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Privatization and greenfield FDI in Central and Eastern Europe: *does the mode of entry matter?*

Introduction and summary

Kálmán Kalotay

Questions about the mode of entry – greenfield investment versus cross-border mergers and acquisitions (M&As) – have come to the forefront of discussions on the benefits of foreign direct investment (FDI). The discussion usually assumes that, at the time of deciding about an investment project, both the potential investors and the host countries have a choice between these two modes of entry. All they need to do is to evaluate the costs and the benefits of the two choices, and formulate their strategies accordingly. In this model, host countries often find greenfield FDI more advantageous for them, because, unlike in the case of M&As, in greenfield projects investors always create new capacities.

This issue of *Transnational Corporations* is devoted exclusively to an exploration of how relevant this ideal world is for Central and Eastern European countries undergoing economic transformation, especially through privatization. As it turns out, unlike in a textbook case, the two modes of entry are practically never substitutes for each other in Central and Eastern Europe because these two basic types play different roles in the transformation from a centrally planned to a market economy. Greenfield FDI provides new facilities while cross-border M&As contribute more to the restructuring of existing capacities. This means that, going beyond the traditional question of "which form is better", another question needs to be asked, namely: "which mode of entry serves transformation better under specific conditions or in specific industries".

In the initial phase of transformation, almost all cross-border M&As took the form of "foreign privatization" (sales of privatized assets to foreign investors) as, with some exceptions, most of the Central and Eastern European countries started their transformation with practically no or very small private enterprises. By default, the only assets foreign investors could acquire were former State-owned assets. Once the generic differentiation between greenfield FDI and cross-border M&As is made, it is legitimate to focus on foreign privatization as a specific and overwhelming form of the latter. That greenfield FDI and cross-border M&As are poor alternatives to each other is quite obvious when looking at the foreign privatization form of the latter: only foreign privatization could bring about the transformation described in this issue, without greenfield investment being a real alternative.

Some of the articles in this issue analyse FDI from the angle of foreign privatization; others do it from the angle of cross-border M&As versus greenfield investment. The conclusions are similar: whether one calls the phenomenon "foreign privatization" or "cross-border M&A", it has been a major component of transformation, although it could have played a bigger role than the one assigned to it by special political constraints.

This issue does not intend to propose definitive policy answers to the questions raised. Nevertheless, it emerges from the majority of authors that the potential role of foreign privatizations has been generally underestimated in Central and Eastern Europe. The recent surge of such privatizations in several countries is an indirect corroboration of that recognition, coupled with a wish to catch up with the time lost in earlier years of transformation.

This issue also provides some insights into the ongoing debate on transformation. In this debate, certain aspects of the conventional wisdom on transformation are challenged. For example, it is no longer certain that the way in which privatization was carried out in most of the Central and Eastern Europe countries – via voucher schemes – was the only possible (or the most efficient) way of transition from State to private ownership. A strong presence of foreign affiliates allows fast restructuring, on condition that, at the same time, host Governments follow sound, efficiency-oriented and internationally competitive economic policies. The impact of privatization-related FDI depends largely on follow-up investments and on the restructuring efforts of the new owners. The role of future policies is to maximize the positive effects and stimulate spillovers to the rest of the economy.

In the lead article, *Matija Rojec* looks at the impact of foreign privatization in Central and Eastern Europe from a firm-level perspective. He warns the reader that, in general, foreign privatizations have not been able to play a major role in the overall privatization schemes. Sales to foreign investors as a privatization method have been important mostly in the privatization of relatively large firms needing fast and thorough restructuring. Foreign privatization has nevertheless had an important qualitative impact as the entry of a strategic foreign investor resulted in an instant wish and ability to restructure and improve the target company. Most of the new (domestic) owners appearing from mass privatization schemes were unable to carry out similar restructuring.

Turning to country case studies, *Miklós Szanyi* compares privatization FDI with greenfield FDI in Hungary. He rejects the validity of the textbook case, under which – in the case of privatizations – investors would not need to change much the physical assets they purchased. This is certainly not the case in real life in economies in transition. Another important issue is whether companies could have done restructuring on their own, without foreign investors? The fact that the insertion of newly acquired facilities into international corporate networks has required more efforts than in the case of usual M&As elsewhere seems to indicate that foreign privatization has indeed played an exceptional role in economic transformation.

Katalin Antalóczy and *Magdolna Sass* take this Hungarian case further by testing again the traditional question, i.e. has greenfield FDI been better in Hungary than privatization-related FDI? The article also deals with the special relationship between greenfield investment and export processing zones in manufacturing. Through analyzing the most important characteristics of greenfield FDI in Hungary – such as its industry and geographical concentration, local embeddendness, employment creation, capital accumulation, technology transfer, competition and productivity – the authors conclude that the two forms have indeed been no substitute for each other. It is interesting to note, for example, that, compared with the sum invested, and in comparison with privatization investments, relatively few new jobs have been created, indicating that greenfield investment by no means offered a solution to the full range of restructuring problems.

To complement the analysis of the Hungarian case from a policy angle, *Peter Mihályi* asks the question how Hungary has become a success case of post-communist privatization. He argues that, by emphasizing macroeconomic stabilization and fast formal ownership change over a concern for who the real owners are, policy makers have for many years misunderstood the *raison d'être* of privatization.

Hungary had avoided the track of fast formal ownership change because it had been forced from the very beginning to divest its State-owned enterprises against hard currency. By the mid-1990s, this policy started producing major positive results in terms of fast export-led growth.

In the subsequent article, *Stanislaw Uminski* assesses the influence of privatization-related FDI on enterprise performance in Poland. As there have been three distinct channels for privatization which are difficult to compare, it is almost impossible to obtain reliable, complete and comparable statistical data on all privatization deals in Poland involving foreign investors. While this is a problem for statistics, the fact that investors could choose among different methods made the whole process more flexible and adjustable to both the firms to be privatized and to the investors, depending on their situation. The performance of the firms privatized to foreign investors, both in terms of qualitative changes and of financial measures, have been better than that of the firms privatized locally.

Alena Zemplinerová and *Martin Jarolim* analyze the role and impact of M&As and greenfield manufacturing FDI in the Czech Republic through a statistical and regression analysis, through classifying the sample of the firms analyzed by ownership (foreign or domestic) and mode of entry (greenfield or M&A). The authors find greenfield firms to be significantly smaller on average than firms acquired through foreign acquisitions. The former, however, have a higher investment rate than the latter. As for productivity growth, both groups of foreign affiliates perform well; M&A firms have nevertheless achieved slightly higher productivity growth than greenfield enterprises. The impact of both groups of foreign affiliates on the productivity growth of indigenous firms is positive. Market concentration can however cancel out the positive impact on productivity growth in industries with insufficient import competition.

To provide a broader regional outlook, *Marina Wes* and *Hans Peter Lankes* analyze in the last note the difference between greenfield