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Financing Investment in the Estern European Countries

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It is a great honour to deliver a lecture at a Conference organized by such a distinguished organization as the Section of International Law of the American Bar Association. I would like to mention in advance, what is incidentally obvious, that I am not representing any official standpoint here but intend to express my own personal views; and, as the head of the Hungarian Foreign Trade Bank, I will rely primarily on my experiences in Hungary as a banker. I would like to add, however that formerly I worked for a longer period in foreign trade as a senior official of the Hungarian Ministry of Foreign Trade, and during this time I was acting as trade counsellor in Moscow and Rome so I have a working knowledge of this field, too.

This Conference also proves that the interest in the markets of the socialist countries which expanded simultaneously with political détente has remained lively in the United States, and I can say, on behalf of the other socialist bankers, too, that we welcome this process. We seek to establish such lasting trade and other economic connections with business circles of the United States and other countries as are based on equality of rights and mutual benefits.

In view of our limited time, I shall not repeat what my written statement, which you have, says about the main benefits the United States can expect from expansion of East-West economic relations. In brief, these are:

- The possibilities of market expansion in an area of 360 million inhabitants of the CMEA countries;
- Additional employment for American workers connected with additional exports to the socialist countries;
- Strengthening of security and peace for the United States and the whole world, the best guarantee of which lies in the economic development of all regions of the earth, in economic cooperation and interdependence.

Ladies and gentlemen, let me come now to my subject, the question of investment financing.

There are certain differences in the economic management and control systems of the individual socialist countries. They are justified by differences in the level of economic development, in the size of the economy, in geographical, historical,

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and other conditions. However, these systems are identical in that the main instrument of economic management and control is central planning. In the national economic plans—and here I have in mind the medium-term, five-year plans—a central role accrues to the correct planning of investments. A whole body of science has emerged from this which I have no time and opportunity to present in further details here, and which anyway is not my line either. However, in the practice of the Soviet Union covering five decades, and nearly three decades in the case of the other socialist countries, a few "golden rules" or general tendencies have emerged which seem useful to present here since they belong to the exposition of our topic:

1. A certain, more or less stable, economically justified ratio has been established for the share of national income that may be allocated to accumulation. The notion of accumulation includes—in our terminology—beyond net investments also the increase in stocks; *i.e.*, it implies all the new value or net material product produced but not consumed during a certain period. In our present judgment this ratio is around 25 to 30 percent. (This figure will be around 24 percent in the current five-year plan period in Hungary, and the directives of the next five-year plan envisage it to be around 25 to 27 percent.)

2. The relative share of infrastructural investments in a wider sense (power supply, transport and communication, trade, housing construction, etc.) has a rising tendency.

3. Accordingly, the relative share of other productive investments, mainly in the manufacturing industries, is declining. This calls for increased efficiency of investments bringing down the capital-output ratio. Considering that the greater protection of environment tends to raise this ratio, the present growth rate of the national income, 6-8 percent on the average of CMEA countries, can be maintained only by the application of all the achievements of the scientific-technological revolution.

4. Growing labour problems, first of all the shortage in qualified labour, tend to produce the same results. Demographic developments, although to a varying degree in the individual CMEA countries, also call for efficient, labour-saving investments. A rising proportion of the increment in the national income—100 percent in the case of Hugary—has to come from the growth of productivity.

5. Finally, also the balance of trade constraint has to be considered in the investment planning: Imports cannot exceed exports for a longer period. "Over-investment" leads to external equilibrium problems depending on the elasticity of imports with respect to investment and demand in general. In Hungary this is rather high: each 1 percent increase in the national income involves a rise by 1.5-2.0 percent of imports, and by implication, of exports, too.

In the course of planning, the financial resources of investment are simultaneously planned in broad lines. Relative shares are again divergent. In Hungary:

• Nonproductive and infrastructural investments, and large individual projects aimed at structural changes, are generally financed from the state budget; partly in the form of state loans;

• Other productive investments are financed partly from the "owned investment funds" of the enterprises (which are denoted differently in each country and which include a certain part of profits and of written down depreciation left with the enterprises) and partly from bank credits.

Naturally these resources can be drawn on also in combination and thus the same investment can be financed from all the three types of funds. Bank credits redistribute partly the savings of the population and of the enterprises and partly the medium and long-term external resources drawn from foreign banks.

Domestic financing of the investments—unless it takes place from owned enterprise funds—is generally handled by the bank designated for this purpose. In Hungary, for instance, state loans are granted by the State Development Bank, investment credits by the National Bank of Hungary and, in certain cases, by the Hungarian Foreign Trade Bank.

Foreign credits are also handled by the banks authorized thereto (in Hungary, the two latter-named banks). As regards foreign credits taken up directly by the importing enterprises (so-called supplier credits), the practice varies with each CMEA country. In Hungary, this is possible only with the authorization of the National Bank and only in such cases when the conditions of the credit are more favorable than those of a bank credit.

Credits for investment purposes are not usual among banks or enterprises in the inter-CMEA trade. Either bilateral government credits are granted or the resources of the International Investment Bank (IIB) established for this purpose by the CMEA countries are drawn upon, or joint organizations are founded the capital of which is supplied from state budget allocations.

The IIB has been operating since 1971, its primary task being to finance the investments of the member countries of common interest to the CMEA area. The registered capital of the Bank is 1052 million roubles, 70 percent of which is to be paid up in transferable roubles, and 30 percent in convertible currencies according to quotas fixed by member countries (the quota set for the Soviet Union is 38 percent, for GDR 17.7 percent, for Czechoslovakia 12.3 percent, for Poland 11.5 percent, for Bulgaria 8.1 percent, for Hungary 7.1 percent, for Rumania 4.9 percent, and for Mongolia 0.4 percent). Since 1974 Cuba has been also a member of the Bank and a cooperation agreement has been concluded with Yugoslavia as well.

In 1973 an agreement was reached to set up a special fund of one billion roubles for helping the developing countries with credits of up to 15 years' maturity. Ninety-five percent of this fund was fixed in transferable roubles and five percent in convertible currency. This Fund has not started its operations as yet.

By the end of 1973 IIB had allocated credits of 588 million transferable roubles to finance 33 investment projects the budget value of which was 2,100 million roubles. Nearly 80 percent of the credits were used to finance investments in metallurgy and engineering with maximum maturity of 12 years and with interest rates fluctuating between 4-6 percent (3-5 percent in 1974-75).

The interest rate of credits granted in convertible currency is adjusted to those prevailing in the international capital markets.

The other bank of the CMEA, the International Bank of Economic Cooperation is the clearing centre of multilateral settlements. It grants transferrable rouble-credits which are utilized by member countries to cover the balance of payments deficits resulting from trade between them. It is not engaged in investment financing, so I am not going to speak here of this bank any further.

II. Questions of Financing East-West Co-operation

I have arranged this topic under three headlines:

- perspectives of economic relations
- forms of profit sharing
- credit sources and institutions

Economic Relations

Obviously this is the most important question since financing is based on definite material processes and it has to be adjusted to them. I think this point is in line with both Marxist and non-Marxist economic-financial thinking.

East-West trade among the member countries of the CMEA and OECD was developing at extremely high rates between 1968 and 1974, exceeding even the remarkably high growth rates of world trade in this period; preliminary estimates for 1974 suggest that it grew more or less in line with world trade in the last year, too. The volume of this bilateral trade flow (exports in both directions) amounted to some $40 billion, *i.e.*, some five percent of the $800 billion world trade. This is an extremely low share; and even the total exports of the CMEA countries, including their intrablock trade, come up to only ten percent of the world trade while some one-third of world industrial production is produced by these countries.

Naturally, this is part attributable to the fact that due to differences in size and in rates of self-sufficiency, dependence of the individual CMEA countries on foreign trade is rather divergent: In the Soviet Union the ratio of exports to the national income is 6-7 percent only (*i.e.*, similar to the corresponding figure of the U.S.A.), while in Hungary the same ratio comes close to 50 percent.

Of the $200 billion foreign trade turnover of the United States in 1974, only 2.3 billion fell to East-West trade in the above sense; that is the United States share in this trade was only about six percent.

These figures themselves suggest that there are rather large reserves for expanding total East-West trade as well as United States participation in it. Where do these reserves lie? Primarily and decisively in the investments of the socialist countries which have a strong demand for advanced technology and where the high level of industrial development ensures the absorption of even the most sophisticated technologies. At the same time western participation, if realized in adequate forms which I will discuss later, is suitable to ease two major constraints mentioned earlier, namely the national income constraint and the foreign trade constraint (and, to a smaller degree the labour constraint, if we think of technological experts and engineers).

The point is that, due to these constraints, some ideas are eliminated from the possible priorities in economic plans or are shelved, even though they are considered to be paying propositions by any standard.

However, a solution can be found to accelerate the implementation of such investments by relying on foreign material and financial resources. For the sake of simple terminology I am going to denote them "additional" investment opportunities.

What fields are eligible for such additional investments? I would mention here three major groups:

- Raw material—mainly fuel—extracting industries. Naturally this may be realized first of all in the Soviet Union which has vast potential reserves.
- Manufacturing industries, where every country has singled out certain fields of expansion on which to concentrate, and where the application of Western technology is desirable. This provides the largest variety of opportunities, and here the good marketing activity of the Western firms may have an important role since initiative is not limited to the socialist countries alone.
- Finally, there are various investments in infrastructure and services, primarily those where a certain degree of western interest is also present (*e.g.*, transit traffic, telecommunication, tourism).

The national income and foreign trade constraints are relieved in the case of these investments by relying on the principle of "self-financing." What do I mean by self-financing? By this term I mean the potential of investments to repay the capital, first of all, foreign capital, invested from its own foreign exchange returns within a reasonable period (*e.g.*, over the period of the foreign credit).

Consequently, the economic process on which this concept is based involves such additional self-financing investments as require foreign participation.

The substance of foreign participation includes:

- technology/licence, know-how/
- machinery
- marketing responsibilities abroad.

Question of Profitsharing

Obviously these activities go beyond the scope of simple mutual deliveries of goods and they presuppose a permanent relationship based on the partners' reciprocal interests.

This partnership, taken in its widest sense, is referred to hereinafter as a "joint venture" which is a rather well-known expression; and for sake of easy reference I shall call their two main forms as "equity joint venture" and "non-equity joint venture." I appologize if I am not using the exact terms of American law but I will do my best to make the legal significance of these terms as clear and unambiguous for you as possible.

With respect to the equity joint venture, which is regarded by American practice as the closest partnership, this is also permitted by the law of some socialist countries (Hungary, Romania, Yugoslavia) in their own jurisdictions. Generally a local majority ownership (at least 51 percent) is mandatory. (I am not speaking here of joint ventures established abroad which is permitted by the law of every socialist country.)

A further statutory limitation imposed by the applicable Hungarian legislation is the exclusion of direct foreign ownership from producing enterprises. To prevent this, the Hungarian law stipulates that economic relations of the newly established joint companies with the Hungarian producing enterprises are regulated by contracts which are independent of the Articles of Association.

The intention of the Hungarian legislation is clear: it tries to avoid the social and other problems that are associated with direct foreign management of producing enterprises exercised on the basis of ownership. At the same time, by way of the respective contractual devices, the legislation provides the means for the parties to the joint venture to achieve the highest possible efficiency in the production process, observing always the laws and rules of the host country. These problems necessarily come up in every socialist country, and the solution may vary from country to country. My personal view is that ownership raises a number of problems for both parties and therefore, in the overwhelming majority of cases the "non-equity" form ensures a more advanageous, more flexible position for both parties.

The "non-equity" form, *i.e.*, the contractual partnership, has given rise to the widest and most diversified legal solutions. This is but another proof of law being the most flexible science of the world. I am not being ironic about this: I myself took my degree in law and I am convinced that law is to have an outstanding role in shaping mankind's future.

All the well-known contractual forms: management contract, franchise contract, service contract, cooperation or collaboration agreement, licensing agreement, *etc.*, that have been widely applied over recent years, may be suitable to regulate favourably for both parties the scope of joint activities, and their control, as well as the sharing of resulting profits while avoiding ownership problems and other associated conflicts and risks. I believe there have been some attempts to set these contractual forms in some uniform, internationally accepted models. Naturally such models may be useful, but I doubt that all the diversified problems produced by such contracts could be squeezed in such a strict legal pattern as, for example, the opening of a letter of credit.

I believe it is widely known in the United States that enterprises of the socialist countries observe strictly their obligations spelled out in the contracts. Thus, a contract if drawn up, clearly guarantees the foreign party that he will obtain every benefit or remuneration that follows from it. In general, the banks of the socialist countries do not object to issuing their guarantees covering these obligations. Appropriate forms of arbitration clauses acceptable for both parties also have been created in recent years.

Credit Sources

In the case of the equity form of joint venture, the capital contribution of the foreign party, and by implication his share in the profits, are fixed by the articles of association.

In the non-equity case, capital—if part of the deal—is contributed in the form of credit. It does not necessarily mean that the creditor-debtor relationship is established between the two partners. The Hungarian practice gives preference even in such cases to a separate "bank-to-bank" financing which may be tied to some specific deal, but occasionally it may assume also the form of wholly independent financial credit.

In such cases the Hungarian banks—the National Bank or the Foreign Trade Bank—support the export promoting investments of the enterprises by credits granted in national or foreign currencies sometimes even on more favourable terms (*e.g.*, interest rates or credit periods) than those attainable abroad at the given moment.

Naturally, if the deal involves a delivery of a large amount of machinery, or complete factories, those countries enjoy priority that permit the financing of such deliveries at preferential rates of interest and with state guarantee without this having any adverse influence for the buyer on the purchase prices or other terms of the contract. Therefore, it seems most important not to tie the hands of the U.S. Eximbank with unrealistic limits that, incidentally, jeopardize the competitiveness of American firms. It is obvious that the buyer considers *all the terms* (price, interest rate, maturity of the credit and others) as one package. A further elaboration on this point may be dispensed with before the present audience.

Larger credit transactions may exceed sometimes the capacity of a single bank. The so-called consortium credits have come to life also in East-West business. The Western affiliates and branches of the banks of the socialist countries, such as the Moscow Narodny Bank in London, also take part in these deals. At present more than 20 such socialist banking corporations are functioning in the West, rendering a very useful service to East-West trade.

With respect to the issuing of bonds, the National Bank of Hungary has done a certain pioneering work. It has floated three such loans with great success and on terms which were in line with the prevailing conditions. In my opinion, the importance of issuing bonds will grow in the future. It would seem reasonable for American banks and other interested parties to look into the matter. Opening the American capital market would bring undoubtedly various benefits also for U.S. exporters.

Finally I would like to emphasize that in general the co-operation of banks is one of the most promising fields of East-West economic relations and at the same time it is the precondition for the expansion of same. I am happy to say that the Hungarian banks have rather good connections with the American banks. These connections have shown a marked development recently. In my opinion the world needs the widest possible co-operation of banks in both the monetary and the financing fields, not only to promote the development of East-West economic relations but also to normalize international financial conditions in general.

Irrespective of the social system of the particular countries, banks act according to certain uniform business principles all over the world. They have, or at least they should have, open-minded leadership sensitive enough to perceive the realities and changes of the international scene and thus they can render indispensable service in harmonizing apparently conflicting interests.

Ladies and gentlemen, on behalf of the Hungarian banks—and I believe the banks of other socialist countries share my views on this score—I can assure you our efforts will not be spared to achieve what I believe to be our common goal: a dynamic stimulation of East-West trade relations.