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CAN JOINT VENTURES IN HUNGARY SERVE AS A “BRIDGE” TO THE CMEA MARKET?

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Much of the research for this paper was carried out while the author was visiting scholar at the Europe; University Institute during June 1986 working on the project “East-West Trade and Financial Relations the 1980s” directed by Prof. Mario Nuti.

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Summary

The relationship between intra-CMEA and East-West commerce is both competitive and complementary, rarely independent. Observers in the West have tended to place more emphasis on the competitive aspects because the complementarities that exist are less visible and because large potential complementarities have remained unexploited, owing to the shortcomings of the CMEA trade and financial mechanisms and to various impediments to East-West commerce.

This paper explores the potentials, the problems, and the possible solutions to using East-West joint ventures (JVs) in Hungary as a "bridge" through which Western companies may penetrate the large CMEA, first and foremost Soviet market.

The topic is timely, for several reasons.

(1) Serious discussions are now under way between the CMEA countries on improving the CMEA trade and financial mechanisms, whose shortcomings are noted with increasing frequency and candor in the Soviet and East European literature.
(2) Although Hungary already has the most liberal JV laws in the CMEA, its policymakers are seeking ways to attract more joint ventures and a much greater amount of foreign equity capital than they have been able to do up to now. Moreover, in recent years, the USSR and several East European countries have also moved to allow or to liberalize JVs on their territory.

(3) Some Western governments and corporations are seeking new opportunities to expand East-West commerce, so there is presumed receptivity to new ideas on how to achieve it.

RELATIONSHIP BETWEEN INTRA-CMEA AND EAST-WEST COMMERCE

**Competitive Aspects**

The consensus of Western opinion is that the relationship between intra-bloc and East-West commerce is mainly competitive. That the competitive aspects are very important cannot be doubted.

First, owing to the severe shortage of convertible currency (CC) that each CMEA country faces, each prefers, *ceteris paribus*, to import goods from the other CMEA countries for transferable rubles (TR). Thus, the more a CMEA country turns to the West, generally speaking the more this signals the unavailability of goods from its CMEA partners in adequate quantities or quality.

Second, the greater is a CMEA country’s need for Western imports and stock of outstanding foreign debt, the more incentives it has to export its primary products, semimanufactures, and best quality finished products (so-called “hard” goods) to the West for CC rather than to its CMEA partners for TRs. Thus, often the very goods that are in greatest demand on the CMEA market are “reoriented” to the West (or sold for CC within the CMEA). For
example, since 1980 the USSR has not been willing to supply increased quantities of oil and raw material exports to Eastern Europe for TR. In trade between the countries of Eastern Europe these pressures are manifest in their practice of willing to sell hard goods only against other hard goods.

Third, if exports to the West cannot be increased at a desirable rate and if the level of CC debt is high—both of which will impede imports from the West—this may give a renewed impetus to intra-CMEA trade in "soft" goods, that is, in items not readily salable on the world market (at all, or at a good price).

Fourth and finally, increased intra-CMEA trade in soft goods will have a long-term adverse affect on ability to trade with the West. This is because the greater a manufacturer's export orientation to the CMEA market, the weaker the competitive pressures and the technical-marketing experience firms must generally have to succeed on the world market with manufactures. Moreover, the less than top quality machinery and equipment as well as operating inputs that he is forced to acquire in the CMEA (because that is the destination of his country's exports) will impede further his ability to remain or become competitive on the world market. And the less competitive on the world market are a CMEA country's exports, the less it is able to afford to buy imports from that source. Such "foregone" gains from trade are of course much smaller for the USSR than for the countries of Eastern Europe.

Complementary Aspects
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First, each CMEA country imports goods for TRs that in some cases are reexported directly to the West (as in the case of Soviet crude oil to Bulgaria a few years ago) or, more typically, become embodied in the importer's Western exports, both directly and several steps removed. For example, the countries of Eastern Europe "convert" Soviet energy and raw materials into semimanufactures and finished products they export to the West. "TR to dollar" conversion is welcome because it helps generate CC, but its extent is limited by the exporter of hard goods and by all the factors that impede the expansion of a CMEA country's CC exports.

Second, offsetting the benefits of TR to dollar conversion is a less advantageous complementarity: the reluctant but necessary conversion of dollar imports into TR exports. Again, this is much more important for Eastern Europe. As domestic and CMEA supplies of hard goods become more scarce and as East Europe has had to increase its export volume to the USSR to finance deteriorating terms of trade, the Western import content of TR exports increased, and the importance of dollar to TR conversion grew. A CMEA partner may insist on purchasing certain (hard or soft) goods that embody large CC imports, or the importer may specify that Western technology or components must be used. As a large net exporter of hard goods, the USSR is in an especially strong bargaining position to obtain compliance with such demands [Racz]. A recent empirical study conducted in Hungary concludes
...the survey of [several Hungarian] manufactures groups leads to the conclusion that in none of these do intra-CMEA exports generate any export potential vis-a-vis the market-economy world...All this finds an expression in the persistent softness of manufactures and in the persistent tendency for that softness to increase. Combined with a dollar content that is high in some product groups and exhibits a rising tendency in all of them, this ... has been growing into something of a problem for the [CC] balance of payments.

The next two complementarities are positive for all the trade partners involved but their potential has as yet not been exploited anywhere near fully.

The third is what might be called "scale complementarities", potentially very important for the countries of Eastern Europe. This means that the CMEA area should help to provide a large enough market to manufacture finished products and components in sufficiently large volumes to take advantage of the economies of scale of production. In the manufacture of certain specialized goods, scale economies should provide CMEA producers a competitive export advantage on the world market also.

There are cases of this having been accomplished. For example, the Hungarian firm Taurus patented the technology to manufacture high-pressure hoses. Large Soviet orders made possible their large-scale, economic production. Taurus was able not only to sell to the Dutch firm Uniroyal its hose-coupling license and to the American firm Gates Co. (Denver) the manufacturing design and equipment license, but also sell at a good price large quantities of the product on the world market, so that Taurus' world market share is above 30% [Becsky, p. 38]. Another Hungarian firm, Raba, has become such a large producer of truck and bus axles for the
domestic and the CMEA market that it has now become a major force in the U.S. also, with the same high quality being produced, on the same assembly line, for all three markets.

But more typically, the East European countries are unable to take advantage of economies of scale on the CMEA market to achieve a comparative advantage on the world market, and for three sets of reasons: the systemic obstacles to intra-CMEA specialization; the autarkic policies of their trade partners, and the frequent incompatibility in the design, quality, and manufacturing standards of goods exported to the CMEA vs those exported to the West.

The systemic obstacles to regional specialization are rooted in the basic features of Soviet-type central planning of the domestic economies of most CMEA members. Planners are moved to trade by perceived bottlenecks and shortages in the availability of goods, not by calculations of comparative advantage. Given that intra-CMEA prices, based on some version of world market prices of a previous period, do not reflect demand and supply in the CMEA, trade is balanced bilaterally, often within each commodity group. For example [Racz, p. 21]:

[Even Hungarian] exporters enjoying autonomous foreign trading rights come up against the trade-limiting impact of rigid balancing at the commodity group level.... Some of the electronics enterprises have found themselves up against extreme forms of the striving to balance trade separately by commodity groups, in the context of [trying to negotiate] specialization: this striving is often frustrated by the fact that the Hungarian economy is, for the purposes of many a commodity group, simply too small to import as much as it exports. In such a situation, trade is restricted as a matter of course because, the commodities being soft ones, turnover within the entire [CMEA] is limited by the purchases of the participant with the least demand.
Moreover, since as a rule, producing for the foreign market is more difficult than supplying the domestic market while depending on CMEA suppliers is more risky, both planners and enterprises are not fundamentally interested in exports and regional imports. Enterprises are ordered to export to fulfill the plan rather than to make a profit; in most cases a firm's existence is not threatened in any fundamental way by its inability to export or to compete efficiently with imports [Marer and Montias, p. 19].

Policy obstacles to specialization include decisions motivated by fear of "excessive" dependence on imports [Torok, p. 64]:

A striking example in the automotive industry is the reaction [of the USSR] to repeated Hungarian offers to expand deliveries of automobile parts, partly with a view to a better utilization of the Hungarian facilities, and partly because there in the Hungarian market a keen demand for for the vehicles obtained in exchange. The partner country, however, responded by developing and maintaining its own production of the parts in question, at the cost of a sizeable investment. No information is available as to the financial indicators of its own production, but even if it were, it would probably not reveal whether it is profitable or loss-making. The fact is, however, that the vehicles earmarked for sale in the West are invariably fitted with the Hungarian parts, whereas those fitted with the domestic ones are retained for the home market. By inference, the foreign partner himself deems his own production to be inferior to the Hungarian supplies... More than one Hungarian enterprise has drawn the inference that the economic leadership and/or the managers of the enterprises in the partner countries will strive to reduce "dependence on foreign markets" even vis-a-vis the enterprises of some other CMEA member countries. In other words, beyond a certain level, security of supply is given prominence over strivings for a more efficient bi- or multilateral division of labour.

Quality considerations also constrain exploiting the potential cost advantages of producing for both the regional and the world market because in many cases these are differences in the design, in the quality of inputs, in the type of machinery
used, or in manufacturing quality control for exports destined to
the Eastern and Western markets. Take the example of Hungary's
IKARUS busses, the country's largest manufactured exports to the
CMEA, an item it also exports to the West for CC [Soviet, p. 32]:

At the Ikarus Body and Coach factory here, the difference
between the U.S. and Soviet way of life all comes down to
a radiator.

Ikarus makes more than half the Soviet Union's buses.
When a radiator doesn't fit, a worker kicks it into the
frame with his boot.

But Ikarus also produces bus bodies for Houston and
eight other U.S. cities. Those are created in an entirely
separate shed, where skilled workers call themselves the
haute couture group. They take much longer to get the
painting and welding up to U.S. standards. And when they
install the radiators, they gently nudge them into place.

This double standard points up a common predicament in
Eastern Europe. Moscow and its allies need cheap, reliable
goods, so they build huge factories to churn out buses,
cameras, and other products. The state-run companies don't
have to worry about marketing or fancy technology until
they want to compete in the West.

To continue with the example of Hungarian buses: even though
IKARUS is one of the world's largest bus assembler, the 14,000
units it produces a year is not of sufficient scale to manufacture
economically most of its components. Yet, that is precisely what
Hungary does because, with very few exceptions, it has been
unable to conclude specialization agreements in components either
with its CMEA partners or with Western firms. One reason why
intra-industry specialization (in contrast to specialization in
finished products) is so problematic in the CMEA is that

[t]he information system in CMEA countries is much too
course to enable the policymaking hierarchy to make
fine-tuned specialization and trade decisions... In
the late 1960s, when Poland and Czechoslovakia agreed
to produce tractor parts and components for each other's
markets, there was so much uncertainty and debate about
the worth of each part or component that they finally
entered into a barter agreement in which 10 kg. of exports
was exchanged for 10 kg. of "similar type" imports. The
uncertainty about whether this kind of specialization yielded gains or losses was a factor in the decision to abandon the agreement (Marer and Montias, p. 19).

Fourth and finally, a potentially very important complementarity between intra-CMEA and East-West commerce is the pull of the large CMEA— notably the Soviet— market for Western firms, especially the large multinational corporations (MNCs), to penetrate the CMEA market through industrial cooperation (IC) or JV deals in a member country of the CMEA.

Empirical evidence shows that the single most important motive for IC, JVs, and setting up wholly-owned subsidiaries abroad, anywhere in the world, is the desire to penetrate local or regional markets. A recent survey by the prestigious Group of Thirty of 52 of the world’s largest MNCs, with combined assets of more than $400 billion and sales in excess of $500 billion in 1981, showed that practically all have identified the penetration of local or regional markets as the most important or one of the most important motives for investing in DCs (Group, pp 30-31). An earlier survey of about 100 U.S. companies interested in, negotiating, or operating IC agreements in the CMEA during the first half of the 1970s yielded similar results concerning motives (Marer and Miller).

The market-penetration motive of a Western firm may be expansionary: a wish to open up new markets to satisfy management’s desire for growth of sales, market share, and profits, or defensive: to protect foreign markets traditionally served through exports if access is threatened by protectionism. Both reasons help explain the large FDI in Western Europe after the EEC was formed; whereas the expansionary motive dominates MNC interest in the
whereas the expansionary motive dominates MNC interest in the CMEA, an area whose markets have by and large remained untapped for most firms.

Reasoning by analogy with Western Europe, MNCs interested in the CMEA believe that having a base in a CMEA member country (typically, Eastern Europe), should facilitate sales to the other CMEA countries (the USSR being of primary interest), given the preferential regional trading arrangements. So far, with very few exceptions, these expectations have not been realized, owing mainly to the obstacles of economic integration within the CMEA already mentioned, and secondarily also to the constraints on East-West trade expansion.

Given the renewed attention in the CMEA to reforming the mechanism of regional cooperation [Csaba], the desire of the USSR and of several East European countries to attract FDI through JVs on their territory [McMillan], and the economic interests of Western governments and corporations in finding new business prospects in the CMEA region, the rest of the article explores the opportunities, the problems, and some possible new approaches to using JVs in Hungary as a "bridge" to the USSR. By and large the same considerations would be involved if bridges were to be built to the other countries in Eastern Europe. Given Hungary's economic reforms, relatively good political and business relations with the West, and its record and policies on JVs, if the idea of building "bridges" to the CMEA would be feasible, Hungary is the most likely East European country to pioneer it.
Overview of Hungary's Joint Venture Experience

Hungary opened up the possibility of equity joint ventures in 1972. But the restrictive nature of the regulations, reflecting doubts and divisions about the wisdom of permitting FDI, limited the interest on both sides. In recent years there has been a succession of efforts to breathe new life into JVs. In 1979 the original limitation prohibiting FDI in manufacturing was removed. In 1982 customs-free zones were established, where JVs have automatic trading rights outside the CMEA; wages, prices, and enterprise incomes can be set more freely; and accounts are kept in foreign currencies so that foreign currency regulations can be sidestepped. As of 1986 the licensing procedure to start JV negotiations was simplified, income taxes were cut, further tax concessions were granted in priority areas, and foreign trading rights outside the CMEA were liberalized.

As a result of these steps, the number of JVs has increased in recent years. As of December 1986, 70 JV agreements had been signed, more than half in manufacturing, whereas those established during the 1970s were mostly in the services [Varga]. However, a significant number of the signed JVs are not yet operating and several of the earlier ones lie dormant. Because all JVs are small, the sum total of foreign capital committed is only about $80 million [Varga], of which $20 million is accounted for by a single banking venture, the Central European Investment Bank [HVG, 10/26/85]. Foreign equity attracted thus far is still tiny relative to Hungary's foreign debt in convertible currency (CC).
($10 billion), and relative to needs and absorptive potential.

Today, policymakers are debating the desirability and feasibility of attracting FDI on a more substantial scale. In addition to the traditional reasons for seeking FDI—to create improved channels for the import of foreign technology (and related management and marketing know-how) and to increase productivity and exports—a new motive is to acquire foreign capital in a form that is less burdensome than taking on additional bank loans [Bacskai]. To succeed, the country would need to entice about a dozen MNCs to invest $20 to $100 million each, to yield a total capital inflow in a few years of about $500 million. An FDI flow of that order of magnitude would have a significant impact on the economy in terms of technology transfer, productivity, exports, and the balance of payments.

Summary of the Main Obstacles to Constructing a Bridge

More and more Hungarian experts recognize the potential interest MNCs have in finding an East European country through which to penetrate the large CMEA market and note the obstacles that stand in the way of Hungary being able to exploit its geopolitical advantage as a "bridge." Geopolitical advantage means this: If penetrating the CMEA markets were facilitated by having a JV production presence in Eastern Europe—paralleling the situation for foreign investors in the EEC ever since it was established in the late 1950s—then Hungary could be the preferred location of many Western firms. Most firms have a perception that it is easier to do business in Hungary than elsewhere in the CMEA, thanks to Hungary's economic reforms and relatively good
political relations with the West. A comparative analysis of the
JV experience and prospects of the CMEA countries by a Western
expert concludes that Hungary's

...mix of plan and market affords a more familiar, and
seemingly more hospitable, environment to Western
investors [McMillan, p. 269].

This means that Hungary should be able to retain its comparative
geopolitical advantage even if the USSR and other East European
countries liberalized further their JV policies. But while Hungary's
favorable image may prompt scores of MNCs to explore industrial
cooperation or JV opportunities in Hungary, it alone will not
guarantee substantial investments in the country:

Foreign interest in setting up joint ventures in Hungary
would sizeably increase if a capital outlay would simultaneously
enable the foreign partner to export to other CMEA countries and
to the Soviet Union in particular. This is, however, practically
impossible at present, due to the method of settlement within the
CMEA [Biro].

Let us assume that there is a JV proposal is to manufacture
a new or improved product whose acquisition would provide substantial
benefits to both Hungary and its CMEA partners. There are major
institutional hurdles to making the JV operational and profitable.
One is that since a JV has no foreign trading rights in the CMEA,
it must convince the Hungarian authorities to try to market the
product in the CMEA. But the perceived national interest of the
authorities may not coincide with the commercial interest of the
JV, for the reasons that will be indicated.

The second hurdle is that the CMEA partners may not be
willing to import the product, or offer acceptable payment terms,
because import decisions, too, may not be made primarily on the
basis of commercial considerations, as will be elaborated.
Third, even if the two sides could agree to trade, the export may not be profitable for the JV, owing to pricing practices in intra-CMEA trade, Hungary's exchange rate policies, and certain aspects of its economic mechanism.

The next three sections discuss these problems in detail and speculate about some possible solutions to them.

Is it in Hungary's Interest to Increase Exports to the USSR?

The first and the second hurdles—insufficient macroeconomic incentives for Hungary to export and for the CMEA partner to import JV products are interrelated and stem from the basic features of CMEA's trade and financial mechanisms.

Whether Hungary would want to increase its exports to a CMEA partner depends on the status of its bilateral balance of payments and what the partner will offer in payment. Even though for years Hungary has been running a trade deficit with the USSR, given Hungary's surplus in invisibles, the agreed capital flows, and the interest of many Hungarian enterprises to increase their exports to the USSR, it is not in Hungary's macroeconomic interest to approve all goods "offered" for export to the CMEA. There is no incentive to export without receiving a specific compensation because the real rate of interest earned on a trade balance is negative and because it would represent uncertain "purchasing power." In fact, it is in the interest of every CMEA country to run as large a transferable ruble (TR) deficit as its trade partners will allow. By contrast, there is a strong incentive to improve the CC trade balance, not only because the real burden of debt is higher, but also because earnings in CC represent untied
purchasing power.

The fact that the product of a JV almost certainly would be a "hard good" complicates matters further. "Hard goods" are items essential to meet national objectives that can be imported in sufficient quantities only by paying for them in CC or goods in strong demand, or items for which effective demand in the CMEA exceeds the supply. "Soft goods" are available in sufficient quantities to satisfy effective demand. The hard and soft distinction provides only a rough and ready ranking of the economic valuation of the products; the classification of items differs by trade partner and may change over time [Hegyi, p. 29].

Even though for years Hungary has imported from the USSR more hard goods than it has exported, given the extreme tension in Hungary's CC balance of payments, scores of Hungarian experts and policymakers say that it is not in the country's macroeconomic interest to sell more hard goods to the USSR unless the payment is in hard goods or in CC. But this is difficult to achieve. The USSR points out that it already has a substantial deficit in hard goods and in transactions settled in CC.

Why does Hungary have a severe tension in its CC balance of payments and can JVs oriented in part to selling on the CMEA market help ease that tension?

Before commenting on this question, let us recall our earlier discussion on the relationship between Hungary's intra-CMEA and East-West trade. The evidence seems clear that during approximately the last 15 years, Hungary's trading position vis-a-vis the USSR and its export performance on the world market have deteriorated
sharply. An important common cause has been that short-term trading advantages on the CMEA were often grabbed without giving much thought to the long-term disadvantages that those very deals have created. Specifically, in many industries the decision to establish or enlarge production capacity was based on the maximum quantity of initially cheap energy and raw material inputs available from the USSR and/or by the willingness of the CMEA partner to purchase the resulting products, initially at attractive prices, without taking into account the ability of the manufacturer to find alternative markets. Trying always to obtain the maximum quantity of hard goods from the USSR while becoming less and less able to find alternative markets for what is being exported to pay for them has led to a large deterioration in the terms of trade vis-a-vis the USSR and increased economic vulnerability. This is such a key point that I repeat part of a statement already quoted, whose conclusions are based on scores of representative case studies of the experiences of Hungarian firms on the CMEA market [Racz, p. 18]:

...the survey of [several Hungarian] manufactures groups leads to the conclusion that in none of these do intra-CMEA exports generate any export potential vis-a-vis the market-economy world....; nor are these enterprises in any position efficaciously to protect the prices of their intra-CMEA exports. All this finds an expression in the persistent softness of manufactures and in a persistent tendency for that softness to increase. Combined with a dollar content that is high in some product groups and exhibits a rising tendency in all of them, this pervasive softness has been growing into something of a problem for the [CC] balance of payments...

To be sure, there are exceptions to this generalization, as was illustrated.

Now back to the question: can JVs be instrumental in helping
Hungary to break out of a vicious circle of deteriorating trading position on both the CMEA and Western markets? The answer would seem to be in the affirmative: by promoting deals that are likely to yield significant long-term advantages for the national economy, even if they may involve some risks in the short run. Specifically, if an important consideration in attracting MNCs to invest large sums in Hungary is to offer the JVs access to the Soviet market, then Hungary should seriously consider using this trump card.

As a realistic example of the possibilities, take the case of heavy-duty diesel engines, where—to my knowledge—at least one leading Western producer has expressed an interest in a JV. But negotiations have stalled, apparently for the reasons already mentioned. Hungary needs a better diesel engine in the busses and trucks operating in Hungary, in the vehicles it exports to the CMEA, and in the machinery and equipment offered for sale on Western markets. Moreover, the savings in fuel consumption and in lower pollution by the domestic vehicles would, by themselves, be substantial. With an up to date diesel engine, Hungary’s single largest manufactured exports to the USSR, busses, could remain or would become hard goods and dependence on the CMEA markets and suppliers would be reduced because the diesel engines or the equipment in which they are embodied could be sold more readily on the world market. And if the JV proved itself to be a reliable and cost-effective producer of quality engines, then the chances would become excellent that the Western partner would source a growing share of its engine needs from Hungary, since the trend throughout the industrial world is to move basic manufacturing out of the most developed countries. But if Hungary were to
insist at the outset that it is interested only in Western markets, then it is not likely to be in a strong position to negotiate an attractive JV deal.

What about the macro balance with the CMEA partner? If neither CC nor hard goods payment can be obtained, then perhaps the Hungarian authorities can arrange their own compensation, so to speak, by reorienting some other hard-good exports from the CMEA partner to CC markets or by reducing the export to the CMEA partner of some soft goods embodying relatively large CC inputs.

**Partner Interest in Purchasing Joint Venture Products**

Assuming that the Hungarian side is willing to export the products of JVs to the USSR, will there be a market? In many cases, neither the manufacturer nor the foreign trade organization (FTO) will have direct access to the final user. Market research and product promotion in the Western sense are generally not feasible in the CMEA. And even if the sterling qualities of the product could be demonstrated to the user, sales do not necessarily follow. There are known cases when even after the substantial benefits and huge costs savings of the JV product were demonstrated, the CMEA partner refused to make a purchase commitment. The reasons may include the availability of substitute products from domestic suppliers (why import something if it can be produced locally?), the concern that the substantial superiority of the imported product would show the domestic producer in a bad light, lack of motivation to disturb prevailing supply arrangements, or the inability of the prospective customer to persuade the foreign trade decisionmakers.
The enumerated problems are not new; what is new is that they are now recognized fully by all of the partners and that the search has begun on ways to reform the CMEA mechanism [Csaba]. While one is justified in maintaining a healthy scepticism about reform prospects, on the grounds that the CMEA mechanism cannot be substantially different than the domestic economic mechanism of the USSR and its other key members, there is at least the possibility that meaningful economic reforms in the USSR will take place and that sensible CMEA reform suggestions by the East Europeans will be implemented.

**Are CMEA-Oriented Joint Ventures Profitable?**

If the Hungarian and Soviet sides could resolve the problems mentioned and agree to include the JV product in the approved bilateral trade list, a further obstacle must be hurdled: the JV deal must be profitable. This will depend, in the first place, on whether the same rules would apply to JVs as to purely Hungarian firms in determining the profitability of exports to the CMEA. Since the prices and the quantities of the goods traded in the CMEA are negotiated by the respective governments, and on the basis more of macro- than micro-economic considerations, the profitability of exports to the CMEA for the manufacturer is regulated by the Hungarian government:

Until the end of 1984, according to the principles regulating exports settled in [transferable] rubles, on the average, enterprises were allowed to realize the same rate of profit on their ruble exports as they realized on their domestic sale. This was secured by an exchange-rate-linked tax and subsidy system with the state budget. Enterprise-specific regulation differentiates in the allowed profit markup on the basis of how economical is the ruble export [Dunai, p. 92].
In 1985, these regulations were modified slightly:

...the [new] principle of regulation is to guarantee the average "profitability" of sales on the domestic and convertible currency markets... [Dunai, p. 92].

These regulations on export profitability may not apply to JVs; instead, they may face a hard budget constraint. (In any event, what rules apply to a JV's exports to the CMEA should be clarified, since some of the MNCs interested in JVs are uncertain about them.)

In that case, the profitability of exports to the CMEA will depend on the negotiated export price in TR, on the forint's TR and dollar exchange rates, and on the cost of production in forints. For prospective partners there is uncertainty about the effects of these variables on JV profitability, for the following reasons.

Prices in Intra-CMEA Trade. Negotiated bilaterally by government delegations, pricing practices (well-documented, for example, in [Ausch], [Hewett], [Pecsi], and [Racz]) will affect the revenues of the JV. Intra-CMEA prices are supposed to be based on average Western world market prices of an agreed previous period (known as the Bucharest price principle) and are settled mostly in TR, except for a modest share settled in CC. The prices of most manufactures in intra-CMEA trade were established during the 1950s and 1960s, when many products first began to be traded. At the time, the prices of manufactures were generally set high relative to the prices of similar products traded in the West [Ausch]. Recent empirical studies, however, show that manufactures prices have softened considerably on the CMEA market since then [Racz, pp. 40]:

Hungary's terms of trade with the CMEA [have been] continually deteriorating since the second half of the 1970s... So far, Hungarian exporters have not managed to defend their prices at all efficaciously.
Even if the JV product is an improved version of an item that the two CMEA partners have been trading for some time, it is difficult to negotiate price increases to compensate for the improvement. The main concern of the importer will be not how well the improved product would meet the requirements of the user but how it would affect the bilateral payments balance. Although there are provisions in the CMEA for price increases to compensate for product improvements, the typical reaction of the partner is to "compensate" for any price increase it might grant by submitting a (justified or unjustified) claim for an equivalent price increase on some of its exports. Under the circumstances, claims are often dispensed with, since the country would not be better off even if higher prices could be negotiated [Racz, p. 26]:

In the setting of TR prices, enterprises have only the right to make proposals to the FTOs, be it their entire range of exports or concerning a novel product. Such proposals, however, tend not to have any palpable influence on the prices thrashed out, as proven by the fact that, so far, rising costs of production have not been followed by any rise in sales prices... One reason is that only the manufacturer is truly interested in the price of a single product. The FTO's interests as an importer and an exporter cancel out; its ultimate interest is in terms of trade, and its attitude determined thereby is that any individual product should be seen only as one of the many components of a given structure.... In setting the prices of certain new products, the Hungarian and Soviet specialist FTOs have, without consulting the manufacturer, agreed upon the application of a pricing proportional to physical weight, based on the Soviet pricing approach which does not remunerate any quality parameter whatsoever. In this case, then, the Bucharest pricing principle has ceased to operate even as a principle. It has been replaced by a practice that keeps Hungarian export prices permanently low and thereby hamstrings technological progress.

Thus, pricing in the CMEA, and the continued central regulation of the export profitability of Hungarian firms (necessary precisely...
because of the trading practices in the CMEA), are important reasons why producers have insufficient incentives to improve the quality and modernity of the products being delivered to CMEA partners. Neither is there much "pull" on the part of the importers, accustomed as they are to cost-plus pricing and captive markets, which tend to make them satisfied with products that are "adequate." They don't have to worry about having to upgrade to meet competition or having to improve the cost-effectiveness of operations by seeking more efficient inputs, such as those that may be offered by JVs hosted by their CMEA partners.

Thus, getting a price for a JV product that reflects its high quality can prove to be difficult.

The possible policy implications are, first, that it would be advantageous for JVs if renewed efforts were made in the CMEA to reform the pricing of new or improved products and, second, that it may be in the interest of the Hungarian government to guarantee reasonable prices to JVs of national importance on exports to the CMEA.

Exchange Rates. Perhaps even more problematic than pricing is the adverse impact of the Hungarian forint’s TR and dollar exchange rates on the profitability of a JV’s sales to the CMEA. This is best shown by a hypothetical but realistic illustration.

Assume that the dollar world market price of a JV product is $100 per unit and that the JV obtains the equivalent price in TR when it exports the product to the USSR. The relevant (actual) exchange rates in mid-1986 were:

\[
\begin{align*}
\text{TR/\$} & = 0.7 \\
\text{Ft/TR} & = 28.0
\end{align*}
\]
This is how the transaction will appear on the books of the JV:

1. The USSR pays the TR equivalent of $100, or TR 70.
2. The revenues of the JV in forints will be 1,960 (TR 70 x 28).
3. The revenues in dollars will be $42.60 (Ft 1,960 : 46).

To the JV's Western partner it will thus appear as if the USSR would be willing to pay less than half of what the product is worth on the world market. Hence, the JV is unlikely to be considered a good business proposition by the Western partner. The problem of course is that Hungary's cross exchange rate between the TR and the dollar is inconsistent with the official TR/$ exchange rate. This appears to generate losses on TR exports (and gains on TR imports) when the transactions are evaluated in dollars, computed through the intermediary of the forint. That is, instead of $1.00 = TR.7, Hungary's exchange rates imply that $1.00 = TR 1.643, i.e., Hungary values the TR at only 42.6% (.7 : 1.643) of its official value. Another way of stating this is to say that Hungary assigns to the dollar a value 2.35 times higher relative to the TR than what the USSR values it.

The reasons for the discrepancy are not entirely clear to this observer. These new types of exchange rates were first introduced in 1968, reportedly on the basis of the average forint cost of earning a TR and a dollar, respectively, in exports. Thus, the rates may reflect the relatively high prices of exports to the CMEA in the 1960s and the relatively low prices Hungary (and the other CPEs) are able to secure in the West, as well as the extra forint cost of manufacturing products for the more
demanding Western markets. Furthermore, today’s exchange rates may also reflect the substantial difference between Hungary’s dollar (CC) and TR (nonconvertible CMEA) balance of payments, whose essence is that "to the West we are unable to export, from the East we are unable to import" [Csikos-Nagy, p. 7]. That is, the authorities may set the dollar exchange rate to stimulate CC exports and to constrain CC imports, and the TR exchange rate to rein in TR exports and to encourage TR imports. This speculation of course assumes that exchange rates do have some influence on enterprise export and import decisions, in addition to the numerous other financial and administrative instruments used to guide exports and imports.

Be that as it may, an unintended consequence of the exchange rates is that they impede possibilities for JVs oriented toward the CMEA. This is recognized by the authorities who are reportedly searching for solutions. One possibility being considered is setting up so-called "umbrella trading companies" (UTCs), a new type of organization whose mission would be the "in-house" conversion to dollars of the TR imports Hungary received in exchange for the JV’s TR exports [Csikos-Nagy]. That is, the UTCs would offset the losses that appear when a JV’s TR exports are converted to dollars through the forint with the gains that would be realized when the goods imported from the CMEA partner in exchange are converted to (or revalued in) dollars.

A further function of the UTCs would be to credit the Western partner with all of the CC purchases it makes in Hungary. One of the obstacles to JVs is the insistence of the Hungarian partner that the Western side buy a sufficient quantity of JV
products to provide the JV a positive CC balance. In some cases it would make more sense for the Western partner to subcontract in Hungary with more than one enterprise to manufacture components for CC export. Such arrangements would be facilitated by setting up the UTCs being proposed.

Cost of Production. A key concern of prospective Western JV partners is how costs and prices are determined under Hungary’s economic mechanism, and how future costs would be affected by the frequent changes in pricing, fiscal, and accounting regulations. Western firms find it unusual that different principles establish the prices (and thus the revenues and costs) of various kinds of goods and services. For example, the prices of

- energy, raw materials, and certain intermediates are set on the basis of their current world prices in CC, regardless of whether the goods are of domestic origin, imported from the world market, or purchased from the CMEA (actual transaction prices, expressed in forints, are different, in view of the deviation of CMEA and world market prices and the inconsistent dollar-TR-forint cross exchange rates);

- all other imports are based on actual transaction prices in foreign currency, converted to forints at the prevailing exchange rate;

- most goods of domestic origin are shaped by the complex rules of "competitive" pricing;

- certain goods of domestic origin are determined freely by demand and supply forces.

Further cost-related concerns include access to and the
reliability of domestic suppliers and subcontractors and ability to obtain the license and foreign exchange to purchase the necessary imports.

The point of enumerating these concerns is to stress that even though JVs in Hungary have greater flexibility than elsewhere in the CMEA, the risks and uncertainties are still substantial.

Risk Perceptions and Risk Management

If perceived risks are too high by either partner, they can waylay even proposals that look very attractive on paper. MNCs contemplating JVs in Hungary face a host of uncertainties, their sum total translating into a perception of high risk.

Several risk factors may be mentioned in addition to those already enumerated in the previous sections.

Administrative procedures to set up a JV are cumbersome and lengthy. Dozens of approvals and permits are required and a maze of regulations must be understood and complied with. This problem could be eased by establishing a one-stop service center for potential investors to assist them with necessary clearances, licenses, and legal referrals and by providing accurate information on how the economic system functions.

More important in the long run are the insufficient competitive pressures on the one hand, and the constraints on the other, on managers of Hungarian enterprises to make production, input, pricing, and marketing decisions that respond to market signals. For example, the rules that determine the prices of, say, diesel engines sold on the domestic and CMEA markets apparently do not take fully into account the fuel consumption, maintenance, and pollution
(i.e., total life cycle cost) aspects of the product. Thus, even if enterprise profitability were to guide a decision on whether to enter into a JV to manufacture a new diesel engine, enterprise interest and the national interest may diverge. This is an example of the risks and uncertainties in Hungary's [Bauer, p. 310]:

...neither plan nor market economy [in which] enterprise decisionmaking was released from central control through instructions, but it is still not controlled by the market."

Thus, even though JVs in Hungary have greater flexibility than elsewhere in the CMEA, the risks and uncertainties are still substantial.

A further issue: are JVs regulated as domestic or foreign firms? Currently, they are subject to many regulations binding on Hungarian enterprises, for example: how many passenger cars, typewriters, telex facilities, and photocopying machines may be owned, size of the entertainment budget, personal compensation, and business travel abroad. Even though it is often possible to get around these limitations, their very existence increases the risks perceived by the foreign partner. In some other areas, JVs are at a disadvantage as compared with Hungarian firms. For example: the costs of an office, an apartment, or that of new construction is often much higher than that paid by Hungarian firms and the arrangements must be made through the Monetary Institution Center Supply Directorate (Penzintezeti Kozpont Ellato Igazgatosag). The same organization must approve all labor contracts of Hungarians employed by a JV.

"A major problem," said the managing director of one of the JVs, "is that sometimes a JV is considered to be a Hungarian, sometime a foreign enterprise, depending on the momentary interest of the
Hungarian authorities" [HVG, November 1984].

The political risk of investing in and sourcing from a CMEA country is also considered to be substantial. MNCs are concerned that their operations there could be adversely affected by political developments in intra-CMEA or in East-West relations.

It might be stressed, in lieu of conclusions, that investing in Hungary is perceived as involving considerable risks. There is a correlation between perceived risks, willingness to invest, and the expected rate of return. Therefore, to attract FDI, a country should try to reduce risks and allow rates of return commensurate with the remaining risk factors. In the long run, moving ahead with market-oriented reforms, in Hungary and in the CMEA, would be the best way of making investing in Hungary, for the purpose of building a "bridge" to the CMEA, more attractive. This is not to deny that are other reasons to enter into JVs in Hungary, such as to take advantage to Hungary's relatively low-priced skilled labor. But the incentive to invest for that and for other possible motives would be strengthened if there were better opportunities to rely on JVs are bridges to the CMEA.
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