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Transformación económica, inversión directa en el exterior (IDE) y desarrollo de nuevas actividades en economías en transición. El caso de Hungría

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Resumen:

Este artículo analiza las consecuencias de las entradas de capital extranjero en la economía húngara, distinguiendo entre los efectos de las transferencias de tecnología realizadas mediante relaciones estrictas matriz-filial (*internalizadas*) de las realizadas a través de otras alternativas (*externalizadas*). El artículo resalta el cambio experimentado por las estrategias de esas multinacionales en Hungría, que inicialmente fomentaban el aprovechamiento de la eficiencia y del mercado, pero actualmente se interesan también por el conocimiento; esta variación constituye una de las características más interesantes de las transferencias de tecnología *internalizadas*. Las transferencias *externalizadas* tienen también una gran importancia, aunque no hayan recibido tanta atención. Este trabajo no las deja de lado, ya que estimulan la reestructuración de la capacidad económica acumulada con los años. Esa capacidad favorece la integración de las empresas húngaras en la red global constituida por las multinacionales, de la que se esperan grandes resultados.

Economic transformation, FDI and development of new businesses in transforming economies. The case of Hungary

Summary:

We assess the effect of foreign capital on the development of local capabilities in Hungary by distinguishing between the internalized and the externalized modes of technology transfer. Both create positive effects as well as negative effects, but not the same ones. As emphasized, the strategy of MNEs, established in Hungary, is changing; while market and efficiency were initially sought after, knowledge is now on the agenda; this change is one of the main positive effects of the internalized mode. In spite of the importance of the externalized mode of transfer, its impact on local development has received relatively little attention, in comparison to FDI. We have explored this transfer mode while stressing that it also encourages the restructuring process, which is implemented by tapping into existing local capabilities accumulated over the years. These capabilities favored the integration of Hungarian firms into MNE's global networks. In return, large contributions are expected.

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1

ECONOMIC TRANSFORMATION, FDI AND DEVELOPMENT OF NEW BUSINESSES IN TRANSFORMING ECONOMIES. THE CASE OF HUNGARY.[1]

José de Sousa[*]

Xavier Richet[**]

1. Introduction.

Whether or not multinational enterprises (MNE) enhance host country's firms' total factor productivity is a common question in empirical literature.[2] Many authors have pointed to foreign direct investment (FDI) as "a catalyst for industrial development" [Markusen and Venables (1999)]. FDI refers to the transfer of competency and technology to affiliates under multinational firms' ownership and control. This mode of transfer is known as the *internalized transfer*. On the other hand, few analyses assess the impact of the *externalized transfer*. This mode of transfer can take on a variety of forms: minority joint-ventures, licenses, subcontracting activities, etc. By establishing a clear-cut distinction between internalized and externalized transfers (although the overlap between the two is considerable).[3] This paper aims to focus on the stimulating role of foreign capital in restructuring local companies

The paper is organized as follows. Section 2 summarizes the role of FDI in economies under transformation. Section 3 reviews the spillover question and is therefore divided into two parts in order to assess the impact of both internalized and externalized transfers on local development. There is also a concluding section.

2. The role of FDI in economies under transformation.

Many studies have pointed to the role of FDI in restructuring enterprises in Central and Eastern European Countries (CEECs), although the share of FDI in national GDP remains low compared, for instance, with the Asian economies.[4] This can be explained in many ways, such as the market environment, the size of the market, the cost

of factors, and all the transaction costs associated with the implementation of new businesses in theses countries [Meyer and Estrin (2000)].

Attractivity, Appropriation and Development.

The recent book published by the French economist Ch. Albert MICHALET (2000), although emphasizing on the 'seduction of Nation', recalls some interesting points that have been raised most than thirty years ago about the so-called 'Trojan Horse' strategy of Transnational corporations (mostly US) in other developed capitalist economies and developing economies. Of course, the context is different but many questioning are still relevant.[5]

There are the following:

- Why do industrial firms, principally, the ones that had some kind of comparative advantages have not been able to turn around themselves instead of 'selling their soul' to foreigners though the sale of assets (often at under-valued prices)?
- What has become the hard core of theses industries once they have been sold to foreign investors? What kind of dispossession of knowledge, reputation, authority [DOCKÈS, (1999)] and value have resulted from the taking over and the restructuring of theses companies? One good example is Skoda-VW in the Czech Republic where the control of local partners has sharply declined, even in the core business, or where the company had its reputation in R&D [RICHET & BOURASSA (2000)]. We could mention Hungarian companies such as Videoton, Ikarus, not to speak of Tunsgram or pharmaceutical companies.
- Are the upstream and downstream needs of Foreign invested companies met by taping on local existing resources, or do foreign companies need to develop their local chain of value through vertical relations with subcontractors?
- What kind of reappropriation is taking place in the medium and long run after Foreign invested companies have entered into routines (through competition, through the capital market, through clusters and high specialized know how segments? Figure 1 on indicators of vertical relations with subcontractors gives an idea of the relative autonomy of subcontractor in integrated industries (such the car industry). It also

depends on the kind of cooperation with foreign partners and local companies (see Figure 2).

- Does the relocation of some R&D facilities in the host country express some kind of reappropriation of some segments of the value chain of the concerned industry (Tunsgram, IBM, Nokia) or is it only a kind of international division of labour among TNC with some autonomy given to local producers/assemblers? As we emphasized below and as other authors (Mako, 2000) have already pointed out, the strategy of TNC might change in the long run: after market and efficiency seeking (factor costs), knowledge seeking is on the agenda in countries where TNC have decided to locate durably their operation (see IBM strategy in France in the 70s, see Fiat strategy in the Former Yugoslavia (in Serbia), for instance. In the most advanced transition economies of CEEs, TNC are, at this stage of their development following '*glocalisation'* strategies [RUIGROCK and R. VAN TULDER (1995)] (see Figure 3) which consist at realizing a regional coordination of their activities (see VW for instance). They increase their subcontractors' workload, change the organization scheme and eventually impose prices and cost level requirement.

Figure 1: Indicators of supply dependencies

Position of supplier

INDEPENDENT	INDEPENDENT WITH INFLUENCE	INTERDEPENDENT	DEPENDENT WITH INFLUENCE	DEPENDENT WITHOUT INFLUENCE
[_____]	[_____]	[_____]	[_____]	[_____]

Attitude of core firm :

COOPERATION OR COMPETITION	COMPLIANCE	COALITION	DIRECT CONTROL	STRUCTURAL CONTROL

- Strategic components
  - delivery (oligopsony) [1]
    - Single sourcing of strategic components (monopoly) [2]
      - Strategic supplier holds

minority share in core firm [3]
- Strategic R&D done by core supplier [4]
  - Supplier has co-maker relationship with other core firms [5]
    - Joint R&D [6]
      - Single sourcing [7]
        - Quality control [8]
          - Multiple sourcing [9]
            - Open bookkeeping [10]
              - Majority-owned subsidiary [11]
                - High frequency of delivery [12]
                - Third (or lower) tier supplier in control network [13]

Source : Ruigrok and v. Tulder (1995)

Figure 2: Types and dimensions of technology transfer

Type of embodiment				Mode of transfer			Role of seller/partner		
Transfer Mechanism	Capital Embodiement	Embedded in subcontracting/ strategic alliances	Disembodied	Market (explicit)	Network (intermediate)	Hierarchies (implicit)	Active	Enabling	Passive
FDI	X	X	X			X	X		
Joint ventures	X	X	X			X	X		
Licensing			X	X					X
Exports		X		X					X
Imports	X			X					X
Subcontracting		X			X		X	X	X
International networks					X		X		X
Transfer by people		X			X			X	
Development assistance	X	X			X		X		

Source: Radosevic (1995)

Figure 3: Comparison between glo*ba*lisation and glo*ca*lisation at the core firm level

Internal firm organisation	**Globalisation**	**Glocalisation**
Organisation of value chain	Worldwide *intra*-firm division of labour	Geographically concentrated *inter*-firm division of labour
Locational strategy of activities based on	Comparative advantages and economies of scale : Progression of international division of labour	Introduction of integrated supply, production and distribution chain in depressed regions of major international trade blocs
Production focus	Production for world market and standard tastes; major research facilities spread around the world	Production for local/regional markets, more allowances to local tastes; basic research concentrated at home, applied research spread

Source: Ruigrok & v. Tulder (1995)

- Eventually, the development of spin offs, of scientific-based small companies can be boosted and contribute to increase the supply of new innovations; but in that case,

does it leads to the development of domestic firms with strong growth potential (like in the US) or, on the contrary, do firms remain constrained by lack of venture-capital, of sufficient market and of high risk associated to the development of new business as it is today witnessed in Israel in the high tech sector? In that case, the process of re-appropriation could be limited to the beginning of the value chain (from science to some R&D) but without going further downstream towards the market.

FDI Flows.

The more advanced CEECs have received the biggest share of FDI. This is due to the pace of transformation and the implementation of their privatization programs. Hungary was the first country to receive FDI as it privatized most of its assets through the market while implementing a stabilization policy. In other countries, the mode of privatization (the Czech Republic) or the reluctance to sell assets to strategic investors (Poland) have delayed the inflow of FDI. The flow of FDI into Hungary decelerated as better opportunities appeared in neighboring countries (the 'shopping around' effect). But, in spite of the fact that the privatization program has come to an end, FDI is now mostly fuelled by the expansion of existing businesses financed by the reinvestment of profits and by greenfield investments (cf. Table 1).

Table 1: FDI inflow in Eastern Europe (million US$)

Country	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999*
Bulgaria	4	56	42	40	105	90	109	505	401	700
Croatia	Na	Na	13	96	113	101	533	487	873	na
Czech Rep.	72	523	1004	654	869	2562	1418	1300	2540	4000
Hungary	**311**	**1495**	**1471**	**2339**	**1147**	**4453**	**1983**	**2085**	**1935**	**2000**
Poland	Na	Na	na	1715	1875	3659	4498	4908	7000	7000
Romania	Na	40	77	94	341	419	263	1215	2031	1500
Slovakia	Na	Na	na	168	250	202	330	177	566	300
Slovenia	4	65	111	113	128	176	186	321	165	300

Source: CSAKI (2000); * Estimations; na : not available.

Structural impact.

Among the most advanced CEEs foreign invested firms (that is companies receiving foreign capital) account, especially in Hungary for an increasing share in employment, sales, exports and investment (Table 2). Concerning the content of export, one can notice the increasing share of skilled labor, human capital and technology intensive (Table 3) of exports of Hungary towards EU markets. This means that the combination of FDI and domestic competitive advantage have led to significantly up-grade the content in added value of Hungarian exports (Table 3) through different stages of the transformation (Table 4). The early opening of the Hungarian economy and the mode of privatization have facilitated a deep restructuring of firms under foreign control.

Table 2: Share of foreign investment enterprises by main indicators of manufacturing companies, 1994 & 1997, (in %)

	Employment		Sales		Export sales		Investments	
	199	1997	1994	1997	1994	1997	1994	1997
Czech Republic	7.1	16.0	12.5	26.3	15.9	42.0	26.9	31.2
Hungary	37.2	42.8	55.4	66.7	65.5	75.4	75.6	79.8
Poland	12.2	18.2	18.7	33.7	.	36.0	.	55.7
Slovenia	7.8	11.4	13.0	21.1	21.1	28.0	.	23.3

Source : Hnuya G. (2000)

Table 3: Composition of Hungary Exports to the EU, by Factor Intensity, 1989-97

Relative Factor Intensity Groups	1989	1990	1991	1992	1993	1994	1995	1996	1997
Natural resources intensive	46.2	41.5	39.3	34.1	30.8	28.9	25.1	21.9	16.5
Unskilled labor intensive	18.8	21.1	22.6	24.8	26.5	23.0	19.2	19.3	17.1
Technology intensive	19.3	21.1	22.5	23.0	25.3	28.9	34.6	36.9	44.1
Human capital intensive	12.9	14.2	13.3	15.7	15.1	17.0	19.1	20.1	22.2

Source : Word Bank (1999)

Table 4 : Changes in Hungary's Exports to the EU, by Stage of Processing, 1989-97

	1989	1997	Average 1989-97	Average 1994-97	Change in %, 1997 vs. 1989	Change in %, 1994-97 vs. 1989-92
Share of primary stage products	19.8	18.3	9.0	17.4	-7.8	-8.6
Share of intermediate stage products	37.3	26.0	33.0	27.4	-30.3	-17.1

Share of final stage products	42.9	55.7	48.0	55.3	+29.8	15.2
Memorandum : share in EU imports						
Primary stage products	0.28	0.32	0.31	0.31	14.3	0.0
Intermediate stage products	2.35	2.27	2.62	2.41	-3.4	-8.0
Final stage products	1.62	2.16	2.03	2.18	33.3	7.4

Source : Word Bank (1999)

Performance.

Foreign invested enterprises encompass a wide range of firms, by sector – manufacturing, services, finance- but concentrate on big enterprises (Table 5). They have better performances in terms of growth, sales, and profitability (Table 6). Bringing in their management and production knowledge, imposing organizational constraints on local firms (*brownfields*) or by building new production unites (*greenfields*) and facing stronger financial constraints (ROI) foreign invested firms are able to turn around their new asset and reach the breakeven point in less time than their domestic counterparts.

Table 5 : FDI Ownership in Manufacturing Firms, 1992 and 1996

% FDI ownership	Number of companies		Companies (%)		FDI (HUF billion)		FDI (% value)	
	1992	1996	1992	1996	1992	1996	1992	1996
<10%	9 151	14 291	78.8%	79.1%	0.3	0.7	0.1%	0.1%
11%-50%	1 111	1 009	9.6%	5.6%	42.3	77.2	21.4%	11.9%
51%-90%	677	813	5.8%	5.1%	65.7	116.7	33.3%	18.0%
91%-100%	681	1 857	5.9%	10.3%	89.2	453.2	45.2%	70.0%
Total	11 620	18 070	100%	100%	197.5	647.7	100%	100%

Source : Word Bank (1999)

Table 6: Enterprises data and performances over years

	FDI controlled		Min. 10% of FDI		State owned		Private domestic	
	1992	1997	1992	1997	1992	1997	1992	1997

Number of firms	662	1 773	1 018	2182	59	146	606	15 751
Total employment	43 030	76 594	151 987	123 938	12 997	26 002	113 241	116 557
Employment per firm in average	65.0	43.2	149.3	56.8	220.3	178.1	20.2	7.4
Sales per firms (HUF Million; PPI adjusted)	297.7	470.3	612.8	490.4	336.3	378.4	61.4	53.2
Assets per firm (HUF million; nominal value)	378.2	736.9	835.6	957.0	493.5	661.0	52.1	74.0
Cash flow to assets	10.6%	30.6%	16.6%	23.4%	2.2%	-0.4%	12.8%	17.9%
Cash flow to sales	13.5%	20.5%	22.7%	19.6%	3.2%	-0.3%	10.9%	10.7%

Source : World Bank (1999)

A cost-advantage analysis.

There is a cost connected with accepting FDI and there might be a trade-off between the increase of FDI and the decrease of a host country's social welfare, such as:

- downsizing policy;
- increase of domestic competition tending to damage local industries;[6]
- sales of high quality assets to foreign owners.

There are also neglected phenomena such as:

- some foreign owners reduce the invested companies' scope for production or immediately stop manufacturing competing products (*e.g.* Tungsram, Schlumberger) or close down a plant in order to reduce competition;
- some foreign investors charge higher prices and take advantage of tax holidays, and tariffs in order to protect their investments;[7]
- in the absence of an objective accounting system, some transactions lead to a kind of despoilment.[8]

Recent contributions maintain that foreign investment encourages the industrialization of the host country [cf. Feenstra and Hanson (1997); Blomström and Kokko (1998); Markusen and Venables (1999)]. Foreign investment creates forward linkage effects for local firms:

- through the contribution of capital, technology, management skills and know-how, which help to improve product quality and diversity;

- through access to international markets and an increase in the propensity to export;

- through growth of total factor productivity;

- by substituting itself for local investment and insuring a high rate of reinvested profits.

Other possible sources of welfare effects are related to competition. As mentioned previously, additional competition leads to the direct destruction of local industry, "but competition in one sector may be beneficial to firms in other sectors" [Markusen and Venables, (1999, p. 336)]. Customer firms benefit from price reductions, and local suppliers observe an increase in demand for intermediate products [De Sousa (2000)]. Competition has another positive effect as it breaks up monopoly and monopsony positions.

3. Spillover effects and mode of transfer.

It is worth mentioning that similar technology transfers have different spillover effects on recipient companies and host economies. Firms have varying absorptive capacities and face learning problems. Consequently, the pace of knowledge and technology transfers is not homogeneous. The impact is also quite different depending on whether the transfer is internalized or externalized. This clear-cut distinction helps to point out some important features of the impact of FDI in Hungary.

Internalized transfers.

Internalized transfers take the form of ***direct investment*** for affiliates and then "control over resources transferred remains with the investor" [Dunning (1993, p. 5)]. The content of the transfer varies depending on the affiliate. It depends on the parent company's strategy, the nature of the transfer, the affiliate's technological and absorptive

capabilities and the host government's policy. UNCTAD (2000) elaborated a classification of internalized technological transfer by affiliate. We revisit this classification and assume that host government policies, FDI regimes and locations are similar:

Affiliate 1: is set up in a developed country and usually serves a regional market. It has a large R&D potential and masters the technology it uses, as well as managerial and marketing functions. It interacts continuously with the parent company.

Affiliate 2: is established in a newly industrializing country and serves a local or regional market. It has an R&D department for certain aspects of design or product development. Local content is important in production, management and marketing, but major strategic functions remain the responsibility of the parent company.

Affiliate 3: is set up in a less industrialized country but is export-oriented. It usually supplies affiliate 2. Local content is less significant. A large proportion of managers and technical staff are expatriates. Technological transfer is mainly used as a means of increasing the affiliate's technical efficiency. R&D facilities are lacking and affiliate 3 simply develops incremental innovations.

Affiliate 4: is established in a less developed country and manufactures standard products with low added value. It is usually a subcontractor of affiliate 3 and local content is scarce.

The Hungarian case: Hungary faces a qualitative evolution in the establishment of foreign affiliates.

♦Stage 1: The establishment of affiliate 3 at the beginning of the transition

It is worth noting that at the beginning of transition, acquisition was the main entryway for FDI. Following acquisition, parent companies introduced new management, organizational techniques, and new quality standards. It shed excess labor, reorganized the production process and invested resources in employee training. However, it paid little attention to promoting R&D. Affiliate 3 is a supplier forming part of the parent company's global strategy. Its technological potential is neglected.

♦Stage 2: The establishment of affiliate 2

As affiliates enhanced their technological capabilities, parent companies' strategies evolved, ascribing new roles to their subsidiaries:

- "product mandate" strategy: the affiliate is commissioned to develop and to distribute a range of products in a regional or a global market (*e.g.* Danone Hungary);

- regional strategy: the affiliate manages a regional market (*e.g.* Knorr-Bremse Hungary);[9] - "knowledge seeking strategy": some multinational companies such as General Electric, Nokia, Ericsson, Knorr-Bremse, ZF or Motorola built up or relocated R&D activities in Hungary.

Externalized transfers.

The externalized transfer takes a variety of forms: minority joint-ventures, licences or subcontracting arrangements. These modes of transfer are becoming more commonplace but their impact is theoretically weaker:

- purchasing licenses is expensive;

- due to the difficulty of protecting patent rights, the technology sold is often outdated;

- tacit elements of knowledge are difficult to transfer.

Subcontracting arrangements are widespread for carmakers and electronics groups in Hungary. These activities make it possible to spread new technologies and knowledge as firms increase their collaboration with suppliers [Helper, MacDuffie, and Sabel (2000)]. This collaboration serves to improve joint products and processes. As a result, communication makes the diffusion of tacit elements easier.

The Hungarian case.

Although technology absorption and the speed of the learning process among Hungarian suppliers are not uniform, we note a forward linkage effect of foreign capital on productivity. At the beginning of the transition, Hungarian firms performed simple outward processing activities for multinational companies. They just offered a low-cost work force and produced commodities using specifications, know-how and raw material provided by the prime manufacturer. In a recent study, we observe that 50% of Hungarian subcontractors mention an increase in their efficiency thanks to help from their prime

manufacturer, and a large majority admit that their clients help them with production and quality problems [De Sousa (2000, p. 333)]. Nevertheless, multinational firms' strategies are not uniform. By contrast, in 1997, the local content of Opel's motor production was 3,5% (1% in 1992) while 26% of the added value of Suzuki was produced by Hungarian suppliers (6% en 1992).

4. Conclusion.

In this paper, we assessed the role of foreign capital on the development of local capabilities by distinguishing between the internalized and the externalized modes of technology transfer. Both create positive effects as well as negative effects, but not the same ones. As emphasized above, the strategy of MNEs, established in Hungary, is changing; while market and efficiency were initially sought after, knowledge is now on the agenda. This change is one of the main positive effects of the internalized mode.

In spite of the importance of the externalized mode of transfer, its impact on local development has received relatively little attention, in comparison to FDI. We have explored this transfer mode while stressing that it also encourages the restructuring process, which is implemented by tapping into existing local capabilities accumulated over the years. These capabilities favored the integration of Hungarian firms into MNE's global networks. In return, large contributions are expected.

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[2] Blomström and Kokko (1998) survey spillover literature.
[3] It is however worth noting that empirically this distinction is blurred by the expansion of network strategies and strategic alliances.
[4] See Estrin, Richet and Brada (2000) for a recent overview.
[5] Here, we do not speak about the motivations of suchs firms to invest in this area.
[6] For instance, the development of big department stores which hurt local retailers.
[7] All car makers investing in the region have enjoyed such privileges.
[8] For example, the sale of Tungsram by Giro Bank to General Electric.

[9] The Knorr-Bremse group (KB) provides a textbook example of this. The first tasks entrusted to KB Hungary were simple subcontracting activities. After an active restructuring phase KB Hungary was assigned a new role in the parent company's global network. It now manages the production and distribution of KB's products in Central Europe. The parent company also promoted R&D in its affiliate.

Even though the establishment of affiliate 2 is becoming increasingly common, manufacturing, assembly and low added value activities remain dominant [Mako (2000)]. Let us now examine the externalized mode of transfer.

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