Foreign direct investment in Hungary

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In the economic transformation of Central and Eastern European countries to market economies, foreign direct investment is expected to play a major role. Transnational corporations have the capabilities to mobilize funds and transfer new technologies that are urgently needed for the modernization of the region and to facilitate the integration of these countries with Western markets. Governments in Central and Eastern Europe have adopted favourable measures and incentives to promote the inflow of foreign direct investment. This article analyses data on such investment inflow to Hungary during 1988-1990. The pattern of investment indicates that most foreign direct investment is accounted for by a large number of small investments, primarily concentrated in trade and other services industries. Apart from a few notable exceptions, transnational corporations have not committed major resources to the country so far. The article concludes that the economic, political and legal uncertainties that arise from the transformation process inevitably limit the role that transnational corporations are willing to assume in the region.

Introduction

Since the Second World War, the collapse of the centrally planned systems in Central and Eastern Europe undoubtedly stands out as the most important global political event. The economic transformation of a highly centralized economic system to a market economy on such a massive scale as to cover the entire Central and Eastern European region constitutes an unprecedented phenomenon. For Western corporations, these changes have

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created major opportunities to enter markets that have only been accessible to a very limited extent in the past few decades. For the democratically elected Governments of the countries in the region, foreign direct investment (FDI) is expected to play a major role in macroeconomic stabilization and in the micro-economic, technological and financial transformation of these economies (Vaňous, 1989; Inotai, 1989; Bagó and Kulcsár, 1990). Transnational corporations (TNCs) are considered to be a linchpin in integrating these economies with the industrialized countries, particularly in Western Europe (Junz, 1991), and in achieving major technological and managerial development (Simai, 1989; Köves, 1991).

The large, pent-up demand that characterized these countries during a continuous shortage economy has resulted in growing, unsatisfied needs for a wide range of consumer and industrial goods.[1] For most Western companies, local industrial enterprises have presented relatively little competition, particularly following the gradual withdrawal of government subsidies that were usually given to state-owned enterprises. The liberalization of prices for almost all products and services has further increased the scope for profitable operations in these markets.

Hopes raised by the dramatic political changes in Central and Eastern Europe have not been paralleled by similar expectations regarding prospects of rapid economic transformation and growth. The substantial initial interest of foreign investors to enter and capture new markets was, however, dampened by the growing uncertainties surrounding the region's political and economic future. In the case of Hungary, the country's high foreign debt and the lack of convertibility of its currency, together with a rapid decline in domestic production, employment and disposable income, have increasingly highlighted the difficulties of economic transformation. Rapid changes and yet unsettled issues related to the legal and regulatory framework have also contributed to the uncertainties facing the country. The cumbersome bureaucracy has also acted as a continuing and further deterrent to potential foreign investors.

Central and Eastern European countries are generally considered to be a high-risk environment for FDI. Continuing uncertainties as to the form and time-frame of economic transformation often render long-term projections of costs and profits in the domestic economy highly questionable. Subsequent depreciations of the local currencies have tended to make export

[1] Probably the best theoretical exposition of the shortage economy under a centrally planned economic system is presented by Kornai (1980).

and import prices, as well as the value of repatriated profits, fairly unpredictable. Consequently, most TNCs have viewed major investments in this region with considerable caution. Many firms for which Central and Eastern Europe are potentially an interesting market continue to monitor economic and political developments closely, but are unwilling to commit major capital investments for the present.[2] Several companies have made investments in Hungary and other countries of the region, but have designed strategies that reduce their exposure while permitting them to capture maximum market share. The perception of a high-risk environment is reflected in the limited size of most FDI projects, the selection of industries and the channels and mechanisms they use to serve the market.

Among Central and Eastern European countries, approximately half of the FDI inflows during the 1987-1991 period have gone to Hungary.[3] The positive attitude of the Government towards such investments and the most liberal measures and regulations in the region towards FDI partly explain this performance. Also, the Hungarian political and economic reforms relating to liberalization have been the longest standing in the region, and a general openness to the West has made the country more attractive than most other Central and Eastern European countries.

This article initially reviews the legislation and other policies that the Government of Hungary enacted towards FDI and that were adopted to encourage the participation of foreign investors. It also examines the response of TNCs to the opening up of the Hungarian market for FDI. Data on FDI inflows and the pattern of such investment in terms of sectoral distribution are also presented. In light of the available information, mostly for the past three years, an assessment is made of the strategy of foreign companies, especially TNCs in this new market.[4] Certain

[2] Interviews with chief executive officers of United States TNCs on the perceived risks of Central and Eastern Europe are contained in a special issue of the *Columbia Journal of World Business* (1991).

[3] Among other sources, this is estimated, for example, by *The Economist* (1991b). For data on the region, see Transnational Corporations and Management Division and Economic Commission for Europe (1992).

[4] The Government of Hungary regularly compiles statistical information on FDI. It is published periodically in the weekly economics paper *Figyelő*. The Hungarian Central Statistical Office also publishes information related to the activity of joint ventures in Hungary. This publication, as well as other official publications, uses the term "joint venture" for all companies with foreign capital participation, including minority- , majority- and wholly owned foreign affiliates. Apart from these statistics, there are a number of in-depth research studies available on the operation of foreign affiliates. Probably the most comprehensive is the study by Bagó and Kulcsár (1990) and Kulcsár and Bagó (1991). The activity of foreign affiliates, particularly in relation to the privatization of state-owned enterprises, has also found wide coverage in the Hungarian press.

variations in operational strategies of TNCs, particularly in organizing their production and the markets they intend to serve, are also identified. To the extent possible, in view of the relatively short period involved, an assessment is made of the operation of these companies. Following its findings, the article suggests certain policies which the Government may consider for enhancing the role and contribution of FDI in the transformation of the economy.

Government policies towards foreign direct investment

Under the centrally planned economic system, the Government of Hungary adopted a fairly negative attitude towards FDI. Yet, since the beginning of the 1970s, certain benefits accruing from FDI were recognized in Hungary, particularly with respect to the inflow of modern technologies and management expertise. Thus, since 1972, the participation of TNCs in the form of joint ventures with Hungarian companies was permitted. Loss of control to foreign partners was to be prevented and effective local participation strenghtened by allowing only minority foreign ownership in these operations. The first Hungarian foreign affiliate dates back to 1972 (King, 1991; Kulcsár and Bagó, 1991). In 1980, there were only eight such companies operating, mostly in the services sector. In the mid-1980s, the legislation towards FDI was somewhat liberalized, and, by the end of 1988, there were about 180 foreign affiliates registered (King, 1991).

Major changes in government regulations took place in 1988, when the most liberal policy towards FDI in Central and Eastern Europe was adopted. Paradoxically, this legislation (which was strongly promotional in spirit) was enacted by the socialist Government. Large foreign debts, unprofitable state-owned enterprises and the need to establish a legal framework for implementing the economic reforms introduced during the 1980s influenced the strongly positive attitude of the Government towards FDI. The legislation that was enacted reflects the essential objective of the Government to encourage increased FDI inflows into Hungary.

The basic laws that relate to FDI are incorporated in the provisions of Act VI of the 1988 Law on Economic Associations which came into effect on 1 January 1989 and modernized Hungary's corporate law, which was adopted in 1875 and modified in 1930 (Gluck, 1991). Among the wide range of legal issues regarding business enterprises, several provisions deal with FDI. The three most important provisions provide, first, that foreigners can own 100 per cent of the equity of a Hungarian enterprise; second, that no government consent is necessary for foreign investors, unless the foreigners own a majority of the equity (except in a few industries, which are designated by the law); and, third, that the repatriation of profits is permitted in the currency of the original investment. Foreigners are allowed to acquire domestic companies or form new enterprises (Gluck, 1991; Benke and Webb, 1991).

Act XXIV of the 1988 Law on Foreign Investment in Hungary expanded the provisions of the Law on Economic Associations and gave further incentives and assurances to foreign investors. It restated that economic enterprises that are wholly or partially foreign-owned may be established "for any economic activity, unless it is restricted or prohibited by law". Furthermore, it guarantees full indemnification to foreign investors in the original currency of their investments for any losses that may result from nationalization or expropriation. It also provides substantial tax incentives to foreign investors. Thus, companies with a minimum of 30 per cent foreign shareholding and which generate at least 50 per cent of their revenues from manufacture or the operation of newly constructed hotels, are eligible for a 60 per cent tax reduction for the first five years and a 40 per cent tax reduction during the next five years.[5] In addition, the Law on Foreign Investment identifies 13 priority areas (including the manufacture of automobiles and parts, machine tools, electronic products, food and pharmaceutical products, tourism and telecommunication services) that are granted a tax holiday for the first five years, to be followed by a 60 per cent tax reduction for the next five-year period. The law also provides for duty-free import of in-kind contributions, such as equipment and machinery.

In 1990, the Foreign Investment Law was amended, effective from 1 January 1991. The amendment provides additional incentives and facilities to foreign investors. It eliminates, for example, the requirement of government approval for the establishment of wholly foreign-owned subsidiaries. It also broadens the scope of the guarantee for profit repatriation to include revenues generated from in-kind contributions by foreign investors (Gluck, 1991). The amendment also has some restrictive provisions, such as the elimination of tax concessions for companies that have only 20 per cent foreign participation or a capital of less than five million forints (about $70,000).

[5] As Hungary's business tax is 40 per cent, this results in an effective tax rate of 16 per cent for the first five years, and 24 per cent for the next five years.

Flow of foreign direct investment

Largely in response to the 1988 legislation on FDI and the election of a democratic Government in early 1989, a significant increase in FDI took place from 1989. For 1989 it was estimated at $300 million, compared with $200 million for the entire ten-year prior period (Creditanstalt, 1991). By the end of 1990, one estimate put it at 72.6 billion forints (*Figyelő*, 1991a), while another put it at 57 billion forints (*Heti Világgazdaság*, 1991), equivalent to about $1 billion and $800 million, respectively.[6]

The rapid inflow of FDI in the country was reflected in a major increase in the number of registered foreign affiliates. As can be seen from table 1, there were about 1,350 foreign affiliates registered in the country at the end of 1989; by the end of 1990, this number had increased to a total of 8,770. The number of registered foreign affiliates that is published regularly by the Government is, however, significantly higher than the number of companies that are actually in operation. Registration by investors may often express an intent to future operation which may or may not materialize.[7] The number of foreign affiliates in operation is estimated to be about half of the total registered companies (table 1).

Table 1. Number of companies with foreign participation, 1988-1991[a]

Year	Registered[b]	In operation
1988	179	..
1989	1 350	582[c]
1990	5 693	3 590[d]
Mid-1991	8 770	3 500-3 600[e]

[a] Hungarian statistics use the term "joint ventures", which includes all companies with foreign participation, irrespective of the share held by the foreign partner, ranging from minority ownership to wholly foreign subsidiaries.

[b] *Figyelő*, 1991a, 1991b, 1991c, 1991d.

[c] Creditanstalt, 1990, p. 49.

[d] *Heti Világgazdaság*, 1991, p. 7.

[e] According to Istvañ Kórösi of the Hungarian Academy of Sciences, Institute of World Economy, October 1991.

[6] Estimates on FDI inflows vary according to the source. Foreign banks, like the Austrian Creditanstalt, and local sources, for example, the Central Statistical Office and National Bank, provide different estimates.

[7] Consequently, depending on the time of the survey, the number of foreign affiliates in operation varies by source. Most frequently, the measurement is based on sampling rather than a complete assessment, which gives rise to further differences among data reported by various sources.

Ownership and size of foreign affiliates

In analyzing the pattern of FDI inflows during the past three years in Hungary, two major characteristics stand out: first, a major share of the rapidly growing number of foreign affiliates has minority foreign ownership; and second, the majority of the companies are very small. Over 85 per cent of the total registered foreign affiliates had a foreign share of less than 51 per cent (table 2). Majority foreign-owned affiliates accounted for only about 13 per cent of all registered foreign affiliates. Foreign investors selected most frequently are those willing to participate in the form of minority ownership, even though, since 1988, FDI regulations have permitted the formation of wholly ownedforeign subsidiaries.

Table 2. Ownership of registered companies with foreign participation, end-1990

Percentage share of foreign capital	Number of registered companies	Percentage
Up to 20	793	13.9
21-30	798	14.0
31-50	3 279	57.6
51-80	433	7.6
81-99	146	2.6
100	244	4.3
Total	5 693	100.0

Source: Figyelő, 1991a.

Another important feature of foreign affiliates that were formed in the 1989-1991 period is the predominance of small companies. By the end of 1990, FDI inflows of approximately $1.2 billion had taken place in about 3,600 operating companies. The amount of foreign investment, however, exceeded $10 million in the case of only ten industrial projects, three construction projects and two retail-distribution projects. These 15 projects accounted for about one third of total investments; two thirds, or approximately $530 million, was invested in more than 3,500 foreign affiliates (*Heti Világgazdaság*, 1991).

The average size of capital of foreign affiliates is thus very low; the majority of them operate in the small business sector. Small companies are defined in Hungary as those with a capital of up to 1 million forints (approximately $14,000). In 1989, foreigners participated in 18 per cent, and in 1990 in 21 per cent, of the new small companies formed in that year (*Figyelő*, 1991b). The presence of small foreign affiliates was particularly dominant in retailing and export/import businesses, where they account for about one third of all companies (*Figyelő*, 1991b).

During the first half of 1991, the average size of newly established foreign affiliates decreased further. By mid-1991, the average capital of these companies was 8.5 million forints, compared with 16.4 million forints a year earlier (about $120,000 and $230,000, respectively) (*Figyelő*, 1991d). Nearly two thirds of all such companies had a capital less than 1 million forints (the equivalent of about $14,000), while, in 1990, only about one third of foreign affiliates were of that size (*Figyelő*, 1991d).

Origin and activity of foreign affiliates

As can be seen from the above, the majority of foreign affiliates are small companies. In most cases, the foreign investor is a medium-sized company from one of the neighbouring countries, predominantly from Germany, Austria and Switzerland. In 1989, companies from these three countries accounted for 56 per cent of all foreign affiliates (Kórösi, 1990). At the end of 1990, 1,052 out of a total of 3,684 foreign affiliates were from Germany, and 669 from Austria. Investments from the United Kingdom were on the rise (*Figyelő*, 1991d), as well as investments by expatriate Hungarians from North America and Western Europe. Foreign investors in these cases are not large TNCs; rather they are small or medium-sized foreign companies that consider the Hungarian market as extensions of their home operations for selling their products or operating small service or manufacturing operations (Bagó and Kulcsár, 1990; Kórösi, 1990).

Sectoral orientation

Measured in terms of the number of registered foreign affiliates, most of these companies concentrated on trade and tourism. As can be seen from table 3, these two industries accounted for 47 per cent of all registered foreign affiliates; and 13 per cent were engaged in the construction industry (*Heti Világgazdaság*, 1991). Over 1,400 foreign affiliates operated in the manufacturing sector, with the largest number of companies and highest capital investment relating to the machine-building industry, followed by such light industries as food and beverages, paper and packaging materials. In all industries the average size of the foreign investment is relatively small (table 3). In most industries, a few large projects account for a major share of the total investment. Similarly, small-scale operations also characterize the growing number of foreign affiliates in the construction and services industries.

Table 3. Sectoral distribution of joint ventures, end-1990

Sector	Number	Total capital (billion forints)	Of which: foreign Capital (billion forints)	Of which: foreign Percent
Manufacturing	1 436	134.0	39.0	67.7
of which:				
Machine building	716	44.3	13.7	
Light industry	388	24.6	9.8	
Chemical industries	196	36.9	6.4	
Others	139	28.3	9.4	
Construction	455	12.9	6.0	10.4
Trade and tourism	1 699	44.6	12.6	21.9
Total	3 590	191.5	57.6[a]	100.0

Source: Heti Világgazdaság, 1991, p. 7.

[a] Approximately $800 million.

The pattern of inflows of FDI during the past three years indicates dual characteristics: on the one hand, there are a large number of small affiliates with predominantly minority foreign ownership; on the other, there are a relatively few large investments by TNCs, which involve either a takeover or majority foreign holdings. In the case of the small affiliates, with investors mostly from neighbouring countries, their activities are largely concentrated in the export-import business, domestic wholesale and retail trade and tourism and other services. Many of these companies took advantage of market gaps and opportunities that emerged as a result of the liberalization of imports (Kulcsár and Bagó, 1991; Bagó and Kulcsár, 1990; Kórösi, 1990). The ability to respond rapidly to new and unfolding opportunities has often resulted in high returns on initial investments. Knowledge of the local market by these companies and proximity to their home-country operations enabled them to react with speed and flexibility to opportunities that a rapidly changing market presents. Often these companies had maintained business relationships with Hungary through previous exports to the country or through licensing and other service arrangements. Established ties in the country and their experience in the Hungarian market facilitated their early entry.

The participation of Hungarian companies in foreign affiliates enabled them to avail themselves of incentives provided under the FDI regulation, even though the company's capital and the foreign investor's participation was limited. Apart from the significant tax reduction, this included the permission to repatriate profits in foreign exchange and to hold bank accounts in foreign exchange. It is argued that, in many cases, access to such privileges, which are not available to domestically owned companies, constituted a major motive for Hungarian investors to seek out foreign investors actively and to obtain the minimum share of foreign participation (a 20 per cent equity share). Often, foreign suppliers, expatriate relatives or the black market may have been used to provide the necessary foreign exchange component that was required to establish a foreign affiliate (Csáki, 1992).

Very different characteristics from the pattern discussed above are shown by the relatively large investments that were undertaken by TNCs. Most TNCs formed their affiliates through the privatization of state-owned enterprises, and their experience in the present Hungarian context is rather unique to the country. It also demonstrates the risks and opportunities that arise in operating in a country which is in the process of a major economic and political transformation. The experience of TNCs covers only a few years so far. Certain patterns in the approach of TNCs to enter and operate in this market are, however, emerging and can be evaluated.

Strategies of transnational corporations

Considerable economic, and perhaps political, risk had to be assessed by TNCs in view of the current and future market situation and potential of the country. Most TNCs that were interested in Central and Eastern Europe sought to limit the capital that they were willing to commit to these markets in the current economic and political environment. At the same time, in view of the long-term growth potential of the region, which has a population of about 420 million, many TNCs considered it important to establish a foothold in the market. Also, early-mover advantages, together with the need to gain experience in an environment that has unique characteristics, were major factors contributing to investment decisions.

The entry of TNCs into the manufacturing sector, the organization of production and their market orientation demonstrate a similar pattern. This is influenced strongly by the specific situation of the country which is in the process of transformation from a centrally planned economy to a market economy (Stark, 1991; Tóth, 1991). This meant, on the one hand, that TNCs could take advantage of the opportunities offered by the privatization of Hungarian state-owned enterprises. On the other hand, entry decisions by TNCs had to be made under a relatively high degree of economic and political uncertainty. These factors exercized major influence on the strategy of TNCs to enter and operate in the Hungarian market.

Local sales offices

For most TNCs, entry to the Central and Eastern European markets took place in the form of exports. The promotion of exports required the establishment of local sales offices or representations, or service operations for products sold. The almost complete liberalization achieved by Hungary in 1990 offered increasing scope for serving the local market through imports (Marer, 1991).[8] In 1991, about 700 major foreign companies, including United States and Japanese TNCs, were represented in Hungary by their own sales branches or by other companies (*Figyelő*, 1991c). Local distributors not only have detailed knowledge of the market, but are also familiar with the bureaucracy and procedures relating to imports.

Local manufacture by transnational corporations

Relatively few TNCs entered the country for the purpose of establishing major manufacturing operations. During the past three years, however, a number of large investments had been undertaken (the largest of these projects, in terms of investment size, are shown in table 4). Several other investments in the manufacturing sector were also made, but they were much smaller in size.

[8] By early 1991, only about 10 per cent of all products required an import licence.

Table 4. Major investments by transnational corporations in Hungary, 1990

Transnational corporation	Foreign direct investment (million dollars)	Foreign share (percentage)	Domestic company	Industry
General Electric (United States)	150	51[a]	Hungarian Credit Bank	Lighting equipment
General Motors (United States)	150	67	Raba	Engines and car assembly
Guardian (United States)	120	80	Hungarian Glass	Glass
Suzuki (Japan)	110	40		Automobile
Itoh (Japan)		13	Suzuki-	assembly
International Finance Corporation (World Bank)		10	Hungary	
Electrolux (Sweden)	83	100	Electrolux-Hungary	Appliances
Hamburger (Austria)	82	..	Dunapack	Packaging
Ford Company (United States)	83	100	Ford-Hungary	Auto-ignition coils
Sanofi (France)	80	40	Chinoin	Pharma-ceuticals
Oberi (India)	80	80	Hungaro-hotels	Hotels
Sara Lee (United States)	60	51	Compack	Food processing
Hunslet (United Kingdom)	..	51	MK Bank MH Bank Budapest Bank OKH Bank	Railway rolling stock
Schlumberger Industries (France)	..	75	Budapest Bank Hungarian Electrical Works Budapest Holding (Ministry of Industry)	Voltage meters

Source: Based on Business International, *Business Eastern Europe*, various issues; Tóth, 1991, pp. 46-47.

[a] With an option to buy an additional 24 per cent.

Entry through privatization

Most TNCs that entered the country for local manufacture acquired assets and production facilities through the privatization of state-owned enterprises. During the early phase of privatization, in the period 1989-1990, the process was referred to as "spontaneous privatization" (Stark, 1991). That involved companies that had previously transferred the effective ownership of a state-owned enterprise to the management of the company (based on the stipulations of the Transformation Law).[9] In such enterprises, the management was entitled to sell part of the company or obtain outside funding in the form of capital participation by foreign investors. Management was also entitled to negotiate the terms and conditions for the participation of foreign partners in the company (Sulkowski, Glick and Richter, 1991). In many cases, however, various government agencies, usually the Ministry of Finance or Industry, intervened in the negotiations. In some cases, they vetoed certain proposals. As many state-owned enterprises had accumulated large debts, the creditor banks were also represented in the negotiations.

Most state-owned enterprises that were privatized were in a weak and deteriorating financial position, and some of them were on the verge of bankruptcy. With the increasing liberalization of imports, the domestic market position of many of these companies rapidly deteriorated (Tóth, 1991). For the Government, privatization with the participation of foreign companies presented a rapid solution to the burden of state enterprises with growing losses. The management of a company could seek to improve the liquidity of the company through a capital infusion by the foreign investor. The creditor banks, mostly including the largest Hungarian commercial banks, were also interested in the participation of foreign investors. In several cases, banks were able to swap part of the company's debt for equity in the privatized company. The banks considered that equity-ownership by a TNC would increase the value of the company and, consequently, the value of their own share.[10] Even though the process and the terms of privatization have often been subject to controversy among the various Hungarian parties involved, there is a consensus regarding the need for foreign partners and the urgency of privatization.

[9] Transformation of state-owned enterprises to management ownership was made possible by Act XIII of the 1989 Law on the Transformation of Business Organisations and Associations.

[10] In the case of the acquisition of a share in Tungsram, the Magyar Hitel Bank, for example, stressed the profit motive (Tóth, 1991).

It has been argued that, in several cases, the sale of state-owned enterprises, whether still in the public sector or in the hands of company management, resulted in a low purchase price for foreign companies. Financially ailing Hungarian enterprises, often close to bankruptcy, with limited or no alternative except to sell part of the company to a foreign investor, have generally placed TNCs in a strong bargaining position. Furthermore, in most cases, the management of the enterprise or the Government privatization agency did not actively explore and search among potential foreign investors. Often, the negotiations have been limited to a foreign licensor or supplier, typically a TNC with which the Hungarian company maintained prior relationships. The narrow search process and the urgency of obtaining new capital infusion inevitably influenced the terms of agreement in favour of the foreign company (Tóth, 1991).

Operations and markets

Most foreign affiliates that were formed through privatization were joint ventures with Hungarian companies (Simai, 1989; Bagó and Kulcsár, 1990; Tóth, 1991). For TNCs to operate with local companies (in most cases, state-owned enterprises) has major advantages. First, it reduces the capital requirements to enter the market and, with this, the risk; second, it ensures the participation of a local company in an unfamiliar environment for TNCs; third, despite less than full equity ownership, TNCs can generally exert control over the operation of their affiliates.

In the negotiations relating to the privatization of state-owned enterprises, a major issue relates to the scope of operation of an affiliate. Most Hungarian state-owned enterprises in the manufacturing sector have a highly integrated production structure and can manufacture a wide range of products. In the privatization of such companies, TNCs, in most cases, carried over only certain parts of the enterprise into the new operation. This not only reduced the size of the investment, but also allowed TNCs to integrate the new affiliates more effectively into the existing regional or global production operations. Parts and components, for example, could be sourced from the parent company or other foreign affiliates of TNCs rather than through local manufacture.

In most cases, the foreign affiliates that were formed through privatization were a "slimmed down" version of the Hungarian state-owned enterprise.[11] As the production capability of the new operation was substantially reduced, the foreign affiliate generally entered into contractual arrangements with the state-owned enterprise from which it acquired a part. Such contracts related, for example, to the provision of services and the delivery of parts and components. The low vertical integration of the operation enabled TNCs to reduce the assets, capital and labour force requirements of the foreign affiliates. It also increased their flexibility to introduce new products and processes and to respond more rapidly to changing market conditions (Bagó and Kulcsár, 1990).

In new affiliates, a major contribution of the Hungarian partner is the "micro-infrastructure".[12] In most cases, this includes office space, telephone and the manpower with required skills for the operation. In view of the weak infrastructure of the country, where to obtain a telephone line may require several years of waiting, such a contribution by the local partner provides considerable time and cost savings to foreign affiliates (Kulcsár and Bagó, 1991).

Some TNCs have reduced the initial investments necessary for local production by importing used equipment from their home country or from other foreign affiliates. During the first half of 1991, 13 per cent of FDI was in the form of non-cash contributions (*Figyelő*, 1991d). Asea Brown Boveri (ABB), the large Swiss-Swedish TNC in the electrical power-engineering industry, for example, has established 21 affiliates in Central and Eastern Europe (including the former German Democratic Republic) since 1989, by bringing in used equipment. As the demand for power engineering products and services is enormous in the region, ABB projects sales of about $1.5 billion by the mid-1990s in this market (*The Economist*, 1991a). To reduce its exposure further, ABB relies heavily on local bank borrowing to finance its activities. The possibility of local borrowing by foreign companies, as well as by domestic enterprises, has, however, been severely curtailed in recent years: to fight growing inflation, Governments have increasingly resorted to restrictive monetary policies.

[11] Szanyi (1991) discussed in detail how, for example, Siemens reduced the capacity and manpower of the Hungarian Telephone Factory as a condition for the partial acquisition of the Hungarian enterprise. See also *Figyelő*, 1991d.

[12] In a study of 21 foreign affiliates in Hungary, Bagó and Kulscár (1990) found the provision of "micro-infrastructure" the most important contribution of the domestic partner. They argued that "in the current Hungarian situation, characterized by catastrophic deficiencies of infrastructure (or of macro-infrastructure, for that matter), this micro-level may imply major facilities in setting off such deficiencies" (p. 31).

While most TNCs acquired assets through the privatization of state-owned enterprises, in a number of cases, particularly in the automobile industry, TNCs undertook greenfield investments. These investments include the largest investment projects in the country, such as those undertaken by Suzuki of Japan, for the assembly of subcompact cars; by General Motors, for the assembly of engines; and by Ford, for the manufacture of fuel-injection systems. For those TNCs, the preference for greenfield investments rather than acquisitions through privatization was related to the nature of the industry. Hungary has no local production of automobiles, and the takeover of other existing plants would have required major retooling. Greenfield investments for the foundation of these enterprises were supported by favourable financing, such as that provided by the European Bank for Reconstruction and Development in the case of the General Motors affiliate, and equity contribution by the International Finance Corporation, in the case of Suzuki Motors.

Markets

Transnational corporations, both large and small, have invested in Hungary predominantly for the purpose of selling in the local market (Kulcsár and Bagó, 1991). In 1990, 86 per cent of the sales of foreign affiliates came from the domestic market, 12 per cent from countries with convertible currencies and 4 per cent from sales in roubles. The corresponding shares for all Hungarian companies were 89.4 per cent from the domestic market, 8.1 per cent from countries with convertible currencies and 2.5 per cent from sales in roubles (*Figyelő*, 1991d). As these statistics show, the export performance of foreign affiliates is only slightly above that of domestic companies. There are, however, indications that exports by foreign affiliates are increasing faster than those by domestic companies. In the middle of 1990, for example, exports of foreign affiliates increased by 186 per cent from the previous year, compared with a rate of increase of 130 per cent for all companies. At the same time, the rate of growth of imports by foreign affiliates exceeded that of domestic companies significantly. In mid-1990, imports from convertible currency countries by foreign affiliates increased by 245 per cent from the previous year, compared with 114 per cent by domestic companies (*Figyelő*, 1991a). Even though the import intensity of foreign affiliates had been significantly higher than that of domestic companies, it would be premature to identify a definitive trend. Statistics do not separate imports of capital goods, which a company utilizes to establish its production capabilities, from those of parts and components and finished goods, which are of a recurring nature. As most foreign affiliates were established during the past two years, it is conceivable that a major part of the increase in imports is related to the purchase of machinery and equipment, which is required for their own production facilities.

The export performance of foreign affiliates does not reflect the motivations that were expressed by many foreign investors in Hungary. In evaluating investment opportunities in the country, many investors took into account the low wage level of the country, which is below that in the South-East Asian region, and the educated labour force. These factors, one would expect, should place the country in a favourable position for locating and developing export-oriented production. As demonstrated by the above statistics, however, TNCs that have established operations in Hungary are, so far, predominantly interested in serving the local market. Relatively weak competition in the domestic market, or absence of domestic competition in certain cases, and pent-up demand are among the major motivating factors for TNCs in Hungary.

Most of the large manufacturing operations of foreign affiliates in Hungary, as discussed above, have a low degree of vertical integration, and production facilities are primarily aimed at producing the finished product for the local market. So far, foreign affiliates have not developed capabilities for the manufacture of specific parts or components that would be integrated with the existing global production of TNCs. In most manufacturing industries, the specialization of foreign affiliates to produce specific products or components with the purpose of export would require large-scale operations and the utilization of advanced and efficient technologies. Such specialization, however, was undertaken by the Hungarian affiliate of Ford. With a major investment, that affiliate built a new plant for the manufacture of ignition coils and fuel-injection systems which will almost entirely be marketed in Western countries. Most other TNCs, however, have not committed such resources to Hungary so far.

The relatively low export-propensity of foreign affiliates has also been a source of major conflict between the foreign and Hungarian partners in the case of smaller affiliates (Kórösi, 1990).[13] Generally, the foreign partner prefers to serve export markets through existing foreign affiliates or from

[13] By 1990, with the deteriorating economic conditions in the country, the need for foreign capital has increasingly become pronounced to ensure the liquidity of local companies. Capital infusion by foreign partners has therefore become a critical contribution to the company (*Figyelő*, 1991c).

the home country. In fact, a number of factors seem to mitigate against developing an export base in Hungary by TNCs. The high rate of inflation in Hungary, its rapidly rising production costs and frequent depreciations of its foreign exchange rate have created uncertainty for exporters and for affiliates seeking to repatriate profits. The low quality of many Hungarian products has also been cited as a constraint (Bagó and Kulcsár, 1990). As an export base for foreign companies, Hungary, as well as other Central and Eastern European countries, faces considerable competition from developing countries in South-East Asia and from a growing number of other developing countries (King, 1991). About 250 export-processing zones in these countries offer important incentives to foreign companies under conditions of greater political and economic stability than those prevailing in Central and Eastern Europe.

Some TNCs, however, have engaged in mostly export-oriented manufacturing in Hungary. The best-known case is Tungsram, of which General Electric acquired a 51 per cent share. Tungsram, founded around the turn of the century, is among the oldest large industrial companies in Hungary, and has been a major producer of electrical lighting equipment and materials in Europe. Prior to its acquisition by General Electric, the company generated annual export revenues of about $300 million from Western markets and was among the major exporters of Hungary (Wolniansky and Garry, 1991). Apart from its monopoly in the domestic market, the acquisition of Tungsram allowed General Electric to obtain an important market share in the lighting-material sector of Western Europe where, until now, it did not have a major presence. General Electric plans to improve the efficiency of Tungsram and increase its current export-market share. The low level of wages in Hungary and the company's strong technological base provide General Electric with a major competitive advantage in Western European markets in this highly cost-competitive industry.

Several TNCs in Hungary produce standardized, relatively low-technology products or other light industrial goods, mostly for Western export markets. In these cases, the initial investment requirement is low and the fast and high returns make Hungary an attractive location. The United States bicycle manufacturer Schwinn Bicycle, for example, manufactures 275,000 bicycles annually with a Hungarian company, mainly for exports to Western Europe (*Business Week*, 1991). Levi Strauss produces jeans, both for local demand and exports. Profits of this affiliate in 1990 came to about 165 billion forints, equivalent to about $2.5 million, which exceeded the total investment of the company (Price, 1991).

Among the motivations to enter the Hungarian market, TNCs often express the intent to use their affiliates to export to other Central and Eastern European countries. Most affiliates, however, have not so far served as a springboard for penetrating these markets (Bagó and Kulcsár, 1990). As of 1990, only about 4 per cent of the total sales of such affiliates came from the rouble area (*Figyelő*, 1991d). This may be partly related to the recent disintegration of the Council for Mutual Economic Assistance (CMEA), which ended the long-term, bilateral trading agreements among member countries (Markov, 1991). In part, political uncertainties and major economic problems in several countries of the region have also limited sales, at least temporarily (Köves, 1991). The collapse of the CMEA market and the different pace and pattern of transformation in the countries of the region also indicate to TNCs that, rather than looking at Central and Eastern Europe as one potential market, a country-by-country approach may be more realistic at this point (King, 1991).

In some cases, TNCs have invested in local manufacture in order to preempt the market from a competing TNC. In several product areas, the relatively small size of the local market (Hungary's population is about 10 million) can only sustain a few enterprises. In the privatization of state-owned monopolies (for example, telephone facilities), those TNCs that become joint-venture partners inevitably occupy dominant local positions (Szanyi, 1991). The local assembly of engines and automobiles by General Motors and the assembly of automobiles by Suzuki, for example, not only gave a foothold to these companies in the market, but also, potentially, discouraged the entry of other TNCs in that industry. Similar motives may have played a role in the strong competition that surrounded the selection of a foreign partner for Skoda, the major automobile manufacturer in Czechoslovakia. In its negotiations with the Government, Volkswagen committed itself to a major future investment programme for the modernization of Skoda.[14] The large production capacity of that company will ensure Volkswagen a dominant position in the market and discourage other TNCs from locating investments there. Such pre-emptive investments on the part of certain TNCs are also noticeable in other industries.

[14] In 1990, when the Government of Czechoslovakia announced that it was looking for a foreign partner for the privatization of Skoda, 24 foreign automobile manufacturers expressed interest. The Government selected Volkswagen, which committed itself to a capital investment of approximately $6.5 billion over the next 10 years for the modernization and expansion of Skoda. Presently, investments by Volkswagen stand at about $150 million (*The Economist*, 1990).

A certain oligopolistic behaviour is discernible in the publishing sector as well.[15] Following the election of a democratic Government in Hungary, foreign publishing companies were among the first entrants in the market, and took advantage of the dearth of Hungarian publications during the centrally planned economic system. In this industry, investment needs are relatively limited to ensure a local presence through affiliation with a Hungarian publication. After the first TNC, News Corporation, established a local affiliate, most of the large British and German publishers followed suit within a short period of time. By 1992, several major foreign publishers were established in Hungary with investments that are, however, quite modest by world standards (*The Economist*, 1991b).

Conclusions

With the political changes in Central and Eastern Europe in 1989, sudden and unprecedented in magnitude, a large and growing market has opened up. The enormous demand for a wide range of goods and services, technology and capital in these countries will undoubtedly present new opportunities for TNCs. The rapidly changing environment, however, has created conditions which, in some of these countries, may assume crisis proportions in the near future. These may well render current investment decisions of TNCs somewhat speculative in nature. Market studies based on conventional projections and feasibility estimates relating to future costs, revenues and profits may often prove inaccurate because of factors that cannot be assessed, or even anticipated, at present. Such major issues as, for example, whether the countries of Central and Eastern Europe should be considered as separate markets or whether they can be viewed as a regional group bound together by integrated trade or other economic relationships, are wide open at this time.

With greater progress in institutional developments and general economic stabilization, the geographical location of Hungary, its educated labour force and nascent entrepreneurial class will increasingly provide greater opportunities for participation of TNCs in its economy, largely through inflow of technological and managerial expertise, with varying degrees of foreign capital participation. For TNCs, Hungary, as well as other Central and Eastern European countries, not only offers a great potential for joint ventures and other equity-based relationships, but also, increas-

[15] Several other examples of that pattern are provided in *The Economist* (1991b).

ingly, a potential for a variety of contractual arrangements, particularly for commercialized transfer of modern technology and management know-how and for various specific services, ranging from specialized construction contracts to export-marketing arrangements for Hungarian products. In several industries, the limited size of the Hungarian market may not justify major investments by TNCs, but it does offer considerable potential for a large number of technology and service arrangements which would enable TNCs to generate revenues and, at the same time, result in the modernization of the economy. In many cases, the needs of a local company may primarily be for proprietary new technologies that would enable Hungarian enterprises to compete in Western European markets. Technology and service agreements, whether with state-owned or private companies, will provide valuable opportunities and experience for TNCs to become familiar with the functioning of Central and Eastern European economies, while, for local enterprises, technological modernization constitutes a critical prerequisite for national, and progressively international, competitiveness.

Given that the present economic transformation in Central and Eastern Europe is quite unprecedented in its nature and scope, the participation of TNCs in this process will require flexibility and, maybe more importantly, adaptation of strategies. Such flexibility, as some evidence to date suggests, has permitted relatively smaller companies to take advantage of the opening of market opportunities in the region. It is also evident that geographic proximity tends to favour companies from neighbouring home countries. With the progress of transformation and economic stabilization, such size and location-specific factors may, however, be outweighed by global strategic considerations.

Clearly, the experience of the past three years suggests that FDI inflows to Hungary, as well as probably to most other Central and Eastern European countries, will increase significantly, once the economic and political uncertainties abate. The prospect of increased FDI is closely linked with overall progress towards stable social and political conditions. With such developments, it can be reasonably expected that the current reliance of TNCs primarily on trade will increasingly shift towards more local manufacture and investments that require longer-term perspectives and commitments on the part of investors.

With the slow progress in privatization and the development of institutions that are required to support a market economy, the transformation of the economy is bound to stretch over an extended period of time. During that period, as it can be seen from the experience so far, the role of TNCs may continue to remain limited in terms of undertaking major capital investments, technological modernization and contributing significantly to the export revenues of the country. For policy makers, it is important to assess realistically those areas in which TNCs can contribute and those in which the behavioural patterns of TNCs and their motivations would limit their role.

By now, there is a broad and general consensus in most countries of Central and Eastern Europe that local entrepreneurs and investors have to be major actors in the economy. Locally owned private and state-owned companies will have to modernize industries in which the current level of technological development has fallen behind that prevailing in the rest of the world. There can be little doubt that major institutional changes will be necessary to achieve this. Particularly critical will be the need to strengthen the financial system if an appropriate environment for new investment is to be created. An important issue in this regard relates to the mobilization of investible resources, both internal and external. In Hungary, the nascent stock market needs considerable institutional and enterprise-level support before it can effectively mobilize such resources. A significant restructuring of the banking system, which has inherited large non-performing loans to state-owned enterprises, will also be essential, before it can function effectively and support new and expanded industrial activities. In the development of a local entrepreneurial class, policies of the Government of Hungary adopted in this regard will have a major role to play. It is through the strengthening of linkages with domestic industry that the positive contributions of TNCs to the country can be enhanced. ■

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