TITLE: ISSUES OF TRANSITION ECONOMIES

1. Non-Performing Loans: Hungarian Banks as Shaky Pillars
2. Involuntary Trade Credit and the Bankruptcy Trigger: Companies in Need of a Divorce
3. Privatization and Competition in Transforming Countries: Conflicting Regulatory Agendas?

AUTHOR: John P. Bonin
        and
        Istvan Abel

THE NATIONAL COUNCIL
FOR SOVIET AND EAST EUROPEAN RESEARCH

1755 Massachusetts Avenue, N.W.
Washington, D.C. 20036
PROJECT INFORMATION:

CONTRACTOR: Wesleyan University

PRINCIPAL INVESTIGATOR: John P. Bonin

COUNCIL CONTRACT NUMBER: 807-07

DATE: July 15, 1992

COPYRIGHT INFORMATION

Individual researchers retain the copyright on work products derived from research funded by Council Contract. The Council and the U.S. Government have the right to duplicate written reports and other materials submitted under Council Contract and to distribute such copies within the Council and U.S. Government for their own use, and to draw upon such reports and materials for their own studies; but the Council and U.S. Government do not have the right to distribute, or make such reports and materials available, outside the Council or U.S. Government without the written consent of the authors, except as may be required under the provisions of the Freedom of Information Act 5 U.S.C. 552, or other applicable law.

* The work leading to this report was supported by contract funds provided by the National Council for Soviet and East European Research. The analysis and interpretations contained in the report are those of the author.
NCSEER NOTE

This report consists of three short papers on specific issues of transition from centrally planned to market economies: banking (page 1); credit and bankruptcy (page 11); and privatization of monopoly (page 21). Based on Hungary, the analysis is in some degree relevant to other transition economies.
Non-Performing Loans: Hungarian Banks as Shaky Pillars

István Ábel* and John P. Bonin**

*Budapest Bank and Budapest University of Economics
**Department of Economics, Wesleyan University, Middletown, CT

Contract #807-07

Abstract

In Hungary, the financial legacies of the old system result in a few large undercapitalized commercial banks, currently earning high profit margins but saddled with non-performing loans against which they are not holding sufficient loan loss reserves. The government retains significant direct and indirect (through the state-owned companies’ shares) ownership in these banks. To the extent that the banks pay out a significant portion of after-tax profit to shareholders in addition to paying a tax on profits to the state (the profit tax rate on the banks in Hungary is around 40%), the banks remain an important source of revenue for the state. A reversal of this flow is required to build up the equity of the commercial banks. Recent government policy and the new banking legislation recognize the need for increased capitalization of the banks and impose required loan loss provisions to be accumulated from pre-tax earnings. To the extent that banks retain more earnings and succeed in building up their reserves and equity base, taxes and dividends paid to the state are reduced. The tension between the revenue requirements of the fiscal budget and the banks’ attempts to improve the health of their balance sheets leaves the final outcome in some doubt. At stake is the possibility that the Hungarian commercial banks will begin to act like profit-making banks. This is crucial for efficient capital allocation in the future.
Banking reform began in 1987 in Hungary with the establishment of a two-tier banking system headed by an independent central bank, the Hungarian National Bank (NHB). The credit sections of this former state monopoly bank were spun-off into three new commercial banks, the Hungarian Credit Bank (HCB), the National Commercial and Credit Bank (NCCB) and the Budapest Bank (BB). Competition for commercial accounts was prevented initially as companies were required to do business with the bank to which they were assigned (in essence, the officers with whom they had previously done business). The portfolios of the newly-created banks and the previous working relationships between bank officers and company clients make up the inherited legacies of past policies.

At their formation, the three major commercial banks faced little competition accounting for 87% of deposits and 76% of gross assets of all financial institutions dealing with the companies. Table 1-1 (page 8) records the financial situations of HCB, NCCB and BB for 1990 along with three joint venture banks, Inter-Europa Bank, Citibank-Budapest, and Creditanstalt (newly formed in 1990). As the first two columns indicate, the Hungarian banks are much larger than the joint venture banks. Ranked

1. Presently, commercial customers are no longer tied to an individual bank so that the potential for competition over clients exists.

2. We use data for 1990 because of its availability and the fact that it is not subject to the financial shocks accompanying the disintegration of CMEA, the administered trading arrangements between Hungary and the other previously socialist countries.
according to total assets in 1990, the National Savings Bank (1), the State Development Bank (2), and the State Foreign Trade Bank (4) would fill out the other top six places. The largest bank with foreign participation (the Central European Credit Bank Ltd) had assets of HUF 43.4 billion in 1990. Referring to the situation immediately following the reform, Szekely (1990) cites "very high pre-tax profits-to-assets (3.2 to 3.8%)" as evidence of a lack of competition. For the three Hungarian commercial banks, pre-tax profit to asset margins range from 5% for BB to 3.6% for HCB in 1990 indicating that competitiveness has not improved since deregulation. A comparison of after-tax profitability measures, return on assets (ROA) and inflation-adjusted return on equity (ROE) in the final two columns of Table 1-1, with U.S. banks corroborates the high profitability of Hungarian banks. The average ROA for U.S. banks in 1990 was about one-half of one percent (0.5%) and the average inflation-adjusted ROE was 2.5%.\footnote{3} For large U.S. banks having assets in excess of $1 billion (about 65 billion forints at the exchange rate in 1990), ROA was 0.4% and ROE was 1.5%.

In light of these profitability figures, why do we claim that Hungarian commercial banks are in a fragile financial condition? First, the banks are not truly independent, second, they are undercapitalized and, third, they have inherited a substantial portfolio of non-performing loans. With respect to independence, Table 1-2 (page 9) records the direct ownership

\footnote{3}{All figures for U.S. banks are from Goudreau and King (1991).}
claim of the state to be between 35% and 50% in the three Hungarian commercial banks. For the most part, the remaining ownership claims are held by state-owned companies and thus indirectly by the state. The new banking law restricts ownership by any shareholder to no more than 25%. However, the state has until January 1, 1997 to comply.

Table 1-2 also exhibits a striking difference in the dividend policies of the Hungarian commercial banks and the joint-venture banks. While the latter pay no dividends, about one-third of after-tax profit is returned to the owners of the Hungarian banks. Taking account of direct ownership revenues only, the three commercial banks contributed about HUF 2b in dividend payments to fiscal revenues in 1990. In addition, these banks paid over HUF 8.8b in profit tax to the state. The total flow from gross profits of the major commercial banks to the fiscal budget was HUF 10.87b in 1990 or about 1.7% of fiscal receipts. Consequently, the banks provide substantial financial support to a state that is struggling to reduce the fiscal deficit.

To evaluate capital adequacy, we use the BIS target of 8% for equity (own capital) to assets. As Table 1-1 indicates, all three of the Hungarian banks fall short of this figure (as does Citibank-Budapest). This is particularly troublesome when, as Table 1-2 indicates, non-performing loans as a percentage of

4. The new banking law in Hungary requires banks to meet a 7.25% capital adequacy ratio by January 1, 1992 to be raised to 8% by January 1, 1993. However, allowance is made for gradual adjustment as the NBH and the State Banking Supervision may grant exemptions until December 31, 1994 to financial institutions in operation since December 1, 1991.
equity ranged from 160.9% for BB to 77.8% for NCCB. How much of the non-performing loan problem is due to the inherited portfolios of the three banks? When the banks were spun off from the central bank, non-performing loans in value (as a percent of the portfolio) were respectively, HUF5 billion (3%) for HCB, HUF2.5 billion (2%) for NCCB, and HUF1.9 billion (2%) for BB. This total of HUF9.4 billion was augmented by HUF4.7 billion of loans to coal mines with government guarantees by BB after 1987 for a total of HUF14.1 billion. By the fall of 1990, non-performing loans on the balance sheets of these three banks totaled HUF36.5 billion. Deteriorating economic conditions in the intervening years undoubtedly turned some existing loans into non-performing ones. However, the combination of high profit margins affording discretionary behavior and "old-boy" linkages between loan officers and "clients" of long-standing also resulted in "business as usual" for many of the less-efficient companies. In addition, representatives of the debtor companies holding ownership shares on the banks' boards. Some of the existing non-performing loans must result from "good money chasing bad."

The balance sheets of the Hungarian commercial banks remain an impediment to their functioning as true banks and hinder the privatization prospects. In 1990, the combined tax and dividend flows in 1990 amounted to about 30% of the accumulated value of their non-performing loans. If these transfers to the state budget had been placed in a loan-loss reserve fund, a sum equal to the value of past accumulated non-performing loans would have accrued in slightly more than three years. Balance sheet changes
would have occurred over a period of time reducing the impact on the fiscal budget in any one year. At a time when equity margins needed to be rebuilt and non-performing loans needed to be covered, the Hungarian commercial banks could ill afford to continue to support financially the fiscal budget.

By 1991, the government recognized this problem and used its voting power to force the three banks to lower dividend payments and augment their capital base despite the opposition of the company shareholders who rely on dividends for cash flow. The new banking act requires banks to set aside general reserves (1.25% of balance sheet totals) from after-tax earnings and also to accumulate provisions against substandard loans (100% against non-performing loans). These loan loss provisions are treated as costs. Presently, the aggregate total of non-performing loans is estimated to be about HUF 50b, the vast majority of which is held by the three commercial banks. The NBH accepted HUF 21b as outstanding from long term credits issued before 1987 and the government guaranteed 50% of this amount (HUF 10.5b) in mid-1991. However, the three commercial banks still must accumulate substantial loan loss reserves against the existing stock of non-performing loans. Since provisions are taken from pre-tax earnings, the struggle between fiscal financing and bank solvency will continue.


6. Bank pre-payments of taxes in 1991 exceeded tax liabilities due to an overestimate of profits. However, the government has been reluctant to reimburse bank overpayments.
Table 1-1

Financial Situation of Selected Banks in Hungary, 1990

<table>
<thead>
<tr>
<th>Name</th>
<th>Assets Ft BN (1)</th>
<th>Ranking by value of assets (2)</th>
<th>Equity as % of Assets (3)</th>
<th>CPI-Adjusted Profit as % of Equity (4)</th>
<th>After Tax Profit as % of Assets (5)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hungarian Credit Bank</td>
<td>256.3</td>
<td>3</td>
<td>5.42</td>
<td>11.72</td>
<td>2.18</td>
</tr>
<tr>
<td>National Commercial and Credit Bank</td>
<td>191.5</td>
<td>5</td>
<td>6.57</td>
<td>9.96</td>
<td>2.51</td>
</tr>
<tr>
<td>Budapest Bank</td>
<td>103.4</td>
<td>6</td>
<td>6.38</td>
<td>18.34</td>
<td>2.96</td>
</tr>
<tr>
<td>Inter-Europa Bank</td>
<td>25.0</td>
<td>9</td>
<td>11.2</td>
<td>17.87</td>
<td>5.16</td>
</tr>
<tr>
<td>Citibank</td>
<td>15.3</td>
<td>14</td>
<td>6.53</td>
<td>64.41</td>
<td>6.03</td>
</tr>
<tr>
<td>Creditanstalt</td>
<td>15.3</td>
<td>15</td>
<td>9.15</td>
<td>(-) 1.98</td>
<td>2.39</td>
</tr>
</tbody>
</table>

Source: Pénzügykutató Rt., Heti Világgazdaság and Figyelő (various issues)
## Table 1-2

Non-performing Loans of Selected Banks in Hungary, 1990

<table>
<thead>
<tr>
<th>Name</th>
<th>Non-performing Loans as % of Equity</th>
<th>Dividends as % of After Tax Profit</th>
<th>State Owned Share in %</th>
<th>Foreign Share in %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hungarian Credit Bank</td>
<td>115.1</td>
<td>35.6</td>
<td>49.3</td>
<td>0.0</td>
</tr>
<tr>
<td>National Commercial and Credit Bank</td>
<td>77.8</td>
<td>38.5</td>
<td>34.9</td>
<td>0.0</td>
</tr>
<tr>
<td>Budapest Bank</td>
<td>160.9</td>
<td>31.4</td>
<td>41.7</td>
<td>0.0</td>
</tr>
<tr>
<td>Inter-Europa Bank</td>
<td>n.a.</td>
<td>0.0</td>
<td>0.0</td>
<td>22.5</td>
</tr>
<tr>
<td>Citibank</td>
<td>n.a.</td>
<td>0.0</td>
<td>0.0</td>
<td>80.0</td>
</tr>
<tr>
<td>Creditanstalt</td>
<td>n.a.</td>
<td>0.0</td>
<td>0.0</td>
<td>75.0</td>
</tr>
</tbody>
</table>

Source: Pénzügykutató Rt., Heti Világgazdaság and Figyelő (various issues)
References


Involuntary Trade Credit and The Bankruptcy Trigger:  
Companies In Need of A Divorce

István Ábel* and John P. Bonin**

* Budapest Bank and Budapest University of Economics  
** Department of Economics, Wesleyan University, Middletown, CT

Contract #807-07

Abstract

In the transforming countries, it is common for state-owned commercial banks to record extremely high profit margins and for companies to make losses while no action is taken by creditors or the government to initiate bankruptcy proceedings. The persistence and pervasiveness of involuntary inter-enterprise trade credit is key to understanding these phenomena. The financial and accounting systems in the transforming economies are primitive legacies of the central planning period. By considering the origin of trade credit and the reasons for its increase in Hungary, we draw general policy implications for the transforming countries. Although Hungary adopted modern bankruptcy legislation during the communist period, only a handful of companies were liquidated over a five-year period. Because companies were linked through trade credit and one bankruptcy had the potential to snowball through the system creating widespread disruption, the government chose not to enforce the legislation. Supply links and near-monopsony positions made creditors reluctant to assert their rights for fear of losing their market. New Hungarian legislation includes an automatic trigger which forces companies to begin bankruptcy proceedings and provisions for creditor companies to accumulate provisions against doubtful receivables from pre-tax profits. However, the government may resist liquidation of large enterprises if substantial unemployment results. As long as companies are tightly linked by trade credit, pulling the trigger will be inefficient if good companies are forced into bankruptcy. Efficiency may be served due to employment concerns.
In the centrally planned economy, financial planning was designed to play a subservient role to physical planning. The annual physical plans contained directives on sectoral capacity expansion and the fiscal budget granted the necessary credits to ministries and enterprises to finance planned investment and intermediate materials. Cash was used to pay workers in accord with the enterprise’s planned wage bill. Fiscal and monetary policies were inseparable as the state bank was simply the financing wing of the state planning commission.

To analyze this financial system in Hungary, Ábel and Székely (1988) separate monetary flows into three circuits, household, enterprise and government, and test for causal links using quarterly data for the period 1974-1986. They find that the household and the enterprise money circuits are entirely separate but that strong causality runs from the government money circuit to enterprise money and weak causality from government money to household money. This evidence indicates that the fiscal budget position (deficit or surplus) influenced significantly all financial flows. In essence, monetized fiscal deficits (combined monetary and fiscal policy) provided overall liquidity to the economy prior to the restructuring of the banking system in 1987.

A second ubiquitous feature of planned economies, persistent shortages of materials, led enterprises to maintain high levels of material inventories. At the same time, the availability of short-term financing was severely restricted and highly concentrated. In Hungary, less than 50% of the enterprises used bank credit and fewer than one percent of the enterprises (often the
inefficient loss-making ones) held 40-50% of the total of loans outstanding to the business sector (Estrin, Hare, and Suranyi, 1992).

Inter-enterprise trade credit became an important source of financing as Table 2-1 (page 18) indicates for Hungary during the early eighties. From 1982 (the year that Hungary solved a liquidity crisis with the help of the BIS and joined the IMF and World Bank) to 1986, the annual increase or decrease of trade credit correlates exactly to the annual decrease or increase of the fiscal deficit as a percent of GDP. When fiscal liquidity was tightened (i.e., the deficit was reduced), trade credit increased. As a consequence, good (solvent but possibly illiquid) and bad (insolvent) companies became linked together by increasing (and involuntary) extensions of inter-enterprise credit in the first half of the eighties.

In 1987, a two-tier banking system was established by dislinking the central bank, the National Bank of Hungary (NBH), from its three business credit divisions which became state- and company-owned commercial banks. As the table indicates, the extension of inter-enterprise trade credit rose dramatically in the subsequent year and continued its increase in 1989. Yet the fiscal budget moved from a small surplus (0.32% of GDP) to a small deficit in 1988 (0.26%) and, subsequently, to a larger deficit in 1989 (1.91%). The inverse relationship between changes in inter-enterprise trade credit and changes in the fiscal deficit observed in each year from 1982-1986 was reversed in 1988.
15

and 1989 as both fiscal liquidity and inter-enterprise credit increased.

During both years, as part of the IMF-advised austerity program, the monetary authorities tightened the credit available to the newly formed commercial banks and increased interest rates. Even though the fiscal deficit provided additional liquidity, the credit queue lengthened as companies tried to temper the credit crunch by allowing accounts payable to become delinquent. The newly formed commercial banks played an important role in this increase in inter-enterprise credit. The accounting system allows banks to debit a client’s account automatically upon receipt of any inflow. In essence, the banks have seniority in the queue (after wage payments but ahead of tax payments, social security contributions and utility bills) allowing them to collect interest due (Estrin, Hare, and Suranyi, 1992). Consequently, the commercial banks are able to maintain high profit margins while, at the same time, their clients fall further in arrears in meeting other payment obligations.

Such a situation makes distinguishing good from bad companies and eventually liquidating insolvent companies extremely difficult. In 1986, Hungary adopted a modern bankruptcy law. From its inception until 1990, only ten requests for initiation of bankruptcy proceedings were submitted by creditors. Explanations for such creditor passivity focus on the near-monopsony positions of many of the large debtor companies (Mitchell, 1991). Creditor companies supplying these debtors feared the loss of their major customer. The government was reluctant to initiate liquidation
because of inter-enterprise trade credit. The financial repercussions of one bankruptcy would reverberate throughout the economy and, most likely, bring down good creditor companies with bad insolvent ones.

The New (Revised) Bankruptcy Law in Hungary and the Act on Accounting, both passed in 1991, encourage and enable the delinking of companies. The Bankruptcy Law contains an automatic trigger requiring bankruptcy procedures to begin for companies in default on any liability for more than ninety days of its due date beginning on January 1, 1992. The Act on Accounting allows companies (as well as banks) to create reserves against potential losses (e.g., on doubtful receivables) from pre-tax profits. This combination of the threat of liquidation and the ability of a creditor to insure against the liquidation of a debtor will enforce more financial discipline and should eventually reduce significantly the inter-enterprise credit queue. However, in the short term when companies are tightly linked by trade credit, forced bankruptcies can quickly snowball through the system taking potentially good, but currently illiquid, companies down along with the bad insolvent ones.

Evidence is beginning to accumulate to indicate that the trigger is increasing substantially the number of bankruptcy filings. In the first three months of 1992, 800 cases were filed with the courts while, in the two weeks following the activation of the trigger, 800 new filings occurred. Hungarian bankruptcy law allows for reorganization or liquidation. A plan for reorganization is to be submitted to the court within 60 days of the
filing date. Presumably many of these companies are exercising this option. In addition, the courts are returning some of the papers because minor of errors thus delaying further any action. Whether the bankruptcy trigger will result in extreme delays due to an overwhelmed legal system or encourage effective reorganization and initiate the important de-linking of companies in the credit queue remains to be seen.

Calvo and Frenkel (1991) consider financial markets with the breadth and depth to provide the information necessary to distinguish good from bad companies a pre-requisite for effective industrial restructuring and efficient capital allocation. Financial markets in the transforming countries are currently unable to provide this sorting outcome. Firm-specific risks that would be diversifiable in well-functioning capital markets remain because of inter-enterprise linkages. Overall macroeconomic and political uncertainty add to non-diversifiable risk. With inflation rates in the 30% to 40% range on an annual basis, the noise in the system makes heroic the task of separating good and bad credit risks. Consequently, legislation designed to begin the necessary liquidation of bad companies may require an initial administered "de-linking" phase. Hungary's experience this year with its bankruptcy trigger will provide useful lessons for other transforming countries.
Table 2-1

Inter-enterprise Trade Credit

<table>
<thead>
<tr>
<th>Year</th>
<th>Inter-enterprise Trade Credit as % of Company Balances in Liquid Deposit Accounts</th>
<th>Inter-enterprise Trade Credit as % of Short Term Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>1982</td>
<td>27.3</td>
<td>14.0</td>
</tr>
<tr>
<td>1983</td>
<td>72.3</td>
<td>29.5</td>
</tr>
<tr>
<td>1984</td>
<td>75.1</td>
<td>29.1</td>
</tr>
<tr>
<td>1985</td>
<td>40.2</td>
<td>19.0</td>
</tr>
<tr>
<td>1986</td>
<td>17.5</td>
<td>7.6</td>
</tr>
<tr>
<td>1987</td>
<td>16.1</td>
<td>7.6</td>
</tr>
<tr>
<td>1988</td>
<td>65.4</td>
<td>27.7</td>
</tr>
<tr>
<td>1989</td>
<td>88.8</td>
<td>34.6</td>
</tr>
</tbody>
</table>

Source: Pénzügykutató Rt. (Heti Világgazdaság, December 22, 1990, p.88.)
References


Privatization and Competition in Transforming Countries: Conflicting Regulatory Agendas?

John P. Bonin
Department of Economics, Wesleyan University, Middletown, CT
Contract #807-07

Abstract

Privatization is fraught with problems in all of the transforming countries. Highly integrated (vertical and horizontal) state-owned companies with dominant (monopoly) positions in the domestic market must be transformed quickly into businesses that respond promptly to market signals. Hungary has chosen what may be the only practical strategy, i.e., placing these large companies with strategic foreign partners. However, the buyer's incentives are likely to clash with the government's objective of nurturing competition in domestic markets. The regulatory agency mandated to promote privatization must have a counter-balancing regulatory agency responsible for creating domestic competition. In Hungary, the playing field is currently not level with the competition office subservient to the privatization agency. We explore the origins and effects of this imbalance and suggest a modification to improve the prospects for the development of an effective market economy.
Privatization in Hungary began in an unregulated fashion, spontaneous privatization, when executives in companies managed by enterprise councils engaged in "legal" asset stripping. The Law on Transformation of Business Organizations enacted in 1989 did not anticipate the problems caused by the existing property rights structure. Insider trading and golden parachutes were the order of the day. To counter these abuses, the State Property Agency (SPA) was formed on March 1, 1990, placed under government control in July 1990, and given extended authority when the government announced its privatization program in the fall of 1990. Supporters of the SPA argued that the scandals associated with virtually every spontaneous privatization deal to date required the SPA to be a cautious watchguard.

Although its surveillance function initially took center stage, the SPA has two other mandates - to play an active role in the privatization of state-owned enterprises and to act as a holding company when privatization proposals involve incomplete divestiture of state assets. In privatization proposals, whether the company takes the initiative or the SPA provides initial assistance (impetus) has little bearing on the eventual outcome as 103 out of 124 of the company-initiated proposals were approved (Jarai, 1992).

---

1. The most publicized case of abusive spontaneous privatization was the APISZ stationery retail trade chain (Bokros, 1990) in which the original state-owned enterprise was transformed into a holding company that sold all the shares and left the original enterprise as only a shell company holding bonds.
A second regulatory agency, the Competition Agency (GVH), was created by the Competition Law of 1990. From the perspective of the GVH, the outcome may depend on the initiative of the aggrieved party. Cartel damage claims initiated by the aggrieved party were successfully prosecuted in two of three cases whereas GVH-initiated cases were successful in only four of seventeen tries (Stadler, 1992). Since cartel damage is difficult to document, information from the aggrieved party is crucial. In the twenty-seven cases of abuse of monopoly power pursued, the success rate was not dramatically different when the aggrieved party initiated the case. Although the legislation defines monopoly structure as a dominant position, it requires conduct or "abuse" to be proven for prosecution. As Western experience indicates, abusive conduct is often difficult and costly to demonstrate.

These two regulatory agencies find themselves on common turf concerning the privatization of state-owned companies and foreign investment. Although tensions arise, legislation has anticipated some problems. When privatization involves a merger (or de-merger), the GVH must be "consulted" but the SPA has final authority. However, the GVH has no mandate to split-up monopoly positions based on structure prior to privatization. Furthermore, special treatment is accorded foreign investors by both agencies.

Hungary has a better-defined vision of the desired privatization process than do other transforming Central European countries and the SPA has been given the authority to carry out this program. Equity versus efficiency debates still continue in
many countries over issues of voucher distribution as opposed to sales and compensation to previous owners. In Hungary, for the majority of the twenty large companies in the first privatization program, placing with a strategic foreign partner is the chosen method.

However, fragmented ownership rights have slowed down privatization in Hungary. Local councils claim ownership of about 15% of the estimated value of the assets of state-owned companies (Jarai, 1992). In the celebrated sale of the Gundel restaurant, the SPA and the Budapest City Council agreed to sell to a foreign owner and resolve their dispute (in court, if necessary) after the deal was completed. The successful litigation of a case of accepted business conduct by United Technologies against Malev Airlines in a Budapest court sent an important signal to the international business community. Hungary’s relative success in attracting foreign investors as compared to other transforming countries is undoubtedly due largely to its enabling regulatory and legal environment.

However, tensions exist as the Hungarian small capitalist is at a decided disadvantage with respect to the foreign investor. Once subsidized preferential loans are exhausted, domestic interest rates are high and loans are rationed. No investment vehicle for the small investor to diversify risk (e.g., a mutual fund) exists. Domestic household savings rates have been extremely low (less than 1% of GDP from 1980–89) and household portfolios are relatively illiquid. The dominance of the foreign investor at this stage seems inevitable if companies are to be
sold. Consequently, the regulatory agencies must have a clear understanding of the motives for foreign investment.

The typical Western investor wishes to pre-empt competition from Hungarian companies in existing markets and to penetrate new markets in the transforming countries. Therefore, it is likely that foreign partners will be in the same business as the privatizing Hungarian company. Monopoly positions are likely to be strengthened rather than reduced in the privatization process; a fact that must be recognized by the GVH. However, existing legislation favors foreign investment. A GVH decision to assess penalties due to a cartel arrangement was overruled in the appellate court because the offending company was a joint-venture and, as such, subject to company law but not punishable by competitive law. Furthermore, foreign investors are not subject to merger restrictions.

Although telecommunications and banking have been identified as two areas ripe for foreign investment, the SPA has placed many telecommunications companies in a category in which majority state ownership is desirable and put several banks (including the large Hungarian Commercial and Credit Bank) in a category in which majority national (state and domestic private) ownership is desirable. The responsibility for protecting the national patrimony currently falls on the SPA. Whereas both agencies have a watchdog function to perform, the GVH is subservient to the SPA in the important matter of privatization.

The transition process generates significant non-diversifiable risk for an investor. The existence of substantial inter-
enterprise trade credit means that normally diversifiable firm-specific risk may be difficult to diversify. Hence, risk premia are likely to be high. If companies are de-linked and uncertainty is reduced by moderately favorable outcomes over time, the actual returns to the early investors will seem excessive. The government through its regulatory agencies must be mindful of the regrets that will then be expressed if the national patrimony is sold to foreigners.

By setting up counter-balancing agencies, the government can reduce the risk of a "fire-sale" result. For example, whether companies should be restructured first or privatized first is vigorously debated (Tirole 1991). If competition-oriented restructuring precedes privatization and efficiency-oriented restructuring is left to the new owners, the possibility of foreigners capitalizing monopoly rents is lessened and better market signals are provided for the second stage of restructuring. For this to occur in Hungary, closer cooperation between the SPA and the GVH would be required in the competition-oriented restructuring phase and more authority must be given to the GVH in privatization matters. Other transforming countries can learn from Hungary's regulatory experience.
References


