


CUTS Centre for  
Competition, Investment  
& Economic Regulation  
**Discussion Paper**

# Investment Policy in Hungary - Performance and Perceptions



Budapest  
University of  
Economic Sciences and  
Public Administration  
  
Dept. of Business Economics

 कट्स ✕ CUTS  
Twenty Years of  
Social Change  
1984 to 2003

#0405

# Investment Policy in Hungary

## - Performance and Perceptions

Published by: कट्स ✕ CUTS

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**Acknowledgement:** This report\* is being published as a part of the Investment for Development Project, with the aim to create awareness and build capacity on investment regimes and international investment issues in seven developing and transition economies: Bangladesh, Brazil, Hungary, India, South Africa, Tanzania and Zambia. It is supported by:



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**Citation:** CUTS, 2003, Investment Policy in Hungary – Performance and Perceptions

**Printed by:** Jaipur Printers P. Ltd., Jaipur 302 001

**ISBN 81-8257-021-02**

*\*Other country reports are also available with CUTS*

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## Acronyms

BoP	Balance of Payments
CAP	Common Agricultural Policy
CEO	Chief Executive Officer
CMEA	Council for Mutual Economic Assistance
COMECON	Council for Mutual Economic Aid
CUTS	Consumer Unity & Trust Society
EU	European Union
FDI	Foreign Direct Investment
FIE	Foreign Institutional Enterprises
GDP	Gross Domestic Product
GM	General Motors
IFD	Investment for Development
ISTP	Integrator Supplier Target Programme
ITD	Investment and Trade Development Agency
JVs	Joint Ventures
MATAV	Magyar Tavkozlesi Vallatat
OECD	Organisation for Economic Cooperation and Development
RDC	Regional Development Company
R&D	Research and Development
SME	Small and Medium Enterprises
STP	Supplier Target Programme
TNC	Transnational Corporation
UNCTAD	United Nations Conference on Trade and Development
WIIW	Wiener Institut fur Internationale Wirtschaftsvergleiche

## Foreword

Time does not flow evenly. Sometimes – like in the case of Hungary after the quelled revolution of 1956 – it is “suspended”, to use the metaphor of Hungarian filmmaker Peter Gothár from his movie (*Suspended Time*) that brilliantly represents the atmosphere of the closed society that followed. And sometimes – like again in Hungary after the political transformation of 1989-1990 – it accelerates abruptly. In fact so abruptly that we have to play the film again and again to grasp the changes in life that took place in the country at an unprecedented speed. Hungary has been among the frontrunners of the transition from centrally planned to market economy, altering radically the life of the majority of the population forever. Fourteen years after the fall of the one-party system, practically nobody works in the same place where she/he used to before; and if somebody is still in the same workplace, she/he does completely different jobs. This change has been accompanied by a transformation in life conditions and lifestyles; mostly for the better, but in some cases for the worse, too. Indeed, successful transition has been possible at a high social cost, for example, in terms of unemployment.

Foreign direct investment (FDI) has been increasingly recognised playing a catalytic role in transformation. Sometimes it has been more than that: the engine of technological change. Just consider the fact that, according to the latest National Accounts compiled by the Hungarian Central Statistical Office, in 2001 more than 37 percent of the gross national value added was produced by foreign affiliates. It was as high as 76 percent in the electronics industry and 89 percent in motor vehicle production (Miklós Szanyi has detailed sectoral data for the rest of the economy in his paper.) So when we are trying to play back again the film of transformation, it is useful to extract the shots containing scenes of FDI, and scrutinise them very carefully.

The study, consolidated by Miklós Szanyi, does exactly that. It dissects and analyses information on FDI in Hungary since 1989, again and again, till he gets a very comprehensive overview of FDI and its impact on development. After an overview of the country and trends in inward and outward FDI, he asks the vital question of how FDI is linked with transformation. He deals separately with the role of FDI in privatisation and the attraction of greenfield FDI through incentives and a special zone scheme the Hungarians have called “industrial free trade zones”. Then he turns to the financial aspects of FDI and asks what kind of impact it has had on the balance of payments. He deals with FDI and trade separately, and then enlarges the scope of his query to restructuring, research and development and local suppliers. It is particularly useful that this initial query is then complemented and corroborated by a questionnaire survey and case studies carried out in the framework, and for the purposes, of the Investment for Development project of CUTS. In particular, the survey of public perceptions is groundbreaking. Indeed, it is quite amazing that one has had to wait for this study till somebody really bothered to ask people seriously what they felt about FDI in transformation!

The most important questions that the author of the study has raised relate to the prospects of FDI in Hungary. FDI has been very successful in putting a part of the country and its population into a fast track towards modernisation. But others – marginal geographical areas, marginal (ised) social groups, many small locally owned firms – have been left out. What are their prospects for catching up? Also, success has raised new challenges for the country. FDI has resulted in important job creation (if job creation at suppliers is also counted) and higher wages. With the accession of the country to the European Union in May 2004, the expectation is that those trends will continue. That makes Hungary suddenly an “expensive” location when compared with countries with larger untapped labour pools and much lower (and less fast growing) wages. Investors have started to react to that, by closing down in Hungary certain activities based on cheap unskilled labour, for example electronics assembly and textile and footwear production.

It may be hypothesised that in Hungary, labour costs have perhaps increased faster than justified, mostly for two reasons. One is the call of populist politics calling for an immediate increase of wages to the “EU level”, without specifying how productivity can be raised to the same level, too. That voice has lured the political parties trying to win the elections in 2002 to let it happen. Another reason has been the country’s perhaps too ambitious aspiration to join the Euro zone as fast as possible. With the structural basis of that aspiration missing, the strengthening of the national currency has been used in a hope to bring down the inflation to the level of the Maastricht criteria. The problem with that has been not just that it penalised exports in a country that specialised itself as an export platform but also resulted in a drying up of inward FDI. The latter then led, in the second half of 2003, to speculative attacks on the Hungarian forint, based on the observation that this time the country had no major FDI inflows to counterbalance the negative current account balance. A temporary solution of this problem was an increase in the interest rates, which, alas, penalised again the production sector in need of working capital.

Let us emphasise that politics, in principle, retains the response to those challenges: through stopping the excessive talk about wage hikes and through announcing a more realistic timetable for the adoption of the Euro, including period of a more flexible exchange rate. The ball is in the court of the policy makers in terms of designing a forceful FDI attraction programme, taking into account the newly emerging comparative advantages of the country in higher value added and more skill intensive activities.

That naturally does not mean that the country would not need to become a net capital exporter one day. The Hungarian market in itself is quite small. Both the locally owned firms (such as the MOL National Oil Company or the OTP Bank) and the foreign affiliates located in the country need new productive capacities and outlets outside the borders of the country. Outward FDI can be just as important and as “healthy” a phenomenon as inward FDI. The problem with Hungary as a capital exporter – as it happened in the first 10 months of 2003 – is that it is too premature. The business sector still needs massive inward FDI to carry out its ongoing modernisation and technological upgrading. That would indeed require larger amounts of inward FDI than the country has experienced so far even in its most successful years (e.g. in 1995). Let us hope that it will happen in 2004.

In the meantime, let me invite you to read carefully the very knowledgeable analysis that follows. You will certainly enjoy it. Thank you very much, Mr. Szanyi. We are looking forward to your sequel.

December 2003  
Geneva, Switzerland

Kalman Kalotay  
Economic Affairs Officer  
United Nations Conference on Trade and Development

## Preface

The transformation process in Hungary had some experiences with FDI even before 1990. The already established cooperation links, as well as the urgent need for cash revenues in the state budget eased the way of foreign investors to participate in the privatisation process. The first main wave of investments was therefore related to privatisation. It affected most manufacturing branches, various parts of services, and financial institutions. The second wave of investments utilised the generous state incentives. Most greenfield investments established in the second half of the 1990s sought an efficient production platform. Cost efficiency was provided by the employment of the then cheap (mainly unskilled) labour, fiscal incentives that included both tax holidays and in-kind investment contributions of the state and special regulatory provisions.

Foreign owned companies (transnational corporations) dominated the Hungarian economy. The path of economic development was earmarked by the decreasing role of state involvement and an increased globalisation of economy and society. It is therefore possible to regard Hungary as an example of FDI-led economic reconstruction and development model. The following analysis tries to sum up both the gains and pitfalls of this FDI-led economic development model. These became more or less clear during the past 10-12 years. Most important areas of change are economic structure, employment, productivity and increased involvement in international labour division. The new model had a strong influence also on the macroeconomic processes of the country. Balance of Payment effects and questions of both the revenue and expenditure side of the state budget are involved. A third major aspect is also covered by the analysis: impacts of foreign firms on local business. This issue leads to longer term aspects of the FDI-led development model. Do foreign firms develop deep roots and seek for establishing local business linkages? Or they concentrate on utilising one-off opportunities of privatisation deals or cheap labor? And what are the options of domestic companies as competitors or business partners? These questions are important from the viewpoint of long-term sustainability of the development model.

The paper summarises the main events and trends over the past 12 years. The analysis concludes that the Hungarian economy and society as a whole gained important benefits from this new model. This should not mean, however, that there were no losers, whose problems still need solutions. The question is also: what should be done in future to maintain the interest of foreign investors in investing in Hungary? For the currently used incentive system cannot be maintained after Hungary's accession to the European Union. What other impacts can be expected after this event? Will an increase in real wages undermine the competitive advantage in capital attraction? How can the negative effects be replaced by the provision of different types of other advantages?

In the final section results of the empirical research of the Investment for Development project are presented. The opinions of local business and civil sector were in many cases more critical towards foreign investments, and especially the potential risks were articulated strongly. In many of the basic questions, however, these opinions were in line with the analysis.

December 2003  
Hungary

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## Introduction

For many years, Hungary has been regarded as a country of economic experiments. The country underwent fundamental changes during the transition period of 1990-2000. The former centrally planned economy became a market economy. Institution building, liberalisation and privatisation have been the major aspects of economic transition. And though Hungary experimented with both domestic and foreign private business even in the communist era, private business development took tremendous momentum in the transition process. The role of foreign investments in this process was eminent.

***Hungary was the first transition economy that attracted foreign investments on a massive scale and received the largest amount of foreign investments in the 1990-1995 period.***

Hungary was the first transition economy that attracted foreign investments on a massive scale. It was promoted by the generous incentive system, and also by privatisation policy that favoured foreign investments. Consequently, Hungary received the largest amount of foreign investments in the 1990-1995 period. This was the result of the “first comer advantage”. Later, other transition economies also liberalised their investment regimes and started selling state companies to foreigners, thus investments increased in other countries too, and Hungary lost its leading place in capital attraction. As part of the “first comer disadvantage”, it seems that privatisation deals in other transition economies were more successful (at least financially). These countries benefited from the Hungarian experience with FDI. Thus, some of the benefits of the pioneering role of Hungary in FDI attraction were realised also in neighbouring transition countries.

***Massive foreign investments in Hungary changed not only the ownership structure, but also the sectoral structure of the country.***

Foreign owned companies (transnational companies) dominated the Hungarian economy. The path of economic development was characterised by the decreasing role of state involvement and an increased globalisation of economy and society. It is therefore possible to regard Hungary as an example of FDI-led economic reconstruction and development model. Massive foreign investments in Hungary changed not only the ownership structure, but also the sectoral structure of the country. Currently, foreign owned companies employ over 20 percent of labour force in manufacturing, produce over 50 percent of manufacturing GDP and 85 percent of total Hungarian exports. Foreign firms contribute above average to income generation too. The foreign sector is superior in terms of productivity, technology, and they have better access to capital, hence they have better options for further development and investments. The driving force of the 3-5 percent economic growth of Hungary between 1995 and 2002 was the export oriented foreign sector.

***Hungary was not successful in establishing and strengthening linkages between domestic and foreign owned firms in the economy.***

However, Hungary was not successful in establishing and strengthening linkages between domestic and foreign owned firms in the economy. Because of the Hungarian privatisation policy, foreign investors purchased not only large export-oriented firms, but also many of the medium-sized industrial companies, the first and second-tier suppliers of big firms. Another important segment of the potential supplier network was eliminated due to the harsh Hungarian bankruptcy system that drew many medium-sized firms into liquidation during 2002 and 2005. New start-ups grow rather slowly because of their low level of capitalisation and difficult access to credits: they could not replace the eliminated companies.

*The most important areas of change are economic structure, employment, productivity, and increased involvement in international labour division.*

The following analysis tries to sum-up both the gains and pitfalls of this FDI-led economic development model. These became more or less clear during the past 10-12 years. The most important areas of change are economic structure, employment, productivity, and increased involvement in international labour division. The new model had a strong influence also on the macroeconomic processes of the country. Balance of Payment effects, and questions on both the revenue and expenditure side of the state budget are involved. A third major aspect is also covered by the analysis: impacts of foreign firms on local business. This issue leads to long-term aspects of the FDI-led development model. Whether foreign firms develop deep roots and seek to establish local business linkages? Or they concentrate on utilising one-off opportunities of privatisation deals or cheap labour? And what are the options of domestic companies as competitors or business partners? These questions are important from the viewpoint of long-term sustainability of the development model.

The paper summarises the main events and trends of the past 12 years. The analysis concludes that the Hungarian economy and society as a whole gained important benefits from this new model. This should not mean, however, that there were no losers, whose problems still need solutions. The question is also raised: what should be done in future to maintain the interest of foreign investors in investing in Hungary? The currently used incentive system cannot be maintained after Hungary's joining the European Union. What other impacts can be expected after this event? Will an increase in real wages undermine the competitive advantage in capital attraction? How can the negative effects be replaced by the provision of different types of other advantages?

In the final section, results of the empirical research of the Investment for Development project are presented. The opinions of local business and civil sector were in many cases more critical towards foreign investments, and the potential risks were articulated strongly. In many of the basic questions, however, these opinions were in line with the analysis.

## The Macroeconomic Context

### 1.1 Basic Facts about Hungary

#### **Area**

Located in Central Europe, in the Basin of the Carpathian Mountains, Hungary is spread over 93,000 square kilometres. Mostly flat, 70 percent of the area is arable land. It is partly hilly and its highest point is 1015 metres above the sea level. The climate is continental, with 500-800 mm precipitation and 1800-2400 hours of sunshine per annum. The average temperatures are (-) 3° Celsius in January and (+) 26° Celsius in July.

#### **Inhabitants**

It has 10 million inhabitants, out of which 93 percent are Hungarians, 5 percent Roma and 2 percent belong to other nationalities. The per capita gross domestic product (GDP) is US\$7000 and the average monthly gross income is US\$430. The number of economically active people is 4.1 million, out of which 260,000 are unemployed. It has 3.5 million pensioners. Of the people employed, 17.2 percent have higher education degrees, 55.3 percent have finished secondary education, 16.7 percent have finished primary education and 10.7 percent have not completed their education. The urbanisation rate is 68 percent.

*Hungary underwent a period of deep transitional recession during 1991-1995 and reached the pre-transition performance level after 10 years of transition.*

### 1.2 Main Macroeconomic Indicators

The main macroeconomic indicators are presented in Table 1.1. As can be seen, Hungary underwent a period of deep transitional recession during 1991-1995. At its lowest level, the GDP reached less than 85 percent of the immediate pre-transition years' level. The recovery started rather slowly and accelerated by 1998. All in all, the Hungarian economy reached the pre-transition performance level after 10 years of transition. This is still much better (a shorter recession period), than in many other transition economies of Central Europe. Other indicators such as inflation, unemployment, per capita real income, budget and Balance of Payments (BoP) deficits also indicate the magnitude of the decline. Real incomes reached the pre-transition level only in 2001.

*The shift from centralised planning to a market-determined one called for realigning of policies and activities to respond to the demands of the latter.*

Other measures also highlight some of the important features of the structural change in the Hungarian economy. The shift from centralised planning to a market-determined one called for realigning of policies and activities to respond to the demands of the latter. This deep structural change is reflected in the rather fierce growth in investment, foreign direct investment (FDI) and exports. Consequently, the sectoral structure of the economy changed to the one presented in Table 1.2. The share of electrical and optical equipment, and transport equipment sectors increased by several times, while the share of heavy industries, which traditionally were very important in the centrally planned economies, reduced.

	1991	1993	1995	1997	1998	1999	2000	2001
GDP growth (1990=100)	88.1	84.9	88.6	93.9	98.5	102.6	108.0	111.5
Inflation %	35.0	22.5	28.2	18.3	11.4	10.0	9.4	9.1
Unemployment %	7.5	12.3	10.4	7.8	7.0	6.3	5.6	8.3
Investment (1990=100)	87.7	88.4	94.2	107.5	121.2	127.6	137.2	141.4
Exports (1990=100)	95.1	83.4	105.3	143.2	175.3	203.3	247.5	255.2
FDI stock* US\$m	1459	5269	10869	14937	16872	18523	20323	22671
Trade a/c deficit (% GDP)	-4.1	-9.4	-5.7	-4.7	-5.8	-6.3	-8.5	-2.7
Current a/c deficit (% GDP)	0.8	-9.1	-5.5	-3.3	-2.0	-4.4	-2.8	-2.2
Budget balance (% of GDP)	0.0	-6.0	-4.6	-4.0	-4.8	-3.7	-3.4	-1.3
Per capita real income (1990=100)	98.4	90.2	88.6	89.4	92.7	93.5	95.5	..
Cumulated value of FDI payments through the banking system, reinvested profits not included								
<i>Source: Central Statistical Office, National Bank of Hungary</i>								

Agriculture, forestry, fishing	4.9
Mining and quarrying	0.2
Manufacturing	38.6
Food, beverages and tobacco	5.8
Textile and textile products	1.3
Leather and leather products	0.3
Wood and wood products	0.4
Pulp, paper and paper products, publishing and printing	1.6
Coke, refined petroleum products and nuclear fuel	2.4
Chemicals, chemical products and man-made fibres	2.7
Rubber and plastic products	1.3
Other non-metallic mineral products	1.2
Basic metals and fabricated metal products	3.1
Machinery and equipment	1.6
Electrical and optical equipment	10.4
Transport equipment	5.9
Manufacturing n.e.c.	0.5
Electricity, gas, steam and water supply	3.5
Construction	4.4
Trade and repair	9.0
Hotels and restaurants	1.4
Transport, storage and communication	6.8
Financial intermediation	2.7
Real estate, renting and business services	10.0
Public administration, defence and social security	3.9
Education	2.4
Health care	2.8
Other community, social and personal services	2.5
<i>Source: Central Statistical Office</i>	

**FDI was the main driving force of the economic restructuring in Hungary and it became one of the most popular investment targets in Central and Eastern Europe.**

FDI was the main driving force of the economic restructuring in Hungary. The Hungarian Government and firms gathered experience with foreign firms through various co-operation links. Licence transfers, creation of joint ventures and regular supplier contacts were developed as early as 1970s. This was an important achievement of the Hungarian economic reforms. Also, foreign firms had some knowledge and experience in Hungary. Thus, the intensification of business contacts became a natural phenomenon, after the transition process started. FDI was strongly promoted through various channels, as will be discussed later. Consequently, Hungary became one of the most popular investment targets in Central and Eastern Europe. Table 1.3 gives information on the share of Hungary in FDI flows.

	1995	1996	1997	1998	1999	2000	2001	2002
World total inward FDI (US\$bn)	331.1	384.9	477.9	692.5	1075.0	1270.8	738	549
Inward FDI to East-Central Europe (US\$m) corrected estimation	14668 (15674)	13547 (15343)	19113 (21543)	22608 (24548)	25363 (27233)	26563 (28698)	27200	26854
Inward FDI to Hungary (US\$m) corrected estimation	4453 (5459)	2275 (3365)	2173 (3743)	2036 (3776)	1944 (3814)	1643 (3643)	2414	1487
Share of Hungary in total inward FDI to East-Central Europe % corrected estimation	30.4 (34.8)	16.8 (21.9)	11.4 (17.4)	9.0 (15.4)	7.7 (14.0)	6.2 (12.7)	8.9	5.5

*Source: UNCTAD World Investment Report 2003; Antalóczy K. – Sass, M.: Magyarország helye a közép-kelet-európai működőtőke-beáramlásban – statisztikai elemzés. Közgazdaság, XLVI.évf. július-augusztus, 33-53.o.; Kalotay K.: Működőtőke – válságban? Közgazdasági Szemle, L.évf. január, 35-55.o.*

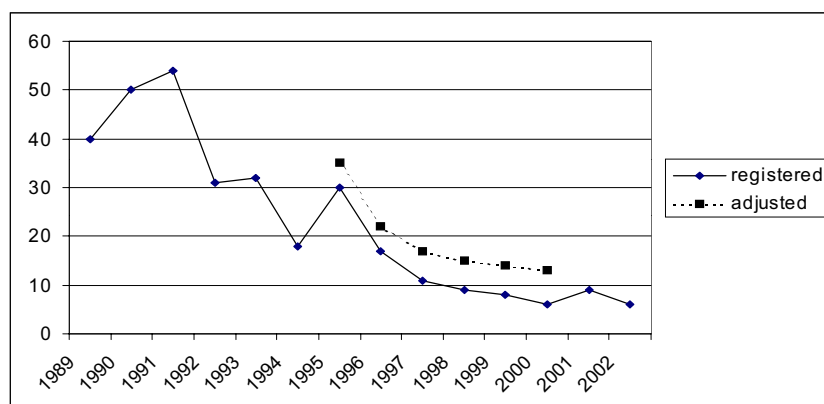
**The turn of the century brought important changes in investment trends. The inflow of FDI started to decrease and transfer of profits abroad started.**

The level of foreign investment varied basically according to the major privatisation deals. There has been a steady level of investment, to the tune of some US\$1-1.5bn, annually. On top of this, privatisation revenues pushed up the level of inward FDI even higher, until the late 1990s. The turn of the century brought important changes in investment trends. The inflow of FDI started to decrease and transfer of profits abroad started. Also, Hungary-based companies started to act as foreign direct investors, mainly in other transition economies of the region. As a result, the net positive FDI balance diminished, and, for the first time, after the transition in the first-quarter of 2003, it became negative. Though the 2002 decline in inward FDI was less dramatic in transition economies than elsewhere, Hungarian figures show a number of important changes in the composition of FDI flows.

**The sectoral composition changed, with services and trade taking over the first place from manufacturing. Manufacturing investors' hesitation to launch new projects in Hungary was very much evident, when Hungary did not receive any new investment in the automobile industry in recent years.**

Inward FDI started to decline by the late 1990s, and the 2001 revival was due to intra-company loans, rather than investment. On the other hand, the stock of FDI continued to increase in Hungary, since firms reinvested most of their profits. The composition of the FDI stock increment changed: net new capital inflow declined and loans and reinvested profits took the first place. Also, the sectoral composition changed, with services and trade taking over the first place from manufacturing. Manufacturing investors' hesitation to launch new projects in Hungary was very much evident, when Hungary did not receive any new investment in the automobile industry in recent years. Figure 1.1 shows the relative importance (higher share) of the reinvested profits in the change in the accumulated FDI stock.

**Figure 1.1: Hungary's Share in Total Inward FDI to East-Central Europe**



Source: UNCTAD World Investment Report, 2003; Antalóczy K. – Sass, M.: Magyarország helye a közép-kelet-európai működőtőke-beáramlásban – statisztikai elemzés. *Külgazdaság*, XLVI.évf. július-augusztus, 33-53.o

As far as outflows of capital are concerned, repatriation of profits, royalties and fee increased together with loans. These cost items started to play an important role in Balance of Payments (BoP). The increasing role of these transfers and profit repatriation drove the capital balances into red. However, their increasing role shows that Hungarian affiliates started to earn profits and were successful.

*These changes can be interpreted also as the end of the first phase of investment in Hungary. The new phase will be based on different properties and will therefore require a redefinition of important elements of economic policy including investment promotion.*

Transfer pricing is wide spread, but reasons of transfer pricing may be very different. Hidden profit repatriation used to be the primary suspect, but, in the case of Hungary, this was not so. The important foreign firms received corporate tax holidays, and were interested in channelling profits to Hungary and not vice-versa. Actually, the transfer of profits to Hungary was observed in many cases when Hungarian affiliates of various transnational corporations (TNCs) reported unexpectedly high profit margins in the country. Still, the levels of business services' costs, and repaid loans continuously rose indicating a different rationale in the background of these transactions.

The changing patterns of capital flows need some more analysis. There are various possible determinants in the background that have important policy relevance. These changes can be interpreted also as the end of the first phase of investment in Hungary. The new phase will be based on different properties and will therefore require a redefinition of important elements of economic policy including investment promotion.

As far as the countries of origin are concerned (Table 1.4), the bulk of the inward stock is owned by firms of the European Union. Even non-European companies register in Hungary through their European affiliates or regional headquarters. Therefore, the Hungarian economy is strongly integrated with the European corporate networks. This phenomenon is consistent with United Nations Conference on Trade and Development's (UNCTAD's) earlier description of the evolution of the triad in world economy, with fairly clearly separated interest areas. Central Europe became the most important backyard of EU-based TNCs.

*The Hungarian economy is strongly integrated with the European corporate networks.*

<b>Table 1.4: Countries of Origin of Inward FDI Stock in 1999 (%)</b>						
<b>Germany</b>	<b>Holland</b>	<b>Austria</b>	<b>USA</b>	<b>France</b>	<b>Italy</b>	<b>Belgium</b>
27.3	22.5	12.1	8.8	6.2	2.7	2.5

*Source: Central Statistical Office*

The figures of Table 1.5 demonstrate that, though Hungary enjoyed a clear advantage in attracting FDI in Central Europe, it lost its dominance by late 1990s. It seems that the amount of capital available for investment in the region exceeded the amount Hungary could absorb. Therefore, other more developed countries like the Czech Republic and Poland caught up with Hungary in attracting FDI.

<b>Table 1.5: Central and Eastern European Countries' Cumulated Stock of FDI in 2000 (US\$m)</b>						
<b>Poland</b>	<b>Czech R.</b>	<b>Hungary</b>	<b>Russia</b>	<b>Romania</b>	<b>Latvia</b>	<b>Estonia</b>
38000	23300	21254	20757	6426	4307	2106

*Source: WIIW database.*

#### **Issue for Comments**

If a slower, more gradual liberalisation should have been applied, would that have provided more time and some temporary protection for local firms to grow up and match foreign competitors?





## Overview of Main Policy Trends

### 2.1 Transforming Hungary as a Location of Foreign Investments

Hungary has always had an open economy. Until 1992, Hungary was a member of the Soviet-led Council for Mutual Economic Aid (COMECON). Exports and imports were dominated by the COMECON member states. Like all other Soviet-oriented countries, Hungary also had a centrally planned economic system. This meant that instead of market mechanisms it was the state that directed the activity of firms. Socialist enterprises had, in fact, no right to take independent decisions on their own activity. They had to fulfil orders of state authorities, the Planning Office and different Ministries. Foreign trade and relationships with foreign firms were also centrally controlled.

*Instead of market mechanisms it was the state that directed the activity of firms.*

The state control was not pushed completely into the background even in the period of the Hungarian Economic Reform, when Hungary experimented with the partial introduction of market forces in certain areas of the economy. But, the reform was not aimed at breaking with central control. Thus, despite partial success (for example, slightly higher standard of living), it did not change the fundamentals of the socialist economic system. This system proved to be inefficient and inferior to the market economy, and was quickly replaced by the market economy in the process of transition during the 1990s.

Economic transition in Hungary was rather quick and straightforward. There was a nationwide consensus about important milestones of the process. Everyone hoped that the introduction of a fully-fledged market economic system would quickly turn around the economy, and also economic agents and companies. Though the process lasted longer than it was expected to, it was perhaps the quickest in Central and Eastern Europe. Today, the Hungarian transition process has been completed, with a few exceptions. The transition process provided a lot of opportunities for foreign investors. It was Hungary where foreign capital started to come in first in the region. Until 1996, Hungary received the most foreign investment among the countries in transition.

*Economic transition in Hungary was rather quick and straightforward. There was a nationwide consensus about important milestones of the process.*

The first step in the transition process was the liberalisation of economic activity, foreign trade, prices and foreign investment. For the small open economy, this meant a sudden increase of deliveries from developed countries that could provide superior quality of goods, sometimes at lower prices than domestic firms. Competition in domestic markets increased, because of both increasing competitive imports and increasing competition among local suppliers.

There is a fair amount of empirical evidence on firms that did not utilise such an opportunity in other transition economies. They tried to pressurise governments when they suspected that liberalisation measures would not benefit them. Strong competition, on the other hand, forced a number of Hungarian firms to undertake major restructuring efforts in order to become more competitive.

*Evidence indicates that the decline in economic activity was a system specific feature of transition, rather than the result of any economic policy mistake or false institution building.*

Macroeconomic decline was reflected in the massive wave of firms exiting the market. There were different forms of market exit. A large number of firms underwent the formal bankruptcy procedure and were liquidated. The Hungarian bankruptcy laws were exceptionally harsh in 1992-93: all debtors with obligations overdue by more than 90 days were legally forced to declare bankruptcy. Another, though less draconian, form of market exit was reduction in economic activities. More companies resorted to downsizing and took recourse to voluntary market exit than those that underwent bankruptcy procedures. Evidence indicates that the decline in economic activity was a system specific feature of transition, rather than the result of any economic policy mistake or false institution building. But, the speed of the process could have been slower, or the extent of decline could be reduced, through the use of appropriate policy measures.

Massive downsizing, both in domestic and foreign markets, necessarily led to a decline of corporate networks. Since former market links vanished, they had to be replaced, in many cases through new contacts with multinational companies. The process was especially strong in the small, open Hungarian economy. Liberalisation of trade and economic activities increased from both domestic and foreign companies in the once protected Hungarian market. In order to improve, or regain, competitive strength, Hungarian firms soon started to replace suppliers of inferior quality and reliability. This process started well before, and was independent of the bankruptcy wave of 1992. Replacement of suppliers usually meant imports from developed economies. Improved supplies substantially increased competitiveness among numerous Hungarian firms.

Increased competition stimulated the Hungarian economy. There were fundamental changes in downstream direction as well. Hungarian firms' sales markets had been altered. The basic direction of change was the replacement of the Council for Mutual Economic Assistance (CMEA) deliveries by the Organisation for Economic Co-operation and Development (OECD) countries, especially European Union (EU) sales. A strong economic growth later, however, was mainly driven by greenfield investment by TNCs. This also meant an increasing role of foreign suppliers in Hungarian production facilities. Hungary's role in the international labour division changed: it became an integral part of the global (mostly European based) business.

## **2.2 Privatisation and Foreign Investment**

*Hungarian privatisation policy favoured sales to foreign strategic investors. The logic was that foreign firms possessed the necessary technology, know-how, market share and capital for the successful restructuring of Hungarian firms.*

Privatisation was also an important factor in the development of corporate networks. Hungarian privatisation policy favoured sales to foreign strategic investors. The logic was that foreign firms possessed the necessary technology, know-how, market share and capital for the successful restructuring of Hungarian firms. The State also needed the cash revenue, in order to finance growing trade balance deficits. Many firms already had collaborations with firms of developed countries. It was rather obvious that privatisation primarily developed along these existing business links.

The management of Hungarian firms also had an active role in shaping the privatisation process. This role was often used to support the sale of firms to previous foreign collaborating partners. In these cases, co-operation links were further strengthened even before the privatisation deal was concluded. Later, when the deal was accomplished and the Hungarian firm became an affiliate, up and downstream business links were reconsidered, and usually substantially changed.

*Earlier contacts of Hungarian firms with foreign partners made matchmaking easy and accelerated the process.*

The success of Hungary in attracting FDI in early 1990s was largely based on FDI preference in the privatisation policy. Earlier, contacts of Hungarian firms with foreign partners made matchmaking easy and accelerated the process. In fact, until 1994-95, the entry of FDI was mostly through either the formation of joint ventures or privatisation. Even some greenfield investment started in the privatisation process. For example, General Motors (GM) purchased a plant from a privatisation agency to put up the Szentgotthárd Opel works.

**Table 2.1: Privatisation and FDI in Hungary 1991-2000**

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Inward FDI (US\$m)	1459	1471	2339	1147	4453	1983	2085	1935	1651	1835
Privatisation FDI (US\$m)	435	492	1163	103	3370	618	1451	485	295	0
% Share of privatisation in total FDI	29.8	33.4	49.7	9.0	75.7	31.2	69.6	25.1	17.9	0
% Share of FDI in total privatisation revenue	79.6	61.0	48.2	8.9	86.9	52.1	78.1	67.9	..	0
% Share of foreign firms in exports	..	..	..	54	58	69	75	77	80	

*Source: Hungarian National Bank, State Asset Holding Plc.*

*Privatisation-related FDI meant, in most cases, an interest of investors in different types of corporate assets, including facilities, workforce, products and brands, markets and in some cases even suppliers.*

Privatisation-related FDI meant, in most cases, an interest of investors in different types of corporate assets, including facilities, workforce, products and brands, markets and in some cases even suppliers. The level of local supplies is markedly higher in these cases than by greenfield investment. In the food industry, for example, the purchase of processing plants automatically meant access to local agricultural output. In the case of the food industry, this fact is a topic of discussions, since agricultural producers feel exposed to superior economic power of foreign-owned food processing companies. This could have been avoided, with farmers' access to at least parts of ownership rights in processing units. Since foreign owners gradually increased their ownership share and even exclusive rights, it is not very likely that they would have allowed significant Hungarian ownership.

Besides, many of the formerly independent Hungarian manufacturers were acquired by larger foreign companies during 1990s, as it is shown by the example of the dairy industry. On the other hand, farmers' fears of their supplies being replaced through imports did not prove to be correct. Still, a more powerful competition policy might be applicable in certain markets where concentration is very high (e.g., vegetable oils, sugar, tobacco, etc.).

*Besides, many of the formerly independent Hungarian manufacturers were acquired by larger foreign companies during 1990s.*

The pioneering role of Hungary in developing adequate policies related to transition was also evident in privatisation. Hungary was the first transition economy to open up markets and sell firms in such service branches as telecommunication, energy, water supply, and banking and finance. The liberalisation of markets and the sale of state-owned monopolies required a redefinition of market regulators in the services area. New laws on telecommunication, concessions, energy and water supply were passed. The laws were passed with specific sales agreements with the buyers of the service firms.

These contracts closely described the duties of the service provider and also contained guidelines and statements for the State for further development of regulatory frames. When prices were kept under government control, the principles of setting prices contained mechanisms of securing a certain level of profit for the new owner's activity. The contracted obligations of the State sometimes clashed with other economic goals, such as anti-inflation and welfare measures. The privatisation of services is, therefore, frequently criticised.

### 2.3 Attracting Foreign Investment

Hungarian Government's policy towards foreign investors has been one of the most favourable ones in Central and Eastern Europe. Origins of the policy can be traced back to a decade before transition started. Inviting FDI to Hungary, mainly in the form of joint ventures (JVs), was a major policy aim during 1980s and a fairly large number of JVs were established. Because of the openness of the Hungarian economy, long-term co-operation links were also being developed rather frequently with major multinationals. Therefore, Hungary was not a *terra incognita* for foreign investors.

*Hungarian Government's policy towards foreign investors has been one of the most favourable ones in Central and Eastern Europe.*

In the beginning of 1990s, parallel with the liberalisation of trade and economic activities, a generous legal framework was created for foreign investors. Establishment of joint ventures with foreign capital participation was promoted by allowances of corporate income tax. Investment policy also favoured foreign investment and joint ventures in the first-half of 1990s. State subsidies were offered for large-scale investment in certain high technology sectors (electronics, automobiles, biotechnology, communications, etc.) and tourism for investment in depressed regions with a requirement of certain amount of job creation and increasing exports. Later, investment subsidies were expanded to domestic companies as well. But, conditions of obtaining investment support were tied to investment size and cost sharing.

This means that it is mainly foreign firms who are able to apply for the investment support. The scope of subsidised investment was further increased in the new Hungarian development plan (the Széchenyi Plan). Among others, creation of industrial parks, industrial clusters, incubator houses, establishment of research and development (R&D) facilities, and R&D co-operation between the industry, university and academia are supported. Local governments or their agents usually receive these payments. Cash subsidies had to be withdrawn, since they did not conform to EU regulations.

*Among others, creation of industrial parks, industrial clusters, incubator houses, establishment of research and development (R&D) facilities, and R&D co-operation between the industry, university and academia are supported.*

Another tool of investment promotion relevant to foreign companies, especially to assemblers, was the regulation of industrial free trade zones. Regulation was introduced in 1982, with the aim of attracting export-oriented and high technology FDI to Hungary. Another objective was to integrate the companies operating in the zones into the host economy. The risk of developing a dual economy through regulation was recognised. It was, therefore, decided to allow any company to set up its own zones without any kind of spatial restrictions under the licence of the customs and finance authorities. The zones are regarded ex-territorial, from the point of view of duties, foreign exchange and other legislation. Otherwise, dutiable machinery and production inputs are not subject to customs duties and value added tax.

One company may set up several free trade zones. This is an extremely favourable regulation for assemblers, with only labour on the side of local inputs, as it enables them to import high value equipment free of duty. They were also allowed to keep books and accounts in foreign currencies, which facilitated them overcome currency exchange risks. Free trade zones will be terminated soon due to the EU accession of the country.

***Privatisation investment was, and usually remained, embedded in the local economy. On the other hand, greenfield investments, especially the assembly plants, mostly utilise only one local input and pay little attention to other valuable local contributions.***

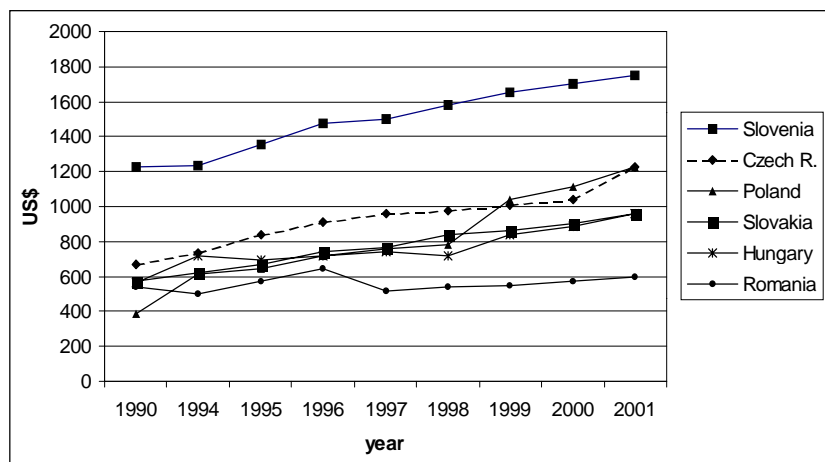
The two main forms of foreign investment were privatisation deals that can be regarded as mergers or acquisitions, and greenfield investments. The logic of these types of investment was different. Privatisation FDI expressed an interest in existing assets, including tangibles and non-tangibles alike (brands, skills, market share, R&D competencies and supplier networks). Privatisation investment was, and usually remained, embedded in the local economy. On the other hand, greenfield investments, especially the assembly plants, mostly utilise only one local input (cheap labour) and pay little attention to other valuable local contributions. This can be hardly changed, even through the most attractive government incentives. They tend to remain isolated and provide little impetus for local firms.

None of the policies to attract FDI will be adequate, if there is no business rationale behind investment decisions. Fears that selling the state property would leave it stripped and abandoned, proved to be wrong. Investors established footholds in order to gain some kind of strategic advantage. The most important investor motives were market penetration and utilisation of cheap labour. In fact, in most cases, both motives played a role. Market-seeking investment crowded out imports, because of low cost production opportunities available locally. Many of the greenfield investments were, on the other hand, efficiency-seeking and benefited from low cost employment. Some of them employed unskilled labour for simple large-scale assembly tasks. Many others were also interested in skilled labour. Hungary was an efficient production location, due to low increase in real wages and quick improvements in labour productivity. As a consequence of both, unit labour costs decreased in most manufacturing branches during 1990s. This meant a continuous improvement of cost competitiveness of Hungarian production locations.

***Market-seeking investment crowded out imports, because of low cost production opportunities available locally. Many of the greenfield investments were, on the other hand, efficiency-seeking and benefited from low cost employment.***

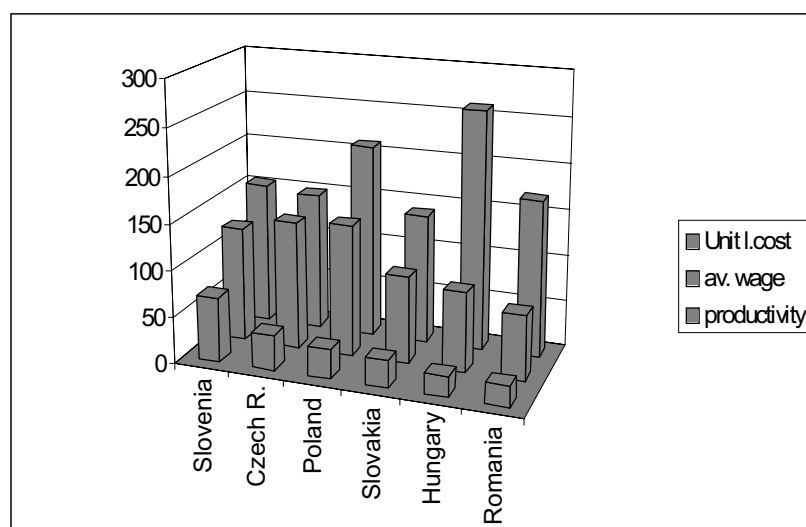
This trend changed in 1998, when real wages started to increase, reaching the level of productivity increase in 2000. Since then, wages increased quicker than productivity and unit labour cost started to increase.

**Figure 2.1: Average Monthly Earnings in 6 Transition Economies (US\$, calculated on PPP base)**



Source: Investment and Trade Development Agency, Hungary.

**Figure 2.2: Productivity Wage Cost and Unit Labour Cost (% change of productivity and average wage costs between 1992 and 2000, as well as wage cost on unit of output in % of the cost level of Austria in 1999)**



Source: Schröder W. (2003): *Arbeitsbeziehungen in Mitteleuropa – die Bedeutung der Tarifpolitik*. WSI Mitteilungen 1. 51-59.o.

## 2.4 Balance of Payments Impact

*The net positive FDI balance diminished, and, for the first time after the transition, in the first-quarter of 2003, it became negative.*

The turn of the century brought important changes in investment trends. The inflow of FDI started to decrease, and transfers of profits abroad started. Also, Hungarian-based companies started to invest, mainly in other transition economies of the region. As a result, the net positive FDI balance diminished, and, for the first time after the transition, in the first-quarter of 2003, it became negative. Years 2001 and 2002 were of general decline of FDI worldwide, following the September 11 bombing. Although in 2002 the decline in inward FDI was less dramatic in transition economies than elsewhere, the Hungarian figures show a number of important changes in the composition of FDI flows. Table 2.2 illustrates the changes:

<b>Table 2.2: Inward and Outward FDI in Hungary, 1995-2002</b>								
	<b>1995</b>	<b>1996</b>	<b>1997</b>	<b>1998</b>	<b>1999</b>	<b>2000</b>	<b>2001</b>	<b>2002</b>
Inward FDI balance (in millions of US\$)	4169	2178	2306	2178	2219	2202	3258	1288
Share of privatisation in inward FDI (%)	75.7	31.2	69.6	25.1	17.9	00	00	00
Outward FDI balance (in million US\$)	40	-2.4	467	514	284	724	442	326

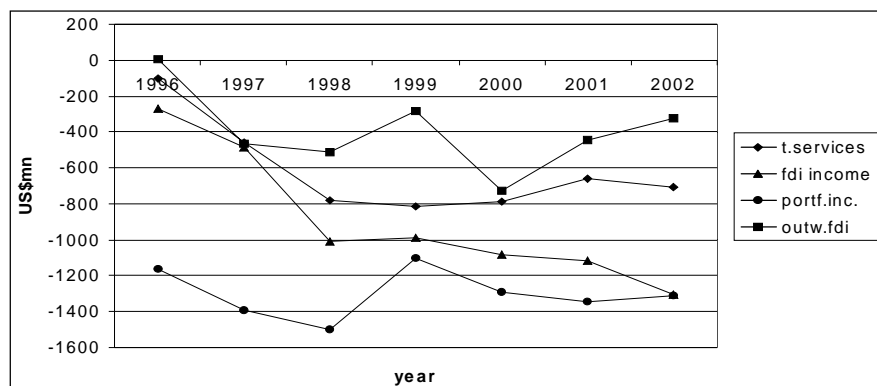
*Source: Hungarian National Bank, State Asset Holding Plc.*

*The fairly low figure for 2002, thus, reflects both a significantly higher level of FDI inflow and several hundred million US\$ worth of capital outflow from the country, which was due to closure of firms in some labour-intensive activities.*

Inward FDI had already started to decline by late 1990s, and the 2001 revival was due to intra-company loans, rather than investment. On the other hand, the stock of FDI continued to increase in Hungary, since firms reinvested most of their profits. The composition of the FDI stock increment changed - net new capital inflow declined, and loans and reinvested profits took the first place. Unfortunately, the picture is further distorted by an important shortcoming of the statistical system. We obtain data of net inflow and outflow of FDI, which means the data contains the cumulative impact of investment and disinvestment of non-resident capital owners. The fairly low figure for 2002, thus, reflects both a significantly higher level of FDI inflow and several hundred million US\$ worth of capital outflow from the country, which was due to closure of firms in some labour-intensive activities. Also, the sectoral composition changed, with services and trade taking over the first place from manufacturing. Manufacturing investors' hesitation to launch new projects in Hungary was very much evident, when Hungary did not receive any of the new investments in the car industry in recent years.

As far as outflows of capital are concerned, importantly, though not dramatically increasing, part of the profits was retracted. Also turnover in royalties and fees increased together with loans. These cost items and loan repayments started to play an important role in balance of payments. Both may cover financial transactions, rather than normal commercial deals. The increasing role of these transfers and profit repatriation was a major factor, time to time driving the capital balance into red. However, their increasing role shows that Hungarian affiliates started to earn profits and were successful.

**Figure 2.3: Capital Outflow**



t.services = technical and business services expenditures  
 fdi income = income transfers of foreign residents from direct investments  
 portf.inc. = income transfers of foreign residents from portfolio investments  
 outw.fdi = outward FDI of Hungarian residents

Source: Hungarian National Bank.

**Open profit transfers on FDI jumped in 1998, and continued to grow more slowly thereafter. Meanwhile, the net outflow of payments on technical and business services stabilised at around US\$720mn per year.**

As shown in Figure 2.3, various channels of investment-related capital outflow played an important role in the second-half of 1990s and early 2000s. The repatriation of profits on portfolio investment was substantial throughout 1990s, and even earlier. Open profit transfers on FDI jumped in 1998, and continued to grow more slowly thereafter. Meanwhile, the net outflow of payments on technical and business services stabilised at around US\$720mn per year. We consider the net outflow of technical payments as a rough measure of hidden profit transfers. The US\$720mn negative balance is the result of inward flows in the range of US\$2400mn, and excessive outward flows. Outward FDI fluctuated. The jump in 2000 was the result of a major privatisation-related deal in Slovakia that incorporated the Hungarian affiliate of a large multinational company.

The analysis of the current account is important because of two reasons. Firstly, because changing investment and income restructuring pattern requires it to have parallel changes in other items of the account. Secondly, because it has been realised net FDI inflows cannot help stabilise the current account, as was expected in 1990s. On the contrary, if the drying-up of nominal FDI inflow and the increasing outflow of incomes and payments of FDI-related fees is considered, the net result of the capital and income flows may even be negative, as it was in the first-quarter of 2003. Obviously, caution must be exercised when combining figures from different parts of the current account. Profit and payment flows come from the current account, capital flows from the financial account. They are of different nature. But, if approached from a mercantile angle of national liquidity, they become comparable.

**Transfer pricing is wide-spread, but the reasons of this may be divergent. Hidden profit repatriation used to be the primary suspect, but, in the case of Hungary, this hardly holds true.**

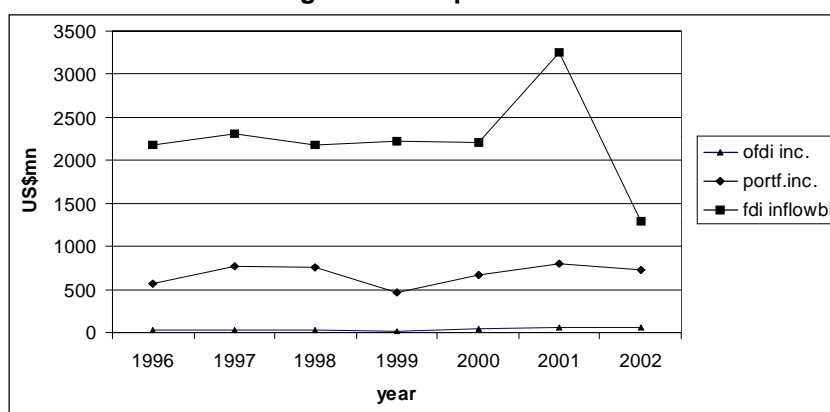
As far as the excessive level of outward flow of technical and business fees is concerned, probably hidden profit transfers played a role, but the level and intensity of this depended mainly on the needs of global company networks. Transfer pricing is wide-spread, but the reasons of this may be divergent. Hidden profit repatriation used to be the primary suspect, but, in the case of Hungary, this hardly holds true. Foreign firms, which were important for the country, received corporate tax holidays and were interested in channelling profits into Hungary. Actually, the transfer of profits to Hungary was observed in many cases, when Hungarian affiliates of various multinationals reported unexpectedly high profit margins realised in Hungary. Still, the brackets of business services' costs and



repaid loans continuously showed high figures, which indicates a different rationale in the background of these transactions.

To understand the issue of restructuring of the current account and the changing role of FDI, we should, primarily, compare inward and outward flows. Figure 2.4. shows income flows from abroad, as well as the net inward FDI levels. If we compare this chart with the previous one, it becomes obvious that inward income levels are significantly lower. Thus, the net of inward and outward income flows is negative. In the case of portfolio-related incomes, the net outflow is larger. However, until the end of 1990s the net inflow of FDI (that is the net of the balances of inward and outward flows) showed a significant surplus that sufficiently covered net income outflows.

**Figure 2.4: Capital Inflow**



ofdi inc. = income inflows from abroad related to FDI  
 portf.inc. = income inflows from abroad related to portfolio investments  
 fdi inflowbl = balance of FDI inflow

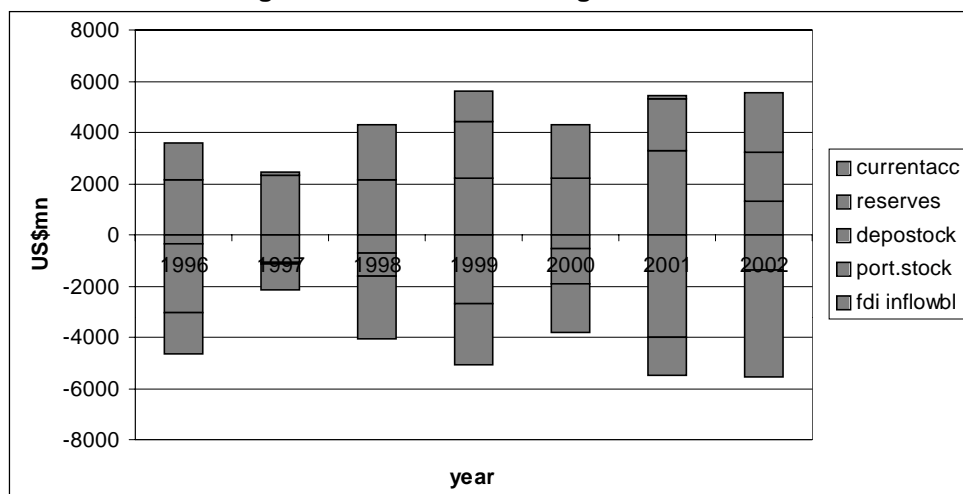
Source: Hungarian National Bank.

***There is, first of all, an alarming increase in the current account deficit. This increase was caused mainly by a huge increase in the trade balance deficit.***

Figure 2.5 shows the relationship of the current account and some important potential sources of financing (changes in stocks of deposits and portfolio, Hungarian National Bank [HNB] reserves and net FDI inflow). The columns in Figure 2.5, primarily, show that negative and positive slopes were roughly equal in each year. This means that the investigated items counterbalanced each other, in general. The slight surplus is obviously due to factors not included here. However, important shifts in the structure can be identified. There is, first of all, an alarming increase in the current account deficit. This increase was caused mainly by a huge increase in the trade balance deficit. As seen earlier, income flows did not change so dramatically. It is also clear that net inflow of FDI lost momentum. This is even clearer if we also consider the 1995 figure of Table 1.1, or the entire period of 1992-1996.

The third important observation is that both the stock of portfolio (mainly Hungarian State securities) held by foreign residents and the level of deposits showed no clear tendencies over time. They changed very sensitively, sometimes in the same direction, but mostly in the opposite. Their changes seemed to depend on monetary policy measures and changes in world financial markets. The change of reserves played, in fact, the true balancing role. In fact, this is the major purpose of it.

**Figure 2.5: Deficit Financing Sources**



currentacc = current account deficit  
 reserves = changes in reserves of the HNB  
 depostock = changes in the stock of bank deposits  
 port.stock = changes in the stock of portfolio investments  
 fdi inflowbl = balance of in and outflows of FDI

Source: Hungarian National Bank.

*The current high level of FDI in the various sectors of the Hungarian economy made FDI the primary resource for future development.*

However, if we count the high current account deficit in the long run, changes in deposits and portfolio stock are not completely controlled by national policies, and without the massive net inflow of FDI reserves, the HNB would have to assume the balancing role. The conclusions are clear: reserves have to be kept at adequate levels and an upswing of net FDI inflow has to be achieved. We deal with the latter option. This is an important task because the current high level of FDI in the various sectors of the Hungarian economy made FDI the primary resource for future development.

## 2.5. The Impact of Trade and Hungary's Positions at WTO

FDI affects the current account through the trade balance as well. The classical cycle was replicated in Hungary in this aspect. FDI, be it greenfield or acquisition, required massive investment in tangible new assets. The establishment of facilities, or the modernisation and reshaping of the acquired ones, was carried out in one major investment effort. Since both types of investment culminated during the same period of time, between 1993-1997, parallel investment efforts went on in many large FDI projects.

*Import needs of investors led to an increase in machinery imports in this period and deteriorated the trade balance, since exports from new facilities generated only after the investment projects were completed.*

Import needs of investors led to an increase in machinery imports in this period and deteriorated the trade balance, since exports from new facilities generated only after the investment projects were completed. Exports started to increase at a fast pace after 1996. The major engines of export growth were large greenfield investment projects in the industrial free trade zones. Currently, firms in the free trade zones strongly contributed to a positive balance of trade. They are also major importers, assembling or transforming parts imported in intra-firm trade. The export surplus roughly equals their local added value (US\$1-2bn annually).

*Experts criticise retail privatisation and the rapid expansion of large international retail chains for contributing to trade deficit, through increased imports of consumer goods.*

The strong and growing deficit on the trade balance is a major concern. It is basically private consumption that fuels the deficit. Experts criticise retail privatisation and the rapid expansion of large international retail chains for contributing to trade deficit, through increased imports of consumer goods. But, these can also be regarded as mere transmission devices between consumers and industry. Large retail chains may influence consumer choice: local producers usually have to deliver commodities on same conditions as foreign firms do. These conditions are usually very tough, and, maybe, not fair. But, they are equally used in doing business with local and foreign partners alike. It is, therefore, the inferior competitiveness that makes firms, domestic and foreign alike, drop out of the sourcing mechanism of the large retail chains. From a number of aspects, local firms enjoy benefits of location advantages, though they are usually less powerful, but their brands are less well known than their multinational competitors.

Hungary used to be a member of the CAIRNS group for several years. This fact determined the Hungarian standpoint at multilateral trade negotiations. Together with the CAIRNS group, Hungary was a supporter of trade liberalisation, especially in agriculture. Hungary also urged the reform of export support systems especially in EU's Common Agricultural Policy (CAP). Today, the Hungarian position has become rather ambivalent. Struggling for EU accession, Hungary could not maintain its position with the CAIRNS group.

Though the medium term pre-accession interest of the country remained the same, the situation may change completely after the enlargement of the EU. Hungary may become an important recipient of EU agriculture funds. However, ongoing reforms of internal regulations of the EU may also include CAP, changing the mechanism altogether. It is also possible that CAP loses importance by the time Hungary joins the EU. The latest guidelines issued in Brussels indicate that the EU does not intend to provide the same level of subsidies, that regular members enjoy, until 2006. This is the year by which the ongoing reforms are to be completed.

There are a number of other issues currently under discussion at WTO that also affect Hungary. Copyrights for drugs are, for example, a hot issue, since the Hungarian patenting practice is technology-oriented. Also, control of computer software usage and punishing illegal copying is rather weak. Meanwhile, these issues seem to be rather marginal. Other, more fundamental, trade problems affect the Hungarian economy rather loosely, since three-quarters of the Hungarian foreign trade is within free trade zones that are not influenced by the WTO agreement.

## **2.6. Restructuring and Performance**

*Privatisation of foreign firms or greenfield investment alike is expected to have strong spillover effects on the host economy. This means that, in the long run, their activity is expected to improve working conditions of other firms as well, including domestically-owned companies.*

Privatisation of foreign firms or greenfield investment alike is expected to have strong spillover effects on the host economy. This means that, in the long run, their activity is expected to improve working conditions of other firms as well, including domestically-owned companies. This paper describes two areas where beneficial spillover effects may be detected – restructuring/productivity growth and R&D activities.

A comparison of state-owned, foreign and domestic privatised firms' downsizing activity found that downsizing was similarly widespread. Foreign firms' downsizing activity was usually quicker, but not necessarily deeper, than other ownership groups. Closure and employment reduction was paralleled, or followed, by investment. Restructuring meant both

elimination of not-to-be-used structures and creation of new ones. Other important areas of reorganisation were human resource development, marketing and corporate organisation/management. Streamlining of the product range was common, but restructuring also meant the picking up of production of new products and entering new markets. Production technology was generally improved (at least quality control and data communication).

*The superior background and the existence of mother companies, large transnationals in many cases, resulted in quicker and deeper restructuring process.*

Comparisons of restructuring of firms of domestic and foreign ownership revealed the better conditions of foreign companies. The superior background and the existence of mother companies, large transnationals in many cases, resulted in quicker and deeper restructuring process. There were two important factors favouring foreign companies, which were hardly accessible to domestic firms: markets and capital. The analysis of corporate investment activity, as the nucleus of restructuring, clearly showed that similar investment projects were launched in restructuring firms, but foreigners were usually able to carry out their projects within 1-2 years. Hungarian companies were able to carry out major investment projects only piecemeal and the whole restructuring project took much longer. The major reason for this was lack of finance.

**Table 2.3: The Role of FDI in Various Sectors of the Hungarian Economy:  
% Shares of Foreign Firms in Economic Indicators (2001)**

Branch	Added Value	Gross Profit	Own Capital	Employment	Real Wages	Net Sales Revenue
<b>Total manufacturing</b>	<b>64.9</b>	<b>66.6</b>	<b>67.6</b>	<b>45.1</b>	<b>130.2</b>	<b>72.1</b>
Food and beverages	62.1	75.6	73.3	39.7	136.9	56.5
Textiles	51.4	-	60.2	34.3	132.4	55.2
Leather and shoes	63.0	-	70.0	50.0	-	64.4
Wood products	43.7	-	63.6	21.4	-	45.4
Paper and pulp, printing, and publishing	43.3	34.4	47.5	25.9	-	46.7
Coke and refined petroleum	79.2	20.5	42.6	68.7	-	89.5
Rubber and plastic products	61.6	72.7	71.7	48.6	120.7	60.0
Other non-metal minerals	64.2	88.0	51.9	37.5	-	57.9
Metal products	39.4	-	52.6	29.5	-	41.9
Machinery and equipment	49.2	-	65.0	40.6	113.1	52.3
Electrical appliances and instruments	77.0	78.2	86.1	69.8	111.8	91.7
Vehicles	86.2	98.7	98.4	62.2	113.0	94.1
Other manufacturing	39.1	-	45.0	25.8	-	38.5
<b>Energy, water and steam supply</b>	<b>52.5</b>	<b>80.2</b>	<b>40.5</b>	<b>35.3</b>	<b>112.1</b>	<b>50.8</b>
<b>Construction</b>	<b>14.9</b>	<b>-</b>	<b>25.6</b>	<b>8.3</b>	<b>196.8</b>	<b>14.6</b>
<b>Trade and repairs</b>	<b>41.9</b>	<b>42.4</b>	<b>46.9</b>	<b>22.5</b>	<b>189.6</b>	<b>41.8</b>
<b>Transport and storage</b>	<b>35.7</b>	<b>-</b>	<b>59.2</b>	<b>13.0</b>	<b>200.2</b>	<b>33.2</b>
<b>Real estate and business services</b>	<b>33.4</b>	<b>29.2</b>	<b>33.7</b>	<b>15.6</b>	<b>-</b>	<b>30.0</b>

*Source: Central Statistical Office.*

***The gap between earnings in foreign and Hungarian-owned companies is rather wide in most branches. This gap could be seen as a sign of superior performance.***

The figures of Table 2.3 demonstrate the deep penetration of foreign capital in Hungary and their superior overall performance. The gap between earnings in foreign and Hungarian-owned companies is rather wide in most branches. This gap could be seen as a sign of superior performance. The above average figures in manufacturing are due to very low wage levels of Hungarian firms. The narrower gaps in engineering may also be due to some kind of a demonstration effect. Wages in the foreign-owned sector push up the same in the domestic sector as well.

***Foreign firms' productivity was higher than the average, but their gross profits were lower and they produced negative net profits.***

Nation-wide databases (e.g., tax office records) were also used to perform a variety of statistical tests. Some observers tried to find evidence of superior performance of foreign companies in the Hungarian economy. An analysis, using a wide range of financial, export and investment indicators, in order to compare the performance of different ownership groups, did not find any striking difference until 1994. Foreign firms' productivity was higher than the average, but their gross profits were lower and they produced negative net profits. Productivity gap continued to increase over time. The reason for higher productivity was lower level of wage costs. This finding, together with the evidence presented in the chapter on case studies on higher wages paid by foreign employers, clearly reflects a strong productivity position of foreign firms. They employ the best labour at higher salaries, but they also achieve an extraordinary high level of output that overcompensates above average wages.

More recent surveys of corporate performance proved that the productivity gap between domestic and foreign firms started to widen in 1995 and continued to do so until at least 1998. The productivity gap was paralleled by profitability gap too, starting in 1996. The main component of superior productivity and profitability in the country remained labour productivity. For example, the share of wages in total costs increased by 2.5 percent from 1997 to 1999 in the Hungarian economy, as a whole. In the case of majority owned foreign firms, a 1.2 percent decline in the same was observed. Foreign firms also started to realise profits. Moreover, due to the favourable tax conditions, many foreign companies allocated much of their global profits to Hungary.

***Despite decreasing and low labour costs foreign investors pay above average wages. The relatively high wages may deteriorate competitive positions of less powerful local firms.***

Despite decreasing and low labour costs foreign investors pay above average wages. The relatively high wages may deteriorate competitive positions of less powerful local firms. The problem is exacerbated by the very high wage taxes. In fact, after every unit wage paid to an employee, approximately two units of different taxes and contributions have to be paid to the State. The two most commonly used methods of overcoming this problem are paying out salaries as contract payments to "quasi-entrepreneurs" and underreporting, both turnover and employment costs.

There is some kind of consensus among a number of scholars that the widening of the productivity and profitability gap started to decelerate by the late 1990s. For example, in the case of capital and total productivity measures, there was no worsening, as regards Hungarian owned firms' relative position, compared to that of foreign firms. Still, it is too early to speak about some kind of convergence. In the light of the similarity of measures taken during the early and late 1990s, one can raise the question: how strong was the influence of large free-trade-zone-based assemblers' activity during mid-1990s, when the rapidly widening productivity and profitability gap was registered? In some measures, there is a huge jump, e.g., when IBM Storage Products started operation in 1996. Obviously, the accelerating divergence was strongly influenced by

the massive entry of high productivity assemblers in Hungarian markets. The same magnitude of change happened in the opposite direction in 2002, when the facility was moved from Hungary to China.

## 2.7 The Impact of FDI on Hungary's R&D Performance

*The transfer of knowledge and technology, as well as the development of R&D activity that received the most interest among potential spillover effects.*

Besides measures of performance, it is the transfer of knowledge and technology, as well as the development of R&D activity that received the most interest among potential spillover effects. Opinions vary from the emphasis on the devastating effects to optimistic views. The statistical figures indicate that there has been a steep decline in R&D spending during 1990s in Hungary. The State, University and industry sponsorship declined drastically. The overall level of expenditure was a mere 0.5 percent of GDP in 1998, compared to 2.3 percent in 1988. Strong critics of FDI argued that the new type of integration of Central and Eastern European companies requires the complete elimination of R&D activity. Laboratories have to be shut down and experts fired. R&D is performed at corporate headquarters and not at local affiliates.

Early empirical evidence suggested that this opinion was not fully justified. There was reduction and a change in the role of R&D activity of firms in transition economies. The former widespread inefficient R&D structure was reduced to a few areas. Also, basic research was usually replaced by greater product development. However, this process was regarded as integrating subsidiaries into global R & D networks at a level "below their technological capability threshold".

*Statistical figures indicated that foreign firms spent 45 percent of total industrial R&D in 1997, and the share was increasing. R&D intensity of foreign companies was much higher than that of the domestic companies.*

Statistical figures indicated that foreign firms spent 45 percent of total industrial R&D in 1997, and the share was increasing. R&D intensity of foreign companies was much higher than that of the domestic companies. A number of companies moved R&D capacities from abroad to Hungary (for example: Audi, Nokia, Philips, Siemens, GE, Knorr Bremse, ABB, Ericsson, etc.). There are firms in Hungary that have no production facilities, just an R&D centre (for example, Japanese Tateyama). Moreover, among the most active in R&D firms, there are also assemblers. There is a differentiation between two periods in Foreign Institutional Enterprises (FIE) behaviour towards local R&D. The first "acquaintance" period was spent with the takeover, or establishment, of capacities, as well as the first confrontation with R&D potentials in Hungary. The second period that started in mid-1990s was characterised by the commencement of the usage of capacities ("feeling at home").

The level and efficiency of technology transfer, and the strong absorption capacity of Central European countries, is based on the inherited high level of human capital. It was the good performance of the local technical staff that raised the interest of multinationals in local R&D potential. Foreign firms themselves actively participate in human resource development. Besides training the staff, many of these maintain active contacts with universities. Interlinking foreign companies, domestic firms and universities in order to improve R & D capacities, is an important programme of the industrial policy of the Hungarian Government. Direct beneficiaries of the programmes are usually foreigners.

The technology level of Hungarian manufacturing, undoubtedly, increased after the transition. The most important component of investments, according to 1998 statistics, was still "imported machinery". Foreign companies imported 81 percent of all machinery and equipment, thus being the major engine of the spread of modern technology. A government

*A government survey found that the level of technology was higher, and machinery and equipment was better if a) the company size was larger, b) the firm had a foreign owner, and c) the firm was operating in certain sectors like telecommunication, and innovative segments of engineering industry.*

survey found that the level of technology was higher, and machinery and equipment was better if a) the company size was larger, b) the firm had a foreign owner, and c) the firm was operating in certain sectors like telecommunication, and innovative segments of engineering industry. Domestic firms, most notably suppliers to foreign firms, also benefit from technology spillovers. All major empirical contributions reported such effects. This was, in fact, a necessity, if regular co-operation was to be maintained.

## **2.8 Creation of Local Supplier Networks**

Most TNCs operate global networks. Thus, joining them with local suppliers means linking local firms into a highly competitive structure. Global networks are not arms-length business contacts. The networks require competitive values from suppliers (adequate technology, reliability, high quality, flexibility, matching communication systems, etc.). These values may be present, or can be developed but the chances of absorption are very different in each firm which depends on the assets and existing qualities of the firm, the economic environment, the role and tasks a potential supplier would fulfil in the network and the willingness of networking partners to support. On the other hand, being a member of a co-operating network means long term commitments of all parties, which also includes a certain level of technology co-operation, continuous knowledge transfer and an adequate level of profits. Network membership also serves as a reference for firms, enabling them to widen co-operation or enter into new contacts.

*The networks require competitive values from suppliers such as adequate technology, reliability, high quality, flexibility, matching communication systems, etc.*

Supplier links of foreign companies started to develop as soon as they took up operations in Hungary. Thus, their interest in developing local roots was already clear. The empirical evidence showed that some foreign firms outsourced only a few services. Meanwhile, others tried to outsource as much of the production as they could. A comparison of Suzuki and GM-Opel, for example, made it clear that substantial local delivery was beneficial for both foreign investor and local supplier, if the production surpassed a minimal volume. Production of 15,000 cars a year by GM was below the threshold: it was not economical to start producing components for this car in Hungary. Thus, besides some auxiliary services, only motor oil was produced in Hungary. At the same time, because of local content requirements, Suzuki actively looked for local suppliers. This activity was supported by the Hungarian Government as well.

Possibilities of foreign firms incorporating and demanding local supplies very much depend on their status in the global network. Local affiliates of huge multinationals may play a rather marginal role, or their role and the scope and nature of their activities may change over time. Sometimes, local affiliates may also perform very simple subcontracting-type activities. In fact, many of them do either assembling or simple labour-intensive processing. These activities do not provide much room for local suppliers. Through further investment, the activities can be developed towards more value-added and sophistication, but this can be influenced primarily by FDI and investment policy, and not by linkage promotion.

## **2.9 State Assistance for Supplier Network Establishment**

The Hungarian Government decided in 1997 to launch a programme aimed at promoting the most promising way of positive FDI spillover effects – the establishment of local supplier ties. The Supplier Target Programme (STP) was launched in 1998. After two years of operation, some basic principles of the programme were reconsidered and the programme was

re-launched in 2000. The basic idea of the Programme was to support potential local suppliers with technical and financial help to improve their technical, financial and knowledge background. The adequate level of technology sophistication, quality control, communication system and reliable delivery was regarded as preconditions for becoming a supplier to multinational firms. Most Hungarian small and medium enterprises (SMEs) did not qualify without some kind of help.

*The basic idea of the programme was to support potential local suppliers with technical and financial help to improve their technical, financial and knowledge background.*

The STP recognised this SME development need. It aimed at the creation of direct links between foreign and Hungarian firms in selected industries like automobiles, electronics, and rubber and plastics. In doing so, it focused on providing information and matchmaking, as well as training and consultancy to SMEs, i.e., would-be suppliers. Hungarian firms, especially SMEs, were set in the centre of the programme. It wished to support preparations of SMEs to qualify for requirements and help in matchmaking and contracting. The programme was not really successful because it did not take into consideration two circumstances: a) that foreign companies had various interests and b) there were Hungarian mediators (first-tier suppliers) already in the market. Matchmaking between Hungarian SMEs and multinational affiliates proved to be difficult.

The STP was reviewed in 2000 and the new Integrator Supplier Target Programme (ISTP) was launched the same year. The basic idea of the new programme is that existing supplier networks could be further developed as the nucleus of a bigger and more colourful co-operation network, a local cluster. It changed the direction of the promotion activity in the opposite direction: it starts with the needs and requirements of foreign firms and other integrator firms. The primary purpose of the programme is to increase local supplies' share from the current 10-20 percent to 30-40 percent.

*The STP was reviewed in 2000 and the new Integrator Supplier Target Programme (ISTP) was launched the same year.*

Matchmaking events are continuously organised and there are plans to update the established database and even expand it to 4-5000 records as well. Training and advising domestic companies still remains on the agenda, and qualification and auditing of supplier members of the programme is also foreseen (with financial support from the programme sources). Long-term finance for necessary investments in supplier firms has also been included in the new programme plan. This would include both loans and equity participation (venture capital function). Support of quality insurance programmes also remained in place. The new State support agency regularly monitors the system and keeps continuous contact with the participants.

There are, however, some problems with the new projects too. The most serious problem is perhaps the role of the State as venture capitalist. The Regional Development Company (RDC) and other state-owned "venture capital firms" were created, in fact, for crisis management, and not for risk management. The new role may cause problems for them. Unfortunately, there are very few private venture capital firms in the region and the State companies serve as a second best solution in the crisis management function as well. It is also questionable whether the new type of local agency, the Supplier Agency, will be very much different, more active and efficient than the predecessor local network. It is, maybe, not fair to expect a new institution to try to cope with all kinds of development preferences. Maybe regional development issues should not be incorporated in this framework. But, it is almost certain that the



new institution will further increase spatial tensions in the country. It supports the development of clusters in the places where they actually are – the relatively most developed parts of Hungary.

#### Issues for Comments

- What was the real impact of institutional changes? Were these responsible for the economic decline or were they the necessary instruments of economic restructuring?
- Whether the FDI attraction capacity of the country will decline.
- What are the risks of a strong, but isolated, assembly-based foreign sector? What are the chances of changing or developing this status?
- Is the productivity gap another sign of foreign isolation? Is the widening of the gap a further negative spillover effect of the foreign sector (a result of increasing competition)? Or, is there a positive spillover effect, and domestic firms can narrow the gap in the long run?
- What is better: being securely integrated at a low level of sophistication or being potentially able, as an independent firm, to run a full-fledged corporate activity with R&D and production of the full range of products, but remaining inefficient and losing markets?



## Analysis of Case Studies

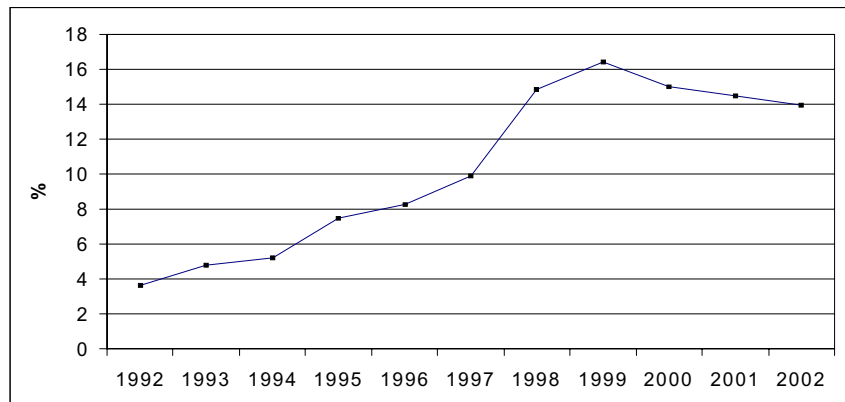
This chapter contains case studies of three sectors carried out under the project. Three case studies were prepared (automobile industry, electricity supply and telecommunication). The chapter also contains results of a survey of the foreign affiliates and local businesses.

### 3.1 Automobile Sector

*The automotive industry was completely changed, not only in its technology and organisation but also its main markets and products.*

From the point of view of re-integration into the world economy, the automotive industry has particular importance. This industry represented an important part of the pre-transition economy as well. It was completely changed, not only in its technology and organisation, but also in its main markets and products. Concentration on bus and medium truck production was replaced mainly by car and engine production. The former main market was CMEA countries; exports now go mainly towards the European Union. The huge increase of production is illustrated in Figure 3.1. The flattening of the curve in the later years is a result of the even much quicker growth of the electronics industry during the late 1990s and 2000.

**Figure 3.1: % Share of Vehicle Manufacturing in the Hungarian Manufacturing Industry Output**



Source: Central Statistical Office.

*The car industry also provided an opportunity to sub-assembly supplier companies to join the new networks.*

The car industry also provided an opportunity to sub-assembly supplier companies to join the new networks. Many of them did not survive but there are also some success stories. Even those who did not survive provided, in many instances, a fertile ground for new companies of the industry to grow. Accumulated knowledge, infrastructure and other values were utilised by spin-offs, or follower companies. Thus, the assets of the previous (bankrupted) state firms were utilised.

	1995*	1998	2000	2001
Investment share %	95	93	90	90
Share in sales turnover %	52	95	92	92
Employment share %	42	77	59	60
% share of foreign ownership in equity capital	50	76	87.5	95.2
Average minimum wage (domestic firms' average =100)	113	110	113	115
Share from operating profit %	83	91	95	97
* Engineering industry.				
Source. Central Statistical Office.				

Those sectors of the industry where foreign penetration was weaker faced more difficulties. This is, however, a typical chicken-and-egg problem: maybe foreign interest is low in these sectors exactly because of the foreseeable difficulties. Bus production, for example, continuously struggles for survival. The former truck company, RÁBA, also has difficulties and its activity is specialised rather on sub-assemblies than on trucks now. The new pattern of integration requires highest level of specialisation from all participants, as well as an increase in batch sizes.

### 3.2 Telecommunications

The other two service sectors were, in a sense, also integrated into their respective global systems. The main interest of investors was tapping new markets, since expansion of their existing highly regulated markets was not possible. Expansion motive was clearly visible, for example, in the activity of MATÁV – the German-owned telecom company, when it purchased Maktel, the Macedonian telecom firm. Telecom companies also wished to expand abroad. This market is highly concentrated and strongly regulated in the EU, thus making expansion difficult, through its own activity as well as through mergers and acquisitions. Many of them are monopolists in their own home markets already.

*Expansion motive was clearly visible, for example, in the activity of MATÁV – the German-owned telecom company, when it purchased Maktel, the Macedonian telecom firm.*

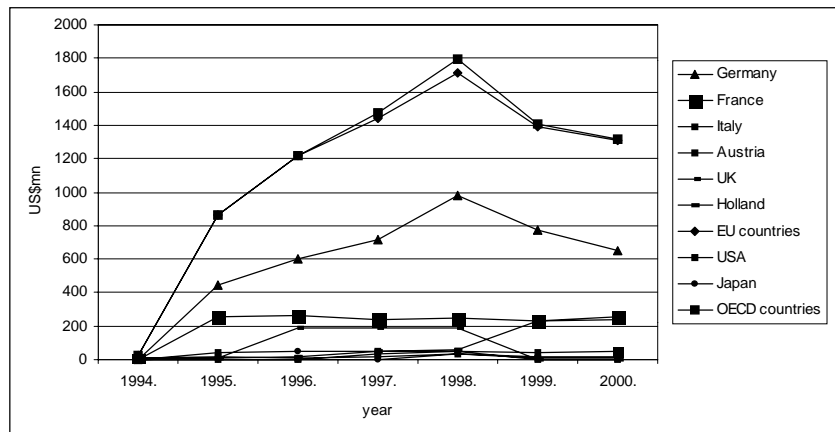
	1995	1998	2000	2001
Investment share %	79	85	72	68
Share in sales turnover %	35	40	42	35
Employment share %	13	13	13	12
% share of foreign ownership in equity capital	25.6	24	52	39
Average minimum wage (domestic firms' average =100)	171	180	176	183
Share from operating profit %			91	
* Together with post and storage.				
Source: Central Statistical Office.				

### 3.3 Electricity

*The price control, as well as the state ownership of electricity transport networks, provides an effective tool for the government to control trade within energy.*

Though electricity firms may wish to import electricity, rather than produce it locally, thus integrating Hungarian affiliates into their international network, market regulation does not yet allow an uncontrolled exchange of energy. The price control, as well as the state ownership of electricity transport networks, provides an effective tool for the government to control trade within energy. The upcoming liberalisation of the electricity market may change this situation. It is almost certain that, subsequently some of the currently operated power plants will shut down. The current operations of these not-efficient power generation plants is supported by the State through a guaranteed 8-percent profit rate in the industry. The main reason for keeping the plants alive is employment.

**Figure 3.2: FDI, by Origin, in the Hungarian Energy Sector**



Source: IFD Project- Background Study on Hungarian Energy Sector.

**Table 3.3: Selected Indicators of Foreign Firms in**

Hungarian Energy Sector				
	1995	1998	2000	2001
Investment share %	58	85	91	89
Share in sales turnover %	54	57	50	51
Employment share %	35	40	35	35
% share of foreign ownership in equity capital	16.4	31.8	29.9	27.8
Average minimum wage (domestic firms' average .=100)	140	111	111	115
Share from operating profit %			71	80

Source: Central Statistical Office.

### 3.4 Results of the Surveys

*The respondents of the civil society survey attached quite strong positive impact on the quality of jobs created, the availability of new technologies and increasing competition.*

Micro-level restructuring and potential spillover effects were properly captured by the questionnaires that were administered on companies. FDI in industry was perceived as a major tool of modernisation. The respondents of the civil society survey attached quite strong positive impact on the quality of jobs created, the availability of new technologies and increasing competition. Also, the quality and the choice of products available improved to a large extent due to the presence of Foreign Institutional Enterprises (FIEs). The benefits of foreign firms for the national economy were also strong in the areas of improving the physical environment, the transfer of technology and knowledge and last, but not

*FDI in trade, especially in retail, was regarded by the respondents less beneficial. Positive effects were expected from more competition, in the form of improved quality and choice of available products.*

least, FIEs were regarded as an important source of tax revenues for the government.

In contrast to the above statements, FDI in trade, especially in retail, was regarded by the respondents less beneficial. Positive effects were expected from more competition, in the form of improved quality and choice of available products. On the other hand, foreign companies' activity was regarded as negative, in terms of the quality of the jobs that they offered. Their activity strongly retarded opportunities for domestic business, both competitors and potential suppliers (producers). They were also thought by the respondents to be contributing to unnecessary increases in the prices of consumer goods. Direct questions on potential spillover effects revealed that respondents thought that FDI had a strong pulling effect, through the introduction of new technologies and management techniques. FDI, in general, also improved access to world markets and improved the competitiveness of the Hungarian economy.

*22 firms perceived increasing competition, and 17 a very high level of competition.*

In contrast to the civil society perception, local business' opinion was somewhat different. 22 local firms were surveyed on 35 product lines. Out of the 35 products, there were only 7 in which the major competitors were foreign firms. This low level of interference clearly indicates the strong duality of the Hungarian economy. Majority of the domestic firms have basically no contact with foreign companies, simply because they operate in different markets. The local business respondents expect no strong direct pulling effects. Still, 22 firms perceived increasing competition, and 17 a very high level of competition. The primary market drive for improvements in efficiency seems to work also in sectors with no foreign impact.

But, the case studies demonstrated that markets with high levels of foreign penetration had showed intensive FDI impacts. In many cases, the impact was, so to say, "too strong" and resulted in the exit of domestic companies. But, the case of the automotive industry provided many examples of successful co-operation. These cases usually included a significant transfer of knowledge, and, in certain cases, also technology. Co-operating Hungarian firms also started to enjoy benefits of the network economy.

*Direct effects of foreign competition affected sales opportunities of domestic firms badly. Out of the 22 companies, 12 reported heavy losses and sales difficulties due to this. On the other hand, they also confirmed improvements in the access of technology and management techniques.*

Direct effects of foreign competition affected sales opportunities of domestic firms badly. Out of the 22 companies, 12 reported heavy losses and sales difficulties due to this. On the other hand, they also confirmed improvements in the access of technology and management techniques - the two major avenues of knowledge transfers through FDI. Due to the competition, they also felt forced to improve product quality and precision, another important benefit of FDI. 14 firms stated that foreign firms contributed to the increase of the costs of skilled labour. In general, 16 of the 22 reported having learnt from the TNCs operating in the local economy. The better competitive position of TNCs was largely due to their size and international networks that enabled them to get lower cost finance and source activities internationally from wherever production cost was lower. Past investment in technology and marketing presented "sunk costs" that could not be counterbalanced by domestic firms easily either.

The questionnaires of foreign firms also supported the existence of a dual structure of the Hungarian economy. Like Hungarian firms, they also felt being their most important competitors. They reported quite high and increasing levels of competition. They obviously work in highly competitive sectors - this is a major reason of their overseas (international)

activity itself. Nevertheless, apart from a number of firms that play a highly specialised role in strict international production network (e.g. JIT Systems), foreign companies usually rely on available local supplies for all kinds of production inputs. This indicates that there are opportunities for local firms to establish supplier links with foreign-owned companies.

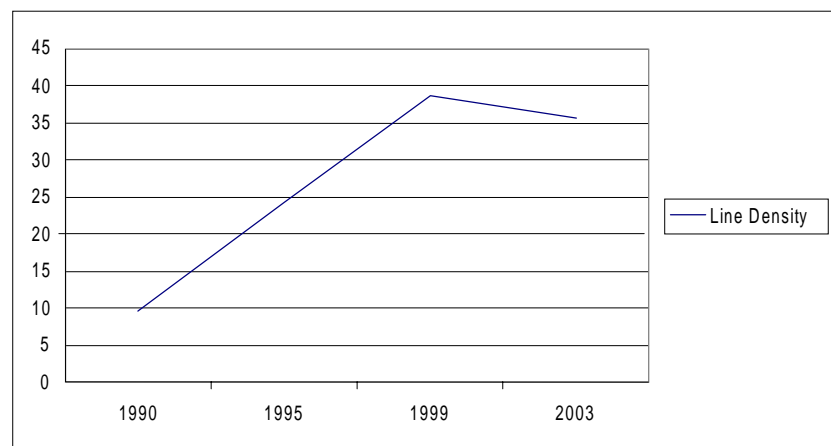
Majority of responding foreign companies reported one or more activities being outsourced. Most frequently, it was informatics, but 4 out of 10 also outsourced production phases. Logistics, sales and accounting also received significant ranking. Nevertheless, there was no indication in the questionnaire if the contractor companies were Hungarian or foreign ones. Thus, for Hungarian firms to become suppliers of TNCs, it may be necessary to compete with other foreign companies.

*It is also of great interest as to where and at what level decisions are taken in multinational companies. There was an important overlap of answers in the case of placement of senior managers.*

It is also of great interest as to where and at what level decisions are taken in multinational companies. There was an important overlap of answers in the case of placement of senior managers. This decision is the most important one, mostly taken in the parent firms' headquarters. In all other aspects, regional and local levels also play a role. In many cases, respondents provided multiple answers, indicating that there are divisions of responsibilities in the single functional areas between the different hierarchical levels.

The case studies also provided interesting results in this respect. In the energy sector, foreign investors left important decisions to be taken at the local level, since these are strictly regulated and not integrated internationally. Pricing as well as investment promotion issues are bargained over with the Hungarian government itself. In many cases, it is not only the Chief Executive Officers (CEOs) of foreign firms that come to Hungary to negotiate but rather a group of CEOs of the most important foreign firms of the affiliates present in Hungary. Whenever this "regulatory negotiation" is finished, conditions are set for several years. Thus, no further major intervention is required.

**Figure 3.3: Development of Wired Telephone Lines in Hungary (No. of lines per 100 inhabitants)**



Source: Central Statistical Office.

*Despite the long period of exclusivity of MATÁV in wired services, there was competition with an important product - the wireless mobile service.*

The case of telecom was somewhat different. It was another fairly strictly regulated market. Despite the long period of exclusivity of MATÁV (the German owned telecom company) in wired services, there was competition in an important product - the wireless mobile service. MATÁV's very impressive results in the improvement of the Hungarian wired phone

*Since automobile affiliates usually work in strict international production systems, almost all the important decisions and functions are delegated to the regional headquarters.*

network and service was partly due to competition and the regulation that required, in exchange for exclusivity, a minimum pace of development. It was, therefore, necessary to take very important decisions, mainly locally, according to the changes in the markets and also in line with the impressive network development project. Highest ranked CEOs of MATÁV were foreigners, while the employment of foreign CEOs in other firms decreased in Hungary by the end of the 1990s. Fifty percent of the responses to the questionnaire indicated that the management was staffed by at least 90 percent Hungarian managers.

In the case of the study of the third sector, automobiles, decision-making patterns were different. Since automobile affiliates usually work in strict international production systems, almost all the important decisions and functions are delegated to the regional headquarters. This is usually the place where the production of a complete product is co-ordinated. In many cases, production is not regional, but truly global, and Hungarian affiliates supply parts to assembly plants all over the world. In this case, most of the important decisions are taken at the global headquarters.

In the case of Suzuki, for example, the choice of local suppliers was a co-ordinated process of the Japanese headquarters and the local affiliate. For Suzuki, it was important to boost local supplies, due to EU local content requirements. But, due to the very strict quality and reliability requirements of car-making, the headquarters maintained strong influence on supplier choice. Other EU-based carmakers did not force an increase in the level of local supplies. Since these decisions are usually not delegated to the local level, it was difficult to deliver to the adequate decision level the message of the Hungarian Government's supplier promotion programmes.

*TNCs only occasionally supported the education of employees, or co-operated in marketing, product development, etc.*

Whenever foreign firms established long-term contacts with Hungarian suppliers, they resorted to facilitating the smooth co-operation through various means of knowledge transfer. Almost all of them reported providing information about standards. Most of them provided technology assistance and established a joint information system with partners. Another important area of assistance was co-operation in quality control systems and the provision of access to advanced tools and technology. These areas of technical support can be regarded as necessary for the technical co-operation among firms. TNCs only occasionally supported the education of employees, or co-operated in marketing, product development, etc.

#### Issues for Comments

- Why was foreign interest low in some segments of the automobile industry?
- What sort of regulatory changes in Hungary and the EU would lead to an expansion of the telecom industry?
- What would be the effect of liberalisation on the electricity sector?



## Analysis of Civil Society Survey

This chapter deals with the problem of social acceptance of foreign-owned companies in Hungary. The modernisation effects of FDI can develop better if there is a social consensus and economic agents as well as individuals are ready and willing to absorb new knowledge.

Transition from centrally planned to market economy was greatly enhanced by FDI in Hungary. FDI played a central role in the privatisation process and directly had a bearing on the transformation of the state-owned sector. This seminal role of FDI was largely due to the positive perceptions of FDI by the public, government and business alike.

*Civil society also had a favourable opinion of FDI. Employees of joint ventures were better paid and enjoyed a variety of fringe benefits.*

The positive experiences with foreign-owned companies had a ten-year-old track record in 1990, when the transition process gained momentum. The legal possibility of founding the first JV with foreign participation was created in the late 1970s. Besides JVs, many Hungarian manufacturers had co-operation contacts with “Western” companies. This co-operation with foreign partners made it easy for the Hungarian state-owned firms to access new technologies and markets.

The Hungarian government supported the creation of linkages with foreign firms. In order to overcome technology access difficulties, technology transfer was expected to spill over through JVs. Quality improvements and new product development was also expected.

Civil society also had a favourable opinion of FDI. Employees of joint ventures were better paid and enjoyed a variety of fringe benefits. The products of JVs were usually of superior quality and performance than competing Hungarian or other “Eastern” products. In the era of the declining economic and social isolation of Hungary, these achievements seemed desirable for most Hungarians.

*The Hungarian manufacturing industry came to be dominated by foreign companies. Also, major service industries like electricity, water supply and telecommunications, and the banking sector received large amounts of foreign investment.*

On the basis of these perceptions, a wide social consensus was created regarding all major aspects of economic and social transition in Hungary. Therefore, despite changes in governments, preference of FDI in privatisation policy remained in place. Regulations advantageous for investors were also put in place, which channelled substantial greenfield investment to the country. As a consequence, the Hungarian manufacturing industry came to be dominated by foreign companies. Also, major service industries like electricity, water supply and telecommunications, and the banking sector received large amounts of foreign investment.

Many of the positive perceptions concerning FDI match with reality. Hungarian affiliates of TNCs were a major engine of growth in the country. They also largely contributed to job creation as it was mainly foreign capital that undertook large investment projects in the country. Domestic firms lacked the necessary capital for that. Adjustment efforts of domestic and foreign privatised firms were compared. Both of these had to scale back previous activities to the size and structure that fitted new market-

oriented production patterns. The main difference was in speed. Foreign firms did downsizing more ruthlessly and efficiently, while Hungarian firms, especially the state-owned ones, tended to be slow in the process. This was partially because they hoped to avoid some cutbacks and partly because they lacked the necessary capital to create, or develop, viable activities.

***Many respondents blamed foreign companies for their decisive restructuring policies and the associated losses.***

Many respondents blamed foreign companies for their decisive restructuring policies and the associated losses. Winding-up of activities, job losses and the reduction of corporate competencies (e.g., closing of R&D departments) were the main discussion points. However, compared to other Hungarian-owned firms, TNCs business policies did not seem to be very different. Adjustment to international co-operation networks requires a recombination of production means, according to the new demand. And, this applies to all firms seeking to become part of the networks, regardless of ownership.

Another frequently heard criticism is that FDI does not help in limiting geographical differences of more and less developed parts of the country. Foreign firms prefer settling in more developed areas with good physical and social infrastructure. This is quite - if they disregard location advantages that competitors enjoy, they will end up on the losing side. This usually applies also to domestic investors, who also tend to invest in more developed areas.

Another critical aspect concerns labour relations. Employers make use of the weak and politically discarded Hungarian trade union background. Observers state that a large part of the impressive increase of labour productivity in Hungary was due to extensive use of labour. The possibilities of moonlighting and overtime were further increased by the most current amendment of the labour Act. But, the extensive use of labour seems to be a general phenomenon rather than a special one for foreign-owned firms.

***Employers make use of the weak and politically discarded Hungarian trade union background.***

The experiences of the last decade with foreign-dominated Hungarian economy did not change much the public perceptions of FDI. This is partly due to foreign firms providing stability and accountability for employees, business partners and the government. The rate of entry and exit of foreign firms is within normal limits. This stability is even more pronounced, because the transition process did not end for most Hungarian ventures. The relatively slow pace of their restructuring and the new challenges posed by the prospects of accession to the EU makes them a little vulnerable. Their rate of entry and exit far exceeds that of foreign firms. This means less stability and security for employees and the public.

The dual structure of the Hungarian economy was also clearly expressed in the responses to policy-related questions. Civil society and domestic business have considered FDI policy differently from foreign-owned companies. All parties agreed, though, that Hungarian capital attraction capacity should be strengthened for FDI contributes to economic development. But, there were differences of opinion on how this policy should be shaped.

In the view of civil society respondents, FDI *per se* should not be the subject of support, but certain development goals should be achieved through it. There was, in fact, unanimity for such purposes like transfer of skills and know-how to local subsidiaries, training of local technical and

*Civil society responses also suggest, though less strongly, conditions like strengthening of sectoral regulation and the support of local business to upgrade employment of local managers and the transfer of skills to local non-affiliate firms.*

managerial personnel, stronger environmental regulation, job creation, and local content requirements. Current FDI policy also contains most of these goals, but less explicitly, especially in the case of technology transfer. Environmental issues are not involved in the incentive schemes at all, though environmental rules do exist and work in Hungary, and these affect FDI decisions as well. Civil society responses also suggest, though less strongly, conditions like strengthening of sectoral regulation and the support of local business to upgrade employment of local managers and the transfer of skills to local non-affiliate firms. These measures would mean a direct and obligatory support for potential competitors or partners.

The number of respondents in the survey was 50. A very small number of the sample had negative perceptions. Most of the responses could be defined as cautiously optimistic. There was also a third group of responses that was characterised by an extremely positive perception. The latter group was clearly differentiated from the slightly positive ones. Their responses usually did not contain any negative statements, only positive ones. The cautious “middle section”, however, raised doubts on some issues, though the balance of their responses was still positive. Some of them agreed with both positive and negative statements, thus producing a close to nil score.

*Foreign investors’ sole interest in capturing local market was the most negative statement. On the other hand, environmental risks were not considered a serious problem.*

The “middle section” played an important role in selecting the most worrisome negative perceptions. Many of them agreed with a number of negative statements. Foreign investors’ sole interest in capturing local market was the most negative statement. On the other hand, environmental risks were not considered a serious problem.

The relatively larger numbers of strong and partial agreements with positive perceptions clearly reflect the overall positive nature of perceptions. Since there were 8 positive and only 5 negative choices, this imbalance in the questions could have diverted opinions towards the positive outcome. This is also the reason why the already mentioned “middle section” was separated from the strongly positive group.

**Table 4.1: Negative Perceptions of Civil Society (Number of Respondents)**

<b>Negative perceptions</b>	<b>Agree strongly</b>	<b>Agree partly</b>	<b>Neither agree nor disagree</b>	<b>Disagree partly</b>	<b>Disagree strongly</b>	<b>Total responses</b>
FDI brings in environmentally harmful technologies	5	9	14	13	9	50
Foreign investors are only interested in getting access to the domestic market	17	6	8	8	11	50
FDI reduces the profitable opportunities available to domestic investors	14	16	12	5	3	50
FDI results out of unfair advantages of multinational firms	14	15	13	3	5	50
Foreign investors do not care about the impact of their investments on civil society	13	13	16	6	2	50

Very strong agreement was recorded concerning the inflow of valuable new technologies, access to world markets, input of valuable new management techniques and the improvement of competitiveness of the national economy. These positive effects were not disputed by civil society representatives.

Positive perceptions	Agree strongly	Agree partly	Neither agree nor disagree	Disagree partly	Disagree strongly	Total responses
FDI makes up for insufficient domestic investment	20	20	4	5	1	50
FDI brings in valuable new technologies	36	10	0	4	0	50
FDI brings in valuable new management techniques	29	15	2	3	1	50
FDI improves the competitiveness of the national economy	28	17	3	2	0	50
FDI increases access to world markets	31	10	5	3	1	50
FDI is a valuable source of foreign capital	21	9	17	0	3	50
FDI helps enhance exports	17	19	9	4	1	50
FDI helps to reduce imports	7	19	16	5	2	49

Out of the 50 responses, 5 or 10 percent represent strong negative perception. On the other hand, 15 or 30 percent, were very strongly in favour of FDI and had important positive experience. The majority of the sample was regarded rather cautiously optimistic. See table 4.3.

	Numbers	Percent
Positively inclined towards FDI	5	10
Neutrally inclined towards FDI	30	60
Negatively inclined towards FDI	15	30

Table 4.4: Policies to Increase the Benefits of FDI									
	Positively Inclined to FDI			Negatively Inclined to FDI			All		
	Yes	No	Don't Know	Yes	No	Don't Know	Yes	No	Don't Know
Support local business to upgrade technology-gain, access to finance, etc.	14	1	0	5	0	0	42	8	0
Strengthen environmental regulation	13	2	0	5	0	0	44	6	0
Strengthen competition policy	8	5	2	4	1	0	32	14	4
Strengthen sectoral regulation	8	3	4	3	1	1	29	14	7
Strengthen labour regulation	7	3	5	3	1	1	20	22	8
Strengthen IPR legislation	11	2	2	4	0	1	25	11	4
Impose requirements on firms to:									
Create jobs	12	1	2	4	0	1	42	5	3
Employ local managers	5	8	2	3	1	1	27	18	5
Transfer technology	10	4	1	5	0	0	41	8	1
Source supplies from local firms or Impose local content norms	10	4	1	4	0	1	39	7	4
Export from the country	4	8	3	2	2	1	24	19	2
Balance foreign exchange impact	3	8	4	0	4	1	19	26	5
Transfer skills and know-how to local subsidiary firms	13	1	1	4	0	1	44	4	2
Transfer skills and know-how to local non-affiliate firms	6	7	2	2	2	1	31	16	3
Train local technical and managerial manpower	14	1	0	4	0	1	46	3	1

As far as policies to increase benefits of FDI are concerned, there were areas where negative, neutral and positive perception groups responded accordingly. Increased support of local business to upgrade technology and improve access to finance, strengthening of environmental regulation, requiring technology transfers to local affiliates and training were almost unanimously suggested by the respondents. Negatively inclined respondents also strongly suggested strengthening of competition policy and Intellectual Property Rights protection, requiring technology transfer, job creation and local sourcing. These policy tools may curtail the freedom of investment decisions, which, in fact, were rejected by many of the strongly positively inclined respondents. But, in fact, there was no striking contrast between the two groups in these questions either. (See table 4.4).

#### Issue for Comments

Would the recent changes in capital attraction factors and the consequent reduction in FDI flows, change civil society perceptions of FDI?



## Conclusion

*The decline in both the demand and the supply side is interpreted as an end of a period of capital attraction.*

There has been a shift in the attraction potential in Hungary. The reserves of the once-successful attraction factors were exhausted. The capital absorption capacity of the country may also have reached saturation. The decline in both the demand and the supply side is interpreted as an end of a period of capital attraction. A revival of capital inflows requires the establishment and strengthening of new attraction features. The argument is supported by several facts .

One reason for exhaustion of capital attraction factors is that the privatisation process is completed in Hungary. By late 1990s, investors, whether interested in penetrating markets or utilising cheap labour, were able to find privatisation opportunities in other transition economies, such as, the Czech Republic, Poland and Slovakia. Fluctuations in privatisation revenues in these transition economies took place with fluctuations in FDI inflows. This indicates that privatisation was the main driving force of FDI in Central European transition economies.

*In the last 10 years, both market and efficiency-seeking investors found plenty of investment opportunities in Central Europe, but this type of investment reached a saturation point in Hungary, and M&As will play a greater role.*

In the last 10 years, both market and efficiency-seeking investors found plenty of investment opportunities in Central Europe, but this type of investment reached a saturation point in Hungary. It is likely that further expansion and investment will take place mainly from investors already present in the markets of Central Europe. Also, mergers and acquisitions (M&As) will play a greater role. A number of major acquisition deals have already been conducted in Hungary among private firms (not to mistake them with privatisation deals, which are, in a sense, also acquisitions). M&As used to be the major driving force of the worldwide skyrocketing FDI during the second-half of 1990s, but the flows slumped with the fall in overall global FDI flows in 2002. Compared to the drop of global FDI flows by two-thirds, the stagnating FDI level of transition economies is a fairly good performance.

Another reason for the saturation was an increase in labour costs. Between 1992 and 1998, real wages increased at slower rate than productivity (even declining in some years), thus decreasing unit labour costs. Between 1998 and 2000, these practically stagnated. Between 2000 and 2002, there were several government measures aimed at increasing salaries and minimum wages. The result was an approximately 30 percent increase in real wages, while productivity only increased by 10 percent. Consequently, unit labour costs increased. In the same period, in other transition economies unit labour costs declined. Hungarian wage costs, therefore, probably increased by 40 percent, relatively to other neighbouring countries, especially if we add the effect of the continuous real appreciation of the local currency. This negatively affected labour-intensive industries and tourism. Also, capital-intensive efficiency-seeking investments, which intended to utilise cheap unskilled labour, were hit. Increasing unit labour costs deteriorated the overall competitive position of the country.

***Fiscal and regulatory incentives were heavily criticised by the European Union in the accession negotiations. They were withdrawn and currently no powerful incentive mechanism is in place.***

A fourth important attraction factor that was very effective in Hungary was fiscal and regulatory incentives. The long tax holidays of corporate income tax were important tools because they effectively created a tax haven in Hungary. Profits of global activity could be channelled to low tax locations. This was especially important in case investors planned to carry out further investments and invested profits that were generated elsewhere in Hungary. Another important tool of attraction was the establishment of industrial free trade zones. These zones provided customs and tax exemption not only for operational purchases but also for fixed assets and investment. Both the incentives were heavily criticised by the European Union in the accession negotiations. They were withdrawn and currently no powerful incentive mechanism is in place.

Mainly due to the above-mentioned changes in the capital attraction tools and conditions, a completely new investment environment has evolved in Hungary. The inflow of FDI will increase again, if the Hungarian economy can provide the necessary conditions for more sophisticated economic activities. The creation of these conditions should be the primary goal of economic policy in future.

***Hungary's role in international labour division requires, most of all, a regular supply of properly educated and healthy labour pool.***

It seems that given the absorption capacity (saturation) of the country, the increasing competitiveness of the neighbours and other regions, as well as the overall decline in FDI, a fundamental change in the current extent and pattern of FDI cannot be expected in near future. The real challenge is, therefore, opening up new opportunities for a new, higher level of integration of the country into the international labour division system.

However, the current national development plan lacks future vision. The increase of Hungary's role in international labour division requires, most of all, a regular supply of properly educated and healthy labour pool. The whole education system and health system should be reorganised. In fact, these were neglected completely. Consequently, the quality and quantity of accessible labour force deteriorated dramatically. The new development plan requires skilled labour that is creative, flexible and properly trained in information technology and also experienced in other sciences.

***Public health services are also in such a situation that they may collapse.***

Public health services are also in such a situation that they may collapse. The deterioration of the health conditions (e.g., the high mortality rate of adult males) is also a consequence of very tough employment conditions. The political turmoil led to the crashing of the trade union system in Hungary. Thus, there is no effective protection of employees' rights. This results in overall deterioration of employment conditions, a continuous overloading of employees by all economic agents: foreign and domestic alike. In fact, weak worker organisations were also important elements of capital attraction. Similar tendencies can be observed in many other countries, but, nevertheless, this leads to declining health conditions. Establishing a stable background of human capital supply is the most important aspect of future development.

***It is also important to create the national lead products.***

It is also important to create the national lead products. There were some trials in this direction, but they all failed, primarily because of the lack of sufficient (financial) support. Campaigns for publicising Hungarian food products were run in many countries with limited success: the food sector, in general, was at a great disadvantage due to massive subsidisation practice of the EU. Now, after joining the EU, this situation may change



over time, though the EU keeps on jealously protecting current producers: for seven more years there will be no equal treatment of current and new members on agriculture and food production. Still, as far as national endowments are concerned, Hungary is poised to be an important and efficient food producer of the European Union.

***Another area of national strength that could be used as a core of future development is information and communication technology.***

Another area of national strength that could be used as a core of future development is information and communication technology (ICT). ICT used to be a successful field of science and also business in Hungary. It was one of the very few sciences that were successfully promoted by subsequent governments. Consequently, there is already a tradition of ICT education in the country, which also resulted in advances in informatics sciences and in business applications. ICT, especially software development, can be another focus of future development.

Stronger support for domestic entrepreneurs would be necessary in order to improve the spread of spillover effects of FDI in the country. Local firms have to grow and develop to the size, technological proficiency and financial strength that provides them a chance of steady contact with multinational companies. The spread of spillover effects should also be enhanced regionally. An important tool for limiting regional disparities is the development of infrastructure. Highway construction proved its role in attracting investments. Important countryside pools of properly educated labour force could be opened for new investments.

***Stronger support for domestic entrepreneurs would be necessary in order to improve the spread of spillover effects of FDI in the country.***

The above listed ambitious policy suggestions require substantial investments. Hungary has not been able to raise so much money. The pace of modernisation crucially depends on two factors. The first is national capital accumulation. This function was also weak during the last few years. This is also a result of the still present high level of uncertainty. Another potential source of investment is EU funding. The EU was rather parsimonious when offering funding for the modernisation process to new entrants. The entry of Spain, Portugal, Greece and Ireland was supported by the EU with larger financial transfers, than the entry of the transition economies. Nevertheless, whatever little EU transfers, may provide the backbone of the national development project envisaged above.

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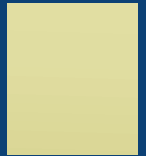
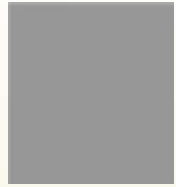
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ISBN 81-8257-021-2