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**OUTWARD FOREIGN DIRECT INVESTMENT**

**IN HUNGARY**

**MOTIVATIONS AND EFFECTS**



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## SUMMARY

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Outward foreign direct investment (OFDI) from Hungary has been increasing since 1997. Until that year, the value of Hungarian investment abroad had been insignificant. Since then, Hungary has become one of the main investors in the CEE region. The quantity and geographical and sectoral distribution of outward investment are heavily influenced by large single projects, which can dominate the annual figures. Apart from the official data, the analysis in this paper was based on a questionnaire survey. The 22 companies that responded represented hardly 2 per cent of the Hungarian companies that have invested abroad, but their investments there amounted to 52 per cent of the total capital placement from Hungary. Thus it covered the large, important investors, who were mainly 'old', traditional, domestically controlled companies that were relatively well capitalized.

Neighbouring countries were clearly favoured by Hungarian investors. Apart from those established in offshore areas, most affiliates of Hungarian companies in the EU or other regions were set up for sales and trading products, while most Hungarian affiliates in the CEE region were production companies. Concerning the market entry modes and forms, acquisition of foreign firms is somewhat more popular than greenfield investment. Hungarian companies prefer 100 per cent ownership. The dominant legal form of the affiliates is a limited company. The main motive for establishing affiliates abroad proved to be the acquisition and expansion of market share and strategic considerations. According to respondents, such expectations were realized, and market share, exports and production increased. Effects on em-

ployment at the parent company were rather neutral.

The most important factors hindering OFDI were said to be host-country risks, followed by financing of investment. Some investors said they would welcome measures by the Hungarian government, banks and other organizations in the fields of providing information and guarantees.

It has been seen that OFDI by Hungarian companies in recent years has become more intensive. Several firms have expanded or plan to do so in the near future. The survey included a question on the plans of companies for their foreign affiliates. Eight respondents said they planned to expand existing affiliates and 10 planned to establish new ones within two years, which means that 82 per cent of the respondents planned to expand soon. In the longer run (the next five years), the figures were 9 and 8 respectively (77 per cent).

The investment strategy and plans of firms are influenced by several factors. The prospects for Hungarian OFDI depend on factors that can be grouped as home-country and host-country factors.

The most important domestic, *home-country factors* were the firm's financial situation and development. Several of the Hungarian companies had begun to prosper, making considerable profits. These profits could be invested in Hungary (assisted by the growth of the domestic market) or abroad. The latter was attractive especially if competition was strong and home markets saturated. (The survey results showed that domestic competition was an important push factor for OFDI.)

The profit-creating capacity of the firms depended, of course, on the trend in the domestic economy. Hungary was showing good results, with average annual GDP increases of 4.8 per cent between 1997 and 2000. The Hungarian productivity increases were also outstanding in the region, while inflation and unemployment were falling. However, the prospects in the immediate future seem to be bleaker, with worldwide recession being forecast. This is already being felt by the multinationals functioning in Hungary, and because of their strong role in the economy, by their many domestic suppliers and partners. The Hungarian economy and industrial output are showing signs of slowing down. Another problem is the sluggish stock exchange, which has caused problems with raising capital for the bigger firms that account for the bulk of Hungarian OFDI.

Turning to *host-country factors*, the most important is the prospect of increasing market share. The survey found that market opportunities in the region were extremely important for Hungarian investors. Future market expansion and economic growth in the neighbouring countries can provide good opportunities. The ongoing privatization process in these countries offers chances of participation. Whether these are taken will depend on the balance between the advantages favouring Hungarian firms (proximity, language, knowledge and contacts) and the drawback of relatively low capitalization compared with Western multinationals.

The trends in *labour costs* and productivity, and possible improvements in human capital, may also play a role in the investment decisions of Hungarian firms, although they have not been significant so far. However, the local *infrastructure* is important. As transport and communications improve, so will the conditions for investment. Another major factor is the *economic policy* of host countries. The macroeconomic situation is less

stable in Eastern European countries than it is in Hungary and inflation is higher. Also significant are direct incentives. The number of special areas, industrial parks and customs-free zones is increasing in neighbouring countries. Certainly, legal and political stability and decreasing bureaucracy are important host-country factors alongside the economic conditions.

All in all, the complexity of the factors influencing Hungarian OFDI makes it very difficult to predict the medium and long-term development of it. In the short term, the rising trend can certainly be expected to continue, although the realization or cancellation of certain large investment projects may be decisive to the outflow figures in particular years.

and the barriers and problems that investing firms face.

## INTRODUCTION\*

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One important phenomenon of the last century has been a rapid increase in the direct investment flows between countries. The spread of globalization and the activity of multinational corporations have been driving forces behind these flows, which have already been analysed from numerous points of view. For less developed countries intent on catching up with the developed economies, the main emphasis is naturally on investment inflows from the latter. This has also been the case in the transformation countries, where inward foreign direct investment (FDI) became in the 1990s a significant source of economic development. Much less attention has been paid to outward investment (OFDI) by these countries, mainly because it was negligible until recently. However, firms in these countries have shown increasing investment activity abroad in the last three or four years. This applies also to Hungary.

The paper begins with an overview of the legislation and macroeconomic situation in Hungary (covering geographical and sectoral distribution and investment in the service sector). It goes on to describe the net investment position of Hungary, attempting to place the country's investment development path and trace the links between inward and outward FDI. The second part analyses the features of outward investment from the firms' point of view, relying partly on the findings of a survey carried out in the first half of 2001. The topics discussed are the motives behind investment, modes of market entry, the effects of investment,

## 1. THE HISTORICAL CONTEXT

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Outward FDI from Hungary existed even in the communist period. The main means of internationalization by firms was exporting, of course, for which the economic system of COMECON created an artificial, regulated geographical structure. According to Oszlay (2000), the main role of OFDI during the period 1950–90 was to offset the effects of this distorted trade structure to some extent. Certainly, the volume of OFDI remained very low and was mainly carried out by foreign-trade organizations in specific industries.<sup>1</sup>

The main targets of the investment activity were Germany and Austria. The OFDI was concentrated on segments in which Hungary was a strong exporter: medical equipment (Medicor), pharmaceuticals (Medimpex) and electrical lighting products (Tungsram). At the end of 1983, Hungary had 107 investments in the West, including 28 in West Germany, 23 in Austria, 10 in the UK, 10 in the United States and 7 in France. There were also 44 investments in the developing South at that time, including 14 in the Middle East, 13 in Africa, 11 in Latin America and 6 in Asia (MCMILLAN, 1987).

Hungarian investment in the West was mainly undertaken to support exports in target countries. The main fields of activity were services (transport, financial and consumer services) and to a small extent manufacturing. In the developing countries, however, export

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<sup>1</sup> This applies even though Hungary, unlike other COMECON countries, allowed firms to effect OFDI without the mediation of foreign trade organizations.

promotion and trade were secondary to the establishment of production facilities and the related infrastructure, and access to raw materials.

Some of these foreign subsidiaries survived the change of system in 1989, but the majority of them were wound up when their parent companies were restructured. At the same time, some agencies of former foreign trade organizations became independent ventures (OSZLAY, 2000).

## 2. LEGISLATION AND AN OVERVIEW AT THE END OF THE 1990s

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The *legal framework* for OFDI in Hungary today is comparable to the one in any developed market economy. Before 1995, outward investment was tied to a case-by-case permit procedure. Permits were issued by the Ministry of Finance and the Ministry of Industry and Trade. With the passage of Act XCV/1995 on foreign exchange, residents in Hungary were able, from January 1996 onwards, to establish or acquire companies or stakes without a permit, although registration at the National Bank of Hungary (NBH) remains necessary, under the following conditions:<sup>2</sup>

- \* The stake to be acquired made up more than 10 per cent of the target company's capital.
- \* The laws of the host country permitted the repatriation of dividends and profits.
- \* The investor fulfilled domestic tax, customs, social insurance and similar regulations and had no debts or liabilities towards the authorities.

- \* The investor had not been subject to insolvency or liquidation proceedings in the previous two years.

If these conditions were not met, a preliminary permit was required.

On June 15, 2001, the Hungarian government lifted all foreign-exchange restrictions and introduced full convertibility of the forint. This means that Hungarian residents may open forint and foreign-currency accounts abroad without applying for permission from the authorities, and direct acquisitions of business associations abroad are exempt from normative criteria and prior notice. This means that firms investing abroad will not be registered at all.

The available data on outward investment is far from adequate. Between 1991 and 1995, the Ministry of Industry and Trade issued detailed reports analysing OFDI. Control over OFDI passed in 1996 to the NBH, but information was made available about the number of investments and the target countries only in 1996–7 and again from 1999. Since 1999, the NBH, as a kind of check on the balance-of-payment figures, collects survey information on flow and stock data from firms that have invested more than HUF 10 million abroad. Last year, the NBH requested information from 191 of the 1187 legal entities registered as investing abroad.<sup>3</sup> These reports are not published, but they are the source of the geographical and sectoral distribution tables of OFDI flows published and sent to Eurostat and the OECD. (Unfortunately, the surveys are not processed or analysed according to the form or structure of the ownership of the investment.) The NBH does not publish sectoral data or data on the geographical distribution of the OFDI holdings.

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<sup>2</sup> For more detail, see Oszlay (2000).

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<sup>3</sup> These 191 firms include 46 productive (manufacturing) companies and others in construction, trade, services or investment. Budapest is the headquarters of 101 of the firms.

Nor is there any information available on non-cash investments in kind. Thus, the data availability and statistical system in Hungary is not perfect and it is not really possible to compile a consistent time series. The structure and the development of the OFDI cannot be analysed thoroughly, so that this paper can only hint at certain tendencies. Apart from the 'central data-source' questionnaires, there have also been some informative case studies and interviews about some companies.

Table 1  
Country profile: Hungary

|                       | 1993  | 1994  | 1995  | 1996  | 1997  | 1998  | 1999  | 2000  |
|-----------------------|-------|-------|-------|-------|-------|-------|-------|-------|
| Real GDP growth (%)   | -0.6  | 2.9   | 1.5   | 1.3   | 4.6   | 4.9   | 4.5   | 5.2   |
| GDP per capita (USD)  | 3745  | 4046  | 4367  | 4433  | 4504  | 4710  | 4808  | 4570  |
| Inflation (CPI)       | 22.5  | 18.8  | 28.2  | 23.6  | 18.3  | 14.3  | 10.0  | 9.8   |
| Unemployment rate (%) | 15.2  | 12.0  | 11.7  | 9.9   | 8.7   | 7.8   | 7.0   | 6.4   |
| Exports/GDP           | 23    | 26    | 29    | 30    | 40    | 49    | 52    | 61    |
| Imports/GDP           | 33    | 35    | 34    | 35    | 45    | 55    | 58    | 70    |
| Agriculture/GDP       | 6.5   | 6.7   | 7.2   | 6.5   | 6.3   | 5.8   | 4.9   | 4.3   |
| Industry/ GDP         | 26.2  | 25.3  | 26.9  | 26.4  | 28.2  | 29.4  | 28.0  | 31.5  |
| Services /GDP         | 61.8  | 62.8  | 60.9  | 62.9  | 61.1  | 60.1  | 62.5  | 59.6  |
| HUF/USD               | 92.03 | 105.1 | 125.7 | 152.5 | 186.7 | 214.4 | 237.3 | 282.2 |
| HUF/EUR               | 107.5 | 124.8 | 162.6 | 191.1 | 210.9 | 240.9 | 252.8 | 260.1 |

Sources: Central Statistical Office (CSO) and NBH data.

Let us turn to the *macroeconomic features* of OFDI from Hungary. The end of the state-socialist economic system and the cataclysmic loss the old COMECON markets put Hungarian firms through a certain learning process about the market economy, liberalization and increased competition, and the entry of foreign capital. By the mid-1990s, the situation

for the survivors had stabilized and the big quoted companies especially had gained the strength and capital to venture into OFDI.

The data in Table 2 derive from the balance-of-payments statistics, which register OFDI since 1993 and inter-company loans since 1996. Between 1993 and 1996, OFDI from Hungary was sporadic and almost negligible, but it has gained momentum since 1997. Hungary, with €389 million of OFDI in 1997, became and remains the most important investor in the Central and Eastern European (CEE) region. The year 2001 showed an exceptionally high share of inter-company loans. In 1998 and 2000, Hungarian OFDI reached remarkable heights (€621 million in 2000). As a consequence, the overall stock of OFDI was around €2.3 billion at the end of 2001 (equivalent to almost one-tenth of the inward FDI stock). In 2001, the outflow of FDI was €377 million.

Table 2  
OFDI from Hungary

|                                    | 1993                                      | 1994 | 1995 | 1996  | 1997 | 1998 | 1999 | 2000 | 2001 |
|------------------------------------|-------------------------------------------|------|------|-------|------|------|------|------|------|
|                                    | Balance-of-payments statistics, € million |      |      |       |      |      |      |      |      |
| Balance of equity and other shares | 9.4                                       | 41.2 | 33.3 | 43.1* | 258  | 412  | 235  | 621  | 358  |
| Balance of inter-company loans     | N/A                                       | N/A  | N/A  | 0     | 131  | 16   | 2    | -18  | 19   |
| Total                              | 9.4                                       | 41.2 | 33.3 | 43.1* | 389  | 428  | 237  | 603  | 377  |
| End-year stock of equity**         | -                                         | -    | -    | -     | -    | 1169 | 1376 | 1915 | 2331 |
| Interconnected loans               | -                                         | -    | -    | -     | -    | 117  | 192  | 248  | 378  |

\* Excluding a €45.5 million divestment by the National Bank of Hungary.

\*\* Stock is calculated from cumulative flows at the NBH.

Source: NBH.

With the *geographical distribution* of annual flows (stock figures are not available), it should be borne in mind that data between 1996 and 1998 were based on investment intentions registered with the NBH. The intentions in a certain year, however, were often realized only in the succeeding year (or never realized at all), so that the sum of these data differs sometimes considerably from the balance-of-payments data. In 1996, the total value of intentions was somewhat higher than the balance-of-payments data, but in

CEE region, above all Slovakia and Romania.

The main destination of investment intention in 1997 was the EU again. Once more, tax avoidance presumably played the main role, but instead of the Channel Islands, the recipient was the Netherlands, which received 78 per cent of the OFDI from Hungary to the EU. (The Netherlands Antilles forms a popular transit destination for investors, because of its very favourable tax regime. In most

cases, an affiliate established in the Netherlands transfers the investment by the parent company to another, final destination. The same applies with inward FDI, where the Dutch share of flows into Hungary is again very high, as it is of flows into Spain and Portugal.<sup>4</sup>)

Apart from such tax-related flows, there was substantial OFDI from Hungary to Austria,<sup>5</sup> but the main des-

Table 3  
Main destinations of OFDI from Hungary  
(%)

|                                | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 |
|--------------------------------|------|------|------|------|------|------|------|------|
| Austria                        | 8.7  | 2.3  | 15.0 | 5.5  | 11.6 | 12.3 | 7.3  | 5.3  |
| Czech Republic<br>and Slovakia | 15.5 | 0.7  | 16.4 | 8.9  | 3.6  | 0.6  | 4.9  | 55.8 |
| Romania                        | 3.8  | 13.5 | 20.5 | 8.5  | 7.6  | 5.7  | 24.0 | 1.5  |
| Germany                        | 8.2  | 3.1  | 10.0 | 2.2  | 3.7  | 1.7  | 2.9  | 7.2  |
| Cyprus                         | N/A  | N/A  | N/A  | 0.6  | 0.7  | 9.8  | 7.7  | 6.1  |
| Denmark                        | -    | -    | -    | -    | -    | -    | -    | 21.7 |
| Netherlands                    | N/A  | N/A  | N/A  | 0.7  | 61.8 | 23.2 | 18.2 | 1.5  |
| United States                  | N/A  | N/A  | N/A  | 4.9  | 2.9  | 0.3  | 16.7 | 1.0  |
| Poland                         | N/A  | N/A  | N/A  | 0.6  | 1.2  | 1.5  | 4.5  | 0.6  |

Source: NBH (registered intentions 1996–8).

1997, it was vice-versa: the balance-of-payments data were higher than the value of the registered intentions. (This means that intentions in the previous year were being realized in 1997.) The situation has been better since 1999, because the geographical structure of the balance-of-payments data (not the intentions any more) has been made available by the NBH.

High year-to-year fluctuations can be observed in the destinations of the OFDI (Table 3). In 1996, 26.7 per cent of the registered investment intentions were directed to CEE countries and 66 per cent to the EU (ANTALÓCZY *et al.*, 2000). However, 80 per cent of the latter was investment in the Channel Islands, with obvious tax motives. Excluding that, the real investments were realized mainly in the

<sup>4</sup> In 1996, for example, 23 per cent of the FDI flow into Spain came statistically from the Netherlands, but only 4.6 per cent really originated in the Netherlands (data from the Spanish Ministry of Industry).

<sup>5</sup> Regarding the amounts invested in *Austria*, the bulk came from a few big Hungarian companies with the necessary capital to establish and maintain trading affiliates abroad. Examples include *MOL Austria Handels GmbH* and *BorsodChem Handelsgesellschaft mbH*. Another big firm, *Neuer Hungarostahl*, is jointly owned. The Hungarian firm Hungexpo had a joint affiliate in Vienna, *Expo-concept*, with Wiener Messen, but this closed after disagreements among the owners. Representative offices of previously big Hungarian foreign trade organizations were converted into companies in some cases, such as *Hungarian Industries-Beteiligungen GmbH*, in which Hungarian textile companies have shares (see Box 4). Apart from the big players, several small-scale businesses

tion remained the CEE region, with Slovakia and Romania to the fore.

In 1998, the Netherlands absorbed 23 per cent of Hungary's OFDI, Switzerland 36.9 per cent and Cyprus almost 10 per cent. Presumably, the main motive remained tax avoidance. Austria remained the most significant EU destination with 12.3 per cent. The CEE region took 18 per cent.

The situation began to change in 1999. The neighbouring CEE region became the main destination of Hungarian OFDI, with Romania the commonest target. The EU absorbed 29.8 per cent of the investment (61 per cent of this went to the Netherlands and 25 per cent to Austria). Interestingly, 'third' countries such as the United States, Canada and South Korea received 22 per cent of Hungary's OFDI.

The dominance of the neighbouring countries continued in 2000, with more than 57 per cent of the OFDI being directed to the CEE region. This is due to the acquisition by the MOL fuels company of a large stake in the Slovak corporation Slovnaft. Romania had a much smaller share than in the previous year, while 1.7 per cent of the investment went to Russia. Regarding the EU, 36.5 per cent of the OFDI was directed there, with Germany and Austria remaining important destinations. However, Denmark

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have set up joint ventures with Austrian partners, unsuccessfully in some cases. According to estimates, about 200 wholly or partly Hungarian firms are present in Austria (information from Károly Bedő, ITDH Trade Office, Vienna). Austria can play an intermediary role in investment as well as in trade. The Hungarian firm Gardenia (textiles, curtains, see Box 4) founded a holding company there at the beginning of the 1990s, through which it channelled investment to the Slovak Republic and Croatia. Intermediary procedures of this kind may help to circumvent national prejudices in the receiving country and obtain better credit conditions there (Antalóczy *et al.*, 2000).

also appeared, with the largest, 21.7 per cent share of the Hungarian OFDI. This could be attributed to an investment by Sara Lee Hungary (see Note 24). Investment in the Netherlands and the United States declined. The year also differs from the others concerning divestments. These had been negligible until 1999, but in 2000, a total of €54 million was divested.

Table 4  
Geographical distribution of OFDI flows  
from Hungarian residents in 2000

| Country                     | Divestment         | Investment | Balance |
|-----------------------------|--------------------|------------|---------|
|                             | Equity (€ million) |            |         |
| USA                         | 0.8                | 7.5        | -6.7    |
| Australia                   | 0.1                | 0.2        | -0.0    |
| Austria                     | 2.0                | 35.2       | -33.3   |
| Belgium                     | 0.4                | 1.3        | -0.9    |
| Bulgaria                    | -                  | 0.1        | -0.1    |
| Cyprus                      | -                  | 38.0       | -38.0   |
| Czech Republic              | -                  | 46.7       | -46.7   |
| Denmark                     | -                  | 136.0      | -136.0  |
| South Korea                 | 11.7               | 0.0        | 11.7    |
| France                      | 0.1                | 0.6        | -0.5    |
| Netherlands                 | 0.2                | 10.0       | -9.7    |
| Croatia                     | 0.0                | 3.4        | -3.4    |
| Ireland                     | -                  | 0.1        | -0.1    |
| Japan                       | -                  | 0.4        | -0.4    |
| Yugoslavia                  | -                  | 0.1        | -0.1    |
| Canada                      | 0.0                | 0.4        | -0.4    |
| Poland                      | -                  | 4.4        | -4.4    |
| Liechtenstein               | -                  | 0.4        | -0.4    |
| Malta                       | 19.6               | -          | 19.6    |
| Moldova                     | -                  | 0.1        | -0.1    |
| UK                          | 0.1                | 0.6        | -0.6    |
| Germany                     | 4.6                | 49.3       | -44.7   |
| Italy                       | 0.2                | 0.5        | -0.3    |
| Russia                      | 0.0                | 11.1       | -11.1   |
| Armenia                     | -                  | 0.1        | -0.1    |
| Romania                     | 7.4                | 16.9       | -9.5    |
| Spain                       | 0.2                | 1.8        | -1.6    |
| Switzerland                 | 6.4                | 1.0        | 5.4     |
| Sweden                      | -                  | 0.2        | -0.2    |
| Slovak Republic             | -                  | 299.9      | -299.9  |
| Slovenia                    | -                  | 0.4        | -0.4    |
| Ukraine                     | -                  | 2.2        | -2.2    |
| International organizations | -                  | 6.4        | -6.4    |
| TOTAL                       | 53.9               | 675.2      | -621.3  |

Source: NBH.



As Table 4 shows, this included €19.6 million from Malta, €6.4 million from Switzerland, €7.4 million from Romania and €11.7 million from South Korea – the same amount that had been invested there a year previously.

In the first half of 2001, there was an important amount of investment (€301 million) directed towards Macedonia, due to the acquisition of the Macedonian telecom company MakTel by the Hungarian one MATÁV. The deal dominated OFDI flow last year, and the CEE region became the major target area in the geographical distribution of Hungarian OFDI once again. (As far as divestment in 2001 is concerned, €11.8 million was withdrawn from Germany, and 6.3 million and 46 million from Austria in March and December respectively.) For 2002 the acquisition of the Slovak Investicna a Rozvojova Banka by the OTP Bank seems certain.

Based on 1999–2000 data, some inkling of the *sectoral distribution* of Hungarian OFDI can be obtained. (Unfortunately, there are no such data on OFDI stocks.) Table 5 shows that the bulk of the OFDI derives from the manufacturing sector, within which oil refining occupies an important place in both years, due to the investments by MOL. The second most important sector for OFDI is trade.

Table 5  
Sectoral distribution of OFDI flows

| Sector of parent (investor) | 1999                   | 2000 |
|-----------------------------|------------------------|------|
|                             | Net equity capital (%) |      |
| Manufacturing               | 63.3                   | 64.0 |
| Wood, paper                 | 2.7                    | 2.2  |
| Refined petroleum           | 34.0                   | 53.2 |
| Chemical products           | 7.4                    | 6.8  |
| Electricity, gas            | 0.0                    | 4.0  |
| Trade and repairs           | 6.9                    | 19.7 |
| Hotels and restaurants      | 2.3                    | 3.7  |
| Transports, communication   | 0.2                    | 0.1  |
| Financial services          | 13.4                   | 0.0* |
| Real estate                 | 2.9                    | 4.1  |

\* €7.3 million divestment in monetary services.

Source: Own calculations from NBH data.

If the OFDI flows are divided into EU and non-EU countries and the United States, a considerable EU/non-EU difference in structure becomes apparent. The trade and repairs sector dominates Hungary's OFDI to EU countries, while manufacturing leads to non-EU countries (Table 6). Concentration is a prominent feature of the investment in the EU, with 93 per cent of the manufacturing capital going to Germany (mainly to wood and printing and to refined petroleum) and 98 per cent of the trade-sector investment going to Denmark (the investment by Sara Lee, see Note 24).

Table 6  
Sectoral distribution of OFDI flows in 2000  
by region

| Sector of parent (investor) | EU                     | Non-EU  | US   |
|-----------------------------|------------------------|---------|------|
|                             | Net equity capital (%) |         |      |
| Manufacturing               | 19.7                   | 91.0    | 29.4 |
| Wood, paper                 | 4.4                    | 1.0     | 0.0  |
| Refined petroleum           | 8.2                    | 80.4    | 9.9  |
| Chemical products           | 0.0                    | 11.0    | 18.0 |
| Electricity, gas            | 0.0                    | 6.4     | 40.9 |
| Trade and repairs           | 60.7                   | div.    | div. |
| Hotels and restaurants      | 0.0                    | 5.9     | 0.1  |
| Transports, communication   | 0.1                    | div.    | 3.3  |
| Financial services          | 8.4                    | 1.7     | 5.7  |
| Real estate                 | 100                    | 100     | 100  |
|                             | Germany                | Denmark | EU   |
| Manufacturing               | 93.0                   | 0.0     | 100  |
| Trade                       | 0.5                    | 98.0    | 100  |

Source: Own calculations from NBH data.

### 3. OFDI IN THE SERVICES

Traditionally, services were considered to be domestically oriented and not liable to move across border. However, globalization and the rapid expansion of information and communication techniques have brought rapid internationalization of services. Furthermore, increased competition has forced govern-

ments to deregulate national systems of protection round the service sector. This liberalization has reached telecommunications, transport, banking and other branches. Outward investment, as well as exports, now affects the service sectors. Indeed the share of the services in the FDI flows among developed countries is rising (LICHTBLAU, 2000).

Increasing amounts of FDI flowed into the service, financial and real-estate segments in the CEE countries during the 1990s. In Hungary's case, 18.5 per cent of the FDI inflows in 2000 went to the trade and repair sector, 29.7 per cent to real estate and financial services, and 11.5 per cent to transport and telecommunications, making altogether 62 per cent for the services.<sup>6</sup>

Analysis of outward investment in the services is complicated by the lack of requisite data and information (STARE, 2000). Macroeconomic OFDI data on services are restricted to short periods and not broken down by sectors or countries. According to NBH data, the services account for about 25 per cent of Hungary's outward investment in equity (Table 7). This consists mainly of OFDI in trade, but real estate and hotels and catering are also represented. The dominant destination was the EU (Denmark) in 2000. It should be noted that the sums invested are relatively small, so that one major investment can influence the sectoral and geographical distribution considerably.

Some information additional to the macroeconomic data can be collected from firms and from the press. Based on these sources, it seems that some Hungarian service companies have made steps to expand into neighbouring countries in the last year or two. Here are some of the more significant instances.

Table 7  
Sectoral distribution of Hungary's  
OFDI flows in the services

|                            | 1999               |      | 2000      |      |
|----------------------------|--------------------|------|-----------|------|
|                            | HUF<br>bn          | %    | HUF<br>bn | %    |
|                            | Net equity capital |      |           |      |
| Trade and repairs          | 4.17               | 6.9  | 32.27     | 19.7 |
| Hotels and restaurants     | 1.41               | 2.3  | 6.03      | 3.7  |
| Transports, communications | 0.17               | 0.2  | 0.22      | 0.1  |
| Transport                  | 0.0                | 0.0  | 0.18      | 0.1  |
| Communications             | 0.17               | 0.2  | 0.04      | 0.0  |
| Financial services         | 7.99               | 13.4 | - 1.84    | 0.0  |
| Monetary services          | 7.99               | 13.4 | - 1.9     | 0.0  |
| Insurance                  | 0.00               | 0.0  | 0.07      | 0.0  |
| Real estate                | 1.73               | 2.9  | 6.83      | 4.1  |
| OFDI in services           | 15.5               | 25.9 | 43.5      | 26.5 |
| Total OFDI                 | 59.7               | 100  | 163.7     | 100  |

Source: NBH.

*Danubius Hotels* was privatized and introduced on the stock exchange in 1993-4. CP Holdings, a British company, holds a majority stake, but there is also Hungarian, Israeli and American capital involved. In 1997-8, the firm was transformed to a holding company. It owns 15.1 per cent of all the hotel capacity in Hungary (most of it in 4-star hotels). Danubius made its first foreign acquisition in 1999, when it paid USD 3.6 million for the Villa Butterfly at Marienské Lazné in the Czech Republic. This four-star hotel fulfilled expectations and became popular. As its next step, Danubius bought in May 2000 a 65 per cent share in Lecebne Lazné Marienské Lazné s.a, which runs the spa complex in the resort. It paid USD 16 million, half of it borrowed money.<sup>7</sup> In 2001, Danubius (with 20 per cent) and three other companies established Salina Invest Srl. in Romania, which acquired 82.17 per cent ownership of the Sovata spa centre (and use of the Medve Lake for 20 years). The venture undertook to invest a further USD 5 million in the spa over the following two years.<sup>8</sup> Danubius plans to expand further

<sup>6</sup> NBH data.

<sup>7</sup> *Üzleti Hét* (Business Week), July 3, 2000.

<sup>8</sup> *Figyelő* (Observer), No.33, August 2001.

in the CEE countries, but decrease the number of its employees by 10 per cent. The company considers that the Hungarian hotel market is saturated and there are many competitors, whereas obvious growth opportunities are available in the neighbouring countries. In February 2002 Danubius gained the tender for the 67 per cent of the Piestany spa complex in Slovakia. The price Danubius pays is USD 20 million with a promise to invest a further 13 million until 2006. The complex has accommodations for 2700 persons and, in general, 60 per cent of the foreign tourists visit it.<sup>9</sup>

The Hungarian telecom group MATÁV headed a consortium that acquired 51 per cent ownership of MakTel in the FYR Macedonia. The investment was financed by a loan from Deutsche Telekom, which owns a majority share in MATÁV, the payment of €343 million being made mainly in January 2001. The investment offers a new market for MATÁV. MakTel holds a monopoly in the FYR Macedonia until 2005. It had 507,000 fixed-line subscribers (25 per cent of the population) and 110,000 GSM mobile-phone clients at the end of 2000 and it was also the leading Internet supplier in the country, with 10,000 accounts.<sup>10</sup> This leaves important growth potential. MATÁV aims to spend an annual €100 million on its affiliate, increasing its subscriber base, digitalizing lines, laying optical cables, introducing new mobile tariff packages and the developing Internet service. (MakTel developed dynamically, reached 549,988 fixed line, 233,820 mobile and 21,674 Internet subscribers by December 31, 2001.) There are signs that MATÁV is also interested in the privatisation of Serbian and Bulgarian companies,

as a further move towards regional expansion.<sup>11</sup>

In June 2001,<sup>12</sup> the leading personal bank in Hungary, *OTP Bank*, made an offer for the majority of the Slovak Investičná a Rozvojová Banka (IRB) which had been offered for privatization (70 per cent to be acquired from the state and 23 per cent from an insurance company). The price of USD 14 million is approximately equal to a quarter of OTP's profits in 2000, so that the acquisition can easily be financed. The Slovak company is a medium-sized bank with 47 branches, a 3 per cent market share and a portfolio of companies.<sup>13</sup> This is the first step in a Central European strategy in which OTP intends to invest its considerable profits in neighbouring countries. The management argues that OTP is better known in Slovakia than the bigger Western banks and the large indigenous Hungarian minority is also possible client. However, an OTP-owned IRB will have to prepare itself for fierce competition on the Slovak market with its Western rivals.<sup>14</sup>

Another major Hungarian bank, *MKB (Hungarian Foreign Trade Bank)* also aspires to a regional role. It was among the few banks to retain its capital strength and financial stability over the transformation period. Privatization ensued in 1994–6, when the Bayerische Landesbank (BLB) acquired a majority stake. Subsequent capital injections and share transactions have left BLB Girozentrale of Munich with 89.27 per cent of MKB, Bank für Arbeit und Wirtschaft (BAWAG) of Vienna with 10.38 per cent and 0.35 per cent in the hands of others. MKB's objective is to develop strongly in the CEE region, which is made easier by being part of the BLB group. MKB has

<sup>9</sup> *Napi Gazdaság* (Daily Economy), February 18, 2002.

<sup>10</sup> The information derives from a MATÁV press release in April 2001.

<sup>11</sup> MATÁV press release, August 14, 2001.

<sup>12</sup> *Világgazdaság* (World Economy), June 6, 2001.

<sup>13</sup> IRB also finances Slovnaft, which is an affiliate of the Hungarian fuels group MOL.

<sup>14</sup> *Business Central Europe*, May 2001.

three regional representative offices, in Bucharest, Bratislava and Ljubljana, and two banking subsidiaries. MKB ownership of Convest Banka Zagreb rose to 100 per cent in April 2001, while Interbanka Prague has been owned jointly since 1997 by Bayerische Landesbank Girozentrale (59 per cent), MKB (33 per cent) and BAWAG (8 per cent).<sup>15</sup>

Quite important examples of OFDI exist in *construction*. The Hungarian construction industry has been growing faster than GDP (it was 5.8 per cent in 2000 and 9.9 per cent in 2001). There has been a steady increase in construction employment since 1997. Small and micro firms dominate in the branch, with 62 per cent of output deriving from firms with less than 50 employees. Internationally, the construction industry is considered inward looking, but Hungarian construction firms have established a foreign presence. The wholly Hungarian-owned KÉSZ group owns two firms in Yugoslavia and established in 2001 a company in Romania (SC KÉSZ Srl) for construction projects. It plans a further one in Croatia. KÉSZ has 1100 employees, HUF 35 billion net sales and HUF 1.5 billion nominal capital in Hungary.<sup>16</sup> A further construction related project is the renovation and functioning of the Rijeka Port, which is carried out by a majority Hungarian owned joint venture (49 per cent Croatian), Ganz Port Rijeka Rt (established in September 1999). The company received a 33-year concession to build and use a terminal for storing 400-600 tons of soy and other agricultural products a year. The USD 28 million investment is due to end in 2003, and according to plans 60 per cent of the subcontractors will be Hungarian firms. Ganz Port Rijeka also won another tender to renovate seven port cranes for USD 3 million, financed by the Croatian State. As far as infrastructure is concerned, the modernisation

of the Budapest-Ploce railway line until 2007, as part of the Fifth European Corridor, is planned with the assistance of EIB and EBRD and EU funds. Similarly, the building of Budapest-Osiek-Rijeka motorway is being planned. Electrosoft Holding from Hungary and the Hargita Council have established a joint venture in Romania (Hargita-Gaz) to install gas lines. The reconstruction and re-building in the neighbouring area will certainly enhance the outward investment activity of Hungarian construction firms in the future.

#### 4. FDI, OFDI AND HUNGARY'S NET INVESTMENT POSITION

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Economic openness is essential in a small country without significant natural resources. Small economies tend to be more internationalized than large economies, and therefore more influenced by external factors. Hungary's degree of openness increased considerably in the 1990s. Quantitative restrictions of trade were abolished, customs tariffs were reduced, and trade in industrial products with the EU and CEFTA was freed. The proportion of exports to GDP in 2000 was 61 per cent and that of imports to GDP 70 per cent, while exports per capita reached USD 2797.<sup>17</sup>

Table 8 shows the degree of openness in selected small European countries (and Poland). Except for Ireland and Estonia, with their extreme degrees of openness, Slovakia and Hungary are the most open countries in terms of their foreign trade/GDP ratios. Austria and Slovenia show much higher exports per capita than Hungary, whose figure is similar to those of Portugal and the Czech Republic. With inward and outward FDI stock/per capita, the EU members in the

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<sup>15</sup> [www.mkb.hu](http://www.mkb.hu).

<sup>16</sup> *Világgazdaság*, September 2001.

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<sup>17</sup> Based on CSO data.

Table 8  
Openness and FDI in selected countries in 2000

|                | Exports/GDP (%) | Imports/GDP (%) | Exports per capita (USD) | FDI stock per capita (USD) | OFDI stock per capita (USD) |
|----------------|-----------------|-----------------|--------------------------|----------------------------|-----------------------------|
| Portugal       | 23.5            | 36.9            | 2474                     | 2656                       | 1735                        |
| Ireland        | 78.0            | 50.8            | 19301                    | 16905                      | 4866                        |
| Austria        | 33.8            | 35.2            | 7927                     | 3489                       | 2569                        |
| Czech Republic | 58.5            | 65.0            | 2820                     | 1947                       | 163                         |
| Slovakia       | 61.7            | 70.0            | 2189                     | 690                        | 59                          |
| Slovenia       | 48.6            | 54.5            | 4433                     | 1510                       | 401                         |
| Hungary        | 61.0            | 70.0            | 2797                     | 1988                       | 199                         |
| Estonia        | 63.1            | 85.7            | 2014                     | 2640                       | 173                         |
| Poland         | 30.8            | 19.9            | 819                      | 830                        | 38.6                        |

Sources: Own calculations from IMF, OECD and national balance-of-payments statistics.

table are well ahead of the transition countries. The difference in openness between small and large countries is exemplified by the figures for Poland.

The effects of FDI on small countries can be greater than those on large ones and generally include trade augmentation (CASTELLO *et al.*, 1997). Small countries are more dependent on inward investment in their early stages of development and then become more strongly oriented towards outward investment. FDI can help small countries to overcome economic constraints, bring them new contacts and markets, obtain them access to new technologies, and promote further openness.<sup>18</sup> Small, open economies are generally dominated by a handful of big firms and numerous small firms (HOGENBIRK AND NARULA, 1999), with big-firm activity determinant. This applies also to Hungary, where three multinationals (Audi, IBM and Philips) ac-

count for 18.3 per cent of total manufacturing net sales and 34 per cent of total manufacturing exports.<sup>19</sup>

The 1990s in Hungary can be divided into two periods in terms of the macroeconomic flows of FDI and OFDI. Up to 1996, Hungary was receiving relatively large amounts of FDI, with significant year-by-year fluctuations (*Figure 1*). These fluctuations were connected with certain large privatization deals, such as the sale of the telecom service provider (1993) and much of the energy sector (1995). OFDI, on the other hand, was almost non-existent in this first period.

The second period started after 1996. The fluctuations in inward FDI ceased, leaving a stable flow of about €1.6 billion a year. Meanwhile OFDI began to grow. However, it should be borne in mind that the inward FDI flows remain considerably greater (about 1.7 times as high), because of reinvested profits. Despite promises to this effect, the NBH has failed so far to publish reinvestment figures, so that the figures for Hungary's FDI flows are not comparable with those of neighbouring countries.

The significance of FDI in the Hungarian economy is unquestionable. It is

<sup>18</sup> Bellak (1997) points out that the small CEE countries have a long-term interest in inward FDI. They can import technology via multinational corporations, which can be applied in a flexible way by small domestic firms as well. Furthermore, productivity increases and favourable location factors create an appropriate environment for multinationals to outsource and subcontract. It is apparent today that the activity of large, well-capitalized multinationals has tied the CEE countries into the globalization process.

<sup>19</sup> If GE, Flextronics and GM are added, the proportions rise to 23.4 per cent and 42 per cent. (Own calculations based on *Figyelő* Top 200.)

very high by international standards, if the FDI stock/GDP ratio is taken as the measure, for example. *Table 9* shows that Hungary has by far the highest share of FDI stock/GDP of any CEE country.<sup>20</sup> Compared with the EU countries in the table, Portugal and Austria have much smaller shares and Ireland a much higher one. The role of foreign investor firms is extremely significant in the Hungarian economy. In 1999, foreign investors accounted for 88 per cent of exports by Hungarian manufacturing, 71 per cent of the value added, 72 per cent of the nominal capital, and 47 per cent of the employment.<sup>21</sup>

According to several authors, the level of FDI and net investment position of a country can bring about a certain development level. The 'investment development path' (IDP) theory introduced by Dunning (1981) assumes an association between a country's level of development (GDP/capita) and its international investment (net FDI) position. The main assumption is that as a country develops, the conditions for domestic and foreign firms change, affecting the flows of inward and outward FDI. However, FDI affects the economic structure as well, so that there is a dynamic interaction between the two. IDP theory classifies countries in four main groups corresponding to four stages of development. (1) There is almost no inward and outward FDI. The domestic market is very small, the infrastructure inadequate and the labour force mainly unskilled. There are insufficient location-specific advantages offered. The development through local policies of some location advantages (such as infrastructure) leads to (2), which is characterized

by more inward investment, mainly aimed to the domestic market. Outward investment is still very little and domestic firms lack ownership advantages. (3) The growth of inward FDI becomes less pronounced, but OFDI increases, so that the net inward investment per capita starts to fall. Domestic firms become more competitive and stronger in domestic and international markets. (4) These trends give countries a net outward-investor position. The ownership advantages of domestic firms are strong and they have an increasing propensity to exploit them internally in a foreign, rather than a domestic location. Intra-industrial trade grows with the increasing similarity to other countries' economic structures. It follows from this theory that the graph of the net outward-investment curve is U or J shaped where the countries' GDP per capita appears on the X coordinate.<sup>22</sup>

Table 9  
Stock of inward FDI as a percentage of GDP

|                | 1990 | 1994 | 1995 | 1997 | 1998 | 1999 | 2000 |
|----------------|------|------|------|------|------|------|------|
| Hungary*       | 1.7  | 15.6 | 26.7 | 34.7 | 38.5 | 39.9 | 43.2 |
| Slovenia       | 3.8  | 2.2  | 9.4  | 12.1 | 14.7 | 15.3 | 16.1 |
| Czech Republic | 4.3  | 9.9  | 16.4 | 22.8 | 23.9 | 31.8 | 36.4 |
| Slovakia       | 0.6  | 5.6  | 7.2  | 8.2  | 9.5  | 10.8 | 19.3 |
| Poland         | 0.2  | 5.3  | 6.2  | 11.6 | 15.8 | 18.3 | 20.1 |
| Estonia        | 5.2  | 30.5 | 20.2 | 24.5 | 35.6 | 47.9 | 53.2 |
| Portugal       | 14   | 6.6  | 17.8 | 17.7 | 19.7 | 20.0 | 23.8 |
| Austria        | 6.2  | 7.1  | 7.6  | 8.6  | 11.3 | 11.8 | 14.8 |
| Ireland        | 12.2 | 10.3 | 18.2 | 23.3 | 28.1 | 47.0 | 67.0 |

\* Reinvested earnings are not registered.

Sources: UNCTAD World Investment Report 1999, WIIW statistics, and balance-of-payments data of central banks.

The analysis by Dunning (1981) is based on cross-sectional country data. It is more difficult to fit the general theory of IDP to a specific country with long

<sup>20</sup> Only the Baltic state of Estonia has the much higher share of 53.2 per cent.

<sup>21</sup> CSO data.

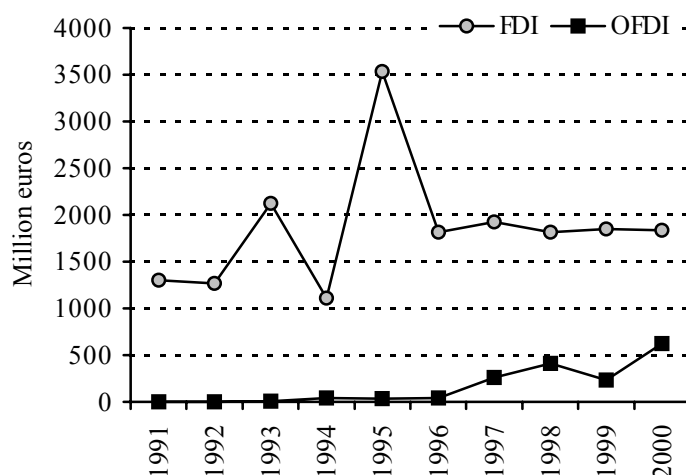
<sup>22</sup> Later a fifth stage was included in the theory, characterized by high cross-border trade within multinational companies, converging economic structures of countries, and more balanced international direct-investment positions. (See Dunning and Narula, 1996.)

time-series data, because of country-specific factors that influence FDI.<sup>23</sup> The extent of the causality between FDI and GDP is not treated in the theory; the two trends are simply juxtaposed. Attempts to apply IDP theory to specific countries have been made by several authors. Bellak and Svetlicic (2001) puts the question whether small and transition countries are different from large and not transition countries regarding the IDP theory. The example is Austria and Slovenia, based on which the authors find that both patterns are different from the ideal investment development path. Transition seems to be more a country-specific reason for that than smallness.

In the case of Hungary, Figure 1 shows the development of outward FDI and the net investment position, along with the recent increase in the flows of OFDI. Figure 2 presents the net outward investment position (NOIP) of Hungary, which means the difference between the FDI and OFDI stocks per capita and the trend in per capita GDP. The recent upward trend in OFDI suggests that Hungary is beginning the third stage of IDP. Apart from the aggregate macro level IDP, a bilateral and sectoral IDP can be calculated (BELLAK, 2001). The first concept reflects a country's NOIP in relation to another

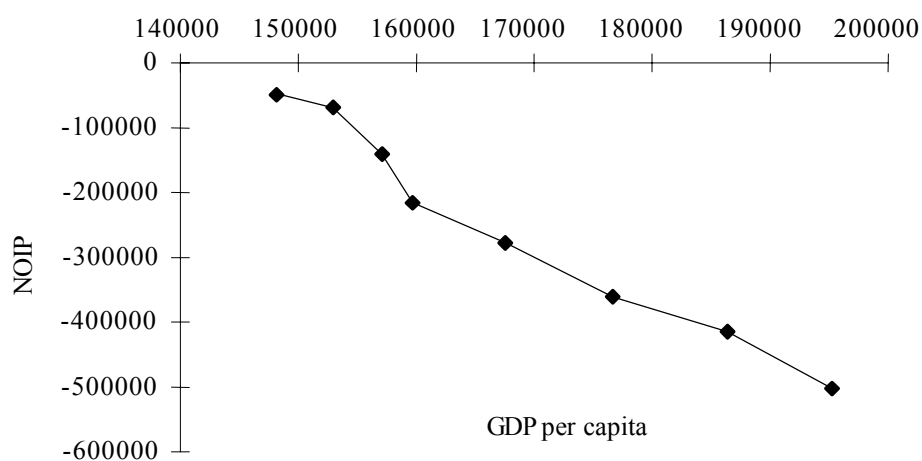
country, while the second shows the position of an industry compared with all its competitors abroad. Such calculations for Hungary are hindered by the lack of proper stock and time-series data, but experience and the existing data suggest that bilateral IDP would be rather differ-

Figure 1  
Inward and outward flows of direct investment in Hungary



Note: Reinvested earnings are not registered.  
Source: Balance-of-payments data, NBH.

Figure 2  
Net outward investment position (NOIP)  
and GDP per capita (constant prices)  
HUF, 1993–2000



ent for Romania and Germany, as the NOIP is positive in the former case and strongly negative in the latter. There may also be sectoral differences. The NOIP of the oil sector, for example, is probably less negative than that of other industries.

<sup>23</sup> Buckley and Castro (1998), for example, concluded after analysing the Portuguese case that careful observation of the individual elements behind IDP is necessary. Integration (joining to EFTA and the EU) and political factors (the end of dictatorship, changes in Central Europe) could be more important to the generation of inward and outward FDI than domestic growth.

FDI inflows affect OFDI as well. Outward investment may derive from domestic companies (direct investment), but also from affiliates of foreign-controlled companies and multinationals (indirect investment), which establishes a link between FDI and OFDI. As Altzinger and Bellak (1999) claim, if a foreign parent makes the investment decisions, the local affiliate is affected only marginally. A bigger impact on the investing firm (for instance on employment) can be expected with direct investment. The authors performed regression analysis on survey data from 112 direct and 38 indirect Austrian investor firms. These gave the result that wage costs play a stronger role and employment effects are greater with direct OFDI, which is strongly associated with relocation of labour-intensive activities.

Statistical analyses often set the general dividing line between indirect and direct investment simply by the degree of foreign ownership (over 10 or 50 per cent). The authors take the view that indirect OFDI should be defined as an investment deriving from a firm in which control is foreign, so that strategic decisions are taken abroad. This is important, because even a simple majority of foreign ownership is not enough to class OFDI as indirect if the strategic decisions are being taken within the domestic firm. In the Hungarian case, the state has retained a 'gold share' in some big companies that have made important outward investments (such as MOL and MATÁV), even though the majority of their stock is foreign owned.

The lack of data on Hungarian experiences makes it difficult to analyse or even distinguish direct and indirect OFDI. Certainly, a proportion of the outward investment must be realized by foreign affiliates functioning in Hungary, but in the author's estimation, this is still not a significant proportion. Most multinational affiliates are export-oriented companies (oriented towards the EU) or designed to serve the domestic/regional

market. Nonetheless, there are some cases that can be considered as indirect FDI.<sup>24</sup>

Apart from the factors already mentioned, analysing or detecting indirect investment is difficult in the CEE countries without knowing the history of the companies concerned. In some cases, Hungarian companies that were important or even leaders in their sector made investments abroad as early as the 1970s and 1980s (establishing trade or production affiliates), thereby creating a network in neighbouring countries. There are examples in Hungary and other CEE countries of a foreign investor buying such a firm with its network during the privatization process, so that the OFDI preceded the FDI.

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<sup>24</sup> Three recent examples of OFDI by foreign affiliates in Hungary have involved *Dunapack* (paper and packaging), Swiss-based *Phoenix Mecano*, and *Sara Lee Hungary* (tea and coffee).

*Dunapack*, 100 per cent owned by the Austrian firm Prinzhorn, was an important Hungarian enterprise with considerable market share and production before privatization. The Hungarian subsidiary was deemed weighty enough for Prinzhorn to make it a Central European centre for expansion and investment further East. A major factor was the relative proximity of the Hungarian subsidiary to target countries, so that transport costs would be lower. Investments were made in Romania (1994), Ukraine (1998) and Poland (1998), partly to follow existing customers.

*Phoenix Mecano*, which makes electrical machinery, plastic and other machine parts and mobile phones at a greenfield factory in Southern Hungary, attained sales of HUF 18 billion and increased profits in 2000. The parent decided to increase production capacity in Hungary and expand from there into Romania and Slovakia (*Világgazdaság*, February 1, 2001).

*Sara Lee Hungary* is an affiliate of the Dutch multinational *Sara Lee/Douwe Egberts*, which decided in 2000 to increase the base capital of the Hungarian affiliate by HUF 26.8 billion. After that, *Sara Lee Hungary* invested HUF 35.4 billion in founding a trade-investment company in Denmark. This investment was a simply tax-reducing measure by the parent and cannot be considered 'real' indirect OFDI.



Table 10  
Groups of companies by ownership and size

|        | Foreign control                                                                   | Domestic control                                                           |
|--------|-----------------------------------------------------------------------------------|----------------------------------------------------------------------------|
| Large  | F1. Multinational affiliates, producing mainly for export; global decision-making | D1. Export and domestic market oriented 'big firms' (oil, foods, services) |
| Medium | F2. Domestic market oriented producing and service firms, global decisions        | D2. SMEs, export oriented, often involved in outward processing trade      |
| Small  | F3. Export and domestic market oriented SMEs, strategic decisions in Hungary      | D3. Small and micro firms, domestically oriented                           |

Other factors besides ownership structure that can be crucial to outward investment include size. The size of a firm seems to have an impact on its internationalization. Smaller firms have fewer financial resources and personnel, less knowledge, *etc.* Larger firms internationalize more rapidly than smaller ones. The combined size-ownership criteria in Table 10 distinguish six groups of firms.

Groups differ strongly in their involvement in outward investment. In Hungarian experience, the most active is D1, followed by F2 and F3. D1 (the most significant in the sums invested and the number of affiliates) includes large domestically controlled companies that are quoted on the stock exchange.<sup>25</sup> Zalakerámia (ceramics), Gedeon Richter (pharmaceuticals), MOL, TVK (oil refining), Gardénia (textiles), Graboplast (plastics) and MÁTÁV (telecom) can be cited as examples. F2 covers companies that are owned by a foreign professional investor, mainly interested in the domestic and regional market. They may be production companies or service providers. Examples include Dunapack (see Note 24), Egis (pharmaceuticals), Délhús (meat) and the MKB (see Section 3). To F3 belong firms with a mixed ownership structure, whose owners are mainly institutional or financial investors. They make considerable export sales, but they are also interested in the domestic market. Cost reduction can be an important mo-

tive for OFDI in their case. F1 consists mainly of multinational affiliates interested in exporting to the EU (IBM, Philips, *etc.*) They are rarely interested in making OFDI from Hungary. An exception may be the Swiss-owned Phoenix Mecano (see Note 24). D3 is made up of small and micro-firms without enough capital to expand abroad. They aim to serve only the domestic market.

Hungarian experience suggests that the divide between investors and non-investors abroad is not foreign or Hungarian ownership, but capital strength and the existence of ownership advantages and a proper strategy.

## 5. THE CHARACTERISTICS OF THE SURVEY

In view of the shortcomings of the data on OFDI, the authors carried out a survey of companies designed to allow the motives, patterns and effects to be assessed more closely. The best approach would have been to consult a list of all the firms that have carried out OFDI. (Such a list exists only at the NBH, where the competent department refused to release it.) Instead, information was collected from ministry and ITD officers and representatives at home and in neighbouring countries. This yielded a list of 57 companies, which were sent questionnaires. In the end, 22 of the firms

<sup>25</sup> This applies even if there is significant or majority foreign ownership of the equity.

responded by sending back the questionnaire, but even in their case, certain questions remained unanswered, in most cases ones that referred to data about affiliates.

The sample consisted mainly of 'big' companies, many of them quoted on the stock exchange. According to the group structure of Table 10, 12 respondents can be said to belong to D1, 5 to D2, 1 to D3, 2 to F1 and 2 to F2. The sizes of the companies in the sample are presented in Table 11.

Table 11  
Main characteristics of the firms  
in the sample

| Sample average:          | 1997   | 2000     |
|--------------------------|--------|----------|
| Fixed assets (HUF bn)    | 59.6   | 91.6     |
| Nominal capital (HUF bn) | 15.1   | 16.9     |
| Net sales (HUF bn)       | 66.3   | 103.5    |
| Exports (HUF bn)         | 17.2   | 31.7     |
| No. of employees         | 4157   | 3964     |
| Export/sales             | 38.9   | 42.6     |
| No. of affiliates        | 2.7    | 3.8      |
| No. of employees:        | Sample | Economy* |
| -9                       | 0.0    | 92.3     |
| 10-49                    | 9.0    | 6.1      |
| 50-249                   | 0.0    | 1.3      |
| 250-499                  | 18.2   | 0.2      |
| 500-                     | 72.8   | 0.1      |

Note: \* Based on CSO data for 2000.

Table 11 confirms that the firms in the sample tend to be large. Compared with the Hungarian economy, firms employing over 500 people are heavily over-represented in the survey. The main reason for this is that firms are mainly older companies, founded in the communist era or earlier. (The mean foundation year of the antecedents of the firms in the sample was 1937.) They have undergone conversion (into a joint-stock company, for example) and privatization at the beginning of the 1990s.

Looking at their main financial data in the period 1997-2000, the firms in the sample reduced their labour force somewhat, but they were able to increase their capital and assets, and still more their

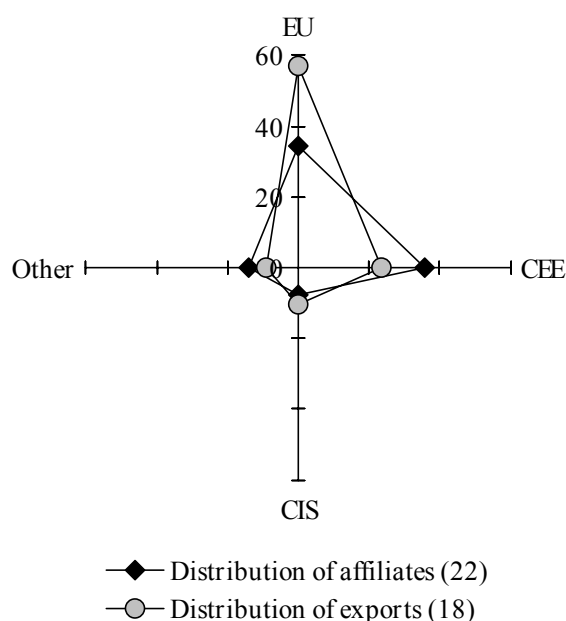
sales. Increasing internationalization was seen in increases in exports and the average number of affiliates. The export intensity of the firms (defined as exports/net sales) also increased, but remained far from strong. (The sample shows a wide dispersion, with export intensity ranging from 4.8 to 73 per cent.)

Eighty-one per cent of the firms in the sample had foreign ownership, with more than 50 per cent foreign ownership in 61 per cent of them. (The share of firms with a foreign stake in the whole economy is only 10 per cent, but it should be borne in mind that the domestic firms also include many micro and even pseudo-firms. (See the lower part of Table 11.) The share of majority foreign-owned firms among firms in which there is foreign investment is 79 per cent in the whole economy, which is somewhat greater than the proportion in the sample. However, majority foreign ownership does not necessarily mean foreign control. Most of the firms in the sample were domestically controlled. The investors came mainly from the EU (77.3 per cent) and the United States (18.2 per cent).

All the companies in the sample were in manufacturing except for one in the services. There were 5 companies in rubber and plastics, 4 in food and beverages, 3 in machinery and electronics, 2 each in the pharmaceutical, oil, and wood and paper industries, and 1 each in textiles, agriculture and ceramics.

It was expected that there would be a link between exports and OFDI activity: earlier trade contacts would enhance foreign investment. This proved to be the case. The geographical distributions of foreign affiliates and of exports (*Figure 3*) show similar patterns, although the share of the EU is higher in exports. On average, 57 per cent of the exports of the firms in the sample were directed to the EU, 23.4 per cent to CEE countries, and 10.5 per cent to CIS countries.

Figure 3  
Geographical distribution of exports and foreign affiliates of sample companies



Note: Valid answers in parentheses.

The proportions for affiliates were 34.2 per cent in the EU, 35.4 per cent in CEE countries, 7.6 per cent in the CIS, and 13.9 per cent in other countries (Cyprus, the United States and the UK). Other features of the respondent companies included an average of 2.4 per cent spent on R and D. Here the two pharmaceutical companies were exceptional with 6–7 per cent, while others spent between 0.8 and 1.8 per cent. The average proportion of graduate employees was 14.6 per cent in 1997 and 15.5 per cent in 2000. The average amount invested in a foreign affiliate was HUF 169.6 million in 1997 and HUF 8877 million in 2000. The total invested was HUF 133.1 billion; the 15 respondents in the sample accounted for 52 per cent of all Hungarian OFDI.<sup>26</sup> In this respect, the sample was quite representative.

Turning to the affiliates, the survey asked about the two most important at

each respondent company. Not all respondents gave answers to these questions, however, and some had only one affiliate, so that information was gathered about altogether 34 affiliates. Of these, 12 were in Romania, 4 in Germany, 3 in Ukraine, 2 in Slovakia, 2 in Croatia, 2 in Russia, and 1 each in FYR Macedonia, Denmark, the United States, the UK, the Czech Republic, Bulgaria, Poland, Austria, and France. Thus, 25 were in the neighbouring region and 9 in the EU or the United States. Sales and marketing were the activity of 15 and production of 19. All affiliates in the West were for trading the products of parent companies. There were 6 trading affiliates in the CEE region, the rest being for production. The form of 85.3 per cent was a limited company, while the rest took the form of a joint stock company (PLC). Many respondents failed to provide requested data on the affiliates (sales, capital, trade *etc.*). Only features mentioned relatively often are mentioned here. The data for affiliates in 2000 appear in Table 12.

Table 12  
Main characteristics of foreign affiliates

| Average               | No. of responses | 2000 |
|-----------------------|------------------|------|
| No. of employees      | (18)             | 808  |
| Fixed assets (USD mn) | (20)             | 83   |
| Own capital (USD mn)  | (18)             | 39   |
| Sales (USD mn)        | (18)             | 140  |
| Exports (USD mn)      | (12)             | 118  |

The exports of the affiliates were directed mainly (67 per cent of exports) to nearby markets. The second largest destination was the EU (17 per cent), while exports to the home country represented 7 per cent, to the CEE countries 5 per cent and to other regions 2 per cent.

<sup>26</sup> OFDI (acquisition of equity capital) from Hungary was HUF 255.8 billion in the period examined (the year 2000 and January 2001).

## 6. FORMS OF ENTRY INTO FOREIGN MARKETS

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It has become essential for companies to appear in foreign markets and internationalize themselves. This gradual process of developing international business makes a firm become increasingly committed to and involved in international business operations, through specific products in selected markets (LUOSTARINEN, 1994). According to the 'Uppsala model' (see, for instance, JOHANSON AND VAHLNE, 1977, and LUOSTARINEN, 1978), firms follow typical stages of internationalization: (i) exporting, (ii) establishment a foreign sales subsidiary, (iii) licensing or subcontracting, and (iv) establishment of a foreign production subsidiary. The same school defined factors of 'domestic push' (smallness, openness, peripheral location) and 'international pull' (large, open foreign markets) for internationalization.

The 'stage' pattern of internationalization has been criticized from certain points of view. The first is the sequence of stages. In reality, companies may stop at a certain stage, jump stages, or even reverse the process for various external and internal reasons. According to Reuber and Fisher (1997), for example, firms with internationally experienced management may skip the first two stages. Management is a kind of resource, which promotes greater internationalization. The second line of criticism is that the empirical evidence for the model was based on a limited number of Scandinavian firms. The third aspect considered was the difficulty of operationalization of a model influenced by so many factors. To assist in this respect, Cavusgil (1980) constructed an 'I model', in which export involvement is operationalized by the export/sales ratio, to reflect the firm's dependence on foreign markets. This was

later applied by other authors (such as GANKEMA *et al.*, 2000) to small and medium-sized enterprises (SMEs), where evidence was found of 'stagnation' (lingering at a stage), 'over-progression' and 'hyper-progression' (jumping stages).

Despite the theoretic debates, there is no doubt that investing abroad is vital in the present era of globalization. Blomström and Kokko (2000) concludes that multinationals have no alternative but to continue expanding abroad. They cannot retain their international market shares in the long run without foreign production. This applies increasingly to SMEs and companies in the CEE countries as well.

Many ventures in the 1980s began to sell and invest abroad earlier than was typical of similar firms, bypassing the traditional pattern of internationalization. Some of this 'premature' internationalization was impelled by multinationals to which the investors were suppliers, but not all. Also associated with early internationalization are clear product differentiation and internationally experienced managers. Although it is a risky procedure, firms may manage their international risks by trading off risk factors against each other (SHRADER, OVIATT AND MCDUGALL, 2000).

Recently, interest has turned towards a relatively new type of firm, the 'born globals'. These are newly established, small to medium-sized firms that face globalization from the outset, due to their product and processing specializations. Such firms have to start domestic and international operations simultaneously, or even foreign operations first, and do not follow any kind of stage development. They are mainly found in knowledge-intensive industries (ALMOR, 2000), where they play an important role as suppliers worldwide.

The choice of *market-entry mode* is influenced by several factors. As Pan and Tse (2000) shows, there exists a hierarchy among the various modes. The first level in this hierarchy distinguishes between

equity and non-equity entry modes. Equity modes (wholly or jointly owned affiliates) require a major resource commitment and investment risks are higher. Non-equity modes (contractual agreement and exports) do not call for the establishment of an independent organization. After the decision on the first level, firms consider factors on a second level (degree of ownership, contract or export, *etc.*). Location and host-country factors influence decisions on the first level rather than the second.

With Hungarian companies, the general tendency is to follow the *stages of internationalization*. The first step is to create branch offices and warehouses abroad. (This was done in the 1970s and 1980s in several cases.) These can help in gathering information about the host country, the regulatory system, market needs, *etc.* Afterwards comes the step of setting up trading firms and finally production firms. Typical examples of this behaviour pattern have been the Hungarian pharmaceutical companies (ANTALÓCZY, 2000)

In terms of entry modes, there are two basic forms of investments. The first is greenfield investment by a Hungarian firm (or jointly with another firm). The second is acquisition of an existing firm (utilizing, for example, the privatization opportunities in neighbouring countries.) However, there is in a sense a third form: buying or renting real estate (empty building or land) and 'filling' it with the company's own machinery and equipment.<sup>27</sup>

The proportion of greenfield affiliates to acquired firms in the survey was 40 per cent to 60 per cent, so that acquisition was more popular. However, the sample was biased towards big, well-

capitalized companies, so that the share of acquisition is probably higher in the general pattern. Companies find greenfield investment riskier and costlier than buying an existing firm. Almost the half the greenfield affiliates were trading firms, as opposed to only 36 per cent of the acquired firms, of which the majority were producers. The vast majority of the affiliates (85.3 per cent) operated under the legal form of a private limited company. None of the respondent firms operated abroad with a licence or franchise agreement.

The findings of the survey confirm previous experiences that Hungarian investors seek a controlling interest in their affiliates: 41 per cent of those cited in the sample were 100 per cent owned by the Hungarian investor, 32 per cent majority owned and 12 per cent 50 per cent owned. Obtaining control was seen as a way to reduce the risks of investment.

## 7. COMPANY STRATEGIES AND MOTIVATIONS

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As in other spheres, the Hungarian company sector abroad is far from homogeneous. Firms have different aims, activities, ownership structures, sizes *etc.*, and their motives or strategies in investing abroad differ as well. The well-known framework applied in Dunning (1993) described four main motives for foreign investment: market seeking, efficiency seeking, strategic-asset seeking and resource seeking. These also fit the motives of Hungarian companies investing abroad. However, in most cases the reason for the investment is a complex one involving more than one motive.

The authors see seven main reasons why Hungarian firms invest abroad: 1. market share, 2. cost reduction, 3. company growth, 4. resource seeking, 5. tariff

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<sup>27</sup> There was a case where a Hungarian pharmaceutical company bought a Polish textile factory, stripped it and brought in its own machines to package products from the parent company (Antalóczy, 2000).

jumping and tax regulations, 6. offshore tax avoidance, and 7. 'follow the customer'.

*Market share* plays an important role in almost all investments. The prospects of increasing domestic market share became weak in the second half of the 1990s, due to stronger competition, which had been enhanced by the trade-liberalization measures and the activities of foreign-owned companies. An increase in sales can be achieved by establishing a trading company or production unit in another country. Following customers is a related motive. Certain companies follow a domestic multinational partner into a neighbouring country to supply it there.

*Cost reduction*, it is generally believed, can be one of the most important motives for investing abroad. The CEE region has been attractive from this point of view. Labour costs differ among CEE countries, being higher in the 'central' countries than the 'eastern' ones. Cost reduction can be an important motive for Hungarian companies to invest in Bulgaria, Romania or the CIS countries. However, the quality of labour (qualification, discipline, and mentality) counts strongly alongside labour costs. Another cost reason for investing in a neighbouring country may be lower transport costs.

*Company growth* is an important element of strategy for bigger companies, connected with gaining market shares and rivalry with competitors. Some firms aim for a leading market position in the CEE region. The best example is MOL, which has declared its intention of becoming a regional multinational. Company growth is essential for firms quoted on the stock exchange, as a way of increasing share values (ANTALÓCZY *et al.*, 2000).

*Resource seeking* is not the most important reason for Hungarian companies, although in certain fields (petroleum, natural gas, *etc.*), ex-Soviet regions or

countries rich in minerals may be a target for Hungarian investors.<sup>28</sup>

*Tariffs and tax regulations* are still important in the CEE region, so that avoidance can be a pertinent motive for investors. Capital contributions in kind are exempt from VAT in most countries and customs duties and intra-firm deliveries are favourably regulated. Romania, Moldavia and Ukraine form a customs union with the CIS countries, so that establishing an affiliate in these countries gives Hungarian firms preferential access to the Russian market. An additional motive is to exploit special local tax and other regulations more favourable than those in Hungary (ANTALÓCZY *et al.*, 2000).

*Tax evasion and founding off shore firms* is a good reason to invest in some 'Western' territories such as Cyprus, Malta, Jersey and the Netherlands Antilles. It has been seen that these have taken important shares of Hungary's OFDI. (Of course, it is not known which companies lie behind the transfers.)

In Hungary's case, the 'follow the customer' strategy of serving a domestic

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<sup>28</sup> MOL has reserve acquisition objectives in Western Siberia. The aim is to implement attractive field development projects under a production-sharing partnership with Russian oil companies. MOL has a joint Siberian project with Yukos, a major Russian oil company, for joint development of the Zapadno-Maloblyk field, which has about 24 million tonnes (175 million barrels) of proven reserves and is located in the Khanty-Mansysk Autonomous Region of Western Siberia. The area has an extensive pipeline and transportation infrastructure. Under the agreement, the parties will form a consortium with 50-50 participation. Under Russian law, a production-sharing agreement defines the rights and obligations of the investors and the state for a period of 20 years, assuring stability. The law guarantees full export rights, bookkeeping and accounting in foreign currency, profit repatriation without limitations, and fixed tax rates. During 2000, a feasibility study for the project was completed and approval obtained from the local-government authority.

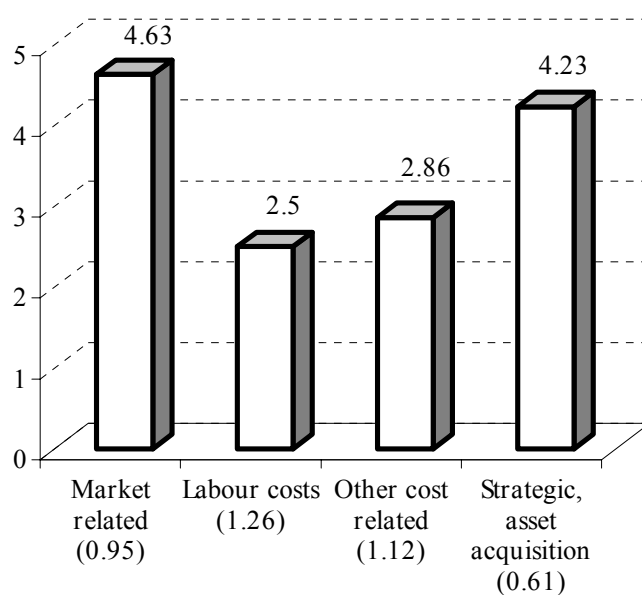
partner already present abroad (LUOSTARINEN, 1994) probably applies primarily to firms in the services and banks, although there is not much evidence available to support this. The investments of Dunapack (see Note 24) have motives of this kind.

The motivating factors were grouped as follows in the questionnaire: market-related motives (market size, growth), labour costs, other cost-related motives (cheaper inputs, transport costs, taxes, tariffs), and acquisitions of strategic assets (trade marks, technologies). The responses show that by far the most important motive for OFDI by Hungarian firms is to obtain or increase market shares (see Figure 4). This was taken to be very important by 82 per cent of the responding firms. The second most important group of motives were the strategic factors (31.8 per cent thought them very important and 59 per cent important.) Cost-related motives seem to be much less significant.

The findings of the survey coincide with those of other surveys about inward FDI motives into Hungary (e.g. ÉLTETŐ AND SASS, 1998), where market access likewise proved to be the most important motive. In this respect, Hungarian firms as investors are behaving like Western companies in their OFDI decisions.

Intense *domestic competition* can also induce companies to look abroad. The following question was therefore included in the questionnaire: 'Are new affiliates a response to the investment strategies of a close competitor or competitors in your industry?' This indeed proved to be an important factor, as 63.4 per cent of the companies answered in the affirmative. The average number of key players competing with the sample companies was 7. The transformation to a market economy considerably increased competition for domestic firms during the 1990s and they had to accustom themselves to this. Expansion abroad could be seen as a way of strengthening the company's position.

Figure 4  
The main motives of the sample companies  
for investing abroad



Note: Mean value of answers: 1 = not important, 5 = very important. Standard deviations are given in parenthesis. Number of answers: 22

Once a company has sufficient motives for investing abroad, it has to collect as much information on the host countries as possible. The questionnaire enquired about where firms obtained the information before investing abroad. Interestingly, all the respondents ticked 'personal contacts'. Such contacts may result from previous trading activity or business partnerships. Other significant sources of information – banks (7 respondents), chambers of commerce (3), ministries (2) and other governmental organizations (2) – proved to be of much less importance.

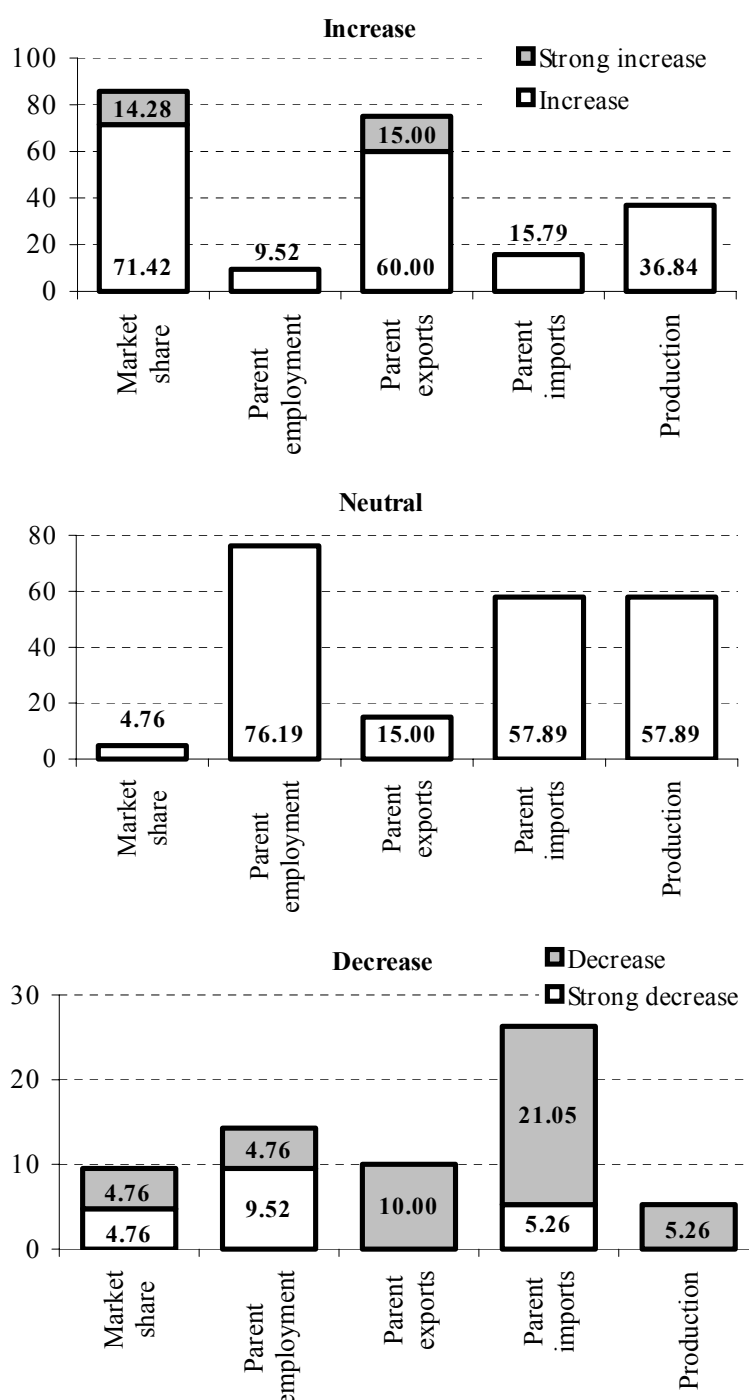
## 8. THE EFFECTS OF OFDI ON PARENT FIRMS

There have been several studies dealing with the effects of OFDI from different points of view (job creation or redundancies, substitution for domestic production, effects on trade, *etc.*) The topic discussed most is perhaps the effect of OFDI on *employment*. The general belief among trade unions is that investing abroad endangers jobs at home, but this has not proved to be a general trend. On the contrary, Lipsey, Ramstetter and Blomström (2000) proved for Japanese investments, for example, that the level of parent production and employment at home tend to rise as production abroad increases. This may result from a need for supervisory or ancillary employment to service foreign operations.

With *trade*, the net impact of FDI derives from a complex of phenomena. On the one hand, foreign production can replace previous home-country exports, but on the other, FDI can also promote exports of intermediate goods to the new foreign affiliate. Apart from that, it is hard to judge what would have happened to the company if it had not invested abroad – whether it would have withstood the competition or been driven out of the market, causing losses of jobs and exports (BLOMSTRÖM AND KOKKO, 2000). There are empirical studies to prove the complementary relationship

between OFDI and exports. For instance, Pfaffermayr (1996) showed in Austria and Bajo and Munoz (1999) in Spain that increased capital outflows led to higher exports during the periods of liberalization they examined.

Figure 5  
Effects of OFDI on firms



Note: Percentages of valid answers. Valid sample: market share: 21, parent employment: 21, parent exports: 20, parent imports: 19, production: 19.



The findings of the survey show that the effects of OFDI were greater on employment than on trade: 76.2 per cent of respondents rated the effects of investment as neutral on employment. The figures were similar for imports and production (*Figure 5*). Only three firms said that parent employment had decreased or strongly decreased as a result of OFDI. With employment, there have been cases where OFDI has made it necessary for a Hungarian parent company to take on new employees and create a separate group or department to manage the investment and functioning of the new affiliate. (This was the case with MOL and MATÁV, two recent big investors.)

The effects on market share and exports proved to be considerable, bringing an increase in market shares at 71.4 per cent of respondent companies and a rise in exports at 60 per cent. Bearing in mind that the most important motive for OFDI was market related, this means that the objectives have been obtained. Indeed, 21 firms out of 22 said its direct investment abroad had been as successful as it had expected.

Table 13  
Effects of OFDI, percentages of responses

| Due to the establishment of your affiliate abroad:                                                                      | Number of Responses | Positive | Negative |
|-------------------------------------------------------------------------------------------------------------------------|---------------------|----------|----------|
|                                                                                                                         |                     | (%)      |          |
| Have you gained access to a cheaper input or inputs?                                                                    | (21)                | 4.76     | 95.24    |
| Has customer feedback improved?                                                                                         | (20)                | 90.00    | 10.00    |
| Has the number of products increased?                                                                                   | (22)                | 72.73    | 27.27    |
| In total, does the investment or investments abroad contribute positively to the financial performance of your company? | (22)                | 86.36    | 13.64    |
| Are the new affiliates a response to the investment strategies of close competitor(s) in your industry?                 | (22)                | 63.64    | 36.36    |

With the subsequent effects (*Table 13*), the responses, like those for motives, show that access to cheaper inputs does not play an important role in OFDI. In-

vestment abroad is not a kind of cheap resource seeking, but a way to serve local markets. Customer feedback improved and the number of products increased, according to the majority of respondents. Affiliates generally contributed positively to the financial performance of 86 per cent of the respondents, which may be surprising, because establishing a foreign affiliate can be a financial burden on the parent in the short term. The survey suggests that this period is fairly limited, although it should be remembered that the companies surveyed were mainly large and well capitalized. Most of the affiliates in the survey were founded in 1996–7.

Companies in the survey felt that their *competitive advantages* (over competitors) in investing abroad lay mainly in technological know-how. This factor was marked as important or very important by 95.4 per cent of respondents. Firms at the end of the 1990s seemed to regard their technological level as adequate. In a sample containing two pharmaceutical companies, the average expenditure on R and D as a proportion of net sales was 2.4 per cent in 2000, which was indeed higher than the general pattern of less than 1 per cent.

Before the transition, the adaptation level of Hungarian enterprises was low. They were left outside the international networks and alliances, their technology was outdated, and so on. Despite the distortions of the system, however, a substantial endowment of human capital remained after its collapse.

There were several negative influences on the technological development of Hungarian firms in the 1990s. Initially,

the opening of domestic markets to Western competitors (the arrival of imports and the establishment of foreign subsidiaries in Hungary) led to the collapse of traditional markets, while the withdrawal of state subsidies further weakened the position of domestic firms (ROMIJN, 1998). The privatization process lasted for several years, involving changes of management and losses of employees (some of them highly qualified and experienced). Under those conditions, R and D became a luxury for firms struggling for survival. However, the arrival of foreign owners had some positive effects on technological development. Increasing efforts by companies to upgrade their technology could be seen in the second half of the 1990s, as the introduction of ISO standards and imports of new machinery became widespread. Expenditure on technology and R and D was financed mainly from external sources and foreign owners (ROMIJN, 1998).

R and D expenditure in manufacturing was concentrated on certain sectors (chemicals and engineering). According to one survey,<sup>29</sup> corporate expenditure on R and D generally formed a low 1–5 per cent of net revenues in the mid-1990s and was directed mainly towards product innovation. The main aims of the innovation were to improve product quality, expand the product range and improve penetration of the domestic market. Technological innovation was a characteristic feature in electricity generation, wood processing and paper, and basic chemicals.

Forty-one per cent of the companies in the present survey marked organizational know-how as important or very important and 57 per cent found marketing knowledge such a factor. Previous

research showed that the past had left Hungarian companies with privatization and reorganization knowledge and experience in crisis management, which they were able to put to good account in their acquisitions abroad (ANTALÓCZY, 2000). There are several cases where marketing knowledge was also important. The Hungarian owners would dismiss inefficient local management after buying a company.

## 9. THE BARRIERS, THE PROBLEMS FOR FIRMS AND PROMOTION OF OFDI

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The risks of FDI are well documented in the international literature. The risks may be specific to the firm, the home country or the host country. Of course, the extent of the risks varies among countries and companies, but they can sometimes lead to failures and mistakes. There have been cases of Hungarian outward investment in which the venture proved unsuccessful. Such failures may be due to insolvency of the parent company, a wrong choice of plant location, too optimistic an assessment of the market prospects, and so on. The case of *Gardénia* shows that sometimes there is not just one reason, but a coincidence of several.

*Gardénia Csipkefüggönygyár Rt.* is the biggest curtain (drapery) factory in Hungary, founded in 1911. The company was privatized in 1991, being sold to two financial investors: Hungarian Industries-Beteiligungen GmbH (62.5 per cent), and Österreichische Kontrollbank (5.77 per cent). The remaining 31.73 per cent of the equity was introduced onto the Budapest Stock Exchange in 1997. The company had 626 employees in 2000. *Gardénia* had been conducting a *market-oriented business policy* of modernized production since the 1970s, and had built up Western contacts. This was commercially success-

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<sup>29</sup> This survey, based on questionnaires examining 110 companies, was conducted by the Innovation Research Centre at the beginning of 1994. The results appeared in *Külgazdaság*, No. 7–8, 1995.

ful, but the company's fortunes peaked in 1995, when the management and the majority owner decided to turn Gardénia into a regional producer of high-category domestic textiles. The management would have preferred a slower rate of growth based on the domestic market, but the majority owner insisted on rapid expansion into neighbouring countries. In 1996, Gardénia began to expand in Hungary and abroad, with clear motives of gaining markets. The subsidiary Gardénia Textilhandels GmbH was founded in 1996 in Austria, as a holding company, which in turn established trade affiliates in Slovakia and Croatia. (There was no other producer of net curtains on the market at the time in either country.) A chain of franchised brand stores was set up. Gardénia Slovakia obtained full ownership of HP Habitatio, which runs a department store. In 1997, Gardénia obtained a controlling interest in Vossen Frottierwaren Produktions- und Vertriebs GmbH in Austria, thus becoming a co-owner of Vossen Hungária Kft. and of two trade firms in the Czech Republic and Germany. Also in 1997, Gardénia Textilhandels GmbH established a trade affiliate in France. Within hardly three years, Gardénia Rt. had been converted from a medium-sized Hungarian company into a holding company with an

international trade network and foreign production subsidiaries.

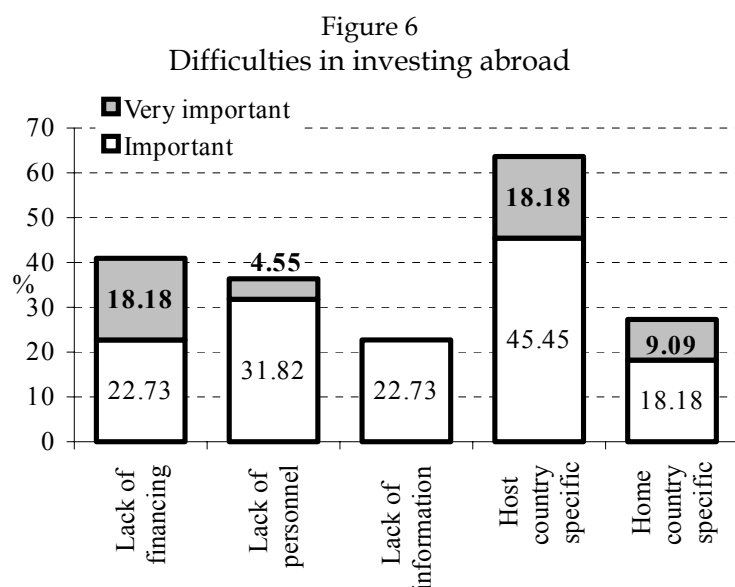
Gardénia's spectacular growth, however, did not bring success or good market positions, for the following reasons: 1. Its expansion coincided with a change in fashions towards netted curtain materials. Gardénia had built its extensive growth on an existing production structure, when a structural change was required to gain markets. 2. Personnel problems appeared. Suitable managers for the Slovakian and Croatian affiliates could not be found and their turnover hardly increased. (The financial capital invested was not matched by the human capital available.) 3. The competition proved greater than expected on both markets, so that the subsidiaries made losses. A major problem was that the main owner of the group (Hungarian Industries-Beteiligungen GmbH) had started as a financial investor but behaved as a professional one. Since the management had different reactions to the problems, there was no consistent strategy.

The 1997 profits of Gardénia Rt. dwindled and turned into losses in 1999. Net sales decreased radically, mainly in export markets, but also in Hungary. A reorganization plan was introduced, the

CEO was replaced and the director representing the main owner took over executive direction. The affiliates abroad did not fulfil expectations. In 2000, Gardénia sold its 48 per cent share in Vossen and its Gardénia Slovakia s.r.o. subsidiary. The Slovakian market is now served now from Hungary.

Table 14  
Investments abroad by Gardénia Rt. in 1996–7

| Name                            | Location | Ownership                        | Capital    | Activity                    |
|---------------------------------|----------|----------------------------------|------------|-----------------------------|
| Gardénia Textilhandels GmbH     | Austria  | Gardénia Rt. 100%                | ATS 4 mn   | Holding company             |
| Gardénia Slovakia s.r.o.        | Slovakia | Gardénia Textilhandels GmbH 100% | SKK 1 mn   | Wholesale                   |
| HP Habitatio s.r.o.             | Slovakia | Gardénia Slovakia s.r.o. 100%    | SKK 0.1 mn | Department store            |
| Gardénia Croatia d.o.o.         | Croatia  | Gardénia Textilhandels GmbH 100% | HRK 0.1 mn | Wholesale and retail        |
| Distribution de Linge de Maison | France   | Gardénia Textilhandels GmbH 100% | FRF 0.1 mn | Wholesale and retail        |
| Vossen GmbH                     | Austria  | Gardénia Rt. 48%                 | ATS 40 mn  | Towel/bath-textile producer |



Note: Percentages of valid sample (22 firms).

The survey ranged investment risks into five main groups: shortage of financing, shortage of personnel, shortage of information, host-specific (destination-related) factors, and home country-specific (domestic) factors. The main difficulty (cited by 63.6 per cent of respondents) proved to be the group of host country-specific factors (risk and investment climate). This can be explained by the fact that the affiliates were mainly situated in Eastern European countries such as Ukraine and Romania, where the market economy is systemically less stable than in Central or Western Europe. Another, less important difficulty (41 per cent of respondents) was lack of financing. This was probably a more important factor with smaller firms. Shortage of appropriate personnel was cited as an important or very important barrier to OFDI by 36.3 per cent of the respondents. Firms venturing abroad need qualified, experienced persons to run the set-up process and functioning of a foreign affiliate. Domestic factors (administrative barriers, legislation) and shortage of information were relatively less important.

The problems of investing companies can be grouped under three heads: information, financing and security. The fact that firms face problems when investing abroad may raise the question of whether some kind of government sup-

port or promotion should be given. The survey asked companies what the government or other organizations should do to promote OFDI. About half the respondents responded to this question. The others did not consider the issue.

One block of questions referred to *information* problems. Firms suggested that the government should establish information offices and that chambers of commerce should help in gathering information. As mentioned earlier, almost the only way that investors collect information at present is through personal contacts. The role of banks and chambers was considered negligible so far. Personal contacts are likely to remain essential in the future, but there is also a need to reinforce and acquire supporting information, where chambers and banks could help more, especially with regulations, legal frameworks and risks in target countries. A major step has been taken in this direction by the Hungarian Investment and Trade Development Agency (ITDH), which has built up a kind of regional database. Its offices abroad constantly collect information on local regulations, measures and laws, and make it available also on the Internet. The ITDH organizes conferences and business-matchmaking programmes at home and abroad, to widen the investment opportunities for Hungarian firms.

With *financing*, there already exist some state institutions to provide capital to firms wishing to invest abroad, of which the best known is Corvinus International Investment Rt., although its capital has been rather limited until recently. Its activities seemed to be strengthening during 2001, but without becoming really significant in scale.<sup>30</sup>

<sup>30</sup> Corvinus International Investment Rt. was established in 1997 with a base capital of HUF 1

billion. It is 100 per cent owned by agencies of the state. In January 2001, the base capital was raised to HUF 2.65 billion by one owner, Eximbank. The new ownership structure is Eximbank 62.7 per cent, Hungarian Development Bank 21.8 per cent, Ministry of Economy 7.5 per cent, Ministry of Education 7.5 per cent, and Mehib Rt. 0.5 per cent (*ITDH Newsletter*, January–February 2001, p. 4). Basically, Corvinus Rt. offers two types of financial services. 1. Using its own resources, it acquires an interest in a target company together with the Hungarian investment partner. In addition, it provides in certain cases credit facilities to assist international expansion. 2. It offers business and investment advice and financial, legal and technical assistance. Capital investment can mean establishing subsidiaries with a Hungarian firm or acquiring stakes in foreign companies. In most cases, Corvinus as a financial investor does not assume a managing role in the venture, leaving this to the co-investor. Corvinus Rt. is interested in making profits and finding investment opportunities offering a potential for raising at least HUF 15 million. At present, the company may not invest more than 10 per cent of the subscribed capital ([www.corvinus.hu](http://www.corvinus.hu)). It usually disposes of its stake after 3–6 years. The first investment by Corvinus was made as a minority owner in a distillery in China in 1998. The second biggest investment (HUF 100 million) was made in Romania with Pécsi Gabona Rt. (40 per cent ownership), representing a 13 per cent stake for Corvinus in a bread factory. These two big investments later proved to be failures. The Chinese factory ceased to function and Pécsi Gabona Rt. became insolvent. Smaller investments in Romania and Slovakia fulfilled expectations (Antalóczy *et al.*, 2000). Since the beginning of 1999, new management has narrowed the activity of Corvinus to neighbouring countries, but expanded its profile to include leasing, guarantees and loans, with the example of a German institution in mind. In May 2000, Corvinus bought 64 per cent of an engineering firm in Romania, together with Műszertechnika Rt., and in March 2001, it bought a 20 per cent stake in the Slovakian Euromilk factory for HUF 100 million. (The predecessor of the firm had failed and then been bought by indigenous Hungarian private investors in Slovakia – HVG, March 24, 2001.) The present portfolio is as follows: China: 15 per cent, Slovakia: 30 per cent and Romania 55 per cent (*ITDH Newsletter*, April 2001). Corvinus, as a partner of Danubius Hotels, also owns 35 per cent of the Romanian Salina Investment Srl, which

Respondents indicated a need for extra tax allowances for OFDI. They would also welcome banks participating in the financing of OFDI by providing favourable credits. SMEs say they need more help with financing investment abroad than bigger firms do. General promotion of SMEs is a stated priority of the government, which can help to put them on the sound financial footing required for OFDI.

The financing of OFDI depends on the financial situation of the investing firm. It has been seen that the bulk of the outward investment so far has been carried out by firms that are or have been quoted on the stock exchange and amassed major quantities of capital there in the second half of the 1990s. However, the Budapest Stock Exchange has been showing a declining trend since 1998, with the number of quoted companies falling and no new introductions. The business results and real asset values of firms are not being reflected in the stock-market prices, which hinder raising capital by this means. These trends call for government consideration and incentives for firms and private investors.

The significant risks of investing abroad enhance the need for *security*. Respondents indicated that the government should provide guarantees and lobbying assistance, support the maintenance of foreign trade offices abroad, and provide political backup. Other desires expressed included less bureaucracy and agreements between countries about OFDI.

There also appeared the view that the government and Hungarian authorities should do nothing. These respondents argued that OFDI is not dependent

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acquired the Sovata spa facilities in September 2001.

Some companies have mixed feelings about Corvinus, not wanting a third party to be involved in their investments or not trusting this company specifically (Antalóczy *et al.*, 2000).

on promotion measures, but 'the business of the companies'. Direct help from governmental organizations will not help to promote OFDI. The decisive factors are the strength of the investing company and other firm-specific characteristics.

This viewpoint brings the discussion to the factors that promote OFDI *indirectly*. The general economic policy needs to create and maintain conditions for proper, sound business activity. The development of cross-border business contacts can be promoted by improving infrastructural links such as bridges, motorways and frontier crossing points. Economic diplomacy can also help indirectly. For instance, the free-trade agreements recently concluded with some neighbouring countries have positive effect on Hungarian OFDI in them. The latest free-trade agreement was signed with Croatia on February 22, 2001 (entering into force in April). There is one in preparation with Macedonia.<sup>31</sup> Hungary also has bilateral investment treaties and agreements on double taxation with the neighbouring countries.

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<sup>31</sup> The existing free-trade agreements with CEE countries are with Poland, the Czech Republic and Slovakia (1992), Slovenia (1995), Romania, Estonia, Lithuania and Latvia (1997), and Croatia (2001).

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