

This PDF is a selection from an out-of-print volume from the National Bureau of Economic Research

Volume Title: Transition in Eastern Europe, Volume 2, The

Volume Author/Editor: Olivier Blanchard, Kenneth Froot, Jeffrey Sachs, eds.

Volume Publisher: University of Chicago Press

Volume ISBN: 0-226-05662-7

Volume URL: <http://www.nber.org/books/blan94-3>

Conference Date: February 26-29, 1992

Publication Date: January 1994

Chapter Title: Foreign Direct Investment in Eastern Europe: Some Economic Considerations

Chapter Author: Kenneth A. Froot

Chapter URL: <http://www.nber.org/chapters/c6729>

Chapter pages in book: (p. 293 - 318)

17 Foreign Direct Investment in Eastern Europe: Some Economic Considerations

Kenneth A. Froot

With the radical transformation of East European economies has come a wave of interest in inward foreign direct investment (FDI). In the past two years, host countries have adopted completely new legal frameworks as well as institutions and agencies to encourage and approve of foreign investments. On the demand side, surveys suggest that almost two-thirds of multinational firms are interested in investing directly in Eastern Europe. Indeed, firms initially showed a keen interest in “beating out the competition” by attempting to invest there first. Some observers became highly optimistic that foreign direct investment inflows would soon be sufficient to fund large current account deficits.

Now that the initial euphoria on both sides has died down, countries and Western companies have scaled back their expectations. In spite of their increased interest in FDI, Western companies have on average invested relatively small dollar amounts. While the *number* of investments and joint ventures with foreigners for all of Eastern Europe has risen extremely rapidly to over 10,000, the average dollar amount per investment remains very small—about \$150,000. The difficulties of setting up the investment and the uncertain status and direction of the transformation programs have led companies to slow the pace of entry and to downsize their expected participation. Today, it is hard to imagine that FDI will provide a major net source of funds to these countries in the near future. A more realistic view is that FDI’s major financial contribution to Eastern Europe is to be one of intermediation rather than inflow.

It is undoubtedly true that the host countries of Eastern Europe badly need the technology, Western organizational experience, and financial depth and intermediation services that foreign companies bring. Yet the entry of foreign firms is also greeted with distrust—not unlike that seen in other countries that

The author is grateful to Ellen Lederman, Jeff Sachs, Jeremy Stein, and Ray Vernon for helpful conversations and to the Division of Research at the Harvard Business School for research support.

have experienced bursts in foreign investment. There are often-heard complaints that foreigners purchase assets at fire-sale prices, taking advantage of inexperienced or corrupt government bureaucrats or managers. Because it is frequently necessary to negotiate with former Communists and government apparatchiks, there is a sense of complicity between the worst parts of the old order and newer foreign entrants. Furthermore, foreigners often displace or are insensitive to original stakeholders in Eastern firms. Many argue that the actions of local domestic owners would be more in line with social interests than are the actions of foreigners. For example, foreign owners may be less concerned with the level of unemployment in a certain municipality than would be local (domestic) stakeholders. And there may well be short-run social and political gains to preserving employment and smoothing needed labor market adjustments over time.

The experience thus far with FDI has intensified the discussion of *how* best to get foreigners involved in the privatization process. One view is that foreign ownership should be explicitly limited and regulated by government, as in the case of, say, the Czechoslovak banking sector. Under this view, needed knowledge of Western technology, organizational skill, and business practice is to be purchased by domestics in fee-for-service kinds of agreements. In practice, many countries have already found that there is no shortage of Western experts ready to give advice on these matters. However, it is not clear that experts' interests are always adequately aligned with those of their advisees.

A second view is that foreigners—like domestic investors—ought to be encouraged to participate in auctions and that these auctions should either be part of the primary privatization process or take place after privatization occurs in the secondary market. In such a case, there would be little specialized treatment of foreign bidders, and competition, as the argument goes, would occur quite naturally between them. The highest bid would win. The difficulty here is that, in practice, little foreign competition actually tends to emerge. And auctions are easily subverted when there are few truly competing bidders—the highest bid may be a very low bid indeed. As I discuss below, even auctions that are highly competitive *ex ante* are, in the context of Eastern Europe, likely to be very imperfectly competitive *ex post*.

A third and very different model, one that is currently being pursued by Germany's Treuhandanstalt, is to involve a governmental agency directly in asset sales and restructuring. The activities of identifying and advertising assets, soliciting bids for their use, and then aiding in their restructuring and ultimate sale to foreign buyers might all be taken on by such an agency. Indeed, the Treuhand frequently uses whatever bargaining power it has to negotiate conditions on payment, current and future employment levels, the range of required production activities, and investment expenditures. It is not so interested in selling rapidly at the best available prices.

While the Treuhand's example is in many ways unsuitable for the rest of Eastern Europe (see Carlin and Mayer, in this volume), it raises the issue of

government involvement in the privatization process specifically with respect to foreigners. Effective competition in foreign purchases may be limited to such a degree that government involvement is needed to improve competition and/or negotiate for a better deal from society's perspective. In these circumstances, privately run auctions may by themselves be a poor means of redistributing control to foreigners. Governments can take (and have taken) a number of steps to protect against this outcome by intervening in the privatization process. But these steps also come with costs—any interventionist strategy that gives discretion to government authorities is subject both to possible administrative lags and to corruption.

The story of Poland's brief encounter with sectoral privatization demonstrates many of these points. The sectoral approach evolved ostensibly out of the need to identify and characterize assets and provide information to a class of interested foreign buyers. Undertaking one sector at a time seemed to economize on the costs of research, of finding interested parties, and of informing the parties about the assets. It also allowed for the trading of certain employment and investment guarantees in return for ownership. For much of 1991, sectoral privatization was expected to become a major track in Poland's privatization program. But the effort now seems to have failed, partly because it was moving too slowly, but, more important, because of the possibilities for and suspicions of corruption throughout the program. This kind of handicap, from which the Treuhand does not suffer, will be a problem for every other East European country.

This paper argues that the treatment of foreign investment is an important consideration in the initial design of privatization programs. I look at how foreigners can be paired efficiently and competitively with assets and conclude that governments may need to intervene in the foreign privatization process in several ways. First, the terms on which sales to foreigners take place can be improved (*relative* to the terms of sales to domestics) by disseminating information on individual assets and sectors, by promoting FDI through various bilateral and multilateral agencies and rules-based approaches, and by clarifying, codifying, and enforcing domestic property rights.

As it will take time to do these things, foreign investment may often be encouraged too hastily. That is, a sequencing of foreign involvement to follow domestic privatization may be desirable. Such a delay in foreign investment would give domestic owners and the government time to disseminate information and provide for a relatively high level of competition in sales to foreigners. In addition, this sequencing would require foreigners to wrest control from a number of private holders. Such transactions are more likely to give greater bargaining power to domestics and less likely to be perceived as corrupt than similar transactions that involve only the government and a foreigner.

The advantages of slowing foreign investment do not, however, imply that domestic privatization should be slowed. Firms or assets that are intended for sale to foreigners can be rapidly privatized to domestics (with certain control

rights being retained by the government) as the government-led process of information collection and dissemination begins. Governments therefore might be involved in actively delaying or restricting foreigners' initial participation in direct investment while working to establish the conditions for active foreign competition at a later date.

The next section outlines the evolution of (primarily) the Polish treatment of foreign investors and argues that this evolution, however flawed it may be, can be interpreted as a response to the naturally low initial levels of foreign competition for domestic assets. Section 17.2 discusses various factors that help determine foreign valuations of domestic assets. Section 17.3 then turns to a more analytic examination of country bargaining power in the process of selling assets that are costly to learn about. The point is to see how costly learning affects the level of foreign competition and to explore various selling and sequencing mechanisms that might help improve seller bargaining power. Section 17.4 offers conclusions.

17.1 Recent Developments in Poland

This section describes very briefly some of the important developments in Poland that affect foreign investment and the terms on which it takes place.

17.1.1 Changes in the Regulatory Framework

The treatment of FDI in Poland is in the process of evolving from an interventionist and discretionary system toward a rules-based framework. Prior to the 1988 Joint Venture Law (which along with the 1991 Foreign Investment Law continues to regulate foreign investments in Poland), FDI into Poland was highly restricted. Foreign participation was limited to firms with fewer than 200 employees, and there were severe restrictions on profit repatriation, use of foreign exchange, and export and import activity. Together, the 1988 and 1991 laws removed virtually all these restrictions. In addition, the 1991 law removed completely the 1988 law's application and approval processes (the 1988 law itself liberalized these processes) and eliminated the regulatory authority of the Foreign Investment Agency (FIA).¹

The Polish FIA was abolished in part because it appeared that the discretionary nature of its approval process actually hindered FDI. As this process was highly bureaucratic in nature, the true requirements for approval often remained vague and uncertain.² This discouraged foreigners from proposing deals in the first place. Furthermore, the uncertainties associated with approval were widely understood to create opportunities for corruption. Bureaucrats generally have an interest in creating the appearance of uncertainty in order to make their authority more valuable to applicants. The perceived opportunities

1. For additional details on the foreign-investment laws in Poland, see Spar (1991).

2. For details, see Maslankiewicz (1991).

for impropriety created fears among the FIA's staff of taking the lead on individual deals—a completed deal was likely to be accused of being a corrupted deal. The result was that no one on the Polish side wanted to pursue investment approval aggressively. Thus, to remove the discretionary nature of the process and to emphasize the importance of rules, the FIA was dissolved.

The evolution of tax policy is another example of the movement toward a rules-based approach. In the aftermath of the political changes in Poland, tax holidays were offered in the attempt to attract foreign investors. However, these benefits often took the form of tax competition with other East European countries (so they had a beggar-thy-neighbor aspect to them) and in any case did not stimulate foreign investment. Indeed, surveys show that many investors view negatively programs that meddle with foreign-investment taxation because of their discretionary nature. Foreign investors are often more comfortable being treated symmetrically with other host-country companies, even if it involves higher initial rates of taxation. Indeed, the 1991 law requires symmetry between foreign and domestic company taxation.

This movement away from discretionary bureaucratic decision making toward a legalistic rules-oriented system is evident in other countries as well. In many cases, detailed regulation of businesses (mandated by early legislation on direct investment) was carried out by low levels of the bureaucracy. Regulation was often perceived to be capricious and in some cases was even of dubious legal status. For example, Soós (1991) argues that the Model Joint Venture Statute issued by the Romanian Ministry of Foreign Trade contained prescriptions whose legality could easily have been questioned. This, combined with the many unpublished ministry directives, magnified the sense of caution with which foreigners approached Romania.

Overall, Poland and other countries have endeavored to lower the costs of foreign investment by moving to a simpler, more transparent rules-based system with less emphasis on bureaucratic intervention. In many cases, the laws and regulations have come to resemble those common in the West, particularly the EC (examples include recent tax codes, accounting principles, bank guarantees, etc.), which helps lower costs of adjusting to Poland.

17.1.2 Changes in the Methods of Foreign Privatization

Alongside the basic legal changes associated with FDI, the Polish government has sought several means of marketing and selling domestic enterprises to foreigners. The main responsibility for this effort resides with Poland's Ministry of Privatization. The ministry is divided into three sections: capital privatization (under which firms are commercialized); liquidation (under which firms are legally dissolved, allowing for their piecemeal sale); and mass privatization (under which a yet-to-be-created group of mutual funds will distribute shares to citizens). Many of the transactions involving foreigners are joint ventures, which may form in the aftermath of a liquidation or through the capital privatization track. In addition, foreign firms purchase assets in trade sales or

Table 17.1 Joint Ventures, 1989-91

	Poland	Czechoslovakia	Romania	Hungary	Bulgaria
1989	867	22	5	180	30
1990	2,799	1,550	1,502	4,400	140
1991:1	4,000	1,318	2,665	2,420	366

Source: *Economist*, 21 September 1991.

IPOs (initial public offerings), which are alternative outcomes under the capital privatization program.

While joint ventures are the predominant form of foreign investment by *number*, they are typically small transactions. By June 1991, there were already 4,350 joint-venture permits issued by the Foreign Investment Agency, but the average value of the total capital (of which any foreign contribution is part) was only about \$150,000.³ Table 17.1 reports the number of joint ventures in several countries through the first quarter of 1991. Table 17.2 shows the location of the foreign investors involved in joint ventures as well as the percentage of equity owned by foreigners.

While there was a good deal of excitement with joint ventures initially, that excitement has waned. In some respects, joint ventures do as much to hinder as to help the privatization effort. First, the terms on which foreigners enter are often perceived to be overly generous. The Polish Main Statistical Office reports that the average rate of return on *total* capital for joint ventures in 1990 was 86 percent. In many cases, foreigners' rate of return was much higher because foreign ownership positions are frequently obtained in return for technology and/or relatively small infusions of liquidity. To see this, we note that the average foreign financial contribution was about half the book value of the equity that foreigners received in return and that their share of total equity has averaged around 60 percent. Thus, an average foreign investor who contributed \$30.00 would receive 60 percent of a firm with \$100 in net worth. On average, one year later this venture had a net worth of \$186, of which the foreign share was \$112, a return of almost four times the initial investment of \$30.00. Even with such high payouts, Polish firms often end up competing with each other for access to foreign resources, with the result that the transactions take place at prices that are probably close to domestic reservation values. Czechoslovakia and Hungary have had similar experiences with joint ventures.⁴ Increasingly, there is concern that the joint-venture process leaves the country with little bargaining power.

A second reason that joint ventures are viewed ambiguously is that they

3. For more comprehensive data on Polish joint ventures, see Maslankiewicz (1991).

4. A commonly cited Hungarian example of underpriced selling to foreigners is that of a large light-bulb-producing firm in Hungary that was sold to one foreign group and then resold almost immediately at a 50 percent capital gain.

Table 17.2 Joint Ventures in Poland

Nationality of Foreign Investor		% Foreign Equity Ownership	
Germany	35.0%	100%	24%
Sweden	9.1%	91%–99%	7%
United States	7.6%	81%–90%	9%
Austria	7.1%	71%–80%	9%
Great Britain	7.1%	61%–70%	6%
Italy	4.7%	51%–60%	8%
France	4.7%	41%–50%	25%
Holland	4.6%	31%–40%	5%
Switzerland	3.2%	20%–30%	7%
Denmark	2.6%		

usually do not aid in the attempt to rationalize an industry's portfolio of assets. Naturally, foreigners pick the assets with which they would like to work. Because these assets are frequently part of a larger firm, the enterprise must liquidate in order to sell specific assets to the joint venture. In these circumstances, the government is left with the least-desirable assets and potentially explosive political problems (shutdowns of the only factory in a one-shop town, environmental cleanup, etc.). In the short run, there is a wedge between private and social values that arises from unemployment of resources (and all its associated political consequences). If the host country had greater bargaining power with the foreign entity, it would be able to require that the new venture deal with these problems.

Partly in response to these disadvantages to joint ventures, the capital privatization program began during 1991 actively to promote its "sectoral" approach to privatization. This approach briefly experienced a limited degree of success. Basically, the sectoral approach involves the identification and ultimate study of some 300 sectors across the economy. The basic plan is that in each sector a consultant is to be brought on to (1) identify companies operating in a given sector and analyze their viability and potential profitability, (2) assemble and prepare for dissemination the sectoral information and analysis, and (3) aid in the process of auctioning off the sectoral firms to interested foreigners. Each consultant is compensated through a retainer fee plus a contingency fee if the firms are successfully sold.

So far, approximately thirty-five sectoral studies are either in process or have already been completed. The means of choosing industries has so far been reactive: when a foreigner indicates a desire to purchase a firm, the Ministry of Privatization initiates a sectoral study. This typically takes about three months to complete, not substantially longer than a more narrowly focused bid evaluation.

The sectoral study serves several purposes. First, it gives the Ministry of Privatization representatives a reasonable basis for understanding the value of the assets and evaluating the offer. Second, it collects information on all similar

facilities in Poland. This is often of use to bidding firms, which usually would not otherwise be able to consider a broad spectrum of alternative investments. It also forms the basis for a wider marketing effort, in which investment bankers and consultants advertise the assets to a wider audience. Third, the increased publicity generates enough competition to allow the pilot firm (and usually several others in the sector) to be sold off in an auction process. Auctions are characterized by reasonable levels of competition and also provide negotiating opportunities for the Polish government to adjust the sale terms based on deviations between private and social values (i.e., employment and investment guarantees can be negotiated).

Sectoral studies would seem to economize on the costs of accomplishing foreign investment. In addition to analyzing the assets and publicizing their sales, they create a safety net for firms involved in the auction process—losing bidders begin negotiations on another firm in the industry immediately after an auction ends. This goes a long way toward conserving on the effort that foreigners must expend to learn about and acquire assets in Poland.

Sectoral privatizations also help improve the host country's bargaining position with foreign firms. The likelihood is much higher that foreigner investors will be bidding against one another, and the possibility of foreign firms playing one host-country firm off against another is eliminated. The Ministry of Privatization is therefore in a better position to negotiate labor contracts, new investment guarantees, and other foreign "investment" requirements that (arguably) have high public returns for Poland.

Finally, sectoral privatizations help generate a game plan even for those firms that do not sell. That is, this approach to privatization usually involves some degree of simultaneous restructuring. Remaining firms (which are usually smaller) can be led through some sort of MBO (management buyout) process. Before letting go, however, the Ministry of Privatization can help rationalize their operations and direct their operations into different "niche" markets.⁵ This process helps guarantee that the postprivatization industry structure has capacity smoothly distributed across various products. While competitive forces would ultimately achieve this type of industry structure (or do even better), these forces may be weak at first.⁶

There is also the argument that the negotiating process and direct government/foreign-investor contact required to make the sectoral approach work partly diffuses foreign perceptions of the costs of poorly defined property rights. To some extent, foreigners are educated in the process about the exact status of these rights. But perhaps more important, as the situation is fluid,

5. For example, in the detergent and soap sector, individual remaining firms were directed into hotel soaps and hospital soaps, respectively.

6. Such activities by the government have a ring of "industrial policy" to them and are often (rightly) criticized by economists in the case of the United States. However, in East European countries, the usual presumption that the existing allocation of capacity is nearly optimal obviously does not hold.

companies gain contacts within the government that understand their interests and keep them apprised of changes.

Initially, observers were critical of the sectoral approach, saying that it would repeatedly flood the market with waves of very similar companies. As a consequence, many were skeptical that the approach could improve host-country bargaining power, and the expectation was that prices would be low. However, this does not seem to have been the case thus far. In the recent sale of assets in the detergent sector, for example, the Ministry of Privatization received sales prices that were 2.5 times higher per ton of capacity (for smaller, somewhat less efficient firms) than did the Czechs, who have relied primarily on joint ventures. In addition to the higher prices, the auctions help lend an air of legitimacy to the selling process, creating a structure that promotes (what at least appear to be) arm's-length transactions.

Another criticism has been that the sectoral approach slows down the privatization process and takes energy away from the mass privatization effort. To the extent that this is true, the diversion must be balanced against the value of the information generated by the sectoral studies. I discuss alternative methods of combining mass privatization and sectoral studies in later sections.

But the sectoral approach's major problem—and the reason for its very recent demise—has been the opportunities for corruption that it affords. Consultants and staff were given considerable discretionary powers. By working closely with individual companies and groups of assets, and by virtue of their power to pursue “applied” industrial policies, consultants and staff often struck deals that were difficult for outsiders to scrutinize. (Indeed, there are accusations that files containing details of agreed-on deals have disappeared.) Germany's Treuhandanstalt has not fallen victim to these perceptions, partly because of the integrity of the German system.

In sum, Poland has made dramatic changes both in the legal basis for foreign investment and in the way in which enterprises are sold to foreigners. Some of these changes (e.g., the emphasis on the sectoral approach to privatization) can be interpreted as helping increase domestic bargaining power *via-à-vis* foreigners. All are at least partly driven by the need to lower the costs of foreigners learning about and investing in doing business in Poland and to raise foreigners' reservation prices for investing.

In the wake of the sectoral approach's demise, it is useful to remember that the earlier FDI tracks (e.g., joint ventures) were also not altogether desirable. It may be wise for Poland to make foreign investors wait for access and in the meanwhile spur on the progress of the mass privatization program for domestics. After these privatizations are completed, there would be room for a revamped sectoral approach, which could help market privately owned firms to foreigners. The informational advantages of the sectoral approach could in this way be retained, but, in these circumstances, the possibilities for corruption would be reduced, as private owners would be the primary counterparty in negotiations with foreigners.

17.2 Foreign Reservation Values

Next I turn to the puzzle of why foreign purchase prices appear to be so low in the first place. In general, one would expect foreigners to value East European assets far more highly than do East Europeans. In this section, I briefly discuss several of the determinants of foreign reservation values as well as the potential for policy-based measures to affect them. In the next section, I discuss the issue of foreign versus domestic bargaining power and how the design of the privatization process affects that power.

The simplest view of foreign reservation values is that they are generated by what foreigners would earn by acquiring East European operations. The overwhelmingly obvious presumption is that foreigners have better technology, more comprehensive experience with doing business in a market-based economy, better knowledge of and relations with suppliers and distributors, better risk-sharing capabilities, and much greater financial strength.⁷ All else equal, these advantages should translate into a tendency for foreigners to pay more for East European assets than do domestic residents.

Foreigners may also be willing to pay more than domestics because they perceive an option value to establishing a “toehold” in the East European market. The aforementioned advantages that Westerners have are most valuable when the domestic economy turns out to be robust and grows rapidly. In such states, foreigners will be in a better position to expand sales and production rapidly than domestic firms that face capital and managerial talent constraints. To the extent that the level of uncertainty about these economies is high, this expansion option may be quite valuable.

Surveys of foreign investor sentiment suggest that this option value is important. Collins and Rodrik (1991) conducted a survey of multinational business focusing on attitudes toward investing in Eastern Europe. Businesses seemed to perceive that current investments gave them the ability to “beat out the competition” and “get to the market first”; indeed, these benefits of investment were ranked well above the benefits associated with low costs of production and a relatively skilled work force. Such perceptions seem to reflect the possibility that first-comers derive disproportionately large benefits from market access in certain states of the world and that, in these states, they will be in a privileged position to increase profits.⁸

However, not all forces tend to drive foreign reservation values above those

7. Naturally, financial strength would not matter in a world with perfect capital markets—i.e., markets in which firms do not face informational asymmetries and agency problems in their use of external financing. However, once such distortions exist, financial strength can be a source of competitive advantage. For an example of how this general idea can be applied to foreign direct investment, see Froot and Stein (1991).

8. To make sense of this story, one must also posit some form of barriers to entry at later stages. Such barriers could come from steep learning curves associated with the unique aspects of doing business in East European countries. For an example of a study that provides evidence of similar kinds of dynamic learning, see Teece (1976).

of domestic entities. For example, foreigners may suffer disproportionately from certain changes in policy, such as restrictions on dividend and profit repatriation, expropriation, controls on moving goods or foreign exchange across borders, etc. A political backlash against foreign involvement could easily motivate such policy changes (note the tenor of the discussion surrounding the relatively meager FDI inflow into the United States). This will be a particular problem if foreigners are held publicly responsible for poor macroeconomic performance or for firing workers at nonviable plants.

The penalty to foreign valuation created by the possibility of asymmetrical government policies can be mitigated in two ways. First, the government can take steps to negotiate contracts with foreign firms that stipulate how many workers must be employed, how much additional investment must be done over time, etc. Such contracts can help align private and social values. This is valuable to the country because it helps internalize the externalities associated with unemployment.

Second, governments may also endeavor to accomplish certain facets of the restructuring that foreigners would otherwise have to undertake themselves. This is again reminiscent of the Treuhandanstalt's attempts to undertake significant restructuring before privatization. Preprivatization restructuring can help guarantee that the foreign buyer will not be held responsible for the criticisms associated with plant shutdowns. Such a program may help countries precommit to eliminating certain forms of political risk from foreign investment, thereby ensuring that the interests of the government do not diverge radically from those of the foreign firm (which is when expropriation is most likely to occur).

It is sometimes argued that foreign reservation values are highest when the country is clearly committed to having a very high degree of foreign involvement (see, e.g., Wolfe 1991). The logic is that, in an economy with coordination externalities, multiple equilibria can arise. If enough firms pursue high-investment policies, then the country will experience rapid demand growth, which will in turn generate high returns on investment and support the initial high-investment policies. However, if firms pursue low-level investment strategies, then growth and returns on investment are sufficiently low to make it unprofitable for individual firms to invest more aggressively.⁹

With this in mind, some have argued that greater foreign participation makes the high-investment equilibrium more likely. This is likely to be a useful insight, especially in cases where foreigners perceive systematically higher returns on investment than do domestic entrepreneurs because of technological or financial advantages. However, it may well be that domestically owned firms are better at resolving the coordination problem that creates the multiplicity in the first place. Foreign-owned firms may make their decisions from all over the world and may not be particularly focused on the investment plans of other

9. For an example of such a model, see Murphy, Shleifer, and Vishny (1989).

firms in a given local economy. Therefore, even in the presence of multiple equilibria, it is not clear that greater levels of foreign involvement would cause higher growth.¹⁰

17.3 Selling Enterprises to Foreigners on Better Terms

There are obviously a number of good reasons why foreign and domestic entrepreneurs might have very different reservation values for East European enterprises and assets. But foreign reservation values are not the only—or perhaps even the major—practical concern in selling to foreigners. First of all, a country's total return from selling to foreigners may be high even if the pecuniary receipts are low: domestic residents may gain valuable technology and experience from a foreign presence in the economy. Some of the pecuniary returns may also come in the form of employment and investment guarantees that are valued more highly by the country. Second, the pecuniary receipts will themselves depend on the bargaining power of the country and the foreign investor in addition to the foreigner's reservation price.

The ability of the country to extract bargaining gains will be important when there is little effective competition among buyers. And competition will be inhibited by the presence of costs to potential bidders learning enough about enterprises (and about doing business in a country) to make bidding worthwhile. Such “costs of entry” are likely to be substantial.

A typical example comes from Sara Lee, Inc., which in mid-1990 was considering importing and/or producing hosiery in the East. Sara Lee chose Hungary—arguably the most promising and liberalized country for foreign investors at the time—as a potential investment site. But, after several trips by a number of senior executives and their aids, Sara Lee remained uncertain about its ability to do business there. There was confusion about the company's ability to import materials and repatriate profits, about the rules for ownership, and about the role of the State Property Agency in arranging for purchases. These explorations ultimately did yield a venture that Sara Lee considered worth pursuing—a \$60 million investment (51 percent) in a Hungarian food company. But participation involved a complete reworking of Sara Lee's food and hosiery strategy in Eastern and Western Europe. Learning about the peculiarities of doing business in Hungary and integrating that into Sara Lee's overall strategy was costly. The whole process ate up far more top-executive time than that typical for comparably sized investments.¹¹

Costly learning by foreigners can dramatically affect the terms under which East European assets should be expected to sell (if they sell at all). Reflecting their bias toward competition, economists usually envision some type of com-

10. There is some empirical work that demonstrates a positive correlation between growth and foreign direct investment inflows, but there is as yet little evidence on the direction of causality.

11. For more details, see Weiner (1990).

petitive auction mechanism for selling assets to foreigners. Regardless of the precise auction rules (Dutch, sealed-bid, English, etc.) and the distribution of information, it does not require many bidders to make the seller's reservation price largely irrelevant to the bidding. For example, in an open-outcry English auction with two bidders with (at least privately) known valuations, an asset will sell at (just above) the second highest bidder's valuation.¹² It usually goes without saying that competition among bidders raises the seller's bargaining power and the price the seller can expect to extract.

However, this conclusion no longer holds once there are costs to learning about the asset's value. The prospect of competition at the auction stage clearly disciplines a bidder's incentive to learn about the asset in the first stage. In such instances, sellers may actually gain by *eliminating* potential bidders rather than encouraging them to participate. I provide an example of a bidding model below in which an increase in the number of bidders does not increase the competitiveness of the auction.¹³

The practical point here is not so much that East European governments or enterprises will want to discourage potential foreign bidders from exploring investments in their countries. Rather, it is that the returns to increasing the universe of potential bidders may be surprising low (unless of course there is an attempt to economize on the costs of bidder information). In addition, whereas highly "redeployable" assets are thought to have relatively high liquidation values (redeployability implies a comparatively broadly based demand for a given asset), redeployable assets might be relatively more undervalued in actual East European auction sales, particularly when foreigners are the buyers. When there are costs to learning about value, having a large number of potential uses for the assets does not necessarily guarantee a high sales price.¹⁴ The presence of costs to foreign bidding therefore strongly argues for more efficient information dissemination. Because this information is a public good, its dissemination may be best accomplished by a governmental agency or trade organization.

17.3.1 Auctions with Costly Participation: An Example

This subsection offers an example of an asset sale in which an increase in the number of bidders does not increase the seller's bargaining power.

Consider a simple two-stage process in which an asset is to be sold to the

12. When bidders are imperfectly informed about an asset's true value, they may use the seller's reservation price (if it is known) in determining their own reservation prices. For a simple overview and further citations, see Milgrom (1989).

13. Bidder elimination improves seller revenues in a number of models of both sequential and simultaneous bidding. In a sequential bidding model, an initial bidder may wish to make a preemptively high initial bid in order to ward off interest from other potential bidders. Fishman (1988) shows that, in such circumstances, the seller receives higher profits than when a preemptive bid does not occur and instead bidders compete in an auction.

14. A number of authors have stressed that redeployability is critical for determining an asset's debt capacity (see, e.g., Williamson 1988; and Shleifer and Vishny 1991).

highest bidder. In the first stage, each of N risk-neutral bidders may spend an amount c to learn their valuation of the asset. In the second stage, those who spend c compete in an open-outcry English auction. The variable c can be interpreted quite broadly as including the cost not only of learning about the specifics of an investment opportunity but also of general learning about the status of property rights and enforcement mechanisms in East European countries.

I start with the simplest situation in which individual bidder reservation values contain only a common component, v_c .¹⁵ For now, I assume that it is common knowledge that $v_c = 1$. Bidders who pay the cost c are able to observe v_c .¹⁶ It is common knowledge that the seller's reservation price, v_s , equals $1/2$ and that the seller has no bargaining power in situations of bilateral negotiation: if only one bidder emerges with a reservation value greater than half, the sales price is the seller's reservation price. If more than one bidder arrives with a reservation value greater than half, then the sales price is equal to the realized common value, $v_c = 1$.

To get a sense for bidder strategies under these circumstances, note first that this example cannot support a pure-strategy bidding equilibrium. To see this, suppose that all N bidders decide to spend c and therefore to compete in the bidding. Competition in the auction will guarantee that the asset sells for a price of one, reducing to zero any expected gains from winning. However, since bidders must pay c to participate, their ex ante expected profits are negative. Individual bidders will therefore not wish to play, so the all-bidders-play outcome cannot be an equilibrium. Alternatively, it cannot be an equilibrium for bidders never to participate: if no bidders spend c to participate, a single bidder would have the incentive to deviate by paying $c < 1/2$, thereby keeping the expected profits from the auction of $1/2$ all to himself.

The equilibrium to this game involves a mixed strategy, in which the n th bidder, with probability p_n , pays c and participates in the auction. (If no bidders arrive, the asset is not sold.) The n th bidder's expected profit from participating can then be expressed as

$$(1) \quad \pi_n = p_n [E(v_c) \prod_{j \neq n} (1 - p_j) - c].$$

In the symmetrical solution to the game, each bidder chooses the same probability of participating. Bidders will have an incentive to raise the probability with which they participate as long as expected profits are positive. As a result, expected profits in (1) are driven to zero, and the common probability of participation satisfies $(1 - p)^{N-1} = c/v_c$. Substituting, the expected profit, π , received by the seller is

$$(2) \quad \pi = \frac{v_c}{2} \left\{ 1 + N \left[\left(\frac{c}{v_c} \right)^{N/N-1} - \frac{c}{v_c} \right] - \left(\frac{c}{v_c} \right)^{N/N-1} \right\},$$

15. The results are not importantly affected by whether v_c is known or random ex ante. I also allow for a random private component of value in the discussion below.

16. A related example can be found in Spatt (1989).

which is decreasing in N for $N > 1$. That is, eliminating bidders from this game *increases* the expected profit to the seller.

Essentially, bidders will participate only if they can expect to use the profits from winning the auction to amortize fully the costs of participating. All else equal, there must be *less* effective competition at the auction in order to justify the higher total learning costs associated with a larger number of bidders. (In the example above, this translates into a higher probability of an individual bidder making it to the auction alone.) More generally, when participation is costly, greater competition *ex ante* can be sustained only by effectively guaranteeing less competition *ex post*.

Costs of Bidding

There are several factors—besides the number of bidders—that help determine how “competitive” the selling-off process is likely to be. First, and most important, is the cost, c , of participating in the bidding. In the example above, if the costs of participation are removed altogether, then all N bidders participate in the auction, and the seller nets with certainty a profit of $v_c = 1$.

Bidding costs are particularly burdensome to expected seller profits because they are borne by each player individually. In the bidding game described above, suppose that the potential universe of bidders is ten. If there are no costs of participation, all ten bidders do bid with probability one, and the seller gets v_c . If, however, we introduce a cost of bidding equal to just 1 percent of the expected gain from winning the auction (i.e., $c/v_c = .01$), the probability with which bidders participate falls dramatically to .4. (Note that this implies that the expected number of participants in the auction is only four.) The addition of this 1 percent cost of bidding also lowers the seller’s expected profit by 5 percent. Thus, even with small costs of entry, bidders compete in the auction much less frequently. This, in turn, has a relatively large negative effect on the competitiveness of the auction.

The magnification effect of small costs of bidding on seller profits implies that countries have a strong incentive to provide to all bidders information that is of common value. Continuing with the example above, if each bidder needs to obtain the same set of information in order to participate, then the country could itself obtain the information for 1 percent of the asset’s value. By making this information public, the expected auction price rises by 5 percent—on net the country saves itself four times the costs of information.

Much of the learning about potential acquisitions in the East concerns the consumption of a public good. Foreign firms repeatedly report how difficult and time consuming it is to sort out the rules of the game, to understand the status (current and future) of property rights, and to determine who has the authority to do what. Simple promotional activities—such as the Hungarian government’s early efforts to provide detailed information on large companies to major European banks, investment banks, and chambers of commerce or the Polish Ministry of Privatization’s activities of studying and promoting individ-

ual sectors—have the potential to lower costs and increase the degree of competition facing foreign investors.

Seller Reservation Values

Because costs of participation make the auction mechanism imperfectly competitive, auction revenues depend importantly on the reservation price of the seller. In cases where seller reservation values are low relative to those of a relatively small number of bidders, seller reservation values will be particularly important to expected auction revenues.

It is important to clear up just what the seller's reservation value means in this context. If the seller has the option to retain control of the asset, then the reservation value depends on the cash flows that the seller would have received by holding on. As has already been discussed, there are reasons to think that these present values might be low, especially relative to those of foreigners. But in Eastern Europe there are many instances in which the present value of cash flows under the holder's control is irrelevant because the holder of the assets must sell. Even if the government and existing enterprises were able to manage the real assets of the economy in the coming years, the credibility of the transition to a decentralized market economy depends largely on the central authority's ability to divest its holdings of assets. Forced selling to foreigners could be avoided if the privatization goes through with only limited initial foreign involvement. In later stages, after firms have been privatized, the urgency to sell is reduced, and domestic reservation values will be higher.

Clearly, if there are factors (other than holding value) that prompt the seller to divest, the seller's reservation price need not equal the assets' value under the seller's control. These factors are evident in cases in which the government sells in response to political pressure. But they are also important in many other instances. Sellers of assets in Eastern Europe, whether they be governmental authorities or managers of firms or equityholders of recently privatized firms, often face severe liquidity constraints. They will view assets sales as a means of raising scarce cash.

This latter point is important because, in Poland, Hungary, and Czechoslovakia, the banking sector is extremely weak and securitization of assets (such as through public debt sales) is not likely to be practical for some time. Even if local banks are able to lend out domestically generated savings, credit allocation is likely to be poor. Recently privatized firms, for example, will find it necessary to sell assets, *not* because the assets are not useful or productive, but because they either need funds to service existing debts or wish to fund even more productive investments. Various levels of country governments, which will find it difficult to borrow for some time and which may not—or, because of slow growth, should not—raise taxes, will also have to resort to rapid asset sales. Thus, with the usual institutional sources of financial intermediation in such an underdeveloped state, asset sales become a disproportionately important source of liquidity.

The distorted importance of asset sales in supporting basic financial intermediation translates into a strong downward pressure on seller reservation prices. Such reservation values may be well below the value of the assets under the seller's control.

Private Information and the Value of Equity Retention

In the example above, the only source of potential bidder profits comes from the weak bargaining position of the seller. This weakness was manifest in the assumption that the seller receives a (relatively low) reservation price if only one high-reservation-price bidder arrives at the auction. However, expected bidder profits do not generally reflect bargaining power alone—they also reflect any private information about value that the bidder may have. The presence of private information increases the incentive for a given bidder to participate. This occurs because the auction requires the winning bidder to pay only the reservation price of the second highest participant. The greater is the dispersion of private-information values, the greater is this source of expected bidder profits.

Private information can be easily incorporated into the example above. Suppose that, instead of a common value, v_c , there is a private signal of value, v_n , $n = 1, \dots, N$, which can take on the values of zero or one with equal probability.¹⁷ By paying c , the n th bidder observes v_n and then competes in a second-price auction. The bidder enters the auction with probability p_n and has a reservation price higher than the seller with probability $p_n/2$. Thus, expected bidder profits become

$$(3) \quad \pi_n = \frac{p_n(1 - v_s)}{2} \prod_{j \neq n} \left(1 - \frac{p_j}{2}\right) - p_n c,$$

where $0 \leq v_s < 1$ is the seller's reservation price. In the symmetrical equilibrium, the common probability of participation is then

$$(4) \quad p = 2 \left[1 - \left(\frac{2c}{1 - v_s} \right) \frac{1}{N} - 1 \right], \quad \text{if } c > \frac{1}{2N}, \\ = 1 \text{ otherwise.}$$

The seller's profits are now

$$(5) \quad \pi_s = 1 - v_s - (1 - v_s) \left(1 - \frac{p}{2}\right)^{N-1} \left(1 - \frac{p}{2} + \frac{Np}{2}\right).$$

These results are similar to those above. The only real difference is that, with private information, the winning bidder expects to buy the asset at a price

17. The binomial distribution is chosen here for simplicity only and has little qualitative significance for the results. In addition, none of the results below are affected if we were to include both common and private value components in the example.

below his reservation value, even if there are other competing bidders. The possibility of positive expected profits means that sufficiently small (but positive) costs will not deter bidders from participating—expected profits can be strictly positive even when all N bidders participate with probability one. Thus, very small costs of bidding (in this case, $c < 1/2^N$) have no effect on the probability of participation and therefore no effect on seller profits. However, once costs reach a level such that the expected gains to a bidder from having the private information equal the costs of participation, $c = 1/2^N$, the situation discussed above applies. That is, small additions to the cost of bidding have large effects on the competitiveness of the auction and therefore lead to large reductions in the price that the seller can expect to receive.

Clearly, once bidders have private information, the seller is at an informational disadvantage. One way of overcoming this disadvantage—at least partially—is for the seller to retain a portion of the equity of the enterprise being sold. To see this, suppose that there are two risk-neutral bidders with privately known valuations, v_1 and v_2 , that are independent draws from a common-knowledge distribution. In an English auction format with open outcry and no costs of bidding, the seller expects to receive the second highest valuation as the winning bid, $E[\min(v_1, v_2)]$, and the i th bidder, $i = 1, 2$, expects to profit by $E[\max(v_i - v_j, 0)]$. By selling only a portion of the asset, the seller can extract some of the high-value bidder's surplus. If the seller retains a fraction α of the asset, the seller's expected profits rise to become $E[\min(v_1, v_2)] + \alpha E[|v_1 - v_2|]$.

The use of equity retention to improve seller revenue demonstrates what Milgrom (1989) calls the "linkage principle," which says that it pays the seller to link his returns to any piece of private information the bidder may have. Naturally, it is best if the linkage occurs with respect to something that is *exogenous* to the bidder's actions—otherwise, there can be a moral hazard or principle-agent problem. For example, if the ultimate realization of value depends on future bidder efforts—which are *endogenous* from the bidder's perspective—then equity retention by the seller will act as a tax on bidder effort. All else equal, the presence of this tax will reduce the value of the asset.

While the positive effects of equity retention on bidder revenue seem intuitive enough, equity retention has a second, *negative* effect on revenue if there are costs of bidding. Greater seller expected profits come at the expense of expected bidder profits, and lower bidder profits reduce the ex ante incentives for bidder participation. The result is that equity retention lowers the average competitiveness of the auction, reducing the probability of participation from that given by equation (4) to

$$(6) \quad p = 2 \left\{ 1 - \left[\frac{2c}{(1 - v_s)(1 - \alpha)} \right]^{1/N - 1} \right\}, \quad \text{if } c > \frac{1}{2^N} (1 - v_s)(1 - \alpha);$$

$$= 1 \text{ otherwise.}$$

Seller profits therefore rise to the extent that the seller retains a share α of equity in the asset but fall to the extent that lower bidder profits reduce the competitiveness of the auction. It is easy to show that expected seller profits are now

$$(7) \quad \pi_s = 1 - v_s - (1 - v_s) \left(1 - \frac{p}{2}\right)^{N-1} \left(1 - \frac{p}{2} + \frac{Np}{2}\right) + \alpha(1 - v_s) \frac{Np}{2} \left(1 - \frac{p}{2}\right)^{N-1}.$$

Even though these two effects act in opposite directions, several unambiguous results emerge. It is possible to show that, for small costs of participation, retention of equity by the seller typically *raises* profits. The reason is that equity retention increases the perceived ex ante costs of bidding by a factor of $1/(1 - \alpha)$. By making costs sufficiently small, the resulting anticompetitiveness effect can be made small as well. But, even as costs go to zero, the positive effect on seller profits of equity retention does not. Thus, with small costs of bidding, equity retention improves the position of the seller.

Figure 17.1 helps us see the behavior of seller profits in these circumstances. The bold line represents profits from a direct auction with private bidder values. The line is convex because (as is the case with common values above) relatively small costs have a disproportionately large negative effect on seller profits. The larger the costs of participation become, however, the smaller is the effect on seller profits of a marginal increase in costs. The dotted line in

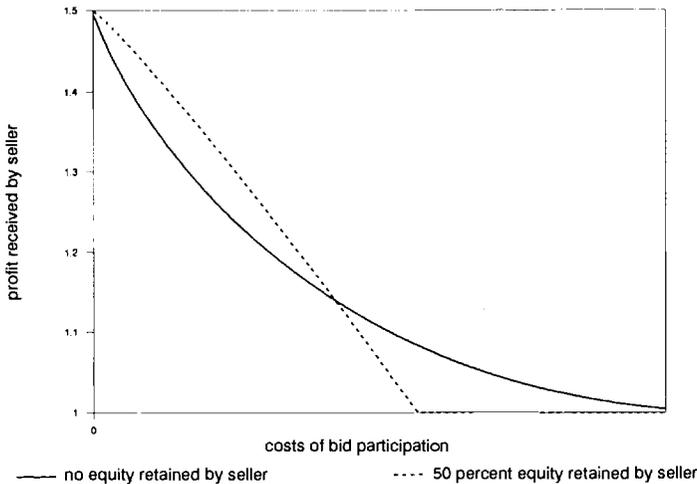


Fig. 17.1 The effect on expected seller profits of equity retention by the seller in an auction with private bidder valuations

the figure represents seller profits when part of the equity is retained by the seller. Note that equity retention mitigates the anticompetitive effects of costly participation when costs are small (relative, i.e., to expected bidder profits conditional on participating in the auction). When costs become large, however, the seller is made worse off if he retains some of the equity. Equity retention increases the ratio of bidding costs to bidding profits for given c ; the result is a lower threshold level of c at which bidders refuse to participate with any positive probability. The less equity is retained, the smaller is the range in which equity retention leads to lower seller profits.

As in the case with no private information, sellers can raise expected profits through the ex ante elimination of bidders, provided that $c > 1/2^N$. This is true regardless of whether the seller plans to retain a portion of the equity. However, once costs are small enough or there are few enough bidders (so that $c < 1/2^N$), bidder elimination is no longer in the seller's interests. At this point, there are so few bidders that bidders expect to gain more from the bidding advantage conferred by the private information than they expect to pay to obtain it (c). Thus, because expected bidder profits are not dissipated through competition or bidding costs, bidders participate with probability one.

Figure 17.2 shows the effect on expected seller profits of an elimination of bidders. Figure 17.3 does the same when the seller is to retain half the asset's equity. Note that, regardless of the number of bidders, equity retention raises seller profits for small relative costs of bidding.

In spite of the potential theoretical benefits to equity retention, there are in practice a number of potential costs of such a policy. For assets that do not have legitimate private owners, complete divestment by the government may

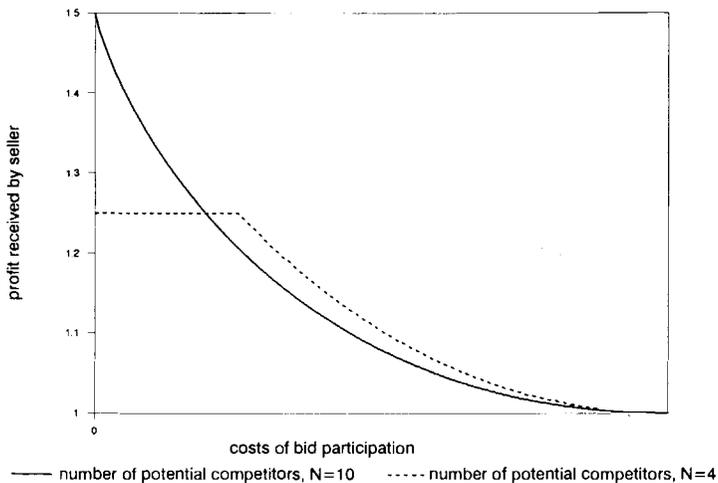


Fig. 17.2 Expected seller profits from an auction with private valuations and no equity retention by the seller

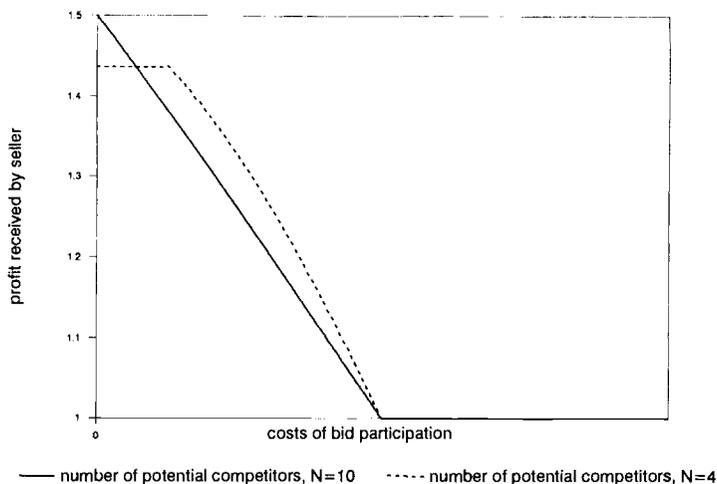


Fig. 17.3 Expected seller profits from an auction with private valuations and 50 percent equity retention by the seller

be a political goal. Minority equity retention by some form of centralized “development fund” is of questionable political viability.

17.3.2 Two-Step Sales to Foreigners

It would seem that holders of East European assets face a dilemma in realizing a high value when selling. The greater the share of the equity they retain, the more they expose themselves to political criticisms that privatization has failed. Yet, by selling a greater share, they suffer more from weak bargaining power and the imperfectness of the auction competition. However, the costs and benefits implied by this trade-off are not immutably fixed—they depend critically on who is selling the equity. In this subsection, I look at the ability of sellers to enhance their revenues by separating control from residual ownership and by selling the ownership of the assets in a two-stage process.

The first point to note is that a country’s bargaining position can be strategically strengthened if foreigners must buy shares from a large number of small investors. These investors will have the incentive to free-ride on any common-knowledge improvements in operations and efficiency that foreigners bring. Since individual shareholders do not view their behavior as pivotal in a foreign acquisition, they will sell into a foreign tender offer only if the price is that which they expect under foreign management.¹⁸

To take a simple example, suppose that, under existing management, an uncommercialized East European firm is worth 100. Also, suppose that it is

18. The point that the free-riding of small shareholders reduces a raider’s profits from taking over a firm was first made by Grossman and Hart (1980).

known that a foreign buyer could effect managerial and operational changes to make this firm worth 200 and that this amount is both observable and verifiable by third parties. If the government (or the firm's management) must bargain bilaterally with the foreign suitor, it can be expected to extract an amount between 100 and 200, say, 150. However, if the shares of the firm are widely dispersed, a public offer by the foreign firm of 150 would not be sufficient to induce small investors to tender. Each small investor—who perceives himself to have no effect on the offer's success—would reason that, by holding on, his shares would be worth 200, rather than the 150 received by tendering. That is, if investors are to tender their shares, they will demand in return the full value of the firm under foreign control. The free-rider problem therefore gives to small investors credible bargaining strength.

Many of the most popularly discussed privatization proposals include measures for widespread share distribution. However, in most cases, these shares are envisioned to be held in blocks by a limited number of investors: investment and pension funds, workers and management, some form of state development fund. These groups of investors are not exactly small, but holdings by even a limited number of investors will give the country much more bargaining power than would a single share owner. Greater bargaining power with foreigners may therefore be a little-stressed advantage of mass privatization policies that emphasize broad share distribution.

This advantage remains even if it is not practical to promote earnest foreign involvement quickly on reasonable terms. It takes time for the government to gather information and contact potential foreign bidders. However, even if the process of engaging foreign investors is slow, there are benefits to pushing quickly ahead with mass privatization. These benefits include not only the avoidance of ambiguities about ownership and control rights but also the ability to negotiate better with foreigners when the time comes. Thus, a two-step approach to firms that are ultimately to be owned by foreigners may be a good one.

In many ways, the actual terms paid by foreign acquirers are not so important politically as are the means by which the terms are determined. That is, there is likely to be suspicion about the legitimacy of insider transactions involving only government representatives and the foreign acquirer. Arm's-length transactions, or negotiated transactions in which representatives from the domestic firm also participate, would make corrupt transactions more difficult.

The economics of two-step foreign acquisitions can be taken one step further, to say something about the voting power of the shares that the government ought to distribute to small investors. To see this, suppose that the foreign firm in the example above receives observable (but not verifiable) private benefits of 40 from controlling the enterprise. (This is in addition to the 200 in value that foreign control generates.) These private benefits can arise from perks to management, from the multinational's increased ability to use transfer pricing to raise its profits, and from other nonpecuniary transfers back to the foreign

parent (e.g., greater familiarity with Eastern markets and with the process of doing business in the East, option value of undertaking further investments, etc.). If the shares have full voting power (one share, one vote) and are initially distributed by the government to many different investors, the foreign firm will still succeed in acquiring the shares by making a tender offer of 200. In other words, small investors *do not* have bargaining power with respect to private benefits that accrue to the foreign firm.

However, this is not the case for the host government (or the firm's management). A central authority will have just as much bargaining power with respect to private benefits as it does with respect to verifiable benefits. So, in this example, it would make sense for the government to retain a "golden share" with special control privileges and to distribute nonvoting equity in the mass privatization stage. A foreign acquirer would then have to negotiate to obtain the golden share while acquiring at arm's length nonvoting shares. By employing this particular ownership/control structure, the host country will retain the full value of the verifiable component of foreign-firm value as well as a share (say, 50 percent) of the private benefits received by the foreign firm. Thus, total host-country gains are $200 + 40/2 = 220$ —much greater than the $150 = 40/2 = 170$ that would result from a negotiation with the government for all the host-country firm's equity.

In practice, such a negotiation would let the government retain its ability to negotiate with foreign investors about future employment and investment spending. It may be that this form of expenditure by foreign firms has a relatively high social return so that it would be very costly for the government to give up its negotiating strength by selling all rights to enterprise control in the mass privatization phase.

17.4 Conclusions

This analysis of the behavior of country bargaining power leads to two types of prescriptions for encouraging FDI and improving the terms on which it takes place. First, it is clear that there are large returns to centralized efforts to collect and disseminate information about the assets and about how to operate them in the host country. If borne by individual bidders, such costs—even if they are small—can have large effects on the degree of foreign competition for domestic assets and on the revenues received by host countries.

Second, if the information acquisition phase takes time, it may be useful to go ahead immediately with some form of mass privatization. Privatization may be best accomplished if done quickly. Furthermore, privatization places a substantial number of shares in private hands so that interested foreign investors must negotiate for shares or purchase them in arm's-length transactions from a variety of private owners in addition to the government. This is likely to help guarantee better purchase terms and to contribute to a greater sense of fairness. To facilitate the government's ability to dictate nonprice terms (such as em-

ployment and investment guarantees), it may be useful for the government to retain some form of control through a golden share. Foreign investors would then have to negotiate for control while needing to tender for ownership of the economic up side.

References

- Collins, Susan M., and Dani Rodrik. 1991. *Eastern Europe and the Soviet Union in the world economy*. Washington, D.C.: Institute for International Economics.
- Fishman, Michael J. 1988. A theory of preemptive takeover bidding. *Rand Journal of Economics* 19:88–101.
- Froot, Kenneth A., and Jeremy Stein. 1991. Exchange rates and foreign direct investment: An imperfect capital markets approach. *Quarterly Journal of Economics*, vol. 56 (November).
- Grossman, S., and O. Hart. 1980. Takeover bids, the free-rider problem, and the theory of the corporation. *Bell Journal of Economics* 11:42–64.
- Maslankiewicz, Jerzy. 1991. Foreign investment in Poland. Warsaw: Foreign Investment Agency, June. Mimeo.
- Milgrom, Paul. 1989. Auctions and bidding: A primer. *Journal of Economic Perspectives* 3 (Summer): 3–23.
- Murphy, Kevin M., Andrei Shleifer, and Robert W. Vishny. 1989. Industrialization and the big push. *Journal of Political Economy* 97 (October): 1003–26.
- Shleifer, Andrei, and Robert W. Vishny. 1991. Asset sales and debt capacity. Working paper. Cambridge, Mass.: NBER, August.
- Soós, Károly Attila. 1991. The changing role of joint ventures in the Central-Eastern European transition process. Institute for East-West Security Studies, July. Typescript.
- Spar, Debora L. 1991. The political economy of foreign direct investment in Eastern Europe. Harvard Business School, November. Typescript.
- Spatt, C. S. 1989. Strategic analyses of takeover bids. In *Financial markets and incomplete information*, ed. S. Bhattacharya and G. Constantinides. Totowa, N.J.: Rowman & Littlefield.
- Teece, D. 1976. *The multinational corporation and the resource cost of international technology transfer*. Cambridge, Mass.: Ballinger.
- Weiner, Steve. 1990. On the road to Eastern Europe. *Forbes*, 10 December.
- Williamson, Oliver E. 1988. Corporate finance and corporate governance. *Journal of Finance* 43 (July): 567–92.
- Wolfe, Holgar. 1991. Privatization and foreign investment in Eastern Europe. Massachusetts Institute of Technology, September. Typescript.

Discussion Summary

Pentti Kouri noted that, in practice, it is rare that there are too many foreign bidders in auctions of state assets. He criticized Froot's emphasis on this special case. Kouri also critiqued Froot's proposal for two-step sales to foreigners. Kouri said that the first step in this process, a rapid, wide-scale dissemination of equity to the general public, would severely restrict the government's capacity to implement a sensible industrial policy.

Kouri estimated that, in 1991, Eastern Europe and Russia jointly received approximately \$1.5 billion dollars of FDI. Kouri said that this total was dominated by Czechoslovakia, Hungary, and Poland, each of which recorded roughly \$500 million of FDI. *Kalman Mizsei* and *Mark Schaffer* suggested that Kouri's estimate for Hungary was too low. Mizsei said that Hungary received \$1.2–\$1.4 billion of FDI in 1991. *Anders Aslund* said that the 1991 FDI total for Eastern Europe and Russia was approximately \$2.5 billion. Aslund also estimated that 30,000 foreign investments and joint ventures have been undertaken so far, three times the estimate given in the paper.

Simon Johnson noted that Western firms may learn about a business in Eastern Europe by sourcing from that firm. Western firms often use this knowledge to determine the potential profitability of investing in the Eastern firm. Johnson conjectured that this type of incidental information gathering reduces the cost of FDI for Western firms.

Andrew Berg supported Froot's proposal for two-stage sales to foreigners. Berg said that the government does not know enough about most state enterprises to conduct an effective program of sales to foreigners. After mass privatization, firms would be sold by private owners, who would probably have more knowledge about the asset.

Olivier Blanchard wondered why the extremely low wages in Russia had failed to attract a significant amount of FDI. Kouri responded that the ambiguous political environment and a lack of clarity in the laws on property rights have delayed the FDI process. Kouri also noted that, even after the political environment stabilizes and the laws are clarified, it will still take a substantial amount of time to complete the planning/negotiation stages of most foreign investment projects.

Geoffrey Carliner said that foreign firms could profitably invest in Russian firms that produce for the domestic Russian market. He noted that the foreign firms could repatriate their profits by purchasing the foreign exchange earned by the Russian natural resource export industry. Schaffer said that, unlike most of the East European countries, Russia will face great difficulty developing strong manufacturing export industries. He emphasized that, even before the collapse of the CMEA (Council for Mutual Economic Assistance), East Europeans were not buying Russian manufactured goods.

Aslund said that it is unlikely that FDI will generate substantial capital in-

flows to Eastern Europe and Russia during the next five to ten years. He noted that, historically, most liberalization and macro stabilization programs have been characterized by low levels of FDI during the first postreform decade. Aslund cited the cases of Spain and Mexico. He said that this kind of experience is likely to be repeated in Russia, with a possible exception in the energy sector. Aslund also noted that relatively high levels of FDI may be realized in Czechoslovakia, Hungary, and Poland because of the proximity of the large European export market.

Stanley Fischer supported the point that FDI will not play an important role in balance-of-payments financing in Russia and Eastern Europe. Fischer noted that Japan is currently the primary source of FDI and that most of Japan's FDI activity is focused in East Asia. Fischer also observed that, in Russia, there is some internal resistance to FDI. For example, many of the bureaucrats and managers who control the oil and minerals industries seem to believe that they can develop these assets without entering joint ventures with foreign firms. Finally, Fischer noted that the history of FDI in developing countries suggests that such deals work best when the FDI project itself generates the foreign exchange that the investing firm can repatriate as profit. Hence, FDI tends to occur only in export industries, suggesting that FDI cannot be relied on to restructure the overwhelming majority of industrial enterprises that manufacture products for domestic markets.

Jeffrey Sachs noted that, in Poland, there is popular resistance to sales of public assets to foreign investors; the current level of FDI activity reflects these internal constraints. However, there has not been any political resistance to joint ventures between private Polish firms and foreign firms. Hence, Sachs concluded that, if a program of mass privatization were implemented, the level of FDI activity would significantly increase.

Kenneth Froot concluded by noting that FDI cannot be counted on as an engine of growth in the near term in Eastern Europe and Russia. He observed that, historically, foreign firms have invested only in developing countries that have already demonstrated a consistent pattern of growth.