Chapter-IV

Foreign Direct Investment in Hungary and Poland
Chapter-IV

Part-I

Foreign Direct investment in Hungary

The process of transformation and integration into world economy took shape owing to social reform measures which paved the way for private property and foreign direct investment. Hungary has chosen the path of planned development since the consolidation of Communist control in 1949. Its society was highly ordered but it has tended to lack the innovative spirit associated with individual initiative. The introduction of planned development in the economy involved the abolition of market relationships and the elimination of independent decision making function of the various units of production. Within a short period the economic system was associated with a new system of tight control which spread rapidly to embrace the other areas of the society.

However, a spirit of liberalism has been rekindled, and there have been some retreat from central planning. Although the objectives of socio-economic development are still formulated in five year plans these were implemented through fiscal measures and incentives, rather than by orders from higher to lower authorities. Hungary is significantly different from other Communist countries of Eastern Europe. Hungary along with Poland have been experiencing a shift from the traditional central planning to the present market driven economy. It has successfully transformed its economy from the inefficient and obsolete central planning and marched ahead to forge a binding
relationship with its western counterpart. The impressive economic indicators in a changing global order made Hungary a fascinating country to deal with. Poland and Hungary became prominent in their effort to integrate their respective economy into the world economy and proved to be the trend-setter of a successful transition economy in the central and East European region.

**National Economic Planning:**

The years immediately after 1945 basically constituted a period of consolidation of the new system with the introduction of a planned development and most importantly the erstwhile Soviet Union approved the system. What was really amazing to observe that the newly approved system did not take account of the Hungarian conditions. Since the pre-war capitalism was believed to have failed to overcome the country's backwardness, a strong central planning seemed to offer the most effective means of modernisation.

With the introduction of the new system the role of the State gained a pivotal role in the economy. Smaller private commercial concerns were squeezed out of existence. Marker prices had no role to play within the system. Though per capita national income increased at an annual rate of 6 per cent\(^{109}\) between 1950 and 1967, the disadvantages of central planning outweighed its initial advantages.

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New Economic Mechanism

The inefficiencies associated with the central planning forced the planners and the general public to sketch out a new system that would arrest the shortages\(^\text{110}\) and provide a fillip to the downward movement of the economy. The new system offered the enterprises much-needed opportunity of taking the investment decision with considerable freedom. Hence the decision was market responsive instead of State sponsored. A portion of profit was allowed to be reinvested than to be siphoned off to cover the loss making units as was earlier. Price system was made more flexible and enterprises were permitted to trade directly with their foreign partners. A beginning was made to integrate the Hungarian price system into the world price system. It has been said that the success of the NEM was primarily reflected in its ability to prevent the declining trend in the Hungarian economy. The process of arresting the declining trend of the economy was later reflected in other communist countries during the 1970s.

Post-Socialist Scenario

Although the official rhetoric in most transition economies has been in favour of foreign direct investment (FDI), few countries have succeeded in attracting sizable inflows. This is despite a dramatic rise in capital flows to developing countries in the early 1990s. The Former Soviet Union and Central and Eastern Europe, with an aggregate Gross Domestic product (GDP) equal to around 20 per cent of all developing country’s GDP, received around 12 per cent of all capital flows to all developing

economies. Clearly, rhetoric alone was not sufficient. It had to be matched by deeds such as privatisation and a business-friendly institutional and policy environment.

Among the transition economies some have been quite successful in attracting foreign capital and Hungary stands out prominently among them. During the early stages of the European Union (EU) accession in 1990-93 Hungary absorbed almost half (45 per cent) of total FDI inflows to 25 countries of the former Soviet Union and Central and Eastern Europe. Its share of FDI subsequently fell to around 25 per cent once other Central European transition economies became attractive of foreign investment. Yet, Hungary’s share of foreign investment outlays in the region from 1990 to 1997 remained very high at around 30 per cent.

Several factors helped Hungary to get ahead of other transition economies in terms of attracting FDI. These included earlier reforms under central planning, strong political commitment to attract foreign capital to finance current account deficits and external debt, and the credible commitment of successive governments to establishing competitive markets.

By 1998, annual inflows of FDI to Hungary had been about 5 per cent of GDP for eight years, and the cumulative impact on the Hungarian economy was huge. Foreign capital accounted for around 20 to 25 per cent of domestic investment outlays. According to an estimate by the World Bank (1999), foreign firms now account for almost two-

111 Bartlomiej, Kaminsky and Michelle, Riboud, “Foreign Investment and Restructuring; The Evidence from Hungary”, World Bank Technical Paper, no. 453, p.1
112 http://www.wbln0018.worldbank.org/eca/eca.nsf
113 Ibid.
114 See n.4.
thirds of total investment and employ around 40 per cent of the Hungarian workforce\textsuperscript{115}. The scope of foreign investment embracing all sectors of Hungarian economy particularly those tradable has no counterpart in other transition economies. For better or worse, behaviour of foreign-owned forms controls the dynamics of the Hungarian economic performance.

A large number of studies were undertaken by different institutions, such as, OECD, World Bank, EBRD and etc., has, however, throws light on the effects of foreign investment into the transition economy. While discussing about the effects of foreign investment into the economy it distinguishes between direct and indirect effects of industrial subsidiaries of foreign firms in a host county. The potential positive direct economic effect is an increase in the real income in a host country accrued due to the import of capital, technology, and skills. However, if government subsidies play the role to obtain profits from the foreign firm then the net benefit fails to materialise. Because the cost of subsidies could become higher than the benefit caused by foreign investment. Externalities or side effects include the diffusion imported skills efficiency both horizontally and vertically and the creation of close links with “home” economies. It has been observed that domestic firms become more competitive and the competitiveness brings efficiency and hence, the market forces plays a predominant role and pushes the central planning into the backseat.

It is a consensus that in both direct and indirect investment the benefits, indeed, goes to the developed economies than to the developing economies. Two sets of factors are usually responsible for the failure of the developing economies to grab the benefits.

\textsuperscript{115} http://www.worldbank.org
First, ill-founded policies employed to attract foreign investment might wipe out the positive effect of foreign investment on real income. Excessive indirect subsidies (protection) or direct subsidies (tax holidays) or project-specific investment in infrastructure to foreign firms might raise the price of certain goods well above that in international markets. A country would then be better off importing rather than producing the goods. Many countries offering high protection to foreign investors belatedly discovered that their domestic industries were unable to compete in international markets. There has been strong evidence that subsidies offered to foreign investors have been usually self-defeating (World Bank 1994).  

Second, indirect benefits may be weakened, if not entirely erased, by the inability of domestic firms to take advantage of new opportunities. Since spillovers to other firms are crucial for economic growth, foreign investment does little to spur economic growth. The evidence on spillover effects remains ambiguous. In a number of cases studies pointed to significant positive spillovers where the local skills and the technological progress adopted the techniques used elsewhere. On the other hand some studies undertaken by EBRD have found a statistically significant negative spillover effect of foreign participation on firms. Although negative spillover may simply suggest the lack of ability among domestic firms to benefit from know-how diffusion, it remains unclear why the performance of domestic firms in an industry worsens with the increased number of foreign owned firms.

One possible explanation is selectivity bias that the best performing domestic firms attract interest among outside investors. Furthermore, firms acquired by foreign investors increase their edge over domestic firms. In a study of Czech firms (World Bank, 1998)\textsuperscript{119} it was found that total productivity growth is positively correlated with the extent of foreign ownership. Firms fully owned by foreigners perform better than joint ventures. A number of other studies on performance to firms purchased by outside investors in transition economies corroborate this result.\textsuperscript{120}

It seems that FDI offers the most efficient way to take advantage of growth opportunities offered by the global economy. Firms receiving FDI are not only efficient but also have direct access to the global networks of their parent companies. FDI offers the opportunity to become part of a process in which a firm can adapt itself to obtain benefits from the foreign investment. An estimated one-third of world trade is among affiliates of single company.\textsuperscript{121} Becoming part of the production and distribution network of a multinational corporation (MNC) offers an inexpensive way to market products.

Hence, with the growth in foreign penetration industries should become more competitive internationally. In Hungary the share of locally owned firms has been precipitously falling since around 1991. The extent of foreign penetration of the Hungarian economy has been substantial not only by the standards of transition economies but also by those of most successful developing countries.\textsuperscript{122} Foreign firms account for almost two-thirds of total investment expenditure, which suggests that their

\textsuperscript{119} http://www.worldbank.org
\textsuperscript{121} Ibid, p. 72.
\textsuperscript{122} http://www.combinet.net/indicators/fordirin.htm
dominance would continue to grow in future. Under these circumstances the question whether spillovers are negative or positive seems to have little relevance.

However, there are other important aspects that have been considered in relation to the impact of FDI on employment. Some suggest that FDI in Hungary has contributed to increases in productivity but not a corresponding (World Bank, 1997). Others complain about the emergence of a dual economy\(^{123}\) – one side increasingly modern and efficient, and the other increasingly backward. Other interesting questions relate to what this omnipresence of foreign firms may mean to current and future economic performance. Considering that Hungarian firms would have been facing competitive pressure of a single European Market, will abundant FDI put them in a better position to withstand these pressures?

What matters for the capacity to compete is survival of economic activity at the higher end of a value-added spectrum. While ultimately the outcome depends on government polices, main FDI-related components pointing to the potential for sustainable performance might be traced. These include characteristics of industries attracting FDI in terms of factor and R&D intensities, and the financial performance i.e., profits, investment activity, and foreign trade orientation of foreign owned firms. These

\(^{123}\) A system in which an economy is consisting of two major sectors. One industrial and the other agricultural breaking the economy into two sectors and looking at the interaction between them is said to increase the understanding of development process. The agricultural sector features subsistence farming often using primitive and inefficient techniques. Standards of living and wages are low. In the urban industrial sector, although wage levels are often high there is a wide spread poverty and unemployment because people are attracted to the urban areas by the high wages but are unable to find employment. This is a major problem in most developing countries but some of the worst examples are South America where huge shanty towns have grown up around the major cities because people can not find employment or accommodation and are unwilling or unable to return to the rural areas. For detail see Lewis-Feiranis model.
aspects of FDI shed light on long-term effects of foreign-owned firms on the Hungarian economy. With privatisation nearing its completion, sudden surges in FDI inflows are rather unlikely, but reinvested earning of foreign-owned firms seem to guarantee their growing presence in the Hungarian economy.

Scope and Depth of Foreign Direct Investment in Hungary

Structural reforms and sound macroeconomic fundamentals are clearly necessary conditions to attract capital flows. Among various determinants of FDI examined in empirical studies, the strength of macroeconomic fundamentals as measured by GDP growth has been consistently very important. Hungary’s impressive growth performance, which raised its GDP per capita from 64 per cent of the EU average in 1983 to 90 per cent in 1996, can be attributed directly to two factors - sound macroeconomic policies and its ability to act as a magnet for U.S. investment.\textsuperscript{124}

Studies of capital flow seem to agree on two observations. Official flows lead or stimulate countries’ reform efforts, where as private capital flows, with FDI as most important component, follow or respond to reform measures. A recent study undertaken by EBRD has found that liberal reform measures provide a powerful explanation for variation in FDI flows to former centrally planned economies (CPEs) than to other developing countries.\textsuperscript{125} Indeed, leaving aside investment in non-renewable natural resources, which are partly immune to an economic regime, there has been rather a strong

\textsuperscript{124} http://www.bizsites.com/1999/impexp.html

and positive relationship between the FDI inflows and the macroeconomic stability in dismantling central planning.

Due to European Association Agreements, the condition of former CPEs improved in access to EU markets. It often referred simply as the "EU factor," that has clearly acted as a magnet for foreign investors. Yet, the former, (that is liberal) reforms seem to prevail over the "EU factor" alone, as the experience of Bulgaria and Romania shows.

The patterns of developments in aggregate FDI inflows to transition economies seem to confirm these observations. Garibaldi and others (1999) argue that the increase in FDI inflows per capita in 1994-95 coincided with the period when in transition economies reforms have begun to take hold, inflation rates fell and growth resumed. Indeed, there was a dramatic increase from $18 per capita in 1994 to $43 per capita in 1995. However, despite rebounding economies and progress in macroeconomic stabilisation, former Soviet republics (excluding Baltic States) failed to increase their share in FDI. Two developments i.e., Hungary’s "big privatisation" sale and Poland’s improved creditworthiness due to the completion of Club of London negotiations, accounted largely for the increase in FDI.

Hungarian Perspective

The EU factor, combined with the rapid movement away from central planning and macroeconomic stability provides a good explanation why the bulk of flows to transition economies went to Central Europe. But these general characteristics fail to explain, for instance, why the Czech republic, with lower inflation and debt, attracted less
FDI than Hungary. It also fails to explain why Poland, despite its much stronger GDP growth performance, has attracted relatively less FDI than the Czech republic.

Hungary together with Poland has received the largest inflow of FDI from 1990 to 1997. But Poland’s economy is almost four times larger, and so is its population. Hungary has a huge lead over other popular transition economies among foreign investors, measured in terms of flows per capita or share of GDP. Cumulative inflows of FDI per capita from 1990 to 1997 to Hungary were 1.8 times larger than to the second largest recipient, the Czech republic. Similarly large are the differences in cumulative inflows of foreign investment in terms of GDP per capita: Hungary absorbed 1.5 times more than the second largest recipient, Estonia.

Inflows amounting on an average to 5 per cent of GDP have produced a very significant penetration of the Hungarian economy by foreign capital – much more extensive than in any other transition economy. In addition, the share of foreign-owned manufacturing enterprises in investment outlays in Hungary amounted to 83 per cent in 1996 (Havlik, 1999). This was 40 per cent more than this share in Poland, which scored second among transition economies.

After all, the Central European countries share similar characteristics. They are all in the EU accession pipeline, thus benefiting from the “EU factor”. They are all well endowed with relatively cheap skill labour, which is associated with a high volume of direct investment (Markusen, 1998). In various surveys of transition economies the Central European countries are usually classified as the most advanced reformers (EBRD

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126 http://www.khb.hu/docs/elemzes/FDIamongCEEcountries.pdf
1998, World Bank 1996, and World Bank 1997). Thus, one would expect a much lower variation in terms of the ratio of FDI to GDP.\textsuperscript{127}

It seems Hungary has been better positioned to benefit from the sharp rise in FDI to developing countries in the 1990s for four reasons. First, Hungary was saddled with a huge international debt at the outset of its full-fledged transition to competitive markets. Unlike Poland, however, it had never sought rescheduling; nor had it defaulted in its payments to private or public creditors. Therefore, Hungary's creditworthiness remained high. Moreover, earlier dealings with international financial community helped Hungarians develop considerable financial management and negotiating skills. Therefore, despite heavy indebtedness, Hungary was perceived as a reliable and creditworthy partner.

Second, early liberalisation of foreign investment, including limited investment opportunity dating back to 1972, set the groundwork for the current high levels of FDI. Limited joint ventures with foreign partners were already allowed under central planning: the 1972 Law permitted establishment of firms with foreign participation not exceeding 50 per cent of the equity. The domestic majority ownership requirement was abolished in 1988. While these legal provisions were of little practical consequence in 1972, they turned out to have positive impact once central planning was abolished. Thanks to the 1972 Law some large MNEs established their presence, but began investing only in late 1980s. In other words, earlier joint ventures have often led to follow-up investments.

\textsuperscript{127} World Investment Report, 2000, p.125.
The early joint ventures enabled foreigners to receive the help of local partners, usually state enterprises, in negotiating the legal and bureaucratic hurdles facing businesses. As the Hungarian private sector was allowed a larger role, foreigners increased their stake in their joint ventures and began to integrate their Hungarian units with their operations abroad. Although the overall number of joint ventures has decreased recently (because the inactive ones were liquidated), new wholly owned subsidiaries have become the norm, not the exception. In 1992, the foreigners’ stake was most often a blocking minority; but this slowly changed over the years, and wholly owned subsidiaries have become more common.

Third, Hungarian firms were allowed to establish direct horizontal links with Western firms. They had been involved in subcontracting since 1968, which created a good base for foreign investors to respond to new opportunities created by the collapse of communism, and for Hungarian managers to seek foreign partnerships. Many first time joint ventures were simply a more advanced stage in this long lasting relation (Hamar, 1998) but eventually they helped generate a virtuous circle of FDI. Investments by MNEs have paved the way for other investments. These include investments made by competing MNEs in similar lines of products as well as subcontractors investing in major MNEs that purchase their products. Early entry of foreign capital has also facilitated participation of foreign investors in privatisation.

Fourth, the Hungarian privatisation programme has specifically targeted outside investors. Hungary has pursued an active policy of selling firms to strategic investors on a case-by-case basis. During the initial stages of restructuring the state played an active role by “packaging” state-owned firms for sale to outside bidders. Furthermore, Hungary
moved much earlier than other transition economies to open the so-called "strategic" sectors to foreign investors. This has set Hungary apart from other transition economies in terms of the scope and timing of the opening. With almost two thirds of privatised assets purchased by foreign, the Hungarian central budget received around $6.4 billion in foreign exchange between 1991 and 1997. This was equivalent of 43 per cent of total FDI inflows during this period.\textsuperscript{128}

The policy of privatisation has generated various cycle of foreign investment measures aimed at deepening the financial sector and opening service to foreign capital have created a favourable environment for FDI in the areas. The inflows of foreign capital have increased competition and improved services. Hungary's banking sector, for instance, is regarded as the best in the region. This can be attributed to a well-designed Government programme of restructuring domestic banks and entry of foreign banks into the country. A whole array of high-quality services—financial intermediation, poor services, telecommunication and others has increased the attractiveness of Hungary to foreign investors. It has also facilitated the inflow of foreign exchange by reducing transaction costs.

Hungary's success in attracting large inflows of FDI sheds light on factors explaining the variation in FDI flows to Central European associates of the European Union. The choice of a method of privatisation, i.e., sale to outside investor in a business-friendly environment and an earlier record of horizontal contacts with Western firms proved to be the relevant ones. While Poland also meets these criteria, a slower pace of privatisation of strategic sectors and the unsolved issue of Poland's restructured private

\textsuperscript{128} Ibid.
debt (until the 1994 London Club deal) negatively impacted FDI. Hungary’s edge over other associate countries can be attributed to an earlier start compared to other Central and Eastern European countries.

To sum up, the answer to the question why Hungary outperformed other countries rests on three interrelated premises: the record of high and historically established creditworthiness, a unique record of opening to the external world foreign investment under central planning, and the Hungarian approach towards microeconomic restructuring and privatisation. An inherited debt seemed initially a liability, but was turned into an asset with a courageous strategic decision not to default on the huge international debt. The authorities had to actively pursue other ways of financing servicing of the external debt. Non debt-creating foreign investment has been the obvious choice. Debt management considerations seem to have provided a strong motive to choose piece-by-piece privatisation to an outside bidder and open the strategic sectors to “external” privatisation earlier than in other transition economies. In addition, restructuring policies have been designed to establish a business environment friendly to foreign and domestic investors alike.

Penetration by Foreign Capital

The first concerns the scope of FDI, and the second relates to its distinctive features. Clearly, the 'weight' of foreign firms in the Hungarian economy is quite dramatic. Foreign firms employ around 40 per cent of the Hungarian workforce. Around half of domestically produced products and services come from firms with foreign
participation. On the basis of these observations alone, one could conclude that almost the entire economy of Hungary has been taken over by foreign capital.

Furthermore, the significance of firms with foreign participation will grow even without new FDI inflows. Their share in total investment considerably exceeds their weight in terms of other indicators. The share of foreign firms in total investment tripled between 1989 and 1991. It increased from 11 to 30 per cent and more than doubled thereafter reaching 62 per cent in 1996. With the share of foreign firms in the total of all newly incorporated firms in 1997 reaching two-third, their role will continue growing. In the manufacturing sector there been a dramatic expansion of firms with "FDI ownership." Their number grew from 11,620 in 1992 to 18,070 in 1996 (Hamar 1998).129

An important feature of FDI in Hungary has been its large scope in terms of sectors covered and actual number of foreign owned firms. FDI has been most widespread in manufacturing, where FDI firms are present in all major industries. Among fifteen major industries FDI firms accounted for more than 50 per cent of total sales in 1996, with other following exceptions: textiles, leather, wood, basic metal, and machinery economies, but their presence was also more evenly distributed across industries.

Although the manufacturing sectors has received the largest FDI inflows of $4.2 billion from 1989 to 1996, accounting for 40 per cent of the total foreign investment stock in 1996, its share declined between 1992 and 1996.130 This was mainly because of

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opening of other sectors of the economy to privatisation, particularly public utilities and energy (the 1995 “big” privatisation). The structure of capital outlay alone does not give a full indication of foreign presence, however. Overall, one in five firms had some form of foreign involvement in 1996. Their presence was particularly large in financial services, with around 60 per cent of all firms having foreign ownership and 50 per cent of assets owned by foreigners.

Hungary owes its impressive economic performance during 1996-98 to the progress achieved in microeconomic restructuring. While gradualism characterised Hungary’s approach to policy areas including foreign trade and exchange rate regimes, radicalism was its trademark in dealing with microeconomic adjustment. Janos Kornai’s aptly mentioned term Gradualism inflicted additional adjustment cost whereas radicalism fully paid off albeit with a delay. Hslopjern and Wyplosz mentioned that “deep restructuring has been partly obscured by the fact that misguided macroeconomic policies allowed some forms and banks to delay adjustment to the new environment.”

However, even if macroeconomic policies were indeed misguided, they appear to have done little to discourage foreign investors.

Long before enterprises were privatised, managers in Hungary were allowed to operate with little government control. In addition, while most of the industry assets were under the control of large state-owned enterprises, numerous small private firms were operating even in the 1960s. This kept the entrepreneurial culture alive and helped Hungarian enterprises established links with foreign enterprises and facilitated the

131 http://www.ikm.iif.hu/english/economy/capital/newfdi.htm
transition to market economy. As result, firms began restructuring even before they were privatised, which explains why this study explained that performance of privatised and state-owned firms differed less in Hungary than in other transition economies.

Privatisation and Foreign Direct Investment

Considerable experience accumulated over decades of experimenting with various forms of ownership under central planning. From the varied experience it appeared that the choice of a particular kind of privatisation policy was supported over the other available options. Many argued that dispersed, passive owner, even private would not manage enterprises better than the state. As a result, Hungary did not fall into the trap of mass privatisation, with preference given to the speed of property transfers over gains in the quality of corporate governance. It could not rely on selling a controlling stake to insiders and this practice remained limited to a large extent. Hungary adopted the practice of case by case sales to the highest bidders and encouraged foreigners to participate in the process. The objective was not only to tap foreign savings, although this was an important consideration in a highly indebted country but over all to encourage transfer of know-how and best international business practice. While the privatisation process was slow and often frustrating, corporate governance has become stable and its quality has become comparable to that in highly industrialised countries.132

The sign of restructuring was further given by the radical changes in the size of enterprises that can be observed since mid 1980s. The decline in the number of large enterprises and increase in the number of enterprises with less than 50 employees was

132 Ibid.
evident during the restructuring process. While in 1938 around 76 per cent of enterprises employed less than 50 workers, this proportion fell to less than 5 per cent in 1997, grew to 16 per cent in 1987, and reached the 1938 level of 76 per cent in 1991. This transformation reversed, almost with the stroke of a pen, a phenomenon that nearly 40 years of central planning has created.\textsuperscript{133}

These changes had a direct impact on enterprise performance. Value added in the manufacturing sector increased in real terms by 40 per cent between 1992 and 1997. Productivity measured in terms of value added per employee more than doubled and profitability almost tripled. The contribution of the private sector-and more importantly of enterprises with foreign ownership-has been determinant. While in 1992 the public sector was the dominant source of value added in the manufacturing sector, its contribution fell to 1.4 per cent in 1997. In sharp contrast, the share of enterprises with foreign ownership (more than 10 per cent of equity) increased to 67.5 per cent in 1997.\textsuperscript{134}

Foreign firms (both fully and partly owned) outperformed both locally owned firms and remaining state-owned firms on all counts. In both fully and partly foreign-owned firms' sales more than doubled, financial results improved, and firms invested heavily in new assets. For those which only became wholly or partially foreign-owned by the end of the period, improvement was equally noticeable with a modest figure. This probably reflects an expected sequence of restructuring measures – first shedding excessive labour and cutting costs before investing in new assets and expanding. At the end of the period, all indicators – cash flow to assets, cash flow to sales, assets and sales

\textsuperscript{133} Ibid.
per firm, and value added per employee – are clearly superior in wholly or partially foreign owned firms.

Impact on Performance: Employment, Productivity, and Wages

The pivotal role of firms with foreign participation invites analysis of their impact on the labour market. Do these firms create jobs? Do they have a positive impact on labour productivity? Do they create demand for highly skilled labour? The empirical evidence based on comparisons of employment pattern in domestic and foreign (both fully and partly foreign owned) firms suggest positive answer to these questions.

Restructuring in Hungary brought about substantial reallocation of labour. Between 1992 and 1997, total employment declined by 37 per cent in the manufacturing sector. This is the outcome of two factors working in opposite directions: a loss of 60 per cent job due to downsizing, merger, or liquidation of enterprise existing in 1992. And gain of 23 per cent due to newly created jobs. This increase in employment was not merely the result of the expanding share of foreign-owned in both 1992 and 1997 and initial shedding was followed by expansion in employment once restructuring had been successfully completed.

Within this overall picture, foreign-owned enterprises clearly has a positive impact, since they are responsible for 75 per cent of newly created jobs during this period. These foreign-owned enterprises absorbed a significant proportion of the labour force released by state-owned enterprises. Employment in wholly or partially foreign-

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135 [http://www.combinet.net/lindicators/fordirin.htm](http://www.combinet.net/lindicators/fordirin.htm)
136 See n. 25.
owned enterprises increased by 67 per cent over the period.\textsuperscript{137} By 1997 it represented 55 per cent of total employment in the manufacturing sector.

Labour productivity also increased dramatically from 1992 to 1997. Productivity measured in terms of real value added per employee more than doubled in the manufacturing sector. The performance of firms with foreign participation combined with the increasing proportion of workers in those firms has been solely accountable for this increase. Labour productivity increased by 68 per cent in firms with 100 per cent foreign ownership,\textsuperscript{138} and by 104 per cent in those with at least 10 per cent foreign ownership.

For enterprises that had become 100 per cent foreign-owned by 1997, productivity increased by 126 per cent. By contrast, labour productivity in enterprises remaining under public ownership as well as in domestic private firms, albeit in the latter to much lesser extent, was lower in 1997 than in 1992. This does not reflect a deteriorating situation within privatised firms but rather shows that newly created domestic firms had relatively lower labour productivity than previously existing firms.

Some of the discrepancies observed between domestic firms, private or state-owned and firms with foreign participation in terms of productivity can be attributed to the selection process during privatisation. Investors, especially foreign, tend to invest in firms that offer the highest potential. However, other factors play a determinant role. One of them is the quality of the labour force measured by its education and skills. Another is the high degree of complementarity that exists between skills and physical capital.

\textsuperscript{137} Ibid.
Among skilled workers, younger employees are in particularly high demand because of
their great capacity to absorb new knowledge and adjust to new technologies.

Available evidence does confirm that foreign firms create jobs requiring higher
skills than locally owned firms. For instance, research by Kertesi and Kollo (1999)
reported “that foreign firms employ a higher proportion of workers with higher education
(about 12 per cent in 1996 compared to 7 per cent in other types of firms). It also
confirmed that the share of young skilled workers in those enterprises has increased over
time.”139 Fazekas and Kollo (1998) also estimate that “younger have a higher workers
probability of being employed at a foreign firm within each occupational category.
Education increases this probability in white-collar occupations and in some, but not all,
manual categories. The workers heavily “over represented” in foreign firms are those
with 3-10 years of work experience”.140

As a result, it is no surprise to find that foreign enterprises pay higher wages than
domestic firms do. The differential is equal to one-third on average. It increases for
higher-skilled positions and falls below 30 per cent for lower-skilled occupational groups.

Overall, this analysis points to a substantial transformation of the labour market
and a rapid pace of restructuring in Hungary over the years of transition. Workers have
left unprofitable sectors or firms and responded to new job and skill-enhancing
opportunities. Foreign direct investment has undoubtedly played a major and positive role
in this transformation. No evidence was found that MNEs have failed to offer wages

140 Ibid.
matching gains in productivity or that they have increased disparities in income and wealth. The income inequality as measured by the difference between the lowest and the highest decimal, increased in the 1990s, but it only moved to the levels of Western Europe. After initial restructuring, foreign owned private firms have significantly expanded employment opportunities contrary to public perception.

Economic Overview of Hungary

With over $8 billion invested over the past five years, Hungary is Central Europe's leader in attracting foreign investment. This amount is nearly double that invested in any other Central European country. Moreover, nearly half of all U.S. investment in the region has gone to Hungary. A major reason why Hungary has achieved such a record despite being a small land-locked country is that Hungary's economic changeover started decades ago, as one of the path breakers to market reform under the communist system. While many of her sister COMECON states were increasing their integration eastward, Hungary sought and succeeded in many respects to open its trade and markets to the West. General Motors, Rockwell, John Deere and others were already doing business in Hungary in the mid-seventies. Owing to the major changes of late eighties and nineties, Hungary was well positioned to intensify its relationship with western and American firms.

A second aspect in Hungary's favour, one that is applicable to the rest of Central Europe, is the region's long-term growth prospects. While some estimates project a tripling of imports by the year 2000, a conservative estimate would be a doubling of import demand over the next five years. Many American firms recognise the strategy of
establishing presence and being poised to take advantage of this long-term growth. Over 400 U.S. firms are actively doing business in Hungary and the American Chamber of Commerce in Hungary is one of the largest in Europe. As a Central European base, Hungary's advantages were location and skilled labour. Budapest is two hours away from the Austrian border while labour costs in Hungary are one-seventh of that in Austria.

In 1995, Hungary undertook economic reform major with significant commercial consequences. First and foremost was the next phase of privatisation of the state sector. Major industries such as oil, gas, and energy production are all scheduled to be relinquished from state hands. A second and related task is to address the serious state debt levels. Unpopular but necessary measures are being taken by the government to rationalise prices especially in the energy sector, raise revenues through an import surcharge, introduce user fees such as university tuition fee as well as confront costs in such sacred areas as social services. The government has taken such difficult steps with the understanding that a trim and balanced economy will reap long-term benefits toward lowering inflation, keeping unemployment within manageable limits, and in strengthening trade and stimulating foreign investment.

Hungary's development into a full market economy has fuelled industrial demand for new technologies as well as releasing pent-up consumer appetites. Sectors such as telecommunications, energy, transport and the environment continued to grow. Over the past five years, Hungary has also developed industry strengths in the automotive field (with major investments by GM, Ford, Audi, Suzuki) and with an expanding automotive industry in plastics and electronics. In other areas, such as, chemicals, food processing,
construction, and especially services such as banking, tourism, franchising, and services related to information management hold very attractive business prospects.

Major Trends and Outlook

Hungary's economic reform process received a big boost in March 1995 with the announcement of a stabilisation programme. It was designed to decrease the budget deficit by 170 billion Forints (3-4 per cent of the GDP) and decrease the current account deficit to USD 2.5 billion from 1994's record high of about USD 4 billion.\textsuperscript{141} The programme cut government expenditures increased revenues; devalued the forint by 9 per cent; introduced a crawling peg exchange rate policy; added an 8 per cent surcharge on imports; and called for wage controls at state-owned companies.\textsuperscript{142}

As of mid-1995, the Hungarian economy is characterised by the following combination of macro and micro indicators: Real GDP increased by 2-3 per cent in 1994 for the first time in four years and is expected to increase by 0-2 per cent in 1995. Hungary continued to have the highest per capita debt burden in Europe: USD 31.6 billion in mid-1995.\textsuperscript{143} Rising interest payments on the debt place an extremely heavy burden on the economy.

The current account deficit reached a record high of USD 4.0 billion in 1994. If the measures introduced in March 1995 have the desired effect, the current account deficit

\textsuperscript{142} Ibid
\textsuperscript{143} Ibid, p. 154.
could decrease to USD 2.5 billion in 1995. This figure, however, counts on foreign direct investment of approximately USD 1.5 billion in 1995.\footnote{144}

Unemployment has levelled off at about 10 per cent in mid 1995, but was expected to rise slightly as a result of privatisation and restructuring at large state-owned companies. This was a decrease from the peak of 13.6 per cent reached in March 1993. It should be noted, however, that unemployment was approximately 20 per cent in some eastern countries and was as high as 75 per cent among certain minority groups such as gypsies. While in Budapest the unemployment levels were significantly lower than the 10 per cent average. As a result of the March 12 programme, inflation was expected to peak around 30-32 per cent in June/July, 1995, but average in the mid-to-high twenties for the whole year. This was up from 18.8 per cent average annual inflation in 1994 by 11 per cent. Industrial exports grew by 34 per cent and investment increased by 10-11 per cent over 1994 figures. The construction industry experienced growth in the first quarter of 1995, continuing a trend that started in 1994 after a decade of stagnation or decline.

**Government Role in the Economy**

Since 1989 the private sector in Hungary has grown from approximately 20 per cent to over 60 per cent of GDP.\footnote{145} The socialist-led government elected in 1994 stated its commitment to accelerate the privatisation programme but the process has been slow. Since the collapse of communism, the state has liquidated or privatised more than 50 per cent of its holdings and aims to increase this figure to 75 per cent. In 1994 the

\footnote{144}{http://www.worldbank.org}
\footnote{145}{World Investment Report, 1996, p. 73.}
Government spending was 59.5 per cent of gross domestic product. These MNEs puts Hungary behind the Czech Republic and Poland in reducing the role of government in the economy.

Labour

Hungary's civilian labour force of 4.5 million women and men is highly educated and skilled. The literacy rate in Hungary tops 98 per cent.\textsuperscript{146} About two-thirds of the workforce has completed some form of secondary, technical, or vocational education. Hungary is particularly strong in engineering, medicine, economics, and the sciences. Many foreign investors have praised the productivity, motivation and adaptability of Hungarian workers, however there are some chronic issues having to do with a liberal view on sick leave and absenteeism, in general. Another remnant of past practices is overstaffing. New management can overcome these problems through worker retraining programmes or early retirement. New management also has discouraged the Hungarian practice of holding down two or three jobs simultaneously and by paying higher wages.

The recent boom in foreign investment in Hungary has resulted in shortages of employees with western-style management skills. The lack of foreign language skills, formerly a major problem, is becoming less so, especially among younger Hungarians. Labour factors have not significantly affected investors' choice of technology.

Unemployment now stands at around 10 per cent,\textsuperscript{147} however there are wide regional discrepancies. In the North-eastern part of the country unemployment exceeds

\textsuperscript{147} Ibid.
20 per cent, while in Budapest and the western portion of the country, unemployment is closer to 6 per cent. Unions in Hungary are relatively weak and divided, however. Less than half the workforce is unionised (down from 90 per cent under communism). Labour-management relations tend to be collegial, with both sides negotiating labour issues at the company level, as well as the national level (within the sphere of the Interest Reconciliation Council, made up of government, employer, and organised labour representatives).

The Hungarian Labour Code guarantees employees the right to form or join trade unions and gives unions the right to operate inside a company. Unions are entitled to conclude collective bargains. Employees may elect factory councils, which the employer is obliged to consult on a number of questions, such as the privatisation of the company or plans for worker retraining. The Labour Code limits the work day (to 12 hours) and overtime, guaranteed maternity leave, at least 20 days of annual leave, at least 30 days notice, and severance pay for those employed at least three years. The law also forbids discrimination based on sex, age, or nationality. The minimum employment age is 16 years, except that apprentice programs may begin at 15. Hungary adheres to the ILO Convention Protecting Worker Rights. The ILO opened an Eastern European Office in Budapest in 1992.\(^{148}\)

\(^{148}\)Http://www.itpa.org/open/hungary.html
Infrastructure

Motorways: Hungary's transportation infrastructure is good compared to other countries in the region. While Hungary expanding to multi-lane limited access highways, the country does have a good network of high-grade two-lane highways. Paved roads connect all major cities and most rural towns, although one may encounter dirt roads in smaller villages in eastern Hungary.

Railways: Hungary has an extensive railway system which links large and medium size cities. Approximately 158 million passengers and 43 million tons of goods are transported annually across 7,600 kilometers of tracks (of this 2,184 kilometers is electrified).

Air: Hungary's major airport, Ferihegy, is located in Budapest. The airport operates from two terminals; a brand new terminal was completed in 1993. Further expansions and additions are underway. There is virtually no domestic air service in Hungary except a few services during the summer months. Some larger cities maintain airports for private aircraft and there are plans to transform former Soviet air bases into domestic passenger and cargo airfields.

Telecom: Hungary had one of Europe's least developed telecommunications systems with an installed base of 1.5 million lines (about 39 per cent accounted for by Budapest) and with a penetration rate of 15 lines per 100 persons resulting in a call completion rate of only 40 per cent. Major investments by the Hungarian Telephone Company's two foreign minority owners (Ameritech and Deutsche Telecom) have resulted in substantial
improvements. Moreover, new technologies such as Motorola's Wireless Local Loop have brought revolutionary changes in the telephone service in large parts of Hungary.

Utilities: Nearly 50 per cent of Hungary's electricity is generated by the Paks nuclear facility; the remainder was generated by coal, lignite or petroleum-fired power plants. Gas usages have been growing and would likely to expand as this sector comes under privatisation. The privatisation of the power generating system in Hungary is also expected to boost efficiencies as well as inject modern technology into the system, both for production as well as address environmental concerns.

Major Foreign Investors

Foreign concerns have invested over $8 billion in Hungary, more than half of all foreign investment in Central and Eastern Europe. The United States is the largest investor, with about $4 billion invested by mid-1995. The lists below details major investments in Hungary, to the present.

Table A

<table>
<thead>
<tr>
<th>COMPANY (Country)</th>
<th>INDUSTRY</th>
<th>INVESTOR (Country)</th>
</tr>
</thead>
<tbody>
<tr>
<td>MATAV (US)</td>
<td>Telecom</td>
<td>Ameritech (US)</td>
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<tr>
<td></td>
<td></td>
<td>Deutsche Telecom (GER)</td>
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<tr>
<td>Tungsram (US)</td>
<td>Light Bulb</td>
<td>General Electric (US)</td>
</tr>
<tr>
<td>Company</td>
<td>Industry</td>
<td>Location</td>
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<td>--------------------------</td>
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<td>-------------------</td>
</tr>
<tr>
<td>Audi Hungary</td>
<td>Car Engines</td>
<td>Volkswagen/Audi (GER)</td>
</tr>
<tr>
<td>Westel</td>
<td>Telecom</td>
<td>US West Int'l (US)</td>
</tr>
<tr>
<td>Opel Hungary</td>
<td>Autos, Parts</td>
<td>General Motors (US)</td>
</tr>
<tr>
<td>Magyar Suzuki</td>
<td>Finished Autos</td>
<td>Suzuki (JPN)</td>
</tr>
<tr>
<td>Pannon GSM</td>
<td>Telecom</td>
<td>Scandinavian PTTs</td>
</tr>
<tr>
<td>Hungaria Biztosito</td>
<td>Insurance</td>
<td>Allianz (GER)</td>
</tr>
<tr>
<td>Hungarian Euro-Expwy</td>
<td>Construction</td>
<td>Various (FR - AUS)</td>
</tr>
<tr>
<td>KOFEM</td>
<td>Aluminum</td>
<td>Alcoa (US)</td>
</tr>
<tr>
<td>NMV</td>
<td>Food/Soap</td>
<td>Feruzzi (IT)</td>
</tr>
<tr>
<td>Dunapack/Halaspack</td>
<td>Paper</td>
<td>Prinzhorn (Aus)</td>
</tr>
<tr>
<td>Ford Hungaria</td>
<td>Automotive, Parts</td>
<td>Ford (US)</td>
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<tr>
<td>Chinoin</td>
<td>Pharmaceuticals</td>
<td>Sanofi (FRA)</td>
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<tr>
<td>Fovarosi, Asvanyviz</td>
<td>Soft Drinks/Snacks</td>
<td>Pepsi International (US)</td>
</tr>
<tr>
<td>Hunguard</td>
<td>Glass</td>
<td>Guardian Glass (US)</td>
</tr>
<tr>
<td>Compack</td>
<td>Food Processing</td>
<td>Sara Lee/Douwe Egbert (US/NETH)</td>
</tr>
<tr>
<td>Unilever ($100)</td>
<td>Food/Soap</td>
<td>(HOL/UK)</td>
</tr>
<tr>
<td>NIKEX ($100)</td>
<td>Investment</td>
<td>Hungarian Inv. (UK)</td>
</tr>
</tbody>
</table>
This progress notwithstanding, Hungary still has a long way to go before bridging the gap with EU countries. Labour productivity in manufacturing was only about 30 per cent of that in Italy or Spain in 1996. Since the employment decline has now slowed down, and with the changes in ownership close to completion, maintaining the same pace of productivity gains become increasingly difficult, albeit not unlikely.

**Part II**

**FDI in Poland**

**Features of the Economy**

Poland is one of the larger European countries, with a territory of 313,000 square kilometres and 38 million inhabitants. In 1990, GDP per capita amounted to US $1,676. More than 60 per cent of the population lives in towns: the capital, Warsaw, has a population of 1.7 million. Poland has generally young population, although the share below 30 years of age decreased from 51 per cent in 1980 to 46 in 1990.\(^\text{149}\)

\(^{149}\) [http://www-partners.unctad.pollenglish/R2/wir99826.htm](http://www-partners.unctad.pollenglish/R2/wir99826.htm)

<table>
<thead>
<tr>
<th>MALEV ($100)</th>
<th>Airline</th>
<th>Alitalia/Simest (ITALY)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Coca-Cola ($100)</td>
<td>Beverages</td>
<td>Amatil (AUSTRALIA)</td>
</tr>
</tbody>
</table>

**Source:** [http://www.ikm.iif.hu/english/economy/capital/newfdi.htm](http://www.ikm.iif.hu/english/economy/capital/newfdi.htm)
workforce is well educated with fairly rapid growth in educational levels over the last two decades. Poland is well endowed with mineral resources mainly coal, lignite, copper, zinc, lead, natural gas, sulphur and salt. For a number of raw materials, including oil, it is reliant on imports. Poland has similar natural conditions for agricultural production most European countries. The long Baltic Sea coastline has provided favourable natural conditions for the development of sea transportation, fishing and shipbuilding.

Industry, including mining, manufacturing and construction, accounts for 58 per cent of GDP and employs 40 per cent of the labour force. The share of industrial output in manufacturing sector has been in the order of 90 per cent since 1997. The shares of agriculture and services in GDP are 13 per cent and 29 per cent respectively, with employment in agriculture equal to 29 per cent of the workforce and 31 per cent in the case of services. The high share of industry in GDP and the relatively low share of services stems from the concerted industrialisation efforts in Poland’s four decades of central planning following the Second World War.

Poland’s economy is dependent on foreign trade: the value of merchandise exports and imports and imports was equal to 44 per cent of GDP in 1990. Over the last decade, Poland’s share in world trade has, however, declined substantially; in 1991, Polish merchandise trade represented 0.36 and 0.38 per cent of world exports and import respectively, compared to 1975 share of 1.18 per cent for exports and 1.04 per cent for imports.

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150 Ibid.
151 Liam P. Ebrill, “Poland the Path to a Market Economy”, Occasional paper, International Monetary Fund, 1994, pp. 4 -5.
Following over forty years as a planned economy, Poland began a process of radical economic transformation in 1990. In the beginning of 1990 and 1991, GDP declined, industrial and agricultural production fell and living standards deteriorated considerably. However, there are some signs that the decline in economic activity has been arrested and perhaps reversed. With industrial output up by slightly under 1 per cent in the first nine months of 1992 relative to the same period in 1991, however, unemployment has risen to an estimated 13.6 per cent, compared to 11.8 per cent at end 1991.152

Poland suffered large losses in the Second World War; including more than one-fifth of its population and nearly 40 per cent of the capital stock. After the War, Soviet influence was a decisive factor in Poland’s immediate political and economic development. At the end of 1948, the Polish United Workers’ Party became the dominant political force.

Central planing was introduced in the period 1945 to 1949, with nationalisation of industry and foreign trade. Agriculture, unlike in other eastern European countries, remained largely in private hands. Poland was founding member of the Council for Mutual Economic Assistance (CMEA).153

Rapid industrialisation was pursued during the 1950s, but with little attention to economic costs and comparative advantage. Under the 1950-1956 Six-Year Plan, preference was given to large industrial units – the average enterprise in the state or co-

152 http://www.progressinfo.net/eng/g/g8/g8_1welf-eu.pdf
operative sector had some 1100 employees in a multi-plant structure – and small and medium-sized firms virtually ceased to exist. Foreign trade was conducted by a small number of specialised enterprises, each enjoy in a monopoly in its sphere of activity.

Change in the political leadership in 1956 led to some redirection of the economy towards satisfying demand for housing and consumer goods, within the planned framework of rapid industrialisation. Economic growth in the 1960s, however, did not keep pace with population growth; efforts to maintain the growth rate in the late 1960s at the expense of real wages led to social disturbance and a change in political leadership.

In the first half of the 1970s, a “high-tech” policy, underpinned by foreign credits and based on imported western technologies and equipment, encouraged high growth rates, functioning within a framework of strict central planning. However, the inefficient implementation of the modernisation programme, aggravated by the effect of the first oil price shock, led to a serious balance of payment crisis in 1975, when the current account deficit rose to almost 10 per cent of GDP. By 1980, external debt deficit accounted for 40 per cent of GDP. The resulting economic austerity programme let to sharp declines in GDP and living standards. Renewed social turbulence contributed to the emergence of Solidarity trade union in 1980 as a determining political force. After a period “dual power”, martial law was declared in December 1981.

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In early 1982 a market oriented economic reform programme was launched together with the introduction of strict adjustment and stabilisation measures. Real wages and per capita consumption declined initially to about 15 per cent below 1978 level.\textsuperscript{157}

Important elements of reform programme included a new legal framework for state enterprises, workers' self-management, socio-economic planning, and price liberalisation. Strict central planning was replaced by non-directive, indicative macroeconomic planning. State-owned enterprises were granted greater autonomy in economic decision making, with State intervention in enterprise management restricted to exceptional cases. Company staff, through workers' councils, were accorded the right to undertake wage bargaining and to influence fundamental management decisions, while the principle of self financing was meant to introduce harder budgetary constraints into enterprise financing.

Real growth in GDP resumed in the second half of 1982 but difficulties were soon cropped up. It included the constant bargaining between the enterprises and the authorities over State support and exceptions to the rules, high inflation and substantial shortages of officially marketed goods, and a large black market for items traded in convertible currencies.\textsuperscript{158}

The system of fixed prices was modified through the introduction of three categories; State, regulated and negotiable prices. State administered prices covered staple consumer goods, raw materials and other means of production. In most of these

\textsuperscript{157} Ibid.
cases prices were subsidised by the State budget.\textsuperscript{159} Regulated prices, for a range of intermediate goods, were set on the basis of actual production costs plus a fixed margin. Negotiable prices, applicable mostly to consumer goods, were determined between buyers and sellers.

The second stage of economic reform, initiated in 1988 aimed at deepening and strengthening market relations while preserving the role of indicative macroeconomic planning. The Law on Economic Activity of 1988 allowed private sector activity practically in all areas, including foreign trade. The Banking Law of 1989 introduced a two-tier banking system,\textsuperscript{160} making the national bank of Poland purely a central bank and established nine commercial banks. Under new foreign exchange retention scheme, exporters had the right to retain 10 to 50 per cent of their foreign exchange earnings, with the rest to be surrendered at the official exchange rate. In addition, direct government intervention in the economy was reduced. The central allocation of inputs was restricted to some "essential" items such as coal, coke, crude oil and paper pulp. However, some 70 per cent of imports remained financed through centrally allocated foreign exchange, while export quotas, necessary because of artificially low domestic prices, continued to be maintained on important raw materials.

Despite the reforms introduced between 1982 and 1989, economic resources were allocated with due regard to efficiency and comparative advantage. Price controls were widespread; at the same time, enterprises, frequently in a monopolistic position,

\textsuperscript{159} Ibid.
found it easier to raise prices or obtain subsidies than to cut costs. The budget deficit increased and, with negative real interest rates and continued availability of financing, enterprises were able to increase wages and investments without effective restraint. Flight from the Zloty to US dollar and other convertible currencies was wide spread. The liberalisation of food prices and wage indexation, introduced in 1989 as a defence against inflation, contributed to the encouragement of hyper inflation, which by October 1989, reached over 18,000 per cent on an annual basis.\textsuperscript{161} Chronic shortages of basic consumer goods emerged and by the autumn of 1989 Poland was in a deep political and economic crisis.

**Recent Economic Developments**

The new government elected in September 1989 introduced a radical macroeconomic stabilisation and structural and reform programme on January 1, 1990. Unlike previous programmes, the objective was not the improvement of the existing system, but the transformation of Poland into a full market economy. The main element of the programme gained the support of the International Monetary Fund and the World Bank. These were complete price liberalisation; fiscal adjustment, involving sharp cuts in subsidies and spending; tight monetary policy; restrictive income policies, with a tax on wage and salary. It resulted in facilitating internal convertibility of the Zloty, following a substantial real devaluation; liberalisation of foreign trade; wide ranging privatisation and

the encouragement of the sector; and reform of financial system and establishment of a capital market. 162

As a first step, almost all price controls were abolished in January 1990. Retail prices administered by the state (for energy, rents, public utilities, public transportation and some milk products) were raised substantially. These measures, together with the major devaluation of the Zloty, resulted in a substantial and, once-for-all increase in inflation, with consumer prices rising by 80 per cent in January 1990 and contributing to a yearly average inflation rate of almost 600 per cent in 1990. Inflation declined to some 70 per cent in 1991 and had fallen further in 1992. The termination of price controls also contributed to the early elimination of major shortages in the consumer goods market.

In 1990 government expenditure was cut by eliminating subsidies for food and agricultural items and substantially reducing payments to coal mining, public utilities and housing. Increased revenue was achieved through the elimination of income tax relief and the introduction of higher income and turnover taxes. In consequence, the State budget with a deficit of some 3 per cent of GDP in 1989 turned to a surplus of 0.4 per cent of GDP in 1990. 163 This was reversed in 1991, when revenue declined sharply, largely because of the diminished tax-paying capacity of State owned enterprises, and with a sharp rise in social expenditure The budget deficit were equivalent to some 4 per cent of GDP in comparison to a surplus of 0.4 per cent of GDP in 1990.

162 http://www.tradereport.org/ts/countries/poland/climate.html
163 Ibid.

131
In 1990 and 1991, the main objectives of Poland's monetary policy were to curb inflation, restore confidence in the national currency, and increase the role of interest rates in stimulating savings and allocation of resources. Credit tightening and policy of positive real interest rates over the medium term was introduced. In mid 1991, the exchange rate was pegged to the U.S. dollar, as a nominal anchor for the financial programme. The growth of the money supply (M2) fell sharply\textsuperscript{164} with the decline in inflation pointing to the broad success of the monetary stance.

The stabilisation programme abandoned the wage and price fixation applied in the late 1980s. It also introduced a tax-based income policy, for State-owned enterprises, through a progressive tax on wage increases in excess of a coefficient set below the rate of inflation. Real wages fell sharply, by 30 per cent in 1990 and a further 4 per cent in 1991.

In January 1990 the Zloty was devalued by 32 per cent and made internally convertible for current account transaction. In May 1991 following a 16 months period of appreciation of the real effective exchange rate (REER), the Zloty was again devalued by 14 per cent. In October 1991, a crawling peg for the exchange rate was introduced, allowing for a gradual nominal depreciation of the Zloty. With domestic inflation still putting upward pressure on the REER, the Zloty was again devalued in late February 1992, by about 11 per cent.

\textsuperscript{164} \textit{World Investment Report}, 1996, p. 89.
In the first two years of reform, the Polish economy underwent a sharp contraction. In 1990 and 1991, real GDP declined by 12 per cent and 7 per cent respectively. Industrial production dropped by 26 and 15 per cent in 1990 and 1991 respectively. Under the combination of low domestic demand, competition from imports and the collapse of CMEA trade. Agricultural output also declined. By the end of 1991, unemployment, which was unknown before, reached 11.8 per cent and the payment of unemployment benefits had become a serious burden for the State budget.

Nevertheless, as a result of the implementation of the stabilisation and reform programme, the supply of goods to both consumers and producers were improved and competition strengthened. Domestic prices have moved into the line of world prices. Despite the slow progress of privatisation in the State-owned enterprise sector, private entrepreneurship has shown a dynamic expansion. By mid-1992, the private sector accounted for some 56 per cent of employment; about 29 per cent of industrial output originated in private enterprise, as against 17 per cent in 1990, and roughly 80 per cent of retail trade and construction was in private hands.

Trade Performance

Liberalisation of trade regime in 1990 marked a clear turning point in Poland’s trade development. It brought a major re-orientation of trade flows away from eastern European trading partners towards market economies. This change was all the more marked in 1991 particularly with the abolition of CMEA as an institution and the virtual collapse of trade between the former Soviet Union and its ex-CMEA partners.
Poland continues to exhibit three characters seen as vital to attracting FDI: low cost but qualified labour, long-term market potential, and access to rich natural resources. Foreign companies have invested $38.9 billion in Poland since 1989. Since 1996, a strong FDI inflow has been recorded in the range of $7 to $10 billion each year. In comparison, revenues from the privatisation of Polish SOEs amounted to only $120 million in 1999. Only in the year 1999 the inflow of FDI into Poland was $8.3 billion with 72 foreign companies invested more than $1 million each.

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166 Ibid. p. 448
(Top 9 Companies investing in Poland)

<table>
<thead>
<tr>
<th>Company (country)</th>
<th>Industry</th>
</tr>
</thead>
<tbody>
<tr>
<td>Vivendi (France)</td>
<td>Telecommunication</td>
</tr>
<tr>
<td>United Pan-Europe (Netherlands)</td>
<td>Media and Entertainment</td>
</tr>
<tr>
<td>Unicredito Italiano (Italy)</td>
<td>Banking</td>
</tr>
<tr>
<td>Eureka B.V/International</td>
<td>Insurance</td>
</tr>
<tr>
<td>Irish Bank (Ireland)</td>
<td>Banking</td>
</tr>
<tr>
<td>Daewoo (Korea)</td>
<td>Automotive, electronics, construction¹⁶⁷</td>
</tr>
<tr>
<td>Acciona (Spain)</td>
<td>Construction, trade and repairs</td>
</tr>
<tr>
<td>Rao Gazprom (Russia)</td>
<td>Construction</td>
</tr>
<tr>
<td>Jeronima Martins Holding (Portugal)</td>
<td>Wholesale and retail trade</td>
</tr>
</tbody>
</table>

Source: <http:www.paiz.gov.pl/invest>. This is the official website to PAIZ [Polska Agencja Inwestycji Zagranicznej – Polish Agency for Foreign Investment].

¹⁶⁷ The situation with Daewoo Motors was complicated by its impending insolvency. In an attempt to safeguard Daewoo’s Polish assets, the Polish government announced that it would guarantee more than half of the $100 million required to launch production of Matiz engines at Daewoo’s FSO [Fabryka Samochodow Osobowych – Passenger auto factory] Motor Plant. Poland feared layoffs from Daewoo’s 5,550 workers at Daewoo-FSA and its 6,200 jobs at the truck plant in Lublin. See John Burton and John Reed, “Companies and Finance International : Poland offers to help support Daewoo plants. Car making Warsaw could guarantee loans,” Financial Times, November 11, 2000, p.22.
Above all, more than 799 individual Polish companies have been the objects of FDI activity since 1989\textsuperscript{168}. It is abundantly clear that Poland has made enormous strides in the period of its transition from central planning to the market. However several significant challenges remain.

Poland must continue to narrow the gap in the standard of living between Poland and western European countries, which now stands at 40 per cent of the EU average. A solution to the persistent unemployment problem must be found in the creation of three to four million jobs, and in increasing business opportunities in medium and small businesses.

FDI inflows i.e., net repatriation to Poland increased from about $90 million in 1990 to around $2.5 billion in 1995.\textsuperscript{169} FDI doubled in 1995 and its value doubled again in 1996. Measured against GDP, its share rose from negligible levels in 1990 to 1.8 per cent in 1992 and 2.2 per cent in 1995. Its current level in terms of the share of GDP is three times higher than the pre-accession share in Portugal and Spain. Admittedly the flows of FDI in the world economy have dramatically expanded over the past decade. FDI has had a more profound impact on Poland’s ability to reintegrate into the world economy than these relatively low numbers alone might suggest.

\textsuperscript{168} For a discussion of the top ten foreign investors in the Polish financial market, see <http://www.polishmarket.com>

\textsuperscript{169} Ibid.
Impact of Foreign Direct Investment

Despite a short time that has elapsed since FDI began flowing into Poland, there are signs that it has already enhanced Poland’s export capabilities. Foreign firms are much more foreign-trade oriented than domestic firms, thus making a relatively larger contribution to reintegration of Poland into the world economy – especially into the EU.\textsuperscript{170} Although firms with foreign capital generated 12.4 per cent of total income and accounted for 7 per cent of total employment, their shares in exports and imports were 34.4 and 42.1 per cent respectively. Among the one hundred largest Polish exporters to the EU, accounting for 38 per cent of total EU-directed exports, there were 23 firms with foreign capital; 13 of these firms were among the top 50 on this list.\textsuperscript{171}

Indirect effects that related to restructuring, productivity spillovers, and foreign firms contribution to development of the export infrastructure are more difficult to capture. With many service sectors still closed to FDI, its impact on the export infrastructure so far has been limited. Some indirect measures suggest, however, foreign firms’ rapidly expanding role in industrial restructuring; consider that the share of foreign companies in total investment outlays increased from around 20 per cent in 1994 to 25 per cent in 1995.\textsuperscript{172}

FDI has become a powerful vehicle for transfers of technology best practices in management and increasingly for integrating domestic production capacities into global

\textsuperscript{170} Anna Krajewska, “Transformation of the Polish Economy: attractiveness and Risk of Investment in Poland”, \textit{Eastern European Economics}, vol. 34, no.1, p. 8.
\textsuperscript{172} See, n. 6.
networks of production and distribution. There is evidence that FDI has contributed to the
growth in linkages between Polish firms and their counterparts in the EU by integrating
some of them into a global network of production and marketing. This can be observed
through the increase in intra-industry trade which allows realisation of economies of scale
with the greater product specialisation and differentiation.

One of the important advantages of intra-industry trade in contrast to inter-
industry trade is that, it leads to lesser inequalities in regional development and income
distribution. Conventional comparative advantage brings about inter–industry
specialisation, as it operates on groups of products rather than within them. The force,
driving two–way trade in similar differentiated products is economies of scale associated
with a larger market, whereas the reason a county cannot produce a complete range of
these products relates to fixed costs of production. In consequence, countries with similar
factor endowments find a reason to trade with each other. This trade does not involve
relocation of whole industries, since both factors of production, labour and capital, gain
from it. Consequently, specialisation in differentiated products associated with intra-
industry trade poses fewer adjustment problems than inter-industry trade.

FDI has thus contributed to dispelling fears that engagement in a preferential
trading arrangement with the highly developed EU might lead to a catastrophic relocation
of Poland’s industries. These fears may have been justified to some extent by findings of
the new trade theory and economic geography models. While the new trade theory
suggests the overall benefits are likely to significantly larger than those suggested by
traditional approaches, economic geography models allow for the possibility that gains,
especially during the early stages of integration, will be distributed in favour of a more
developed partner - namely, the EU. Firms operating under the conditions of imperfect competition and economies of scale, such as in increasing return to scale industries, tend to cluster together, drawn by the availability of supplies due to the higher concentration of demand, which occurs in a more developed country.

FDI is often accused of having an adverse effect on the balance of payments. Instead, exports of foreign firms were lower than their imports, and they accounted for 71 per cent of Poland’s trade deficit in 1995. But this is hardly surprising. Imports of capital goods associated with FDI always increase the current account deficit. But their contribution to the current account deficit seems to have been more than offset by the positive impact of FDI inflows on the capital account and induced export earning.

The Challenge of Maintaining Momentum

Overall FDI has eased the pain of transition and contributed to the achieved progress in reintegration into the European economy. But several concerns loom on the horizon, as some pull factors that were responsible for attracting FDI have been losing their importance. First, during the initial phases of transition some FDIs have been attracted by “black holes” inherited from central planning such as shortages of higher quality consumer goods, both durable and non-durable. They have aimed primarily, albeit not exclusively, at such products as processed food, beverages (especially beer and soft drink), tobacco, soap and publishing industries.173

But the initial excess demand gap has probably reached its saturation levels, and FDI inflows may dry up. Opening of sectors to FDI where privatisation was delayed may spur new inflows, and recent market successes of high quality “no-name” brands may suggest new sources of FDI inflows. Although Polish consumers have limited spending power, they have so far been more brand conscious than their Western counterparts. This has benefited many foreign investors. However, there are some signs that consumers are already becoming more brand-cynical, and some international manufacturers are now beginning to introduce high quality local brands or to improve existing ones. It will lead to a greater involvement of local companies in FDI.

Second, the continued attractiveness of Poland as a location for FDI is closely linked to trends in labour costs and flexibility of labour markets. These hinge critically on the relationship between labour productivity and wage movements as well as on the pace of appreciation of the Polish Zloty. The latter is also shaped by foreign investment inflows, as their increases, contribute an upward movement in the real exchange rate. Wage restraint was of great importance to the successful economic development of Japan and the Asian tigers. It is difficult to predict whether this will be also the case in Poland. But the Polish hidden advantage may be that the wage differential between Poland and the EU is particularly large for highly skilled labour.

Third, FDI has been most common in low cost sectors due to cheap labour but especially with those that are considered ‘sensitive’ under the Europe Agreement.

174 Anna Krajewska and others, n. 5, p. 9.
Fourth, some foreign investors have been lured by government subsidies. These were in the form of either suppressing import competition through protection measures or offering tax-break in Special Economic Zones. These strategies are counter-productive and there has been a positive correlation between FDI-intensive sectors and the level of tariff protection. These sectors in 1992 have average tariff rates on imports 66 per cent higher than that in manufacturing as a whole. In fact, the list of sectors with the largest FDI commitments (cars, drinks and tobacco) corresponds fully with that of sectors favoured by tariff rescheduling.

The use of Special Economic Zones to attract FDI through tax concessions is of more recent vintage (the Katowice Motors). But this type of a measure is similarly harmful. It introduces a bargaining component into the relationship between government and foreign investors, suggesting that rules of the involvement of foreign firms be up for negotiation. The increased bureaucratisation of entry usually discourage high-quality investment inflows, raising serious doubts as to credibility of government commitment to liberal economic policies.

Poland’s potential as a recipient of FDI is yet to be tapped by foreign investors. Until 1994 the annual changes in net FDI inflows per capita in Poland were very similar to these in Slovakia. In 1995 Poland moved ahead in terms of total net inflows per capita for the period of 1990-95. But both the Czech Republic and Hungary have attracted considerably larger flows of FDI than Poland on a per capita basis. The differences in

176 Ibid.
177 http://www.progressinfo.net/eng/g8/g8_lwef-eu.pdf
distance to EU markets or in infrastructure do not seem to account for it, since these are negligible. Three factors seem to account for Poland’s sub-par performance. First, the perception among foreign investors of the inherently unstable political situation following the implementation of the stabilisation cum transformation programmes in 1990.\textsuperscript{179} It does not matter that the perception was unfounded, as subsequent elections and a peaceful transfer of power have demonstrated. Second, until the London Club debt-restructuring agreement was concluded in late 1994, many potential investors continued to have doubts about Poland’s ability to sustain macroeconomic stability. The third factor clearly much more important was related to differences in economic policies. In Czech Republic and Hungary privatisation has not only proceeded faster but it has been more extensive in terms of sectoral coverage. This points to the significant potential to increase FDI provided that the right mix of policies is implemented.

**Government incentives to attract Foreign Direct Investment**

On theoretical grounds, a common justification for offering government incentives in that FDI generates benefits to the home country that are ignored by the investor. If the social benefits of FDI to host country outweigh the private benefits to the investor, government intervention may need for the welfare of the masses. The benefits generated by the investment usually outweigh the cost to the public of paying for the investment incentives. However, several discrepancies do occur. First, even if there is a justified argument for government intervention, trade policy is seen as a wrong policy instrument. A direct production subsidy would have the same impact as far as the foreign investor is concerned. But it would involve lower welfare losses, since a production

subsidy only distorts the production side of the economy, leaving the price to consumers unaffected. In contrast, any trade policy instrument distorts both production and consumption leading to welfare losses.

Second, offering special incentives to foreign investors induces them to deceive the government. For instance, foreign investors would try to attain special treatment whether or not it is needed for the investment to be realised. Furthermore, the government may find itself seated with inefficient firms supported by subsidies. The country still saddled with inefficient white elephants inherited from central planning. In consequence, these negative welfare effects likely outweigh any positive effects associated with the investment.

With new communication technologies and more competitive international markets the role of FDI in development have undergone a profound change. Rather than exploiting local and protected markets through import-substitution FDI disperses its activities across countries linking "borderless" subsidiaries in global networks of production and marketing. In this context, luring investment through offering import protection is counterproductive. Attracting FDI by a liberal trade and investment-friendly environment is the only efficient tool for developing new industries and restructuring the existing sectors.

East-European economies have attracted huge inflows of FDI thanks to sound macroeconomic policies and economic openness. A survey of 173 Japanese investors identified among others, the following disincentives to investment: local ownership and

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180 Http://www.polishmarket.com
use of local input requirement; reservations on repatriation of profits; and high tariffs on parts and components.\textsuperscript{181}

In addition, Poland’s strategic location between Western Europe and the New Independent States (NIS) of former Soviet Union makes it a very attractive base from which to serve the regional market. Further reforms in the NIS will increase market-oriented investment in Poland. In order to maximise the gains from regional market expansion, further trade liberalisation within Central and Easton Europe and the NIS is of the greatest importance. Deeper integration within CEFTA in terms of common competition policy, rules on state aids and removing technical barriers would attract FDI\textsuperscript{182} to the region, including Poland. Combined with liberalisation in trade with the NIS, this would effectively increase the market size of those foreign investors in Poland.

\textbf{Commercial Code}

The Commercial Code decreed by the President of the Republic of Poland on 27th June 1934 (with later amendments) regulates the economic activity of the businessman.\textsuperscript{183} A businessman is a person who on his own behalf runs a profit-orientated enterprise. The provisions of the Commercial Code apply to commercial companies (registered partnerships, limited partnerships, limited liability companies and joint stock companies) as well as firms, procurement and the right of lien, the commercial register and liquidation of companies.\textsuperscript{184} A section of the Commercial Code, dealing with commercial

\textsuperscript{181} Ibid.
\textsuperscript{183} http://www.warsawvoice.pl/v495/busl05.html
\textsuperscript{184} S. Markowski and others, “Attractiveness of Poland to Direct Foreign Investors”, \textit{Communist Economies and Economic Transformation}, vol. 6, no. 4, 1994, p. 519.
contracts (agency, consignment, mediation and storage) was repealed in 1964 and it is now a part of the Civil Code. All Commercial Code provisions take precedence over those of the Civil Code. The Commercial Code guarantees a certain degree of space for parties negotiating the terms or founding the agreements of new firms. The provisions of the agreements take precedence over those of the Commercial Code. Amendments to the Commercial Code, which have been in preparation for over a year were aimed at modernising its legal norms and adapting them to models prevailing in the EU. The provisions of the Commercial Code are strictly linked to such normative Acts as that of 13th July 1990, dealing with the privatisation of State-owned enterprises, or the Act of 14th June 1991, concerning companies with foreign capital investment (Joint Ventures). The Commercial Code also includes: the 1926 law on restricting unfair competition; the bankruptcy law of the 1936 Decree of the President of the Republic of Poland; the law on settlement procedures from the Decree of the President of the Republic of Poland of 1934.

**Protection of Industrial and Intellectual Property Rights**

In the last few years a number of changes have taken place with regard to the legal protection afforded industrial and intellectual property. One of the aims was to confirm with contemporary international standards and was the result of Poland signing the Association Agreement with the European Communities, the Patent Co-operation Treaty and the Polish-American Trade and Economic Treaty, all concluded in 1991.\(^\text{185}\)

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A patent grants exclusive rights to an invention and its development for 20 years. The rights to a patent and the patent itself are transferable and can be inherited. Priority in claiming the rights to a patent is determined by the date of its submission to the Patent Office. The law on inventions provides for two exceptions to the above rule. The first one determines priority to the rights to the exploitation of a patent according to the date on which the invention was first shown at an exhibition or fair in Poland or abroad, should submission to the Patent Office take place within a six month period after this date. The Monitor Polski (Government Gazette) published the list of exhibitions/trade fairs decided upon by the President of the Patent Office as being eligible for consideration in these matters. The patent must be submitted to the Polish Patent Office no later than 12 months after that date.\(^{186}\) The regulations concerning priority rights to a patent are also applicable to designs, patterns and trademarks. In order to receive a patent, an application and description have to be filed at the Patent Office. After at most 18 months from the moment of submission or the priority date, the Office announces the submission. From this moment the invention enjoys temporary protection. Within 6 month period following the announcement third parties can acquaint themselves with its particulars and lodge comments. When inventions are patented, a one-off fee is payable as well as regular payments throughout the period under patent protection. An invention can be submitted to the Patent Office in person or through the offices of a patent agency a registry of which is kept by the Office.\(^{187}\)

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\(^{187}\) Ibid.
Current Trend

The momentum in FDI inflows now works in favour of Poland. In the first quarter of 1996 alone FDI of $1.1 billion amounted to 40 per cent of total 1995 inflows of $2.5 billion. With the privatisation of many sectors still unfinished, Poland’s capacity to absorb FDI is probably four times larger than its value in 1995. The projections of FDI in 1996 put its value at $5 billion. With accession one would expect at least doubling of FDI, as it occurred in Spain but under a less friendly global environment for FDI in the 1980s. The task now is to assure a continued expansion of these flows. Improving the environment for private business activity, both foreign and domestic has become a necessary condition to achieve this goal.

A comparative study of certain indicators like, GDP growth rate, industrial output, inflation and unemployment rate in Hungary and Poland in the recent years of 1997 and 1998 and their official 2000 forecast is as follows along with the tables.

<table>
<thead>
<tr>
<th>Table</th>
<th>Basic Economic Indication for the ECE transition Economics, 1997-2000</th>
</tr>
</thead>
<tbody>
<tr>
<td>(Rates of Change and Shares, per cent)</td>
<td></td>
</tr>
<tr>
<td>-------------------</td>
<td>----</td>
</tr>
<tr>
<td>Eastern Europe</td>
<td>2.1</td>
</tr>
<tr>
<td>Hungary</td>
<td>4.6</td>
</tr>
<tr>
<td>Poland</td>
<td>6.9</td>
</tr>
</tbody>
</table>

*Source: National Statistics; CIS Statistical Committee; direct communications from National Statistical Offices to UN/ECE Secretariat*
From the above table, it shows that Hungary has an increasing trend in GDP growth (4.6 to 4.9) as compared to Poland (6.9 to 4.8). While in Eastern Europe, the GDP decreases from 2.1 to 1.8. The difference between ex-ante GDP growth rate and the ex-post growth in Hungary and Poland is marginal, while in Eastern Europe the difference is more than half showing a negative growth. The recent official forecast in Hungary and Poland is marginally higher than its actual performance in 1998, while the GDP forecast in Eastern Europe is much higher than its actual performance, showing an optimistic growth.

<table>
<thead>
<tr>
<th>Country</th>
<th>Industrial Output (growth rates)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1997</td>
</tr>
<tr>
<td>Eastern Europe</td>
<td>4.9</td>
</tr>
<tr>
<td>Hungary</td>
<td>11.1</td>
</tr>
<tr>
<td>Poland</td>
<td>11.5</td>
</tr>
</tbody>
</table>

*Source: National Statistics; CIS Statistical Committee; direct communications from National Statistical Offices to UN/ECE Secretariat*

In case of industrial output, Eastern Europe has a negative growth in 1999 (-0.2) as compared to 1997 (4.9). Similarly, Poland has also a negative growth in the same period, that is, 11.5 from 1997 to 4.4 in 1999. It is Hungary which has also registered a
negative growth rate but the decline is marginal unlike Poland or the Eastern Europe, in general.

Table

Basic Economic Indication for the ECE transition Economics, 1997-2000
(Rates of Change and Shares, per cent)

<table>
<thead>
<tr>
<th></th>
<th>Inflation (per cent change, Dec./Dec.)</th>
<th>2000 Official forecast</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1997</td>
<td>1998</td>
</tr>
<tr>
<td>Eastern Europe</td>
<td>--</td>
<td>--</td>
</tr>
<tr>
<td>Hungary</td>
<td>18.4</td>
<td>10.4</td>
</tr>
<tr>
<td>Poland</td>
<td>13.2</td>
<td>8.5</td>
</tr>
</tbody>
</table>

Source: National Statistics; CIS Statistical Committee; direct communications from National Statistical Offices to UN/ECE Secretariat

Due to the unavailability of Eastern Europe data, the present study only covers the inflation percentage change data of Hungary and Poland, which as shown in the above table. The inflation rate in Hungary has declined from 18.4 in 1997 to 11.3 in 1999, while the official forecast for 2000 is 6-7 per cent. Similarly in Poland, the inflation rate has shown a decline, that is, from 13.2 in 1997 to 9.9 in 1999, while the official forecast of 2000 is 5.7 which is lower than Hungary.
Table
Basic Economic Indication for the ECE transition Economies, 1997-2000
(Rates of Change and Shares, per cent)

<table>
<thead>
<tr>
<th></th>
<th>Unemployment Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1997</td>
</tr>
<tr>
<td>Eastern Europe</td>
<td>11.9</td>
</tr>
<tr>
<td>Hungary</td>
<td>10.4</td>
</tr>
<tr>
<td>Poland</td>
<td>10.3</td>
</tr>
</tbody>
</table>

Source: National Statistics; CIS Statistical Committee; direct communications from National Statistical Offices to UN/ECE Secretariat

The above table shows a steady rise in the unemployment rate in Eastern Europe, in general and Poland reflecting a similar trend. But in case of Hungary, the trend is in reverse, that is, its rate shows a steady decline.

The New Competitive Context

With the advent of a new, open and global economy, the development priorities of the transition economies have undergone tremendous changes. It include income growth, raising investments and exports, creating more and better employment opportunities, and benefiting from technological progress. Governments are committed to achieving these in a sustainable manner, ensuring that resources are available to future generations. The new international economic environment places considerable pressures on developing countries to upgrade their resources and capabilities if they are to achieve these
objectives. In a liberalised policy setting, governments focus increasingly on providing an institutional framework within which private enterprises can thrive.

Foreign direct investment can play an important role in the development process. However, the objectives of MNEs differ from those of host governments. Governments seek to spur national development, while MNEs seek to enhance their own competitiveness in an international context. There can be considerable overlap between the two, but there are also differences. These differences created much suspicion of FDI in the past in transition economies. However, perceptions have changed rapidly in recent years. So have the ways in which the MNEs operate and organise themselves globally. Both are in response to the new global context: rapid technical progress, shrinking of economic space, improved communication, intensification of communication, new forms of market rivalry, increasingly mobile capital, widespread policy liberalisation and more vocal stakeholders.

A vital part of the new context is the need to improve competitiveness, "competitiveness" being defined as the ability to sustain income growth in an open setting. In a liberalising and globalising world, growth can be sustained only if countries can create new, higher value added activities that hold their own in open markets. This requires many things. Central among them is the ability to use new technologies efficiently, furnishing the requisite skills and institutions. Globalisation also affects MNEs. The ownership advantages that account for their international activity are changing in line with technical change and shrinking economic space. Rapid innovation and deployment of new technologies in line with logistic and market demand is more important than ever before. The rising complexities of information flows and the
diversities of possible locations mean that MNEs have to organise and manage their activities differently. They also have to change relations with suppliers, buyers and competitors to manage better processes of technical change and innovation. And they have to strike closer links with institutions dealing with science, technology, skills and information. The spread of technology to, and growth of skills in, different countries means that new MNEs are constantly entering the arena to challenge established ones. Many of the entrants are small firms previously owned enterprises that were traditionally confine to home markets; a significant number are enterprises from developing countries.

A striking feature of the new context is how MNEs are shifting increasingly their portfolios of mobile assets across the globe to find the best match with the immobile assets of different locations. In the process, they are also shifting some functions that create their ownership assets like R&D, training and strategic management to different locations within an internationally integrated production & marketing and marketing system (the process of “deep integration”). The ability to provide the necessary immobile assets thus becomes a critical part of an FDI- and competitiveness – strategy for developing countries. While a large domestic market remains a powerful magnet for investors, MNEs serving global markets increasingly look for other attributes that can help raise their competitiveness. The opening of markets creates new opportunities and challenges for MNEs and gives them a broader choice of modes with which to access those markets. It also makes them more selective in their choices of potential investment sites.

Apart from primary resources, the most attractive immobile assets for export-oriented MNEs are now world-class infrastructure, skilled and productive labour,
innovator capacities and an agglomeration of efficient suppliers, competitors, support institutions and services. Low-cost unskilled labour remains a source of competitive advantage for countries, but its importance is diminishing. Moreover, it does not provide a base for sustainable growth since rising incomes erodes the edge it provides. The same applies to natural resources. Natural resources provide a rent for as long as the resource is in demand. But without upgrading the technologies used or establishing downstream industries, the resource may face eventually stagnant price and the risk of substitution. In both cases, to draw the most dynamic assets of MNEs requires that host countries improve the quality of their immobile assets.

There is no conflict between exploiting static sources of comparative advantage and developing new ones: existing advantages provide the means with which new advantages can be developed. A steady evolution from lone to the other is the bases for sustained growth. What is needed is a policy framework to facilitate and accelerated the process: this is the essence of a competitiveness strategy. The need for such strategy does not disappear once growth accelerates or economic development reaches a certain level; it merely changes its form and focus. This is why competitiveness remains a concern of governments in developed countries as much as (if not more than) in developing ones. The starting point for this concern is that providing a level playing field and letting firms respond to market signals is sufficient jointly to the extent that markets work efficiently. In theory, two sets of conditions justify policy intervention:
**Market failure**

Markets fail to exploit existing endowments fully, or to develop new competitive advantages, if they do not give the correct signals to economic agents so that they can make improper investment decisions. Many market failures are the result of past policies; here the correct strategy is to remove inefficient interventions. Many are inherent to markets, particularly in developing countries. Where markets are weak and supporting institutions absent, information may not flow efficiently, risky projects may never take place, costly learning may not undertaken, and externalities and linkages with other agents may result in under-investment. It then becomes necessary for development for governments to strengthen markets and institutions.

**Government capabilities**

Governments should be able to formulate a development vision, decide on trade-offs between objectives, and design, monitor and implement policies to overcome market failures that beset these objectives. In other words government failure must not be more costly than market failure. This condition is often not met. Economic history has many instances of badly designed and implemented policies. This does not rule out the case for intervention. Many strategies have been efficient (some as in East Asia, dramatically so). Moreover government skills and capabilities are not static. Governments can learn and their capabilities can be improved with training, information and correct incentives. Policy design must reflect current (and future) government capabilities, and not require interventions that exceed those capabilities. This means policies must be flexible and constantly monitored. They must also be coherent and consistent in addressing
objectives, with co-ordination between different branches of government and between the government and economic agents.

Co-ordination

The need for coherence and co-ordination means that a strategy for development using FDI can benefit from an overall vision of what the development objective are and how they can be achieved. Such visions can differ greatly across countries, depending on the nature of the economy and the government. Take the mature East Asian newly industrialising economies. One vision pursued by Singapore—was to rely heavily on FDI, integrate the relatively small economy into MNE production networks and promote competitiveness by upgrading within these networks. Another, that of the Republic of Korea and Taiwan Province of China, was to develop domestic enterprises and autonomous innovative capabilities, relying on MNE as arm’s-length sources of technology. Yet another, that of the administration of Hong Kong (China), was to leave resource allocation largely to market forces, while providing infrastructure and governance. Strategies can be made, of course, without explicit visions. They can emerge from political and social processes, inter-group and intra-governmental interactions, and other internal or external pressures. In such cases, however, there is a risk that policies are not fully co-ordinated, signals are unclear, difficult strategic decisions are not taken and responses to changes are slow.

There is no ideal development strategy that uses FDI for all countries at all times. Any good strategy must be context specific, reflecting the level of economic development, the resource base, the specific technological context and the competitive
setting. Each must take into account government capabilities. The appropriate strategy for a country with an advanced industrial and skill base and a well-developed administration must differ from one for a country with rudimentary industry, deficient skills and weak administrative structures. With these general considerations in mind, and with competitiveness as the long-term objective, we now turn to the impact of FDI in Hungary and Poland.

Hungary and Poland have all along been successful in attracting FDI into their respective economies since the last five years. Though in 1998 the level of FDI in Hungary as well as Poland was experiencing stagnation but later by the end of 1999 the situation improved. As the MNEs have been facing competitiveness in capturing the emerging market, the economies those are in transition also striving hard to attract their foreign counterpart in order to avail the ever-increasing benefit of foreign investment.

Table B: Cumulative inflows per capita, 1990-97

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<th></th>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Estonia</td>
<td>0</td>
<td>0</td>
<td>55</td>
<td>163</td>
<td>305</td>
<td>440</td>
<td>513</td>
<td>620</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>12</td>
<td>61</td>
<td>153</td>
<td>216</td>
<td>301</td>
<td>549</td>
<td>683</td>
<td>809</td>
</tr>
<tr>
<td>Hungary</td>
<td>29</td>
<td>168</td>
<td>308</td>
<td>531</td>
<td>639</td>
<td>1068</td>
<td>1256</td>
<td>1439</td>
</tr>
<tr>
<td>Poland</td>
<td>2</td>
<td>10</td>
<td>27</td>
<td>71</td>
<td>119</td>
<td>214</td>
<td>329</td>
<td>412</td>
</tr>
<tr>
<td>Slovenia</td>
<td>0</td>
<td>0</td>
<td>56</td>
<td>112</td>
<td>154</td>
<td>239</td>
<td>328</td>
<td>476</td>
</tr>
</tbody>
</table>
Table C: Cumulative inflows in terms of the share (cumulative) in GDP

(million dollar US)

<table>
<thead>
<tr>
<th></th>
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<th></th>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Estonia</td>
<td>0.00</td>
<td>0.00</td>
<td>1.90</td>
<td>6.05</td>
<td>11.69</td>
<td>16.66</td>
<td>20.10</td>
<td>25.04</td>
</tr>
<tr>
<td>Czech republic</td>
<td>0.66</td>
<td>2.30</td>
<td>4.44</td>
<td>6.26</td>
<td>8.38</td>
<td>13.83</td>
<td>16.48</td>
<td>19.10</td>
</tr>
<tr>
<td>Hungary</td>
<td>0.98</td>
<td>5.54</td>
<td>9.65</td>
<td>15.93</td>
<td>18.78</td>
<td>29.32</td>
<td>33.90</td>
<td>37.85</td>
</tr>
<tr>
<td>Poland</td>
<td>0.16</td>
<td>0.56</td>
<td>1.36</td>
<td>3.36</td>
<td>5.39</td>
<td>8.45</td>
<td>11.76</td>
<td>13.89</td>
</tr>
<tr>
<td>Slovenia</td>
<td>0.00</td>
<td>0.00</td>
<td>0.90</td>
<td>1.79</td>
<td>2.37</td>
<td>3.27</td>
<td>4.2</td>
<td>5.77</td>
</tr>
</tbody>
</table>


The increasing trend of FDI is evident from the tables given above. Table B representing the cumulative inflows per capita from 1990-1997 shows that the per capita inflow of FDI has been experiencing a increasing trend for both Hungary and Poland. In 1990 the per capita cumulative inflow of FDI to Hungary was 29 million dollar but by 1997 it galloped to 1439. In case of Poland the cumulative per capita inflow in 1990 was mere 2 million dollar but it went up to 412 million dollar in 1997.
Cumulative inflows in terms of the share in GDP for both the countries experienced a similar trend during those period. While Hungary’s FDI share to GDP increased from 0.98 per cent to 37.85 in between 1990 to 1997, the share of Poland for the corresponding period was increased from 0.16 to 13.89 per cent.

The trend is an indicator of how both the countries are successful in attracting FDI into their respective economies. The impact FDI made on both countries are evident from the above data. It could, therefore, be safely said that the reform measures taken by both the countries from time to time have produced the desired result. However, both countries need to go a long way before establishing their economy at par with their western counterpart.