# RESHUFFLING CARDS BETWEEN THE BUSINESS AND THE STATE: BANKING AND MANUFACTURING IN TIMES OF UNCERTAINTY

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# Abstract

A financial crisis acts as a turning point: not only it poses the challenges for the private sector as well as for policymakers, but it also creates windows of opportunity for policy change. The present thesis analyzes how Hungary and Latvia, small and open economies dependent on foreign capital, could capitalize on the changes in the external and internal environment and improve their economic prospects. Based on the combination of sectoral theories and bargaining models, I argue that the interplay between the intersectoral and intrasectoral differences in banking and manufacturing has influenced bargaining positions of multinational enterprises and the respective governments. The analysis shows that the affinity of interests of Latvian and Hungarian governments with a particular sector directed the cooperation between them. While the ability to pool the support of their home countries certainly increases their leverage in influencing state policies, it does not always pay off if the external sources of financing increase government's political autonomy.

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**List of abbreviations:**

CEE – Central Eastern Europe

EBRD – European Bank for Reconstruction and Development

EMU- European Monetary Union

EU – European Union

FDI – Foreign Direct Investment

FICIL – Foreign Investors Council in Latvia

FX loan – foreign currency denominated loan

IMF – International Monetary Fund

MNB – multinational bank

TNC/MNC – transnational/Multinational corporation

SPA – Strategic Partnership Agreement

Visegrad four – Czech Republic, Hungary, Poland, Slovakia

# INTRODUCTION

The economic success of small economies dependent on foreign capital owes a lot to the willingness of multinational corporations to integrate these economies into global value chains and the agility of the host country in persuading those companies to do so. When it comes to particular industrial policies,[1] host country specifics and the international environment set the stage for bargaining between the interested parties. When things turn sour, policy responses tend to be very different. The literature on business-government bargaining has developed a number of models that try to explain such policy outcomes. Stressing different aspects of bargaining, they reconcile the similarity of interests of the actors, their potential bargaining resources and motivation to influence bargaining, the way actors can mobilize their power through the network of relations and constraints they face in doing so.[2] The versatility of these models has generated a number of conflicting views on bargaining relationships with regards to dynamics of economic and investment cycle across different sectors.

The cases of Hungary and Latvia represent a specific interest in this sense. First, foreign investors own the majority of both banking and manufacturing industries in these countries, which makes them dependent on foreign capital. Thus, relations between the government and multinational companies are highly relevant for their economic wellbeing. Second, both countries were facing similar challenges during the crisis related to the liquidity crunch and foreign currency denominated loans, as well as stagnating demand. At the same time their policy responses to these challenges diverged significantly across banking and manufacturing industries. Third, different export specializations of these countries – namely light manufacturing



[1] In this thesis industrial policy is understood in a broader sense as "structural" policy that refers to various industries and services alike.

[2] James Nebus and Carlos Rufin, "Extending the Bargaining Power Model: Explaining Bargaining Outcomes among Nations, MNEs, and NGOs," *Journal of International Business Studies* 41, no. 6 (August 2010): 996–1015, doi:10.1057/jibs.2009.43.

sector (wood, apparel and food industries) in Latvia and complex manufacturing sector (automotive, electronics and chemical industries) in Hungary – would allow us to analyze how the interplay between the intersectoral (complex and light manufacturing) and intrasectoral (banking) differences influences the bargaining positions of the state and multinational enterprises, without restricting ourselves to one leading sector.[3] And fourth, neither of the two countries was able to weather the crisis without resorting to IMF and the EU. Negotiations in Latvian case involved a broader set of stakeholders. Thus we can examine how the relationships with international institutions and home country of multinationals affect the interests and bargaining hand of the state agency and business.

The policy responses in question, however, can only be understood in the context of pre-post crisis dynamics in industrial policy (see table 1). Since the beginning of 2000s the influx of cheap foreign credit pumped up these economies, causing dangerous overheating. Both countries supported the increasing credit expansion and excessive mortgage borrowing. The governments closed their eyes on the risks of large scale lending in foreign currency, which later contributed to the turmoil in the financial sphere.[4] Their policies towards the banking sector diverged significantly after 2010. Surprisingly, having no significant problems with the bank bailouts, and having Vienna Initiative that assured commitment of foreign banks to the CEE countries, newly elected Fidesz government started to "show its teeth" to foreign banks. Oppressive measures against banks increased gradually from the adoption of the unprecedentedly high crisis tax to the reduction of foreign ownership in banking sector, all accompanied by a very strong anti-bank rhetoric.



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[3] Multiple sectors can have multiple interests that do not necessarily coincide with those of the most influential actors.

[4] Dorothee Bohle, "Post-Socialist Housing Meets Transnational Finance: Foreign Banks, Mortgage Lending, and the Privatization of Welfare in Hungary and Estonia," *Review of International Political Economy* 21, no. 4 (August 2014): 913–48, doi:http://www.tandfonline.com/loi/rrip20.

Interestingly, while having cherished the idea of joining the Eurozone, the Latvian authorities chose to bail out its largest domestic bank at the price of losing on the budget deficit criteria for euro in 2009. Nevertheless, they still kept the currency peg that also safeguarded banks from credit losses.[5] Later on Latvia allowed foreign banks to strengthen their position in the country and provided more favorable administrative conditions and taxation policy for non-residence banking.

**TABLE 1 PRE-POST CRISIS INDUSTRIAL POLICY TRENDS IN HUNGARY AND LATVIA**

| **COUNTRY\SECTOR** | BANKING | MANUFACTURING |
|---|---|---|
| HUNGARY | **Supportive/Repressive** | Supportive/Supportive |
| LATVIA | Supportive/Supportive | **Neutral/Supportive** |

Against this background, the development of policies towards manufacturing seems not less puzzling. While Prime Minister Orbán was cautious about foreign ownership in banking that increases Hungarian vulnerability to externally made decisions, such apprehensions did not concern foreign investors in manufacturing. Moreover, while increasing the share of domestic ownership in banking, no significant attempts were made to strengthen the position of Hungarian suppliers. In fact, having a long record of concessions to international producers, Hungary gave a helping hand to complex manufacturers and established the ground for even closer dialogue with the multinationals already present in the country.[6]

Keeping in mind that Latvia is a small and open economy that is fully dependent on exports and foreign capital, Latvian government provided no support for its light manufacturers, letting them



[5] Anders Åslund and Valdis Dombrovskis, *How Latvia Came Through the Financial Crisis* (Peterson Institute, 2011).
[6] Transparency International Hungary, "Lifting the Lid on Lobbying: National Report on Hungary. Lobbying in an Uncertain Business and Regulatory Environment," 2014, http://www.transparency.hu/uploads/docs/lobbi2014_web_eng.pdf.

leave the country or adjust to degraded market conditions, while at the same time spending one fifth of its GDP to bail out its largest domestic bank. Having realized that the growth in financial sphere needs to be balanced by the productive output, the government headed by Dombrovskis started in 2010 to redirect Latvian neutral industrial policy towards developing a technologically intensive export-oriented sector. Nevertheless, these efforts did not prove to be very fruitful.

These developments call for a number of questions that motivate my study:

1. ***Why did Latvia and Hungary that faced similar challenges reacted to the crisis in a different manner?***
2. ***Why did post-crisis industrial policies treat foreign manufacturers and foreign banks differently*?**
3. ***How did the structural powers of the business and the state change after the crisis and how did this change affect industrial policymaking?***

**Methodological framework and the main propositions**

In order to answer these questions, I combined quantitative and qualitative research methods. To understand the specificities of structural bargaining powers, I have conducted a number of semi-structured interviews with the representatives of business associations and offices of Transparency International in both Hungary and Latvia (for the list of interviews see appendix A). The first group of interviewees represents interests of the most prominent business actors in these countries.[7] I focused on their relationship with the respective governments and how the business reacted to specific state policies. I asked about the challenges that members of these associations had faced during the crisis and how they dealt with those challenges, particularly about the possibilities of foreign companies to enlist the support of their home governments and business associations at the EU level. The interviewees from Transparency International

[7] Due to the nature of this study, the interviewed represenative of Hungarian banking sector wished to remain anonymous.

provided an impartial picture of the political situation in both countries and insights of lobbying practices and bargaining positions of different industries.

For the actual analysis I will use a combination of sectoral theories of Michael Shafer[8] and Jeff Frieden[9] and a number of TNC-host country bargaining frameworks,[10] whose implication will serve as the grounding for my hypothesis. The two sectoral models offer a clear mechanism through which the specifics of the leading sectors shape policy preferences of industrial players and their ability to push those interests into the policy agenda of the state.

*H1. Sectors with greater capital intensity and resource commitment to the local economy would incur stronger preference for interventionist industrial policy.*

Bargaining models consider similarity of the state's and MNEs' interests as well as the size of their stakes in cooperation as the driving source of bargaining,[11] thus my second hypothesis is:

*H2. The extent to which the host government needs MNEs to achieve its goals determines the direction of the industrial policy.*

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[8] D. Michael Shafer, *Winners and Losers: How Sectors Shape the Developmental Prospects of States* (Cornell University Press, 1994).

[9] Jeff Frieden, "Classes, Sectors, and Foreign Debt in Latin America," *Comparative Politics* 21, no. 1 (October 1, 1988): 1–20, doi:10.2307/422068.

[10] Theodore H. Moran, "Multinational Corporations and Dependency: A Dialogue for Dependentistas and Non-Dependentistas," *International Organization* 32, no. 01 (December 1978): 79–100, doi:10.1017/S0020818300003878; Douglas C. Bennett and Kenneth E. Sharpe, "Agenda Setting and Bargaining Power: The Mexican State Versus Transnational Automobile Corporations," *World Politics* 32, no. 01 (October 1979): 57–89, doi:10.2307/2010082; Lorraine Eden, Stefanie Lenway, and Douglas A. Schuler, "From the Obsolescing Bargain to the Political Bargaining Model," in *International Business and Government Relations in the 21st Century* (Cambridge University Press, 2005), http://dx.doi.org/10.1017/CBO9780511488597.011; Caner Bakir, "Bargaining with Multinationals: Why State Capacity Matters," *New Political Economy* 20, no. 1 (January 2, 2015): 63–84, doi:10.1080/13563467.2013.872610; Robert Grosse, "The Bargaining View of Government?business Relations," in *International Business and Government Relations in the 21st Century* (Cambridge University Press, 2005), http://dx.doi.org/10.1017/CBO9780511488597.012; Michael R King, "Political Bargaining and Multinational Bank Bailouts," *Journal of International Business Studies* 46, no. 2 (March 2015): 206–22, doi:10.1057/jibs.2014.47.

[11] Eden, Lenway, and Schuler, "From the Obsolescing Bargain to the Political Bargaining Model."

To pursue their interests, actors must consider their relative resources and their ability to utilize network relationships with domestic and external actors, including international agencies and the home countries of multinationals.[12]

*H3. The ability of foreign investors to pool support of their home countries and international agencies increases investors' leverage over the host government.*

And finally, bargaining models prioritize the importance of factors that constrain or facilitate actors' bargaining positions in their ability to actually influence the policy outcome, which drives my fourth hypothesis:

*H4. The prevalence of supportive factors from international and/or domestic environment over actor's organizational, institutional and structural constraints would determine its upper hand in the bargain.*

**Contribution to the literature**

As outlined at the beginning, the literature on state-MNE bargaining shares contradicting views on the dynamics of the MNC power over time depending on the specifics of the sector. According to one view, introduced by Theodore R. Moran,[13] heavy manufacturing companies have the highest bargaining power at the initial stage of investment. Once they make their commitment to the economy, non-flexible nature of their business and large fixed costs increase the bargaining position of the host state. According to the other view, introduced by Benneth and Sharpe,[14] the position of manufacturers increases over time with their ability to raise their voice by the threat of exit, claiming that the country needs their production as they provide developmental base for the local suppliers, plus they can mobilize their local allies for collective action. Most of the bargaining models were developed to explain the industrial development of

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[12] Bennett and Sharpe, "Agenda Setting and Bargaining Power."
[13] Moran, "Multinational Corporations and Dependency."
[14] "Agenda Setting and Bargaining Power."

Latin America[15] and East Asia.[16] The literature on FDI in CEE made significant contribution to the debate, demonstrating how foreign investors in automotive and electronics industries magnified their bargaining position via encouraging CEE countries to engage into investment incentive contest.[17] Some of the most recent studies looked at the bank bail-outs,[18] pointing out that the magnitude of the banks' role in the economy and their capacity to act collectively increased their leverage vis-à-vis the government.[19] At the same time most of these studies deal with specific investment projects or rescue measures for the business, while much less attention has been devoted to broader industrial policies.

In this thesis I aim to contribute to the debate by explaining the dynamics of policy variation in Hungary and Latvia via analysis of structural powers, pressures and vulnerabilities. It will extend the debate to the financial sector by looking at how the banks in Latvia were able to push their interests into the broader policy agenda of the government, and what constrained banks in Hungary in doing so. I will examine how specificities of the financial sector influence banks' bargaining position and how they used their relationship networks, external environment and institutions as tools of leverage, and how these tools differ from those of traditional complex manufacturers or light industries. To understand the formation of the industrial policy, I will need to focus on structural bargaining positions, rather than looking at the specifics of the bargaining process with negotiations and lobbying.



[15] Leslie Sklair, *Assembling for Development: The Maquila Industry in Mexico and the United States* (Routledge, 2013); Bennett and Sharpe, "Agenda Setting and Bargaining Power."
[16] Andrew MacIntyre, "Business, Government and Development: Northeast and Southeast Asian Comparisons," in *Business and Government in Industrialising Asia*, ed. Andrew MacIntyre (Ithaca:, 1994), 1–28.
[17] David Bartlett and Anna Seleny, "The Political Enforcement of Liberalism: Bargaining, Institutions, and Auto Multinationals in Hungary," *International Studies Quarterly* 42, no. 2 (June 1, 1998): 319–38, doi:10.1111/1468-2478.00084.
[18] E Grossman and C Woll, "Saving the Banks: The Political Economy of Bailouts," *COMPARATIVE POLITICAL STUDIES* 47, no. 4 (March 2014): 574–600; Cornelia Woll, *The Power of Inaction: Bank Bailouts in Comparison*, Cornell Studies in Political Economy (Ithaca, NY: Cornell University Press, 2014).
[19] King, "Political Bargaining and Multinational Bank Bailouts."

In doing so I will need to solve a number of tasks throughout the thesis. First, map the interests of the state and the societal actors, as well as their stakes in cooperation. Second, assess the structural resources that determined the potential bargaining power of the parties. And third, analyze how the players were able to actually turn potential structural powers into actual bargaining strength. Examine which factors prevented them from using the bargaining assets or, in contrast, enabled them to do so.

In the first chapter I will provide the theoretical foundation of my thesis alongside with the initial input of sectoral data to be able to draw the predictions that the models would provide for my cases.

The second chapter represents an analysis of policy dynamics before, during and after the crisis, namely from 2010, when the new Hungarian government took the oppressive stance towards banks.

In the third chapter I will investigate pre-post crisis development in manufacturing and how state policies were crafted by external and internal factors.

The final part concludes upon the findings and reveals the extension of Moran – Benneth and Sharpe debate for the cases examined in the thesis. Lastly it uncovers limitations of the analysis and provides suggestions for further research.

# CHAPTER 1. THEORETICAL FRAMEWORK: SECTORAL ANALYSIS IN THE CONTEXT OF BALANCE OF BARGAINING POWER FRAMEWORK

Before we proceed with the analysis of developments in the industrial policy and try to understand which forces contributed to the preservation of status quo or change in the industrial policies, I will describe the theoretical framework underlying the analysis of my thesis. It will help us understand the interests of the political and economic actors, provide the tools to assess the distribution of power between those actors and factors that determine their ability to actually use this power. Adding sectoral data for the analysis will allow us to form some predictions based on the theories.

## 1.1. Industrial policy preferences through the lens of sectoral analysis

The literature in political economy has produced a number of sectoral approaches which explain how major industries affect societal cleavages, state policies and politics.[20] These studies address different aspects of the relationships between the societal actors and the state, however in this thesis the models of Shaffer and Frieden represent the biggest interest for us. They focus on the policy preferences of the individual firms based on the challenges that they face within their sector and their relationships with labor, and how specifics of the sectors influence the degree to which state policies are affected by the business. Both approaches refer to bad times, Frieden looks at financial downswing and national reactions to change in external conditions, while Shafer focuses more on the economic restructuring and the capacity of state to reorient economic activity, all of which is strongly affected by existing sectoral composition in a country. Both of



[20] James R. Kurth, "The Political Consequences of the Product Cycle: Industrial History and Political Outcomes," *International Organization* 33, no. 1 (January 1, 1979): 1–34; Peter Alexis Gourevitch, *Politics in Hard Times: Comparative Responses to International Economic Crises* (Cornell University Press, 1986); Frieden, "Classes, Sectors, and Foreign Debt in Latin America"; Jeffry Frieden, "Invested Interests: The Politics of National Economic Policies in a World of Global Finance," *International Organization* 45, no. 04 (1991): 425–51; Sklair, *Assembling for Development*; Shafer, *Winners and Losers*; Terry Lynn Karl, *The Paradox of Plenty: Oil Booms and Petro-States* (University of California Press, 1997).

our cases, Hungary and Latvia, rely heavily on foreign capital as their major sources of growth, hence when things turned sour the actions of the multinational corporations in leading sectors had very strong impact on their host countries.[21] Thus sectoral models should provide us with strong explanatory tools that would help us understand the policy preferences of the societal actors, while bargaining models would help explain how those preferences were translated into actual policy outcomes.

Fundamental characteristics of sectors, namely capital intensity, ability to capitalize on the economies of scale, production flexibility and asset/factor flexibility, influence the ability of sectors to adapt to changing circumstances, hence, the need for state's support, and their ability to organize for collective action to pursue their interests and preferences. These characteristics of the leading sector(s) influence the autonomy of the state to be impartial of the interest of industry in formulating policy goals; the state's bureaucratic, regulatory and monitoring capabilities in absolute terms and in relation to the resources and capacities for collective action of its allies and opponents.[22]

Heavy sectors (both complex like automotive, electronics or chemical manufacturing and basic like cash-crop agriculture, oil, gas, electricity, coal, stone or metals) are characterized by high capital intensity and inflexibility of production born of big investments in equipment and infrastructure, high specificity of labor skills and large fixed costs. It is very difficult and costly for these fixed asset holders to adjust to market changes or to exit. Thus, being stuck in struggling sectors, these companies seek state support and benefit from sectoral policies.[23]



[21] Cornel Ban, "From Cocktail to Dependence: Revisiting the Foundations of Dependent Market Economies" (Boston University, the Department of International Relations, 2013), http://blogs.bu.edu/cban/files/2013/03/Cornel-Ban_dependent-market-economy1.pdf.
[22] Shafer, *Winners and Losers*, 7.
[23] Frieden, "Classes, Sectors, and Foreign Debt in Latin America," 4–5.

"Downturns devastate firms, lead to intense pressure on the state for aid, and gut government revenues".[24]

At the same time firms in the light sectors (like textiles, footwear, wood, food production or light machinery) possess high managerial and technical flexibility to adjust to the changes in the market conditions, as well as flexible low-skill workforce to adapt to productivity and delivery demands.[25] Since the ability to shift is high and barriers to exit are relatively low, firms in light sector can weather downturns without much support from the state. As their assets are relatively more liquid, under increased economic uncertainty they can cash those assets easier and transfer them into sectors with higher rate of return, or shift their funds into safer outlets at home or elsewhere.[26] They also benefit much more from the market-oriented horizontal policies during the economic upswing.

Frieden considers banks as the most liquid asset holders, who can easily adjust to changes in economic cycles. However, a number of recent studies on bank bailouts show the opposite: in times of uncertainty banks seek support from the state, being at the same time very influential and powerful actors, which is related to their exceptional role in the economy.[27] Thus I would expect banks to share similar characteristics with firms in heavy sectors and behave accordingly.

When approaching the issue from the side of the state, the host government "typically hopes to accomplish broader economic, social and political objectives."[28] The relationship between the political elites and bourgeoisie can also be an important generator of national demands.[29] When the government finds its interests in cooperation with the foreign investors it is likely to adopt



[24] Shafer, *Winners and Losers*, 13.
[25] Ibid., 28.
[26] Frieden, "Classes, Sectors, and Foreign Debt in Latin America," 4–5.
[27] Grossman and Woll, "Saving the Banks"; Woll, *The Power of Inaction*.
[28] Eden, Lenway, and Schuler, "From the Obsolescing Bargain to the Political Bargaining Model," 259.
[29] Bennett and Sharpe, "Agenda Setting and Bargaining Power"; Grosse, "The Bargaining View of Government?"

industrial policy geared towards a particular industry. If they find their interests contradicting with that of the MNEs, especially if there is a perceived threat from the foreign ownership, economic nationalism for a specific sector is likely to emerge on the policy agenda. Thus we would expect that *the more similar the interests of the firms and the government, the higher the likelihood that their cooperation would be successful.*

The size of government stakes also matter. The more government values the investment and resources that MNE offers or the relationship with the company's home government, and the less alternative sources of investment it has, the more it is likely to seek cooperation with MNEs.[30]

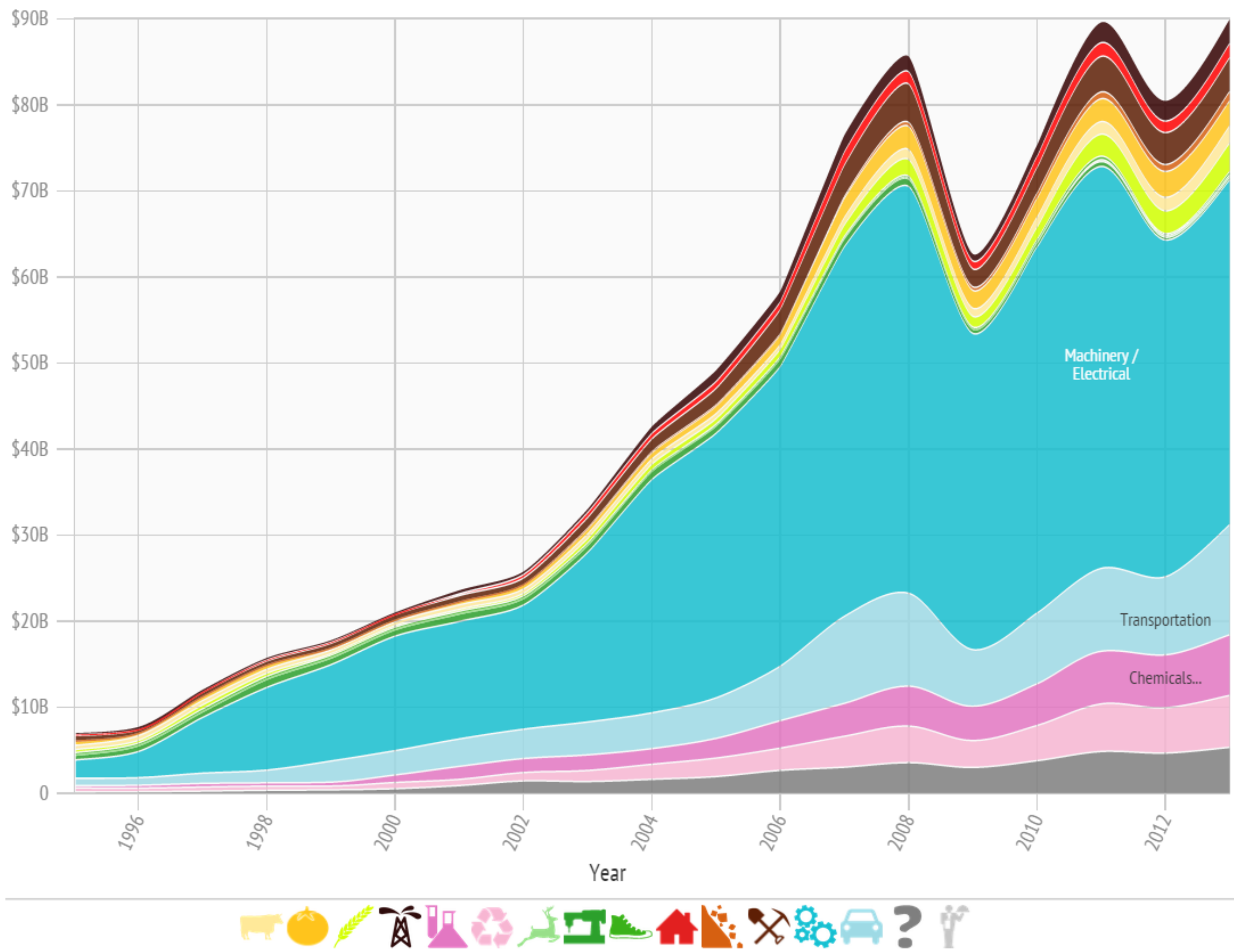
Now it is useful to take a look at the sectoral distribution of Latvian and Hungarian exports as the input of the analysis and see what predictions would these sectoral theories provide for our cases (see figures 1 and 2). I will use sectoral classification adopted by Béla Greskovits in "Leading Sectors and the Variety of Capitalism in Eastern Europe"[31]. Heavy-basic industries include agriculture, oil, gas, electricity, coal, stone, non-ferrous metals, paper, rubber, plastic, ferrous metals. Heavy-complex industries include chemicals (except pharmaceuticals), transport and heavy industrial machinery, railways, planes, etc. Light industries include wood, simple wood products, textiles, clothes, footwear, furniture, pharmaceuticals, electronics, electrical, light machinery.



[30] Eden, Lenway, and Schuler, "From the Obsolescing Bargain to the Political Bargaining Model"; Grosse, "The Bargaining View of Government?"

[31] Béla Greskovits, "Leading Sectors and the Variety of Capitalism in Eastern Europe," *Actes Du GERPISA* 39 (2005): 115.

**FIGURE 1 . HUNGARY'S EXPORT STRUCTURE BETWEEN 1995 AND 2013**




Source: UN Comtrade Labs[32]

Hungary is a highly industrialized economy with a high level of complex manufacturing that flourished under constantly promoted investment attraction policy that turned the country into an assembly platform for Western automotive and electronics TNCs.[33] By 2006 the share of



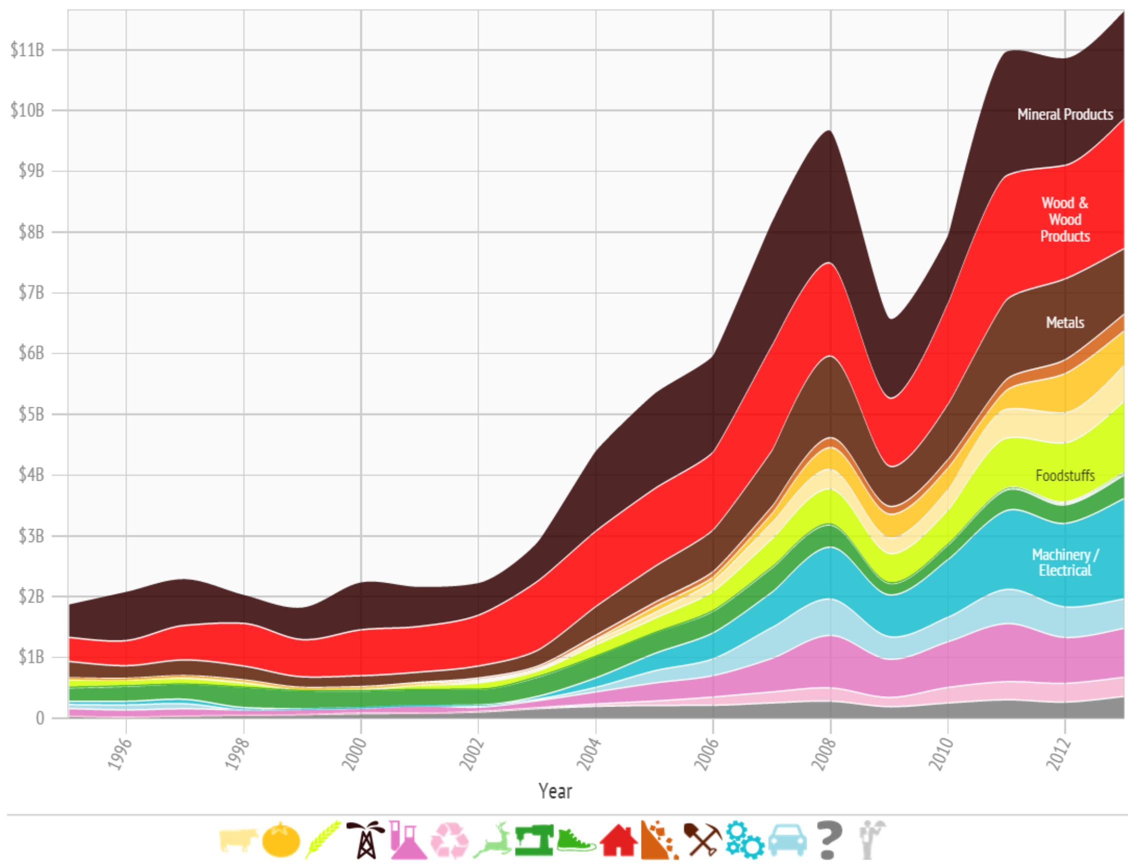
[32] UN Comtrade Labs: The Atlas of Economic Complexity, "What Did Hungary Export between 1995 and 2012? | The Atlas Of Economic Complexity," accessed April 10, 2015, http://atlas.cid.harvard.edu/explore/stacked/export/hun/all/show/1995.2012.2/.
[33] Andreas Nölke and Arjan Vliegenthart, "Enlarging the Varieties of Capitalism: The Emergence of Dependent Market Economies in East Central Europe," *World Politics* 61, no. 04 (October 2009): 670–702, doi:10.1017/S0043887109990098.

complex manufacturing already reached 79% of country's exports.[34] Hungary's export is dominated by chemicals, cars and spare parts, heavy industrial machinery, electronics etc. The country is a typical case of heavy complex sector dominance, which is characterized by high capital intensity and concentration of production within relatively few large foreign owned firms run by sophisticated well-connected managers for whom it is easy to mobilize for collective action. According to Shafer these large firms possess the control over the channels of interest representation and can exert pressure on the state to adopt industry-preferential policies. Thus relative state's autonomy in separating its interest from that of the industry and capacity to withstand sectoral pressures is rather limited. *In case of Hungary we would expect that due to the inflexible nature of their production and high exit costs those large manufacturers would seek and obtain state support during economic downturn.*



[34] Béla Greskovits, "Legacies of Industrialization and Paths of Transnational Integration after Socialism," in *In Beissinger, M. R. and Kotkin, S., Eds., The Historical Legacies of Communism in Russia and Eastern Europe* (Cambridge: Cambridge University Press, 2014), 68–90.

**FIGURE 2. LATVIA'S EXPORT STRUCTURE BETWEEN 1995 AND 2013**




Source: UN Comtrade Labs[35]

Latvian economy, on the contrary, has experienced large-scale deindustrialization since the beginning of post-socialist restructuring,[36] while the recent changes in the structure of its exports show the declining role of the mineral products and some increase in the machinery and electrical products.[37] Nevertheless, Latvia's export is still dominated by the products of light manufacturing industry including wood, simple wood products, textiles, clothes, footwear,



[35] UN Comtrade Labs: The Atlas of Economic Complexity, "What Did Latvia Export between 1995 and 2012? | The Atlas Of Economic Complexity," accessed April 10, 2015, http://atlas.cid.harvard.edu/explore/stacked/export/lva/all/show/1995.2012.2/.

[36] Greskovits, "Legacies of Industrialization and Paths of Transnational Integration after Socialism."

[37] Interestingly, without having any car production Latvia became a car exporter for a few months in late 2009 and early 2010, as the demand fell so sharply that car dealers were unable to sell their inventory in the country and sold them to foreign dealers. Olivier J. Blanchard, Mark Griffiths, and Bertrand Gruss, "Boom, Bust, Recovery: Forensics of the Latvia Crisis," *Brookings Papers on Economic Activity*, 2013, 343.

furniture, food products etc. Production in the light sector is characterized by higher flexibility and lower fixed costs, thus it is easier for the firms to adapt to the changing market conditions and regulatory changes implemented by the government. Hence, *during economic downturn firms in Latvian light sector would be more likely to choose the strategy of adaption or exit rather than voice*.[38]

Another feature of the economy dominated by the light sector is the low level of industrial concentration and organization of production in rather small units. The problem of this dispersion translates into obstacles for the industrial actors to organize for collective action to confront the state. This implies that the state would be rather impartial of industrial interests and would have high autonomy to implement restructuring policies.[39] Hence, according to Shafer, *we would expect that Latvian authorities will control the political space to design strategies to reorient economic structure*.

Indeed, relative state autonomy and capacity is, beyond doubt, a necessary component of economic restructuring, however the importance of state's autonomy and capacity might be overstated and some other explanation should be taken into account. Such a strong state "capable of withstanding rent-seekers and governing the behavior of firms through coordinated market intervention may not be a prerequisite for major economic adjustment after all".[40] What matters here is the central political dilemma for the reform: "though significant benefits may accrue to the society as a whole, policy adjustment involves significant startup costs and reduction of rents of particular groups".[41] Even if the state is able to withstand opposition of the affected



[38] Albert O. Hirschman, *Exit, Voice, and Loyalty: Responses to Decline in Firms, Organizations, and States* (Harvard University Press, 1970).
[39] Shafer, *Winners and Losers*.
[40] MacIntyre, "Business, Government and Development," 13.
[41] Stephan Haggard and Robert R. Kaufman, "Institutions and Economic Adjustment," in *The Politics of Economic Adjustment: International Constraints, Distributive Conflicts and the State* (Princeton: Princeton University Press, 1992), 13.

businesses, reduction in their rents translates into lower tax base which further influences the availability of resources for restructuring. The long-lasting practice of Visegrad countries to outbid each other in generosity of their investment incentives makes it even more difficult for Latvia to attract high value added investment.

## 1.2. Mapping potential bargaining assets and turning them into actual bargaining power

The ability of multinationals and the state to pursue their interest depends on their potential bargaining strength, which is determined by the actual resources that parties can offer for a deal, but more importantly on the ability of interest groups to capitalize on institutions and structural conditions to actually deploy those bargaining resources.

Early bargaining models, including obsolescing bargain, traditionally assumed that what matters the most in MNC-host government bargaining is the resources they possess. MNC's can offer ownership advantages, such as capital, technology, know-how, financial resources, and access to foreign markets. A host government's resources include its location-specific advantages, such as access to home markets, raw materials and cheap and skilled labor.[42] However, what constitutes a power resource depends on the context of structural and institutional relationships between the actors and the extent to which TNCs and host government need each other to achieve their goals.[43] The relationships of state agency and those of the TNCs determine when they can or cannot deploy the resources in their possession (especially relevant for structural dependencies of host country on home countries or the EU) and draw in other actors to form alliances and increase legitimacy of their actions.

[42] Eden, Lenway, and Schuler, "From the Obsolescing Bargain to the Political Bargaining Model"; Thomas A. Poynter, *Multinational Enterprises and Government Intervention (RLE International Business)* (Routledge, 2013).
[43] Bennett and Sharpe, "Agenda Setting and Bargaining Power"; Grosse, "The Bargaining View of Government?"

The most crucial factor of the success of either of the parties is how well they can utilize their potential power. Acting collectively, of course, increases chances to achieve a party's goals, but it does not guarantee success. Drawing support from different relationships can increase the leverage of a player. At the same time factors of international and domestic environment can set constraints on certain actions or, on the contrary, enable them.

**Mobilization of corporate power**

Acting collectively can increase the leverage of business players by pulling together their resources.[44] The propensity for cooperation across heavy and light sectors has been outlined previously as a part of the sectors' characteristics. At the same time the likelihood of collective action increases with the intensity of cooperation among the holders of capital. This is reflected in the ownership structures in the economy. Banks prominence in the networks of ownership facilitates channeling of finance and information sharing. When the banks are invited to sit on the board of the companies they get privileged access to information about suppliers or customers. At the same time they increase cooperation among the interlocked firms, facilitate bargaining and political cohesion among the actors of the network.[45] Thus *we would expect banks to act together to exert stronger influence to protect their interests, especially in bad times.* At the same time, since banks provide finance to or share common ownership in firms across different sectors, they would tilt collective action towards non-sector-specific preferences and development of broad institutions during good times.[46]

Large foreign investors can increase their bargaining position emphasizing their importance for the local economy in case they are large employers and have developed extensive networks with



[44] Shafer, *Winners and Losers*.
[45] Roger Schoenman, *Networks and Institutions in Europe's Emerging Markets* (Cambridge University Press, 2014), 64–65.
[46] Ibid., 67.

their local subcontractors, thereby increasing the weight of their threat of exit. MNCs can also enlist support of their employees and these local firms.[47] At the same time transaction costs economics suggest that MNCs might be constrained by their previous agreements with the host government and local partners.[48]

MNCs can act through chambers of commerce, business associations or pursue their interests on their own. If they cannot achieve their goal exerting their influence through these channels, they may resort to their home government. Home governments of developed-country multinationals would provide additional bargaining leverage to their MNCs over the host government through agreements and/or organizations.[49] This option can be especially effective if the home country is one of the major trading partners of the host country, and/or enjoys central position in an international organization that is influential for the host country. Thus, the bargaining approach would predict that the *ability of foreign investors to pool the support of their home countries and that of local actors increases investor's leverage over the host government.*

**Constraints on and enablers of the exercise of the state power**

Particular relations with international/domestic actors can enhance or inhibit state's position. Lack of organizational coordination related to internal conflicts within/between the government agencies can create obstacles for particular actions to take place. Regulatory convergence fostered by bilateral and regional agreements, as well as supranational institutions and international organization can act as a constraint on national governments.[50] Dependency of the



[47] Bennett and Sharpe, "Agenda Setting and Bargaining Power."
[48] Frieden, "Invested Interests," 265.
[49] Ravi Ramamurti, "The Obsolescing 'Bargaining Model'? MNC-Host Developing Country Relations Revisited," *Journal of International Business Studies* 32, no. 1 (March 1, 2001): 23–39.
[50] Eden, Lenway, and Schuler, "From the Obsolescing Bargain to the Political Bargaining Model," 265–66.

state and the home country of multinationals or simply tradition of good relationships can also have an impact on the leeway for local government's action.[51]

Bargaining models prioritize the importance of factors that constrain or facilitate actors' bargaining positions in their ability to actually influence the outcome. Johnson and Barnes argue that continuous provision of the EU funds and state's capacity to tap financial resources of the international financial markets increases the autonomy of government's action,[52] at the same time it decreases the leverage of MNEs' actions. *Thus, prevalence of supportive factors from international and/or domestic environment over actor's organizational, institutional and structural constraints would determine its upper hand in the bargain.*

## 1.3. The role of business loyalty in the policy outcome

According to Frieden, the success of certain policies and actions undertaken by the government depends on the loyal or skeptical attitude of the business to those policies and government in general.[53] Thus the ability of the political and economic actors to establish trust in their mutual relationships would determine the strength of cooperation between them. Absence of trust would hinder the state-led efforts for restructuring and might result in the disloyal behavior of international investors already present in the country or failure to attract investors in the targeted sectors.



[51] Bennett and Sharpe, "Agenda Setting and Bargaining Power."
[52] Juliet Johnson and Andrew Barnes, "Financial Nationalism and Its International Enablers: The Hungarian Experience," *Review of International Political Economy* 0, no. 0 (May 22, 2014): 1–35, doi:10.1080/09692290.2014.919336.
[53] Frieden, "Classes, Sectors, and Foreign Debt in Latin America."

# CHAPTER 2. BANKING: THE STORY OF LOVE AND HATE

Pre-crisis trends in banking have been similar across most of the CEE countries. Excessive mortgage lending, underestimation of the real risks and complacency related to the economic boom have been widespread. The perspective of EMU entry created the perception of informal "euroization", implying that the eventual adoption of euro would shield borrowers from the forex risks. Thus banks got encouraged to issue loans in foreign currencies. The bust revealed low credit quality and the balance sheets soared from the non-performing loans denominated in foreign currency that turned too expensive for the nationals to pay back. Neither Hungary nor Latvia were able to weather the crisis without the help of the IMF and the EU. After 2010 banking sector fell into disgrace of Hungarian authorities, which turned banks into the scapegoats to blame for the crisis, while cooperation between Latvian authorities and the banks got even tighter.

There has been a number of valuable contributions explaining CEE countries' road to the crisis,[54] with particular emphasis on the FX lending,[55] and its relationship with the housing policy.[56] I do not aim to contribute to this debate as it would go beyond the scope of the present project. I will rely on the findings of Borothee Bohle, Margit Molnár, Anders Åslund and Valdis Dombrovskis to demonstrate the supportive perspective of pre-crisis policies towards banking in Latvia and Hungary as well as the strength of the banks' position.

In this chapter I aim to explain the divergence of Latvian and Hungarian policies towards banks after the elections of 2010. My analysis in this section is driven by the questions of *why having the same pre-crisis tendencies in banking and facing similar problems in financial sphere during*



[54] Åslund and Dombrovskis, *How Latvia Came Through the Financial Crisis*.
[55] Margit Molnár, "Enhancing Financial Stability Through Better Regulation in Hungary," OECD Economics Department Working Papers (Paris: Organisation for Economic Co-operation and Development, June 17, 2010), http://www.oecd-ilibrary.org/content/workingpaper/5kmd41chjg34-en.
[56] Bohle, "Post-Socialist Housing Meets Transnational Finance."

*the crisis Hungarian government took a militant position towards foreign banks while Latvian government came with even friendlier stance? Did the crisis create conditions that allowed Hungarian political elites to take the upper hand and override the counter-pressures from the foreign bankers and their allies? Did conditions for the power shift emerge in case of Latvia? What was the role of international and domestic factors in shaping the positions of actors and their bargaining powers?*

Based on the interviews with business representatives and Transparency International and a number of secondary sources, I will argue that during economic downturn banks in Latvia and Hungary shared similar characteristics with firms in heavy sectors, namely their inflexibility which made them susceptible to the government policies. In line with the bargaining framework, banks' ability to influence those policies would build on their capacity to secure the support of their home governments, the EU and other international institutions. The effectiveness of this, however, depends on the government's stake in cooperation with banks in the context of its relationships with external actors.

## 2.1. Run up to the crisis: the influx of cheap foreign credit and the politics of complacency

Hungary was a frontrunner in privatizing its banks to foreign investors from the beginning of the transition. Soon financial space of the country got flooded with banks from Austria, Belgium, Italy and other countries. By 2005 foreign asset share of foreign banks reached 82.6% (see table 2). Russian financial crisis of 1998 facilitated consolidation of Latvian banks, which were bought up by foreign investors, mainly Swedish banks, the largest of which were Swedbank, SEB and Nordea.[57]

[57] Åslund and Dombrovskis, *How Latvia Came Through the Financial Crisis*, 19.

**TABLE 2 FOREIGN OWNERSHIP IN HUNGARIAN AND LATVIAN BANKING SECTOR**

| | Number of banks (foreign owned) | | Asset share of foreign banks (%) | |
|---|---|---|---|---|
| | Hungary | Latvia | Hungary | Latvia |
| 1995 | 43(21) | 41 (17) | 36.8 | 34.6 |
| 2000 | 42 (33) | 22 (12) | 67.4 | 74.4 |
| 2005 | 38 (27) | 23 (9) | 82.6 | 57.9 |
| 2010 | 38 (23) | 27 (18) | 81.3 | 69.3 |

Source: Wachtel et. al. (2014)[58]

The CEE region lured foreign banks by high returns on equity, low competition and increasing demand on practically non-existent credit markets. These banks could easily tap international finance mostly relying on credit from their parent banks or European wholesale markets. They were also important donors of capital adequacy, solid banking practices, knowledge and credibility in financial sector.[59] Facilitated by the EU entry requirements, both countries liberalized capital movements, implemented a number of institutions and regulatory standards required for a sound financial system.

From the early 2000s mortgage lending gradually became one of the most lucrative businesses for banks in the region. In Hungary it was closely related to the state housing policy, in Latvia mortgages became a substitute for it. The governments developed favorable conditions for the development of the corporate lending as increasing well-being of their citizens increased chances for reelection. In 2003 Hungarian government has spent 137 billion HUF on interest rate subsidies for long-term mortgage loans and new housing construction, in 2004 the figure was



[58] Paul Wachtel, John Bonin, and Iftekhar Hasan, "Banking in Transition Countries," BOFIT Discussion Papers 8/2014 (Bank of Finland, Institute for Economies in Transition, March 18, 2014), 31–33, http://www.suomenpankki.fi/pdf/173167.pdf.
[59] László Csaba, "Financial Institutions in Transition: The Long View," *Post-Communist Economies* 23, no. 1 (March 1, 2011): 1–13, doi:10.1080/14631377.2011.546991.

already 204 billion.[60] However, continuous expansion of the program proved financially not feasible and the program was abolished. As the maximum bound of 6% interest was abolished in 2003 the rates skyrocketed to 16% over short time. Banks quickly found the solution: switch to foreign currency loans with much lower interest rates. Having no privileged access to international money markets, OTP, the domestic player that owned two thirds of the market share, has been actively lobbying against foreign currency denominated loans. [61] But eventually it had to give in to the competition from foreign banks. From 2004 FX loans soared in Hungary, increasing tenfold during 2004-2007.[62]

In Latvia there was no substantial housing program and the lack of state funding was substituted by the commercial loans. Attractive business climate and fast growth drove extraordinary credit expansion of 37 to 64% from 2000 to 2006 outsizing that of many other countries. Government posed no restrictions on landing and no taxes on real estate speculation. Latvian entry into the Exchange Rate Mechanism (ERM 2) in 2005 accelerated foreign exchange borrowing due to the perception that risks will soon disappear with the imminent adoption of euro. Easy access to the international wholesale money markets and parent bank financing encouraged lending in foreign currency when inflation started to grow, hovering between yearly 6 and 8 percent and hiked to double digits in late 2007.[63]

The lure of lower interest rate for foreign currencies triggered steady increase in the proportion of loans denominated in foreign currency, in Hungary most of the loans were in Swiss Franc while in Latvia initially mostly in dollars, but by the end of the boom almost entirely in Euro. In



[60] Ferenc László, "Az OTP Elleni Bankháború Vezetett a Devizahitel-Robbanáshoz [The Bank War against OTP Led to the Explosion of Foreign Currency Loans]," *Hvg.hu*, November 7, 2011, http://hvg.hu/gazdasag/20111105_OTP_bankok_devizahitelezes_okai.
[61] Ibid.
[62] Molnár, "Enhancing Financial Stability Through Better Regulation in Hungary," 9.
[63] Åslund and Dombrovskis, *How Latvia Came Through the Financial Crisis*, 20–22.

Latvia the share of foreign denominated loans has risen from 50 percent in 2001 to more than 85 percent in 2007,[64] in Hungary the rise was from almost 40 percent in 2005 to over 60 percent in 2009.[65]

Neither Hungarian nor Latvian regulators displayed any attempts to curb foreign currency lending while being aware of the issue. In addition Megyessy's government did not want to inhibit the growth of its citizens' material wellbeing. Hungarian Financial Supervisory Authority looked into the issue and concluded that there should be no high risks involved in the Swiss lending.[66] Only in late 2007 Hungarian government did adopt some measures, including monitoring of foreign exchange risks and compelling banks to disclose the risks to their customers (for full list of discouraging measures in CEE countries see Appendix B). However, these measures did not prove to have strong discouraging and banks in Hungary continued foreign currency lending as it was a very lucrative and they could tap limitless resources from their parent banks or interbank markets.

Latvian authorities and banks were similarly relaxed about the foreign currency borrowing. Since 2005 IMF has been constantly warning Latvia about the economy overheat and the risks of growing FX lending.[67] Latvian government did respond to these warnings by raising the reserve requirements for the commercial banks, but it did not restrict mortgage lending, did not introduce limits for credit expansion, did not impose measures to channel the credit from consumption and real estate to production.[68] This response could merely serve as a cushion effect for the risks but did not contain the exaggerated lending activity. In March 2007 the government adopted an



[64] Blanchard, Griffiths, and Gruss, "Boom, Bust, Recovery," 333.
[65] Rachel A. Epstein, "When Do Foreign Banks 'cut and Run'? Evidence from West European Bailouts and East European Markets," *Review of International Political Economy* 21, no. 4 (July 4, 2014): 864, doi:10.1080/09692290.2013.824913.
[66] Bohle, "Post-Socialist Housing Meets Transnational Finance," 931.
[67] The Baltic Times, "IMF Warns That Economy Could Overheat," June 7, 2006, http://www.baltictimes.com/news/articles/15611/.
[68] Åslund and Dombrovskis, *How Latvia Came Through the Financial Crisis*, 29.

additional set of policies under the so-called “Anti-Inflation plan” obliging commercial banks to require a statement of legal income to issue new loans and setting minimum down payment of 10%, however, the latter measure was abolished in June 2008. [69]

Overall, this section has shown that the influence of the banks was very strong in the pre-crisis period, and both Latvian and Hungarian governments found their stakes in close cooperation with foreign banks. In the next two sections I will analyze how the crisis influenced this relationship in the context of domestic developments and international environment.

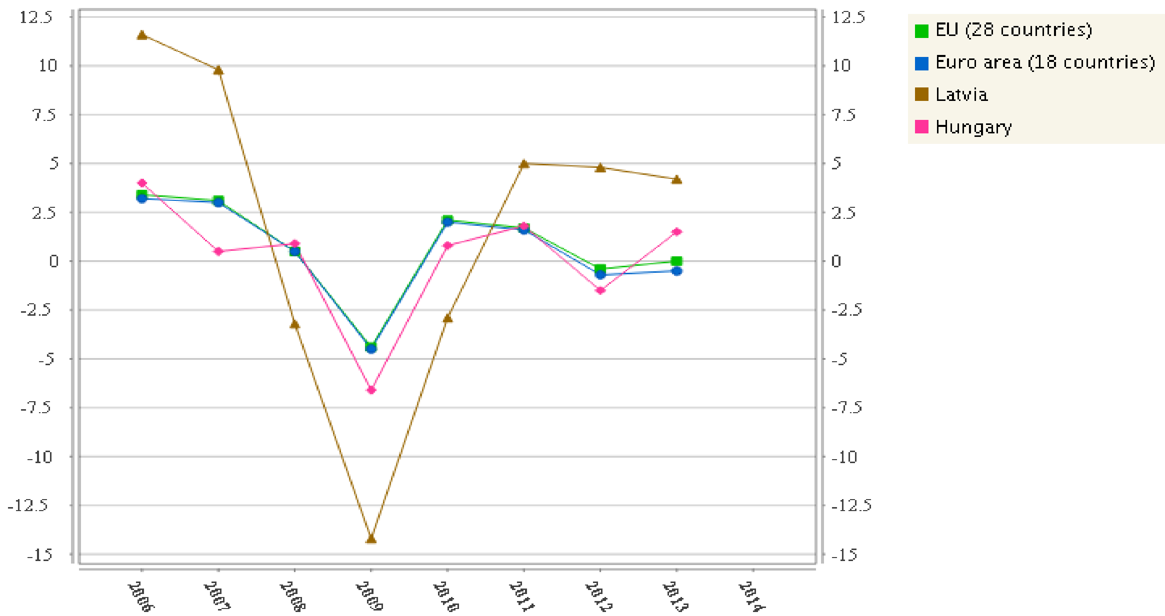
## 2.2. When the bubble burst

Overheated by the excessive credit expansion, both countries experienced a sharp decline in economic output. Hungarian economy contracted by more than 5%, Latvian economy, same as the rest of the Baltics, had one of the deepest recession in Europe: its GDP fell by almost 15% (see figure 3).



[69] Audun Grønn and Maria Wallin Fredholm, “Baltic and Icelandic Experiences of Capital Flows and Capital Flow Measures,” IMF Working Paper, 2013, 13.

**FIGURE 3 REAL GDP GROWTH RATE**




Source: Eurostat

In October 2008 forint fell victim of speculators. To save the currency and ameliorate the problem of liquidity crunch, the country had to turn to the IMF. New crisis administration of Gordon Bajnai took the office for 2009-2010 and expressed strong commitment to the IMF conditionality. Besides the tasks of curbing public debt and deficit, the government had to deal with the problem of soaring debt service which emerged as a result of forint's depreciation and unilaterally raised fees by banks. Bajnai's administration decided not to impose regulation directly, bust asked banks to voluntarily agree on the code of conduct. In July of 2009 16 banks represented by the Banking Association committed themselves not to change contracts unilaterally, not to increase the fees more than once a year and higher than the inflation rate, and to increase time-span for defaulted borrowers to sell their flat before the bank forecloses it. The code mainly contained "general principles and practices that have already constituted part of banks' internal regulation or have been recommended by the regulatory agency".[70]

During the crisis only three banks required support of Hungarian government: OTP, provided with a government loan of HUF 400 billion, Hungarian development bank (Magyar Fejlesztési Bank, MFB), which has received a HUF 170 billion loan, and Földhitel és Jelzálogbank (FHB) with HUF 120 billion loan. This support was provided on non-subsidy basis as a countercyclical measure directed to foster lending to non-financial enterprises.[71]

During the downturn many feared that foreign banks would "cut and run" to eliminate excessive exposure (the scenario which happened during the Asian crisis of 1997-98). To contain funding withdrawals from the CEE region, Vienna Initiative was set up in January 2009. The initiative represented a series of agreements according to which parent banks agreed to maintain certain exposures in Latvia, Hungary, Romania, Serbia and Bosnia-Herzegovina in exchange for host country compliance with IMF conditionality and IMF assistance to those host countries.[72]

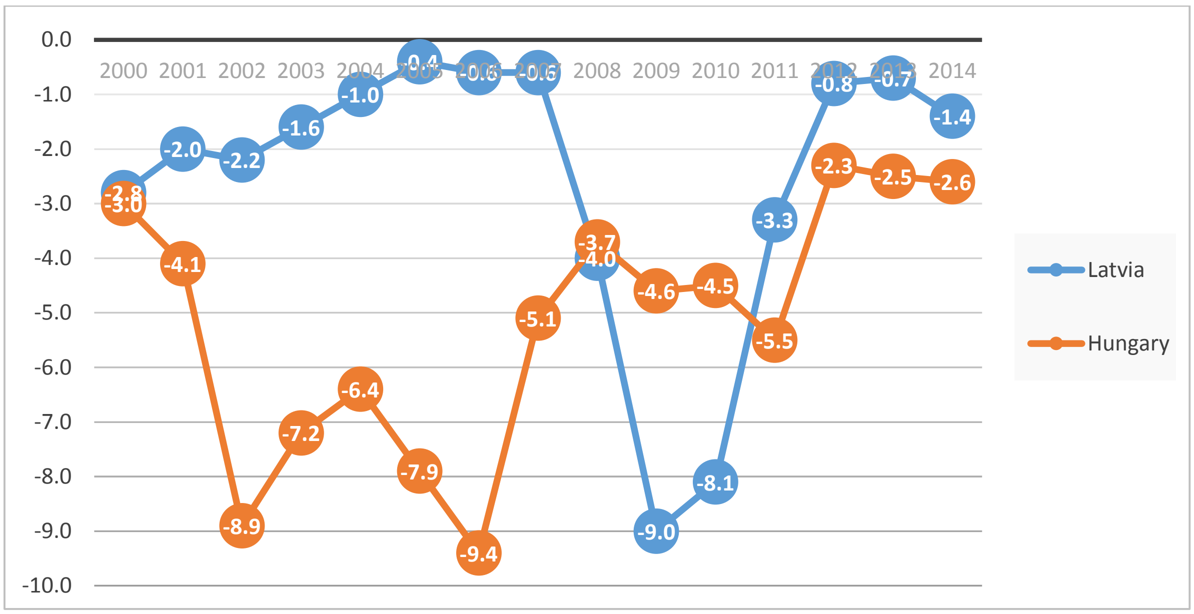
When the international liquidity dried up for Latvia, its largest domestic bank Parex got into trouble, having no option, unlike its Swedish peers, to secure financing from the parent bank. Parex had almost 8 billion in syndicated loans coming due in February and June 2009, and 2 billion in Eurobonds which could be called any time.[73] From August 2008 Parex was facing a deposit run and lost a quarter of its deposits. Government reacted with increasing liquidity, extending domestic credit and easing reserve ratios. From end-August to end-November the official reserves fell to €3.4 billion after government sold out €900m (almost 20 percent of total



[70] Molnár, "Enhancing Financial Stability Through Better Regulation in Hungary," 25.
[71] Ibid., 12.
[72] Epstein, "When Do Foreign Banks 'cut and Run'?," 586.
[73] Birgitta Forsberg, "Operation Baltikum," *Affärsvärlden*, February 20, 2009, http://www.affarsvarlden.se/hem/nyheter/article2590127.ece.

official reserves).[74] The government negotiated a takeover of 51% of the bank with the owners and kept the management. All this was designed to restore the confidence, especially of non-resident depositors, in addition authorities imposed a partial deposit freeze to maintain financial stability, but it did not help. The government had to raise its ownership of the bank to 85% and appointed new management. Due to the problems with Parex Latvia had lost on its budget deficit criteria for euro, and the situation became even worse in 2009 after the deficit increased from 4% to 9% of GDP (see figure 4).

**FIGURE 4 BUDGET DEFICIT AS A PERCENTAGE OF GPD**




Source: Eurostat[75]

Parex was the country's second largest bank and had 220,000 Latvian customers. In addition, the bank held a large amount of deposits from local municipalities and the state.[76] It could not be

[74] IMF, "Republic of Latvia: Request for Stand-By Arrangement—Staff Report," January 2009, https://www.imf.org/external/pubs/ft/scr/2009/cr0903.pdf.
[75] Eurostat, "Government Deficit/surplus, Debt and Associated Data," accessed May 12, 2015, http://ec.europa.eu/eurostat/web/government-finance-statistics/data/database.
[76] Author's interview with Agnese Alksne, researcher from Transparency International, author of the 2014 report on Lobbying in Latvia., May 21, 2015.

allowed to fall. According to the IMF estimates, the total costs for bank restructuring was to fall between 15 to 20 percent of GDP. It was evident that the economy could not keep the peg and keep up with the Parex crisis, thus the decision was to turn to the IMF for help.

Foreign banks have shown much greater commitment from the beginning of the crisis. Despite the relatively small share of the Baltic countries in the operations of Swedish banks, there was a fear of domino effect, thus Swedish authorities had the interest in assisting Latvia. The Nordic and Baltic neighbors mobilized their efforts in providing the support for Latvia on the IMF Board and in European Commission. One of the hotly debated item on the conditionality agenda was the devaluation of Latvian currency. Latvia was a member of the European Exchange Rate Mechanism II (ERM II), which implied that the fluctuation of MS currency should not exceed 15 percent band relative to the Euro before joining the Eurozone, still Latvia had even more rigorous commitment of plus/minus 1%.[77] The IMF and the EU had different views on Latvian currency (see table 3). From July 2009 Latvia fell under the excessive deficit procedure of the EU, which set 3% budget deficit target by 2012, for which corrective measures needed to be taken by 2010. The IMF was less optimistic about Latvian ability to achieve its deficit targets and advised higher targets that would be more socio-economically appropriate, but which would mean that the adoption of Euro would have to be postponed further than 2014.



[77] Susanne Lütz and Matthias Kranke, "The European Rescue of the Washington Consensus? EU and IMF Lending to Central and Eastern European Countries," *Review of International Political Economy* 21, no. 2 (March 4, 2014): 319, doi:10.1080/09692290.2012.747104.

**TABLE 3 MAJOR LINES OF CONFLICT BETWEEN THE IMF AND THE EU OVER LATVIAN RESCUE PROGRAM**

| IMF POSITION | EU POSITION |
|---|---|
| Deficit target of 13% of GDP in 2009 | Deficit target of 8.5% of GDP in 2009 |
| 3% target to be achieved by 2014 | 3% target by 2012 |
| Devaluation of Latvian currency advisable | Peg to be kept |
| Euroisation or later euro adoption despite ERM II framework | No euro introduction without compliance with Maastricht criteria |

Source: Susanne Lütz & Matthias Kranke (2014), 320

Central bank governor Ilmārs Rimšēvičs refused to negotiate devaluation of Latvian currency whatsoever. The Latvian authorities valued the peg and aimed for Euro adoption. "The fixed exchange rate is a national symbol in the same class as the flag or the national anthem. It has kept the country stable before, such as in the Russian crisis in 1998", stated one of the chief Latvian economists.[78] The Nordic banks would be hit hard by a devaluation as the credit losses would damage market confidence in these banks, thus Swedish authorities pushed the issue of non-devaluation to protect the well-being of its banks. Then the Swedish Minister of finance Anders Borg expressed during one of his interviews that: "It was a Nordic-Baltic cooperation within the framework of the IMF constituency. We have contributed to the Latvians got to keep the exchange rate regime they want."[79] As a result the Latvian government, the European Commission, Sweden and other countries agreed that Latvia would be better off resorting to internal devaluation through drastic cuts in wages, public spending and imposing higher taxes.

Furthermore, as the negotiated EU-IMF financial package of 5,3 billion was not enough to cover Latvia's urgent financial needs, the Swedish Finance minister initiated a call to Latvia's Nordic and Baltic friends for securing Latvia's 2,2 billion Euro financing gap. As a result of this mutual

[78] Forsberg, "Operation Baltikum."
[79] Ibid.

cooperation Sweden, Denmark, Norway and Finland committed 1,8 billion Euro, Czech Republic, Poland and Estonia 400 bln Euro[80] (see table 4).

**TABLE 4. INTERNATIONAL FINANCIAL SUPPORT FOR LATVIA, 2008-11 (MILLION EUROS)**

| | Disbursements | | | Commitments | |
|---|---|---|---|---|---|
| **Lender** | **2008** | **2009** | **2010** | **2011** | **Total** |
| European Union | — | 2,200 | 700 | 200 | 3,100 |
| International Monetary Fund | 591 | 194 | 301 | 631 | 1,717 |
| World Bank | — | 200 | 100 | 100 | 400 |
| European Bank for Reconstruction and Development | — | 80 | — | — | 80 |
| Nordics (Denmark, Estonia, Finland, Norway, and Sweden) | — | — | — | 1,900 | 1,900 |
| Poland | — | — | — | 100 | 100 |
| Czech Republic | — | — | — | 200 | 200 |
| Total | 591 | 2,674 | 1,101 | 3,131 | 7,497 |

Source: Åslund and Dombrovskis (2011)[81]

Overall, the actual cumulative losses from banking and real estate sector were not as problematic in Hungary as they were in Latvia or other countries that confronted expensive bank bailouts. Against this background and historically influential position of foreign banks in the region, one would expect the Hungarian government to maintain good relations with the banks, which basically weathered crisis by their own means. Moreover, having Vienna Initiative in place assured the commitment of foreign banks to the CEE countries. Yet further developments show the opposite: while Latvian authorities intensified its cooperation with banks, Hungarian policy towards banks got flavored with punishing measures and ideology of liberation from foreign dependency.



[80] Åslund and Dombrovskis, *How Latvia Came Through the Financial Crisis*, 45–46.
[81] Ibid., 46.

## 2.3. Diverging pathways

### 2.3.1. Hungary: Orbán's freedom fight against the world of bankers and the IMF

During the elections of 2010 Hungarians responded to the crisis with economic voting. Condemning Socialist government with unpopular and uneffective austerity measures required by the IMF and EU and harsh impact of global financial crisis, Hungarians turned their expectations to Fidesz. Thus new government headed by Viktor Orbán was empowered with the two third supermajority in the parliament.

In May 2010 Orbán paid his first visit to Brussels and Berlin aiming to ask for an easing of the strict deficit and debt targets. However, he was confronted by both President Barroso and Chancellor Merkel, who made it crystal clear "that they would not tolerate a laxer fiscal stance, even in exchange for major structural reforms".[82]

Such an unprecented degree of rigidity from the EU, frequent miscommunications with the IMF and other foreign partners may explain the reasons behind sudden change in the position of Hungarian government and suspension of IMF stand-by in June 2010. Orbán declared Hungary's economic freedom fight against the "world symbolized by banks, multinationals and a bullying IMF".[83] In one of his speeches Orbán said: "It is unacceptable, with common sense, to respect banks as sacred cows at a time when a global crisis that started from the banks happens to be sweeping over the world".[84]



[82] Csaba, "Growth, Crisis Management and EU: The Hungarian Trilemma," *Südosteuropa Mitteilungen* 53, no. 03–04 (2013): 160.
[83] Péter Oszkó, "Guest Post: Orbán's Hazy Memory of Debts, Cuts and Economic Policy," *Financial Times*, January 23, 2012, http://blogs.ft.com/beyond-brics/2012/01/23/guest-post-orbans-hazy-economic-memory/.
[84] Bloomberg, "Hungarian Lawmakers Approve 'Brutal' Bank Tax Defying IMF, EU," *Bloomberg.com*, July 22, 2010, http://www.bloomberg.com/news/articles/2010-07-22/hungarian-lawmakers-to-approve-brutal-bank-tax-in-defiance-of-imf-eu.

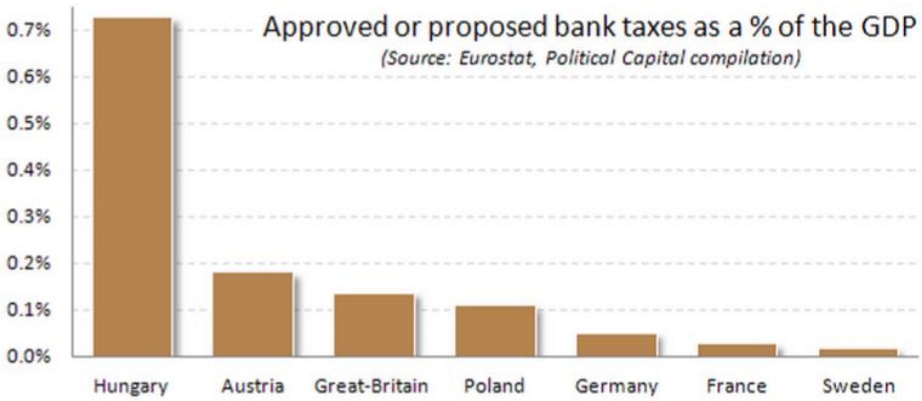
After Brussels rejected Orbán's request he accepted lower deficit target as Hungary was still under the EU's excessive deficit procedure. At the same time the Hungarian Prime Minister implemented a number of measures which derailed structural deficit. After failed attempts to negotiate the implicit debt in the pension funds, Orbán decided to nationalize private pension funds.[85] In addition, to plug the deficit gap the government introduced a number of special taxes on energy, banking, retailing and telecommunication industries.

New ***crisis tax regime*** was the most severe for banking sector, taxing 0.5 percent of banks' assets over 50 billion forint.[86] Promising to reverse the social costs of austerity, the government aimed to shift the burden of the crisis onto the shoulders of foreign banks. The crisis tax was unprecedentedly high: the rate exceeded that of similar taxes implemented in other EU countries by at least three times, in absolute amount it reached by far the highest proportion of GDP (see figure 5 ).[87] The levy caused a storm of resentment in the banking community. Hungarian central bank, European Banking Federation and IMF expressed their concerns that the tax would "considerably" hurt growth prospects by shifting lending and causing losses at some lenders. Their calls for profound modification of the tax did not bring any changes. Orbán claimed the bank tax was "necessary, fair and effective, because it serves the interests of the country and the people in a very difficult situation". [88]



[85] Ironically, facing a similar problem, Poland was allowed to deduct pension related deficits from the general government deficit thereby avoiding the consequences of increased debt / GDP ratio.
[86] Bloomberg, "Hungarian Lawmakers Approve 'Brutal' Bank Tax Defying IMF, EU."
[87] Political Capital, "The Bank Tax in Europe and Hungary. In Depth Analysis: Key Findings," *Political Capital Policy Research & Consulting Institute*, February 11, 2010, http://www.riskandforecast.com/post/hungary/the-bank-tax-in-europe-and-hungary_606.html.
[88] Bloomberg, "Hungarian Lawmakers Approve 'Brutal' Bank Tax Defying IMF, EU."

**FIGURE 5 HUNGARIAN CRISIS TAX ON BANKS IS THE HIGHEST IN EUROPE**




Source: [89]

Another step to "help those in distress" was the 2010 temporary moratorium on evictions of those homeowners that failed to service their mortgage payments. The moratorium was extended several times, as a result in 2012 banks had 100000 flats in their non-performing loan portfolios that they could not sell.[90] In September 2011, claiming that foreign banks mislead the borrowers, Orbán government made an attempt to reduce the exposure of households to foreign currency denominated loans by imposing an ***early FX repayment scheme*** and ***forced mortgage replacement scheme.*** These schemes allowed converting foreign currency loans and mortgages under a fixed below-market exchange rate (CHF/HUF 180 and EUR/HUF 250). The losses due to the exchange rate difference, which amounted 25% from the real 240 HUF/CHF rate, were to be incurred by the banks. This was met by strong contestations from the side of the banks[91] and harsh assessments of the impact for banking sector stability from home-country authorities,

[89] Political Capital, "The Bank Tax in Europe and Hungary. In Depth Analysis: Key Findings."

[90] Realdeal, "Why the 'good News' on Evictions in Hungary Isn't Really so Good at All," *Realdeal.hu*, March 2, 2012, http://www.realdeal.hu/20120302/why-the-good-news-on-evictions-in-hungary-isnt-really-so-good-at-all/.

[91] Eight banks with subsidiaries in Hungary pushed for the European Commission to take action against the scheme. The CEOs or CFO of BayernLB, Erste Group, Intesa Sanpaolo, KBC, Raiffeisen Bank International and its parent Raiffeisen Zentralbank, Oesterreichische Volksbanken, and UniCredit claimed the scheme was a "blatant violation" of their rights in their letter to the Commission: Budapest Business Journal, "Brussels Gives Hungary Deadline to Respond to Bank Concerns over FX Scheme - Wire," November 21, 2011, http://www.bbj.hu/politics/brussels-gives-hungary-deadline-to-respond-to-bank-concerns-over-fx-scheme---wire_61521.

Austria in particular, the European Commission and the ECB. Eventually market pressures (threat of further downgrading Hungary's sovereign rating to non-investment level) and international organizations, particularly the efforts of IMF and ECB, made Hungarian government reconsider the unilateral imposition of mortgage relief plans. In December 2011 an agreement, according to which the costs for easing Hungarian households' debt burden would be shared between the government and banks was reached allowing, banks to deduct 30% of the losses from their 2011 bank levy.[92]

On the one hand we see a government that is trying to manage the country during the Eurozone crisis without resorting to external help, using banks as a source to fill the budget and as the scapegoats to blame for the crisis. On the other hand, there are large foreign banks with the record of strong influence being unable to change the direction of oppressive government policy and accepting new demands. So what enabled Hungarian government to undertake these increasingly oppressive measures despite warnings from the international community?

One explanation refers to a number of external factors, such as Hungarian non-membership in the Eurozone, further provision of financial assistance from the Cohesion funds and tolerance of international bond markets. They all empowered Orbán with the financial means to carry on his "freedom fighter" policies and made the EU basically toothless in confronting him.[93] Yet it is less clear how stable Orbán's position is. At least what concerns capital markets, so far Hungary has been able to maintain macroeconomic fundamentals that are crucial for international investors.



[92] Olena Havrylchyk, "Ensuring Stability and Efficiency of the Hungarian Financial Sector," Working Paper (OECD, May 23, 2012), 11, http://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=ECO/WKP(2012)36&docLanguage=En.

[93] Johnson and Barnes, "Financial Nationalism and Its International Enablers," 20.

Another explanation is related to the position of the banks within the society and government in particular. The banks' reputation was falling into pieces with increasing dissatisfaction of the society. The fundamental trust was strongly injured between the economical players, also between the banks and the clients. Banks tried to slow down the speed of the reputation loss. At the same time politicians were able to reverse the traditional order of things getting the upper hand over banks. Political influence of the banks narrowed or even disappeared. Thus, banks were an easy target to pay for the large profits they made before the crisis.[94]

Third one stems from the nature of banking industry and the investments banks make. During the interview high-level representative of Hungarian banking sector explained:

> *„In banking sector the period of investment is calculated for 20-30 years. Thus it is not that easy to move a subsidy from one country to another. For banks the real value is the clientele. Unlike in the real sector where machinery and equipment can be transferred, clientele is not transferrable. Thus if extra tax would be introduced for car producers, dissatisfied investors can move the production to another country, but banks cannot do it so easily. There is no other chance for the banking sector than just to pay the tax."*[95]

Thus, the power of banks was heavily undermined. Prime Minister Viktor Orbán's freedom fight against the IMF and his worsened communication with Brussels made banks unable to utilize their influence through these channels. „*In general the communication between the banks and the government remained open and free, however most of the regulations that affected banking sector were designed and adopted without any prior consultations with the banks, which was not the case during previous government*».

In 2014 the Orbán government started to ***increase the share of Hungarian ownership in the banking sector*** aiming to reach 50% of domestic ownership. The government has purchased

[94] Author's interview with a high-level representative of Hungarian banking sector, May 18, 2015.
[95] Ibid.

large MKB and Budapest Bank on the open market with further intention to sell it to Hungarian owners, bought out German owners from smaller TakarékBank (later passed on its stake to a Hungarian group Magyar Takarék), and became a 48% co-owner of Gránit and Széchenyi Kereskedelmi Bank[96] and together with EBRD is about to buy 15% of Erste Hungary. According to the representative of Hungarian banking sector, there was no pressure on the foreign investors to sell those banks, rather the Hungarian government was the only player on the market that was willing and had the means to buy them.

There is a political idea behind increasing Hungarian share in the banking sector: if Hungarians own the majority of the banking sector, in time of uncertainty they will focus on Hungarian economy and the situation will be more stable than before.

> "*In the event of the crisis headquarter of any transnational bank will focus on the activities of the mother bank and sacrifice/cut down the activities of its subsidies. Consequently it will hurt all the network of local businesses financed by the subsidiary. Mr. Orbán realized that to build a stable economy and new system in the country the majority of the banking sector needs to be in Hungarian hands*" explained Hungarian banker during the interview.[97]

Is there a real threat of such vulnerability due to the prevalence of foreigners in its banking? Austrian bankers have been denying the threat of excessive deleveraging from CEE region. [98] At the same time capital requirements set by the Basel III urge banks to reduce their exposure to highly vulnerable CEE markets. Perspectives of excessive deleveraging raised concerns about the possible credit crunch and disorderly retrenchment. This would trigger negative consequences for the economic growth, particularly infrastructure finance and loans to SMEs fall



[96] Hungary seeks to restore domestic ownership of major enterprises. *Budapest Telegraph.* From 10.12.2014. http://www.budapesttelegraph.com/news/819/hungary_seeks_to_restore_domestic_ownership_of_major_enterprises

[97] Author's interview with a high-level representative of Hungarian banking sector, May 18, 2015.

[98] Lucy Fitzgeorge-Parker, "Ittner Explains Austria's CEE Banking Policies @Euromoney," September 10, 2012, http://www.euromoney.com/Article/3086946/Ittner-explains-Austrias-CEE-banking-policies.html?copyrightInfo=true.

under the greatest exposure.[99] A number of reasons cast doubts about the strength of assurances against deleveraging provided by the Vienna Initiative, they were related to the facts that:

- the nature of the commitment letters was non-binding and specifications of the exposures to which banks had committed themselves were not disclosed;
- not all commitments were kept in Romania.[100]

Even though foreign banks eventually kept most of their commitments and did not "cut and run, but incurred losses" and supported their distressed subsidiaries in both countries,[101] this did not diminish the fears of Hungarian politicians. Mr. Orbán decided to be on the safe side and reduce the exposure to foreign threats.

### 2.2.2. Latvia: teaming up with banks to attract investors

Strong commitment of Nordic banks to Latvian market, magnified by the help of their respective governments during the negotiations of IMF-EU financial aid for Latvia, has played a significant role in allaying the fears of disloyal foreign banks and related vulnerabilities in Latvia. Latvian banking sector was subject to large-scale restructuring with further increase of foreign ownership in banking from 62% of total assets in 2009 to 69.3% in 2010.

After the crisis Riga has become the major financial center of the Baltics increasingly attracting deposits from CIS countries. The government has provided supportive administrative environment to non-resident banking including an extension of temporary residence permits to



[99] Financial Stability Board, IMF, and World Bank, "Identifying the Effects of Regulatory Reforms onEmerging Market and Developing Economies: A Review of Potential Unintended Consequences Report to the G20 Finance Ministers and Central Bank Governors," June 19, 2012, http://www.financialstabilityboard.org/wp-content/uploads/r_120619e.pdf?page_moved=1.
[100] Epstein, "When Do Foreign Banks 'cut and Run'?," 577–78.
[101] Epstein, "When Do Foreign Banks 'cut and Run'?."

investors from the Commonwealth of Independent States (CIS) that make financial commitments in Latvia, building up a network of agreements to avoid double taxation with Russia and other CIS countries.[102] In 2014 changes were introduced in Latvian corporate tax legislation making the tax regime even more favorable for foreign investors. Thus profits earned by foreigners via dividends and stock sales as well as interest and licensing fees paid to foreign companies by Latvian holding companies became exempt from taxes.[103] This liberal corporate tax policy favors the establishment of international holdings, aiming to benefit from large cross-border corporate income transfers. These changes are likely to draw business registrations and financial flows from the CIS countries, which would increase banks' fee-based incomes and the state's tax revenue. Some experts raised concerns about the possible inflow of dubious investment from offshores and possible wider use of aggressive tax planning and evasion schemes. The Latvian authorities have tightened money laundering regulations including black-listing low tax or tax free territories, but more action is recommended by the EU due to potential loopholes used for repatriation of profits to non-EU "tax havens".[104]

In addition, the Latvian government took effective measures to enhance stability and restore confidence in the Latvian banking sector by successful restructuring of Parex Banka and resolution experiences with Latvijas Krājbanka (a subsidiary of Lithuanian bank Snoras that failed because of a scandal about money laundering). Parex was split into two: into a resolution bank and a viable "Citadele" whose privatization was initiated later. After the fraud scandal of Snoras, its nationalization by the Lithuanian government and an insolvency procedure in 2011,



[102] ECFIN, "Assessing Business Practices in Latvia's Financial Sector," ECFIN: Country Focus (European Commission, April 2014), 1,8, http://ec.europa.eu/economy_finance/publications/country_focus/2014/pdf/cf_vol11_issue6_en.pdf.
[103] Marco Giuli, "Letting Another Cyprus In? The Dark Side Of Latvia's Success Story," *Social Europe*, October 2, 2013, http://www.socialeurope.eu/2013/10/letting-another-cyprus-in-the-dark-side-of-latvias-success-story/.
[104] ECFIN, "Assessing Business Practices in Latvia's Financial Sector," 8.

the Latvian government limited the operations of the bank's Latvian subsidiary Krājbanka and initiated bankruptcy proceedings against it.[105]

During the recession lending almost stopped, which made access to finance become one of the major problems for the business in Latvia even in 2014.[106] Foreign investors encouraged the Latvian government to introduce measures that would safeguard the availability of bank financing,[107] and thus increase the stakes in cooperation with foreign banks.

Scandinavian-owned banks remained the dominant players in the local credit market relying on cheap funding from parent banks and resident deposits, while domestically-owned banks mostly specialize in financial services to non-residents relying on funding from these sources.[108] Thus by promoting non-resident banking Latvian authorities strengthen the position of local Latvian banks while also allowing foreign banks to expand their activities.

**Conclusions.**

The analysis shows that Latvian and Hungarian banking sectors suffered from their balance sheets soared from the non-performing loans of long-term maturity, and network of clientele that became far less liquid than during the boom times. This decreased banks inflexibility and made them susceptible to the government policies. While the Latvian banking sector was able to secure the support of government and their further cooperation, banks in Hungary lost their influence and even their efforts to enlist external support did not exert to strong leverage on Fidesz.

Both internal and external factors played their role here. In case of the Latvian Parex Bank, the government had high stakes in bailing it out, which was not only related to the size of the bank,



105 European Commission, "Convergence Report 2013 on Latvia," European Economy, 2013, 41, http://ec.europa.eu/economy_finance/publications/european_economy/2013/pdf/ee3_en.pdf.

106 EBRD, "Business Environment and Enterprise Performance Survey (BEEPS) V Country Profile: Latvia," 2014, http://ebrd-beeps.com/countries/latvia/.

107 Author's interview with Marta Jaksona, Project Director of Foreign Investor's Council in Latvia (FICIL), Written correspondence, May 29, 2015.

108 ECFIN, "Assessing Business Practices in Latvia's Financial Sector," 5.

but also to the fact that it held a large number of municipalities' deposits. The early actions of Nordic banks to secure the support of their home countries in aiding Latvia proved their commitment to Latvian markets. This provided the ground for further cooperation driven by Latvian needs to attract investors and improve its economic prospects.

The rigidity of Brussels induced the Orbán government to adopt unorthodox measures, the magnitude of which increased overtime with continued freedom fight. The government's interest now contradicted with those of the banks. The continued flow of EU funds and tolerance of international markets, as well as non-membership in the EMU increased Orbán's political autonomy and diminished the leverage of banks.

# CHAPTER 3. MANUFACTURING: MAKE THEM STAY OR LET THEM GO?

Stagnating demand was one of the biggest challenges for companies during the recession. As it has been mentioned before, while attacking the banking sector and making them pay for the excessive profits they made before the crisis, the Fidesz government supported manufacturing companies encouraging them to reinvest their profits.

The executive director of Transparency International in Hungary described the political situation in the country:

> *"Since 2010 the government has been pursuing a very centralized approach, which almost entirely eliminated independency of policy sphere. Governance became very much politicized and the economy became more subordinated to the politics".*[109]

This subordination does not seem to apply to large producers in complex manufacturing, who enjoy an exceptional status relative to the other sectors. Same as before the crisis, the government provided favorable concessions to the industry, keeping close relationships with large investors. So does this policy continuation mean that economic and political perturbations created no conditions for the shift in the bargaining position of parties? Or is it possible that they did, and the position of Hungarian government strengthened, but it decided not to use this opportunity to urge MNCs to upgrade domestic industry? If this is the case what were the reasons behind it?

In contrast the Latvian government provided no support for its light manufacturers letting them leave the country or adjust to new market conditions, while at the same time spending one fifth of its GDP to bail out its largest domestic bank. A representative of the Foreign Investors Council in Latvia (FICIL) characterized Latvia as "*a small and open economy that is fully*

[109] Author's interview with József Péter Martin, executive director of Transparency International in Hungary, May 12, 2015.

*dependent on trade, exports, also foreign capital*".[110] If foreign producers are so important for Latvian development, why did Latvia remain neutral towards the light manufacturers and let them flee the country, while supporting its banks?

Having realized that the growth in the financial sphere needs to be balanced by the productive output, the Latvian government started to redirect its sectorally neutral industrial policy towards developing a technologically intensive export-oriented sector. Which factors enabled the country to undertake economic restructuring and how effective was this policy?

## 3.1. Pre-crisis trends

Examining industrial development during post-socialist transition is important at least for two reasons. First, it provides us with the basis for analyzing policy dynamics. Second, and most important, it relates to the fact that path dependency is an important factor for industrial development providing industrial and institutional basis for further activities.[111] Thus the outcomes of pre-crisis industrial policies will help us understand sectoral differences that influenced the development of industrial policies during the recession.

Since the beginning of the transition period Hungary and Latvia exhibited different strategies towards manufacturing. Hungarian authorities chose to capitalize on the legacies of complex industry from the Soviet times and supported the development of technologically intensive electrical machinery, automotive and chemical industry. In contrast, Latvia as well as Estonia and Lithuania have rejected Soviet industrial legacies. The Baltic countries were pursuing liberal



[110] Author's interview with Marta Jaksona, Project Director of Foreign Investor's Council in Latvia (FICIL).
[111] Path dependence should not be understood as a restrictive and conservative interpretation (of 'lock-in') but rather as an evolutionary concept. Ron Martin, "(Re)Placing Path Dependence: A Response to the Debate," *International Journal of Urban and Regional Research* 36, no. 1 (January 1, 2012): 179–92, doi:10.1111/j.1468-2427.2011.01091.x.

market policies that were horizontal in nature and their investment promotion activities were relatively modest.

During the transition period Visegrad states tried to ease adjustment through varied combinations of gradualism in phasing out subsidies, partially and selectively maintained protective tariffs, new credits for survival and/or restructuring, and labor market and social policy measures that helped owners of industry-specific human capital weather the hardest times”.[112] Having similar production profiles, Visegrad countries have engaged in the cut throat competition for FDI in complex manufacturing: both luring foreign investors with generous incentives and lowering labor standards. For a long time Hungary was taking the lead in this bidding war, providing tax exemptions up to 10 years, subsidies and investment guarantees for large investments in selected sectors.

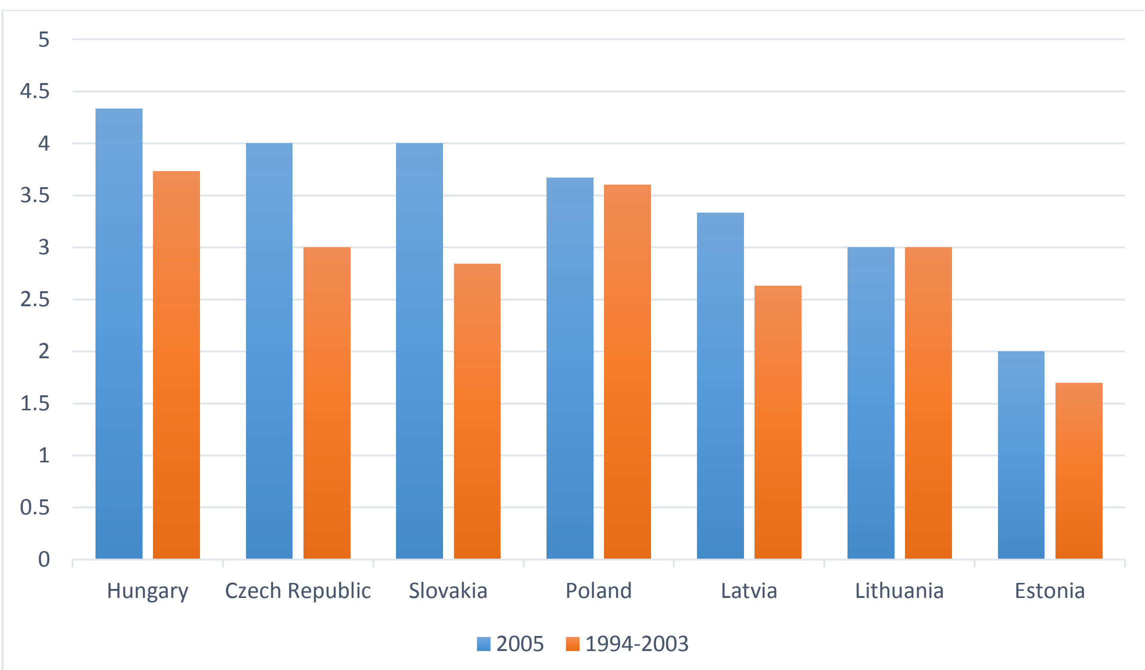
EU accession had some curbing effect on the investment incentives requiring to eliminate the aid given by local authorities and convert incompatible state aid for large companies and car manufacturing into regional investment aid (with upper limits).[113] Generosity of Hungarian investment promotion policy was the highest in the region even after limitations related to the accession were accepted (see figure 6). This bidding war among the Visegrad Four made attraction of foreign complex manufacturers very costly, making it difficult for the countries such as the Baltics to keep up with the race. Despite the fact that later in 2000s Latvia increased the magnitude of incentives and investment promotion services, taking the lead among the Baltic states, generosity and sophistication of its investment policies were considerably lagging behind that of the Visegrad countries (see figure 6).



[112] Greskovits, “Leading Sectors and the Variety of Capitalism in Eastern Europe,” 77.
[113] Fergus Cass, “Attracting FDI to Transition Countries: The Role and Impact of Incentives and Promotion Agencies,” January 2006, 48.

The Baltic states have shown clear signs of affinity with the regulatory state model providing institutional environment geared towards regulating the economy without intervening in it.[114] Latvian regulators have put marketization and institutional convergence with the West as their top priorities. This, however, was achieved at the expense of increasing divergence in production and skill profiles. Radical liberalization without compensation derailed manufacturing experience, inherited from Soviet economy, and hampered the emergence of new complex manufacturing activities.[115] Thus complex manufacturing TNCs were not prone to invest in the country. The country's production profile had shifted towards traditional light and resource-based industries dominated by foreign companies, which did only require modest skills and used relatively flexible production systems.

**FIGURE 6: INVESTMENT INCENTIVE SCORES FOR THE VISEGRAD GROUP AND BALTIC STATES**



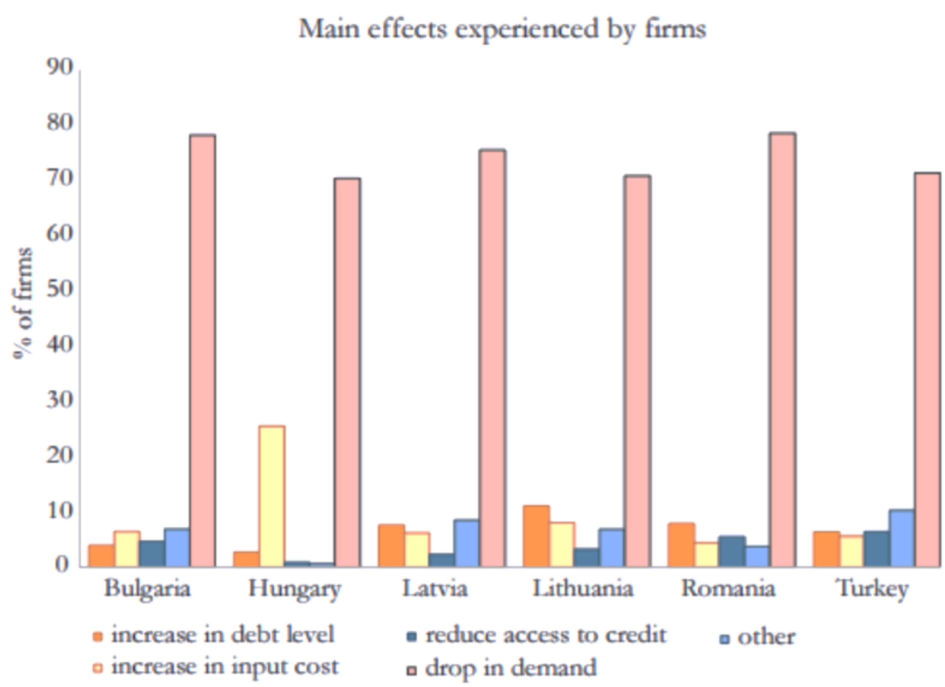

Source: Cass (2006) "Attracting FDI to Transition Countries," 50

[114] Dorothee Bohle and Béla Greskovits, *Capitalist Diversity on Europe's Periphery*, Cornell Studies in Political Economy (Ithaca: Cornell University Press, 2012), 132.
[115] Greskovits, "Legacies of Industrialization and Paths of Transnational Integration after Socialism," 78.

## 3.2. The problem of shrinking demand and policy responses

For the real sector of small and open economies like Hungary and Latvia, the financial crisis meant a sharp decline in the demand. Almost 70% of firms in Hungary and over 75% of Latvian firms indicated to have been affected by the declining demand (see figure 7), consequently their sales and capacity utilization decreased substantially. Export and investment levels have fallen in both countries in the period of 2008-2010 and urging existing investors to cut production. Inflexible automotive and electronics manufacturers in Hungary needed both financial and regulatory support from the state, while light manufacturers in Latvia were able to adjust to new market conditions or fled the country without exerting influence on Latvian political space.

**FIGURE *7* DROP IN DEMAND WAS THE MAIN EFFECT OF CRISIS**



Source: Ramalho and Rodríguez-Meza (2010)[116] based on Financial Crisis Survey/Enterprise Surveys[117]

The Hungarian government undertook a number of measures to convince investors in the strategic industries to maintain their production in the country. Bajnai's government introduced temporary amendments to Hungarian Labour Code that increased flexibility of the employment on 1st June 2009 and 31st December 2011. This was done to enable businesses "to transfer the hours "saved" during the crisis to the boom period prognosticated for 2011 without any additional costs".[118] These measures followed the "German scheme of reduced time", thus German complex manufacturers, especially those in automotive industry, were already familiar with the scheme and were among those who benefited the most from this change. The Head of Communications at the German-Hungarian Chamber of Commerce, Dirk Wölfer has confirmed in the interview that these changes in the Labor Code were among the most crucial measures that helped manufacturing companies during the crisis:

> "*Companies could adjust the worktime to demand and therefore they did not have to fire workers from the staff. These measures made it much easier to recover from the crisis because they still kept the staff and could gradually increase the worktime again*"[119]

[116] Rita Ramalho, Jorge Rodríguez-Meza, and Judy Yang, "How Are Firms in Eastern and Central Europe Reacting to the Financial Crisis?" (The World Bank, January 1, 2010), 3, http://documents.worldbank.org/curated/en/2010/01/11800547/firms-eastern-central-europe-reacting-financial-crisis.

[117] The study is based on the World Bank's Financial Crisis Survey, which was conducted in six Eastern European countries: Romania, Bulgaria, Hungary, Lithuania, Latvia, and Turkey (the countries among those that were hit hardest by the crisis). The three waves of survey were conducted in June-July 2009; April 2010 and August 2010

[118] Károly Fazekas and György Molnár, "The Hungarian Labour Market Review and Analysis, 2011" (Budapest: Institute of Economics, IE HAS Nationa Employment Foundation, 2011), 92, http://econ.core.hu/file/download/HLM2011/TheHungarianLabourMarket_2011_onefile.pdf.

[119] Author's interview with Dirk Wölfer, the Head of Communications at the German-Hungarian Chamber of Commerce and Industry, May 20, 2015.

The large firms have significantly reduced permanent employment, in contrast to small and medium-size firms, which actually increased their permanent employment during the crisis.[120] Later in 2012 Orbán's government adopted the new Labour Code further extending possibilities for flexible work arrangements and the ability to cut costs, which was welcomed by employers' associations and representatives of big business.[121] German producers consider the New Labor Code to be much more "balanced" as it takes into account more needs of the producers, it is even more flexible than the German one. This step made the country very attractive for foreign investors, increasing Hungary's competitiveness among its regional peers.[122]

The Hungarian government also provided generous financial support to manufacturing and construction. To boost economic recovery, the amount of subsidies and investment grants increased substantially in 2010 (see table 5). The measures proved to be successful as the exit rate of firms in Hungary was one of the lowest in the CEE region according to the World Bank's Financial Crisis Survey.

**TABLE *5* GOVERNMENT SUBSIDIES AND INVESTMENT INCENTIVES FOR MANUFACTURING, MINING AND CONSTRUCTION (MILLION EUR)**

| GEO/TIME | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 |
|---|---|---|---|---|---|---|
| HUNGARY | 7.6 | 10.6 | 6.0 | 27.8 | 14.8 | 9.2 |
| LATVIA | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |

Source: author's calculations based on the data from Eurostat

The Latvian private sector was one of the most affected in the region. The manufacturing sector did not receive any subsidies or investment grants from the government (see table 5). Moreover,



[120] Ramalho, Rodríguez-Meza, and Yang, "How Are Firms in Eastern and Central Europe Reacting to the Financial Crisis?," 3.
[121] András Tóth, "The New Hungarian Labour Code - Background, Conflicts, Compromises," Working Paper (Budapest: Friedrich Ebert Foundation, June 2012), 9–10, http://www.fesbp.hu/common/pdf/Nachrichten_aus_Ungarn_june_2012.pdf.
[122] Author's interview with Dirk Wölfer, the Head of Communications at the German-Hungarian Chamber of Commerce and Industry.

"*the medicine that Latvia was taking i.e. internal devaluation, regain of competitiveness through wage and job cuts, was extremely bitter*."[123] As a consequence, Latvia had the second-highest firm exit rate of all countries from the World Bank's Financial Crisis Survey and third highest reduction in permanent employment.[124] Thus in line with Shafer's predictions, small and relatively flexible firms in the wood and textile industries have left the country or cut their production substantially during the crisis.

Likewise, there were no strong sector-specific demands raised during the crisis. Business was most interested in predictability of governmental actions as well as deeper structural reforms, especially in terms of tax policy. Access to finance became one of the biggest obstacles for business in Latvia, which was further reflected in EBRD survey (see figure 9). Foreign investors called the government *"to accelerate and deepen structural reforms to safeguard the availability of foreign financing and improve the long-term growth potential of the country"*.[125] In light of this, strengthening cooperation with foreign banks seemed to be a reasonable step for the government, especially since the state finance to support the industry was more than limited.

The only sources of funds that the Latvian government could tap to stimulate investment and output were the EU grants.[126] The Cohesion fund, European Development fund and European Social fund allocated around €4.6 billion in total throughout 2007–2013, which was four times more than for the previous programming period, 2004–06. Despite severe cuts in government expenditures, Latvia maintained and increased matching funds for those projects to accelerate absorption of the EU funds, thus increasing the EU revenues from 4% of GDP to 7.4% in



[123] Author's interview with Marta Jaksona, Project Director of Foreign Investor's Council in Latvia (FICIL).
[124] Ramalho, Rodríguez-Meza, and Yang, "How Are Firms in Eastern and Central Europe Reacting to the Financial Crisis?," 7.
[125] Author's interview with Marta Jaksona, Project Director of Foreign Investor's Council in Latvia (FICIL).
[126] To be noted that the EU funds did not apply for foreign investors.

2010.[127] These funds were used under the three programs encompassing the entire country's territory: 'Entrepreneurship and Innovations', 'Infrastructure and Services' and 'Human Resources and Employment'. [128] The programs targeted the advancement of overall infrastructural and economic conditions in the country and had no sectoral preferences.

### 3.2.1. Hungary shifts the focus towards reinvestment

After the crisis the average investment level[129] in Hungary did not exceed 20% of GDP, which meant deeper recession than previously estimated and gloomy prospects for growth in the long run. In 2012 the investment rate fell below 17.4 % of GDP which was a warning sign for the government.[130] In July Hungary's car production slowed down, marking the plunge in industrial output.[131] Conducting the freedom fight against the IMF and bank dominance was becoming tougher. The threat of default urged the Hungarian government to request financial support from the IMF in November 2011. Despite deteriorating economic conditions Orbán refused to accept aid conditionality, namely pension cuts and the elimination of the bank tax, the negotiations dragged on till the late fall of 2012.[132] Under these circumstances the government needed strong allies to be able to go on with the "freedom fighter" rhetoric. Foreign investors in manufacturing sector suited the best for this purpose as such an alliance would be in line with the official rhetoric of moving away from debt-fare to „a work-fare state, where activity and employment



[127] Åslund and Dombrovskis, *How Latvia Came Through the Financial Crisis*, 77.
[128] European Commission, "European Cohesion Policy 2007-2013 in Latvia: Priorities and Impact of Cohesion Policy in the Member States," January 10, 2009, 2, http://ec.europa.eu/regional_policy/en/information/publications/brochures/2009/european-cohesion-policy-2007-2013-in-latvia-priorities-and-impact-of-cohesion-policy-in-the-member-states.
[129] Gross fixed capital formation
[130] Transparency International Hungary, "Lifting the Lid on Lobbying: National Report on Hungary. Lobbying in an Uncertain Business and Regulatory Environment," 17.
[131] Zoltan Simon and Ras Gergely, "Hungary Needs IMF Aid, Disputes Conditions, Orban Says," *Bloomberg.com*, accessed May 24, 2015, http://www.bloomberg.com/news/articles/2012-09-07/hungary-needs-imf-aid-disputes-conditions-orban-says.
[132] Ibid.

ratios are encouraged to become as high as possible”.[133] Boosting loyalty of foreign manufacturers that provided the core of Hungarian exports became a priority on the industrial policy agenda.

To this end, the Hungarian Investment promotion agency introduce the ***Reinvestment Programme Initiative*** that targeted the subsidiaries of multinational companies that already have a presence in Hungary to find out their managers’ opinions and preferences regarding the investment environment, channel those to government decision-makers, encouraging them to expand and reinvest.[134]

Until 2010 the bulk of the staff in the ministries was relatively stable, so the business sphere could easily refer to known contacts within the administration. After coming into power in 2010 Orbán replaced a large part of the staff in the ministries, including some important positions. As FIDESZ was in opposition for eight years (2002-2010), it lacked professional experience and know-how in running the government, which triggered some initial difficulties in establishing the ties with the industry.[135] During the interview Mr. Wölfer from the German chamber of Commerce explained:

> *“In the first two years [of FIDESZ government] it was difficult to find contact with persons from the ministries that were able on a professional basis to talk to the business representative and had the mandate to do so. At the same time, they tried to minimize external influence on planned measures and decisions in order to ensure that their original intentions are not "diluted" by third parties. In 2012 the situation started to improve… Now the Chamber has established a standing platform in the ministry of economy with regular monthly meetings”.*[136]



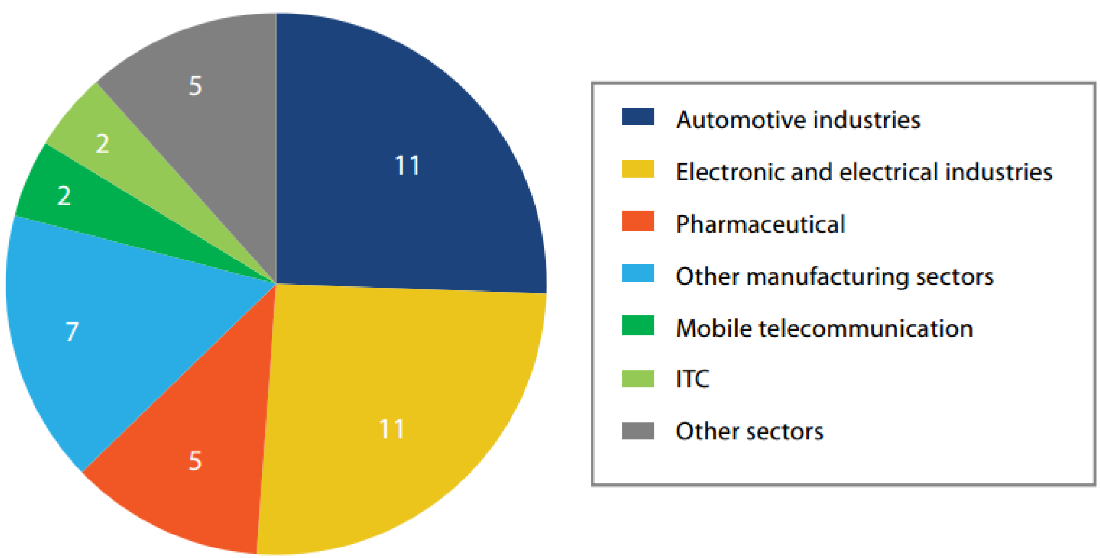
[133] György Barcza, “Guest Post: In Defense of Hungary’s Economic Policy,” *Financial Times*, February 18, 2013, http://blogs.ft.com/beyond-brics/2013/02/18/guest-post-in-defense-of-hungarys-economic-policy/.
[134] PwC, “Investing Guide Hungary” (Budapest: PricewaterhouseCoopers Hungary, 2014), 51.
[135] Author’s interview with Dirk Wölfer, the Head of Communications at the German-Hungarian Chamber of Commerce and Industry.
[136] Ibid.

In 2012 the government also introduced ***Strategic Partnership Agreements*** (SPA), which became a sort of "Hungaricum" designed to restore and improve the communication between the business and the government via signing specific agreement. Specific economic requirements for the eligibility of a company to sign an agreement include size, minimum employment, minimum share for domestic suppliers and significant share of export. The latter criteria represents strong sectoral preference towards automotive and electronics industries that dominate Hungarian exports.[137]

Government's bias towards large foreign manufacturers is illustrated by a number of facts:

1) Officially SPAs are initiated by the interested companies, yet on practice senior government officials take the lead.[138] Companies in the complex manufacturing represent more than half of those that have signed an SPA by April 2014 (see figure 8).

**FIGURE 8 SECTORAL DISTRIBUTION OF 43 COMPANIES INVOLVED IN STRATEGIC PARTNERSHIP AGREEMENTS (JULY 2012 – APRIL 2014)**




137 Author's interview with József Péter Martin, executive director of Transparency International in Hungary.
138 Transparency International Hungary, "Lifting the Lid on Lobbying: National Report on Hungary. Lobbying in an Uncertain Business and Regulatory Environment," 33.

Source: Transparency International in Hungary[139]

2) Subsidies based on Individual government decisions (Egyedi Kormány Döntések) apply only for large investments.[140]
3) After several reorganizations the attention of Hungarian Investment Promotion Agency (HIPA) became geared towards large companies and projects which are not covered by the EU cohesion money.[141]

Such preference for large industrial projects is partially a result of institutional factors and the problem of resources. Regulations on EU grants put an upper ceiling on the subsidies to certain companies and the budget of HIPA is restricted, thus increased attention to large companies happens at the expense of smaller projects.[142] In addition "large companies, especially in the automotive industry (Audi, Mercedes, Opel, Bosh (automotive electronics)) have direct connection with the government, for them it is much easier to channel their interest to the government than for the smaller suppliers."[143]

FIDESZ displayed its willingness to work tighter with large foreign investors even before the elections. During our interview the Head of Communication at German Chamber of Commerce acknowledged that even before the 2010 elections a FIDESZ representative contacted the German Chamber to discuss possible cooperation on designing new a vocational training system in the event of FIDESZ winning the elections. After coming to power they started the consultations with the representatives from the industry. The law was adopted in 2012 and it started to be compulsory in 2014. The government is still fine tuning the system using the

[139] Ibid., 35.
[140]Projects eligible for EKD subsidies must be of min. EUR 20 M investment volume, and 100 new jobs or min. EUR 10 M investment volume, and 50 new jobs if undertaken in the preferred regions.
[141] Author's interview with Dirk Wölfer, the Head of Communications at the German-Hungarian Chamber of Commerce and Industry.
[142] Ibid.
[143] Ibid.

recommendations and consultations from the business to shape it in the best way that would suit the industry, especially automotive producers.[144]

We can see that the need to enlist the support of foreign manufacturers made the Hungarian government even more susceptible to the demands of the complex sector, increasing the leverage of MNCs, which was further magnified by the EU regulations and limited finance. Despite the social costs related to the deteriorated position of labor and absence of ability to urge increasing supplies by Hungarian producers, the strategy for "freedom fight" worked and on August 12, 2013, when Hungary has returned its debt to the IMF, Orbán declared: "Hungary enjoys the trust of investors," referring to investors who produce something in Hungary for Hungarians, providing employment to people, improving their lives and enabling true economic growth.[145]

### 3.2.2. Latvia turns towards export oriented policy and promotion of high value added investment

The crisis has prompted the government to reconsider its industrial policy and many of the leaders became convinced that the country needs to take effective measures that would upgrade the industry and attract foreign investors in complex sectors.

The first sign of the shift in the industrial policy towards promotion of high value added activities took place already in 2007, when the government adopted the "Programme for promotion of business competitiveness and innovation for 2007-2013". A number of measures facilitating knowledge-intensive production and exports, mostly (co-)financed by the European Union, has been adopted during the crisis. These measures envisaged grants and loans, administrative support or consultancy to increase number of R&D projects, registered patents



[144] Ibid.
[145] Ronald L. Ray, "Hungary Sheds Bankers' Shackles," *Amercian Free Press*, August 23, 2013, http://americanfreepress.net/?p=12418.

and investments in technology in a broad range of industries both in manufacturing and services (see appendix C).

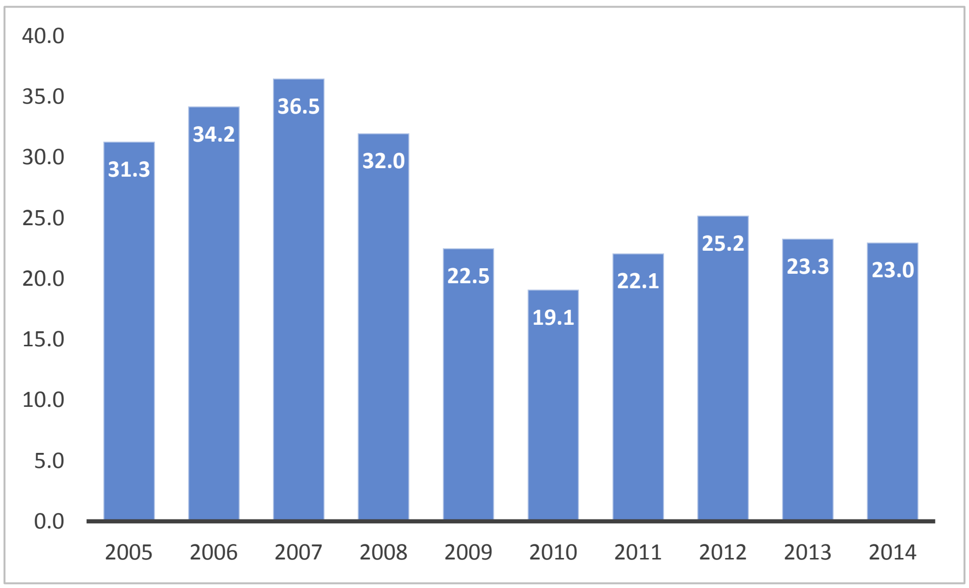
One of the most prominent measures for improving Latvian competitiveness was the **'High value-added investments' programme'** (2009-2013). The project was designed to create opportunities to local businesses to invest in knowledge-intensive or technology-intensive projects, and attract foreign investments in high value added sectors. It covered up to 35% of the long-term investment projects in fixed or intangible assets (e.g. equipment acquisition, building and reconstruction, upgrading of production process, purchase of licenses and patents).[146] The programs under European Structural funds benefited the manufacturing sector through reconstruction of infrastructure, modernization of production process, technological innovation and staff training.

A more serious step towards economic restructuring was taken in 2010 when the aggregate investment level reached the lowest point since the beginning of the crisis falling from over 36,5% of 2007 to 19,1% (see figure 9). As a part of the solution to the investment slump the Latvian government has established the **Coordination Council for Large and Strategically Important Investment Projects** in 2010. Assessing the council's prerogatives Prime Minister Dombrovskis stressed that "The main incentive for growth of the Latvian economy, unlike in previous years, should be export, as well as the ability to replace some imported products with domestic products. Therefore, Latvia needs export-oriented investments, which would provide currency earnings, enhance trade and improve the balance of payments".[147] The council introduced a new turn in the investment policy with the adoption of the new **"Strategy for the**

[146] Erawatch, "High Value Added Investments: Project Description" (European Commission, May 9, 2012), http://erawatch.jrc.ec.europa.eu/erawatch/opencms/system/modules/com.everis.erawatch.template/pages/exportTypesToHtml.jsp?contentid=e7e0971f-9094-11e0-a33b-3b1a37daf5b5&country=Latvia&option=PDF.
[147] FICIL, "Government Takes Action to Attract Large Foreign Investments," *Foreign Investors' Council in Latvia*, August 25, 2010, http://www.ficil.lv/index.php/news/25082010/.

**Attraction of Foreign Direct Investment for 2011-2017"**. The main objective of the strategy is restructuring Latvian economy towards high value added production based on demand and innovation by attracting FDI to export-oriented sectors. Alongside the traditional industries that have developed in Latvia such as wood processing, food industry and metalworking, the strategy prioritizes investment in complex and innovation sectors like machinery, electronics, transport and logistics, green technologies and IT.[148]

**FIGURE 9 LATVIAN INVESTMENT RATE: GROSS FIXED CAPITAL FORMATION AS A % OF THE GDP**




Source: Eurostat[149]

The Council died out soon after the necessary research was done and the Strategy was created. The most crucial part, however, namely "*how to implement the strategy and what the government could actually do to achieve the objectives of the strategy, was left unsolved*"

[148] BestRiga, "On the Lookout for Investment Opportunities: 160 Investment Projects Requests Received in First Half of 2011," September 1, 2011, http://www.bestriga.com/en/page/expanded/article/576.
[149] http://ec.europa.eu/eurostat/web/national-accounts/data/database

admitted the interviewee from the Latvian office of Transparency International.[150] Nevertheless, some steps to increase Latvian investment competitiveness among the CEE countries were taken. These included a number of measures supporting manufacturing, such as R&D incentives, investment guarantees and renewing income tax abatements for investors undertaking committing at least 7,1 million EUR.[151] Very generous tax rebate packages have been envisaged under the Special Economic Zones and Free ports covering up to 80% of corporate income tax and withholding tax for dividends. Large-scale investment projects under EUR 50 million now enjoy 25% tax rebate of total initial long-term investment, and those exceeding EUR 50 million enjoy 15% tax rebate.[152]

According to the Investment and Development Agency of Latvia, mechanical engineering and metalworking industries have been one of the major targets of restructuring. Government supported activities in export-oriented contract manufacturing, technology and productivity enhancement, improvement of managerial and employee skills mainly through European Structural Funds for economic development programmes. In 2013 80% of the sector's total output went for export, the sector provided employment to 27 000 workers.[153] The composition of Latvian exports changed from the wood and apparel sectors and into higher value added electrical equipment and machinery (see figure 10). [154]



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150 Author's interview with Agnese Alksne, researcher from Transparency International, author of the 2014 report on Lobbying in Latvia.

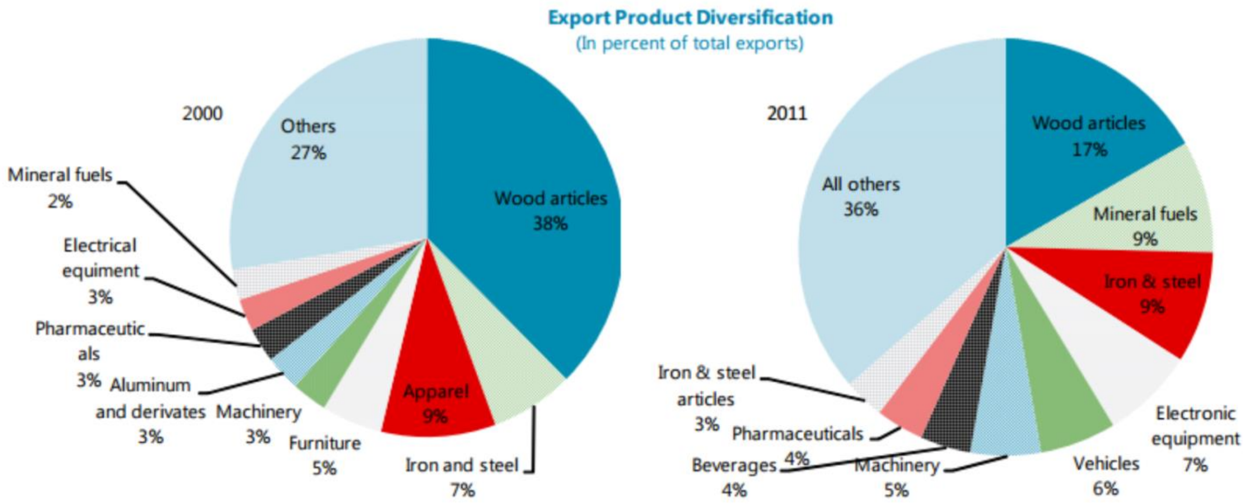
151 Balticexport, "Manufacturing Is Forced to Become Export Oriented," accessed May 13, 2015, https://www.google.hu/url?sa=t&rct=j&q=&esrc=s&source=web&cd=3&cad=rja&uact=8&ved=0CCsQFjAC&url=http%3A%2F%2Fbalticexport.com%2F%3Farticle%3Dprioritate-rupniecibas-stimulesana-un-eksportapjomu-audzesana&ei=TSBTVcjaFIPiywPqxIDgBg&usg=AFQjCNF8MMr50mdaJe4ds6W14Q23GuAoQg&sig2=dcvNSMcQYH8J3_gddMcXPQ&bvm=bv.93112503,d.bGQ.

152 LIAA, "Tax Incentives," *Investment and Development Agency of Latvia*, accessed April 20, 2015, http://www.liaa.gov.lv/invest-latvia/competitive-advantages/business-incentives/tax-incentives-0.

153 LIAA, "Mechanical Engineering and Metalworking Industry," April 29, 2015, http://www.liaa.gov.lv/trade/industry-profiles/mechanical-engineering-and-metalworking-industry.

154 IMF, "Republic of Latvia 2012 Article IV Consultation and Second Post-Program Monitoring Discussions," IMF Country Report, No. 13/28 (Washington, D.C., January 2013), 19,

**FIGURE *10* COMPOSITION OF LATVIAN EXPORTS IN 2000 AND 2011**




Source: IMF[155]

Note: Increase in the share of other sectors (i.e. sectors not ranking in the top ten for exports) indicates that producers in these sectors have found and expanded their small niche products.

In fact, "*these changes were mainly caused by changes in demand – changes in the EU, Russia, not due to a specific state policy*" revealed the project director of FICIL during personal correspondence. Manufacturers in Latvia started to reorient to external markets after 2009, when the internal market shrunk with the drastic fall in consumption during the crisis and its slow recovery afterwards.[156]

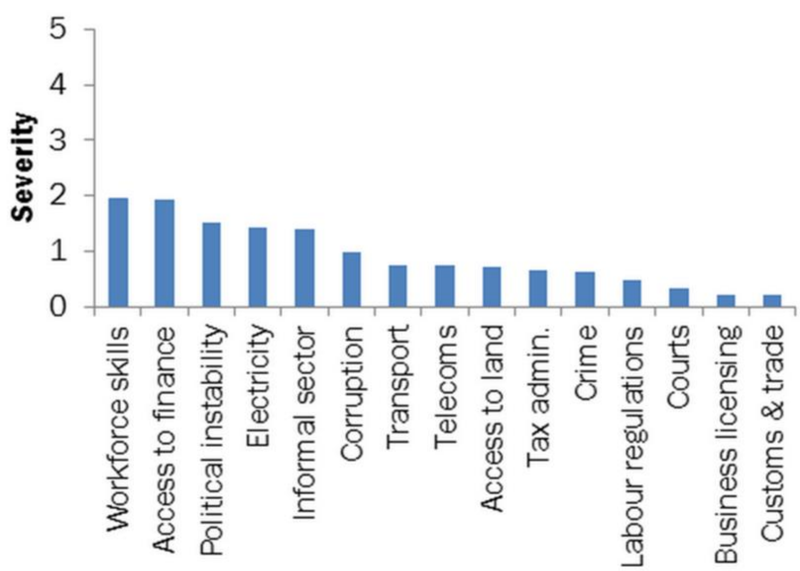
It is clear that the government has included industry upgrading and export promotion among its policy priorities, yet pursuing such an ambitious goal requires a lot of resources and is influenced by many external factors. To attract new high value added investment Latvia needs to tackle its most urgent problems with the investment environment. Recent Business Enterprise Performance

https://www.imf.org/external/pubs/ft/scr/2013/cr1328.pdf.

155 Ibid.
156 Balticexport, "Manufacturing Is Forced to Become Export Oriented."

Survey conducted by World Bank and EBRD shows that employee skills, access to finance and political instability are the main obstacles for doing business in Latvia (see figure 11). The 2015 report of the German Chamber of Commerce in Estonia, Latvia, Lithuania shows that 49% of the respondents indicated that economic sanctions and embargoes from Russia and closeness of the Ukrainian-Russian crisis had negative effect on their business.[157] Another issue is the low levels of trust in political institutions, which has negative implications for the business-government relations and loyalty of investors.

**FIGURE 11. BUSINESS ENVIRONMENT OBSTACLES IN LATVIA**




Source: EBRD – Business Enterprise Performance Survey (BEEPS)[158]

**Conclusions**



[157] Deutsch-Baltischen Handelskammer in Estland, Lettland, Litauen, "Lage Und Erwartungen Der Unternehmen Mit Deutscher Beteiligung in Den Baltischen Staaten Im Jahr 2015," Ergebnisse Der Konjunkturumfrage Der Deutsch-Baltischen Handelskammer in Estland, Lettland, Litauen (AHK Baltische Staaten), 2015, 7, http://www.ahk-balt.org/fileadmin/ahk_baltikum/Publikationen/Konjunkturumfrage/2015/Konjunkturumfrage_2015_DE_Ergebnisse.pdf.

[158] EBRD, "Business Environment and Enterprise Performance Survey (BEEPS) V Country Profile: Latvia."

To sum up, the analysis revealed that capital intensity and inflexibility of Hungarian automotive and electronics industries urged these firms to seek support from the Hungarian state. They achieved increased flexibility of labor regulations that allowed them to weather the crisis and recover afterwards. The Hungarian government possessed high stakes in cooperation with foreign manufacturers, which made it even more susceptible to the demands of the complex sector, increasing the leverage of MNCs.

Latvian small flexible producers in the light wood and textile sectors adjusted to changing market conditions or left the country, raising no sector-specific demands. Crisis has pointed at the shortcomings of a previously neutral regulatory policy, while full control of the policy space allowed the Latvian government to undertake restructuring measures towards export oriented sectors policy and attraction of high value added investments. Nevertheless these aspirations require action, namely creating the favorable investment environment, reshaping the system of vocational training and winning the trust of foreign investors. These are not easy tasks themselves, yet competition for investment form the rest of CEE, slow recovery of the EU, Russian economic problems further magnify the complexity of restructuring project.

# CONCLUSIONS

For a small emerging economy dependence on the foreign capital, economic crisis not only increases vulnerability and the exposure to external market trends, but it also increases uncertainty that itself drives economic and political actors to seek new alliances and strengthen the old ones. This creates conditions that allow to reshuffle the power balance between the multinationals and the host government. In this thesis I have tried to understand what determines the ability of the host government and multinationals to use this opportunity to reshuffle cards of their bargaining power and shape industrial policy according to their preferences. To this aim, I analyzed change in Latvian and Hungarian policy variation across the banking and manufacturing sectors.

Based on the combination of sectoral theories and bargaining models, I have constructed a set of hypotheses that relates specifics of the leading sectors to the pressures and vulnerabilities of political and economic actors. The first set of hypotheses relates policy preferences and the ability of the firms to influence regulatory space to their sectoral specificities and the extent to which the state needs multinational corporations to reach its goals. The second relates the distribution of bargaining resources to the structure of relationships of the state and the business to international environment and specific actors.

The analysis shows that sectoral specifics matter. Indeed, large capital intensity and inflexibility of Hungarian automotive and electronics industries urged these firms to seek support from the Hungarian state. They achieved increased flexibility of labor regulations that allowed them to weather the crisis and recover afterwards. Latvian small flexible producers in the light wood and textile sectors adjusted to changing market conditions or fled the country. Crisis has pointed at the shortcomings of previously neutral regulatory policy, while full control of the policy space allowed the Latvian government to undertake restructuring measures towards export oriented sectors policy and attraction of high value added investments. Yet the issue of lack of trust and barriers to enter the bidding game for investment in the complex sector make Latvian aspirations a difficult target to achieve.

The network of relationships also matters. The ability of Nordic banks to push their home governments to provide support for Latvia – both in aid conditionality negotiations with EU and the IMF, and in securing the remaining financial gap – contributed to strengthening of their relations with the Latvian state. This provided the ground for further cooperation driven by the Latvian needs to attract investors and improve its economic prospects. Non-finance investors encouraged the Latvian government to cooperate with foreign banks improve business access to finance. Thus the government had high stakes in teaming up with the banks, which further strengthened their position.

On the other hand, the ability of multinationals to pool the support of their home countries does not always increase the investor's leverage over the host government. The attempts of foreign banks to induce support from Austrian and German governments, IMF and Brussels did not prove to be fruitful in the context of Orbán's freedom fight against these institutions. The interests of the Orbán government contradicted with those of the banks. Furthermore, it had even higher stakes not to cooperate with the banks: the government needed to secure sources of revenue and it was cautious about vulnerabilities that excessive foreign ownership entails. The banks, whose reputation and influence nearly collapsed, were used as the scapegoats to blame for the crisis and to help those in distress and pay for the large profits they made before the crisis.

The Hungarian story represents an interesting case itself. The banking story provides support to the Moran's argument (from the debate in the introduction) that once multinationals make their commitment to the economy, non-flexible nature of their business and large fixed costs increase the bargaining position of the host state. His argument, however, refers to heavy manufacturing, yet my findings (including those from the interview with a representative of Hungarian banking sector) demonstrate that the argument can be extended to the banking, where investments are calculated for long-term and non-transferrable clientele, making banks even less flexible than heavy manufacturers.

The story with automotive manufacturing, on the contrary, supports the claim of Benneth and Sharpe that the position of manufacturing TNCs increases over time with their ability to raise voice by the threat of exit, claiming that the country needs their production as they provide developmental base for local suppliers. In our case Hungary does need transnational manufacturers, but not because they nurture local suppliers (in fact, in Hungary manufacturing TNCs use their international network of suppliers and only very few, mostly non-production-specific suppliers, are of domestic origin),[159] but because it is hard for Orbán to carry out his freedom fight alone. Fidesz needs foreign investors for strategic reasons. One is to develop the workfare economy that nurtures production which provides real employment and economic growth. Second is to do it without relying on EU or IMF resources. Therefore, restoring the trust of foreign investors in manufacturing sectors was among the priorities for the government. Thus the need for a strong ally "to do politics the Hungarian way" lifted the leverage of manufacturing MNCs.

Limitations of this thesis stems from the fact that it does not consider how the relationship of business with their local employees alter the picture and to which extent the position of the labor influences industrial policy in the manufacturing and banking sector. At the same time the networks of the relationships that influence state-MNC bargaining are very broad, thus the list of

[159] Author's interview with Dirk Wölfer, the Head of Communications at the German-Hungarian Chamber of Commerce and Industry.

relevant actors highlighted in the thesis might not be extensive. At the same time the role of international capital markets and the trends in international manufacturing is beyond the scope of the thesis, but, by all means, they do have an influence on domestic developments in small emerging economies. Therefore further research in these areas would be needed and welcomed.

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# APPENDIX

## APPENDIX A. LIST OF INTERVIEWS

Agnese Alksne, researcher from Transparency International, author of the 2014 report on Lobbying in Latvia., May 21, 2015.

Dirk Wölfer, the Head of Communications at the German-Hungarian Chamber of Commerce and Industry, May 20, 2015.

József Péter Martin, executive director of Transparency International in Hungary, May 12, 2015.

High-level representative of Hungarian banking sector, May 20, 2015. Due to the nature of this study the person wished to remain anonymous.

Marta Jaksona, Project Director of Foreign Investor's Council in Latvia (FICIL). Written correspondence, May 29, 2015.

## APPENDIX B: POLICIES TO DISCOURAGE FOREIGN CURRENCY BORROWING

2004Q4

| | CZ | EE | HU | LV | LT | PL | SK | SI | BG | RO | CR |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Monitor fx risk | X | | | X | | | | | | | |
| Disclose fx risks to customers | | | | | | | | | | | |
| Tighten eligibility criteria for fx borrowing | | | | | | | | | | | |
| Higher risk weights, provisioning, reserve requirements depending on banks' fx exposure | | | | | | | | | | | X |
| Ceiling on banks' fx exposure | | | | | | | | | | | |

2007Q4

| | CZ | EE | HU | LV | LT | PL | SK | SI | BG | RO | CR |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Monitor fx risk | X | | X | X | | | | | | X | X |
| Disclose fx risks to customers | | | X | | | X | | | | | |
| Tighten eligibility criteria for fx borrowing | | | | X | | X | | | | | |
| Higher risk weights, provisioning, reserve requirements depending on banks' fx exposure | | | | X | | | | | | X | X |
| Ceiling on banks' fx exposure | | | | | | | | | | | |

Source: Rosenberg and Tirpák (2008)[160]



[160] Christoph B. Rosenberg and Marcel Tirpák, "Determinants of Foreign Currency. Borrowing in the New Member States of the EU," IMF Working Paper, July 2008, 11, https://www.imf.org/external/pubs/ft/wp/2008/wp08173.pdf.

## APPENDIX C. SUPPORT MEASURES PROMOTING INVESTMENT AND INNOVATION IN LATVIA DISPLAY POLICY NEUTRALITY TOWARDS SECTORS

| Supportive measures | Duration | Aim | Targeting specific sector | Target groups /beneficiaries | Eligible Funding (million euro) |
|---|---|---|---|---|---|
| **Export and innovation award** | 2005 - present | Innovation prizes incl. design prizes | None | | NA |
| **Support for development of innovation centers and business incubators** | 2007-2008 | Support to innovative start-ups | None | SMEs | 4.653 |
| **Support for establishing industrial property rights** | 2008-2009 | Consultancy and financial incentives to the use of industrial property rights | None | | 0.249 |
| **Support for introduction of new products and technologies into production** | 2008-2013 | Direct support of business R&D (grants and loans) | None | Technology based firms in industrial production, knowledge intensive service firms | 55.918 |
| **Support for development of new products and technologies** | 2009-2011 | Direct support of business R&D (grants and loans) | none | | 10.381 |
| **High value-added investments programme** | 2009-2013 | Attract foreign investments in knowledge-intensive or technology-intensive projects | none | | 116.384 |

Source: composed by the author on the basis of specific policy descriptions from ERAWATCH webpage and [161]



[161] INNO Policy TrendChart and ERAWATCH, "Mini Country Report/Latvia," December 2011, 17–19, http://ec.europa.eu/enterprise/policies/innovation/files/countryreports/latvia_en.pdf.