



Multinational enterprise strategy, foreign direct investment and economic development: the case of the Hungarian banking industry

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Abstract

This paper examines foreign direct investment (FDI) in the Hungarian economy in the period of post-Communist transition since 1989. Hungary took a quite aggressive approach in welcoming foreign investment during this period and as a result had the highest per capita FDI in the region as of 2001. We discuss the impact of FDI in terms of strategic intent, i.e., market serving and resource seeking FDI. The effect of these two kinds of FDI is contrasted by examining the impact of resource seeking FDI in manufacturing sectors and market serving FDI in service industries. In the case of transition economies, we argue that due to the strategic intent, resource seeking FDI can imply a short-term impact on economic development whereas market serving FDI strategically implies a long-term presence with increased benefits for the economic development of a transition economy. Our focus is that of market serving FDI in the Hungarian banking sector, which has brought improved service and products to multinational and Hungarian firms. This has been accompanied by the introduction of innovative financial products to the Hungarian consumer, in particular consumer credit including mortgage financing. However, the latter remains an underserved segment with much growth potential. For public policy in Hungary and other transition economies, we conclude that policymakers should consider the strategic intent of FDI in order to maximize its benefits in their economies.

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1. Introduction

It is claimed in the literature (Dunning, 1993; Porter, 1990; Vernon, 1966) that foreign direct investment (FDI) and multinational enterprise (MNE) activity contribute to the economic development of an emerging economy through numerous channels.

These include employment creation (and associated rising incomes), technology transfer and general upgrading of industrial standards to world levels. Furthermore, it is possible to draw a contrast between FDI that is fundamentally resource seeking and FDI in services which is market serving (Birkinshaw & Hood, 1998). This allows us to focus on the strategic intent of FDI.

The dramatic changes that occurred in 1989 in central and eastern Europe (CEE) created an ideal setting for an empirical appraisal of these claims. With the collapse of state socialism, there was a desperate need to move towards a market-led enterprise economy. One of the most frequent policy prescriptions

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for transition economies was to liberalize their industrial sectors by encouraging FDI and foreign ownership. Among the CEE economies, Hungary has led the way in adopting this development strategy. At the same time as the 1989 changes, increasing economic integration at a global and regional level has significantly strengthened the role of MNEs in the economic development of countries in general.

The first few years of the arrival of FDI in Hungary were heralded as a significant step forward in the modernization of the Hungarian economy. Old, obsolete capital was replaced with new, efficient plant and machinery. New business practices were introduced with a commercial, market focus. Those areas of excellence in Hungary that were regarded as world class have been supported by injections of new capital. Above all, unemployment caused by the collapse of the state socialist planned economy has been partially solved by employment created by MNEs. In international organizations and governments around the world, Hungary has been lauded for undertaking the necessary liberalization of its economy. Today, over 50% of Hungarian GDP is produced by MNEs and a staggering 80% of Hungary's exports is produced by MNEs. Most modern western European economies were based on the activities of small national firms created in an era of closed economies and which would later grow and become multinationals through the course of the twentieth century. But in the globalized economy post-1989 this model of development via the creation of a national entrepreneurial structure was not available to the transition countries of Central and Eastern Europe (Inotai, 2000). Therefore, the MNEs have become the engine of economic development for this region.

As long as the Hungarian economy continues to grow, one can expect to see foreign companies remaining active, particularly in the emerging service sectors. The objective of this study is to trace the development and effects of foreign direct investment in Hungary, one of the leading transitional economies of Central Europe and which in 2004 will attain EU accession. Given the broad and extensive nature of this topic, we wish to pursue that branch of FDI known as *market serving* investment (as opposed to the export-driven or *resource seeking* variety), and concentrate on the role played by FDI in one key market serving sector in particular, that of banking, regarded as being central to

the sound development of an economy. In doing so, we will attempt to determine if some of the claims made in the literature regarding the effects of FDI on transitional economies hold true in the case of the Hungarian banking sector during the post-Communist period.

The paper is organized as follows: Section 2 provides a conceptual framework for the impact of FDI in a transition economy. Section 3 gives an overview of FDI in Hungary. It presents aggregate data on FDI and presents a general picture of the state of MNE involvement in Hungary. Section 4 focuses on FDI in the Hungarian banking sector as a case study of the role of FDI in service industries. Section 5 is a concluding section.

2. Effect of FDI on transition economies

First of all, it is important to “define” our concept of transition economy by highlighting what we regard as key characteristics of this kind of economy. We impose the following restrictions on our “definition.” We are making claims about transition economies (TEs) based largely in Central and East Europe (CEE). In doing so, we are not examining the development of TEs in South East Asia such as Vietnam or the former Soviet Republics in Central Asia such as Kazakhstan. Second, we wish to take account of approximately one decade of economic reform and hence focus on TEs in CEE that are making strides to join the European Union in the coming decade. In this sense, we eliminate from our analysis TEs such as Russia, Ukraine and Belarus, which are highly unlikely to be considered EU candidates in the immediate term largely due to a relative inability to undertake substantial EU-compliant reforms in their economies. Third, we conceptualize CEE TEs as being relatively small in economic terms, i.e., GDP per capita. This has an important implication when we consider the strategic intent of FDI below. Fourth, with the exception of Slovenia, we ignore the former Yugoslavia given the unique situation caused by war during the break-up of the former federal republic. By imposing these restrictions, we are left with a raft of CEE economies. Even among these, we can see significant differences between larger TEs such as Poland and Romania and the small Baltic republics.

Despite these differences there are significant similarities among these CEE TEs. First, GDP per capita levels in these nations are below the EU average but are growing at a rapid rate. Second, industrial restructuring including privatization of industry has taken place to a significant, if not complete, degree in these transitional economies. Third, there is a growing middle income class of consumers who are demanding increased variety and sophistication of products and services. Fourth, the legal and legislative framework in these economies is stable and predictable in most instances. Fifth, their geographical proximity to the EU creates major incentives for FDI for re-export to the EU. Lastly, the CEE TEs are significant sources of scarce but relatively low-cost factors of production such as skilled labor—this itself a product of the state socialist system that prevailed before 1989. These six factors make CEE TEs highly attractive locations for FDI from multinational firms based in the EU and the OECD countries more generally.

We choose Hungary as our case study because as a transitional economy, it epitomizes the situation of its neighbors on the basis of our six characterizations above. Thus Hungary, as our case, illustrates a number of our general claims about FDI in transitional economies in the region which could be extended to other such economies. We now turn to a discussion of the predicted effects of FDI in these markets.

While there are several effects of FDI that the international business literature has identified depending on the strategic intent of the FDI in question, we aim to take some of these general propositions and apply them to the specific (and sometimes different) context of a transition economy. In our paper we differentiate between FDI that is strategically intended to access key resources available in the host country (resource seeking FDI) primarily for transformation and subsequent export of manufactured products, and FDI which is aimed primarily at accessing the market of the host country (market serving FDI). A further delineation distinguishes FDI in manufacturing and service sectors. Our table examines the relationship between manufacturing and service FDI and the resource seeking and market serving FDI-types in transition economies. The table attempts to combine these two “dimensions” in a simple two-by-two matrix.

As our table illustrates, in transition economies, three of our four quadrants are significant conceptual

explanations for FDI. It is worth noting that resource seeking FDI in service sectors is relatively unimportant. Possible exceptions are in the field of internet services where key educated human capital exists, e.g., computer programmers in Hungary or the provision of regional service centers as in telephone banking (again where skilled human capital is key). Examining each of the remaining three quadrants, we derive some interesting claims. First, resource seeking FDI in manufacturing sectors in CEE TEs has been strategically designed to access an abundance of relatively low cost, high-skilled labor in a number of instances. By bringing proprietary technology to host TEs, MNEs have been able to make use of the highly educated and flexible workforces available in the CEE TEs. Given this, we therefore expect that as wage demands from workforces in these countries rise, the incentives for resource seeking FDI in manufacturing are likely to decline and MNEs will be required to seek out alternative lower-cost locations for FDI.

Where resource seeking FDI in manufacturing has been strategically designed to access other natural resources, the maintenance and continuing presence of FDI in these TE sectors is closely related to the opportunity costs of exploitation of these natural resources relative to other locations and other natural resources.

If we consider market serving FDI in manufacturing industries, the strategic driver of FDI is to serve the local market with goods and services. In an initial phase, MNEs are likely to serve the local market with lower priced, less sophisticated products in order to get a relatively low risk, foothold in the market. As incomes among the population rise, products offered are likely to increase in sophistication. It is important to note that the products offered by the MNE are usually likely to be of a higher quality and sophistication than that of local rivals (if they exist at all). However, by comparison with their home markets, the products marketed in these TEs can often be considered “old products” (Fig. 1).

By comparison with market serving FDI, resource seeking FDI is unlikely to be a long-term strategic explanation for FDI as relative costs in the CEE TEs are likely to rise thus making them relatively less attractive hosts for MNE activity. We would expect the FDI shift to occur among CEE TEs and also between CEE TEs and other economies. Also, FDI can be used

	Manufacturing FDI	Service FDI
Resource Seeking	Common, closely related to two strategies (a) Accessing lower labor costs (relative to home country) (b) Key natural resources not readily available in home economy	Rare. Unlikely to be a strong strategic intent in transition economies
Market Serving	Common for two product marketing strategies (a) Local market sales (b) Regional market sales	Common. Significant FDI of this type occurs in (a) Privatized sectors (b) De-regulated, restructured industries (c) Serving an emerging demand caused by increased economic/income growth in transition economy

Fig. 1. Comparing strategic intent of FDI in manufacturing and service sectors.

to serve a regional market where the host country acts as a production and distribution “hub.” In this case, the product marketing strategy is likely to be similar as to that of serving the local market.

An important specificity of the CEE TE case is that a number of manufacturing companies were acquired as part of a privatization tender offered by local governments. In this instance, acquisition by strategic foreign investors has led to substantial rationalization in the sector concerned. For example, as part of “Central Europe” FDI strategy, some MNEs have acquired a number of companies in the same sector in different countries. The aim has been to reduce the number of production locations, creating a regional production hub and thereby using modern, efficient logistics and distributions systems to serve a number of local and regional markets. In other cases, MNEs have acquired previous state monopolies and carried out a similar restructuring in the local market.

Market serving FDI in manufacturing industries has both a short-term and long-term component. Some MNEs may see acquisitions through FDI in CEE TEs as part of a short-term profit strategy of benefiting from a relative lack of competition in the local market thereby reaping significant profits. Over time, as local

competitors and foreign rivals enter the market, profits may be squeezed and thus exit may be a sensible strategy as profits fall below a target level decided by company strategy. However, if an MNE recognizes that growing consumer incomes are likely to lead to increased demand for its products, then a long-term presence is likely to be central to its strategy. The longer term incentive is enhanced where FDI is part of a greenfield entry strategy where significant initial set-up cost and cash flow requires time to be recouped. In CEE TEs, this kind of FDI is likely to be highly beneficial to the economic development of the economy both in terms of employment and in increasing consumer choice and sophistication.

Market serving FDI in the service sector reveals some of the most interesting effects of FDI in the transitional economies. The relationship between service demand and income growth suggests that the increasing wealth and growing middle classes in CEE TEs mean that service sector firms will have significant future opportunities in these economies. In particular, the telecommunications and financial services sectors are likely to witness significant demand growth and therefore market serving FDI in these sectors is likely to be of a longer-term, patient variety.

The service sector in most CEE TEs is the least developed sector of the economy. It has the greatest potential for the growth and is likely to develop as a consequence of privatization as the initial driver of that change. FDI flows of capital and technology have revolutionized the quality and breadth of service provision in markets such as Hungary. Furthermore, employment growth in the service sector has outstripped the manufacturing sector. This has led to increased incomes and hence further demand for services among the population. This is an important “virtuous circle” that can help explain the successful growth of developed market economies in the past.

The development of new skills among the working population has also benefited the CEE TEs. While technical and scientific skills of workers in the CEE TEs were as good, if not better than in some EU and OECD economies, the absence of a “service culture” has been filled by FDI in service industries. Thus, market serving FDI strategy in service sectors is likely to be the longest lasting and probably the most profound compared to our other types above. Successful FDI strategy in this context is predicated on the ability to capture consumer loyalty over the longer-term and the recognition that rising incomes predict future success for the MNE investing in CEE TEs inevitably encourages a longer-term view of strategy.

We now turn to our case study to illustrate our arguments. We have chosen Hungary as our case because it epitomizes the issues above. We have examined manufacturing and service sector FDI in Hungary. As we argue that market serving FDI in service sectors is likely to have the most profound impact on CEE TEs, our main industry case study is the banking sector in Hungary. Hungary’s experience with FDI has important implications for other CEE TEs from both a conceptual perspective and from a public policy perspective.

While the initial phase of FDI into Hungary was largely determined by the acquisition of privatized enterprises by strategic foreign investors (often in resource seeking FDI in manufacturing), a significant portion of FDI is now in greenfield investment. The World Bank reported that in 1998, 94% of FDI in Hungary went into greenfield investments vs. only 34% in 1995, noting that “such investments support

restructuring and economic growth more directly than takeovers” (World Bank, 1999). Furthermore, as Hungarian GDP per capita rises, we should see continued foreign investment in the market serving service sector. Recent and pending decisions of MNEs to draw back or slowdown their FDI in some manufacturing sectors demonstrates the frailty of Hungary’s cost advantage over other CEE TEs and economies elsewhere. In order for Hungary as well as other CEE TEs to continue to attract FDI, flexible factor markets will be crucial. One of the most important requirements here is that of a well-functioning and competitive capital market. The role of foreign banks is crucial to this success. Recent evidence suggests that as labor costs rise and housing market bottlenecks continue, the attractiveness of Hungary as a location for manufacturing FDI may be threatened.

3. Foreign direct investment in Hungary

Hungary attracted over \$15 billion in foreign investment in the period from 1989 to 1997, equivalent to one-third of the entire FDI invested in central and eastern Europe. By 1999, over 30,000 foreign companies have established operations in this relatively small country of 10 million inhabitants (US Department of Commerce, 1999). And as of 2002, Hungary had attracted \$27 billion in FDI, mostly in greenfield investments, while per capita FDI was \$2,711, the highest in central Europe (World Bank, 2002). This is due in part to the country’s highly skilled-low wage labor force, social stability, proximity to the prosperous markets of Western Europe and future EU accession. Foreign investment in Hungary began to grow significantly after 1989 with the extensive cash privatization of state assets. The privatization law of 1995 and a later amendment of 1997 accelerated privatization and increased the transparency of related legal procedures. The Investment Act governs the establishment and operations of companies with foreign participation, and grants significant rights and benefits to foreign investors. It guarantees national treatment for foreign investments, abolishes the general requirement of government approval, and also provides protection against losses resulting from nationalization, expropriation or similar measures, and guarantees free repatriation of invested capital and dividends.

Hungarian regulations concerning foreign investment allow foreign ownership of up to 100% with the exception of some defense-related industries, the national airline and a small number of other designated strategic holdings, most of which are in infrastructure and natural resources. Another singular exception is agricultural land, where restrictions on the purchase by foreign natural persons are still in effect (although this may soon be modified). Furthermore, the legal system provides strong protection of property rights, and tax, labor, health and safety laws do not impede investment overall. The highest marginal corporate tax rate at present is 18%, while for individuals it is 40%, and a respected survey of world competitiveness ranks Hungary as 28th out of 49 countries, ahead of every other CEE country other than Estonia (IMD, 2002).

Table 1 outlines the source country of Hungarian FDI. From the table, we note that Germany, Austria, the United States and the Netherlands are the main

Table 1
Distribution of FDI by exporting country

	1993	1994	1995	1996
<i>Total</i>	100.0	100.0	100.0	100.0
Austria	15.8	19.9	15.9	14.5
Belgium	3.2	2.1	3.1	2.6
Denmark	0.2	0.6	0.6	0.7
Finland	0.2	0.2	0.3	0.5
France	4.7	5.2	8.1	7.8
Germany	28.4	22.3	24.6	23.8
Greece	0.2	0.1	0.1	0.1
Ireland	0.1	0.3	0.3	0.2
Italy	3.9	4.7	3.8	3.8
Luxembourg	1.1	1.8	1.1	1.1
Spain	0.1	0.1	0.2	0.1
Sweden	0.7	1.1	0.7	0.6
The Netherlands	5.6	11.1	10.5	9.5
UK	3.9	4.5	3.8	5.8
<i>EU (without Portugal)</i>	68.2	74.0	73.2	71.2
Australia	1.3	0.2	0.0	0.1
Canada	0.6	0.9	0.6	0.4
Cyprus	0.1	0.2	0.8	0.7
Japan	2.6	1.9	1.3	1.6
Korea	0.4	0.4	0.5	0.8
Russia	0.0	0.0	0.7	0.8
Switzerland	2.0	3.8	2.9	2.3
USA	21.0	14.3	16.0	17.1
Others (including Portugal)	3.9	4.5	4.1	4.9

Source. World Investment Report (1998).

Table 2
Sectoral distribution of FDI stock in Hungary

	Proportion of the stated capital hold by foreigners			
	1992	1994	1996	1998
Total economy	100.0	100.0	100.0	100.0
Agriculture, forestry, etc.	0.7	1.2	1.2	0.9
Mining	1.8	1.1	1.2	0.5
Processing	54.1	48.6	39.6	38.1
Foods, drinks, tobacco	–	15.9	9.1	10.0
Textiles, clothing, leatherware	–	2.0	2.0	1.7
Wood, paper and press products	–	3.1	2.7	2.2
Chemicals, oil	–	6.5	8.7	7.8
Non-metal products	–	4.0	2.8	2.4
Metallurgy, metal processing	–	3.1	2.5	3.4
Machinery	–	13.4	11.5	10.2
Furniture and other processing	–	0.7	0.4	0.5
Utilities (electricity, water, gas, etc.)	0.6	0.5	14.2	14.3
Building	4.1	4.7	3.7	1.6
Trade	14.3	14.1	11.9	12.2
Tourism	3.2	3.6	2.5	1.7
Transportation and telecommunication	2.0	7.9	8.8	6.7
Financial services	9.5	8.9	8.9	11.4
Real estate	8.8	8.5	7.3	11.1
Education	0.0	0.0	0.0	0.0
Health and social care	0.1	0.2	0.1	0.1
Other	0.8	0.6	0.5	1.4

Source. World Investment Report (1998).

exporting countries of FDI to Hungary. This is in line with general international trends of FDI as well as the geographic proximity of Austria and Germany.

In Table 2, the sectoral distribution of FDI is outlined. First, the main sector for FDI has been in manufacturing, the largest of which is in the agro-alimentary and machinery sectors. Investment in services overall, as of 1998, exceeded manufacturing, and utilities, trade and financial services were the largest components. Second, the amount of FDI has fluctuated since 1992, reaching a high point of over \$4.4 billion in 1995 when the banking sector was opened to foreign investment. Nevertheless, the trend of significant foreign direct investment in Hungary has continued, and it has the second largest accumulation of FDI in the region, only slightly lower than Poland, a country with almost four times the population.

Lastly, in Table 3, we can see the companies which have been the largest investors in Hungary. Deutsche Telekom are top of the list with their US\$ 4 billion

Table 3
FDI investment in Hungary by company

Country	Company	Industry	Contribution
USA/Germany	Ameritech & Deutsche Telecom	Telecom	\$1,727 billion
USA	General Electric	Lighting	\$826 million
Germany	RWE Energie/Energie Baden-Württemberg AG	Electricity	\$550 million
France	Eridania Beghin-Say SA	Sugar	\$540 million
The Netherlands	Aegon Insurance	Insurance	\$460 million
USA	General Motors	Finished auto parts	\$450 million
The Netherlands/others	PTT Telecom, Telenor, Teledemark, Telecom	Telecom	\$400 million
Germany	Volkswagen/Audi	Car manufacturing	\$372 million
Italy	Banca Commerciale Italiana	Banking	\$370 million
Germany	Bayernwerk AG	Electricity	\$370 million
Sweden	Ericsson	Telecom	\$350 million
USA	US West	Cellular phone	\$330 million
USA and others	Coca-Cola	Beverages	\$280 million
France	Electricite de France	Electricity	\$253 million
The Netherlands	Vivindy CG Sat Hungary	Telephone operator	\$250 million
USA	Hungarian Telephone & Cable Corporation	Telephone operator	\$250 million
Japan	Suzuki Motor Corporation	Cars	\$250 million
The Netherlands	ABN-AMRO	Banking	\$237 million
Germany	VEW/Ruhrgas	Gas distribution	\$227 million
Germany	Allianz	Insurance	\$220 million

Source. Figyelő Top 2000.

acquisition of Matav, the former state telecom monopoly from Ameritech. General Electric, GM and Audi/VW are other large investors in Hungary. There is also an important presence of foreign ownership in the energy sector with French and German companies notably active (Table 4).

On the eve of EU membership however, there is an increasingly held view that while the early years of Hungary's internationalization was a unique "golden era," the future is going to be much more challenging (see *Budapest Business Journal*, 2002). In the early years, Hungary moved much quicker in inviting foreign investment than its regional neighbors who are now beginning to catch up, and furthermore, as costs rise in Hungary (accompanying a rising standard of living), Asia will be an increasingly attractive competitor for manufacturing FDI. This challenge is evidenced by the recent decisions of several major investors to scale down or relocate operations from Hungary. For example, Mannesmann, a German engineering firm has relocated some manufacturing operations to China. At the same time, Flextronics International and Microsoft also moved production of the latter's Xbox game consoles from Hungary to China; and Shanwa of Japan closed a cassette tape

deck manufacturing plant in the eastern city of Miskolc, shifting operations to China for cost reasons.

Peter Simonyi, of KPMG in Budapest, has commented that besides competition from other countries, Hungary has lost much of its initial appeal as the number of potential acquisition targets has declined and the bulk of privatization is now completed while at the same time real wages have increased faster than the productivity of the labor force. Thus in the manufacturing sector, there appears to be cause for concern. However, the contribution of FDI in the service sector presents the potential for more stable long term growth. This is because post-socialist economies suffered greatly from the absence of a service culture in industry. The presence of foreign firms raises standards in these emerging service industries, and rising living standards (with accompanied rise in consumer expectations) provide an increasingly attractive market for investors in the service sector.

Therefore, we draw a contrast between MNE entry for the purposes of service provision and that of manufacturing for export. It is certainly the case that MNEs which located in Hungary for the purposes of re-export to the EU were required to produce to EU product and process standards. However, both the

Table 4
FDI-intensity indicators of CEE countries

	1993	1994	1995	1996	1997
Hungary					
FDI (million US\$)	2339	1146	4453	1983	2085
FDI as % of GDP	6.1	2.8	10.0	4.4	4.6
Cumulated FDI (million US\$)	5795	6941	11394	13377	15462
Cumulated FDI per capita (US\$)	563	677	1115	1313	1523
Czech Republic					
FDI (million US\$)	568	862	2562	1428	1300
FDI as % of GDP	1.8	2.4	5.4	2.7	2.5
Cumulated FDI (million US\$)	2519	3381	5943	7371	7671
Cumulated FDI per capita (US\$)	244	327	575	714	842
Slovakia					
FDI (million US\$)	144	169	157	206	140
FDI as % of GDP	1.2	1.2	0.9	1.1	0.7
Cumulated FDI (million US\$)	354	523	680	886	1026
Cumulated FDI per capita (US\$)	67	98	127	165	192
Poland					
FDI (million US\$)	1715	1875	3659	4498	4908
FDI as % of GDP	2.0	2.0	3.1	3.3	3.6
Cumulated FDI (million US\$)	2799	4674	8333	12831	17739
Cumulated FDI per capita (US\$)	73	121	216	332	459
Romania					
FDI (million US\$)	94	341	419	263	956
FDI as % of GDP	0.4	1.1	1.2	0.7	2.7
Cumulated FDI (million US\$)	214	555	974	1237	2193
Cumulated FDI per capita (US\$)	9	24	43	55	97
Russia					
FDI (million US\$)	660	637	2017	2479	6697
FDI as % of GDP	0.4	0.2	0.6	0.6	1.5
Cumulated FDI (million US\$)	2958	3595	5612	8091	14788
Cumulated FDI per capita (US\$)	20	24	38	55	100
Estonia					
FDI (million US\$)	162	214	205	150	308
FDI as % of GDP	9.7	9.2	5.8	3.4	6.6
Cumulated FDI (million US\$)	229	443	648	798	1106
Cumulated FDI per capita (US\$)	151	295	438	543	758
Slovenia					
FDI (million US\$)	113	128	176	185	315
FDI as % of GDP	0.9	0.9	0.9	1.0	1.7
Cumulated FDI (million US\$)	295	423	599	784	1099
Cumulated FDI per capita (US\$)	148	213	301	394	552
CEE					
FDI (million US\$)	5540	5895	14504	13102	19013
FDI as % of GDP	–	–	1.7	1.4	1.7
Cumulated FDI (million US\$)	13109	19004	33508	46610	65623
Cumulated FDI per capita (US\$)	–	–	101	140	198

Source. Economic Survey of Europe (1998).

likelihood of the removal of tax exemptions prior to EU accession and the relatively lower factor costs in neighboring countries such as Slovakia and Romania or distant Asia, have encouraged MNEs to consider relocation. This is further enhanced by the fact that the nature of production in Hungary is predominantly the assembly, medium-technology kind. As a result, the Hungarian economy is likely to be unable to sustain its position as the leading recipient of FDI. This is further reinforced by forthcoming privatizations in Poland, Slovenia and Czech Republic that will be significant targets for MNE acquisition.

Having outlined the macro FDI data, we now turn to the issue of FDI in the promising area of Hungarian services. We focus on the banking and financial sector in Hungary as this industry, among others, has experienced some of the most significant foreign investment.

4. FDI in services: the banking industry in Hungary

Hungary's banking system has gone through a remarkable transformation in recent years, from being a money-losing state-owned drain on public resources in the 1980s to becoming 75% privately owned and a generally sophisticated financial sector operating at western European standards by the late 1990s. The key to this transformation has been foreign investment, to the point where up to two-thirds of Hungary's banks are now fully or partially foreign-owned. Postabank, the second largest domestic account holding bank in Hungary may soon be sold as part of a government-driven policy to solve the financial difficulties of the bank, and most likely the buyer will be a foreign firm. At the time of this writing, it appears there will be an ongoing consolidation of banking in the near future, as many observers regard the Hungarian financial sector as "definitely overbanked ... and consolidation is likely and desirable."²

Until the end of the communist period in Hungary (late 1989), the political authorities in the country sought to promote limited reforms without threatening

the system itself. The reforms that were introduced turned out to provide a solid foundation for the completion of Hungary's transition to a market economy in the 1990s (Estrin, Hare, & Suranyi, 1992). By 1982, the country had become heavily indebted (the foreign debt surpassed \$10 billion that year) and was experiencing a deteriorating current account, in part due to efforts to cushion the economy from adverse international events and the growing inability of the Soviet Union to continue financing their socialist neighbors. This motivated the government to seek membership in the IMF and World Bank. About the same time, a law was passed allowing Hungarian enterprises to issue domestic bonds, which resulted in a growing bond market funded in large part by domestic savings.

In 1987, during this period of broad liberalization and the approaching end of state socialism, the Hungarian government created a two-tier banking system, separating the central bank from commercial and retail banking. Three commercial banks were created, each oriented toward different sectors of the economy. The principal goal of this reform was to promote competition between banks and create an effective commercial banking sector able to deal with companies without government intervention (Suranyi, 1998). In 1991, another part package of banking reforms was instituted, requiring banks to: accumulate loan loss provisions and meet capital adequacy ratios of 8% (the Banking Act LXIX of 1991), maintain conformity with international accounting standards (the Act on Accounting XVIII of 1991), and follow strict rules of bankruptcy and receivership (the Bankruptcy Act IL of 1991).

Unfortunately, the newly created commercial banks were left with what would become a large amount of substandard or qualified debt (according to Bank for International Settlements—BIS—definitions) inherited from the previous system. At the outset of two-tiered banking, without the infrastructure in place to measure debt quality, there was little in the way of bad debt. However, after 1991, with the implementation of international credit standards, accompanied by the effects of increased market discipline on both banks and their borrowers plus a severe post-Communist economic recession, qualified debt began to soar until it reached nearly 30% of all debt in 1993 (Abel, Siklos, & Szekely, 1998).

²Comments of Hungarian KPMG partner Robert Stollinger in media release dated 14 February 2002 (www.kpmg.hu/dbfetch/52616e646f6d4956e9e7d434c70a584015a5b77c334a22c9/fif_-_new_book_e_-_2002_january.doc.pdf).

Table 5
Foreign and domestic shareholdings within the Hungarian banking sector (2000)

Bank	Principal shareholder	Holding (%)
ABN-AMRO	AMN Amro Bank NV	99.85
Bank Austria Creditanstalt	BACA Int. AG	90
Budapest Bank	Banca Intesa spa	10
	Credit & Development SPHC	23.8
	Other Hungarian shareholders	12.8
	EBRD	33.6
	GE Capital	28.4
Citibank Rt	Citibank Overseas Inv Corp	100
Central European International Bank (CIB)	Banca Commerciale Italiana	100
Erste Bank Hungary	Erste Bank Sparkassen	98.6
General Banking & Trust Co. Ltd.	Gazprombank	42.5
	Acma Inv. PTE	10
	Citycom Holdings	10
	Hungarian Shareholders	37.5
	Bank Bayerische Bank Landesbank	83.3
	Bank fur Arbeit & Wirtschaft	10.4
	Hungarian State	100
Eximbank	Bayerische Hype und Vereinsbank	100
Hypovereinsbank	ING Bank NV	100
ING Bank (Hungary)	KBC Bank	73.3
Kereskedelmi & Hitelbank (K&H)	Irish Life Plc	17.9
	Raiffeisen Bank Austria	95.9
Raiffeisen Bank	Oesterreichische Volksbank	61.73
Volksbank Hungary	Westdeutsche Landesbank	99.8
Wesdeutsche Landesbank		

Source. Hungarian Banking Association.

The continuation of state ownership after 1989 resulted in inadequate corporate governance and a lack of transparent criteria for lending, which made the outflow of credits to low-quality debtors a regular practice. At the same time, reforms previously enacted by the government were not rigidly enforced, and debt relief was provided to the commercial banks unconditionally which did little to enforce discipline among bank management. Under the terms of two workout programs in 1991–1992, the government took over about \$1 billion, or 90% of the banks' non-performing debt, with little demand for significant improvement of bank practices in return (Török, 2000). This lack of control helped create the dismal situation where 45% of loans on the books of Hungarian banks at year-end 1993 and originating in the year 1990 were classified as "bad" (Abel et al., 1998). As a result of bank consolidation and the related government assumption of bad debt, the percentage of non-performing debt began to fall sharply, descending to a very reasonable 4% of the total portfolio in 1997 (Economist, 1998).

By late 1995, the government had forced the merger or liquidation of small and unprofitable banks, and began to sell the larger banks as well. To make the banks possible to sell, the government had to inject about 9% of GDP into the banking system, re-capitalizing banks to meet BIS standards. In troubled banks, loans were separated so that a core bank with a solid portfolio could be readied for privatization. By 1998, state ownership had descended from 67 to 20%. Furthermore, this privatization was accomplished in significant part through foreign direct investment, and was undertaken with relative speed. Table 5 demonstrates the broad ownership of the Hungarian banking sector. A number of foreign banks have entered the market as greenfield investments such as Citibank, ABN-AMRO, ING and Banca Commerciale Italia. Others have entered as joint ventures with Hungarian or other foreign partners.

Tables 6 and 7 demonstrate the revenue and asset and branch structure of the Hungarian banking sector. The data demonstrates two things. First, OTP dominates the Hungarian sector in terms of revenue and

Table 6
Top Hungarian banks (million HUF)

Rank		Bank	Balance sheet total	Profit after tax
1999	1998			
1	1	OTP Bank	1872383	29643
2	2	MKB	677845	6036
3	6	CIB	558751	7765
4	3	K&H	546473	-7602
5	5	ABN-AMRO Bank	430780	-17686
6	4	Postabank	346132	-2158
7	8	Budapest Bank	307628	1667
8	9	Bank-Austria Creditanstalt	290600	3961
9	10	Raiffeisen Bank	259969	4431
10	11	ÁÉB	224308	5783
11	-	Citibank	213759	3224
12	7	MFB	179138	2264

Source. Figyelő Top 2000.

branch numbers. The former state savings bank, it has been privatized through share issuance. Its management and majority shareholders remain Hungarian. Second, there is a significant degree of foreign activity ranging from relatively low-level services to foreign companies based in Hungary to more ambitious banking services for a broader market.

4.1. FDI in the banking sector

Liberalization of the capital account of the balance of payments involves allowing both capital imports

and exports, abolition of foreign exchange controls and restrictions on the activities of foreign and domestic banks, as well as allowing citizens to borrow and invest abroad (Buch, 1997). Many economists believe that liberalization of the capital account should follow deregulation of the domestic financial system, and that opening domestic markets to foreign competition should be a gradual process. This would allow the protected domestic sector time to become more competitive, and avoid situations where strong foreign institutions enter a market suddenly and provide their own nationals favored treatment to the detriment of host-country residents (Edwards & van Wijnbergen, 1987).

Hungary did not follow this path, and opened the gates to foreign investment in the financial sector at an early stage of overall bank privatization. As a result, 44.5% of Hungarian bank assets were owned by foreign financial institutions by 1996 (Economist, 1998). This was a far greater percent than the neighboring countries of Poland (13.6%), Czech Republic (12.6%) and Slovakia (12.7%) at that time, where the policies regarding foreign ownership of the financial sector were more restrictive, particularly regarding the direct market entry of foreign banks. Five years after the full-scale privatization effort began, the IMF reported that the portion of the Hungarian banking system in foreign hands exceeded 67% in 2000 (Moody, 2001). In part, this was due to the lack of accumulated domestic capital in a relatively small and

Table 7
Branch numbers by bank in Hungary (2001)

Bank	Number of branches
OTP	440
K&H	117
ABN-AMRO	103
Budapest Bank	75
Postabank	60
Erste Bank	55
CIB	37
Konzumbank	34
Raiffeisen	33
MKB	30
Bank Austria-Creditanstalt	25
Hypovereinsbank	19
Inter-Europa Bank	19
Citibank	17

Source. Hungarian Banking Association.

struggling post-Communist society. There was no powerful class of extremely wealthy local investors to quickly repurchase nationalized banks, as in Mexico's privatization experience. In Hungary, if the banks were going to be sold by the government, foreigners would have to participate in the purchase. Again, the Hungarian experience was different from that of neighboring Czech Republic and Slovakia, where instead of rapid foreign investment, privatization was through a voucher system and mutual-type investment funds, most run by the very banks in which they invested, thus tending to create an obvious conflict of interest.

Foreign ownership has advantages, including the fact that foreign banks have easier access to capital and financial expertise from beyond a nation's borders. Outside ownership can bring sources of capital from abroad to cash-starved business in a less developed economy and can smooth out regional variations in wealth and financial opportunity. The leveling effect of capital investment can be expected (absent other mitigating factors) to reduce the difference between relatively poor and wealthy regions, especially important in a country such as Hungary which fervently desires to enjoy the living standards of western Europe.

In the literature of economics and finance, the process of financial reform and liberalization has been much discussed in the context of both developing countries and transition economies. The principal difference between these two groups (for example, Mexico vs. Hungary) rests in the fact that liberalization in transition economies involves the replacement of a state-owned mono-bank with a two-tiered banking system that separates the central bank from retail/commercial banking. Liberalization also includes the lifting of administrative controls on the activities of the commercial banks, such as the loosening of interest rate and credit controls as well as the demise of many subsidized lending programs (Buch, 1997).

Domestic banks in transition countries suffer many disadvantages, often including troublesome operational inefficiencies and low-quality assets. They often lack experienced personnel and reliable sources of information on the performance of potential borrowers, and in many cases they have inherited low quality loans from past years. The question remains: is

the development of an efficient and responsive banking system which promotes economic growth in a society best obtained through rapid external liberalization, in other words, opening the market to foreign competitors? The Hungarian experience would suggest that foreign investment in the banking sector of a transition economy does indeed promote these goals, at least in part. The bad loans problem has improved, bank services are much better, and in fact, technology and product offerings are at or near west European levels. The foreign banks in Hungary are now well integrated into the international financial system and particularly, their networks of branches Europe-wide. This means there is little difference nowadays between the products and services at a bank in Hungary and a branch of the same bank in Austria, for example. The most significant difference between these two hypothetical bank branches as of this writing is most likely the income level of their customer base which makes it more difficult for lower income Hungarians to avail themselves of some of these product offerings, such as consumer or mortgage loans.

Also, most foreign banks are reasonably profitable and adequately capitalized. Data from Moody's (2001) has graded three major foreign-owned Hungarian banks (ABN-AMRO, K&H Bank and MKB) with a very positive A3 credit rating. For comparison, two domestically owned banks with large shares of household deposits received ratings of D+ (OTP Bank) and E (Postabank). Indeed, IMF data indicate that from 1996 to 1998, the return on equity of foreign owned banks in Hungary was 16.1% as opposed to a loss of 26% for domestic owned banks (IMF, 2000: 166). Similar differences in ROE are noted in Czech Republic and Poland, to the benefit of foreign owned banks. However, this comparison can be quite misleading and is of limited use in proving the supposed benefits of foreign capital, as foreign investors will tend to seek out the most profitable of previously state or private domestic owned institutions. Perhaps a more telling figure is that of interest rate spread (the difference between interest paid on bank liabilities and interest charged on assets), which has declined by almost 50% during the last half of the 1990s (Bonin & Abel, 2001), a fact which supports Buch's (1997) view that the achievement of a threshold level of foreign ownership of bank assets may be necessary before competitive pressure is felt by domestic banks.

4.2. Dilemmas despite privatization and the arrival of foreign banks

Some disturbing gaps remain and have even grown after privatization of financial services and the arrival of foreign investment in this sector. Two particular problems stand out. First, banks are still lending a significant amount to the government at the expense of the private sector. And second, this diminished amount that the private sector receives in loans (after deducting public sector financing) from foreign owned banks is not sufficiently channeled to households, which in turn limits the consumption and future capital growth of families and individuals, the foundations of the society. These two problems will be discussed below.

First, the presence of foreign ownership has not resolved the worrisome fact that banks are investing in government securities rather than lending to the private sector. Research (Abel et al., 1998) has also shown that generally, domestic banks in Central and Eastern Europe tend to hold more cash and long-term securities than do foreign banks. In Hungary, this is due in part to the fact that domestic banks received consolidation bonds to compensate them for their bad debt, but the same overall difference between foreign and domestic banks has been noted in Poland (Buch, 1997). Foreign bank lending has not resolved the problem of insufficient availability of private sector bank credit in Hungary, however. Table 8 shows the proportion of total bank assets (both foreign and domestically owned banks) representing credits to the central government in both Hungary and Poland, and one can see that the banks in Hungary still devote almost half their assets to lending to the public sector.

In the banking systems of developed countries, whose ranks Hungary aspires to join, the proportion

of bank assets in government securities is more similar to the figures from Poland. This data reveals that Hungarian banks, both foreign and domestic, are still quite timid in their willingness to lend to the private sector, and this is surely a drag on the economic development that the country desires. We will discuss in greater detail later in this section the reasons for this situation, which include certain remaining weaknesses (after significant earlier reforms) in the legal system that inhibit banks' willingness to assume the risk inherent in private sector loans. But the point we wish to raise here is that without adequate protection for lenders, foreign owned banks can be quite reluctant to invest in the development of the private sector, preferring the safety of government securities, and the private sector growth one associates with FDI in a transitional economy is restrained. It is urgent that the Hungarian government address this issue quickly.

Secondly, foreign banks have shown relatively little interest in certain market segments where they are most needed, which is to say retail banking, household credit, mortgage lending and small business lending, for example. Instead they tend to "skim the cream" through dealings with only the most profitable sectors such as MNE corporate accounts which demand a Western standard of services. As noted by Abel et al. (1998: 110), "domestic banks and financial institutions are very inexperienced and ill-equipped to provide certain services and make markets for sophisticated products (such as options or commercial paper). They also lack the necessary infrastructure to meet Western standards in very traditional banking services for foreign and joint venture firms." These sophisticated corporate segments do not require a large network of bank branches throughout the country, so the foreign banks can keep overhead costs relatively low and resulting profit margins high, which is a rational strategy for foreign banks to pursue.

However, while corporate banking service is very important to the development of a transition economy, the expertise of foreign banks in household consumer and mortgage lending is sorely needed to raise the standard of living in economies such as Hungary. Here, foreign investment suggests much room for growth. This is demonstrated by the fact that the largest retail, consumer-oriented bank in Hungary is locally owned OTP Bank, which held 52.4% of

Table 8
Credits to the central government—percent of total bank assets

Year	Hungary (%)	Poland (%)
1991	35	29
1992	38	5
1993	42	3
1994	40	1
1995	34	2
1996	41	2

Source. Abel et al. (1998) and data from the National Bank of Hungary and National Bank of Poland.

Table 9

Percentage of total household deposits (and household loans) held by individual Hungarian banks

Banks	1990	1999
MHB-ABN-AMRO ^a	1.6 (0.0)	5.4 (0.9)
K&H ^a	1.0 (0.2)	7.1 (2.9)
MKB ^a	0.9 (0.0)	10.2 (1.1)
Budapest Bank ^a	0.1 (0.0)	5.1 (3.9)
Postabank	2.5 (0.8)	4.3 (1.8)
OTP	93.2 (98.4)	52.4 (55.7)

Since July 1996, in accordance with the terms of Hungary's accession to the OECD, foreign investment in financial institutions has not required government approval, but only official notification. *Source.* Hungarian Banking Association.

^a Foreign majority ownership.

household deposits and 55.7% of household loans in 1999 (see Table 9).

A fundamental dilemma facing foreign banks in Hungary is the need to develop a critical mass in the form of a widespread branch or service infrastructure if they are to serve the general retail market profitably. In the mid-1990s, ING Bank's entry strategy was to challenge OTP's dominance through large-scale entry. However, less than five years later, they had to reverse that strategic decision. The costs of such entry were too high and customer loyalty to OTP made it difficult to break in this market. Nevertheless, an important motivating factor for OTP and its continuing competitiveness in the Hungarian retail banking market has been the stimulating effect of foreign bank competition (Bonin & Abel, 2001). One example of the ongoing strength of OTP has been in the fast growing bank card segment, where (in 2000) OTP had over 40% of all ATM's and bank cards in Hungary and over 70% of all bank card transactions (Bonin & Abel, 2001: 2). One might then conclude that the combination of aggressive foreign competition and competitive local management in a domestic owned bank have created a scenario to benefit the Hungarian consumer.

The future of the Hungarian economy rests in large part on its ability to remain competitive vis-à-vis its lower cost neighbors. Hungary has a higher GDP per capita and income level than all of its neighbors to the north, south and east (Slovakia, Ukraine, Romania, Serbia and Croatia), so it cannot rely on cheap labor costs alone to attract additional foreign investment (see Adler & Viszt, 2001). Many of its neighbors also have labor forces equally well

trained as Hungary's—no doubt one of the few benefits of the region's Communist period is a well-educated population. Hungary does have a better infrastructure, less corruption and a more transparent legal system than most of its post-Communist neighbors, but the risk of losing this competitive advantage remains as neighboring countries advance.

One of the most significant needs in Hungary these days is to match the labor force supply to demand. Already, skilled labor shortages are being noticed in the more industrialized and relatively prosperous west and Budapest regions. On the other hand, the relatively poor east and south of Hungary suffer from both unemployment and under-employment of people who could possibly alleviate the skills shortages in the west. However, the housing market in Hungary remains underdeveloped, and a low income individual willing to move from some small town in the east to Győr or Szekesfehervar in the booming northwest will face the very daunting task of locating affordable housing, either rental or to buy. Studies have indicated that lending for housing actually declined in the time after the post-Communist transition began (Struyk, 2000). For example, the volume of home purchase finance as a percentage of housing investment in Hungary fell steadily from 22% in 1991 to 3% in 1997 (Hegedus & Varhegyi, 1999).

There is an evident need for stronger consumer banking with affordable mortgage plans and other forms of consumer loans. Foreign banks have the experience with credit reporting systems, secondary mortgage markets and all the other aspects of modern mortgage lending that could surely benefit this country if foreign bank investment were channeled in this direction. This situation is complicated by the fact that the infrastructure to develop mortgage securitization through a secondary market is in its infancy. Furthermore, in order for mortgage and household lending to be attractive to banks, it is necessary that Hungary improve its legal system allowing timely foreclosure in case of loan default. Real property title conveyance is still extremely inefficient in Hungary, often resulting in years of delay in the recording of ownership transfer, while at the same time there are widespread unresolved disputes dating back to the time of privatization over who has rightful ownership to real property. As mentioned previously, in order for mortgage lending to be attractive to the financial

sector, these complicated issues must be addressed by the Hungarian government in an equitable and transparent manner, and it should be done without further delay.³

The domestic banks and traditional saving banks (such as OTP in Hungary) have access to a branch network that eases the accumulation of household savings (Buch, 1997). However, foreign banks have superior assessment skills and are often better positioned to participate in the market for loans. And the creation of a sound mortgage financing system for households is one of the most significant needs of Hungary if it is to approach western European living standards in the future. Certainly, this lack of ability to easily convert property to cash, or easily acquire capital gains producing assets is a glaring weakness throughout the transition and developing economies, from Central and Eastern Europe to Latin America.

Hungary now has strong basic protection of property rights incorporated into its legal system (US Department of Commerce, 1999), so a key reason for lack of foreign investment in mortgage financing is not present. However, as noted above, the creation of infrastructure for a secondary mortgage market is a necessary condition for the healthy development of residential and commercial real estate financing, as are timely procedures for foreclosure in the event of loan default and efficient recording of real property deeds. The question of whether this business can be profitable for foreign owned banks is an issue that will have to be resolved in the future.

5. Conclusions and implications

This paper has analyzed the development of FDI in the post-Communist transition process in Hungary, in particular in the market serving financial sector. The starting point was based on the claim that FDI plays an important role in economic development in general. Our case study was Hungary as this allowed us to examine a number of the key issues. First, Hungary is the largest per capita recipient of inward-FDI in the region (see Table 4) and is a small economy of ten

million people. In the case of Hungary, service sector FDI has been, naturally, predominantly market serving. Within the service sector, we chose banking, which has been subject to significant flows of inward investment such that most companies are wholly or partially foreign-owned. We argued that as incomes rise, MNEs based in service sectors are more likely to remain in the market given the positive correlation between rising income and demand for consumer services. This is because they are using market serving strategies. Our study in Hungary does indicate, however, that a number of these initial foreign entrants may eventually disappear from the market non-voluntarily, through the classic shakeout or consolidation process as a market can indeed become “over-banked.” Nevertheless, as an indicator of financial health noted earlier, the credit ratings of foreign banks are still much superior overall to their domestic owned competitors.

From our evaluation of the role played by foreign banks in the Hungarian banking sector, one can draw some other conclusions. First, FDI played an important role in restructuring the sector at a time when there was insufficient local capital to achieve these ends. This experience is in marked contrast to that of the Czech Republic and Poland. It appears that the Hungarian strategy of immediately opening the financial sector to foreign investors was sound, when compared to the early unsatisfactory experience of neighbors such as Czech Republic which initially tried voucher privatization schemes. Within a few years, these neighboring countries had followed Hungary’s lead in opening the financial sector to FDI. In capital-poor countries in the early stages of transition from state socialism, there was simply too little capital and financial service expertise to address the urgent need for an efficient and modern financial system.

Second, while important structural changes were achieved by inward-FDI, problems remain. In the banking sector, foreign banks have not taken the most aggressive role in providing capital to the retail and domestic real-estate sector. These segments, particularly home mortgage lending, are still underserved in spite of significant FDI. The reasons for this are complex but the dominance of OTP, the former state savings bank, in the retail sector has held back the growth of foreign banks in this critical area. But at the same time, the presence of foreign competition has

³ In 2001, the Hungarian government expanded a program to cover 4.5% in interest on bank loans for new housing, which has significantly stimulated the real estate market in the country.

been a significant incentive for OTP to offer new and innovative financial services to Hungarian households, so here the indirect effect of FDI on retail banking has been positive by motivating this domestic owned bank. Still, the mortgage culture in Hungary is not fully developed and there is insufficient retail lending, aggravated by the need for further legal reforms to protect mortgage lenders, as discussed in the previous section. Finally, there is often an inadequate level of income to secure loans; this problem is being mitigated by recently created government mortgage interest subsidy programs offered in conjunction with the banks, which are making home purchase affordable for a wider segment of the population. In the future, this should be a significant stimulant to first home purchase.

Another conclusion here, supported by a BIS study on the subject of bank privatization, is that there is little evidence in Hungary or elsewhere in the region, that FDI has made local banks unsound (witness the success of OTP Bank), siphoned off domestic deposits, or crowded out small borrowers (Hawkins & Mihaljek, 2001). On the contrary, foreign banks have adequately demonstrated the service seeking motives of FDI. They exist to acquire profitable market share and have significantly improved the quality of technology, products and services provided in all areas of banking. The modernization of the Hungarian banking sector in the past decade offers abundant proof of this. Moreover, in spite of some impending consolidation, the strategies of the foreign banks seem to be based around long-term presence as they anticipate growth in per capita income will increase demand for their services over the medium term. This predicted increase in demand is enhanced by a degree of competition between banks in the sector and the development of a modern, competitive financial system in the country. The evidence from the Hungarian banking sector is thus consistent with Buch's (1997) argument that foreign bank entry improves the production of financial services, promotes competition (with such benefits to the consumer as reduced interest rate spread), facilitates the privatization of domestic banks and transfers technology to host countries.

The above observations are in line with the relationship between service sector growth and income growth in small economies. As incomes rise in such economies, the quantitative and qualitative demand for

services rise. As small economies are unlikely to be able to find sufficient domestic capital to supply these services, it is likely that FDI will serve this purpose. Moreover, there is less of a danger of FDI departure as relative factor costs rise because the strategy of service based FDI is different from manufacturing FDI. This implies that FDI for the purposes of service provision can have significant long-term beneficial impact on the economic development of transition economies.

As a final comment here, the financial system is one component (albeit a quite significant one) of the larger economy and society of contemporary Hungary. There are noticeable signs of development in all regions, in spite of the difficulty of home mortgage financing noted in this study.⁴ Budapest is awash in scaffolding and construction projects which are updating and renovating the city. Even rural regions in the poorer eastern counties feature new housing developments and retail shopping centers of all types (in cities such as Nyiregyhaza or Kisvarda, for example, in the traditionally poorest region of the country, which after accession will be just inside the new eastern border of the EU). It appears that the transition process in Hungary has been an overall successful one, in part due to reasonable policy implementation which includes welcoming foreign direct investment.

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⁴ An excellent topic for future study will be the effect of recently introduced government mortgage interest-subsidy programs in participation with the banks, on the growth of the primary residential housing market in Hungary.

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