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FOREIGN DIRECT INVESTMENT IN HUNGARY – THE POST-COMMUNIST PRIVATISATION STORY RE-CONSIDERED*

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This paper explores the theoretical possibility of re-interpreting the conventional wisdom of the transition economy literature on privatisation. Around 1989/90 the emphasis had been put on de-etatization and good corporate governance and little attention was paid to the necessity of integrating the Eastern economies into the network of transnational corporations (TNCs). Today, it is clear that this is the name of game. Without TNCs, privatisation simply does not produce the expected results. Based on the experience of Hungary, this paper describes an alternative model where the key policy variable is the rise of manufacturing exports. It is argued that for resource-poor transition economies privatisation to foreign strategic investors is the single most important question of the ownership revolution. Once this policy is advanced, the rise in exports can help to underpin macroeconomic stability. In other words divesting the manufacturing sector to TNCs is the beginning of a virtuous circle, where large and well publicized sell-offs help to attract portfolio investors and greenfield investors as well.

Keywords: privatisation, foreign direct investment (FDI), transition economies, greenfield investments

JEL classification index: G34, L33, P11, P52

INTRODUCTION

Today, it is widely accepted that Hungary has accomplished post-communist privatisation successfully. Indeed, there are some observers willing to declare Hungary as *the* winner of the East European privatisation beauty-contest. This paper addresses the problem *not* from a comparative perspective. We will argue –

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and this is the main message of this paper – that policy makers of the East and the West have for many years misunderstood the *raison d'être* of privatisation.

The first mistake was that around 1989/90 the emphasis had been put on de-etatization and good corporate governance. In sequencing the privatisation process little attention was paid to the necessity of integrating the Eastern economies into the network of TNCs. Today, it is clear that this is the name of game. Without TNCs, privatisation simply does not produce the expected results.[1]

The second error was to neglect the motivation of the TNCs themselves. It was assumed that the willingness of privatisation would automatically trigger a "*pull*"-effect – and this is enough. Little importance was attached to the findings of the scholarly literature suggesting that the "*push*"-effect is the prime mover of TNCs.[2] TNCs move if and when rivalry in their home markets is compelling them to do so. Moreover, as the FDI-literature suggests fierce competition and consequently FDI flows are concentrated in a few sectors (i.e. telecommunication, information technology, autos, pharmaceuticals and consumer products). *TNCs are not omnivorous, especially during the first stage of expansion into a new country.*

The third mistake – almost inevitably following the second one – was the underestimation of geographical considerations. *Geography matters.*[3] As we move eastwards on the map of Eastern Europe, the appetite of TNCs is continuously weakening. There are several factors working here: increased transportation costs, cultural differences and language problems. The situation of small, landlocked countries far away from the financial centers of Western Europe is particularly difficult, except for those that possess large hydrocarbon reserves. In sum: bad geographical location is a big handicap that even perfectly implemented market reforms cannot fully counterbalance.

It is well known that Hungary had been forced from the very beginning to divest its most valuable state owned enterprises (SOEs) against hard currency. For many observers – let alone politicians – this was a painful and regrettable step. It was only around 1994/95, when Hungarian privatisation officials understood that selling virtually each and every "crown jewel" of the Hungarian economy to the "multies" was a blessing in disguise. This was the only conceivable way to put Hungary firmly on an *export-led growth path* – something that Hungarian policy makers have urged in vain for two decades.

1 To prevent the criticism of being one-sided, let us saying in advance that this paper is not aimed at analyzing the down side of the process. Like any medicine, privatisation policies always produce effects and side effects, as well.

2 In this context Mundell's trade substitution theory of foreign investment is of great relevance.

3 The importance of geography was strongly emphasized by J. Sachs at a recent Warsaw conference celebrating the 10th anniversary of Polish economic reforms.

Once this new interpretation is accepted, it becomes easy to fit the post-1990 developments into a broader historical picture. Prior to World War II, the industry of Hungary – as well as the industry of the other Central European countries – was dominated by foreign investors. Post-communist privatisation has done nothing else, but re-created the pre-1945 ownership structures. Between the two World Wars, foreign capital did not deliver spectacular results in the Central European countries. With hindsight, we know why not. That historical period was a depressed period of the globalized world economy. In other words, Central Europe had been integrated into the (Western) global economy at the wrong historical moment.[4]

This paper revisits the post-communist privatisation process in the context of globalization. An attempt will be made to fit this story into a worldwide perspective. It must be clear that from a global perspective, the penetration of TNCs into Eastern Europe has been so far quantitatively unimportant:

- 72% of global FDI in the 1990s was a flow among the developed market economies.
- Much of the remaining 28% went to a few emerging market economies such as China, Brazil and Mexico.[5]

Subsequent sections will discuss the early period of post-communist privatisation from an ideological perspective (Section I). This will be followed by a historical summary from a hundred-year perspective (Section II). Section III is devoted to the re-interpretation of the Hungarian privatisation story. The task of Section IV is to define the scope of further empirical research.

[4] According to Maddison (1989) the combined growth performance of France, Germany, Japan, the UK and the US averaged 1.75% per annum between 1913 and 1950. By contrast, the same countries had a combined per capita GDP growth rate of 5.4% between 1950 and 1973. The contrast between the two periods is even more striking if export figures are compared. The combined exports of 16 OECD countries rose by merely 0.7% between 1900 and 1950, while 6.0% average annual rate was recorded between 1950 and 1986.

[5] In 1998, for example, an estimated $ 24 bn reached the transition economies in the form of net direct investment and net portfolio investment out of a total flow of $168 bn absorbed by all developing countries (including the transition economies). This is less than 15%. UNCTAD (1999), pp. 59, 115–116. (Data refer to net direct investment and net portfolio investment taken together.)

SECTION I

This section returns to the problem highlighted in the Introduction: what was the intellectual justification of privatisation in 1989/1990?

Privatisation, as a critique of socialist planning

In transition from socialism to Western-type market economy, the *raison d'être* of privatisation was to eliminate the inherent inefficiencies of social ownership and planning. It was argued that replacing bureaucratic incentives with profit-oriented ones at the company level would lead to increased *production efficiency.* As an OECD conference paper formulated in June 1990, "under more competitive market structures, privatisation coupled with appropriate incentives would also promote a general increase in the effort of workers and managers to improve organizational and technological conditions".[6]

Arguably, thinking of privatisation merely at company level was too limiting. As top-notch American economists formulated at that time, under socialism SOEs had operated in a legal no-man's-land (Blanchard et al., 1991). From this logic it followed that priority should be given to legal reforms, encompassing a wide range of socio-economic issues. A more intimate observer of the region, Brabant (1992) went on to note that ownership, competition, the regulatory environment as well macro-economic stabilization and trade liberalization are all interrelated influences on *allocative efficiency*. It is even possible, he said, that the latter factors have a larger effect on performance than ownership change at the company level.

Kornai (1989) argued that the immediate and forced selling of existing SOEs was neither possible, nor desirable. He was very critical to such sell-offs, especially if the transaction price was not "realistic". He thought, as many of his contemporaries did as well, that encouraging start-up ventures was far more important than dumping the existing SOEs on the international markets. Such views were echoed in the recommendations of the United Nations Economic Commission for Europe. There is a danger, the UN said, that rapid privatisation might "simply transform a public monopoly into a private one".[7]

The list of "do's" was continuously extended as time went by. The multilateral agencies fervently argued that the success of Eastern transformation was crucially dependent on the opening of Western markets. And indeed, the EC lifted discriminatory quantitative restrictions on goods from Hungary and Poland from the beginning of 1990 and from Bulgaria and Czechoslovakia as of October 1990. In

[6] See Blommestein et al. (1991), p. 12.
[7] UN ECE (1990), p. 16.

October 1989, Hungary received permanent most favored nation status from the United States. The same has happened to Poland.[8] Some influential advisers and policy makers – such J. Sachs from Harvard University, van Brabant from the United Nations – argued that the post-communist reconstruction could not be conceived without a new Marshall Plan.[9]

Privatisation, as a critique of the mixed economy

The justification of the Eastern privatisation process was further complicated by the fact that it occurred almost simultaneously with the highly publicized sell-offs in Western Europe. This latter one had little to do with the liquidation of Soviet-type of central planning. Nonetheless, Vickers and Yarrow (1989) put all the emphasis on the importance of downsizing governments. They praised managerial incentives and argued that the mixed ownership structure of the UK – and other Western European countries – did not lead to the highest possible economic outcome. By changing the ownership structure from state to private, managerial behaviour can be positively influenced. In supporting their argument, they recalled the Leibenstein (1966) article on X-inefficiency, the principal-agent theory, stressed the importance of shareholder monitoring and the benign effect of takeover threats and bankruptcies. For Western advisers coming to Eastern Europe with the Vickers– Yarrow book in their suitcase, these theoretical considerations offered themselves as convenient starting points for post-communist privatisation.

From the perspective of the present paper, it is interesting to note that in the Vickers–Yarrow book, the expression 'foreign investors' was mentioned only once (p. 180). In the British context, as the authors saw at that time, ownership change mattered only in one sense: Her Majesty's government must be out. Any other owner will be a better owner than the government itself. In the context of the globalization of the late 1990s, and the transborder mega-mergers of the year 2000, even the British authors would argue differently. Forcing the government out of ownership is just the first step in the right direction.

8 For a short review of trade liberalization measures in 1989/90, see UN ECE (1991).

9 The idea of a new Marshall Plan for Eastern Europe was strongly and repeatedly advocated by the United Nations Economic Commission for Europe (UN ECE, 1990). Initially, the European Union embraced this suggestion, as well. See the address of Jacques Delors, President of the Commission of the European Communities to the European Parliament on January 17, 1990. If his proposals were accepted, six countries of Eastern Europe could have received roughly $23 bn a year, which was nearly 5 times larger (!) than the Marshall Plan equivalent, if the sums were adjusted to the size of the six countries.

The role of FDI, as seen in 1989/90

Against the background of the West European wave of divestment, one can hardly be surprised that virtually all participants of the early debates used close analogies between privatisation in Western and Eastern Europe. Everybody looked for ‘good owners’ and ‘good corporate governance’ to replace the government. In contrast to the West European experience, however, the role of foreign investors *was* explicitly considered in all transition economies. Commentators had no difficulty arguing why FDI was needed. Usually three reasons were mentioned:

- capital stock gap,
- technology gap,
- lack of entrepreneurship.[10]

Many transition specialists, however, were skeptical from the outset. They thought that foreign investors would not be interested in participating in the Eastern transition process, even if the Eastern countries did their best to “pull” them. Blanchard et al. (1991) assumed that foreign strategic investors would be cautious for two reasons. First and foremost, the ‘option value of waiting’ was thought to be very high. The same idea was formulated by the UN: “Private investors do not normally get heavily involved in ‘transition processes’ of the type under way in eastern Europe until the outcome is virtually assured.[11] The lack of adequate infrastructure was mentioned as a second, but also relevant motive. Kornai (1989) believed that TNCs would not move until they saw firm evidences of the successful societal transition: law and order, fair taxation and correct treatment of the domestic investor class. Crane (1991) feared that FDI was going to be geared towards expropriating rents made possible by barriers to imports, more focused on the domestic market than exports. Brabant (1992) also took the view that FDI inflows would remain low for quite a time, and if they come at all, they would go for projects with high short-term returns, rather than for assets with substantial sunk costs.[12]

[10] See e.g. Mádi (1995)
[11] UN ECE (1994) p. 5.
[12] Perhaps surprisingly, development specialists not so close to the problematics of East European transition were initially much more optimistic about the prospects of FDI flows into this region. This view appeared – at least partially – linked to the concern of many Third World countries. These countries thought that the worldwide flow of FDI was a zero sum game: the more goes to Eastern Europe, the less will reach Africa, Asia and Latin America. With respect to FDI, this assumption was obviously bad economics, but the point raised by these development economists was important for official development assistance.

SECTION II

This section of the paper is a historical detour. The objective is to provide a brief statistical summary of what is known about FDI penetration in Eastern Europe prior to the 1989/1990.

FDI in Central and Eastern Europe before 1945

Between the two World Wars, foreign capital played a major role in the region. *Tables 1* and *2* below illustrate this with numbers. It is not the task of this paper to assess whether the penetration of FDI was advantageous to the countries concerned. It is noteworthy, however that at the beginning of the 1980s, when most of the statistical and analytical work was done, the prevailing view of economic historians was somewhat skeptical.

> The industrial policy of (…) east European states may be summarized as an endeavor to bridge the gap between their own level of industrialization and the advanced level of their fully industrialized Western political and business partners. Where domestic private enterprise was incapable of achieving this, the state took over, and at the same time sought and encouraged foreign participation, in order to gain capital resources, and also to benefit from the experience and the technical know-how of the advanced industrial economies. In this way industrialization was centrally directed and encouraged, and this aided the process of concentration. (…) While foreign investment in east European industries satisfied to a certain extent their urgent need for capital, and brought higher forms of economic organization into some sections of their relatively underdeveloped economies, they aggravated the disproportions in their industrial development. Labour, modern technology, and capital were oriented towards producers' goods, while the growth of other branches of industry, mainly in the finishing stages of manufacturing, was retarded (Teichova, 1985, pp. 315–316).

Table 1

The role of foreign capital in Eastern Europe around 1937
(percentage)

	Foreign holdings of public debts	Share of foreign ownership in registered equity			
		Joint stock companies	Other limited companies	Banks	Insurance companies
Romania	89.2[a]	83	…	75	70
Yugoslavia	82.5[a]	61	…	75	…
Hungary	81.1[a]	around 25	…	…	…
Bulgaria	72.3[a]	48	…	…	…
Poland[b]	63.1	44	90	29	…
Czechoslovakia	17.5	29	3	15	26

Notes: [a] 1931/32; [b] 1936
Source: Teichova (1985), p. 292

Table 2

The role of foreign capital in industry
(around 1936–39)

	The share of foreign capital	Most preferred branches
Czechoslovakia	30%	heavy industry, metallurgy
Hungary	24%	…
Poland	above 40%	mining, metallurgy, oil industry, electro-machinery
Romania	below 50%	oil industry, metallurgy, pulp and paper industry
Yugoslavia	around 33%	mining, electricity, transport, insurance
Bulgaria	18%	tobacco, sugar, construction, building materials

Source: Berend and Ránki (1976), pp. 474–477; Teichova (1985), pp. 310–311

With hindsight, the figures in Tables 1 and 2 deserve a comment. Clearly, the less developed countries of Central Europe were more strongly dominated by foreign owners than in the case of the more advanced economies (Czechoslovakia, Hungary).[13] The explanation is straightforward. Between the two world wars, the large raw material deposits of the Balkan countries exerted a strong pull effect on West European investors. Today, natural endowment is less important, partly because the region's reserves have been already exhausted and partly because improved transport technologies undermined the region's competitiveness vis-à-vis other continents.

Forms of FDI between 1945 and 1990

During the Cold War decades, the ownership structure of the East European countries changed fundamentally. The bulk of the of pre-war FDI was nationalized by 1950 at the latest and new flows did not arrive at all. For many years, the only permitted form of foreign economic presence was the system of East-West *industrial-technical cooperation agreements*. According to Simai (1989), 1600–1700 such agreements were signed, including those of the Soviet Union. These cooperation agreements then served as a basis for *joint ventures* (JV) and *industrial free trade zones* (IFTZ). Legal conditions of absorbing FDI were first established in Yugoslavia during the 1960s, then in Romania (1971), Hungary (1972) and Poland (1976). The noticeable rise of JVs, however, started only after 1986

[13] I express my gratitude to G. Hunya for noting this point.

(Table 3). Until that year the total number of JVs remained below 800, and even from this low number almost 700 JVs were Polish enterprises (the so-called Polonia-companies, started by Polish emigrants in the late 1970s).

Table 3

The number of joint ventures in Eastern Europe

Country	End-1986	End-1988
Poland	700	760
Hungary	84	200
Bulgaria	9	10–12
Romania	5	6–7
Czechoslovakia	1	6
GDR	0	0
Soviet Union	0	0

Source: Simai (1989)

Between 1986 and 1988, the number of JVs rose rapidly. In the Soviet Union, where JVs were not allowed until 1989, such agreements were signed by the hundreds and 15–20 did start operation in the first months of 1989. At the regional level, however, the total value of imported FDI remained below $200 mn. This sum was not only insignificant in its own, but it dwarfed even in comparison to the volume of FDI exported by the socialist countries into other parts of the world.

SECTION III

This section of the paper combines two approaches. First, we summarize the present state of knowledge about the Hungarian macroeconomic scene that prevailed around 1990 with the help of some data and the review of the scholarly literature. Then we change style. An attempt will be made to present the rapidly changing thinking of those Hungarian government officials who were in charge of privatisation in the critical period of 1994/95. This section of the paper has a more subjective nature, due to the fact that in this period the author was personally involved in steering the privatisation process.

The origins of the Hungarian approach to privatisation

At the outset of economic transition, the situation in Hungary was not fundamentally different from any other countries of East and Central Europe. However, due to some particular characteristics of the Hungarian political and economic landscape – such as the extremely high level of foreign debt, the existence of JVs, the early start of co-operation with Western banks and multilateral institutions –, successive governments were forced to steer privatisation in a direction that explicitly favoured TNCs. Although this policy was not fully embraced by all governments and in all times, by the end of 1995 the most valuable companies of the Hungarian economy were – *de facto* – taken over by TNCs. With hindsight, the subsequent steps of these developments can be summarized as follows.

In the months before and after the first democratic elections of 1990, the ruling political elite had to find answers to two pressing questions:

- what to do with the country's accumulated \$20 bn gross debt?
- is re-privatisation (or restitution) a possible avenue towards the rapid divestment of state assets?

As it turned out later, the representatives of TNCs already present in Hungary heavily influenced the answers to both questions. Although the sums involved up to 1990 were still insignificant – less than 100 joint ventures (JVs) with an estimated value of \$500 mn –, the words came from the mouth of influential Western companies: Girozentrale, Siemens, Adidas, Volvo, Ikea, Citibank, Société Générale, Creditanstalt, etc.[14] The voice of the international financial community – including the Bretton Woods institutions[15] and foreign private banks[16] was also important.

If Hungary defaults on its debt, the government was told, the short-term implications on the exchange rate would question the economic rationale of all foreign investments made so far. A privatisation policy that has a significant restitution component might question retroactively the legality of these investments. Quite logically, TNCs used all opportunities to express their strong objection towards both proposals. They lobbied strongly together with their respective home governments and the international organizations. On the top of this, elementary calculations showed that the two issues – i.e. debt management and privatisation – were closely interrelated. Hungary wanted to keep servicing foreign debts fully in order

[14] For more detailed arguments see Mihályi (1993), the full list can be found in the *Hungarian Trade Journal,* No. 3, 1988. For comparison, let us note that in Poland the first 'big' name appeared in 1990 only (Asea Brown Boveri).

[15] Hungary joined GATT in 1973. The accession to the IMF and the World Bank took place in 1982.

[16] The Austrian bank, Creditanstalt opened his Budapest representation office as early as 1975, and the first joint venture offshore bank was founded in 1979. The law regulating IFTZs was passed in 1982 with the explicit objective to attract export-oriented high-tech companies to Hungary.

to maintain the country's credit-worthiness, but this was not doable without FDI imports in the order of \$1–2 bn per annum. In this logic, any attempt to re-schedule the debt was disastrous from the point of view of credit-worthiness and the chances of further borrowing. By servicing the debt, despite the huge social burden it requires, the government wanted to impress private foreign creditors and investors.[17] In other words, the divestment of Hungarian SOEs to foreign investors turned out to be an implicit *debt-equity swap.*[18]

Needless to say, that adopting and implementing a privatisation strategy that openly favoured foreign investors was not an easy proposition in Hungary either. Like in all other post-communist countries – or indeed in *all* countries of the world – lawmakers and privatisation officials had to face suspicion and fear on the part of the electorate. To make matters even worse, the majority of Western "transition-experts" were critical to the emerging case-by-case selling strategy. This approach was called "crazy and disastrous" even three years after its launch, and therefore Hungary was constantly downgraded in comparison to those countries that espoused Czech or Russian-type of voucher privatisation.

> "The typical state enterprise would not fetch on the capital market the amount just needed just to cover the fee that the investment banks would charge for their services in taking the enterprise to the market. And it would not have been feasible to achieve by this laborious means the massive scale of privatisation that was desired in less than a decade, maybe two decades."

– wrote one leading advocate of mass privatisation.[19]

17 On the official debt strategy and its critics see Oblath (1993). On the links between the interests of the existing FDI owners and the prospects of a pro-restitution privatisation policy, see the personal recollections of Diczházi (1998), a close advisor of Prime Minister J. Antall. It is worth quoting his summary from a (still) unpublished policy paper of that time. "From the perspective of attracting *foreign direct investments* a policy of in-kind restitution would have especially serious consequences. Since entering office, the government has completed a series of international political and economic negotiations in order to assess the likely reaction of foreign governments, international monetary institutions and leading investor groups to an eventual all-encompassing reprivatisation strategy. It became crystal clear that from a business point of view, the international community would react negatively to changes in the Hungarian economy and society that may risk *retroactively* past investments and newly developed business relationships. And – as far as the future is concerned – such policies will freeze for many years the *majority of potential foreign direct investments*. (*Op. cit.,* p. 26; translated from Hungarian, highlights from Mr. Diczházi.)

18 As Diczházi (*op. cit.*) recently revealed, the Antall government had made some unsuccessful attempts to mobilize international support behind an explicit debt-equity swap as well. Although the proposals were formulated, the response of the markets was generally negative.

19 These are direct quotes from Edmund S. Phelps' Foreword to Frydman and Rapaczynski (1994).

Paradoxically, successive governments were *helped* by short-term financial considerations. Indeed, privatisation revenues were important for balance-of-payments reasons, as well as to underpin the country's international prestige. But it was much easier to defend such sales as "no-choice" decisions, rather than arguing why policy makers did not trust Hungarian entrepreneurs.

The origins of open-door policies to FDI

Fortunately, there was a unique circumstance that helped the Hungarian government. Let us recall the fact, that since the introduction of the 1968 economic reform, Hungary has suffered from British-type stop-go cycles. Good years of expansion ended repeatedly in balance-of-payments crisis. The country's development strategy was based for two decades on import-substitution. This strategy failed repeatedly. The growth coefficients worked always in the wrong proportions: 1% GDP growth required a larger than 1% export growth, which in turn required an even larger growth of (Western) imports. In order to have a handle on this issue, Hungarian policy makers received intellectual support from two of their compatriots: Béla Balassa and Nicholas Kaldor, living in the United States and England respectively. These outstanding economists of Hungarian origin were frequent visitors to their native country already in the 1970s.

Both Balassa (1982) and Kaldor[20] were strong proponents of *export-led growth* and opposed all forms of consumption-led demand management policies. Their teachings and policy recommendations were well received in Hungary by foreign trade experts such as András Inotai, Béla Kádár, András Köves and András Nagy. From the works of these Hungarian authors a new concept of industrial development emerged already in the 1980s. From the analysis of export statistics of fast-growing countries these authors concluded that even moderately sophisticated manufactured goods cannot be exported successfully unless the country in question was fully integrated into the international sales network of multinationals. In itself, *the capability to produce "high quality – low price" goods is not a guarantee to find markets*. The fast growing part of world trade is intra-industry trade. Hungary has no chance to increase its exports if it continues to produce

[20] See e.g. Kaldor's seminal paper entitled "Conflicts on National Economic Objectives", published – *inter alia* in the *Economic Journal* (March 1971). This paper was translated into Hungarian and published in a volume of essays of Kaldor in 1989.

manufactured end products. In the context of growing globalization, export-led growth can be achieved only through the integration into the network of TNCs.

Although this line of reasoning was a provocation against the background of traditional Marxist hostility to TNCs, it laid down the foundation for a forthcoming public attitude to FDI. As Csaba (1997) rightly says, this change in the perception of understanding the conditions of a successful export-led growth policy turned Hungary by the early 1990s into the only transforming country conducting a fully-fledged open door policy *vis-à-vis* FDI.

Privatisation or M&A – a personal recollection

The privatisation process in Hungary cannot be understood without stressing strongly its centralized nature. From March 1990 to date, SOEs have been owned, managed and divested by a single institution headquartered in Budapest. This is unique. In most countries, the privatisation agency is only a policy arm of a national property fund or the branch ministries and a geographical division of labour characterized by the daily work of (both type of) privatisation agencies. The first advantage of this extreme centralization was power itself. Privatisation went ahead, because the privatisation agency had the power to do it. The benefit of centralization demonstrated itself in the transparency of the procedures, as well. For all stakeholders – including foreign and Hungarian investors, the media and the Hungarian public opinion at large – it was much easier to monitor developments in a single organization. The close scrutiny forced discipline upon privatisation managers as well.

This was a learning process, where decision-makers learned from each other, from foreign advisors and from the investors themselves. In the course of practical work, thorny theoretical questions often presented themselves in a much simpler form. The following issues became clear very early on:

- Different investment proposals can be compared adequately only on a cash basis; compared to the downpayment of cash, plans of expansion and/or job preservation commitments are soft promises only;
- There is no effective mechanism preventing Hungarian buyers to act as agents (*Strohmann*) of foreign companies or to forbid them to re-sell their investments to foreigners at a later stage;
- There is no possibility to distinguish between “true” Hungarian entrepreneurs on the one hand and foreign “adventurers” on the other, since the early inves-

tors were predominantly Hungarian emigrants returning to their native countries.[21]

- Divestment of existing SOEs and foreign greenfield investments go hand in hand. A commercially successful, clean and well-publicized sales transaction helps to attract FDI into other branches through the general improvement of investment climate.
- Mass-privatisation techniques and trade sales assisted by soft credits or discounts can lead only to giveaways of the country's most valuable firms to politically well-connected crooks and the Mafia.

Once understood the above said, the top management of the privatisation agency became convinced *that selling Hungarian companies to foreigners was not only an economically justified strategy, but it was the only way to protect their own self-esteem.* Indirectly, this was also a good strategy in preserving their jobs under a permanent public fire of corruption accusations. Although, it was politically difficult to defend transaction decisions week after week,[22] when Hungarian investors were ranked second or third behind the foreign investors, a reference to higher (hard currency) cash payments helped enormously.

In the early period, sales agreements were relatively short and simple: *x* million USD paid in exchange of *y* amount of shares of company *z*. As time passed by, however, new concerns emerged and it became necessary to increase the scope and the length of the privatisation documents. First and foremost, a section on indemnities and guarantees had to be built in. This was new not only to the privatisation officials – mostly economists by training –, but also to Hungarian lawyers. New technical terms had to be learned and understood such as: closing, default provision, conflict of interest, claw-back, etc. After a few consultations with the legal advisers of the potential foreign partners, the Hungarian side grasped that *from a Western perspective these privatisation deals were M&A transactions and the language they had to learn was the jargon of the M&A business.*

It was only in the second half of 1994, when Hungarian privatisation officials realized that out of a potential supply of the remaining 1500 Hungarian firms, the

[21] According to the Hungarian jurisprudence, Hungarian citizenship cannot be lost or given up. Once you are Hungarian, you remain Hungarian for the rest of your life, even if you become the holder of a foreign passport.

[22] To illustrate this point, it is worth recalling that in the early years of privatisation, the board meetings of the State Privatisation Agency (SPA) were followed by a televised press conference. Week after week, the managing directors of the SPA had to explain and justify each and every sell-off decision in front of a large circle specialized journalists.

interest of TNCs was limited to 30–50 industrial companies and financial institutions. Only then, it became clear that the earlier analytical approach that distinguished between *small-* and *large-*scale privatisation was inadequate. From a macroeconomic point of view, special attention had to be devoted to these 30–50 companies, the *hard core* of the Hungarian economy (Mihályi, 1996). These are the companies which

- attract TNCs;
- can generate significant privatisation revenues in hard currency;
- are important as export producers;
- from which positive externalities can be expected on the domestic markets (e.g. banks, telecommunication);
- need to be regulated even if privatisation does not take place (e.g. banking, energy, and telecommunication).

The recognition of these links helped the privatisation agency to concentrate on the very large deals – essentially deals with TNCs –, while the divestment of the remaining portfolio was treated almost as a political public relation exercise. As long as the minimum level of transparency and fairness was guaranteed, the sell-off of these smaller companies was viewed as a ploy to make politicians happy. Different interest groups,[23] lobbies and business circles were allowed to fight for these companies. From the point of revenues, it did not really matter who gets what in this nationwide giveaway masquerade. It was clear that sooner or later, these companies would change owners anyway – the first owners were mostly rent-seekers. Their hope was to buy companies with the help of soft payment techniques and to re-sell it to foreign strategic investors at a later stage. In other cases, the plans were even more short-term oriented. The idea was to dismember the existing SOEs through various asset-stripping tricks.[24]

The importance of this latter point can be hardly overemphasized in this paper. It is a widely held view in many countries that rent seeking and asset-stripping intentions are the characteristics of foreign investors. The East European experience, by contrast, suggests otherwise. Short-termism is characteristic to investors with little money (be they foreigners or Hungarian). Since in a privatisation deal

[23] According to the privatisation legislation, the following social groups and institutions were given privileges and preferences: local governments, the self-governing board of the social insurance funds, the largest churches, holders of compensation coupons, the associations of agricultural producers, employees of SOEs, etc.

[24] In many medium-size SOEs, the only valuable part of the company was the building that housed it.

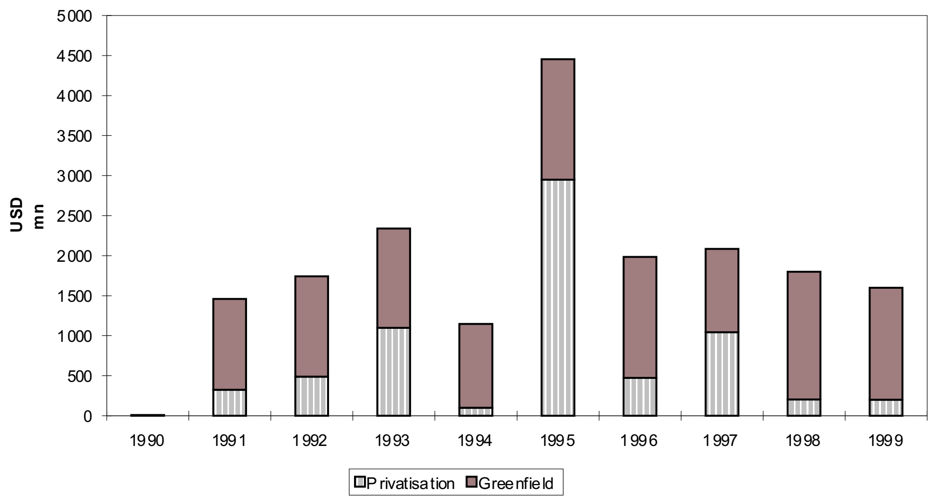
not just money, but scarce top managerial time is involved – together with the prestige of the investor –, TNCs can hardly afford such malpractice.

Table 4

Hungary: Share of convertible currency revenues in total privatisation revenues (percentage)

Year	%
1990*	79.1
1991	80.9
1992	61.2
1993	67.3
1994*	7.4
1995	87.2
1996	57.0
1997	61.1
1998*	37.0
1999	71.5

Note: * Years of general and local elections
Source: ÁPV Rt.



Source: ÁPV Rt., Ministry of Economy

Figure 1. FDI and privatisation

SECTION IV

Conclusion and the direction of further research

In the period 1980–1994, the total export of Hungary fluctuated between 9.2 and 10.7 billion dollars with blips in 1989 and 1993. It was only in 1995, when exports from Hungary were put firmly on a steeply rising growth path *(Figure 2)*. The connection between export performance and the presence of TNCs was easy to establish. In 1992, half of the top 10 Hungarian exporters were still owned and managed by Hungarians. By 1998, out of the top 10 exporters only three companies remained under Hungarian management and there was only one, where state ownership still prevailed. In this way, the open door policy towards TNCs and the intellectual support for export-led growth policies have mutually re-inforced each other. Hungary was lucky to find itself in a virtuous circle *(Table 5).*

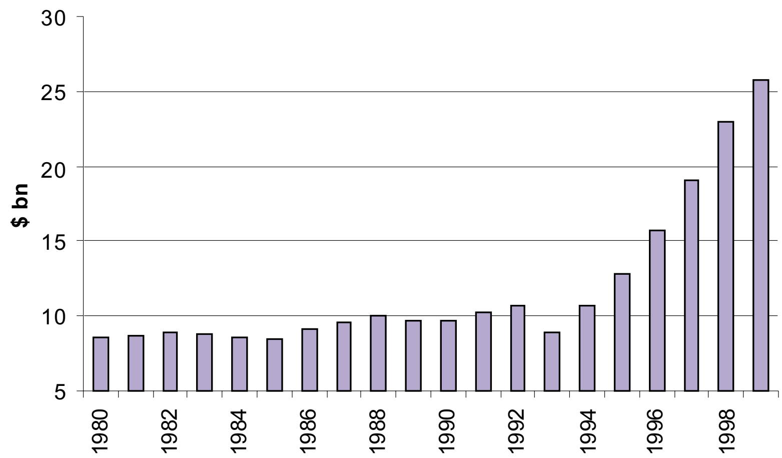


Figure 2. Hungarian exports, 1980–1999

Until 1994/95, Hungary was the only country in the region that was willing and capable to embark upon the privatisation of its strategic companies (the hard core). The first successful mega-deals in the energy and banking sectors made headlines in international business community. Since then, other Central European countries have joined this bandwagon. First Poland, then the Czech Republic followed the Hungarian path in selling the “crown jewels” of their telecommunication sector, the petrochemical industry, etc. As a result of these successful

Table 5

Top 20 Hungarian exporters
(based on 1998 reports)

	Short name of the company	Technique of ownership change	Year established in Hungary	Total investment in Hungary ($ mn)	Nationality of majority owner(s)	Listed on the Budapest Stock Exchange	Controlled by a TNC	Main products	Nationality of top local executive
1	Audi	Greenfield	1993	600	German	No	Yes	Components	German
2	IBM	Greenfield	1995	150	US	No	Yes	Components	US
3	Philips	Greenfield	1989	125	Dutch	No	Yes	Components	Dutch
4	Opel	Greenfield	1990	440	USA	No	Yes	End-product	German
5	MOL (national oil and gas company)	Privatisation through IPO	Existed before 1989	840	Foreign institutional investors	Yes	No	Intermediary	Hungarian
6	GE Lighting	M & A[1]	1988	776	US	No	Yes	End-product	US
7	Flextronic (producer of components to Psion computers)	Greenfield	1992	46	US	No	Yes	Components	US
8	Dunaferr (steel work)	Asset management agreement	Existed before 1989	–	Hungarian state	No	No	Intermediary	Hungarian
9	Alcoa	M & A[2]	1993	300[3]	US	No	Yes	Intermediary	US
10	BorsodChem (plastic processing material)	Privatisation through IPO	Existed before 1989	90 (1)	Foreign institutional investors	Yes	No	Intermediary	Hungarian

(*Table 5*, continued)

	Short name of the company	Technique of ownership change	Year established in Hungary	Total investment in Hungary ($ mn)	Nationality of majority owner(s)	Listed on the Budapest Stock Exchange	Controlled by a TNC	Main products	Nationality of top local executive
11	TVK (petrochemical)	Privatization through IPO	Existed before 1989	210	Foreign and Hungarian institutional investors	Yes	No	Intermediary	Hungarian
12	Suzuki	Greenfield	1991	234	Japanese	No	Yes	End-product	Japan
13	Ford	Greenfield	1990	180	US	No	Yes	Components	US
14	Richter (pharmaceutical)	Privatisation through IPO	Existed before 1989	253	Foreign institutional investors	Yes	No	End-products	Hungarian
15	Electrolux	M & A	1991	70	Swedish	No	Yes	End-products	Swedish
16	North American Bus Industries	Private ownership after liquidation	1993	n.a.	US	Yes	No	End-product	Hungarian
17	Rába (vehicle parts, engines)	Privatisation through IPO	Existed before 1989	57	Foreign and Hungarian institutional investors	Yes	No	Components	Hungarian
18	Videoton (electronics)	Private ownership after liquidation	…	–	Hungarian private individuals	No	No	Components	Hungarian
19	Chinoin – Sanofi	M & A	1990	220	French	No	Yes	End-product	French
20	Hajdú – Bét (processing of poultry)	Privatisation	1992	n.a.	Hungarian investors	No	No	End-product	Hungarian

Notes:

[1] The foreign investor purchased the shares from a Hungarian state owned commercial bank and *not* from the privatisation agency (debt-equity swap + decentralized privatisation).

[2] The foreign investor purchased the shares directly from the state owned aluminum holding and *not* from the privatisation agency (decentralized privatisation).

[3] Including another privatisation deal and two greenfield investments.

Source: Budapest Business Journal: Book of Lists 2000, author's own research sell-offs, these two countries experienced the same growth that Hungary did: the privatisation deals helped the process of attracting greenfield FDI investments.

As more and more privatisation takes place and the level of FDI grows in more and more transition economies, the conditions are improving to test the underlying hypothesis of this paper through rigorous analysis. First, there is a need to test the causality links between the advancement of privatisation and economic growth *(Figure 3).*

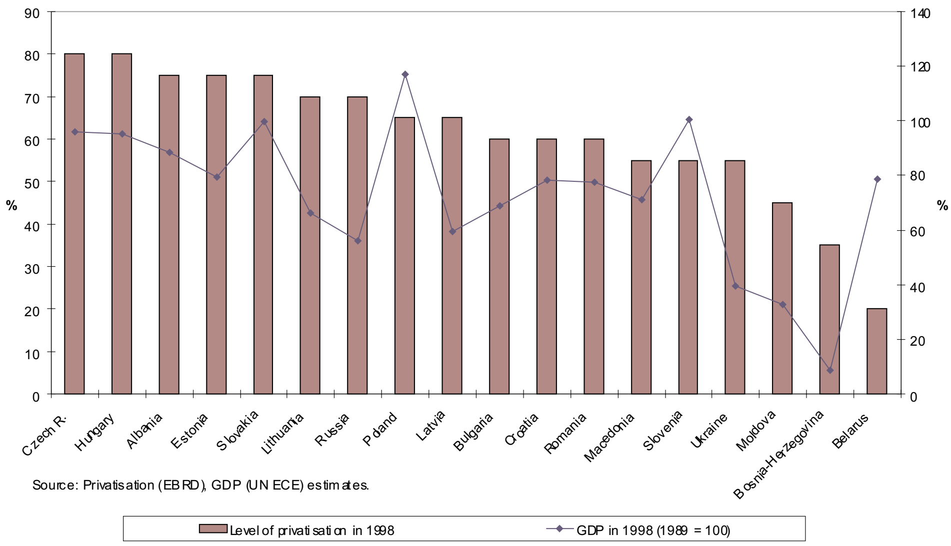
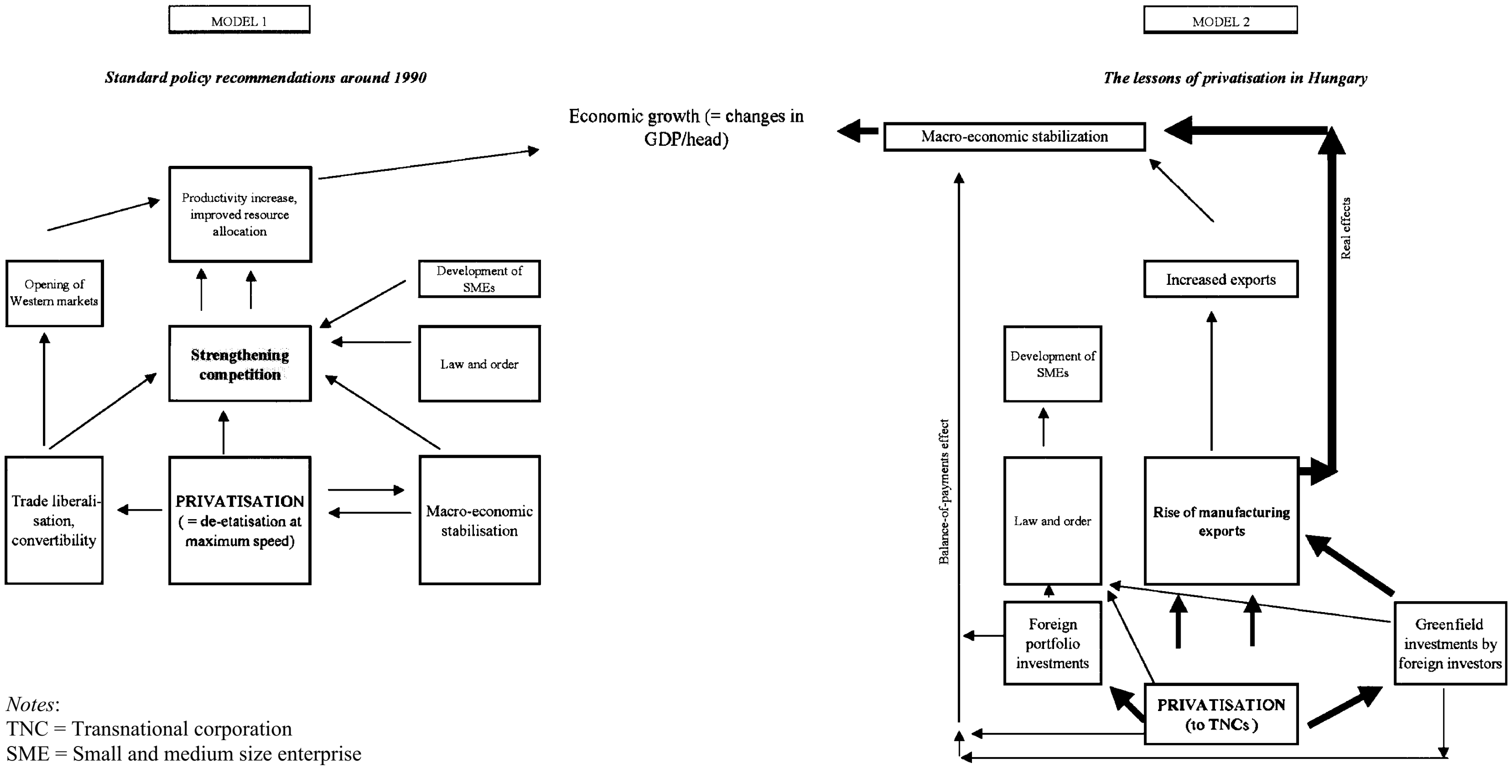


Figure 3. Level of privatisation and GDP after 10 years (1989–1998)

A more challenging task will be to test the hypothesis whether the lessons of the Hungarian privatisation can be generalized to other transition economies. The boxes on the left side of *Figure 4* presents the stylized facts of the standard privatisation policy recommendations. In the standard model, de-etatization – i.e. the removal of the state from enterprise ownership – is the key step towards increasing competition, increased efficiency and output growth. By contrast, the model on the right hand side of Figure 4 directs the focus on FDI and the acquisition of a country's manufacturing capacities by transnational companies. The experience of Hungary suggests that only the presence of TNCs can lead to a rise in manufacturing exports, which in turn helps to keep the country on an export-led growth path. It is noteworthy also that the Hungarian experience suggests an *indirect* link



Notes:
TNC = Transnational corporation
SME = Small and medium size enterprise

Figure 4. Two policy models of privatisation

between privatisation on the one hand and export performance on the other. It seems that privatisation of existing SOEs is a pre-condition to massive FDI inflow, which, in turn, generates the export upswing with a certain time lag. *In other words, the good export performance does not come from restructured SOEs. But without selling and restructuring SOEs, greenfield investments do not come.*

At the beginning of this paper, we argued that geography matters. However, as we glance through the map of Central and Eastern Europe, at least two countries can be found where our assumptions do not seem to hold. The first “outlier” is Slovakia. A country next door to Austria, but it has relatively little FDI. The second counter-example is Slovenia, which did almost everything in the opposite way, as Hungary did. Nonetheless, the overall economic performance of this country is satisfactory. Without absorbing large amounts of FDI, Slovenia was capable of doubling its exports over 10 years.[25] It requires further analysis to explain the developments in both countries. I suspect, nonetheless, that within the next 3–5 years both Slovakia and Slovenia will catch up with Czech Republic, Hungary and Poland. Then, the correlation between FDI absorption and export performance will be similar in these two countries as well.

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[25] I am grateful to G. Hunya for pinpointing to this contradiction in my reasoning.

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