The Evolution of Multinational Participation in Eastern Europe

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Eastern Europe needs investment, access to world-wide distribution networks, and managerial/marketing/technical expertise. To fulfill these needs, it offers firms major incentives to establish presence in the region. Interviews with the senior representatives of six multinational firms in Hungary, the leading country in the transition to a market economy, revealed an evolutionary pattern of the firms' involvement and investment in the Hungarian economy. This article describes the evolutionary pattern, provides firms with strategic insight, and makes recommendations to accelerate the entrance of global firms into the region. © 1993 John Wiley & Sons, Inc.

FOREIGN DIRECT INVESTMENT IN HUNGARY

Hungary leads the European CMEA[1] countries in attracting Foreign Direct Investment (FDI), attracting approximately U.S.$ 1.2 billion (Soos, 1991). By the end of 1990 over 7,000 firms realized foreign

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[1]Council of Mutual Economic Assistance—Bulgaria, Czechoslovakia, Hungary, Poland, Romania, and the Soviet Union.

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capital participation, as compared to approximately 9,000 firms in the other five countries. Hungary's record, however, is still not enough to move the country to a market-driven economy. Small investment oriented toward sectors with high, short-term returns (more toward commerce and services than production) are common (Soos, 1991). The average foreign capital invested in one firm is approximately US$ 170,000. This total investment is 3.5 to 4% of the Hungarian company sector, a long way from the government's 25% medium term target (Denton, 1991). See Table 1.

In a global prospective, the country's needs are small, but it attracts only a fraction of the worldwide FDI despite the fact that the Hungarian government passed enlightened legislation providing powerful incentives for FDI. These incentives are based on four guiding principles of the government's economic planners: privatization, liberalization, decentralization, and deregulation. Incentives include a foreign investment tax holiday, ability to take profits in hard currency, relaxed import–export regulations, and liberal labor laws. They give the foreign investor a competitive advantage over the domestic entrepreneur (Szakál, 1991).

In assistance to Hungary, the private sector in America, Japan, and Western Europe needs to step forward to speed this transformation. William Pfaff (1991) states:

> Business and industry depend upon the larger society in which they function, and they have obligations to that society. The integration of the ex-Communist world into the politically stable and economically progressive system of market-economy democracies is essential to peace and to the stability of the West as well as that of the ex-Communist countries. This will not be accomplished by governmental negotiations and summit decisions. The web of interactions must be spun as widely and densely as can be done. The private sector in America as well as Western Europe bears a public responsibility. Too much is at stake for that responsibility to be neglected.

Table 1. Joint Ventures in Eastern Europe (Jackson, 1991)

Country	Number of Ventures	Total Foreign Capital Participation (U.S. $ millions)	Foreign Capital Participation per unit (U.S. $ thousands)
Bulgaria	17	10	85
Czechoslovakia	1,700	250	132
Poland	2,799	374	134
Romania	1,679	N.A.	N.A.
Soviet Union	2,600	529	182

Lessons learned by Hungary need to be shared with other countries—particularly with the other East European countries and the nations that comprised the USSR. We gathered data for this article from one-on-one interviews in six major multinational corporations (MNCs) with a presence in Hungary. These firms are representative of global firms with a presence in Hungary (and Eastern Europe). In each case, we interviewed a senior, in-country representative, who always was non-Hungarian. Because some firms requested anonymity, none are named. All firms are large with production and marketing presence in many countries: two chemical companies, two companies producing and marketing personal care products, one basic metals company, and one fashion manufacturer/distributor. Five are based in Europe; the sixth in America. Four companies' Hungarian revenues exceed HUF 1 billion ($12.5 million). Our interviews revealed an evolutionary pattern of deepening involvement by and increasing complexity of the individual firms—very similar to a pattern observed in China. Two interacting forces determine the form of the firm's presence in Hungary: prior Hungarian experience and the legislation at the time the company entered Hungary.

The first force is based on relationships. A firm builds relationships through its life. Contact is required—if it is positive the relationship strengthens and trust begins to form; relationships deepen and become more complex. Fortunately, MNCs in Hungary found beneficial relationships; Hungary is now profiting from FDI and expertise that MNCs contributed. The pattern showed a positive deepening of MNC involvement the Hungarian economy.

Many publications have documented the second force, the legislative framework in Hungary and other CMEA countries. The legislative process is dynamic—when a document is published, it is often out of date. Key changes in the law, in their historical context, are noted throughout this article.

EVOLUTIONARY PATTERN

The pattern of deepening involvement and increasing complexity is reflected by the changing form of the firm's venture. No firm evolved through every step of the pattern: buyer–seller, licensing, representative office, joint venture, and wholly owned subsidiary. The movement is always in one direction, from buyer–seller to wholly owned subsidiary. Table 2 details the pattern, and each step is described below. Following the description of the pattern are six case studies describing how the interviewed firms developed their relationships with the Hungarian economy.

Table 2. Evolution of a Firm in Hungary and Its Related FDI Level

Form of Venture	Level of FDI
Buyer–seller	None
↓	
Licensing	Minimal
↓	
Commercial representative office	Low
↓	
Technical representative office	Low
↓	
Joint venture	Large
↓	
Wholly owned subsidiary	Major

Buyer–Seller

Firms start with a basic buyer–seller relationship. In the previous economic system, the buyer–seller relationships between Hungary and MNCs were unnecessarily complicated. The government defined by product type the nation's agents, State Export Import Trading Companies (SEITCs). Centrally planned economies created firms for specialized functions. It became the responsibility of the SEITC to market a firm's exports or to obtain its imported base materials. Thus, manufacturing firms never developed in-house expertise in overseas marketing or foreign procurement. For import items, availability of convertible or "hard" currency was an ongoing problem. Today, these relationships are less complicated, but tariff and nontariff barriers to import still exist, as well as many currency controls. Trying to export their products, Hungarian firms are hampered by:

- lack of knowledge of Western markets,
- the collapse of their previous major customer base (CMEA), and
- lack of an export credit function by the Hungarian government.

Licensing

As the market for a multinational's product emerged, establishing Hungarian production facilities within Hungary allowed:

- reduced transportation costs,
- avoided or reduced import restrictions,

- supported governmental interests,
- produced cost advantages from Hungary's educated, low-cost labor force, and
- (before 1991) provided access to all CMEA markets.

Before 1972, Hungary did not permit foreign ownership of production facilities. Licensing agreements were the most common mode of production. These agreements normally included MNC supply of trademarks, base materials, packaging materials, and quality control. No FDI, management, or marketing expertise was included. The trademark was essential to exploit the established market and to increase desirability for the product (since Western goods were in great demand throughout the CMEA shortage economies). This drove other elements of the licensing agreement: provision of base materials and quality control oversight. Although Hungarian workers can produce high-quality work, the incentives under the CMEA shortage economies did not require quality. Therefore, the MNC closely monitored the raw materials and final products produced. Even today, some MNCs are avoiding FDI in production facilities for many reasons:

- high levels of perceived risk due to political/economic instability
  - vague ownership, especially real estate ownership
  - confusing rival political parties
  - new laws enacted by government daily—some changing the previously passed, favorable legislation (Lengyel, 1991)
  - slow bureaucratic administration, especially at registry courts and during privatization by the State Property Agency
  - restricted functioning of investment companies
  - restricted participation in securities trade
- small Hungarian market (dissolution of CMEA and breakup of the Soviet Union reduced the potential market size)
- better invested capital returns in other venues
- poorly developed telecommunications, roads, railroads, and public utilities [The Government established an Investment Stimulation Fund of HUF 1,500 million for infrastructure investments linked to foreign investments at only 2.5% of the investment that the government wished to attract. The international norm in this kind of situation is 15–20% (Aczél, 1991]
- lack of a modern banking system with the requisite interbank clearing system.

Representative Offices

After licensing, the next step, normally, is establishing a commercial representative office. Opening such an office is the easiest means of establishing formal presence in Hungary (which improves the communications with licensees and enhances the possibility of subcontracting for domestic sales or export). As the relationship between Hungary and a MNC deepen, the firm upgrades the commercial representative office to a technical representative office. This allows the firm to market a full range of products (not just those produced in Hungary), make direct sales, and provide a market economy level of customer support. The challenge presented is to shift from the attitudes evidenced in a shortage economy, where without sales support, the salesperson is doing the buyers a favor selling to them to the demands of a market economy where the salesperson is competing to make the sale.

Joint Venture

The next step in the evolution is forming a joint venture, popularized since the sweeping legislation of 1988 and 1989. Throughout the firm's evolution in Hungary, this is the first place that the MNC made FDI to a meaningful degree. The firm now parents the venture and lends its name to the venture. The MNC provides money; managerial, marketing, and technical expertise; capital equipment; and a worldwide distribution network. The local partner provides knowledge of the local (and CMEA) market; understanding of the local business practices and customs; language skills; entry into the network of local businesses; a known labor force; and real estate—some in prime locations. Many such contributions become less valuable as the MNC becomes established in the host country.

MNCs are aware that international joint ventures often fail: partners may have different objectives and expectations of the venture. (This is especially true in Hungary where one partner is the government with an economic philosophy that may be changed by the next election.) Corporate cultures or administrative procedures may clash. Loyalties of assigned personnel may go to one partner, the other, or to the newly born venture.

Wholly Owned Subsidiary

The final phase in the evolution is a wholly owned subsidiary with MNC independent production and marketing in Hungary. The venture needs certain critical mass to justify the cost of sending non-

Hungarian manager and technicians to operate the firm or to train local staff. Some firms have evolved to the point in their relationship with the Hungarian economy where they make a commitment of funds, leading technology, and managers. These managers may be non-Hungarian or Hungarians whom the firm has trained during the evolutionary process described above. A well-publicized example is General Electric's (GE) purchase of 51% of Tungsram's shares. The first year, GE invested $20 million. With $35 million planned for 1991, GE sent 12 American managers to help transform the company to a world standard. GE projects that Tungsram will produce a reliable profit in 5 to 6 years (Kaan, 1991).

CASE STUDIES

In the following case study, a MNC is in the buyer–seller phase of evolution:

Case Study #1: A Chemical Firm—Early in the Process

Until July 1988, this firm's SEITC handled all transactions. When the SEITCs lost their monopoly-like power, the firm set up a small, technical representative office in Hungary. Now it is facing a Catch 22 dilemma: lack of high quality warehousing in Eastern Europe limits the firm's sales; low sales do not justify building and operating a controlled environment warehouse. Until either high sales or controlled environment warehousing is in place, the firm is unwilling to make the FDI needed to expand into the Hungarian market. The local representative believes that his home office is negotiating with two other major chemical companies on a joint venture to construct a controlled environment warehouse in Hungary.

Case Studies 2, 3, and 4 show the nature of Representative Offices:

Case Study #2: A Personal Care Products Firm—Early in the Process

Since 1970, this firm has licensed a Hungarian company to produce its world famous skin cream product, providing product licenses, base chemicals, and quality control. Although the product demand was always solid, the Hungarian licensee did not always have sufficient hard currency to purchase base materials. In 1990, the MNC strengthened its presence by opening a commercial representative office; there are no plans for further expansion at present.

Case Study #3: Basic Metals Company—Moving Through the Process

This firm is new to the Hungary and has quickly established a major role—following the pattern with a technical representative office in 1990. Ninety percent of its present cash flow comes from the export of metal. Import operations are limited. The firm is cooperating with a Hungarian R&D center and is negotiating the establishment of a production joint venture. Projected 1991 revenue is $29 million (HUF 2.175 billion). The representative is positive about his firm's role in the Hungarian economy.

Case Study #4: A Chemical Company—Ready for the Next Stage

This chemical company, active in Hungary for 25 years, is fully dedicated to in-Hungary sales of its complete product line. Although most of its sales was through SEITC, before 1988 it had a small commercial representative office. In 1988, it upgraded to a technical representative office—permitting marketing, direct sales, and client service. Invoicing and other financial controls remained at the company headquarters. Revenues in 1990 were $32 million. In June 1991, it formed a production joint venture to start operations in 1992 intent on significant FDI.

The Joint Venture phase is characterized by the dynamics in the following case:

Case Study #5: The Second Personal Care Firm—A Major Player

This firm built a Hungarian-based production plant in 1927 that was destroyed during World War II. After the war, sales (hard currency only) were managed by the home office and were small. Later, control shifted to the MNC's Austrian office. Involvement in Hungary increased as the firm entered licensing arrangements with a Hungarian firm. Demand for the firm's products continued to increase. In 1987, the firm formed a joint venture with three Hungarian firms and retained 51% of the joint venture's ownership; the licensed Hungarian firm held 22%, a SEITC held 22%, and a supplier of base materials owns 5%.

As a note, it is common for foreign firms to form joint ventures with several specialized Hungarian firms. In a planned economy, firms became specialized. Vertical integration was rarely employed. Manufacturing companies did not acquire the means of producing their input materials.

Upon deciding to form a joint venture, this MNC defined the contributions required of the Hungarian partners: production facilities, knowledge of the CMEA export markets, and a reliable source of base supplies. A set of specialized forms (with previous, satisfactory MNC relationships) formed the partnership. Today, the joint venture produces products, subcontracts with other Hungarian firms to produce other products, and manages the retail agent network. The subcontracts call for MNC to supply base materials, packaging, and quality control. Projected 1991 revenues are $20 million (HUF 1.5 billion).

Finally, the full evolution is evidenced by:

Case Study #6: A Fashion Manufacturer and Retailer—The Total Evolution

This MNC manufactures and sells clothing products worldwide. It is instantly recognized in Beijing, Roma, New York, and Budapest. In the 1960s and 1970s, product demand was high in the CMEA countries, despite their reluctance to use hard currency on clothing items. To penetrate the Hungarian market, the firm employed a license agreement. Demand continued to outstrip production. The licensee did not achieve the production efficiency of similar plants in market economies. In 1988, it set up a joint venture with four Hungarian partners, retaining slightly more than 50% ownership. The joint venture has been profitable for all Hungarian partners: a SEITC, a clothing manufacturer, a retail company, and warehouse/distribution company. Still, the MNC prefers to own its factories. (Its only other joint ventures are in Yugoslavia and Turkey.) The joint venture agreement was signed for a set period, ending in 1994, when the MNC will establish a wholly owned subsidiary. The joint venture also owns two retail stores and plans to expand its Hungarian retail presence in the next few years. The firm believes control of retail outlets may inhibit widespread trademark piracy. The firm's turnover in 1990 was $14 million (HUF 1 billion).

RECOMMENDATIONS FOR ACCELERATING THE PATTERN

Table 3 summarizes the evolution of the six MNCs. For each case study, the date when the firm entered a particular venture form is given. Note that every firm chose to follow the evolutionary path—one of deepening involvement and increasing complexity. The pattern of involvement in the economy is clear; as relationships strengthened and as Hungarian legal requirements liberalized, in-

Table 3. Evolution of Six MNCs in Hungary

Form of Venture	1st Chemical (Case #1)	1st Personal Care Products (Case #2)	Basic Metals (Case #3)	2nd Chemical (Case #4)	2nd Personal Care Products (Case #5)	Fashion (Case #6)
Buyer–Seller	Entered			1965	1945	
↓	↓			↓	↓	
Licensing	↓	1970		↓	1960s	1970s
↓	↓	↓		↓	↓	↓
Commercial	↓	1990		↓	↓	↓
representative	↓	to		1965	↓	↓
office	↓	present		↓	↓	↓
↓	↓			↓	↓	↓
Technical	1988			↓	↓	↓
representative	to		1990	1988	↓	↓
office	present		↓	↓	1987	↓
↓			↓	↓	to	↓
Joint venture			In	1991	present	1988
↓			Process			↓
Wholly owned						1994
subsidiary						

volvement deepened. In the last two phases, they contributed significant FDI to the new Hungarian economy.

A MNC in Hungary starts in a buyer–seller or licensing agreement with minimum financial involvement. Certain of the viability of the market and capability of industry in Hungary, it opens a representative office, staffed by an experienced, trusted employee. This allows the firm to assess the desirability of pursuing FDI. Finally, when the relationships with Hungarian firms are established, the market is understood, and appropriate governmental incentives are in place, the MNC invests in a joint venture or wholly owned subsidiary.

The evolution of strategic joint ventures incurs the building of trust and understanding—time-consuming work. Hungary and the rest of Eastern Europe need investment, managerial/ marketing/ technical expertise, and access to worldwide distribution networks now. Compressing the time needed for the establishment of joint ventures is essential and difficult. The government needs to engage the commitment of firms to move directly to the joint venture or wholly owned subsidiary form of involvement, skipping intermediate phases. As well, Hungary and the other new market economies are looking to socially responsible global firms for the transfer of their expertise and funding.

Barriers to involvement in the industrial retooling of the CMEA countries are evidenced in Case Study #1. The chemical company is constrained by the Catch 22 of controlled environment warehousing, a symptom of a bigger problem facing Hungary—the *lack of adequate infrastructure*. Foreign firms will be slow to enter a country where the infrastructure cannot support its needs, e.g., special warehousing, consistent telecommunications, a reliable power supply, just-in-time inventory techniques based on good rail and road networks, quality banking system, etc. Moving in the correct direction, the government is now establishing an Investment Stimulation Fund. Still, the fund is too small to meet the demand. The government needs to prioritize industrial infrastructure development even at the expense of improved domestic infrastructure.

Two MNCs formed joint ventures with Hungarian firms with previous business relationships. With trust established, it is clear where, in the value-added-activity-chain, the Hungarian partner needs to contribute. Because of the high level of specialization in Hungarian industry, both joint ventures are complicated by requiring multiple Hungarian partners. A single firm cannot make all necessary contributions to the value-added-activity-chain. The difficult task of *finding compatible firms to form a joint venture* falls upon the MNC. The Hungarian firms lack understanding of how the final venture will function and be structured to compete successfully in the world marketplace.

The first wave of joint ventures, where the MNC and Hungarian firm(s) had established relationships, is over. Now the second wave of joint ventures needs to be formed between firms who lacked contact in the past. This challenges the MNC to invest time, energy, and money to find an acceptable set of partners. Alternatively, the MNC can make a larger investment that meets the critical mass test for a wholly owned subsidiary.

Thus to increase the FDI in Hungary, the government needs to provide MNCs with infrastructure of a world standard. The MNCs are then responsible for finding appropriate partners with whom to form a joint venture or to skip the joint venture step, and form a wholly owned subsidiary. In partnership, the government and the MNCs must hasten movement through the process, identified herein, and provide Hungary with the ingredients for a dynamic market economy.

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