financial position is currently not deteriorating.



If we look at the inflow of FDI, i.e., foreign direct investments, we see that the improved financial position is not primarily due to a decrease in FDI, but rather a decline in portfolio equity and debt related foreign investments.

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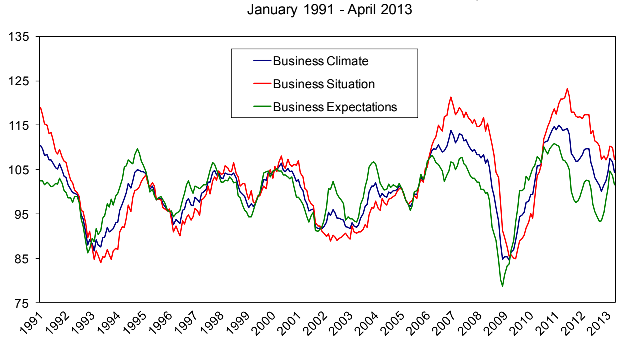
International trends

The Ifo Business Climate Index for German industry and trade in April 2013 showed a decline. Although the majority of companies surveyed considered the current business situation to be satisfactory, they have become much more cautious than they were in the previous month. Expectations for the next six months have also deteriorated. The gap between the current business situation and expected developments, as calculated by the IEER asynchrony index, fell slightly in April, so the business confidence index shows less uncertainty than the previous month. Ifo analysts see the German economy losing a little momentum. (Source: Ifo, http://www.cesifo-group.de)

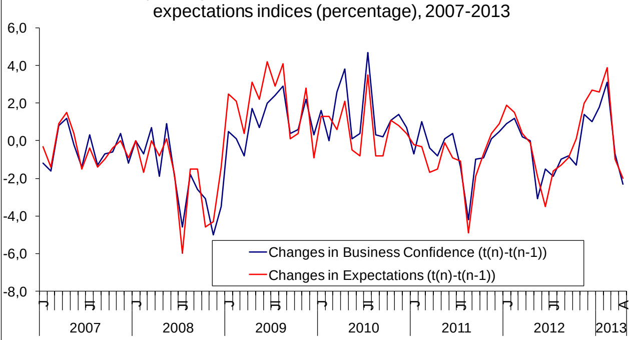
The French statistical office's (INSEE) survey of business leaders interviewed in April finds that the French business climate has deteriorated. The INSEE business confidence index fell three points compared to March and is well below its long term average. After a significant decline the turning point indicator is now in the unfavourable business climate zone. The managers' individual business forecast indicator shows a strong downturn and is at a very low level. The overall outlook index -- which represents a summary of respondent opinions on French industrial activity as a whole -- also declined in April compared to the previous month, and the indicator remains at a very low level. (Source: INSEE, http://www.insee.fr)

The Ifo business climate index for German trade and industry, 2000=100%, January 1991 - April 2013



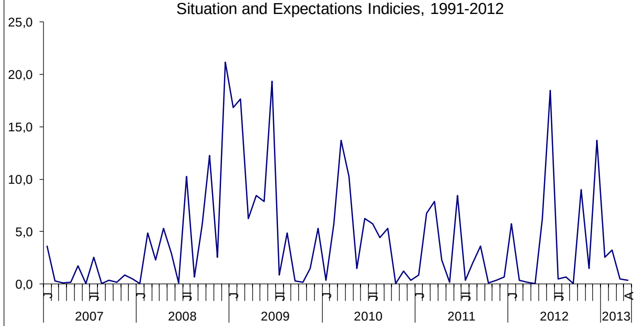
Source: www.cesifo.de

Monthly changes to the Ifo business confidence and business expectations indices (percentage), 2007-2013



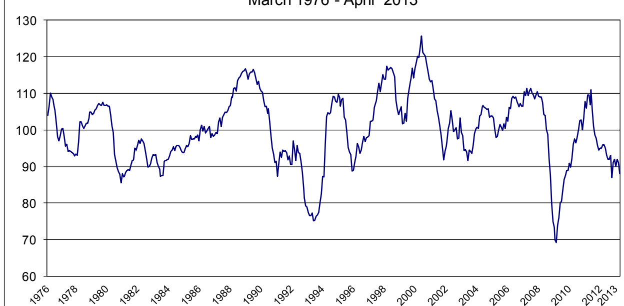
Source: calculations based on data from http://www.cesifo.de/

Index of Asynchrony between the monthly changes in the Ifo Business Situation and Expectations Indicies, 1991-2012



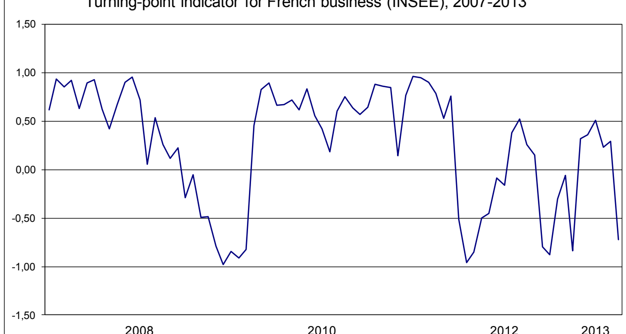
Source: calculations based on data from http://www.cesifo.de/

Business Confidence for French Industry based on the INSEE Business Climate Survey (synthetic index,100=long-term average, March 1976 - April 2013



Source: www.insee.fr

Turning-point indicator for French business (INSEE), 2007-2013



Source: www.insee.fr

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